Structuring Ownership of Privately-Owned Businesses:

Tax and Estate Planning Implications

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This document has three tables of contents:

I believe this document is most useful when the reader reviews the relevant portion of the full table of contents throughout the research process.

 (Printed January 25, 2024.) This is not intended to be comprehensive; many portions only lightly touch the surface; and not all of the issues are updated at the same time (in fact, the author does not systematically refresh citations), so some parts may be less current than others. The author invites suggested changes, whether substantive or to point out typos (the author does not have a second set of eyes reviewing the author's work). The views expressed herein reflect the author's preliminary thoughts when initially written and are not necessarily those of Thompson Coburn LLP (or even of the author). Before using any information contained in these materials, a taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor. Tax advisors should research these issues independently rather than rely on these materials.

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Structuring Ownership of Privately-Owned Businesses:

Tax and Estate Planning Implications

by Steven B. Gorin[*]

I. Introduction

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

With rapid changes in our global economy, flexibility in structuring a business entity is more important than ever. This document focuses on income tax flexibility in buying into a business and also exiting from or dividing a business, also discussing particular aspects of the taxation of operations, as well as individual and fiduciary income taxation (including the 3.8% tax on net investment income) on the income relating to a business entity that is taxable to them. It also discusses estate planning issues, including transfer tax issues and drafting and administering trusts to hold business interests. In addition to the issues covered in this document, consider whether a family-controlled entity requires a legitimate and significant nontax reason.[1]

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All references to the "Code" are to the Internal Revenue Code of 1986, as amended. All references to a "Reg." section are to U.S. Treasury Regulations promulgated under the Code.
[1] Such a reason may be necessary to ensure estate tax recognition of the entity and to avoid double inclusion of the post-formation appreciation in the value of any business interest the decedent owned

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

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II. Income Tax Flexibility

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

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

II.A. Corporation

II.A.1. C Corporation

II.A.1.a. C Corporations Generally

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

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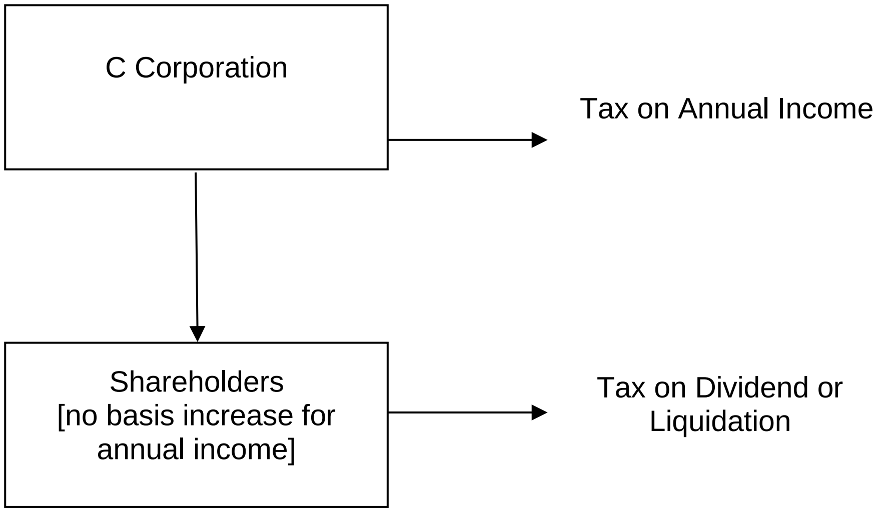
within three years of death. See fns. 91-92 in part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders.

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

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



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

Other corporations are C corporations to minimize taxes. C corporations now pay a flat 21% federal rate,[4] and they may also pay state income tax. Shareholders are not subject to income tax or self-employment tax on the reinvested income. More fringe benefits are allowed to C corporation shareholders than the owners of any other entity. C corporations do not receive capital gain rates on the sale of capital assets or business assets,[5] so C corporations used to pay higher taxes on the business' sale of such assets than do owners of S corporations or partnerships.[6] However, now C corporations tend to have lower rates on not only ordinary income but also capital gain inside the corporation.

If the shareholders do not take dividends, and later sell the company, even the wealthiest taxpayer could eventually pay federal capital gains tax of only 23.8% (20% plus 3.8% tax on net investment income). Some special rules provide an exclusion on the sale of certain stock in a C corporation;[7] however, this exclusion is not necessarily the advantage that one might initially think.[8] See also parts II.G.11 Personal Service Corporations and II.G.12 Planning for C Corporation Using the Lowest Corporate Brackets and Is Owned by Taxpayer with Modest Wealth.

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

[5] For the sale of business assets, see part II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business, especially fn. 1483 (business assets often are not capital assets and therefore require a special provision to receive capital gain tax rates).

[6] Code § 1(h).

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

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

Corporations may exclude from income 50%-100% of dividends received from most other corporations.[9] For taxable years beginning after December 31, 2017, the following deductions are allowed against taxable dividends from a domestic[10] corporation:

- 100% for a dividend received within certain affiliated groups[11] or by small business investment company operating under the Small Business Investment Act of 1958.
- 65% for a dividend received from a 20%-owned corporation,[12] which effectively reduces the tax rate to 7.35% (21% corporation tax rate multiplied by the 35% excess of 100% over 65%).
- 50% for a dividend received from other corporations,[13] which effectively reduces the tax rate to 10.5% (21% corporation tax rate multiplied by 50%).

Generally, a corporation can be formed tax-free,[14] but distributions may trigger taxation at the corporate level, shareholder level, or both.[15] Prof. Sam Donaldson compared a C corporation to a roach motel – easy to get in but difficult to leave.[16]

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

For tax years beginning before January 1, 2018: To take advantage of low corporate income tax rates, C corporations often pay just enough compensation to take advantage of the lowest corporate brackets. However, all of the taxable income of a "qualified personal service corporation" is taxed at a flat 35%;[17] see part II.G.11 Personal Service Corporations. For the latter, zeroing out taxable income is frequently the goal.

For tax years beginning after December 31, 2017, all taxable income of every corporation is taxed at 21%.[18] Given that federal income rates that apply to individuals exceed those of corporations, in the short run one may be less inclined to pay as much compensation to shareholder-employees. Consider the following factors:

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[9] Code § 243.

[10] Code § 243(e) provides:

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

[11] Code § 243(a)(3), (b).

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

[13] Code § 243(a)(1).

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

[15] See part II.Q.7 Exiting from or Dividing a Corporation.

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

[17] Code § 11(b)(2).

[18] Code § 11(b).

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

- Compensation is subject to FICA.[19]

- A corporation is not limited to the amount of state income tax it may deduct. For any taxable year beginning after December 31, 2017 and before January 1, 2026, Code § 164(b)(6) limits an individual's deduction for state and local income and property tax to $10,000 ($5,000 for married filing separately), but it does not apply this limit to property taxes attributable to Code § 212 trade or business (which generally would be rental real estate, if it is a trade or business).[20]

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

A business may deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered", with compensation deductible if "reasonable" and "purely for services."[21] Corporate officers are employees, subject to certain exceptions; see part II.A.2.c Avoiding Double Taxation and Self-Employment Tax.

"Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible."[22] Payments may be disguised dividends[23] or purchase price for the business.[24] "The IRS' determination of constructive dividend income is a determination of unreported income."[25] "Once the IRS has produced evidence linking the taxpayer with an income-producing activity, the burden of proof shifts to the taxpayer to prove by a

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[19] See part II.L.1 FICA: Corporation. For the amount of wages subject to the highest FICA rates (the taxable wage base), see fn 3393 in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.

[20] For more details about my comment on real estate as a trade or business, see part II.E.1.e Whether Real Estate Qualifies as a Trade or Business.

[21] Reg. § 1.162-7(a).

[22] Reg. § 1.162-7(b)(1).

[23] Reg. § 1.162-7(b)(1), providing:

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

[24] Reg. § 1.162-7(b)(1), providing:

> An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

[25] *Pacific Management Group v. Commissioner*, T.C. Memo. 2018-131, citing and elaborating:

> *See Coastal Heart Med. Grp., Inc. v. Commissioner*, T.C. Memo. 2015-84, 109 T.C.M. (CCH) 1424, 1429. The Ninth Circuit has held that the IRS must provide some reasonable foundation connecting the taxpayer with the income-producing activity. *See Weimerskirch v. Commissioner*, 596 F.2d 358, 360 (9th Cir. 1979), *rev'g* 67 T.C. 672 (1977).

preponderance of the evidence that the IRS' determinations are arbitrary or erroneous."[26] A noncompensatory taxable payment from a C corporation to a shareholder is presumed to be a dividend unless the taxpayer proves the corporation had insufficient earnings and profits.[27] Such a payment made to an entity owned by shareholders generally would be a taxable dividend to those shareholders.[28]

"While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate."[29]

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[26] *Pacific Management Group v. Commissioner*, T.C. Memo. 2018-131, citing *Helvering v. Taylor*, 293 U.S. 507, 515 (1935).

[27] *Pacific Management Group v. Commissioner*, T.C. Memo. 2018-131, stating:

> Sections 301 and 316 govern the characterization for Federal income tax purposes of corporate distributions of property to shareholders. If the distributing corporation has sufficient earnings and profits (E&P), the distribution is a dividend that the shareholder must include in gross income. Sec. 301(c)(1). If the distribution exceeds the corporation's E&P, the excess represents a nontaxable return of capital or capital gain. Sec. 301(c)(2) and (3).
>
> The taxpayer bears the burden of proving that the corporation lacks sufficient E&P to support dividend treatment at the shareholder level. *Truesdell v. Commissioner*, 89 T.C. 1280, 1295-1296 (1987); *Fazzio v. Commissioner*, T.C. Memo. 1991-130, *aff'd*, 959 F.2d 630 (6th Cir. 1992); *Zalewski v. Commissioner*, T.C. Memo. 1988-340; *Delgado v. Commissioner*, T.C. Memo. 1988-66. Petitioners produced no evidence concerning the Water Companies' E&P during the years at issue and have thus failed to satisfy their burden of proof. See *Truesdell*, 89 T.C. at 1295-1296; *Vlach v. Commissioner*, T.C. Memo. 2013-116, 105 T.C.M. (CCH) 1690, 1694 n.23. We therefore deem the Water Companies to have had, after add-back of the disallowed deductions for bonuses and factoring fees, sufficient E&P in each year to support dividend treatment.

[28] *Pacific Management Group v. Commissioner*, T.C. Memo. 2018-131, reasoning:

> Dividends may be formally declared or constructive. A constructive dividend is an economic benefit conferred upon a shareholder by a corporation without an expectation of repayment. *Truesdell*, 89 T.C. at 1295 (citing Noble v. Commissioner, 368 F.2d 439, 443 (9th Cir. 1966), *aff'g* T.C. Memo. 1965-84). "Corporate expenditures constitute constructive dividends only if (1) the expenditures do not give rise to a deduction on behalf of the corporation and (2) the expenditures create `economic gain, benefit, or income to the owner-taxpayer." *P.R. Farms, Inc. v. Commissioner*, 820 F.2d 1084, 1088 (9th Cir. 1987) (quoting *Meridian Wood Prods. Co. v. United States*, 725 F.2d 1183, 1191 (9th Cir. 1984)), *aff'g* T.C. Memo. 1984-549.
>
> Corporate payments to third parties may constitute constructive dividends if they are made on behalf of a shareholder or for his economic benefit. *United States v. Mews*, 923 F.2d 67, 68 (7th Cir. 1991); see, *e.g.*, *Grossman v. Commissioner*, 182 F.3d 275 (4th Cir. 1999) (corporate payments for family vacations), *aff'g* T.C. Memo. 1996-452; *Noble*, 368 F.2d at 441 (corporate payment for repairs and painting of shareholder's residence and for shareholder's travel expenses). The amount of the constructive dividend equals the fair market value of the benefit received *Challenge Mfg. Co. v. Commissioner*, 37 T.C. 650, 663 (1962); *Schank v. Commissioner*, T.C. Memo. 2015-235, 110 T.C.M. (CCH) 542, 548. Whether corporate expenditures are disguised dividends presents a question of fact. *DKD Enters. v. Commissioner*, 685 F.3d 730, 735 (8th Cir. 2012), *aff'g* in part, *rev'g* in part, T.C. Memo. 2011-29; *Schank*, 110 T.C.M. (CCH) at 548.
>
> In disallowing the Water Companies' deductions for factoring fees and the bulk of PACE's claimed deductions for bonuses, we have determined that none of these expenditures "give[s] rise to a deduction on behalf of the corporation." *P.R. Farms, Inc. v. Commissioner*, 820 F.2d at 1088. The remaining question is whether these expenditures "create[d] `economic gain, benefit, or income to the owner-taxpayer." *Ibid*. We find that they did.

[29] Reg. § 1.162-7(b)(2), providing:

One may not deduct compensation in excess of "what is reasonable under all the circumstances." [30]

For compensating shareholders for financial risk, see part III.B.1.a.ii.(d) Income Tax Consequences Involving Loan Guarantees.

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

Because an independent investor would require a return on investment, a C corporation needs to be wary of relying too much on this strategy, which has been a point of contention in many cases over the years.[31]

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

[30] Reg. § 1.162-7(b)(3), providing:

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

[31] Code § 162 requires any business deduction to be reasonable and necessary. If the future payments relate to compensation earned in the current year, then the taxpayer must prove that (a) the total compensation (current and deferred payments) earned that year is reasonable (to obtain a Code § 162 deduction) and (b) that it was entered into before January 1 of calendar year in which the services were provided (to satisfy Code § 409A(a)(4)(B)(i) and Reg. § 1.409A-2(a)(1)). For a summary of cases, see Looney and Levitt, "Compensation Reclassification Risks for C and S corporations," *Journal of Taxation* (May 2015); Moran, "The Independent Investor Test for Reasonable Compensation: Lens, Laser or Labyrinth?" *TM Memorandum* (BNA) (12/26/2016); and Adams, Inger and Mackfessel, "Reasonable Compensation: Circuit Court Differences Create Confusion and Inconsistency," *ATA Journal of Legal Tax Research* (Vol. 20, No. 1, Fall 2022, pp. 1-29). Abstract of the latter includes:

> The courts have generally followed two approaches: a multi-factor test and an independent investor test. We provide an in-depth exploration of reasonable compensation case law with a focus on disparity within and across court circuits. We supplement this exploration with an analysis of whether multi-factor determined court outcomes would have changed under the independent investor test.

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

> We note in closing our puzzlement that the firm chose to organize as a conventional business corporation in the first place. But that was in 1979 and there were fewer pass-through options then than there are now; a general partnership would have been the obvious alternative but it would not have conferred limited liability, which protects members' personal assets from a firm's creditors. Why the firm continued as a C corporation and sought to avoid double taxation by overstating deductions for business expenses, when reorganizing as a passthrough entity would have achieved the same result without inviting a legal challenge, see 1 Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 5.01[5], p. 5-8 (7th ed. 2006), is a greater puzzle. But "while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not," *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974)—consequences that in this case include a large tax deficiency and a

The IRS' web page on "Valuation of Assets"[32] includes:

- "Reasonable Compensation - Job Aid for IRS Valuation Professionals"[33]

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hefty penalty. The Tax Court was correct to disallow the deduction of the "consulting fees" from the firm's taxable income and likewise correct to impose the 20 percent penalty.

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

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

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

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

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

- “Appendix to Reasonable Compensation - Job Aid for IRS Valuation Professionals”[34]

H.W. Johnson, Inc. v. Commissioner, T.C. Memo. 2016-95, approved millions of dollars of compensation when the corporation reported only a few hundred thousand dollars in base compensation and perhaps a couple hundred thousand in dividends. It set forth the test it applied:[35]

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

In analyzing the officer-shareholders’ role in the company, the court pointed to not only their reputation for excellence and hands-on management but also their guaranteeing the corporation’s indebtedness to purchase materials and supplies.[36]

In comparing compensation to other taxpayers, the court said:

> This factor compares the employee’s compensation with that paid by similar companies for similar services. *Elliotts, Inc. v. Commissioner*, 716 F.2d at 1246; sec. 1.162-7(b)(3), Income Tax Regs. Respondent concedes that petitioner’s performance so exceeded that of any of the companies identified by the parties’ experts as comparable that compensation comparisons are not meaningful. Petitioner’s expert calculated that petitioner’s officers’ compensation as a percentage of gross revenue was 18.4% and 20.9% for 2003 and 2004, respectively, whereas the industry average for those years was 2.2%. Petitioner contends that its performance so exceeded the industry average that the divergence of its compensation from the average is justified. On this record we lack any reliable benchmarks from which to assess petitioner’s claim and therefore find it unpersuasive. In view of this and respondent’s concession, we conclude that this factor is essentially neutral. See *Multi-Pak Corp. v. Commissioner*, T.C. Memo. 2010-139.

The court suggested that “conflict of interest” factor cited above applies when the shareholders are the officers being compensated, in such a case the court should scrutinize the issue, applying the independent investor test. The court rejected the IRS’ expert’s reliance on (a) ”guideline” companies that the court found not to be comparable, (b) Risk Management

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

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

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

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

Association's annual statement that RMA itself cautions might include small sample sizes, (c) the Construction Financial Management Association's annual financial survey, the court commenting that many of the companies in that data sample operated in industries dissimilar from the taxpayer's, and (d) a "market required return on equity" that the IRS' expert derived from data published by Ibbotson Associates, which data the court characterized and being from companies engaged in the construction industry generally, not the concrete contracting sector of which the taxpayer is a part. Instead, the court found credible the taxpayer's expert's use of Integra data from 33 companies falling under the SIC code that closely described the taxpayer's line of business. In response to the taxpayer's contention that its return on equity was in line with the industry average and therefore would have satisfied an independent investor, the court said:

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

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

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

> In view of the foregoing, respondent's contention that petitioner's payment to DBJ was voluntary, given the absence of a written agreement or evidence of an oral agreement to compensate DBJ, is unavailing. "Closely held corporations, as is well known, often act informally, their decisions being made in conversations, and oftentimes recorded not in

> the minutes, but by action." *Levenson & Klein, Inc. v. Commissioner*, 67 T.C. 694, 714 (1977) (quoting *Reub Isaacs & Co. v. Commissioner*, 1 B.T.A. 45, 48 (1924)). We are satisfied that petitioner's board, including majority shareholder Margaret, concluded at the close of 2004 that the $500,000 payment to DBJ was appropriate to compensate Bruce and Donald for the substantial benefit they conferred on petitioner in their individual capacities. In short, the action in making the payment undoubtedly reflected an informal understanding among petitioner's shareholders, Margaret, Bruce, and Donald, that the latter two ought to be compensated for their individual efforts and their assumption of the risks entailed in averting the consequences of a concrete shortage for petitioner during 2004.

Leaving that case, consider that a taxpayer who litigates this issue needs to coordinate the statute of limitations on the corporation's and employee's income and payroll tax returns. *K & K Veterinary Supply, Inc.*, T.C. Memo. 2013-84 denied equitable recoupment, holding:[37]

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

The court agreed with the IRS' citation of a case holding that an S corporation and its shareholder were two separate taxpayers that should not be treated as one.[38] The court pointed out that, if an S corporation should be treated as separate from its shareholder, then a C corporation certainly would also be treated as separate, given that the C corporation is not even a pass-through entity.

A 2016 Tax Court case penalized a personal service corporation that had significant net assets and zeroed out its taxable income.[39] Another one penalized a wholesaler that paid the founder's sons compensation based on skilled officer positions when the sons actually had little skill and mainly did menial work.[40]

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

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

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

[39] *Brinks Gilson & Lione A Professional Corporation v. Commissioner*, T.C. Memo. 2016-20, discussed in fn. 31.

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

> In *Transupport I*, we quoted portions of the testimony of each of the Foote sons in which each denied knowledge of principles basic to the performance of his respective functions on behalf of petitioner. Because petitioner ignores the evidence, we repeat our observations here: K. Foote worked closely with purchases and sales but had "no clue" as to how much the inventory was worth and did not know how costs of goods sold were determined. J. Foote, who acted as petitioner's chief financial officer, testified that he had "no idea" or "not a clue" about petitioner's inventory at cost in 2007. J. Foote provided to petitioner's accountant the numbers used in

In *Pacific Management Group v. Commissioner*, T.C. Memo. 2018-131, the officers formed a partnership to which the corporation paid management fees for their services. The Tax Court looked through the partnership to determine whether the officers' compensation was reasonable.[41] Applying Ninth Circuit law,[42] the court allowed only part of the bonuses paid to the officers:

> preparing petitioner's tax returns, but he had no idea whether the amounts reported on the *returns were correct. W. Foote, whose duties included inventory management, asserted that* "nobody understands … our inventory" or that nobody can put a total valuation on it. As to a specific part in the inventory, he had "no earthly clue" as to the purchase price.
>
> None of the Foote sons had special experience or educational background. Each of the four sons testified that they had overlapping duties, but those duties included menial tasks as well as managerial ones because there were no other employees. Foote testified that he intended to treat his sons equally, that he alone determined their compensation, and that he was aware of their marginal tax rates, obviously intending to minimize petitioner's tax liability. The amounts and equivalency of the brothers' compensation, the proportionality to their stock interests, the disproportionality to Foote's compensation, the manner in which Foote alone dictated the amounts, the reduction of reported taxable income to minimal amounts, and the admissions in the promotional materials relating to their compensation all justify skepticism toward petitioner's assertions that the amounts claimed on the returns are reasonable.

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

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

The First Circuit affirmed, 121 A.F.T.R.2d 2018-XXXX (2/14/2018).

[41] The court reasoned:

> In form, the Water Companies paid management fees to PMG. PMG was a paper entity, and its partners-the five S corporations-were likewise paper entities. Neither PMG nor the S corporations provided the Water Companies with actual management services of any kind Rather, they were simply vehicles for supplying the personal services of the five principals, who performed for the Water Companies during 2002-2005 essentially the same services they had performed as direct employees of the Water Companies previously. In assessing the reasonableness of the "management fees," therefore, the question is whether those sums represented reasonable compensation for the personal services rendered by five principals or instead represented (at least in part) nondeductible distributions of corporate profits.

[42] The court stated:

> The Court of Appeals for the Ninth Circuit, the appellate venue in these cases absent stipulation to the contrary, applies five factors to determine the reasonableness of compensation: (1) the employee's role in the company, (2) a comparison of the employee's salary with salaries paid by similar companies for similar services, (3) the character and condition of the company, (4) potential conflicts of interest, and (5) the internal consistency of the company's compensation arrangement. *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1245-1247 (9th Cir. 1983), *rev'g* and remanding T.C. Memo. 1980-282. The Ninth Circuit also considers whether the amounts paid would be regarded as reasonable by a hypothetical independent investor See *Metro Leasing & Dev. Corp. v. Commissioner*, 376 F.3d 1015, 1019 (9th Cir. 2004), aff'g 119 T.C. 8 (2002); *Elliotts Inc.*, 716 F.2d at 1247 ("If the bulk of the corporation's earnings [pg. 1108] are being paid out in the form of compensation, so that the corporate profits, after payment of the compensation, do not represent a reasonable return on the shareholder's equity in the corporation, then an independent shareholder would probably not approve of the compensation arrangement.").

Allowing bonuses of this magnitude leaves sufficient profits in PACE to provide shareholder returns on equity of 17.2%, 11.3%, and 11.4% for 2003, 2004, and 2005, respectively. The data supplied by Mr. Atkins suggest that these returns would be deemed adequate by a hypothetical investor in a company like PACE. We accordingly find and hold that PACE is entitled to deductions under section 162 for bonus expenses of $134,276 for 2003, $626,581 for 2004, and $547,971 for 2005. The balances of the bonuses paid - $165,724 for 2003, $623,419 for 2004, and $1,517,029 for 2005 - do not represent bona fide compensation for services rendered but rather constituted nondeductible distributions of corporate profits.

Aspro, Inc. v. Commissioner, T.C. Memo. 2021-8, concluded its analysis:

e. Comparison of Salary to Distributions to Stockholders and Retained Earnings

As discussed above, the failure to pay more than a minimal number of dividends may suggest that some of the amount paid as shareholder-employee compensation is a dividend. See *Charles Schneider & Co. v. Commissioner*, 500 F.2d 148. A corporation is not required to pay dividends, however; shareholders may be equally content with appreciation of their stock. See *Home Interiors & Gifts, Inc. v. Commissioner*, 73 T.C. at 1161. The independent investor test is used often to assess whether the amount of shareholder compensation was reasonable in the light of the return on equity the corporation's shareholders received during the same timeframe. *Miller & Sons Drywall, Inc. v. Commissioner*, 2005 WL 1200189, at *5 (citing *Rapco, Inc. v. Commissioner*, 85 F.3d 950, 955 (2d Cir. 1996), *aff'g* T.C. Memo. 1995-128).

Petitioner never paid dividends. And while petitioner argues correctly that it was not required to pay dividends, it did not show that the shareholders received a fair return on account of their shares. Petitioner did not present evidence or expert witness testimony regarding what return on equity an independent investor might find reasonable. And while we can calculate petitioner's return on equity, we do not have sufficient information to assess whether such a return was adequate for petitioner's industry. See *id.* at *13 n.4 (calculating return on equity by dividing the year's net income by the year's beginning shareholders equity).[7]

[7] Here, that formula indicates returns of approximately 1% for tax year 2012, !1% for tax year 2013, and 7% for tax year 2014.

Additionally, the Nunes report contains data and analysis that indicates that petitioner's shareholder compensation scheme did not allow for adequate shareholder returns. The Nunes report concludes that petitioner's operating income margins were significantly below those of its industry peers. The top quarter of petitioner's industry peers had operating margins of 6% of revenue during the years in issue, while half had operating margins of more than 2.5%. Petitioner's operating margins before paying management fees were strong compared to those of its industry peers (4.4% in tax year 2012, 7.6% in tax year 2013, and 8.1% in tax year 2014) but were relatively very weak once management fees were paid (negative 0.1%, negative 0.2%, and 0.4%), as computed by the Nunes report. While the Nunes report does not compare petitioner's return on equity to those of its industry peers, we find its conclusions regarding petitioner's operating margins illuminating. By paying such high shareholder compensation, petitioner was less profitable as illustrated by its lower operating income margins] compared to those of its industry peers. Low profitability led to relatively lower retained earnings and,

> consequently, low returns for the hypothetical independent investor. At bottom, petitioner has not shown that a hypothetical independent investor in its stock would find its investment returns reasonable with the shareholder compensation.[8] Accordingly, we find that this factor weighs heavily in favor of respondent.
>
> [8] And we think that conclusion applies equally to management fees paid to all three shareholders, not just Mr. Dakovich.
>
> In sum, petitioner has not carried its burden of showing that the management fees paid to Mr. Dakovich were reasonable. They were not for any services beyond his responsibilities as president, and respondent has provided persuasive expert testimony that Mr. Dakovich was already overcompensated by his salary and bonus alone. As we concluded above, there are numerous indicia that the management fees paid to Mr. Dakovich were simply disguised distributions; and much of the evidence supports the conclusion that the management fees paid to him were not reasonable. Finally, petitioner never paid dividends to its shareholders and presented no evidence showing that an independent investor would have been satisfied with investment returns after shareholder compensation.

In affirming the Tax Court, the Eighth Circuit, 32 F.4th 673 (2022), generally agreed with the above and added:

> Furthermore, the payments made to Dakovich were a disguised distribution and were not purely for services. See *David E. Watson*, 668 F.3d. at 1019. As with Jackson Enterprises Corp. and Manatt's Enterprises, Ltd., Aspro paid the management fees as lump sums at the end of the tax year even though the purported services were performed throughout the year, had an unstructured process of setting the management fees that did not relate to the services performed, and had a relatively small amount of taxable income after deducting the management fees. See *Nor-Cal Adjusters*, 503 F.2d at 362-63. Therefore, the tax court did not clearly err in finding that Aspro failed to carry its burden of showing that the management fees were reasonable and purely for services actually performed.

Clary Hood, Inc. v. Commissioner, T.C. Memo. 2022-15, commented on employee-shareholders:

> Another consideration is whether the employee was also a shareholder of the corporation. Where officer-shareholders are in control of a closely held corporation and set their own compensation, careful scrutiny is required to determine whether the alleged deductible compensation is in fact a nondeductible dividend. *Richlands Med. Ass'n v. Commissioner*, 953 F.2d 639, 1992 WL 14603, at *2 (4th Cir. 1992), *aff'g per curiam* T.C. Memo. 1990-660; *Estate of Wallace v. Commissioner*, 95 T.C. at 556. An "ostensible salary" paid by a closely held corporation to one of its few shareholders is likely to constitute a disguised dividend where the amount is "in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a

> close relationship to the stockholdings of the officers or employees". Sec. 1.162-7(b)(1), Income Tax Regs.

In that case, the Tax Court explained the Fourth Circuit's approach:

> The U.S. Court of Appeals for the Fourth Circuit, the court to which an appeal of this case would lie, see sec. 7482(b), requires consideration of multiple factors in determining reasonable compensation (multifactor approach): the employee's qualifications; the nature, extent, and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with gross income and net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; and the salary policy of the taxpayer as to all employees. *Richlands Med. Ass'n v. Commissioner*, 1992 WL 14603, at *2.
>
> In the context of small corporations with a limited number of officers, additional factors may include the amount of compensation paid to the particular employee in the previous years, *Mayson Mfg. Co. v. Commissioner*, 178 F.2d 115, 119 (6th Cir. 1949), *rev'g* and remanding a Memorandum Opinion of this Court dated Nov. 16, 1948, and personal guaranties of debts or other obligations of the corporation, *E.J. Harrison & Sons, Inc. v. Commissioner*, T.C. Memo. 2003-239, 2003 WL 21921049, at *14-*16, *aff'd in part, rev'd in part and remanded on another issue*, 138 F. App'x 994 (9th Cir. 2005).
>
> No single factor is decisive; instead, we must consider and weigh the totality of the facts and circumstances when making a decision. *Martens v. Commissioner*, 1991 WL 87160, at *9. In doing so, we may find certain factors less relevant or helpful than other factors when considering the facts necessary to reach a conclusion. See *Medina v. Commissioner*, T.C. Memo. 1983-253.

The Tax Court declined to follow the independent investor test:

> Petitioner contends that we should follow the independent investor test in determining whether the purported compensation paid to Mr. Hood in the years at issue was reasonable. While at least one Court of Appeals has found value in this approach, the U.S. Court of Appeals for the Fourth Circuit has not adopted any iteration of the independent investor test. Moreover, we generally apply the multifactor approach unless a case is appealable to a Court of Appeals which has expressly applied the independent investor test. *See, e.g., Pepsi-Cola Bottling Co. of Salina v. Commissioner*, 61 T.C. 564, 567 (1974) (noting that it is "well settled" that the Court should consider the multifactor approach in reasonable compensation cases), *aff'd*, 528 F.2d 176, 179 (10th Cir. 1975); *Beiner, Inc. v. Commissioner*, T.C. Memo. 2004-219, 2004 WL 2164888, at *15 (refusing to apply the independent investor test exclusively by finding comparative industry salaries the most relevant factor in that case); *Metro Leasing & Dev. Corp. v. Commissioner*, 2001 WL 530694, at *9 (concluding that it was not "appropriate to rely solely on the independent investor test to reach our findings and/or holding"). Accordingly, we will apply the multifactor approach to determine the reasonableness of petitioner's purported compensation paid to Mr. Hood on the basis of the precedent of this Court and, more importantly, of the Court of Appeals for the Fourth Circuit. See *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

The court also sustained the substantial understatement penalty for 2016 but found it did not apply to 2015. Although the court found that it was reasonable to rely on the tax preparers for 2015, it found different facts for 2016:

> Petitioner contends that it also reasonably relied on professional advice in awarding Mr. Hood the 2016 amount. In contrast to the detailed record surrounding the advice given to determine the 2015 amount, petitioner provided almost no evidence with respect to the advice it may have received to determine the 2016 amount. Mr. Phillips prepared an updated compensation due spreadsheet for the 2016 amount; however, there is no evidence that petitioner's board of directors considered or relied on his worksheet when deciding to award Mr. Hood the 2016 amount. Mr. Phillips and Mr. Stokes each testified that an analysis similar to the one performed for the 2015 amount was undertaken in 2016, but there is no evidence in the record of any communication between petitioner and its advisers that would credibly support a finding that advice was actually rendered with respect to the 2016 amount. This absence becomes even more critical when considering that (1) in awarding Mr. Hood the 2015 amount, the record does not reflect that petitioner still believed Mr. Hood remained entitled to additional backpay compensation for the review period and (2) in awarding Mr. Hood the 2016 amount, the board minutes did not attempt to address why it felt the 2015 amount had been insufficient in this regard. If this changing view was based on advice petitioner received during its 2016 tax year, we would need to know what that specific advice was and who provided it. Without such facts we cannot properly apply the *Neonatology Assocs., P.A.* factors to determine whether any such advice was reasonable and followed by petitioner in good faith as to the 2016 amount. See *Higbee v. Commissioner*, 116 T.C. at 446-447.

Perhaps one might be able to reward the original owners for prior services rendered,[43] but at some point one should consider an S election to be able to avoid double taxation on distributions.[44] As to prior services rendered, *Clary Hood, Inc. v. Commissioner*, T.C. Memo. 2022-15, commented:

> An employer may deduct compensation paid to an employee in a year although the employee may have performed the services in a prior year.[14] *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115, 119 (1930), *aff'g Ox Fibre Brush Co. v. Blair*, 32 F.2d 42 (4th Cir. 1929), *rev'g* 8 B.T.A. 422 (1927); *R.J. Nicoll Co. v. Commissioner*, 59 T.C. 37, 50 (1972). The employer must show that the employee was not sufficiently compensated in the prior year and that the current year's compensation was in fact to compensate for that underpayment. *Estate of Wallace v. Commissioner*, 95 T.C. 525, 553-554 (1990), *aff'd*, 965 F.2d 1038 (11th Cir. 1992).
>
> [14] Respondent does not argue that any portion of the compensation paid to Mr. Hood should have been reported in a year other than the years at issue.

In applying this prior services theory to the case at hand, the Tax Court commented:

> Where a large salary increase is in issue (as in the case at hand), it may be useful to compare past and present duties and salary payments, *Elliotts, Inc. v. Commissioner*, 716 F.2d at 1245, to determine whether and to what extent the current payments

[43] See part II.Q.1.d.ii Using Nonqualified Deferred Compensation to Facilitate a Sale.
[44] See parts II.A.2.b Existing Corporation - Paying Retired Shareholder-Officers and II.P.3.b Conversion from C Corporation to S Corporation.

> represent compensation for services performed in prior years that can be currently deductible, *Lucas v. Ox Fibre Brush Co.*, 281 U.S. at 119-120.
>
> Mr. Hood's total purported compensation increased over 300% in petitioner's 2015 tax year, its most profitable year to date, yet there was no corresponding increase in Mr. Hood's duties or responsibilities in that year. See *Miles-Conley Co. v. Commissioner*, 173 F.2d 958, 960 (4th Cir. 1949) (finding that where a taxpayer's sole stockholder had been paid much less for his service in the same position in previous years, and his compensation increased dramatically when the corporation's profits increased, an inference is warranted that the taxpayer's sole stockholder was attempting to drain off the corporate profits in the guise of salary), *aff'g* 10 T.C. 754 (1948). The stated justification per the corporate minutes for this increase is that Mr. Hood was undercompensated in prior years. While we do not disagree that Mr. Hood was undercompensated in certain years of the review period, this does not entitle petitioner to carte blanche in deducting Mr. Hood's backpay bonus amount, see *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d at 1325 ("[L]imits to reasonable compensation exist even for the most valuable employees."), and we view board minutes statements like these with a certain degree of skepticism, see *United States v. Smith*, 418 F.2d 589, 593-594 (5th Cir. 1969). Moreover, petitioner did not sufficiently demonstrate through reliable means how the full amount of each of the 2015 and 2016 amounts was proportionate in value to each of the purported past services rendered by Mr. Hood. See *Botany Worsted Mills v. United States*, 278 U.S 282, 293 (1929); *Estate of Wallace v. Commissioner*, 95 T.C. at 553-554; *Woesner Abstract & Title Co. v. Commissioner*, T.C. Memo. 1983-764.

When reviewing reasonable compensation, *Clary Hood, Inc. v. Commissioner*, 131 A.F.T.R.2d 2023-XXXX (4th Cir. 5/31/2023), explained:

> To make this determination, we apply a standard of reasonableness "under all the circumstances," taking into account practices and payments "by like enterprises under like circumstances." 26 C.F.R. § 1.162-7(b)(3). This, we conclude, calls for application of a multifactor approach that assesses the reasonableness of compensation under the totality of the circumstances. *See, e.g., Charles Schneider & Co. v. Comm'r*, 500 F.2d 148, 151- 52 (8th Cir. 1974); *Kennedy v. Comm'r*, 671 F.2d 167, 173-74 (6th Cir. 1982); *Elliotts, Inc. v. Comm'r*, 716 F.2d 1241, 1245 (9th Cir. 1983); *B.B. Rider Corp. v. Comm'r*, 725 F.2d 945, 952 (3d Cir. 1984); *Owensby & Kritikos, Inc. v. Comm'r*, 819 F.2d 1315, 1323 (5th Cir. 1987); *Dexsil Corp.*, 147 F.3d at 100; *Eberl's Claim Serv., Inc. v. Comm'r*, 249 F.3d 994, 999 (10th Cir. 2001); *Haffner's Serv. Stations, Inc. v. Comm'r*, 326 F.3d 1, 3-5 (1st Cir. 2003). As we have previously explained, albeit in an unpublished opinion, under the multifactor approach, no single factor is decisive, but rather we consider numerous factors, such as
>
> > the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with gross income and net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; [and] the salary policy of the taxpayer as to all employees.
>
> *Richlands Med. Ass'n v. Comm'r*, 953 F.2d 639, 1992 WL 14603, at *2 (4th Cir. 1992) (unpublished) (per curiam) (quoting *Owensby & Kritikos, Inc.*, 819 F.2d at 1323). And in

> the context of small corporations that have a limited number of officers, additional factors may be considered, such as the amount of compensation paid to the officer in previous years, see *Mayson Mfg. Co. v. Comm'r*, 178 F.2d 115, 119 (6th Cir. 1949), and whether the officer personally guaranteed debts or other obligations of the corporation, see *Owensby & Kritikos, Inc.*, 819 F.2d at 1325 n.33. Moreover, we find appropriate the suggestion of some other courts of appeal that the various relevant factors may be reviewed through the "lens" of, *Dexsil Corp.*, 147 F.3d at 101, or "from the perspective of," a hypothetical independent investor by asking "whether [such an] investor would be willing to compensate the employee as he was compensated," *Elliotts, Inc.*, 716 F.2d at 1245.
>
> Hood, Inc. contends that because we have not formally adopted the multifactor test, the Tax Court erred in applying it here and that we should consider the adoption of a singular "independent investor" test, which establishes a rebuttable presumption that an executive's compensation is reasonable if the corporation's shareholders are receiving a sufficiently high rate of return on their equity investment. See *Menard, Inc. v. Comm'r*, 560 F.3d 620, 622-23 (7th Cir. 2009); *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833, 839 (7th Cir. 1999). Hood, Inc. reasons that under that test we should approve Mr. Hood's bonuses because Hood, Inc. generated a 22% return on equity for its shareholders in 2015 and a 36% return in 2016 after accounting for Mr. Hood's total compensation.
>
> While it might be reasonable to consider the Seventh Circuit's independent investor test along with other factors relevant to the totality of the circumstances, we conclude that solely using that test to establish a presumption of reasonableness, as Hood, Inc. urges, would be too narrow in light of the regulatory demand that we consider "what is reasonable under all the circumstances." 26 C.F.R. § 1.162-7(b)(3). For instance, under the independent investor test, an executive's compensation could be presumed to be reasonable even if it exceeded the amount that was genuinely compensation "for personal services actually rendered," 26 U.S.C. § 162(a)(1), and that "would ordinarily be paid for like services by like enterprises under like circumstances," 26 C.F.R. § 1.162-7(b)(3). By contrast, the multifactor test allows for consideration of the numerous other relevant factors. Accordingly, we conclude that it is the appropriate test to apply and that the Tax Court did not err in applying it here.

The Court of Appeals then reviewed how the Tax Court applied that test:

> Finding no legal error in the Tax Court's use of the multifactor approach, we review the Tax Court's findings made under that test for clear error. See *Miles-Conley Co. v. Comm'r*, 173 F.2d 958, 960 (4th Cir. 1949).
>
> Hood, Inc. contends that the Tax Court did not adequately account for the return on equity generated for the company's shareholders; that it did not appropriately credit Mr. Hood's extraordinary performance and recognize that such performance could justify compensation in excess of the norm; and that it placed too much emphasis on the comparison of Mr. Hood's compensation with that of similarly situated executives in the industry. These arguments, however, simply raise questions regarding the weight to assign the factors, as the Tax Court considered them among the many factors it addressed in its extensive opinion.
>
> As a starting point, the Tax Court recognized that Mr. Hood was "extraordinarily talented in his industry," served as the company's "key employee and driving force from its

inception," and that the company's business of land excavation and grading was "more complex than that of a general construction company." The court also acknowledged that the trend of Hood, Inc.'s increasing revenue, culminating with an annual revenue of roughly $69 million in 2016, "[could] not be credited to economic conditions alone" and that Mr. Hood was instrumental in transitioning the business to more profitable projects. The court took account of these factors as well as others in its opinion, allowing reasonable compensation to Mr. Hood for his personal services in this regard.

The Tax Court also recognized that it was permissible for Hood, Inc. to compensate Mr. Hood for undercompensation in prior years, as explained in *Alpha Medical, Inc. v. Commissioner*, 172 F.3d 942, 950 (6th Cir. 1999). In Alpha Medical, the court noted that "[a] taxpayer making such a claim must show: (1) the insufficiency of the officer's compensation in the previous year[s]; and (2) the amount of the current year's compensation that was intended as compensation for that underpayment." 172 F.3d at 950. Thus, the Tax Court agreed with Mr. Hood that he was entitled to some degree of additional compensation for the services rendered in prior years.

But, focusing in large part on comparative compensation paid by relevant enterprises, as required by regulation, the court did not agree that a $5 million bonus was appropriate for either year, even when including amounts for previous undercompensation as well as a bonus for the current year. In reaching that conclusion, the court pointed to several relevant factors that indicated overpayment.

First, the court noted that Hood, Inc. had never declared or paid a cash dividend to its shareholders, even after it began to accumulate significant capital during the period from 2013 to 2016. Although companies are not required to pay dividends, a court may nonetheless consider a profitable corporation's failure to do so in determining the reasonableness of compensation paid to its shareholder-employees. *See Miles-Conley Co.*, 173 F.2d at 960; *see also Paul E. Kummer Realty Co. v. Comm'r*, 511 F.2d 313, 315 (8th Cir. 1975). In this case, the Tax Court agreed that Hood, Inc. had advanced persuasive reasons for not declaring dividends for many years, such as 2010, when business was slow and capital needs were high. It also recognized, as Hood, Inc. pointed out, that Hood, Inc.'s business was capital-intensive due to the cost of obtaining and maintaining heavy equipment. But the court noted that this rationale became less persuasive in later years given that Hood, Inc.'s year-end shareholder equity value had increased nearly sixfold, from approximately $5.5 million in 2010 to over $31 million in 2016. Yet the company opted to pay out large bonuses to Mr. Hood rather than paying any dividends. And the lack of dividends became especially suspect in light of Mr. Hood's testimony that in 2015, he was aware that he needed to start making preparations from an "income tax" perspective for "*getting money out of [the] corporation*" in preparation for "a changing of the guard." (Emphasis added).

Second, the Tax Court noted that Hood, Inc. had "no structured system in place" for determining compensation and that Mr. Hood's compensation was set by himself and his wife. "Bonuses that have not been awarded under a structured, formal, consistently applied program generally are suspect ...." *Elliotts, Inc.*, 716 F.2d at 1247. Moreover, "salaries paid to controlling shareholders are open to question if, when compared to salaries paid non-owner management, they indicate that the level of compensation is a *function of ownership*, not corporate management responsibility." *Id*. (emphasis added). Thus, the Tax Court's suspicion was enhanced by the fact that in 2015 and 2016, Mr. Hood's compensation represented almost 90% of the total compensation that Hood, Inc.

paid to its officers, despite the fact that other non-shareholder officers worked similar hours and shared similar responsibilities. While some of that discrepancy could have been attributed to the need to remedy Mr. Hood's past undercompensation, it was nonetheless glaring that Hood, Inc.'s other officers each received a bonus of $100,000 or less for the 2015 and 2016 tax years, while Mr. Hood received a bonus of $5 million for each year.

Finally, the Tax Court placed considerable weight on the comparison of Mr. Hood's compensation with that paid to similarly situated executives in comparable companies. While no single factor is decisive under the multifactor test, such comparisons have been described as "a most significant factor." *Aspro, Inc. v. Comm'r*, 32 F.4th 673, 680 (8th Cir. 2022) (quoting *Charles Schneider & Co.*, 500 F.2d at 154); see also 26 C.F.R. § 1.162-7(b)(3) (requiring consideration of what "would ordinarily be paid for like services by like enterprises under like circumstances"). Relying on survey data included in Fuller's expert report about comparably sized site-preparation contractors and their compensation of employee-shareholders, the Tax Court noted that for the years 2013 through 2016, Fuller treated Mr. Hood as meriting compensation in the 99th percentile based on the company's success and still found that the compensation actually paid to Mr. Hood exceeded what was reasonable. Instead, relying on this comparative data, the Fuller report calculated that reasonable compensation for Mr. Hood would amount to $3,681,269 for 2015 and $1,362,831 for 2016. The Tax Court found these calculations to be "the most credible and complete source of data, analyses, and conclusions." At the same time, the court discounted the testimony of Hood, Inc.'s expert witnesses because they "did not provide satisfactory countervailing evidence ... that would credibly support a greater allowable amount." It noted, for example, that one of Hood, Inc.'s expert reports based its analysis on survey data for CEO compensation from 2011 to 2016 for companies with a revenue of up to $500 million, which, the Tax Court concluded, was a poor match for both Hood, Inc.'s size and the relevant time period at issue.

At bottom, the Tax Court held that a reasonable total compensation for Mr. Hood was $3,681,269 for 2015 and $1,362,831 for 2016, and that a $5 million bonus for each year - on top of his salary - was excessive.

We find that Hood, Inc. has not demonstrated that the Tax Court's factual findings were clearly erroneous or that its reliance on Fuller's report was inappropriate. The court explained its reason for relying on Fuller and rejecting Hood, Inc.'s experts, and we see no basis to disturb that determination. See *United States v. Hall*, 664 F.3d 456, 462 (4th Cir. 2012) ("Evaluating the credibility of experts and the value of their opinions is ... a function best committed to the district courts, and one to which appellate courts must defer, and we should be especially reluctant to set aside a finding based on the trial court's evaluation of conflicting expert testimony" (cleaned up))…..

Mr. Hood's business acumen and his contribution to Hood, Inc.'s prosperity was fully recognized by the Tax Court, and the Tax Court thus concluded that Hood, Inc. was entitled to compensate Mr. Hood well. And we agree.

This case is not about such compensation but rather about whether the amount paid was entirely for Mr. Hood's personal services or whether it included profits distributable to him as a function of his ownership of the company. To make that determination, the Tax Court took a multifactor approach designed to measure the portion of compensation that was attributable only to Mr. Hood's personal services and concluded that not all his

> compensation was so attributable. We now affirm the court's decision with respect to that finding.
>
> Nonetheless, we agree that Hood, Inc. used a consistent methodology to determine the amount of Mr. Hood's bonuses for both 2015 and 2016 with the advice of independent accountants, and therefore, the reasons that the Tax Court gave for not imposing a substantial underpayment penalty for 2015 likewise provided an adequate defense against imposing a similar penalty for 2016.

As the concluding paragraph quoted above confirmed, the Fourth Circuit held that no penalties applied, given that the company provided complete information to the CPAs and reasonably relied on their advice.

II.A.1.b.ii. Compensating Owner(s) with Management Fees

Aspro, Inc. v. Commissioner, T.C. Memo. 2021-8, involved a C corporation that had as owners two entities and one individual that the Tax Court held sought to distribute its profits by compensating the owners. Before getting to details below, let's discuss some strategy:

- After paying tax or making tax distributions to owners, most businesses reinvest part or all of their income and distribute the rest.

- For income that is being distributed, pass-through taxation tends to be best. For income that is reinvested, C corporation taxation tends to be best. See parts II.E.1.a Taxes Imposed on C Corporations and II.E.1.b Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships, subject to the strategic considerations (including exit strategies) discussed in parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart.

- One might try to find a middle ground through part II.E.4 Reaping C Corporation Annual Taxation Benefits Using Hybrid Structure. But such a structure would lock the business into a given mixture of distribution and reinvestment, which may seem good when set but might turn out to be much less than ideal as time goes by.

Given the latter point, one might find C corporations trying a more flexible approach of compensating owners and giving performance bonuses. However, owners' annual performance metrics may differ from their ownership percentages, and the owners might prefer to have that variability reflected in compensation for not just services but also capital. Then the IRS and courts evaluate how much of these payments are compensation for deductible services and how much as a nondeductible return on capital. Also, be careful that whoever actually earns the income is the one who reports it – see part II.G.24 Taxing Entity or Individual Performing Services.

A corporate subsidiary cannot deduct an ostensible management fee paid to its parent unless the parent actually provides services.[45]

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

> In this case, we have four individuals who were equal corporate shareholders in a home care business, petitioner, that they had acquired in 1994. During 2010 the same four shareholders

Aspro, Inc. v. Commissioner, T.C. Memo. 2021-8, upheld the IRS' disallowance of management fees paid to two entities that owned the taxpayer C corporation:

> Petitioner has not shown that the management fees were paid "purely for services." See sec. 1.162-7(a), Income Tax Regs. To the contrary, most of the evidence indicates that petitioner paid the management fees to its three shareholders as disguised distributions. See *id*. para. (b)(1). Petitioner made no distributions to its three shareholders but paid management fees each year. Indeed, no evidence indicates that petitioner ever made distributions to its shareholders during its entire corporate history. This indicates a lack of compensatory purpose. See *id*.; see also *Paul E. Kummer Realty Co. v. Commissioner*, 511 F.2d 313, 315 (8th Cir. 1975) ("[T]he absence of dividends to stockholders out of available profits justifies an inference that some of the purported compensation really represented a distribution of profits as dividends."), *aff'g* T.C. Memo. 1974-44; *Nor-Cal Adjusters v. Commissioner*, 503 F.2d 359, 362-363 (9th Cir. 1974) (holding that the complete absence of formal dividend distributions was an indication that compensation paid to shareholders was disguised distributions), *aff'g* T.C. Memo. 1971-200; *Charles Schneider & Co. v. Commissioner*, 500 F.2d at 153 ("Perhaps most important [in finding purported shareholder compensation represented disguised distributions] is the fact that no dividends were ever paid by any of these companies during … [the years in issue], even though they enjoyed consistent profits and immense success in the industry.").
>
> Although the management fees were not exactly pro rata among the three shareholders, the two large shareholders always got equal amounts, and the percentages of management fees all three shareholders received roughly correspond to their respective ownership interests. This equal distribution supports an inference that petitioner paid management fees to Mr. Dakovich, Jackson Enterprises Corp., and Manatt's Enterprises, Ltd., as distributions of profits. See sec. 1.162-7(b)(1), Income Tax Regs.; see also *Paul E. Kummer Realty Co. v. Commissioner*, 511 F.2d at 316 (stating that the fact that amounts received by shareholders were "almost identical" to the percentage of stock held by each shareholder was indicative of disguised distributions). The management fees paid have a close relationship with each shareholder's stockholding in petitioner….

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

The fact that petitioner paid Jackson Enterprises Corp. and Manatt's Enterprises, Ltd., instead of the entities and individuals actually performing services indicates a lack of compensatory purpose. If petitioner was concerned with paying for services, it very easily could have paid the service providers directly whether that was Cedar Valley Corp., Manatt's, Inc., Tim Manatt, or someone else. But instead, petitioner paid entities that did not directly perform any of the services that it argues justify the management fees.

Also, petitioner paid management fees as lump sums at the end of the tax year, rather than throughout the year as the services were performed, even though many services were performed throughout, or early in, the tax year. For example, petitioner argues that the management fees paid to Jackson Enterprises Corp. are partly attributable to the human resources assistance Ms. Robinson provided and that the management fees paid to Manatt's Enterprises, Ltd., were partly attributable to environmental assistance Ms. Bond provided. But petitioner paid nothing for those services until the very end of the tax year. This practice indicates a lack of compensatory purpose. See *Nor-Cal Adjusters v. Commissioner*, 503 F.2d at 362-363 (holding that taxpayer's payments of compensation to shareholders in lump sums rather than as services were performed was an indication that payments were disguised distributions); *Heil Beauty v. Commissioner*, 199 F.2d at 195 (concluding that the taxpayer's payment scheme was indicative of a disguised distribution of profit where the shareholder was paid in one lump sum each year as opposed to throughout the year as services were rendered).

Another indication that the management fees were disguised distributions to the shareholders is the fact that petitioner had relatively little taxable income after deducting the management fees. See *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315, 1325-1326 (5th Cir. 1987) (stating that considering compensation as a percentage of taxable income before deducting the compensation in question is an accurate gauge of whether a corporation is disguising distributions of dividends as compensation), *aff'g* T.C. Memo. 1985-287 [sic, 1985-267]; *Nor-Cal Adjusters v. Commissioner*, 503 F.2d at 362-363 (holding that the fact that the taxpayer consistently had negligible taxable income was an indication that compensation paid to shareholders was disguised distributions); *Wycoff v. Commissioner*, T.C. Memo. 2017-203, at *46-*49 (holding that shareholder compensation paid was unreasonable when it depleted "most, if not all" of the company's profits, an indication that the compensation was a disguise for nondeductible profit distributions). Without deducting management fees petitioner would have had taxable income of $1,307,712 for tax year 2012, $2,031,371 for tax year 2013, and $2,324,358 for tax year 2014. The management fees of $1,166,000 for tax year 2012, $1,750,000 for tax year 2013, and $1,800,000 for tax year 2014 thus eliminated 89%, 86%, and 77% of what would have been petitioner's taxable income for tax years 2012 through 2014, respectively. One of petitioner's board members, Brad Manatt, credibly testified that he understood a dividend to be a "distribution of profits"; and when he was asked to describe his understanding of the difference between a dividend and a management fee, he testified that "a management fee is a distribution from the company that's not taxed by the company and a distribution is a [sic] after-tax distribution of profits.… They're both distributions." It is not a stretch to infer that petitioner was using management fee payments to lower its taxable income while getting cash to its three shareholders.

Lastly, petitioner's process of setting management fees was unstructured and had little if any relation to the services performed. The fees for services were not set in advance of the services being provided. None of the witnesses could explain how petitioner determined the management fees. And there was contradictory testimony on who proposed the initial amount of management fees at the board meetings: For instance, Mr. Dakovich recalled that the amounts of the management fees were determined by the board after a discussion. On the other hand some board members testified that Mr. Dakovich made a recommendation of the amount of the management fees at the board meeting, and after a brief discussion they would be approved. Some board members understood that the management fees had been determined before the board meetings and did not recall discussions about the different services performed. Tim Manatt vaguely speculated that the higher fees in 2013 were to make up for the lack of fees in 2010, but on brief petitioner was unable to stitch together any more evidentiary support. Petitioner did not attempt to value the individual services attributable to the management fees paid to Jackson Enterprises Corp. and Manatt's Enterprises, Ltd. And Mr. Dakovich conceded that his management fees were not paid for any specific services he performed beyond his duties as petitioner's president. This unstructured process for setting management fees indicates that petitioner paid management fees as a way to distribute earnings to its shareholders and not to compensate them for services rendered. See *Nor-Cal Adjusters v. Commissioner*, 503 F.2d at 362-363 (holding that an unstructured system of setting shareholder compensation, with no preset criteria, indicated that the shareholder compensation was actually disguised distributions).

The numerous indicia of disguised distributions show that the management fees paid to the three shareholders were not "in fact payments purely for services." See secs. 1.162-7(a) and (b)(1), Income Tax Regs. Accordingly, we hold that the management fees are not deductible, even if petitioner could show the amounts were reasonable. See *Charles Schneider & Co. v. Commissioner*, 500 F.2d at 153 (stating that compensation paid to shareholders who set their own compensation "may be distributions of earnings rather than payments of compensation for services rendered; even if they are reasonable, they would not be deductible")….

Petitioner also failed to meet its burden of showing that the management fees paid to Jackson Enterprises Corp. and Manatt's Enterprise, Ltd., were ordinary, necessary, and reasonable. First, the parties did nothing to document a service relationship between petitioner and either Jackson Enterprises Corp. or Manatt's Enterprises, Ltd. There were no written management services agreements outlining what services were to be performed. No evidence—documentary or otherwise—outlines the cost or value of any particular service. Neither corporate shareholder billed or sent invoices for services rendered. See *ASAT, Inc. v. Commissioner*, 108 T.C. 147, 174-175 (1997) (holding that the taxpayer was not entitled to deduct consulting fees where there was no written contract, no evidence regarding how the fees were determined, almost no detail in the billing invoices, and indications that the parties were not dealing at arm's length); see also *Fuhrman v. Commissioner*, T.C. Memo. 2011-236, 2011 WL 4502290, at *2-*3 (holding that the taxpayer was not entitled to deduct management fees paid to an affiliate when there was no written management services contract or other contemporaneous documentation, and the invoices had no details as to the services provided or the derivation of the invoiced amounts).

Additionally, petitioner presented no evidence showing how management fee amounts were determined. See *Fuhrman v. Commissioner*, 2011 WL 4502290, at *2-*3 (holding that the taxpayer was not entitled to deduct management fees paid to an affiliate when the taxpayer failed to demonstrate how the management fees were determined). As we observed above, the testimony about how the amounts of management fees were set was vague and contradictory. No witness could explain how much any particular service cost. No witness could explain how the lump-sum management fee amounts paid to each of Jackson Enterprises Corp. and Manatt's Enterprises, Ltd., were determined. No witness could explain what portion of each management fee paid to either Jackson Enterprises Corp. or Manatt's Enterprises, Ltd., was attributable to any given service.

Reasonable compensation is only the amount that would ordinarily be paid for like services by like enterprises under like circumstances. Sec. 1.162-7(b)(3), Income Tax Regs. Petitioner presented no evidence concerning what like enterprises would pay for like services. Petitioner and its corporate shareholders made no attempt, either during the years in issue or later at trial, to attach dollar values to the individual services provided, let alone demonstrate that like enterprises would pay that amount for such services. Petitioner failed to introduce any expert testimony to aid us in assessing the reasonableness of amounts paid for the various services. And petitioner failed to establish the nature, occurrence, and frequency of most of the services that it argues "justify" the management fees paid to its corporate shareholders. Indeed, petitioner's rationale for the management fees appears to be a last-minute scramble to list everything anyone remotely associated with either corporate shareholder did for petitioner. Neither Jackson Enterprises Corp. nor Manatt's Enterprises, Ltd., actually performed any of the "personal services" that petitioner argues justify payment of management fees. See sec. 162(a)(1) (providing for a deduction for compensation paid for "personal services" actually rendered). Neither corporate shareholder was in the business of providing management services or even was in a business related to that of petitioner's. Jackson Enterprises Corp. was a holding company, and Manatt's Enterprises, Ltd., was a farming business. Instead, the services were performed by individuals who worked for different entities. For example, the environmental advice, safety advice, and best practices meetings were provided by employees of MAS, Ltd., or Manatt's, Inc., not Manatt's Enterprises, Ltd. The alternate bid advice, human resources assistance, and equipment advice were performed by employees of Cedar Valley Management Corp., not Jackson Enterprises Corp. Petitioner glosses over this by referring to the "Jackson family of companies" and the "Manatt's family of companies."

We have held that management fees paid to an affiliate are only necessary and reasonable - and therefore, deductible - if the affiliate provided the management services. See *Elick v. Commissioner*, T.C. Memo. 2013-139, at *11-*12 (holding that the taxpayer was not entitled to deduct management fees paid to affiliate when the taxpayer failed to show that management services outlined in management services agreement were actually performed by the affiliate), *aff'd*, 638 F. App'x 609 (9th Cir. 2016); *Weekend Warrior Trailers, Inc. v. Commissioner*, T.C. Memo. 2011-105, 2011 WL 1900159, at *19-*21 (holding that management fees paid to an affiliate were not deductible when the evidence did not adequately establish the services performed and who performed them). Petitioner offered no evidence that the entities or individuals providing the services did so on behalf of the shareholders and were compensated for those services; in effect we are asked to imagine their relationships. Petitioner cites no authority for the proposition that it can claim a deduction for management fees paid to its corporate shareholders just because individuals employed by other entities in the "Jackson family of companies" or "Manatt's family of companies" may have done something of value for petitioner. Petitioner has to connect the dots between the services performed and the management fees it paid. Petitioner failed to do so.

> Petitioner's arguments are even less convincing when we consider each "service" it asserts "justifies" the management fees paid to each corporate shareholder….
>
> We cannot identify any "personal services" performed by Manatt's Enterprises, Ltd., or Jackson Enterprises Corp., and petitioner did not establish what amounts of the management fees paid to each shareholder were to compensate for these "services" and whether such amounts would have been paid by like enterprises under like circumstances.

Aspro, Inc. v. Commissioner, T.C. Memo. 2021-8, also upheld the IRS' disallowance of management fees paid to an individual shareholder of the taxpayer C corporation:

> We now turn to whether the management fees paid to Mr. Dakovich, petitioner's president, were ordinary, necessary, and reasonable. Unlike the two corporate shareholders, Mr. Dakovich was an employee of petitioner, providing personal services on an ongoing basis. We do not see any reason to question whether it was ordinary or necessary for petitioner to compensate its president. But his total compensation still must be reasonable.
>
> In the case of shareholder-employee compensation, courts have considered the following factors: the employee's qualification; the nature, extent, and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; a comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable [*40] concerns; the taxpayer's salary policy for all employees; and in the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years. *Charles Schneider & Co. v. Commissioner*, 500 F.2d at 152; *Mayson Mfg. Co. v. Commissioner*, 178 F.2d 115, 119 (6th Cir. 1949), *rev'g* a Memorandum Opinion of this Court; *Home Interiors & Gifts, Inc. v. Commissioner*, 73 T.C. at 1155-1156. No single factor is dispositive of the issue; instead, the Court's decision must be based on a careful consideration of applicable factors in the light of the relevant facts. See *Mayson Mfg. Co. v. Commissioner*, 178 F.2d at 119.
>
> Some courts have supplemented or completely replaced the multifactor approach for analyzing shareholder-employee compensation with the independent investor test. See *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*, 680 F.3d 867 (7th Cir. 2012), *aff'g* T.C. Memo. 2011-. The Court of Appeals for the Eighth Circuit has not opined on this test yet. But in cases appealable to that Court of Appeals, we have applied the independent investor test as a way to view each factor. See *Wagner Constr., Inc. v. Commissioner*, T.C. Memo. 2001-160, 2001 WL 739234, at *22 (examining the factors from the perspective of an independent investor). The independent investor test asks whether an inactive, independent investor would have been willing to pay the amount of disputed shareholder-employee compensation considering the particular facts of each case. *Miller & Sons Drywall, Inc. v. Commissioner*, T.C. Memo. 2005-114, 2005 WL 1200189, at *5. In assessing whether Mr. Dakovich's management fees were reasonable in amount, we find respondent's expert witness report prepared by Ken Nunes (Nunes report) helpful and persuasive. Mr. Nunes is a chartered financial analyst, and we recognized him as an expert in business valuation with experience in valuing compensation arrangements…

The court then discussed “the employee’s qualifications and the nature, extent, and scope of employee’s work,” that “a company’s performance in the context of prevailing general economic conditions reveals some information about the effectiveness of management,” and a comparison of the shareholder-employee compensation with prevailing rates of compensation paid to individuals in similar positions in comparable companies within the same industry, then continued:

> Courts also have compared compensation paid to shareholder-employees to gross income and net income in deciding whether compensation is reasonable. See *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d at 1322-1323; *Wagner Constr., Inc. v. Commissioner*, 2001 WL 739234, at *25. Computing shareholder compensation paid as a percentage of net income before shareholder compensation is paid often is more probative as it can show whether the shareholder compensation is actually a disguised distribution of profits. *Wagner Constr., Inc. v. Commissioner*, 2001 WL 739234, at *25 (citing *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d at 1325-1326).
>
> Petitioner’s total shareholder compensation[5] was 90%[6] of net income for tax year 2012, over 100% of net income for tax year 2013, and 67% of net income for tax year 2014. We hold that this factor weighs against petitioner. See *Miller & Sons Drywall, Inc. v. Commissioner*, 2005 WL 1200189, at *13 (holding that this factor weighed in favor of the Commissioner when shareholder compensation was 89%, 108%, and 74% of net income before taxes and shareholder compensation for the years in issue).
>
> [5] Total shareholder compensation is Mr. Dakovich’s total compensation (salary, bonus, and management fees) plus the management fees paid to the other two shareholders, which was $1,705,760 for tax year 2012, $2,103,560 for tax year 2013, and $2,287,649 for tax year 2014.
>
> [6] To compute these percentages, we divided the total shareholder compensation each year by the sum of (i) the net income reported on petitioner’s audited financial statements and (ii) total shareholder compensation. Petitioner had net income of $192,608 for 2013, a net loss of $131,710 for 2013, and net income of $1,103,149 for 2014.
>
> **e. Comparison of Salary to Distributions to Stockholders and Retained Earnings**
>
> As discussed above, the failure to pay more than a minimal amount of dividends may suggest that some of the amount paid as shareholder-employee compensation is a dividend. See *Charles Schneider & Co. v. Commissioner*, 500 F.2d 148. A corporation is not required to pay dividends, however; shareholders may be equally content with appreciation of their stock. See *Home Interiors & Gifts, Inc. v. Commissioner*, 73 T.C. at 1161. The independent investor test is used often to assess whether the amount of shareholder compensation was reasonable in the light of the return on equity the corporation’s shareholders received during the same timeframe. *Miller & Sons Drywall, Inc. v. Commissioner*, 2005 WL 1200189, at *5 (citing *Rapco, Inc. v. Commissioner*, 85 F.3d 950, 955 (2d Cir. 1996), *aff’g* T.C. Memo. 1995-128).
>
> Petitioner never paid dividends. And while petitioner argues correctly that it was not required to pay dividends, it did not show that the shareholders received a fair return on account of their shares. Petitioner did not present evidence or expert witness testimony regarding what return on equity an independent investor might find reasonable. And

while we can calculate petitioner's return on equity, we do not have sufficient information to assess whether such a return was adequate for petitioner's industry. See *id*. at *13 n.4 (calculating return on equity by dividing the year's net income by the year's beginning shareholders equity).[7]

[7] Here, that formula indicates returns of approximately 1% for tax year 2012, 11% for tax year 2013, and 7% for tax year 2014.

Additionally, the Nunes report contains data and analysis that indicates that petitioner's shareholder compensation scheme did not allow for adequate shareholder returns. The Nunes report concludes that petitioner's operating income margins were significantly below those of its industry peers. The top quarter of petitioner's industry peers had operating margins of 6% of revenue during the years in issue, while half had operating margins of more than 2.5%. Petitioner's operating margins before paying management fees were strong compared to those of its industry peers (4.4% in tax year 2012, 7.6% in tax year 2013, and 8.1% in tax year 2014) but were relatively very weak once management fees were paid (negative 0.1%, negative 0.2%, and 0.4%), as computed by the Nunes report. While the Nunes report does not compare petitioner's return on equity to those of its industry peers, we find its conclusions regarding petitioner's operating margins illuminating. By paying such high shareholder compensation, petitioner was less profitable as illustrated by its lower operating income margins [*48] compared to those of its industry peers. Low profitability led to relatively lower retained earnings and, consequently, low returns for the hypothetical independent investor. At bottom, petitioner has not shown that a hypothetical independent investor in its stock would find its investment returns reasonable with the shareholder compensation.[8] Accordingly, we find that this factor weighs heavily in favor of respondent.

[8] And we think that conclusion applies equally to management fees paid to all three shareholders, not just Mr. Dakovich.

In sum, petitioner has not carried its burden of showing that the management fees paid to Mr. Dakovich were reasonable. They were not for any services beyond his responsibilities as president, and respondent has provided persuasive expert testimony that Mr. Dakovich was already overcompensated by his salary and bonus alone. As we concluded above, there are numerous indicia that the management fees paid to Mr. Dakovich were simply disguised distributions; and much of the evidence supports the conclusion that the management fees paid to him were not reasonable. Finally, petitioner never paid dividends to its shareholders and presented no evidence showing that an independent investor would have been satisfied with investment returns after shareholder compensation.

The management fee and employment arguments arise in a similar context. Because each separate employer generally must pay FICA, if a person works for more than one related company then one company might pay the compensation to the person and collect a management fee (or fees under an employee leasing arrangement) from the other related companies. For an example of how sloppiness in doing that can get a taxpayer into trouble, see *Blossom Day Care Centers, Inc. v. Commissioner*, T.C. Memo. 2021-86, in part II.A.2.c Avoiding Double Taxation and Self-Employment Tax.

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

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

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

The "Up-C" structure takes advantage of this difference:[46] First, the owners of a partnership orchestrate a public offering of a C corporation shell. The C corporation uses the proceeds to buy the LLC interests. The resulting inside basis step-up[47] generates valuable tax benefits. Generally, the market supports a tax reimbursement agreement (TRA) passing along to the selling LLC owners about 85% of the tax benefits. By increasing the purchase price, the TRA generates even more tax benefits – a taxpayer-friendly circular calculation.

Entrepreneurs also like the idea of attracting venture capital investors. Some VC investors appreciate the tax benefits of a partnership. Others might set up a C corporation to own the LLC so that the corporation pays all of the taxes and the investment does not complicate the VC investors' tax returns. Sometimes the VC investors force the business to be a C corporation. As described in part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation, founders and others to whom a C corporation issues stock may exclude a portion of their gain from income.[48] Founders may get the best tax results under that exclusion by starting as a partnership and then converting to that partnership just over 5 years before they cash out.[49]

II.A.1.d. Lending Securities

II.A.1.d.i. Code § 1058 Loan of Securities

Predating Code § 1058 is a common stock brokerage practice that Rev. Rul. 57-451 approved as not being a taxable disposition:

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[46] See Polsky and Rosenzweig, "The Up-C Revolution" (10/13/2016), University of Georgia School of Law Legal Studies Research Paper No. 2016-40, available at SSRN: https://ssrn.com/abstract=2851872. See also Bilsky and Goodman, "An Alternate Route to an IPO: Up-C Partnership Tax Considerations," Parts 1 and 2 in the November 2015 and December 2015 issues of *The Tax Adviser*.
[47] See part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.
[48] Partnerships and S corporations have less need for this exclusion than do C corporations, because reinvested earnings increase the outside basis of the owners of partnerships and S corporations, whereas reinvested earnings do not have that effect of C corporation shareholders. For a comparison of taxation of gain not reflected by reinvested earnings, see part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis.
[49] See part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership? for that recommendation.

The Internal Revenue Service has been requested to determine whether the situations described below involve the "disposition" of stock acquired pursuant to a restricted stock option within the meaning of section 421(d)(4) of the Internal Revenue Code of 1954.

(1) The stockholder deposits his stock with a bank or trust company in an "agency" account and authorizes such company to collect the dividends thereon. Although the stock certificate remains in the stockholder's name, for convenience the stockholder signs a stock assignment form in blank, enabling the bank or trust company to dispose of the shares upon subsequent order of the stockholder.

(2) The stockholder deposits his stock with his broker in a "safekeeping" account and, at the time of deposit, endorses the stock certificates and then authorizes the broker to "lend" such certificates in the ordinary course of the broker's business to other customers of the broker. The broker has the certificates cancelled and new ones reissued in his own name.

(3) Same as (2) above, except that the stockholder does not authorize the broker to "lend" the securities to other customers and the certificates remain in the stockholder's name.

Section 421 of the Internal Revenue Code of 1954 provides for the Federal income tax treatment of restricted stock options. In addition to defining a restricted stock option, section 421 sets forth the tax consequences of the receipt and subsequent exercise or disposition of the stock option and the tax consequences of the sale or other disposition of the stock obtained by exercise of the option. Subsection (d)(4) defines the term "disposition" as a sale, exchange, gift, or transfer of legal title but not, among other things, an exchange to which section 1036 of the Code applies.

The phrase "transfer of legal title" is defined neither in section 421 nor in the proposed regulations under that section. However, the phrase has been frequently considered in connection with Federal and State stock transfer taxation; and, in the absence of a definition of "transfer of legal title" in section 421, the construction placed upon the phrase by courts in the area of stock transfer taxes will be relied upon.

Courts, in cases concerning stock transfer taxes, have observed that the expression "legal title" is frequently used in stock transactions to describe a naked appearance of title, or a limited title appearing complete on its face. See *William P. Bonbright & Co. v. New York*, 165 App. Div. 640, 151 N. Y. Supp. 35 (1915); and *Travis v. Ann Arbor Co.*, 180 App. Div. 799, 168 N.Y.Supp. 53 (1917), *affirmed without opinion*, 227 N.Y. 640, 126 N.E. 925 (1919). On this basis, it has been held, in cases constructing the Federal stock transfer tax provisions of the Code, that a nominee in whose name stock is registered on the books of the corporation holds legal title to such stocks. See *Founders General Corp. v. Hoey*, 300 U.S. 268, Ct. D. 1209, C. B. 1937-1, 344; and *Nee v. United Funds, Inc.*, 169 Fed.(2) 33. However, in *Selected American Shares, Inc. v. United States*, 196 Fed.(2) 473, the court viewed a mere custodian of stock as the alter ego of the true owner and as taking no legal title to stock deposited with it for safe-keeping where the stock, accompanied by a blank assignment, was not reissued in the custodian's name so as to necessitate a retransfer by the custodian in the event of a subsequent sale by the true owner.

From the foregoing, it is held in the first and third situations described above, that where certificates representing shares of stock received by an optionee under a restricted stock option are endorsed or assigned in blank by such optionee and are deposited with a custodian, such as a bank or trust company or a broker, under a written agreement between the parties providing that such stock is to be held or disposed of by such custodian for, and subject at all times to the instructions of, the optionee, who remains the registered owner of such certificates on the books of the corporation, such deposit does not constitute a "disposition" of the stock within the meaning of section 421(d)(4) of the Internal Revenue Code of 1954.

The second situation described above, wherein the optionee authorizes the broker to "lend" his stock certificates to other customers in the ordinary course of business, presumably anticipates the "loan" of the stock to others for use in satisfying obligations incurred in short sale transactions. In such a case, all of the incidents of ownership in the stock and not mere legal title, pass to the "borrowing" customer from the "lending" broker. For such incidents of ownership, the "lending" broker has substituted the personal obligation, wholly contractual, of the "borrowing" customer to restore him, on demand, to the economic position in which he would have been as owner of the stock, had the "loan" transaction not been entered into. See *Provost v. United States*, 269, U.S. 443, T.D. 3811, C.B. V-1, 417 (1926). Since the "lending" broker is not acting as the agent of the optionee in such a transaction, he must have necessarily obtained from the optionee all of the incidents of ownership in the stock which he passes to his "borrowing" customer.

Section 1036 of the Code, which relates to the exchange of stock for stock, provides as follows:

(a) *General Rule*. No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

Section 1.1036-1(a) of the Income Tax Regulations provides that the exchange referred to in section 1036 is not limited to a transaction between a stockholder and a corporation but also includes an exchange between two individual stockholders.

If this transaction, when completed, amounts to an exchange between two stockholders of common stock for other common stock (or preferred stock for preferred stock) in the same corporation, there would be no "disposition" of the optionee's stock within section 421. If, for example, by exercise of a restricted stock option, an optionee obtains a certificate for 100 shares of common stock in M Corporation, and if he then endorses the certificate, deposits it with his broker, and authorizes the broker to "lend" the stock to other customers, there would be no "disposition" of the stock for purposes of section 421 if the broker satisfies his resulting obligation to the optionee by transferring to him 100 shares of common stock in M Corporation. If the broker, on the other hand, satisfies his obligation by delivering to the optionee stock or other property which does not bring the transaction within the scope of section 1036, the optionee makes a "disposition" of his stock for purposes of section 421 as of that time.

That the delivery of shares of stock by the optionee to his broker and the satisfaction by the latter of the resulting obligation to replace them may constitute an exchange is

> supported by authority. A simultaneous delivery of property is not essential to an exchange. If the parties so intend, title to property delivered on one side may pass even though the contract remains executory on the other side.
>
> Accordingly, it is concluded that the delivery of endorsed certificates of stock by the optionee to a broker, the latter being authorized to "lend" the certificates to his customers in the ordinary course of trade or business and having such certificates cancelled and new ones reissued in his own name, and the satisfaction by the broker of the resulting obligation to replace such certificates, will not constitute a "disposition" if the broker satisfies such obligation with certificates representing shares of stock of such kind and amount as to bring the then-completed exchange within the scope of section 1036 of the Code.

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

> Share-lending agreements are often entered into by equity holders who have taken a long position with respect to a stock and plan on holding it for an extended period. The equity owner can agree to lend the stock to a counterparty, who can then use the borrowed shares to increase market liquidity and facilitate stock sales. For example, the equity owner can lend shares to an investment bank, which could then use the lent shares to execute short sales on behalf of its clients.
>
> The borrower will normally pledge cash collateral, and the lender will derive a profit lending the shares by retaining a portion of the interest earned by this cash collateral. At the end of the lending period, the counterparty will return the borrowed shares to the equity owner/lender.

Code § 1058, "Transfers of securities under certain agreements," codifies Rev. Rul. 57-451[50] by providing in subsection (a):

> *General rule*. In the case of a taxpayer who transfers securities (as defined in section 1236(c)) pursuant to an agreement which meets the requirements of subsection (b), no gain or loss shall be recognized on the exchange of such securities by the taxpayer for an obligation under such agreement, or on the exchange of rights under such agreement by that taxpayer for securities identical to the securities transferred by that taxpayer.

Code § 1236(c) defines "security" as "any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing."

Given that Code § 1058(a) provides no gain or loss, Code § 1058(c), "Basis," provides, "Property acquired by a taxpayer described in subsection (a), in a transaction described in that subsection, shall have the same basis as the property transferred by that taxpayer."[51]

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[50] Referring to this as a codification was *Calloway v. Commissioner*, 135 T.C. 26, 43 (2010) (a reviewed opinion), *aff'd* 691 F3d 1315 (11th Cir. 2012)
[51] Prop. Reg. § 1.1058-1(c), "Basis," provides:

Code § 1058(b) requires an agreement to:

(1) provide for the return to the transferor of securities identical to the securities transferred.

(2) require that payments shall be made to the transferor of amounts equivalent to all interest, dividends, and other distributions which the owner of the securities is entitled to receive during the period beginning with the transfer of the securities by the transferor and ending with the transfer of identical securities back to the transferor;

(3) not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred; and

(4) meet such other requirements as the Secretary may by regulation prescribe.

Promulgated in 1983, with no substantive explanation in its preamble, Prop. Reg. § 1.1058-1(b), "Agreement requirements," provides:

> The agreement between the borrower and lender described in paragraph (a) of this section must be in writing and must -
>
> (1) Require the borrower to return to the lender securities identical to those which were lent to the borrower. For the purposes of this section securities are defined in section 1236(c). Identical securities are securities of the same class and issue as the securities lent to the borrower. If, however, the agreement permits the borrower to return equivalent securities in the event of reorganization, recapitalization or merger of the issuer of the securities during the term of the loan, this requirement will be deemed to be satisfied.
>
> (2) Require the borrower to make payments to the lender of amounts equivalent to all interest, dividends, and other distributions which the owner of the securities is entitled to for the period during which the securities are borrowed.

> (1) *Lender's basis in securities*. If this section applies, the lender's basis in the identical securities returned by the borrower shall be the same as the lender's basis in the securities lent to the borrower.
> (2) *Lender's basis in contractual obligation*. If this section applies, the lender's basis in the contractual obligation received from the borrower in exchange for the lender's securities is equal to the lender's securities is equal to the lender's basis in the securities exchanged.

Prop. Reg. § 1.1058-1(g) refers to Prop. Reg. § 1.1223-2 regarding the lender's holding period. Prop. Reg. § 1.1223-2(a), "General rule," provides:

> In the case of a transfer of securities pursuant to an agreement which meets the requirements of section 1058 (relating to transfers of securities under certain agreements), the holding period in the hands of the lender of the securities received by the lender from the borrower shall include -
> (1) The period for which the lender held the securities which were transferred to the borrower; and
> (2) The period between the transfer of the securities from the lender to the borrower and the return of the securities to the lender.

(3) Not reduce the lender's risk of loss or opportunity for gain. Accordingly, the agreement must provide that the lender may terminate the loan upon notice of not more than 5 business days.

> See section 512(a)(5) and the regulations thereunder for additional requirements with respect to loans of securities made by exempt organizations.

Prop. Reg. § 1.1058-1(d), "Treatment of payments to lender," provides:

> Except as otherwise provided in section 512(a)(5), a payment of amounts required to be paid by the borrower that are equivalent to all interest, dividends, and other distributions as provided in paragraph (b)(2) of this section, shall be treated by the lender as a fee for the temporary use of property. Thus, for example, an amount received by the lender that is equivalent to a dividend paid during the term of the loan shall not constitute a dividend to the lender for purposes of the Internal Revenue Code, but shall be taken into account as ordinary income.

Prop. Reg. § 1.1058-1(e), "Noncompliance with section 1058," provides:[52]

(1) If a transfer of securities is intended to comply with section 1058 and fails to do so because the contractual obligation does not meet the requirements of section 1058(b) and § 1.1058-1(b), gain or loss is recognized in accordance with section 1001 and § 1.1001-1(a) upon the initial transfer of the securities. However, see section 1091 of the Code for disallowance of loss from wash sales of stock or securities.

(2) If securities are transferred pursuant to an agreement which meets the requirements of section 1058(b) and § 1058-1(b) and the borrower fails to return to the lender securities identical to the securities transferred as required by the agreement, or otherwise defaults under the agreement, gain or loss is recognized on the day the borrower fails to return identical securities as required by the agreement, or otherwise defaults under the agreement. However, see section 1091 of the Code for disallowance of loss from wash sales of stock or securities.

When the loaned securities are involved in a corporate restructuring, Prop. Reg. § 1.1058-1(f), "Special rule," explains:

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[52] Reg. § 1.1223-2(a), "Failure to comply with section 1058," provides holding period rules:

(1) If a transfer of securities is intended to comply with section 1058 and fails to do so because the contractual obligation does not meet the requirements of section 1058(b) and §1.1058-1(b), the holding period in the hands of the lender of the securities transferred to the borrower, shall terminate on the day the securities are transferred to the borrower and the holding period in the hands of the borrower of the property transferred to it shall begin on the date that the securities are delivered pursuant to the transfer loan agreement.

(2) If securities are transferred pursuant to an agreement which meets the requirements of section 1058(b) and § 1.1058-1(b) and the borrower fails to return identical securities as required by the agreement or otherwise defaults under the agreement, the holding period in the hands of the lender of the securities transferred to the borrower shall terminate on the day the borrower fails to return identical securities as required by the agreement or otherwise defaults under the agreement, and the holding period in the hands of the borrower of the securities transferred to it shall begin on the day the borrower fails to return identical securities as required by the agreement or otherwise defaults under the agreement.

> For purposes of determining the tax consequences to the lender of securities when a merger, recapitalization or reorganization (including, but not limited to, a reorganization described in section 368(a)(1) of the Internal Revenue Code) of the issuer occurs during the term of a loan to which section 1058 applies, the section 1058 loan transaction is deemed terminated immediately prior to the merger, recapitalization or reorganization and a second section 1058 transaction is deemed entered into immediately following the merger, recapitalization or reorganization. Therefore, the borrower of the securities is deemed to have returned the securities to the lender immediately prior to the merger, recapitalization or reorganization and immediately following the merger, recapitalization or reorganization the lender and borrower are deemed to have entered into a second section 1058 loan transaction, on terms identical to the original section 1058 loan transaction. The special rule in this paragraph (f) shall not apply in the case where the lender ultimately is repaid with securities identical to the securities originally transferred.

Prop. Reg. § 1.1058-2 provides examples illustrating Prop. Reg. § 1.1058-1.

Prop. Reg. § 1.1058-2, Example (1), provides:

> A owns 1,000 shares of XYZ common stock. A instructs A's broker, B, to sell the XYZ stock. B sells to C. After the sale, B learns that A will not be able to deliver to B certificates representing the 1,000 shares in time for B to deliver them to C on the settlement date. B decides to effect the delivery by borrowing stock from a third party. To this end, B enters into a written agreement with D, an non-exempt corporation having a large stock portfolio of XYZ common stock. The agreement includes the following terms:
>
> (i) D will transfer to B certificates representing 1,000 shares of XYZ common stock.
>
> (ii) B will pay D an amount equivalent to any dividends or other distributions paid on the XYZ stock during the period of the loan.
>
> (iii) Regardless of any increases or decreases in the market value of XYZ common stock, B will transfer to D 1,000 shares of XYZ common stock of the same issue as that of the XYZ common stock transferred from D to B.
>
> (iv) B agrees that upon notice of 5 business days, B will return identical securities to D.
>
> The agreement between B and D satisfies the requirements of paragraph (b) of § 1.1058-1. The agreement is in writing. It requires the borrower, B, to return to the lender, D, identical securities and to pay to the lender, D, amounts equivalent to any dividends or other distributions paid on the stock during the period of the loan. It does not reduce D's risk of loss or opportunity for gain because, regardless of fluctuations in the market value of XYZ common stock, B is obligated to return 1,000 shares of XYZ common stock.

Prop. Reg. § 1.1058-2, Example (2), provides:

> Assume the same facts as in Example (1) except that the agreement between B and D includes the following additional terms:

(1) Upon D's transfer to B of the certificates representing the 1,000 shares of XYZ common stock, B will transfer to D, cash equal to the market value of the XYZ common stock on the business day preceding the transfer, as collateral for the stock. The collateral will be increased or decreased daily to reflect increases or decreases in the market value of the XYZ stock during the period of the loan.

(2) B agrees that upon notice of 5 business days, B will return to D 1,000 shares of XYZ common stock, or the equivalent thereof in the event of reorganization, recapitalization, or merger of XYZ during the term of the loan. Upon delivery of the stock to D, D will return the cash collateral to B.

The agreement between B and D satisfies the requirements of paragraph (b) of this section. If XYZ is merged into another corporation and B returns to D an equivalent amount of stock in the resulting corporation, paragraph (f) of this section provides that the section 1058 transaction is deemed terminated immediately before the merger. Thus, D is deemed to be the owner of the XYZ common stock at the time of the merger. Furthermore, paragraph (a) of this section provides that D does not recognize gain or loss upon the transfer of the XYZ common stock to B or upon the return of the stock of the resulting corporation to D. Nonetheless, gain or loss may be recognized with respect to the merger. If the merger is described in section 368(a)(1), gain will be recognized to the extent section 354(a)(2) or 356 applies to the merger. If the merger is not described in section 368(a)(1), D generally will recognize the entire gain or loss with respect to such stock as a result of the merger.

Prop. Reg. § 1.1058-2, Example (3), provides:

Assume the same facts as in example (2) and in addition that on March 1, D transfers certificates representing 1,000 shares of XYZ common stock to B. D's basis in the stock is $60,000. On the business day preceding the transfer, the stock has a market value of $75 a share. Consequently, B transfers to D $75,000 as collateral for the stock. B then uses the certificates to complete a timely delivery to C. On March 20, when the market value of XYZ common stock is $69 a share, D gives B notice of termination. On March 24, B delivers to D 1,000 shares of XYZ common stock of the same issue as that of the XYZ common stock transferred to B on March 1. D returns the $69,000 cash collateral to B. (Because the market value of the stock had declined during the period of the loan, the collateral was adjusted to reflect the new market value and the $6,000 had previously been returned to B.) Because the agreement between B and D contains the provisions required by paragraph (b) of § 1.1058-1 and such provisions were complied with, D does not recognize gain on the transfer of the XYZ common stock to B. Nor does D recognize gain upon the return of XYZ common stock. D's basis in the XYZ common stock returned to it by B is $60,000. As to the holding period of the XYZ common stock returned to D, see § 1.1223-2(a).

Prop. Reg. § 1.1058-2, Example (4), provides:

Assume the same facts as in example (3) and in addition that on March 3, XYZ pays a dividend on its common stock. B pays to D an amount equivalent to the dividend. The amount paid by B does not constitute a dividend to D, but rather constitutes a fee for the temporary use of property as provided in § 1.1058-1(d).

Prop. Reg. § 1.1058-2, Example (5), provides:

> (i) Assume the same facts as in example (3) except that on March 24 B notifies D that delivery of the 1000 shares of XYZ common stock, of the same issue as that of the XYZ common stock transferred to B on March 1, cannot be completed on March 24. Assume further that B informs D that delivery would be completed on March 27.
>
> (ii) If B and D agree to extend the time period in which B is to return the identical securities to D till March 27, then the section 1058 agreement will not be treated as breached when B delivers the securities on March 27, pursuant to the modified section 1058 agreement. As a result, D does not recognize gain on the transfer of XYZ common stock to B. Nor does D recognize gain upon the return of XYZ common stock.
>
> (iii) If B and D do not agree to extend the time period, in which B is to return the identical securities to D, then as of March 25 B's failure to transfer the identical securities as required by the agreement will be treated as a breach of the agreement. As a result D will be treated as selling the XYZ common stock on March 25. D must then recognize gain or (subject to 1091) loss, whichever is appropriate, on the sale of the securities.

Rev. Proc. 2008-63, § 1, "Purpose," provides:

> This revenue procedure provides guidance with respect to the application of § 1058(a) of the Internal Revenue Code to situations in which securities are originally transferred pursuant to an agreement that meets the requirements of § 1058(b), the transferee subsequently defaults under the agreement as a direct or indirect result of its bankruptcy (or the bankruptcy of an affiliate), and as soon as is commercially practicable (but in no event more than 30 days following the default), the transferor uses collateral provided pursuant to the agreement to purchase identical securities.

Rev. Proc. 2008-63, § 3, "Background," provides:

> .01. Section 1058(a) provides that in the case of a taxpayer who transfers securities (as defined in § 1236(c)) pursuant to an agreement which meets the requirements of § 1058(b), no gain or loss shall be recognized on the exchange of such securities by the taxpayer for an obligation under such agreement, or on the exchange of rights under such agreement by that taxpayer for securities identical to the securities transferred by that taxpayer.
>
> .02. In adding § 1058 to the Code, Congress intended to provide nonrecognition treatment to securities loans in which "the contractual obligation [to return identical securities] does not differ materially either in kind or in extent from the securities exchanged...." S. Rep. No. 762, 95th Cong., 2d Sess. 7 (1978); 1978-2 C.B. 357, 361 ("Senate Report"). Congress also sought to encourage securities holders to make their securities available for loans. Congress explained:
>
>> Under present law, uncertainty has developed as to the correct income tax treatment of certain securities lending transactions. As a result, some owners of securities are reluctant to enter into such transactions.

Senate Report at 3; 1978-2 C.B. 359.

> Because of time delays which a broker may face in obtaining securities (from the seller or transfer agent) to deliver to a purchaser, brokers are frequently required to borrow securities from organizations and individuals with investment portfolios for use in completing these market transactions. It is generally thought to be desirable to encourage organizations and individuals with securities holdings to make the securities available for such loans since the greater the volume of securities available for loan the less frequently will brokers fail to deliver a security to a purchaser within the time required by the relevant market rules.

Senate Report at 5; 1978-2 C.B 360.

.03. Recently, a significant number of securities loans have terminated as a result of a default by the borrower of the securities. These defaults are often the direct or indirect result of the bankruptcy of the borrower (or an affiliate of the borrower). For example, the bankruptcy of the borrower might, by itself, constitute an event of default under the securities loan agreement. Likewise, the bankruptcy of an affiliate of the borrower might indirectly prevent the borrower from returning identical securities upon notice of termination by the lender, if, for example, such a bankruptcy affects the borrower's liquidity and practical ability to acquire identical securities in the secondary market. In many of these situations, the lender thereafter purchases identical securities and applies collateral provided by the borrower pursuant to the securities loan agreement against the purchase price (and the borrower's obligation to return identical securities is terminated).

Rev. Proc. 2008-63, § 3, "Scope," provides:

This revenue procedure applies to taxpayers ("Lenders") who have transferred securities to an unrelated person ("Borrower") in a securities loan in which –

.01. The securities loan agreement ("Agreement") satisfies the requirements of § 1058(b);

.02. The Agreement requires that the Borrower transfer collateral to secure the Borrower's obligations under the Agreement;

.03. The Borrower defaults under the Agreement as a direct or indirect result of its bankruptcy (or the bankruptcy of an affiliate); and

.04. As soon as is commercially practicable after the default (but in no event more than 30 days following the default), the Lender applies collateral provided under the Agreement (or cash generated by the sale of such collateral) to the purchase of identical securities.

Rev. Proc. 2008-63, § 4, "Application," provides:

For taxpayers within the scope of this revenue procedure, the Internal Revenue Service will treat the purchase described in section 3.04 of this revenue procedure as an

> exchange of rights under the Agreement for identical securities to which § 1058(a) applies.

Samueli v. Commissioner, 132 T.C. 37 (2009), had the following Official Tax Court Syllabus:

> Ps-S purchased an approximate $1.64 billion of securities from F in October 2001 and simultaneously transferred the securities back to F pursuant to F's promise to transfer identical securities to Ps-S on Jan. 15, 2003. The agreement between Ps-S and F allowed Ps-S to require an earlier transfer of the identical securities only by terminating the transaction on July 1 or Dec. 2, 2002. Ps-S did not require an earlier transfer and sold the securities to F on Jan. 15, 2003. Ps treated the transaction as a securities lending arrangement subject to sec. 1058, I.R.C., and Ps-S reported an approximate $50.6 million long-term capital gain on the sale. Ps also deducted millions of dollars of interest related to the transaction. R determined that the transaction was not a securities lending arrangement subject to sec. 1058, I.R.C. Instead, R determined that Ps-S purchased the securities from and immediately sold the securities to F in 2001 at no gain or loss and then repurchased from (pursuant to a forward contract) and immediately resold the securities to F in 2003 realizing an approximate $13.5 million short-term capital gain. R also disallowed all of Ps' interest deductions because the corresponding debt that Ps claimed was related to the transaction did not exist.
>
> *Held*: The transaction is not a securities lending arrangement subject to sec. 1058, I.R.C., because the ability of Ps-S to cause F to transfer the identical securities to Ps-S on only three of the approximate 450 days during the transaction period reduced their "opportunity for gain … in the transferred securities" under sec. 1058(b)(3), I.R.C. The substance of the transaction was the purchases and sales that R determined.
>
> *Held, further*, Ps are not entitled to their claimed interest deductions because the debt Ps claimed was related to the transaction did not exist.

Samueli v. Commissioner, 132 T.C. 37 (2009), *aff'd* 661 F3d 399 (9th Cir. 2011), held:

> The primary issue under section 1058(b)(3) is ripe for summary judgment. That issue turns on the interpretation of section 1058(b)(3), and the parties agree on all material facts relating to the issue. Thus, to decide the issue we need only interpret the plain meaning of the text "not reduce the … opportunity for gain of the transferor of the securities in the securities transferred" and apply that interpretation to the agreed-upon facts. See *Glass v. Commissioner*, 124 T.C. 258, 281 (2005), *affd*. 471 F.3d 698 (6th Cir. 2006). We interpret that text as written in the setting of the statute as a whole. See *Fla. Country Clubs, Inc. v. Commissioner*, *supra* at 75-76; see also *Huffman v. Commissioner*, 978 F.2d 1139, 1145 (9th Cir. 1992), *affg*. T.C. Memo. 1991-144. We focus on the meaning of the phrase "not reduce the … opportunity for gain of the transferor of the securities in the securities transferred." We understand the verb "reduce" to mean "to diminish in size, amount, extent, or number." *Webster's Third New International Dictionary* 1905 (2002). We understand the noun "opportunity" to mean "a combination of circumstances, time, and place suitable or favorable for a particular activity or action" and to be synonymous with the word "chance." *Id*. at 1583. We therefore read the relevant phrase in the context of the statutory scheme to mean that the Agreement will not meet the requirement set forth in section 1058(b)(3) if the Agreement diminished the Samuelis' chance to realize a gain that was present in the Securities during the transaction period. Stated differently, the Samuelis' opportunity for

gain as to the Securities was reduced on account of the Agreement if during the transaction period their ability to realize a gain in the Securities was less with the Agreement than it would have been without the Agreement.

We conclude that the Agreement reduced the Samuelis' opportunity for gain in the Securities for purposes of section 1058(b)(3) because the Agreement prevented the Samuelis on all but three days of the approximate 450-day transaction period from causing Refco to transfer the Securities to the Samuelis. Absent the Agreement, the Samuelis could have sold the Securities and realized any inherent gain whenever they wanted to simply by instructing their broker to execute such a sale. With the Agreement, however, the Samuelis' ability to realize such an inherent gain was severely reduced in that the Samuelis could realize such a gain only if the gain continued to be present on one or more of the three stated days. Stated differently, the Samuelis' opportunity for gain was reduced by the Agreement because the Agreement limited their ability to sell the Securities at any time that the possibility for a profitable sale arose.[10]

[10] Petitioners concede that the Agreement increased the Samuelis' risk of loss because the Samuelis could not terminate the Transaction at any time. We infer from this concession that the Agreement also reduced the Samuelis' opportunity for gain as to the Securities.

In so concluding, we reject petitioners' argument that they always retained the opportunity for gain in the Securities by continuing to own the Securities from the day they purchased them until the day they sold them. A taxpayer's opportunity for gain under petitioners' theory is not reduced for section 1058 purposes if the taxpayer retains the opportunity for gain as of the end of a loan period. The statute does not speak to retaining the opportunity for gain. It speaks to whether the opportunity for gain was reduced.

In addition, we read the relevant requirement differently from petitioners to measure a taxpayer's opportunity for gain as of each day during the loan period. A taxpayer has such an opportunity for gain as to a security only if the taxpayer is able to effect a sale of the security in the ordinary course of the relevant market (*e.g.*, by calling a broker to place a sale) whenever the security is in-the-money. A significant impediment to the taxpayer's ability to effect such a sale, e.g., as occurred here through the specific 3-day limit as to when the Samuelis could demand that Refco transfer the Securities to them, is a reduction in a taxpayer's opportunity for gain.

Nor did the Samuelis' opportunity for gain turn, as petitioners would have it, on the consequences of the Samuelis' variable rate financing arrangement. Petitioners assert that their opportunity for gain as to the Securities depended entirely on whether their fixed return on the Securities was greater than their financing expense (i*.e.*, the variable rate fee paid to Refco) and conclude that the Agreement did not reduce this opportunity because they continued to retain this opportunity throughout the transaction period. Section 1058(b)(3) speaks solely to the transferor's "opportunity for gain … in the securities transferred" and does not implicate the consideration of any independent gain that the transferor may realize outside of those securities (*e.g.*, through a favorable financing arrangement). Thus, while the profitability of the Transaction may have depended on the return that the Samuelis earned on the Securities vis-a-vis the amount of the variable rate fee that they paid to Refco, the Samuelis' opportunity for gain in the transferred securities rested on the fluctuation in the value of the Securities.

We also reject petitioners' assertion that the Samuelis could have locked in their gain in the Securities on any day of the transaction period simply by entering in the marketplace into a financial transaction that allowed them to fix their gain, *e.g.*, by purchasing an option to sell the Securities at a fixed price. This assertion has no direct bearing on our inquiry. Section 1058 concerns itself only with the agreement connected with the transfer of the securities. Whether the Samuelis could have entered into another agreement to lock in their gain is of no moment.[11]

[11] Petitioners also assert that the Transaction is a routine securities lending transaction in the marketplace. We disagree. A lender could terminate a security loan on any business day under the standard form used in the marketplace. The parties to the Transaction, however, modified the standard form to eliminate that standard provision and to prevent the Samuelis from demanding that the Securities be transferred to them during the transaction period, except on the three specific days.

We also reject petitioners' argument that section 1058(b)(3) cannot contain a requirement that loaned securities be returned to the lender upon the lender's demand at any time because section 512(a)(5)(B) specifically contains such a requirement. Section 512(a)(5)(A) generally defines the phrase "payments with respect to securities loans" by reference to "a security … transferred by the owner to another person in a transaction to which section 1058 applies." Section 512(a)(5)(B) adds that section 512(a)(5)(A) shall apply only where the agreement underlying the transaction "provides for … termination of the loan by the transferor upon notice of not more than 5 business days." Petitioners argue that sections 512(a)(5)(B) and 1058(b)(3) were enacted in the same legislation and that Congress is presumed not to have included unnecessary words in a statute. See, *e.g.*, *Kawaauhau v. Geiger*, 523 U.S. 57, 62 (1998); *Johnson v. Commissioner*, 441 F.3d 845, 850 (9th Cir. 2006). Petitioners conclude that part of section 512(a)(5)(B) would be surplusage were a prompt return of a security already a requirement of section 1058(b). Again, we disagree.

Our reading of section 1058(b)(3) to require that the lender be able to demand a prompt return of the loaned securities does not render any part of section 512(a)(5)(B) surplusage. Section 1058(b)(3) does not require explicitly that a securities loan be terminable within a set period akin to the 5-day period of section 512(a)(5)(B). It does not necessarily follow, however, as petitioners ask us to conclude, that section 1058(b)(3) fails to require that the lender be able to demand a prompt return of the loaned securities. The firmly established law at the time of the enactment of those sections provided that a lender in a securities loan arrangement be able to terminate the loan agreement upon demand and require a prompt return of the securities to the lender. We read nothing in the statute or in its history that reveals that Congress intended to overrule that firmly established law by enacting sections 512(a)(5)(B) and 1058(b)(3). We decline to read such an intent into the statute. Such is especially so given the plain reading of the terms "reduce" and "opportunity for gain" and our finding that the Agreement reduced the Samuelis' opportunity for gain by limiting their ability to sell the Securities at any time that the possibility for a profitable sale arose.

We recognize that unequivocal evidence of a clear legislative intent may sometimes override a plain meaning interpretation and lead to a different result. See *Consumer Prod. Safety Commn. v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980); see also *Albertson's, Inc. v. Commissioner*, 42 F.3d 537, 545 (9th Cir. 1994), *affg*. 95 T.C. 415 (1990). The legislative history of the applicable statute supports the plain meaning of the relevant text and does not override it. Congress enacted section 1058 mainly to clarify the then-existing law that applied to the loan of securities by regulated investment companies and tax-exempt entities, on the one hand, and by general security lenders, on the other hand. See S. Rept. 95-762, at 4 (1978). The former group of lenders was concerned that payments made to them by the borrowers of securities could be considered unrelated business taxable income. See *id*. The latter group of lenders was concerned that a securities loan could be considered a taxable disposition. See *id*. at 5-6. Congress added section 1058 to the Code to address each of these concerns, explicitly providing through the statute that payments from borrowers to tax-exempt entities were considered investment income to the tax-exempt entities and clarifying that the existing law that applied to lenders of securities in general continued to apply. *See id*. at 6-7.

The Senate Committee on Finance noted that owners of securities were reluctant under existing law to enter into securities lending transactions because the income tax treatment of those transactions was uncertain. See *id.* at 4. The committee also noted that the Commissioner apparently agreed that a securities lending transaction was not a taxable disposition of the loaned securities and that the transaction did not interrupt the lender's holding period, but that the Commissioner had recently declined to issue rulings stating as much. See *id*. at 4. The committee believed a clarification of existing law was required to encourage organizations and individuals with securities holdings to enter into securities lending transactions so as to allow the lendee brokers to deliver the securities to a purchaser of the securities within the time required by the relevant market rules. See *id*. at 5. The committee explained that section 1058 codified the existing law on securities lending arrangements that required that a contractual obligation subject to that law did not differ materially either in kind or in extent from the securities exchanged. See *id*. at 7.

This legislative history is consistent with our analysis. The legislative history explains that section 1058 codified the firmly established law requiring that a securities loan agreement keep the lender in the same economic position that the lender would have been in had the lender not entered into the agreement. For example, the lender must possess all of the benefits and burdens of ownership of the transferred securities and be able to terminate the loan agreement upon demand. The firmly established law came from the United States Supreme Court in *Provost v. United States*, 269 U.S. 443 (1926). There, the taxpayers sought to recover the cost of internal revenue stamps affixed by them to "tickets" that evidenced transactions where shares of stock were "loaned" to brokers or returned by the borrower to the lender, each in accordance with the rules and practice of the Stock Exchange. See *id*. at 449. The Court held that those transfers of stock were taxable transfers within the meaning of the applicable Revenue Acts because "both the loan of stock and the return of the borrowed stock involve 'transfers of legal title to shares of stock'." *Id*. at 456. The Court noted that a lender of securities under a loan agreement retained all of the benefits and burdens of the loaned stock throughout the loan period, as though the lender had retained the stock, and that both parties to the loan agreement could terminate the agreement on demand and thus cause a return of the stock to the lender.[12] See *id*. at 452-453.

[12] The Commissioner later ruled similarly in Rev. Rul. 57-451, 1957-2 C.B. 295. That ruling, which is referenced in the legislative history to sec. 1058, see S. Rept. 95-762, at 4 (1978), states in relevant part:

The second situation described above, wherein the optionee authorizes the broker to "lend" his stock certificates to other customers in the ordinary course of business, presumably anticipates the "loan" of the stock to others for use in satisfying obligations incurred in short sale transactions. In such a case, all of the incidents of ownership in the stock and not mere legal title, pass to the "borrowing" customer from the "lending" broker. For such incidents of ownership, the "lending" broker has substituted the personal obligation, wholly contractual, of the "borrowing" customer to restore him, on demand, to the economic position in which he would have been as owner of the stock, had the "loan" transaction not been entered into. See *Provost v. United States*, 269, U.S. 443, T.D. 3811, C.B. V-1, 417 (1926). Since the "lending" broker is not acting as the agent of the optionee in such a transaction, he must have necessarily obtained from the optionee all of the incidents of ownership in the stock which he passes to his "borrowing" customer.

We conclude that the Transaction was not a securities lending arrangement subject to section 1058 and that the underlying transfers of the Securities in 2001 and 2003 were therefore taxable events. Respondent determined and argues that the Samuelis' transfer of the Securities to Refco in 2001 was in substance a sale of the Securities by the Samuelis in exchange for the $1.64 billion they received as cash collateral and that Refco's purchase of the Securities in 2003 was a second sale of the Securities by the Samuelis in exchange for the money wired to them on January 16, 2003. For Federal tax purposes, the characterization of a transaction depends on economic reality and not just on the form employed by the parties to the transaction. See *Frank Lyon Co. v. United States*, 435 U.S. 561, 572-573 (1978).

We agree with respondent that the economic reality of the Transaction establishes that the Transaction was not a securities lending arrangement as structured but was in substance two separate sales of the Securities without any resulting debt obligation running between petitioners and Refco from October 2001 through January 15, 2003.[13] The transfers in 2001 were in substance the Samuelis' purchase and sale of the Securities at the same price of $1.64 billion. The Samuelis therefore did not realize any gain in 2001 as to the Securities. The transfers in 2003 were in substance the Samuelis' purchase of the Securities from Refco at $1.68 billion (the purchase price determined in accordance with the terms of the Addendum, which operated as a forward contract), followed immediately by the $1.69 billion market-price sale of the Securities by the Samuelis back to Refco. The Samuelis therefore realized a capital gain on the sale in 2003 equal to the difference between the purchase and sale prices. See sec. 1001. That capital gain is taxed as a short-term capital gain because the Samuelis held the Securities for less than a year.[14] See sec. 1222.

[13] The Transaction is similar to the transactions involved in a long line of cases involving M. Eli Livingstone, a broker and securities dealer who aspired to create debt through initial steps that completely offset each other. Courts consistently disregarded those offsetting steps because they left the parties to the transactions in the same position they were in before the steps were taken. See, *e.g.*, *Cahn v. Commissioner*, 358 F.2d 492 (9th Cir. 1966), *affg*. 41 T.C. 858 (1964); *Jockmus v. United States*, 335 F.2d 23, 29 (2d Cir. 1964); *Rubin v. United States*, 304 F.2d 766 (7th Cir. 1962); *Lynch v. Commissioner*, 273 F.2d 867, 872 (1st Cir. 1959), *affg*. 31 T.C. 990 (1959) and *Julian v. Commissioner*, 31 T.C. 998 (1959); *Goodstein v. Commissioner*, 267 F.2d 127, 131 (2d Cir. 1959), *affg*. 30 T.C. 1178 (1958); *MacRae v. Commissioner*, 34 T.C. 20, 26 (1960), *affd*. on this issue 294 F.2d 56 (9th Cir. 1961).

The courts did not disregard the transactions entirely as shams or as lacking economic substance. The courts disregarded the initial steps and recast the transactions as exchanges of promises for future performance. The transaction in one case was even recast where the taxpayer made an economic profit. See *Rubin v. United States*, *supra*.

[14] Petitioners argue they still prevail even if we accept, as we do, respondent's characterization of the Transaction. Petitioners assert that their sale of the Securities in 2003 was in consideration for their surrender of their contractual right to receive the Securities. Petitioners assert that this contractual right was a long-term asset acquired in October 2001 and that they may offset the $1.69 billion sale proceeds by their $1.64 billion basis in that long-term asset. We disagree with this argument. The Securities were the subject of the sale in 2003, not the surrender of a contractual right as petitioners assert. In addition, the Samuelis transferred the $1.64 billion to Refco in 2001 to purchase the Securities.

Samueli v. Commissioner, 661 F3d 399 (9th Cir. 2011), *aff'g* 132 T.C. 37 (2009), held:

Third, and most importantly, our conclusion that the transaction at issue in this case reduced Taxpayers' opportunity for gain does not necessarily imply a conclusion that a securities loan must be terminable upon demand to satisfy the requirements of § 1058(b)(3). In 1983, the Department of the Treasury considered adopting implementing regulations for § 1058(b)(3). that would have incorporated the five-business-days' notice requirement. The proposed regulations were never adopted, but the debate surrounding them is illuminating. Specifically, proposed 26 C.F.R. 1.1058-1(b)(3) would have provided that a qualifying agreement must "[n]ot reduce the lender's risk of loss or opportunity for gain. Accordingly, the agreement must provide that the lender may terminate the loan upon notice of not more than 5 business days." Transfers of Securities Under Certain Agreements, 48 Fed. Reg. 33912, 33913 (proposed July 26, 1983). In response to the proposed regulation, the American Bar Association's Committee on Financial Transactions (the "ABA Committee") issued a report objecting to the requirement, in part because it would prevent parties from lending securities for fixed terms longer than five days. The ABA Committee advocated instead a "facts and circumstances" test to address 1058(b)(3) rather than a bright-line rule and suggested that such a "facts and circumstances" test should "take into account both the length of time until the debt investment security matures and the length of the time the security is borrowed." ABA Committee Reports on Securities Lending Transactions ("ABA Report"), 91 Tax Notes Today 107-33 (May 15, 1991), Section IV.2.

The ABA Committee's concern that 1058 not be construed in such a way as to exclude all loans for fixed terms was echoed in a report that the Tax Section of the New York State Bar Association (the "NYSBA Committee") issued in response to several recent decisions of the Tax Court, including its decision now on appeal in this case. Report of the Tax Section of the New York State Bar Association on Certain Aspects of the Taxation of Securities Loans and the Operation of Section 1058 (June 9, 2011) ("NYSBA Report"), at 10-11. We are cognizant that a holding that no securities loan for a fixed term can qualify for § 1058 nonrecognition "could affect commonplace market transactions in a manner that arguably violates the overarching policy of section 1058." *Id*. at 10. But we do not so hold today because the resolution of this case does not require us to do so. First, as will be discussed more thoroughly in the next section of this opinion, we believe this transaction falls outside "the overarching policy of section 1058."

> Second, the transaction at issue here would fail the "facts and circumstances" test that the ABA Committee proposed as an alternative to a rule that would exclude all fixed-term loans from the scope of 1058. Taxpayers' inability to terminate the loan except on one of three dates is clearly not "consistent with the continued evolution of commercial practices," ABA Report, Section = IV.2, because the current standard practice for loans of bonds like the Securities is to allow termination by the lender on three days' notice (as is evidenced by the terms of the standard form Loan Agreement in this transaction, which were overridden by the Addendum). The length of the loan term under the Addendum (approximately 450 days), the fact that the loan term extended almost to the maturity date of the Securities, and Taxpayers' inability to terminate the loan on any but two dates during that term all severely hampered Taxpayers' ability to take advantage of market fluctuations in the price of the Securities. Moreover, Refco's option to purchase the Securities at the LIBOR formula price meant that Taxpayers' ability to liquidate the Securities at the actual market price was limited even further.
>
> As the NYSBA noted, the question of whether securities loans for shorter fixed terms, made for the purposes animating 1058, qualify for nonrecognition treatment is more appropriately settled by further guidance from the Department of the Treasury and the IRS. NYSBA Report, at 10. The present case does not require us to settle this question; thus, we decline to address it.

Anschutz Co. v. Commissioner, 135 T.C. 78 (2010), distinguished between a loan and a sale:[53]

> To determine whether an agreement transfers substantially all of the incidents of ownership, we look at all of the facts and circumstances surrounding the transfer, relying on objective evidence of the parties' intentions provided by their overt acts. *Ragghianti v. Commissioner*, 71 T.C. 346, 349-350 (1978); *Pac. Coast Music Jobbers, Inc. v. Commissioner*, 55 T.C. 866, 874 (1971), *affd*. 457 F.2d 1165 (5th Cir. 1972); *Dunne v. Commissioner*, T.C. Memo. 2008-63.
>
> In *Dunne v. Commissioner*, *supra*, we compiled the following nonexclusive factors that are evaluated in determining whether a transaction transfers the accoutrements of stock ownership:
>
> (1) Whether the taxpayer has legal title or a contractual right to obtain legal title in the future;
>
> (2) whether the taxpayer has the right to receive consideration from a transferee of the stock;
>
> (3) whether the taxpayer enjoys the economic benefits and burdens of being a shareholder;
>
> (4) whether the taxpayer has the power to control the company;
>
> (5) whether the taxpayer has the right to attend shareholder meetings;

[53] In affirming the decision, the Tenth Circuit used different factors. See fn 56 in part II.A.1.d.ii Monetizing Founder's Remaining Shares After Going Public.

(6) whether the taxpayer has the ability to vote the shares;

(7) whether the stock certificates are in the taxpayer's possession or are being held in escrow for the benefit of that taxpayer;

(8) whether the corporation lists the taxpayer as a shareholder on its tax return;

(9) whether the taxpayer lists himself as a shareholder on his individual tax return;

(10) whether the taxpayer has been compensated for the amount of income taxes due by reason of shareholder status;

(11) whether the taxpayer has access to the corporate books; and

(12) whether the taxpayer shows by his overt acts that he believes he is the owner of the stock. No one factor is necessarily determinative, and the weight of a factor in each case depends on the surrounding facts and circumstances. *Id.*

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

> In August 2001 P entered into an agreement with Derivium whereby P transferred 990 shares of IBM common stock to Derivium in exchange for $93,586.23. The terms of the agreement characterized the transaction as a loan of 90 percent of the value of the IBM stock pledged as collateral. The purported loan was nonrecourse and prohibited P from making any interest or principal payments during the 3-year term of the purported loan. The terms of the agreement allowed Derivium to sell the stock, which it did immediately upon receipt. At maturity P had the option of either paying the balance due and having an equivalent amount of IBM stock returned to him, renewing the purported loan for an additional term, or satisfying the "loan" by surrendering any right to receive IBM stock. At maturity in August 2004 the balance due was $40,924.57 more than the then value of the IBM stock. P elected to satisfy his purported loan by surrendering any right to receive IBM stock. P was not required to and did not make any payments toward either principal or interest on the purported loan.
>
> 1. *Held*: The transaction between P and Derivium in August 2001 was a sale. P transferred all the benefits and burdens of ownership of the stock to Derivium for $93,586.23 with no obligation to repay that amount.
>
> 2. Held, further, the transaction was not analogous to the securities lending arrangement in Rev. Rul. 57-451, 1957-2 C.B. 295, nor was it equivalent to a securities lending arrangement under sec. 1058, I.R.C.
>
> 3. Held, further, Ps are liable for an addition to tax under sec. 6651(a)(1), I.R.C., for the late filing of their 2001 Federal income tax return.
>
> 4. Held, further, Ps are liable for the accuracy-related penalty pursuant to sec. 6662, I.R.C.

Calloway, 135 T.C. at 33-34, looked at whether the purported loan was a sale:

> "The term 'sale' is given its ordinary meaning for Federal income tax purposes and is generally defined as a transfer of property for money or a promise to pay money." *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981) (citing *Commissioner v. Brown*, 380 U.S. 563, 570-571 (1965)). Since the economic substance of a transaction, rather than its form, controls for tax purposes, the key to deciding whether the transaction was a sale or other disposition is to determine whether the benefits and burdens of ownership of the IBM stock passed from petitioner to Derivium. Whether the benefits and burdens of ownership have passed from one taxpayer to another is a question of fact that is determined from the intention of the parties as established by the written agreements read in the light of the attending facts and circumstances. See *Arevalo v. Commissioner*, 124 T.C. 244, 251-252 (2005), *affd*. 469 F.3d 436 (5th Cir. 2006). Factors the courts have considered in making this determination include: (1) Whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity interest in the property is acquired; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property. See *id*. at 252; see also *Grodt & McKay Realty, Inc. v. Commissioner*, *supra* at 1237-1238.

After reviewing those factors, the *Calloway* Tax Court held that the arrangement was not a loan:

> At best the master agreement gave petitioner an option to repurchase IBM stock from Derivium at the end of the 3 years;[9] however, this option depended on Derivium's ability to acquire IBM stock in 2004. The foregoing factors indicate that the transaction was a sale of IBM stock in 2001.
>
> [9] *Welch*, 204 F.3d at 1230-31.
>
> In the context of taxation, courts have defined a loan as "an agreement, either express or implied, whereby one person advances money to the other and the other agrees to repay it upon such terms as to time and rate of interest, or without interest, as the parties may agree." *Welch v. Commissioner*, 204 F.3d 1228, 1230 (9th Cir. 2000) (quoting *Commissioner v. Valley Morris Plan*, 305 F.2d 610, 618 (9th Cir. 1962)), *affg*. T.C. Memo. 1998-121; see also *Talmage v. Commissioner*, T.C. Memo. 2008-34. For a transaction to be a bona fide loan the parties must have actually intended to establish a debtor-creditor relationship at the time the funds were advanced. *Fisher v. Commissioner*, 54 T.C. 905, 909-910 (1970). "Whether a bona fide debtor-creditor relationship exists is a question of fact to be determined upon a consideration of all the pertinent facts in the case." *Id*. at 909. "For disbursements to constitute true loans there must have been, at the time the funds were transferred, an unconditional obligation on the part of the transferee to repay the money, and an unconditional intention on the part of the transferor to secure repayment." *Haag v. Commissioner*, 88 T.C. 604, 615-616 (1987), *affd*. without published opinion 855 F.2d 855 (8th Cir. 1988).
>
> Courts have considered various factors in determining whether a transfer constitutes genuine indebtedness. No one factor is necessarily determinative, and the factors considered do not constitute an exclusive list. See *Ellinger v. United States*,

470 F.3d 1325, 1333-1334 (11th Cir. 2006) (listing a nonexclusive list of 13 factors); *Welch v. Commissioner*, *supra* at 1230.[10] Often it comes down to a question of substance over form requiring courts to "look beyond the parties' terminology to the substance and economic realities". *BB&T Corp. v. United States*, 523 F.3d 461, 476 (4th Cir. 2008) (quoting *Halle v. Commissioner*, 83 F.3d 649, 655 (4th Cir. 1996), *revg*. *Kingstowne L.P. v. Commissioner*, T.C. Memo. 1994-630). Our analysis of the factors relevant to this case leads to the conclusion that even though the documents prepared by Derivium use the term "loan", the transaction lacked the characteristics of a true loan.

[10] *Id*.; *United Natl.*, 33 B.T.A. at 796.

The transaction was structured so that petitioner could receive 90 percent of the value of his IBM stock. Petitioner would have no personal liability to pay principal or interest to Derivium, and it would have made no sense to do so unless the value of the stock had substantially appreciated. Petitioner transferred ownership of the stock to Derivium, who received all rights and privileges of ownership and was free to sell the stock. Derivium did immediately sell the stock and immediately passed 90 percent of the proceeds to petitioner. The only right petitioner retained regarding shares of IBM stock was an option, exercisable 3 years later, in 2004, to require Derivium to acquire 990 shares of IBM stock and deliver them to him in 2004. Petitioner's right to exercise this option in 2004 was wholly contractual because he had already transferred all of the incidents of ownership to Derivium, which had immediately sold the 990 shares.[11] See *Provost v. United States, 269 U.S. 443 [5 AFTR 5681] (1926). Petitioner engaged in the transaction because* he thought that the "loan" characterization would allow him to realize 90 percent of the value of the stock, whereas a "sale" would have netted only 80 percent of the stock's value after payment of tax on the gain. After the transfer petitioners did not conduct themselves as if the transaction was a loan. Petitioners did not report dividends earned on the 990 shares of IBM stock on their Federal income tax returns. When petitioners decided not to "repay the loan" in 2004, they did not report a sale of the stock on their 2004 Federal income tax return and failed to report any discharge of indebtedness income. This failure was totally inconsistent with petitioners' "loan" characterization.

[11] *Welch*, 204 F.3d at 1230.

As to Derivium, immediately upon its receipt of petitioner's stock, it sold the stock in order to fund the "loan". It did not hold the stock as collateral for a loan. In an ordinary lending transaction the risk of loss to a lender is that the borrower might not repay the loan. In contrast to the ordinary risk assumed by a lender, Derivium's only risk of loss would have arisen if petitioner had actually repaid the "loan". Petitioner would very likely have exercised his option to "repay the loan" if the value of the 990 shares of IBM stock, in August 2004, had exceeded the balance due. However, if petitioner had exercised his option under those circumstances, Derivium would have been required to acquire 990 shares of IBM stock at a cost exceeding the amount it would have received from petitioner. On the basis of all of these factors we must conclude that Derivium did not expect or want the "loan" to be repaid. Of course if the value of the IBM stock had been less than the "loan" balance in 2004, it would have been foolish for petitioner to pay the "loan" balance. As petitioner explained at trial, he did not exercise his right to "buy back my shares" because it would have cost more than the shares were worth.

We hold that the transaction was not a loan and that petitioner sold his IBM stock for $93,586.23 in 2001.[12]

[12] *United Natl.*, 33 B.T.A. at 797; *Fisher*, 30 B.T.A. at 441.

This case presents an issue of first impression in this Court. However, two other Federal courts have recently considered whether the transfer of securities to Derivium under its 90-percent-stock-loan program was a sale for Federal tax purposes. In each of those cases the courts, using essentially the same facts and applying the same legal standards that are found in cases such as *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. at 1237-1238, and *Welch v. Commissioner*, 204 F.3d at 1230, found that the 90-percent-stock-loan-program transactions were sales of securities and not bona fide loans. See *Nagy v. United States*, 104 AFTR 2d 2009-7789, 2010-1 USTC par. 50,177 (D.S.C. 2009) (in an action involving section 6700 promoter penalties, Chief Judge Norton for the U.S. District Court for the District of South Carolina granted the Government's motion for partial summary judgment, holding that the 90-percent-stock-loan-program transactions offered by Derivium were sales of securities, not bona fide loans); *United States v. Cathcart*, 104 A.F.T.R.2d 2009-6625, 2009-2 USTC par. 50,658 (N.D. Cal. 2009) (in an action to enjoin defendants from continuing to promote Derivium's 90-percent-stock-loan program, Judge Hamilton of the U.S. District Court for the Northern District of California granted the Government's motion for partial summary judgment, holding that the 90-percent-stock-loan-program transactions offered by Derivium were sales of securities, not bona fide loans). Subsequently, the District Court for the Northern District of California permanently enjoined Charles Cathcart from, directly or indirectly, by use of any means or instrumentalities:

1. Organizing, promoting, marketing, selling, or implementing the "90% Loan" program that is the subject of the complaint herein;

2. Organizing, promoting, marketing, selling, or implementing any program, plan or arrangement similar to the 90% Loan program that purports to enable customers to receive valuable consideration in exchange for stocks and other securities that are transferred or pledged by those customers, without the need to pay tax on any gains because the transaction is characterized as a loan rather than a sale; *United States v. Cathcart*, No. 4:07-CV-04762-PJH (N.D. Cal. Nov. 23, 2009). We note that Mr. Cathcart stipulated to the entry of this permanent injunction.

With respect to Derivium, a magistrate judge for the District Court for the Northern District of California recommended that "injunctive relief against Derivium is 'necessary or appropriate for the enforcement of the Internal laws." *United States v. Cathcart*, 105 AFTR 2d 2010-Revenue 1287, at 2010-1292 (N.D. Cal. 2010). District Court Judge Hamilton adopted the magistrate judge's recommendations, finding that the report was well reasoned and thorough in every respect. *United States v. Cathcart*, 105 AFTR 2d 2010-1293 (N.D. Cal. 2010).[13]

[13] *Welch*, 204 F.2d at 1230; *United Natl.*, 33 B.T.A. at 794; *Fisher*, 30 B.T.A. at 440; see also *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981).

Sollberger v. Commissioner, 691 F.3d 1119, 1126 (9th Cir. 2012), held:

> Section 1058 exempts certain transfers of securities from the capital gains tax so long as the transferor is entitled to receive payments in amounts equivalent to all interest that the owner of the securities is entitled to receive, and provided that the transfer does "not reduce the risk of loss or opportunity for gain of the transferor." See 26 U.S.C. § 1058(b)(2), (3). Even assuming Sollberger did not waive this argument below, the Master Agreement gave Optech the right to receive all dividends and interest on the FRNs. The nonrecourse nature of the loan eliminated any risk that Sollberger would receive less than the loan amount, and the seven-year term during which Sollberger could not pay off the loan and receive the FRNs back eliminated his opportunity for gain for at least seven years. Thus, Sollberger is not eligible for the safe harbor because he fails to meet § 1058's requirements. See *Calloway*, 135 T.C. at 43-45; see also *Samueli v. Comm'r*, 661 F.3d 399, 407 (9th Cir. 2011) (agreeing that a transaction did not meet the requirements of § 1058 where the taxpayers relinquished all control over securities for all but 2 days in a term of approximately 450 days).

See also part III.B.1.a.i.(a) Loans Must be Bona Fide.

On its own, a share-lending arrangement can be relatively innocuous. However, coupled with other transactions, it can cause a sale to be deemed to occur. See the cases described in part II.A.1.d.ii Monetizing Founder's Remaining Shares After Going Public.

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

A founder or other person with low basis stock might agree to deliver shares at a future date in exchange for cash now, which cash could be used to buy a diversified portfolio of stock. Also, the cash proceeds may be transferred using leveraged estate planning tools, while maintaining a security interest in the founder's stock.[54]

This agreement regarding the low basis shares might be done in a way that is not an installment sale that produces income in respect of a decedent but rather an open transaction that generates a basis step-up in the shares that have not yet been delivered. (Note that part of the proceeds of a founder's stock in a qualified C corporation might be excluded from regular taxation.)[55]

Rev. Rul. 2003-7 involved the following transaction:

> An individual ("Shareholder") held shares of common stock in Y corporation, which is publicly traded. Shareholder's basis in the shares of Y corporation is less than $20 per share. On September 15, 2002 (the "Execution Date"), Shareholder entered into an arm's length agreement (the "Agreement") with Investment Bank, at which time a share of common stock in Y corporation had a fair market value of $20. Shareholder received $z of cash upon execution of the Agreement. In return, Shareholder became obligated to deliver to Investment Bank on September 15, 2005 (the "Exchange Date"), a number of shares of common stock of Y corporation to be determined by a formula. Under the formula, if the market price of a share of Y corporation common stock is less

[54] See part II.H.10 Extracting Equity to Fund Large Gift.
[55] See part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation.

> than \$20 on the Exchange Date, Investment Bank will receive 100 shares of common stock. If the market price of a share is at least \$20 and no more than \$25 on the Exchange Date, Investment Bank will receive a number of shares having a total market value equal to \$2000. If the market price of a share exceeds \$25 on the Exchange Date, Investment Bank will receive 80 shares of common stock. In addition, Shareholder has the right to deliver to Investment Bank on the Exchange Date cash equal to the value of the common stock that Shareholder would otherwise be required to deliver under the formula.
>
> In order to secure Shareholder's obligations under the Agreement, Shareholder pledged to Investment Bank on the Execution Date 100 shares (that is, the maximum number of shares that Shareholder could be required to deliver under the Agreement). Shareholder effected this pledge by transferring the shares in trust to a third-party trustee, unrelated to Investment Bank. Under the declaration of trust, Shareholder retained the right to vote the pledged shares and to receive dividends.
>
> Under the Agreement, Shareholder had the unrestricted legal right to deliver the pledged shares, cash, or shares other than the pledged shares to satisfy its obligation under the Agreement. Shareholder is not otherwise economically compelled to deliver the pledged shares. At the time Shareholder and Investment Bank entered into the Agreement, however, Shareholder intended to deliver the pledged shares to Investment Bank on the Exchange Date in order to satisfy Shareholder's obligations under the Agreement.

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

> In the present case, on the Execution Date, Shareholder received a fixed payment without any restriction on its use and also transferred in trust the maximum number of shares that might be required to be delivered under the Agreement. Like the taxpayers in *Miami National Bank* and *Richardson*, but unlike the taxpayer in *Hope*, Shareholder retained the right to receive dividends and exercise voting rights with respect to the pledged shares. Also unlike *Hope*, the legal title to, and actual possession of, the shares were transferred to an unrelated trustee rather than to Investment Bank. Moreover, Shareholder was not required by the terms of the Agreement to surrender the shares to Investment Bank on the Exchange Date. Rather, Shareholder had a right, unrestricted by agreement or economic circumstances, to reacquire the shares on the Exchange Date by delivering cash or other shares. See *Miami National Bank* and *Richardson*. Accordingly, the execution of the Agreement did not cause a sale or other disposition of the shares.
>
> A different outcome may be warranted if a shareholder is under any legal restraint or requirement or under any economic compulsion to deliver pledged shares rather than to exercise a right to deliver cash or other shares. For example, restrictions placed upon a shareholder's right to own pledged common stock after the Exchange Date, or an expectation that a shareholder will lack sufficient resources to exercise the right to deliver cash or shares other than pledged shares, would be significant factors to be weighed in determining whether a sale has occurred.

> Section 1259(a)(1) provides that, if there is a constructive sale of an appreciated financial position, the taxpayer shall recognize gain as if such position were sold, assigned, or otherwise terminated at its fair market value on the date of such constructive sale. Under § 1259(b), the term "appreciated financial position" means any position with respect to any stock, debt instrument, or partnership interest if there would be gain were such position sold, assigned, or otherwise terminated at its fair market value. Furthermore, for purposes of § 1259, the term "position" means an interest, including a futures or forward contract, short sale, or option. Under § 1259(c)(1)(C), a taxpayer is treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person) enters into a futures or forward contract to deliver the same or substantially identical property. The term "forward contract" is defined under § 1259(d)(1) as a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price. The legislative history indicates that a forward contract that provides for the delivery of an amount of stock that is subject to "significant variation" under the terms of the contract is not within the statutory definition of a forward contract. S. Rep. No. 33, 105th Cong., 1st Sess. 125-26 (1997), 1997-4 (Vol. 2) C.B. 1067, 1205-06.
>
> Under these facts, the Agreement does not cause a constructive sale of the shares under § 1259(c)(1)(C). According to the Agreement, delivery of a number of shares, which may vary between 80 and 100 shares, depends on the fair market value of the stock on the Exchange Date. Because this variation in the number of shares that may be delivered under the Agreement is a significant variation, the Agreement is not a contract to deliver a substantially fixed amount of property for purposes of § 1259(d)(1). As a result, the Agreement does not meet the definition of a forward contract under § 1259(d)(1) and does not cause a constructive sale under § 1259(c)(1)(C).
>
> **Holding**
>
> Shareholder has neither sold stock currently nor caused a constructive sale of stock if Shareholder receives a fixed amount of cash, simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date, pledges the maximum number of shares for which delivery could be required under the agreement, retains an unrestricted legal right to substitute cash or other shares for the pledged shares, and is not economically compelled to deliver the pledged shares.

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

> … a forward contract is treated as a constructive sale if it is for a substantially fixed amount of property for a substantially fixed price. Sec. 1259(c)(1)(C), (d)(1). Section 1259 does not define the terms "substantially fixed amount of property" or "substantially fixed price". Section 1259 gives the Secretary two sources of authority for issuing regulations to carry out Congress' intent— section 1259(c)(1)(E) and (f)—but no regulations have been issued defining either phrase.
>
> The legislative history provides some guidance as to determining whether a transaction is treated as a constructive sale under section 1259. The Senate Finance Committee report, S. Rept. 105-33, at 125-126 (1997), 1997-4 C.B. (Vol. 2) 1067, 1205-1206, in stating that a forward contract results in a constructive sale only if it provides for delivery

of a substantially fixed amount of property at a substantially fixed price, goes on to say that “a forward contract providing for delivery of an amount of property, such as shares of stock, that is subject to significant variation under the contract terms does not result in a constructive sale.” The report does not define or provide any guidance relative to the term “significant variation” and the Secretary has not issued any regulations interpreting this term.

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

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

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

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

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

> P-PA, an individual, owned P-AC, an S corporation. TAC is a wholly owned qualified subch. S subsidiary of P-AC, and its items of income and gain are reported on P-AC's Federal tax return. P-PA used TAC as an investment vehicle. TAC held the stock of companies that P-PA decided to invest in. TAC entered into a master stock purchase agreement (MSPA) for the sale of some of those corporate stocks in 2000 and 2001 to DLJ, an investment bank. The MSPA consisted of forward contracts and share-lending agreements. The forward contracts were prepaid in cash and would be settled with variable numbers of shares of stock. The share-lending agreements called for TAC to lend the shares of stock subject to the forward contracts to DLJ.
>
> P-PA and P-AC treated the MSPA as an open transaction and did not report any gain or loss on the transfers of stock. R determined that the MSPA was a sale of stock and that P-AC was liable for built-in gains tax pursuant to sec. 1374, I.R.C., as a result of TAC's income and gain being reported on P-AC's return. R also determined that there were deficiencies in the personal income tax of P-PA, the sole shareholder of P-AC, as a result of adjustments including in his income a distributive share of the built-in gain.
>
> Under sec. 1058, I.R.C., no gain or loss is recognized by a taxpayer who transfers securities pursuant to an agreement that meets the requirements of sec. 1058(b), I.R.C. Sec. 1259, I.R.C., provides for constructive sale treatment if a taxpayer enters into a transaction listed in sec. 1259(c)(1), I.R.C.
>
> *Held*: The MSPA constituted a sale and TAC and P-AC must recognize gain to the extent of the upfront cash payments received in 2000 and 2001; the MSPA called for the lending of shares but did not meet the requirements of sec. 1058(b), I.R.C., because it limited TAC's risk of loss.
>
> Held, further: TAC did not engage in constructive sales of stock in 2000 and 2001 pursuant to sec. 1259, I.R.C.

Anschutz Co. v. Commissioner, 664 F3d 313 (10th Cir. 2011), discussed what constitutes a sale:[56]

> For purposes of the IRC, the term "sale" is given its ordinary meaning and is generally defined as a transfer of property for money or a promise to pay money. *Commissioner v. Brown*, 380 U.S. 563, 570-71 (1965). Whether a sale has occurred depends upon whether, as a matter of historical fact, there has been a transfer of the benefits and burdens of ownership. *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981). "Some of the factors that have been considered by courts in making this determination are: (1) Whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damages to the property; and (8) which party receives the profits from the operation and sale of the property." *Id.* (internal citations omitted). With respect to stock transactions in particular, the following factors are also considered relevant to this determination: "(i) whether the purchaser bears the risk of loss and opportunity for gain;

[56] The *Anschutz* Tax Court used a different list of factors. See fn 53 in part II.A.1.d.i Code § 1058 Loan of Securities.

> (ii) which party receives the right to any current income from the property; (iii) whether legal title has passed; and (iv) whether an equity interest was acquired in the property." *H.J. Heinz Co. and Subsidiaries v. United States*, 76 Fed. Cl. 570, 581 (Fed. Cl. 2007).

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

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

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

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

This "open transaction" concept is related to the income in respect of a decedent concept described in part II.Q.4.e.i Life Insurance Basis Adjustment on the Death of an Owner Who Is Not the Insured, fns 4434-4436.

The Syllabus to *Estate of McKelvey v. Commissioner*, 161 T.C. No. 9 (2023), described the case:

> Decedent (D) entered into variable prepaid forward contracts (first set of VPFCs) with two investment banks in 2007. Pursuant to the terms of the first set of VPFCs, the investment banks made cash payments to D, and D was obligated to deliver variable quantities of stock or their cash equivalent to the investment banks on specified future

settlement dates in 2008 (original settlement dates). Treating the execution of the first set of VPFCs as an open transaction, D did not report any gain or loss for 2007 in connection with entering into the first set of VPFCs.

In 2008, before the original settlement dates, D paid consideration to the investment banks to exchange the first set of VPFCs for an amended set of VPFCs that had settlement dates in 2010 (second set of VPFCs). Treating the first set of VPFCs as remaining open after the exchanges, D did not report any gain or loss for 2008 with respect to those VPFCs as a result of the exchange. Later in 2008, and after the exchanges, D passed away. R determined with respect to D’s 2008 tax year that the exchanges of the VPFCs constituted sales or exchanges of property under 26 U.S.C. § 1001, that the exchanges also resulted in constructive sales under 26 U.S.C. § 1259 of the stock shares D used to collateralize the first set of VPFCs, and that, as a result, D should have reported gain from the transactions.

In *Estate of McKelvey v. Commissioner* (*Estate of McKelvey I*), 148 T.C. 312 (2017), we held that D’s treatment of the first set of VPFCs as remaining open after the exchanges was appropriate and that the exchanges constituted neither the sale nor the exchange of property under 26 U.S.C. § 1001 nor resulted in constructive sales of stock under 26 U.S.C. § 1259. Consequently, we concluded D did not have gain from the exchanges with respect to 2008. In *Estate of McKelvey v. Commissioner* (*Estate of McKelvey II*), 906 F.3d 26 (2d Cir. 2018), the U.S. Court of Appeals for the Second Circuit reversed, determining that the exchanges of the VPFCs terminated the first set of VPFCs and resulted in the constructive sale of stock under 26 U.S.C. § 1259. The Second Circuit remanded for us to determine whether the exchanges terminated D’s underlying obligations with respect to the first set of VPFCs for purposes of 26 U.S.C. § 1234A and, if so, the amount of D’s gain from the termination. The Second Circuit also remanded for us to determine D’s gain with respect to the constructive sale of stock under 26 U.S.C. § 1259, an amount which the parties subsequently stipulated.

In the light of the Second Circuit’s decision in Estate of McKelvey II, we reach the following holdings.

Held: Upon the exchange of the first set of VPFCs for the second set of VPFCs, the first set of VPFCs was closed and D’s underlying obligations with respect to that first set terminated for purposes of 26 U.S.C. § 1234A.

Held, further, D realized $71,668,034 of short-term capital gain for tax year 2008 from the exchange of VPFCs.

The court’s “Supplemental Opinion” began:

This case is before the Court on remand from the U.S. Court of Appeals for the Second Circuit for further consideration consistent with its opinion in *Estate of McKelvey v. Commissioner* (*Estate of McKelvey II*), 906 F.3d 26 (2d Cir. 2018), reversing and remanding our decision in *Estate of McKelvey v. Commissioner* (*Estate of McKelvey I*), 148 T.C. 312 (2017).

In *Estate of McKelvey I*, we considered whether Andrew J. McKelvey (decedent) realized over $200 million in short-term and long-term capital gain pursuant to sections 1001 and 1259, respectively, by executing amendments extending two variable prepaid forward contracts (VPFCs) in 2008 (year at issue).[3] In so doing, we rejected respondent's contention that decedent's execution of the extensions constituted taxable exchanges of "property" under section 1001. *Estate of McKelvey I*, 148 T.C. at 320-32. We also rejected his contention that the extensions resulted in constructive sales under section 1259 of the collateralized stock shares decedent pledged under the VPFCs. *Estate of McKelvey I*, 148 T.C. at 332-33. We thus concluded that the extensions did not trigger any capital gain for the year at issue. *Id.* at 320-33.

[3] Unless otherwise indicated, statutory references are to the Internal Revenue Code, Title 26 U.S.C. (Code), in effect at all relevant times, regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and Rule references are to the Tax Court Rules of Practice and Procedure. Some monetary amounts are rounded to the nearest dollar.

In *Estate of McKelvey II*, the Second Circuit agreed with us that decedent's execution of the extensions did not constitute exchanges of "property," such that no short-term capital gain was triggered pursuant to section 1001. *Estate of McKelvey II*, 906 F.3d at 34. However, it also considered a new, alternative argument by respondent that the extensions nevertheless triggered short-term capital gain under section 1234A by terminating decedent's obligations under the original VPFCs.[4] *Estate of McKelvey II*, 906 F.3d at 34-35. With respect to this argument, the Second Circuit concluded that, although not exchanges of "property" for purposes of section 1001, the original VPFCs were exchanged for amended VPFCs. *Estate of McKelvey II*, 906 F.3d at 34-35. It correspondingly remanded the case for us to determine "whether the replacement of the obligations in the original VPFCs with the obligations in what we hold are new contracts satisfies the criteria for a termination of obligations that gives rise to taxable income, presumably capital gain, and the amount of such gain." *Id*. at 35; see also *id*. at 41 (directing the Court, more succinctly, to determine "whether the termination of obligations that occurred when the amended contracts were executed resulted in taxable short-term capital gains").

[4] The parties agreed the Second Circuit could consider this argument because petitioner had asserted before this Court that the extensions did not result in a termination of decedent's obligations under the original VPFCs. *Estate of McKelvey II*, 906 F.3d at 34.

Additionally, the Second Circuit reversed our holding as to section 1259, concluding that the extensions did result in constructive sales of the collateralized shares that triggered long-term capital gains. *Estate of McKelvey II*, 906 F.3d at 40-41. In the light of this conclusion, the Second Circuit further mandated that we calculate the amount of such gain. *Id*. at 41. The parties having subsequently stipulated that amount as $102,406,962.12, only the issues identified by the Second Circuit with respect to the "replacement of the obligations in the original VPFCs with the obligations in...[the] new contracts" remain.

In the light of the Second Circuit's holdings, we will refer to the transactions at issue as "replacements" or "exchanges" for the remainder of this Opinion.

The court reasoned in its opinion titled “Discussion”:

I. *Taxability of the Replacement of Obligations*

The first question we have been asked to address is whether a taxable termination of obligations occurred when decedent exchanged VPFCs with BofA and MSI, resulting in taxable gain. The Second Circuit opined briefly on the exchanges, holding that the extensions of the valuation dates resulted in the replacement of the original contracts. *Estate of McKelvey II*, 906 F.3d at 35. More specifically, the Second Circuit concluded that extending the valuation dates by an additional 17 months for the BofA contracts and 16 months for the MSI contracts resulted in amended contracts that replaced the original contracts. *Id*. The Second Circuit reasoned that the parties “changed the bets that the VPFCs represented”, which it determined to be a “fundamental change,” invoking a phrase from Revenue Ruling 90-109, 1990-2 C.B. 191. *Estate of McKelvey II*, 906 F.3d at 35. Revenue Ruling 90-109 discusses a change in contractual terms that causes an old contract to be “treated as if” it was actually exchanged for a new one. See Rev. Rul. 90-109, 1990-2 C.B. at 192 (“A change in contractual terms effected through an option provided in the original contract is treated as an exchange under section 1001 if there is a sufficiently fundamental or material change that the substance of the original contract is altered through the exercise of the option. Under such circumstances, the old contract is treated as if it were actually exchanged for a new one.”); see also *id*. (referring to the exercise of the option as resulting in a change that is “substantively the same as an actual exchange” and as obviating the need for an “actual exchange” but effecting a “de facto exchange”). The revenue ruling employed the phrase “sufficiently fundamental or material change” to indicate the point at which the original contracts had been exchanged for new contracts, a gain recognition event as an exchange under section 1001. Id. The Second Circuit ultimately concluded that the extension resulted in an exchange of the first set of contracts for new contracts, as well as an exchange of the underlying obligations. *Estate of McKelvey II*, 906 F.3d at 35.

The Second Circuit stopped short, however, of reaching a holding on whether a termination of obligations occurred. Id. On appeal, respondent raised an alternative claim that the exchanges resulted in the termination of derivative obligations with respect to capital assets. *Id.* at 34-35. Respondent argued that such a termination of obligations resulted in short-term capital gain under section 1234A. *Estate of McKelvey II*, 906 F.3d at 34-35. The parties acknowledged that respondent was entitled to raise the new claim, and the Second Circuit left for us to address on remand the issue of whether decedent realized short-term capital gain under section 1234A.

A. *Termination of the Obligations Under the VPFCs*

The Second Circuit described the exchanges as a “replacement of the obligations,” establishing that by executing the transactions, decedent surrendered one set of obligations and cash in an exchange for an entirely separate set of obligations that, in turn, represented fundamentally changed bets. *Estate of McKelvey II*, 906 F.3d at 35; see Rev. Rul. 90-109. In order to determine whether such an exchange qualifies as a taxable termination of the first set of obligations, we turn to guidance regarding the treatment of options contracts.[17] Broadly speaking, an option is the right to buy or sell a stock at a certain price within a set period and involves a buyer (or holder) and a seller (also known as a writer or grantor). *Laureys v. Commissioner*, 92 T.C. 101, 102 (1989). Revenue Ruling 90-109 applies sale or exchange treatment to fundamental changes in the terms of options contracts. See *Estate of McKelvey II*, 906 F.3d at 35. The revenue ruling states that where a change to contractual terms effected through an option provided in the original contract is so substantial as to amount to a fundamental or material change, the "old contract is treated as if it were actually exchanged for a new one." Rev. Rul. 90-109, 1990-2 C.B. at 192. Such treatment is "substantively the same as an actual exchange of contracts and is a sale or other disposition for purposes of section 1001." *Id*.; see *supra* p. 11.

[17] The Second Circuit left the issue of "whether the replacement of obligations...*satisfies the criteria for a termination* of obligations that gives rise to taxable income" to be decided by this Court. *Estate of McKelvey II*, 906 F.3d at 35 (emphasis added). The Second Circuit also directed this Court to determine "whether *the termination of obligations that occurred* when the amended contracts were executed resulted in taxable short-term capital gains." *Id*. at 41 (emphasis added). In the light of the former statement and discussion by the Second Circuit, we understand the latter statement to not be a conclusion with respect to whether a termination occurred for purposes of section 1234A.

While VPFCs are not options themselves, options are similar, open transactions from which principles can be applied to VPFCs, a shared treatment acknowledged through prior IRS guidance and the Second Circuit. See Rev. Rul. 78-182, 1978-1 C.B. 265; Rev. Rul. 58-234, 1958-1 C.B. 279; see also *Estate of McKelvey II*, 906 F.3d at 35 ("The new valuation dates in the amended contracts resulted in new contracts just as new expiration dates for option contracts result in new option contracts."). From the grantor's perspective, the obligations under an option contract terminate, in relevant part, through the grantor's repurchase of the option from the holder or the grantor's purchase of an option with terms identical to the original option granted and designating the purchase as a closing transaction. *Laureys*, 92 T.C. at 102-04; Treas. Reg. § 1.1234-3(b)(1). Each option has its own identity and is a separate asset from all other options, so the holding period of an option does not relate back to prior option contracts. *Reily v. Commissioner*, 53 T.C. 8, 12 (1969). The time factor goes to the very essence of options contracts. *Id.*

The Second Circuit held that decedent's extensions of the VPFCs represented such fundamental changes as to warrant treatment as if actual exchanges of the old and new contracts had occurred. *Estate of McKelvey II*, 906 F.3d at 35. In treating decedent's extensions of the contracts as if the first set of VPFCs was actually exchanged for the second set of VPFCs, the exchange takes the form of an option repurchase. Decedent made payments to MSI and BofA and undertook obligations as part of the new contracts, in exchange for the termination of the prior contracts. Decedent repurchased the options held by MSI and BofA, thereby executing closing transactions that terminated his obligations with respect to the first set of contracts. See Treas. Reg. § 1.1234-3(b)(1)(i); see also *Laureys*, 92 T.C. at 102-04. Decedent's obligations under the first set of VPFCs do not relate forward to his separate obligations under the second set of VPFCs, and likewise the obligations under the second set of VPFCs do not relate back to his obligations under the first set. See *Reily*, 53 T.C. at 12. We therefore find that, upon executing the exchanges, decedent terminated the obligations under the first set of VPFCs.

B. ***Sale Treatment Under Section 1234A***

Although entry into a VPFC is not a taxable event, its termination and replacement are another matter. The Second Circuit established its agreement with our conclusion in *Estate of McKelvey I* that, at the time the VPFCs were extended, decedent did not have any rights in the VPFCs that could constitute property; but instead all that remained were his obligations to deliver Monster shares (or their cash equivalent) such that there was no taxable exchange of "property" for purposes of section 1001. It remanded, however, for us to consider the exchanges of the original VPFCs for the amended contracts in the context of section 1234A.[18] *Estate of McKelvey II*, 906 F.3d at 34-35. Section 1234A, in relevant part, determines the taxable treatment of the termination of obligations with respect to capital assets, providing:

> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of -
>
> (1) a right or obligation...with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer....
>
> shall be treated as gain or loss from the sale of a capital asset.

[18] In so doing, the Second Circuit was careful to note the parties' agreement that the case concerns contracts that are not debt instruments and that it was making "no implication as to the tax consequences of fundamental changes in debt instruments." *Estate of McKelvey II*, 906 F.3d at 35 n.13.

Thus, by its terms, section 1234A(1) applies to the termination of obligations with respect to capital assets, which include derivative or contractual rights to buy or sell such assets. *Pilgrim's Pride Corp. v. Commissioner*, 779 F.3d 311, 317 (5th Cir. 2015), *rev'g on other grounds* 141 T.C. 533 (2013); see also *Estate of McKelvey II*, 906 F.3d at 34 (citing same for its interpretation of section 1234A(1)). A "capital asset" for the purposes of section 1234A means any property held by the taxpayer, with certain exclusions that do not apply here. § 1221(a). And the Second Circuit, to which appeal would lie, has opined that "a gain or loss from the cancellation of a futures or forward contract would result in capital gain or loss pursuant to [section] 1234A." *Wolff v. Commissioner*, 148 F.3d 186, 188 (2d Cir. 1998), *rev'g and remanding on other grounds* T.C. Memo. 1994-196.

Decedent held obligations with respect to Monster shares, which are capital assets under section 1221(a). As the exchanges resulted in the termination of those obligations, we hold that section 1234A(1) applies to the exchanges. Therefore, any gain that decedent realized from the exchanges shall be treated as gain from the sale of a capital asset. "Short-term capital gain" is defined as the gain from the sale or exchange of a capital asset held not more than 1 year. § 1222(1). The period for which a taxpayer has held an option, rather than the property that is the subject of the option, determines whether the capital gain is short term or long term. See Treas. Reg. § 1.1234-1(a)(1). Decedent terminated the first set of VPFCs after holding them for less than one year, and consequently any gain that decedent realized from the exchange is short-term capital gain.

II. *Open Transaction Doctrine*

As previously mentioned, VPFCs are afforded open transaction treatment upon execution. *Burnet v. Logan*, 283 U.S. 404 (1931); Rev. Rul. 2003-7, 2003-1 C.B. 363. Petitioner contends the replacement of VPFCs requires equal treatment under the doctrine. The open transaction doctrine finds its origins in the Code, which generally concerns itself only with realized gains or losses or with unrealized gains or losses that are reasonably certain and ascertainable. *Lucas v. Am. Code Co.*, 280 U.S. 445, 449 (1930). The doctrine governs transactions where the realization of income is so uncertain or contingent as to prevent accurate gain or loss calculations. *Burnet v. Logan*, 283 U.S. 404. Such limitations mean that the open transaction doctrine applies only when we cannot determine the value of either of the exchanged assets. *Davis v. Commissioner*, 210 F.3d 1346, 1348 (11th Cir. 2000), *aff'g* T.C. Memo. 1998-248; see also *United States v. Davis*, 370 U.S. 65 (1962). In scenarios where the value of only one asset is ascertainable, the exchanged assets are deemed to be of equal value. *Davis v. Commissioner*, 210 F.3d at 1348; see also *Davis*, 370 U.S. at 72.

Petitioner contends that the open transaction doctrine applies to the transactions before us. Petitioner argues that in the exchanges of VPFCs, VPFCs in the second set are open, which renders any gain calculation from the exchanges an impossibility at that time. Petitioner continues that, regardless of whether the Court deems them extensions or replacements, the gain amount, identity, and cost basis of the property to be delivered remained undetermined when the amendments were executed. By reiterating that the ultimate exchange of cash or property for the prepayment is what is relevant, petitioner makes clear the view that rigid adherence to the settlement options contemplated in the original contracts is the only way that parties to the contracts may calculate their gain.

A. *Applicability of* Virginia Iron *and* Hicks

Petitioner attempts to support the position that the open transaction doctrine applies with various options-writing cases, primarily relying on *Virginia Iron Coal & Coke Co. v. Commissioner*, 37 B.T.A. 195 (1938), *aff'd*, 99 F.2d 919 (4th Cir. 1938), and *Hicks v. Commissioner*, T.C. Memo. 1978-373, 37 T.C.M. (CCH) 1540. Each case evaluates written call options that were extended at or after expiration, and in each case the Court held that gain or loss was not realized upon extension as uncertainty remained regarding what property would be delivered to the taxpayers' counterparties. *Va. Iron*, 37 B.T.A. 195; *Hicks*, 37 T.C.M. (CCH) 1540. *Virginia Iron*, in relevant part, concerns an option that the taxpayer wrote for a third party to purchase land and mineral rights owned by the taxpayer's subsidiary or stock in the subsidiary owned by the taxpayer. *Va. Iron*, 37 B.T.A. at 196. The option retained the third party's purchase rights for one year in exchange for an up-front payment of $300,000; the purchase rights could be renewed annually on August 1 for the following five years at a rate of $125,000 per year. *Id*. The third party failed to make a payment on August 1 of the second year, letting the option lapse, but on September 21 of that year entered into a supplemental contract, continuing the option with some modifications. *Id*. The following year, the third party formally declined to exercise the option. *Id*. at 197. The Board of Tax Appeals (BTA) held that the up-front and renewal payments to the taxpayer were not income for the years in which received, but rather income for the year when the option was declined because only then could "a satisfactory determination of their character" be made. *Id*. at 198.

Hicks, in relevant part, concerned two real property parcels that the taxpayer and a business partner agreed to sell to a developer. *Hicks*, 37 T.C.M. (CCH) at 1541. The purchase agreement, signed in December 1972, dictated that the developer would purchase the first parcel for $208,598, and would make a downpayment of $25,000 for the second parcel, plus an interest-bearing note for the balance of $189,162. Id. The purchase agreement stated that the closing for the second parcel would not be more than one year after the closing for the first parcel; however, the developer could reconvey the second parcel to the taxpayer and his partner at no additional cost. Id. If the developer decided to exercise its option to reconvey the second parcel, the taxpayer and his partner would keep the downpayment. *Id*. In November 1973 the developer reconveyed the second parcel, and the parties voided the note for $189,162 and agreed to grant the developer for $10 an option to repurchase the second parcel (purchase option). *Id*. at 1542. The purchase option provided for the developer to purchase the parcel for $204,000 between January 15, 1974, and June 7, 1975, plus $1,200 per month after January 15, 1974. *Id*. The downpayment of $25,000 would be credited against the purchase price if the developer exercised the purchase option. Id. The Court held that any gain recognition for the taxpayer with respect to the downpayment should be delayed until the extended option was exercised or lapsed, on the basis that the character of the payment could not be determined until then. *Id*. at 1544.

In citing *Virginia Iron* and *Hicks*, petitioner encourages the Court to ignore whether obligations are “continuing” or “replaced,” proposing that such terms are merely irrelevant formalisms. Instead, per petitioner, we should focus exclusively on whether it is possible to determine the amount and character of any gain or loss. While we agree with maintaining a focus on whether the amount and character of any gain or loss is determinable, we disagree that doing so requires us to act as though the Second Circuit’s holding that the obligations were replaced is “irrelevant” and ultimately unnecessary. The option contracts at issue in Virginia Iron and in Hicks bear a few notable differences from the VPFCs at hand, the first of which is that the BTA in Virginia Iron and the Court in Hicks did not establish that the expiration and subsequent renewal of the option was a replacement of the option. Indeed, as petitioner stated on brief, the BTA was not focused on such details and did not provide any opinion on the distinction between “continuing” and “replacing” the contract. We, on the other hand, are operating under the established decision that decedent replaced the original set of VPFCs with a distinct second set.

The second difference arises from the underlying property to which the derivative contracts relate. In both *Virginia Iron* and *Hicks*, the options concerned the rights to purchase defined plots of real property for a fixed amount set at the signing of each contract. *Va. Iron*, 37 B.T.A. at 196; *Hicks*, 37 T.C.M. (CCH) at 1541. As time passed, the underlying real property the parties contemplated did not vary in amount or price. Consequently, the bet that the parties made upon signing resembled the position that they continued to hold in subsequent years; the land values did not significantly change and the acres subject to the options remained fixed. *Va. Iron*, 37 B.T.A. at 196; *Hicks*, 37 T.C.M. (CCH) at 1544. The BTA, and later the Court, found that the option renewals left each taxpayer holding an obligation that had not materially changed from what it was before the renewal. *Va. Iron*, 37 B.T.A. at 196; *Hicks*, 37 T.C.M. (CCH) at 1541. The same cannot be said of decedent’s obligations. As respondent’s expert witness, Henrick Bessembinder, revealed, the VPFCs carried substantially different values depending on the length of time remaining on the contract and on the share price relative to the set strike price. With an eye toward those variables and the depressed value of the Monster shares at the time of extension, the Second Circuit agreed that the change in expiration dates fundamentally altered the bets that the VPFCs represented. As these fundamental changes were not considerations in *Virginia Iron* and *Hicks*, we find those cases to be factually distinct and noncontrolling.[19]

[19] This Court relied on *Virginia Iron* in *Estate of McKelvey I* to conclude that open transaction treatment applied to the first set of VPFCs so long as uncertainty existed with respect to the second set of VPFCs. In the light of the Second Circuit's holding that the exchanges terminated the first set of VPFCs and created a second set of VPFCs that represented different bets, we no longer find *Virginia Iron* to dictate that conclusion in this case.

B. *Open Transaction Doctrine as Applied to Exchanged Contracts*

Having established that we are not bound to the holdings in Virgina Iron and Hicks, we turn to petitioner's argument that the VPFCs remained open through their replacement because the gain or loss decedent would realize from the second set of VPFCs could not be calculated at the time of replacement. Petitioner asserts, and we agree, that the first set of VPFCs held uncertainty regarding the property to be delivered at settlement, which led to further uncertainty regarding decedent's tax basis in any gain or loss calculation. However, petitioner also asserts that the replacement of the first set of VPFCs by the second set does not resolve any of this uncertainty as it does not identify or determine decedent's cost basis in the property eventually used to settle the second set of VPFCs. In essence, petitioner's argument is that gain cannot be calculated on the then-closed first set of VPFCs because gain could not yet be determined on the second set of VPFCs; uncertainty replaced with uncertainty does not close the transaction. This argument is at odds with the mechanics of the open transaction doctrine.

As mentioned above, the open transaction doctrine applies only when it is impossible to determine the value of either asset exchanged. *Davis v. Commissioner*, 210 F.3d at 1348. It says nothing of requiring certainty in calculating the eventual gain of every asset or obligation involved. We therefore look to when it is first possible to determine the value of either asset exchanged.

Petitioner points out that, at the time of the exchange, the parties had yet to resolve the contracts in the manner originally contemplated and the stock or cash equivalent remained undelivered. The issue petitioner highlights on brief is whether the exchange "resolved the uncertainties regarding the amount, identity and cost basis of the money or other property to be delivered in exchange for the prepayment," arguing it did not. But the Second Circuit has already made clear that rigid adherence to the original design of the VPFCs is not the only acceptable conclusion to the contracts. By extending the contracts, the parties replaced the first set of VPFCs with the second set, transactions the Second Circuit held to be exchanges of contracts. *Estate of McKelvey II*, 906 F.3d at 35. The exchanges were a trade of decedent's obligations under the first set of VPFCs for decedent's obligations under the second set of VPFCs, plus additional payments of $8,190,640 to MSI and $3,477,950 to BofA. This termination of the first set of VPFCs also terminated the uncertainty that existed with respect to the identity and the cost basis of the property to be delivered in exchange for the prepayment under those contracts. Decedent satisfied the obligations from the first set of VPFCs by delivering a combination of cash and new obligations to which he was bound. Together, the cash and the new obligations establish a value and a tax basis sufficient to calculate any gain or loss derived from the first set of VPFCs.

It has long been established that gain is not exclusively derived from cash-settled transactions, but rather that gain may be realized from the "exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction." *Helvering v. Bruun*, 309 U.S. 461, 469 (1940). Thus, the fact that gain is a portion of the value of property received in the transaction does not negate its realization. *Id*. Decedent made such an exchange of obligations and property between the first and second set of VPFCs and consequently realized the gains or losses from those transactions. As it is possible to determine the values of property and obligations exchanged, and from there to determine the realized gain, the open transaction doctrine does not apply.

Petitioner is correct that the second set of VPFCs, at the time of the exchange, existed as an open transaction. At the time of the exchange, it would have been impossible to calculate the gain from those VPFCs, as decedent was still free to settle the transaction in cash or shares. However, we are not addressing decedent's possible gain from the second set of VPFCs; instead, we merely need their value at the time of the exchanges. The Second Circuit is not directing us to determine decedent's gain with respect to all VPFCs, merely those terminated by way of the exchanges.

III. *Calculation of Gain*

A. *Applicability of Section 1001*

Having established that the open transaction doctrine does not apply, and that any gain derived from the transactions is classified as short-term capital gain, we turn to the calculation of decedent's gain at the moments of the exchanges. Section 1001 dictates the method for calculating such gain:

> The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

§ 1001(a).

Problems arise in applying that introductory computation paragraph to our facts as the section limits its scope to gain from the sale or other disposition of property. See *id*. Both the Second Circuit and this Court have ruled that decedent's positions with respect to the VPFCs are not property, but rather obligations. *Estate of McKelvey II*, 906 F.3d at 34; *Estate of McKelvey I*, 148 T.C. at 322. The capital gain calculation as codified under section 1001 requires the sale or exchange of property, and decedent's gain from the VPFCs, while derived from a sale or exchange, would seem to be omitted as nonproperty.

Yet strict adherence to the idea that such wording exempts sales or exchanges of VPFCs from gain calculation leaves a gap in the Code's application of capital gain tax treatment when it comes to VPFCs and other nonproperty derivatives. With respect to the treatment of derivatives elsewhere in the Code, the character of the gain and loss does not turn on the classification of the taxpayer's position with respect to the derivative, but rather the property to which the contract relates. Gain or loss attributable to the sale or exchange of a securities futures contract is considered gain or loss from the sale or exchange of the underlying property for purposes of determining the character of the gain or loss, and the property or nonproperty nature of the taxpayer's position does not dictate taxability. § 1234B. The same holds true for the taxability of derivatives as capital assets. Gain or loss from the cancellation or lapse of an obligation with respect to property that is a capital asset in the hands of the taxpayer is treated as gain or loss from the sale of a capital asset, disregarding the nonproperty nature of the obligation. § 1234A. For options holders, gain or loss from the sale or exchange of options in property is considered to have the same character as gain or loss derived from the sale of the underlying property. § 1234(a). For options writers, the gain or loss is treated as gain or loss from the sale or exchange of a capital asset without regard to whether the position is property or an obligation in the hands of the writer. § 1234(b).

These examples paint a clear picture of the Code's priorities when it comes to taxing the gains or losses of derivatives: The nature of the underlying property controls. Even when it is well established that the taxpayer's position with respect to a derivative is not property, the Code dictates that any gain or loss is treated as if derived from property. We will continue to evenly apply that principle to the VPFCs in question. Consequently, the applicability of section 1001(a) is not affected by the nonproperty nature of decedent's position with respect to the VPFCs, but rather by the fact that the underlying shares are property. The underlying Monster shares are property in the hands of decedent, and therefore section 1001(a) applies to gain from the sale or other disposition of derivatives relating to those shares. Where section 1001 restricts gain calculations, either to property or otherwise, we will look to the nature of the underlying shares as a basis for the section's applicability, rather than to the nature of the taxpayer's position.

B. *Gain Calculation Under Section 1001*

The gain from the exchange is determined under section 1001 and is calculated as the excess of the amount realized over decedent's adjusted basis in the VPFCs. See § 1001(a). The amount realized from the exchange is defined as the sum of any money received plus the fair market value of any property received other than money. § 1001(b). Gain or loss is realized from the exchange of property for other property differing materially either in kind or extent and is treated as income or loss sustained. Treas. Reg. § 1.1001-1(a); see *Helvering v. Bruun*, 309 U.S. at 468-69 (applying section 22 of the Revenue Act of 1932, ch. 209, 47 Stat. 169, 178, the predecessor of the current section 61(a), and holding that gain may be derived from the exchange of property, payment of a taxpayer's indebtedness, relief from liability, or other profit realized from the completion of a transaction). When property is exchanged for property in a taxable exchange, the taxpayer is taxed on the difference between the adjusted basis of the property given and the fair market value of the property received. *Williams v. Commissioner*, 37 T.C. 1099, 1106 (1962) (citing *Phila. Park Amusement Co. v. United States*, 126 F. Supp. 184, 188 (Ct. Cl. 1954)).

We calculate decedent's amount realized by taking the prepayment amount he received and subtracting his basis in the transactions, which consists of his payments to the VPFC holders and decedent's outstanding liability as a result of the second set of VPFCs in the moment immediately following the exchanges.

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

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

Code § 541 is intended to require most C Corporations with excess investment income to pay dividends.[57] "Undistributed personal holding company income" is the excess of a personal holding company's adjusted taxable income[58] over dividends paid or deemed paid.[59] Dividends paid or deemed paid include dividends paid during or shortly after[60] the taxable year, consent dividends[61] for the taxable year, and dividends carried over from a prior year[62] for purposes of this test.[63]

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

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

[59] Code § 545(a).

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

[61] A corporation and its shareholders may agree to deem dividends as paid on the last day of the corporation's taxable year, Code § 565(a), and contributed to the capital of the corporation by the shareholder on that last day. Code § 565(c). However, generally the deemed dividend must qualify under fn 57. Code § 565(b).

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

(1) For each of the 2 preceding taxable years there shall be determined the taxable income computed with the adjustments provided in section 545 (whether or not the taxpayer was a personal holding company for either of such preceding taxable years), and there shall also be determined for each such year the deduction for dividends paid during such year as provided in section 561 (but determined without regard to the dividend carryover to such year).

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

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

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

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

[63] Code § 561.

Code § 542(a) provides that, unless excluded from this tax,[64] a corporation is a "personal holding company" if:

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

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

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[64] Code § 542(c) excludes the following:
- (1) a corporation exempt from tax under subchapter F (sec. 501 and following);
- (2) a bank as defined in section 581, or a domestic building and loan association within the meaning of section 7701(a)(19);
- (3) a life insurance company;
- (4) a surety company;
- (5) a foreign corporation,
- (6) a lending or finance company if-
  - (A) 60 percent or more of its ordinary gross income (as defined in section 543(b)(1)) is derived directly from the active and regular conduct of a lending or finance business;
  - (B) the personal holding company income for the taxable year (computed without regard to income described in subsection (d)(3) and income derived directly from the active and regular conduct of a lending or finance business, and computed by including as personal holding company income the entire amount of the gross income from rents, royalties, produced film rents, and compensation for use of corporate property by shareholders) is not more than 20 percent of the ordinary gross income;
  - (C) the sum of the deductions which are directly allocable to the active and regular conduct of its lending or finance business equals or exceeds the sum of-
    - (i) 15 percent of so much of the ordinary gross income derived therefrom as does not exceed $500,000, plus
    - (ii) 5 percent of so much of the ordinary gross income derived therefrom as exceeds $500,000; and
  - (D) the loans to a person who is a shareholder in such company during the taxable year by or for whom 10 percent or more in value of its outstanding stock is owned directly or indirectly (including, in the case of an individual, stock owned by members of his family as defined in section 544(a)(2)), outstanding at any time during such year do not exceed $5,000 in principal amount;
- (7) a small business investment company which is licensed by the Small Business Administration and operating under the Small Business Investment Act of 1958 (15 U.S.C. 661 and following) and which is actively engaged in the business of providing funds to small business concerns under that Act. This paragraph shall not apply if any shareholder of the small business investment company owns at any time during the taxable year directly or indirectly (including, in the case of an individual, ownership by the members of his family as defined in section 544(a)(2)) a 5 per centum or more proprietary interest in a small business concern to which funds are provided by the investment company or 5 per centum or more in value of the outstanding stock of such concern; and
- (8) a corporation which is subject to the jurisdiction of the court in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) unless a major purpose of instituting or continuing such case is the avoidance of the tax imposed by section 541.

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

section 642(c) or a corresponding provision of a prior income tax law shall be considered an individual.

In calculating adjusted ordinary gross income, any business income is based on gross receipts, not net income.[65]

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

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

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

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

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

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

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

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

(ii) margin accounts, or

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

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

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

(B) the sum of-

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

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[65] Reg. § 1.542-2 begins:

> To meet the gross income requirement it is necessary that at least 80 percent of the total gross income of the corporation for the taxable year be personal holding company income as defined in section 543 and §§1.543-1 and 1.543-2. For the definition of "gross income" see section 61 and §§1.61-1 through 1.61-14. Under such provisions gross income is not necessarily synonymous with gross receipts.

The latter refers to the fact that basis, cost of goods sold, and similar items are subtracted.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(ii) deductions for royalties paid or accrued, and

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

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

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

(5) *Produced film rents*.

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

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

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

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

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

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

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

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

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

(7) *Personal service contracts*.

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

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

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

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

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

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

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

(ii) property taxes,

(iii) interest, and

(iv) rent,

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

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

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

(ii) property and severance taxes,

(iii) interest, and

(iv) rent,

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

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

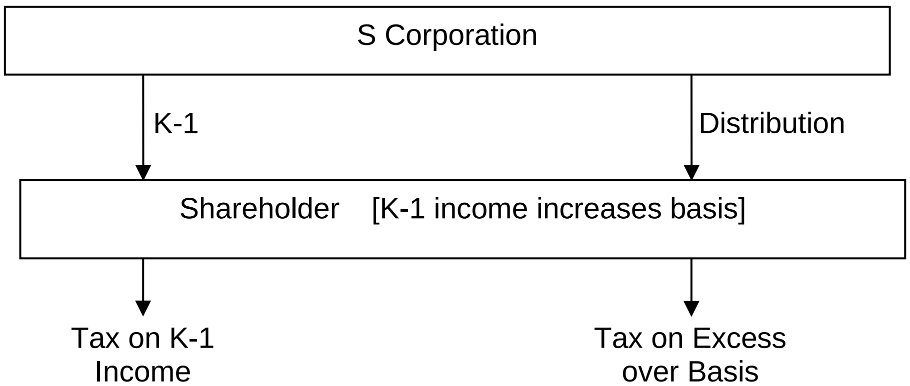
(i) interest received on a direct obligation of the United States held for sale to customers in the ordinary course of trade or business by a regular dealer who is making a primary market in such obligations, and

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

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

II.A.2. S Corporation

An S corporation is an entity taxed as a corporation whose income generally is taxed to its owners rather than being taxed to the entity itself;[66] the entity issues a Schedule K-1 to its owners each year to report the income. If the entity was never a C corporation:



Rather than using a corporation as the state law entity, consider using a limited liability company (or other unincorporated entity) that elects taxation as an S corporation.[67] Compared to a traditional corporation, an LLC or other unincorporated entity might offer better protection from an owner's creditors,[68] provide more flexibility in making distributions to pay the seller's taxes after a change in control,[69] allow the parties to control future actions,[70] and provide a nongrantor trust a better opportunity to materially participate[71] to avoid the 3.8% tax on net investment income.[72] However, there might be a slight risk that the LLC might not qualify for the S corporation exemption from self-employment tax.[73]

Note that, in the case of a seller-financed sale of goodwill, using a C corporation causes a triple tax, an S corporation causes a double tax, and a partnership causes a single tax.[74] When an owner dies, the assets of a sole proprietorship (including an LLC owned by an individual that has not elected corporate taxation) or a partnership (including an LLC owned by more than one person that has not elected corporate taxation) can obtain a basis step-up (or down) when an owner dies, whereas the assets of a C corporation or an S corporation do not receive a new basis.[75] For what might be an ideal structure, see part II.E Recommended Structure for Entities.

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

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[66] Code § 1363. See Hill and Anderson, "Computing S corporation Taxable Income: Unraveling the Mysteries of Section 1363(b)," *Business Entities* (WG&L), July/Aug. 2009.
[67] See text accompanying fn. 359 for how such an entity makes an S election.
[68] See part II.F.1 Business Entities and Creditors Generally.
[69] See part III.B.2.j.ii.(f) Distribution after Transfer.
[70] See part II.F.3 Limited Partnerships and LLCs as Control Vehicles.
[71] See parts II.K.1.a Counting Work as Participation and II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues (under II.K.2.b Participation by an Estate or Nongrantor Trust).
[72] See parts II.I 3.8% Tax on Excess Net Investment Income and II.I.8.a General Application of 3.8% Tax to Business Income.
[73] See part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election.
[74] See part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis.
[75] See part II.H.2 Basis Step-Up Issues.

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

An existing corporation would like to start paying dividends to its shareholders. However, as a regular corporation (described by tax practitioners as a C corporation), it would pay tax on its earnings, and its shareholders would pay tax on the dividends. The shareholders make an S election, so that they (rather than the corporation itself) are taxed on the corporation's earnings. The shareholders will not be taxed on dividends, to the extent that the dividends represent earnings that constitute reinvested earnings while the corporation was an S corporation.[76]

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

One of the shareholders decides to retire but would still like the company to pay him the substantial salary he is used to receiving. The shareholders have never formally agreed what would happen when one of them retires. If the company pays "compensation" to a shareholder who is not working, the IRS could try to disallow a deduction for the payment, claiming that it is really a dividend. The shareholders make an "S" election, so that they (rather than the corporation itself) are taxed on the corporation's earnings. Each shareholder receives a pro rata share of the corporation's earnings. The shareholders will not be taxed on dividends, to the extent that the dividends represent earnings while the corporation was an S corporation. At the same time, the shareholders agree on a formula for how much compensation each shareholder-officer will receive, so that the retired shareholder can be sure that the remaining shareholders do not receive all of the profits through compensation.

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

As new business owners, clients should be concerned with double taxation - once when the company earns profits, and again when the company pays dividends. Even if a reduced capital gain tax rate applies to dividends, one must add up two levels of federal income tax and two levels of state income tax. However, partnership income tax might not be desirable, either, since the owners generally must pay self-employment tax (under which the owner in effect pays the company's and the employee's share of Social Security and Medicare tax) on all of her share of the company's earnings. Instead, the client might want to pay payroll taxes on only what they receive as compensation and not pay self-employment tax on money that is reinvested in the business. As the business grows, clients do not want to pay self-employment tax on a return of their investment, just on compensation they receive for services they perform. It is possible that an S corporation may be an appropriate entity. However, in many cases taxpayers are better off starting as an LLC taxed as a partnership until undistributed self-employment earnings become material, then switch to a limited partnership with an S corporation general partner. See part II.E Recommended Structure for Entities, especially parts II.E.2.b and II.E.7.b Flowcharts: Migrating LLC into Preferred Structure.

Some tax professionals advise using an S corporation instead of a partnership to avoid Self-Employment (FICA) tax.[77] We will see later how a partnership is a much better entity for exit strategies than is a C corporation or even an S corporation.[78] Furthermore, aggressively

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[76] See part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally, especially fn. 4874.

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

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

characterizing payments to employee-shareholders as distributions rather than compensation can lead to penalties[79] and potentially loss of the tax preparer's license;[80] to avoid that problem, consider using a partnership of S corporations, so that any income that each corporation accumulates is not subject to FICA/self-employment tax and any payments actually made to the owner are subjected to FICA to the extent they constitute reasonable compensation.[81]

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[79] For a summary of cases, see Looney and Levitt, "Compensation Reclassification Risks for C and S corporations," *Journal of Taxation* (May 2015). Note the tips provided by Kirkland, "Helping S corporations avoid unreasonable compensation audits: Find out what entries on Forms 1120S may trigger these audits," *Journal of Accountancy* (6/1/2015). See IRS Fact Sheet 2008-25, "Wage Compensation for S corporation Officers," http://www.irs.gov/uac/Wage-Compensation-for-S-Corporation-Officers and "S Corporation Compensation and Medical Insurance Issues," https://www.irs.gov/businesses/small-businesses-self-employed/s-corporation-compensation-and-medical-insurance-issues (lasted visited 9/2/2017), as well as http://www.irs.gov/Businesses/Valuation-of-Assets (which includes reasonable compensation issues); Rev. Rul. 74-44; *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990) (law firm); *Joly v. Commissioner*, T.C. Memo 1998-361 (20% penalty assessed when S corporation treated compensation as loans); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990) (accounting firm); *Dunn & Clark, P.A. v. Commissioner*, 853 F.Supp. 365 (D. Idaho 1994) (law firm); *Wiley L. Barron, CPA, Ltd. v. Commissioner*, T.C. Summary Opinion 2001-10 (CPA firm); *Yeagle Drywall Co. v. Commissioner*, T.C. Memo. 2001-284 (drywall construction business); *Veterinary Surgical Consultants P.C. v. Commissioner*, 117 T.C. 141 (2001) (consulting and surgical services provided to veterinarians); *Joseph M. Grey, P.C. v. Commissioner*, 119 T.C. 121 (2002) (accounting firm); *Nu-Look Design Inc. v. Commissioner*, 356 F.3d 290 (3rd Cir. 2004) (residential home improvement company); see *Herbert v. Commissioner*, T.C. Summary Opinion 2012-124 (taxpayer claimed only $2,400 of compensation; IRS alleged $55,000 in compensation; court used taxpayer's approximately $30,000 average annual compensation; penalties do not appear to have been imposed on wages but were imposed on other items); *Sean McAlary Ltd, Inc. v. Commissioner*, T.C. Summary Opinion 2013-62 (taxpayer penalized for failing to report any compensation; court reject IRS' expert's reliance on merely a percentage of gross receipts, instead computing an hourly wage based on its view of the cases: "the employee's qualifications, the nature, extent, and scope of the employee's work, the size and complexity of the business, prevailing general economic conditions, the employee's compensation as a percentage of gross and net income, the employee/shareholder's compensation compared with distributions to shareholders, the employee/shareholder's compensation compared with that paid to non-shareholder/employees, prevailing rates of compensation for comparable positions in comparable concerns, and comparable compensation paid to a particular shareholder/employee in previous years where the corporation has a limited number of officers"). The IRS might even recharacterize purported repayments of open account indebtedness as compensation, even when the amounts significantly exceed the K-1 income; see *Glass Blocks Unlimited v. Commissioner*, T.C. Memo. 2013-180, discussed in fn. 1220. For more detailed summaries and additional cases, see Christian & Grant, "¶34.06. Reasons for Payment of Salaries," *Subchapter S Taxation* (WG&L). However, it appears that, in a professional services firm, the IRS might concede that a significant portion of distributions are not subject to FICA. See footnote 3502.

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

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

At http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/S-Corporation-Compensation-and-Medical-Insurance-Issues (IRS last reviewed or updated 4/20/2022) (not precedent), the IRS commented:

> The key to establishing reasonable compensation is determining what the shareholder-employee did for the S corporation by looking to the source of the S corporation's gross receipts.
>
> The three major sources are:
>
> 1. Services of shareholder
> 2. Services of non-shareholder employees or
> 3. Capital and equipment
>
> To the extent gross receipts are generated by services of non-shareholder employees and capital and equipment, payments to the shareholder would properly be treated as non-wage distributions that are not subject to employment taxes.
>
> But to the extent gross receipts are generated by the shareholder's personal services, then payments to the shareholder-employee should be classified as wages that are subject to employment taxes.
>
> In addition to gross receipts generated directly by the shareholder-employee, the shareholder-employee should also be subject to wage treatment for administrative work performed by him for the other income-producing employees or assets. For example, a manager may not directly produce gross receipts, but he assists the other employees or assets which are producing the day-to-day gross receipts.
>
> Some factors in determining reasonable compensation:
>
> - Training and experience
> - Duties and responsibilities
> - Time and effort devoted to the business
> - Dividend history
> - Payments to non-shareholder employees
> - Timing and manner of paying bonuses to key people
> - What comparable businesses pay for similar services
> - Compensation agreements
> - The use of a formula to determine compensation

Some owners who are also officers try to pay themselves outside of the payroll system and call it nonemployee compensation. However, as officers, they are employees,[82] and payments to them for services are wages.[83] Rev. Rul. 82-83 held that a corporation that treats officers as independent contractors rather than as employees when they are performing duties normally within the scope of duties of a corporate officer is absolutely not entitled to relief under section 530 of the Revenue Act of 1978:

> Sections 3121(d) and 3401(c) of the Internal Revenue Code, applicable to the Federal Insurance Contributions Act and income tax withholding, respectively, provide that the

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[82] Reg. § 31.3121(d)-1(b) provides:

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

Rev. Rul. 71-86 addressed the following:

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

The ruling concluded:

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

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

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

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

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

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

[83] See fn. 82 and *Veterinary Surgical Consultants P.C. v. Commissioner*, 117 T.C. 141 (2001) (consulting and surgical services provided to veterinarians); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990) (accounting firm); *Durando v. U.S.*, 70 F.3d 548 (9th Cir. 1995) (amount shown on Form 1099-MISC did not constitute earnings that a shareholder could use to create a self-employed person's retirement plan).

> term “employee” includes any officer of a corporation. Section 3306(i), applicable to the Federal Unemployment Tax Act, includes within the meaning of the term “employee” the meaning assigned by section 3121(d).
>
> Section 31.3121(d)-1(b) of the Employment Tax Regulations states that, generally, an officer of a corporation is an employee of the corporation. However, an officer of a corporation who as such does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any pay is considered not to be an employee of the corporation. For instance, directors of corporations in their capacity as such are not employees of the corporations.
>
> Rev. Rul. 71-86, 1971-1 C.B. 285, holds that when an individual who is the president and sole shareholder, except for qualifying shares, of a closely held corporation performs services as an officer of the corporation, the president is an employee for purposes of employment taxes and income tax withholding, even though all services performed and the amount of compensation for them are under the individual’s complete control.
>
> Rev. Rul. 73-361, 1973-2 C.B. 331, holds that a stockholder-officer of an electing small business corporation who performs substantial services as an officer of the corporation is its employee for purposes of the FICA, the FUTA, and income tax withholding.
>
> In *Royal Theatre Corp. v. United States*, 66 F.Supp. 301 (D. Kan. 1946), the sole shareholder and president of two corporations contracted with each for him to manage each corporation’s operations and to determine matters of policy for each corporation. The court observed that compensation an officer receives for services as an officer is subject to social security taxes, and held that the contracts by which the president of each corporation purportedly managed the affairs of each corporation as an independent contractor could be disregarded in determining the reality of the situation.
>
> It is a question of fact in all cases whether officers of a corporation are performing services within the scope of their duties as officers or whether they are performing services as independent contractors. Here, the duties being performed customarily fall within the scope of duties of corporate officers. Involved are fundamental decisions regarding the operation of the corporation. Such decisions are rarely delegated to independent contractors, and are customarily made by corporate officers or other employees. Thus, since the officers are performing substantial services typical of officers and are paid for those services, they are employees of the corporation for purposes of federal tax law. Therefore, even though the corporation calls the officers’ pay “draws” rather than “salaries,” there is no reasonable basis for treating the officers as other than employees, even under a liberal application of the reasonable basis rule of section 530 of the Act.

The Redi Foundation, Inc. v. Commissioner, T.C. Memo. 2022-34, held:

> Turning next to petitioner’s initial argument, we find that petitioner has pointed to no credible evidence that Mr. Abraham worked for or was engaged by petitioner in a capacity other than as an officer. See *Joseph M. Grey Pub. Acct., P.C.*, 119 T.C. at 130; Rev. Rul. 82-83, 1982-1 C.B. 151, 152 (stating that an officer’s potential dual capacity is “a question of fact” and concluding that officer was statutory employee when duties involved “fundamental decisions regarding the operation of the corporation”). The only

> items in the record that could suggest a separate independent contractor relationship are the Form 1099-MISC reporting nonemployee compensation and Mr. Abraham's own testimony that he served petitioner in a dual capacity. Without support from other evidence - such as a written service contractor agreement between petitioner and Mr. Abraham - the Form 1099-MISC and the self-serving testimony are entitled to little evidentiary weight and cannot sustain petitioner's burden. See *Joseph M. Grey Pub. Acct., P.C.*, 119 T.C. at 130; see also *Blossom Day Care Centers, Inc. v. Commissioner*, T.C. Memo. 2021-86, at *13–14; *Cent. Motorplex, Inc. v. Commissioner*, T.C. Memo. 2014-207, at *9; *Veterinary Surgical Consultants, P.C. v. Commissioner*, 2003 WL 548572, at *7.
>
> Mr. Abraham was the sole person in charge of overseeing and executing the online course (petitioner's only business activity); he necessarily provided a wide variety of services to petitioner, including managerial decisions about the content, marketing, and enrollment of the online course. See *Joseph M. Grey Pub. Acct., P.C.*, 119 T.C. at 129-30 & n.7 (rejecting dual capacity argument where officer was sole provider of managerial and accounting services to petitioner, and stating that "fundamental decisions regarding the operation of the corporation...are customarily made by corporate officers or other employees" (quoting *Van Camp & Bennion v. United States*, 251 F.3d 862, 866 (9th Cir. 2001))); see also *Spicer Acct., Inc. v. United States*, 918 F.2d 90, 95 (9th Cir. 1990) ("[A] corporation's sole full-time worker must be treated as an employee."). On the record before us, we see no clear distinction between Mr. Abraham's role as a corporate officer and his provision of services to the corporation. We conclude that petitioner has failed to carry its burden of establishing that Mr. Abraham was engaged in dual roles as both an employee and an independent contractor.

The court rejected the argument that the taxpayer had a reasonable basis for treating the officer as an independent contractor due to a purportedly longstanding industry practice:

> But it is well settled by this Court that the scope of Act section 530 relief is limited to common law worker classification determinations. See *Joseph M. Grey Pub. Acct., P.C.*, 119 T.C. at 132; see also *Charlotte's Office Boutique*, 121 T.C. at 109 n. 10. In providing Act section 530 relief, Congress did not intend for relief to be available in situations where an individual - such as a corporate officer - was already classified as an employee by statute.[6] See *Joseph M. Grey Pub. Acct., P.C.*, 119 T.C. at 132-33 (analyzing legislative history and concluding that section 530 relief was not available for statutory employees). Because we conclude that Mr. Abraham is a statutory employee under section 3121(d)(1), Act section 530 relief is not available to petitioner. *See*, *e.g.*, *Loughman v. Commissioner*, T.C. Memo. 2018-85, at *11–12; *Donald G. Cave A Pro. Law Corp. v. Commissioner*, T.C. Memo. 2011-48, 2011 WL 802696, at *13, *aff'd per curiam*, 476 F. App'x 424 (5th Cir. 2012).
>
>> [6] With *certain limited statutory exceptions*, the classification of particular workers or classes of workers as employees...for purposes of Federal employment taxes must be made under common law rules...The bill provides an interim solution for controversies between the [IRS] and taxpayers involving whether certain individuals are employees *under interpretations of the common law*....
>>
>> H. R. Rep. No. 95-1748, at 3, 4 (1978) (emphasis added).

Based on a couple of dismissals it procured,[84] the IRS takes the position that the Tax Court has no jurisdiction to review the IRS' determinations of employment taxes on shareholder-employees and has instructed its examiners how to attain this result;[85] the IRS asserts that the

[84] About 15 months after the IRS issued PMTA cited in fn 85, in *Azarian, P.A. v. Commissioner*, 897 F.3d 943 (2018), the Eighth Circuit agreed with the Tax Court that the Tax Court had no jurisdiction when the amount of wages was an issue and the service provider was admittedly an employee.

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

> In the scenario you provided, there is no dispute that the corporate officers are employees of the taxpayer under section 3121(d)(1) and that certain amounts were treated as wages for employment tax purposes. Rather, the dispute is limited to the correct amount of payments required to be treated as "wages" for employment tax purposes, *i.e.* whether the additional payments constitute wages, rather than dividends or distributions, return of capital, loan repayments, distributions in excess of reasonable compensation, or other non-service related type payments. Nor is there any dispute concerning entitlement to Section 530 relief.
>
> Accordingly, the Service is not making a determination regarding the employment status of the corporate officers when it recharacterizes certain payments as wages that were not treated as wages. The Service is also not making a determination with respect to the taxpayer's entitlement to Section 530 relief. Since the Service has not made a determination with respect to either of the two requisite matters specified in § 7436(a)(1) or (2), the Tax Court lacks jurisdiction to determine the correct amount of employment taxes due as a result of the employment tax assessment under section 6201 on the additional wages.
>
> The position taken in this memorandum is consistent with two recent Tax Court Orders with respect to cases described below. (Copies of the Orders are attached to this memorandum).
>
> In *Martin S. Azarian, P.A. v. Commissioner*, Docket No. 28957-15, Petitioner, an S corporation, treated its sole owner and officer, Mr. Azarian, as an employee during the taxable periods at issue and reported wages paid to Mr. Azarian on Forms W-2. Respondent sent petitioner Forms 4668, Employment Tax Examination Changes Report, which (1) concluded that petitioner failed to report reasonable compensation paid to Mr. Azarian for the taxable periods at issue, (2) proposed increased annual wages to Mr. Azarian for those periods, and (3) concluded that petitioner was liable for proposed employment tax increases and additions to tax. Respondent did not issue a Letter 3523 to petitioner.
>
> Nevertheless, petitioner filed a petition requesting the Court overturn respondent's findings. Respondent filed a Motion to Dismiss for Lack of Jurisdiction on the grounds that (1) no Notice of Determination of Worker Classification was sent to petitioner, and (2) no other determination was made by respondent which would confer jurisdiction on the Court.[3]
>
> > [3] Motions to dismiss for lack of jurisdiction, citing the grounds that a Notice of Determination of Worker Classification was not issued, were filed in several cases before the Service concluded that such notices were no longer a jurisdictional prerequisite to Tax Court Review in line with the Court's decision in *SECC*. See Chief Counsel Notice 2016-002.
>
> On February 21, 2017, the Tax Court issued an Order dismissing the case for lack of jurisdiction. The Court found that respondent did not make a determination under section 7436(a)(2) regarding whether petitioner was entitled to relief under Section 530. The Court also found that since petitioner consistently treated Mr. Azarian as an employee for the taxable periods at issue, respondent did not make a determination that Mr. Azarian was an employee of petitioner under section 7436(a)(1). The Court stated, "Section 7436(a)(1) only confers jurisdiction upon this Court to determine the ["]correct and the proper amount of employment tax["] when respondent makes a worker classification determination, not when respondent concludes that petitioner underreported reasonable wage compensation, as is the case here."
>
> Similarly, in *Patricia Arroyo DDS, Corp., Alex Mansilla and Mercedes P. Arroyo v. Commissioner* , Docket No. 5874-15, the Tax Court dismissed the case with respect to Patricia Arroyo DDS Corp. (DDS Corp.) for lack of jurisdiction finding that the Service had not made any determinations for purposes of section 7436. In this case the Service determined that the amounts treated as

analysis does not change when the service recipient uses a professional employer organization (PEO) to pay compensation to its sole corporate officer, even when the PEO issues Forms W-2 using its own EIN.[86] In this context, employment taxes mean Federal Insurance Contributions

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> salaries paid to the corporate officers and reported on Form W-2 as wages were artificially low, recharacterized higher amounts as salaries, and thus as wages, based on nationwide market information, and assessed additional employment taxes. Petitioners asserted that the amounts treated as salaries paid by DDS Corp were appropriate and contended the Court had jurisdiction as to the amount of employment taxes owed.
>
> On February 23, 2017, the Tax Court issued an Order dismissing the case for lack of jurisdiction. The Tax Court stated that petitioner consistently treated the corporate officers as employees and contested only respondent's determination that the compensation paid to the corporate officers was inadequate. The Court stated that because respondent did not make a determination with respect to either of the two requisite matters specified in section 7436(a)(1) or (2), the Court lacked jurisdiction to determine the correct amount of employment taxes due as a result of respondent's determination that DDS Corp under-reported corporate officers' wages during the tax years at issue.

[86] CCA 201735021, in which:

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

The CCA asserted:

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

Act (FICA) taxes, Federal Unemployment Tax Act (FUTA) taxes, and Federal income tax withholding.[87] Rev. Proc. 2022-13, § 3.01, "Jurisdictional requirements," assets:

> The Tax Court has jurisdiction under § 7436 only if all the following four requirements are satisfied:
>
> (1) the IRS conducts an examination in connection with an audit of any person;
>
> (2) as part of the audit, the IRS determines that
>
> (a) one or more individuals performing services for the person are employees of the person for purposes of subtitle C (worker reclassification), or
>
> (b) the person is not entitled to the relief under section 530(a) with respect to such an individual (section 530 relief);
>
> (3) there is an "actual controversy" involving the determination as part of an examination; and
>
> (4) the person for whom the services at issue were performed files an appropriate pleading in the Tax Court.

Ward v. Commissioner, T.C. Memo. 2021-32, reasoned and held:

> For all years at issue in these cases, the Commissioner argues that the firm did not pay employment taxes on all the wages that Ward received. The disagreement is largely about what the firm calls the "officer compensation" that it paid Ward.[8] The firm acknowledges that some of this compensation was salary or wages, but says the rest constituted distributions of the firm's earnings and profits.[9]

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the PEO - for employment tax purposes, *i.e.* whether the additional payments constitute wages, rather than distributions.

[87] Footnote 1 of PMTA 2017-05, cited in fn. 85. Regarding the 0.9% additional Medicare tax on earned income over $250,000 (married filing jointly), $125,000 (married filing separately), or $200,000 (all others), PMTA 2019-006 (6/28/2019) concluded:

1. Yes. The "Additional Medicare Tax" imposed under I.R.C. § 1401(b)(2) is subject to the deficiency procedures under sections 6211-6213 since it is an income tax imposed under subtitle A of the Internal Revenue Code.
2. No. The "Additional Medicare Tax" imposed under I.R.C. § 3101(b)(2) is not subject to the deficiency procedures under sections 6211-6213 since it is a tax imposed under subtitle C of the Internal Revenue Code.
3. The filing of the Form 1040, U.S. Individual Income Tax Return, starts the running of the period of limitations for assessment with respect to the "Additional Medicare Tax" imposed under section 3101(b)(2).
4. Form SS-10, Consent to Extend the Time to Assess Employment Taxes, should be used to extend the period of limitations for assessment with respect to the employer's withholding liability pursuant to section 3102. To extend the period of limitations for assessment with respect to the employee's liability for "Additional Medicare Tax" imposed under section 3101(b)(2), the best practice is to use the Form 872, Consent to Extend the Time to Assess Tax.

The reference to Code § 3101(b)(2) is employee withholding and to Code § 1401 is to self-employment tax; see part II.L Self-Employment Tax (FICA).

[8] The firm didn't claim to pay any "officer compensation" in 2013. Ward instead claimed $48,136 as "Wages/Draws" on her personal return. Like the officer compensation from the previous two years, the Commissioner argues it's all wages.

[9] The firm also says that portions of those distributions should not be taxed because they were returns of Ward's basis in the firm. Under section 1368(a) and (b) an S corporation shareholder doesn't have to include distributions from the corporation in income if she has basis in the corporation that exceeds the amount distributed. Unfortunately for the firm, even if we were to accept that it paid Ward distributions in any amount, there is no evidence of what basis, if any, she had in the firm for any of the years before us.

The parties now agree that Ward is indeed an employee of the firm. (Under the Code, officers are employees. Sec. 3121(d)(1).) Any compensation paid to Ward in her role as an officer is considered wages. See *Joseph M. Grey Pub. Accountant, P.C. v. Commissioner*, 119 T.C. 121, 129-130 (2002), *aff'd*, 93 F. App'x 473 (3d Cir. 2004). It's settled law that the firm is liable for employment taxes on these wages.

The firm offers no evidence other than Ward's own testimony that any of these payments were anything but compensation. The firm, therefore, is liable for employment taxes on all amounts that the Commissioner identified as officer compensation.[10]

[10] The firm, while acknowledging that Ward was an employee who received compensation, nonetheless requests at various points in its brief that Ward's compensation be taxed directly to her as self-employment income. Since there's no evidence that Ward's work for the firm was as anything other than its officer, we deny this request.

Section 530 of the Revenue Act of 1978 relieves some firms from liability in situations somewhat like this. A firm that has consistently not treated an individual as an employee isn't liable for employment tax on compensation paid to that individual unless the firm had no reasonable basis for not treating the individual as an employee. See Revenue Act of 1978, Pub. L. No. 95-600, sec. 530(a)(1) and (2), 92 Stat. at 2885-86; see also *Donald G. Cave a Prof'l Law Corp. v. Commissioner*, T.C. Memo. 2011-48, 101 T.C.M. (CCH) 1224, 1231 (2011), *aff'd per curiam*, 476 F. App'x 424 (5th Cir. 2012). Here, though, we find the firm had no reasonable basis for treating Ward as anything other than an employee. The Code is clear that officers are employees. See sec. 3121(d)(1). Ward stated that she was an employee. And by filing Forms 941, the firm showed it was aware that it had to pay employment taxes on wages.

Here are some ways that taxpayers trip themselves up:

- Sometimes they try to deduct various expenses on Schedule C, which reports income as a sole proprietor. This position asserts that expenses are netted against their income.
    - The IRS will say that the income constitutes Form W-2 wages, and the expenses are deductible as employee business expenses (Form 2106). Employee business expenses constitute miscellaneous itemized deductions, from which 2% of the taxpayer's adjusted gross income is subtracted. This reduced number is subject to other limitations imposed on itemized deductions and is disallowed in computing alternative minimum tax.

- If the owner-employee had run these expenses through the company using an "accountable plan,"[88] then they would be fully deductible (subject to any limitations imposed on business deductions) and netted against business income. By not using this mechanism, the owner-employee forgoes the benefits of an accountable plan.

- Qualified retirement plans (including Code § 401(k) plans) provide current deductions and provide tax-deferred income and growth (as well as protection from creditors). For an S corporation, contributions are based only on wage income (as one taxpayer discovered the hard way).[89] Properly declaring wages gives the owner-employee an opportunity to develop a thoughtful qualified retirement plan.

Because each separate employer generally must pay FICA, if a person works for more than one related company then one company might pay the compensation to the person and collect a management fee (or fees under an employee leasing arrangement) from the other related companies. When doing so, carefully document the arrangements, to avoid mistakes like what the taxpayer made in *Blossom Day Care Centers, Inc. v. Commissioner*, T.C. Memo. 2021-86, which reasoned and held:

> **II. Worker Classification**
>
> For the purposes of respondent's determination, "employee" is defined for FICA and FUTA purposes to include "any officer of a corporation". See secs. 3121(d)(1) and (2), 3306(i). For purposes of income tax withholding under section 3402, the term "employee" also includes "an officer of a corporation". See sec. 3401(c). FICA and FUTA impose "employment taxes" that employers must pay and are obligated to withhold in addition to income tax withholding under section 3402. Employers are required to make periodic deposits of amounts withheld from employees' wages and amounts corresponding to the employer's share of FICA and FUTA tax. Secs. 6302, 6157; secs. 31.6302-1, 31.6302(c)-3, Employment Tax Regs.
>
> **III. Petitioner's Corporate Officers**
>
> An officer of a corporation who performs more than minor services and receives remuneration for such services is a "statutory" employee for employment tax purposes. See *Joseph M. Grey Pub. Accountant, P.C. v. Commissioner*, 119 T.C. 121, 126 (2002), *aff'd*, 93 F. App'x 473 (3d Cir. 2004); *Central Motorplex, Inc. v. Commissioner*, T.C. Memo. 2014-207; *Glass Blocks Unlimited v. Commissioner*, T.C. Memo. 2013-180; *Nu-Look Design, Inc. v. Commissioner*, T.C. Memo. 2003-52, 85 T.C.M. (CCH) 927, 931 (2003), *aff'd*, 356 F.3d 290 (3d Cir. 2004); secs. 31.3121(d)-1(b), 31.3306(i)-1(c), 31.3401(c)-1(f), Employment Tax Regs. An officer can escape statutory employee status only if he performs no services (or only minor services) for that corporation and neither receives nor is entitled to receive any remuneration, directly or indirectly, for services performed. See *Veterinary Surgical Consultants, P.C. v. Commissioner*, 117 T.C. 141, 144-145 (2001), *aff'd sub nom. Yeagle Drywall Co. v. Commissioner*, 54 F. App'x 100 3d Cir. 2002); secs. 31.3121(d)-1(b), 31.3306(i)-1(e), 31.3401(c)-1(f), Employment Tax Regs.

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[88] Reg. § 1.62-2.

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

Petitioner has stipulated that the Hackers were corporate officers during all of the calendar quarters and years 2005 through 2008. Both provided substantial services far beyond minor services, and both directly and indirectly received remuneration for their services. Mrs. Hacker was petitioner's 51% shareholder and acted as president of the corporation and director of curriculum and education for all six child care locations and supervised over 90 employees and students of those centers. See *Nu-Look Design, Inc. v. Commissioner*, 85 T.C.M. (CCH) at 931-932 (characterizing as statutory employee S corporation shareholder who served as corporation's president). Mr. Hacker was 49% shareholder and acted as vice president, secretary, and treasurer; as director of Blossom Day Care Centers; and as director of accounting and finance for petitioner. Both Mr. and Mrs. Hacker had check-signing authority over petitioner's bank accounts and credit card authorization in their corporate capacity.

In addition, Mr. Hacker's daily responsibilities included but were not limited to depositing parents' payments for child care and personally writing all of the payroll checks to petitioner's 90 employees. Both Mr. and Mrs. Hacker provided numerous services to petitioner, any one of which could be considered substantial. Both received direct and indirect remuneration in the form of cars for themselves, a Lexus and a Hummer; cars for their children and relatives; credit cards; and access to all cash distributions.

Petitioner has asserted that it operates under an oral management contract and pays management fees to a related S corporation, Hacker Corp., to provide services, and that the Hackers, as employees of Hacker Corp., provide services to petitioner and its day care centers. Whether a corporate officer is performing services in his capacity as an officer is a question of fact. Joseph M. Grey Public Accounting, P.C. v. Commissioner, 119 T.C. at 129-130; Rev. Rul. 82-83, 1982-1 C.B. 151, 152. The conclusion that a corporate officer is a statutory employee may not apply to the extent that he or she performs services in some other capacity. *Nu-Look Design, Inc. v. Commissioner*, 85 T.C.M. (CCH) at 931-932.

Petitioner did pay Hacker Corp. money classified as management fees on its general ledger for the years at issue in the following amounts: $382,650 in 2005, $378,484 in 2006, $0 in 2007, and $204,514 in 2008. From these management fees, Hacker Corp. paid Form W-2 wages to the Hackers for 2005 through 2008 of $73,848, $40,000, $53,847, and $58,462, supposedly for the services the Hackers were to render to petitioner under an oral management contract. Petitioner has submitted no evidence of a management agreement, either written or oral, with Hacker Corp. Likewise, petitioner has submitted no evidence, written or otherwise, as to a service agreement directing the Hackers to perform substantial services on behalf of Hacker Corp. to benefit petitioner, or even a service or employment agreement between the Hackers and Hacker Corp. Therefore, there is no evidence in the record that Mr. Hacker or Mrs. Hacker performed services in a capacity other than as a corporate officer.

The Court finds that the Hackers were both "statutory" employees of petitioner for employment tax purposes for all calendar quarters and years of 2005 through 2008. Having made that determination, the Court is not required to consider whether they would also be classified as "employees" under the common law test. See *Nu-Look Design, Inc. v. Commissioner*, 356 F.3d at 293.

IV. Reasonableness of Compensation

> Petitioner also contends that, even if the Court determines that its corporate officers are statutory employees, the determination of additional wages paid to the Hackers should be no more than the difference between what was paid to the Hackers as Form W-2 employees of Hacker Corp. and the reasonable wage determinations of respondent. Petitioner's arguments are misguided in that wages paid by Hacker Corp. do not offset reasonable compensation requirements for the services provided by petitioner's corporate officers to petitioner. Whatever wages paid for whatever purposes by Hacker Corp. to the Hackers as employees of the S corporation will be better addressed in relation to respondent's notice of deficiency for the Hackers' individual income tax, in consideration that Hacker Corp. is a wholly owned S corporation.
>
> Additionally, petitioner contends that the notice of determination is flawed in that the determined compensation reflects requirements of higher educational qualifications than either Mr. Hacker or Mrs. Hacker has achieved, since Mr. Hacker did not graduate from college and Mrs. Hacker has only an associate's degree in child development. While petitioner has not further developed this contention in its briefs and there was limited trial testimony on the topic, whatever higher educational qualifications might be required have been far eclipsed by the Hackers' practical experience, professional qualifications, success in running day care centers, and ownership prerogatives.
>
> Reasonableness of compensation is a question determined by all the facts and circumstances of the case. *E.g.*, *Glass Blocks Unlimited v. Commissioner*, at *13; *Joly v. Commissioner*, T.C. Memo. 1998-361, 1998 WL 712528, at *4, *aff'd without published opinion*, 211 F.3d 1269 (6th Cir. 2000). Factors affecting the reasonableness of compensation include the employee's role in the company, comparisons of the employee's salary to those paid by similar companies for similar services, and the character and condition of the company. *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1245-1246 (9th Cir. 1983), *rev'g* T.C. Memo. 1980-282; see also *Pepsi-Cola Bottling Co. of Salina, Inc. v. Commissioner*, 528 F.2d 176, 179 (10th Cir. 1975), *aff'g* 61 T.C. 564 (1974). The Court does not find persuasive petitioner's evidence that the services provided by the Hackers were worth something less than respondent's determination. Once again, although the issue was passingly addressed in evidence at trial, petitioner's briefs have failed to show why respondent's determination is unreasonable and, accordingly, petitioner has not carried its burden to show that the amounts respondent determined are unreasonable compensation.

The court then imposed penalties. Note that the taxpayer claimed that essentially the officers were leased employees because the corporation paid a related company that employed them a management fee that covered their services. The court rejected that argument, because there was no evidence of a management agreement, either written or oral, with that related company and no evidence, written or otherwise, as to a service agreement directing the officers to perform substantial services on behalf of the related company to benefit the corporation, or even a service or employment agreement between the officers and the related company. This failure to document the basis for a management agreement was also the taxpayers' downfall in a C corporation dividend case decided the same year as this case; see part II.A.1.b.ii Compensating Owner(s) with Management Fees.

For the S corporation's earnings to avoid self-employment tax, the S corporation must actually have received the income. See part II.G.24 Taxing Entity or Individual Performing Services.

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

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

A trust owning stock in an S corporation may be converted into a QSST – a trust in which the beneficiary pays the tax on the trust's current and accumulated income.[90] See part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs for discussions of how to:

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

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

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

For nontax issues, an unincorporated entity may be more attractive than a state law corporation. See part II.F.1 Business Entities and Creditors Generally.

The courts have created special rules expanding Code § 2036 to cause partnerships to be disregarded for estate tax purposes, artificially increasing the value included in the owner's estate unless the taxpayer proves that each entity was created for a "legitimate and significant nontax reason;"[91] this increase may cause double inclusion of the appreciation of the retained

[90] See part III.A.3.e QSSTs and ESBTs for a description of how QSSTs work and creative planning opportunities.
[91] For *Bongard* and related cases regarding scrutiny of a family business entity for estate tax purposes, see part III.C.1 Whether Code § 2036 Applies.

partnership interest.[92] S corporation owners can avoid this issue by retaining voting stock and transferring nonvoting stock.[93]

Although the "check-the-box" rules generally apply for all tax purposes,[94] an LLC case held that state law property attributes control for gift tax purposes.[95] "Partnership" and "corporation" are not defined for gift and estate purposes, so it is unclear how the rules described in the prior paragraph may apply to an LLC taxed as an S corporation. To deal with that uncertainty, consider converting the LLC to a corporation taxed as an S corporation (or a single member disregarded entity of such a corporation) in a tax-free organization as described in part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization and elaborated upon in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).

Code § 6166 provides estate tax deferral for closely-held businesses.[96] Tiered structures create significant limitations on the election and sometimes uncertainty as to whether the election is available.[97] However, if an S corporation is structured with multiple wholly owned subsidiaries, the parent of all of the subsidiaries should be treated as one entity for purposes of Code § 6166;[98] no authority directly addresses this conclusion, so one might consider obtaining

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

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

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

[94] See part II.B Limited Liability Company (LLC).

[95] *Pierre*, a 2009 reviewed Tax Court opinion described in fn. 4041, held that, for gift tax purposes, the transfer of a partial interest in an LLC must be valued as an interest in the LLC as an entity rather than an interest in the underlying assets, even though before the transfer all of the assets were deemed owned directly by the sole member for income tax purposes. *Pierre* squarely held that the check-the-box rules do not override property rights, because state law property rights are fundamental to gift taxation. See part III.B.1.e Valuation Issues. *Mirowski v. Commissioner*, T.C. Memo. 2008-74, approved the nontax reasons for forming a single member LLC that was disregarded for income tax purposes, which approval was helpful when gifts of LLC interests were made later. *Mirowski* did not address the check-the-box rules.

[96] See part III.B.5.e.ii Code § 6166 Deferral.

[97] See part III.B.5.e.ii.(b) Tiered Structures.

[98] See part II.A.2.g Qualified Subchapter S Subsidiary, especially the text accompanying fns. 178-187.

a private letter ruling confirming this result (if the IRS is willing to rule on this issue, which likely would be only for a decedent).[99]

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

S corporations include the following disadvantages relative to partnership taxation:

- Perhaps more difficult to deduct start-up losses.[100]
- Less advantageous seller-financed sales to key employees or others.[101]
- No inside basis step-up when an owner sells in a taxable sale or dies.[102]
- Possible unavailability of a tax-free split-up of the entity, which might be very important when a trust terminates and is divided among beneficiaries.[103]
- The sale of S corporation stock and an S corporation's actual or deemed sale of its assets constitute unrelated business income per se, so charitable strategies are much less attractive.[104] Same with any K-1 income from an S corporation; if a marital trust terminates in favor of charity, consider converting the S corporation to an LLC taxed as an S corporation, so that the S corporation can be liquidated into a partnership or disregarded entity retroactive to immediately after the surviving spouse's death by the LLC revoking its election to be taxed as a corporation within 75 days after death.[105]

A structure that avoids these concerns, saves self-employment tax the way an S corporation would, and reduces the possibility of the 3.8% tax on net investment income being imposed on rent income is described in part II.E Recommended Structure for Entities. This structure is a limited partnership that has an S corporation general partner, which can avoid Code § 2036 issues and provide a limited partnership's superior income tax attributes. Owners of entities taxed as partnerships and owners of S corporations should consider migrating towards this structure.[106]

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[99] Rev. Proc. 2016-3, Section 3.1(118) says that the IRS will not rule on Code § 6166 "if there is no decedent."
[100] See part II.G.4.c Basis Limitations for Deducting Partnership and S Corporation Losses.
[101] See part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis.
[102] See parts II.H.2 Basis Step-Up Issues and II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation.
[103] See generally part II.Q.7 Exiting from or Dividing a Corporation; for the steps required to have a tax-free corporate split-up, see part II.Q.7.f.ii Code § 355 Requirements. For partnership divisions, see part II.Q.8 Exiting From or Dividing a Partnership.
[104] See part II.Q.6 Contributing a Business Interest to Charity to place context to part II.Q.6.d.ii UBTI Related to an S Corporation. Also, a charitable remainder trust cannot hold stock in an S corporation. See fn. 4908 in part II.Q.7.c S Corporation Owned by a Trust Benefitting Charity.
[105] Reg. § 301.7701-3(c)(iii).
[106] For migrating an S corporation, see parts II.Q.7.h Distributing Assets; Drop-Down into Partnership and II.E.9 Real Estate Drop Down into Preferred Limited Partnership.

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

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

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

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

- If the limited partnership has no other owners and all of the deceased owner's successors want S corporation status, then the limited partnership could elect S corporation status; note, however, that a limited partnership must have at least two separate owners – a general partner and a limited partner.[107] However, because an S corporation cannot have another S corporation as a shareholder unless the other latter is the former's sole shareholder,[108] the general partner needs to be dissolved, which would be a taxable event.[109]

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

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

For asset protection planning purposes,[110] consider using a limited liability limited partnership (LLLP) that makes an S election.[111] An LLLP is a limited partnership that uses the registration process for a limited liability partnership to protect the general partner from liability.

To avoid creating a second class of stock, be careful not to include partnership capital account provisions in the partnership agreement.[112]

An existing corporation may convert to such an entity on a tax-free basis.[113]

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[107] See part II.C.12 Limited Partnership.
[108] See part II.A.2.e.v Relief for Late S Corporation and Entity Classification Elections for the Same Entity.
[109] See part II.Q.7.a.vii Corporate Liquidation.
[110] See part II.F Asset Protection Planning.
[111] For why I suggest a limited partnership over an LLC, see part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election.
[112] See part II.A.2.i Single Class of Stock Rule and especially fn. 361 in part II.B Limited Liability Company (LLC).
[113] Code § 368(a)(1)(F), described more fully in part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

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

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

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

Also, distributions from a former C corporation may be taxable dividends, if they exceed certain S corporation earnings. See part II.Q.7.b.iv.(a) S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations. If the S election is not made effective until after the entity is first taxed as a C corporation, then one needs to determine whether the entity earned any earning and profits as a C corporation that generate a taxable dividend for distributions in excess of those S corporation earnings.[114]

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

S elections are made on IRS Form 2553, filed no later than two months and 15 days after the beginning of the tax year the election is to take effect;[115] an S corporation elects to treat its subsidiary as a disregarded entity[116] using Form 8869, with the same deadline and similar relied for later filing. The instructions to IRS Form 2553 and 8869 discuss when an extension of time to file might be granted. The S election may be rescinded during the period during which an election could have been made timely.[117]

Directing the IRS to provide relief for mistakes in making or preserving an S election if doing so will not whipsaw the government, Code § 1362(f), "Inadvertent invalid elections or terminations," provides:

> If -
>
> (1) an election under subsection (a) or section 1361(b)(3)(B)(ii) by any corporation -

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

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

[115] The procedure for corporations electing S corporation status also applies to unincorporated entities, which do not need to (and usually should not) elect corporate income taxation before making the S election. See text accompanying fns. 359-360 in part II.B Limited Liability Company (LLC).

[116] See fn. 139, which also recommends that the corporate subsidiary convert into a limited liability company that is treated a disregarded entity to avoid potential issues relating to future ownership.

[117] See text accompanying fns. 4055-4057.

(A) as not effective for the taxable year for which made (determined without regard to subsection (b)(2)) by reason of a failure to meet the requirements of section 1361(b) or to obtain shareholder consents, or

(B) was terminated under paragraph (2) or (3) of subsection (d) or section 1361(b)(3)(C),

(2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent,

(3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken—

(A) so that the corporation for which the election was made or the termination occurred is a small business corporation or a qualified subchapter S subsidiary, as the case may be, or

(B) to acquire the required shareholder consents, and

(4) the corporation for which the election was made or the termination occurred, and each person who was a shareholder in such corporation at any time during the period specified pursuant to this subsection , agrees to make such adjustments (consistent with the treatment of such corporation as an S corporation or a qualified subchapter S subsidiary, as the case may be) as may be required by the Secretary with respect to such period,

then, notwithstanding the circumstances resulting in such ineffectiveness or termination, such corporation shall be treated as an S corporation or a qualified subchapter S subsidiary, as the case may be, during the period specified by the Secretary.

For relief when one makes mistakes when trying to comply with what is described below in this part II.A.2.e.ii, see part II.A.2.e.vi Relief for Inadvertent Errors or Omissions on Form 2553 or Form 8869.

An election on Form 2553 is valid only if all persons who are shareholders[118] in the corporation on the day on which such election is made consent to such election.[119] An executor or administrator of the shareholder's estate may consent to a new S^selection on behalf of a decedent.[120] When a married couple owns stock as tenants in common, joint tenants, or

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

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

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

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

tenants by the entirety, each tenant in common, joint tenant and tenant by the entirety must consent to the election.[121] Although the consent of each spouse who has a community property interest is required,[122] the IRS waives the consent requirement if certain procedures are followed, the election failed to include the signature of a community property spouse who was a shareholder solely pursuant to state community property law, and both spouses have reported all their K-1 items on all affected federal income tax returns.[123] The deemed owner (whether the grantor or, in the case of a QSST election, the beneficiary) of a grantor trust must sign the consent,[124] even if the trust is an ESBT (but the trustee of the ESBT must also sign).[125]

Until Rev. Proc. 2022-19 was issued: One may verify that Form 2553 was filed by filing Form 8821 with the Internal Revenue Service.[126] Obtain a signed Form 8821, call the IRS, then

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

It held:

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

[121] Reg. § 1.1362-6(b)(2)(i).

[122] Reg. § 1.1362-6(b)(2)(i). For a community property trust's eligibility to hold stock, see fn. 5857, found in part III.A.3.a.i Qualifying as a Wholly Owned Grantor Trust.

[123] Rev. Proc. 2004-35. Letter Ruling 201644003 granted relief where the spouses had failed to sign and the number of shares owned by each shareholder was inaccurate. Letter Ruling 202105005 granted retroactive relief when some spouses of shareholders located in community property states at the time of the election failed to properly consent to the S election.

[124] Letter Ruling 201516009.

[125] Reg. § 1.1362-6(b)(2)(iv) provides:

> In the case of an ESBT, the trustee and the owner of any portion of the trust that consists of the stock in one or more S corporations under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code must consent to the S corporation election. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must consent to the S corporation election.

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

fax Form 8821 to the person who will provide the verification.[127] Now that Rev. Proc. 2022-19 has been issued, first look to part II.A.2.e.vii Missing Administrative Acceptance Letter for S Election or QSub Election.

An election that is timely filed for any taxable year and that would be valid except for the failure of any shareholder to file a timely consent can be granted additional time to file by the district director or director of the service center with which the corporation files its income tax return if (1) there was reasonable cause for the failure to file the consent, (2) the request for the extension of time is made within a reasonable time under the circumstances, and (3) treating the election as valid will not jeopardize the government's interest.[128] Consents must be filed within the extended period of time by all persons who have not previously consented to the election and were shareholders of the corporation at any time during the period beginning as of the date of the invalid election and ending on the date on which an extension of time is granted.[129]

For the statute authorizing relief and the importance of provisions in a shareholders' agreement ensuring that this relief would be available, see part II.A.2.h Important Protections for S Corporation Shareholder Agreements.

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

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

[128] Reg. § 1.1362-6(b)(3)(iii)(A). For IRS processing procedures, see IRM 3.13.2.22.1 (01-01-2015). Regarding whether the government's interests are prejudiced, Letter Ruling 200333017 denied relief under the following circumstances:

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

If the government's interests are not prejudiced, the IRS might be required to grant consent. See *Kean v. Commissioner*, 469 F.2d 1183 (9th Cir. 1972) (prior regulations) (needed to provide additional time to make election once who was required to sign was determined), *rev'g* 51 T.C. 337 (1968) (Tax Court rejected consent as not being authorized without addressing granting additional time to consent) as to that issue. Letter Ruling 202240015 (issued before Rev. Proc. 2022-19), provide relief as of Date 1 when:

> X's sole shareholders, A and B, intended for X to elect S corporation status for federal tax purposes effective Date 1. However, X failed to timely file the Form 2553, Election by a Small Business Corporation, for X effective Date 1. Additionally, X inadvertently filed Form 1120, U.S. Corporation Income Tax Return, for X's Year 1 taxable year rather than Form 1120S, U.S. Income Tax Return for an S Corporation. Nevertheless, A and B have filed tax returns consistent with X being an S corporation effective Date 1 and thereafter. Upon discovery of the error, X sought relief under Rev. Proc. 2013-30, 2013- 36 I.R.B. 173 to make a late S corporation election effective Date 1. However, the Service granted relief effective Date 2, the first date that X was eligible for relief under Rev. Proc. 2013-30. Therefore, X requests a private letter ruling under § 1362(b)(5) that its S corporation election will be treated as timely made effective Date 1.

[129] Reg. § 1.1362-6(b)(3)(iii)(B).

when the defects to Form 2553 were cured under the extension to file Form 2553 that the ruling also granted.

Letter Ruling 201714014 provided relief for a late S election and a late QSub[130] election. The following paragraphs are the facts, followed by a description of the effect of following through with the granted extensions of time to file (skipping what was in between):

> X was formed on D1 under the laws of State. X's initial shareholders are trusts that X represents are eligible S corporation shareholders. X represents that it filed Form 2553, Election by a Small Business Corporation, to be treated as an S corporation effective D2. However, X received no acceptance notice from the service center and does not know whether the service center received the election.
>
> On D3, an unrelated S corporation, Y, acquired shares of stock in X. Because Y is an ineligible S corporation shareholder, X's S corporation election, had it been effective, would have terminated on D3. In D4, X learned that Y is an ineligible S corporation shareholder and that as of D3 it no longer qualified as an S corporation. On D5, the trusts transferred their X stock to Y in exchange for Y stock. Y plans to elect under § 1361(b)(3) to treat wholly owned X as a qualified subchapter S subsidiary (QSub) effective D5.
>
> … if X makes an election to be an S corporation by filing a completed Form 2553 with the appropriate service center effective D2, within 120 days from the date of this letter, then such election will be treated as timely made.
>
> X failed to timely file an election to be treated as an S corporation effective D2. Had X timely filed the election, it would have terminated on D3 when shares of X stock were transferred to Y, an ineligible S corporation shareholder. Based solely on the facts submitted and representations made, we conclude that X's S corporation election terminated on D3 when shares of X stock were transferred to Y. However, we conclude that the circumstances surrounding the termination were inadvertent within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from D3 to D5, provided that X's S corporation election is otherwise valid and was not otherwise terminated under § 1362(d).

If the corporation comes in for relief for late filing due to mistakes and not all eligible shareholders have consented, the IRS might grant relief while requiring the corporation to work out with the District Director those eligible shareholders' late consents.[131]

If the corporation has an ineligible shareholder at the time of the election and does not realize the issue, the election is invalid, but inadvertent termination relief would give the S election retroactive application if the ineligible shareholder is eliminated.[132]

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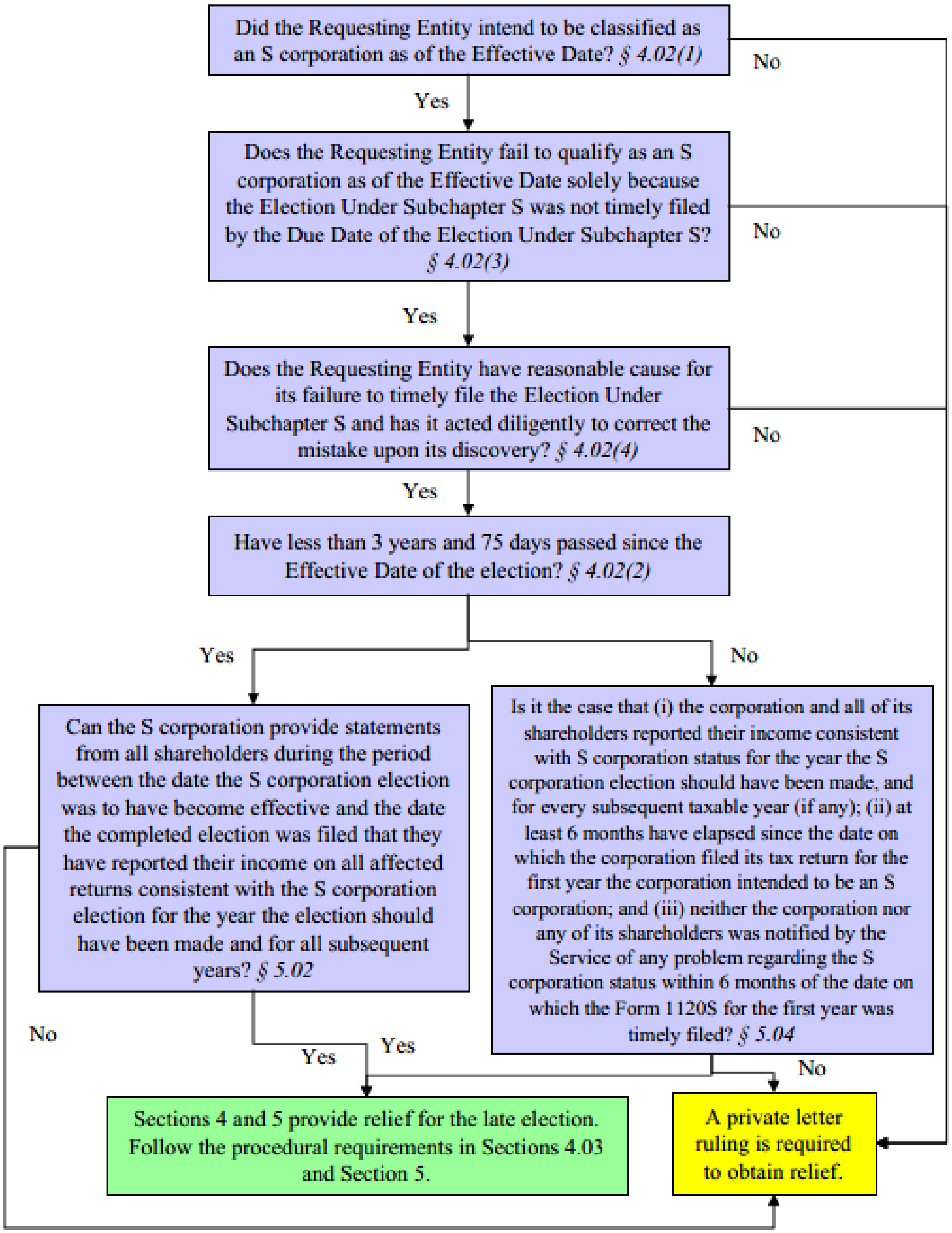
[130] See part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[131] Letter Ruling 201714018, referring to the relief in the text accompanying fns. 128-129.
[132] Letter Rulings 201427007 and 201427017, which also included relief for possible flaws in the single class of stock rules that were cured.

The following parts reproduce in their entirety (including apparently non-substantive typos) flowcharts the IRS kindly provided when it kindly gave taxpayers 3 years and 75 days from the effective date of the S election,[133] then discuss other relief that may be more far-reaching.

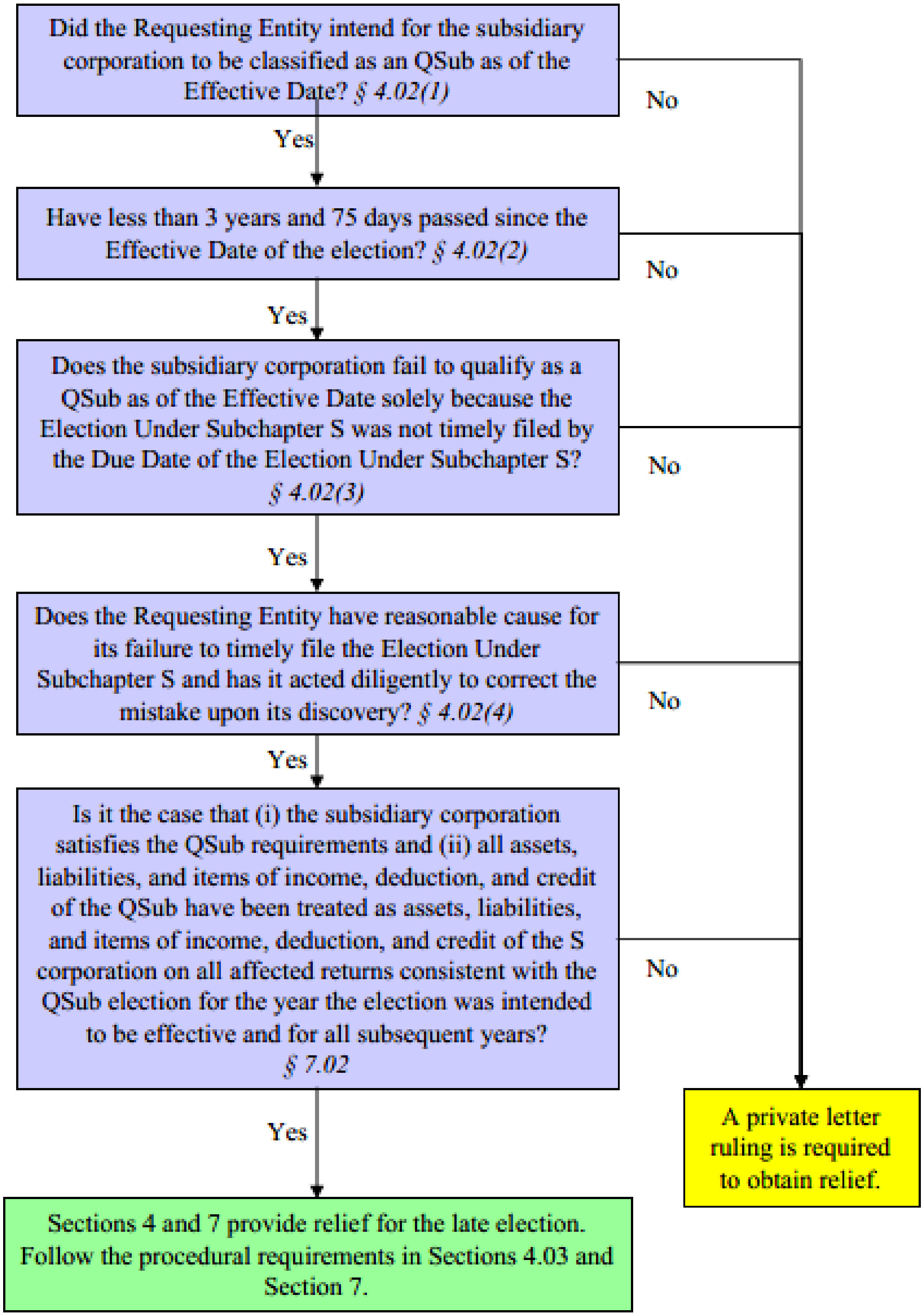
For a webinar (not free) describing the automatic relief provided by Rev. Procs. 2013-30 and 2022-19, see https://new.leimbergservices.com/wdev/register.cfm?id=2078.

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

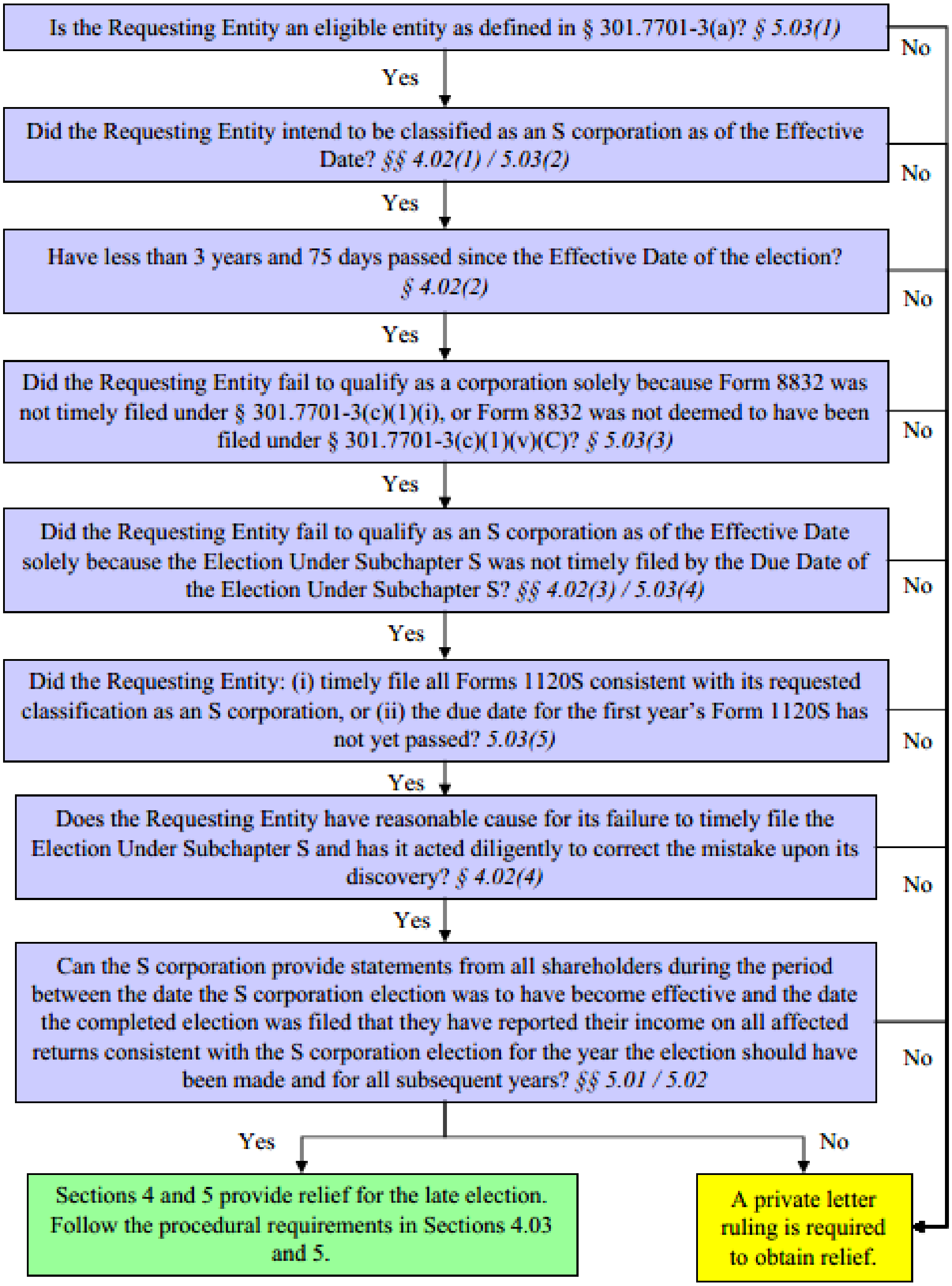
II.A.2.e.iii. Relief for Late S corporation Elections Within 3+ Years



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



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



II.A.2.e.vi. Relief for Inadvertent Errors or Omissions on Form 2553 or Form 8869

This relates to parts II.A.2.e.ii Procedure for Making the S Election; Relief for Certain Defects in Making the Election (done on Form 2553) and II.A.2.g Qualified Subchapter S Subsidiary (QSub) (done on Form 8869).

Rev. Proc. 2022-19, § 2.03(3), "Certain inadvertent errors or omissions on Form 2553 or Form 8869," provides:

> An inadvertent error or omission on Form 2553 or Form 8869 does not invalidate an S election or a QSub election, unless the error or omission is with respect to a shareholder consent, a selection of a permitted year (as defined in § 1378(b) and § 1.1378-1(b)), or an officer's signature. See generally § 1362(a)(2) (an S election is valid " only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election"), § 1.1378-1 (requiring that the taxable year of an S corporation must be a permitted year, which is defined to include a calendar year or any other taxable year for which the corporation establishes a business purpose to the satisfaction of the Commissioner), and § 1.1361-3(a)(2) (a QSub election form must be signed by a person authorized to sign the S corporation return). See section 3.03 of this revenue procedure (providing procedures for a taxpayer to correct, without the receipt of a PLR, an error, an omission, or a missing required consent on a Form 2553 or Form 8869).

Rev. Proc. 2022-19, § 3.03(1), "Correction of a missing shareholder consent," provides:

> An S election that fails to include the consent of a shareholder may be corrected pursuant to the following:
>
> a Section 1.1362-6(b)(3)(iii) (providing an extension of time for filing a shareholder consent to an S election);
>
> b Rev. Proc. 2013-30 (providing a simplified method for taxpayers to request relief for late S elections);
>
> c Rev. Proc. 2004-35, 2004-1 C.B. 1029 (providing automatic relief for certain taxpayers requesting relief for late shareholder consents for S elections in community property States); or
>
> d If the remedies listed in section 3.03(1)(a) through (c) of this revenue procedure do not apply, a taxpayer or the taxpayer's authorized representative may request relief by submitting a request for a PLR under § 1362(f) to the Associate Chief Counsel (Passthroughs and Special Industries).

Rev. Proc. 2022-19, § 3.03(2), "Correction of an error with regard to a permitted year," provides:

> A Form 2553 that contains an inadvertent error with regard to a permitted year may be corrected pursuant to Rev. Proc. 2013-30 (providing a simplified method for taxpayers to request relief for late S elections). If a taxpayer is not eligible for relief under Rev. Proc. 2013-30, a correction may be obtained through the receipt of a PLR under § 1362(f) from the Associate Chief Counsel (Passthroughs and Special Industries).

Rev. Proc. 2022-19, § 3.03(3), "Correction of missing officer's signature," provides:

> A Form 2553 or Form 8869 that is missing the signature of an authorized officer of the S corporation that affects the validity of the S election or QSub election may be corrected pursuant to Rev. Proc. 2013-30 (providing a simplified method for taxpayers to request relief for late S elections and QSub elections). If a taxpayer is not eligible for relief under Rev. Proc. 2013-30, a correction may be obtained through the receipt of a PLR under § 1362(f) from the Associate Chief Counsel (Passthroughs and Special Industries).

Rev. Proc. 2022-19, § 3.03(4), "Correction of other inadvertent errors or omissions," provides:

> Errors and omissions on Form 2553 or Form 8869, other than those addressed in section 3.03(1) through (3) of this revenue procedure, may be corrected by explaining in writing the error(s) or omission(s) and the necessary correction(s) and submitting the written explanation to one of the following addresses (depending on the Internal Revenue Submission Processing Center with which the S corporation files its Form 1120-S) or any successor address the IRS may provide:
>
> a Internal Revenue Service, MS 6055, 333 W. Pershing Rd., Kansas City, MO 64108.
>
> b Internal Revenue Service, MS 6273, 1973 N. Rulon White Blvd., Ogden, UT 84404.

Rev. Proc. 2022-19, § 3.03(5), "Unavailability of a PLR for certain inadvertent errors, omissions, or missing required consents," provides:

> The IRS will not issue a PLR under § 1362(f) regarding any error or omission described in section 3.03(4) of this revenue procedure. Such inadvertent errors or omissions do not impact a corporation's S election or QSub election. See section 2.03(3) of this revenue procedure. The IRS will also not issue a PLR under § 1362(f) for a missing required consent, errors with regard to a permitted year, or a missing officer's signature where the taxpayer qualifies for relief under any of the means of relief identified in section 3.03(1) through (3) of this revenue procedure. The Associate Chief Counsel (Passthroughs and Special Industries) will consider the issuance of a PLR only if the error or omission concerns a shareholder consent, the selection of a permitted year, or a missing officer's signature, and the taxpayer has no other means of requesting relief. See section 4.02(2) of this revenue procedure.

II.A.2.e.vii. Missing Administrative Acceptance Letter for S Election or QSub Election

Rev. Proc. 2022-19, § 2.03(4), "Missing administrative acceptance letter for S election or QSub election," provides:

> Generally, within 90 days after the IRS receives a corporation's Form 2553, the IRS mails a CP261 Notice as an acknowledgment to the corporation that the IRS has accepted the corporation's filing. For QSub elections filed on Form 8869, the IRS mails a CP279 Notice to the filer and a CP279A Notice to the subsidiary, generally within 60 days after the IRS accepts the QSub election. A lack of written acknowledgement that the IRS has accepted the corporation's S election or its subsidiary's QSub election (for example, because it was lost or never received) creates uncertainty for some taxpayers about the validity of the election. However, neither subchapter S of the Code nor the

Income Tax Regulations thereunder provide that a lack of possession of a CP261 Notice, CP279 Notice, or CP279A Notice affects the validity of an S election or a QSub election, respectively. Rather, such notices are merely administrative acknowledgments of an effective election that can be reproduced upon the taxpayer's request. See section 3.04 of this revenue procedure (providing procedures to replace a missing CP261 Notice, CP279 Notice, or CP279A Notice).

Rev. Proc. 2022-19, § 3.03(4), "Missing administrative acceptance letter for S election or QSub election," provides:

(1) *Availability of replacement letters*. With regard to a missing administrative acceptance letter for an S election or an administrative acceptance letter for a QSub election, as appropriate, a replacement letter may be requested:

a For an S corporation and shareholders of an S corporation, by contacting the IRS Business and Specialty Tax Line at 800-829-4933; and

b For practitioners, by contacting the IRS Practitioner Priority Service at 866 860 4259.

(2) *Unavailability of a PLR*. The IRS will not issue a PLR under § 1362(f) with regard to any missing administrative acceptance letter described in section 3.04(1) of this revenue procedure. See section 4.01(2) of this revenue procedure. A missing administrative acceptance letter does not impact an S election or a QSub election. See section 2.03(4) of this revenue procedure.

II.A.2.e.viii. Tax Return Filing Inconsistent with an S Election or a QSub Election

Rev. Proc. 2022-19, § 2.03(5), "A Federal income tax return filing inconsistent with an S election or a QSub election," provides:

Occasionally, a corporation files a Federal income tax return that is inconsistent with the corporation's status as an S corporation or a QSub (for example, an S corporation files a Form 1065, *U.S. Return of Partnership Income*, or Form 1120, *U.S. Corporation Income Tax Return*, instead of Form 1120-S, *U.S. Income Tax Return for an S Corporation*). Although an inconsistent Federal income tax return filing can create several complications for the filer, nothing in the Code or Income Tax Regulations thereunder provides that such a filing affects the validity of a corporation's S election or QSub election. For example, neither § 1362(d) nor § 1.1361-5(a) lists an inconsistent Federal income tax return filing as an event that gives rise to a termination of an S election or a QSub election. See section 3.05 of this revenue procedure (providing procedures for taxpayers to address, without the receipt of a PLR, a Federal income tax return filing inconsistent with an S election or a QSub election, as appropriate).

For what is a Qsub election, see part II.A.2.g Qualified Subchapter S Subsidiary (QSub).

Rev. Proc. 2022-19, § 3.05, "Procedures for Addressing a Federal Income Tax Return Filing Inconsistent with an S Election or a QSub Election," provides:

(1) *Filing a corrected original return or an amended return*. An S corporation, or a parent S corporation of a QSub, that files a Federal income tax return for a taxable year that

is inconsistent with the status of the corporation as an S corporation, or inconsistent with the status of a subsidiary of the parent S corporation as a QSub, must file a Federal income tax return for open taxable years consistent with its status, as appropriate -

a to reflect the status of the corporation as an S corporation or parent of a QSub; or

b to reflect the status of the subsidiary as a QSub.

(2) *Unavailability of a PLR*. The IRS will not issue a PLR under § 1362(f) with regard to any inconsistent return filing described in section 3.05(1) of this revenue procedure. See section 4.01(2) of this revenue procedure. Such an inconsistent return filing does not impact an S election or a QSub election. See section 2.03(5) of this revenue procedure.

(3) *Federal income tax effect of a corporation's prior transactions*. Because a corporation is not treated as having terminated its S election or QSub election, as appropriate, merely due to the filing of one or more Federal income tax returns inconsistent with its S election or QSub election, the corporation's distributions and other transactions will be treated consistent with its status as an S corporation or a QSub, as appropriate. Thus, a QSub's income or deductions will be treated as income or deductions of the parent S corporation and distributions between the QSub and its parent will be disregarded.

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

To be eligible for an S election, a corporation must be a domestic corporation that is not an ineligible corporation and does not have:[134]

- more than 100 shareholders,[135]

[134] Code § 1361(b)(1).

[135] Of course, it must have at least one shareholder – meaning someone who owns the entity. *Deckard v. Commissioner*, 155 T.C. No. 8 (2020), held:

> As a Kentucky nonstock, nonprofit corporation subject to the provisions of the Act, Waterfront had no stock and could issue no stock. Consequently, petitioner does not fall within the four corners of the regulation which "[o]rdinarily" treats as an S corporation shareholder "the person who would have to include in gross income dividends distributed with respect to the stock of the corporation (if the corporation were a C corporation)". Sec. 1.1361-1(e)(1), Income Tax Regs. (emphasis added).
>
> Furthermore, petitioner did not otherwise possess an ownership interest in Waterfront equivalent to that of a shareholder. Because he was president and a director of Waterfront, the Act, along with Waterfront's articles of incorporation, expressly prohibited any part of Waterfront's income or profit from being distributed to him or inuring to his benefit. See Ky. Rev. Stat. Ann. sec. 273.237. 10 In the light of this nondistribution constraint, treating petitioner as a shareholder of Waterfront would be fundamentally incompatible with the purpose and operation of subchapter S, which generally taxes an S corporation's income currently at the shareholder level.
>
> Furthermore, petitioner lacked dissolution rights in Waterfront typical of a shareholder. None of Waterfront's assets could be distributed to him upon Waterfront's dissolution. See Ky. Rev. Stat. Ann. sec. 273.303. 11 Consistent with the constraints of the Act, Waterfront's articles of incorporation provide that, upon its dissolution, its assets shall be distributed for exempt purposes

- a shareholder who is a person (other than an estate, an eligible trust,[136] or a qualified retirement plan[137] or charity[138]) who is not an individual,[139]

- a nonresident alien as a shareholder, and

- more than 1 class of stock.

However, a domestic trust that is an electing small business trust (ESBT)[140] may have a nonresident alien (NRA) as a permissible current distributee.[141] Thus, one may give or

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> within the meaning of section 501(c)(3) or shall be distributed to an entity established for public purposes.
>
> Petitioner asserts that in August 2012 he "assumed complete control over the planning of the fashion week event" and began "treating … [it] as a for-profit business". Even assuming that this is true, any such actions would not give rise to ownership rights in Waterfront greater than those afforded by the Act and Waterfront's articles of incorporation. Control over Waterfront was vested in its three directors, as fiduciaries entrusted with the duties and powers imposed upon them by the Act and the articles of incorporation. See Ky. Rev. Stat. Ann. sec. 273.215(1); *Ballard v. 1400 Willow Council of Co-Owners, Inc.*, 430 S.W.3d 229, 241 (Ky. 2013).
>
> In the light of these various considerations, we conclude that petitioner, as an officer and director of Waterfront, subject to the constraints of the Act and Waterfront's articles of incorporation, lacked ownership rights in Waterfront equivalent to those of a shareholder for purposes of applying subchapter S.

[136] Code § 1361(c)(2) describes eligible trusts, which are described in more detail in part III.A.3 Trusts Holding Stock in S Corporations.

[137] Described in Code § 401(a) and exempt from taxation under Code § 501(a). An IRA is not an eligible shareholder; see Code § 1361(e)(1)(A)(i) and Letter Rulings 202010001 (granting inadvertent termination relief when an LLC taxed as an S corporation issued a membership interest to an IRA) and 202105005 (granting inadvertent termination relief when a corporation did not realize it had allowed an individual to transfer his stock to his IRA).

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

[139] Reg. § 1.1361-1(f), "Shareholder must be an individual or estate," provides:

> Except as otherwise provided in paragraph (e)(1) of this section (relating to nominees), paragraph (h) of this section (relating to certain trusts), and, for taxable years beginning after December 31, 1997, section 1361(c)(6) (relating to certain exempt organizations), a corporation in which any shareholder is a corporation, partnership, or trust does not qualify as a small business corporation.

Although a corporation cannot hold stock in an S corporation, a parent S corporation may elect to treat its wholly owned subsidiary as a "qualified subchapter S subsidiary," which is treated as a disregarded entity. See part II.A.2.g Qualified Subchapter S Subsidiary.

[140] See part III.A.3.e.ii Electing Small Business Trusts (ESBTs.

[141] Code § 1361(c)(2)(B)(v) provides:

> In the case of a trust described in clause (v) of subparagraph (A), each potential current beneficiary of such trust shall be treated as a shareholder; except that, if for any period there is no potential current beneficiary of such trust, such trust shall be treated as the shareholder during such period. This clause shall not apply for purposes of subsection (b)(1)(C).

The first sentence states that each person who may receive a distribution for the current taxable year is counted as a shareholder, so that an ESBT cannot have any such beneficiaries whose stock ownership would make the S corporation ineligible. However, 2017 tax reform added the last sentence, stating the usual disqualification of an NRA does not apply if the NRA is merely a beneficiary of an ESBT.

Reg. § 1.1361-1(m)(1)(ii)(D), "Nonresident aliens," provides:

> A nonresident alien (NRA), as defined in section 7701(b)(1)(B), is an eligible beneficiary of an ESBT and an eligible potential current beneficiary.

Reg. § 1.1361-1(m)(2)(ii)(E)(2) provides:

bequeath stock to an NRA by making sure the gift or bequest is to a trust that has an ESBT election in place. If and to the extent that the NRA is the deemed owner of the ESBT, for "all ESBTs after December 31, 2017"[142] the items of income, deduction, and credit from that grantor portion must be reallocated from the grantor portion to the S portion of the ESBT,[143] thereby being subjected to U.S. income tax.

As mentioned above, a person who does not hold formal legal title but has a community property interest in stock is counted as a shareholder whose consent is required.[144] Accordingly, consider making sure that the spouse of each shareholder, who lives or has lived

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> All potential current beneficiaries of the trust meet the shareholder requirements of section 1361(b)(1); for the purpose of this paragraph (m)(2)(ii)(E)(2), an NRA potential current beneficiary does not violate the requirement under section 1361(b)(1)(C) that an S corporation cannot have an NRA as a shareholder.

See fn 6017 in part III.A.3.e.ii.(a) Qualification as an ESBT where the last two sentences of Reg. § 1.1361-1(m)(4)(i) provide that NRAs count toward the 100-shareholder limit but do not count for purposes of the prohibition against NRA shareholders.

[142] Reg. § 1.641(c)-1(k).

[143] Reg. § 1.641(c)-1(b) provides:

(1) *Grantor portion* -
  - (i) *In general*. Subject to paragraph (b)(1)(ii) of this section, the grantor portion of an ESBT is the portion of the trust that is treated as owned by the grantor or another person under subpart E of the Code.
  - (ii) *Nonresident alien deemed owner*. If, pursuant to section 672(f)(2)(A)(ii), the deemed owner of a grantor portion of the ESBT is a nonresident alien, as defined in section 7701(b)(1)(B) (NRA), the items of income, deduction, and credit from that grantor portion must be reallocated from the grantor portion to the S portion, as defined in paragraph (b)(2) of this section, of the ESBT.

(2) *S portion*
  - (i) *In general*. Subject to paragraph (b)(2)(ii) of this section, the S portion of an ESBT is the portion of the trust that consists of S corporation stock and that is not treated as owned by the grantor or another person under subpart E of the Code.
  - (ii) *NRA deemed owner of grantor portion*. The S portion of an ESBT also includes the grantor portion of the items of income, deduction, and credit reallocated under paragraph (b)(1)(ii) of this section from the grantor portion of the ESBT to the S portion of the ESBT.

Reg. § 1.641(c)-1(*l*)(6) provides:

> *Example 6*: *NRA as potential current beneficiary*. Domestic Trust (DT) has a valid ESBT election in effect. DT owns S corporation stock. The S corporation owns U.S. and foreign assets. The foreign assets produce foreign source income. B, an NRA, is the grantor and the only trust beneficiary and potential current beneficiary of DT. B is not a resident of a country with which the United States has an income tax treaty. Under section 677(a), B is treated as the owner of DT because, under the trust documents, income and corpus may be distributed only to B during B's lifetime. Paragraph (b)(2)(ii) of this section requires that the S corporation income of the ESBT that otherwise would have been allocated to B under the grantor trust rules must be reallocated from B's grantor portion to the S portion of DT. In this example, the S portion of DT is treated as including the grantor portion of the ESBT, and thus all of DT's income from the S corporation is taxable to DT.

Presumably the Example refers to a domestic trust, because a foreign trust is never an eligible shareholder. See fn 5901 in part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation. I seriously doubt that a revocable trust created by an NRA can ever qualify as a domestic trust, but I have not researched the issue.

[144] See part II.A.2.e.ii Procedure for Making the S Election; Relief for Certain Defects in Making the Election, especially fns. 122-123.

in a community property state, is not and does not become a nonresident alien.[145] *Deckard v. Commissioner*, 155 T.C. No. 8 (2020), explained:

> The subchapter S regulations provide: "Ordinarily, the person who would have to include in gross income dividends distributed with respect to the stock of the corporation (if the corporation were a C corporation) is considered to be the shareholder of the corporation." Sec. 1.1361-1(e)(1), Income Tax Regs. Citing this regulation, one court has observed that "the question whether a person was a shareholder on the date of the election to be taxed under Subchapter S is equivalent to the question whether, had there been a valid election, he would have been required to report as personal income profits earned by the corporation on that date." *Cabintaxi Corp. v. Commissioner*, 63 F.3d 614, 616 (7th Cir. 1995), *aff'g in part*, *rev'g in part on other grounds* T.C. Memo. 1994-316. The resolution of this question depends on whether the person "would have been deemed a beneficial owner of shares in the corporation, entitled therefore to demand from the nominal owner the dividends or any other distributions of earnings on those shares." *Id*.
>
> The courts look to State law to determine whether a person is a beneficial owner of corporate shares:
>
>> [A]lthough the meaning of "shareholder" for purposes of Subchapter S election has been said to be a matter of federal law rather than of state law, this means only that it is federal law which determines which kind of shareholder - namely, beneficial rather than record - is required to elect in order for the corporation to achieve

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[145] Reg. § 1.1361-1(g)(1)(i) provides:

> A corporation having a shareholder who is a nonresident alien as defined in section 7701(b)(1)(B) does not qualify as a small business corporation. If a U.S. shareholder's spouse is a nonresident alien who has a current ownership interest (as opposed, for example, to a survivorship interest) in the stock of the corporation by reason of any applicable law, such as a state community property law or a foreign country's law, the corporation does not qualify as a small business corporation from the time the nonresident alien spouse acquires the interest in the stock. If a corporation's S election is inadvertently terminated as a result of a nonresident alien spouse being considered a shareholder, the corporation may request relief under section 1362(f).

Reg. § 1.1361-1(g)(1)(ii) provides examples illustrating this rule:

> *Example (1)*. In 1990, W, a U.S. citizen, married H, a citizen of a foreign country. At all times H is a nonresident alien under section 7701(b)(1)(B). Under the foreign country's law, all property acquired by a husband and wife during the existence of the marriage is community property and owned jointly by the husband and wife. In 1996 while residing in the foreign country, W formed X, a U.S. corporation, and X simultaneously filed an election to be an S corporation. X issued all of its outstanding stock in W's name. Under the foreign country's law, X's stock became the community property of and jointly owned by H and W. Thus, X does not meet the definition of a small business corporation and therefore could not file a valid S election because H, a nonresident alien, has a current interest in the stock.
>
> *Example (2)*. Assume the same facts as Example 1, except that in 1991, W and H filed a section 6013(g) election allowing them to file a joint U.S. tax return and causing H to be treated as a U.S. resident for purposes of chapters 1, 5, and 24 of the Internal Revenue Code. The section 6013(g) election applies to the taxable year for which made and to all subsequent taxable years until terminated. Because H is treated as a U.S. resident under section 6013(g), X does meet the definition of a small business corporation. Thus, the election filed by X to be an S corporation is valid.

Letter Ruling 202149004 provided inadvertent termination relief in a situation similar to Example (1).

> Subchapter S status. Whether a particular investor was a shareholder of that kind—in this case was a beneficial shareholder of … [the corporation] on the date of the election—is an issue of state law. [Citation omitted.]

Id. at 617 (citing *United States v. Nat'l Bank of Commerce*, 472 U.S. 713, 722 (1985), *Aquilino v. United States*, 363 U.S. 509, 513 (1960), and *United States v. Denlinger*, 982 F.2d 233, 235 (7th Cir. 1992)); *accord Pahl v. Commissioner*, 150 F.3d 1124, 1129 (9th Cir. 1998), *aff'g* T.C. Memo. 1996-176; see *Swenson v. Commissioner*, 37 T.C. 124, 131 (1961) ("In determining when petitioner acquired the stock in question, we must look to the applicable State law."), *rev'd on other grounds*, 309 F.2d 672 (8th Cir. 1962).

Consistently with these precepts, in deciding whether a person is properly treated as an S corporation shareholder, courts have frequently considered whether the person is a beneficial owner of the corporation's stock. See, *e.g.*, *Pahl v. Commissioner*, 150 F.3d 1124; *Cabintaxi Corp. v. Commissioner*, 63 F.3d 614; *Wilson v. Commissioner*, 560 F.2d 687 (5th Cir. 1977), *aff'g* T.C. Memo. 1975-92; *Hook v. Commissioner*, 58 T.C. 267 (1972); *Beirne v. Commissioner*, 52 T.C. 210 (1969); *Hoffman v. Commissioner*, 47 T.C. 218 (1966), *aff'd per curiam*, 391 F.2d 930 (5th Cir. 1968); *Hightower v. Commissioner*, T.C. Memo. 2005-274, *aff'd*, 266 F. App'x 646 (9th Cir. 2008).

If an individual holds S corporation stock through a disregarded entity, the individual and not the disregarded entity is treated as the shareholder, whether the disregarded entity is a single member LLC,[146] is a partnership of disregarded entities all taxed to the same person (and therefore the partnership itself is disregarded),[147] or is an unincorporated entity owned by a married couple as community property that the couple elects to treat as disregarded.[148] Note, of course, that such a disregarded entity[149] or nominee[150] could easily be transformed into a

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[146] Letter Rulings 9739014 and 200008015, which are implicitly reinforced by fn. 150.

[147] Letter Rulings 200008015 and 200513001 (the latter expressly mentioning that Rev. Rul. 2004-77 disregards a partnership of disregarded entities all taxed to the same person), which are implicitly reinforced by the part of Reg. § 1.1361-1(e)(1) that is reproduced in fn. 150. Also see fn. 330 in part II.B Limited Liability Company (LLC), discussing generally when an LLC with more than one member constitutes a disregarded entity.

[148] Letter Ruling 201610007. For disregarding such an entity, see Rev. Proc. 2002-69, which is described in fn. 348, found in part II.B Limited Liability Company (LLC). Rev. Proc. 2002-69 allows a married couple to disregard the entity by reporting its activity directly on their tax returns. In Letter Ruling 201610007, the couple filed partnership tax returns, which the Letter Ruling ruled was an inadvertent termination. The IRS approved the S election so long as the couple elected to disregard the entity as provided in Rev. Proc. 2002-69 for all open taxable years.

[149] Regarding a partnership of disregarded entities, Letter Ruling 201730002 granted inadvertent termination relief for the following:

> On Date 2, A, the sole shareholder of X, transferred A's entire interest in X to Y, a limited liability company wholly owned by A and treated as a disregarded entity for federal tax purposes. On Date 3, A transferred a n% interest in Y to Trust, a grantor trust that was treated (under subpart E of part I of subchapter J of chapter 1) as entirely owned by A. Trust was an eligible shareholder under § 1361(c)(2)(A)(i). On Date 4, A died, causing Trust to cease being a grantor trust. On Date 4, X's S corporation election terminated as Y, the sole owner of X, became a partnership for federal tax purposes, an ineligible shareholder. On Date 5, Y redeemed the shares of Estate (which were received by Estate at A's death), causing Y to be treated as a disregarded entity owned by Trust for federal tax purposes.

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

partnership, thereby becoming an ineligible shareholder; however, inadvertent termination relief may be available.[151] Bequeathing a partnership interest to the only other partner through one's will generally is not enough to prevent the partnership from being a separate entity, because the process of estate administration causes the estate itself to have a legal life.[152] Query whether a nonprobate transfer through a transfer on death statute[153] might be considered instantaneous, because any claims are asserted after the transfer to the beneficiary, not before. Having the partnership term end upon the death of the grantor of multiple grantor trusts that are the sole partners might prevent the stock from being considered owned by a partnership,[154] but I would

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

In light of the regulation expressly authorizing nominees, the Letter Rulings in fns. 146 and 147 ignoring disregarded entities seem doubly well-grounded (grounded in the check-the-box regulations and this regulation).

Note also that a partnership that has long ago wound up its operations might be an eligible shareholder. See fn. 154.

[151] Letter Ruling 200841007 granted relief as follows:

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

Letter Rulings 201801007, 201709015, 200237011 200237014, and 202003001 also granted inadvertent termination relief for a partnership owning S corporation stock. In granting relief, Letter Ruling 201709015 treated the partners as the shareholders, allowing QSST and ESBT elections retroactive to when the partnership first obtained the stock; Letter Ruling 202003001 took a somewhat similar position involving a complex set of facts.

Letter Rulings 8948015 (partnership and individuals transfer to empty shell), 8934020 (transfer to empty shell), 8926016 (transfer to empty shell), 9010042 (transfer to empty shell), and 9421022 (transfer to empty shell) ignored transitory ownership by a partnership of an S corporation as part of a series of immediately effective transactions. See also parts II.A.2.j.ii Disregarding Transitory Owners and II.P.3.c.i Formless Conversion, text accompanying fn. 3992 (formless conversion of a partnership to an S corporation the same as a Code § 351 followed by a liquidation of the partnership, and the transitory ownership of the S corporation by the partnership is disregarded).

[152] Rev. Rul. 62-116.

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

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

> In the final analysis, our decision turns on whether paper transfer of the shares from the Partnership to the individual Guzowskis was required. The Partnership discontinued manufacturing operations by February 28, 1953 and all other operations by June 30, 1953. Sometime after that date all of the assets were disposed of. The term of the Partnership expired on January 2, 1957, and there is not one scintilla of evidence that there was any intent or action on the part of the partners to extend the term. Long prior to September 2, 1958—the critical date

not recommend that in planning mode. Rather than hold S corporation stock in a partnership that is a disregarded entity and risk the need for an inadvertent termination ruling, consider whether the S corporation's business can be moved to a partnership;[155] such an arrangement can be done seamlessly via merger or conversion statutes through a reorganization under Code § 368(a)(1)(F),[156] and the IRS generally accepts using a partnership to avoid concerns over ineligible shareholders.[157]

If an S corporation that is a partner in a partnership gives its stock to an employee of the partnership as compensation, which presumably would be treated as contributing the stock to the partnership and the partnership then transferring the stock as compensation to the employee,[158] the partnership will not be treated as a momentary owner of the S corporation stock.[159]

In counting the number of shareholders, Reg. § 1.1361-1(e)(1) provides the following regarding trusts and estates:

> Except as otherwise provided in paragraphs (h) and (j) of this section, and for purposes of this paragraph (e) and paragraphs (f) and (g) of this section, if stock is held by a decedent's estate or a trust described in section 1361(c)(2)(A)(ii) or (iii), the estate or

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

This case preceded Reg. § 1.1361-1(e)(1), which allows a partnership to hold S corporation stock as a nominee; see fn. 150.

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

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

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

[158] Presumably such a transfer would be analogous to a shareholder's transfer of stock to an employee of the corporation described in part II.M.4.c.i When a Gift to a Service Provider Is Compensation and Not a Gift, fn. 3671.

[159] Letter Ruling 200009029.

> trust (and not the beneficiaries of the estate or trust) is considered to be the shareholder; however, if stock is held by a subpart E trust (which includes a voting trust) or an electing QSST described in section 1361(d)(1), the deemed owner of the trust is considered to be the shareholder. If stock is held by an ESBT described in section 1361(c)(2)(A)(v), each potential current beneficiary of the trust shall be treated as a shareholder, except that the trust shall be treated as the shareholder during any period in which there is no potential current beneficiary of the trust. If stock is held by a trust described in section 1361(c)(2)(A)(vi), the individual for whose benefit the trust was created shall be treated as the shareholder. See paragraph (h) of this section for special rules relating to trusts.

Reg. § 1.1361-1(e)(2), "Special rules relating to stock owned by husband and wife," provides:

> For purposes of paragraph (e)(1) of this section, stock owned by a husband and wife (or by either or both of their estates) is treated as if owned by one shareholder, regardless of the form in which they own the stock. For example, if husband and wife are owners of a subpart E trust, they will be treated as one individual. Both husband and wife must be U.S. citizens or residents, and a decedent spouse's estate must not be a foreign estate as defined in section 7701(a)(31). The treatment described in this paragraph (e)(2) will cease upon dissolution of the marriage for any reason other than death.

Special family attribution rules ameliorate the 100-shareholder limitation.[160]

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[160] Code § 1361(c)(1). See 2004 Blue Book (General Explanation of Tax Legislation Enacted in the 108th Congress), p. 189, footnote 321. Reg. § 1.1361-1(e)(3)(i) interprets the family attribution rule:

> *In general*. For purposes of paragraph (e)(1) of this section, stock owned by members of a family is treated as owned by one shareholder. Members of a family include a common ancestor, any lineal descendant of the common ancestor (without any generational limit), and any spouse (or former spouse) of the common ancestor or of any lineal descendants of the common ancestor. An individual shall not be considered to be a common ancestor if, on the applicable date, the individual is more than six generations removed from the youngest generation of shareholders who would be members of the family determined by deeming that individual as the common ancestor. For purposes of this six-generation test, a spouse (or former spouse) is treated as being of the same generation as the individual to whom the spouse is or was married. This test is applied on the latest of the date the election under section 1362(a) is made for the corporation, the earliest date that a member of the family (determined by deeming that individual as the common ancestor) holds stock in the corporation, or October 22, 2004. For this purpose, the date the election under section 1362(a) is made for the corporation is the effective date of the election, not the date it is signed or received by any person. The test is only applied as of the applicable date, and lineal descendants (and spouses) more than six generations removed from the common ancestor will be treated as members of the family even if they acquire stock in the corporation after that date. The members of a family are treated as one shareholder under this paragraph (e)(3) solely for purposes of section 1361(b)(1)(A), and not for any other purpose, whether under section 1361 or any other provision. Specifically, each member of the family who owns or is deemed to own stock must meet the requirements of sections 1361(b)(1)(B) and (C) (regarding permissible shareholders) and section 1362(a)(2) (regarding shareholder consents to an S corporation election). Although a person may be a member of more than one family under this paragraph (e)(3), each family (not all of whose members are also members of the other family) will be treated as one shareholder. For purposes of this paragraph (e)(3), any legally adopted child of an individual, any child who is lawfully placed with an individual for legal adoption by that individual, and any eligible foster child of an individual (within the meaning of section 152(f)(1)(C)), shall be treated as a child of such individual by blood.

In counting the number of shareholders, the following are treated as 1 shareholder:[161]

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

The term "members of a family" means a common ancestor, any lineal descendant of such common ancestor, and any spouse or former spouse of such common ancestor or any such lineal descendant.[162]

An individual is considered to be a common ancestor only if, on the applicable date, the individual is not more than six generations removed from the youngest generation of shareholders who otherwise would be members of the family.[163] "Applicable date" means the latest of the date the S election is made, the earliest date that a member of the family holds stock in the S corporation, or October 22, 2004.[164] The test is only applied as of the applicable date, and lineal descendants (and spouses) more than six generations removed from the common ancestor will be treated as members of the family even if they acquire stock in the corporation after that date.[165]

The members of a family are treated as one shareholder solely for purposes of counting shareholders.[166] Each member of the family who owns or is deemed to own stock must be an eligible shareholder.[167] Although a person may be a member of more than one family under these rules, each family (not all of whose members are also members of the other family) will be treated as one shareholder.[168]

In counting shareholders, the estate or grantor trust of a deceased member of the family will be considered to be a member of the family during the period in which the estate or trust (such trust during the two years the trust is eligible) holds stock in the S corporation, and the members of the family also include:[169]

- In the case of an ESBT, each potential current beneficiary who is a member of the family;
- In the case of a QSST, the income beneficiary who makes the QSST election, if that income beneficiary is a member of the family;
- In the case of a qualified voting trust, each beneficiary who is a member of the family;

[161] Code § 1361(c)(1)(A).
[162] Code § 1361(c)(1)(B)(i). Any legally adopted child of an individual, any child who is lawfully placed with an individual for legal adoption by the individual, and any eligible foster child of an individual (under Code § 152(f)(1)(C)), shall be treated as a child of such individual by blood. Code § 1361(c)(1)(C).
[163] Code § 1361(c)(1)(B)(ii). For purposes of the preceding sentence, a spouse (or former spouse) shall be treated as being of the same generation as the individual to whom such spouse is (or was) married.
[164] Code § 1361(c)(1)(B)(iii).
[165] Reg. § 1.1361-1(e)(3)(i).
[166] Reg. § 1.1361-1(e)(3)(i).
[167] Reg. § 1.1361-1(e)(3)(i).
[168] Reg. § 1.1361-1(e)(3)(i).
[169] Reg. § 1.1361-1(e)(3)(ii).

- The deemed owner of a grantor trust if that deemed owner is a member of the family; and

- The owner of an entity disregarded as an entity separate from its owner under the check-the-box rules, if that owner is a member of the family.

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

An S corporation can own a wholly[170] owned subsidiary, which the Code calls a "qualified subchapter S subsidiary"[171] and the regulations and this author refer to as a QSub.[172] A Qsub may own another QSub, in which case the ultimate parent makes the Qsub election at every level.[173]

A QSub is any domestic corporation that is not an ineligible corporation,[174] is wholly owned by an S corporation, and that the parent elects to treat as a QSub.[175] The parent files Form 8869 no more than 12 months before or 2 months and 15 days after the election's effective date.[176] For relief for a late election, see parts II.A.2.e.ii Procedure for Making the S Election; Relief for Certain Defects in Making the Election (especially part II.A.2.e.iv Relief for Late QSub Elections) and II.A.2.e.vi Relief for Inadvertent Errors or Omissions on Form 2553 or Form 8869. If a QSub was timely but was ineffective due to the subsidiary's failure to meet all the requirements of Code § 1361(b)(3)(B) at the time the election was made, relief for inadvertent ineffectiveness may be available,[177] but first see part II.A.2.e.vi Relief for Inadvertent Errors or Omissions on Form 2553 or Form 8869.

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170 If an S corporation owns less than all of another corporation, that other corporation is not eligible to be an S corporation; however, inadvertent termination relief may be available. Letter Ruling 202017020.

171 Code § 1361(b)(3), especially Code § 1361(b)(3)(B).

172 Reg. § 1.1361-2(a).

173 Reg. § 1.1361-2(d), Example (1).

174 Referring to Code § 1362(b)(2), which provides that the following are ineligible to make an S election:

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

175 Code § 1361(b)(3)(B); Reg. § 1.1361-2(a). Letter Ruling 201821011 granted relief when a Qsub did not meet the requirements when the Qsub election was made:

> On Date 4, incident to what A represents was part of a reorganization under § 368(a)(1)(F), Shareholder 1 and Shareholder 2 contributed all of their stock in B to A, resulting in A wholly owning B. On Date 6, B merged into C. In a letter dated Date 7, A sent the Internal Revenue Service a Form 8869, Qualified Subchapter S Subsidiary Election, effective on Date 4. A later discovered that its election to treat B as a Qualified Subchapter S Subsidiary (QSub) was ineffective due to B's failure to meet all the requirements of § 1361(b)(3)(B) and § 1.1361-3(a)(1) of the Income Tax Regulations at the time the election was made.
>
> A represents that its ineffective QSub election for B was inadvertent. A further represents that no federal tax return of any person has been filed inconsistent with a valid QSub election having been made for B effective Date 4. B and A have agreed to make any adjustments required by the Service consistent with the treatment of B as a QSub.

176 Reg. § 1.1361-3(a)(4). If the parent is a newly formed holding company and the subsidiary is electing to be a QSub, see fn 4078 in part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

177 Letter Ruling 202015003.

A QSub is not treated as a separate corporation, and all of the QSub's assets, liabilities, and items of income, deduction, and credit are treated as assets, liabilities, and such items (as the case may be) of its parent;[178] this treatment applies for all purposes of the Code, except as provided in regulations.[179] Reg. § 1.1361-4(a)(1) states that this rule applies "for Federal tax purposes," except for certain provisions it references:[180]

- If the parent or a QSub is a bank, then the special bank rules govern items of income, deduction, and credit at the bank entity level; however, after applying those rules, all of the QSub's assets, liabilities, and items of income, deduction, and credit, as determined in accordance with the special bank rules, are treated as the parent's.[181]

- A QSub is treated as a separate corporation for purposes of its Federal tax liabilities with respect to any taxable period for which the QSub was treated as a separate corporation, Federal tax liabilities of any other entity for which the QSub is liable, and refunds or credits of Federal tax.[182]

- A QSub is treated as a separate corporation for purposes of Federal employment taxes and withholding.[183]

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[178] CCA 201552026 asserts that a parent may not take a Code § 165(g)(3) worthless stock deduction with respect to its QSub's stock.
[179] Code § 1361(b)(3)(A).
[180] Rev. Rul. 2008-18 explains:

> For tax years beginning after December 31, 2004, Congress amended § 1361(b)(3)(E) to provide that, except to the extent provided by the Secretary, QSubs are not disregarded for purposes of information returns under part III of subchapter A of chapter 61. Further, QSubs are not disregarded for certain other purposes as provided in regulations. For example, § 1.1361-4(a)(7) provides that a QSub is treated as a separate corporation for purposes of employment tax and related reporting requirements (effective for wages paid on or after January 1, 2009), and § 1.1361-4(a)(8) provides that a QSub is treated as a separate corporation for purposes of certain excise taxes (effective for liabilities imposed and actions first required or permitted in periods beginning on or after January 1, 2008).

[181] Reg. § 1.1361-4(a)(3), especially Reg. § 1.1361-4(a)(3)(ii), Example (2).
[182] Reg. § 1.1361-4(a)(6).
[183] Reg. § 1.1361-4(a)(7) provides:

> (i) *In general*. A QSub is treated as a separate corporation for purposes of Subtitle C - Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal Revenue Code).
>
> (ii) *Effective/applicability date*. This paragraph (a)(7) applies with respect to wages paid on or after January 1, 2009.

- A QSub is treated as a separate corporation for purposes of certain excise taxes,[184] none of which seem to have anything to do with estate, gift, or generation-skipping transfer taxes.[185]

- QSubs separately file certain information returns,[186] none of which seem to have anything to do with estate, gift, or generation-skipping transfer taxes.[187]

Consistent with the above and elaborating on the results of some transactions listed later in this part II.A.2.g, Reg. § 301.6109-1(i), "Special rule for qualified subchapter S subsidiaries (QSubs)," describes a current or former QSub's tax ID:

(1) *General rule*. Any entity that has an employer identification number (EIN) will retain that EIN if a QSub election is made for the entity under § 1.1361-3 or if a QSub election that was in effect for the entity terminates under § 1.1361-5.

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[184] Reg. § 1.1361-4(a)(8) provides:

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

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

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

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

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

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

(ii) *Effective/applicability date*.

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

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

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

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

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

[186] Reg. § 1.1361-4(a)(9) provides:

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

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

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

(2) *EIN while QSub election in effect*. Except as otherwise provided in regulations or other published guidance,[188] a QSub must use the parent S corporation's EIN for Federal tax purposes.

(3) *EIN when QSub election terminates*. If an entity's QSub election terminates, it may not use the EIN of the parent S corporation after the termination. If the entity had an EIN prior to becoming a QSub or obtained an EIN while it was a QSub in accordance with regulations or other published guidance, the entity must use that EIN. If the entity had no EIN, it must obtain an EIN upon termination of the QSub election.

(4) *Effective date*. The rules of this paragraph (i) apply on January 20, 2000.

If a corporation becomes a QSub as the result of an S corporation in which its new parent obtains the subsidiary's former tax attributes, it needs to keep its EIN for two purposes:[189]

- A QSub is treated as a separate corporation for certain federal tax purposes, such as employment and various excise taxes.[190]

- As described in Reg. § 301.6109-1(i)(3) above, it must use its old tax ID when its QSub status terminates.[191]

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[188] [my footnote – not in the regulation itself:] See fn 180 and accompanying text.

[189] See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization, especially fn .

[190] See fn 180 and accompanying text. Rev. Rul. 2008-18, Situation 2, involves the following facts:

> C, an individual owns all of the stock of Z, an S corporation. Z's EIN is 33-3333333. In Year 1, Z forms Newco, which in turn forms Mergeco. Pursuant to a plan of reorganization, Mergeco merges with and into Z, with Z surviving and C receiving solely Newco stock in exchange for Z stock. Newco meets the requirements for qualification as a small business corporation and timely elects to treat Z as a QSUB, effective immediately following the transaction. The transaction meets the requirements of a reorganization under § 368(a)(1)(F).

Rev. Rul. 2008-18, Situation 2, concludes:

> In Situation 2, consistent with Rev. Rul. 64-250, Z's original S election does not terminate but continues for Newco. Newco must obtain a new EIN. Z must retain its EIN (EIN 33-3333333) even though a QSub election is made for Z and must use its original EIN any time the QSub is otherwise treated as a separate entity for federal tax purposes (including for employment and certain excise taxes) or if the QSub election terminates.

[191] Rev. Rul. 2008-18, Situation 1, involves the following facts:

> B, an individual, owns all of the stock in Y, an S corporation. Y's EIN is 22-2222222. In Year 1, B forms Newco and contributes all of the Y stock to Newco. Newco meets the requirements for qualification as a small business corporation and timely elects to treat Y as a qualified subchapter S subsidiary (QSub), effective immediately following the transaction. The transaction meets the requirements of a reorganization under § 368(a)(1)(F). In Year 2, Newco sells a 1% interest in Y to D.

Rev. Rul. 2008-18, Situation 1, concludes:

> In Situation 1, consistent with Rev. Rul. 64-250, Y's original S election does not terminate but continues for Newco. Newco must obtain a new EIN. Y must retain its EIN (EIN 22-2222222) even though a QSub election is made for it and must use its original EIN any time the QSub is otherwise treated as a separate entity for federal tax purposes (including for employment and certain excise taxes) or if the QSub election terminates. In Year 2, when Newco sells a 1% interest of Y to D, Y's QSub election terminates pursuant to § 1361(b)(3)(C). Y must use its original EIN of 22-2222222 following the termination of Y's QSub election.

- None of this changes the QSub's need to use its parent's tax ID for regular federal income tax purposes, as described in Reg. § 301.6109-1(i)(3) above.

QSubs have some nice uses. First, suppose one would like to drop all of an S corporation's assets into a partnership, per part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons. The shareholders can contribute their stock to a new corporation and make a QSub election for the old S corporation, both as part of a tax-free reorganization,[192] then merge the QSub into a new disregarded LLC as a disregarded transaction, even if the new LLC converts to a partnership immediately thereafter;[193] this transaction is diagrammed and explained in part II.E.7.c.i.(b) Use F Reorganization to Form LLC. A QSub might also allow a tiered structure to qualify for Code § 6166 estate tax deferral[194] when it might not have qualified or on more favorable terms than might otherwise have applied.[195] It might also be used to preserve the AAA of a corporation whose S election is revoked.[196] In the latter case, following the recommended reorganization the QSub election could be immediately terminated;[197] terminating it the same day as the day the QSub election is

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[192] See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization, especially fn. 4078, which includes the procedure when one combines such a reorganization with a QSub election. Consider whether the election to treat the old S corporation as a QSub should be made before merging into the LLC, out of concern that the surviving LLC is not taxed as a corporation and therefore can no longer make a QSub election on behalf of the old S corporation. See Letter Rulings 201501007 and 201724013.

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

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

(ii) The merger of Y into T causes a termination of Y's QSub election. The new corporation Newco) that is formed as a result of the termination is immediately merged into T, an entity that is disregarded for Federal tax purposes. Because, at the end of the series of transactions, the assets continue to be held by X for Federal tax purposes, under step transaction principles, the formation of Newco and the transfer of assets pursuant to the merger of Newco into T are disregarded. The sale of 21 percent of T is treated as a sale of a 21 percent undivided interest in each of T's assets. Immediately thereafter, X and Z are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

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

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

[195] See part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders, especially the text accompanying fns. 96-99.

[196] See part II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation, especially fns. 3977-3979.

[197] Reg. § 1.1361-3(b), "Revocation of QSub election," provides in paragraphs (1) and (2):

(1) *Manner of revoking QSub election*. An S corporation may revoke a QSub election under section 1361 by filing a statement with the service center where the S corporation's most recent tax return was properly filed. The revocation statement must include the names, addresses,

made prevents the 5-year waiting period for re-electing QSub status[198] from applying.[199] The revocation of the QSub election is treated as forming a new C corporation.[200]

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and taxpayer identification numbers of both the parent S corporation and the QSub, if any. The statement must be signed by a person authorized to sign the S corporation's return required to be filed under section 6037.

(2) *Effective date of revocation*. The revocation of a QSub election is effective on the date specified on the revocation statement or on the date the revocation statement is filed if no date is specified. The effective date specified on the revocation statement cannot be more than two months and 15 days prior to the date on which the revocation statement is filed and cannot be more than 12 months after the date on which the revocation statement is filed. If a revocation statement specifies an effective date more than two months and 15 days prior to the date on which the statement is filed, it will be effective two months and 15 days prior to the date it is filed. If a revocation statement specifies an effective date more than 12 months after the date on which the statement is filed, it will be effective 12 months after the date it is filed.

[198] Reg. § 1.1361-5(c)(1). Code § 1361(b)(3)(D) provides:

> *Election after termination*. If a corporation's status as a qualified subchapter S subsidiary terminates, such corporation (and any successor corporation) shall not be eligible to make-
>
> (i) an election under subparagraph (B)(ii) to be treated as a qualified subchapter S subsidiary, or
>
> (ii) an election under section 1362(a) to be treated as an S corporation,
>
> before its 5th taxable year which begins after the 1st taxable year for which such termination was effective, unless the Secretary consents to such election.

[199] Reg. § 1.1361-3(b)(4) provides:

> *Revocation before QSub election effective*. For purposes of Section 1361(b)(3)(D) and § 1.1361-5(c) (five-year prohibition on re-election), a revocation effective on the first day the QSub election was to be effective will not be treated as a termination of a QSub election.

Eustice, Kuntz & Bogdanski, *Federal Income Taxation of S Corporations* (WG&L), ¶ 3.08[3][g][ii] Revocation, includes this example:

> X, an S corporation, files a proper qualified subchapter S subsidiary election for its wholly owned subsidiary, S, on January 1, 2016, effective on that date. On March 10 of the same year, while S is still an eligible qualified subchapter S subsidiary, X changes its mind and files a revocation of the election, effective January 1. Because the intended effective date is less than two months and fifteen days prior to the filing of the revocation statement, the revocation is effective, as stated, on January 1. Because this was also the first day on which the election was to be effective, S is not barred from being a qualified subchapter S subsidiary, or an S corporation, in the years 2016 to 2020.

RIA Checkpoint ¶ 254:182 Termination by Revocation includes an example making the same point. See Reg. § 1.1361-3(b)(2) in fn 197, supporting retroactive revocation in this manner.

[200] Reg. § 1.1361-5(b)(1)(i) provides:

> *In general*. If a QSub election terminates under paragraph (a) of this section, the former QSub is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation. The tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. For purposes of determining the application of section 351 with respect to this transaction, instruments, obligations, or other arrangements that are not treated as stock of the QSub under § 1.1361-2(b) are disregarded in determining control for purposes of section 368(c) even if they are equity under general principles of tax law.

Reg. § 1.1361-5(b)(3), Example (5) provides:

> X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X subsequently revokes the QSub election. Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the revocation from its S corporation parent in a deemed exchange for Y stock. On a subsequent date, X sells 21 percent

If the parent later owns less than all of the stock of the subsidiary, the subsidiary becomes a C corporation.[201] Consider merging a QSub into a wholly owned LLC that is a disregarded entity, so that its pass-flow status is not lost if ownership of part of the entity is transferred or if potential changes in capital structure cause equity to be deemed to be issued (it was suggested to me that an underpriced warrant issued in a financing might cause problems), but beware state income taxation if a state in which the company is subject to income tax does not treat a QSub as a disregarded entity[202] and that a disregarded entity subsidiary might not have as strong an argument that Code § 6166 estate tax deferral applies.[203]

On the reverse side, if an S corporation makes a valid QSub election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation in a generally tax-free transaction.[204]

A Qsub might be spun off. Bloomberg BNA's Tax Management Weekly Report (11/11/2019) described Letter Ruling 201945016:

> The IRS issued 13 rulings on an S corporation's ("Distributing") proposed reorganization entailing a transfer of assets to a controlled qualified subchapter S subsidiary with Controlled then assuming certain liabilities (the "Contribution"), and distribution of all of the Controlled stock proportionately to each of a group of "Split-Off Shareholders" in exchange for all of their Distributing stock, pursuant to equalization of the value of Controlled and Distributing (the "Distribution"). Ruling (1) Upon the Distribution, Controlled will no longer be a QSub. Ruling (2) The Contribution followed by the Distribution will qualify as a reorganization under tax code Section 368(a)(1)(D), with Distributing and Controlled each "a party to a reorganization" within the meaning of Section 368(b). Rulings (3), (4), (7), (8) No gain or loss will be recognized by relevant

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of the stock of Y to Z, an unrelated corporation, for cash. Assume that under general principles of tax law including the step transaction doctrine, the sale is not taken into account in determining whether X is in control of Y immediately after the deemed exchange of assets for stock. The deemed exchange by X of assets for Y stock and the deemed assumption by Y of its liabilities qualify under section 351 because, for purposes of that section, X is in control of Y within the meaning of section 368(c) immediately after the transfer.

[201] Reg. § 1.1361-5(a)(1)(iii) and Code § 1361(b)(3)(b)(i). Reg. § 1.1361-5(b)(3), Example (1) provides: X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X sells 21 percent of the Y stock to Z, an unrelated corporation, for cash, thereby terminating the QSub election. Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for Y stock immediately before the termination from the S corporation. The deemed exchange by X of assets for Y stock does not qualify under section 351 because X is not in control of Y within the meaning of section 368(c) immediately after the transfer as a result of the sale of stock to Z. Therefore, X must recognize gain, if any, on the assets transferred to Y in exchange for its stock. X's losses, if any, on the assets transferred are subject to the limitations of section 267.

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

[203] See part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders, especially the text accompanying fns. 96-98.

[204] Reg. § 1.1361-4(a)(2)(i), which further provides that, subject to certain transition rules that apply to pre-2001 QSub elections, "the tax treatment of the liquidation or of a larger transaction that includes the liquidation will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine." Reg. § 1.1361-4(a)(2)(ii) illustrates this liquidation concept, including the Example (1) a liquidation that under Code §§ 332 and 337 is tax-free to the parent and subsidiary, respectively. For the latter, see part II.Q.7.a.vii Corporate Liquidation.

entities in the Contribution or the Distribution. Rulings (5), (9) The basis of assets transferred in the Contribution and in the Distribution won't change upon the moment of transfer. Rulings (6), (10) The holding period for the recipient for a given asset will include that of the previous owner in the Contribution and in the Distribution. Rulings (11),(12) Any earnings and profits will be allocated between Distributing and Controlled in accordance with Section 312(h) and regulations, and Distributing's accumulated adjustments account will be allocated between Distributing and Controlled in a similar manner. Ruling (13) Distributing's momentary ownership of Controlled stock won't cause Controlled to have an ineligible shareholder for any portion of its first taxable year under Section 1361(b)(1)(B); therefore Controlled will be permitted to elect to be an S corporation for its first taxable year provided it otherwise qualifies and makes such election effective immediately upon its QSub termination.

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

Always provide that stock cannot be transferred to any person if such a transfer would make the corporation fail to be a "small business corporation" under Code § 1361(b)(1).[205] Because the tax laws change, the restriction should be as simple and broad as the preceding sentence. Define "transfer" to be any event that causes federal tax law to treat ownership as having changed, which might include a trust no longer being a wholly-owned grantor trust[206] even though shares have not changed hands.

Notwithstanding these protections, problems might occur – especially if the company does not have a qualified tax advisor approve every transfer other than to an individual who is a US citizen. The consequences of losing an S election are harsh,[207] including loss of AAA[208] and possible built-in gain tax.[209]

Fortunately, Code § 1362(f), "Inadvertent invalid elections or terminations," provides that a corporation "shall be treated as an S corporation or a qualified subchapter S subsidiary, as the case may be, during the period specified by the Secretary" if:

(1) an election under subsection (a) or section 1361(b)(3)(B)(ii) by any corporation -

> (A) was not effective for the taxable year for which made (determined without regard to subsection (b)(2)) by reason of a failure to meet the requirements of section 1361(b) or to obtain shareholder consents, or
>
> (B) was terminated under paragraph (2) or (3) of subsection (d) or section 1361(b)(3)(C),

(2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent,

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205 See part II.A.2.f Shareholders Eligible to Hold S Corporation Stock.
206 See part III.A.3.a Wholly Owned Grantor Trusts – How to Qualify, Risks, and Protective Measures.
207 See parts II.E.2.b Converting from S Corporation to C Corporation and II.P.3.d Conversion from S Corporation to C Corporation.
208 See parts II.Q.7.b Redemptions or Distributions Involving S Corporations and II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation.
209 See part II.P.3.b.ii Built-in Gain Tax on Former C Corporations under Code § 1374.

(3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken -

(A) so that the corporation for which the election was made or the termination occurred is a small business corporation or a qualified subchapter S subsidiary, as the case may be, or

(B) to acquire the required shareholder consents, and

(4) the corporation for which the election was made or the termination occurred, and each person who was a shareholder in such corporation at any time during the period specified pursuant to this subsection , agrees to make such adjustments (consistent with the treatment of such corporation as an S corporation or a qualified subchapter S subsidiary, as the case may be) as may be required by the Secretary with respect to such period.

Reg. § 1.1362-4(b), "Inadvertent termination or inadvertently invalid election," provides:

> For purposes of paragraph (a) of this section, the determination of whether a termination or invalid election was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination or invalid election was inadvertent. The fact that the terminating event or invalidity of the election was not reasonably within the control of the corporation and, in the case of a termination, was not part of a plan to terminate the election, or the fact that the terminating event or circumstance took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event or circumstance, tends to establish that the termination or invalidity of the election was inadvertent.

The legislative history to Code § 1362(f) explains:[210]

> If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.
>
> The committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped that taxpayers and the government will work out agreements that protect the revenues without undue hardship to taxpayers. For example, if a corporation, in good faith, determined that it had no earnings and profits, but it is later determined on audit that its election terminated by reason of violating the passive income test for three consecutive years because the corporation in fact did have accumulated earnings, if the shareholders were to agree to treat the earnings as distributed and include the dividends in income, it may be appropriate to waive the terminating events, so that the election is treated as never terminated. Likewise, it may be appropriate to waive the terminating

[210] Senate Explanation of the Subchapter S Revision Act, P.L. 97-354 (10/19/82), "(e) Inadvertent terminations (secs. 1362(f))."

> event when the one class of stock requirement was inadvertently breached, but no tax avoidance had resulted. It is expected that the waiver may be made retroactive for all years, or retroactive for the period in which the corporation again became eligible for subchapter S treatment, depending on the facts.

Accordingly, the IRS provides retroactive relief, so long as taxpayers cannot get some benefit they would have not received had they not followed the rules. Therefore, the IRS may require adjustments to avoid unfair benefits.[211] By allowing retroactive reinstatement, the IRS is allowing the corporation to avoid corporate level tax; it would not be difficult to imagine a shareholder disagreeing with the relief and refusing to pay tax on K-1 income, whipsawing the IRS for having allowed the corporation to avoid tax. To avoid this whipsaw, everyone who might be affected by the relief must consent. Reg. § 1.1362-4(e), "Corporation and shareholder consents," provides:

> The corporation and all persons who were shareholders of the corporation at any time during the period specified by the Commissioner must consent to any adjustments that the Commissioner may require. Each consent should be in the form of a statement agreeing to make the adjustments. The statement must be signed by the shareholder (in the case of shareholder consent) or a person authorized to sign the return required by section 6037 (in the case of corporate consent). See § 1.1362-6(b)(2) for persons required to sign consents. A shareholder's consent statement should include the name, address, and taxpayer identification numbers of the corporation and shareholder, the number of shares of stock owned by the shareholder, and the dates on which the shareholder owned any stock. The corporate consent statement should include the name, address, and taxpayer identification numbers of the corporation and each shareholder.

If caught and corrected soon enough (generally 3 years and 75 days after the transfer), one can obtain automatic relief;[212] otherwise, correction might require an expensive and potentially time-consuming private letter ruling.[213] As described above, either relief has the stated requirement that all shareholders consent to relief for inadvertent termination. Obtaining such consent might be difficult, for example, if the owner is no longer a shareholder or is incapacitated, deceased, or

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[211] Reg. § 1.1362-4(d), "Adjustments," provides:

> The Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation or QSub during the period specified by the Commissioner. In the case of stock held by an ineligible shareholder that causes an inadvertent termination or invalid election for an S corporation under section 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of the S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent the loss of any revenue due to the holding of stock by an ineligible shareholder (for example, a nonresident alien).

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

[213] See parts II.A.2.e.ii Procedure for Making the S Election; Relief for Certain Defects in Making the Election (and its companion parts II.A.2.e.iii Relief for Late S corporation Elections Within 3+ Years, II.A.2.e.iv Relief for Late QSub Elections, and II.A.2.e.v Relief for Late S Corporation and Entity Classification Elections for the Same Entity) and III.A.3.c.iii.(a) General Description of Deadlines for QSST and ESBT Elections (and its companion, part III.A.3.c.iii.(b) Flowchart Showing Relief for Late QSST & ESBT Elections).

simply uncooperative. A shareholder agreement should grant the company an irrevocable[214] durable power of attorney to sign such consents.

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

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

Consider using provisions found in the ACTEC Shareholders Agreement Form 2007,[215] which uses as a general reference the ACTEC Shareholders Agreement Outline 2011.[216]

II.A.2.i. Single Class of Stock Rule

S corporations cannot have more than one class of stock.[217] Please read this part II.A.2.i.iv in the context of part II.A.2.i.xii Automatic Relief If Governing Provisions Violate Single Class of Stock Rule.

Use great caution to strip any partnership tax and accounting provisions from any operating agreement or partnership agreement forms if an unincorporated entity makes the election.[218] Letter Ruling 200548021 refers to the operating agreement as a governing provision for purposes of Reg. § 1.1361-1(*l*)(2)(i). Letter Rulings 201136004 and 201351017 allowed relief for inadvertent ineligibility to make an S election where perhaps the capital account partnership provisions had not been stripped out and were later caught; same with Letter Rulings 201528025, 202203004and 202235003, which definitely involved capital account partnership provisions that had not been stripped out and were later caught.[219] Letter Ruling 201822003 implicitly took the position that the presence of such provisions is disqualifying only when an LLC no longer has only one owner. Letter Ruling 201949009 involved not only partnership provisions but also issued profits interests that needed to be cured to cure the S election being ineffective due to those provisions. Same with Letter

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214 Generally, a principal may revoke a durable power of attorney. However, a power coupled with an interest, such as in a shareholder agreement, may be irrevocable.
215 http://apps.americanbar.org/webupload/commupload/RP519000/relatedresources/ACTEC-ShareholdersAgreementForm_9.20.07.pdf.
216 http://apps.americanbar.org/webupload/commupload/RP519000/relatedresources/ACTEC-ShareholdersAgreementOutline_12.27.11.pdf
217 Code § 1361(b)(1)(D).
218 For how to make the election and related strategy, see fns 359-363 and accompanying text in part II.B Limited Liability Company (LLC).
219 Letter Ruling 202110010 said that among offending provisions that was later removed to qualify for inadvertent termination relief was:

> … in the event X is liquidated within the meaning of § 1.704-1(b)(2)(ii)(g) of the Income Tax Regulations, distributions shall be made to the members who have positive capital accounts in compliance with § 1.704-1(b)(2)(ii)(b)(2).

Ruling 202124002, which included curative action regarding profits interests issued to employees:

> Company and its shareholders represent that Company and its shareholders will file amended returns for Years as needed to reflect units that vested in Years and as necessary to reflect additional income and taxes resulting from the vesting of those units. Company also represents that it will amend Agreement to provide for identical rights to distribution and liquidation proceeds in accordance with § 1.1361-1(*l*).

The IRS will not rule on whether a state law limited partnership violates the single class of stock rule. Rev. Proc. 2021-3, § 3.01(106), which rule originated in Rev. Proc. 99-51.

Preferred stock having been issued when an S election is made makes the election ineffective, but the IRS may grant relief retroactively if all defects are cured.[220] Similarly, preferred stock being issued after an S election is made can be cured.[221]

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[220] Letter Rulings 201716009 and 201751007.

[221] Letter Ruling 201949003, with the following fixes having occurred in addition to the usual representations of inadvertence and promise to make any adjustments the IRS requires:

> X represents that on or about Date 5 it became aware that the issuance of the preferred stock may have inadvertently terminated its S corporation election. X represents that on Date 6 it took corrective action and (1) converted the preferred stock to common stock, (2) voted to cancel and retire all preferred stock, and (3) amended and restated its Articles of Incorporation to authorize only a single class of stock. X represents that as of Date 6 all issued and outstanding shares of preferred stock have been cancelled and retired. X also represents that its shareholders have taken into account their pro rate shares of X's separately and non-separately computed items pursuant to § 1366 and have made any adjustments to stock basis as required under § 1367. Furthermore, X represents that its shareholders have accounted for any distributions made under § 1368.

Issuing a profits interest[222] would violate the single class of stock rule, but it can qualify for inadvertent termination relief.[223] If a profits interest is desirable, the S corporation should form an LLC subsidiary[224] and have the LLC issue profits interests.

Letter Ruling 202149004 provided inadvertent termination relief for the following:

> On Date 3, X entered into an agreement with C, a shareholder in X, to purchase additional shares of stock in X. The agreement contained an anti-dilution provision with respect to C's shares in X such that C would maintain a fixed ownership percentage in X. X represents that the agreement is a governing provision within the meaning of § 1.1361-1(l)(2)(i) of the Income Tax Regulations and that the effect of the anti-dilution provision in the agreement caused X to have more than one class of stock. Consequently, had X's S corporation election been effective Date 1, it would have terminated on Date 3. Upon learning that it had more than one class of stock, X amended the agreement with C pursuant to which the anti-dilution provision was stricken, and B's ownership interest was adjusted to exclude the application of the anti-dilution provision.

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

The issues discussed in this part II.A.2.i.i apply to C corporations as well, except to the extent they specify S corporations.

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

Differences in voting rights do not by themselves create a second class of stock.[225] Generally, if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, a corporation is treated as having only one class of stock.[226] Thus, the corporation may issue

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222 For profits interests, see part II.M.4.f Issuing a Profits Interest to a Service Provider.

223 In Letter Ruling 201949009, an LLC made an S election. Later:

> On Date 3, X's Operating Agreement included provisions regarding partnerships. Section 4(j) of the Operating Agreement provides, in part, that it is intended that X will be treated as a partnership for federal income tax purposes and that each Member will be treated as a partner of a partnership for tax purposes. Section 4(a) provides, in part, that X shall have two (2) classes of Units: Class A Units and Profits Units. Sections, 4, 8, and 19 of the Operating Agreement state that a Profits Interest only shares in liquidation proceeds due to profits earned after the issuance of the Profit Unit. On Date 4 and Date 5, X issued Profits Interests.
>
> When X's shareholders discovered the effect of the partnership provisions and the issuance of the Profits Interests, X canceled the Profits Interests between Date 6 and Date 7. X amended its operating agreement on Date 8 to remove the partnership provisions and the Profits Interest provisions and to provide identical distribution and liquidation rights to X's shareholders.

The ruling held:

> Based solely on the facts submitted and representations made, we conclude that X's S corporation election terminated on Date 3 because X had more than one class of stock due to the provisions in the Operating Agreement. We also conclude that the termination of X's S corporation was inadvertent within the meaning of § 1362(f). Accordingly, under the provisions of § 1362(f), X will be treated as an S corporation from Date 3 until Date 9, provided that X's S corporation election was otherwise valid and not otherwise terminated under § 1362(d).

224 See part II.E.7.c.i Corporation Forms New LLC.

225 Code § 1361(c)(4).

226 Reg. § 1.1361-1(*l*)(1), which provides:

voting and nonvoting stock, each of which confers identical rights to distribution and liquidation proceeds. This capital structure also avoids gift and estate tax problems under the anti-freeze valuation rules of Chapter 14.[227]

A shareholder being wrongfully shut out from participating in management did not cause the shareholder to lose status as a shareholder when the shareholder continued to enjoy the financial benefits of being a shareholder.[228]

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

The retention of the right to vote (directly or indirectly) shares of stock of a "controlled corporation" causes estate inclusion of the transferred stock.[229]

> *General rule*. A corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in paragraph (*l*)(4) of this section (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

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

[228] *Enis v. Commissioner*, T.C. Memo. 2017-222, reasoning:

> In determining stock ownership for Federal income tax purposes, the Court must look to the beneficial ownership of shares, not mere legal title. See *Ragghianti v. Commissioner*, 71 T.C. 346, 349 (1978), *aff'd*, 652 F.2d 65 (9th Cir. 1981). Cases concluding that a shareholder did not have beneficial ownership have considered both agreements between shareholders that removed ownership and provisions in the corporation's governing articles affecting ownership rights. See *Dunne v. Commissioner*, 2008 WL 656496, at *9. Mere interference with a "shareholder's participation in the corporation as a result of a poor relationship between the shareholders … does not amount to a deprivation of the economic benefit of the shares." *Id*. (citing *Hightower v. Commissioner*, T.C. Memo. 2005-274, *aff'd* without published opinion, 266 F.App'x 646 (9th Cir. 2008)); *Kumar v. Commissioner*, T.C. Memo. 2013-184.
>
> Petitioners contend that while Mrs. Enis was issued NLS shares, the removal of her power to exercise shareholder rights, as well as the actions of Dr. Ginsburg, removed the beneficial ownership of her shares. Petitioners, therefore, assert that they are not required to include pro rata shares of NLS' income. Petitioners identified no agreement or provisions in the corporation's governing articles removing beneficial ownership. *Kumar* does not support their position that a violation of the shareholders agreement could deprive them of the beneficial ownership of their shares. In *Kumar* we found that in the absence of an agreement passing the taxpayer's rights to his stock to another shareholder, a poor relationship between shareholders does not deprive one shareholder of the economic benefit of his shares. *Kumar v. Commissioner*, at *3. We, therefore, held that the taxpayer retained beneficial ownership. *Id*.
>
> Further, petitioners cited no authority, nor are we aware of any, that allows shareholders to exclude their shares of an S corporation's income because of poor relationships with other shareholders. While the relationships among the shareholders of NLS deteriorated, those poor relationships did not deprive Mrs. Enis of the economic benefit of her NLS shares. Indeed, ultimately, she sold her shares in 2014 for $436,165.

[229] Code § 2036(b)(1). TAM 199938005 argued that decedent's authority as general partner attributed to him the right to vote voting stock help by a limited partnership. Given that an entity taxed as a partnership cannot hold S corporation stock, that TAM may seem irrelevant, but it does support the conclusion that

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

If the trustee consults with the grantor regarding how to vote stock the trust owns, the IRS may take the position that the grantor has indirectly retained the right to vote in conjunction with the trustee and that therefore the stock is includible in the grantor’s estate for estate tax purposes.[230] If the grantor is the trustee over transferred nonvoting stock, the fact that nonvoting stock can vote in extraordinary matters, such as mergers or liquidations, will not cause Code § 2036 inclusion.[231]

However, if the grantor transfers nonvoting stock and retains the voting stock, the transferred nonvoting stock will not be includible in the grantor’s estate for estate tax purposes.[232] *U.S. v. Byrum*, 408 U.S. 125 (1972), reasoned:

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the grantor should keep ownership simple, holding voting stock in her own revocable trust and transferring nonvoting stock.

[230] Rev. Rul. 80-346. TAM 9515003 argued that a taxpayer could not invoke Rev. Rul. 80-346 to argue for estate inclusion of voting stock:

> As the court noted in *In re Steen v. United States*, *supra*, allowing a taxpayer to disavow the form of the transaction (in this case, the explicit terms of the trust instrument) under these circumstances, would encourage inappropriate tax planning and unwarranted litigation and places the Service in an untenable administrative position. Accordingly, we doubt that a court would allow a taxpayer to disavow the trust instrument under the circumstances presented here.[2]
>
> [2] We note that the Tax Court has held that a taxpayer is precluded from even arguing against the form of the transaction in the absence of strong proof. Other courts have adopted an even more restrictive rule. *Estate of Robinson v. Commissioner*, 101 T.C. 499, 513-514 (1993).

The TAM concluded:

> However, we doubt that the decedent detrimentally “relied” on the revenue ruling and structured the transaction to ensure that the transferred stock would be includible in the gross estate on his death. On the contrary, the decedent was advised by counsel and, no doubt, created the trust in order to EXCLUDE the stock from his gross estate. If the intent was to ensure the stock was included in the gross estate, the trust instrument would have expressly provided for the decedent’s retention of voting rights. Further, if the decedent had in some way relied on Rev. Rul. 80-346 in creating the trust, then consistency would require that the transfer be reported on the gift tax return as a transfer with a retained interest. This was not done.
>
> Finally, even though A, as executrix, followed the revenue ruling in including the stock in the gross estate, nonetheless, we do not believe that, as discussed above, the estate can gain a tax advantage by now disavowing the form of the transaction.

For more about the TAM and arguing estate tax inclusion, see fn 5699 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership’s Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

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

[232] See Code § 2036(b) (transfers of voting stock in a controlled corporation can be included in the transferor’s estate for estate tax purposes if the transferor retains strings such as voting rights), Rev. Rul. 80-346 (even informal strings on voting stock held in trust can bring it into the settlor’s estate), and both Rev. Rul. 81-15 (revoking a ruling that had held that the settlor’s retention of voting stock outside of a trust will not cause the Code § 2036(b) inclusion of nonvoting stock transferred in trust) and Prop. Reg. § 20.2036-2 (the settlor’s retention of voting stock outside of a trust will not cause the Code § 2036(b) inclusion of nonvoting stock transferred in trust); *Boykin v. Commissioner*, T.C.

It must be conceded that Byrum reserved no such "right" in the trust instrument or otherwise. The term "right," certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and legally enforceable power, such as that involved in *O'Malley*.[9] Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to "regulate the flow of dividends" to the trust. That "right" was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term.[10]

[9] Although Mr. Justice White's dissent argues that the use of the word "power" in O'Malley implies that the Court's concern was with practical reality rather than legal form, an examination of that opinion does not indicate that the term was used other than in the sense of legally empowered. At any rate, the "power" was a right reserved to the settlor in the trust instrument itself.

[10] The "control" rationale, urged by the Government and adopted by the dissenting opinion, would create a standard—not specified in the statute—so vague and amorphous as to be impossible of ascertainment in many instances. See n. 13, infra. Neither the Government nor the dissent sheds light on the absence of an ascertainable standard. The Government speaks vaguely of drawing the line between "an unimportant minority interest" (whatever that may be) and "voting control." The dissenting opinion does not address this problem at all. See Comment, Sale of Control Stock and the Brokers, Transaction Exemption—Before and After the Wheat Report, 49 Tex. L. Rev. 475, 479-481 (1971).

Byrum did retain the legal right to vote shares held by the trust and to veto investments and reinvestments. But the corporate trustee alone, not Byrum, had the right to pay out or withhold income and thereby to designate who among the beneficiaries enjoyed such income. Whatever power Byrum may have possessed, with respect to the flow of income into the trust, was derived not from an enforceable legal right specified in the trust instrument, but from the fact that he could elect a majority of the directors of the three corporations. The power to elect the directors conferred no legal right to command them to pay or not to pay dividends. A majority shareholder has a fiduciary duty not to misuse his power by promoting his personal interests at the expense of corporate interests.[11] Moreover, the directors also have a fiduciary duty to promote the interests of the corporation.[12] However great Byrum's influence may have been with the corporate directors, their responsibilities were to all stockholders and were enforceable according to legal standards entirely unrelated to the needs of the trust or to Byrum's desires with respect thereto.

[11] Such a fiduciary relationship would exist in almost every, if not every State. Ohio, from which this case arises, is no exception:

Memo. 1987-134 (same conclusion as Rev. Rul. 81-15 but without citing it). Rev. Rul. 81-15 does not appear to recognize that even nonvoting stock has some limited voting rights; fortunately, Prop. Reg. § 20.2036-2(a) seems to recognize and approve of such a retention, as mentioned in fn. 231. Given that estate tax definitions regarding business entities tend to be sparse, one might also look to income tax rules regarding when the right to vote is significant. For purposes of determining whether a corporation was eligible to file a consolidated return, which turned on the presence of voting stock, voting for directors constituted a critical part of the right to vote. *Alumax Inc. v. Commissioner*, 109 T.C. 133 (1197), *aff'd* 165 F.3d 822 (11th Cir. 1999).

"[I]f the majority undertakes, either directly or indirectly, through the directors, to conduct, manage, or direct the corporation's affairs, they must do so in good faith, and with an eye single to the best interests of the corporation. It is clear that the interests of the majority are not always identical with the interests of all the shareholders. The obligation of the majority or of the dominant group of shareholders acting for, or through the corporation, is fiduciary in nature. A court of equity will grant appropriate relief where the majority or dominant group of shareholders act in their own interest or in the interest of others so as to oppress the minority or commit a fraud upon their rights." 13 Ohio Jurisprudence 2d. § 662, at 90-91 (footnotes omitted).

See *Overfield v. Pennroad Corp.*, 42 F. Supp. 586 (ED Pa. 1941); rev'd on other grounds, 146 F. 2d 889 (CA3 1944).

[12] "The directors of the corporation represent the corporation, not just one segment of it, but all of it. The fiduciary nature of the directors' obligation requires that, in the management of the corporation's affairs, they do not presume to play favorites among the shareholders or among the classes of shareholders." 12 Ohio Jurisprudence, 2d, §497, at 618.

The Government seeks to equate the de facto position of a controlling stockholder with the legally enforceable "right" specified by the statute. Retention of corporate control (through the right to vote the shares) is said to be "tantamount to the power to accumulate income" in the trust which resulted in estate tax consequences in *O'Malley*. The Government goes on to assert that "through exercise of that retained power [Byrum] could increase or decrease corporate dividends, and thereby shift or defer the beneficial enjoyment of the trust."[13] This approach seems to us not only to depart from the specific statutory language,[14] but also to misconceive the realities of corporate life.

[13] The Government uses the terms "control" and "controlling stockholder" as if they were words of art with a fixed and ascertainable meaning. In fact, the concept of "control" is a nebulous one. Although in this case Byrum possessed "voting control" of the three corporations (in view of his being able to vote more than 50% of the stock in each), the concept is too variable and imprecise to constitute the basis per se for imposing tax liability under §2036 (a). Under most circumstances, a stockholder who has the right to vote more than 50% of the voting shares of a corporation "controls it" in the sense that he may elect the board of directors. But such a stockholder would not control, under the laws of most States, certain corporate transactions such as mergers and sales of assets. Moreover, control - in terms of effective power to elect the Board under normal circumstances - may exist where there is a right to vote far less than 50% of the shares. This will vary with the size of the corporation, the number of shareholders and the concentration (or lack of it) of ownership. See generally 2 L. Loss., Securities Regulation, 770-783 (1961). Securities law practitioners recognize that possessing 10% or more of voting power is one of the factors on which the Securities and Exchange Commission relies as an indicia of control. SEC, Disclosure to Investors - The Wheat Report, 245-247 (1969).

[14] In advocating this de facto approach, the Government relies on our opinion in *Commissioner v. Sunnen*, 333 U.S. 591 (1948). *Sunnen* was a personal income tax case in which the Court found the taxpayer had made an assignment of income. The reasoning relied on the de facto power of a controlling shareholder to regulate corporate business for his personal objectives. This case is an estate tax case, not an

income tax case. Moreover, unlike assignment of income cases, in which the issue is who has the power over income, this case concerns a statute written in terms of the "right" to designate the recipient of income. The use of the term "right" implies that restraints on the exercise of power are to be recognized and that such restraints deprive the person exercising the power of a "right" to do so.

There is no reason to suppose that the three corporations controlled by Byrum were other than typical small businesses. The customary vicissitudes of such enterprises - bad years; product obsolescence; new competition; disastrous litigation; new, inhibiting Government regulations; even bankruptcy - prevent any certainty or predictability as to earnings or dividends. There is no assurance that a small corporation will have a flow of net earnings or that income earned will in fact be available for dividends. Thus, Byrum's alleged de facto "power to control the flow of dividends" to the trust was subject to business and economic variables over which he had little or no control.

Even where there are corporate earnings, the legal power to declare dividends is vested solely in the corporate board. In making decisions with respect to dividends, the board must consider a number of factors. It must balance the expectation of stockholders to reasonable dividends when earned against corporate needs for retention of earnings. The first responsibility of the board is to safeguard corporate financial viability for the long term. This means, among other things, the retention of sufficient earnings to assure adequate working capital as well as resources for retirement of debt, for replacement and modernization of plant and equipment, and for growth and expansion. The nature of a corporation's business, as well as the policies and long range plans of management, are also relevant to dividend payment decisions.[15] Directors of a closely-held, small corporation must bear in mind the relatively limited access of such an enterprise to capital markets. This may require a more conservative policy with respect to dividends than would be expected of an established corporation with securities listed on national exchanges.[16]

[15] The spectrum of types of corporation businesses, and of permissible policies with respect to the retention of earnings, is broad indeed. It ranges from the public utility with relatively assured and stable income to the new and speculative corporation engaged in a cyclical business or organized to exploit a new patent or unproved technology. Some corporations pay no dividends at all, as they are organized merely to hold static assets for prolonged periods (*e.g.*, land, mineral resources, and the like). Corporations which emphasize growth tend to low dividend payments, whereas mature corporations may pursue generous dividend policies.

[15] *Thomas v. Matthews*, 94 Ohio St. 32, 55-56, 113 N.E. 669 (1916):

"[I]t is the duty of the directors, in determining the amount of net earnings available for the payment of dividends, to take into account the needs of the company in its business and sums necessary in the operation of its business until the income from further operations is available, the amount of its debts, the necessity or advisability of paying its debts or at least reducing them within the limits of the company's credit, the preservation of its capital stock as represented in the assets of the company as a fund for the protection of its creditors and the character of its surplus assets, whether cash, credits or merchandise."

Nor do small corporations have the flexibility or the opportunity available to national concerns in the utilization of retained earnings. When earnings are substantial, a decision not to pay dividends may result only in the accumulation of surplus rather than growth through internal or external expansion. The accumulated earnings may result in the imposition of a penalty tax.[17]

[17] Internal Revenue Code of 1954, Subch. G, pt. I §§ 531-537, 26 U.S.C. §§ 531-537.

These various economic considerations are ignored at the directors' peril. Although vested with broad discretion in determining whether, when, and what amount of dividends shall be paid, that discretion is subject to legal restraints. If, in obedience to the will of the majority stockholder, corporate directors disregard the interests of shareholders by accumulating earnings to an unreasonable extent, they are vulnerable to a derivative suit.[18] They are similarly vulnerable if they make an unlawful payment of dividends in the absence of net earnings or available surplus,[19] or if they fail to exercise the requisite degree of care in discharging their duty to act only in the best interest of the corporation and its stockholders.

[18] Had Byrum caused the Board to follow a dividend policy, designed to minimize or cut off income to the trust, which resulted in the imposition of the penalty for accumulated earnings not distributed to shareholders, there might be substantial grounds for a derivative suit. A derivative suit also would have been a possibility had dividends been paid imprudently to increase the trust's income at the expense of corporate liquidity. Minority shareholders in Ohio may bring derivative suits under Ohio R. Civ. P. 23.1.

[19] In most States, the power to declare dividends is vested solely in the directors. 11 Fletcher Cyclopedia Corporations, c. 58, §5320. Ohio is no exception, and it limits the authority of directors to pay dividends depending on available corporate surplus. 17 Page's Ohio Code Ann. § 1701.33. Although liability generally exists irrespective of a statute, nearly all States have statutes regulating the liability of directors who participate in the payment of improper dividends. 12 Fletcher Cyclopedia Corporations; c. 58, §5432. Again, Ohio is no exception. 17 Page's Ohio Rev. Code Ann. § 1701.95.

Byrum was similarly inhibited by a fiduciary duty from abusing his position as majority shareholder for personal or family advantage to the detriment of the corporation or other stockholders. There were a substantial number of minority stockholders in these corporations who were unrelated to Byrum.[20] Had Byrum and the directors violated their duties, the minority shareholders would have had a cause of action under Ohio law.[21] The Huntington National Bank, as trustee, was one of the minority stockholders, and it had both the right and the duty to hold Byrum responsible for any wrongful or negligent action as a controlling stockholder or as a director of the corporations.[22] Although Byrum had reserved the right to remove the trustee, he would have been imprudent to do this when confronted by the trustee's complaint against his conduct. A successor trustee would succeed to the rights of the one removed.

[20] Appendix, 30-32. In *Byrum Lithographing Co., Inc.*, none of the other 11 stockholders appears to be related by name to Byrum. In *Bychrome Co.* five of the eight stockholders appear to be unrelated to the Byrums; and in *Graphic Realty Co.* 11 of the 14 stockholders appear to be unrelated.

[21] See *Wilberding v. Miller*, 90 Ohio St. 28, 42, 106 N.E. 665 (1914):

"An arbitrary disregard of the rights of stockholders to dividends or other improper treatment of the assets of the company will be relieved against."

[22] The trust instrument, n. 1, supra, explicitly granted the trustee the power "To enforce, abandon, defend against, or have adjudicated by legal proceedings, arbitration or by compromise, any claim or demand whatsoever arising out of or which may exist against the Trust Estate."

We conclude that Byrum did not have an unconstrained de facto power to regulate the flow of dividends to the trust, much less the "right" to designate who was to enjoy the income from trust property. His ability to affect, but not control trust income, was a qualitatively different power from that of the settlor in *O'Malley*, who had a specific and enforceable right to control the income paid to the beneficiaries.[23] Even had Byrum managed to flood the trust with income, he had no way of compelling the trustee to pay it out rather than accumulate it. Nor could he prevent the trustee from making payments from other trust assets,[24] although admittedly there were few of these at the time of Byrum's death. We cannot assume, however, that no other assets would come into the trust from reinvestments or other gifts.[25]

[23] The Government cites two other opinions of this Court, in addition to O'Malley, to support its argument. In both *Commissioner v. Estate of Holmes*, 326 U.S. 480 (1946), and *Lober v. United States*, 346 U.S. 335 (1953), the grantor reserved to himself the power to distribute to the beneficiaries the entire principal and accumulated interest of the trust at any time. This power to terminate the trust and thereby designate the beneficiaries at a time selected by the settlor, is not comparable to the powers reserved by Byrum in this case.

[24] While the trustee could not acquire or dispose of investments without Byrum's approval, he was not subject to Byrum's orders. Byrum could prevent the acquisition of an asset, but he could not require the trustee to acquire any investment. Nor could he compel a sale, although he could prevent one. Thus, if there were other income-producing assets in the trust, Byrum could not compel the trustee to dispose of them.

[25] In purporting to summarize the basis of our distinction of O'Malley, the dissenting opinion states:

"Now the majority would have us accept the incompatible position that a settlor seeking tax exemption may keep the power of income allocation by rendering the trust dependent on an income flow he controls because the general fiduciary obligations of a director are sufficient to eliminate the power to designate within the meaning of §2036 (a)(2)." Post, at—.

This statement, which assumes the critical and ultimate conclusion, incorrectly states the position of the Court. We do not hold that a settlor "may keep the power of income allocation" in the way Mr. Justice White sets out; we hold, for the reasons stated in this opinion, that this settlor did not retain the power to allocate income within the meaning of the statute.

> We find no merit to the Government's contention that Byrum's de facto "control," subject as it was to the economic and legal constraints set forth above, was tantamount to the right to designate the persons who shall enjoy trust income, specified by §2036(a)(2).[26]
>
> > [26] The dissenting opinion's view of the business world will come as a surprise to many. The dissent states:
> >
> > "Thus by declaring or not declaring dividends in the controlled corporations Byrum was able to open or close the spigot, through which the income flowed to the trust's life tenant." Post, at—.
> >
> > This appears to assume that all corporations including the small family type involved in this case, have a regular and dependable flow of earnings available for dividends, and that if there is a controlling stockholder he simply turn the "spigot" on or off as dividends may be desired. For the reasons set forth in this opinion, no such dream world exists in the life of many corporations. But whatever the situation may be generally, the fallacy in the dissenting opinion's position here is that the record simply does not support it. This case was decided on a motion for summary judgment. The record does not disclose anything with respect to the earnings or financial conditions of these corporations. We simply do not know whether there were any earnings for the years in question, whether there was an earned surplus in any of the corporations, or whether - if some earnings be assumed - they were adequate in light of other corporate needs to justify dividend payments. Nor can we infer from the increase in dividend payments in the year following Byrum's death that higher dividends could have been paid previously. The increase could be explained as easily by insurance held by the corporations on Byrum's life.

The Court rebuffed the IRS' argument that, "by retaining control, Byrum guaranteed himself continued employment and remuneration, as well as the right to determine whether and when the corporations would be liquidated or merged" and therefore Byrum retained enjoyment of the transferred stock:

> Even if Byrum had transferred a majority of the stock, but had retained voting control, he would not have retained "substantial present economic benefits." The Government points to the retention of two "benefits." The first of these, the power to liquidate or merge, is not a present benefit; rather, it is a speculative and contingent benefit which may or may not be realized. Nor is the probability of continued employment and compensation the substantial "enjoyment of ... [the transferred] property" within the meaning of the statute. The dominant stockholder in a closely held corporation, if he is active and productive, is likely to hold a senior position and to enjoy the advantage of a significant voice in his own compensation. These are inevitable facts of the free enterprise system, but the influence and capability of a controlling stockholder to favor himself are not without constraints. Where there are minority stockholders, as in this case, directors may be held accountable if their employment, compensation and retention of officers violates their duty to act reasonably in the best interest of the corporation and all of its stockholders.[35] Moreover, this duty is policed, albeit indirectly, by the Internal Revenue Service, which disallows the deduction of unreasonable compensation paid to a corporate executive as a business expense.[36] We conclude that Byrum's retention of voting control was not the retention of the enjoyment of the transferred property within the meaning of the statute.

[35] Directors of Ohio corporations have been held liable for payment of excessive compensation. *Berkwitz v. Humpherey*, 163 F. Supp. 78 (ND Ohio 1958).

[36] 26 U.S.C. § 162 (a)(1) permits corporations to deduct "reasonable" compensation as business expenses. If the Internal Revenue Service determines that compensation exceeds the bounds of reason, it will not permit a deduction. See, *e.g.*, *Botany Worsted Mills v. United States*, 278 U.S. 282 (1929).

Typically, the S corporation starts with one type of voting stock. Then it issues a stock dividend of nonvoting stock. The stock dividend does not constitute a taxable distribution.[233] The author's tendency is to distribute 19 shares of nonvoting stock for each share of voting stock. This allows the voting stock to retain a significant portion yet allows the original owner to shift 95% of the distribution and liquidation rights when transferring the nonvoting stock to the next generation.

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

One should consider filing Form 8937 to report the issuance of nonvoting shares.[234] It is due 45 days after issuing the shares or, if earlier, on January 15 following the calendar year of the issuance.[235] However, "an S corporation can satisfy the reporting requirement for any organizational action that affects the basis if it reports the effect of the organizational action on a timely filed Schedule K-1 (Form 1120S) for each shareholder and timely gives a copy to all proper parties."[236] These deadlines and exceptions are from the December 2011 instructions to Form 8937; be sure to check the instructions, as well as the IRS' webpage for future developments regarding Form 8937.[237]

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

Issue nonvoting shares will not remove grandfathering from Code § 2703.[238]

If the corporation is a C corporation, then the stock issuance will not blow the Code § 1202 exclusion of gain on sale of qualified small business stock.[239]

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[233] Code § 301(a) taxes only a distribution of property, and refers to the Code § 317(a) definition of "property." Code § 317(a) provides that "property" does not include stock in the corporation making the distribution.
[234] Code § 6045(g).
[235] Instructions for Form 8937 (revised December 2011). See www.irs.gov/pub/irs-pdf/i8937.pdf.
[236] Instructions for Form 8937 (revised December 2011). See www.irs.gov/pub/irs-pdf/i8937.pdf.
[237] See www.irs.gov/form8937.
[238] See part II.Q.4.h Establishing Estate Tax Values, especially fn. 4600.
[239] See fn 5211 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

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

Future reallocations between voting and nonvoting stock would not create income tax consequences.[240] However, to avoid a taxable gift, a swap of voting for nonvoting stock (or vice versa) should consider the disparity in their values.[241] It is not unusual for even minority voting shares to have 3%-5% more value than nonvoting shares, so one might consider consulting a qualified appraiser when doing a swap like this.

A redemption plan did not cause second-class-of-stock issues when its purposes were to ensure that voting power and economic ownership between A and A's family and B and B's family remain approximately equal and to prevent an individual shareholder from owning a disproportionate amount of voting versus nonvoting common stock.[242]

II.A.2.i.i.(e). Example of Recapitalizing Voting and Nonvoting

Suppose there were 100 shares – all voting – and the grantor gave 20 shares to the trust.

Here are the steps:

1. Amend articles of incorporation to allow nonvoting

2. Give 19 shares of nonvoting for every share of voting, meaning:

   a. Grantor has 80 voting and 1,520 nonvoting

   b. Trust has 20 voting and 380 voting

3. Then grantor transfers to the trust nonvoting shares pursuant to a formula[243] (which will likely be 21 shares) in exchange for all of the trust's 20 voting shares.

Code § 1036[244] allows step 4 to be income tax-free, even if the trust is not a grantor trust.

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

Please read this part II.A.2.i.ii in the context of parts II.A.2.i.xiii Automatic Relief If Disproportionate Distributions Violate Single Class of Stock Rule and II.A.2.i.xii Automatic Relief If Governing Provisions Violate Single Class of Stock Rule, which generally confirm my approach that the issues described in this part II.A.2.i.ii are best handled by administrative procedures that are not contractually agreed to by the shareholders.

Suppose an S corporation has two equal shareholders, A and B. Under its bylaws, A and B are entitled to equal distributions. The corporation distributes $50,000 to A in the current year but does not distribute $50,000 to B until one year later. The circumstances indicate that the

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

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

[242] Letter Ruling 201506003.

[243] Use the principles of part III.B.3.e Disclaimers, found in part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.

[244] See fn 6638 in part III.B.2.h.iii Swap Power (Code § 1036 generally) and fn 678 in part II.D.4.a.i Classifying an Investment Trust (voting trust certificates).

difference in timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds. The difference in timing of the distributions to A and B does not cause the corporation to be treated as having more than one class of stock; Reg. § 1.1361-1(l)(2)(i), "In general," provides:

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

Reg. § 1.1361-1(*l*)(2)(vi), Example (2), "Distributions that differ in timing," provides:

> (i) S, a corporation, has two equal shareholders, A and B. Under S's bylaws. A and B are entitled to equal distributions. S distributes $50,000 to A in the current year but does not distribute $50,000 to B until one year later. The circumstances indicate that the difference in timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds.
>
> (ii) Under paragraph (l)(2)(i) of this section, the difference in timing of the distributions to A and B does not cause S to be treated as having more than one class of stock. However, section 7872 or other recharacterization principles may apply to determine the appropriate tax consequences.

The single class of stock rule is not violated by a governing provision providing that, "as a result of a change in stock ownership, distributions in a taxable year are to be made on the basis of the shareholders' varying interests in the S corporation's income in the current or immediately preceding taxable year."[245] For example, distributions in year 2 to pay taxes on income earned in year 1 that are based on ownership in year 1 will not violate the single class of stock rules; note, however, that the corporation would need to satisfy any state law restrictions on the timing of setting the record date for such distributions.

Paying state taxes might lead to temporary timing differences, if the shareholders have different state income tax situations. As long as any resulting disproportionate distributions are only temporary, the timing differences should not jeopardize the S election.[246] Letter

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

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

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

> *State law requirements for payment and withholding of income tax*. State laws may require a corporation to pay or withhold state income taxes on behalf of some or all of the corporation's

Ruling 201608007 approved correction of disproportionate distributions related to composite state income tax filings, and the corporation implemented policies and procedures to ensure that future state composite and withholding taxes paid by the corporation for the benefit of the applicable shareholders will be equalized annually with reciprocal cash distributions to the other shareholders. So did Letter Ruling 201633017, in which the corporation treated excess distributions as interest-free loans that were not necessarily repaid; the ruling pointed out, however, that disproportionate and corrective distributions must be given appropriate tax effect.

Letter Ruling 200944018 held that, when disproportionate distributions were made in one year, corrective action taken in the following year should cure any inadvertent termination that might have occurred.[247] The fact that the corrective action was necessarily non-pro-rata did not itself cause any second-class-of stock problem.

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

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

Alternatively, excess distributions might be characterized as advances, then documented as loans and repaid with interest.[248]

The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions).[249] A buy-sell

shareholders. Such laws are disregarded in determining whether all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds, within the meaning of paragraph (*l*)(1) of this section, provided that, when the constructive distributions resulting from the payment or withholding of taxes by the corporation are taken into account, the outstanding shares confer identical rights to distribution and liquidation proceeds. A difference in timing between the constructive distributions and the actual distributions to the other shareholders does not cause the corporation to be treated as having more than one class of stock.

247 Letter Ruling 201220024 had a similar result.

248 Letter Ruling 201150030.

249 Reg. § 1.1361-1(l)(2)(i).

redemption/distribution agreement unrelated to employment[250] may violate the single class of stock rules.[251]

A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement.[252]

Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.[253]

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

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

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

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

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[250] See part II.A.2.i.iv Providing Equity-Type Incentives without Violating the Single Class of Stock Rules.

[251] Letter Ruling 201919005 granted inadvertent termination relief after finding that on Date 4 a violation occurred (fortunately, no shares were sold after Date 4 and before the offending provision was removed):

> A, B, and C have been the only shareholders of X since Date 3; A and B each own g% of the shares and C owns h% of the shares.
>
> On Date 4, X's shareholders entered into Agreement. Agreement provided that: (1) if a shareholder's voting stock is sold, a corresponding percentage of such shareholder's non-voting stock must be cancelled, and in the event that the remaining shareholders have other than equal ownership of the remaining shares of non-voting stock, those shareholders would be entitled to distributable earnings pro rata in accordance with the shares of non-voting stock; and (2) in the event of a sale of X, C would be entitled to receive from the proceeds a payment in excess of the payments to A and B.

[252] Reg. § 1.1361-1(l)(2)(i).

[253] Reg. § 1.1361-1(l)(2)(i).

Letter Ruling 201017019 took this concept one step further in approving distributions: (1) made in accordance with the shareholders' respective interests in taxable income or loss for that taxable year; (2) that may take into account any interest, penalties, or the like attributable to a post-filing adjustment; and (3) that will be made at a reasonable time after the relevant post-filing adjustment is finally determined. Similarly, Letter Ruling 201306005 approved an agreement under which the corporation will make distributions (including to enable shareholders to pay their quarterly estimated taxes) based on the shareholders' varying interests in its income in the current or immediately preceding taxable year or earlier if such earlier year's taxable income is adjusted after X's original return for the such earlier year is filed. Be sure, however, to check whether applicable state law permits such a lengthy delay from the record date to the distribution date.

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

If one wishes to adopt more elaborate formal procedures, one should consider obtaining a Letter Ruling, with one exception: state law requirements for payment and withholding of income tax. Regulations recognize that state laws might require a corporation to pay or withhold state income taxes on behalf of some or all of the corporation's shareholders. Such laws are disregarded in determining whether all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds, so long as the deemed distributions and actual distributions wind up being pro rata in the aggregate. A difference in timing between the constructive distributions and the actual distributions to the other shareholders does not cause the corporation to be treated as having more than one class of stock.[254]

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

Letter Ruling 202103010 involved the following:

> The information submitted states that X was formed on Date 1 under the laws of State, and elected to be classified as an S corporation effective Date 2. X's articles of incorporation provide that X shall maintain only one class of stock with identical rights to distributions and liquidation proceeds.
>
> X states that, beginning on Date 3, it made annual non-resident income tax payments to certain states on behalf of its shareholders, and that these payments were disproportionate to the shareholders' ownership interests. X represents that these

[254] Reg. § 1.1361-1(l)(2)(ii).

> payments created a second class of stock, and thus, caused the termination of X's S corporation election effective Date 3.

Letter Ruling 202103010 held:

> Based solely on the facts submitted and the representations made, we conclude that X's S corporation election terminated on Date 3 as a result of X having more than one class of stock. We further conclude that this termination was inadvertent within the meaning of § 1362(f).
>
> X has taken corrective action so that it meets the requirements of a small business corporation under § 1361(b). Therefore, we determine that pursuant to the provisions of § 1362(f), X will be treated an S corporation effective Date 3 and thereafter, provided that its S corporation election has not otherwise terminated under § 1362(d).

Note that the corporation represented that these payments created a second class of stock and caused the termination of X's S corporation election. Presumably that representation was required to get the ruling because if a skittish tax advisor. The articles incorporation had the required language, and the principles described in fn 255 and the rest of part II.A.2.i.iii Disproportionate Distributions provide that this situation did not involve a second class of stock.

II.A.2.i.iii. Disproportionate Distributions (Not Temporary)

Please read this part II.A.2.i.iii in the context of parts II.A.2.i.xiii Automatic Relief If Disproportionate Distributions Violate Single Class of Stock Rule and II.A.2.i.xii Automatic Relief If Governing Provisions Violate Single Class of Stock Rule, which generally confirm my approach that the issues described in this part II.A.2.i.ii are best handled by administrative procedures that are not contractually agreed to by the shareholders.

Disproportionate distributions that are not contemplated by the governing provisions do not necessarily violate the rules against a second class of stock.[255] They are often fixed by make-up distributions to those who received less; see part II.A.2.i.ii Temporary Timing Differences.

In *Minton v. Commissioner*,[256] the Tax Court held, and the Fifth Circuit affirmed, that distributions that were allegedly disproportionate did not violate the rules against a second class of stock because the shareholders that received the alleged distributions were not legally entitled to receive disproportionate distributions; that case involved minority shareholders arguing that the corporation's S election had terminated.[257] *Kumar v. Commissioner*[258] held that a shareholder who was effectively shut out of management remained a shareholder of record and was taxed on his distributive share of income. Same with *Mowry v. Commissioner*,[259] in which the minority shareholder also did not prove transfer of his shares to the majority

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[255] Reg. § 1.1361-1(l)(2)(i), which is reproduced in part II.A.2.i.ii Temporary Timing Differences:
[256] 562 F.3d 730 (5th Cir. 2009) (per curiam), *aff'g* T.C. Memo. 2007-372.
[257] *Minton* is summarized in Steve Leimberg's Business Entities Email Newsletter - Archive Message #124.
[258] T.C. Memo. 2013-184.
[259] T.C. Memo. 2018-105. The case is also discussed in fn 5699 in part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, in the context of when the taxpayer can use form over substance.

shareholder, the latter who was allegedly stealing from the company.[260] However, in Letter Ruling 202103010, the taxpayer represented that disproportionate distributions (annual non-resident income tax payments to certain states on behalf of its shareholders) created a second class of stock, for which the ruling provided inadvertent termination relief; see the end of part II.A.2.i.ii Temporary Timing Differences; Other Varying Differences.

Furthermore, when some shareholders of an S corporation sought compensation for financial damages they sustained due to some inadequate advice the corporation had received, the corporation's payments to compensate them did not constitute issuance of a second class of stock.[261]

Similarly, when a trust agreement specifies to whom distributions from an S corporation pass, that is an internal trust matter and is not a governing provision that is required to be taken into account under Reg. § 1.1361-1(l)(2)(i).[262]

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

As discussed earlier, S corporations cannot have more than one class of stock.[263] The single-class-of-stock rules focus on rights to distribution and liquidation proceeds.[264] However, many techniques allow employees to be compensated in a manner similar to a shareholder without being considered to be a shareholder. Or, employees could hold actual stock whose liquidation rights materially differ from the other stock but is not deemed a second class of stock because of special exceptions that apply only to shareholders who are employees. For additional aspects of equity compensation or issuing stock to employees, see part II.M.4.b.ii Income Tax Recognition Timing Rules re Equity Incentives, especially part II.M.4.e.i Issuing Stock to an Employee - Generally (particularly noting fns. 3710-3715).

Please read this part II.A.2.i.iv in the context of part II.A.2.i.xii Automatic Relief If Governing Provisions Violate Single Class of Stock Rule.

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[260] See part II.G.8 Code § 165(a) Loss for Worthlessness; Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy, with fns 1563-1564 addressing acts needed to abandon an asset. *Mowry* held:

> Petitioner testified that G. Mowry never paid him for his shares, and petitioners did not report a sale of stock on their 2012 return. For 2012 they continued to list Mowry Rebar as an entity in which they held an interest. That petitioner quit his employment with Mowry Rebar does not necessarily indicate that he ceased to hold his ownership interest in the company.

[261] Letter Ruling 201016040.

[262] Letter Ruling 201834007, saying that "the Trust Agreement is disregarded in determining whether the outstanding shares of X stock confer identical rights to distributions and liquidation proceeds" and therefore the following facts did not concern the IRS:

> Some or all distributions received by the Trust from X will be used by the trustee of Trust to make required payments on the liabilities against which the X stock is pledged, and those payments will be made equally from A's share and B's share. In exchange for B agreeing to have the liabilities be paid from B's Share, A's Share will issue to B's Share a promissory note for amounts paid out of B's share with respect to the liabilities. Additionally, although distributions from X to Trust will be applied equally to each share, A will have a right to certain distributions from Trust that will not be shared by B.

[263] Code § 1361(b)(1)(D).

[264] Reg. § 1.1361-1(*l*)(1), which is reproduced in fn 226 in part II.A.2.i.i.(a) Nonvoting Stock Permitted for S Corporations.

Certainly, an employer can give an employee a bonus based on the company's profitability. Reg. § 1.1361-1(b)(4) provides:[265]

> *Treatment of deferred compensation plans*. For purposes of subchapter S, an instrument, obligation, or arrangement is not outstanding stock if it -
>
> (i) Does not convey the right to vote;
>
> (ii) Is an unfunded and unsecured promise to pay money or property in the future;
>
> (iii) Is issued to an individual who is an employee in connection with the performance of services for the corporation or to an individual who is an independent contractor in connection with the performance of services for the corporation (and is not excessive by reference to the services performed); and
>
> (iv) Is issued pursuant to a plan with respect to which the employee or independent contractor is not taxed currently on income.
>
> A deferred compensation plan that has a current payment feature (e.g., payment of dividend equivalent amounts that are taxed currently as compensation) is not for that reason excluded from this paragraph (b)(4).

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

- An employment agreement is not a binding agreement relating to distribution and liquidation proceeds (and therefore is not a second class of stock) unless a principal purpose of the agreement is to circumvent the single class of stock rules.[266] Even if the IRS finds that one shareholder's compensation is excessive, that finding will not violate the single class of stock rules unless a principal purpose of the agreement is to circumvent those rules.[267] Same with disparate fringe benefits;[268] however, if an employer treats a compensatory split-

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[265] This is important for Reg. § 1.1361-1(*l*)(3), which is reproduced in fn 3715 in part II.M.4.e.i Issuing Stock to an Employee - Generally.

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

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

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

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

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

dollar agreement as distributions rather than compensation, the employer risks the IRS making a second-class-of-stock challenge if the employer does not properly adjust distributions to take into account the resulting disproportionate distributions.[269]

- If a call option issued to an employee does not constitute excessive compensation, the option is not treated as a second class of stock if it is nontransferable and does not have a readily ascertainable fair market value when issued.[270] However, if the strike price is substantially below the stock's fair market value when the option becomes transferable, it may be treated as a second class of stock if the option is materially modified or transferred to an ineligible shareholder.[271] The safest course of action would be to (1) make the option always be nontransferable without a readily ascertainable fair market value as described above, or (2) start with an option that is transferable only to eligible shareholders and has a strike price that, at inception, is at least 90% of the stock's fair market value.[272]

- Providing a key employee with certain payments upon certain liquidity events did not constitute an issuance of equity to that employee, even though deferred payments may be secured by stock.[273]

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

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

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

[269] See text accompanying fn 4473 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

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

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

[272] Reg. § 1.1361-1(l)(4)(iii)(C).

[273] Letter Ruling 201926008 involved the following facts:

At all relevant times, X had one shareholder, A, an individual. X engaged another individual, B, through a State 3 corporation, Y, in marketing various business services and products to its merchant clients. On Date 2, X, A, B, and Y entered into Agreement 1, which provided for the sale of N1 percent of the stock of X held by A upon the satisfaction of certain conditions. On Date 3, X, A, B, and Y terminated Agreement 1 at a time when no stock had been transferred pursuant to Agreement 1 and entered into Agreement 2, which provided B with certain payment rights upon the occurrence of a Liquidity Event. Under the terms of Agreement 2, a Liquidity Event generally included a sale of a majority of X's assets, the transfer of rights to control over any use of all or substantially all of X's assets under a lease, exchange, license or similar agreement, a merger or consolidation in which X's shareholders own less than 50% of the voting securities of the surviving company or an IPO of X stock.

Agreement 2 contemplated that X, A, B, and Y may agree to a buy-out of B's rights under Agreement 2 prior to the occurrence of a Liquidity Event. In the case of a buy-out, N2 percent of the amount owed was to be paid within N3 days of the determination of the amount owed and the remainder was payable in equal monthly installments over N4 months, including N5 percent

Reg. § 1.1361-1(b)(3) provides:[274]

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

Under certain circumstances, an employer may issue stock to an employee and repurchase it at a bargain price without violating the single class of stock rules:[275]

> Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights. In addition, if stock that is substantially nonvested (within the meaning of section 1.83-3(b))[276] is treated as outstanding under these regulations, the forfeiture provisions that cause the stock to be substantially nonvested are disregarded.

The company can redeem an employee's stock for an amount significantly below its fair market value on the termination of employment or if the company's sales fall below certain levels, when the employee did not receive the stock in connection with his performing services and a principal purpose of the agreement is not to circumvent the single class of stock rules.[277] Could a sale price that is nominal be considered not to be bona fide or be considered to make the stock forfeitable, throwing it into the rules that apply to forfeitable stock? The author has not researched whether this is a legitimate issue, but generally would feel comfortable with a

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> interest on the outstanding balance. Monthly installment payments were to be secured by a pledge of not less than N1 percent of the X stock held by A.

Citing Reg. § 1.1361-1(b)(4), Letter Ruling 201926008 held:

> Based solely on the facts submitted and the representations made, we conclude that Agreement 1 and Agreement 2 satisfy the requirements of § 1.1361-1(b)(4). Accordingly, Agreement 1 and Agreement 2 are not considered outstanding stock, and X's S corporation election was not terminated by virtue of the existence of Agreement 1 or Agreement 2.

[274] See part II.M.4.e.i Issuing Stock to an Employee - Generally, especially text accompanying fns. 3710-3715.

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

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

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

redemption price at book value,[278] because Reg. § 1.1361-1(*l*)(2)(iii)(A) provides (emphasis added):

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

Such a price would prevent the terminated employee from benefiting from valuation methods based on earnings or unrealized appreciation in the company's tangible or intangible assets. Also, the IRS approved a bonus plan to be funded by a portion of any future recovery from a claim against a third party; the plan would award certain of its employees for their work on the matter relating to that claim.[279]

The shareholder agreement can go even further and provide that an employee's shares are to be redeemed at less than fair market value on the termination of employment or if the corporation's sales fall below certain levels, even though the shares were not issued to the employee, in connection with the performance of services; the regulations permit this unless a principal purpose of that portion of the agreement is to circumvent the one class of stock requirement.[280] Stock issued to key employees may be subjected to transfer restrictions and service-related risks of forfeiture.[281] Letter Ruling 201918013 held that the transfer restrictions and repurchase provisions in the following Agreement and Plan will be disregarded in determining whether X's shares of stock confer identical rights:

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[278] Letter Ruling 200708018 approved a stock option plan where the employee could buy at book value and the corporation could repurchase at the same value one year later if the employee transferred the stock. The corporation also had an ongoing right to redeem the shares; the ruling did not disclose the redemption price.
[279] Letter Ruling 201309003.
[280] Reg. § 1.1361-1(l)(2)(vi), Ex. (9).
[281] Letter Ruling 201405005 involved a corporation's redemption of its two only shareholders in exchange for installment notes issued to each. Key employees were issued stock with the restrictions and made Code § 83(b) elections so that the stock was considered outstanding. It is a good example of a transition plan.

> Under an agreement entered into by X and its shareholders, the Agreement, shares generally may not be transferred without the prior written consent of the Chairman of the Board of Directors of X.
>
> X has adopted an equity compensation plan, the Plan, which authorizes X to sell shares of X's stock to key employees of X or to grant shares or options to purchase shares to such employees. Shares acquired under the Plan are subject to the same transfer restrictions set forth in the Agreement. In addition, shares held by employees may be repurchased under certain circumstances by X (generally, upon termination of employment) at either the "non-forfeiture repurchase price," which equals the fair market value of the shares, or the "forfeiture repurchase price," which is the lesser of: (i) the fair market value of the shares or (ii) the price paid, if any, to acquire the shares. Depending on the circumstances, the forfeiture repurchase price could be as low as zero. The repurchase price of the shares will only be the forfeiture repurchase price if the employee has engaged in activity meeting the definition of "cause" in the Plan, which generally only includes theft or fraud by the employee that materially harms X.
>
> Some employees of X have requested (i) permission to transfer their shares of X to a trust for the benefit of themselves and/or their family members, or (ii) that the shares of X that would otherwise be issued to them pursuant to the Plan instead be issued to such a trust. X will confirm that the trusts are eligible S corporation shareholders. Shares held in such trusts will be subject to the same restrictions under the Agreement and the Plan as shares directly held by employees.
>
> X represents that the Agreement and the Plan were not created as a plan to circumvent the one class of stock requirement for S corporations.

Letter Ruling 9413023 approved the following plan as not causing second-class-of-stock issues:

> Based on representations made and information submitted, X is a closely held corporation that was incorporated on May 25, 1955, and X has filed an S election effective for the tax year beginning September 27, 1993. Since its incorporation, X has entered into a buy-sell agreement and a split-dollar life insurance arrangement with shareholders A and B, respectively.
>
> X entered into the buy-sell agreement with A on October 31, 1980. The buy-sell agreement was the result of arm's length business negotiations, and it established a purchase price that reflected fair market value less a minority discount.
>
> Under the split-dollar life insurance arrangement with B, X pays the premiums on the policies. To the extent that the premium confers an economic benefit on B, X reports the amount as taxable compensation to B, and B reports the benefit as taxable income. B works exclusively in the business operations of X.
>
> In addition, X proposes to adopt for the benefit of its employees a plan that X refers to as a stock appreciation rights plan (Plan). Under the Plan, full-time employees who have satisfied certain requirements may acquire non-transferrable Certificates either by purchase or award. A Certificate's value equals the book value of a share of X's stock as of the appropriate valuation date (generally, the last day of X's preceding fiscal year). Book value is determined in accordance with provisions in the Plan.

> The Plan provides an annual 30-day window period when eligible employees may purchase a limited number of Certificates. Once a Participant has held these Certificates for 24 months, the Participant may voluntarily surrender them for immediate payment. No waiting period applies for payments made in the event of an Unforeseen Emergency, as defined in the Plan, and all purchased Certificates must be surrendered for immediate payment upon Separation of Service, even if Separation of Service occurs before the end of the 24 month waiting period. The amount due a Participant with respect to the surrender of purchased Certificates will be the greater of the amount equal to the purchase price paid by the Participant or the book value of the surrendered Certificates determined as of the appropriate valuation date.
>
> Awarded Certificates are purchased by X on behalf of selected awardees and subsequently delivered to them. These Certificates may not be redeemed for two years after the date of X's purchase of them unless the awardee Separates from Service or experiences an Unforeseen Emergency. Payment made in connection with the surrender of an awarded Certificate will equal the book value of a share of X's stock as of a stipulated valuation date.
>
> Certificates are nontransferable and nonassignable. They do not provide voting rights or dividend rights. Under the Plan, X's obligation to pay constitutes a mere unsecured promise and a participant's rights are no greater than those of a general creditor of X.

Letter Ruling 9413023 analyzed the timing of the employees recognizing income under the constructive receipt rule of Reg. § 1.451-2(a):[282]

> The Code and regulations do not define the phrase "substantial limitation or restriction." Both the courts and the Internal Revenue Service have recognized that such a restriction exists if the taxpayer must surrender or forfeit a valuable right to receive the income. *Hales v. Commissioner*, 40 BTA 1245 (1939), *acq.*, 1940-1 C.B. 2; *Knapp v. Commissioner*, 41 BTA 23 (1940).
>
> Rev. Rul. 80-300, 1980-2 C.B. 165, as amplified by Rev. Rul. 82- 121, 1982-1 C.B. 79, finds the right to enjoy appreciation of the employer's stock without making any capital investment in the stock is a valuable right and holds that an employee is not in constructive receipt before such stock appreciation rights (SARs), previously granted, are exercised. In the revenue ruling, surrender of the SARs resulted in the loss of the right to further appreciation without risking capital. Upon withdrawal, the employee received only an amount representing appreciation. The subsequent purchase of an interest providing similar rights to appreciation would require the investment of additional capital by the employee.
>
> Similarly, the profit sharing plan in *Knapp* provided a unique economic opportunity that could not be duplicated upon withdrawal. Under the profit sharing plan, profits were allocated pro rata based on the participants' deposits the preceding year. A participant who had completed a specified number of years of service was entitled to withdraw all the money credited to his account. However, when a participant withdrew from the plan, he could not participate in the plan in the future.

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[282] Reg. § 1.451-2(a) is reproduced in the text accompanying fns 4205-4206 in part II.Q.1.e Trying to Avoid Possible Ordinary Income on the Sale of a Partnership or S Corporation.

> The Plan in this case although termed a stock appreciation rights plan is in reality a phantom stock or shadow stock plan and not a stock appreciation rights plan as described in Rev. Rul. 80-300 and Rev. Rul. 82-121, because Participants receive more than the value of appreciation on redemption. Additionally, Participants give up no valuable rights when they redeem Certificates. Because they receive the full value of a share of X's stock upon redemption, nothing restricts Participants from reinvesting these amounts in substantially similar products available to the public. Redemption does not cause a Participant to forfeit the right to acquire additional Certificates in the future.
>
> On these facts, a participant reporting his or her income on the cash receipts and disbursements method of accounting will not be in constructive receipt of income when Certificates are purchased or awarded because amounts are not available so that they can be drawn upon by the participant. However, amounts will be includible in income on the earlier of the expiration of the waiting period, Separation of Service, or the determination of an Unforeseen Emergency.

Letter Ruling 9413023 then evaluated any interplay with the second-class-of-stock rule:

> The facts reveal that the buy-sell agreement with A established a purchase price of fair market value less a minority discount. When a purchase price is the result of arm's length business negotiations, the mere presence, or absence, of a minority discount does not cause an agreement to establish a purchase price that is significantly in excess of or below the fair market value of the stock. Therefore, the agreement will be disregarded in determining whether X's shares of stock confer identical distribution and liquidation rights.
>
> Rev. Rul. 91-26, 1991-1 C.B. 185, states that the Service does not consider payments of accident and health insurance premiums by an S corporation on behalf of 2-percent shareholder-employees to be distributions for purposes of the single class of stock requirement of section 1361(b)(1)(D).
>
> Like the payment of accident and health insurance premiums described in Rev. Rul. 91-26, X's payment of premiums under the split-dollar life insurance agreement is a fringe benefit to B, not a vehicle for the circumvention of the one class of stock requirement. Therefore, the agreement will be disregarded in determining whether X's shares of stock confer identical distribution and liquidation rights.
>
> Section 1.1361-1(b)(4) provides that an instrument, obligation, or arrangement is not treated as outstanding stock if it: (i) does not convey the right to vote; (ii) is an unfunded and unsecured promise to pay compensation; (iii) is issued to an employee in connection with the performance of services for the corporation or to an individual who is an independent contractor in connection with the performance of services for the corporation (and is not excessive by reference to the services performed); and (iv) is issued under a plan with respect to which the employee or independent contractor is not taxed currently on income. Furthermore, the mere inclusion of a current payment feature in such an instrument, obligation, or arrangement does not change this conclusion.
>
> The Plan does not grant participants common shares of stock. The Plan units constitute unfunded and unsecured promises to pay compensation in the future that are not taxed currently as income. Furthermore, the Plan does not convey the right to vote, and it is issued to employees in connection with the performance of services for the corporation.

> Accordingly, pursuant to section 1.1361-1(b)(4), the Plan units are not treated as outstanding stock.

Letter Ruling 9413023 concluded:

> Based solely on the representations made and the information submitted, we conclude the following:
>
> 1) the buy-sell agreement, the split-dollar arrangement, and the Plan will not create more than one class of stock within the meaning of section 1361(b)(1)(D); and
>
> 2) a Plan participant reporting his or her income on the cash receipts and disbursements method of accounting will not be in constructive receipt of income when Certificates are purchased or awarded because amounts are not available so that they can be drawn upon by the participant. However, amounts will be includible in income on the earlier of the expiration of the waiting period, Separation of Service, or the determination of an Unforeseen Emergency.
>
> Pursuant to section 3.01(32) of Rev. Proc. 93-3, 1993-1 I.R.B. 71, 76, this ruling is not applicable to any participant who is a controlling shareholder of taxpayer. If the proposed Plan is substantially amended, this ruling may not remain in effect.

II.A.2.i.v. Discounts in Redeeming Minority Shareholders

Citing Reg. § 1.1361-1(*l*)(2)(iii)(A),[283] Letter Ruling 9433024 held that the following redemption agreement described below would be "disregarded in determining whether X's shares of stock confer identical rights":

> X is a corporation organized under the laws of A. X filed a subchapter S election effective January 31, 1983. X's capital structure consists of a single class of common stock, 65% owned by the Majority Shareholder, Y, and 35% owned by 10 other shareholders (collectively, Minority Shareholders).
>
> Presently, X is negotiating a sale of substantially all of its assets to an unrelated third party. In the event a sale takes place, it is represented that each minority shareholder, pursuant to a Redemption Agreement, has agreed to allow X to purchase their stock at a price equal to the proportionate share of the net fair market value of X's assets attributable to their block of X stock, subject to a minority discount. However, the Redemption Agreement establishes a minimum purchase price equal to the book value of the minority shareholders' stock as of the date the agreement is entered into.

II.A.2.i.vi. Post-Redemption or Post-Sale Price Adjustments

Relying on Reg. § 1.1361-1(*l*)(2)(iii)(A), Letter Ruling 201218004 allowed redemption proceeds to be adjusted such that the redeemed shareholders would receive additional payments if the corporation engages in certain sales transactions specified in the redemption agreement. Similarly, Letter Ruling 201309003 approved a clause allowing the value of a certain claim against a third party to benefit members who sold their interest if any recovery is made and

[283] Reg. § 1.1361-1(*l*)(2)(iii)(A) is reproduced in part II.A.2.i.iv Providing Equity-Type Incentives without Violating the Single Class of Stock Rules.

allows a person to purchase the S corporation's stock without requiring the selling original shareholder and purchaser to come to an agreement on the value of the claim.

II.A.2.i.vii. Adjustments in Code § 338(h)(10) Sales

Reg. § 1.1361-1(l)(2)(v), "Special rule for section 338(h)(10) elections," provides:

> If the shareholders of an S corporation sell their stock in a transaction for which an election is made under section 338(h)(10) and § 1.338(h)(10)-1, the receipt of varying amounts per share by the shareholders will not cause the S corporation to have more than one class of stock, provided that the varying amounts are determined in arm's length negotiations with the purchaser.

See part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.

II.A.2.i.viii. Special Price Protection for Leveraged ESOP Approved

Letter Ruling 201038001 involved the following regarding an ESOP:[284]

> On Date4, Company undertook a series of transactions that resulted in ESOP becoming the sole owner of Company's outstanding stock. First, Company made a loan, secured by Company stock, to ESOP (ESOP Loan). Next, ESOP used the ESOP Loan proceeds to purchase all of the remaining outstanding shares of Company stock (Second Purchase Shares).
>
> Among its provisions, ESOP provides generally that benefits are distributed to participants at stated periods of time following their termination of employment due to retirement, disability, death, or other reason. Provision A of ESOP provides generally that for purposes of distributions under the plan, the value of the shares held by ESOP is determined by an independent appraiser. The independent appraiser calculates the fair market value of ESOP's assets and reduces that value by any liabilities of ESOP, including the outstanding balance of the ESOP Loan.
>
> Provision B of ESOP provides a special valuation rule with respect to First Purchase Shares for purposes of distributions under the plan. Provision B provides that the value of Company shares purchased in connection with the First Purchase Shares will not be decreased or otherwise affected by the outstanding balance of the ESOP Loan proceeds used to purchase the Second Purchase Shares.
>
> Company represents that the purpose of Provision B is to protect the value of the First Purchase Shares from a steep decline in value that is normally associated with a highly leveraged employee stock ownership plan transaction. Company further represents that a serious employee relations problem would have occurred if a voluntary corporate action had the effect of reducing the value of First Purchase Shares already owned by ESOP. This would have negatively impacted employees who were close to retirement or who had previously terminated employment and were waiting for distributions. According to Company, First Purchase Shares continue to fluctuate in value with the fortunes of

[284] See part II.G.21 Employee Stock Ownership Plans (ESOPs) and Other Code § 401(a) Qualified Retirement Plans Investing in Businesses.

Company and general market conditions, as would occur in the absence of a leveraged employee stock ownership plan transaction.

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

II.A.2.i.ix. Warrants Designed to Restore Original Shareholders' Equity Position

As described by a court:[285]

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

The court concluded that the warrants constituted a second class of stock:[286]

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

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[285] *Santa Clara Valley Housing Group, Inc. v. U.S.*, 108 AFTR.2d 2011-6361 (N.D. CA 2012).
[286] Pursuant to Reg. § 1.1361-1(l)(4)(ii).

> any purpose other than to protect the Schott family's equity in Santa Clara for the period of time that the majority shares were "parked" in LAPF.

That tax shelter idea no longer works,[287] but the idea that one cannot retain too many strings on transferred stock remains an important point.[288]

II.A.2.i.x. Straight Debt

"Straight debt" does not constitute a second class of stock[289] (or as stock for purposes of subchapter S).[290] This rule applies notwithstanding part II.A.2.i.xi Debt.[291]

"Straight debt" means a written unconditional obligation, regardless of whether embodied in a formal note, to pay a sum certain on demand, or on a specified due date, if it:[292]

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

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

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

Code § 1361(c)(2) is described in part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation. Clause (C) above omits another type of creditor who qualifies under Code § 1361(c)(5)(B)(iii): "a person which is actively and regularly engaged in the business of lending money." The regulation quoted above was promulgated before the statute referred to commercial lenders; legislative history suggests that commercial lender qualification not include individuals who are commercial lenders.[293]

Being subordinated to other debt does not prevent the obligation from qualifying as straight debt.[294]

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[287] See fn 4716 in part II.Q.6.d.ii UBTI Related to an S Corporation.
[288] See part II.Q.6.f.ii Forced Sale to Related Party for Note.
[289] Reg. § 1.1361-1(l)(5)(i).
[290] Reg. § 1.1361-1(b)(5) provides:

> *Treatment of straight debt*. For purposes of subchapter S, an instrument or obligation that satisfies the definition of straight debt in paragraph (*l*)(5) of this section is not treated as outstanding stock.

This is important for Reg. § 1.1361-1(*l*)(3), which is reproduced in fn 3715 in part II.M.4.e.i Issuing Stock to an Employee - Generally.
[291] Reg. § 1.1361-1(l)(5)(i).
[292] Reg. § 1.1361-1(l)(5)(i).
[293] House Report 104-586 (5/20/1996) for P.L. 104-188 (the Small Business Job Protection Act of 1996) expressed an intent that this cover "creditors, other than individuals, that are actively and regularly engaged in the business of lending money."
[294] Reg. § 1.1361-1(l)(5)(ii).

An obligation can lose its "straight debt" qualification by being materially modified or transferred to a third party who is not an eligible shareholder.[295]

Being "considered equity under general principles of Federal tax law"[296] does not disqualify the obligation from being straight debt under this rule.[297] Thus, interest on a straight debt obligation is generally treated as interest by the corporation and the recipient and does not constitute a distribution.[298] However, if the interest rate is unreasonably high, an appropriate portion of the interest may be recharacterized and treated as a payment that is not interest (without resulting in a second class of stock).[299]

Conversion from C corporation status to S corporation status is not treated as an exchange of debt for stock with respect to "straight debt" that is considered equity under general principles of Federal tax law.[300]

II.A.2.i.xi. Debt other than Straight Debt

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

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

However, debt is treated as a second class of stock of the corporation if it constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law and a principal purpose of creating the debt is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders.[301] This rule does not apply to unwritten advances from a shareholder that do not exceed $10,000 in the aggregate at any time during the taxable year of the corporation, are treated as debt by the parties, and are expected to be repaid within a reasonable time.[302] It also does not apply to obligations of the same class that are owned solely by the owners of, and in the same proportion as, the outstanding stock of the corporation, are not treated as a second class of stock.[303] Obligations that are considered equity that do not meet this safe harbor will not result in a second class of stock unless a principal purpose of the obligations is to circumvent the rights of the outstanding shares of stock or the limitation on eligible shareholders.[304]

A convertible debt instrument is considered a second class of stock if it (A) would be treated as a second class of stock under provisions relating to instruments, obligations, or arrangements treated as equity under general principles, or (B) embodies rights equivalent to those of a call option that would be treated as a second class of stock under provisions relating to certain call

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[295] Reg. § 1.1361-1(l)(5)(iii).
[296] See part II.G.20 Debt vs. Equity; Potential Denial of Deduction for Business Interest Expense.
[297] Reg. § 1.1361-1(l)(5)(iv).
[298] Reg. § 1.1361-1(l)(5)(iv).
[299] Reg. § 1.1361-1(l)(5)(iv).
[300] Reg. § 1.1361-1(l)(5)(v).
[301] Reg. § 1.1361-1(l)(4)(ii)(A).
[302] Reg. § 1.1361-1(l)(4)(ii)(B)(1).
[303] Reg. § 1.1361-1(l)(4)(ii)(B)(2), which further provides:

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

[304] Reg. § 1.1361-1(l)(4)(ii)(B)(2).

options, warrants, and similar instruments.[305] Allowing for conversion of debt to equity using the stock's value at the time the debt instrument is issued is not a second class of stock under this rule.[306]

II.A.2.i.xii. Automatic Relief If Governing Provisions Violate Single Class of Stock Rule

Rev. Proc. 2022-19, § 2.03(1), "One class of stock requirement and governing provisions, including 'principal purpose' conditions," provides:

(a) *Overview*. Pursuant to § 1361(b)(1)(D) and § 1.1361-1(*l*)(1), a corporation that has more than one class of stock does not qualify as a small business corporation. Section 1.1361-1(*l*)(1) provides generally that a corporation is treated as having only one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds.

(b) *Governing provisions*. Section 1.1361-1(*l*)(2)(i) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable State law, and binding agreements relating to distribution and liquidation proceeds (collectively, governing provisions). A commercial contractual agreement is not a binding agreement relating to distribution and liquidation proceeds, and therefore is not a governing provision, unless a principal purpose of the agreement is to circumvent the one class of stock requirement. See § 1.1361-1(*l*)(2)(i).

(c) *Other agreements and arrangements*. The Income Tax Regulations identify a number of other agreements and arrangements between or among an S corporation and its shareholders that may or may not be treated as second classes of stock depending in part on whether a principal purpose of the agreement or arrangement was to circumvent the one class of stock requirement or otherwise alter shareholders' rights to distribution and liquidation proceeds. See § 1.1361-1(l)(2)(iii)(A) (buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements), § 1.1361-1(l)(4)(ii)(A) (special rules for instruments, obligations, or arrangements treated as equity under general principles of Federal tax law), § 1.1361-1(l)(4)(ii)(B)(1) (short-term unwritten advances that fail the safe harbor described in § 1.1361-1(l)(4)(ii)(B)(1)), and § 1.1361-1(l)(4)(ii)(B)(2) (obligations of the same class that are considered equity under general principles of Federal tax law but fail the safe harbor described in § 1.1361-1(l)(4)(ii)(B)(2)). See section 3.01 of this revenue procedure (providing that the IRS will not treat taxpayers who have entered into the agreements or arrangements described in this section 2.03(1)(c) as violating the one class of stock requirement of § 1361(b)(1)(D) so long as there was no principal purpose to use the agreement or arrangement as a means to circumvent the one class of stock requirement).

Rev. Proc. 2022-19, § 3.01, "Agreements and Arrangements with No Principal Purpose to Circumvent One Class of Stock Requirement," provides:

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[305] Reg. § 1.1361-1(l)(4)(iv).
[306] Letter Ruling 201326012.

> Certain agreements and arrangements described in section 2.03(1)(c) of this revenue procedure are not governing provisions and are not treated as second classes of stock so long as there was no principal purpose to use the agreement as a means to circumvent the one class of stock requirement. Accordingly, the IRS will not treat an S corporation as violating the one class of stock requirement of § 1361(b)(1)(D) as a result of an agreement or arrangement identified in section 2.03(1)(c) of this revenue procedure that does not have a principal purpose to circumvent the one class of stock requirement. Because entering into these specific agreements in these circumstances will not result in termination of S corporation status, taxpayers do not need to seek relief from the IRS. For this reason, and because the existence of a principal purpose is inherently factual in nature, the IRS will not rule in these situations. See section 4.01(1) of this revenue procedure.

Suppose one is concerned whether an agreement described above might constitutes a "governing provision." Presumably, not satisfying the principal purpose test would make such an agreement constitute a "governing provision," which would violate the single class of stock requirement as non-identical governing provision. Consider terminating the concerning arrangement and obtaining the relief provided below.

Rev. Proc. 2022-19, § 2.03(6), "Non-identical governing provisions," provides:

> (a) *Overview*. Section 1361(b)(1)(D) requires an S corporation to have only one class of stock. Section 1.1361-1(*l*) provides that a corporation is treated as having only one class of stock if all outstanding shares of the corporation's stock confer identical rights to distribution and liquidation proceeds and if the corporation has not issued any instrument or obligation, or entered into any arrangement, that is treated as a second class of stock. An S corporation in compliance with § 1.1361-1(*l*) is commonly referred to as having "identical governing provisions." The term "non-identical governing provision" means a governing provision, as defined by § 1.1361-1(*l*)(2)(i), on its own or as part of another governing provision, that for Federal income tax purposes results in the S corporation having more than one class of stock under § 1.1361-1(*l*)(1) (even if the S corporation never made a non-pro rata distribution or liquidating distribution).
>
> (b) *Consequences of non-identical governing provisions*. If an entity files an S election when it has more than a single class of stock, the entity does not meet the requirements to be an S corporation and its attempted election is invalid. See § 1361(a)(1). If a valid S corporation later provides for more than a single class of stock, its S election automatically terminates on the day the disqualifying event occurs. See § 1362(d)(2). See section 3.06 of this revenue procedure (providing procedures for correcting, without the receipt of a PLR, the validity or continuation of an S election with regard to one or more non identical governing provisions, as defined in section 2.03(6)(a) of this revenue procedure).

Rev. Proc. 2022-19, § 3.06, "Procedures for Retroactively Correcting One or More Non-Identical Governing Provisions," provides:

> (1) *Definitions*. For purposes of this section 3.06:

a Applicable shareholder. The term “applicable shareholder” means a current or former shareholder of a corporation who owns or owned stock of the corporation at any time during the period:

(i) Beginning on the date on which the non-identical governing provision was adopted (on its own or as part of another governing provision); and

(ii) Ending on the date on which the non-identical governing provision was removed or modified in a manner such that the governing provision complies with the one class of stock requirement.

(b) *Discovered by the IRS*. The term “discovered by the IRS” has the meaning given the term in § 301.9100-3(b)(1)(i) of the Procedure and Administration Regulations (26 CFR part 301).

(c) *Disproportionate distribution*. The term “disproportionate distribution” is defined in section 2.03(2) of this revenue procedure.

(d) *Non-identical governing provision*. The term “non-identical governing provision” is defined in section 2.03(6)(a) of this revenue procedure.

(2) *Retroactive corrective relief procedures*.

(a) *Retroactive continuing validity of S election*. If an S corporation and its applicable shareholders meet the requirements of this section 3.06, an S election that is invalid or terminated solely as the result of one or more non-identical governing provisions will be treated for Federal income tax purposes as continuing from the date on which the first non-identical governing provision that invalidated or terminated the corporation’s S election was adopted.

(b) *Eligibility*. A small business corporation and each applicable shareholder of the corporation are eligible for corrective relief under this section 3.06 if the following requirements are satisfied:

(i) The corporation has or had one or more non-identical governing provisions;

(ii) The corporation has not made, and for Federal income tax purposes is not deemed to have made, a disproportionate distribution to an applicable shareholder;

(iii) The corporation timely filed a return on Form 1120-S (as required under § 6037 of the Code and § 1.6037-1 of the Income Tax Regulations) for each taxable year of the corporation beginning with the taxable year in which the first non-identical governing provision was adopted and through the taxable year immediately preceding the taxable year in which the corporation made a request for corrective relief under this section 3.06 (a corporation is treated as having timely filed a required Form 1120-S under this section 3.06(2)(b)(iii) if the Form 1120-S is filed within six months after its original due date, excluding extensions); and

(iv) Before any non-identical governing provision is discovered by the IRS, all of the requirements described in section 3.06(2)(c) of this revenue procedure are satisfied.

(c) *Corrective relief statements*.

(i) *Corporate governing provision and shareholder statements*. The corporation must complete a Corporate Governing Provision Statement in accordance with section 3.06(2)(c)(ii) of this revenue procedure and a Shareholder Statement signed by each applicable shareholder in accordance with section 3.06(2)(c)(iii) of this revenue procedure.

(ii) *Corporate Governing Provision Statement*. The Corporate Governing Provision Statement, a sample of which is provided in Appendix A, must be completed in accordance with this section 3.06(2)(c)(ii).

(A) *Designation*. The Corporate Governing Provision Statement must state at the top of the document: "CORPORATE GOVERNING PROVISION STATEMENT PURSUANT TO REV. PROC. 2022-19, SECTION 3.06(2)(c)(ii)" .

(B) *Information*. The Corporate Governing Provision Statement must provide the following information:

(1) The date of the Corporate Governing Provision Statement, the corporation's name, employment identification number (EIN), address, date of formation or incorporation, and State of formation or incorporation;

(2) The actual or intended effective date of the corporation's S election filed on Form 2553 (see Form 2553, Part I, line E) that is the subject of the request for corrective relief under this section 3.06;

(3) The name, address, and social security number or taxpayer identification number of each applicable shareholder; and

(4) To establish an inadvertent termination or invalidation of the S election of the corporation, a description of all relevant facts regarding why each non-identical governing provision was adopted, how each non identical governing provision was discovered, and each action taken to correct or remove each non-identical governing provision before any non-identical governing provision is discovered by the IRS. This description must include each action taken by the corporation and each applicable shareholder to establish that the corporation and each applicable shareholder acted reasonably and in good faith in correcting or removing each non-identical governing provision upon discovery to demonstrate reasonable cause for relief.

(C) *Representations*. Except as provided in section 3.06(2)(c)(ii)(D), the corporation must provide the following four representations:

(1) “The corporation’s S election was inadvertently invalid or terminated solely because of the adoption of one or more non-identical governing provisions.” ;

(2) “The corporation and each applicable shareholder satisfy all of the requirements set forth in section 3.06 of Rev. Proc. 2022-19.”;

(3) “The corporation responds in the negative to each requested statement set forth in section 7.01(4) or (5) of Rev. Proc. 2022-1, or any successor revenue procedure (statements regarding whether the same or a similar issue was previously ruled on or whether a request involving the same or a similar issue was submitted or is currently pending).”; and

(4) “The corporation and each applicable shareholder acted reasonably and in good faith in correcting or removing each non-identical governing provision upon discovery.”

(D) *Explanation regarding previously ruled on, submitted, or pending PLRs*. If the corporation cannot respond in the negative to any requested statement set forth in section 7.01(4) or (5) of Rev. Proc. 2022 1, or any successor revenue procedure (and therefore cannot make the representation described in section 3.06(2)(c)(ii)(C)(3) of this revenue procedure), the corporation must provide an explanation for each such response as part of the description of all relevant facts required by section 3.06(2)(c)(ii)(B)(4) of this revenue procedure.

(E) *Statements*. The corporation must provide the statements set forth in section 3.06(2)(c)(ii)(E)(1) through (3) of this revenue procedure:

(1) “The corporation acknowledges that the relief provided by section 3.06 of Rev. Proc. 2022-19 is limited solely to each non-identical governing provision described in this Corporate Governing Provision Statement.” ;

(2) “The corporation acknowledges that the relief provided by section 3.06 of Rev. Proc. 2022-19 is based solely on the information, representations, and other statements provided by the corporation pursuant to section 3.06 of Rev. Proc. 2022-19, each of which is subject to verification during IRS examination.” ; and

(3) “During the period between the date on which the non-identical governing became effective and the date on which all of the procedures described in section 3.06 of Rev. Proc. 2022-19 are completed, each applicable shareholder has reported their income on all affected returns consistent with the S corporation election for the taxable year the non-identical governing provision became effective and for all subsequent years for which each applicable shareholder owned shares of the corporation.”.

(F) *Signature*. The Corporate Governing Provision Statement must be signed under penalties of perjury by a person authorized to sign the corporation's Federal income tax return under § 6062 of the Code. The penalties of perjury statement must be provided in the following format: " Under penalties of perjury, I declare that I have examined this Corporate Governing Provision Statement for corrective relief for one or more non-identical governing provisions, as provided by Rev. Proc. 2022-19, section 3.06, including accompanying documents, and, to the best of my knowledge and belief, the request contains all the relevant facts, and such facts are true, correct, and complete."

(iii) *Shareholder Statement*. The Shareholder Statement, a sample of which is provided in Appendix B, must be completed in accordance with this section 3.06(2)(c)(iii).

(A) *Designation*. The Shareholder Statement must state at the top of the document: "SHAREHOLDER STATEMENT PURSUANT TO REV. PROC. 2022-19, SECTION 3.06(2)(c)(iii)".

(B) *Information*. The Shareholder Statement must provide:

(1) The date of the Shareholder Statement, the corporation's name, EIN, address, date of formation or incorporation, and State of formation or incorporation;

(2) The name and address of each applicable shareholder;

(3) The social security number or taxpayer identification number of each applicable shareholder;

(4) The number of shares of stock or, in the case of a limited liability company, percentage of ownership each applicable shareholder owns or owned and the date(s) the stock was acquired and, if applicable, transferred; and

(5) The date that each applicable shareholder provided their signature, as required by section 3.06(2)(c)(iii)(D) of this revenue procedure.

(C) *Statement of consent*. Each applicable shareholder must provide the following statement of consent: "Under penalties of perjury, I declare that I consent to the election of [insert corporation's name], referred to herein as "the Corporation," located at [insert the Corporation's address], whose employment identification number (EIN) is [insert the Corporation's EIN], to be an S corporation under § 1362(a)(1) of the Code. I have examined this consent statement, including accompanying documents, and, to the best of my knowledge and belief, the request for corrective relief contains all the relevant facts, and such facts are true, correct, and complete. I understand that my consent is binding and may not be withdrawn after the Corporation receives relief pursuant to Rev. Proc. 2022-19, section 3.06. I also declare under penalties of perjury that I have reported my income on all affected returns consistent with the Corporation's election to be an S corporation for the taxable year for which the election would have been in effect but for the non-identical governing provision(s) described in the Corporate Governing Provision Statement for corrective relief and for all subsequent years I have owned shares of the Corporation."

(D) *Signature*. The Shareholder Statement must be signed under penalties of perjury by each applicable shareholder.

(d) *Record retention* requirement. The corporation is required to retain the Corporate Governing Provision Statement, the Shareholder Statement(s), and the revised governing provisions in accordance with § 6001 of the Code and the Income Tax Regulations thereunder. The Corporate Governing Provision Statement, the Shareholder Statement(s), and the revised governing provisions must be retained by the corporation for inspection by authorized Internal Revenue officers or employees, and must be retained so long as the contents thereof may become material in the administration of any provision of the Code or the Income Tax Regulations. See § 1.6001-1(e).

(e) *Alternative relief*.

(i) *General rule*. An S corporation or applicable shareholder that does not qualify for corrective relief under this section 3.06 may seek corrective relief through a request submitted by the S corporation, applicable shareholder, or authorized representative (as appropriate) to the Associate Chief Counsel (Passthroughs and Special Industries) for a PLR. The request must provide the required explanation described in section 3.06(2)(e)(ii) of this revenue procedure. See generally Rev. Proc. 2022-1 (or any successor revenue procedure).

(ii) *Required explanation*. A request for a PLR by an S corporation or applicable shareholder, or authorized representative, under section 3.06(2)(e)(i) of this revenue procedure must include an explanation regarding each reason why the requirements for corrective relief under this section 3.06 could not be satisfied.

II.A.2.i.xiii. Automatic Relief If Disproportionate Distributions Violate Single Class of Stock Rule

The discussion below follows up on parts II.A.2.i.ii Temporary Timing Differences; Other Varying Differences and II.A.2.i.iii Disproportionate Distributions (Not Temporary).

Rev. Proc. 2022-19, § 2.03(2), "Disproportionate distributions," provides:

> A "disproportionate distribution" is any distribution (including an actual distribution, a constructive distribution, or a deemed distribution) of property by a corporation with respect to shares of its stock that differs in timing or amount from the distribution with respect to any other shares of its stock. See § 1.1361 1(l)(1) and (2). Section 1.1361 1(l)(2)(i) provides that, "[a]lthough a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed

> distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances." Despite this regulation providing that "a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights," taxpayers and practitioners have indicated concern with the language of § 1.1361-1(*l*)(2)(i). The articulated concern is that the word "although" in combination with the subsequent language requiring that certain disproportionate distributions "be given appropriate tax effect" creates uncertainty as to whether an S corporation has created a second class of stock – even though the governing provisions provide identical distribution and liquidation rights with respect to each share. Practitioners suggest that the language in § 1.1361-1(*l*)(2)(i) could be clarified by removing the word "[a]lthough" and point to inconsistency in PLRs in the treatment of disproportionate distributions. See section 3.02 of this revenue procedure (providing that the IRS will not treat any disproportionate distributions by a corporation as violating the one class of stock requirement of § 1361(b)(1)(D) so long as the corporation's governing provisions provide for identical distribution and liquidation rights).

Rev. Proc. 2022-19, § 3.02, "Governing Provisions That Provide for Identical Distribution and Liquidation Rights," provides:

> As outlined in section 2.03(2) of this revenue procedure, § 1.1361-1(*l*)(2)(i) provides that a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights. Accordingly, the IRS will not treat any disproportionate distributions made by a corporation as violating the one class of stock requirement of § 1361(b)(1)(D) so long as the governing provisions of the corporation provide for identical distribution and liquidation rights. Because disproportionate distributions made in these circumstances will not result in the termination of S corporation status, taxpayers do not need to seek relief from the IRS and the IRS will not rule in these situations. See section 4.01(2)(a) of this revenue procedure.

II.A.2.j. Overcoming Above Rules

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

The S corporation can contribute its assets to an entity taxed as a partnership with an ineligible shareholder as a member,[307] with another S corporation as a member (to avoid the limitation on

[307] Reg. § 1.701-2(d), Example (2).

number of shareholders),[308] with profits interests issued to (former) employees,[309] or with an investor who wants a non-pro rata equity interest in the business.

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

In corporate reorganizations, sometimes transitory entities are created, or transitory stock ownership occurs, to achieve some state law objective. For example:[310]

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

If a corporation owns stock in an S corporation that is undergoing such a transaction so that the ownership is transitory, the transaction's being disregarded also means that the transitory stock ownership does not terminate the S corporation's S election.[311]

For disregarding transitory partnerships that own S corporation stock, see part II.A.2.f Shareholders Eligible to Hold S Corporation Stock, especially fn. 151.

II.A.2.k. Terminating an S Election

For the effects of terminating an S election, see part II.P.3.d Conversion from S Corporation to C Corporation.

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[308] Rev. Rul. 94-43, which Letter Ruling 201544020 cited as authority for holding that the following did not cause a violation of the 100-shareholder limit:

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

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

[309] For profits interests, see part II.M.4.f Issuing a Profits Interest to a Service Provider.

[310] Rev. Rul. 78-250.

[311] Letter Ruling 201330018. See also Letter Ruling 201314031 (transitory ownership in a split-off). For a discussion of F reorganizations, see part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization, especially fn. 4078.

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

(1) Shareholders holding more than one-half of the shares consent to the revocation.[312] Generally, instead of revoking the S election, consider reorganizing the entity into an S corporation parent with a C corporation subsidiary.[313]

(2) The corporation ceases to be eligible.[314]

(3) The corporation has prior C corporation earnings and profits at the close of each of three consecutive taxable years and has gross receipts for each of such taxable years more than 25% of which are passive investment income.[315]

Do the tax benefits of an S election constitute an asset of the corporation, so that a corporate bankruptcy places a "stay" that prevents shareholders from revoking the S election? A 2017

[312] Code § 1362(d)(1)(B). Reg. § 1.1362-6(a)(3), "Revocation of S election," provides:

(i) *Manner of revoking election*. To revoke an election, the corporation files a statement that the corporation revokes the election made under section 1362(a). The statement must be filed with the service center where the election was properly filed. The revocation statement must include the number of shares of stock (including non-voting stock) issued and outstanding at the time the revocation is made. A revocation may be made only with the consent of shareholders who, at the time the revocation is made, hold more than one-half of the number of issued and outstanding shares of stock (including non-voting stock) of the corporation. Each shareholder who consents to the revocation must consent in the manner required under paragraph (b) of this section. In addition, each consent should indicate the number of issued and outstanding shares of stock (including non-voting stock) held by each shareholder at the time of the revocation.

(ii) *Time of revoking election*. For rules concerning when a revocation is effective, see § 1.1362-2(a)(2).

(iii) *Examples*. The principles of this paragraph (a)(3) are illustrated by the following examples:

Example (1). *Revocation; consent of shareholders owning more than one-half of issued and outstanding shares*. A calendar year S corporation has issued and outstanding 40,000 shares of class A voting common stock and 20,000 shares of class B non-voting common stock. The corporation wishes to revoke its election of subchapter S status. Shareholders owning 11,000 shares of class A stock sign revocation consents. Shareholders owning 20,000 shares of class B stock sign revocation consents. The corporation has obtained the required shareholder consent to revoke its subchapter S election because shareholders owning more than one-half of the total number of issued and outstanding shares of stock of the corporation consented to the revocation.

Example (2). *Effective prospective revocation*. In June 1993, a calendar year S corporation determines that it will revoke its subchapter S election effective August 1, 1993. To do so it must file its revocation statement with consents attached on or before August 1, 1993, and the statement must indicate that the revocation is intended to be effective August 1, 1993.

[313] That structure can be superior for the reasons described in fns 3977-3985 in part II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation.

[314] Code § 1362(b)(2).

[315] Code § 1362(b)(3). See part II.P.3.b.iii Excess Passive Investment Income.

case said that bankruptcy does not place such a stay,[316] after citing mixed authority that tended to the opposite conclusion.[317]

If an S election has been terminated under Code § 1362(d), the corporation may not make another S election under before its fifth taxable year which begins after the first taxable year for which such termination is effective, unless the IRS consents to such election.[318] In the case of a voluntary termination, presumably this waiting period can be avoided as described in fn 313.

If an S corporation intentionally permits an ineligible shareholder because a third party prevented it from making tax distributions, the IRS will not consent to making the S election again until this waiting period has run.[319]

On the other hand, when eligible shareholders sold stock to ineligible shareholders without anyone intending to terminate the S election, the IRS consented to waiving the waiting period.[320] But when the sole shareholder sold all of the stock in the S corporation to an ineligible shareholder, the IRS denied the waiver.[321]

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[316] *In re Health Diagnostic Laboratory, Inc.*, 578 B.R. 552 (Bankr. E.D. Va. 2017) held:

> After weighing all the factors, this Court will adopt the holding of the Court of Appeals for the Third Circuit that S corporation status is not property under federal tax law. See *In re Majestic Star Casino, LLC*, 716 F.3d 736 (3d Cir. 2013) (concluding that S corporation status was not "property" under the Bankruptcy Code and sharply disagreeing with In re Trans-Line West and the cases that followed). Although a corporation and its shareholders can elect to use S corporation status in order to avoid double taxation, that factor alone is not enough to outweigh all the remaining characteristics essential to qualify tax status as a property right. Accordingly, this Court holds that S corporation status is not "property" under federal tax law, and thus cannot be considered "property" for the purposes of sections 544(b) and 548(a)(1) of the Bankruptcy Code.

[317] *In re Health Diagnostic Laboratory, Inc.*, 578 B.R. 552 (Bankr. E.D. Va. 2017) summarized prior cases before going into details about their reasoning and why the court concluded as it did:

> The issue whether S corporation status constitutes property of the estate in bankruptcy is a matter of first impression within the Fourth Circuit. Only a handful of courts outside the Fourth Circuit have considered this issue in the context of fraudulent transfers. See *Majestic Star Casino, LLC v. Barden Dev., Inc.* (*In re Majestic Star Casino, LLC*), 716 F.3d 736 (3d Cir. 2013); *Halverson v. Funaro* (*In re Frank Funaro, Inc.*), 263 B.R. 892 (B.A.P. 8th Cir. 2001); *Parker v. Saunders* (*In re Bakersfield Westar*), 226 B.R. 227 (B.A.P. 9th Cir. 1998); *Hanrahan v. Walterman* (*In re Walterman Implement, Inc.*), No. 05-07284, 2006 WL 1562401 (Bankr. N.D. Iowa May 22, 2006); *Guinn v. Lines* (*In re Trans-Line West, Inc.*), 203 B.R. 653 (Bankr. E.D. Tenn. 1996). Of these courts, only the Court of Appeals for the Third Circuit has concluded that S corporation status does not constitute a property right in bankruptcy. See *In re Majestic Star Casino*, 716 F.3d at 758; see also *Official Comm. Unsecured Creditors v. Forman* (*In re Forman Enterprises, Inc.*), 281 B.R. 600, 612 (Bankr. W.D. Pa. 2002) ("[W]e are reluctant to believe that a post-bankruptcy revocation of S status could, under the tax laws of the United States, be utilized to undo previously executed acts. Humpty Dumpty could not be restructured using this scenario."). All of the other courts that have addressed the issue have found S corporation status to be a property right in bankruptcy. See *In re Frank Funaro, Inc.*, 263 B.R. at 898; *In re Bakersfield Westar*, 226 B.R. at 234; *In re Walterman Implement, Inc.*, 2006 WL 1562401 at *3; *In re Trans-Line West, Inc.*, 203 B.R. at 662.

[318] Code § 1362(g).

[319] Letter Ruling 201403001.

[320] Letter Ruling 201550022.

[321] Letter Ruling 201636033.

The entire day on which the election terminates is treated as the first day of the C corporation year.[322]

A Code § 1362(d) termination generates a pro-rata, per-share, per-day allocation,[323] except that an accounting cut-off applies:

- To the extent that the corporation is deemed to have sold its assets under Code § 338 (see, *e.g.*, part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold),[324] or

- If the shareholders elect to use an accounting cut-off.[325]

[322] Code § 1362(e)(1), "In general," provides:

In the case of an S termination year, for purposes of this title -

(A) *S short year*. The portion of such year ending before the 1st day for which the termination is effective shall be treated as a short taxable year for which the corporation is an S corporation.

(B) *C short year*. The portion of such year beginning on such 1st day shall be treated as a short taxable year for which the corporation is a C corporation.

[323] Code § 1362(e)(2).

[324] Code § 1362(e)(6)(C); Reg. § 1.1362-3(b)(2).

[325] Reg. § 1.1362-3(b)(1).

II.B. Limited Liability Company (LLC)

A limited liability company (LLC) is a business entity[326] that generally has liability protection similar to that of a corporation. However, for federal tax purposes,[327] an LLC is treated as follows[328] (with specific rules for series LLCs):[329]

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[326] Reg. § 301.7701-2(a) provides:

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

[327] For some examples of federal civil procedure and state real estate transfer tax issues involving single-member LLCs, see Kleinberger and Bishop, "The Single-Member Limited Liability Company as Disregarded Entity: Now You See It, Now You Don't," *Business Law Today* (8/2/2010), found at http://www.abanet.org/buslaw/blt/content/articles/2010/08/0002.html. For creditor issues, see part II.F Asset Protection Planning.

[328] TD 8697 (12/17/1996) explains:

> Any business entity that is not required to be treated as a corporation for federal tax purposes (referred to in the regulation as an eligible entity) may choose its classification under the rules of § 301.7701-3. Those rules provide that an eligible entity with at least two members can be classified as either a partnership or an association, and that an eligible entity with a single member can be classified as an association or can be disregarded as an entity separate from its owner. However, if the single owner of a business entity is a bank (as defined in section 581), then the special rules applicable to banks will continue to apply to the single owner as if the wholly owned entity were a separate entity.
>
> In order to provide most eligible entities with the classification they would choose without requiring them to file an election, the regulations provide default classification rules that aim to match taxpayers' expectations (and thus reduce the number of elections that will be needed). The regulations adopt a passthrough default for domestic entities, under which a newly formed eligible entity will be classified as a partnership if it has at least two members, or will be disregarded as an entity separate from its owner if it has a single owner. The default for foreign entities is based on whether the members have limited liability. Thus a foreign eligible entity will be classified as an association if all members have limited liability. A foreign eligible entity will be classified as a partnership if it has two or more members and at least one member does not have limited liability; the entity will be disregarded as an entity separate from its owner if it has a single owner and that owner does not have limited liability. Finally, the default classification for an existing entity is the classification that the entity claimed immediately prior to the effective date of these regulations. An entity's default classification continues until the entity elects to change its classification by means of an affirmative election.

[329] REG-119921-09 (9/14/2010) proposes regulations recognizing series as separate entities. Prop. Reg. § 301.7701-1(a)(5)(x), Example (1) provides (emphasis added):

> Domestic Series LLC. (i) Facts. Series LLC is a series organization (within the meaning of paragraph (a)(5)(viii)(A) of this section). Series LLC has three members (1, 2, and 3). Series LLC establishes two series (A and B) pursuant to the LLC statute of state Y, a series statute within the meaning of paragraph (a)(5)(viii)(B) of this section. Under general tax principles, Members 1 and 2 are the owners of Series A, and Member 3 is the owner of Series B. **Series A and B** are not described in § 301.7701-2(b) or paragraph (a)(3) of this section and **are not trusts within the meaning of § 301.7701-4**.
>
> (ii) Analysis. Under paragraph (a)(5)(i) of this section, Series A and Series B are each treated as an entity formed under local law. The classification of Series A and Series B is determined under paragraph (b) of this section. The default classification under §301.7701-3 of Series A is a partnership and of Series B is a disregarded entity.

- **Disregarded Entity**. If it has only one member (owner),[330] it is disregarded for federal tax purposes unless it elects otherwise.[331] If the sole member sells the LLC, the sole member is deemed to have sold the LLC's assets;[332] thus, generally, the owner of the LLC is deemed to directly own the LLC's assets for income tax purposes.[333] If a charity is the sole owner of

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

[330] An entity is treated as a disregarded entity if it has two owners for state law purposes that are considered to be the same entity for tax purposes. Rev. Rul. 2004-77, interpreting Reg. § 301.7701-2(c)(2); see also Letter Rulings 201349001 and 200102037, as well as the authority in fn. 147 (disregarded entity with more than one owner is not an ineligible shareholder of an S corporation by reason of having more than one state law owner).

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

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

[331] Reg. § 301.7701-3(b)(1)(ii), which provides that such an entity is "Disregarded as an entity separate from its owner if it has a single owner," was upheld as valid by *Littriello v. United States*, 99 A.F.T.R.2d 2007-2210 (6th Cir. 2007), and *McNamee v. Dept. of Treasury*, 99 AFTR.2d 2007-2871 (2nd Cir. 2007). Cancellation of a disregarded single member LLC's debt is taxable to its deemed owner. *Jacobowitz v. Commissioner*, T.C. Memo. 2023-107. See part II.G.31.b Debt Forgiveness.

Reg. § 301.7701-2(a) provides:

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

Because an entity may use a different accounting method for each separate trade or business, a single member LLC that is a disregarded entity may use a different accounting method than its parent if the single member LLC engages in a separate trade or business. CCA 201430013, applying Code § 446(d). See fn 813 in part II.E.1.c.iii.(b) Multiple Trades or Businesses Within an Entity – Identification of Businesses and Allocation of Items.

[332] See part II.P.3.f Conversions from Partnership to Sole Proprietorships and Vice Versa, fns. 4033-4034. However, the parties can avoid this result; see fns. 4035-4038.

[333] AM 2012-001 reasoned:

> Rev. Rul. 99-5 does not ever mention a taxpayer's outside basis in his disregarded entity interest, because the owner of a disregarded entity has no outside basis in the entity for federal tax purposes. Therefore, outside basis has no relevance to a taxpayer's disposition of his interest in a disregarded entity.
>
> Likewise, a disregarded entity cannot make distributions in a manner where the federal income tax consequences would turn on the member's nonexistent outside basis. Section 301.7701-2(a) provides that if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. For federal tax purposes, the member already owns all of the disregarded entity's property. Therefore, while a preferred interest in an eligible entity may entitle the owner of the preferred interest to preferential distribution or liquidation rights under state law, such preferences have no meaning for federal tax purposes while the same taxpayer owns one-hundred percent of all classes of interests.

an LLC, then contributions to the LLC are deductible.[334] An S corporation that has a Qualified Subchapter S Subsidiary should convert the subsidiary to a single member LLC if the conversion is not more trouble than it's worth.[335] Ordinarily, a disregarded entity uses its owner's taxpayer ID.[336] However, if it has employees (other than the owner), the LLC has the same employment filing requirements as a corporation,[337] but that separate status has no effect on the fact that the entity is disregarded in determining self-employment income[338] or its employees' eligibility for the employer's benefit plans.[339] It is also treated as a separate taxpayer for purposes of certain excise taxes[340] and for certain other purposes as well.[341] However, in valuing the transfer of an interest in a single-member LLC, the interest in the LLC – and not just the LLC's assets themselves – must be valued[342] before applying

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A grantor's payment of rent to an LLC wholly owned by a trust deemed owned by the grantor for income tax purposes is disregarded for income tax purposes. Letter Ruling 200102037.

334 Notice 2012-52, expanding the scope of Ann. 99-102. The Notice requested the charity owning the LLC "to disclose, in the acknowledgment or another statement, that the SMLLC is wholly owned by the U.S. charity and treated by the U.S. charity as a disregarded entity." This Notice cleared up longstanding concern. See Vishnepolskaya, "Deductibility of Gifts to Domestic, Single-Member LLCs as Contributions 'to the Charity' Under Recent Guidance," *The Exempt Organization Tax Review*, vol. 69, no. 2, at 135-147 (Feb. 2012). Ann. 99-102 provides that "an owner that is exempt from taxation under section 501(a) of the Internal Revenue Code must include, as its own, information pertaining to the finances and operations of a disregarded entity in its annual information return." Also note that IRS Information Letter 2010-0052, which described itself as "a well-established interpretation or principle of tax law" but also as a document that cannot be relied on the way a Revenue Ruling can be, stated that a contribution to an LLC wholly owned by a public charity generally will be treated as a qualifying distribution to the public charity for purposes of Code § 4942 and as a distribution with respect to which a grant-making private foundation will not be required to exercise expenditure responsibility under Code § 4945(d). For an LLC qualifying as a charity by its own merits, see text accompanying fn 355.

335 See text accompanying fn. 139 for the reason and consequences.

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

337 Reg. § 301.7701-2(c)(2)(iv), reproduced in fn 3448 in part II.L.3 Self-Employment Tax: General Partner or Sole Proprietor. Under a prior version of that regulation, the sole member of an LLC and the LLC itself were personally liable for purposes of employment tax reporting and wages paid before January 1, 2009. *Costello, LLC v. Commissioner*, T.C. Memo. 2016-184, citing *Med. Practice Sols., LLC v. Commissioner*, 132 T.C. 125, 127 (2009), *aff'd without published opinion sub nom. Britton v. Shulman*, 2010 U.S. App. LEXIS 19925 (1st Cir. 2010).

338 Reg. § 301.7701-2T(c)(2)(iv)(C)(2), reproduced in fn 3447 in part II.L.3 Self-Employment Tax: General Partner or Sole Proprietor. For more on self-employment tax, see that part and part II.L.4 Self-Employment Tax Exclusion for Limited Partner.

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

340 Reg. § 301.7701-2(c)(2)(v).

341 The check-the-box regulations do not apply to tax administered by the Alcohol and Tobacco Tax and Trade Bureau (TTB) or the U.S. Customs and Border Protection (Customs), because rules in 26 CFR part 301 generally do not apply for purposes of those taxes. See T.D. 9553 (effective 10/26/2011). For treatment of otherwise-disregarded single member LLCs under the TEFRA partnership audit rules, see fn. 1718 in part II.G.19.c.i Overview of Rules Before and After TEFRA Repeal.

342 *Pierre*, a reviewed Tax Court opinion, held that, for gift tax purposes, the transfer of a partial interest in an LLC must be valued as an interest in the LLC as an entity rather than an interest in the underlying assets, even though before the transfer all of the assets were deemed owned directly by the sole member for income tax purposes; *Pierre* is described in part III.B.1.e Valuation Issues. *RERI Holdings I, LLC v. Commissioner*, 143 T.C. 41 (2014), held that the gift tax rule applied for income tax purposes as well – for purposes of the charitable deduction, a gift of the sole member interest in an LLC needed to have the LLC

the results of that transfer to each asset.[343] Query how the at-risk rules of Code § 465 treat a disregarded LLC.[344]

- **Partnership**. If it has more than one member[345] for tax purposes, it is taxed as a partnership for federal tax purposes, unless it elects otherwise[346] or is publicly traded.[347] However, if the sole owners are a married couple, then the LLC may be treated as a disregarded entity if it held as community property.[348] For information on co-ownership rising to the level of a partnership and the consequences of failing to file partnership returns, see part II.C.10 Whether Tenancy-in-Common or other Arrangement Constitutes a Partnership. In Missouri, an LLC is assumed owned equally by the members unless they agree otherwise or make different contributions.[349]

- **Corporation**. An LLC can elect to be taxed as a corporation for federal tax purposes.[350]

  - LLCs electing taxation as a C corporation must file IRS Form 8832[351] no later than 75 days after the effective date of an election for an LLC to be taxed as a corporation (or

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member interest valued. However, listing the LLC on Form 8283 (substantiation for a noncash charitable contribution) and the possibility that the sole member interest in an LLC might have a value identical to that of the underlying assets were enough to make proper substantiation a fact issue rather than a matter of summary judgment. Ultimately, the taxpayer lost for other reasons and was penalized; see part II.J.4.c Charitable Distributions.

[343] See fn. 332-333, the former re: selling an interest in a single member LLC that was a disregarded entity before the sale.

[344] See part II.G.4.j At Risk Rules.

[345] See text accompanying fn 380 in part II.C.1 General Overview of Partnerships.

[346] Reg. § 301.7701-3(b)(1)(i).

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

[348] Rev. Proc. 2002-69, relating to community property ownership of 100% of an entity that the taxpayers may treat as a disregarded entity. That Rev. Proc. applies only to community property ownership, not to joint tenants or tenants-by-the-entirety (TBE). A number of years ago, I called the author of the Rev. Proc. and asked why limit to community property when TBE was an even stronger unity of interest, and he said that people in community property states couldn't always determine whether property transferred to a single member LLC was separate property or community property, and the Rev. Proc. was offered to avoid inadvertently violating the rules. He said the IRS was not even considering extending it to joint or TBE property. Query whether this rule would be extended to registered domestic partners under California law under Letter Ruling 201021048 and CCAs 201021049 and 201021050 or under similar laws; Rev. Rul. 2013-17 makes me assume (announcing the IRS' response to the *Windsor* case recognizing same-sex marriages but not civil unions) that will not be the case. The IRS informally takes the position that an LLC does not qualify to be disregarded as a qualified joint venture under this provision; see fn. 612.

[349] An operating agreement is required, RSMo § 347.081.1, found at http://www.moga.mo.gov/mostatutes/stathtml/34700000811.html. However, it may be oral, RSMo § 347.015(13), found at http://www.moga.mo.gov/mostatutes/stathtml/34700000151.html. I would assume that everything was equal, unless evidence suggests otherwise. RSMo §§ 347.101 and 347.111, found at http://www.moga.mo.gov/mostatutes/stathtml/34700001011.html and http://www.moga.mo.gov/mostatutes/stathtml/34700001111.html.

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

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

for a foreign unincorporated entity to be taxed as a partnership),[352] signed correctly.[353] However, if a taxpayer has reasonable cause for failing to meet the deadline, the taxpayer might be able to file IRS Form 8832 as late as 3 years after its due date.[354] An LLC that has been determined to be, or claims to be, exempt from taxation under Code § 501(a) is treated as having made an election under this section to be classified as a corporation;[355] the IRS outlines its view on how an LLC can qualify as a tax-exempt entity at https://www.irs.gov/charities-non-profits/other-non-profits/exempt-organization-sample-questions-limited-liability-company and in Notice 2021-56.

- Generally, if an eligible entity elects to change its classification, the entity cannot change its classification by election again during the 60 months succeeding the effective date of the election.[356] However, the IRS may permit the entity to change its classification by election within the 60 months if more than 50% of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of the entity's prior

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352 Reg. § 301.7701-3(c)(1)(i) provides:

In general. Except as provided in paragraphs (c)(1)(iv) and (v) of this section, an eligible entity may elect to be classified other than as provided under paragraph (b) of this section, or to change its classification, by filing Form 8832, Entity Classification Election, with the service center designated on Form 8832. An election will not be accepted unless all of the information required by the form and instructions, including the taxpayer identifying number of the entity, is provided on Form 8832. See section 301.6109-1 for rules on applying for and displaying Employer Identification Numbers.

Reg. § 301.7701-3(c)(1)(ii) provides:

Further notification of elections. An eligible entity required to file a Federal tax or information return for the taxable year for which an election is made under § 301.7701-3(c)(1)(i) must attach a copy of its Form 8832 to its Federal tax or information return for that year. If the entity is not required to file a return for that year, a copy of its Form 8832 (``Entity Classification Election'') must be attached to the Federal income tax or information return of any direct or indirect owner of the entity for the taxable year of the owner that includes the date on which the election was effective. An indirect owner of the entity does not have to attach a copy of the Form 8832 to its return if an entity in which it has an interest is already filing a copy of the Form 8832 with its return. If an entity, or one of its direct or indirect owners, fails to attach a copy of a Form 8832 to its return as directed in this section, an otherwise valid election under § 301.7701-3(c)(1)(i) will not be invalidated, but the non-filing party may be subject to penalties, including any applicable penalties if the Federal tax or information returns are inconsistent with the entity's election under § 301.7701-3(c)(1)(i). In the case of returns for taxable years beginning after December 31, 2002, the copy of Form 8832 attached to a return pursuant to this paragraph (c)(1)(ii) is not required to be a signed copy.

353 Reg. § 301.7701-3(c)(2) provides:

In general. In general. An election made under paragraph (c)(1)(i) of this section must be signed by -

(A) Each member of the electing entity who is an owner at the time the election is filed; or

(B) Any officer, manager, or member of the electing entity who is authorized (under local law or the entity's organizational documents) to make the election and who represents to having such authorization under penalties of perjury.

354 Rev. Proc. 2009-41.

355 Reg. § 301.7701-3(c)(1)(v)(A), which further provides:

Such election will be effective as of the first day for which exemption is claimed or determined to apply, regardless of when the claim or determination is made, and will remain in effect unless an election is made under paragraph (c)(1)(i) of this section after the date the claim for exempt status is withdrawn or rejected or the date the determination of exempt status is revoked.

356 Reg. § 301.7701-3(c)(1)(iv).

election.[357] An election by a newly formed eligible entity that is effective on the date of formation is not considered a change for purposes of this rule.[358]

- LLCs electing taxation as an S corporation file Form 2553 without needing to file Form 8832.[359] Generally, it's better to file only Form 2553 so that a failure of Form 2553 to be valid will revert the LLC back to a flow-through entity; this reversion applies to only the failure of the initial election and not to any subsequent terminating events, the latter which would convert the LLC to a C corporation unless cured.[360]

- Note that every unit of ownership must have identical rights to distributions and liquidation proceeds (the "single-class-of-stock" rule).[361] If the LLC had been taxed as a partnership, make sure that distributions upon liquidation are made pro rata instead of according to capital accounts; if a partnership with non-pro rata capital accounts is making an S election, consider issuing notes in the amount of the non-pro rata amounts. Various employment agreements and other side agreements among owners generally do not violate the single-class-of-stock rule, but that's because they are not part of the governing documents;[362] make sure that such agreements are not part of the operating agreement, which may cause them to fall outside the scope of the regulations' protection.

- Be sure to consider part II.A.2.h Important Protections for S Corporation Shareholder Agreements.

- Regulations appear to question whether an LLC that makes an S election is subject to self-employment tax, but those regulations appear to be obsolete.[363]

Information on conversions by LLCs to corporate tax status is covered at part II.P.3.c Conversions from Partnerships and Sole Proprietorships to C Corporations or

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

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

For cures, see part II.A.2.e Making the S Election and III.A.3.c.iii Deadlines for QSST and ESBT Elections.
[361] See part II.A.2.i Single Class of Stock Rule.
[362] See parts II.A.2.i.ii Temporary Timing Differences; Other Varying Differences (especially fns 249-253) and II.A.2.i.iii Disproportionate Distributions.
[363] See part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election.

S Corporations. To the extent that a topic is not fully covered there, consider reading, “Now You See It, Now You Don’t: The Comings and Goings of Disregarded Entities.”[364]

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

- **Real Estate - Sole Owner**. A client holds one or more parcels of real estate. The client would like to insulate his/her other assets from liability for what occurs on his/her real estate. Furthermore, the client would like each parcel to be insulated from liability for what happens on each other parcel. A possible solution may be to form a separate LLC to hold each parcel. Because each LLC would be disregarded for federal tax purposes, forming the LLCs would not complicate his/her tax situation. However, if the client holds the property for investment (and is not a dealer) but later wants to develop the property, the client should consider some pre-development tax planning.[365]

- **Real Estate - Co-Owners**. A client owns real estate with one or more other co-owners. One of the client’s co-owners manages the property, or perhaps the client has a management company manage the property. In some situations, co-ownership is considered a general partnership even if no formal partnership agreement exists.[366]

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

  A possible solution may be to form an LLC to hold the property. The LLC may relieve the client from joint and several liability and provide a mechanism for a majority to control the property. Any creditor who obtains an interest in the LLC would have no right to vote on how the LLC is run and should not be able to get a court order to sell the property. Rarely is

[364] McMahon, pages 259-307 of the *Tax Lawyer*, Vol. 65, No. 2 (Winter 2012).
[365] See part II.G.26.c, Future Development of Real Estate If the client started with a single-member LLC before making these plans, the client might sell his/her interest in the LLC to an S corporation.
[366] In addition to state law liability, for federal income tax purposes a tenancy-in-common might be treated as a partnership. See part II.C.10 Whether Tenancy-in-Common or other Arrangement .

a corporation an appropriate entity for real estate;[367] however, his analysis does not consider foreign tax issues.[368]

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

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

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

- **One Business, Multiple Locations**. A client's business has several locations, whether in the same city or even in different states. He or she would like each location to be insulated

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[367] If the owners want to go in separate directions without a current taxable event, each shareholder must receive an interest in an active business that has been carried for five years (among many other requirements of Code § 355). A distribution of real estate from a corporation to a shareholder is taxed as a sale of the distributed property (see part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders), even if the corporation is an S corporation; if the corporation converted from a C corporation to an S corporation during the past 10 years, built-in gain tax might apply, as described in part II.P.3.b.ii Built-in Gain Tax. If the shareholders disagree on whether to do a like-kind exchange, it is difficult to satisfy all parties. When a shareholder dies, the real estate does not receive a basis step-up. However, see part II.G.26.c, Future Development of Real Estate, discussing tax strategies for converting investment real estate into property that is subdivided and held for sale. For a possible opportunity to replicate a basis step-up by liquidating the S corporation in the same year all of its assets are sold to an unrelated third party, see part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation.

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

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

from the liabilities of other locations. His or her business could set up a separate LLC for each location, but for federal income tax purposes nothing has changed.

- **Bankruptcy-Remote LLC to Facilitate Borrowing**. The lender insists that legal title be held by a bankruptcy remote entity. To satisfy this requirement, the borrower forms an LLC between the borrower and a corporation wholly owned by the borrower. To protect the lender's interest, one of the members of the corporation's board of directors will be a representative of the lender. The corporation has management rights only in certain events, and all of the LLC's profits, losses, and credits will be allocated to the borrower. Also, all distributions of net cash flow and capital proceeds will be made entirely to the borrower. Furthermore, when the dissolves, the borrower will wind up the LLC's affairs in any manner permitted or required by law, but the payment of any outstanding obligations owed to the lender will have priority over all other expenses or liabilities. The borrower is treated as owning the LLC's property directly.[369]

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

  - Suppose private equity is being transferred to a GRAT,[370] and part of it needs to be transferred back to the donor to make annuity payments. Effectuating transfers working with the private equity fund might prove cumbersome. Putting the private equity in an LLC and transferring LLC interests back to the donor might be easier. Furthermore, formula transfers[371] of LLC interests might be done, whereas a formula transfer of the private equity fund might be awkward to explain and for which to obtain consent.

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

  - LLCs can be used to centralize management of assets when a trust is distributed to its remaindermen.[372]

  - An LLC might avoid a state's rule against perpetuities (RAP). For example, a perpetual trust buys real estate in a state that imposes the RAP. That state's laws might very well

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[369] Letter Ruling 199911033, which also held that the borrower could use the LLC's property for a Code § 1031 nontaxable deferred exchange (See part II.G.16 Like-Kind Exchanges). The lender's consent was required for the LLC to:

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

See also Letter Rulings 199914006 and 200201024.

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

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

[372] In Letter Ruling 201421001, a trust used two series LLCs – one invested in equities (X) and the other in fixed income securities (Y) – to distribute its investment assets to remaindermen. For details, see fn. 3875, found in part II.P.1.a.i.(b) Special Rules for Allocations of Income in Securities Partnerships.

cause the real estate (and perhaps proceeds from its sale) to be subject to the RAP. Suppose instead that the trust forms an LLC to hold the real estate. The LLC constitutes personal property, so that the trust never owns real estate in that state. Presumably that state would not be able to impose the RAP against the real estate.

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

- An LLC might also help when a person living in a state that does not impose estate tax buys real estate in a state that does impose an estate tax. Real estate in the latter state would be subject to estate tax. However, if the person owns the property through an LLC, the person has converted the real property to personal property, as far as his estate's legal title is concerned. Beware that, just as the federal and most states' income tax laws disregard single member LLCs, state estate taxing authorities would also tend to disregard a single member LLC[373] –perhaps disregarding even an LLC owned by more than one person if the state views the LLC as a mere tax avoidance measure.

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

Although it is not uncommon for operating agreements to refer to LLC units, the nomenclature of units might mislead members into believing that their ownership is treated as stock rather than as a partnership interest, so I prefer to avoid that practice.[374]

An LLC can be managed by its members or managers. To simplify signature lines, I use the manager-managed model.[375] Death or other dissociation can cause voting and other rights to

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

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

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

lapse. This is especially a concern for a single-member LLC owned by an individual, so be sure to plan for how the governing documents handle that situation.[376]

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

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

Some states impose high annual registration fees, and registered agent fees can also mount. To make registration easier, some states (including Missouri) offer "Series LLCs," in which one registration is done describing various compartments, each of which is treated as a separate entity for liability protection purposes.[377] The IRS appears to be willing to respect these "Series" as separate entities.[378] Whether other states would respect this compartmentalization of groups of assets is uncertain in many states.[379] Although generally I do not recommend them, in some cases their use may be appropriate.

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

[377] For a list of jurisdictions, see fn. 379.

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

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

> The LLC acts that authorize series are: Alabama (Ala. Code §10A-5A-11.01); District of Columbia (D.C. Code §29-802.06); Illinois (805 ILCS 180/37-40); Iowa (Iowa Code Ann. §489.1201); Kansas (Kan. Stat. Ann. §17-76,143); Missouri (Mo. Rev. Stat. §347.186); Montana (Mont. Code Ann. §35-8-304(4)); Nevada (Nev. Rev. Stat. § 86.296.3); Oklahoma (18 Okla. Stat. §18-2054.4B); Puerto Rico (P.R. Laws Ann. Tit. 14, §3967 (General Corporations Act 2009)); Tennessee (Tenn. Code Ann. §48-249-309); Texas (Tex. Bus. Org. §101.601); Utah (Utah Code Ann. §48-3-1201). Series are also provided for in the ABA's Revised Prototype Limited Liability Act, 67 Bus. Law. 117 (November 2011) at §§1101 through 1116. Delaware alone has series limited partnerships. See Del. Code Ann. Tit. 6, §17-218. Several other states have series in their business/statutory trust acts: Conn. Gen. Stat. §§34-5167(b)(2), §34-502(b); Del. Code Ann. tit. 12, §§3804(a), 3805(h), 3806(b); D.C. Code §29-1204.01 et seq.; Ky. Rev. Stat. Ann. §§386A.4-010 through 386A.4-110; Va. Code Ann. §§13.1-1219, 13.1-1231, 13.1-1240; Wyo. Stat. §§17-23-106, 17-23-108. See also the Revised Uniform Statutory Trust Entity Act (2009). The Uniform Law Commission has in place a series statute drafting committee, which presented a first draft of its work at the 2014 annual meeting. While the present author is a member of that drafting committee, all views expressed herein are his own.

II.C. Partnership

II.C.1. General Overview of Partnerships

Clients doing business as a partnership (whether an intentional or not, the latter as described in part II.C.10 Whether Tenancy-in-Common or other Arrangement), who are concerned about protection from liabilities incurred by the business, might consider whether registering as an LLP, converting to an LLC, converting a general partner to an LLC, or forming one or more LLC subsidiaries might be an appropriate strategy.

A partnership must have more than one owner. How small can a minority interest be for purposes of that rule? This answer is uncertain and has been the subject of several articles.[380] *Peking Investment Fund LLC v. Commissioner*, Tax Court Docket No. 12772-09 Order 2/13/2018, noted:

> In fact, under ruling guidelines issued under the entity classification regulations in effect before 1997, the Internal Revenue Service generally required the general partner of a limited partnership to maintain an interest of at least 1% in each material item of partnership income, gain, loss, deduction, or credit. See Rev. Proc. 89-12, sec. 4.01, 1989-1 C.B. 798, 800. Those guidelines, though no longer in effect, provide historical support for the proposition that a 1% interest in a partnership cannot be disregarded as *de minimis*.

Some federal tax incentives encourage the use of partnerships that reward investors with tax creditors in exchange for the capital needed to fulfill the program's purpose. For example:

- Rev. Proc. 2020-12 establishes a safe harbor for using partnerships to allocate the credit for carbon oxide sequestration under Code § 45Q, under which the developer has at least a 1% and each investor has at least 5%.[381] As background, Rev. Proc. 2020-12, § 2.05 explained:

  > A partnership exists when two or more "parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949). In making this determination, courts "look not so much at the labels used by the partnership but at true facts and circumstances" to determine whether a partner has a "meaningful stake in the success or failure" of the enterprise. *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 231 and 241 (2d Cir. 2006). A purported partner in a partnership may in substance be more properly viewed as a lender to the partnership or purchaser of partnership assets if the purported partner lacks "any meaningful downside risk or any meaningful upside potential in" the partnership. *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425, 455 (3d Cir. 2012).

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[380] See Shop Talk, "The 1% Standard: Back from the Dead?," 120 JTAX 317 (June 2014); "Revisiting the 1% Minimum Ownership Interest in Safe Harbors," 132 JTAX 38 (May 2020); "More on the 1% Minimum Ownership Interest Standard in Safe Harbors: A Drafter Responds," 133 JTAX 35 (August 2020); and "How Small Can a Partner's Interest Be: Did "Small" Just Get Smaller?" 137 JTAX No. 2 (August 2022). Fn 345 in part II.B Limited Liability Company (LLC) mentions that an LLC with one member is disregarded, whereas an LLC with more than one member is taxed as a partnership.
[381] T.D. 9944 (1/15/2021) cited with approval Rev. Proc. 2020-12.

- Rev. Proc. 2007-65 provides a safe harbor with respect to respect the allocation of Code § 45 wind energy production tax credits by partnerships. Its safe harbor is similar to that of Rev. Proc. 2020-12.

- In response to concern about *Historic Boardwalk*, Rev. Proc. 2014-12 provides a safe harbor regarding the allocation of Code § 47 rehabilitation credits. Among other requirements, Section 4.02(1) of the Rev. Proc. requires the principal to have at least a 1% interest in each material item of partnership income, gain, loss, deduction, and credit at all times during the partnership's existence, and Section 4.02(2) requires to investor to have, at all times during the period it owns an interest in the partnership, a minimum interest in each material item of Partnership income, gain, loss, deduction, and credit equal to at least 5% of the investor's percentage interest in each such item for the taxable year for which the investor's percentage share of that item is the largest (as adjusted for sales, redemptions, or dilution of the investor's interest) and must participate in profits in a manner that is not limited to a preferred return that is in the nature of a payment for capital.

- A case that was not an IRS controversy, *SunAmerica Housing Fund 1050 v. Pathway of Pontiac, Inc*., 6th Cir. No. 21-1243 (file 22a0100p.06) (5/10/2022), explains how a low-income housing tax credit (LIHTC) partnerships work:

> A typical arrangement under LIHTC proceeds as follows. See generally Off. of the Comptroller of the Currency, *Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks* 6–9 (Mar. 2014), https://www.occ.gov/publications-and-resources/publications/community-affairs/community-developments-insights/pub-insights-mar-2014.pdf (providing general overview of the mechanics of LIHTC). A low-income housing developer first applies to a state housing credit agency for an award of federal tax credits. If the state agency grants the application, the developer then enters into a limited partnership as a general partner with a private investor as a limited partner. Often, the investor is a bank or another financial entity that has ample annual tax liability of its own that makes acquiring the nonrefundable tax credits a worthwhile investment. The limited partner investor then provides the capital needed to build and develop the low-income housing development. In return, the partnership allocates the vast majority (usually 99.99%) of tax credits and other tax benefits to the investor. These benefits alone provide the investor with a significant return on investment that makes the arrangement attractive and worthwhile to the investor. *See, e.g.*, Ernst & Young, Low-Income Housing Tax Credit Assessment Survey 6 (2009), https://www.nahma.org/wp-content/uploads/files/member/Tax%20Credit/Legislative%20Study_FINAL%2009250 9.pdf (finding average annual post-tax rate of return on investment to be approximately 10%).

SunAmerica explained how Congress limited the tax credit investors' upside through a right of first refusal (ROFR) authorized by Code § 42(i)(7)[382] that was built into the limited partnership agreement (LPA):

[382] Code § 42(i)(7), "Impact of tenant's right of 1st refusal to acquire property," provides:

(A) *In general*. No Federal income tax benefit shall fail to be allowable to the taxpayer with respect to any qualified low-income building merely by reason of a right of 1st refusal held by the

As discussed earlier, Congress enacted § 42(i)(7) to create a mechanism through which properties could be transferred to nonprofit organizations to ensure that the housing remains affordable over the long term. It chose to do so by allowing nonprofits to retain a ROFR at a below-market price. See 26 U.S.C. § 42(i)(7). During Congress's early discussions of LIHTC, the initial thought was to grant nonprofit organizations an option to purchase the property at a below-market price. S. 980, 101st Cong., § 2(y) (1989) (proposed bill). Lawmakers raised concerns, however, that nonprofit organizations would then be deemed the true owners of the property and the IRS could reclaim the tax credits that were needed to attract private investor limited partners. See *Frank Lyon Co.*, 435 U.S. at 571-73. Congress chose to avoid that problem by enacting a safe harbor for the ROFR, recognizing that a nonprofit could not unilaterally exercise the ROFR in the same way that an option could be exercised.

As the Massachusetts Supreme Court explained,

> Section 42(i)(7) therefore represents a compromise, facilitating the inexpensive transfer of property to nonprofit organizations, but in a way that does the least violence to the traditional rules of tax law. The right of first refusal described in § 42(i)(7) is not a typical right of first refusal, for the obvious reason that it favors the nonprofit organization with a statutorily prescribed, often below-market price. At common law, a right of first refusal allows the holder to purchase the property only by matching the price offered by a third party. In contrast, a right of first refusal under § 42(i)(7) allows the holder to purchase the property at the § 42 price, even if it is far below the third-party offer. Yet, a right of first refusal under § 42(i)(7) is not completely unanchored from its common-law meaning. In enacting § 42(i)(7), Congress relied on the common-law distinction between an option to purchase, which can be unilaterally exercised, and a right of first refusal, which cannot. Congress specifically chose to allow one but not the other, recognizing that a right of first refusal - which cannot be exercised until the owner decides to sell - is for that very reason a less serious curtailment on ownership rights.

Homeowner's Rehab, Inc. v. Related Corporate V SLP, LP, 99 N.E.3d 744, 757-58 (Mass. 2018) (internal citations omitted).

The ROFR contemplated by § 42 varies markedly from a ROFR in a "typical" real estate transaction, where the holder of the ROFR can purchase the property if he or she is willing to match the price of a third-party offer. In that context, as explained earlier, the bona fide offer requirement functions to allow the third-party bidder to prevail by offering a high price that cannot be matched, if that offer is, in fact, genuine and made in good

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tenants (in cooperative form or otherwise) or resident management corporation of such building or by a qualified nonprofit organization (as defined in subsection (h)(5)(C)) or government agency to purchase the property after the close of the compliance period for a price which is not less than the minimum purchase price determined under subparagraph (B).

(B) *Minimum purchase price*. For purposes of subparagraph (A), the minimum purchase price under this subparagraph is an amount equal to the sum of-

(i) the principal amount of outstanding indebtedness secured by the building (other than indebtedness incurred within the 5-year period ending on the date of the sale to the tenants), and

(ii) all Federal, State, and local taxes attributable to such sale.

Except in the case of Federal income taxes, there shall not be taken into account under clause (ii) any additional tax attributable to the application of clause (ii) .

faith. The “bona fide” offer requirement, therefore, operates to protect the ROFR holder from an unreasonable offer it cannot beat that would preclude it from exercising its contractual right of first refusal. By contrast, the ROFR in the LPA and under § 42(i)(7) eliminates that possibility because the holder need not match the price. The § 42-established ROFR defines ex ante the price at which the nonprofit will purchase the project: the outstanding debt on the property plus any “exit taxes” that result from the sale (sometimes referred to as “debt plus taxes”). See 26 U.S.C. § 42(i)(7)(B); *AMTAC Holdings 227, LLC v. Tenants’ Dev. II Corp.*, 15 F.4th 551, 557 (1st Cir. 2021). In this respect, § 42(i)(7) clearly deviates from the general “common law” definition of ROFRs. To implement the LIHTC, Congress therefore chose to employ a statutorily-specified ROFR that differs from that contemplated under general common law. See *Homeowner’s Rehab, Inc.*, 99 N.E.3d at 757-58 (holding that importing common law bona fide offer requirements into a § 42(i)(7) ROFR would “contravene the purpose of § 42(i)(7)”); *Opa-Locka Cmty. Dev. Corp. v. HK Aswan, LLC*, No. 2019-16912-CA-01, 2020 WL 4381624, at *9 (Fla. Cir. Ct. July 7, 2020) (declining to read a bona fide offer requirement into § 42(i)(7) because doing so was not consistent with § 42).

We cannot impress the general common law meaning of bona fide offer on the term as it is used in the LPA that was created to accord with the LIHTC program. To do so would, in essence, contravene the purpose of § 42(i)(7). A practical example reveals why: based on the common law, no reasonable buyer, much less a serious buyer, would offer to buy a property knowing full well that a third-party (here, Presbyterian) would win the deal no matter how good the offer was. In these circumstances, soliciting an offer from a serious buyer that knew the ROFR-holder would exercise its right, as the General Partners did, may well be the only way to trigger the ROFR. Wholesale importation of the common law understanding of bona fide offer into the plain language of the LPA, therefore, would make the ROFR provision, as specified in the LIHTC, meaningless. See *Klapp v. United Ins. Grp. Agency, Inc.*, 663 N.W.2d 447, 468 (Mich. 2003) (declining to construe provision of contract in a way that would render the provision meaningless).

Not only would it contravene Congress’s intentions, but it also would contravene the Partners’ bargained-for exchange under the LIHTC arrangement. The purpose of the Partnership arrangement was for SunAmerica to reap the benefits from the housing tax credits, not from the Property’s long-term appreciation gains. See, *e.g.*, LPA §§ 4.02(a)-(c), (j), 8.02(a) (requiring “best efforts” to produce for SunAmerica’s benefit “maximum allowable” Housing Credits). That purpose is further evinced by the fact that SunAmerica’s role in the Partnership was meant to be entirely passive. *Id*. at § 10.01 (stating that “No Limited Partner shall take part in the management or control of the business of the Partnership nor transact any business in the name of the Partnership.”). By gaining the tax credit, SunAmerica received its benefit of the bargain.

SunAmerica argues that because the LIHTC program does not mandate that the Property be conveyed to a nonprofit or even require that a ROFR be granted in LIHTC transactions, Congress had no intention to “transfer” the property back to a nonprofit. In addition, SunAmerica contends that the General Partners and Presbyterian’s understanding treats the ROFR as a transfer provision, which would also render the Option provision meaningless. Thus, they argue, the common law understanding is appropriate here. But the fact that Congress did not require the LIHTC program to transfer the property makes no difference here because § 42(i)(7) specified a certain ROFR - one that allows the parties to negotiate a below-market price for the property - and the parties agreed to incorporate that statutory provision into the LPA. When

> interpreting such an ROFR provision, we must account for Congress's goals expressed in LIHTC, including its intention to make it easier for nonprofits to regain ownership of the property and continue the availability of low-income housing. Thus, those Congressional intentions confirm that the general common law understanding of bona fide offer cannot be substituted for the ROFR mechanism created by Congress in LIHTC.
>
> To SunAmerica's second point, the bona fide offer requirement operates as a condition precedent that works to distinguish it from the Option in the LPA. The Option could become relevant if none of the General Partners, manifested an intent to sell the Property and if they never received a bona fide offer to satisfy that condition precedent. In that circumstance, Presbyterian could still acquire the property via the Option mechanism in the LPA. Recognizing the nature of the statutory ROFR does not transform the ROFR provision into an Option; unlike the Option, the ROFR has additional condition precedents, including the "bona fide offer" requirement.
>
> In light of the foregoing, this court cannot impress the general common law meaning of "bona fide offer" on an ROFR and LPA that expressly incorporated the LIHTC program and thus was created to accord with the LIHTC program. Nevertheless, the undisputed facts in the record do not clearly resolve the meaning of the term - "bona fide offer" - as it is to be construed under the LIHTC. We, therefore, find that the term as it is used in the LPA is ambiguous. Accordingly, there are disputed issues of material fact concerning the meaning of the term in the LPA - specifically, how the term "bona fide offer" in the LPA is to be formulated to accord with the Congressional expressions of intent in the LIHTC-promulgated ROFR - and whether that condition has been satisfied. These are matters that are better developed at trial and decided by a jury. See *Klapp*, 663 N.W.2d at 454-55 ("[T]he meaning of an ambiguous contract is a question of fact that must be decided by the jury.").

Now that we have reviewed elements of entrepreneurial risk and benefits required to have a partnership, let's look at some strategic issues regarding using partnerships.

Note that, in the case of a seller-financed sale of goodwill, using a C corporation causes a triple tax, an S corporation causes a double tax, and a partnership causes a single tax.[383] When an owner dies, the assets of a sole proprietorship (including an LLC owned by an individual that has not elected corporate taxation) or a partnership (including an LLC owned by more than one person that has not elected corporate taxation) can obtain a basis step-up (or down) when an owner dies, whereas the assets of a C corporation or an S corporation do not receive a new basis.[384] For what might be an ideal structure involving a partnership, see part II.E Recommended Structure for Entities.

Generally, partnership formation and distributions from a partnership are tax-free, but very notable exceptions apply. See parts II.M.3 Buying into or Forming a Partnership and II.Q.8 Exiting From or Dividing a Partnership. Increasing the basis of the partnership's assets when a partnership interest is sold or otherwise exchanged or passes by reason of death

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

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

is a big advantage of partnerships relative to corporations. See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

A partnership needs to account for built-in gain and loss not only with respect to assets contributed to the partnership but also for assets that the partnership owns when partners come and go. See parts II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them), II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, and II.P.1.a.i.(b) Special Rules for Allocations of Income in Securities Partnerships. Also, contributions of cash within two years before or after a distribution of property raises issues described in part II.Q.8.b.i.(c) Disguised Sale from Partnership to Partner, and contributions of property within two years before or after a distributions of cash raises issues described in part II.M.3.e Exception: Disguised Sale Rules. Furthermore, the preceding sentence describes presumptions rather than safe harbors.

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

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

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

II.C.2. Publicly Traded Partnerships

If interests in a partnership are traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof), then the partnership constitutes a "publicly traded partnership"[385] and may be taxed as a corporation.[386]

If, for the taxable year and each preceding taxable year beginning after December 31, 1987 during which the partnership (or any predecessor) existed, 90% or more of the gross income of a publicly traded partnership consists of qualifying income, the rule mandating corporate treatment may not apply.[387]

"Qualifying income" generally includes most interest, dividends, real property rents, gain from the sale of real property, income and gains from various energy or natural resource activities, any gain from the sale or disposition of a capital asset (or property described in Code § 1231(b))[388] held for the production of income described above, and certain income and gain related to commodities.[389]

[385] Code § 7704(b).
[386] Code § 7704(a).
[387] Code § 7704(c).
[388] See part II.G.6.a Code § 1231 Property.
[389] Code § 7704(d).

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

How debt is allocated is central to partnership income tax. Debt allocations interact with allocations of income and loss[390] and the consequences of entering into, exiting from, dividing, or merging a partnership.

"New Partnership Regulations under Sections 707 and 752," a discussion at the January 2017 meeting of the ABA's Section on Taxation that included those who write the regulations, discussed 2016 changes to regulations and included slides with charts explaining some key changes.[391] Regulations under Code § 752 have been issued since then.

Resources available to IRS examiners include those in part II.G.2.e IRS Practice Units.

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

Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, is deemed a contribution of money by such partner to the partnership.[392]

Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, is deemed a distribution of money to the partner by the partnership.[393]

In applying the above rules, a liability to which property is subject is, to the extent of the fair market value of such property, deemed a liability of the owner of the property.[394]

When a partnership interest is sold or exchanged, liabilities are treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.[395]

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

An obligation is a liability for purposes of part II.C.3 Allocating Liabilities (Including Debt) only if, when, and to the extent that incurring the obligation:[396]

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

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

---

390 See part II.G.4.e Basis Limitations for Partners in a Partnership and text accompanying and the extensive discussion following fn 3811 in part II.P.1.a.i.(a) General Rules for Allocations of Income in Partnerships. The latter coordinates with part II.C.3.c.ii.(a) Permanent Rules Allocating Economic Risk of Loss to Recourse Liabilities.

391 The text above references a two-part panel discussion chaired by Eric Sloan. The slides, "New Partnership Regulations under Sections 707 and 752," are saved as Thompson Coburn LLP doc. no. 6591807.

392 Code § 752(a).

393 Code § 752(b).

394 Code § 752(c).

395 Code § 752(d).

396 Reg. § 1.752-1(a)(4)(i).

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

An "obligation" is:[397]

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

See part II.G.20.b When Debt Is Recharacterized as Equity, especially fn. 1853.

LB&I Concept Unit, "Recourse vs. Nonrecourse Liabilities," Document Control Number (DCN) PAR-C-003 (last updated 9/29/2020) (the "Concept Unit"), explains in its Detailed Explanation of the Concept "Liabilities Defined":

> The IRC 752 regulations speak of both "obligations" and "partnership liabilities." "Obligations" are an umbrella term that includes partnership liabilities. However, not all obligations are partnership liabilities. Only partnership liabilities can increase a partner's outside basis.
>
> An obligation is an IRC 752 liability only if, when, and to the extent that incurring the obligation does the following:
>
> 1. Creates or increases the basis of the obligor's assets (including cash);
>
> 2. Gives rise to an immediate deduction to the obligor; or
>
> 3. Gives rise to an immediate expense that is not deductible in computing the obligor's taxable income and is not chargeable to the obligor's capital.
>
> In this context, the term "obligor" refers to the partnership which is borrowing money, generally from a third-party creditor or a partner acting in the capacity of a creditor. The following slides articulate this concept in terms of debits and credits reflected in the partnership's accounting records.
>
> If a partnership borrows the purchase price of an asset, rather than using its own cash to buy the asset, then the loan meets the definition of a liability for IRC 752 purposes.
>
> A liability of $100 that currently creates or increases the basis of any of the obligor's assets (including cash) would be booked as follows:
>
> Debit Asset Purchased $100
>
> Credit Loan to Purchase Asset $100

[397] Reg. § 1.752-1(a)(4)(ii).

If an accrual basis partnership obtains $500 worth of services today, and under the service agreement is billed for those services later, then the account payable meets the definition of a liability for IRC 752 purposes.

Assuming such a liability gives rise to an immediate deduction, it would be booked as follows:

Debit Expense for General and Administrative Services $500

Credit Accounts Payable to Service Provider $500

CAUTION: A cash basis partnership's accounts payable are not partnership liabilities under IRC 752 as discussed in Rev. Rul. 88-77, 1988-2 CB 129.

A liability that gives rise to an expense that is not deductible in computing the obligor's taxable income, and is not chargeable to the obligor's capital, meets the definition of liability under IRC 752.

For example, if an accrual basis partnership charges $1,800 in country club membership dues on a credit card, then the expense is not deductible under IRC 274(a)(3). However, the credit card charge would still meet the definition of a liability for IRC 752 purposes, and would be booked as follows:

Debit Expense for Country Club Dues $1,800

Credit to Credit Card Charge Payable $1,800

As previously stated, not all obligations are partnership liabilities as defined by IRC 752. Confusingly, the regulations use the term "liability" when discussing non-liability obligations. Examples of this are Treas. Reg. 1.752-6 liabilities (partnership's assumption of partner's contingent liability after October 18, 1999, and before June 24, 2003) and Treas. Reg. 1.752-7 liabilities (partnership's assumption of partner's contingent liability on or after June 24, 2003). Treas. Reg. 1.752-7 non-liability obligations, known in the regulations as 1.752-7 liabilities, are discussed on the next slide.

Treas. Reg. 1.752-7 prevents the duplication or acceleration of loss from transfers and assumptions of obligations that are not liabilities for IRC 752 purposes. When a partnership assumes a Treas. Reg. 1.752-7 liability from a partner, that partner's outside basis is reduced, but the reduction is deferred until a triggering event affects the partner's share of the liability.

A common example of a Treas. Reg. 1.752-7 liability is an environmental remediation liability. A partnership may have booked a $100,000 liability to clean up pollution on its property from a time when the business improperly disposed of hazardous chemicals in its production processes. That $100,000 was deductible for Generally Accepted Accounting Principles (GAAP) purposes but was not allowed as an immediate deduction on its tax return. The partnership should have reported the environmental remediation expense on Schedule M-1 as an expense allowed for books but not for tax. Although the environmental remediation liability appears on the partnership's GAAP balance sheet in the liability section, it is a non-liability obligation for IRC 752 purposes.

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

T.D. 9877 (10/9/2019) explains:

> Section 752 separates partnership liabilities into two categories: Recourse liabilities and nonrecourse liabilities. Section 1.752-1(a)(1) provides that a partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss (EROL) for that liability under § 1.752-2. Section 1.752-1(a)(2) provides that a partnership liability is a nonrecourse liability to the extent that no partner or related person bears the EROL for that liability under § 1.752-2.
>
> A partner generally bears the EROL for a partnership liability if the partner or related person has an obligation to make a payment to any person within the meaning of § 1.752-2(b). For purposes of determining the extent to which a partner or related person has an obligation to make a payment, an obligation to restore a deficit capital account upon liquidation of the partnership under the section 704(b) regulations is taken into account (deficit restoration obligation). Further, for this purpose, § 1.752-2(b)(6) of the existing regulations presumes that partners and related persons who have payment obligations actually perform those obligations, irrespective of their net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation (the satisfaction presumption). However, the satisfaction presumption is subject to an anti-abuse rule in § 1.752-2(j) pursuant to which a payment obligation of a partner or related person may be disregarded or treated as an obligation of another person if facts and circumstances indicate that a principal purpose of the arrangement is to eliminate the partner's EROL with respect to that obligation or create the appearance of the partner or related person bearing the EROL when the substance is otherwise. Under the existing rules, the satisfaction presumption is also subject to a disregarded entity net value requirement under § 1.752-2(k) pursuant to which, for purposes of determining the extent to which a partner bears the EROL for a partnership liability, a payment obligation of a disregarded entity is taken into account only to the extent of the net value of the disregarded entity as of the allocation date that is allocated to the partnership liability.

The rest of this part II.C.3.c describes regulations under Code § 752. Given that changes in liabilities may constitute deemed cash payments, allocation of debt is also important when applying the disguised sale rules; see part II.M.3.e.i.(a) Distributions Presumed to Be Disguised Sales. For regulations under Code § 704(b), see part II.P.1.a.i.(a) General Rules for Allocations of Income in Partnerships.

LB&I Concept Unit, "Determining Liability Allocations," Document Control Number (DCN) PAR-C-004 (last updated 9/15/20) (the "LB&I Concept Unit"), in its "General Overview" explains "Determining Liability Allocations":

> The concept of liability allocation is covered under IRC 752 and the related regulations.
>
> Partnership liability allocations have a major impact on the computation of a partner's basis in his partnership interest (outside basis). A partner must calculate outside basis in many situations, including when he receives a routine distribution of money, when he is allocated a loss, when the partnership redeems his interest in a liquidating distribution, or when he sells his interest in the partnership.

> The partnership reports each partner's share of partnership liabilities at the end of the year on Schedule K-1 Part II, Section K. Liabilities are reported on Schedule K-1 in three categories: recourse, nonrecourse, and qualified nonrecourse. Qualified nonrecourse financing is nonrecourse financing borrowed for use in an activity of holding real property and is primarily relevant for purposes of the at-risk rules (which are beyond the scope of this practice unit). The subchapter K rules for allocating liabilities to partners distinguish only between nonrecourse and recourse debts.
>
> An increase in a partner's share of partnership liabilities is treated as a contribution of money by the partner to the partnership and thus increases his outside basis. A decrease in a partner's share of partnership liabilities is treated as a distribution of money to the partner and thus decreases his outside basis. IRC 752(a) and (b).
>
> Not all liabilities shown on a partnership's tax return balance sheet (Form 1065, Schedule L) are recognized as liabilities for tax purposes.
>
> Treas. Reg. 1.752-1 defines partnership liabilities. In general, for a liability to be recognized for tax purposes, it must (1) create or increase the basis of any of the partnership's assets, (2) give rise to a tax deduction, or (3) give rise to an expense not properly deductible or chargeable to capital. With some liabilities such as environmental obligations, tort obligations, contract obligations, and pension obligations, the obligation might be recognized for Generally Accepted Accounting Principles (GAAP) purposes but do not meet the tests set forth in Treas. Reg. 1.752-1 and do not affect basis for tax purposes until satisfied. For additional information, see the Practice Unit on Recourse vs. Nonrecourse Liabilities.

The LB&I Concept Unit, in its part on Determining Liability Allocations, explains in its Analysis of "Allocating Recourse Liabilities":

> Publication 541 and Treas. Reg 1.752-2 discuss the allocation rules for recourse liabilities.
>
> A partnership liability is a recourse liability to the extent that any partner or a related person has an economic risk of loss for that liability. A partner's share of a recourse liability equals his economic risk of loss for that liability. A partner has an economic risk of loss if that partner or a related person would be obligated, whether by agreement or law, to make a payment to the creditor or a contribution to the partnership with respect to the liability if the partnership were constructively liquidated. A partner who is the creditor for a liability that would otherwise be a nonrecourse liability of the partnership has an economic risk of loss in that liability.
>
> In sum, a partner bears the economic risk of loss if the partner or related person (1) has a payment obligation, Treas. Reg 1.752-2(b) (except for 1.752-2(d)(2)); (2) is a lender to the partnership, 1.752-2(c) (except for 1.752-2(d)(1)); (3) guarantees payment of interest, 1.752-2(e); or (4) pledges property as security for a partnership liability, 1.752-2(h).

Referring to Reg. §§ 1.1001-2, 1.752-4(b), 1.752-2(b)(4),and 1.752-2(d)(2), that analysis continues:

> A partner has an economic risk of loss if that partner or a related person would be obligated, whether by agreement or law, to make a payment to the creditor or a contribution to the partnership with respect to the liability if the partnership were constructively liquidated. This constructive liquidation test is a mechanical test used to quantify the extent of each partner economic risk.
>
> The constructive liquidation test has the following steps that are deemed to occur at the same time:
>
> 1. The partnership liabilities are due and payable in full.
>
> 2. Except for property contributed to secure a partnership liability, the assets held by the partnership are assumed to be worthless (including cash).
>
> 3. The assets are sold in a taxable exchange for zero sales proceeds.
>
> 4. The resulting losses and other attributes are allocated to the partners based on the partnership agreement.
>
> 5. The partnership liquidates.
>
> The result of this hypothetical liquidation will normally produce deficits in the capital accounts of one or more partners. The extent to which a partner would be required to contribute capital to eliminate these deficits represents the extent to which the partner is economically at risk on the recourse debt.

Referring to Reg. §§ 1.752-2(e), 1.704-2(b)(4), and 1.752-2(c), that analysis continues:

> In limited liability companies (LLCs), LLC members are usually not economically at risk on LLC debt, absent a deficit-restoration obligation or member-level guarantee. If, however, an LLC member is economically at risk on an LLC liability, the constructive liquidation test will indicate the extent to which the LLC liability is allocated to that member under the recourse liability rules.
>
> A partner's nonrecourse loan to a partnership is a recourse loan to the partner to the extent another partner does not bear the economic risk of loss.

The LB&I Concept Unit, in its part on Determining Liability Allocations, referring to Reg. § 1.752-2(e), explains in its Analysis of "Allocating Nonrecourse Liability With a Greater Than 25% Interest Guaranteed by a Partner":

> If partner or related person guarantees the payment of more than 25% of the total interest that will accrue on the partnership nonrecourse liability, and the guarantor will be required to pay substantially all of the guaranteed future interest if the partnership fails to do so, then the liability is treated as two separate partnership liabilities. The partner or related person is treated as bearing the economic risk of loss for the liability to the extent of the present value of the guaranteed future interest. The remainder of the stated principal amount of the liability constitutes a nonrecourse liability. This rule does not apply for guarantees that do not exceed the lesser of five years or one-third of the term of the liability. Under a de minimis exception, this rule also does not apply if a partner or

related person is a 10 percent or less partner any year when a partner and guarantees the interest on a partnership loan that is qualified nonrecourse financing.

The LB&I Concept Unit, in its part on Determining Liability Allocations, referring to Reg. § 1.752-3 and 1.752-1(a)(2) and Code § 704(b), (c), explains in its Analysis of "Nonrecourse Debt":

> A partnership liability is a nonrecourse liability if no partner or related person has an economic risk of loss for that liability.
>
> A partner's share of a nonrecourse liability is the sum of the following three components determined in the following order:
>
> 1. The partner's share of partnership IRC 704(b) minimum gain (the amount by which nonrecourse debt exceeds the book basis of property securing the debt)
>
> 2. The partner's share of IRC 704(c) minimum gain. IRC 704(c) minimum gain is amount by which the nonrecourse debt exceeds the tax basis of property securing the debt. This gain is generally allocated to the partner who contributed encumbered property.
>
> 3. The partner's share of excess nonrecourse liabilities (the amount of debt not allocated by steps one and two above).

The LB&I Concept Unit, in its part on Determining Liability Allocations, referring to Code § 704(b) and Reg. §§ 1.704-2, 1.704-1, and 1.752-3(a)(1), explains in its Analysis of "Minimum Gain":

> Determining a partner's share of "minimum gain" is the first of the three steps in determining if nonrecourse debts are allocated properly to a partner.
>
> Minimum gain with respect to each nonrecourse loan is the amount of hypothetical gain (if any) that the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability. The amount outstanding on each nonrecourse loan is treated as sales proceeds for property securing the loan. For purposes of this hypothetical sale, the property's basis is the book basis and not the tax basis.
>
> Minimum gain commonly occurs when:
>
> 1. Depreciation deductions on the property securing the debt reduce the property's basis below the balance on the debt;
>
> 2. The partnership refinances the debt or takes out additional nonrecourse loans using partnership property as collateral; or
>
> 3. The partnership makes a nonrecourse distribution to its partners. This occurs when the partnership borrows against the property on a nonrecourse basis and distributes the proceeds to is partners. If the resulting liability exceeds the securing property's book basis, the difference will result in minimum gain.

Consider whether a book-up with certain partnership changes may affect this allocation.[398] If that causes an unfavorable impact, consider a different way to document reverse-Code § 704(c) allocations.[399]

The LB&I Concept Unit, in its part on Determining Liability Allocations, referring to Code § 704(c) and Reg. § 1.752-3(a)(2), explains in its Analysis of "Nonrecourse Liability Allocation Under IRC 704(c) IRC 704(c) Minimum Gain":

> The second of the three steps in determining if a partnership has allocated nonrecourse liabilities correctly is to see if there is any IRC 704(c) minimum gain. IRC 704(c) minimum gain usually occurs when a partner contributes property subject to nonrecourse debt and the fair market value of the property is greater than its tax basis. This "built in" gain is known as IRC 704(c) gain. The excess of the nonrecourse debt over the tax basis of the contributed property is the amount of IRC 704(c) minimum gain. That is, it is the amount of IRC 704(c) gain that the contributing partner would recognize if the lender foreclosed on the contributed property and the partnership received nothing other than relief of the liability.
>
> One way to determine if a partner contributed built-in gain property is to review the partners' Schedules K-1 and see if Part II, Section M indicates that the partner contributed property with a built-in gain or loss.

The LB&I Concept Unit, in its part on Determining Liability Allocations, referring to Reg. § 1.752-3(a)(3) and Rev. Rul. 95-41, explains in its Analysis of "Excess Nonrecourse Liabilities":

> The third of the three steps in allocating nonrecourse liabilities is to allocate the excess nonrecourse liabilities; i.e., the amount left over after allocating under the first and second steps.
>
> Generally, excess nonrecourse liabilities are allocated to the partners in proportion to how they share profits.
>
> The partnership may specify in the partnership agreement each partner's share of profits for purposes of allocating excess nonrecourse liabilities. The shares specified must be consistent with allocations of other significant items of partnership income and gain having substantial economic effect. All the facts and circumstances of the economic arrangement of the partners must be taken into account.
>
> The partnership can also allocate excess nonrecourse liabilities in the same manner it reasonably expects to allocate deductions attributable to the nonrecourse liabilities.

The LB&I Concept Unit, in its part on Determining Liability Allocations, provides an example of "Allocation of a Nonrecourse Liability":

> X and Y form Partnership XY, a general partnership. X contributes $40 and Y contributes $360.

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[398] See Reg. § 1.704-1(b)(2)(iv)(f), which is reproduced in fn 507 in part II.C.7 Maintaining Capital Accounts.
[399] See text accompanying fn in part .

Partnership XY purchases a building for $2,000 and obtains a loan of $1,600 with the building securing the loan.

Depreciation expense is $180 per year and is allocated 75% to X and 25% to Y. All other expenses are allocated 50% to each partner.

Partnership XY pays only interest on the loan for the first 5 years. As of the end of year 3, the building has an adjusted tax basis of $1,460 ($2,000 original cost basis – $540 tax depreciation).

Because Partnership XY made no principal payments on the loan, the balance of the loan is still $1,600. The reduction in adjusted tax basis below the loan balance results in IRC 704(b) “minimum gain” of $140 ($1,600 loan balance - $1,460 tax basis).

1. The liability is first allocated in accordance with how the partners share minimum gain. The minimum gain resulted from nonrecourse depreciation deductions (75%/25%). X’s share of minimum gain = $105 ($140 multiplied by 75%) and Y’s share = $35 ($140 multiplied by 25%).

2. Since the building was purchased by the partnership, it was not contributed by either partner. Under these facts, there is no IRC 704(c) minimum gain.

3. The partnership allocates the remaining liability, $1,460 ($1,600 total balance minus $140 minimum gain) equally based on how the partners share items other than depreciation, $730 each.

The result is that X’s share of nonrecourse liabilities is $835 ($105 minimum gain plus $730 excess nonrecourse liabilities) and Y’s share is $765 ($35 minimum gain plus $730 excess nonrecourse liabilities).

The LB&I Concept Unit, in its part on Determining Liability Allocations, provides an example of “Allocation of a Recourse Liability”:

A and B form Partnership AB, a general partnership. A contributes $40,000 and B contributes $40,000.

The partnership borrows $120,000 on a fully recourse basis and purchases a building for $200,000. Partnership AB allocates losses 90% to A and 10% to B.

Both A and B are jointly and severally liable for the loan and the partnership agreement provides each has a full deficit restoration obligation.

In a constructive liquidation, Partnership AB’s assets are deemed worthless and “sold” in a taxable transaction resulting in a loss of $200,000 (the basis of the building).

The resulting loss of $200,000 is allocated as follows:

A $180,000 ($200,000 multiplied by 90%).

B $20,000 ($200,000 multiplied by 10%).

The impact of the loss on the partners’ capital accounts is as follows:

	Partner A	Partner B
Beginning Capital	$40,000	$40,000
Loss on hypothetical sale	($180,000)	($20,000)
Ending Capital	($140,000)	$20,000

> The extent to which any partner is required to restore a negative capital account reflects the extent the partner's economic risk on the recourse debt. All facts and circumstances must be developed in the analysis, as other items may affect the requirement to restore the deficit. Such items may include contractual obligations outside of the partnership agreement (e.g. indemnification agreements, loss limiting arrangements, etc.).

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

"A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss" under Reg. § 1.752-2.[400]

"A partnership liability is a nonrecourse liability to the extent that no partner or related person bears economic risk of loss for that liability" under Reg. § 1.752-2.[401]

"A partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the economic risk of loss."[402]

LB&I Concept Unit, "Recourse vs. Nonrecourse Liabilities," Document Control Number (DCN) PAR-C-003 (last updated 9/29/2020) (the "Concept Unit"), explains in its General Overview of "Recourse vs. Nonrecourse Liabilities":

> This Practice Unit addresses the definition of liabilities for federal income tax purposes in the context of partnerships. Both recourse and nonrecourse liabilities are discussed in this Unit. Rules for allocating partnership liabilities among the partners are covered in a separate Concept Unit, Determining Liability Allocation.
>
> Understanding partnership liabilities is critical to understanding a partner's outside basis. Outside basis is a partner's basis in his partnership interest. A partner's outside basis is the sum of his capital account plus his share of the partnership's liabilities. A separate Practice Unit, Partner's Outside Basis, provides an overview of how to calculate a partner's outside basis in a partnership interest.
>
> As previously stated, a partner's outside basis in his partnership interest is the sum of his capital account plus his share of the partnership's liabilities. An increase in a partner's share of partnership liabilities is treated as a contribution of money by the partner to the partnership and thus increases his outside basis. A decrease in a partner's share of partnership liabilities is treated as a distribution of money to the partner and thus decreases his outside basis. IRC 752(a) and (b). Each partnership liability is part of at least one partner's outside basis.

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[400] Reg. § 1.752-1(a)(1).
[401] Reg. § 1.752-1(a)(2).
[402] Reg. § 1.752-2(a).

> Liabilities affect partnerships and their partners (and limited-liability companies treated as partnerships and their members) differently from any other types of flow-through entity. Generally, S corporation shareholders and owners of interests in trusts cannot include the respective entity's liabilities in calculating their ownership basis in the entity.

The Concept Unit's definition of liabilities is quoted in part II.C.3.b What Is a "Liability".

Referring to the IRS' Practice Unit, "Partner's Outside Basis," the Concept Unit, in its "Detailed Explanation of the Concept" focusing on "Recourse vs. Nonrecourse Liabilities," explains in its analysis of "Recourse vs. Nonrecourse Liabilities":

> After determining that a partnership's obligation is an IRC 752 liability, the next step is to determine if the liability is recourse or nonrecourse.
>
> There are two important reasons to make this determination:
>
> 1. A partner's allocable share of partnership liabilities increases outside basis. The amount of outside basis has significant tax consequences in several situations. See Practice Unit, Partner's Outside Basis. However, recourse and nonrecourse liabilities are allocated among partners under two different regimes.
>
> 2. Unrepaid recourse debt forgiven by a creditor gives rise to ordinary cancellation-of-debt income. Nonrecourse debt forgiven by a creditor is generally treated as an amount realized on the sale or exchange of the asset securing the nonrecourse debt. The debt forgiveness can potentially result in taxable gain.

Referring to Reg. § 1.752-2, the Concept Unit, in its "Detailed Explanation of the Concept" focusing on "Recourse vs. Nonrecourse Liabilities," explains in its analysis of "Recourse Liabilities":

> A partnership liability is a recourse liability to the extent a partner or related person bears the economic risk of loss for the liability. In other words, if the partnership were unable to pay the creditor, the extent to which a partner would be obligated to pay the debt from personal funds, with no right of reimbursement from another partner, indicates the partner's economic risk of loss.
>
> To determine each partner's economic risk of loss, the regulations post a worst-case scenario in which all of the partnership's assets (including cash) become worthless and the partnership's liabilities become due and payable. In this worst-case scenario, the partnership sells its assets for no consideration and liquidates. The impact of the partnership's allocations on the partners' capital accounts indicates the partners' economic risk of loss. The extent to which a partner must contribute to the partnership to eliminate a capital account deficit or directly pay the partnership's creditors represents the partner's economic risk of loss.
>
> It is important to note that all the facts and circumstances come into play in this worst-case scenario. In addition to the terms of the partnership agreement and the terms of the partnership's loan agreement(s), there may be other documents that impact the partner's ultimate risk of loss, for example:
>
> - Side agreements;

- Reimbursement agreements;
- Guarantees;
- Indemnification agreements;
- Provision of applicable state law.

That analysis continues, referring to *Uniform Partnership Act*, Part III, Sec. 15, Nature of Partner's Liability; *Revised Uniform Partnership Act*, Article 3, Sec. 306, Partner's Liability; *Uniform Limited Partnership Act*, Sec. 7, Limited Partner Not Liable to Creditors; *Revised Uniform Limited Partnership Act*, Sec. 303, No Liability as Limited Partner for Limited Partnership; and *Uniform Limited Liability Company* Act, Sec. 304, Liability of Members and Managers:

> In a general partnership, state law ordinarily provides that the partners are personally liable for the partnership liabilities, except for those that are expressly nonrecourse. For example, in the case of a recourse mortgage on real property, if the partnership was unable to pay the mortgage and the lender foreclosed, the partners would be obligated to pay any deficiency out of their own assets.
>
> Similarly, in a limited partnership, state law generally provides that the general partners are personally liable for partnership liabilities. Limited partners are not personally liable for any unpaid debts of the partnership, except to the extent they have a deficit restoration obligation.
>
> Members of a limited liability company (LLC) taxed as a partnership are generally treated under state law as limited partners in a limited partnership. LLC liabilities are generally allocated to partners in a manner similar to nonrecourse liabilities.
>
> While the resources in the right pane lists various provisions of "uniform" statutes for partnerships and LLCs, it is critically important to research the state law that applies to the entity under examination to determine which uniform statute provisions the applicable state adopted. The entity's operating agreement should specify which state law applies.

Referring to Reg. § 1.752-2, that analysis continues:

> As previously stated, it is important to review all of the facts and circumstances when determining a partner's economic risk of loss. For example, a partner may actually bear economic risk of loss even if a debt is labeled as nonrecourse. Debt labeled as nonrecourse is treated as recourse if:
>
> 1. The partner is also the creditor; i.e., the partner lent money to the partnership;
> 2. The partner is related to the creditor; or
> 3. The partner guarantees an otherwise nonrecourse liability.

Referring to Reg. § 1.752-3, the Concept Unit, in its “Detailed Explanation of the Concept” focusing on “Recourse vs. Nonrecourse Liabilities,” explains in its analysis of “Nonrecourse Liabilities”:

> A partnership liability is nonrecourse if no partner, or person related to a partner, bears the economic risk of loss. In the partnership context, a nonrecourse liability is only paid in full out of the partnership’s profits.
>
> There are generally two types of nonrecourse liabilities:
>
> 1. Unsecured liabilities.
>
> 2. Secured Liabilities, such as automobile loans, that are secured by property.
>
> Unsecured liabilities are not backed by any collateral. In this situation, the lender has limited protection against any default. While the lender may sell the debt on the secondary market and report the default to credit agencies, the lender may not enforce payment against the partners. However, if the nonrecourse debt is collateralized by property, the lender may foreclose on the property. Nonrecourse debt in the context of real estate partnership is typically secured by the underlying property.
>
> A detailed discussion of qualified nonrecourse liabilities is beyond the scope of this Practice Unit. In most cases, qualified nonrecourse financing involves nonrecourse liabilities secured by real estate used in the activity of holding real property, most commonly nonrecourse real estate mortgages.

Referring to Reg. § 1.752-2, the Concept Unit, in its “Detailed Explanation of the Concept” focusing on “Recourse vs. Nonrecourse Liabilities,” explains in its analysis of “Bifurcated Liability”:

> A liability can be both recourse and nonrecourse; this is known as a bifurcated liability. For example, a partnership borrows $1,000,000 on a nonrecourse basis and a partner guarantees $100,000 of the liability. The liability is therefore bifurcated into a nonrecourse portion and a recourse portion that increases the guaranteeing partner’s outside basis.

Referring to Reg. § 1.752-2, the Concept Unit, in its “Detailed Explanation of the Concept” focusing on “Recourse vs. Nonrecourse Liabilities,” explains in its analysis of “Bottom Dollar Payment Obligation”:

> Prior to October 4, 2016, partners were able to engage in “bottom dollar” payment obligations. Using the above example, the partner would only be liable to pay the $100,000 guaranteed amount after the creditor had collected on the first $900,000. Although this was unlikely, the “bottom dollar guarantee” or payment obligation of $100,000 was still allocated to the guaranteeing partner as a recourse debt. In many situations, the guaranteeing partner did not truly bear an economic risk of loss. For obligations entered into after October 4, 2016, the creditor must be able to immediately enforce payment on the guaranteeing partner in order for the partnership to allocate that debt as recourse.

> Guarantees entered into in a binding contract before October 5, 2016, are excepted from this requirement. Also, any obligation may be a bottom dollar payment liability if it is deficit restoration obligation under Treas. Reg. 1.704-1(b).

Referring to IRS AM 2016-001, the Concept Unit, in its “Detailed Explanation of the Concept” focusing on “Recourse vs. Nonrecourse Liabilities,” explains in its analysis of “Bad Boy Guarantees”:

> Generally, “bad boy guarantees” do not convert nonrecourse debt to recourse debt for federal income tax purposes. A bad boy guarantee occurs when a partner’s guarantee of partnership nonrecourse debt is conditioned on certain “nonrecourse carve-out” events described below.
>
> The Associate Chief Counsel (Passthroughs and Special Industries) has identified at least seven nonrecourse carve-out events contained in bad boy guarantees: (1) the borrower fails to obtain the lender’s consent before obtaining subordinate financing or transfer of the secured property; (2) the borrower files a voluntary bankruptcy petition; (3) any person in control of the borrower files an involuntary bankruptcy petition against the borrower; (4) any person in control of the borrower solicits other creditors of the borrower to file an involuntary bankruptcy petition against the borrower; (5) the borrower consents to or otherwise acquiesces or joins in an involuntary bankruptcy or insolvency proceeding; (6) any person in control of the borrower consents to the appointment of a receiver or custodian of assets; or (7) the borrower makes an assignment for the benefit of creditors, or admits in writing or in any legal proceeding that it is insolvent or unable to pay its debts as they come due. IRS AM 2016-001.
>
> Consistent with commercial practices of not treating these guarantees as creating recourse debt, the IRS does not treat bad boy guarantees as creating recourse debt unless the condition actually occurs.

Referring to Reg. § 1.752-2(c), the Concept Unit, in its “Detailed Explanation of the Concept” focusing on “Recourse vs. Nonrecourse Liabilities,” explains in its analysis of “Wrapped Debt”:

> Wrapped debt is a partnership liability owed to a partner or related person that includes (*i.e.*, is wrapped around) underlying debt that a partner or related person owes to an unrelated lender. If the debt is wrapped around a nonrecourse obligation secured by partnership property that is owed to another person, then the partnership liability is treated as two separate liabilities.
>
> Generally, wrapped debt situations occur when a partner contributes real estate to a partnership secured by a pre-existing nonrecourse mortgage. The partnership may not want to pay off the existing mortgage as its interest rate may be very low. The partnership enters into a loan agreement with equivalent terms to the original mortgage and the debtor-partner remains liable for the original mortgage. The original mortgage is the wrapped debt and the partnership loan payable to the partner is the wraparound debt.
>
> Although owed to a partner, the wraparound debt assumes the characteristics of the wrapped debt. Since in this example, the wrapped debt is a nonrecourse mortgage, the wraparound debt is also treated as a nonrecourse liability, even though owed to a partner.

The Concept Unit provides "Examples of the Concept":

> <u>Example 1</u>
>
> Mr. Apple and Mrs. Pear form a partnership to operate a restaurant. Mr. Apple is a general partner who contributes $100,000. Mrs. Pear is a limited partner who contributes $500,000. The partnership buys restaurant equipment for $500,000, which is subject to a note for $400,000. The additional $500,000 that Mrs. Pear contributed is used for working capital. As the general partner, Mr. Apple may be held personally liable for payments on the equipment note. Since Mr. Apple bears the economic risk of loss on the note, the equipment note is a recourse liability.
>
> <u>Example 2</u>
>
> Assume the same facts as in Example 1, except that the equipment was purchased with a nonrecourse note, the seller of the equipment is limited to repossessing the equipment in the event of default on the note, and the seller cannot collect any balance owed from either partner. As neither partner bears the economic risk for the loan (only the lender does), the equipment note is nonrecourse.

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

LB&I Concept Unit, "Determining Liability Allocations," Document Control Number (DCN) PAR-C-004 (last updated 9/15/20) (the "LB&I Concept Unit"), includes allocating economic risk of loss to recourse liabilities and is reproduced in part II.C.3.c Allocations of Recourse and Nonrecourse Liabilities.

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

Reg. § 1.752-2(b)(1) provides that, generally:

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

In an earlier taxable year to which the above regulation applied as quoted, *Bordelon v. Commissioner*, T.C. Memo. 2020-26 reasoned:[403]

> During the relevant years, Mr. Bordelon was the majority member—a 90% member—of Kilgore LLC. Kilgore LLC reported losses for 2008, and Mr. Bordelon claimed a deduction for 90% of those losses on his 2008 return. The Commissioner disallowed the deduction for lack of basis in the partnership, and Mr. Bordelon agreed to the adjustment for 2008, acknowledging that he had a zero basis in Kilgore LLC. The losses became suspended until such time as Mr. Bordelon acquired a basis in Kilgore LLC.
>
> In 2011 Kilgore LLC borrowed $550,000 from HFB. The loan had a three-year term and a 36-month payment schedule. Mr. Bordelon personally guaranteed the loan. There were no other guarantors on the loan, and no other member of Kilgore LLC had personal liability for any amount of the loan. Nothing in the record indicates that the terms of the loan, including its 36-month payment schedule and three-year term, were not honored; nothing in the record indicates that Mr. Bordelon withdrew his guarantee or was released from his guarantee; and nothing in the record indicates the loan was paid in full before its maturity date in 2014.[13]
>
> > [13] The Commissioner argued that Mr. Bordelon failed to show that the loan was outstanding in 2011. We are persuaded that the loan remained outstanding at the end of 2011. The only means by which the loan could not have remained outstanding in 2011 would be payment in full before the end of 2011 - which we do not find occurred in these cases. Moreover, if we presumed full repayment did in fact occur, then we would further presume repayment would have resulted in a partnership item reported by Kilgore LLC as a distribution to Mr. Bordelon for relief of his recourse liability—a liability which the parties stipulated. See sec. 752(b); see also 26 C.F.R. sec. 301.6231(a)(3)-1(a)(4), Proced. & Admin. Regs. However, neither party provided partnership returns indicating such a discrepancy or issue concerning partnership items relevant to these cases, and the Commissioner failed to raise or present any issue as to any such item or a pending partnership audit (which under TEFRA would preclude us from deciding the instant cases until the TEFRA partnership case was resolved), and thus we hold the matter to be conceded.
>
> Applying the "constructive liquidation" test to these facts, we do not perceive any scenario in which Mr. Bordelon could not be considered economically at risk for the HFB debt to the full extent of his guarantee. There were no other partnership assets securing any of the debt; no other partner was liable for any portion of the debt; and if the debt were due in full, HFB would certainly have sought payment directly from Mr. Bordelon. Thus, we are persuaded that when Mr. Bordelon guaranteed the loan in 2011, it became a recourse obligation to Mr. Bordelon and increased his basis in Kilgore LLC by $550,000,[14] which then allowed him to deduct the same amount in Kilgore LLC losses carried forward from 2008.
>
> > [14] The Commissioner has made no argument (other than disputing that the debt was recourse) against the contention that, when Mr. Bordelon guaranteed the Kilgore Loan in 2011, his basis increased by the full $550,000.

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[403] *Bordelon* is further discussed in part II.G.4.j At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities) in the text accompanying fn 1292.

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

- If the creditor's right to repayment of a partnership liability is limited solely to one or more assets of the partnership, gain or loss is recognized in an amount equal to the difference between the amount of the liability that is extinguished by the deemed disposition and the tax basis[404] in those assets.[405]

- A loss is recognized equal to the remaining tax basis[406] of all the partnership's assets not taken into account in the bullet point above.[407]

T.D. 9877, "Liabilities Recognized as Recourse Partnership Liabilities Under Section 752," RIN 1545-BM83 (10/9/2019), explains in its "Summary of Comments and Explanations of Revisions":

> ***1. Bottom Dollar Payment Obligations***
>
> **A. Obligations Treated as Bottom Dollar Payment Obligations**
>
> The 752 Temporary Regulations provide that a bottom dollar payment obligation is not recognized as a payment obligation for purposes of § 1.752-2. The 752 Temporary Regulations provide that a bottom dollar payment obligation is the same as or similar to one of the following three types of payment obligations or arrangements: (1) With respect to a guarantee or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied; (2) with respect to an indemnity or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation, if, and to the extent that, any amount of the indemnitee's or benefited party's payment obligation is recognized; and (3) an arrangement with respect to a partnership liability that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements, and with a principal purpose of avoiding having at least one of such liabilities or payment obligations with respect to such liabilities being treated as a bottom dollar payment obligation. A payment obligation is not a bottom dollar payment obligation merely because a maximum amount is placed on the partner's or related person's payment obligation, a partner's or related person's payment obligation is stated as a fixed

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

percentage of every dollar of the partnership liability, or there is a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable. The 752 Temporary Regulations also provide an exception to the non-recognition rule of bottom dollar payment obligations. That is, a bottom dollar payment obligation is recognized when a partner or related person is liable for at least 90 percent of the partner's or related person's initial payment obligation despite an indemnity, a reimbursement agreement, or a similar arrangement.

One commenter stated that the 752 Temporary Regulations are conceptually flawed, result in inconsistent answers, and are directly contrary to Congressional intent. That commenter explained that the prior regulations appropriately followed Congress's mandate that debt is allocated by a partnership to the partners who bear the EROL with respect to the debt. See Section 79 of the Deficit Reduction Act of 1984 (Pub. L. 98-369) overruling the decision in *Raphan v. United States*, 3 Cl.Ct. 457 (1983) (holding that a guarantee on a partnership liability by a general partner did not require that partner to be treated as personally liable for that liability and did not preclude the other partners who did not guarantee the loan from sharing in the step up in basis on account of the debt). The commenter argued that the 752 Temporary Regulations instead treat all guarantees as bottom dollar payment obligations which do not create EROL unless the partner is liable for the full amount of that partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. The commenter asserted that, under the 752 Temporary Regulations, all guarantees below 90 percent of a payment obligation are ignored, even if the partnership and the partners believe that the guaranteeing partner bears the EROL with respect to the payment obligation.

As an example of these concerns, the commenter pointed to the different results in Examples 10 and 11 in § 1.752-2T(f). In Examples 10 and 11, A, B, and C are equal members of a partnership, ABC. ABC borrows $1,000 from Bank. In Example 10, A guarantees up to $300 of the liability if any amount of the $1,000 liability is not recovered by Bank, while B guarantees payment of up to $200, but only if Bank otherwise recovers less than $200. In Example 11, C additionally agrees to indemnify A for up to $100 that A pays with respect to A's guarantee. The comment explained that, in Example 10, $300 of the liability is recognized and allocated (to A), but in Example 11, only $100 is recognized and allocated (in the amount indemnified by C). The full $300 payment obligation would have been recognized and allocated if made by one partner, but splitting it across two partners caused $200 of the collective payment obligation to be ignored. This result is notwithstanding that $300 of the same first-dollars of the $1,000 partnership liability in the example was guaranteed by the partners.

Although recommending revocation of the 752 Temporary Regulations, this commenter recognized that prior regulations under section 752 allow partners that have no practical economic risk to be allocated debt. As a compromise, this commenter proposed that if the Treasury Department and the IRS are concerned with bottom dollar payment obligations that lack economic reality, the temporary regulations should be replaced with a rule that does not recognize obligations below a certain threshold. The commenter recommended, as an example, that obligations limited to the bottom one-third of a debt obligation not be recognized, but once the obligation is above that threshold, the entire obligation is recognized. The commenter argued that such a rule would provide greater certainty than the 752 Temporary Regulations and recognize that the guarantor has risk.

The 752 Temporary Regulations and these final regulations implement Congressional intent. Bottom dollar payment obligations do not represent real EROL because those payment obligations are structured to insulate the obligor from having to pay their obligations. Moreover, bottom dollar guarantees are not relevant to loan risk underwriting generally. These obligations generally lack a significant non-tax commercial business purpose. Therefore, bottom dollar payment obligations should not be recognized as payment obligations. Despite the commenter's assertion that there could be some risk to partners with bottom dollar payment obligations, the Treasury Department and the IRS received no comments (including from this commenter) on the 752 Temporary Regulations or the 752 Proposed Regulations demonstrating that bottom dollar payment obligations have a significant non-tax commercial business purpose. Nor did any commenter propose an alternative that resolves the concerns raised in the preamble to the 752 Temporary Regulations that, under the prior section 752 regulations, partners and related persons entered into payment obligations that were not commercial solely to achieve an allocation of a partnership liability. The compromise proposal offered by this commenter would significantly lower the threshold for the amount required to be economically at risk from 90 percent of a partner's or related person's initial payment obligation to 33 percent without explaining why the lower threshold is more appropriate. Indeed, the compromise could still allow a partner with no practical economic risk to be allocated debt. These final regulations comport with Congress' directive in response to *Raphan*. Moreover, Examples 10 and 11 in § 1.752-2(f) are not inconsistent with one another, but show how an otherwise recognized payment obligation can become a bottom dollar payment obligation when the initial payment obligor no longer bears the real EROL as a result of a subsequent indemnity. For these reasons, the Treasury Department and the IRS do not adopt the commenter's suggestions.

The 752 Temporary Regulations further require taxpayers to disclose bottom dollar payment obligations by filing Form 8275, Disclosure Statement, or any successor form, with the return of the partnership for the taxable year in which a bottom dollar payment obligation is undertaken or modified. These final regulations clarify that identifying the payment obligation with respect to which disclosure is made includes stating whether the obligation is a guarantee, a reimbursement, an indemnity, or deficit restoration obligation.

B. Capital Contribution and Deficit Restoration Obligations

Generally, the regulations under section 752 provide a description of obligations recognized as payment obligations under § 1.752-2(b)(1). The 752 Temporary Regulations further provide that all statutory and contractual obligations relating to the partnership liability are taken into account for purposes of applying § 1.752-2, including obligations to the partnership that are imposed by the partnership agreement, such as the obligation to make a capital contribution and a deficit restoration obligation. See § 1.752-2T(b)(3).

A commenter expressed concerns that, although it is clear that a capital contribution obligation and a deficit restoration obligation are types of payment obligations to which § 1.752-2 applies, the definition of a bottom dollar payment obligation provides no guidance as to how to determine whether a capital contribution obligation or a deficit restoration obligation is a bottom dollar payment obligation. For example, a deficit restoration obligation does not relate to a particular partnership liability and the proceeds of the deficit restoration obligation may be paid to creditors of the partnership or distributed to other partners. See § 1.704-1(b)(2)(ii)(b)(3). These final regulations thus revise the definition of a bottom dollar payment obligation to specifically address capital contribution obligations and deficit restoration obligations. Section 1.752-2(b)(3)(ii)(C)(1)(iii) in these final regulations provides that a bottom dollar payment obligation includes, with respect to a capital contribution obligation and a deficit restoration obligation, any payment obligation other than one in which the partner is or would be required to make the full amount of the partner's capital contribution or to restore the full amount of the partner's deficit capital account.

C. Anti-Abuse Rule in § 1.752-2(j)(2)

The 752 Temporary Regulations provide that irrespective of the form of the contractual obligation, the Commissioner may treat a partner as bearing the EROL with respect to a partnership liability, or portion thereof, to the extent that: (1) The partner or related person undertakes one or more contractual obligations so that the partnership may obtain or retain a loan; (2) the contractual obligations of the partner or related person significantly reduce the risk to the lender that the partnership will not satisfy its obligations under the loan, or portion thereof; and (3) with respect to the contractual obligations described in (1) or (2), (i) one of the principal purposes of using the contractual obligation is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests, or (ii) another partner, or person related to another partner, enters into a payment obligation and a principal purpose of the arrangement is to cause the payment obligation to be disregarded. See § 1.752-2T(j)(2).

A commenter argued that because this anti-abuse rule is at the Commissioner's discretion, taxpayers are uncertain how to treat certain liabilities that would otherwise be bottom dollar payment obligations. One of the purposes of the 752 Temporary Regulations is to ensure that only genuine commercial payment obligations, including guarantees and indemnities, affect the allocation of partnership liabilities. Indeed, commenters to the 2014 Proposed Regulations noted that partners can manipulate contractual arrangements to achieve a federal income tax result that is not consistent with the economics of an arrangement. This is true both of a payment obligation that does not represent a real EROL as well as an agreement that purposefully creates the appearance of a bottom dollar payment obligation even if that taxpayer (or a person related to that taxpayer) bears the EROL. The anti-abuse rule, therefore, is appropriate. However, in response to comments regarding uncertainty caused because the anti-abuse rule in the 752 Temporary Regulations applied at the Commissioner's discretion, the final regulations remove the discretionary language consistent with the rule in the regulations under section 752 prior to the 752 Temporary Regulations.

D. Applicability Date and Transitional Rule

The 752 Temporary Regulations for bottom dollar payment obligations generally apply to liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken with respect to a partnership liability on or after October 5, 2016, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date. Under the 752 Temporary Regulations, a transitional rule applies to any partner whose allocable share of partnership liabilities under § 1.752-2 exceeded its adjusted basis in its partnership interest as determined under § 1.705-1 on October 5, 2016 (Grandfathered

Amount). To the extent of that excess, those partners may continue to apply the prior regulations under § 1.752-2 with respect to a partnership liability for a seven-year period. The amount of partnership liabilities subject to transition relief decreases for certain reductions in the amount of liabilities allocated to that partner under the transitional rule and, upon the sale of any partnership property, for any tax gain (including section 704(c) gain) allocated to the partner less that partner's share of amount realized.

A commenter explained that the rule in § 1.704-2(g)(3) regarding conversions of recourse or partner nonrecourse liabilities into nonrecourse liabilities may overlap and potentially conflict with the transitional rule. This commenter noted that the transitional rule may be unnecessary, but, regardless, believes that the transitional rule should be coordinated with § 1.704-2(g)(3).

Section 1.704-2(g)(3) provides that a partner's share of partnership minimum gain is increased to the extent provided in § 1.704-2(g)(3) if a recourse or partner nonrecourse liability becomes partially or wholly nonrecourse. If a recourse liability becomes a nonrecourse liability, a partner has a share of the partnership's minimum gain that results from the conversion equal to the partner's deficit capital account (determined under § 1.704-1(b)(2)(iv)) to the extent the partner no longer bears the economic burden for the entire deficit capital account as a result of the conversion. The determination of the extent to which a partner bears the economic burden for a deficit capital account is made by determining the consequences to the partner in the case of a complete liquidation of the partnership immediately after the conversion applying the rules described in § 1.704-1(b)(2)(iii)(c) that deem the value of partnership property to equal its basis, taking into account section 7701(g) in the case of property that secures nonrecourse indebtedness. If a partner nonrecourse debt becomes a nonrecourse liability, the partner's share of partnership minimum gain is increased to the extent the partner is not subject to the minimum gain chargeback requirement under § 1.704-2(i)(4). The commenter asserts that § 1.704-2(g)(3) increases a partner's share of minimum gain which increases the partner's capital account to reflect the same result as if nonrecourse deductions had been taken all along. The gain, if it would have been triggered as a result of a partner's negative section 704(b) account with no deficit reduction obligation, is deferred because under § 1.704-2(g)(3), the partner's share of minimum gain increases. The commenter argues that § 1.752-3(a)(1) or (2) would apply to allocate the nonrecourse liability to the partner and, therefore, the partner would still be allocated a share of the partnership liability eliminating the need for the transitional rule.

Notwithstanding the rule in § 1.704-2(g)(3), the transitional rule is necessary to address certain situations when § 1.704-2(g)(3) would not apply because, for example, before these regulations were finalized, a bottom dollar deficit restoration obligation is regarded for section 704 purposes, but is disregarded for section 752 purposes. In that case, a partner could recognize gain under section 731 without the transitional rule. Additionally, because § 1.752-3(a)(1) and (2) do not apply in determining a partner's share of a partnership nonrecourse liability for disguised sale purposes, a disguised sale could occur if a partner's share of liabilities under § 1.752-3(a)(3) does not cover the Grandfathered Amount.

To the extent that the transitional rule applies to a partner's share of a recourse partnership liability as a result of the partner bearing the EROL under § 1.752-2(b), the partner's share of the liability can continue to be determined under § 1.752-2 and is not converted into a nonrecourse liability under § 1.752-3. In this situation, because a recourse or partner nonrecourse liability does not become partially or wholly nonrecourse as a result of the transitional rule, the rule in § 1.704-2(g)(3) would not apply until the expiration of the seven-year period. If a partner does not want to apply the transitional rule in determining its share of a partnership liability because it believes that the rule in § 1.704-2(g)(3) effectively defers any negative tax consequences that could occur when a recourse or partner nonrecourse liability becomes partially or wholly nonrecourse, the partner must then apply the rules under § 1.752-2, as amended after October 5, 2016, in determining its share of a partnership liability.

This commenter also noted that the transitional rule should clarify whether it applies to refinanced liabilities. The bottom dollar payment obligation rules do not apply to liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect before October 5, 2016. The preamble to the 752 Temporary Regulations explains that commenters on the 2014 Proposed Regulations had recommended that partnership liabilities or payment obligations that are modified or refinanced continue to be subject to the provisions of the previous regulations to the extent of the amount and duration of the pre-modification (or refinancing) liability or payment obligation. The preamble explains that the 752 Temporary Regulations do not adopt this recommendation as the terms of the partnership liabilities and payment obligations could be changed, which would affect the determination of whether or not an obligation is a bottom dollar payment obligation, but instead provided transition relief. Under the transitional rule, if a debt entered into before October 5, 2016, is not refinanced, these final regulations do not apply. If the debt is refinanced, then these regulations apply, but the partner could instead choose to apply the transitional rule to the extent of the Grandfathered Amount. Although the transitional rule in the 752 Temporary Regulations applies to modified or refinanced obligations, these final regulations further clarify that the transitional rule applies to modified and refinanced liabilities.

2. Additional Guidance on Disregarding Purported Payment Obligations

A. Deficit Restoration Obligation Factors

The 752 Proposed Regulations add a list of factors to § 1.704-1(b)(2)(ii)(c) that are similar to the factors in the proposed anti-abuse rule under § 1.752-2(j) (discussed in Section 2.B. of the Summary of Comments and Explanations of Revisions in this preamble), but specific to deficit restoration obligations, to indicate when a plan to circumvent or avoid an obligation exists. If a plan to circumvent or avoid an obligation exists, the obligation is disregarded for purposes of sections 704 and 752. Under proposed § 1.704-1(b)(2)(ii)(c), the following factors indicate a plan to circumvent or avoid an obligation: (1) The partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation; (2) the partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner’s financial condition to the partnership; (3) the obligation ends or could, by its terms, be terminated before the liquidation of the partner’s interest in the partnership or when the partner’s capital account as provided in § 1.704-1(b)(2)(iv) is negative; and (4) the terms of the obligation are not provided to all the partners in the partnership in a timely manner.

The Treasury Department and the IRS are aware that a partner's transfer of its deficit restoration obligation to a transferee who agrees to the same deficit restoration obligation could run afoul of the third factor and cause the partner's deficit restoration obligation to be disregarded. However, under these final regulations, the weight to be given to any particular factor depends on the particular facts and the presence or absence of any particular factor is not, in itself, necessarily indicative of whether or not the obligation is respected. The fact that a transferee agrees to the same deficit restoration obligation should be taken into account when determining whether a plan to circumvent or avoid an obligation exists. In addition, these final regulations add an exception to this factor when a transferee partner assumes the obligation.

B. Anti-Abuse Factors Under § 1.752-2(j)(3)

The 2014 Proposed Regulations included a list of factors to determine whether a partner's or related person's obligation to make a payment with respect to a partnership liability (excluding those imposed by state law) would be recognized for purposes of section 752. In response to comments, the 752 Proposed Regulations moved the list of factors to an anti-abuse rule in § 1.752-2(j)(3), other than the recognition factors concerning bottom dollar guarantees and indemnities, which are addressed in the 752 Temporary Regulations. Under the anti-abuse rule in the 752 Proposed Regulations, the following non-exclusive factors are weighed to determine whether a payment obligation should be respected: (1) The partner or related person is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, (2) the partner or related person is not required to provide commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party, (3) the term of the payment obligation ends prior to the term of the partnership liability, or the partner or related person has a right to terminate its payment obligation, (4) there exists a plan or arrangement in which the primary obligor or any other obligor with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonable foreseeable needs of such obligor, (5) the payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection, (6) in the case of a guarantee or similar arrangement, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee, and (7) the creditor or other party benefiting from the obligation did not receive executed documentation with respect to the payment obligation from the partner or related person before, or within a commercially reasonable period of time after, the creation of the obligation. The weight to be given to any particular factor depends on the particular case and the presence or absence of any particular factor, in itself, is not necessarily indicative of whether or not a payment obligation is recognized under § 1.752-2(b).

A commenter expressed concerns with the listed factors asserting that they are drafted to make an obligation fail (that the debt will be nonrecourse) because an obligation is unlikely to satisfy all seven factors. The commenter also argued that the factors are subject to manipulation by taxpayers who desire nonrecourse debt treatment. Finally, the commenter was concerned with the subjective and speculative inquiry regarding the fourth and sixth factors.

The seven factors are appropriate considerations in determining whether a plan to circumvent or avoid an obligation exists. The 2014 Proposed Regulations provided that a payment obligation with respect to a partnership liability was not recognized under § 1.752-2(b)(3) unless all of the factors were met. At commenters' requests and due to concerns that the rule was too strict, the 752 Proposed Regulations moved the list of factors from the operative rule to the anti-abuse rule where they are now just factors to examine in determining whether a plan to circumvent or avoid an obligation exists. In response to the comment on the 752 Proposed Regulations, however, these final regulations add clarification to the fourth factor that amounts are not held in excess of the reasonably foreseeable needs of an obligor if the partnership purchases standard commercial insurance, such as casualty insurance. Additionally, these final regulations list certain types of commercially reasonable documentation (balance sheets and financial statements) as examples of documents a lender would typically require.

A commenter also requested that the final regulations clarify how the assumption rule in § 1.752-1(d) relates to the factors in § 1.752-2(j). Under § 1.752-1(b), any increase in a partner's share of partnership liabilities, or any increase in a partner's individual liabilities by reason of the partner's assumption of partnership liabilities, is treated as a contribution of money by that partner to the partnership. Conversely, § 1.752-1(c) provides that any decrease in a partner's share of partnership liabilities, or any decrease in a partner's individual liabilities by reason of the partnership's assumption of the individual liabilities of the partner, is treated as a distribution of money by the partnership to that partner. The assumption rule in § 1.752-1(d) applies to determine whether a partner has assumed a partnership liability (treated as a contribution under section 752(a)), or the partnership has assumed a partner liability (treated as a distribution under section 752(b)). Generally under § 1.752-1(d), a person is considered to assume a liability only to the extent that (1) the assuming person is personally obligated to pay the liability; and (2) if a partner or related person assumes a partnership liability, the person to whom the liability is owed knows of the assumption and can directly enforce the partner's or related person's obligation for the liability, and no other partner or person that is a related person to another partner would bear the EROL for the liability immediately after the assumption. Sections 1.752-2 and 1.752-3 provide the rules for determining a partner's share of partnership recourse and nonrecourse liabilities.

The analysis for determining whether a partner or person that is a related person to a partner bears the EROL for a liability for purposes of the assumption rule in § 1.752-1(d) should be the same analysis for determining whether a partner or related person bears the EROL under § 1.752-2, including the factors in § 1.752-2(j) for payment obligations. Therefore, these final regulations add a cross reference in § 1.752-1(d) to clarify that an assumption will be treated as giving rise to a payment obligation only to the extent no other partner or a person related to another partner bears the EROL for the liability as determined under § 1.752-2.

C. Reasonable Expectation of Ability to Satisfy Obligation

The satisfaction presumption in § 1.752-2(b)(6) of the existing regulations is subject to a disregarded entity net value requirement under existing § 1.752-2(k). The 2014 Proposed Regulations expanded the scope of the net value requirement and provided that, in determining the extent to which a partner or related person other than an individual or a decedent's estate bears the EROL for a partnership liability other than a trade payable, a payment obligation is recognized only to the extent of the net value of the partner or related person that, as of the allocation date, is allocated to the liability, as determined under § 1.752-2(k). The 2014 Proposed Regulations also required a partner to provide a statement concerning the net value of a person with a payment obligation (a payment obligor) to the partnership. The preamble to the 2014 Proposed Regulations requested comments concerning whether the net value rule should also apply to individuals and estates and whether the regulations should consolidate these rules under § 1.752-2(k).

Comments on the 2014 Proposed Regulations suggested that if the net value rule is retained, § 1.752-2(k) should be extended to all partners and related persons other than individuals. A commenter expressed concerns that a partner who may be treated as bearing the EROL with respect to a partnership liability would have to provide information regarding the net value of a payment obligor, which is unnecessarily intrusive. Another commenter believed that if the rules requiring net value were extended to all partners in partnerships, the attempt to achieve more realistic substance would be accompanied by a corresponding increase in the potential for manipulation.

The preamble to the 752 Proposed Regulations explains that the Treasury Department and the IRS remain concerned with ensuring that a partner or related person be presumed to satisfy its payment obligation only to the extent that such partner or related person would be able to pay the obligation. After consideration of the comments to the 2014 Proposed Regulations, however, the Treasury Department and the IRS agreed that expanding the application of the net value rules under § 1.752-2(k) may lead to more litigation and may unduly burden taxpayers. Furthermore, net value as provided in § 1.752-2(k) may not accurately take into account future earnings of a business entity, which normally factor into lending decisions. Therefore, the 752 Proposed Regulations proposed to remove § 1.752-2(k) of the existing regulations and instead create a new presumption under the anti-abuse rule in § 1.752-2(j).

Under the presumption in the 752 Proposed Regulations, evidence of a plan to circumvent or avoid an obligation is deemed to exist if the facts and circumstances indicate that there is not a reasonable expectation that the payment obligor will have the ability to make the required payments if the payment obligation becomes due and payable (Presumed Anti-abuse Rule). A payment obligor includes disregarded entities (including grantor trusts). If evidence of a plan to circumvent or avoid the obligation exists or is deemed to exist, the obligation is not recognized under § 1.752-2(b) and therefore the partnership liability is treated as a nonrecourse liability under § 1.752-1(a)(2).

Commenters argued that § 1.752-2(k) should be retained, however, because it provides clarity and certainty to taxpayers. One commenter suggested that if the government believes that the Presumed Anti-abuse Rule is necessary, § 1.752-2(k) should still be retained, or, alternatively, expanded to all partners and related persons other than individuals. This commenter noted that the Presumed Anti-abuse Rule creates uncertainty as it is not clear that taxpayers may proactively assert the Presumed Anti-abuse Rule. The commenter suggested that the final regulations clarify that motive and intent are irrelevant in determining whether the Presumed Anti-abuse Rule applies and that no actual plan to circumvent or avoid an obligation needs to exist.

Expanding the application of § 1.752-2(k) in the existing regulations would unduly burden taxpayers and would not accurately reflect economics. A more accurate reflection of economics is to determine whether a debtor will have the ability to make payments when due, not necessarily to whether the debtor has sufficient assets to satisfy an obligation currently. The Treasury Department and the IRS agree with the commenter, however, that the Presumed Anti-abuse Rule could create confusion and uncertainty. These final regulations, therefore, amend § 1.752-2(k) and clarify how the satisfaction presumption in § 1.752-2(b)(6) relates to § 1.752-2(k) in these final regulations. Amended § 1.752-2(k) applies to all partners of a partnership, including partners that are disregarded entities or grantor trusts.

Under these final regulations, it is assumed that all payment obligors actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate that at the time the partnership determines a partner's share of partnership liabilities under §§ 1.705-1(a) and 1.752-4(d) there is not a commercially reasonable expectation that the payment obligor will have the ability to make the required payments under the terms of the obligation if the obligation becomes due and payable. A partner or related person's ability to pay may be based on documents such as, but not limited to, balance sheets, income statements, cash flow statements, credit reports, and projected future financial results.

D. General Applicability Date

Except as provided in Section 1.D. of the Summary of Comments and Explanations of Revisions in this preamble relating to bottom dollar payments obligations, these final regulations apply to liabilities incurred or assumed by a partnership and to payment obligations imposed or undertaken with respect to a partnership liability on or after October 9, 2019, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date.

3. Additional Issues Concerning Partnership Liabilities That Are Outside the Scope of These Regulations

A commenter recommended guidance in determining a partner's amount at risk under section 465 for deficit restoration obligations. This commenter noted that under *Hubert Enterprises, Inc. v. Commissioner*, T.C. Memo. 2008-46, a deficit restoration obligation was not treated as giving a partner at risk basis because the obligation was contingent (because it was dependent upon the partner liquidating his interest) and the amount was uncertain (the deficit restoration obligation covered only the deficit in the partner's capital account at the time of liquidation and did not cover the entire debt obligation at issue). The commenter also recommended providing guidance under section 465 similar to that provided in these final regulations regarding when guarantees will be recognized. Providing guidance concerning section 465 is beyond the scope of these regulations. The Treasury Department and the IRS request comments, however, concerning whether guidance is needed to address issues under section 465.

The commenter recommended that these regulations incorporate standards to determine when a debt is recourse to a partnership under section 1001. The commenter questioned whether that test under section 1001 is performed at the partnership or partner level. These final regulations provide guidance as to how liabilities are allocated

> to partners in a partnership and do not concern how liabilities are characterized to the partnership under section 1001. This comment is thus outside the scope of these regulations.
>
> This commenter also suggested that the Treasury Department and the IRS consider whether the rules in section 357(d) should have been adopted for partnerships since section 357(d)(3) states that the Secretary may also prescribe regulations which provide that the manner in which a liability is treated as assumed under section 357(d) is applied, where appropriate, elsewhere in Title 26. Section 357(d)(1)(A) provides that a recourse liability (or portion thereof) shall be treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed to, and is expected to, satisfy such liability (or portion), whether or not the transferor has been relieved of such liability. Section 357(d)(1)(B) provides that except as provided in section 357(d)(2), a nonrecourse liability shall be treated as having been assumed by the transferee of any asset subject to such liability. This recommended change is beyond the scope of these regulations, which are concerned with whether a partnership debt is recourse or non-recourse to a partner in the partnership.
>
> The 752 Proposed Regulations requested comments concerning exculpatory liabilities in response to comments received on the 2014 Proposed Regulations requesting guidance with respect to such liabilities. An exculpatory liability is a liability that is recourse to an entity under state law and section 1001, but no partner bears the EROL within the meaning of section 752. Thus, the liability is treated as nonrecourse for section 752 purposes. The Treasury Department and the IRS, after acknowledging that exculpatory liabilities are beyond the scope of the 752 Proposed Regulations, sought additional comments regarding the proper treatment of an exculpatory liability under regulations under section 704(b) and the effect of such a liability's classification under section 1001. Further, the Treasury Department and the IRS requested additional comments addressing the allocation of an exculpatory liability among multiple assets and possible methods for calculating minimum gain with respect to such liability, such as the so-called "floating lien" approach (whereby all the assets in the entity, including cash, are considered to be subject to the exculpatory liability) or a specific allocation approach. The Treasury Department and the IRS continue to consider the comments received concerning exculpatory liabilities under sections 704 and 752.

Regarding rules governing a bottom-dollar guarantee (BDG), Lipton & Schneider, "Replacing Certainty with Uncertainty-IRS Fumbles with the Final Regulations on Partnership Debt Guarantees," *Journal of Taxation* (1/2020), comment:

> The adoption of the final regulations on BDGs, to the extent that such final regulations merely followed the approach of the temporary regulations which had been in effect since 2016, was fully expected by tax practitioners. Indeed, if the final regulations had simply taken that step, there would have been little controversy.
>
> Although there are theoretical problems with the BDG limitation, in that it runs contrary to the presumption that all of a partnership's assets (including cash) are worthless in order to determine whether a partner bears any risk with respect to a liability, the fact is that most partnerships have been applying these rules for the past three years and were now accustomed to them. Specifically, most partners who previously had made or wanted to make a BDG changed to a vertical slice guarantee (VSG) in which the partner was liable for a percentage of the debt. Thus, if a partnership had $100 of nonrecourse debt that

was secured by Blackacre (which was worth $200), and a partner wanted to be allocated $10 of that debt, under a BDG the partner would have guaranteed the bottom $10, meaning that there was no liability as long as Blackacre had a value of at least $10. In other words, in order for the guarantor to have any loss under the BDG, Blackacre would have had to lose 95% of its value.

Under a VSG, the partner who guaranteed a 10% slice would bear $1 of liability for each $10 lost by the lender. However, because the loan-to-value ratio was 50%, the guarantor under the VSG would not suffer any loss as long as Blackacre was worth at least $100. And even if Blackacre declined in value to $90, the guarantor would, in that case, lose only $1. The risk under a VSG is real and begins with the first dollar of risk born by the lender, but is still modest as long as the debt is adequately collateralized, as this example shows. Thus, in the "real world," these VSGs are a good replacement to the BDGs while still including the "first dollar" risk sharing with the lender.

If the final regulations had stopped there, the adoption of the final regulations to replace the temporary regulations would have resulted in a workable solution for both the IRS and tax practitioners-these rules concerning BDGs have already been internalized by the tax community and are a part of routine transaction planning. However, the inclusion of the Factors Test in the final regulations is a horse of a completely different color.

The discussion of the Factors Test is further below.

Reg. § 1.752-2(b)(3), "Obligations recognized," provides:

(i) *In general*. The determination of the extent to which a partner or related person has an obligation to make a payment under § 1.752-2(b)(1) is based on the facts and circumstances at the time of the determination. To the extent that the obligation of a partner or related person to make a payment with respect to a partnership liability is not recognized under this paragraph (b)(3), § 1.752-2(b) is applied as if the obligation did not exist. All statutory and contractual obligations relating to the partnership liability are taken into account for purposes of applying this section, including—

(A) Contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors, to other partners, or to the partnership;

(B) Obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership as described in § 1.704-1(b)(2)(ii)(b)(3) (taking into account § 1.704-1(b)(2)(ii)(c)); and

(C) Payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state or local law, including the governing state or local law partnership statute.

(ii) *Special rules for bottom dollar payment obligations*.

(A) *In general*. For purposes of § 1.752-2, a bottom dollar payment obligation (as defined in paragraph (b)(3)(ii)(C) of this section) is not recognized under this paragraph (b)(3).

(B) *Exception*. If a partner or related person has a payment obligation that would be recognized under this paragraph (b)(3) (initial payment obligation) but for the effect of an indemnity, a reimbursement agreement, or a similar arrangement, such bottom dollar payment obligation is recognized under this paragraph (b)(3) if, taking into account the indemnity, reimbursement agreement, or similar arrangement, the partner or related person is liable for at least 90 percent of the partner's or related person's initial payment obligation.

(C) *Definition of bottom dollar payment obligation*.

(1) *In general*. Except as provided in paragraph (b)(3)(ii)(C)(2) of this section, a bottom dollar payment obligation is a payment obligation that is the same as or similar to a payment obligation or arrangement described in this paragraph (b)(3)(ii)(C)(1).

(i) With respect to a guarantee or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.

(ii) With respect to an indemnity or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation, if, and to the extent that, any amount of the indemnitee's or benefited party's payment obligation that is recognized under this paragraph (b)(3) is satisfied.

(iii) With respect to an obligation to make a capital contribution or to restore a deficit capital account upon liquidation of the partnership as described in § 1.704-1(b)(2)(ii)(b)(3) (taking into account § 1.704-1(b)(2)(ii)(c)), any payment obligation other than one in which the partner is or would be required to make the full amount of the partner's capital contribution or to restore the full amount of the partner's deficit capital account.

(iv) An arrangement with respect to a partnership liability that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements, and with a principal purpose of avoiding having at least one of such liabilities or payment obligations with respect to such liabilities being treated as a bottom dollar payment obligation as described in paragraph (b)(3)(ii)(C)(1)(i), (ii), or (iii) of this section.

(2) *Exceptions*. A payment obligation is not a bottom dollar payment obligation merely because a maximum amount is placed on the partner's or related person's payment obligation, a partner's or related person's payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates, or there is a right of proportionate

contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.

(3) *Benefited party defined*. For purposes of § 1.752-2, a benefited party is the person to whom a partner or related person has the payment obligation.

(D) *Disclosure of bottom dollar payment obligations*. A partnership must disclose to the Internal Revenue Service a bottom dollar payment obligation (including a bottom dollar payment obligation that is recognized under paragraph (b)(3)(ii)(B) of this section) with respect to a partnership liability on a completed Form 8275, Disclosure Statement, or successor form, attached to the return of the partnership for the taxable year in which the bottom dollar payment obligation is undertaken or modified, that includes all of the following information:

(1) A caption identifying the statement as a disclosure of a bottom dollar payment obligation under section 752.

(2) An identification of the payment obligation with respect to which disclosure is made (including whether the obligation is a guarantee, a reimbursement, an indemnity, or an obligation to restore a deficit balance in a partner's capital account).

(3) The amount of the payment obligation.

(4) The parties to the payment obligation.

(5) A statement of whether the payment obligation is treated as recognized for purposes of this paragraph (b)(3).

(6) If the payment obligation is recognized under paragraph (b)(3)(ii)(B) of this section, the facts and circumstances that clearly establish that a partner or related person is liable for up to 90 percent of the partner's or related person's initial payment obligation and, but for an indemnity, a reimbursement agreement, or a similar arrangement, the partner's or related person's initial payment obligation would have been recognized under this paragraph (b)(3).

(iii) *Special rule for indemnities and reimbursement agreements*. An indemnity, a reimbursement agreement, or a similar arrangement will be recognized under this paragraph (b)(3) only if, before taking into account the indemnity, reimbursement agreement, or similar arrangement, the indemnitee's or other benefited party's payment obligation is recognized under this paragraph (b)(3), or would be recognized under this paragraph (b)(3) if such person were a partner or related person.

A payment obligation is ignored if "subject to contingencies that make it unlikely that the obligation will ever be discharged."[408] Also, if a payment obligation "would arise at a future time

[408] Reg. § 1.752-2(b)(4).

after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs."[409]

A partner's or related person's payment obligation with respect to a partnership liability is reduced to the extent that the partner or related person is entitled to reimbursement from another partner or a person who is a related person to another partner.[410] For purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments (a payment obligor) actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate (i)a plan to circumvent or avoid the obligation under Reg. § 1.752-2(j), or (ii) that there is not a commercially reasonable expectation that the payment obligor will have the ability to make the required payments under the terms of the obligation if the obligation becomes due and payable as described in Reg. § 1.752-2(k).[411]

If and to the extent that a partner or a related person makes (or acquires an interest in) a nonrecourse loan to the partnership and the economic risk of loss for a liability is not borne by another partner, that partner bears the economic risk of loss for that liability,[412] unless the partnership interest involved is no more than 10% and the loan is qualified nonrecourse financing.[413] However, wrapped debt nonrecourse debt is allocated to the partner involved only to the extent that the partner added to the amount advanced by the other lender.[414] On the other hand, substantial partners who guarantee the interest on a nonrecourse debt may be treated as having economic risk of loss of part of the loan.[415]

Reg. § 1.752-2(f)(10), Example (10), "Guarantee of first and last dollars," provides:

(i) A, B, and C are equal members of a limited liability company, ABC, that is treated as a partnership for federal tax purposes. ABC borrows $1,000 from Bank. A guarantees payment of up to $300 of the ABC liability if any amount of the full $1,000 liability is not recovered by Bank. B guarantees payment of up to $200, but only if the Bank otherwise recovers less than $200. Both A and B waive their rights of contribution against each other.

(ii) Because A is obligated to pay up to $300 if, and to the extent that, any amount of the $1,000 partnership liability is not recovered by Bank, A's guarantee is not a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section. Therefore, A's payment obligation is recognized under paragraph (b)(3) of this section. The amount of A's economic risk of loss under § 1.752- 2(b)(1) is $300.

(iii) Because B is obligated to pay up to $200 only if and to the extent that the Bank otherwise recovers less than $200 of the $1,000 partnership liability, B's guarantee is a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section and,

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409 Reg. § 1.752-2(b)(4).
410 Reg. § 1.752-2(b)(5).
411 Reg. § 1.752-2(b)(6). Reg. § 1.752-2(k) is described further below in this part II.C.3.c.ii.
412 Reg. § 1.752-2(c)(1).
413 Reg. § 1.752-2(d)(1). Reg. § 1.752-2(d)(2) provides that guarantees of such loans related to such small ownership do not cause the partner to have economic risk of loss. The reference to qualified nonrecourse financing for the loan or guarantee refers to Code § 465(b)(6) but applies it without regard to the type of activity financed.
414 Reg. § 1.752-2(c)(2).
415 Reg. § 1.752-2(e).

therefore, is not recognized under paragraph (b)(3)(ii)(A) of this section. Accordingly, B bears no economic risk of loss under § 1.752-2(b)(1) for ABC's liability.

(iv) In sum, $300 of ABC's liability is allocated to A under § 1.752-2(a), and the remaining $700 liability is allocated to A, B, and C under § 1.752-3.

Reg. § 1.752-2(f)(11), Example (11), "Indemnification of guarantees," provides:

(i) The facts are the same as in paragraph (f)(10) of this section (Example 10), except that, in addition, C agrees to indemnify A up to $100 that A pays with respect to its guarantee and agrees to indemnify B fully with respect to its guarantee.

(ii) The determination of whether C's indemnity is recognized under paragraph (b)(3) of this section is made without regard to whether C's indemnity itself causes A's guarantee not to be recognized. Because A's obligation would be recognized but for the effect of C's indemnity and C is obligated to pay A up to the full amount of C's indemnity if A pays any amount on its guarantee of ABC's liability, C's indemnity of A's guarantee is not a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section and, therefore, is recognized under paragraph (b)(3) of this section. The amount of C's economic risk of loss under § 1.752-2(b)(1) for its indemnity of A's guarantee is $100.

(iii) Because C's indemnity is recognized under paragraph (b)(3) of this section, A is treated as liable for $200 only to the extent any amount beyond $100 of the partnership liability is not satisfied. Thus, A is not liable if, and to the extent, any amount of the partnership liability is not otherwise satisfied, and the exception in paragraph (b)(3)(ii)(B) of this section does not apply. As a result, A's guarantee is a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section and is not recognized under paragraph (b)(3)(ii)(A) of this section. Therefore, A bears no economic risk of loss under § 1.752-2(b)(1) for ABC's liability.

(iv) Because B's obligation is not recognized under paragraph (b)(3)(ii) of this section independent of C's indemnity of B's guarantee, C's indemnity is not recognized under paragraph (b)(3)(iii) of this section. Therefore, C bears no economic risk of loss under § 1.752-2(b)(1) for its indemnity of B's guarantee.

(v) In sum, $100 of ABC's liability is allocated to C under § 1.752-2(a) and the remaining $900 liability is allocated to A, B, and C under § 1.752-3.

Present value principles may reduce the amount of a payment obligation allocated to a partner if it is not required to be satisfied before the later of a reasonable time after the liability becomes due and payable, the end of the year in which the partner's interest is liquidated, or 90 days after the liquidation.[416]

Pledging property to secure a loan or contributing property to a partnership to secure a loan may cause part or all of the loan to be allocated to the partner who does this.[417]

[416] Reg. § 1.752-2(g).
[417] Reg. § 1.752-2(h).

Special rules apply to tiered partnerships.[418]

Within Reg. § 1.752-2(j), "Anti-abuse rules," Reg. § 1.752-2(j)(1), "In general," provides:

> An obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person for purposes of this section if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Circumstances with respect to which a payment obligation may be disregarded include, but are not limited to, the situations described in paragraphs (j)(2) and (j)(3) of this section.

Reg. § 1.752-2(j)(2), "Arrangements tantamount to a guarantee," provides:

(i) *In general*. Irrespective of the form of a contractual obligation, a partner is considered to bear the economic risk of loss with respect to a partnership liability, or a portion thereof, to the extent that—

(A) The partner or related person undertakes one or more contractual obligations so that the partnership may obtain or retain a loan;

(B) The contractual obligations of the partner or related person significantly reduce the risk to the lender that the partnership will not satisfy its obligations under the loan, or a portion thereof; and

(C) With respect to the contractual obligations described in paragraphs (j)(2)(i)(A) and (B) of this section—

(1) One of the principal purposes of using the contractual obligations is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests; or

(2) Another partner, or a person related to another partner, enters into a payment obligation and a principal purpose of the arrangement is to cause the payment obligation described in paragraphs (j)(2)(i)(A) and (B) of this section to be disregarded under paragraph (b)(3) of this section.

(ii) *Economic risk of loss*. For purposes of this paragraph (j)(2), partners are considered to bear the economic risk of loss for a liability in accordance with their relative economic burdens for the liability pursuant to the contractual obligations. For example, a lease between a partner and a partnership that is not on commercially reasonable terms may be tantamount to a guarantee by the partner of the partnership liability.

[418] Reg. § 1.752-2(i).

Regarding the above anti-abuse rule, Lipton & Schneider, “Replacing Certainty with Uncertainty-IRS Fumbles with the Final Regulations on Partnership Debt Guarantees,” *Journal of Taxation* (1/2020) comment:

> The expansion of the BDG rule to cover DROs raised additional corollary problems. The regulations under Section 752 concerning the allocation of liabilities include a specific anti-abuse rule, Reg. 1.752-2(j)(2), under which the Commissioner may treat a partner as bearing the EROL with respect to a partnership liability, or portion thereof, to the extent that: (1) the partner or related person undertakes one or more contractual obligations so that the partnership may obtain or retain a loan; (2) the contractual obligations of the partner or related person significantly reduce the risk to the lender that the partnership will not satisfy its obligations under the loan, or portion thereof; and (3) with respect to the contractual obligations described in (1) or (2), (i) one of the principal purposes of using the contractual obligation is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests, or (ii) another partner, or person related to another partner, enters into a payment obligation and a principal purpose of the arrangement is to cause the payment obligation to be disregarded. (See Reg. 1.752-2T(j)(2).)
>
> However, this rule does not apply to a DRO. To address this problem, 752 Proposed Regulations added a list of factors to Reg. 1.704-1(b)(2)(ii)(c) that are similar to the factors in the anti-abuse rule under Reg 1.752-2(j) (discussed below), but specific to DROs, to indicate when a plan to circumvent or avoid an obligation exists. If a plan to circumvent or avoid an obligation exists, the obligation is disregarded for purposes of Sections 704 and 752 . Under proposed Reg. 1.704-1(b)(2)(ii)(c) , the following factors (the DRO Factors Test) indicate a plan to circumvent or avoid an obligation: (1) the partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation; (2) the partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner’s financial condition to the partnership; (3) the obligation ends or could, by its terms, be terminated before the liquidation of the partner’s interest in the partnership or when the partner’s capital account as provided in Reg. 1.704-1(b)(2)(iv) is negative; and (4) the terms of the obligation are not provided to all the partners in the partnership in a timely manner.
>
> The inclusion of these factors in determining whether a DRO is respected leads to the major problem in the final regulations-the Factors Test. The Factors Test is applied to determine whether or not an obligation is respected. In other words, if a partner guarantees a loan and the guarantee is not a BDG, so it is otherwise respected as creating a recourse liability, the 2014 Proposed Regulations included a list of factors to determine whether a partner’s or related person’s obligation to make a payment with respect to a partnership liability (excluding those imposed by state law) would be recognized for purposes of Section 752 .
>
> In response to comments, the 752 Proposed Regulations moved the list of factors to an anti-abuse rule in Reg. 1.752-2(j)(3) . Under the anti-abuse rule in the 752 Proposed Regulations, the following non-exclusive factors are weighed to determine whether a payment obligation should be respected: (1) the partner or related person is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, (2) the partner or related person is not required to provide commercially

reasonable documentation regarding the partner's or related person's financial condition to the benefited party, (3) the term of the payment obligation ends prior to the term of the partnership liability, or the partner or related person has a right to terminate its payment obligation, (4) there exists a plan or arrangement in which the primary obligor or any other obligor with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonable foreseeable needs of such obligor, (5) the payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection, (6) in the case of a guarantee or similar arrangement, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee, and (7) the creditor or other party benefiting from the obligation did not receive executed documentation with respect to the payment obligation from the partner or related person before, or within a commercially reasonable period of time after, the creation of the obligation. The weight to be given to any particular factor depends on the particular case and the presence or absence of any particular factor, in itself, is not necessarily indicative of whether or not a payment obligation is recognized under Reg. 1.752-2(b) .

Commenters to the 752 Proposed Regulations criticized the proposed Factors Test on the grounds that it was unlikely that any debt would satisfy all seven factors (including particularly the somewhat ridiculous sixth factor that the terms of the loan changed because of the guarantee). The IRS rejected all of these comments, stating that because the Factors Test was simply part of an anti-abuse rule in determining whether a plan to circumvent or avoid an obligation exists, they should not be of concern in most situations. The final regulations also clarified that (1) with respect to the fourth factor, amounts are not held in excess of the reasonably foreseeable needs of an obligor if the partnership purchases standard commercial insurance, such as casualty insurance and (2) with respect to the second factor, certain types of commercially reasonable documentation (balance sheets and financial statements) are examples of documents a lender would typically require.

Reg. § 1.752-2(j)(3), "Plan to circumvent or avoid an obligation," provides:

(i) G*eneral Rule*. An obligation of a partner or related person to make a payment is not recognized under paragraph (b) of this section if the facts and circumstances evidence a plan to circumvent or avoid the obligation.

(ii) *Factors indicating plan to circumvent or avoid an obligation*. In the case of a payment obligation, other than an obligation to restore a deficit capital account upon liquidation of a partnership, paragraphs (j)(3)(ii)(A) through (G) of this section provide a non-exclusive list of factors that may indicate a plan to circumvent or avoid the payment obligation. The presence or absence of a factor is based on all of the facts and circumstances at the time the partner or related person makes the payment obligation or if the obligation is modified, at the time of the modification. For purposes of making determinations under this paragraph (j)(3), the weight to be given to any particular factor depends on the particular case and the presence or absence of a factor is not necessarily indicative of whether a payment obligation is or is not recognized under paragraph (b) of this section.

(A) The partner or related person is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, including, for example, restrictions on transfers for inadequate consideration or distributions by the partner or related person to equity owners in the partner or related person.

(B) The partner or related person is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party, including, for example, balance sheets and financial statements.

(C) The term of the payment obligation ends prior to the term of the partnership liability, or the partner or related person has a right to terminate its payment obligation, if the purpose of limiting the duration of the payment obligation is to terminate such payment obligation prior to the occurrence of an event or events that increase the risk of economic loss to the guarantor or benefited party (for example, termination prior to the due date of a balloon payment or a right to terminate that can be exercised because the value of loan collateral decreases). This factor typically will not be present if the termination of the obligation occurs by reason of an event or events that decrease the risk of economic loss to the guarantor or benefited party (for example, the payment obligation terminates upon the completion of a building construction project, upon the leasing of a building, or when certain income and asset coverage ratios are satisfied for a specified number of quarters).

(D) There exists a plan or arrangement in which the primary obligor or any other obligor (or a person related to the obligor) with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonably foreseeable needs of such obligor (but not taking into account standard commercial insurance, for example, casualty insurance).

(E) The payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection.

(F) In the case of a guarantee or similar arrangement, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee.

(G) The creditor or other party benefiting from the obligation did not receive executed documents with respect to the payment obligation from the partner or related person before, or within a commercially reasonable period of time after, the creation of the obligation.

Regarding the above test, Lipton & Schneider, "Replacing Certainty with Uncertainty - IRS Fumbles with the Final Regulations on Partnership Debt Guarantees," *Journal of Taxation* (1/2020) comment:

> The Factors Test is the worst type of tax guidance because it adds both complexity and uncertainty. Every partnership is required to annually provide every partner with a

statement concerning that partner's share of the liabilities of the partnership, including a statement about the partner's share of the recourse and nonrecourse liabilities of the partnership. To make that determination, the partnership needs to know whether a liability is a recourse liability or a nonrecourse liability, since the rules for allocating such liabilities are different. Prior to the adoption of the Factors Test, this was always a straightforward determination because the operating rules were completely clear. The temporary regulations concerning BDGs did nothing to alter this certainty, because the BDG rules provided clear guidance when a liability must be treated as nonrecourse (instead of recourse) because a BDG would be disregarded.

The Factors Test completely alters this reality. The Factors Test sets forth seven individual points, but does not make clear whether any of these factors are more important than the others. Many of the factors have major problems.

To illustrate the problems, let's use a simple example (taken from a current transaction in which your authors are involved). A financial investor is contributing 80% of the equity to a new construction project, and the individual developer is contributing 20% of the equity; the development will be undertaken by an LLC formed for that purpose. The parties have engaged in multiple similar transactions over the past few decades. There will be a loan from either a third-party lender or, alternatively, the financial investor will make a loan to the LLC; if the lender is a third party, it might require a guarantee from the financial investor. In any event, the parties want to have the developer, which has put up 20% of the equity, also share in 20% of all deductions and credits from the project, so the developer will guarantee 20% of the loan, without regard to who the lender is. The guarantee is in the form of a VSG, so the developer is responsible for 20% of all losses to the lender; a copy of the guarantee is always provided to the lender. However, the developer does not provide an annual financial statement to the financial investor (or the lender) because they all know him and do not require it.

The first negative factor is the partner or related person is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, including restrictions on transfers for inadequate consideration or distributions by the partner to equity owners in the partner. As noted above, the developer in this example is an individual who did not provide a balance sheet to the lender. But what if an individual guarantor provides the lender with a copy of the guarantee and a balance sheet, but the guarantor does not promise he won't take vacations, does not promise not to send his kids to college, and also does not promise that he won't buy any jewelry for his wife? Does this mean that the guarantor has not agreed to "commercially reasonable contractual restrictions to protect the likelihood of payment" of the liability (whatever those are)? The regulations imply that any of these actions might be suspect, because they are all transfers for inadequate consideration by the partner who made the guaranty.

The second negative factor is if the partner or related person is not required to provide commercially reasonable documentation regarding the partner's or related person's financial condition to the benefitted party, including balance sheets and financial statements. Even though the developer/guarantor furnishes a copy of that guarantee to the lender, because the lender does not require a financial statement, the guarantee could be disregarded. This seems an odd result given that the lender knows it is better off with the guarantee than without it (without regard to the net worth of the guarantor).

The third factor applies if the term of the payment obligation ends prior to the term of the partnership liability, or the partner or related person has a right to terminate its payment obligation if the purpose of such limitation is to terminate such payment obligation prior to the occurrence of an event that increases the risk of economic loss to the guarantor or the benefitted party, although this factor is not present if the termination occurs because of an event that decreases the risk of loss, such as completion of construction or satisfaction of a coverage ratio. This factor is not as problematic as the others, because the termination of a guarantee makes the guarantee less worthwhile unless it is terminated for one of the specified events. In other words, the third factor is consistent with commercial reality.

The fourth factor applies if there exists a plan or arrangement in which the primary obligor or any other related person directly or indirectly holds money or other liquid assets in an amount that exceeds reasonably foreseeable needs of such obligor. Implicit in this factor is that if a lender makes a loan to a financially healthy obligor which has significant cash flow, any guarantee of that loan could be disregarded. Does this mean that the tax return preparer will need to examine the cash flow of every partnership which has a guaranteed loan in order to determine whether or not to respect a guarantee? And what if the guarantee is made in year one, when the venture has limited cash flow, but the venture is a success and by year two the partnership is rolling in cash-is the guarantee then disregarded because it is superfluous?

This factor is problematic in our example because the parties fully expect that there will be significant profits from this development-after all, they have done deals together for years, and they keep doing them together because they are profitable. There is a fully recourse VSG, but it might be disregarded because there was no financial need for the guarantee.

The fifth factor applies if the payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability. This factor does not recognize the commercial reality that most guarantees address ultimate loss to the lender. A lender usually cannot pursue the guarantor of a loan unless and until the primary obligor has failed to pay and all remedies against the primary obligor have been exhausted, but the Factors Test states that a payment obligation must allow the creditor to promptly pursue payment from the guarantor upon a default-and without requiring the creditor to first seek payment from the primary obligor. No well-represented guarantor would ever agree to this request; your authors have been involved in hundreds of transactions in which third-party lenders have required guarantees, and the guarantees have always been of ultimate collection and not initial payment. This is a commercially unreasonable standard.

The most absurd provision in the Factors Test is the sixth factor, which is that in the case of a guarantee, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee. This determination can NEVER be made. Your authors have never, in decades of experience working with lenders, seen a loan term sheet where the interest rate is x% with a guarantee and y% without it. Instead, lenders may require a guarantee in order to make a loan, or make the loan without a guarantee, but in each case, the loan terms are what they are. There will never be a way for a partnership to establish in hindsight that the terms of the loan would have been different if the guarantee had not been made. So, the final regulations include a factor that can NEVER be satisfied.

Turning to the example, as noted previously, the parties have worked together for years. The lender might be an unrelated bank, or it could be the financial investor itself, but in no circumstances would there be a term sheet setting forth the terms of the financing with or without the guarantee from the developer. Thus, there is no possibility that the sixth factor will ever be satisfied even in a completely arms' length commercial setting.

The seventh factor provides the creditor or other party benefitting from the obligation did not receive executed documents with respect to the payment obligation from the partner or a related person before, or within a commercially reasonable time after, the creation of the obligation. This may be the most reasonable of the factors-it is appropriate for the guarantor to notify the lender of the guarantee. As noted above, in the hypothetical transaction, this requirement will be satisfied.

So two of the factors are reasonable-the others are all commercially unrealistic. A "standard" transaction such as described above will likely fail to meet four or five of the factors, which means there will be significant doubt as to the manner in which the guaranteed liability should be allocated.

The application of the Factors Test to loan guarantees is contrary to commercial reality. This problem is magnified by the IRS's inclusion of a similar test (the DRO Factors Test) in the final regulations to determine whether a DRO is respected. As noted above, the IRS could determine that there was a plan to circumvent an obligation if (1) the partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation; (2) the partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership; (3) the obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account as provided in Reg. 1.704-1(b)(2)(iv) is negative; and (4) the terms of the obligation are not provided to all the partners in the partnership in a timely manner.

Notwithstanding that comments urged the IRS not to go down this path, the inclusion of the DRO Factors Test in the final regulations will again lead to uncertainty. Your authors have written or reviewed partnership or LLC agreements with DROs (they are not common, but they do happen), and not a single one would satisfy all four of these tests. Indeed, most partners refuse to sign an agreement that includes a DRO because of the economic risk which a DRO creates, yet the regulations do not recognize this reality. If a partner (including particularly an individual) is willing to sign a DRO that is included in the partnership agreement, that should be the end of the inquiry-the DRO should be respected because of the risk entailed. If the partner is not an individual, then the "net value" rule still would serve to address the IRS's concern that the DRO may be illusory. In other words, the DRO Factors Test creates uncertainty for a partnership which needs to determine how to allocate losses, and the partnership needs to take any DRO into account in making this determination.

The inclusion of the Factors Test and the DRO Factors Test in the final regulations is an example of poorly thought out regulatory rulemaking. Because these rules do not appear to take fully into account all of the comments which were made, and because they are arguably inconsistent with Congress' purpose when it provided in Section 752 that a liability must be allocated to the partner who bears the risk of loss, the validity of this aspect of the final regulations could be questioned. However, any argument that a

> regulation is invalid will usually be an uphill battle, and it would be better for the tax system (and the IRS's reputation) if it were to reconsider these rules. It would have been appropriate for the IRS to require that a loan guarantee (or a DRO) had to be provided to a lender (or the other partners) and could not be terminated at will-these are objective facts which are consistent with commercial reality. The remaining factors should be moved to the dustbin in which they belong.

Reg. § 1.752-2(j)(3) provides the following example illustrating the principles of Reg. § 1.752-2(j):

> (i) In 2020, A, B, and C form a domestic limited liability company (LLC) that is classified as a partnership for federal tax purposes. Also in 2020, LLC receives a loan from a bank. A, B, and C do not bear the economic risk of loss with respect to that partnership liability, and, as a result, the liability is treated as nonrecourse under § 1.752-1(a)(2) in 2020. In 2022, A guarantees the entire amount of the liability. The bank did not request the guarantee and the terms of the loan did not change as a result of the guarantee. A did not provide any executed documents with respect to A's guarantee to the bank. The bank also did not require any restrictions on asset transfers by A and no such restrictions exist.
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> (ii) Under paragraph (j)(3) of this section, A's 2022 guarantee (payment obligation) is not recognized under paragraph (b)(3) of this section if the facts and circumstances evidence a plan to circumvent or avoid the payment obligation. In this case, the following factors indicate a plan to circumvent or avoid A's payment obligation: the partner is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, such as restrictions on transfers for inadequate consideration or equity distributions; the partner is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party; in the case of a guarantee or similar arrangement, the terms of the liability are the same as they would have been without the guarantee; and the creditor did not receive executed documents with respect to the payment obligation from the partner or related person at the time the obligation was created. Absent the existence of other facts or circumstances that would weigh in favor of respecting A's guarantee, evidence of a plan to circumvent or avoid the obligation exists and, pursuant to paragraph (j)(3)(i) of this section, A's guarantee is not recognized under paragraph (b) of this section. As a result, LLC's liability continues to be treated as nonrecourse.

Regarding the above example, Lipton & Schneider, "Replacing Certainty with Uncertainty-IRS Fumbles with the Final Regulations on Partnership Debt Guarantees," *Journal of Taxation* (1/2020) commented:

> This example is obviously somewhat unrealistic because A is attempting to rely upon a guarantee that was not provided to the lending institution. However, the example does not treat that factor as dispositive, raising the question whether the guarantee would have been respected if it had been provided to the bank but no documentation of the obligor's net worth was provided. The example also does not address whether A, an individual, had somehow limited the scope of his guarantee or whether all of A's assets, including his home and personal belongings, were available to the bank as a potential creditor. Thus, the example failed to address many of the important facts and focused

mostly on factors which are not meaningful, such as whether A was subject to commercially reasonable contractual restrictions on transfers of assets (ignoring that such transfers could result in an individual bankruptcy).

Tribune Media Company v. Commissioner, T.C. Memo. 2021-122, reasoned and held:

> Even if the business purpose requirement did not apply to the Cubs transaction as a whole, the Commissioner's attempt to discredit the senior debt guaranty is unpersuasive. The purpose of a guaranty is to provide an ultimate payor on a loan if the original obligor is unable to pay. A valid guaranty ensures that the guarantor will shoulder the ultimate economic burden of a debt. Because a guaranty certifies that a debt will be paid, it may convey additional benefits to the parties, such as a favorable interest rate, an improved credit standing, and a payment from the creditor to the guarantor. The Commissioner cites these benefits as proof of a guaranty's "business purpose," and insists that because the senior debt guaranty lacked these enhancements, it is not a valid guaranty. But a guaranty does not require a separate purpose other than pledging ultimate payment for a loan; additional perks may be desired but are not the purpose of the guaranty. Conditioning the validity of a guaranty on its provision of additional extrinsic benefits overlooks its essential function. The Commissioner's position is an incorrect analysis of the circumstances under which we will honor a guaranty. We honor a guaranty if the guarantor has ultimate economic responsibility for the loan. As we discussed at length, Tribune bore ultimate responsibility for the senior debt.
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> The Commissioner's claim that the senior debt guaranty had no real-world consequences is similarly false. He argues that the senior debt guaranty lacked substance because Tribune did not report it on its financial statements per GAAP guidelines.[178] As Mr. Erickson, an expert for petitioners, credibly testified, Tribune properly followed these guidelines when it reported the guaranties had no contingent or noncontingent value but disclosed its economic exposure from the guaranties. Dr. Skinner, expert for the Commissioner, affirmed that Tribune accurately represented the guaranties on its financial statements. Mr. Erickson also credibly testified that the "GAAP value does not equate to the economic value" because the GAAP calculation measures the likelihood of payment, not the economic value of a guaranty. Dr. Skinner seemed to agree when he calculated the economic value of the guaranties at $6,120,000 to $18,860,000. The Commissioner's claim that Tribune's GAAP reporting reflects the guaranties' true lack of substance is thus inaccurate. The reporting indicates Tribune's assessment that the likelihood it would be called to service the guaranties was remote. As discussed above, a remote possibility that a guaranty will be called is still a possibility and does not invalidate a guaranty. Furthermore, the guaranties had economic value, and the senior debt guaranty is not a sham or an illusory agreement created solely for tax purposes.
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> [178] The GAAP guidance relevant to Tribune's guaranties was the Financial 178 Accounting Standards Board's Interpretation No. 45 (FIN No. 45), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including indirect Guarantees of Indebtedness of Others." FIN No. 45 specified that entities must recognize the fair value of guarantees as liabilities on their balance sheet for contingent and noncontingent components of the guarantees. If a guarantee does not have value, GAAP does not require the entity to report its value. But even if an entity's guarantees lack value, it must still disclose its guarantees on financial statements.

The guaranties affected Tribune's credit rating. The Commissioner claims that the credit agencies gave the guaranties "little or no credence," but that is not true. In its credit rating analyses of Tribune, S&P accounted for the guaranties when calculating Tribune's leverage and risk. In its 2016 credit report, it attributed $100 million of CBH's debt to Tribune as a result of the guaranties. According to Ms. Shoesmith, who worked on Tribune's credit report at S&P, this additional $100 million of attributable debt affected Tribune's credit rating by increasing its debt to earnings ratio by 0.4. Not only did S&P give more than "a little" credence to the guaranties, but the guaranties had a real-world effect on Tribune's credit rating. The senior debt guaranty had genuine consequences outside of its tax benefits.

The Commissioner makes two other arguments as to why the senior debt guaranty fails the general anti-abuse rule. First is the Commissioner's claim that the senior debt guaranty was a phony guaranty that was "trumped by the cash-backed competing guarantee of the Ricketts family," the operating support agreement. But the operating support agreement did not guarantee the senior debt and was established to fund necessary Cubs operating costs. In fact, the operating support agreement expressly prohibited CBH from using the operating support agreement funds to satisfy debts. This argument is not persuasive.

Second, the Commissioner states that the senior debt guaranty's status as a collection guaranty makes the likelihood of Tribune's ultimate payment too attenuated. He cites the protections embedded in the senior debt guaranty requiring the lenders to exhaust other legal remedies before seeking payment from Tribune and the protections in the debt structure that minimized the risk of the senior debt guaranty's being called. Collection guaranties are valid guaranties. The regulations in fact provide an example where the partner who has a guaranty of collection is allocated the debt as a recourse liability.[179] We will not invalidate a collection guaranty simply because the lenders must seek payment from other potential sources before turning to the guarantor. Similarly, we will not invalidate a guaranty because the borrowing entity structured its debt to mitigate the risk of default. An entity may (and is perhaps encouraged to) create a debt structure that maximizes its ability to satisfy the terms of its debt agreements. Tribune's foresight on this issue does not invalidate the senior debt guaranty.

[179] Sec. 1.752-2(j)(4), Income Tax Regs.

Reg. § 1.752-2(j)(4), "Example," provides:

(i) In 2020, A, B, and C form a domestic limited liability company (LLC) that is classified as a partnership for federal tax purposes. Also in 2020, LLC receives a loan from a bank. A, B, and C do not bear the economic risk of loss with respect to that partnership liability, and, as a result, the liability is treated as nonrecourse under § 1.752-1(a)(2) in 2020. In 2022, A guarantees the entire amount of the liability. The bank did not request the guarantee and the terms of the loan did not change as a result of the guarantee. A did not provide any executed documents with respect to A's guarantee to the bank. The bank also did not require any restrictions on asset transfers by A and no such restrictions exist.

(ii) Under paragraph (j)(3) of this section, A's 2022 guarantee (payment obligation) is not recognized under paragraph (b)(3) of this section if the facts and circumstances evidence a plan to circumvent or avoid the payment obligation. In this case, the following factors indicate a plan to circumvent or avoid A's payment obligation: the partner is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, such as restrictions on transfers for inadequate consideration or equity distributions; the partner is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party; in the case of a guarantee or similar arrangement, the terms of the liability are the same as they would have been without the guarantee; and the creditor did not receive executed documents with respect to the payment obligation from the partner or related person at the time the obligation was created. Absent the existence of other facts or circumstances that would weigh in favor of respecting A's guarantee, evidence of a plan to circumvent or avoid the obligation exists and, pursuant to paragraph (j)(3)(i) of this section, A's guarantee is not recognized under paragraph (b) of this section. As a result, LLC's liability continues to be treated as nonrecourse.

Lipton, "*Tribune Media*: A Split Decision for the Chicago Cubs' Leveraged Partnership Transaction," *Journal of Taxation* (2/2022), asserts:[419]

> The Tax Court stated that its decision in *Tribune Media* was "split" because the taxpayer won in part and the IRS won in part, but in fact this decision is a huge victory for taxpayers. The transaction that the taxpayer utilized in Tribune Media was carefully structured to conform to the terms of the disguised sale regulations that the IRS has promulgated, and the Tax Court did not allow the IRS to avoid the consequences of its own regulations. The court also refused to allow the IRS to utilize generalized anti-abuse rules and the judicial doctrines to recharacterize a transaction that adopted a structure that is expressly contemplated in the Code and regulations. And the court also refused to allow the IRS to disregard a collection guarantee that was issued by a taxpayer where the guarantor had sufficient assets to honor the guarantee if ever called upon to do so, even though the likelihood that such guarantee would be called was remote.
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> Moreover, the part of the decision that was a "loss" for the taxpayer focused on whether a subordinated loan made by an owner of an entity to that entity should be treated as debt or equity for tax purposes. This aspect of the decision followed well-trod ground and applied principles that have been outstanding for decades. Although one could quibble with how the various factors were applied by the Tax Court in this case, the determination that the Sub Debt had to be treated as equity rather than debt for tax purposes should not come as a complete surprise to tax practitioners.
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> However, tax planners should be very pleased that the Tax Court refused to accept the IRS' arguments which were aimed at recharacterizing a carefully-structured transaction that followed all of the rules and regulations to obtain a tax benefit. Was the transaction structured to obtain a tax-free distribution of cash to the Tribune – of course it was! Did the regulations allow for this treatment – of course they did! And was this transaction the result of careful tax planning that took into account the terms of the applicable regulations – obviously, it was. The court respected the transaction because its

[419] Additional articles on this case that Lipton wrote include; "What Was the IRS Thinking in Appealing Tribune Media?," 139 JTAX 33 (July 2023); "The Taxpayer and Amicus Appellate Briefs in Tribune Media Throw Tough Pitches at the IRS," 139 JTAX 43 (November 2023); and "More on *Tribune Media*," *Journal of Taxation* (Jan. 2024).

substance was the same as its form, and that form was specifically addressed in the regulations. The court did not allow the IRS to use broad anti-abuse rules and the judicial doctrines in a situation in which the tax results of a transaction were expressly set forth in the applicable law.

So the Tax Court's decision in *Tribune Media* will go down in the books as a win for tax planners who are willing to be meticulous in following the disguised sale regulations. These regulations could apply almost any time that property is contributed to a partnership, so tax practitioners need to be very familiar with them in order to take advantage of the rules (as happened in *Tribune Media*) and to avoid running afoul of these rules. *Tribune Media* is a case that shows that careful tax planning will be rewarded.

Within Reg. § 1.752-2(k), "No reasonable expectation of payment," Reg. § 1.752-2(k)(1), "In general," provides:

> An obligation of any partner or related person to make a payment is not recognized under paragraph (b) of this section if the facts and circumstances indicate that at the time the partnership must determine a partner's share of partnership liabilities under §§ 1.705-1(a) and 1.752-4(d) there is not a commercially reasonable expectation that the payment obligor will have the ability to make the required payments under the terms of the obligation if the obligation becomes due and payable. Facts and circumstances to consider in determining a commercially reasonable expectation of payment include factors a third party creditor would take into account when determining whether to grant a loan. For purposes of this section, a payment obligor includes an entity disregarded as an entity separate from its owner under section 856(i), section 1361(b)(3), or §§ 301.7701-1 through 301.7701-3 of this chapter (a disregarded entity), and a trust to which subpart E of part I of subchapter J of chapter 1 of the Code applies.

Reg. § 1.752-2(k)(2)(i), Example (1), "Undercapitalization," provides:

> (A) In 2020, A forms a wholly owned domestic limited liability company, LLC, with a contribution of $100,000. A has no liability for LLC's debts, and LLC has no enforceable right to a contribution from A. Under § 301.7701-3(b)(1)(ii) of this chapter, LLC is treated for federal tax purposes as a disregarded entity. Also in 2020, LLC contributes $100,000 to LP, a limited partnership with a calendar year taxable year, in exchange for a general partnership interest in LP, and B and C each contributes $100,000 to LP in exchange for a limited partnership interest in LP. The partnership agreement provides that only LLC is required to restore any deficit in its capital account. On January 1, 2021, LP borrows $300,000 from a bank and uses $600,000 to purchase nondepreciable property. The $300,000 is secured by the property and is also a general obligation of LP. LP makes payments of only interest on its $300,000 debt during 2021. LP has a net taxable loss in 2021, and, under §§ 1.705-1(a) and 1.752-4(d), LP determines its partners' shares of the $300,000 debt at the end of its taxable year, December 31, 2021. As of that date, LLC holds no assets other than its interest in LP.
>
> (B) Because LLC is a disregarded entity, A is treated as the partner in LP for federal income tax purposes. Only LLC has an obligation to make a payment on account of the $300,000 debt if LP were to constructively liquidate as described in paragraph (b)(1) of this section. Therefore, paragraph (k) of this section is applied to

the LLC and not to A. LLC has no assets with which to pay if the payment obligation becomes due and payable. Because there is no commercially reasonable expectation that LLC will be able to satisfy its payment obligation, LLC's obligation to restore its deficit capital account is not recognized under paragraph (b) of this section. As a result, LP's $300,000 debt is characterized as nonrecourse under § 1.752-1(a)(2) and is allocated among A, B, and C under § 1.752-3.

Reg. § 1.752-2(k)(2)(ii), Example (2), "Disregarded entity with ability to pay," provides:

(A) The facts are the same as in paragraph (k)(2)(i) of this section (Example 1), except LLC also holds real property worth $475,000 subject to a $200,000 liability. Additionally, LLC reasonably projects to earn $20,000 of net rental income per year from such real property.

(B) Because LLC is a disregarded entity, A is treated as the partner in LP for federal income tax purposes. Only LLC has an obligation to make a payment on account of the $300,000 debt if LP were to constructively liquidate as described in paragraph (b)(1) of this section. Therefore, paragraph (k) of this section is applied to the LLC and not to A. Because there is a commercially reasonable expectation that LLC will be able to satisfy its payment obligation, LLC's obligation to restore its deficit capital account is recognized under paragraph (b) of this section. As a result, LP's $300,000 debt is characterized as recourse under § 1.752-1(a)(1) and is allocated to A under § 1.752-2.

Reg. § 1.752-2(*l*), "Applicability dates," provides:

(1) Paragraphs (a) and (h)(3) of this section apply to liabilities incurred or assumed by a partnership on or after October 11, 2006, other than liabilities incurred or assumed by a partnership pursuant to a written binding contract in effect prior to that date. The rules applicable to liabilities incurred or assumed (or pursuant to a written binding contract in effect) prior to October 11, 2006, are contained in § 1.752-2 in effect prior to October 11, 2006, (see 26 CFR part 1 revised as of April 1, 2006). Paragraphs (b)(6), (j)(3) and (4), and (k) of this section apply to liabilities incurred or assumed by a partnership and to payment obligations imposed or undertaken with respect to a partnership liability on or after October 9, 2019, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date. However, taxpayers may apply paragraphs (b)(6), (j)(3) and (4), and (k) of this section to all of their liabilities as of the beginning of the first taxable year of the partnership ending on or after October 5, 2016. The rules applicable to liabilities incurred or assumed (or pursuant to a written binding contract in effect) prior to October 9, 2019, are contained in § 1.752-2 in effect prior to October 9, 2019, (see 26 CFR part 1 revised as of April 1, 2019).

(2) Paragraphs (b)(3), (f)(10) and (11), and (j)(2) of this section apply to liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken with respect to a partnership liability on or after October 5, 2016, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date. Partnerships may apply paragraphs (b)(3), (f)(10) and (11), and (j)(2) of this section to all of their liabilities as of the beginning of the first taxable year of the

partnership ending on or after October 5, 2016. The rules applicable to liabilities incurred or assumed (or subject to a written binding contract in effect) prior to October 5, 2016, are contained in § 1.752-2 in effect prior to October 5, 2016, (see 26 CFR part 1 revised as of April 1, 2016).

(3) If a partner has a share of a recourse partnership liability under § 1.752-2(a) as a result of bearing the economic risk of loss under § 1.752-2(b) immediately prior to October 5, 2016 (Transition Partner), and such liability is modified or refinanced, the partnership (Transition Partnership) may choose not to apply paragraphs (b)(3), (f)(10) and (11), and (j)(2)(i)(C)(2) of this section to the extent the amount of the Transition Partner's share of liabilities under § 1.752-2(a) as a result of bearing the economic risk of loss under § 1.752-2(b) immediately prior to October 5, 2016, exceeds the amount of the Transition Partner's adjusted basis in its partnership interest as determined under § 1.705-1 at such time (Grandfathered Amount). See also § 1.704-2(g)(3). A liability is modified or refinanced for purposes of this paragraph (l) to the extent that the proceeds of a partnership liability (the refinancing debt) are allocable under the rules of § 1.163-8T to payments discharging all or part of any other liability (pre-modification liability) of that partnership or there is a significant modification of that liability as provided under § 1.1001-3. A Transition Partner that is a partnership, S corporation, or a business entity disregarded as an entity separate from its owner under section 856(i) or 1361(b)(3) or §§ 301.7701-1 through 301.7701-3 of this chapter ceases to qualify as a Transition Partner if the direct or indirect ownership of that Transition Partner changes by 50 percent or more. The Transition Partnership may continue to apply the rules under § 1.752-2 in effect prior to October 5, 2016, with respect to a Transition Partner for payment obligations described in § 1.752-2(b) to the extent of the Transition Partner's adjusted Grandfathered Amount for the seven-year period beginning October 5, 2016. The termination of a Transition Partnership under section 708(b)(1)(B) and applicable regulations prior to January 1, 2018,[420] does not affect the Grandfathered Amount of a Transition Partner that remains a partner in the new partnership (as described in § 1.708-1(b)(4)), and the new partnership is treated as a continuation of the Transition Partnership for purposes of this paragraph (*l*)(3). However, a Transition Partner's Grandfathered Amount is reduced (not below zero), but never increased by—

(i) Upon the sale of any property by the Transition Partnership, an amount equal to the excess of any gain allocated for federal income tax purposes to the Transition Partner by the Transition Partnership (including amounts allocated under section 704(c) and applicable regulations) over the product of the total amount realized by the Transition Partnership from the property sale multiplied by the Transition Partner's percentage interest in the partnership; and

(ii) An amount equal to any decrease in the Transition Partner's share of liabilities to which the rules of this paragraph (*l*)(3) apply, other than by operation of paragraph (*l*)(3)(i) of this section.

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[420] [My footnote:] See part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).

II.C.3.c.ii.(b). 1/18/2017-10/13/2019 Temporary Rules Allocating Economic Risk of Loss to Recourse Liabilities

T.D. 9877 (10/9/2019) did the following, the results of which I did not work into my materials below:

> In § 1.752-2T, paragraphs (a) and (b), (c)(1) and (2), (d) through (k), (*l*)(1) through (3), and (m)(1) are removed and reserved.

Reg. § 1.752-2T provided rules that applied until October 13, 2019.[421] All statutory and contractual obligations relating to the partnership liability were taken into account for purposes of applying this part II.C.3.c.ii, including:[422]

(A) Contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors, to other partners, or to the partnership;

(B) Obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership as described in § 1.704-1(b)(2)(ii)(b)(3) (taking into account § 1.704-1(b)(2)(ii)(c)); and

(C) Payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state or local law, including the governing state or local law partnership statute.

Reg. § 1.752-2T(b)(3)(ii) disregarded a "bottom dollar payment obligation" unless, taking into account an indemnity, reimbursement agreement, or similar arrangement, the partner or related person is liable for at least 90% of the partner's or related person's initial payment obligation.[423] Subject to an exception, a "bottom dollar payment obligation" was one of the following:[424]

(i) With respect to a guarantee or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.

(ii) With respect to an indemnity or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation, if, and to the extent that, any amount of the indemnitee's or benefited party's payment obligation that is recognized under this paragraph (b)(3) is satisfied.

(iii) An arrangement with respect to a partnership liability that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions

421 Reg. § 1.752-2T(m), added by T.D. 9788 (10/4/2016), as amended by T.D. 9790 (10/13/2016).
422 Reg. § 1.752-2T(b)(3)(i).
423 Reg. § 1.752-2T(b)(3)(ii)(A), (B).
424 Reg. § 1.752-2T(b)(3)(ii)(C)(1).

> or arrangements, and with a principal purpose of avoiding having at least one of such liabilities or payment obligations with respect to such liabilities being treated as a bottom dollar payment obligation as described in … (i) or (ii) [above].

However:[425]

> A payment obligation is not a bottom dollar payment obligation merely because a maximum amount is placed on the partner's or related person's payment obligation, a partner's or related person's payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates, or there is a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.

A partnership must disclose to the Internal Revenue Service a bottom dollar payment obligation (including a bottom dollar payment obligation that is respected) with respect to a partnership liability on a completed Form 8275, Disclosure Statement, for the taxable year in which the bottom dollar payment obligation is undertaken or modified.[426]

An indemnity, reimbursement agreement, or similar arrangement would be recognized under the above rules only if, before taking into account the indemnity, reimbursement agreement, or similar arrangement, the indemnitee's or other benefited party's payment obligation was recognized under these rules, or would be recognized under these rules if such person were a partner or related person.[427] A "benefited party" was "the person to whom a partner or related person has the payment obligation."[428]

The IRS could have disregarded form and treated a partner as bearing the economic risk of loss with respect to a partnership liability, or a portion thereof, to the extent that all of the following were present:[429]

- The partner or related person undertakes one or more contractual obligations so that the partnership may obtain or retain a loan;

- The contractual obligations of the partner or related person significantly reduce the risk to the lender that the partnership will not satisfy its obligations under the loan, or a portion thereof; and

- With respect to the above, ether one of the principal purposes of using the contractual obligations is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests, or another partner, or a person related to another partner, enters into a payment obligation and a principal purpose of the arrangement is to cause the payment obligation described above to be disregarded under this part II.C.3.c.ii.(b).

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[425] Reg. § 1.752-2T(b)(3)(ii)(C)(2).
[426] Reg. § 1.752-2T(b)(3)(ii)(D).
[427] Reg. § 1.752-2T(b)(3)(iii).
[428] Reg. § 1.752-2T(b)(3)(ii)(C)(3).
[429] Reg. § 1.752-2T(j)(2)(i).

For purposes of the above three bullet points:[430]

> partners are considered to bear the economic risk of loss for a liability in accordance with their relative economic burdens for the liability pursuant to the contractual obligations. For example, a lease between a partner and a partnership that is not on commercially reasonable terms may be tantamount to a guarantee by the partner of the partnership liability.

Prop. Reg. § 1.752-2(j)(3)[431] would attack plans to circumvent an obligation. An obligation of a partner or related person to make a payment would not be recognized under Reg. § 1.752-2(b) (the general rules for allocating recourse liabilities) if the facts and circumstances evidence a plan to circumvent or avoid the obligation.[432] Here are some factors that may indicate a plan to circumvent or avoid the payment obligation, the weight of which may vary (and sometimes a single factor may be determinative):[433]

> (A) The partner or related person is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, including, for example, restrictions on transfers for inadequate consideration or distributions by the partner or related person to equity owners in the partner or related person.
>
> (B) The partner or related person is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party.
>
> (C) The term of the payment obligation ends prior to the term of the partnership liability, or the partner or related person has a right to terminate its payment obligation, if the purpose of limiting the duration of the payment obligation is to terminate such payment obligation prior to the occurrence of an event or events that increase the risk of economic loss to the guarantor or benefited party (for example, termination prior to the due date of a balloon payment or a right to terminate that can be exercised because the value of loan collateral decreases). This factor typically will not be present if the termination of the obligation occurs by reason of an event or events that decrease the risk of economic loss to the guarantor or benefited party (for example, the payment obligation terminates upon the completion of a building construction project, upon the leasing of a building, or when certain income and asset coverage ratios are satisfied for a specified number of quarters).

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[430] Reg. § 1.752-2T(j)(2)(ii).

[431] REG-122855-15, promulgated 10/5/2016.

[432] Prop. Reg. § 1.752-2(j)(3)(i).

[433] Prop. Reg. § 1.752-2(j)(3)(ii) listed the factors quoted in the text that immediately follows, explaining:

> The presence or absence of a factor is based on all of the facts and circumstances at the time the partner or related person makes the payment obligation or if the obligation is modified, at the time of the modification. For purposes of making determinations under this paragraph (j)(3), the weight to be given to any particular factor depends on the particular case and the presence or absence of a factor is not necessarily indicative of whether a payment obligation is or is not recognized under paragraph (b) of this section.

Oral remarks by Clifford Warren of the Internal Revenue Service at the ABA Tax Section Midyear Meeting on January 19, 2017 (which of course do not necessarily represent the government's view) suggested that one factor may show such an intent. I don't remember the example he gave, but it seemed to make a lot of sense when I heard it in the recording.

(D) There exists a plan or arrangement in which the primary obligor or any other obligor (or a person related to the obligor) with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonable foreseeable needs of such obligor.

(E) The payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection.

(F) In the case of a guarantee or similar arrangement, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee.

(G) The creditor or other party benefiting from the obligation did not receive executed documents with respect to the payment obligation from the partner or related person before, or within a commercially reasonable period of time after, the creation of the obligation.

For example, under the proposed regulation:

- A guarantee not requested by the lender and not restricting the guarantor's asset transfers may indicate a plan to circumvent or avoid the guarantor's payment obligation.[434]

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[434] Prop. Reg. § 1.752-2(j)(4), Example (1), "Gratuitous guarantee," provided:

(i) In 2016, A, B, and C form a domestic limited liability company (LLC) that is classified as a partnership for federal tax purposes. Also in 2016, LLC receives a loan from a bank. A, B, and C do not bear the economic risk of loss with respect to that partnership liability, and, as a result, the liability is treated as nonrecourse under § 1.752-1(a)(2) in 2016. In 2018, A guarantees the entire amount of the liability. The bank did not request the guarantee and the terms of the loan did not change as a result of the guarantee. A did not provide any executed documents with respect to A's guarantee to the bank. The bank also did not require any restrictions on asset transfers by A and no such restrictions exist.

(ii) Under paragraph (j)(3) of this section, A's 2018 guarantee (payment obligation) is not recognized under paragraph (b)(3) of this section if the facts and circumstances evidence a plan to circumvent or avoid the payment obligation. In this case, the following factors indicate a plan to circumvent or avoid A's payment obligation: (1) The partner is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, such as restrictions on transfers for inadequate consideration or equity distributions; (2) the partner is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party; (3) in the case of a guarantee or similar arrangement, the terms of the liability are the same as they would have been without the guarantee; and (4) the creditor did not receive executed documents with respect to the payment obligation from the partner or related person at the time the obligation was created. Absent the existence of other facts or circumstances that would weigh in favor of respecting A's guarantee, evidence of a plan to circumvent or avoid the obligation exists and, pursuant to paragraph (j)(3)(i) of this section, A's guarantee is not recognized under paragraph (b) of this section. As a result, LLC's liability continues to be treated as nonrecourse.

- The unlimited liability an LLC general partner that has no assets may be disregarded.[435]

Furthermore, evidence of a plan to circumvent or avoid an obligation would be deemed to exist if the facts and circumstances indicate that there was not a reasonable expectation that the payment obligor will have the ability to make the required payments if the payment obligation became due and payable.[436]

Transition rules applied to certain liabilities existing on October 5, 2016.[437]

II.C.3.c.iii. Allocating Nonrecourse (Remaining) Liabilities

After liabilities are allocated to those partners bearing the economic risk under part II.C.3.c.ii Allocating Economic Risk of Loss to Recourse Liabilities, the remaining liabilities constitute nonrecourse liabilities[438] are allocated as described below in this part II.C.3.c.iii.

LB&I Concept Unit, "Determining Liability Allocations," Document Control Number (DCN) PAR-C-004 (last updated 9/15/20) (the "LB&I Concept Unit"), includes allocating nonrecourse liabilities and is reproduced in part II.C.3.c Allocations of Recourse and Nonrecourse Liabilities.

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[435] Prop. Reg. § 1.752-2(j)(4), Example (2), "Underfunded disregarded entity payment obligor," provided:
(i) In 2016, A forms a wholly owned domestic limited liability company, LLC, with a contribution of $100,000. A has no liability for LLC's debts, and LLC has no enforceable right to a contribution from A. Under § 301.7701-3(b)(1)(ii) of this chapter, LLC is a treated for federal tax purposes as a disregarded entity. Also in 2016, LLC contributes $100,000 to LP, a limited partnership with a calendar year taxable year, in exchange for a general partnership interest in LP, and B and C each contributes $100,000 to LP in exchange for a limited partnership interest in LP. The partnership agreement provides that only LLC is required to restore any deficit in its capital account. On January 1, 2017, LP borrows $300,000 from a bank and uses $600,000 to purchase nondepreciable property. The $300,000 is secured by the property and is also a general obligation of LP. LP makes payments of only interest on its $300,000 debt during 2017. LP has a net taxable loss in 2017, and, under Sec. § 1.705-1(a) and 1.752-4(d), LP determines its partners' shares of the $300,000 debt at the end of its taxable year, December 31, 2017. As of that date, LLC holds no assets other than its interest in LP.
(ii) Because LLC is a disregarded entity, A is treated as the partner in LP for federal income tax purposes. Only LLC has an obligation to make a payment on account of the $300,000 debt if LP were to constructively liquidate as described in paragraph (b)(1) of this section. Therefore, paragraph (j)(3)(iii) of this section is applied to the LLC and not to A. LLC has no assets with which to pay if the payment obligation becomes due and payable. As such, evidence of a plan to circumvent or avoid the obligation is deemed to exist and, pursuant to paragraph (j)(3)(i) of this section, LLC's obligation to restore its deficit capital account is not recognized under paragraph (b) of this section. As a result, LP's $300,000 debt is characterized as nonrecourse under § 1.752-1(a)(2) and is allocated among A, B, and C under § 1.752-3.

[436] Prop. Reg. § 1.752-2(j)(3)(iii), which continues:
For purposes of this section, a payment obligor includes an entity disregarded as an entity separate from its owner under section 856(i), section 1361(b)(3), or Sec. § 301.7701-1 through 301.7701-3 of this chapter (a disregarded entity), and a trust to which subpart E of part I of subchapter J of chapter 1 of the Code applies.

[437] Reg. § 1.752-2T(*l*).

[438] See part II.C.3.c.i Definition of "Recourse" or "Nonrecourse".

A partner's share of the nonrecourse liabilities of a partnership equals the sum of:[439]

(1) The partner's share of partnership minimum gain determined in accordance with the rules of section 704(b) and the regulations thereunder;

(2) The amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration; and

(3) The partner's share of the excess nonrecourse liabilities (those not allocated under paragraphs (a)(1) and (a)(2) of this section) of the partnership as determined in accordance with the partner's share of partnership profits.

Regulations provide additional rules to determine a partner's share of partnership profits in allocating excess nonrecourse liabilities.[440] They also provide that some of these rules of not apply for purposes of the disguised sale rules.[441]

In applying the above rules re Code § 704(c) gain, if a partnership holds multiple properties subject to a single nonrecourse liability, the partnership may allocate the liability among the multiple properties under any reasonable method.[442] When the outstanding principal of a

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[439] Reg. § 1.752-3(a).

[440] Reg. § 1.752-3(a)(3) continues:

> The partner's interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain (significant item method). Alternatively, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated (alternative method). Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property (as defined under § 1.704-3(a)(3)(ii)) or property for which reverse section 704(c) allocations are applicable (as described in § 1.704-3(a)(6)(i)) where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the gain described in paragraph (a)(2) of this section with respect to such property (additional method). The significant item method, alternative method, and additional method do not apply for purposes of § 1.707-5(a)(2). To the extent that a partnership uses this additional method and the entire amount of the excess nonrecourse liability is not allocated to the contributing partner, the partnership must allocate the remaining amount of the excess nonrecourse liability under one of the other methods in this paragraph (a)(3). Excess nonrecourse liabilities are not required to be allocated under the same method each year.

[441] The excerpt from Reg. § 1.752-3(a)(3) in fn. 440 included, "The significant item method, alternative method, and additional method do not apply for purposes of § 1.707-5(a)(2)." See part II.M.3.e.i.(a) Distributions Presumed to Be Disguised Sales, especially fn. 3603.

[442] Reg. § 1.752-3(b)(1) further provides:

> A method is not reasonable if it allocates to any item of property an amount of the liability that, when combined with any other liabilities allocated to the property, is in excess of the fair market value of the property at the time the liability is incurred. The portion of the nonrecourse liability allocated to each item of partnership property is then treated as a separate loan under

partnership liability is reduced, the reduction of outstanding principal is allocated among the multiple properties in the same proportion that the partnership liability originally was allocated to the properties under the preceding sentence.[443]

II.C.3.c.iv. Assumption of Liabilities

If a partner contributes property to the partnership or the partnership distributes property to a partner and the property is subject to a liability of the transferor, the transferee is treated as having assumed the liability, to the extent that the amount of the liability does not exceed the property's fair market value at the time of the contribution or distribution.[444]

Except for such a deemed assumption, a person is considered to assume a liability only to the extent that the assuming person is personally obligated to pay the liability.[445] However, if a partner or related person assumes a partnership liability, the person to whom the liability is owed knows of the assumption and can directly enforce the partner's or related person's obligation for the liability, and no other partner or person that is a related person to another partner would bear the economic risk of loss for the liability under Reg. § 1.752-2 immediately after the assumption.[446]

If a general partner, who is jointly and severally liable for a partnership's debt, terminates that partner's interest but remains personally liable on part of that debt, the former partner may have been treated as having assumed the debt under case law that applied before the rules in the two preceding paragraphs were adopted.[447]

II.C.3.d. Deducting Interest Expense on Debt Incurred by a Partnership

Generally, debt is allocated to expenditures in accordance with the use of the debt proceeds, and interest expense accruing on a debt during any period is allocated to expenditures in the same manner as the debt is allocated from time to time during such period.[448] Generally, debt proceeds and related interest expense are allocated solely by reference to the use of the proceeds, and the allocation is not affected by the use of an interest in any property to secure the repayment of such debt or interest.[449] For example:[450]

> paragraph (a)(2) of this section. In general, a partnership may not change the method of allocating a single nonrecourse liability under this paragraph (b) while any portion of the liability is outstanding. However, if one or more of the multiple properties subject to the liability is no longer subject to the liability, the portion of the liability allocated to that property must be reallocated among the properties still subject to the liability so that the amount of the liability allocated to any property does not exceed the fair market value of such property at the time of reallocation.

[443] Reg. § 1.752-3(b)(2).
[444] Reg. § 1.752-1(e).
[445] Reg. § 1.752-1(d)(1)(i).
[446] Reg. § 1.752-1(d)(1)(ii). Reg. § 1.752-1(d)(2), "Applicability date," provides:

> Paragraph (d)(1)(ii) of this section applies to liabilities incurred or assumed by a partnership on or after October 9, 2019. The rules applicable to liabilities incurred or assumed prior to October 9, 2019, are contained in § 1.752-1 in effect prior to October 9, 2019 (see 26 CFR part 1 revised as of April 1, 2019).

[447] *Weiss v. Commissioner*, 956 F.2d 242 (11th Cir. 1992) (tax year 1979), *rev'g* T.C. Memo. 1990-492.
[448] Reg. § 1.163-8T(c)(1).
[449] Reg. § 1.163-8T(c)(1).
[450] Reg. § 1.163-8T(c)(1), Example.

> Taxpayer A, an individual, pledges corporate stock held for investment as security for a loan and uses the debt proceeds to purchase an automobile for personal use. Interest expense accruing on the debt is allocated to the personal expenditure to purchase the automobile even though the debt is secured by investment property.

Unless the context provides otherwise, the discussion below also applies to debt related to an S corporation.

Debt is allocated to an expenditure for the period beginning on the date the proceeds of the debt are used or treated as used under the rules of this section to make the expenditure and ending on the earlier of the debt being repaid or reallocated.[451] Generally, interest expense accruing on a debt for any period is allocated in the same manner as the debt is allocated from time to time, regardless of when the interest is paid.[452]

If a lender disburses debt proceeds to a person other than the borrower for the sale or use of property, services, or any other purpose, the debt is treated as if the borrower used an amount of the debt proceeds equal to such disbursement to make an expenditure for that property, services, or other purpose.[453] If a taxpayer incurs or assumes a debt for the sale or use of property, services, or any other purpose, or takes property subject to a debt, and no debt proceeds are disbursed to the taxpayer, the debt is treated as if the taxpayer used an amount of the debt proceeds equal to the balance of the debt outstanding at such time to make an expenditure for such property, services, or other purpose.[454]

If the borrower directly receives the loan proceeds, a variety of tracing rules apply.[455]

Now let's apply these rules to a partnership. Notice 88-37 provides guidance on reporting interest expense with respect to debt-financed acquisitions and debt-financed distributions for post-1986 taxable years. Notice 89-35 expands on that guidance, providing:[456]

> guidance with respect to the allocation of interest expense in connection with certain transactions involving partnerships and S corporations ("passthrough entities") and the allocation of interest expense on debt proceeds received in cash or deposited in an account.

in Section V, "Treatment of Debt of Passthrough Entities Allocated to Distributions by Such Entities (Debt-Financed Distributions)," Notice 89-35 provides:

> **A. General Allocation Rule**
>
> Unless the optional allocation rule is used, debt of passthrough entities and the associated interest expense shall be allocated under the rules of section 1.163-8T. In general, when debt proceeds of a passthrough entity are allocated under section 1.163-8T to distributions to owners of the entity, the debt proceeds distributed to any owner and the associated interest expense shall be allocated under section 1.163-8T in accordance with such owner's use of such debt proceeds. For example, if the owner

[451] Reg. § 1.163-8T(c)(2)(i).
[452] Reg. § 1.163-8T(c)(2)(ii).
[453] Reg. § 1.163-8T(c)(3)(i).
[454] Reg. § 1.163-8T(c)(3)(ii).
[455] Reg. § 1.163-8T(c)(4).
[456] Notice 89-35, Section I, "Purpose."

uses distributed debt proceeds to purchase an interest in a passive activity, the owner's share of the interest expense on such debt proceeds is allocated to a passive activity expenditure (within the meaning of section 1.163-8T(b)(4)).

An owner's share of a passthrough entity's interest expense on debt proceeds allocated to distributions to owners may exceed the entity's interest expense on the portion of the debt proceeds distributed to that particular owner. In such cases, the entity shall allocate the owner's excess interest expense using any reasonable method. The determination of whether a particular method of allocating such excess interest expense is reasonable depends on the facts and circumstances including, without limitation, whether the entity consistently applies the method from year to year.

B. Optional Allocation Rule

A passthrough entity may allocate distributed debt proceeds and the associated interest expense to one or more expenditures (other than distributions) of the entity that are made during the same taxable year of the entity as the distribution, to the extent that debt proceeds (including other distributed debt proceeds) are not otherwise allocated to such expenditures. However, distributed debt proceeds must be allocated under the general allocation rule to distributions to owners of the entity to the extent that such distributed debt proceeds exceed the entity's expenditures (other than distributions) for the taxable year to which debt proceeds are not otherwise allocated. Once debt proceeds are allocated under this section V.B., the debt proceeds shall be reallocated, when necessary, under the rules of section 1.163-8T.

C. Coordination with Repayment Rule

Paragraph (d) of section 1.163-8T provides rules governing the treatment of debt repayments. Any repayment of debt of a passthrough entity allocated to distributions to owners of the entity and to one or more other expenditures may, at the option of the passthrough entity, be treated first as a repayment of the portion of the debt allocated to such distributions.

D. Reporting Rules

1. Reporting Under the General Allocation Rule

To the extent that debt proceeds of a passthrough entity are allocated to distributions to owners of the entity, the portion of an owner's share of the entity's interest expense on debt proceeds allocated to distributions to owners that does not exceed the entity's interest expense on the portion of the debt proceeds distributed to such owner should be included on the line on Schedule K-1 for other deductions. This interest expense should be identified on an attached schedule as "Interest expense allocated to debt-financed distributions." The manner in which the owner should report such interest expense depends on the types of expenditures that the owner makes with the distributed debt proceeds. For example, if the owner uses the debt proceeds to make a personal expenditure (within the meaning of section 1.163-8T(b)(5)), the owner should report the interest expense as personal interest on Schedule A.

To the extent that an owner's share of a passthrough entity's interest expense on debt proceeds allocated to distributions to owners exceeds the entity's interest expense on the portion of the debt proceeds distributed to such owner, the excess interest expense should be reported on Schedule K-1 in a manner consistent with the allocation of such interest expense by such entity.

2. Reporting Under the Optional Allocation Rule

If the passthrough entity uses the optional rule to allocate distributed debt proceeds and associated interest expense, the entity's interest expense on debt proceeds allocated to such other expenditures should be reported on Schedule K-1 in a manner consistent with the allocation of the debt proceeds. For example, if the passthrough entity allocates distributed debt and the associated interest expense to an expenditure in connection with a rental activity, the entity should take the interest expense on the debt into account in computing the income or loss from the rental activity that is reported to the owner on Schedule K-1.

Notice 88-37 provides additional guidance on the reporting of interest expenses in connection with debt-financed distributions.

Lipnick v. Commissioner, 153 T.C. No. 1 (2019), looks to whether a partner's use of debt-financed distributions affects that partner's successor's interest deduction. The Official Tax Court Syllabus summarizes the case:

P-H's father owned interests in partnerships that made debt-financed distributions to the partners. P-H's father used the proceeds of those distributions to purchase assets that he held for investment. P-H s father treated the interest paid by the partnerships on those debts and passed through to him as "investment interest" subject to the limitation on deductibility imposed by I.R.C. sec. 163(d).

In 2011 and 2013 P-H s father transferred interests in the partnerships to P-H by gift and bequest. The partnerships continued to incur interest expense on the debts, which was passed through to P-H as a new partner. P-H treated the debts as properly allocable to the partnerships real estate assets and reported the interest expense on his 2013 and 2014 Schedules E, Supplemental Income and Loss, as offsetting the passed-through real estate income.

For Ps taxable years 2013 and 2014, R characterized the interest passed through to P-H as "investment interest." Because Ps had insufficient investment income for these years, R disallowed 100% of the deductions for interest expense under I.R.C. sec. 163(d).

Held: P-H, unlike his father, did not receive the proceeds of any debt-financed distributions and did not use partnership distributions to acquire property held for investment. Rather, he is deemed to have made a debt-financed acquisition of the partnership interests he acquired by gift and bequest, and the associated interest expense is allocated among the assets of the partnerships.

Because the transferee took the partnership interest subject to debt, Reg. § 1.163-8T(c)(3)(ii)[457] controlled,[458] making the transfer be a bargain sale.[459]

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[457] Reproduced in the text accompanying fn 454.

[458] The court held:

> These authorities show that William acquired his interests in Mar-Cal, May-fair, Brinkley, and Claridge "subject to" the M&T and W&D debts, even though he did not personally assume those debts, which remained nonrecourse with respect to the partners individually. In the converse situation, where a partner sells a partnership interest, the regulations provide that the partner's "amount realized" includes his share of the partnership liabilities of which he is relieved, even if the liabilities are nonrecourse. See secs. 1.752-1, 1.1001-2(a)(4)(v), Income Tax Regs.; see also sec. 1.1001-2(c), Example (4), Income Tax Regs. (stating that a taxpayer's "amount realized" on transfer of a partnership interest includes the non-recourse liabilities of which he is relieved, where the transferee "takes the partnership interest subject to the … liabilities"). For purposes of subchapter K generally, any increase or decrease in a partner's share of partnership liabilities is treated as a deemed contribution or distribution, regardless of whether the debt is recourse or nonrecourse. See sec. 752; sec. 1.752-1, Income Tax Regs. In short, the fact that a partner is not personally liable for a partnership's debt does not mean that his partnership interest is not "subject to a debt" for purposes of subchapter K.[6]
>
> > [6] When Maurice gratuitously transferred interests in Mar-Cal, Mayfair, and Brinkley to William in 2011, he was required to include the partnership debt from which he was relieved as an "amount realized," and he reported capital gains tax accordingly. See *supra* p. 6. To the extent Maurice was relieved of the debt, liability therefore necessarily shifted to the other partners, including William. William thus took his partnership interests "subject to the debt," even though the liabilities were nonrecourse.
>
> For these reasons, we conclude that section 1.163-8T(c)(3)(ii), Temporary Income Tax Regs., supra, in conjunction with Notice 89-35, *supra*, dictates that the interest expense passed through to William from the partnerships was not "investment interest" under section 163(d). But even if that temporary regulation were somehow thought inapplicable here, respondent has not articulated any principle or rule that would affirmatively require the interest in question to be characterized as "investment interest." The principle that required such interest to be characterized as "investment interest" in Maurice's hands clearly does not apply because William (unlike Maurice) did not receive any debt-financed distributions from the partnerships. Respondent does not contend that William received debt-financed distributions indirectly or that the substance of the parties' transactions differed from their form. Respondent's position thus reduces to the contention that, because William acquired the partnership interests from his father, he stands in his father's shoes and must treat the passed-through interest the same way his father did. But neither section 163(d) nor its implementing regulations include any family attribution rule or similar principle that would require this result.
>
> It seems obvious that William would have no "investment interest" if he had acquired his ownership interests in the four partnerships from a third party for cash. Respondent has not explained why the result should be different because William acquired those interests from his father by gift and bequest. Respondent, in short, has enunciated no principle that would justify characterizing the interest passed through to William as "properly allocable to property held for investment" by William. Sec. 163(d)(3)(A).
>
> Respondent urges us to adopt a "once investment interest, always investment interest" rule on the theory that any other approach would "place a myriad of additional administrative burdens on both taxpayers and the government." But the temporary regulations and IRS guidance clearly dictate different outcomes depending on whether the partner receives a debt-financed distribution or makes a debt-financed acquisition. See sec. 1.163-8T(c)(3)(ii), Temporary Income Tax Regs., *supra*; Notice 89-35, *supra*. Recognition that partnership interests may change hands is thus an inherent part of the regulatory structure. And the allocation is no more cumbersome than allocating debt for any other purpose under subchapter K.

II.C.4. Mandatory Allocations of Certain Losses or Gains

This part II.C.4 discusses certain allocations. Note, however, that losses might be suspended by the passive loss[460] or at-risk[461] rules or basis limitations.[462]

Notwithstanding any other provision in Reg. §§ 1.704-1 and 1.704-2, allocations of partner nonrecourse deductions, nonrecourse deductions, and minimum gain chargebacks are made before any other allocations. Furthermore, partnership agreements tend to apply income in later years to reverse those special allocations until capital accounts reach their proportions to each other generally contemplated under the agreement.

II.C.4.a. Partner Nonrecourse Deductions

Partnership losses, deductions, and Code § 705(a)(2)(B) expenditures are treated as partner nonrecourse deductions in the amount determined under Reg. § 1.704-2(i)(2) (determining partner nonrecourse deductions) in the following order:[463]

1. First, depreciation or cost recovery deductions with respect to property that is subject to partner nonrecourse debt;

2. Then, if necessary, a pro rata portion of the partnership's other deductions, losses, and Code § 705(a)(2)(B) items.

Depreciation or cost recovery deductions with respect to property that is subject to a partnership nonrecourse liability is first treated as a partnership nonrecourse deduction under part II.C.4.b and any excess is treated as a partner nonrecourse deduction under this part II.C.4.a.[464]

If the amount of partner nonrecourse deductions or nonrecourse deductions exceeds the partnership's losses, deductions, and Code § 705(a)(2)(B) expenditures for the taxable year (determined under parts II.C.4.a and II.C.4.b), the excess is treated as an increase in partner

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In sum, we hold that the interest expense passed through to William from the M&T and W&D loans was not "investment interest" under section 163(d). When William acquired the partnership interests from his father, he was in the same position as any other person who acquired partnership interests encumbered by debt. He did not receive the proceeds of those debts, and he did not use (and could not have used) the proceeds of those debts to acquire property that he subsequently held for investment. There is thus no justification for treating the interest expense passed through to him as investment interest under section 163(d). Rather, petitioners correctly reported it on Schedule E as allocable to the real estate assets held by the partnerships. Concluding that there are no deficiencies in petitioners' income tax for 2013 and 2014, we find that they are likewise liable for no penalties.

[459] See part III.B.1.c.i Gifts with Consideration – Bargain Sales**.** For what happens when grantor trust powers are turned off and the trust holds a partnership interest to which debt is allocated, see *Madorin v. Commissioner*, 84 T.C. 667 (1985), described in fn 6554 in part III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation and fn 6591 in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System.

[460] See parts II.G.4.i Passive Loss Limitations and II.K Passive Loss Rules.

[461] See part II.G.4.j At Risk Rules.

[462] See part II.G.4.e Basis Limitations for Partners in a Partnership.

[463] Reg. § 1.704-2(j)(1)(i).

[464] Reg. § 1.704-2(j)(1)(i) (flush language).

nonrecourse debt minimum gain or partnership minimum gain in the immediately succeeding partnership taxable year.[465]

II.C.4.b. Partnership Nonrecourse Deduction

Partnership losses, deductions, and Code § 705(a)(2)(B) expenditures are treated as partnership nonrecourse deductions in the amount determined under Reg. 1.704-2(c) (determining nonrecourse deductions) in the following order:[466]

1. First, depreciation or cost recovery deductions with respect to property that is subject to partnership nonrecourse liabilities;

2. Then, if necessary, a pro rata portion of the partnership's other deductions, losses, and Code § 705(a)(2)(B) items.

Depreciation or cost recovery deductions with respect to property that is subject to partner nonrecourse debt is first treated as a partner nonrecourse deduction under part II.C.4.a and any excess is treated as a partnership nonrecourse deduction under this part II.C.4.b.[467] Any other item that is treated as a partner nonrecourse deduction will in no event be treated as a partnership nonrecourse deduction.[468]

If the amount of partner nonrecourse deductions or nonrecourse deductions exceeds the partnership's losses, deductions, and Code § 705(a)(2)(B) expenditures for the taxable year (determined under parts II.C.4.a and II.C.4.b), the excess is treated as an increase in partner nonrecourse debt minimum gain or partnership minimum gain in the immediately succeeding partnership taxable year.[469]

II.C.4.c. Minimum Gain Chargeback

Items of partnership income and gain equal to the minimum gain chargeback requirement (determined under Reg. § 1.704-2(f) of this section) are allocated as a minimum gain chargeback in the following order:[470]

1. First, a pro rata portion of gain from the disposition of property subject to partnership nonrecourse liabilities and discharge of indebtedness income relating to partnership nonrecourse liabilities to which property is subject;

2. Then, if necessary, a pro rata portion of the partnership's other items of income and gain for that year.

Gain from the disposition of property subject to partner nonrecourse debt is allocated to satisfy a minimum gain chargeback requirement for partnership nonrecourse debt only to the extent not allocated under Reg. § 1.704-2(j)(2)(ii).[471]

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465 Reg. § 1.704-2(j)(1)(i), which also cross-references Reg. § 1.704-2(m), Example (1)(vi).
466 Reg. § 1.704-2(j)(1)(ii).
467 Reg. § 1.704-2(j)(ii) (flush language).
468 Reg. § 1.704-2(j)(ii) (flush language).
469 Reg. § 1.704-2(j)(1)(i), which also cross-references Reg. § 1.704-2(m), Example (1)(vi).
470 Reg. § 1.704-2(j)(2)(i).
471 Reg. § 1.704-2(j)(2)(i) (flush language).

If a minimum gain chargeback requirement (determined under part II.C.4.c and II.C.4.d) exceeds the partnership's income and gains for the taxable year, the excess is treated as a minimum gain chargeback requirement in the immediately succeeding partnership taxable years until fully charged back.[472]

II.C.4.d. Chargeback Attributable to Decrease In Partner Nonrecourse Debt Minimum Gain

Items of partnership income and gain equal to the partner nonrecourse debt minimum gain chargeback (determined under Reg. § 1.704-2(i)(4)) are allocated to satisfy a partner nonrecourse debt minimum gain chargeback in the following order:[473]

1. First, a pro rata portion of gain from the disposition of property subject to partner nonrecourse debt and discharge of indebtedness income relating to partner nonrecourse debt to which property is subject.

2. Then, if necessary, a pro rata portion of the partnership's other items of income and gain for that year.

Gain from the disposition of property subject to a partnership nonrecourse liability is allocated to satisfy a partner nonrecourse debt minimum gain chargeback only to the extent not allocated under Reg. § 1.704-2(j)(2)(i).[474] An item of partnership income and gain that is allocated to satisfy a minimum gain chargeback under Reg. § 1.704-2(f) is not allocated to satisfy a minimum gain chargeback under Reg. § 1.704-2(i)(4).[475]

If a minimum gain chargeback requirement (determined under part II.C.4.c and II.C.4.d) exceeds the partnership's income and gains for the taxable year, the excess is treated as a minimum gain chargeback requirement in the immediately succeeding partnership taxable years until fully charged back.[476]

II.C.5. Converting from One Entity Taxed as a Partnership to Another

Generally, a partnership's conversion from one type of state law entity to another (that is still taxed as a partnership) will not trigger income taxation absent a shift in liabilities[477] allocated to various partners.[478] The first formal reliance guidance on this was Rev. Rul. 84-52, which addressed the following situation:

> In 1975, X was formed as a general partnership under the Uniform Partnership Act of state M. X is engaged in the business of farming. The partners of X are A, B, C, and D. The partners have equal interest in the partnership.
>
> The partners propose to amend the partnership agreement to convert the general partnership into a limited partnership under the Uniform Limited Partnership Act of

[472] Reg. § 1.704-2(j)(2)(iii).
[473] Reg. § 1.704-2(j)(2)(ii).
[474] Reg. § 1.704-2(j)(2)(ii) (flush language).
[475] Reg. § 1.704-2(j)(2)(ii) (flush language).
[476] Reg. § 1.704-2(j)(2)(iii).
[477] See part II.C.3 Allocating Liabilities (Including Debt).
[478] See Rev. Rul. 95-37 (converted to an LLC), amplifying Rev. Ruls. 84-52 (converting a general partnership to a limited partnership) and 86-111 (a conversion does not close the partnership's tax year).

State M, a statute that corresponds in all material respects to the Uniform Limited Partnership Act. Under the certificate of limited partnership, A and B will be limited partners, and both C and D will be general partners and limited partners. Each partner's total percent interest in the partnership's profits, losses, and capital will remain the same when the general partnership is converted into a limited partnership. The business of the general partnership will continue to be carried on after the conversion.

The IRS ruled:

(1) Except as provided below, pursuant to section 721 of the Code, no gain or loss will be recognized by A, B, C, or D under section 741 or section 1001 of the Code as a result of the conversion of a general partnership interest in X into a limited partnership in X.

(2) Because the business of X will continue after the conversion and because, under section 1.708-1(b)(1)(ii) of the regulations, a transaction governed by section 721 of the Code is not treated as a sale or exchange for purposes of section 708 of the Code, X will not be terminated under section 708 of the Code.

(3) If, as a result of the conversion, there is no change in the partners' shares of X's liabilities under section 1.752-1(e) of the regulations, there will be no change to the adjusted basis of any partner's interest in X, and C and D will each have a single adjusted basis with respect to each partner's interest in X (both as limited partner and general partner) equal to the adjusted basis of each partner's respective general partner interest in X prior to the conversion. See Rev. Rul. 84-53, page 159, this Bulletin.

(4) If, as a result of the conversion, there is a change in the partners' shares of X's liabilities under section 1.752-1(e) of the regulations, and such change causes a deemed contribution of money to X by a partner under section 752(a) of the Code, then the adjusted basis of that partner's interest shall, under section 722 of the Code, be increased by the amount of such deemed contribution. If the change in the partners' shares of X's liabilities causes a deemed distribution of money by X to a partner under section 752(b) of the Code, then the basis of that partner's interest shall, under section 733 of the Code, be reduced (but not below zero) by the amount of such deemed distribution, and gain will be recognized by that partner under section 731 of the Code to the extent the deemed distribution exceeds the adjusted basis of that partner's interest in X.

(5) Pursuant to section 1223(1) of the Code, there will be no change to the holding period of any partner's total interest in X.

The holdings contained herein would apply with equal force if the conversion had been from a limited partnership to a general partnership.

Rev. Rul. 95-37 held:[479]

(1) The federal income tax consequences described in Rev. Rul. 84-52 apply to the conversion of an interest in a domestic partnership into an interest in a domestic LLC

[479] Letter Ruling 200414013 followed this result.

that is classified as a partnership for federal tax purposes. The federal tax consequences are the same whether the resulting LLC is formed in the same state or in a different state than the converting domestic partnership.

(2) The taxable year of the converting domestic partnership does not close with respect to all the partners or with respect to any partner.

(3) The resulting domestic LLC does not need to obtain a new taxpayer identification number.

> The holdings contained herein would apply in a similar manner if the conversion had been of an interest in a domestic LLC that is classified as a partnership for federal tax purposes into an interest in a domestic partnership. The holdings contained herein apply regardless of the manner in which the conversion is achieved under state law.

For more information on the liability issues described above, see part II.C.3 Allocating Liabilities (Including Debt).

It has been suggested that implicit in these rulings is the following approach to converting a partnership to an LLC:[480]

> The partners contribute their partnership interests to the limited liability company in exchange for LLC interests. The partnership is then instantaneously dissolved, wound up, and terminated for state law purposes by virtue of the limited liability company's ownership of all of the interests therein (the "two-partner" rule).

This approach seems to me to be the cleanest method as a matter of general state law, unless the state's laws have a statute specifically addressing the conversion of a partnership into an LLC. Regardless of the method of conversion, any assets that require formal written title will need to be retitled so that third parties know of the LLC's existence.

Converting a limited partnership into an LLC is not a taxable event, absent a liability shift.[481] Same with converting a general partnership into a limited partnership[482] or the registration of a general partnership as a limited liability partnership.[483] When an LLC was converted to a limited partnership and the managing members formed disregarded LLC that became the general partners, the conversion was not a taxable event.[484] Rearranging interests in limited partnerships without any substantive change in ownership might be disregarded. Letter Ruling 201605004, which was a little convoluted, involved these facts:

> According to the information submitted, PRS 1 is a limited partnership organized under the laws of State on Date 1, PRS 2, through disregarded entities, owned all of the general and limited partnership interests in PRS 1. PRS 1 was classified as a disregarded entity for federal income tax purposes. PRS 1 owned a% interest in PRS 3, a State limited partnership.

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480 Bishop & Kleinberger, *Limited Liability Companies: Tax and Business Law*, ¶12.04, "Conversion of General Partnership to Limited Liability Company."
481 Letter Rulings 9210019, 9210019.
482 Letter Rulings 9029019, 9119029 (the most helpful), and 200538005.
483 Rev. Rul. 95-55.
484 Letter Ruling 201745005, which contained so many representations about factual and tax issues that one wonders what the point was. The ruling cited Rev. Ruls. 84-52 and 95-37.

> On Date 2, PRS 4 acquired an interest in PRS 3. Also on Date 2, PRS 4 exchanged its interest in PRS 3 for an interest in PRS 1, causing PRS 3 to become a disregarded entity and PRS 1 to become a partnership for federal income tax purposes. Effectively PRS 3 was converted into PRS 1. On Date 3, PRS 4 sold its b% interest in PRS 1 and PRS 2 sold a c% interest in PRS 1 to PRS 5. The transfer of interests in PRS 1 during the 12-month period was less than 50%.

Pointing to Code §§ 708 and 721(a), Reg. § 1.708-1(b)(1)(ii), and Rev. Ruls. 84-52 and 95-37, Letter Ruling 201605004 held:

> Based on the representations and the facts submitted, we conclude that PRS 1 will be considered a continuation of the partnership, PRS 3, and there was no termination of the partnership under § 708. Other than with respect to the sale of the partnership interests sold, the conversion of PRS 3 into PRS 1 did not cause the partners in PRS 3 or PRS 1 to recognize gain or loss under §§ 741 or 1001, except as provided in § 752. The holding period of the partners' interests in PRS 1 includes the period of time during which those interests were held as partners in PRS 3. The conversion of PRS 3 into PRS 1 did not cause the taxable year of the partnership to close under § 706. PRS 1 does not need to obtain a new taxpayer identification number. The basis of the assets held by PRS 1 is the same as the basis of the assets in the hands of PRS 3 prior to the conversion. Finally, the conversion PRS 3 into PRS 1 did not result in the assets of the partnership being contributed or distributed to the partners of the partnership.

That the like-kind exchange rules do not apply to an exchange of partnership interests[485] does not affect these principles. T.D. 8346 provides:

The final regulations otherwise retain the provisions of the proposed regulations regarding exchanges of interests in a partnership. Under the proposed and final regulations, an exchange of partnership interests will not qualify for nonrecognition of gain or loss under section 1031(a) regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership or different partnerships. No inference is to be drawn from these regulations, however, with respect to the application of other Code sections that allow nonrecognition of gain of loss in an exchange of interests in a partnership. For example, as stated in the preamble to the proposed regulations, these regulations are not intended to affect the applicability of Rev. Rul. 84-52, 1984-1 C.B. 157, concerning conversions of partnership interests. More generally, the regulations are not intended to restrict in any way the application of the rules of subchapter K of the Code to exchanges of partnership interests.

[485] Code § 1031(a)(2)(D); Reg. § 1.1031(a)-1(a)(1)(iv).

II.C.6. Shifting Rights to Future Profits

Shifting partners' rights to future profits within a partnership, without any change in capital accounts[486] or allocation of liabilities, would not have any income tax consequences,[487] even if

[486] See Reg. § 1.704-1(b)(2)(iv)(b), which is reproduced in the text accompanying fn. 500 in part II.C.7 Maintaining Capital Accounts, describing when capital accounts should be booked up. For cases discussing the taxation on the issuance of a partnership interest for services, distinguishing between issuing a profits interest (which is usually nontaxable) and a capital shift (which is always taxable), see fn 3739 in part II.M.4.f.ii.(a) Tax Effects of Issuing a Profits Interest.
Also, when partners are admitted later, the existing partners' built-in gain needs to be taken into account in some manner, as described in the text accompanying fns. 5444-5447 in part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value. Thus, one might consider whether reallocating profits might constitute a disguised shift of an unbooked asset unless a book-up or some other special allocation of unrealized gain occurs. However, in a service partnership, it is not uncommon to shift profits each year to reflect each partner's expected contribution to the firm's profitability; if capital merely supports the services but the services themselves generate the income, a capital shift is less likely to be found. For a statutory rule regarding complete redemptions of partnership interests, see part II.Q.8.b.ii.(b) Flexibility in Choosing between Code § 736(a) and (b) Payments, especially fns 5502-5504.

[487] Letter Ruling 200345007 involved the following situation:

> According to the representations made, X is a State LLC taxed as a partnership for Federal tax purposes. X began operations on D1. X has more than a members. There are currently b shares of A Units outstanding.
>
> X intends to (1) designate A Unit as B Unit, (2) create C Unit, D Unit, and E Unit, each of which has different rights, preferences, privileges, and restrictions from one another and (3) allow its members to convert, on a one-to-one basis, (i) B Units into C Units, D Units, or E Units, (ii) C Units into E Units, (iii) D Units into C Units or E Units, and (iv) E Units into C Units.
>
> The following has been further represented. X is not a publicly traded partnership as defined under § 7704 of the Internal Revenue Code. Each member's proportionate share in X's capital will remain the same after the planned conversion of the membership interests. The conversion will not change each member's proportionate share of X's liabilities.

The ruling held:

(1) No gain or loss will be recognized by the members of X as a result of the designation of A Units as B Units, the conversion of B Units into C Units, D Units, or E Units, the conversion of C Units into E Units, the conversion of D Units into C Units or E Units, and the conversion of E Units into C Units, on a one-to-one basis.
(2) No termination of X will occur under § 708, regardless whether more than 50 percent of the existing membership interest units are converted into other newly created membership interest units.
(3) No gain or loss will be recognized by any converting members upon the proposed conversions of their existing membership interest units.
(4) Provided that there will be no change in the members' shares of X's liabilities as a result of the conversions, the adjusted basis of a converting member will not be affected by the conversion.
(5) Pursuant to § 1223(1), there will be no change to the holding period of any member's membership interest in X.
(6) The designation of A Units as B Units and the subsequent conversions of units will not constitute an issuance of additional units as described in § 1.7704-1(e)(4)(i) of the Procedure and Administration Regulations.

the shift of the right to profits is compensatory;[488] however, a shift might have unexpected gift tax consequences.[489]

The parties should consider having a revaluation event before this shift, so that each partner's economic rights are reflected in its capital accounts and the shifting of rights to profits does not move any value based on the partners' rights immediately before the shift. See CCA 201517006, which addressed the question, "Did a taxable exchange result when the general partner of a publicly traded partnership restructured its interest in the partnership, including exchanging its Incentive Distribution Rights for newly issued publicly-traded common units?" Here were the facts:

> Taxpayer, a corporation, is the general partner of Partnership, a publicly traded partnership within the meaning of § 7704(b) that is treated as a partnership for federal tax purposes through the operation of § 7704(c). Partnership was formed on Date 1, and its original partnership agreement granted Taxpayer an a percent general partner interest in profits, losses, and capital, and in addition granted Taxpayer certain "Incentive Distribution Rights" (IDRs). The IDRs are a form of non-publicly-traded limited partnership profits interest that did not carry any interest in partnership capital on Date 1, but entitled Taxpayer to share in future partnership profits and quarterly distributions. The original partnership agreement provided that, as Partnership's total quarterly distributions reached certain thresholds, distributions and income allocations to Taxpayer under the IDRs increased, up to a maximum of b percent. Additionally, the IDRs entitled Taxpayer to a share of Partnership's proceeds on liquidation if Partnership's assets appreciated after Date 1.
>
> On Date 2, Taxpayer and Partnership consummated an exchange agreement and amended the partnership agreement to replace Taxpayer's IDRs with common units and less valuable IDRs. Specifically, Taxpayer's interest was restructured as follows: Taxpayer continued to hold its a percent general partner interest; Taxpayer's old IDRs were cancelled; Partnership granted Taxpayer c newly-issued publicly-traded common units; Taxpayer also received new, less valuable, IDRs containing higher thresholds and a lower maximum (d percent rather than b percent). The terms of the newly-issued IDRs and the number of newly-issued publicly-traded common units were calculated to produce the same distribution to Taxpayer as the old IDRs had produced the prior quarter.
>
> Although Taxpayer's IDRs did not carry any capital interest on Date 1, by Date 2 Partnership had significant appreciation in its assets, and if Partnership were to have liquidated immediately before the Date 2 restructuring, a substantial amount of the proceeds would have been allocated to Taxpayer under the old IDRs. However, before Date 2, Partnership had not experienced a revaluation event in some time, and as a result its significant unrealized appreciation in its assets had not been "booked-up" and reflected in the capital accounts of its partners. Thus, Taxpayer's capital account at the beginning of Date 2 did not reflect Taxpayer's full economic entitlements upon liquidation. Thus, Taxpayer's capital account with respect to its newly-issued publicly-traded common units would have been below the capital account of the other publicly-

[488] See part II.M.4.f Issuing a Profits Interest to a Service Provider, especially II.M.4.f.ii.(a) Tax Effects of Issuing a Profits Interest.
[489] See parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.

> traded common units, which would have meant that Partnership's publicly-traded common units were no longer fungible. However, also on Date 2, Taxpayer's corporate owner Parent contributed approximately $e to Partnership in exchange for newly-issued publicly-traded common units of Partnership. As a result of this contribution, Partnership revalued its assets, crediting its partners' capital accounts to reflect how its built-in gain would be allocated if Partnership sold the assets. Partnership had sufficient unbooked built-in gain to equalize Taxpayer's capital account with respect to the c newly-issued publicly-traded common units without needing to shift capital from other partners or allocate extra taxable income to Taxpayer.

The CCA reasoned:

> The restructuring of Taxpayer's interest in Partnership was a readjustment of partnership items among existing partners, not a taxable exchange. Additionally, no taxable capital shift occurred; although the restructuring of Taxpayer's rights under the partnership agreement was not a revaluation event under § 1.704-1(b)(2)(iv)(f)(5) and did not itself affect Taxpayer's capital account, Parent's Date 2 contribution was a revaluation event under § 1.704-1(b)(2)(iv)(f)(5)(i) and Partnership had sufficient unbooked built-in gain in its assets to increase Taxpayer's capital account with respect to the newly issued common units without needing to shift capital from other partners.

If partnership does not have a revaluation event, it might want to consider memorializing allocations of unrealized gains and losses at the time of the event. But, if the partnership agreement does not clarify the partners' rights, a clarification will not be a taxable event. Letter Ruling 9821051, which did not mention any state law rights absent clarification, ruled that an amendment the following situation "will not result in the realization of income by the Partnership, Limited, or any of their respective partners":[490]

> The Partnership conducts a medical practice and currently owns a unit in Limited (the Units). Limited is a limited partnership that provides management services to the Partnership and other medical groups.
>
> Under the general partnership agreement (the Agreement), the Partnership does not have a fixed method to determine the current and future allocations of the Partnership's profits or losses from its disposition of the Units. The Partnership's profits and losses from the disposition of the Units are currently allocated based on the determinations of an executive committee, subject to certain minimum allocation requirements.
>
> Because of the financial success of Limited, the partners of the Partnership believe it is important to have a method of reasonably determining their respective shares of the proceeds from Partnership's disposition of the Units. To accomplish this, the Partnership intends to amend the Agreement to provide a mechanism to determine each partner's minimum share of the proceeds from the Partnership's disposition of the Units (the Amendments). As explained above, the potential gain or loss that would be realized

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[490] Without citing any regulations, the ruling commented:

> Section 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) is determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances) if (1) the partnership agreement does not provide for the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

> from the Partnership's disposition of the Units has not been allocated among the partners and is not reflected in the capital account of any partner.
>
> Under the Amendments, until a Liquidity Event occurs, the Partnership retains the legal title to the Units, all distributions and other profits on the Units will be paid to the Partnership, and to the extent the executive committee of the Partnership determines the distributions and profits on the Units are to be distributed to the partners, the allocation of any such items will be made by the executive committee under the terms of the Agreement. A Liquidity Event is any one of the following events: (1) Limited makes an initial public offering of its equity securities through a registration statement under the Securities Act of 1933, (2) Limited or its owners enter into a transaction with a party that, prior to such transaction, does not own an interest in Limited so that such party acquires equity securities of Limited resulting in such party having the power to elect a majority of Limited's governing body, or (3) Limited enters into a merger, reorganization, combination or acquisition transaction with another company and in such transaction the equity securities of Limited outstanding immediately prior to such transaction do not constitute, or are not converted into or exchanged for, a majority of the equity securities of the resulting entity outstanding immediately after such transaction. On the occurrence of a Liquidity Event, the Partnership will transfer to each partner the partner's share of the Units.

This ruling is important to the way many large law firms work. Every year, management determines how the partners share profits – including collections of accounts receivable using the cash receipts and disbursements method. Much administrative burden would be incurred if they had to account for unrealized income based on rights to profits when the bills were sent instead of when they were collected. Essentially, a large law firm's discretion to change annually how partners share in the receipt of accounts receivable reflects an agreement that no partner has a right to any bills collected in the following taxable year. Absent such a right, the accounts receivable could be reallocated. One might view this reallocation as violating the assignment of income doctrine, but as a practical matter receipts from bills need to be matched against the expenses incurred to clearly reflect the partnership's net income.

McKee comments:[491]

> Standing alone, §§ 704(a) and 761(c) appear to give persons who are partners during a particular period the right to allocate partnership income or loss for the period among themselves by agreement, without reference to the § 706 varying interests rules, provided only that the agreed allocations (1) satisfy the requirements of §§ 704(b) through 704(e), and (2) are entered into before the due date of the partnership return for the period.[79] Conversely, § 706(d) provides that if there is a change of any partner's interest in the partnership during the partnership year, each partner's distributive share must take into account the varying interests of the partners during the year.
>
> [79] S. Rep. No. 938, 94th Cong., 2d Sess. 98 (1976); accord HR Rep. No. 658, 94th Cong., 1st Sess. 124 (1975). See *Danny Curtis*, 70 TCM 205 (1995) (effort

[491] Within ¶12.04, "The Effect of Section 706(d) on the Power of Partners to Change Their Distributive Shares by Agreement," McKee, Nelson & Whitmire: *Federal Taxation of Partnerships & Partners* (WG&L) (quote copied 12/25/2022), this quote is found in ¶ 12.04[1] Contemporaneous Partners. In the same treatise, see also ¶ 16.04[2][b] Conversions of Interests in the Same Partnership.

retroactively to allocate to one member of equal two-person partnership income of partnership that was unreported owing to actions of such partner; attempt made after partnership's tax returns examined; retroactive allocation not respected because not timely under § 761(c); "innocent" partner liable for tax on his share of unreported income).

These statutory concepts are appropriately reflected in Regulations § 1.706-4(b)(1), which provides that the variance rules in Regulations § 1.706-4(a)(3) do "not preclude changes in the allocations of the distributive share of [partnership] items" among contemporaneous partners for an entire year (or any segment thereof if the item is entirely attributable to the segment) provided that the allocations are valid under § 704(b) and do not reflect variances attributable to contributions to or distributions from the partnership.

A somewhat related question is whether partners may reallocate their indirect interests in appreciation in partnership assets prior to its realization by the partnership. For example, suppose that equal partnership AB purchases an asset for $100 and then, when the asset has appreciated in value to $300 (while its book value for § 704(b) purposes remains $100), the partnership agreement is amended to allocate partnership gain 75 percent to A and 25 percent to B. Has A received a $50 taxable capital shift from B? Although the § 704 Regulations contain a vague hint that, in certain circumstances, a failure to restate capital to prevent a shift in unrealized appreciation may be taxable,[80] it seems quite clear that no taxable shift results when existing partners agree to adjust their interests in unrealized appreciation in partnership assets. Otherwise, any reallocation of profits by an existing partnership, for example, an accounting firm, would result in a taxable capital shift with respect to partnership assets if their fair market values differ from their book values. This conclusion is confirmed by a Private Letter Ruling in which the Service ruled that no tax consequences resulted from an amendment to a partnership agreement that fixed the partners' interests in certain appreciated partnership assets.[81]

[80] See Reg. § 1.704-1(b)(2)(iv)(f). The existing Regulations do not permit restatement of capital accounts in these circumstances. However, Prop. Reg. § 1.704-1(b)(2)(iv)(F)(5)(v) (2014) would allow it. See ¶ 10.02[2][c].

[81] Priv. Ltr. Rul. 9821051 (Feb. 23, 1998).

Conversely, the Service has concluded that a state court's retroactive award, in a divorce proceeding, of a spouse's community property rights in a partnership interest should not be given effect for tax purposes.[82] The court's order purported to be retroactive, thus giving the spouse an interest in the partnership commencing in a taxable year prior to the date of the award. The Field Service Advice states that the Service does "not believe that the ... order should be given retroactive tax effect," because "state court orders that retroactively change the rights of the parties or the status of payments are not given retroactive effect for federal tax purposes." For this proposition, the Service did not cite § 704 or § 706, but relied instead on *Arthur Z. Gordon*,[83] in which the Tax Court held that state court orders redesignating divorce-related payments as alimony (and not child support)—or vice versa—are disregarded for federal income tax purposes even if the order retroactively changes the rights of the parties or the legal status of the payments. The Service also determined that the tax benefit rule could not be applied on these facts to achieve the same effect as the retroactive reallocation.

[82] FSA 200128031 (Apr. 12, 2001).

[83] *Arthur Z. Gordon*, 70 TC 525 (1978) .

Reg. § 1.721-1, "Nonrecognition of gain or loss on contribution,"[492] informs this discussion in a different context in subsection (b):

(1) Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest. To the extent that an interest in capital representing compensation for services rendered by the decedent prior to his death is transferred after his death to the decedent's successor in interest, the fair market value of such interest is income in respect of a decedent under section 691.

(2) To the extent that the value of such interest is: (i) compensation for services rendered to the partnership, it is a guaranteed payment for services under section 707(c); (ii) compensation for services rendered to a partner, it is not deductible by the partnership, but is deductible only by such partner to the extent allowable under this chapter.

Reg. § 1.721-1(b) taxes a partner giving up any part of his right to be repaid his contributions but not giving up a share in partnership profits. In determining when income is realized, it looks to "all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest." Returning to my large law firm example above, if a partner is not entitled to any portion of accounts receivable collected after yearend because the partnership agreement allocates each year's collections separately, then no partner in the first year is entitled to those accounts receivable and has not given up rights to those receivables when allocated in the following year.

Willis, Postlewaite & Alexander, *Partnership Taxation*, addresses these issues in ¶ 6.06. Tax Consequences of a Flip in Partners' Interests in Profits or Losses. Among the cases cited is

[492] See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.

Lipke v. Commissioner, 81 T.C. 689 (1983), the Official Tax Court Syllabus to which summarizes:

> Marc Equity Partners I, a limited partnership, was organized in 1972 for the purpose of acquiring and operating apartment buildings. Shortly after formation, limited partnership interests were sold to 14 investors for a total amount of $1,175,000. All profits and losses were allocated to these limited partners.
>
> In 1974 and 1975, the partnership experienced severe financial problems which necessitated additional capital contributions. On Oct. 1, 1975, six of the original limited partners, one of the general partners, and three other persons (herein collectively referred to as the class B limited partners) contributed a total of $300,000 to the partnership in exchange for limited partnership interests. An Oct. 1, 1975, amendment to the partnership agreement reallocated 98 percent of all of the partnership's 1975 profits and losses to the class B limited partners in consideration for these additional capital contributions. The remaining 2 percent of the partnership's 1975 profits and losses was reallocated to the general partners.
>
> *Held*: The reallocation of losses accrued by the partnership before October 1975, to the class B limited partners is not permitted by sec. 706(c)(2)(B), I.R.C. 1954, because it was made as a result of the additional capital contributions. It makes no difference that the additional capital was contributed by, and the resulting retroactive reallocation was made to, both new and existing partners. *Richardson v. Commissioner*, 76 T.C. 512 (1981), *affd*. 693 F.2d 1189 (5th Cir. 1982), extended. Held, further, the partnership's retroactive reallocation of losses to the general partners is permissible since it did not result from additional capital contributions. Held, further, the partnership is not now entitled to use the "year-end totals" method of accounting in order to allocate its 1975 losses ratably over the year.

The court reasoned and held:

> The primary issue is whether the partnership properly allocated its 1975 losses among its partners. Respondent contends that section 706(c)(2)(B) prevents the partnership from reallocating losses accrued before October 1,1975, to either the class B limited partners or to the general partners. Petitioners counter that prior to the Tax Reform Act of 1976, section 706(c)(2)(B) did not prevent the retroactive reallocation of losses to new partners. Petitioners further argue that, even assuming former section 706(c)(2)(B) governs situations involving the admission of new partners, it does not prevent the retroactive reallocation of losses to those petitioners who were already partners when the reallocation was made. For the following reasons, we hold that the partnership's retroactive reallocation of losses to the class B limited partners was not permitted by section 706(c)(2)(B) because it was made as a result of additional capital contributions. It makes no difference that the additional capital was contributed by, and the resulting retroactive reallocation was made to, both new and existing partners. However, we also hold that the partnership's retroactive reallocation of losses to the general partners was permissible since it did not result from additional capital [pg. 696]contributions and, therefore, constituted nothing more than a readjustment of partnership items among existing partners.

Section 702(a) requires a partner to report his distributive share of the partnership's income or loss. With certain exceptions, section 704(a) provides that a partner's distributive share is to be determined by the partnership agreement.[12] A partnership agreement includes any amendments made before the time for filing the partnership return. Sec. 761(c). However, section 706(c)(2) provides for certain tax consequences to a partner whose partnership interest changes during the partnership's taxable year. Prior to the Tax Reform Act of 1976, that section provided in part as follows:

> The taxable year of a partnership shall not close (other than at the end of a partnership's taxable year as determined under subsection (b)(1) with respect to a partner who sells or exchanges less than his entire interest in the partnership or with respect to a partner whose interest is reduced, but such partner's distributive share of items described in section 702(a) shall be determined by taking into account his varying interests in the partnership during the taxable year. [Emphasis added.]

[12] Respondent does not contend herein that the principal purpose of the partnership's allocation of its 1975 losses was the "avoidance or evasion of any tax" within the meaning of sec. 704(b)(2) as in effect during that year. *Cf. Goldfine v. Commissioner*, 80 T.C. 843 (1983).

In *Richardson v. Commissioner*, 76 T.C. 512 (1981), *affd*. 693 F.2d 1189 (5th Cir. 1982), this Court ruled that even prior to the Tax Reform Act of 1976, section 706(c)(2)(B) was applicable to situations involving the admission of new partners.[13] Therein, we held that the reduction in the capital interests of the original partners resulting from the admission of the new partners constituted a reduction of interest within the meaning of section 706(c)(2)(B). The fact that the original partner's equity interests in the partnership remained the same was deemed to be irrelevant. Accordingly, under section 706(c)(2)(B), the original partners and the new partners were required to determine their distributive shares of partnership items by taking into account their varying interests in the partnership during the taxable year. Thus, a retroactive reallocation of partnership items to the new partners was not allowable. See also *Moore v. Commissioner*, 70 T.C. 1024, 1031 (1978).

[13] After the phrase "with respect to a partner whose interest is reduced," the Tax Reform Act of 1976 inserted into sec. 706(c)(2)(B) the parenthetical "whether by entry of a new partner, partial liquidation of a partner's interest, gift, or otherwise." This Court determined in *Richardson v. Commissioner*, 76 T.C. 512 (1981), *affd*. 693 F.2d 1189 (5th Cir. 1982), that this amendment merely codified prior law.

Although petitioners admit Richardson is directly on point with respect to the allocation of losses to the new partners in the instant case, they contend that the case was wrongly decided and now ask us to overrule it. However, buttressed by the affirmance of our decision by the Fifth Circuit Court of Appeals, we are fully satisfied with our decision in Richardson and are therefore unwilling to overrule it. See also *Hawkins v. Commissioner*, 713 F.2d 347 (8th Cir. 1983), *affg*. a Memorandum Opinion of this Court; *Snell v. United States*, 680 F.2d 545 (8th Cir. 1982); *Williams v. United States*, 680 F.2d 382 (5th Cir. 1982). Accordingly, since petitioners James, Francis, and Lipke were newly admitted as partners on October 1, 1975, they are not entitled to report losses accrued by the partnership prior to that date.

> We also hold that section 706(c)(2)(B) prevents the retroactive reallocation of losses to petitioner Reger as a limited partner even though he was already a partner when he made his additional capital contribution. Together with the new capital contributions made by the new partners and by six of the original limited partners, Reger's additional capital contribution reduced the capital interests of the noncontributing partners. For purposes of section 706(c)(2)(B), we find no difference between a reduction in partners' interests resulting from the admission of new partners, as in Richardson, and, as here, the reduction in partners' interests resulting from additional capital contributions made by existing partners. In both situations, partners' interests were reduced and retroactive reallocations were made as a result of the additional capital contributions. We are unwilling to sustain, for example, the retroactive reallocations of losses made to petitioner Reger merely because he had previously contributed $34 to the partnership, and yet deny petitioners Lipke, James, and Francis that same benefit because they were new partners. That would create an illusory distinction which the language of section 706(c)(2)(B) simply does not require us to make.
>
> With respect to the partnership's retroactive reallocation of losses to the general partners, however, we find that it did not result from additional capital contributions and therefore did not contravene the varying interest rules of section 706(c)(2)(B). Prior to October 1, 1975, the general partners held only a residual interest in gains arising from "major capital events." See note 5 supra. Pursuant to the October 1, 1975, amendment to the partnership agreement, however, the general partners were granted a 2-percent interest in the partnership's 1975 profits and losses including the losses accrued by the partnership during the preceding 9 months. In contrast to the retroactive reallocation of losses to the class B limited partners, this reallocation to the general partners was not made in consideration for additional capital contributions. General partners Rautenstrauch and Luksch made no additional capital contributions and Reger's contribution was made in exchange for a limited partnership interest, not for an increase in his interest as a general partner. Accordingly, this reallocation of losses to the general partners was not directly accompanied by a reduction in any other partner's capital interest within the meaning of section 706(c)(2)(B). It constituted nothing more than a readjustment of partnership items among existing partners which, by itself, is permissible. *Smith v. Commissioner*, 331 F.2d 298 (7th Cir. 1964), *affg*. a Memorandum Opinion of this Court; *Foxman v. Commissioner*, 41 T.C. 535 (1964), *affd*. 352 F.2d 466 (3d Cir. 1965). See *Moore v. Commissioner*, 70 T.C. 1024, 1033 (1978).

McKee also suggests comparing *Silberman v. Commissioner*, TC Memo 1983-782, which in turn quoted the following statement from *Moore v. Commissioner*, 70 T.C. 1024, 1031-1032 (1978):

> Where a partner sells or exchanges less than his entire interest, section 706(c)(2)(B) requires that the transferor partner determine his distributive share "by taking into account his varying interests in the partnership during the taxable year." Sec. 1.706-1(c)(4), Income Tax Regs. It follows that the transferee's distributive share must also be determined by taking into account his varying interests in the partnership. See generally H. Rept. 94-658, 1976-3, C.B. (Vol. 2) 695, 815-816; S. Rept. 94-938, 1976-3 C.B. (Vol. 3) 49, 96. Since a partner who transfers his entire interest is required to report his distributive share of partnership items for the period he was a partner *and cannot transfer retroactively those items to the transferee*, it is reasonable to conclude that Congress intended for the transferor and transferee of a partial interest to determine the variation in their interests in the same manner. There is no reason to believe Congress

> intended to allow the transferor of a partial interest to assign his distributive share of partnership items occurring before the transfer and deny a similar privilege to the transferor of an entire interest. Consequently, we conclude that when there is a transfer of a partial partnership interest, section 706(c)(2)(B) requires the transferor to report his distributive share of partnership items for the period before the transfer, requires the transferor and transferee to report their distributive shares of partnership items for the period after the transfer, and prohibits the retroactive shifting of such interests. [Emphasis in original.]

Silberman concluded:

> … no changes in partnership membership occurred during partnership taxable year 1976, and the allocations as set forth in the partnership agreement will be respected. During partnership taxable year 1975, however, several changes in partnership membership occurred. Two of the three original partners, Rosenberg and Waldman, transferred their interests in the partnership by amendment to the partnership agreement or by execution of a document entitled "Sale of Limited Partnership Interest." Furthermore, all petitioners in this case were added as partners at various dates throughout the partnership taxable year. The allocation of interests among the three original partners[11] was amended to reflect the allocations included in the amendments to the partnership agreement.[12] Under these circumstances, section 706(c)(2)(B) requires that distributive shares of partnership items must be allocated to reflect the changing membership of the partnership during taxable year 1975. See *Richardson v. Commissioner*, 76 T.C. 512 (1981), *affd*. 693 F.2d 1189 (5th Cir. 1982); *Moore v. Commissioner*, *supra*; *Rodman v. Commissioner*, T.C. Memo. 1973-277. See also *Hawkins v. Commissioner*, 713 F.2d 347 (8th Cir. 1983); *Williams v. United States*, 680 F.2d 382 (5th Cir. 1982); *Snell v. United States*, 680 F.2d 545 (8th Cir. 1982); *Lipke v. Commissioner*, 81 T.C. 689 (1983).
>
> [11] All partners were to share equally in the profits at 33⅓ percent each. Each of the two limited partners was to receive 45 percent of the losses, and the general partner was to receive 10 percent of the losses.
>
> [12] Each limited partner was entitled to profits of three times his or her capital investment and to losses of two times his or her capital investment.

Banoff, "Partnership Ownership Realignments via Partnership Reallocations, Legal Status Changes, Recapitalizations, and Conversions: What Are the Tax Consequences?" 83 Taxes 105 (2005),[493] categorizes various changes to partnerships as follows:

> These changes can be classified in four basic forms which are discussed herein: (1) partnership profits/profits and loss reallocations; (2) partnership and partner legal status changes; (3) partnership recapitalizations; and (4) partner interest conversions.
>
> "Partnership reallocations" refers to changes in the partners' profits (or profits and loss) allocations, typically in the form of a special allocation, to reflect a change in their economic arrangement for sharing distributions, in accordance with Code Sec. 704(b).[2]

[493] Thompson Coburn doc. no. 6217476.

[2] Payments in respect of funds provided by a partner to his partnership generally constitute one of five categories: (1) interest on debt (see Code Sec. 707(a)); (2) guaranteed payments for the use of capital (Code Sec. 707(c)); (3) gross income allocations that are not characterized as guaranteed payments (Code Sec. 702(c)), (4) net income preferential allocations (Code Secs. 702(a)(7) and 704(b)); and (5) residual income allocations (Code Secs. 702(a)(8) and 704(b)). For purposes of this article, payments in categories (4) and (5) are the most relevant and are discussed in several of the examples.

Partnership or partner "legal status changes" (commonly known as "conversions" in IRS rulings and tax literature) refers to changes in the legal status of the unincorporated entity (*e.g.*, a change from a general partnership to a limited partnership, LLP or LLC) and/or a change in the legal status of one or more of the members (e.g., a general partner becoming a limited partner or LLC member), with no change in the members' economic ownership interest in capital, profits and losses.

"Partnership recapitalizations" includes changes in the economic interests of one or more partners which typically are reflected through the issuance of a different class of interests; inherent in the class are certain economic rights, preferences and/or priorities which may be transferred or assigned (akin to preferred stock or common stock) with the necessary approvals required by the partnership agreement. As used herein, a partnership recapitalization requires the approval of some percentage (e.g., a majority or greater percentage-in-interest) of the members of the partnership, akin to the shareholders or directors of a corporation approving a corporate recapitalization of the corporation's stock. In a partnership recapitalization there is no legal status change of the unincorporated entity or in the liability exposure of the partner.

"Partner interest conversions" refers to the unilateral exercise of a partner's ("conversion") right to receive a partnership interest with different economic rights, which replaces his existing ("convertible") interest in the same unincorporated entity. The conversion effectuates an isolated decision by the partner to exercise his privilege. As used herein, there is no change in the legal status of the unincorporated entity or the liability exposure of the partner whose interest is converted; only in his rights to capital and/or profits and/or losses.

Banoff then analyzes the law and concludes [footnotes omitted]:

1) Partnership reallocations of profits and losses undoubtedly are nonrealization events.

2) Partnership and partner legal status changes are governed by Code Sec. 721 treatment, but little thought need be given to the tangential tax consequences that arise therefrom (much less to consider the numerous approaches discussed in this article).

3) Partnership recapitalizations are tax free under Code Sec. 721 because changes in legal status, which also involve partner interest realignments, are tax free under Code Sec. 721, courtesy of Rev. Rul. 84-52. (The key prerequisite in Rev. Rul. 84-52 (as noted by the Tax Court in *Matray*), *i.e.*, that it only applies to situations where none of the partners change any interest in capital, profits and losses, is apparently never reconciled with the fact that such changes automatically occur in every partnership recapitalization.)

4) Partner interest conversions will be treated akin to corporate stock conversions or recapitalizations, *i.e.*, as somehow being tax-free, while not contemplating the potentially adverse tangential tax consequences (including possible “corrective” gross income allocations to the converting partner which may spring up immediately after the conversion) as would be required by the proposed regulations on noncompensatory partnership options.

Banoff further suggests the following principles:

1. In determining whether a partnership ownership realignment is a taxable event for which gain or loss is reported by one or more partners (and the partnership), there must first be realization, and recognition in absence of the application of a nonrecognition provision.

2. All four types of partnership ownership realignments could merely be considered as adjustments to the contractual arrangement among the partners that do not rise to the level of an “exchange” for realization purposes under Code Sec. 1001.

3. If the hair trigger of *Cottage Savings* extends to subchapter K, all four types of partnership ownership realignments likely would be realization events.

4. Subchapter K, as a matter of legislative policy, is intended to promote flexibility, simplicity and equality among those using the partnership form. The objectives of subchapter K would be sabotaged if partnership reallocations are viewed as realization events (absent an applicable nonrecognition provision). Therefore, there should be a relaxed concept of realization applicable in subchapter K. Cottage Savings should not be extended to partnership reallocations.

5. Partnership recapitalizations which in substance merely change the partners’ interests in future profits (or profits and losses) should be treated for tax purposes in the same manner as partnership reallocations. The mere classification or delineation of differing economic interests in profits and losses, in the form of “common interests” or “preferred interests” should not change their economic equivalence to that of vanilla reallocations. Similarly, the unitization of such interests as “common units” or “preferred units” (resembling and being quantified like shares of stock) should not change their economic equivalence to that of mere partnership reallocations of profits and loss.

6. Absent a capital shift among the partners, partnership recapitalizations should not be realization events, just as reallocations should not be.

7. Partnership recapitalizations which result in capital shifts resemble realization events, as there is something more happening than a mere change in the partner’s allocable share of future profits (or profits and losses).

8. The (potential) economic equivalence of partnership reallocations, partnership recapitalizations and partner interest conversions (as demonstrated in Examples 1A, 3 and 5) provide a compelling case for treating all three types of realignments in the same fashion.

9. However, subchapter K, founded on the aforementioned principles including flexibility and simplicity, has generally given full effect to the form partners select to conduct their transactions. Having claimed their form, taxpayers and their tax advisors can understand (and should be responsible for) the tax consequences of their choice. An exception to the principle of permitting form to control in subchapter K is when clear tax policy (whether established by statute or regulations) requires to the contrary.

10. There is no clear answer whether substance (as reflected in 8, above) or form (as reflected in 9, above) is the correct approach to characterizing the treatment of these different forms of partnership ownership alignments for tax purposes.

11. Subchapter C serves as a useful benchmark for subchapter K, with respect to equity ownership realignments. Subchapter C (particularly Code Sec. 368) is rich in its history and development, both by case law and Congressional responses thereto. In contrast, subchapter K is not the product of 75 years of judicial, regulatory and legislative development as to partnership ownership realignments and restructurings. One cannot conclude that subchapters K and C are running on parallel tracks for purposes of dealing with partnership realignments.

12. Subchapter C, on balance, is not a compelling analogy for purposes of our subchapter K situations. The corporate world's tax rules serve a completely different master, *i.e.*, to sanctify restructurings involving a complete entity approach (with judicial doctrines focusing on, inter alia, continuity of the entity's business enterprise and the presence of an entity-level business purpose).[342] Inherent in subchapter C's provisions is the assumption that realization occurs under Code Sec. 1001 for every type of corporate reorganization, necessitating the need for rigid statutory nonrecognition provisions under Code Sec. 354, 361 and 368(a)(1) designed to give explicit guidance and protection to restructurings of the corporate entity.

    [342] It is recognized that unlike other corporate reorganizations, a recapitalization under Code Sec. 368(a)(1)(E) and a mere change in corporate identity or form under Code Sec. 368(a)(1)(F) are less subject to these additional corporate-type doctrines. For example, recently promulgated Proposed Reg. § 1.368-1(b), in amending the introductory portion of the "overview" regulation on reorganizations, would prospectively add an exception for such recapitalizations and reincorporations from the generally applicable continuity of proprietary interest and continuity of business enterprise requirements. See REG-106889-04 (Aug. 12, 2004); Jasper L. Cummings, Jr., *Three New Sets of Proposed Regs. Should Make Planning for Reorganizations Much Easier*, 101 J. TAX'N 271, 284 (Nov. 2004).

    In contrast, subchapter K takes much more of an aggregate approach to ownership realignments. Indeed, partnership reallocations of profits and losses and the partners' respective rights inter sese solely affect the partners, not the partnership; judicial doctrines have not developed as to partnership realignments and restructurings, and in general such realignments have not been the focus of legislative, judicial or administrative activity or the object of taxpayer misuse and abuse. For these and other reasons, subchapter C treatment of corporate entity restructurings should not be dispositive for subchapter K purposes; and the absence of a statute in subchapter K comparable to Code Sec. 368 does not imply that all or some partnership realignments are both realization and recognition events.

13. If partnership ownership realignments are realization events, then a nonrecognition provision must be found (or one created) to avoid the absurd result that longstanding Congressionally sanctioned flexibility among the partners is to be thwarted by potential recognition of gain (or loss) each time the partners take advantage of that flexibility in their restructurings or reallocations.

14. Capital shifts, whether arising in a partnership recapitalization, a partner interest conversion, or even a partnership reallocation of previously allocated (not future) profits, are a whole other matter. Capital shifts are slippery creatures; unlike Justice Potter Stewart's definition of obscenity, [footnote omitted] I don't (always) know it when I see it. Capital shifts may have tax consequences, immediate or otherwise. Capital shifts may signify "something else is going on" among the partners and/or the partnership that the tax law rightly must deal with, *e.g.*, an indirect gift, the payment of compensation, or the satisfaction of some obligation.

15. Code Sec. 721 is the primary statutory provision that gives credence to nonrecognition treatment in the context of partnership realignments and restructurings (which by definition involve the ownership interests of one or more of its partners). Neither Code Sec. 721 nor its accompanying regulations provides a model of clarity or even a crude roadmap for that Code Section's application to partnership realignments.

16. Code Sec. 721 was selected by the IRS as the "poster child" for the characterization of legal status changes, commencing with Rev. Rul. 84-52 and continuing for partner interest conversions under the proposed regulations. If that's the horse one must ride to get away from the realization/recognition quagmire, one must be careful where that horse takes us. The characterization of partnership ownership realignments as Code Sec. 721 "interest-over" (or "interest-in"?) transfers is not a good fit, as noted by my fellow commentator.[344] Moreover, the tangential tax consequences that flow from Code Sec. 721 treatment are unclear; support exists for a broad approach, a narrow approach, and several intermediate or limited approaches, including three discussed in this article. In the name of simplicity, is it too late to go back to the "no sale or exchange" (nonrealization) approach to legal status changes, which was the IRS's stated position prior to issuance of Rev. Rul. 84-52, and generally apply that concept to partnership ownership realignments?

[343] Philip F. Postlewaite, The Transmogrification of Subchapter K, TAXES, Mar. 2005, at 189.

17. Two (or more) partners wishing to enter into a mirror-image recapitalization can accomplish their objective either through simultaneous exchanges of their respective (*e.g.*, preferred and common) interests with the partnership (*i.e.*, as a recapitalization as illustrated in Example 3A) or as direct exchanges of interests between themselves (as in Example 3B). A direct exchange between the partners looks and smells like a realization event, even though both of the exchanging partners alternatively could have reached the same economic result through an amendment of the partnership agreement that provides for a mere reallocation of future profits and loss (as in Example 1A). If the form selected by the partners should control, then a direct exchange may have substantially different tax consequences (as to realization and recognition of gain or loss, and as to tangential tax consequences) when compared to its functionally equivalent recapitalization or reallocation counterparts.

18. The tax treatment of mirror-image recapitalizations is open to substantial debate; support exists for several alternative approaches. Similarly, the tax treatment of direct exchanges of preferred and common interests remains open to debate. The transaction may be characterized as a tax-free swap by the partners of interests in the partnership; as a taxable swap by the partners of partnership interests; as a recharacterized recapitalization; as a recharacterized reallocation of profits and loss; or perhaps something else still.

19. It is possible that the treatment of preferred-to-common partner conversions in the proposed regulations is materially different from that of preferred-to-common partnership recapitalizations. However, none readily comes to mind.

20. The tangential tax consequences of all four of these partnership ownership realignment mechanisms is uncertain in whole or substantial part, and largely depends on how each mechanism is characterized.

21. No matter what conclusions one properly reaches on the many open issues raised in this paper, there seems to be some authority for almost everything, even if only via a well-reasoned construction of the applicable statutory provisions (which for now primarily are Code Secs. 721, 1001 and 1031), and their legislative histories.

Query whether each alternative interpretation rises to the level of constituting "substantial authority,"[345] for purposes of taxpayers' avoiding the substantial understatement of income taxes penalty under Code Sec. 6662, or to the level of a "realistic possibility of success,"[346] to avoid tax return preparer penalties under Code Sec. 6694.

[345] Reg. § 1.6662-4(d).

[346] Reg. § 1.6694-2.

So where do we go from here? It would appear that a statutory or regulatory solution to provide clarity on relevant aspects of realignments would be preferable. Statutes trump regulations, which can be held invalid, just as rock beats scissors. However, obtaining corrective tax legislation has not been a priority of Congress in recent years, particularly with respect to subchapter K provisions which are not viewed as revenue raisers or tax shelter loophole pluggers.

As a practical matter, therefore, a regulation (or package of regulations) dealing with clarification of the tax consequences of partnership realignments would be the more viable, if not preferable, solution. Just as scissors cuts paper, regulations trump revenue rulings and letter rulings, for purposes of taxpayer reliance and application by IRS agents and ultimately the courts. Partnership realignments and restructurings generally should be encouraged, absent an abusive tax purpose (which is rarely the case), and in any event the IRS and Treasury certainly know how to write partnership anti-abuse rules where the government perceives the need to do so.[347] Any regulatory clarification is likely to be given prospective effect only, pursuant to Code Sec. 7805(b); however, references in the preamble to any such regulations' clarification of existing law (perhaps coupled with an election granted to taxpayers to provide retroactive effect) might be sufficient to clarify the tax aspects of some existing partnership realignment transactions.

[347] *E.g.*, Reg. § 1.701-2. See, *e.g.*, Sheldon I. Banoff, *Anatomy of an Anti-Abuse Rule: What's Really Wrong with Reg. Section 1.701-2*, 66 TAX NOTES 1859 (Mar. 20, 1995); Sheldon I. Banoff, *The Use and Misuse of Anti-Abuse Rules*, 48 TAX LAW. 827 (Spring 1995); Joseph F. Schlueter, *The Partnership Anti-Abuse Rule: A Chronological Perspective*, 6 J. PASSTHROUGH ENTITIES 37 (July–Aug. 2003).

Still another alternative would be the issuance of guidance in the form of one or more revenue rulings,

containing illustrations of relevant fact patterns. This paper has identified what little guidance exists in the area of partnership ownership realignments to have arisen in the form of revenue rulings (primarily Rev. Rul. 84-52 and Rev. Rul. 95-37) and letter rulings (*i.e.*, those predating Rev. Rul. 84-52, with respect to legal status changes, and LTR 200345007, dealing with partnership recapitalizations and partner interest common-to-preferred and preferred-to-preferred conversions). Revenue rulings can address a few particular fact patterns and, when appropriate, provide a way for the IRS to reconsider and/or reverse its prior position, as it did with respect to permitting form to control (where the tax consequences of a partnership's incorporation can differ, depending upon the form chosen) in Rev. Rul. 84-111, which effectively overturned Rev. Rul. 70-239. The disadvantage of returning to the revenue ruling route to readdress partnership realignments is that the process likely would not get the breadth of input and review as would a proposed regulation. Moreover, the authoritative status of a revenue ruling is substantially less than that of a regulation, and less likely to be respected by the courts;[348] however, some courts do defer to revenue rulings—it's just hard to predict when they will do so.[349]

[348] See *Banoff*, note 249, *supra*.

[349] See, *e.g.*, *Business Ventures Int'l v. Olive*, CA-3, 893 F2d 641. *Also see* Shop Talk, *Challenge Revenue Ruling? Pay Negligence Penalty!* 77 J. TAX'N 62 (July 1992).

On balance, we would not recommend a revenue ruling as the sole solution (although rulings, notices or other IRS guidance that interpret or apply any legislative or regulatory fix would most likely be useful and welcomed). The answers to the questions raised in this paper appear to be too important (and - in a perverted sense, which sentiment seemed to be shared by many in attendance when we presented this paper - too much fun and consternation, intellectually) to leave solely to the IRS in a rulings project. We recall that, over 20 years ago, the Tax Court in *Applebaum* sidestepped the question of whether a change in legal status constitutes an exchange for tax purposes, identifying it as "such an important issue,"[350] and finding other grounds to dispose of the case at hand. We think the same is true today, and even more so with respect to the broader issue of the treatment (and interrelationship) of all the forms of partnership ownership realignments discussed herein, even as to the relatively simplistic situations covered in this paper.

[350] *Applebaum*, *supra* note 72, 43 TCM, at 1423.

Hopefully, this article proves helpful in identifying these issues and the number of alternative treatments which may be applicable. We leave it to the Treasury (perhaps in its finalization of the proposed regulations, hopefully as appropriately modified to deal with issues raised herein; perhaps in a new regulations project), the IRS and the courts to identify which treatments should control. We are compelled to remind our readers and IRS and Treasury rules-drafters) that, in limiting its assumptions,[351] this paper has purposely dodged a number of really hard issues that also must be considered, in providing much-needed clarification for partnership ownership realignments. Notwithstanding the numerous technical issues and areas in need of clarification as described herein, it is submitted that as a matter of policy the tax consequences of such business transactions should generally be neutral for the partnership and both its participating and non-participating partners. Partnership ownership realignments are not inherently abusive or suspect transactions; unlike his fellow commentator,[352] this author does not fault the IRS and the Treasury for grappling during the past 25 years to find a result of nontaxability in such realignments - even absent explicit statutory or regulatory authority on point. The Treasury and the IRS recognize that subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities without incurring an entity-level tax.[353] One commentator dryly summarized this flexibility (in an article published two days after this Tax Conference) as follows: "The whole premise of Subchapter K is summed up in the notion that tax law will not interfere with the joint pursuit of profit as long as the joint pursuit of profit does not interfere with the tax law."[354] Partnership ownership realignments do not interfere with the tax law; therefore, it is submitted that subchapter K must be interpreted (or, if need be, amended) so as not to interfere with a wide variety of partnership ownership realignments that for valid nontax reasons are being widely undertaken.

[351] *E.g.*, that there are no new partner admissions or withdrawals and thus no redemptions or liquidations of partnership interests; that the partners are unrelated parties acting arm's length, and that there is no infusion of capital (i.e., cash or other property) to the partnership from any partner. See "Introduction," *supra*.

[352] See Postlewaite, *supra* note 344.

[353] Reg. § 1.701-2(a).

[354] Darryll K. Jones, *Complexity is Good*, 105 TAX NOTES 1003 (Nov. 15, 2004).

Postlewaite, "The Transmogrification of Subchapter K," Taxes (3/1/2005),[494] commented on Sheldon Banoff's article above [most footnotes omitted]:

III. Form - Present and Accountable or Missing in Action?

Shelly in his paper raises a fundamental problem with partnership restructurings, particularly when they do not involve clearly identifiable steps in the reorganization of the enterprise. In the absence of legislation, how is such an event configured for tax purposes? For example, one second the enterprise is a general partnership, the next it is an LLC. Seldom is there an actual step-by-step procedure that is followed in effectuating the restructuring of the enterprise. At best, if knowledgeable tax counsel is involved, there is a mere recital in the governing document, crafted to establish, if respected, the desired treatment for tax purposes as to how the transaction is to be conceptualized.

[494] Thompson Coburn LLP doc. no. 6217488.

A. Shelly's Views on Form and the Initial Openness of the IRS to Such Matters

Shelly places the issue squarely before us. Initially, he instructs that: "Indeed, the changes in the entity's legal status can be accomplished in various forms." Thereafter, he recounts the variations on a theme - assets over, assets up, interests over, statutory merger and statutory conversion, which vie for application in a partnership restructuring. However, in reality, could it be that many of these restructurings are formless transactions and thus form has little or no effect on their essence? If so, how should this phenomenon impact the tax treatment of such restructurings?

In another of his offerings to the University of Chicago Tax Conference, Shelly ruminated on issues of form and substance regarding changes in an entity's legal status. Therein, Shelly employed a number of models addressing similar changes in form and offered a variety of approaches. He ultimately advocated "permitting form to control, except in those situations where Congress or the courts have mandated a contrary approach." Emphasizing that different tax consequences may prove determinative, he noted, "Where different substantive tax consequences may arise depending on the route taken, with each route having the same economic effect - *i.e.*, a change in form of legal entity - then taxpayers should be permitted to select (and thereby be bound by) the tax consequences that arise from the form of the conversion utilized." Implicit in his proposal is that form plays a significant role in the restructuring. Such may well be the case in the movement between one subchapter of the Code to another, *e.g.*, corporation to partnership, but appears to be less certain for movement within a specific subchapter, *e.g.*, general partnership to limited partnership.

Shelly's expansive treatment is similar to that permitted by the IRS on the incorporation of a partnership. In Rev. Rul. 84-111, form was not only tolerated but practically encouraged. Therein, three conceptual models were used in characterizing the transformation of the partnership and thereby determining the tax consequences of the transaction. The IRS acknowledged that a single event, the incorporation of a partnership, could be effectuated in one of three ways.

In Rev. Rul. 84-111, the IRS concluded that there are three procedures available for incorporating a partnership: (1) the transfer of the partnership assets by the partnership to a corporation followed by a distribution of the corporate stock to the partners, *i.e.*, assets over; (2) a transfer of the partnership interests by the partners to the corporation in return for stock and a distribution of the partnership's assets to the corporation, *i.e.*, interests over; and (3) a liquidation by the partners of the partnership followed by a transfer by the partners of the distributed assets to the corporation in return for stock, *i.e.*, assets up.

It would be excessive for purposes of our discussion to present the various hypothetical settings which would illustrate the different tax consequences generated which of the methods is selected to govern the incorporation. Shelly and I have done so in other work. Suffice it to say that the basis of the assets to the corporation and the basis of the stock to the partners may differ depending upon the method selected. Similar differences may arise with respect to the holding period for the assets and the stock, recognition upon the transfer, the characterization of the gain and other tax issues.

The IRS concluded that it would respect the form selected because, depending on the format chosen for the transfer to a controlled corporation, the basis and holding periods of the various assets received by the corporation and the basis and holding periods of the stock received by the former partners can vary. Acceptance of the form selected facilitates flexibility, an intended consequence for transactions arising under subchapter K.

B. Recent Indications by the IRS That It Will Impose Form

Surprisingly, after this initial acquiescence regarding the restructuring of an enterprise, the IRS has been inconsistent and intolerant on these matters. On elective incorporations, even though they involve movement between subchapters, the check-the-box regulations insist upon an assets-over approach. The preamble to those regulations emphasized that the mandated configuration was selected in an attempt “to minimize tax consequences of the change in classification and achieve administrative simplicity.” However, the single method configuration imposed by the regulations for elective treatment was not intended to impact the triple method vitality of Rev. Rul. 84-111 and the flexibility afforded participants upon an actual conversion of a partnership to a corporation.

Furthermore, regarding the role of “form” in entity conversions, the IRS recently addressed an actual conversion of a partnership into a corporation where state law did not require a transfer of assets or interests.[44] Applying the same treatment mandated for elective conversions from partnership status to corporate status, the IRS was singular in its approach, mandating an assets-over approach. While neither a transfer of assets nor a transfer of interests was required under state law, it was unclear from the ruling whether such transfers were prohibited under state law. Nevertheless, the IRS rejected any other conceptualization of the method through which the change of status was effectuated. The IRS failed to permit the flexible approach of Rev. Rul. 84-111 to apply because the conversion was “formless” under local law.

[44] *See* Rev. Rul. 2004-59, IRB 2004-23, 1050.

C. Taxpayer Election of Form on Partnership Transactions

Why is the latitude available to taxpayers on actual conversions not extended to actual conversions involving “formless” incorporations as well as elective conversions? If partnership restructurings are conceptualized as occurring under Code Sec. 721, similar issues present themselves as to whether a stipulation of form or adoption of the steps involved in an assets-up, assets-over or interests-over characterization should govern the tax consequences of the transaction, particularly since movement within a subchapter may be devoid of form itself.

The tax technicalities of these activities should be minimized. Parties should decide their preferred tax treatment, they should agree to report the transactions consistently both for themselves and the partnership, and the IRS should accord their choice controlling governance. Once made, the form selected should be irrevocable. With the appropriate modification by the IRS, its administrative pronouncements should be expanded to provide that all three methods (assets over, assets up and interests over) of conceptualizing the incorporation of a partnership are available in actual or elective conversions as well as in partnership restructurings. Whichever configuration is chosen by the parties should govern for tax purposes.[45]

[45] There should be no reason to craft a default rule since by definition the parties will have adopted an approach by the end of the tax year as will be evidenced by their basis calculations and the like.

In reviewing the Banoff and Postlewaite, consider the following discussions:

- The authors point out that the IRS has been letting form control in other contexts and suggest doing so here. For discussions of the check-the-box regulations and Rev Ruls. 84-111 and 2004-59, see part II.P.3.c Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations.

- The authors distinguish reallocating profits from issuing a new partnership interest. For the latter, see part II.M.4.f Issuing a Profits Interest to a Service Provider.

- Banoff views *Cottage Savings* as imposing a harsh rule. However, the IRS does not interpret *Cottage Savings* as harshly as suggested.[495] Perhaps one might analogize between the flexibility of Subchapter K partnership income tax rules and trust distributions of property under Subchapter J (see part II.J.8.d.i Distribution in Kind - Generally)[496] and modifications/restructuring (see part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting).

Elaborating on the last bullet point, part II.J.18.f Commutation vs Mere Division explores seemingly inconsistent theories in regulations under Code § 1001: trust modifications, divisions, mergers, etc. are not subject to income tax unless they constitute a commutation. In a commutation, a trust is terminated, with each party receiving the actuarial value of its beneficial interest or other property in exchange for that value. On the other hand, if a trustee had absolute discretion regarding distributions, a trustee could simply distribute to each party what seems fair to the trustee. Part II.J.18.f suggests that the key is whether the beneficiaries have expectancies to which they are entitled and can be ascertained.

Similarly, in partnerships, one might look to see whether partners have legal rights to a particular portion of partnership property or whether the rights are fluid as the partnership evolves:

- Given that Reg. § 1.704-1(b)(2)(iv)(f)[497] does not require revaluation (which accounts for unrealized appreciation and other book/value differences) when existing interests in partnership profits change, arguably a partnership agreement that is based on that Reg. § 1.704-1(b)(2)(iv) capital accounts without addressing that issue contemplates that the partners do not have any expectation regarding the allocation of unrealized appreciation and other book/value differences before recognition occurs. If that is a correct assumption, then unrealized appreciation and other book/value differences do not need to be accounted for when interests in partnership profits change.

- Most modern partnership agreements use target allocations rather than strictly following Reg. § 1.704-1(b)(2)(iv). Instead of tracking initial capital accounts and layering on top of them income, gains, and losses based on mechanical allocations (a "layer cake approach"),

[495] See Letter Ruling 200527007, discussed in the text accompanying fn 2950 in part II.J.18.a Trust Divisions.
[496] For further context, see the rest of part II.J.8.d Distribution in Kind; Specific Bequests)
[497] Reg. § 1.704-1(b)(2)(iv)(f) is reproduced in fn 507 in part II.C.7 Maintaining Capital Accounts.

a target allocation paradigm looks to what each partner would receive if the partnership were to liquidate at the end of the taxable year and then adjusts capital accounts to effectuate those rights. In an actual liquidation, all assets are deemed sold for their fair market value, which may suggest that unrealized appreciation and other book/value differences may need to be accounted for. However, most target allocations assume a hypothetical annual liquidation based on book value, not fair market value, which may support the opposite conclusion.

- In the law firm example further above, goodwill is never allocated to anyone. Each partner's right to profits is determined a year at a time based on performance, and a lawyer who leaves receives only any unwithdrawn previously taxed earnings. Because a client can choose any lawyer at any time, neither the firm nor the departing lawyer has any right to the client's future work, so neither goodwill nor any other client-based intangible is allocated or distributed. However, in other service firms, goodwill and client-based intangibles can be allocated and distributed; in a 2022 case, that allocation led to the departing partners receiving ordinary income![498]

Absent a clear answer, I hope that this part II.C.6 helps readers analyze the issues to come to your own conclusion appropriate to the facts and circumstances facing you.

II.C.7. Maintaining Capital Accounts

Sowell, "Concepts and Context in Partnership Capital Shifts," *TAXES - The Tax Magazine* (Feb. 3, 2023),[499] is a great summary of many aspects of keeping capital accounts.

A capital account tracks a partner's equity in a partnership. It starts by measuring the partner's contributions of property to the partnership. Next, add the partner's share of partnership income or subtract the partner's share of losses. Finally, subtract distributions the partnership makes to the partner.

One can use capital accounts to track tax or financial attributes. Financial attributes might follow fair market value only or take the hybrid approach commonly used in traditional accounting. When analyzing a partner's equity, consider the following approaches:

- <u>Tax Basis</u>. Contributions and distributions are measured using their tax basis, and income and loss are measured based on transactions that are recognized for tax purposes (even if the income is nontaxable or an expense or loss is nondeductible).

- <u>Fair Market Value</u>. A contribution or distribution is measured using its fair market value (FMV). All assets are valued at the beginning and end of the year. The overall income or loss whatever change in the assets' aggregate FMV that is not accounted for by contributions or distributions. That overall income or loss consists of actual transactions and changes in FMV due to market fluctuations (unrealized gain or loss).

- <u>Book Value</u>. Traditional accounting focuses on measurable events and generally does not give effect to market fluctuations. When forming a partnership, counting FMV is essential to determining the percentage of value each partner contributed. From there, however, measuring FMV tends to be impractical and involve judgment calls. Thus, book value tends

[498] See text accompanying and preceding fn 510 in part II.C.7 Maintaining Capital Accounts.
[499] Saved as Thompson Coburn LLP doc. no. 29656856.

> to use FMV accounting when the partnership is formed and tax basis accounting during normal operations. Book value will apply FMV accounting when certain important events occur that require redetermining the partners' financial relationships with each other.

Code § 704(b) and the regulations under it require the partnership to use a form of book value capital accounts. Reg. § 1.704-1(b)(2)(iv) provides:[500]

> *Basic rules*. Except as otherwise provided in this paragraph (b)(2)(iv), the partners' capital accounts will be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) if, and only if, each partner's capital account is increased by
>
> (1) the amount of money contributed by him to the partnership,
>
> (2) the fair market value of property contributed by him to the partnership (net of liabilities that the partnership is considered to assume or take subject to), and
>
> (3) allocations to him of partnership income and gain (or items thereof), including income and gain exempt from tax and income and gain described in paragraph (b)(2)(iv)(g) of this section, but excluding income and gain described in paragraph (b)(4)(i) of this section; and
>
> is decreased by
>
> (4) the amount of money distributed to him by the partnership,
>
> (5) the fair market value of property distributed to him by the partnership (net of liabilities that such partner is considered to assume or take subject to),
>
> (6) allocations to him of expenditures of the partnership described in section 705(a)(2)(B), and
>
> (7) allocations of partnership loss and deduction (or item thereof), including loss and deduction described in paragraph (b)(2)(iv)(g) of this section, but excluding items described in (6) above and loss or deduction described in paragraphs (b)(4)(i) or (b)(4)(iii) of this section; and is otherwise adjusted in accordance with the additional rules set forth in this paragraph (b)(2)(iv).
>
> For purposes of this paragraph, a partner who has more than one interest in a partnership shall have a single capital account that reflects all such interests, regardless of the class of interests owned by such partner (*e.g.*, general or limited) and regardless of the time or manner in which such interests were acquired. For liabilities assumed before June 24, 2003, references to liabilities in this paragraph (b)(2)(iv)(b) shall include only liabilities secured by the contributed or distributed property that are taken into account under section 752(a) and (b).

The IRS explains differences between book value and tax basis capital accounts in its "Partner's Instructions for Schedule K-1 (Form 1065) (2022)":

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[500] Reg. § 1.704-1(b)(2)(iv)(b). I added some formatting not found in the regulation but have not changed a single word.

Item L

> The partnership must report your beginning capital account and ending capital account for the year using the Tax Basis Method, including the amount of capital you contributed to the partnership during the year, your share of the partnership's current year net income or loss as computed for tax purposes, any withdrawals and distributions made to you by the partnership, and any other increases or decreases to your capital account determined in a manner generally consistent with figuring the partner's adjusted tax basis in its partnership interest (without regard to partnership liabilities), taking into account the rules and principles of sections 705, 722, 733, and 742. See the Instructions for Form 1065 for more details.
>
> For many reasons, your ending capital account as reported to you by the partnership in item L may not equal the adjusted tax basis in your partnership interest. Generally, this is because a partner's adjusted tax basis in its partnership interest includes the partner's share of partnership liabilities (and capital accounts determined by using the tax basis method do not). In addition, your partnership may not have all the necessary information from you to accurately figure the adjusted tax basis in your partnership interest due to partner-level adjustments. You are responsible for maintaining an annual record of the adjusted tax basis in your partnership interest as determined under the principles and provisions of subchapter K, including, for example, those under sections 705, 722, 733, and 742. Regulations section 1.705-1(a)(1) provides that a partner is required to determine the adjusted basis of its interest in a partnership when necessary to determine its tax liability or that of any other person. For example, a determination is required in ascertaining the extent to which a partner's share of loss is allowed, when there is a sale or exchange of all or part of a partnership interest, and when a partner's entire partnership interest is liquidated. The adjusted basis of a partner's interest in a partnership is determined without regard to any amount shown in the partnership books as the partner's "capital," "equity," or similar account.

Reg. § 1.704-1(b)(2)(ii) generally governs the allocation of income and loss, which determines the annual income tax consequences from operations, but which also needs to reflect the reality of who benefits from that allocation. If income is allocated to a partner who will not receive the financial benefit sooner or later, that tends to indicate that the parties are playing income tax gains. Because capital accounts are intended measure how much each partner would get upon liquidation, capital accounts tell us whether the allocations of income and loss are merely gaming the system or reflect real economic consequences. Of course, tax basis and book value capital accounts are not as accurate as FMV capital accounts, so the tax system needs to ensure that allocations of income and loss, when applied to book value capital account, do not create distortions between the partners' book value capital accounts and their eventual FMV capital accounts.

Accordingly, Reg. § 1.704-1(b)(2)(ii), "Economic effect," provides:

> (a) *Fundamental principles*. In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.

(b) *Three requirements*. Based on the principles contained in paragraph (b)(2)(ii)(a) of this section, and except as otherwise provided in this paragraph, an allocation of income, gain, loss, or deduction (or item thereof) to a partner will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides -

(1) For the determination and maintenance of the partners' capital accounts in accordance with the rules of paragraph (b)(2)(iv) of this section,

(2) Upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (2) and requirement (3) of this paragraph (b)(2)(ii)(b)), by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), and

(3) If such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (3)), he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances (in accordance with requirement (2) of this paragraph (b)(2)(ii)(b)). Notwithstanding the partnership agreement, an obligation to restore a deficit balance in a partner's capital account, including an obligation described in paragraph (b)(2)(ii)(c)(1) of this section, will not be respected for purposes of this section to the extent the obligation is disregarded under paragraph (b)(2)(ii)(c)(4) of this section.

(4) For purposes of paragraphs (b)(2)(ii)(b)(1) through (3) of this section, a partnership taxable year shall be determined without regard to section 706(c)(2)(A).

(5) The requirements in paragraphs (b)(2)(ii)(b)(2) and (3) of this section are not violated if all or part of the partnership interest of one or more partners is purchased (other than in connection with the liquidation of the partnership) by the partnership or by one or more partners (or one or more persons related, within the meaning of section 267(b) (without modification by section 267(e)(1)) or section 707(b)(1), to a partner) pursuant to an agreement negotiated at arm's length by persons who at the time such agreement is entered into have materially adverse interests and if a principal purpose of such purchase and sale is not to avoid the principles of the second sentence of paragraph (b)(2)(ii)(a) of this section.

(6) The requirement in paragraph (b)(2)(ii)(b)(2) of this section is not violated if, upon the liquidation of the partnership, the capital accounts of the partners are increased or decreased pursuant to paragraph (b)(2)(iv)(f) of this section as of

the date of such liquidation and the partnership makes liquidating distributions within the time set out in the requirement in paragraph (b)(2)(ii)(b)(2) of this section in the ratios of the partners' positive capital accounts, except that it does not distribute reserves reasonably required to provide for liabilities (contingent or otherwise) of the partnership and installment obligations owed to the partnership, so long as such withheld amounts are distributed as soon as practicable and in the ratios of the partners' positive capital account balances.

(7) See Examples 1.(i) and (ii), 4.(i), 8.(i), and 16.(i) of paragraph (b)(5) of this section for issues concerning paragraph (b)(2)(ii)(b) of this section.

If a partnership does not comply with all the detailed rules of Reg. § 1.704-1(b)(2)(iv), Reg. § 1.704-1(b)(2)(ii)(d), "Alternate test for economic effect," explains how to comply with Code § 704(b):

If-

(1) Requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied, and

(2) The partner to whom an allocation is made is not obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section), or is obligated to restore only a limited dollar amount of such deficit balance, and

(3) The partnership agreement contains a "qualified income offset,"

such allocation will be considered to have economic effect under this paragraph (b)(2)(ii)(d) to the extent such allocation does not cause or increase a deficit balance in such partner's capital account (in excess of any limited dollar amount of such deficit balance that such partner is obligated to restore) as of the end of the partnership taxable year to which such allocation relates. In determining the extent to which the previous sentence is satisfied, such partner's capital account also shall be reduced for-

(4) Adjustments that, as of the end of such year, reasonably are expected to be made to such partner's capital account under paragraph (b)(2)(iv)(k) of this section for depletion allowances with respect to oil and gas properties of the partnership, and

(5) Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to section 704(e)(2), section 706(d), and paragraph (b)(2)(ii) of §1.751-1, and

(6) Distributions that, as of the end of such year, reasonably are expected to be made to such partner to the extent they exceed offsetting increases to such partner's capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made (other than increases pursuant to a minimum gain chargeback under paragraph (b)(4)(iv)(e) of this section or under § 1.704-2(f); however, increases to a partner's capital account pursuant to a minimum gain chargeback requirement are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain.

> For purposes of determining the amount of expected distributions and expected capital account increases described in (6) above, the rule set out in paragraph (b)(2)(iii)(c) of this section concerning the presumed value of partnership property shall apply. The partnership agreement contains a "qualified income offset" if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation, or distribution described in (4), (5), or (6) above, will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible. Allocations of items of income and gain made pursuant to the immediately preceding sentence shall be deemed to be made in accordance with the partners' interests in the partnership if requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied. See examples (1)(iii), (iv), (v), (vi), (vii), (ix), and (x), (15), and (16)(ii) of paragraph (b)(5) of this section.

Notwithstanding regulations under Code § 704(b), the IRS is moving toward using tax basis capital accounts for tax returns. Notice 2020-43, part II, "Background," explains developments preceding the Notice's issuance:

> The 2019 instructions for Form 1065 and Partner's Instructions for Schedule K-1 (Form 1065), like the 2018 instructions for these forms, require that a partnership reporting its partners' capital on a method other than the tax basis method report a partner's tax capital account at both the beginning and the end of the partnership's taxable year if either amount is negative with respect to the partner. The 2019 instructions for Form 8865, Schedule K-1, incorporate this requirement by reference to the instructions for Form 1065.
>
> On April 5, 2019, the IRS released Form 1065 Frequently Asked Questions (FAQs) explaining how a partnership should determine a partner's tax capital account and providing a safe harbor approach based on a partner's outside basis in its partnership interest. Thereafter, early releases of drafts of the 2019 Form 1065 and the 2019 Form 8865, released September 30, 2019, and related draft instructions for the 2019 Form 1065 (to which the draft instructions for the 2019 Form 8865 refer), and the 2019 Partner's Instructions for Schedule K-1 (Form 1065), released October 29, 2019, expanded partner tax capital reporting to require all partnerships and certain other persons who file Form 8865 to report all partners' tax capital accounts using the tax basis method.
>
> In response to the change requiring all partnerships to report their partners' tax capital on a tax basis method, commenters stated that some partnerships might be unable to comply, either in a timely manner or ever. These commenters explained that partnerships that have not historically maintained partner tax capital accounts may face difficulties in calculating their partners' tax capital by means of a historical transactional analysis of events. Commenters stated that a partnership would find such a transactional analysis particularly difficult and burdensome where the partnership has been operating for many years and either documentation regarding historical transactional events affecting partner tax capital no longer exists, or the documentation does exist, but its volume or complexity precludes reconstruction of accurate tax capital accounts. In addition, commenters asked for guidance on how to calculate tax capital using a transactional analysis under complicated transactions and structures.

> Accordingly, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) released Notice 2019-66, 2019-52 I.R.B. 1509 on December 11, 2019, removing the requirement that partnerships and other persons required to furnish and file Form 1065, Schedule K-1 or Form 8865, Schedule K-1, report partner capital accounts in Item L of the 2019 Form 1065, Schedule K-1, or in Item F of the 2019 Form 8865, Schedule K-1, using the tax basis method for 2019. In addition, Notice 2019-66 announced that further guidance would be provided regarding the definition of partner tax capital. In lieu of providing a definition of tax basis capital, this notice proposes two methods that satisfy the Tax Capital Reporting Requirement. Section III of this notice describes the two proposed methods for complying with the Tax Capital Reporting Requirement. Part IV of this notice requests comments on those proposed methods. The Treasury Department and the IRS anticipate that the two proposed methods outlined in section III of this notice will be the only methods that meet the Tax Capital Reporting Requirement for partnership taxable years ending on or after December 31, 2020.

First, we will go through the rest of the Notice. Then, we will go through the prior guidance described above.

Notice 2020-43, part III, "Proposed Methods for Complying With The Tax Capital Reporting Requirement For Taxable Years Ending On Or After December 31, 2020," provides an overview of what's in store, the describes two alternative methods taxpayers may use. Here's the overview:

> Commenters have indicated that many partnerships that currently possess partner tax capital information generally develop and maintain partner tax capital by applying the provisions and principles of subchapter K of chapter 1 of the Code (subchapter K), including those contained in §§ 705, 722, 733, and 742 of the Code, to relevant partnership and partner events. In such a situation, commenters have indicated that partnerships maintaining tax capital (i) increase a partner's tax capital account by the amount of money and the tax basis of property contributed by the partner to the partnership (less any liabilities assumed by the partnership or to which the property is subject) as well as allocations of income or gain made by the partnership to the partner, and (ii) decrease a partner's tax capital account by the amount of money and the tax basis of property distributed by the partnership to the partner (less any liabilities assumed by the partner or to which the property is subject) as well as allocations of loss or deduction made by the partnership to the partner (Transactional Approach).
>
> The Treasury Department and the IRS understand that many partnerships and other persons have maintained partner tax capital accounts according to the Transactional Approach, but due to the array of transactions that might affect partner tax capital, it is possible that partnerships and other persons that have been using the Transactional Approach may not have been adjusting partner tax capital accounts in the same way under similar fact patterns. Several commenters explained that providing detailed guidance that would make the Transactional Approach consistent in all potential transactions would be a major project that would consume significant IRS resources.
>
> The IRS and Treasury believe that a consistent framework for all partnerships and other persons to comply with the Tax Capital Reporting Requirement will aid the IRS in administering the tax law, and consistency will ultimately reduce complexity of the preparation of partnership returns. Accordingly, this notice proposes two alternative

> methods that a partnership would be required to use to comply with the Tax Capital Reporting Requirement. For such purpose, a partnership may report, for each partner, either (i) the partner's basis in its partnership interest, reduced by the partner's allocable share of partnership liabilities, as determined under § 752 of the Code (Modified Outside Basis Method) or (ii) the partner's share of previously taxed capital, as calculated under a modified version of § 1.743-1(d) of the Income Tax Regulations (Modified Previously Taxed Capital Method). Both methods are further described below. It is intended that a partnership must use one of these two methods for purposes of satisfying the Tax Capital Reporting Requirement and the method selected must be used with respect to all of the partnership's partners. Capital account amounts based on the Transactional Approach will not satisfy the Tax Capital Reporting Requirement. For taxable years after 2020, a partnership may change its Tax Capital Reporting Requirement method from the Modified Outside Basis Method to the Modified Previously Taxed Capital Method, or vice versa, by attaching a disclosure to each Schedule K-1 describing the change, if any, to the amount attributable to each partner's beginning and end of year balances, and the reason for the change.

Notice 2020-43, part III, item (1)," The Modified Outside Basis Method," provides:

> A partnership may satisfy the Tax Capital Reporting Requirement by determining, or being provided by its partners, the partner's adjusted basis in its partnership interest, determined under the principles and provisions of subchapter K (including those contained in §§ 705, 722, 733, and 742), and subtracting from that basis the partner's share of partnership liabilities under § 752.
>
> If the partnership is satisfying the Tax Capital Reporting Requirement by using the Modified Outside Basis Method, a partner must notify its partnership, in writing, of any changes to the partner's basis in its partnership interest during each partnership taxable year other than changes attributable to contributions to and distributions from the partnership and the partner's share of income, gain, loss, or deduction that are otherwise reflected on the partnership's schedule K-1. The partner must provide such written notification of such changes to the partner's basis within thirty days or by the taxable year-end of the partnership, whichever is later. For example, if a person purchases an interest in a partnership that has chosen to use the Modified Outside Basis Method, the purchasing partner must notify the partnership of its basis in the acquired partnership interest, regardless of whether the partnership has an election under § 754 of the Code in effect or has a substantial built-in loss, as defined in § 743(d) of the Code, at the time of such interest purchase. For purposes of the Modified Outside Basis Method, a partnership is entitled to rely on the partner basis information that the partnership is provided by its partners unless the partnership has knowledge of facts indicating that the provided information is clearly erroneous.

Notice 2020-43, part III, item (2)," Modified Previously Taxed Capital Method," provides:

> A partnership that does not satisfy the Tax Capital Reporting Requirement by using the Modified Outside Basis Method would be required to do so by using the Modified Previously Taxed Capital Method. Section 1.743-1(d)(1) generally provides that a partnership interest transferee's (transferee's) share of the adjusted basis of partnership property is equal to the sum of the transferee's interest as a partner in the partnership's previously taxed capital, plus the transferee's share of partnership liabilities. The regulation further provides that the transferee's previously taxed capital is equal to -

(i) The amount of cash that the partner would receive on a liquidation of the partnership following a hypothetical transaction; increased by

(ii) The amount of tax loss (including any remedial allocations under § 1.704-3(d) of the Income Tax Regulations) that would be allocated to the partner from the hypothetical transaction; and decreased by

(iii) The amount of tax gain (including any remedial allocations under § 1.704-3(d)) that would be allocated to the partner from the hypothetical transaction.

The hypothetical transaction is a disposition by the partnership of all of its assets in a fully taxable transaction for cash equal to the fair market value of the assets. See § 1.743-1(d)(2).

Part (i) of the above calculation is intended to quantify, for each partner, the partner's economic right to a share of the distributable proceeds of the partnership immediately after the hypothetical transaction and the payment by the partnership of all of its liabilities (partnership net liquidity value). The Treasury Department and the IRS understand that although some partnerships may be able to determine the fair market value of their assets for each taxable period, such information will not be readily available for all partnerships. In most instances, a partnership that calculates its partnership net liquidity value by using a consistent measurement for the value of its assets (such as GAAP basis or § 704(b) basis) rather than their actual fair market value will determine the same amount for each of its partners as would be determined if the partnership had calculated its partnership net liquidity value by hypothesizing a sale of its assets for actual fair market value. Accordingly, for purposes of the Tax Capital Reporting Requirement, the Modified Previously Taxed Capital Method modifies the calculation described in § 1.743-1(d)(2) (for purposes of the Tax Capital Reporting Requirement only) as follows:

(i) The cash a partner would receive on a partnership liquidation and calculations of gain and loss in the hypothetical transaction would be based on the assets' fair market value, if readily available. Otherwise, a partnership may determine its partnership net liquidity value and gain or loss by using such assets' bases as determined under § 704(b), GAAP, or the basis set forth in the partnership agreement for purposes of determining what each partner would receive if the partnership were to liquidate, as determined by partnership management; and

(ii) All liabilities are treated as nonrecourse for purposes of parts (ii) and (iii) of the calculation referring to gain or loss, respectively. This is to avoid the burden of having to characterize the underlying debt and to simplify the computation.

Example - Facts. A and B are equal partners in AB LLC, a calendar-year partnership. On December 31, 2020, AB LLC's balance sheet reflects the following assets and liabilities:

- $500 of cash;
- Inventory with a tax and book basis of $1,000;
- Equipment with a tax and book basis of $500;

- Land with a tax and book basis of $1,000; and
- A long-term loan of $5,000.

AB LLC chooses to comply with the Tax Capital Reporting Requirement by using the Previously Taxed Capital Method and calculating liquidation values, gains, and losses, based on the book basis of the assets. Each of A and B's Previously Taxed Capital under that method would be $(1,000), an amount equal to (i) the cash each would receive after the hypothetical liquidation (zero, because the debt of $5,000 exceeds the $3,000 book basis of the assets), less (ii) gain that would be allocated to each partner on the hypothetical liquidation and sale ($1,000, each partner's 50% share of the excess of the $5,000 amount realized on a sale of the property for the debt over the tax basis of $3,000), plus (iii) loss that would be allocated to each partner (zero).

A partnership that adopts the Modified Previously Taxed Capital Method would be required, for each taxable year in which the method is used, to attach a statement indicating that the Modified Previously Taxed Capital Method is used and the method it used to determine its partnership net liquidity value (for example, fair market value, § 704(b) book basis, etc.).

AICPA resources include: AICPA comment letter – Form 1065, Schedule K-1 and Accompanying Instructions (December 2020)

- AICPA comment letter – Comments on Notice 2020-43
- The Tax Adviser article - Draft instructions for reporting partnership capital accounts are issued

Some basic applications are described in Hamill, "The Mechanics of Maintaining Transactional Tax Basis Capital Accounts," *Corporate Taxation* (WG&L) (Nov/Dec 2021).

Sections 3 and 4 of Notice 2021-13 provide:

3. RELIEF FROM PENALTIES UNDER SECTIONS 6698, 6721, AND 6722

A partnership will not be subject to a penalty under sections 6698, 6721, or 6722 due to the inclusion of incorrect information in reporting its partners' beginning capital account balances on the 2020 Schedules K-1 if the partnership can show that it took ordinary and prudent business care in following the 2020 Form 1065 Instructions to report its partners' beginning capital account balances using any one of the following methods, as outlined in the instructions: the tax basis method, modified outside basis method, modified previously taxed capital method, or section 704(b) method. For purposes of this notice, "ordinary and prudent business care" means the standard of care that a reasonably prudent person would use under the circumstances in the course of his business in handling account information. In demonstrating ordinary and prudent business care, taxpayers are reminded that capital account balances are part of a partnership's books and records and must be maintained accordingly.

In addition, a partnership will not be subject to a penalty under sections 6698, 6721, or 6722 due to the inclusion of incorrect information in reporting its partners' ending capital account balances on Schedules K-1 in taxable year 2020 or its partners' beginning or ending capital account balances on Schedules K-1 in taxable years after 2020 to the extent the incorrect information is attributable solely to the incorrect information reported as the beginning capital account balance on the 2020 Schedule K-1 for which relief under this notice is available. The penalty relief provided in this notice is in addition to the reasonable cause exception to penalties for failing to properly report the partners' beginning capital account balances, as described in section 2 of this notice.

A partnership that fails to timely file a 2020 Form 1065, Form 8865, and Schedules K-1 is not eligible for the relief provided by this notice. A partnership that fails to include a partner's beginning capital account balance on the Schedule K-1 is also not eligible for relief. This notice does not relieve a partner of its obligation to determine the adjusted basis of its interest in the partnership for purposes of determining its tax liability or that of any other person as prescribed in section 705 of the Code and § 1.705-1(a)(1) of the Income Tax Regulations.

4. RELIEF FROM PENALTIES UNDER SECTION 6662

The IRS will waive any accuracy-related penalty under section 6662 for any taxable year with respect to any portion of an imputed underpayment that is attributable to an adjustment to a partner's beginning capital account balance reported by the partnership for the 2020 taxable year to the extent the adjustment arises from the inclusion of incorrect information for which the partnership qualifies for relief under section 3 of this notice. This notice does not prevent the IRS from imposing an accuracy-related penalty under section 6662 for any portion of an imputed underpayment related to capital account reporting by the partnership that is not described in the previous sentence.

The Treasury Department and the IRS understand that many partnerships and other persons have maintained partner tax capital accounts according to the Transactional Instructions for Form 1065 (2018), page 30, Item L. Partner's Capital Account Analysis, provides for reporting "tax basis capital," presumably to catch "negative basis" situations:[501]

> If a partnership reports other than tax basis capital accounts to its partners on Schedule K-1 in Item L (that is, GAAP, 704(b) book, or other), and tax basis capital, if reported on any partner's Schedule K-1 at the beginning or end of the tax year would be negative, the partnership must report on line 20 of Schedule K-1, using code AH, such partner's beginning and ending shares of tax basis capital. This is in addition to the required reporting in Item L of Schedule K-1.
>
> For these purposes, the term "tax basis capital" means (i) the amount of cash plus the tax basis of property contributed to a partnership by a partner minus the amount of cash plus the tax basis of property distributed to a partner by the partnership net of any liabilities assumed or taken subject to in connection with such contribution or distribution, plus (ii) the partner's cumulative share of partnership taxable income and tax-exempt income, minus (iii) the partner's cumulative share of taxable loss and nondeductible, noncapital expenditures.

[501] For a description of how a "negative basis" situation arises, see fn. 6590 in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System.

Notice 2019-20 provides some relief when providing the above information late for 2018 returns.[502] Notice 2019-66 provides:

> This notice provides that partnerships and other persons required to furnish and file Form 1065, Schedule K-1 or Form 8865, Schedule K-1, will not be required to report partner capital accounts in Item L of the 2019 Form 1065, Schedule K-1, or in Item F of the 2019 Form 8865, Schedule K-1, using the tax basis method for 2019.
>
> Instead, partnerships and other persons must report partner capital accounts for 2019 consistent with the reporting requirements for the 2018 Forms 1065, Schedule K-1, or 8865, Schedule K-1, as applicable. This means that partnerships and other persons may continue to report partner capital accounts on Forms 1065, Schedule K-1, Item L, or 8865, Schedule K-1, Item F, using any method available in 2018 (tax basis, Section 704(b), GAAP, or any other method) for 2019. These partnerships and other persons must include a statement identifying the method upon which a partner's capital account is reported. The final instructions for the 2019 Forms 1065, Schedule K-1, Item L and 8865, Schedule K-1, Item F, are expected to include additional details on how such reporting should be done.
>
> For 2019 partnership taxable years, partner "tax basis capital" must be calculated as provided in the 2018 Form 1065 and Schedule K-1 instructions. Beginning with the 2018

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[502] Under "Penalty Relief," the Notice provides:

> The IRS will waive penalties under section 6722 for furnishing a partner a Schedule K-1 and section 6698 for filing a Schedule K-1 with a partnership return that fails to report negative tax basis capital account information if both the following conditions are met:
>
> 1. The partner Schedules K-1 are timely filed, including extensions, with the IRS and furnished to the partners and contain all other required information.
> 2. The partnership files with the IRS no later than 180 days after the six-month extended due date for the partnership's Form 1065 or, for a calendar year partnership, no later than March 15, 2020, a schedule setting forth, for each partner for whom the partnership is required to furnish negative tax basis capital account information, the partner's name, address, taxpayer identification number, and the amount of the partner's tax basis capital account at the beginning and end of the tax year at issue in accordance with instructions and additional guidance posted by the IRS on IRS.gov. Whether or not a partnership files a Form 7004, Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns, it can use the six-month extended due date in calculating the due date for filing the required schedule described in this paragraph. The schedule should be sent to the following address:
>   1973 North Rulon White Blvd.
>   Ogden, UT 84404-7843
>   MS 4700
>   Attn: Ogden PTE
>
> This penalty relief applies only for a partnership's taxable year beginning after December 31, 2017, but before January 1, 2019. To receive a waiver of the penalty, a partnership is not required to furnish amended Schedules K-1 to its partners or to file an administrative adjustment request under section 6227, and partnerships should not delay issuing partner Schedules K-1 on account of this Notice. The timely furnishing, including extensions, of Schedules K-1 to partners is a requirement to be eligible for relief under this Notice. The IRS will post instructions and additional information about the relief provided by this Notice in the coming weeks on IRS.gov, where forms, instructions, and other tax assistance are available.
>
> The penalty relief under this Notice will allow additional time for partnerships to provide the negative tax basis capital account information with respect to the partnerships' taxable years beginning after December 31, 2017, but before January 1, 2019.

partnership taxable year, if a partner's tax basis capital was negative at the beginning or end of a partnership's taxable year, a partnership or other person is required to report on line 20 of a partner's Schedule K-1, using Code AH, such partner's beginning and ending tax basis capital. Partnerships and other persons who follow this notice and report partner capital accounts for 2019 in Item L of the Form 1065, Schedule K-1, or in Item F of the Form 8865, Schedule K-1, by using a method other than the tax basis method must continue to comply with the requirement in the 2018 forms and instructions with respect to negative tax basis capital accounts.

The IRS website for Form 1065 Frequently Asked Questions (FAQs), "Negative Tax Basis Capital Account Reporting Requirements," provides guidance on the calculation of a partner's tax basis capital account in FAQ 2, and, for clarity, the definition of tax basis capital includes (A)(v) and (B)(vii) of FAQ 2. Additionally, in lieu of following the definition of tax basis capital in FAQ 2, partnerships and other persons may instead use the partner outside basis safe harbor approach referenced in FAQ 6. If a partnership or other person uses the safe harbor approach, the partnership or other person must attach a statement to the partner's Schedule K-1 with the information described in (2)(d)(iii) of FAQ 8. Other than the information described in (2)(d)(iii) of FAQ 8, the remainder of FAQ 8 is inapplicable for 2019, including the penalty relief and extension of time to file described therein, which applied only for 2018. The FAQs are found at: https://www.irs.gov/businesses/partnerships/form-1065-frequently-asked-questions. In preparation for filing partnership tax returns for the 2020 taxable year, further guidance will be published that provides, and requests comments on, the definition of partner tax basis capital.

Form 1065 Frequently Asked Questions (last updated 12/11/2019) answers the following questions:

1. What is a partner's tax basis capital account?

2. How do partnerships calculate a partner's tax basis capital account?

3. How can a partner's tax basis capital account be negative when the tax basis of its interest in the partnership (outside basis) is zero or positive?

4. Do revaluations of partnership property affect a partner's tax basis capital account?

5. What is the tax capital account of a partner who acquired its partnership interest by transfer from another partner?

6. Is there a safe harbor approach for determining whether a partnership has an obligation to report negative tax basis capital account information?

7. Must partnerships that satisfy all four of the conditions provided in question 4 on Schedule B to the Form 1065 comply with the requirement to report negative tax basis capital account information?

8. What is the procedure for complying with the requirement to report negative tax basis capital account information for tax year 2018?

Notice 2019-66 provides instructions for 2019 tax reporting on:

- Reporting partners' shares of net unrecognized Code § 704(c) gain or loss. See parts II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value and II.P.1.a.i.(b) Special Rules for Allocations of Income in Securities Partnerships.

- Reporting Code § 465 at-risk activity. See part II.G.4.j At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities).

2022 Form 1065 Instructions, "Specific Instructions (Schedule K-1 Only)," provides in "How To Complete Schedule K-1":

> **Item L. Partner's Capital Account Analysis**
>
> You aren't required to complete item L if the answer to question 4 of Schedule B is "Yes." If you are required to complete this item, also see the instructions for Schedule M-2, later.
>
> **Tax basis method**. Figure each partner's capital account for the partnership's tax year using the transactional approach, discussed below, for the tax basis method.
>
> ***How to report partnership events or transactions***. If you are uncertain how to report a partnership event or transaction, you should account for the event or transaction in a manner generally consistent with figuring the partner's adjusted tax basis in its partnership interest (without regard to partnership liabilities), taking into account the rules and principles of sections 705, 722, 733, and 742 and by reporting the amount on the line for other increase (decrease). The partner's ending capital account as reported using the tax basis method in item L might not equal the partner's adjusted tax basis in its partnership interest. Generally, this is because a partner's adjusted tax basis in its partnership interest includes the partner's share of partnership liabilities, as well as partner-specific adjustments. Each partner is responsible for maintaining a record of the adjusted tax basis in its partnership interest.
>
> ***Beginning capital account***. Enter the partner's ending capital account as determined for last year on the line for beginning capital account. If a partner joined the partnership through a contribution to the partnership this year, enter zero as the partner's beginning capital account.
>
> ***Capital contributed during the year***. On the line for capital contributed during the year, enter the amount of cash plus the adjusted tax basis of all property contributed by the partner to the partnership during the year. The amount you enter on this line should be reduced by any liabilities assumed by the partnership in connection with, or liabilities to which the property is subject immediately before, the contribution. This amount might be negative.
>
> ***Current year net income (loss)***. On the line for current year net income (loss), enter the partner's distributive share of partnership income and gain (including tax-exempt income) as figured for tax purposes for the year, minus the partner's distributive share of

partnership loss and deductions (including nondeductible, noncapital expenditures) as figured for tax purposes for the year.

Other increase (decrease). On the line for other increase (decrease), enter the sum of all other increases or decreases that affected the partner's capital account for tax purposes during the year and attach a statement explaining each adjustment. For example, if a new partner acquired its interest in the partnership from another partner in a purchase, exchange, gift, or inheritance, enter an amount for the transferee under other increase that is equal to the transferor partner's ending capital account with respect to the interest transferred immediately before the transfer figured using the tax basis method. Other examples of increases include the following.

- The partner's distributive share of the excess of the tax deductions for depletion (other than oil and gas depletion) over the adjusted tax basis of the property subject to depletion.

- The partner's share of any increase to the adjusted tax basis of partnership property under section 734(b).

If a transferor partner disposed of its interest in the partnership by sale, exchange, or gift, or as the result of death, enter the transferor partner's ending capital account with respect to the interest transferred immediately before the transfer figured using the tax basis method. Other examples of decreases include the following.

- The partner's distributive share of tax deductions for depletion of any partnership oil and gas property, but not exceeding the partner's share of the adjusted tax basis of that property.

- The partner's share of any decrease to the adjusted tax basis of partnership property under section 734(b).

Note. Section 743(b) basis adjustments are not taken into account in calculating a partner's capital account under the tax basis method.

Withdrawals and distributions. On the line for withdrawals and distributions, enter the amount of cash plus the adjusted tax basis of all property distributed by the partnership to the partner during the year. The amount you enter on this line should be reduced by any liabilities assumed by the partner in connection with, or liabilities to which the property is subject immediately before, the distribution. This amount might be negative.

Ending capital account. The sum of the amounts shown on the lines in item L above the line for ending capital account must equal the amount reported on the line for ending capital account. A partner's ending capital account determined under the tax basis method may be negative if the sum of a partner's losses and distributions exceeds the sum of the partner's contributions and share of income.

Publicly traded partnerships (PTPs). In the case of a sale or exchange of an interest in a PTP, you may determine a transferee partner's beginning capital account by adjusting the partner's beginning capital account to reflect the transferee partner's purchase price of the interest rather than entering the transferor partner's ending capital account. In making the adjustments, you may use information required to be reported to you under Regulations section 1.6031(c)-1T, and publicly available trading price information.

IRS Fact Sheet 2023-20, "IRS issues a frequently asked question for pass-through entities to report negative amounts to the IRS on Part II of Schedules K-2 and K-3," as updated 9/6/2023, explains:

> This fact sheet is about a frequently asked question that addresses how pass-through entities electronically file and report negative amounts to the IRS on Part II of Schedules K-2 and K-3.
>
> This frequently asked question (FAQ) is being issued to provide general information to taxpayers and tax professionals as expeditiously as possible. Accordingly, this FAQ may not address any particular taxpayer's specific facts and circumstances, and it may be updated or modified upon further review. Because this FAQ has not been published in the Internal Revenue Bulletin, it will not be relied on or used by the IRS to resolve a case. Similarly, if an FAQ turns out to be an inaccurate statement of the law as applied to a particular taxpayer's case, the law will control the taxpayer's tax liability. Nonetheless, a taxpayer who reasonably and in good faith relies on this FAQ will not be subject to a penalty that provides a reasonable cause standard for relief, including a negligence penalty or other accuracy-related penalty, to the extent that reliance results in an underpayment of tax. Any later updates or modifications to this FAQ will be dated to enable taxpayers to confirm the date on which any changes to the FAQ were made. Additionally, prior versions of this FAQ will be maintained on IRS.gov to ensure that taxpayers, who may have relied on a prior version, can locate that version if they later need to do so.
>
> More information about reliance is available. This FAQ was announced in IR 2023-162.
>
> **Frequently asked question for pass-through entities to report negative amounts to the IRS on Part II of Schedules K-2 and K-3**
>
> **Q. For the 2022 tax year, a pass-through entity receives information (for example, a Schedule K-3 from a lower-tier pass-through entity) that certain gross income amounts to be reported on the Schedules K-2 and K-3 are negative. However, the current schema for electronic filing of the Schedules K-2 and K-3 does not permit negative values for certain line items in Part II, Section 1 of Schedules K-2 and K-3. How should these negative amounts be reported on Schedules K-2 and K-3 to the IRS and to the partners or members? (added September 5, 2023)**
>
> A. A pass-through entity electronically filing the Schedules K-2 and K-3 for the 2022 tax year should enter zero on the line items in Schedules K-2 and K-3, Part II, Section 1 for which the schema does not permit negative values. A pass-through entity must attach a General Dependency (XML) schema to the Schedule K-2 identifying the line items and the negative values for which the pass-through entity reported zero on Part II, Section 1. Additionally, a pass-through entity should attach a list of the impacted line items and the negative numbers, partner by partner. A pass-through entity should report to its partners or members any changes to the amounts reported on the original Schedules K-3 issued to the partners or members. The IRS has not opined on whether it is legally appropriate to use negative values.

When a capital account differs from tax basis, be careful to comply with part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.[503] Part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value deals with differences between value and capital accounts, not only for contributions of property but also when partners enter or exit when the value of the partnership's property differs from its basis.[504]

Furthermore, if the specific capital account rules "fail to provide guidance on how adjustments to the capital accounts of the partners should be made to reflect particular adjustments to partnership capital on the books of the partnership":[505]

> such capital accounts will not be considered to be determined and maintained in accordance with those rules unless such capital account adjustments are made in a manner that
>
> (1) maintains equality between the aggregate governing capital accounts of the partners and the amount of partnership capital reflected on the partnership's balance sheet, as computed for book purposes,
>
> (2) is consistent with the underlying economic arrangement of the partners, and
>
> (3) is based, wherever practicable, on Federal tax accounting principles.

A clause referring to the above rule is especially recommended when using target allocations rather than traditional allocations.

Each partner has a unitary capital account (and unitary basis).[506]

When a partner enters or exits or makes a non-pro-rata contribution or takes a non-pro-rata distribution, often the partnership's property is revalued and capital accounts adjusted (without

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503 See Reg. § 1.704-1(b)(2)(iv)(d)(3) for applying these rules in maintaining capital accounts.
504 See fns. 5444-5447 (describing reverse-Code § 704(c) allocations, which is where a partner makes a disproportionate contribution or receives a disproportionate distribution when the partner has assets with values not equal to basis, which book-tax difference needs to be accounted for) and II.P.1.a.i.(b) Special Rules for Allocations of Income in Securities Partnerships.
505 Reg. § 1.704-1(b)(2)(iv)(q).
506 See fn. 5628 (unitary capital account), found in part II.Q.8.e.ii.(a) Unitary Basis.

changing tax basis).[507] Beware that a book-up resulting from a revaluation may shift nonrecourse liabilities,[508] which can generate income tax.[509]

Many partnership (or LLC operating) agreements require maintaining Code § 704(b) capital accounts; failure to keep such records might lead to IRS assertions of income tax or estate/gift tax adjustments. *Hohl v. Commissioner*, T.C. Memo. 2021-5, explained:

> Partners must recognize as ordinary income their distributive shares of partnership discharge of indebtedness income.[18] Except as otherwise required by the Code, a partner's distributive share of income is determined by the partnership agreement.[19] If the partnership agreement does not provide for the partner's share, or if the allocation made by the agreement does not have substantial economic effect, the partner's

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[507] Reg. § 1.704-1(b)(2)(iv)(f) provides:

> *Revaluations of property*. A partnership agreement may, upon the occurrence of certain events, increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property (including intangible assets such as goodwill) on the partnership's books. Capital accounts so adjusted will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless -
>
> (1) The adjustments are based on the fair market value of partnership property (taking section 7701(g) into account) on the date of adjustment, as determined under paragraph (b)(2)(iv)(h) of this section. See Example 33 of paragraph (b)(5) of this section.
>
> (2) The adjustments reflect the manner in which the unrealized income, gain, loss, or deduction inherent in such property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for such fair market value on that date, and
>
> (3) The partnership agreement requires that the partners' capital accounts be adjusted in accordance with paragraph (b)(2)(iv)(g) of this section for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property, and
>
> (4) The partnership agreement requires that the partners' distributive shares of depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to such property be determined so as to take account of the variation between the adjusted tax basis and book value of such property in the same manner as under section 704(c) (see paragraph (b)(4)(i) of this section), and
>
> (5) The adjustments are made principally for a substantial non-tax business purpose -
>
> (i) In connection with a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership, or
>
> (ii) In connection with the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership, or
>
> (iii) In connection with the grant of an interest in the partnership (other than a de minimis interest) on or after May 6, 2004, as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner, or
>
> (iv) In connection with the issuance by the partnership of a noncompensatory option (other than an option for a de minimis partnership interest), or
>
> (v) Under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

[508] See text preceding and accompanying fn 398 in part II.C.3.c Allocations of Recourse and Nonrecourse Liabilities.

[509] See part II.C.3.a Basic Consequences of Changes in Liability Allocations.

distributive share of income is determined "in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances)."[20]

[18] *Gershkowitz v. Commissioner*, 88 T.C. 984, 1006-1008 (1987).

[19] Sec. 704(a).

[20] Sec. 704(b).

Echo's operating agreement allocates distributive shares of income to its partners according to a formula based on the partner's capital accounts. If those allocations have substantial economic effect, the income from the discharge of the indebtedness is allocated in the manner provided by the operating agreement.

To have substantial economic effect, allocations must be consistent with the underlying economic arrangement of the partners.[21] The allocations made by Echo's operating agreement (based on capital accounts) do not have substantial economic effect. In all other respects, the partnership and its partners shared items 30-30-30-10, instead of following the formula provided by the operating agreement. This course of conduct makes clear that Echo did not adhere to the allocations in the operating agreement and instead allocated losses on the basis of the partners' 30%, 30%, 30%, and 10% ownership interests. The partners also did not follow the operating agreement's provisions for contributing capital or maintaining capital accounts.

[21] Sec. 1.704-1(b)(2)(ii)(a), Income Tax Regs.

Because the allocations provided by the operating agreement do not have substantial economic effect, the partners' distributive shares of income are determined according to their interests in the partnership.[22] A partner's interest in the partnership depends on the facts and circumstances.[23] In these cases, during all four years Echo operated, it allocated losses according to the stated 30%, 30%, 30%, and 10% ownership interests. Allocation of the income in 2012 should follow the allocation of losses for each other year of the partnership's existence. Mr. Hohl and Mr. Blake should each have included a 30% share of the income from the discharge of indebtedness in their income for 2012.

[22] Sec. 704(b).

[23] Sec. 704(b); sec. 1.704-1(b)(3)(i), Income Tax Regs.

The Hohls and the Blakes argue that if Echo recognized income from the discharge of indebtedness all of that income should be allocated to Mr. Rodriguez. They argue that the loans were nonrecourse loans and therefore the lending partner bears the economic risk of loss so it is treated as a recourse liability allocated to that partner. They conclude:

> Thus, a nonrecourse loan from a partner is, in effect, treated as a recourse liability allocated solely to the lending partner. … [*See* sec. 1.704-2(b)(4), Income Tax Regs.] Its allocation is covered by the nonrecourse deduction regulations. See Treas. Reg. sec. 1.704-2(i). In other words, a partner cannot make a nonrecourse loan to a partnership that gives other partners basis. Treas. Reg. sec. 1.752-2(c).

Their argument is incorrect for several reasons.

The partners chose to treat the liability as a recourse liability and to allocate it according to the partners' 30%, 30%, 30%, and 10% interests in the partnership. Additionally, the partners claimed, and took the tax benefit from, the additional basis arising from their shares of the loans. They were not required to structure their economic relationship that way but chose to reflect their economic arrangement as a recourse loan shared by all partners.

Further, the section 704 regulations petitioners cite govern allocations attributable to nonrecourse liabilities, not the allocation of the liabilities themselves, which are governed by the regulations under section 752. Under the section 752 regulations, a partnership liability is recourse to the extent a partner bears the economic risk of loss and nonrecourse to the extent no partner bears the economic risk of loss.[24] When the lender is also a partner, that partner bears the economic risk of loss to the extent that the partner makes a nonrecourse loan to the partnership and no other partner bears the economic risk of loss.[25] The regulations contemplate a partner other than the lending partner bearing the economic risk of loss for, and receiving the corresponding allocation of, a loan made by another partner.

[24] Sec. 1.752-1(a)(1) and (2), Income Tax Regs.

[25] Sec. 1.752-2(c)(1), Income Tax Regs.

Finally, the item at issue is income, not a liability. Echo failed to include the income from the discharge of a debt, specifically the loans from Mr. Rodriguez. Once the loans were discharged, they ceased to be a partnership liability and instead became partnership income.

Banoff, Lipton and Cohen, "Partnership Agreement Allocations Don't Require Economic Effect: That's the *Hohl* Truth," *Journal of Taxation* (6/2021), comment:

Rather than analyzing the operating agreement under the entirety of the test in Reg. 1.704-1 and 1.704-2 to determine whether the allocations under the agreement had substantial economic effect, however, the opinion cites only to the first sentence of Reg. 1.704-1(b)(2)(ii)(a). The "fundamental principle" stated there is that the allocation "must be consistent with the underlying economic arrangement of the partners." The opinion jumps from that sentence to the conclusion that the agreement did not have substantial economic effect. To support this conclusion, the court states that the percentage interests of the partners were used to share items "[i]n all other respects" but that the allocations in the agreement were to follow a formula based on capital accounts (*i.e.*, an obtuse reference to the "targeted capital account" allocations in the operating agreement). The court also notes that Echo allocated losses on the basis of the percentage interests and that the court did not believe the partners followed the operating agreement's provisions for contributing capital or maintaining capital accounts.

Reg. 1.704-1(b)(2) is more nuanced than this analysis would indicate. The above-quoted first sentence of Reg. 1.704-1(b)(2)(ii)(a) is followed by an explanation that "the partner to whom the allocation is made must receive [the] economic benefit or bear [the] economic burden" associated with the allocation. Reg. 1.704-1(b)(2)(ii)(b) further provides that an allocation "will have economic effect if, and only if" the partnership agreement meets three requirements (with various special rules throughout Reg. 1.704-1(b)(2)). While "fundamental principles" are stated in Reg. 1.704-1(b)(2)(ii)(a), the use of specific requirements in Reg. 1.704-1(b)(2)(ii)(b) and the statement that the allocations "will have economic effect" where the requirements are met have been taken as the means by which the fundamental principles are satisfied. Further, it is possible for allocations to be deemed to have economic effect if there is "economic effect equivalence" as set forth in Reg. 1.704-1(b)(2)(ii)(i) (i.e., as of the end of each partnership taxable year a liquidation of the partnership at the end of that year or any future year would produce the same economic results to the partners as would occur if the economic effect requirements had been met, regardless of the economic performance of the partnership).

Should one take the Hohl opinion as indicating that there are some scenarios where keeping capital accounts under the Section 704(b) regulations, having a qualified income offset or deficit restoration obligation, and liquidating in accordance with capital accounts (and compliance with the other rules in Reg. 1.704-1(b) and 1.704-2) are insufficient to ensure allocations set forth in the agreement will be respected (assuming the allocations have substantiality, which this article does not discuss because the opinion does not provide adequate information to make that analysis)? Was the downfall of these taxpayers the messy tax return reporting? Or was it that they failed to comply with their agreement, meaning the failure was in the practice (rather than in the terms of the agreement)? Alternatively, are the "fundamental principles" independent requirements, where failure to meet those requirements (but compliance with the specific requirements in the regulations) could lead to a revision to the parties' allocations? Or is this opinion effectively holding that targeted capital account allocations do not have economic effect equivalence?

Reg. 1.704-1(b)(2) does not tell the entire story, especially where debt is involved. Echo was an LLC, and it is unclear whether for tax purposes the liability owed to Rodriguez was being treated as a recourse liability or a nonrecourse liability. In 2009, the liability was apparently treated for tax purposes as a recourse liability (with each partner being liable for a share of the liability) and allocated in accordance with the partners' percentages, but in 2010 and 2011, it was apparently treated as a nonrecourse liability and allocated solely to Rodriguez, the partner that had the economic risk of loss. Was it this inconsistent reporting that sunk Hohl and the other service-providing partner? If Echo and the partners had consistently reported the liability as a recourse liability, would the allocations of partnership loss in proportion to capital accounts (which were in proportion to the partners' percentages) have had economic effect (or, at least, economic effect equivalence)? Certainly, if they had properly and consistently reported the liability as a partner nonrecourse debt under Reg. 1.704-2, all of the losses would have been allocated to Rodriguez (and all of the cancellation of debt income would have been allocated to him, too).

Hohl and the other service-providing partner would have their cake (*i.e.*, the prior years' allocations of losses, for which the statute of limitations had run) and eat it too (i.e., shift the cancellation of debt income to Rodriguez). They argued that the liability should have always been allocated to Rodriguez and, so, the income from the liability should also be allocated to Rodriguez. However, as the court pointed out, the rules applicable to allocation of the liability are not the same as the rules applicable to allocation of the income among the partners arising from the cancellation of the liability. See, *e.g.*, Rev. Rul. 99-43, 1999-2 CB 506.

> We can't help but observe that Rodriguez does not appear to have been treated very well by his co-venturers. The venture in hindsight appears to be an economic failure. Then, after the other partners claimed 90% of the losses (all being funded by Rodriguez), their litigating position in the Tax Court was to sock Rodriguez with 100% of the cancellation of indebtedness (COD) income that was attributable to the nonpayment of his loans. The opinion does not delve into this attempted, uneven treatment of the money partner.
>
> This brings us to the point of wondering whether the court was ignoring the rest of Reg. 1.704-1 (other than the one cited sentence) from the result-oriented view that the partners should be held to an allocation of Echo's income that matched up to the allocation of losses in prior years. With the inability to reconcile the treatment of the debt throughout Echo's term to the manner in which allocations of losses were made, perhaps the court decided (without so saying in the opinion) that the best way to get the income allocated to match up was by first finding the agreement lacked substantial economic effect and then allocating the income in accordance with the partners' interests in the partnership (which, in Echo, was fairly easy to determine since everything (other than the liability allocation) had been done in accordance with the partners' percentages).
>
> In your editors' view, Hohl was rightly designated a memorandum opinion by the Tax Court. Memorandum opinions are not binding precedent upon the Tax Court (or the IRS, or taxpayers, or anyone else). See Banoff, "The True Value of Tax Court Memorandum Opinions," 58 *Tax Notes* 1551 (1993). Hohl is extremely fact-driven, and it shows that messy facts make messy law. Absent further analysis and discussion by the court, a number of questions pertaining to the partnership's allocations remain unanswered….
>
> There are very few cases with published opinions that apply the substantial economic effect test (and, to the knowledge of your editors, none that address targeted capital account allocations). *Hohl* applies that test but only superficially and to messy facts. Your authors hope that this opinion does not mean that the technical requirements of Reg. 1.704-1(b)(2)(ii) can be read out of the regulation where a judge feels that the agreement does not match up with the judge's understanding of the parties' economic deal. If the parties properly maintain capital accounts (and perhaps these did not) and observe the requirements of the regulations, the allocations in the partnership agreement should be respected. That's our *Hohl* story, and we're sticking to it.

The Tax Court's Syllabus of *Clark Raymond & Co., PLLC v. Commissioner*, T.C. Memo. 2022-105, summarizes:

> CRC, an accounting firm, is a partnership subject to the TEFRA provisions of I.R.C. §§ 6221–6234. Three single-member entities - C, N, and T - were partners of CRC in 2013 and negotiated a buyout of C in anticipation of the retirement of C's principal owner, which they memorialized in a restated partnership agreement. The partnership agreement also included provisions governing allocations of income and distributions (both liquidating and non-liquidating) to the partners, and it included a qualified income offset (QIO) provision. The partnership agreement anticipated that a partner could receive a distribution of "clients" from the partnership and provided a method for valuing such a distribution.

Shortly after executing the restated partnership agreement, N and T withdrew from CRC, and certain clients of CRC stopped engaging CRC and instead retained N's and T's new partnership (NT PLLC). C, as tax matters partner for CRC, reported on CRC's 2013 Form 1065, "U.S. Return of Partnership Income", that N and T received distributions from CRC in amounts equal to the value of the clients (as determined under the restated partnership agreement) that followed N and T to NT PLLC. C also decreased N's and T's capital accounts by the value of the reported distributions, and thereby reduced N's and T's capital accounts below zero. To restore N's and T's capital accounts to zero, C allocated (for tax purposes) all of CRC's ordinary income for 2013 to N and T, pursuant to a QIO provision in the partnership agreement, and so reported on CRC's tax return. As a result, C allocated to itself no taxable income from CRC.

N and T filed Forms 8082, "Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)", contesting CRC's 2013 income allocations, and R subsequently audited CRC's 2013 return. R issued a Letter 1830-F, "Notice of Final Partnership Administrative Adjustment" (FPAA), disregarding CRC's reported "client distributions" and redetermining allocations of ordinary income to N and T. Specifically, R determined that CRC's "client distributions" had not been substantiated and that CRC's corresponding allocations of income lacked substantial economic effect.

C, as TMP of CRC, timely filed a Petition in this Court contesting R's determinations in the FPAA. The parties filed a joint motion to submit this case pursuant to Rule 122, which we granted.

Held: CRC distributed client-based intangible assets to N and T when they withdrew from CRC, and the value of the assets so distributed are properly valued under the terms of CRC's partnership agreement.

Held, further, CRC failed to maintain capital accounts in accordance with Treas. Reg. § 1.704-1(b)(2)(iv); therefore, CRC's special allocations of income to N and T lacked substantial economic effect and must be reallocated in accordance with the partners' interests in the partnership under I.R.C. § 704(b) and Treas. Reg. § 1.704-1(b)(3).

Held, further, because N and T had negative capital accounts at the end of the taxable year and CRC's partnership agreement included a QIO, ordinary income must be allocated first to N and T in an amount necessary to bring each partner's capital account up to zero.

Held, further, R's determinations disregarding CRC's "client distributions" and redetermining allocations of ordinary income are not sustained.

Some key lessons:

- The court respected the partnership's valuation method for client lists, which was based on gross revenue invoiced over the prior 12 months, because the partners' interests were adverse and negotiations had been at arm's length.

- Because the allocations of book gain on the distribution of these client-based intangible assets did not have substantial economic effect, the court had to evaluate the partners' interests in the partnership under Reg. § 1.704-1(b)(1)(i).

The court described the allocation systems in footnotes 24 and 25:

> An FMG system calculates wage compensation, profit or loss allocations, and cash distributions to partners by applying metrics and ratios to determine the revenue attributable to the accountant that brought the client to the firm (the finder), the accountant who managed the client and the engagement (the minder), and the accountant who worked the billable hours on the client's engagement (the grinder).
>
> An AAV system computes the amount payable to a departing partner for the value of goodwill that he leaves behind at the firm. A partner's AAV "balance" at departure is the amount payable to the departing partner for his portion of the firm's goodwill. When implementing an AAV system, the partners will agree upon a value of the firm's total goodwill, using the prior 12 months' revenue multiplied by an appropriate factor, and allocate a portion of the total to each partner's AAV balance. A partner's AAV balance may increase or decrease according to the formula employed by the CPA firm to compute the individual partner's contribution to the CPA firm's growth (and presumably, to its goodwill).

Under the heading, "Partnership intangible assets," the court explained:

> Business entities may own intangible assets. *See, e.g., Tomlinson v. Commissioner*, 58 T.C. 570, 580 (1972) ("We have long recognized that these intangibles [including customer lists] are capital assets"), *aff'd*, 507 F.2d 723 (9th Cir. 1974) ;*Topeka State J., Inc. v. Commissioner*, 34 T.C. 205, 215, 221 (1960) ("It is well established that [subscription lists] are an intangible asset of a newspaper [company]").[47] Intangible assets are generally included in the valuation of a partnership (and partnership interest). *See, e.g., Watson v. Commissioner*, 35 T.C. 203, 208, 214 (1960) (holding that purchase price for partnership included payment for tangible assets and goodwill); *Tolmach v. Commissioner*, T.C. Memo 1991-538.
>
> > [47] The Code and the Treasury Regulations also anticipate that partnerships will own intangible assets by providing an amortization deduction for the capitalized costs of intangibles owned by the partnership (for federal income tax purposes), *see generally* § 197, and requiring the inclusion of intangible assets in the valuation of a transferred business interest (for federal gift tax purposes), *see generally* Treas. Reg. §§ 1.197-2, 25.2512-3.
>
> A "client-based intangible" asset (such as a customer list or "book of business"[48]) is one example of an intangible asset, and it may be capable of valuation, distribution, and sale to third parties. See, e.g., Newark Morning Ledger Co. v. United States, 507 U.S. 546, 570 [71 AFTR 2d 93-1380] (1993) (holding that a corporation proved that a customer list of "'paid [*30] subscribers' constitute[d] an intangible asset with an ascertainable value and a limited useful life, the duration of which [could] be ascertained with reasonable accuracy" for depreciation purposes); JHK Enters., Inc. v. Commissioner, T.C. Memo. 2003-79, 85 T.C.M. (CCH) 1032, 1032 ("Among the assets received by [the partner] in the liquidating distribution were client files, a client list, going concern value (goodwill), and equipment"); *Holden Fuel Oil Co. v. Commissioner*, T.C. Memo. 1972-45, 31 T.C.M. (CCH) 184, 187–89 (holding that where the taxpayer purchased customer lists from another company it was entitled to an amortization deduction for a portion of the amount paid), *aff'd*, 479 F.2d 613 (6th Cir. 1973).

[48] A "book of business" generally has value. *See, e.g., Mitchell v. Garrison Protective Servs., Inc.*, 819 F.3d 636, 641 (2d Cir. 2016) (affirming the district court's valuation of a book of business).

Under the heading, "Partnership intangible assets," the court explained:

> The basic capital accounting rules in Treasury Regulation section 1.704-1(b)(2)(iv)(b) require that partners' capital accounts be decreased by the fair market values of property distributed to them by the partnership. Treas. Reg. § 1.704-1(b)(2)(iv)(e)(1). If property is in fact distributed, then these rules must be applied even if the partners and the partnership overlook the distribution or attempt to impose another characterization on it. *See, e.g., Seay v. Commissioner*, T.C. Memo. 1992-254, 63 T.C.M. (CCH) 2911, 2913 (holding that the taxpayer received a distribution of partnership assets when he withdrew cash from the partnership, despite claiming that his withdrawals were loans from the partnership). To satisfy this requirement, the capital accounts of the partners first must be adjusted to reflect how any unrealized[52] income, gain, loss, and deduction inherent in the property (not already reflected in the capital accounts) would be allocated among the partners if there were a taxable disposition of the property for its fair market value (colloquially referred to as a "book-up"). Treas. Reg. § 1.704-1(b)(2)(iv)*(e)(1)*.
>
> [52] Gain is defined as the excess of the amount realized from a sale or other disposition of property over the taxpayer's adjusted basis in the property. § 1001(a). An amount realized is the sum of money or fair market value of property received from the sale or other disposition of the property. § 1001(b). "Realization" of these amounts typically occurs when the transferor is in receipt of cash or property, but realization may also occur when the last step is taken by the transferor by which he obtains the fruition of the economic gain which has already accrued to him. *Helvering v. Horst*, 311 U.S. 112, 115 (1940). A taxpayer's basis in an asset is generally its cost of acquiring the property. § 1012. The basis of property contributed to a partnership by a partner is the adjusted basis of the property to the contributing partner at the time of the contribution (adjusted for any gain recognized by the contributing partner). § 723. In the case of intangible assets, basis includes amounts that are required to be capitalized, such as amounts paid to create or enhance an intangible asset. Treas. Reg. § 1.263(a)-4(b)(1), (g)(1). "Unrealized gain", therefore, refers to the excess of the fair market value of property over its basis (i.e., its appreciation in value) at a point before a realization event (before it is disposed of). *See, e.g.*, Treas. Reg. § 1.704-1(b)(5) (example 14).
>
> The fair market value assigned to property contributed to, distributed by, or otherwise revalued by a partnership will be regarded as correct, provided that (1) the value is reasonably agreed to among the partners in arm's-length negotiations and (2) the partners have sufficiently adverse interests. Treas. Reg. § 1.704-1(b)(2)(iv)*(h)(1)*. The determination of fair market value is a question of fact. *S. Tulsa Pathology Lab'y, Inc. v. Commissioner*, 118 T.C. 84, 101 (2002).

The court then explained that what the partners described as goodwill was what the court described as client-based intangibles:

> Taking into consideration the terminology used in the FPAA (*i.e.*, "client distribution"), it is clear to us that, although both parties intermittently refer to a contribution to and distribution of general "goodwill" from CRC, at issue in this case is a distribution of CRC's clients or a client list in particular, both of which we refer to as the "client-based

intangibles”. Client lists and other client-based intangibles have value. *See, e.g., Newark Morning Ledger Co.*, 507 U.S. at 570; *Holden Fuel Oil Co.*, 31 T.C.M. (CCH) at 187-89. This value can exist even where the client is not contractually bound to keep bringing his business. See *Aitken v. Commissioner*, 35 T.C. 227, 230-31 (1960) (holding that insurance contract “expirations”, which did not guarantee renewal of an insurance contract, but contained client and policy information and were analogous to customer lists, goodwill, or just intangibles in the nature of goodwill, constituted valuable capital assets capable of transfer); see also *Holden*, 31 T.C.M. at 184-85, 187 (“[Although] customers [on a customer list] were not obligated to purchase fuel oil from [the taxpayer]...[i]n acquiring the list [the taxpayer] was afforded the opportunity of contacting persons who were known to be using fuel oil to heat their homes and who were in the need of a new supplier; clearly providing [the taxpayer] with a valuable asset.”). Business entities, such as limited liability companies, may own and distribute such intangible assets. *See, e.g., JHK Enters., Inc.*, 8T.C.M. (CCH) at 1032. CRC could therefore hold and distribute such assets, and although the evidence does not support that Newman PLLC and Town PS either contributed client-based intangibles to CRC or transferred client-based intangibles in exchange for their AAV account, the evidence does support CRC’s ownership of client-based intangible assets capable of valuation and distribution.

CRC’s dealings demonstrate that it and its partners understood that a partner’s “book of business” consisting of current clients would be valued upon entry of a partner and charged for upon withdrawal....

Consequently, we hold that CRC’s method for valuing client-based intangibles upon the withdrawal of Newman PLLC and Town PS comports with the fair market value definition of Treasury Regulation section 1.704-1(b)(2)(iv)*(h)(1)*. In the absence of any competing valuation presented by the Commissioner, or any critique of this valuation, we accept it as correct….

Obviously, this was not a textbook instance of a partnership distribution, labeled as such by agreement of the parties when the partner withdrew. Rather, CRC initially contended that the taking of property (*i.e.*, the clients) was wrongful and was a breach of the 2013 LLC Agreement. We can imagine a circumstance in which a partner’s taking of property from a partnership was outright robbery and in such; a circumstance it might be treated for tax purposes not as a distribution but as a theft, perhaps deductible on the partnership return as a theft loss under section 165(e) and includible as ordinary income to the partner. See *James v. United States*, 366 U.S. 213, 219 (1961). But here the partners and the partnership had a disagreement about the entitlement to the property, and before the end of the tax year, they agreed to a settlement of their dispute under which the partners would be entitled to keep the property they had taken. We conclude we should accept their agreed-upon resolution of the dispute and should apply the provisions of the Code pertinent to that characterization. Neither party to this case argues that it should instead be treated as a theft. The ultimately agreed-upon transfer of the client-based intangibles is best understood as a distribution.

The Commissioner argues, in effect, that the transfer of the client-based intangibles should be ignored as non-factual, because (he says) the intangibles did not exist and were not transferred. For the reasons stated above, we reject that approach. The Commissioner also presents an alternative argument:

> Having structured the economic deal that goodwill was not a partnership asset, petitioner is bound by the treatment the parties negotiated. A taxpayer, although free to structure his transaction as he chooses, "once having done so, he must accept the consequences of his choice, whether contemplated or not...and may not enjoy the benefit of some other route he might have chosen to follow but did not." *Comm'r v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974) (citations omitted). To disavow the LLC Agreement's treatment of goodwill, petitioner must present strong proof that the LLC Agreement was wrong.

But the partners of CRC did not negotiate a deal that clients were not a value that could be brought into the firm and taken out of it. Rather, the partners took into account an entering partner's book of business in determining on what terms the partner would enter the partnership; and Section 5.1 of the 2013 LLC Agreement acknowledges that CRC "expended substantial time and funds in developing...the Company's clientele and their patronage"; Section 1.6 postulates a "goodwill value of the Company" (used for calculating AAV rights); and it expressly makes provision (in Section 9.3(b)) for "Clients [to be] Distributed under this Agreement" and (in Section 1.19) for the "Client Value" to be determined. When Newman PLLC and Town PS did withdraw, they took clients with them, and the parties executed an "Agreement Regarding Client File Transfer Procedure".

It is true that the 2013 LLC Agreement does not make express provision for goodwill to be contributed by a partner and included in his capital account, but that silence does not amount to an agreement that client-based intangibles do not exist and cannot be transferred. It is also true that CRC failed to reflect intangible values in partners' capital accounts (and that is part of the reason that we hold below that CRC's special allocation fails the tests for economic effect, *see* infra Part II.B); but a partnership's failure to reflect an asset on its books does not make the asset cease to exist. If a partnership fails to book its cash (to choose an extreme instance), a distribution of that unbooked cash is still a distribution. Treating the distribution of the client-based intangibles as a distribution does not (in the words of the Commissioner's brief quoted above) require "disavow[ing] the LLC Agreement's treatment of goodwill". Rather, it requires invoking and giving effect to the express terms of Section 9.3(b).

The court then determined that the allocations in the partnership agreement did not satisfy any of the tests under Reg. § 1.704-1(b)(2)(ii) that would deem them to have economic effect. First, citing Reg. § 1.704-1(b)(2)(ii)*(b)*, it held that the partnership agreement expressly precluding a deficit restoration obligation from applying caused special allocations not to satisfy the basic test for economic effect. The court described that test:

> The basic test for economic effect is set forth in Treasury Regulation section 1.704-1(b)(2)(ii)(b). The test provides, in general, that a special allocation has economic effect if it is made pursuant to a partnership agreement that contains provisions requiring: (1) the determination and maintenance of partners' capital accounts in accordance with the rules of Treasury Regulation section 1.704-1(b)(2)(iv); (2) upon liquidation of the partnership, the proceeds of liquidation be distributed in accordance with the partners positive' capital account balances; and (3) upon liquidation of the partnership, any partner with a deficit capital account balance is unconditionally obligated to restore the amount of the deficit balance to the partnership by the end of the taxable year (commonly referred to as a "deficit restoration obligation" or "DRO"). Treas. Reg. § 1.704-1(b)(2)(ii)(b). This test ensures that the economic benefits or burdens

corresponding to any given special allocation are borne by the partner receiving the allocation.

The partnership agreement was good, but the actual accounting was not:

The 2013 LLC Agreement does contain provisions that (1) require maintenance of capital accounts in accordance with Treasury Regulation section 1.704-1(b)(2)(iv), (2) require liquidation distributions in accordance with partners' positive capital account balances, (3) require reductions for reasonably expected allocations or distributions, and (4) implement a QIO. However, the special allocation of income cannot have economic effect because, as we explain below, CRC did not actually maintain the capital accounts of its partners in accordance with the 2013 LLC Agreement and Treasury Regulation section 1.704-1(b)(2)(iv) ("[A]n allocation of income, gain, loss, or deduction will not have economic effect...unless the capital accounts of the partners are *determined and maintained* throughout the full term of the partnership in accordance with the capital accounting rules" (emphasis added)).

The Commissioner asserts persuasively that CRC failed to maintain capital accounts in accordance with Treasury Regulation section 1.704-1(b)(2)(iv) because, before distributing those assets, CRC did not increase the partners' capital accounts by the value of the unrealized gain[55] inherent in the client-based intangible assets. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(e)(1). In response, petitioner argues that the client-based intangibles did not have unrealized gain because the partners transferred their "goodwill" (at fair market value) to CRC in exchange for their AAV account balances, such that the value of that goodwill resided in the AAV account. Petitioner further argues that the partners' AAV accounts control the allocation of any taxable gain on the sale of the client-based intangibles and that, in effect, "[section] 704 and its regulations do not apply because [the section] 704 book-up only [*42] applies to capital accounts and not AAV accounts (which are deferred compensation liability accounts)."

[55] *See* supra note 52. With his assertion, the Commissioner necessarily assumes that a client-based intangible asset may indeed bear unrealized gain, and we therefore adopt his assumption.

As we have discussed, petitioner has not shown that the partners ever actually contributed "goodwill" or client-based intangibles to CRC[56] (or exchanged client-based intangibles for an AAV account), or, if such a contribution (or exchange) did occur, the value of the assets at that time. Neither does it cite any authority (controlling or otherwise) to support its position regarding the AAV accounts and the inapplicability of section 704(b), so we cannot accept its position. Indeed, AAV accounts (used here by CRC as a method of calculating deferred compensation payable to retiring partners) are not capital accounts, and we are unaware of any authority relieving CRC from its capital account maintenance responsibilities simply because it used such a mechanism. We must therefore examine whether the client-based intangible assets that Town PS and Newman PLLC received contained unrealized gain, and if so, whether CRC failed to increase the partners' capital accounts by such unrealized gain before the distribution to Newman PLLC and Town PS.

[56] As we have mentioned, Clark PLLC discounted the purchase price of Town PS's partnership interest for the "[a]greed upon value of John's book brought in". This discount by itself is insufficient to establish that Town PS contributed its "book of

business" or "clients" to CRC because Town PS did not make a capital contribution to CRC to acquire its partnership interest; rather, it purchased its interest from Clark PLLC. We interpret the discount as the value that Clark PLLC (the seller in that transaction) must have placed on the future benefit it would realize from its distributive share of income generated by Town PS's book of business, and not as an indication that Town PS was somehow contributing its clients to CRC. Our interpretation is further supported by the fact that CRC credited Town PS's capital account with an initial balance equal to the discounted purchase price of its partnership interest (i.e., Town PS's initial capital account balance was not increased for contribution of a "book of business", see Treas. Reg. § 1.704-1(b)(2)(iv)*(b)*). That is, when the discount reduced Town PS's purchase price of $872,996 by $234,046, for a final purchase price of $639,000, CRC set Town PS's initial capital account balance not at $872,996 (as if Town PS had contributed the cash and a client-based intangible) but rather at $639,000 (the amount of cash only).

The FPAA determined that the income allocation lacked substantial economic effect, and so the burden is on Clark PLLC, as petitioner, to prove that such allocation did have substantial economic effect. It necessarily follows that, under an analysis of the economic effect of the income allocation, one element of petitioner's burden is to prove that CRC maintained capital accounts in accordance with Treasury Regulation section 1.704-1(b)(2)(iv). This burden includes proving that CRC increased the capital accounts in accordance with subdivision (iv)(e)(1), or, in the alternative, proving that the client-based intangible asset lacked any unrealized gain. Petitioner does not argue that this burden should shift to the Commissioner.

To determine whether the client-based intangible asset contained unrealized gain, we must determine the partnership's adjusted basis in the asset. See § 1001(a). Petitioner made no showing of the cost to acquire or develop the client-based intangible assets, see Treas. Reg. § 1.263(a)-4(g)(1), or (tangential to its argument that partners "exchanged" or "contributed" the assets to CRC) the partners' adjusted bases in the client-based intangibles before their alleged contribution, see §§ 723, 732. We hold that petitioner has failed to prove CRC's adjusted basis in the client-based intangibles distributed to Newman PLLC and Town PS, and we therefore assign zero-dollar bases to these assets.[57] Accordingly, with a collective fair market value of $742,569 and a zero-dollar basis, the unrealized gain in the distributed client-based intangibles is $742,569. See § 1001(a).

[57] In the absence of proof of basis by CRC (the party with the burden of proof), we assume zero basis because that would be the finding adverse to CRC. If we found instead that the client-based intangible assets had bases equal to their fair market values at the time of transfer (despite the fact that CRC did not produce evidence to support it), the assets would not have had built-in gain that CRC would have been required to allocate among the partners' capital accounts before distribution. In such circumstance, it is possible that we would have held that CRC had maintained its capital accounts in accordance with the Treasury Regulation § 1.704-1(b)(2)(iv) and, therefore, that CRC's allocations of income had economic effect. A holding of economic effect would conflict with the IRS's determination in the FPAA that the allocations lacked substantial economic effect, and CRC has the burden to disprove that determination.

> The parties have stipulated that the partners' opening capital account balances in 2013 did not include the value of any intangibles and that CRC did not increase the partners' capital accounts by the value of any inherent gain in the client-based intangibles. Therefore, CRC failed to maintain the partners' capital accounts in accordance with Treasury Regulation section 1.704-1(b)(2)(iv),[58] and the special allocation accordingly cannot satisfy the alternate test for economic effect. The allocation will therefore be deemed to have economic effect only if it is able to satisfy the third test - the economic equivalence test.
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> > [58] The fact that the partners "agreed" to their capital account balances incident to negotiations might suggest that CRC did not strictly adhere to the capital accounting rules of Treasury Regulation § 1.704-1(b)(2)(iv). See *supra* pp. 12-13.

The court explained in the heading, "The allocation does not have economic equivalence":

> In some cases, despite not adhering to the formal requirements of the economic effect tests, an allocation may produce the same income tax results as if the allocation had satisfied the requirements of the basic test. Treas. Reg. § 1.704-1(b)(2)(ii)(i). Petitioner has neither argued nor demonstrated that the special allocation satisfies the economic equivalence test.[59] Therefore, the allocations have neither economic equivalence nor economic effect.
>
> > [59] CRC's failure to increase the capital accounts by the unrealized gain in the client-based intangibles before distribution resulted in incorrect capital account balances (before distribution) for each partner in 2013. Therefore, its income allocations were not based on correct capital account balances and cannot have economic equivalence because the resulting amounts of income allocated per partner differ from those resulting from an application of the basic test for economic effect.
>
> The substantial economic effect analysis under Treasury Regulation section 1.704-1(b)(2)(i) has two parts: first, the allocation must have economic effect, and second, the economic effect of the allocation must be substantial. Because we have determined that CRC's allocations of income to Newman PLLC and Town PS do not have economic effect, we do not conduct an analysis of substantiality.[60]
>
> > [60] The Commissioner stated that if the Court were to find economic effect, then he "does not dispute that the economic effect of the allocations was substantial."

After determining that the allocations in the partnership agreement did not satisfy any of the tests under Reg. § 1.704-1(b)(2)(ii) that would deem them to have economic effect, the court explained, under the heading, "Partner's interest in the partnership":

> Having determined that CRC's allocations of income to Newman PLLC and Town PS lack substantial economic effect, we must redetermine the allocations in accordance with "the partners' interests in the partnership". Treas. Reg. § 1.704-1(b)(1)(i). In this analysis, we must determine the "manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated, taking" into account all the facts and circumstances. Treas. Reg. § 1.704-1(b)(3)(i). To do so, the regulation calls on us to examine (1) the partners' relative contributions to the partnership, (2) the interests of the respective partners in profits and losses (if different from that in taxable income or loss),

(3) their relative interests in cash flow and other non-liquidating distributions, and (4) their rights to distributions of capital upon liquidation.[61] Treas. Reg. § 1.704-1(b)(3)(ii). Petitioner does not offer any argument regarding the analysis of "the partner's interest in the partnership" or the individual factors set out in the regulation.

[61] Treasury Regulation § 1.704-1(b)(3)(iii) provides that if the first two requirements of the basic test are met (*i.e.*, that the partnership agreement provides for (1) the determination and maintenance of the partners' capital accounts in accordance with the capital account rules and (2) liquidating distributions to be made in accordance with the positive capital account balances of the partners), then "the partners' interests in the partnership with respect to the portion of the allocation that lacks economic effect will be determined" with a comparative liquidation analysis. *See, e.g., Interhotel Co. v. Commissioner*, T.C. Memo. 2001-151, 81 T.C.M. (CCH) 1804, 1809, supplementing T.C. Memo. 1997-449. However, neither party argues that this comparative liquidation test should govern our analysis (in fact, the Commissioner argues explicitly that it should not apply, and CRC does not contest the Commissioner's argument), so we do not address it.

The terms of the 2013 LLC Agreement ostensibly complied with the criteria of the alternate test for economic effect, but the special allocation lacked substantial economic effect because the partnership failed to correctly maintain capital accounts in accordance with those terms and with the regulations.[62] We proceed with examining the relevant factors, keeping in mind that our goal is to derive the "manner in which the partners *have agreed* to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated", Treas. Reg. § 1.704-1(b)(3)(i) (emphasis added), and that the 2013 LLC Agreement is evidence of such agreement.

[62] In some of the cases that have employed a partner's interest in the partnership analysis, the Court has examined the actual distributions received by the partners (and other similar items) to determine the partners' interests in the partnership because the partnerships lacked written partnership agreements. *See, e.g., Holdner v. Commissioner*, T.C. Memo. 2010-175, 100 T.C.M. (CCH) 108, 116-17, *aff'd*, 483 F.App'x 383 (9th Cir. 2012); *Estate of Ballantyne v. Commissioner*, T.C. Memo. 2002-160, 83 T.C.M. (CCH) 1896, 1904-06, *aff'd*, 341 F.3d 802 (8th Cir. 2003). In other cases the partnership agreement lacked the provisions for capital account maintenance or distributions in liquidation of the partnership under Treasury Regulation § 1.704-1(b)(2)(ii)(b)(1) and (2), or the allocations prescribed by the partnership agreement lacked substantial economic effect, and so the Court relied heavily on the history of the partners' relative contributions (or the impact of the partners' relative contributions on prospective liquidating distributions) to determine the partners' interests in the partnership. *See, e.g., Estate of Tobias v. Commissioner*, T.C. Memo. 2001-37, 81 T.C.M. (CCH) 1163, 1169-71; *PNRC Ltd. P'ship v. Commissioner*, T.C. Memo. 1993-335, 66 T.C.M. (CCH) 265, 268, 270. In this case, however, the partnership did have a written partnership agreement, and that written agreement did have provisions of the sort that, in other cases, were lacking and had to be inferred or hypothesized.

Under the heading, "'Align[ing]' distribution and income allocation in the 'book-up'," the court reasoned:

> The Commissioner has another argument to resist the allocation of income away from Clark PLLC and toward the other two partners. He contends:
>
> > Section 9.3 [of the 2013 LLC Agreement], when read in conjunction with...section 9.1 requires a matching of the book-up and the distribution. Because section 9.3(a) requires that non-cash distributions reflect how the cash proceeds from the sale of such property would have been distributed, it follows that the book-up must be allocated to the distributee[s] – had the property been sold first, with the proceeds distributed to Newman PLLC and Town PS, the matching rule of section 9.1 would have required the gain from the hypothetical sale to be allocated in a manner that is consistent with that cash distribution from a hypothetical sale.... If CRC would have distributed the cash proceeds from a hypothetical sale of $419,043 and $447,437, to Newman PLLC and Town PS, respectively, then it follows that the book-up would have been allocated in these same amounts to the distributee partners, resulting in a wash to their capital accounts.
>
> Assuming his premises, the Commissioner is partly right: He is right that, if the unrealized gain is allocated only to the distribute partners (Newman PLLC and Town PS) and not to Clark PLLC, then that gain allocation would increase their capital accounts, and the immediately subsequent distribution would reduce their capital accounts, and the net effect would be "a wash". Their accounts would not be driven into negative status; the QIO would not be triggered; and CRC's 2013 income would not be allocated to those partners.
>
> But we disagree with the Commissioner's insistence that a "matching" is required and that the unrealized gain is allocated solely to the distributee partners. The 2013 LLC Agreement explicitly says otherwise. Section 9.3(a) requires that, before the distribution, unrealized gain must be allocated among the partners not in accordance with their being distributees of the gain but rather "in accordance with Article 8" (*i.e.*, in accordance with their allocations of "Net Profit or Net Loss for [the] fiscal year of the Company"). The LLC agreement could hardly be clearer. The allocation of gain, made before any distribution has occurred, is in accordance with Article 8.
>
> Less clear is how to reconcile the 2013 LLC Agreement with the distribution of client-based intangible assets to only two of the partners. Section 9.3(a) states that "[n]oncash assets...shall be distributed in a manner that reflects how cash proceeds from the sale of such assets for fair market value would have been distributed"; and Section 9.1 states that "Distributions of Distributable Cash may be made to the Members as such time and amounts as determined in the Managers' reasonable discretion, provided that such Distributions will be consistent with the allocations of income made pursuant to Section 8.1". Section 9.1 thus does state that the distributions "will be consistent with" the provisions of Section 8.1 (providing for allocations of net profit or loss); but Section 9.1 commits the matter to managerial discretion, so opinions might differ about the propriety of the client distribution under the 2013 LLC Agreement.
>
> However, we are adjudicating a dispute about the tax consequences of a distribution that was in fact made; we are not adjudicating a dispute about a partner's claim that he was wrongly left out of a distribution. Either dispute is resolved by the Settlement Agreement,

which compromised the parties' disagreements about the withdrawal of Newman PLLC and Town PS from CRC and left the client-based intangibles in the hands of the withdrawing partners. The Commissioner is certainly right to begin his analysis with the text of Sections 8.1, 9.1, and 9.3 of the 2013 LLC Agreement, but ending there without resort to the Settlement Agreement makes the puzzle seem more difficult than it actually is. We construe the 2013 LLC Agreement in light of the later Settlement Agreement, which superseded the LLC agreement.

We conclude that the unrealized gain is properly allocated among all three partners (as set out in Section 8.1) so that the capital accounts of all three are increased, but we conclude that because the agreed-upon distribution was made only to the withdrawing partners, only their capital accounts are reduced. Consequently, the withdrawing partners' capital accounts did go negative, the QIO was triggered, and considering our analysis of the partners' interests in the partnership (and weighing most heavily the partners' agreement regarding their interests in economic profits and losses), CRC's 2013 income should be allocated to the withdrawing partners' accounts to bring them up to zero.[71]

[71] The Commissioner contends that all of CRC's ordinary income for the period of January 2013 to April 2013 is properly allocable to Clark PLLC under Section 8.1(c), which allocates all income remaining after the allocations of Section 8.1(a) and (b) according to the FMG system. The parties have stipulated that $15,387 of income is allocable to Clark PLLC under Section 8.1(b) (for amounts collected on accounts receivable) and that all remaining income is allocable to Clark PLLC under Section 8.1(c), but our analysis does not reach Section 8.1(a)-(c) of the 2013 LLC Agreement, and therefore the parties' stipulations regarding these allocations of income are not helpful in this regard. Instead, the introductory text of Section 8.1 subjects the partnership's income allocations to Section 8.3 (regarding special allocations), and therefore, due to the deficit capital account balances of Newman PLLC and Town PS, the QIO provision under Section 8.3 controls the allocation of CRC's entire amount of income for 2013.

We will order the parties to submit computations under Rule 155 to determine the exact amount of Newman PLLC's and Town PS's capital account balance deficiencies (after applicable adjustments to their capital accounts) and the amounts of income allocable to the partners' capital accounts as a result. Those computations should account for the following capital account adjustments, beginning with the partners' reported opening capital account balances in 2013, see *supra* p. 24: (1) the allocation of $742,569 of unrealized gain (in the client-based intangible assets) according to Section 8.1 of the 2013 LLC Agreement; (2) the distribution of client-based intangible assets of $318,144 to Newman PLLC and $424,425 to Town PS; (3) the distribution on account of the WTB Loan of $183,737, see *supra* note 3; and (4) the cash distributions to the partners in the amounts stipulated by the parties, see *supra* note 3. By our preliminary calculations, the amount of CRC's income in 2013 is insufficient to bring both Newman PLLC's and Town PS's capital accounts up to zero. Therefore, the income must be allocated between them in some proportion. In the absence of contentions by the parties as to how to divide the total amount of ordinary income, we hold that CRC's income should be allocated to each partner's deficit capital account in an amount equal to that partner's pro rata "share" of the total negative balances of those accounts, calculated by dividing the deficit balance of each partner's capital account by the combined deficits of both partners' capital

> accounts and then multiplying the resulting ratio for each partner by the total amount of ordinary income to be allocated.

The court concluded:

> CRC's special allocation of income of $307,759 to Newman PLLC and $255,799 to Town PS in 2013 did lack substantial economic effect (as the FPAA determined) because the partnership failed to maintain capital accounts in accordance with the requirement of Treasury Regulation section 1.704-1(b)(2)(iv) that CRC must allocate the unrealized gain inherent in the client-based intangibles across the partners' capital accounts before decreasing Newman PLLC's and Town PS's capital accounts by the value of the distribution. However, an analysis of the partners' interests in the partnership reveals that although Clark PLLC was the largest percentage owner of CRC's "membership units", the partners agreed to income allocations in their partnership agreement (including a QIO) that are most indicative of how they agreed to share the economic benefits and burdens of the partnership, particularly in light of the unanticipated distribution of client-based intangibles to Newman PLLC and Town PS.

This case's result departs dramatically from the normal result of distributing assets whose value exceeds their basis. In this case, that excess value was ordinary income to the recipient partners and a reduction in gross receipts (generating an ordinary loss) to the remaining partners. Normally, such a distribution would merely provide carryover basis (zero in this case) to the recipient partners, without any tax benefit to the remaining partners.[510] Here, the book gain on the distribution of the client-based intangibles was allocated to the remaining partners, so the recipient partners receipt of the client-based intangibles drove their capital accounts negative. Given that their capital accounts must end with a zero balance, they received an allocation of ordinary income to increase their capital accounts. Presumably the distributees would amortize the client-based intangibles over 15 years.[511] For a very brief comment about planning around this result, see part II.Q.8.b.i.(d) Capital Accounting May Trigger Ordinary Income.

For family partnerships, properly maintaining capital accounts is important to avoiding taxable gifts[512] and in analyzing Code § 2701.[513]

Sometimes distributions of property and other transfers change the partnership's property's basis. See part II.Q.8.e.iii.(e) Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election. Such a change may be reflected in capital accounts.[514]

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[510] See part II.Q.8.b.i Distribution of Property by a Partnership, especially subpart II.Q.8.b.i.(a) Code § 731: General Rule for Distributions.

[511] See part II.Q.1.c Personal Goodwill and Covenants Not to Compete, especially subpart II.Q.1.c.i Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation.

[512] See part III.B.1.a.iv.(a) Gift/Estate Tax Uses and Issues Regarding Family Partnerships, especially fn. 6308.

[513] See part III.B.7.b Code § 2701 Overview, especially fn. 7315.

[514] Reg. § 1.704-1(b)(2)(iv)(m)(4), "Section 734 adjustments," provides:

> Except as provided in paragraph (b)(2)(iv)(m)(5) of this section, in the case of a distribution of property in liquidation of a partner's interest in the partnership by a partnership that has a

When part or all of a partnership interest is transferred, the transferor's capital account attributable to the transferred interest must carry over to the transferee partner.[515] Generally, when transfers trigger adjustment as a result of a Code § 754 election,[516] adjustments to the adjusted tax basis of partnership property are not reflected in the capital account of the transferee partner or on the books of the partnership, and subsequent capital account adjustments for distributions and for depreciation, depletion, amortization, and gain or loss with respect to such property will disregard the effect of such basis adjustment; however, adjustments that affect the partnership's common basis might need to be reflected.[517] Although generally partner-specific Code § 743(b) adjustments do not generate inside basis and capital

> section 754 election in effect for the partnership taxable year in which the distribution occurs, the partner who receives the distribution that gives rise to the adjustment to the adjusted tax basis of partnership property under section 734 shall have a corresponding adjustment made to his capital account. If such distribution is made other than in liquidation of a partner's interest in the partnership, however, except as provided in paragraph (b)(2)(iv)(m)(5) of this section, the capital accounts of the partners shall be adjusted by the amount of the adjustment to the adjusted tax basis of partnership property under section 734, and such capital account adjustment shall be shared among the partners in the manner in which the unrealized income and gain that is displaced by such adjustment would have been shared if the property whose basis is adjusted were sold immediately prior to such adjustment for its recomputed adjusted tax basis.

Reg. § 1.704-1(b)(2)(iv)(m)(5), "Limitations on adjustments," is reproduced in fn 519.

[515] Reg. § 1.704-1(b)(2)(iv)(*l*), which requires that "upon the transfer of all or a part of an interest in the partnership, the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner."

[516] See parts II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest, and II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

[517] Reg. § 1.704-1(b)(2)(iv)(m). The description in the text above does not capture exceptions provided by the regulation, so read the regulation to get the full flavor. If capital account adjustments are made, Reg. § 1.704-1(b)(2)(iv)(m) limits them:

> Adjustments may be made to the capital account of a partner (or his successor in interest) in respect of basis adjustments to partnership property under sections 732, 734, and 743 only to the extent that such basis adjustments (i) are permitted to be made to one or more items of partnership property under section 755, and (ii) result in an increase or a decrease in the amount at which such property is carried on the partnership's balance sheet, as computed for book purposes. For example, if the book value of partnership property exceeds the adjusted tax basis of such property, a basis adjustment to such property may be reflected in a partner's capital account only to the extent such adjustment exceeds the difference between the book value of such property and the adjusted tax basis of such property prior to such adjustment.

account adjustments, they may generate basis[518] and capital account[519] adjustments when a person who has partner-specific Code § 743(b) adjustments has his or her partnership interest liquidated without having received the benefit of those partner-specific Code § 743(b) adjustments.

When considering the practical issues of maintaining a chart of accounts and a fixed asset system and implementing a Code § 754 basis step-up, consider setting up a separate capital account on the system for the Code § 754 basis step-up and for the stepped-up assets. Use these items on the tax return but eliminate them when preparing financial statements, because they are not GAAP. Thus, the stepped-up assets would be in a separate grouping in the system to facilitate their elimination on financial statements.

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[518] Reg. § 1.734-2(b)(1) provides:

> If a transferee partner, in liquidation of his entire partnership interest, receives a distribution of property (including money) with respect to which he has no special basis adjustment, in exchange for his interest in property with respect to which he has a special basis adjustment, and does not utilize his entire special basis adjustment in determining the basis of the distributed property to him under section 732, the unused special basis adjustment of the distributee shall be applied as an adjustment to the partnership basis of the property retained by the partnership and as to which the distributee did not use his special basis adjustment. The provisions of this subparagraph may be illustrated by the following example:
>
> *Example*. Upon the death of his father, partner S acquires by inheritance a half-interest in partnership ACS. Partners A and C each have a one-quarter interest. The assets of the partnership consist of $10,000 cash and land used in farming worth $10,000 with a basis of $1,000 to the partnership. Since the partnership had made the election under section 754 at the time of transfer, partner S had a special basis adjustment of $4,500 under section 743(b) with respect to his undivided half-interest in the real estate. The basis of S's partnership interest, in accordance with section 742, is $10,000. S retires from the partnership and receives $10,000 in cash in exchange for his entire interest. Since S has received no part of the real estate, his special basis adjustment of $4,500 will be allocated to the real estate, the remaining partnership property, and will increase its basis to the partnership to $5,500.

[519] Reg. § 1.704-1(b)(2)(iv)(m)(2), "Section 743 adjustments," provides:

> In the case of a transfer of all or a part of an interest in a partnership that has a section 754 election in effect for the partnership taxable year in which such transfer occurs, adjustments to the adjusted tax basis of partnership property under section 743 shall not be reflected in the capital account of the transferee partner or on the books of the partnership, and subsequent capital account adjustments for distributions (see paragraph (b)(2)(iv)(e)(1) of this section) and for depreciation, depletion, amortization, and gain or loss with respect to such property will disregard the effect of such basis adjustment. The preceding sentence shall not apply to the extent such basis adjustment is allocated to the common basis of partnership property under paragraph (b)(1) of §1.734-2; in these cases, such basis adjustment shall, except as provided in paragraph (b)(2)(iv)(m)(5) of this section, give rise to adjustments to the capital accounts of the partners in accordance with their interests in the partnership under paragraph (b)(3) of this section. See examples (13)(iii) and (iv) of paragraph (b)(5) of this section.

Reg. § 1.704-1(b)(2)(iv)(m)(5), "Limitations on adjustments," provides:

> Adjustments may be made to the capital account of a partner (or his successor in interest) in respect of basis adjustments to partnership property under sections 732, 734, and 743 only to the extent that such basis adjustments (i) are permitted to be made to one or more items of partnership property under section 755, and (ii) result in an increase or a decrease in the amount at which such property is carried on the partnership's balance sheet, as computed for book purposes. For example, if the book value of partnership property exceeds the adjusted tax basis of such property, a basis adjustment to such property may be reflected in a partner's capital account only to the extent such adjustment exceeds the difference between the book value of such property and the adjusted tax basis of such property prior to such adjustment.

II.C.8. Effect of Employee Becoming a Partner

When an employee becomes a partner,[520] that person is no longer an employee.[521]

II.C.8.a. Code § 707 - Compensating a Partner for Services Performed

Code § 707(a)(1) provides that, if a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in Code § 707, be considered as occurring between the partnership and one who is not a partner.

Code § 707(a)(2)(A) provides that, under regulations, if a partner performs services for a partnership, there is a related direct or indirect allocation and distribution to such partner, and the performance of such services and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, such allocation and distribution shall be treated as a transaction described in Code § 707(a)(1).

Code § 707(c), "Guaranteed payments," provides that, to the extent determined without regard to the income of the partnership, payments to a partner for are considered as made to one who is not a member of the partnership, but only for the purposes of including the payments in the partner's income or the partnership deducting or capitalizing the payments.[522]

Although Code § 707(a)(2)(A) and (c) and Reg. § 1.707-1(c) (cited below) refer to payments for services or for the use of capital, this part II.C.8.a focuses on services performed.

Payments made by a partnership to a partner for services (as used in this part II.C.8.a, "guaranteed payments") are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership.[523]

The construct of Code § 707 is really intended to create three separate kinds of arrangements for services provided:

- If a partner performs services as a partner – exercising authority under the partnership agreement and fulfilling duties as a partner – the partner may be compensated through two types of arrangements:

[520] See part II.M.4.f Issuing a Profits Interest to a Service Provider.
[521] See parts II.L.3 Self-Employment Tax: General Partner or Sole Proprietor (especially fn. 3454, regarding wages paid to partners), II.P.2 C Corporation Advantage Regarding Fringe Benefits (especially fn. 3896) and III.B.7.c.viii Creative Bonus Arrangements (especially fn. 7378).
[522] Referring to Code §§ 61(a), 162(a), and 263 are the only Code sections affected. As to the partnership deducting or capitalizing payments, Reg. § 1.707-1(c) provides:

> For a guaranteed payment to be a partnership deduction, it must meet the same tests under section 162(a) as it would if the payment had been to a person who is not a member of the partnership, and the rules of section 263 (relating to capital expenditures) must be taken into account. This rule does not affect the deductibility to the partnership of a payment described in section 736(a)(2) to a retiring partner or to a deceased partner's successor in interest.

For the latter, see part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.
[523] Reg. § 1.707-1(c).

- The partner's interest in the partnership's profits (non-Code § 707 distributions), or

- Payments that are based on something other than the partnership's profits, which are Code § 707(c) guaranteed payments.[524]

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[524] Former Rev. Rul. 81-300 reasoned:

> In *Pratt v. Commissioner*, 64 T.C. 203 (1975), *aff'd in part, rev'd in part*, 550 F.2d 1023 (5th Cir. 1977), under substantially similar facts to those in this case, both the United States Tax Court and the United States Court of Appeals for the Fifth Circuit held that management fees based on a percentage of gross rentals were not payments described in section 707(a) of the Code. The courts found that the terms of the partnership agreement and the actions of the parties indicated that the taxpayers were performing the management services in their capacities as general partners. *Compare* Rev. Rul. 81-301, this page, this Bulletin.
>
> When a determination is made that a partner is performing services in the capacity of a partner, a question arises whether the compensation for the services is a guaranteed payment under section 707(c) of the Code or a distributive share of partnership income under section 704. In *Pratt*, the Tax Court held that the management fees were not guaranteed payments because they were computed as a percentage of gross rental income received by the partnership. The court reasoned that the gross rental income was income of the partnerships and, thus, the statutory test for a guaranteed payment, that it be determined without regard to the income of the partnership, was not satisfied. On appeal, the taxpayer's argument was limited to the section 707(a) issue and the Fifth Circuit found it unnecessary to consider the application of section 707(c).
>
> The legislative history of the Internal Revenue Code of 1954 indicates the intent of Congress to treat partnerships as entities in the case of certain transactions between partners and their partnerships. *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 92 (1954). The Internal Revenue Code of 1939 and prior Revenue Acts contain no comparable provision and the courts had split on the question of whether a partner could deal with the partnership as an outsider. *Compare Lloyd v. Commissioner*, 15 B.T.A. 82 (1929) and *Wegener v. Commissioner*, 119 F.2d 49 (5th Cir. 1941), *aff'g* 41 B.T.A. 857 (1940), *cert. denied* 314 U.S. 643 (1941). This resulted both in uncertainty and in substantial computational problems when an aggregate theory was applied and the payment to a partner exceeded the partnership income. In such situations, the fixed salary was treated as a withdrawal of capital, taxable to the salaried partner to the extent that the withdrawal was made from the capital of other partners. *See*, for example, Rev. Rul. 55-30, 1955-1 C.B. 430. Terming such treatment as unrealistic and unnecessarily complicated, Congress enacted section 707(a) and (c) of the Code of 1954. Under section 707(a) the partnership is considered an unrelated entity for all purposes. Under section 707(c), the partnership is considered an unrelated entity for purposes of sections 61 and 162 to the extent that it makes a guaranteed payment for services or for the use of capital.
>
> Although a fixed amount is the most obvious form of guaranteed payment, there are situations in which compensation for services is determined by reference to an item of gross income. For example, it is not unusual to compensate a manager of real property by reference to the gross rental income that the property produces. Such compensation arrangements do not give the provider of the service a share in the profits of the enterprise, but are designed to accurately measure the value of the services that are provided.
>
> Thus, and [sic] view of the legislative history and the purpose underlying section 707 of the Code, the term guaranteed payment should not be limited to fixed amounts. A payment for services determined by reference to an item of gross income will be a guaranteed payment if, on the basis of all of the facts and circumstances, the payment is compensation rather than a share of partnership profits. Relevant facts would include the reasonableness of the payment for the services provided and whether the method used to determine the amount of the payment would have been used to compensate an unrelated party for the services.

- If the partner performs services as an independent contractor and not as a partner, then Code § 707(a) applies.[525]

Whether a particular compensation arrangement is a guaranteed payment or a distributive share of profits is a fluid concept. Generally, a payment based on gross income constitutes a guaranteed payment (such as a fixed percentage of gross rent), whereas a payment based on net income constitutes a distributive share (such as rental income net of all allocable expenses).[526] Reg. § 1.707-1(c) provides some examples:

> *Example (1)*. Under the ABC partnership agreement, partner A is entitled to a fixed annual payment of $10,000 for services, without regard to the income of the partnership. His distributive share is 10 percent. After deducting the guaranteed payment, the partnership has $50,000 ordinary income. A must include $15,000 as ordinary income for his taxable year within or with which the partnership taxable year ends ($10,000 guaranteed payment plus $5,000 distributive share).

> It is the position of the Internal Revenue Service that in *Pratt* the management fees were guaranteed payments under section 707(c) of the Code. On the facts presented, the payments were not disguised distributions of partnership net income, but were compensation for services payable without regard to partnership income.

However, the IRS has revoked Rev. Rul. 81-300; see fn. 527. Its text is reproduced to distinguish between services that are or are not subject to Code § 707 rather than to distinguish between Code § 707(a) and (c).

[525] See The Lost Regulations—Section 707 and the Definition of Partner Capacity, *Business Entities* (WG&L), Jan./Feb. 2009. Rev Rul. 81-301 reasoned that Code § 707(a), rather than Code § 707(c), governed the following arrangement:

> Although the adviser is identified in the agreement as an adviser general partner, the adviser provides similar services to others as part of its regular trade or business, and its management of the investment and reinvestment of ABC's assets is supervised by the directors. Also it can be relieved of its duties and right to compensation at any time (with 60 days' notice) by a majority vote of the directors. Further, the adviser pays its own expenses and is not personally liable to the other partners for any losses incurred in the investment and reinvestment of ABC's assets. The services performed by the adviser are, in substance, not performed in the capacity of a general partner, but are performed in the capacity of a person who is not a partner.

It held:

> The 10 percent daily gross income allocation paid to the adviser is subject to section 707(a) of the Code and taxable to the adviser under section 61 as compensation for services rendered. The amount paid is deductible by the partnership under section 162, subject to the provisions of section 265.

[526] McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 14.03 Partners Acting in Their Capacities as Partners: Section 707(c) Guaranteed Payments, discusses that the Tax Court held that a management fee equal to 3% of gross rents constituted a distributive share rather than a guaranteed payment. The treatise states that the IRS disagreed with the Tax Court's ruling, both citing the Rev. Rul. and providing details in a footnote:

> Rev. Rul. 81-300, 1981-2 CB 143. The legislative history of the Deficit Reduction Act of 1984, however, states that the transaction described in Rev. Rul. 81-300 should be governed by § 707(a), not § 707(c). Moreover, it seems that § 707(a) treatment is dictated by the fact that the services rendered (real estate management) are traditionally compensated by fees that are a percentage of gross income, thus triggering § 707(a)(2)(A). 1 Senate Comm. on Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984, S. Rpt. No. 169, at 229, 230 (Comm. Print 1984)….

Since then, Rev. Rul. 81-300 has been obsoleted; see fn. 524. I have not looked for changes to the treatise.

> *Example (2)*. Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000, $6,000 (30 percent of $20,000) would be partner C's distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.
>
> *Example (3)*. Partner X in the XY partnership is to receive a payment of $10,000 for services, plus 30 percent of the taxable income or loss of the partnership. After deducting the payment of $10,000 to partner X, the XY partnership has a loss of $9,000. Of this amount, $2,700 (30 percent of the loss) is X's distributive share of partnership loss and, subject to section 704(d), is to be taken into account by him in his return. In addition, he must report as ordinary income the guaranteed payment of $10,000 made to him by the partnership.
>
> *Example (4)*. Assume the same facts as in example (3) of this paragraph, except that, instead of a $9,000 loss, the partnership has $30,000 in capital gains and no other items of income or deduction except the $10,000 paid X as a guaranteed payment. Since the items of partnership income or loss must be segregated under section 702(a), the partnership has a $10,000 ordinary loss and $30,000 in capital gains. X's 30 percent distributive shares of these amounts are $3,000 ordinary loss and $9,000 capital gain. In addition, X has received a $10,000 guaranteed payment which is ordinary income to him.

In 2015, the IRS announced a more aggressive posture in reclassifying arrangements as disguised payments for services.[527] Example (2) is now on the chopping block.[528] REG-115452-14, "Disguised Payments for Services," proposes the following:

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[527] On July 22, 2015, REG-115452-14, "Disguised Payments for Services," revoked Rev. Rul. 81-300, promulgating Prop. Reg. § 1.707-2, explaining:

REG-115452-14 immediately changed the government's position:

> The proposed regulations would be effective on the date the final regulations are published in the Federal Register and would apply to any arrangement entered into or modified on or after the date of publication of the final regulations. In the case of any arrangement entered into or modified before the final regulations are published in the Federal Register, the determination of whether an arrangement is a disguised payment for services under section 707(a)(2)(A) is made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 707(a)(2)(A). Pending the publication of final regulations, the position of the Treasury Department and the IRS is that the proposed regulations generally reflect Congressional intent as to which arrangements are appropriately treated as disguised payments for services.

The legislative history referred to above includes:

> … the committee intends that the provision will lead to the conclusions contained in Revenue Ruling 81-300, 1981-2 CB 143, and Revenue Ruling 81-301, 1981-2 CB 144, except that the transaction described in Revenue Ruling 81-300 would be treated as a transaction described in section 707(a).

[528] REG-115452-14, Disguised Payments for Services (July 22, 2015), commented:

> Congress's emphasis on entrepreneurial risk requires changes to existing regulations under section 707(c). Specifically, Example 2 of § 1.707-1(c) provides that if a partner is entitled to an allocation of the greater of 30 percent of partnership income or a minimum guaranteed amount,

Par. 3. Section 1.707–1 is amended by adding a sentence at the end of paragraph (a) and revising paragraph (c) Example 2 to read as follows.

§ 1.707–1. Transactions between partner and partnership.

(a) … For arrangements pursuant to which a purported partner performs services for a partnership and the partner receives a related direct or indirect allocation and distribution from the partnership, see § 1.707–2 to determine whether the arrangement should be treated as a disguised payment for services.

(c) …

Example 2. Partner C in the CD partnership is to receive 30 percent of partnership income, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000). Of this amount, $10,000 is a guaranteed payment to C. The $10,000 guaranteed payment reduces the partnership's net income to $50,000 of which C receives $8,000 as C's distributive share.

Below much space is devoted to analyzing the proposed regulations, which the IRS views as reflecting current law to a large degree. REG-115452-14, "Disguised Payments for Services" (7/23/2015), discusses "Effective Dates":

> The proposed regulations would be effective on the date the final regulations are published in the *Federal Register* and would apply to any arrangement entered into or modified on or after the date of publication of the final regulations. In the case of any arrangement entered into or modified before the final regulations are published in the *Federal Register*, the determination of whether an arrangement is a disguised payment for services under section 707(a)(2)(A) is made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 707(a)(2)(A). Pending the publication of final regulations, the position of the Treasury Department and the IRS is that the proposed regulations generally reflect Congressional intent as to which arrangements are appropriately treated as disguised payments for services.

and the income allocation exceeds the minimum guaranteed amount, then the entire income allocation is treated as a distributive share under section 704(b). Example 2 also provides that if the income allocation is less than the guaranteed amount, then the partner is treated as receiving a distributive share to the extent of the income allocation and a guaranteed payment to the extent that the minimum guaranteed payment exceeds the income allocation. The treatment of the arrangements in Example 2 is inconsistent with the concept that an allocation must be subject to significant entrepreneurial risk to be treated as a distributive share under section 704(b). Accordingly, the proposed regulations modify Example 2 to provide that the entire minimum amount is treated as a guaranteed payment under section 707(c) regardless of the amount of the income allocation. Rev. Rul. 66-95, 1966-1 C.B. 169, and Rev. Rul. 69-180, 1969-1 C.B. 183, are also inconsistent with these proposed regulations. The Treasury Department and the IRS intend to obsolete Rev. Rul. 66-95 and revise Rev. Rul. 69-180, when these regulations are published in final form.

REG-115452-14, “Disguised Payments for Services,” explained its view of the legislative history to Code § 707(a)(2):[529]

> Congress determined that allocations and distributions that were, in substance, direct payments for services should be treated as a payment of fees rather than as an arrangement for the allocation and distribution of partnership income. H.R. Rep. at 1218; S. Prt. at 225. Congress differentiated these arrangements from situations in which a partner receives an allocation (or increased allocation) for an extended period to reflect its contribution of property or services to the partnership, such that the partner receives the allocation in its capacity as a partner. In balancing these potentially conflicting concerns, Congress anticipated that the regulations would take five factors into account in determining whether a service provider would receive its putative allocation and distribution in its capacity as a partner. H.R. Rep. at 1219–20; S. Prt. at 227.
>
> Congress identified as its first and most important factor whether the payment is subject to significant entrepreneurial risk as to both the amount and fact of payment. In explaining why entrepreneurial risk is the most important factor, Congress provides that ‘‘[p]artners extract the profits of the partnership with reference to the business success of the venture, while third parties generally receive payments which are not subject to this risk.’’ S. Prt. at 227. An arrangement for an allocation and distribution to a service provider which involves limited risk as to amount and payment is treated as a fee under section 707(a)(2)(A). Congress specified examples of allocations that presumptively limit a partner’s risk, including (i) capped allocations of income, (ii) allocations for a fixed number of years under which the income that will go to the partner is reasonably certain, (iii) continuing arrangements in which purported allocations and distributions are fixed in amount or reasonably determinable under all facts and circumstances, and (iv) allocations of gross income items.
>
> An arrangement in which an allocation and distribution to a service provider are subject to significant entrepreneurial risk as to amount will generally be recognized as a distributive share, although other factors are also relevant. The legislative history to section 707(a)(2)(A) includes the following examples of factors that could bear on this determination: (i) Whether the partner status of the recipient is transitory; (ii) whether the allocation and distribution that are made to the partner are close in time to the partner’s performance of services; (iii) whether the facts and circumstances indicate that the recipient became a partner primarily to obtain tax benefits for itself or the partnership that would not otherwise have been available; and (iv) whether the value of the recipient’s interest in general and in continuing partnership profits is small in relation to the allocation in question.

REG-115452-14, “Disguised Payments for Services,” describes the proposed regulations:

> *I. General Rules Regarding Disguised Payments for Services*
>
> A. Scope
>
> Consistent with the language of section 707(a)(2)(A), § 1.707-2(b) of the proposed regulations provides that an arrangement will be treated as a disguised payment for

[529] It cited H.R. Rep. No. 432 (Pt. 2), 98th Cong., 2d Sess. 1216-21 (1984) (H.R. Rep.); S. Prt. No. 169 (Vol. 1), 98th Cong., 2d Sess. 223–32 (1984) (S. Prt.).

services if (i) a person (service provider), either in a partner capacity or in anticipation of being a partner, performs services (directly or through its delegate) to or for the benefit of the partnership; (ii) there is a related direct or indirect allocation and distribution to the service provider; and (iii) the performance of the services and the allocation and distribution when viewed together, are properly characterized as a transaction occurring between the partnership and a person acting other than in that person's capacity as a partner.

The proposed regulations provide a mechanism for determining whether or not an arrangement is treated as a disguised payment for services under section 707(a)(2)(A). An arrangement that is treated as a disguised payment for services under these proposed regulations will be treated as a payment for services for all purposes of the Code. Thus, the partnership must treat the payments as payments to a non-partner in determining the remaining partners' shares of taxable income or loss. Where appropriate, the partnership must capitalize the payments or otherwise treat them in a manner consistent with the recharacterization.

The consequence of characterizing an arrangement as a payment for services is otherwise beyond the scope of these regulations. For example, the proposed regulations do not address the timing of inclusion by the service provider or the timing of a deduction by the partnership other than to provide that each is taken into account as provided for under applicable law by applying all relevant sections of the Code and all relevant judicial doctrines. Further, if an arrangement is subject to section 707(a), taxpayers should look to relevant authorities to determine the status of the service provider as an independent contractor or employee. See, generally, Rev. Rul. 69-184, 1969-1 C.B. 256.[530] The Treasury Department and the IRS believe that section 707(a)(2)(A) generally should not apply to arrangements that the partnership has reasonably characterized as a guaranteed payment under section 707(c).

Allocations pursuant to an arrangement between a partnership and a service provider to which sections 707(a) and 707(c) do not apply will be treated as a distributive share under section 704(b). Rev. Proc. 93-27 and Rev. Proc. 2001–43 may apply to such an arrangement if the specific requirements of those Revenue Procedures are also satisfied. The Treasury Department and the IRS intend to modify the exceptions set forth in those revenue procedures to include an additional exception for profits interests issued in conjunction with a partner forgoing payment of a substantially fixed amount. This exception is discussed in part IV of the Explanation of Provisions section of this preamble.

B. Application and Timing

These proposed regulations apply to a service provider who purports to be a partner even if applying the regulations causes the service provider to be treated as a person who is not a partner. S. Prt. at 227. Further, the proposed regulations may apply even if their application results in a determination that no partnership exists. The regulations also apply to a special allocation and distribution received in exchange for services by a

[530] [My footnote:] For using a tiered partnership structure to enable a partner's salary-type compensation to be reported on Form W-2, see text accompanying and flowchart following fn 556 in part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

service provider who receives other allocations and distributions in a partner capacity under section 704(b).

The proposed regulations characterize the nature of an arrangement at the time at which the parties enter into or modify the arrangement. Although section 707(a)(2)(A)(ii) requires both an allocation and a distribution to the service provider, the Treasury Department and the IRS believe that a premise of section 704(b) is that an income allocation correlates with an increased distribution right, justifying the assumption that an arrangement that provides for an income allocation should be treated as also providing for an associated distribution for purposes of applying section 707(a)(2)(A). The Treasury Department and the IRS considered that some arrangements provide for distributions in a later year, and that those later distributions may be subject to independent risk. However, the Treasury Department and the IRS believe that recharacterizing an arrangement retroactively is administratively difficult. Thus, the proposed regulations characterize the nature of an arrangement when the arrangement is entered into (or modified) regardless of when income is allocated and when money or property is distributed. The proposed regulations apply to both one-time transactions and continuing arrangements. S. Prt. at 226.

II. Factors Considered

Whether an arrangement constitutes a payment for services (in whole or in part) depends on all of the facts and circumstances. The proposed regulations include six non-exclusive factors that may indicate that an arrangement constitutes a disguised payment for services. Of these factors, the first five factors generally track the facts and circumstances identified as relevant in the legislative history for purposes of applying section 707(a)(2)(A). The proposed regulations also add a sixth factor not specifically identified by Congress. The first of these six factors, the existence of significant entrepreneurial risk, is accorded more weight than the other factors, and arrangements that lack significant entrepreneurial risk are treated as disguised payments for services. The weight given to each of the other five factors depends on the particular case, and the absence of a particular factor (other than significant entrepreneurial risk) is not necessarily determinative of whether an arrangement is treated as a payment for services.

A. Significant Entrepreneurial Risk

As described in the Background section of this preamble, Congress indicated that the most important factor in determining whether or not an arrangement constitutes a payment for services is that the allocation and distribution is subject to significant entrepreneurial risk. S. Prt. at 227. Congress noted that partners extract the profits of the partnership based on the business success of the venture, while third parties generally receive payments that are not subject to this risk. *Id.*

The proposed regulations reflect Congress's view that this factor is most important. Under the proposed regulations, an arrangement that lacks significant entrepreneurial risk constitutes a disguised payment for services. An arrangement in which allocations and distributions to the service provider are subject to significant entrepreneurial risk will generally be recognized as a distributive share but the ultimate determination depends on the totality of the facts and circumstances. The Treasury Department and the IRS request comments on whether allocations to service providers that lack significant entrepreneurial risk could be characterized as distributive shares under section 704(b) in any circumstances.

Whether an arrangement lacks significant entrepreneurial risk is based on the service provider's entrepreneurial risk relative to the overall entrepreneurial risk of the partnership. For example, a service provider who receives a percentage of net profits in each of a partnership that invests in high-quality debt instruments and a partnership that invests in volatile or unproven businesses may have significant entrepreneurial risk with respect to both interests.

Section 1.707-2(c)(1)(i) through (v) of the proposed regulations set forth arrangements that presumptively lack significant entrepreneurial risk. These arrangements are presumed to result in an absence of significant entrepreneurial risk (and therefore, a disguised payment for services) unless other facts and circumstances can establish the presence of significant entrepreneurial risk by clear and convincing evidence. These examples generally describe facts and circumstances in which there is a high likelihood that the service provider will receive an allocation regardless of the overall success of the business operation, including (i) capped allocations of partnership income if the cap would reasonably be expected to apply in most years, (ii) allocations for a fixed number of years under which the service provider's distributive share of income is reasonably certain, (iii) allocations of gross income items, (iv) an allocation (under a formula or otherwise) that is predominantly fixed in amount, is reasonably determinable under all the facts and circumstances, or is designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service provider (for example, if the partnership agreement provides for an allocation of net profits from specific transactions or accounting periods and this allocation does not depend on the overall success of the enterprise), and (v) arrangements in which a service provider either waives its right to receive payment for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.

With respect to the fourth example, the presence of certain facts, when coupled with a priority allocation to the service provider that is measured over any accounting period of the partnership of 12 months or less, may create opportunities that will lead to a higher likelihood that sufficient net profits will be available to make the allocation. One fact is that the value of partnership assets is not easily ascertainable and the partnership agreement allows the service provider or a related party in connection with a revaluation to control the determination of asset values, including by controlling events that may affect those values (such as timing of announcements that affect the value of the assets). (See Example 3(iv).) Another fact is that the service provider or a related party controls the entities in which the partnership invests, including controlling the timing and amount of distributions by those controlled entities. (These two facts by themselves do not, however, necessarily establish the absence of significant entrepreneurial risk.) By contrast, certain priority allocations that are intended to equalize a service provider's return with priority allocations already allocated to investing partners over the life of the partnership (commonly known as ''catch-up allocations'') typically will not fall within the types of allocations covered by the fourth example and will not lack significant entrepreneurial risk, although all of the facts and circumstances are considered in making that determination.

With respect to the fifth example, the Treasury Department and the IRS request suggestions regarding fee waiver requirements that sufficiently bind the waiving service provider and that are administrable by the partnership and its partners.

[The preamble then discusses matter described elsewhere.]

B. Secondary Factors

Section 1.707-2(c)(2) through (6) describes additional factors of secondary importance in determining whether or not an arrangement that gives the appearance of significant entrepreneurial risk constitutes a payment for services. The weight given to each of the other factors depends on the particular case, and the absence of a particular factor is not necessarily determinative of whether an arrangement is treated as a payment for services. Four of these factors, described by Congress in the legislative history to section 707(a)(2)(A), are (i) that the service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration, (ii) that the service provider receives an allocation and distribution in a time frame comparable to the time frame that a non-partner service provider would typically receive payment, (iii) that the service provider became a partner primarily to obtain tax benefits which would not have been available if the services were rendered to the partnership in a third party capacity, and (iv) that the value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution.

To these four factors, the proposed regulations add a fifth factor. The fifth factor is present if the arrangement provides for different allocations or distributions with respect to different services received, where the services are provided either by a single person or by persons that are related under sections 707(b) or 267(b), and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly. For example, assume that a partnership receives services from both its general partner and from a management company that is related to the general partner under section 707(b). Both the general partner and the management company receive a share in future partnership net profits in exchange for their services. The general partner is entitled to an allocation of 20 percent of net profits and undertakes an enforceable obligation to repay any amounts distributed pursuant to its interest (reduced by reasonable allowance for tax payments made on the general partner's allocable shares of partnership income and gain) that exceed 20 percent of the overall net amount of partnership profits computed over the partnership's life and it is reasonable to anticipate that the general partner can and will comply fully with this obligation. The proposed regulations refer to this type of obligation and similar obligations, as a ''clawback obligation.''[531] In contrast, the management company is entitled to a preferred amount of net income that, once paid, is not subject to a clawback obligation. Because the general partner and the management company are service providers that are related parties under section 707(b), and because the terms of the allocations and distributions to the management company create a significantly lower level of economic risk than the terms for the general partner, the management company's arrangement might properly be treated as a disguised payment for services (depending on all other facts and circumstances, including amount of entrepreneurial risk).

[531] [footnote not in the preamble] For a discussion of clawback obligations, see text accompanying fn 545.

Prop. Reg. § 1.707-2, "Disguised payments for services," provides (a)-(c) as follows:

(a) *In general*. This section prescribes rules for characterizing arrangements as disguised payments for services. Paragraph (b) of this section outlines the elements necessary to characterize an arrangement as a payment for services, and it provides operational rules regarding application and timing of this section. Paragraph (c) of this section identifies the factors that weigh in the determination of whether an arrangement includes the elements described in paragraph (b) of this section that make it appropriate to characterize the arrangement as a payment for services. Paragraph (d) of this section provides examples applying these rules to determine whether an arrangement is a payment for services.

(b) *Elements necessary to characterize arrangements as disguised payments for services*.

(1) *In general*. An arrangement will be treated as a disguised payment for services if-

(i) A person (service provider), either in a partner capacity or in anticipation of becoming a partner, performs services (directly or through its delegate) to or for the benefit of a partnership;

(ii) There is a related direct or indirect allocation and distribution to such service provider; and

(iii) The performance of such services and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a person acting other than in that person's capacity as a partner.

(2) *Application and timing*.

(i) *Timing and effect of the determination*. Whether an arrangement is properly characterized as a payment for services is determined at the time the arrangement is entered into or modified and without regard to whether the terms of the arrangement require the allocation and distribution to occur in the same taxable year. An arrangement that is treated as a payment for services under this paragraph (b) is treated as a payment for services for all purposes of the Internal Revenue Code, including for example, sections 61, 409A, and 457A (as applicable). The amount paid to a person in consideration for services under this section is treated as a payment for services provided to the partnership, and, when appropriate, the partnership must capitalize these amounts (or otherwise treat such amounts in a manner consistent with their recharacterization). The partnership must also treat the arrangement as a payment to a non-partner in determining the remaining partners' shares of taxable income or loss.

(ii) *Timing of inclusion*. The inclusion of income by the service provider and deduction (if applicable) by the partnership of amounts paid pursuant to an arrangement that is characterized as a payment for services under paragraph (b)(1) of this section is taken into account in the taxable year as required under applicable law by applying all relevant sections of the Internal Revenue Code, including for example, sections 409A and 457A (as applicable), to the allocation and distribution when they occur (or are deemed to occur under all other provisions of the Internal Revenue Code).

(3) *Application of disguised payment rules*. If a person purports to provide services to a partnership in a capacity as a partner or in anticipation of becoming a partner, the rules of this section apply for purposes of determining whether the services were provided in exchange for a disguised payment, even if it is determined after applying the rules of this section that the service provider is not a partner. If after applying the rules of this section, no partnership exists as a result of the service provider failing to become a partner under the arrangement, then the service provider is treated as having provided services directly to the other purported partner.

(c) *Factors considered*. Whether an arrangement constitutes a payment for services (in whole or in part) depends on all of the facts and circumstances. Paragraphs (c)(1) through (6) of this section provide a non-exclusive list of factors that may indicate that an arrangement constitutes (in whole or in part) a payment for services. The presence or absence of a factor is based on all of the facts and circumstances at the time the parties enter into the arrangement (or if the parties modify the arrangement, at the time of the modification). The most important factor is significant entrepreneurial risk as set forth in paragraph (c)(1) of this section. An arrangement that lacks significant entrepreneurial risk constitutes a payment for services. An arrangement that has significant entrepreneurial risk will generally not constitute a payment for services unless other factors establish otherwise. For purposes of making determinations under this paragraph (c), the weight to be given to any particular factor, other than entrepreneurial risk, depends on the particular case and the absence of a factor is not necessarily indicative of whether or not an arrangement is treated as a payment for services.

(1) *The arrangement lacks significant entrepreneurial risk*. Whether an arrangement lacks significant entrepreneurial risk is based on the service provider’s entrepreneurial risk relative to the overall entrepreneurial risk of the partnership. Paragraphs (c)(1)(i) through (v) of this section provide facts and circumstances that create a presumption that an arrangement lacks significant entrepreneurial risk and will be treated as a disguised payment for services unless other facts and circumstances establish the presence of significant entrepreneurial risk by clear and convincing evidence:

(i) Capped allocations of partnership income if the cap is reasonably expected to apply in most years;

(ii) An allocation for one or more years under which the service provider’s share of income is reasonably certain;

(iii) An allocation of gross income;

(iv) An allocation (under a formula or otherwise) that is predominantly fixed in amount, is reasonably determinable under all the facts and circumstances, or is designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service provider (*e.g.* if the partnership agreement provides for an allocation of net profits from specific transactions or accounting periods and this allocation does not depend on the long-term future success of the enterprise); or

(v) An arrangement in which a service provider waives its right to receive payment for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.

(2) The service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration.

(3) The service provider receives an allocation and distribution in a time frame comparable to the time frame that a non-partner service provider would typically receive payment.

(4) The service provider became a partner primarily to obtain tax benefits that would not have been available if the services were rendered to the partnership in a third party capacity.

(5) The value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution.

(6) The arrangement provides for different allocations or distributions with respect to different services received, the services are provided either by one person or by persons that are related under sections 707(b) or 267(b), and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

REG-115452-14, "Disguised Payments for Services," part III, describes the examples in Prop. Reg. § 1.707-2(d):

> Section 1.707-2(d) of the proposed regulations contains a number of examples illustrating the application of the factors described in § 1.707-2(c). The examples illustrate the application of these regulations to arrangements that contain certain facts and circumstances that the Treasury Department and the IRS believe demonstrate the existence or absence of significant entrepreneurial risk.
>
> Several of the examples consider arrangements in which a partner agrees to forgo fees for services and also receives a share of future partnership income and gains. The examples consider the application of section 707(a)(2)(A) based on the manner in which the service provider (i) forgoes its right to receive fees, and (ii) is entitled to share in future partnership income and gains. In Examples 5 and 6, the service provider forgoes the right to receive fees in a manner that supports the existence of significant entrepreneurial risk by forgoing its right to receive fees before the period begins and by executing a waiver that is binding, irrevocable, and clearly communicated to the other partners. Similarly, the service provider's arrangement in these examples include the following facts and circumstances that taken together support the existence of significant entrepreneurial risk: The allocation to the service provider is determined out of net profits and is neither highly likely to be available nor reasonably determinable based on all facts

and circumstances available at the time of the arrangement, and the service provider undertakes a clawback obligation and is reasonably expected to be able to comply with that obligation.[532] The presence of each fact described in these examples is not necessarily required to determine that section 707(a)(2)(A) does not apply to an arrangement. However, the absence of certain facts, such as a failure to measure future profits over at least a 12-month period, may suggest that an arrangement constitutes a fee for services.

The proposed regulations also contain examples that consider arrangements to which section 707(a)(2)(A) applies. Example 1 concludes that an arrangement in which a service provider receives a capped amount of partnership allocations and distributions and the cap is likely to apply provides for a disguised payment for services under section 707(a)(2)(A). In Example 3(iii), a service provider is entitled to a share of future partnership net profits, the partnership can allocate net profits from specific transactions or accounting periods, those allocations do not depend on the long-term future success of the enterprise, and a party that is related to the service provider controls the timing of purchases, sales, and distributions. The example concludes that under these facts, the arrangement lacks significant entrepreneurial risk and provides for a disguised payment for services. Example 4 considers similar facts, but assumes that the partnership's assets are publicly traded and are marked-to-market under section 475(f)(1). Under these facts, the example concludes that the arrangement has significant entrepreneurial risk, and thus that section 707(a)(2)(A) does not apply.

Reg. § 1.707-2(d) provides the following examples:

Example (1). Partnership ABC constructed a building that is projected to generate $100,000 of gross income annually. A, an architect, performs services for partnership ABC for which A's normal fee would be $40,000 and contributes cash in an amount equal to the value of a 25 percent interest in the partnership. In exchange, A will receive a 25 percent distributive share for the life of the partnership and a special allocation of $20,000 of partnership gross income for the first two years of the partnership's operations. The ABC partnership agreement satisfies the requirements for economic effect contained in § 1.704-1(b)(2)(ii), including requiring that liquidating distributions are made in accordance with the partners' positive capital account balances. Under paragraph (c) of this section, whether the arrangement is treated as a payment for services depends on the facts and circumstances. The special allocation to A is a capped amount and the cap is reasonably expected to apply. The special allocation is also made out of gross income. Under paragraphs (c)(1)(i) and (iii) of this section, the capped allocations of income and gross income allocations described are presumed to lack significant entrepreneurial risk. No additional facts and circumstances establish otherwise by clear and convincing evidence. Thus, the allocation lacks significant entrepreneurial risk. Accordingly, the arrangement provides for a disguised payment for services as of the date that A and ABC enter into the arrangement and, pursuant to paragraph (b)(2)(ii) of this section, should be included in income by A in the time and manner required under applicable law as determined by applying all relevant sections of the Internal Revenue Code to the arrangement.

[532] [footnote not in the preamble] For a discussion of clawback obligations, see text accompanying fn 545.

Example (2). A, a stock broker, agrees to effect trades for Partnership ABC without the normal brokerage commission. A contributes 51 percent of partnership capital and in exchange, receives a 51 percent interest in residual partnership profits and losses. In addition, A receives a special allocation of gross income that is computed in a manner which approximates its foregone commissions. The special allocation to A is computed by means of a formula similar to a normal brokerage fee and varies with the value and amount of services rendered rather than with the income of the partnership. It is reasonably expected that Partnership ABC will have sufficient gross income to make this allocation. The ABC partnership agreement satisfies the requirements for economic effect contained in § 1.704-1(b)(2)(ii), including requiring that liquidating distributions are made in accordance with the partners' positive capital account balances. Under paragraph (c) of this section, whether the arrangement is treated as a payment for services depends on the facts and circumstances. Under paragraphs (c)(1)(iii) and (iv) of this section, because the allocation is an allocation of gross income and is reasonably determinable under the facts and circumstances, it is presumed to lack significant entrepreneurial risk. No additional facts and circumstances establish otherwise by clear and convincing evidence. Thus, the allocation lacks significant entrepreneurial risk. Accordingly, the arrangement provides for a disguised payment for services as of the date that A and ABC enter into the arrangement and, pursuant to paragraph (b)(2)(ii) of this section, should be included in income by A in the time and manner required under applicable law as determined by applying all relevant sections of the Internal Revenue Code to the arrangement.

Example (3).

(i) M performs services for which a fee would normally be charged to new partnership ABC, an investment partnership that will acquire a portfolio of investment assets that are not readily tradable on an established securities market. M will also contribute $500,000 in exchange for a one percent interest in ABC's capital and profits. In addition to M's one percent interest, M is entitled to receive a priority allocation and distribution of net gain from the sale of any one or more assets during any 12-month accounting period in which the partnership has overall net gain in an amount intended to approximate the fee that would normally be charged for the services M performs. A, a company that controls M, is the general partner of ABC and directs all operations of the partnership consistent with the partnership agreement, including causing ABC to purchase or sell an asset during any accounting period. A also controls the timing of distributions to M including distributions arising from M's priority allocation. Given the nature of the assets in which ABC will invest and A's ability to control the timing of asset dispositions, the amount of partnership net income or gains that will be allocable to M under the ABC partnership agreement is highly likely to be available and reasonably determinable based on all facts and circumstances available upon formation of the partnership. A will be allocated 10 percent of any net profits or net losses of ABC earned over the life of the partnership. A undertakes an enforceable obligation to repay any amounts allocated and distributed pursuant to this interest (reduced by reasonable allowances for tax payments made on A's allocable shares of partnership income and gain) that exceed 10 percent of the overall net amount of partnership profits computed over the life of the partnership (a "clawback obligation").[533] It is reasonable to anticipate that

[533] [footnote not in the Example] For a discussion of clawback obligations, see text accompanying fn 545.

A could and would comply fully with any repayment responsibilities that arise pursuant to this obligation. The ABC partnership agreement satisfies the requirements for economic effect contained in § 1.704-1(b)(2)(ii), including requiring that liquidating distributions are made in accordance with the partners' positive capital account balances.

(ii) Under paragraph (c) of this section, whether A's arrangement is treated as a payment for services in directing ABC's operations depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of significant entrepreneurial risk. The arrangement with respect to A creates significant entrepreneurial risk under paragraph (c)(1) of this section because the allocation to A is of net profits earned over the life of the partnership, the allocation is subject to a clawback obligation and it is reasonable to anticipate that A could and would comply with this obligation,[534] and the allocation is neither reasonably determinable nor highly likely to be available. Additionally, other relevant factors do not establish that the arrangement should be treated as a payment for services. Thus, the arrangement with respect to A does not constitute a payment for services for purposes of paragraph (b)(1) of this section.

(iii) Under paragraph (c) of this section, whether M's arrangement is treated as a payment for services depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of entrepreneurial risk. The priority allocation to M is an allocation of net profit from any 12-month accounting period in which the partnership has net gain, and thus it does not depend on the overall success of the enterprise. Moreover, the sale of the assets by ABC, and hence the timing of recognition of gains and losses, is controlled by A, a company related to M. Taken in combination, the facts indicate that the allocation is reasonably determinable under all the facts and circumstances and that sufficient net profits are highly likely to be available to make the priority allocation to the service provider. As a result, the allocation presumptively lacks significant entrepreneurial risk. No additional facts and circumstances establish otherwise by clear and convincing evidence. Accordingly, the arrangement provides for a disguised payment for services as of the date M and ABC enter into the arrangement and, pursuant to paragraph (b)(2)(ii) of this section, should be included in income by M in the time and manner required under applicable law as determined by applying all relevant sections of the Internal Revenue Code to the arrangement.

(iv) Assume the facts are the same as paragraph (i) of this example, except that the partnership can also fund M's priority allocation and distribution of net gain from the revaluation of any partnership assets pursuant to § 1.704-1(b)(2)(iv)(f). As the general partner of ABC, A controls the timing of events that permit revaluation of partnership assets and assigns values to those assets for purposes of the revaluation. Under paragraph (c) of this section, whether M's arrangement is treated as a payment for services depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of significant entrepreneurial risk. Under this arrangement, the valuation of the assets is controlled by A, a company related to M, and the assets of the company are difficult to value. This fact, taken in combination with the partnership's determination of M's profits by reference to a specified accounting period, causes the

[534] [footnote not in the Example] For a discussion of clawback obligations, see text accompanying fn 545.

allocation to be reasonably determinable under all the facts and circumstances or to ensure that net profits are highly likely to be available to make the priority allocation to the service provider. No additional facts and circumstances establish otherwise by clear and convincing evidence. Accordingly, the arrangement provides for a disguised payment for services as of the date M and ABC enter into the arrangement and, pursuant to paragraph (b)(2)(ii) of this section, should be included in income by M in time and manner required under applicable law as determined by applying all relevant sections of the Internal Revenue Code to the arrangement.

Example (4).

(i) The facts are the same as in Example 3, except that ABC's investment assets are securities that are readily tradable on an established securities market, and ABC is in the trade or business of trading in securities and has validly elected to mark-to-market under section 475(f)(1). In addition, M is entitled to receive a special allocation and distribution of partnership net gain attributable to a specified future 12-month taxable year. Although it is expected that one or more of the partnership's assets will be sold for a gain, it cannot reasonably be predicted whether the partnership will have net profits with respect to its entire portfolio in that 12-month taxable year.

(ii) Under paragraph (c) of this section, whether the arrangement is treated as a payment for services depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of significant entrepreneurial risk. The special allocation to M is allocable out of net profits, the partnership assets have a readily ascertainable market value that is determined at the close of each taxable year, and it cannot reasonably be predicted whether the partnership will have net profits with respect to its entire portfolio for the year to which the special allocation would relate. Accordingly, the special allocation is neither reasonably determinable nor highly likely to be available because the partnership assets have a readily ascertainable fair market value that is determined at the beginning of the year and at the end of the year. Thus, the arrangement does not lack significant entrepreneurial risk under paragraph (c)(1) of this section. Additionally, the facts and circumstances do not establish the presence of other factors that would suggest that the arrangement is properly characterized as a payment for services. Accordingly, the arrangement does not constitute a payment for services under paragraph (b)(1) of this section.

Example (5).

(i) A is a general partner in newly-formed partnership ABC, an investment fund. A is responsible for providing management services to ABC, but has delegated that management function to M, a company controlled by A. Funds that are comparable to ABC commonly require the general partner to contribute capital in an amount equal to one percent of the capital contributed by the limited partners, provide the general partner with an interest in 20 percent of future partnership net income and gains as measured over the life of the fund, and pay the fund manager annually an amount equal to two percent of capital committed by the partners.

(ii) Upon formation of ABC, the partners of ABC execute a partnership agreement with terms that differ from those commonly agreed upon by other comparable funds. The

ABC partnership agreement provides that A will contribute nominal capital to ABC, that ABC will annually pay M an amount equal to one percent of capital committed by the partners, and that A will receive an interest in 20 percent of future partnership net income and gains as measured over the life of the fund. A will also receive an additional interest in future partnership net income and gains determined by a formula (the “Additional Interest”). The parties intend that the estimated present value of the Additional Interest approximately equals the present value of one percent of capital committed by the partners determined annually over the life of the fund. However, the amount of net profits that will be allocable to A under the Additional Interest is neither highly likely to be available nor reasonably determinable based on all facts and circumstances available upon formation of the partnership. A undertakes a clawback obligation, and it is reasonable to anticipate that A could and would comply fully with any repayment responsibilities that arise pursuant to this obligation.[535] The ABC partnership agreement satisfies the requirements for economic effect contained in § 1.704-1(b)(2)(ii), including requiring that liquidating distributions are made in accordance with the partners’ positive capital account balances.

(iii) Under paragraph (c) of this section, whether the arrangement relating to the Additional Interest is treated as a payment for services depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of significant entrepreneurial risk. The arrangement with respect to A creates significant entrepreneurial risk under paragraph (c)(1) of this section because the allocation to A is of net profits, the allocation is subject to a clawback obligation over the life of the fund and it is reasonable to anticipate that A could and would comply with this obligation, and the allocation is neither reasonably determinable nor highly likely to be available. Additionally, the facts and circumstances do not establish the presence of other factors that would suggest that the arrangement is properly characterized as a payment for services. Accordingly, the arrangement does not constitute a payment for services under paragraph (b)(1) of this section.

Example (6).[536]

(i) A is a general partner in limited partnership ABC, an investment fund. A is responsible for providing management services to ABC, but has delegated that management function to M, a company controlled by A. The ABC partnership agreement provides that A must contribute capital in an amount equal to one percent of the capital contributed by the limited partners, that A is entitled to an interest in 20 percent of future partnership net income and gains as measured over the life of the fund, and that M is entitled to receive an annual fee in an amount equal to two percent of capital committed by the partners. The amount of partnership net income or gains that will be allocable to A under the ABC partnership agreement is neither highly likely to be available nor reasonably determinable based on all facts and circumstances available upon formation of the partnership. A also undertakes a

[535] [footnote not in the Example] For a discussion of clawback obligations, see text accompanying fn 545.
[536] [not in proposed regulation] See my commentary in the text accompanying fn 544.

clawback obligation, and it is reasonable to anticipate that A could and would comply fully with any repayment responsibilities that arise pursuant to this obligation.[537]

(ii) ABC's partnership agreement also permits M (as A's appointed delegate) to waive all or a portion of its fee for any year if it provides written notice to the limited partners of ABC at least 60 days prior to the commencement of the partnership taxable year for which the fee is payable. If M elects to waive irrevocably its fee pursuant to this provision, the partnership will, immediately following the commencement of the partnership taxable year for which the fee would have been payable, issue to M an interest determined by a formula in subsequent partnership net income and gains (the "Additional Interest"). The parties intend that the estimated present value of the Additional Interest approximately equals the estimated present value of the fee that was waived. However, the amount of net income or gains that will be allocable to M is neither highly likely to be available nor reasonably determinable based on all facts and circumstances available at the time of the waiver of the fee. The ABC partnership agreement satisfies the requirements for economic effect contained in § 1.704-1(b)(2)(ii), including requiring that liquidating distributions are made in accordance with the partners' positive capital account balances. The partnership agreement also requires ABC to maintain capital accounts pursuant to § 1.704-1(b)(2)(iv) and to revalue partner capital accounts under § 1.704-1(b)(2)(iv)(f) immediately prior to the issuance of the partnership interest to M. M undertakes a clawback obligation, and it is reasonable to anticipate that M could and would comply fully with any repayment responsibilities that arise pursuant to this obligation.[538]

(iii) Under paragraph (c) of this section, whether the arrangements relating to A's 20 percent interest in future partnership net income and gains and M's Additional Interest are treated as payment for services depends on the facts and circumstances. The most important factor in this facts and circumstances determination is the presence or absence of significant entrepreneurial risk. The allocations to A and M do not presumptively lack significant entrepreneurial risk under paragraph (c)(1) of this section because the allocations are based on net profits, the allocations are subject to a clawback obligation over the life of the fund and it is reasonable to anticipate that A and M could and would comply with this obligation, and the allocations are neither reasonably determinable nor highly likely to be available. Additionally, the facts and circumstances do not establish the presence of other factors that would suggest that the arrangement is properly characterized as a payment for services. Accordingly, the arrangements do not constitute payment for services under paragraph (b)(1) of this section.

In the context of a family business, one needs to consider parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning. Whether granting a profits interest might be a deemed transfer of the capital of the family investors has generated debate, and the IRS does not seem to understand the rules.[539] The subtraction method used in applying Code § 2701 includes:[540]

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[537] [footnote not in the Example] For a discussion of clawback obligations, see text accompanying fn 545.
[538] [footnote not in the Example] For a discussion of clawback obligations, see text accompanying fn 545.
[539] See part III.B.7.c.i.(b) CCA 201442053 Discusses Profits Interest in a Partnership That Was a Straight-Up Partnership before the Transfer, criticizing very important errors in the CCA's analysis.
[540] Reg. § 25.2701-3(b)(4)(iv).

> *Reduction for consideration*. The amount of the transfer (determined under section 2701) is reduced by the amount of consideration in money or money's worth received by the transferor, but not in excess of the amount of the gift (determined without regard to section 2701). The value of consideration received by the transferor in the form of an applicable retained interest in the entity is determined under section 2701 except that, in the case of a contribution to capital, the Step 4 value of such an interest is zero.

Furthermore, Reg. § 25.2512-8 discusses when a transfer made for legitimate business purposes might not be treated as a gift, but with an interesting caveat at the end:

> Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth…. See also sections 2701, 2702, 2703 and 2704 and the regulations at § 25.2701-0 through 25.2704-3 for special rules for valuing transfers of business interests, transfers in trust, and transfers pursuant to options and purchase agreements.

So, in a family business, one wants to prove that any interest in a partnership for services was purely for business reasons, but uncertainty remains whether Code § 2701 may impute a higher value. Profits interests may be especially desirable when awarded to a C corporation managing an investment partnership.[541] Making a profits interest readily terminable may help reduce gift tax risk, but try to avoid making the service provider's interest seem transitory.[542] Ideally, one should intend for the service provider to manage the partnership permanently, but the service provider must continually prove its value to the partnership or risk being fired. Planning the service provider's cash may be somewhat dicey, in that distributions should not be too predictable, should be tied to the partnership's current and long-term success, subject to being repaid if the partnership does not succeed (a "clawback").[543] Thus, the service provider should be well-capitalized through either capital contributions or access to credit provided by a person other than the partnership. Although the proposed regulations approve a so-called 2-and-20 general partner interest for venture capital, the 2% management fee may produce little or no tax benefit unless converted into an additional partnership interest.[544]

Another challenging aspect to designing a profits interest for a service partner (SP) is the proposed regulations' suggestion that the SP undertake an enforceable obligation to repay any amounts distributed pursuant to its interest (reduced by reasonable allowance for tax payments made on the SP's allocable shares of partnership income and gain) that exceed its percentage

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[541] See part II.G.4.l.i.(e) Family Office as a Trade or Business.

[542] Reg. § 1.707-2(c)(2), which is one of several factors to be considered after determining that the dominant factor, entrepreneurial; risk, is satisfied.

[543] See Prop. Reg. §§ 1.707-2(c)(i)(iv) and 1.707-2(d), Example (3)(iii).

[544] Prop. Reg. 1.707-2(d), Example (6) sets forth this arrangement; see fn 536. The management fee's possible lack of deductibility is described in part II.G.4.n Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax, and neither the management fee nor any investment income on the service provider's K-1 is "qualified business income" eligible for a Code § 199A deduction – see part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

of the overall net amount of partnership profits computed over the partnership's life and that it be reasonable to anticipate that the SP can and will comply fully with this obligation. The proposed regulations refer to this type of obligation and similar obligations, as a ''clawback obligation.''[545] A clawback is also referred to as a deficit restoration obligation (DRO);[546] although the IRS has attacked certain types of DROs, this type would be respected.[547] Here's an example of how I envision a clawback obligation working:

- In each of year 1 and year 2, SP is allocated $100K of profit/gain and receives $100K cash, for a total cumulative of $200K income/gain and cash.

- Suppose that, in year 3, SP would be allocated $60K loss, based on SP's percentage interest. SP must repay that full $60K, because that is not more than the a total cumulative of $200K income/gain and cash SP has received. In future years, SP's clawback with respect to years 1 and 2 would be limited to the $140K ($200K minus $60K) of income/gain and cash not subjected to clawback in year 3.

- Suppose instead that, in year 3, SP would be allocated $250K loss, based on SP's percentage interest. SP must repay $200K, which is the lesser of the tentative $250K loss allocation or the total cumulative of $200K income/gain and cash in prior years. The $50K excess loss ($250K minus $200K) would be allocated to the other partners. If year 4 were sufficiently profitable, SP's allocation of income/gain would be reduced by $50K. Normally, one would simply reverse the $50K allocated to the other partners. Instead of doing that, we need to give full effect to SP's allocation of $50K of losses. For example, if SP were a 5% partner, then the first $1M income/gain would be allocated to the other partners, consisting of $950K that they normally would have received (95% of $1M) and $50K that SP would have received but needs to be allocated to the other partners instead. That would contrast to the normal drafting of reversing losses, which would have been to allocate the first $50K of income/gain to the other partners, then the remaining $950K (which is $1M minus the $50K special allocation) of income/gain would have been allocated $902.5K to the other partners (95% of $950K) and $47.5K to SP (5% of $950K).

Now, let's take the analysis a step further. The preamble and the proposed regulations refer to the clawback obligation being reduced by a reasonable allowance for tax payments made on the service partner's allocable shares of partnership income and gain.[548] Let's add that to the example above:

- In each of year 1 and year 2, SP is allocated $100K of profit/gain and receives $100K cash, for a total cumulative of $200K income/gain and cash. The partnership agreement requires tax distributions equal to 30% of taxable income, consisting of 20% capital gain tax rate on qualified dividends, 3.8% net investment income tax, state income tax, and the fact that some income is ordinary income other than qualified dividends and some capital gain may

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[545] A clawback obligation is described in the preamble in the text accompanying fn 531 and in Prop. Reg. § 1.707-2(d), Example 3(i), which is reproduced in the text accompanying fn 533. Other references to a clawback obligation are in the text accompanying fns 532, 534, 535, 537, and 538.
[546] See the paragraph of text accompanying fns 3813-3814 in part II.P.1.a.i.(a) General Rules for Allocations of Income in Partnerships and accompanying fns 421-422 in part II.C.3.c.ii.(b) 1/18/2017-10/13/2019 Temporary Rules Allocating Economic Risk of Loss to Recourse Liabilities.
[547] See text accompanying fns 423-425 in part II.C.3.c.ii.(b) 1/18/2017-10/13/2019 Temporary Rules Allocating Economic Risk of Loss to Recourse Liabilities.
[548] See the preamble in the text accompanying fn 531 and Prop. Reg. § 1.707-2(d), Example 3(i), which is reproduced in the text accompanying fn 533.

be short-term. Thus, of the cumulative $200K of distributions, $60K (30% of $200K cumulative taxable income) constitutes tax distributions and $140K constitutes other distributions.

- Suppose that, in year 3, SP would be allocated $60K loss, based on SP's percentage interest. SP must repay that full $60K, because that is not more than the a total cumulative of $140K income/gain and cash SP has received in excess of tax distributions. In future years, SP's clawback with respect to years 1 and 2 would be limited to the $80K ($140K minus $60K) of income/gain and cash in excess of tax distributions not subjected to clawback in year 3.

- Suppose instead that, in year 3, SP would be allocated $190K loss, based on SP's percentage interest. SP must repay $140K, which is the lesser of the tentative $190K loss allocation or the total cumulative of $140K income/gain and cash in prior years in excess of tax distributions. The $50K excess loss ($190K minus $140K) would be allocated to the other partners. If year 4 were sufficiently profitable, SP's allocation of income/gain would be reduced by $50K. Normally, one would simply reverse the $50K allocated to the other partners. Instead of doing that, we need to give full effect to SP's allocation of $50K of losses. For example, if SP were a 5% partner, then the first $1M income/gain would be allocated to the other partners, consisting of $950K that they normally would have received (95% of $1M) and $50K that SP would have received but needs to be allocated to the other partners instead. That would contrast to the normal drafting of reversing losses, which would have been to allocate the first $50K of income/gain to the other partners, then the remaining $950K (which is $1M minus the $50K special allocation) of income/gain would have been allocated $902.5K to the other partners (95% of $950K) and $47.5K to SP (5% of $950K).

Given that the proposed regulations and their preamble emphasize entrepreneurial risk and express concern above a service provider's ability to manipulate income to generate payments, consider limiting distributions to the cumulative realized and unrealized gains and losses and impose a clawback with respect to not only realized but also unrealized losses.

For how to apply these rules in the context of an investment partnership, see the text following the text accompanying fn 1375 in part II.G.4.l.i.(e) Family Office as a Trade or Business.

Lipton, "Proposed Regulations Issued on Disguised Payments for Services to a Partnership," *Journal of Taxation* (Feb. 2016), criticized certain aspects of Prop. Reg. § 1.707-2, especially certain aspects governing preferred returns [footnote omitted]:

> In the preamble to the proposed regulations, concerning the application of Section 707(a) to a partner who provides services to a partnership, the IRS specifically requested comments concerning a topic totally unrelated to the remainder of the proposed regulations. Specifically, the IRS asked questions about the treatment of preferred returns in situations in which the partnership agreement provides for targeted capital accounts. The IRS implied that it believes that gross items must be allocated to a partner who is entitled to receive a preferred return (the preferred return partner) even if the partnership agreement provides only for allocations of net income.

The IRS stated as follows:

> The Treasury Department and the IRS have become aware that some partnerships that assert reliance on § 1.704-1(b)(2)(ii)(i) (the economic effect equivalence rule) have expressed uncertainty on the proper treatment of partners who receive an increased right to share in partnership property upon a partnership liquidation without respect to the partnership's net income. These partnerships typically set forth each partner's distribution rights upon a liquidation of the partnership and require the partnership to allocate net income annually in a manner that causes partners' capital accounts to match partnership distribution rights to the extent possible. Such agreements are commonly referred to as "targeted capital account agreements." Some taxpayers have expressed uncertainty whether a partnership with a targeted capital account agreement must allocate income or a guaranteed payment to a partner who has an increased right to partnership assets determined as if the partnership liquidated at the end of the year even in the event that the partnership recognizes no, or insufficient, net income. The Treasury Department and the IRS generally believe that existing rules under §§ 1.704–1(b)(2)(ii) and 1.707-1(c) address this circumstance by requiring partner capital accounts to reflect the partner's distribution rights as if the partnership liquidated at the end of the taxable year, but request comments on specific issues and examples with respect to which further guidance would be helpful. No inference is intended as to whether and when targeted capital account agreements could satisfy the economic effect equivalence rule.

The IRS obviously believes that an annual allocation of gross items of income (or a deemed guaranteed payment) is required in this situation, notwithstanding that the partnership agreement does not provide for such an allocation. This approach is wrong.

Everyone agrees that if a partnership agreement provides for an allocation of gross items of income to the partner who is entitled to a preferred return, such items must be allocated to the preferred return partner whether or not the partnership has net income, assuming that the partnership has gross items of income. However, if the partnership agreement provides only for an allocation of net income to the preferred return partner, the question asked by the IRS is whether the parties' agreement should be ignored and items of gross income must be allocated to the preferred return partner in any event because of the target final balance provision in the partnership agreement.

Of course, Section 704(b) provides that the allocations set forth in a partnership agreement must be respected if such allocations have substantial economic effect. The "net income limitation" means that income will not be allocated to the preferred return partner until there is any net income. If there is no net income, the preferred return partner is not entitled to receive any allocation of net income.

The concern when a partnership agreement contains a targeted capital account provision is that upon liquidation, assets will be distributed according to the distribution waterfall. In that case, even if there is no net income, assets will be distributed to the preferred return partner to reflect its preferred return, so that the assets of the partnership are economically shifting in favor of the preferred return partner over time, whether or not there is net income, because the partnership's assets will be distributed first to the preferred return partner. In essence, the issue is whether the preferred return provided in the partnership agreement, when combined with the targeted capital account provisions, necessitates annual allocations of gross items of income to the preferred return partner.

A simple example illustrates this problem. Jane contributes Blackacre, which is vacant land worth $1 million, to the JB partnership; Boris contributes $1 million in cash which will be used for future development of Blackacre. The partnership agreement provides that Boris is supposed to receive a preferred return equal to 5% of his contributed cash per annum, or $50,000 per year. Upon liquidation of the partnership, Boris is to receive back his contributed capital plus his return before distributions are made to Jane (who receives the next $1 million), with distributions thereafter being shared equally.

The view expressed by the IRS is that Boris should be allocated gross income of $50,000 per year to reflect his liquidation preference, even if the partnership has no net income. This allocation appears to assume that the partnership has gross items of income that can be allocated to Boris, which is not true in the hypothetical, because there were no gross items of income at all. Although Boris is “entitled” to receive a preferred return, until money is available for distribution, he will not know the amount (if any) that he will receive. For example, if Blackacre becomes totally worthless (an environmental problem arises), Boris will be lucky to get back his $1 million, let alone a preferred return. Thus, it seems that in situations in which there is no gross income, it would not make sense to allocate a guaranteed payment to the partner who is scheduled to receive a preferred return because there is no certainty that the preferred return will be paid.

This result should not change merely because the partnership has gross items of income. Change the facts in the above example, and assume that there is $50,000 per year of rent received for Blackacre and also $50,000 of taxes paid, so that the JB partnership has no net income to allocate to Boris. An allocation of gross items of income to Boris does not reflect the fact that his preferred return will be paid, if at all, from the value of the property held by the partnership and not from its gross income. Again, if Blackacre is worthless at the time of liquidation of the partnership, Boris will not receive a single penny of his preferred return. Any focus on items of gross income when there is no net income misses the fundamental point, which is that the preferred return will not be paid unless the partnership has sufficient assets upon liquidation.

This is all a matter of timing . Under the view expressed by the IRS in the preamble to the proposed regulations, the partner who is slated to receive a preferred return must accrue income annually to reflect the possibility that the preferred return will eventually be paid - if it is not paid, presumably the preferred return partner would recognize a loss on liquidation of the partnership. In other words, the value of assets is deemed to shift in favor of the preferred return partner, even if no such shifting is actually occurring. The presumption that the preferred return will eventually be paid is just an assumption that often would not be correct. In the event a payment is actually made, if the partner who received the preferred return does not receive a matching allocation of net income at that time, the amount paid in excess of net income should be treated as a guaranteed payment. As a result, the partner will always have income with respect to payments received, and the timing of the income and payment will be the same.

The fundamental flaw in the question raised by the IRS is the assumption that the partners know that the preferred return will be paid and a partnership will always have sufficient assets to pay the preferred return. If the value of all assets held by partnerships only increased, or never declined, so that there would always be assets available to satisfy the preferred return, the question posed by the IRS might be an accurate one. However, as everyone witnessed during the Great Recession, assets can go up in value as well as down. For example, assume that instead of contributing Blackacre, Jane contributed shares of Lehman Brothers to the JB partnership in 2000; by 2009 it was obvious that Boris would never receive a single penny of his preferred return. However, under the construct suggested by the IRS, the fact that the partnership agreement provided for target final balances means that Boris would have been required to accrue income each year from 2000 through 2009, even though the JB partnership would never have assets to pay him his preferred return.

Any guidance would also have to address the fact that the annual allocations of income would likely be treated as ordinary income, whereas the loss on liquidation of the partner's interest would be a capital loss. It also must address the fact that requiring annual allocations in favor of the preferred return partner could lead to allocations that have no economic effect, because it will not be known until liquidation whether or not the preferred return will actually be paid. The IRS asked whether a failure to include an annual allocation of gross items would lack substantial economic effect, but perhaps the IRS should have asked whether an allocation of gross items not provided for in the partnership agreement would lack substantial economic effect until it was certain that the preferred return would be paid. The regulations under Section 704(b) should not be interpreted to require a partner to recognize income unless and until it is clear that an income recognition event will occur.

Moving past the question of whether an allocation is merely a disguised payment, timing is also important. Code § 707(a)(2) compensation is income to the service provider when paid. A partner must include a Code § 707(c) guaranteed payment "as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership" accounted for the payment under its method of accounting.[549] Thus, the characterization between the two can make a big difference in timing.[550]

Compensation payments are reported on the Schedule K-1 that the partnership issues to the partner. Issuing Form W-2 that applies to employees violates the regulations governing FICA;[551] whether a partner is eligible for certain tax exclusions for fringe benefits afforded

[549] Reg. § 1.707-1(c), which continues, "See section 706(a) and paragraph (a) of § 1.706-1."
[550] *Herrmann v. U.S.*, 119 A.F.T.R.2d 2017-2273 (Ct. Fed Cl. 6/21/2017), held that a person who was a partner merely to comply with local (United Kingdom) employment laws, the partnership was merely a conduit for flowing through compensation payments, and the taxpayer's compensation was wildly disproportionate to the taxpayer's percentage of capital, compensation paid to the taxpayer was taxable under Code § 707(a)(2) when received; it is possible that the taxpayer was not really a partner, but the court declined to rule on that, because in either case the taxpayer was taxed as an independent contractor. The case was sympathetic in that the partnership did not provide information to the taxpayer notwithstanding the taxpayer's diligent efforts when the taxpayer's very reputable tax preparer worked on the returns; furthermore, the taxpayer was compensated the same as when she was an employee in the U.S. and viewed the arrangements the same when moving to the U.K., the move being not intended as a change in relationship to the employer but rather merely giving the taxpayer access to better resources to do her job (which she did very well – the timing of over $18 million in compensation was at issue.)
[551] Rev. Rul. 69-184 (Rev. Rul. 91-26, which was clarified by Ann. 92-16, applied this rule to fringe benefits of greater-than-2% owners of S corporations); Reg. § 1.707-1(c) ("…a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding

employees has been a matter of debate.[552] The government was exploring the issue of issuing W-2s to partners in 2014 and perhaps later, in an effort to be flexible to businesses.[553] However, given that reclassifying guaranteed payments as wages would help support a Code § 199A deduction with respect to those receiving a distributive share of profits,[554] I am skeptical. Guidance issued in 2016 clarified that a disregarded LLC being treated as an employer for employment taxes does not change the factor that a partner in the LLC's partnership owner is not treated as an employee for federal tax purposes.[555] The government

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of tax at source, deferred compensation plans, etc."); Reg § 1.1402(a)-1(b); *Grubb v. Commissioner*, T.C. Memo. 1990-425; *Riether v. U.S.*, 919 F.Supp.2d 1140 (D. NM 2012) (reporting on Form W-2 was incorrect, but IRS did not complain so no consequence; remaining distributive share of income was subject to self-employment tax; 20% accuracy-related underpayment penalty applied because taxpayers did not receive a communication about self-employment tax from a professional that sets forth the professional's analysis or conclusion under Reg. § 1.6664-4(b)(1)); see fn. 3473 in part II.L.4 Self-Employment Tax Exclusion for Limited Partners' Distributive Share. For a laundry list of problems when partnership compensation is reported on Form W-2, see fn. 563 and accompanying text in part II.C.8.b Consequences of Incorrectly Reporting Partner Compensation on a W-2 Instead of As a Guaranteed Payment. See Brock, "Partners as Employees? Properly Reporting Partner Compensation," *The Tax Advisor* (11/1/2013); Banoff's and Lipton's Shop Talk column, "LLC Member Who Provides Services: Partner, Employee, or Both?" *Journal of Taxation* (July 2014) (concluding that a tax partner is still a tax partner, even if the IRS does not challenge his W-2 reporting (and withholding), as occurred in *Riether*.); and Griffith, "Passthrough Partner: Partners and W-2 Employee Status," *Taxes* (CCH) (2/2015).

552 Courts differ on whether fringe benefits paid to a partner are eligible for exclusions afforded to employees. *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1961) (see fn. 3896 In part II.P.2 C Corporation Advantage Regarding Fringe Benefits, held that the enactment of Code § 707(a), allowing partners to act in a non-partner capacity, superseded the aggregate approach adopted by courts under the Internal Revenue Code of 1939, refusing to follow *Wilson v. U.S.*, 376 F.2d 280 (Ct. Cl. 1967) (denying a Code § 119 exclusion for meals and lodging for the employer's convenience) because Wilson had not considered Code § 707(a). *Zahler v. Commissioner*, T.C. Memo 1981-112, denied a Code § 119 exclusion to a commission salesman who was acting in his capacity as a partner; a similar result applied to an S corporation owner in *Dilts v. U.S.*, 845 F. Supp. 1505 (D. Wyo. 1994). See also McKee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners*, ¶ 14.02[4][b] Collateral Consequences of Section 707(a) Treatment; Willis & Postlewaite, *Partnership Taxation*, ¶ 11.03[5] Treatment of Guaranteed Payments Under Other Code Provisions; Bishop & Kleinberger, *Limited Liability Companies: Tax and Business Law*, ¶ 4.11 Availability of Fringe Benefits; and Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts*, ¶ 63.6.4 Qualified Recipients [of Code § 119 payments], ¶ 89.1.2 Guaranteed Payments, and ¶ 89.1.3 Transactions in Nonpartner Capacity Generally.

553 On December 15, 2014, the LLC/LLP Subcommittee of the Partnerships & LLCs Committee of the Section of Taxation of the American Bar Association (which is working with the Section's Employee Benefits Committee) solicited volunteers to explore this area and comment to the government on issues to consider in any guidance it might issue.

554 See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

555 See fn 3447 in part II.L.3 Self-Employment Tax: General Partner or Sole Proprietor. Look at (iii) in Reg. § 301.7701-2(c)(2)(iv)(D):

> *Example*. The following example illustrates the application of paragraph (c)(2)(iv) of this section:
>
> (i) LLCA is an eligible entity owned by individual A and is generally disregarded as an entity separate from its owner for Federal tax purposes. However, LLCA is treated as an entity separate from its owner for purposes of subtitle C of the Internal Revenue Code. LLCA has employees and pays wages as defined in sections 3121(a), 3306(b), and 3401(a).
>
> (ii) LLCA is subject to the provisions of subtitle C of the Internal Revenue Code and related provisions under 26 CFR subchapter C, Employment Taxes and Collection of Income Tax at Source, parts 31 through 39. Accordingly, LLCA is required to perform such acts as are required of an employer under those provisions of the Internal Revenue Code and regulations

declined to clarify what happens for tiered partnerships;[556] for example, a partner in a partnership should be able to be an employee in another partnership that is also a partner in the partnership. For example, suppose that Partnership P owns 95% of Partnership S, and A is an

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thereunder that apply. All provisions of law (including penalties) and the regulations prescribed in pursuance of law applicable to employers in respect of such acts are applicable to LLCA. Thus, for example, LLCA is liable for income tax withholding, Federal Insurance Contributions Act (FICA) taxes, and Federal Unemployment Tax Act (FUTA) taxes. See sections 3402 and 3403 (relating to income tax withholding); 3102(b) and 3111 (relating to FICA taxes), and 3301 (relating to FUTA taxes). In addition, LLCA must file under its name and EIN the applicable Forms in the 94X series, for example, Form 941, "Employer's Quarterly Employment Tax Return," Form 940, "Employer's Annual Federal Unemployment Tax Return;" file with the Social Security Administration and furnish to LLCA's employees statements on Forms W-2, "Wage and Tax Statement;" and make timely employment tax deposits. See §§ 31.6011(a)-1, 31.6011(a)-3, 31.6051-1, 31.6051-2, and 31.6302-1 of this chapter.

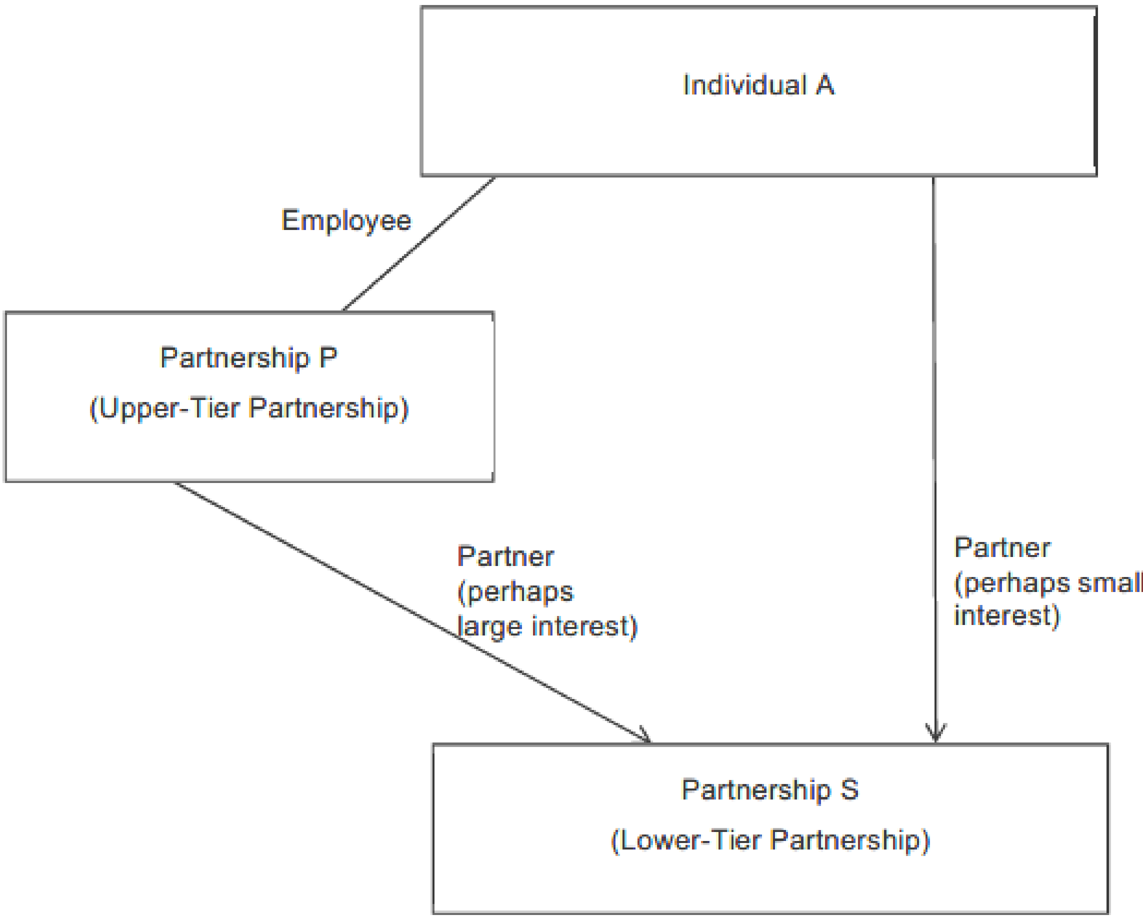
(iii) A is self-employed for purposes of subtitle A, chapter 2, Tax on Self-Employment Income, of the Internal Revenue Code. Thus, A is subject to tax under section 1401 on A's net earnings from self-employment with respect to LLCA's activities. A is not an employee of LLCA for purposes of subtitle C of the Internal Revenue Code. Because LLCA is treated as a sole proprietorship of A for income tax purposes, A is entitled to deduct trade or business expenses paid or incurred with respect to activities carried on through LLCA, including the employer's share of employment taxes imposed under sections 3111 and 3301, on A's Form 1040, Schedule C, "Profit or Loss for Business (Sole Proprietorship)."

[556] T.D. 9766 (5/4/2016) said:

> While these temporary regulations provide that a disregarded entity owned by a partnership is not treated as a corporation for purposes of employing any partner of the partnership, these regulations do not address the application of Rev. Rul. 69-184 in tiered partnership situations. Several commenters have requested that the IRS provide additional guidance on the application of Rev. Rul. 69-184 to tiered partnership situations, and have also suggested modifying the holding of Rev. Rul. 69-184 to allow partnerships to treat partners as employees in certain circumstances, such as, for example, employees in a partnership who obtain a small ownership interest in the partnership as an employee compensatory award or incentive. However, these commenters have not provided detailed analyses and suggestions as to how the employee benefit and employment tax rules would apply in such situations. The Treasury Department and the IRS request comments on the appropriate application of the principles of Rev. Rul. 69-184 to tiered partnership situations, the circumstances in which it may be appropriate to permit partners to also be employees of the partnership, and the impact on employee benefit plans (including, but not limited to, qualified retirement plans, health and welfare plans, and fringe benefit plans) and on employment taxes if Rev. Rul. 69-184 were to be modified to permit partners to also be employees in certain circumstances.

Given that T.D. 9766 applied prospectively, presumably any change regarding tiered partnerships would also be prospective. See fn 3447 in part II.L.3 Self-Employment Tax: General Partner or Sole Proprietor, in which T.D. 9869 (7/2/2019) commented that the treatment of a partner in a tiered partnership is still open.

individual who owns the other 5% of Partnership S. A cannot be an employee of Partnership S, because A is a partner in Partnership S. However, A can be an employee of Partnership P:



Of course, if A worked exclusively for Partnership S and Partnership P merely acted as a conduit through which Partnership S compensated A, then Partnership S might be considered the true payor of compensation, recharacterizing payments to A as those to a partner. The IRS took a similar position in CCA 201916004, which asserted that running a partner's compensation through a Certified Professional Employer Organization (CPEO) does not convert the compensation to wages; rather, the CPEO needs to use Form 1099-MISC to report that compensation.[557] Even if payments to A in the above example are not recharacterized under the principles of CCA 201916004, they will not constitute W-2 wages under Code § 199A, because Partnership P's receipt of a management fee from Partnership S does not constitute qualified business income, making any W-2 wages incurred in generating that management fee be ineligible for providing W-2 credit under Code § 199A.[558]

[557] Citing Code § 3511(c) (providing that a CPEO is not treated as an employer of a self-employed individual) and Prop. Regs. §§ 31.3511-1(f)(2) and 301.7705-1(b)(14).
[558] See part II.E.5.c.ii Code § 199A Deduction under Recommended Structure, especially the text accompanying fns 1076-1079.

An alternative way to avoid being a partner in the main partnership is described in part II.L.5.a S Corporation Blocker Generally, an idea with which I am not particularly enamored.[559]

Not being considered an employee, a partner nevertheless may remain in the Social Security system, with guaranteed payments often subjected to self-employment tax.[560]

Guaranteed payments do not constitute an interest in partnership profits for purposes of Code §§ 706(b)(3), 707(b),[561] and 708(b). Reg. § 1.707-1(c), which continues:

> For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income. Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d). Similarly, a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc.

If the service provider is a family member, consider part III.B.7.c Code § 2701 Interaction with Income Tax Planning.

II.C.8.b. Consequences of Incorrectly Reporting Partner Compensation on a W-2 Instead of As a Guaranteed Payment

Although reporting compensation income to a partner on Form W-2 might seem to be harmless error,[562] consequences include:[563]

- Timely filing Forms W-2 helps support the 20% deduction related to qualified business income ("QBI") for owners of partnerships,[564] but W-2 income itself does not constitute QBI.[565] Thus, misclassifying partner compensation as W-2 wages could overstate the QBI-related deduction. Furthermore,

- The safe harbor for the nontaxable issuance of profits interests, Rev. Proc. 2001-43,[566] might not apply.

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[559] In part II.L.5.a. see paragraph of text accompanying fn 3504.
[560] See part II.L.3 Self-Employment Tax: General Partner or Sole Proprietor, fns. 3452-3454.
[561] For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.
[562] There is no basis for reporting compensation income to a partner on Form W-2. See fn 551.
[563] Brock, "Treating Partners as Employees: Risks to Consider," *Journal of Accountancy*, pp. 55-59 (August 2014); see Griffith, "Passthrough Partner: Partners and W-2 Employee Status," *Taxes* (CCH) (2/2015). See also fn. 551 for authority in this area. On December 15, 2014, the LLC/LLP Subcommittee of the Partnerships & LLCs Committee of the Section of Taxation of the American Bar Association (which was working with the Section's Employee Benefits Committee) solicited volunteers to explore this area and comment to the government on issues to consider in any guidance it might issue.
[564] See part II.E.1.c.vi.(a) W-2 wages under Code § 199A, especially fns 891-892 and the text following them.
[565] See parts II.E.1.c.ii.(b) Trade or Business of Being an Employee (Excluded from QBI) and II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.
[566] See part II.M.4.f Issuing a Profits Interest to a Service Provider.

- Cafeteria plans might be disqualified, because partners cannot participate.[567]

- FICA taxes might be underpaid (due to timing issues) or overpaid. The partnership's FICA tax deduction might be overstated, because the partnership paid FICA for partners for whom it should not have paid FICA.

- The Code § 199 deduction for domestic production activities might be miscalculated, because Form W-2 income cannot properly include partner compensation.[568] This deduction has been repealed, effective taxable years beginning after December 31, 2017. However, the Code § 199A deduction for qualified business income is limited by W-2 wages if the taxpayer claiming the deduction has taxable income above certain thresholds, so a similar concern remains.[569]

- Although guaranteed payments to partners for services might not be required to be capitalized under Code § 263A, Form W-2 wages must be capitalized.

- State tax apportionment, which can use a payroll factor, might be distorted.

- Income tax exclusions for benefits do not apply to partners, and the partnership's benefit reporting might mistakenly omit amounts taxable to the partner/former employee.[570]

- Bonuses paid after yearend are guaranteed payments deductible to the partnership and taxable to the partner in the current year[571] but might be incorrectly deferred to the next year.

- A person who has losses from self-employment in other activities can reduce FICA by offsetting those losses against self-employment income, but the losses would not reduce Form W-2 wages subject to FICA.

- A person with unreimbursed business expenses from Form W-2 employment treats them as miscellaneous itemized deductions, subject to various haircuts as well as complete disallow for alternative minimum tax purposes, whereas a partner can deduct them in full (if not reimbursable under the partnership agreement).

- If the person has an interest in profits/losses, the person will get a K-1 and be subject to partnership income tax complexity notwithstanding the treatment of wages.

- If the company goes out of business and has failed to pay the withholding to the government, the person from whom the withholdings occurred will not get credit for having paid the tax withheld if the person is a partner (but will get credit if the person is an employee); it would have been better to have received the payment in full and then pay the taxes individually.

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567 Prop. Reg. § 1.125-1(g)(2).
568 Note the W-2 limitation mentioned in part II.G.25 Code § 199 Deduction for Domestic Production Activities especially fn. 1898.
569 See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds, especially part II.E.1.c.vi.(a) W-2 wages under Code § 199A.
570 See part II.P.2 C Corporation Advantage Regarding Fringe Benefits.
571 Reg. § 1.707-1(c). see part III.B.7.c.viii Creative Bonus Arrangements, especially fns. 550-553.

- Because such a position has no reasonable basis, the preparer will violate ethical rules. If a client sues for malpractice as a result of any harm, the lawsuit might be impossible to defend.

Local governments that impose a payroll tax might tax partner compensation as wages.[572]

II.C.9. When Is a Partner in Form Not a Partner in Substance?

For whether an arrangement that does not call itself a partnership nevertheless is properly characterized as a partnership, see part II.C.10 Whether Tenancy-in-Common or other Arrangement Constitutes a Partnership.

Commissioner v. Culbertson, 337 U.S. 733 (1949), discussed *Commissioner v. Tower*, 327 U.S. 280 (1946):[573]

> The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the Tower case, but whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

Historic Boardwalk Hall, LLC v. Commissioner, 694 F.3d 425 (3rd Cir. 2012),[574] dealt with a partnership formed to award tax credits to investors:

> This case involves the availability of federal historic rehabilitation tax credits ("HRTCs") in connection with the restoration of an iconic venue known as the "East Hall" (also known as "Historic Boardwalk Hall"), located on the boardwalk in Atlantic City, New Jersey. The New Jersey Sports and Exposition Authority ("NJSEA"), a state agency which owned a leasehold interest in the East Hall, was tasked with restoring it. After learning of the market for HRTCs among corporate investors, and of the additional revenue which that market could bring to the state through a syndicated partnership with one or more investors, NJSEA created a New Jersey limited liability company, Historic Boardwalk Hall, LLC ("HBH"), and subsequently sold a membership interest in HBH[1] to a wholly-owned subsidiary of Pitney Bowes, Inc. ("PB").[2] Through a series of agreements, the transactions that were executed to admit PB as a member of HBH and to transfer ownership of NJSEA's property interest in the East Hall to HBH were designed so that PB could earn the HRTCs generated from the East Hall rehabilitation. The Internal Revenue Service ("IRS") determined that HBH was simply a vehicle to impermissibly transfer HRTCs from NJSEA to PB and that all HRTCs taken by PB should be reallocated to NJSEA.[3] The Tax Court disagreed, and sustained the allocation of the HRTCs to PB through its membership interest in HBH. Because we agree with the IRS's

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[572] See "California State Court of Appeals Holds Payroll Expense Tax Applies To Partnership Distributions to Law Firm's Equity Partners," *TM Real Estate Journal* (BNA), Vol. 31, No. 03 (3/4/2015).
[573] The quote concluded with a footnote reproducing the IRS' stated general position on partnerships.
[574] Rehearing denied 10/22/2012; cert. denied 5/28/2013.

contention that PB, in substance, was not a bona fide partner in HBH, we will reverse the decision of the Tax Court.

[1] An LLC "offers the best of both worlds - the limited liability of a corporation and the favorable tax treatment of a partnership." *Canterbury Holdings, LLC v. Comm'r*, 98 T.C.M. (CCH) 60, 61 n.1 (2009). Generally, an LLC is a pass-through entity that does not pay federal income tax. See I.R.C. § 701; Treas. Reg. § 301.7701-3(a). Rather, profits and losses "pass through" the LLC to its owners, called members, who pay individual income tax on their allocable shares of the tax items. See I.R.C. §§ 701-04, 6031. Although an LLC with just one owner is, for tax purposes, disregarded as an entity separate from its owner for tax purposes, an LLC with two or more members is classified as a partnership for tax purposes unless it elects to be treated as a corporation. Treas. Reg. § 301.7701-3(b)(1). Once HBH, as a duly formed New Jersey limited liability company, had two members, it did not elect to be treated as a corporation and thus was classified as a partnership for tax purposes for the tax years in which it had more than one member. Thus, as the parties do, we refer to HBH as a partnership when analyzing whether one of its stated members was a bona fide partner.

[2] PB's membership interest in HBH was through PB Historic Renovations, LLC, whose sole member was Pitney Bowes Credit Corp. At all relevant times, Pitney Bowes Credit Corp. was a wholly-owned subsidiary of PB. For ease of reference, we will refer to PB Historic Renovations, LLC, Pitney Bowes Credit Corp., and PB as "PB."

[3] The alphabet-soup of acronyms in this case is perhaps beyond parody, but the acronyms are a more efficient means of referring to various corporate and state entities, as well as the tax credits and other concepts, so we reluctantly fall into the soup.

The Third Circuit explained its conclusion:

… While the Commissioner raises several arguments in his effort to reallocate the HRTCs from NJSEA to PB, we focus primarily on his contention that PB should not be treated as a bona fide partner in HBH because PB did not have a meaningful stake in the success or failure of the partnership.[50] We agree that PB was not a bona fide partner in HBH.

[50] The Commissioner also contends that HBH was a sham. Specifically, the Commissioner invokes a "sham-partnership theory," which he says is "a variant of the economic-substance (sham-transaction) doctrine." (Appellant's Opening Br. at 50.) That theory, according to the Commissioner "focus[es] on (1) whether the formation of the partnership made sense from an economic standpoint, as would be the case [under the *Culbertson* inquiry], and (2) whether there was otherwise a legitimate business purpose for the use of the partnership form." (*Id*.)

HBH contends that the IRS's sham-partnership theory, which HBH asserts is "merely a rehash of the factual claims that [the IRS] made in challenging [PB's] status as a partner in HBH," is distinct from the sham-transaction doctrine (also known as the economic substance doctrine) that was litigated before the Tax Court. Amicus Real Estate Roundtable (the "Roundtable") agrees, submitting that the Commissioner's sham-partnership argument "inappropriately blur[s] the line between the [economic substance doctrine] and the [substance-over-form doctrine]," the latter of which applies when the form of a transaction is not the same as its economic reality. (Roundtable Br. at 7.) The point is well-taken, as the economic substance doctrine and the substance-over-form doctrine certainly "are distinct." *Neonatology Assocs., P.A. v. Comm'r*, 299 F.3d 221, 230 n.12 (3d Cir. 2002); see generally *Rogers v. United States*, 281 F.3d 1108, 1115-17 (10th Cir. 2002) (noting differences between the substance-over-form doctrine and the economic substance doctrine). The substance-over-form doctrine "is applicable to instances where the "substance" of a particular transaction produces tax results inconsistent with the "form" embodied in the underlying documentation, permitting a court to recharacterize the transaction in accordance with its substance." *Neonatology Assocs.*, 299 F.3d at 230 n.12. On the other hand, the economic substance doctrine "applies where the economic or business purpose of a transaction is relatively insignificant in relation to the comparatively large tax benefits that accrue." *Id.*

As the Roundtable correctly explains, "[t]he fact that [a] taxpayer might not be viewed as a partner (under the [substance-over-form doctrine]) or that the transaction should be characterized as a sale (again, under the [substance-over-form doctrine]) [does] not mean that the underlying transaction violated the [economic substance doctrine]." (Roundtable Br. at 7.) Put another way, even if a transaction has economic substance, the tax treatment of those engaged in the transaction is still subject to a substance-over-form inquiry to determine whether a party was a bona fide partner in the business engaged in the transaction. See *Southgate Master Fund, L.L.C. ex rel. Montgomery Capital Advisors, LLC v. United States*, 659 F.3d 466, 484 (5th Cir. 2011) ("The fact that a partnership's underlying business activities had economic substance does not, standing alone, immunize the partnership from judicial scrutiny [under Culbertson]."); id. ("If there was not a legitimate, profit-motivated reason to operate as a partnership, then the partnership will be disregarded for tax purposes even if it engaged in transactions that had economic substance.").

At oral argument, the IRS conceded that this case "lends itself more cleanly to the bona fide partner theory," under which we look to the substance of the putative partner's interest over its form. Oral Argument at 11:00, *Historic Boardwalk Hall, LLC v. Comm'r* (No. 11-1832), available at http://www.ca3.uscourts.gov/oralargument/audio/11-1832Historic%20Boardwalk%20LLC%20v%20Commissioner%20IRS.wma. Accordingly, we focus our analysis on whether PB is as a bona fide partner in HBH, and in doing so, we assume, without deciding, that this transaction had economic substance. Specifically, we do not opine on the parties' dispute as to whether, under *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995), we can consider the HRTCs in evaluating whether a transaction has economic substance.

A. The Test

A partnership exists when, as the Supreme Court said in *Commissioner v. Culbertson*, two or more "parties in good faith and acting with a business purpose intend[] to join together in the present conduct of the enterprise." 337 U.S. at 742; see also *Comm'r v. Tower*, 327 U.S. 280, 286-87 (1946) ("When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both."); *Southgate Master Fund, L.L.C. ex rel. Montgomery*

Capital Advisors v. United States, 659 F.3d 466, 488 (5th Cir. 2011) ("The sine qua non of a partnership is an intent to join together for the purpose of sharing in the profits and losses of a genuine business.").

The *Culbertson* test is used to analyze the bona fides of a partnership and to decide whether a party's "interest was a bona fide equity partnership participation." *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 232 (2d Cir. 2006) (hereinafter "*Castle Harbour*). To determine, under *Culbertson*, whether PB was a bona fide partner in HBH, we must consider the totality of the circumstances,

> considering all the facts - the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent.

337 U.S. at 742. That "test turns on the fair, objective characterization of the interest in question upon consideration of all the circumstances." *Castle Harbour*, 459 F.2d at 232.

The *Culbertson* test "illustrat[es] ... the principle that a transaction must be judged by its substance, rather than its form, for income tax purposes." *Trousdale v. Comm'r*, 219 F.2d 563, 568 (9th Cir. 1955). Even if there are "indicia of an equity participation in a partnership," *Castle Harbour*, 459 F.3d at 231, we should not "accept[] at face value artificial constructs of the partnership agreement," *id*. at 232. Rather, we must examine those indicia to determine whether they truly reflect an intent to share in the profits or losses of an enterprise or, instead, are "either illusory of insignificant." *Id*. at 231. In essence, to be a bona fide partner for tax purposes, a party must have a "meaningful stake in the success or failure" of the enterprise. *Id*.

B. The Commissioner's Guideposts

The Commissioner points us to two cases he calls "recent guideposts" bearing on the bona fide equity partner inquiry. (Appellant's Opening Br. at 34.) First, he cites to the decision of the United States Court of Appeals for the Second Circuit in *Castle Harbour*, 459 F.3d 220. The *Castle Harbour* court relied on *Culbertson* in disregarding the claimed partnership status of two foreign banks. Those banks had allegedly formed a partnership, known as Castle Harbour, LLC, with TIFD III-E, Inc. ("TIFD"), a subsidiary of General Electric Capital Corporation, with an intent to allocate certain income away from TIFD, an entity subject to United States income taxes, to the two foreign banks, which were not subject to such taxes. *Id*. at 223. Relying on the sham-transaction doctrine, the district court had rejected the IRS's contention that the foreign banks' interest was not a bona fide equity partnership participation "because, in addition to the strong and obvious tax motivations, the [partnership] had some additional non-tax motivation to raise equity capital." *Id*. at 231. In reversing the district court, the Second Circuit stated that it "[did] not mean to imply that it was error to consider the sham test, as the IRS purported to rely in part on that test. The error was in failing to test the banks' interest also under *Culbertson* after finding that the [partnership's] characterization survived the sham test." *Id*. The Second Circuit focused primarily on the *Culbertson* inquiry, and specifically on the IRS's contention that the foreign banks "should not be treated as equity partners in the Castle Harbour partnership because they had no meaningful stake in the success or failure of the partnership." *Id*. at 224.

Applying the bona fide partner theory as embodied in *Culbertson*'s totality-of-the-circumstances test, the *Castle Harbour* court held that the banks' purported partnership interest was, in substance, "overwhelmingly in the nature of a secured lender's interest, which would neither be harmed by poor performance of the partnership nor significantly enhanced by extraordinary profits." *Id*. at 231. Although it acknowledged that the banks' interest "was not totally devoid of indicia of an equity participation in a partnership," the Court said that those indicia "were either illusory or insignificant in the overall context of the banks' investment," and, thus, "[t]he IRS appropriately rejected the equity characterization." *Id*.

The *Castle Harbour* court observed that "consider[ing] whether an interest has the prevailing character of debt or equity can be helpful in analyzing whether, for tax purposes, the interest should be deemed a bona fide equity participation." *Id*. at 232. In differentiating between debt and equity, it counseled that "the significant factor ... [is] whether the funds were advanced with reasonable expectation of repayment regardless of the success of the venture or were placed at the risk of the business." Id. (citation and internal quotation marks omitted). Thus, in determining whether the banks' interest was a bona fide equity participation, the Second Circuit focused both on the banks' lack of downside risk and lack of upside potential in the partnership. It agreed with the "district court['s] recogni[tion] that the banks ran no meaningful risk of being paid anything less than the reimbursement of their investment at the [agreed-upon rate] of return." *Id*. at 233. In support of that finding, the Court noted that:

> [TIFD] was required ... to keep ... high-grade commercial paper or cash, in an amount equal to 110% of the current value of the [amount that the banks would receive upon dissolution of the partnership.] The partnership, in addition, was obliged for the banks' protection to maintain $300 million worth of casualty-loss insurance. Finally, and most importantly, [General Electric Capital Corporation] - a large and very stable corporation - gave the banks its personal guaranty, which effectively secured the partnership's obligations to the banks.

Id. at 228.

Regarding upside potential, however, the Second Circuit disagreed with the district court's conclusion that the banks had a "meaningful and unlimited share of the upside potential." *Id*. at 233. That conclusion could not be credited because it "depended on the fictions projected by the partnership agreement, rather than on assessment of the practical realities." *Id*. at 234. Indeed, the Second Circuit stated that "[t]he realistic possibility of upside potential - not the absence of formal caps - is what governs this analysis." *Id*. In reality, "the banks enjoyed only a narrowly circumscribed ability to participate in profits in excess of" the repayment of its investment, id., because TIFD had the power to either effectively restrict the banks' share of profits at 1% above an agreed-upon return of $2.85 million, or to buy out their interest at any time at a "negligible cost" of approximately $150,000, *id*. at 226, 235. The return on the banks' initial investment of $117.5 million was thus limited to $2.85 million plus 1% - "a relatively insignificant incremental return over the projected eight-year life of the partnership," *id*. at 235. In sum, "look[ing] not so much at the labels used by the partnership but at true facts and circumstances," as Culbertson directs, the *Castle Harbour* court was "compel[led] [to] conclu[de] that the ... banks' interest was, for tax purposes, not a bona fide equity participation." *Id*. at 241.

The second, more recent, precedent that the Commissioner directs us to as a "guidepost" is *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011) (hereinafter "*Virginia Historic*"). There, the United States Court of Appeals for the Fourth Circuit held that certain transactions between a partnership and its partners which sought to qualify for tax credits under the Commonwealth of Virginia's Historic Rehabilitation Credit Program (the "Virginia Program")[51] were, in substance, sales of those credits which resulted in taxable income to the partnership. *Id*. at 132. In Virginia Historic, certain investment funds (the "Funds") were structured "as partnerships that investors could join by contributing capital." *Id*. at 133. Through four linked partnership entities with one "source partnership" entity (the "Source Partnership"), "[t]he Funds would use [the] capital [provided by investors] to partner with historic property developers ["Operating Partnerships"] renovating smaller projects, in exchange for state tax credits." Id. The confidential offering memorandum given to potential investors provided that, "[f]or every $.74-$.80 contributed by an investor, [one of the] Fund[s] would provide the investor with $1 in tax credits. If such credits could not be obtained, the partnership agreement promised a refund of capital to the investor, net of expenses." *Id*. at 134 (citation and internal quotation marks omitted). Additionally, "the partnership agreement stated that the Funds would invest only in completed projects, thereby eliminating a significant area of risk" to the investors. *Id*. "[T]he Funds reported the money paid to Operating Partnerships in exchange for tax credits as partnership expenses and reported the investors' contributions to the Funds as nontaxable contributions to capital." *Id*. at 135.

[51] The Virginia Program, much like the federal HRTC statute, was enacted to encourage investment in renovating historic properties. *Virginia Historic*, 639 F.3d at 132. Similar to federal HRTCs, the credits under the Virginia Program could be applied to reduce a taxpayer's Virginia income tax liability, dollar-for-dollar, up to 25% of eligible expenses incurred in rehabilitating the property. *Id*. Also like federal HRTCs, credits under the Virginia program could not be sold or transferred to another party. *Id*. at 132-33.

The IRS "challenged [the Funds'] characterization of investors' funding as "contributions to capital"" because the IRS believed that the investors were, in substance, purchasers of state income tax credits, and thus the money that the Funds received from the investors should have been reported as taxable income. Id. At trial, the Commissioner supported his position with two theories. First, he relied on the substance-over-form doctrine, saying that the investors were not bona fide partners in the Funds but were instead purchasers; and, second, he said that the transactions between the investors and the partnerships were "disguised sales" under I.R.C. § 707.[52] *Id*. at 136. The Tax Court rejected both of those assertions, and found that the investors were partners in the Funds for federal tax purposes. *Id*. at 136–37.

[52] Under I.R.C. § 707(a)(2)(A),

> [i]f (i) a partner performs services for a partnership or transfers property to a partnership, (ii) there is a related direct or indirect allocation and distribution to such partner, and (iii) the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, such allocation and distribution shall be treated as a transaction [between the partnership and one who is not a partner].

The Fourth Circuit reversed the Tax Court. "Assuming, without deciding, that a "bona fide" partnership existed," the *Virginia Historic* court found that "the Commissioner properly characterized the transactions at issue as "sales"" under the disguised-sale rules. *Id*. at 137. The Fourth Circuit first turned to the regulations that provide guidance in determining whether a disguised sale has occurred. See *id*. at 137-39 (citing to, inter alia, Treas. Reg. §§ 1.707-3, 1.707-6(a)). Specifically, it explained that a transaction should be reclassified as a sale if, based on all the facts and circumstances, (1) a partner would not have transferred money to the partnership but for the transfer of property - the receipt of tax credits - to the partner; and (2) the latter transfer - the receipt of tax credits - "is not dependent on the entrepreneurial risks of partnership operations." *Id*. at 145 (quoting Treas. Reg. § 1.707-3(b)(1)). The Fourth Circuit concluded that the risks cited by the Tax Court — such as the "risk that developers would not complete their projects on time because of construction, zoning, or management issues," "risk ... [of] liability for improper construction," and "risk of mismanagement or fraud at the developer partnership level" - "appear[ed] both speculative and circumscribed." *Id*. While the Fourth Circuit acknowledged that "there was ... no guarantee that resources would remain available in the source partnership to make the promised refunds," it determined "that the Funds were structured in such a way as to render the possibility of insolvency remote." *Id*.

In holding "that there was no true entrepreneurial risk faced by investors" in the transactions at issue, the Virginia Historic court pointed to several different factors:

> First, investors were promised what was, in essence, a fixed rate of return on investment rather than any share in partnership profits tied to their partnership interests.... Second, the Funds assigned each investor an approximate .01% partnership interest and explicitly told investors to expect no allocations of material amounts of ... partnership items of income, gain, loss or deduction. Third, investors were secured against losing their contributions by the promise of a refund from the Funds if tax credits could not be delivered or were revoked. And fourth, the Funds hedged against the possibility of insolvency by promising investors that contributions would be made only to completed projects and by requiring the Operating Partnerships to promise refunds, in some cases backed by guarantors, if promised credits could not be delivered.

Id. (internal citations and quotation marks omitted). In sum, the Fourth Circuit deemed "persuasive the Commissioner's contention that the only risk ... was that faced by any advance purchaser who pays for an item with a promise of later delivery. It [was] not the risk of the entrepreneur who puts money into a venture with the hope that it might grow in amount but with the knowledge that it may well shrink." *Id*. at 145-46 (citing *Tower*, 327 U.S. at 287; Staff of J. Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 , at 226 ("To the extent that a partner's profit from a transaction is assured without regard to the success or failure of the joint undertaking, there is not the requisite joint profit motive." (alteration in original))). Accordingly, it agreed with the Commissioner that the Funds should have reported the money received from the investors as taxable income. *Id*. at 146.

The Fourth Circuit concluded its opinion with an important note regarding its awareness of the legislative policy of providing tax credits to spur private investment in historic rehabilitation projects:

> We reach this conclusion mindful of the fact that it is “the policy of the Federal Government” to “assist State and local governments ... to expand and accelerate their historic preservation programs and activities.” 16 U.S.C. § 470-1(6). And we find no fault in the Tax Court’s conclusion that both the Funds and the Funds’ investors engaged in the challenged transactions with the partial goal of aiding Virginia’s historic rehabilitation efforts. But Virginia’s Historic Rehabilitation Program is not under attack here.

Id. at 146 n.20.

C. Application of the Guideposts to HBH

The Commissioner asserts that Castle Harbour and Virginia Historic “provide a highly pertinent frame of reference for analyzing the instant case.” (Appellant’s Opening Br. At 40.) According to the Commissioner, “[m]any of the same factors upon which the [*Castle Harbour* court] relied in finding that the purported bank partners ... were, in substance, lenders to the GE entity also support the conclusion that [PB] was, in substance, not a partner in HBH but, instead, was a purchaser of tax credits from HBH.”[53] (*Id*.) That is so, says the Commissioner, because, as confirmed by the *Virginia Historic* court’s reliance on the “entrepreneurial risks of partnership operations,” Treas. Reg. § 1.707-3(b)(1), “the distinction between an equity contribution to a partnership ... and a transfer of funds to a partnership as payment of the sales price of partnership property [, *i.e.*, tax credits,] ... is the same as the principal distinction between equity and debt” (Appellant’s Opening Br. at 40-41). The key point is that the “recovery of an equity investment in a partnership is dependent on the entrepreneurial risks of partnership operations, whereas recovery of a loan to a partnership - or receipt of an asset purchased from a partnership - is not.” (*Id*. at 41.) In other words, “an equity investor in a partnership (*i.e.*, a bona fide partner) has a meaningful stake in the success or failure of the enterprise, whereas a lender to, or purchaser from, the partnership does not.” (*Id*.) In sum, the Commissioner argues that, just as the banks in Castle Harbour had no meaningful stake in their respective partnerships, and the “investors” in Virginia Historic were more like purchasers than participants in a business venture, “it is clear from the record in this case that [PB] had no meaningful stake in the success or failure of HBH.” (*Id*.)

[53] The Commissioner acknowledges that “[a]lthough certain aspects of [PB’s] cash investment in HBH were debt-like (e.g., its 3-percent preferred return), this case does not fit neatly within the debt-equity dichotomy, since [PB] recovered its “principal,” i.e. its purported capital contributions to HBH, in the form of tax credits rather than cash.” (Appellant’s Opening Br. at 40 n.14.)

In response, HBH asserts that “[t]here are a plethora of errors in the IRS’s tortured effort ... to apply *Castle Harbour* and *Virginia Historic*...to the facts of the present case.” (Appellee’s Br. at 38.) First, HBH argues that it is “abundantly apparent” that *Castle Harbour* “is completely inapposite” to it because the actual provisions in *Castle Harbour*’s partnership agreement that minimized the banks’ downside risk and upside potential were more limiting than the provisions in the AREA. (Appellee’s Br. at 35.) HBH contends that, unlike the partnership agreement in Castle Harbour, “[PB] has no rights under the AREA to compel HBH to repay all or any part of its capital contribution,” PB’s 3% Preferred Return was “not guaranteed,” and “NJSEA has no ... right to divest [PB] of its interest in any income or gains from the East Hall.” (*Id*.)

As to Virginia Historic, HBH argues that it “has no application whatsoever” here. (*Id*. at 38.) It reasons that the decision in that case “assumed that valid partnerships existed as a necessary condition to applying I.R.C. § 707(b)’s disguised sale rules” (id. at 36), and that the case was “analyzed ... solely under the disguised sale regime” - which is not at issue in the FPAA sent to HBH (*id*. at 38).

Overall, HBH characterizes *Castle Harbour* and *Virginia Historic* as “pure misdirections which lead to an analytical dead end” (*id*. at 32), and emphasizes that “[t]he question ... *Culbertson* asks is simply whether the parties intended to conduct a business together and share in the profits and losses therefrom” (*id*. at 39). We have no quarrel with how HBH frames the *Culbertson* inquiry. But what HBH fails to recognize is that resolving whether a purported partner had a “meaningful stake in the success or failure of the partnership,” *Castle Harbour*, 459 F.3d at 224, goes to the core of the ultimate determination of whether the parties ““intended to join together in the present conduct of the enterprise,” *id*. at 232 (quoting *Culbertson*, 337 U.S. at 742). *Castle Harbour*’s analysis that concluded that the banks’ “indicia of an equity participation in a partnership” was only “illusory or insignificant,” *id*. at 231, and *Virginia Historic*’s determination that the limited partner investors did not face the “entrepreneurial risks of partnership operations,” 639 F.3d at 145 (citation and internal quotation marks omitted), are both highly relevant to the question of whether HBH was a partnership in which PB had a true interest in profit and loss,[54] and the answer to that question turns on an assessment of risk participation. We are persuaded by the Commissioner’s argument that PB, like the purported bank partners in *Castle Harbour*, did not have any meaningful downside risk or any meaningful upside potential in HBH.

[54] We reject, moreover, any suggestion that the disguised-sale rules and the bona fide-partner theory apply in mutually exclusive contexts. *Virginia Historic* did not “assume[] that valid partnerships existed as a necessary condition” prior to applying the disguised-sale rules. (Appellee’s Br. at 36.) Rather, as the Virginia Historic court observed, “[t]he Department of the Treasury specifically contemplates that its regulations regarding disguised sales can be applied before it is determined whether a valid partnership exists.” 639 F.3d at 137 n.9 (citing Treas. Reg. § 1.707-3).

More importantly, HBH simply ignores why many of the principles espoused in Virginia Historic are applicable here. It is true that the challenged transaction here does not involve state tax credits and that the IRS has not invoked the disguised-sale rules, but distinguishing the case on those grounds fails to address the real issue. *Virginia Historic* is telling because the disguised-sale analysis in that case “touches on the same risk-reward analysis that lies at the heart of the bona fide-partner determination.” (Appellant’s Reply Br. at 9.) Under the disguised-sale regulations, a transfer of “property ... by a partner to a partnership” and a “transfer of money or other consideration ... by the partnership to the partner” will be classified as a disguised sale if, based on the facts and circumstances, “(i) [t]he transfer of money or other consideration would not have been made but for the transfer of property; and (ii) [i]n cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.” Treas. Reg. § 1.707-3(b)(1).

Thus, the disguised-sale analysis includes an examination of “whether the benefit running from the partnership to the person allegedly acting in the capacity of a partner is “dependent upon the entrepreneurial risks of partnership operations.”“ (Appellant’s

Reply Br. at 9 (quoting Treas. Reg. § 1.707-3(b)(1)(ii)).) That entrepreneurial risk issue also arises in the bona fide-partner analysis, which focuses on whether the partner has a meaningful stake in the profits and losses of the enterprise. Moreover, many of the facts and circumstances laid out in the pertinent treasury regulations that "tend to prove the existence of a [disguised] sale," Treas. Reg. § 1.707-3(b)(2), are also relevant to the bona fide-partner analysis here. See, *e.g.*, *id*. § 1.707-3(b)(2)(i) ("That the timing and amount of a subsequent transfer [i.e., the HRTCs] are determinable with reasonable certainty at the time of an earlier transfer [i.e., PB's capital contributions];"); *id*. § 1.707-3(b)(2)(iii) ("That the partner's [i.e., PB's] right to receive the transfer of money or other consideration [i.e., the HRTCs] is secured in any manner, taking into account the period during which it is secured;"); *id*. § 1.707-3(b)(2)(iv) ("That any person [i.e., NJSEA] has made or is legally obligated to make contributions [e.g., the Tax Benefits Guaranty] to the partnership in order to permit the partnership to make the transfer of money or other consideration [i.e., the HRTCs];"); *id*. § 1.707-3(b)(2)(v) ("That any person [i.e., NJSEA] has loaned or has agreed to loan the partnership the money or other consideration [e.g., Completion Guaranty, Operating Deficit Guaranty] required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;"). Although we are not suggesting that a disguised-sale determination and a bona fide-partner inquiry are interchangeable, the analysis pertinent to each look to whether the putative partner is subject to meaningful risks of partnership operations before that partner receives the benefits which may flow from that enterprise.

1. Lack of Meaningful Downside Risk

PB had no meaningful downside risk because it was, for all intents and purposes, certain to recoup the contributions it had made to HBH and to receive the primary benefit it sought - the HRTCs or their cash equivalent. First, any risk that PB would not receive HRTCs in an amount that was at least equivalent to installments it had made to-date (*i.e.*, the "Investment Risk") was non-existent. That is so because, under the AREA, PB was not required to make an installment contribution to HBH until NJSEA had verified that it had achieved a certain level of progress with the East Hall renovation that would generate enough cumulative HRTCs to at least equal the sum of the installment which was then to be contributed and all prior capital contributions that had been made by PB. (See J.A. at 176, 242 (first installment of $650,000 due at closing was paid when NJ-SEA had already incurred over $53 million of QREs which would generate over $10 million in HRTCs); *id*. at 176-77 (second installment, projected to be $7,092,588, was not due until, among other events, a projection of the HRTCs for 2000 (which were estimated at closing to be $7,789,284) based on a "determination of the actual rehabilitation costs of [HBH] that qualify for Tax Credits in 2000"); *id*. at 177 (third installment, projected to be $8,523,630, was not due until the later of, among other events, (1) "evidence of Substantial Completion of Phase 4 ...."; and (2) a projection of the HRTCs for 2001 (which were estimated at closing to be $11,622,889) based on a "determination of the actual rehabilitation costs of [HBH] that qualify for Tax Credits in 2001"); *id*. (fourth installment, projected to be $1,929,580, was not due until, among other events, PB received a "K-1 for 2001 evidencing the actual Tax Credits for 2001," a tax document that would not have been available until after the estimated completion date of the entire project).) While PB did not have the contractual right to "compel HBH to repay all or any part of its capital contribution" (Appellee's Br. at 35), PB had an even more secure deal. Even before PB made an installment contribution, it knew it would receive at least that amount in return.

Second, once an installment contribution had been made, the Tax Benefits Guaranty eliminated any risk that, due to a successful IRS challenge in disallowing any HRTCs, PB would not receive at least the cash equivalent of the bargained-for tax credits (i.e., the "Audit Risk"). The Tax Benefits Guaranty obligated NJSEA[55] to pay PB not only the amount of tax credit disallowed, but also any penalties and interest, as well as up to $75,000 in legal and administrative expenses incurred in connection with such a challenge, and the amount necessary to pay any tax due on those reimbursements. *Cf*. *Virginia Historic*, 639 F.3d at 145 (noting the fact that "investors were secured against losing their contributions by the promise of a refund from the Funds if tax credits could not be delivered or were revoked" "point[ed] to the conclusion that there was no true entrepreneurial risk faced by investors").

[55] Although HBH was the named obligor under the Tax Benefits Guaranty, the agreement provided that "NJSEA ... shall fund any obligations of [HBH] to [PB]" under the Tax Benefits Guaranty. (J.A. at 303.)

Third, any risk that PB would not receive all of its bargained-for tax credits (or cash equivalent through the Tax Benefits Guaranty) due to a failure of any part of the rehabilitation to be successfully completed (i.e., the "Project Risk") was also effectively eliminated because the project was already fully funded before PB entered into any agreement to provide contributions to HBH. (See J.A. at 962 (statement in the Confidential Memorandum that "[t]he rehabilitation is being funded entirely by [NJSEA]"); *id*. at 1134 (notes from a NJSEA executive committee meeting in March 2000 indicating that "[t]he bulk of the Investor's equity is generally contributed to the company after the project is placed into service and the tax credit is earned, the balance when stabilization is achieved"); *id*. at 1714 (notes to NJSEA's 1999 annual report stating that the Casino Reinvestment Development Authority had "agreed to reimburse [NJSEA] [for] ... all costs in excess of bond proceeds for the project").) That funding, moreover, included coverage for any excess development costs.[56] In other words, PB's contributions were not at all necessary for the East Hall project to be completed. *Cf*. *Virginia Historic*, 639 F.3d at 145 (noting that the fact that "the Funds hedged against the possibility of insolvency by promising investors that contributions would be made only to completed projects" "point[ed] to the conclusion that there was not true entrepreneurial risk faced by investors"). Furthermore, HBH's own accountants came to the conclusion that the source of the project's funds - NJSEA (backed by the Casino Reinvestment Development Authority) - was more than capable of covering any excess development costs incurred by the project, as well as any operating deficits of HBH, and NJSEA had promised that coverage through the Completion Guaranty and the Operating Deficit Guaranty, respectively, in the AREA. (See J.A. at 1638 (memo to audit file noting that, because "[NJSEA] has the ability to fund the [operating] deficits as a result of the luxury and other taxes provided by the hospitality and entertainment industry in the state," and "there is no ceiling on the amount of funds to be provided [by NJSEA to HBH]," "no triggering event [had occurred] which require[d] [a write down] under FASB 144").) *Cf*. *Virginia Historic*, 639 F.3d at 145 (noting that although "[i]t [was] true ... there was ... no guarantee that resources would remain available in the source partnership to make the promised refunds ... it [was] also true that the Funds were structured in such a way as to render the possibility of insolvency remote").) Thus, although the Tax Court determined that PB "faced the risk that the rehabilitation would not be completed" (J.A. at 43), the record belies that conclusion. Because NJSEA had deep pockets, and, as succinctly stated by Reznick, "there [was] no ceiling on the amount of funds to be provided [by NJSEA to HBH]" (*id*. at 1638), PB was not subject to any legally significant risk that the renovations would falter.[57]

[56] PB had no exposure to the risk of excess construction costs, as the Completion Guaranty in the AREA provided that NJSEA was obligated to pay all such costs. Additionally, even after the renovation was completed, PB need not worry about any operating deficits that HBH would incur, as NJSEA promised to cover any such deficits through the Operating Deficit Guaranty. Furthermore, as detailed infra note 58, PB ran no real risk of incurring any environmental liability in connection with the East Hall renovation.

[57] Although the question of the existence of a risk is a factual issue we would review for clear error, there was certainly no error in acknowledging that there were risks associated with the rehabilitation. The relevant question, here, however, is not the factual one of whether there was risk; it is the purely the legal question of how the parties agreed to divide that risk, or, in other words, whether a party to the transactions bore any legally significant risk under the governing documents. That question - whether PB was subject to any legally meaningful risk in connection with the East Hall rehabilitation - depends on the AREA and related documents and hence is a question of law that we review de novo.

In short, PB bore no meaningful risk in joining HBH, as it would have had it acquired a bona-fide partnership interest. See *ASA Investerings P'ship v. Comm'r*, 201 F.3d 505, 514 (D.C. Cir. 2000) (noting that the Tax Court did not err "by carving out an exception for de minimis risks" when assessing whether the parties assumed risk for the purpose of determining whether a partnership was valid for tax purposes, and determining that the decision not to consider de minimis risk was "consistent with the Supreme Court's view ... that a transaction will be disregarded if it did "not appreciably affect [taxpayer's] beneficial interest except to reduce his tax"" (alteration in original) (quoting *Knetsch v. United States*, 364 U.S. 361, 366 (1960))).[58]

[58] The Tax Court thought that "[PB] faced potential liability for environmental hazards from the rehabilitation." (J.A. at 43.) Specifically, it theorized that PB could be on the hook for environmental liability (1) if environmental insurance proceeds did not cover any such potential liability, and (2) NJSEA was unable to cover that difference. In reality, however, PB was not subject to any real risk of environmental liability because of the Environmental Guaranty and the fact that PB had a priority distribution right to any environmental insurance proceeds that HBH received (HBH's counsel at oral argument indicated that HBH carried a $25 million policy). Moreover, PB received a legal opinion that it would not be subject to any environmental liability associated with the East Hall renovation.

PB's effective elimination of Investment Risk, Audit Risk, and Project Risk is evidenced by the "agreement ... of the parties." *Culbertson*, 337 U.S. at 742. PB and NJSEA, in substance, did not join together in HBH's stated business purpose - to rehabilitate and operate the East Hall. Rather, the parties' focus from the very beginning was to effect a sale and purchase of HRTCs. (See J.A. at 691 (Sovereign's "consulting proposal ... for the sale of historic rehabilitation tax credits expected to be generated" by the East Hall renovation); *id*. at 955 (Confidential Memorandum entitled "The Sale of Historic Tax

Credits Generated by the Renovation of the Historic Atlantic City Boardwalk Convention Hall"); *id*. at 1143 (cover letter from Sovereign to NJSEA providing NJSEA "with four original investment offers from institutions that have responded to the [Confidential] Memorandum regarding the purchase of the historic tax credits expected to be generated by" the East Hall renovation).)[59]

[59] Although we do not "[p]ermit[] a taxpayer to control the economic destiny of a transaction with labels" when conducting a substance-over-form inquiry, *Schering-Plough, Corp. v. United States*, 651 F. Supp. 2d 219, 242 (D.N.J. 2009), the labels chosen are indicative of what the parties were trying to accomplish and thus those labels "throw[] light on [the parties'] true intent," *Culbertson*, 337 U.S. at 742.

That conclusion is not undermined by PB's receipt of a secondary benefit - the 3% Preferred Return on its contributions to HBH. Although, in form, PB was "not guaranteed" that return on an annual basis if HBH did not generate sufficient cash flow (Appellee's Br. at 35), in substance, PB had the ability to ensure that it would eventually receive it. If PB exercised its Put Option (or NJSEA exercised its Call Option), the purchase price to be paid by NJSEA was effectively measured by PB's accrued and unpaid Preferred Return. See infra note 63 and accompanying text. And to guarantee that there would be sufficient cash to cover that purchase price, NJSEA was required to purchase the Guaranteed Investment Contract in the event that NJSEA exercised its Call Option.[60] *Cf. Virginia Historic*, 639 F.3d at 145 (noting the fact that "investors were promised what was, in essence, a fixed rate of return on investment rather than any share in partnership profits tied to their partnership interests" "point[ed] to the conclusion that there was not true entrepreneurial risk faced by investors"). Thus, the Tax Court's finding that PB "might not receive its preferred return ... at all" unless NJSEA exercised its Call Option (J.A. at 51-52), was clearly erroneous because it ignored the reality that PB could assure its return by unilaterally exercising its Put Option.[61]

[60] As noted supra in Section I.B.4.a, the Guaranteed Investment Contract was "sized to pay off" the accrued but unpaid Preferred Return, as well as the outstanding balance on the Investor Loan with accrued interest. (J.A. at 1211.)

[61] It is true, of course, that PB could not exercise its Put Option until seven years from the date that the East Hall was placed in service. However, PB would have no interest in exercising that option within the first five years anyway because the HRTCs that PB received would be subject to recapture during that period. See supra note 20.

HBH, of course, attacks the Commissioner's assertion that PB lacked downside risk, claiming that "the IRS's theory that a valid partnership cannot exist unless an investor-partner shares in all of the risks and costs of the partnership has no basis in partnership or tax law," and "is contrary to the standard economic terms of innumerable real estate investment partnerships in the United States for every type of real estate project." (Appellee's Br. at 44.) HBH also asserts that many of the negotiated provisions - such as the Completion Guaranty, Operating Deficit Guaranty, and the Preferred Return - are "typical in a real estate investment partnership." (*Id*. at 45.) The Commissioner has not claimed, however, and we do not suggest, that a limited partner is prohibited from capping its risk at the amount it invests in a partnership. Such a cap, in and of itself, would not jeopardize its partner status for tax purposes. We also recognize that a limited partner's status as a bona fide equity participant will not be stripped away merely because it has successfully negotiated measures that minimize its risk of losing a portion of its investment in an enterprise. Here, however, the parties agreed to shield PB's "investment" from any meaningful risk. PB was assured of receiving the value of the HRTCs and its Preferred Return regardless of the success or failure of the rehabilitation of the East Hall and HBH's subsequent operations. And that lack of meaningful risk weighs heavily in determining whether PB is a bona fide partner in HBH. *Cf. Virginia Historic*, 639 F.3d at 145-46 (explaining that "entrepreneurial risks of partnership operations" involves placing "money into a venture with the hope that it might grow in amount but with the knowledge that it may well shrink"); *Castle Harbour*, 459 F.3d at 232 (noting that "Congress appears to have intended that "the significant factor" in differentiating between [debt and equity] be whether "the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business"" (quoting *Gilbert v. Comm'r*, 248 F.2d 399, 406 (2d Cir. 1957))).

2. Lack of Meaningful Upside Potential

PB's avoidance of all meaningful downside risk in HBH was accompanied by a dearth of any meaningful upside potential. "Whether [a putative partner] is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprise." *Culbertson*, 337 U.S. at 747. PB, in substance, was not free to enjoy the fruits of HBH. Like the foreign banks' illusory 98% interest in *Castle Harbour*, PB's 99.9% interest in HBH's residual cash flow gave a false impression that it had a chance to share in potential profits of HBH. In reality, PB would only benefit from its 99.9% interest in residual cash flow after payments to it on its Investor Loan and Preferred Return and the following payments to NJSEA: (1) annual installment payment on the Acquisition Loan ($3,580,840 annual payment for 39 years plus arrears); (2) annual installment payment on the Construction Loan;[62] and (3) payment in full of the operating deficit loan (in excess of $28 million as of 2007). Even HBH's own rosy financial projections from 2000 to 2042, which (at least through 2007) had proven fantastically inaccurate, forecasted no residual cash flow available for distribution. Thus, although in form PB had the potential to receive the fair market value of its interest (assuming such value was greater than its accrued but unpaid Preferred Return) if either NJSEA exercised its Call Option or PB exercised its Put Option, in reality, PB could never expect to share in any upside.[63] *Cf. Castle Harbour*, 459 F.3d at 234 ("The realistic possibility of upside potential - not the absence of formal caps - is what governs [the bona fide equity participation] analysis."). Even if there were an upside, however, NJSEA could exercise its Consent Option, and cut PB out by paying a purchase price unrelated to any fair market value.[64] See supra Section I.B.4.a. In sum, "the structure of the ... transaction ensured that [PB] would never receive any [economic benefits from HBH]." *Southgate Master Fund*, 659 F.3d at 486-87. And "[i]n light of *Culbertson*'s identification of "the actual control of income and the purposes for which it [was] used" as a metric of a partnership's legitimacy, the terms of the [AREA and the structure of the various options] constitute compelling evidence" that PB was not a bona fide partner in HBH. *Id*. at 486 (quoting *Culbertson*, 337 U.S. at 742).

[62] The Construction Loan called for annual interest-only payments until April 30, 2002, and thereafter, called for annual installments of principal and interest that would fully pay off the amount of the principal as then had been advanced by April 30, 2040. Under the original principal amount of $57,215,733 with an interest rate of 0.1% over a 39-year period, and assuming no arrearage in the payment of principal and interest, the annual installment of principal and interest would be approximately $1.5 million.

[63] To put it mildly, the parties and their advisors were imaginative in creating financial projections to make it appear that HBH would be a profit-making enterprise. For example, after Sovereign said that it was "cautious about [Spectacor's projections of net losses for HBH since] they might prove excessively conservative" (J.A. at 793), and suggested that NJSEA "could explore shifting the burden of some of [HBH's] operating expenses ... to improve results" (*id*. at 804), Spectacor made two sets of revisions to HBH's five-year draft projections that turned an annual average $1.7 million net operating loss to annual net operating gains ranging from $716,000 to $1.24 million by removing HBH's projected utilities expenses for each of the five years. Similarly, when an accountant from Reznick informed Hoffman that the two proposed loans from NJSEA to HBH "ha[d] been set up to be paid from available cash flow" but that "[t]here was not sufficient cash to amortize this debt" (*id*. at 1160), Hoffman instructed that accountant to remedy that issue by increasing the projection of baseline revenues in 2002 by $1 million by adding a new revenue source of $750,000 titled "naming rights," and by increasing both "parking revenue" and "net concession revenue" by $125,000 each (*id*. at 1196). Overall, although Reznick projected near closing that HBH would generate an aggregate net operating income of approximately $9.9 million for 2003 through 2007, HBH actually experienced an aggregate net operating loss of over $10.5 million for those five years.

Despite the smoke and mirrors of the financial projections, the parties' behind-the-scenes statements reveal that they never anticipated that the fair market value of PB's interest would exceed PB's accrued but unpaid Preferred Return. (See *id*. at 1162 (pre-closing memo from NJSEA's outside counsel to NJSEA that "[d]ue to the structure of the transaction," the fair market value would not come into play in determining the amount that PB would be owed if NJSEA exercised its Call Option).) That admission is hardly surprising because the substance of the transaction indicated that this was not a profit-generating enterprise. *Cf. Virginia Historic*, 639 F.3d at 145 (noting that the fact that "the Funds ... explicitly told investors to expect no allocation of material amounts of ... partnership items of income, gain, loss, or deduction " "point[ed] to the conclusion that there was no true entrepreneurial risk faced by investors" (citation and internal quotation marks omitted)).

[64] Thus, contrary to HBH's assertion, NJSEA effectively did have the "right to divest [PB] of its interest in any income or gains from the East Hall." (Appellee's Br. at 35.)

3. HBH's Reliance on Form over Substance

After attempting to downplay PB's lack of any meaningful stake in the success or failure of the enterprise, HBH presses us to consider certain evidence that it believes "overwhelmingly proves that [PB] is a partner in HBH" under the *Culbertson* totality-of-the-circumstances test. (Appellee's Br. at 38.) That "overwhelming" evidence includes: (1) that HBH was duly organized as an LLC under New Jersey law and, as the AREA provides, "was formed to acquire, develop, finance, rehabilitate, maintain, operate, license, and sell or otherwise to dispose of the East Hall" (*id*. at 40; see J.A. at 157); (2) PB's "net economic benefit" from the HRTCs and the 3% Preferred Return (Appellee's Br. at 41); (3) PB's representatives' "vigorous[] negotiat[ion] [of] the terms of the AREA" (*id*. at 41); (4) "the nature and thoroughness" of PB's "comprehensive due diligence investigation in connection with its investment in HBH" (*id*. at 42); (5) PB's "substantial financial investment in HBH" (*id*.); (6) various business agreements that had been entered into between NJSEA and certain third parties that were all assigned to, and assumed by, HBH (*id*. at 43); (7) bank and payroll accounts that were opened in HBH's name and insurance agreements that were amended to identify HBH as an owner and include PB as an additional insured; and (8) the fact that, following closing, "NJSEA kept in constant communication with [PB] regarding the renovations to the East Hall, and the business operations of the Hall" (*id*.).

Much of that evidence may give an "outward appearance of an arrangement to engage in a common enterprise." *Culbertson*, 337 U.S. at 752 (Frankfurter, J., concurring). But "the sharp eyes of the law" require more from parties than just putting on the "habiliments of a partnership whenever it advantages them to be treated as partners underneath." *Id*. Indeed, *Culbertson* requires that a partner "really and truly intend[] to ... shar[e] in the profits and losses" of the enterprise, *id*. at 741 (majority opinion) (emphasis added) (citation and internal quotation marks omitted), or, in other words, have a "meaningful stake in the success or failure" of the enterprise, *Castle Harbour*, 459 F.3d at 231. Looking past the outward appearance, HBH's cited evidence does not demonstrate such a meaningful stake.

First, the recitation of partnership formalities - that HBH was duly organized, that it had a stated purpose under the AREA, that it opened bank and payroll accounts, and that it assumed various obligation - misses the point. We are prepared to accept for purposes of argument that there was economic substance to HBH. The question is whether PB had a meaningful stake in that enterprise. See *Castle Harbour*, 459 F.3d at 232 ("The IRS's challenge to the taxpayer's characterization is not foreclosed merely because the taxpayer can point to the existence of some business purpose or objective reality in addition to its tax-avoidance objective."); *Southgate Master Fund*, 659 F.3d at 484 ("The fact that a partnership's underlying business activities had economic substance does not, standing alone, immunize the partnership from judicial scrutiny [under *Culbertson*]. The parties' selection of the partnership form must have been driven by a genuine business purpose." (internal footnote omitted)). To answer that, we must "look beyond the superficial formalities of a transaction to determine the proper tax treatment." *Edwards v. Your Credit, Inc.*, 148 F.3d 427, 436 (5th Cir. 1998) (citation and internal quotation marks omitted).

Second, evidence that PB received a "net economic benefit" from HBH and made a "substantial financial investment in HBH" can only support a finding that PB is a bona fide partner if there was a meaningful intent to share in the profits and the losses of that investment. The structure of PB's "investment," however, shows clearly that there was no such intent. Recovery of each of the contributions that made up the "substantial financial investment" was assured by the provisions of the AREA and the Tax Benefits Guaranty. And, as the Commissioner rightly notes, PB's net after-tax economic benefit from the transaction — in the form of the HRTCs (or the cash equivalent via the Tax Benefits Guaranty) and the effectively guaranteed Preferred Return — "merely demonstrates [PB's] intent to make an economically rational use of its money on an after-tax basis." (Appellant's Reply Br. at 13.) Indeed, both parties in a transaction such as this one will always think they are going to receive a net economic benefit; otherwise, the transaction would never occur. If in fact that was the test, there would be a green-light for every tax-structured transaction that calls itself a "partnership."

Third, the fact that NJSEA "kept in constant communication" regarding the East Hall is hardly surprising. As discussed earlier, supra Section II.C.1, each installment contribution from PB was contingent upon NJSEA verifying that a certain amount of work had been completed on the East Hall so that PB was assured it would not be contributing more money than it would be guaranteed to receive in HRTCs or their cash equivalent. The mere fact that a party receives regular updates on a project does not transform it into a bona fide partner for tax purposes.

Fourth, looking past the form of the transaction to its substance, neither PB's "vigorous[] negotiat[ion]" nor its "comprehensive due diligence investigation" is, in this context, indicative of an intent to be a bona fide partner in HBH. We do not doubt that PB spent a significant amount of time conducting a thorough investigation and negotiating favorable terms. And we acknowledge that one of the factors cited by *Culbertson* is "the conduct of the parties in execution of its provisions." 337 U.S. at 742. But the record reflects that those efforts were made so that PB would not be subject to any real risks that would stand in the way of its receiving the value of the HRTCs; not, as HBH asserts, "to form a true business relationship." (Appellee's Br. at 41.) We do not believe that courts are compelled to respect a taxpayer's characterization of a transaction for tax purposes based on how document-intensive the transaction becomes. Recruiting teams of lawyers, accountants, and tax consultants does not mean that a partnership, with all its tax credit gold, can be conjured from a zero-risk investment of the sort PB made here.

In the end, the evidence HBH cites focuses only on form, not substance. From the moment Sovereign approached NJSEA, the substance of any transaction with a corporate investor was calculated to be a "sale of ... historic rehabilitation tax credits." (J.A. at 691.) *Cf. Castle Harbour*, 459 F.3d at 236 (finding that the banks' interest "was more in the nature of window dressing designed to give ostensible support to the characterization of equity participation ... than a meaningful stake in the profits of the venture"). And in the end, that is what the substance turned out to be.

Like the *Virginia Historic* court, we reach our conclusion mindful of Congress's goal of encouraging rehabilitation of historic buildings. See 639 F.3d at 146 n.20. We have not ignored the predictions of HBH and amici that, if we reallocate the HRTCs away from PB, we may jeopardize the viability of future historic rehabilitation projects. Those forecasts, however, distort the real dispute.

The HRTC statute "is not under attack here." *Id*. It is the prohibited sale of tax credits, not the tax credit provision itself, that the IRS has challenged. Where the line lies between a defensible distribution of risk and reward in a partnership on the one hand and a form-over-substance violation of the tax laws on the other is not for us to say in the abstract. But, "[w]here, as here, we confront taxpayers who have taken a circuitous route to reach an end more easily accessible by a straightforward path, we look to the substance over form." *Southgate Master Fund*, 659 F.3d at 491 (citation and internal quotation marks omitted). And, after looking to the substance of the interests at play in this case, we conclude that, because PB lacked a meaningful stake in either the success or failure of HBH, it was not a bona fide partner.

Cross Refined Coal, LLC v. Commissioner, 130 A.F.T.R.2d 2022-5343, 45 F.4th 150, (D.C. Cir. 2022), summarized:

Congress enacted a tax credit to incentivize the production of refined coal, which releases fewer emissions than unrefined coal. AJG Coal, Inc. responded by forming Cross Refined Coal, LLC and recruiting two other investors in that enterprise. Limited-liability companies are taxed like partnerships, so the company's tax liabilities and

> credits passed through to its member investors. Yet the Internal Revenue Service balked when Cross's members tried to claim the refined-coal credit. The IRS asserted that Cross was not a bona fide partnership for tax purposes, in part because it could never have made a profit without the tax credit. The tax court disagreed, and so do we. We hold that partnerships formed to conduct activity made profitable by tax credits engage in legitimate business activity for tax purposes. We further conclude that all of Cross's members shared in its profits and losses, and thus had a meaningful stake in its success or failure. Accordingly, we affirm the tax court's conclusion that Cross was a bona fide partnership.

One argument made before the Tax Court was not addressed by the Court of Appeals comes from the trial transcript:[575]

> In his pretrial memorandum (at 3), the Commissioner states that the issue in this case is whether "Cross was not formed to carry on a business or for the sharing of profits and losses from the production or sale of refined coal by its purported members, but rather was formed as a vehicle for the sale of Tax Credits from" AJGC to USARC and Schneider. It is true that the credits were a critical feature of the arrangement, that no rational actor would have invested in the refined coal facility without the credits, that the parties took every necessary effort to assure their obtaining of the credits. It is also true that their communications speak of the obtaining of the credits as the desired outcome, and that some of their communications used "purchasing" or "selling" the credits as a shorthand for entering into or acting under the contracts into which they had entered. There may be circumstances in which such facts might undermine the existence of a bona fide partnership - but that is not the case here.

The Court of Appeals first mentioned *Culbertson* and *Tower* and its own precedent, *ASA Investerings P'ship v. Commissioner*, 201 F.3d 505, 506 (D.C. Cir. 2000). Then it set forth what is a partnership:

> The partnership definition in *Tower* and *Culbertson* consists of two requirements. First, the partners must intend to "carry on business as a partnership." *Tower*, 327 U.S. at 287; *Culbertson*, 337 U.S. at 742-43. In other words, the enterprise must be "undertaken for profit or for other legitimate nontax business purposes." *BCP Trading*, 991 F.3d at 1271 (cleaned up). In most cases, this inquiry turns on whether the partnership has a genuine opportunity to make a profit and whether the partners direct their efforts toward realizing it. See *id*. at 1271-72. In contrast, a partnership that has "no practical economic effect other than the creation of tax losses" is treated as a sham. *Id*. at 1272; see *ASA Investerings*, 201 F.3d at 506 (finding sham partnership where "transactions that in substance added up to a wash were transmuted into ones generating tax losses of several hundred million dollars"). Other factors that are probative of a sincere intent to carry on a business include the duration of the partnership, see *Andantech*, 331 F.3d at 979, and the business rationale for using the partnership form, *id*. at 980; *Boca Investerings P'ship v. United States*, 314 F.3d 625, 632 (D.C. Cir. 2003).
>
> Though we look to economic reality in assessing intent to carry on a business, we do not lightly set aside de jure partnerships as shams. "It is uniformly recognized that taxpayers are entitled to structure their transactions in such a way as to minimize tax," *ASA Investerings*, 201 F.3d at 513, so "[t]ax minimization as a primary consideration is not

[575] Docket No. 19502-17, transcript dated August 29, 2019.

> unlawful," *BCP Trading*, 991 F.3d at 1272. Taxpayers that structure their dealings to receive tax benefits afforded by statute are entitled to those benefits, no matter their subjective motivations. Otherwise, the sham-partnership doctrine, like the more general economic-substance doctrine, would allow the Commissioner "to place labels on transactions to avoid textual consequences he doesn't like." *Summa Holdings, Inc. v. Comm'r*, 848 F.3d 779, 787 (6th Cir. 2017).
>
> The second requirement of the Supreme Court's definition of partnership is that the partners must intend to "shar[e] in the profits or losses or both." *Tower*, 327 U.S. at 287. In other words, the partners' interests must have the "prevailing character" of equity, with each partner having a "meaningful stake in the success or failure" of the partnership. *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 231–32 (2d Cir. 2006). If one putative partner is insulated from the upside and downside risks of the business, its interest resembles that of a secured creditor, not an equity partner. See *Historic Boardwalk Hall, LLC v. Comm'r*, 694 F.3d 425, 462 (3d Cir. 2012) ("a partnership, with all its tax credit gold, can[not] be conjured from a zero-risk investment"); *Southgate*, 659 F.3d at 486–89.
>
> In our circuit, the leading case on partnership validity epitomizes the failure to meet these two requirements. In *ASA Investerings*, a U.S. corporation seeking to offset a large capital gain formed a putative partnership with a foreign bank not subject to U.S. tax. 201 F.3d at 508. During its brief existence, the partnership executed only two transactions: the purchase and offsetting sale of certain debt instruments. *Id*. Relying on the tax code's installment-sale rules, the partners engaged in wash transactions that created a large capital gain for the tax-indifferent bank and a large capital loss (and accompanying tax deduction) for the U.S. corporation. *Id*.
>
> We held that the purported partnership was not bona fide. First, the partners did not intend to carry on a business together, for the partnership was not designed to be profitable on a pre-or post-tax basis, and it had no other apparent non-tax business purpose. 201 F.3d at 513-14. The partnership claimed that it hoped to profit from a change in interest rates between the time of the offsetting transactions, but we found that they were designed to eliminate all relevant risks. *Id*. at 514. Second, and relatedly, the foreign bank did not share in the supposed risk of the putative partnership. Instead, it received a guaranteed rate of return for its participation and faced only a "de minimis risk" to its investment. *Id*. at 514-15 ("A partner whose risks are all insured at the expense of another partner hardly fits within the traditional notion of partnership.").

In analyzing the case, the court first determined that the parties intended to jointly carry on a business:

> First, the tax court correctly determined that AJG, Fidelity, and Schneider intended to jointly carry on a business. As the tax court found and the government concedes, AJG had legitimate non-tax motives for forming Cross and for recruiting partners, such as spreading its investment risk over a larger number of projects. Moreover, there was nothing untoward about seeking partners who could apply the refined-coal credits immediately, rather than carrying them forward to future tax years. Low-tax entities (like AJG) often use the prospect of tax credits to attract high-tax entities (like Fidelity and Schneider) into a partnership, and in return, the high-tax partners provide the financing needed to make the tax-incentivized project possible. See *Va. Historic Tax Credit Fund 2001 LP v. Comm'r*, 639 F.3d 129, 132-33 (4th Cir. 2011); Office of the Comptroller of the Currency, Low-Income Housing Tax Credits: Affordable Housing Investment

Opportunities for Banks 1–3 (last updated Apr. 2014). And Congress expressly provided for coal refiners to employ this investment strategy, for the tax code specifies how the credit must be divided when a refining facility has multiple owners. 26 U.S.C. §§ 45(e)(3). Cross therefore fits comfortably within the scope of entities that Congress envisioned claiming the credit.

Fidelity and Schneider, while no doubt motivated by the prospect of refined-coal tax credits, also became legitimate partners in the enterprise. Though AJG did much of the heavy lifting to launch Cross, Fidelity and Schneider jointly controlled its major decisions once they became members, and they were actively involved in its day-to-day operations. Both also made monthly contributions to Cross "commensurate with their status as partners" - Fidelity contributed $26 million, and Schneider contributed $12.3 million. A. 1821-22. And both remained members of Cross for several years, even during unprofitable shutdowns.

The Commissioner's chief objection is that Cross did not pursue business activity to obtain a pre-tax profit. Instead, tax credits were its sole profit driver, and the production of those credits thus permeated every aspect of its business model. According to the Commissioner, Cross's partners did not have the requisite intent to carry on a business together because Cross was not "undertaken for profit or for other legitimate *nontax* business purposes." *BCP Trading*, 991 F.3d at 1271 (cleaned up) (emphasis added).

We disagree. As a general matter, a partnership's pursuit of after-tax profit can be legitimate business activity for partners to carry on together. This is especially true in the context of tax incentives, which exist precisely to encourage activity that would not otherwise be profitable. The production of refined coal illustrates this point: Congress recognized its environmental benefits, but, as the tax court explained, refiners must sell it at a discount "in order to induce the utility to assume the risk of buying and using" it. A. 1792-93. Thus, Cross did not simply engage in "wasteful activity," which is typical of sham partnerships that merely manufacture tax losses. *ASA Investerings*, 201 F.3d at 513. Rather, Cross engaged in business activity with a "practical economic effect," *BCP Trading*, 991 F.3d at 1272 - the production of cleaner-burning refined coal, which Congress specifically sought to encourage.

The Ninth Circuit has likewise held that taxpayers may legitimately conduct business activity that Congress has deliberately made profitable through statutory tax incentives - and may do so with no hope of a pre-tax profit. In *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995), that court explained: "If the government treats tax-advantaged transactions as shams unless they make economic sense on a pre-tax basis, then it takes away with the executive hand what it gives with the legislative." *Id*. at 992. For "Congress has purposely used tax incentives" to "induce investments which otherwise would not have been made," and "[i]f the Commissioner were permitted to deny tax benefits when the investments would not have been made but for the tax advantages, then only those investments would be made which would have been made without the Congressional decision to favor them." Id. at 991-92. The Commissioner's view would thus hamstring Congress's ability to use tax credits to encourage all kinds of activity that is socially desirable but unprofitable to those undertaking it - such as building low-income housing, 26 U.S.C. §§ 42; producing renewable energy, *id*. § 45; or developing medicines for rare diseases, *id*. § 45C.

> The Commissioner falls back to the position that a partnership is bona fide only if each partner expects to make a pre-tax profit "at some point in time." Reply Br. at 23-24. He invokes *Alternative Carbon Resources, LLC v. United States*, 939 F.3d 1320 (Fed. Cir. 2019), which held that a taxpayer could not claim an alternative-fuel tax credit absent evidence that it "ever reasonably expected to generate any profit apart from the tax credits." *Id*. at 1330 (cleaned up). Like the Commissioner, *Alternative Carbon* sought to distinguish *Sacks* as a case where the taxpayer could eventually turn a pre-tax profit. *Id*. at 1331. But *Sacks* did not turn on that possibility; to the contrary, it explained that an investment does "not become a sham just because its profitability was based on after-tax instead of pre-tax projections." 69 F.3d at 991. And even *Alternative Carbon* acknowledged that a transaction "unprofitable absent a tax credit" may still have economic substance if it "meaningfully alters the taxpayer's economic position (other than with regard to the tax consequences)" and has a "bona fide business purpose." 939 F.3d at 1331-32 (cleaned up). Cross passes muster under this test: Its partners all made sizable contributions to become part owners and help Cross engage in the business of producing refined coal.
>
> The Commissioner also points to our remark in *ASA Investerings* that "the absence of a nontax business purpose is fatal" to bona fide partnership status. 201 F.3d at 512. But transactions that are profitable only on a post-tax basis can still have a "nontax business purpose." The ASA partnership - an "elaborate" scheme that engaged in "wasteful activity" with "very substantial transaction costs" - had no purpose apart from the creation of tax losses. *Id*. at 513, 516. Indeed, the partnership itself could not profit even on a post-tax basis, making it "no more than a facade." *Id*. at 513-14. Cross, on the other hand, sought to produce a post-tax profit, and it did so by pursuing the congressionally encouraged business purpose of producing refined coal. Moreover, its use of the partnership form furthered that purpose by enabling AJG to raise more capital and spread its investment risk across multiple coal-refining projects.
>
> Even the Commissioner ultimately recognizes that an enterprise profitable only on a post-tax basis can have a valid business purpose. He acknowledges that Cross would have had a legitimate business purpose had AJG alone operated it, even with no potential for pre-tax profit. But if one entity could validly seek after-tax profit through Cross, there is no reason why three partners could not validly pursue the same objective.

When Congress codified the economic substance doctrine, Congress intended not to apply it to discourage projects motivated by tax credits if the partners were engaging in the encouraged activity.[576]

The court then reviewed the parties' sharing in the partnership's potential for profit and risk of loss:

> The tax court also correctly concluded that Fidelity and Schneider shared in Cross's potential for profit and risk of loss, giving their investment the prevailing character of equity. If Cross refined more coal, Fidelity and Schneider made more money. If Cross struggled - whether due to regulatory obstacles, environmental problems, or shortcomings in the newly developed refining technology - Fidelity and Schneider would lose money. And Cross did at times struggle: During its two shutdowns, it incurred

[576] See text accompanying fn 1660 in part II.G.17.a What Is the Codified Economic Substance Doctrine.

almost $2.9 million in operating expenses without generating any offsetting revenue. As partners, Fidelity and Schneider were liable for, and paid, their pro rata shares of those expenses.

To be sure, Fidelity and Schneider were insulated from some of Cross's downside risk. Most notably, Fidelity's purchase agreement contained the liquidated-damages provision. Likewise, Cross's sub-license agreement was structured to protect Fidelity and Schneider from minor fluctuations in variable operating costs. But these provisions hardly made their investments effectively like debt, for which funds are "advanced with reasonable expectations of repayment regardless of the success of the venture" rather than being "placed at the risk of the business." *Gilbert v. Comm'r*, 248 F.2d 399, 406 (2d Cir. 1957). By and large, Fidelity and Schneider's fortunes rose or fell with the amount of coal that Cross refined, which made them bona fide equity partners. See *Historic Boardwalk*, 694 F.3d at 459 ("a limited partner's status as a bona fide equity participant will not be stripped away merely because it has successfully negotiated measures that minimize its risk of losing a portion of its investment"); *Hunt v. Comm'r*, 59 T.C.M. (CCH) 635, 648 (1990) (bona fide partner could have a 98% guaranteed return of its capital contribution).

The Commissioner acknowledges that Fidelity and Schneider faced downside risk, but he contends that it was not meaningful given the magnitude of the expected tax benefits. In support of this argument, the Commissioner invokes cases relying on the economic-substance doctrine, which evaluates transactions based on economic reality as opposed to formal labels. See *Gregory v. Helvering*, 293 U.S. 465, 468-70 (1935). The cited cases assessed the legitimacy of offshore transactions that gave rise to large U.S. tax losses. *Bank of N.Y. Mellon Corp. v. Comm'r*, 801 F.3d 104, 106–07 (2d Cir. 2015); *Reddam v. Comm'r*, 755 F.3d 1051, 1055-57 (9th Cir. 2014). In these cases, the courts compared the magnitude of the expected tax and non-tax benefits to gauge whether the disputed transactions had a legitimate business purpose. *Bank of N.Y. Mellon*, 801 F.3d at 120; *Reddam*, 755 F.3d at 1061. Similar logic applies to sham-partnership analysis, the Commissioner contends, as evidenced by our statement in *ASA Investerings* that "any potential gain from the partnership's investments was in its view at all times dwarfed by its interest in the tax benefit." 201 F.3d at 513.

In this case, the Commissioner modifies the comparison and balances capital placed at risk with the expected tax benefits. He asserts that at most, Fidelity and Schneider respectively placed at risk about $4 million and $3 million, which represent the sum of (1) the initial buy-in amounts (less the amount that Fidelity later received in liquidated damages), (2) the initial contributions to cover two months of operating expenses, and (3) the monthly contributions to cover operating expenses during shutdown months when no tax credits accrued. On the other side of the ledger, Fidelity and Schneider anticipated that, under a best-case scenario, they would collectively earn $105 million in after-tax profit over ten years. The Commissioner contends that this imbalance between the relatively small amounts that Fidelity and Schneider placed at risk and the large expected tax benefits shows that they merely bought tax credits rather than becoming true equity partners.[2]

[2] The Commissioner argues that the tax court, in evaluating the extent of Fidelity and Schneider's risk, improperly considered operating expenses accrued during non-shutdown months when Cross produced refined coal and thus earned the tax credit. The tax court did not do so. *See* A. 1825-32. But regardless of whether these

expenses are considered, we conclude that Fidelity and Schneider had meaningful downside risk.

We reject this argument. The cited economic-substance cases compared expected tax and non-tax benefits to discern the nature of the contested transactions for tax purposes. As explained above, Congress recognized the environmental benefits of cleaner coal and provided tax incentives that it deemed appropriate as a result. We thus cannot ignore tax consequences in assessing the legitimacy of the encouraged activity. By contrast, the financial engineering in *Bank of New York Mellon* and *Reddam* had no "practical economic effects," *Reddam*, 755 F.3d at 1062 (quoting *Sacks*, 69 F.3d at 987); *Bank of N.Y. Mellon*, 801 F.3d at 120 (similar), and the comparison between the transactions' tax and non-tax benefits confirmed that they lacked substance. As for *ASA Investerings*, the putative partnership activity there was unprofitable even on a post-tax basis, in contrast to the activity here of producing refined coal. Also, in weighing expected benefits, the Commissioner relies on a best-case scenario "assum[ing] uninterrupted high volume sales of refined coal over the entire 10-year period," A. 1794, rather than a more realistic, risk-adjusted projection.

Moreover, even if we accepted the Commissioner's modification and compared capital placed at risk to anticipated tax benefits under a best-case scenario, we still see no reason to doubt Fidelity and Schneider's status as bona fide partners. As explained above, the production of refined coal is legitimate business activity that Congress sought to make profitable through tax incentives, including for partnerships. Without more, high after-tax profit margins suggest only that the tax credit is a generous one, not that the entities obtaining them are something other than a legitimate partnership. In this case, for example, nobody doubts that AJG could benefit from the tax credit, no matter how small its investment or how large its tax-driven profits. Fidelity and Schneider were no less eligible to reap the rewards of Congress's generosity.

We recognize that Fidelity and Schneider could not fairly be treated as equity partners if their investments in Cross were so trivial or so insulated from risk as to make them indifferent to Cross's success or failure. But as shown above, Fidelity and Schneider had much skin in the game. Through their initial investments and contributions to operating expenses, they put millions of dollars at risk, in amounts proportionate to their respective ownership interests. Moreover, as the tax court explained, "it was entirely within the realm of possibility" that they would not recover much of their capital, A. 1829, in sharp contrast to the cases cited by the Commissioner, see *ASA Investerings*, 201 F.3d at 514-15 (hedge transactions made any risk of loss "de minimis"); *Bank of N.Y. Mellon*, 801 F.3d at 122 (transactions amounted to a "circular cash flow"); *Reddam*, 755 F.3d at 1061 ("tax loss" from transaction "would always...have overshadowed" any underlying gains or losses). The tax benefits that the partners received varied entirely with the amount of coal that Cross was able to refine. And there were significant downside risks, which materialized for long periods. For instance, though the best-case forecasts projected that Fidelity and Schneider would receive $105 million in tax credits over 10 years, they ended up earning only $14.25 million over four years due to two lengthy shutdowns. Moreover, the two partners lost $2.9 million and $700,000 respectively on the Jefferies refining facility, which used the same investment structure as Cross. And it could have been even worse: Fidelity and Schneider were exposed to significant litigation and regulatory risks, and they faced the possibility that the refined coal might not meet emissions standards and thus not qualify for any tax credits.

> A material risk of failing to receive a return on investment is the essence of every equity stake. Fidelity and Schneider's investments in Cross carried that risk, which distinguishes this case from sham partnerships that guarantee a fixed return to one putative partner. The tax court correctly concluded that all members of Cross shared its profits and losses. See *Tower*, 327 U.S. at 287.

Lipton, "IRS' Argument in Cross Refined Coal Gets Burned by the DC Circuit," *Journal of Taxation* (Jan. 2023), comments:

> The most important *aspect* of the DC Circuit's decision in *Cross Refined* Coal is its recognition that Sacks was a correct statement of the law – the IRS cannot claim that a partnership is not bona fide simply because the partnership relies on Congressionally-provided tax benefits (such as tax credits) to turn a profit. When Congress provides an economic incentive for an activity, taxpayers who engage in that activity (and thereby do what Congress encouraged) should not lose their claimed tax benefits just because the activity would not have been profitable without the tax benefits that Congress created. Indeed, as the Ninth Circuit so aptly noted, any other conclusion would directly frustrate Congress' will, which is not within the power of an administrative agency like the IRS.
>
> Congress frequently uses tax credits to incentivize taxpayer behavior. For example, the recently-enacted Inflation Reduction Act is replete with numerous tax credits addressing climate change, and it can be anticipated that individuals and industries will change their behavior in order to obtain the appropriate tax benefits. Likewise, there are entire industries (such as wind and solar power generation) that might not make economic sense absent tax credits, not to mention low-income housing. Thus, the IRS' argument that only a trade or business that is anticipated to make a pre-tax profit was contrary to many provisions in the Code, and not just the special rules that relate to the production of refined coal.
>
> The DC Circuit also appropriately addressed the language in its own tax shelter opinions and relegated them to the era in which they belonged. The tax shelters which arose several decades ago required a tough response from the IRS and the courts, and the courts sometimes used language (and analysis) in addressing these transactions that was potentially much broader in its application. In *Cross Refined Coal*, the DC Circuit essentially concluded that a tax-shelter case like *ASA Investerings* needed to be viewed in the light of the particular issues raised by tax shelters, so that the broad statements in *ASA Investerings* could be ignored in addressing the tax treatment of a partnership which was engaged in a bona fide business (even if that business made economic sense only because of tax credits provided by Congress). Likewise, the DC Circuit appropriately rejected the IRS' attempt to bring the economic substance doctrine into play with respect to a business where Congress had expressly provided incentives for taxpayers to engage in that business. Thus, the DC Circuit limited the potentially-broad scope of its own prior decisions to situations in which those decisions were intended to apply (tax shelters), concluding that those rules did not apply outside of the tax shelter arena.

II.C.10. Whether Tenancy-in-Common or other Arrangement Constitutes a Partnership

Taxation as a partnership, although generally more flexible than corporate taxation, might be more unfavorable than taxation as co-owners who are not partners. For example, if co-owners have different goals regarding whether to reinvest sale proceeds or engage in a Code § 1031 like-kind exchange,[577] they might want to unwind anything that makes them considered partners.[578] Also, the Code § 121 exclusion for gain on the sale of a residence does not apply when spouses hold their residence in a partnership.[579] On the other hand, partnership income tax reporting generally is easier than separately listing every item on each co-owner's income tax return.

Those holding properties as tenants-in-common[580] or a trust created by its beneficiaries[581] should consider whether they are deemed to have formed a partnership; for whether a loan may be recharacterized as an equity investment in a partnership, see part II.G.20.b When Debt Is Recharacterized as Equity. Generally, as a matter of state law, "the association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership."[582] Furthermore, the Uniform Partnership Act provides

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[577] See part II.G.16 Like-Kind Exchanges.

[578] For how to unwind a partnership in anticipation of a possible Code § 1031 exchange, see "Like-Kind Exchanges of Partnership Properties," *The Tax Adviser*, page 812, December 2008. Letter Ruling 9741017 drove this point home in the following situation:

> … each of the brothers, A and B, owns a one-half interest in Taxpayer, which itself owns ten rental real properties. A and B have responsibility for making major decisions regarding their properties. Management of the properties is performed by a property management corporation of which A and B are equal stockholders, but are no longer employees. A and B represent that they have never executed any partnership agreement regarding Taxpayer or considered themselves to be anything other than equal owners of the properties. For the five consecutive tax years 19x1 to 19x5, however, all net income and losses of Taxpayer relating to the properties have been reported on Form 1065, a Partnership Return.
>
> A and B represent that irreconcilable differences have developed between them regarding their ownership of the properties. Moreover, A and B are considering estate planning issues relating to the properties. To address those issues, A and B propose a like-kind exchange between themselves involving nine of the properties. After the exchange, six of the properties will be owned entirely by B, and three will be owned by A. The tenth property will continue to be owned by A and B as co-owners.

The ruling held:

> Without making a determination under Rev. Rul. 75-374 regarding A's and B's joint business activities relating to the properties, we note a crucial test under case law of whether the co-owners of property intended to create a partnership, as evidenced by their actions, notwithstanding the lack of characterization of their relationship. See *Estate of Levine*, 72 T.C. 780, 785 (1979). In this instance, we believe that Taxpayer's filing of partnership tax returns for several tax years indicates an intention to be taxed as a partnership. Accordingly, we conclude that A's and B's co-ownership of Taxpayer constitutes a partnership under section 761(a) and the regulations thereunder rather than a mere co-ownership.
>
> Since an exchange of partnership interests can not qualify for deferral under section 1031(a)(1) by reason of section 1031(a)(2)(D) we can not rule that the transaction qualifies for deferral as a like-kind exchange.

[579] *Farah v. Commissioner*, T.C. Memo. 2007-369, and Letter Ruling 200119014.

[580] For an excellent discussion of taxation of tenants-in-common, as well as when such an arrangement is taxed as a partnership, see Tucker and Langlieb, fn. 1918. In the real estate context, see also fn. 366.

[581] See parts II.D.1 Trust as a Business Entity and II.K.2.b.iii Participating in Business Activities Does Not Convert a Trust Created by Only One Grantor into a Business Entity.

[582] Section 202(a) of the Uniform Partnership Act ("UPA"), found at http://www.uniformlaws.org/Act.aspx?title=Partnership Act (1997) (Last Amended 2013) (general description of the UPA) or http://www.uniformlaws.org/Shared/Docs/Partnership/UPA%20_Final_2014_2015aug19.pdf (text of the UPA).

standards for forming a partnership, even if the partners do not intend to form a business entity.[583]

Co-owners of real estate might form a partnership with respect to operations conducted on the real estate without the partnership applying to the ability to sell the real estate itself,[584] but equitable principles are likely to determine whether the court finds a partnership.[585]

As a matter of federal tax law, regulations provide a fundamental definition:[586]

> *In general*. The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

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[583] An excerpt accompanies fn 618 in part II.C.11 General Partnership.

[584] *Holton v. Guinn*, 76 F. 96 (W.D. Mo. 1896), held, "It might be conceded, for the purpose of this case, that a partnership existed between the parties in conducting a business on these lands, without affecting the legal status of the land or property, for the separate properties may be employed in partnership business." Although one of a few co-tenants might engage in conduct suggesting a partnership, that conduct must be authorized to find a partnership. Looking to the actions of all of the co-owners and finding a mere tenancy in common, *Hudson v. French*, 241 S.W. 443 (W.D. Mo. 1922), quoted *Holton*:

> "Where the conduct and acts of the parties in dealing with the estate may with reason be referred to the office of a tenant in common, the courts, in construing those acts, will prefer to attribute them to that relation."

Continuing this line of reasoning, *Thomas v. Lloyd*, 17 S.W.3d 177 (S.D. Mo. 2000), found a mere tenancy in common regarding real estate, analyzing the law as follows:

> In attempting to demonstrate that the parties intended for the real estate to be a partnership asset, Defendant points to the joint ownership of the farm and the fact that the parties operated the partnership cattle business on the farm as evidence that the two understood and intended for the farm to be a partnership asset. His reliance on those facts is misplaced, however. A joint purchase of real estate by two individuals does not, in and of itself, prove the land is a partnership asset. See *Hudson*, 241 S.W. at 446; 68 C.J.S. Partnership § 73, at 274–75 (1998). On the contrary, when land is conveyed to partnership members without any statement in the deed that the grantees hold the land as property of the firm, there is a presumption that title is in the individual grantees. 68 C.J.S. Partnership § 75, at 277 (1998). Moreover, "[e]vidence that the land is used by the firm is of itself insufficient to rebut the presumption." *Id.* The mere use of land by a partnership does little to show the land is owned by the partnership. 1 Bromberg and Ribstein on Partnership, § 3.02(b), at 3:7 (Release No. 7—1999–2 Supp.). Standing alone, evidence of partnership usage does not compel a finding that the land is a partnership asset. *Mischke v. Mischke*, 247 Neb. 752, 530 N.W.2d 235, 240 (1995); *In re Estate of Schreiber*, 227 N.W.2d 917, 925[9] (Wis. Sup. 1975). See *Shawneetown Feed and Seed Co. v. Ford*, 468 S.W.2d 54, 56 (Mo. App. 1971).

The result may be different if partnership funds were used to buy the property. *Engeman v. Engeman*, 123 S.W.3d 227 (W.D. Mo. 2003).

[585] *State Auto. and Cas. Underwriters v. Johnson*, 766 S.W.2d 113 (S.D. 1969), held that the building, furniture and fixtures destroyed by the fire constituted partnership property when a 50% tenant in common received insurance proceeds equal to 100% of the value of the property destroyed. Although the partnership agreement was terminated:

> We hold the trial court's findings that no final division had ever been made of the partnership property or partnership debts, that the partnership affairs were never wound up, and that the partnership had not been terminated at the time of the fire are supported by substantial evidence and are not against the weight of the evidence, and that in making such findings the trial court neither erroneously declared nor erroneously applied the law.

[586] Reg. § 301.7701-1(a)(1).

Reg. § 301.7701-1(a)(2) provides:[587]

> *Certain joint undertakings give rise to entities for federal tax purposes*. A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.

The controlling U.S. Supreme Court case held:[588]

> The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

Presenting sufficient evidence to raise a genuine issue of material fact as to the parties' intent prevents the IRS from winning on summary judgment;[589] the IRS can't succeed merely by showing that the generation of tax losses was one of the purposes of a partnership's

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[587] Code § 7701(a)(2) provides:

> The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

Reg. § 301.7701-1(a)(2) is also important to help determine whether a tenancy-in-common is eligible for a like-kind exchange. See fn 1644 in part II.G.16.b Pre-2018 Code § 1031.

[588] *Commissioner v. Culbertson*, 337 U.S. 733 (1949), clarifying *Commissioner v. Tower*, 327 U.S. 280 (1946).

[589] In denying summary judgment to the government, *Broadwood Investment Fund, LLC v. U.S.*, 116 A.F.T.R.2d 2015-5492 (9th Cir. 2015), held:

> In particular, Petitioners presented evidence that some of the investment materials projected that the partnerships could be profitable, and that the partners performed due diligence on the assets before acquiring them. Petitioners also presented evidence of efforts made to collect on the debts owned by the partnerships. And there is no dispute that the partnerships allocated distributions, profits, and losses to partners *pro rata*. The government also presented substantial evidence in support of its determination that the partnerships were shams, and we express no opinion on how this issue ultimately should be resolved on the merits. But the genuine factual dispute as to the partners' intent precludes summary judgment on the issue.

formation.[590] On the other hand, if a partnership return is filed for a tenant-in-common arrangement, a co-owner who objects to partnership treatment must file Form 8282 asserting that the Schedule K-1 is erroneous and that the co-owner is adopting a position inconsistent with it; failure to do so precludes the taxpayer from challenging partnership treatment.[591]

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[590] *Peking Investment Fund LLC v. Commissioner*, Tax Court Docker No. 12772-09 Order 2/13/2018, regarding a distressed asset/debt ("DAD") transaction:

> Respondent has moved for partial summary adjudication in his favor that his FPAA properly disallowed a loss of $26,903,619 that PIF claimed for its taxable year ended December 31, 2001, as a result of its exchange of an interest in one portfolio of nonperforming loans (NPLs) for another. Specifically, PIF transferred an interest in a portfolio of NPLs originated by China Construction Bank (the CCB NPL portfolio) that it had received as a contribution from China Cinda Asset Management Corporation (Cinda). In exchange, PIF received interests in portfolios of NPLs originated by Korean Development Bank (the KDB NPL portfolios)….
>
> To determine whether respondent has submitted sufficient evidence to establish that, as a matter of law, PIF should be disregarded as a sham, we must first identify the relevant legal standard. The prior cases that have disregarded DAD partnerships as shams applied the Culbertson test. See *Southgate Master Fund, LLC v. United States*, 659 F.3d 466, 485 (5th Cir. 2011); *Kenna Trading, LLC v. Commissioner*, 143 T.C. 322, 351 (2014); *Superior Trading, LLC v. Commissioner*, 137 T.C. at 81; *Russian Recovery Fund Ltd. v. United States*, 122 Fed. Cl. At 615. And, as noted above, the parties before us appear to agree that *Culbertson* provides the governing test. Therefore, for purposes of the present motion, we will treat *Culbertson* test as the legal standard governing the recognition of a partnership for Federal income tax purposes. But see *AD Inv. 2000 Fund, LLC v. Commissioner*, T.C. Memo. 2015-223, at *25 (observing that Culbertson predated entity classification regulations adopted in 1997 that "may place the question of whether there is a tax-recognized entity ahead of the classification of the entity as a partnership or corporation for tax purposes"), vacated and superseded on reconsideration, T.C. Memo. 2016-226….
>
> The mere fact that the generation of tax losses was one of the purposes of a partnership's formation would not justify disregarding the partnership as a sham under the Culbertson test. That test requires us to ask "whether, considering all the facts … the parties in good faith and acting with a business purpose intended to join together in the present conduct of … [a business] enterprise." *Commissioner v. Culbertson*, 337 U.S. at 742. Even if the generation of tax losses is the primary purpose for a partnership's formation, the partnership may also have as a secondary purpose the conduct of a business enterprise. To prevail in disregarding a DAD partnership as a sham under *Culbertson*, the Commissioner must establish that carrying out a business of collecting NPLs was so minimal a factor in the decision to form the partnership that it can be dismissed. In prior cases in which this Court and others have disregarded DAD partnerships as shams, the evidence showed that the partners ultimately had no real interest in collecting the NPLs. See, *e.g.*, *Superior Trading, LLC v. Commissioner*, 728 F.3d at 680 (noting that partnership's "purportedly active partner" made only "a few, feeble attempts" at collection and dismissing those efforts as "window dressing" because the partnership had not taken measures necessary under Brazilian law to pursue collection); *Southgate*, 659 F.3d at 485 (reasoning that partners' decision to abandon efforts to improve collection by servicer "manifests an unmistakable intent to forego the joint conduct of a profit-seeking venture"); *Kenna Trading, LLC v. Commissioner*, 143 T.C. at 353 (finding ambiguities in the record regarding the identity of the partners and their proportionate interests and observing that "[p]arties genuinely embarking on a joint business endeavor … would not accept such ambiguity"). But if the facts show an objective of profiting from collection, even though that objective may be outweighed by investors' objective of realizing the benefit of substantial tax losses, the partnership should not be disregarded as a sham under *Culbertson*.
>
> … the parties' interest in or indifference to collections on PIF's NPL portfolio is a contested question of fact to be resolved at trial.

[591] *Gluck v. Commissioner*, T.C. Memo. 2020-66, *aff'd* 129 A.F.T.R.2d 2022-1103 (2nd Cir. 3/17/2022).

The most commonly cited factors in federal tax case law, none of which is conclusive, are:[592]

- [t]he agreement of the parties and their conduct in executing its terms;
- the contributions, if any, which each party has made to the venture;[593]
- the parties' control over income and capital and the right of each to make withdrawals;[594]
- whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses,[595] or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income;
- whether business was conducted in the joint names of the parties;
- whether the parties filed Federal partnership returns or otherwise represented to [the IRS] or to persons with whom they dealt that they were joint venturers;
- whether separate books of account were maintained for the venture; and
- whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

Furthermore:[596]

> [T]he parties, to form a valid tax partnership, must have two separate intents: (1) the intent to act in good faith for some genuine business purpose and (2) the intent to be partners, demonstrated by an intent to share "the profits and losses." If the parties lack either intent, then no valid tax partnership has been formed. To determine whether the parties had these intents, a court must consider "all the relevant facts and circumstances," including (a) "the agreement," (b) "the conduct of the parties in execution of its provisions," (c) the parties' statements, (d) "the testimony of disinterested persons," (e) "the relationship of the parties," (f) the parties' "respective abilities and

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[592] *Luna v. Commissioner*, 42 T.C. 1067, 1077-78 (1964).
[593] See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.
[594] This factor is not, by itself, sufficient to prove the existence of a partnership. *Azimzadeh v. Commissioner*, T.C. Memo. 2013-169.
[595] Later cases held that, if a purported partner lacks any meaningful downside or upside potential, that person is not a partner. *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425 (3rd Cir. 2012), *cert. den.* 2013 WL 249846 (5/28/2013); *Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, 107 AFTR.2d 2011-1523 (4th Cir. 2011). On the other hand, a mere interest in future capital appreciation might suffice. See CCA 201326018, discussed in Banoff's and. Lipton's Shop Talk column, "General Partners Who Only Share in Capital Appreciation," *Journal of Taxation* (8/2013) (in-depth discussion of the issue of treating as a partner someone with no interest in the current year's operating profits) and their follow-up, "General Partners Who Only Share in Future Years' Profits: TEFRA and Beyond," *Journal of Tax*ation (5/2014).
[596] *Chemtech Royalty Associates, L.P. v. U.S.*, 114 A.F.T.R.2d 2014-5940 (5th Cir 2014), quoting *Southgate Master Fund, L.L.C. ex rel. Montgomery Capital Advisors, LLC v. United States*, 659 F.3d 466, 488 (5th Cir. 2011).

> capital contributions," (g) "the actual control of income and the purposes for which it is used," and (h) "any other facts throwing light on their true intent."

Although this case dealt with an insurance agent, it has been cited in many other situations, including CCA 201323015 (joint venture between two corporations constituted a partnership because of their "sharing in the net profits and losses from the manufacture, development, and marketing of" [a particular undisclosed product]), *Holdner v. Commissioner*, T.C. Memo. 2010-175 (presumption of partners holding equal interests), *aff'd* 110 A.F.T.R.2d 2012-6324 (9th Cir. unpublished summary opinion), and *6611, Ltd., Ricardo Garcia, Tax Matters Partner, v. Commissioner*, T.C. Memo. 2013-49 (disregarding a partnership for purposes of applying IRS partnership audit procedures). In the context of whether an arrangement to provide services that awards equity-type incentives might constitute a partnership, see part III.B.7.c.viii Creative Bonus Arrangements.

Rev. Rul. 70-435 described a situation and ruled:

> The taxpayer, a theatrical performer, enters into an agreement with a producer whereby the taxpayer and the producer agree to share the profits and losses from the production of a play. Under the agreement the producer is to furnish the cash necessary to produce the play and will assume the usual duties and obligations of a producer. The taxpayer will play the leading role in the production and will also direct the play. In addition, the taxpayer is responsible for supervising various aspects of the production itself, including the hiring of other performers and the designing of scenery. The agreement further provides that no more than 25 percent of the taxpayer's share of the net profits from the play are to be paid to him annually during the run of the play. The net profits accumulated for the taxpayer are to be paid him in equal amounts annually for a period of four years commencing with the closing of the play. Provision is also made for the actor to obtain periodic financial statements as to the income and expenditures relating to the production of the play.
>
> In this case the individual performer and the producer are each acting in his own right; the proposed production of the play is a joint venture considered a partnership under section 761(a) of the Code and the taxpayer is neither an employee nor an independent contractor as to the producer. This joint venture is required to file a return for each taxable year under section 6031 of the Code, computing the taxable income of the partnership under section 703 and the regulations thereunder. Pursuant to sections 702 and 706 of the Code and the regulations thereunder, each partner is required, in determining his own income tax to take into account his distributive share (whether or not distributed) of each class or item of partnership income, gain, loss, deduction or credit, determined under the provisions of the partnership agreement pursuant to section 704, for each partnership year ending within or with his own taxable year. The effect of this is that the performer taxpayer's distributive share of the net profits from the play is includible in his taxable income in his first taxable year ending with or after the first taxable year of the partnership, although the joint venture retains physical possession thereof by virtue of the arrangement with the taxpayer who, in substance, has thus authorized it to take possession and hold such net profits for him for distribution at a later time. Thereafter, the taxpayer's proportionate share of the net profits for each taxable year of the joint venture is includible in his gross income for each taxable year of his which ends with or after the taxable year of the joint venture.

Note that, by getting paid in later years for current services, the service partner in Rev. Rul. 70-435 did not have deferred compensation; rather the service partner had a capital account to be paid later.[597] This paves the way for providing golden handcuffs without the complexity of deferred compensation.[598]

LAFA 20161101F asserted that in an investor in a coal production partnership was not entitled to the related credits because the capital contributions were based on future production and were nonrecourse and any chance of profit other than through tax credits was small.

The Tax Court has "consistently disregarded entities that attempt to generate artificial losses by exploiting the partnership tax rules."[599] When a partnership is disregarded for tax purposes, partnership income rules no longer apply, and one or more of the purported partners will be deemed to have engaged in the partnership's activities.[600]

If preferred payments are relatively fixed and certain, the following facts need to be considered:[601]

- whether the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits and losses or both

- whether the preferred partner was a bona fide partner because the payments it expected to receive were essentially fixed and relatively secure[602]

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597 See part II.Q.1.d Nonqualified Deferred Compensation.

598 See part II.M.4.f.i Overview of Profits Interest; Contrast with Code § 409A.

599 *New Millennium Trading, LLC v. Commissioner*, T.C. Memo. 2017-9, supporting this statement with: See *AD Inv. 2000 Fund, LLC v. Commissioner*, T.C. Memo. 2016-226; *436, Ltd. v. Commissioner*, T.C. Memo. 2015-28; *Markell Co. v. Commissioner*, T.C. Memo. 2014-86; *6611, Ltd. v. Commissioner*, T.C. Memo. 2013-49; *Palm Canyon X Invs., LLC v. Commissioner*, T.C. Memo. 2009-288; see also *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. 161 (2009) (disallowing the losses because the "transaction lacked economic substance"), *aff'd*, 408 F.App'x 908 (6th Cir. 2010); *Humboldt Shelby Holding Corp. v. Commissioner*, T.C. Memo. 2014-47 (similar), *aff'd* per summary order, 606 F.App'x 20 (2d Cir. 2015). Each scheme involved an entity (partnership or LLC) whose sole purpose was to provide its members with a high-basis membership interest to be disposed of at a loss; or, on its redemption, to put high-basis entity assets into the hands of the member, who would then dispose of them at a loss.

600 *New Millennium Trading, LLC v. Commissioner*, T.C. Memo. 2017-9, supporting this statement with: See, *e.g.*, *6611, Ltd. v. Commissioner*, T.C. Memo. 2013-49. A disregarded partnership has no identity separate from its owners, and we treat is as an agent or nominee. See *Tigers Eye Trading v. Commissioner*, 138 T.C. at 94, 99. Pursuant to section 6233(a) and (b), TEFRA procedures still apply to the entity, its items, and persons holding an interest in the entity as long as the purported partnership filed a return, which NMT did for tax year 1999. See sec. 6233(b); sec. 301.6233-1987). Thus, we have jurisdiction to determine any items that would have been "partnership items", as defined in section 6231(a)(3), and section 301.6231(a)(3)-1, Proced. & Admin. Regs., had NMT been a valid partnership for tax purposes. See *Tigers Eye Trading v. Commissioner*, 138 T.C. at 97.

601 *Principal Life Ins. Co. & Subs v. U.S.*, 120 Fed. Cl. 41 (Ct. Fed. Cl. 2/4/2015).

602 The court also held:

> Even if a partnership exists, "consideration whether an interest has the prevailing character of debt or equity can be helpful in analyzing whether, for tax purposes, the interest should be deemed a bona fide equity participation in a partnership." [citations omitted] A party will not be considered a bona fide partner in a partnership if its interest is more akin to a debt-like interest,

- whether the existence of a preferred equity interest in a partnership, providing a relatively secure return, is sufficient to treat the holder of the interest as other than a partner

When one person contributes capital, another contributes management skill, and the person contributing management skill takes reduced compensation and a 20% share of the sale proceeds after the moneyed partner receives a nice preferred return, the person contributing management skill is a partner who can treat the receipt of 20% of the sale proceeds as capital gain.[603]

In light of uncertainty, generally co-owners may elect not to be treated as a partnership in either of two circumstances:[604]

(2) *Investing partnership*. Where the participants in the joint purchase, retention, sale, or exchange of investment property –

(i) Own the property as coowners,[605]

(ii) Reserve the right separately to take or dispose of their shares of any property acquired or retained, and

(iii) Do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year, …. [or]

> with little or no risk aside from credit risk, than to an equity participation, a share of ownership in which the party takes on true entrepreneurial risk in the partnership venture. [citations omitted] In the court's view, significant questions of fact remain as to how the interests in question should be treated in this regard, precluding a ruling on summary judgment….

[603] *U.S. v. Stewart*, 116 A.F.T.R.2d 2015-5720 (S.D. Tex. 8/20/2015), relying on *Haley v. Commissioner*, 203 F.2d 815, 818 (5th Cir. 1953). *Stewart* did not cite *Luna* or any of the traditional cases defining what a partnership is.

[604] Reg. § 1.761-2(a)(2), (3). CCA 201323015 asserted that a joint venture between two corporations could not make this election. It was not an investment partnership under Reg. § 1.761-2(a)(2) for either one of two reasons:

- The product produced did not qualify as "investment property" (looking to the Code § 148(b)(2) definition of "investment property" the Reg. § 1.148-1(e) definition of "investment-type property").
- It actively conducted the business of producing and selling the product.

The joint venture failed the requirements of Reg. § 1.761-2(a)(3) because the two corporations jointly sold the product.

[605] [my footnote – not found in the regulations that are quoted above:] The IRS has asserted that "coowners" means direct co-ownership and not ownership through a commonly owned LLC. FSA 200216005. Rev. Rul. 2004-86 confirmed that position, addressing what happens if a Delaware Statutory Trust does not qualify as a unit investment trust:

> In addition, because the assets of DST will not be owned by the beneficiaries as coowners under state law, DST will not be able to elect to be excluded from the application of subchapter K. See § 1.761-2(a)(2)(i).

Rev. Rul. 2004-86 is discussed in part II.D.4.a.i Classifying an Investment Trust in the text accompanying and following fn 655.

(3) *Operating agreements*. Where the participants in the joint production, extraction, or use of property—

(i) Own the property as coowners, either in fee or under lease or other form of contract granting exclusive operating rights, and

(ii) Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used, and

(iii) Do not jointly sell services or the property produced or extracted, although each separate participant may delegate authority to sell his share of the property produced or extracted for the time being for his account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than 1 year....

This election-out of partnership treatment applies only for the purposes of the partnership income tax rules of subchapter K.[606]

A group of owners of undivided interests in rental real property[607] might seek a private letter ruling that their ownership does not rise to the level of being a partnership. To do so, they must satisfy the following conditions:[608]

> Each of the co-owners must hold title to the Property (either directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the Property as a whole may not be held by an entity recognized under local law.

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[606] In *Methvin v. Commissioner*, T.C. Memo. 2015-81, *aff'd* 653 Fed. Appx. 616 (10th Cir. 6/24/2016), the Tax Court held:

> Petitioner also argues that in article 14 of the operating agreement the parties specifically elected to be excluded from the application of subchapter K and therefore cannot be considered a partnership. We have held that making this election "'does not operate to change the nature of the entity. A partnership remains a partnership; the exclusion simply prevents the application of subchapter K. The partnership remains intact and other sections of the Code are applicable as if no exclusion existed.'" *Cokes v. Commissioner*, 91 T.C. at 230-231 (quoting *Bryant v. Commissioner*, 46 T.C. 848, 864 (1966), *aff'd*, 399 F.2d 800 (5th Cir. 1968)). Accordingly, the parties' election under section 761(a) does not prevent us from finding that the operating agreements created a partnership.
>
> We conclude that the working interest owners and well operator created a pool or joint venture for operation of the wells. Accordingly, petitioner's income from the working interests was income from a partnership of which he was a member under the broad definition of "partnership" found in section 7701(a)(2). See *Cokes v. Commissioner*, 91 T.C. at 232; *Bentex Oil Corp. v. Commissioner*, 20 T.C. 565 (1953). Therefore, petitioner is liable for self-employment tax on the net income received from his working interests.

[607] For an excellent discussion of taxation of tenants-in-common, as well as when such an arrangement is taxed as a partnership, see Tucker and Langlieb, fn. 1918. In Letter Ruling 200826005, two individuals held a number of properties together, and their tenancy-in-common agreements, which included buy-sell provisions, were held not to constitute a partnership. As natural products of the land that are attached to the land, commercial plants, that were mature, had complex root systems, and were expected to produce a commercially harvestable crop, constituted real estate under Code § 865. Letter Ruling 201424017.

[608] Rev. Proc. 2002-22, Section 6, as modified by Rev. Proc. 2003-3, Section 1.02(8), which deleted Sections 6.03 and 6.06 of Rev. Proc. 2002-22.

The number of co-owners must be limited to no more than 35 persons. For this purpose, “person” is defined as in § 7701(a)(1), except that a husband and wife are treated as a single person and all persons who acquire interests from a co-owner by inheritance are treated as a single person.

The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition (see section 6.06 of this revenue procedure for conditions relating to restrictions on alienation); or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the Property (see section 6.05 of this revenue procedure for conditions relating to voting).

The co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the Property, any leases of a portion or all of the Property, or the creation or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the Property. A co-owner who has consented to an action in conformance with this section 6.05 may provide the manager or other person a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a global power of attorney.

If the Property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.

Each co-owner must share in all revenues generated by the Property and all costs associated with the Property in proportion to the co-owner’s undivided interest in the Property. Neither the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days.

The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

A co-owner may issue an option to purchase the co-owner’s undivided interest (call option), provided that the exercise price for the call option reflects the fair market value of the Property determined as of the time the option is exercised. For this purpose, the fair market value of an undivided interest in the Property is equal to the co-owner’s percentage interest in the Property multiplied by the fair market value of the Property as a whole. A co-owner may not acquire an option to sell the co-owner’s undivided interest (put option) to the sponsor, the lessee, another co-owner, or the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender.

The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). See Rev. Rul. 75-374, 1975-2 C.B. 261. Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in § 511(a)(2) from qualifying as rent under § 512(b)(3)(A) and the regulations thereunder. In determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the Property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the Property will be taken into account in determining whether the co-owners' activities are customary activities. However, activities of a co-owner or a related person with respect to the Property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the Property for less than 6 months.

The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee. The management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the Property against any revenues before disbursing each co-owner's share of net revenues. In all events, however, the manager must disburse to the co-owners their shares of net revenues within 3 months from the date of receipt of those revenues. The management agreement may also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the Property. In addition, the management agreement may authorize the manager to obtain or modify insurance on the Property, and to negotiate modifications of the terms of any lease or any indebtedness encumbering the Property, subject to the approval of the co-owners. (See section 6.05 of this revenue procedure for conditions relating to the approval of lease and debt modifications.) The determination of any fees paid by the co-ownership to the manager must not depend in whole or in part on the income or profits derived by any person from the Property and may not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.

All leasing arrangements must be bona fide leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value for the use of the Property. The determination of the amount of the rent must not depend, in whole or in part, on the income or profits derived by any person from the Property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). See section 856(d)(2)(A) and the regulations thereunder. Thus, for example, the amount of rent paid by a lessee may not be based on a percentage of net income from the Property, cash flow, increases in equity, or similar arrangements.

The lender with respect to any debt that encumbers the Property or with respect to any debt incurred to acquire an undivided interest in the Property may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the Property.

Except as otherwise provided in this revenue procedure, the amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the Property.

A co-tenancy agreement satisfied these requirements, where the initial landlord owned 100% of the property through a disregarded LLC and had the right to sell fractional interests to the tenant (or the tenant's disregarded LLC) for fair market value, determined taking the initial appraised value and increasing it annually by a flat percentage that was a reasonable appreciation factor.[609]

See also part II.D.1 Trust as a Business Entity for whether pooling together ownership interests rises to the level of a business entity, when the owners used a trust to own real estate – especially for guidelines on whether a lease arrangement might separate ownership of the real estate from the activity done on the property.

Spouses who own and operate a business as co-owners and who materially participate[610] may elect to treat the business as a disregarded entity (a "qualified joint venture")[611] if it is not in the name of a limited partnership, limited liability company or other state law entity.[612] If both spouses make that election, then "all items of income, gain, loss, deduction, and credit shall be divided between the spouses in accordance with their respective interests in the venture, and each spouse shall take into account such spouse's respective share of such items as if they were attributable to a trade or business conducted by such spouse as a sole proprietor.[613] Thus, each reports his or her portion of business income on a separate Schedule C or E.[614] See also Married Couples in Business (irs.gov).

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[609] Letter Ruling 201622008.

[610] Code § 761(f)(2)(B) cross-references Code § 469(h) but eliminates the application of Code § 469(h)(5), the latter of which would let each spouse count the other's participation. For more on Code § 469(h), see part II.K.1.a Counting Work as Participation in Business under the Passive Loss Rules.

[611] Code §761(f)(2), effective tax years beginning after December 31, 2006.

[612] If one goes to www.irs.gov, searches "qualified joint venture," and follows the hyperlink entitled "Election for Husband and Wife Unincorporated Businesses," then one can find (at https://www.irs.gov/businesses/small-businesses-self-employed/election-for-husband-and-wife-unincorporated-businesses when I last searched) the IRS' view that a state law entity owned by a married couple cannot qualify for treatment as a qualified joint venture, which is consistent with a related position taken in fn 605. Similarly, an LLC owned by spouses does not qualify under special procedures for a favorable private letter ruling, which pre-date Code § 761(f) but remain in effect; see Section 6.01 of Rev. Proc. 2002-22 (which does, however, allow each spouse to have a single member LLC and have those LLCs own the properties as tenants in common). The IRS' view does not appear to be confirmed or refuted by the legislative history. *Argosy Technologies, LLC v. Commissioner*, T.C. Memo. 2018-35, subjected to penalties, for late filing of 2010 and 2011 returns, an LLC owned 100% by a married couple; the LLC protested, claiming it was a disregarded entity, but the court held that filing partnership returns admitted to partnership status and pointed out that there was no evidence of a Code § 761(f) election. The court did not reach the merits of whether a Code § 761(f) election could have been made.

[613] Code §761(f)(1), effective tax years beginning after December 31, 2006.

[614] Chief Counsel Advice 200816030 held that active rental that qualified as a Code § 761(f) trade or business did not generate self-employment income, reasoning that Code § 1402(17) is intended to allocate income one-half to each spouse rather than overriding various exceptions (including the rental exception) to self-employment tax. This CCA carries much more weight than most CCAs, as it was to the Asst. Division Counsel (Prefiling) (Small Business/Self-Employed) from the Branch Chief, Employment

A purported partnership shall be treated as a lease of property if the arrangement is properly treated as a lease of property, taking into account all relevant factors.[615]

For additional ways that co-owners might escape partnership income tax treatment, see part II.D.4 Disregarding Multiple Owner Trust for Income Tax Purposes.

When an LLC that is taxed as a partnership signed a revenue sharing agreement with a person, held him out as an owner, and treated him as a partner in tax filings, the person was taxed as a partner even though he never signed the LLC's operating agreement and even though the K-1 the LLC issued to him reported only guaranteed payments and no profits interest.[616]

Transitory ownership in a partnership with almost no rights does not make a person a partner:[617]

> In the present case, Organization, as an assignee of Partner, was not a full-fledged partner of Partnership. Partner's assignment of Units to Organization entitled Organization to distributions made with respect to Units while Partner retained all other indicia of ownership of Units. Organization was only an assignee of Partner for one day before the Organization transferred it rights in Units to Corporation in exchange for Note. Partner determined the selling price of Units. Organization's momentary rights to distribution (which are totally controlled by Partner) are not sufficient to make Organization a partner in Partnership. Organization had no meaningful right to participate in Partnership's success or failure and as such, was not in substance a partner of Partnership.

Tax Branch 1 (Exempt Organizations/Employment Tax/Government Entities) and recommended specific procedures for IRS Service Centers. See also "New Law Has Social Security Impact on Husband-Wife Partnerships," *Business Entities* (WG&L), Jan/Feb 2009.

[615] Code § 7701(e)(2).

[616] *Cahill v. Commissioner*, T.C. Memo. 2013-220. This case involved an insurance agent. The court pointed out:

> Petitioner entered into the memorandum of agreement and the revenue sharing agreement, both of which provided for the mechanism under which he would share in the profits of FC/CFC. Moreover, the memorandum of agreement and the revenue sharing agreement stated that FC/CFC would issue petitioner a Form 1099-MISC or a Schedule K-1 with respect to any money he received under either agreement. There is no indication in the record that petitioner objected to receiving a Schedule K-1 on the grounds that he was not a partner.

The court also pointed out that the parties held out the taxpayer as an owner and changed the LLC's name to include the taxpayer's.

[617] CCA 201507018, which also invoked Reg. § 1.701-2 to disregard a transitory interest as a partner in a partnership:

> In this case, Partner purportedly transferred Units in Partnership with a low basis and a high fair market value to Organization, for which Partner took a charitable deduction based on the fair market value of Units on Partner's personal tax return. Subsequently, Partner arranged for Organization to sell those Units to Corp for the Note. As a result of this second purported transfer, Corp takes a deduction for interest payments on Note and a goodwill amortization deduction as a result of Partnership's § 743(b) adjustment. In this way, Partner and Partner affiliates take three deductions for one charitable contribution that never in substance occurred. Transaction significantly reduced Partner and Corp's tax liability. The purported transfer of Units to Organization was necessary to achieve that claimed result. Organization, an assignee of Partner with respect to Units, only momentarily had rights to distributions and no other rights to Units.

II.C.11. General Partnership

In general partnerships, which are governed by the Uniform Partnership Act, all partners have management rights and are jointly and severally liable for the partnership's activities. For how to limit liability, see part II.C.13 Limited Liability Partnership Registration for General Partners in General or Limited Partnerships.

A general partnership can be formed by an express agreement or through an activity in which co-owners work together to try to earn a profit (even if a general partnership was not intended).

The Uniform Partnership Act of 1997 (last amended 2013) (the "Act")[618] § 202, "Formation of Partnership," provides:

(a) Except as otherwise provided in subsection (b), the association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership.

(b) An association formed under a statute other than this [act], a predecessor statute, or a comparable statute of another jurisdiction is not a partnership under this [act].

(c) In determining whether a partnership is formed, the following rules apply:

(1) Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not by itself establish a partnership, even if the co-owners share profits made by the use of the property.[619]

(2) The sharing of gross returns does not by itself establish a partnership, even if the persons sharing them have a joint or common right or interest in property from which the returns are derived.

(3) A person who receives a share of the profits of a business is presumed to be a partner in the business, unless the profits were received in payment:

(A) of a debt by installments or otherwise;

(B) for services as an independent contractor or of wages or other compensation to an employee;

(C) of rent;

(D) of an annuity or other retirement or health benefit to a deceased or retired partner or a beneficiary, representative, or designee of a deceased or retired partner;

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618 The Word version is found at https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=39673426-f648-cbfe-c3a8-c30a13044e63&forceDialog=1. The Uniform Law Commission's web page for the Act is Partnership Act - Uniform Law Commission (uniformlaws.org).

619 [my footnote:] Regarding references below to types of joint ownership, see part II.F.7 Tenancy by the Entirety.

(E) of interest or other charge on a loan, even if the amount of payment varies with the profits of the business, including a direct or indirect present or future ownership of the collateral, or rights to income, proceeds, or increase in value derived from the collateral; or

(F) for the sale of the goodwill of a business or other property by installments or otherwise.

The official Comment elaborates:[620]

> UPA (1997) § 202 combined UPA (1914) §§ 6 and 7, recasting the "definition" of a partnership in UPA (1914) § 6(1) "as an operative rule of law – i.e., "[a] partnership is an association of two or more persons . …" became "the association of two or more persons… forms." The change was stylistic and made no substantive change in the law. The Harmonization Project made no substantive change to this section, except to clarify that this act is not linked to the uniform limited partnership act. See Subsection (b), cmt.
>
> The addition of the phrase, "whether or not the persons intend to form a partnership," merely codifies the universal judicial construction of UPA (1914) § 6(1) that a partnership is created by the association of persons whose intent is to carry on as co-owners a business for profit, regardless of their subjective intention to be "partners." Indeed, they may inadvertently create a partnership despite their expressed subjective intention not to do so. The language of Section 202 alerts readers to this possibility.
>
> **Subsection (a) -** Consistent with the common law and UPA (1914), under this act "coownership" is a key concept. Ownership involves the power of ultimate control (albeit a power that can be substantially diminished by agreement) and a right to share in the profits of the co-owned business. To state that partners are co-owners of a business is to state that: (i) they share in the profits (if any) of the enterprise; and (ii) ab initio at least, they collectively have the power of ultimate control. Consequently:
>
> - mere passive co-ownership of property, as distinguished from using the property to carry on a business, does not establish a partnership, Subsection (c)(1); and
>
> - merely sharing gross revenues is likewise insufficient, Subsection (c)(2).
>
> UPA (1997) added, "whether or not the persons intend to form a partnership" to the UPA (1914) formulation, thereby codifying a rule uniformly applied by courts: Subjective intent to create the legal relationship of "partnership" is irrelevant. What matters is the intent vel non to establish the business relationship that the law labels a "partnership." Thus, a disclaimer of partnership status is ineffective to the extent the parties' intended arrangements meet the criteria stated in this subsection.
>
> **Subsection (b) -** This subsection continues the UPA (1914) concept that the general partnership is the residual form of business association. Accordingly, partnership-like

620 https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=9e30c4d7-dbed-c173-dfc1-26394e60152d&forceDialog=1.

organizations formed under specially applicable statutes are not within this act. *E.g.*, MONT. CODE ANN. §§ 35-13-101 to 102 (pertaining to mining partnerships).

An arrangement labeled a "joint venture" is a partnership if the arrangement meets the criteria stated in Subsection (a). In fact, in many jurisdictions, the law of general partnerships applies almost without analysis to joint ventures in which the co-venturers share profits. *See Jonathan Woodner Co. v. Laufer*, 531 A.2d 280, 285 n.7 (D.C. 1987) (stating that: (i) "[s]trictly speaking, a joint venture is not the same as a partnership, but there is 'very little law ... applicable to one that does not apply to the other'"; (ii) "the rights and liabilities of joint venturers among themselves are generally governed by the laws of partnership"; and (iii) "[p]rinciples of partnership law, in particular the Uniform Partnership act, apply in most instances to joint ventures") (quoting 46 AM. JUR. 2D JOINT VENTURES § 4, at 25 (1969) and collecting cases).

A limited partnership is not a partnership under this act; a limited partnership is "formed under a statute other than this [act]" (i.e., ULPA (2001) (Last Amended 2013) § 201). Moreover, ULPA (2001) delinked the uniform limited partnership act from the uniform general partnership act. *See* ULPA (2001) (Last Amended 2013) Prefatory Note, *The Decision to "De-Link" and Create a Stand Alone Act*.

An unincorporated nonprofit organization is not a partnership under this act, because the organization is limited to "nonprofit purposes" and therefore cannot "carry on a business" in the traditional sense of that concept. See UUNA (2008) (Last Amended 2013) § 102(11) (defining "unincorporated nonprofit association").

Subsection (c) - UPA (1997) derived this subsection from UPA (1914) § 7 and with one exception, made no substantive change to the law. The substantive change pertains to the sharing of profits, which UPA (1997) recast as creating a rebuttable presumption of partnership rather merely constituting prima facie evidence. "Prima facie" means that the party with the burden of proof has adduced sufficient evidence to carry that burden, subject to the finder of fact's view of any contrary evidence. The burden of persuasion is unchanged. In contrast, "rebuttable presumption" switches the burden of persuasion.

Subsection (c)(3) - The protected categories listed in this paragraph apply regardless of whether the profit share is a single, unvarying percentage or a ratio that varies; for example, after reaching a dollar floor or different levels of profits. Like UPA (1914), this act makes no attempt to answer in every case whether a partnership is formed. Whether a relationship is more properly characterized as that of borrower and lender, employer and employee, or landlord and tenant is left to the trier of fact. As under UPA (1914), a person may function in both partner and non-partner capacities.

Subsection (c)(3)(E) - UPA (1997) added this protected category, excepting from the rebuttable presumption a share of the profits received in payment of interest or other charges on a loan, "including a direct or indirect present or future ownership in the collateral, or rights to income, proceeds, or increase in value derived from the collateral." The quoted language was taken from Section 211 of the Uniform Land Security Interest Act and is intended to protect shared-appreciation mortgages, contingent or other variable or performance-related mortgages, and other equity participation arrangements by clarifying that contingent payments do not presumptively convert lending arrangements into partnerships.

Note some consequences to a tenancy in common being characterized as a partnership:

- Joint and several liability for all of the partnership's debts, obligations, and other liabilities, subject to various exceptions.[621]

- The right to withdraw at will,[622] even in contravention to any agreement of the parties,[623] either giving the owner the right to cash out for the greater of the liquidation value or the value based on a sale of the entire business as a going concern without the person[624] or causing the partnership to dissolve[625] and wind up its business.[626] The right to cash out might be especially troubling for the other owners. Also, federal case law has established that an interest as a tenant in common is worth less (15%-20% tends to be a common valuation adjustment, but much higher adjustments may be appropriate when property is not easily partitioned) than a percentage of the property's value as a whole, this right to cash out might reduce that valuation adjustment. In the federal tax lien area, courts tend to view this valuation adjustment as ground for forcing the sale of the underlying property, because selling the tenant-in-common interest would prejudice the government's interest in collecting what is due.[627]

Given that partnership property is subjected to buy-sell provisions, whether property is partnership property can determine rights when co-owners are separating. With that in mind, consider that Act § 204, "When Property Is Partnership Property," provides:

> (a) Property is partnership property if acquired in the name of:
>
> > (1) the partnership; or
> >
> > (2) one or more partners with an indication in the instrument transferring title to the property of the person's capacity as a partner or of the existence of a partnership but without an indication of the name of the partnership.
>
> (b) Property is acquired in the name of the partnership by a transfer to:
>
> > (1) the partnership in its name; or
> >
> > (2) one or more partners in their capacity as partners in the partnership, if the name of the partnership is indicated in the instrument transferring title to the property.
>
> (c) Property is presumed to be partnership property if purchased with partnership assets, even if not acquired in the name of the partnership or of one or more partners with an indication in the instrument transferring title to the property of the person's capacity as a partner or of the existence of a partnership.

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621 Act § 306.
622 Act §§ 601(1), 602(a).
623 Act § 110(c)(9).
624 Act § 701.
625 Act § 801.
626 Act § 802.
627 See *U.S. v. Adent*, cited in fn. 7197, found in part III.B.5.e.iv.(i) Effect of Liens on Dealings with Third Parties.

(d) Property acquired in the name of one or more of the partners, without an indication in the instrument transferring title to the property of the person's capacity as a partner or of the existence of a partnership and without use of partnership assets, is presumed to be separate property, even if used for partnership purposes.

The official Comment elaborates:[628]

> Section 204 states the rules inter se the partners and partnership for determining when property is acquired by the partnership and so becomes partnership property. These rules apply to "all property, whether real, personal, or mixed or tangible or intangible, or any right or interest therein." Section 102(16) (defining "property").
>
> These rules provide three separate approaches - according to:
>
> - the name or names used in acquiring the property;
> - when a partner's name appears as a transferee, the capacity in which the partner is acting; and
> - for property acquired by purchase, whether the partnership provided the consideration for the property.
>
> These approaches are complementary, not mutually exclusive.
>
> This section omits any provision corresponding to UPA (1914) § 8(4), which states: "A conveyance to a partnership in the partnership name, even without words of inheritance, passes the entire estate of the grantor unless a contrary intent appears." UPA (1997) omitted the provision as unnecessary because under modern conveyancing law all transfers pass the entire estate or interest of the grantor unless a contrary intent appears.
>
> To what extent this section's *inter se* rules affect third party rights is a matter for other law, but in any event these rules yield automatically to statutes providing record title for particular types of property. For an example, see Subsection (c), comment.
>
> **Subsection (a) and (b) -** These subsections act in combination to provide the first two of the approaches listed above. Under these subsections, property becomes partnership property if acquired:
>
> - in the name of the partnership; or
> - in the name of one or more of the partners with an indication in the instrument transferring title of either:
>   - their capacity as partners; or

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628 https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=9e30c4d7-dbed-c173-dfc1-26394e60152d&forceDialog=1.

- of the existence of a partnership, even if the name of the partnership is not indicated.

Property acquired "in the name of the partnership" includes property acquired in the name of one or more partners in their capacity as partners, but only if the name of the partnership is indicated in the instrument transferring title.

Property transferred to a partner is partnership property, even though the name of the partnership is not indicated, if the instrument transferring title indicates either: (i) the partner's capacity as a partner; or (ii) the existence of a partnership. This approach is consonant with the entity theory of partnership and resolves the troublesome issue of a conveyance to fewer than all the partners but that nevertheless indicates their partner status.

Subsections (c) and (d) - At least *inter se* the partners and partnership, it is the intention of the partners that controls whether property belongs to the partnership or to one or more of the partners in their individual capacities. These subsections each contain a rebuttable presumption as to the partners' intent.

When applicable, the presumptions switch the burden of persuasion but are subject to an important limitation in favor of third parties. See Section 302(a)(3) ("Partnership property held in the name of one or more persons other than the partnership, without an indication in the instrument transferring the property to them of their capacity as partners or of the existence of a partnership, may be transferred by an instrument of transfer executed signed by the persons in whose name the property is held.").

Subsection (c) - Under this subsection, property purchased with partnership property is presumed to be partnership property, notwithstanding the name in which title is held or any other indicia. In this context, a promise made by a partnership in exchange for property triggers the presumption, including a promise to perform services or to guarantee another person's obligation with regard to the purchase of the property.

The presumption is entirely ineffective against third parties with regard to property with record title.

EXAMPLE: Using partnership funds, a partner purchases realty in the partner's own name and records the purchase in the appropriate land records. The partner later transfers title to the realty to a third party that has neither knowledge nor notice of any rights the partnership may have in the property. The relevant real estate statute is the applicable law; this subsection is entirely inapposite.

Subsection (d) - Under this subsection, property acquired in the name of one or more of the partners, without an indication of their capacity as partners and without use of partnership funds or credit, is presumed to be the partners' separate property, even if used for partnership purposes. In effect, this subsection presumes that only the use of the property is contributed to the partnership.

II.C.12. Limited Partnership

A limited partnership is formed by filing a Certificate of Limited Partnership with the secretary of state for the state in which the partnership is formed. The Uniform Limited Partnership Act limits the rights and liability of limited partners and vests control in the general partners. The rights and liabilities of the general partners among themselves, including joint and several liability for the limited partnership's activities, are governed by the Uniform Partnership Act; see part II.C.13 Limited Liability Partnership Registration for General Partners in General or Limited Partnerships.

A limited partnership needs to have at least one general partner (GP) and one limited partner, and the same person cannot be both the sole general partner and the sole limited partner. However, for example, the GP could be an individual, and the limited partner could be that individual's revocable trust. Such a limited partnership would be disregarded for income tax purposes unless it elects to be treated as a corporation. The GP being an individual simplifies the signature line and also causes the GP's liability to be extinguished with respect to any creditor that does not file a claim in probate court within the prescribed time period (one year or less under most nonclaim statutes) after the GP's death.

II.C.13. Limited Liability Partnership Registration for General Partners in General or Limited Partnerships

In recent years, the Uniform Partnership Act has added an optional feature to limit the liability of general partners of general or limited partnerships. This feature allows the general partners to limit their liability by registering the entity as a limited liability partnership (LLP) with the secretary of state.

A limited partnership with an LLP registration is known as a limited liability limited partnership (LLLP).

However, in Missouri, LLP (or LLLP) registration often is not quite as easy as LLC registration, and it cannot be retroactively reinstated if not renewed timely.

II.C.14. Penalty for Failure to File a Partnership Return

Failure to file a partnership return is subjected to a penalty of $125 times the number of partners or shareholders for each month (or fraction of a month) that the failure continues, up to a maximum of 12 months.[629]

However, this penalty does not apply if ten or fewer owners are involved and each owner fully reports that owner's share of the income, deductions, and credits of the partnership;[630] this rule is based on the version of Code § 6231 that will not apply to returns filed for partnership taxable

[629] Code § 6698(b)(1). The penalty is $89 instead of $125 for taxable years beginning before January 1, 2010. Program Manager Technical Advice (PMTA) 2013-015 provides advice on the application of failure to file penalties to S corporations and partnerships.
[630] Rev. Proc. 84-35.

years beginning after December 31, 2017[631] but was reaffirmed by Program Manager Technical Advice 2020-1 (11/19/2019).[632] CCA 201733013 emphasizes limitations to this rule:

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[631] For changes to partnership audit rules, see part II.G.19.c Audits of Partnership. The PMTA reasoned:

> A partnership that fails to timely file a partnership return as required by section 6031(a) is subject to a penalty under section 6698, unless the failure to comply with section 6031(a) is due to reasonable cause. I.R.C. § 6698.
>
> Congress enacted section 6698 in 1978 as part of Pub. L. No. 95-600, 92 Stat. 2763. In legislative history, Congress indicated that it intended for the reasonable cause exception to the section 6698 penalty to apply automatically to small partnerships that meet certain criteria. The Conference Committee Report stated:
>
> > The penalty will not be imposed if the partnership can show reasonable cause for failure to file a complete or timely return. Smaller partnerships (those with 10 or fewer partners) will not be subject to the penalty under this reasonable cause test so long as each partner fully reports his share of the income, deductions and credits of the partnership.
>
> H.R. Rep. No. 95-1800, at 221 (1978) (Conf. Rep.).
>
> Revenue Procedure 81-11 set forth procedures, consistent with the legislative history, under which partnerships with ten or fewer partners would not be subject to the section 6698 penalty for failure to file a partnership return.
>
> Shortly after the issuance of Revenue Procedure 81-11, Congress enacted a definition of small partnership as part of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, Pub. L. 97-248. Section 6231(a)(1)(B), as enacted in TEFRA, provided that the term "partnership," for purposes of sections 6221 through 6232, did not include a partnership if the partnership had 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and each partner's share of each partnership item is the same as such partner's share of every other item. A husband and wife, and their estates, were treated as one partner in determining whether the partnership had 10 or fewer partners for purposes of section 6231(a)(1)(B). TEFRA did not amend section 6698 or redefine the scope of the penalty for failure to file a partnership return.
>
> To conform the relief provided in Revenue Procedure 81-11 to the definition of small partnership newly provided by section 6231(a)(1)(B), the IRS issued Revenue Procedure 84-35 to modify and supersede Revenue Procedure 81-11. Revenue Procedure 84-35 cited the definition of small partnership provided by section 6231(a)(1)(B). In order to qualify for the relief provided in Revenue Procedure 84-35, the partnership must come "within the exceptions outlined in section 6231(a)(1)(B) of the Code." See Rev. Proc. 84-35, § 3.01. In citing section 6231(a)(1)(B), Revenue Procedure 84-35 was referencing law that existed at the time the revenue procedure was issued. The IRS did not express an intent that later amendments to TEFRA audit procedures would affect application of the exception to the partnership failure to file penalty.
>
> Section 6231(a)(1)(B) was repealed by the Bipartisan Budget Act of 2015, Pub. L. No. 114-74, 129 Stat. 584 (BBA). The BBA rules, including the repeal of section 6231(a)(1)(B), are generally applicable to partnerships with taxable years beginning after December 31, 2017. The BBA provisions automatically apply to a partnership unless the partnership files a partnership return electing out of the BBA regime. See I.R.C. §§ 6221(b), 6241(1); Treas. Reg. § 301.6221(b)-1. Thus, the BBA rules are applicable to such partnerships for which the relief provided in Revenue Procedure 84-35 would be relevant.
>
> A question was raised concerning how to interpret Revenue Procedure 84-35 now that section 6231(a)(1)(B) has been repealed and will be inapplicable to any partnership for which the relief provided in Revenue Procedure 84-35 is relevant. Significantly, the reference in Revenue Procedure 84-35 to IRC section 6231(a)(1)(B) is a reference to IRC section 6231(a)(1)(B) as it was in effect when Revenue Procedure 84-35 was originally issued. Thus, it is irrelevant that there does not exist any current section 6231(a)(1)(B) that is generally effective and applicable to partnerships seeking relief under Revenue Procedure 84-35. Moreover, the legislative history of section 6698, which is the basis for the relief provided in Revenue Procedure 84-35, is still

Accordingly, we conclude that Rev. Proc. 84-35 does not provide an automatic exemption to partnerships from the requirement of filing a Form 1065. Neither I.R.C. § 6031 nor I.R.C. § 6698 contain an exception to the general filing requirement set forth in I.R.C. § 6031(a). Although the I.R.C. § 6698 penalty may be avoided if it is shown that the failure to file a complete or timely return was due to reasonable cause, such relief may be granted under Rev. Proc. 84-35 if the partnership meets its requirements and examiners follow the procedures set forth in IRM 20.1.2.3.3.1.

The most recent Internal Revenue Manual rule, 20.1.2.4.3.1 (03-09-2022), Revenue Procedure 84−35, 20.1.2 Failure To File/Failure To Pay Penalties | Internal Revenue Service (irs.gov), includes [gaps indicated by ellipses were redacted on the IRS website]:

(1) IRC 6231(a)(1)(B) exempts certain small partnerships from the unified audit procedures contained in subchapter C of chapter 63 of the IRC. However, an exemption from the unified audit procedures is not an exemption from the requirement to file a timely and complete partnership return.

(2) Rev. Proc. 84−35 provides reasonable cause for filing a late or incomplete return will be presumed for certain small partnerships if certain criteria are met:

a. The partnership must consist of 10 or fewer partners. For the purpose of this requirement, a husband and wife (or their estate) filing a joint return is considered one partner.

b. Each partner is either an individual (excluding nonresident aliens), or the estate of a deceased partner.

c. Each partner's items of income, deductions, and credits are allocated in the same proportion as all other items of income, deductions, and credits.

d. Each partner reported the partner's share of partnership income on the partner's timely filed income tax return….

(6) When abating the penalty under the provisions of Rev. Proc. 84-35, advise the taxpayer the penalty **will be reassessed** if it is later determined any of the criteria outlined in Rev. Proc. 84-35 have not been met: Specifically, if it is found any partner was not a qualifying partner; or, if any partner filed late; or, if any partner failed to

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relevant, and the scope of the section 6698 penalty for failure to file a partnership return has not been affected by the repeal of the TEFRA provisions. Thus, Revenue Procedure 84-35 is not obsolete and continues to apply.

Revenue Procedure 84-35 provides that in order to qualify for the relief provided in the revenue procedure, the partnership, or any of the partners, must establish, if so requested by the IRS, that all partners have fully reported their shares of the income, deductions, and credits of the partnership on their timely filed income tax returns. Rev. Proc. 84-35, § 3.01. Additionally, the revenue procedure states that all the relevant facts and circumstances will be taken into account in determining whether a partner has fully reported the partner's share of the income, deductions, and credits of the partnership. Rev. Proc. 84-35, § 3.04. Accordingly, the IRS may develop procedures in accordance with Revenue Procedure 84-35 to ensure that any partnership claiming relief is in fact entitled to such relief.

[632] PMTA 2020-1 is found at https://www.irs.gov/pub/lanoa/pmta-2020-01.pdf.

report their share of partnership income on their return, then the penalty will be reassessed.

(7) A request for penalty abatement under Rev. Proc. 84-35 must initially be denied **if** it appears the partnership is under an election to be subject to the unified audit procedures. See *IRM 20.1.2.4.3.1.1*, Form 8893 and 8894. A response to such a denial should not be treated as an appeal if the taxpayer provides additional information with respect to the election:

a. If the account reflects a processed election (Form 8893, Election of Partnership Level Tax Treatment, or similar statement) that has not been revoked, and the taxpayer claims the election was revoked, then the taxpayer must provide a copy of the IRS letter approving the revocation of the election….

Note: Do not reject a penalty abatement request to obtain additional information if the partnership qualifies for "first time" abatement of the penalty. See IRM 20.1.1.3.3.2.1, First Time Abate (FTA).

(8) Partnerships that do not qualify for abatement of the penalty under Rev. Proc. 84-35 may still qualify for abatement of the penalty under normal reasonable cause criteria.

Also, a partnership with no income, deductions, or credits for Federal income tax purposes for a taxable year is not required to file a partnership return for that year.[633]

Co-tenants of real estate who fit within this safe harbor should avoid filing partnership returns, to facilitate future like-kind exchanges of real estate.[634]

II.C.15. Partner's Right to Copy of Partnership Tax Return

Upon request, a partnership must disclose its federal return to "any person who was a member of such partnership during any part of the period covered by the return."[635]

However, "the information inspected or disclosed shall not include any supporting schedule, attachment, or list which includes the taxpayer identity information of a person other than the entity making the return or the person conducting the inspection or to whom the disclosure is made."[636] In a memo, the IRS's Privacy, Governmental Liaison and Disclosure division said that partner(s) or a partnership representative are entitled to request and receive administrative file record(s) containing partnership returns and return information:[637]

> Until parts 11.3.2, 11.3.3, 11.3.13 and 11.3.35 of the IRM are revised, this memorandum serves as 26 United States Code (U.S.C.) § 6103(e)(10) guidance on requests for

[633] Reg. § 301.6031(a)-(1)(a)(3)(i).
[634] See Letter Ruling 9741017, described in fn. 578.
[635] Code § 6103(e)(1)(C).
[636] Code § 6103(e)(10).
[637] April 14, 2021 MEMORANDUM FOR ALL DISCLOSURE EMPLOYEES, from Phyllis T. Grimes, Director, Governmental Liaison, Disclosure and Safeguards, "Interim Guidance on application of 26 U.S.C. § 6103(e)(10) for TEFRA and BBA Partnerships, Control Number PGLD 11-0221-0001, Expiration Date April 14, 2023. For questions, contact her or Debra Middleton, Senior Disclosure Analyst, at 801-620-2147.

> records for returns and return information of Tax Equity and Fiscal Responsibility (TEFRA) partnerships and Bipartisan Budget Act (BBA) partnerships…
>
> 26 U.S.C. § 6103(e)(10) extends to a request made for a partnership return, Form 1065; and does not extend to a request made under IRC 6103(e), FOIA or Treasury Regulations 301.9000 for access to IRS administrative file record(s), pertaining to a TEFRA or BBA partnership, made by any partner or partnership representative.
>
> Therefore, partner(s) or a partnership representative, for a TEFRA or BBA partnership, are entitled to request and receive administrative file record(s) containing partnership returns and return information without application of 26 U.S.C. § 6103(e)(10).
>
> **Effect on Other Documents**: This guidance will be incorporated into *IRM 11.3.2, Disclosure to Persons with a Material Interest, IRM 11.3.3, Disclosure to Designees and Practitioners, IRM 11.3.13, Freedom of Information Act and IRM 11.3.35, Requests and Demands for Testimony and Production of Documents* by September 30, 2022.

II.D. Special Purpose Trusts

Sometimes multiple owners would like to hold investment or business assets together without being subjected to the complexities of partnership income tax.

Below are discussions of when a multiple owner trust might be considered to be a business entity and when the trust might be disregarded entirely.

For rules that apply to most trusts, see part II.J Fiduciary Income Taxation.

II.D.1. Trust as a Business Entity

For a traditional trust, conducting business activities does not somehow turn the trust into a business entity. For details, see part II.K.2.b.iii Participating in Business Activities Does Not Convert a Trust Created by Only One Grantor into a Business Entity.

If more than one person contributes to a trust so that they can profit from investments or business activity, a trust might be classified as a business activity.

The case that set the tone for classifying arrangements as business entities for well over 60 years, *Morrissey v. Commissioner*,[638] classified a trust as a corporation:

> The trustees were authorized to add to their number and to choose their successors; to purchase, encumber, sell, lease, and operate the “described or other lands”; to construct and operate golf courses, club houses, etc.; to receive the rents, profits, and income; to make loans and investments; to make regulations; and generally to manage the trust estate as if the trustees were its absolute owners. The trustees were declared to be without power to bind the beneficiaries personally by “any act, neglect or default,” and the beneficiaries and all persons dealing with the trustees were required to look for payment or indemnity to the trust property. The beneficial interests were to be evidenced solely by transferable certificates for shares which were divided into 2,000 preferred shares of the par value of $100 each, and 2,000 common shares of no

[638] 296 U.S. 344 (1935).

> par value, and the rights of the respective shareholders in the surplus, profits, and capital assets were defined. "Share ledgers" showing the names and addresses of shareholders were to be kept.

Morrissey contrasted the single grantor trust from the multi-grantor trust:

> "Association" implies associates. It implies the entering into a joint enterprise, and, as the applicable regulation imports, an enterprise for the transaction of business. This is not the characteristic of an ordinary trust — whether created by will, deed, or declaration — by which particular property is conveyed to a trustee or is to be held by the settlor, on specified trusts, for the benefit of named or described persons. Such beneficiaries do not ordinarily, and as mere cestuis que trust, plan a common effort or enter into a combination for the conduct of a business enterprise. Undoubtedly the terms of an association may make the taking or acquiring of shares or interests sufficient to constitute participation, and may leave the management, or even control of the enterprise, to designated persons. But the nature and purpose of the co-operative undertaking will differentiate it from an ordinary trust. In what are called "business trusts" the object is not to hold and conserve particular property, with incidental powers, as in the traditional type of trusts, but to provide a medium for the conduct of a business and sharing its gains. Thus a trust may be created as a convenient method by which persons become associated for dealings in real estate, the development of tracts of land, the construction of improvements, and the purchase, management, and sale of properties; or for dealings in securities or other personal property; or for the production, or manufacture, and sale of commodities; or for commerce, or other sorts of business; where those who become beneficially interested, either by joining in the plan at the outset, or by later participation according to the terms of the arrangement, seek to share the advantages of a union of their interests in the common enterprise.

After recounting how the ownership structure was like that of a corporation, *Morrissey* explained the significant level of activity:

> They were not the less associated in that undertaking because the arrangement vested the management and control in the trustees. And the contemplated development of the tract of land held at the outset, even if other properties were not acquired, involved what was essentially a business enterprise. The arrangement provided for centralized control, continuity, and limited liability, and the analogy to corporate organization was carried still further by the provision for the issue of transferable certificates.
>
> Under the trust, a considerable portion of the property was surveyed and subdivided into lots which were sold and, to facilitate the sales, the subdivided property was improved by the construction of streets, sidewalks, and curbs. The fact that these sales were made before the beginning of the tax years here in question, and that the remaining property was conveyed to a corporation in exchange for its stock, did not alter the character of the organization. Its character was determined by the terms of the trust instrument. It was not a liquidating trust; it was still an organization for profit, and the profits were still coming in. The powers conferred on the trustees continued and could be exercised for such activities as the instrument authorized.

Although the check-the-box regulations overrode the prior regulations the arose from *Morrissey*, they did so only with respect to whether a business entity is classified as a corporation or a partnership, not whether a trust is classified as a business entity.[639] So, let's look further at *Morrissey* and the cases and rulings it spawned.

A companion case to *Morrissey*, *Swanson v. Commissioner*, 296 U.S. 362 (1935), involved two persons who built and rented an apartment house:

> The material facts as found by the Board of Tax Appeals are as follows: Joseph E. Swanson and Ralph C. Otis, in 1914, acquired a piece of vacant land in the city of Chicago with the view of improving it by the erection of an apartment house, the title being taken by Swanson. An apartment house was built. Subsequently, in 1915, at the suggestion of their attorney, they entered into a trust agreement for the purpose of carrying the title to the property. The trust was designated as the "Lake View Land Association." The first trustees were Ralph C. Otis, Joseph E. Swanson, and Allen G. Mills. Petitioners set forth the following summary of the trust agreement, taken from the opinion of the Circuit Court of Appeals:
>
> "Under the trust agreement, the trustees were given the complete management and control of the property, to exchange, reconstruct, remodel, sell, or improve at their discretion or to borrow money secured by the property. They were authorized to rent suitable quarters for the transaction of the business of the trust and employ such assistants as they required. The agreement provided for the issuance of 'receipts' to evidence the interests of the beneficiaries, representing 1,000 shares at the par value of $100 each. It was provided that the receipts were evidences of the ownership of personal property and not real estate. They might be transferred by assignment. Originally, one-half of the shares were issued to Otis and one-half to Swanson, who later transferred their interests to their wives, who owned the shares during 1925 and 1926. The agreement provided that the trust could sue and be sued;3 that neither the trustees nor the beneficiaries should be personally liable, and that all persons dealing with the trustees must look only to the property of the trust; that it should be terminated at the expiration of twenty years after the death of the last survivor of certain named persons or by the trustees in their discretion at any time before the expiration of the twenty years by selling all the property held by them as such and distributing the net proceeds of such sale. The trust had succession and was not terminated by the death of a trustee or beneficiary."

In concluding that the trust was taxable as a corporation, the Court reasoned:

> The compensation of the trustees was to be fixed by themselves, but was not to exceed 2½ per cent. of the gross income of the trust. After making provision for the payment of outstanding claims, the net income was to be divided among the beneficiaries according to their interests, and on the request of any beneficiary the trustees were to render annual accounts. The trust agreement also made provision for a written registry of beneficiaries, who could transfer their interests in a described manner, after having first offered them to the other beneficiaries.

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[639] I am unaware of any case addressing this issue after the adoption of Reg. § 301.7701-4(a). The regulation's preamble, T.D. 8697, provides:

> The regulations provide that trusts generally do not have associates or an objective to carry on business for profit. The distinctions between trusts and business entities, although restated, are not changed by these regulations.

> The renting of apartments, the details of management, and the distribution of net income were committed to a firm (of which Joseph E. Swanson was a member) engaged in the business of buying and selling real estate and managing properties. That firm acted under the direction of Ralph C. Otis and Joseph E. Swanson and the "entire affairs of the Lake View Land Association" were at all times in their hands.
>
> Applying the governing principles, as set forth in our opinion in *Morrissey v. Commissioner, supra*, we agree with the Court of Appeals that the trust constituted an association and was taxable as such. The limited number of actual beneficiaries did not alter the nature and purpose of the common undertaking. Nor did the fact that the operations of the association did not extend beyond the real property first acquired change the quality of that undertaking.

A companion case to *Morrissey*, *Helvering v. Combs*, 296 U.S. 365 (1935), involved a couple of developers who assembled 13 investors:

> The "whole beneficial interest" in the trust was defined as .71333 per cent. of gross production, and the beneficiaries were to be paid their pro rata shares, after deduction for the payment of lawful trust obligations, as follows: (a) 25 per cent. of gross production to the beneficiaries who provided money for the trust purposes; (b) .44333 per cent. to E. E. Combs; and (c) 2 per cent. to Edward Everett. Certificates of beneficial interest were to issue in approved legal form and were to be held in escrow until a producing well was brought in. Thirteen persons were named as beneficiaries, with the amounts contributed and the percentages owned by each, these amounts aggregating $25,000 and the percentage of ownership amounting to 25 per cent. The "certificate of beneficial interest" recited that the party named was the holder of a beneficial interest under the trust agreement in the amount stated and that the same was transferable only upon the books of the trustees, upon indorsement and surrender of the certificate. The trustees were authorized to hold all property and property rights, the legal title to which might vest in them under the trust, to use the moneys deposited by beneficiaries to pay for labor, casing, and other materials incident to drilling and production, to manage and protect the trust property, to pay "trust debts," to sell all products of the well, to borrow money upon the credit of the trust, and to sell any "unsold beneficial interests" as they might deem best for trust purposes. The trustees were not to be individually liable except for willful misconduct. E. E. Combs was to act as production manager at a stated salary after the well was in production. All proceeds "of sale of well products" were to be paid into a designated bank to be distributed as agreed.

In concluding that the trust was taxable as a corporation, the Court reasoned:

> In considering whether an association was created, the fact that the beneficiaries [pg. 1274]did not exercise control is not determinative. *Hecht v. Malley*, 265 U.S. 144, 44 S.Ct. 462, 68 L.Ed. 949; *Morrissey v. Commissioner*, *supra*. The parties joined in a common enterprise for the transaction of business, and the beneficiaries who contributed money for that purpose became associated in the enterprise according to the terms of the arrangement. The essential features of the enterprise were not affected by the fact that the parties confined their operations to one oil well. See *Swanson v. Commissioner*, 296 U.S. --, 56 S.Ct. 283, 80 L.Ed. -- decided this day. Parties may form an association for a small business as well as for a large one. Here, through the medium of a trust the parties secured centralized management of their enterprise, and its continuity during the trust term without termination or interruption by death or changes in

> the ownership of interests, and with limited liability and transferable beneficial interests evidenced by certificates. Entering into a joint undertaking they avoided the characteristic responsibilities of partners and secured advantages analogous to those which pertain to corporate organization. The fact that meetings were not held or that particular forms of corporate procedure were absent is not controlling. *Morrissey v. Commissioner, supra*.

A companion case to *Morrissey*, *Helvering v. Coleman-Gilbert Associates*, 296 U.S. 369 (1935), involved five persons who were co-owners of real property consisting of about twenty apartment houses in the city of Boston and vicinity:

> The property had originally been owned by Harry Coleman, Bernard Gilbert, and Harris Levine in equal shares, but subsequently Coleman and Levine transferred to their wives one-half of their interests. These five persons had for some time been associated in the business of owning and operating apartment houses. By the trust instrument, which recited a contemporaneous conveyance of the property to themselves, they declared that the real estate so conveyed, and any real estate thereafter acquired under the trust, should be held by them in trust for the purposes described, with the designation "Coleman-Gilbert Associates." The trust was to continue for fifteen years unless sooner terminated by sale and distribution of the trust estate. The trustees were to hold the property in order to improve and dispose of it for the benefit of the persons named as "cestuis que trustent and beneficiaries, and their respective representatives and assigns, devisees, or legatees" in the shares provided in the instrument. Except as stated, the beneficiaries were to have no interest in the trust property, and "especially" they were to have "no right to call for any partition thereof." The interests of the beneficiaries were to be personal property, and the death of any one or of all the beneficiaries was not to determine the trust nor entitle the legal representatives of the decedent to an accounting by the trustees.

In concluding that the trust was taxable as a corporation, the Court reasoned:

> We agree with the Circuit Court of Appeals that weight should be given to the purpose for which the trust was organized, but that purpose is found in the agreement of the parties. Not only were they actually engaged, as the Board of Tax Appeals determined, in carrying on an extensive business for profit, but the terms of the trust instrument authorized a wide range of activities in the purchase, improvement and sale of properties in the cities and towns of the state. The parties are not at liberty to say that their purpose was other or narrower than that which they formally set forth in the instrument under which their activities were conducted. Undoubtedly they wished to avoid partition of the property of which they had been co-owners, but their purpose as declared in their agreement was much broader than that. They formed a combination to conduct the business of holding, improving and selling real estate, with provision for management through representatives, with continuity which was not to be disturbed by death or changes in ownership of beneficial interests, and with limited liability. They had been co-owners but they preferred to become "associates," and also not to become partners. *Morrissey v. Commissioner, supra*.

Sears v. Hassett[640] recharacterized the following trust as a business entity:

> The trustees have wide powers to buy and sell real estate;[3] to improve and develop the same by the erection of buildings, or otherwise; to repair or rebuild any building damaged by fire or otherwise; to lease; to employ such agents here and assistants as deemed necessary; to invest and reinvest funds "in any securities they see fit"; to pay from the net income of the trust property "such dividends to the beneficiaries as they may from time to time deem expedient". In quest of profits the trustees are in effect empowered to engage in extensive real estate operations and in the business of investing and reinvesting in securities. Even if at any time all of the real estate may have been disposed of, the termination of the trust is at the absolute discretion of the trustees. In the language of the *Morrissey* case, 296 U.S. at page 357, 56 S.Ct. at page 295, 80 L.Ed. 263, this trust provides "a medium for the conduct of a business and sharing its gains". As was said in the *Coleman-Gilbert* case, *supra*, "the parties are not at liberty to say that their purpose was other or narrower than that which they formally set forth in the instrument under which their activities were conducted".
>
> [3] The trust indenture provides: "The trustees may purchase with such funds as they may from time to time have in their hands any real estate or any interest in real estate encumbered or unencumbered, and may hire and become lessees of any property, easement or right, the use of which is, in their judgment, advantageous to real estate held hereunder." Appellants contend that this does not confer an unrestricted power to purchase land, but that the power to purchase as well as the power to become lessees of land is limited by the last clause in the provision just quoted. We do not so read this provision of the indenture, but our conclusion would not be different if the narrower interpretation were given.

However, when beneficiaries of an estate formed a couple of trusts and the trustees merely executed and extended the leases and collected and distributed the rents, the trusts were not business entities.[641] Another case holding that trusts were not business entities involved a little

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[640] 111 F.2d 961 (1st Cir. 1940).

[641] *Wyman Building Trust v. Commissioner*, 45 B.T.A. 155 (1941), *acq.*, 1941-2 C.B. 14, holding:

> One important element in deciding whether a trust is taxable as a corporation is its form—does it resemble a corporation? *Morrissey v. Commissioner*, 296 U. S. 344; *Sears v. Hassett*, 111 Fed.(2d) 961. This trust does bear some resemblance to a corporation in form. But that circumstance is not necessarily determinative, "it must also have been created as a joint enterprise for the carrying on of a business and sharing its gains, as distinguished from the mere holding and conserving of particular property, with incidental powers, as in the traditional type of trusts." *Sears v. Hassett*, *supra*. These trusts were not intended or permitted to deal with other than a single piece of property. They could not deal with the property generally. Their only purpose was to provide a convenient authority for executing and extending the leases on behalf of a more cumbersome group of beneficial owners and for receiving and distributing the rent. There was no larger purpose to engage in business or to deal with the property in other ways. *Cf. Sears v. Hassett*, *supra*. The lessee paid all expenses, including taxes and repairs. There was no change in the lessee or the provisions of the leases. The only change in beneficiaries was caused by death. The trusts were for definite, short terms. Some of these circumstances may be fortuitous and of little or no significance, but the case is as strong for the taxpayer as some other recent ones. *Cf. Commissioner v. i denied*, 312 U.S. 704; *Lewis & Co. v. Commissioner*, 301 U. S. 385.
>
> The *Sears* case, *supra*, is distinguishable. The court looked at the entire purpose and history of the Sears trust and saw that it had a broad purpose and extensive powers to deal with a number

more management by the trustee, with some of the beneficiaries directing the trustees on behalf of the others:[642]

> At the time of creation of the respective trusts, two parcels of the real estate were managed by a real estate agency and the remaining properties were directly managed by the sons of decedent, who acted as agents for the other beneficiaries in the making of leases, supervising repairs, erecting new buildings, etc. There was a contemporaneous oral agreement between the parties to the written trusts that where the properties involved were managed by members of the family or beneficiaries, such persons would be considered agents of the beneficiaries of the trusts, and the properties have been so managed since the creation of the trusts. Leases have been negotiated, tenants secured, rentals fixed and repairs and improvements made by the members of the family in the management of the properties of the trusts. In some instances, buildings have been erected or the existing ones remodeled, the necessity for which was determined by members of the Gibbs family, contracts for the work executed by them and the necessary funds contributed by the beneficiaries.
>
> The trustee paid for insurance and taxes from the trust income whenever the lease did not require the lessee to do so, but the members of the family selected the company in which the insurance was placed and the amount to be carried.
>
> On the execution of the trust instruments, certificates of beneficial interest were issued to the several beneficiaries in proportion to their respective interests, some of which have been since transferred in trust for other members of the family. The trustee has at no time exercised control or management of any of the trust property, but has limited its activities to the holding of legal title to them, the payment of taxes and maintenance and insurance items upon order of a member of the Gibbs family. It has signed leases at the direction of members of the family, collected the rents, paid the bills and kept the necessary records. There have been no sales of any of the real estate in the trusts nor any additional purchased and no accumulations of funds by the trustee except for the payment of taxes.

The case from which the quote above was excerpted involved the IRS trying to tax the trust as a corporation. It did not address whether the owners had formed a partnership that then created a trust.

Guar. Emps. Ass'n v. United States, 241 F.2d 565, 571 (5th Cir. 1957), involved a trust established by an employer:

> The pertinent facts are not in dispute. Guaranty Employees Association was organized in 1939 for the exclusive benefit of employees of Guaranty Title & Trust Company of

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> of properties to the best advantage of the beneficial owners for an indefinite time. Here the purpose and powers as set forth in the instruments were much more limited.

Lewis & Co .involved only one grantor, who assigned his interest in the trust to only one purchaser, who then died. *Commissioner v. Gibbs-Preyer Trusts* is the case described in fn. 642 and the accompanying text.

[642] *Commissioner v. Gibbs-Preyer Trusts Nos. 1 & 2*, 117 F.2d 619 (6th Cir. 1941), holding:

> In the present cases, the trustee did nothing of any consequence with respect to the management and conduct of the business, all of it being carried on by the cestuis que trustent. Article X of the trust instruments limited the duties of the trustee substantially to the receipt of rentals, keeping accounts and making distribution of net rentals to the cestuis que trustent.

> Corpus Christi, Texas. The latter company, hereinafter called Guaranty Title, is primarily a title insurance and trust company managing and investing in real estate in the Corpus Christi area. It had frequent requests from its employees for small loans, and it encouraged the creation of Guaranty Employees Association to take care of that need and further to encourage thrift, establish a savings plan among the employees, and to promote cooperation, loyalty, continuity of employment and better employer-employee relations in general.
>
> On August 2, 1939, some 43 employees of Guaranty Title met in its offices and, without incorporating, adopted a constitution and by-laws for Guaranty Employees Association….
>
> "The assets consisted of real estate notes purchased through trust companies and trust departments in banks, stock in building-loan associations, first mortgage loans made direct to borrowers, a comparatively insignificant amount loaned to members on passbooks, and cash to meet withdrawals of deposits." *A-C Inv. Ass'n v. Helvering*, *supra*, 68 F.2d at page 387.

The Fifth Circuit held that, because the members could withdraw their accounts at any time, the trust was not taxed as a corporation:

> 1. There is no substantial economic independence of the Association from its members. (a) The business of the Association necessarily expands or contracts as the members find it essential or desirable to deposit or withdraw their investments (though some incorporated open-end investment trusts have the same characteristic); if all members should withdraw their investments (due to a strike or cessation of employer's business, etc.) the Association would have to terminate its business—and perhaps liquidate at a loss. (It might also be noted that though on the death of a member if he had a spouse or children they might maintain his investment in the Association, the relationship between the inheritor and the Association is no longer the same as between it and a member—all that remains is the obligation to pay a proportionate share of the income and to repay the principal on demand—there is no right to increase the investment, to borrow against it, or to vote; in effect a debtor-creditor relationship is created, similar to the arrangement sometimes made upon the death of a partner if the business is carried on by the remaining members and the widow in effect becomes a limited partner). Moreover the Association cannot grow through retained earnings. (b) Since there is no limitation of personal liability as to outside creditors the insolvency or bankruptcy of the Association would directly affect the fortunes of its members; on the other hand the good fortune of the Association would also benefit the members almost immediately.
>
> Thus, in effect, this Association has continuity only of management; continuity of property depends largely on the independent decisions of each of its members. There is not much more than an agency, through which a group of individuals in a joint enterprise can make a temporary, diversified investment. See *Helm & Smith Syndicate v. C.I.R.*, *supra*, 136 F.2d at 442.
>
> It appearing therefore that there is here no truly separate entity whose economic fortunes are in any way independent from the fortunes of the participants, we conclude that the Government has not carried its burden of proving that appellant resembles, in its essential economic features, a corporation more than it does a partnership.

The dissenting judge argued that centralized management and the members lack of participation in the business made the trust resemble a corporation. Those issues are no longer relevant in the check-the-box issue, given that unincorporated entities with those characteristics are now taxed as partnerships. More common in recent years is for an employer to form a trust taxable to the employer, where payments to employees constitute deferred compensation; for more about deferred compensation, see part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules. If a trust with multiple owners does not actively manage its assets, it may be taxed as a grantor trust; see part II.D.4.a Investment Trusts. I would tend to use one of the above two approaches rather than the strategy used in *Guar. Emps. Ass'n v. United States*, because the issue of partnership vs. trust may cause uncertainty.

The following trust was treated as a business entity:[643]

> The heirs to a number of contiguous parcels of real estate established a real estate trust, *T*. *T* is to collect the income from the real estate and to distribute such income to the heirs.
>
> The real estate transferred to *T* is subject to a net lease, which provides that the lessee will pay all property taxes, betterment assessments, water rates, sewer and utility charges, and fire and general public liability insurance. The lessee is required to manage, maintain, and repair the property under the terms of the lease.
>
> The property transferred to *T* was allocated on its books in undivided fractional interests, corresponding to each heir's interest in the property contributed.
>
> All the income of *T* is required to be distributed quarterly. *T*'s governing instrument may be amended by the consent of all the beneficiaries, and *T* will terminate 30 years from the date of its creation, unless terminated earlier by the consent of all the beneficiaries.
>
> Upon an express determination by the trustees that it is necessary to conserve or protect *T*'s real estate, beneficiaries or members of their families may contribute to *T* interests in real estate adjacent or contiguous to the real estate held in trust by *T*, in which event such persons shall become additional beneficiaries.
>
> If necessary to conserve and protect the value of *T*'s real estate, the trustees of *T* have the power to accept from any source and retain real estate contiguous or adjacent to the trust's real estate. The trustees also have the power to sell any real estate of the trust, and may purchase any real estate adjacent or contiguous to the real estate originally contributed to *T*, including any tangible personal property located on such real estate. Funds derived from the sale of property held by *T* and not reinvested in real estate can

[643] Rev. Rul. 78-371, citing *Wyman* from fn 641 and *Sears* from fn. 640, holding:

> While the facts in the instant case are similar to the facts in *Wyman*, the trustees of *T* also have the power to purchase and sell contiguous or adjacent real estate, and to accept and retain contributions of contiguous or adjacent real estate from the beneficiaries or members of their families. The trustees have the further power to raze or erect any building or other structure and make any improvements they deem proper on the land originally donated to the trust or on any adjacent or contiguous land subsequently acquired by the trust. The trustees are also empowered to borrow money and to mortgage and lease the property. These additional powers taken together indicate that the trustees of *T* are empowered to do more than merely protect and conserve the trust's property. Thus, the arrangement, in the instant case, is similar to the trust ruled to be an association in the *Sears* case.

only be invested in certificates of deposits, or obligations of federal or state governments.

The trustees are further empowered to borrow money, mortgage and lease property, raze or erect any building or other structure, and make any improvements they deem proper.

Shortly thereafter, the following trust was not held to be a business entity:[644]

Individuals A, B, and C, who owned a commercial building and the land upon which it was situated as tenants in common, established a trust with a bank as trustee. Simultaneously, A, B, and C transferred the land and building to the trust and named themselves as beneficiaries. A, B, and C receive proportionate quarterly distributions of all net income of the trust.

The trust agreement provides that the purpose of the trust is to empower the trustee to act on behalf of the beneficiaries as signatory of leasing agreements and management agreements, to hold title to the land and building and to the proceeds and income of the property, to distribute all trust income and to protect and conserve the property.

The beneficiaries' interests in the trust are evidenced by certificates that are transferable only on the death of a beneficiary or by unanimous written agreement of the beneficiaries. In addition, after the initial contribution no additional contributions may be made to the trust.

The beneficiaries must approve all agreements entered into by the trustee and they are personally liable for all debts of the trust. The trustee may determine whether to allow minor nonstructural alterations to the building and can institute legal or equitable action to enforce any provisions of a lease. The trust will terminate upon the sale of substantially all its assets or upon unanimous agreement of the beneficiaries.

The beneficiaries directed the trustee to sign a lease of the property to X, a corporation, for 20 years with options for three six-year extensions. X is to pay all taxes, assessments, fees or other charges imposed on the property by federal, state or local authorities. In addition, X is to pay for all insurance, maintenance, repairs, and utilities relating to the property.

The trustee as lessor prepared the building for X's use and can approve additional alterations by X only if the alterations protect and conserve the building or are required by law. The rent remains fixed for 20 years, but if the lease is renewed the rent will be recomputed based on the fair market value of the property. X has an option to purchase

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[644] Rev. Rul. 79-77, citing Rev. Rul. 78-371 in fn. 643 and *Wyman* in fn. 641, held:

This case is distinguishable from Rev. Rul. 78-371 in that the trustee is restricted to dealing with a single piece of property subject to a net lease. Further, the trustee has none of the powers described in Rev. Rul. 78-371. Thus, the arrangement is similar to the trust held not to be a corporation in the WYMAN case.

HOLDING. The arrangement is classified as a trust for federal income tax purposes. Further, A, B, and C are the owners of the trust and are taxable on the income therefrom under subpart E of subchapter J, chapter 1 of the Code (sections 671-678).

> the property every tenth year during the term of the initial lease for an amount equal to the greater of the property's cost to the owners or its fair market value.

When two investors formed a trust to hold real estate to facilitate their estate planning as a form of ownership by which later transfers of beneficial interest to other members of their families would be permitted, the trustee's role was passive,[645] and the IRS attacked the trust when the investors has passed their interests to their beneficiaries, the trust was not a business entity because the beneficiaries were not associates.[646]

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[645] *Elm Street Realty Trust v. Commissioner*, 76 T.C. 803 (1981), described the trustee's Johnson's role and relationship with the grantors:

> Johnson's understanding with respect to the Elm Street Realty Trust was that it was to be a passive trust; his duties would be to collect the rent from the tenant, pay the mortgage and distribute the income. The lease was a net lease under which Risley bore all expenses in connection with the property. Moreover, the trust was a "simple" trust which did not allow for any accumulation of income.
>
> It was never suggested to Johnson that the trust purchase additional property. He had no duties with respect to the Elm Street property because they were all assumed by the lessee. He never had occasion to confer with any of the beneficiaries regarding the real estate nor did he ever see the trust real estate.
>
> The various discretionary powers given to the trustee in the declaration of trust were inserted by Johnson as the attorney who drafted the trust instrument, without any participation by Egan and Harvey. It was Johnson's practice to include such powers in trust instruments in order to deal with any problems that might result from a wide array of unforeseen circumstances (*e.g.*, fire, disaster, condemnations, etc.). Johnson never discussed the wording of these powers with Egan and Harvey.

[646] *Elm Street Realty Trust v. Commissioner*, 76 T.C. 803 (1981), described the beneficiaries' roles:

> Turning to the circumstances of the instant case in light of the above-mentioned considerations, we note that the beneficiaries played no role in petitioner's creation. Egan and Harvey transferred the Elm Street property to petitioner and were the original beneficiaries, but they soon thereafter assigned their interests pursuant to article Sixth of the declaration of trust. It also appears that the subsequent beneficiaries received their interests gratuitously.[4] We think it can be safely said that the individuals who were petitioner's beneficiaries during the years in issue played no active role either in the creation of petitioner or upon their subsequent entrance into a beneficial relationship with the trust.[5]
>
> [4] This fact can be reasonably inferred from the lack of consideration referred to in the assignment documents as well as the estate planning purpose which Egan and Harvey stated as being one of the main reasons they chose a trust form of ownership.
>
> [5] For example, beneficiaries' purchase of beneficial interests would tend to indicate the presence of associates, since the purchase signifies a voluntary and affirmative entrance into the enterprise. See *Second Carey Trust v. Helvering*, 126 F.2d 526 (D.C. Cir. 1942), *cert. denied* 317 U.S. 642 (1942).
>
> The interests of the beneficiaries in the trust were transferable only under certain restrictive provisions contained in article Sixth. That article generally prohibited a transfer of the beneficiaries' interests with the exception of testamentary transfers pursuant to the will of a beneficiary and transfers assented to by the trustee and all of the other beneficiaries. The requirement that all other beneficiaries agree to any transfer of a beneficial interest imposes a substantial limitation on free transferability (sec. 301.7701-2(e)(1), Proced. & Admin. Regs.), and thus significantly hinders the ability of the beneficiaries to voluntarily and unilaterally substitute others for themselves as associates.
>
> The beneficiaries' other powers under the trust instrument included the authority to appoint a successor trustee in the event of the trustee's death, inability to serve, or resignation; amend or modify the trust instrument if acknowledged in writing by the trustee and all of the other

If the beneficiaries are associates in a joint enterprise for the conduct of business for profit, then the trust might be characterized as a business entity, not only for tax purposes[647] but also under state partnership law.[648] A business trust, created by the beneficiaries simply as a device to carry on a profit-making business that normally would have been carried on through a corporation or partnership, might be treated as a business entity.[649]

> beneficiaries; and terminate the trust prior to the expiration of the stated 11-year period if all of the beneficiaries notified the trustee in writing, or if any 25-percent (or greater) interestholder notified the trustee, subject to the trustee's absolute discretion to refuse to terminate the trust.
>
> In our view, the ability of the beneficiaries to influence or otherwise participate in the trust's activities is limited in scope by virtue of the conditions attached to the exercise of the relevant powers — either concurrence by all of the beneficiaries or concurrence of the trustee in addition. Although petitioner possessed a business objective, the evidence concerning the trust's creation and its subsequent operations does not indicate that the beneficiaries affirmatively planned or entered into a joint effort for the conduct of a common enterprise. Similarly, the nature of the beneficiaries' interests, including the powers incident thereto, does not suggest that they could effect an unfettered, significant influence on petitioner. We thus conclude that petitioner's form did not afford a medium by which the beneficiaries could conduct income-producing activities through a quasi-corporate entity. The beneficiaries were not associates for purposes of section 7701(a)(3) and the regulations thereunder.

[647] Reg. § 301.7701-4(a) provides that generally a trust will be respected as a trust if its purpose is to "vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit."

[648] *Roby v. Colehour*, 25 N.E. 777, 778 (Ill. Supreme Ct. 1890).

[649] Reg. § 301.7701-4(b), which elaborates:

> … the fact that the corpus of the trust is not supplied by the beneficiaries is not sufficient reason in itself for classifying the arrangement as an ordinary trust rather than as an association or partnership. The fact that any organization is technically cast in the trust form, by conveying title to property to trustees for the benefit of persons designated as beneficiaries, will not change the real character of the organization if the organization is more properly classified as a business entity under § 301.7701-2.

Rev. Rul. 88-79 treated as a business entity the following arrangement:

> Six individuals formed an organization, O, in Missouri, under the terms of an Agreement styled "Royalty Trust Agreement" (Agreement). O was formed for the purpose of buying, holding, and selling oil and gas royalty interests. The six individuals, referred to in the Agreement as the managers, contributed cash to O in exchange for certificates of beneficial interest. The managers of O collectively have substantial assets other than their interests in O. Certificates of beneficial interest were sold also to members of the general public pursuant to a public offering registered with the Securities and Exchange Commission. The agreement refers to these public investors as participants. The certificates of beneficial interest represent the right to share in the profits and losses of O and the right to a share of the assets of O upon its liquidation. The managers own 10 percent of the certificates of beneficial interest, and the participants own the remaining 90 percent.
>
> The Agreement provides that the investment activity of O is to be controlled and managed solely by the managers. The managers will determine the timing and amount of distributions from O to the certificate holders. Although the Agreement designates a commercial bank to serve as a trustee of O, the trustee does nothing more than hold legal title to the assets of O. The managers may replace the trustee with another bank at any time….
>
> Under the terms of the Agreement, O has associates and an objective to carry on business and divide the gains therefrom, and, therefore, O is not classified as a trust for tax purposes. Rather, it is classified as a partnership or as an association….

Rev. Rul. 98-37 obsoleted Rev. Rul. 88-79 in light of Reg. § 301.7701-4(a), but fn. 3340 indicates that Reg. § 301.7701-4(a) was not intended to change the principles of prior law.

A trust that constitutes a pooling of assets that are actively managed is at risk for being treated as a business entity.[650] For example, the IRS ruled that a trust formed by a couple and their grandchildren would not qualify as a charitable remainder trust (or be taxed as any type of trust), because the grantors would be deemed associates who pooled their assets with an object to carry on business and divide the gains therefrom.[651] It also ruled that a trust and subtrusts to control the exploitation of the patents, which would distribute to the grantors the royalties received from licensing the patents (net of administration expenses and other required payments), was a partnership.[652]

The last major case before the check-the-box regulations were issued, *Bedell Trust v. Commissioner*, (1986), *acq*. 1987-2 C.B. 1, involved a trust that ran real estate businesses and provided mandatory income interests as separate shares for descendants. The court analyzed the law:

> The principal matter before us is the determination of which side of the shadowy line of separation between trusts and associations the Bedell Trust falls. The starting point for considering whether any particular organization or entity qualifies as an "association" taxable as a corporation is *Morrissey v. Commissioner*, 296 U.S. 344 (1935). The Supreme Court granted certiorari in *Morrissey* (and three companion cases)[5] for the obvious purpose of establishing authoritative guidelines in a field which was then regarded as "seemingly in a hopeless state of confusion", and in which there was a widespread conflict of decisions in the lower courts. 296 U.S. at 347. To be sure, the Court recognized that it was not feasible to draw a hard and fast line between "associations" and other entities like trusts and partnerships. It noted that (p. 356) "it is impossible in the nature of things to translate the statutory concept of 'association' into a particularity of detail that would fix the status of every sort of enterprise or organization which ingenuity may create". It nevertheless proceeded to establish a degree of consistency in this field and give guidance in the attempt to classify a particular entity.
>
> [5] *Swanson v. Commissioner*, 296 U.S. 362 (1935); *Helvering v. Combs*, 296 U.S. 365 (1935); *Helvering v. Coleman-Gilbert*, 296 U.S. 369 (1935).
>
> The Court noted that (p. 357) "The inclusion of associations with corporations implies resemblance … and not identity", and it set forth six significant criteria or attributes to be taken into account in the process of determining the status of a given entity. These consisted of (i) Associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of beneficial interests. The Court stated that (p. 360) "these attributes make the trust sufficiently analogous to corporate organization to justify the conclusion that Congress intended that the income of the enterprise should be taxed in the same manner as that of corporations". Moreover, apart from the foregoing six criteria, the Court recognized that "the use of corporate forms may furnish persuasive evidence of the existence of an association", but it added that "the absence of particular forms, or of the usual terminology of corporations, cannot be regarded as decisive". (296 U.S. at 358.)

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[650] See generally Zaritsky, Lane & Danforth, "¶ 1.07 The Income Tax Meaning of 'Trust,'" *Federal Income Taxation of Estates and Trusts* (WG&L).
[651] Letter Ruling 9547004.
[652] Letter Ruling 200219017.

The opinion in *Morrissey* also pointed out with approval that the Treasury Department had authority within permissible bounds of administrative construction to promulgate regulations or supply rules for the “enforcement” of the statute. 296 U.S. at 354-355. The statute in question in Morrissey and as subsequently reenacted and now in effect is section 7701(a)(3) of the Code which defines the term “corporation” to include “associations”. It was in the exercise of the authority recognized by the Supreme Court that the Treasury promulgated the present regulations modifying and expanding upon prior regulations. The new regulations, as amended, are currently to be found in sections 301.7701-1 through 301.7701-4, Proced. & Admin. Regs. The six tests outlined in *Morrissey* were incorporated in the new regulations, which further provided that “other factors may be found in some cases which may be significant in classifying an organization” and that the classification of an entity will depend on whether the “organization more nearly resembles a corporation than a partnership or trust. See Morrissey et al v. Commissioner (1935) 296 U.S. 344”. Sec. 301.7701-2(a)(1), Proced. & Admin. Regs.

In respect of both trusts and partnerships the regulations contain the following significant provisions (sec. 301.7701-2(a)(2) and (3)):

> (2) … Some of the major characteristics of a corporation are common to trusts and corporations, and others are common to partnerships and corporations. *Characteristics common to trusts and corporations are not material in attempting to distinguish between a trust and an association*, and characteristics common to partnerships and corporations are not material in attempting to distinguish between an association and a partnership. For example, since centralization of management, continuity of life, free transferability of interests, and limited liability are generally common to trusts and corporations, *the determination of whether a trust which has such characteristics is to be treated for tax purposes as a trust or as an association depends on whether there are associates and an objective to carry on business and divide the gains therefrom*. On the other hand, since associates and an objective to carry on business and divide the gains therefrom are generally common to both corporations and partnerships, *the determination of whether an organization which has such characteristics is to be treated for tax purposes as a partnership or as an association depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability*.
>
> (3) An unincorporated organization shall not be classified as an association *unless such organization has more corporate characteristics than noncorporate characteristics*. In determining whether an organization has more corporate characteristics than noncorporate characteristics, *all characteristics common to both types of organizations shall not be considered*.

[Emphasis supplied.]

Central to the application of these provisions is the final clause quoted above to the effect that all characteristics common to corporations and trusts or partnerships “shall not be considered”. (Emphasis supplied.) Thus, the regulations provide that since four of the six criteria are generally characteristic of both trusts and associations, the determinative test depends upon only the two remaining criteria, namely, whether there are “associates and an objective to carry on business and divide the gains therefrom”. (Emphasis supplied.) Similarly, where the problem is one of distinguishing between partnerships and associations, the regulations state that, after eliminating two of the criteria applicable generally to partnerships and corporations (associates and business purpose), the determinative test depends on the four remaining criteria.

The governing methodology in dealing with these regulations was established by this Court in *Larson v. Commissioner*, 66 T.C. 159 (1976). That case involved the provisions relating to distinguishing between partnerships and associations. The Court held that under the regulations, an entity could not be classified as an association (as opposed to a partnership) unless it had more than half (*i.e.*, more than two) of the four attributes specified in the regulations in respect of partnerships, assuming that there were no "other factors" in addition to the original six that might be significant. Furthermore, the Court applied a purely mechanical test in which each of the individual four factors were to be given equal weight, and in which it was simply necessary to count the critical factors to see whether they came to at least three. Thus, an entity might fail to be classified as an association rather than a partnership even though considering all four significant attributes as a group under a more flexible approach giving each attribute a different level of significance in the context of the particular case, one might arrive at an opposite conclusion.[6]

[6] This more flexible approach on the record before us would not result in an opposite conclusion in this case but would even further support the conclusion that we reach hereinafter in this opinion.

In our judgment, this Court's literal reading of the regulations in respect of partnership v. association is equally applicable in the case of trust v. association, dealt with in the same provisions of the regulations. In the case of classifying an entity as an association rather than a trust, the regulations provide that the result depends merely upon the two (not six) critical criteria relating to trusts, *i.e.*, "whether there are associates *and* an objective to carry on business and divide the gains therefrom". (Emphasis supplied.) In short, applying the regulations literally, as was done in *Larson*, the Bedell Trust cannot be classified as an association unless it satisfies both the associates and the business tests. Not only do the regulations refer to both attributes in the conjunctive, but they also specifically require that, after eliminating "all characteristics common to both types of organizations", an organization "shall not be classified as an association unless [it] … has *more* corporate characteristics than noncorporate characteristics". (Emphasis supplied.) Sec. 301.7701-2(a)(3), Proced. & Admin. Regs. Thus, in accordance with the latter requirement, since the trust must have "more" than half of the two determinative characteristics to qualify as an "association" rather than a trust, it must fail to qualify as such if it satisfies only one of the tests. So much is plainly called for by the methodology employed in *Larson* that was approved by a majority of the Court.

Turning to the case before us, we must conclude that the Bedell Trust is not an association since we find that it does not have "associates". Failure to satisfy the "associates" test is itself sufficient to prevent it from being classified as an association. Such failure alone was held to be decisive in *Elm Street Realty Trust v. Commissioner*, 76 T.C. 803 (1981), wholly apart from whether the entity may have also satisfied the conduct of a business test. The same result is called for here, since we find that there was similarly an absence of associates in respect of the Bedell Trust.

In considering whether there were associates, it is pertinent to examine the basic nature of the Bedell Trust. The trust was established pursuant to the Will of Harry M. Bedell, Sr., which undertook to set forth the testator's complete estate plan. After making some specific bequests of certain tangible personal property to his wife and son, the testator provided for the transfer of his entire remaining assets, the bulk of his estate, to the testamentary trust before us. Those assets included his large home in Washington, a summer home in Maryland, certain commercial real estate in Maryland, his sole proprietorship (the Bedell Manufacturing Co.), and all other remaining assets owned by him.[7] The will is an extraordinary document, drafted by the testator himself with what appears to have been only a minimal amount of professional legal assistance. The testator's image as disclosed by the will is that of a strong-willed person accustomed to being the dominant figure in his family and having his own way, who was emphatic upon seeing to it that only his blood descendants should benefit from his estate. It is in the context of this will that we must determine whether the Bedell Trust fails to qualify as an association by reason of the absence of "associates". We note preliminarily that its status as a trust has never been challenged by the IRS since its creation in 1964, until the Commissioner's determination in respect of the years 1980 and 1981, the years before us now.

[7] We are aware that most of the assets apart from the Bedell Manufacturing Co. had been disposed of prior to the years in issue, 1980 and 1981. On the other hand, it is clear on this record that the highly valuable land owned by the trust during the tax year was being held for appreciation, particularly for the benefit of the remaindermen-an objective wholly apart from that of conducting the business of the company. Moreover, even as to that portion of the land occupied by the company, the facilities therein were far in excess of its needs and such excess facilities were being held by the trust simply for profitable leasing so as to augment the amount of distributable current income payable to the lifetime beneficiaries. To be sure, the company was certainly engaged in conducting a business, but whether that was enough to conclude that it outweighed the nonbusiness aspects of the trust so as to satisfy the business test under the regulations is a matter that we need not decide. For, even if the business test be regarded as satisfied-and a strong case can be made out that it is-decision must nevertheless go against the Government in view of our conclusion that the associates test has not been satisfied.

We find that the trust under consideration lacks associates and is thereby not classifiable as an association. The beneficiaries here have not "plan[ned] a common effort or enter[ed] into a combination for the conduct of a business enterprise". *Morrissey v. Commissioner*, 296 U.S. 344, 357 (1935). Additionally, they did not affirmatively enter into the enterprise by way of a purchase of their beneficial interests. *Elm Street Realty Trust v. Commissioner*, 76 T.C. at 814.

Further, a relevant factor to be taken into account is that it was the decedent's "desire to create an estate for [his] …children [and grandchildren] which could not be dissipated by spendthrift operations, a desire which was effectuated by the restriction on the beneficiaries' interests against any anticipatory assignment thereof". *Elm Street Realty Trust v. Commissioner*, *supra*, 76 T.C. at 815. To be sure, there were no specific provisions against assignment in the decedent's will, but his desire that the beneficial interests in the trust remain within the family comes through loud and clear.

The beneficiaries' interests were too personal to be freely transferable. It was Mr. Bedell's clear intention that the trust income be used only to benefit children and grandchildren of the whole blood-an intention that, in our judgment, would be given

> effect by any local court construing the will. Only one of those so limited descendants can look to trust funds in case he contracts a "crippling disease and is unable financially to bear the expense". Since a beneficiary cannot confer upon a substitute "all the attributes of his interest" in the trust, such interest is not transferable. *Foster v. Commissioner*, 80 T.C. 34, 190 (1983), *affd. on this issue* 756 F.2d 1430 (9th Cir. 1985). Sec. 301.7701-2(e)(1), Proced. & Admin. Regs. This non-transferability of interests militates against a finding of associates. *Elm Street Realty Trust v. Commissioner*, *supra* at 815. See *Curt Teich Trust No. One v. Commissioner*, 25 T.C. 884 (1956); *Living Funded Trust of Harry E. Lyman v. Commissioner*, 36 B.T.A. 161 (1937). We cannot find, where one person has created an entity, unilaterally distributed interests in it to others, and then restricted their ability to transfer their interests, that there exists "a voluntary association of individuals for convenience and profit", which characteristic is the very essence of an association. *Blair v. Wilson Syndicate Trust*, 39 F.2d 43, 46 (5th Cir. 1930).
>
> Further, the beneficiaries did not, *qua* beneficiaries, control trust affairs. Only 3 of the original 10 beneficiaries (wife, 3 children, 6 grandchildren) 8 participated in trust affairs as trustees in the years at issue. These trustees, to a large extent, are responsible for the "protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility", those beneficiaries being the wife and grandchildren. Sec. 301.7701-4(a), Proced. & Admin. Regs. Participation in trust management by so few beneficiaries does not transform all the beneficiaries into associates and the trust into an association. See *United States v. Davidson*, 115 F.2d 799, 800, 801 (6th Cir. 1940); *Curt Teich Trust No. One v. Commissioner*, 25 T.C. at 892; *Living Funded Trust of Harry E. Lyman v. Commissioner*, 36 B.T.A. at 166, 168. This conclusion is particularly clear where the non-participating beneficiaries have no right to appoint or control those beneficiaries who do act as trustees.

The court held:

> We conclude that the beneficiaries, who neither created nor contributed to the trust, whose interests in the trust are not transferable, and only a few of whom participate in the trust affairs, are not associates and their trust is not an association.

The court further commented:

> We understand that the Government regarded this case as a test case in respect of testamentary trusts and trusts engaged in the conduct of a business, and that high levels in the IRS were active in pressing the matter. It is difficult to imagine a more unsuitable vehicle than this case for any such purpose, and we think it regrettable that extensive misguided efforts were exerted to such a fruitless end in this litigation.

Some trusts with multiple owners are disregarded for income tax purposes,[653] including unit investment trusts, which limit the trustee's role to a relatively passive one.[654] Rev. Rul. 2004-86 ruled that a Delaware statutory trust (DST)[655] owned by multiple investors who invested to make

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653 See part II.D Special Purpose Trusts.
654 See part II.D.4.a Investment Trusts.
655 The DST Act provides much freedom to contractually set rules. See Swoyer, "Don't Let the Name Fool You: Delaware Statutory Trusts are Controlled by Contract," *Business Law Today* (12/2016) (saved as Thompson Coburn LLP document number 6488741), discussing *Grand Acquisition, LLC v. Passco Indian Springs DST*, 145 A.3d 990 (Del. Ch. 2016).

a profit was a unit investment trust that was a disregarded entity rather than a partnership. Before discussing the tax issues, here's a comment about DSTs I received 6/28/2023 in response to an inquiry I made where a potential client has been told that it would require fire-sale-type prices to sell their DSTs in a secondary market:

> Generally, the structure of the DST is not very participant friendly when it comes to try to sell an individual ownership unit. The operating agreement should outline the process, and generally there is a first right of refusal or some other inside sale path that may have to be executed before going to market, including but not limited to appraisal. Some also have submarket valuations for allowing the sale, hence the "fire-sale" discussions.

Rev. Rul. 2004-86 involved the following:

> On January 1, 2005, A, an individual, borrows money from BK, a bank, and signs a 10-year note bearing adequate stated interest, within the meaning of § 483. On January 1, 2005, A used the proceeds of the loan to purchase Blackacre, rental real property. The note is secured by Blackacre and is nonrecourse to A.
>
> Immediately following A's purchase of Blackacre, A enters into a net lease with Z for a term of 10 years. Under the terms of the lease, Z is to pay all taxes, assessments, fees, or other charges imposed on Blackacre by federal, state, or local authorities. In addition, Z is to pay all insurance, maintenance, ordinary repairs, and utilities relating to Blackacre. Z may sublease Blackacre. Z's rent is a fixed amount that may be adjusted by a formula described in the lease agreement that is based upon a fixed rate or an objective index, such as an escalator clause based upon the Consumer Price Index, but adjustments to the rate or index are not within the control of any of the parties to the lease. Z's rent is not contingent on Z's ability to lease the property or on Z's gross sales or net profits derived from the property.
>
> Also on January 1, 2005, A forms DST, a Delaware statutory trust described in the Delaware Statutory Trust Act, Del. Code Ann. Title 12, §§ 3801-3824, to hold property for investment. A contributes Blackacre to DST. Upon contribution, DST assumes A's rights and obligations under the note with BK and the lease with Z. In accordance with the terms of the note, neither DST nor any of its beneficial owners are personally liable to BK on the note, which continues to be secured by Blackacre.
>
> The trust agreement provides that interests in DST are freely transferable. However, DST interests are not publicly traded on an established securities market. DST will terminate on the earlier of 10 years from the date of its creation or the disposition of Blackacre, but will not terminate on the bankruptcy, death, or incapacity of any owner or on the transfer of any right, title, or interest of the owners. The trust agreement further provides that interests in DST will be of a single class, representing undivided beneficial interests in the assets of DST.
>
> Under the trust agreement, the trustee is authorized to establish a reasonable reserve for expenses associated with holding Blackacre that may be payable out of trust funds. The trustee is required to distribute all available cash less reserves quarterly to each beneficial owner in proportion to their respective interests in DST. The trustee is required to invest cash received from Blackacre between each quarterly distribution and all cash held in reserve in short-term obligations of (or guaranteed by) the United States, or any agency or instrumentality thereof, and in certificates of deposit of any bank or

> trust company having a minimum stated surplus and capital. The trustee is permitted to invest only in obligations maturing prior to the next distribution date and is required to hold such obligations until maturity. In addition to the right to a quarterly distribution of cash, each beneficial owner has the right to an in-kind distribution of its proportionate share of trust property.
>
> The trust agreement provides that the trustee's activities are limited to the collection and distribution of income. The trustee may not exchange Blackacre for other property, purchase assets other than the short-term investments described above, or accept additional contributions of assets (including money) to DST. The trustee may not renegotiate the terms of the debt used to acquire Blackacre and may not renegotiate the lease with Z or enter into leases with tenants other than Z, except in the case of Z's bankruptcy or insolvency. In addition, the trustee may make only minor non-structural modifications to Blackacre, unless otherwise required by law. The trust agreement further provides that the trustee may engage in ministerial activities to the extent required to maintain and operate DST under local law.

The facts did not discuss whether the tenants maintain the property or merely reimburse the landlord for expenses incurred. However, given the trustee's limited authority described above, I seriously doubt that the trustee could have contracted to maintain the property and get reimbursed.

The Ruling pointed out:

> Under Delaware law, DST is an entity that is recognized as separate from its owners. Creditors of the beneficial owners of DST may not assert claims directly against Blackacre. DST may sue or be sued, and the property of DST is subject to attachment and execution as if it were a corporation. The beneficial owners of DST are entitled to the same limitation on personal liability because of actions of DST that is extended to stockholders of Delaware corporations. DST may merge or consolidate with or into one or more statutory entities or other business entities. DST is formed for investment purposes. Thus, DST is an entity for federal tax purposes.
>
> Whether DST or its trustee is an agent of DST's beneficial owners depends upon the arrangement between the parties. The beneficiaries of DST do not enter into an agency agreement with DST or its trustee. Further, neither DST nor its trustee acts as an agent for A, B, or C in dealings with third parties. Thus, neither DST nor its trustee is the agent of DST's beneficial owners. *Cf. Comm'r v. Bollinger*, 485 U.S. 340 (1988).
>
> This situation is distinguishable from Rev. Rul. 92-105. First, in Rev. Rul. 92-105, the beneficiary retained the direct obligation to pay liabilities and taxes relating to the property. DST, in contrast, assumed A's obligations on the lease with Z and on the loan with BK, and Delaware law provides the beneficial owners of DST with the same limitation on personal liability extended to shareholders of Delaware corporations. Second, unlike A, the beneficiary in Rev. Rul. 92-105 retained the right to manage and control the trust property.

The Ruling the addressed the DST's status as an entity:

> Because DST is an entity separate from its owner, DST is either a trust or a business entity for federal tax purposes. To determine whether DST is a trust or a business entity

for federal tax purposes, it is necessary, under § 301.7701-4(c)(1), to determine whether there is a power under the trust agreement to vary the investment of the certificate holders.

Prior to, but on the same date as, the transfer of Blackacre to DST, A entered into a 10-year nonrecourse loan secured by Blackacre. A also entered into the 10-year net lease agreement with Z. A's rights and obligations under the loan and lease were assumed by DST. Because the duration of DST is 10 years (unless Blackacre is disposed of prior to that time), the financing and leasing arrangements related to Blackacre that were made prior to the inception of DST are fixed for the entire life of DST. Further, the trustee may only invest in short-term obligations that mature prior to the next distribution date and is required to hold these obligations until maturity. Because the trust agreement requires that any cash from Blackacre, and any cash earned on short-term obligations held by DST between distribution dates, be distributed quarterly, and because the disposition of Blackacre results in the termination of DST, no reinvestment of such monies is possible.

The trust agreement provides that the trustee's activities are limited to the collection and distribution of income. The trustee may not exchange Blackacre for other property, purchase assets other than the short-term investments described above, or accept additional contributions of assets (including money) to DST. The trustee may not renegotiate the terms of the debt used to acquire Blackacre and may not renegotiate the lease with Z or enter into leases with tenants other than Z, except in the case of Z's bankruptcy or insolvency. In addition, the trustee may make only minor non-structural modifications to Blackacre, unless otherwise required by law.

This situation is distinguishable from Rev. Rul. 78-371, because DST's trustee has none of the powers described in Rev. Rul. 78-371, which evidence an intent to carry on a profit making business. Because all of the interests in DST are of a single class representing undivided beneficial interests in the assets of DST and DST's trustee has no power to vary the investment of the certificate holders to benefit from variations in the market, DST is an investment trust that will be classified as a trust under § 301.7701-4(c)(1).

Thus, when tenants in common lease the property to an entity that itself engages in an active rental business (a "master lease") and the tenants in common do not themselves maintain the property, the tenants in common may be able to avoid partnership treatment. Ideally, the tenant under the master lease (that subleases to various tenants in its real estate business) would have ownership different than those who own the tenants in common, to avoid the master tenant being considered merely an extension of the tenants in common. However, Rev. Rul. 2004-86 did not specify who owned X, the master tenant, and whether the master tenant needs to have a different ownership structure is subject to debate.[656]

Rev. Proc. 2020-34, § 3.06 points out that Rev. Rul. 2004-86 "states that Trust would have been treated as a business entity and not a trust if Trust's trustee had a power under the trust agreement to, among other things, renegotiate the lease with its tenant, to enter into leases with

[656] Consider obtaining the recording to "Use of Delaware Statutory Trusts in Non-Syndicated Exchange and Drop-and-Swap Situations," American Bar Association Section of Taxation May 2016 meeting. Slides are at http://www.americanbar.org/content/dam/aba/events/taxation/taxiq/may16/taxiq-16may-seb-useofdelaware-foster-slides.pdf, and recordings may be purchased for $30 at http://www.dcprovidersonline.com/abatx.

other tenants, or to renegotiate or refinance the mortgage loan whose proceeds were used to purchase Blackacre."

Rev. Proc. 2020-34, § 7, "Safe Harbor," provides, "For the purpose of determining whether the arrangement is treated as a trust under § 301.7701-4(c) and Revenue Ruling 2004-86, the actions described in section 6 of this revenue procedure are not manifestations of a power to vary." Rev. Proc. 2020-34, § 6, "Scope," provides relief regarding the COVID-19 pandemic:[657]

.01 This revenue procedure applies to arrangements that are trusts under § 301.7701-4(c) and Rev. Rul. 2004-86 and that hold real property and engage in one or more of the actions described in sections 6.02, 6.03, or 6.04 of this revenue procedure.

.02 Modification of one or more mortgage loans that secure the trust's real property in -

(1) A CARES Act Forbearance (and all related modifications); or

(2) A forbearance (and all related modifications) –

(a) That are described in section 2.07 of Rev. Proc. 2020-26;

(b) That the trust requested, or agreed to, between March 27, 2020, and December 31, 2020; and

(c) That were granted as a result of the trust experiencing a financial hardship due to the COVID-19 emergency.

.03 Modifications of one or more real property leases (including modifications to the specific allocations of fixed rent in the lease agreements as described in § 467 of the Code and the regulations under § 467; see section 9.01 of this revenue procedure). The lease must have been entered into by the trust on or before March 13, 2020, and the modifications must have been requested and agreed to on or after March 27, 2020, and on or before December 31, 2020. The reason for the modifications must be -

(1) To coordinate the lease cash flows with the cash flows that result from one or more transactions described in section 6.02 of this revenue procedure; or

(2) To defer or waive one or more tenants' rental payments for any period between March 27, 2020, and December 31, 2020 (and all related modifications), because the tenants are experiencing a financial hardship due to the COVID-19 emergency.

.04 Acceptance of cash contributions that are made between March 27, 2020, and December 31, 2020, as a result of the trust experiencing financial hardship due to the COVID-19 emergency, provided the contribution must be needed to increase permitted trust reserves, to maintain trust property, to fulfill obligations under mortgage loans, or to fulfill obligations under real property leases. See section 10 of

[657] Rev. Proc. 2020-34, § 4.04 describes the forbearances set forth in Rev. Proc. 2020-34, § 7.02.

> this revenue procedure regarding the tax treatment of non-pro rata contributions or contributions from new investors for an interest in the trust.

Rev. Proc. 2021-12 further extended to September 30, 2021 certain deadlines that Rev. Proc. 2020-26 or 2020-34 had extended to December 31, 2020.

When using the master lease, however, note that the rental income will be subject to the 3.8% net investment income tax, because rental generally is passive and does not qualify for certain exceptions that may apply to rental that is an active trade or business.[658] The owners would also want to take steps to limit liability, either holding the real estate through a unit investment trust such as the DST described in Rev. Rul. 2004-86 or by each owner forming a separate LLC to hold that owner's undivided interest in the real estate. See Lipton, Donovan, and Kassab, "The Promise (and Perils) of Using Delaware Statutory Trusts in Real Estate Offerings," *Journal of Taxation* (June 2008).

Rost v. U.S., 130 A.F.T.R.2d 2022-5462 (5th Cir. 8/11/2022), involved a foreign entity which, if classified as a foreign trust, would subject the decedent to penalties for failure to file certain information returns. The court summarized the facts:

> In 2005, John Rebold formed the Enelre Foundation as a *Stiftung* under the laws of Liechtenstein. *Stiftung* is a German word meaning, roughly, "foundation" or "endowment." Enelre's purpose is to provide education and general support for Rebold and his children. Rebold transferred $3 million to Enelre's bank accounts. He later learned the IRS would consider Enelre a "foreign trust," triggering certain reporting requirements. Rebold belatedly filed the reports, and the IRS assessed penalties. Rebold paid the penalties and then filed this refund action. The district court granted summary judgment for the government. We affirm.

The court reviewed the law on when an arrangement is classified as a trust, absent authority directly on point:

> The classification of an organization "for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law." Treas. Reg. § 301.7701-1(a). Sections 301.7701-2, 301.7701-3, and 301.7701-4 determine the classification of organizations recognized as separate entities, unless the IRC "provides for special treatment of that organization." *Id*. § 301.7701-1(b). Neither the IRC nor its regulations specifically classify or provide for special treatment of *Stiftungen*. *Cf. id*. § 301.7701-2(b)(8) (classifying Liechtenstein *Aktiengesellschaften* as corporations).
>
> Determining whether an arrangement is a foreign trust requires a two-step inquiry: (1) whether it is a trust under section 301.7701-4 or a business entity under sections 301.7701-2 or 301.7701-3, and (2) if it is a trust, whether it is a United States person (*i.e.,* a domestic trust) or a foreign trust. See I.R.C. § 7701(a)(30)(E), (31)(B); Treas. Reg. §§ 301.7701-1(a)-(b), (d), 301.7701-2(a), 301.7701-4(a), 301.7701-5(a), 301.7701-7.
>
> A "trust" in the IRC is an arrangement where "trustees take title to property for the purpose of protecting or conserving it for the beneficiaries." Treas. Reg. § 301.7701-

[658] See part II.I.8.c Application of 3.8% Tax to Rental Income.

4(a). An arrangement generally qualifies as a trust if "the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit." *Ibid*.; see also *Frank Aragona Tr. v. Comm'r*, 142 T.C. 165, 175 (2014).

An arrangement's purpose thus distinguishes a trust from other entities. "[A]ny entity recognized for federal tax purposes...that is not properly classified as a trust under § 301.7701-4" is a "business entity." Treas. Reg. § 301.7701-2(a). Arrangements "known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries" may nevertheless not qualify as trusts under the IRC "because they are not simply arrangements to protect or conserve the property for the beneficiaries." *Id*. § 301.7701-4(b). "Business trusts," for example, "generally are created by the beneficiaries simply as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships under the [IRC]." *Ibid*.; see *Petersen v. Comm'r*, 148 T.C. 463, 475 n.8 (2017).

In classifying an arrangement as a trust or other business entity for tax purposes, "there is no one rule or set formula," and "[e]ach case must be decided upon its own particular facts." *Keating-Snyder Tr. v. Comm'r*, 126 F.2d 860, 862 (5th Cir. 1942); see also *Comm'r v. Horseshoe Lease Syndicate*, 110 F.2d 748, 749 (5th Cir. 1940) ("the facts of each case[] must control"). The seminal case is *Morrissey v. Commissioner*, 296 U.S. 344 (1935). There, the Supreme Court held that a trust created for developing tracts of land and constructing and operating a golf course was properly classified and taxed as "an association" (i.e., a business trust), rather than an ordinary trust, based on its "character" and "salient features," including the trustees' "use and adaptation of the trust mechanism." *Id*. at 359-61. The Court applied *Morrissey*'s fact-specific approach in three companion cases decided that same day. See *Swanson v. Comm'r*, 296 U.S. 362 (1935); *Helvering v. Coleman-Gilbert Assocs.*, 296 U.S. 369 (1935); *Helvering v. Combs*, 296 U.S. 365 (1935).

An arrangement's most relevant features for tax-classification purposes are its "nature," "purpose," and "operations." *Morrissey*, 296 U.S. at 357; *Swanson*, 296 U.S. at 365.[5] The form of organization under which the arrangement operates "may furnish persuasive evidence" of a classification but "cannot be regarded as decisive." *Morrissey*, 296 U.S. at 358. No feature is dispositive; they "all go to the point of whether the trust is being used to achieve the organizational conveniences of the corporate form." *Guar. Emps. Ass'n v. United States*, 241 F.2d 565, 571 (5th Cir. 1957).

[5] Morrissey relied on five corporate features to conclude the trust was "analogous to a corporate organization" and thus qualified as an "association," or "business trust." 296 U.S. at 359-61. These features are "(1) title to the property held by the entity, (2) centralized management, (3) continuity uninterrupted by deaths among the beneficial owners, (4) transfer of interest without affecting the continuity of the enterprise, and (5) limitation of the personal liability of participants." *Comm'r v. Rector & Davidson*, 111 F.2d 332, 333 (5th Cir. 1940); see *Kurzner v. Comm'r*, 413 F.2d 97, 101-04 & n.22 (5th Cir. 1969) (reviewing Morrissey 's discussion of "distinguishing attributes of 'corporateness'").

> In assessing these features, the arrangement's organizing documents are determinative. See *Swanson*, 296 U.S. at 363-65; *Morrissey*, 296 U.S. at 360-61. As the Supreme Court has explained, "parties are not at liberty to say that their purpose was other or narrower than that which they formally set forth in the instrument under which their activities were conducted." *Coleman-Gilbert*, 296 U.S. at 374.[6]
>
> [6] See also *Abraham v. United States*, 406 F.2d 1259, 1262-63, 1263 n.4 (6th Cir. 1969) (finding "broad powers...for conducting a business for profit...carefully spelled out" in the trust instrument could not "be negated by [a] self-serving limiting declaration contained in the last paragraph" that the trust "shall not be deemed or considered a trust operated for financial profit"); *Nee v. Main St. Bank*, 174 F.2d 425, 429 (8th Cir. 1949) ("The intention, through the creation of a trust, to conduct a business enterprise may accordingly legally be inferred...from the enumeration in the instrument of powers which, if exercised, would necessarily cause such an enterprise to result."); *Sears v. Hassett*, 111 F.2d 961, 962-63 (1st Cir. 1940) (noting the "character of the trust" is determined by "the purposes and potential activities as disclosed on the face of the trust instrument").

The court then explained why the arrangement in this case is properly characterized as a trust:

> The district court correctly found that Enelre qualifies as a foreign trust. Its organizing documents explain that Enelre's purpose is to support its beneficiaries and limit its transactions to "pursuing and realising its purpose." This is "characteristic of an ordinary trust." *Morrissey*, 296 U.S. at 356-57. The documents also prohibit Enelre from conducting commercial trade. Liechtensteinian Public Registry filings confirm this prohibition. Enelre's familial purpose, lack of business objective, and bar on commercial activity render it a trust. See *McKean v. Scofield*, 108 F.2d 764, 765-66 (5th Cir. 1940) (holding a trust was taxable as a trust and not an association because "[s]olicitude for the future of [the settlor's] family [wa]s a main purpose of the trust"); see also *Estate of Bedell v. Comm'r*, 86 T.C. 1207, 1221 (1986) (holding a "trust characterized by a dominant familial objective" was taxable as a trust and not an association because it lacked a business purpose).[7]
>
> [7] *Cf. Coleman-Gilbert*, 296 U.S. at 373-74 (holding trust was taxable as an association because the parties engaged "in carrying on an extensive business for profit"); *Adkins Props. v. Comm'r*, 143 F.2d 380, 381 (5th Cir. 1944) (holding trust with "an active business purpose, having the general characteristics and advantages of corporate organization" was taxable as an association); cases cited supra note 6.
>
> Enelre's form of organization confirms it is a trust. Enelre is subject to Liechtenstein's "Act on Trust Enterprises." Its board members serve the same function as independent trustees, and Enelre's counsel considered them trustees. Enelre also has beneficiaries like an ordinary trust. Rebold described himself as "Settlor and Beneficiary" of Enelre, and he transferred money to Enelre the same way a trust grantor would. Rebold's children, the other beneficiaries, were not involved with Enelre and did not know it existed during the years in question, so they could not have been "associates" engaged in a common business enterprise. See *Morrissey*, 296 U.S. at 357; *cf. Elm St. Realty Tr. v. Comm'r*, 76 T.C. 803, 813-18 (1981). And Enelre's organizing documents do not provide for profit sharing. See *Morrissey*, 296 U.S. at 357.

II.D.2. Business Entity as Grantor of Trust or Donor to Charity or Other Donee

II.D.2.a. Business Entity as Grantor of Trust

If a partnership or corporation makes a gratuitous transfer to a trust for a business purpose of the partnership or corporation, the partnership or corporation will generally be treated as the grantor of the trust.[659]

For example, if a partnership creates a trust to secure a legal obligation of the partnership to a third party unrelated to the partnership, the partnership will be treated as the trust's grantor.[660]

However, if a partnership or a corporation creates a trust that is not for a business purpose of the entity but is for the personal purposes of one or more of the entity's owners, the gratuitous transfer will be treated as a constructive distribution to those owners under federal tax principles and the owners will be treated as the trust's grantors.[661] For example:

- If a corporation creates a trust that includes not only the corporation but also its shareholders as beneficiaries, the corporation shall be treated as having distributed property to those shareholders and those shareholders being considered to have contributed that property to the trust.[662]
- If a partnership creates a trust for the benefit of a child of a partner, the gratuitous transfer will be treated as a distribution to the partner and a subsequent gratuitous transfer by the partner to the trust.[663]

For example, in *Sage v. Commissioner*, 154 T.C. No. 12 (2020), the Official Tax Court Syllabus said:

> P, a real estate developer, owned through subchapter S corporation IDG three parcels of Oregon real estate encumbered by liabilities in excess of their fair market values. In response to the 2008 economic recession, IDG engaged in a series of transactions in December 2009 designed to transfer the parcels to three separate liquidating trusts for the benefit of the mortgage holders. Between 2010 and 2012 the liquidating trusts disposed of the parcels, and the mortgage holders applied the proceeds from these

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[659] Reg. § 1.671-2(e)(4). Jonathan Blattmachr's 2015 Heckerling presentation cites the following examples of split-interest trusts created by business entities:

> PLR 9205031 (not precedent) and PLR 8102093: CRT could be created by C corporation; PLR 9340043: CRT could be created by S corporation; PLR 9419021 and PLR 199952071: CRT could be created by partnership (or LLC treated as partnership)
> …
> PLR 9512002: S corporation could create charitable lead trust; PLR 8145101: C corporation could create charitable lead trust. (These were non-grantor trust CLATs)

[660] Reg. § 1.671-2(e)(4).

[661] Reg. § 25.2511-1(h)(1), which controls gift tax treatment and is reproduced in part III.B.1.h Transfers in the Ordinary Course of Business.

[662] See fn. 4969 in part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax.

[663] Reg. § 1.671-2(e)(4). Also, TAM 200733024 asserts a similar position (deemed distribution from corporation to shareholder for a trust that the corporation established for shareholder's family) before the regulation's effective date.

dispositions against the outstanding liabilities of IDG and its wholly owned limited liability company (LLC).

IDG reported significant losses as a result of the 2009 transactions, which losses P claimed on his 2009 individual tax return. These losses gave rise to a net operating loss (NOL), which P, inter alia, carried back to his 2006 taxable year as an NOL carryback deduction and forward to his 2012 taxable year as an NOL carryover deduction. R disallowed the losses reported by IDG and claimed by P for the 2009 taxable year, made correlative adjustments to the 2006 and 2012 NOL deductions, and determined deficiencies for 2006 and 2012.

Held: As the proceeds of the Oregon parcels held by the liquidating trusts were applied to discharge certain liabilities of IDG and its wholly owned LLC between 2010 and 2012, IDG and the LLC were the owners of the corresponding liquidating trusts during those respective years pursuant to the grantor trust provisions. I.R.C. secs. 671-679.

Held, further, because IDG and the LLC owned the liquidating trusts beyond the close of the 2009 taxable year, the losses reported by IDG and claimed by P for 2009 were not bona fide dispositions and not evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during that year. Sec. 1.165-1(b), Income Tax Regs. The deductions were properly disallowed.

Sage v. Commissioner, 154 T.C. No. 12 (2020), held:[664]

Under the specific facts of this case, section 677(a)(1) and its accompanying regulations compel the conclusions that (1) IDG was the owner of Village and Plains in 2010 and 2012, respectively, and Gales Creek Terrace LLC was the owner of Creek in 2011, and (2) the Village Trust and the Plains Trust were not separate taxable entities from IDG, and the Creek Trust was not a separate taxable entity from Gales Creek Terrace LLC, during those years. These twin conclusions preclude the tax treatment Mr. Sage seeks.

As an initial matter, IDG and Gales Creek Terrace LLC were grantors of the respective trusts. IDG was a grantor of the Village Trust and the Plains Trust by virtue of its direct gratuitous transfer of ownership of the project LLCs (which in turn held the properties) to the trusts. Sec. 1.671-2(e)(1), Income Tax Regs. For its part Gales Creek Terrace LLC was a grantor of the Creek Trust because of its indirect gratuitous transfer of Creek to the Creek Trust (through its contribution of Creek to the Creek Project LLC). See *id.*

As explained above, the grantor of a trust is treated as an owner where, inter alia, trust income is "applied in discharge of a legal obligation of the grantor". Sec. 1.677(a)-1(d), Income Tax Regs. Income, in this regard, includes the trust corpus. Sec. 1.671-2(b), Income Tax Regs.

The parties before us agree that IDG and Gales Creek Terrace LLC remained liable to Sterling and CFC, respectively, for the loans secured by Village, Plains, and Creek after the ownership of those properties had passed to the respective trusts. When Village was sold in 2010 for $3,469,390 and Plains was sold in 2012 for $350,000, the proceeds were distributed to Sterling, which credited the amounts against IDG's outstanding loans

[664] The opinion includes a reference to the subject matter of part II.D.4.b Liquidating Trusts.

secured by those respective properties. For its part, Creek was transferred to CFC in 2011 in partial satisfaction of Gales Creek Terrace LLC's loan.

As the corpus of each trust was used to satisfy the legal obligations of IDG or Gales Creek Terrace LLC, we conclude that they were owners of the respective trusts after 2009, and that the trusts therefore were not separate taxable entities as to them. See sec. 1.677(a)-1(d), Income Tax Regs.; see also *Gould v. Commissioner*, 139 T.C. at 435; *Madorin v. Commissioner*, 84 T.C. at 671. The 2009 transfers accordingly did not accomplish bona fide dispositions of the property evidenced by closed and completed transactions as necessary to support the losses ultimately reported by IDG and passed on to Mr. Sage.[17]

[17] In his briefs Mr. Sage argues that the lenders had no legal obligation to apply any income realized from the properties to satisfy the debt of IDG or Gales Creek Terrace LLC. This point is of no moment given that the trust corpus was used in fact to pay these obligations. Even setting aside that fact and, further, assuming arguendo that the lenders had discretion as Mr. Sage suggests, the trusts nonetheless would constitute grantor trusts because they were trusts "whose income …, in the discretion of … a nonadverse party … may be applied in discharge of a legal obligation of the grantor". Sec. 1.677(a)-1(d), Income Tax Regs. (emphasis added). The respective trust documents require the distribution of all net trust income and all net proceeds from the sale of trust assets to Sterling and CFC. Although trust beneficiaries are ordinarily considered adverse parties, sec. 1.672(a)-1(b), Income Tax Regs., a party "can hardly be considered adverse regarding distributions for … [its] benefit", *Luman v. Commissioner*, 79 T.C. 846, 854 (1982); see also *Vercio v. Commissioner*, 73 T.C. at 1258. Sterling and CFC, two nonadverse parties, had unfettered discretion to apply trust income and sale proceeds to satisfy the legal obligations of IDG and Gales Creek Terrace LLC. Of course that is precisely what the lenders did.

C. *Mr. Sage's Contentions* Mr. Sage counters that the application of the grantor trust provisions in this case requires that Sterling and CFC be considered the owners of the respective trusts, not IDG and Gales Creek Terrace LLC. He first argues that this result is required by the nature of a liquidating trust.[18] In a slightly different vein he also contends that section 1.671-2(e)(3), Income Tax Regs., should be read to mean that Sterling and CFC were owners of the respective trusts by virtue of their status as trust beneficiaries. We find neither argument persuasive.

[18] Assuming that the trusts at issue here qualify as trusts under Oregon law, we conclude that they were "liquidating trusts" within the meaning of sec. 301.7701-4(d), Proced. & Admin. Regs. The express terms of each trust instrument comported with the requirements of that regulation, the record reflects that the trusts abided by those requirements, and respondent has not meaningfully contested their treatment as such.

1. *Liquidating Trust Argument*

Mr. Sage contends that the nature of liquidating trusts compels the conclusion that Sterling and CFC were the true owners of the respective trusts beginning in 2009. Mr. Sage asserts that the creation of the liquidating trusts here implicitly involved two steps: (1) the transfer of property from IDG to Sterling or CFC and (2) the transfer of property from Sterling or CFC to the respective trust. According to Mr. Sage, the first step is tantamount to a sale, and IDG should be able to recognize a loss equaling the difference between IDG's adjusted basis in the respective piece of property and its fair market value - as unilaterally determined by Mr. Sage, apparently - on December 31, 2009.

This argument has no foundation in either the Code or the applicable regulations. As an initial matter the Code does not specifically address liquidating trusts whatsoever and thus provides no support for Mr. Sage's view.

Nor do the applicable regulations. Section 301.7701-4(d), Proced. & Admin. Regs., defines a liquidating trust as "organized for the primary purpose of liquidating and distributing the assets transferred to it," with all activities "reasonably necessary to, and consistent with, the accomplishment of that purpose." Paragraph (d) further specifies that such liquidating trusts "are treated as trusts for purposes of the Internal Revenue Code." *Id*. The regulations, like the Code, offer no hint that liquidating trusts incorporate an implicit two-step structure or that they provide a safe harbor from the normal operation of the grantor trust rules.

Mr. Sage places his hopes in IRS administrative guidance that addresses certain liquidating trust arrangements. This administrative guidance, however, does not weigh in favor of Mr. Sage's view of liquidating trusts.[19]

[19] As will be discussed, Mr. Sage relies on a Chief Counsel Advisory memorandum and certain revenue rulings. This type of memorandum is non-precedential but may provide some insight into IRS policy. See *Hulett v. Commissioner*, 150 T.C. 60, 86 n. 21 (2018), appeal filed (8th Cir. Oct. 19, 2018); *Dover Corp. & Subs. v. Commissioner*, 122 T.C. 324, 341 n.11 (2004). Revenue rulings likewise are not binding on the courts. *N. Ind. Pub. Serv. Co. v. Commissioner*, 105 T.C. 341, 350 (1995), *aff'd*, 115 F.3d 506 (7th Cir. 1997).

Mr. Sage principally relies on a 2001 Chief Counsel Advisory (CCA), 200149006, 2001 WL 1559018 (Dec. 7, 2001), which sets forth the Commissioner's views on a proposed chapter 11 bankruptcy plan. The plan proposed placing certain assets in a liquidating trust for the benefit of holders of allowed claims. See *id*. The CCA provides that "[g]enerally, liquidating trusts are taxed as grantor trusts with the creditors treated as the grantors and deemed owners" under the theory that "the debtor transferred its assets to the creditors in exchange for relief from its indebtedness to them, and that the creditors then transferred those assets to the trust for purposes of liquidation." *Id.*

In our case, however, apparently neither Sterling nor CFC was aware of the creation of the liquidating trusts before receiving the notifications sent by Mr. Winter in the late afternoon of December 31, 2009, much less agreed to relieve IDG or Gales Creek Terrace LLC from its respective indebtedness in exchange for the assets that were transferred to the liquidating trusts. The predicate underlying the CCA is simply not present, and this administrative guidance offers no insight here.

Mr. Sage next turns to a string of revenue rulings. See Rev. Rul. 72-137, 1972-1 C.B. 101; see also Rev. Rul. 80-150, 1980-1 C.B. 316; Rev. Rul. 75-379, 1975-2 C.B. 505; Rev. Rul. 63-245, 1963-2 C.B. 144. In each, a corporation had enacted a plan of complete liquidation that required distribution of all assets within 12 months. With the consent of the shareholders in each instance, certain assets not readily disposed of were placed in liquidating trusts for the shareholders' benefit. The Commissioner concluded that placing such assets in liquidating trusts complied with the requirement of divestment within 12 months because the shareholders had essentially received the assets that were transferred to the trusts.

Again, Mr. Sage's unilateral transactions in which he placed properties in trusts without any involvement from the beneficiaries does not resemble the factual situations addressed in the revenue rulings. And we see nothing in them to suggest that liquidating trusts qua liquidating trusts should be treated differently under the grantor trust rules absent the involvement of the beneficiaries.[20]

[20] Mr. Sage argues in a footnote that the lenders ratified the liquidating trust transactions by not filing suit or taking other action to overturn or void them. In support Mr. Sage relies upon an Oregon case addressing ratification of an agent's actions by a principal. *Lemley v. Lemley*, 188 P.3d 468, 473-475 (Or. Ct. App. 2008). *Lemley* plainly has no applicability here. In any event, the record before us shows that both Sterling (in the January 2010 email from a Sterling employee) and CFC (in its February 2010 demand letter) notified Mr. Sage that they did not view the liquidating trust transactions as having any practical effect.

2. *Interest Received from the Grantor of a Liquidating Trust* Mr. Sage further argues that Sterling and CFC were grantors of the trusts under section 1.671-2(e)(3), Income Tax Regs., which provides that the term "grantor" includes any person "who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in … liquidating trusts described in § 301.7701-4(d) of this chapter". According to Mr. Sage, Sterling and CFC "acquire[d]" interests by virtue of being named beneficiaries and, therefore, are grantors.

We are unconvinced. The only example in the regulations illustrating the operation of section 1.671-2(e)(3), Income Tax Regs., refers to the acquisition of a pre-existing grantor's interest after the formation of the trust: "A makes an investment in a fixed investment trust, T, that is classified as a trust under § 301.7701-4(c)(1) of this chapter. A is a grantor of T. B subsequently acquires A's entire interest in T. Under paragraph (e)(3) of this section, B is a grantor of T with respect to such interest." Sec. 1.671-2(e)(6), Example (2), Income Tax Regs. Moreover, if Mr. Sage is right on this point, every beneficiary of a liquidating trust is automatically a grantor, with the tax repercussions that follow. If the regulations intended such a sea change, we believe that they would say so directly.[21] See *Time Ins. Co. v. Commissioner*, 86 T.C. 298, 320 (1986); *Bituminous Cas. Corp. v. Commissioner*, 57 T.C. 58, 83 (1971).

[21] We further observe that, even assuming that Mr. Sage's reading of sec. 1.671-2(e)(3), Income Tax Regs., were correct *(i.e.*, Sterling and CFC were grantors), the result in this case would not change. The grantor trust regime contemplates the possibility for multiple grantors to be treated as the owners of a single trust. See, *e.g.*, sec. 1.671-4(b)(3), Income Tax Regs. (prescribing certain reporting obligations for trustees "[i]n the case of a trust all of which is treated as owned by two or more grantors or other persons"). Mr. Sage fails to show that the banks' status as grantors has any effect on our analysis as to IDG and Gales Creek Terrace LLC.

The ultimate parent entity of a multinational enterprise group that has annual revenue for the preceding annual accounting period of at least $850 million may be required to file Form 8975, annual country-by-country reporting. A grantor trust owned by a business entity is itself considered a business entity subject to these rules.[665]

II.D.2.b. Business Entity as Donor to Charity or Other Donee

Beware that, generally, "if a taxable corporation transfers all or substantially all of its assets to one or more tax-exempt entities, the taxable corporation must recognize gain or loss immediately before the transfer as if the assets transferred were sold at their fair market values."[666] This rule also applies to "a taxable corporation's change in status to a tax-exempt entity."[667]

Subject to that caution, an S corporation that is about to sell an asset that would incur built-in gain tax should consider contributing the asset to a charitable remainder trust if the sale will not generate unrelated business taxable income (UBTI).[668]

Code § 2511(a) provides that gift tax applies "whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible." Reg. § 25.2511-1(c)(1) provides:

> The gift tax also applies to gifts indirectly made. Thus, any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax. See further § 25.2512-8 relating to transfers for insufficient consideration.

Reg. § 25.2512-8 is reproduced in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts. This part II.D.2.b focuses on gifts made by the business entity that are attributed to owners, whereas part III.B.1.b focuses on transfers of business interests by the owners.

Reg. § 25.2511-1(h)(1) provides:

> A transfer of property by a corporation to B is a gift to B from the stockholders of the corporation. If B himself is a stockholder, the transfer is a gift to him from the other stockholders but only to the extent it exceeds B's own interest in such amount as a shareholder. A transfer of property by B to a corporation generally represents gifts by B to the other individual shareholders of the corporation to the extent of their proportionate interests in the corporation. However, there may be an exception to this rule, such as a transfer made by an individual to a charitable, public, political or similar organization which may constitute a gift to the organization as a single entity, depending upon the facts and circumstances in the particular case.

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[665] Reg. § 1.6038-4(b)(2).
[666] Reg. § 1.337(d)-4(a)(1).
[667] Reg. § 1.337(d)-4(a)(2).
[668] See parts II.Q.6.d Unrelated Business Taxable Income and II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax.

Instructions for 2022 Form 709 (gift tax return) include:

> Only individuals are required to file gift tax returns. If a trust, estate, partnership, or corporation makes a gift, the individual beneficiaries, partners, or stockholders are considered donors and may be liable for the gift and GST taxes.
>
> If an estate, trust, partnership, corporation, or other entity (other than governmental entities and certain charitable organizations and trusts, described in sections 511(a)(2) and 511(b)(2), as discussed later) is a donee, then each person who indirectly receives the gift through the entity is treated as a donee and is assigned to a generation as explained in the above rules.

If a business entity makes a charitable contribution, we have clearly defined income tax rules, but no rule specifically addresses whether the owner(s) should report the gift on gift tax return(s):

- Reg. § 25.2512-8, referred to above, provides that "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth," but that does not apply to a charitable contribution many with "any donative intent."

- In the adequate disclosure gift tax regulations, Reg. § 301.6501(c)-1(f)(4) provides, "Completed transfers to members of the transferor's family, as defined in section 2032A(e)(2), that are made in the ordinary course of operating a business are deemed to be adequately disclosed under paragraph (f)(2) of this section, even if the transfer is not reported on a gift tax return, provided the transfer is properly reported by all parties for income tax purposes," but it applies to transfers to members of the transferor's family, not to transfers to charity.

If an owner has no input into whether the business entity makes the contribution, I do not view that as a gift by the owner. On the other hand, if an owner controls or could readily veto the contribution, that appears to be a potentially reportable gift, absent some value being received by the business entity or owner. For income tax purposes, part II.G.4.g.i Charitable Deduction vs. Business Expense delineates between a contribution that is deductible as such and a contribution that constitutes a business expense, but most contributions are the former, so it provides little solace. I am unaware of any advisor (including me) recommending reporting charitable contributions by business entities on owners' gift tax returns (or the IRS arguing about the lack of such reporting); I might consider reporting such a gift if it is an unusual one, perhaps such as a gift to split-interest trust. But I see no guidance explaining the profession's and IRS' lack of interest in such reporting.

II.D.3. Trust as Grantor or Deemed Owner of Another Trust

When the trustee of a trust creates another trust, the original grantor is treated as the grantor of both trusts;[669] furthermore, the first trust is treated as the Code § 678 owner of the second trust if the first trust can revoke the second trust.[670] See also part II.J.9.b Trust Divisions.

When Trust 1 distributed assets to Trust 2, retaining the right to withdraw all of Trust 2's income, which right lapsed at the end of each year, Letter Ruling 201633021 held that Code § 678 would tax Trust 1 on all of Trust 2's income and capital gain. The trusts had identical terms regarding current distributions. The facts were:

> Original Trust was established by Decedent on Date 1. Decedent died on Date 3.
>
> On Date 2, Court ratified the division of Original Trust into separate trusts for the benefit of each child of Decedent, and his or her spouse and issue. Trust 1 resulted from this division.
>
> The governing document for Trust 1 (Trust 1 Agreement) authorizes Trustee, at any time, to distribute all or any portion of the net income or principal or both of Trust 1 directly to any one or more of the Beneficiaries living at the time of such distribution or to the trustees of any trust of which such Beneficiary is a beneficiary.
>
> Pursuant to the authority granted to the Trustee under the Trust 1 Agreement, the Trustee proposes to transfer funds from Trust 1 to Trust 2 which also benefits Beneficiaries. Beneficiaries' rights to distributions under the Trust 2 agreement are the same as those under the Trust 1 Agreement.
>
> The governing document of Trust 2 (Trust 2 Agreement) provides that Trust 1 retains the power, solely exercisable by Trust 1, to revest the net income of Trust 2 in Trust 1; provided, however, that such power shall lapse on the last day of such calendar year.
>
> The Trust 2 agreement provides that income includes (i) any dividends, interest, fees and other amounts characterized as income under § 643(b) of the Code, (ii) any net capital gains realized with respect to assets held less than twelve months, and (iii) any net capital gains realized with respect to assets held longer than twelve months.

Letter Ruling 201633021 held:

> Trust 1 will be treated as the owner of the portion of Trust 2 over which they have the power to withdraw under § 678(a). Accordingly, Trust 1 will take into account in

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[669] Reg. § 1.671-2(e)(5), which is reproduced in fn 6620 in part III.B.2.h.i Who Is the Grantor. T.D. 8831 discussed this rule in a parenthetical:

> These rules do not affect the determination of whether or not the gratuitous transfer from the transferor trust is a distribution subject to sections 651 or 661.

[670] Reg. § 1.671-2(e)(6), Example (8) provides:

> G creates and funds a trust, T1, for the benefit of G's children and grandchildren. After G's death, under authority granted to the trustees in the trust instrument, the trustees of T1 transfer a portion of the assets of T1 to another trust, T2, and retain a power to revoke T2 and revest the assets of T2 in T1. Under paragraphs (e)(1) and (5) of this section, G is the grantor of T1 and T2. In addition, because the trustees of T1 have retained a power to revest the assets of T2 in T1, T1 is treated as the owner of T2 under section 678(a).

computing their tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to which enter into the computation of distributable net income. Additionally, Trust 1 will also take into account the net capital gains of Trust 2.

It is unclear what the point was. Query whether decanting with a similar withdrawal right might allow the decanted trust to grow if, unlike this ruling, one would like to benefit one subset of beneficiaries.[671] It did not hold that Trust 1 would be treated as owning the assets of Trust 2 or that the sale of assets from Trust 1 to Trust 2 would be disregarded (although presumably the sale of assets from Trust 2 to Trust 1 would be disregarded, given that Trust 1 would be deemed own the gain on that sale).

A variation of this might be:

- Trust 1 has GST inclusion ratio of zero, and the primary beneficiary has a general power of appointment to avoid GST tax.

- Same or different grantor establishes Trust 2, a nongrantor trust for the benefit of the same beneficiaries, except that the primary beneficiary has a nongeneral power of appointment (because GST exemption was allocated to Trust 2) and Trust 1 has the power to withdraw all of Trust 2's assets.

  - Many excellent lawyers suggest relying on Letter Ruling 201633021. However, that ruling did not address sales of assets between trusts. Although gain on sales from Trust 2 to Trust 1 are taxed to Trust 1 and therefore may be protected from income taxation, I have much less confidence about sales from Trust 1 to Trust 2.

  - Ultimately, one should rely not on private letter rulings (which are unavailable in the Code § 678 area when used to protect sales) but rather on the regulations. See part III.B.2.i.vii Portion Owned When a Gift Over $5,000 is Made.

  - If splitting off the portion with respect to which the withdrawal right has lapsed is desirable, see part III.B.2.i.viii.(b) Large Gift for Multiple Beneficiaries.

- For a right to withdraw only gross income that lapses over time, see text accompanying fn 2628 in part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary. A right to withdraw the entire trust would be a simpler version of that.

- If Trust 2 is grandfathered from GST and the lapse of the withdrawal "is treated to any extent as a taxable transfer under chapter 11 or chapter 12," then the lapsed amount "treated as if that portion had been withdrawn and immediately retransferred to the trust at the time of the release, exercise, or lapse."[672] A similar rule applies if Trust 2 is not grandfathered.[673] Might

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[671] See part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.

[672] Reg. § 26.2601-1(b)(1)(v)(A).

[673] Reg. § 26.2652-1(a)(5), Example (5), "Effect of lapse of withdrawal right on identity of transferor," provides:

> T transfers $10,000 to a new trust providing that the trust income is to be paid to T's child, C, for C's life and, on the death of C, the trust principal is to be paid to T's grandchild, GC. The trustee has discretion to distribute principal for GC's benefit during C's lifetime. C has a right to withdraw $10,000 from the trust for a 60-day period following the transfer. Thereafter, the power lapses.

a lapse of Trust 1's withdrawal right, exercisable by its trustee, that exceeds 5% of the value of Trust 2 constitute a taxable transfer? See part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts.

- Because of the concerns described above, I would rather the withdrawal right be a one-time withdrawal right of Trust 2's corpus and that Trust 2 be funded by no more than $5,000. See part III.B.2.i.ii Building Up Trust. Trust 1 then might have an ongoing power to borrow from Trust 2 for adequate interest but not adequate security. See part III.B.2.h.iv Borrow Power.

The beneficiary of a nongrantor trust can, through the exercise of a power of appointment, create a charitable remainder trust for a term of years where the original trust is the noncharitable beneficiary.[674]

II.D.4. Disregarding Multiple Owner Trust for Income Tax Purposes

II.D.4.a. Investment Trusts

II.D.4.a.i. Classifying an Investment Trust

An investment trust with a single class of ownership interests, representing undivided beneficial interests in the trust's assets, will be classified as a trust if the trust agreement does not authorize varying the investment of the certificate holders.[675]

> If the investment trust has multiple classes of ownership interests, but the trust agreement does not authorize varying the investment of the certificate holders, it will be classified as a trust if the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose.[676] However, if an investment trust with multiple classes of ownership interests is not described in the preceding sentence, ordinarily it will be classified as a business entity.[677]

C does not exercise the withdrawal right. The transfer by T is subject to Federal gift tax because a gift tax is imposed under section 2501(a) (without regard to exemptions, exclusions, deductions, and credits) and, thus, T is treated as having transferred the entire $10,000 to the trust. On the lapse of the withdrawal right, C becomes a transferor to the extent C is treated as having made a completed transfer for purposes of chapter 12. Therefore, except to the extent that the amount with respect to which the power of withdrawal lapses exceeds the greater of $5,000 or 5% of the value of the trust property, T remains the transferor of the trust property for purposes of chapter 13.

[674] Letter Ruling 9821029.

[675] Reg. § 301.7701-4(c)(1), citing *Commissioner v. North American Bond Trust*, 122 F.2d 545 (2d Cir. 1941), cert. denied, 314 U.S. 701 (1942).

[676] Reg. § 301.7701-4(c)(1).

[677] Reg. § 301.7701-4(c)(1). If the timing of payments is sufficiently similar to that found in a preferred partnership, the trust effectively creates investment interests with respect to the trust's assets that differ significantly from direct investment in the assets and therefore is classified as a business entity. See Reg. § 301.7701-4(c)(2), contrasting Example (1)(classified as business entity) with Example (2) (classified as trust). If a trust holds publicly traded stock and creates classes of ownership interest in the trust, which effectively separate dividend rights from a portion of the right to appreciation in the stock's value, so that the investors, by transferring one of the certificates and retaining the other, can fulfill their

Letter Ruling 202347001 involved the following facts:

> Taxpayer structures a variety of mortgage-backed securities offerings pursuant to multi-class mortgage-backed securities programs maintained by Agencies. In each case, qualified mortgages[1] are conveyed to a trust (referred to herein as a "REMIC Trust" or a "Grantor Trust," each defined below) pursuant to the terms of a trust agreement in exchange for several classes of mortgage-backed pass-through certificates (each such certificate (other than the residual class) is referred to herein as a "Certificate").
>
> > [1] For purposes of this letter, the term "qualified mortgages" includes certain pass-through certificates issued by single-class pass-through trusts that are classified as trusts for federal income tax purposes as well as REMIC regular interests or grantor trust certificates indirectly representing REMIC regular interests. *See* §§ 860G(a)(3); 1.860G-2(a)(5).
>
> For REMIC Trusts, each trust agreement requires that one or more Real Estate Mortgage Investment Conduit ("REMIC") elections be made with respect to the assets of the trust. With respect to each REMIC, one class of certificates is designated as the sole class of residual interest in the REMIC that is not entitled to distributions from the sole REMIC (or top-level REMIC in the case of a structure with tiers of REMICs). All other classes of certificates in each REMIC, referred to herein as "REMIC Certificates," are designated as classes of regular interests of the sole REMIC.[2]
>
> > [2] Each REMIC Certificate (other than a principal-only class) will bear interest at a fixed rate or floating rate permitted by § 1.860G-1(a)(3) or consist of a specified portion of the interest payments on qualified mortgages as described in § 1.860G-1(a)(2).
>
> For Grantor Trust transactions, qualified mortgages are conveyed to a trust that is or includes a grantor trust. These grantor trusts issue "Grantor Trust Certificates" representing discrete entitlements to income and principal.[3]
>
> > [3] Each Grantor Trust Certificate (other than a principal-only class) will bear interest at a fixed rate or floating rate or will consist of a specified portion (within the meaning of § 1.860G-1(a)(2)) of the interest payments on grantor trust certificates backed by qualified mortgages.
>
> Taxpayer offers Certificates for sale to its customers pursuant to the terms of an offering document. In many Agency transactions, the owner of a Certificate has the right to deposit the Certificate in a supplemental trust (an "Exchange Trust") in exchange for a proportionate interest in newly issued classes of pass-through certificates issued by the Exchange Trust (the "Exchange Certificates") in accordance with the Exchange Mechanism discussed below. Taxpayer intends to contribute all or a portion of a single class of Certificates to an Exchange Trust in exchange for Exchange Certificates.

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varying investment objectives of seeking primarily either dividend income or capital appreciation from the trust's stock, the trust is classified as a business entity. Reg. § 301.7701-4(c)(2), Example (3). However, this prohibition against stripping dividends does not extend to bonds, because Code § 1286 already allows investors to strip bonds without using an investment trust. Reg. § 301.7701-4(c)(2), Example (4).

The Exchange Trust

The sole assets of an Exchange Trust will be all the Certificates contributed by Taxpayer. Subsequent contributions of Certificates to the Exchange Trust must be of the same class that the Exchange Trust already holds.

All distributions made with respect to Certificates held by the Exchange Trust are immediately distributed in respect of the Exchange Certificates. The aggregate principal and interest entitlements on the Exchange Certificates received will equal the aggregate principal and interest entitlements on the Certificates deposited in the Exchange Trust.

The sole activities of an Exchange Trust will consist of accepting deposits of Certificates, issuing Exchange Certificates, and distributing principal and interest received in respect of the Certificates held by the Exchange Trust to the holders of the Exchange Certificates issued by the Exchange Trust. An Exchange Trust will not have the power to reinvest amounts collected on the Certificates held by the Exchange Trust. Taxpayer represents that an Exchange Trust will not be a taxable mortgage pool and will not be an obligor of debt instruments with two or more maturities within the meaning of §§ 7701(i)(2)(A)(ii) and 301.7701(i)-1(e).

The Exchange Certificates

The Exchange Certificates each represent the right to receive a portion of the interest and principal distributions on the underlying Certificates; each class of Exchange Certificate typically has rights to distributions of principal and/or interest on the underlying Certificates that differ from those of any other class of Exchange Certificates issued in respect of the Certificates. In each case, however, the aggregate distributions of principal and interest on the various classes of Exchange Certificates outstanding on any distribution date will always equal the distributions of principal and interest on the underlying Certificates for the distribution date. Further, the aggregate principal amount of any issued Exchange Certificates will always equal the principal amount of the underlying Certificates.

The Exchange Certificates will represent collectively a 100 percent beneficial ownership interest in the Exchange Trust and will be entitled to 100 percent of all amounts distributed in respect of the Certificates held by the Exchange Trust. They will be issued in multiple classes that will be separately assignable.

Exchange Certificates may provide for principal and interest, principal-only, or interest-only entitlements. Moreover, the Exchange Certificates' interest distributions may be based on fixed rates, floating rates, or inverse floating rates. For interest-only Exchange Certificates, there will be no right to receive principal, but interest payments will be based upon a notional principal amount. Each Exchange Certificate within a class will be entitled to a pro rata portion of payments allocated to the class. All Exchange Certificates (other than principal-only classes) will provide for interest distributions based on a fixed rate, a floating rate described in § 1.860G-1(a)(3), or a specified portion4 of the interest payments on the Certificates under § 1.860G-1(a)(2) as if the Exchange Trust were a REMIC. There exists in place a mechanism for accounting for the Exchange Certificates as separate bonds.

Exchange Certificates issued by an Exchange Trust will have the same maturity as the underlying Certificates exchanged for them. Each class of Exchange Certificates having a principal amount will receive on each distribution date a pro-rata portion of the principal distributions on the underlying Certificates based on the related principal amounts of each such class of Exchange Certificates immediately before the distribution (*i.e.*, no Exchange Certificates will be issued in a fast-pay/slow-pay structure or with any time-tranching).

The Exchange Mechanism

The Exchange Mechanism will operate in the following manner. Certificates may be deposited in exchange for Exchange Certificates on the issue date of the Certificates or any time thereafter and may occur repeatedly. Exchange Certificates may also be deposited into an Exchange Trust at any time in exchange for a proportionate interest in the underlying Certificates or for different classes of Exchange Certificates, provided the owner holds the necessary Exchange Certificates in the correct proportion to permit the exchange.

Each exchange, including the initial deposit of the Certificates (or portion thereof) in exchange for the Exchange Certificates, will be for matching amounts, in that: (1) the aggregate principal and interest entitlements on the Exchange Certificates received will equal the aggregate principal and interest entitlements on the Certificates or Exchange Certificates deposited in the Exchange Trust and (2) the Exchange Certificates or Certificates received from the Exchange Trust will retain the same tax attributes as the Certificates or Exchange Certificates deposited in the Exchange Trust. A certificate owner will be charged a fee for each exchange, generally based on a percentage of the principal amount of the certificates exchanged.

Although an Exchange Trust can accept additional deposits of Certificates over time, the subsequent deposits of Certificates must be the same class of Certificates as is already held by the Exchange Trust. Taxpayer represents that the exchanges will not be taxable events under § 1001 and that they involve no change in economic interests in underlying assets. Taxpayer further represents that the exchanges will not cause exchanging Certificate holders or non-exchanging Certificate holders to be entitled to a differing stream of aggregate payments from differing obligors. Additionally, Taxpayer represents that the exchanges will have no effect on the rights to principal or interest of any Certificate or Exchange Certificate holder not participating in the exchange.

Letter Ruling 202347001 included the following among its description of the law:

…. Rev. Ruls. 84-10, 1984-1 C.B. 155; 77-349, 1977-2 C.B. 20; and 74-169, 1974-1 C.B. 147, provide that the holders of a single class of certificates in a mortgage pass-through trust are treated as holding undivided interests in the pool of mortgages held by the trust….

Section 301.7701-4(c)(2), Example 4, applies this rule to a trust that holds bonds and issues certificates evidencing interests in the bonds. Example 4 provides:

> Corporation N purchases a portfolio of bonds and transfers the bonds to a bank under a trust agreement. At the same time, the trustee delivers to N certificates evidencing interests in the bonds. These certificates are sold to public investors.

> Each certificate represents the right to receive a particular payment with respect to a specific bond. Under section 1286, stripped coupons and stripped bonds are treated as separate bonds for federal income tax purposes. Although the interest of each certificate holder is different from that of each other certificate holder, and the trust thus has multiple classes of ownership, the multiple classes simply provide each certificate holder with a direct interest in what is treated under section 1286 as a separate bond. Given the similarity of the interests acquired by the certificate holders to the interests that could be acquired by direct investment, the multiple classes of trust interests merely facilitate direct investment in the assets held by the trust. Accordingly, the trust is classified as a trust.

A power to contribute assets to a trust that are identical to existing assets in exchange for new certificates identical to those already outstanding is not a power to vary because it does not change the economic position of existing certificate holders. *Comm'r v. Chase Nat'l Bank*, 122 F.2d 540 (2d Cir. 1941) (an investment trust holding stocks was not an association where the depositor could make up additional units of the same number and type of stock as originally deposited).

Rev. Rul. 90-7, 1990-1 C.B. 153, provides that the redemption of pass-through certificates issued by a fixed investment trust for a pro rata share of trust assets is not a realization event for the certificate holder who goes from being a co-owner of all of the trust's assets to a sole owner of a proportionate share of the trust's assets because the redemption effects no material change in his position.

Letter Ruling 202347001 ruled:

(1) The Exchange Certificates to be issued by the Exchange Trust will qualify as interests in stripped coupons or stripped bonds within the meaning of § 1286 (assuming that all Exchange Certificates issued by an Exchange Trust are not held by one person); and

(2) The Exchange Trust's Exchange Mechanism, including the ability to exchange fixed rate REMIC Certificates or Grantor Trust Certificates for floating rate and inverse floating rate Exchange Certificates, will not cause the Exchange Trust to fail to be classified as a fixed investment trust under § 301.7701-4(c).

A power to sell trust assets does not constitute a power to vary the investment.[678]

[678] Rev. Rul. 78-149 (holding that the authority to reinvest sale proceeds, rather than the authority to sell, causes a trust to be taxable as a business entity). Letter Ruling 201226019 held that a voting trust to hold stock in an S corporation qualified as an investment trust; the trust could sell stock in limited circumstances, although the ruling did not address the issue of the ability vary investments and did not cite Rev. Rul. 78-149, perhaps because the trust would terminate in that event. For additional guidance, see Rev. Ruls. 2004-86, 89-124 (OK to deposit additional assets and issue units within 90 days after trust's formation if the contributed assets are substantially the same as the assets originally contributed), 86-92, and 75-192. A voting trust may participate in a Code § 1036 exchange of stock. Letter Ruling 200618004.

A trust does not qualify as an investment trust when it holds a partnership interest to enable information to be provided to investors under the Reg. § 1.671-5 widely held fixed investment trusts rather than have the LLC partnership issue Schedule K-1s to investors.[679]

For more information, see Gray, "Investment Trusts, the Power to Vary, and Holding Partnership Interests," *Journal of Taxation* (WG&L), May 2016.[680]

For powers ordinarily withheld from the trustee of an investment trust that may be exercised in the COVID-19 pandemic, see Rev. Proc. 2020-34, described in part II.D.1 Trust as a Business Entity.

A land trust is more of an agency relationship than the buy-and-hold-or-sell-but-not-reinvest philosophy of an investment trust.[681]

II.D.4.a.ii. Tax Treatment of Investment Trusts

The beneficial owner is treated as a grantor under the grantor trust rules.[682] A person acquiring a beneficial owner's entire interest in a fixed investment trust becomes a grantor with respect to that interest.[683]

A beneficial owner of an investment trust does not realize gain or loss upon exchanging the certificates for a proportionate share of each of the trust's assets, other than cash.[684]

On the other hand, when a deemed owner sells its beneficial interest, the seller should be deemed to sell a proportionate share of each of the trust's assets to the buyer.[685]

II.D.4.a.iii. Practical Applications of Investment Trusts

Voting trusts are equivalent to investment trusts and expressly qualify to hold stock in an S corporation.[686]

Consider a formula gift or sale of real estate. The formula gift would be made public through the recorder of deeds, causing loss of privacy and messy detail that would create uncertainty in dealing with lenders and future buyers. Instead, the donor transfers the real estate to a unit investment trust, a simple event in the chain of title. Then the donor makes a formula transfer of the investment certificates.

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679 AM 2007-005.

680 Saved as Thompson Coburn LLP doc. no. 6392112.

681 See part II.D.6 Land Trusts.

682 Reg. § 1.671-2(e)(3). Because a beneficial owner of a unit investment trust is deemed to own the trust's assets, the assets can be distributed to the beneficial owner tax-free. Rev. Rul. 90-7.

683 Reg. § 1.671-2(e)(6), Examples (2) and (5), the latter which is reproduced in fn. 6612 in part III.B.2.h.i Who Is the Grantor.

684 Rev. Rul. 90-7, which was reaffirmed in Letter Ruling 202347001 in part II.D.4.a.i Classifying an Investment Trust.

685 See TAM 200814026, reproduced in part in fn. 6528 in part III.B.2.d.i.(a) General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation. TAM 200814026 did not deal with unit investment trusts, but its reasoning should apply.

686 See part III.A.3.b.iv A Trust Created Primarily to Exercise the Voting Power of Stock Transferred to It.

Sometimes partners (including LLC members treated as partners) disagree on whether to reinvest the proceeds from the sale of real estate. However, the partners are not direct owners of the property, so they cannot separately choose to have a tax-deferred like-kind exchange[687] inside the partnership. Instead, the partnership needs to distribute the property to the partners who want to achieve tax-deferral, and the distributees need to establish an investment purpose, which might be challenging in that they very recently obtained the property and intend to sell it rather than hold it. If all of the daily financial arrangements have been decided, such as through a long-term triple-net lease in which the owner does not maintain the property itself, consider using an investment trust hold the real estate and provide limited liability. That allows the real estate to be securitized and the beneficial owners to obtain like-kind exchange treatment on the transfer of the trust's underlying assets.[688] Such an arrangement may face challenges qualifying for the Code § 199A deduction for qualified business income.[689]

II.D.4.b. Liquidating Trusts

An organization will be considered a liquidating trust if both:[690]

- It is organized for the primary purpose of liquidating and distributing the assets transferred to it, and

- Its activities are all reasonably necessary to, and consistent with, the accomplishment of that purpose.

A liquidating trust is treated as a trust because it is formed with the objective of liquidating particular assets and not for the purpose the carrying on of a profit-making business which normally would be conducted through business organizations classified as corporations or partnerships.[691] However, if the liquidation is unreasonably prolonged or if business activities eventually become the trust's main focus, the trust will no longer be treated as a liquidating trust.[692] Arrangements to protect the interests of security holders during insolvency, bankruptcy, or corporate reorganization proceedings can begin as liquidating trusts but lose that status if later used to further the control or profitable operation of a going business on a permanent continuing basis.[693] Letter Ruling 201940004 approved continuing status as a liquidating trust when the Bankruptcy Court extended the term of a bankruptcy trust with an initial term of three years, approving extensions of two, three, and finally another three years, based on the trust's representation that, "due to continuing events outside the control of the trustee of Trust, it is not possible to completely liquidate" the trust, so that the final three-year extension was granted.

The IRS will rule on whether a liquidating trust is treated as such.[694]

[687] Code § 1031.
[688] Rev. Rul. 2004-86, which is quoted extensively in part II.D.1 Trust as a Business Entity.
[689] See part II.E.1.e.i.(a) Whether Real Estate Activity Constitutes A Trade Or Business.
[690] Reg. § 301.7701-4(d).
[691] Reg. § 301.7701-4(d).
[692] Reg. § 301.7701-4(d).
[693] Reg. § 301.7701-4(d).
[694] Rev. Proc. 82-58 which specifies the conditions that must be present before the IRS will consider issuing advance rulings whether a liquidating trust is treated as such or as a business entity under Reg. § 301.7701-4, and Rev. Proc. 91-15 provides a checklist that must accompany all such requests. Rev. Rul. 72-137 discusses the treatment of liquidating trusts as grantor trusts. For grantor trusts

A case involving liquidating trusts is in the text accompanying fn 664 in part II.D.2 Business Entity as Grantor of Tru.

II.D.4.c. Environmental Remediation Trusts

An environmental remediation trust receives a special classification as a trust if all of the following apply:[695]

- It is organized under state law as a trust; the primary purpose of the trust is collecting and disbursing amounts for environmental remediation of an existing waste site to resolve, satisfy, mitigate, address, or prevent the liability or potential liability of persons imposed by federal, state, or local environmental laws;[696]

- All contributors to the trust have (at the time of contribution and thereafter) actual or potential liability or a reasonable expectation of liability under federal, state, or local environmental laws for environmental remediation of the waste site; and

- The trust is not a qualified settlement fund.[697]

This classification is because its primary purpose is environmental remediation[698] of an existing waste site and not the carrying on of a profit-making business that normally would be conducted through business organizations classified as corporations or partnerships.[699]

If the remedial purpose is altered or business or investment activities dominate such that the declared remedial purpose is no longer controlling, the organization will no longer be classified as a trust.[700]

Each contributor to the trust is treated as the owner of the portion of the trust contributed by that person under the grantor trust rules, including treatment of that person as the owner of a portion of a trust applied in discharge of the grantor's legal obligation.[701] The trust needs to file a Form 1041 with a grantor information statement that includes certain specified items.[702]

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generally, see part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

[695] Reg. § 301.7701-4(e)(1).

[696] For purpose of this test, persons have potential liability or a reasonable expectation of liability under federal, state, or local environmental laws for remediation of the existing waste site if there is authority under a federal, state, or local law that requires or could reasonably be expected to require such persons to satisfy all or a portion of the costs of the environmental remediation.

[697] As defined in Reg. § 1.468B-1(a).

[698] For purpose of this test, "environmental remediation" includes the costs of assessing environmental conditions, remedying and removing environmental contamination, monitoring remedial activities and the release of substances, preventing future releases of substances, and collecting amounts from persons liable or potentially liable for the costs of these activities. Reg. § 301.7701-4(e)(1).

[699] Reg. § 301.7701-4(e)(1).

[700] Reg. § 301.7701-4(e)(1).

[701] Reg. § 301.7701-4(e)(2), referring to Code § 677 and Reg. § 1.677(a)-1(d). See also fn 4663 in part II.Q.6.c Possible Adverse Consequences When Contributing Partnership Interest to Charitable Remainder Trust, discussing contributions of property subject to debt.

[702] Reg. § 301.7701-4(e)(2).

II.D.5. Severing Trusts with Multiple Grantors

If a multiple grantor trust is not a business trust under part II.D.1 Trust as a Business Entity and is not described in part II.D.4 Disregarding Multiple Owner Trust for Income Tax Purposes, generally one will need to separate it at some point.

First, note that, for fiduciary income tax purposes, to the extent such person directly or indirectly makes a gratuitous transfer of property to a trust, that person is considered the grantor.[703]

If more than one person transfers property to a trust, the portions of the trust attributable to the different transferors are treated as separate trusts for GST purposes.[704] The GST rules recognize the severance of such trusts.[705]

Severing a trust does not trigger gain or loss if an applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust and any non-pro rata funding of the separate trusts resulting from the severance, whether mandatory or in the trustee's discretion, is authorized by an applicable state statute or the governing instrument.[706] See also part II.J.8.d.i Distribution in Kind - Generally regarding non-pro rata distributions.

II.D.6. Land Trusts

An interest in an Illinois land trust constitutes real property that may qualify for a nontaxable like-kind exchange[707] for other real property, so long as the arrangement involving the land trust is not treated as a business entity.[708] The following arrangement qualified for this treatment:

- The grantor created an Illinois land trust, under which he was the beneficiary. The trust's purpose was to hold title to Illinois real property that the grantor had held for investment purposes. The beneficiary's interest in the trust was characterized as personal property under state law.

- The beneficiary or any person designated by the beneficiary has the exclusive power to direct or control the trustee in dealing with the title to the property in the land trust.

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[703] Reg. § 1.671-2(e)(1) provides (emphasis added):

> For purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(2) of this section) of property to a trust.

[704] Reg. § 26.2654-1(a)(2), "Multiple transferors with respect to single trust," is reproduced in part III.B.1.d.iii Who Is the Transferor.

[705] Reg. § 26.2654-1(a)(3), "Severance of a single trust," provides:

> A single trust treated as separate trusts under paragraphs (a)(1) or (2) of this section may be divided at any time into separate trusts to reflect that treatment. For this purpose, the rules of paragraph (b)(1)(ii)(C) of this section apply with respect to the severance and funding of the severed trusts.

For more discussion on the desirability of such a division, see the text accompanying and preceding fn 6403 in part III.B.1.d.iii Who Is the Transferor.

[706] Reg. § 1.1001-1(h).

[707] Code § 1031.

[708] Rev. Rul. 92-105.

- The beneficiary has the exclusive control of the management of the property and the exclusive right to the earnings and proceeds from the property.

- Any person dealing with the trustee would take any interest in the trust's property free and clear of the claims of the grantor/beneficiary.

- The trust paid the trustee an annual fee, and the trust agreement authorized the trustee to execute deeds, mortgages, or otherwise deal with the legal title of the property at the beneficiary's direction.

- The beneficiary retained the exclusive control of the management, operation, renting, and selling of the land, together with the exclusive right to the earnings and proceeds from the land. The beneficiary was required to file all tax returns, pay all taxes, and satisfy any other liabilities with respect to the land.

- The beneficiary also retained the right to assign his interest in the Illinois land trust.

- The trust agreement precluded the trustee from disclosing the beneficiary's identity unless directed to do so by the beneficiary in writing.

Although the ruling applies to Illinois land trusts, it recognized that other states' common law and statutes permitted similar arrangements, which would receive the same treatment if:[709]

- The trustee has title to real property;

- The beneficiary (or a designee of the beneficiary) has the exclusive right to direct or control the trustee in dealing with the title to the property; and

- The beneficiary has the exclusive control of the management of the property, the exclusive right to the earnings and proceeds from the property, and the obligation to pay any taxes and liabilities relating to the property.

Similarly, a *fideicomiso* or Mexican Land Trust arrangement ("MLT"), is disregarded as a trust, and the beneficiary is treated as the owner, for U.S. income tax purposes.[710] Because the Mexican Federal Constitution prohibits non-Mexican persons from directly holding title to

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[709] Rev Rul. 92-105. The ruling mentioned that other states, such as California, Florida, Hawaii, Indiana, North Dakota, and Virginia, then had statutorily or judicially sanction arrangements that are similar to the Illinois land trust arrangement described in the ruling.

[710] Rev. Rul. 2013-14. Shortly after the ruling was issued, the AICPA applauded the ruling, stating at http://www.aicpa.org/Advocacy/Tax/TrustEstateGift/DownloadableDocuments/Trust%20Advocacy%20Documents/aicpa_comments_on_Rev_Rul_2013-14_submitted.pdf:

> The holding in the revenue ruling means that many U.S. taxpayers finally have certainty on the U.S. tax treatment of such common MLTs, and will no longer need to incur the expense and burden associated with preparing and filing the Form 3520 and Form 3520-A foreign trust reporting forms on a protective basis.

However, the AICPA noted certain limitations:

> We realize that the ruling does not apply if the MLT owns any other property or is permitted or required to engage in any activity beyond holding legal title to the Mexican real property. Therefore, we will continue to review trust agreements to evaluate these points.

The AICPA's resource page on Foreign Trust Documents is at http://www.aicpa.org/Advocacy/Tax/TrustEstateGift/Pages/ForeignTrustAdvocacyDocuments.aspx.

residential real property in certain areas of Mexico, they hold such property through an MLT with a Mexican bank after obtaining a permit from the Mexican government.[711] The MLT qualifying for this treatment had the following characteristics:

- The beneficiary has the right to sell without permission from the trustee.

- The trustee must grant a security interest in the property to a third party, such as a mortgage lender, if the beneficiary so requests.

- The beneficiary is directly responsible for the payment of all liabilities relating to the property, including pay any Mexican real estate taxes directly to the Mexican taxing authority.

- The beneficiary has the exclusive right to possess the property and to make any desired modifications, limited only by the need to obtain the proper licenses and permits in Mexico. If the property is occasionally leased, the beneficiary directly receives the rental income and reports the income on the beneficiary's U.S. federal income tax return.

- The trustee disclaims all responsibility for the property, including obtaining clear title and defending or maintaining the property.

- The trustee collects a nominal annual fee from the beneficiary.

- No other agreement or arrangement is in place between one or more of the beneficiary, trustee, or any third party that would cause the overall relationship to be classified as a partnership (or any other type of entity) for U.S. federal income tax purposes.

If qualification as a land trust is in doubt, consider a unit investment trust.[712]

II.D.7. Sham Trusts

The Tax Court looks to the following factors to determine whether a trust has economic substance:[713]

(1) whether the taxpayer's relationship to the transferred property differed materially before and after the trust's creation;

(2) whether the trust had an independent trustee;

(3) whether an economic interest passed to other trust beneficiaries; and

(4) whether the taxpayer respected restrictions imposed on the trust's operation as set forth in the trust documents or by the law of trusts.

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[711] Rev. Rul. 2013-14. I have been told that Mexico has a capital gain tax and that it has a real estate transfer tax of up to 4.5%, so one needs to be careful to structure ownership correctly from inception.
[712] See part II.D.4.a Investment Trust.
[713] *Close v. Commissioner*, T.C. Memo. 2014-25, citing *Markosian v. Commissioner*, 73 T.C. 1235, 1243-1244 (1980).

II.E. Recommended Structure for Entities

II.E.1. Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities

Below is a comparison of annual federal and state income tax burdens when the owners are in the highest or in a modest tax bracket, based on calculations shown in Parts II.E.1.a Taxes Imposed on C Corporations and II.E.1.b Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships. The assumptions made in putting together the chart can be criticized, but hopefully reviewing them helps one understand the post-2017 paradigm.

Moderate State Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Distributing 100% of Corporate Net Income After Income Tax	47.3%	40.8%
Distributing 50% of Corporate Net Income After Income Tax	36.7%	33.4%
Distributing None of Corporate Net Income After Income Tax	26.0%	26.0%
S Corporation, Partnership, or Sole Proprietorship (Pass-Through)	34.6%-45.8%	27.4%-46.2%

<u>Note, however, that distributing less than 100% of corporate net income after tax does not reflect the true tax cost, because additional tax will often be incurred when extracting the earnings later through a dividend or sale.</u> For a discussion of the extent to which that is true and how choice of entity affects exit strategies, see part II.E.2.a Transferring the Business.

Also consider that the excess of pass-through income tax rates over corporate rates is at an all-time high.

A partnership or S corporation that does business in many states incurs extra state compliance obligations, because states often require withholding on nonresident owners, require all owners to file in all of those states, or require both. Also note that individuals or trusts owning pass-through businesses will be able to deduct little or no of the state income tax on their business income, whereas C corporations are not subject to such limitations.[714]

For a start-up entity, consider that most businesses lose money initially, and some never get into the black. An LLC taxed as a sole proprietorship or partnership is a much better vehicle for

[714] See text accompanying fn 20 in part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment.

deducting losses[715] than is an S corporation[716] or C corporation.[717] If one is enamored with corporate income taxation, one might start as an LLC and then contribute the LLC to a corporation when one becomes sufficiently profitable to save taxes.[718] The disadvantage of such an approach occurs when the owner is in a low tax bracket, so that losses provide little, if any, benefit; in that case, having the C corporation carry forward its losses to offset them against income that would otherwise have been taxed at a higher rate – and relying on Code § 1244 for ordinary loss treatment if the business is unsuccessful[719] – might be of greater benefit.

Incentive pay and deferred compensation can be more difficult in a corporate setting than in a partnership setting.[720] However, C corporations provide better fringe benefits.[721]

II.E.1.a. Taxes Imposed on C Corporations

For taxable years beginning after December 31, 2017, all C corporations pay tax at a flat 21% rate, unless some industry-specific exclusions, such as those for insurance companies, apply.[722] However, if a C corporation receives a dividend from another corporation, only part of that dividend is taxed,[723] reducing the effective tax rate to 10.5% for dividends from unrelated companies or zero or 7.35% for dividends from affiliates.

Below includes discussion of Biden's 2020 plan to increase rates, which never came to fruition and if unlikely to unless the Democrats get a solid majority in the House and Senate. However, he did succeed in imposing a 15% corporate alternative minimum tax under Code § 55 on billion-dollar C corporations, which is explained to some extent by Notice 2023-7.

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[715] See part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner, especially part II.G.4.e Basis Limitations for Partners in a Partnership.
[716] See part II.A.2 S Corporation.
[717] See parts II.G.4.b C Corporations: Losses Incurred by Business, Owner, or Employee and II.G.4.f Comparing C Corporation Loss Limitations to Those for Partnership and S Corporation Losses.
[718] Although one could just "check the box" by filing Form 8832 or 2553, as the case may be, contributing an interest in the LLC sets one up for an ideal entity structure and avoids possible (remote) self-employment tax issues. See parts II.E Recommended Structure for Entities and II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election, respectively. For entity conversion issues, see part II.P.3 Conversions.
[719] See parts II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244 and II.J.11.b Code § 1244 Treatment Not Available for Trusts.
[720] See parts II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules and II.M.4.f.i Overview of Profits Interest; Contrast with Code § 409A.
[721] See part II.P.2 C Corporation Advantage Regarding Fringe Benefits.
[722] Code § 11(a), (b). Code § 11(c) provides that corporate income tax does not apply to a corporation subject to a tax imposed by:

(1) section 594 (relating to mutual savings banks conducting life insurance business),
(2) subchapter L (sec. 801 and following, relating to insurance companies), or
(3) subchapter M (sec. 851 and following, relating to regulated investment companies and real estate investment trusts).

Code § 11(d), "Foreign corporations," provides:

> In the case of a foreign corporation, the tax imposed by subsection (a) shall apply only as provided by section 882.

[723] See fns. 9-13 in part II.A.1.a C Corporations Generally.

Biden would raise the top corporate income tax rate to 28% and increase the top income tax rate on dividends to 39.6% (before 3.8% net investment income tax).

In addition to taxes on annual operations, consider:

- Dividends to shareholders, which are distributions out of a corporation's current or accumulated earnings and profits, are subject to regular tax at capital gain rates[724] (if qualified dividends)[725] and the 3.8% tax on net investment income.[726] However, Biden proposed that high-income taxpayers' long-term capital gains would be taxed at 39.6% instead of 20%.

- A corporation that does not pay dividends may become subject to the 20% accumulated earnings tax or personal holding company income tax. See part II.E.1.a.iii Incentives to Declare Dividends.

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724 Code §§ 1(h)(3), 1(h)(11)(A).

725 Code § 1(h)(11)(B) provides the following parameters for "qualified dividend income":

(i) *In general*. The term "qualified dividend income" means dividends received during the taxable year from-
  (I) domestic corporations, and
  (II) qualified foreign corporations.

(ii) *Certain dividends excluded*. Such term shall not include-
  (I) any dividend from a corporation which for the taxable year of the corporation in which the distribution is made, or the preceding taxable year, is a corporation exempt from tax under section 501 or 521,
  (II) any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.), and
  (III) any dividend described in section 404(k).

(iii) *Coordination with section 246(c)*. Such term shall not include any dividend on any share of stock-
  (I) with respect to which the holding period requirements of section 246(c) are not met (determined by substituting in section 246(c) "60 days" for "45 days" each place it appears and by substituting "121-day period" for "91-day period"), or
  (II) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Elaborating on Code § 1(h)(11)(B)(i)(II), Code § 1(h)(11)(C) provides rules for qualified foreign corporations.

Code § 1(h)(11)(D) provides special rules:

(i) *Amounts taken into account as investment income*. Qualified dividend income shall not include any amount which the taxpayer takes into account as investment income under section 163(d)(4)(B). [My note: This relates to income against which investment interest may be deducted. See part II.G.20.a Code § 163(j) Limitation on Deducting Business Interest Expense, which mentions in passing investment interest expense.]

(ii) *Extraordinary dividends*. If a taxpayer to whom this section applies receives, with respect to any share of stock, qualified dividend income from 1 or more dividends which are extraordinary dividends (within the meaning of section 1059(c)), any loss on the sale or exchange of such share shall, to the extent of such dividends, be treated as long-term capital loss.

(iii) *Treatment of dividends from regulated investment companies and real estate investment trusts*. A dividend received from a regulated investment company or a real estate investment trust shall be subject to the limitations prescribed in sections 854 and 857.

726 See part II.I 3.8% Tax on Excess Net Investment Income (NII).

- A corporation that distributes property to its shareholders generally is subject to tax on the excess of value over basis (but cannot deduct a loss). See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

II.E.1.a.i. Corporate Tax Rates in Moderate Tax States

Let's examine the effects of earning $100,000 taxable income inside the corporation and distributing various proportions of the net after-tax profits, assuming the taxpayer lives in a state that imposes moderate (5%) income tax on corporations and individuals. The individual in a top bracket is assumed taxed at a rate of 48.4%, consisting of 39.6% capital gain tax, 3.8% net investment income tax, and 5% state income tax. The individual in a modest bracket is assumed taxed at a rate of 20%, consisting of 15% capital gain tax, no net investment income tax, and 5% state income tax.

Distributing 100% of Corporate Net Income After Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,000
Federal and State Income Tax	-26,000	-26,000
Net Income after Income Tax	$74,000	$74,000
Income Taxes at 28.8% or 20%	-21,312	-14,800
Net Cash to Owner	$52,688	$59,200

Note that the tax rates above seem somewhat high – 47.3% or 40.8%, depending on whether the shareholder is in a high or modest bracket. The corporation might try paying more compensation to avoid double taxation, but compensation income is taxed at ordinary income rates, and the employer's and employee's share of FICA combines to add tax equal to 2.5%-13.3%.[727] So, add that tax to the employee's federal, state, and local income tax rate and compare to the above. Consider, however, that a corporation cannot deduct more than reasonable compensation - see part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment – and in 2017 the IRS has instructed its examiners how to prevent taxpayers from contesting the issue in Tax Court.[728]

[727] The tax hit is 2.9%-15.3%, as described in part II.E.1.b Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships, text accompanying fn 732-734. However, the employer's deduction for half of this amount at an assumed 26% rate lowers the effective rate to 2.5%-13.3%.
[728] See fns. 85-87 in part II.A.2.c Avoiding Double Taxation and Self-Employment Tax.

Here is the same chart under Biden, with federal corporate tax rate increased from 21% to 28% and the top federal income tax rate on dividends increased from 20% to 39.6%:

Biden Plan		
Distributing 100% of Corporate Net Income After Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,000
Federal and State Income Tax	-33,000	-33,000
Net Income after Income Tax	$67,000	$67,000
Income Taxes at 48.4% or 20%	-32,428	-13,400
Net Cash to Owner	$34,572	$53,600

Returning to current law:

Distributing 50% of Corporate Net Income After Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,000
Federal and State Income Tax	-26,000	-26,000
Net Income after Income Tax	$74,000	$74,000
Distribution to Owner	$37,000	$37,000
Income Taxes at 28.8% or 20%	-10,656	-7,400
Net Cash to Owner	$26,344	$29,600
Corporate Cash Plus Shareholder Cash	$63,344	$66,600

Here is the same chart under Biden, with federal corporate tax rate increased from 21% to 28% and the top federal income tax rate on dividends increased from 20% to 39.6%:

Biden Plan		
Distributing 50% of Corporate Net Income After Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,000
Federal and State Income Tax	-33,000	-33,000
Net Income after Income Tax	$67,000	$67,000
Distribution to Owner	$33,500	$33,500
Income Taxes at 48.4% or 20%	-16,214	-6,700
Net Cash to Owner	$17,286	$26,800
Corporate Cash Plus Shareholder Cash	$50,786	$60,300

Returning to current law:

Distributing None of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-26,000
Net Income after Income Tax	$74,000

Here is the same chart under Biden, with federal corporate tax rate increased from 21% to 28%:

Biden Plan	
Distributing None of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-33,000
Net Income after Income Tax	$67,000

II.E.1.a.ii. Corporate Tax Rates in California

Let's examine the effects of earning $100,000 taxable income inside the corporation and distributing various proportions of the net after-tax profits, assuming the taxpayer lives in California, which imposed an 8.84% corporate tax rate. The individual in a top bracket is assumed taxed at a rate of 37.1%, consisting of 20% capital gain tax, 3.8% net investment income tax, and 13.3% state income tax.

Distributing 100% of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-29,800
Net Income after Income Tax	$70,200
Income Taxes at 37.1%	-26,044
Net Cash to Owner	$44,156

Note that the effective annual tax rate above seems somewhat high at just under 56%. The corporation might try paying more compensation to avoid double taxation, but compensation income is taxed at ordinary income rates, and the employer's and employee's share of FICA combines to add tax equal to 2.5%-13.3%.[729] So, add that tax to the employee's federal, state, and local income tax rate and compare to the above. Consider, however, that a corporation cannot deduct more than reasonable compensation - see part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment – and in 2017 the IRS has instructed its examiners how to prevent taxpayers from contesting the issue in Tax Court.[730]

Biden would raise the top corporate income tax rate to 28% and increase the top income tax rate on dividends to 39.6% (before 3.8% net investment income tax). This would increase the top corporate rate in California to approximately 36.8% (28% + 8.84%) and the top individual rate for dividends of 56.7%, consisting of 39.6% capital gain tax, 3.8% net investment income tax, and 13.3% state income tax.

Biden Plan	
Distributing 100% of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-36,800
Net Income after Income Tax	$63,200
Income Taxes at 56.7%	-35,834
Net Cash to Owner	$27,366

[729] The tax hit is 2.9%-15.3%, as described in part II.E.1.b Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships, text accompanying fn 732-734. However, the employer's deduction for half of this amount at an assumed 26% rate lowers the effective rate to 2%-13%.
[730] See fns. 85-87 in part II.A.2.c Avoiding Double Taxation and Self-Employment Tax.

Here's distributing half of the profits:

Distributing 50% of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-29,800
Net Income after Income Tax	$70,200
Distribution to Owner	$35,100
Income Taxes at 37.1%	-13,022
Net Cash to Owner	$22,078
Corporate Cash Plus Shareholder Cash	$57,178

Distributing half under Biden's plan:

Biden Plan	
Distributing 50% of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-36,800
Net Income after Income Tax	$63,200
Distribution to Owner	$31,600
Income Taxes at 56.7%	-17,917
Net Cash to Owner	$13,683
Corporate Cash Plus Shareholder Cash	$45,283

No distributions under current law:

Distributing None of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-29,800
Net Income after Income Tax	$70,200

No distributions under Biden's plan:

Biden Plan	
Distributing 50% of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-36,800
Net Income after Income Tax	$63,200

So, effective tax rates under current law are 55.8% distributing all earnings, 42.8% distributing half of the earnings, and 29.8% distributing none of the earnings.

Effective tax rates under the Biden plan are 72.6% distributing all earnings, 54.7% distributing half of the earnings, and 36.8% distributing none of the earnings.

II.E.1.a.iii. Incentives to Declare Dividends

Many years ago, Congress incentivized corporations to declare dividends, through the imposition of two taxes:

- Personal holding company tax. A personal holding company is taxed on 20% of its undistributed personal holding company income. See part II.A.1.e Personal Holding Company Tax.

- Accumulated earnings tax. Generally, a C corporation that accumulates funds could be subject to the 20% accumulated earnings tax on its excess undistributed accumulated earnings and profits. The corporation needs to articulate specific reasons why its needs to reinvest its earnings. For details, see part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax. This tax does not apply to personal holding companies (as used in the preceding bullet point). If the company not a personal holding company but is a mere holding or investment company, the tax kicks in if undistributed earnings exceed $125,000.[731]

Each of these taxes can be avoided by paying sufficient dividends. The corporation may manage these taxes by actual or deemed dividends; see the relevant tax for rules on the extent to which this is permitted and how to do it.

II.E.1.b. Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships

Generally, S corporations and partnerships do not pay entity-level income tax; instead, their owners pay tax on their distributive share of the entity's income. However, some state or local governments do impose an entity-level tax, which may be in addition to imposing income tax on the owners' distributive share of the entity's income.

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[731] See fn 4850 in part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax.

Tax reform in 2017 introduced a deduction of up to 20% of business earnings. See part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

An owner of a partnership or sole proprietorship also generally pays tax self-employment ("SE") tax on income from a trade or business, subject to various exceptions; see part II.L Self-Employment Tax (FICA). SE tax is 15.3% OASDI and Medicare taxes until the taxpayer reaches the taxable wage base ($160,200 in 2023 and $168,600 in 2024),[732] then is 2.9% Medicare tax until it reaches 3.8%, when the supplemental Medicare tax (employee's portion) kicks in.[733] The employer's portion of SE tax, which is 7.65% up to the taxable wage base and 1.45% thereafter, is deductible in determining adjusted gross income (not as an itemized deduction).[734]

An owner of an S corporation or partnership may pay the 3.8% tax on net investment income ("NII"); see part II.I 3.8% Tax on Excess Net Investment Income (NII). SE income is excluded from NII.[735] The deduction for the employer's share of SE tax makes SE tax preferable to NII tax, except to the extent that the income would be below the taxable wage base.

To the extent that an owner's distributive share of a partnership's or S corporation's income is reinvested, the owner's basis in the partnership interest[736] or stock[737] increases. Generally, an owner can withdraw the earnings tax-free, merely reducing basis in the owner's partnership interest or stock. See parts II.Q.8.b.i Distribution of Property by a Partnership and II.Q.7.b Redemptions or Distributions Involving S Corporations. However, an S corporation that distributes property triggers tax on the gain,[738] which gain is taxed at its shareholders' respective income tax rates and in many cases does not qualify for favorable capital gain rates.[739]

Let's examine the effects of earning $100,000 taxable income inside the entity, assuming the taxpayer lives in a state that imposes moderate (5%) income tax on corporations and individuals:

An individual in a top bracket might be taxed at a rate of 34.6%-45.8%, consisting of:

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732 See http://www.ssa.gov/OACT/COLA/cbb.html for the current amount.

733 See fns 3391-3393 in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.

734 Code § 164(f), "Deduction for one-half of self-employment taxes," provides:

(1) *In general*. In the case of an individual, in addition to the taxes described in subsection (a), there shall be allowed as a deduction for the taxable year an amount equal to one-half of the taxes imposed by section 1401 (other than the taxes imposed by section 1401(b)(2)) for such taxable year.

(2) *Deduction treated as attributable to trade or business*. For purposes of this chapter, the deduction allowed by paragraph (1) shall be treated as attributable to a trade or business carried on by the taxpayer which does not consist of the performance of services by the taxpayer as an employee.

735 As to SE income being excluded from NII, see fn 2290 in part II.I.5 What is Net Investment Income Generally.

736 Code § 705.

737 Code § 1367, which is reproduced in part II.G.4.d.i Basis Limitation Generally.

738 See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

739 See parts II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business and II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).

- 29.6%-37% ordinary income tax (depending on whether the Code § 199A 20% deduction is available)

- zero-3.8% net investment income tax (working in the business may avoid this tax, and exceptions to SE tax may apply as well), and

- 5% state income tax.

Biden wants to raise the top bracket from 37% to 39.6% and disallow the Code § 199A deduction for such individuals. An individual in a top bracket might be taxed at a rate of 44.6%-48.4%, consisting of:

- 39.6% ordinary income tax,

- zero-3.8% net investment income tax (working in the business may avoid this tax, and exceptions to SE tax may apply as well), and

- 5% state income tax.

An individual in a modest bracket might be taxed at a rate of 27.4%-46.2%, consisting of:

- 22.4%-28% ordinary income tax (depending on whether the Code § 199A 20% deduction is available, and the wage limitations[740] and restrictions on types of businesses do not apply to modest income taxpayers)

- zero-13.2% SE tax income tax (after considering the deduction for one-half of SE tax)

- 5% state income tax.

In California, the rates are as follows, as described in part II.Q.1.a.ii California Scenarios:

S corporation income rate:	29.6%-37%	federal
	13.3%	state individual
	1.5%	state entity
	zero-3.8%	NII tax
	44.4%-55.6%	
Partnership income rate:	29.6%-37%	federal
	13.3%	state
	zero-3.8%	NII or SE tax
	42.9%-54.1%	

II.E.1.c. Code § 199A Pass-Through Deduction for Qualified Business Income

For taxpayers other than C corporations,[741] Code § 199A provides a deduction for taxable years beginning after December 31, 2017 but not beginning after December 31, 2025.[742] When applying Prop. Regs. §§ 1.199A-1 through 1.199A-6 or Regs. §§ 1.199A-1 through 1.199A-6, a

[740] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
[741] Code § 199A(a).
[742] Code § 199A(i).

reference to an individual includes a reference to a trust (other than a grantor trust) or an estate to the extent that the Code § 199A deduction is determined by the trust or estate under the rules of Reg. § 1.199A-6 or Reg. § 1.199A-6.[743] The Proposed Regulations and preamble, together with public comments, are found at https://www.federalregister.gov/documents/2018/08/16/2018-17276/qualified-business-income-deduction. The Final Regulations and preamble are found at https://www.govinfo.gov/content/pkg/FR-2019-02-08/pdf/2019-01025.pdf.

IRS training, "Qualified Business Income Deduction," is found at https://www.irs.gov/pub/newsroom/tcja-training-provision-11011-qbid.pdf.

In the case of a partnership or S corporation, Code § 199A applies at the partner or shareholder level.[744] In the case of an S corporation, an allocable share is the shareholder's pro rata share of an item.[745] The deduction does not reduce one's basis in one's partnership interest or S corporation stock.[746]

Grantor trusts are of course disregarded and their activity attributed to their deemed owners, but estates and nongrantor trusts compute their distributive net income ("DNI") with considering the Code § 199A deduction. Then they allocate each Code § 199A item to the trust and the beneficiaries according to their respective shares of DNI. The trust uses its taxable income for its Code § 199A calculation, and each beneficiary uses his or her taxable income for his or her own Code § 199A calculation. See part II.E.1.f Trusts/Estates and the Code § 199A Deduction.

The IRS is to "prescribe such regulations as are necessary to carry out the purposes of" Code § 199A, including regulations:[747]

> (A) for requiring or restricting the allocation of items and wages under this section and such reporting requirements as the Secretary determines appropriate, and
>
> (B) for the application of this section in the case of tiered entities.

The regulations implementing subparagraph (A) follow the definitions below. Prop. Reg. § 1.199A-1(f), "Effective/applicability date," provides:

> (1) *General rule*. Except as provided in paragraph (f)(2) of this section, the provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register.

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743 Reg. § 1.199A-1(a)(2), "Usage of term individual," provides:

> For purposes of applying the rules of §§ 1.199A-1 through 1.199A-6, a reference to an individual includes a reference to a trust (other than a grantor trust) or an estate to the extent that the section 199A deduction is determined by the trust or estate under the rules of § 1.199A-6.

744 Code § 199A(f)(1)(A)(i).

745 Code § 199A(f)(1)(A) (flush language).

746 Reg. § 1.199A-1(e)(1) provides:

> *Effect of deduction*. In the case of a partnership or S corporation, section 199A is applied at the partner or shareholder level. The rules of subchapter K and subchapter S apply in their entirety for purposes of determining each partner's or shareholder's share of QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income or loss. The section 199A deduction has no effect on the adjusted basis of a partner's interest in the partnership, the adjusted basis of a shareholder's stock in an S corporation, or an S corporation's accumulated adjustments account.

747 Code § 199A(f)(4).

However, taxpayers may rely on the rules of this section until the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register.

(2) *Exception for non-calendar year RPE*. For purposes of determining QBI, W-2 wages, and UBIA of qualified property, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

Reg. § 1.199A-1(f), "Effective/applicability date," provides that the final regulations apply to taxable years ending after the January 2019 date of publication in the Federal Register, except as provided below. Reg. § 1.199A-1(f)(2) is unchanged from the proposed regulation cited above and allows a fiscal year estate (including a qualified revocable trust electing taxation as such)[748] that distributes income to its beneficiaries to convert 2017 income into QBI. For example, suppose an S corporation issues a K-1 to an estate for calendar year 2017, and the estate elects a calendar year ending September 30, 2018. That K-1 is reported on the estate's return for a taxable year that begins before January 1, 2018 and ends after December 31, 2017, meaning that the K-1 will pass through QBI, W-2 wages and UBIA to the extent that the estate is an RPE.[749] The estate is an RPE only to the extent QBI is allocated to beneficiaries on K-1s issued to them.[750] The government is not disturbed by this conversion of 2017 income to QBI.[751] However, the RPE conducting the qualified trade or business may be – it might not have been expecting to compute QBI, W-2 wages and UBIA for 2017! Nevertheless, I believe that they are required to report this information, because S corporations[752] and partnerships[753] must separately report any items that affect an owner's tax return differently than the entity's overall taxable income.

The rules described in the various subparts of this part II.E.1.c apply to pass-throughs, but similar rules apply to any "specified agricultural or horticultural cooperative."[754]

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[748] See part II.J.7 Code § 645 Election to Treat a Revocable Trust as an Estate.

[749] See part II.E.1.f Trusts/Estates and the Code § 199A Deduction, text accompanying fn 980.

[750] See part II.E.1.f.i.(a) How Qualified Business Income Flows to Beneficiaries.

[751] The preamble to Prop. Reg. § 1.199A-6(d), REG-107892-18 (8/16/2018), explains:

> Section 199A applies to taxable years beginning after December 31, 2017. However, there is no statutory requirement under section 199A that a qualified item arise after December 31, 2017.

[752] See fns 994-996 in part II.E.1.f.ii Electing Small Business Trusts (ESBTs).

[753] Using language similar to regulations referred to in fn 753, Reg. § 1.702-1(a)(8)(ii) provides:

> Each partner must also take into account separately the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately.

Instructions for Form 1065 (2017), pages 34-35 provide much detail on how partnerships report items relating to Code § 199, which Code § 199A replaced. Instructions for Form 1065 (2018), pages 46-47 provide much detail on how partnerships report items relating to Code § 199A.

[754] Code § 199A(g) describes qualified entities and the related deduction, and
Rev. Proc. 2021-11 interprets "W-2 wages" under Code § 199A(g)(1)(B)(ii). The Senate report said (note that the Conference Committee reduced the deduction from 23% to 20% and pushed up the effective date by one year):

Reg. § 1.199A-1(b) provides the following definitions for Code § 199A and Regs. §§ 1.199A-1 through 1.199A-6:

(1) *Aggregated trade or business* means two or more trades or businesses that have been aggregated pursuant to § 1.199A-4.

(2) *Applicable percentage* means, with respect to any taxable year, 100 percent reduced (not below zero) by the percentage equal to the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return).

(3) *Net capital gain* means net capital gain as defined in section 1222(11) plus any *qualified dividend income* (as defined in section 1(h)(11)(B)) for the taxable year.

(4) *Phase-in range* means a range of taxable income between the threshold amount and the threshold amount plus $50,000 (or $100,000 in the case of a joint return).

(5) *Qualified business income* (QBI) means the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business (or aggregated trade or business) as determined under the rules of § 1.199A-3(b).

(6) *QBI component* means the amount determined under paragraph (d)(2) of this section.

(7) *Qualified PTP income* is defined in § 1.199A-3(c)(3).

(8) *Qualified REIT dividends* are defined in § 1.199A-3(c)(2).

(9) *Reduction amount* means, with respect to any taxable year, the excess amount multiplied by the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return). For purposes of this paragraph (b)(9), the *excess amount* is the amount by which 20 percent of QBI exceeds the greater of 50 percent of W-2 wages or the sum of 25 percent of W-2 wages plus 2.5 percent of the UBIA of qualified property.

(10) *Relevant passthrough entity* (RPE) means a partnership (other than a PTP) or an S corporation that is owned, directly or indirectly, by at least one individual, estate, or trust. Other passthrough entities including common trust funds as described in § 1.6032-T and religious or apostolic organizations described in section 501(d) are also treated as RPEs if the entity files a Form 1065, U.S. Return of Partnership Income, and is owned, directly or indirectly, by at least one individual, estate, or trust. A trust or estate is treated as an RPE to the extent it passes through QBI,

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For taxable years beginning after December 31, 2018 but not after December 31, 2025, a deduction is allowed to any specified agricultural or horticultural cooperative equal to the lesser of 23 percent of the cooperative's taxable income for the taxable year or 50 percent of the W-2 wages paid by the cooperative with respect to its trade or business. A specified agricultural or horticultural cooperative is an organization to which subchapter T applies that is engaged in (a) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, (b) the marketing of agricultural or horticultural products that its patrons have so manufactured, produced, grown, or extracted, or (c) the provision of supplies, equipment, or services to farmers or organizations described in the foregoing.

W-2 wages, UBI of qualified property, qualified REIT dividends, or qualified PTP income.[755]

(11) *Specified service trade or business* (SSTB) means a specified service trade or business as defined in § 1.199A-5(b).

(12) *Threshold amount* means, for any taxable year beginning before 2019, $157,500 (or $315,000 in the case of a taxpayer filing a joint return). In the case of any taxable year beginning after 2018, the threshold amount is the dollar amount in the preceding sentence increased by an amount equal to such dollar amount, multiplied by the cost-of-living adjustment determined under section 1(f)(3) of the Code for the calendar year in which the taxable year begins, determined by substituting "calendar year 2017" for "calendar year 2016" in section 1(f)(3)(A)(ii). The amount of any increase under the preceding sentence is rounded as provided in section 1(f)(7) of the Code. [My addition not in the regulations:] For taxable years beginning in 2019, the threshold amount is $321,400 for married filing joint returns, $160,725 for married filing separate returns, and $160,700 for any other returns.[756] For taxable years beginning in 2020, the threshold amount is $326,600 for married filing joint returns, $163,300 for married filing separate returns and for any other returns.[757]

(13) *Total QBI amount* means the net total QBI from all trades or businesses (including the individual's share of QBI from trades or business conducted by RPEs).

(14) *Trade or business* means a trade or business that is a trade or business under section 162 (a section 162 trade or business) other than the trade or business of performing services as an employee. In addition, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business for purposes of Section 199A, if the property is rented or licensed to a trade or business conducted by the individual or an RPE which is commonly controlled under § 1.199A-4(b)(1)(i) (regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under § 1.199A-4(b)(1)).

(15) *Unadjusted basis immediately after acquisition of qualified property* (UBIA of qualified property) is defined in § 1.199A-2(c).

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[755] [not in the regulation] The preamble to the final regulations, T.D. 9847 (2/8/2019), part II.A.2, "Relevant Passthrough Entity," explains:

> The proposed regulations define an RPE as a partnership (other than a PTP) or an S corporation that is owned, directly or indirectly, by at least one individual, estate, or trust. A trust or estate is treated as an RPE to the extent it passes through QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, or qualified PTP income. In response to a comment, the final regulations provide that other passthrough entities, including common trust funds as described in § 1.6032-T and religious or apostolic organizations described in section 501(d), are also treated as RPEs if the entity files a Form 1065, *U.S. Return of Partnership Income*, and is owned, directly or indirectly, by at least one individual, estate, or trust. The Treasury Department and the IRS decline to adopt the recommendation of another commenter to treat regulated investment companies (RICs) as RPEs because RICs are C corporations, not passthrough entities.

[756] Rev. Proc. 2018-57, § 3.27.

[757] Rev. Proc. 2019-44, § 3.27.

(16) *W-2 wages* means a trade or business's W-2 wages properly allocable to QBI as defined in § 1.199A-2(b).

These definitions and other authority within Code § 199A refer to a "trade or business," which is the basic unit for applying everything related to Code § 199A. Throughout my materials, I often use "business" to refer to a "trade or business."

Various items described in part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds are to be allocated pursuant to fn 747 above. Accordingly, Reg. § 1.199A-2(a) provides:[758]

(1) *In general*. This section provides guidance on calculating a trade or business's W-2 wages properly allocable to QBI (W-2 wages) and the trade or business's unadjusted basis immediately after acquisition of all qualified property (UBIA of qualified property). The provisions of this section apply solely for purposes of Section 199A of the Internal Revenue Code (Code).

(2) *W-2 wages*. Paragraph (b) of this section provides guidance on the determination of W-2 wages. The determination of W-2 wages must be made for each trade or business by the individual or RPE that directly conducts the trade or business (or aggregated trade or business). In the case of W-2 wages paid by an RPE, the RPE must determine and report W-2 wages for each trade or business (or aggregated trade or business) conducted by the RPE. W-2 wages are presumed to be zero if not determined and reported for each trade or business (or aggregated trade or business).

(3) *UBIA of qualified property*.

(i) *In general*. Paragraph (c) of this section provides guidance on the determination of the UBIA of qualified property. The determination of the UBIA of qualified property must be made for each trade or business (or aggregated trade or business) by the individual or RPE that directly conducts the trade or business (or aggregated trade or business). The UBIA of qualified property is presumed to be zero if not determined and reported for each trade or business (or aggregated trade or business).

(ii) *UBIA of qualified property held by a partnership*. In the case of qualified property held by a partnership, each partner's share of the UBIA of qualified property is determined in accordance with how the partnership would allocate depreciation under § 1.704-1(b)(2)(iv)(g) on the last day of the taxable year.

(iii) *UBIA of qualified property held by an S corporation*. In the case of qualified property held by an S corporation, each shareholder's share of the UBIA of qualified property is the share of the unadjusted basis proportionate to the ratio of shares in the S corporation held by the shareholder on the last day of the taxable year over the total issued and outstanding shares of the S corporation.

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[758] See parts II.E.1.c.vi.(a) W-2 wages under Code § 199A and II.E.1.c.vi.(b) Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A.

Reg. § 1.199A-2(a)(3)(iv), "UBIA and section 743(b) basis adjustments," is reproduced in part II.E.1.c.vi.(b) Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A.

Reg. § 1.199A-2(b) and (c) are described in part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds. For now, let's delve into how those items get reported to the ultimate individual or trust. Note that the sentence describing S corporation UBIA is simplistic compared to part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

Reg. § 1.199A-6(b) describes computational and reporting rules for a relevant passthrough entity (RPE). It provides:

(1) *In general*. An RPE must determine and report information attributable to any trades or businesses it is engaged in necessary for its owners to determine their Section 199A deduction.

(2) *Computational rules*. Using the following four rules, an RPE must determine the items necessary for individuals who own interests in the RPE to calculate their Section 199A deduction under § 1.199A-1(c) or (d). An RPE that chooses to aggregate trades or businesses under the rules of § 1.199A-4 may determine these items for the aggregated trade or business.

(i) First, the RPE must determine if it is engaged in one or more trades or businesses. The RPE must also determine whether any of its trades or businesses is an SSTB under the rules of § 1.199A-5.

(ii) Second, the RPE must apply the rules in § 1.199A-3 to determine the QBI for each trade or business engaged in directly.

(iii) Third, the RPE must apply the rules in § 1.199A-2 to determine the W-2 wages and UBIA of qualified property for each trade or business engaged in directly.

(iv) Fourth, the RPE must determine whether it has any qualified REIT dividends as defined in § 1.199A-3(c)(1) earned directly or through another RPE. The RPE must also determine the amount of qualified PTP income as defined in § 1.199A-3(c)(2) earned directly or indirectly through investments in PTPs.

(3) *Reporting rules for RPEs* -

(i) *Trade or business directly engaged in*. An RPE must separately identify and report on the Schedule K-1 issued to its owners for any trade or business engaged in directly by the RPE -

(A) Each owner's allocable share of QBI, W-2 wages, and UBIA of qualified property attributable to each such trade or business, and

(B) Whether any of the trades or businesses described in paragraph (b)(3)(i) of this section is an SSTB.

(ii) *Other items*. An RPE must also report on an attachment to the Schedule K-1, any QBI, W-2 wages, UBIA of qualified property, or SSTB determinations, reported to it by any RPE in which the RPE owns a direct or indirect interest. The RPE must also report each owner's allocated share of any qualified REIT dividends received by the RPE (including through another RPE) as well as any qualified PTP income or loss received by the RPE for each PTP in which the RPE holds an interest (including through another RPE). Such information can be reported on an amended or late filed return to the extent that the period of limitations remains open.

(iii) *Failure to report information*. If an RPE fails to separately identify or report on the Schedule K-1 (or any attachments thereto) issued to an owner any items described in paragraph (b)(3)(i) of this section, the owner's share (and the share of any upper-tier indirect owner) of positive QBI, W-2 wages, and UBIA of qualified property attributable to trades or businesses engaged in by that RPE will be presumed to be zero.

Paragraph (3)(i), (ii) above is consistent with reporting requirements for partnerships in Code § 702(a)(7) and Reg. § 1.702-1(a)(8)(iii) and for S corporations in Code § 1366(a)(1)(A).

This RPE paradigm means that each RPE is treated as a stand-alone taxpayer for purposes of evaluating the nature of the business. This has negative consequences for real estate owners and for those conducting tiered partnerships.[759]

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), comments in part VI.A., "Computational steps for RPEs and PTPs," starts with a description of RPE reporting requirements:

> Although RPEs cannot take the Section 199A deduction at the RPE level, each RPE must determine and report the information necessary for its direct and indirect owners to determine their own Section 199A deduction. Proposed § 1.199A-6(b) follows the rules applicable to individuals with taxable income above the threshold amount set forth in § 1.199A-1(d) in directing RPEs to determine what amounts and information to report to their owners and the IRS, including QBI, W-2 wages, the UBIA of qualified property for each trade or business directly engaged in, and whether any of its trades or businesses are SSTBs. RPEs must also determine and report qualified REIT dividends and qualified PTP income received directly by the RPE. Proposed § 1.199A-6(b)(3) then requires each RPE to report this information on or with the Schedules K-1 issued to the owners. RPEs must report this information regardless of whether a taxpayer is below the threshold. The Treasury Department and the IRS request comments whether it is administrable to provide a special rule that if none of the owners of the RPE have taxable income above the threshold amount, the RPE does not need to determine and report W-2 wages, UBIA of qualified property, or whether the trade or business is an SSTB. Although such a rule would relieve an RPE of an unnecessary burden, the RPE would need to have knowledge of the ultimate owner's taxable income.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VII.A, "Reporting Rules," explains:

> The proposed regulations provide that an RPE must determine and separately report QBI, W-2 wages, UBIA of qualified property, and whether the trade or business is an

[759] See part II.E.5.c.ii Code § 199A Deduction under Recommended Structure.

SSTB for each of the RPE's trades or businesses. To help simplify the administration and compliance burden, several commenters suggested that there be an option to compute, aggregate, and report activities at the RPE or entity level. As discussed in part V of this Summary of Comments and Explanation of Revisions, the final regulations allow an RPE to aggregate its trades or businesses provided the rules of § 1.199A-4 are satisfied. An RPE that chooses to aggregate can report combined QBI, W-2 wages, and UBIA of qualified property for the aggregated trade of business. This aggregation must be maintained and reported by all direct and indirect owners of the RPE, including upper-tier RPEs.

The proposed regulations provide that if an RPE fails to separately identify or report any QBI, W-2 wages, UBIA of qualified property, or SSTB determinations, the owner's share (and the share of any upper-tier indirect owner) of QBI, W-2 wages, and UBIA of qualified property attributable to trades or businesses engaged in by that RPE will be presumed to be zero. A few commenters suggested that the final regulations clarify that if an RPE fails to separately identify or report each owner's allocable share of QBI, W-2 wages, or UBIA of qualified property, then only the unidentified or unreported amount is presumed to be zero. Another commenter suggested that a return be considered substantially complete even if an RPE chooses not to report QBI, W-2 wages, and UBIA of qualified property, while other commenters suggested that taxpayers could rebut the presumption. One commenter requested that the final regulations clarify that if an RPE fails to report QBI, W-2 wages, UBIA of qualified property, and SSTB information, the information can still be reported on an amended or late filed return if filed while the period of limitations is still open. Another commenter suggested that to incentivize accurate and timely reporting, taxpayers should be given reasonable opportunities to correct errors and not be subject to penalties for such errors.

The Treasury Department and the IRS agree with commenters that all of an RPE's items related to Section 199A should not be presumed to be zero because of a failure to report one item. For example, an RPE may have sufficient W-2 wages and send out that information, but decline to provide information for UBIA of qualified property because it is not necessary or is an insignificant amount. Accordingly, the final regulations retain the reporting requirement but revise the presumption to provide that if an RPE fails to separately identify or report an item of QBI, W-2 wages, or UBIA of qualified property, the owner's share of each unreported item of positive QBI, W-2 wages, or UBIA of qualified property attributable to trades or businesses engaged in by that RPE will be presumed to be zero. The final regulations also provide that such information can be reported on an amended or late filed return for any open tax year. Guidance on the application of penalties is beyond the scope of these regulations.

The preamble to the proposed regulations requested comments regarding whether it is administrable to provide a special rule that if none of the owners of the RPE have taxable income above the threshold amount, the RPE does not need to determine and report W-2 wages, UBIA of qualified property, or whether the trade or business is an SSTB. One commenter recommended that a special rule be provided that an RPE need not determine or report W-2 wages, UBIA of qualified property or whether the trade or business is an SSTB if none of the owners of the RPE have taxable income above the threshold amount. The commenter suggested that the final regulations provide an exception to the reporting requirements if (1) an RPE does not have gross receipts that constitute QBI; (2) none of the owners of the RPE are non-corporate taxpayers; or (3) none of the RPE owners have taxable income above the threshold amount. The commenter suggested that an RPE could establish the taxable income of its owners through the review and maintenance of its owners' tax returns or written statements signed under the penalty of perjury. Another commenter suggested that an RPE should not be subject to the reporting requirements unless the RPE is aware of a non-corporate owner. Another commenter suggested that the RPE only needs to report W-2 wages when it is clear that the amount will result in an amount greater than 20 percent of QBI. Another commenter requested guidance on how to qualify for the special rule and what information the RPE would be required to report to its owners and retain in connection with the rule. One commenter, however, cautioned against a special rule because of the lack of knowledge the RPE has about the owners. The commenter also suggested that a certification process by the owners would create an administrative burden. The commenter requested guidance on who would be responsible for corrections and penalties due to failure to disclose the information on the Schedule K-1 when the determination affects the owner's QBI deduction. One commenter suggested that RPEs should not have to report QBI, W-2 wages, and UBIA of qualified property with respect to trades or businesses not effectively connected with the United States.

The Treasury Department and the IRS remain concerned that RPEs do not have sufficient information to determine an ultimate owner's taxable income or whether the ultimate owner will require W-2 wage or UBIA of qualified property information for the RPE's trades or businesses in order to determine the owner's Section 199A deduction. Conversely, the RPE itself, not its ultimate owners, is in the best position to determine the RPE's Section 199A items. Accordingly, the final regulations do not contain a special reporting rule for RPEs based on whether the RPE's owners have taxable income below the threshold amounts. Similarly, the Treasury Department and the IRS decline to create a reporting exception based on whether an RPE has non-corporate owners. Finally, a trade or businesses that is not effectively connected with the United States produces no QBI, W-2 wages, or UBIA of qualified property and thus has no reporting requirement under § 1.199A-6.

Reg. § 1.199A-6(b)(3), "Reporting rules for RPEs," provides:

(i) *Trade or business directly engaged in*. An RPE must separately identify and report on the Schedule K-1 issued to its owners for any trade or business (including an aggregated trade or business) engaged in directly by the RPE –

(A) Each owner's allocable share of QBI, W-2 wages, and UBIA of qualified property attributable to each such trade or business, and

(B) Whether any of the trades or businesses described in paragraph (b)(3)(i) of this section is an SSTB.

(ii) *Other items*. An RPE must also report on an attachment to the Schedule K-1, any QBI, W-2 wages, UBIA of qualified property, or SSTB determinations, reported to it by any RPE in which the RPE owns a direct or indirect interest. The RPE must also report each owner's allocated share of any qualified REIT dividends received by the RPE (including through another RPE) as well as any qualified PTP income or loss received by the RPE for each PTP in which the RPE holds an interest (including through another RPE). Such information can be reported on an amended or late filed return to the extent that the period of limitations remains open.

(iii) *Failure to report information*. If an RPE fails to separately identify or report on the Schedule K-1 (or any attachments thereto) issued to an owner an item described in paragraph (b)(3)(i) of this section, the owner's share (and the share of any upper-tier indirect owner) of each unreported item of positive QBI, W-2 wages, or UBIA of qualified property attributable to trades or businesses engaged in by that RPE will be presumed to be zero.

Part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A describes when taxpayers may combine QBI, W-2 wages, and UBIA from multiple businesses. It does not, however, change the fundamental concept that whether an activity rises to the level of a trade or business is tested only for the RPE and is not tested across RPEs:

- For example, if a triple-net lease does not qualify for special relief due to common ownership and would not rise to the level of a trade or business,[760] one cannot consider the fact the owners have 100 different RPEs with triple-net leases, which together add up to one big trade or business. Instead, the owners would need to have one master partnership with multiple single-member LLCs that are disregarded for income tax purposes. The safe harbor for treating real estate as a business confirms this approach.[761] Presumably owners could have special allocations to adjust for any economic distortions of holding the various properties in one master partnership.

- Suppose the activities are conducted within one or more S corporations (which is unusual for real estate but not for other activities). An S corporation could use as a subsidiary disregarded entity either an LLC or another corporation. For the latter, see part II.A.2.g Qualified Subchapter S Subsidiary (QSub). As part II.A.2.g discusses, unless there is a good state income tax or other reason, I tend to prefer single member LLC subsidiaries over QSubs.

The preamble to the final regulations confirms this view of disregarded entities:[762]

> The proposed regulations do not address the treatment of disregarded entities for purposes of Section 199A. A few commenters questioned whether trades or businesses conducted by disregarded entities would be treated as if conducted directly by the owner of the entity. Section 1.199A-1(e)(2) of the final regulations provides that an entity with a single owner that is treated as disregarded as an entity separate from its owner under any provision of the Code is disregarded for purposes of Section 199A and 1.199A-1 through 1.199A-6. Accordingly, trades or businesses conducted by a disregarded entity will be treated as conducted directly by the owner of the entity for purposes of Section 199A.

Reg. § 1.199A-1(e)(2), "Disregarded entities," provides:

> An entity with a single owner that is treated as disregarded as an entity separate from its owner under any provision of the Code is disregarded for purposes of Section 199A and §§ 1.199A-1 through 1.199A-6.

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[760] Part II.E.1.e.i General Rules Regarding U.S. Real Estate , text accompanying fns 951-782.
[761] See part II.E.1.e.i.(a) Whether Real Estate Activity Constitutes A Trade Or Business.
[762] T.D. 9847 (2/8/2019), part II.C.1.

II.E.1.c.i. What Kind of Deduction; Maximum Impact of Deduction

II.E.1.c.i.(a). Summary of Federal Impact of Deduction

The deduction is not allowed in computing adjusted gross income[763] but also is not an itemized deduction,[764] so it is in its own category of deduction.

The deduction applies for income tax but not for net investment income tax[765] or self-employment tax[766] purposes.[767]

When calculating alternative minimum taxable income under Code § 55, qualified business income is determined without regard to any adjustments under Code §§ 56-59.[768]

Although wage income is not qualified business income,[769] in computing withholding allowances and employee may take into account the estimated deduction under Code § 199A.[770]

With a top regular income tax bracket of 37%, the deduction's maximum relief is the equivalent of a 7.4% (20% of 37%) rate reduction, reducing the effective regular income tax rate to 29.6% (37% minus 7.4%).

However, the rate reduction may be thought of as being somewhere between zero and 7.4%, for the following reasons:

- Each trade or business the entity runs needs to be separately subjected to the limitations described below.

- Some income does not qualify for the deduction at all, although generally business activities qualify if the taxpayer's taxable income is below certain thresholds. See

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[763] Code § 62(a).
[764] Code § 63(d)(3).
[765] Net investment income tax, described in part II.I 3.8% Tax on Excess Net Investment Income (NII), is provided by Code § 1411, which is Chapter 2A.
[766] Self-employment tax, described in part II.L Self-Employment Tax (FICA), is provided by Code §§ 1401-1403, which is Chapter 2.
[767] Code § 199A(f)(3) provides:

> *Deduction Limited to Income Taxes*.—The deduction under subsection (a) shall only be allowed for purposes of this chapter.

Chapter 1 of Subtitle A of the Code includes Code §§ 1-1400U-3.
Reg. § 1.199A-1(e)(3), "Self-employment tax and net investment income tax," provides:

> The deduction allowed under section 199A does not reduce net earnings from self-employment under section 1402 or net investment income under section 1411.

[768] Code § 199A(f)(2). Chapter 1 of Subtitle A of the Code includes Code §§ 1-1400U-3.
Reg. § 1.199A-1(e)(5), "Coordination with alternative minimum tax," provides:

> For purposes of determining alternative minimum taxable income under section 55, the deduction allowed under section 199A(a) for a taxable year is equal in amount to the deduction allowed under section 199A(a) in determining taxable income for that taxable year (that is, without regard to any adjustments under sections 56 through 59).

[769] See parts II.E.1.c.ii.(b) Trade or Business of Being an Employee (Excluded from QBI) and II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.
[770] Code § 3402(m)(1).

parts II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction and II.E.1.c.v.(a) Calculation of Deduction Generally.

- An activity that does qualify may have its deduction limited if it has insufficient wages and not enough investment to make up for insufficient wages, although this limitation does not apply if the taxpayer's taxable income is below certain thresholds. See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds regarding those particular items and part II.E.1.c.v Calculation of Deduction Generally showing how they affect the deduction.

- The deduction benefits the taxpayer only if and to the extent that the taxpayer has taxable income taxed at ordinary income rates.[771]

- Deducting a net operating loss may in some situations cause the taxpayer to lose part or all of the benefit of the Code § 199A deduction.[772]

II.E.1.c.i.(b). Other Federal Effects of Code § 199A Deduction

When determining how much Code § 172 net operating loss is applied, the Code § 199A deduction is disallowed.[773]

Claiming the Code § 199A deduction makes the taxpayer more susceptible to the penalty for understatement of income tax.[774]

The Code § 199A deduction does not reduce income when computing the percentages of income used in calculating the individual income tax charitable deduction.[775]

It does not reduce taxable income in computing the taxable income limitation for percentage depletion under Code § 613(a) or 613A(d)(1).

The Code § 199A deduction also has some interaction with the dividends-received deduction that I have not yet tried to analyze,[776] which is unexpected in that the dividends-received deduction applies only to corporations; presumably this applies to a specified agricultural or horticultural cooperative.[777]

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[771] See fn 849 in part II.E.1.c.v Calculation of Deduction Generally.
[772] See part II.E.1.c.i.(b) Other Federal Effects of Code § 199A Deduction, fn. 773.
[773] Code § 172(d)(8). See part II.G.4.l.ii Net Operating Loss Deduction.
[774] Reg. § 1.199A-1(e)(6), "Imposition of accuracy-related penalty on underpayments," provides:

> For rules related to the imposition of the accuracy-related penalty on underpayments for taxpayers who claim the deduction allowed under section 199A, see section 6662(d)(1)(C).

Code § 6662(d)(1)(C) provides:

> (C) *Special Rule For Taxpayers Claiming Section 199A Deduction*. In the case of any taxpayer who claims the deduction allowed under section 199A for the taxable year, subparagraph (A) shall be applied by substituting "5 percent" for "10 percent."

[775] Code § 170(b)(2)(D)(vi).
[776] Code § 246(b)(1).
[777] See fn 754.

II.E.1.c.i.(c). Effect (if any) of Code § 199A on State Income Taxation

States have not universally integrated Code § 199A into their income tax systems.

For example, Missouri does not refer to Code § 199A, but it offers some breaks to owners of pass-through entities, as described in part II.G.29 Missouri Income Tax Cut for Pass-Through Entities and Sole Proprietorships.

On July 7, 2019, I used RIA Checkpoint to create a State Tax Chart, using the feature "State Conformity to IRC Section 199A Pass-Through Deduction—Enacted by TCJA of 2017" and found that the only states that conformed to Code § 199A were Colorado, Idaho, and North Dakota.[778]

II.E.1.c.ii. Types of Income and Activities Eligible or Ineligible for Deduction

II.E.1.c.ii.(a). Generally; List of Items Included in QBI

QBI means "the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer;"[779] see part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A. It does not include any "qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income."[780] (Note that the Code § 199A separately takes into account qualified cooperative dividends in addition to QBI.) Reg. § 1.199A-3 applies solely for purposes of Code § 199A; in particular, "QBI must be determined and reported for each trade or business by the individual or relevant passthrough entity (RPE) that directly conducts the trade or business before applying the aggregation rules of § 1.199A-4. "[781]

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[778] Thompson Coburn doc. no. 7356823.

[779] Code § 199A(c)(1).

[780] Code § 199A(c)(1). Code § 199A(e)(3) provides:

> *Qualified REIT Dividend*. The *term qualified REIT dividend* means any dividend from a real estate investment trust received during the taxable year which -
> (A) is not a capital gain dividend, as defined in section 857(b)(3), and
> (B) is not qualified dividend income, as defined in section 1(h)(11).

Code § 199A(e)(4) provides:

> *Qualified Publicly Traded Partnership Income*. The term "qualified publicly traded partnership income" means, with respect to any qualified trade or business of a taxpayer, the sum of -
> (A) the net amount of such taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (as defined in subsection (c)(3) and determined after the application of subsection (c)(4)) from a publicly traded partnership (as defined in section 7704(a)) which is not treated as a corporation under section 7704(c), plus
> (B) any gain recognized by such taxpayer upon disposition of its interest in such partnership to the extent such gain is treated as an amount realized from the sale or exchange of property other than a capital asset under section 751(a).

[781] Reg. § 1.199A-3(a) provides:

> *In general*. This section provides rules on the determination of a trade or business's qualified business income (QBI), as well as the determination of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income. The provisions of this section apply solely for purposes of section 199A of the Internal Revenue Code (Code). Paragraph (b) of this section provides rules for the determination of QBI. Paragraph (c) of this section provides rules for the determination of qualified REIT dividends and qualified PTP

In the case of a partnership or S corporation, each partner or shareholder takes into account such person's allocable share of each qualified item of income, gain, deduction, and loss.[782] In the case of an S corporation, an allocable share is the shareholder's pro rata share of an item.[783]

To be a qualified item of "income, gain, deduction, and loss," the item must be a U.S.-source item[784] and "included or allowed in determining taxable income for the taxable year."[785] Reg. § 1.199A-3(b)(2)(i) provides:

> *In general*. The term *qualified items of income, gain, deduction, and loss* means items of gross income, gain, deduction, and loss to the extent such items are -
>
> (A) Effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting "trade or business (within the meaning of Section 199A)" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears); and
>
> (B) Included or allowed in determining taxable income for the taxable year.

See part II.E.1.c.ix QBI and Effectively Connected Income.

In the preamble to the final regulations, T.D. 9847 (2/8/2019), part IV.A.5, "Treatment of Other Deductions," provides:

> Section 199A(c)(1) provides that QBI includes the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. Commenters requested additional guidance on whether certain items constitute qualified items under this provision. Several commenters suggested that deductions for self-employment tax, self-employed health insurance, and certain other retirement plan contribution deductions should not reduce QBI. One commenter reasoned that qualified retirement plan contributions should not reduce QBI because they should not be treated as being associated with a trade or business, consistent with the treatment when calculating net operating losses under section 172(d)(4)(D). The commenter also suggested that while self-employed health insurance is treated as

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> income. QBI must be determined and reported for each trade or business by the individual or relevant passthrough entity (RPE) that directly conducts the trade or business before applying the aggregation rules of § 1.199A-4.

[782] Code § 199A(f)(1)(A)(ii).

[783] Code § 199A(f)(1)(A) (flush language).

[784] Code § 199A(c)(3)(A)(i) requires the item to be:

> effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting 'qualified trade or business (within the meaning of section 199A)' for 'nonresident alien individual or a foreign corporation' or for 'a foreign corporation' each place it appears)"

Code § 199A(f)(1)(C)(i) provides:

> *In General*. In the case of any taxpayer with qualified business income from sources within the commonwealth of Puerto Rico, if all such income is taxable under section 1 for such taxable year, then for purposes of determining the qualified business income of such taxpayer for such taxable year, the term "United States" shall include the Commonwealth of Puerto Rico.

Reg. §§ 1.199A-1(e)(4) and 1.199A-3(b)(3) reproduce Code § 199A(f)(1)(C)(i) without any significant change.

[785] Code § 199A(c)(3)(A)(ii).

> associated with a trade or business, such expense should likewise not reduce QBI for purposes of simplification in administering the rule. Another commenter suggested that QBI should not be reduced by these expenses because they are personal adjustments. One commenter also requested guidance on whether unreimbursed partnership expenses, the interest expense to acquire partnership and S corporation interests, and state and local taxes reduce QBI.
>
> The Treasury Department and the IRS have not adopted these recommendations because they are inconsistent with the statutory language of Section 199A(c). Whether a deduction is attributable to a trade or business must be determined under the section of the Code governing the deduction. All deductions attributable to a trade or business should be taken into account for purposes of computing QBI except to the extent provided by Section 199A and these regulations. Accordingly, § 1.199A-3(b)(1)(vi) provides that, in general, deductions attributable to a trade or business are taken into account for purposes of computing QBI to the extent that the requirements of Section 199A and § 1.199A-3 are otherwise satisfied. Thus, for purposes of Section 199A, deductions such as the deductible portion of the tax on self-employment income under section 164(f), the self-employed health insurance deduction under section 162(l), and the deduction for contributions to qualified retirement plans under section 404 are considered attributable to a trade or business to the extent that the individual's gross income from the trade or business is taken into account in calculating the allowable deduction, on a proportionate basis. The Treasury Department and the IRS decline to address whether deductions for unreimbursed partnership expenses, the interest expense to acquire partnership and S corporation interests, and state and local taxes are attributable to a trade or business as such guidance is beyond the scope of these regulations.

Reg. § 1.199A-3(b)(1) provides:

> *In general*. For purposes of this section, the term qualified business income or QBI means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business of the taxpayer as described in paragraph (b)(2) of this section, provided the other requirements of this section and Section 199A are satisfied (including, for example, the exclusion of income not effectively connected with a United States trade or business).
>
> (i) *Section 751 gain*. With respect to a partnership, if section 751(a) or (b) applies, then gain or loss attributable to assets of the partnership giving rise to ordinary income under section 751(a) or (b) is considered attributable to the trades or businesses conducted by the partnership, and is taken into account for purposes of computing QBI.
>
> (ii) *Guaranteed payments for the use of capital*. Income attributable to a guaranteed payment for the use of capital is not considered to be attributable to a trade or business, and thus is not taken into account for purposes of computing QBI except to the extent properly allocable to a trade or business of the recipient. The partnership's deduction associated with the guaranteed payment will be taken into account for purposes of computing QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

(iii) *Section 481 adjustments*. Section 481 adjustments (whether positive or negative) are taken into account for purposes of computing QBI to the extent that the requirements of this section and Section 199A are otherwise satisfied, but only if the adjustment arises in taxable years ending after December 31, 2017.[786]

(iv) *Previously disallowed losses*. Generally, previously disallowed losses or deductions (including under sections 465, 469, 704(d), and 1366(d)) allowed in the taxable year are taken into account for purposes of computing QBI. These losses shall be used, for purposes of Section 199A and these regulations, in order from the oldest to the most recent on a first-in, first-out (FIFO) basis. However, losses or deductions that were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018 (including under sections 465, 469, 704(d), and 1366(d)), are not taken into account in a later taxable year for purposes of computing QBI.

(v) *Net operating losses*. Generally, a net operating loss deduction under section 172 is not considered with respect to a trade or business and therefore, is not taken into account in computing QBI. However, an excess business loss under section 461(l) is treated as a net operating loss carryover to the following taxable year and is taken into account for purposes of computing QBI in the subsequent taxable year in which it is deducted.

(vi) *Other deductions*. Generally, deductions attributable to a trade or business are taken into account for purposes of computing QBI to the extent that the requirements of Section 199A and this section are otherwise satisfied. For purposes of Section 199A only, deductions such as the deductible portion of the tax on self-employment income under section 164(f), the self-employed health insurance deduction under section 162(l), and the deduction for contributions to qualified retirement plans under section 404 are considered attributable to a trade or business to the extent that the individual's gross income from the trade or business is taken into account in calculating the allowable deduction, on a proportionate basis to the gross income received from the trade or business.

Expenses for all wages paid (or incurred in the case of an accrual method taxpayer) must be taken into account in computing QBI (if the requirements of this section and Section 199A are satisfied) regardless of the application of the W-2 wage limitation described in part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.[787]

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[786] [my footnote:] T.D. 9847 (2/8/2019), part IV.A.1, "Items Spanning Multiple Tax Years," provides:
Section 1.199A-3(b)(1)(iii) provides that section 481 adjustments (whether positive or negative) are taken into account for purposes of computing QBI to the extent that the requirements of this section and section 199A are otherwise satisfied, but only if the adjustment arises in taxable years ending after December 31, 2017. One commenter suggested that income from installment sales and deferred cancellation of indebtedness income under section 108(i) arising in taxable years ending before January 1, 2018, should not be taken into account for purposes of computing QBI. The commenter also recommended that items deferred under Revenue Procedure 2004-34, 2004-1 C.B. 911 (advanced payments not included in revenue) prior to January 1, 2018, should be included in QBI. The Treasury Department and the IRS continue to study this issue and request additional comments on when items arising in taxable years prior to January 1, 2018, should be taken into account for purposes of computing QBI.

[787] Reg. § 1.199A-3(b)(4).

Comments submitted October 12, 2018 by the American Bar Association's Section on Taxation asserted that Prop. Reg. § 1.199A-3(b)(1)(ii) incorrectly took the position that guaranteed payments for the use of capital (GPUC) are per se not QBI.[788] However, if the government had changed that rule, note that, to the extent that GPUC is viewed as the equivalent of an interest payment,[789] that characterization may disallow part or all of the GPUC.[790]

In the preamble to the final regulations, T.D. 9847 (2/8/2019), part IV.A.6, "Guaranteed Payments for the Use of Capital," responded:

> A few commenters suggested that the rule in the proposed regulations which excludes guaranteed payments for the use of capital under section 707(c) should be removed. Commenters argued that while Section 199A(c)(4) excludes guaranteed payments paid to a partner for services rendered with respect to a trade or business under section 707(a), the statutory language does not likewise exclude guaranteed payments for the use of capital under section 707(c). The commenters argued that Congress drew a line between payments for services and payments for the use of capital when it drafted Section 199A(c) and that even though payments for the use of capital are determined without regard to the partnership's income, that does not mean that they are not attributable to a trade or business. Several commenters stated that contrary to the reasoning in the preamble to the proposed regulations, there is risk involved when making guaranteed payments for the use of capital because the payments do rely to some degree on the partnership's success. Commenters noted that guaranteed payments for the use of capital are generally accepted as part of the partner's

[788] After making several arguments, the comments said (footnotes omitted):

> A plain reading of the statute would indicate Congress's intent to include GPUCs as QBI. There is no provision in section 199A that excludes a guaranteed payment (either for services or for the use of capital) from being a Qualified Item. Although guaranteed payments for services can be Qualified Items, they are specifically excluded from QBI under section 199A(c)(4)(B). Notably, there is no exclusion of GPUCs from QBI. This suggests that a GPUC may be QBI because a guaranteed payment may be a Qualified Item, but a guaranteed payment may not be included in QBI if it is paid with respect to services rendered by the partner to the partnership's trade or business. In fact, if all guaranteed payments failed to be Qualified Items, then section 199A(c)(4)(B) would be superfluous because QBI only includes Qualified Items. The statutory silence with respect to GPUCs could suggest that Congress had no intention to exclude GPUCs from QBI because Congress clearly contemplated guaranteed payments under section 707(c) and chose only to exclude from QBI those guaranteed payments that are made for services rendered with respect to the trade or business.
>
> On balance, there are strong arguments that a GPUC is treated as a partner's distributive share, and therefore as the payee partner's allocable share of the partnership's Qualified Items, for purposes of section 199A. We believe treating a GPUC as a Qualified Item to the extent of a partnership's Qualified Items most furthers the intent of section 199A. Therefore, we recommend that final guidance allow GPUCs under section 707(c) to be a Qualified Item and included in QBI to the extent of the partnership's Qualified Items, determined without regard to the GPUC expense.
>
> If the Final Regulations follow the Proposed Regulations and preclude GPUCs from being included in QBI, then we recommend that the Final Regulations also exclude from QBI any expense related to guaranteed payments for the use of capital. Otherwise, the existence of a GPUC arrangement would reduce (inappropriately, in our view) the section 199A benefit afforded with respect to the QBI of a partnership.

[789] See part II.I.8.d.iii Treatment of Code § 707(c) Guaranteed Payments under Code § 1411.

[790] See part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

> distributive share from the partnership and taxed as such, and should be included in calculating QBI. Similarly, another commenter generally requested additional guidance for how to determine when a payment to a partner is considered for the use of capital and excluded from the calculation of QBI. Another commenter suggested that if guaranteed payments for the use of capital under section 707(c) are excluded from the calculation of QBI, a partnership's expense related to guaranteed payments for the use of capital also should be excluded from the calculation of QBI. One commenter suggested that to the extent a guaranteed payment for the use of capital is considered akin to interest income on indebtedness, it is generally appropriate to exclude the payment from QBI but noted the significant uncertainty in determining whether an arrangement is a guaranteed payment for the use of capital, a gross income allocation, or something else. The commenter also noted that guaranteed payments for the use of capital are not necessarily akin to interest income.
>
> The Treasury Department and the IRS decline to adopt the comments suggesting that guaranteed payments for the use of capital are generally attributable to a trade or business. Although Section 199A is silent with respect to guaranteed payments for the use of capital, Section 199A does limit the deduction under Section 199A to income from qualified trades or businesses. The Treasury Department and the IRS believe that guaranteed payments for the use of capital are not attributable to the trade or business of the partnership because they are determined without regard to the partnership's income. Consequently, such payments should not generally be considered part of the recipient's QBI. Rather, for purposes of Section 199A, guaranteed payments for the use of capital should be treated in a manner similar to interest income. Interest income other than interest income which is properly allocated to trade or business is specifically excluded from qualified items of income, gain, deduction or loss under Section 199A(c)(3)(B)(iii). One commenter noted that if guaranteed payments are treated like interest income for purposes of Section 199A, and if such payments are properly allocated to a qualified trade or business of the recipient, they should constitute QBI to that recipient in respect of such qualified trade or business. Although, this is an unlikely fact pattern to occur, the Treasury Department and the IRS agree with this comment and the final regulations adopt this comment. Further, guidance under sections 707(a) and 707(c) is beyond the scope of these regulations.

Various items of investment income, including short- or long-term capital gains and losses, are not qualified items. Code § 199A(c)(3)(B), which is reproduced in full in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

Code § 199A(d)(1) provides that "qualified trade or business" means any trade or business other than:

> (A) a specified service trade or business, or
>
> (B) the trade or business of performing services as an employee.

Reg. § 1.199A-5(a)(1) effectuates this:

> This section provides guidance on specified service trades or businesses (SSTBs) and the trade or business of performing services as an employee. This paragraph (a) describes the effect of a trade or business being an SSTB and the trade or business of performing services as an employee. Paragraph (b) of this section provides definitional

> guidance on SSTBs. Paragraph (c) of this section provides special rules related to SSTBs. Paragraph (d) of this section provides guidance on the trade or business of performing services as an employee. The provisions of this section apply solely for purposes of Section 199A of the Internal Revenue Code (Code).

See parts II.E.1.c.iv Specified Service Trade or Business and II.E.1.c.ii.(b) Trade or Business of Being an Employee.

II.E.1.c.ii.(b). Trade or Business of Being an Employee (Excluded from QBI)

Code § 199A(d)(1)(B) excludes from a "qualified trade or business" the trade or business of performing services as an employee. Effective dates are in Prop. Reg. § 1.199A-5(e) and Reg. § 1.199A-5(e) in the text following fn 845 in part II.E.1.c.iv.(a) Introduction to Specified Service Trade or Business (SSTB).

Reg. § 1.199A-5(a)(3), "Trade or business of performing services as an employee," provides:

> The trade or business of performing services as an employee is not a trade or business for purposes of Section 199A and the regulations thereunder. Therefore, no items of income, gain, deduction, or loss from the trade or business of performing services as an employee constitute QBI within the meaning of Section 199A and § 1.199A-3. No taxpayer may claim a Section 199A deduction for wage income, regardless of the amount of taxable income.

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), provides in part V.B.:

> **B. Trade or Business of Performing Services as an Employee**
>
> Under section 199(d)(1)(B), the trade or business of performing services as an employee is not a qualified trade or business. Unlike an SSTB, there is no threshold amount that applies to the trade or business of performing services as an employee. Thus, wage or compensation income earned by any employee is not eligible for the Section 199A deduction no matter the amount.
>
> **1. Definition**
>
> An individual is an employee for Federal employment tax purposes if he or she has the status of an employee under the usual common law and statutory rules applicable in determining the employer-employee relationship. Guides for determining employment status are found in §§ 31.3121(d)-1, 31.3306 (i)-1, and 31.3401(c)-1. As stated in the regulations, generally, the common law relationship of employer and employee exists when the person for whom the services are performed has the right to direct and control the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the direction and control of the employer not only as to what shall be done but how it shall be done. In this connection it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he or she has the right to do so.

In addition, the regulations and section 3401(c) state, generally, that an officer of a corporation (including an S corporation) is an employee of the corporation. However, an officer of a corporation who does not perform any services or performs only minor services in his or her capacity as officer and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is not considered to be an employee of the corporation. Whether an officer's services are minor is a question of fact that depends on the nature of the services, the frequency and duration of their performance, and the actual and potential importance or necessity of the services in relation to the conduct of the corporation's business. See Rev. Rul. 74-390.

To provide clarity, proposed § 1.199A-5(d) provides a general rule that income from the trade or business of performing services as an employee refers to all wages (within the meaning of section 3401(a)) and other income earned in a capacity as an employee, including payments described in § 1.6041-2(a)(1) (other than payments to individuals described in section 3121(d)(3)) and § 1.6041-2(b)(1). If an individual derives income in the course of a trade or business that is not described in section 3401(a), § 1.6041-2(a)(1) (other than payments to individuals described in section 3121(d)(3)), or § 1.6041-2(b)(1), that individual is not considered to be in the trade or business of performing services as an employee with regard to such income.

2. Presumption for Former Employees

Section 199A provides that the trade or business of providing services as an employee is not eligible for the Section 199A deduction. Therefore, taxpayers and practitioners noted that it may be beneficial for employees to treat themselves as independent contractors or as having an equity interest in a partnership or S corporation in order to benefit from the deduction under Section 199A.

Section 530(b) of the Revenue Act of 1978 (Pub. L. 95-600), as amended by section 9(d)(2) of Public Law 96-167, section 1(a) of Public Law 96-541, and section 269(c) of Public Law 97-248, provides a prohibition against regulations and rulings on employment status for purposes of employment taxes. Specifically, section 530(b) provides that no regulation or revenue ruling shall be published before the effective date of any law clarifying the employment status of individuals for purposes of the employment taxes by the Treasury Department (including the IRS) with respect to the employment status of any individual for purposes of the employment taxes. Section 530(c) of the Revenue Act of 1978 provides that, for purposes of section 530, the term 'employment tax' means any tax imposed by subtitle C of the Internal Revenue Code of 1954, and the term 'employment status' means the status of an individual, under the usual common law rules applicable in determining the employer-employee relationship as an employee or as an independent contractor (or other individual who is not an employee). These longstanding rules of section 530 of the Revenue Act of 1978 limit the ability of the IRS to impose employment tax liability on employers for misclassifying employees as independent contractors but do not preclude challenging a worker's status for purposes of Section 199A, an income tax provision under subtitle A of the Code.

Therefore, proposed § 1.199A-5(d)(3) provides that for purposes of Section 199A, if an employer improperly treats an employee as an independent contractor or other non-employee, the improperly classified employee is in the trade or business of performing services as an employee notwithstanding the employer's improper classification. This issue is particularly important in the case of individuals who cease being treated as employees of an employer, but subsequently provide substantially the same services to the employer (or a related entity) but claim to do so in a capacity other than as an employee. However, it would not be appropriate to provide that someone who formerly was an employee of an employer is now 'less likely' to be respected as an independent contractor. Such a rule would not treat similarly-situated taxpayers similarly: two individuals who have a similar relationship with a company and each claim to be treated as independent contractors would be treated differently depending on any prior employment history with the company. Therefore, proposed § 1.199A-5(d)(3) does not provide any new or different standards to be properly classified as an independent contractor or owner of a business. Instead, proposed § 1.199A-5(d)(3) contains a presumption that applies in certain situations to ensure that individuals properly substantiate their status.

> Specifically, proposed § 1.199A-5(d)(3) provides that, solely for purposes of Section 199A(d)(1)(B) and the regulations thereunder, an individual who was treated as an employee for Federal employment tax purposes by the person to whom he or she provided services, and who is subsequently treated as other than an employee by such person with regard to the provision of substantially the same services directly or indirectly to the person (or a related person), is presumed to be in the trade or business of performing services as an employee with regard to such services. This presumption may be rebutted only upon a showing by the individual that, under Federal tax rules, regulations, and principles (including common-law employee classification rules), the individual is performing services in a capacity other than as an employee. This presumption applies regardless of whether the individual provides services directly or indirectly through an entity or entities. This presumption is solely for purposes of Section 199A and does not otherwise change the employment tax classification of the individual. Section 199A is in subtitle A of the Code, and this rule does not apply for purposes of any other subtitle, including subtitle C. Accordingly, this rule does not implicate section 530(b) of the Revenue Act of 1978. Proposed § 1.199A-5(d)(3)(ii) contains three examples illustrating this rule.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VI.E, "Trade or Business of Performing Services as an Employee," explains:

> Multiple commenters expressed support for the rule in the proposed regulations that provides that an individual who was previously treated as an employee and is subsequently treated as other than an employee while performing substantially the same services to the same person, or a related person, will be presumed to be in the trade or business of performing services as an employee for purposes of Section 199A. The commenters noted that the presumption furthers the public policy goal of preventing worker misclassification, preserves agency resources, and prevents a decline in Federal and state tax revenues. The commenters also state that regulations should not incentivize workers to accept misclassification by their employer in order to obtain a tax benefit.

> Other commenters recommended that the presumption be removed arguing that the common law test under current law is sufficient for determining whether a former employee is properly classified as an employee and that the presumption would impede the objective of ensuring similar treatment of similarly situated taxpayers because two similarly situated taxpayers who provide services to the same company would be treated

differently if one was a former employee of the company and the other was not. The commenter also notes that the presumption would create uncertainty for taxpayers and would cause former employees to not claim the deduction in order to avoid a dispute with the IRS.

Another commenter expressed concern that the presumption as written in the proposed regulations could create a dual standard for worker classification under the Code, in which a worker could be classified as an independent contractor for employment tax purposes, and an employee for purposes of claiming Section 199A deduction. This could result in an independent contractor being held liable for self-employment taxes and unable to claim the Section 199A deduction on income that would otherwise qualify as QBI. The commenter suggested that if the presumption is retained, it should include an exemption for certain independent contractors based on factors including income, source of income, industry practice, and timeframe.

A different commenter suggested that the presumption should provide that an independent contractor is operating as such and that it is up to the relevant Federal agencies to determine whether the business misclassified the individual. The commenter also noted that the IRS is barred from issuing regulations with respect to the employment status of any individual for employment tax purposes under Section 530(b) of the Revenue Act of 1978 (Pub. L. 95-600), as amended by section 9(d)(2) of Public Law 96-167, section 1(a) of Public Law 96-541, and section 269(c) of Public Law 97-248, and that the presumption could result in an individual otherwise subject to self-employment tax to not get the benefit of the Section 199A deduction. Another commenter argued that an employee who changes his status from employee to independent contractor so he may deduct business expenses on Schedule C and claim a Section 199A deduction is exercising his right to structure his business transactions to minimize his tax liability.

Another commenter questioned how the rule would be applied, asking for clarification on whether the rule is intended to prohibit employers from firing employees and rehiring them as independent contractors; whether it applies to former employees regardless of current relationship; and how far the IRS would look back at prior employees. Another commenter suggested that a new example be added to the final regulations demonstrating that the presumption is inapplicable when the facts demonstrate that a service recipient and a service provider have materially modified their relationship such that its proper classification is that of a service recipient and a partner.

The Treasury Department and the IRS believe that the presumption is necessary to prevent misclassifications but agree that some clarification of the presumption is necessary. In accordance with commenter’s suggestions, the final regulations provide a three-year look back rule for purposes of the presumption. The final regulations provide that an individual may rebut the presumption by showing records, such as contracts or partnership agreements, that are sufficient to corroborate the individual’s status as a non-employee for three years from the date a person ceases to treat the individual as an employee for Federal employment taxes. Finally, the final regulations contain an additional example demonstrating the application of the presumption for the situation in which an employee has materially modified his relationship with his employer such that the employee can successfully rebut the presumption.

Reg. § 1.199A-5(d), “Trade or business of performing services as an employee,” provides:

(1) *In general*. The trade or business of performing services as an employee is not a trade or business for purposes of Section 199A and the regulations thereunder. Therefore, no items of income, gain, deduction, and loss from the trade or business of performing services as an employee constitute QBI within the meaning of Section 199A and § 1.199A-3. Except as provided in paragraph (d)(3) of this section, income from the trade or business of performing services as an employee refers to all wages (within the meaning of section 3401(a)) and other income earned in a capacity as an employee, including payments described in § 1.6041-2(a)(1) (other than payments to individuals described in section 3121(d)(3)) and § 1.6041-2(b)(1).

(2) *Employer’s Federal employment tax classification of employee immaterial*. For purposes of determining whether wages are earned in a capacity as an employee as provided in paragraph (d)(1) of this section, the treatment of an employee by an employer as anything other than an employee for Federal employment tax purposes is immaterial. Thus, if a worker should be properly classified as an employee, it is of no consequence that the employee is treated as a non-employee by the employer for Federal employment tax purposes.

(3) *Presumption that former employees are still employees*.

(i) *Presumption*. Solely for purposes of Section 199A(d)(1)(B) and paragraph (d)(1) of this section, an individual that was properly treated as an employee for Federal employment tax purposes by the person to which he or she provided services and who is subsequently treated as other than an employee by such person with regard to the provision of substantially the same services directly or indirectly to the person (or a related person), is presumed, for three years after ceasing to be treated as an employee for Federal employment tax purposes, to be in the trade or business of performing services as an employee with regard to such services. As provided in paragraph (d)(3)(ii) of this section, this presumption may be rebutted upon a showing by the individual that, under Federal tax law, regulations, and principles (including common-law employee classification rules), the individual is performing services in a capacity other than as an employee. This presumption applies regardless of whether the individual provides services directly or indirectly through an entity or entities.

(ii) *Rebuttal of presumption*. Upon notice from the IRS, an individual rebuts the presumption in paragraph (d)(3)(i) of this section by providing records, such as contracts or partnership agreements, that provide sufficient evidence to corroborate the individual’s status as a non-employee.

(iii) *Examples*. The following examples illustrate the provision of paragraph (d)(3) of this section. Unless otherwise provided, the individual in each example has taxable income in excess of the threshold amount.

(A) *Example 1.* A is employed by PRS, a partnership for Federal tax purposes, as a fulltime employee and is treated as such for Federal employment tax purposes. A quits his job for PRS and enters into a contract with PRS under which A provides substantially the same services that A previously provided to PRS in A's capacity as an employee. Because A was treated as an employee for services he provided to PRS, and now is no longer treated as an employee with regard to such services, A is presumed (solely for purposes of Section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with regard to his services performed for PRS. Unless the presumption is rebutted with a showing that, under Federal tax law, regulations, and principles (including the common-law employee classification rules), A is not an employee, any amounts paid by PRS to A with respect to such services will not be QBI for purposes of Section 199A. The presumption would apply even if, instead of contracting directly with PRS, A formed a disregarded entity, or a passthrough entity, and the entity entered into the contract with PRS.

(B) *Example 2*. C is an attorney employed as an associate in a law firm (Law Firm 1) and was treated as such for Federal employment tax purposes. C and the other associates in Law Firm 1 have taxable income below the threshold amount. Law Firm 1 terminates its employment relationship with C and its other associates. C and the other former associates form a new partnership, Law Firm 2, which contracts to perform legal services for Law Firm 1. Therefore, in form, C is now a partner in Law Firm 2 which earns income from providing legal services to Law Firm 1. C continues to provide substantially the same legal services to Law Firm 1 and its clients. Because C was previously treated as an employee for services she provided to Law Firm 1, and now is no longer treated as an employee with regard to such services, C is presumed (solely for purposes of Section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with respect to the services C provides to Law Firm 1 indirectly through Law Firm 2. Unless the presumption is rebutted with a showing that, under Federal tax law, regulations, and principles (including common-law employee classification rules), C's distributive share of Law Firm 2 income (including any guaranteed payments) will not be QBI for purposes of Section 199A. The results in this example would not change if, instead of contracting with Law Firm 1, Law Firm 2 was instead admitted as a partner in Law Firm 1.

(C) *Example 3*. E is an engineer employed as a senior project engineer in an engineering firm, Engineering Firm. Engineering Firm is a partnership for Federal tax purposes and structured such that after 10 years, senior project engineers are considered for partner if certain career milestones are met. After 10 years, E meets those career milestones and is admitted as a partner in Engineering Firm. As a partner in Engineering Firm, E shares in the net profits of Engineering Firm, and also otherwise satisfies the requirements under Federal tax law, regulations, and principles (including common-law employee classification rules) to be respected as a partner. E is presumed (solely for purposes of Section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with respect to the services E provides to Engineering Firm. However, E is able to rebut the presumption by showing that E became a partner in Engineering Firm as a career milestone, shares in the overall net profits in Engineering Firm, and otherwise satisfies the requirements under

Federal tax law, regulations, and principles (including common-law employee classification rules) to be respected as a partner.

(D) *Example 4*. F is a financial advisor employed by a financial advisory firm, Advisory Firm, a partnership for Federal tax purposes, as a fulltime employee and is treated as such for Federal employment tax purposes. F has taxable income below the threshold amount. Advisory Firm is a partnership and offers F the opportunity to be admitted as a partner. F elects to be admitted as a partner to Advisory Firm and is admitted as a partner to Advisory Firm. As a partner in Advisory Firm, F shares in the net profits of Advisory Firm, is obligated to Advisory Firm in ways that F was not previously obligated as an employee, is no longer entitled to certain benefits available only to employees of Advisory Firm, and has materially modified his relationship with Advisory Firm. F's share of net profits is not subject to a floor or capped at a dollar amount. F is presumed (solely for purposes of Section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with respect to the services F provides to Advisory Firm. However, F is able to rebut the presumption by showing that F became a partner in Advisory Firm by sharing in the profits of Advisory Firm, materially modifying F's relationship with Advisory Firm, and otherwise satisfying the requirements under Federal tax law, regulations, and principles (including common-law employee classification rules) to be respected as a partner.

The closing parenthetical to Reg. § 1.199A-5(d)(1) refers to statutory employees under Code § 3121(d)(3) as not being in the trade or business of being an employee. Code § 3121(d)(3) is reproduced in the text preceding fn 889 in part II.E.1.c.vi.(a) W-2 wages under Code § 199A.

II.E.1.c.ii.(c). Items Excluded from Treatment as Qualified Business Income Under Code § 199A

Various items of investment income, including short- or long-term capital gains and losses, are not qualified items. Code § 199A(c)(3)(B) lists those nonqualified items, originally providing:

> *Exceptions*. The following investment items shall not be taken into account as a qualified item of income, gain, deduction, or loss:
>
> (i) Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss.
>
> (ii) Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in section 954(c)(1)(G).[791]
>
> (iii) Any interest income other than interest income which is properly allocable to a trade or business.

[791] [My footnote – not from the statute:] Code § 954(c)(1)(G) refers to "payments in lieu of dividends which are made pursuant to an agreement to which" Code § 1058 applies. See part II.A.1.d.i Code § 1058 Loan of Securities.

(iv) Any item of gain or loss described in subparagraph (c) or (D) of section 954(c)(1) (applied by substituting "qualified trade or business" for "controlled foreign corporation").

(v) Any item of income, gain, deduction, or loss taken into account under section 954(c)(1)(F) (determined without regard to clause (ii) thereof and other than items attributable to notional principal contracts entered into in transactions qualifying under section 1221(a)(7)).[792]

(vi) Any amount received from an annuity which is not received in connection with the trade or business.

(vii) Any item of deduction or loss properly allocable to an amount described in any of the preceding clauses.

The Senate report said that the statute excludes "specified investment-related income" such as "any item taken into account in determining net long-term capital gain or net long-term capital loss:"[793]

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[792] [My footnote – not from the statute:] Code § 954(c)(1)(F)(i) provides that foreign personal holding company income" includes the portion of the gross income which consists of "net income from notional principal contracts." Code § 1221(a)(7) provides that "capital asset" does not include:

> any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe)…

Code § 1221(b)(2)(a) provides that "hedging transaction" is "any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily:"

(i) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer,
(ii) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or
(iii) to manage such other risks as the Secretary may prescribe in regulations.

[793] The Senate report said:

> *Treatment of investment income*
>
> Qualified items do not include specified investment-related income, deductions, or loss. Specifically, qualified items of income, gain, deduction and loss do not include (1) any item taken into account in determining net long-term capital gain or net long-term capital loss, (2) dividends, income equivalent to a dividend, or payments in lieu of dividends, (3) interest income other than that which is properly allocable to a trade or business, (4) the excess of gain over loss from commodities transactions, other than those entered into in the normal course of the trade or business or with respect to stock in trade or property held primarily for sale to customers in the ordinary course of the trade or business, property used in the trade or business, or supplies regularly used or consumed in the trade or business, (5) the excess of foreign currency gains over foreign currency losses from section 988 transactions, other than transactions directly related to the business needs of the business activity, (6) net income from notional principal contracts, other than clearly identified hedging transactions that are treated as ordinary (*i.e.*, not treated as capital assets), and (7) any amount received from an annuity that is not used in the trade or business of the business activity. Qualified items under this provision do not include any item of deduction or loss properly allocable to such income.

However, the Consolidated Appropriations Act, 2018 amended Code § 199A(c)(3)(B) to delete "investment," clarifying that an item does not have to be derived from an "investment" to be excluded from QBI.

Code § 199A(c)(4) provides that QBI does not include:

(A) reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business,

(B) any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, and

(C) to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business.

The Senate report made it apparent that subparagraph (A) was aimed at reasonable compensation paid by an S corporation. Thus, the reasonable compensation exception means that wages paid to an owner-employee of an S corporation are not themselves QBI. See also part II.E.1.c.ii.(b) Trade or Business of Being an Employee (Excluded from QBI). However, those wages would increase the QBI-related deduction to the extent that the wage limitation is a concern.[794]

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), provides:

vii. Exclusion from QBI for certain items

a. Treatment of section 1231 gains and losses

Section 199A(c)(3)(B)(i) provides that QBI does not include any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss. The Treasury Department and the IRS have received comments requesting guidance on the extent to which gains and losses subject to section 1231 may be taken into account in calculating QBI. Section 1231 provides rules under which gains and losses from certain involuntary conversions and the sale of certain property used in a trade or business are either treated as long-term capital gains or long-term capital losses, or not treated as gains and losses from sales or exchanges of capital assets.

Section 199A(c)(3)(B)(i) excludes capital gains or losses, regardless of whether those items arise from the sale or exchange of a capital asset. The legislative history of Section 199A provides that QBI does not include any item taken into account in determining net long-term capital gain or net long-term capital loss. Conference Report page 30. Accordingly, proposed § 1.199A-3(b)(2)(ii)(A) clarifies that, to the extent gain or loss is treated as capital gain or loss, it is not included in QBI. Specifically, if gain or loss is treated as capital gain or loss under section 1231, it is not QBI. Conversely, if section 1231 provides that gains or losses are not treated as gains and losses from sales or exchanges of capital assets, Section 199A(c)(3)(B)(i) does not apply and thus, the gains or losses must be included in QBI (provided all other requirements are met).

[794] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds, the impact of which may be reduced or eliminated under part II.E.1.c.v.(a) Taxable Income "Threshold.

b. Interest Income.

Section 199A(c)(4)(C) provides that QBI does not include any interest income other than interest income that is properly allocable to a trade or business. The Treasury Department and the IRS believe that interest income received on working capital, reserves, and similar accounts is not properly allocable to a trade or business, and therefore should not be included in QBI, because such interest income, although held by a trade or business, is simply income from assets held for investment. Accordingly, proposed § 1.199A-3(b)(2)(ii)(C) provides that interest income received on working capital, reserves, and similar accounts is not properly allocable to a trade or business. In contrast, interest income received on accounts or notes receivable for services or goods provided by the trade or business is not income from assets held for investment, but income received on assets acquired in the ordinary course of trade or business.

c. Reasonable compensation

Section 199A(c)(4)(A) provides that QBI does not include "reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business." Similarly, guaranteed payments for services under section 707(c) are excluded from QBI. The phrase "reasonable compensation" is a well-known standard in the context of S corporations. Under Rev. Rul. 74-44, 1974-1 C.B. 287, S corporations must pay shareholder-employees "reasonable compensation for services performed" prior to making "dividend" distributions with respect to shareholder-employees' stock in the S corporation under section 1368. See also *David E. Watson, P.C. v. United States*, 668 F.3d 1008, 1017 (8th Cir. 2012). The legislative history of Section 199A confirms that the reasonable compensation rule was intended to apply to S corporations.

The Treasury Department and the IRS have received requests for guidance on whether the phrase "reasonable compensation" within the meaning of Section 199A extends beyond the context of S corporations for purposes of Section 199A. The Treasury Department and the IRS believe "reasonable compensation" is best read as limited to the context from which it derives: compensation of S corporation shareholders-employees. If reasonable compensation were to apply outside of the context of S corporations, a partnership could be required to apply the concept of reasonable compensation to its partners, regardless of whether amounts paid to partners were guaranteed. Such a result would violate the principle set forth in Rev. Rul. 69-184, 1969-1 CB 256, that a partner of a partnership cannot be an employee of that partnership.[795] There is no indication that Congress intended to change this long-standing Federal income tax principle. Accordingly, proposed § 1.199A-3(b)(2)(ii)(H) provides that QBI does not include reasonable compensation paid by an S corporation but does not extend this rule to partnerships. Because the trade or business of performing services as an employee is not a qualified trade or business under Section 199A(d)(1)(B), wage income received by an employee is never QBI. The rule for reasonable compensation is merely a clarification that, even if an S corporation fails to pay a reasonable wage to its shareholder-employees, the shareholder-employees are

[795] [My footnote:] For using a tiered partnership structure to enable a partner's salary-type compensation to be reported on Form W-2, see text accompanying and flowchart following fn 556 in part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

nonetheless prevented from including an amount equal to reasonable compensation in QBI.

d. Guaranteed payments

Section 199A(c)(4)(B) provides that QBI does not include any guaranteed payment described in section 707(c) paid by a partnership to a partner for services rendered with respect to the trade or business. Proposed § 1.199A-3(b)(2)(ii)(I) restates this statutory rule and clarifies that the partnership's deduction for such guaranteed payment is an item of QBI if it is properly allocable to the partnership's trade or business and is otherwise deductible for Federal income tax purposes. It may be unclear whether a guaranteed payment to an upper-tier partnership for services performed for a lower-tier partnership is QBI for the individual partners of the upper-tier partnership if the upper-tier partnership does not itself make a guaranteed payment to its partners.
Section 199A(c)(4)(B) does not limit the term "partner" to an individual. Consequently, for purposes of the guaranteed payment rule, a partner may be an RPE. Accordingly, proposed § 1.199A-3(b)(2)(ii)(I) clarifies that QBI does not include any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. Therefore, for the purposes of this rule, a guaranteed payment paid by a lower-tier partnership to an upper-tier partnership retains its character as a guaranteed payment and is not included in QBI of a partner of the upper-tier partnership regardless of whether it is guaranteed to the ultimate recipient.

e. Section 707(a) payments

Section 199A(c)(4)(C) provides that QBI does not include, to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business. Section 707(a) addresses arrangements in which a partner engages with the partnership other than in its capacity as a partner. Within the context of Section 199A, payments under section 707(a) for services are similar to, and therefore, should be treated similarly as, guaranteed payments, reasonable compensation, and wages, none of which is includable in QBI. In addition, consistent with the tiered partnership rule for guaranteed payments described previously, to the extent an upper-tier RPE receives a section 707(a) payment, that income should not constitute QBI to the partners of the upper-tier entity. Accordingly, proposed § 1.199A-3(b)(2)(ii)(J) provides that QBI does not include any payment described in section 707(a) to a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. The Treasury Department and the IRS request comments on whether there are situations in which it is appropriate to include section 707(a) payments in QBI.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part IV.A.9, "Reasonable Compensation," declined to provide additional regulatory guidance regarding S corporation shareholder-employees' compensation and Code § 199A:

The preamble to the final regulations, T.D. 9847 (2/8/2019), part IV.A.10, "Items Treated as Capital Gain or Loss," explains:

The proposed regulations provide that any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss, including any item treated as one of such items, such as gains or losses under section 1231, that are treated as capital gains or losses, are not taken into account as a qualified item of income, gain, deduction, or loss in computing QBI.

Several commenters suggested that many technical complications arise from the exclusion of section 1231 gain from QBI. Specifically, commenters noted that whether a taxpayer has long-term capital gain or loss under section 1231 is determined at the taxpayer level and not at the level of the various trades or businesses for which QBI is being determined. For example, if a taxpayer has two businesses, the taxpayer may have section 1231 gains in one trade or business and section 1231 losses in the other trade or business. One commenter suggested that both section 1231 gains and losses be included in the calculation of QBI regardless of whether they result in a capital or ordinary amount when combined at the taxpayer level. The commenter asserts that this approach would not affect the overall limitation that restricts a taxpayer's deduction to 20 percent of the excess of taxable income over net capital gain.

Another potential complication noted by commenters is the section 1231(c) recapture rule. Under the rule, a taxpayer that has a section 1231 capital gain in the current year must look back to any section 1231 ordinary loss taken in the previous five years and convert a portion of the current year section 1231 capital gain to ordinary gain, based on the previous losses taken. One commenter asked for further guidance on how to allocate ordinary gains and losses that may result from the section 1231 calculation to multiple trades or businesses. While the Treasury Department and the IRS recognize the complexity in applying the section 1231(c) recapture rules and allocating gain to multiple trades or businesses, providing additional guidance with respect to section 1231(c) is beyond the scope of these regulations. For purposes of determining whether ordinary income is included in QBI, taxpayers should apply the section 1231(c) recapture rules in the same manner as they would otherwise. Notice 97-59, 1997-2 C.B. 309, provides guidance on netting capital gains and losses and how that netting incorporates the section 1231(c) recapture rule.

Given the specific reference to section 1231 gain in the proposed regulations, other commenters requested guidance with respect to whether gain or loss under other provisions of the Code would be included in QBI. One commenter asked for clarification about whether real estate gain, which is taxed at a preferential rate, is included in QBI. Additionally, other commenters requested clarification regarding whether items treated as ordinary income, such as gain under sections 475, 1245, and 1250, are included in QBI.

To avoid any unintended inferences, the final regulations remove the specific reference to section 1231 and provide that any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss, including any item treated as one of such items under any other provision of the Code, is not taken into account as a qualified item of income, gain, deduction, or loss. To the extent an item is not treated as an item of capital gain or capital loss under any other provision of the Code, it is taken into account as a qualified item of income, gain, deduction, or loss unless otherwise excluded by Section 199A or these regulations.

Similarly, another commenter requested clarification regarding whether income from foreign currencies and notional principal contracts are excluded from QBI if they are ordinary income. Section 199A(c)(3)(B)(iv) and § 1.199A-3(b)(2)(ii)(D) provide that any item of gain or loss described in section 954(c)(1)(C) (transactions in commodities) or section 954(c)(1)(D) (excess foreign currency gains) is not included as a qualified item of income, gain, deduction, or loss. Section 199A(c)(3)(B)(v) and § 1.199A-3(b)(2)(ii)(E) provide any item of income, gain, deduction, or loss described in section 954(c)(1)(F) (income from notional principal contracts) determined without regard to section 954(c)(1)(F)(ii) and other than items attributable to notional principal contracts entered into in transactions qualifying under section 1221(a)(7) is not included as a qualified item of income, gain, deduction, or loss. The statutory language does not provide for the ability to permit an exception to these rules based on the character of the income. Accordingly, income from foreign currencies and notional principal contracts described in the listed sections is excluded from QBI, regardless of whether it is ordinary income.

Odom, "QBI deduction: Interaction with various Code provisions," *The Tax Advise*r (12/1/2020), comments:

QBI and Sec. 1231

Under Sec. 1231, a netting process must be used to determine the nature of the income or loss. Gains and losses from all activities, including publicly traded partnerships (PTPs), must be netted to determine if there is a net Sec. 1231 gain or a net Sec. 1231 loss. The preamble to the Sec. 199A regulations makes clear that:

- Net unrecaptured Sec. 1231 gain is characterized as long-term capital gain and is excluded from QBI;

- Net Sec. 1231 loss is characterized as ordinary loss and is included in QBI; and

- The character then tracks back to the trade or business that disposed of the assets (T.D. 9847).

If the net Sec. 1231 loss stems from multiple activities, then the loss would need to be allocated pro rata to each activity to determine the QBI for each activity.

How is Sec. 1231(c) recapture handled? Sec. 1231(c) recapture occurs when ordinary losses have been claimed in the five prior years and there is Sec. 1231 gain in the current year. The gain is converted from capital gain to ordinary gain to the extent of unrecaptured losses. Ordinary gain or loss under Sec. 1231 is included in QBI. The preamble to the Sec. 199A regulations states that applying Sec. 1231(c) recapture rules and allocating gain to multiple activities is beyond the scope of those regulations and that taxpayers should apply the Sec. 1231(c) recapture rules in the same manner as they would otherwise (T.D. 9847).

A reasonable position would be to treat these losses like the regulations treat carryover losses from years prior to 2018, which is to apply them on a first-in, first-out (FIFO) basis. Therefore, to the extent the recaptured income is from years prior to 2018, the income would be excluded from QBI. Because this income must be used to determine the QBI of specific activities, then the unrecaptured Sec. 1231(c) amounts should be allocated pro rata and tracked by year and by activity. Another, more taxpayer-friendly position is to include the current-year ordinary gain in current-year QBI since the gain originated in the current year, unlike suspended losses that originated in pre-2018 years.

> Sec. 1231(c) simply changes the character of the gain; it does not work to allow a previously unrecognized item from a prior year to be recognized in the current year.

As the preamble summarizes in the section explaining economic impact:[796]

> Because guaranteed payments for capital, for example, are not at risk in the same way as other forms of income, it would generally be economically efficient to exclude them from QBI. Similarly, the Treasury Department and the IRS proposes that income that is a guaranteed payment, but which is filtered through a tiered partnership in order to avoid being labeled as such, should be treated similarly to guaranteed payments in general and therefore excluded from QBI. This principle applies to other forms of income that similarly represent income that either is not at risk or does not flow from the specific economic value provided by a qualifying trade or business, such as returns on investments of working capital.

The preamble explaining economic impact continued:[797]

> For example, § 1.199A-3 will discourage the creation of tiered partnerships purely for the purposes of increasing the Section 199A deduction. In the absence of regulation, some taxpayers would likely create tiered partnerships under which a lower-tier partnership would make a guaranteed payment to an upper-tier partnership, and the upper-tier partnership would pay out this income to its partners without guaranteeing it. Such an organizational structure would likely be economically inefficient because it was, apparently, created solely for tax minimization purposes and not for reasons related to efficient economic decision-making.

In the preamble to the final regulations, T.D. 9847 (2/8/2019), part IV.A.7, "Section 707(a) Payments for Services," said:

> The proposed regulations provide that any payment described in section 707(a) received by a partner for services rendered with respect to a trade or business, regardless of whether the partner is an individual or an RPE, is excluded from QBI. A number of commenters suggested that payments to partners in exchange for services provided to the partnership under section 707(a) should not be excluded from QBI and others suggested a narrowing of the rule for certain circumstances. Some commenters suggested that the payments should be QBI when the arrangement is structured as it would be with a third-party. Many commenters argued that section 707(a) payments should be QBI when the partner who is providing services has its own business separate from that of the partnership. On a related note, one commenter suggested payments for services should be QBI when the services provided are a different business from that of the partnership. Other commenters further suggested that payments should be QBI when the partner is not primarily providing services solely to one partnership. One commenter suggested that the rule excluding section 707(a) payments from QBI should be narrowed to apply only in the context of SSTBs or if the payments would be considered wages by the partner, but that generally payments from the partner's

[796] T.D. 9847 (2/8/2019), Special Analyses, part I, "Regulatory Planning and Review – Economic Analysis," subpart E [F?], "Economic Analysis of § 1.199A-3," paragraph 1, "Background."
[797] T.D. 9847 (2/8/2019), Special Analyses, part I, "Regulatory Planning and Review – Economic Analysis," subpart E [F?], "Economic Analysis of § 1.199A-3," paragraph 2, "Anticipated benefits of § 1.199A-3."

> qualified trade or business should be QBI. One commenter suggested that the regulations excluding section 707(a) payments from QBI be applied only to individuals and RPEs that are either (i) not otherwise engaged in a trade or business of providing similar services to other consumers or (ii) whose ownership interests in the partnership exceed a de minimis amount. Another commenter suggested that the exclusion of section 707(a) payments be replaced with a narrowly tailored anti-abuse rule that would exclude from QBI section 707(a) payments (i) paid to a partner owning more than 50 percent of the capital or profits interests in the partnership and (ii) designed with a primary purpose of causing income that would not otherwise have qualified as QBI to be treated as QBI.
>
> The Treasury Department and the IRS decline to adopt these recommendations. As stated in the preamble to the proposed regulations, payments under section 707(a) for services are similar to guaranteed payments, reasonable compensation, and wages, none of which are includable in QBI. Thus, treating section 707(a) payments received by a partner for services rendered to a partnership as QBI would be inconsistent with the statute. Further, as noted by one commenter, it is difficult to distinguish between payments under section 707(c) and payments under section 707(a). Therefore, creating such a distinction would be difficult for both taxpayers and the IRS to administer.
>
> Section 1.199A-3(b)(2) of the proposed regulations addresses items that are not taken into account as qualified items of income, gain, deduction, or loss, and includes all of the items listed in both Section 199A(c)(3) (exceptions from qualified items of income, gain, deduction, and loss) and Section 199A(c)(4) (treatment of reasonable compensation and guaranteed payments). As suggested by one commenter, the final regulations clarify that amounts received by an S corporation shareholder as reasonable compensation or by a partner as a payment for services under sections 707(a) or 707(c) are not taken into account as qualified items of income, gain, deduction, or loss, and thus are excluded from QBI.

Reg. § 1.199A-3(b)(2)(ii), "Items not taken into account," provides:

> Notwithstanding paragraph (b)(2)(i) of this section and in accordance with Section 199A(c)(3)(B) and (c)(4), the following items are not taken into account as qualified items of income, gain, deduction, or loss and thus are not included in determining QBI:
>
> (A) Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss, including any item treated as one of such items under any other provision of the Code. This provision does not apply to the extent an item is treated as anything other than short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss.
>
> (B) Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in section 954(c)(1)(G). Any amount described in section 1385(a)(1) is not treated as described in this clause.
>
> (C) Any interest income other than interest income which is properly allocable to a trade or business. For purposes of Section 199A and this section, interest income attributable to an investment of working capital, reserves, or similar accounts is not properly allocable to a trade or business.

(D) Any item of gain or loss described in section 954(c)(1)(C) (transactions in commodities) or section 954(c)(1)(D) (excess foreign currency gains) applied in each case by substituting "trade or business (within the meaning of Section 199A)" for "controlled foreign corporation."

(E) Any item of income, gain, deduction, or loss described in section 954(c)(1)(F) (income from notional principal contracts) determined without regard to section 954(c)(1)(F)(ii) and other than items attributable to notional principal contracts entered into in transactions qualifying under section 1221(a)(7).

(F) Any amount received from an annuity which is not received in connection with the trade or business.

(G) Any qualified REIT dividends as defined in paragraph (c)(2) of this section or qualified PTP income as defined in paragraph (c)(3) of this section.

(H) Reasonable compensation received by a shareholder from an S corporation. However, the S corporation's deduction for such reasonable compensation will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

(I) Any guaranteed payment described in section 707(c) received by a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. However, the partnership's deduction for such guaranteed payment will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

(J) Any payment described in section 707(a) received by a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. However, the partnership's deduction for such payment will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

I had speculated that the exclusion of Code § 707(a) and (c) payments from QBI was intended to prevent the service provider from attributing the partnership's QBI to any Code § 707(a) or (c) payment. Therefore, my speculation went, if the service provider is in the trade or business of providing those services, the Code § 707(a) or (c) payment may be QBI as to that trade or business. My thought was that holding a small partnership interest in a service recipient should not disqualify a person in the trade or business of supplying such services to many businesses. For example, a company manages many properties for their owners. Management fees would be QBI. However, if the company becomes a partner in a landlord partnership, then the management fees would be payments under Code § 707(a) if an independent contractor relationship or under Code § 707(c) is provided as a partner. To me, becoming a partner should disqualify the management fees from being QBI as relates to the landlord's trade or business status but should not disqualify them as to the management company's own status. In addition to including this in ACTEC's comments, I orally explained my position to government representatives. The government declined to accept this idea. Thus, continuing the proposed regulations' approach, Reg. § 1.199A-3(b)(2)(ii)(I) provides no relief from the Code § 707(a) or (c) disallowance in such a situation.

Instead of making Code § 707(c) guaranteed payments to service partners, consider granting them a preferred profits interest. See part II.M.4.f Issuing a Profits Interest to a Service Provider. Consider whether doing so would, from a financial viewpoint, be relatively safe or relative risky for the service partners.

Another benefit to such a change in the nature of payments is self-employment (SE) tax savings when the underlying activity is not subject to SE tax. For example, suppose a partner provides services to the partnership that engages in the long-term rental of real estate. A distributive share of the partnership's income (including a preferred profits interest) is not subject to SE tax.[798] However, a guaranteed payment received for services rendered is subject to SE tax.[799]

For details on the references to Code § 707(a) and (c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

II.E.1.c.ii.(d). Qualified REIT Dividends and Qualified PTP Income

Reg. § 1.199A-3(c), "Qualified REIT Dividends and Qualified PTP Income," provides:

(1) *In general*. Qualified REIT dividends and qualified PTP income are the sum of qualified REIT dividends as defined in paragraph (c)(2) of this section earned directly or through an RPE and the net amount of qualified PTP income as defined in paragraph (c)(3) of this section earned directly or through an RPE.

(2) *Qualified REIT dividend* –

(i) The term *qualified REIT dividend* means any dividend from a REIT received during the taxable year which -

(A) Is not a capital gain dividend, as defined in section 857(b)(3), and

(B) Is not qualified dividend income, as defined in section 1(h)(11).

(ii) The term qualified REIT dividend does not include any REIT dividend received with respect to any share of REIT stock -

(A) That is held by the shareholder for 45 days or less (taking into account the principles of section 246(c)(3) and (4)) during the 91-day period beginning on the date which is 45 days before the date on which such share becomes ex-dividend with respect to such dividend; or

(B) To the extent that the shareholder is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(3) *Qualified PTP income* –

(i) *In general*. The term qualified PTP income means the sum of -

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798 See part II.L.4 Self-Employment Tax Exclusion for Limited Partners' Distributive Shares.
799 See fns 3453-3457 in parts II.L.3 Self-Employment Tax: General Partner or Sole Proprietor and II.L.4 Self-Employment Tax Exclusion for Limited Partners' Distributive Shares.

(A) The net amount of such taxpayer's allocable share of income, gain, deduction, and loss from a PTP as defined in section 7704(b) that is not taxed as a corporation under section 7704(a); plus

(B) Any gain or loss attributable to assets of the PTP giving rise to ordinary income under section 751(a) or (b) that is considered attributable to the trades or businesses conducted by the partnership.

(ii) *Special rules*. The rules applicable to the determination of QBI described in paragraph (b) of this section also apply to the determination of a taxpayer's allocable share of income, gain, deduction, and loss from a PTP. An individual's allocable share of income from a PTP, and any section 751 gain or loss is qualified PTP income only to the extent the items meet the qualifications of Section 199A and this section, including the requirement that the item is included or allowed in determining taxable income for the taxable year, and the requirement that the item be effectively connected with the conduct of a trade or business within the United States. For example, if an individual owns an interest in a PTP, and for the taxable year is allocated a distributive share of net loss which is disallowed under the passive activity rules of section 469, such loss is not taken into account for purposes of Section 199A. The specified service trade or business limitations described in §§ 1.199A-1(d)(3) and 1.199A-5 also apply to income earned from a PTP. Furthermore, each PTP is required to determine its qualified PTP income for each trade or business and report that information to its owners as described in § 1.199A-6(b)(3).

Reg. § 1.199A-6(c), "Computational and reporting rules for PTPs," provides:

(1) *Computational rules*. Each PTP must determine its QBI under the rules of § 1.199A-3 for each trade or business in which the PTP is engaged in directly. The PTP must also determine whether any of the trades or businesses it is engaged in directly is an SSTB.

(2) *Reporting rules*. Each PTP is required to separately identify and report the information described in paragraph (c)(1) of this section on Schedules K-1 issued to its partners. Each PTP must also determine and report any qualified REIT dividends or qualified PTP income or loss received by the PTP including through an RPE, a REIT, or another PTP. A PTP is not required to determine or report W-2 wages or the UBIA of qualified property attributable to trades or businesses it is engaged in directly.

II.E.1.c.iii. "Trade or Business" for Code § 199A

How do we delineate what is a "trade or business" to which we apply these rules?

Part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A allows taxpayers to add together QBI, W-2 wages, and UBIA from separate trades or businesses.

Part II.E.1.c.iii.(b) Multiple Trades or Businesses Within an Entity elaborates on part II.E.1.c.iii.(a), but I think one should understand how aggregation works under part General Standards for "Trade or Business" for Code § 199A.

Segregating gross receipts from one trade or business from another may be critically important if any significant portion of the gross receipts is from a Specified Service Trade or Business (SSTB). See part II.E.1.c.iv.(o) SSTB Very Broad Gross Receipts Test and Anti-Abuse Rules.

Reg. § 1.199A-3(e), "Effective/ applicability date," provides:

> (1) *General rule*. Except as provided in paragraph (e)(2) of this section, the provisions of this section apply to taxable years ending after February 8, 2019.
>
> (2) *Exceptions* -
>
> (i) *Anti-abuse rules*. The provisions of paragraph (c)(2)(ii) of this section apply to taxable years ending after December 22, 2017.
>
> (ii) *Non-calendar year RPE*. For purposes of determining QBI, W-2 wages, UBIA of qualified property, and the aggregate amount of qualified REIT dividends and qualified PTP income if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

II.E.1.c.iii.(a). General Standards for "Trade or Business" for Code § 199A

The preamble to the final regulations, T.D. 9847 (2/8/2019), part II.A.3.a, "Relevant Passthrough Entity," first provides rules for what is a trade or business generally:

> The calculation of QBI and therefore, the benefits of Section 199A, are limited to taxpayers with income from a trade or business. Section 199A and its legislative history, however, do not define the phrase "trade or business." The proposed regulations define trade or business by reference to section 162. Section 162(a) permits a deduction for all the ordinary and necessary expenses paid or incurred in carrying on a trade or business. Multiple commenters agreed that section 162 is the most appropriate standard for what constitutes a trade or business for purposes of Section 199A, but noted that there are significant uncertainties in the meaning of trade or business under section 162. However, because many taxpayers who will now benefit from the Section 199A deduction are already familiar with the trade or business standard under section 162, using the section 162 standard appears to be the most practical for taxpayers and the IRS. Therefore, after considering all relevant comments, the final regulations retain and slightly reword the proposed regulation's definition of trade or business. Specifically, for purposes of Section 199A and the regulations thereunder, § 1.199A-1(b)(14) defines trade or business as a trade or business under section 162 (section 162 trade or business) other than the trade or business of performing services as an employee.
>
> The Treasury Department and the IRS received a number of comments requesting additional guidance with respect to determining whether an activity rises to the level of a section 162 trade or business, and therefore, will be considered to be a trade or business for purposes of determining the Section 199A deduction. Commenters suggested guidance in the form of a regulatory definition, a bright-line test, a factor-based test, or a safe harbor. Whether an activity rises to the level of a section 162 trade or business, however, is inherently a factual question and specific guidance under

section 162 is beyond the scope of these regulations. Accordingly, the Treasury Department and the IRS have concluded that the factual setting of various trades or businesses varies so widely that a single rule or list of factors would be difficult to provide in a timely and manageable manner and would be difficult for taxpayers to apply.

In *Higgins v. Commissioner*, 312 U.S. 212 (1941), the Supreme Court noted that determining whether a trade or business exists is a factual determination. Specifically, the Court stated that the determination of "whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case." 312 U.S. at 217. Because there is no statutory or regulatory definition of a section 162 trade or business, courts have established elements to determine the existence of a trade or business. The courts have developed two definitional requirements. One, in relation to profit motive, is said to require the taxpayer to enter into and carry on the activity with a good faith intention to make a profit or with the belief that a profit can be made from the activity. The second is in relation to the scope of the activities and is said to require considerable, regular, and continuous activity. *See generally Commissioner v. Groetzinger*, 480 U.S. 23 (1987). In the seminal case of *Groetzinger*, the Supreme Court stated, "[w]e do not overrule or cut back on the Court's holding in Higgins when we conclude that if one's gambling activity is pursued full time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business within the statutes with which we are here concerned." *Id.* at 35.[800]

A few commenters suggested adopting the definitions or rules regarding a trade or business found in other provisions of the Code, including sections 469 and 1411. Section 469(c)(6) and § 1.469- 4(b)(1) broadly define trade or business activities other than rental activities to include any activity performed: (i) In connection with a trade or business within the meaning of section 162, (ii) with respect to which expenses are allowable as a deduction under section 212, (iii) conducted in anticipation of the commencement of a trade or business, or (iv) that involves research and experimentation expenditures (within the meaning of section 174). Section 1.469-4(b)(2) defines a rental activity as an activity that constitutes a rental activity within the meaning of § 1.469-1T(e)(3). Passive activities for purposes of section 469 are defined as any activity that involves the conduct of a trade or business in which the taxpayer does not materially participate and includes all rental activity. The definition of trade or business for section 469 purposes is significantly broader than the definition for purposes of section 162 as it is intended to capture a larger universe of activities, including passive activities. Section 469 was enacted to limit the deduction of certain passive losses and therefore, serves a very different purpose than the allowance of a deduction under Section 199A. Further, Section 199A does not require that a taxpayer materially participate in a trade or business in order to qualify for the Section 199A deduction. Consequently, the Treasury Department and the IRS decline to adopt the recommendation to define trade or business for purposes of Section 199A by reference to section 469. The Treasury Department and the IRS also decline to define trade or business by reference to section 1411 as § 1.1411-1(d)(12) defines trade or business by reference to section 162 in a manner similar to § 1.199A-1(b)(14).

Commenters also suggested that the Section 199A regulations incorporate the real estate professional provisions in section 469(c)(7) in a manner similar to the cross

[800] [my footnote – not from preamble:] Both cases are described in part II.G.4.l.i.(a) "Trade or Business" Under Code § 162, particularly the text accompanying and immediately following fns 1298-1301.

> references in section 163(j) and § 1.1411-4(g)(7). Under section 469, a real estate professional may treat rental real estate activities described in section 469(c)(7)(C) as nonpassive if the taxpayer materially participates in such activities. Section 1.469-5T(a) provides seven tests to establish material participation, but as noted above, these tests only determine whether an individual materially participates in a rental real estate activity. They cannot be used to determine whether the activity itself is a trade or business. Unlike section 469, whether a taxpayer is entitled to a Section 199A deduction is not determined based on the taxpayer's level of participation in a trade or business, nor does it require that an individual materially participate in the trade or business. Instead, Section 199A is dependent on whether the individual has QBI from a trade or business. Consequently, the Treasury Department and the IRS decline to adopt these comments because the § 1.469-5T material participation tests are not a proxy to establish regular, continuous, and considerable activity that rises to the level of a trade or business for purposes of Section 199A.

Code § 469 and relevant authority are covered in part II.K Passive Loss Rules.

The Joint Committee On Taxation's "General Explanation Of Public Law 115–97," JCS-1-18 (12/18), under the heading "Trade or business," on pages 14-15, explained:

> For Federal income tax purposes, a taxpayer conducting activities giving rise to income or loss must evaluate whether its activities rise to the level of constituting a trade or business, and if so, how many trades or businesses the taxpayer has.
>
> Many areas of Federal income tax law require a taxpayer to make a threshold determination of whether its activities rise to the level of constituting a trade or business. For example, expenses are deductible under section 162 if they are incurred "in carrying on any trade or business,"[50] the passive activity loss limitation of section 469 can limit losses from an activity that "involves the conduct of any trade or business,"[51] and research and experimental expenditures are eligible for deduction under section 174 if they are paid or incurred "in connection with [a] trade or business."[52]
> [50] Sec. 162(a).
> [51] Sec. 469(c)(1)(A). A passive activity generally is one in which the taxpayer does not materially participate, and additional rules apply.
> [52] Sec. 174(a). Another example outside the domestic context is that a foreign corporation may be subject to U.S. corporate income tax rules if it is engaged in the "conduct of a trade or business within the United States." These examples are not exhaustive.
>
> Courts have held that for an activity to rise to the level of constituting a trade or business, "the taxpayer must be involved in the activity with continuity and regularity and ... the taxpayer's primary purpose for engaging in the activity must be for income or profit."[53] In order to meet this standard, the taxpayer must satisfy two requirements: (1) regular and continuous conduct of the activity;[54] and (2) a primary purpose to earn a profit.[55] Whether a taxpayer's activities meet these factors depends on the facts and circumstances of each case.[56] While most activities determined to be trades or businesses are so treated because the taxpayer offers goods or services to the public, a trade or business may also include other activities if such activities are the source of the taxpayer's livelihood.[57]
> [53] *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987).

> [54] This first factor depends on the extent of the taxpayer's activities. For example, a taxpayer who devoted 60 to 80 hours per week to gambling on dog races was determined to have engaged in the activity regularly and continuously such that the gambling activity rose to the level of constituting a trade or business. See *Commissioner v. Groetzinger*, 480 U.S. 23 (1987). As another example, a taxpayer who executed a total of 372 securities trades in a year, with at least one trade taking place on 110 days of the year, was determined not to have engaged in securities trading on a regular or continuous basis. See *Holsinger v. Commissioner*, T.C. Memo 2008–191. As a third example, a married couple who owned two homes, one of which they lived in and renovated while monitoring the home market with an eye toward potential sale, and the other of which they rented out but eventually planned to occupy, were held to have neither engaged in the activity with sufficient frequency nor possessed the required profit motive necessary to meet the standard for being engaged in a trade or business. See *Ohana v. Commissioner*, T.C. Memo 2014–83.
> [55] This second factor depends on the taxpayer's state of mind. The taxpayer must have a good faith intention to make a profit from the activity, and not be engaged in it "merely for pleasure, exhibition, or social diversion." See *Doggett v. Burnet*, 65 F.2d 191 (D.C. Cir. 1933), rev'g 23 B.T.A. 744 (1931).
> [56] See, *e.g.*, *Higgins v. Commissioner*, 61 S. Ct. 475 (1941).
> [57] *Commissioner v. Groetzinger*, 480 U.S. 23, at 34–35 (1987).

Also, the preamble to final regulations explains the importance of taxpayer consistency:[801]

> In cases in which other Code provisions use a trade or business standard that is the same or substantially similar to the section 162 standard adopted in these final regulations, taxpayers should report such items consistently. For example, if taxpayers who own tenancy in common interests in rental property treat such joint interests as a trade or business for purposes of Section 199A but do not treat the joint interests as a separate entity for purposes of § 301.7701-1(a)(2), the IRS will consider the facts and circumstances surrounding the differing treatment. Similarly, taxpayers should consider the appropriateness of treating a rental activity as a trade or business for purposes of Section 199A where the taxpayer does not comply with the information return filing requirements under section 6041.

Regarding the above comment on real property, see part II.C.10 Whether Tenancy-in-Common or other Arrangement Constitutes a Partnership. For example, those who own real estate as tenants in common may want to opt out of partnership treatment so that they can separately do nontaxable like-kind exchanges[802] or avoid the complexities of partnership income taxation. However, as part II.C.10 explains, opting out of partnership treatment is inconsistent with saying that the rental is a trade or business. Of course, whether rental is a trade or business under Code § 199A is a complex issue beyond these ideas.[803]

[801] T.D. 9847 (2/8/2019), part II.A.3.e.
[802] See part II.G.16 Like-Kind Exchanges.
[803] See part II.E.1.e Whether Real Estate Qualifies as a Trade or Business.

Reg. § 1.199A-1(b)(14) provides:[804]

> Trade or business means a trade or business that is a trade or business under section 162 (a section 162 trade or business) other than the trade or business of performing services as an employee. In addition, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business for purposes of Section 199A, if the property is rented or licensed to a trade or business conducted by the individual or an RPE which is commonly controlled under § 1.199A-4(b)(1)(i) (regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under § 1.199A-4(b)(1)).

Part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A explains Reg. § 1.199A-4.

The preamble to Prop. Reg. § 1.199A-1, REG-107892-18 (8/16/2018), explains the general definition:

> Proposed § 1.199A-1(b) also defines trade or business for purposes of Section 199A and proposed §§ 1.199A-1 through 1.199A-6. Neither the statutory text of Section 199A nor the legislative history provides a definition of trade or business for purposes of Section 199A. Multiple commenters stated that section 162 is the most appropriate definition for purposes of Section 199A. Although the term trade or business is defined in more than one provision of the Code, the Department of the Treasury (Treasury Department) and the IRS agree with commenters that for purposes of Section 199A, section 162(a) provides the most appropriate definition of a trade or business. This is based on the fact that the definition of trade or business under section 162 is derived from a large body of existing case law and administrative guidance interpreting the meaning of trade or business in the context of a broad range of industries. Thus, the definition of a trade or business under section 162 provides for administrable rules that are appropriate for the purposes of Section 199A and which taxpayers have experience applying and therefore defining trade or business as a section 162 trade or business will reduce compliance costs, burden, and administrative complexity.
>
> The proposed regulations extend the definition of trade or business for purposes of Section 199A beyond section 162 in one circumstance. Solely for purposes of Section 199A, the rental or licensing of tangible or intangible property to a related trade or business is treated as a trade or business if the rental or licensing and the other trade or business are commonly controlled under proposed § 1.199A-4(b)(1)(i). It is not uncommon that for legal or other non-tax reasons taxpayers may segregate rental property from operating businesses. This rule allows taxpayers to aggregate their trades or businesses with the associated rental or intangible property under proposed § 1.199A-4 if all of the requirements of proposed § 1.199A-4 are met. In addition, this rule may prevent taxpayers from improperly allocating losses or deductions away from trades or businesses that generate income that is eligible for a Section 199A deduction.

[804] The second sentence is referred to in Reg. § 1.199A-4(d)(8) and (9), Examples (8) and (9), reproduced in full in the text before and after fn 841 in part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A.

Nothing in the Code § 469 passive activity rules prevents an activity from qualifying as a business. In fact, Reg. § 1.469-4(b)(1)(i) expressly contemplates that a Code § 162 business can be a passive activity.[805]

II.E.1.c.iii.(b). Multiple Trades or Businesses Within an Entity – Identification of Businesses and Allocation of Items

Within an entity, one may want to combine or separate various activities, depending on how their QBI, W-2 wages, and UBIA relate to each other and whether they can be combined with other entities' activities under part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A.

Also, delineating activities as a separate trade or business may be critically important in avoiding contaminating a qualifying business with a nonqualifying business under the overreaching rules described in part II.E.1.c.iv.(o) SSTB Very Broad Gross Receipts Test and Anti-Abuse Rules.

The preamble to the final regulations explains how to delineate businesses within an entity:[806]

> Several commenters suggested that there should be safe harbors or factors to determine how to delineate separate section 162 trades or businesses within an entity and when an entity's combined activities should be considered a single section 162 trade or business. Some of the factors suggested include whether the activities: Have separate books and records, facilities, locations, employees, and bank accounts; operate separate types of businesses or activities; are held out as separate to the public; and are housed in separate legal entities. One commenter suggested adopting the separate trade or business rules provided in regulations under sections 446 and 469.
>
> The Treasury Department and the IRS decline to adopt these recommendations because specific guidance under section 162 is beyond the scope of these final regulations and, as described in part II.A.3.a. of this Summary of Comments and Explanation of Revisions, guidance under section 469 is inapplicable.[807] Further, § 1.446-1(d) does not provide guidance on when trades or businesses will be considered separate and distinct. Instead, it provides that a taxpayer can use different methods of accounting for separate and distinct trades or businesses and specifies two circumstances in which trades or businesses will not be considered separate and distinct. Section 1.446-1(d)(2) provides that no trade or business will be considered separate and distinct unless a complete and separable set of books and records is kept for such trade or business.
>
> The Treasury Department and the IRS acknowledge that an entity can conduct more than one section 162 trade or business. This position is inherent in the reporting requirements detailed in § 1.199A-6, which require an entity to separately report QBI, W-2 wages, UBIA of qualified property, and SSTB information for each trade or business engaged in by the entity. Whether a single entity has multiple trades or businesses is a factual determination. However, court decisions that help define the meaning of "trade or business" provide taxpayers guidance in determining whether more than one trades

[805] Reg. § 1.469-4(b)(1) is reproduced in fn. 3131 within part II.K.1.b.ii Grouping Activities – General Rules.

[806] T.D. 9847 (2/8/2019), part II.A.3.d.

[807] [my footnote – not from preamble:] That reasoning is described in part II.E.1.c.iii.(a) General Standards for "Trade or Business" for Code § 199A.

> or businesses exist. As discussed in part II.A.3.a. of this Summary of Comments and Explanation of Revisions, generally under section 162, to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and the taxpayer's primary purpose for engaging in the activity must be for income or profit. *Groetzinger*, at 35.[808]
>
> The Treasury Department and the IRS also believe that multiple trades or businesses will generally not exist within an entity unless different methods of accounting could be used for each trade or business under § 1.446-1(d). Section 1.446-1(d) explains that no trade or business is considered separate and distinct unless a complete and separable set of books and records is kept for that trade or business. Further, trades or businesses will not be considered separate and distinct if, by reason of maintaining different methods of accounting, there is a creation or shifting of profits and losses between the businesses of the taxpayer so that income of the taxpayer is not clearly reflected.

The Joint Committee On Taxation's "General Explanation Of Public Law 115-97," JCS-1-18 (12/18), under the heading "Trade or business," on pages 14-15, explained:

> Once a taxpayer has made the threshold determination that its activities rise to the level of constituting a trade or business, the taxpayer must determine whether it is carrying on a single unified trade or business (involving one or more activities) or multiple separate trades or businesses. The determination of whether the taxpayer is conducting one, or multiple, trades or businesses is relevant to the taxpayer's choices of methods of accounting used to compute taxable income (*e.g.*, the cash method or an accrual method, and various special methods of accounting for certain items).[58] Under section 446, a taxpayer with multiple separate trades or businesses may use different overall methods of accounting (and different special methods of accounting for an item, if applicable) to compute taxable income for each trade or business.[59] However, a taxpayer with a single unified trade or business must use the same overall method of accounting for the activities (and the same special method of accounting, if applicable) within that trade or business.[60] A taxpayer filing its first return may adopt any permissible method of accounting in connection with each separate trade or business.[61]
> [58] Sec. 446(c) and Treas. Reg. sec. 1.446–1(c)(1).
> [59] Sec. 446(d) and Treas. Reg. sec. 1.446–1(d)(1). For example, a taxpayer may account for a personal service trade or business using the cash method and may account for a manufacturing business on an accrual method if such activities constitute separate trades or businesses. For a discussion of trades or businesses eligible to use the cash method and an accrual method, including changes to such rules by the Act, see discussion of section 13102 of the Act (Small Business Accounting Method Reform).
> [60] For example, a taxpayer with a single trade or business that includes both manufacturing and service activities generally must account for such trade or business using an accrual method. See, *e.g.*, *Thompson Electric, Inc. v. Commissioner*, T.C. Memo. 1995-292. For a discussion of trades or businesses eligible to use the cash method and an accrual method, including changes to such rules by the Act, see discussion of section 13102 of the Act (Small Business Accounting Method Reform).
> [61] Treas. Reg. sec. 1.446-1(e)(1). See also, Rev. Rul. 90–38, 1990–1 C.B. 57 (holding that a taxpayer adopts a method of accounting (1) when it uses a permissible method of

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[808] [my footnote – not from preamble:] *Groetzinger* described in part II.G.4.l.i.(a) "Trade or Business" Under Code § 162, particularly the text accompanying and immediately following fns 1299-1301.

accounting on a single tax return, or (2) when it uses the same impermissible method of accounting on two or more consecutive tax returns). Except as otherwise provided, section 446(e) requires taxpayers to secure the consent of the Secretary before changing a method of accounting, including any change in method of accounting attributable to a taxpayer's redetermination of how many separate trades or businesses it has.

Treasury regulations provide that activities are not considered separate and distinct trades or businesses unless they each keep a complete and separable set of books and records.[62] Courts evaluating whether activities are separate and distinct trades or businesses have looked to factors such as the existence of common management, use of shared office space (or lack thereof), use of shared employees (or the lack thereof), and the nature of each business.[63] The IRS has ruled that an entity that is disregarded for Federal income tax purposes, and thus treated as a separate division of its owner (*e.g.*, a single-member limited liability company or a qualified subchapter S subsidiary); may constitute a separate trade or business under section 446 depending on the taxpayer's facts and circumstances.[64]

[62] Treas. Reg. sec. 1.446-1(d)(2).

[63] Two cases addressing activities involving chicken farming and other related activities illustrate the nature of the analysis. First, in *Peterson Produce, Inc. v. United States*, 313 F.2d 609 (8th Cir. 1963), aff'g 205 F.Supp. 229 (W.D. Ark. 1962), the court upheld a U.S. district court determination that the taxpayer's newly-formed chicken farming division was not separate and distinct from the taxpayer's feed and hatchery trade or business because the existing business primarily sold chicks to the new division and the taxpayer did not keep separate books and records for the two activities.[809] In *Burgess Poultry Mkt., Inc. v. United States*, 64-2 USTC 9515 (E.D. Tex. 1964), however, the court held that the taxpayer's two divisions, one of which raised chicks and the other of which processed broiler chickens, were separate and distinct trades or businesses because they kept separate books and records, had separate employees, and did substantial business with third parties.[810] See also Rev. Rul. 74-270, 1974-1 C.B. 109 (ruling that a bank's commercial banking division and trust division were separate trades or businesses where they had separate books and records, separate employees, separate office space, and separate management).[811]

[64] See, *e.g.*, Sections 9.01 and 15.07(4)(b) of Rev. Proc. 2018-1, 2018-1 I.R.B. 1 (and its predecessors). See also CCA 201430013, July 25, 2014.[812]

Authorized under Code § 446(d), Reg. § 1.446-1(d), "Taxpayer engaged in more than one business," provides:

(1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The

[809] [my footnote:] *Peterson Produce* is discussed in fn 823.

[810] [my footnote:] *Burgess Poultry* is discussed in fn 821.

[811] [my footnote:] Rev. Rul. 74–270 is discussed in fn 818.

[812] [my footnote:] CCA 201430013 is discussed in fn 813.

method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

(2) No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.

(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct.

A single member LLC that is a disregarded entity may use a different accounting method than its parent if the single member LLC engages in a separate trade or business.[813] A corporate subsidiary that was liquidated tax-free to attain efficiencies in distribution but continued to have complete physical separation of products, books, and records from the rest of the parent corporation was permitted to maintain a different method of accounting as a separate division.[814] However, corporate subsidiaries that are separate taxpayers are separate businesses.[815]

Difficulty in maintaining separate businesses or separate books and records for a taxpayer's various business activities does not justify failure to do so.[816] Loans to employees, which of

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[813] CCA 201430013 (see fn 331 in part II.B Limited Liability Company (LLC)) held that "Company and LLC separate and distinct trades or businesses" in the following situation:

> LLC was previously a subsidiary of Company that converted in Year A to a limited liability company, whose sole member is Company. LLC has not made an election under Procedure and Administration Reg. § 301.7701-3 to be taxed as a corporation, thus, LLC is not regarded as an entity separate from Company for federal income tax purposes but is instead treated as a division of Company.
>
> Company's activities include sales, marketing, distribution, sale support, research and development, and administrative and headquarters functions. LLC primarily manufactures products but does provide some research and development services to the [redacted data] purchaser of its products, Purchase A. Purchaser A will subsequently sell these products to Purchaser B, who will ultimately sell the products to Company.
>
> Company and LLC have separate books and records. These books and records are prepared at Company's location. Company and LLC are in different geographical locations. Further, Company and LLC do not share employees, but, do share the highest-level executives. Company and LLC use the same accounting method, presumably, that method is an accrual accounting method.

[814] Letter Ruling 7950016.

[815] *Specialty Restaurants Corporation and Subs*. v. Commissioner, T.C. Memo. 1992-221, held that separately taxed corporate subsidiaries had to establish their own businesses and accordingly had capitalized start-up expenses instead of being able to deduct expenses in the same line of business as their affiliates.

[816] *Herbert C. Haynes, Inc. v. Commissioner*, T.C. Memo. 2004-185, reasoned and held:

> Petitioner does not maintain separate businesses or separate books and records for its various business activities. Indeed, petitioner stipulated: "Because of the scope of petitioner's activities and the entrepreneurial nature of the industry, it is impossible to describe a single business

course generate interest income instead of business income, did not constitute a business because they were not separable from the taxpayer's overall business activities.[817]

A bank may use different methods of accounting for its commercial banking activities and its trust department.[818] A national bank that operates a bond department and is a dealer in securities may use different methods of accounting for its bond department and for other activities.[819]

> model. Further, the extent of petitioner's activities … will vary from year [to year] and involve many unique transactions."
>
> Petitioner engages in various business activities. In *Wilkinson-Beane, Inc. v. Commissioner*, 420 F.2d at 355, the Court of Appeals for the First Circuit, the court to which an appeal of this case would lie, held that the taxpayer had to use the accrual method where its business involved providing funeral services and supplying caskets for the funeral services. In *Knight-Ridder Newspapers, Inc. v. United States*, 743 F.2d at 790, the Court of Appeals for the Eleventh Circuit held that a newspaper that provided the service of presenting information to its readers had to use the accrual method where the cost of newsprint and ink was 17.6 percent of the total cash receipts....
>
> Some of petitioner's business activities involve no growing of trees, no harvesting of trees, and no ownership of the land on which the trees are grown. Other business activities involve a combination of the above. The business activities related to buying and selling wood generate merchandise for petitioner. The merchandise is an income-producing factor to petitioner. Thus, the facts and circumstances of this case are analogous to those described in *Wilkinson-Beane, Inc.* and *Knight Ridder Newspapers*.
>
> Petitioner must use the accrual method of accounting for all of its business activities. See *Thompson Elec., Inc. v. Commissioner*, T.C. Memo. 1995-292.

Failing to keep books and records precluded a taxpayer from proving different businesses. *Humphrey v. Commissioner*, T.C. Memo. 1995-110. In The *J. F. Stevenhagen Co. v. Commissioner*, T.C. Memo. 1975-198, the IRS unsuccessfully tried to impose a different method of accounting for interest on loans than the rest of the business.

[817] *W.W. Enterprises, Inc. v. Commissioner*, T.C. Memo. 1985-313, which ran a commercial laundry business and allowed the employees to repay the loans with bonuses. The taxpayer was on the accrual method for its business and wanted to use the cash method to report interest on the loans.

[818] Applying Reg. § 1.446-1(d), Rev. Rul. 74-270 reasoned and held:

> The right to operate a trust department is granted by the Comptroller of the Currency pursuant to law. Under such law all national banks exercising fiduciary powers are required to segregate their general assets from assets held in any fiduciary capacity and to keep separate books and records. The banking activities and fiduciary functions must be operated separately and the separate identity of the trust department must be preserved. The activities of a trust department of a national bank are governed by regulations under the law. The trust activities differ basically from the banking business in that banking is a mercantile business which consists of receiving deposits, making collections and loans, discounting commercial paper, and issuing notes. The trust business is a personal service business consisting of acting as trustee, executor or administrator, registering stocks and bonds, guarding estates, and acting in other fiduciary capacities. The trust department has its own management, staff of employees, and office space. Accordingly, under the foregoing circumstances the taxpayer will be permitted to use different methods of accounting for its commercial banking activities and its trust department for Federal income tax purposes. Further, permission will be granted by the Commissioner to change its method of accounting for its commercial banking activities, for Federal income tax purposes, from the hybrid method to the accrual method provided that the taxpayer and the Commissioner of Internal Revenue agree to the terms, conditions, and adjustments under which the change will be effected.

[819] Applying Reg. § 1.446-1(d), Rev. Rul. 74-280 reasoned and held:

The sale of food supplements and merchandise and the providing of services under weight reduction contracts did not represent separate trades or businesses, when food supplements were offered only to active members of the weight reduction program and not to the general public.[820]

A corporation engaged in the business of processing and selling nine-week-old broiler chickens was able to distinguish as a separate business its new business of raising chickens until they were nine weeks old.[821] A different taxpayer was unable to prove that its cattle feeding

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> Taxpayers engaged in the banking business are permitted to use the cash receipts and disbursements method with respect to their banking activities provided such method clearly reflects income…. However, a bank, as the instant taxpayer, also may be a dealer in securities with respect to the securities activities of its bond department….
>
> The purchase and sale of securities by a dealer is an income-producing factor within the meaning of section 1.471-1 of the regulations. Thus, in order to clearly reflect income, a dealer in securities (just as a dealer in other merchandise) must maintain an inventory of his securities held for resale….
>
> Accordingly, in the instant case, the taxpayer is using an improper method of accounting with respect to its securities activity. The taxpayer must use the accrual method of accounting with regard to its bond department, but the items of income and expense of its business other than the bond department, may continue to be accounted for under the cash receipts and disbursements method, provided it clearly reflects income, a complete and separate set of books and records are maintained for each trade or business, and there is no shifting of profits or losses between trades or businesses so that income of the taxpayer is not clearly reflected. See section 1.446-1(d) of the regulations.

[820] TAM 9408003 held:

> The question of whether activities under common ownership constitute separate businesses has arisen in several contexts. In *Peterson Produce Company v. U.S.*, 313 F.2d 609 (8th Cir. 1963), the taxpayer was engaged in the poultry business and attempted to use the cash method for its newly-created broiler department. The court held that the departments were not separate trades or businesses, because the newly-created broiler department was too interdependent and functionally integrated with the poultry business.
>
> Similarly, in *Nielsen v. Commissioner*, 61 T.C. 311 (1973), it was determined that two hospitals owned by the same shareholders were separate businesses. Although the two hospitals shared some management and professional services, each hospital had a separate medical staff, served patients living primarily within its own geographical area, and functioned independently of the other hospital.
>
> Further, Rev. Rul. 74-270, 1974-1, C.B. 109, provides that the taxpayer, a bank, is permitted to use different methods of accounting for its commercial banking activities and its trust department for Federal income tax purposes. The trust department is required by Federal statute to operate separately from the commercial band and must keep separate books and records, and must have its own management, offices, and employees.
>
> In order for a taxpayer to be considered to have more than one trade or business, it must be shown that each such trade or business is separate and distinct from the other, and each business must maintain a complete and separable set of books and records.
>
> In the present situation, only clients who have purchased weight reduction contracts are eligible to buy the food supplements and other merchandise. The products are displayed and sold at each center, and they are sold by the same personnel who sell the weight reduction contracts. Although the taxpayer separately accounts for the sales of products and weight reduction contracts, expenses from the taxpayer's books and records cannot be separated in order to compute a net income for each activity. Because the resale activity is neither operated nor accounted for separately from the service activity, the taxpayer has only one trade or business.

[821] *Burgess Poultry Market, Inc. v. U.S.*, 14 A.F.T.R.2d 5036 (E.D. Tex. 1964). Relevant facts include:

operations were separate and distinct from its meat processing operations.[822] However, a chicken farmer was not able to show that its expansion from raising chickens to marketing through a broiler division was a separate and distinct business.[823] A corporation that published

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(2.) Since its incorporation in 1953, plaintiff has been engaged in the business of processing and selling broiler chickens, and in connection with that business plaintiff has kept its books and filed its income tax returns on the accrual basis of accounting. Said books consisted of cash disbursements journal, cash receipts journal, sales journal, voucher register, payroll journal, general journal and general ledger.

(3.) Plaintiff's broiler processing business generally consisted of procuring live broiler chickens when they were approximately nine weeks old, slaughtering, cleaning and preparing such chickens for market, and selling same both in a fresh and frozen state.

(5.) From its inception, the principal business of plaintiff's farm division was feeding and raising baby chicks for approximately nine weeks, after which time they reached a stage where they were sold as broilers.

(6.) Sometime after the commencement of plaintiff's farm division, there was added thereto a feed mill which mixed feed to be fed to the growing chickens, a hatchery to provide baby chicks to be raised, and a breeder flock of chickens to provide eggs to the hatchery.

(7.) From the inception of the farm division and throughout the fiscal years ended October 31, 1960, and October 31, 1961, plaintiff kept a set of books for its farm division operations which consisted of a cash disbursement journal, payroll journal, and general ledger. The books kept for the farm division were completely separate from the books kept for the broiler processing division. The books of the farm division were kept on the cash receipts and disbursements method of accounting and this method was used in reporting plaintiff's income and expenses from its farm division on its federal income tax returns for the fiscal years ended October 31, 1960, and October 31, 1961.

(8.) Upon commencement of the poultry raising business in its farm division, all new operating employees were hired in the farm division and no employees were transferred to the farm division from the processing division. Throughout the period in question, each division had its own separate employees, including separate bookkeepers and each division paid its own employees out of its own separate bank accounts. Separate bank accounts were maintained by the plaintiff for both its broiler processing division, in the name of Burgess Poultry Market, Inc., and its farm division, in the name of Burgess Poultry Farms…. Each division handled all its income and expenses through its own bank accounts in said banks.

[822] *Gold-Pak Meat Co., Inc. v. Commissioner*, T.C. Memo. 1971-83, held:

The cattle Gold-Pak fed on its own account were ultimately destined for its own slaughtering operations, and therefore were most intimately connected with those operations. The cattle feeding operation of Gold-Pak was not treated as a separate division, with separate books of account, employees, and other accouterments of a business enterprise. Rather Gold-Pak completely integrated the bookkeeping, personnel, and other incidents of business of both its meat processing and cattle feeding operations. The accountant who kept Gold-Pak's books clearly indicated that the transfer of the cattle from the feeding operation to the slaughtering operation was accomplished by adding to the cost of sales the inventory cost of the cattle. The close interrelationship between Gold-Pak's cattle feeding operation and the meat processing makes section 1.446-1(d) inapplicable.

[823] *Peterson Produce Co. v. U.S.*, 205 F.Supp. 229 (W.D. Ark. 1962), *aff'd* 313 F.2d 609 (8th Cir. 1963), held:

The plaintiff argues that its broiler farming operation is a new, separate and distinct business. Granted that if plaintiff is presently engaged in a farming operation by virtue of having created a new division, the question arises as to what sort of operation it was engaged in prior to September 1, 1958. The court is convinced that plaintiff did not substantially change its over-all operation on September 1, 1958, by the creation of the broiler division to handle the operation that the plaintiff had operated through its other two departments during the previous years. The "new" division was created within an existing corporate entity which at all times previous to and

and sold various farm publications was allowed to use a different method of accounting than its farming operations for which it maintained a complete and separable set of books and records.[824] However, where pre-existing businesses with different methods of accounting in

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> subsequent to September 1, 1958, has remained the same taxable entity. The creation of the new division was a convenience and perhaps an economic necessity to the plaintiff, and by concurrent utilization of the new form of contracts with the farmers, the plaintiff acquired more control over the growing and marketing of the chickens, but the fact remains that as a farming or nonfarming enterprise the plaintiff's over-all operation for the past ten years or more was the growing and marketing of broilers.
>
> Even if the broiler farming division constituted a new business, the further question arises whether the broiler farming operation was "separate and distinct."

The court quoted Reg. § 1.446-1(d) then continued:

> The regulation requires not only separate and distinct businesses, but also the keeping of separate and distinct books for each of the businesses. As to the operations of the plaintiff, its feed, hatchery and broiler departments are interdependent. The volume of the outside sales of feed and chicks is small compared to the transfers at cost of feed and chicks to the broiler division by the other two departments. There is no doubt but that plaintiff functions as a corporate entity made up of three well-integrated departments, not as a loose confederation made up of autonomous divisions. Whatever internal arrangements have been worked out over the years have not altered its corporate image in dealing with growers or in entering the chicken market as a seller. As the court concluded in the *Chemell* case, *supra*, at page 948:
>
> "… The term 'farm', by the definition of the regulations, includes poultry farms. The maintaining of a flock of hens producing eggs to be hatched into chicks and the growing of feed are agricultural pursuits and are parts of an integrated operation."
>
> As for the requirement of "complete and separable" books, while it is true that the general ledger accounts of the plaintiff's three departments could be physically separated, the fact remains that the books of original entries, such as daily journals, were not physically separable. The plaintiff contends that its books were "complete and separable" to the extent that they "clearly reflected" the income from each of the departments as an economic unit and that this conformed to good accounting practice. While this may be true, this court must base its determination of the case upon the plaintiff as a taxable entity, and the integrated or separate status of its departmental operations must be ascertained as a matter of fact, not as a matter of bookkeeping entries in particular or of accounting practice in general. *United States v. Ekberg*, *supra*; *Welp v. United States*, (D.C. Iowa 1952), 103 F. Supp. 551, reversed on other grounds 201 F.2d 128.
>
> Therefore, because of the functional integration of the three departments of the plaintiff's business, as well as the fact that the plaintiff did not maintain a "complete and separable" set of books and records with respect to each division, the broiler division cannot be characterized as a "separate and distinct" business for tax accounting purposes, and the Commissioner was correct in requiring that the taxpayer use the same method of accounting consistently with respect to all of its departments.

The court had said above that the taxpayer had contended that the broiler division "qualifies as a separate and distinct farming business," and stated:

> In support of this contention plaintiff cites the case of *United States v. Chemell*, (5 Cir. 1957), 243 F.2d 944, in which the court held an almost identical feed, hatchery and broiler operation to be a farming rather than an industrial operation, thus allowing the taxpayer to use the cash method of accounting and to disregard the livestock as inventory items. While the court agrees with the Fifth Circuit's designation of a feed, hatchery and broiler operation as a farming enterprise, it must be pointed out that in the cited case the taxpayer was not seeking a change in method of accounting once having elected the cash method, and furthermore the taxpayer maintained the same method of accounting in all of its departments.

United States v. Ekberg was a reference to 291 F.2d 913 (8th Cir. 1961).

[824] TAM 8245009.

different corporations became part of an affiliated group that filed a consolidated return, they could continue to use different methods of accounting.[825]

A taxpayer may distinguish an illegal trade or business, expenses of which Code § 280E precludes deducting,[826] from a legal trade or business, expenses of which are deductible.[827]

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[825] *Rocco, Inc. v. Commissioner*, 72 T.C. 140, 153-154 (1979), held:

> The basis of respondent's adjustments with regard to the inventories is that the end result of the incorporation of the subsidiaries and their adoption of the cash method of accounting is a change in the method of accounting used by Rocco and Turkeys without obtaining the Commissioner's consent.[15] For support of this rather oblique approach, respondent relies heavily on *Peterson Produce Co. v. United States*, 205 F.Supp. 229 (W.D. Ark. 1962), *affd.* 313 F.2d 609 (8th Cir. 1962). While Peterson involved a change in method of accounting within the feed and hatchery business, it is not particularly relevant to this discussion. There, the taxpayer established a separate broiler farming division which adopted the cash method of accounting. The court held, under section 446, that the new division did not qualify as a separate and distinct business which permitted it to elect the cash method of reporting under section 1.446-1(d), Income Tax Regs. Here Broiler Farms and Turkey Farms were organized and operated as separate corporations and they were entitled to elect the cash method of accounting, regardless of whether their businesses were separate and distinct from [Rocco's and Turkeys'. Furthermore, Peterson was concerned with section 446, not section 269.
>
> > [15] is not clear how respondent expects Broiler Farms and Turkey Farms to compute their incomes in future years. In resorting to sec. 269 respondent disallows deductions for the years involved, he does not change them to the inventory method of accounting. But unless the corporations are permitted to use opening inventories in the succeeding year there will be a real distortion of income. See *Clement v. United States*, 217 Ct. Cl. __, 580 F.2d 422, 432 (1978), *cert, denied* 440 U.S. 907 (1979), as to whether respondent has the right to place a farmer on the inventory method.
>
> It was not the acquisition of control of Broiler Farms by Rocco and of Turkey Farms by Turkeys that resulted in the tax benefit herein decried by respondent - it was a combination of the accounting method Broiler Farms and Turkey Farms were authorized to use and the filing of consolidated returns which the consolidated group was also authorized to use which produced the tax benefits in those particular years. See *Cromwell Corp. v. Commissioner*, 43 T.C. 313 (1964); *Siegel v. Commissioner*, *supra*. Even under section 446 respondent could hardly claim that the cash method would not clearly reflect the incomes of Broiler Farms and Turkey Farms if used consistently over the years.
>
> Thus, while we recognize that respondent is given broad authority by this statute, we question whether he has overstepped the bounds in applying section 269 in this case.
>
> However, we need not decide the legal issue posed above because, assuming that section 269 is applicable here, we have found as a fact that the principal purpose for Rocco and Turkeys "acquiring control" of Broiler Farms and Turkey Farms was not to avoid or evade tax by securing the benefit of a deduction, credit, or other allowance they would not otherwise enjoy.[16]
>
> [16] 16 It is not clear from the notice of deficiency or respondent's brief just who secured the tax benefit by acquiring control. Presumably respondent claims that Rocco and Turkeys did. But they acquired the tax benefit by virtue of filing consolidated returns with Broiler Farms and Turkey Farms, not directly by acquiring control of the new corporations.

[826] For the impact of Code § 280E on the purchase and sale of a business, including part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest, see "The potential for lost benefits of Up-Cs in a Sec. 280E environment," *The Tax Adviser* (9/1/2021).

[827] *Californians Helping to Alleviate Medical Problems., Inc. v. Commissioner*, 128 T.C. 173 (2007):

> We hold that section 280E does not preclude petitioner from deducting expenses attributable to a trade or business other than that of illegal trafficking in controlled substances simply because petitioner also is involved in the trafficking in a controlled substance ….

Once the court believes the businesses are separate, the taxpayer has some leeway in allocating expenses:

> Given petitioner's separate trades or businesses, we are required to apportion its overall expenses accordingly. Respondent argues that "petitioner failed to justify any particular allocation and failed to present evidence as to how … [petitioner's expenses] should be allocated between marijuana trafficking and other activities." We disagree. Respondent concedes that many of petitioner's activities are legal and unrelated to petitioner's provision of medical marijuana. The evidence at hand permits an allocation of expenses to those activities. Although the record may not lend itself to a perfect allocation with pinpoint accuracy, the record permits us with sufficient confidence to allocate petitioner's expenses between its two trades or businesses on the basis of the number of petitioner's employees and the portion of its facilities devoted to each business. Accordingly, in a manner that is most consistent with petitioner's breakdown of the disputed expenses, we allocate to petitioner's caregiving services 18/25 of the expenses for salaries, wages, payroll taxes, employee benefits, employee development training, meals and entertainment, and parking and tolls (18 of petitioner's 25 employees did not work directly in petitioner's provision of medical marijuana), all expenses incurred in renting facilities at the church (petitioner did not use the church to any extent to provide medical marijuana), all expenses incurred for "truck and auto" and "laundry and cleaning" (those expenses did not relate to any extent to petitioner's provision of medical marijuana), and 9/10 of the remaining expenses (90 percent of the square footage of petitioner's main facility was not used in petitioner's provision of medical marijuana).[6] We disagree with respondent that petitioner must further justify the allocation of its expenses, reluctant to substitute our judgment for the judgment of petitioner's management as to its understanding of the expenses that petitioner incurred as to each of its trades or businesses. *Cf. Boyd Gaming Corp. v. Commissioner*, 177 F.3d 1096 (9th Cir. 1999), *revg.* T.C. Memo. 1997-445.

> We now turn to analyze whether petitioner's furnishing of its caregiving services is a trade or business that is separate from its trade or business of providing medical marijuana. Taxpayers may be involved in more than one trade or business, see, *e.g.*, *Hoye v. Commissioner*, T.C. Memo. 1990-57, and whether an activity is a trade or business separate from another trade or business is a question of fact that depends on (among other things) the degree of economic interrelationship between the two undertakings, see *Collins v. Commissioner*, 34 T.C. 592 (1960); sec. 1.183-1(d)(1), Income Tax Regs. The Commissioner generally accepts a taxpayer's characterization of two or more undertakings as separate activities unless the characterization is artificial or unreasonable. See sec. 1.183-1(d)(1), Income Tax Regs.
>
> We do not believe it to have been artificial or unreasonable for petitioner to have characterized as separate activities its provision of caregiving services and its provision of medical marijuana. Petitioner was regularly and extensively involved in the provision of caregiving services, and those services are substantially different from petitioner's provision of medical marijuana. By conducting its recurring discussion groups, regularly distributing food and hygiene supplies, advertising and making available the services of personal counselors, coordinating social events and field trips, hosting educational classes, and providing other social services, petitioner's caregiving business stood on its own, separate and apart from petitioner's provision of medical marijuana. On the basis of all of the facts and circumstances of this case, we hold that petitioner's provision of caregiving services was a trade or business separate and apart from its provision of medical marijuana.

As to Code § 183, see part II.G.4.l.i.(c) Hobby Loss Benefits of Code § 183, which is found within part II.G.4.l.i Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit.

> [6] While we apportion most of the $212,958 in "Total deductions" to petitioner's caregiving services, we note that the costs of petitioner's medical marijuana business included the $203,661 in labor and $43,783 in other costs respondent conceded to have been properly reported on petitioner's tax return as attributable to cost of goods sold in the medical marijuana business.

However, one can carry this only so far:[828]

> Under the circumstances, we hold that selling non-marijuana merchandise was not separate from the business of selling marijuana merchandise. First, Altermeds, LLC, derived almost all of its revenue from marijuana merchandise. Second, the types of non-marijuana products that it sold (pipes and other marijuana paraphernalia) complemented its efforts to sell marijuana.[18] Altermeds, LLC, had only one unitary business, selling marijuana. See *Canna Care, Inc. v. Commissioner*, T.C. Memo. 2015-206, at *12, *aff'd*, 694 F.App'x 570 (9th Cir. 2017).
>
> [18] Besides marijuana paraphernalia, Alterman testified that the dispensary also sold (1) hats and T-shirts with the name and business logo of Altermeds, LLC, (2) magazines about marijuana, (3) and chicken soup. No documentary evidence corroborates the existence or extent of these sales. On a preponderance of evidence, we find that no such items were sold. Furthermore, these types of products as described by Alterman would generally complement the sales of marijuana by the dispensary. For example, the hats and T-shirts as described by Alterman bore the name and business logo of Altermeds, LLC. Thus, even if Altermeds, LLC, sold such hats and T-shirts, selling those items would have helped advertise medical marijuana.

Most cases cited by research services are old. See III.B. Multiple Trades or Businesses T.M. 570-4th *Accounting Methods*; ¶ G-2052 Multiple methods of accounting *Federal Tax Coordinator Analysis* (RIA).

The preamble to the final regulations, T.D. 9847 (2/8/2019), part IV.A.10, "Reasonable Methods for Allocation of Items Among Multiple Trades or Businesses," explains:

> The proposed regulations provide that if an individual or an RPE directly conducts multiple trades or businesses, and has items of QBI which are properly attributable to more than one trade or business, the individual or RPE must allocate those items among the several trades or businesses to which they are attributable using a reasonable method based on all the facts and circumstances. The chosen reasonable method for each item must be consistently applied from one taxable year to another and must clearly reflect the income and expenses of each trade or business. One commenter suggested that a reasonable approach to allocating items that are not clearly attributable to a single trade or business could be the cost allocation methods used in § 1.199-4(b)(2). The commenter suggested that the reasonableness standard could be applied to determine the allocation of items of QBI among multiple trades or businesses. The commenter also suggested a safe harbor allocation method allowing a taxpayer to bypass direct tracing if the amount of other items of QBI that must be allocated is below

[828] After citing *Californians Helping to Alleviate Medical Problems., Inc. v. Commissioner*, 128 T.C. 173 (2007), *Alterman v. Commissioner*, T.C. Memo. 2018-83, held that the taxpayer did not prove separateness and did not prove that various deductions were allocable to legal activities.

a pre-determined threshold, such as a percentage of total QBI or a specified dollar amount.

The Treasury Department and the IRS decline to adopt this comment as the rules under § 1.199-4 were intended solely for the allocation of expenses. By contrast, the rule described in § 1.199A- 3(b)(5) requires the allocation of all qualified items of income, gain, loss, and deduction across multiple trades or businesses. Whether direct tracing or allocations based on gross income are reasonable methods depends on the facts and circumstances of each trade or business. Different reasonable methods may be appropriate for different items. Accordingly, the final regulations retain the rule in the proposed regulations. However, once a method is chosen for an item, it must be applied consistently with respect to that item. The Treasury Department and the IRS continue to study this issue and request additional comments, including comments with respect to potential safe harbors.

Another commenter requested guidance on when or how a method can be changed from year to year if, for example, it is no longer reasonable or no longer clearly reflects income. The Treasury Department and the IRS decline to adopt this comment as it is beyond the scope of these regulations. If a method is no longer reasonable or no longer clearly reflects income, the method cannot continue to be used. The individual or RPE must choose a new method that is reasonable under the facts and circumstances and apply it consistently going forward.

Reg. § 1.199A-3(b)(5), "Allocation of items among directly-conducted trades or businesses," provides:

If an individual or an RPE directly conducts multiple trades or businesses, and has items of QBI that are properly attributable to more than one trade or business, the individual or RPE must allocate those items among the several trades or businesses to which they are attributable using a reasonable method based on all the facts and circumstances. The individual or RPE may use a different reasonable method with respect to different items of income, gain, deduction, and loss. The chosen reasonable method for each item must be consistently applied from one taxable year to another and must clearly reflect the income and expenses of each trade or business. The overall combination of methods must also be reasonable based on all facts and circumstances. The books and records maintained for a trade or business must be consistent with any allocations under this paragraph (b)(5).

Applying 2017 tax reform to determine separate businesses is relevant not only for Code § 199A but also for Code § 512(a)(6) (preventing a tax-exempt entity from uses losses from one business against income from a separate business), which is discussed in part II.E.1.f.viii Tax-Exempt Trusts. Discussed there is guidance under Code § 512(a)(6), under which NAICS codes delineate between various businesses. The NAICS is an industry classification system for purposes of collecting, analyzing, and publishing statistical data related to the United States business economy. See Executive Office of the President, Office of Management and Budget, North American Industry Classification System (2017), available at https://www.census.gov/eos/www/naics/2017NAICS/2017_NAICS_Manual.pdf. I am not suggesting any authority directly applying these codes for Code § 199A. However, given that guidance on how to delineate separate businesses leaves a lot of room for interpretation, using these codes may show a good-faith attempt to delineate between businesses.

II.E.1.c.iii.(c). "Trade or Business" in Other Areas of Tax Law

Neither the statute nor the legislative history explains what is a "trade or business." The preamble to the final regulations strongly favors looking to Reg. § 1.446-1(d).[829]

Here are some resources that may help, to the extent that regulations do not provide guidance:

- Part II.G.4.l.i Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit would be the most important source.

- What is a "trade or business" is important regarding particular issues for the Code § 1411 3.8% tax on net investment income ("NII"), which is tied to the Code § 469 passive activity loss ("PAL") rules. When reviewing the resources below, keep in mind that (a) being passive tends to be bad for taxpayers in the context of the NII and PAL rules but is irrelevant for Code § 199A, and (b) real estate has special rules regarding its character as passive, which again is irrelevant for Code § 199A:

    - The government received and responded to comments on what is a "trade or business" when working on regulations for the net investment income. See:

        - Part II.I.8.a General Application of 3.8% Tax to Business Income, fns 2333-2342, and

        - Part II.I.8.c.iii Rental as a Trade or Business, fns 2397-2407.

    - In the PAL rules:

        - What is a trade or business has received some attention in the real estate professional exception, but most of that tends to be whether the trade or business qualifies as a real estate trade or business. Although I don't view those as particularly instructive as to what is a trade or business, here is the discussion so you can see for yourself: Part II.K.1.e.iii Real Estate Professional Converts Rental to Nonpassive Activity.

        - Part II.K.1.f Royalty as a Trade or Business may have some application.

        - Because what is a "trade or business" is so driven by facts and circumstances and one needs to delineate among separate trades or businesses in applying Code § 199A, one wonders whether the government might provide some guidance. The PAL rules provide guidance that one might speculate the government might consider adopting, rather than creating a whole new set of rules. The PAL rules allow taxpayers to group activities, with a general grouping rule and a rule specific to real estate professionals. See parts II.K.1.b Grouping Activities and II.K.1.e.iii.(b) Aggregating Real Estate Activities for a Real Estate Professional. The net investment income tax rules were required to refer to the PAL rules, so they also adopted those grouping rules, but allowed taxpayers to regroup when first subject to the NII tax. See part II.I.8.a.ii Passive Activity Grouping Rules.

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[829] See part II.E.1.c.iii.(b) Multiple Trades or Businesses Within an Entity.

- Self-employment tax is imposed only on activity that is a trade or business. See:
    - Part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax, fns 3410-3413.
    - Part II.L.2.a.ii Rental Exception to SE Tax and II.L.2.a.iii Whether Gain from Sale of Property is Subject to SE Tax, keeping in mind that the rental exception excludes certain trades or businesses for self-employment tax purposes. Part II.L.2.a.ii also discusses that generally equipment rental is a trade or business, in contrast to real estate, which needs more activity to rise to the level of a trade or business.
- A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business. The final regulations expressly refer to this, as is elaborated on in part II.E.1.c.iii.(b) Multiple Trades or Businesses Within an Entity**.**

II.E.1.c.iii.(d). Aggregating Activities for Code § 199A

This part II.E.1.c.iii.(d) describes optional aggregation that allows taxpayers to combine wages and UBIA from separate (but related in some manner) businesses. For whether an individual, trust, or RPE has more than one trade or business, see part II.E.1.c.iii.(b) Multiple Trades or Businesses Within an Entity – Identification of Businesses and Allocation of Items.

Each RPE separately determines whether its activity qualifies as a trade or business. Owners might want to combine their RPEs into a master partnership in which each LLC is a disregarded entity. See the discussion at the end of the introductory portion of part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.[830]

Although these rules are optional, parts II.E.1.c.v.(c) Calculation When Taxable Income Exceeds the Threshold Amount and II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction show how aggregation is beneficial in most cases. Whether or not a taxpayers aggregates, real estate rented to a commonly controlled business also receives relief; see part II.E.1.e.i General Rules Regarding U.S. Real Estate .[831]

In contrast to optional aggregation under this part II.E.1.c.iii.(d), part II.E.1.c.iv.(o) SSTB Very Broad Gross Receipts Test and Anti-Abuse Rules shows how businesses closely tied to a specified service trade or business (SSTB) may lose part or all of their QBI solely because of that connection.

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), explains optional aggregation:

> **IV. Proposed § 1.199A-4: Aggregation Rules**
>
> **A. Overview**
>
> The proposed regulations incorporate the rules under section 162 for determining whether a trade or business exists for purposes of Section 199A. A taxpayer can have more than one trade or business for purposes of section 162. See § 1.446-1(d)(1).

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[830] See text accompanying fn 760, which also mentions the possibility of using QSubs when the master RPE is an S corporation.

[831] Especially the text accompanying fns 951-953.

However, in most cases, a trade or business cannot be conducted through more than one entity.

The Treasury Department and the IRS have received comments requesting that the regulations provide that taxpayers be permitted to group or “aggregate” trades or businesses under Section 199A using the grouping rules described in § 1.469-4 (grouping rules). Section 1.469-4 sets forth the rules for grouping a taxpayer’s trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules of section 469. Section 469 uses the term “activities” in determining the application of the limitation rules under section 469. In contrast, Section 199A applies to trades or businesses. By focusing on activity, the grouping rules may be both under and over inclusive in determining what activities give rise to a trade or business for Section 199A purposes.

Additionally, section 469 is a loss limitation rule used to prevent taxpayers from sheltering passive losses with nonpassive income. The Section 199A deduction is not based on the level of a taxpayer’s involvement in the trade or business (that is, both active and passive owners of a trade or business may be entitled to a Section 199A deduction if they otherwise satisfy the requirements of Section 199A and these proposed regulations). Complicating matters further, a taxpayer’s section 469 groupings may include specified service trades or businesses, requiring separate rules to segregate the two categories of trades or businesses to calculate the Section 199A deduction.

Therefore, the grouping rules under section 469 are not appropriate for determining a trade or business for Section 199A purposes. Accordingly, the Treasury Department and the IRS are not adopting the section 469 grouping rules as the means by which taxpayers can aggregate trades or businesses for purposes of applying Section 199A.

Although it is not appropriate to apply the grouping rules under section 469 to Section 199A, the Treasury Department and the IRS agree with practitioners that some amount of aggregation should be permitted. It is not uncommon for what are commonly thought of as single trades or businesses to be operated across multiple entities. Trades or businesses may be structured this way for various legal, economic, or other non-tax reasons. The fact that businesses are operated across entities raises the question of whether, in defining trade or business for purposes of Section 199A, section 162 trades or businesses should be permitted or required to be aggregated or disaggregated, and if so, whether such aggregation or disaggregation should occur at the entity level or the individual level. Allowing taxpayers to aggregate trades or businesses offers taxpayers a means of combining their trades or businesses for purposes of applying the W-2 wage and UBIA of qualified property limitations and potentially maximizing the deduction under Section 199A. If such aggregation is not permitted, taxpayers could be forced to incur costs to restructure solely for tax purposes. In addition, business and non-tax law requirements may not permit many taxpayers to restructure their operations. Therefore, proposed § 1.199A-4 permits the aggregation of separate trades or businesses, provided certain requirements are satisfied.

The Treasury Department and the IRS are aware that many commenters were concerned with having multiple regimes for grouping (that is, under sections 199A, 1411, and 469). Accordingly, comments are requested on the aggregation method described in proposed § 1.199A-4, including whether this would be an appropriate grouping method for purposes of sections 469 and 1411, in addition to Section 199A.

B. Aggregation rules

Under proposed § 1.199A-4, aggregation is permitted but is not required. However, an individual may aggregate trades or businesses only if the individual can demonstrate that the requirements in proposed § 1.199A-4(b)(1) are satisfied. First, consistent with other provisions in the proposed regulations, each trade or business must itself be a trade or business as defined in § 1.199A-1(b)(13).

Second, the same person, or group of persons, must directly or indirectly, own a majority interest in each of the businesses to be aggregated for the majority of the taxable year in which the items attributable to each trade or business are included in income. All of the items attributable to the trades or businesses must be reported on returns with the same taxable year (not including short years). Proposed § 1.199A-4(b)(3) provides rules allowing for family attribution. Because the proposed rules look to a group of persons, non-majority owners may benefit from the common ownership and are permitted to aggregate. The Treasury Department and the IRS considered certain reporting requirements in which the majority owner or group of owners would be required to provide information about all of the other pass-through entities in which they held a majority interest. Due to the complexity and potential burden on taxpayers of such an approach, proposed § 1.199A-4 does not provide such a reporting requirement. The Treasury Department and the IRS request comments on whether a reporting or other information sharing requirement should be required.

Third, none of the aggregated trades or businesses can be an SSTB. Proposed § 1.199A-5 addresses SSTBs and trades or businesses with SSTB income.

Fourth, individuals and trusts must establish that the trades or businesses meet at least two of three factors, which demonstrate that the businesses are in fact part of a larger, integrated trade or business. These factors include: (1) the businesses provide products and services that are the same (for example, a restaurant and a food truck) or they provide products and services that are customarily provided together (for example, a gas station and a car wash); (2) the businesses share facilities or share significant centralized business elements (for example, common personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources); or (3) the businesses are operated in coordination with, or reliance on, other businesses in the aggregated group (for example, supply chain interdependencies).

C. Individuals

An individual is permitted to aggregate trades or businesses operated directly and trades or businesses operated through RPEs. Individual owners of the same RPEs are not required to aggregate in the same manner.

An individual directly engaged in a trade or business must compute QBI, W-2 wages, and UBIA of qualified property for each trade or business before applying the aggregation rules. If an individual has aggregated two or more trades or businesses, then the combined QBI, W-2 wages, and UBIA of qualified property for all aggregated trades or businesses is used for purposes of applying the W-2 wage and UBIA of qualified property limitations described in proposed § 1.199A-1(d)(2)(iv).

D. RPEs

RPEs must compute QBI, W-2 wages, and UBIA of qualified property for each trade or business. An RPE must provide its owners with information regarding QBI, W-2 wages, and UBIA of qualified property attributable to its trades or businesses.

The Treasury Department and the IRS considered permitting aggregation by an RPE in a tiered structure. The Treasury Department and the IRS considered several approaches to tiered structures, including permitting only the operating entity to aggregate the trades or businesses or permitting each tier to add to the aggregated trade or business from a lower-tier, provided that the combined aggregated trade or business otherwise satisfied the requirements of proposed § 1.199A-4(b)(1) had the businesses all been owned by the lower-tier entity. The Treasury Department and the IRS are concerned that the reporting requirements needed for either of these rules would be overly complex for both taxpayers and the IRS to administer. In addition, because the Section 199A deduction is in all cases taken at the individual level, it should not be detrimental, and in fact may provide flexibility to taxpayers, to provide for aggregation at only one level. The Treasury Department and the IRS request comments on the proposed approach to tiered structures and the reporting necessary to allow an individual to demonstrate to which trades or businesses his or her QBI, W-2 wages, and UBIA of qualified property are attributable for purposes of calculating his or her Section 199A deduction.

E. Reporting and consistency

Proposed § 1.199A-4(c)(1) requires that once multiple trades or businesses are aggregated into a single aggregated trade or business, individuals must consistently report the aggregated group in subsequent tax years. Proposed § 1.199A-4(c)(1) provides rules for situations in which the aggregation rules are no longer met as well as rules for when a newly created or acquired trade or business can be added to an existing aggregated group.

Proposed § 1.199A-4(c)(2)(i) provides reporting and disclosure requirements for individuals that choose to aggregate, including identifying information about each trade or business that constitutes a part of the aggregated trade or business. Proposed § 1.199A-4(c)(2)(ii) allows the Commissioner to disaggregate trades or businesses if an individual fails to make the required aggregation disclosure. The Treasury Department and the IRS request comments as to whether it is administrable to create a standard under which trades or businesses will be disaggregated by the Commissioner and what that standard might be.

However, the final regulations change several aspects, as the preamble summarizes in the section explaining economic impact:[832]

The final regulations allow an RPE to aggregate trades or businesses it operates directly or through lower-tier RPEs for the purposes of calculating the Section 199A deduction in addition to allowing aggregation at the individual owner level. This change to the

[832] T.D. 9847 (2/8/2019), Special Analyses, part I, "Regulatory Planning and Review – Economic Analysis," subpart C, "Economic Analysis of Changes in Final Regulations," paragraph 2, "Entity Aggregation."

proposed rules allows RPEs, if they meet the ownership and other tests outlined in the regulations, to aggregate QBI, wages, and capital amounts and report aggregated figures to owners. This change was made in response to comments suggesting that allowing aggregation at the RPE level would simplify reporting and compliance efforts for owners because the RPEs may more easily obtain the information to determine whether the trades or businesses meet the tests for aggregation and whether it is beneficial to aggregate. Because RPEs that aggregate must meet all of the aggregation requirements, the change is consistent with the aggregation concept, which allows trades or businesses that operate across multiple entities but are commonly considered one business to benefit from calculating their Section 199A deduction using combined income and expenses.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part V "Aggregation," explains:

A. Overview

As described in part II of this Summary of Comments and Explanation of Revisions, the final regulations incorporate the principles of section 162 for determining whether a trade or business exists for purposes of Section 199A. A taxpayer can have more than one section 162 trade or business. See § 1.446-1(d)(1). Multiple trades or businesses can also be conducted within one entity. A trade or business, however, cannot generally be conducted across multiple entities for tax purposes. The preamble to the proposed regulations acknowledges that it is not uncommon for what may be thought of as single trades or businesses to be operated across multiple entities, for various legal, economic, or other non-tax reasons. It is because trades or businesses may be structured this way that the proposed regulations permit aggregation.

The proposed regulations provide a set of rules under which an individual can aggregate multiple trades or businesses for purposes of applying the W-2 wage and UBIA of qualified property limitations described in § 1.199A-1(d)(2)(iv). Based on comments received, the final regulations retain these rules with modifications as described in the remainder of this part V. The Treasury Department and the IRS received comments in support of the aggregation rules generally, though some commenters suggested that the grouping rules described in the regulations under section 469 be used to determine when a taxpayer may aggregate. The Treasury Department and the IRS decline to adopt this suggestion. For reasons stated in the proposed regulations (that is, the differences in the definition of trade or business, section 469's reliance on a taxpayer's level of involvement in the trade or business, and the use of separate rules for specified service trades or businesses), the Treasury Department and the IRS do not consider the grouping rules under section 469 an appropriate method for determining whether a taxpayer can aggregate trades or businesses for purposes of applying Section 199A. Another commenter suggested looking to the controlled group rules under section 414 rather than creating a new framework for aggregation. The Treasury Department and the IRS decline to adopt the controlled group rules under section 414 as those rules are too specific to be applied as a general aggregation rule under Section 199A.

The preamble to the proposed regulations requested comments on whether the aggregation method described in § 1.199A-4 would be an appropriate grouping method for purposes of sections 469 and 1411, in addition to Section 199A. One commenter suggested that the Section 199A aggregation method would not be an appropriate method for sections 469 and 1411 because the primary focus of grouping under those sections is based on the taxpayer's level of participation. Another commenter, noting that the standard for aggregation under the proposed regulations is narrower than the section 469 grouping requirements, recommended that taxpayers be permitted to adopt their Section 199A aggregation for purposes of section 469. The commenter stated that this would provide taxpayers with an option to mitigate the administrative burden of multiple grouping rules. The Treasury Department and the IRS continue to study this issue and request additional comments.

B. General Rules

The proposed regulations provide rules that allow a taxpayer to aggregate trades or businesses based on a 50-percent ownership test, which must be maintained for a majority of the taxable year. The final regulations clarify that majority of the taxable year must include the last day of the taxable year. One commenter requested guidance on whether each individual included in making the ownership determination must own an interest in each trade or business to be aggregated. Another commenter suggested that to avoid abuse in situations where actual overlapping ownership is low, anyone who owns less than 10 percent of the value of an enterprise could be excluded from the group of owners whose ownership is considered in testing. The commenter suggested clarification or modification of the overlapping ownership requirement including by requiring a minimum ownership threshold of the trades or businesses, or that the 50 percent test use each owner's lowest interest in the RPE. The ownership rule in the proposed regulations does not require that every person involved in the ownership determination own an interest in every trade or business. The rule is satisfied so long as one person or group of persons holds a 50 percent or more ownership interest in each trade or business. The Treasury Department and the IRS decline to require a minimum ownership threshold for purposes of the ownership test as the abuse potential is outweighed by the administrative complexity such a rule would create. The Treasury Department and the IRS note that trades or businesses to be aggregated must meet all of the requirements of § 1.199A-4, not just the ownership requirement.

Other commenters suggested that aggregation should be allowed for trades or businesses that do not meet the common ownership test if the general partner or managing member is the same for each entity. The Treasury Department and the IRS decline to adopt this recommendation. The aggregation rules are intended to allow aggregation of what is commonly thought of as a single trade or business where the business is spread across multiple entities. Common ownership is an essential element of a single trade or business.

Several commenters noted that the family attribution rules under Section 199A do not include grandparents, siblings, or adopted children. One commenter requested clarification that the family attribution rules would not cause an aggregated trade or business to cease to qualify for aggregation when children and grandchildren reached adulthood. A few commenters requested guidance on the manner in which beneficial interests in trusts are considered for purposes of the common ownership rule. Other commenters suggested that the attribution rules in sections 267 and 707 should be used in place of the family attribution rule. Another commenter suggested that final regulations provide a specific attribution rule that treats owners of entities as owning a pro rata share of any business owned by the entity for purposes of the 50 percent ownership test. Another commenter recommended defining "directly or indirectly" as used in the proposed regulations by reference to a specific ownership rule. The final regulations address these recommendations by requiring that the same person or group of persons, directly or by attribution through sections 267(b) or 707(b), own 50 percent or more of each trade or business. A C corporation may constitute part of this group.

In addition, the proposed regulations require that all items attributable to aggregated trades or businesses be reported on returns for the same taxable year. Several commenters recommended that this requirement be removed, arguing that trades or businesses that meet the ownership and factor tests could have different taxable years. The Treasury Department and the IRS decline to adopt this recommendation because the aggregation rules are intended for use in applying the W-2 wage and UBIA of qualified property limitations. As described in § 1.199A- 2(b), W-2 wages are determined based on a calendar year. Allowing trades or businesses with different taxable years to aggregate would require special rules for apportioning W-2 wages for purposes of applying the W-2 wage limitation. Accordingly, the final regulations retain the requirement that all of the items attributable to each trade or business to be aggregated are reported on returns at the trade or business level with the same taxable year, not taking into account short taxable years. One commenter asked for clarification regarding whether the majority of the taxable year requirement refers to the taxable year of the taxpayer claiming the deduction or of the RPE reporting the items. The aggregation rules are applied at the trade or business level. Accordingly, the majority of the taxable year requirement refers to the individual or RPE that conducts the trade or business to be aggregated.

The proposed regulations also provide that an SSTB cannot be aggregated. One commenter requested guidance on whether SSTBs with de minimis gross receipts are permitted to aggregate. A trade or business with gross receipts from a specified service activity below the de minimis thresholds described in § 1.199A-5(c)(1) is not treated as an SSTB and therefore may be aggregated under the rules described in § 1.199A-4. Another commenter suggested that the prohibition on aggregation for SSTBs is unnecessary because a taxpayer must combine W-2 wages and UBIA of qualified property for the aggregated trade or business prior to applying the W-2 wages and UBIA limitations. The commenter recommended that at a minimum, the prohibition be removed for taxpayers within the phase-in range and that taxpayers should be permitted to aggregate SSTBs with other SSTBs for reporting purposes. The Treasury Department and the IRS decline to adopt the recommendation to allow SSTBs to aggregate as doing so would increase administrative burden and complexity without providing significant benefit. Aggregation is intended to assist taxpayers in applying the W-2 wage and UBIA of qualified property limitations. A taxpayer with taxable income below the threshold amount does not need to apply the W- 2 wage and UBIA of qualified property limitations and therefore will not benefit from aggregation. Further, the Treasury Department and the IRS decline to adopt the recommendation that the prohibition on aggregation of SSTBs be removed for taxpayers with taxable income within the phase-in range as taxpayers may have taxable income within the phase-in range for some taxable years and taxable income that exceeds the phase-in range in other taxable years.

To determine whether trades or businesses may be aggregated, the proposed regulations provide that multiple trades or businesses must, among other requirements, satisfy two of three listed factors, which demonstrate that the businesses are part of a larger, integrated trade or business. These factors include: (1) The businesses provide products and services that are the same (for example, a restaurant and a food truck) or customarily provided together (for example, a gas station and a car wash); (2) the businesses share facilities or share significant centralized business elements (for example, common personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources); or (3) the businesses are operated in coordination with, or reliance on, other businesses in the aggregated group (for example, supply chain interdependencies). Some commenters expressed support for the factors in the proposed regulations while others suggested modifications to the test. One commenter questioned whether, to meet the first factor, trades or businesses must provide both products and services that are the same. Another commenter noted that it is unclear how to apply the first factor with respect to real estate as real estate is neither a product nor a service. In response to these comments, the final regulations describe the first factor as products, property, or services that are the same or customarily offered together. Additionally, the final regulations add examples clarifying when a real estate trade or business satisfies the aggregation rules. Other commenters requested additional guidance on whether certain fact patterns regarding specific trades or businesses would satisfy a particular factor. The Treasury Department and the IRS decline to address specific fact patterns or trades or businesses because this test is based on all the facts and circumstances. Therefore, specific rules would be impractical and imprecise. Similarly, the Treasury Department and the IRS decline to define "significant" in terms of centralized business elements in the second factor because the answer is dependent on the facts and circumstances of each combination of trades and businesses.

Another commenter suggested that operational interdependence could be determined more precisely by using tests such as the twelve factor test outlined in § 1.469-4T(g)(3). The commenter noted that such a test would be less likely to inappropriately preclude a Section 199A deduction. Other commenters suggested that taxpayers be permitted to aggregate when two of the four factors are met. The Treasury Department and the IRS have carefully considered alternatives, including the factors outlined in § 1.469-4T(g)(3). Aggregation of multiple trades or businesses is not provided for in the statutory text, but was added to the regulations to enhance administrability for taxpayers and the IRS in situations when what is thought of as a single trade or business is operated across multiple entities for various legal, economic, or other non-tax reasons. Aggregation is optional and the inability to aggregate does not preclude a taxpayer with QBI from multiple trades or businesses from claiming a Section 199A deduction on the separate trades or businesses to the extent otherwise allowed by Section 199A and these regulations. The Treasury Department and the IRS believe that reducing the required number of factors would allow the aggregation of trades or businesses that are not owned and operated as integrated businesses. Conversely, adding new factors would increase complexity and burden for both taxpayers and the IRS. Accordingly, the final regulations retain the factors provided in the proposed regulations, modified to take real estate into account.

C. Aggregation by RPEs

Multiple commenters recommended that RPEs be permitted to aggregate at the entity level. One commenter suggested that allowing aggregation at the entity level would reduce reporting requirements if the owners or beneficiaries of the entity were required to follow the entity's aggregation. The commenter also suggested that entity aggregation would help non-majority owners by allowing them to benefit from aggregation without requiring the entity to provide ownership information. Another commenter suggested that reporting would be simplified if aggregation was allowed at the entity level when it is known that the owners want to aggregate. A third commenter suggested that aggregation should be allowed where each owner provides consent, including through provisions in the operating agreements. Another commenter suggested that if entity level aggregation is not allowed generally, an exception should be made for disregarded and wholly-owned entities.

The Treasury Department and the IRS agree that aggregation should be allowed at the entity level. Accordingly, the final regulations permit an RPE to aggregate trades or businesses it operates directly or through lower-tier RPEs. The resulting aggregation must be reported by the RPE and by all owners of the RPE. An individual or upper-tier RPE may not separate the aggregated trade or business of a lower-tier RPE, but instead must maintain the lower-tier RPE's aggregation. An individual or upper-tier RPE may aggregate additional trades or businesses with the lower-tier RPE's aggregation if the rules of § 1.199A-4 are otherwise satisfied. Each RPE in a tiered structure is subject to the disclosure and reporting requirements in § 1.199A- 4(c)(1). Further, as discussed in part II.C.1 of this Summary of Comments and Explanation of Revisions, § 1.199A-1(e)(2) of the final regulations provides that an entity with a single owner that is treated as disregarded as an entity separate from its owner under any other provision of the Code is disregarded for purposes of Section 199A and §§ 1.199A-1 through 1.199A-6.[833]

D. Reporting and Disclosure

The proposed regulations require consistent reporting of aggregated trades or businesses. Each individual who chooses to aggregate must attach a statement to their return annually identifying each trade or business to be aggregated. A few commenters requested clarification of these rules in situations in which a taxpayer did not aggregate or failed to report an aggregation. Several commenters suggested that taxpayers be required to file only one disclosure in the first year the taxpayer chooses to aggregate and that any subsequent aggregation information be reported on the same form used to report a taxpayer's Section 199A deduction. Further, these commenters suggested that taxpayers be allowed to remedy a failure to provide the required information by filing an amended return or upon examination, provided that the taxpayer can establish reasonable cause for the failure. One commenter recommended that any required aggregation information be reported on a form for the Section 199A deduction instead of as a separate statement. Additionally, commenters requested guidance as to whether a taxpayer is required to aggregate in its first year and if the failure to aggregate precludes aggregation in a later year. Finally, one commenter requested guidance regarding when a taxpayer could re-aggregate. The commenter suggested that options could include during an open season; after a change in circumstances; under a formal process similar to a change in accounting method; or based on a list of circumstances that would allow for automatic permission to re-aggregate.

Based on these comments, the final regulations provide that a taxpayer's failure to aggregate trades or businesses will not be considered to be an aggregation under this rule; that is, later aggregation is not precluded. The final regulations do not generally allow for an initial aggregation to be made on an amended return as this would allow aggregation decisions to be made with the benefit of hindsight. A taxpayer who fails or

[833] [footnote not in preamble:] See text accompanying fn 762 in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

chooses not to aggregate in Year 1 can still choose to aggregate in Year 2 or other future year (but cannot amend returns to choose to aggregate for Year 1). A taxpayer who chooses to aggregate must continue to aggregate each taxable year unless there is a material change in circumstances that would cause a change to the aggregation. However, the Treasury Department and the IRS acknowledge that many individuals and RPEs may be unaware of the aggregation rules when filing returns for the 2018 taxable year. Therefore, the IRS will allow initial aggregations to be made on amended returns for the 2018 taxable year. The final regulations retain the annual disclosure requirement and, in order to provide flexibility as forms and instructions change, allow the Commissioner to require disclosure of information on aggregated trades or businesses as provided in a variety of formats including forms, instructions, or published guidance. The final regulations contain similar reporting and disclosure rules for RPEs.

The preamble to the proposed regulations requested comments on whether reporting requirements should be imposed on RPEs requiring majority owners to provide information about all of the other RPEs in which they hold a majority interest. One commenter stated that the extra time and cost of imposing additional reporting requirements on aggregated trades or businesses would not be worth the potential benefit a non-majority owner may gain by having such information. Another commenter suggested that the need for such a rule would be reduced if the final regulations allowed aggregation by RPEs. The Treasury Department and the IRS agree with these comments. Accordingly, the final regulations do not adopt a rule requiring the disclosure of such information to non-majority owners.

The proposed regulations permit the Commissioner to disaggregate trades or businesses if a taxpayer fails to attach the required annual disclosure. The preamble to the proposed regulations requested comments on an administrable standard under which trades or businesses will be disaggregated. One commenter suggested that a disaggregation rule is unnecessary because the Commissioner can always assert that an aggregation that was inappropriate should be disregarded. The commenter suggested that the Treasury Department and the IRS consider a rule allowing the Commissioner to aggregate trades or businesses in which the taxpayer engages in a transaction or series of transactions to divide trades or businesses in a manner that allows the taxpayer to use the aggregation rules to artificially increase the taxpayer's Section 199A deduction.

The Treasury Department and the IRS decline to adopt both of these suggestions. Although the Treasury Department and the IRS agree with the commenter that the Commissioner can always assert that an inappropriate aggregation should be disregarded, the reporting requirements, including the disaggregation rule, are necessary for the Commissioner to administer Section 199A in accordance with the statutory intent. The final regulations clarify that the disaggregation is not permanent by providing that trades or businesses that are disaggregated by the Commissioner may not be re-aggregated for the three subsequent taxable years, similar to the typical period during which a tax return may be audited. The Treasury Department and the IRS also decline to adopt the commenter's suggestion that the final regulations include an additional anti-abuse rule that would allow the Commissioner to aggregate trades or business in cases in which a division of the taxpayer's trades or businesses is used in conjunction with the aggregation rules with a principal purpose of increasing the taxpayer's Section 199A deduction. As explained in part II.D. of this Summary of Comments and Explanation of Revisions, taxpayers and entities can have more than one trade or business. The suggested anti-abuse rule is overly broad and would create unnecessary complexity for both taxpayers and the IRS.

> **E. Examples**
>
> The proposed regulations provide several examples of the aggregation rules. One commenter noted that proposed § 1.199A-4(b)(1)(i) refers to the capital or profits of a partnership while the examples refer to the capital and profits of a partnership. The language in the examples was intended to demonstrate that the taxpayers were sharing proportionately in all items. For clarification, the final regulations retain the reference to capital or profits in § 1.199A-4(b)(1)(i) and update the examples to remove the references to capital and profits.

Reg. § 1.199A-4(a), "Scope and purpose, provides:[834]

> An individual or RPE may be engaged in more than one trade or business. Except as provided in this section, each trade or business is a separate trade or business for purposes of applying the limitations described in § 1.199A-1(d)(2)(iv). This section sets forth rules to allow individuals and RPEs to aggregate trades or businesses, treating the aggregate as a single trade or business for purposes of applying the limitations described in § 1.199A-1(d)(2)(iv). Trades or businesses may be aggregated only to the extent provided in this section, but aggregation by taxpayers is not required.

Prop. Reg. § 1.199A-4 applies to taxable years ending after the date the Treasury decision adopting it as a final regulation is published in the Federal Register, but taxpayers may rely on it until the date the Treasury decision adopting it as final regulations is published in the Federal Register.[835]

Reg. § 1.199A-4(e), "Effective/ applicability date," provides:

> (1) *General rule*. Except as provided in paragraph (e)(2) of this section, the provisions of this section apply to taxable years ending after February 8, 2019.
>
> (2) *Exception for non-calendar year RPE*. For purposes of determining QBI, W-2 wages, and UBIA of qualified property, and the aggregate amount of qualified REIT dividends and qualified PTP income, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

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[834] Reg. § 1.199A-1(d)(2)(iv) is reproduced in part II.E.1.c.v.(c) Calculation When Taxable Income Exceeds the Threshold Amount.

[835] Prop. Reg. § 1.199A-4(e)(1), which is expressly subject to Prop. Reg. § 1.199A-4(e)(2), "Exception for non-calendar year RPE," which provides:

> For purposes of determining QBI, W-2 wages, and UBIA of qualified property, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

Before getting into when one may aggregate, note that an election to treat more than one real estate rental activity as a single rental real estate enterprise under the optional safe harbor of Rev. Proc. 2019-38 constitutes an election to aggregate.[836]

Reg. § 1.199A-4(b)(1), "General rule," provides that trades or businesses may be aggregated only if an individual or RPE can demonstrate that -

(i) The same person or group of persons, directly or by attribution under sections 267(b) or 707(b), owns 50 percent or more of each trade or business to be aggregated, meaning in the case of such trades or businesses owned by an S corporation, 50 percent or more of the issued and outstanding shares of the corporation, or, in the case of such trades or businesses owned by a partnership, 50 percent or more of the capital or profits in the partnership;

(ii) The ownership described in paragraph (b)(1)(i) of this section exists for a majority of the taxable year, including the last day of the taxable year, in which the items attributable to each trade or business to be aggregated are included in income;

(iii) All of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years;

(iv) None of the trades or businesses to be aggregated is a *specified service trade or business* (SSTB) as defined in § 1.199A-5; and

(v) The trades or businesses to be aggregated satisfy at least two of the following factors (based on all of the facts and circumstances):

  (A) The trades or businesses provide products, property, or services that are the same or customarily offered together.

  (B) The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.

  (C) The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

Code § 267(b) is reproduced in part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses. For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

These aggregation rules are very different than the passive loss rules under parts II.K.1.b Grouping Activities, II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity, and II.K.1.e.iii.(b) Aggregating Real Estate Activities for a Real Estate Professional.

[Below are references to Examples in Reg. § 1.199A-4(d). Each Example is bookmarked so that users of the full set of materials can click on it and go to the Example. Each Example has

[836] See text accompanying fn 958 in part II.E.1.e.i.(a) Whether Real Estate Activity Constitutes A Trade Or Business. For flexibility in choosing which properties can be combined, see text accompanying fn 960 in that part.

its own subparagraph, so that Example (1) is Reg. § 1.199A-4(d)(1), Example (2) is Reg. § 1.199A-4(d)(2), etc.]

As to the Reg. § 1.199A-4(b)(1)(i) ownership requirement:

- It allows partnerships and S corporations to be aggregated (which is often important for real estate, which often is held by a partnership that leases it to an S corporation).[837] Example (3) provides, "W owns more than 50% of the stock of S1 and more than 50% of PRS thereby satisfying paragraph (b)(1)(i) of this section." Example (8) concludes, "G owns more than 50% of the stock of S1 and more than 50% of LLC1 and LLC2 thus satisfying paragraph (b)(1)(i) of this section."

- Example (5), allowing a 10% owner to aggregate when another person owned more than 50%, implements the statement from the preamble above, "Because the proposed rules look to a group of persons, non-majority owners may benefit from the common ownership and are permitted to aggregate." So does Example (10), allowing 5% and 10% owners to aggregate.

- Example (9) shows that family attribution can allow an owner to satisfy Reg. § 1.199A-4(b)(1)(i).

Only passthrough activities can be aggregated. Example (11).

Regarding the Reg. § 1.199A-4(b)(1)(v)(B) requirement that "the trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources":

- Example (1) states that subparagraph (b) was satisfied when two businesses, a catering business and a restaurant, "share the same kitchen facilities in addition to centralized purchasing, marketing, and accounting."[838]

- In Example (3), the 75% owner of two businesses manages the businesses, but the Example states that does not satisfy subparagraph (b).

- In Example (4), "A team of executives oversees the operations of all four of the businesses and controls the policy decisions involving the business as a whole. Human resources and accounting are centralized for the four businesses." The analysis concludes that subparagraph (b) is satisfied "because the businesses share accounting and human resource functions." The analysis implicitly seems to suggest that having a team of

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[837] In part II.E.1.e.i General Rules Regarding U.S. Real Estate under Code § 199A, fn 951 refers back to these Examples. That part demonstrates that real estate might not qualify as a trade or business and mentions that leasing it to a business under common control under Reg. § 1.199A-4(b)(1)(i) can allow the rental to be eligible for the Code § 199A deduction.

[838] Facts included the following, with A being the common sole owner:

> The catering business and the restaurant share centralized purchasing to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business. A maintains a website and print advertising materials that reference both the catering business and the restaurant. A uses the restaurant kitchen to prepare food for the catering business. The catering business employs its own staff and owns equipment and trucks that are not used or associated with the restaurant.

executives overseeing operations and controlling policy decisions adds little or no weight to analyzing how subparagraph (b) operates but rather places great weight on common accounting and human resource functions.

- In Example (6), two businesses share “centralized purchasing functions to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business.” The Example analysis concludes that subparagraph (b) is satisfied “because of their centralized purchasing and accounting offices.”

- Example (7) has the same facts as Example (6), but the businesses “do not have centralized purchasing or accounting functions.” Its analysis concludes that taking away these centralized functions prevents subparagraph (b) from being satisfied.

- In Example (8), sharing “common advertising and management” appears to satisfy subparagraph (b) because they are viewed as sharing “significant centralized business elements.”

- In Example (10), a 5% owner of various restaurants, G, “is the executive chef of all of the restaurants and as such he creates the menus and orders the food supplies.” The Example’s analysis concludes, “paragraph (b)(1)(v)(B) of this section is satisfied as G is the executive chef of all of the restaurants and the businesses share a centralized function for ordering food and supplies.”

- Example (14) states that subparagraph (b) is satisfied when the businesses “have a centralized human resources department, payroll, and accounting department.”

For what is an SSTB, when being concerned about violating the Reg. § 1.199A-4(b)(1)(iv) prohibition against aggregating SSTBs,[839] see part II.E.1.c.iv Specified Service Trade or Business.

Reg. § 1.199A-4(b)(2), “Operating rules,” explains how an individual or an RPE may aggregate:

(i) *Individuals*. An individual may aggregate trades or businesses operated directly or through an RPE to the extent an aggregation is not inconsistent with the aggregation of an RPE. If an individual aggregates multiple trades or businesses under paragraph (b)(1) of this section, QBI, W-2 wages, and UBIA of qualified property must be combined for the aggregated trades or businesses for purposes of applying the W-2 wage and UBIA of qualified property limitations described in § 1.199A-1(d)(2)(iv). An individual may not subtract from the trades or businesses aggregated by an RPE but may aggregate additional trades or businesses with the RPE’s aggregation if the rules of this section are otherwise satisfied.

(ii) *RPEs*. An RPE may aggregate trades or businesses operated directly or through a lower-tier RPE to the extent an aggregation is not inconsistent with the aggregation of a lower-tier RPE. If an RPE itself does not aggregate, multiple owners of an RPE need not aggregate in the same manner. If an RPE aggregates multiple trades or businesses under paragraph (b)(1) of this section, the RPE must compute and report

[839].Reg. § 1.199A-4(d)(10), Example (10) implicitly assumes that restaurants owned in part and run to a large degree by an executive chef are not SSTBs.

QBI, W-2 wages, and UBIA of qualified property for the aggregated trade or business under the rules described in § 1.199A- 6(b). An RPE may not subtract from the trades or businesses aggregated by a lower-tier RPE but may aggregate additional trades or businesses with a lower-tier RPE's aggregation if the rules of this section are otherwise satisfied.

Reg. § 1.199A-1(d)(2)(iv) is reproduced in part II.E.1.c.v.(c) Calculation When Taxable Income Exceeds the Threshold Amount.

Reg. § 1.199A-4(c), "Reporting and consistency requirements," provides:

(1) *Individuals*. Once an individual chooses to aggregate two or more trades or businesses, the individual must consistently report the aggregated trades or businesses in all subsequent taxable years. A failure to aggregate will not be considered to be an aggregation for purposes of this rule. An individual that fails to aggregate may not aggregate trades or businesses on an amended return (other than an amended return for the 2018 taxable year). However, an individual may add a newly created or newly acquired (including through non-recognition transfers) trade or business to an existing aggregated trade or business (including the aggregated trade or business of an RPE) if the requirements of paragraph (b)(1) of this section are satisfied. In a subsequent year, if there is a significant change in facts and circumstances such that an individual's prior aggregation of trades or businesses no longer qualifies for aggregation under the rules of this section, then the trades or businesses will no longer be aggregated within the meaning of this section, and the individual must reapply the rules in paragraph (b)(1) of this section to determine a new permissible aggregation (if any). An individual also must report aggregated trades or businesses of an RPE in which the individual holds a direct or indirect interest.

(2) *Individual disclosure* –

(i) *Required annual disclosure*. For each taxable year, individuals must attach a statement to their returns identifying each trade or business aggregated under paragraph (b)(1) of this section. The statement must contain –

(A) A description of each trade or business;

(B) The name and EIN of each entity in which a trade or business is operated;

(C) Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year;

(D) Information identifying any aggregated trade or business of an RPE in which the individual holds an ownership interest; and

(E) Such other information as the Commissioner may require in forms, instructions, or other published guidance.

(ii) *Failure to disclose*. If an individual fails to attach the statement required in paragraph (c)(2)(i) of this section, the Commissioner may disaggregate the individual's trades or businesses. The individual may not aggregate trades or businesses that are disaggregated by the Commissioner for the subsequent three taxable years.

(3) *RPEs*. Once an RPE chooses to aggregate two or more trades or businesses, the RPE must consistently report the aggregated trades or businesses in all subsequent taxable years. A failure to aggregate will not be considered to be an aggregation for purposes of this rule. An RPE that fails to aggregate may not aggregate trades or businesses on an amended return (other than an amended return for the 2018 taxable year). However, an RPE may add a newly created or newly acquired (including through non-recognition transfers) trade or business to an existing aggregated trade or business (other than the aggregated trade or business of a lower-tier RPE) if the requirements of paragraph (b)(1) of this section are satisfied. In a subsequent year, if there is a significant change in facts and circumstances such that an RPE's prior aggregation of trades or businesses no longer qualifies for aggregation under the rules of this section, then the trades or businesses will no longer be aggregated within the meaning of this section, and the RPE must reapply the rules in paragraph (b)(1) of this section to determine a new permissible aggregation (if any). An RPE also must report aggregated trades or businesses of a lower-tier RPE in which the RPE holds a direct or indirect interest.

(4) *RPE disclosure* –

(i) *Required annual disclosure*. For each taxable year, RPEs (including each RPE in a tiered structure) must attach a statement to each owner's Schedule K-1 identifying each trade or business aggregated under paragraph (b)(1) of this section. The statement must contain -

(A) A description of each trade or business;

(B) The name and EIN of each entity in which a trade or business is operated;

(C) Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year;

(D) Information identifying any aggregated trade or business of an RPE in which the RPE holds an ownership interest; and

(E) Such other information as the Commissioner may require in forms, instructions, or other published guidance.

(ii) *Failure to disclose*. If an RPE fails to attach the statement required in paragraph (c)(2)(i) of this section, the Commissioner may disaggregate the RPE's trades or businesses. The RPE may not aggregate trades or businesses that are disaggregated by the Commissioner for the subsequent three taxable years.

As mentioned above, under the proposed regulations only an individual could aggregate, and the final regulations allow an RPE to aggregate. If an RPE aggregates, an owner may aggregate other businesses with the RPTE's aggregated businesses, but only if all of the businesses in this further aggregation qualify to be aggregated with each other. In other words, an RPE's aggregation cannot be used to let its owners bootstrap in a way that combines businesses that could have not been aggregated at the owner level if the RPE had not itself aggregated the businesses. Example (15) illustrates this idea and also shows how an RPE's decision to aggregate can impair its owners' ability to aggregate; see the discussion immediately following Example (15) elaborating on this issue.

Reg. § 1.199A-4(d) provides the examples listed in the rest of this part II.E.1.c.iii.(d), all of which include the following assumptions:[840]

> The following examples illustrate the principles of this section. For purposes of these examples, assume the taxpayer is a United States citizen, all individuals and RPEs use a calendar taxable year, there are no ownership changes during the taxable year, all trades or businesses satisfy the requirements under section 162, all tax items are effectively connected to a trade or business within the United States within the meaning of section 864(c), and none of the trades or businesses is an SSTB within the meaning of § 1.199A-5. Except as otherwise specified, a single capital letter denotes an individual taxpayer.

Reg. § 1.199A-4(d)(1), Example (1) provides:

> (i) *Facts*. A wholly owns and operates a catering business and a restaurant through separate disregarded entities. The catering business and the restaurant share centralized purchasing to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business. A maintains a website and print advertising materials that reference both the catering business and the restaurant. A uses the restaurant kitchen to prepare food for the catering business. The catering business employs its own staff and owns equipment and trucks that are not used or associated with the restaurant.
>
> (ii) *Analysis*. Because the restaurant and catering business are held in disregarded entities, A will be treated as operating each of these businesses directly and thereby satisfies paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, A satisfies the following factors: Paragraph (b)(1)(v)(A) of this section is met as both businesses offer prepared food to customers; and paragraph (b)(1)(v)(B) of this section is met because the two businesses share the same kitchen facilities in addition to centralized purchasing, marketing, and accounting. Having satisfied paragraphs (b)(1)(i) through (v) of this section, A may treat the catering business and the restaurant as a single trade or business for purposes of applying § 1.199A-1(d).

Reg. § 1.199A-4(d)(2), Example (2) provides:

> (i) *Facts*. Assume the same facts as in *Example 1* of this paragraph, but the catering and restaurant businesses are owned in separate partnerships and A, B, C, and D each own a 25% interest in each of the two partnerships. A, B, C, and D are unrelated.
>
> (ii) *Analysis*. Because under paragraph (b)(1)(i) of this section A, B, C, and D together own more than 50% of each of the two partnerships, they may each treat the

[840] Example (16), Example (17), and Example (18) follow the cross-reference to these assumptions in fn 967 in part II.E.1.e.i.(b) Aggregating Real Estate Businesses.

catering business and the restaurant as a single trade or business for purposes of applying § 1.199A-1(d).

Reg. § 1.199A-4(d)(3), Example (3) provides:

(i) *Facts*. W owns a 75% interest in S1, an S corporation, and a 75% interest in PRS, a partnership. S1 manufactures clothing and PRS is a retail pet food store. W manages S1 and PRS.

(ii) *Analysis*. W owns more than 50% of the stock of S1 and more than 50% of PRS thereby satisfying paragraph (b)(1)(i) of this section. Although W manages both S1 and PRS, W is not able to satisfy the requirements of paragraph (b)(1)(v) of this section as the two businesses do not provide goods or services that are the same or customarily offered together; there are no significant centralized business elements; and no facts indicate that the businesses are operated in coordination with, or reliance upon, one another. We [sic] must treat S1 and PRS as separate trades or businesses for purposes of applying § 1.199A-1(d).

Reg. § 1.199A-4(d)(4), Example (4) provides:

(i) *Facts*. E owns a 60% interest in each of four partnerships (PRS1, PRS3, and PRS4). Each partnership operates a hardware store. A team of executives oversees the operations of all four of the businesses and controls the policy decisions involving the business as a whole. Human resources and accounting are centralized for the four businesses. E reports PRS1, PRS3, and PRS4 as an aggregated trade or business under paragraph (b)(1) of this section and reports PRS2 as a separate trade or business. Only PRS2 generates a net taxable loss.

(ii) *Analysis*. E owns more than 50% of each partnership thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, the following factors are satisfied: Paragraph (b)(1)(v)(A) of this section because each partnership operates a hardware store; and paragraph (b)(1)(v)(B) of this section because the businesses share accounting and human resource functions. E's decision to aggregate only PRS1, PRS3, and PRS4 into a single trade or business for purposes of applying § 1.199A-1(d) is permissible. The loss from PRS2 will be netted against the aggregate profits of PRS1, and PRS4 pursuant to § 1.199A-1(d)(2)(iii).

Reg. § 1.199A-4(d)(5), Example (5) provides:

(i) *Facts*. Assume the same facts as *Example 4* of paragraph (d)(4) of this paragraph, and that F owns a 10% interest in PRS1, PRS2, PRS3, and PRS4.

(ii) *Analysis*. Because under paragraph (b)(1)(i) of this section E owns more than 50% of the four partnerships, F may aggregate PRS 1, PRS2, PRS3, and PRS4 as a single trade or business for purposes of applying § 1.199A-1(d), provided that F can demonstrate that the ownership test is met by E.

Reg. § 1.199A-4(d)(6), Example (6) provides:

(i) *Facts*. D owns 75% of the stock of S1, S2, and S3, each of which is an S corporation. Each S corporation operates a grocery store in a separate state. S1 and S2 share centralized purchasing functions to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business. S3 is operated independently from the other businesses.

(ii) *Analysis*. D owns more than 50% of the stock of each S corporation thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, the grocery stores satisfy paragraph (b)(1)(v)(A) of this section because they are in the same trade or business. Only S1 and S2 satisfy paragraph (b)(1)(v)(B) of this section because of their centralized purchasing and accounting offices. D is only able to show that the requirements of paragraph (b)(1)(v)(B) of this section are satisfied for S1 and S2; therefore, D only may aggregate S1 and S2 into a single trade or business for purposes of § 1.199A-1(d). D must report S3 as a separate trade or business for purposes of applying § 1.199A- 1(d).

Reg. § 1.199A-4(d)(7), Example (7) provides:

(i) *Facts*. Assume the same facts as *Example 6* of paragraph (d)(6) of this paragraph except each store is independently operated and S1 and S2 do not have centralized purchasing or accounting functions.

(ii) *Analysis*. Although the stores provide the same products and services within the meaning of paragraph (b)(1)(v)(A) of this section, D cannot show that another factor under paragraph (b)(1)(v) of this section is present. Therefore, D must report S1, S2, and S3 as separate trades or businesses for purposes of applying § 1.199A-1(d).

Reg. § 1.199A-4(d)(8), Example (8) provides:

(i) *Facts*. G owns 80% of the stock in S1, an S corporation and 80% of LLC1 and LLC2, each of which is a partnership for Federal tax purposes. LLC1 manufactures and supplies all of the widgets sold by LLC2. LLC2 operates a retail store that sells LLC1's widgets. S1 owns the real property leased to LLC1 and LLC2 for use by the factory and retail store. The entities share common advertising and management.

(ii) *Analysis*. G owns more than 50% of the stock of S1 and more than 50% of LLC1 and LLC2 thus satisfying paragraph (b)(1)(i) of this section. LLC1, LLC2, and S1 share significant centralized business elements and are operated in coordination with, or in reliance upon, one or more of the businesses in the aggregated group. G can treat the business operations of LLC1 and LLC2 as a single trade or business for purposes of applying § 1.199A-1(d). S1 is eligible to be included in the aggregated group because it leases property to a trade or business within the aggregated trade or business as described in § 1.199A-1(b)(14) and meets the requirements of paragraph (b)(1) of this section.

Reg. § 1.199A-1(b)(14) provides in part:[841]

> … rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business for purposes of Section 199A, if the property is rented or licensed to a trade or business conducted by the individual or an RPE which is commonly controlled under § 1.199A-4(b)(1)(i) (regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under § 1.199A-4(b)(1)).

Reg. § 1.199A-4(d)(9), Example (9) provides:

> (i) *Facts*. Same facts as *Example 8* of paragraph (d)(8) of this section, except G owns 80% of the stock in S1 and 20% of each of LLC1 and LLC2. B, G's son, owns a majority interest in LLC2, and M, G's mother, owns a majority interest in LLC1. B does not own an interest in S1 or LLC1, and M does not own an interest in S1 or LLC2.
>
> (ii) *Analysis*. Under the rules in paragraph (b)(1) of this section, B and M's interest in LLC2 and LLC1, respectively, are attributable to G and G is treated as owning a majority interest in LLC2 and LLC1; G thus satisfies paragraph (b)(1)(i) of this section. G may aggregate his interests in LLC1, LLC2, and S1 as a single trade or business for purposes of applying § 1.199A-1(d). Under paragraph (b)(1) of this section, S1 is eligible to be included in the aggregated group because it leases property to a trade or business within the aggregated trade or business as described in § 1.199A-1(b)(14) and meets the requirements of paragraph (b)(1) of this section.

Reg. § 1.199A-4(d)(10), Example (10) provides:

> (i) *Facts*. F owns a 75% interest and G owns a 5% interest in five partnerships (PRS1-PRS5). H owns a 10% interest in PRS1 and PRS2. Each partnership operates a restaurant and each restaurant separately constitutes a trade or business for purposes of section 162. G is the executive chef of all of the restaurants and as such he creates the menus and orders the food supplies.
>
> (ii) *Analysis*. F owns more than 50% of the partnerships thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, the restaurants satisfy paragraph (b)(1)(v)(A) of this section because they are in the same trade or business, and paragraph (b)(1)(v)(B) of this section is satisfied as G is the executive chef of all of the restaurants and the businesses share a centralized function for ordering food and supplies. F can show the requirements under paragraph (b)(1) of this section are satisfied as to all of the restaurants. Because F owns a majority interest in each of the partnerships, G can demonstrate that paragraph (b)(1)(i) of this section is satisfied. G can also aggregate all five restaurants into a single trade or business for purposes of applying § 1.199A-1(d). H, however, only owns an interest in PRS1 and PRS2. Like G, H satisfies paragraph (b)(1)(i) of this section because F owns a majority interest. H can,

[841] Reg. § 1.199A-1(b)(14) is reproduced in full in fn 804 in part II.E.1.c.iii.(a) General Standards for "Trade or Business" for Code § 199A.

therefore, aggregate PRS1 and PRS2 into a single trade or business for purposes of applying § 1.199A-1(d).

Reg. § 1.199A-4(d)(11), Example (11) provides:

(i) *Facts*. H, J, K, and L own interests in PRS1 and PRS2, each a partnership, and S1 and S2, each an S corporation. H, J, K, and L also own interests in C, an entity taxable as a C corporation. H owns 30%, J owns 20%, K owns 5%, and L owns 45% of each of the five entities. All of the entities satisfy 2 of the 3 factors under paragraph (b)(1)(v) of this section. For purposes of Section 199A the taxpayers report the following aggregated trades or businesses: H aggregates PRS1 and S1 together and aggregates PRS2 and S2 together; J aggregates PRS1, S1 and S2 together and reports PRS2 separately; K aggregates PRS1 and PRS2 together and aggregates S1 and S2 together; and L aggregates S1, S2, and PRS2 together and reports PRS1 separately. C cannot be aggregated.

(ii) *Analysis*. Under paragraph (b)(1)(i) of this section, because H, J, and K together own a majority interest in PRS1, PRS2, S1, and S2, H, J, K, and L are permitted to aggregate under paragraph (b)(1) of this section. Further, the aggregations reported by the taxpayers are permitted, but not required for each of H, J, K, and L. C's income is not eligible for the Section 199A deduction and it cannot be aggregated for purposes of applying § 1.199A-1(d).

Reg. § 1.199A-4(d)(12), Example (12) provides:

(i) *Facts*. L owns 60% of PRS1, a partnership, a business that sells non-food items to grocery stores. L also owns 55% of PRS2, a partnership, which owns and operates a distribution trucking business. The predominant portion of PRS2's business is transporting goods for PRS1.

(ii) *Analysis*. L is able to meet paragraph (b)(1)(i) of this section as the majority owner of PRS1 and PRS2. Under paragraph (b)(1)(v) of this section, L is only able to show the operations of PRS1 and PRS2 are operated in reliance of one another under paragraph (b)(1)(v)(C) of this section. For purposes of applying § 1.199A-1(d), L must treat PRS1 and PRS2 as separate trades or businesses.

Example (12)'s point is that satisfying only one of the three factors in Reg. § 1.199A-4(b)(1)(v) is not enough.

Reg. § 1.199A-4(d)(13), Example (13) provides:

(i) *Facts*. C owns a majority interest in a sailboat racing team and also owns an interest in PRS1 which operates a marina. PRS1 is a trade or business under section 162, but the sailboat racing team is not a trade or business within the meaning of section 162.

(ii) *Analysis*. C has only one trade or business for purposes of Section 199A and, therefore, cannot aggregate the interest in the racing team with PRS1 under paragraph (b)(1) of this section.

Contrast Example (13) with Examples (8) and (9) above, which referred to Reg. § 1.199A-1(b)(14), which allows rental activity that does not rise to the level of trade or business to be treated as a trade or business.[842] The sailboat racing team is not a trade or business in the facts of Example (13), and Example (13) implicitly assume it is not tangible or intangible property rented or licensed to the marina.

Reg. § 1.199A-4(d)(14), Example (14) provides:

(i) *Facts*. Trust wholly owns LLC1, LLC2, and LLC3. LLC1 operates a trucking company that delivers lumber and other supplies sold by LLC2. LLC2 operates a lumber yard and supplies LLC3 with building materials. LLC3 operates a construction business. LLC1, LLC2, and LLC3 have a centralized human resources department, payroll, and accounting department.

(ii) *Analysis*. Because Trust owns 100% of the interests in LLC1, LLC2, and LLC3, Trust satisfies paragraph (b)(1)(i) of this section. Trust can also show that it satisfies paragraph (b)(1)(v)(B) of this section as the trades or businesses have a centralized human resources department, payroll, and accounting department. Trust also can show is meets paragraph (b)(1)(v)(C) of this section as the trades or businesses are operated in coordination, or reliance upon, one or more in the aggregated group. Trust can aggregate LLC1, LLC2, and LLC3 for purposes of applying § 1.199A-1(d).

Reg. § 1.199A-4(d)(15), Example (15) provides:

(i) *Facts*. PRS1, a partnership, directly operates a food service trade or business and owns 60% of PRS2, which directly operates a movie theater trade or business and a food service trade or business. PRS2's movie theater and food service businesses operate in coordination with, or reliance upon, one another and share a centralized human resources department, payroll, and accounting department. PRS1's and PRS2's food service businesses provide products and services that are the same and share centralized purchasing and shipping to obtain volume discounts.

(ii) *Analysis*. PRS2 may aggregate its movie theater and food service businesses. Paragraph (b)(1)(v) of this section is satisfied because the businesses operate in coordination with one another and share centralized business elements. If PRS does aggregate the two businesses, PRS1 may not aggregate its food service business with PRS2's aggregated trades or businesses. Because PRS1 owns more than 50% of PRS2, thereby satisfying paragraph (b)(1)(i) of this section, PRS1 may aggregate its food service businesses with PRS2's food service business if PRS2 has not aggregated its movie theater and food service businesses.
Paragraph (b)(1)(v) of this section is satisfied because the businesses provide the same products and services and share centralized business elements. Under either alternative, PRS1's food service business and PRS2's movie theater cannot be aggregated because there are no factors in paragraph (b)(1)(v) of this section present between the businesses.

Example (15) illustrates some key ideas when RPEs aggregate:

[842] See text accompanying fn 841.

- Under the above facts, PRS1's food service business cannot under any circumstances be aggregated with PRS2's movie theater business. Example (15) provides that PRS2's aggregation of its two businesses cannot be used to bootstrap the aggregation of PRS1's food service business with PRS2's movie theater business.

- PRS2's aggregation of its two businesses would prevent PRS2's food service business with PRS1's food service business. What at first seems to be a convenient aggregation at the PRS2 level in fact precludes an option that PRS1 may like to have.

- Given the preceding bullet point, arguably an RPE should not aggregate unless its owners cannot benefit different mixing and matching of the RPE's various businesses with their own businesses. Instead, the RPE should provide to its owners all of the information it would have provided if it had aggregated, as well as ownership information sufficient to enable them to determine whether they can aggregate.

- The above bullet point says "arguably" because this decision is very much a judgment call. The RPE itself aggregating may save its owners income tax preparers' significant time and therefore significant expense. Often, aggregating horizontally (various businesses within the same RPE) is much more beneficial than aggregating vertically (the same business spread among various RPEs). Aggregation's benefits tend to be maximized when a business with lots of W-2 wages can share them with a separate but related business that does not have lots of W-2 wages. This is illustrated by Gorin Example 15A below:

<u>Gorin Example 15A</u>:

A is a group of owners that owns Parent 1 and Parent 2. Parent 1 has a manufacturing subsidiary, M1, and a real estate LLC, R1. Similarly, Parent 2 has a manufacturing subsidiary, M2, and a real estate LLC, R2. M1's operations are not sufficiently integrated with R2's operations to aggregate with it, and M2's operations are not sufficiently integrated with R1's operations to aggregate with it. Each of M1 and M2 relies heavily on labor and has wages well in excess of what is needed to maximize the QBI deduction. M1 rents from R1 the building it uses, and the R1 has very small wages and insufficient UBIA to get anywhere near needed to maximize the QBI deduction; a similar relationship exists between M2 and R2. If Parent 1 aggregates M1 with R1, M1's wages will fully support the QBI deduction from both M1 and R1. On the other hand, that aggregation may preclude A from aggregating M1 with M2. However, M1 doesn't need M-2's W-2 wages, because M2 also has lots of W-2 wages - due to the similarity of their businesses. Similarly, aggregating R1 with R2 would be pointless.

The simplest approach would be for Parent 1 to aggregate M1 with R1 and for Parent 2 to aggregate M2 with R2. That would save the tax return preparers for each person within the A ownership group from having to do the work needed to do those aggregations themselves. However:

- Each member of the A ownership group would have the ability to separately do those aggregations if Parent 1 and Parent 2 did not do them.

- If any member of the A ownership group would be better off with vertical aggregation (aggregating all manufacturers together and all commercial rental real estate together) than with horizontal aggregation (aggregating manufacturing with real estate operations), then that member should communicate with whoever is managing Parent 1 and Parent 2 and ask them not to aggregate.

- Similarly, management of Parent 1 and Parent 2 should communicate with their owners to see whether anyone objects to Parent 1 or Parent 2 aggregating.

- However, just because one member of the A ownership group (X) asks management not to aggregate, that doesn't mean that management will honor that member's request. Management needs to weigh the costs of forcing everyone to aggregate against X's benefit and may need to bring this issue to the owners to let them decide how to deal with it.

- For example, the other owners may agree to bear the cost of separate aggregation elections as a favor to X, who is a valuable business partner in many projects; or X may agree to pay for the costs imposed on the other owners of Parent 1 and Parent 2, out of concern for the extra costs X is making everyone else bear.

- When in doubt, management should prepare aggregation statements that each owner's tax preparers could tweak as needed and attach. That allows the work for making an aggregation election to be done at the entity level, where the work is most efficient, while allowing each owner to do his/her/its own thing. Given that an aggregation election is irrevocable, consider taking this approach for 2018 and then in 2019 or a future year perhaps making an RPE-level aggregation election if everyone agrees.

For Example (16), Example (17), and Example (18), see part II.E.1.e.i General Rules Regarding U.S. Real Estate .

II.E.1.c.iv. Specified Service Trade or Business (SSTB) If Taxable Income Exceeds Certain Thresholds

II.E.1.c.iv.(a). Introduction to Specified Service Trade or Business (SSTB)

Reg. § 1.199A-5(a)(2), "Effect of being an SSTB," provides:

> If a trade or business is an SSTB, no qualified business income (QBI), W-2 wages, or unadjusted basis immediately after acquisition (UBIA) of qualified property from the SSTB may be taken into account by any individual whose taxable income exceeds the phase-in range as defined in § 1.199A-1(b)(4), even if the item is derived from an activity that is not itself a specified service activity. The SSTB limitation also applies to income earned from a publicly traded partnership (PTP). If a trade or business conducted by a relevant passthrough entity (RPE) or PTP is an SSTB, this limitation applies to any direct or indirect individual owners of the business, regardless of whether the owner is passive or participated in any specified service activity. However, the SSTB limitation does not apply to individuals with taxable income below the threshold amount as defined in § 1.199A-1(b)(12). A phase-in rule, provided in § 1.199A- 1(d)(2), applies to individuals with taxable income within the phase-in range, allowing them to take into account a certain "applicable percentage" of QBI, W-2 wages, and UBIA of qualified property from an SSTB. The phase-in rule also applies to income earned from a PTP. A direct or indirect owner of a trade or business engaged in the performance of a specified service is engaged in the performance of the specified service for purposes of Section 199A and this section, regardless of whether the owner is passive or participated in the specified service activity.

A "specified service trade or business" is any trade or business other than (A) certain businesses listed in Code § 1202(e)(3)(A) that do not qualify for the Code § 1202 exclusion from capital gain on the sale of C corporation stock, or (B) which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in Code § 475(c)(2)), partnership interests, or commodities (as defined in Code § 475(e)(2)).[843]

Code § 1202(e)(3)(A), which is discussed in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation, fns. 5243-5244, lists as a "specified service trade or business" (SSTB) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees. However, Code § 199A(d)(2)(A) specifically excludes engineering and architecture from this blacklist, so that those professions do qualify for QBI treatment. Also, Code § 199A(d)(2)(A) specifically looks to the work of not only employees but also owners.

This blacklisting of a specified service trade or business is relaxed or does not apply if taxable income is below certain thresholds.[844] See part II.E.1.c.v.(a) Taxable Income "Threshold.

Getting into details:

Prop. Reg. § 1.199A-5(e) provides the effective date of Prop. Reg. § 1.199A-5 (described below), regarding SSTBs and the trade or business of being an employee:[845]

(1) *General rule*. Except as provided in paragraph (e)(2) of this section, the provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. However, taxpayers may rely on the rules of this section until the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register.

(2) *Exceptions*.

(i) *Anti-abuse rules*. The provisions of paragraphs (c)(2), (c)(3), and (d)(3) of this section apply to taxable years ending after December 22, 2017.

(ii) *Non-calendar year RPE*. For purposes of determining QBI, W-2 wages, and UBIA of qualified property, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

Reg. § 1.199A-5(e) provides the effective date of Reg. § 1.199A-5, regarding SSTBs and the trade or business of being an employee:

(1) *General rule*. Except as provided in paragraph (e)(2) of this section, the provisions of this section apply to taxable years ending after February 8, 2019.

[843] Code § 199A(d)(2).
[844] Code § 199A(d)(3).
[845] For the latter, see part II.E.1.c.ii.(b) Trade or Business of Being an Employee (Excluded from QBI).

(2) *Exceptions* –

(i) *Anti-abuse rules*. The provisions of paragraphs (c)(2) and (d)(3) of this section apply to taxable years ending after December 22, 2017.

(ii) *Non-calendar year RPE*. For purposes of determining QBI, W-2 wages, UBIA of qualified property, and the aggregate amount of qualified REIT dividends and qualified PTP income, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), provides:

V. Proposed § 1.199A-5: Specified Service Trade or Business and the Trade or Business of Performing Services as an Employee

Section 199A(c)(1) provides that only items attributable to a qualified trade or business are taken into account in determining the Section 199A deduction for QBI.
Section 199A(d)(1) provides that a "qualified trade or business" means any trade or business other than (A) an SSTB, or (B) the trade or business of performing services as an employee.

A. SSTB

This part V.A. explains the provisions under proposed § 1.199A-5 relating to SSTBs. First, the effect of classification as an SSTB is discussed. Second, the exceptions for taxpayers below the threshold amount and a de minimis exception are described. Third, guidance is provided on the meaning of the activities listed in the definition of SSTB. Fourth, the rules for determining whether a trade or business is treated as part of an SSTB are described. Finally, rules regarding classification as an employee for purposes of Section 199A are discussed.

1. Effect of being an SSTB

a. General Rule

Consistent with Section 199A, proposed § 1.199A-5(a)(2) provides that, unless an exception applies, if a trade or business is an SSTB, none of its items are to be taken into account for purposes of determining a taxpayer's QBI. In the case of an SSTB conducted by an entity, such as a partnership or an S corporation, if it is determined that the trade or business is an SSTB, none of the income from that trade or business flowing to an owner of the entity is QBI, regardless of whether the owner participates in the specified service activity. Therefore, a direct or indirect owner of a trade or business engaged in an SSTB is treated as engaged in the SSTB for purposes of Section 199A regardless of whether the owner is passive or participated in the SSTB. Similarly, none of the W-2 wages or UBIA of qualified property will be taken into account for purposes of Section 199A. For example, because the field of athletics is an SSTB, if a partnership owns a professional sports team, the partners' distributive shares of income from the partnership's athletics trade or business is not QBI, regardless of whether the partners participate in the partnership's trade or business. Proposed § 1.199A-5 contains further examples illustrating the operation of this rule.

b. Exceptions to the General Rule

Under Section 199A(d)(3), individuals with taxable income below the threshold amount are not subject to a restriction with respect to SSTBs. Therefore, if an individual or trust has taxable income below the threshold amount, the individual or trust is eligible to receive the deduction under Section 199A notwithstanding that a trade or business is an SSTB. As described in part I.C of this Explanation of Provisions, the exclusion of QBI, W-2 wages, and UBIA of qualified property from the computation of the Section 199A deduction is subject to a phase-in for individuals with taxable income within the phase-in range. The application of this phase-in is determined at the individual, trust, or estate level, which may not be where the trade or business is operated. Therefore, if a partnership or an S corporation operates an SSTB, the application of the threshold does not depend on the partnership or S corporation's taxable income but rather, the taxable income of the individual partner or shareholder claiming the Section 199A deduction. For example, if the partnership's taxable income is less than the threshold amount, but each of the partnership's individual partners have income that exceeds the threshold amount plus $50,000 ($100,000 in the case of a joint return) then none of the partners may claim a Section 199A deduction with respect to any income from the partnership's SSTB.

An RPE conducting an SSTB may not know whether the taxable income of any of its equity owners is below the threshold amount. However, the RPE is best positioned to make the determination as to whether its trade or business is an SSTB. Therefore, reporting rules under proposed § 1.199A-6(b)(3)(B) requires each RPE to determine whether it conducts an SSTB and disclose that information to its partners, shareholders, or owners. With respect to each trade or business, once it is determined that a trade or business is an SSTB, it remains an SSTB and cannot be aggregated with other trades or business. In the case of a trade or business conducted by an individual, such as a sole proprietorship, disregarded entity, or grantor trust, the determination of whether the business is an SSTB is made by the individual.

Section 199A defines an SSTB to include any trade or business that "involves the performance of services in" a specified service activity. Although the statute, read literally, does not suggest that a certain quantum of specified service activity is necessary to find an SSTB, the Treasury Department and the IRS believe that requiring all taxpayers to evaluate and quantify any amount of specified service activity would create administrative complexity and undue burdens for both taxpayers and the IRS. Therefore, analogous to the regulations under section 448, it is appropriate to provide a de minimis rule, under which a trade or business will not be considered to be an SSTB merely because it provides a small amount of services in a specified service activity.

Therefore, analogous to the regulations under section 448, it is appropriate to provide a de minimis rule, under which a trade or business will not be considered to be an SSTB merely because it provides a small amount of services in a specified service activity.

Accordingly, proposed § 1.199A-5(c)(1) provides that a trade or business (determined before the application of the aggregation rules in proposed § 1.199A-4) is not an SSTB if the trade or business has gross receipts of $25 million or less (in a taxable year) and less than 10 percent of the gross receipts of the trade or business is attributable to the performance of services in an SSTB. For trades or business with gross receipts greater than $25 million (in a taxable year), a trade or business is not an SSTB if less than 5 percent of the gross receipts of the trade or business are attributable to the performance of services in an SSTB.

2. Definition of Specified Service Trade or Business

The definition of an SSTB set forth in Section 199A incorporates, with modifications, the text of section 1202(e)(3)(A). The text of section 1202(e)(3)(A) substantially tracks the definition of 'qualified personal service corporation' under section 448. Therefore, consistent with ordinary rules of statutory construction, the guidance in proposed § 1.199A-5(b) is informed by existing interpretations and guidance under both sections 1202 and 448 when relevant. However, existing guidance under those sections is sparse and the scope and purpose of those sections and Section 199A are different. The Treasury Department and the IRS also note that, unlike sections 1202(e)(3)(A) and 448, the purpose of Section 199A is to provide a deduction based on the character of the taxpayer's trade or business. Distinct guidance for Section 199A is warranted. Therefore, the guidance in proposed § 1.199A-5(b) applies only to Section 199A, not sections 1202 and 448.

a. Guidance on the Meaning of the Listed Activities

Section 199A(d)(2)(A) provides that an SSTB is any trade or business described in section 1202(e)(3)(A) (applied without regard to the words "engineering [and] architecture") or that would be so described if the term "employees or owners" were substituted for "employees" therein. Section 199A(d)(2)(B) provides that an SSTB is any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).

Section 1202 provides an exclusion from gross income for some or all of the gain on the sale of certain qualified small business stock. Section 1202 generally requires that, for stock to be qualified small business stock, the corporation must be engaged in a qualified trade or business. Section 1202(e)(3) provides that, for purposes of section 1201(e), the term 'qualified trade or business' means any trade or business other than any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees; any banking, insurance, financing, leasing, investing, or similar business; any farming business (including the business of raising or harvesting trees); any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and; any business of operating a hotel, motel, restaurant, or similar business.

Thus, after application of the modifications described in Section 199A(d)(2)(A), the definition of an SSTB for purposes of Section 199A is (1) any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade

> or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, and (2) any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).
>
> The Treasury Department and the IRS have received comments requesting guidance on the meaning and scope of the various trades or businesses described in the preceding paragraph. The Treasury Department and the IRS agree with commenters that guidance with respect to these trades or businesses is necessary for several reasons. Most importantly, Section 199A is a new Code provision intended to benefit a wide range of businesses, and taxpayers need certainty in determining whether their trade or business generates income that is eligible for the Section 199A deduction. As previously discussed, given the differing scope, objectives, and, in some respects, language of sections 199A, 448, and 1202, the guidance under sections 1202(e)(3)(A) and 448(d)(2) is not an appropriate substitute for clear and distinct guidance governing what constitutes an SSTB under Section 199A. In particular, some SSTBs are listed in section 1202(e)(3)(A), but not listed in section 448(d)(2), such as athletics, financial services, brokerage services, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. In addition, some activities are mentioned only in 199A, such as investment management, trading, and dealing. As described in the remainder of this part V.A.2., proposed § 1.199A-5(b) provides guidance on the definition of an SSTB based on the plain meaning of the statute, past interpretations of substantially similar language in other Code provisions, and other indicia of legislative intent.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VI.A.1. explains the general rules for the definition of a specified service trade or business:

> The proposed regulations provide definitional guidance on the meaning of a trade or business involving the performance of services in each of the fields listed in Section 199A(d)(2). Multiple commenters requested guidance on whether specific trades or businesses would constitute SSTBs. In many cases, the determination of whether a specific trade or business is an SSTB depends on whether the facts and circumstances demonstrate that the trade or business is in one of the listed fields. Although the Treasury Department and the IRS understand the desire for certainty, because the determination of whether a particular trade or business is an SSTB is factually dependent, this analysis is beyond the scope of these regulations.
>
> Several commenters argued that the meaning of performance of services in the various fields should be limited to the definitions provided in § 1.448-1T(e)(4). A few commenters noted that any expansion beyond these definitions is contrary to legislative intent as expressed in “Tax Cuts and Jobs Act,” Statement of Managers to the Conference Report to Accompany H.R. 1, H.R. Rept. 115-466 (Dec. 15, 2017), p. 216-222. These commenters argue that the Statement of Managers notes that the committee adopted the Senate Amendment and described the section 448 regulations as an indicator of the meaning of services in the health, performing arts, and consulting fields referenced in section 1202(e)(3)(A) as incorporated by Section 199A. The Treasury Department and the IRS decline to adopt these comments. While the Statement of Managers does reference § 1.448-1T(e)(4), nothing in the language of the report limits the definitions for purposes of Section 199A to those provided in § 1.448-

1T(e)(4). Section 199A does not reference section 448; instead, Section 199A incorporates section 1202(e)(3)(A) with modifications. The Treasury Department and the IRS believe it is appropriate to look to the definitions provided for in the regulations under section 448 because guidance under section 1202 is limited. However, as stated in the preamble to the proposed regulations, the existing guidance under section 448 is not a substitute for guidance under Section 199A.

The intent of section 448 and the intent of Section 199A are different. Section 448 prohibits certain taxpayers from computing taxable income under the cash receipts and disbursements method of accounting. Qualified personal services corporations are excluded from this prohibition. Section 448(d)(2) defines the term qualified personal service corporation to include certain employee-owned corporations, substantially all of the activities of which involve the performance of services in the fields of health, law, engineering architecture, accounting, actuarial sciences, performing arts, or consulting. By contrast, Section 199A provides a deduction based on QBI from a qualified trade or business. For taxpayers with taxable income above the phase-in range, an SSTB is not a qualified trade or business. Section 199A, through reference to section 1202, defines an SSTB as a trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. The trade or business of the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in (c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)) is also defined as an SSTB for purposes of Section 199A. Further, Section 199A looks to the trade or business of performing services involving one or more of the listed fields, and not the performance of services themselves in determining whether a trade or business is an SSTB. The designation of a trade or business as an SSTB applies to owners of the trade or business, regardless of whether the owner is passive or participated in any specified service activity. Accordingly, it is both necessary and consistent with the statute and the legislative history to expand the definitions of the fields of services listed in Section 199A(d)(1) and (2) and § 1.199A-5 beyond those provided in § 1.448-1T(e)(4).

One commenter suggested that in order to provide certainty and further economic growth, the final regulations should include a franchising example to clarify that a franchisor will not be considered to be an SSTB based solely on the selling of a franchise in a listed field of service. The Treasury Department and the IRS adopt this comment and have included a franchising example in the final regulations.

Finally, the final regulations add two rules of general application. First, the final regulations specify that the rules for determining whether a business is an SSTB within the meaning of Section 199A(d)(2) apply solely for purposes of Section 199A and therefore, may not be taken into account for purposes of applying any other provision of law, except to the extent that another provision expressly refers to Section 199A(d). Second, the final regulations include a hedging rule that is applicable to any trade or business conducted by an individual or an RPE. The hedging rule provides that income, deduction, gain, or loss from a hedging transaction entered into in the normal course of a trade or business is included as income, deduction, gain, or loss from that trade or business. A hedging transaction for these purposes is defined in § 1.1221-2(b) and the timing rules of § 1.446-4 are also applicable.

The remainder of this part VI.A. responds to those comments advocating that a specific category of trade or business should be excluded from one of the listed fields in section 199(d)(2) or from the SSTB provisions entirely.

The preamble to the 2018 proposed regulations then provides an overview of parts II.E.1.c.iv.(b) Health, II.E.1.c.iv.(c) Law, II.E.1.c.iv.(d) Accounting, II.E.1.c.iv.(e) Actuarial Science, II.E.1.c.iv.(f) Performing Arts, II.E.1.c.iv.(g) Consulting, II.E.1.c.iv.(h) Athletics, II.E.1.c.iv.(i) Financial Services, II.E.1.c.iv.(j) Brokerage Services, and II.E.1.c.iv.(n) Any Trade or Business Where the Principal Asset of Such Trade or Business Is the Reputation or Skill of One or More of Its Employees or Owners:

i. SSTBs Listed in Section 199A(d)(2)(A)

The definition of an SSTB under Section 199A is substantially similar to the list of service trades or businesses provided in section 448(d)(2)(A) and § 1.448-1T(e)(4)(i), as the legislative history notes. See Joint Explanatory Statement of the Committee of Conference, footnotes 44-46. Section 448 prohibits certain taxpayers from computing taxable income under the cash receipts and disbursements method of accounting. Under section 448, qualified personal service corporations generally are not subject to the prohibition from using the cash method. Section 448(d)(2) defines the term qualified personal service corporation to include certain employee-owned corporations, substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. The regulations under section 448(d)(2), found in § 1.448-1T(e)(4)(i), provide additional guidance on several of the terms, including health, performing arts, and consulting. In addition, there have been several court opinions, technical advice memoranda, and private letter rulings interpreting the various fields listed in section 448(d)(2) and § 1.448-1T(e)(4)(i).

In general, the guidance under section 448(d)(2) emphasizes the direct provision of services by the employees of a trade or business, rather than the application of capital. Commenters have suggested that the regulations under section 448 serve as a reasonable starting point for defining an SSTB for purposes of Section 199A. However, commenters also noted that the objectives and included categories of trades or businesses within section 448 and Section 199A are different. Consistent with ordinary rules of statutory construction and the legislative history of Section 199A, proposed § 1.199A-5(b) draws upon the existing guidance under section 448(d)(2) when appropriate for purposes of Section 199A. Proposed § 1.199A-5(b) generally follows the guidance issued under section 448(d)(2) with some modifications. In certain instances, the principles of section 448(d)(2) provide useful analogies in defining the particular fields listed in section 1202(e)(3)(A) (as modified by Section 199A(d)(2)(A)) for purposes of Section 199A.

In addition, section 1202(e)(3)(A) also includes 'any trade or business where the principal asset of such trade or business is the reputation of skill of 1 or more of its employees.' Section 199A(d)(2)(A) modifies this clause by adding the words 'or owners' to the end, to read as follows: 'any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners.' The meaning of this clause is best determined by examining the language of section 1202(e)(3) (A) in light of the purpose of Section 199A.

> Case law under section 448 provides that whether a service is performed in a qualifying field under section 448(d)(2) is to be decided by examining all relevant indicia and is not controlled by state licensing laws. *See Rainbow Tax Serv., Inc. v. Commissioner*, 128 T.C. 42 (2007); *Kraatz & Craig Surveying Inc., v. Commissioner*, 134 T.C. 167 (2010). This approach also is appropriate for Section 199A purposes.
>
> Additionally, states can widely vary in what they require in terms of licensure or certification. The Treasury Department and the IRS believe that the Federal tax law should not treat similarly situated taxpayers differently based on a particular state's decision that for consumer protection purposes or otherwise a particular business type requires a license or certification. Thus, proposed § 1.199A-5(b) does not adopt a bright-line licensing rule for purposes of determining whether a trade or business is within a certain field for purposes of Section 199A.

The preamble to the 2018 proposed regulations then provides an overview of parts II.E.1.c.iv.(k) Investing and Investment Management, II.E.1.c.iv.(l) Trading, and II.E.1.c.iv.(m) Dealing in Securities, Partnership Interests, or Commodities:

> **ii. SSTBs Described in 199A(d)(2)(B)**
>
> As mentioned previously, Section 199A(d)(2)(B) provides that an SSTB also includes any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)). This rule does not appear in section 1202(e)(3)(A) or section 448(d)(2).
>
> Section 475(c)(2) provides a detailed list of interests treated as securities, including stock in a corporation; ownership interests in widely held or publicly traded partnerships or trusts; notes, bonds, debentures, or other evidences of indebtedness; interest rate, currency, or equity notional principal contracts; evidences of an interest in, or derivative financial instruments in any of the foregoing securities or any currency, including any option, forward contract, short position, or any similar financial instruments; and certain hedges with respect to any such securities. Section 475(e)(2) provides a similarly detailed list of property treated as a commodity, including any commodity which is actively traded (within the meaning of section 1092(d)(1)) or any notional principal contract with respect to any such commodity, evidences of an interest in, or derivative financial instruments in any of the foregoing commodities, and certain hedges with respect to any such commodities.

The preamble then provides some anti-abuse rules, which are in part II.E.1.c.iv.(o).

Implementing the above, Reg. § 1.199A-5(b), "Definition of specified service trade or business," provides:

> Except as provided in paragraph (c)(1) of this section, the term specified service trade or business (SSTB) means any of the following:
>
> (1) *Listed SSTBs*. Any trade or business involving the performance of services in one or more of the following fields:

(i) *Health* as described in paragraph (b)(2)(ii) of this section;

(ii) *Law* as described in paragraph (b)(2)(iii) of this section;

(iii) *Accounting* as described in paragraph (b)(2)(iv) of this section;

(iv) *Actuarial science* as described in paragraph (b)(2)(v) of this section;

(v) *Performing arts* as described in paragraph (b)(2)(vi) of this section;

(vi) *Consulting* as described in paragraph (b)(2)(vii) of this section;

(vii) *Athletics* as described in paragraph (b)(2)(viii) of this section;

(viii) *Financial services* as described in paragraph (b)(2)(ix) of this section;

(ix) *Brokerage services* as described in paragraph (b)(2)(x) of this section;

(x) *Investing and investment management* as described in paragraph (b)(2)(xi) of this section;

(xi) *Trading* as described in paragraph (b)(2)(xii) of this section;

(xii) *Dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2))* as described in paragraph (b)(2)(xiii) of this section; or

(xiii) *Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners* as defined in paragraph (b)(2)(xiv) of this section.

(2) *Additional rules for applying Section 199A(d)(2) and paragraph (b) of this section*.

(i) *In general*.

(A) *No effect on other tax rules*. This paragraph (b)(2) provides additional rules for determining whether a business is an SSTB within the meaning of Section 199A(d)(2) and paragraph (b) of this section only. The rules of this paragraph (b)(2) apply solely for purposes of Section 199A and therefore may not be taken into account for purposes of applying any provision of law or regulation other than Section 199A and the regulations thereunder, except to the extent such provision expressly refers to Section 199A(d) or this section.

(B) *Hedging transactions*. Income, deduction, gain or loss from a hedging transaction (as defined in § 1.1221-2(b)) entered into by an individual or RPE in the normal course of the individual's or RPE's trade or business is treated as income, deduction, gain, or loss from that trade or business for purposes of this paragraph (b)(2). See also § 1.446-4.

Reg. § 1.199A-5(b)(3), "Examples," provides caveats to its examples that are reproduced below in various parts of this part II.E.1.c.iv:

> The following examples illustrate the rules in paragraphs (a) and (b) of this section. The examples do not address all types of services that may or may not qualify as specified services. Unless otherwise provided, the individual in each example has taxable income in excess of the threshold amount.

The distributive share of a person who provides SSTB services or property in exchange for an interest in an RPE may be recharacterized as an SSTB, even though the RPE itself is not engaged in an SSTB. See Reg. § 1.199A-5(b)(3)(xvi), Example (16) [click on citation for caveats].

II.E.1.c.iv.(b). Health

Footnote 44 of the Senate report commented about the services in the field of health:

> A similar list of service trades or business is provided in section 448(d)(2)(A) and Treas. Reg. sec. 1.448-1T(e)(4)(i). For purposes of section 448, Treasury regulations provide that the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals. The performance of services in the field of health does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers. See Treas. Reg. sec. 1.448-1T(e)(4)(ii).

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), describes "Health":

> Proposed § 1.199A-5(b)(2)(ii) is informed by the definition of 'health' under section 448 and provides that the term 'performance of services in the field of health' means the provision of medical services by physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals who provide medical services directly to a patient. The performance of services in the field of health does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or research, testing, and manufacture and/or sales of pharmaceuticals or medical devices.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VI.A.2, "Health," explains:

> Multiple commenters submitted comments requesting additional guidance on the meaning of performance of services in the field of health. Several commenters recommended that the definition of the performance of services in the field of health should differentiate between institutional health care providers (such as skilled nursing homes), which bill on a fee-for-service or per diem-basis, versus health care providers who provide and bill for professional services (such as a physician's practice). Another commenter suggested a distinction between these types of providers based on whether the trade or business had made the capital investment necessary to function as a custodial institution. One commenter recommended the definition be restricted to health

care providers who derive a majority of their revenue from billing patients and third party payers for professional services, thereby excluding health care providers who derive a majority of their revenue from billing for institutional services (skilled nursing facilities, hospitals, ambulatory surgery centers, home health care agencies, outpatient radiology centers, and hospice agencies).

Commenters noted the many services that skilled nursing facilities and assisted living facilities provide are unrelated to health care, including housing, meals, laundry facilities, security, and socialization activities. In some cases, skilled nursing and similar facilities may make available independent contractors who provide services related to health care available to patients, without the facility receiving any payment or revenue with respect to such services. Another commenter suggested that skilled nursing facilities, assisted living, and similar facilities should be excluded from the definition of services in the field of health unless 95 percent or more of the time spent by employees of the facility are directly related to providing medical care.

The Treasury Department and the IRS agree that skilled nursing, assisted living, and similar facilities provide multi-faceted services to their residents. Whether such a facility and its owners are in the trade or business of performing services in the field of health requires a facts and circumstances inquiry that is beyond the scope of these final regulations. The final regulations provide an additional example of one such facility offering services that the Treasury Department and the IRS do not believe rises to the level of the performance of services in the field of health.

Several commenters asked for clarification regarding when two separate activities would generally be viewed separately, particularly in the context of health care facilities such as emergency centers, urgent care centers, and surgical centers that provide improved real estate and equipment but do not directly provide treatment or diagnostic care to service recipients. One commenter noted that there is precedent under section 469 for distinguishing between the provision of direct treatment and diagnostic care versus the business of providing services or facilities ancillary to direct care, even if the physicians own an interest in the entity owning the facilities. The commenter suggested that the final regulations provide examples or other clarification regarding when these and similar facilities will be treated as performing services in the field of health, particularly if one of the owners of a facility also performs medical services in the facility. The final regulations provide an additional example of an outpatient surgical center demonstrating a fact pattern that the Treasury Department and the IRS do not believe is a trade or business providing services in the field of health.

Several commenters requested clarification regarding whether a retail pharmacy selling pharmaceuticals or medical devices is engaged in a health service trade or business. One commenter suggested that final regulations include an example of when a pharmacist would be considered in the health profession. The commenter agreed that a pharmacist working as an independent contractor at various pharmacies, a pharmacist providing inoculations directly to the patient, and a consulting pharmacist working as an independent contractor would all be examples of a pharmacist engaged in an SSTB. Another commenter stated that the inclusion of pharmacists in the definition might be overbroad, suggesting that a pharmacist who was also a pharmacy owner generating revenue from selling pharmaceuticals or medical devices would not be engaged in an SSTB while a pharmacist operating as a consultant and paid as an independent contractor would be engaged in an SSTB. A third commenter suggested that a pharmacist working as an independent contractor for several pharmacies would not be performing services in the field of health unless the pharmacists provide medical services, such as inoculations, directly to a patient.

The Treasury Department and the IRS agree that the sale of pharmaceuticals and medical devices by a retail pharmacy is not by itself a trade or business performing services in the field of health. As the commenters note, however, some services provided by a retail pharmacy through a pharmacist are the performance of services in the field of health. The final regulations provide an additional example of a pharmacist performing services in the field of health.

Another commenter argued that gene therapy and similar injectable products such as stem cell therapy and RNA-based therapies manufactured or produced from the patient's body itself should be treated in the same manner as pharmaceuticals. The commenter argued that their manufacture and production should not be treated as an SSTB, regardless of whether they take place in a hospital or in a separate production facility. The Treasury Department and the IRS decline to adopt this recommendation as this is a question of facts and circumstances.

Another commenter argued that veterinary medicine should not be considered an SSTB. The commenter stated that delivery of veterinary care is different than delivery of human health care because veterinary patients are property and the nature of the animal may dictate the level of veterinary care provided by the owner. Most veterinary practices have other streams of income such as retail, laboratory and diagnostic services, boarding and grooming services, and pharmacies, and the commenter expressed concern that it would be difficult for veterinarians to segregate those other streams of income. The commenter noted that animal boarding and grooming would ordinarily generate income eligible for the deduction and that should not change when services are provided by a veterinarian. The commenter also stated that Federal health legislation does not apply to veterinarians unless the legislation specifically refers to veterinarians, veterinary medicine, or animal health. Finally, the commenter noted that § 1.448-1T(e)(4)(ii) does not reference veterinarians, suggesting that this is an indication that Congress did not intend for veterinary medicine to be treated as a business in the field of health.

Issued nearly three decades ago, Rev. Rul. 91-30, 1991-1 C.B. 61, described a corporation in which employees spend all of their time in the performance of veterinary services, including diagnostic and recuperative services as well as activities, such as the boarding and grooming of animals, that are incident to the performance of these services. The ruling also describes the definition of the performance of services in the field of health contained in § 1.448- 1T(e)(4)(ii) and holds that a corporation whose employees perform veterinary services is a qualified personal service corporation within the meaning of sections 448(d)(2) and 11(b)(2) and a personal service corporation within the meaning of section 441(i). Accordingly, the Treasury Department and the IRS believe that it is appropriate to continue the long-standing treatment of veterinary services as the performance of services in the field of health for purposes of Section 199A and these final regulations.

Another commenter noted that there is a dividing line between physical therapists and other health-related occupations. For example, reimbursement rates from third-party payers are higher for doctors, nurses, and dentists. The commenter also noted that

> Congress initially attempted to exclude physical therapists from participating in Medicare and Medicaid incentive programs and health service student loan forgiveness programs. The Treasury Department and the IRS decline to adopt this comment as multiple health services are reimbursed differently, but are still within the field of health.
>
> One commenter suggested that services are not performed in the field of health unless services are performed directly to a patient. As an example, the commenter argued that a physician who reads x-rays for another physician but does not work directly with the patient would not be performing a service in the field of health. Another commenter stated that defining services in the field of health by proximity to patients could lead to arbitrary results, pointing out that a radiologist who acts as an expert consultant to a physician engages in the same exercise of medical skills and judgment as a physician who sees patients. The commenter suggested that technicians who operate medical equipment or test samples, but are not required to exercise medical judgment should not be considered as performing services in the field of health. The Treasury Department and the IRS agree with the second commenter that proximity to patients is not a necessary component of providing services in the field of health. Accordingly, the final regulations remove the requirement that medical services be provided directly to the patient. The final regulations do not adopt the suggestion that technicians who operate medical equipment or test samples are not considered to be performing services in the field of health as this is a question of fact. However, the final regulations do include an additional example related to laboratory services.

For additional preamble on the selling of medical devices by a person in the field of health, see part II.E.1.c.iv.(o) SSTB Very Broad Gross Receipts Test and Anti-Abuse Rules.

Reg. § 1.199A-5(b)(2)(ii), "Meaning of services performed in the field of health," provides:

> For purposes of Section 199A(d)(2) and paragraph (b)(1)(i) of this section only, the *performance of services in the field of health* means the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals performing services in their capacity as such. The performance of services in the field of health does not include the provision of services not directly related to a medical services field, even though the services provided may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or the research, testing, and manufacture and/or sales of pharmaceuticals or medical devices.

Reg. § 1.199A-5(b)(3)(i) [click on citation for caveats], Example (1) provides:

> B is a board-certified pharmacist who contracts as an independent contractor with X, a small medical facility in a rural area. X employs one full time pharmacist, but contracts with B when X's needs exceed the capacity of its full-time staff. When engaged by X, B is responsible for receiving and reviewing orders from physicians providing medical care at the facility; making recommendations on dosing and alternatives to the ordering physician; performing inoculations, checking for drug interactions, and filling pharmaceutical orders for patients receiving care at X. B is engaged in the performance of services in the field of health within the meaning of Section 199A(d)(2) and paragraphs (b)(1)(i) and (b)(2)(ii) of this section.

Reg. § 1.199A-5(b)(3)(ii) [click on citation for caveats], Example (2) provides:

> X is the operator of a residential facility that provides a variety of services to senior citizens who reside on campus. For residents, X offers standard domestic services including housing management and maintenance, meals, laundry, entertainment, and other similar services. In addition, X contracts with local professional healthcare organizations to offer residents a range of medical and health services provided at the facility, including skilled nursing care, physical and occupational therapy, speech-language pathology services, medical social services, medications, medical supplies and equipment used in the facility, ambulance transportation to the nearest supplier of needed services, and dietary counseling. X receives all of its income from residents for the costs associated with residing at the facility. Any health and medical services are billed directly by the healthcare providers to the senior citizens for those professional healthcare services even though those services are provided at the facility. X does not perform services in the field of health within the meaning of Section 199A(d)(2) and paragraphs (b)(1)(i) and (b)(2)(ii) of this section.

Reg. § 1.199A-5(b)(3)(iii) [click on citation for caveats], Example (3) provides:

> Y operates specialty surgical centers that provide outpatient medical procedures that do not require the patient to remain overnight for recovery or observation following the procedure. Y is a private organization that owns a number of facilities throughout the country. For each facility, Y ensures compliance with state and Federal laws for medical facilities and manages the facility's operations and performs all administrative functions. Y does not employ physicians, nurses, and medical assistants, but enters into agreements with other professional medical organizations or directly with the medical professionals to perform the procedures and provide all medical care. Patients are billed by Y for the facility costs relating to their procedure and by the healthcare professional or their affiliated organization for the actual costs of the procedure conducted by the physician and medical support team. Y does not perform services in the field of health within the meaning of Section 199A(d)(2) and paragraphs (b)(1)(i) and (b)(2)(ii) of this section.

Reg. § 1.199A-5(b)(3)(iv) [click on citation for caveats], Example (4) provides:[846]

> Z is the developer and the only provider of a patented test used to detect a particular medical condition. Z accepts test orders only from health care professionals (Z's clients), does not have contact with patients, and Z's employees do not diagnose, treat, or manage any aspect of patient care. A, who manages Z's testing operations, is the only employee with an advanced medical degree. All other employees are technical support staff and not healthcare professionals. Z's workers are highly educated, but the skills the workers bring to the job are not often useful for Z's testing methods. In order to perform the duties required by Z, employees receive more than a year of specialized training for working with Z's test, which is of no use to other employers. Upon completion of an ordered test, Z analyses the results and provides its clients a report summarizing the findings. Z does not discuss the report's results, or the patient's diagnosis or treatment with any health care provider or the patient. Z is not informed by the healthcare provider as to the healthcare provider's diagnosis or treatment. Z is not

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[846] Example (4) also relates to part II.E.1.c.iv.(n) Any Trade or Business Where the Principal Asset of Such Trade or Business Is the Reputation or Skill of One or More of Its Employees or Owners.

> providing services in the field of health within the meaning of Section 199A(d)(2) and paragraphs (b)(1)(i) and (b)(2)(ii) of this section or where the principal asset of the trade or business is the reputation or skill of one or more of its employees within the meaning of paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.

II.E.1.c.iv.(c). Law

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), describes "Law":

> Proposed § 1.199A-5(b)(2)(iii) is based on the ordinary meaning of 'services in the field of law' and provides that the term 'performance of services in the field of law' means the provision of services by lawyers, paralegals, legal arbitrators, mediators, and similar professionals in their capacity as such. The performance of services in the field of law does not include the provision of services that do not require skills unique to the field of law, for example, the provision of services in the field of law does not include the provision of services by printers, delivery services, or stenography services.

Reg. § 1.199A-5(b)(2)(iii), "Meaning of services performed in the field of law," provides:

> For purposes of Section 199A(d)(2) and paragraph (b)(1)(ii) of this section only, the *performance of services in the field of law* means the performance of legal services by individuals such as lawyers, paralegals, legal arbitrators, mediators, and similar professionals performing services in their capacity as such. The performance of services in the field of law does not include the provision of services that do not require skills unique to the field of law; for example, the provision of services in the field of law does not include the provision of services by printers, delivery services, or stenography services.

II.E.1.c.iv.(d). Accounting

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), describes "Accounting":

> Proposed § 1.199A-5(b)(2)(iv) is based on the ordinary meaning of 'accounting' and provides that the term 'performance of services in the field of accounting' means the provision of services by accountants, enrolled agents, return preparers, financial auditors, and similar professionals in their capacity as such. Provision of services in the field of accounting is not limited to services requiring state licensure as a certified public accountant (CPA). The aim of proposed § 1.199A-5(b)(2)(iv) is to capture the common understanding of accounting, which includes tax return and bookkeeping services, even though the provision of such services may not require the same education, training, or mastery of accounting principles as a CPA. The field of accounting does not include payment processing and billing analysis.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VI.A.3, "Accounting," explains:

> One commenter suggested that real estate settlement agents should be excluded from the definition of those who perform services in the field of accounting. The commenter recommended that final regulations define the performance of services in the field of accounting as the performance of core accounting services such as bookkeeping (including data entry), write-up work, review services, and attest functions, as well as tax

> preparation and similar functions. As an alternative, the commenter recommends that settlement agents be added as not constituting the practice of accounting. A second commenter stated that the definition of accounting should be narrowed to the ordinary meaning of accounting. This comment noted that the field of accounting should include bookkeeping and financial statement preparation, but not tax return advice and preparation. A third commenter noted that the proposed regulations treat bookkeeping services, which do not require professional training or license, as an accounting service. The commenter argued that if the intent of Section 199A is to create parity between C corporations and passthrough entities, the regulations should narrowly define SSTBs, as was done for reputation and skill, and not expand the definitions beyond what was expressly contemplated by Congress.
>
> The Treasury Department and the IRS decline to adopt these comments. As noted in the preamble to the proposed regulations, the provision of services in the field of accounting is not limited to services requiring state licensure. It is based on a common understanding of accounting, which includes tax return and bookkeeping services. Whether a real estate settlement agent is engaged in the performance of services in the field of accounting depends on the facts and circumstances including the specific services offered and performed by the trade or business.

Reg. § 1.199A-5(b)(2)(iv), "Meaning of services performed in the field of accounting," provides:

> For purposes of Section 199A(d)(2) and paragraph (b)(1)(iii) of this section only, the *performance of services in the field of accounting* means the provision of services by individuals such as accountants, enrolled agents, return preparers, financial auditors, and similar professionals performing services in their capacity as such.

II.E.1.c.iv.(e). Actuarial Science

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), describes "Actuarial Science":

> Proposed § 1.199A-5(b)(2)(v) is based on the ordinary meaning 'actuarial science' and provides that the term 'performance of services in the field of actuarial science' means the provision of services by actuaries and similar professionals in their capacity as such. Accordingly, the field of actuarial science does not include the provision of services by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial costs of risk or uncertainty of events.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VI.A.4, "Actuarial Science," explains:

> The proposed regulations provide that the performance of services in the field of actuarial science means the provision of services by individuals such as actuaries and similar professionals performing services in their capacity as such. One commenter stated that the definition creates uncertainty for businesses that employ actuaries but do not separately bill for the services (such as insurance businesses). The commenter recommended providing a rule similar to the rule for consulting services related to the manufacture and sale of goods for actuarial science. The Treasury Department and the IRS decline to adopt this comment as Section 199A looks to the trade or business of performing services rather than the performance of services themselves. As stated in

> the preamble to the proposed regulations, the field of actuarial science does not include the provision of services by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial cost of risk or uncertainty of events. The mere employment of an actuary does not itself cause a trade or business to be treated as performing services in the field of actuarial science. Whether a trade or business is providing actuarial services is a question of fact and circumstance.

Reg. § 1.199A-5(b)(2)(v), "Meaning of services performed in the field of actuarial science," provides:

> For purposes of Section 199A(d)(2) and paragraph (b)(1)(iv) of this section only, the *performance of services in the field of actuarial science* means the provision of services by individuals such as actuaries and similar professionals performing services in their capacity as such.

II.E.1.c.iv.(f). Performing Arts

Footnote 45 of the Senate report commented about the services in the field of performing arts:

> For purposes of the similar list of services in section 448, Treasury regulations provide that the performance of services in the field of the performing arts means the provision of services by actors, actresses, singers, musicians, entertainers, and similar artists in their capacity as such. The performance of services in the field of the performing arts does not include the provision of services by persons who themselves are not performing artists (*e.g.*, persons who may manage or promote such artists, and other persons in a trade or business that relates to the performing arts). Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate the performance of such artists to members of the public (*e.g.*, employees of a radio station that broadcasts the performances of musicians and singers). See Treas. Reg. sec. 1.448-1T(e)(4)(iii).

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), describes "Performing Arts":

> Proposed § 1.199A-5(b)(2)(vi) is informed by the definition of 'performing arts' under section 448 and provides that the term 'performance of services in the field of the performing arts' means the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such. The performance of services in the field of performing arts does not include the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts. Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VI.A.5, "Performing Arts," explains:

> Multiple commenters stated that the definition of performance of services in the field of performing arts should be limited to the definition in § 1.448- 1T(e)(4)(iii). One

> commenter argued that the position in the proposed regulations that includes individuals who participate in the creation of the performing arts is not supported by the legislative history, namely the Statement of Managers that references the section 448 regulations. As described in part VII.A.1. of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS decline to limit the definition of the performance of services in the field of performing arts to the definition in § 1.448-1T(e)(4)(iii). Another commenter suggested that writers should fall outside the definition of the performance of services in the field of performing arts because writing does not require a skill unique to the creation of performing arts. Further, writers create a wide variety of works not intended to be performed before an audience. The Treasury Department and the IRS also decline to adopt this comment. To the extent that a writer is paid for written material, such as a song or screenplay, that is integral to the creation of the performing arts, the writer is performing services in the field of performing arts.

Reg. § 1.199A-5(b)(2)(vi), "Meaning of services performed in the field of performing arts," provides:

> For purposes of Section 199A(d)(2) and paragraph (b)(1)(v) of this section only, the *performance of services in the field of the performing arts* means the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such. The performance of services in the field of performing arts does not include the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts. Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public.

Reg. § 1.199A-5(b)(3)(v) [click on citation for caveats], Example (5) provides:

> A, a singer and songwriter, writes and records a song. A is paid a mechanical royalty when the song is licensed or streamed. A is also paid a performance royalty when the recorded song is played publicly. A is engaged in the performance of services in an SSTB in the field of performing arts within the meaning of Section 199A(d)(2) or paragraphs (b)(1)(v) and (b)(2)(vi) of this section. The royalties that A receives for the song are not eligible for a deduction under Section 199A.

Reg. § 1.199A-5(b)(3)(vi) [click on citation for caveats], Example (6) provides:

> B is a partner in Movie LLC, a partnership. Movie LLC is a film production company. Movie LLC plans and coordinates film production. Movie LLC shares in the profits of the films that it produces. Therefore, Movie LLC is engaged in the performance of services in an SSTB in the field of performing arts within the meaning of Section 199A(d)(2) or paragraphs (b)(1)(v) and (b)(2)(vi) of this section. B is a passive owner in Movie LLC and does not provide any services with respect to Movie LLC. However, because Movie LLC is engaged in an SSTB in the field of performing arts, B's distributive share of the income, gain, deduction, and loss with respect to Movie LLC is not eligible for a deduction under Section 199A.

II.E.1.c.iv.(g). Consulting

Footnote 46 of the Senate report commented about the services in the field of consulting:

> For purposes of the similar list of services in section 448, Treasury regulations provide that the performance of services in the field of consulting means the provision of advice and counsel. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or brokerage services, or economically similar services. For purposes of the preceding sentence, the determination of whether a person's services are sales or brokerage services, or economically similar services, shall be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided (*e.g.*, whether the compensation for the services is contingent upon the consummation of the transaction that the services were intended to effect). See Treas. Reg. sec. 1.448-1T(e)(4)(iv).

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), describes "Consulting":

> Proposed § 1.199A-5(b)(2)(vii) is informed by the definition of 'consulting' under section 448 and provides that the term 'performance of services in the field of consulting' means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Consulting includes providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such. The performance of services in the field of consulting does not include the performance of services other than advice and counsel. This determination is made based on all the facts and circumstances of a person's business.
>
> Additionally, the Treasury Department and the IRS are aware of the concern noted by commenters that in certain kinds of sales transactions it is common for businesses to provide consulting services in connection with the purchase of goods by customers. For example, a company that sells computers may provide customers with consulting services relating to the setup, operation, and repair of the computers, or a contractor who remodels homes may provide consulting prior to remodeling a kitchen. As described previously in this Explanation of Provisions, proposed § 1.199A-5(c) provides a de minimis rule, under which a trade or business is not an SSTB if less than 10 percent of the gross receipts (5 percent if the gross receipts are greater than $25 million) of the trade or business are attributable to the performance of services in a specified service activity. However, this de minimis rule may not provide sufficient relief for certain trades or business that provide ancillary consulting services. The Treasury Department and the IRS believe that if a trade or business involves the selling or manufacturing of goods, and such trade or business provides ancillary consulting services that are not separately purchased or billed, then such trades or businesses are not in a trade or business in the field of consulting. Accordingly, proposed § 1.199A-5(b)(2)(vii) provides that the field of consulting does not include consulting that is embedded in, or ancillary to, the sale of goods if there is no separate payment for the consulting services.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VI.A.6, "Consulting," explains:

> One commenter suggested that proposed § 1.199A-5(b)(3), Example 3, should be modified to clarify that C, a taxpayer in the business of providing services that assist unrelated entities in making their personnel structures more efficient, does not provide any temporary workers, and C's compensation and fees are not affected by whether C's clients use temporary workers. The commenter argued that such a change would prevent the example from being interpreted as treating any recommendation for a business to use temporary workers as consulting services. The commenter also suggested that the final regulations include an additional example similar to Example 7 of § 1.448-1T(e)(4)(iv)(B) related to staffing firms. The commenter recommended that the example provide that a business that assists other businesses in meeting their personnel needs by referring job applicants to them does not engage in the performance of services in the field of consulting when the compensation for the business referring job applicants is based on whether the applicants accept employment positions with the businesses searching for employees. The final regulations adopt these suggestions.
>
> Another commenter suggested that final regulations clarify whether services provided by engineers and architects could be considered to be an SSTB if their services meet the definition of consulting services. The Treasury Department and the IRS adopt this comment. Section 1.199A- 5(b)(2)(vii) of the final regulations provides that services within the fields of architecture and engineering are not treated as consulting services for purposes of Section 199A.
>
> One commenter suggested that the definition of consulting should be narrowed to stand-alone advice and counsel with no link to production, manufacturing, sales, or licensing of products. The Treasury Department and the IRS decline to adopt this suggestion as it would be difficult to administer and subject to manipulation. Another commenter suggested that the phrase "provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems" is overly broad as it could apply to almost any service-based business that assists clients in achieving goals and solving problems. The commenter stated that applying the ancillary rule would be difficult where a taxpayer is required to separately bill for embedded consulting services under state or local sales tax laws. The commenter suggested that the consulting field should be limited to taxpayers that fall under a consulting-related business activity code under the North American Industry Classification Systems (NAICS). The Treasury Department and the IRS agree with the commenter that many service-based businesses could be construed as providing professional advice and counsel to clients to assist the client in achieving goals and solving problems; however, the Treasury Department and the IRS decline to adopt the recommendation to limit the consulting field based on NAICS codes. Section 1.199A-5(b)(2)(vii) excludes the performance of services other than providing advice and counsel from the field of consulting. At issue is whether advice and counsel is provided in the context of the provision of goods or services (that are not otherwise SSTBs). This is a question of facts and circumstances. Consulting services that are separately billed are generally not considered to be provided in the context of the provisions of goods or services.

Reg. § 1.199A-5(b)(2)(vii), "Meaning of services performed in the field of consulting," provides:

> For purposes of Section 199A(d)(2) and paragraph (b)(1)(vi) of this section only, the *performance of services in the field of consulting* means the provision of professional

> advice and counsel to clients to assist the client in achieving goals and solving problems. Consulting includes providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales (or economically similar services) or the provision of training and educational courses. For purposes of the preceding sentence, the determination of whether a person's services are sales or economically similar services will be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided. Performance of services in the field of consulting does not include the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services. Services within the fields of architecture and engineering are not treated as consulting services.

Reg. § 1.199A-5(b)(3)(viii) [click on citation for caveats], Example (8) provides:

> D is in the business of providing services that assist unrelated entities in making their personnel structures more efficient. D studies its client's organization and structure and compares it to peers in its industry. D then makes recommendations and provides advice to its client regarding possible changes in the client's personnel structure, including the use of temporary workers. D does not provide any temporary workers to its clients and D's compensation and fees are not affected by whether D's clients used temporary workers. D is engaged in the performance of services in an SSTB in the field of consulting within the meaning of Section 199A(d)(2) or paragraphs (b)(1)(vi) and (b)(2)(vii) of this section.

Reg. § 1.199A-5(b)(3)(ix) [click on citation for caveats], Example (9) provides:

> E is an individual who owns and operates a temporary worker staffing firm primarily focused on the software consulting industry. Business clients hire E to provide temporary workers that have the necessary technical skills and experience with a variety of business software to provide consulting and advice regarding the proper selection and operation of software most appropriate for the business they are advising. E does not have a technical software engineering background and does not provide software consulting advice herself. E reviews resumes and refers candidates to the client when the client indicates a need for temporary workers. E does not evaluate her clients' needs about whether the client needs workers and does not evaluate the clients' consulting contracts to determine the type of expertise needed. Rather, the client provides E with a job description indicating the required skills for the upcoming consulting project. E is paid a fixed fee for each temporary worker actually hired by the client and receives a bonus if that worker is hired permanently within a year of referral. E's fee is not contingent on the profits of its clients. E is not considered to be engaged in the performance of services in the field of consulting within the meaning of Section 199A(d)(2) or (b)(1)(vi) and (b)(2)(vii) of this section.

Reg. § 1.199A-5(b)(3)(x) [click on citation for caveats], Example (10) provides:

> F is in the business of licensing software to customers. F discusses and evaluates the customer's software needs with the customer. The taxpayer advises the customer on the particular software products it licenses. F is paid a flat price for the software license. After the customer licenses the software, F helps to implement the software. F is engaged in the trade or business of licensing software and not engaged in an SSTB in the field of consulting within the meaning of Section 199A(d)(2) or paragraphs (b)(1)(vi) and (b)(2)(vii) of this section.

II.E.1.c.iv.(h). Athletics

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), describes "Athletics":

> The field of athletics is not listed in section 448(d)(2), and there is little guidance on its meaning as used in section 1202(e)(3)(A). However, commenters noted, and the Treasury Department and the IRS agree, that among the services specified in Section 199A(d)(2)(A) the field of athletics is most similar to the field of performing arts. Accordingly, proposed § 1.199A-5(b)(2) (viii) provides that the term 'performance of services in the field of athletics' means the performances of services by individuals who participate in athletic competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing. The performance of services in the field of athletics does not include the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events. Similarly, the performance of services in the field of athletics does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VI.A.7, "Athletics," explains:

> A few commenters suggested that the definition of a trade or business involving the performance of services in the field of athletics should not include the trade or business of owning a professional sports team. One commenter stated that the definition should be limited to entities that are either owned or controlled by, or whose primary beneficiaries are, professional athletes or that involve the performance of services by those athletes; in other words, the definition should apply solely to athletes' personal services companies.
>
> Another commenter recommended that § 1.199A-5(b)(3) Example 2 be revised to reflect that neither sports clubs nor club owners perform services described in section 1202(e)(3)(A). The commenter stated that a professional sports club and its owners do not perform services in the field of athletics. Instead, a sports club sells tickets, licenses, sponsorships, and other intellectual property, creates digital content, engages in community activities, manages a stadium, and produces an entertainment product. The commenter argued that Congress intended through the SSTB rules to prevent W-2 wage income from being converted to QBI and that only the trade or business of an athlete involves W-2 wage income from athletic performance. The commenter continued, stating that professional sports clubs are not described in section 1202(e)(3)(A) or provided in section 448(d)(2)(A).

> The Treasury Department and the IRS decline to adopt this comment. As described in part VII.A.1. of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS do not believe that definitional guidance should be limited to that provided in § 1.448-1T(e)(4)(i) (by analogy to performing arts for athletics). While sports club and team owners are not performing athletic services directly, that is not a requirement of Section 199A, which looks to whether there is income attributable to a trade or business involving the performance of services in a specified activity, not who performed the services. A professional sports club may operate more than one trade or business. For example, a team may operate its concession services as a separate trade or business. The Treasury Department and the IRS agree that such concession services generally would not be a trade or business of performing services in the field of athletics. Nonetheless, a professional sports club's operation of an athletic team is a trade or business of performing services in the field of athletics. Income from that trade or business, including income from ticket sales and broadcast rights, is income from a trade or business of performing services in the field of athletics. The performance of services in the field of athletics does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.

Reg. § 1.199A-5(b)(2)(viii), "Meaning of services performed in the field of athletics," provides:

> For purposes of Section 199A(d)(2) and paragraph (b)(1)(vii) of this section only, the *performance of services in the field of athletics* means the performance of services by individuals who participate in athletic competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing. The performance of services in the field of athletics does not include the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events. Similarly, the performance of services in the field of athletics does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.

Reg. § 1.199A-5(b)(3)(vii) [click on citation for caveats], Example (7) provides:

> C is a partner in Partnership, which solely owns and operates a professional sports team. Partnership employs athletes and sells tickets and broadcast rights for games in which the sports team competes. Partnership sells the broadcast rights to Broadcast LLC, a separate trade or business. Broadcast LLC solely broadcasts the games. Partnership is engaged in the performance of services in an SSTB in the field of athletics within the meaning of Section 199A(d)(2) or paragraphs (b)(1)(vii) and (b)(2)(viii) of this section. The tickets sales and the sale of the broadcast rights are both the performance of services in the field of athletics. C is a passive owner in Partnership and C does not provide any services with respect to Partnership or the sports team. However, because Partnership is engaged in an SSTB in the field of athletics, C's distributive share of the income, gain, deduction, and loss with respect to Partnership is not eligible for a deduction under Section 199A. Broadcast LLC is not engaged in the performance of services in an SSTB in the field of athletics.

II.E.1.c.iv.(i). Financial Services

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), describes "Financial Services":

> Commenters requested guidance as to whether financial services includes banking. These commenters noted that section 1202(e)(3)(A) includes the term financial services, but that banking in separately listed in section 1202(e)(3)(B) which suggests that banking is not included as part of financial services in section 1202(e)(3)(A). The Treasury Department and the IRS agree with such commenters that this suggests that financial services should be more narrowly interpreted here. Therefore, proposed § 1.199A-5(b)(2)(ix) limits the definition of financial services to services typically performed by financial advisors and investment bankers and provides that the field of financial services includes the provision of financial services to clients including managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 or similar cases), and raising financial capital by underwriting, or acting as the client's agent in the issuance of securities, and similar services. This includes services provided by financial advisors, investment bankers, wealth planners, and retirement advisors and other similar professionals, but does not include taking deposits or making loans.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VI.A.8, "Financial Services," explains:

> Several commenters suggested that final regulations clarify that financing, including taking deposits, making loans, and entering into financing contracts, is not a financial service. One commenter requested an explicit rule clarifying that non-bank mortgage bankers are not SSTBs and that customary activities of mortgage bankers including mortgage loan origination, sales of mortgage loans, mortgage loan servicing, and sale of mortgage servicing rights are not financial services. The preamble to the proposed regulations provides that the provision of financial services does not include taking deposits or making loans. The final regulations clarify that the provision of financial services does not include taking deposits or making loans.
>
> One commenter stated that the determination that banking is not a financial service appears to be wrong and inconsistent with statutory construction since any common definition of financial services includes banking services. As stated in the preamble to the proposed regulations, banking is listed in section 1202(e)(3)(B) but not section 1202(e)(3)(A). As a matter of statutory construction, the Treasury Department and the IRS believe that banking must therefore be excluded from the definition of financial services for purposes of Section 199A. Another commenter suggested that insurance should be categorically excluded from the meaning of financial services because insurance is described in section 1202(e)(3)(B). The Treasury Department and the IRS agree that by operation of section 1202(e)(3)(B), insurance cannot be considered a financial service for purposes of Section 199A. The commenter also suggested that a rule similar to the ancillary services rule for consulting should be extended to cover financial services. Another commenter argued that insurance agents and others who provide investment advice are not in the field of financial services, unless the agent receives a fee for the advice, rather than a commission on the sale.

> The Treasury Department and the IRS decline to categorically exclude services provided by insurance agents from the definition of financial services as financial services such as managing wealth, advising clients with respect to finances, and the provision of advisory and other similar services that can be provided by insurance agents. However, the Treasury Department and the IRS note that the provision of these services to the extent that they are ancillary to the commission-based sale of an insurance policy will generally not be considered the provision of financial services for purposes of Section 199A.

Reg. § 1.199A-5(b)(2)(ix), "Meaning of services performed in the field of financial services," provides:

> For purposes of Section 199A(d)(2) and paragraph (b)(1)(viii) of this section only, the *performance of services in the field of financial services* means he provision of financial services to clients including managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 of the Code or similar cases), and raising financial capital by underwriting, or acting as a client's agent in the issuance of securities and similar services. This includes services provided by financial advisors, investment bankers, wealth planners, retirement advisors, and other similar professionals performing services in their capacity as such. Solely for purposes of Section 199A, the performance of services in the field of financial services does not include taking deposits or making loans, but does include arranging lending transactions between a lender and borrower.

Reg. § 1.199A-5(b)(3)(xi) [click on citation for caveats], Example (11) provides:

> G is in the business of providing services to assist clients with their finances. G will study a particular client's financial situation, including, the client's present income, savings, and investments, and anticipated future economic and financial needs. Based on this study, G will then assist the client in making decisions and plans regarding the client's financial activities. Such financial planning includes the design of a personal budget to assist the client in monitoring the client's financial situation, the adoption of investment strategies tailored to the client's needs, and other similar services. G is engaged in the performance of services in an SSTB in the field of financial services within the meaning of Section 199A(d)(2) or paragraphs (b)(1)(viii) and (b)(2)(ix) of this section.

Reg. § 1.199A-5(b)(3)(xii) [click on citation for caveats], Example (12) provides:

> H is in the business of franchising a brand of personal financial planning offices, which generally provide personal wealth management, retirement planning, and other financial advice services to customers for a fee. H does not provide financial planning services itself. H licenses the right to use the business tradename, other branding intellectual property, and a marketing plan to third-party financial planner franchisees that operate the franchised locations and provide all services to customers. In exchange, the franchisees compensate H based on a fee structure, which includes a one-time fee to acquire the franchise. H is not engaged in the performance of services in the field of financial services within the meaning of Section 199A(d)(2) or paragraphs (b)(1)(viii) and (b)(2)(ix) of this section.

II.E.1.c.iv.(j). Brokerage Services

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), describes "Brokerage Services":

> Proposed § 1.199A-5(b)(2)(x) uses the ordinary meaning of 'brokerage services' and provides that the field of brokerage services includes services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in section 475(c)(2)) for a commission or fee. This includes services provided by stock brokers and other similar professionals, but does not include services provided by real estate agents and brokers, or insurance agents and brokers.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VI.A.9, "Brokerage Services," explains:

> One commenter stated that the ordinary definition of a broker is any person who buys and sells goods or services for others, including agents, and argued that nothing in the statute limits this to stock brokers. The commenter said that the definition in the proposed regulations artificially narrows the standard to appease special interests without any justification. The definition provided for in the proposed regulations applies more broadly than stock brokers and includes all services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in section 475(c)(2)) for a commission or fee. While the term "broker" is sometimes used in a broad sense to include anyone who facilitates the purchase and sale of goods for a fee or commission, the term "brokerage services" is most commonly associated with services, such as those provided by brokerage firms, involving the facilitation of purchases and sales of stock and other securities.
>
> Another commenter suggested that final regulations clarify that life insurance products are not securities for purposes of Section 199A or that life insurance brokers engaged in their capacity as such are not brokers in securities for purposes of Section 199A. Other commenters requested the final regulations clarify that the business of financing or making loans, including the services provided by mortgage banking companies, does not fall within the definition of brokerage services. The Treasury Department and the IRS address this comment in the final regulations by explicitly stating that although the performance of services in the field of financial services does not include taking deposits or making loans, it does include arranging lending transactions between a lender and borrower. The final regulations define securities by reference to section 475(c)(2).

Reg. § 1.199A-5(b)(2)(x), "Meaning of services performed in the field of brokerage services," provides:

> For purposes of Section 199A(d)(2) and paragraph (b)(1)(ix) of this section only, the *performance of services in the field of brokerage services* includes services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in section 475(c)(2)) for a commission or fee. This includes services provided by stock brokers and other similar professionals, but does not include services provided by real estate agents and brokers, or insurance agents and brokers.

Reg. § 1.199A-5(b)(3)(xiii) [click on citation for caveats], Example (13) provides:

> J is in the business of executing transactions for customers involving various types of securities or commodities generally traded through organized exchanges or other similar networks. Customers place orders with J to trade securities or commodities based on the taxpayer's recommendations. J's compensation for its services typically is based on completion of the trade orders. J is engaged in an SSTB in the field of brokerage services within the meaning of Section 199A(d)(2) or paragraphs (b)(1)(ix) and (b)(2)(x) of this section.

II.E.1.c.iv.(k). Investing and Investment Management

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), describes "Investing and Investment Management":

> Proposed § 1.199A-5(b)(2)(xi) uses the ordinary meaning of 'investing and investment management' and provides that any trade or business that involves the 'performance of services that consist of investing and investment management' means a trade or business that earns fees for investment, asset management services, or investment management services including providing advice with respect to buying and selling investments. The performance of services that consist of investing and investment management would include a trade or business that receives either a commission, a flat fee, or an investment management fee calculated as a percentage of assets under management. The performance of services of investing and investment management does not include directly managing real property.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VI.A.10, "Investing and Investment Management," explains:

> One commenter recommended that the performance of services that consist of investing and investment management be limited to investment management and investment advisory businesses whose income is principally attributable to the performance of personal services involving the provision of investment advice or the regular and contemporaneous management of investors' assets by individual employees or owners of the business. The commenter recommended that the definition exclude large, diversified asset managers that invest significant capital in and derive significant income from the research, development, and sale of investment products. The commenter suggested that rather than making business-by-business determinations, the final regulations should look to rules such as the regulations under now repealed section 1348, which did not treat income from a business in which capital is a material income producing factor as earned income. As an alternative, the commenter suggested that the final regulations could provide a safe harbor for firms that research, develop, and sell investment products, including changes to the de minimis and incidental rules necessary to effectuate the safe harbor. An example of such a rule could be similar to the rule provided for ancillary consulting services.
>
> The Treasury Department and the IRS decline to adopt this comment as the regulations under now repealed section 1348 looked to earned income including fees received by taxpayers engaged in a professional occupation. Section 199A is focused on a trade or business, not a profession of an individual. Accordingly, the determination of whether a trade or business in an SSTB must be made on a business-by-business basis.

> Another commenter suggested that final regulations clarify that investing and investment management does not include the sale of life insurance products and that life insurance products are not investments for purposes of Section 199A. The Treasury Department and the IRS decline to define investment for purposes of Section 199A but note that commission-based sales of insurance policies generally will not be considered the performance of services in the field of investing and investing management for purposes of Section 199A.
>
> Another commenter recommended that final regulations clarify that directly managing real property includes management through agents and affiliates acting as agents for the property manager. The SSTB limitations apply to direct and indirect owners of a trade or business that is an SSTB, regardless of whether the owner is passive or participated in any specified service activity. Accordingly, direct and indirect management of real property includes management through agents, employees, and independent contractors.

Reg. § 1.199A-5(b)(2)(xi), "Meaning of the provision of services in investing and investment management," provides:

> For purposes of Section 199A(d)(2) and paragraph (b)(1)(x) of this section only, the *performance of services that consist of investing and investment management* refers to a trade or business involving the receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments. The performance of services of investing and investment management does not include directly managing real property.

II.E.1.c.iv.(l). Trading

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), describes "Trading":

> Proposed § 1.199A-5(b)(2)(xii) provides that any trade or business involving the 'performance of services that consist of trading' means a trade or business of trading in securities, commodities, or partnership interests. Whether a person is a trader is determined taking into account the relevant facts and circumstances. Factors that have been considered relevant to determining whether a person is a trader include the source and type of profit generally sought from engaging in the activity regardless of whether the activity is being provided on behalf of customers or for a taxpayer's own account. See *Endicott v. Commissioner*, T.C. Memo. 2013-199; *Nelson v. Commissioner*, T.C. Memo. 2013-259, *King v. Commissioner*, 89 T.C. 445 (1987). A person that is a trader under these principles will be treated as performing the services of trading for purposes of Section 199A(d)(2)(B).

Reg. § 1.199A-5(b)(2)(xii), "Meaning of the provision of services in trading," provides:

> For purposes of Section 199A(d)(2) and paragraph (b)(1)(xi) of this section only, the *performance of services that consist of trading* means a trade or business of trading in securities (as defined in section 475(c)(2)), commodities (as defined in section 475(e)(2)), or partnership interests. Whether a person is a trader in securities, commodities, or partnership interests is determined by taking into account all relevant facts and circumstances, including the source and type of profit that is associated with

> engaging in the activity regardless of whether that person trades for the person's own account, for the account of others, or any combination thereof.

II.E.1.c.iv.(m). Dealing in Securities, Partnership Interests, or Commodities

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), describes "Dealing in Securities, Partnership Interests, and Commodities":

> For purposes of proposed § 1.199A-5(b)(2)(xiii), the 'performance of services that consist of dealing in securities (as defined in section 475(c)(2))' means regularly purchasing securities from and selling securities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. For purposes of the preceding sentence, a taxpayer that regularly originates loans in the ordinary course of a trade or business of making loans but engages in no more than negligible sales of the loans is not dealing in securities for purposes of Section 199A(d)(2). See § 1.475(c)-1(c)(2) and (4) for the definition of negligible sales.
>
> For purposes of proposed § 1.199A-5(b)(2)(xiii), 'the performance of services that consist of dealing in partnership interests' means regularly purchasing partnership interests from and selling partnership interests to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in partnership interests with customers in the ordinary course of a trade or business.
>
> For purposes of proposed § 1.199A-5(b)(2)(xiii), 'the performance of services that consist of dealing in commodities (as defined in section 475(e)(2))' means regularly purchasing commodities from and selling commodities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in commodities with customers in the ordinary course of a trade or business.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VI.A.11, "Dealing," explains:

> **a. Mortgage Banking, Credit Sales, and Non-Bank Lending**
>
> Several commenters suggested that the provisions regarding dealing in securities should exclude mortgage banking and other lending activities in which lending is the primary business focus. Several of these commenters noted that the plain language meaning of "purchasing securities" does not include making loans. One commenter suggested that the reference to the definition of negligible sales should be clarified to explain that negligible sales as defined in § 1.475(c)-1(c)(2) and (4) does not apply if the loan is in connection with mortgage servicing contracts as excluded in section 451(b)(1)(B). Another commenter suggested that portfolio lenders should also be able to use the negligible sales exemption and all sales of loans outside the ordinary course of business should be excluded from consideration in applying the negligible sales test. A third commenter suggested that the regulation clarify that the negligible sales exception is simply an exception to the general definition of dealing in securities. Another commenter suggested that application of dealing in securities should be limited to taxpayers engaged in broker-dealer activities for which registration under Federal law would be required. Another commenter suggested that the creation of a loan should not be

construed as a purchase and a taxpayer should be considered a dealer in securities only if they both purchase and sell securities. As an alternative, this commenter suggested that negligible sales could be defined in terms of the number of customers that the lender sells loans to each year. For this purpose, the Government National Mortgage Association (GNMA) would be considered to be the customer for purpose of sales of GNMA mortgage pools through the issuance of mortgage backed securities. Another commenter suggested that sales of retail installment contracts or loans for purposes of liquidity, portfolio diversification, and similar purposes should be considered to be outside of recurring business activity and thus not dealing in securities. In response to these comments, the final regulations provide that for purposes of Section 199A and the definition of performing services that consist of dealing in securities, the performance of services to originate a loan is not treated as the purchase of a security from the borrower. Additionally, the final regulations remove the reference to the negligible sales exception under § 1.475(c)-1(c)(2) and (4) from the definition of dealing in securities.

Another commenter suggested that under Section 199A, the term “securities” should be defined by reference to section 475 but not the terms “dealer” or “dealer in securities.” The commenter suggested that a lender should be considered to be a dealer in securities for purposes of Section 199A only to the extent that loans, including retail sales contracts, acquired by the lender are held in inventory or held for sale to customers in the ordinary course of a trade or business within the meaning of section 1221. The commenter also suggested that when a loan is acquired with a view towards holding the loan to maturity in the lender’s portfolio and the loan is later sold outside the normal course of business; such a sale should not result in the lender being viewed as a dealer in securities. Another commenter suggested that the meaning of sales to customers should be clarified in the context of a mortgage finance business. This commenter requested that the regulations clarify that a mortgage loan originator which transfers mortgages to an agency or broker/dealer for cash or mortgage-backed securities does not engage in a sale by the originator to a customer for purposes of Section 199A.

In response to these comments, the final regulations provide that the performance of services to originate a loan is not treated as the purchase of a security from the borrower in determining whether the lender is performing services consisting of dealing in securities. The comment regarding the definition of a dealer in securities, however, is not accepted, as the definition of a securities dealer has never depended on whether securities were held in inventory. The final regulations also do not address loans that are sold outside the normal course of business, which is an inherently factual question. Similarly, the Treasury Department and the IRS decline to address the question of whether a person is a customer as this is a subject which is beyond the scope of these regulations.

b. Banking

Many commenters recommended that traditional banking activities be excluded entirely from the definition of an SSTB, including the performance of services that consist of dealing in securities. The commenters argued that Congress intended banks that elect under section 1362(a) to be S corporations (subchapter S banks) to have the same relative reduction in taxes as C corporation banks after enactment of the TCJA. Many commenters noted that subchapter S bank activities are already strictly limited by the Bank Holding Company Act and this effectively serves as a guardrail against abuse of the Section 199A deduction. As an alternative, commenters suggested that the definition of SSTB should be more narrowly drawn to exclude bank services such as trust or fiduciary services, securities brokerage, and the origination and sale of mortgages and loans. Commenters also expressed concern that the de minimis rule is insufficient to protect banks. These commenters suggested revisions including raising the de minimis threshold to 25 percent regardless of the amount of gross receipts and using net income rather than gross receipts for the measure.

The Treasury Department and the IRS decline to accept these comments. Although the final regulations continue to exclude taking deposits or making loans from the definition of an SSTB involving the performance of financial services, and exclude the origination of loans from the definition of dealing in securities for purposes of Section 199A, the Treasury Department and the IRS do not believe that there is a broad exemption from the listed SSTBs with respect to all services that may be legally permitted to be performed by banks. Therefore, to the extent a bank operates a single trade or business that involves the performance of services listed as SSTBs outside of the de minimis exception, such as investing and investment management, the bank's single trade or business will be treated as an SSTB. However, as noted previously, an RPE, including a subchapter S bank, may operate more than one trade or business. Thus, a subchapter S bank could segregate specified service activities from an existing trade or business and operate such specified service activities as an SSTB separate from its remaining trade or business, either within the same legal entity or in a separate entity.

c. Commodities

Several commenters suggested that the final regulations provide that a trade or business is not engaged in the performance of services of investing, trading, or dealing in commodities if it regularly takes physical possession of the underlying commodity in the ordinary course of its trade or business. These commenters also argued that a business that takes physical possession of the commodity should not be treated as an SSTB if it hedges its risk with respect to the commodity as part of the ordinary course of its trade or business. The commenters state that dealing in commodities for purposes of Section 199A should be understood to mean an activity similar to dealing in securities and should be limited to the dealing in financial instruments referenced to commodities, such as commodities futures or options that are traded on regulated exchanges. One commenter argued that if the regulations were to apply to physical commodities it would result in different tax treatment depending on whether the commodity is actively traded and that Congress intended the definition of commodities to apply only to commodities derivatives. Another commenter suggested that manufacturing activities as defined under the now repealed section 199 should be expressly excluded from the definition of both trading in commodities and dealing in commodities.

The Treasury Department and the IRS agree with commenters that the definition of dealing in commodities for purposes of Section 199A should be limited to a trade or business that is dealing in financial instruments or otherwise does not engage in substantial activities with respect to physical commodities. To distinguish a trade or business that performs substantial activities with physical commodities from a trade or business that engages in a commodities trade or business by dealing or trading in financial instruments that are commodities (within the meaning of section 475(e)(2)), or a trade or business that otherwise does not perform substantial activities with commodities, the final regulations adopt rules similar to the rules that apply to qualified active sales of commodities in § 1.954-2(f)(2)(iii). Those rules generally require a person to be engaged in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities and to perform certain activities with respect to those commodities.

Accordingly, for purposes of Section 199A, gains and losses from the sale of commodities in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities will be qualified active sales and gains and losses from qualified active sales are not taken into account in determining whether a person is engaged in the trade or business of dealing in commodities. Similarly, income, deduction, gain, or loss from a hedging transaction (as defined in § 1.1221-2(b)) entered into in the normal course of a commodities business conducted by a producer, processor, merchant, or handler of commodities will be treated as gains and losses from qualified active sales that are part of that trade or business. Qualified active sales generally require a taxpayer to hold commodities as inventory or similar property and to satisfy specified conditions regarding substantial and significant activities described in the final regulations. A sale by a trade or business of commodities held for investment or speculation is not a qualified active sale.

Reg. § 1.199A-5(b)(2)(xiii), "Meaning of the provision of services in dealing," provides:

(A) *Dealing in securities*. For purposes of Section 199A(d)(2) and paragraph (b)(1)(xii) of this section only, the *performance of services that consist of dealing in securities* (as defined in section 475(c)(2)) means regularly purchasing securities from and selling securities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. Solely for purposes of the preceding sentence, the performance of services to originate a loan is not treated as the purchase of a security from the borrower in determining whether the lender is dealing in securities.

(B) *Dealing in commodities*. For purposes of Section 199A(d)(2) and paragraph (b)(1)(xii) of this section only, *the performance of services that consist of dealing in commodities (as defined in section 475(e)(2))* means regularly purchasing commodities from and selling commodities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in commodities with customers in the ordinary course of a trade or business. Solely for purposes of the preceding sentence, gains and losses from qualified active sales as defined in paragraph (b)(2)(xiii)(B)(1) of this section are not taken into account in determining whether a person is engaged in the trade or business of dealing in commodities.

(1) Qualified active sale. The term *qualified active sale* means the sale of commodities in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities if the trade or business is as an active producer, processor, merchant or handler of commodities. A hedging transaction described in paragraph (b)(2)(i)(B) of this section is treated as a qualified active sale. The sale of commodities held by a trade or business other than in its capacity as an active producer, processor, merchant, or handler of commodities is not a qualified active sale. For example, the sale by a trade or

business of commodities that were held for investment or speculation would not be a qualified active sale.

(2) *Active conduct of a commodities business*. For purposes of paragraph (b)(2)(xiii)(B)(1) of this section, a trade or business is engaged in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities only with respect to commodities for which each of the conditions described in paragraphs (b)(2)(xiii)(B)(3) through (5) of this section are satisfied.

(3) *Directly holds commodities as inventory or similar property*. The commodities trade or business holds the commodities directly, and not through an agent or independent contractor, as inventory or similar property. The term inventory or similar property means property that is stock in trade of the trade or business or other property of a kind that would properly be included in the inventory of the trade or business if on hand at the close of the taxable year, or property held by the trade or business primarily for sale to customers in the ordinary course of its trade or business.

(4) *Directly incurs substantial expenses in the ordinary course*. The commodities trade or business incurs substantial expenses in the ordinary course of the commodities trade or business from engaging in one or more of the following activities directly, and not through an agent or independent contractor -

(i) Substantial activities in the production of the commodities, including planting, tending or harvesting crops, raising or slaughtering livestock, or extracting minerals;

(ii) Substantial processing activities prior to the sale of the commodities, including the blending and drying of agricultural commodities, or the concentrating, refining, mixing, crushing, aerating or milling of commodities; or

(iii) Significant activities as described in paragraph (b)(2)(xiii)(B)(*5*) of this section.

(5) Significant activities for purposes of paragraph (b)(2)(xiii)(B)(4)(iii). The commodities trade or business performs significant activities with respect to the commodities that consists of -

(i) The physical movement, handling and storage of the commodities, including preparation of contracts and invoices, arranging transportation, insurance and credit, arranging for receipt, transfer or negotiation of shipping documents, arranging storage or warehousing, and dealing with quality claims;

(ii) Owning and operating facilities for storage or warehousing; or

(iii) Owning, chartering, or leasing vessels or vehicles for the transportation of the commodities.

(C) *Dealing in partnership interests*. For purposes of Section 199A(d)(2) and paragraph (b)(1)(xii) of this section only, the *performance of services that consist of* *dealing in partnership interests* means regularly purchasing partnership interests from and selling partnership interests to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in partnership interests with customers in the ordinary course of a trade or business.

II.E.1.c.iv.(n). Any Trade or Business Where the Principal Asset of Such Trade or Business Is the Reputation or Skill of One or More of Its Employees or Owners

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), describes "Any Trade or Business Where the Principal Asset of Such Trade or Business Is the Reputation or Skill of 1 or More of Its Employees or Owners":

> Guidance on the meaning of the 'reputation or skill' clause in section 1202(e)(3)(A) is limited to dicta in one case. In *John P. Owen v. Commissioner*, T.C. Memo. 2012-21, the Tax Court examined whether Mr. Owen, whose business was insurance, was entitled to benefits under section 1202 with respect to the sale of his interest in a corporation conducting such business. Under the facts described in the case, the corporation had extensive training programs and sales structures, but primarily relied on the services of independent contractors (including Mr. Owen) in conducting its business. Although the Tax Court acknowledged that the business' success was due to Mr. Owen's efforts, it found that the principal asset of the company in question was the training program and sales structure of the business rather than Mr. Owen's services.
>
> The Treasury Department and the IRS received several comments regarding the meaning of the 'reputation or skill' clause. Commenters described potential methods to give maximum effect to the literal language of the reputation or skill clause by describing ways to (1) determine the extent to which the reputation or skill of employees or owners constitutes an asset of the business under Federal tax accounting principles, and (2) measure whether such an asset is in fact the principal asset of the business.
>
> One commenter suggested using an activity-based standard under which no service-based businesses would qualify for the Section 199A deduction. An SSTB definition this broad would not comport with the statute and would deny a Section 199A deduction to businesses that the statute does not appear to exclude. If the 'reputation or skill' clause was intended to exclude all service businesses from Section 199A, there would have been no reason to enumerate specific types of businesses in Section 199A(d)(2); that language would be pure surplusage. A broad service-based test would also fail to provide a clear classification of businesses that combine services with sales of products, such as plumbing and HVAC services, if those businesses sell goods or equipment in the course of providing services. Therefore, the Treasury Department and the IRS do not believe it is consistent with the text, structure, or purpose of Section 199A to exclude all service businesses above the threshold amount from qualifying for the Section 199A deduction.
>
> Another commenter described a balance sheet test that would compare the value of assets other than goodwill and workforce in place to the value of such goodwill and workforce in place. The commenter acknowledged that such a test could also be broader than Congress intended. In addition, the commenter noted that such a test could easily lead to strange and unintuitive results, and may be difficult to apply in the case of small businesses that do not maintain audited financial statements and would

both be ripe for abuse, and could potentially result in many legal disputes between taxpayers and the IRS.

Finally, one commenter described a standard based on whether the trade or business involves the provision of highly-skilled services. The commenter argued that the primary benefit of a standard like this is that it would harmonize the meaning of the reputation or skill phrase with the trades or businesses listed in section 1202(e)(3)(A), each of which involve the provision of services by professionals who either received a substantial amount of training (for example, doctors, nurses, lawyers, and accountants), or who have otherwise achieved a high degree of skill in a given field (for example, professional athletes or performing artists).

Congress enacted Section 199A to provide a deduction from taxable income to trades or businesses conducted by sole proprietorships and passthrough entities that do not benefit from the income tax rate reduction afforded to C corporations under the TCJA. The Treasury Department and the IRS are concerned that a broad definition of the 'reputation or skill' phrase that relied on a balance sheet test or numerical ratios would have several consequences inconsistent with the intent of Section 199A. Testing businesses based on metrics, some of them subjective, that change over time could result in inappropriate year-over-year tax consequences and lead to distorted decision-making. As the commenters noted, such mechanical tests pose administrative difficulties and fail to provide taxpayers with needed certainty regarding the tax law necessary for conducting their business affairs. Most significantly, such mechanical rules might prevent trades or businesses that Congress intended to be eligible for the Section 199A deduction from claiming the Section 199A deduction.

In sum, the Treasury Department and the IRS believe that the 'reputation or skill' clause as used in Section 199A was intended to describe a narrow set of trades or businesses, not otherwise covered by the enumerated specified services, in which income is received based directly on the skill and/or reputation of employees or owners. Additionally, the Treasury Department and the IRS believe that 'reputation or skill' must be interpreted in a manner that is both objective and administrable. Thus, proposed § 1.199A-5(b)(2)(xiv) limits the meaning of the 'reputation or skill' clause to fact patterns in which the individual or RPE is engaged in the trade or business of: (1) receiving income for endorsing products or services, including an individual's distributive share of income or distributions from an RPE for which the individual provides endorsement services; (2) licensing or receiving income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity, including an individual's distributive share of income or distributions from an RPE to which an individual contributes the rights to use the individual's image; or (3) receiving appearance fees or income (including fees or income to reality performers performing as themselves on television, social media, or other forums, radio, television, and other media hosts, and video game players). Proposed § 1.199A-5(b)(4) contains two examples illustrating the application of this definition. The Treasury Department and the IRS request comments on this rule, the clarity of definitions for the statutorily enumerated trades or businesses that are SSTBs under Section 199A(d)(2)(A), and the accompanying examples.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VI.A.13 [12?], "Reputation/Skill," explains:

> Many commenters expressed support for the position in the proposed regulations that reputation or skill was intended to describe a narrow set of trades or businesses not otherwise covered by the other listed SSTBs, often writing that a more broad interpretation would be inherently complex and unworkable. Other commenters disagreed with the definition in the proposed regulations, expressing concern that the narrowness of the definition is contrary to the language of the statute and Congressional intent.
>
> The Treasury Department and the IRS remain concerned that a broad interpretation of the reputation and skill clause would result in substantial uncertainty for both taxpayers and the IRS. As stated in the preamble to the proposed regulations, it would be inconsistent with the text, structure, and purpose of Section 199A to potentially exclude income from all service businesses from qualifying for the Section 199A deduction for taxpayers with taxable income above the threshold amount. If Congressional intent was to exclude all service businesses, Congress clearly could have drafted such a rule. Accordingly, the final regulations retain the proposed rule limiting the meaning of the reputation or skill clause to fact patterns in which an individual or RPE is engaged in the trade or business of receiving income from endorsements, the licensing of an individual's likeness or features, and appearance fees.
>
> One commenter requested additional clarification regarding whether advertising income received for on air advertising spots in which a program host reads a script describing the positive qualities of a product or service, and may also choose to describe his or her own positive experiences with the product, is endorsement income as described in § 1.199A- 5(b)(2)(xiv)(A). The commenter argued that such income should not be considered endorsement income because it is not received in connection with a separate trade or business of making endorsements. The Treasury Department and the IRS decline to adopt this suggestion as § 1.199A- 5(b)(2)(xiv)(A) looks to whether the individual or RPE is receiving income from the endorsement of products or services, not whether the income is received in connection with a separate trade or business of making endorsements. Whether a taxpayer endorses a product or services is dependent on the facts and circumstances.

Reg. § 1.199A-5(b)(2)(xiv), "Meaning of trade or business where the principal asset of such trade or business is the reputation or skill of one or more employees or owners," provides:

> For purposes of Section 199A(d)(2) and paragraph (b)(1)(xiii) of this section only, the term *any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners* means any trade or business that consists of any of the following (or any combination thereof):
>
> (A) A trade or business in which a person receives fees, compensation, or other income for endorsing products or services;
>
> (B) A trade or business in which a person licenses or receives fees, compensation, or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity; or

(C) Receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format.

(D) For purposes of paragraphs (b)(2)(xiv)(A) through (C) of this section, the term fees, compensation, or other income includes the receipt of a partnership interest and the corresponding distributive share of income, deduction, gain, or loss from the partnership, or the receipt of stock of an S corporation and the corresponding income, deduction, gain, or loss from the S corporation stock.

Reg. § 1.199A-5(b)(3)(iv), Example (4), dealing with a lab with highly skilled employees, is reproduced in the text accompanying fn 846 of part II.E.1.c.iv.(b) Health.

Reg. § 1.199A-5(b)(3)(xiv) [click on citation for caveats], Example (14) provides:

> K owns 100% of Corp, an S corporation, which operates a bicycle sales and repair business. Corp has 8 employees, including K. Half of Corp's net income is generated from sales of new and used bicycles and related goods, such as helmets, and bicycle-related equipment. The other half of Corp's net income is generated from bicycle repair services performed by K and Corp's other employees. Corp's assets consist of inventory, fixtures, bicycle repair equipment, and a leasehold on its retail location. Several of the employees and G have worked in the bicycle business for many years, and have acquired substantial skill and reputation in the field. Customers often consult with the employees on the best bicycle for purchase. K is in the business of sales and repairs of bicycles and is not engaged in an SSTB within the meaning of Section 199A(d)(2) or paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.

Reg. § 1.199A-5(b)(3)(xv) [click on citation for caveats], Example (15) provides:

> L is a well-known chef and the sole owner of multiple restaurants each of which is owned in a disregarded entity. Due to L's skill and reputation as a chef, L receives an endorsement fee of $500,000 for the use of L's name on a line of cooking utensils and cookware. L is in the trade or business of being a chef and owning restaurants and such trade or business is not an SSTB. However, L is also in the trade or business of receiving endorsement income. L's trade or business consisting of the receipt of the endorsement fee for L's skill and/or reputation is an SSTB within the meaning of Section 199A(d)(2) or paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.

Reg. § 1.199A-5(b)(3)(xvi) [click on citation for caveats], Example (16) provides:

> M is a well-known actor. M entered into a partnership with Shoe Company, in which M contributed her likeness and the use of her name to the partnership in exchange for a 50% interest in the partnership and a guaranteed payment. M's trade or business consisting of the receipt of the partnership interest and the corresponding distributive share with respect to the partnership interest for M's likeness and the use of her name is an SSTB within the meaning of Section 199A(d)(2) or paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.

II.E.1.c.iv.(o). SSTB Very Broad Gross Receipts Test and Anti-Abuse Rules

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), "Defining What is Included in an SSTB," provides:

> The Treasury Department and the IRS are aware that some taxpayers have contemplated a strategy to separate out parts of what otherwise would be an integrated SSTB, such as the administrative functions, in an attempt to qualify those separated parts for the Section 199A deduction. Such a strategy is inconsistent with the purpose of Section 199A. Therefore, in accordance with Section 199A(f)(4), in order to carry out the purposes of Section 199A, proposed § 1.199A-5(c)(2) provides that an SSTB includes any trade or business with 50 percent or more common ownership (directly or indirectly) that provides 80 percent or more of its property or services to an SSTB. Additionally, if a trade or business has 50 percent or more common ownership with an SSTB, to the extent that the trade or business provides property or services to the commonly-owned SSTB, the portion of the property or services provided to the SSTB will be treated as an SSTB (meaning the income will be treated as income from an SSTB). For example, A, a dentist, owns a dental practice and also owns an office building. A rents half the building to the dental practice and half the building to unrelated persons. Under proposed § 1.199A-5(c)(2), the renting of half of the building to the dental practice will be treated as an SSTB.
>
> Additionally, proposed § 1.199A-5 provides a rule that if a trade or business (that would not otherwise be treated as an SSTB) has 50 percent or more common ownership with an SSTB and shared expenses, including wages or overhead expenses with the SSTB, it is treated as incidental to an SSTB and, therefore, as an SSTB, if the trade or business represents no more than five percent of gross receipts of the combined business.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VI.B, "De Minimis Rule," explains:

> The proposed regulations provide that for a trade or business with gross receipts of $25 million or less for the taxable year, a trade or business is not an SSTB if less than 10 percent of the gross receipts of the trade or business are attributable to a specified service field. The percentage is reduced to 5 percent in the case of trades or businesses with gross receipts in excess of $25 million. Several commenters requested clarification regarding whether the entire trade or business is designated an SSTB if the threshold is exceeded. Some of these commenters suggested that the rule be modified so that the deduction could be claimed on the portion of the trade or business activity that was not an SSTB. A few suggested that an allocation similar to that in now repealed section 199 could be used. One commenter suggested using the cost accounting principles of section 861 with a safe harbor allowing a simplified method for entities with average annual gross receipts less than $25 million. Another commenter stated that treating the entire trade or business as an SSTB is a trap for the unwary because well-advised taxpayers could avoid application of the rule by rearranging their activities into separate entities. One commenter suggested that the de minimis rule allow for minor year-to-year changes in gross receipts for businesses that are close to the de minimis thresholds. The commenter also suggested that the thresholds be increased and recommended an incremental approach in which the deduction is calculated based on the portion of the business that is not engaged in an SSTB. Another commenter suggested that if the rule is retained, it should be imposed only at a

greater than 50 percent threshold since only at that point would SSTB gross receipts predominate over non-SSTB gross receipts. The commenter also noted that a higher threshold would be easier to track. Several commenters also suggested that the de minimis threshold be raised. One commenter suggested that the de minimis threshold be raised to 20 percent for all qualified businesses, regardless of gross receipts. The commenter argued that a 20 percent threshold is supported by Congress's decision to use section 1202(e) for its definition of an SSTB, noting that section 1202(e)(1)(A) uses an at least 80 percent (by value) rule for determining whether a qualified trade or business satisfies the section's active business requirement. Other commenters recommended that the ten percent threshold should apply for purposes of the de minimis threshold regardless of the amount of gross receipts of the trade or business. Public comments lacked consensus regarding the 5-percent de minimis threshold. After considering all of the comments, the Treasury Department and the IRS chose to retain the 5-percent threshold in the final regulations as it is a de minimis threshold that is generally consistent with prior regulations under the Code in similar circumstances and therefore, such a standard should be familiar to affected entities.

Another commenter suggested that final regulations clarify whether revenue generated from the sale of medical products or devices should be excluded from the overall QBI for trades or businesses that provide services in the field of health. The commenter noted that physicians who provide their patients with medical devices should be able to use the deduction with respect to income from such devices and expressed concern that the de minimis thresholds could limit the ability of some practitioners to use the deduction. Another commenter suggested that a business with SSTB gross receipts in excess of the de minimis should not be entirely disqualified, but that the facts and circumstances should be analyzed to determine the true nature of the trade or business. The commenter also suggested that a safe harbor should be provided in which a business can make an election to deem the SSTB activity as a separate trade or business solely for the purposes of Section 199A. Finally, one commenter suggested that final regulations include an example of what result occurs if a taxpayer's SSTB revenue is not de minimis.

The Treasury Department and the IRS decline to adopt most of the recommendations in these comments. As stated in the preamble to the proposed regulations, the statutory language of Section 199A does not provide a certain quantum of activity before an SSTB is found. Rather, Section 199A looks to whether the trade or business involves the performance of services in the list of SSTBs. The use of the word "involving" suggests that any amount of specified service activity causes a trade or business to be an SSTB. Consequently, the Treasury Department and the IRS believe that it would be inappropriate to adopt a pro rata rule. However, requiring all taxpayers to evaluate and quantify any amount of specified service activity would be unduly burdensome and complex for both taxpayers and the IRS. Accordingly, the proposed rule provides a de minimis threshold under which a trade or business will not be considered an SSTB merely because it provides a small amount of services in a specified service activity. Trades or business with gross income from a specified service activity in excess of the de minimis threshold are considered to be SSTBs. The final regulations retain the proposed rule but add an additional example demonstrating the result in which a trade or business has income from a specified service activity in excess of the de minimis threshold.

> As discussed in part II of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS acknowledge that an RPE can have more than one trade or business for purposes of section 162 and thus for Section 199A. However, each trade or business is required under Section 199A to be separately tested to determine whether that trade or business is an SSTB. Similarly, the de minimis threshold is applied to each trade or business of an RPE separately, not in the aggregate to all the trades or businesses of the RPE. Thus, to the extent that an individual or RPE has more than one trade or business, the presence of specified service activity in one of those trades or business will not cause the individual's or RPE's other trades or businesses to be considered SSTBs except to the extent that the rules in § 1.199A-5(c)(2) (services or property provided to an SSTB) apply.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VI.C, "Services or Property Provided to an SSTB," explains:

> The proposed regulations provide special rules for service or property provided to an SSTB by a trade or business with common ownership. A trade or business that provides more than 80 percent of its property or services to an SSTB is treated as an SSTB if there is 50 percent or more common ownership of the trades or businesses. In cases in which a trade or business provides less than 80 percent of its property or services to a commonly owned SSTB, the portion of the trade or business providing property to the commonly owned SSTB is treated as part of the SSTB with respect to the related parties.
>
> One commenter suggested that the provision is warranted because of abuse potential but is overbroad and prevents legitimate transactions. The commenter recommended that the rule be modified into a presumption that a taxpayer could rebut with evidence demonstrating that the property or services provided to the SSTB by the related RPE are (1) comparable to those available from competing organizations and (2) that prices charged by the RPE and paid by the SSTB are comparable to those charged in the market. The commenter also suggested that the IRS could examine the totality of facts and circumstances, including historic conduct between the SSTB and RPE. Another commenter suggested that the final rule add an exception to the rule for taxpayers that can demonstrate they have a substantial purpose (apart from Federal income tax effects) for structuring their trade or business in a particular manner. For example, title to a skilled nursing facility could be held by one passthrough entity that is operated by a related passthrough entity in order to satisfy Department of Housing and Urban Development lending requirements. The Treasury Department and the IRS decline to adopt these recommendations. Creating a presumption or substantial purpose test would lead to greater complexity and administrative burden for both taxpayers and the IRS.

As the preamble to the final regulations, T.D. 9847 (2/8/2019), summarizes in the section explaining economic impact:[847]

> The final regulations removed the "incidental to an SSTB" rule requiring that businesses with majority ownership and shared expenses with an SSTB be considered as part of the

[847] T.D. 9847 (2/8/2019), Special Analyses, part I, "Regulatory Planning and Review – Economic Analysis," subpart C, "Economic Analysis of Changes in Final Regulations," paragraph 3, "Anti-abuse Rules."

same trade or business for purposes of the Section 199A deduction. This anti-abuse rule was intended to limit the ability of taxpayers to separate their SSTB and non-SSTB income into two trades or businesses in order to receive the deduction on their non-SSTB income. In response to comments, the rule was removed from the final regulations for a number of reasons. First, defining when two businesses have shared expenses is difficult to administer and could be overly inclusive. Second, there was a concern that start-up businesses could be excluded from the Section 199A deduction if they shared expenses and ownership with a larger business that could be considered an SSTB.

The final regulations modify the anti-abuse rule concerning services or property provided to an SSTB. The rule is meant to disallow SSTBs from splitting their trade or business into two pieces with one providing services or leasing property to the other. For example, imagine a dentist office that owns a building. The dental practice would be considered an SSTB. Suppose the dentist split the business into two trades or businesses, the first of which was the dental practice and the second of which owned the building and leased it to the dental practice. This rule states that the income from leasing the building to the dental practice would also be considered SSTB income and ineligible for the Section 199A deduction. Under the proposed regulations, a trade or business that provides more than 80 percent of its property or services to an SSTB is treated as an SSTB if there is 50 percent or more common ownership of the trades or businesses. In cases in which a trade or business provides less than 80 percent of its property or services to a commonly owned SSTB, the portion of the trade or business providing property to the commonly owned SSTB is treated as part of the SSTB with respect to the related parties. The final regulations remove the 80 percent threshold and allow any portion that is not provided to an SSTB to be eligible for the Section 199A deduction. For example, if the dentist's leasing trade or business leased 90 percent of the building to the dental office and 10 percent to a coffee shop, the 10 percent would now be eligible for the Section 199A deduction. This change removed a threshold in the anti-abuse rule, which will remove any incentive to stay below the 80 percent threshold, while still disallowing the income from providing property or services to related SSTBs to be eligible for the deduction.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VI.D, "Incidental to a Specified Service Trade or Business," explains:

The proposed regulations provide that if a trade or business (that would not otherwise be treated as an SSTB) has both 50 percent or more common ownership with an SSTB and shared expenses with an SSTB, then the trade or business is treated as incidental to and, therefore, part of the SSTB, if the gross receipts of the trade or business represent no more than five percent of the total combined gross receipts of the trade or business and the SSTB in a taxable year. One commenter recommended that this rule be removed because it is unnecessary and causes administrative difficulties for taxpayers who must determine whether a trade or business is incidental in order to apply the rule. If the rule is retained, the commenter recommended that final regulations define gross receipts and shared expenses, make adjustments to avoid double counting the same gross receipts, clarify what businesses are taken into account for purposes of the rule, and treat a trade or business to which the anti-abuse rule applies as a separate SSTB rather than as part of the SSTB. Another commenter suggested that the final regulations add an exception for start-ups such as a three to five year grace period and also clarify the ownership standard, how the rule would apply if the trades or business have different tax years, and how shared expenses would be determined. In accordance with the comments, the rule is removed from the final regulations.

Reg. § 1.199A-5(c), "Special rules," provides:

(1) *De minimis rule*.

(i) *Gross receipts of $25 million or less*. For a trade or business with gross receipts of $25 million or less for the taxable year, a trade or business is not an SSTB if less than 10 percent of the gross receipts of the trade or business are attributable to the performance of services in a field described in paragraph (b) of this section. For purposes of determining whether this 10 percent test is satisfied, the performance of any activity incident to the actual performance of services in the field is considered the performance of services in that field.

(ii) *Gross receipts of greater than $25 million*. For a trade or business with gross receipts of greater than $25 million for the taxable year, the rules of paragraph (c)(1)(i) of this section are applied by substituting "5 percent" for "10 percent" each place it appears.

(iii) *Examples*. The following examples illustrate the provisions of paragraph (c)(1) of this section.

(A) *Example 1*. Landscape LLC sells lawn care and landscaping equipment and also provides advice and counsel on landscape design for large office parks and residential buildings. The landscape design services include advice on the selection and placement of trees, shrubs, and flowers and are considered to be the performance of services in the field of consulting under paragraphs (b)(1)(vi) and (b)(2)(vii) of this section. Landscape LLC separately invoices for its landscape design services and does not sell the trees, shrubs, or flowers it recommends for use in the landscape design. Landscape LLC maintains one set of books and records and treats the equipment sales and design services as a single trade or business for purposes of sections 162 and 199A. Landscape LLC has gross receipts of $2 million. $ 250,000 of the gross receipts is attributable to the landscape design services, an SSTB. Because the gross receipts from the consulting services exceed 10 percent of Landscape LLC's total gross receipts, the entirety of Landscape LLC's trade or business is considered an SSTB.

(B) *Example 2*. Animal Care LLC provides veterinarian services performed by licensed staff and also develops and sells its own line of organic dog food at its veterinarian clinic and online. The veterinarian services are considered to be the performance of services in the field of health under paragraphs (b)(1)(i) and (b)(2)(ii) of this section. Animal Care LLC separately invoices for its veterinarian services and the sale of its organic dog food. Animal Care LLC maintains separate books and records for its veterinarian clinic and its development and sale of its dog food. Animal Care LLC also has separate employees who are unaffiliated with the veterinary clinic and who only work on the formulation, marketing, sales, and distribution of the organic dog food products. Animal Care LLC treats its veterinary practice and the dog food development and sales as separate trades or businesses for purposes of section 162 and 199A. Animal Care LLC has gross receipts of $3,000,000. $1,000,000 of the gross receipts is attributable to the veterinary services, an SSTB. Although the gross receipts from the services in the field of health exceed 10 percent of Animal Care LLC's total gross receipts, the dog food development and sales business is not considered an SSTB due to the fact that the veterinary practice and the dog food development and sales are separate trades or businesses under section 162.

(2) *Services or property provided to an SSTB*.

(i) *In general*. If a trade or business provides property or services to an SSTB within the meaning of this section and there is 50 percent or more common ownership of the trades or businesses, that portion of the trade or business of providing property or services to the 50 percent or more commonly-owned SSTB will be treated as a separate SSTB with respect to the related parties.

(ii) *50 percent or more common ownership*. For purposes of paragraph (c)(2)(i) and (ii) of this section, 50 percent or more common ownership includes direct or indirect ownership by related parties within the meaning of sections 267(b) or 707(b).

(iii) *Examples*. The following examples illustrate the provisions of paragraph (c)(2) of this section.

(A) *Example 1*. Law Firm is a partnership that provides legal services to clients, owns its own office building and employs its own administrative staff. Law Firm divides into three partnerships. Partnership 1 performs legal services to clients. Partnership 2 owns the office building and rents the entire building to Partnership 1. Partnership 3 employs the administrative staff and through a contract with Partnership 1 provides administrative services to Partnership 1 in exchange for fees. All three of the partnerships are owned by the same people (the original owners of Law Firm). Because Partnership 2 provides all of its property to Partnership 1, and Partnership 3 provides all of its services to Partnership 1, Partnerships 2 and 3 will each be treated as an SSTB under paragraph (c)(2) of this section.

(B) *Example 2*. Assume the same facts as in Example 1 of this paragraph (c)(2), except that Partnership 2, which owns the office building, rents 50 percent of the building to Partnership 1, which provides legal services, and the other 50 percent to various unrelated third party tenants. Because Partnership 2 is owned by the same people as Partnership 1, the portion of Partnership 2's leasing activity related to the lease of the building to Partnership 1 will be treated as a separate SSTB. The remaining 50 percent of Partnership 2's leasing activity will not be treated as an SSTB.

Code § 267(b) is reproduced in part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses. For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

Reg. § 1.199A-5(c)(1) is a snake in the grass. The corollary of ignoring SSTB components of a business if gross receipts are less than 5% or 10% of gross receipts is that a business can have as much as 95% or 90% gross receipts be from non-SSTB sources and be counted as an SSTB.

To minimize or avoid an SSTB's contamination, consider segregating business that involve SSTBs from those that do not involve SSTBs. For how to segregate businesses, see part II.E.1.c.iii.(b) Multiple Trades or Businesses Within an Entity – Identification of Businesses and Allocation of Items. Reg. § 1.199A-5(c)(1)(iii)(B) above confirms the efficacy of this strategy.

II.E.1.c.v. Calculation of Deduction Generally

The preamble to final regulations explains:[848]

> As noted in the preamble to the proposed regulations, Section 199A was enacted on December 22, 2017, by section 11011 of "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Public Law 115-97 (TCJA), and was amended on March 23, 2018, retroactively to January 1, 2018, by section 101 of Division T of the Consolidated Appropriations Act, 2018, Public Law 115-141, (2018 Act). Section 199A applies to taxable years beginning after 2017 and before 2026.
>
> Section 199A provides a deduction of up to 20 percent of income from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate. The Section 199A deduction may be taken by individuals and by some estates and trusts. A Section 199A deduction is not available for wage income or for business income earned through a C corporation (as defined in section 1361(a)(2)). For taxpayers whose taxable income exceeds a statutorily-defined amount (threshold amount), Section 199A may limit the taxpayer's Section 199A deduction based on (i) the type of trade or business engaged in by the taxpayer, (ii) the amount of W-2 wages paid with respect to the trade or business (W-2 wages), and/or (iii) the UBIA of qualified property held for use in the trade or business (UBIA of qualified property). These statutory limitations are subject to phase-in rules based upon taxable income above the threshold amount.
>
> Section 199A also allows individuals and some trusts and estates (but not corporations) a deduction of up to 20 percent of their combined qualified REIT dividends and qualified PTP income, including qualified REIT dividends and qualified PTP income earned through passthrough entities. This component of the Section 199A deduction is not limited by W-2 wages or UBIA of qualified property.
>
> The Section 199A deduction is the lesser of (1) the sum of the combined amounts described in the prior two paragraphs or (2) an amount equal to 20 percent of the excess (if any) of taxable income of the taxpayer for the taxable year over the net capital gain of the taxpayer for the taxable year.
>
> Additionally, Section 199A(g), as amended by the 2018 Act effective as of January 1, 2018, provides that specified agricultural or horticultural cooperatives may claim a special entity-level deduction that is substantially similar to the domestic production activities deduction under former section 199. The Treasury Department and

[848] T.D. 9847 (2/8/2019), part I.A.

the IRS intend to issue a future notice of proposed rulemaking describing proposed rules for applying Section 199A to specified agricultural and horticultural cooperatives and their patrons.

Finally, the statute expressly grants the Secretary authority to prescribe such regulations as are necessary to carry out the purposes of Section 199A (Section 199A(f)(4)), and provides specific grants of authority with respect to: The treatment of acquisitions, dispositions, and short taxable years (Section 199A(b)(5)); certain payments to partners for services rendered in a non-partner capacity (Section 199A(c)(4)(C)); the allocation of W-2 wages and UBIA of qualified property (Section 199A(f)(1)(A)(iii)); restricting the allocation of items and wages under Section 199A and such reporting requirements as the Secretary determines appropriate (Section 199A(f)(4)(A)); the application of Section 199A in the case of tiered entities (Section 199A(f)(4)(B); preventing the manipulation of the depreciable period of qualified property using transactions between related parties (Section 199A(h)(1)); and determining the UBIA of qualified property acquired in like-kind exchanges or involuntary conversions (Section 199A(h)(2)).

Taxpayers other than C corporations may deduct a portion of qualified business income ("QBI") and qualified cooperative dividends ("QCDs"). Code § 199A(a) provides:

In general. In the case of a taxpayer other than a corporation, there shall be allowed as a deduction for any taxable year an amount equal to the sum of—

(1) the lesser of -

(A) the combined qualified business income amount of the taxpayer, or

(B) an amount equal to 20 percent of the excess (if any) of-

(i) the taxable income of the taxpayer for the taxable year, over

(ii) the sum of any net capital gain (as defined in section 1(h)), plus the aggregate amount of the qualified cooperative dividends, of the taxpayer for the taxable year, plus

(2) the lesser of -

(A) 20 percent of the aggregate amount of the qualified cooperative dividends of the taxpayer for the taxable year, or

(B) taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.

The amount determined under the preceding sentence shall not exceed the taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.

Thus, the deduction relating to QBI is effectively limited to taxable income that is not taxed as long-term capital gain.[849]

The deduction for QCDs[850] is not a focus of this document,[851] nor do Prop. Reg. §§ 1.199A-1 through 1.199A-6 or Reg. §§ 1.199A-1 through 1.199A-6 address it,[852] except to provide special rules for QBI from any trade or business of a patron of a specified agricultural or horticultural cooperative.[853] Note the limitation related to net capital gain; it includes qualified dividends and also includes capital gains and qualified dividends that do not receive capital gain rates because they are treated as investment income under Code § 163(d)(4)(B)(iii).[854] This limitation seems

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849 This is a major limitation among others listed in part II.E.1.c.i.(a) Summary of Federal Impact of Deduction, especially fn 771.

850 Code § 199A(e)(4) provides:

> *Qualified Cooperative Dividend*. The term "qualified cooperative dividend" means any patronage dividend (as defined in section 1388(a)), any per-unit retain allocation (as defined in section 1388(f)), and any qualified written notice of allocation (as defined in section 1388(c)), or any similar amount received from an organization described in subparagraph (B)(ii), which—
>
> (A) is includible in gross income, and
>
> (B) is received from—
>
> (i) an organization or corporation described in section 501(c)(12) or 1381(a), or
>
> (ii) an organization which is governed under this title by the rules applicable to cooperatives under this title before the enactment of subchapter T.

851 The Senate report explained (footnotes omitted) (remember that the Conference Committee reduced the deduction from 23% to 20%):

> A deduction is allowed under the provision for 23 percent of the taxpayer's aggregate amount of qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income for the taxable year. Qualified REIT dividends do not include any portion of a dividend received from a REIT that is a capital gain dividend or a qualified dividend. A qualified cooperative dividend means a patronage dividend, per-unit retain allocation, qualified written notice of allocation, or any similar amount, provided it is includible in gross income and is received from either (1) a tax-exempt benevolent life insurance association, mutual ditch or irrigation company, cooperative telephone company, like cooperative organization, or a taxable or tax-exempt cooperative that is described in section 1381(a), or (2) a taxable cooperative governed by tax rules applicable to cooperatives before the enactment of subchapter T of the Code in 1962. Qualified publicly traded partnership income means (with respect to any qualified trade or business of the taxpayer), the sum of the (a) the net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (that are effectively connected with a U.S. trade or business and are included or allowed in determining taxable income for the taxable year and do not constitute excepted enumerated investment-type income, and not including the taxpayer's reasonable compensation, guaranteed payments for services, or (to the extent provided in regulations) section 707(a) payments for services) from a publicly traded partnership not treated as a corporation, and (b) gain recognized by the taxpayer on disposition of its interest in the partnership that is treated as ordinary income (for example, by reason of section 751).

852 Each of Prop. Reg. § 1.199A-1(a)(1) and Reg. § 1.199A-1(a)(1) concludes with:

> This section and §§ 1.199A-2 through 1.199A-6 do not apply for purposes of calculating the deduction in section 199A(g) for specified agricultural and horticultural cooperatives.

853 See Reg. § 1.199A-1(e)(7).

854 Although Code § 199A(a)(1)(B)(ii) refers to Code § 1(h) to define "net capital gain," Code § 1(h) does not define the term. "Net capital gain" means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year. Code § 1222(11), which applies for purposes of subtitle A (Code §§ 1-1563). The preamble to the final regulations, T.D. 9847 (2/8/2019), part II.A.1, reasons:

designed to keep the capital gain rate as the floor for a taxpayer's rate and not let the QBI/QCD deduction reduce that rate. Capital gains cannot be QBI.[855] In understanding how this limitation works, note that the QBI/QCD deduction is not a deduction in arriving at gross income, is not a deduction in arriving at adjusted gross income, and is not an itemized deduction.[856] When one calculates income tax, one calculates it on taxable income with and without net capital gain.[857] Thus, this limit on the QBI deduction is applied after all business and nonbusiness income and deductions are calculated to determine taxable income. Therefore, if capital gain can be QBI, the related deduction can be applied against any business or nonbusiness income that is not net capital gain.

The QBI-based deduction is the lesser of the taxpayer's combined QBI amount or 20% of the excess (if any) of (i) the taxpayer's taxable income over (ii) the sum of the taxpayer's net capital gain and aggregate QCDs.[858]

The combined QBI amount is (A) the sum of certain QBI-related amounts for each qualified trade or business the taxpayer carries on, plus (B) "20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the

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The final regulations provide a definition of net capital gain for purposes of section 199A. Section 1(h) establishes the maximum capital gains rates imposed on individuals, trusts, and estates that have a net capital gain for the taxable year. Section 1222(11) defines net capital gain as the excess of net long-term capital gain for the taxable year over the net short-term capital loss for such year. Section 1(h)(11) provides that for purposes of section 1(h), net capital gain means net capital gain (determined without regard to section 1(h)(11)) increased by qualified dividend income. Accordingly, § 1.199A-1(b)(3) defines net capital gain for purposes of section 199A as net capital gain within the meaning of section 1222(11) plus any qualified dividend income (as defined in section 1(h)(11)(B)) for the taxable year.

The Treasury Department and the IRS note that under section 1(h)(2), net capital gain is reduced by the amount that the taxpayer takes into account as investment income under section 163(d)(4)(B)(iii). This reduction does not change the definition of net capital gain for purposes of section 1(h). Instead, it reduces the amount of gains that can be taxed at the maximum capital gains rates as a tradeoff for allowing a taxpayer to elect to deduct more investment interest under section 163(d). Consequently, capital gains and qualified dividends treated as investment income are net capital gain for purposes of determining the section 199A deduction.

[855] See Reg. § 1.199A-3(b)(2)(ii)(A), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

[856] See fns 763-764 in part II.E.1.c.i.(a) Summary of Federal Impact of Deduction.

[857] Code § 1(h).

[858] Code § 199A(a)(1).

taxable year."[859] By "qualified" I mean not a specified service trade or business (SSTB)[860] unless taxable income is below certain thresholds.[861]

All of the analysis in this part II.E.1.c.v Calculation of Deduction Generally needs to be viewed in light of part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

Parts II.E.1.c.v.(b) and II.E.1.c.v.(c) below provide details on this part II.E.1.c.v and refer to the threshold amount, which is described in part II.E.1.c.v.(a) Taxable Income "Threshold.

An overview of Reg. § 1.199A-6, "Relevant passthrough entities (RPEs), publicly traded partnerships (PTPs), trusts, and estates," is provided in Reg. § 1.199A-6(a):

> This section provides special rules for RPEs, PTPs, trusts, and estates necessary for the computation of the Section 199A deduction of their owners or beneficiaries. Paragraph (b) of this section provides computational and reporting rules for RPEs necessary for individuals who own interests in RPEs to calculate their Section 199A deduction. Paragraph (c) of this section provides computational and reporting rules for PTPs necessary for individuals who own interests in PTPs to calculate their Section 199A deduction. Paragraph (d) of this section provides computational and reporting rules for trusts (other than grantor trusts) and estates necessary for their beneficiaries to calculate their Section 199A deduction.

See the introduction to part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income for general rules regarding RPEs. For trusts and estates, see part II.E.1.f Trusts/Estates and the Code § 199A Deduction.

[859] Code § 199A(b)(1). Fn 780 defines "qualified REIT dividend" and "qualified publicly traded partnership income." Reg. § 1.199A-1(d)(3)(i) provides:

> (i) *In general*. The qualified REIT dividend/qualified PTP income component is 20 percent of the combined amount of qualified REIT dividends and qualified PTP income received by the individual (including the individual's share of qualified REIT dividends and qualified PTP income from RPEs).
>
> (ii) *SSTB exclusion*. If the individual's taxable income is within the phase-in range, then only the applicable percentage of qualified PTP income generated by an SSTB is taken into account for purposes of determining the individual's section 199A deduction, including the determination of the combined amount of qualified REIT dividends and qualified PTP income described in paragraph (d)(1) of this section. If the individual's taxable income exceeds the phase-in range, then none of the individual's share of qualified PTP income generated by an SSTB may be taken into account for purposes of determining the individual's section 199A deduction.

Reg. § 1.199A-1(d)(3)(iii), "Negative combined qualified REIT dividends/qualified PTP income," is reproduced in part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

[860] See part II.E.1.c.iv Specified Service Trade or Business (SSTB).

[861] For the latter, see part II.E.1.c.v.(a) Taxable Income "Threshold.

II.E.1.c.v.(a). Taxable Income "Threshold Amount"

The wage limitation[862] and the disqualification of SSTBs[863] are eased up or do not apply if the taxpayer's taxable income, computed without regard to the Code § 199A deduction,[864] is below the "threshold amount." The "threshold amount" is $315,000 for a joint return and $157,500 for any other return.[865] The "threshold amount" will be indexed for inflation in a manner similar to indexing the income tax brackets.[866] For taxable years beginning in 2019, the threshold amount is $321,400 for married filing joint returns, $160,725 for married filing separate returns, and $160,700 for any other returns.[867] For taxable years beginning in 2020, the threshold amount is $326,600 for married filing joint returns, $163,300 for married filing separate returns, and $163,300 for all other returns.[868] For taxable years beginning in 2021, the threshold amount is $329,800 for married filing joint returns, $164,925 for married filing separate returns, and $164,900 for all other returns.[869] For taxable years beginning in 2022, the threshold amount is $340,100 for married filing joint returns, $170,050 for married filing separate returns, and $170,050 for all other returns.[870] For taxable years beginning in 2023, the threshold amount is $364,200 for married filing joint returns, $182,100 for married filing separate returns, and $182,100 for all other returns.[871] For taxable years beginning in 2024, the threshold amount is $383,900 for married filing joint returns, $191,950 for married filing separate returns, and $191,950 for all other returns.[872]

Reg. § 1.199A-1(b)(11) provides:

> *Threshold amount* means, for any taxable year beginning before 2019, $157,500 (or $315,000 in the case of a taxpayer filing a joint return). In the case of any taxable year beginning after 2018, the threshold amount is the dollar amount in the preceding sentence increased by an amount equal to such dollar amount, multiplied by the cost-of-living adjustment determined under section 1(f)(3) of the Code for the calendar year in which the taxable year begins, determined by substituting "calendar year 2017" for "calendar year 2016" in section 1(f)(3)(A)(ii). The amount of any increase under the preceding sentence is rounded as provided in section 1(f)(7) of the Code.

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862 See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
863 See text accompanying fns. 843-844 in part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.
864 Code § 199A(e)(1).
865 Code § 199A(e)(2)(A).
866 Code § 199A(e)(2)(B) provides:

> *Inflation Adjustment*. In the case of any taxable year beginning after 2018, the dollar amount in subparagraph (A) shall be increased by an amount equal to -
> (i) such dollar amount, multiplied by
> (ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting "calendar year 2017" for "calendar year 2016" in subparagraph (A)(ii) thereof.
> The amount of any increase under the preceding sentence shall be rounded as provided in section 1(f)(7).

867 Rev. Proc. 2018-57, § 3.27.
868 Rev. Proc. 2019-44, § 3.27.
869 Rev. Proc. 2020-45, § 3.27.
870 Rev. Proc. 2021-45, § 3.27.
871 Rev. Proc. 2022-38, § 3.27.
872 Rev. Proc. 2023-34, § 3.27.

The preamble to Prop. Reg. § 1.199A-2, REG-107892-18 (8/16/2018), explains:

B. Computation of the Section 199A Deduction for Individuals With Taxable Income Below the Threshold Amount

1. Basic Computational Rules

An individual with income attributable to one or more domestic trades or businesses, other than as a result of owning stock of a C corporation or engaging in the trade or business of being an employee, and with taxable income (before computing the Section 199A deduction) at or below the threshold amount, is entitled to a Section 199A deduction equal to the lesser of (i) 20 percent of the QBI (generally defined as the net amount of qualified items of income, gain, deduction, and loss with respect to a qualified trade or business of the taxpayer) from the individual's trades or businesses plus 20 percent of the individual's combined qualified REIT dividends and qualified PTP income or (ii) 20 percent of the excess (if any) of the individual's taxable income over the individual's net capital gain. Proposed § 1.199A-1(c) contains guidance on calculating the amount of the deduction in these circumstances. If an individual's combined QBI is negative or combined qualified REIT dividends and PTP income is less than zero, proposed § 1.199A-1(c)(2) provides rules for the carryover of the losses.

2. Carryover Loss Rules for Negative Total QBI Amounts

If an individual has multiple trades or businesses, the individual must calculate the QBI from each trade or business and then net the amounts. Section 199A(c)(2) provides that, for purposes of Section 199A, if the net QBI with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, such amount shall be treated as a loss from a qualified trade or business in the succeeding taxable year. Proposed § 1.199A-1(c)(2)(i) repeats this rule and provides that the Section 199A carryover rules do not affect the deductibility of the losses for purposes of other provisions of the Code.

3. Carryover Loss Rules if Combined Qualified REIT Dividends and Qualified PTP Income is Less Than Zero

One commenter stated it was not clear whether, if a taxpayer has an overall loss from combined qualified REIT dividends and qualified PTP income (because a loss from a PTP exceeds REIT dividends and PTP income), the negative amount should be netted against any net positive QBI (regardless of source), or whether the negative amount should be segregated and subject to its own loss carryforward rule distinct from but analogous to the QBI loss carryforward rule. Section 199A contemplates that qualified REIT dividends and qualified PTP income are computed and taken into account separately from QBI and should not affect QBI. If overall losses attributable to qualified REIT dividends and qualified PTP income were netted against QBI, these losses would affect QBI. Therefore, a separate loss carryforward rule is needed to segregate an overall loss attributable to qualified REIT dividends and qualified PTP income from QBI. Additionally, commenters have expressed concern that losses in excess of income could create a negative Section 199A deduction, a result incompatible with the statute. Accordingly, proposed § 1.199A-1(c)(2)(ii) provides that if an individual has an overall loss after qualified REIT dividends and qualified PTP income are combined, the portion of the individual's Section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. In addition, the overall loss does not affect the amount of the taxpayer's QBI. Instead, such overall loss is carried forward and must be used to offset combined qualified REIT dividends and qualified PTP income in the succeeding taxable year or years for purposes of Section 199A.

Reg. § 1.199A-1(c), "Computation of the § 199A deduction for individuals with taxable income not exceeding threshold amount," provides:

(1) *In general*. The Section 199A deduction is determined for individuals with taxable income for the taxable year that does not exceed the threshold amount by adding 20 percent of the total QBI amount (including the individual's share of QBI from an RPE and QBI attributable to an SSTB) and 20 percent of the combined amount of qualified REIT dividends and qualified PTP income (including the individual's share of qualified REIT dividends and qualified PTP income from RPEs and qualified PTP income attributable to an SSTB). That sum is then compared to 20 percent of the amount by which the individual's taxable income exceeds net capital gain. The lesser of these two amounts is the individual's Section 199A deduction.

(2) *Carryover rules*.

(i) *Negative total QBI amount*. If the total QBI amount is less than zero, the portion of the individual's Section 199A deduction related to QBI is zero for the taxable year. The negative total QBI amount is treated as negative QBI from a separate trade or business in the succeeding taxable years of the individual for purposes of Section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

(ii) *Negative combined qualified REIT dividends/qualified PTP income*. If the combined amount of REIT dividends and qualified PTP income is less than zero, the portion of the individual's Section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. The negative combined amount must be carried forward and used to offset the combined amount of REIT dividends and qualified PTP income in the succeeding taxable years of the individual for purposes of Section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

Reg. § 1.199A-1(c)(3), "Examples," provides:

The following examples illustrate the provisions of this paragraph (c). For purposes of these examples, unless indicated otherwise, assume that all of the trades or businesses are trades or businesses as defined in paragraph (b)(14) of this section and all of the tax items are effectively connected to a trade or business within the United States within the meaning of section 864(c). Total taxable income does not include the Section 199A deduction.

Reg. § 1.199A-1(c)(3)(i), Example (1), provides:

A, an unmarried individual, owns and operates a computer repair shop as a sole proprietorship. The business generates $100,000 in net taxable income from operations in 2018. A has no capital gains or losses. After allowable deductions not relating to the business, A's total taxable income for 2018 is $81,000. The business's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. A's Section 199A deduction for 2018 is equal to $16,200, the lesser of 20% of A's QBI from the business ($100,000*20% = $20,000) and 20% of A's total taxable income for the taxable year ($81,000*20% = $16,200).

Reg. § 1.199A-1(c)(3)(ii), Example (2), provides:

> Assume the same facts as in *Example 1* of paragraph (c)(3)(i) of this section, except that A also has $7,000 in net capital gain for 2018 and that, after allowable deductions not relating to the business, A's taxable income for 2018 is $74,000. A's taxable income minus net capital gain is $67,000 ($74,000¥$7,000). A's Section 199A deduction is equal to $13,400, the lesser of 20% of A's QBI from the business ($100,000*20% = $20,000) and 20% of A's total taxable income minus net capital gain for the taxable year ($67,000*20% = $13,400).

Reg. § 1.199A-1(c)(3)(iii), Example (3), provides:

> B and C are married and file a joint individual income tax return. B earns $50,000 in wages as an employee of an unrelated company in 2018. C owns 100% of the shares of X, an S corporation that provides landscaping services. X generates $100,000 in net income from operations in 2018. X pays C $150,000 in wages in 2018. B and C have no capital gains or losses. After allowable deductions not related to X, B and C's total taxable income for 2018 is $270,000. B's and C's wages are not considered to be income from a trade or business for purposes of the Section 199A deduction. Because X is an S corporation, its QBI is determined at the S corporation level. X's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. The wages paid by X to C are considered to be a qualified item of deduction for purposes of determining X's QBI. The Section 199A deduction with respect to X's QBI is then determined by C, X's sole shareholder, and is claimed on the joint return filed by B and C. B and C's Section 199A deduction is equal to $20,000, the lesser of 20% of C's QBI from the business ($100,000*20% = $20,000) and 20% of B and C's total taxable income for the taxable year ($270,000*20% = $54,000).

Reg. § 1.199A-1(c)(3)(iv), Example (4), provides:

> Assume the same facts as in *Example 3* of paragraph (c)(3)(iii) of this section except that B also earns $1,000 in qualified REIT dividends and $500 in qualified PTP income in 2018, increasing taxable income to $271,500. B and C's Section 199A deduction is equal to $20,300, the lesser of:
>
> (A) 20% of C's QBI from the business ($100,000*20% = $20,000) plus 20% of B's combined qualified REIT dividends and qualified PTP income ($1,500*20% = $300); and
>
> (B) 20% of B and C's total taxable for the taxable year ($271,500*20% = $54,300).

II.E.1.c.v.(b). Calculation When Taxable Income Does Not Exceed the Threshold Amount

Reg. § 1.199A-1(c)(1) combines the above, as well as the benefits of taxable income not exceeding the threshold amount:[873]

> *In general*. The Section 199A deduction is determined for individuals with taxable income for the taxable year that does not exceed the threshold amount by adding 20 percent of the total QBI amount (including the individual's share of QBI from an RPE and QBI attributable to an SSTB) and 20 percent of the combined amount of qualified REIT dividends and qualified PTP income (including the individual's share of qualified REIT dividends and qualified PTP income from RPEs and qualified PTP income attributable to an SSTB). That sum is then compared to 20 percent of the amount by which the individual's taxable income exceeds net capital gain. The lesser of these two amounts is the individual's Section 199A deduction.

Reg. § 1.199A-1(b)(13) provides:

> *Total QBI amount* means the net total QBI from all trades or businesses (including the individual's share of QBI from trades or business conducted by RPEs).

Reg. § 1.199A-1(c)(3), "Examples," provides:

> The following examples illustrate the provisions of this paragraph (c). For purposes of these examples, unless indicated otherwise, assume that all of the trades or businesses are trades or businesses as defined in paragraph (b)(14) of this section and all of the tax items are effectively connected to a trade or business within the United States within the meaning of section 864(c). Total taxable income does not include the Section 199A deduction.

Reg. § 1.199A-1(c)(3)(i), Example (1) provides:

> A, an unmarried individual, owns and operates a computer repair shop as a sole proprietorship. The business generates $100,000 in net taxable income from operations in 2018. A has no capital gains or losses. After allowable deductions not relating to the business, A's total taxable income for 2018 is $81,000. The business's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. A's Section 199A deduction for 2018 is equal to $16,200, the lesser of 20% of A's QBI from the business ($100,000*20% = $20,000) and 20% of A's total taxable income for the taxable year ($81,000*20% = $16,200).

Reg. § 1.199A-1(c)(3)(ii), Example (2) provides:

> Assume the same facts as in *Example 1* of paragraph (c)(3)(i) of this section, except that A also has $7,000 in net capital gain for 2018 and that, after allowable deductions not relating to the business, A's taxable income for 2018 is $74,000. A's taxable income minus net capital gain is $67,000 ($74,000-$7,000). A's Section 199A deduction is equal to $13,400, the lesser of 20% of A's QBI from the business ($100,000*20% =

[873] For the latter, see part II.E.1.c.v.(a) Taxable Income "Threshold.

> \$20,000) and 20% of A's total taxable income minus net capital gain for the taxable year (\$67,000*20% = \$13,400).

The difference between the facts in the two examples is that A's total taxable income minus net capital gain in Example (2) was only \$67,000, which is \$14,000 less than \$81,000 in Example (1). Because in each example the total QBI amount exceeded total taxable income minus net capital gain, the change in total taxable income minus net capital gain is the sole difference accounting for the difference in the deduction. Multiplying this \$14,000 difference by 20% equals \$2,800, which equals the difference between the \$16,200 deduction in Example (1) and the \$13,400 deduction in Example (2).

Reg. § 1.199A-1(c)(3)(iii), Example (3) provides:

> B and C are married and file a joint individual income tax return. B earns \$50,000 in wages as an employee of an unrelated company in 2018. C owns 100% of the shares of X, an S corporation that provides landscaping services. X generates \$100,000 in net income from operations in 2018. X pays C \$150,000 in wages in 2018. B and C have no capital gains or losses. After allowable deductions not related to X, B and C's total taxable income for 2018 is \$270,000. B's and C's wages are not considered to be income from a trade or business for purposes of the Section 199A deduction. Because X is an S corporation, its QBI is determined at the S corporation level. X's QBI is \$100,000, the net amount of its qualified items of income, gain, deduction, and loss. The wages paid by X to C are considered to be a qualified item of deduction for purposes of determining X's QBI. The Section 199A deduction with respect to X's QBI is then determined by C, X's sole shareholder, and is claimed on the joint return filed by B and C. B and C's Section 199A deduction is equal to \$20,000, the lesser of 20% of C's QBI from the business (\$100,000*20% = \$20,000) and 20% of B and C's total taxable income for the taxable year (\$270,000*20% = \$54,000).

Example (3) points out that, even though B and C have income that is significantly higher than the \$315,000 (subject to future indexing) threshold amount, their \$270,000 taxable income is below that. For B's and C's wages not being QBI, see part II.E.1.c.ii.(b) Trade or Business of Being an Employee.

Reg. § 1.199A-1(c)(3)(iv), Example (4) provides:

> Assume the same facts as in *Example 3* of paragraph (c)(3)(iii) of this section except that B also earns \$1,000 in qualified REIT dividends and \$500 in qualified PTP income in 2018, increasing taxable income to \$271,500. B and C's Section 199A deduction is equal to \$20,300, the lesser of:
>
> (A) 20% of C's QBI from the business (\$100,000*20% = \$20,000) plus 20% of B's combined qualified REIT dividends and qualified PTP income (\$1,500*20% = \$300); and
>
> (B) 20% of B and C's total taxable for the taxable year (\$271,500*20% = \$54,300).

II.E.1.c.v.(c). Calculation When Taxable Income Exceeds the Threshold Amount

Parts II.E.1.c.iv Specified Service Trade or Business (SSTB) and II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds apply when not fully protected by part II.E.1.c.v.(a) Taxable Income "Threshold Amount".

If the wage limitation reduces the QBI-related amount (20% of QBI income)[874] with respect to any qualified trade or business, and the taxpayer's taxable income does not exceed the threshold amount by $100,000 for a joint return or $50,000 for other returns, then the reduction is pro-rated.[875] The reduction is multiplied by the excess over the threshold divided by $100,000 or $50,000, as applicable.[876] Thus, the phase-out of the benefit of modest taxable income occurs initially from $315,000-$415,000 for married filing jointly and $157,500-$207,500 for all others (all subject to future indexing).

If an SSTB is excluded from being QBI, the taxpayer having taxable income below the threshold removes the exclusion, so that the trade or business qualifies for the deduction.[877] If the taxpayer's taxable exceeds the threshold, the deduction is phased out using a $100,000 or $50,000 calculation similar to that described above:[878]

> only the applicable percentage of qualified items of income, gain, deduction, or loss, and the W-2 wages and the unadjusted basis immediately after acquisition of qualified property, of the taxpayer allocable to such specified service trade or business shall be taken into account in computing the qualified business income, W-2 wages, and the

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[874] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

[875] Code § 199A(b)(3)(B)(i), "Phase-in of limit for certain taxpayers," provides:

> *In general*. If-
> (I) the taxable income of a taxpayer for any taxable year exceeds the threshold amount, but does not exceed the sum of the threshold amount plus $50,000 ($100,000 in the case of a joint return), and
> (II) the amount determined under paragraph (2)(B) (determined without regard to this subparagraph) with respect to any qualified trade or business carried on by the taxpayer is less than the amount determined under paragraph (2)(A) with respect such trade or business,
>
> then paragraph (2) shall be applied with respect to such trade or business without regard to subparagraph (B) thereof and by reducing the amount determined under subparagraph (A) thereof by the amount determined under clause (ii).

[876] Code § 199A(b)(3)(B)(ii) and (iii) provide:

> (ii) *Amount of reduction*. The amount determined under this subparagraph is the amount which bears the same ratio to the excess amount as-
> (I) the amount by which the taxpayer's taxable income for the taxable year exceeds the threshold amount, bears to
> (II) $50,000 ($100,000 in the case of a joint return).
>
> (iii) *Excess amount*. For purposes of clause (ii), the excess amount is the excess of-
> (I) the amount determined under paragraph (2)(A) (determined without regard to this paragraph), over
> (II) the amount determined under paragraph (2)(B) (determined without regard to this paragraph).

[877] Code § 199(d)(3)(A)(i) provides, "any specified service trade or business of the taxpayer shall not fail to be treated as a qualified trade or business due to paragraph (1)(A)," so one needs to go to Code § 199(d)(1)(A).

[878] Code § 199A(d)(3)(A)(ii).

unadjusted basis immediately after acquisition of qualified property of the taxpayer for the taxable year for purposes of applying this section.

The "applicable percentage" is 100% minus the ratio of the excess taxable income to the $100,000 or $50,000 threshold.[879]

Applying these concepts, Reg. § 1.199A-1(b) includes the following definitions:

(2) *Applicable percentage* means, with respect to any taxable year, 100 percent reduced (not below zero) by the percentage equal to the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return).

(4) *Phase-in range* means a range of taxable income between the threshold amount and the threshold amount plus $50,000 (or $100,000 in the case of a joint return).

(9) *Reduction amount* means, with respect to any taxable year, the excess amount multiplied by the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return). For purposes of this paragraph (b)(9), the *excess amount* is the amount by which 20 percent of QBI exceeds the greater of 50 percent of W-2 wages or the sum of 25 percent of W-2 wages plus 2.5 percent of the UBIA of qualified property.

Reg. § 1.199A-1(d)(1) explains:

In general. The Section 199A deduction is determined for individuals with taxable income for the taxable year that exceeds the threshold amount by adding the QBI component described in paragraph (d)(2) of this section and the qualified REIT dividends/qualified PTP income component described in paragraph (d)(3) of this section (including the individual's share of qualified REIT dividends and qualified PTP income from RPEs). That sum is then compared to 20 percent of the amount by which the individual's taxable income exceeds net capital gain. The lesser of these two amounts is the individual's Section 199A deduction.

Note the reference to "the QBI component" for individuals with taxable income above the threshold amount, contrasted with Reg. § 1.199A-1(c)(1) referring to "20 percent of the total QBI amount" for individuals with taxable income below the threshold amount. Reg. § 1.199A-1(d)(2), "QBI component," provides:

An individual with taxable income for the taxable year that exceeds the threshold amount determines the QBI component using the following computational rules, which are to be applied in the order they appear.

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[879] Code § 199A(d)(3)(B) provides:

Applicable percentage. For purposes of subparagraph (A), the term "applicable percentage" means, with respect to any taxable year, 100 percent reduced (not below zero) by the percentage equal to the ratio of-

(i) the taxable income of the taxpayer for the taxable year in excess of the threshold amount, bears to

(ii) $50,000 ($100,000 in the case of a joint return).

(i) *SSTB exclusion*. If the individual's taxable income is within the phase-in range, then only the applicable percentage of QBI, W-2 wages, and UBIA of qualified property for each SSTB is taken into account for all purposes of determining the individual's Section 199A deduction, including the application of the netting and carryover rules described in paragraph (d)(2)(iii) of this section. If the individual's taxable income exceeds the phase-in range, then none of the individual's share of QBI, W-2 wages, or UBIA of qualified property attributable to an SSTB may be taken into account for purposes of determining the individual's Section 199A deduction.

(ii) *Aggregated trade or business*. If an individual chooses to aggregate trades or businesses under the rules of § 1.199A-4, the individual must combine the QBI, W-2 wages, and UBIA of qualified property of each trade or business within an aggregated trade or business prior to applying the netting and carryover rules described in paragraph (d)(2)(iii) of this section and the W-2 wage and UBIA of qualified property limitations described in paragraph (d)(2)(iv) of this section.

Reg. § 1.199A-1(d)(2)(iv), "QBI component calculation," provides:

(A) *General rule*. Except as provided in paragraph (d)(2)(iv)(B) of this section, the QBI component is the sum of the amounts determined under this paragraph (d)(2)(iv)(A) for each trade or business (or aggregated trade or business). For each trade or business (or aggregated trade or business) (including trades or businesses operated through RPEs) the individual must determine the lesser of -

(1) 20 percent of the QBI for that trade or business (or aggregated trade or business); or

(2) The greater of—

(i) 50 percent of W-2 wages with respect to that trade or business (or aggregated trade or business), or

(ii) the sum of 25 percent of W-2 wages with respect to that trade or business (or aggregated trade or business) plus 2.5 percent of the UBIA of qualified property with respect to that trade or business (or aggregated trade or business).

(B) *Taxpayers with taxable income within phase-in range*. If the individual's taxable income is within the phase-in range and the amount determined under paragraph (d)(2)(iv)(A)(2) of this section for a trade or business (or aggregated trade or business) is less than the amount determined under paragraph (d)(2)(iv)(A)(1) of this section for that trade or business (or aggregated trade or business), the amount determined under paragraph (d)(2)(iv)(A) of this section for such trade or business (or aggregated trade or business) is modified. Instead of the amount determined under paragraph (d)(2)(iv)(A)(2) of this section, the QBI component for the trade or business (or aggregated trade or business) is the amount determined under paragraph (d)(2)(iv)(A)(1) of this section reduced by the reduction amount as defined in paragraph (b)(9) of this section. This reduction amount does not apply if the amount determined in paragraph (d)(2)(iv)(A)(2) of this section is greater than the amount determined under paragraph (d)(2)(iv)(A)(1) of this section (in which circumstance the QBI component for the trade or business (or aggregated trade or business) will be the unreduced amount determined in paragraph (d)(2)(iv)(A)(1) of this section).

Reg. § 1.199A-1(d)(3)(iii), "Negative combined qualified REIT dividends/qualified PTP income," is discussed in part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

Reg. § 1.199A-1(d)(4), "Examples," provides:

> The following examples illustrate the provisions of this paragraph (d). For purposes of these examples, unless indicated otherwise, assume that all of the trades or businesses are trades or businesses as defined in paragraph (b)(14) of this section, none of the trades or businesses are SSTBs as defined in paragraph (b)(11) of this section and § 1.199A-5(b); and all of the tax items associated with the trades or businesses are effectively connected to a trade or business within the United States within the meaning of section 864(c). Also assume that the taxpayers report no capital gains or losses or other tax items not specified in the examples. Total taxable income does not include the Section 199A deduction.

Reg. § 1.199A-1(d)(4)(i) provides Example (1):

> D, an unmarried individual, operates a business as a sole proprietorship. The business generates $1,000,000 of QBI in 2018. Solely for purposes of this example, assume that the business paid no wages and holds no qualified property for use in the business. After allowable deductions unrelated to the business, D's total taxable income for 2018 is $980,000. Because D's taxable income exceeds the applicable threshold amount, D's Section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. D's Section 199A deduction is limited to zero because the business paid no wages and held no qualified property.

This example illustrates part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

Reg. § 1.199A-1(d)(4)(ii) provides Example (2):

> Assume the same facts as in *Example 1* of paragraph (d)(4)(i) of this section, except that D holds qualified property with a UBIA of $10,000,000 for use in the trade or business. D reports $4,000,000 of QBI for 2020. After allowable deductions unrelated to the business, D's total taxable income for 2020 is $3,980,000. Because D's taxable income is above the threshold amount, the QBI component of D's Section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. Because the business has no W-2 wages, the QBI component of D's Section 199A deduction is limited to the lesser of 20% of the business's QBI or 2.5% of its UBIA of qualified property. Twenty percent of the $4,000,000 of QBI is $800,000. Two and one-half percent of the $10,000,000 UBIA of qualified property is $250,000. The QBI component of D's Section 199A deduction is thus limited to $250,000. D's Section 199A deduction is equal to the lesser of:
>
> (A) 20% of the QBI from the business as limited ($250,000); or

(B) 20% of D's taxable income ($3,980,000*20% = $796,000). Therefore, D's Section 199A deduction for 2020 is $250,000.

See part II.E.1.c.vi.(b) Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A.

Reg. § 1.199A-1(d)(4)(iii) provides Example (3):

> E, an unmarried individual, is a 30% owner of LLC, which is classified as a partnership for Federal income tax purposes. In 2018, the LLC has a single trade or business and reports QBI of $3,000,000. The LLC pays total W-2 wages of $1,000,000, and its total UBIA of qualified property is $100,000. E is allocated 30% of all items of the partnership. For the 2018 taxable year, E reports $900,000 of QBI from the LLC. After allowable deductions unrelated to LLC, E's taxable income is $880,000. Because E's taxable income is above the threshold amount, the QBI component of E's Section 199A deduction will be limited to the lesser of 20% of E's share of LLC's QBI or the greater of the W- 2 wage or UBIA of qualified property limitations. Twenty percent of E's share of QBI of $900,000 is $180,000. The W-2 wage limitation equals 50% of E's share of the LLC's wages ($300,000) or $150,000. The UBIA of qualified property limitation equals $75,750, the sum of 25% of E's share of LLC's wages ($300,000) or $75,000 plus 2.5% of E's share of UBIA of qualified property ($30,000) or $750. The greater of the limitation amounts ($150,000 and $75,750) is $150,000. The QBI component of E's Section 199A deduction is thus limited to $150,000, the lesser of 20% of QBI ($180,000) and the greater of the limitations amounts ($150,000). E's Section 199A deduction is equal to the lesser of 20% of the QBI from the business as limited ($150,000) or 20% of E's taxable income ($880,000*20% = $176,000). Therefore, E's Section 199A deduction is $150,000 for 2018.

Reg. § 1.199A-1(d)(4)(iv) provides Example (4):

> F, an unmarried individual, owns a 50% interest in Z, an S corporation for Federal income tax purposes that conducts a single trade or business. In 2018, Z reports QBI of $6,000,000. Z pays total W-2 wages of $2,000,000, and its total UBIA of qualified property is $200,000. For the 2018 taxable year, F reports $3,000,000 of QBI from Z. F is not an employee of Z and receives no wages or reasonable compensation from Z. After allowable deductions unrelated to Z and a deductible qualified net loss from a PTP of ($10,000), F's taxable income is $1,880,000. Because F's taxable income is above the threshold amount, the QBI component of F's Section 199A deduction will be limited to the lesser of 20% of F's share of Z's QBI or the greater of the W-2 wage and UBIA of qualified property limitations. Twenty percent of F's share of Z's QBI ($3,000,000) is $600,000. The W-2 wage limitation equals 50% of F's share of Z's W-2 wages ($1,000,000) or $500,000. The UBIA of qualified property limitation equals $252,500, the sum of 25% of F's share of Z's W-2 wages ($1,000,000) or $250,000 plus 2.5% of E's share of UBIA of qualified property ($100,000) or $2,500. The greater of the limitation amounts ($500,000 and $252,500) is $500,000. The QBI component of F's Section 199A deduction is thus limited to $500,000, the lesser of 20% of QBI ($600,000) and the greater of the limitations amounts ($500,000). F reports a qualified loss from a PTP and has no qualified REIT dividend. F does not net the ($10,000) loss from the PTP against QBI. Instead, the portion of F's Section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for 2018. F's section is 199A deduction is equal to the lesser of 20% of the QBI from the business as limited

($500,000) or 20% of F's taxable income over net capital gain ($1,880,000 x 20% = $376,000). Therefore, F's Section 199A deduction is $376,000 for 2018. F must also carry forward the ($10,000) qualified loss from a PTP to be netted against F's qualified REIT dividends and qualified PTP income in the succeeding taxable year.

Reg. § 1.199A-1(d)(4)(v) provides Example (5), "Phase-in range":

(A) B and C are married and file a joint individual income tax return. B is a shareholder in M, an entity taxed as an S corporation for Federal income tax purposes that conducts a single trade or business. M holds no qualified property. B's share of the M's QBI is $300,000 in 2018. B's share of the W-2 wages from M in 2018 is $40,000. C earns wage income from employment by an unrelated company. After allowable deductions unrelated to M, B and C's taxable income for 2018 is $375,000. B and C are within the phase-in range because their taxable income exceeds the applicable threshold amount, $315,000, but does not exceed the threshold amount plus $100,000, or $415,000. Consequently, the QBI component of B and C's Section 199A deduction may be limited by the W-2 wage and UBIA of qualified property limitations but the limitations will be phased in.

(B) Because M does not hold qualified property, only the W-2 wage limitation must be calculated. In order to apply the W-2 wage limitation, B and C must first determine 20% of B's share of M's QBI. Twenty percent of B's share of M's QBI of $300,000 is $60,000. Next, B and C must determine 50% of B's share of M's W-2 wages. Fifty percent of B's share of M's W-2 wages of $40,000 is $20,000. Because 50% of B's share of M's W- 2 wages ($20,000) is less than 20% of B's share of M's QBI ($60,000), B and C must determine the QBI component of their Section 199A deduction by reducing 20% of B's share of M's QBI by the reduction amount.

(C) B and C are 60% through the phase-in range (that is, their taxable income exceeds the threshold amount by $60,000 and their phase-in range is $100,000). B and C must determine the excess amount, which is the excess of 20% of B's share of M's QBI, or $60,000, over 50% of B's share of M's W-2 wages, or $20,000. Thus, the excess amount is $40,000. The reduction amount is equal to 60% of the excess amount, or $24,000. Thus, the QBI component of B and C's Section 199A deduction is equal to $36,000, 20% of B's $300,000 share M's QBI (that is, $60,000), reduced by $24,000. B and C's Section 199A deduction is equal to the lesser of 20% of the QBI from the business as limited ($36,000) or 20% of B and C's taxable income ($375,000*20% = $75,000). Therefore, B and C's Section 199A deduction is $36,000 for 2018.

Reg. § 1.199A-1(d)(4)(vi) uses Example (6) to explain how the phase-in works when the business is an SSTB and has insufficient wages (or wages and UBIA):

(A) Assume the same facts as in *Example 5* of paragraph (d)(4)(v) of this section, except that M is engaged in an SSTB. Because B and C are within the phase-in range, B must reduce the QBI and W-2 wages allocable to B from M to the applicable percentage of those items. B and C's applicable percentage is 100% reduced by the percentage equal to the ratio that their taxable income for the taxable year ($375,000) exceeds their threshold amount ($315,000), or $60,000, bears to $100,000. Their applicable percentage is 40%. The applicable percentage of B's QBI is ($300,000*40% =) $120,000, and the applicable percentage of B's share of

W-2 wages is ($40,000*40% =) $16,000. These reduced numbers must then be used to determine how B's Section 199A deduction is limited.

(B) B and C must apply the W-2 wage limitation by first determining 20% of B's share of M's QBI as limited by paragraph (d)(4)(vi)(A) of this section. Twenty percent of B's share of M's QBI of $120,000 is $24,000. Next, B and C must determine 50% of B's share of M's W-2 wages. Fifty percent of B's share of M's W-2 wages of $16,000 is $8,000. Because 50% of B's share of M's W-2 wages ($8,000) is less than 20% of B's share of M's QBI ($24,000), B and C's must determine the QBI component of their Section 199A deduction by reducing 20% of B's share of M's QBI by the reduction amount.

(C) B and C are 60% through the phase-in range (that is, their taxable income exceeds the threshold amount by $60,000 and their phase-in range is $100,000). B and C must determine the excess amount, which is the excess of 20% of B's share of M's QBI, as adjusted in paragraph (d)(4)(vi)(A) of this section or $24,000, over 50% of B's share of M's W-2 wages, as adjusted in paragraph (d)(4)(vi)(A) of this section, or $8,000. Thus, the excess amount is $16,000. The reduction amount is equal to 60% of the excess amount or $9,600. Thus, the QBI component of B and C's Section 199A deduction is equal to $14,400, 20% of B's share M's QBI of $24,000, reduced by $9,600. B and C's Section 199A deduction is equal to the lesser of 20% of the QBI from the business as limited ($14,400) or 20% of B's and C's taxable income ($375,000*20% = $75,000). Therefore, B and C's Section 199A deduction is $14,400 for 2018.

The $14,400 deduction in Example (6) is 40% of the $36,000 deduction in Example (5). Being 60% through the phase-in range leaves 40% of the benefit of the threshold remaining when applying the SSTB limitation.

Reg. § 1.199A-1(d)(4)(vii) provides Example (7):

(A) F, an unmarried individual, owns as a sole proprietor 100 percent of three trades or businesses, Business X, Business Y, and Business Z. None of the businesses hold qualified property. F does not aggregate the trades or businesses under § 1.199A-4. For taxable year 2018, Business X generates $1 million of QBI and pays $500,000 of W-2 wages with respect to the business. Business Y also generates $1 million of QBI but pays no wages. Business Z generates $2,000 of QBI and pays $500,000 of W-2 wages with respect to the business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F's taxable income is $2,722,000.

(B) Because F's taxable income is above the threshold amount, the QBI component of F's Section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W-2 wage limitation must be calculated. Because QBI from each business is positive, F applies the limitation by determining the lesser of 20% of QBI and 50% of W-2 wages for each business. For Business X, the lesser of 20% of QBI ($1,000,000*20 percent = $200,000) and 50% of Business X's W-2 wages ($500,000*50% = $250,000) is $200,000. Business Y pays no W-2 wages. The lesser of 20% of Business Y's QBI ($1,000,000*20% = $200,000) and 50% of its W-2 wages (zero) is zero. For

Business Z, the lesser of 20% of QBI ($2,000*20% = $400) and 50% of W-2 wages ($500,000*50% = $250,000) is $400.

(C) Next, F must then combine the amounts determined in paragraph (d)(4)(vii)(B) of this section and compare that sum to 20% of F's taxable income. The lesser of these two amounts equals F's Section 199A deduction. The total of the combined amounts in paragraph (d)(4)(vii)(B) of this section is $200,400 ($200,000 + zero + 400). Twenty percent of F's taxable income is $544,400 ($2,722,000*20%). Thus, F's Section 199A deduction for 2018 is $200,400.

Note that $100,000 of Business X's wages were wasted, in that Business X needed only $400,000 of wages to support a $200,000 deduction. Similarly, all but $800 ($400 deduction divided by 50%) of Business Z's $500,000 of wages were wasted. Thus, $599,200 of wages are wasted ($100,000 + $500,000 minus $800).

Reg. § 1.199A-1(d)(4), Example (8) provides:

(A) Assume the same facts as in *Example 7* of paragraph (d)(4)(vii) of this section, except that F aggregates Business X, Business Y, and Business Z under the rules of § 1.199A-4.

(B) Because F's taxable income is above the threshold amount, the QBI component of F's Section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. Because the businesses are aggregated, these limitations are applied on an aggregated basis. None of the businesses holds qualified property, therefore only the W-2 wage limitation must be calculated. F applies the limitation by determining the lesser of 20% of the QBI from the aggregated businesses, which is $400,400 ($2,002,000*20%) and 50% of W-2 wages from the aggregated businesses, which is $500,000 ($1,000,000 x 50%). F's Section 199A deduction is equal to the lesser of $400,400 and 20% of F's taxable income ($2,722,000*20% = $544,400). Thus, F's Section 199A deduction for 2018 is $400,400.

Example (8) shows the benefit of irrevocably electing to aggregate, as described in part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A – a $400,400 deduction in Example (8) instead of the $200,400 deduction in Example (7). Although Example (8) has more wages than necessary to support the $400,400 deduction, aggregation enabled F to use most of wages that were wasted in Example (7).

Reg. § 1.199A-1(d)(4), Examples (9) through (12) are reproduced in part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

II.E.1.c.v.(d). Rules for Cooperatives and Their Patrons

SUPPLEMENTARY INFORMATION in T.D. 9947 (1/19/2021) begins with:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under sections 199A, 1382, and 1388 of the Code.

Section 199A was enacted on December 22, 2017, by section 11011 of Public Law 115-97, 131 Stat. 2054, 2063, commonly referred to as the Tax Cuts and Jobs Act (TCJA). Parts of Section 199A were amended on March 23, 2018, effective as if included in the TCJA, by section 101 of Division T of the Consolidated Appropriations Act, 2018, Public Law 115-141, 132 Stat. 348, 1151 (2018 Act). Section 199A applies to taxable years beginning after 2017 and before 2026. Unless otherwise indicated, all references to Section 199A are to Section 199A as amended by the 2018 Act.

In addition, section 13305 of the TCJA repealed section 199 (former section 199), which provided a deduction for income attributable to domestic production activities (section 199 deduction). Public Law 115-97, 131 Stat. 2054, 2126. The repeal of former section 199 is effective for all taxable years beginning after 2017.

Section 199A(a) provides taxpayers a deduction of up to 20 percent of QBI from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate, and up to 20 percent of qualified real estate investment trust (REIT) dividends and publicly traded partnership (PTP) income (Section 199A(a) deduction). Section 199A(b)(7) requires patrons of Specified Cooperatives to reduce their Section 199A(a) deduction if those patrons receive certain payments from Specified Cooperatives.

Section 199A(g) provides a deduction for Specified Cooperatives and their patrons (Section 199A(g) deduction) that is based on the former section 199 deduction. Section 199A(g)(4)(A) defines a Specified Cooperative, in part, as an organization to which part I of subchapter T of chapter 1 of the Code (subchapter T) applies. Under section 1381(a)(2), subchapter T applies to any corporation operating on a cooperative basis, with certain exceptions not relevant here. Section 1382 provides rules regarding the taxable income of Cooperatives and section 1388 provides definitions applicable for purposes of subchapter T.

The Department of the Treasury (Treasury Department) and the IRS published proposed regulations (REG-107892-18) providing guidance on the Section 199A(a) deduction in the Federal Register (83 FR 40884) on August 16, 2018. A second notice of proposed rulemaking providing guidance (REG-134652-18) and final regulations implementing the Section 199A(a) deduction (TD 9847) were published in the Federal Register (84 FR 3015 and 84 FR 2952, respectively) on February 8, 2019, with corrections to TD 9847 published in the Federal Register (84 FR 15954) on April 17, 2019. TD 9847, which promulgated §§ 1.199A-1 through 1.199A-6 to implement the Section 199A(a) deduction, does not include all the rules needed for patrons of Cooperatives to calculate their particular Section 199A(a) deductions. Specifically, the rules included in TD 9847 do not address patrons' treatment of payments received from Cooperatives for purposes of Section 199A(a) or the Section 199A(g) deduction for Specified Cooperatives, though § 1.199A-1(e)(7) restates the reduction to a patron's Section 199A(a) deduction required under Section 199A(b)(7).

To address these matters, on June 19, 2019, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-118425-18) in the Federal Register (84 FR 28668) containing proposed regulations under sections 199A and 1388, with corrections published in the Federal Register (84 FR 38148) on August 6, 2019 (together, Proposed Regulations). The Proposed Regulations set forth rules to address patrons' treatment of payments received from Cooperatives for purposes of

Section 199A(a) and the Section 199A(g) deduction for Specified Cooperatives in proposed §§ 1.199A-7 through 1.199A-12, as well as proposed rules under section 1388 regarding patronage and nonpatronage sources of income of Cooperatives. The Proposed Regulations also withdrew all proposed regulations issued under former section 199 that had not been finalized and proposed to remove the final and temporary regulations under former section 199.

The Summary of Comments and Explanation of Revisions of the final regulations summarizes the provisions of the Proposed Regulations, which are explained in greater detail in the preamble to the Proposed Regulations. After full consideration of the comments received on the Proposed Regulations, this Treasury decision adopts the Proposed Regulations with modifications in response to such comments as described in the Summary of Comments and Explanation of Revisions.

Summary of Comments and Explanation of Revisions

The purpose and scope of the final regulations is limited to providing guidance regarding the application of sections 199A(a), 199A(b)(7), 199A(g), 1382, and 1388. Section 199A(a) is generally applicable to patrons of all Cooperatives, whereas sections 199A(b)(7) and 199A(g) apply only to Specified Cooperatives and their patrons. Section 1388 generally applies to all Cooperatives and their patrons….

"3. Economic Analysis of Specific Provisions" in T.D. 9947 (1/19/2021) explains:

The final regulations embody certain regulatory decisions that reflect necessary regulatory discretion. These decisions specify more fully how the 2018 Act is to be implemented.

i. Determining Section 199A(g) Deduction for Specified Cooperatives

The final regulations outline the process by which Specified Cooperatives calculate their Section 199A(g) deductions. The rules concern two types of Specified Cooperatives, those that are exempt (qualified as a Cooperative under section 521) and those that are nonexempt (qualified under subchapter T of the Code), and two sources of income, patronage and nonpatronage. The patronage and nonpatronage income of Specified Cooperatives is taxed differently depending on whether the Specified Cooperative is exempt or nonexempt. In the case of exempt Specified Cooperatives, patronage and nonpatronage source income is subject to a single level of tax at the patron level. Whereas, for nonexempt Specified Cooperatives only patronage source income is subject to a single level of tax at the patron level; nonpatronage source income is subject to a double level of tax, similar to other C corporation income.

Because the Code does not define patronage and nonpatronage sourced items, § 1.1388-1(f) of these final regulations sets forth a definition that is consistent with the current state of federal case law. Specifically, the definition adopts the directly related test, which is a fact specific test for determining whether income and deductions of a Cooperative are patronage or nonpatronage. The final regulations also make revisions to clarify patronage versus nonpatronage items. In response to a commenter, the final regulations remove the last sentence in the proposed definition, because the Treasury Department and the IRS agree that the sentence is not needed to define patronage and nonpatronage. Specifying a definition that is consistent with current case law will help to minimize the economic impacts of these regulations that may arise from lack of clarity.

The final regulations adopt the proposed rule requiring Specified Cooperatives to identify gross receipts, COGS, deductions, W-2 wages, etc. as patronage or nonpatronage, and only allows the patronage activities of nonexempt Specified Cooperatives to be included in the calculation of the Section 199A(g) deduction, unless the Specified Cooperative falls under the expanded de minimis rules, which are discussed later. The TCJA reduced the corporate tax rate for C corporations under section 11 and provided the Section 199A deduction for domestic businesses operating as sole proprietorships or through partnerships, S corporations, trusts, or estates. The TCJA also repealed section 199, which did not preclude deductions on income earned by C corporations. The 2018 Act amended Section 199A to address concerns that the TCJA created an unintended incentive for farmers to sell their agricultural or horticultural products to Specified Cooperatives over independent buyers. Specifically, the 2018 Act amended Section 199A(g) to allow Specified Cooperatives and their patrons a deduction similar to the former section 199 deduction. Because the Section 199A(g) deduction is not intended to benefit C corporations and their shareholders, in general, the final regulations specify that the Section 199A(g) deduction can be claimed only on income that can be subject to tax only at the patron level. Under the final regulations, a non-exempt Specified Cooperative may not claim the Section 199A(g) deductions on income that cannot be paid to patrons and deducted under section 1382(b) and exempt Specified Cooperatives may not claim Section 199A(g) deductions on income that cannot be paid to patrons and deducted under sections 1382(b) or 1382(c)(2).

In the absence of these regulations, a Specified Cooperative may have uncertainty as to whether nonpatronage source income, which would be taxed in the same manner as a C corporation, could receive both the lower corporate tax rate and be further offset by a Section 199A(g) deduction. Other C corporations performing identical activities would only benefit from the lower corporate tax rate. This would confer an unintended economic benefit to Specified Cooperatives over other C corporations and undermine the intent of the 2018 Act's amendments of Section 199A to reduce competitive distortions between C corporations and Specified Cooperatives.

The Treasury Department and the IRS have determined that this potential uncertainty as to tax treatment could distort economic decisions in the agricultural or horticultural sector. The final regulations avoid this outcome, promoting a more efficient allocation of resources by providing more uniform incentives across taxpayers.

ii. Definition of Agricultural or Horticultural Products

The Section 199A(g) deduction is focused solely on dispositions of agricultural or horticultural products. As a result, the Treasury Department and the IRS determined that it was necessary to provide a definition. Because there is no definition of agricultural or horticultural products in the Code or Income Tax Regulations, the Treasury Department and the IRS looked to the United States Department of Agriculture (USDA) for definitions because the USDA has expertise concerning Specified Cooperatives, and Specified Cooperatives are likely familiar with USDA law. The proposed regulations defined agricultural or horticultural products within the meaning of the Cooperative Marketing Act of 1926 as agricultural, horticultural, viticultural, and dairy products, livestock and the products thereof, the products of poultry and bee raising, the edible products of forestry, and any and all products raised or produced on farms and processed or manufactured products thereof. Agricultural or horticultural products also include aquatic products that are farmed as well as fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by the Specified Cooperative. Agricultural or horticultural products, however, do not include intangible property, since agricultural or horticultural products were considered a subset of tangible property under former section 199. Intangible property (defined in § 1.199-3(j)(2)(iii)) was a separate category of property and gross receipts from intangible property did not qualify as domestic production gross receipts (DPGR).

The final regulations made clarifying changes to the definition of agricultural or horticultural products in response to commenters. The final regulations provide examples (without limitation) of products that are considered agricultural or horticultural products, including specific agricultural or horticultural products, livestock products, edible forestry products, and farmed aquatic products. The final regulations also provide language further clarifying that agricultural or horticultural products do not include intangible property. Finally, the final regulations include more examples of "other supplies" being agricultural or horticultural products.

The Treasury Department and the IRS considered a similar but alternative definition of agricultural or horticultural products within the meaning of the Agricultural Marketing Act of 1946 as agricultural, horticultural, viticultural, and dairy products, livestock and poultry, bees, forest products, fish and shellfish, and any products thereof, including processed and manufactured products, and any and all products raised or produced on farms and any processed or manufactured product thereof. While very similar to the definition in the rules adopted in these final regulations, the rules under the Agricultural Marketing Act of 1946 concern the marketing and distribution of agricultural products without reference to Cooperatives.

The Treasury Department and the IRS also considered an alternative definition of agricultural or horticultural products based on the definition of agricultural commodities within the meaning of general regulations under the Commodity Exchange Act. The Treasury Department and the IRS concluded that this definition was too narrow, because it is limited to products that can be commodities. The use of this narrow definition would have restricted the range of products for which the Section 199A(g) deduction would be otherwise available.

The Treasury Department and the IRS did not attempt to provide quantitative estimates of the economic consequences of different designations of agricultural or horticultural products because suitable data are not readily available at this level of detail.

iii. De Minimis Threshold for Domestic Production Gross Receipts of Specified Cooperatives

In general, § 1.199A-9 of the final regulations requires that Specified Cooperatives allocate gross receipts between DPGR and non-DPGR. However, § 1.199A-9(c)(3) of the proposed regulations includes a de minimis provision that allows Specified Cooperatives to allocate total gross receipts to DPGR if less than 5 percent of total gross receipts are non-DPGR or to allocate total gross receipts to non-DPGR if less than 5 percent of total gross receipts are DPGR. The thresholds provided in the proposed regulations are based on the thresholds set forth in § 1.199-1(d)(3) under former section

199. The Treasury Department and the IRS chose to include a de minimis rule to reduce compliance costs and simplify tax filing relative to an alternative of no de minimis rule.

The Treasury Department and the IRS considered changes to the de minimis provisions in the proposed regulations, but determined that materially changing these rules from provisions that were previously available would lead to taxpayer confusion. The final regulations generally maintain the rules of the proposed regulations, but increase the threshold. Thus, under § 1.199A-9(c)(3) of the final regulations, Specified Cooperatives when calculating the patronage Section 199A(g) deduction may allocate total gross receipts to DPGR if less than 10 percent of total gross receipts are non-DPGR (which now can include nonpatronage gross receipts as well as patronage non-DPGR pursuant to § 1.199A-8(b)(2)(ii)), or alternatively, may allocate total gross receipts to non-DPGR if less than 10 percent of total gross receipts are DPGR. The de minimis threshold modestly reduces compliance costs for businesses with relatively small amounts of non-DPGR or DPGR by allowing them to avoid allocating receipts between DPGR and non-DPGR activities. The de minimis threshold is unlikely to create any substantial effects on market activity because any change in the ratio of DPGR to non-DPGR will be localized around the threshold, meaning that the movement will be a small fraction of receipts to get below the de minimis threshold. Because the de minimis provision exempts taxpayers from having to perform certain allocations and therefore reporting these allocations, the Treasury Department and the IRS do not have information on taxpayers' use of this exemption under former section 199 to perform a quantitative analysis of the impacts of the de minimis provision.

iv. Reporting Requirements for Cooperatives

Final regulations § 1.199A-7(c) and (d) provide that, when a patron conducts a trade or business that receives distributions from a Cooperative, the Cooperative is required to provide the patron with qualified items of income, gain, deduction, and loss and specified service trade or business (SSTB) determinations with respect to those distributions. This increases the compliance burden on such Cooperatives. However, in the absence of these regulations, the burden for determining of the amount of distributions from a Cooperative that constitute qualified items of income, gain, deduction, and loss from a non-SSTB and an SSTB would lie with the patron. Because patrons are less well positioned to acquire the relevant information to determine whether distributions from a Cooperative are qualified items of income, gain, deduction, and loss and whether items that would otherwise qualify are from an SSTB, the Treasury Department and the IRS expect that these regulations will reduce overall compliance costs relative to an alternative approach of not introducing a reporting requirement. After consideration of comments, the reporting requirements of Cooperatives have been modified to simplify the Cooperatives' reporting obligations in order to balance the burden on the Cooperatives and the patrons' need to receive information to determine their Section 199A(a) deduction.

v. Allocation Safe Harbor

If a patron receives both income or gain related to qualified payments and income or gain that is not related to qualified payments in a qualified trade or business, the patron must allocate those items and related deductions, losses, and W-2 wages using a reasonable method based on all of the facts and circumstances. The final regulations provide a safe harbor that allows patrons who receive income or gain related to qualified payments in addition to income or gain that is not related to qualified payments to use a simpler method to allocate deductions, losses, and W-2 wages between income or gain related to qualified payments and income or gain that is not related to qualified payments to calculate the Section 199A(b)(7) reduction to the Section 199A(a) deduction. The safe harbor allocation method allows patrons to allocate by ratably apportioning deductions, losses, and W-2 wages based on the proportion that the amount of income or gain related to qualified payments bears to the total income or gain used to determine QBI. This safe harbor is available to patrons with taxable incomes below the threshold amounts set forth in Section 199A(e)(2).

The Treasury Department and the IRS considered an alternative of not allowing a safe harbor but determined that a safe harbor could reduce compliance costs and simplify tax filing. The threshold was set at amounts set forth in Section 199A(e)(2) to avoid a proliferation of thresholds applicable to taxpayers claiming a Section 199A(a) deduction. Because the threshold amounts are relatively low, the Treasury Department and the IRS expect that the safe harbor would not distort business decisions or reduce revenue to any meaningful extent.

i. Patrons May Allocate Expenses to Specified Service Trade or Business Items of Income Reported by Cooperative

A commenter asked the Treasury Department and the IRS to revise proposed reporting requirements in circumstances where a Cooperative engages in a specified service trade or business (SSTB) business with patrons. In response to the commenter's request, the final regulations allow patrons to allocate expenses between qualified trade or business income and any SSTB income received from the Cooperative up to the amount of the income from the SSTB. The final regulations more accurately track the substance of the transaction. In the absence of these regulations, the patron may calculate lower qualified business income, resulting in a lower Section 199A(a) deduction.

ii. Specified Cooperatives May Pass Through All, Some, or None of the Section 199A(g) Deduction

Section 199A(g) permits Specified Cooperatives to pass through their Section 199A(g) deduction, and allows eligible taxpayers to claim the deduction passed through. The proposed regulations required Specified Cooperatives to identify whether the patrons are eligible taxpayers and only pass through the deduction to those patrons. Commenters requested that the rule be modified so that patrons, and not Specified Cooperatives, have to identify whether the patrons are eligible taxpayers for purposes of using the Section 199A(g) deduction. The rules have been modified in the final regulations to provide Specified Cooperatives with maximum flexibility. If a Specified Cooperative does not identify the eligibility status of all of its patrons, it may pass through all, some, or none of the Section 199A(g) deduction. Only patrons that are eligible taxpayers may use the Section 199A(g) deduction passed through to them. If a Specified Cooperative does determine the eligibility status of its patrons, it has the discretion to retain the Section 199A(g) deduction attributable to any ineligible taxpayer, and pass out the remainder to eligible taxpayers.

In the absence of these regulations, a Specified Cooperative may have uncertainty as to whether to distribute the Section 199A(g) deduction to eligible taxpayers. The final regulations provide Specified Cooperatives with the option of retaining and using the amounts equal to the Section 199A(g) deduction attributable to ineligible taxpayers, or passing out the deduction, which only eligible taxpayers may claim. This allows Specified Cooperatives to choose whether to engage in information gathering regarding patrons' eligibility to use the deduction. The Treasury Department and the IRS have determined that this increased flexibility promotes a more efficient allocation of resources by allowing Specified Cooperatives to choose the extent to which they engage in information gathering in relation to the use of the Section 199A(g) deduction at the Specified Cooperative level or the patron level.

iii. Special Rule for Specified Cooperative Partners

The final regulations provide special rules for Specified Cooperatives that are partners in a partnership. A commenter recommended that the proposed regulations be modified to permit partnerships to pass through W-2 wages to Specified Cooperative partners, thereby increasing the Specified Cooperatives' Section 199A(g) deduction. A commenter also recommended that, to the extent a partnership conducts activities that result in gross receipts, a Specified Cooperative partner in that partnership should be permitted to treat those activities as conducted directed by the Specified Cooperative. The Treasury Department and the IRS agree with these comments. The final regulations permit the partnerships to pass through W-2 wages and COGS to Specified Cooperative partners. Additionally, the final regulations allow for two-way attribution, meaning: (1) A partnership's activities alone with respect to an agricultural or horticultural product can qualify as gross receipts for the Specified Cooperative partner and (2) a partnership can be attributed the activities of the Specified Cooperative partner. These rules permit additional activities and the resulting income, as well as additional W-2 wages and COGS, to be considered in the calculation of the Section 199A(g) deduction.

This stipulation allows for greater flexibility in determining deductions when Specified Cooperatives are partners. Flexibility will increase economic efficiency by making it more likely that Specified Cooperatives comply with regulations by lowering the compliance burden.

The Treasury Department and the IRS anticipate that these regulations in aggregate will have a marginal impact on economic activity. Compared to the economic impacts resulting from the 2018 Act, the final regulations' primary impact will be through increasing comprehension of the tax code. Increased understanding will reduce the risk that firms and the IRS will disagree on tax reporting and allocation and therefore engage in costly legal transactions. Increased comprehension will also reduce the possibility that firms will engage in activities that would yield negative economic impacts if clarity were stronger. These final regulations also respond to commenters by adding additional examples to further increase comprehension.

II.E.1.c.vi. Wage Limitation If Taxable Income Is Above Certain Thresholds

After considering part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A,[880] the wage limitation is the greater of:[881]

(i) 50 percent of the W-2 wages with respect to the qualified trade or business, or

(ii) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.

For details on the wage limitation, see parts II.E.1.c.vi.(a) W-2 wages under Code § 199A and II.E.1.c.vi.(b) Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A, which generally are effectuated under Reg § 1.199A-2. Prop. Reg § 1.199A-2(d), "Effective/applicability date," provides:

> (1) *General rule*. Except as provided in paragraph (d)(2) of this section, the provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. However, taxpayers may rely on the rules of this section until the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register.
>
> (2) *Exceptions*.
>
> (i) *Anti-abuse rules*. The provisions of paragraph (c)(1)(iv) of this section apply to taxable years ending after December 22, 2017.
>
> (ii) *Non-calendar year RPE*. For purposes of determining QBI, W-2 wages, and UBIA of qualified property, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

As to the final regulations, Reg § 1.199A-2(d), "Effective/applicability date," provides:

> (1) *General rule*. Except as provided in paragraph (d)(2) of this section, the provisions of this section apply to taxable years ending after February 8, 2019.
>
> (2) *Exceptions*.
>
> (i) *Anti-abuse rules*. The provisions of paragraph (c)(1)(iv) of this section apply to taxable years ending after December 22, 2017.
>
> (ii) *Non-calendar year RPE*. For purposes of determining QBI, W-2 wages, UBIA of qualified property, and the aggregate amount of qualified REIT dividends and

[880] Within that part, fn 834 cross-references fn 881 of this part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
[881] Code § 199A(b)(2)(B). Reg. § 1.199A-1(d)(2)(iv) is reproduced in part II.E.1.c.v.(c) Calculation When Taxable Income Exceeds the Threshold Amount.

qualified PTP income if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

The wage limitation is relaxed or does not apply if taxable income is below certain thresholds.[882] See part II.E.1.c.v.(a) Taxable Income "Threshold.

II.E.1.c.vi.(a). W-2 wages under Code § 199A

The preamble to Prop. Reg. § 1.199A-2, REG-107892-18 (8/16/2018), explains:

> **II. Proposed § 1.199A-2: Determination of W-2 wages and the UBIA of Qualified Property**
>
> As described in part I.C. of this Explanation of Provisions, if an individual's taxable income exceeds the threshold amount, Section 199A(b)(2)(B) imposes a limit on the Section 199A deduction based on the greater of either (i) the W-2 wages paid, or (ii) the W-2 wages paid and UBIA of qualified property attributable to a trade or business. This part of this Explanation of Provisions describes the rules in proposed § 1.199A-2 regarding the determination of W-2 wages and UBIA of qualified property.
>
> **A. W-2 wages attributable to a trade or business**
>
> The W-2 wage rules of proposed § 1.199A-2 generally follow the rules under former section 199. Section 199, which was repealed by the TCJA, provided for a deduction with respect to certain domestic production activities and contained a W-2 wage limitation similar to the one in Section 199A. The legislative text of the W-2 wage limitation in Section 199A is modeled on the text of former section 199, and both taxpayers and the IRS have developed experience in applying those W-2 wage rules for over a decade. The regulations under former section 199 provided rules to determine W-2 wages, which provide a useful starting point in developing the W-2 wage rules under Section 199A, including rules on the definition of W-2 wages, wages paid by persons other than the common-law employer, and methods for calculating W-2 wages.
>
> The Treasury Department and the IRS have received comments concerning whether amounts paid to workers who receive Forms W-2 from third party payors (such as professional employer organizations, certified professional employer organizations, or agents under section 3504) that pay these wages to workers on behalf of their clients and report wages on Forms W-2, with the third party payor as the employer listed in Box c of the Forms W-2, may be included in the W-2 wages of the clients of third party payors. In order for wages reported on a Form W-2 to be included in the determination of W-2 wages of a taxpayer, the Form W-2 must be for employment by the taxpayer. The regulations under former section 199, specifically § 1.199-2(a)(2), addressed this issue, providing that, since employees of the taxpayer are defined in the regulations as including only common law employees of the taxpayer and officers of a corporate taxpayer, taxpayers may take into account wages reported on Forms W-2 issued by

[882] Code § 199A(b)(3).

other parties provided that the wages reported on the Forms W-2 were paid to employees of the taxpayer for employment by the taxpayer.

Proposed § 1.199A-2(b)(2)(ii) provides a rule for wages paid by a person other than the common law employer that is substantially similar to the rule in § 1.199-2(a)(2). Specifically, the proposed regulations provide that, in determining W-2 wages, a person may take into account any W-2 wages paid by another person and reported by the other person on Forms W-2 with the other person as the employer listed in Box c of the Forms W-2, provided that the W-2 wages were paid to common law employees or officers of the person for employment by the person. In such cases, the person paying the W-2 wages and reporting the W-2 wages on Forms W-2 is precluded from taking into account such wages for purposes of determining W-2 wages with respect to that person. Persons that pay and report W-2 wages on behalf of or with respect to others can include certified professional employer organizations under section 7705, statutory employers under section 3401(d)(1), and agents under section 3504. Under this rule, persons who otherwise qualify for the deduction under Section 199A are not limited in applying the deduction merely because they use a third party payor to pay and report wages to their employees. However, with respect to individuals who taxpayers assert are their common law employees for purposes of Section 199A, taxpayers are reminded of their duty to file returns and apply the tax law on a consistent basis.

Unlike former section 199, the W-2 wage limitation in Section 199A applies separately for each trade or business. Accordingly, proposed § 1.199A-2 provides that, in the case of W-2 wages that are allocable to more than one trade or business, the portion of the W-2 wages allocable to each trade or business is determined to be in the same proportion to total W-2 wages as the deductions associated with those wages are allocated among the particular trades or businesses. Section 199A(b)(4) also requires that to be taken into account, W-2 wages must be properly allocable to QBI. W-2 wages are properly allocable to QBI if the associated wage expense is taken into account in computing QBI.

Additionally, proposed § 1.199A-2(b)(4) restates the rule of Section 199A(f)(1)(A)(iii), which provides that, in the case of a trade or business conducted by an RPE, a partner's or shareholder's allocable share of wages must be determined in the same manner as the partner's allocable share or a shareholder's pro rata share of wage expenses.

Consistent with Section 199A(b)(5) and the legislative history of the TCJA, which direct the Secretary to provide rules for applying the W-2 wage limitation in cases in which the taxpayer acquires, or disposes of, a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business during the year, proposed § 1.199A-2 (b)(2)(iv)(B) provides rules that apply in the case of an acquisition or disposition of a trade or business. See Joint Explanatory Statement of the Committee of Conference, 38. Specifically, proposed § 1.199A-2(b)(2)(iv)(B)(1) provides that, in the case of an acquisition or disposition of a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business that causes more than one individual or entity to be an employer of the employees of the acquired or disposed of trade or business during the calendar year, the W-2 wages of the individual or entity for the calendar year of the acquisition or disposition are allocated between each individual or entity based on the period during which the employees of the acquired or disposed of trade or business were employed by the individual or entity, regardless of which permissible method is used for reporting predecessor and successor wages on

> Form W-2. For this purpose, the period of employment is determined consistently with the principles for determining whether an individual is an employee described in proposed § 1.199A-2(b).
>
> A notice of proposed revenue procedure, Notice 2018-64, 2018-35 IRB ____, which provides three methods for calculating W-2 wages is being issued concurrently with this notice of proposed rulemaking. The three methods in the notice are substantially similar to the methods provided in Rev. Proc. 2006-47, 2006-2 C.B. 869, for purposes of calculating "paragraph (e)(1) wages" (that is, wages described in § 1.199-2(e)(1) issued under former section 199). The first method (the unmodified Box method) allows for a simplified calculation while the second and third methods (the modified Box 1 method and the tracking wages method) provide for greater accuracy.

Notice 2018-64, referred to in the last paragraph above, resulted in Rev. Proc. 2019-11, section 2 of which explains:

> W-2 wages calculated under this revenue procedure are not necessarily the W-2 wages that are properly allocable to QBI and eligible for use in computing the Section 199A limitations. As mentioned above, only W-2 wages that are properly allocable to QBI may be taken into account in computing the Section 199A(b)(2) W-2 wage limitations. Thus, after computing W-2 wages under this revenue procedure, under § 1.199A-2(b)(3), the taxpayer must determine the extent to which the W-2 wages are properly allocable to QBI. Then, the properly allocable W-2 wages amount is used in determining the W-2 wage limitation under Section 199A(b)(2) for that trade or business as well as any reduction for income received from cooperatives under Section 199A(b)(7).

For a taxpayer using W-2 wages in calculating the QBI deduction, see Reg. § 1.199A-2(a)(2), reproduced in the text accompanying fn 758 in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

Reg. § 1.199A-2(b)(1) provides an overview of the rules for W-2 wages:

> *In general*. Section 199A(b)(2)(B) provides limitations on the Section 199A deduction based on the W-2 wages paid with respect to each trade or business (or aggregated trade or business). Section 199A(b)(4)(B) provides that W-2 wages do not include any amount which is not properly allocable to QBI for purposes of Section 199A(c)(1). This section provides a three step process for determining the W-2 wages paid with respect to a trade or business that are properly allocable to QBI. First, each individual or RPE must determine its total W-2 wages paid for the taxable year under the rules in paragraph (b)(2) of this section. Second, each individual or RPE must allocate its W-2 wages between or among one or more trades or businesses under the rules in paragraph (b)(3) of this section. Third, each individual or RPE must determine the amount of such wages with respect to each trade or business, which are allocable to the QBI of the trade or business (or aggregated trade or business) under the rules in paragraph (b)(4) of this section.

"W-2 wages" means, with respect to any person for any taxable year of such person, the W-2 wages paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year:[883]

- In the case of a partnership or S corporation, each partner or shareholder is treated "as having W-2 wages and unadjusted basis immediately after acquisition of qualified property for the taxable year in an amount equal to such person's allocable share of the W-2 wages and the unadjusted basis immediately after acquisition of qualified property of the partnership or S corporation for the taxable year (as determined under regulations prescribed by the Secretary)."[884] A partner's or shareholder's allocable share of W-2 wages is determined in the same manner as the partner's or shareholder's allocable share of wage expenses.[885] A partner's or shareholder's allocable share of the unadjusted basis immediately after acquisition of qualified property is determined in the same manner as the partner's or shareholder's allocable share of depreciation.[886] In the case of an S corporation, an allocable share is the shareholder's pro rata share of an item.[887]

- For trusts and estates, rules similar to those that applied to the former Code § 199 deduction for domestic production activities apply.[888] See part II.E.1.f Trusts/Estates and the Code § 199A Deduction.

For a clue how statutory employees are treated, Rev. Proc. 2019-11, § 3.01 provides:

> Section 1.199A-2(b)(2)(i) also provides that, for purposes of § 1.199A-2, employees of the person are limited to employees of the person as defined in section 3121(d)(1) and (2) (that is, officers of a corporation and employees of the person under the common law rules). Therefore, Forms W-2 provided to statutory employees described in section 3121(d)(3) (that is, Forms W-2 in which the "Statutory Employee" box in Box 13 is checked) should not be included in calculating W-2 wages under any of the methods described in this revenue procedure.

Code § 3121(d)(3) excludes from "employee" any person, other than "any officer of a corporation" or a common law employee, "who performs services for remuneration for any person":

> (A) as an agent-driver or commission-driver engaged in distributing meat products, vegetable products, fruit products, bakery products, beverages (other than milk), or laundry or dry-cleaning services, for his principal;
>
> (B) as a full-time life insurance salesman;

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[883] Code § 199A(b)(4)(A).
[884] Code § 199A(f)(1)(A)(iii).
[885] Code § 199A(f)(1)(A) (flush language).
[886] Code § 199A(f)(1)(A) (flush language).
[887] Code § 199A(f)(1)(A) (flush language).
[888] Code § 199A(f)(1)(B) provides:

> *Application to Trusts and Estates*. Rules similar to the rules under section 199(d)(1)(B)(i) (as in effect on December 1, 2017) for the apportionment of W-2 wages shall apply to the apportionment of W-2 wages and the apportionment of unadjusted basis immediately after acquisition of qualified property under this section.

(C) as a home worker performing work, according to specifications furnished by the person for whom the services are performed, on materials or goods furnished by such person which are required to be returned to such person or a person designated by him; or

(D) as a traveling or city salesman, other than as an agent-driver or commission-driver, engaged upon a full-time basis in the solicitation on behalf of, and the transmission to, his principal (except for side-line sales activities on behalf of some other person) of orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments for merchandise for resale or supplies for use in their business operations;

if the contract of service contemplates that substantially all of such services are to be performed personally by such individual; except that an individual shall not be included in the term "employee" under the provisions of this paragraph if such individual has a substantial investment in facilities used in connection with the performance of such services (other than in facilities for transportation), or if the services are in the nature of a single transaction not part of a continuing relationship with the person for whom the services are performed….

If employers cannot treat payments to these statutory employees as wages under part II.E.1.c.vi.(a) W-2 wages under Code § 199A, then these payments should not be treated as wages excluded from QBI. Indeed, the closing parenthetical to Reg. § 1.199A-5(d) confirms this result.[889]

W-2 wages generally are wages subject to withholding and include elective deferral, such as Code § 401(k) and similar plans.[890] The wages must be "properly allocable to" QBI.[891] The wages must be "properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return."[892]

Reg. § 1.199A-2(b)(2), "Definition of W-2 wages," elaborates on the above, starting with:

(i) *In general*. Section 199A(b)(4)(A) provides that the term W-2 wages means with respect to any person for any taxable year of such person, the amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Thus, the term W-2 wages includes the total amount of wages as defined in

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889 See Reg. § 1.199A-5(d)(1), reproduced in part II.E.1.c.ii.(b) Trade or Business of Being an Employee (Excluded from QBI).

890 Code § 199A(b)(4)(A) provides:

> *In General*. The term "W-2 wages" means, with respect to any person for any taxable year of such person, the amounts described in paragraphs (3) and (8) of section 6051(a) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year.

If a taxpayer has qualified business income from sources within the commonwealth of Puerto Rico and all that income is taxable under Code § 1 for the taxable year, then Code § 199A(f)(1)(C)(ii) provides that:

> the determination of W-2 wages of such taxpayer with respect to any qualified trade or business conducted in Puerto Rico shall be made without regard to any exclusion under section 3401(a)(8) for remuneration paid for services in Puerto Rico.

891 Code § 199A(b)(4)(B).

892 Code § 199A(b)(4)(C).

section 3401(a) plus the total amount of elective deferrals (within the meaning of section 402(g)(3)), the compensation deferred under section 457, and the amount of designated Roth contributions (as defined in section 402A). For this purpose, except as provided in paragraphs (b)(2)(iv)(C)(2) and (b)(2)(iv)(D) of this section, the Forms W-2, "Wage and Tax Statement," or any subsequent form or document used in determining the amount of W-2 wages, are those issued for the calendar year ending during the individual's or RPE's taxable year for wages paid to employees (or former employees) of the individual or RPE for employment by the individual or RPE. For purposes of this section, employees of the individual or RPE are limited to employees of the individual or RPE as defined in section 3121(d)(1) and (2). (For purposes of Section 199A, this includes officers of an S corporation and employees of an individual or RPE under common law.)

(ii) *Wages paid by a person other than a common law employer*. In determining W-2 wages, an individual or RPE may take into account any W-2 wages paid by another person and reported by the other person on Forms W-2 with the other person as the employer listed in Box c of the Forms W-2, provided that the W-2 wages were paid to common law employees or officers of the individual or RPE for employment by the individual or RPE. In such cases, the person paying the W-2 wages and reporting the W-2 wages on Forms W-2 is precluded from taking into account such wages for purposes of determining W-2 wages with respect to that person. For purposes of this paragraph (b)(2)(ii), persons that pay and report W-2 wages on behalf of or with respect to others can include, but are not limited to, certified professional employer organizations under section 7705, statutory employers under section 3401(d)(1), and agents under section 3504.

(iii) *Requirement that wages must be reported on return filed with the Social Security Administration (SSA)*.

(A) *In general*. Pursuant to Section 199A(b)(4)(C), the term W-2 wages does not include any amount that is not properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return. Under § 31.6051-2 of this chapter, each Form W-2 and the transmittal Form W-3, "Transmittal of Wage and Tax Statements," together constitute an information return to be filed with SSA. Similarly, each Form W-2c, "Corrected Wage and Tax Statement," and the transmittal Form W-3 or W-3c, "Transmittal of Corrected Wage and Tax Statements," together constitute an information return to be filed with SSA. In determining whether any amount has been properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return, each Form W-2 together with its accompanying Form W-3 will be considered a separate information return and each Form W-2c together with its accompanying Form W-3 or Form W-3c will be considered a separate information return. Section 6071(c) provides that Forms W-2 and W-3 must be filed on or before January 31 of the year following the calendar year to which such returns relate (but see the special rule in § 31.6071(a)-1T(a)(3)(1) of this chapter for monthly returns filed under § 31.6011(a)-5(a) of this chapter). Corrected Forms W-2 are required to be filed with SSA on or before January 31 of the year following the year in which the correction is made.

(B) *Corrected return filed to correct a return that was filed within 60 days of the due date*. If a corrected information return (Return B) is filed with SSA on or before the

60th day after the due date (including extensions) of Return B to correct an information return (Return A) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return A) and paragraph (b)(2)(iii)(C) of this section does not apply, then the wage information on Return B must be included in determining W-2 wages. If a corrected information return (Return D) is filed with SSA later than the 60th day after the due date (including extensions) of Return D to correct an information return (Return C) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return C), and if Return D reports an increase (or increases) in wages included in determining W-2 wages from the wage amounts reported on Return C, then such increase (or increases) on Return D will be disregarded in determining W- 2 wages (and only the wage amounts on Return C may be included in determining W-2 wages). If Return D reports a decrease (or decreases) in wages included in determining W-2 wages from the amounts reported on Return C, then, in determining W-2 wages, the wages reported on Return C must be reduced by the decrease (or decreases) reflected on Return D.

(C) *Corrected return filed to correct a return that was filed later than 60 days after the due date*. If an information return (Return F) is filed to correct an information return (Return E) that was not filed with SSA on or before the 60th day after the due date (including extensions) of Return E, then Return F (and any subsequent information returns filed with respect to Return E) will not be considered filed on or before the 60th day after the due date (including extensions) of Return F (or the subsequent corrected information return). Thus, if a Form W-2c is filed to correct a Form W-2 that was not filed with SSA on or before the 60th day after the due date (including extensions) of the Form W-2 (or to correct a Form W-2c relating to Form W-2 that had not been filed with SSA on or before the 60th day after the due date (including extensions) of the Form W-2), then this Form W-2c will not be considered to have been filed with SSA on or before the 60th day after the due date (including extensions) for this Form W-2c (or corrected Form W-2), regardless of when the Form W-2c is filed.

The IRS must explain how the QBI rules apply "in cases of a short taxable year or where the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the taxable year."[893]

Reg. § 1.199A-2(b)(2), "Methods for calculating W-2 wages," implements the above:

(A) *In general*. The Secretary may provide for methods to be used in calculating W-2 wages, including W-2 wages for short taxable years by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter).

(B) *Acquisition or disposition of a trade or business*.

(1) *In general*. In the case of an acquisition or disposition of a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business that causes more than one individual or entity to be an employer of the employees of the acquired or disposed of trade or business during the calendar year, the W-2 wages of the individual or entity for the

[893] Code § 199A(b)(5).

calendar year of the acquisition or disposition are allocated between each individual or entity based on the period during which the employees of the acquired or disposed of trade or business were employed by the individual or entity, regardless of which permissible method is used for reporting predecessor and successor wages on Form W-2, "Wage and Tax Statement." For this purpose, the period of employment is determined consistently with the principles for determining whether an individual is an employee described in paragraph (b) of this section.

(2) *Acquisition or disposition*. For purposes of this paragraph (b)(2)(iv)(B), the term acquisition or disposition includes an incorporation, a formation, a liquidation, a reorganization, or a purchase or sale of assets.

(C) *Application in the case of a person with a short taxable year*.

(1) *In general*. In the case of an individual or RPE with a short taxable year, subject to the rules of paragraph (b)(2) of this section, the W-2 wages of the individual or RPE for the short taxable year include only those wages paid during the short taxable year to employees of the individuals or RPE, only those elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the individual or RPE and only compensation actually deferred under section 457 during the short taxable year with respect to employees of the individual or RPE.

(2) *Short taxable year that does not include December 31*. If an individual or RPE has a short taxable year that does not contain a calendar year ending during such short taxable year, wages paid to employees for employment by such individual or RPE during the short taxable year are treated as W-2 wages for such short taxable year for purposes of paragraph (b) of this section (if the wages would otherwise meet the requirements to be W-2 wages under this section but for the requirement that a calendar year must end during the short taxable year).

(D) *Remuneration paid for services performed in the Commonwealth of Puerto Rico*. In the case of an individual or RPE that conducts a trade or business in the Commonwealth of Puerto Rico, the determination of W-2 wages of such individual or RPE will be made without regard to any exclusion under section 3401(a)(8) for remuneration paid for services performed in the Commonwealth of Puerto Rico. The individual or RPE must maintain sufficient documentation (for example, Forms 499R-2/W-2PR) to substantiate the amount of remuneration paid for services performed in the Commonwealth of Puerto Rico that is used in determining the W-2 wages of such individual or RPE with respect to any trade or business conducted in the Commonwealth of Puerto Rico.

Reg. § 1.199A-2(b)(3), "Allocation of wages to trades or businesses," provides:

After calculating total W-2 wages for a taxable year, each individual or RPE that directly conducts more than one trade or business must allocate those wages among its various trades or businesses. W-2 wages must be allocated to the trade or business that generated those wages. In the case of W-2 wages that are allocable to more than one trade or business, the portion of the W-2 wages allocable to each trade or business is determined in the same manner as the expenses associated with those wages are allocated among the trades or businesses under § 1.199A- 3(b)(5).

Reg. § 1.199A-2(b)(4), "Allocation of wages to QBI," completes the allocation process:

> Once W-2 wages for each trade or business have been determined, each individual or RPE must identify the amount of W-2 wages properly allocable to QBI for each trade or business (or aggregated trade or business). W-2 wages are properly allocable to QBI if the associated wage expense is taken into account in computing QBI under § 1.199A-3. In the case of an RPE, the wage expense must be allocated and reported to the partners or shareholders of the RPE as required by the Code, including subchapters K and S of chapter 1 of subtitle A of the Code. The RPE must also identify and report the associated W-2 wages to its partners or shareholders.

Reg. § 1.199A-2(b)(5), "Non-duplication rule," provides:

> Amounts that are treated as W-2 wages for a taxable year under any method cannot be treated as W-2 wages of any other taxable year. Also, an amount cannot be treated as W-2 wages by more than one trade or business (or aggregated trade or business).

II.E.1.c.vi.(b). Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A

As discussed above, part of the wage limitation test is an alternative calculation relating to qualified property.[894] For a taxpayer using Unadjusted Basis Immediately after Acquisition (UBIA) of qualified property in calculating the QBI deduction, see Reg. § 1.199A-2(a)(3), reproduced in the text accompanying fn 758 in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

The preamble to Prop. Reg. § 1.199A-2, REG-107892-18 (8/16/2018), explains:

> **B. The UBIA of qualified property**
>
> Section 199A(b)(2)(B)(ii) provides an alternative deduction limitation based on 25 percent of W-2 wages with respect to the qualified trade or business and 2.5 percent of the UBIA of qualified property. Proposed § 1.199A-2 restates the statutory definitions under the qualified property rules, and provides additional guidance.
>
> **1. General definition of UBIA of qualified property**
>
> Proposed § 1.199A-2(c)(1) restates the definition of qualified property in Section 199A(b)(6)(A), which provides that "qualified property" means tangible property of a character subject to depreciation that is held by, and available for use in, a trade or business at the close of the taxable year, and which is used in the production of QBI, and for which the depreciable period has not ended before the close of the taxable year. Proposed § 1.199A-2(c)(2) also restates the definition of depreciable period in Section 199A(b)(6)(B), which provides that "depreciable" period means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (a) the date 10 years after that date, or (b) the last day of the last full year

[894] Code § 199A(b)(2)(B)(ii).

in the applicable recovery period that would apply to the property under section 168(c), regardless of the application of section 168(g).

Because the applicable recovery period under section 168(c) of the property is not changed by any additional first-year depreciation deduction allowable under section 168, proposed § 1.199A-2(c)(2)(ii) also clarifies that the additional first-year depreciation deduction allowable under section 168 (for example, under section 168(k) or section 168(m)) does not affect the applicable recovery period under section 168(c).

Proposed § 1.199A-2(c)(3) provides a definition of UBIA. The Treasury Department and the IRS believe that existing general principles used to define "unadjusted basis" in § 1.263(a)-3(h)(5) provide a reasonable basis for an administrable rule that is appropriate for the purposes of Section 199A and that their use will reduce compliance costs, burden, and administrative complexity because taxpayers have experience applying them. In addition, the Treasury Department and the IRS believe that "immediately after acquisition" means as of the date the property is placed in service because Section 199A provides that "qualified property" must be used in the production of QBI. In order to be used in the production of QBI, the qualified property necessarily must be placed in service. Determining UBIA as of the date the property is placed in service ensures consistency between purchased and produced qualified property, and reduces compliance costs, burden, and administrative complexity because taxpayers are already required to determine that amount. Accordingly, proposed § 1.199A-2 provides that the term "UBIA" means the basis as determined under section 1012 or other applicable sections of chapter 1, including subchapter O (relating to gain or loss on dispositions of property), subchapter C (relating to corporate distributions and adjustments), subchapter K (relating to partners and partnerships), and subchapter P (relating to capital gains and losses). UBIA is determined without regard to any adjustments described in section 1016(a)(2) or (3), any adjustments for tax credits claimed by the taxpayer (for example, under section 50(c)), or any adjustments for any portion of the basis for which the taxpayer has elected to treat as an expense (for example, under sections 179, 179B, or 179C). Therefore, for purchased or produced qualified property, UBIA generally will be its cost under section 1012 as of the date the property is placed in service. For qualified property contributed to a partnership in a section 721 transaction and immediately placed in service, UBIA generally will be its basis under section 723. For qualified property contributed to an S corporation in a section 351 transaction and immediately placed in service, UBIA generally will be its basis under section 362. Further, for property inherited from a decedent and immediately placed in service by the heir, the UBIA generally will be its fair market value at the time of the decedent's death under section 1014. However, proposed § 1.199A-2(c)(3) provides that UBIA does reflect the reduction in basis for the percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business.

2. Partnership special basis adjustments

After the enactment of the TCJA, the Treasury Department and the IRS received comments requesting guidance as to whether partnership special basis adjustments under sections 734(b) or 743(b) constitute qualified property for purposes of Section 199A. Treating partnership special basis adjustments as qualified property could result in inappropriate duplication of UBIA of qualified property (if, for example, the fair market value of the property has not increased and its depreciable period has not ended).

Accordingly, proposed § 1.199A-2(c)(1)(iii) provides that partnership special basis adjustments are not treated as separate qualified property.

3. Property transferred with a principal purpose of increasing Section 199A deduction

Qualified property includes depreciable property used during the taxable year in the production of QBI and held by, and available for use in, the trade or business at the close of the taxable year. However, it would be inconsistent with the purposes of Section 199A to permit trades or businesses to transfer or acquire property at the end of the year merely to manipulate the UBIA of qualified property attributable to the trade or business. Therefore, pursuant to the authority granted to the Secretary under Section 199A(f)(4), proposed § 1.199A-2(c)(1)(iv) provides that property is not qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the Section 199A deduction.

4. Like-kind exchanges and involuntary conversions

Section 199A does not provide rules to determine UBIA for qualified property in the case of an exchange of property under section 1031 (like-kind exchange) or involuntary conversion under section 1033. However, Section 199A(h)(2) specifically instructs the Secretary to do so. The Treasury Department and the IRS believe that existing general principles used for like-kind exchanges and involuntary conversions under § 1.168(i)-(6) provide a useful analogy for administrable rules that are appropriate for the purposes of Section 199A and that their use will reduce compliance costs, burden, and administrative complexity because taxpayers have experience applying them. Accordingly, proposed § 1.199A-2(c)(2)(iii) generally follows the rules of § 1.168(i)-6 to provide that qualified property that is acquired in a like-kind exchange, as defined in § 1.168(i)-6(b)(11), or in an involuntary conversion, as defined in § 1.168(i)-6(b)(12), is treated as replacement Modified Accelerated Cost Recovery System (MACRS) property as defined in § 1.168(i)-6(b)(1) whose depreciable period generally is determined as of the date the relinquished property was first placed in service. Accordingly, subject to one exception, proposed § 1.199A-2(c)(2)(iii) provides that, for purposes of determining the depreciable period, the date the exchanged basis in the replacement qualified property is first placed in service by the trade or business is the date on which the relinquished property was first placed in service by the individual or RPE and the date the excess basis in the replacement qualified property is first placed in service by the individual or RPE is the date on which the replacement qualified property was first placed in service by the individual or RPE. As a result, the depreciable period under Section 199A for the exchanged basis of the replacement qualified property will end before the depreciable period for the excess basis of the replacement qualified property ends.

The exception is that proposed § 1.199A-2(c)(2)(iii)(C) provides that, for purposes of determining the depreciable period, if the individual or RPE makes an election under § 1.168(i)-6(i)(1) (the election not to apply § 1.168(i)-6)), the date the exchanged basis and excess basis in the replacement qualified property are first placed in service by the trade or business is the date on which the replacement qualified property is first placed in service by the individual or RPE, with UBIA determined as of that date. In this case, the depreciable periods under Section 199A for the exchanged basis and the excess basis of the replacement qualified property will end on the same date.

Thus, unless the exception applies, qualified property acquired in a like-kind exchange or involuntary conversion will have two separate placed in service dates under the proposed regulations: for purposes of determining the UBIA of the property, the relevant placed in service date will be the date the acquired property is actually placed in service; for purposes of determining the depreciable period of the property, the relevant placed in service date generally will be the date the relinquished property was first placed in service. The proposed regulations contain an example illustrating these rules.

5. Other nonrecognition transactions

The Treasury Department and the IRS have received comments requesting guidance on the application of the qualified property rules to nonrecognition transfers involving transferred basis property within the meaning of section 7701(a)(43) (transferred basis transactions). For example, taxpayers and practitioners requested guidance on how to determine the depreciable period of the property if a partnership conducts a trade or business and qualified property is contributed to that trade or business in a nonrecognition transfer under section 721(a). Also of relevance in the context of non-recognition transfers, Section 199A(h)(1) grants the Secretary anti-abuse authority to apply rules similar to the rules under section 179(d)(2) (which can restrict the expensing of certain assets in transferred basis transactions) to prevent the manipulation of the depreciable period of qualified property using transactions between related parties.

The Treasury Department and the IRS believe that existing general principles used for transferred basis transactions under § 168(i)(7) provide a useful analogy for administrable rules that are appropriate for the purposes of Section 199A and that their use will reduce compliance costs, burden, and administrative complexity because taxpayers have experience applying them. Accordingly, proposed § 1.199A-2(c)(2)(iv) provides that, for purposes of determining the depreciable period, if an individual or RPE (the transferee) acquires qualified property in a transaction described in section 168(i)(7)(B), the transferee determines the date on which the qualified property was first placed in service using a two-step approach. First, for the portion of the transferee's UBIA of the qualified property that does not exceed the transferor's UBIA of such property, the date such portion was first placed in service by the transferee is the date on which the transferor first placed the qualified property in service. Second, for the portion of the transferee's UBIA of the qualified property that exceeds the transferor's UBIA of such property, if any, such portion is treated as separate qualified property that the transferee first placed in service on the date of the transfer. Thus, qualified property acquired in these non-recognition transactions will have two separate placed in service dates under the proposed regulations: for purposes of determining the UBIA of the property, the relevant placed in service date will be the date the acquired property is placed in service by the transferee (for instance, the date the partnership places in service property received in a section 721 transaction); for purposes of determining the depreciable period of the property, the relevant placed in service date generally will be the date the transferor first placed the property in service (for instance, the date the partner placed the property in service in his or her sole proprietorship). The proposed regulations contain an example illustrating these rules.

The Treasury Department and the IRS request comments concerning appropriate methods for accounting for non-recognition transactions, including rules to prevent the manipulation of the depreciable period of qualified property using transactions between related parties.

6. Redetermination of UBIA and subsequent improvements to qualified property

The Treasury Department and the IRS have received comments requesting guidance on the treatment of subsequent improvements to qualified property. Subsequent improvements to qualified property are generally treated as a separate item of property under section 168(i)(6). The Treasury Department and the IRS do not believe a different approach is necessary for purposes of Section 199A. Accordingly, proposed § 1.199A-2(c)(1)(ii) provides that, in the case of any addition to, or improvement of, qualified property that is already placed in service by the taxpayer, such addition or improvement is treated as separate qualified property that the taxpayer first placed in service on the date such addition or improvement is placed in service by the taxpayer for purposes of determining the depreciable period of the qualified property. For example, if a taxpayer acquired and placed in service a machine on March 26, 2018, and then incurs additional capital expenditures to improve the machine in May 2020, and places such improvements in service on May 27, 2020, the taxpayer has two qualified properties: the machine acquired and placed in service on March 26, 2018, and the improvements to the machine incurred in May 2020 and placed in service on May 27, 2020.

7. Allocation of UBIA of qualified property by RPEs

In the case of a trade or business conducted by an RPE, Section 199A(f) provides that a partner's or shareholder's allocable share of the UBIA of qualified property is determined in the same manner as the partner's allocable share or shareholder's pro rata share of depreciation. Proposed § 1.199A-2(a)(3) provides that, in the case of qualified property held by an RPE, each partner's or shareholder's share of the UBIA of qualified property is an amount that bears the same proportion to the total UBIA of qualified property as the partner's or shareholder's share of tax depreciation bears to the entity's total tax depreciation attributable to the property for the year. In the case of qualified property of a partnership that does not produce tax depreciation during the year (for example, property that has been held for less than 10 years but whose recovery period has ended), each partner's share of the UBIA of qualified property is based on how gain would be allocated to the partners pursuant to sections 704(b) and 704(c) if the qualified property were sold in a hypothetical transaction for cash equal to the fair market value of the qualified property. In the case of qualified property of an S corporation that does not produce tax depreciation during the year, each shareholder's share of the UBIA of the qualified property is a share of the UBIA proportionate to the ratio of shares in the S corporation held by the shareholder over the total shares of the S corporation.

However, the final regulations change several aspects, as the preamble summarizes in the section explaining economic impact:[895]

> Relative to the proposed 199A regulations, the final regulations make several changes in the determination of UBIA of qualified property. In particular, proposed § 1.199A-2 adjusted UBIA for (i) qualified property contributed to a partnership or S corporation in a nonrecognition transaction, (ii) like-kind exchanges, or (iii) involuntary conversions. Upon review of comments received addressing these rules, the Treasury Department and the IRS have amended these rules in the final regulations such that UBIA of qualified property generally remains unadjusted as a result of these three types of transactions. As several commenters pointed out, the proposed regulations would have introduced distortions into the economic incentives for businesses to invest or earn income. In cases where UBIA would have been reduced following a nonrecognition transfer under the proposed regulations, the treatment under the proposed regulations would have discouraged such transactions by introducing a financial cost (in the form of a reduced 199A deduction) where no resource cost exists. An analogous distortion exists for the other two types of transactions. Such distortions are economically inefficient.
>
> To avoid such distortion, the final regulations establish that qualified property contributed to a partnership or S corporation in a nonrecognition transaction generally retains its UBIA on the date it was first placed in service by the contributing partner or shareholder. Similar rules are adopted for the other two transaction forms mentioned above. In particular, the final regulations provide that the UBIA of qualified property received in a section 1031 like-kind exchange is generally the UBIA of the relinquished property. The rule is the same for qualified property acquired pursuant to an involuntary conversion under section 1033.

The preamble to the final regulations explains:[896]

> **1. Qualified Property Held by an RPE**
>
> The proposed regulations provide that in the case of qualified property held by an RPE, each partner's or shareholder's share of the UBIA of qualified property is an amount that bears the same proportion to the total UBIA of qualified property as the partner's or shareholder's share of tax depreciation bears to the RPE's total tax depreciation with respect to the property for the year. In the case of a partnership with qualified property that does not produce tax depreciation during the year, each partner's share of the UBIA of qualified property would be based on how gain would be allocated to the partners pursuant to sections 704(b) and 704(c) if the qualified property were sold in a hypothetical transaction for cash equal to the fair market value of the qualified property. Several commenters suggested that only section 704(b) should be used for this purpose, arguing that the use of section 704(c) allocation methods would be unduly burdensome and could lead to unintended results. One commenter recommended that partners should share UBIA of qualified property in the same manner that they share the economic depreciation of the property. Another commenter suggested allocating UBIA based on a ratio of each partner's allocation of depreciation and the partnership's total

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[895] T.D. 9847 (2/8/2019), Special Analyses, part I, "Regulatory Planning and Review – Economic Analysis," subpart C, "Economic Analysis of Changes in Final Regulations," paragraph 1, "UBIA."
[896] T.D. 9847 (2/8/2019), part III.B, "UBIA."

depreciation of qualified property for the year. One commenter requested clarification regarding how UBIA is allocated when a partner or shareholder has depreciation expense as an ordinary deduction and as a rental real estate deduction and they are allocated differently.

The Treasury Department and the IRS agree with the commenters that relying on section 704(c) to allocate UBIA could lead to unintended shifts in the allocation of UBIA. Therefore, the final regulations provide that each partner's share of the UBIA of qualified property is determined in accordance with how depreciation would be allocated for section 704(b) book purposes under § 1.704-1(b)(2)(iv)(g) on the last day of the taxable year. To the extent a partner has depreciation expense as an ordinary deduction and as a rental real estate deduction, the allocation of the UBIA should match the allocation of the expenses. The Treasury Department and the IRS request comments on whether a new regime is necessary in the case of a partnership with qualified property that does not produce tax depreciation during the taxable year. In the case of qualified property held by an S corporation, each shareholder's share of UBIA of qualified property is a share of the unadjusted basis proportionate to the ratio of shares in the S corporation held by the shareholder on the last day of the taxable year over the total issued and outstanding shares of the S corporation.

2. Property Contributed to a Partnership or S Corporation in a Nonrecognition Transfer

The proposed regulations provide that the UBIA of qualified property means the basis on the placed in service date of the property. Therefore, the UBIA of qualified property contributed to a partnership in a section 721 transaction generally equals the partnership's tax basis under section 723 rather than the contributing partner's original UBIA of the property. Similarly, the UBIA of qualified property contributed to an S corporation in a section 351 transaction is determined by reference to section 362. Multiple commenters expressed concern that this treatment could result in a step-down in the UBIA of qualified property used in a trade or business at the time of the contribution due only to the change in entity structure. These commenters suggested that the UBIA of qualified property contributed to a partnership under section 721 or to an S corporation under section 351 should be determined as of the date it was first placed in service by the contributing partner or shareholder. Another commenter suggested that final regulations should generally provide for carryover of UBIA of qualified property in non-recognition transactions, but provide an anti-abuse rule for cases in which a transaction was engaged in with a principal purpose of increasing the Section 199A deduction.

The Treasury Department and the IRS agree that qualified property contributed to a partnership or S corporation in a nonrecognition transaction should generally retain its UBIA on the date it was first placed in service by the contributing partner or shareholder. Accordingly, § 1.199A-2(c)(3)(iv) provides that, solely for the purposes of Section 199A, if qualified property is acquired in a transaction described in section 168(i)(7)(B), the transferee's UBIA in the qualified property is the same as the transferor's UBIA in the property, decreased by the amount of money received by the transferor in the transaction or increased by the amount of money paid by the transferee to acquire the property in the transaction.

The rules set forth in these regulations are limited solely to the determination of UBIA of qualified property for purposes of Section 199A and are not applicable to the determination of gain, loss, basis, or depreciation with respect to transactions described in section 168(i)(7).

3. Property Received in a Section 1031 Like-Kind Exchange or Section 1033 Involuntary Conversion

Section 1.199A-2(c)(3) of the proposed regulations explains that UBIA of qualified property means the basis of qualified property on the placed in service date of the property as determined under applicable sections of chapter 1 of subtitle A of the Code, which includes sections 1012 (Basis of property-cost), 1031 (Exchange of real property held for productive use or investment), and 1033 (Involuntary conversions).
Section 1.199A-2(c)(3) of the proposed regulations also explains that UBIA of qualified property is determined without regard to any adjustments for depreciation described in section 1016(a)(2) or (3). Example 2 to proposed § 1.199A-2(c)(4) illustrates that the UBIA of qualified property received in a section 1031 like-kind exchange is the adjusted basis of the relinquished property transferred in the exchange as determined under section 1031(d), which reflects the adjustment in basis for depreciation deductions previously taken under section 168.

Several commenters argued that the proposed regulations discourage like-kind exchanges by providing an incentive to retain property in order to maintain greater UBIA of qualified property. These commenters argue that the UBIA of replacement qualified property should be the taxpayer’s UBIA of the relinquished property on the placed in service date by the taxpayer, increased by any additional capital invested by the taxpayer to acquire the replacement property, rather than the adjusted basis of the replacement property at the time of the exchange as determined under section 1031(d). This would be consistent with the step-in-the-shoes rule for determining the depreciable period. Another commenter suggested that if the rule is retained, the provision should be revised to treat the placed in service date as the date of the exchange.

Section 1.1002-1(c) of the Income Tax Regulations generally describes nonrecognition sections, including section 1031, as “exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal that substantial,” so that recognition and income inclusion at that time of the exchange are not appropriate. The underlying assumption of these exceptions to the recognition requirement is that the new property is substantially a continuation of the old investment still unliquidated; and in the case of reorganization, that the new enterprise, the new corporate structure, and the new property are substantially a continuation of the old still unliquidated investment. *Id.*

Application of section 1031(d) in determining UBIA for the replacement property would require, among other possible adjustments, a downward adjustment for depreciation deductions. This approach is contrary to the rule in § 1.199A-2(c)(3) of the proposed regulations that UBIA of qualified property is determined without regard to any adjustments for depreciation described in section 1016(a)(2) or (3).

Accordingly, the final regulations provide that the UBIA of qualified like-kind property that a taxpayer receives in a section 1031 like-kind exchange is the UBIA of the relinquished property. However, if a taxpayer either receives money or property not of a like kind to the relinquished property (other property) or provides money or other property as part of the exchange, the taxpayer's UBIA in the replacement property is adjusted. The taxpayer's UBIA in the replacement property is adjusted downward by the excess of any money or the fair market value of other property received by the taxpayer in the exchange over the taxpayer's appreciation in the relinquished property (excess boot). Appreciation for this purpose is the excess of the relinquished property's fair market value on the date of the exchange over the fair market value of the relinquished property on the date of acquisition by the taxpayer. This reduction for excess boot in the taxpayer's UBIA in the replacement property reflects a partial liquidation of the taxpayer's investment in qualified property.

If the taxpayer adds money or other property to acquire replacement property, the taxpayer's UBIA in the replacement property is adjusted upward by the amount of money paid or the fair market value of the other property transferred to reflect additional taxpayer investment.

If the taxpayer receives other property in the exchange that is qualified property, the taxpayer's UBIA in the qualified other property will equal the fair market value of the other property. Consequently, a taxpayer who receives qualified other property in the exchange is treated, for UBIA purposes, as if the taxpayer receives cash in the exchange and uses that cash to purchase the qualified property.

The rules are similar for qualified property acquired pursuant to an involuntary conversion under section 1033, except that appreciation for this purpose is the difference between the fair market value of the converted property on the date of the conversion over the fair market value of the converted property on the date of acquisition by the taxpayer. In addition, other property is property not similar or related in service or use to the converted property.

The rules set forth in these final regulations are limited solely to the determination of UBIA of qualified property for purposes of Section 199A and are not applicable to the determination of gain, loss, basis, or depreciation with respect to transactions governed by sections 1031 or 1033.

In determining the depreciable period of replacement property acquired in a like-kind exchange or in an involuntary conversion, the proposed regulations apply § 1.168(i)-6 which, in turn, follows the rules in section 1031(d) or 1033(b), as applicable. Because the final regulations do not determine the UBIA of replacement property under section 1031(d) or 1033(b), the final regulations correspondingly remove the indirect references to those rules for determining the depreciable period of replacement property. To be consistent with the rules regarding the UBIA of replacement property that is of like kind to the relinquished property or that is similar or related in service or use to the involuntarily converted property, the final regulations provide that (i) for the portion of the individual's or RPE's UBIA in the replacement property that does not exceed the individual's or RPE's UBIA in the relinquished property or involuntarily converted property, the date such portion in the replacement property was first placed in service by the individual or RPE is the date on which the relinquished property or involuntarily converted property was first placed in service by the individual or RPE, and (ii) for the portion of the individual's or RPE's UBIA in the replacement property that exceeds the individual's or RPE's UBIA in the relinquished property or involuntarily converted property, such portion in the replacement property is treated as separate qualified property that the individual or RPE first placed in service on the date on which the replacement property was first placed in service by the individual or RPE. This rule is not a change from the proposed regulations, but is consistent with the step-in-the-shoes rationale for determining the depreciable period for certain non-recognition transactions described in section 168(i)(7)(B).

In addition, the final regulations provide that when qualified property that is not of like kind to the relinquished property or qualified property that is not similar or related in service or use to involuntarily converted property is received in a section 1031 or 1033 transaction, such qualified property is treated as separate qualified property that the individual or RPE first placed in service on the date on which such qualified property was first placed in service by the individual or RPE. This rule is consistent with the rules regarding the UBIA of such qualified property.

The rules set forth in these final regulations are limited solely to the determination of the depreciable period for purposes of Section 199A and are not applicable to the determination of the placed in service date for depreciation or tax credit purposes.

4. Sections 734(b) and 743(b) Special Basis Adjustments

The proposed regulations provide that basis adjustments under sections 734(b) and 743(b) are not treated as qualified property. The preamble to the proposed regulations describes concerns about inappropriate duplication of the UBIA of qualified property in circumstances such as when the fair market value of property has not increased and its depreciable period has not ended. Several commenters agreed that special basis adjustments could result in the duplication of UBIA of qualified property to the extent that the fair market value of the qualified property does not exceed UBIA. However, many of these commenters suggested that basis adjustments under section 734(b) and 743(b) should be treated as qualified property to the extent that the fair market value of the qualified property to which the adjustments relate exceeds the UBIA of such property immediately before the special basis adjustment. Other commenters recommended that both section 734(b) and section 743(b) adjustments should generate new UBIA. Commenters suggested a variety of methods for adjusting UBIA to account for the special basis adjustments. These included incorporating existing principles of sections 734(b), 743(b), 754, and 755 by determining the UBIA of separate qualified property by reference to the difference between the transferee partner's outside basis and its share of UBIA; treating the entire amount of the section 743(b) adjustment as separate qualified property with a new depreciation period, with adjustments to the partner's share of the partnership's UBIA to avoid duplicating UBIA; and creating an entirely new regime mirroring the principles of sections 734(b), 743(b), 754, and 755.

The Treasury Department and the IRS agree that section 743(b) basis adjustments should be treated as qualified property to extent the section 743(b) basis adjustment reflects an increase in the fair market value of the underlying qualified property. Accordingly, the final regulations define an "excess section 743(b) basis adjustment" as an amount that is determined with respect to each item of qualified property and is equal to an amount that would represent the partner's section 743(b) basis adjustment with respect to the property, as determined under § 1.743-1(b) and § 1.755-1, but calculated as if the adjusted basis of all of the partnership's property was equal to the UBIA of such property. The absolute value of the excess section 743(b) basis adjustment cannot exceed the absolute value of the total section 743(b) basis adjustment with respect to qualified property. The excess section 743(b) basis adjustment is treated as a separate item of qualified property placed in service when the transfer of the partnership interest occurs. This rule is limited solely to the determination of the depreciable period for purposes of Section 199A and is not applicable to the determination of the placed in service date for depreciation or tax credit purposes. The recovery period for such property is determined under § 1.743-1(j)(4)(i)(B) with respect to positive basis adjustments and § 1.743-1(j)(4)(ii)(B) with respect to negative basis adjustments.

The Treasury Department and the IRS do not believe that a section 734(b) adjustment is an acquisition of qualified property for purposes of determining UBIA. Section 734(b)(1) provides that, in the case of a distribution of property to a partner with respect to which a section 754 election is in effect (or when there is a substantial basis reduction under section 734(d)), the partnership will increase the adjusted basis of partnership property by the sum of (A) the amount of any gain recognized to the distributee partner under section 731(a)(1), and (B) in the case of distributed property to which section 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by section 732(d)) over the basis of the distributed property to the distributee, as determined under section 732. The Treasury Department and the IRS do not believe that the adjustment to basis is an acquisition for purposes of Section 199A.

Commenters also noted that the failure to adjust UBIA for reduction of basis under section 734 could result in a duplication of UBIA if property is distributed in liquidation of a partner's interest in a partnership and the partner takes that property with the partner's outside basis under section 732(b) without the partnership adjusting the UBIA in the partnership's remaining assets. The Treasury Department and the IRS agree that such a duplication is inappropriate, but do not agree with commenters that such a distribution results in an increase in UBIA. These regulations provide that the partnership's UBIA in the qualified property carries over to a partner that receives a distribution of the qualified property.

The Treasury Department and the IRS continue to study this issue and request additional comments on the interaction of the special basis adjustments under sections 734(b) and 743(b) with Section 199A and whether a new regime for calculating adjustments with respect to UBIA is necessary.

5. Qualified Property Held by a Trade or Business at the Close of the Taxable Year

Section 199A(b)(6)(A)(i) and proposed § 1.199A-2(c) provide that qualified property must be held by, and available for use in, the qualified trade or business at the close of the taxable year. One commenter suggested the final regulations contain a rule for determining the UBIA of qualified property in a short year on acquisition or disposition of a trade or business, similar to the guidance provided in § 1.199A-2(b)(2)(v) for purposes of calculating W-2 wages. The commenter suggested that one approach for UBIA could be a pro rata calculation based on the number of days the qualified property is held during the year. The Treasury Department and the IRS decline to adopt this suggestion because the statute looks to qualified property held at the close of the taxable year.

Another commenter asked for additional guidance on this rule with respect to qualified property held by an RPE. The commenter questioned whether the applicable taxable year is that of the taxpayer or the RPE. The commenter also asked how the rule would be applied if a taxpayer transferred his or her interest in an RPE. The Treasury Department and the IRS believe that the UBIA of qualified property is measured at the trade or business level. Accordingly, in the case of qualified property held by an RPE, the applicable taxable year is that of the RPE. A taxpayer who transfers an interest in an RPE prior to the close of the RPE's taxable year is not entitled to a share of UBIA from the RPE.

In the context of S corporations, one commenter noted that section 1377(a) provides that income for the taxable year is allocated among shareholders on a pro rata basis by assigning a pro rata share of each corporate item to each day of the taxable year. The commenter suggested that all shareholders who were owners during the taxable year should be given access to the UBIA of qualified property held by an S corporation at the close of the S corporation's taxable year. The Treasury Department and the IRS decline to adopt this comment because Section 199A does not have a rule comparable to the rule in section 1377(a).

The proposed regulations provide that property is not qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the Section 199A deduction. The Treasury Department and the IRS received no comments with respect to this rule. The final regulations retain the rule but clarify that the 120 day period begins with the acquisition of the property.

6. Qualified Property Acquired from a Decedent

The preamble to the proposed regulations provides that for property acquired from a decedent and immediately placed in service, the UBIA generally will be its fair market value at the time of the decedent's death under section 1014. One commenter recommended that the regulations should clearly state this rule in the regulatory text. The commenter recommended that the regulations should further clarify that the date of the decedent's death should commence a new depreciable period for the property. The Treasury Department and the IRS adopt these comments. The final regulations provide that for qualified property acquired from a decedent and immediately placed in service, the UBIA of the property will generally be the fair market value at the date of the decedent's death under section 1014. Further, the regulations provide that a new depreciable period for the property commences as of the date of the decedent's death.

Getting into the Code and Regulations themselves:

"Qualified property" means, with respect to any QBI for a taxable year, tangible property of a character subject to the allowance for depreciation under Code § 167:[897]

[897] Code § 199A(b)(6)(A).

(i) which is held by, and available for use in, the qualified trade or business at the close of the taxable year,

(ii) which is used at any point during the taxable year in the production of qualified business income, and

(iii) the depreciable period for which has not ended before the close of the taxable year.

Reg. § 1.199A-2(c)(1), "Qualified property," provides:

(ii) *In general*. The term qualified property means, with respect to any trade or business (or aggregated trade or business) of an individual or RPE for a taxable year, tangible property of a character subject to the allowance for depreciation under section 167(a) -

(A) Which is held by, and available for use in, the trade or business (or aggregated trade or business) at the close of the taxable year,

(B) Which is used at any point during the taxable year in the trade or business's (or aggregated trade or business's) production of QBI, and

(C) The depreciable period for which has not ended before the close of the individual's or RPE's taxable year.

(ii) *Improvements to qualified property*. In the case of any addition to, or improvement of, qualified property that has already been placed in service by the individual or RPE, such addition or improvement is treated as separate qualified property first placed in service on the date such addition or improvement is placed in service for purposes of paragraph (c)(2) of this section.

(iii) *Adjustments under sections 734(b) and 743(b)*. Excess section 743(b) basis adjustments as defined in paragraph (a)(3)(iv)(B) of this section are treated as qualified property. Otherwise, basis adjustments under sections 734(b) and 743(b) are not treated as qualified property.

(iv) *Property acquired at end of year*. Property is not qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days of acquisition without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the Section 199A deduction.

A unique aspect of partnerships is the opportunity to change the basis of the partnership's assets ("inside basis") to reflect the basis of one's partnership interest ("outside basis"). See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations. A partner's death and the sale of a partnership interest are among the events that trigger this opportunity. The proposed regulations would not have applied an inside basis adjustment to UBIA, but the final regulations do. However, as the preamble mentions above, this applies only to a transfer of a partnership interest that triggers a Code § 743(b) basis adjustment and not to a distribution of property that triggers a Code § 743(b) basis adjustment.

The proposed regulations expressed concern about UBIA. My example is a property with an original purchase price and current value of $100,000, accumulated depreciation of $40,000, and therefore an adjusted basis of $60,000 ($100,000 minus $40,000). Under the rules of part II.Q.8.e.iii, if all of the partnership interests were transferred for $100,000 in a taxable exchange then a $40,000 basis adjustment would be needed to match the inside basis ($60,000) to the outside basis ($100,000). However, the property's $100,000 UBIA already matches outside basis. Adjusting UBIA by the $40,000 basis adjustment would generate total UBIA of $140,000, which would be too much.

Suppose the above example were modified to have a $125,000 value at the time of the transfer. The property's basis adjustment would be $65,000 – the excess of $125,000 value over the $65,000 inside basis. The UBIA adjustment would be $25,000 – the excess of $125,000 value over $100,000 UBIA.

With these ideas in mind, let's read Reg. § 1.199A-2(a)(3)(iv), "UBIA and section 743(b) basis adjustments," which provides:

(A) *In general*. A partner will be allowed to take into account UBIA with respect to an item of qualified property in addition to the amount of UBIA with respect to such qualified property determined under paragraphs (a)(3)(i) and (c) of this section and allocated to such partner under paragraph (a)(3)(ii) of this section to the extent of the partner's excess section 743(b) basis adjustment with respect to such item of qualified property.

(B) *Excess section 743(b) basis adjustments*. A partner's *excess section 743(b) basis adjustment* is an amount that is determined with respect to each item of qualified property and is equal to an amount that would represent the partner's section 743(b) basis adjustment with respect to the same item of qualified property, as determined under §§ 1.743-1(b) and 1.755-1, but calculated as if the adjusted basis of all of the partnership's property was equal to the UBIA of such property. The absolute value of the excess section 743(b) basis adjustment cannot exceed the absolute value of the total section 743(b) basis adjustment with respect to qualified property.

(C) *Computation of partner's share of UBIA with excess section 743(b) basis adjustments*. The partnership first computes its UBIA with respect to qualified property under paragraphs (a)(3)(i) and (c) of this section and allocates such UBIA under paragraph (a)(3)(ii) of this section. If the sum of the excess section 743(b) basis adjustment for all of the items of qualified property is a negative number, that amount will be subtracted from the partner's UBIA of qualified property determined under paragraphs (a)(3)(i) and (c) of this section and allocated under paragraph (a)(3)(ii) of this section. A partner's UBIA of qualified property may not be below $0. Excess section 743(b) basis adjustments are computed with respect to all section 743(b) adjustments, including adjustments made as a result of a substantial built-in loss under section 743(d).

(D) *Examples*. The provisions of this paragraph (a)(3)(iv) are illustrated by the following examples:

(1) *Example 1*.

(i) *Facts*. A, B, and C are equal partners in partnership, PRS. PRS has a single trade or business that generates QBI. PRS has no liabilities and only one asset, a single item of qualified property with a UBIA equal to $900,000. Each partner's share of the UBIA is $300,000.

(ii)[898] A sells its one-third interest in PRS to T for $350,000 when a section 754 election is in effect. At the time of the sale, the tax basis of the qualified property held by PRS is $750,000. The amount of gain that would be allocated to T from a hypothetical transaction under § 1.743-1(d)(2) is $100,000. Thus, T's interest in PRS's previously taxed capital is equal to $250,000 ($350,000, the amount of cash T would receive if PRS liquidated immediately after the hypothetical transaction, decreased by $100,000, T's share of gain from the hypothetical transaction). The amount of T's section 743(b) basis adjustment to PRS's qualified property is $100,000 (the excess of $350,000, T's cost basis for its interest, over $250,000, T's share of the adjusted basis to PRS of the partnership's property).

(iii) *Analysis*. In order for T to determine its UBIA, T must calculate its excess section 743(b) basis adjustment. T's excess section 743(b) basis adjustment is equal to an amount that would represent T's section 743(b) basis adjustment with respect to the same item of qualified property, as determined under §§ 1.743-1(b) and 1.755-1, but calculated as if the adjusted basis of all of PRS's property was equal to the UBIA of such property. T's section 743(b) basis adjustment calculated as if adjusted basis of the qualified property were equal to its UBIA is $50,000 (the excess of $350,000, T's cost basis for its interest, over $300,000, T's share of the adjusted basis to PRS of the partnership's property). Thus, T's excess section 743(b) basis adjustment is equal to $50,000. For purposes of applying the UBIA limitation to T's share of QBI from PRS's trade or business, T's UBIA is equal to $350,000 ($300,000, T's one-third share of the qualified property's UBIA, plus $50,000, T's excess section 743(b) basis adjustment).

(2) *Example 2*.

(i) *Facts*. Assume the same facts as in *Example 1* of paragraph (a)(3)(iv)(D)(1) of this section, except that A sells its one-third interest in PRS to T for $200,000 when a section 754 election is in effect. At the time of the sale, the tax basis of the qualified property held by PRS is $750,000, and the amount of loss that would be allocated to T from a hypothetical transaction under § 1.743-1(d)(2) is $50,000. Thus, T's interest in PRS's previously taxed capital is equal to $250,000 ($200,000, the amount of cash T would receive if PRS liquidated immediately after the hypothetical transaction, increased by $50,000, T's share of loss from the hypothetical transaction). The amount of T's section 743(b) basis adjustment to PRS's qualified property is negative

[898] The "(ii)" prefix here was included in the regulations the IRS submitted but not included in the Federal Register. Everything following that prefix was in both versions. I retained this prefix given that the "(iii)" prefix was retained.

$50,000 (the excess of $250,000, T's share of the adjusted basis to PRS of the partnership's property, over $200,000, T's cost basis for its interest).

(ii) *Analysis*. In order for T to determine its UBIA, T must calculate its excess section 743(b) basis adjustment. T's excess section 743(b) basis adjustment is equal to an amount that would represent T's section 743(b) basis adjustment with respect to the same item of qualified property, as determined under §§ 1.743-1(b) and 1.755-1, but calculated as if the adjusted basis of all of PRS's property was equal to the UBIA of such property. T's section 743(b) basis adjustment calculated as if adjusted basis of the qualified property were equal to its UBIA is negative $100,000 (the excess of $300,000, T's share of the adjusted basis to PRS of the partnership's property, over $200,000, T's cost basis for its interest). T's excess section 743(b) basis adjustment to the qualified property is limited to the amount of T's section 743(b) basis adjustment of negative $50,000. Thus, T's excess section 743(b) basis adjustment is equal to negative $50,000. For purposes of applying the UBIA limitation to T's share of QBI from PRS's trade or business, T's UBIA is equal to $250,000 ($300,000, T's one-third share of the qualified property's UBIA, reduced by T's negative $50,000 excess section 743(b) basis adjustment).

Note that the test for qualified property refers to "unadjusted basis," so it does not take into account depreciation deductions or any other basis reductions, such as bonus depreciation deductions.[899] Also note that land is not "qualified property" except to the extent of depreciable land improvements.

Reg. § 1.199A-2(c)(3), "Unadjusted basis immediately after acquisition," provides:

(i) *In general*. Except as provided in paragraphs (c)(3)(ii) through (v) of this section, the term *unadjusted basis immediately after acquisition* (UBIA) means the basis on the placed in service date of the property as determined under section 1012 or other applicable sections of chapter 1 of the Code, including the provisions of subchapters O (relating to gain or loss on dispositions of property), C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). UBIA is determined without regard to any adjustments described in section 1016(a)(2) or (3), to any adjustments for tax credits claimed by the individual or RPE (for example, under section 50(c)), or to any adjustments for any portion of the basis which the individual or RPE has elected to treat as an expense (for example, under sections 179, 179B, or 179C). However, UBIA does reflect the reduction in basis for the percentage of the individual's or RPE's use of property for the taxable year other than in the trade or business.

(ii) *Qualified property acquired in a like-kind exchange* –

(A) *In general*. Solely for purposes of this section, if property that is qualified property (replacement property) is acquired in a like-kind exchange that qualifies for deferral of gain or loss under section 1031, then the UBIA of such property is the same as the UBIA of the qualified property exchanged (relinquished property), decreased by excess boot or increased by the amount of money paid

[899] See part II.G.5 Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation. Code § 179 expense is not available to nongrantor trusts.

or the fair market value of property not of a like kind to the relinquished property (other property) transferred by the taxpayer to acquire the replacement property. If the taxpayer acquires more than one piece of qualified property as replacement property that is of a like kind to the relinquished property in an exchange described in section 1031, UBIA is apportioned between or among the qualified replacement properties in proportion to their relative fair market values. Other property received by the taxpayer in a section 1031 transaction that is qualified property has a UBIA equal to the fair market value of such other property.

(B) *Excess boot*. For purposes of paragraph (c)(3)(ii)(A) of this section, excess boot is the amount of any money or the fair market value of other property received by the taxpayer in the exchange over the amount of appreciation in the relinquished property. Appreciation for this purpose is the excess of the fair market value of the relinquished property on the date of the exchange over the fair market value of the relinquished property on the date of the acquisition by the taxpayer.

(iii) *Qualified property acquired pursuant to an involuntary conversion* –

(A) *In general*. Solely for purposes of this section, if qualified property is compulsorily or involuntarily converted (converted property) within the meaning of section 1033 and qualified replacement property is acquired in a transaction that qualifies for deferral of gain under section 1033, then the UBIA of the replacement property is the same as the UBIA of the converted property, decreased by excess boot or increased by the amount of money paid or the fair market value of property not similar or related in service or use to the converted property (other property) transferred by the taxpayer to acquire the replacement property. If the taxpayer acquires more than one piece of qualified replacement property that meets the similar or related in service or use requirements in section 1033, UBIA is apportioned between the qualified replacement properties in proportion to their relative fair market values. Other property acquired by the taxpayer with the proceeds of an involuntary conversion that is qualified property has a UBIA equal to the fair market value of such other property.

(B) *Excess boot*. For purposes of paragraph (c)(3)(iii)(A) of this section, *excess boot* is the amount of any money or the fair market value of other property received by the taxpayer in the conversion over the amount of appreciation in the converted property. Appreciation for this purpose is the excess of the fair market value of the converted property on the date of the conversion over the fair market value of the converted property on the date of the acquisition by the taxpayer.

(iv) *Qualified property acquired in transactions described in section 168(i)(7)(B)*. Solely for purposes of this section, if qualified property is acquired in a transaction described in section 168(i)(7)(B) (pertaining to treatment of transferees in certain nonrecognition transactions), the transferee's UBIA in the qualified property shall be the same as the transferor's UBIA in the property, decreased by the amount of money received by the transferor in the transaction or increased by the amount of money paid by the transferee to acquire the property in the transaction.

(v) *Qualified property acquired from a decedent*. In the case of qualified property acquired from a decedent and immediately placed in service, the UBIA of the property will generally be the fair market value at the date of the decedent's death under section 1014. See section 1014 and the regulations thereunder. Solely for purposes of paragraph (c)(2)(i) of this section, a new depreciable period for the property commences as of the date of the decedent's death.

(vi) *Property acquired in a nonrecognition transaction with principal purpose of increasing UBIA*. If qualified property is acquired in a transaction described in section 1031, 1033, or 168(i)(7) with the principal purpose of increasing the UBIA of the qualified property, the UBIA of the acquired qualified property is its basis as determined under relevant Code sections and not under the rules described in paragraphs (c)(3)(i) through (iv) of this section. For example, in a section 1031 transaction undertaken with the principal purpose of increasing the UBIA of the replacement property, the UBIA of the replacement property is its basis as determined under section 1031(d).

Code § 1016(a)(2), (3) is the basis adjustment for accumulated depreciation.

Code § 168(i)(7)(B) refers to Code §§ 332 (parent corporation not recognizing gain on liquidation of a subsidiary), 351 (no gain or loss on contribution of property to a controlled corporation in exchange for stock in that corporation),[900] 721 (no gain or loss on contribution of property to a partnership in exchange for a partnership interest),[901] and 731 (no gain or loss on distribution of property from a partnership).[902]

The "depreciable period" means the period beginning on the date the taxpayer first placed the property in service and ending on the later of the tenth anniversary of being placed in service or the last day of the last full year in the applicable recovery period under Code § 168 (the current depreciation rules).[903] The IRS must:[904]

(1) apply rules similar to the rules under section 179(d)(2) in order to prevent the manipulation of the depreciable period of qualified property using transactions between related parties, and

(2) prescribe rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions.

Reg. § 1.199A-2(c)(2), "Depreciable period," provides:

(i) *In general*. The term *depreciable period* means, with respect to qualified property of a trade or business, the period beginning on the date the property was first placed in service by the individual or RPE and ending on the later of -

(A) The date that is 10 years after such date, or

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[900] See part § II.M.2 Buying into or Forming a Corporation.
[901] See part II.M.3 Buying into or Forming a Partnership.
[902] See part II.Q.8.b.i Distribution of Property by a Partnership.
[903] Code § 199A(b)(6)(B), which also provides that Code § 168(g), under which an extended depreciable life is required or permitted to be elected, does not apply in determining the property's depreciable life.
[904] Code § 199A(h).

(B) The last day of the last full year in the applicable recovery period that would apply to the property under section 168(c), regardless of any application of section 168(g).

(ii) *Additional first-year depreciation under section 168*. The additional first-year depreciation deduction allowable under section 168 (for example, under section 168(k) or (m)) does not affect the applicable recovery period under this paragraph for the qualified property.

(iii) *Qualified property acquired in transactions subject to section 1031 or section 1033*. Solely for purposes of paragraph (c)(2)(i) of this section, the following rules apply to qualified property acquired in a like-kind exchange or in an involuntary conversion (replacement property).

(A) *Replacement property received in a section 1031 or 1033 transaction*. The date on which replacement property that is of like-kind to relinquished property or is similar or related in service or use to involuntarily converted property was first placed in service by the individual or RPE is determined as follows -

(1) For the portion of the individual's or RPE's UBIA, as defined in paragraph (c)(3) of this section, in such replacement property that does not exceed the individual's or RPE's UBIA in the relinquished property or involuntarily converted property, the date such portion in the replacement property was first placed in service by the individual or RPE is the date on which the relinquished property or involuntarily converted property was first placed in service by the individual or RPE; and

(2) For the portion of the individual's or RPE's UBIA, as defined in paragraph (c)(3) of this section, in such replacement property that exceeds the individual's or RPE's UBIA in the relinquished property or involuntarily converted property, such portion in the replacement property is treated as separate qualified property that the individual or RPE first placed in service on the date on which the replacement property was first placed in service by the individual or RPE.

(B) *Other property received in a section 1031 or 1033 transaction*. Other property, as defined in paragraph (c)(3)(ii) or (iii) of this section, that is qualified property is treated as separate qualified property that the individual or RPE first placed in service on the date on which such other property was first placed in service by the individual or RPE.

(iv) *Qualified property acquired in transactions subject to section 168(i)(7)*. If an individual or RPE acquires qualified property in a transaction described in section 168(i)(7)(B) (pertaining to treatment of transferees in certain nonrecognition transactions), the individual or RPE must determine the date on which the qualified property was first placed in service solely for purposes of paragraph (c)(2)(i) of this section as follows -

(A) For the portion of the transferee's UBIA in the qualified property that does not exceed the transferor's UBIA in such property, the date such portion was first placed in service by the transferee is the date on which the transferor first placed the qualified property in service; and

(B) For the portion of the transferee's UBIA in the qualified property that exceeds the transferor's UBIA in such property, such portion is treated as separate qualified property that the transferee first placed in service on the date of the transfer.

(iv) *Excess section 743(b) basis adjustment*. Solely for purposes of paragraph (c)(2)(i) of this section, an excess section 743(b) basis adjustment with respect to an item of partnership property that is qualified property is treated as being placed in service when the transfer of the partnership interest occurs, and the recovery period for such property is determined under § 1.743-1(j)(4)(i)(B) with respect to positive basis adjustments and § 1.743-1(j)(4)(ii)(B) with respect to negative basis adjustments.

Reg. § 1.199A-2(c)(4) provides examples illustrating Reg. § 1.199A-2(c).

Reg. § 1.199A-2(c)(4)(i), Example (1), provides:

(A) On January 5, 2012, A purchases Real Property X for $1 million and places it in service in A's trade or business. A's trade or business is not an SSTB. A's basis in Real Property X under section 1012 is $1 million. Real Property X is qualified property within the meaning of Section 199A(b)(6). As of December 31, 2018, A's basis in Real Property X, as adjusted under section 1016(a)(2) for depreciation deductions under section 168(a), is $821,550.

(B) For purposes of Section 199A(b)(2)(B)(ii) and this section, A's UBIA of Real Property X is its $1 million cost basis under section 1012, regardless of any later depreciation deductions under section 168(a) and resulting basis adjustments under section 1016(a)(2).

Reg. § 1.199A-2(c)(4)(ii), Example (2), provides:

(A) The facts are the same as in *Example1* of paragraph (c)(4)(i) of this section, except that on January 15, 2019, A enters into a like-kind exchange under section 1031 in which A exchanges Real Property X for Real Property Y. Real Property Y has a value of $1 million. No cash or other property is involved in the exchange. As of January 15, 2019, A's basis in Real Property X, as adjusted under section 1016(a)(2) for depreciation deductions under section 168(a), is $820,482.

(B) A's UBIA in Real Property Y is $1 million as determined under paragraph (c)(3)(ii) of this section. Pursuant to paragraph (c)(2)(iii)(A) of this section, Real Property Y is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A.

Reg. § 1.199A-2(c)(4)(iii), Example (3), provides:

(A) The facts are the same as in *Example 1* of paragraph (c)(4)(i) of this section, except that on January 15, 2019, A enters into a like-kind exchange under section 1031, in which A exchanges Real Property X for Real Property Y. Real Property X has appreciated in value to $1.3 million, and Real Property Y also has a value of $1.3 million. No cash or other property is involved in the exchange. As of

January 15, 2019, A's basis in Real Property X, as adjusted under section 1016(a)(2), is $820,482.

(B) A's UBIA in Real Property Y is $1 million as determined under paragraph (c)(3)(ii) of this section. Pursuant to paragraph (c)(2)(iii)(A) of this section, Real Property Y is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A.

Reg. § 1.199A-2(c)(4)(iv), Example (4), provides:

(A) The facts are the same as in *Example 1* of paragraph (c)(4)(i) of this section, except that on January 15, 2019, A enters into a like-kind exchange under section 1031, in which A exchanges Real Property X for Real Property Y. Real Property X has appreciated in value to $1.3 million, but Real Property Y has a value of $1.5 million. A therefore adds $200,000 in cash to the exchange of Real Property X for Real Property Y. On January 15, 2019, A places Real Property Y in service. As of January 15, 2019, A's basis in Real Property X, as adjusted under section 1016(a)(2), is $820,482.

(B) A's UBIA in Real Property Y is $1.2 million as determined under paragraph (c)(3)(ii) of this section ($1 million in UBIA from Real Property X plus $200,000 cash paid by A to acquire Real Property Y). Because the UBIA of Real Property Y exceeds the UBIA of Real Property X, Real Property Y is treated as being two separate qualified properties for purposes of applying paragraph (c)(2)(iii)(A) of this section. One property has a UBIA of $1 million (the portion of A's UBIA of $1.2 million in Real Property Y that does not exceed A's UBIA of $1 million in Real Property X) and it is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A. The other property has a UBIA of $200,000 (the portion of A's UBIA of $1.2 million in Real Property Y that exceeds A's UBIA of $1 million in Real Property X) and it is first placed in service by A on January 15, 2019, which is the date on which Real Property Y was first placed in service by A.

Reg. § 1.199A-2(c)(4)(v), Example (5), provides:

(A) The facts are the same as in *Example 1* of paragraph (c)(4)(i) of this section, except that on January 15, 2019, A enters into a like-kind exchange under section 1031, in which A exchanges Real Property X for Real Property Y. Real Property X has appreciated in value to $1.3 million. Real Property Y has a fair market value of $1 million. As of January 15, 2019, A's basis in Real Property X, as adjusted under section 1016(a)(2), is $820,482. Pursuant to the exchange, A receives Real Property Y and $300,000 in cash.

(B) A's UBIA in Real Property Y is $1 million as determined under paragraph (c)(3)(ii) of this section ($1 million in UBIA from Real Property X, less $0 excess boot ($300,000 cash received in the exchange over $300,000 in appreciation in Property X, which is equal to the excess of the $1.3 million fair market value of Property X on the date of the exchange over $1 million fair market value of Property X on the date of acquisition by the taxpayer)). Pursuant to paragraph (c)(2)(iii)(A) of this section, Real Property Y is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A.

Reg. § 1.199A-2(c)(4)(vi), Example (6), provides:

(A) The facts are the same as in *Example 1* of paragraph (c)(4)(i) of this section, except that on January 15, 2019, A enters into a like-kind exchange under section 1031, in which A exchanges Real Property X for Real Property Y. Real Property X has appreciated in value to $1.3 million. Real Property Y has a fair market value of $900,000. Pursuant to the exchange, A receives Real Property Y and $400,000 in cash. As of January 15, 2019, A’s basis in Real Property X, as adjusted under section 1016(a)(2), is $820,482.

(B) A’s UBIA in Real Property Y is $900,000 as determined under paragraph (c)(3)(ii) of this section ($1 million in UBIA from Real Property X less $100,000 excess boot ($400,000 in cash received in the exchange over $300,000 in appreciation in Property X, which is equal to the excess of the $1.3 million fair market value of Property X on the date of the exchange over the $1 million fair market value of Property X on the date of acquisition by the taxpayer)). Pursuant to paragraph (c)(2)(iii)(A) of this section, Real Property Y is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A.

Reg. § 1.199A-2(c)(4)(vii), Example (7), provides:

(A) The facts are the same as in *Example 1* of paragraph (c)(4)(i) of this section, except that on January 15, 2019, A enters into a like-kind exchange under section 1031, in which A exchanges Real Property X for Real Property Y. Real Property X has declined in value to $900,000, and Real Property Y also has a value of $900,000. No cash or other property is involved in the exchange. As of January 15, 2019, A’s basis in Real Property X, as adjusted under section 1016(a)(2), is $820,482.

(B) Even though Real Property Y is worth only $900,000, A’s UBIA in Real Property Y is $1 million as determined under paragraph (c)(3)(ii) of this section because no cash or other property was involved in the exchange. Pursuant to paragraph (c)(2)(iii)(A) of this section, Real Property Y is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A.

Reg. § 1.199A-2(c)(4)(viii), Example (8), provides:

(A) C operates a trade or business that is not an SSTB as a sole proprietorship. On January 5, 2011, C purchases Machinery Y for $10,000 and places it in service in C’s trade or business. C’s basis in Machinery Y under section 1012 is $10,000. Machinery Y is qualified property within the meaning of Section 199A(b)(6). Assume that Machinery Y’s recovery period under section 168(c) is 10 years, and C depreciates Machinery Y under the general depreciation system by using the straight-line depreciation method, a 10-year recovery period, and the half-year convention. As of December 31, 2018, C’s basis in Machinery Y, as adjusted under section 1016(a)(2) for depreciation deductions under section 168(a), is $2,500. On January 1, 2019, C incorporates the sole proprietorship and elects to treat the newly formed entity as an S corporation for Federal income tax purposes. C contributes

Machinery Y and all other assets of the trade or business to the S corporation in a non-recognition transaction under section 351. The S corporation immediately places all the assets in service.

(B) For purposes of Section 199A(b)(2)(B)(ii) and this section, C's UBIA of Machinery Y from 2011 through 2018 is its $10,000 cost basis under section 1012, regardless of any later depreciation deductions under section 168(a) and resulting basis adjustments under section 1016(a)(2). The S corporation's basis of Machinery Y is $2,500, the basis of the property under section 362 at the time the S corporation places the property in service. Pursuant to paragraph (c)(3)(iv) of this section, S corporation's UBIA of Machinery Y is $10,000, which is C's UBIA of Machinery Y. Pursuant to paragraph (c)(2)(iv)(A) of this section, for purposes of determining the depreciable period of Machinery Y, the S corporation's placed in service date of Machinery Y will be January 5, 2011, which is the date C originally placed the property in service in 2011. Therefore, Machinery Y may be qualified property of the S corporation (assuming it continues to be used in the business) for 2019 and 2020 and will not be qualified property of the S corporation after 2020, because its depreciable period will have expired.

Reg. § 1.199A-2(c)(4)(ix), Example (9), provides:

(A) LLC, a partnership, operates a trade or business that is not an SSTB. On January 5, 2011, LLC purchases Machinery Z for $30,000 and places it in service in LLC's trade or business. LLC's basis in Machinery Z under section 1012 is $30,000. Machinery Z is qualified property within the meaning of Section 199A(b)(6). Assume that Machinery Z's recovery period under section 168(c) is 10 years, and LLC depreciates Machinery Z under the general depreciation system by using the straight-line depreciation method, a 10-year recovery period, and the half-year convention. As of December 31, 2018, LLC's basis in Machinery Z, as adjusted under section 1016(a)(2) for depreciation deductions under section 168(a), is $7,500. On January 1, 2019, LLC distributes Machinery Z to Partner A in full liquidation of Partner A's interest in LLC. Partner A's outside basis in LLC is $35,000.

(B) For purposes of Section 199A(b)(2)(B)(ii) and this section, LLC's UBIA of Machinery Z from 2011 through 2018 is its $30,000 cost basis under section 1012, regardless of any later depreciation deductions under section 168(a) and resulting basis adjustments under section 1016(a)(2). Prior to the distribution to Partner A, LLC's basis of Machinery Z is $7,500. Under section 732(b), Partner A's basis in Machinery Z is $35,000. Pursuant to paragraph (c)(3)(iv) of this section, upon distribution of Machinery Z, Partner A's UBIA of Machinery Z is $30,000, which was LLC's UBIA of Machinery Z.

II.E.1.c.vii. Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction

For some practical examples of the ideas this part discusses, see Masciantonio, "Limiting the impact of negative QBI," *Journal of Accountancy* pp. 46-52 (11/2020).

If the net amount of qualified income, gain, deduction, and loss with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, that amount is treated as a loss from a qualified trade or business in the succeeding taxable year.[905] The Senate's report states (note that the Conference Committee reduced the deduction from 23% to 20%):

> If the net amount of qualified business income from all qualified trades or businesses during the taxable year is a loss, it is carried forward as a loss from a qualified trade or business in the next taxable year. Similar to a qualified trade or business that has a qualified business loss for the current taxable year, any deduction allowed in a subsequent year is reduced (but not below zero) by 23 percent of any carryover qualified business loss. For example, Taxpayer has qualified business income of $20,000 from qualified business A and a qualified business loss of $50,000 from qualified business B in Year 1. Taxpayer is not permitted a deduction for Year 1 and has a carryover qualified business loss of $30,000 to Year 2. In Year 2, Taxpayer has qualified business income of $20,000 from qualified business A and qualified business income of $50,000 from qualified business B. To determine the deduction for Year 2, Taxpayer reduces the 23 percent deductible amount determined for the qualified business income of $70,000 from qualified businesses A and B by 23 percent of the $30,000 carryover qualified business loss.

For individuals with taxable income for the taxable year that does not exceed the threshold amount, Reg. § 1.199A-1(c)(2), "Carryover rules," provides:

> (i) *Negative total QBI amount*. If the total QBI amount is less than zero, the portion of the individual's Section 199A deduction related to QBI is zero for the taxable year. The negative total QBI amount is treated as negative QBI from a separate trade or business in the succeeding taxable years of the individual for purposes of Section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.
>
> (ii) *Negative combined qualified REIT dividends/qualified PTP income*. If the combined amount of REIT dividends and qualified PTP income is less than zero, the portion of the individual's Section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. The negative combined amount must be carried forward and used to offset the combined amount of REIT dividends and qualified PTP income in the succeeding taxable years of the individual for purposes of Section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

Reg. § 1.199A-1(d)(3)(iii), "Negative combined qualified REIT dividends/qualified PTP income," provides:

> If the combined amount of REIT dividends and qualified PTP income is less than zero, the portion of the individual's Section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. The negative combined amount must be carried forward and used to offset the combined amount of REIT dividends and qualified PTP income in the succeeding taxable years of the individual for purposes of Section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

[905] Code § 199A(c)(2).

Thus, losses from QBI are computed completely separately from losses from qualified PTP income that exceed qualified REIT dividends.

For individuals with taxable income for the taxable year that exceeds the threshold amount, Reg. § 1.199A-1(d)(2)(iii), "Netting and Carryover," provides:

> (A) *Netting*. If an individual's QBI from at least one trade or business (including an aggregated trade or business) is less than zero, the individual must offset the QBI attributable to each trade or business (or aggregated trade or business) that produced net positive QBI with the QBI from each trade or business (or aggregated trade or business) that produced net negative QBI in proportion to the relative amounts of net QBI in the trades or businesses (or aggregated trades or businesses) with positive QBI. The adjusted QBI is then used in paragraph (d)(2)(iv) of this section. The W-2 wages and UBIA of qualified property from the trades or businesses (including aggregated trades or businesses) that produced net negative QBI are not taken into account for purposes of this paragraph (d) and are not carried over to the subsequent year.
>
> (B) *Carryover of negative total QBI amount*. If an individual's QBI from all trades or businesses (including aggregated trades or businesses) combined is less than zero, the QBI component is zero for the taxable year. This negative amount is treated as negative QBI from a separate trade or business in the succeeding taxable years of the individual for purposes of Section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code. The W-2 wages and UBIA of qualified property from the trades or businesses (including aggregated trades or businesses) that produced net negative QBI are not taken into account for purposes of this paragraph (d) and are not carried over to the subsequent year.

Let's see how some examples apply these rules. Reg. § 1.199A-1(d)(4)(vii), Example (7), part (A) provides the facts on which the examples below are based:

> F, an unmarried individual, owns as a sole proprietor 100 percent of three trades or businesses, Business X, Business Y, and Business Z. None of the businesses hold qualified property. F does not aggregate the trades or businesses under § 1.199A-4. For taxable year 2018, Business X generates $1 million of QBI and pays $500,000 of W-2 wages with respect to the business. Business Y also generates $1 million of QBI but pays no wages. Business Z generates $2,000 of QBI and pays $500,000 of W-2 wages with respect to the business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F's taxable income is $2,722,000.

Reg. § 1.199A-1(d)(4)(ix) provides Example (9):

> (A) Assume the same facts as in *Example 7* of paragraph (d)(4)(vii) of this section, except that for taxable year 2018, Business Z generates a loss that results in ($600,000) of negative QBI and pays $500,000 of W-2 wages. After allowable deductions unrelated to the businesses, F's taxable income is $2,120,000. Because Business Z had negative QBI, F must offset the positive QBI from Business X and Business Y with the negative QBI from Business Z in proportion to the relative amounts of positive QBI from Business X and Business Y. Because Business X and

Business Y produced the same amount of positive QBI, the negative QBI from Business Z is apportioned equally among Business X and Business Y. Therefore, the adjusted QBI for each of Business X and Business Y is $700,000 ($1 million plus 50% of the negative QBI of $600,000). The adjusted QBI in Business Z is $0, because its negative QBI has been fully apportioned to Business X and Business Y.

(B) Because F's taxable income is above the threshold amount, the QBI component of F's Section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W-2 wage limitation must be calculated. For Business X, the lesser of 20% of QBI ($700,000*20% = $140,000) and 50% of W-2 wages ($500,000*50% = $250,000) is $140,000. Business Y pays no W-2 wages. The lesser of 20% of Business Y's QBI ($700,000*20% = $140,000) and 50% of its W-2 wages (zero) is zero.

(C) F must combine the amounts determined in paragraph (d)(4)(ix)(B) of this section and compare the sum to 20% of taxable income. F's Section 199A deduction equals the lesser of these two amounts. The combined amount from paragraph (d)(4)(ix)(B) of this section is $140,000 ($140,000 + zero) and 20% of F's taxable income is $424,000 ($2,120,000*20%). Thus, F's Section 199A deduction for 2018 is $140,000. There is no carryover of any loss into the following taxable year for purposes of Section 199A.

Business Z's wages are totally wasted from a Code § 199A view, because it has a loss and the wages cannot support a deduction. That's not much of a different result that Example (7), where Business Z has nominal income. Note also the way that the losses were apportioned from Business Z to Businesses X and Y according to their respective shares of QBI.

Reg. § 1.199A-1(d)(4)(x) provides Example (10):

(A) Assume the same facts as in *Example 9* of paragraph (d)(4)(ix) of this section, except that F aggregates Business X, Business Y, and Business Z under the rules of § 1.199A-4.

(B) Because F's taxable income is above the threshold amount, the QBI component of F's Section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. Because the businesses are aggregated, these limitations are applied on an aggregated basis. None of the businesses holds qualified property, therefore only the W-2 wage limitation must be calculated. F applies the limitation by determining the lesser of 20% of the QBI from the aggregated businesses ($1,400,000*20% = $280,000) and 50% of W-2 wages from the aggregated businesses ($1,000,000*50% = $500,000), or $280,000. F's Section 199A deduction is equal to the lesser of $280,000 and 20% of F's taxable income ($2,120,000*20% = $424,000). Thus, F's Section 199A deduction for 2018 is $280,000. There is no carryover of any loss into the following taxable year for purposes of Section 199A.

Example (10) shows the benefit of irrevocably electing to aggregate, as described in part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A. Although Example (10) has more wages than necessary to support the $280,000 deduction, aggregation enabled F to use most of wages that were wasted in Example (9).

Reg. § 1.199A-1(d)(4)(xi) provides Example (11):

(A) Assume the same facts as in *Example 7* of paragraph (d)(4)(vii) of this section, except that Business Z generates a loss that results in ($2,150,000) of negative QBI and pays $500,000 of W-2 wages with respect to the business in 2018. Thus, F has a negative combined QBI of ($150,000) when the QBI from all of the businesses are added together ($1 million plus $1 million minus the loss of ($2,150,000)). Because F has a negative combined QBI for 2018, F has no Section 199A deduction with respect to any trade or business for 2018. Instead, the negative combined QBI of ($150,000) carries forward and will be treated as negative QBI from a separate trade or business for purposes of computing the Section 199A deduction in the next taxable year. None of the W-2 wages carry forward. However, for income tax purposes, the $150,000 loss may offset F's $750,000 of wage income (assuming the loss is otherwise allowable under the Code).

(B) In taxable year 2019, Business X generates $200,000 of net QBI and pays $100,000 of W-2 wages with respect to the business. Business Y generates $150,000 of net QBI but pays no wages. Business Z generates a loss that results in ($120,000) of negative QBI and pays $500 of W-2 wages with respect to the business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F's taxable income is $960,000. Pursuant to paragraph (d)(2)(iii)(B) of this section, the ($150,000) of negative QBI from 2018 is treated as arising in 2019 from a separate trade or business. Thus, F has overall net QBI of $80,000 when all trades or businesses are taken together ($200,000) plus $150,000 minus $120,000 minus the carryover loss of $150,000). Because Business Z had negative QBI and F also has a negative QBI carryover amount, F must offset the positive QBI from Business X and Business Y with the negative QBI from Business Z and the carryover amount in proportion to the relative amounts of positive QBI from Business X and Business Y. Because Business X produced 57.14% of the total QBI from Business X and Business Y, 57.14% of the negative QBI from Business Z and the negative QBI carryforward must be apportioned to Business X, and the remaining 42.86% allocated to Business Y. Therefore, the adjusted QBI in Business X is $45,722 ($200,000 minus 57.14% of the loss from Business Z ($68,568), minus 57.14% of the carryover loss ($85,710). The adjusted QBI in Business Y is $34,278 ($150,000, minus 42.86% of the loss from Business Z ($51,432) minus 42.86% of the carryover loss ($64,290)). The adjusted QBI in Business Z is $0, because its negative QBI has been apportioned to Business X and Business Y.

(C) Because F's taxable income is above the threshold amount, the QBI component of F's Section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W-2 wage limitation must be calculated. For Business X, 20% of QBI is $9,144 ($45,722*20%) and 50% of W-2 wages is $50,000 ($100,000*50%), so the lesser amount is $9,144. Business Y pays no W-2 wages. Twenty percent of Business Y's QBI is $6,856 ($34,278*20%) and 50% of its W-2 wages (zero) is zero, so the lesser amount is zero.

(D) F must then compare the combined amounts determined in paragraph (d)(4)(xi)(C) of this section to 20% of F's taxable income. The Section 199A deduction equals the lesser of these amounts. F's combined amount from paragraph (d)(4)(xi)(C) of this section is $9,144 ($9,144 plus zero) and 20% of F's taxable income is $192,000 ($960,000 x 20%).[906] Thus, F's Section 199A deduction for 2019 is $9,144. There is no carryover of any negative QBI into the following taxable year for purposes of Section 199A.

Note again how losses were apportioned from Business Z to Businesses X and Y according to their respective shares of QBI – this time not only for the current loss but also the carryover loss. Also note that some wages from Business X and all wages from Business Z were wasted, with Business Y not receiving any benefit from them. However, at least Business Y was able to absorb some of the losses from Business Z and the carryover losses, so the Business X was not hit with all of them and was therefore able to use its wages.

Reg. § 1.199A-1(d)(4)(xii) provides Example (12):

(A) Assume the same facts as in Example 11 of paragraph (d)(4)(xi) of this section, except that F aggregates Business X, Business Y, and Business Z under the rules of § 1.199A-4. For 2018, F's QBI from the aggregated trade or business is ($150,000). Because F has a combined negative QBI for 2018, F has no Section 199A deduction with respect to any trade or business for 2018. Instead, the negative combined QBI of ($150,000) carries forward and will be treated as negative QBI from a separate trade or business for purposes of computing the Section 199A deduction in the next taxable year. However, for income tax purposes, the $150,000 loss may offset taxpayer's $750,000 of wage income (assuming the loss is otherwise allowable under the Code).

(B) In taxable year 2019, F will have QBI of $230,000 and W-2 wages of $100,500 from the aggregated trade or business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F's taxable income is $960,000. F must treat the negative QBI carryover loss ($150,000) from 2018 as a loss from a separate trade or business for purposes of Section 199A. This loss will offset the positive QBI from the aggregated trade or business, resulting in an adjusted QBI of $80,000 ($230,000-$150,000).

(C) Because F's taxable income is above the threshold amount, the QBI component of F's Section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W-2 wage limitation must be calculated. For the aggregated trade or business, the lesser of 20% of QBI ($80,000*20% = $16,000) and 50% of W-2 wages ($100,500*50% = $50,250) is $16,000. F's Section 199A deduction equals the lesser of that amount ($16,000) and 20% of F's taxable income ($960,000*20% = $192,000). Thus, F's Section 199A deduction for 2019 is $16,000. There is no carryover of any negative QBI into the following taxable year for purposes of Section 199A.

Once again, aggregation has increased the deduction by allowing the wages of all of the qualified businesses to be counted.

[906] I added the period at the end of the sentence, because it was in the originally released regulations.

A business that is projected to lose money might consider deferring wages to the next year if the wage limitation is a significant limitation in determining its owners' Code § 199A deduction. Of course, deferring that deduction also increases the owners' current taxable income, so any such planning should consider its context in the owners' overall tax planning.

As the preamble to the final regulations summarizes in the section explaining economic impact:[907]

> As an example, § 1.199A-1 prescribes the steps taxpayers must take to calculate the QBI deduction in a manner that avoids perverse incentives for shifting wages and capital assets across businesses. The statute does not address the ordering for how the W-2 wages and UBIA of qualified property limitations should be applied when taxpayers have both positive and negative QBI from different businesses. The final regulations clarify that in such cases the negative QBI should offset positive QBI prior to applying the wage and capital limitations. For taxpayers who would have assumed in the alternate that negative QBI offsets positive QBI after applying the wage and capital limitations, the regulations weaken the incentive to shift W-2 wage labor or capital (in the form of qualified property) from one business to another to maximize the Section 199A deduction.
>
> To illustrate this, consider a taxpayer who is above the statutory threshold and owns two non-service sector businesses, A and B. A has net qualified income of $10,000, while B has net qualified income of -$5,000. Suppose that A paid $3,000 in W-2 wages, B paid $1,000 in W-2 wages, and neither business has tangible capital. If negative QBI offsets positive QBI after applying the wage and capital limitations, then A generates a tentative deduction of $1,500, while B generates a tentative deduction of -$1,000, for a total deduction of $500. After moving B's W-2 wages to A, A's tentative deduction rises to $2,000, while B's remains -$1,000, increasing the total deduction to $1,000. If, on the other hand, negative QBI offsets positive QBI prior to applying the wage and capital limitations (as in the final regulations), then A and B have combined income of $5,000, and the total deduction is $1,000 because the wage and capital limitations are non-binding. After moving B's wages to A, the total deduction remains $1,000. Thus, an incentive to shift wages arises if negative QBI offsets positive QBI after applying the wage and capital limitations. By taking the opposite approach, § 1.199A-1 reduces incentives for such tax-motivated, economically inefficient reallocations of labor (or capital) relative to a scenario in which offsets were taken after wage and capital limitations were applied.

In the preamble to the final regulations, T.D. 9847 (2/8/2019), parts IV.A.2 and 3 provide:

> **2. Previously Disallowed Losses**
>
> The proposed regulations provide that previously disallowed losses or deductions (including under sections 465, 469, 704(d), and 1366(d)) allowed in the taxable year are taken into account for purposes of computing QBI so long as the losses were incurred in a taxable year beginning after January 1, 2018. Because previously disallowed losses incurred for taxable years beginning before January 1, 2018, cannot be taken into

[907] T.D. 9847 (2/8/2019), Special Analyses, part I, "Regulatory Planning and Review – Economic Analysis," subpart C [D?], "Economic Analysis of § 1.199A-1," paragraph 2, "Anticipated benefits of § 1.199A-1."

account for purposes of computing QBI, several commenters recommended that final regulations provide an ordering rule for the use of such losses. Commenters recommended both “last-in, first-out” (LIFO) and “first-in, first-out” (FIFO) approaches, with a slight preference for the FIFO approach as consistent with former section 199. The Treasury Department and the IRS agree that taxpayers with previously disallowed losses for taxable years beginning both before and after January 1, 2018, require an ordering rule to determine which portion of a previously disallowed loss can be taken into account for purposes of Section 199A. Consistent with regulations under former section 199, these regulations provide that any losses disallowed, suspended, or limited under the provisions of sections 465, 469, 704(d), and 1366(d), or any other similar provisions, shall be used, for purposes of Section 199A and these regulations, in order from the oldest to the most recent on a FIFO basis.

One commenter suggested that a special rule should be provided to identify the section 469 trade or business losses that are used to offset income if the taxpayer’s section 469 groupings differ from the taxpayer’s Section 199A aggregations. The commenter recommended that any section 469 loss carryforward that is later used should be allocated across the taxpayer’s Section 199A aggregations based on income with respect to such aggregations in the year the loss was generated. The Treasury Department and the IRS decline to adopt this comment. Concurrently with the publication of these proposed regulations, the Treasury Department and the IRS are publishing proposed regulations under Section 199A (REG-134652-18) that treat previously suspended losses as losses from a separate trade or business for purposes of Section 199A.

3. Net Operating Losses and the Interaction of Section 199A with Section 461(l)

The preamble to the proposed regulations requested comments on the interaction of sections 199A and 461(l). Commenters requested guidance in many areas including: Ordering rules for the use of suspended active business losses; methods for tracing losses to a taxpayer’s various trades or businesses; whether a loss retains its character; whether a deduction under Section 199A is a loss for calculating the loss limitation; and how the Section 199A loss carryover rules interact with a loss limited under section 461(l). The Treasury Department and the IRS understand that taxpayers will need guidance as to the interaction of Section 199A and section 461(l). However, these issues are beyond the scope of these regulations and will be considered in future guidance under section 461(l). Section 1.199A-3(b)(1)(v) retains and clarifies the rule that while a deduction under section 172 for a net operating loss is generally not considered to be with respect to a trade or business (and thus not taken into account in determining QBI), an excess business loss under section 461(l) is treated as a net operating loss carryover to the following taxable year and is taken into account for purposes of computing QBI in the subsequent taxable year in which it is deducted.

The preamble to the proposed regulations [REG-134652-18] referred to in the final regulations (the “2019 Proposed Regs”) explain (with the “August Proposed Regulations” referring to REG-107892-18 (8/16/2018)):

These proposed regulations propose rules addressing issues not addressed in the August Proposed Regulations that are necessary to provide taxpayers with computational, definitional, and anti-avoidance guidance regarding the application of Section 199A. Specifically, these proposed regulations contain amendments to two substantive sections of the August Proposed Regulations, §§ 1.199A-3 and 1.199A-6, each of which provides rules relevant to the calculation of the Section 199A deduction. These additional proposed rules respond to comments received on the August Proposed Regulations as well as address certain issues identified after additional study. This Explanation of Provisions describes each of the proposed rules contained in this document in turn. The Treasury Department and the IRS request comments on all aspects of these proposed regulations.

I. Treatment of Previously Suspended Losses That Constitute QBI.

Section 1.199A-3(b)(1)(iv) of the final regulations provides that previously disallowed losses or deductions (including under sections 465, 469, 704(d), and 1366(d)) allowed in the taxable year are generally taken into account for purposes of computing QBI except to the extent the losses or deductions were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018. The final regulations also provide a first-in-first-out ordering rule. One commenter on the August Proposed Regulations suggested that a special rule should be provided to identify the section 469 trade or business losses that are used to offset income if the taxpayer’s section 469 groupings differ from the taxpayer’s Section 199A aggregations. The commenter recommended that any section 469 loss carryforward that is later used should be allocated across the taxpayer’s Section 199A aggregations based on income with respect to such aggregations in the year the loss was generated.

The Treasury Department and the IRS believe that that previously disallowed losses should be treated as losses from a separate trade or business for both the reasons stated by the commenter and because the losses may relate to a trade or business that is no longer in existence. Accordingly, these proposed regulations amend § 1.199A-3(b)(1)(iv) to provide that such losses are treated as loss from a separate trade or business. To the extent that losses relate to a PTP, they must be treated as losses from a separate PTP. Section 1.199A-3(b)(1)(iv)(B) provides that attributes of the disallowed loss are determined in the year the loss is incurred.

In the preamble to the 2020 final regulations, T.D. 9899 (6/25/2020), “SUPPLEMENTARY INFORMATION” provides:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under Section 199A of the Code.

Section 199A was enacted on December 22, 2017, by section 11011 of Public Law 115-97, 131 Stat. 2054, commonly referred to as the Tax Cuts and Jobs Act (TCJA), and was amended on March 23, 2018, retroactively to January 1, 2018, by section 101 of Division T of the Consolidated Appropriations Act, 2018, Pub. L. 115-141, 132 Stat. 348 (2018 Act). Section 199A applies to taxable years beginning after 2017 and before 2026.

Section 199A provides a deduction of up to 20 percent of QBI from a U.S. trade or business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate (Section 199A deduction). The Section 199A deduction may be taken by individuals and by some trusts and estates. A Section 199A deduction is not available for wage income or for income earned by a C corporation (as defined in section 1361(a)(2)).

If the taxpayer's taxable income exceeds the statutorily defined amount in Section 199A(e)(2) (threshold amount), the taxpayer's Section 199A deduction may be limited based on (i) the type of trade or business conducted, (ii) the amount of W-2 wages paid with respect to the trade or business (W-2 wages), and/or (iii) the unadjusted basis immediately after acquisition (UBIA) of qualified property held for use in the trade or business (UBIA of qualified property). These statutory limitations are subject to phase-in rules in Section 199A(b)(3)(B) based upon taxable income above the threshold amount (phase-in rules).

Section 199A also provides individuals and some trusts and estates, but not corporations, a deduction of up to 20 percent of their combined qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income, including qualified REIT dividends and qualified PTP income earned through passthrough entities. This component of the Section 199A deduction is not limited by W-2 wages or UBIA of qualified property.

Overall, the Section 199A deduction is the lesser of (1) the sum of the combined QBI and qualified REIT and PTP components described in the prior two paragraphs or (2) an amount equal to 20 percent of the excess (if any) of the taxpayer's taxable income for the taxable year over the taxpayer's net capital gain for the taxable year.

Additionally, Section 199A(g) provides that specified agricultural or horticultural cooperatives may claim a special entity-level deduction that is substantially similar to the domestic production activities deduction under former section 199.

The statute expressly grants the Secretary of the Treasury or his delegate (Secretary) authority to prescribe such regulations as are necessary to carry out the purposes of Section 199A (Section 199A(f)(4)), and provides specific grants of authority with respect to certain issues including: the treatment of acquisitions, dispositions, and short taxable years (Section 199A(b)(5)); certain payments to partners for services rendered in a non-partner capacity (Section 199A(c)(4)(C)); the allocation of W-2 wages and UBIA of qualified property (Section 199A(f)(1)(A)(iii)); restricting the allocation of items and wages under Section 199A and such reporting requirements as the Secretary determines appropriate (Section 199A(f)(4)(A)); the application of Section 199A in the case of tiered entities (Section 199A(f)(4)(B)); preventing the manipulation of the depreciable period of qualified property using transactions between related parties (Section 199A(h)(1)); and determining the UBIA of qualified property acquired in like-kind exchanges or involuntary conversions (Section 199A(h)(2)).

The Department of the Treasury (Treasury Department) and the IRS published final regulations () interpreting Section 199A on February 8, 2019 (February 2019 Final Regulations) in the Federal Register (84 FR 2952). Along with the publication of the February 2019 Final Regulations, the Treasury Department and the IRS published a notice of proposed rulemaking (REG 134652-18) in the Federal Register (84 FR 3015) providing additional guidance under Section 199A relating to the treatment of previously suspended losses included in qualified business income and determining the Section 199A deduction for taxpayers that hold interests in regulated investment companies, split-interest trusts, and charitable remainder trusts (February 2019 Proposed Regulations). No public hearing on the February 2019 Proposed Regulations was requested or held. After full consideration of the comments received on the February 2019 Proposed Regulations, this Treasury decision adopts the proposed regulations with clarifying changes and additional modifications in response to comments as described in the Summary of Comments and Explanation of Revisions.

Comments on issues related to the February 2019 Proposed Regulations that are beyond the scope of these final regulations are not discussed in this preamble, but may be addressed in future guidance.

The Treasury Department and the IRS also received comments on the February 2019 Final Regulations. The Treasury Department and the IRS continue to study the issues raised in those comments and may address them in future guidance.

Summary of Comments and Explanation of Revisions

These final regulations contain amendments to two substantive sections of the February 2019 Final Regulations, §§ 1.199A-3 and 1.199A-6, each of which provides rules relevant to the calculation of the Section 199A deduction. The amendments to § 1.199A-3(b)(1)(iv) provide additional rules and clarification on the treatment of suspended losses. Section 1.199A-3(d) provides guidance that allows a shareholder in a regulated investment company (RIC) within the meaning of section 851(a) to take a Section 199A deduction with respect to certain income of, or distributions from, the RIC. The amendments to § 1.199A-6(d) include additional rules related to trusts and estates under section 663 of the Code. This Summary of Comments and Explanation of Revisions describes each of the final rules contained in this document in turn.

I. Treatment of Previously Suspended Losses Included in QBI

Section 1.199A-3(b)(1)(iv) of the February 2019 Final Regulations provides that previously disallowed losses or deductions (including under sections 465, 469, 704(d), and 1366(d)) allowed in the taxable year are generally taken into account for purposes of computing QBI, except to the extent the losses or deductions were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018. These losses are used, for purposes of Section 199A, in order from the oldest to the most recent on a first-in, first-out (FIFO) basis. The February 2019 Proposed Regulations expanded this rule to provide that previously disallowed losses or deductions are treated as losses from a separate trade or business in the year they are taken into account in determining taxable income. Further, the attributes of the previously disallowed losses or deductions, including whether they are attributable to a trade or business and whether they would otherwise be included in QBI, are determined in the year the loss or deduction is incurred.

The Treasury Department and the IRS are aware that taxpayers and practitioners have questioned whether the exclusion of section 461(l) from the list of loss disallowance and suspension provisions in § 1.199A-3(b)(1)(iv) means that losses disallowed under section 461(l) are not considered QBI in the year the losses are taken into account in determining taxable income. Generally, for taxable years beginning after December 31, 2020, and before January 1, 2026, section 461(l) disallows an excess business loss for taxpayers other than C corporations. See section 2304(a) of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Pub. L. 116-136, 134 Stat. 281 (2020). Any disallowed excess business loss is treated as a net operating loss carryover for the taxable year for purposes of determining any net operating loss carryover under section

172(b) in subsequent taxable years. See section 172(b) as amended by section 2304(b) of the CARES Act.

The list of loss disallowance and suspension provisions in § 1.199A-3(b)(1)(iv) is not exhaustive. If a loss or deduction that would otherwise be included in QBI under the rules of § 1.199A-3 is disallowed or suspended under any provision of the Code, such loss or deduction is generally taken into account for purposes of computing QBI in the year it is taken into account in determining taxable income. These final regulations clarify this point by amending § 1.199A-3(b)(1)(iv)(A) to specifically reference excess business losses disallowed by section 461(l) and treated as a net operating loss carryover for the taxable year for purposes of determining any net operating loss carryover under section 172(b) in subsequent taxable years.

The Treasury Department and the IRS are also aware that taxpayers and practitioners have questioned how the phase-in rules apply when a taxpayer has a suspended or disallowed loss or deduction from a Specified Service Trade or Business (SSTB). Whether an individual has taxable income at or below the threshold amount, within the phase-in range, or in excess of the phase-in range, the determination of whether a suspended or disallowed loss or deduction attributable to an SSTB is from a qualified trade or business is made in the year the loss or deduction is incurred. If the individual's taxable income is at or below the threshold amount in the year the loss or deduction is incurred, and such loss would otherwise be QBI, the entire disallowed loss or deduction is treated as QBI from a separate trade or business in the subsequent taxable year in which the loss is allowed. If the individual's taxable income is within the phase-in range, then only the applicable percentage of the disallowed loss or deduction is taken into account in the subsequent taxable year. If the individual's taxable income exceeds the phase-in range, none of the disallowed loss or deduction will be taken into account in the subsequent taxable year. These final regulations clarify this treatment and provide an example of a taxpayer with taxable income in the phase-in range and a suspended loss from an SSTB.

The Treasury Department and the IRS received one comment requesting further clarification of the FIFO ordering rule. The commenter questioned whether the FIFO ordering rule should continue to apply for losses incurred in taxable years beginning on or after January 1, 2018. The commenter also asked for clarification regarding whether the rule applied on an annual basis such that each year is tracked separately and FIFO is applied for losses that are incurred each year or whether FIFO applies such that there is a single bucket of losses no matter the year incurred. The commenter recommended additional supporting worksheets or other forms to assist in the calculation, particularly if every year must be tracked individually.

The Treasury Department and the IRS have determined that in order to properly calculate the deduction, it is necessary for the FIFO rule to apply for losses incurred in taxable years beginning on or after January 1, 2018, and that the rule must be applied on an annual basis by category (i.e., sections 465, 469, etc.). Accordingly, these final regulations retain the FIFO rule as proposed. The Treasury Department and the IRS continue to consider whether new worksheets or forms are necessary to assist in the calculation.

The February 2019 Proposed Regulations also provide that if a loss or deduction is partially disallowed, QBI in the year of disallowance must be reduced proportionately.

> These final regulations retain this rule, but with slight modifications, and provide examples.

From the 2018 proposed regulations, Prop. Reg. § 1.199A-3(b)(1)(iv), "Previously disallowed losses," provided:

> Generally, previously disallowed losses or deductions (including under sections 465, 469, 704(d), and 1366(d)) allowed in the taxable year are taken into account for purposes of computing QBI. However, losses or deductions that were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018 (including under sections 465, 469, 704(d), and 1366(d)), are not taken into account in a later taxable year for purposes of computing QBI.

From the 2019 proposed regulations, Prop. Reg. § 1.199A-3(b)(1)(iv), "Previously disallowed losses," provided:

> (A) *In general*. Previously disallowed losses or deductions (including losses disallowed under sections 465, 469, 704(d), and 1366(d)) allowed in the taxable year generally are taken into account for purposes of computing QBI to the extent the disallowed loss or deduction is otherwise allowed by Section 199A and this section. These losses shall be used, for purposes of Section 199A and these regulations, in order from the oldest to the most recent on a first-in, first-out (FIFO) basis and shall be treated as losses from a separate trade or business. To the extent such losses relate to a PTP, they must be treated as a loss from a separate PTP in the taxable year the losses are taken into account. However, losses or deductions that were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018 (including under sections 465, 469, 704(d), and 1366(d)), are not taken into account in a later taxable year for purposes of computing QBI.
>
> (B) *Attributes of disallowed loss determined in year loss is incurred*. Whether a disallowed loss or deduction is attributable to a trade or business, and otherwise meets the requirements of this section is determined in the year the loss is incurred. Whether a disallowed loss or deduction is attributable to a specified service trade or business (including whether an individual has taxable income under the threshold amount, within the phase-in range, or in excess of the phase-in range) also is determined in the year the loss is incurred. To the extent a loss is partially disallowed, QBI in the year of disallowance must be reduced proportionately.

Effective for taxable years beginning after August 24, 2020,[908] Reg. § 1.199A-3(b)(1)(iv), "Previously disallowed losses," now provides:

> (A) *In general*. Previously disallowed losses or deductions allowed in the taxable year generally are taken into account for purposes of computing QBI to the extent the disallowed loss or deduction is otherwise allowed by Section 199A. These previously disallowed losses include, but are not limited to losses disallowed under sections 461(l), 465, 469, 704(d), and 1366(d). These losses are used for purposes

[908] Reg. § 1.199A-3(e)(2)(iii), "Previously disallowed losses," provides:

> The provisions of paragraph (b)(1)(iv) of this section apply to taxable years beginning after August 24, 2020. Taxpayers may choose to apply the rules in paragraph (b)(1)(iv) of this section for taxable years beginning on or before August 24, 2020, so long as the taxpayers consistently apply the rules in paragraph (b)(1)(iv) of this section for each such year.

of Section 199A and this section in order from the oldest to the most recent on a first-in, first-out (FIFO) basis and are treated as losses from a separate trade or business. To the extent such losses relate to a PTP, they must be treated as a loss from a separate PTP in the taxable year the losses are taken into account. However, losses or deductions that were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018 (including under sections 465, 469, 704(d), and 1366(d)), are not taken into account in a subsequent taxable year for purposes of computing QBI.

(B) *Partial allowance*. If a loss or deduction attributable to a trade or business is only partially allowed during the taxable year in which incurred, only the portion of the allowed loss or deduction that is attributable to QBI will be considered in determining QBI from the trade or business in the year the loss or deduction is incurred. The portion of the allowed loss or deduction attributable to QBI is determined by multiplying the total amount of the allowed loss by a fraction, the numerator of which is the portion of the total loss incurred during the taxable year that is attributable to QBI and the denominator of which is the amount of the total loss incurred during the taxable year.

(C) *Attributes of disallowed loss determined in year loss is incurred*.

(1) *In general*. Whether a disallowed loss or deduction is attributable to a trade or business, and otherwise meets the requirements of this section, is determined in the year the loss is incurred.

(2) Specified service trades or businesses. If a disallowed loss or deduction is attributable to a specified service trade or business (SSTB), whether an individual has taxable income at or below the threshold amount as defined in § 1.199A-1(b)(12), within the phase-in range as defined in § 1.199A-1(b)(4), or in excess of the phase-in range is determined in the year the loss or deduction is incurred. If the individual's taxable income is at or below the threshold amount in the year the loss or deduction is incurred, the entire disallowed loss or deduction must be taken into account when applying paragraph (b)(1)(iv)(A) of this section. If the individual's taxable income is within the phase-in range, then only the applicable percentage, as defined in § 1.199A-1(b)(2), of the disallowed loss or deduction is taken into account when applying paragraph (b)(1)(iv)(A) of this section. If the individual's taxable income exceeds the phase-in range, none of the disallowed loss or deduction will be taken into account in applying paragraph (b)(1)(iv)(A) of this section.

(D) *Examples*. The following examples illustrate the provisions of this paragraph (b)(1)(iv).

(1) *Example 1*. A is an unmarried individual and a 50% owner of LLC, an entity classified as a partnership for Federal income tax purposes. In 2018, A's allocable share of loss from LLC is $100,000 of which $80,000 is negative QBI. Under section 465, $60,000 of the allocable loss is allowed in determining A's taxable income. A has no other previously disallowed losses under section 465 or any other provision of the Code for 2018 or prior years. Because 80% of A's allocable loss is attributable to QBI ($80,000/$100,000), A will reduce the amount A takes into account in determining QBI proportionately. Thus, A will include $48,000 of the

allowed loss in negative QBI (80% of $60,000) in determining A's Section 199A deduction in 2018. The remaining $32,000 of negative QBI is treated as negative QBI from a separate trade or business for purposes of computing the Section 199A deduction in the year the loss is taken into account in determining taxable income as described in § 1.199A-1(d)(2)(iii).

(2) *Example 2*. B is an unmarried individual and a 50% owner of LLC, an entity classified as a partnership for Federal income tax purposes. After allowable deductions other than the Section 199A deduction, B's taxable income for 2018 is $177,500. In 2018, LLC has a single trade or business that is an SSTB. B's allocable share of loss is $100,000, all of which is suspended under section 465. B's allocable share of negative QBI is also $100,000. B has no other previously disallowed losses under section 465 or any other provision of the Code for 2018 or prior years. Because the entire loss is suspended, none of the negative QBI is taken into account in determining B's Section 199A deduction for 2018. Further, because the negative QBI is from an SSTB and B's taxable income before the section 199A deduction is within the phase-in range, B must determine the applicable percentage of the negative QBI that must be taken into account in the year that the loss is taken into account in determining taxable income. B's applicable percentage is 100% reduced by 40% (the percentage equal to the amount that B's taxable income for the taxable year exceeds B's threshold amount ($20,000=$177,500-$157,500) over $50,000). Thus, B's applicable percentage is 60%. Therefore, B will have $60,000 (60% of $100,000) of negative QBI from a separate trade or business to be applied proportionately to QBI in the year(s) the loss is taken into account in determining taxable income, regardless of the amount of taxable income and how rules under § 1.199A-5 apply in the year the loss is taken into account in determining taxable income.

This does not authorize the wage and UBIA attributes to be carried over as well. However, for other reasons, being passive may be beneficial; see part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good. On the other hand, being passive is unfavorable if it generates the 3.8% tax on net investment income; see part II.I.8.a General Application of 3.8% Tax to Business Income.

Odom, "QBI deduction: Interaction with various Code provisions," *The Tax Advise*r (12/1/2020), comments:

QBI and loss disallowance provisions

Since the inclusion of losses in QBI reduces the deduction, it is extremely important to understand these provisions so that QBI is not reduced before the losses are allowed in calculating taxable income. Disallowed losses are carried forward and reduce Sec. 199A QBI when allowed in computing taxable income in a subsequent year. These provisions are determined before making the QBI calculation, so these carryforwards should not be confused with the overall net QBI amount of a taxpayer that is less than zero, which is treated as a loss from a qualified trade or business in the succeeding tax year (Sec. 199A(c)(2)).

When a taxpayer incurs a net business loss, the Code provisions that determine if that loss is allowable in the current year must be applied in a certain order. If the income and losses that result in this net loss come from multiple entities and have multiple activities, then the allowable losses and carryforward amounts must be allocated.

The first loss limitation that must be considered is that of basis. For a taxpayer to claim a deduction for a loss from a relevant passthrough entity, the taxpayer must have basis in the entity. Losses in excess of basis are not allowed in the current year for regular tax purposes (Secs. 1366(d)(1) and 704(d)(1)). Likewise, they are not allowed for QBI. These losses will be allowed for regular tax and QBI purposes in subsequent years when basis is restored (Secs. 1366(d)(2) and 704(d)(2)). Since the basis rule applies to each entity separately and the losses are suspended, no allocations of these loss limitations with other entities are required. If the entity has multiple activities and only part of the losses is allowed, the losses will need to be allocated between the entity's different activities.

Once it is determined the losses are allowed because the taxpayer has basis, the second loss limitation rule must be applied, which is to determine whether the taxpayer is at risk for those losses. With a few exceptions noted in Prop. Regs. Secs. 1.465-42 and -44 and Temp. Regs. Sec. 1.465-1T, as with the basis rules, the at-risk rules of Sec. 465 apply to each entity and activity of the entity separately, so allocations of limited losses with other entities are not required. If the taxpayer is not at risk for the losses, then the losses will not be included in either taxable income or QBI.

The third set of loss limitation rules that must be applied are the passive loss rules of Sec. 469. Complications come into play when a taxpayer has multiple activities requiring separate tracking. In addition, special rules apply for PTPs.

Losses from a PTP business activity cannot be used to offset gains from other activities or portfolio income from its own activities (Sec. 469(k)). If the PTP reports only business losses, those losses will not be allowed for regular tax purposes and will not be allowed as qualified PTP income (Regs. Sec. 1.199A-3(c)(3)(ii)). If the PTP reports Sec. 1231 gain, then the other business losses will be allowed if they are less than or equal to the Sec. 1231 gain, and they will likewise be included in qualified PTP income. If a taxpayer disposes of a PTP, a portion of the gain is taxed as ordinary income (Sec. 751(a)). This ordinary income will be included as part of qualified PTP income, which is a separate component of QBI (Sec. 199A(e)(4)(B)).

For non-PTP activities, passive losses can offset passive gains regardless of the activity generating the gains or losses. When the losses exceed the gains, pro rata allocations must be made between the losses to determine how much of the loss from each entity and activity is allowed (Sec. 469(j)(4)). If qualified business activities mirror passive activities, these same allocations apply for QBI. If qualified business activities are different from passive activities, then additional computations and allocations will be required to make sure only the losses allowed for regular taxable income are allowed for QBI. The disallowed amounts must be carried forward and tracked by year and will be allowed in subsequent years when passive income exceeds passive losses or when there is a complete disposition of the passive activity.

Tracking suspended losses

The tracking of suspended passive losses is straightforward: They are to be tracked by entity, by activity, and by nature of income. A taxpayer must track allocated losses within activities if the type of income would result in an income tax liability that would be different if the items were not separately stated. The types of income that must be accounted for separately are active participation rental real estate activities, non—active participation rental real estate activities, capital losses limited under Sec. 1211, and Sec. 1231 losses related to property used in a trade or business and involuntary conversions (Temp. Regs. Sec. 1.469-1T(f)(2)(iii)). These items must be tracked for both regular and alternative minimum tax (AMT) purposes. Fortunately, for AMT purposes, the Sec. 199A deduction is the same as for regular tax purposes, so no adjustments are required (Regs. Sec. 1.199A-1(e)(5)).

Noticeably absent is a requirement to track these losses by year. For regular tax purposes, there really is not a need for this, as the passive losses may be carried over indefinitely since they do not expire. In addition, the carryover losses are treated as deductions from the activity for the succeeding tax year (Regs. Sec. 1.469-1(f)(4)). At some point, these suspended losses will be included in taxable income, either because the taxpayer has passive income in excess of total passive losses or when there is a complete disposition of the activity. Herein lies the issue: The QBI deduction is allowed only for items arising in tax years beginning after Dec. 22, 2017, and before Dec. 31, 2025. Since losses carried over from years prior to 2018 never reduce QBI (Regs. Sec. 1.199A-3(b)(1)(iv)(A)), it is important to properly trace loss carryforwards by year. So, the separately tracked items must now be tracked by year so that deduction and loss items prior to 2018 do not reduce QBI when they are allowed for regular taxable income purposes.

The IRS in June issued amendments to Regs. Secs. 1.199A-3 and 1.199A-6, which apply to tax years beginning after Aug. 24, 2020. Taxpayers may choose to apply these amendments to tax years beginning on or before Aug. 24, 2020 (T.D. 9899). Regs. Sec. 1.199A-3(b)(1)(iv) was amended and deals specifically with previously disallowed losses, whether from pre-2018 tax years or post-2017 tax years. This discussion incorporates this amended subparagraph. While these rules are discussed in the context of Sec. 469’s passive loss rules, the same concepts apply to disallowed, suspended, and limited losses under Secs. 461(l) (excess business loss rules), 465 (at-risk rules), and 704(d) and 1366(d) (basis rules). These provisions add another level of complexity since the allocations for QBI will now be different than for regular tax, requiring another set of carryforwards to be tracked.

So how do you handle these pre-2018 passive loss carryforwards when they can be claimed in the current year? For QBI, the carryforward losses are applied using FIFO — the oldest losses are utilized first (Regs. Sec. 1.199A-3(b)(1)(iv)(A)). Also, the amended regulations state they are treated as losses from a separate trade or business. If the losses relate to a PTP, they must be treated as a loss from a separate PTP (id.). Thus, if there are pre-2018 losses, they are taken into regular taxable income first but do not reduce QBI. Only when pre-2018 losses have been fully utilized do 2018 and subsequent-year losses reduce QBI.

Other guidance

The amended regulations also provide guidance regarding the partial allowance of a current-year loss or deduction. Only the portion allowed that is attributable to QBI will be used in determining QBI in the year the loss or deduction is incurred. The allocation is pro rata based on the portion of the loss that is attributable to QBI incurred in the year divided by the total loss incurred in the year (Regs. Sec. 1.199A-3(b)(1)(iv)(B)).

Attributes of the disallowed loss or deduction are determined in the year the loss is incurred, not the year the loss is allowed (Regs. Sec. 1.199A-3(b)(1)(iv)(C)). So, when preparing the current-year return, one must make these determinations as they relate to the carryover amount to subsequent years because, in the subsequent year, this carryover will be treated as arising from a separate trade or business. The first step is to determine if the disallowed amount is attributable to a trade or business and otherwise meets the requirements of Sec. 199A (Regs. Sec. 1.199A-3(b)(1)(iv)(C)(1)).

The second step is to determine whether the activity is from a specified service trade or business (SSTB) (Regs. Sec. 1.199A-3(b)(1)(iv)(C)(2)). If the activity is an SSTB, then all the SSTB calculations must be made in the current year on the disallowed amounts to determine how much of the disallowed amounts may be carried forward to the subsequent year and treated as a separate trade or business. In the subsequent year(s), these separate trades or businesses will not be subjected to the SSTB rules for the subsequent year(s); rather, the negative QBI from each separate trade or business will be applied proportionately to QBI in the subsequent year(s) when the loss is taken into account in calculating taxable income, regardless of the taxable income amount and application of the SSTB rules in the year the loss is allowed for calculating regular taxable income (Regs. Sec. 1.199A-3(b)(1)(iv)(D), Example (2)).

The SSTB rules provide limitations on the allowable amount for QBI based on threshold amounts. If taxable income is at or below the threshold amount in the year the loss or deduction is incurred (not the year allowed), the entire disallowed amount is carried over. If taxable income is within the phase-in range, then the applicable percentage of the allowed amount is carried over. Finally, if the taxable income exceeds the phase-in range, then none of the disallowed amounts will be carried over.

Once a determination is made that passive losses are allowed, a fourth provision comes into play that may further limit the ability to deduct losses. Sec. 461(l) limits excess business losses for noncorporate taxpayers to the excess of the taxpayer's aggregate trade or business deductions for the tax year over the sum of the taxpayer's aggregate trade or business income or gain plus $250,000. If the loss is limited for regular tax purposes, then the loss is limited for QBI. The Coronavirus Aid, Relief, and Economic Security (CARES) Act, P.L. 116-136, made several modifications to Sec. 461(l) including modifying the dates to which the provision applies: The provision no longer applies for losses arising in 2018, 2019, and 2020 but continues to apply for tax years beginning after Dec. 31, 2020, and before Jan. 1, 2026.

Any disallowed excess business loss is treated as a net operating loss (NOL) for the tax year for purposes of determining any NOL carryover under Sec. 172(b) for subsequent tax years (Sec. 461(l)(2)). Generally, an NOL deduction is not considered with respect to a trade or business and therefore is not considered in computing QBI. However, the excess business loss is included for purposes of computing QBI in the subsequent tax year in which it is deducted (Regs. Sec. 1.199A-3(b)(1)(v)).

When an entire interest in a passive activity is disposed of under the installment sale method of Sec. 453, special rules apply related to passive losses that are freed up as the result of a complete disposition. Sec. 469(g)(3) states that suspended losses that exceed the gain on the disposition are recognized over the term of the installment obligation using the same gross profit percentage that is used to recognize the gain on the installment sale. If there is a loss on the disposition, all suspended losses are recognized in the year of disposition, as installment sale reporting only applies to gains, not losses. Any freed-up suspended losses incurred after Dec. 31, 2017, will be included in QBI in the same year they are recognized for regular tax purposes. The election out of the installment sale method would accelerate the recognition of suspended losses, which can be beneficial for reducing regular taxable income. However, it is also detrimental, as it reduces QBI, so an analysis of the overall impact on taxable income over the life of the obligation may be needed to determine if the election out is truly beneficial for a taxpayer.

Also, if a taxpayer disposes of a partnership, a portion of the gain may be taxed as ordinary income (Sec. 751(a)). This ordinary income is attributable to the trades or businesses conducted by the partnership and therefore is part of the QBI computation for that activity (Regs. Sec. 1.199A-3(b)(1)(i)). Ordinary income under Sec. 751 is recapture income if received under the installment method and must be recognized in the year of disposition as if all payments to be received were received in the tax year of disposition (Sec. 453(i)(2)); accordingly, the ordinary income would also be included in QBI in the year of disposition.

II.E.1.c.viii. Income or Gain from or Sale of Property Used in the Business or Business Interest Itself

This part II.E.1.c.viii discusses specific applications:

- Part II.E.1.c.viii.(a) Passthrough Sale of Equipment It Is Using

- Part II.E.1.c.viii.(b) Passthrough Sale of a Building It Is Using.

- Part II.E.1.c.viii.(c) Sale of an Interest in a Partnership Conducting a Trade or Business.

- Part II.E.1.c.viii.(d) Sale of a Stock in an S Corporation Conducting a Trade or Business.

II.E.1.c.viii.(a). Passthrough Sale of Equipment It Is Using

Qualified business income ("QBI") means "the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer."[909] Thus, gain from the sale of equipment can be QBI only if it is with respect to a qualified trade or business.

Long-term capital gain is not QBI; see Reg. § 1.199A-3(b)(2)(ii)(A), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A. However, Part II.E.1.c.ii.(c) includes an excerpt from the preamble (Treatment of section 1231 gains and losses) that gain taxed as ordinary income is QBI.

[909] Code § 199A(c)(1), first cited in fn 779 in part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.

II.E.1.c.viii.(b). Passthrough Sale of a Building It Is Using

Qualified business income ("QBI") means "the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer."[910] Thus, gain from the sale of a building can be QBI only if it is with respect to a qualified trade or business.

Strangely enough, property used in a business is not a capital asset. When real estate that is depreciated using straight-line depreciation (which generally applies to real estate acquired after 1986 and some acquired before 1986), Code § 1231 taxes gain of real estate held more than one year as long-term capital gain and losses as ordinary losses. Capital gain that recaptures straight-line depreciation is subject to capital gain tax higher that regular capital gain tax rates. However, if and to the extent that the taxpayer previously deducted ordinary losses under Code § 1231, the gain is taxed as ordinary income. See part II.G.6.a Code § 1231 Property, which also covers the sale of goodwill.

If and to the extent that a cost segregation study causes components to be subject to accelerated depreciation or if accelerated depreciation was used for the building, see the analysis in part II.E.1.c.viii.(a) Passthrough Sale of Equipment It Is Using.

Also, if a passthrough sells depreciable property to a related party, generally any gain is taxed as ordinary income. See parts II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill) and II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships. That, too would use the analysis in part II.E.1.c.viii.(a) Passthrough Sale of Equipment It Is Using.

To the extent that the sale of a building is taxed as long-term capital gain, it is not QBI. See Reg. § 1.199A-3(b)(2)(ii)(A), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A. However, Part II.E.1.c.ii.(c) includes an excerpt from the preamble (Treatment of section 1231 gains and losses) that gain taxed as ordinary income is QBI.

II.E.1.c.viii.(c). Sale of an Interest in a Partnership Conducting a Trade or Business

Qualified business income ("QBI") means "the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer."[911] Thus, gain from the sale of a partnership interest can be QBI only if it is with respect to a qualified trade or business.

The sale of a partnership interest may be taxed as capital gain, as provided in part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest, or as gain from the sale of an asset that is not a capital asset (ordinary income), under part II.Q.8.b.i.(g) Code § 751 – Hot Assets. Capital gain from the sale of a partnership interest is not QBI. See Reg. § 1.199A-3(b)(2)(ii)(A), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

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[910] Code § 199A(c)(1), first cited in fn 779 in part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.

[911] Code § 199A(c)(1), first cited in fn 779 in part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.

However, Code § 751 ordinary income qualifies. See Reg. § 1.199A-3(b)(1)(i), reproduced in part II.E.1.c.ii.(a) Generally; List of Items Included in QBI.

II.E.1.c.viii.(d). Sale of a Stock in an S Corporation Conducting a Trade or Business

Because the sale of S corporation stock is taxed as capital gain, it is not QBI. See Reg. § 1.199A-3(b)(2)(ii)(A), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

However, the sale of S corporation stock is often treated as a sale of the underlying assets, with the gain increasing the stock's basis, followed by a deemed liquidation of the corporation, shifting the gain on sale of stock to a gain on sale of assets. See part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold. Such a sale tends to trigger ordinary income on the deemed sale of the assets, to the extent of depreciation recapture on personal property and any other property not depreciable as real estate. For additional ordinary income concerns if the buyer is a related party, see part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property. Part II.E.1.c.ii.(c) includes an excerpt from the preamble (Treatment of section 1231 gains and losses) that gain taxed as ordinary income is QBI. Thus, the Code § 199A deduction would ameliorate tax on actual or deemed asset sales.

II.E.1.c.ix. QBI and Effectively Connected Income

Items of QBI are "of income, gain, deduction, and loss" included or allowed in determining taxable income for the taxable year to the extent such items are:[912]

> effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting "qualified trade or business (within the meaning of Section 199A)" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears)….

The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), provides:

> **vi. Requirement that an item be effectively connected with a U.S. trade or business**
>
> Section 199A applies to all noncorporate taxpayers, whether such taxpayers are domestic or foreign. Accordingly, Section 199A applies to both U.S. citizens and resident aliens as well as nonresident aliens that have QBI. As noted previously in this Explanation of Provisions, QBI includes items of income, gain, deduction, and loss to the extent such items are (i) included or allowed in determining taxable income for the taxable year and (ii) effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting

[912] Code § 199A(c)(3)(A)(i), cited in fn 784 in part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction. Literally plugging Code § 199A(c)(3)(A)(i) into Code § 864(c) would make Code § 864(c)(1) read as follows:

> In the case of a qualified trade or business (within the meaning of section 199A) engaged in trade or business within the United States during the taxable year, the rules set forth in paragraphs (2), (3), (4), (6), (7), and (8) shall apply in determining the income, gain, or loss which shall be treated as effectively connected with the conduct of a trade or business within the United States.

“qualified trade or business (within the meaning of Section 199A)” for “nonresident alien individual or a foreign corporation” or for “a foreign corporation” each place it appears).

a. Summary of rules for generally determining whether income is effectively connected with a United States trade or business

Section 864(c) provides rules that nonresident alien individuals and foreign corporations use to determine which items of income, gain, or loss are effectively connected with a United States trade or business. Section 873(a) permits nonresident aliens to deduct expenses only if and to the extent that they are connected with, or properly allocable and apportioned to, income effectively connected with a United States trade or business.

Thus, for example, a U.S. partner of a partnership that operates a trade or business in both the United States and in a foreign country would only include the items of income, gain, deductions, and loss that would be effectively connected with a United States trade or business. Similarly, a shareholder of an S corporation that is engaged in a trade or business in both the United States and in a foreign country would only take into account the items of income, gain, deduction, and loss that would be effectively connected to the portion of the business conducted by the S corporation in the United States, determined by applying the principles of section 864(c).

In general, whether a nonresident alien is engaged in a trade or business within the United States, as opposed to a trade or business conducted solely outside the United States, is based upon the all the facts and circumstances, as developed through case law and other published guidance. Pursuant to section 875(1), a nonresident alien is considered engaged in a trade or business within the United States if the partnership of which such individual is a member is so engaged.

Section 864(b) provides that the term “trade or business within the United States” includes (but is not limited to) the performance of personal services within the United States at any time during the taxable year, but excludes the performance of services described in section 864(b)(1) and (2). Section 864(b)(1) covers a limited set of nonresident aliens who perform services in the United States on behalf of foreign persons not otherwise engaged in a U.S. trade or business, or on behalf of U.S. persons through a foreign office, if the nonresident aliens are present in the United States less than 90 days during the taxable year and their compensation does not exceed $3,000. Section 864(b)(2) generally treats foreign persons, including partnerships, who are trading in stocks, securities, and in commodities for their own account or through a broker or other independent agent as not engaged in a United States trade or business.

b. Application to Section 199A

Although the cross reference in Section 199A(c)(3)(A)(i) to section 864 is limited to paragraph (c) of that section, no income derived from excluded services under section 864(b)(1) or (2) could ever be effectively connected income in the hands of a nonresident alien. Accordingly, Section 199A incorporates the specific rules regarding the scope of the term “trade or business in the United States” in determining QBI. As such, if a trade or business is not engaged in a U.S. trade or business by reason of section 864(b), items of income, gain, deduction, or loss from that trade or business will not be included in QBI because such items would not be effectively connected with the conduct of a U.S. trade or business.

> If a trade or business is determined to be conducted in the United States, section 864(c)(3) generally treats all income of a nonresident alien from sources within the United States as effectively connected with the conduct of a U.S. trade or business. However, any income from sources within the United States described in section 871(a)(1) or (h) and any gain or loss from the sale of capital assets are only effectively connected if the income meets requirements of section 864(c)(2) and the regulations thereunder. Under section 864(c)(4), income from sources without the United States is generally not treated as effectively connected with the conduct of a U.S. trade or business unless an exception under section 864(c)(4)(B) applies. Thus, a trade or business's foreign source income, gain, or loss, (and any deductions effectively connected with such foreign source income, gain, or loss) would generally not be included in QBI, unless the income meets an exception in section 864(c)(4)(B). Whether income is U.S. or foreign sourced is determined under sections 861, 862, 863, and 865, and the regulations thereunder.
>
> This rule does not mean that any item that is effectively connected with the conduct of a trade or business with the United States is therefore QBI. As discussed previously, the item must also be "with respect to" a trade or business. Certain provisions of the Code allow items to be treated as effectively connected, even though they are not with respect to a trade or business. For example, section 871(d) allows a nonresident alien individual to elect to treat income from real property in the United States that would not otherwise be treated as effectively connected with the conduct of a trade or business within the United Sates as effectively connected. However, for purposes of Section 199A, if items are not attributable to a trade or business under 162, such items do not constitute QBI.
>
> Similarly, the fact that a deduction is allowed for purposes of computing effectively connected taxable income does not necessarily mean that it is taken into account for purposes of Section 199A. For example, for purposes of computing effectively connected taxable income, section 873(b) allows certain deductions, including for theft losses of property located within the United States and charitable contributions allowed under section 170, to be taken into account regardless of whether they are connected with income that is effectively connected with the conduct of a trade or business within the United States. However, for purposes of Section 199A, these items would not be taken into account because Section 199A only permits a deduction for income that is both attributable to a trade or business and that is also effectively connected income.

In the preamble to the final regulations, T.D. 9847 (2/8/2019), part IV.A.4, "Recapture of Overall Foreign Losses," provides:

> One commentator requested that Treasury and the IRS provide that U.S.-source taxable income arising upon recapture of an overall foreign loss described in section 904(f) be treated as QBI in the recapture year to the extent the overall foreign loss limited the Section 199A deduction in a prior tax year. This comment was not adopted. Section 199A(c)(3)(A)(i) limits QBI to items that are effectively connected to a U.S. trade or business in the tax year concerned and the recapture rules in section 904(f) apply only for purposes of subchapter N, Part III, Subpart A of the Code. In addition, it would not be appropriate to expand the scope of QBI for recaptured foreign losses when no similar relief is available if non-qualifying domestic losses are subsequently offset by non-qualifying domestic income.

In the preamble to the final regulations, T.D. 9847 (2/8/2019), part IV.A.8, "Interaction of Sections 875(l) and 199A," provides:

> Section 199A(c)(3)(A)(i) provides that for purposes of determining QBI, the term qualified items of income, gain, deduction, and loss means items of income, gain, deduction and loss to the extent such items are effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting "qualified trade or business (within the meaning of Section 199A" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears). The preamble to the proposed regulations provides that certain items of income, gain, deduction, and loss are treated as effectively connected income but are not with respect to a domestic trade or business (such as items attributable to the election to treat certain U.S. real property sales as effectively connected pursuant to section 871(d)), and are thus not QBI because they are not items attributable to a qualified trade or business for purposes of Section 199A. One commenter agreed with this interpretation but requested additional guidance on the interaction between sections 875(l) and 199A, specifically whether the determination of whether an activity is a trade or business is made at the entity level for purposes of Section 199A. The commenter also recommended that regulations distinguish between (1) items of income, gain, loss, or deduction that are incurred in a trade or business applying the principles of section 162 and (2) items of income, gain, deduction, or loss that are not incurred in such a trade or business.
>
> For purposes of Section 199A, the determination of whether an activity is a trade or business is made at the entity level. If an RPE is engaged in a trade or business, items of income, gain, loss, or deduction from such trade or business retain their character as they pass from the entity to the taxpayer—even if the taxpayer is not personally engaged in the trade or business of the entity. Conversely, if an RPE is not engaged in a trade or business, income, gain, loss, or deduction allocated to a taxpayer from such entity will not qualify for the Section 199A deduction even if the taxpayer or an intervening entity is otherwise engaged in a trade or business. As described in part II.A.3 of this Summary of Comments and Explanation of Revisions, a trade or business for purposes of Section 199A is generally defined by reference to the standards for a section 162 trade or business. A rental real estate enterprise that meets the safe harbor described in Notice 2017-07, released concurrently with these final regulations, may also treated as trades or businesses for purposes of Section 199A. Additionally, the rental or licensing of property if the property is rented or licensed to a trade or business conducted by the individual or an RPE which is commonly controlled under § 1.199A-4(b)(1)(i) is also treated as a trade or business for purposes of Section 199A. In addition to these requirements, the items must be effectively connected to a trade or business within the United States as described in section 864(c).
>
> One commenter requested guidance coordinating Section 199A with section 751(a) and the rules for dispositions of certain interests by foreign persons in section 864(c)(8). The proposed regulations provide that, with respect to a partnership, if section 751(a) or (b) applies, then gain or loss attributable to assets of the partnership giving rise to ordinary income under section 751(a) or (b) is considered attributable to the trades or businesses conducted by the partnership, and is taken into account for purposes of computing QBI. The commenter questioned whether income treated as ordinary income under section 751 for purposes of section 864(c)(8) should be QBI. The treatment of ordinary income under section 751 under subchapter N of chapter 1 of subtitle A of the Code is generally

> a function of section 864(c)(8). On December 27, 2018, the Federal Register published a notice of proposed rulemaking (REG-113604-18) at 83 FR 66647 under section 864(c)(8) (proposed section 864(c)(8) regulations). The proposed section 864(c)(8) regulations provide rules for determining the amount of gain or loss treated as effectively connected with the conduct of a trade or business within the United States ("effectively connected gain" or "effectively connected loss") described in section 864(c)(8), including rules coordinating section 864(c)(8) with sections 741 and 751 (relating to the character of gain or loss realized in connection with the sale or exchange of an interest in a partnership). Because the proposed section 864(c)(8) regulations apply the deemed sale construct of section 751(a) to determine whether gain or loss on the sale of a partnership interest is subject to tax under section 864(c)(8), the issue raised in this comment does not arise, and thus this comment is not adopted. The Treasury Department and the IRS request further comments on the interaction of Section 199A and the proposed regulations under section 864(c)(8) after the publication of those proposed regulations.

Reg. § 1.199A-3(b)(2)(i) provides:

> *In general*. The term qualified items of income, gain, deduction, and loss means items of gross income, gain, deduction, and loss to the extent such items are -
>
> (A) Effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting "trade or business (within the meaning of Section 199A)" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears); and
>
> (B) Included or allowed in determining taxable income for the taxable year.

Code § 864(c) taxes nonresident alien individuals on income and sets forth rules that "apply in determining the income, gain, or loss which shall be treated as effectively connected with the conduct of a trade or business within the United States."[913] See Appel & Karlin, "Gain or Loss of Foreign Persons from Sale or Exchange of Partnership Interests," *Journal of International Taxation* (5/2021).

Note re: various citations below to regulations under Code § 864(c): various tax research services warn that the Treasury has not yet amended them to reflect changes made by laws since 1984, and they include this warning even for regulations promulgated many years after 1984. I have not taken the time to look how accurate these warnings are; however, it has been suggested to me that the regulations are good law. Furthermore, ruling or determination letters will not ordinarily be issued:[914]

> Section 864. - Definitions and Special Rules. - Whether a taxpayer is engaged in a trade or business within the United States, and whether income is effectively connected with the conduct of a trade or business within the United States; whether an instrument is a security as defined in § 1.864-2(c)(2); whether a taxpayer effects transactions in the United States in stocks or securities under § 1.864-2(c)(2); whether an instrument or item is a commodity as defined in § 1.864-2(d)(3); and for purposes of § 1.864-2(d)(1) and (2), whether a commodity is of a kind customarily dealt in on an organized

[913] Code § 864(c)(1)(A).
[914] Rev. Proc. 2018-7, Section 4.01(4).

commodity exchange, and whether a transaction is of a kind customarily consummated at such place.

Code § 864(c)(2) provides that, in determining whether certain "fixed or determinable income" -or:[915]

> whether gain or loss from sources within the United States from the sale or exchange of capital assets, is effectively connected with the conduct of a trade or business within the United States, the factors taken into account shall include whether-
>
> (A) the income, gain, or loss is derived from assets used in or held for use in the conduct of such trade or business, or
>
> (B) the activities of such trade or business were a material factor in the realization of the income, gain, or loss.
>
> In determining whether an asset is used in or held for use in the conduct of such trade or business or whether the activities of such trade or business were a material factor in realizing an item of income, gain, or loss, due regard shall be given to whether or not such asset or such income, gain, or loss was accounted for through such trade or business.

The fixed or determinable income to which Code § 864(c)(2) refers is "income from sources within the United States of the types described in section 871(a)(1), section 871(h), section 881(a), or section 881(c)." Code § 871(a)(1), "Income other than capital gains," provides that, except as provided in Code § 871(h) (relating to "portfolio interest"), a 30% tax is imposed on

> the amount received from sources within the United States by a nonresident alien individual as—
>
> (A) interest (other than original issue discount as defined in section 1273), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income,
>
> (B) gains described in subsection (b) or (c) of section 631,

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[915] Reg. § 1.864-4(a), "In general," provides:

> This section applies only to a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, and to the income, gain, or loss of such person form sources within the United States. If the income, gain, or loss of such person for the taxable year from sources within the United States consists of (1) gain or loss from the sale or exchange of capital assets or (2) fixed or determinable annual or periodical gains, profits, and income or certain other gains described in section 871(a)(1) or 881(a), certain factors must be taken into account, as prescribed by section 864(c)(2) and paragraph (c) of this section, in order to determine whether the income, gain, or loss is effectively connected for the taxable year with the conduct of a trade or business in the United States by that person. All other income, gain, or loss of such person for the taxable year from sources within the United States shall be treated as effectively connected for the taxable year with conduct of a trade or business in the United States by that person, as prescribed by section 864(c)(3) and paragraph (b) of this section.

(C) in the case of—

(i) a sale or exchange of an original issue discount obligation, the amount of the original issue discount accruing while such obligation was held by the nonresident alien individual (to the extent such discount was not theretofore taken into account under clause (ii)), and

(ii) a payment on an original issue discount obligation, an amount equal to the original issue discount accruing while such obligation was held by the nonresident alien individual (except that such original issue discount shall be taken into account under this clause only to the extent such discount was not theretofore taken into account under this clause and only to the extent that the tax thereon does not exceed the payment less the tax imposed by subparagraph (A) thereon), and

(D) gains from the sale or exchange after October 4, 1966, of patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property, or of any interest in any such property, to the extent such gains are from payments which are contingent on the productivity, use, or disposition of the property or interest sold or exchanged,

but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.

Code § 881, which applies to foreign corporations, is similar to Code § 871, which applies to nonresident aliens, regarding the above items.

Code § 871(a)(1)(A) is further described in part II.E.1.e.ii Real Estate As a Trade or Business under the Effectively Connected Income (ECI) Rules.[916]

In determining whether fixed or determinable income and capital gains for the taxable year from sources within the United States is effectively connected for the taxable year with the conduct of a trade or business in the United States:[917]

> the principal tests to be applied are (a) the asset-use test, that is, whether the income, gain, or loss is derived from assets used in, or held for use in, the conduct of the trade or business in the United States, and (b) the business-activities test, that is, whether the

[916] Absent any guidance under the ECI rules, see part II.E.1.e.i General Rules Regarding U.S. Real Estate .

[917] Reg. § 1.864-4(c)(1)(i). Reg. § 1.864-4(c)(1)(ii) provides:

> *Special rule relating to interest on certain deposits*. For purposes of determining under section 861(a)(1)(A) (relating to interest on deposits with banks, savings and loan associations, and insurance companies paid or credited before Jan. 1, 1976) whether the interest described therein is effectively connected for the taxable year with the conduct of a trade or business in the United States, such interest shall be treated as income from sources within the United States for purposes of applying this paragraph and § 1.864-5. If by reason of the application of this paragraph such interest is determined to be income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States, it shall then be treated as interest from sources without the United States which is not subject to the application of § 1.864-5.

activities of the trade or business conducted in the United States were a material factor in the realization of the income, gain, or loss.

The asset-use test ordinarily applies in:[918]

> making a determination with respect to income, gain, or loss of a passive type where the trade or business activities as such do not give rise directly to the realization of the income, gain, or loss. However, even in the case of such income, gain, or loss, any activities of the trade or business which materially contribute to the realization of such income, gain, or loss shall also be taken into account as a factor in determining whether the income, gain, or loss is effectively connected with the conduct of a trade or business in the United States. The asset-use test is of primary significance where, for example, interest income is derived from sources within the United States by a nonresident alien individual or foreign corporation that is engaged in the business of manufacturing or selling goods in the United States.

Ordinarily, an asset is treated as used in, or held for use in, the conduct of a trade or business in the United States if the asset is:[919]

(a) Held for the principal purpose of promoting the present conduct of the trade or business in the United States; or

(b) Acquired and held in the ordinary course of the trade or business conducted in the United States, as, for example, in the case of an account or note receivable arising from that trade or business; or

(c) Otherwise held in a direct relationship to the trade or business conducted in the United States, as determined under paragraph (c)(2)(iv) of this section.

Generally, "stock of a corporation (whether domestic or foreign) shall not be treated as an asset used in, or held for use in, the conduct of a trade or business in the United States."[920] However, the preceding sentence "shall not apply to stock of a corporation (whether domestic or foreign) held by a foreign insurance company unless the foreign insurance company owns 10 percent or more of the total voting power or value of all classes of stock of such corporation."[921]

Reg. § 1.864-4(c)(2)(iv), "Direct relationship between holding of asset and trade or business," provides:

(a) *In general*. In determining whether an asset is held in a direct relationship to the trade or business conducted in the United States, principal consideration shall be given to whether the asset is needed in that trade or business. An asset shall be

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[918] Reg. § 1.864-4(c)(2)(i), which concludes:

> See also subparagraph (5) of this paragraph for rules applicable to taxpayers conducting a banking, financing, or similar business in the United States.

[919] Reg. § 1.864-4(c)(2)(ii).

[920] Reg. § 1.864-4(c)(2)(iii)(a).

[921] Reg. § 1.864-4(c)(2)(iii)(b), which further provides:

> For purposes of this section, section 318(a) shall be applied in determining ownership, except that in applying section 318(a)(2)(C), the phrase "10 percent" is used instead of the phrase "50 percent."

For Code § 318(a), see part II.Q.7.a.viii Code § 318 Family Attribution under Subchapter C.

considered needed in a trade or business, for this purpose, only if the asset is held to meet the present needs of that trade or business and not its anticipated future needs. An asset shall be considered as needed in the trade or business conducted in the United States if, for example, the asset is held to meet the operating expenses of that trade or business. Conversely, an asset shall be considered as not needed in the trade or business conducted in the United States if, for example, the asset is held for the purpose of providing for (1) future diversification into a new trade or business, (2) expansion of trade or business activities conducted outside of the United States, (3) future plant replacement, or (4) future business contingencies.

(b) *Presumption of direct relationship*. Generally, an asset will be treated as held in a direct relationship to the trade or business if (1) the asset was acquired with funds generated by that trade or business, (2) the income from the asset is retained or reinvested in that trade or business, and (3) personnel who are present in the United States and actively involved in the conduct of that trade or business exercise significant management and control over the investment of such asset.

The following examples illustrate Reg. § 1.864-4(c)(2)(iv):[922]

Example (1). M, a foreign corporation which uses the calendar year as the taxable year, is engaged in industrial manufacturing in a foreign country. M maintains a branch in the United States which acts as importer and distributor of the merchandise it manufactures abroad; by reason of these branch activities, M is engaged in business in the United States during 1968. The branch in the United States is required to hold a large current cash balance for business purposes, but the amount of the cash balance so required varies because of the fluctuating seasonal nature of the branch's business. During 1968 at a time when large cash balances are not required the branch invests the surplus amount in U.S. Treasury bills. Since these Treasury bills are held to meet the present needs of the business conducted in the United States they are held in a direct relationship to that business, and the interest for 1968 on these bills is effectively connected for that year with the conduct of the business in the United States by M.

Example (2). Foreign corporation M, which uses the calendar year as the taxable year, has a branch office in the United States where it sells to customers located in the United States various products which are manufactured by that corporation in a foreign country. By reason of this activity M is engaged in business in the United States during 1997. The U.S. branch establishes in 1997 a fund to which are periodically credited various amounts which are derived from the business carried on at such branch. The amounts in this fund are invested in various securities issued by domestic corporations by the managing officers of the U.S. branch, who have the responsibility for maintaining proper investment diversification and investment of the fund. During 1997, the branch office derives from sources within the United States interest on these securities, and gains and losses resulting from the sale or exchange of such securities. Since the securities were acquired with amounts generated by the business conducted in the United States, the interest is retained in that business, and the portfolio is managed by personnel actively involved in the conduct of that business, the securities are presumed under paragraph (c)(2)(iv)(b) of this section to be held in a direct relationship to that business. However, M is able to rebut this presumption by demonstrating that the fund was established to carry out a program of future expansion and not to meet the present

[922] Reg. § 1.864-4(c)(2)(v).

needs of the business conducted in the United States. Consequently, the income, gains, and losses from the securities for 1997 are not effectively connected for that year with the conduct of a trade or business in the United States by M.

The business-activities test ordinarily applies:[923]

> in making a determination with respect to income, gain, or loss which, even though generally of the passive type, arises directly from the active conduct of the taxpayer's trade or business in the United States. The business-activities test is of primary significance, for example, where (a) dividends or interest are derived by a dealer in stocks or securities, (b) gain or loss is derived from the sale or exchange of capital assets in the active conduct of a trade or business by an investment company, (c) royalties are derived in the active conduct of a business consisting of the licensing of patents or similar intangible property, or (d) service fees are derived in the active conduct of a servicing business. In applying the business-activities test, activities relating to the management of investment portfolios shall not be treated as activities of the trade or business conducted in the United States unless the maintenance of the investments constitutes the principal activity of that trade or business.

The following examples illustrate the business-activities test:[924]

> *Example (1)*. Foreign corporation S is a foreign investment company organized for the purpose of investing in stocks and securities. S is not a personal holding company or a corporation which would be a personal holding company but for section 542(c)(7) or 543(b)(1)(C). Its investment portfolios consist of common stocks issued by both foreign and domestic corporations and a substantial amount of high grade bonds. The business activity of S consists of the management of its portfolios for the purpose of investing, reinvesting, or trading in stocks and securities. During the taxable year 1968, S has its principal office in the United States within the meaning of paragraph (c)(2)(iii) of § 1.864-2, and, by reason of its trading in the United States in stocks and securities, is engaged in business in the United States. The dividends and interest derived by S during 1968 from sources within the United States, and the gains and losses from sources within the United States for such year from the sale of stocks and securities from its investment portfolios, are effectively connected for 1968 with the conduct of the business in the United States by that corporation, since its activities in connection with the management of its investment portfolios are activities of that business and such activities are a material factor in the realization of such income, gains, or losses.

> *Example (2)*. N, a foreign corporation which uses the calendar year as the taxable year, has a branch in the United States which acts as an importer and distributor of merchandise; by reason of the activities of that branch, N is engaged in business in the United States during 1968. N also carries on a business in which it licenses patents to unrelated persons in the United States for use in the United States. The businesses of the licensees in which these patents are used have no direct relationship to the business carried on in N's branch in the United States, although the merchandise marketed by the branch is similar in type to that manufactured under the patents. The negotiations and

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[923] Reg. § 1.864-4(c)(3)(i), which concludes:

> See also subparagraph (5) of this paragraph for rules applicable to taxpayers conducting a banking, financing, or similar business in the United States.

[924] Reg. § 1.864-4(c)(3)(ii).

> other activities leading up to the consummation of these licenses are conducted by employees of N who are not connected with the U.S. branch of that corporation, and the U.S. branch does not otherwise participate in arranging for the licenses. Royalties received by N during 1968 from these licenses are not effectively connected for that year with the conduct of its business in the United States because the activities of that business are not a material factor in the realization of such income.

In applying the asset-use test or the business-activities test described above:[925]

> due regard shall be given to whether or not the asset, or the income, gain, or loss is accounted for through the trade or business conducted in the United States, that is, whether or not the asset, or the income, gain or loss, is carried on books of account separately kept for that trade or business, but this accounting test shall not by itself be controlling. In applying this subparagraph, consideration shall be given to whether the accounting treatment of an item reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted condition or practices in that trade or business and whether there is a consistent accounting treatment of that item from year to year by the taxpayer.

Regarding income related to an individual's personal services:[926]

> (i) *Income, gain, or loss from assets*. Income or gains from sources within the United States described in section 871(a)(1) and derived from an asset, and gain or loss from sources within the United States from the sale of exchange of capital assets, realized by a nonresident alien individual engaged in a trade or business in the United States during the taxable year solely by reason of his performing personal services in the United States shall not be treated as income, gain, or loss which is effectively connected for the taxable year with the conduct of a trade or business in the United States, unless there is a direct economic relationship between his holding of the asset from which the income, gain, or loss results and his trade or business or performing the personal services.
>
> (ii) *Wages, salaries, and pensions*. Wages, salaries, fees, compensations, emoluments, or other remunerations, including bonuses, received by a nonresident alien individual for performing personal services in the United States which, under paragraph (a) of § 1.864-2, constitute engaging in a trade or business in the United States, and pensions and retirement pay attributable to such personal services, constitute income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual if he is engaged in a trade or business in the United States at some time during the taxable year in which such income is received.

[925] Reg. § 1.864-4(c)(4).
[926] Reg. § 1.864-4(c)(6).

Other than fixed or determinable income and capital gains, all income, gain, or loss "from sources within the United States" is "treated as effectively connected with the conduct of a trade or business within the United States."[927] For example:[928]

> *Example (1)*. M, a foreign corporation which uses the calendar year as the taxable year, is engaged in the business of manufacturing machine tools in a foreign country. It establishes a branch office in the United States during 1968 which solicits orders from customers in the United States for the machine tools manufactured by that corporation. All negotiations with respect to such sales are carried on in the United States. By reason of its activity in the United States M is engaged in business in the United States during 1968. The income or loss from sources within the United States from such sales during 1968 is treated as effectively connected for that year with the conduct of a business in the United States by M. Occasionally, during 1968 the customers in the United States write directly to the home office of M, and the home office makes sales directly to such customers without routing the transactions through it branch office in the United States. The income or loss from sources within the United States for 1968 from these occasional direct sales by the home office is also treated as effectively connected for that year with the conduct of a business in the United States by M.
>
> *Example (2)*. The facts are the same as in example (1) except that during 1967 M was also engaged in the business of purchasing and selling office machines and that it used the installment method of accounting for the sales made in this separate business. During 1967 M was engaged in business in the United States by reason of the sales activities it carried on in the United States for the purpose of selling therein a number of the office machines which it had purchased. Although M discontinued this business activity in the United States in December of 1967, it received in 1968 some installment payments on the sales which it had made in the United States during 1967. The income of M for 1968 from sources within the United States which is attributable to such installment payments is effectively connected for 1968 with the conduct of a business in the United States, even though such income is not connected with the business carried on in the United States during 1968 through its sales office located in the United States for the solicitation of orders for the machine tools it manufacturers.
>
> *Example (3)*. Foreign corporation S, which uses the calendar year as the taxable year, is engaged in the business of purchasing and selling electronic equipment. The home office of such corporation is also engaged in the business of purchasing and selling vintage wines. During 1968, S establishes a branch office in the United States to sell electronic equipment to customers, some of whom are located in the United States and the balance, in foreign countries. This branch office is not equipped to sell, and does not

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[927] Code § 864(c)(3). Reg. § 1.864-4(b), "Income other than fixed or determinable income and capital gains," provides:

> All income, gain, or loss for the taxable year derived by a nonresident alien individual or foreign corporation engaged in a trade or business in the United States from sources within the United States which does not consist of income, gain, or loss described in section 871(a)(1) or 881(a), or of gain or loss from the sale or exchange of capital assets, shall, for purposes of paragraph (a) of this section, be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States. This income, gain, or loss shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States, whether or not the income, gain, or loss is derived from the trade or business being carried on in the United States during the taxable year.

[928] Reg. § 1.864-4(b).

participate in sales of, wine purchased by the home office. Negotiations for the sales of the electronic equipment take place in the United States. By reason of the activity of its branch office in the United States, S is engaged in business in the United States during 1968. As a result of advertisements which the home office of S places in periodicals sold in the United States, customers in the United States frequently place orders for the purchase of wines with the home office in the foreign country, and the home office makes sales of wine in 1968 directly to such customers without routing the transactions through its branch office in the United States. The income or loss from sources within the United States for 1968 from sales of electronic equipment by the branch office, together with the income or loss from sources within the United States for that year from sales of wine by the home office, is treated as effectively connected for that year with the conduct of a business in the United States by S.

Special rules apply to whether income, gain or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States by a nonresident alien individual. Code § 864(c)(4), "Income from sources without United States," provides:

(A) Except as provided in subparagraphs (B) and (C), no income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States.

(B) Income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States by a nonresident alien individual or a foreign corporation if such person has an office or other fixed place of business within the United States to which such income, gain, or loss is attributable and such income, gain, or loss-[929]

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[929] [my footnote – not in statute]: Code § 864(c)(5), which is discussed in case at fns 933 (together with Code § 864(c)(4)(B)) and 935 of this part II.E.1.c.ix QBI and Effectively Connected Income, provides the following rules in applying Code § 864(c)(4)(B):

(A) in determining whether a nonresident alien individual or a foreign corporation has an office or other fixed place of business, an office or other fixed place of business of an agent shall be disregarded unless such agent (i) has the authority to negotiate and conclude contracts in the name of the nonresident alien individual or foreign corporation and regularly exercises that authority or has a stock of merchandise from which he regularly fills orders on behalf of such individual or foreign corporation, and (ii) is not a general commission agent, broker, or other agent of independent status acting in the ordinary course of his business,

(B) income, gain, or loss shall not be considered as attributable to an office or other fixed place of business within the United States unless such office or fixed place of business is a material factor in the production of such income, gain, or loss and such office or fixed place of business regularly carries on activities of the type from which such income, gain, or loss is derived, and

(C) the income, gain, or loss which shall be attributable to an office or other fixed place of business within the United States shall be the income, gain, or loss property allocable thereto, but, in the case of a sale or exchange described in clause (iii) of such subparagraph , the income which shall be treated as attributable to an office or other fixed place of business within the United States shall not exceed the income which would be derived from sources within the United States if the sale or exchange were made in the United States.

(i) consists of rents or royalties for the use of or for the privilege of using intangible property described in section 862(a)(4) derived in the active conduct of such trade or business;

(ii) consists of dividends, interest, or amounts received for the provision of guarantees of indebtedness, and either is derived in the active conduct of a banking, financing, or similar business within the United States or is received by a corporation the principal business of which is trading in stocks or securities for its own account; or

(iii) is derived from the sale or exchange (outside the United States) through such office or other fixed place of business of personal property described in section 1221(a)(1), except that this clause shall not apply if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer in a foreign country participated materially in such sale.

Any income or gain which is equivalent to any item of income or gain described in clause (i), (ii), or (iii) shall be treated in the same manner as such item for purposes of this subparagraph.

(C) In the case of a foreign corporation taxable under part I or part II of subchapter L, any income from sources without the United States which is attributable to its United States business shall be treated as effectively connected with the conduct of a trade or business within the United States.

(D) No income from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States if it either -

(i) consists of dividends, interest, or royalties paid by a foreign corporation in which the taxpayer owns (within the meaning of section 958(a)), or is considered as owning (by applying the ownership rules of section 958(b)), more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or

(ii) is subpart F income within the meaning of section 952(a).

Reg. § 1.864-5(a), "In general," provides:

This section applies only to a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, and to the income, gain, or loss of such person from sources without the United States. The income, gain, or loss of such person for the taxable year from sources without the United States which is specified in paragraph (b) of this section shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States, only if he also has in the United States at some time during the taxable year, but not necessarily at the time the income, gain, or loss is realized, an office or other fixed place of business, as defined in § 1.864-7, to which such income, gain, or loss is attributable in accordance with § 1.864-6. The income of such person for the taxable year from sources without the United States which is specified in paragraph (c) of this section shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States when derived by a foreign corporation carrying on a life insurance business in the United States. Except as provided in paragraphs (b) and (c) of this section, no income, gain, or loss of a nonresident alien individual or a foreign corporation for the taxable year from sources without the United States shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that person. Any income, gain, or loss described in paragraph (b) or (c) of this section which, if it were derived by the taxpayer from sources within the United States for the taxable year, would not be treated under § 1.864-4 as effectively connected for the taxable year with the conduct of a trade or business in the United States shall not be treated under this section as effectively connected for the taxable year with the conduct of a trade or business in the United States.

Reg. § 1.864-5(b)(1) provides that rents, royalties, or gains on sales of intangible property related to the use of the intangible property outside the United States are taken into account under Reg. § 1.864-5(a) only if "derived in the active conduct of the trade or business in the United States."

Reg. § 1.864-5(b)(2) provides that dividends or interest, or gains or loss from sales of stocks or securities are taken into account under Reg. § 1.864-5(a) if "realized by (a) a nonresident alien individual or a foreign corporation in the active conduct of a banking, financing, or similar business in the United States or (b) a foreign corporation engaged in business in the United States whose principal business is trading in stocks or securities for its own account," with "engaged in the active conduct of a banking, financing, or similar business in the United States" being determined under Reg. § 1.864-4(c)(5)(i).

Reg. § 1.864-5(b)(3)(i) provides that, to the extent not covered above:

> Income, gain, or loss from the sale of inventory items or of property held primarily for sale to customers in the ordinary course of business, as described in section 1221(1), where the sale is outside the United States but through the office or other fixed place of business which the nonresident alien or foreign corporation has in the United States, irrespective of the destination to which such property is sent for use, consumption, or disposition.

However, Reg. § 1.864-6(a) provides that Reg. § 1.864-5(b) does not make income effectively connected for the taxable year with the conduct of a trade or business in the United States unless:

> the income, gain, or loss is attributable under paragraphs (b) and (c) of this section to an office or other fixed place of business, as defined in § 1.864-7, which the taxpayer has in the United States at some time during the taxable year.

However, Reg. § 1.864-6(b)(1) provides:[930]

> For purposes of paragraph (a) of this section, income, gain, or loss is attributable to an office or other fixed place of business which a nonresident alien individual or a foreign corporation has in the United States only if such office or other fixed place of business is

[930] A case discusses Reg. § 1.864-6(b)(1) at fns 933, 934 and 936 in this part II.E.1.c.ix QBI and Effectively Connected Income.

a material factor in the realization of the income, gain, or loss, and if the income, gain, or loss is realized in the ordinary course of the trade or business carried on through that office or other fixed place of business. For this purpose, the activities of the office or other fixed place of business shall not be considered to be a material factor in the realization of the income, gain, or loss unless they provide a significant contribution to, by being an essential economic element in, the realization of the income, gain, or loss. Thus, for example, meetings in the United States of the board of directors of a foreign corporation do not of themselves constitute a material factor in the realization of income, gain, or loss. It is not necessary that the activities of the office or other fixed place of business in the United States be a major factor in the realization of income, gain, or loss. An office or other fixed place of business located in the United States at some time during a taxable year may be a material factor in the realization of an item of income, gain, or loss for that year even though the office or other fixed place of business is not present in the United States when the income, gain, or loss is realized.

Reg. § 1.864-6(b)(2) provides special rules for rents, royalties, or gains or losses, from intangible personal property, and dividends or interest from any transaction, or gains or losses on the sale or exchange of stocks or securities:[931]

(i) *Rents, royalties, or gains on sales of intangible property*. Rents, royalties, or gains or losses, from intangible personal property specified in paragraph (b)(1) of § 1.864-5, if the office or other fixed place of business either actively participates in soliciting, negotiating, or performing other activities required to arrange, the lease, license, sale, or exchange from which such income, gain, or loss is derived or performs significant services incident to such lease, license, sale, or exchange. An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because the office or other fixed place of business conducts one or more of the following activities: (a) develops, creates, produces, or acquires and adds substantial value to, the property which is leased, licensed, or sold, or exchanged, (b) collects or accounts for the rents, royalties, gains, or losses, (c) exercises general supervision over the activities of the persons directly responsible for carrying on the activities or services described in the immediately preceding sentence, (d) performs merely clerical functions incident to the lease, license, sale, or exchange or (e) exercises final approval over the execution of the lease, license, sale, or exchange. The application of this subdivision may be illustrated by the following examples:

Example (1). F, a foreign corporation, is engaged in the active conduct of the business of licensing patents which it has either purchased or developed in the United States. F has a business office in the United States. Licenses for the use of such patents outside the United States are negotiated by offices of F located outside the United States, subject to approval by an officer of such corporation located in the U.S. office. All services which are rendered to F's foreign licenses are performed by employees of F's offices located outside the United States. None of the income, gain, or loss resulting from the foreign licenses so negotiated by F is attributable to its business office in the United States.

[931] A case discusses Reg. § 1.864-6(b)(2)(i) at fn 935 in this part II.E.1.c.ix QBI and Effectively Connected Income.

Example (2). N, a foreign corporation, is engaged in the active conduct of the business of distributing motion picture films and television programs. N does not distribute such films or programs in the United States. The foreign distribution rights to these films and programs are acquired by N's U.S. business office from the U.S. owners of these films and programs. Employees of N's offices located in various foreign countries carry on in such countries all the solicitations and negotiations for the licensing of these films and programs to licensees located in such countries and provide the necessary incidental services to the licensees. N's U.S. office collects the rentals from the foreign licensees and maintains the necessary records of income and expense. Officers of N located in the United States also maintain general supervision over the employees of the foreign offices, but the foreign employees conduct the day to day business of N outside the United States of soliciting, negotiating, or performing other activities required to arrange the foreign licenses. None of the income, gain, or loss resulting from the foreign licenses so negotiated by N is attributable to N's U.S. office.

(ii) *Dividends or interest, or gains or losses from sales of stock or securities*.

(a) *In general*. Dividends, or interest from any transaction, or gains or losses on the sale or exchange of stocks or securities, specified in paragraph (b)(2) of § 1.864-5, if the office or other fixed place of business either activity participates in soliciting, negotiating, or performing other activities required to arrange, the issue, acquisition, sale, or exchange, of the asset from which such income, gain, or loss is derived or performs significant services incident to such issue, acquisition, sale or exchange. An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because the office or other fixed place of business conducts one or more of the following activities: (1) collects or accounts for the dividends, interest, gains, or losses, (2) exercises general supervision over the activities of the persons directly responsible for carrying on the activities or services described in the immediately preceding sentence, (3) performs merely clerical functions incident to the issue, acquisition, sale, or exchange, or (4) exercises final approval over the execution of the issue, acquisition, sale, or exchange.

(b) *Effective connection of income from stocks or securities with active conduct of a banking, financing, or similar business*. Notwithstanding (a) of this subdivision (ii), the determination as to whether any dividends or interest from stocks or securities, or gain or loss from the sale or exchange of stocks or securities which are capital assets, which is from sources without the United States and derived by a nonresident alien individual or a foreign corporation in the active conduct during the taxable year of a banking, financing, or similar business in the United States, shall be treated as effectively connected for such year with the active conduct of that business shall be made by applying the principles of paragraph (c)(5)(ii) of § 1.864-4 for determining whether income, gain, or loss of such type from sources within the United States is effectively connected for such year with the active conduct of that business.

(c) *Security defined*. For purposes of this subdivision (ii), a security is any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing items.

(d) *Limitations on application of rules on banking, financing, or similar business*.

(1) *Trading for taxpayer's own account*. The provisions of (b) of this subdivision (ii) apply for purposes of determining when certain income, gain, or loss from stocks or securities is effectively connected with the active conduct of a banking, financing, or similar business in the United States. Any dividends, interest, gain, or loss from sources without the United States which by reason of the application of (b) of this subdivision (ii) is not effectively connected with the active conduct by a foreign corporation of a banking, financing, or similar business in the United States may be effectively connected for the taxable year, under (a) of this subdivision (ii), with the conduct by such taxpayer of a trade or business in the United States which consists of trading in stocks or securities for the taxpayer's own account.

(2) *Other income*. For rules relating to dividends or interest from sources without the United States (other than dividends or interest from, or gain or loss from the sale or exchange of, stocks or securities referred to in (b) of this subdivision (ii)) derived in the active conduct of a banking, financing, or similar business in the United States, see (a) of this subdivision (ii).

(iii) *Sale of goods or merchandise through U.S. office*. Income, gain, or loss from sales of goods or merchandise specified in paragraph (b)(3) of § 1.864-5, if the office or other fixed place of business actively participates in soliciting the order, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale which are not the subject of a separate agreement between the seller and the buyer. The office or other fixed place of business in the United States shall be considered a material factor in the realization of income, gain, or loss from a sale made as a result of a sales order received in such office or other fixed place of business except where the sales order is received unsolicited and that office or other fixed place of business is not held out of potential customers as the place to which such sales should be sent. The income, gain, or loss must be realized in the ordinary course of the trade or business carried on through the office or other fixed place of business in the United States. Thus, if a foreign corporation is engaged solely in a manufacturing business in the United States, the income derived by its office in the United States as a result of an occasional sale outside the United States is not attributable to the U.S. office if the sales office of the manufacturing business is located outside the United States. On the other hand, if a foreign corporation establishes a sales office in the United States to sell for consumption in the Western Hemisphere merchandise which the corporation produces in Africa, the income derived by the sales office in the United States as a result of an occasional sale made by it in Europe shall be attributable to the U.S. sales office. An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because of one or more of the following activities: (a) the sale is made subject to the final approval of such office or other fixed place of business, (b) the property sold is held in, and distributed from, such office or other fixed place of business, (c) samples of the property sold are displayed (but not otherwise promoted or sold) in such office or other fixed place of business, or (d) such office or other fixed place of business performs merely clerical functions incident to the sale. Activities carried on by employees of an office or other fixed place of business constitute activities of that office or other fixed place of business.

For purposes of that provision, Reg. § 1.864-6(c) defines a security as "any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing items."

Reg. § 1.864-7 defines "an office or other fixed place of business in the United States."

Reg. § 1.864-5(c) relates to income attributable to certain foreign corporations' U.S. life insurance business.

The above analysis is informed by *Grecian Magnesite Mining v. Commissioner*, 149 T.C. 63 (2017),[932] which is described in in part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest, especially fn. 5651. That case dealt with the sale of a partnership interest by a nonresident alien that was a passive investor in a U.S. business. The IRS argued that one must look through the partnership to determine whether gain on sale was ECI, and the taxpayer argued that the taxpayer did not participate in the business and that a partnership interest should be treated as ownership of an entity – not of the underlying assets. As described further below, 2017 tax reform added the rules relating to the sale of a partnership interest, but it did not overturn any other aspect of that ruling.

The court provided an overview of whether the redemption of the taxpayer's partnership interest was ECI:[933]

> Section 865(e)(3) provides that, in order to determine whether income from a sale is attributable to a U.S. office or fixed place of business, we must look to "[t]he principles of section 864(c)(5)", which provides rules for applying section 864(c)(4)(B) to determine what tax items are "attributable to" a U.S. office.[20] Under section 864(c)(5)(B), income, gain, or loss is attributable to a U.S. office only if: (a) the U.S. office is "a *material factor* in the production of such income", and (b) the U.S. office "*regularly carries* on activities of the type from which such income, gain, or loss is derived."[21] (Emphasis added.) 26 C.F.R. section 1.864-6, Income Tax Regs., refers to these two elements together as the "material factor" test, explaining "regularly carries on activities of the type", see sec. 864(c)(5)(B), as "realized in the ordinary course". Because the regulation employs the phrase "in the ordinary course" in its application of the statute, we also use "ordinary course" here as a synonym for "regularly carries on activities of the type".
>
> [20] By its terms, section 864(c)(4)(B) and (c)(5) does not apply to gains from dispositions of partnership interests, because such gains are not one of the three types of income denoted in section 864(c)(4)(B)(i)-(iii). Thus, section 865(e)(3) does not incorporate section 864(c)(5) per se but rather invokes only "*[t]he principles* of section 864(c)(5)". (Emphasis added.)
>
> [21] The parties have not directed us to any caselaw applying these "material factor" and "ordinary course" standards, and we find none.

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[932] Aff'd 926 F3d 819 (D.C. Cir. 2019).

[933] Reg. § 1.864-6(b)(1) is quoted at fn 930 in this part II.E.1.c.ix QBI and Effectively Connected Income. Code § 864(c)(5) is quoted at fn 929 in this part II.E.1.c.ix QBI and Effectively Connected Income. After 2017 tax reform, these provisions no longer apply to partnership interests, but they would apply to stock.

The court discussed Reg. § 1.864-6(b)(1):[934]

> … the Commissioner argues in the alternative that because Premier increased the value of its underlying assets and increased its overall value as a going concern during the period that GMM was a partner, thereby increasing the value of GMM's interest, Premier's U.S. offices were an essential economic element in GMM's realization of gain in the redemption. In so arguing, the Commissioner conflates the ongoing value of a business operation with gain from the sale of an interest in that business. As we have explained previously, GMM's gain in the redemption was not realized from Premier's trade or business of mining magnesite, that is, from activities at the partnership level; rather, GMM realized gain at the partner level from the distinct sale of its partnership interest.

The court discussed Reg. § 1.864-6(b)(2)(i), to which the taxpayer pointed as requiring a higher level of activity than the taxpayer's:[935]

> The Commissioner dismisses this argument with the observation, correct as far as it goes, that the regulation concerns "[r]ents, royalties, or gains on sales of intangible property", whereas here the income at issue is different - *i.e.*, proceeds from the redemption of a partnership interest. The Commissioner is correct in the sense that this regulation is not directly on point; however, in determining whether a sale is attributable to an office, we are directed by section 865(e)(3) to consult not "section 864(c)(5)" (which by its terms does not apply here, see supra note 19) but rather "*the principles of* section 864(c)(5)". (Emphasis added.) It therefore seems we must take guidance as appropriate from section 864(c)(5) and the regulations promulgated thereunder *without* dismissing, as the Commissioner would, provisions that are not directly on point, since the set of provisions that are directly on point is an empty set. We acknowledge it is fair to observe that a provision applicable to one kind of income might not be suited to a "material factor" analysis for another kind of income. But we see no reason to disregard this "[r]ents, royalties", etc., provision insofar as it provides an instance in which a U.S. office that "[d]evelops" and "adds substantial value to" an income-generating asset is nonetheless not a "material factor" in the realization of income from that asset. GMM reasonably derives from this regulation the principle that the creation of underlying value is simply a distinct function from being a material factor in the realization of income in a specific transaction.
>
> The material factor test is not satisfied here because Premier's actions to increase its overall value were not "an essential economic element in the realization of the income", 26 C.F.R. sec. 1.864-6(b)(1), that GMM received upon the sale of its interest. Increasing the value of Premier's business as a going concern, without a subsequent sale, would not have resulted in the realization of gain by GMM.
>
> To be sure, GMM's investment in Premier increased in value, presumably from Premier's business activities; but GMM did not realize gain from holding its interest in Premier until that amount became liquid, that is, until its partnership interest was redeemed. The regulations call for this focus in two ways—by providing that adding value alone is not a material factor, see *id.* subpara. (2)(i)(a), and by providing that performing merely clerical functions incident

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[934] Reg. § 1.864-6(b)(1) is quoted at fn 930 in this part II.E.1.c.ix QBI and Effectively Connected Income. Code § 864(c)(5) is quoted at fn 929 in this part II.E.1.c.ix QBI and Effectively Connected Income. After 2017 tax reform, these provisions no longer apply to partnership interests, but they would apply to stock.
[935] Reg. § 1.864-6(b)(2)(i) is quoted at fn 931 in this part II.E.1.c.ix QBI and Effectively Connected Income. After 2017 tax reform, these provisions no longer apply to partnership interests, but they would apply to stock.

> to the sale or exchange (*i.e.*, a reasonable description of Premier's role in effecting the liquidation)[23] is not a material factor, see *id.* subdiv. (i)(d). Thus, Premier's efforts to develop, create, or add substantial value to the property sold are not considered to be a material factor in the realization of the disputed gain pursuant to 26 C.F.R. section 1.864-6(b)(1), and the Commissioner therefore fails to show that the first test for attributing the disputed gain to a U.S. office - "material factor" - is met.
>
> [23] The Commissioner would dispute the reasonableness of that description, but in part IV.B.3.b below we discuss the nature and modest quantum of Premier's activity in the redemption

Finally, the court concluded that the taxpayer's gain on redemption of its partnership interest was not in the ordinary course of the partnership's business:[936]

> The second part of the U.S.-source attribution inquiry—"ordinary course"— is found in 26 C.F.R. section 1.864-6(b)(1), which provides:
>
>> [I]ncome, gain, or loss is attributable to an office or other fixed place of business which *** a foreign corporation has in the United States only *** *if the income, gain, or loss is realized in the ordinary course of the trade or business carried on through that office or other fixed place of business.* *** [Emphasis added.]
>
> Even if we were to decide that Premier's office was a "material factor" in the production of the disputed gain (which we do not), we would also need to find that the disputed gain was realized in the ordinary course of Premier's business conducted through its U.S. office in order for the gain to be attributable to that office, and thereby to be U.S.-source income.[24]
>
> As required by its bylaws, Premier extended to GMM an offer to redeem its interest according to the terms of Premier's prior transaction with IMin. GMM accepted Premier's offer without any negotiation of the terms of the deal.
>
> According to GMM, the redemption of its interest in Premier was a one-time, extraordinary event and therefore was not undertaken in the ordinary course of Premier's business. GMM argues that Premier's U.S. office is in the business of selling and producing magnesite, not buying and selling partnership interests. Because the disputed gain was realized in the redemption of GMM's partnership interest in Premier, not from Premier's ordinary business - magnesite production and sale - it does not satisfy the ordinary course requirement and is not U.S. source.
>
> The Commissioner disagrees with GMM's characterization of Premier, and points to Premier's other actions - admitting a new partner and redeeming IMin's interest - to show that Premier's redemption of GMM's interest was not an isolated event. The Commissioner takes the position that the wording of section 865(e)(2)(A) ("any sale of personal property") is broad enough to cover all sales of personal property, including occasional sales. The Commissioner explains:

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[936] Reg. § 1.864-6(b)(1) is quoted at fn 930 in this part II.E.1.c.ix QBI and Effectively Connected Income. After 2017 tax reform, this provision no longer apply to partnership interests, but they would apply to stock.

> The language of section 864(c)(5)(B) does not require that the sale of personal property occur regularly; it requires that the type of activities giving rise to the income occur regularly. In this regard, the language is amply broad to support attribution to an office of income from an occasional sale of personal property, *if the gain on the sale is derived from the business activities regularly conducted* through the office or other fixed place of business. [Emphasis added.]

The Commissioner again conflates the ongoing income-producing activities of Premier (magnesite production and sale), which certainly occurred in the ordinary course, and the redemption of GMM's partnership interest in Premier, which was an extraordinary event; and he thereby would effectively eliminate the "ordinary course" test and would allow the "material factor" test to stand for both tests. Premier's business did regularly produce income (and GMM paid tax on its distributive share of that income each year). However, contrary to the Commissioner's assertion, Premier was not engaged in the business of buying or selling interests in itself and did not do so in the ordinary course of its business. Premier engaged in only two such transactions (other than the redemption of GMM's interest) over the course of seven years, and this quantum of activity is not sufficient to show that Premier was in the business of redeeming and selling partnership interests. Rather, Premier is of course in the business of producing and selling magnesite products, and therefore GMM's gain realized on the redemption of its partnership interest in Premier was not realized in the ordinary course of the trade or business carried on through Premier's U.S. offices.

Since we have held that GMM's disputed gain on its redemption was not attributable to a U.S. office or other fixed place of business, it is therefore not U.S.-source income under section 865(e)(2)(A). As noted above, the Commissioner concedes that the disputed gain is not one of the types of foreign-source income treated as effectively connected by section 864(c)(4)(B). Consequently, the disputed gain is not effectively connected income.

[24] Rev. Rul. 91-32 *supra*, makes no mention of the "ordinary course" prong of the "attributable to" analysis, and this detracts from the persuasiveness of its conclusion that gain such as the disputed gain is attributable to U.S. offices.

Also, certain dividends, interest, or royalties paid by a related foreign corporation and certain Subpart F income from a controlled foreign corporation, which are from sources without the United States, are excluded from treatment as effectively connected for any taxable year with the conduct of a trade or business in the United States by a nonresident alien individual or a foreign corporation.[937]

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[937] Reg. § 1.864-5(d). Reg. § 1.864-5(d)(3) also coordinates with Reg. § 1.864-4:

> Interest which, by reason of section 861(a)(1)(A) (relating to interest on deposits with banks, savings and loan associations, and insurance companies paid or credited before January 1, 1976) and paragraph (c) of § 1.864-4, is determined to be income from sources without the United States because it is not effectively connected for the taxable year with the conduct of a trade or business in the United States by the nonresident alien individual or foreign corporation.

Additional rules apply to deferred payment[938] and to property disposed of within 10 years after it to be used or held for use in connection with the conduct of a trade or business within the United States.[939]

In response to *Grecian Magnesite*,[940] 2017 tax reform added Code § 864(c)(8), which provides:[941]

> *Gain or loss of foreign persons from sale or exchange of certain partnership interests*.
>
> (A) *In general*. Notwithstanding any other provision of this subtitle, if a nonresident alien individual or foreign corporation owns, directly or indirectly, an interest in a partnership which is engaged in any trade or business within the United States, gain or loss on the sale or exchange of all (or any portion of) such interest shall be treated as effectively connected with the conduct of such trade or business to the extent such gain or loss does not exceed the amount determined under subparagraph (b).
>
> (B) *Amount treated as effectively connected*. The amount determined under this subparagraph with respect to any partnership interest sold or exchanged-
>
> (i) in the case of any gain on the sale or exchange of the partnership interest, is-
>
> (I) the portion of the partner's distributive share of the amount of gain which would have been effectively connected with the conduct of a trade or business within the United States if the partnership had sold all of its assets at their fair market value as of the date of the sale or exchange of such interest, or
>
> (II) zero if no gain on such deemed sale would have been so effectively connected, and
>
> (ii) in the case of any loss on the sale or exchange of the partnership interest, is-

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938 Code § 864(c)(6).
939 Code § 864(c)(7).
940 *Grecian Magnesite Mining v. Commissioner*, which is described above and further described in part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest, especially fn. 5651. The Conference report provided:

> Under a 1991 revenue ruling, in determining the source of gain or loss from the sale or exchange of an interest in a foreign partnership, the IRS applied the asset-use test and business activities test at the partnership level to determine the extent to which income derived from the sale or exchange is effectively connected with that U.S. business.[1107] Under the ruling, if there is unrealized gain or loss in partnership assets that would be treated as effectively connected with the conduct of a U.S. trade or business if those assets were sold by the partnership, some or all of the foreign person's gain or loss from the sale or exchange of a partnership interest may be treated as effectively connected with the conduct of a U.S. trade or business. However, a 2017 Tax Court case rejects the logic of the ruling and instead holds that, generally, gain or loss on sale or exchange by a foreign person of an interest in a partnership that is engaged in a U.S. trade or business is foreign-source.[1108]
> 1107 Rev. Rul. 91-32, 1991-1 C.B. 107.
> 1108 *See Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (July 13, 2017).

941 For further discussion, see part II.E.1.c.viii.(c) Sale of an Interest in a Partnership Conducting a Trade or Business.

(I) the portion of the partner's distributive share of the amount of loss on the deemed sale described in clause (i)(I) which would have been so effectively connected, or

(II) zero if no loss on such deemed sale would be have been so effectively connected.

For purposes of this subparagraph, a partner's distributive share of gain or loss on the deemed sale shall be determined in the same manner as such partner's distributive share of the non-separately stated taxable income or loss of such partnership.

(C) *Coordination with United States real property interests*. If a partnership described in subparagraph (A) holds any United States real property interest (as defined in section 897(c)) at the time of the sale or exchange of the partnership interest, then the gain or loss treated as effectively connected income under subparagraph (A) shall be reduced by the amount so treated with respect to such United States real property interest under section 897.

(D) *Sale or exchange*. For purposes of this paragraph, the term "sale or exchange" means any sale, exchange, or other disposition.

(E) *Secretarial authority*. The Secretary shall prescribe such regulations or other guidance as the Secretary determines appropriate for the application of this paragraph, including with respect to exchanges described in section 332, 351, 354, 355 , 356, or 361.

Code § 897(a)(1) provides:

Treatment as effectively connected with United States trade or business. For purposes of this title, gain or loss of a nonresident alien individual or a foreign corporation from the disposition of a United States real property interest shall be taken into account-

(A) in the case of a nonresident alien individual, under section 871(b)(1), or

(B) in the case of a foreign corporation, under section 882(a)(1),

as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business.

Code § 897(c), "United States Real Property Interest," provides:

For purposes of this section-

(1) *United States real property interest*.

(A) *In general*. Except as provided in subparagraph (b) or subsection(k), the term "United States real property interest" means-

(i) an interest in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the Virgin Islands, and

(ii) any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes (at such time and in such manner as the Secretary by regulations prescribes) that such corporation was at no time a United States real property holding corporation during the shorter of-

(I) the period after June 18, 1980, during which the taxpayer held such interest, or

(II) the 5-year period ending on the date of the disposition of such interest.

(B) *Exclusion for interest in certain corporations*. The term “United States real property interest” does not include any interest in a corporation if-

(i) as of the date of the disposition of such interest, such corporation did not hold any United States real property interests,

(ii) all of the United States real property interests held by such corporation at any time during the shorter of the periods described in subparagraph (A)(ii)-

(I) were disposed of in transactions in which the full amount of the gain (if any) was recognized, or

(II) ceased to be United States real property interests by reason of the application of this subparagraph to 1 or more other corporations, and

(iii) such corporation nor any predecessor of such corporation was a regulated investment company or a real estate investment trust at any time during the shorter of the periods described in subparagraph (A)(ii).

(2) *United States real property holding corporation*. The term “United States real property holding corporation” means any corporation if-

(A) the fair market value of its United States real property interests equals or exceeds 50 percent of

(B) the fair market value of-

(i) its United States real property interests,

(ii) its interests in real property located outside the United States, plus

(iii) any other of its assets which are used or held for use in a trade or business.

(3) *Exception for stock regularly traded on established securities markets*. If any class of stock of a corporation is regularly traded on an established securities market, stock of such class shall be treated as a United States real property interest only in the case of a person who, at some time during the shorter of the periods described in paragraph (1)(A)(ii), held more than 5 percent of such class of stock.

(4) *Interests held by foreign corporations and by partnerships, trusts, and estates*. For purpose of determining whether any corporation is a United States real property holding corporation-

(A) *Foreign corporations*. Paragraph (1)(A)(ii) shall be applied by substituting "any corporation (whether foreign or domestic)" for "any domestic corporation".

(B) *Assets held by partnerships, etc.* Under regulations prescribed by the Secretary, assets held by a partnership, trust, or estate shall be treated as held proportionately by its partners or beneficiaries. Any asset treated as held by a partner or beneficiary by reason of this subparagraph which is used or held for use by the partnership, trust, or estate in a trade or business shall be treated as so used or held by the partner or beneficiary Any asset treated as held by a partner or beneficiary by reason of this subparagraph shall be so treated for purposes of applying this subparagraph successively to partnerships, trusts, or estates which are above the first partnership, trust, or estate in a chain thereof.

(5) *Treatment of controlling interests*.

(A) *In general*. Under regulations, for purposes of determining whether any corporation is a United States real property holding corporation, if any corporation (hereinafter in this paragraph referred to as the "first corporation") holds a controlling interest in a second corporation-

(i) the stock which the first corporation holds in the second corporation shall not be taken into account,

(ii) the first corporation shall be treated as holding a portion of each asset of the second corporation equal to the percentage of the fair market value of the stock of the second corporation represented by the stock held by the first corporation, and

(iii) any asset treated as held by the first corporation by reason of clause (ii) which is used or held for use by the second corporation in a trade or business shall be treated as so used or held by the first corporation.

Any asset treated as held by the first corporation by reason of the preceding sentence shall be so treated for purposes of applying the preceding sentence successively to corporations which are above the first corporation in a chain of corporations.

(B) *Controlling interest*. For purposes of subparagraph (A), the term "controlling interest" means 50 percent or more of the fair market value of all classes of stock of a corporation.

(6) *Other special rules*.

(A) *Interest in real property*. The term "interest in real property" includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.

(B) *Real property includes associated personal property*. The term “real property” includes movable walls, furnishings, and other personal property associated with the use of the real property.

(C) *Constructive ownership rules*. For purposes of determining under paragraph (3) whether any person holds more than 5 percent of any class of stock and of determining under paragraph (5) whether a person holds a controlling interest in any corporation, section 318(a) shall apply (except that paragraphs (2)(C) and (3)(C) of section 318(a) shall be applied by substituting “5 percent” for “50 percent”).

For Code § 318(a), see part II.Q.7.a.viii Code § 318 Family Attribution under Subchapter C.

II.E.1.c.x. Bonus Depreciation and the Code § 199A Deduction

By reducing qualified business income, bonus depreciation reduces the 20% deduction.

The 20% deduction will eventually go away, whereas the lack of future depreciation deductions will come back to haunt taxpayers when rates increase and the 20% deduction is not available.

In 2018, taking bonus depreciation is an easy decision for most property, in that most property eligible for bonus depreciation has a depreciable life of 7 years or less, and the 20% deduction lasts for 7 years.

If the law does not change, then taking bonus depreciation in 2025 may be inadvisable, because it reduces the 20% deduction and eliminates depreciation deductions in more highly taxed future years.

Between 2018 and 2025 (or any change in the tax law affecting these issues), the trade-off between bonus depreciation and the 20% deduction moves over time from being not worthy of consideration to being very worthy of consideration.

See part II.G.5.b Bonus Depreciation.

II.E.1.c.xi. Transition Rules Relating to Proposed and Final Regulations under Code § 199A

The preamble to the final regulations, T.D. 9847 (2/8/2019), “Effective/Applicability Date,” explains:

> Section 7805(b)(1)(A) and (B) of the Code generally provide that no temporary, proposed, or final regulation relating to the internal revenue laws may apply to any taxable period ending before the earliest of (A) the date on which such regulation is filed with the Federal Register, or (B) in the case of a final regulation, the date on which a proposed or temporary regulation to which the final regulation relates was filed with the Federal Register.
>
> Consistent with authority provided by Section 7805(b)(1)(A), §§ 1.199A-1 through 1.199A-6 generally apply to taxable years ending after February 8, 2019. However, taxpayers may rely on the rules set forth in §§ 1.199A-1 through 1.199A-6, in their entirety, or on the proposed regulations under §§ 1.199A-1 through 1.199A-6

issued on August 16, 2018, in their entirety, for taxable years ending in calendar year 2018. In addition, to prevent abuse of Section 199A and the regulations thereunder, the anti-abuse rules in §§ 1.199A-2(c)(1)(iv), 1.199A-3(c)(2)(ii), 1.199A-5(c)(2), 1.199A-5(d)(3), and 1.199A-6(d)(3)(vii) apply to taxable years ending after December 22, 2017, the date of enactment of the TCJA. Finally, the provisions of § 1.643-1, which prevent abuse of the Code generally through the use of trusts, apply to taxable years ending after August 16, 2018.

Section 199A(f)(1) provides that Section 199A applies at the partner or S corporation shareholder level, and that each partner or shareholder takes into account such person's allocable share of each qualified item. Section 199A(c)(3) provides that the term "qualified item" means items that are effectively connected with a U.S. trade or business, and "included or allowed in determining taxable income from the taxable year." Section 199A applies to taxable years beginning after December 31, 2017. However, there is no statutory requirement under Section 199A that a qualified item arise after December 31, 2017.

Section 1366(a) generally provides that, in determining the income tax of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends, the shareholder's pro rata share of the corporation's items is taken into account. Similarly, section 706(a) generally provides that, in computing the taxable income of a partner for a taxable year, the partner includes items of the partnership for any taxable year of the partnership ending within or with the partner's taxable year. Therefore, income flowing to an individual from a partnership or S corporation is subject to the tax rates and rules in effect in the year of the individual in which the entity's year closes, not the year in which the item actually arose.

Accordingly, for purposes of determining QBI, W-2 wages, UBIA of qualified property, and the aggregate amount of qualified REIT dividends and qualified PTP income, the effective date provisions provide that if an individual receives QBI, W-2 wages, UBIA of qualified property, and the aggregate amount of qualified REIT dividends and qualified PTP income from an RPE with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's tax year during which such RPE taxable year ends.

II.E.1.d. Partnerships Compared to S Corporations for Code § 199A

The preamble to the final regulations explains wages paid to shareholders:[942]

> A few commenters asked for confirmation that W-2 wages include S corporation owner/employee W-2 wages for purposes of the W-2 wage limitation (assuming the wages are included on the Form W-2 filed within 60 days of the due date). The definition of W-2 wages includes amounts paid to officers of an S corporation and common-law employees of an individual or RPE. Amounts paid as W- 2 wages to an S corporation shareholder cannot be included in the recipient's QBI. However, these amounts are included as W-2 wages for purposes of the W-2 wage limitation to the extent that the requirements of § 1.199A-2 are otherwise satisfied.

[942] T.D. 9847 (2/8/2019), part III.A, "W-2 Wages." See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part IV.A.9, “Reasonable Compensation,” declined to provide additional regulatory guidance regarding S corporation shareholder-employees’ compensation and Code § 199A:

> Several commenters were concerned that an overlap of the QBI, W-2 wage limitation, and reasonable compensation rules for S corporations would cause disparities between taxpayers operating businesses in different entity structures. These commenters stated that the rules might have the unintended consequence of encouraging taxpayers to select or avoid certain business entities. For example, one commenter noted that the reasonable compensation requirement for S corporations favors S corporations for purposes of the W-2 wage limitation when calculating the Section 199A deduction, compared to sole proprietorships and partnerships which may not pay any wages. That commenter suggested the final regulations include an election for partners or sole proprietors to treat an amount of reasonable compensation paid as wages for purposes of the W-2 wage limitation. Other commenters similarly noted the entity choice issue, but from the perspective that S corporations can be less advantageous. The commenters argued that QBI is reduced for S corporation shareholders because reasonable compensation is not included in QBI and noted there could be further impacts depending on whether the taxpayer is above or below the income thresholds. These commenters suggested that the final regulations should strive for equity between taxpayers operating businesses in different entity structures. Finally, one commenter suggested the need for additional guidance regarding whether and how reasonable compensation paid to an S corporation shareholder is considered wages for purposes of the W-2 wage limitation.
>
> One commenter maintained that to avoid incentivizing minimization of compensation and Federal Insurance Contributions Act tax, the final regulations should provide that deductions with respect to reasonable compensation should not reduce QBI. The commenter stated that reasonable compensation must be added back in calculating QBI.
>
> The Treasury Department and the IRS decline to adopt these suggestions. Section 199A(c)(4) clearly excludes reasonable compensation paid to a taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business from QBI. These amounts are attributable to a trade or business and are thus qualified items of deduction as described in Section 199A(c)(3) to the extent they are effectively connected with the conduct of a trade or business within the United States and included or allowed in determining taxable income for the taxable year. In addition, reasonable compensation paid to a shareholder-employee is included as W-2 wages for purposes of the W-2 wage limitation to the extent that the requirements of § 1.199A-2 are otherwise satisfied. Further, guaranteed payments and payments to independent contractors are not W-2 wages and therefore, cannot be counted for purposes of the W-2 wage limitation.
>
> A few commenters were concerned about whether tax return preparers would have the responsibility to closely examine whether compensation paid to a shareholder of an S corporation is reasonable before calculating the Section 199A deduction, and whether tax return preparers could be subject to penalties. One commenter suggested a small business safe harbor approach where certain cash method S corporations that treat at least 70 percent of dividend distributions to shareholder-employees as wages are deemed to satisfy the reasonable compensation requirement of Rev. Rul. 74-44, 1974-1 C.B. 287. Providing additional guidance with respect to what constitutes reasonable

compensation for a shareholder-employee of an S corporation or the application or non-application of assessable penalties applicable to tax return preparers is beyond the scope of these final regulations.

Suppose, before considering the owner's compensation, a business has $300,000 of qualified business income ("QBI"), reasonable compensation would be $200,000, distributions to the owner are at least $200,000, and the owner's taxable income is below the $315,000 threshold for married filing jointly (all subject to future indexing).

The wage limitation would not apply. See part II.E.1.c.v.(a) Taxable Income "Threshold.

If the business is an S corporation, then the $200,000 wages the S corporation pays its owner will reduce the QBI from $300,000 down to $100,000. If the taxpayer argues that the payments to the owner-employee were distributions and not wages, the IRS will have the upper hand in the dispute, because in 2017 the IRS figured out (and instructed its examiners) how to effectively keep taxpayers out of Tax Court on this issue[943] – meaning that taxpayers would have to pay the tax and sue for a refund.

However, if the wage limitation reduces the QBI deduction,[944] the S corporation may wish to increase compensation payments to get a better deduction. Given that FICA is 15.3% combined employer and employee up to the taxable wage base, this strategy would tend to be beneficial only when compensation is above the taxable wage base ($160,200 in 2023 and $168,600 in 2024)[945] and is ultimately in a range that is neither too high not too low.

In addition to an S corporation tending to generate less QBI, the sale of a partnership interest may be easier to constitute QBI than the sale of stock in an S corporation. Compare part II.E.1.c.viii.(c) Sale of an Interest in a Partnership Conducting a Trade or Business with part II.E.1.c.viii.(d) Sale of a Stock in an S Corporation Conducting a Trade or Business.

II.E.1.e. Whether Real Estate Qualifies as a Trade or Business

Part II.E.1.e.i General Rules Regarding U.S. Real Estate describes the definitions of a trade or business generally applied to real estate.

For nonresident aliens, Part II.E.1.e.ii Real Estate As a Trade or Business under the Effectively Connected Income (ECI) Rules explains when real estate may be eligible for a Code § 199A deduction.

Before analyzing the rules for whether real estate qualifies as a business, consider whether one really wants to do so. Real estate tends to generate ordinary losses, which may reduce the Code § 199A deduction from other businesses.[946] Much of the profit tends to be capital gain on sale, which is not eligible for the deduction.[947] A partner in the national office of a Big Four CPA firm told me that the percentage of real estate investors who benefitted

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[943] See part II.A.2.c Avoiding Double Taxation and Self-Employment Tax, especially fns 85-86.
[944] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
[945] See text accompanying fn 3393 in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.
[946] See part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.
[947] See part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

materially from Code § 199A with respect to their real estate was in the single digits, and the burdens of recordkeeping for UBIA[948] were often more costly than the benefits.

II.E.1.e.i. General Rules Regarding U.S. Real Estate under Code § 199A

To constitute qualified business income, the income must be from a trade or business.[949] However:

- Rental activity that is not a trade or business can qualify as if it were a trade or business if it is rented or licensed to a trade or business which is commonly controlled under Reg. § 1.199A-4(b)(1)(i), meaning that the same person or group of persons, directly or by attribution under Code §§ 267(b) or 707(b),[950] owns 50% percent or more of the renting trade or business, including 50% or more of the issued and outstanding shares of an S corporation or 50% or more of the capital or profits in a partnership.[951] This is described in part II.E.1.c.iii.(a) General Standards for "Trade or Business" for Code § 199A[952] and illustrated in part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A,[953] but it applies whether or not the real estate is aggregated (see fn 952).

- On the other hand, if rental is tied too closely to a specified service trade or business (SSTB), part or all of the rental income could be disqualified, even the rental on its own qualifies as a trade or business. See part II.E.1.c.iv.(o) SSTB Very Broad Gross Receipts Test and Anti-Abuse Rules.

As to the first bullet point, the preamble to the final regulations, T.D. 9847 (2/8/2019), part II.A.3.c, "Special Rule for Renting Property to a Related Person Real Estate Activities as a Trade or Business," explains:

> In one instance, the proposed regulations and the final regulations extend the definition of trade or business for purposes of Section 199A beyond section 162. Solely for purposes of Section 199A, the rental or licensing of tangible or intangible property to a related trade or business is treated as a trade or business if the rental or licensing activity and the other trade or business are commonly controlled under proposed § 1.199A-4(b)(1)(i). This rule also allows taxpayers to aggregate their trades or businesses with the leasing or licensing of the associated rental or intangible property if all of the requirements of proposed § 1.199A-4 are met.

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948 See part II.E.1.c.vi.(b) Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A, which is within part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

949 See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.

950 For Code §§ 267(b), see part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses. For Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships

951 Reg. § 1.199A-4(b)(1)(i) is reproduced in full in part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A and illustrated by various Examples accompanying fn 837, including those demonstrating that a pass-through entity that owns a business can be in a different type of pass-through entity (S corporation compared to partnership) than the type that owns the real estate.

952 See Reg. § 1.199A-1(b)(14), which is reproduced in full in fn 804 in that part.

953 Within that part, see text accompanying fn 841, analyzing Reg. § 1.199A-4(d)(8), Example (8) and Reg. § 1.199A-4(d)(9), Example (9).

> One commenter asked for clarification regarding whether this rule applies to situations in which the rental or licensing is to a commonly controlled C corporation. Another commenter suggested that the rule in the proposed regulations could allow passive leasing and licensing-type activities to benefit from Section 199A even if the counterparty is not an individual or an RPE. The commenter recommended that the exception be limited to scenarios in which the related party is an individual or an RPE and that the term related party be defined with reference to existing attribution rules under sections 267, 707, or 414. The final regulations clarify these rules by adopting these recommendations and limiting this special rule to situations in which the related party is an individual or an RPE. Further, as discussed in part V.B. of this Summary of Comments and Explanation of Revisions, the final regulations provide that the related party rules under sections 267(b) or 707(b) will be used to determine relatedness for purposes of § 1.199A-4 and this special rule.

The preamble to the final regulations also considers whether the taxpayer treats the activity as a trade or business for other tax purposes.[954]

Each RPE separately determines whether its real estate qualifies as a trade or business. Real estate owners might want to combine their RPEs into a master partnership in which each LLC is a disregarded entity. See the discussion at the end of the introductory portion of part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.[955]

The rest of the discussion in this part II.E.1.e.i discusses:

- Whether real estate activity constitutes a trade or business under Code § 162. See part II.E.1.e.i.(a) Whether Real Estate Activity Constitutes A Trade Or Business.

- Whether separate real estate businesses can combine their QBI, W-2 wages, and UBIA. See part II.E.1.e.i.(b) Aggregating Real Estate Businesses.

II.E.1.e.i.(a). Whether Real Estate Activity Constitutes A Trade Or Business

Whether real estate is a trade or business depends on the circumstances. The best discussion of the issue in this document is in part II.I.8.c.iii Rental as a Trade or Business, fns 2397-2407. Another discussion on what is a trade or business is in part II.G.4.l.i.(a) "Trade or Business" Under Code § 162. See also part II.G.26.b Real Estate as a Trade or Business.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part II.A.3.b, "Rental Real Estate Activities as a Trade or Business," explains:

> A majority of the comments received on the meaning of a trade or business focus on the treatment of rental real estate activities. Commenters noted inconsistency in the case law in determining whether a taxpayer renting real estate is engaged in a trade or business. Some commenters suggested including safe harbors, tests, or a variety of factors, which if satisfied, would qualify a rental real estate activity as a trade or business. A number of commenters suggested that all rental real estate activity should qualify as a trade or business. Further, one commenter suggested that rental income

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[954] See text preceding fn 803 in part II.E.1.c.iii.(a) General Standards for "Trade or Business" for Code § 199A.
[955] See text accompanying fn 760.

from real property held for the production of rents within the meaning of section 62(a)(4) should be considered a trade or business for purposes of Section 199A. Another commenter suggested that final regulations provide that an individual whose taxable income does not exceed the threshold amount will be considered to be conducting a trade or business with respect to any real estate rental of which the individual owns at least ten percent and in which the individual actively participates within the meaning of section 469(i).

In determining whether a rental real estate activity is a section 162 trade or business, relevant factors might include, but are not limited to (i) the type of rented property (commercial real property versus residential property), (ii) the number of properties rented, (iii) the owner's or the owner's agents day-to-day involvement, (iv) the types and significance of any ancillary services provided under the lease, and (v) the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease).

Providing bright line rules on whether a rental real estate activity is a section 162 trade or business for purposes of Section 199A is beyond the scope of these regulations. Additionally, the Treasury Department and the IRS decline to adopt a position deeming all rental real estate activity to be a trade or business for purposes of Section 199A. However, the Treasury Department and IRS recognize the difficulties taxpayers and practitioners may have in determining whether a taxpayer's rental real estate activity is sufficiently regular, continuous, and considerable for the activity to constitute a section 162 trade or business. Accordingly, Notice 2019- 07, 2019-9 IRB, released concurrently with these final regulations, provides notice of a proposed revenue procedure detailing a proposed safe harbor under which a rental real estate enterprise may be treated as a trade or business solely for purposes of Section 199A.

Under the proposed safe harbor, a rental real estate enterprise may be treated as a trade or business for purposes of Section 199A if at least 250 hours of services are performed each taxable year with respect to the enterprise. This includes services performed by owners, employees, and independent contractors and time spent on maintenance, repairs, collection of rent, payment of expenses, provision of services to tenants, and efforts to rent the property. Hours spent by any person with respect to the owner's capacity as an investor, such as arranging financing, procuring property, reviewing financial statements or reports on operations, planning, managing, or constructing long-term capital improvements, and traveling to and from the real estate are not considered to be hours of service with respect to the enterprise. The proposed safe harbor also would require that separate books and records and separate bank accounts be maintained for the rental real estate enterprise. Property leased under a triple net lease or used by the taxpayer (including an owner or beneficiary of an RPE) as a residence for any part of the year under section 280A would not be eligible under the proposed safe harbor. A rental real estate enterprise that satisfies the proposed safe harbor may be treated as a trade or business solely for purposes of Section 199A and such satisfaction does not necessarily determine whether the rental real estate activity is a section 162 trade or business. Likewise, failure to meet the proposed safe harbor would not necessarily preclude rental real estate activities from being a section 162 trade or business.

Examples 1 and 2 of proposed § 1.199A-1(d)(4) describe a taxpayer who owns several parcels of land that the taxpayer manages and leases to airports for parking lots. The

> Treasury Department and the IRS are aware that some practitioners and taxpayers questioned whether the use of the lease of unimproved land in these examples was intended to imply that the lease of unimproved land is a trade or business for purposes of Section 199A. Proposed § 1.199A-1(d)(4) provides that for purposes of the examples all businesses described in the examples are trades or business for purposes of Section 199A. Example 1 was intended to provide a simple illustration of how the calculation would work if a taxpayer lacked sufficient W-2 wages or UBIA of qualified property to claim the deduction. Example 2 built on the fact pattern by adding UBIA of qualified property to the facts. The examples in the proposed regulations were not intended to imply that the lease of the land is, or is not, a trade or business for purposes of Section 199A beyond the assumption in the examples. In order to avoid any confusion, the final regulations remove the references to land in both examples.

Rev. Proc. 2019-38 "provides a safe harbor under which a rental real estate enterprise will be treated as a trade or business" solely for purposes of Code § 199A and the regulations thereunder.[956] "If an enterprise fails to satisfy the requirements of this safe harbor, it may be treated as a trade or business for purposes of Section 199A if the enterprise otherwise meets the definition of trade or business in § 1.199A-1(b)(14)."[957]

Below we will describe the safe harbor and then discuss actions to take if not within the safe harbor.

Rev. Proc. 2019-38, § 3.01 describes who may use the safe harbor:[958]

> This safe harbor is available to taxpayers who seek to claim the deduction under Section 199A with respect to a rental real estate enterprise as defined in section 3.02. If the safe harbor requirements are met, the rental real estate enterprise will be treated as a single trade or business as defined in Section 199A(d) for purposes of applying the regulations under Section 199A, including the application of the aggregation rules in § 1.199A-4. RPEs, as defined in § 1.199A-1(b)(10),[959] may also use this safe harbor. In order to rely upon the safe harbor, taxpayers and RPEs must satisfy all of the requirements of this revenue procedure.

Rev Proc. 2019-38, § 3.02, "Rental real estate enterprise," provides:

> Solely for purposes of this safe harbor, a rental real estate enterprise is defined as an interest in real property held for the production of rents and may consist of an interest in a single property or interests in multiple properties. The taxpayer or RPE relying on this revenue procedure must hold each interest directly or through an entity disregarded as an entity separate from its owner under any provision of the Code.
>
> Except for those property interests described in paragraph .05 of this section, taxpayers and RPEs may either treat each interest in similar property held for the production of

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[956] Rev. Proc. 2019-38, § 1.

[957] Rev. Proc. 2019-38, § 1. Rev. Proc. 2019-38, § 3.01 reiterates this:

> Failure to satisfy the requirements of this safe harbor does not preclude a taxpayer or the Service from otherwise establishing that an interest in rental real estate is a trade or business for purposes of section 199A.

[958] See part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A, which references this issue in fn 836.

[959] [My footnote:] Reg. § 1.199A-1(b)(10) is reproduced in the text accompanying fn 755 in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

> rents as a separate rental real estate enterprise or treat interests in all similar properties held for the production of rents as a single rental real estate enterprise. For purposes of applying this revenue procedure, properties held for the production of rents are similar if they are part of the same rental real estate category. The two types of rental real estate categories for the purpose of combining properties into a single rental real estate enterprise are residential and commercial. Thus, commercial real estate held for the production of rents may only be part of the same enterprise with other commercial real estate, and residential properties may only be part of the same enterprise with other residential properties.
>
> Once a taxpayer or RPE treats interests in similar commercial properties or similar residential properties as a single rental real estate enterprise under the safe harbor, the taxpayer or RPE must continue to treat interests in all similar properties, including newly acquired properties, as a single rental real estate enterprise when the taxpayer or RPE continues to rely on the safe harbor. However, a taxpayer or RPE that chooses to treat its interest in each residential or commercial property as a separate rental real estate enterprise may choose to treat its interests in all similar commercial or all similar residential properties as a single rental real estate enterprise in a future year.
>
> An interest in mixed-use property may be treated as a single rental real estate enterprise or may be bifurcated into separate residential and commercial interests. For purposes of this revenue procedure, mixed-use property is defined as a single building that combines residential and commercial units. An interest in mixed-use property, if treated as a single rental real estate enterprise, may not be treated as part of the same enterprise as other residential, commercial, or mixed-use property.
>
> Each rental real estate enterprise that satisfies the requirements of this safe harbor is treated as a separate trade or business for purposes of applying Section 199A and the regulations thereunder.

The first two paragraphs of § 3.02 closely follow Notice 2019-7, and the rest is elaboration. The decision to treat interests in all similar properties held for the production of rents as a single rental real estate enterprise is the equivalent of a decision to aggregate.[960] Providing that commercial and residential real estate may not be part of the same enterprise is consistent with Reg. § 1.199A-4(d)(17), Example (17), which is reproduced in part II.E.1.e.i.(b) Aggregating Real Estate Businesses (the latter also including other commentary about delineating between separate real estate businesses).

Rev Proc. 2019-38, § 3.03, "Safe harbor," provides:

> The determination to use this safe harbor must be made annually. Solely for the purposes of Section 199A, each rental real estate enterprise will be treated as a single trade or business if the following requirements are satisfied during the taxable year with respect to the rental real estate enterprise:
>
> (A) Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise. If a rental real estate enterprise contains more than one

[960] See Rev Proc. 2019-38, § 3.01, reproduced in the text accompanying fn 958.

property, this requirement may be satisfied if income and expense information statements for each property are maintained and then consolidated;

(B) For rental real estate enterprises that have been in existence less than four years, 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental real estate enterprise. For rental real estate enterprises that have been in existence for at least four years, in any three of the five consecutive taxable years that end with the taxable year, 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental real estate enterprise; and

(C) The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. If services with respect to the rental real estate enterprise are performed by employees or independent contractors, the taxpayer may provide a description of the rental services performed by such employee or independent contractor, the amount of time such employee or independent contractor generally spends performing such services for the enterprise, and time, wage, or payment records for such employee or independent contractor. Such records are to be made available for inspection at the request of the IRS.

The second sentences of each of (A) and (C) above were not in Notice 2019-7.

Although the IRS steadfastly rejects using the passive loss rules for Code § 199A, cases under those rules may give a clue to how courts approach documenting work. See part II.K.1.a.vi Proving Participation. I view the regulations under the passive loss rules as a little less strict than the rules provided above, so please read part II.K.1.a.vi keeping that in mind.

Rev Proc. 2019-38, § 3.03(D) provides more details about what the taxpayer must attach:

> The taxpayer or RPE attaches a statement to a timely filed original return (or an amended return for the 2018 taxable year only) for each taxable year in which the taxpayer or RPE relies on the safe harbor. An individual or RPE with more than one rental real estate enterprise relying on this safe harbor may submit a single statement but the statement must list the required information separately for each rental real estate enterprise. The statement must include the following information:
>
> (1) A description (including the address and rental category) of all rental real estate properties that are included in each rental real estate enterprise;
>
> (2) A description (including the address and rental category) of rental real estate properties acquired and disposed of during the taxable year; and
>
> (3) A representation that the requirements of this revenue procedure have been satisfied.

That requirement lessens the burden of Notice 2019-7, which required a statement signed under penalties of perjury.

Rev Proc. 2019-38, § 3.04, “Rental services,” provides:

> Rental services for purpose of this revenue procedure include, but are not limited to: (i) advertising to rent or lease the real estate; (ii) negotiating and executing leases; (iii) verifying information contained in prospective tenant applications; (iv) collection of rent; (v) daily operation, maintenance, and repair of the property, including the purchase of materials and supplies; (vi) management of the real estate; and (vii) supervision of employees and independent contractors. Rental services may be performed by owners, including owners of an RPE, or by employees, agents, and/or independent contractors of the owners. The term rental services does not include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on operations; improving property under § 1.263(a)-3(d); or hours spent traveling to and from the real estate.

The above is essentially the same as what was in Notice 2019-7.

Rev Proc. 2019-38, § 3.05, “Certain rental real estate arrangements excluded,” provides:

> The following types of property may not be included in a rental real estate enterprise and are therefore not eligible for the safe harbor:
>
> (A) Real estate used by the taxpayer (including an owner or beneficiary of an RPE) as a residence under section 280A(d).
>
> (B) Real estate rented or leased under a triple net lease. For purposes of this revenue procedure, a triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to pay for maintenance activities for a property in addition to rent and utilities.
>
> (C) Real estate rented to a trade or business conducted by a taxpayer or an RPE which is commonly controlled under § 1.199A-4(b)(1)(i).
>
> (D) The entire rental real estate interest if any portion of the interest is treated as an SSTB under § 1.199A-5(c)(2) (which provides special rules where property or services are provided to an SSTB).

Subparagraph (B) is narrower than Notice 2019-7, which provided:

> For purposes of this revenue procedure, a triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities. This includes a lease agreement that requires the tenant or lessee to pay a portion of the taxes, fees, and insurance, and to be responsible for maintenance activities allocable to the portion of the property rented by the tenant.

“To be responsible for maintenance activities” indicated to me that, for the lease to be a disfavored “triple net lease” under Notice 2019-7, the tenant had to not only pay for maintenance but also arrange the maintenance. Rev Proc. 2019-38 eliminates the responsibility requirement by providing that mere payment of maintenance is enough connection to maintenance activity that, when combined with other factors in both tests, would make the lease a triple net lease. My understanding is that this change will knock most large shopping centers and large office buildings out of the safe harbor; however, those activities do not appear to need a safe harbor anyway, given the level of service typically provided. I am more concerned about real estate with only one or a very few tenants, where the IRS seems to want the landlord to take more risk

Subparagraph (d) is new, greatly expanding the scope of the anti-abuse rules described in part II.E.1.c.iv.(o) SSTB Very Broad Gross Receipts Test and Anti-Abuse Rules. For example, suppose a real estate developer owned a building through an LLC and used separate S corporations to run its development business, its engineering affiliate, its architectural affiliate, and its furniture leasing affiliate. Because these are different types of businesses,[961] they would be segregated under the anti-abuse rules, and only real estate rental payments received from the furniture leasing affiliate would constitute income from an SSTB.[962]

In addition to making sure that one provides enough qualifying services, beware of the possible cost of providing services beyond what a landlord provides in a traditional long-term lease. Although traditional services should be exempt from self-employment (SE) tax, services beyond that may be subject to SE tax. See part II.L.2.a.ii Rental Exception to SE Tax, especially the text accompanying fns 3429-3432.

Rev Proc. 2019-38, § 4, "Effective Date," provides:

> This revenue procedure applies to taxable years ending after December 31, 2017. Alternatively, taxpayers and RPEs may rely on the safe harbor set forth in Notice 2019-07, 2019-09 IRB 740, for the 2018 taxable year. The contemporaneous records requirement will not apply to taxable years beginning prior to January 1, 2020. However, taxpayers are reminded that they bear the burden of showing the right to any claimed deductions in all taxable years. *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 84; 112 S.Ct. 1039, 1043) (1992); *Interstate Transit Lines v. Comm'r*, 319 U.S. 590, 593, 63 S.Ct. 1279, 1281 (1943). See also I.R.C. § 6001; Treas. Reg. § 1.6001-1(a) and (e).

Prop. Rev Proc. § 3.05 provides that triple net leases do not qualify for the safe harbor. (It assumes that a tenant does all of the work in a triple net lease, but it is also common for a landlord to actively maintain the property on a substantial and continuous basis that would qualify as a business, while still requiring tenants to reimburse the landlord for all annual operating costs, which is also a triple net lease.) Instead of the tenant arranging for and paying for maintenance, have the landlord take care of that and obtain reimbursement from the tenant. Consider having the landlord hire the janitors and maintenance staff and the tenant reimburse the landlord for those expenses, which helps not only move the real estate toward being a trade or business but also may improve the landlord's Code § 199A deduction:

- The tenant may have plenty of wages for purposes of the wage limitation for the Code § 199A deduction, whereas paying those wages may provide the landlord with a higher Code § 199A deduction (because the wage limitation will not reduce the deduction as much).[963] However, if the real estate activity is aggregated with a business under common

[961] They would constitute separate businesses even if in the same RPE - see part II.E.1.c.iii.(b) Multiple Trades or Businesses Within an Entity – Identification of Businesses and Allocation of Items.
[962] Reg. § 1.199A-5(c)(iii)(B), Example (2) segregates SSTBs from non-SSTB's so that the former do not contaminate the latter even when the former is not de minimis. Furthermore, Reg. § 1.199A-5(c)(2) disqualifies self-rental to an SSTB only to the extent of payments the landlord receives from the SSTB.
[963] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

control,[964] that business' wages and property count toward the Code § 199A deduction relating to the real estate's income.

- If the landlord and tenant have similar ownership, then moving duties from one entity to another may be an easy decision. On the other hand, if they have different owners and the landlord does not want an increased role, these changes may be impractical.

- Consider asset protection issues. If the landlord hires janitors and maintenance staff, the landlord would be liable if they fail to remedy any hazardous conditions. Furthermore, if an owner of the landlord is personally involved in hiring decisions, that owner may be personally liable for negligent hiring. Liability insurance may ameliorate these concerns, and every landlord should have such insurance anyway to try to avoid corporate veil piercing. This is very much a judgment call. For more on asset protection, see part II.F Asset Protection Planning.

Even the long-term rental of one property to one tenant can constitute a trade or business.[965] For further thoughts on how to make real estate a trade or business, see my summary at the end of part II.I.8.c.iii Rental as a Trade or Business.

Note also what is required for real estate not to be passive income for purposes of restrictions on S corporations that used to be C corporations, described in part II.P.3.b.iii Excess Passive Investment Income. A triple net lease in which the landlord did nothing except collect rents would not work for that test, but incurring expenses and having them reimbursed by the tenant may work.[966] Following these rules for S corporations does not directly address the "trade or business" issue, but if the IRS views it as nonpassive for one purpose (the S corporation test) then an examiner might have a positive view for other purposes (trade or business qualification).

Ultimately, one needs to decide whether the effort of and exposure from rearranging lease arrangements are worth the potential tax benefits, and it is impossible to provide a one-size-fits-all solution.

II.E.1.e.i.(b). Aggregating Real Estate Businesses

This part II.E.1.e.i.(b) applies to real estate the rules of part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A. For the assumptions to Example (16), Example (17), and Example (18), see the introduction to Reg. § 1.199A-4(d), reproduced in part II.E.1.c.iii.(d).[967]

Reg. § 1.199A-4(d)(16), Example (16) provides:

(i) *Facts*. PRS1, a partnership, owns 60% of a commercial rental office building in state A, and 80% of a commercial rental office building in state B. Both commercial rental office building operations share centralized accounting, legal, and human resource functions. PRS1 treats the two commercial rental office buildings as an aggregated trade or business under paragraph (b)(1) of this section.

[964] See fns 952-951.
[965] See part II.I.8.c.iii Rental as a Trade or Business, fn 2402.
[966] See fns 3948-3951.
[967] See text accompanying fn 840.

(ii) *Analysis*. PRS1 owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, PRS1 may aggregate its commercial rental office buildings because the businesses provide the same type of property and share accounting, legal, and human resource functions.

Example (16) helpfully demonstrates that real estate activities in different states can be aggregated.

Reg. § 1.199A-4(d)(17), Example (17) provides:

(i) *Facts*. S, an S corporation owns 100% of the interests in a residential condominium building and 100% of the interests in a commercial rental office building. Both building operations share centralized accounting, legal, and human resource functions.

(ii) *Analysis*. S owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Although both businesses share significant centralized business elements, S cannot show that another factor under paragraph (b)(1)(v) of this section is present because the two building operations are not of the same type of property. S must treat the residential condominium building and the commercial rental office building as separate trades or businesses for purposes of applying § 1.199A-1(d).

Example (17) demonstrates that the IRS views residential and commercial rental as separate businesses, even if operated and managed by the same owner. Reg. § 1.199A-4(b)(1)(v) provides that trades or businesses may be aggregated only if an individual or RPE can demonstrate that -

> The trades or businesses to be aggregated satisfy at least two of the following factors (based on all of the facts and circumstances):
>
> (A) The trades or businesses provide products, property, or services that are the same or customarily offered together.
>
> (B) The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.
>
> (C) The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

Thus, to aggregate, they need not only similar management (satisfying (B)) but also one other factor in (A) or (C). Reg. § 1.199A-4(d)(18), Example (18) includes another factor, providing:

(i) *Facts*. M owns 75% of a residential apartment building. M also owns 80% of PRS2. PRS2 owns 80% of the interests in a residential condominium building and 80% of the interests in a residential apartment building. PRS2's residential condominium building and residential apartment building operations share centralized back office functions and management. M's residential apartment building and PRS2's residential condominium and apartment building operate in coordination with each other in renting apartments to tenants.

(ii) *Analysis*. PRS2 may aggregate its residential condominium and residential apartment building operations. PRS2 owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Paragraph (b)(1)(v) of this section is satisfied because the businesses are of the same type of property and share centralized back office functions and management. M may also add its residential apartment building operations to PRS2's aggregated residential condominium and apartment building operations. M owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Paragraph (b)(1)(v) of this section is also satisfied because the businesses operate in coordination with each other.

Thus, renting similar real estate (residential) is a sufficient other factor, as is operating in coordination with each other.

See also part II.E.1.c.iii.(b) Multiple Trades or Businesses Within an Entity – Identification of Businesses and Allocation of Items. Applying 2017 tax reform to determine separate businesses is relevant not only for Code § 199A but also for Code § 512(a)(6) (preventing a tax-exempt entity from uses losses from one business against income from a separate business), which is discussed in part II.E.1.f.viii Tax-Exempt Trusts. Under that guidance, for now the IRS will consider the use of NAICS 6-digit codes to be a reasonable, good-faith interpretation under section 3.02 of this notice. The NAICS is an industry classification system for purposes of collecting, analyzing, and publishing statistical data related to the United States business economy. See Executive Office of the President, Office of Management and Budget, North American Industry Classification System (2017), available at https://www.census.gov/eos/www/naics/2017NAICS/2017_NAICS_Manual.pdf. Here are some codes for real estate:

- 531110 Lessors of Residential Buildings and Dwellings
- 531120 Lessors of Nonresidential Buildings (except Miniwarehouses)
- 531130 Lessors of Miniwarehouses and Self-Storage Units
- 531190 Lessors of Other Real Estate Property
- 531210 Offices of Real Estate Agents and Brokers
- 531311 Residential Property Managers
- 531312 Nonresidential Property Managers
- 531320 Offices of Real Estate Appraisers
- 531390 Other Activities Related to Real Estate

I am not suggesting any authority directly applying these codes for Code § 199A. However, given that guidance on how to delineate separate businesses leaves a lot of room for interpretation, using these codes may show a good-faith attempt to delineate between businesses. Furthermore, the regulations assume that residential and commercial real estate are separate businesses, and these codes tend to support that assumption.

II.E.1.e.ii. Real Estate As a Trade or Business under the Effectively Connected Income (ECI) Rules

A nonresident alien may be eligible for the Code § 199A deduction only for income qualifying under Part II.E.1.c.ix QBI and Effectively Connected Income. Within that part, the text accompanying and immediately preceding fn 916 cross-references Code § 871(a)(1)(A), which taxes rents (among other income) and therefore is the subject of this part II.E.1.e.ii. Below is guidance on when rent constitutes QBI.

Rev. Rul. 73-522 discussed the following situation involving triple net leases:

> The taxpayer owned rental property situated in the United States that was subject to long-term leases each providing for a minimum monthly rental and the payment by the lessee of real estate taxes, operating expenses, ground rent, repairs, interest and principal on existing mortgages, and insurance in connection with the property leased. The leases are referred to as "net leases" and were entered into by the taxpayer on December 1, 1971. The taxpayer visited the United States for approximately one week during November 1971 for the purpose of supervising new leasing negotiations, attending conferences, making phone calls, drafting documents, and making significant decisions with respect to the leases. This was his only visit to the United States in 1971. The leases were identical in form (net leases) to those applicable to the properties owned by the taxpayer prior to December 1, 1971, and were entered into with lessees unrelated to each other or to the taxpayer.

Rev. Rul. 73-522 held:

> Court decisions involving nonresident alien individual owners of real estate in the United States have developed a test for determining when such individuals are engaged in trade or business within the United States as a result of such ownership. These cases hold that activity of nonresident alien individuals (or their agents) in connection with domestic real estate that is beyond the mere receipt of income from rented property, and the payment of expenses incidental to the collection thereof, places the owner in a trade or business within the United States, provided that such activity is considerable, continuous, and regular. *Jan Casimir Lewenhaupt*, 20 T.C. 151 (1953), *aff'd per curiam*, 221 F.2d 227 (9th Cir. 1955); *Elizabeth Herbert*, 30 T.C. 26 (1958), *acq.* 1958-2 C.B. 6; *Inez De Amodio*, 34 T.C. 894 (1960), *aff'd* 229 F.2d 623 (3rd Cir. 1962).
>
> In the instant case the taxpayer's only activity in the United States during the taxable year ended December 31, 1971, was the supervision of the negotiation of leases covering rental property that he owned during that year. No other activity was necessary on the part of the lessor in connection with the properties because of the provisions of the net leases. The taxpayer's supervision of the negotiation of new leases is not considered to be beyond the scope of mere ownership of real property or the mere receipt of income from real property since such activity was sporadic rather than continuous (that is a day-to-day activity), irregular rather than regular, and minimal rather than considerable.

> Accordingly, the taxpayer in the instant case is not considered to be engaged in trade or business within the United States during the taxable year ended December 31, 1971, within the meaning of section 871 of the Code. See *Evelyn M. L. Neil*, 46 B.T.A. 197 (1942), wherein the operation of one parcel of real estate by the lessee did not result in the owner being considered to be engaged in trade or business.[968] Compare *Adolph Schwarcz*, 24 T.C. 733, *acq.* 1956-1, C.B. 5, wherein an owner operating one parcel of rental property in all its aspects was considered to be engaging in trade or business.
>
> With regard to the second question presented, section 1.871-7(b)(1) of the Income Tax Regulations provides that for purposes of section 871(a)(1) of the Code "amounts" received (including rents) means "gross income." Section 1.61-8(c), to the extent pertinent, provides that if a lessee pays any of the expenses of the lessor such payments are additional rental income of the lessor.
>
> Accordingly, "rents," as used in section 871 of the Code, includes considerations other than the payment of a stipulated rental, *i.e.*, amounts paid by the lessee for taxes, repairs, etc., in accordance with the terms of a net lease.

Note that the taxpayer held more than one property with triple-net-leases, and the taxpayer's triple-net-lease was not part of a trade or business notwithstanding the taxpayer owning multiple properties.

Also note that expense reimbursements constituted rent.

As to rental that is not a triple-net-lease, *Schwarcz v. Commissioner*, 24 T.C. 733 (1955), cited with approval in Rev. Rul. 73-522, stated, "We take it to be well settled that the operation of even a single parcel of rental realty may constitute the regular operation of a business."[969]

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[968] [My footnote, not from the ruling:] *Neill v. Commissioner*, 46 B.T.A. 197 (1942), found that a net lease held by a NRA did not constitute carrying on a business. The facts were:

> … It is held under a long term lease by a tenant who, under the terms of that lease, erected a building thereon and is obligated under the lease to pay taxes and insurance and maintain the property.
>
> The property referred to is encumbered by a mortgage …, the ground lease on the property having been assigned at that time to the mortgagee as collateral security for the mortgage. For many years petitioner has employed a firm of attorneys with offices in Philadelphia, to whom the tenant pays the rentals due petitioner under her direction. These attorneys then pay for her the interest due upon the mortgage and such incidental expenses for which petitioner may be obligated.

The Board of Tax Appeals held:

> The ownership of this property by petitioner is no more a business activity carried on within the United States than her ownership of stocks or bonds of American companies held for her by an American agent. *Cf. Higgins v. Commissioner*, 312 U.S. 212. We think the rule is settled that the mere ownership of property from which income is drawn does not constitute the carrying on of business within the purview of the cited section. *McCoach v. Minehill & Schuylkill Haven Railroad Co.*, 228 U.S. 295; *Stafford Owners, Inc. v. United States*, 39 Fed.(2d) 743.

For a discussion of *Higgins*, see part II.G.4.l.i.(a) "Trade or Business" Under Code § 162, fn 1298.

[969] The court continued:

> In *Anders I. Lagreide*, 23 T.C. 508, 511 , we said:
>
> > The first issue to be considered is whether or not the renting out in 1949, by Alice Lagreide, of a single piece of residential real estate, amounted to the operation by her of a trade or business regularly carried on. She inherited the property from her mother in 1948 and never

Furthermore, the "fact that the taxpayer operates the rental property through an agent does not prevent him from being regularly engaged in the business,[970] and "the rule applies even though the property and the agent are in a foreign country (Austria)."[971] The court concluded:

> The record shows that petitioner actively managed the properties prior to his departure for the United States and that he was in frequent contact with his partner who managed the properties after petitioner left. We are of the opinion, accordingly, that petitioner was regularly engaged in the business of operating the … properties ….

The NRA handling repairs – even through an agent – seemed to be a tipping point in *Amodio v. Commissioner*, 34 T.C. 894 (1960) (trade or business found),[972] *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953), *aff'd*. 221 F.2d 227 (9th Cir. 1955) (trade or business found),[973] and *Herbert*

> occupied or maintained it as her own residence. Since the time of the mother's death, the property was either rented or available for renting, and was actually rented during part of 1948 and almost all of 1949.
>
> It is clear from the facts that the real estate was devoted to rental purposes, and we have repeatedly held that such use constitutes use of the property in trade or business, regardless of whether or not it is the only property so used. *Leland Hazard*, 7 T.C. 372 (1946). See also *Quincy A. Shaw McKean*, 6 T.C. 757 (1946); *N. Stuart Campbell*, 5 T.C. 272 (1945); *John D. Fackler*, 45 B.T.A. 708, 714 (1941), *affd.* (C.A. 6, 1943) 133 F.2d 509. We add that the use of the property in trade or business was, upon the facts, an operation of the trade or business in which it was so used (see *Industrial Commission v. Hammond*, 77 Colo. 414, 236 Pac. 1006, 1008). It is clear, also, that the business was "regularly" carried on, there having been no deviation, at any time, from the obviously planned use.

[970] Citing "*Gilford v. Commissioner*, 201 F.2d 735, affirming a Memorandum Opinion of this Court."

[971] Citing *Reiner v. United States*, 222 F.2d 770 (7th Cir. 1955).

[972] The court held:

> The properties were managed by local real estate agents who negotiated or renewed leases, arranged for repairs, collected rents, paid taxes and assessments, and remitted net proceeds to Fidelity after deducting commissions. From the proceeds Fidelity or the local agent paid principal and interest on the mortgages, insurance premiums, and taxes. Fidelity retained its commissions and amounts to be applied on Amodio's income taxes and the remainder was sent to him. The acts of the agents are attributable to Amodio. These activities were beyond the scope of mere ownership of property and the receipt of income. They were considerable, continuous, and regular, as in the *Lewenhaupt* case. Such activities of a nonresident alien through his agents in the United States constitute engaging in business in the United States. Amodio is taxable as a nonresident alien engaged in trade or business in the United States.

[973] The Tax Court described the agent's activities:

> LaMontagne's activities, during the taxable year, in the management and operation of petitioner's real properties included the following: executing leases and renting the properties, collecting the rents, keeping books of account, supervising any necessary repairs to the properties, paying taxes and mortgage interest, insuring the properties, executing an option to purchase the El Camino Real property, and executing the sale of the Modesto property. In addition, the agent conducted a regular correspondence with the petitioner's father in England who held a power of attorney from petitioner identical with that given to LaMontagne; he submitted monthly reports to the petitioner's father; and he advised him of prospective and advantageous sales or purchases of property.
>
> The aforementioned activities, carried on in the petitioner's behalf by his agent, are beyond the scope of mere ownership of real property, or the receipt of income from real property. The activities were considerable, continuous, and regular and, in our opinion, constituted engaging in a business within the meaning of section 211(b) of the Code. See *Pinchot v. Commissioner*, 113 F.2d 718.

v. Commissioner, 30 T.C. 26, 33 (1958) (isolated minor repairs not a trade or business).[974] Letter Ruling 7904019 asserted that paying mortgages and reimbursing tenant expenses was insufficient to move the taxpayer out of the holding of Rev. Rul. 73-522.[975] However, *Pinchot v. Commissioner*, 113 F.2d 718 (2nd Cir. 1940), held that maintaining a portfolio of 11 rental

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[974] The Tax Court held:

> In the instant case the real property consisted of one building rented in its entirety to one tenant who has occupied it since 1940, has complete charge of its operation, and is responsible for all repairs except as to outer walls and foundation. This property (the only real property owned by petitioner in the United States) was acquired by petitioner 50 years ago, not as the result of a business transaction entered into for profit (*cf. Fackler v. Commissioner*, 133 F.2d 509) but by gift from petitioner's father when she was a very young girl (see *Grier v. United States*, 120 F.Supp. 395). During the taxable years her only activities, in addition to the receipt of rentals, were the payment of taxes, mortgage principal and interest, and insurance premiums. See *Evelyn M. L. Neill*, *supra*. The record also shows that petitioner executed a lease of the property in 1940 and a modified renewal thereof in 1946, and made minor repairs to the walls and roof in 1954 and 1955.
>
> We are of the opinion that petitioner's activities with regard to the real property here involved, which might be considered as "beyond the scope of mere ownership of real property, or the receipt of income from real property," were sporadic rather than "continuous," were irregular rather than "regular," and were minimal rather than "considerable." We therefore conclude that petitioner was "not engaged in trade or business in the United States" during the taxable years within the meaning of article IX (1) of the United States-United Kingdom tax convention.

[975] The IRS pointed out:

> The Lease between Corp M and Corp P, although not identical to the net leases described in Rev. Rul. 73-522, differs only in three respects. One, the lessor rather than the lessee pays real estate taxes imposed on the leased property; two, the lessor rather than the lessee pays installments on existing encumbrances; and three, the lessor, Corp M, pays a yearly fee to the lessee as reimbursement for grass, pest, and weed control and fertilization.

The IRS reasoned:

> With respect to the payment of a yearly fee by Corp M to Corp P as reimbursement for grass, pest, and weed control and fertilization, we note that Corp M does not supervise or participate in any way in the activities for which it pays the fee. Further, the fee is paid once each year and does not involve Corp M in the farming of the land. Consequently, the payment of the fee is sporadic, irregular, and minimal and does not, in and of itself, cause Corp M to be engaged in a trade or business within the United States.

properties, which probably were not triple-net leases, constituted a business;[976] *Lewenhaupt* cited *Pinchot* with approval.[977]

A small interest in oil & gas that did not influence annual operations did not contribute a trade or business.[978]

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[976] The court summarized the facts and reasoned:

> The essential facts were stipulated and, so far as now important, are that the decedent, Antoinette Eno Johnstone, died July 1, 1934, a British subject and a non-resident. Much of her property in this country consisted of improved real estate in the City of New York owned in common by her and her two brothers of whom one is her executor and the petitioner herein. This real estate was made up of eleven parcels of which the decedent's share had a gross value of about one million dollars. The petitioner, Amos R.E. Pinchot, managed the properties for her and the third owner under broad powers of attorney which included also the management of certain personal property owned by the three. He bought and sold property for the co-owners in his discretion without consulting the decedent who did not personally take part in the transactions. This management "consisted of the leasing and renting of the properties when they became idle, collection of rents and payment of operating expenses, taxes, mortgage interest and other necessary obligations." Over a period of eighteen years five parcels of real estate had been sold and five had been purchased. There were no sales or purchases during the last three years before the decedent's death.
>
> Though the stipulation does not show the number or the amount of the transactions of the petitioner in managing these eleven buildings in New York, it is certain that they must have been considerable in both respects as well as continuous and regular. Their maintenance required the care and attention of the owners and the decedent supplied her part of that by means of her agent and attorney in fact. *Richards v. Commissioner*, 9 Cir., 81 F.2d 369, 106 A.L.R. 249. What was done was more than the investment and re-investment of funds in real estate. It was the management of the real estate itself for profit. Whether or not that was engaging in business within the meaning of federal tax statutes is a federal question which cannot be controlled by state decisions. *Lyeth v. Hoey*, 305 U.S. 188, 59 S.Ct. 155, 83 L.Ed. 119, 119 A.L.R. 410. It necessarily involved alterations and repairs commensurate with the value and number of buildings cared for and such transactions as were necessary constitute a recognized form of business. The management of real estate on such a scale for income producing purposes required regular and continuous activity of the kind which is commonly concerned with the employment of labor; the purchase of materials; the making of contracts; and many other things which come within the definition of business in *Flint v. Stone Tracy Co.*, 220 U.S. 107, 31 S.Ct. 342, 55 L.Ed. 389, Ann.Cas.1912B, 1312, and within the commonly accepted meaning of that word. We think the Board was right in deciding that this decedent was engaged in business in this country at the time of her death. The bank deposits in the United States were, therefore, properly treated as property in this country. Our decision in *Higgins v. Commissioner*, 2 Cir., 111 F.2d 795, did not touch the question of real estate management as a business.

[977] See text at end of fn 973.

[978] After citing *Pinchot*, which was discussed in fn 976, *Di Portanova v. U.S.*, 690 F.2d 169 (Ct. Cl. 1982), held:

> In this respect, an oil lease is similar to real estate. "Whether coownership in a mineral lease constitutes the carrying on of a 'trade or business' is dependent upon all the facts and circumstances in the particular case." Rev. Rul. 58-166, 1958-1 C.B. 324, 325.
>
> The oil and gas business is complex. "The proper development of an oil and gas lease requires a high degree of skill and discretion." Rev. Rul. 58-166, 1958-1 C.B. at 326. To be engaged in the oil business requires active involvement, personally or through an agent, in the operation of that business. *Cataphote Corp. v. United States*, 210 Ct.Cl. 125, 143-46, 535 F.2d 1225, 1235-37 (1976); *Wier v. Enochs*, 64-1 U.S.T.C. ¶ 9387 at 92,009, 92,011 (S.D. Miss. 1963); *aff'd* per curiam, 353 F.2d 211 (5th Cir. 1965); *Nemours Corp. v. Commissioner*, 38 T.C. 585, 601 & n.3

II.E.1.f. Trusts/Estates and the Code § 199A Deduction

Estates and nongrantor trusts may present special opportunities in working with the taxable income thresholds described in part II.E.1.c.v.(a) Taxable Income "Threshold Amount".

Estates and nongrantor trusts would have the same taxable income threshold as a single individual.

Beware that part II.J.9.c.i Multiple Trusts Created for Tax Avoidance would undermine the use of multiple trusts.

Grantor trusts are disregarded, and their items attributed to their deemed owners. See part II.E.1.f.iii Grantor Trusts (Including QSSTs).

The trust and beneficiaries are allocated the various items in proportion to their respective portions of distributable net income ("DNI"), determined after applying the separate share rules, if relevant.[979]

The preamble to Prop. Reg. § 1.199A-6(d), REG-107892-18 (8/16/2018), explains:

> **B. Application to Trusts, Estates, and Beneficiaries**
>
> Proposed § 1.199A-6(d) contains special rules for applying Section 199A to trusts and decedents' estates. To the extent that a grantor or another person is treated as owning all or part of a trust under sections 671 through 679 (grantor trust), including qualified subchapter S trusts (QSSTs) with respect to which the beneficiary has made an election under section 1361(d), the owner will compute its QBI with respect to the owned portion of the trust as if that QBI had been received directly by the owner.
>
> In the case of a Section 199A deduction claimed by a non-grantor trust or estate, Section 199A(f)(1)(B) applies rules similar to the rules under former section 199(d)(1)(B)(i) for the apportionment of W-2 wages and the apportionment of UBIA of qualified property. In the case of a non-grantor trust or estate, the QBI and expenses properly allocable to the business, including the W-2 wages relevant to the

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(1962) *aff'd* per curiam, 325 F.2d 559 (3d Cir. 1963); *John Provence #1 Well v. Commissioner*, 37 T.C. 376 (1961), *aff'd*, 321 F.2d 840 (3d Cir. 1963).

(3.) The government properly has conceded that the activities of the trusts regarding the properties subject to the 1953 and 1965 agreements do not constitute a trade or business and we so hold. The activities are functionally indistinguishable from the mere receipt of income from investments and the payment of expenses incidental to that receipt. The trusts do not manage or control the field operations or participate actively in them. Indeed, the agreements give Quintana exclusive control over "all operations of every kind." The trusts have little power under the agreements. Moreover, in view of their meager percentage of the total interest and the plaintiff's estrangement from the Cullen family, they also have virtually no informal influence over the operations.

Although the trusts have the right to receive their actual share of the oil and gas produced and Quintana negotiates the sale of the minerals as an agent of the trusts, the Service by its concession recognizes that this is not enough to constitute a trade or business. Considering all the circumstances, we hold that the trusts' activities under the 1953 operating agreement and its amendments did not constitute trade or business.

[979] See parts II.E.1.f.i.(d) Separate Shares, II.J.8.f.i.(a) Allocating Deductions to Various Income Items, II.J.8.f.i.(b) Allocating Income Items Among Those Receiving It, and II.J.9.a.ii Separate Share Rule.

> computation of the wage limitation, and relevant UBIA of depreciable property must be allocated among the trust or estate and its various beneficiaries. Specifically, proposed § 1.199A-6(d)(3)(ii) provides that each beneficiary's share of the trust's or estate's W-2 wages is determined based on the proportion of the trust's or estate's DNI that is deemed to be distributed to that beneficiary for that taxable year. Similarly, the proportion of the entity's DNI that is not deemed distributed by the trust or estate will determine the entity's share of the QBI and W-2 wages. In addition, if the trust or estate has no DNI in a particular taxable year, any QBI and W-2 wages are allocated to the trust or estate, and not to any beneficiary.
>
> In addition, proposed § 1.199A-6(d)(3)(ii) provides that, to the extent the trust's or estate's UBIA of qualified property is relevant to a trust or estate and any beneficiary, the trust's or estate's UBIA of qualified property will be allocated among the trust or estate and its beneficiaries in the same proportion as DNI of the trust or estate is allocated. This is the case regardless of how any depreciation or depletion deductions resulting from the same property may be allocated under section 643(c) among the trust or estate and its beneficiaries for purposes other than Section 199A.
>
> Under Section 199A, the threshold amount is determined at the trust level without taking into account any distribution deductions. Commenters have noted that taxpayers could circumvent the threshold amount by dividing assets among multiple trusts, each of which would claim its own threshold amount. This result is inappropriate and inconsistent with the purpose of Section 199A. Therefore, proposed § 1.199A-6(d)(3)(v) provides that trusts formed or funded with a significant purpose of receiving a deduction under Section 199A will not be respected for purposes of Section 199A.
>
> The Treasury Department and the IRS request comments with respect to whether taxable recipients of annuity and unitrust interests in charitable remainder trusts and taxable beneficiaries of other split-interest trusts may be eligible for the Section 199A deduction to the extent that the amounts received by such recipients include amounts that may give rise to the deduction. Such comments should include explanations of how amounts that may give rise to the Section 199A deduction would be identified and reported in the various classes of income of the trusts received by such recipients and how the excise tax rules in section 664(c) would apply to such amounts.

The preamble to the 2019 proposed regulations [REG-134652-18] (the "2019 Proposed Regs") explains (with the "August Proposed Regulations" referring to REG-107892-18 (8/16/2018)), part III, "Special Rules for Trusts and Estates," explains:

> Section 1.199A-6 provides guidance that certain specified entities (for example, trusts and estates) may need to follow to enable the computation of the Section 199A deduction of the entity and each of its owners. Section 1.199A-6(d) contains special rules for applying Section 199A to trusts and decedents' estates. The August Proposed Regulations expressly requested comments, and comments were submitted, on whether and how certain trusts and other entities would be able to take a deduction under Section 199A. These proposed regulations take those suggestions into consideration in proposing rules applicable to those particular situations identified by commenters.
>
> In the case of a Section 199A deduction claimed by a non-grantor trust or estate, Section 199A(f)(1)(B) applies rules similar to the rules under former section 199(d)(1)(B)(i) for the apportionment of W-2 wages and the apportionment of

UBIA of qualified property. In the case of a non-grantor trust or estate, the QBI and expenses properly allocable to the business, including the W-2 wages relevant to the computation of the wage limitation, and relevant UBIA of depreciable property must be allocated among the trust or estate and its various beneficiaries. Specifically, § 1.199A-6(d)(3)(ii) provides that each beneficiary's share of the trust's or estate's QBI and W-2 wages is determined based on the proportion of the trust's or estate's DNI that is deemed to be distributed to that beneficiary for that taxable year. Similarly, the proportion of the entity's DNI that is not deemed distributed by the trust or estate will determine the entity's share of the QBI and W-2 wages. In addition, if the trust or estate has no DNI in a particular taxable year, any QBI and W-2 wages are allocated to the trust or estate, and not to any beneficiary.

> In addition, § 1.199A-6(d)(3)(ii) provides that, to the extent the trust's or estate's UBIA of qualified property is relevant to a trust or estate and any beneficiary, the trust's or estate's UBIA of qualified property will be allocated among the trust or estate and its beneficiaries in the same proportions as is the DNI of the trust or estate. This is the case regardless of how any depreciation or depletion deductions resulting from the same property may be allocated under section 643(c) among the trust or estate and its beneficiaries for purposes other than Section 199A.

> Under § 1.199A-6(d)(3)(iv), the threshold amount is determined at the trust level after taking into account any distribution deductions. Commenters have noted that taxpayers could circumvent the threshold amount by dividing assets among multiple trusts, each of which would claim its own threshold amount. This result is inappropriate and inconsistent with the purpose of Section 199A. Therefore, § 1.199A-6(d)(3)(vii) provides that a trust formed or funded with a principal purpose of receiving a deduction under Section 199A will not be respected for purposes of determining the threshold amount under Section 199A.

For nongrantor trusts or estates, Reg. § 1.199A-6(d)(1) provides:

> *In general*. A trust or estate computes its Section 199A deduction based on the QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income that are allocated to the trust or estate. An individual beneficiary of a trust or estate takes into account any QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income allocated from a trust or estate in calculating the beneficiary's Section 199A deduction, in the same manner as though the items had been allocated from an RPE. For purposes of this section and §§ 1.199A- 1 through 1.199A-5, a trust or estate is treated as an RPE to the extent it allocates QBI and other items to its beneficiaries, and is treated as an individual to the extent it retains the QBI and other items.

This last sentence is important not just as a matter of calculation but also because it allows estates with fiscal years straddling 2017-2018 to pass to their beneficiaries 2017 business income that gets treated as QBI.[980]

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[980] See part II.E.1.c.i What Kind of Deduction; Maximum Impact of Deduction, especially the paragraph accompanying fn 749.

Consistent with the Code § 199 rules regarding grantor trusts, Reg. § 1.199A-6(d)(2) provides:

> *Grantor trusts*. To the extent that the grantor or another person is treated as owning all or part of a trust under sections 671 through 679, such person computes its Section 199A deduction as if that person directly conducted the activities of the trust with respect to the portion of the trust treated as owned by the grantor or other person.

Reg. § 1.199A-6(d)(3)(i), "Calculation at entity level," provides:

> A trust or estate must calculate its QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income. The QBI of a trust or estate must be computed by allocating qualified items of deduction described in Section 199A(c)(3) in accordance with the classification of those deductions under § 1.652(b)-3(a), and deductions not directly attributable within the meaning of § 1.652(b)-3(b) (other deductions) are allocated in a manner consistent with the rules in § 1.652(b)-3(b). Any depletion and depreciation deductions described in section 642(e) and any amortization deductions described in section 642(f) that otherwise are properly included in the computation of QBI are included in the computation of QBI of the trust or estate, regardless of how those deductions may otherwise be allocated between the trust or estate and its beneficiaries for other purposes of the Code.

See parts II.J.8.f.i.(a) Allocating Deductions to Various Income Items and II.J.8.f.i.(a) Allocating Deductions to Various Income Items. See also part II.J.11.a Depreciation Advantages and Disadvantages.

Reg. § 1.199A-6(d)(3)(ii), "Allocation among trust or estate and beneficiaries," provides:

> The QBI (including any amounts that may be less than zero as calculated at the trust or estate level), W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income of a trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust's or estate's distributable net income (DNI), as defined by section 643(a), for the taxable year that is distributed or required to be distributed to the beneficiary or is retained by the trust or estate. For this purpose, the trust's or estate's DNI is determined with regard to the separate share rule of section 663(c), but without regard to Section 199A. If the trust or estate has no DNI for the taxable year, any QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income are allocated entirely to the trust or estate.

In determining how much income to report on a K-1 to a beneficiary, an estate or nongrantor trust first nets expenses against that income. See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items. Although this process determines how much business income appears as an income item on a beneficiary's K-1, it does not apply to expenses that are not from the qualified trade or business. Instead, QBI is allocated according to DNI without regard to the amount of QBI the trust reports as income to the beneficiary after allocating expenses that are unrelated to QBI. For example, Reg. § 1.199A-6(d)(3)(ii) above provides that negative QBI can be reported on a K-1, as does the Example in Reg. § 1.199A-6(d)(3)(viii) below. However, losses cannot be carried out to beneficiaries except on the estate or trust's final return. See part II.J.3.i Planning for Excess Losses. Thus, the regulations view QBI as a mere informational item to be allocated, rather than bearing any particular relationship to amount of business income or loss actually passing through to any beneficiary on a K-1.

Thus, a trust/estate with small DNI can allocate significantly larger amounts of QBI to a beneficiary, and distributions that are relatively small compared to QBI but are a high percentage of DNI can cause what may seem to be a disproportionately large amount of QBI to the beneficiary. Although this may seem to be a great income tax planning opportunity, note that it works only if and to the extent that the beneficiary has taxable income taxed as ordinary income rates.[981]

Reg. § 1.199A-6(d)(3)(iii) is reserved. Prop. Reg. § 1.199A-6(d)(3)(iii) is quoted and discussed in part II.E.1.f.i.(d) Separate Shares.

Reg. § 1.199A-6(d)(3)(iv), "Threshold amount," provides:

> The threshold amount applicable to a trust or estate is $157,500 for any taxable year beginning before 2019. For taxable years beginning after 2018, the threshold amount shall be $157,500 increased by the cost-of-living adjustment as outlined in § 1.199A-1(b)(12). For purposes of determining whether a trust or estate has taxable income in excess of the threshold amount, the taxable income of the trust or estate is determined after taking into account any distribution deduction under sections 651 or 661.

Reg. § 1.199A-6(d)(3)(v) is reserved. Prop. Reg. § 1.199A-6(d)(3)(v) is quoted and discussed in part II.E.1.f.vii Charitable Remainder Trusts and Other Split-Interest Trusts.

Reg. § 1.199A-6(d)(3)(vi), "Electing small business trusts," is quoted and discussed in part II.E.1.f.ii Electing Small Business Trusts (ESBTs).

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VII.B.6, "Section 199A Anti-Abuse Rule," changed the proposed regulations to the final regulation reproduced below:

> One commenter requested clarification on whether a trust with a reasonable estate or business planning purpose would be respected. Another commenter argued that the rule is overbroad and lacks clarity as to what would be abusive and what the consequences would be of not respecting the trust for Section 199A purposes. The commenter also stated that the rule is not needed because of § 1.643-1 and if both rules are retained, they should use the same test (principal versus significant purpose). Finally, the commenter asked for clarification on whether the rule applies to a single trust and suggested it should apply on an annual basis. This last suggestion has not been adopted because the test goes to the creation of the trust, factors which would not change in later years. The final regulations clarify that the anti-abuse rule is designed to thwart the creation of even one single trust with a principal purpose of avoiding, or using more than one, threshold amount. If such trust creation violates the rule, the trust will be aggregated with the grantor or other trusts from which it was funded for purposes of determining the threshold amount for calculating the deduction under Section 199A.

Reg. § 1.199A-6(d)(3)(vii), "Anti-abuse rule for creation of a trust to avoid exceeding the threshold amount," provides:

> A trust formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under Section 199A will not

[981] See fn 771 in part II.E.1.c.i.(a) Summary of Federal Impact of Deduction, which is among factors that make the Code § 199A deduction less beneficial than a casual observer might realize.

be respected as a separate trust entity for purposes of determining the threshold amount for purposes of Section 199A. *See also* § 1.643(f)-1 of the regulations.

Because Reg. § 1.199A-6(d)(3)(vii), is contained within the paragraph covering nongrantor trusts, Reg. § 1.199A-6(d)(3), rather than the paragraph covering grantor trusts, Reg. § 1.199A-6(d)(2), I believe that the anti-abuse rule applies only to nongrantor trusts and not to grantor trusts.

Although the literal language of the regs does not expressly address your question, I think its placement is prima facie evidence of the intent to apply the anti-abuse rules only to nongrantor trusts.

Reg. § 1.643(f)-1 is discussed in part II.J.9.c.i Multiple Trusts Created for Tax Avoidance.

Reg. § 1.199A-6(d)(3)(viii), Example (1)(A) (the only example), begins with (1), "Computation of DNI and inclusion and deduction amounts":

(i) *Trust's distributive share of partnership items*. Trust, an irrevocable testamentary complex trust, is a 25% partner in PRS, a family partnership that operates a restaurant that generates QBI and W-2 wages. A and B, Trust's beneficiaries, own the remaining 75% of PRS directly. In 2018, PRS properly allocates gross income from the restaurant of $55,000, and expenses directly allocable to the restaurant of $45,000 (including W-2 wages of $25,000, and miscellaneous expenses of $20,000) to Trust. These items are properly included in Trust's DNI. PRS distributes $10,000 of cash to Trust in 2018.

(ii) *Trust's activities*. In addition to its interest in PRS, Trust also operates a family bakery conducted through an LLC wholly-owned by the Trust that is treated as a disregarded entity. In 2018, the bakery produces $100,000 of gross income and $155,000 of expenses directly allocable to operation of the bakery (including W-2 wages of $50,000, rental expense of $75,000, miscellaneous expenses of $25,000, and depreciation deductions of $5,000). (The net loss from the bakery operations is not subject to any loss disallowance provisions outside of Section 199A.) Trust maintains a reserve of $5,000 for depreciation. Trust also has $125,000 of UBIA of qualified property in the bakery. For purposes of computing its Section 199A deduction, Trust and its beneficiaries have properly chosen to aggregate the family restaurant conducted through PRS with the bakery conducted directly by Trust under § 1.199A-4. Trust also owns various investment assets that produce portfolio-type income consisting of dividends ($25,000), interest ($15,000), and tax-exempt interest ($15,000). Accordingly, Trust has the following items which are properly included in Trust's DNI:

Interest Income	15,000
Dividends	25,000
Tax-exempt interest	15,000
Net business loss from PRS and bakery	(45,000)
Trustee commissions	3,000
State and local taxes	5,000

(iii) *Allocation of deductions under § 1.652(b)-3* (*Directly attributable expenses)*.

In computing Trust's DNI for the taxable year, the distributive share of expenses of PRS are directly attributable under § 1.652(b)-3(a) to the distributive share of income of PRS. Accordingly, Trust has gross business income of $155,000 ($55,000 from PRS and $100,000 from the bakery) and direct business expenses of $200,000 ($45,000 from PRS and $155,000 from the bakery) . In addition, $1,000 of the trustee commissions and $1,000 of state and local taxes are directly attributable under § 1.652(b)-3(a) to Trust's business income. Accordingly, Trust has excess business deductions of $47,000. Pursuant to its authority recognized under § 1.652(b)-3(d), Trust allocates the $47,000 excess business deductions as follows: $15,000 to the interest income, resulting in $0 interest income, $25,000 to the dividends, resulting in $0 dividend income, and $7,000 to the tax exempt interest.

(iv) *Allocation of deductions under § 1.652(b)-3* (*Non-directly attributable expenses)*.

The trustee must allocate the sum of the balance of the trustee commissions ($2,000) and state and local taxes ($4,000) to Trust's remaining tax-exempt interest income, resulting in $2,000 of tax exempt interest.

(v) *Amounts included in taxable income*. For 2018, Trust has DNI of $2,000. Pursuant to Trust's governing instrument, Trustee distributes 50%, or $1,000, of that DNI to A, an individual who is a discretionary beneficiary of Trust. In addition, Trustee is required to distribute 25%, or $500, of that DNI to B, a current income beneficiary of Trust. Trust retains the remaining 25% of DNI. Consequently, with respect to the $1,000 distribution A receives from Trust, A properly excludes $1,000 of tax-exempt interest income under section 662(b). With respect to the $500 distribution B receives from Trust, B properly excludes $500 of tax exempt interest income under section 662(b). Because the DNI consists entirely of tax-exempt income, Trust deducts $0 under section 661 with respect to the distributions to A and B.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VII.B.5, "Allocation between Trust or Estate and Beneficiaries," corrected a mistake in the proposed regulations relating to depreciation:

> One commenter argued that proposed § 1.199A-6(d)(3)(v)(C) and (D) and the accompanying example are wrong in allocating the whole depreciation deduction to the trust. Instead, the commenter said that the depreciation should be allocated based on fiduciary accounting income. Another commenter stated that the QBI net loss should be allocated entirely to the trust or estate and not passed through to the beneficiaries. Another commenter stated that the example in proposed § 1.199A-6(d)(3)(vi) overlooks section 167(d) and that final regulations should clarify whether reporting of depreciation is being changed. An additional commenter stated that a charitable lead trust's threshold amount should be the same as other trusts after the charitable deduction. Based on comments received, the final regulations provide that the treatment of depreciation applies solely for purposes of Section 199A, and the example has been revised to clarify the allocation of QBI and depreciation to the trust and the beneficiaries. As an RPE, the final regulations continue to require that a trust or estate allocates QBI (which may be a negative amount) to its beneficiaries based on the relative portions of DNI distributed to its beneficiaries or retained by the trust or estate.

Reg. § 1.199A-6(d)(3)(viii)(A), Example (1) (the only example), ends with (2), “Section 199A deduction”:

(i) *Trust’s W-2 wages and QBI*. For the 2018 taxable year, prior to allocating the beneficiaries’ shares of the Section 199A items, Trust has $75,000 ($25,000 from PRS + $50,000 of Trust) of W-2 wages. Trust also has $125,000 of UBIA of qualified property. Trust has negative QBI of ($47,000) ($155,000 gross income from aggregated businesses less the sum of $200,000 direct expenses from aggregated businesses and $2,000 directly attributable business expenses from Trust under the rules of § 1.652(b)-3(a)).

(ii) *A’s Section 199A deduction computation*.

Because the $1,000 Trust distribution to A equals one-half of Trust’s DNI, A has W-2 wages from Trust of $37,500. A also has W-2 wages of $2,500 from a trade or business outside of Trust (computed without regard to A’s interest in Trust), which A has properly aggregated under § 1.199A-4 with the Trust’s trade or businesses (the family’s restaurant and bakery), for a total of $40,000 of W-2 wages from the aggregate trade or businesses. A also has $62,500 of UBIA from Trust and $25,000 of UBIA of qualified property from the trade or business outside of Trust for $87,500 of total UBIA of qualified property. A has $100,000 of QBI from the non-Trust trade or businesses in which A owns an interest.

Because the $1,000 Trust distribution to A equals one-half of Trust’s DNI, A has (negative) QBI from Trust of ($23,500). A’s total QBI is determined by combining the $100,000 QBI from non-Trust sources with the ($23,500) QBI from Trust for a total of $76,500 of QBI. Assume that A’s taxable income is $357,500, which exceeds A’s applicable threshold amount for 2018 by $200,000. A’s tentative deductible amount is $15,300 (20% * $76,500 of QBI), limited to the greater of (i) $20,000 (50% * $40,000 of W-2 wages), or (ii) $12,187.50 ($10,000, 25% * $40,000 of W-2 wages, plus $2,187.50, 2.5% * $87,500 of UBIA of qualified property). A’s Section 199A deduction is equal to the lesser of $15,300, or $71,500 (20% ´ $357,500 of taxable income). Accordingly, A’s Section 199A deduction for 2018 is $15,300.

(iii) *B’s Section 199A deduction computation*.

For 2018, B’s taxable income is below the threshold amount so B is not subject to the W-2 wage limitation. Because the $500 Trust distribution to B equals one-quarter of Trust’s DNI, B has a total of ($11,750) of QBI. B also has no QBI from non-Trust trades or businesses, so B has a total of ($11,750) of QBI. Accordingly, B’s Section 199A deduction for 2018 is zero. The ($11,750) of QBI is carried over to 2019 as a loss from a qualified business in the hands of B pursuant to Section 199A(c)(2).

(iii) *Trust’s Section 199A deduction computation*.

For 2018, Trust’s taxable income is below the threshold amount so it is not subject to the W-2 wage limitation. Because Trust retained 25% of Trust’s DNI, Trust is allocated 25% of its QBI, which is ($11,750). Trust’s Section 199A deduction for 2018 is zero. The ($11,750) of QBI is carried over to 2019 as a loss from a qualified business in the hands of Trust pursuant to Section 199A(c)(2).

(B) is reserved.

Prop. Reg. § 1.199A-6(e), "Effective/applicability date," provides:

(1) *General rule*. Except as provided in paragraph (e)(2) of this section, the provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. However, taxpayers may rely on the rules of this section until the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register.

(2) *Exceptions*.

(i) *Anti-abuse rules*. The provisions of paragraph (d)(3)(v) of this section apply to taxable years ending after December 22, 2017.

(ii) *Non-calendar year RPE*. For purposes of determining QBI, W-2 wages, and UBIA of qualified property, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

II.E.1.f.i. Nongrantor Trusts Other Than ESBTs

II.E.1.f.i.(a). How Qualified Business Income Flows to Beneficiaries

By managing their taxable income through the income distribution deduction, trusts may be able to get below the desired threshold to qualify for a better deduction. Planning for estates and nongrantor trusts generally is discussed in part II.J Fiduciary Income Taxation.

Suppose a partnership distributes its entire $1 million K-1 income (all "QBI" - qualified business income) to a trust. Suppose the partnership then distributes enough income so that its taxable income, before the Code § 199A deduction, is $157,500. The trust's allocable portion of QBI receives the 20% deduction, without regard to the wage limitation[982] and without regard to whether the partnership conducts otherwise disqualified professional services.[983] The beneficiary's K-1 income from the trust pushes the beneficiary's taxable income way above the taxable income threshold. The beneficiary might very well have been above the taxable income threshold anyway.

Thus, we might have two taxpayers that might have been above the taxable income threshold, yet one of them gets the full benefit of being below the threshold.

Suppose each of the trust and beneficiary has zero taxable income but for a $315,000 K-1 that the trust receives. If the trust distributes to the beneficiary $157,500 plus all of its other income, each of the trust and the beneficiary may have $157,500 of taxable income. Thus, each one should be able to qualify fully for all of the benefits that taxable income below the thresholds

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[982] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
[983] See part II.E.1.f Trusts/Estates and the Code § 199A Deduction.

provides,[984] even though if the trust had retained all of the K-1 income it would have not received any of those benefits (with $315,000 taxable income, which is above $207,500).

II.E.1.f.i.(b). When to Shift Qualified Business Income (QBI) to Beneficiaries

Before focusing on QBI, consider planning for the trust and beneficiaries generally. See part II.J Fiduciary Income Taxation, especially part II.J.3 Strategic Fiduciary Income Tax Planning.

Generally, distributions effectively shift the trust's income to its beneficiaries.[985]

After allocating deductions to the trust's income,[986] the trustee usually needs to allocate all items of distributable net income to beneficiaries in proportion to the distributions they receive,[987] subject to the separate share rule.[988] As the latter, see part II.E.1.f.i.(d) Separate Shares.

Be sure to consider planning opportunities described in part II.J.11.a Depreciation Advantages and Disadvantages.

A beneficiary may have business losses, deductions against gross income, or the itemized or standard deduction against which to offset income, so that shifting income to the beneficiary may provide more.

Also, if a beneficiary is a married person filing jointly, then the beneficiary's taxable income threshold is double that of a trust's, so shifting QBI to the beneficiary may allow a more favorable threshold, even if the beneficiary's losses and deductions don't make much of a difference.

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[984] The preamble to the final regulations, T.D. 9847 (2/8/2019), part VII.B.4, "Inclusion of Trust Distributions in Taxable Income," reversed a rule in the proposed regulations that would have disallowed the distribution deduction in computing the trust's taxable income threshold:

> Multiple commenters suggested that distributions should not be counted twice in determining whether the threshold amount is met or exceeded, saying this is counter to the statute and beyond the regulatory authority of the Treasury Department and the IRS. Further, sections 651 and 661 are fundamental principles of fiduciary income taxation and the possible duplication of the threshold is better addressed in anti-abuse provisions. Another commenter suggested that double counted income should be ignored, arguing that double counting is punitive because it fails to take into account the economic consequences of distributions and is inconsistent with the longstanding fundamental principles of subchapter J. Another commenter recommended that the distribution deduction should be given effect in computing thresholds, consistent with section 1411 and fiduciary obligations. The Treasury Department and IRS agree with the commenters that distributions should reduce taxable income because the trust is not taxed on that income. The final regulations remove the provision that would exclude distributions from taxable income for purposes of determining whether taxable income for a trust or estate exceeds the threshold amount. The final regulations specifically provide that for purposes of determining whether a trust or estate has taxable income that exceeds the threshold amount, the taxable income of the trust or estate is determined after taking into account any distribution deduction under sections 651 or 661.

[985] See part II.J.1 Trust's Income Less Deductions and Exemptions Is Split Between Trust and Beneficiaries.

[986] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items.

[987] See part II.J.8.f.i.(b) Allocating Income Items Among Those Receiving It.

[988] See part II.J.9.a.ii Separate Share Rule.

II.E.1.f.i.(c). Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs

Suppose a trust holds a partnership but would like to take advantage of the benefits provided for S corporation shareholders by part II.E.1.f.ii Electing Small Business Trusts (ESBTs) or II.E.1.f.iii Grantor Trusts. It could contribute its partnership interest to an S corporation and then take advantage of those benefits. See parts II.J.4.g Making the Trust a Complete Grantor Trust as to the Beneficiary and II.J.4.h.i Trapping Income in Trust Notwithstanding Distributions – ESBT. This possibility is discussed in part II.E.1.f.ii Electing Small Business Trusts (ESBTs).

Such a strategy would also have the benefit of qualifying the partnership from electing out of the Bipartisan Budget Act partnership audit rules that became effective for years beginning after December 31, 2017. See part II.G.19.c Audits of Partnership Returns. I don't view being able to elect out of those rules to be a substantial benefit, if beneficial at all.

However, given that an S corporation that does not itself conduct a business cannot be divided tax-free, consider creating the same number of S corporations as there are remaindermen. That way, each remainderman will have his or her own S corporation and independently determine distributions from the S corporation or whether the S corporation should sell the partnership interest. For more thoughts on this, see part III.A.3.e.vi.(b), the title of which focuses on QSSTs, but which also applies to ESBTs.

II.E.1.f.i.(d). Separate Shares

For context, see part II.J.9.a.ii Separate Share Rule.

The preamble to the 2019 proposed regulations [REG-134652-18] (the "2019 Proposed Regs") explains (with the "August Proposed Regulations" referring to REG-107892-18 (8/16/2018)), part III.C, "Separate shares," explains:

> Although no comments were received with respect the application of the threshold amount to separate shares, the Treasury Department and the IRS believe that clarification with respect to this issue may be necessary. These proposed regulations provide that, in the case of a trust described in section 663(c) with substantially separate and independent shares for multiple beneficiaries, such separate shares will not be treated as separate trusts for purposes of applying the threshold amount. Instead, the trust will be treated as a single trust for purposes of determining whether the taxable income of the trust exceeds the threshold amount. The purpose of the separate share rule in section 663(c) is to treat distributions of trust DNI to trust beneficiaries as independent taxable events solely for purposes of applying sections 661 and 662 with respect to each beneficiary's separate share. The rule determines each beneficiary's share of DNI based on the amount of DNI from that beneficiary's separate share, rather than as a percentage of the trust's DNI.
>
> Nevertheless, under the separate share rule, if a trust retains any portion of DNI, the trust will be subject to tax as a single trust with respect to the retained DNI. Only trusts with retained DNI will be eligible for the Section 199A deduction, because a trust will be allocated QBI, qualified REIT dividends, and qualified PTP income only in proportion to the amount of DNI retained by the trust for the taxable year. For this reason, a trust, regardless of the number of separate shares it has for its beneficiaries under the separate share rule of section 663(c), will be treated as a single trust for purposes of

> applying the threshold amount under Section 199A. To the extent that a taxable beneficiary of a trust receives a distribution of DNI from the beneficiary's separate share of the trust which includes Section 199A items, the beneficiary would apply its own threshold amount to those Section 199A items in computing its Section 199A deduction in accordance with the rules of § 1.199A-6(d).

The preamble to the 2020 final regulations, T.D. 9899 (6/24/2020)), part III, "Special Rules for Trusts and Estates," explains:

> Section 1.199A-6 provides guidance that certain specified entities (including trusts and estates) might need to compute the Section 199A deduction of the entity and/or passthrough information to each of its owners or beneficiaries, so they may compute their Section 199A deduction. Section 1.199A-6(d) contains special rules for applying Section 199A to trusts and decedents' estates.
>
> Under § 1.199A-6(d)(3)(ii), the QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income of a trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust's or estate's distributable net income (DNI) for the taxable year that is distributed or required to be distributed to the beneficiary or is retained by the trust or estate.
>
> Proposed § 1.199A-6(d)(3)(iii) further provides that a trust described in section 663(c) with substantially separate and independent shares for multiple beneficiaries will be treated as a single trust for purposes of determining whether the taxable income of the trust exceeds the threshold amount.
>
> The Treasury Department and the IRS received comments requesting guidance on the interaction between Section 199A and the separate share rule in section 663(c). In particular, the commenters requested guidance on the allocation of QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income of a trust or estate to beneficiaries and the trust or estate based on DNI. The commenters noted differences in the allocation of overall DNI to beneficiaries of a trust or estate under sections 643(a) and 663(c) and asked about the allocation of these items in circumstances involving tax-exempt income and charitable deductions, as well as situations in which no DNI is allocated to a beneficiary. The commenters asserted that under § 1.663(c)-2(b)(5), deductions, including the Section 199A deduction, attributable solely to one share are not available to any other separate share of the trust or estate.
>
> The commenters recommended that the allocation of QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income of a trust or estate should be based on the portion of such items that are attributable to the income of each separate share. In addition, the commenters recommended that § 1.663(c)-2(b) be amended to clarify how gross income not included in accounting income is allocated among separate shares.
>
> After considering the comments and studying the separate share rule in more depth, the Treasury Department and the IRS have clarified the separate share rule in these final regulations to provide that, in the case of a trust or estate described in section 663(c) with substantially separate and independent shares for multiple beneficiaries, the trust or estate will be treated as a single trust or estate not only for purposes of determining whether the taxable income of the trust or estate exceeds the threshold amount but also

in determining taxable income, net capital gain, net QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income for each trade or business of the trust or estate, and computing the W-2 wage and UBIA of qualified property limitations. Further clarification of the separate share rule under section 663 is beyond the scope of these final regulations, but the Treasury Department and the IRS intend to continue to study the issues raised by the commenters.

> Accordingly, these final regulations provide that the allocation of these items to the separate shares of a trust or estate described in section 663(c) will be governed by the rules under section 663(e) and such guidance as may be published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b)).

Accordingly, Reg. § 1.199A-6(d)(3)(iii), "Separate shares," provides:[989]

> In the case of a trust or estate described in section 663(c) with substantially separate and independent shares for multiple beneficiaries, such trust or estate will be treated as a single trust or estate for purposes of determining whether the taxable income of the trust or estate exceeds the threshold amount; determining taxable income, net capital gain, net QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income for each trade or business of the trust and estate; and computing the W-2 wage and UBIA of qualified property limitations. The allocation of these items to the separate shares of a trust or estate will be governed by the rules under §§ 1.663(c)-1 through 1.663(c)-5, as they may be adjusted or clarified by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter).

II.E.1.f.ii. Electing Small Business Trusts (ESBTs)

As described in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview,[990] ESBT income taxation is complicated. An ESBT is treated as two separate trusts for purposes of chapter 1 of Subtitle A of the Code. The portion that consists of stock in one or more S corporations is treated as one trust, and the portion that consists of all the other assets in the trust is treated as a separate trust. The grantor trust rules trump this treatment. However, the ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return. (A side benefit is that the $10,000 limit on state income tax deductions would apply separately to the S portion and the non-S portion, allowing the trust to deduct up to $20,000 in state income tax.)[991]

Code § 641(c)(2) limits the deductions that an ESBT can take. However, Code § 641(c)(2)(C)[992] and Reg. § 1.641(c)-1(d)(2)(i)[993] provide that one takes into items reported on Schedule K-1 that

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[989] Reg. § 1.199A-6(e)(2)(iii), "Separate shares," provides:
> The provisions of paragraph (d)(3)(iii) of this section apply to taxable years beginning after August 24, 2020. Taxpayers may choose to apply the rules in paragraph (d)(3)(iii) of this section for taxable years beginning on or before August 24, 2020, so long as the taxpayers consistently apply the rules in paragraph (d)(3)(iii) of this section for each such year.

[990] This is part of part III.A.3.e.ii Electing Small Business Trusts (ESBTs.

[991] See text accompanying fns 6050-6053 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview.

[992] Code § 641(c)(2)(C) provides:
> The only items of income, loss, deduction, or credit to be taken into account are the following:
> (i) The items required to be taken into account under section 1366….

[993] Reg. § 1.641(c)-1(d)(2)(i) provides:

the S corporation issues to the trust.[994] Code § 199A(f)(1)(B) refers back to Code § 199 for the apportionment of W-2 wages and the apportionment of unadjusted basis.[995] Code § 199 items were separately stated on Schedules K-1.[996] Consistent with this framework, Reg. § 1.199A-6(d)(3)(vi), "Electing small business trusts," provides:

> An electing small business trust (ESBT) is entitled to the deduction under Section 199A. Any Section 199A deduction attributable to the assets in the S portion of the ESBT is to be taken into account by the S portion. The S portion of the ESBT must take into account the QBI and other items from any S corporation owned by the ESBT, the grantor portion of the ESBT must take into account the QBI and other items from any assets treated as owned by a grantor or another person (owned portion) of a trust under sections 671 through 679, and the non-S portion of the ESBT must take into account any QBI and other items from any other entities or assets owned by the ESBT. For purposes of determining whether the taxable income of an ESBT exceeds the threshold amount, the S portion and the non-S portion of an ESBT are treated as a single trust. *See* § 1.641(c)-1.

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VII.B.3, "ESBTs," explains:

> One commenter supported the proposed regulation's position on ESBT's eligibility for the deduction. Another commenter stated that based on § 1.641(c)-1(a) and its reference to an ESBT being two separate trusts for purposes of chapter 1 of subtitle A of the Code (except regarding administrative purposes), the S portion and non-S portion should each have its own threshold. The Treasury Department and the IRS disagree with this comment. Although an ESBT has separate portions, it is one trust. Therefore, in order to provide clarity, the final regulations state that the S and non-S portions of an ESBT are treated as a single trust for purposes of determining the threshold amount.

> *In general*. The S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Rules otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. See § 1.1361-1(m)(3)(iv) for allocation of those items in the taxable year of the S corporation in which the trust is an ESBT for part of the year and an eligible shareholder under section 1361(a)(2)(A)(i) through (iv) for the rest of the year.

[994] Reg. § 1.1366-1(a)(2) provides:

> Each shareholder must take into account separately the shareholder's pro rata share of any item of income (including tax-exempt income), loss, deduction, or credit of the S corporation that if separately taken into account by any shareholder could affect the shareholder's tax liability for that taxable year differently than if the shareholder did not take the item into account separately.

[995] Code § 199A(f)(1)(B) is reproduced in fn 888 in part II.E.1.c.vi.(a) W-2 wages under Code § 199A.

[996] Reg. § 1.1366-1(a)(2)(x) provides that among the items a shareholder takes into account is:

> Any item identified in guidance (including forms and instructions) issued by the Commissioner as an item required to be separately stated under this paragraph (a)(2).

2017 Instructions for Form 1120S, Schedule K-1, Box 12, page 15, includes:

> **Code P. Domestic production activities information.** The corporation will provide you with a statement with information that you must use to figure the domestic production activities deduction. Use Form 8903, Domestic Production Activities Deduction, to figure this deduction. For details, see the Instructions for Form 8903.

2017s Instructions for Form 1120S, Schedule K-1, Box 17, Codes V through Z, provide details on those codes on pages 19-20.

It's ironic that the regulation implementing this explanation is followed by a cross-reference to Reg. § 1.641(c)-1, which contradicts that regulation by providing that the S portion and non-S portion are treated as separate trusts for all income tax purposes (other than using one Form 1041).[997]

Any planning regarding ESBTs should be in conjunction with part II.E.1.f.i.(c) Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs.

II.E.1.f.iii. Grantor Trusts (Including QSSTs)

"Grantor trust" means that one or more person is treated for income tax purposes as owning the trust's assets. Often this person is the grantor, but it can also be a beneficiary. See part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust, especially parts III.B.2.h How to Make a Trust a Grantor Trust and III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.

The most common grantor trust is the revocable trust, but that's just a probate avoidance tool that doesn't inform planning. During the settlor's life, we often look to whether the settlor of an irrevocable trust may be the deemed owner, although significant tools allow us to plan to have the primary beneficiary be the deemed owner. After the settlor's death, making the beneficiary the deemed owner is the only grantor trust planning option.

Given that all Code § 199A items are attributable to the relevant grantor(s), a grantor trust is helpful when the beneficiary has low income.

Suppose a trust has huge taxable income, as well as having a partnership K-1 with no more than $157,500 of taxable income (before applying Code § 199A). As discussed in part II.E.1.f.ii Electing Small Business Trusts (ESBTs)II.E.1.f.ii, the trust could form an S corporation, contribute the partnership interest to the S corporation, and make an ESBT election, thereby qualifying for the full Code § 199A deduction – but at the highest taxable income rates. Another alternative is to do the same, only the beneficiary elects QSST taxation.[998] All of the partnership's K-1 items are reported directly on the beneficiary's return, using the beneficiary's taxable income threshold and being taxed at the beneficiary's income tax rates. Before considering this, carefully read part II.E.1.f.i.(c) Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs.

II.E.1.f.iv. Interaction with Net Investment Income Tax

The 3.8% tax on net investment income (NII) applies not only to investments but also to passive business income. See part II.I.8 Application of 3.8% Tax to Business Income.

To avoid the tax on passive business income, the trustee of a nongrantor trust or the deemed owner of a grantor trust must sufficiently participate in the business. See part II.K.2 Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business.

If the trust is a QSST, then consider also having the trustee sufficiently participate, to avoid NII tax in case the business is sold. See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale

[997] See fn 6042 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview
[998] See part III.A.3.e.i.(a) QSSTs Generally.

of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax) and II.I.8.g Structuring Businesses in Response to 3.8% Tax.

II.E.1.f.v. Example Using Trusts to Split Income

Suppose Marla Alexander, a widow, owns an S corporation, which annually generates $1.5 million of taxable income each year.

Being in a state with a 5% income tax rate, Marla pays $75,000 of state income tax each year. Unfortunately, for any taxable year beginning after December 31, 2017 and before January 1, 2026, Code § 164(b)(6) limits her deductions for state taxes to $10,000.[999] Given that Marla pays some real estate tax on her residence, more than $65,000 of her state income tax deduction is disallowed.

Marla has two children, Sam and Dolly. Marla needs only 60% of her stock to live quite comfortably. After converting the stock in 5 shares of voting and 95 shares of nonvoting stock,[1000] Marla gifts 40 shares of nonvoting stock, 10 into each of four trusts: a discretionary trust for Sam, a QSST for Sam, a discretionary trust for Dolly, and a QSST for Dolly. See part III.A.3.e QSSTs and ESBTs.

Each ESBT will deduct its $7,500 share of state income tax. Because QSSTs are taxable as grantor trusts, each of Sam and Dolly will deduct up to $7,500 of state income tax if he or she itemizes deductions ("up to" because they may have real estate tax or other state tax deductions). Although part II.J.9.c.i Multiple Trusts Created for Tax Avoidance is concerning, Marla's desire to distribute some income and accumulate the rest of the income, combined with the fact that a QSST must distribute all of its income, may suffice. More conservative from an income tax viewpoint would be to make gifts outright instead of using QSSTs, but that might not meet Marla's estate planning objectives.

Also consider that each trust's distributive share of income is $150,000 (10% of $1.5 million). This means that each ESBT's taxable income will be less than $157,500; thus, in computing their Code § 199A deduction, any disallowance of specific service business income[1001] and any limitations placed on insufficient wages[1002] would not apply. See part II.E.1.f.ii Electing Small Business Trusts (ESBTs). Whether Sam and Dolly will benefit from eliminating these potential disallowances regarding the QSST's distributive shares that are taxed to them depends on their other income and deductions; see part II.E.1.f.iii Grantor Trusts (Including QSSTs).

Also consider part II.I 3.8% Tax on Excess Net Investment Income (NII), especially part II.I.8 Application of 3.8% Tax to Business Income:

- If Sam or Dolly's adjusted gross income exceeds $200,000 so that the 3.8% NII tax may apply to them, does Sam or Dolly work enough in the business to prevent the NII tax from applying to his or her distributive share of business income through his or her QSST? Working more than 100 hours per year – a mere 2 hours per week – may suffice; see

[999] It does not apply this limit to property taxes attributable to Code § 212 trade or business (which generally would be rental real estate, if it is a trade or business). See part II.G.4.l.i Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit.
[1000] See part II.A.2.i.i Voting and Nonvoting Stock.
[1001] See part II.E.1.c.iv Specified Service Trade or Business.
[1002] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

part II.K.1.i Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.

- Because an ESBT's threshold for the NII tax is so low, we also need to consider whether the trustee of each ESBT works enough in the business on behalf of the relevant trust to avoid NII tax. See part II.J.14 Application of 3.8% NII Tax to ESBTs. If the trustee works in the business as an individual, on audit the IRS is likely to assert that work as an individual does not count – it needs to be work expressly as a trustee. However, one can plan to avoid that argument. For all of these issues, see part II.K.2.b Participation by an Estate or Nongrantor Trust.

- The trustee of the QSSTs should also consider the planning mentioned for the ESBT. That's because the gain on sale of S corporation stock is taxed to the trust itself, rather than to the beneficiary; see parts II.J.15 QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items and II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets.

Suppose, instead of Marla's business being in an S corporation, it were held in an LLC taxed as a partnership. Let's first consider the state income tax issue, then consider the QBI issue.

Because there is no partnership income tax equivalent of a QSST, the mandatory income trust would apply the state income deduction at the trust level rather than at the beneficiary level. That may be more favorable, given that Sam's and Dolly's other state tax issues would not impinge on the benefits of the deduction for state income tax on the pass-through income. On the other hand, it may be more difficult to justify two separate trusts, given that a trust holding a partnership interest does not have the same type of drafting considerations that a QSST would have; therefore, one may be more wary of possible application of part II.J.9.c.i Multiple Trusts Created for Tax Avoidance. In response to this concern, one may consider the mandatory income trust placing the partnership in an S corporation, with the trust's beneficiary electing QSST treatment; query, however, whether such a strategy is more trouble than it's worth, as pointed out in part II.E.1.f.i.(c) Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs.

Moving to the QBI issues, issues with the specific service business income[1003] and any limitations placed on insufficient wages[1004] would be divided between the trust and beneficiaries who receive distributions, as described in part II.E.1.f.i Nongrantor Trusts Other Than ESBTs. However, if the LLC does not distribute much more than enough to pay taxes, then the beneficiaries might not receive much of a distribution, because the trust would use all or most of the distribution to pay the trust's own taxes; see parts III.A.4 Trust Accounting Income Regarding Business Interests and III.F.2 Trust Accounting and Taxation. To shift half of the gifted distributive shares of income to Sam or Dolly, one may need to consider having a separate mandatory income trust that places its LLC interest in an S corporation, with the trust's beneficiary electing QSST treatment; again, consider whether such a strategy is more trouble than it's worth, as pointed out in part II.E.1.f.i.(c) Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs.

Also consider the same NII tax issues we did for the ESBTs.

[1003] See part II.E.1.c.iv Specified Service Trade or Business.

[1004] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

II.E.1.f.vi. Ownership Restrictions

If an ownership interest cannot be transferred to a trust because it is a professional firm, consider which services can be split off into an entity that does not require professional ownership.

For example, CPA firms could split off their tax return and personal financial planning services.

However, if the business is inside a corporation, consider whether goodwill is personal or corporate,[1005] the latter causing taxation when moving the line of business unless one can do a tax-free split-up.[1006]

II.E.1.f.vii. Charitable Remainder Trusts and Other Split-Interest Trusts

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VII.B.1, "Charitable Remainder Trust Beneficiary's Eligibility for the Deduction," explains:

> The preamble to the proposed regulations requested comments with respect to whether taxable recipients of annuity and unitrust interests in charitable remainder trusts and taxable beneficiaries of other split-interest trusts may be eligible for the Section 199A deduction to the extent that the amounts received by such recipients include amounts that may give rise to the deduction. Concurrently with the publication of these proposed regulations, the Treasury Department and the IRS are publishing proposed regulations under Section 199A (REG-134652-18) that address the eligibility of taxable recipients of annuity and unitrust interests in charitable remainder trusts and taxable beneficiaries of other split-interests trusts to receive the Section 199A deduction.

The preamble to the 2019 proposed regulations [REG-134652-18] (the "2019 Proposed Regs") explains (with the "August Proposed Regulations" referring to REG-107892-18 (8/16/2018)), part III, "Special Rules for Trusts and Estates," explains:

> In the August Proposed Regulations, the Treasury Department and the IRS requested comments with respect to whether taxable recipients of annuity and unitrust interests in charitable remainder trusts and taxable beneficiaries of other split-interest trusts may be eligible for the Section 199A deduction to the extent that the amounts received by such recipients include amounts that may give rise to the deduction. The request for such comments indicated that such comments should include explanations of how amounts that may give rise to the Section 199A deduction would be identified and reported in the various classes of income of the trusts received by such recipients and how the excise tax rules in section 664(c) would apply to such amounts.
>
> **A. CHARITABLE REMAINDER TRUST BENEFICIARY'S ELIGIBILITY FOR THE DEDUCTION**
>
> A few commenters suggested that a charitable remainder trust under section 664 should be allowed to calculate the deduction at the trust level and that the charitable remainder

[1005] See part II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees?
[1006] See part II.Q.7.f Corporate Division into More Than One Corporation.

trust should be treated as a single taxpayer for purposes of the thresholds for taxable income, W-2 wages, and UBIA of qualified property.

Several commenters recommended that, if unrelated business taxable income (UBTI) is qualified business income, the Section 199A deduction should be allowed before the UBTI excise tax is imposed. However, other commenters disagreed. Another commenter stated that the Section 199A deduction should not be allowed when calculating UBTI because it is not a deduction directly connected with carrying on the trade or business and is allowable only for purposes of chapter 1, while the excise tax on UBTI is imposed under chapter 42 (that is, it is not an income tax). Another commenter said the UBTI excise tax under section 664(c) should not affect QBI because that tax is charged to principal.

One commenter recommended that QBI should be allocated to the ordinary income tier. Another recommended that QBI should be the bottom of the first tier (last to be distributed) and Section 199A items should be reported on the Schedule K-1 when QBI is deemed distributed. Another commenter stated that a charitable remainder trust has no taxable income and no DNI, so the allocation of QBI, W-2 wages, and UBIA of qualified property should be allocated to beneficiaries based on the percentage of distributions from the ordinary income tier, with QBI allocated to the charitable remainder trust remaining a tier one item. Another commenter stated that QBI cannot be a separate tier because it is a deduction, rather than a rate difference.

The Treasury Department and the IRS believe that, because a charitable remainder trust described in section 664 is not subject to income tax, and because the excise tax imposed by section 664(c) is treated as imposed under chapter 42, the trust does not either have or calculate a Section 199A deduction and the threshold amount described in Section 199A(e)(2) does not apply to the trust. Furthermore, application of Section 199A to effectively reduce the 100 percent rate of tax imposed by section 664(c) on any UBTI would be inconsistent with the intent of section 664(c) to deter trusts from making investments that generate significant UBTI. However, any taxable recipient of a unitrust or annuity amount from the trust must determine and apply the recipient’s own threshold amount for purposes of Section 199A, taking into account any annuity or unitrust amounts received from the trust. Therefore, a taxable recipient of a unitrust or annuity amount from a charitable remainder trust may take into account QBI, qualified REIT dividends, and qualified PTP income for purposes of determining the recipient’s Section 199A deduction for the taxable year to the extent that the unitrust or annuity amount distributed to such recipient consists of such Section 199A items under § 1.664-1(d).

In order to determine the order of distribution of the various classes of income of the trust for purposes of applying § 1.664-1(d), QBI, qualified REIT dividends, and qualified PTP income of a charitable remainder trust will be allocated to the classes of income within the category of income described in § 1.664-1(d)(1)(i)(a)(1) based on the rate of tax that normally would apply to that type of income, not taking into account the characterization of that income as QBI, qualified REIT dividends, or qualified PTP income for purposes of Section 199A. Accordingly, any QBI, qualified REIT dividends, and qualified PTP income will be treated as distributed from the trust to a unitrust or annuity recipient only when all other classes of income within the ordinary income category subject to a higher rate of tax (not taking into account Section 199A) have been exhausted. The unitrust or annuity recipient will be treated as receiving a proportionate

> amount of any QBI, qualified REIT dividends, and qualified PTP income that is distributed along with other income in the same class within the ordinary income category. To the extent that a trust is treated as distributing QBI, qualified REIT dividends, or qualified PTP income to more than one unitrust or annuity recipient in the taxable year, the distribution of such income will be treated as made to the recipients proportionately, based on their respective shares of the total of QBI, qualified REIT dividends, and qualified PTP income distributed for that year. The amount of any W-2 wages or UBIA of qualified property of the charitable remainder trust in a taxable year will be allocable to unitrust or annuity recipients based on each recipient's share of the trust's total QBI (whether or not distributed) for that taxable year.
>
> Any QBI, qualified REIT dividends, or qualified PTP income of the trust that is unrelated business taxable income is subject to excise tax and § 1.664-1(c) requires that tax to be allocated to the corpus of the trust. Certain other rules relating to charitable remainder trusts are provided.
>
> **B. SPLIT-INTEREST TRUSTS**
>
> The August Proposed Regulations requested comments on whether any special rules were necessary with respect to split-interest trusts. One commenter suggested that additional rules may be necessary for split-interest trusts other than charitable reminder trusts. After considering the comment and studying other split-interest trusts in more depth after the publication of the August Proposed Regulations, the Treasury Department and the IRS have determined that special rules for other split-interest trusts, such as non-grantor charitable lead trusts or pooled income funds, are not necessary because such trusts are taxable under part I, subchapter J, chapter 1 of the Code, except subpart E. Such split-interest trusts would apply the rules for non-grantor trusts and estates set forth in § 1.199A-6(d)(3) to determine any applicable Section 199A deduction for the trust or its taxable beneficiaries.

The preamble to the 2020 final regulations, T.D. 9899 (6/24/2020)), part III, "Special Rules for Trusts and Estates," explains:

> Section 1.199A-6(d)(3)(v) of the February 2019 Proposed Regulations provides rules under which the taxable recipient of a unitrust or annuity amount from a charitable remainder trust described in section 664 can take into account QBI, qualified REIT dividends, or qualified PTP income for purpose of determining the recipient's Section 199A deduction . The Treasury Department and the IRS received no comments on these rules and these final regulations adopt these rules as proposed.

Accordingly, Reg. § 1.199A-6(d)(3)(v), "Charitable remainder trusts," provides:[1007]

> A charitable remainder trust described in section 664 is not entitled to and does not calculate a Section 199A deduction, and the threshold amount described in Section 199A(e)(2) does not apply to the trust. However, any taxable recipient of a unitrust or annuity amount from the trust must determine and apply the recipient's own

[1007] Reg. § 1.199A-6(e)(2)(iv), "Charitable remainder trusts," provides:

> The provisions of paragraph (d)(3)(v) of this section apply to taxable years beginning after August 24, 2020. Taxpayers may choose to apply the rules in paragraph (d) of this section for taxable years beginning on or before August 24, 2020, so long as the taxpayers consistently apply the rules in paragraph (d)(3)(v) of this section for each such year.

threshold amount for purposes of Section 199A taking into account any annuity or unitrust amounts received from the trust. A recipient of a unitrust or annuity amount from a trust may take into account QBI, qualified REIT dividends, or qualified PTP income for purposes of determining the recipient's Section 199A deduction for the taxable year to the extent that the unitrust or annuity amount distributed to such recipient consists of such Section 199A items under § 1.664-1(d). For example, if a charitable remainder trust has investment income of $500, qualified dividend income of $200, and qualified REIT dividends of $1,000, and distributes $1,000 to the recipient, the trust would be treated as having income in two classes within the category of income, described in § 1.664-1(d)(1)(i)(a)(1), for purposes of § 1.664-1(d)(1)(ii)(b). Because the annuity amount first carries out income in the class subject to the highest income tax rate, the entire annuity payment comes from the class with the investment income and qualified REIT dividends. Thus, the charitable remainder trust would be treated as distributing a proportionate amount of the investment income ($500/(1,000+500)*1,000 = $333) and qualified REIT dividends ($1000/(1,000+500)*1000 = $667) because the investment income and qualified REIT dividends are taxed at the same rate and within the same class, which is higher than the rate of tax for the qualified dividend income in a separate class. The charitable remainder trust in this example would not be treated as distributing any of the qualified dividend income until it distributed all the investment income and qualified REIT dividends (more than $1,500 in total) to the recipient. To the extent that a trust is treated as distributing QBI, qualified REIT dividends, or qualified PTP income to more than one unitrust or annuity recipient in the taxable year, the distribution of such income will be treated as made to the recipients proportionately, based on their respective shares of total QBI, qualified REIT dividends, or qualified PTP income distributed for that year. The trust allocates and reports any W-2 wages or UBIA of qualified property to the taxable recipient of the annuity or unitrust interest based on each recipient's share of the trust's total QBI (whether or not distributed) for that taxable year. Accordingly, if 10 percent of the QBI of a charitable remainder trust is distributed to the recipient and 90 percent of the QBI is retained by the trust, 10 percent of the W-2 wages and UBIA of qualified property is allocated and reported to the recipient and 90 percent of the W-2 wages and UBIA of qualified property is treated as retained by the trust. However, any W-2 wages retained by the trust cannot be used to compute W-2 wages in a subsequent taxable year for Section 199A purposes. Any QBI, qualified REIT dividends, or qualified PTP income of the trust that is unrelated business taxable income is subject to excise tax and that tax must be allocated to the corpus of the trust under § 1.664-1(c).

II.E.1.f.viii. Tax-Exempt Trusts

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VII.B.2, "Tax Exempt Trusts," explains:

> One commenter requested guidance on whether "exempt trust organizations" (that is, trusts that are exempt from income tax under section 501(a) or "tax exempt trusts") are entitled to a Section 199A deduction in computing their unrelated business taxable income. The commenter also requested confirmation regarding whether the method of determining or separating trades of businesses is the same for sections 199A and 512(a)(6). The Treasury Department and the IRS decline to adopt these comments here because they are beyond the scope of these final regulations. The Treasury Department and the IRS continue to study this issue and request comments on the interaction of sections 199A and 512. We will consider all comments and decide whether

> further guidance on these issues, including as part of a forthcoming notice of a proposed rulemaking under section 512(a)(6), is warranted.

Notice 2018-67 provides guidance in separating businesses, setting forth "interim guidance and transition rules relating to" Code § 512(a)(6), and Section 3 of the Notice "outlines general concepts for identifying separate trades or businesses for purposes of § 512(a)(6) and provides interim reliance on a reasonable, good-faith standard for making such a determination."[1008] Section 3.03 includes:

> To provide additional guidance in proposed regulations for determining whether an exempt organization has more than one unrelated trade or business for purposes of § 512(a)(6) and how to identify separate trades or businesses for purposes of calculating UBTI under § 512(a)(6)(A), the Treasury Department and the IRS are considering the use of North American Industry Classification System (NAICS) codes. Prior to proposed regulations, the Treasury Department and the IRS will consider the use of NAICS 6-digit codes to be a reasonable, good-faith interpretation under section 3.02 of this notice.
>
> The NAICS is an industry classification system for purposes of collecting, analyzing, and publishing statistical data related to the United States business economy. See Executive Office of the President, Office of Management and Budget, North American Industry Classification System (2017), available at https://www.census.gov/eos/www/naics/2017NAICS/2017_NAICS_Manual.pdf. For example, under a NAICS 6-digit code, all of an exempt organization's advertising activities and related services (NAICS code 541800) might be considered one unrelated trade or business activity, regardless of the source of the advertising income. Use of all 6 digits of the NAICS codes would result in more specific categories of trades or businesses whereas use of fewer than 6 digits of the NAICS codes would result in broader categories of trades or businesses. Exempt organizations filing Form 990-T, "Exempt Organization Business Income Tax Return," already are required to use the 6-digit NAICS codes when describing the organization's unrelated trades or businesses in Block E. The Treasury Department and the IRS request comments regarding whether using less than 6 digits of the NAICS codes, or combining NAICS codes with other criteria, would appropriately identify separate trades or businesses for purposes of achieving the objective of § 512(a)(6). The Treasury Department and the IRS also request comments on the utility of this method, other methods, or a combination of methods that could be used for making this determination.

The preamble to proposed regulations under Code § 512(a)(6), [REG-106864-18] (4/24/2020) which will supersede Notice 2018-67, describes why the proposed regulations would allow taxpayers to use the 2-digit NAICS codes instead of the 6-digit NAICS codes. Prop. Reg. § 1.512(a)-6(b), "North American Industry Classification System," provides:

> (1) *In general*. Except as provided in paragraphs (c) through (e) of this section, an organization will identify each of its separate unrelated trades or businesses using the first two digits of the North American Industry Classification System code (NAICS 2-digit code) that most accurately describes the trade or business. The NAICS 2-digit code chosen must identify the unrelated trade or business in which the organization engages (directly or indirectly) and not the activities the conduct of which are substantially related to the exercise or performance by such organization

[1008] Notice 2018-67, § 1.

of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3)). For example, a college or university described in section 501(c)(3) cannot use the NAICS 2-digit code for educational services to identify all its separate unrelated trades or businesses, and a qualified retirement plan described in section 401(a) cannot use the NAICS 2-digit code for finance and insurance to identify all of its unrelated trades or businesses.

(2) *Codes only reported once*. An organization will report each NAICS 2-digit code only once. For example, a hospital organization that operates several hospital facilities in a geographic area (or multiple geographic areas), all of which include pharmacies that sell goods to the general public, would include all the pharmacies under the NAICS 2-digit code for retail trade, regardless of whether the hospital organization keeps separate books and records for each pharmacy.

(3) *Erroneous codes*. Once an organization has identified a separate unrelated trade or business using a particular NAICS 2-digit code, the organization may not change the NAICS 2-digit code describing that unrelated trade or business unless the organization can show that the NAICS 2-digit code chosen was due to an unintentional error and that another NAICS 2-digit code more accurately describes the trade or business.

II.E.1.g. Whether a High-Bracket Taxpayer Should Hold Long-Term Investments in a C Corporation

As mentioned earlier:

- Dividends a C corporation receives from another domestic C corporation are subjected to federal income tax of no more than 10.5%.[1009]

- Taxable interest and capital gains are subjected to 21% federal income tax.[1010]

Contrast this to a taxpayer in the highest tax bracket, who is subjected to federal income tax of:

[1009] See part II.E.1.a Taxes Imposed on C Corporations, especially the text accompanying fn 723, referring to fns. 9-13 in part II.A.1.a C Corporations Generally.

[1010] Code § 11(a), (b). Code § 11(c) provides that corporate income tax does not apply to a corporation subject to a tax imposed by:

(1) section 594 (relating to mutual savings banks conducting life insurance business),
(2) subchapter L (sec. 801 and following, relating to insurance companies), or
(3) subchapter M (sec. 851 and following, relating to regulated investment companies and real estate investment trusts).

Code § 11(d), "Foreign corporations," provides:

> In the case of a foreign corporation, the tax imposed by subsection (a) shall apply only as provided by section 882.

- 23.8% on qualified dividends[1011] and net long-term capital gains, considering the 20% top capital gain rate[1012] and 3.8% net investment income tax.[1013]

- 40.8% on taxable interest income, nonqualified dividends, and net short-term capital gains, considering the 37% top ordinary income tax rate[1014] and 3.8% net investment income tax.[1015]

- For any taxable year beginning after December 31, 2017 and before January 1, 2026, individuals cannot deduct investment management fees relating to managing their own marketable securities.[1016] This disallowance does not apply to C corporations, because C corporation deductions are not itemized deductions.

However, the chart in part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities, which also considers moderate state income tax, illustrates that the C corporation advantage quickly dissipates if the corporation makes distributions.

The personal holding company tax or accumulated earnings tax may essentially force a corporation to declare dividends – especially if the corporation accumulates more than $125,000 in earnings.[1017]

Eventually, however, income will need to be distributed so that the owner actually benefits from the investment return, imposing dividend tax at that time and undermining – to some extent (small or large) the advantage of C corporation income tax savings. Another option, which can make this strategy much more tenable, is: the investor grows the assets at smaller income tax rates, increasing future annual income, then converts to an S corporation and distributes current income while leaving prior years' income in the corporation to grow; see part II.E.2.c Converting a C Corporation to an S Corporation, which also includes warnings regarding investment mix after making the S election.

Harvesting the accumulated income by simply selling the C corporation does not produce good results. See part II.E.2 Comparing Exit Strategies from C Corporations and Pass-Through Entities.

Finally, if one decides to use a corporation to hold investments, consider what happens when one passes them to one's children or other various beneficiaries. A similar but perhaps more predictable termination concern applies to trusts. A corporation that invests in portfolio assets cannot divide without triggering income tax. One might consider creating a few corporations (in the case of a trust, one for each remainderman). These corporations then invest in a partnership, which can divide without triggering income tax. That way, each corporation can receive a mix of assets more along the lines of the beneficiary's preferences. For more details, see part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned

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1011 See part II.E.1.a Taxes Imposed on C Corporations, fns 724-725 and text accompanying them.
1012 Code § 1(h)(1), with exceptions under Code § 1(h)(3)-(8) for depreciation recapture, collectibles and Code § 1202 gain taxed as a capital gain at 28%
1013 See part II.I 3.8% Tax on Excess Net Investment Income (NII).
1014 Code § 1(j), for any taxable year beginning after December 31, 2017, and before January 1, 2026.
1015 See part II.I 3.8% Tax on Excess Net Investment Income (NII).
1016 Code § 67(g).
1017 See text accompanying and preceding fn 731 in part II.E.1.a Taxes Imposed on C Corporations.

Trusts (Whether or Not a Sale Is Made), which describes the corporate division issue and a solution.

I cannot emphasize enough the need to consider an exit strategy. Political winds change over time, and it is very likely that at some point Congress will increase corporate taxes to bring them closer to individual rates. Beware getting into a structure that has costly exit steps and then being stuck there because of that high exit tax. Consider that the Tax Reform Act of 1986 taxed all income, including long-term capital gains, at a top rate of 28%, and the paradigm before 2017 tax reform was very different. The paradigm from 2017 tax reform will change, whether by creeping as the 1986 one did or by dramatic changes needed to reduce the exploding national debt or pay for Medicare or Social Security.

II.E.1.h. Effect of 2017 Tax Reform on Debt-Equity Structure

See part II.G.20.a Code § 163(j) Limitation on Deducting Business Interest Expense.

Business interest deduction limitations vary by industry.

Businesses with average annual gross receipts of no more than $ 25 million are exempt from this limitation.[1018]

II.E.1.i. Conducting Businesses in Different Entities to Facilitate Using the Code § 199A Deduction

Each separate trade or business applies the Code § 199A separately,[1019] which may at first glance seem to make shifting operations around meaningless. However, each business activity may have, within the same entity, one or more sets of functions that support that activity, which functions might themselves be viewed as a separate business if conducted in that manner.

A prime example is real estate used in a business. Suppose a law partnership owned its own real estate. If a partner's income is too high, her partnership income would not generate a Code § 199A deduction, because the income is derived from a specific service business.[1020] The benefit of owning the real estate is subsumed in the disqualified income. However, if instead the real estate were owned by a separate LLC that was the landlord, the real estate could generate qualified business income (QBI) if the landlord undertook sufficient activity to qualify it as a trade or business; see part II.E.1.e Whether Real Estate Qualifies as a Trade or Business.

Unlike real estate, equipment leasing almost automatically qualifies as a trade or business, according to cases and rulings in the self-employment tax and unrelated business income tax areas.[1021] So consider forming a separate equipment leasing venture that services the equipment, with the services perhaps not needed to qualify as a business but helpful to prevent the wage limitation from reducing the Code § 199A deduction.[1022] To avoid self-employment tax, be sure to make the venture be a limited partnership with an S corporation general partner or an S corporation; see parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons, II.E.6 Recommended Partnership Structure – Flowchart

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[1018] See text accompanying fns 1810-1811.
[1019] See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.
[1020] See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction, fn 844.
[1021] See part II.L.2.a.ii Rental Exception to SE Tax, fns 3433-3437.
[1022] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

and II.E.7 Migrating into Partnership Structure (with the latter not as important because a new leasing venture could be started for new equipment). Also, as the Code § 199A deduction approaches its termination, consider part II.E.1.c.ix QBI and Effectively Connected Income.

If a professional service firm also sells goods, consider separating the sale of goods from the provision of services. Depending on how the government approaches classifying trades or business as separate,[1023] a separate entity may not be needed.

II.E.2. Comparing Exit Strategies from C Corporations and Pass-Through Entities

II.E.2.a. Transferring the Business

Part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis shows that, when doing a seller-financed sale of a business, such as to key employees, other owners, or family members, the value of a business attributable to goodwill can be transferred much more tax-efficiently when using a partnership compared to a C corporation or an S corporation. Part or all of these dynamics can be replicated in other transactions.

A shareholder's stock's basis does not increase as a result of a C corporation's reinvested income. However, part or all of the gain on the sale of original issue stock in a qualified corporation that runs a qualified business is excluded from income. See part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation, explaining Code § 1202.

However, to the extent that an owner's distributive share of a partnership's or S corporation's income is reinvested, the owner's basis in the partnership interest[1024] or stock[1025] increases. Thus, the gain on sale usually is much lower when selling a partnership interest or S corporation stock than when selling C corporation stock.

S corporations and partnerships are ideal candidates for estate planning transfers using irrevocable grantor trusts. See part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust, especially the text preceding fn 6499. When the pass-through entity makes distributions to pay its owners' taxes, the irrevocable grantor trust that bought the stock or partnership interest uses those distributions to pay down the note owed to seller, and the seller uses this to pay taxes. Thus, tax distributions are used to build equity in the purchasing irrevocable grantor trust. Contrast this with C corporations, where the corporation pays taxes directly to the government, and any distributions are subject to double taxation. See part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities, using the scenario of a C corporation distributing all of its earnings to its shareholders.

Also, gain on the sale of C corporation stock is subject to the 3.8% tax on net investment income.[1026] Gain on the sale of an S corporation or partnership that conducts a trade or business may be largely excluded from that tax when the owner sufficiently participates.[1027]

Furthermore, when an owner dies, the assets of a sole proprietorship (including an LLC owned by an individual that has not elected corporate taxation) or a partnership (including an LLC

[1023] See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.
[1024] Code § 705.
[1025] Code § 1367, which is reproduced in part II.G.4.d.i Basis Limitation Generally.
[1026] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[1027] See part II.I.8 Application of 3.8% Tax to Business Income.

owned by more than one person that has not elected corporate taxation) can obtain a basis step-up (or down) when an owner dies, whereas the assets of a C corporation or an S corporation do not receive a new basis.[1028]

Part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons describes more reasons why I tend to prefer partnerships over S corporations and S corporations over C corporations.

II.E.2.b. Converting from S Corporation to C Corporation

See parts II.A.2.k Terminating an S Election and II.P.3.d Conversion from S Corporation to C Corporation for short-term planning. Ideas include:

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

- Additional steps may be needed to preserve or distribute the S corporation's accumulated adjustment account (which generally lets S corporations distribute its reinvested taxable earnings later without taxing it shareholders – see part II.Q.7.b Redemptions or Distributions Involving S Corporations). Note that, if the corporation distributes a note before converting, interest income on the note will be taxable at its shareholders' full ordinary income rates and subject to net investment income tax, which together combine to impose a 40.8% federal tax rate, whereas the corporation may receive (see part II.G.20.a Code § 163(j) Limitation on Deducting Business Interest Expense) a deduction at a 21% federal rate.

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

Generally, I recommend forming an S corporation parent and then converting the original corporation to a C corporation, for the reasons and using the method described in fns 3977-3985 in part II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation and at the end of part II.P.3.b.v, which in a nutshell include (see part II.P.3.b.v for details):

- Preserving the corporation's AAA in case it converts back to being an S corporation.

- Avoiding (so it appears) having to wait 5 years before converting back to being an S corporation.[1029]

- Potentially qualifying for the benefits described in part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation, which does not apply to former S corporations but does apply to C corporation subsidiaries of S corporations.

[1028] See part II.H.2 Basis Step-Up Issues.

[1029] See fns 197-199 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).

- Avoiding double tax on assets with value in excess of basis when sold within the C corporation (to the extent later distributed) or after being sold within 5 years after converting from c corporation back to S corporation again.

However, the strategy of distributing a note before converting might trigger tax; see fns 3983-3984 in part II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation.

II.E.2.c. Converting a C Corporation to an S Corporation

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

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

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

- Although an S corporation that has accumulated earnings and profits from when it was a C corporation cannot have excess passive investment income, that issue is easily managed through the corporation's investment mix – if one considers the issue and plans for it; investment mix may not need to be managed if the corporation is a partner in an active business that has substantial gross receipts (which is tested rather than the partnership's profits). See part II.P.3.b.iii Excess Passive Investment Income, especially fns 3952-3955.

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

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

II.E.3. Recommended Structure for Start-Ups

The structure should start as a simple one and then, when the entity is making a lot money, would be transitioned to a more complex structure. For long-term reasons why an entity taxed as a sole proprietorship or partnership makes sense, see part II.E.5.a Strategic Income Tax Benefits of Recommended Structure.

Consider starting with an LLC. Start-up businesses often lose money initially, and an LLC taxed as a sole proprietorship or partnership facilitate loss deductions better than other entities[1030]

[1030] See part II.G.4 Limitations on Losses.

(although deducting start-up losses might not always generate the best result).[1031] Also, often owners of closely-held businesses operate with a high degree of informality, and owners of corporations can get into trouble by taking money out without documenting compensation or documenting loans;[1032] contrast that to an LLC that for income tax purposes is either disregarded entity or a partnership,[1033] in which case distributions are either disregarded or generally nontaxable.[1034]

A business with owners that work more than 100 but not more than 500 hours per year might want to move its real estate into the desired structure to avoid the 3.8% net investment income tax on the rental income (because the rental income and expense are disregarded for income tax purposes, being in the same umbrella as the operating business) or on the sale of the rental property. For example, a parent LLC might own an operating LLC and a real estate LLC. See parts II.I.8.c.i If Not Self-Rental, Most Rental Income Is *Per Se* Passive Income, II.I.8.a.iii Qualifying Self-Charged Interest or Rent Is Not NII, II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax, and II.E.9 Real Estate Drop Down into Preferred Limited Partnership.

However, deducting start-up losses may not be desirable, because the owner is in a lower tax bracket now and expects not to be in a low tax bracket in the future. See part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good. In that case, consider using an entity taxed as an S corporation, with the owners guaranteeing loans by third parties but not investing or lending a lot of money themselves. If that, too, generates more losses than desirable, then try a C corporation, which will just roll forward the losses. When using a C corporation or an S corporation, consider planning to qualify for the requirements of part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244 (which is not available to trusts).[1035] Beware, however, that using either kind of corporation can make getting into an ideal long-term structure more difficult, because one needs to avoid triggering taxation on a deemed distribution of assets. See part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure. Often a trigger for moving a corporation into the structure is the desire to avoid capital gain tax on the seller-financed sale of the business, which often

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[1031] If the owner is in a lower bracket in start-up years than in later years, losses might best be deferred, if possible. A variation of this idea is in part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good. If deferring losses is expected to be particularly beneficial, consider:

- If loans are bank-financed, an S corporation can easily ensure that its owners' distributive share of losses be suspended due to basis limitations until the S corporation becomes profitable. See part II.G.4.d.ii.(a) Limitations on Using Debt to Deduct S Corporation Losses.
- A start-up C corporation's losses are simply carried forward and deducted against its later income. See part II.G.4.l.ii Net Operating Loss Deduction. In case the C corporation doesn't succeed, certain start-up documentation can generate ordinary loss (instead of capital loss) treatment when the stock becomes worthless. See part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244, subject to part II.J.11.b Code § 1244 Treatment Not Available for Trusts. The timing and documentation (including initial documentation in the case of a loan) of a worthless stock or bad debt deduction can be tricky. See part II.G.4.b C Corporations: Losses Incurred by Business, Owner, or Employee, especially fns. 1182-1183 (stock) and 1185-1187 (loans).

[1032] Such payments are potentially taxable distributions to shareholders; see the text accompanying fns. 4799-4800 in part II.Q.7 Exiting from or Dividing a Corporation. The IRS attacks distributions from S corporations, asserting (often successfully) that they are disguised compensation (and perhaps assessing penalties as well); see part II.A.2.c Avoiding Double Taxation and Self-Employment Tax, especially fns. 79-80.

[1033] See part II.B Limited Liability Company (LLC).

[1034] See part II.Q.8.b.i Distribution of Property by a Partnership.

[1035] See part II.J.11.b Code § 1244 Treatment Not Available for Trusts.

makes the costs of transition worthwhile if the business has significant goodwill. See part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis.

When the business starts making money but only enough to pay owner compensation and equipment that is expensed immediately, no additional self-employment tax is due relative to if the entity were a corporation paying compensation to its owners. Furthermore, if the business is investing profits in equipment, etc., generous write-offs are available.[1036] However, note that wages paid by an S corporation may provide a higher Code § 199A deduction relative to compensation paid to a partner, so consider this corporate advantage.[1037]

Then, when the client is ready for the ideal entity (for example, when self-employment tax on reinvested earnings becomes a significant number), the client can simply assign the LLC to the limited partnership described in parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart; see part II.E.7.b Flowcharts: Migrating LLC into Preferred Structure. However, the client might express a preference in the long-run to use part II.E.8 Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary. If so, the client might want to start with that structure instead of starting with an LLC. If one starts with an entity taxed as an S or C corporation instead of an LLC, then the presence of non-compete agreements would make migration to a partnership structure less effective, because the value of the goodwill at the time of the migration would remain inside the corporation.

Suppose that one concludes that a C corporation would be ideal. Starting with an LLC taxed as a partnership and then converting to a C corporation the earlier of five years before a sale is anticipated or shortly before its gross assets reach $50 million might be the most tax-efficient approach.[1038]

Whether or not one likes the above recommendations, consider asset protection with a business' net profits. An entity's creditors' claims take priority over distributions to owners. If an entity distributes to its owners any profits not needed to keep the entity fiscally responsible, generally those assets will not be subjected to the claims of the entity's future creditors. For tax purposes, investments are best kept outside the entity, particularly for a C or an S corporation,[1039] but also, to a certain but more limited extent, for a partnership.[1040] The owners might consider loaning the distributions back to the entity, becoming creditors, rather

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[1036] See part II.G.4.n Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax.

[1037] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

[1038] See part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation, especially parts II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold and II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership? (particularly the text accompanying fns. 5309-5317).

[1039] Any distributions of appreciated assets trigger corporate-level income tax, whether paid by the corporation (C corporation) or shareholders (S corporation). See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders. Note also that S corporations that have accumulated earnings and profits from prior periods as an S corporation might want to avoid investments that generate tax-free income; see part II.P.3.b.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds.

[1040] See part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them). Such distributions have more potential to trigger tax than do distributions of other assets, but tax can be avoided with careful planning.

than owners, to that extent. The owners might also consider forming an LLC taxed as a partnership to hold any distributions that they neither loan to the company nor keep for personal purposes, viewing the LLC as a source for funding future capital projects or exit strategies or perhaps for providing or securing a line of credit for the business;[1041] however, S corporations might want to avoid any formal requirement in their governing documents that distributions be made to such an LLC.[1042]

II.E.4. Reaping C Corporation Annual Taxation Benefits Using Hybrid Structure

In part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities, we learned that:

- To the extent that a C corporation reinvests profits, it is more tax-efficient from the perspective of annual income from operations.

- To the extent that it distributes profits, it is not more tax-efficient.

Given that pass-through entities tend to have superior exit strategies,[1043] the portion of the business that distributes profits should be in a pass-through entity.

One might also consider holding any new equipment in an LLC and leasing it to the C corporation. Bonus depreciation would provide an immediate benefit,[1044] and any inside basis step-up that occurs on the death of, or other transfer by,[1045] an owner may reduce or eliminate depreciation recapture. Then, when a sale of the business is contemplated, the LLC might be contributed to the C corporation so that a later asset sale would be taxed at lower corporate

[1041] If there is a risk that the corporation will have losses but the shareholders' basis will be insufficient to deduct those losses, then the LLC should loan the funds to its members who should then lend them to the corporation. See part II.G.4.d.ii Using Debt to Deduct S Corporation Losses, which is part of part II.G.4.d Basis Limitation for Shareholders in an S Corporation. Presumably, if the loan from the LLC to the corporation is already in place, the LLC could simply distribute the loan to its members. See fn. 1212 in part II.G.4.d.ii Using Debt to Deduct S Corporation Losses.

[1042] A partnership is not an eligible shareholder of an S corporation; see part II.A.2.f Shareholders Eligible to Hold S Corporation Stock. Therefore, one might consider avoiding any distribution arrangements that might make a partnership appear to be a shareholder. However, distribution arrangements that are not baked into the governing documents do not count for determining whether a second class of stock exists (see part II.A.2.i.iii Disproportionate Distributions, and within that see fn. 255 for what constitutes governing documents and the effect, if any, given to certain arrangements), so presumably they would not count as creating a shareholder relationship. Although I have not seen anything directly on point, presumably an S corporation can contribute to a partnership in exchange for a partnership interest and then distribute that partnership interest to its shareholders; the parties would have substantial authority for not applying undesirable valuation discounts to that distribution – see part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders for general rules, fn. 5104 for authority for no valuation discounts, and part II.Q.7.h.iii.(b) Nondeductible Loss to Corporation When It Distributes Property to Shareholders for why valuation discounts are undesirable.

[1043] See part II.E.2.a Transferring the Business.

[1044] See part II.G.4.n

[1045] See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

rates, which contribution may work out with little problem or may raise too many issues to be practical.[1046]

Consider forming a limited partnership owned by a C corporation and a pass-through entity, with ownership based on the desired long-term goal for distributions:

- This might be worked in with the general ideas of parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart.

- If the entity is already a C corporation or an S corporation, see part II.E.7 Migrating into Partnership Structure.

The C corporation would annually receive any earnings that are to be reinvested, whereas the balance would be owned by limited partners receiving distributions. The C corporation would loan back to the partnership the earnings to be reinvested:

- The corporation's interest income would be taxed at a federal rate of 21%, whereas the interest would be deducted at the higher individual rate, causing a taxpayer-favorable tax arbitrage. However, the Code § 199A deduction of up to 20% of qualified business income[1047] may reduce this benefit, and the interest might not be fully deductible.[1048]

- If the interest income becomes too significant, consider whether the personal holding company tax[1049] or accumulated earnings tax[1050] may be triggered. If these possible taxes eventually become a factor, consider part II.E.2.c Converting a C Corporation to an S Corporation. Also consider possible deferral of the interest deduction under part II.G.20.a Code § 163(j) Limitation on Deducting Business Interest Expense.

Before doing any of this, consider that investing in a partnership might make a C corporation ineligible for part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation. However, as described in part II.Q.7.k, not all businesses are eligible for the exclusion, and the exclusion applies only to stock originally issued to the owner (or to the person who gifted or bequeathed the stock to the current owner).

An S corporation with separate business lines could also reorganize into an S corporation parent with various subsidiaries, some of which might be disregarded entity LLCs and others of which might be C corporations that reinvest their profits and may qualify for part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation. See part II.E.2.b Converting from S Corporation to C Corporation.

[1046] See part II.M.2 Buying into or Forming a Corporation, especially part II.M.2.c Contribution of Partnership Interest to Corporation

[1047] See part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

[1048] See part II.G.20.a Code § 163(j) Limitation on Deducting Business Interest Expense.

[1049] See part II.A.1.e Personal Holding Company Tax. I am not too concerned about this tax, because the corporation's distributive share of the partnership's gross income – not net income – would be compared against the interest income. In part II.A.1.e, see fn 65.

[1050] See part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax,

II.E.5. Recommended Long-Term Structure for Pass-Throughs – Description and Reasons

II.E.5.a. Strategic Income Tax Benefits of Recommended Structure

To maximize basis step-up of assets used in a business[1051] and promote tax-efficient exit strategies,[1052] the main entity should be a partnership. A partnership often is a better exit vehicle than a C corporation, notwithstanding part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation;[1053] if the exclusion of gain on sale of a C corporation is particularly compelling, consider instead starting as an LLC taxable as a partnership then later converting to a corporation.[1054] However, corporate structure has some advantages:

- The partnership audit rules are becoming onerous and may artificially increase tax.[1055] Even though S corporations generally are pass-throughs, Congress has not targeted them, and the IRS needs to consider the burdens of making adjustments at both the entity and shareholder level.[1056]

- If the owners find a corporate buyer and can, on a tax-free basis, merge the business into the buyer and receive the buyer's stock, and they don't mind having low basis publicly-traded stock, then note that a tax-free merger or similar reorganization under Code § 368 is available only to corporations. Forming a corporation immediately before the sale might not work;[1057] I am unsure whether checking-the-box to elect corporate treatment helps any.

[1051] See parts II.H.2 Basis Step-Up Issues, II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation, and II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

[1052] See part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis, for how to save capital gain tax on the seller-financed sale of an interest in a business. Also compare part II.Q.7.f Corporate Division into More Than One Corporation (including the cumbersome requirements of Code § 355 mentioned in parts II.Q.7.f.ii Code § 355 Requirements and II.Q.7.f.iii Active Business Requirement for Code § 355), with part II.Q.8 Exiting From or Dividing a Partnership (partnership divisions are generally tax-free, subject to certain rules about shifting unrealized gain in property whose value had been used to determine partnership percentage interests). Also, corporate redemptions might be recharacterized as distributions (see part II.Q.7.a.iii Redemption Taxed Either as Sale of Stock or Distribution; Which Is Better When) and lose installment sale treatment, whereas partnership redemptions are nontaxable until basis is fully recovered (see part II.Q.7.b.ii Redemptions or Distributions Involving S Corporations Compared with Partnerships).

[1053] See parts II.Q.1.a.i.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill and II.Q.1.a.ii.(h) Partnership Use of Same Earnings as C Corporation – No Federal Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation in Sale of Goodwill (California)Partnership Use of Same Earnings as C Corporation – No Federal Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation in Sale of Goodwill (California).

[1054] See part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership? (especially the text accompanying fns. 5309-5317).

[1055] See part II.G.19.c Audits of Partnership Returns.

[1056] See part II.G.19.b Audits of S Corporation Returns.

[1057] See part and II.P.3.c Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations, especially fn. 3541.

- If the owners would like for a qualified retirement plan to own the business, then an S corporation owned by an ESOP would be the ideal structure;[1058] on the other hand, an entity can start in the structure set forth below and then easily assign the interests in the operating LLCs to the S corporation general partner, in what generally would be a tax-free transaction.[1059]

Also, incentive pay and deferred compensation can be more difficult in a corporate setting than in a partnership setting.[1060]

Furthermore, a partnership often is a better vehicle for deducting start-up losses.[1061] However, using a partnership may knock one out of the small business exception to the Code § 163(j) limitations on deducting business interest.[1062] On the other hand, Code § 163(j) provides relief for self-charged interest for partnerships but not for S corporations.[1063]

II.E.5.b. Self-Employment Tax and State Income Tax Implications of Recommended Structure

To avoid self-employment tax, the entity should be a limited partnership, since an interest as a limited partner is not subject to self-employment (SE) tax.[1064] One should involve a local tax expert regarding any state or local taxes on pass-through entities in the states in which the entity does business.[1065]

II.E.5.c. Operating the Recommended Structure

II.E.5.c.i. General Considerations

This paradigm might not work well if owner compensation is needed to get the full Code § 199A deduction. See part II.E.5.c.ii Code § 199A Deduction under Recommended Structure. This concern applies only if the ultimate taxpayer computing the deduction has taxable income in excess of certain thresholds. See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

To protect any real estate from business losses, maximize protection from creditors, and facilitate future restructuring of the business:

- Operations should be conducted in one or more LLCs, wholly owned by the limited partnership.

[1058] See part II.G.21 Employee Stock Ownership Plans (ESOPs, which also explains that a partnership interest does not qualify as employer stock.
[1059] See parts II.M.2.c Contribution of Partnership Interest to Corporation and II.P.3.c Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations.
[1060] See parts II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules and II.M.4.f.i Overview of Profits Interest; Contrast with Code § 409A.
[1061] See part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner.
[1062] See fn 1812 in part II.G.20.a Code § 163(j) Limitation on Deducting Business Interest Expense.
[1063] See text preceding fn 1831 in part II.G.20.a Code § 163(j) Limitation on Deducting Business Interest Expense, subpart II.G.20.a.i Generally.
[1064] See part II.L.4 Self-Employment Tax Exclusion for Limited Partner.
[1065] See part II.G.3 State Income Taxation.

- Real estate should be held in one or more LLCs, wholly owned by the limited partnership. However, it would also be fine for the real estate to be held in a separate LLC outside of the limited partnership structure,[1066] if the owner materially participates in the business.[1067] Note that keeping the real estate inside the master LP umbrella would take the place of or facilitate grouping under the passive loss rules,[1068] which might be more important in the case of a real estate professional, because grouping does not help with the real estate professional test under part II.K.1.e.iii Real Estate Professional Converts Rental to Nonpassive Activity, although those rules do provide a separate aggregation election.[1069]

- The real estate LLC(s) should lease the property to the operating LLC(s) for fair rental, which will be ignored for tax purposes but should allow the LLCs' respective assets to be segregated for purposes of protection from creditors.

The individuals involved in the business would own:

- An S corporation[1070] that is a 1% general partnership, and

- In the aggregate, the remaining 99% interest as limited partners.

To respect the S corporation's role as a general partner and to prevent the 3.8% tax from applying to their distributive shares of the S corporation's 1% interest as a general partner, the individuals would be employees of the S corporation and receive reasonable compensation for the services they perform. The employment arrangement also keeps the individual owners from tainting their limited partnership interests. The individuals' participation would be attributed to both the corporation (if applicable) and themselves.[1071]

[1066] The 2012 proposed regulations on the 3.8% tax on net investment income called into question the treatment of real estate rented to one's business. However, under the final regulations, any rental income considered nonpassive income under the self-charged rental rules would not be subject to the 3.8% tax. However, self-rental might not fully work, in that ownership of the real estate and the operating business might change over time. See parts II.I.8.c Application of 3.8% Tax to Rental Income. These issues can be addressed through special allocations and preferred returns inside the partnership structure.
[1067] The self-charged rental rules require that the landlord materially participate in the tenant's business (which the landlord must also own at least in part). See part II.I.8.c Application of 3.8% Tax to Rental Income and II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity. If a business owner wants to rely on the more-than-100-hour significant participation rules rather than the material participation rules (which generally require more than 500 hours of work), then the business owner will not be able to rely on the self-rental exception and needs to keep the real estate inside the limited partnership umbrella so that the rent is disregarded for income tax purposes.
[1068] See part II.K.1.b.ii Grouping Activities – General Rules, particularly fn. 3146.
[1069] See fns. 3203-3204.
[1070] The entity being an LLC taxed as an S corporation would facilitate material participation of any trust that is or might eventually become an owner of the general partner. See part II.K.2.b Participation by an Estate or Nongrantor Trust. (Material participation is important to avoid the 3.8% tax on net investment income that might otherwise apply. See part II.I.8 Application of 3.8% Tax to Business Income.) If one is concerned that an LLC taxed as an S corporation might be subjected to self-employment tax because of some regulations that appear to be obsolete (see part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election), using a statutory close corporation might be a safer approach. See text accompanying fn. 3328 within part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.
[1071] See part II.K.1.c Limited Partnership with Corporate General Partner, particularly fn. 3179.

On a daily basis, the operation is simple:

- The S corporation, as general partner of the limited partnership, controls each LLC subsidiary, because the limited partnership is the LLC's sole member.

- In this capacity, the S corporation appoints its owners as the LLC's managers (and can give them more traditional titles, such as president, chief financial officer, etc.) who sign documents on behalf of the LLC showing their capacity as the LLC's managers or other officers.

- Each LLC subsidiary pays the S corporation a management fee to the S corporation to pay for the cost of the services provided by the owners and any other employees leased to the LLC. To protect each LLC's separateness from the other LLCs (if the partnership has more than one LLC subsidiary), it would be best for each LLC to have its own employees and not simply use the S corporation as a central payroll master; however, this might not be practical, depending on how the business is run. An entity that is disregarded for income tax purposes is also disregarded for self-employment tax purposes, notwithstanding that it is treated as a separate entity for payroll tax purposes.[1072] ***Caution***: See part II.E.5.c.ii Code § 199A Deduction under Recommended Structure. Also note that the reasonableness of the management fee (in terms of deducting the fee) depends on the reasonableness of the compensation of those whose services generated the management fee.[1073] Carefully document each employee-owner's employment agreement with the corporation.[1074]

- Only the S corporation and limited partnership file federal income tax returns. No matter how many LLC subsidiaries the partnership owns, the partnership files one federal income return to report all of their activity. (These materials do not attempt to cover state income or other tax issues in any systematic way that would help with state issues here.)

The tiered structure comes into play more when quarterly distributions are made to pay taxes or otherwise provide investment return to the owners. The LLCs would distribute part or all of their profits to the limited partnership, which then makes appropriate distributions to the limited partners and the S corporation general partner.

II.E.5.c.ii. Code § 199A Deduction under Recommended Structure

The S corporation general partner ("GP") of the limited partnership ("LP") receives a K-1 with QBI, wages, and UBIA. However, because the GP is a separate RPE from the LP, any activity on the K-1 the GP receives is siloed from the GP's own activities.[1075] In other words, K-1 income is QBI of the RPE that issues the K-1, not QBI of a business carried on by the K-1 recipient.

[1072] See part II.B Limited Liability Company (LLC), fns. 337-338.
[1073] See fn 42 and the accompanying text in part II.A.1.b.i Compensating Individuals.
[1074] See fn 1895 in part II.G.24 Taxing Entity or Individual Performing Services.
[1075] See Reg. § 1.199A-6(b), reproduced shortly before fn 759 in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

Thus, the GP needs to conduct its own trade or business for any wages it pays to count as being related to QBI.[1076] Guaranteed payments for services (which is how any payment for services to a partner for its work as a partner must be characterized)[1077] are not QBI.[1078]

When the GP receives a management fee and pays compensation to those working for the LP, those wages can be attributed back to the LP, but only if the W 2 wages were paid to the LP's common law employees or officers of the individual or RPE for employment by the LP – in other words, the GP leased the employees to the LP.[1079] Thus, compensation for services rendered by the limited partners themselves would not qualify, because they cannot be common law employees of the LP.

II.E.5.d. Net Investment Income Tax and Passive Loss Rules Under Recommended Structure

If any individual participates no more than 500 hours per year, that person might be subjected to the 3.8% tax more readily as a limited partner than as the owner of an S corporation, because limited partners have fewer ways to satisfy the material participation test than do other owners of pass-through entities.[1080] On the other hand, if one is concerned only about avoiding the 3.8% tax on net investment income and not about disallowing passive losses or credits,[1081] then a limited partner who works for more than 100 hours generally would avoid the 3.8% tax.[1082]

However, in light of the Tax Court's interpretation of the definition of limited partner for purposes of (and as described in) part II.L.4 Self-Employment Tax Exclusion for Limited Partners' Distributive Shares, consider whether the participation of a limited partner attributed to that person through his or her ownership of the S corporation general partner and work in the business in that capacity may make that person treated as participating for all interests that person owns in the underlying partnership. See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business,[1083] which to benefit the taxpayer may require a grouping election as described in part II.K.1.b Grouping Activities (passive loss rules)[1084] or II.I.8.a.ii Passive Activity Grouping Rules (3.8% net investment income tax).

II.E.5.e. Estate Planning Aspects of Recommended Structure

II.E.5.e.i. Family Conflicts

When some family members are in the business and others outside the business, conflicts can develop. The insiders want to reinvest earnings to grow the business and would like compensation commensurate with the value they view they bring to the business, including

[1076] See Reg. § 1.199A-2(b)(1), reproduced in part II.E.1.c.vi.(a) W-2 wages under Code § 199A.
[1077] See part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.
[1078] Reg. § 1.199A-3(b)(2)(ii)(I), (J), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.
[1079] See Reg. § 1.199A-2(b)(2)(ii), reproduced in part II.E.1.c.vi.(a) W-2 wages under Code § 199A.
[1080] See part II.K.1.a.ii Material Participation.
[1081] See part II.K.1.i.i.(b) Tax Trap from Recharacterizing PIGs as Nonpassive Income.
[1082] For more details, see part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.
[1083] Especially fn 3055.
[1084] The recommended structure seems to qualify as a vertically integrated structure under Reg. § 1.469-4T(f)(4)(iii), which is reproduced in part II.K.1.b.i What Constitutes an Activity as part of a discussion in the text accompanying fns 3105-3109 in that part, and Reg. § 1.469-4T(f)(5), Example (4) (not directly on point, but it is a tiered structure), which is also reproduced in that part.

incentive equity compensation. The outsiders want to distribute earnings for their own use and believe that they should share in the business' growth because that is part of the ownership legacy their parents left to them.

The first generation might want to put a long-term lease on real estate used in the business and bequeath the real estate to the outsiders. That allows the outsiders to have significant cash flow locked in for a while and allows more (or all) of the business to be bequeathed to the insiders.

The cleanest break would be for any LLCs holding real estate to be distributed from the limited partnership and then bequeathed. Generally, such a distribution would not generate any income tax.[1085] To maximize income tax planning opportunities, all of the real estate LLCs might stay under one partnership umbrella.[1086]

If insiders are pitted against insiders, generally a partnership structure is easier to divide than a corporate structure.[1087]

II.E.5.e.ii. Estate Tax Deferral Using Recommended Structure

If long-term estate tax deferral is required,[1088] deferring estate on a partnership interest involves more uncertainty than deferring estate on stock.[1089]

II.E.5.e.iii. Grantor Trust Planning

When a business is sold, clients may wish to turn off grantor trust status[1090] so that the income tax burden does not deplete their assets more than they are comfortable with.

For a grantor trust owning an S corporation, generally grantor trust status should be turned off before January 1 of the year of the sale if the grantor wishes to avoid all tax on the gain on sale. This concern is diminished or may not even exist for a partnership. See part III.B.2.j.i Changing Grantor Trust Status, especially the text accompanying fns. 6839-6841.

II.E.5.e.iv. Code § 2036

See part III.C Code § 2036.

However, retaining voting stock and transferring nonvoting stock does not cause Code § 2036 inclusion.[1091] Using an S corporation general partner may help address this issue.

1085 See part II.Q.8 Exiting From or Dividing a Partnership.
1086 See part II.Q.8.a Partnership as a Master Entity.
1087 See parts II.Q.7 Exiting from or Dividing a Corporation (especially part II.Q.7.f Corporate Division into More Than One Corporation) and II.Q.8 Exiting From or Dividing a Partnership.
1088 See part III.B.5.e.ii Code § 6166 Deferral.
1089 See part III.B.5.e.ii.(b) Tiered Structures.
1090 See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.
1091 See fn 232 in part II.A.2.i.i.(b). Why Nonvoting Shares Are Needed for Estate Planning.

II.E.5.f. Recommended Structure with C Corporation

Because 2017 tax reform caused C corporation annual income taxation to be quite attractive, one might change the S corporation shown in the structure to instead be a C corporation, and give the corporation more than 1%.

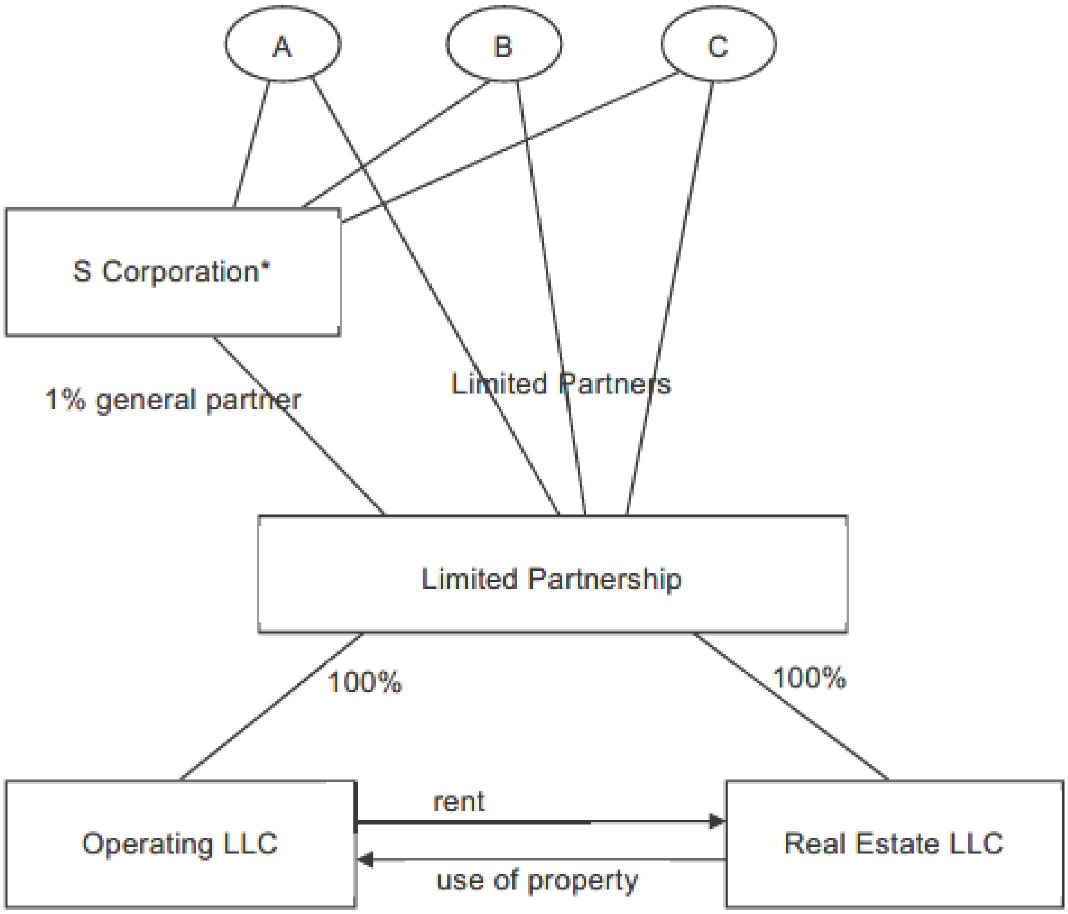
See part II.E.4 Reaping C Corporation Annual Taxation Benefits Using Hybrid Structure.

II.E.5.g. Other Aspects of Recommended Structure

Parts II.E.7 Migrating into Partnership Structure discusses moving to the recommended structure. Consider not only it but also part II.E.9 Real Estate Drop Down into Preferred Limited Partnership for real estate, long-lived tangible personal property, or intangible assets. The latter might generate royalty income subject to the 3.8% tax on net investment income, but in the recommended structure royalties would be disregarded the same way rent would be.

If the client would prefer not to have an S corporation general partner, see part II.E.8 Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary. Note, however, that a corporation transitioning into that structure (instead of retaining a preferred partnership interest) would pay tax; see parts II.P.3.a From Corporations to Partnerships and Sole Proprietorships and II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially parts II.Q.7.h.ii Taxation of Shareholders When Corporation Distributes Cash or Other Property and II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

II.E.6. Recommended Partnership Structure – Flowchart



* See part II.E.5.f. Recommended Structure with C Corporation.

If no real estate is ever held and the client balks at creating what the client perceives as too many entities, this structure could simply be a limited partnership without the LLCs. However, it would be much easier to start the operating business in its own LLC and later simply add other LLCs than it would be for the limited partnership to later transfer all of its business operations into a new LLC when real estate or a separate location or line of business is acquired.

II.E.7. Migrating into Partnership Structure

Compelling reasons to migrate from S corporation taxation to partnership include parts II.Q.8.e.iii.(a) Illustration of Inside Basis Issue and II.Q.1.a.i.(f) Partnership Use of Same Earnings as S Corporation in Sale of Goodwill, the latter illustrating substantial savings using a partnership when engaging in a seller-financed sale.

II.E.7.a. Overview of How to Migrate into Desired Structure

Moving an existing LLC, that is taxed as a partnership or as a disregarded entity, into this structure is relatively straightforward. The member or members form an S corporation. The S corporation contributes to a new limited partnership cash equal to 1/99 of the appraised value of the LLC's business, in exchange for a 1% interest as a general partner. The member or members contribute their interests in the LLC to the partnership in exchange.

Forming the S corporation and the limited partnership are not taxable events,[1092] so long as the liabilities are not shifted (or reallocated) too much from the members of the LLC to the corporate general partner.[1093] Any gain inherent in the contributed assets will be taxed to the original owners when those assets are sold.[1094] The work-in-process, appreciated inventory, and accounts receivable would tend to be the assets to watch, and accounts receivable would not be a concern if the LLC's income was reported using the accrual method. Given that the S corporation would probably have been formed with a modest cash contribution and therefore would have not contributed such assets, the only gain likely to receive a special allocation would be those inherent in the LLC. If reallocation of liability becomes an issue, the original members can guarantee the debts to get the debts allocated to them.

These two transactions are illustrated in part II.E.7.b Flowcharts: Migrating LLC into Preferred Structure, including parts II.E.7.b.i Using Cash Contribution to Fund New S Corporation and II.E.7.b.ii Using LLC to Fund New S Corporation.

This migration would be much more involved if the business is operated inside a corporation. Converting a corporation into a partnership would trigger gain.[1095] Instead, generally the corporation would move its assets into an LLC and then contribute that LLC to the limited partnership.[1096] The corporate partner would receive a preferred return on this invested capital (for which it receives a capital account),[1097] with at least 10% of the value of its equity being an interest in the residual profits (the "common interest"), and the individuals would receive the rest of the common interest as limited partners; although receiving only a pure preferred partnership interest would not violate the disguised sale rules,[1098] providing a significant interest in common helps support the corporate partner's role as a true partner, especially if the preferred payments are, for all practical purposes, extremely likely to occur. The considerations about debt reallocation described above would also apply. In some cases, a C corporation might retain certain assets, collect them in due course, and then make an S election. For more information

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[1092] See part II.M.1. Taxation on Formation of Entity: Comparison between Partnership and Corporation.
[1093] If formed as described above, the concern would be that the reallocation of liabilities from a partner would be a deemed cash distribution that would generate gain if and to the extent that it exceeds the basis of that partner's partnership interest; see part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions. If formed as described below, where the partners contribute to the S corporation their interests as general partner, then, in addition to the issue described above, a shareholder would have gain to the extent that the debt the corporation assumed exceeds the basis of the partnership interest the shareholder contributes to the corporation; see part II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities.
[1094] See part II.P.1.a.i Allocations of Income in Partnerships.
[1095] See part II.P.3.a From Corporations to Partnerships and Sole Proprietorships.
[1096] The corporation would do this either gradually or in one fell swoop, as described in part II.E.7.c.i Corporation Forms New LLC, including parts II.E.7.c.i.(a) Direct Formation of LLC and II.E.7.c.i.(b) Use F Reorganization to Form LLC.
[1097] The exchange for a capital account (not intended to be redeemed in any manner in the first several years) and preferred payments (made from operating cash flow) can easily be done in a nontaxable manner that prevents the disguised sale rules from applying. See part II.M.3 Buying into or Forming a Partnership, particularly part II.M.3.e Exception: Disguised Sale. If any owners are members of the same family or if any owner might split up his ownership in the corporate general partner from his interest as a limited partner when making transfers to family members, see parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.
[1098] As illustrated in part II.E.7.c.ii Moving New LLC into Preferred Structure.

on this conversion, see part II.Q.7.h.viii Value Freeze as Conservative Alternative, especially fn 5141 (explaining why we recommend a common interest equal to at least 10% of the contributed equity). However, this 10% recommendation does not apply where other factors prevail, such as a marketplace business model or where the preferred partner has significant economic risk of loss from operations.

Note that starting as an LLC and migrating into the structure permits giving the corporate partner only a small common interest, whereas starting as a corporation and migrating requires giving the corporate partner both preferred and substantial common interests.

Finally, if a business entity lacks a noncompete binding those with the key client/customer contacts:

- They can also migrate over time by letting the old entity wind down and doing business in a new entity taxed as a partnership, with the new entity leasing equipment from the old entity until the new entity is ready to buy new equipment to replace the old equipment as the latter becomes obsolete. Practical issues in collecting receivables in the old entity vs. doing business in the new entity require close consultation with the corporate/partnership's income tax preparer.

- The corporation's business might be worth very little if those with those contacts left and took those contacts with them. Consider obtaining an appraisal of the corporation's assets on that basis, which would minimize its capital account in the new entity. Those with the contacts sign a non-compete agreement with the new partnership, thereby establishing that they are providing that value to the partnership and deserve an interest in the partnership.

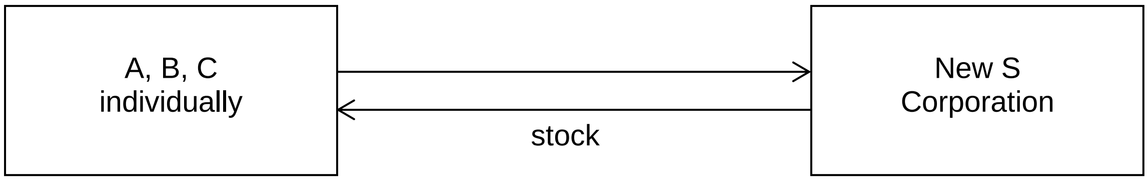
The strategy I propose envisions a limited partnership, so that the individual owners can avoid part II.L Self-Employment Tax (FICA) as limited partners; see part II.L.4 Self-Employment Tax Exclusion for Limited Partners' Distributive Shares. If that exclusion is repealed or avoiding self-employment tax is no longer an objective,[1099] the individuals might simply become members of the new LLC.

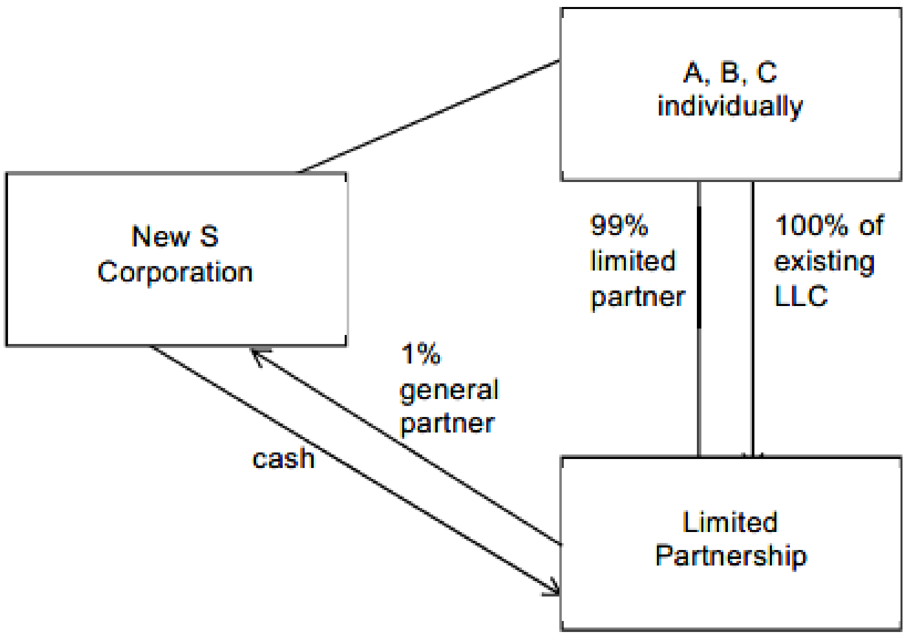
Also, any migration directly or indirectly involving real estate may require consideration of real estate transfer tax or fees or property tax reassessment.

[1099] If the part II.I.8 Application of 3.8% Tax to Business Income exclusion from II.I 3.8% Tax on Excess Net Investment Income (NII) is repealed and the individual owners already receive compensation over the taxable wage based described in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax, then self-employment (SE) tax may be more attractive than net investment income tax, because the employer portion of SE tax is deductible for income tax purposes, making it a lower rate in many cases.

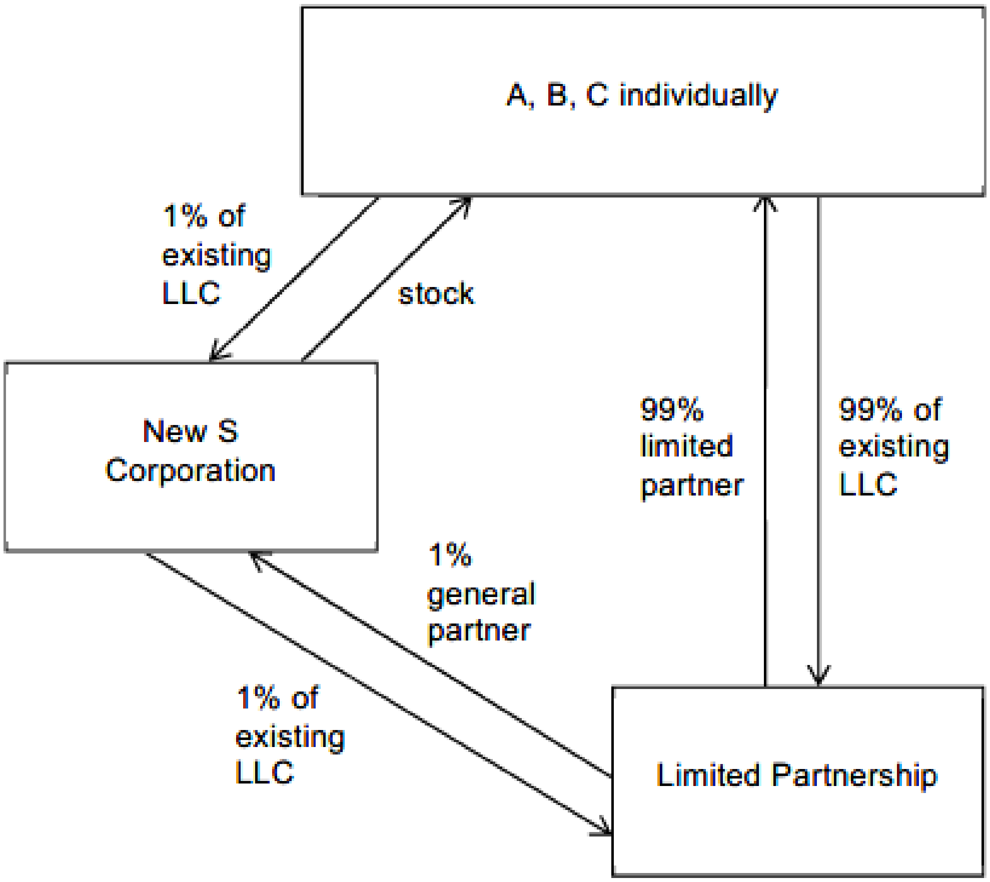
II.E.7.b. Flowcharts: Migrating LLC into Preferred Structure

II.E.7.b.i. Using Cash Contribution to Fund New S Corporation





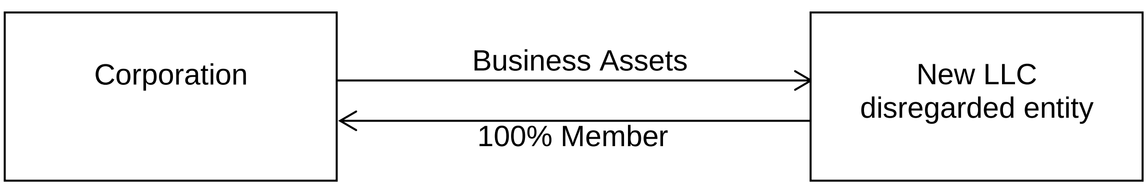
II.E.7.b.ii. Using LLC to Fund New S Corporation



II.E.7.c. Flowcharts: Migrating Existing Corporation into Preferred Structure

II.E.7.c.i. Corporation Forms New LLC

II.E.7.c.i.(a). Direct Formation of LLC



<u>Advantages</u>

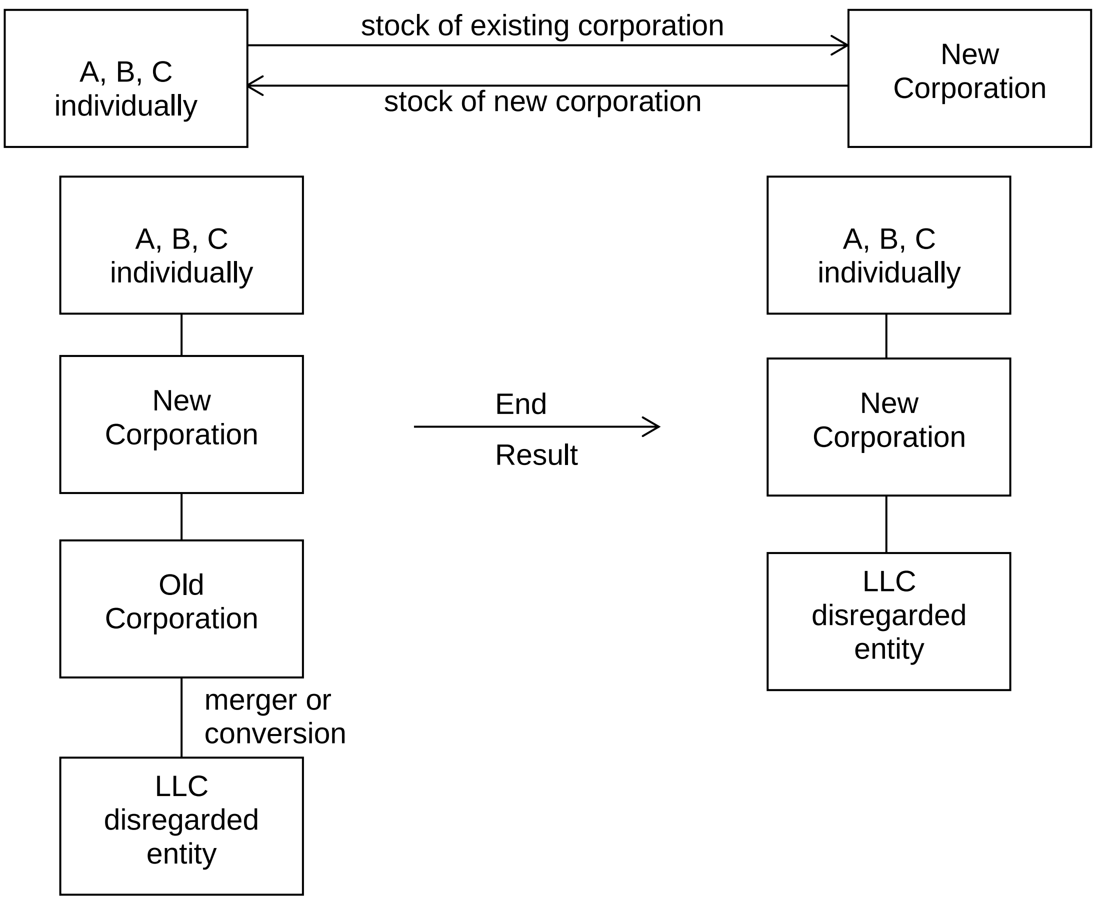
- Corporation can keep nonbusiness assets
- Corporation can keep business assets that would generate complications if transferred to the limited partnership structure and then had income recognition event
- New LLC can stay as a disregarded entity for a while as transition to new structure and get everyone used to working in LLC structure

Disadvantages

- Piecemeal transfer of assets

- Some assets not readily transferable

II.E.7.c.i.(b). Use F Reorganization to Form LLC



Advantage

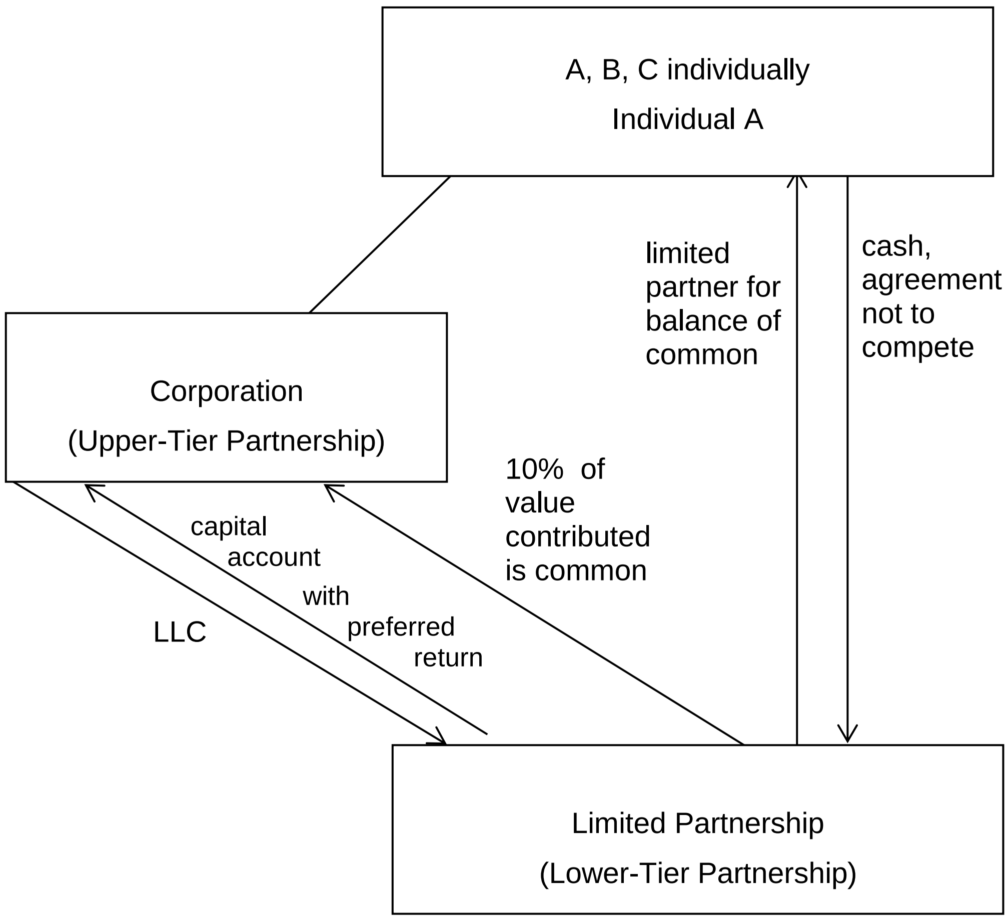
- Moves all assets in one fell swoop

Disadvantages

- No selectivity of retained assets
- Contribution of stock of old corporation to new corporation and merger or conversion of old corporation into new corporation need to be done at the same time
- If S corporation involved, new corporation does new S election and old corporation does qualified subchapter S subsidiary election.

See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. For an S corporation, see also part II.A.2.g Qualified Subchapter S Subsidiary (QSub), especially fn. 193.

II.E.7.c.ii. Moving New LLC into Preferred Structure



II.E.7.c.iii. Migrating Gradually Over Time

A company might have its employees and intellectual property locked down so tightly that the migrations described in the preceding provisions of this part II.E.7 Migrating into Partnership Structure result in a large value and large preferred return that might be so large that they cause very significant estate tax issues that seem impossible to overcome. Consider:

- A corporation that needs to migrate to these structures to obtain income tax efficiencies.

- Any type of company that is subject to estate tax and difficult to move into a structure outside the estate tax system. For example, it might have too low a cash flow to make a GRAT or a sale to an irrevocable grantor trust be efficient.

In those cases, consider that, in today's economy and global environment, businesses need to reinvent themselves – sometime gradually, sometimes quickly – to keep up with or try to out-perform their competitors.

The company might reinvent itself over time through a sister company that is held in the business structure recommended in this part II.E Recommended Structure for Entities. For example, the senior generation makes gifts or loans to new trusts that establish this structure.

The new trusts own the S corporation and limited partnership (or LLC, in the case of a state such as Tennessee).

For examples of new activities, see part III.B.1.a Business Opportunities.

Certain IRS responses to such movement and generally successful taxpayer responses are described in parts III.B.1.a.v Sending Business and III.B.1.a.vi Asset Transfers to Children or Their Businesses.

If the business being transitioned is a corporation, see part II.Q.7.h Distributing Assets; Drop-Down into Partnership.

II.E.8. Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary

II.E.8.a. Description of Structure; Nontax Issues

The structure would be one of the following:

- <u>Limited Liability Limited Partnership (LLLP)</u>. An LLLP is a limited partnership (LP) (a partnership consisting of one or more general partners (GPs) and one or more limited partners) that registers for limited liability protection for its GPs.

- <u>LP with LLC Subsidiary</u>. The LP parents functions as a holding company and does business through one or more LLC subsidiaries, the latter which are disregarded entities for most tax purposes.[1100]

See parts II.C.12 Limited Partnership and II.C.13 Limited Liability Partnership Registration for General Partners in General or Limited Partnerships, the latter covering LLLPs as variations of LPs.

If one were to choose between the two structure, I would tend to favor the LP with LLC Subsidiary structure, because it facilitates opening separate branches or lines of businesses as separate LLCs without the initial business being comingled with the ownership of these new branches or lines of business. I also tend to favor it in Missouri, because in Missouri the lapse of an LLLP's registration cannot be cured, leaving the GPs exposed, whereas a Missouri LLC does not require annual registration and cannot have any lapse in liability protection. A disadvantage of the LP with LLC Subsidiary structure is that two registrations might be required in each state in which the company does business, contrasted with one registration per state for a LLLP. However, the latter might not be a disadvantage relative to the LP with LLC Subsidiary structure when separate branches or lines of businesses operate as separate LLCs.

The LP with LLC Subsidiary structure also permits the general partner's name to be kept confidential in most business dealings if the general partner is not active in the business, in that each LLC can be run by a manager who is not an owner.

II.E.8.b. Tax Issues

Let's discuss FICA/ self-employment (SE) tax issues and passive loss issues.

[1100] See part II.B Limited Liability Company (LLC).

According to the legislative history of the SE tax, a person who is not only a GP but also a limited partner is subjected to SE tax only with respect to the GP interest.[1101] However, this is based on legislative history, and I am unaware of any cases or rulings applying this principle. Any compensation paid to a partner for services is subject to SE tax to the extent that the services are rendered in carrying out a trade or business,[1102] whether or not the partner is a GP.[1103] Presumably the IRS would seek to reclassify distributions to a limited partner as compensation for services rendered, in a manner similar to what it does in the S corporation arena.[1104]

Although originally a limited partner lost liability protection by participating in the partnership's activities, that has not been the case for quite some time.[1105] In the passive loss area, being a general partner has a different effect – it converts an interest as a limited partner into an interest as a general partner when determining material participation.[1106]

The idea that an interest as a limited partner has passive loss characteristics that differ from its SE tax characteristics might cause confusion in reporting and auditing. A Tax Court case includes language about the self-employment exclusion as applied to active limited partners that concerns a tax expert I highly respect,[1107] and I would rather not tempt fate. Thus, I would

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1101 See part II.L.4 Self-Employment Tax Exclusion for Limited Partner, especially fn. 3462 and accompanying text.

1102 See part II.L.3 Self-Employment Tax: General Partner or Sole Proprietor, especially the text accompanying fns. 3453-3455.

1103 See part II.L.4 Self-Employment Tax Exclusion for Limited Partner, especially fn. 3456 and accompanying text.

1104 See part II.L.1 FICA: Corporation, especially fn. 3380, and part II.L.5.a S Corporation Blocker Generally, especially fn. 3500.

1105 A prior version of Willis & Postlewaite, *Partnership Taxation*, ¶2.02. Requirements of Section 704(e), stated:

> As originally written, the Uniform Limited Partnership Act provided that "[a] limited partner shall not become liable as a general partner unless…he takes part in the control of the business." ULPA, § 7 (1916). The versions of the Revised Uniform Limited Partnership Act approved in 1976 and 1985 relaxed the control requirement by providing a safe harbor in the form of a lengthy list of activities deemed not to constitute participation in the control of the partnership and a limitation on a limited partner's liability for participation in activities not within the safe harbor to only those persons who transacted business with the limited partnership "reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner." RULPA, § 303 (1985). Section 303 of the Uniform Limited Partnership Act approved in 2001 has eliminated the control requirement and provides that:
>
> > A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership.
>
> RULPA, § 303 (2001). According to the commentary accompanying the act, this provision is intended to provide "a full, status-based liability shield for each limited partner" even when the limited partner participates in the management and control of the limited partnership. The purpose is to bring limited partners into parity with the members of a limited liability company, partners in a limited liability partnership, and corporate shareholders. It is unclear how this change in state partnership law might affect the application of federal tax law in the context of family partnerships. Nevertheless, if the limited partners are to have no role in the management of the partnership, the partnership agreement should expressly provide that the limited partners have no management power.

1106 See part II.K.1.a.ii Material Participation, especially fn. 3071.

1107 See fn. 3493, found in part II.L.4 Self-Employment Tax Exclusion for Limited Partner.

generally prefer to place a client in the recommended structure with an S corporation general partner described in part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and illustrated in part II.E.6 Recommended Partnership Structure – Flowchart. However, if the client resists that structure, the LLLP Alone and LP with LLC Subsidiary structures are alternatives to consider, after warning the client appropriately.

Also, if the business engages in domestic manufacturing, note that wages paid by a corporation would provide a small tax benefit relative to compensation paid to a partner.[1108]

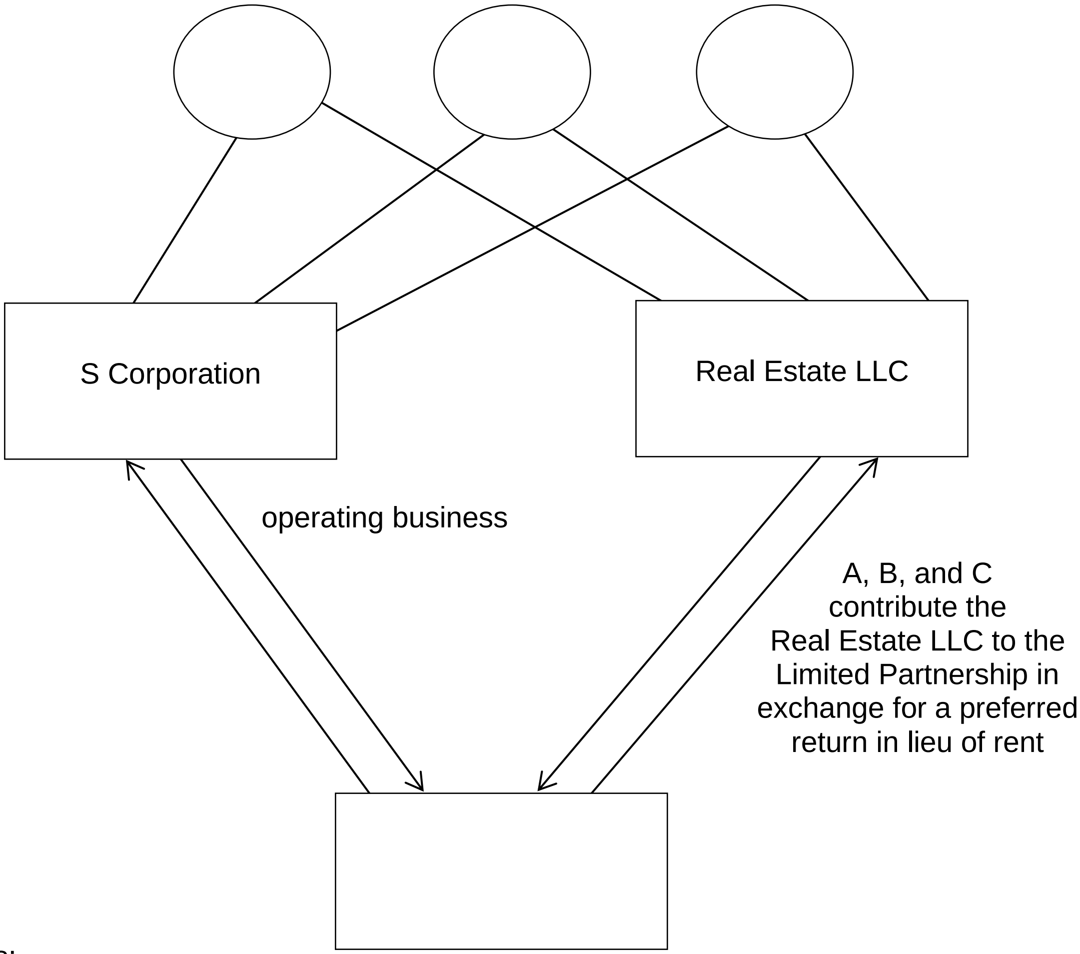
II.E.8.c. Migrating to LP with LLC Subsidiary Structure

Migrating from an LLC to an LP with LLC Subsidiary structure is much easier than migrating to my preferred recommended structure.[1109]

The members of the LLC simply form the LP and then contribute their LLC interests to it. That transaction has no income tax consequences.[1110] Both the LP and the LLC will continue to use LLC's tax ID – the LP because it has assumed the LLC's prior tax existence[1111] and the LLC because it is a disregarded entity.[1112] Presumably the LLC would need to obtain a new tax ID for payroll tax purposes, if it has its own payroll,[1113] as well as for purposes of excise and certain other taxes.[1114]

[1108] Note the W-2 limitation mentioned in part II.G.25 Code § 199 Deduction for Domestic Production Activities especially fn. 1898.
[1109] For the latter, see part II.E.7.b Flowcharts: Migrating LLC into Preferred Structure.
[1110] See part II.C.5 Converting from One Entity Taxed as a Partnership to Another.
[1111] See part II.C.5 Converting from One Entity Taxed as a Partnership to Another, especially fn. 479.
[1112] See part II.B Limited Liability Company (LLC), especially fn. 331.
[1113] See part II.B Limited Liability Company (LLC), especially fn. 337.
[1114] See part II.B Limited Liability Company (LLC), especially fn. 340-341.

II.E.9. Real Estate Drop Down into Preferred Limited Partnership



Notes:

- Assume A, B, and C are active in business (more than 500 hours) and receive reasonable compensation from the general partner for services rendered to the corporation, which is the general partner of the limited partnership.

- A, B, and C assign their interests in the LLC to the limited partnership, converting the LLC into a disregarded entity and making A, B, and C directly hold interests as a limited partner.

- Similarly, the S corporation might contribute its assets to a single member operating LLC that the limited partnership then owns, which would then rent the property from the Real Estate LLC. The rental payments would be disregarded for income tax purposes, and the properties would be separate for asset protection purposes.

- Even better would be for the S corporation also to hold a preferred interest preferred based on the value of its assets (and a small common interest) and for A, B and C to hold some or most of the common interests, maximizing the partnership component to obtain a basis step-up at death and minimize tax on a seller-financed sale of the business.

- This would not avoid self-employment tax on the limited partners if the long-ago proposed regulations defining limited partner for purposes of the self-employment tax were finalized.

For more details on this drop-down structure, see part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially part II.Q.7.h.viii Value Freeze as Conservative Alternative.

II.E.10. What if Self-Employment Tax Rules Change Unfavorably?

If self-employment tax would apply to the limited partners and the parties would prefer to have the operating business inside an S corporation structure, then the limited partnership dissolves.

The limited partners take all of the real estate LLC(s) and an appropriate portion of the operating LLC(s), with the S corporation taking its fair share of the operating LLC(s).[1115]

Next, the limited partners contribute all of their interest in the operating LLC(s) to the S corporation.[1116]

The final structure is the S corporation holding one or more LLCs that are disregarded for tax purposes and the individuals owning a real estate LLC taxed as a partnership. As a matter of state law, all of the transactions listed above are done by assigning LLC interests rather than more burdensome transfers of operating assets.

II.F. Asset Protection Planning

II.F.1. Business Entities and Creditors Generally

This part II.F.1 discusses not only how entities can protect their owners from liability but also how the state law entity can affect the ability of an owner's creditors to disrupt business operations. State law defaults typically give a transferee of stock full voting and information rights, whereas state law defaults (as modified by certain federal laws) give a transferee of an interest in a partnership or LLC little or no voting rights and limited information rights. For the reasons described below, one might consider doing a tax-free conversion of a corporation to an LLC or a limited partnership taxed as a corporation.

Piercing the corporate veil – when a creditor of an entity can go after the entity's owner(s) - is a doctrine that can apply to any type of limited liability entity.[1117]

[1115] If the business was started from scratch with only cash and labor, then generally this transaction will not be taxable. If a partner contributed any particular property within seven years of this dissolution, then it might be necessary for that partner to receive the LLC holding that property. For a general discussion of all of these ideas, see part II.Q.8 Exiting From or Dividing a Partnership.

[1116] Code 351 precludes income taxation of this transaction.

[1117] For a general discussion of such issues and doctrines that go beyond equitable veil-piercing, see Donn, "Is the Liability of Limited Liability Entities Really Limited?" *ALI-ABA seminar on Choice of Business Entity* 2/13/2008. Elizabeth S. Miller, Professor of Law, Baylor University School of Law, summarizes recent developments in limited liability partnerships and LLCs at http://www.baylor.edu/law/faculty/index.php?id=75536. A trade creditor needs to prove not only that the entity was not run in a financially responsible way but also that the creditor made a reasonable inquiry into the debtor's financial position, by obtaining a credit report and perhaps a balance sheet. *On Command Video Corporation v. Roti*, 705 F.3d 267 (7th Cir. 2013). In selecting the law to apply, that court held that, under Illinois law, "veil-piercing claims are governed by the law of the state of the corporation whose veil is sought to be pierced." The court also accepted the parties' acceptance of applying corporate veil-piercing standards to an LLC.

"Reverse piercing" is the common name for when a creditor of an owner obtains an interest in a business entity and then tries to get to the entity's assets. Courts tend to be reluctant to disrupt business operations, when doing so would be unfair to the other owners of the business.

A "charging order" is an order for an entity to turn over to the creditors of a partner (or owner of an LLC or other unincorporated entity) that debtor's share of distributions. This remedy for a creditor of an owner of a partnership interest or interest in an LLC[1118] might be more unattractive than a creditor's remedies of taking possession of stock (particularly voting stock) of a corporation:[1119] if a creditor is able to foreclose on stock, the creditor obtains voting rights and other shareholder rights, whereas a creditor foreclosing on an interest in a partnership or LLC generally obtains only an assignee interest (the right to receive a pro rata share of any distributions but not to vote or in any other way obtain information about the entity's operations).[1120] If the creditor forecloses, then the creditor becomes the owner and is taxed as such;[1121] however, if the creditor does not foreclose, generally the debtor will continue to be taxed as the owner,[1122] and any cash the creditor receives from the charging order will constitute a payment by the debtor.[1123]

Regarding interests in LLCs and partnerships, states vary on whether they make a charging order the exclusive remedy or allow creditors to foreclose on the LLC or partnership interest and possibly pursue aggressive reverse piercing strategies. Most states authorize charging orders

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1118 See Bishop, "LLC Charging Orders: A Jurisdictional and Governing Law Quagmire," *Business Entities* (May/June 2010), discussing reverse piercing and whether an LLC is a necessary party to a charging order action brought by a judgment creditor against a member (but not the LLC itself) and, if the LLC was formed in another state, which state law controls the limits of the charging order remedy. *New Times Media LLC v. Bay Guardian Co., Inc.* (U.S. District Court for Delaware Case No. 10-CV-72), rebuffed an attempt to have a California case be moved to Delaware to have a court sympathetic to Delaware's anti-reverse-piercing rules.

1119 See Forsberg, Spratt and Stein, "Conversion of Business Entities Into Limited Liability Companies: Asset Protection Issues Surrounding LLC Interests," American Bar Association Section of Real Property, Trust & Estate Law, 2009 Spring Symposia.

1120 See fn. 3777 for an assignee being admitted as a member.

1121 Rev. Rul. 77-137, the facts of which are brief enough to recite here:

> A, a limited partner in a limited partnership formed under the Uniform Limited Partnership Act of a state, assigned the limited partnership interest to B. The agreement of the partnership provides, in part, that assignees of limited partners may not become substituted limited partners in the partnership without the written consent of the general partners. However, it also provides that a limited partner may, without the consent of the general partners, assign irrevocably to another the right to share in the profits and losses of the partnership and to receive all distributions, including liquidating distributions, to which the limited partner would have been entitled had the assignment not been made. Under the terms of the assignment A, who was the nominal limited partner under local law, agreed to exercise any residual powers remaining in A solely in favor of and in the interest of B.
>
> *Held*, even though the general partners did not give their consent to the assignment, since B, the assignee, acquired substantially all of the dominion and control over the limited partnership interest, for Federal income tax purposes B is treated as a substituted limited partner. Therefore, B must report the distributive share of partnership items of income, gain, loss, deduction, and credit attributable to the assigned interest on B's Federal income tax return in the same manner and in the same amounts that would be required if B was a substituted limited partner.

1122 See GCM 36960, which provided the basis for and explains the context of Rev. Rul. 77-137.

1123 Adkisson, Bishop, and Rutledge, "Recent Developments in Charging Orders," *Business Law Today* (Feb. 2013).

but do not address whether charging orders are the exclusive remedy.[1124] If the charging order is not enough to pay the creditor, a judge might then order the sale of the interest in the entity. Since third parties are unlikely to buy at the sale, the creditor would acquire the interest in the entity as an assignee. Rather than foreclosing and having the interest in the entity convert to that of an assignee, a judge might order a receiver to take control of the interest in the entity so that the receiver attempts to exercise the debtor's rights. In a nonbankruptcy case, the debtor objected to a charging order against his interests in two LLCs, the court issued a sweeping charging order against the LLCs that the court acknowledged were not parties to the case;[1125] presumably the LLCs would need to fight the lack of jurisdiction.

Disalvo Properties, LLC v. Bluff View Commercial, LLC, 464 S.W.3d 243 (E.D. Mo. 2015), help that RSMo § 347.119 "authorizes a charging order to be entered against an individual debtor-

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[1124] Professor Carter G. Bishop has written extensively in the area, including "Fifty State Series: LLC Charging Order Statutes" (Suffolk University Law School Research Paper No. 10-03, written January 25, 2010 and updated March 1, 2016 (or later) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1542244), "Fifty State Series: LLC Charging Order Case Table" (Suffolk University Law School Research Paper No. 10-15, written 3/19/2010 and updated at http://papers.ssrn.com/abstract=1565595), and "Fifty State Series: LLC & Partnership Transfer Statutes" (Suffolk University Law School Research Paper No. 10-25, written 6/7/2010 and updated at http://papers.ssrn.com/abstract=1621694). For a complete set of his articles, see http://ssrn.com/author=55232. Another helpful resource is at http://www.internationalcounselor.com/chargingorder.htm. However, it has been suggested that choice of law for governing documents is overrated, because the law of the jurisdiction in which a foreclosure is attempted controls, rather than law of the state of formation. Adkisson, Bishop, and Rutledge, "Recent Developments in Charging Orders," *Business Law Today* (Feb. 2013).

[1125] *Rockstone Capital, LLC v. Marketing Horizons*, LTD, 2013 WL 4046597 (Conn. Super., 7/17/2013) (unpublished), ordering:

1. The interests of the Defendant/Judgment Debtor, Ashton Edwards (the "Defendant"), in the Companies (as defined in the Motion for Charging Order) are charged with payment of the unsatisfied amount of the judgment debt herein and also with costs, attorneys fees and interest. Within 10 days of the entry of this Order, the Defendant is ordered to provide the complete name and current mailing address of the managing member of each of the Companies, Marketing Ventures Worldwide, LLC & Nonprofit Solutions, LLC.
2. The Companies are each directed to pay the Plaintiff present and future shares of any and all distributions, credits, drawings, or payments due to the Defendant until the judgment is satisfied in full, including attorney's fees, interest and costs.
3. Until said judgment is satisfied in full, including attorney's fees, interest and costs, the Companies shall make no loans, directly or indirectly, to or for the benefit of the Defendant or other partners or anyone else for the benefit of the Defendant without further Order of this Court.
4. Within twenty days of service of a copy of this Order upon any members of the Companies, the Companies shall supply the Plaintiff full, complete and accurate copies of the Companies' Operating Agreements including any and all amendments or modifications thereto; true, complete and accurate copies of any and all Federal and State income tax or informational income tax returns filed within the past two years; balance sheets and profit and loss statements for the past two years; and balance sheet and profit and loss statements for the past two years; and balance sheet and profit and loss statements for the most recent present period for which same have been computed. Further, upon twenty-day notice from the Plaintiff to the Companies, all books and records shall be produced for inspection, copying and examination in the Plaintiff's counsel's office.
5. Until said judgment is satisfied in full, including all costs and interest thereon, the Companies shall supply the Plaintiff, within thirty days of the close of the respective accounting period for which said data is or may be generated, all future statements reflecting cash position, balance sheet position, and profit and loss.

member's interest in an LLC" but that a "foreclosure or court-ordered sale of charged membership interests in an LLC is not expressly contemplated by section 347.119 or any other section of the Missouri LLC Act."[1126]

In a bankruptcy case, courts vary on whether an LLC operating agreement is considered an "executory contract."[1127]

Although for purposes of estate tax generally an intangible asset is considered located where the decedent was domiciled, for purposes of bankruptcy venue might lie there or might lie in another venue that facilitates the bankruptcy trustee's collection of the estate.[1128] The bankruptcy trustee might take the bankruptcy debtors' interest as a member, as bankruptcy law supersedes the state's LLC statutory conversion of the debtors' interest into an assignee's interest.[1129] Notably, the court did not follow prior cases that said that an LLC was not protected from its sole owner's bankruptcy simply because there was no third party member to protect. Rather, it held that the event of bankruptcy itself cannot strip the original owner of his or her pre-petition rights. Thus, a debtor needs to divest himself or herself of rights in an LLC (or a partnership) if and to the extent it is legitimate to do so before the filing the petition.

[1126] In its reasoning, the court noted at 247-248 that:

> … section 358.280.2 of the Uniform Partnership Law, unlike the provisions of the Missouri LLC Act and the Uniform Limited Partnership Law, expressly contemplates and authorizes a foreclosure and court-ordered sale of charged partnership interests in a partnership. *See Wills v. Wills*, 750 S.W.2d 567, 574 (Mo.App.E.D.1988) (holding foreclosure of charged partnership interests is an available remedy under section 358.280).

[1127] *In re Denman*, 513 B.R. 720 (W.D. Tenn. 2014) (holding that an operating agreement was not in that case - and generally would not be - an executory contract, recognizing that several other courts disagree but suggesting that those other courts are wrong). The court also threw out an "ipso facto" clause that provided a bargain sale from a bankruptcy estate.

[1128] *In re Blixseth*, 484 B.R. 360 (9th Cir. BAP Nev. 2012), holding that Nevada was an appropriate venue since its statutes governing the subject entities required any charging order or dissolution proceeding to be brought in a Nevada court. See "Jay Adkisson on Blixseth: Rags-to-Riches to," *Steve Leimberg's Asset Protection Planning Email Newsletter* - Archive Message #220. See also G. Rothschild, "Recent Developments in Asset Protection," *TM Memorandum* (BNA) (6/17/2013), summarizing *Weddell v. H2O, Inc.*, 128 Nev. Adv. Op. No. 9 (3/1/2012), as follows:

> The Supreme Court of Nevada reversed the district court's judgment relating to the scope of the charging order against Weddell's membership interests. The Supreme Court ruled that the charging order only divested Weddell of his economic opportunity to obtain profits and distributions from Granite, not his managerial rights.
>
> …
>
> This decision is in line with decisions in other charging order cases. It is noteworthy that this case was decided under the Nevada charging order laws prior to the revisions that were modified in the 2003 legislative session and did not include the substantial enhancements made in the 2011 legislative session. The 2011 legislative changes to Nevada's charging order laws specifically disallow the issuance of any equitable remedies. However, there were no provisions prohibiting the judge from issuing an equitable remedy to find a way around the exclusive remedy language. Therefore, in future litigation, members of Nevada LLCs will be even more protected than the degree of protection provided by pre-2011 laws.

[1129] *In re First Protection, Inc.*, 2010 WL 5059589 (9th Cir. BAP Ariz. 11/22/2010) (allowing the bankruptcy trustee to step into the debtor's shoes). See also *In re Blixseth*, 484 B.R. 360, (9th Cir. BAP Nev. 2012), which noted that, although a charging is the only remedy of a creditor to satisfy a judgment, the bankruptcy trustee steps into the debtor's shoes and may exercise all rights that the debtor had immediately before bankruptcy.

Generally, single member LLCs are not protected from foreclosure and reverse piercing, because no co-owner needs to be protected from the member's debts[1130] (but be sure to have records sufficient to prove not owned solely by the person whose actions led to the reverse-piercing claim).[1131] Otherwise, one can create something better than a self-settled spendthrift trust. However, Wyoming[1132] and Nevada[1133] provide such protection (which protection might be limited to cases outside a bankruptcy setting).[1134] Another practitioner suggests having the managing member be an irrevocable grantor trust the client sets up for his children, with the client being the trustee and with the passive member being the client's revocable trust. Although this other strategy might help for asset protection, consider whether the client wants to be accountable to his children for how he manages the LLC on behalf of the trust. Sometimes lenders insist on placing collateral in a bankruptcy-remote LLC - an LLC that is treated as a

[1130] See, e.g., *Olmstead vs. The Federal Trade Commission*, Supreme Court of Florida, 2010 WL 2158106 (June 24, 2010) (www.floridasupremecourt.org/decisions/2010/sc08-1009.pdf), followed by the 11th Cir. even though the FTC argued that the Supreme Court of Florida was wrong; *In re Modanlo*, 412 B.R. 715, 727 (Bankr. D. Md. 2006); *In re Albright*, 291 B.R. 538, 540 (D. Colo. 2003). In an unpublished opinion, the Montana Supreme Court upheld a trial court's imposition of a charging order, appointment of a receiver, and dissolution of an LLC that appeared to have been owned solely by the judgment debtor. *Jonas v. Jonas*, 2010 MT 240N, Supreme Court case number DA 10-0137 (11/9/2010). The IRS can presumptively obtain a lien on the assets of a single member LLC (disregarded for tax purposes) when the member owes taxes. *Little Italy Oceanside Investments, LLC v. U.S.*, Case No. 14-cv-10217 (E.D. Mich. 8/14/2015). The case did not seem to turn on the LLC having only one member; rather, the LLC failed to contest the lien on its property before the property was sold, and the LLC did not have any remedies against the IRS after the property was sold when the IRS provided evidence that it timely mailed a notice of lien to the taxpayer. See also *Politte v. U.S.*, 104 A.F.T.R.2d 2009-6229 (S.D. Cal. 2009) (collecting from shareholders money the company loaned to them when the company owed the IRS), upheld through various procedural moves, ultimately by an unpublished opinion, 115 A.F.T.R.2d 2015-874 (9th Cir. 2015).
Furthermore, when a married couple, in the aggregate, owned all of an LLC and the couple filed for bankruptcy in a single consolidated case, the court allowed the bankruptcy trustee to take over the LLC. *In re First Protection, Inc.*, 2010 WL 5059589 (9th Cir. BAP Ariz. 11/22/2010).

[1131] See *Sky Cable, LLC v. Coley*, Civ. Action No. 5:11cv00048, 2016 WL 3926492 (W.D. Va. 7/18/2016), applying Delaware law, all according to a summary prepared by Prof. Elizabeth S. Miller for an 4/7/2017 ABA Business Law Section meeting.

[1132] Wyo. Stat. § 17-29-503(g), provides:

> This section provides the exclusive remedy by which a person seeking to enforce a judgment against a judgment debtor, including any judgment debtor who may be the sole member, dissociated member or transferee, may, in the capacity of the judgment creditor, satisfy the judgment from the judgment debtor's transferable interest or from the assets of the limited liability company. Other remedies, including foreclosure on the judgment debtor's limited liability interest and a court order for directions, accounts and inquiries that the judgment debtor might have made are not available to the judgment creditor attempting to satisfy a judgment out of the judgment debtor's interest in the limited liability company and may not be ordered by the court.

[1133] NRS § 86.401.2(a) states that a charging order:

> Provides the exclusive remedy by which a judgment creditor of a member or an assignee of a member may satisfy a judgment out of the member's interest of the judgment debtor, whether the limited-liability company has one member or more than one member. No other remedy, including, without limitation, foreclosure on the member's interest or a court order for directions, accounts and inquiries that the debtor or member might have made, is available to the judgment creditor attempting to satisfy the judgment out of the judgment debtor's interest in the limited-liability company, and no other remedy may be ordered by a court.

[1134] See fn. 1129.

disregarded entity but in which the lender has certain protections through an entity that is a member without an economic interest.[1135]

Even if a creditor can foreclose on a single member LLC, the creditor might prefer to impose a charging order, so that the debtor can run its business and continue to generate cash flow to repay the creditor, without the creditor expending any effort. If the LLC's only income is from the debtor's services and the LLC distributes all of its net income, one court held that the charging order of the creditor (the U.S. government) was limited to the 25% statutory maximum for garnishing earnings under applicable state law.[1136]

To maximize asset protection planning, when drafting LLC operating agreements consider limiting any fiduciary duties a manager of an insolvent LLC might owe a lender.[1137]

1135 See fn. 369 and the accompanying text.

1136 *U.S. v. Alexander*, 2016 WL 2893406 (D. Ariz. 5/18/2016), holding:

> The United States is entitled to a charging order against Defendant's member interest in E-Logic. "The United States may enforce a judgment imposing a fine in accordance with the practices and procedures for the enforcement of a civil judgment under Federal law or State law." 18 U.S.C. § 3613(a); see also *United States v. Berger*, 574 F.3d 1202, 1204 (9th Cir. 2009). Under Arizona law, a court of competent jurisdiction "may charge the member's interest in the limited liability company with payment of the unsatisfied amount of the judgment plus interest." A.R.S. § 29-655(A). In such a case, "the judgment creditor has only the rights of an assignee of the member's interest." *Id.* An assignee of a member's interest is not entitled to participate in the LLC's management. A.R.S. § 29-732(A). Instead, an assignee "is only entitled to receive, to the extent assigned, the share of distributions, including distributions representing the return of contributions, and the allocation of profits and losses, to which the assignor would otherwise be entitled with respect to the assigned interest." *Id.* A charging order is the exclusive remedy by which a judgment creditor may satisfy a judgment out of a member's interest in a limited liability company. A.R.S. § 29-655(C). Here, Defendant is the sole member of E-Logic, LLC. The United States may charge Defendant's interest in E-Logic for Defendant's unpaid restitution plus interest. The United States, however, is not entitled to participate in E-Logic's management. Instead, the United States is only entitled to Defendant's share of ELogic's distributions.
>
> But the charging order is limited to the garnishment permitted by Arizona law. The fact that a charging order is entered, however, "does not deprive any member of the benefit of any exemption laws applicable to his interest in the limited liability company." A.R.S. § 29-655(B). Arizona law limits garnishment to 25 percent of a garnishee's disposable earnings. A.R.S. § 33-1131(B). "Earnings" are defined broadly to include "compensation paid or payable for personal services, whether these payments are called wages, salary, commission, bonus or otherwise." A.R.S. § 12-1598(4). "Disposable earnings" is defined as the "amount remaining from the gross earnings for a pay period after the deductions required by state and federal law." A.R.S. § 12-1598(3). As the sole member of E-Logic, Defendant receives distributions equivalent to the LLC's annual income. These are provided as compensation for his personal services to E-Logic. These distributions qualify as earnings and are protected by the personal property exemption. The charging order therefore cannot deprive Defendant of more than 25 percent of his disposable earnings. [footnote omitted]

1137 Maloney and Carter, "Asserting Breach-of-fiduciary-duty Claims In the Context of Delaware LLCs," p. 36 of *ABI Journal* (September 2009). *CML V, LLC v. Bax*, C.A. No. 5373-VCL (Del. Ch. 11/3/2010) held that, absent a contractual agreement with the creditor or in the LLC's operating agreement, the members and managers of a Delaware LLC owed no fiduciary duties to creditors. Generally, managers of financially troubled Missouri limited liability companies do not owe a fiduciary duty to creditors of their troubled enterprises. See http://www.thompsoncoburn.com/insights/blogs/credit-report/post/2016-12-07/managers-of-insolvent-missouri-llcs-have-no-fiduciary-duty-to-creditors, discussing *Imperial Zinc Corp. v. Engineered Products Industries, L.L.C.*, No. 4:14-CV-1015-AGF, 2016 WL 812695 (E.D. Mo.

If the entity is already a corporation, consider an F reorganization to convert the corporation into a partnership or LLC taxed as a corporation; see part II.P.3.h. Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. If any such conversion causes transitory ownership, see part II.A.2.j.ii Disregarding Transitory Owners.

Note that some corporate statutes provide some protection against transfers to creditors, such as close corporation statutes, that allow a corporation to be managed largely like a partnership or LLC.[1138] It might be possible to convert a regular corporation into a close corporation without creating a new entity. That can help an ongoing business but does not provide the protection of the dissolution without a merger following the sale of the business assets.

II.F.2. Asset Protection Benefits of Dissolving the Business Entity After Asset Sale

Subject to tax issues triggered on dissolution of an entity, consider the following approach when the corporation has sold all of its business assets:

Form a single member LLC owned by the corporation, transfer all of corporation's assets into the LLC, dissolve and liquidate the corporation (distributing the LLC to the shareholders), and have the LLC elect (as of the date of liquidation) the same corporate status the corporation had. The corporation's dissolution will start the statute of limitations for making claims relating to the corporation's business (or other) operations; thus, the sale proceeds will be subjected to claims for only a limited time period.

Even if the buyer assumes the business' liabilities and agrees to indemnify the corporation, the corporation is relying on the buyer to always be able to satisfy its indemnification obligation; the suggested dissolution approach removes that risk once the dissolution statute of limitations has passed. Contrast that to a merger, in which the claims are never cut off, because the old entity is deemed for state law purposes merely to continue in a new form.

II.F.3. Limited Partnerships and LLCs as Control Vehicles

In a limited partnership, the general partner runs the entity, and the limited partners have no rights to vote, except perhaps on major structural decisions such as liquidation. Giving an interest as a limited partner is a way of transferring property without transferring control of that property.

Similarly, LLC operating agreements can provide for members with or without voting rights.

These can provide the asset protection benefits mentioned above, as well as preventing the limited partner or nonvoting member from having undesirable control. When a trust distributes outright to a beneficiary who the trustee deems not ready to receive large liquid sums, the

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Mar. 2, 2016); *Imperial Zinc Corp. v. Engineered Products Industries, L.L.C.*, No. 4:16-CV-551-RWS, 2016 WL 6611129 (E.D. Mo. Nov. 9, 2016).

[1138] See fn. 3328 for a discussion of changing the normal rules for corporate governance that might also help with control issues, including links to a survey of all states. My understanding is that Nevada has enacted some sort of charging order protection for corporations with up to 75 shareholders. See, *e.g.*, Missouri's close corporation statutes, at RSMo § 351.750 et seq. Chapter 351 is at www.moga.mo.gov/STATUTES/C351.HTM. RSMo § 351.770.2(1) (www.moga.mo.gov/statutes/C300-399/3510000770.HTM) might block a creditor that is not an eligible shareholder of an S corporation from acquiring shares in an S corporation, although perhaps the creditor could assign its claim to an eligible shareholder.

trustee might consider forming a limited partnership or LLC and distributing limited partner or nonvoting member interests to the beneficiary. Before doing that, however, the trustee should consider that the beneficiaries might very well contest that action.[1139]

II.F.4. Taxing Authorities Piercing Corporate Veil

A partner who has control over payroll tax withholdings generally is personally liable for paying those to the taxing authority. New York makes any member or partner responsible for unpaid sales tax, even if the partner does not have any control over the collection and remittance of that tax;[1140] the statute providing that result does not impose liability on a shareholder who has no control over business.[1141]

U.S. v. Lothringer, 128 A.F.T.R.2d 2021-6305 (5th Cir. 10/08/2021), affirmed a District Court's piercing the corporate veil:

> The district court applied Texas law and concluded there was no genuine issue of material fact and that the totality of the circumstances established "such unity between [Pick-Ups] and [Lothringer] that the separateness of the corporation...ceased and holding only the corporation liable would result in injustice." *Castleberry*, 721 S.W.2d at 272. The court relied on a slew of undisputed facts, including that Lothringer was the sole shareholder, officer, director and owner of Pick-Ups; exercised complete dominion and control over Pick-Ups; failed to observe certain corporate formalities; loaned substantial money to Pick-Ups; and made payments from the corporate bank account to service personal loans.

II.F.5. Tax Liens

See part III.B.5.e.iv Federal Estate Tax Liens, including reference to an article about the effect of a beneficiary's tax liens on a trust,[1142] as well as rules piercing tenancy by the entirety and community property.[1143]

[1139] *Schumacher v. Schumacher*, 303 S.W.3d 170 (Mo. App. W.D. 2010), holding that the forming the entity was not a per se violation of fiduciary duties and the trustees could present defenses. Based on my search done 1/1/2011, it appears that the trustees lost on remand and are appealing again, which is docketed as WD73012.

[1140] Banoff and Lipton, "Personal Liability of LLC Members and Limited Partners for New York Sales/Use Tax," in their "Shop Talk" column, *Journal of Taxation* (WG&L) (Feb. 2015). The case they described was affirmed; see *In the Matter of the Petitions of Eugene Boissiere and Jason Krystal*, 2015 WL 4713238 (N.Y. Tax. App. Trib.). Thank you to Allan G. Donn of Willcox & Savage, P.C. for bringing this to my attention.

[1141] The *Boissiere/Krystal* case cited in fn. 1140 quoted the relevant statute:

> "also include[s] any officer, director or employee of a corporation ..., any employee of a partnership, any employee or manager of a limited liability company ... who as such officer, director, employee or manager is under a duty to act for such corporation, partnership, limited liability company ... in complying with any requirement of this article; *and any member of a partnership or limited liability company*" (emphasis added).

[1142] See fn. 7207.

[1143] See part II.F.7 Tenancy by the Entirety.

II.F.6. Asset Protection for IRAs

Although IRAs enjoy certain protection from creditors (particularly in the bankruptcy arena), note that they can lose that protection by directly or indirectly engaging in transactions that cause them to lose their status as IRAs.[1144]

II.F.7. Tenancy by the Entirety

"Tenancy by the Entirety" is ownership by both spouses in which neither spouse can convey an interest in the property alone. Whether that type of ownership can exist and what property is eligible for that type of ownership vary from state to state.

Generally, federal tax refunds are owned as tenants in common. *In re: Somerset Regional Water Resources, LLC*, 949 F.3d 837 (3rd Cir. 2020), held:[1145]

> **A. Federal tax refunds are separately owned if the income is separately owned**
>
> As we shall explain, a mixture of federal and state law governs ownership of federal tax refunds. We discuss each in turn.
>
> 1. *Federal tax law*. The Internal Revenue Code does not automatically treat refunds from joint marital returns as jointly owned. Rather, each spouse owns a portion of the refund separately, according to his or her share of the tax overpayment. See 26 U.S.C. § 6402(a) (2012) (authorizing the IRS to "credit the amount of [any] overpayment ... against any [tax] liability ... *on the part of the person who made the overpayment* and ... [to] refund any balance to such person" (emphasis added)). So the ownership of the spouses' income determines how they own a tax refund on that income. If the income is separate going in, then the refund is separate coming out. Merely filing a joint tax return does not change that.
>
> Our sister circuits concur. The Fifth Circuit, for instance, has held that if the income leading to a tax overpayment belongs to one spouse, then, even if the two file a joint tax return, the refund does not belong jointly to both spouses. *Ragan v. Comm'r*, 135 F.3d 329, 333 (5th Cir. 1998). As Judge Higginbotham explained for the court, "[a] joint income tax return does not create new property interests for the husband or wife in each other's income tax overpayment." *Id.* Because the income was the husband's alone under Texas law, the wife had no interest in the resulting refund. *Id.*
>
> Nor is the Fifth Circuit alone. In the words of the Ninth Circuit: "A joint return does not itself create equal property interests for each party in a refund. Spouses who file a joint return have separate interests in any overpayment, the interest of each depending upon his or her relative contribution to the overpaid tax." *United States v. Elam*, 112 F.3d 1036, 1038 (9th Cir. 1997). Thus, "fil[ing] a joint tax return ... does not change the underlying property interests at stake." *Id.*; see also *Callaway v. Comm'r*, 231 F.3d 106, 117 (2d Cir. 2000) ("[T]he filing of a joint return does not have the effect of converting the income of one spouse into the income of another." (citing *McClelland v. Massinga*, 786 F.2d 1205, 1210 (4th Cir. 1986)); *Gordon v. United States*,

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[1144] See part II.G.22 IRA as Business Owner, especially fn. 1888.

[1145] This case involved tax refunds result from net operating loss carrybacks. See part II.G.4.l.ii Net Operating Loss Deduction, with this case cited in fns 1407-1408.

757 F.2d 1157, 1160 (11th Cir. 1985) ("Where spouses claim a refund under a joint return, the refund is divided between the spouses, with each receiving a percentage of the refund equivalent to his or her proportion of the withheld tax payments."); *cf.* Rev. Rul. 74-611, 1974-2 C.B. 399, 399 ("Court decisions have consistently held that a husband and wife who file a joint return do not have a joint interest in an overpayment; each has a separate interest.").

We now join our sister circuits in adopting this rule. Thus, when the Mostollers got their refund check, each spouse acquired a separate interest in it proportional to his or her contribution to the overpayments. If the income was jointly owned, then the Mostollers had a common interest in the refund. But if it was separately owned by Mr. Mostoller, then his wife had no interest in the refund when it arrived.

To figure out who owned what (and how), we turn to Pennsylvania law. See *United States v. Nat'l Bank of Commerce*, 472 U.S. 713, 722 (1985) ("[S]tate law controls in determining the nature of the legal interest which the taxpayer had in the property.... [F]ederal statute[s] create[] no property rights but merely attach[] consequences, federally defined, to rights created under state law." (internal quotation marks omitted)).

2. *State property law*. Under Pennsylvania law, Mr. Mostoller owned most of the spouses' income in 2013, 2014, and 2015, because he separately owned the main producer of that income: the Debtor. So he also owned most of the refund when it arrived.

In Pennsylvania, spouses ordinarily own property in one of three ways: separately, as tenants in common, or as tenants by the entirety. In the first, only one spouse owns the property; the other does not. The second means that each spouse possesses the property but has "separate and distinct" legal title to it. *In re Estate of Quick*, 905 A.2d 471, 474 (Pa. 2006). And the third gives each spouse a joint, singular interest in "'the whole or the entirety,' and not a 'share, moiety or divisible part' " of the property. *Clientron Corp.*, 894 F.3d at 579 (quoting *In re Brannon*, 476 F.3d 170, 173 (3d Cir. 2007)). Creditors of one spouse can attach separate or common interests of that spouse, but they cannot attach jointly held entirety interests without the other spouse's consent. See *id.* At 575. To win, the Mostollers must show that they owned their income as tenants by the entirety.

For a tenancy by the entirety, Pennsylvania requires the traditional common-law elements: a marriage, plus the "four unities" of time, title, possession, and interest. *In re Estate of Quick*, 905 A.2d at 474. To satisfy those unities, the spouses must (1) have their interests "vest at the same time," (2) "obtain[] their title by the same instrument," (3) have "an undivided interest in the whole," and (4) own interests "of the same type, duration and amount." *In re Estate of Rivera*, 194 A.3d 579, 586-87 (Pa. Super. Ct. 2018) (quoting *Fenderson v. Fenderson*, 685 A.2d 600, 607 (Pa. Super. Ct. 1996)).

Here, none of the unities was present. Because Mr. Mostoller was the Debtor's sole owner, he alone had legal title to, possession of, and an interest in its income when it accrued. Thus, he owned that income as separate property. As the Mostollers had no other significant source of income, the Debtor accounted for the lion's share of their taxable income from 2013 to 2015. So under federal tax law, Mr. Mostoller owned most of the refund separately.

B. The Mostollers never merged their separate interests into entireties interests

After spouses get a refund, they can change their ownership of that money under state property law. For instance, spouses can merge their separate interests into entireties interests over time, as long as they satisfy the four unities needed for a tenancy by the entirety. *Cf. In re Estate of Brose*, 206 A.2d 301, 304 (Pa. 1965). But when the IRS issued the Mostollers' refund check, Mr. Mostoller owned almost all of it separately through his sole ownership of the Debtor's income, even though the check was made out to both spouses. While the unities of time and title were satisfied by then, the unities of possession and interest were still missing. See *In re Estate of Rivera*, 194 A.3d at 586. And the Mostollers could not have merged their interests: their accountant immediately deposited the refund check with the bankruptcy court before they could commingle the proceeds.

Because their interests both started and remained separate, Mr. Mostoller validly pledged his share on his own.

II.G. Income Tax Operating Issues

The IRS portal, "Tax Information For Businesses," was found at https://www.irs.gov/Businesses on April 6, 2016.

Part II.Q.1 General Principles of Exiting from or Dividing a Business illustrates that selling the goodwill component of a business is much more tax efficient by a partnership than by a corporation and that an S corporation is more efficient that a C corporation. Estate planning considerations tend to generate a similar conclusion. However, current taxation of undistributed income from business operations tends to work in the reverse. A high income, passive investor in a partnership or S corporation might be subject to a higher short-term tax rate than a shareholder in a C corporation; see part II.I 3.8% Tax on Excess Net Investment Income. Also, a general partner (or LLC equivalent) faces additional FICA tax on undistributed business income, an issue that does not apply to a shareholder of an S or C corporation; see part II.L Self-Employment Tax (FICA) for a discussion of this issue and how to plan around it.

II.G.1. How and When to Obtain or Change an Employer Identification Number (EIN)

IRS EIN resources include:

- https://www.irs.gov/businesses/small-businesses-self-employed/employer-id-numbers-eins (general EIN webpage)
- https://www.irs.gov/businesses/small-businesses-self-employed/do-you-need-a-new-ein (whether to get a new tax ID)
- https://www.irs.gov/pub/irs-pdf/p1635.pdf (summary of whether to get a new tax ID and an explanation of various terms used and requirements for completing Form SS-4).

Generally, go to Code § 6109 and start with Reg. § 301.6109-1. See also parts:

- II.A.2.g Qualified Subchapter S Subsidiary (QSub), especially text accompanying fns. 180-191

- II.P.3 Conversions, the introduction to which reproduces Reg. § 301.6109-1(h), “Special rules for certain entities under § 301.7701-3.”

- II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization, especially fns 4078-4080.

- III.B.2.e.i Grantor Trust Treatment During the Grantor’s Life

- III.B.2.e.ii Tax ID Issues When the Deemed Owner of a Grantor Trust Dies

I am uncertain about the effect of decanting[1146] on a tax ID.[1147]

II.G.2. IRS Resources

II.G.2.a. Applicable Federal Rate (AFR)

See http://apps.irs.gov/app/picklist/list/federalRates.html for the current month’s rates and a complete history from January 2000.

II.G.2.b. Internal Revenue Manual

See http://www.irs.gov/irm/index.html.

II.G.2.c. IRS Audit Techniques Guides (ATGs)

See https://www.irs.gov/businesses/small-businesses-self-employed/audit-techniques-guides-atgs, explaining industry-specific examination techniques and common and unique industry issues, business practices and terminology, as well as providing guidance on the examination of income, interview techniques and evaluation of evidence.

II.G.2.d. IRS Valuation Resources; Tax Affecting Pass-Through Entities

See http://www.irs.gov/Businesses/Valuation-of-Assets.[1148]

Estate of Jones v. Commissioner, T.C. Memo. 2019-101, is the first case to accept tax-affecting, which in that case consisted of the following, with respect to a partnership:

> In his DCF method Mr. Reilly[1149] “tax-affected” SJTC’s earnings. To do this he used 38% as a proxy for the combined Federal and State tax burdens that owners of SJTC would bear (treating SJTC in effect as a taxable C corporation, albeit at an individual, not corporate, tax rate), and adjusted both the earnings he used to calculate SJTC’s net cashflow and the cost of debt capital he used to determine the appropriate

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1146 See part II.J.4.i Modifying Trust to Make More Income Tax Efficient.
1147 See also part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.
1148 Critiques include Grossman, “Dissecting the IRS Job Aid On S corporation Tax-Affecting,” *Valuation Strategies* (WG&L) (Sept./Oct. 2015).
1149 [My footnote:] the court referred to Richard Reilly, but the appraiser was Robert Reilly of Willamette Management Associates (“WMA”). In the Leimberg Webinar Services program, “Understanding “Tax-Affecting” and Other Critical Valuation Issues Impacting Pass-Through Entities after Estate of Aaron Jones v Commissioner” (9/26/2019), I discuss the case with WMA representatives; to access this webinar (for a fee) before or after that date, go to https://leimbergservices.com/wdev/register.cfm?id=332.

> discount rate. He then computed the benefit of the dividend tax avoided by estimating the implied benefit for SJTC's partners in prior years and considering an empirical study analyzing S corporation acquisitions cited in his report. In his guideline publicly traded companies valuation, he used the tax-affected earnings as well, although the metrics he used to compare the companies to SJTC were pretax. Finally, he applied a 22% premium to SJTC's weighted business enterprise value (that is, his weighted DCF method and guideline publicly traded companies method valuations) to reflect that benefit.

The court reasoned:

> In effect, both parties argue that a hypothetical buyer and seller would take into account SJTC's business form when determining the fair market value of a limited partner interest; they just disagree about how to do this. As we did in *Gross v. Commissioner*, T.C. Memo. 1999-254, 1999 WL 549463, *aff'd*, 272 F.3d 333 (6th Cir. 2001), and subsequent cases, we decide this question of fact on the basis of the record before us.
>
> While respondent objects vociferously in his brief to petitioner's tax-affecting, his experts are notably silent. The only mention comes in Mr. Schwab's rebuttal report, in which he argues that Mr. Reilly's tax-affecting was improper, not because SJTC pays no entity level tax, but because SJTC is a natural resources holding company and therefore its "rate of return is closer to the property rates of return". They do not offer any defense of respondent's proposed zero tax rate. Thus, we do not have a fight between valuation experts but a fight between lawyers. We do not find respondent's arguments against Mr. Reilly's methodology convincing. While respondent correctly points out that we rejected the proffered tax-affecting in *Gross* and later cases, he misconstrues our rationale. In *Gross v. Commissioner*, 1999 WL 549463, at *10, we concluded that "the principal benefit that shareholders expect from an S corporation election is a reduction in the total tax burden imposed on the enterprise. The owners expect to save money, and we see no reason why that savings ought to be ignored as a matter of course in valuing the S corporation." We then concluded that, on the record in that case, a zero-percent corporate tax rate properly reflected those tax savings, rejecting the expert's offered justifications.[5] More recently, in *Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148, 2011 WL 2559847, at *12, supplemented by T.C. Memo. 2011-244, we again rejected tax-affecting because the taxpayer's expert did not justify it but again acknowledged that the benefit of a reduction in the total tax burden borne by S corporation owners should be considered when valuing an S corporation. And in *Estate of Giustina v. Commissioner*, 2011 WL 2516168, at *6, we rejected tax-affecting in the valuation of a partnership because we found the taxpayer's expert's method to be faulty: He used a pretax discount rate to present value post tax cashflow. The question in those cases, as here, was not whether to take into account the tax benefits inuring to a flowthrough entity but how.
>
> [5] Indeed in discussing the analysis by the Commissioner's expert in *Gross* we noted the importance of treating both cashflows and the discount rate consistently, as Mr. Reilly did here. *Gross v. Commissioner*, T.C. Memo. 1999- 254, 1999 WL 549463, at *10-*11, *aff'd*, 272 F.3d 333 (6th Cir. 2001). In *Gross* the expert applied a hypothetical 40% corporate tax rate to earnings but did not apply any premium to reflect the benefit of avoided dividend tax. Thus the Court was presented with a choice between a 40% or a 0% corporate tax rate. *Id.* That is not the choice before us here.

> We find on the record before us that Mr. Reilly has more accurately taken into account the tax consequences of SJTC's flowthrough status for purposes of estimating what a willing buyer and willing seller might conclude regarding its value. His adjustments include a reduction in the total tax burden by imputing the burden of the current tax that an owner might owe on the entity's earnings and the benefit of a future dividend tax avoided that an owner might enjoy. We are mindful that the science of valuing closely held companies usually results in a "gross terminal logical inexactitude" in the words of Winston Churchill. *E.g.*, *Maris v. Commissioner*, T.C. Memo. 1980-444. And as we admonished in *Buffalo Tool & Die Mfg. Co. v. Commissioner*, 74 T.C. at 452, "in the final analysis, the Court may find the evidence of valuation by one of the parties sufficiently more convincing than that of the other party, so that the final result will produce a significant financial defeat for one or the other, rather than a middle-of-the-road compromise which we suspect each of the parties expects the Court to reach." Mr. Reilly's tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate.

II.G.2.e. IRS Practice Units

https://www.irs.gov/businesses/corporations/practice-units explains:

> As part of LB&I's knowledge management efforts, Practice Units are developed through internal collaboration and serve as both job aids and training materials on tax issues. For example, Practice Units provide IRS staff with explanations of general tax concepts as well as information about a specific type of transaction. Practice Units will continue to evolve as the compliance environment changes and new insights and experiences are contributed. Please visit this site periodically for new and updated Practice Units which are shared below….
>
> NOTE: Practice Units are not official pronouncements of law or directives and cannot be used, cited or relied upon as such. Practice Units provide a general discussion of a concept, process or transaction and are a means for collaborating and sharing knowledge among IRS employees. Practice Units may not contain a comprehensive discussion of all pertinent issues, law or the IRS's interpretation of current law. Practice Units do not limit an IRS examiner's ability to use other approaches when examining issues. Practice Units and any non-precedential material (e.g., a private letter ruling, determination letter, or Chief Counsel advice) that may be referenced in a Practice Unit may not be used or cited as precedent. References to third party service providers and documents, like news or journal articles, are for informational purposes only and do not constitute an endorsement of any vendor, document, or the services or views offered by such third party.

On 5/22/2022, I noted some Practice Units available in links at that web page:

• 12-14-2021	Interest on Deferred Tax Liability
• 06-10-2021	Partner's Outside Basis

• 04-02-2021	Liquidating Distributions of a Partner's Interest in a Partnership
• 04-02-2021	Reasonable Cause and Good Faith
• 03-12-2021	Sale of a Partnership Interest
• 12-18-2020	Determining Liability Allocations
• 12-18-2020	Recourse vs. Nonrecourse Liabilities

You might review those practice units in light of parts II.Q.8 Exiting From or Dividing a Partnership (and you will especially want to review the subparts in the FULL TABLE OF CONTENTS for what maps to which Practice Unit) and II.C.3 Allocating Liabilities (Including Debt).

In 2020 the IRS issued a few Practice Units on S corps that used to be C corporations, which Practice Units are already in part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally.

IRS also has dedicated pages, which are helpful for all levels of experience, under Business Structures - https://www.irs.gov/businesses/small-businesses-self-employed/business-structures, which includes links to:

- Tax Information For Partnerships - https://www.irs.gov/businesses/partnerships
- S Corporations - https://www.irs.gov/businesses/small-businesses-self-employed/s-corporations
- The links to corporations and LLCs don't say much.

II.G.3. State Income Taxation

Generally, an owner of an interest in a pass-through entity such as an S corporation or partnership (including an LLC) will report income taxable to the states in which the entity does business, or the entity will pay tax on the income taxable to one or more of its owners instead of its owners reporting that income. Of course, if the entity is a C corporation, it pays tax on its own income, and only the gain on sale of the S corporation stock may be taxable to the owner, but only in the jurisdiction in which the owner is a resident. In any event, states that tax income have various methods to apportion a business' income, which tend to consider one or more of sales, property, or wages within the taxing state. Because states may use different methods to apportion income, these different methods may lead to double (or worse) taxation. To avoid unfair duplication, consider how the Multistate Tax Commission can help.[1150] Also note that each owner needs to file state income tax returns (or the pass-through entity needs to pay tax on that owner's behalf, generally at the highest marginal state income tax rate that would apply to that income); whereas, with a C corporation, only the corporation needs to file.

For various permutations of income taxation when businesses are sold, see parts II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis, II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold, and II.Q.9 Trust Selling a Business. Also consider part II.H.8.a.ii State Income Tax Disconnect, found within part II.H.8.a Depreciable Real Estate in an S Corporation – Possible Way to Replicate Effect of Basis Step-Up If the Stars Align Correctly.

An additional consideration is that the Code § 199A deduction[1151] is available in only a few states. See part II.E.1.c.i.(c) Effect (if any) of Code § 199A on State Income Taxation.

Illinois imposes an income tax, called the "replacement tax," on partnerships, S corporations and C corporations.[1152] LLCs that are treated as disregarded entities do not appear to be subject to this tax.[1153]

For the leading U.S. Supreme Court case and other issues relating to state fiduciary income taxation, see part II.J.3.e.ii When a State Can or Does Tax a Trust's Income. State income law that is broader than fiduciary income tax principles in in part II.J.3.e.ii.(f) Business Income; *Fielding* (MN 2018); *Metropoulos* (CA 2022).

States impose franchise tax and other taxes, some of which vary according to the type of entity. This includes differences between general partnerships, limited partnerships, and LLCs.[1154]

[1150] From http://www.mtc.gov/The-Commission:

> The Multistate Tax Commission is an intergovernmental state tax agency working on behalf of states and taxpayers to facilitate the equitable and efficient administration of state tax laws that apply to multistate and multinational enterprises. Created by the Multistate Tax Compact, the Commission is charged by this law with:
>
> - Facilitating the proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes;
> - Promoting uniformity or compatibility in significant components of tax systems;
> - Facilitating taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration;
> - Avoiding duplicative taxation.

[1151] See generally part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

[1152] 35 ILCS 5/201(c).

[1153] Illinois taxes LLCs as corporations or partnerships if they are classified as such for federal income tax purposes. 35 ILCS 5/1501(a)(4), (16); IL Admin. Code § 100.9750(b), (d)(1). IL Admin. Code § 100.9750(b)(1)(A) provides that a corporation and its federally disregarded subsidiary are taxed as a single corporation.

[1154] See, *e.g.*, Ely, Thistle, and Rhyne, "State Tax Treatment of LLCs and LLPs: Update for 2014," *Journal of Multistate Taxation and Incentives* (5/2014). Other resources include not only various state tax treatises, such as Hellerstein & Hellerstein, *State Taxation*, and Fenwick, McLoughlin, Salmon, Smith, Tilley, Wood, *State Taxation of Pass-Through Entities and Their Owners*, but also magazines, such the *Journal of Business Entities*. Before starting new operations, one might explore state and local tax incentives.

Also, *South Dakota v. Wayfair, Inc.*, 585 U.S. ___ (2018), was a key decision regarding taxing nexus in the context of state sales tax. The Council on State Taxation, https://cost.org, tracks not only the implications of that case but also which elements of federal law are integrated into state income taxation of C corporations and pass-through entities.

II.G.4. Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner

As described further below in this part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner, a loan to an S corporation or a partnership or a guarantee of a third party loan to a partnership can generate current deductions of losses that the loan finances, whereas a loan to a C corporation or a loan guarantee to an S or C corporation does not. Losses financed by even third-party loans remain subject to parts II.G.4.c Basis Limitations for Deducting Partnership and S Corporation Losses (including parts II.G.4.d Basis Limitation for Shareholders in an S Corporation and II.G.4.e Basis Limitations for Partners in a Partnership, the latter being complicated by part II.C.3 Allocating Liabilities (Including Debt)), II.G.4.j At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities), and II.G.4.l.ii Net Operating Loss Deduction.

Furthermore, a worthless loan to a C corporation is difficult to deduct and might or might not qualify for ordinary loss treatment, and such a deduction might be subject to a 7-year statute of limitations rather than a 3-year statute of limitations (as would a deduction for worthless stock).

II.G.4.a. Loans to Businesses or Business Associates

Loans are important in business planning and estate planning, and these topics overlap.

In estate planning, they can fund the sale of a business to a family trust (part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust) or otherwise help family members pursue business opportunities (part III.B.1.a Business Opportunities).

The grantor may lend the money directly (part III.B.1.a.i Loans) or extend credit by guaranteeing a loan made by a third party (part III.B.1.a.ii Loan Guarantees).

This part II.G.4.a includes parts:

- II.G.4.a.i Loans to Businesses – Whether AFR Is Required
- II.G.4.a.ii Bad Debt Loss – Must be Bona Fide Debt
- II.G.4.a.iii Character of Bad Debt
- II.G.4.a.iv Extension of Statute of Limitations for Deduction for Bad Debt or Worthless Securities
- II.G.4.a.v Tax Effect of Loan to S Corporation or Partnership

A business' capital structure often includes components of debt and equity. Protection from creditors may play a role, in that an entity must pay its debts before providing an equity return to its owners, and a debt owed a shareholder may compete with the claims of unsecured creditors (for example, those suing the business for torts), whereas any equity return is clearly subordinate to paying unsecured creditors. A parent may want to help an entrepreneurial child and get repaid with interest but want that child to benefit from equity returns. An equity investor may get benefits such as tax credits and depreciation deductions, as well as receive capital gain treatment on the investor's return, whereas a commercial lender wants to lock down cash returns. Given possibly high tax benefits, Congress has limited interest deductions and the IRS has challenged taxpayers' characterization; see part II.G.20 Debt vs. Equity; Potential Denial of Deduction for Business Interest Expense, including parts:

- II.G.20.a Code § 163(j) Limitation on Deducting Business Interest Expense
- II.G.20.b When Debt Is Recharacterized as Equity
- II.G.20.c Changing from LIBOR or Other Interbank Offered Rates

II.G.4.a.i. Loans to Businesses – Whether AFR Is Required

Generally, loans between corporations and shareholders are subject to the Code § 7872 rules governing below-market loans.[1155]

However, loans between partners and partnerships are subject to those rules only if one of the principal purposes of the interest arrangements of which is the avoidance of any Federal tax.[1156]

II.G.4.a.ii. Bad Debt Loss – Must be Bona Fide Debt

Only a bona fide debt qualifies for purposes of Code § 166.[1157] The debt must arise from "a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money."[1158] *Rutter v. Commissioner*, T.C. Memo. 2017-174, elaborated:

> A bona fide debt is a debt that arises from "a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." *Kean v. Commissioner*, 91 T.C. 575, 594 (1988); sec. 1.166-1(c), Income Tax Regs. A gift or contribution to capital is not considered a "debt" for purposes of section 166. *Kean*, 91 T.C. at 594. Whether a purported loan is a bona fide debt for tax purposes is determined from the facts and circumstances of each case. See *A.R. Lantz Co. v. United States*, 424 F.2d 1330, 1333 (9th Cir. 1970); *Gross v. Commissioner*, 401 F.2d 600, 603 (9th Cir. 1968), *aff'g* T.C. Memo. 1967-31; *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 493 (1980).

1155 Code § 7872(c)(1)(C).

1156 Whitmire, Nelson, McKee, et al, "¶3.08. Partner and Member Loans," *Structuring & Drafting Partnership Agreements: Including LLC Agreements*, conclude:

> If no interest is charged on partner-to-partnership loans, or if interest is charged at less than the applicable "federal rate," interest may be imputed under § 7872 if (1) the loan is determined to be a "tax avoidance loan" under § 7872(c)(1)(D) or (2) the loan is an "other below-market loan" described in regulations promulgated under § 7872(c)(1)(E). At present, no regulations have been proposed that would generally treat garden-variety partner-to-partnership loans as below-market loans or tax-avoidance loans.

Code § 2701 provides a backstop in a family partnership. See part III.B.7.c.i.(b) CCA 201442053 Discusses Profits Interest in a Partnership That Was a Straight-Up Partnership before the Transfer.

1157 Reg. § 1.166-1(c).

1158 Reg. § 1.166-1(c).

Rutter held that advances not documented with promissory notes were equity, not debt. See fn. 1839 in part II.G.20 Debt vs. Equity; Potential Denial of Deduction for Business Interest Expense. *Povolny Group, Inc. v. Commissioner*, T.C. Memo. 2018-37, elaborated:

> We note first that the purported loans had none of the standard indicia of debt: no formal loan documentation, no set maturity date, and no interest payments. See, *e.g.*, *Hardman v. United States*, 827 F.2d 1409, 1412 (9th Cir. 1987) (formal loan documentation tends to show bona fide debt); *Estate of Mixon v. United States*, 464 F.2d 394, 404 (5th Cir. 1972) (fixed maturity date is characteristic of debt); *Am. Offshore, Inc.*, 97 T.C. at 605 (lack of interest payments suggests equity). We recognize that "transactions between closely held corporations and their shareholders are often conducted in an informal manner." *Epps v. Commissioner*, T.C. Memo. 1995-297, 1995 WL 389638, at *4. But because of the amount of the purported loans at issue here - over $300,000 - the lack of any loan documentation whatsoever weighs against a finding of debt. See i*d*. (lack of formality weighs against debt finding where payment was $112,000). The only documents Povolny produced about the purported loans were printouts of QuickBooks entries. At trial Povolny discussed a two-page printout from Archetone Limited's QuickBooks labeled "A/R Archetone International" that lists the $241,000 in payments that Archetone Limited deducted as "bad debt." The $74,000 that PG paid and that Archetone Limited deducted that same year as "Loss on Archetone International Expenses Paid" appears in two separate entries from PG's QuickBooks: one entitled "Quarterly Distributions" and another called "Due from Related Parties Write off - Archetone." 9 But we don't just look at the label a corporation sticks on a transaction; we look for proof of its substance. See, *e.g.*, *Shedd*, 2000 WL 1337177, at *4. And there's none of that here - Povolny apparently didn't even give his CPA anything beyond such QuickBooks printouts. This strongly suggests that Povolny was simply trying to recast some of the investment in the failed Algerian hospital project as loans to recoup some of the loss. In other words, it wasn't bona fide debt.
>
> [9] This fact is also relevant to the PG-wage issue that we'll discuss in the next section- *i.e.*, whether PG's $74,000 in payments to Archetone International's and Archetone Limited's creditors were "loans" to those entities or compensation to Povolny. But there was another adjustment for those payments: Archetone Limited's $74,000 deduction - which flowed through to the Povolnys—was also disallowed by the Commissioner. There was some confusion at trial and in the briefs about this deduction. The Povolnys argued on brief that the $74,000 deduction was part of Archetone Limited's bad-debt deduction for 2011. So we've focused on that argument here. But even if it wasn't part of Archetone Limited's bad-debt deduction for 2011 - for example, if it was a current claimed business expense by Archetone Limited—the Commissioner says that that adjustment was still appropriate because Povolny "failed to provide documentation or explanation for Archetone Limited having a business purpose for paying Archetone International's expenses." Povolny didn't have anything to say about that at trial or on brief, so we deem that issue conceded. See Rule 34(b)(4); *McNeil v. Commissioner*, T.C. Memo. 2011-150, 2011 WL 2559802, at *1 n.3, *aff'd* 451 F.App'x 622 (8th Cir. 2012).
>
> Archetone International's lack of capital also suggests that what the Povolnys deducted weren't bona fide debts. A transferee's undercapitalization is strong evidence that the transfer is a capital contribution. *Am. Offshore, Inc.*, 97 T.C. at 604. Here, Archetone International had no capital at all - Povolny testified that it "had no funds or wasn't capitalized, so it basically was capitalized through the assets that Archetone, Limited

had." This complete lack of capitalization weighs heavily in favor of finding that the payments at issue were capital contributions and not bona fide debt.

Along the same lines, repayment dependent on earnings suggests that an advance is more likely to be equity. *Estate of Mixon*, 464 F.2d at 405; *Am. Offshore, Inc.*, 97 T.C. at 602; *Calumet Indus., Inc.*, 95 T.C. at 287-88; *Provost v. Commissioner*, T.C. Memo. 2000-177, 2000 WL 687889, at *5. And because Archetone International had no capital at the time of the purported loans, the only potential source of repayment was earnings on its single contract - the Algerian hospital. This, too, weighs against finding that a bona fide debt existed. The evidence we have, then, shows no formal signs that a debt existed, and the underlying economics of the situation strongly suggests that Povolny was once again just using one of his companies' funds to pay another of the companies' debts. We therefore find that Archetone Limited's advances to Archetone International did not create bona fide debt.

For this purpose, an accrual method taxpayer's account receivable is deemed to be an enforceable obligation to the extent that the income such debt represents has been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year.[1159] Conversely, worthless debts arising from unpaid wages, salaries, fees, rents, and similar items of taxable income are not deductible under Code § 166 unless the income such items represent has been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year.[1160]

A gift or contribution to capital is not a debt for purposes of Code § 166.[1161] See part II.G.20 Debt vs. Equity; Potential Denial of Deduction for Business Interest Expense. For example, in a Code § 166 case, *2590 Associates, LLC v. Commissioner*, T.C. Memo. 2019-3, cited 13 factors from *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972),[1162] because the case was appealable to the Fifth Circuit, then commented:

[1159] Reg. § 1.166-1(c), which continues:

For example, a debt arising out of gambling receivables that are unenforceable under state or local law, which an accrual method taxpayer includes in income under section 61, is an enforceable obligation for purposes of this paragraph.

[1160] Reg. § 1.166-1(e).

[1161] Reg. § 1.166-1(c). *Rutter v. Commissioner*, T.C. Memo. 2017-174, elaborated:

Advances made by an investor to a closely held or controlled corporation may properly be characterized, not as a bona fide loan, but as a capital contribution. See *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968); *Shaw v. Commissioner*, T.C. Memo. 2013-170, 106 T.C.M. (CCH) 54, 56, *aff'd*, 623 F. App'x 467 (9th Cir. 2015). In general, advances made to an insolvent debtor are not debts for tax purposes but are characterized as capital contributions or gifts. See *Dixie Dairies Corp.*, 74 T.C. at 497; *Davis v. Commissioner*, 69 T.C. 814, 835-836 (1978). For an advance to constitute a bona fide loan, the purported creditor must expect that the amount will be repaid. See *CMA Consol., Inc. v. Commissioner*, T.C. Memo. 2005-16, 89 T.C.M. (CCH) 701, 724.

Povolny Group, Inc. v. Commissioner, T.C. Memo. 2018-37, had a similar result, only the lender was a related corporation, so the payment to the related corporation was a dividend from the payor to the shareholder, followed by a contribution to capital from the shareholder to the recipient. (The case is also mentioned in fn. 1839 in part II.G.20.b When Debt Is Recharacterized as Equity.) For dividend treatment, see part II.Q.7.a.iv Dividends; Avoiding Dividend Treatment Using Redemptions under Code §§ 302 and 303.

[1162] *Mixon* is described in the text accompanying fn 1840 in part II.G.20.b When Debt Is Recharacterized as Equity.

> The factors are not of equal importance, and no single factor is determinative. See *Dillin v. United States*, 433 F.2d 1097, 1100 (5th Cir. 1970); *Segel v. Commissioner*, 89 T.C. 816, 827 (1987). Some factors may not be relevant in a given situation. *Estate of Mixon*, 464 F.2d at 402.
>
> The object of the inquiry is not to count the factors but to evaluate them. *Tyler v. Tomlinson*, 414 F.2d 844, 848 (5th Cir. 1969). The factors aid in our determination of whether the parties intended to create indebtedness with a reasonable expectation of repayment and whether that expectation comported with economic reality. See *Estate of Mixon*, 464 F.2d at 407. The Court of Appeals for the Fifth Circuit recognizes that the "real issue for tax purposes has long been held to be the extent to which the transaction complies with arm's length standards and normal business practice." *Id.* at 402-403. We apply special scrutiny to transactions between entities in the same corporate family or with shared ownership. See *Kean v. Commissioner*, 91 T.C. at 594; *Malone & Hyde, Inc. v. Commissioner*, 49 T.C. 575, 578 (1968); *Vinikoor v. Commissioner*, T.C. Memo. 1998-152.

2590 Associates criticized the IRS for not addressing the 13 factors from *Mixon* and found a bona fide debt when the loan was made and when the lender contributed it to a business in exchange for equity.[1163]

[1163] After reviewing the overall situation, the court held:

> Under the 13 factors considered by the Court of Appeals for the Fifth Circuit, we find that a bona fide debt existed between Perkins Rowe and 2590 Associates. Respondent did not address the 13 factors used by the Court of Appeals. 2590 Associates held a promissory note with a fixed maturity date and accrued interest at an above-market rate. The interest rate increased upon default, and the note provided for an award of attorney's fees for any collection actions. We find that at the time of the 2008 note's transfer, 2590 Associates intended to collect the debt from Perkins Rowe. Mr. Spinosa believed that Perkins Rowe would succeed and would repay the debt. 2590 Associates had the right to enforce payment. However, as the note was unsecured, collection attempts would have been futile. Mr. Spinosa credibly testified that he believed the Perkins Rowe development could be successful at the time Mr. Saban contributed the note to 2590 Associates and even after the foreclosure case's filing. Mr. Spinosa had extensive experience in real estate investments, and he was optimistic that Perkins Rowe would be successful despite the difficulties it encountered. The source of repayment was not limited to Perkins Rowe's income. There is no evidence of a thin capitalization. In fact, the 2008 appraisal performed for KeyBank indicated that there was substantial equity in Perkins Rowe. The 2008 note was not given to acquire capital assets. Each of these factors weighs in favor of the existence of a bona fide debt.
>
> Two factors weigh against a bona fide debt, the note's subordination to secured creditors and Perkins Rowe's failure to repay the debt and accrued interest. Finally, two remaining factors for us to address are Perkins Rowe's ability to obtain outside loans and the nature of the relationship between 2590 Associates and Perkins Rowe. We find both factors to be neutral in the light of the other factors supporting the existence of a bona fide debt. By the time of the 2008 note's execution, Perkins Rowe had been attempting to refinance the construction loan for nearly one year. Ultimately, the loan was not refinanced, and the property was foreclosed on. However, at the time of the 2008 note and even after the foreclosure case began, Mr. Spinosa believed he could work out a refinancing and continued to negotiate with lenders and potential investors. Mr. Spinosa was able to amend the terms of the construction loan agreement in 2008, and all but one lender agreed to a refinancing deal after the foreclosure began. Nor do we find the relationship between Perkins Rowe and 2590 Associates, discussed *infra*, to negate the other factors supporting a bona fide debt. On the basis of the Court of Appeals for the Fifth Circuit's 13 factors, we find that the debt between Perkins Rowe and 2590 Associates was bona fide.

Allen v. Commissioner, T.C. Memo. 2023-86 described its "Tests for Evaluating Debt Versus Equity":

> "We determine whether a purported debt is in substance and fact a debt for tax purposes from the facts and circumstances of each case, with the taxpayer bearing the burden of proof." *VHC, Inc.*, T.C. Memo. 2017-220, at *52 (first citing *Arlington Park Jockey Club, Inc. v. Sauber*, 262 F.2d 902, 905 (7th Cir. 1959); and then citing *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 493 (1980)). For a bona fide debt to exist, the parties to a transaction must have had an actual, good-faith intent to establish a debtor-creditor relationship at the time the funds were advanced. *Beaver v. Commissioner*, 55 T.C. 85, 91 (1970).
>
> An intent to establish a debtor-creditor relationship exists if the debtor intends to repay the loan and the creditor intends to enforce repayment. *Fisher v. Commissioner*, 54 T.C. 905, 909–10 (1970). The expectation of repayment must not "depend solely on the success of the borrower's venture." *Am. Processing & Sales Co. v. United States*, 371 F.2d 842, 856 (Ct. Cl. 1967). For that matter "[a]dvances made by an investor to a closely held or controlled corporation may properly be characterized, not as a bona fide loan, but as a capit al contribution." See *Shaw*, T.C. Memo. 2013-170, at *9 (citing *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968)).
>
> Absent stipulation to the contrary, we follow the relevant precedent of the court of appeals to which an appeal would generally lie. See *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971). In these cases the appeal would lie in the U.S. Court of Appeals for the Fourth and the Eleventh Circuits, which use slightly different methods to determine the parties' intent. See *Fairchild Dornier GMBH v. Off. Comm. of Unsecured Creditors (In re Dornier Aviation (N. Am.), Inc.)*, 453 F.3d 225, 233-34 (4th Cir. 2006); *Lane v. United States (In re Lane)*, 742 F.2d 1311, 1314-15 (11th Cir. 1984).
>
> The Eleventh Circuit has approved use of certain guidelines to facilitate a determination of whether advances constitute debt or equity. There are at least 13 factors which merit consideration in determining this issue: (1) names given to the certificates evidencing the indebtedness; (2) presence or absence of a fixed maturity date; (3) source of payments; (4) right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) status of the contribution in relation to regular corporate creditors; (7) intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) ability of the corporation to obtain loans from outside lending institutions; (12) extent to which the advance was used to acquire capital assets; and (13) failure of the debtor to repay on the due date or seek a postponement. *Lane*, 742 F.2d at 1314-15 (citing *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972)). The Eleventh Circuit has stressed that "these guidelines are not rigid rules mandating a particular conclusion when the court finds certain facts." *Id*. at 1315; see also *Tyler v. Tomlinson*, 414 F.2d 844, 848 (5th Cir. 1969) ("[T]ests are, at most, helpful factors to be considered and not fiats to be bound by." (quoting *Ga. S. & Fla. Ry. Co. v. Alt. Coast Line R.R. Co.*, 373 F.2d 493, 498 (5th Cir. 1967))).
>
> While the Fourth Circuit has not adopted the Mixon factors, it has used a similar test for determining whether a claim should be recharacterized from debt to equity under the Bankruptcy Code. See *Fairchild Dornier GMBH*, 453 F.3d at 233-34 (citing *Bayer Corp.*

> *v. MascoTech, Inc. (In re AutoStyle Plastics, Inc.)*, 269 F.3d 726, 749-50 (6th Cir. 2001)); see also *Bd. of Trs., Sheet Metal Workers' Nat'l Pension Fund v. Lane & Roderick, Inc.*, 736 F. App'x 400 (4th Cir. 2018). There are 11 nonexclusive factors: (1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments. See *Fairchild Dornier GMBH*, 453 F.3d at 233.
>
> Regardless of the factors employed, both the Fourth and the Eleventh Circuits recognize that "[t]he substance of all of these multi-factor tests is identical," and application of the factors is helpful but what is necessary is evaluating the factors selected by the court to determine the taxpayer's intent concerning a transaction. *Id*. at 234 n.6; see also *Lane*, 742 F.2d at 1315 (citing *Tyler*, 414 F.2d at 848). Because the *Mixon* factors used in the Eleventh Circuit are more expansive, we will use them for the analysis.

The court thoroughly address the various factors and concluded:

> Of the 13 factors listed in *Estate of Mixon*, 7 favor equity, 3 favor debt, and 3 are neutral. After weighing them in the context of these cases, we conclude that the advances do not constitute debt and were therefore not deductible under section 166. That finding precludes the need for any analysis on whether the amounts were wholly or partially worthless.

Not being due yet does not prevent a Code § 166 deduction.[1164]

Rather, the debt must become worthless during the tax year.[1165]

[1164] Reg. § 1.166-1(c).

[1165] *2590 Associates, LLC v. Commissioner*, T.C. Memo. 2019-3, explained:

> For a section 166 deduction, the debt must become worthless during the tax year, *i.e.*, it must have had value at the beginning of the year and become worthless during that year. *Milenbach v. Commissioner*, 106 T.C. 184, 204 (1996), *aff'd in part, rev'd in part on other grounds*, 318 F.3d 924 (9th Cir. 2003). A debt's worthlessness is determined by identifiable events that occurred to render the debt worthless during the year. *Am. Offshore, Inc. v. Commissioner*, 97 T.C. 579, 594 (1991). A debt becomes worthless when the taxpayer has no reasonable expectation of repayment. *Crown v. Commissioner*, 77 T.C. 582, 598 (1981). Some objective factors considered by the Court in determining worthlessness include the value of property securing the debt, the debtor's earning capacity, events of default, the debtor's refusal to pay, actions to collect the debt, any subsequent dealings between the parties, and the debtor's lack of assets. *Am. Offshore, Inc. v. Commissioner*, 97 T.C. at 594-595. No single factor is conclusive. *Id.* at 595. The determination of when a debt becomes worthless depends upon the particular facts and circumstances of each case. *Riss v. Commissioner*, 56 T.C. 388, 407 (1971), *aff'd*, 478 F.2d 1160 (8th Cir. 1973). At trial we held that respondent has the burden of proof with respect to the issue of worthlessness in 2011. We find that respondent has failed to satisfy his burden of proof and that the debt became worthless in 2011.

II.G.4.a.iii. Character of Bad Debt

Where any nonbusiness debt held by a noncorporate taxpayer becomes worthless within the taxable year, the resulting loss is a short-term capital loss;[1166] note that reporting a large short-term capital loss might stand out, given that the IRS now matches proceeds and basis on sale and the basis would not match any report to the IRS by a broker. Code § 166(d)(2) provides that "nonbusiness debt" means a debt other than:[1167]

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

After reciting the above, Reg. § 1.166-5(b) provides:

> The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph. For purposes of section 166 and this section, a nonbusiness debt does not include a debt described in section 165(g)(2)(C). See § 1.165-5, relating to losses on worthless securities.

When part or all of a debt, which is not a security[1168] and is not a nonbusiness debt, becomes worthless, the taxpayer holding the debt can deduct the worthless portion,[1169] if the taxpayer

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[1166] Code § 166(d)(1). Capital losses are deductible only against the sum of capital gains plus $3,000. Short-term capital gains are taxed using ordinary income tax rates, so short-term capital losses from bad debts have the most benefit for taxpayers with short-term capital gains.
[1167] Code § 166(d)(1).
[1168] Code § 166(e) provides, "This section shall not apply to a debt which is evidenced by a security as defined in section 165(g)(2)(C)."
[1169] Code § 166(a), which allows a taxpayer to deduct a debt that is worthless in whole or in part, with Reg. § 1.166-3(a)(2)(iii) providing:

> Before a taxpayer may deduct a debt in part, he must be able to demonstrate to the satisfaction of the district director the amount thereof which is worthless and the part thereof which has been charged off.

Rutter v. Commissioner, T.C. Memo. 2017-174, elaborated:

> The Commissioner's disallowance of a deduction under section 166(a)(2) will be sustained so long as he exercises his discretion reasonably. *Brimberry v. Commissioner*, 588 F.2d 975, 977 (5th Cir. 1979), *aff'g* T.C. Memo. 1976-209; *Portland Mfg. Co. v. Commissioner*, 56 T.C. 58, 72 (1971), *aff'd* on other grounds, 35 A.F.T.R.2d (RIA) 75-1439, 75-1 U.S. Tax Cas. (CCH) para. 9449 (9th Cir. 1975). His exercise of discretion will not be set aside unless it is arbitrary and

charges off the loan.[1170] Nonbusiness bad debts must be wholly worthless to be deductible;[1171] the debtor's filing of bankruptcy does not show that the debt is wholly worthless if the creditor files a claim.[1172] In contrast, a business bad debt is deductible when partially or wholly worthless, as *Bercy v. Commissioner*, T.C. Memo. 2019-118, described:

unreasonable. *Ark. Best Corp. & Subs. v. Commissioner*, 800 F.2d 215, 221 (8th Cir. 1986), *aff'g* in part, *rev'g* in part 83 T.C. 640 (1984), *aff'd* on other grounds, 485 U.S. 212 (1988).

> Petitioner has not made the showing that the statute and the regulations require. First, he has not established to the Commissioner's satisfaction, or ours, the amount of the debt that was worthless at year-end 2009. Sec. 1.166-3(a)(2)(iii), Income Tax Regs. The $8.55 million number he chose for the writedown (reduced from the $10 million "placeholder" figure Mr. Bardoff had used initially) appears to have been selected because it approximated the income petitioner realized earlier in 2009 from another of his startup companies. He made no effort to tie this writedown to IM's actual financial condition or ability to repay.
>
> Second, petitioner did not show that any portion of his advances became worthless during 2009. He appears to have had a reasonable hope of recovering on his investments; that is presumably why he continued to advance another $37.75 million to IM during 2010-2013. See *Crown*, 77 T.C. 582, 598 (1981); *Flood v. Commissioner*, T.C. Memo. 2001-39, 81 T.C.M. (CCH) 1175, 1180 ("A debt becomes worthless in the tax year in which a creditor, using sound business judgment, abandons all reasonable hope of recovery[.]"); sec. 1.166-2(a), Income Tax Regs. Conversely, if any portion of the debt was worthless, petitioner did not show that it became worthless in 2009 rather than in some earlier year. See *Hirsch v. Commissioner*, 124 F.2d 24, 31 (9th Cir. 1941) ("A taxpayer should not be permitted to close his eyes to the obvious, and to carry accounts on his books as good when in fact they are worthless, and then deduct them in a year subsequent to the one in which he must be presumed to have ascertained their worthlessness." (citing *Avery v. Commissioner*, 22 F.2d 6, 7-8 (5th Cir. 1927))), *aff'g* 42 B.T.A. 566 (1940).

After reviewing the parties' contentions and testimony, the court concluded:

> In sum, the IRS did not abuse its discretion in determining that petitioner was not entitled to a deduction of $8.55 million for a partially worthless debt for 2009. Even if petitioner established that his advances were debt and that this debt was a business debt, he did not meet the requirements for deducting a partially worthless debt under section 166(a)(2) and section 1.166-3(a)(2)(iii), Income Tax Regs.[7]
>
> [7] Given our disposition, we need not address respondent's contention that petitioner's deduction should be disallowed because the documents implementing the writedown were executed in February or March 2010 and backdated to 2009.

[1170] LAFA 20153501F argued that the taxpayer created a reserve rather than charging off the debt:

> The purpose of the charge-off requirement is to perpetuate evidence of a taxpayer's election to abandon part of the debt as an asset. *Findley v. Commissioner*, 25 T.C. 311, 319 (1955), *aff'd per curium*, 236 F.2d 959 (3d Cir. 1956) (emphasis added). An increase in a general reserve account does not constitute the required charge off. *International Proprietaries. Inc. v. Commissioner*, 18 T.C. 133 (1952). The taxpayer's intent to abandon the charged-off portion of the debt must be reflected in its books and records. *Id.*

[1171] Reg. § 1.166-5(a)(2). *Rutter v. Commissioner*, T.C. Memo. 2017-174, elaborated:

> To give rise to a deduction under section 166(a)(1), a debt must have become wholly worthless during the tax year. Sec. 1.166-3(b), Income Tax Regs.; see *Bodzy v. Commissioner*, 321 F.2d 331, 335 (5th Cir. 1963), *aff'g* in part, *rev'g* in part T.C. Memo. 1962-40. In the case of a partially worthless debt, section 166(a)(2) provides that, "[w]hen satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction." "Before a taxpayer may deduct a debt in part, he must be able to demonstrate to the satisfaction of the district director the amount thereof which is worthless and the part thereof which has been charged off." Sec. 1.166-3(a)(2)(iii), Income Tax Regs.

[1172] *Bunch v. Commissioner*, TC Memo. 2014-177, held:

> Section 166(a) allows a deduction for the taxable year in which a business debt becomes wholly or partially worthless. The year in which a debt becomes worthless is fixed by identifiable events that make it reasonable for the lender to abandon any hope of recovery. *Crown v. Commissioner*, 77 T.C. 582, 598 (1981). "When a debt becomes worthless is to be decided by the trier of fact." *Am. Off-shore, Inc. v. Commissioner*, 97 T.C. 579, 594 (1991) (citing *Cole v. Commissioner*, 871 F.2d 64, 66 (7th Cir. 1989), *aff'g* T.C. Memo. 1987-228).
>
> Ascertaining when a debt becomes worthless requires "examination of all the circumstances." *Dallmeyer v. Commissioner*, 14 T.C. 1282, 1291 (1950). There is no standard test or formula for determining worthlessness, but relevant factors include the debtor's solvency, the lender's collection efforts, and subsequent dealings between the parties. See *Lucas v. Am. Code Co.*, 280 U.S. 445, 449 (1930); *Aston v. Commissioner*, 109 T.C. 400, 415 (1997); *Am. Offshore, Inc.*, 97 T.C. at 594; sec. 1.166-2(a), Income Tax Regs. The taxpayer must establish objective facts from which worthlessness can be determined; mere belief that a debt has gone bad is insufficient. *Fox v. Commissioner*, 50 T.C. 813, 822-823 (1968), *aff'd per curiam*, 70-1 U.S. Tax Cas. (CCH) para. 9373 (9th Cir. 1970). A taxpayer is not required to take legal action to enforce payment where it "would in all probability not result in the satisfaction of execution on a judgment." Sec. 1.166-2(b), Income Tax Regs.
>
> In evaluating a taxpayer's contention that a debt has become wholly or partially worthless, we give weight to the creditor's "soundly exercised business judgment." *Portland Mfg. Co. v. Commissioner*, 56 T.C. 58, 73 (1971). We do not require a creditor to pursue "theoretical possibilities" of recovery that ignore the "realities of the business environment." *ABC Beverage Corp. v. Commissioner*, T.C. Memo. 2006-195, 92 T.C.M. (CCH) 268, 272. "Whether a bad debt deduction is proper must be analyzed according to 'reasonableness, commonsense and economic reality." *Id.* At 271 (quoting *Scoville Mfg. Co. v. Fitzpatrick*, 215 F.2d 567, 570 (2d Cir. 1954)).

A loss may be a business bad debt only if the taxpayer was engaged in a trade or business and the debt was proximately related to that trade or business;[1173] and whether the debt has a proximate relationship to the taxpayer's trade or business turns on the taxpayer's dominant motivation in making the loan.[1174] *Bercy v. Commissioner*, T.C. Memo. 2019-118, described one taxpayer's lending business, viewing the business' scope broadly:

> We find that Mr. Bercy was engaged in a distinct trade or business of lending money. Aside from his activities on behalf of Argus and Astin-Carr,[3] Mr. Bercy personally made loans to a variety of borrowers, solely for his own account, on a regular basis. His personal lending activity was substantial, comprising numerous loans totaling an estimated $25 million. And he engaged in this activity with the intent of making a profit.

Even if we were to accept that the proof of claim established the amount of petitioners' loss, the document does not establish that petitioners had no hope of recovery in 2006. On the contrary, it tends to establish the reverse: By filing a proof of claim in Mortgage Co.'s bankruptcy, petitioners took the requisite step to secure a place in the order of distribution from the bankruptcy estate and thereby increased their odds of recovering at least some of the loaned funds.

[1173] *Bercy v. Commissioner*, T.C. Memo. 2019-118, citing *Putoma Corp. v. Commissioner*, 66 T.C. 652, 673 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979).

[1174] *Bercy v. Commissioner*, T.C. Memo. 2019-118, citing *Putoma Corp.*, 66 T.C. at 673.

[3] Argus was engaged in the business of making real estate loans, and Mr. Bercy supplied capital to Argus directly (as a shareholder of that S corporation) and through Astin-Carr (an entity he wholly owned). Petitioners do not contend that Mr. Bercy should be deemed to be in the lending business solely by virtue of the activities conducted by his S corporation. *Cf. Dagres v. Commissioner*, 136 T.C. 263, 289 (2011) (holding that managing member of an LLC was deemed to carry on the lending business of his LLC).

Mr. Aken credibly testified that he approached Mr. Bercy because he knew that Mr. Bercy was in the lending business. The fact that the two men were unrelated negated any familial motivation for the loan. Mr. Bercy agreed to lend only after investigating Girari's business and finances, performing due diligence as he did for his other loans. To hedge his bet he secured as a co-lender Mr. Levitt, with whom he had previously joined in making a personal property loan. His behavior in connection with the Girari loan was consistent with his general business practices, and that loan was proximately related to his trade or business of lending money. See *Ruppel v. Commissioner*, T.C. Memo. 1987-248, 53 T.C.M. (CCH) 829, 834 ("Since we have held that petitioner was in the trade or business of lending money, it follows that the most significant loans created with respect to that business were proximately related to it unless the facts show some other reason for the loan.").

Respondent concedes that "Mr. Bercy was admittedly engaged in the business of real estate lending." But respondent contends that making personal property loans was outside the scope of that business. And in respondent's view, the scale of Mr. Bercy's non-real-estate lending activity was insufficiently robust to constitute a "trade or business" distinct from his business of real estate lending.

We are not persuaded to construe the term "trade or business" so narrowly in this context. When previously considering the status of loans as "business debts" under section 166, we have not segmented the taxpayer's lending business according to the nature of the loan or type of customer. Rather, we have simply asked whether the taxpayer was in the business of lending money, separate and distinct from any other gainful employment he or she may have had. See, *e.g.*, *Yaryan v. Commissioner*, T.C. Memo. 2018-129, at *26 ("The parties agree that petitioners were not in a trade or business of lending funds."); *Owens v. Commissioner*, T.C. Memo. 2017-157, 114 T.C.M. (CCH) 188, 194 (inquiring whether the taxpayer's "personal lending was a trade or business"); *Hatcher v. Commissioner*, T.C. Memo. 2016-188, 112 T.C.M. (CCH) 415, 418 (finding that the taxpayer "was not engaged in the trade or business of lending money"), *aff'd*, 726 F. App'x 207 (5th Cir. 2018); *Ruppel*, 53 T.C.M. (CCH) at 832 (requiring the taxpayer to show "that he was in the trade or business of lending money"); *Jessup v. Commissioner*, T.C. Memo. 1977-289, 36 T.C.M. (CCH) 1145, 1150 (finding that the taxpayer was "in the business of making loans").

When a manager of venture capital funds loaned money to a business associate who provided leads on companies in which the venture capital funds might invest, with the expectation that the lender would receive carried interests in the venture capital fund, the loan was made in the trade or business of managing venture capital funds.[1175] Key is whether the lender merely expects a normal investor's return (not a trade or business)[1176] or is "flipping" businesses.[1177]

[1175] *Dagres v. Commissioner*, 136 T.C. 263 (2003). This case involved a number of factors when taking a bad debt deduction, such that it is worth reproducing the heart of the court's analysis:

> …We have held that the General Partner L.L.C.s' activity was not mere investment but was the trade or business of managing venture capital funds. Consequently, it follows that Mr. Dagres was in that trade or business.
>
> However, as we have noted, Mr. Dagres was also an investor (i.e., of his portion of 1 percent of the Venture Fund L.P.'s capital), and if his loan to Mr. Schrader was proximately related to his investment interest, then the resulting bad debt was not a business bad debt. Moreover, Mr. Dagres was also a salaried employee of BMC and was therefore in the trade or business of being an employee. If his loan to Mr. Schrader was proximately related to his employment, rather than to the venture capital business, then the deduction of the resulting bad debt loss is severely limited. See *supra* part II.A. We must therefore determine to which of these activities--his investment, his employment, or his venture capital management--the loan was proximately related.
>
> In *United States v. Generes*, 405 U.S. at 103, the Supreme Court indicated that when determining whether a bad debt has a proximate relation to a taxpayer's trade or business and therefore qualifies as a business bad debt, the question to ask is whether the "dominant motivation" for the loan was business; a merely "significant motivation" is insufficient to show a proximate relation. In *Generes*, the Supreme Court held that the dominant motivation for the taxpayer's lending money to his company was not the business motive of protecting his modest salary; rather, in addition to protecting his son-in-law's livelihood, he was motivated to protect his sizable investment in the company. *Id.* at 106. Accordingly, non-business motives prompted the loan, and therefore the loss was not a business bad debt.
>
> In this case, however, Mr. Dagres's compensation for his work as a manager of the Venture Fund L.P.s--*i.e.*, his share of the 20-percent profits interest and the 2-percent management fee--exceeded by twenty-fold his share of the return on the 1-percent investment. Moreover, although his salary from BMC (i.e., his share of the management fees) was significant in absolute terms (nearly $11 million in five years, of which he received almost $2.6 million in the year of the loan), his carry was clearly dominant ($43 million of capital gains in those same five years, of which $40 million was carry received in the year of the loan). He lent $5 million to Mr. Schrader to protect and enhance what he considered a valuable source of leads on promising companies in which, as Member Manager of General Partner L.L.C.s, he could invest the money of the Venture Fund L.P.s, help manage those companies, and earn substantial income in the form of carry. Mr. Dagres's carry significantly exceeded both his salary and his return on his own investment. We are satisfied that venture capital motives and not employment or investment motives were the primary motivation for his loan. It is that venture capital business motive that characterizes the subsequent bad debt loss.

[1176] *Rutter v. Commissioner*, T.C. Memo. 2017-174, elaborated:

> … we have held that a taxpayer is not in the business of being a "promoter" where he is entitled to no compensation other than a normal investor's return. See, *e.g.*, *Dagres*, 136 T.C. at 281-282 (noting that a promoter "receives not just a return on his own investment but compensation attributable to his services"); *Deely v. Commissioner*, 73 T.C. 1081, 1095-1096 (1980) (stating that, "in order for a promoter to be engaged in a trade or business for tax purposes he must do so for `compensation other than the normal investor's return'" (quoting *Millsap v. Commissioner*, 46 T.C. 751, 756 (1966), *aff'd*, 387 F.2d 420 (8th Cir. 1968))); *Ackerman v. Commissioner*, T.C. Memo. 2009-80, 97 T.C.M. (CCH) 1392, 1414 (finding no trade or business as "promoter" where taxpayer did not receive fees or commissions for providing advisory services). Here, petitioner received no fees, commissions, or other compensation for his services. He expected to receive the return that equity investors normally hope for, namely, long-term gain upon appreciation or sale of IM's assets.

If a loss is not connected with a trade or business, generally it must be incurred in any transaction entered into for profit.[1178] That standard requires that the taxpayer's "primary reason for investing … was to make an economic profit, or in other words, a profit without consideration to any tax benefit flowing from the [investment]."[1179]

See also part II.G.4.l.i Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit.

For deducting loans to corporations, see part II.G.4.b C Corporations, particularly fns. 1185-1187.

II.G.4.a.iv. Extension of Statute of Limitations for Deduction for Bad Debt or Worthless Securities

Code § 6511(d) provides a 7-year statute of limitations of certain deductions for bad debt or worthless securities rather than the normal 3-year statute of limitations.

II.G.4.a.v. Tax Effect of Loan to S Corporation or Partnership

Loans to S corporations or partnerships can allow the owner who is a lender to deduct losses against the owner's basis in the loan; this generally generates ordinary losses and, to the extent of those losses, that one does not need to worry about whether writing off that part of the loan would be a business bad debt or a nonbusiness bad debt. See part II.G.4.c Basis Limitations for Deducting Partnership and S Corporation Losses.

However, a loan to a partnership can backfire if the loan is not repaid until the partnership is rescued by an angel investor's infusing capital. In that case, the lending partner would contribute the loan to the partnership in exchange for a partnership interest. Unfortunately, often the founder will receive only pennies on the dollar for the founder's original investment (capital and debt):

- To the extent that the amount of debt contributed to the partnership exceeds the value of the partnership interest that the lending partner received in exchange for that debt, the

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[1177] *Rutter v. Commissioner*, T.C. Memo. 2017-174, suggested:

> A taxpayer may be able to show that he is engaged in business as a "promoter" or "trader" if he establishes that his goal is to earn profits by "flipping" assets, *i.e.*, making quick and profitable sales of real estate, securities, or other property. See, *e.g.*, *Assaderaghi v. Commissioner*, T.C. Memo. 2014-33. Central to these holdings is that the taxpayer aimed for profit from frequent short-term sales, not from patient long-term investment. "It is the early resale which makes the profits income received directly for services, for the longer an interest is held, the more profit becomes attributable to the successful operation of the corporate business." *Deely*, 73 T.C. at 1093-1094; see *Millsap*, 46 T.C. at 756-757.

[1178] Code § 165(c)(2). Code § 165(c)(3) also allows a taxpayer to deduct nonbusiness losses that "arise from fire, storm, shipwreck, or other casualty, or from theft."

[1179] *McElroy v. Commissioner*, T.C. Memo. 2014-163, citing:

> *See Fox v. Commissioner*, 82 T.C. 1001, 1018-1027 (1984); *see also Friedman v. Commissioner*, 869 F.2d 785, 789-790 (4th Cir. 1989), *aff'g Glass v. Commissioner*, 87 T.C. 1087 (1986); *cf. Surloff v. Commissioner*, 81 T.C. 210, 233 (1983) (noting that an intent to make a profit for purposes of section 162 requires an intent to make an economic profit, independent of tax savings).

See also part II.G.17 Economic Substance for the possibility of penalties for tax-motivated transactions not entered into for either profit or a Congressionally approved tax benefit (such as a tax credit).

partnership will have cancellation of indebtedness (COD) income.[1180] Generally, partnership agreements require income to be allocated to a partner to the extent that the partner deducted losses against the debt. Therefore, the lending partner would be allocated all of this COD income; this allocation essentially is a recapture of the lending partner's prior losses and gives the lending partner basis in the partnership interest.

- If, instead of lending money to the partnership, the partner had contributed the money, the partner would have avoided this COD income. Providing a priority return of capital might be adequate to let that partner be repaid. If enough money is at stake to justify the complexity, consider providing a preferred partnership interest instead of a loan.[1181] Realistically, the only way the loan would be repaid would be if the partnership makes money. Furthermore, a preferred return could be high enough to provide reward commensurate with risk. If the preferred return needs to be eliminated in an angel investor rescue, the restructuring would generate any adverse consequences.

See part II.C.3.d Deducting Interest Expense on Debt Incurred by a Partnership, which applies to S corporations to a large degree.

II.G.4.b. C Corporations: Losses Incurred by Business, Owner, or Employee

C corporations are taxed on their own operations. C corporations that have losses carry them back or forward to other years; C shareholders generally may not take current deductions for a decrease in the value of their stock unless the stock becomes worthless.[1182] A taxpayer who

[1180] Code § 108(e)(8); Reg. § 1.108-8 (subsection (c) has a specific example, but the example involved a creditor who was not also a partner). If and to the extent that the value of the partnership interest issued in exchange for the debt is attributable to accrued interest, the lender partner is taxed on that interest. Reg. § 1.721-1(d)(2).

[1181] The preferred partnership interest must not be a substitute for debt. The fact that the partner already has a regular partnership interest should help significantly; *see, e.g.*, parts II.G.20 Debt vs. Equity; Potential Denial of Deduction for Business Interest Expense and III.B.7.c.viii Creative Bonus Arrangements (discussing when a financial interest might rise to the level of being a partner). The interest component should not be based on fixed or variable interest rates, because then it looks like a loan under Code § 707(a). Instead, it would be a preference on cash flow and structured so as not to be a guaranteed payment; *see* Reg. § 1.707-1(c).

[1182] *Bilthouse v. U.S.*, 553 F.3d 513 (7th Cir. 2009), held:

> The worthlessness of a stock as of a particular year is a factual inquiry, varying according to the circumstances of each case. *Boehm v. Comm'r*, 326 U.S. 287, 293 (1945); see *United States v. Davenport*, 412 F. Supp. 2d 1201, 1207 (W.D. Okla. 2005). Although section 165(g) does not define "worthless," most courts consider both the liquidating value and the potential value of the company to determine the year of worthlessness. See *Morton v. Comm'r*, 38 B.T.A. 1270, 1278 (B.T.A. 1938), aff'd 112 F.2d 320 (7th Cir. 1940) (worthlessness of stock depends on current liquidating value and potential value); see also *Delk v. Comm'r*, 113 F.3d 984, 986 (9th Cir. 1997); *Figgie Int'l, Inc. v. Comm'r*., 807 F.2d 59, 62 (6th Cir. 1986).

Continuing to earn substantial revenue suggests that the corporation might not be worthless. *In Re: Carpenter*, 118 A.F.T.R.2d 2016-XXXX (Bankruptcy. Ct. MT 9/15/2016) held that stock became worthless when the corporation ceased operations and its creditor seized its assets. The court applied the following:

> The tax court set forth a test for determining whether stock is worthless:
>
> > The ultimate value of stock, and conversely its worthlessness, will depend not only on its current liquidating value, but also on what value it may acquire in the future through foreseeable operations of the corporation. Both factors of value must be wiped out before we can definitely fix the loss. If the assets of the corporation exceed its liabilities, the stock has

tried to deduct his C corporation's losses, claiming that the he incurred the losses and the C corporation was merely his agent, was penalized for taking that position.[1183]

A founding shareholder might be able to take an ordinary loss of up to $50,000 ($100,000 for joint returns) on the sale of stock under Code § 1244.[1184]

A shareholder who loans money to a C corporation that cannot repay the loan might be stuck deducting the loan as a nonbusiness bad debt, which is deducted as a short term capital loss (deductible each year against only capital gains plus up to $3,000 of other income) rather than an ordinary loss;[1185] alternatively, if the primary purpose of the debt is to preserve the

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> > liquidating value. If its assets are less than its liabilities but there is a reasonable hope and expectation that the assets will exceed the liabilities of the corporation in the future, its stock, while having no liquidating value, has potential value and can not be said to be worthless. The loss of potential value, if that exists, can be established ordinarily with satisfaction only by some "identifiable event" in the corporation's life which puts an end to such hope and expectation.
>
> *Morton v. Comm'r*, 38 B.T.A. 1270, 1278–1279 (1938), *aff'd* 112 F.2d 320 (7th Cir. 1940). The Ninth Circuit more recently echoed this test:
>
> > Securities may not be considered worthless, even when they have no liquidating value, if there is a reasonable hope and expectation that they will become valuable in the future. *Lawson v. Commissioner*, 42 B.T.A. 1103, 1108, 1940 WL 144 (1940). But, "such hope and expectation may be foreclosed by the happening of certain events such as the bankruptcy, cessation from doing business, or liquidation of the corporation, or the appointment of a receiver...." *Morton v. Commissioner*, 38 B.T.A. 1270, 1278, 1938 WL 165 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940). To establish worthlessness, the taxpayer "must show a relevant identifiable event ... which clearly evidences destruction of both the potential and liquidating values of the stock." *Austin Co. v. Commissioner*, 71 T.C. 955, 970, 1979 WL 3593 (1979). The burden of establishing worthlessness is on the taxpayer. *Figgie Int'l Inc. v. Commissioner*, 807 F.2d 59, 62 (6th Cir. 1986).
>
> *Delk v. C.I.R.*, 113 F.3d 984, 986 (9th Cir. 1997). *See also Textron, Inc . v. U.S.*, 418 F.Supp. 39, 44-47 (D. RI 1976) (requiring that the stock be wholly worthless and that the "deduction for a worthless security be claimed for the year in which said security becomes worthless without the benefit of hindsight").

[1183] *Barnhart Ranch, Co. v. Commissioner*, T.C. Memo. 2016-170.

[1184] See part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation. A trust or estate is not eligible for this treatment. Part II.J.11.b Code § 1244 Treatment Not Available for Trusts.

[1185] *Haury v. Commissioner*, T.C. Memo 2012-215. Advances that were not documented as loans were treated as equity in *Ramig v. Commissioner*, 110 A.F.T.R.2d 2012-6450 (9th Cir. 2012), an "unpublished" opinion affirming an unpublished Tax Court opinion. Same result in *Herrera v. Commissioner*, T.C. Memo. 2012-308 (imposing accuracy-related penalty), which focused on lack of consistent documentation, the lack of interest payments, and the lack of a Form 1099 reporting cancellation of indebtedness income, and which cited 13 factors from the Fifth Circuit, the weight to each of which varies by case:

> (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement."

The Fifth Circuit affirmed, at 112 A.F.T.R.2d 2013-6858 (11/11/2013), commenting:

shareholder's job and therefore would be bad debt, presumably the deduction would be an employee business expense, deductible as a miscellaneous itemized deduction; miscellaneous itemized deductions are allowable for regular income tax purposes only to the extent that they exceed 2% of the taxpayer's adjusted gross income and are not deductible at all for alternative minimum tax purposes.[1186] The shareholder must prove that the debt was bona fide and then became worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment.[1187]

For a very brief overview of the principles of this part II.G.4.b, see *Aleamoni v. Commissioner*, T.C. Summ. Op. 2016-21.

… the Treasury Regulations provide that a guaranty payment only qualifies for a bad debt deduction if "[t]here was an enforceable legal duty upon the taxpayer to make the payment." Treas. Reg. § 1.166–9(d)(2). Voluntary payments do not qualify. See id. § 1.166–1(c) ("A gift ... shall not be considered a debt for purposes of section 166."); *see also Piggy Bank Stations, Inc. v. Comm'r*, 755 F.2d 450, 452–53 (5th Cir. 1985).

[1186] See part II.G.4.a Loans to Businesses or Business Associates, especially fn. 1175.

[1187] *Shaw v. Commissioner*, T.C. Memo 2013-170 (taxpayer failed to prove that the advance was a bona fide loan and not a capital contribution and also failed to prove worthless; 20% accuracy-related penalty imposed), *aff'd* 116 A.F.T.R.2d ¶ 2015-5471 (9th Cir. 2015); *Alpert v. Commissioner*, TC. Memo. 2014-70 (similar result outside a corporate setting).

II.G.4.c. Basis Limitations for Deducting Partnership and S Corporation Losses

II.G.4.c.i. Overview of Pass-Through Basis Limitations

Owners generally may deduct losses to the extent of the owners' basis in their S stock[1188] or partnership interest;[1189] this basis includes certain debt basis, as described below.

Page E-10 of the 2019 Instructions to Schedule E explains what happens when losses have been limited by basis and no longer are:

> **Losses Not Allowed in Prior Years Due to the Basis or At-Risk Rules**
>
> - Enter your total prior year unallowed losses that are now deductible on a separate line in column (i) of line 28. Do not combine these losses with, or net them against, any current year amounts from the partnership or S corporation.
>
> - Enter "PYA" in column (a) of the same line.

[1188] See Code § 1366(d) and Rev. Rul. 2008-16, discussing losses generally and specifically how charitable contributions interact with these limitations. If the shareholder later transfers stock without having been able to use the losses, the losses are permanently disallowed. Reg. § 1.1366-2(a)(5). T.D. 9682 (2014), finalizing regulations using debt to deduct losses as described in part II.G.4.d.ii.(a) Limitations on Using Debt to Deduct S Corporation Losses, commented on stock basis:

> The preamble to the proposed regulations requested comments regarding the basis treatment when an S corporation shareholder or a partner contributes the shareholder's or partner's own note to an S corporation or a partnership. An S corporation shareholder does not increase his basis in the stock of his S corporation under section 1366(d)(1)(A) from a contribution of his own note. See Rev. Rul. 81-187 (1981-2 CB 167) (holding that a shareholder who (i) merely executed and transferred the shareholder's demand note to the shareholder's wholly owned S corporation, and (ii) made no payment on the note until the following year had a zero basis in the note until the following year when the shareholder made a payment on the note). The preamble to the proposed regulations described as one potential model § 1.704-1(b)(2)(iv)(d)(2), which provides that a partner's capital account is increased with respect to non-readily tradable partner notes only (i) when there is a taxable disposition of such note by the partnership, or (ii) when the partner makes principal payments on such note. One commentator recommended consideration of, and consistency with, § 1.166-9(c) (regarding contributions of debt to capital). Another commentator noted that courts have applied the "actual economic outlay" standard to determine when shareholders increase their bases in their S corporation stock. See, for example, *Maguire v. Commissioner*, T.C. Memo. 2012-160. This commentator requested that the final regulations provide that actual economic outlay does not apply to determinations of a shareholder's stock basis under section 1366(d)(1)(A). To expedite finalization of the proposed regulations, the scope of these final regulations is limited to basis of indebtedness. The Treasury Department and the IRS continue to study issues relating to stock basis and may address these issues in future guidance.

[1189] See Code § 704(d). See also Collins, "Charitable Gifts of Partnership Interests and Partnership Property," ACTEC Business Planning Committee (Summer 2008). A partner must prove basis; *Nwabasili v. Commissioner*, T.C. Memo. 2016-220, held:

> The record does not reveal the contributions that Nwabasili made to the partnership or the distributions that the partnership made to him. Without this information, we cannot calculate his adjusted basis in his partnership interest. Because Nwabasili has the burden of proof, we hold that section 704(d) precludes him from deducting any part of the partnership loss.[9]
>
> [9] A similar approach was taken in *Mladinich v. Commissioner*, T.C. Memo. 1969-185, and *Lemons v. Commissioner*, T.C. Memo. 1997-404.

For basis limitations, see parts II.G.4.d Basis Limitation for Shareholders in an S Corporation, II.G.4.e Basis Limitations for Partners in a Partnership, and II.G.4.g Limitations on Deducting Charitable Contributions. These basis limitations provide more optionality for S corporations than for partnerships:

- When an S corporation borrows from a third party, its owners do not get basis for the borrowing, even if they provide very strong guarantees to the lenders. An owner gets basis from a loan only if the owner is the lender. However, if an owner borrows from a lender and loans that money to the S corporation, the owner gets basis. In such a back-to-back loan, the owner may take a security interest in the company's assets and then assign that security interest to the lender, so that the lender has a security interest in the company's assets. By choosing between a back-to-back loan and a direct loan from a lender to the company, the owner can determine how much basis is available to absorb losses.

- When a partnership borrows from a third party, its owners are allocated the liabilities and get basis for the borrowing. Guarantees may change how the liabilities are allocated among the owners, but they do not change whether the liabilities are allocated to the owners as a whole.

The at-risk rules are in part II.G.4.j At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities). An example of their application is a partner who is allocated a liability but has not guaranteed or otherwise become subjected to paying that liability out-of-pocket; the at-risk rules may prevent that partner from deducting losses against the basis created by that liability. Sometimes partners guarantee liabilities to support losses (which guarantees the IRS will respect only if real), but the most common guarantees are required by lenders.

Suppose a nongrantor trust owns an interest in an S corporation[1190] or a partnership that incurs losses suspended by the basis limitation. When the trust terminates, the suspended losses are lost forever, with no tax benefit.[1191] This reinforces my inclination to draft trusts that last the beneficiary's lifetime, with the beneficiary becoming trustee when appropriate, rather than terminating and artificially forcing the issue of suspended losses going away.

Compare this part II.G.4.c to parts II.K.2.d Effect of Death of an Individual or Termination of Trust on Suspended Passive Losses and II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good. The idea is that suspending a loss and using it against income in a high-earning year may be better than using the loss right away against modest income or income that the standard deduction or itemized deductions already protect from tax.

[1190] Beware of the limitations described in part III.A.3 Trusts Holding Stock in S Corporations.
[1191] In the case of an S corporation, see Reg. § 1.1366-2(a)(6), reproduced in part II.G.4.d.i Basis Limitation Generally. In the case of a partnership, see the fn 1233 and accompanying text in part II.G.4.e Basis Limitations for Partners in a Partnership.

II.G.4.c.ii. Effect of Nontaxable Items on Basis in Pass-Through Entities

The basis of a partnership interest is increased by nontaxable income[1192] and decreased by nondeductible expenses.[1193] Similarly, the basis of S corporation stock is increased by nontaxable income[1194] and decreased by nondeductible expenses.[1195]

Despite this basis increase, nontaxable income does not increase AAA – the amount an S corporation that had been a C corporation can distribute before dipping into its earnings and profits that make part or all of a distribution be a taxable dividend. See part II.P.3.b.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds, which is fleshed out in part II.Q.7.b.iv.(a) S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations. If the S corporation has no C corporation earnings and profits or never was a C corporation, this paragraph is a nonissue.

May nontaxable income that generate basis that supports losses? Theoretically, yes. However, consider Code § 265(a)(1), which provides:

> *Expenses*. Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle, or any amount otherwise allowable under section 212 (relating to expenses for production of income) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.

Manocchio v. Commissioner, 78 T.C. 989 (1982), was a unanimous reviewed decision, with the following Official Tax Court Syllabus at 989-990:[1196]

[1192] Code § 705(a)(1)(B), referring to "income of the partnership exempt from tax under this title."

[1193] Code § 705(a)(2)(B), referring to "expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account."

[1194] Code § 1367(a)(1)(B), referring to "any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1)." Code § 1367 is reproduced in part II.G.4.d.i Basis Limitation Generally. Code § 1366(a), "Determination of shareholder's tax liability," provides:

> (1) *In general*. In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's
>
> (A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and
>
> (B) nonseparately computed income or loss.
>
> For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702(a).
>
> (2) *Nonseparately computed income or loss defined*. For purposes of this subchapter, the term "nonseparately computed income or loss" means gross income minus the deductions allowed to the corporation under this chapter, determined by excluding all items described in paragraph (1)(A).

[1195] Code § 1367(a)(1)(B), referring to "any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1)." Code § 1367 is reproduced in part II.G.4.d.i Basis Limitation Generally. Code § 1366(a)(1) is reproduced in fn 1194.

[1196] At 997, the court pointed out:

> During 1977, petitioner, an airline pilot and an Air Force veteran, attended a flight-training course which maintained and improved skills required in his trade or business. Pursuant to 38 U.S.C. sec. 1677 (1976), he received checks from the Veterans' Administration (VA) totaling 90 percent of the cost of the classes and endorsed them over to the flight-training school. Because the payments received were exempt from taxation under 38 U.S.C. sec. 3101(a) (1976), petitioner did not report them on his 1977 Federal income tax return. He did, however, deduct the entire cost of the flight-training course, including the portion which had been reimbursed by the VA. *Held*, the reimbursed flight-training expenses are allocable to a class of tax-exempt income - the reimbursement - and, therefore, are nondeductible under sect. 265(1), I.R.C. 1954. *Held*, further, respondent is not estopped from disallowing a deduction for such amounts.

Although a couple of cases had held reimbursed expenses were not deductible, a large majority of the court viewed Code § 265 as the strongest ground for disallowance. The Ninth Circuit affirmed, 710 F.2d 1400 (1983), but on the grounds that reimbursed expenses are not deductible; it declined to pass on the merits of Code § 265. *Benningfield v. Commissioner*, 81 T.C. 408 (1983), which did not involve tax-exempt income, cited with approval the Ninth Circuit's opinion that reimbursed expenses are not deductible.

Relying on the Tax Court in *Manocchio*, Rev. Rul. 83-3 disallows deductions attributable to tax-exempt income when a veteran incurs educational expenses allocable to veterans benefits that are exempt from taxation or a student incurs educational expenses if allocable to a scholarship that is excluded from gross income under Code § 117.[1197] Rev. Rul. 83-3 describes how to allocate expenses in those cases. Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts* (WG&L), ¶ 22.7. Expenses Related to Tax-Exempt Income, recites a litany of cases generally consistent with this disallowance.

> Moreover, we do not view our decision in this case as having any effect on the exemption provided by 38 U.S.C. sec. 3101(a) with respect to flight-training benefits. Although it is true that petitioner is left in the identical situation, from the standpoint of tax consequences, as if he had received a taxable reimbursement, in which case section 265 would not bar his deduction, there will obviously be instances where the veteran's flight-training expenses will be nondeductible irrespective of section 265. For example, the expenses might not satisfy the conditions for deductibility imposed by section 1.162-5, Income Tax Regs., or, assuming they do, the veteran might not have sufficient itemized deductions to take advantage of the deduction. In either of these situations, he would realize additional taxable income in the absence of the exemption provision.
>
> In short, there is nothing in the legislative history of the relevant veterans' provisions to suggest that Congress intended for a veteran to have both an exemption and a tax deduction where his reimbursed flight-training expenses otherwise qualify as deductible business-related education. On the other hand, the legislative purpose behind section 265 is abundantly clear: Congress sought to prevent taxpayers from reaping a double tax benefit by using expenses attributable to tax-exempt income to offset other sources of taxable income. This is precisely what petitioner is attempting to do here, and in our judgment, the application of section 265(1) to disallow the reimbursed portion of the flight-training expense deduction is both reasonable and equitable.

[1197] It also disallowed deductions when a minister incurs interest and taxes paid on a personal residence to the extent that the amounts expended are allocable to a rental allowance excluded from gross income under Code § 107. Rev. Rul. 85-96 modifies the formula for a minister, but Rev. Rul. 87-32 changes how that rule is applied, obsoleting Rev. Rul. 85-96 and also recognizing that then-new Code § 265(a)(6) prevents Code § 265 from denying a deduction for "interest on a mortgage on, or real property taxes on, the home of the taxpayer by reason of the receipt of an amount as (A) a military housing allowance, or (B) a parsonage allowance excludable from gross income under section 107."

If income is exempt from tax because the recipient is a tax-exempt organization, related expenditures are similarly nondeductible.[1198]

A corollary to the idea that reimbursed expenses are not deductible is the tax benefit rule, which states that reimbursements of previously deducted expenses are income. Some tax preparers take the position that one may deduct the expenses in one year and then not recapture the income in a later year if an exception to the tax benefit rule provides relief. For further discussion of tax issues, see part II.G.4.m.iii Tax Benefit Rule.

When a loan is forgiven under the rules of the SBA Paycheck Protection Program (PPP), the debt cancellation is not taxable. However, the debt is forgiven only if certain expenses are incurred, so Notice 2020-32 confirms that those expenses are not deductible in the amount of the loan forgiveness and Rev. Rul. 2020-27 provides procedures. However, Rev. Rul. 2021-2 revoked Notice 2020-32 and Rev. Rul. 2020-27 due to section 278(a) of the Consolidated Appropriations Act, 2021, the latter which provides:

> UNITED STATES TREASURY PROGRAM MANAGEMENT AUTHORITY. For purposes of the Internal Revenue Code of 1986 -
>
> (1) no amount shall be included in the gross income of a borrower by reason of forgiveness of indebtedness described in section 1109(d)(2)(D) of the CARES Act,
>
> (2) no deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income provided by paragraph (1), and

---

[1198] *Anclote Psychiatric Center Inc. v. Commissioner*, T.C. Memo. 1998-273:

> We are satisfied that the FPCF liabilities are allocable to petitioner's hospital income in the periods prior to the sale of the hospital and that section 265(1) applies. That being the case, the fact that those payments might have been deductible under section 162(a) had petitioner's hospital business produced taxable income becomes irrelevant since section 265(1) prevails over section 162(a) by disallowing deductions falling within its ambit which are "otherwise allowable". See *supra* note 12 [citing Code § 265]; see also *Stroud v. United States*, 906 F.Supp. 990, 996 (D.S.C. 1995), *affd. in part and vacated in part* without published opinion 94 F.3d 642 (4th Cir. 1996); *Rickard v. Commissioner*, 88 T.C. 188, 193-194 (1987). The fact that the nontaxability of the hospital income derived from petitioner's status rather than from the character of the income as such does not prevent the application of section 265(1). As we stated in *Rickard v. Commissioner*, *supra* at 193-194, where the tax exemption attaching to the taxpayer's farm income derived from his status as an Indian and the location of the farm on Indian land:
>
> > The legislative purpose behind section 265 is abundantly clear: Congress sought to prevent taxpayers from reaping a double tax benefit by using expenses attributable to tax-exempt income to offset other sources of taxable income. *Manocchio v. Commissioner*, 78 T.C. 989, 997 (1982), *affd*. 710 F.2d 1400 (9th Cir. 1983). More importantly, the Supreme Court has concluded that Congress intended to limit deductions to those expenses related to taxed income. *Rockford Life Insurance Co. v. Commissioner*, 292 U.S. 382 (1934). *** [Fn. refs. omitted.)
>
> Nor is it relevant that the tax-exempt income to which FPCF relates was earned by petitioner in an earlier year. In *Stroud v. United States*, *supra*, the taxpayer was denied a deduction for amounts paid in the taxable year because of a breach of contract to provide medical service in return for a tax-exempt scholarship received in an earlier year.
>
> We hold that the FPCF payments in question are not deductible.

(3) in the case of a borrower that is a partnership or S corporation -

(A) any amount excluded from income by reason of paragraph (1) shall be treated as tax exempt income for purposes of sections 705 and 1366 of the Internal Revenue Code of 1986, and

(B) except as provided by the Secretary of the Treasury (or the Secretary's delegate), any increase in the adjusted basis of a partner's interest in a partnership under section 705 of the Internal Revenue Code of 1986 with respect to any amount described in subparagraph (A) shall equal the partner's distributive share of deductions resulting from costs giving rise to forgiveness described in section 1109(d)(2)(D) of the CARES Act.

As tax-exempt income, PPP forgiveness does not increase an S corporation's accumulated adjustments account (AAA). Instead, it increases the other adjustments account (OAA). For the importance of these ideas, see part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally. However, that is not the whole story. The IRS takes the position that deductible expenses relating to PPP, which one might assume would reduce AAA because they are deductible, are reclassified from AAA to OAA. By reducing expenses allocated to AAA, PPP forgiveness indirectly increases AAA! The IRS' position is reflected not in any formal pronouncements but rather the following from the Instructions to 2022 Form 1120-S:

Column (d). Other Adjustments Account

The other adjustments account is adjusted for tax-exempt income (and related expenses) and federal taxes attributable to a C corporation tax year. After these adjustments are made, the account is reduced for any distributions made during the year. See Distributions, later.

An S corporation should include tax-exempt income from the forgiveness of PPP loans in column (d) on line 3 of the Schedule M-2.

An S corporation should report expenses paid this year with proceeds from PPP loans that were forgiven this year in column (d) on line 5 of the Schedule M-2.

If column (a) on line 2 or line 4 of the Schedule M-2 includes expenses paid with proceeds from forgiven PPP loans, an S corporation should report that amount in column (a) on line 3 and in column (d) on line 5 of the Schedule M-2.

If column (a) on line 1 of the Schedule M-2 includes expenses that were paid in a prior year with proceeds from PPP loans that were forgiven this year, an S corporation should report that amount in column (a) on line 3 and in column (d) on line 5 of the Schedule M-2.

Rev. Proc. 2021-48, § 3. "Timing Of Tax-Exempt Income," provides:

.01. *Overview*. Subject to section 3.03 of this revenue procedure, a taxpayer that received a PPP Loan may treat tax-exempt income resulting from the partial or complete forgiveness of such PPP Loan as received or accrued:

(1) As, and to the extent that, the taxpayer pays or incurs eligible expenses as described in section 2.01(2). Under this section 3.01(1), a taxpayer that has elected to use the safe harbor provided under Revenue Procedure 2021-20 will be treated as paying or incurring the eligible expenses during the taxpayer's immediately subsequent taxable year following the taxpayer's 2020 taxable year in which the expenses were actually paid or incurred, as described in Revenue Procedure 2021-20;

(2) When the taxpayer files an application for forgiveness of the PPP Loan; or

(3) When the PPP Loan forgiveness is granted.

.02. *Amended returns*. Taxpayers may report tax-exempt income pursuant to section 3.01 on a timely filed original or amended Federal income tax return, information return or administrative adjustment request (AAR) under § 6227 of the Code. *See also* Revenue Procedure 2021-50, 2021-49 I.R.B. ___, released November 18, 2021, allowing an eligible partnership to file an amended Form 1065, *U.S. Return of Partnership Income, as an alternative to filing an AAR, and furnish a corresponding amended Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc.*, to each of its partners. Partners and shareholders that receive amended Forms K-1 as provided in this section 3.02 must file amended Federal income tax returns, information returns or AARs, as applicable, consistent with the Forms K-1 received.

.03. *When PPP Loan is not fully forgiven*. Unless otherwise provided in the 2021 filing year form instructions, if the taxpayer receives forgiveness for an amount of the PPP Loan that is less than the amount that the taxpayer previously treated as tax-exempt income, the taxpayer must make appropriate adjustments on an amended Federal income tax return, information return or AAR, as applicable, for the taxable year(s) in which the taxpayer treated tax-exempt income from the forgiveness of such PPP Loan as received or accrued. Partners and shareholders that receive amended Forms K-1 as provided in this section 3.03 must file amended Federal income tax returns, information returns or AARs, as applicable, consistent with the Forms K-1 received.

.04. *Reporting consistent with this revenue procedure*. The IRS will publish form instructions for the 2021 filing season that will detail how taxpayers can report consistently with sections 3.01 through 3.03 of this revenue procedure. However, taxpayers do not need to wait until the instructions are published to apply this revenue procedure.

.05. *Gross receipts application*. To the extent tax-exempt income resulting from the partial or complete forgiveness of a PPP Loan is treated as gross receipts under a particular Federal tax provision, including but not limited to § § 448(c) and 6033 of the Code, section 3 of this revenue procedure applies for purposes of determining the timing and, to the extent relevant, reporting of such gross receipts.

Rev. Proc. 2021-49 provides additional guidance. Rather than reciting details, here is an excerpt, § 1, "Purpose":

.01. This revenue procedure provides guidance for partnerships and consolidated groups regarding amounts excluded from gross income (tax exempt income) and deductions relating to the Paycheck Protection Program (PPP) and certain other COVID-19 relief programs. More specifically:

(1) This revenue procedure provides guidance for partners and their partnerships regarding:

(a) allocations under § 704(b) of the Internal Revenue Code (Code) of tax exempt income arising from the forgiveness of PPP Loans, the receipt of certain grant proceeds, or the subsidized payment of certain principal, interest and fees;

(b) allocations under § 704(b) of the Code of deductions resulting from expenditures attributable to the use of forgiven PPP Loans or certain grant proceeds, or subsidized payments of certain interest and fees; and

(c) the corresponding adjustments to be made with respect to the partners' bases in their partnership interests under § 705 of the Code.

(2) This revenue procedure also provides guidance under § 1502 of the Code and § 1.1502-32 of the Income Tax Regulations regarding the corresponding basis adjustments for stock of subsidiary members of consolidated groups as a result of tax exempt income arising from certain forgiven PPP Loans, grant proceeds, or subsidized payment of certain principal, interest and fees.

.02. For guidance on the timing of tax exempt income arising from forgiven PPP Loans, see Rev. Proc. 2021-48, 2021-49 I.R.B. ___, released on November 18, 2021.

Similarly, Rev. Proc. 2021-50, § 1, "Purpose," provides:

> This revenue procedure allows eligible partnerships to file amended partnership returns for taxable years ending after March 27, 2020 using a Form 1065, U.S. Return of Partnership Income (Form 1065), with the "Amended Return" box checked, and issue an amended Schedule K-1, Partner's Share of Income, Deductions, Credits, etc. (Schedule K-1), to each of its partners. An eligible partnership may file an amended return under Rev. Proc. 2021-48, 2021-49 I.R.B.___, or Rev. Proc. 2021-49, 2021-49 I.R.B. ___, if the requirements of section 3 of this revenue procedure are met. In order to take advantage of the option to amend provided in this revenue procedure, amended partnership returns must be filed, and corresponding Schedules K-1 must be furnished, on or before December 31, 2021.

The *Journal of Accountancy* (11/1/2020) summarizes accounting issues relating to PPP loan forgiveness.[1199]

[1199] https://www.journalofaccountancy.com/issues/2020/nov/coronavirus-pandemic-accounting-judgments.html.

II.G.4.d. Basis Limitation for Shareholders in an S Corporation

II.G.4.d.i. Basis Limitation Generally

As to S corporations, Code § 1366(d)(1), "Cannot exceed shareholder's basis in stock and debt," provides:

> The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of
>
> (A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and
>
> (B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

The extent to which they may use debt in addition to this is described in part II.G.4.d.ii Using Debt to Deduct S Corporation Losses.

Code § 1367(a) provides the general rules for calculating basis in S corporation stock (Code § 1366 being items in the K-1 the corporation issues the shareholder):

> (1) *Increases in basis*. The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:
>
> (A) the items of income described in subparagraph (A) of section 1366(a)(1),
>
> (B) any nonseparately computed income determined under subparagraph (b) of section 1366(a)(1), and
>
> (C) the excess of the deductions for depletion over the basis of the property subject to depletion.
>
> (2) *Decreases in basis*. The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:
>
> (A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,
>
> (B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),
>
> (C) any nonseparately computed loss determined under subparagraph (b) of section 1366(a)(1),

(D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account,[1200] and

(E) the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under section 613A(c)(11)(B) .

The decrease under subparagraph (b) by reason of a charitable contribution (as defined in section 170(c)) of property shall be the amount equal to the shareholder's pro rata share of the adjusted basis of such property.

"The shareholder bears the burden of establishing his basis in an S corporation."[1201] IRS provides a guide to determining that basis – see https://www.irs.gov/businesses/small-businesses-self-employed/s-corporation-stock-and-debt-basis – and provides a form – see About Form 7203, S Corporation Shareholder Stock and Debt Basis Limitations.

Code § 1366(d)(2), "Indefinite carryover of disallowed losses and deductions," provides:

(A) *In general*. Except as provided in subparagraph (B), any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

[1200] Reg. § 1.1367-1(c)(2) provides:

Noncapital, nondeductible expenses. For purposes of section 1367(a)(2)(D), expenses of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account (noncapital, nondeductible expenses) are only those items for which no loss or deduction is allowable and do not include items the deduction for which is deferred to a later taxable year. Examples of noncapital, nondeductible expenses include (but are not limited to) the following: illegal bribes, kickbacks, and other payments not deductible under section 162(c); fines and penalties not deductible under section 162(f); expenses and interest relating to tax-exempt income under section 265; losses for which the deduction is disallowed under section 267(a)(1); the portion of meals and entertainment expenses disallowed under section 274; and the two-thirds portion of treble damages paid for violating antitrust laws not deductible under section 162. For basis adjustments necessary to coordinate sections 1367 and 362(e)(2), see § 1.362-4(f)(ii).

Among loss disallowances that lose basis under Code § 267 is part II.Q.7.h.iii.(b) Nondeductible Loss to Corporation When It Distributes Property to Shareholders.

[1201] *Hall v. Commissioner*, T.C. Memo. 2014-171, citing *Broz v. Commissioner*, 137 T.C. 46, 60 (2011), *aff'd* 727 F.3d 621 (6th Cir. 2013). The taxpayers asked for trouble and got it:

[The CPA firm] did not prepare a basis schedule for Mr. Hall's basis in Ophthalmic Associates. Instead, [the CPA firm's forensic accountant] testified that he analyzed gross receipts to estimate Mr. Hall's basis. Mr. Hall and Mrs. Hall did not offer into evidence the purported analysis used by [the CPA] to estimate Mr. Hall's basis. Instead, Mr. Hall and Mrs. Hall offered into evidence monthly bank statements for Ophthalmic Associates for January 2005 and December 2006. We note that Mr. Hall and Mrs. Hall did not share these bank statements with respondent before trial pursuant to the Court's pretrial order. Mrs. Hall testified that during the weekend before trial she realized that two of the deposits were actually loans made to Ophthalmic Associates. Mr. Hall and Mrs. Hall did not provide sufficient evidence for us to find that these amounts were loans. We are not required to accept Mr. Hall and Mrs. Hall's self-serving testimony. See *Tokarski v. Commissioner*, 87 T.C. 74, 77 (1986). We find that petitioners have failed to prove that Mr. Hall and Mrs. Hall had a basis in Ophthalmic Associates in an amount greater than respondent determined.

(B) *Transfers of stock between spouses or incident to divorce*. In the case of any transfer described in section 1041(a) of stock of an S corporation, any loss or deduction described in subparagraph (A) with respect such stock shall be treated as incurred by the corporation in the succeeding taxable year with respect to the transferee.

Implementing Code § 1366(d)(2), Reg. § 1.1366-2(a)(6), "Nontransferability of losses and deductions," provides:

(i) *In general*. Except as provided in paragraph (a)(6)(ii) of this section, any loss or deduction disallowed under paragraph (a)(1) of this section is personal to the shareholder and cannot in any manner be transferred to another person. If a shareholder transfers some but not all of the shareholder's stock in the corporation, the amount of any disallowed loss or deduction under this section is not reduced and the transferee does not acquire any portion of the disallowed loss or deduction. If a shareholder transfers all of the shareholder's stock in the corporation, any disallowed loss or deduction is permanently disallowed.

(ii) *Exceptions for transfers of stock under section 1041(a)*. If a shareholder transfers stock of an S corporation after December 31, 2004, in a transfer described in section 1041(a), any loss or deduction with respect to the transferred stock that is disallowed to the transferring shareholder under paragraph (a)(1) of this section shall be treated as incurred by the corporation in the following taxable year with respect to the transferee spouse or former spouse. The amount of any loss or deduction with respect to the stock transferred shall be determined by prorating any losses or deductions disallowed under paragraph (a)(1) of this section for the year of the transfer between the transferor and the spouse or former spouse based on the stock ownership at the beginning of the following taxable year. If a transferor claims a deduction for losses in the taxable year of transfer, then under paragraph (a)(5) of this section, if the transferor's pro rata share of the losses and deductions in the year of transfer exceeds the transferor's basis in stock and the indebtedness of the corporation to the transferor, then the limitation must be allocated among the transferor spouse's pro rata share of each loss or deduction, including disallowed losses and deductions carried over from the prior year.

(iii) *Examples*. The following examples illustrates the provisions of paragraph (a)(6)(ii) of this section:

Example (1). A owns all 100 shares in X, a calendar year S corporation. For X's taxable year ending December 31, 2006, A has zero basis in the shares and X does not have any indebtedness to A. For the 2006 taxable year, X had $100 in losses that A cannot use because of the basis limitation in section 1366(d)(1) and that are treated as incurred by the corporation with respect to A in the following taxable year. Halfway through the 2007 taxable year, A transfers 50 shares to B, A's former spouse in a transfer to which section 1041(a) applies. In the 2007 taxable year, X has $80 in losses. On A's 2007 individual income tax return, A may use the entire $100 carryover loss from 2006, as well as A's share of the $80 2007 loss determined under section 1377(a) ($60), assuming A acquires sufficient basis in the X stock. On B's 2007 individual income tax return, B may use B's share of the $80 2007 loss determined under section 1377(a) ($20), assuming B has sufficient basis in the X stock. If any disallowed 2006 loss is disallowed to A under section 1366(d)(1) in 2007, that loss is prorated between A and B based on their stock ownership at the beginning of 2008. On B's 2008 individual income tax return, B may use that loss, assuming B acquires sufficient basis in the X stock. If neither A nor B acquires any basis during the 2007 taxable year, then as of the beginning of 2008, the corporation will be treated as incurring $50 of loss with respect to A and $50 of loss with respect to B for the $100 of disallowed 2006 loss, and the corporation will be treated as incurring $60 of loss with respect to A and $20 with respect to B for the $80 of disallowed 2007 loss.

Example (2). Assume the same facts as Example 1, except that during the 2007 taxable year, A acquires $10 of basis in A's shares in X. For the 2007 taxable year, A may claim a $10 loss deduction, which represents $6.25 of the disallowed 2006 loss of $100 and $3.75 of A's 2007 loss of $60. The disallowed 2006 loss is reduced to $93.75. As of the beginning of 2008, the corporation will be treated as incurring half of the remaining $93.75 of loss with respect to A and half of that loss with respect to B for the remaining $93.75 of disallowed 2006 loss, and if B does not acquire any basis during 2007, the corporation will be treated as incurring $56.25 of loss with respect to A and $20 with respect to B for the remaining disallowed 2007 loss.

II.G.4.d.ii. Using Debt to Deduct S Corporation Losses

II.G.4.d.ii.(a). Limitations on Using Debt to Deduct S Corporation Losses

Owners of S corporations generally may not deduct losses financed by the corporation's debt except to the extent that the shareholders are the lenders;[1202] instead of guaranteeing a

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[1202] Code § 1366(d)(1)(B) allows deductions against:

> the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

Code § 1367 is reproduced in part II.G.4.d.i Basis Limitation Generally. Code § 1367(c)(2) provides:

> (A) *Reduction of basis*. If for any taxable year the amounts specified in subparagraphs (B), (C), (D), and (E) of subsection (a)(2) exceed the amount which reduces the shareholder's basis to zero, such excess shall be applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder.
>
> (B) *Restoration of basis*. If for any taxable year beginning after December 31, 1982, there is a reduction under subparagraph (A) in the shareholder's basis in the indebtedness of an S corporation to a shareholder, any net increase (after the application of paragraphs (1) and (2) of subsection (a)) for any subsequent taxable year shall be applied to restore such reduction in basis before any of it may be used to increase the shareholder's basis in the stock of the S corporation.

Reg. § 1.1366-2(a)(2)(i) provides:

> *In general*. The term basis of any indebtedness of the S corporation to the shareholder means the shareholder's adjusted basis (as defined in § 1.1011-1 and as specifically provided in section 1367(b)(2)) in any bona fide indebtedness of the S corporation that runs directly to the shareholder. Whether indebtedness is bona fide indebtedness to a shareholder is determined under general Federal tax principles and depends upon all of the facts and circumstances.

corporation's bank loan,[1203] S corporation shareholders should borrow and then loan the proceeds to the corporation to deduct the loss.[1204]

[1203] Reg. § 1.1366-2(a)(2)(ii) provides:

> *Special rule for guarantees*. A shareholder does not obtain basis of indebtedness in the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan. When a shareholder makes a payment on bona fide indebtedness of the S corporation for which the shareholder has acted as guarantor or in a similar capacity, then the shareholder may increase the shareholder's basis of indebtedness to the extent of that payment.

[1204] Reg. § 1.1366-2(a)(2)(iii), Examples (2) (shareholder borrowed from another S corporation she owned and loaned the proceeds to the loss corporation) and (4) (no basis in loan for guarantee, but guarantor received basis in indebtedness when she made payments to the bank because the corporation no longer could).

To cut down on controversy in this area,[1205] regulations focus on whether the corporation's debt to the shareholder is bona fide[1206] and intend to override the "actual economic outlay" doctrine that had been developed.[1207] The preamble to the Proposed Regulations explained:[1208]

[1205] Starr, "How to Obtain Debt Basis in an S Corporation? Use Bona Fide Indebtedness, Say Proposed Rules, Journal of Taxation," *Journal of Taxation* (obtained from the *Journal*'s preview service; probably published November 2012). The author of this article suggests that the Proposed Regulations adopted the recommendations of the American Bar Association's Section of Taxation (the "Tax Section"), http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2010/072610comments.authcheckdam.pdf, in which the author participated. The Tax Section's comments on the Proposed Regulations are at
http://www.americanbar.org/content/dam/aba/administrative/taxation/091712comments2.authcheckdam.pdf (9/17/2012). T.D. 9682 (7/23/2014) adopted the proposed regulations with very few changes. Reg. § 1.1366-5(b) allows taxpayers to rely on Reg. § 1.1366-2(a)(2) with respect to indebtedness between an S corporation and its shareholder that resulted from any transaction that occurred in a year for which the period of limitations on the assessment of tax has not expired before July 23, 2014. Reg. § 1.1366-2(a)(2) preempts case law, which provided unpredictable results. See *Russell v. Commissioner*, T.C. Memo. 2008-246 (shareholders co-signing loans made by others did not provides basis; also, adjusting journal entries regarding loans were not respected because timing was suspicious), *aff'd per curiam United Energy Corporation v. Commissioner*, 106 AFTR.2d 2010-6056 (8th Cir. 2010). On the other hand, the fact that a loan made directly to the shareholder was repaid by the corporation did not mean that the corporation was deemed to have borrowed the money. *Gleason v. Commissioner*, T.C. Memo. 2006-191. If a creditor obtains a judgment against a shareholder who guaranteed a loan to the corporation, the shareholder is not deemed to have made a loan to the corporation until the shareholder actually makes a payment to the creditor. *Montgomery v. Commissioner*, T.C. Memo. 2013-151.

[1206] See part II.G.20.b When Debt Is Recharacterized as Equity for various cases determining whether debt was bona fide.

[1207] The preamble to the proposed regulations, REG-1342042-07, explained:

> The frequency of disputes between S corporation shareholders and the government regarding whether certain loan transactions involving multiple parties, including back-to-back loan transactions, create shareholder basis of indebtedness demonstrates the complexity of and uncertainty about this issue for both shareholders and the government. The Treasury Department and the IRS propose these regulations to clarify the requirements for increasing basis of indebtedness and to assist S corporation shareholders in determining with greater certainty whether their particular arrangement creates basis of indebtedness. These proposed regulations require that loan transactions represent bona fide indebtedness of the S corporation to the shareholder in order to increase basis of indebtedness; therefore, an S corporation shareholder need not otherwise satisfy the "actual economic outlay" doctrine for purposes of section 1366(d)(1)(B).

The IRS had attacked loans that seem too circular. See, e.g. TAM 200619021, which was upheld in *Kerzner v. Commissioner*, T.C. Memo. 2009-76 (S corp. paid rent to partnership owned by its shareholders, partnership then loaned rent to its partners, who then loaned the same money to the S corp.). The preamble to the Proposed Regulations summarized these cases, some of which are cited in the *Kerzner* case as well. See Example 4 of the regulations, discussed in fn. 1212, for comments on the circular flow of funds and the *Kerzner* case.

[1208] The preamble cites the following cases as examples:

> *Knetsch v. U.S.*, 364 U.S. 361 (1960) (disallowing interest deductions for lack of actual indebtedness); *Geftman v. Comm'r*, 154 F.3d 61, 68-75 (3d Cir. 1998) (based on the objective attributes and the economic realities of the transaction, holding that the transaction at issue was not a bona fide debt); *Estate of Mixon v. U.S.*, 464 F.2d 394, 402 (5th Cir. 1972) (discussion of factors indicative that debt is bona fide); *Litton Business Systems, Inc. v. Comm'r*, 61 T.C. 367, 376-77 (1973).

The article at footnote 1205 discusses the approaches recommended by the AICPA and the Section of Taxation of the American Bar Association took regarding what is bona fide debt.

> The key requirement of these proposed regulations is that purported indebtedness of the S corporation to a shareholder must be bona fide indebtedness to the shareholder. These proposed regulations do not attempt to provide a different standard for purposes of section 1366 as to what constitutes bona fide indebtedness. Rather, general Federal tax principles — many of which have developed outside of section 1366 — determine whether indebtedness is bona fide.

Final Regulations retained this rule, without any changes.[1209]

The Regulations provide some helpful examples:

- A shareholder who lends money to an S corporation has basis of indebtedness, even if the shareholder's wholly-owned disregarded (for income tax purposes) LLC makes the loan.[1210] Query whether the at-risk rules might limit the loss.

- If a shareholder borrows money from one S corporation he wholly owns and lends it to another S corporation, the loan to the S corporation gives the shareholder basis of indebtedness.[1211]

- If one S corporation borrows from another S corporation and the lending corporation distributes the loan to the person who is the sole shareholder of both corporations, the distribution of the loan gives the shareholder basis of indebtedness.[1212] Until the loan is

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[1209] T.D. 9682 (2014) included commented on the actual economic outlay test:

> Courts developed the actual economic outlay standard, which requires that shareholders be made "poorer in a material sense" to increase their bases of indebtedness. Some courts concluded that an S corporation shareholder was not poorer in a material sense if the shareholder borrowed funds from a related entity and then lent those funds to his S corporation. See, for example, *Oren v. Commissioner*, 357 F.3d 854 (8th Cir. 2004), *aff'g*, T.C. Memo. 2002-172. Instead of applying the actual economic outlay standard, the proposed regulations provided that shareholders receive basis of indebtedness if it is bona fide indebtedness of the S corporation to the shareholder.
>
> One commentator suggested that language be added to the regulations providing that actual economic outlay is no longer the standard used to determine whether a shareholder obtains basis of indebtedness. After considering this comment, the Treasury Department and the IRS believe that the proposed regulations clearly articulate the standard for determining basis of indebtedness of an S corporation to its shareholder, and further discussion of the actual economic outlay test in the regulations is unnecessary. Accordingly, the final regulations adopt the rule in the proposed regulations without change.
>
> With respect to guarantees, however, the final regulations retain the economic outlay standard by adopting the rule in the proposed regulations that S corporation shareholders may increase their basis of indebtedness only to the extent they actually perform under a guarantee. The final regulations make some minor changes to clarify the treatment of guarantees, including changing the heading to reiterate that the rule for guarantees is distinguished from the general rule adopting a bona fide indebtedness standard and moving the guarantee example after the examples illustrating the general rule consistent with the order of the regulations.

[1210] Reg. § 1.1366-2(a)(2)(iii), Example 1.

[1211] Reg. § 1.1366-2(a)(2)(iii), Example 2.

[1212] Reg. § 1.1366-2(a)(2)(iii), Example 3. Make sure that the distribution of the loans is well documented contemporaneously, as did <u>not</u> happen in *Broz v. Commissioner*, 137 T.C. 46 (2011), *aff'd* 727 F.3d 621 (6th Cir. 2013). T.D. 9682, adopting final regulations, commented on Example 4:

> The Treasury Department and the IRS recognize that there are numerous ways, including certain circular cash flows, in which an S corporation can become indebted to its shareholder. The

distributed, however, the owner of the lending S corporation cannot receive basis for the loan, according to cases that applied to a taxable year before the Regulations applied.[1213]

> proposed regulations included Example 4 as an example of a loan originating between two related entities that is restructured to be from the S corporation to the shareholder to show that the debt need not originate between the S corporation and its shareholder, provided that the resulting debt running between the S corporation and the shareholder is bona fide. The Treasury Department and the IRS are aware, however, of cases involving circular flow of funds that do not result in bona fide indebtedness. See, for example, *Oren v. Commissioner*, 357 F.3d at 859 (purported loans, although meeting all the proper formalities, lacked substance); *Kerzner v. Commissioner*, T.C. Memo. 2009-76, at 5 (transaction lacked substance because money wound up right where it started and shareholder was merely a conduit through which the money flowed). Whether a restructuring results in bona fide indebtedness depends on the facts and circumstances. Because the Treasury Department and the IRS believe that the examples in the proposed regulations adequately illustrate that a restructuring of a debt that did not originate between the shareholder and the S corporation may result in basis of indebtedness as long as the resulting debt is bona fide, these final regulations do not contain additional examples.

[1213] *Messina v. Commissioner*, T.C. Memo. 2017-213, *aff'd* 124 A.F.T.R.2d 2019-7144 (9th Cir. 12/27/2019), rejecting taxpayers' arguments that the lending S corporation be treated as a mere agent for its owners rather than being respected as an entity. The court rejected the taxpayers' assertion that *Commissioner v. Bollinger*, 485 U.S. 340 (1988), or *Lee v. Commissioner*, T.C. Memo. 1976-265, allowed taxpayers to disregard the form of the transaction they chose. *Meruelo v. Commissioner*, T.C. Memo. 2018-16, had a similar result, reasoning:

> Finally, in *Yates* and *Culnen* the transactions alleged to create basis were actually booked as loans. The corporations contemporaneously recorded shareholder loans on their ledgers, and payments of principal and interest were made on the loans. *Yates*, 82 T.C.M. (CCH) at 806-807; *Culnen*, 79 T.C.M. (CCH) at 1934-1935. Here, by contrast, the transactions were contemporaneously booked as capital contributions, payroll expenses, or inter-company accounts payable and receivable. Merco's net accounts payable to affiliates were recharacterized as "shareholder loans" only after the close of each year, when Mr. Carerras prepared the tax returns and adjusted Merco's book entries to match. No payments of principal or interest were ever made on these supposed "shareholder loans." See *Broz*, 137 T.C. at 52-53 (rejecting incorporated pocketbook theory where corporation made year-end adjustments reclassifying advances as shareholder loans); *Wilson v. Commissioner*, T.C. Memo. 1991-544 (rejecting reclassification of transactions on the basis of year-end journal entries).
>
> For these reasons, we find that petitioner has not carried his burden of proving that he used the 11 Merco affiliates as an "incorporated pocketbook" to pay Merco's expenses. Under this theory, as under his back-to-back loan theory, petitioner seeks to disavow the form of inter-company extensions of credit in an effort to generate basis for himself.[7] Because petitioner has not established the existence of bona fide indebtedness running from Merco directly to him, he is not entitled to the increased basis he claims. *Hitchins*, 103 T.C. at 715; sec. 1.1366-2(a)(2)(i), Income Tax Regs. [The 2014 regulations did not apply, but the court said that they would not have helped the taxpayer even if they had applied.]
>
> [7] Petitioner errs in seeking to accomplish the same result by invoking the doctrine of "constructive receipt." See sec. 1.451-2(a), Income Tax Regs. This doctrine addresses a timing issue, *viz.*, whether an item of income is includible in a taxpayer's gross income regardless of actual receipt. It has no conceivable relevance in determining whether a taxpayer has made an actual economic outlay sufficient to create increased basis in the stock or indebtedness of an S corporation.

Reg. § 1.451-2(a), the constructive receipt doctrine, is reproduced in the text accompanying fns 4205-4206 in part II.Q.1.e Trying to Avoid Possible Ordinary Income on the Sale of a Partnership or S Corporation.

In *Meruelo v. Commissioner*, 923 F.3d 938 (2019) affirmed the *Meruelo* Tax Court. Among its holdings, the Eleventh Circuit rejected the taxpayer's attempt to recharacterize intercompany loans:

- If a shareholder makes payment with respect to a loan guarantee, the payment gives the shareholder basis of indebtedness.[1214]

> Meruelo also argues that his accountant's end-of-year reclassification of the intercompany transfers, as reflected on his tax returns and on the annual adjustments to the line-of-credit from the 2004 Note, were sufficient to establish that the transactions amounted to shareholder, but we disagree. "After-the-fact reclassification cannot satisfy the requirement that the debt run directly from the S corporation to the taxpayer/shareholder, and courts have previously rejected efforts by taxpayers to establish debt basis in an S corporation using this method." *Broz v. Comm'r*, 727 F.3d 621, 627 (6th Cir. 2013); *Ruckriegel v. Comm'r*, 91 T.C.M. (CCH) 1035 (2006) (ruling that yearend reclassification of intercorporate loans as back-to-back loans through the taxpayer was insufficient to provide debt basis); *Burnstein v. Comm'r*, 47 T.C.M. (CCH) 1100 (1984) (same). Because the transactions were contemporaneously classified as transactions between the affiliates and Merco, the designation Meruelo's accountant gave them at the end of the year does not govern. And we agree with the Tax Court that the accountant's adjustments to "a notional line of credit, uniformly made after the close of each relevant tax year, do not suffice to create indebtedness to [Meruelo] where none in fact existed."

The Eleventh Circuit agreed with the Tax Court in rejecting the taxpayer's incorporated pocketbook theory, concluding:

> As the Tax Court explained, no court has ever ruled that a group of non-wholly owned entities that both receive and disburse funds in this fashion can constitute an incorporated pocketbook. And Meruelo failed to establish that he habitually paid third parties on his behalf through the putative incorporated-pocketbook companies. Meruelo's evidence established only that the Merco affiliates regularly paid the expenses of other companies within the affiliate group - not his personal expenses. See *Broz*, 727 F.3d at 628 (affirming Tax Court's rejection of taxpayers' "incorporated pocketbook" argument where the taxpayers failed to establish that they habitually paid third parties through the entities); *Messina v. Comm'r*, 114 T.C. Memo. 2017-213, at *32–33 (2017) (rejecting theory on the same ground); *Ruckriegel*, 91 T.C.M. (CCH) 1035 (same).

[1214] Reg. § 1.1366-2(a)(2)(iii), Example (4), "Guarantee," which is reproduced in fn 6259 in part III.B.1.a.ii.(a) Gift Tax Issues Involving Loan Guarantees. For a taxable year before the regulation was effective, see *Franklin v. Commissioner*, T.C. Memo. 2016-207, describing when an S corporation's creditor, ARCO, seized property of the taxpayer who owned the S corporation:

> On the basis of his testimony, applying a preponderance-of-the-evidence standard, we find that, in 2007, ACRO seized and sold petitioner's property and applied the proceeds, $496,000, to FDI's indebtedness to it pursuant to petitioner's obligation as a guarantor. That gave rise to an indebtedness from FDI to petitioner in an equal amount. See *Putnam v. Commissioner*, 352 U.S. 82, 85 (1946) ("The familiar rule is that, instanter upon the payment by the guarantor of the debt, the debtor's obligation to the creditor becomes an obligation to the guarantor[.]"); *Perry v. Commissioner*, 47 T.C. 159, 164 (1966), *aff'd*, 392 F.2d 458 (8th Cir. 1968). Petitioner's basis in that indebtedness increased the limitation on the amount of FDI's losses and deductions that he could take into account. See sec. 1366(d)(1)(B); see also Rev. Rul. 70-50, 1970-1 C.B. 178 (1970) ("Payment by a shareholder-guarantor of a loan made by a bank to an electing small business corporation is treated as an indebtedness of the corporation to the shareholder for purposes of computing his portion of a net operating loss.").[7] That is not so with respect to the remaining $500,000 that petitioner claims he guaranteed. As we said in *Raynor v. Commissioner*, 50 T.C. 762, 770-771 (1968): "No form of indirect borrowing, be it guaranty, surety, accommodation, comaking or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay part or all of the obligation." See also *Borg v. Commissioner*, 50 T.C. 257 (1968). Petitioner may, therefore, deduct the $343,939 passthrough loss from FDI that he reported on his 2007 Form 1040.
>
> [7] Although entitled to consideration, revenue rulings do not have the force of law. *Dixon v. United States*, 381 U.S. 68, 73 (1965); see, *e.g.*, *Murray v. Commissioner*, T.C. Memo. 2012-213, 2012 WL 3030366, at *2 n.3.

When the shareholder is named as a co-borrower but really is just a guarantor, the shareholder is not deemed to have borrowed the money and loaned it to the corporation.[1215]

II.G.4.d.ii.(b). Consequences of Using Shareholder Debt to Deduct S Corporation Losses

When losses are deducted against the basis in a loan, the shareholder's basis in the loan is less than the principal, generally causing income recognition when principal payments are made.[1216]

For a taxable year before the regulation was effective, *Phillips v. Commissioner*, TC Memo 2017-61, held that judgments against a shareholder did not constitute an "economic outlay" (fn. 1207) until the shareholder paid on a guarantee.

For a taxable year before the regulation was effective, the sole owner of an S corporation that liquidated failed to prove that he had assumed the debt when the loan continued to show the corporation as the borrower. *Tinsley v. Commissioner*, T.C. Summary Opinion 2017-9. Although common sense suggests that the sole owner had assumed the debt because presumably the business was operated as a sole proprietorship, the taxpayer did not prove the form of business post-liquidation and bizarrely kept the loan in the liquidated corporation's name when it was renewed after liquidation; presumably the lender did not care about that detail because he personally guaranteed the loan, and payments were made (with the owner not proving who was making post-liquidation payments on the loan).

[1215] *Hargis v. Commissioner*, T.C. Memo. 2016-232, *aff'd Hargis v. Koskinen*, 121 A.F.T.R.2d 2018-2206 (8th Cir. 6/22/2018), applied the old economic outlay test (fn. 1207), but the analysis seems consistent with the bona fide loan requirement under Reg. § 1.1366-2 (fn. 1208). The Tax Court stated:

> …. Petitioners ask us to view petitioner's comaking and guaranty arrangements constructively as back-to-back loans from the lenders to petitioner and from petitioner to the operating companies. The "substance over form" argument advanced by petitioners here has been mostly rejected by this Court in past cases…..
>
> In the case at hand none of the proceeds of the loan agreements entered into by petitioner and his operating companies were ever advanced to petitioner individually….
>
> None of the notes petitioner signed as coborrower or guarantor were collateralized by petitioner's own property….
>
> Lastly, petitioners provided no convincing evidence that any of the lenders looked to petitioner as the primary obligor on the loans received by the operating companies….
>
> Because the form of the transactions shows the indebtedness existed directly between the operating companies and the lenders, and because petitioners have not shown that the substance of those transactions should be viewed differently from their form, we conclude that petitioner's role as comaker or guarantor of the operating companies' notes did not entitle him to claim basis in the indebtedness of the operating companies under section 1366(d)(1).

[1216] When losses are deducted against the loan's basis, with under Code § 1367(b)(2)(A) making the loan's basis less than the principal that is owed, refinancing by repaying the loan from the shareholders to the corporation might cause a creditor-shareholder to recognize income. Any net increase (the amount by which the shareholder's pro rata share of the items described in Code § 1367(a)(1), relating to income items and excess deduction for depletion, exceed the items described in Code § 1367(a)(2), relating to losses, deductions, noncapital, nondeductible expenses, certain oil and gas depletion deductions, and certain distributions) in any subsequent taxable year of the corporation is applied to restore that reduction. Reg. § 1.1367-2(c)(1), interpreting Code § 1367(b)(2)(B). Some taxpayers argued that Code § 118(a) excludes contributions to capital from income, and therefore such contributions constituted tax-exempt income that increased basis in the loan; the Tax Court and Second Circuit held that such contributions are not tax-exempt income because they are not income at all. *Nathel v. Commissioner*, 131 T.C. 262 (2008), *aff'd* 615 F.3d 83 (2nd Cir. 2010).

Special rules apply to "open account" debt - shareholder advances not evidenced by separate written instruments and repayments on the advances, the aggregate outstanding principal of which does not exceed $25,000 of indebtedness of the S corporation to the shareholder at the close of the

When the corporation's later income gives the shareholder basis, the loan's basis is restored before the stock's basis increases.[1217]

When the debt to the shareholder is evidenced by a note or other written instrument held at least one year, the debt is a capital asset and repayment will result in long-term capital gain.[1218] However, if the debt is not evidenced by a written instrument (*e.g.*, open account debt), the income upon repayment will be ordinary income;[1219] open account debt also risks being recharacterized as a contribution to capital, the repayment of which might be recharacterized as a distribution that might then be recharacterized as disguised compensation.[1220] Unless a

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S corporation's taxable year. Reg. § 1.1367-2(a)(2), (d)(2), (e) (Exs. 7 & 8). See Bailey, "Managing S corporation Open Account Debt," *Practical Tax Strategies* (11/2013).

Code § 1367 is reproduced in part II.G.4.d.i Basis Limitation Generally.

[1217] Code § 1367(b)(2)(B). Code § 1367 is reproduced in part II.G.4.d.i Basis Limitation Generally.

[1218] Rev. Rul. 64-162.

[1219] Rev. Rul. 68-537.

[1220] *Glass Blocks Unlimited v. Commissioner*, T.C. Memo. 2013-180, upheld the IRS determination of wages, resulting in payroll taxes and penalties on what the taxpayer claimed to be repayment of open account debt. In testing for contribution to capital vs. loan treatment, the court held that:

> factors include: (1) the names given to the documents that would be evidence of the purported loans; (2) the presence or absence of a fixed maturity date; (3) the likely source of repayment; (4) the right to enforce payments; (5) participation in management as a result of the advances; (6) subordination of the purported loans to the loans of the corporation's creditors; (7) the intent of the parties; (8) the capitalization of the corporation; (9) the ability of the corporation to obtain financing from outside sources; (10) thinness of capital structure in relation to debt; (11) use to which the funds were put; (12) the failure of the corporation to repay; and (13) the risk involved in making the transfers. *Calumet Indus., Inc. v. Commissioner*, 95 T.C. 257, 285 (1990).

But for the court's view that the taxpayer was lying (testified in court that he worked 20 hours per week when he told the IRS examiner that he worked full time and all evidence supported his statements to the IRS), the situation appeared sympathetic. The company barely broke even, and the relatively modest payments to the shareholder-employee that were recharacterized as wages were much larger than his K-1 income. The taxpayer would have paid lower employment taxes if the entity had been taxed as sole proprietorship.

On the other hand, after citing the same 13 factors, *Scott Singer Installations, Inc. v. Commissioner*, TC Memo 2016-161, *acq.* 2017-15 I.R.B. 1072 (see fn. 1221 for the limited scope of acquiescence and hostility toward the court's decision), held:

> No single factor is controlling. *Dixie Dairies Corp. v. Commissioner*, 74 T.C. at 493. However, the ultimate question is whether there was a genuine intention to create a debt, with a reasonable expectation of repayment, and whether that intention comported with the economic reality of creating a debtor-creditor relationship. *Litton Bus. Sys., Inc. v. Commissioner*, 61 T.C. 367, 377 (1973).
>
> Transfers to closely held corporations by controlling shareholders are subject to heightened scrutiny, however, and the labels attached to such transfers by the controlling shareholder through bookkeeping entries or testimony have limited significance unless these labels are supported by other objective evidence. *E.g.*, *Boatner v. Commissioner*, T.C. Memo. 1997-379, 1997 WL 473162, at *3, *aff'd without published opinion*, 164 F.3d 629 (9th Cir. 1998).
>
> Rather than analyze every factor on the debt-equity checklists, we confine our discussion to those points we find most pertinent. In our analysis we look at the relative financial status of petitioner at the time the advances were made; the financial status of petitioner at the time the advances were repaid; the relationship between Mr. Singer and petitioner; the method by which the advances were repaid; the consistency with which the advances were repaid; and the way the advances were accounted for on petitioner's financial statements and tax returns. After looking at all these criteria in the light of the other factors traditionally distinguishing debt from equity, particularly the intent factor, we believe Mr. Singer intended his advances to be loans and we find

taxpayer objectively substantiates both the existence of a loan and that payments made were in repayment of that loan, the IRS will assert that the payment of personal expenses by an S corporation on behalf of its corporate officer/employee constitute wages subject to Federal employment taxes.[1221]

> that his intention was reasonable for a substantial portion of the advances. Consequently, we also find that petitioner's repayments of those loans are valid as such and should not be characterized as wages subject to employment taxes.

With the same result – no wage income - *Goldsmith v. Commissioner*, T.C. Memo. 2017-020, followed *Scott Singer*, pointing out (emphasis in original):

> There's no rule that an S corporation *has* to pay its sole shareholder a wage, especially when it's bleeding money the way G&A did. The real question is one of fact—were the payments a return of capital, repayments of loans, or wages? See *Scott Singer Installations, Inc., v. Commissioner*, T.C. Memo. 2016-161.

[1221] A.O.D. 2017-04 (4/17/2017), taking the position in the text above and strongly criticizing *Scott Singer Installations, Inc. v. Commissioner*, TC Memo 2016-161, *acq.* 2017-15 I.R.B. 1072 (see fn. 1220):

> The critical factor in determining the appropriate tax treatment is whether the payments are remuneration (i.e., compensation) for services provided to the employer. The Service disagrees with the Court's reasoning, which failed to properly address the critical issue of whether the payments made by Taxpayer to creditors on behalf of Mr. Singer were compensation for his services and thus wages under the applicable statutory and regulatory provisions. The Service's position is that the Court incorrectly decided that no portion of the payment of personal expenses by Taxpayer on behalf of Mr. Singer should be characterized as wages subject to Federal employment taxes. Whether advances made to a corporation by a shareholder-officer are characterized as loans rather than capital contributions does not control whether a payment made by the corporation to the shareholder-officer is compensation for services and therefore properly characterized as wages. The Court failed to acknowledge that, similar to debt repayments, wages are also paid in a recurring nature and may be paid even if a business is operating at a loss.
>
> In focusing on the intention to create a debtor-creditor relationship and whether Mr. Singer had a reasonable expectation of repayment of the advances, the Court failed to analyze or even cite the relevant statutory or regulatory provisions governing the definition of wages for Federal employment tax purposes. Nor did the Court review its own substantial body of case law that repeatedly rejects taxpayers' attempted characterizations of payments to officers who perform substantial services as something other than compensation for services. The Court failed to analyze why precedents concerning officer compensation were not applicable. See *Veterinary Surgical Consultants PC v. Commissioner*, 117 T.C. 141 (2001) (stating that "the characterization of the payment to [president] as a distribution of net income is but a subterfuge for reality;" and holding the payments constituted remuneration for services performed by the [president] and were subject to employment taxes). See *also Glass Blocks Unlimited v. Commissioner*, T.C. Memo 2013-180 (holding that "[a]n employer cannot avoid Federal employment taxes by characterizing payments to its employee, sole officer and shareholder as something other than wages where such payments represent remuneration for services rendered"). See *Smith v. Commissioner*, T.C. Memo. 1995-410 (finding that payments of personal living expenses made by a wholly owned corporation on behalf of its president/employee and sole shareholder, who received no salary in the year at issue, are properly characterized as wages when they represent remuneration for employment).
>
> Several circuit courts have also rejected arguments that officers who perform substantial services received something other than compensation for those services. See *Joseph M. Grey Accountant, P.C. v. Commissioner*, 119 T.C. 121 (2002), *aff'd* 93 Fed. Appx. 473 (3rd Cir. 2004) (holding that money taken from corporate account by the sole shareholder and president of the corporation to pay for his needs as they arose was wages subject to employment taxes); *Joly v. Commissioner*, 211 F.3d 1269 (6th Cir. 2000) (holding that distributions to controlling shareholders

When a loan has basis less than principal, basis is prorated, meaning that part of each payment is recovery of basis and part is income.[1222] To avoid this, a shareholder may contribute the loan to the capital of the corporation, getting increased stock basis to the extent of the loan's basis (without the corporation reporting cancellation of indebtedness income),[1223] against which distributions may be taken, fully tax-free (assuming AAA is sufficient or no prior C corporation earnings and profits).[1224] If a shareholder makes a non-pro rata contribution to capital of loans owed to that shareholder, consider the nontax issue: the shareholder will not receive a non-pro rata distribution on liquidation of the corporation;[1225] note that, in a partnership, non-pro rata distributions would be permitted, so a non-pro rata contribution could be repaid through a non-pro rata distribution.

> were wages despite an express written agreement that any excess distributions would be treated as loans); *Joseph Radtke S.C. v. United States*, 895 F.2d 1196, 1197 (7th Cir. 1990) (holding that dividends paid by the corporation to the only significant employee, who otherwise received no salary for his substantial services, were in fact wages subject to employment taxes because the payments "were clearly remuneration for services performed"); *David E. Watson, P.C. v United States*, 668 F.3d 1008 (8th Cir. 2012) (holding that the proper legal analysis was whether the payments at issue were made as remuneration for services performed; rejecting the argument that taxpayer intent controls when characterizing payments and finding dividend distributions should properly be characterized as wages, despite repeated assertions by the taxpayer that there is no statute, regulation, or rule requiring an employer to pay minimum compensation); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90, 93 (9th Cir. 1990) (holding that the only stockholder of an S corporation, who "donated" his services and withdrew earnings in the form of dividends, actually received wages; stating that regardless of how an employer chooses to characterize payments made to employees, "the true analysis is whether the payments are for remuneration for services rendered").
>
> While none of the courts in the cases cited above found the existence of a debtor-creditor relationship, the applicable employment tax regulations defining the scope of wages as all remuneration for employment does not cease to apply even if such debtor-creditor relationship is present. As previously noted, the regulations expressly provide that an employer's characterization of the payment is irrelevant. Accordingly, when a corporation makes any payment of personal expenses to or on behalf of a shareholder-officer, the question must be asked - is the payment being made as remuneration for services? If so, then the payment is wages. While the Service may recognize a payment from a corporation to its shareholder-officer who is also an employee as a loan repayment, the taxpayer must provide objective evidence that both substantiates that a bona fide loan exists between the parties and substantiates that the payment from the taxpayer to the employee was specifically in repayment of that loan and is separate from compensation paid to the employee for the performance of services for the taxpayer.

See also https://www.irs.gov/businesses/small-businesses-self-employed/s-corporation-employees-shareholders-and-corporate-officers (last visited 9/2/2017).

[1222] Rev. Rul. 64-162.

[1223] See part II.M.2.a Initial Incorporation – Generally. Code § 108(e)(6) provides, "Indebtedness contributed to capital," provides:

> Except as provided in regulations, for purposes of determining income of the debtor from discharge of indebtedness, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital -
>
> (A) section 118 shall not apply, but
>
> (B) such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness.

[1224] See part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally.

[1225] Rights to distributions must be proportionate to stock ownership, as described in part II.A.2.i Single Class of Stock Rule.

I have seen tax preparers report fictitious loans on S corporation tax returns, taking the position that a distribution was made and loaned back to the corporation. They do this because a shareholder's position as an unsecured creditor may be better than as an owner if the corporation gets sued or goes into bankruptcy. It is not unusual for the tax preparer to forget to impute interest as well. This fictitious loan is a bad idea, not only because of the issues described in the preceding paragraph but also because a smart litigator for the creditor will argue that this constitutes cooking the books, and what else about the books may be cooked? Instead of risking this vulnerability, the corporation should document a formal line of credit with the shareholder, not only accruing but also paying annual interest.[1226] Any distributions that generate such a loan from the shareholder should either be documented through corporate action or should actually be made, with the latter being the stronger case and preferably merely be the shareholder loaning part (whether a small part or a large part) of distributions that are made to pay taxes or once the earnings have been determined.

This line of credit concept may also be useful when selling to an irrevocable grantor trust.[1227] I prefer to get the debt that the trust owes the seller paid as soon as possible. If distributions to make those payments strain the corporation's cash flow, the seller could loan the sales proceeds to the corporation, using whatever terms seem appropriate.

II.G.4.e. Basis Limitations for Partners in a Partnership

II.G.4.e.i. Gorin Analysis

Generally, partners may deduct losses only to the extent of basis.[1228] Not all deductions are subject to these rules,[1229] but the those deductions would reduce basis[1230] and therefore can

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[1226] This might be a demand note with interest at the blended rate that applies to such notes. See part III.B.1.a.i.(c) Demand Loans.

[1227] See generally part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust

[1228] Reg. § 1.704-1(d)(2) provides:

> In computing the adjusted basis of a partner's interest for the purpose of ascertaining the extent to which a partner's distributive share of partnership loss shall be allowed as a deduction for the taxable year, the basis shall first be increased under section 705(a)(1) and decreased under section 705(a)(2), except for losses of the taxable year and losses previously disallowed. If the partner's distributive share of the aggregate of items of loss specified in section 702(a)(1), (2), (3), (8), and (9) exceeds the basis of the partner's interest computed under the preceding sentence, the limitation on losses under section 704(d) must be allocated to his distributive share of each such loss. This allocation shall be determined by taking the proportion that each loss bears to the total of all such losses. For purposes of the preceding sentence, the total losses for the taxable year shall be the sum of his distributive share of losses for the current year and his losses disallowed and carried forward from prior years.

[1229] Reg. § 1.704-1(d)(2), reproduced in fn. 1228, implicitly does not suspend the following deductions under Code § 702(a):

> (4) charitable contributions (as defined in section 170(c)),
> (5) dividends with respect to which section 1(h)(11) or part VIII of subchapter B applies,
> (6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,
> (7) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary…

Confirming this interpretation, see fn. 1262 in part II.G.4.g.ii Basis Limitations on Deducting Charitable Contributions Made by an S corporation or a Partnership.

[1230] Code § 705(a)(2)(B). See also fn. 1263 in part II.G.4.g.ii Basis Limitations on Deducting Charitable Contributions Made by an S corporation or a Partnership.

cause their deductions to be suspended.[1231] The basis limitation limits the loss not only for regular income tax purposes but also for purposes of part II.L.2.a Types of Income Subject to Self-Employment Tax.[1232]

Code § 704(d) provides:

(1) *In general*. A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred.

(2) *Carryover*. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

(3) *Special rules*.

(A) *In general*. In determining the amount of any loss under paragraph (1), there shall be taken into account the partner's distributive share of amounts described in paragraphs (4) and (6) of section 702(a).

(B) *Exception*. In the case of a charitable contribution of property whose fair market value exceeds its adjusted basis, subparagraph (A) shall not apply to the extent of the partner's distributive share of such excess.

Implementing Code § 704(d), Reg. § 1.704-1(d), "Limitation on allowance of losses," provides:

(1) A partner's distributive share of partnership loss will be allowed only to the extent of the adjusted basis (before reduction by current year's losses) of such partner's interest in the partnership at the end of the partnership taxable year in which such loss occurred. A partner's share of loss in excess of his adjusted basis at the end of the partnership taxable year will not be allowed for that year. However, any loss so disallowed shall be allowed as a deduction at the end of the first succeeding partnership taxable year, and subsequent partnership taxable years, to the extent that the partner's adjusted basis for his partnership interest at the end of any such year exceeds zero (before reduction by such loss for such year).

(2) In computing the adjusted basis of a partner's interest for the purpose of ascertaining the extent to which a partner's distributive share of partnership loss shall be allowed as a deduction for the taxable year, the basis shall first be increased under section 705(a)(1) and decreased under section 705(a)(2), except for losses of the taxable year and losses previously disallowed. If the partner's distributive share of the aggregate of items of loss specified in section 702(a)(1), (2), (3), (8), and (9) exceeds the basis of the partner's interest computed under the preceding sentence, the limitation on losses under section 704(d) must be allocated to his distributive share of each such loss. This allocation shall be determined by taking the proportion that each loss bears to the total of all such losses. For purposes of the preceding sentence, the total losses for the taxable year shall be the sum of his distributive

[1231] The first sentence of Reg. § 1.704-1(d)(2), reproduced in fn. 1228, provides that "In computing the adjusted basis of a partner's interest for the purpose of ascertaining the extent to which a partner's distributive share of partnership loss shall be allowed as a deduction for the taxable year, the basis shall first be … decreased under section 705(a)(2)…."
[1232] CCA 202009024, which applied this principle to a partnership, but a similar analysis would apply to a.

share of losses for the current year and his losses disallowed and carried forward from prior years.

(3) For the treatment of certain liabilities of the partner or partnership, see section 752 and § 1.752-1.

(4) The provisions of this paragraph may be illustrated by the following examples:

Example (1). At the end of the partnership taxable year 1955, partnership AB has a loss of $20,000. Partner A's distributive share of this loss is $10,000. At the end of such year, A's adjusted basis for his interest in the partnership (not taking into account his distributive share of the loss) is $6,000. Under section 704(d), A's distributive share of partnership loss is allowed to him (in his taxable year within or with which the partnership taxable year ends) only to the extent of his adjusted basis of $6,000. The $6,000 loss allowed for 1955 decreases the adjusted basis of A's interest to zero. Assume that, at the end of partnership taxable year 1956, A's share of partnership income has increased the adjusted basis of A's interest in the partnership to $3,000 (not taking into account the $4,000 loss disallowed in 1955). Of the $4,000 loss disallowed for the partnership taxable year 1955, $3,000 is allowed A for the partnership taxable year 1956, thus again decreasing the adjusted basis of his interest to zero. If, at the end of partnership taxable year 1957, A has an adjusted basis of his interest of at least $1,000 (not taking into account the disallowed loss of $1,000), he will be allowed the $1,000 loss previously disallowed.

Example (2). At the end of partnership taxable year 1955, partnership CD has a loss of $20,000. Partner C's distributive share of this loss is $10,000. The adjusted basis of his interest in the partnership (not taking into account his distributive share of such loss) is $6,000. Therefore, $4,000 of the loss is disallowed. At the end of partnership taxable year 1956, the partnership has no taxable income or loss, but owes $8,000 to a bank for money borrowed. Since C's share of this liability is $4,000, the basis of his partnership interest is increased from zero to $4,000. (See sections 752 and 722, and §§ 1.752-1 and 1.722-1.) C is allowed the $4,000 loss, disallowed for the preceding year under section 704(d), for his taxable year within or with which partnership taxable year 1956 ends.

Example (3). At the end of partnership taxable year 1955, partner C has the following distributive share of partnership items described in section 702(a): long-term capital loss, $4,000; short-term capital loss, $2,000; income as described in section 702(a)(9), $4,000. Partner C's adjusted basis for his partnership interest at the end of 1955, before adjustment for any of the above items, is $1,000. As adjusted under section 705(a)(1)(A), C's basis is increased from $1,000 to $5,000 at the end of the year. C's total distributive share of partnership loss is $6,000. Since without regard to losses, C has a basis of only $5,000, C is allowed only $5,000/$6,000 of each loss, that is, $3,333 of his long-term capital loss, and $1,667 of his short-term capital loss. C must carry forward to succeeding taxable years $667 as a long-term capital loss and $333 as a short-term capital loss.

If a partner who is selling her partnership interest plans to contribute assets to the partnership and wants to use that contribution to provide basis to deduct losses suspended under

Code § 704(d), the contribution must be made on or before the sale.[1233] Thus, as is the case with S corporations, the taxpayer can deduct such losses only while the taxpayer still owns the partnership interest.

Partners generally may deduct losses financed by certain obligations (including bank loans to the partnership) to the extent permitted by the Code § 465 at-risk rules. Although loan guaranties can cause debt to be allocated to the guarantor instead of to other partners, contributing the partner's own promissory note to a partnership does not constitute such a guarantee.[1234] For a discussion of the Code § 465 at-risk rules, as well as the Code § 752 treatment of certain nonrecourse or other liabilities, see part II.G.4.j At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities).

Among liabilities that create basis are "debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and

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[1233] *Sennett v. Commissioner*, 80 T.C. 825, 831 (1983), *aff'd* 752 F2d 428 (9th Cir. 1985), holding (emphasis in original):

> Applying section 706(c)(2)(A)(i) to the facts in the instant case, the taxable year of PPP with respect to petitioner closed in December 1968, when he sold his entire interest in PPP. That being the case, petitioner paid 80 percent of his share of PPP's losses for 1967 and 1968 to PPP after the close of his last partnership year with PPP which fails to come within the provisions of section 704(d) which allows the deduction "at the end of the partnership year in which such excess is repaid to the partnership." Such a construction of section 704(d) is not only supported by section 706(c)(2)(A)(i) but is confirmed by the language of the report of the Senate Finance Committee, quoted above (S. Rept. 1622, *supra*) wherein it explains that the loss is deductible *only at the end of the partnership year in which the loss is repaid, either directly, or out of future profits*. The payment from the partner to the partnership could not be paid out of future profits if the partner had previously sold his partnership interest because he would have no right to share in the future profits.

Although Code § 706(c)(2)(A) has since been changed, as of 5/18/2019 it still directly supports *Sennett*.

[1234] *VisionMonitor Software, LLC v. Commissioner*, T.C. Memo. 2014-182. The court's analysis of not obtaining basis for contributing the notes is described in fn. 3566. In discussing the loan issue, the court reasoned:

> VisionMonitor argues that the notes in this case, like the assumption of debt in *Gefen*, were necessary to persuade a third party to kick in more funding to a cash-strapped partnership. But unlike the partner in Gefen, neither Mantor nor Smith were guaranteeing a preexisting partnership debt to a third party. And they did not directly assume any of VisionMonitor's outside liabilities—these notes are their liability to VisionMonitor, not an assumption or guaranty of VisionMonitor's debt to a third party. Mantor did sign a resolution in 2007 that included a promise "to provide *** personal credit to the company vendors *** to ensure continued uninterrupted operations"—but there's no evidence that either he or Smith ever actually provided that credit. And there's also no evidence that Mantor or Smith were personally obliged under the VisionMonitor partnership agreement to contribute a fixed amount for a specific, preexisting partnership liability.

obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps."[1235] However, an obligation counts: [1236]

> only if, when, and to the extent that incurring the obligation-
>
> (A) Creates or increases the basis of any of the obligor's assets (including cash);
>
> (B) Gives rise to an immediate deduction to the obligor; or
>
> (C) Gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.

For more information, see part II.C.3 Allocating Liabilities (Including Debt).

[1235] Reg. § 1.752-1(a)(4)(ii). Letter Ruling 201608005 gave the owners of partnership P basis for certain obligations owed to O under construction contract guarantees:

> Before P is entitled to receive payments under the contracts and, explicitly, to receive the Notice to Proceed payments, P is required to provide certain guarantees and also to deliver to O irrevocable standby letters of credit. The letters of credit secure P's obligations to perform under the contracts and cover O's damages in the event of non-performance or default by P. The amount of the letters of credit securing P's obligations roughly corresponds to the amount of the Notice to Proceed payments.
>
> The contracts provide that if P fails to prosecute the work in a diligent and efficient manner, or if P abandons the project or repudiates any of its obligations, a default occurs. In that event, O is entitled to several remedies, including seeking specific performance (that is, obtaining judicial enforcement requiring to make good on its obligation to perform the work) and recovery from P of costs, damages, losses, and expenses (that is, requiring P to make good on its obligation to cover O's damages in the event of nonperformance). Specifically, the contracts allow O to draw-down directly against the letters of credit in the event of a default by P.

The Letter Ruling discussed certain authority:

> Revenue Ruling 95-26, 1995-1 C.B. 131, concludes that a partnership's obligation to deliver securities in a short sale transaction constitutes a section 752 liability under a definition of partnership liability similar to the definition quoted above. The Revenue Ruling reasons that a short sale creates such a liability inasmuch as: (1) a short sale creates an obligation to return the borrowed securities, citing *Deputy v. Du Pont*, 308 U.S. 488, 497-98 (1940), 1940-1 C.B. 118; and (2) the partnership's basis in its assets is increased by the amount of cash received on the sale of the borrowed securities. Therefore, the Revenue Ruling concludes that the partners' bases in their partnership interests are increased under section 722 to reflect their shares of the partnership's liability under section 752. In *Salina Partnership LP v. Commissioner*, T.C. Memo 2000-352, the Tax Court examined the policy underlying section 752 and the analysis of Revenue Ruling 95-26 and held that a partnership's obligation to close its short sale by replacing borrowed securities represented a partnership liability within the meaning of section 752.

The Letter Ruling held:

> Based solely on the facts submitted and the representations made, we conclude that P's obligations under the contracts to proceed with performing work and to incur costs in performing the work, and the corresponding obligations to satisfy O's remedies in the event P were to default or suspend work, constitute liabilities under section 752 upon and to the extent P receives the Notice to Proceed payments but has not yet reported the related income.

[1236] Reg. § 1.752-1(a)(4)(i).

In a partnership setting, generally no income is recognized on the repayment of a debt until distributions (including deemed distributions when the partner's share of partnership debt is reduced) exceed basis.[1237]

If a partner loans money to the partnership that is a start-up venture and it is possible that the partnership might need a capital infusion by another party in which the debt is converted to equity, the later capital infusion might trigger ordinary income taxation.[1238] One might consider using preferred equity instead of loaning the money to the partnership.

II.G.4.e.ii. IRS Description of Basis

LB&I Process Unit, "Partner's Outside Basis," Document Control Number (DCN) PAR-P-002 (last updated 5/19/2021) (the "Process Unit") discusses calculating a partner's basis in that person's partnership interest. The Process Unit's "Background" explains:

> A partnership is a relationship between two or more persons who join together to carry on a trade, business, or investment activity. Each partner has a basis in his partnership interest. The partner's basis in his partnership interest is separate from the partnership's basis in its assets. Partnership tax law often refers to "outside" and "inside" basis. Outside basis refers to a partner's interest in a partnership. Inside basis refers to a partnership's basis in its assets. Publication 541 contains information on outside basis. This Practice Unit focuses on key concepts you must understand in order to properly calculate outside basis.
>
> The rules regarding the computation of outside basis apply to all types of partners including general partners, limited partners, and limited liability company (LLC) members. The rules apply to entities which are treated as partnerships for federal income tax purposes including general partnerships, limited partnerships, publicly traded partnerships, limited liability partnerships and limited liability companies (which have at least two owners and which do not elect to be treated as a corporation).
>
> A partner may hold both a general and a limited partnership interest in the same partnership. In this case, the partner is considered to have only one unitary basis equal to the combined interests. Rev. Rul. 84-52. Note that the owner of a disregarded entity has no outside basis in the entity for federal income tax purposes.
>
> Computing a partner's outside basis is necessary when determining:
>
> - The maximum amount of any deduction or loss that passes through to the partner,
> - The gain or loss from the disposition of a partnership interest,
> - The tax consequences of cash distributions, and

[1237] Code §§ 752(a), (b) and 731(a)(1). For a scathing critique of proposed regulations under Code § 752, see Lipton, "Proposed Regulations on Debt Allocations: Controversial, and Deservedly So," *Journal of Taxation* (WG&L), Vol. 120, No. 4 (April 2014); Schneider and O'Connor, "The IRS Did What to the Partnership Debt Allocation and Disguised Sale Rules?!?" *TM Real Estate Journal* (BNA), Vol. 30 No. 8 (8/6/2014).
[1238] See part II.G.4.a.v Tax Effect of Loan to S Corporation or Partnership, especially the text accompanying fns. 1180-1181.

- The tax consequences of property distributions.

In "Nature of Partnerships," the Process Unit explains:

> Subchapter K of the Internal Revenue Code addresses rules regarding the taxation of partnerships and partners. Certain aspects of Subchapter K are governed by the "aggregate theory" which views the partnership as a collection of its partners. Other aspects are governed by the "entity theory" which treats the partnership as a "taxpayer," even though it pays no tax. For example, partnerships function as entities when a tax year and a method of accounting are chosen. It is the partnership that selects the tax year and method of accounting, not each partner. Most elections are made by the partnership. The concept that each partner must track a basis in his partnership interest reflects the entity view of partnerships.
>
> A partnership is called a "flow-through entity" or a "pass-through entity." Partnerships pay no tax. Rather, each partner includes his share of the partnership's income, gain, loss, deduction, or credits on his personal tax return. Therefore, for purposes of reporting tax items and calculating tax liabilities, the partnership is treated as an aggregate of its partners.
>
> As previously stated, outside basis is a partner's basis in his partnership interest. Inside basis is the partnership's basis in its assets. Typically, at the start of the partnership, the sum of each partner's outside basis equals the partnership's inside adjusted tax basis in its assets. The reason for this equality is the accounting equation Assets equal Liabilities plus Owners' Equity. In the partnership context, this is phrased as Assets equal Liabilities plus Partners' Capital Accounts. The partnership's assets were either contributed by the partners, purchased with contributed cash or earned income, or purchased with money the partnership borrowed.
>
> There are three common reasons why the equality between inside and outside basis may change:
>
> 1. Acquisition of a partnership interest other than by contribution.
>
> 2. Gain or loss recognized by a partner on a distribution.
>
> 3. Decrease in the basis of an asset of the partnership on a current distribution or an increase in the basis of a partnership asset on a liquidating distribution (excluding 732(d) application).
>
> If a partnership made a section 754 election, a partner's outside basis can be estimated by added his tax basis capital account, his share of liabilities, and his section 743(b) basis adjustments which can be found on the Schedule K-1 (Form 1065).

The Process Unit explains "Outside Basis and Inside Basis":

> A partner's outside basis in his partnership interest can be estimated by adding his tax basis capital account, his share of liabilities, and his section 743(b) basis adjustments (if the partnership made a section 754 election). An increase in a partner's share of partnership liabilities is treated as a contribution of money by the partner to the partnership and thus increases his outside basis. A decrease in a partner's share of

partnership liabilities is treated as a distribution of money to the partner and thus decreases his outside basis. IRC 752(a) and (b). Each partnership liability is part of at least one partner's outside basis. Rules concerning the definition of partnership liabilities are covered in the Determining Liability Allocations Concept Unit. Rules for allocating partnership liabilities among the partners are covered in the Determining Liability Allocations Concept Unit.

While a partner's capital account may be negative (due to allocated losses and distributions), a partner's outside basis may never be a negative number. A partner whose capital account is negative may still have a positive basis in his partnership interest because his share of partnership liabilities is greater than his negative capital account.

The Process Unit provides a "Capital Account Overview":

Capital accounts increase or decrease every year. If the partnership is profitable, the partner's distributive share of profits increases his capital account. If the partnership generates a loss, then the partner's distributive share of the loss decreases his capital account.

Additionally, a partner's contributions of cash or property increase his capital account. Conversely, a partnership's distribution of cash or property to the partner decreases his capital account.

A partner may have a negative capital account. However, a partner may never have a negative outside basis. A partner whose capital account is negative may still have a positive basis if his share of partnership liabilities exceeds his negative capital account. The four types of capital accounts are:

1. Section 704(b) Book.

2. Generally Accepted Accounting Principles (GAAP).

3. Tax Basis.

4. Other.

See Slides 10-12 for an explanation of the four types of capital accounts.

CAUTION: The capital account reporting requirements on Schedule K-1 changed beginning in 2020. Beginning in 2020, taxpayers are required, with few exceptions, to report capital accounts on the tax basis. Please see the instructions to the Form 1065 for 2020 and later years for further guidance.

The Process Unit explains the "Impact of Partnership Operations on Partnership Outside Basis":

A partner's basis in his partnership interest increases or decreases each year depending on a variety of factors. The following items increase outside basis:

- An increase in the partner's share of either recourse or nonrecourse liabilities. IRC 752(a).

- A partner's contributions of property or money including an increased share of, or assumption of, partnership liabilities. IRC 722.

- The partner's share of taxable partnership income, including capital gains. IRC 705(a)(1)(A).

- The partner's share of tax-exempt income. IRC 705(a)(1)(B).

- The partner's share of percentage depletion deductions exceeding the adjusted basis in depletable property. IRC 705(a)(1)(C).

The follow items decrease outside basis:

- A decrease in the partner's share of partnership liabilities. IRC 752(b).

- Distributions of money (including a decreased share of partnership liabilities or an assumption of the partner's individual liabilities by the partnership) and property distributed to the partner by the partnership. IRC 733 and IRC 732.

- The partner's share of partnership losses, including capital losses. IRC 705(a)(2)(A).

- The partner's share of expenses that are neither deductible nor capitalized for income tax purposes. IRC 705(a)(2)(B).

- The partner's share of depletion from oil and gas properties. IRC 705(a)(3).

The Process Unit explains a "Partner's Initial Outside Basis":

> A partner may acquire an interest in a partnership in a variety of ways. For example, the partner may purchase his interest from an existing partner. Like any other asset, a partnership interest may be acquired through a gift or an inheritance. Additionally, a partner may contribute property and/or cash in exchange for a partnership interest. Lastly, a partner may contribute services in exchange for a partnership interest. The partner's initial outside basis depends on how the interest was acquired.
>
> The basis of a partnership interest acquired by contribution is the amount of cash plus the adjusted basis of any contributed property. IRC 722. Generally, a partner does not recognize gain or loss upon contributions of property to a partnership in exchange for a partnership interest. IRC 721. Instead, the contributing partner's basis in the property becomes the partnership's basis. IRC 723.
>
> A partner's holding period in a partnership interest received for a property contribution depends on the type of property contributed. If the property contributed for the interest was a capital asset or an IRC 1231 asset, the holding period of the partnership interest will include the holding period of the contributed assets. If a partner contributes any other property or money, his holding period will begin on the day after the interest is acquired. If a combination of property is contributed, the holding period of the partnership interest will be split.
>
> When a partner buys a partnership interest from an existing partner, the purchasing partner's initial outside basis is the consideration paid to the seller (cash plus the value

of any property) plus his share of partnership liabilities assumed. IRC 742 and IRC 1012. When a partnership interest is acquired by gift, the partner's outside basis will generally be the outside basis of the donor. IRC 742 and IRC 1015. The basis of an inherited partnership interest equals the fair market value of the partnership interest at the decedent's date of death or the alternate valuation date, if applicable. IRC 1014.

As previously stated, a partner may acquire a partnership interest in exchange for contributing cash or property. Additionally, a partner may contribute services in exchange for a partnership interest. The impact on the partner's outside basis depends on whether the partner recognizes compensation income for the services performed. This, in turn, depends on the type of interest received (a capital interest or a profits interest). Under Treas. Reg. 1.721-1(b)(1), the receipt of a vested partnership capital interest in exchange for services is taxable as compensation. An interest is vested if it is either transferable or not subject to a substantial risk of forfeiture. The partner's outside basis is increased by the amount of the compensation income recognized.

Unless an exception is met, a partner who contributes services to a partnership in exchange for a profits interest does not recognize compensation income. Therefore, the transaction has no impact on the partner's outside basis. Revenue Procedure 93-27, 1993-2 C.B. 343 and Rev. Proc. 2001-43 address the receipt of a partnership profits interest when services are provided to or on behalf of the partnership.

Under Rev. Proc. 93-27, the grant of a profits interest to a service partner is generally not a taxable event. However, under the following three exceptions, a partner who contributes services in exchange for a profits interest must recognize income:

1. The partner disposes of the interest within two years of its receipt;

2. The partnership units are publicly traded; or

3. The profits interest relates to a "substantially certain and predictable stream of income from partnership assets."

The Process Unit explains "Capital Accounts":

A partner's equity equals the amount of money or property the partner would receive if the partnership liquidated. A partner's outside basis includes a partner's share of liabilities whereas a partner's capital account does not (Assets minus Liabilities equals Capital). When performing a risk analysis, adding the capital account as reported on the Schedule K-1, allocable share of liabilities, and any IRC 743(b) adjustments allows for an estimation of the partner's outside basis. As noted throughout this unit, the accuracy of this estimation depends on whether the capital accounts on the Schedule K-1 are reported on a tax basis.

Prior to 2020, a partnership could choose the method for reporting a partner's capital account. It could select (1) section 704(b) book; (2) GAAP; (3) tax basis; or (4) other.

Prior to 2020, the partnership had to check the appropriate box that described the method of accounting used to figure the partner's capital account for reporting purposes on each Schedule K-1 in Section L. If the method of accounting used to figure the partnership's capital account was based on the partnership's income and deductions for federal income tax purposes, the “Tax basis” box had to be checked. On the other hand, the “GAAP” box had to be checked if the figure was determined based on generally accepted accounting principles (GAAP). If the partnership arrived at the figure based on the capital accounting rules under Treas. Reg. 1.704-1(b)(2)(iv), the “Section 704(b) book” box had to be checked. If none of the three methods named above (tax basis, GAAP, or Section 704(b) book) were used, the “Other” box had to be checked, and the partnership had to attach a statement describing the method and showing how the partner’s capital account was determined.

CAUTION: The capital account reporting requirements on Schedule K-1 changed beginning in 2020. Beginning in 2020, taxpayers are required, with few exceptions, to report capital accounts on the Schedule K-1 on the tax basis for their ending capital account amounts and thereafter both beginning and ending balances must be reported on the tax basis. Please see the instructions to the Form 1065 for 2020 and later years for further guidance.

The Process Unit explains a “Tax Basis Capital Account”:

As its name implies, the tax basis capital account is based on tax accounting. The tax basis capital account is increased by the

adjusted tax basis of the contributed assets (net of liabilities) and decreased by the adjusted basis of assets distributed (net of liabilities). Second, the tax basis capital account is increased or decreased annually by increases and decreases as reflected on the partners’ Schedules K-1 Part III and attached statements. Tax gain or loss on the sale or other disposition of partnership property is computed using the asset’s tax basis. A partner’s tax basis capital account plus his share of partnership liabilities plus his section 743(b) adjustment (assuming that the partnership made a section 754 election) generally equals his outside basis in his partnership interest. Note: The accuracy of this computation may be materially reduced if the partnership did not make a section 754 election.

The Process Unit explains “IRC 704(b) Book Capital Accounts”:

The IRC 704(b) book capital accounting system is a creation of the partnership regulations. It is important to distinguish these “IRC 704(b) book capital accounts” from tax or GAAP capital accounts. The purpose of IRC 704(b) book capital is to reflect each partner’s economic share of the partnership’s assets equal to their equity in the partnership.

The rules for computing and maintaining book capital accounts are found in Treas. Reg. 1.704-1(b)(2)(iv)(b), a regulation section supporting IRC 704(b). For that reason, such capital accounts are known as “704(b) book” capital accounts. This term can be confusing because the accounting profession often equates the term “book” with financial accounting principles. Maintenance of IRC 704(b) book capital accounts are often included into partnership agreements to satisfy the safe harbor for economic effect as well as to assist in determining whether a partner’s allocation has economic effect. Treas. Reg. 1.704-1(b).

IRC 704(b) book capital accounts use fair market value for property contributions and property distributions. For example, if two individuals desire to form a 50/50 partnership, they agree as to the amount of money and the value of property each must contribute so their interests are equal. Professional appraisals may be obtained to value the property or services contributed.

A partner's book capital is increased/decreased by his allocable share of partnership book income/loss for the year, including taxexempt income. The tax character of the income or loss is not relevant, capital gain and ordinary income are treated the same. IRC 704(b) book income/loss is the same as taxable income/loss with three adjustments. First, depreciation deductions are computed by using tax depreciation concepts (that is, life method) applied to the book basis of assets. Second, gain/loss on an asset sale is computed by using the adjusted book basis of the disposed asset. Third, any inherent gain/loss in the distribution of property to a partner must be allocated to all partners in accordance with their allocation arrangement immediately prior to the distribution. A partnership agreement may, upon the occurrence of certain events, increase or decrease the book capital accounts of the partners to reflect a revaluation of partnership property (including intangible assets such as goodwill) on the partnership's books. Treas. Reg. 1.704-1(b)(2)(iv)(f).

The Process Unit's "Step 1: Pre-Audit Analysis/Estimate Outside Basis," instructs, "Inspect the return with a focus on the Schedules K-1 for potential issues. If outside basis is relevant to the issue, use tax return information to estimate the pertinent partner's outside basis." Citing Code § 731 as a resource, it lists the following "Considerations":

Generally, outside basis is not itself an issue. However, outside basis is inexorably intertwined with several issues which tend to be significant events. For example, if a partner sells or disposes of his partnership interest, he must know his outside basis in order to correctly determine the tax consequences. See Slide 15 [reproduced in the third paragraph below] for brief discussion on identifying transfers of partnership interests.

The partners' Schedules K-1 indicate whether the partners were allocated a loss and whether the partners received a distribution of cash or property. As noted previously, losses in excess of outside basis are suspended.

A partner may receive a distribution of cash or property in a liquidating or in a current distribution. A partner exits the partnership upon a liquidating distribution. On the other hand, a partner who receives a current distribution remains in the partnership. The type of distribution, the tax basis of the property, the amount of cash distributed, and the amount of the partner's outside basis determine the tax consequences.

Look for evidence of transfers of partnership interests. Some indicators are:

- Form 8308 is attached to the partnership return.
- A Schedule K-1 is marked "Final."
- A partner's Schedule K-1 reflects 0% at year end.
- A statement is attached to the partnership return indicating there was a sale, exchange, or liquidation of a partner's interest during the tax year.
- The partner does not receive a Schedule K-1 in the subsequent year.

A quick method for estimating a partner's outside basis from the Schedule K-1 (prior to consideration of current year activity) is to add the partner's beginning tax basis capital account, his share of liabilities (both recourse and nonrecourse), and any IRC 743(b) adjustments. The first two amounts are shown on each partner's Schedule K-1 as follows:

- Schedule K-1, Item L "Beginning capital account"
- Schedule K-1, Item K "Partner's share of liabilities"

Note: This estimation becomes much less accurate if the partnership did not use the tax basis method for reporting capital accounts and if the partnership did not make a Section 754 election.

Beginning in 2019, taxpayers are required to report on Schedule K-1, line 20, Code AH, the remaining Sec. 743(b) adjustments. Further, taxpayers are required to report on Schedule K-1, line 11, Code F, and line 13, Code V, any income, gain, loss, or deduction items related to an IRC 743(b) adjustment. Please see the instructions to the Form 1065 for years after 2019.

Note: This represents the partner's share of the partnership's inside tax basis of its assets less the partner's share of liabilities. It is not the partner's actual outside basis which must be computed by the partner; thus, it can only be used as an estimate.

As noted, for years prior to 2020, this estimate of a partner's outside basis will be more accurate if capital accounts are reported using the tax basis method, as opposed to the IRC 704(b) book or GAAP methods. The type of capital account reported is identified on Schedule K-1, Part I, Item L for years prior to 2019. The type of capital reflected on Schedule K-1 may be different from year-to-year. These factors should be considered when assessing the accuracy of an estimate of a partner's basis. Compare the prior year ending capital account on the Schedule K-1 to the beginning capital account balance. If there is a difference, request an explanation and documentation from the partnership.

For 2019 and later years, line 20, Code AH of the Schedule K-1 will have the IRC 743(b) adjustment (if the partnership made an IRC 754 election). This figure should be added to the tax basis capital account plus allocated liabilities calculation discussed earlier.

CAUTION: The capital account reporting requirements on Schedule K-1 have changed. Beginning In 2020, taxpayers are required, with few exceptions, to report capital accounts on the tax basis for their ending capital account amounts and thereafter both beginning and ending balances must be reported on the tax basis. Please see the instructions to the Form 1065 for 2020 and later years for further guidance.

The Process Unit's "Step 2: Verify or Reconstruct Outside Basis," instructs, "Use taxpayer records and internal sources to verify or reconstruct outside basis." It lists the following "Considerations":

Step One described how to estimate outside basis. Verify the estimate by obtaining additional information from both the partnership's representative and from internal sources.

> Often, basis is tracked at the partnership level. However, tracking outside basis is the responsibility of each partner. Treas. Reg. 1.705-1(a). The requirement to keep books and records is contained in Treas. Reg. 1.6001-1(a). A partner is required to maintain adequate books and records to substantiate basis. If a partner does not maintain adequate recordkeeping, then the burden of proof is on the partner to prove sufficient basis to deduct losses. See *Nwabasili v. CIR*, T.C. Memo. 2016-220.
>
> To verify or reconstruct a partner's outside basis, you must obtain the partner's Schedules K-1 starting with the year in which the partner was admitted to the partnership. The partnership's representative may be able to furnish the Schedules K-1. Additionally, use internal systems such as EUP, IDRS, LIN and yK-1.
>
> Once the Schedules K-1 are obtained, the partner's basis can be computed by using the Partner's Basis Computation Spreadsheet available in the Partnerships Knowledge Base within the IRS Virtual Library. When using the basis spreadsheet, it is important to include all partner contributions, distributions, liabilities and items of income/loss that impacts basis.
>
> You may obtain necessary information from years barred by the statute of limitations in order to correctly compute a partner's outside basis in your year under examination.

As to the last sentence above, if a prior return includes an improper deduction, the IRS would likely reduce basis for that incorrect item.

The Process Unit's "Step 3: Use Alternative Rule to Compute Outside Basis," instructs, "In certain circumstances, it is possible to calculate outside basis using an alternative rule under IRC 705(b)." It lists the following "Considerations" under "IRC 705(b) Alternative Basis Calculation Rule":

> IRC 705(b) provides an alternative rule for computing outside basis. This alternative rule can only be used in two circumstances:
>
> 1. The circumstances are such that the partner cannot practicably apply the general rules for the computation of outside basis.
>
> 2. In the Service's opinion, it is reasonable to conclude that the result produced will not vary substantially from the result produced under the general basis rules.
>
> A partner wishing to use the alternative rule must show that the circumstances are such that he is entitled to do so. See Treas. Reg. 1.705-1(b) and examples. When the alternative rule under IRC 705(b) is used to compute a partner's outside basis, adjustments to this calculation are necessary in certain situations. For example, contributions of property by a partner to a partnership, transfers of partnership interests, and distributions of property to partners are all situations that may require adjustments.

The Process Unit's "Examples of the Process" includes "Example 2 - Reconstructing a Partner's Outside Basis":

> You are assigned to examine XYZ Partnership's 2016 Form 1065. The Schedule K-1 of a partner named Joe Johnson shows he received a $465,000 cash distribution. You

> estimate that his outside basis is less than $465,000. His 2016 Form 1040 Schedule D reflects no capital gain from a cash distribution in excess of his basis in XYZ Partnership.
>
> You expand the audit to include Joe Johnson's 2016 Form 1040. An Information Document Request (IDR) is issued that requests a computation of his outside basis in XYZ Partnership as of December 31, 2016. Joe Johnson responds by providing his 2014 to 2016 Schedules K-1. He states that he has not tracked his outside basis in his partnership interest. You learn from reviewing the 2014 Schedule K-1 that Joe became a partner in XYZ Partnership on January 1, 2014. Joe Johnson's 2014 to 2016 Schedules K-1 show the following information:

The charts show that, in 2014, Joe contributed $150,000, was allocated $125,000 ordinary business income and $1,000 interest income, and received $20,000 cash distributions, leaving him with a capital account and basis of $256,000. In 2015, he was allocated a ($200,000) ordinary business loss, $30,0000 net real estate rental income, $1,000 interest income, and a ($5,000) net long-term capital loss, giving him a $82,000 capital account and, because of $100,000 recourse liabilities allocated to him, a $182,000 basis. In 2016, Joe was allocated $50,000 ordinary business income, $10,000 net rental real estate income, $1,000 interest income, and $2,000 net long-term capital gain, but his $465,000 in cash distributions left him with a ($320,000) negative capital account, the latter which was supported by only $100,000 in recourse liabilities at yearend. Therefore, he had a $220,000 capital gain from distributions in excess of basis. Moving from the charts to the narrative:

> You use the Basis Computation Spreadsheet in order to reconstruct Joe Johnson's basis which shows Joe Johnson's basis was $245,000 on line 11 before considering his $465,000 cash distribution. Therefore, his basis is $0 as of 12/31/2016, and he must report a $220,000 capital gain on his 2016 Form 1040 Schedule D.
>
> *CAUTION*: Line 19 of the Joe Johnson's Basis Spreadsheet shows a basis of ($220,000). As explained earlier in this Practice Unit, a partner's basis cannot fall below zero. Therefore, Joe Johnson is required to report a $220,000 capital gain for distributions in excess of basis.

The Process Unit's "Examples of the Process" includes "Example 3 - Alternative Rule for Reconstructing a Partner's Outside Basis":

> You are assigned the 2016 ABC Partnership return and one of its major partners, Mr. Apple, for examination. The exam plan includes Mr. Apple's distributive share of partnership loss and any potential basis limitation. An IDR was issued to Mr. Apple for documentation pertaining to his outside basis in his ABC Partnership interest. Mr. Apple is unable to provide any documentation because his records were destroyed in a house fire the previous year. He states that he and two other partners contributed cash and property in 2005 when the partnership was formed. Since 2005, no partners left, and no new partners were admitted.
>
> You determine the circumstances warrant the use of the alternative rule under IRC 705(b). You inspect the partnership's tax basis balance sheet which shows:

The chart shows $100,000 cash, $250,000 inventory, $475,000 PP&E, and $75,00 other assets, for $900,000 total assets; and $50,000 other liabilities and $250,000 mortgages, for $300,000 total liabilities. More narrative:

> Since the partnership has liabilities, Mr. Apple's share of the basis of partnership property is computed net of liabilities. Treas. Reg. 1.705-1(b) Example 3. Since Mr. Apple has a one-third ownership in the partnership, his basis in the partnership is $300,000. This is computed as follows:

The chart shows that the $900,00 total assets minus $300,000 total liabilities equals a $600,000 net value of the partnership, which was then multiplied by 1/3 to show that his share of net assets is $200,000. Adding his $100,000 share of liabilities to his $20,0000 share of net assets equals$300,000 basis under Reg. § 1.705-1(b). The example then comments:

> **CAUTION**: If the liabilities were not allocated in proportion to Mr. Apple's ownership in ABC Partnership, Mr. Apple's basis would have been different than shown in the example above.

The Process Unit's "Examples of the Process" includes "Example 4 - Basis Reduction for Donated Appreciated Property":

> In 1990, Partner X and Partner Y formed the XY Law Partnership and opened an office. To celebrate the office's opening, a friend gifted a painting to X and Y which they contributed to the partnership and hung in the office's lobby. The donor had a zero basis in the painting. The partnership's inside basis was also zero. In 2020, in anticipation of retiring, X and Y decide to donate the painting to a museum which is an IRC 501(c)(3) charity. An appraisal determine that its fair market value is $1M. No outside basis reduction is necessary for either X or Y as the painting has a zero tax basis. However, X and Y each may claim a charitable contribution deduction of $500,000 regardless of their amounts of outside basis in the XY Partnership. The property's appreciation is not subject to a basis limitation.

The Process Unit's "Examples of the Process" includes "Example - Basis Reduction for Donated Appreciated Property":

> The facts are the same as in Example 4, but the XY Partnership purchased the painting for its lobby in 1990 for $100,000. Additionally, X has an outside basis of $50,000 and Y has an outside basis of $30,000. In this fact pattern, the painting's built-in gain is $900,000 ($1M minus $100,000). X and Y must reduce their outside basis by their shares of the painting's tax basis ($50,000 each). While each partner's outside basis is reduced to zero, X's charitable donation amount is $500,000 ($50,000 basis plus $450,000 share of appreciation). However, Y's charitable donation amount is limited to $480,000 (his outside basis of $30,000 plus his share of appreciation of $450,000). Note that Y's $20,000 unused charitable donation amount would carry over to a year in which he has sufficient outside basis.
>
> Note that in both examples other limitations may apply at the level of the individuals.

II.G.4.e.iii. IRS Description of Loss Limitations

LB&I Process Unit, "Partner's Outside Basis," Document Control Number (DCN) PAR-P-002 (last updated 5/19/2021) (the "Process Unit") discusses calculating a partner's basis in that person's partnership interest. The Process Unit describes "Loss Limitations":

> In general, a partner's distributive share of partnership loss, including capital loss, is allowed only to the extent of the partner's outside basis. IRC 704(d). In determining the extent to which loss or deduction may be claimed, the partner's outside basis is first increased by his share of income, contributions, and liabilities, and decreased by both cash and property distributions and any decrease in his share of partnership liabilities. IRC 705. If the current year aggregate loss exceeds the adjusted outside basis, the loss limitation must be allocated to each type of loss or deduction, including any amounts carried over from prior years due to previous basis limitations. Treas. Reg. 1.704-1(d)(2).
>
> The Tax Cuts and Jobs Act (TCJA) amended IRC 704(d). IRC 704(d)(3)(A) provides that charitable contributions and foreign tax payments are taken into account under the basis limitation rules. Under prior law, a partner could take into account their entire distributive shares of charitable contributions or foreign tax payments even if they were in excess of outside basis.
>
> Under TCJA, for partnership tax years beginning after December 31, 2017, a partner may not take into account his distributive share of foreign tax payments if the amount of the payments exceed his outside basis. The new rule for charitable contributions is more complicated. New IRC 704(d)(3)(B) addresses situations in which a partnership donates built-in gain property, in other words, property whose fair market value exceeds its tax basis. Partners must reduce outside basis by their share of the appreciated property's tax basis. The donated property's built-in gain does not reduce outside basis and is not subject to IRC 704(d).
>
> See Examples 4 and 5 on Slide 29.

The Process Unit's "Examples of the Process" begins with "Example 1 - Determine if a Potential Basis Issue Exists":

> You are assigned to audit ABC Partnership's 2015 Form 1065 Tax Return. As part of your risk analysis, you review the tax return, which includes the partners' Schedule K-1s. A review of the Schedule K-1 shows the following relevant information for partner Sally Smith. Sally does not have an IRC 743(b) adjustment. Assume that the partnership uses the tax basis capital account method for purposes of the calculation:

It then includes a chart showing ($140,000) beginning capital account; ($120,000) ordinary business loss; $10,000 net rental real estate income; ($5,000) net long-term capital loss; ($115,000) current year decrease adding together the income and loss; ($255,000) ending capital account, combining the beginning capital account and current year activity; $75,000 nonrecourse liabilities; $100,000 recourse liabilities; and ($80,000) estimated loss in excess of basis, combining current loss with liabilities and beginning capital account. The analysis continues:

> An estimate of Sally Smith's outside basis (($140,000) plus $175,000 plus $10,000 equals $45,000) shows she may be able to deduct $45,000 of the $125,000 ($120,000 plus $5,000) in partnership losses. The remaining $80,000 loss must be suspended under IRC 704(d) until she has adequate outside basis. Remember to check the Schedule K-1, line 19 for distributions of cash and/or property. Sally's disallowed loss would have increased by the amount of the adjusted basis of any property distributed or any cash distributed.

Please note that this is an estimate of basis because the partnership is not required to track a partner's outside basis. The tax basis capital account reflects the partner's share of the partnership's inside tax basis of its assets less the partner's share of liabilities. For years prior to 2020, the accuracy of this computation was dependent upon the type of capital account that is reflected on Schedule K-1. If the capital account was an "IRC 704(b) book capital" or "GAAP capital," those amounts may have differed significantly from the tax allocations to the partner since the start of her investment. For example, the book income statement may have reflected book deductions that were not allowed for tax purposes (Schedule M-3) in prior years and the current year. In that case, the capital account for book purposes will be lower than that for tax, and thus the estimated basis computed above will be lower than the actual tax basis.

Beginning in 2020, partnerships are required to report capital accounts on a tax basis. In addition, for 2019 and later years, partnerships are required to report a partner's net remaining unrecovered IRC 743(b) adjustment to line 20, Code AH. Please see the instructions to the Form 1065 for later years.

CAUTION: You should not assume the partner deducted the losses in excess of basis. A review of the partner's tax return would need to be performed to determine if she deducted all of the losses. In this example, the ordinary business losses and net rental real estate income would be reported on Sally Smith's Form 1040, Schedule E. The net long-term capital loss would be reported on Form 1040, Schedule D. If Sally Smith correctly limited her 2015 deductible losses from ABC Partnership, then no audit adjustment to suspend the excess losses under IRC 704(d) would be necessary.

If you determine Sally Smith deducted all of the 2015 losses from ABC Partnership on her 2015 Form 1040 return, then you should verify her basis in ABC Partnership to determine whether she deducted losses in excess of basis.

II.G.4.f. Comparing C Corporation Loss Limitations to Those for Partnership and S Corporation Losses

Thus, partnership and S corporations are better for deducting losses against debt than C corporations, because they permit ordinary loss treatment for any portion of the debt not repaid. For partnerships and S corporations, the deduction comes not when the note is worthless but rather every year as the owner's distributive share of the entity's income or loss. Contrast this against needing to prove the C corporation's inability to pay the debt and the additional restrictions imposed on the nature of the loss – partnership and S corporation deducting in calculating adjusted gross income (the most valuable way to deduct anything) compared to a C corporation shareholder's short-term capital loss or miscellaneous itemized deduction.

Rutter v. Commissioner, T.C. Memo. 2017-174, is a good example of this. The taxpayer, a "world-renowned scientist in the field of biotechnology," struck it rich. Then he poured tens of millions of dollars into a new losing business, hoping to replicate his earlier success. First, he used documented loans, which he later converted to preferred stock. Eventually he made advances to the business that were not documented by loans and that never paid interest. The Tax Court held that the advances constituted equity, and even if it might be reversed on that issue the advances would have been nonbusiness bad debts, deductible as capital losses when wholly worthless. If the entity had been taxed as a partnership and his investment structured as a partnership interest, his advances could have generated annually deductible losses.

If one exits from a C corporation that has lost money, see part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244.

II.G.4.g. Limitations on Deducting Charitable Contributions

In addition to limitations described in this part II.G.4.g, also see part II.J.4.c.ii Individual Contribution Deduction Requirements, which is part of a contrast with fiduciary income tax in part II.J.4.c Charitable Distributions.

This part II.G.4.g includes parts:

- II.G.4.g.i Charitable Deduction vs. Business Expense
- II.G.4.g.ii Basis Limitations on Deducting Charitable Contributions Made by an S corporation or a Partnership
- II.G.4.g.iii Bargain Sale to Charity
- II.G.4.g.iv Value of Charitable Contribution

II.G.4.g.i. Charitable Deduction vs. Business Expense

Deductions for charitable contributions made by C corporations are limited to 10% of their taxable income,[1239] whereas such contributions made by S corporations and partnerships are deducted at the owner level, subject to limitations due to basis,[1240] percentage (20%-50%) of modified adjusted gross income if the taxpayer is an individual[1241] or if the taxpayer is a fiduciary with unrelated business taxable income,[1242] and certain reductions of itemized deductions (for individuals).[1243]

[1239] Code § 170(b)(2)(A). For a very helpful chart, see Wittenbach, Milani, and Riegel, "Charting The Interactions Of The Charitable Contribution Deduction For Corporations," *Taxation of Exempts* (WG&L) May/Jun 2017, which is saved as Thompson Coburn doc. no. 6568468 (chart in PDF embedded at bottom of first page). For how this rule interacts with the net operating loss (NOL) deduction, see fn 1414 in part II.G.4.l.ii Net Operating Loss Deduction.

[1240] See part II.G.4.g.ii Basis Limitations on Deducting Charitable Contributions Made by an S corporation or a Partnership.

[1241] Code § 170(b)(1).

[1242] See parts II.Q.6.d Unrelated Business Taxable Income and II.Q.7.c S Corporation Owned by a Trust Benefitting Charity, especially part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction. As described in that part (including Code §§ 681 and 512(e)), the focus is on S corporations because all S corporation K-1 income received by a nongrantor trust deducting charitable contributions is per se unrelated business income, but partnerships can generate unrelated business income, too. Trusts without unrelated business income can deduct all of their charitable contributions, if and to the extent paid from gross income. Code § 642(c)(1). However, Code § 642(c) does not apply to an ESBT. See fn 6055 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview.

[1243] Code § 68.

IR News Release 2021-27 explains:

New law increases deduction limit for corporate cash contributions for disaster relief; IRS provides recordkeeping relief

The Internal Revenue Service today explained how corporations may qualify for the new 100% limit for disaster relief contributions and offered a temporary waiver of the recordkeeping requirement for corporations otherwise qualifying for the increased limit.

The Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTRA of 2020), enacted Dec. 27, temporarily increased the limit, to up to 100% of a corporation's taxable income, for contributions paid in cash for relief efforts in qualified disaster areas.

Under the new law, qualified disaster areas are those in which a major disaster has been declared under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act. This does not include any disaster declaration related to COVID-19. Otherwise, it includes any major disaster declaration made by the President during the period beginning on Jan. 1, 2020, and ending on Feb. 25, 2021, as long as it is for an occurrence specified by the Federal Emergency Management Agency as beginning after Dec. 27, 2019, and no later than Dec. 27, 2020. For a list of disaster declarations, visit FEMA.gov.

Qualified contributions must be paid by the corporation during the period beginning on Jan. 1, 2020, and ending on Feb. 25, 2021. Cash contributions to most charitable organizations qualify for this increased limit. Contributions made to a supporting organization or to establish or maintain a donor advised fund do not qualify.

A corporation elects the increased limit by computing its deductible amount of qualified contributions using the increased limit and by claiming the amount on its return for the tax year in which the contribution was made.

Corporations must meet the usual recordkeeping requirements that apply to charitable contributions, including obtaining a contemporaneous written acknowledgment (CWA) from the charity. The CWA must be obtained before the corporation files its return, but no later than the due date, including extensions, for filing that return.

The TCDTRA of 2020 added an additional substantiation requirement for qualified contributions. For corporations electing this increased limit, a corporation's CWA must include a disaster relief statement, stating that the contribution was used, or is to be used, by the eligible charity for relief efforts in one or more qualified disaster areas.

Because of the timing of the new law, the IRS recognizes that some corporations may have obtained a CWA that lacks the disaster relief statement. Accordingly, the agency will not challenge a corporation's deduction of any qualified contribution made before Feb. 1, 2021, solely on the grounds that the corporation's CWA does not include the disaster relief statement.

For additional details on the recordkeeping rules for substantiating gifts to charity, see Publication 526, Charitable Contributions, available on IRS.gov. More information about other coronavirus-related relief, can be found at IRS.gov.

The 50% limit in the preceding sentence is 60% for cash contributions made in any taxable year beginning after December 31, 2017, and before January 1, 2026[1244] and is increased to 100% in 2020 for certain cash contributions, as part of broader relief provided in the CARES Act, § 2205, "Modification of Limitations on Charitable Contributions during 2020"“

(a) TEMPORARY SUSPENSION OF LIMITATIONS ON CERTAIN CASH CONTRIBUTIONS.

(1) IN GENERAL. Except as otherwise provided in paragraph (2), qualified contributions shall be disregarded in applying subsections (b) and (d) of section 170 of the Internal Revenue Code of 1986.

(2) TREATMENT OF EXCESS CONTRIBUTIONS. For purposes of section 170 of the Internal Revenue Code of 1986-

(A) INDIVIDUALS. In the case of an individual-

(i) LIMITATION. Any qualified contribution shall be allowed as a deduction only to the extent that the aggregate of such contributions does not exceed the excess of the taxpayer's contribution base (as defined in subparagraph (H) of section 170(b)(1) of such Code) over the amount of all other charitable contributions allowed under section 170(b)(1) of such Code.

(ii) CARRYOVER. If the aggregate amount of qualified contributions made in the contribution year (within the meaning of section 170(d)(1) of such Code) exceeds the limitation of clause (i), such excess shall be added to the excess described in section 170(b)(1)(G)(ii).

(B) CORPORATIONS. In the case of a corporation-

(i) LIMITATION. Any qualified contribution shall be allowed as a deduction only to the extent that the aggregate of such contributions does not exceed the excess of 25 percent of the taxpayer's taxable income (as determined under paragraph (2) of section 170(b) of such Code) over the amount of all other charitable contributions allowed under such paragraph.

(ii) CARRYOVER. If the aggregate amount of qualified contributions made in the contribution year (within the meaning of section 170(d)(2) of such Code) exceeds the limitation of clause (i), such excess shall be appropriately taken into account under section 170(d)(2) subject to the limitations thereof.

[1244] Code § 170(b)(1)(G)(i).

(3) QUALIFIED CONTRIBUTIONS.

(A) IN GENERAL. For purposes of this subsection, the term “qualified contribution” means any charitable contribution (as defined in section 170(c) of the Internal Revenue Code of 1986) if -

(i) such contribution is paid in cash during calendar year 2020 to an organization described in section 170(b)(1)(A) of such Code, and

(ii) the taxpayer has elected the application of this section with respect to such contribution.

(B) EXCEPTION. Such term shall not include a contribution by a donor if the contribution is-

(i) to an organization described in section 509(a)(3) of the Internal Revenue Code of 1986, or

(ii) for the establishment of a new, or maintenance of an existing, donor advised fund (as defined in section 4966(d)(2) of such Code).

(C) APPLICATION OF ELECTION TO PARTNERSHIPS AND S CORPORATIONS. In the case of a partnership or S corporation, the election under subparagraph (A)(ii) shall be made separately by each partner or shareholder.

(b) INCREASE IN LIMITS ON CONTRIBUTIONS OF FOOD INVENTORY. In the case of any charitable contribution of food during 2020 to which section 170(e)(3)(C) of the Internal Revenue Code of 1986 applies, subclauses (I) and (II) of clause (ii) thereof shall each be applied by substituting “25 percent” for “15 percent.”

(c) EFFECTIVE DATE. This section shall apply to taxable years ending after December 31, 2019.

The Consolidated Appropriations Act, 2021, § 213, “Modification of Limitations on Charitable Contributions,” extended the 100% limited for individuals’ qualified cash contributions:

(a) IN GENERAL. Subsections (a)(3)(A)(i) and (b) of section 2205 of the CARES Act are each amended by inserting ‘‘or 2021’’ after ‘‘2020’’.

(b) CONFORMING AMENDMENT. The heading of section 2205 of the CARES Act is amended by striking ‘‘modification of limitations on charitable contributions during 2020’’ and inserting ‘‘temporary modification of limitations on charitable contributions’’.

(c) EFFECTIVE DATE. The amendments made by this section shall apply to contributions made after December 31, 2020.

The Consolidated Appropriations Act, 2021, § 304(a), “SPECIAL RULES FOR QUALIFIED DISASTER RELIEF CONTRIBUTIONS,” provides:

(1) IN GENERAL. In the case of a qualified disaster relief contribution made by a corporation-

(A) section 2205(a)(2)(B) of the CARES Act shall be applied first to qualified contributions without regard to any qualified disaster relief contributions and then separately to such qualified disaster relief contribution, and

(B) in applying such section to such qualified disaster relief contributions, clause (i) thereof shall be applied-

(i) by substituting ‘‘100 percent’’ for ‘‘25 percent’’, and

(ii) by treating qualified contributions other than qualified disaster relief contributions as contributions allowed under section 170(b)(2) of the Internal Revenue Code of 1986.

(2) QUALIFIED DISASTER RELIEF CONTRIBUTION. For purposes of this subsection, the term ‘‘qualified disaster relief contribution’’ means any qualified contribution (as defined in section 2205(a)(3) of the CARES Act) if -

(A) such contribution-

(i) is paid, during the period beginning on January 1, 2020, and ending on the date which is 60 days after the date of the enactment of this Act, and

(ii) is made for relief efforts in one or more qualified disaster areas,

(B) the taxpayer obtains from such organization contemporaneous written acknowledgment (within the meaning of section 170(f)(8) of such Code) that such contribution was used (or is to be used) for relief efforts described in subparagraph (A)(ii), and

(C) the taxpayer has elected the application of this subsection with respect to such contribution.

(3) CROSS-REFERENCE. For the suspension of the limitation on qualified disaster relief contributions made by an individual during 2020, see section 2205(a) of the CARES Act.

Additional limitations apply to contributions of ordinary income and capital gain property.[1245]

Transfers of property to a Code § 170(c) organization bearing a direct relationship to the taxpayer’s trade or business that are made with a reasonable expectation of financial return commensurate with the amount of the transfer may constitute allowable deductions as trade or

[1245] Code § 170(e).

business expenses[1246] rather than as charitable contributions.[1247] Note that some trade or business expenses, such as entertainment, are disallowed.[1248] As an aside, when an individual formed and funded a nonprofit corporation that never sought a tax exemption from the IRS, which corporation ran an event to benefit a charity, that individual was unable to treat the corporation as an S corporation and deduct the losses from the event, because the founder could not and did not own the nonprofit corporation.[1249]

A taxpayer that promises to donate a portion of its sales or profits to organizations that it specifies may deduct those donations as business expenses so long as the expenditure is not expressly precluded from being deducted (the latter including lobbying expenses).[1250]

[1246] Reg. § 1.162-15(a)(1) provides that any amounts characterized as Code § 170 charitable contributions are not deductible as Code § 162 business expenses. Rul. 84-110 amplifies Rev. Rul. 73-113 (fn. 1247) by providing that expenditures of serving as a public official are Code § 162 business expenses, even if not engaged in for profit (in the ruling, the expenses were much more than the annual income), because Code § 7701(a)(26) eliminates the profit motive as a requirement for being in the business of serving as a public official.

[1247] Reg. § 1.170A-1(c)(5); Rev. Rul. 73-113, which provides, "Whether a particular transfer was made with a reasonable expectation of a financial return, commensurate with the amount of the transfer, is a question of fact."

[1248] Code § 274(a), "Entertainment, amusement, recreation, or qualified transportation fringes," includes:

(1) *In general*. No deduction otherwise allowable under this chapter shall be allowed for any item—
   - (A) *Activity*. With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or
   - (B) *Facility*. With respect to a facility used in connection with an activity referred to in subparagraph (A).

(2) *Special rules*. For purposes of applying paragraph (1) —
   - (A) Dues or fees to any social, athletic, or sporting club or organization shall be treated as items with respect to facilities.
   - (B) An activity described in section 212 shall be treated as a trade or business.
   - (C) Repealed.

(3) *Denial of deduction for club dues*. Notwithstanding the preceding provisions of this subsection, no deduction shall be allowed under this chapter for amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose.

[1249] *Deckard v. Commissioner*, 155 T.C. No. 8 (2020). Given that the event seemed consistent with the charity's goals, the organizer should have asked the charity to form a single member LLC for the event, and then he could have taken a charitable contribution deduction for the event's losses that he funded.

[1250] CCA 201543013, which discussed the customers' charitable intent:

> Here, it does not appear that Taxpayer's customers have a right to a share of the amounts in Program X. The [promise to make certain donations] does not by itself appear to give the customers control over these funds such that Taxpayer is the agent of the customer or is acting as a mere conduit for the dispersal of these funds.
>
> You have indicated that factual development of this issue is ongoing. If you wish to pursue the agency theory, we suggest that you develop the facts consistent with the criteria set out in *National Carbide v. Commissioner*, 336 U.S. 422 (1949) and *Commissioner v. Bollinger*, 485 U.S. 340 (1988). If you wish to pursue a conduit theory, you may want to review *Seven-Up Co. v. Commissioner*, 14 T.C. 965 (1950) *acq. in result*, 1974-2 C.B. 1. It does not appear from the facts supplied so far that the funds in Program X belong to and are donated by Taxpayer's customers.

However, Rev. Proc. 2019-12 provides new rules for when a business entity makes a charitable contribution that qualifies for a state tax credit. Below are rules for C corporations, followed by rules for pass-through entities.

If a C corporation makes a payment to or for the use of a Code § 170(c) organization and receives or expects to receive a tax credit that reduces a state or local tax imposed on the C corporation in return for such payment, the C corporation may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of Code § 162(a) to the extent of the credit received or expected to be received, without needing to prove the business purpose for that part.[1251] Thus, a C corporation that receives a 100% tax credit deducts the entire contribution as a business expense without needing to prove business purposes,[1252] and a C corporation that receives an 80% tax credit deducts 80% as a business expense without needing to prove business purposes and 20% if and to the extent that taxpayer proves a business purpose.[1253]

Under certain conditions, pass-through entities, such as partnerships and S corporations but not disregarded entities, may deduct contributions that provide credits against tax imposed at an entity level (a "specified pass-through entity").[1254] If a specified pass-through entity makes a qualified payment and receives or expects to receive a credit against a state or local tax other

[1251] Rev. Proc. 2019-12, § 3.02. Rev. Proc. 2019-12, § 2 reasons:

> To the extent a C corporation receives or expects to receive a state or local tax credit in return for a payment to an organization described in section 170(c), it is reasonable to conclude that there is a direct benefit to the C corporation's business in the form of a reduction in the state or local taxes the C corporation would otherwise have to pay and, therefore, to the extent of the amount of the credit received or expected to be received, there is a reasonable expectation of financial return to the C corporation commensurate with the amount of the transfer.

[1252] Rev. Proc. 2019-12, § 3.03(1) provides:

> *Example 1*. A, a C corporation engaged in a trade or business, makes a payment of $1,000 to an organization described in section 170(c). In return for the payment, A receives or expects to receive a dollar-for-dollar state tax credit to be applied to A's state corporate income tax liability. Under section 3 of this revenue procedure, A may treat the $1,000 payment as meeting the requirements of an ordinary and necessary business expense under section 162.

[1253] Rev. Proc. 2019-12, § 3.03(2) provides:

> *Example 2*. B, a C corporation engaged in a trade or business, makes a payment of $1,000 to an organization described in section 170(c). In return for the payment, B receives or expects to receive a tax credit equal to 80 percent of the amount of this payment ($800) to be applied to B's local real property tax liability. Under section 3 of this revenue procedure, B may treat $800 as meeting the requirements of an ordinary and necessary business expense under section 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by this revenue procedure.

[1254] Rev. Proc. 2019-12, § 4.02 provides:

> *Specified pass-through entity*. An entity will be considered a specified pass-through entity described in this section 4.02 only if each of the requirements set forth in section 4.02(1) through (4) is satisfied.
>
> (1) The entity is a business entity other than a C corporation that is regarded for all federal income tax purposes as separate from its owners under section 301.7701-3;
> (2) The entity operates a trade or business within the meaning of section 162;
> (3) The entity is subject to a state or local tax incurred in carrying on its trade or business that is imposed directly on the entity; and
> (4) In return for a payment to an organization described in section 170(c), the entity receives or expects to receive a state or local tax credit that the entity applies or expects to apply to offset a state or local tax described in section 4.02(3) of this revenue procedure other than a state or local income tax.

than income tax, the specified pass-through entity may treat such payment as a Code § 162(a) expense to the extent of the credit received or expected to be received.[1255] "Good" taxes, credits against which count under this rule, include excise[1256] or real property tax[1257] that the entity pays.

Rev. Proc. 2019-12 follows up on questions raised about a business' charitable deductions in light of administrative action limiting charitable contributions that generate state tax credits and should be analyzed in the context of that action.[1258]

Regulations codify Rev. Proc. 2019-12, with some modifications. The preamble to the proposed regulations explained:[1259]

> In the interest of providing certainty for taxpayers, the Treasury Department and the IRS believe that it is appropriate to propose regulations to incorporate the safe harbors set out in Rev. Proc. 2019-12 and to request comments on these safe harbors. Thus, these proposed regulations propose amending § 1.162-15(a) to incorporate the Rev. Proc. 2019-12 safe harbors. These proposed regulations also propose amending § 1.170A-1(c)(5) and (h)(3)(viii) to provide cross references to § 1.162-15(a). The Treasury Department and the IRS specifically request comments on whether the safe harbors should be expanded to apply to an individual who is carrying on a trade or business or an activity described in section 212.
>
> The proposed regulations propose additional revisions to § 1.162-15(a) to more clearly reflect the current state of the law regarding a taxpayer's payment or transfer to an entity described in section 170(c). If the taxpayer's payment or transfer bears a direct relationship to its trade or business, and the payment is made with a reasonable expectation of commensurate financial return, the payment or transfer to the section 170(c) entity may constitute an allowable deduction as a trade or business expense under section 162, rather than a charitable contribution under section 170. See § 1.170A-1(c)(5); *Marquis v. Commissioner*, 49 T.C. 695 (1968). A proposed example illustrates that this rule applies regardless of whether the taxpayer expects to receive a state or local tax credit in return.
>
> The proposed revisions are also consistent with the decision in *American Bar Endowment*, which states that a payment to an entity described in section 170(c) may have a dual character—part charitable contribution and part business expense.

[1255] Rev. Proc. 2019-12, § 4.03 "safe harbor."
[1256] Rev. Proc. 2019-12, § 4.04(1), Example 1.
[1257] Rev. Proc. 2019-12, § 4.04(2), Example 2, which provides:

> S is an S corporation engaged in a trade or business and is owned by individuals C and D. S makes a payment of $1,000 to an organization described in section 170(c). In return for the payment, S receives or expects to receive a state tax credit equal to 80 percent of the amount of this payment ($800) to be applied to S's local real property tax liability incurred by S in carrying on its trade or business. Under applicable state and local law, the real property tax is imposed at the entity level (not the owner level). Under section 4 of this revenue procedure, S may treat $800 of the payment as meeting the requirements of an ordinary and necessary business expense under section 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by this revenue procedure.

[1258] See text accompanying fn 1437 in part II.G.4.n Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax.
[1259] [REG-107431-19], RIN 1545-BP40 (12/17/2019).

> 477 U.S. at 117. Under *American Bar Endowment* and § 1.170A-1(h), if a taxpayer makes a payment to an entity described under section 170(c) in an amount that exceeds the fair market value of the benefit that the taxpayer receives or expects to receive in return, and this excess amount is paid with charitable intent, the taxpayer is allowed a charitable contribution deduction under section 170 for this excess amount.
>
> In addition, the proposed regulations propose to add a cross-reference to § 1.170A-1(h) (payments to section 170(c) entities in exchange for consideration), which provides more detailed rules for determining whether a payment, or a portion of a payment, to an entity described in section 170(c) may be deducted under section 162(a) or section 170.

After discussing comments to Notice 2019-12, the preamble said:[1260]

> Under these proposed regulations, an individual who itemizes deductions and who makes a payment to a section 170(c) entity in exchange for a state or local tax credit may treat as a payment of state or local tax for purposes of section 164 the portion of such payment for which a charitable contribution deduction under section 170 is or will be disallowed under § 1.170A-1(h)(3). This treatment is allowed in the taxable year in which the payment is made, but only to the extent that the resulting credit is applied pursuant to applicable state or local law to offset the individual's state or local tax liability for such taxable year or the preceding taxable year. Any unused credit permitted to be carried forward may be treated as a payment of state or local tax under section 164 in the taxable year or years for which the carryover credit is applied in accordance with state or local law. The safe harbor for individuals applies only to payments of cash and cash equivalents.
>
> The proposed regulations are not intended to permit a taxpayer to avoid the limitations of section 164(b)(6). Therefore, the proposed regulations provide that any payment treated as a state or local tax under section 164, pursuant to the safe harbor provided in § 1.164-3(j) of the proposed regulations, is subject to the limitations on deductions in section 164(b)(6). Furthermore, the proposed regulations are not intended to permit deductions of the same payments under more than one provision. Thus, the proposed regulations provide that an individual who relies on the safe harbor in § 1.164-3(j) to deduct qualifying payments under section 164 may not also deduct the same payments under any other section of the Code.

After reviewing the history of quid pro quo cases, the preamble said:[1261]

> The quid pro quo principle is thus equally applicable regardless of whether the donor expects to receive the benefit from the donee or from a third party. In either case, the donor's payment is not a charitable contribution or gift to the extent that the donor expects a substantial benefit in return. Accordingly, the Treasury Department and the IRS propose amendments to § 1.170A-1(h) that address a donor's payments in exchange for consideration in order for the regulation to reflect existing law. Specifically, these proposed amendments revise paragraph (h)(4) to provide definitions of "in consideration for" and "goods and services" for purposes of applying the rules in § 1.170A-1(h). Under the proposed regulations, a taxpayer will be treated as receiving goods and services in consideration for a taxpayer's payment or transfer to an entity

[1260] [REG-107431-19], RIN 1545-BP40 (12/17/2019).
[1261] [REG-107431-19], RIN 1545-BP40 (12/17/2019).

> described in section 170(c) if, at the time the taxpayer makes the payment or transfer, the taxpayer receives or expects to receive goods or services in return.
>
> The proposed regulations do not amend the language of § 1.170A-13(f)(6) which discusses "in consideration for" for purposes of determining whether the taxpayer provides proper substantiation of its charitable contribution. Section 1.170A-13(f) details the requirements of a contemporaneous written acknowledgment, including a statement of whether the donee organization provides any goods or services in consideration for any cash or other property transferred to the donee organization and a description and a good faith estimate of the value of those goods or services. See § 1.170A-13(f)(2)(ii) and (iii). These substantiation provisions refer only to written acknowledgments from donee organizations and do not address the application of quid pro quo principles to benefits received from parties other than donees. The Treasury Department and the IRS request comments on whether guidance concerning substantiation and reporting of quid pro quo benefits provided or expected to be provided by third parties, including state governments, would be beneficial to taxpayers in demonstrating that they have given more than they received or expected to receive and to the IRS in administering the proposed regulation. In addition, the Treasury Department and the IRS request comments regarding the manner by which donors, donees, or third parties may report or provide substantiation for the value or type of consideration received or expected to be received from third parties.
>
> For additional clarity, the proposed regulation amends the language in § 1.170A-1(h)(2)(i)(B) to clarify that the fair market value of goods and services includes the value of goods and services provided by parties other than the donee. Also, the proposed regulation adds a definition of "goods and services" that is the same as the definition in § 1.170A-13(f)(5). Finally, the proposed regulation revises the cross-references defining "in consideration for" and "goods and services" in paragraphs (h)(1) and (h)(3)(iii) to be consistent with the proposed definitions provided in paragraph (h)(4).

The proposed regulations would be prospective, but taxpayers would be able to rely on them for any post-2017 payments and transfers.

The preamble to the final regulations, T.D. 9907 (8/7/2020), explains:

> The Treasury Department and the IRS adopt the proposed regulations with clarifications in response to the written comments received and testimony provided.
>
> First, the final regulations retain the proposed amendments to § 1.162-15(a). The final regulations continue to clarify that a taxpayer's payment or transfer to a section 170(c) entity may constitute an allowable deduction as a trade or business expense under section 162, rather than a charitable contribution under section 170. The final regulations also retain the examples demonstrating the application of this rule with minor clarifying changes.
>
> Second, the final regulations retain the safe harbors under section 162 to provide certainty with respect to the treatment of payments made by business entities to an entity described in section 170(c). The final regulations provide safe harbors under section 162 for payments made by a business entity that is a C corporation or specified passthrough entity to or for the use of an organization described in section 170(c) if the C corporation or specified passthrough entity receives or expects to receive State or

local tax credits in return. To the extent that a C corporation or specified passthrough entity receives or expects to receive a State or local tax credit in return for a payment to an organization described in section 170(c), it is reasonable to conclude that there is a direct benefit and a reasonable expectation of commensurate financial return to the C corporation's or specified passthrough entity's business in the form of a reduction in the State or local taxes that the entity would otherwise be required to pay. Thus, the final regulations provide safe harbors that allow a C corporation or specified passthrough entity engaged in a trade or business to treat the portion of the payment that is equal to the amount of the credit received or expected to be received as meeting the requirements of an ordinary and necessary business expense under section 162. The safe harbors for C corporations and specified passthrough entities apply only to payments of cash and cash equivalents. The safe harbor for specified passthrough entities does not apply if the credit received or expected to be received reduces a State or local income tax.

Reg. § 1.162-15, "Contributions, dues, etc.," restates subsection (a), "Payments and transfers to entities described in section 170(c)":

(1) *In general*. A payment or transfer to or for the use of an entity described in section 170(c) that bears a direct relationship to the taxpayer's trade or business and that is made with a reasonable expectation of financial return commensurate with the amount of the payment or transfer may constitute an allowable deduction as a trade or business expense rather than a charitable contribution deduction under section 170. For payments or transfers in excess of the amount deductible under section 162(a), see § 1.170A-1(h).

(2) *Examples*. The following examples illustrate the rules of paragraph (a)(1) of this section:

(i) *Example (1)*. A, an individual, is a sole proprietor who manufactures musical instruments and sells them through a website. A makes a $1,000 payment to a local church (which is a charitable organization described in section 170(c)) for a half-page advertisement in the church's program for a concert. In the program, the church thanks its concert supporters, including A. A's advertisement includes the URL for the website through which A sells its instruments. A reasonably expects that the advertisement will attract new customers to A's website and will help A to sell more musical instruments. A may treat the $1,000 payment as an expense of carrying on a trade or business under section 162.

(ii) *Example (2)*. P, a partnership, operates a chain of supermarkets, some of which are located in State N. P operates a promotional program in which it sets aside the proceeds from one percent of its sales each year, which it pays to one or more charities described in section 170(c). The funds are earmarked for use in projects that improve conditions in State N. P makes the final determination on which charities receive payments. P advertises the program. P reasonably believes the program will generate a significant degree of name recognition and goodwill in the communities where it operates and thereby increase its revenue. As part of the program, P makes a $1,000 payment to a charity described in section 170(c). P may treat the $1,000 payment as an expense of carrying on a trade or business under section 162. This result is unchanged if, under State N's tax credit program, P expects to receive a $1,000 income tax credit on account of

P’s payment, and under State N law, the credit can be passed through to P’s partners.

(3) *Safe harbors for C corporations and specified passthrough entities making payments in exchange for State or local tax credits*.

(i) *Safe harbor for C corporations*. If a C corporation makes a payment to or for the use of an entity described in section 170(c) and receives or expects to receive in return a State or local tax credit that reduces a State or local tax imposed on the C corporation, the C corporation may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of section 162(a) to the extent of the amount of the credit received or expected to be received.

(ii) *Safe harbor for specified passthrough entities*.

(A) *Definition of specified passthrough entity*. For purposes of this paragraph (a)(3)(ii), an entity is a specified passthrough entity if each of the following requirements is satisfied -

(1) The entity is a business entity other than a C corporation and is regarded for all Federal income tax purposes as separate from its owners under § 301.7701-3 of this chapter;

(2) The entity operates a trade or business within the meaning of section 162;

(3) The entity is subject to a State or local tax incurred in carrying on its trade or business that is imposed directly on the entity; and

(4) In return for a payment to an entity described in section 170(c), the entity described in paragraph (a)(3)(ii)(A)(1) of this section receives or expects to receive a State or local tax credit that the entity applies or expects to apply to offset a State or local tax described in paragraph (a)(3)(ii)(A)(3) of this section.

(B) *Safe harbor*. Except as provided in paragraph (a)(3)(ii)(C) of this section, if a specified passthrough entity makes a payment to or for the use of an entity described in section 170(c), and receives or expects to receive in return a State or local tax credit that reduces a State or local tax described in paragraph (a)(3)(ii)(A)(3) of this section, the specified passthrough entity may treat such payment as an ordinary and necessary business expense for purposes of section 162(a) to the extent of the amount of credit received or expected to be received.

(C) *Exception*. The safe harbor described in this paragraph (a)(3)(ii) does not apply if the credit received or expected to be received reduces a State or local income tax.

(iii) *Definition of payment*. For purposes of this paragraph (a)(3), payment is defined as a payment of cash or cash equivalent.

(iv) *Examples*. The following examples illustrate the rules of paragraph (a)(3) of this section.

(A) *Example (1)*. *C corporation that receives or expects to receive dollar-for-dollar State or local tax credit*. A, a C corporation engaged in a trade or business, makes a payment of $1,000 to an entity described in section 170(c). In return for the payment, A expects to receive a dollar-for-dollar State tax credit to be applied to A's State corporate income tax liability. Under paragraph (a)(3)(i) of this section, A may treat the $1,000 payment as an expense of carrying on a trade or business under section 162.

(B) *Example (2)*. *C corporation that receives or expects to receive percentage-based State or local tax credit*. B, a C corporation engaged in a trade or business, makes a payment of $1,000 to an entity described in section 170(c). In return for the payment, B expects to receive a local tax credit equal to 80 percent of the amount of this payment ($800) to be applied to B's local real property tax liability. Under paragraph (a)(3)(i) of this section, B may treat $800 as an expense of carrying on a trade or business under section 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by paragraph (a)(3)(i) of this section.

(C) *Example (3)*. *Partnership that receives or expects to receive dollar-for-dollar State or local tax credit*. P is a limited liability company classified as a partnership for Federal income tax purposes under § 301.7701-3 of this chapter. P is engaged in a trade or business and makes a payment of $1,000 to an entity described in section 170(c). In return for the payment, P expects to receive a dollar-for-dollar State tax credit to be applied to P's State excise tax liability incurred by P in carrying on its trade or business. Under applicable State law, the State's excise tax is imposed at the entity level (not the owner level). Under paragraph (a)(3)(ii) of this section, P may treat the $1,000 as an expense of carrying on a trade or business under section 162.

(D) *Example (4)*. *S corporation that receives or expects to receive percentage-based State or local tax credit*. S is an S corporation engaged in a trade or business and is owned by individuals C and D. S makes a payment of $1,000 to an entity described in section 170(c). In return for the payment, S expects to receive a local tax credit equal to 80 percent of the amount of this payment ($800) to be applied to S's local real property tax liability incurred by S in carrying on its trade or business. Under applicable local law, the real property tax is imposed at the entity level (not the owner level). Under paragraph (a)(3)(ii) of this section, S may treat $800 of the payment as an expense of carrying on a trade or business under section 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by paragraph (a)(3)(ii) of this section.

(v) *Applicability of section 170 to payments in exchange for State or local tax benefits*. For rules regarding the availability of a charitable contribution deduction under section 170 where a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c) and receives or expects to receive a State or local tax benefit in return for such payment, see § 1.170A-1(h)(3).

(4) *Applicability dates*. Paragraphs (a)(1) and (2) of this section, regarding the application of section 162 to taxpayers making payments or transfers to entities described in section 170(c), apply to payments or transfers made on or after December 17, 2019. Section 1.162-15(a), as it appeared in the April 1, 2020 edition of 26 CFR part 1, generally applies to payments or transfers made prior to December 17, 2019. However, taxpayers may choose to apply paragraphs (a)(1) and (2) of this section to payments and transfers made on or after January 1, 2018. Paragraph (a)(3) of this section, regarding the safe harbors for C corporations and specified passthrough entities making payments to section 170(c) entities in exchange for State or local tax credits, applies to payments made by these entities on or after December 17, 2019. However, taxpayers may choose to apply the safe harbors of paragraph (a)(3) to payments made on or after January 1, 2018.

New Reg. § 1.162-15(d), "Cross reference," provides:

For provisions dealing with expenditures for institutional or "good will" advertising, see § 1.162-20(a)(2).

For the flip side of the advertising deduction, see Advertising Unrelated Business Taxable Income and 3rd Party Contractor Issues | Internal Revenue Service (irs.gov).

Reg. § 1.164-3, "Definitions and special rules," adds subsection (j), "Safe harbor for payments by individuals in exchange for State or local tax credits":

(1) *In general*. An individual who itemizes deductions and who makes a payment to or for the use of an entity described in section 170(c) in consideration for a State or local tax credit may treat as a payment of State or local tax for purposes of section 164 the portion of such payment for which a charitable contribution deduction under section 170 is disallowed under § 1.170A-1(h)(3). This treatment as payment of a State or local tax is allowed in the taxable year in which the payment is made to the extent that the resulting credit is applied, consistent with applicable State or local law, to offset the individual's State or local tax liability for such taxable year or the preceding taxable year.

(2) *Credits carried forward*. To the extent that a State or local tax credit described in paragraph (j)(1) of this section is not applied to offset the individual's applicable State or local tax liability for the taxable year of the payment or the preceding taxable year, any excess State or local tax credit permitted to be carried forward may be treated as a payment of State or local tax under section 164(a) in the taxable year or years for which the carryover credit is applied in accordance with State or local law.

(3) *Limitation on individual deductions*. Nothing in this paragraph (j) may be construed as permitting a taxpayer who applies this safe harbor to avoid the limitation of section 164(b)(6) for any amount paid as a tax or treated under this paragraph (j) as a payment of tax.

(4) *No safe harbor for transfers of property*. The safe harbor provided in this paragraph (j) applies only to a payment of cash or cash equivalent.

(5) *Coordination with other deductions*. An individual who deducts a payment under section 164 may not also deduct the same payment under any other Code section.

(6) *Examples*. In the following examples, assume that the taxpayer is an individual who itemizes deductions for Federal income tax purposes.

(i) *Example (1)*. In year 1, Taxpayer A makes a payment of $500 to an entity described in section 170(c). In return for the payment, A receives a dollar-for-dollar State income tax credit. Prior to application of the credit, A's State income tax liability for year 1 was more than $500. A applies the $500 credit to A's year 1 State income tax liability. Under paragraph (j)(1) of this section, A treats the $500 payment as a payment of State income tax in year 1. To determine A's deduction amount, A must apply the provisions of section 164 applicable to payments of State and local taxes, including the limitation in section 164(b)(6). See paragraph (j)(3) of this section.

(ii) *Example (2)*. In year 1, Taxpayer B makes a payment of $7,000 to an entity described in section 170(c). In return for the payment, B receives a dollar-for-dollar State income tax credit, which under State law may be carried forward for three taxable years. Prior to application of the credit, B's State income tax liability for year 1 was $5,000; B applies $5,000 of the $7,000 credit to B's year 1 State income tax liability.

Under paragraph (j)(1) of this section, B treats $5,000 of the $7,000 payment as a payment of State income tax in year 1. Prior to application of the remaining credit, B's State income tax liability for year 2 exceeds $2,000. B applies the excess credit of $2,000 to B's year 2 State income tax liability. For year 2, under paragraph (j)(2) of this section, B treats the $2,000 as a payment of State income tax under section 164. To determine B's deduction amounts in years 1 and 2, B must apply the provisions of section 164 applicable to payments of State and local taxes, including the limitation under section 164(b)(6). See paragraph (j)(3) of this section.

(iii) *Example (3)*. In year 1, Taxpayer C makes a payment of $7,000 to an entity described in section 170(c). In return for the payment, C receives a local real property tax credit equal to 25 percent of the amount of this payment ($1,750). Prior to application of the credit, C's local real property tax liability in year 1 was more than $1,750. C applies the $1,750 credit to C's year 1 local real property tax liability. Under paragraph (j)(1) of this section, for year 1, C treats $1,750 of the $7,000 payment as a payment of local real property tax for purposes of section 164. To determine C's deduction amount, C must apply the provisions of section 164 applicable to payments of State and local taxes, including the limitation under section 164(b)(6). See paragraph (j)(3) of this section.

(7) *Applicability date*. This paragraph (j) applies to payments made to section 170(c) entities on or after June 11, 2019. However, a taxpayer may choose to apply this paragraph (j) to payments made to section 170(c) entities after August 27, 2018.

Reg. § 1.170A-1(h)(3), "Payment in exchange for consideration," complements Reg. § 1.164-3 regarding any related contributions and is reproduced with the rest of Reg. § 1.170A-1(h) in part II.G.4.g.iii Bargain Sale to Charity.

II.G.4.g.ii. Basis Limitations on Deducting Charitable Contributions Made by an S corporation or a Partnership

A partner may deduct charitable contributions without regard to the partner's basis.[1262] The basis of the partner's interest in the partnership is decreased (but not below zero) by the partner's share of the partnership's basis in the property contributed.[1263]

Until recently, the full fair market value of the contribution reduced basis, and triggering the regular basis limitations under part II.G.4.c Basis Limitations for Deducting Partnership and S Corporation Losses. However, for contributions made in tax years beginning after December 21, 2005,[1264] appreciation does not reduce basis and therefore is not subject to these basis limitations.[1265]

Trusts that are partners or S corporation shareholders may see their charitable contributions reduced due to certain rules relating to unrelated business income (which rules apply to all S corporation K-1 income even if the S corporation does not engage in a trade or business and does not have any debt-financed income). See part II.Q.7.c S Corporation Owned by a Trust Benefitting Charity (some of which applies to partnerships, even though the focus is S corporations). Although generally a trust cannot deduct contributions unless the trust agreement authorizes contributions to be made, trust deductions of partnership contributions are not so limited.[1266]

II.G.4.g.iii. Bargain Sale to Charity

Reg. § 1.170A-1(h), "Payment in exchange for consideration," provides:

(1) Burden on taxpayer to show that all or part of payment is a charitable contribution or gift. No part of a payment that a taxpayer makes to or for the use of an organization described in section 170(c) that is in consideration for (as defined in paragraph (h)(4)(i) of this section) goods or services (as defined in paragraph (h)(4)(ii) of this section) is a contribution or gift within the meaning of section 170(c) unless the taxpayer -

(i) Intends to make a payment in an amount that exceeds the fair market value of the goods or services; and

(ii) Makes a payment in an amount that exceeds the fair market value of the goods or services.

[1262] Letter Ruling 8405084; see fns. 1228-1229 in part II.G.4.e Basis Limitations for Partners in a Partnership. See discussion in McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 11.05[1][b] "Exclusion of Charitable Contributions From the Limitation."
[1263] Rev. Rul. 96-11; see Code § 705(a)(2)(B).
[1264] P.L. 109-280, section 1203(a).
[1265] Code § 1366(d)(4), 1367(a)(2).
[1266] Rev. Rul. 2004-5, which is discussed in fn. 4914, which is found in part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction. Note that charitable contributions by trusts are more beneficial for net investment income tax purposes than charitable contributions by individuals. See fn. 2324.

(2) *Limitation on amount deductible*.

(i) *In general*. The charitable contribution deduction under section 170(a) for a payment a taxpayer makes partly in consideration for goods or services may not exceed the excess of -

(A) The amount of any cash paid and the fair market value of any property (other than cash) transferred by the taxpayer to an organization described in section 170(c); over

(B) The fair market value of the goods or services received or expected to be received in return.

(ii) *Special rules*. For special limits on the deduction for charitable contributions of ordinary income and capital gain property, see section 170(e) and §§ 1.170A-4 and 1.170A-4A.

(3) *Payments resulting in state or local tax benefits*.

(i) *State or local tax credits*. Except as provided in paragraph (h)(3)(vi) of this section, if a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c), the amount of the taxpayer's charitable contribution deduction under section 170(a) is reduced by the amount of any state or local tax credit that the taxpayer receives or expects to receive in consideration for the taxpayer's payment or transfer.

(ii) *State or local tax deductions*.

(A) *In general*. If a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c), and the taxpayer receives or expects to receive state or local tax deductions that do not exceed the amount of the taxpayer's payment or the fair market value of the property transferred by the taxpayer to the entity, the taxpayer is not required to reduce its charitable contribution deduction under section 170(a) on account of the state or local tax deductions.

(B) *Excess state or local tax deductions*. If the taxpayer receives or expects to receive a state or local tax deduction that exceeds the amount of the taxpayer's payment or the fair market value of the property transferred, the taxpayer's charitable contribution deduction under section 170(a) is reduced.

(iii) *In consideration for*. For purposes of paragraph (h) of this section, the term in consideration for has the meaning set forth in paragraph (h)(4)(i) of this section.

(iv) *Amount of reduction*. For purposes of paragraph (h)(3)(i) of this section, the amount of any state or local tax credit is the maximum credit allowable that corresponds to the amount of the taxpayer's payment or transfer to the entity described in section 170(c).

(v) *State or local tax*. For purposes of paragraph (h)(3) of this section, the term state or local tax means a tax imposed by a State, a possession of the United States, or by a political subdivision of any of the foregoing, or by the District of Columbia.

(vi) *Exception*. Paragraph (h)(3)(i) of this section shall not apply to any payment or transfer of property if the total amount of the state and local tax credits received or expected to be received by the taxpayer is 15 percent or less of the taxpayer's payment, or 15 percent or less of the fair market value of the property transferred by the taxpayer.

(vii) *Examples*. The following examples illustrate the provisions of this paragraph (h)(3). The examples in paragraph (h)(6) of this section are not illustrative for purposes of this paragraph (h)(3).

(A) *Example (1)*. A, an individual, makes a payment $1,000 to X, an entity described in section 170(c). In exchange for the payment, A receives or expects to receive a state tax credit of 70 percent of the amount of A's payment to X. Under paragraph (h)(3)(i) of this section, A's charitable contribution deduction is reduced by $700 (0.70 x $1,000). This reduction occurs regardless of whether A is able to claim the state tax credit in that year. Thus, A's charitable contribution deduction for the $1,000 payment to X may not exceed $300.

(B) *Example (2)*. B, an individual, transfers a painting to Y, an entity described in section 170(c). At the time of the transfer, the painting has a fair market value of $100,000. In exchange for the painting, B receives or expects to receive a state tax credit equal to 10 percent of the fair market value of the painting. Under paragraph (h)(3)(vi) of this section, B is not required to apply the general rule of paragraph (h)(3)(i) of this section because the amount of the tax credit received or expected to be received by B does not exceed 15 percent of the fair market value of the property transferred to Y. Accordingly, the amount of B's charitable contribution deduction for the transfer of the painting is not reduced under paragraph (h)(3)(i) of this section.

(C) *Example (3)*. C, an individual, makes a payment of $1,000 to Z, an entity described in section 170(c). In exchange for the payment, under state M law, C is entitled to receive a state tax deduction equal to the amount paid by C to Z. Under paragraph (h)(3)(ii)(A) of this section, C's charitable contribution deduction under section 170(a) is not required to be reduced on account of C's state tax deduction for C's payment to Z.

(viii) *Safe harbor for payments by C corporations and specified passthrough entities*. For payments by a C corporation or by a specified passthrough entity to an entity described in section 170(c), where the C corporation or specified passthrough entity receives or expects to receive a State or local tax credit that reduces the charitable contribution deduction for such payments under paragraph (h)(3) of this section, see § 1.162-15(a)(3) (providing safe harbors under section 162(a) to the extent of that reduction).

(ix) *Safe harbor for individuals*. Under certain circumstances, an individual who itemizes deductions and makes a payment to an entity described in section 170(c) in consideration for a State or local tax credit may treat the portion of such payment for which a charitable contribution deduction is disallowed under paragraph (h)(3) of this section as a payment of State or local taxes under section 164. See § 1.164-3(j), providing a safe harbor for certain payments by individuals in exchange for State or local tax credits.

(x) *Effective/applicability date*. This paragraph (h)(3) applies to amounts paid or property transferred by a taxpayer after August 27, 2018.

(4) *Definitions*. For purposes of this paragraph (h), the following definitions apply:

(i) *In consideration for*. A taxpayer receives goods or services in consideration for a taxpayer's payment or transfer to an entity described in section 170(c) if, at the time the taxpayer makes the payment to such entity, the taxpayer receives or expects to receive goods or services from that entity or any other party in return.

(ii) *Goods or services*. Goods or services means cash, property, services, benefits, and privileges.

(iii) *Applicability date*. The definitions provided in this paragraph (h)(4) are applicable to amounts paid or property transferred on or after December 17, 2019.

Braen v. Commissioner, T.C. Memo. 2023-85, reasoned and held:

1. Governing Standards

"Contributions of property `generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return.'" *Seventeen Seventy*, T.C. Memo. 2014-124, at *19 (quoting *United States v. Am. Bar Endowment*, 477 U.S. 105, 116 (1986)); see also *Emanouil v. Commissioner*, T.C. Memo. 2020-120, at *45. According to the Supreme Court, the "relevant inquiry" focuses on "whether the transaction...is structured as a quid pro quo exchange." *Hernandez v. Commissioner*, 490 U.S. 680, 701-02 (1989). We do not inquire into the taxpayer's subjective motives, instead giving weight to "the external features of the transaction." *Costello v. Commissioner*, T.C. Memo. 2015-87, at *26–27. "If it is understood that the property will not pass to the charitable recipient unless the taxpayer receives a specific benefit, and if the taxpayer cannot garner that benefit unless he makes the required `contribution,' the transfer does not qualify the taxpayer for a deduction under section 170." *Id*. at *27.

"The relevant question is whether the taxpayer expected a benefit in return for the payment; deductibility does not depend on what type of benefit the taxpayer received." *Triumph*, T.C. Memo. 2018-65, at *31 (quoting *Christiansen v. Commissioner*, 843 F.2d 418, 420 (10th Cir. 1988)); see also *Seventeen Seventy*, T.C. Memo. 2014-124, at *23-24 ("Medical, educational, scientific, religious, or other benefits can be consideration that vitiates charitable intent."). The benefit does not need to be financial, and we "have found that a transfer of real property in exchange for development approvals...is a benefit and precludes a finding of the requisite donative intent." *Triumph*, T.C. Memo. 2018-65, at *32; see also *Grinslade v. Commissioner*, 59 T.C. 566, 574-76 (1973); *Pollard v. Commissioner*, T.C. Memo. 2013-38; *Ackerman Buick, Inc. v. Commissioner*, T.C. Memo. 1973-224, 1973 Tax Ct. Memo LEXIS 64, at *9 ("Receipt of a desired zoning variance from a city which would or might not be available without making a dedication of land to the city has been held to be a direct economic benefit which would preclude a charitable deduction.").

"[A] taxpayer may still deduct a contribution of property if(1) the value of the property transferred...exceeds the fair market value of any goods or services received in exchange and (2) the excess payment is made `with the intention of making a gift.'" *Triumph*, T.C. Memo. 2018-65, at *29 (quoting *Am. Bar Endowment*, 477 U.S. at 117); *Seventeen Seventy*, T.C. Memo. 2014-124, at *19; Treas. Reg. § 1.170A-1(h)(1). In that instance, taxpayers may deduct the difference between the fair market value of the contributed property and that of the goods or services provided by the charitable organization. *Boone Operations Co. v. Commissioner*, T.C. Memo. 2013-101, at *15. Where a taxpayer, however, "fails to identify or value all of the consideration received in the transaction, the taxpayer is not entitled to any charitable contribution deduction." *Seventeen Seventy*, T.C. Memo. 2014-124, at *27; see also *Triumph*, T.C. Memo. 2018-65, at *35; *Boone*, T.C. Memo. 2013-101, at *48.

2. Value of Consideration Received

The Braens have not established the value of all consideration Holdings received as part of the purported bargain sale, and thus they are not entitled to the claimed charitable contribution deductions.

As an initial matter, the land purchase agreement and the settlement of the zoning litigation must be considered together as parts of an "inseparable package." See *Grinslade*, 59 T.C. at 574; see also *Boone*, T.C. Memo. 2013-101, at *23 ("When a taxpayer enters into a contractual arrangement with another party and claims that a bargain sale occurred, we consider the entire contractual arrangement in determining whether the taxpayer contributed money or property in excess of the value of the benefits received."). The land purchase agreement expressly notes that the zoning litigation "is being settled as part of the conveyance of the [p]roperty." It further specifies that the purchase was conditioned on "the entry by the Court of an Order which shall include the subdivision of the property in substantial conformity with the proposed order appended hereto." And the settlement agreement unambiguously references the land purchase agreement, which was included as an attachment.

We accordingly will examine both parts of the "integrated transaction." See *Derby v. Commissioner*, T.C. Memo. 2008-45, 2008 WL 540271, at *16. Holdings received two types of consideration: (1) $5,250,000 and (2) reversion of the zoning designation over the portion of the property Holdings retained "to its prior designation of [planned industrial]." See, e.g., *Grinslade*, 59 T.C. at 576 ("[T]he zoning variance was...an additional financial benefit anticipated by [the taxpayers] as a result of the conveyance...."); *Triumph*, T.C. Memo. 2018-65, at *35-40; *Seventeen Seventy*, T.C. Memo. 2014-124, at *31-33; *Ackerman*, 1973 Tax Ct. Memo LEXIS 64, at *17.

The Braens attempt to avoid this conclusion by arguing that Holdings was entitled to the zoning reversion as a matter of law and that the zoning litigation would have vindicated its entitlement. *Cf*. *Emanouil*, T.C. Memo. 2020-120, at *45 (explaining that "if the taxpayer cannot garner [a] benefit unless he makes the required `contribution', then the transfer does not qualify the taxpayer" for a section 170 deduction). The Braens rely on the opinion of Mr. Bazydlo, who represented Holdings during the zoning litigation, and their own analysis of New York law.

We decline to give weight to Mr. Bazydlo's opinions. Although we do not doubt his sincerity, Mr. Bazydlo is by-and-large offering legal opinions, which are the province of the Court. See In re Revel AC, Inc., 802 F.3d 558, 567 (3d Cir. 2015) ("[L]ikelihood of success...involves a purely legal determination."); *Cottillion v. United Refin. Co.*, 781 F.3d 47, 59 (3d Cir. 2015); *Alumax Inc. v. Commissioner*, 109 T.C. 133, 175 (1997), *aff'd*, 165 F.3d 822 (11th Cir. 1999). Further, Mr. Bazydlo represented Holdings in the zoning litigation (and in many other capacities in connection with the property), calling into question whether his opinion is that of an impartial expert or an advocate. See *Neonatology Assocs., P.A. v. Commissioner*, 115 T.C. 43, 86 (2000) ("An expert witness loses his or her impartiality when he or she is too closely connected with one of the parties."), *aff'd*, 299 F.3d 221 (3d Cir. 2002) ; *V.R. DeAngelis M.D.P.C. v. Commissioner*, T.C. Memo. 2007-360, 2007 WL 4257483, at *21–22, *aff'd*, 574 F.3d 789 (2d Cir. 2009).

In any event, the Braens' confidence in Holdings' ultimate success in the zoning litigation has no bearing on whether the rezoning achieved at settlement constituted a benefit. The record amply demonstrates that Holdings prized the planned industrial zoning designation for potential future development. After Ramapo's 2004 rezoning, Holdings was required to take action to secure its desired zoning. Holdings chose to obtain its end through the certain means of negotiated settlement rather than expend time and resources to continue along the unpredictable path of litigation. See *Perlmutter v. Commissioner*, 45 T.C. 311, 318 (1965) ("[Taxpayers] received a direct benefit because of the transfer. It appears from the evidence that even if the partnership might have ultimately prevailed in its efforts to get approval of its plans without making the transfers, it certainly avoided considerable and perhaps protracted difficulty in this regard by making the transfers in question.").

Although we are agnostic as to whether Holdings would have been able to prevail in litigation, we are certain that Holdings gained the significant benefit of a change to its then-governing zoning designation as part of the coordinated settlement and land purchase agreement. This benefit was required to be taken into account when analyzing any charitable contribution deduction.[9] Having failed to do so, the Braens are not entitled to the claimed charitable contribution deductions. See *Triumph*, T.C. Memo. 2018-65, at *35, *41–42; *Seventeen Seventy*, T.C. Memo. 2014-124, at *27–28; *Derby v. Commissioner*, 2008 WL 540271, at *19.

[9] The Braens argue that Ramapo's decision to settle the lawsuit indicates that it knew it would lose the zoning litigation. Any number of reasons might spur a party to settle a lawsuit, and we will not speculate as to motivations. See *Holmes v. Godinez*, 991 F.3d 775, 783 (7th Cir. 2021) ("Settlements are compromises in which the parties...sacrifice some goals to achieve others and to resolve a dispute without the expense of future litigation."); *RFF Fam. P'ship, LP v. Ross*, 814 F.3d 520, 530 (1st Cir. 2016) ("[A] settlement is born of compromise."); *Nault v. United States*, 517 F.3d 2, 6 (1st Cir. 2008) ("Parties to a settlement, almost by definition, eschew the possibility of obtaining some portion of what they would like in exchange for certain terms with which they can live.").

The court's holding that the deduction nonetheless would be barred because of a fatal defect in the contemporaneous written acknowledgment is reproduced in part II.J.4.c.ii.(a) Contemporaneous Written Acknowledgement (CWA).

II.G.4.g.iv. Value of Charitable Contribution

Reg. § 1.170A-1(c), "Value of a contribution in property," provides:

(1) If a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution reduced as provided in section 170(e)(1) and paragraph (a) of § 1.170A-4, or section 170(e)(3) and paragraph (c) of § 1.170A-4A.

(2) The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. If the contribution is made in property of a type which the taxpayer sells in the course of his business, the fair market value is the price which the taxpayer would have received if he had sold the contributed property in the usual market in which he customarily sells, at the time and place of the contribution and, in the case of a contribution of goods in quantity, in the quantity contributed. The usual market of a manufacturer or other producer consists of the wholesalers or other distributors to or through whom he customarily sells, but if he sells only at retail the usual market consists of his retail customers.

(3) If a donor makes a charitable contribution of property, such as stock in trade, at a time when he could not reasonably have been expected to realize its usual selling price, the value of the gift is not the usual selling price but is the amount for which the quantity of property contributed would have been sold by the donor at the time of the contribution.

(4) Any costs and expenses pertaining to the contributed property which were incurred in taxable years preceding the year of contribution and are properly reflected in the opening inventory for the year of contribution must be removed from inventory and are not a part of the cost of goods sold for purposes of determining gross income for the year of contribution. Any costs and expenses pertaining to the contributed property which are incurred in the year of contribution and would, under the method of accounting used, be properly reflected in the cost of goods sold for such year are to be treated as part of the cost of goods sold for such year. If costs and expenses incurred in producing or acquiring the contributed property are, under the method of accounting used, properly deducted under section 162 or other section of the Code, such costs and expenses will be allowed as deductions for the taxable year in which they are paid or incurred, whether or not such year is the year of the contribution. Any such costs and expenses which are treated as part of the cost of goods sold for the year of contribution, and any such costs and expenses which are properly deducted under section 162 or other section of the Code, are not to be treated under any section of the Code as resulting in any basis for the contributed property. Thus, for example, the contributed property has no basis for purposes of determining under section 170(e)(1)(A) and paragraph (a) of § 1.170A-4 the amount of gain which would have been recognized if such property had been sold by the donor at its fair market value at the time of its contribution. The amount of any charitable contribution for the taxable year is not to be reduced by the amount of any costs or expenses

pertaining to the contributed property which was properly deducted under section 162 or other section of the Code for any taxable year preceding the year of the contribution. This subparagraph applies only to property which was held by the taxpayer for sale in the course of a trade or business. The application of this subparagraph may be illustrated by the following examples:

Example (1). In 1970, A, an individual using the calendar year as the taxable year and the accrual method of accounting, contributed to a church property from inventory having a fair market value of $600. The closing inventory at the end of 1969 properly included $400 of costs attributable to the acquisition of such property, and in 1969 A properly deducted under section 162 $50 of administrative and other expenses attributable to such property. Under section 170(e)(1)(A) and paragraph (a) of § 1.170A-4, the amount of the charitable contribution allowed for 1970 is $400 ($600 − [$600 − $400]). Pursuant to this subparagraph, the cost of goods sold to be used in determining gross income for 1970 may not include the $400 which was included in opening inventory for that year.

Example (2). The facts are the same as in example (1) except that the contributed property was acquired in 1970 at a cost of $400. The $400 cost of the property is included in determining the cost of goods sold for 1970, and $50 is allowed as a deduction for that year under section 162. A is not allowed any deduction under section 170 for the contributed property, since under section 170(e)(1)(A) and paragraph (a) of § 1.170A-4 the amount of the charitable contribution is reduced to zero ($600 − [$600 − $0]).

Example (3). In 1970, B, an individual using the calendar year as the taxable year and the accrual method of accounting, contributed to a church property from inventory having a fair market value of $600. Under § 1.471-3(c), the closing inventory at the end of 1969 properly included $450 costs attributable to the production of such property, including $50 of administrative and other indirect expenses which, under his method of accounting, was properly added to inventory rather than deducted as a business expense. Under section 170(e)(1)(A) and paragraph (a) of § 1.170A-4, the amount of the charitable contribution allowed for 1970 is $450 ($600 − [$600 − $450]). Pursuant to this subparagraph, the cost of goods sold to be used in determining gross income for 1970 may not include the $450 which was included in opening inventory for that year.

Example (4). The facts are the same as in example (3) except that the contributed property was produced in 1970 at a cost of $450, including $50 of administrative and other indirect expenses. The $450 cost of the property is included in determining the cost of goods sold for 1970. B is not allowed any deduction under section 170 for the contributed property, since under section 170(e)(1)(A) and paragraph (a) of § 1.170A-4 the amount of the charitable contribution is reduced to zero ($600 − [$600 − $0]).

Example (5). In 1970, C, a farmer using the cash method of accounting and the calendar year as the taxable year, contributed to a church a quantity of grain which he had raised having a fair market value of $600. In 1969, C paid expenses of $450 in raising the property which he properly deducted for such year under section 162. Under section 170(e)(1)(A) and paragraph (a) of § 1.170A-4, the amount of the charitable contribution in 1970 is reduced to zero ($600 − [$600 − $0]). Accordingly, C is not allowed any deduction under section 170 for the contributed property.

Example (6). The facts are the same as in example (5) except that the $450 expenses incurred in raising the contributed property were paid in 1970. The result in the same as in example (5), except the amount of $450 is deductible under section 162 for 1970.

(5) For payments or transfers to an entity described in section 170(c) by a taxpayer carrying on a trade or business, see § 1.162-15(a).

As to Reg. § 1.162-15(a), see part II.G.4.g.i Charitable Deduction vs. Business Expense.

Braen v. Commissioner, T.C. Memo. 2023-85, discussed "Highest and Best Use":

> "A `critical aspect' in calculating fair market value is determining the `highest and best use' of the property" at issue. *PBBM-Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193, 209 (5th Cir. 2018) (quoting *Whitehouse Hotel Ltd. P'ship v. Commissioner*, 615 F.3d 321, 335 (5th Cir. 2010), vacating 131 T.C. 112 (2008)). We look to "[t]he highest and most profitable use for which the property is adaptable and needed or likely to be needed in the reasonably near future." *Palmer Ranch Holdings Ltd. v. Commissioner*, 812 F.3d 982, 996 (11th Cir. 2016) (quoting *Symington v. Commissioner*, 87 T.C. 892, 897 (1986)), *aff'g in part*, *rev'g in part and remanding* T.C. Memo. 2014-79. We must consider "[a]ny realistically available special use of property due to its adaptability to a particular business," but the fair market value "is not affected by whether the owner actually has put the property to its highest and best use." *Stanley Works & Subs. v. Commissioner*, 87 T.C. 389, 400 (1986).
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> "The highest and best use inquiry is one of objective probabilities," and the "`realistic, objective potential uses for property control' its valuation." *Esgar Corp. v. Commissioner*, 744 F.3d 648, 657 (10th Cir. 2014) (quoting *Symington*, 87 T.C. at 896), *aff'g* T.C. Memo. 2012-35, 2012 WL 371809, and *aff'g Temple v. Commissioner*, 136 T.C. 341 (2011). Importantly, "[a] suggested higher use other than current use `requires both "closeness in time" and "reasonable probability."'" *Id*. at 658 (quoting *Hilborn v. Commissioner*, 85 T.C. 677, 689 (1985)); see also *United States v. 269 Acres, More or Less, Located in Beaufort Cnty.*, 995 F.3d 152, 164 (4th Cir. 2021) ("[T]o base [value] on a use other than the current one, the landowner must produce evidence that the proffered use is "`reasonably probable" and that the probability has a real market value.'" (quoting *United States v. 69.1 Acres of Land, More or Less, Situated in Platt Springs Twp., Cnty. of Lexington*, 942 F.2d 290, 296 (4th Cir. 1991)).
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> "Any proposed use[] that `depend[s] upon events or combinations of occurrences which, while within the realm of possibility, are not fairly shown to be reasonably probable,'" should not be considered a viable use. See *Esgar Corp. v. Commissioner*, 2012 WL 371809, at *7 (quoting *Olson v. United States*, 292 U.S. 246, 257 (1934)). Although the highest and best use can be a use prohibited by zoning laws as of the date of contribution, such a proposed use "cannot be remote, speculative, or conjectural." *Dynamo Holdings Ltd. P'ship v. Commissioner*, T.C. Memo. 2018-61, at *80.
>
> The parties' experts reach vastly different values based primarily on differing conclusions as to the highest and best use of the property sold to Ramapo. The Braens rely on two

experts: (1) Mr. Zdunczyk, who determined that the highest and best use of the sale parcel was a quarry and valued the mineral rights at $11,000,000, and (2) Mr. Fader, who provided four different potential valuations, including a value of $12,190,000 if quarrying were the highest and best use. The Commissioner relies on a report by Hilco Real Estate Appraisal (Hilco), which valued the sale parcel at $4,850,000 with a highest and best use of limited residential development.

As an initial matter, the record leaves us with the firm conviction that, as of September 29, 2010, no reasonable probability existed that Holdings would be able to procure within a reasonable time the approvals, zoning changes, and permits required for quarrying. Although we do not doubt Holdings' intentions when it purchased the property or the land's suitability for a quarry, the governmental obstacles proved too much. Any thought otherwise represents a mixture of hope and conjecture.

Specifically, Holdings failed to make significant progress with DEC in obtaining the required state mining permit. From the start, DEC identified significant environmental concerns that needed to be addressed before the issuance of a mining permit. Despite investing time, effort, and expense, Holdings did not obtain authorization of studies relating to two of the major issues, much less assuage DEC's underlying concerns. *Cf. Palmer Ranch Holdings Ltd. v. Commissioner*, 812 F.3d at 997 (finding reasonable probability that development would be approved where the decision-making agency issued an ordinance describing particular requirements for development applications).

Holdings was similarly unsuccessful with Ramapo, and there were no real prospects that the town would change its stance. Ramapo had a longstanding prohibition on quarrying when Holdings submitted its petition for a zoning amendment in 1997, which was consistent with the negative views of quarrying expressed during and after the 1998 scoping hearing. *Cf. Johnston v. Commissioner*, T.C. Memo. 1997-475, 1997 WL 643299, at *19.

Ramapo's views only hardened over time. Seven years after Holdings initially sought the zoning amendment that would remove quarrying from prohibited uses, Ramapo passed a comprehensive zoning law that changed the zoning of the Ramapo portion of the property to an "R-40" low-density rural residential district. In the Draft Comprehensive Plan, Ramapo stressed that "additional...industrial development...would have considerable potential to cause significant harm to these critical resources" and recommended the prohibition of "uses that have the greatest potential to cause environmental impact."

We have previously remarked that "we should not consider [a] potential use in valuing the property" "if a hypothetical buyer [at the time of the bargain sale] would not have reasonably considered a potential use of the property." *Boone*, T.C. Memo. 2013-101, at *27 (citing *Boltar, L.L.C. v. Commissioner*, 136 T.C. 326, 336 (2011)); *Glade Creek Partners, LLC v. Commissioner*, T.C. Memo. 2020-148, at *34, *aff'd in part, vacated in part and remanded*, No. 21-11251, 2022 WL 3582113 (11th Cir. Aug. 22, 2022). A hypothetical buyer here would be unlikely to view quarrying as possible in light of the inability of Holdings - an established mining company with a long history of success - to obtain the requisite government approvals despite a decade of effort.

The quarry here is exactly the sort of proposed use that, at best, depended "upon events or combinations of occurrences which, while within the realm of possibility, are not fairly shown to be reasonably probable." See *Esgar Corp. v. Commissioner*, 2012 WL 371809, at *7 (quoting Olson, 292 U.S. at 257). We see no reasonable probability that Holdings could obtain DEC's blessing of the mining permit or overcome Ramapo's entrenched opposition after eight years of stasis. Accordingly, quarrying was not the property's highest and best use.[14]

> [14] Given our conclusion that the highest and best use of the property was not quarrying, we will not further consider Mr. Zdunczyk's mineral appraisal. See *Glade Creek*, T.C. Memo. 2020-148, at *37 (noting that an expert's valuation "is of little relevance" where the expert adopted a different highest and best use from the Court's).

Excluding quarrying leaves residential development as the highest and best use of the property. Our conclusion on this point rests on the common opinion of the parties' experts, each of whom identified residential development as the property's highest and best use in the absence of quarrying.[15]

> [15] Although Mr. Fader's expert report also provides a valuation based on a highest and best use under the assumption that the Ramapo portion of the property would be zoned industrial, he affirmed both during cross and redirect examination that "it was [his] opinion that the highest and best use was as residential."

The court discussed using later sales as evidence:

> "[E]vidence of lot sales within a reasonable period after the date of valuation...tends to make a given estimate of the lot prices more or less likely...." *Trout Ranch, LLC v. Commissioner*, T.C. Memo. 2010-283, 2010 WL 5395108, at *12, *aff'd*, 493 F. App'x 944 (10th Cir. 2012). We wonder whether five years constitutes a reasonable period even granting the relatively stable market for vacant residential land described in Hilco's report, and we will accordingly give less weight to the 2016 sales.

II.G.4.h. Expenses Incurred by Owner-Officer

Under Code § 162(a), an S corporation shareholder could deduct losses arising from lawsuits against him personally relating to that person managing the business.[1267]

[1267] Letter Ruling 201548011, which discussed the origin of the claim doctrine and mentioned:

> Generally, amounts paid in settlement of lawsuits are currently deductible if the acts which gave rise to the litigation were performed in the ordinary conduct of the taxpayer's business. See, *e.g.*, *Federation Bank & Trust Co. v. Commissioner*, 27 T.C. 960, 973 (1957), *aff'd*, 256 F.2d 764 (2d Cir. 1958), *acq.*, 1969-2 C.B. xxiv (allowing petitioner to deduct amounts paid in settlement of legal proceedings charging petitioner with mismanagement in the liquidation of assets); *Butler v. Commissioner*, 17 T.C. 675, 679-81 (1951), *acq.*, 1952-1 C.B. 1 (settlement payment arising from shareholder suit for damages against principal officer for mismanagement of corporate affairs held deductible as an ordinary and necessary business expense directly connected to and proximately resulting from his business activity); Rev. Rul. 79-208, 1979-2 C.B. 79 (permitting taxpayer to deduct payments to settle lawsuit and obtain a release from breach of contract claims under a franchise agreement).
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> Similarly, amounts paid for legal expenses in connection with litigation are allowed as business expenses where such litigation is directly connected to, or proximately results from, the conduct of a taxpayer's business. See, *e.g.*, *Howard v. Commissioner*, 22 B.T.A. 375, 378 (1931), *acq.*,

II.G.4.i. Passive Loss Limitations

See part II.K Passive Loss Rules for limitations on deductions and credits under the Code § 469 passive loss rules.

Although these limitations are significant, they are temporary, except when an individual dies or a trust terminates.[1268] More important than the timing of losses is the application of the passive loss rules in determining whether income is subject to the 3.8% tax on net investment income, which is why the detailed discussion is moved to the part describing that tax.[1269]

II.G.4.j. At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities)

Partners generally may deduct losses financed by bank loans to the partnership only to the extent permitted by the rules described in this part II.G.4.j.[1270]

An individual (as well as certain personal holding companies) may not deduct a loss to the extent not "at risk" with respect to the activity that generated the loss; any excess losses are suspended until they can be used.[1271]

When a taxpayer transfers all of a business interest in a substituted basis transaction, any associated at risk losses are added to the basis of the transferred property[1272] and part or all of

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1945 C.B. 4 (holding that legal fees incurred by taxpayer to settle a shareholder's claim of misrepresentation in the conduct of business are deductible as business expenses); *D'Angelo v. Commissioner*, T.C. Memo. 2003-295 (petitioner entitled to a section 162 deduction for legal fees paid in defending suits alleging breach of fiduciary duty, mismanagement, and breach of contract in his capacity as an officer, partner, and shareholder of entities in which he had an ownership interest).

In Rev. Rul. 80-211, 1980-2 C.B. 57, the taxpayer was sued civilly for breach of contract and fraud relating to the ordinary conduct of its trade or business. A judgment was rendered that included punitive damages. The ruling allowed the taxpayer to deduct amounts paid as punitive damages under section 162(a) as an ordinary and necessary business expense because the acts that gave rise to the civil suit were performed in the ordinary course of the taxpayer's business.

Proceeds from a settlement or court award are taxed according to the nature of the relevant claims. *Blum v. Commissioner*, T.C. Memo. 2021-18; *Holliday v. Commissioner*, T.C. Memo. 2021-69 (taxpayer failed to prove settlement was for nontaxable claims); *Tressler v. Commissioner*, T.C. Summary Op. 2021-33 (nontaxable to the extent reimbursed for past expenses not deducted).

[1268] See part II.K.2.d Effect of Death of an Individual or Termination of Trust .

[1269] See part II.I.8 Application of 3.8% Tax to Business Income.

[1270] See Code § 465(b)(6), treating certain nonrecourse real estate loans as at-risk to partner. Also, compare Prop. Reg. § 1.465-24(a)(2) (which would treat partners as at-risk for loan guarantees) with Prop. Reg. § 1.465-24(a)(3) (contrary rule for S corporations). If a grantor trust borrows on a recourse basis but the lender's only recourse is against the trust's assets, its grantor is "at risk" for purposes of Code § 465(b) only to the extent of the trust's assets. Rev. Rul. 78-175.

[1271] Code § 465.

[1272] Prop. Reg. § 1.465-67, "Transfers and dispositions; pass through of losses suspended under section 465(a)," provides:

(a) *Applicability*. This section shall apply to any transfer or disposition in which -
   (1) The taxpayer transfers or disposes of such taxpayer's entire interest in the activity or the entity conducting the activity,
   (2) The basis of the transferee is determined in whole or in part by reference to the basis of the transferor; and

any at risk amount in excess of losses is added to the transferee's amount at risk.[1273] It has been suggested that, if less than the entire interest is transferred, it might be appropriate to allocate at risk amounts in proportion to what is transferred.[1274] For more discussion, see 550-4th T.M., At-Risk Rules, Detailed Analysis, VIII. Effect of Transfer/Disposition of Activity on Amount at Risk, C. Effect on Transferee with Carryover Basis. For the effect of a disposition on losses that were allowed under the at-risk rules but suspended under the Code § 469 passive loss rules, see part II.K.1.j Complete Disposition of Passive Activity.

AM 2014-003 addressed LLC Member guarantees of LLC debt and "qualified nonrecourse financing," taking the following positions:[1275]

- When a member of an LLC classified as a partnership or disregarded entity for federal tax purposes guarantees the LLC's debt, the member is at risk with respect to the amount of the guaranteed debt, without regard to whether such member waives any right to subrogation, reimbursement, or indemnification from the LLC, but only to the extent that the member has no right of contribution or reimbursement from persons other than the LLC, the member is not otherwise protected against loss within the meaning of

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(3) The transferor has suspended losses under section 465(a) at the time of the transfer or disposition.

For the treatment of any gain recognized by the transferor, see § 1.465-66.

(b) *Pass through of suspended losses*. If at the close of the taxable year in which the transfer or disposition occurs, the amount of the transferor's section 465(d) loss from the activity is in excess of the transferor's amount at risk in the activity, such excess shall be added to the transferor's basis in the activity. The preceding sentence is to be applied after the determination of any gain to the transferor and is to be used solely for the purpose of determining the basis of the property in the hands of the transferee.

[1273] Prop. Reg. § 1.465-68.

[1274] Willis, *Postlewaite & Alexander: Partnership Taxation*, ¶ 7.07. At Risk Aspects of Transfer of Partnership Interest Where Basis Carries Over and at Death of Partner, suggests possibly looking to Rev. Rul. 84-53. See part II.Q.8.e.ii.(a) Unitary Basis, citing Rev. Rul. 84-53. Also relevant in that treatise is ¶ 7.06 Adjustment to Basis of Partnership Interest for Loss Disallowed by Section 465; Tax Consequences of a Sale of That Interest.

[1275] AM 2014-003, authored by Curt G. Wilson, Associate Chief Counsel (Passthroughs & Special Industries) and sent to Division Counsel (Large Business & International) to the attention of a Senior Level Counsel (Domestic). In addition to the comments made below, the memo commented:

> This memorandum does not address the effect of a member guarantee of qualified nonrecourse financing in the context of a single member LLC taxed as a disregarded entity for federal tax purposes, because the member's at-risk amount generally will not be affected by the guarantee. As the sole owner of an LLC with qualified nonrecourse financing, the single member is at risk prior to guaranteeing the debt because the debt is qualified nonrecourse financing. After guaranteeing the debt, the debt no longer meets the definition of qualified nonrecourse financing, but as the guarantor, the single member is still at risk to the extent of the amount guaranteed and to the extent the single member is not otherwise protected against loss.

In addition to being concerned about using a disregarded entity LLC to avoid the at-risk rules, the IRS is also leery of using a QSST to avoid the at-risk rules. A QSST is a trust owning stock in an S corporation, which trust is taxed as a grantor trust deemed owned by the beneficiary; see part III.A.3.e.i QSSTs. CCA 201327009 allows the beneficiary to deduct the interest when the QSST buys from a third party using a promissory note; see part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs. The IRS declined to rule on the loan's effect under the at-risk rules out of concern that taxpayers would set up a Code § 465(c)(4) device to limit liability. For how that interest is classified, see text accompanying fn 456 in part II.C.3.d Deducting Interest Expense on Debt Incurred by a Partnership.

Code § 465(b)(4), and the guarantee is bona fide and enforceable by creditors of the LLC under local law.[1276]

- When a member of an LLC classified as a partnership for federal tax purposes guarantees qualified nonrecourse financing of the LLC, the member's amount at risk is increased by the amount guaranteed, but only to the extent such debt was not previously taken into account by that member, the guaranteeing member has no right of contribution or reimbursement from persons other than the LLC, the guaranteeing member is not otherwise protected against loss within the meaning of Code § 465(b)(4), and the guarantee is bona fide and enforceable by creditors of the LLC under local law.

- When a member of an LLC guarantees qualified nonrecourse financing of the LLC, the amount of the guaranteed debt no longer meets the definition of "qualified nonrecourse financing" under Code § 465(b)(6)(B) if the guarantee is bona fide and enforceable by creditors of the LLC under local law, and the amount of the guaranteed debt will no

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[1276] Reasoning:

> In the case of an LLC, all members have limited liability with respect to LLC debt. In the absence of any co-guarantors or other similar arrangement, an LLC member who guarantees LLC debt becomes personally liable for the guaranteed debt and is in a position akin to the general partners in the example in Prop. [Reg.] § 1.465-24(a)(2)(ii) who had personally assumed the partnership's debt and who had no right of reimbursement for their $12,500 share. If called upon to pay under the guarantee, the guaranteeing member may seek recourse only against the LLC's assets, if any. As in the case of a general partner, a right to subrogation, reimbursement, or indemnification from the LLC (and only the LLC) does not protect the guaranteeing LLC member against loss within the meaning of § 465(b)(4).

Moreno v. U.S., 113 A.F.T.R.2d 2014-2149 (D. La. 5/19/2014), agreed with this principle and rebuffed government arguments looking to the individual guarantor's net worth or the practical matter of how the guaranty would be satisfied, instead counting only a legal right to contribution as reducing the amount at risk. *Moreno* said:

> With respect to rights of contribution and reimbursement, where a member of a limited liability company guarantees a liability of the limited liability company, he or she is at risk, except to the extent he or she has a right of contribution or reimbursement from the other guarantors. See e.g. IRS Field Service Advisory 2000-25-018 (June 23, 2000), 2000 WL 33116072 (each member of a limited liability company "who has guaranteed a liability of the limited liability company is at-risk, except to the extent the member has a right of reimbursement against the remaining members"); IRS Chief Counsel Advisory 20130828 (February 22, 2013), 2013 WL 653295 ("an LLC member is at risk with respect to LLC debt guaranteed by the member (where the LLC is treated as either a partnership or a disregarded entity for federal tax purposes), but only to the extent that the member has no right of contribution or reimbursement from the other guarantors..."; taxpayer is not at risk "for those amounts" for which he has a right of contribution against co-sureties); Susan Kalinka, *Limited Liability Companies and Partnerships: A Guide to Business and Tax Planning*, 9A LACIVL § 6.7 (3d ed.) (2012) (a member of an LLC who guarantees an obligation of the LLC will assume personal liability for the LLC's obligation, and that member should be entitled to include in his or her at risk amount the portion of the guaranteed liability for which the member may not seek reimbursement); S. Rep. 94-938, 49, 1976 U.S.C.C.A.N. 3438, 3485 ("a taxpayer's capital is not "at risk" in the business ... to the extent he is protected against economic loss of all or part of such capital by reason of an ... arrangement for compensation or reimbursement to him of any loss which he may suffer"). Here, all parties acknowledge that if either Dynamic or Moreno were to pay Aerodynamic's obligation, the paying entity would have right of contribution against the other for half the amount it paid, pursuant to La. Civ. Code arts. 3055 and 3056. Under such circumstances, the IRS has determined a guarantor is at risk for fifty percent of the amount guaranteed.

> longer be includible in the at-risk amount of the other non-guarantor members of the LLC.[1277]

The IRS has addressed whether a guarantor of debt of an LLC treated as either a partnership or a disregarded entity for federal tax purposes be "at risk" with respect to the guaranteed debt if the guarantor does not completely waive his rights of subrogation and reimbursement from the

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[1277] Reasoning:

> As a general rule, LLC members may not include liabilities of the LLC in their at-risk amounts unless the members are personally liable for the debt as provided by § 465(b)(2)(A). Further, under § 465(b)(4), taxpayers are not at risk with respect to amounts protected against loss through nonrecourse financing. Section 465(b)(6)(A) creates an exception to these rules when a nonrecourse liability meets the definition of qualified nonrecourse financing. Under § 465(b)(6)(B)(iii), a liability is qualified nonrecourse financing only if no person is personally liable for repayment. When a member of an LLC treated as a partnership for federal tax purposes guarantees LLC qualified nonrecourse financing, the member becomes personally liable for that debt because the lender may seek to recover that amount of the debt from the personal assets of the guarantor. Because the guarantor is personally liable for that debt, that debt is no longer qualified nonrecourse financing as defined in § 465(b)(6)(B) and § 1.465-27(b)(1). Further, because the creditor may proceed against the property of the LLC securing the debt, or against any other property of the guarantor member, that debt also fails to satisfy the requirement in § 1.465-27(b)(2)(i) that qualified nonrecourse financing must be secured only by real property used in the activity of holding real property.
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> Because that debt is no longer qualified nonrecourse financing, the nonguaranteeing members of the LLC who previously included that portion of the qualified nonrecourse financing in their amount at risk and who have not guaranteed any portion of that debt may no longer include that amount of the debt in determining their amount at risk. Any reduction that causes an LLC member's at-risk amount to fall below zero will trigger recapture of losses under § 465(e). The at-risk amount of the LLC member that guarantees LLC debt is increased, but only to the extent such debt was not previously taken into account by that member, the guaranteeing member has no right of contribution or reimbursement from persons other than the LLC, the guaranteeing member is not otherwise protected against loss within the meaning of § 465(b)(4) with respect to the guaranteed amounts, and the guarantee is bona fide and enforceable by creditors of the LLC under local law.
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> The Field Office noted that non-guaranteeing LLC members may assert that a guarantee of qualified nonrecourse financing by another LLC member does not increase the guarantor's amount at risk and, therefore, should not reduce the at-risk amount of the non-guaranteeing members with respect to that financing. As discussed above, we do not adopt that reading of Prop. [Reg.] § 1.465-6(d). Even if it did apply in this situation, it would not aid the non-guaranteeing members because the financing would still cease to be qualified nonrecourse financing under Section 465(b)(6)(B). Section 465(b)(6)(B)(iii) defines qualified nonrecourse financing as financing for which no person is personally liable. Because a guarantor becomes personally liable for the amount guaranteed, any liability previously treated as qualified nonrecourse financing no longer meets the definition of qualified nonrecourse financing once it is guaranteed (whether or not the guarantor is at risk). As a result, the non-guaranteeing members may no longer avail themselves of the exception in § 465(b)(6)(A) to include any portion of the guaranteed liability in their at-risk amounts regardless of the impact of the guarantee on the guarantor's amount at risk. Whether Prop. [Reg.] § 1.465-6(d) applies to a guarantor of LLC debt is an inquiry that does not affect the analysis of whether a guaranteed liability constitutes qualified nonrecourse financing.

LLC with respect to that guaranteed debt. The IRS applied the following requirements (assuming certain exceptions[1278] do not already apply):[1279]

- The taxpayer must be personally liable for the debt,[1280] and

- The taxpayer is not otherwise protected from loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.[1281]

The IRS took the position that the mere fact that a taxpayer may be entitled to subrogation, reimbursement, or indemnification from an LLC (and only the LLC) under local law when payment is made on the guarantee does not mean that the taxpayer is "protected against loss." The IRS also stated that, to the extent that co-guarantors protect the taxpayer from loss under the economic realities existing at the end of a taxable year, to the taxpayer is not at risk for that year.

CCA 201606027[1282] addressed LLC Member guarantees of LLC debt and "qualified nonrecourse financing," taking the following positions regarding certain provisions that can trigger personal liability made the loans recourse (sometimes referred to as "bad boy guarantees"):

[1278] Code § 465(b)(2)(B).

[1279] CCA 201308028. The IRS noted:

> It should be noted that the conclusions contained within this advice may be viewed as contrary to Prop. Treas. Reg. § 1.465-6(d) (1979), which provides that if a taxpayer guarantees repayment of an amount borrowed by another person (primary obligor) for use in an activity, the guaranty shall not increase the taxpayer's amount at risk. Prop. Reg. § 1.465-6(d) further provides that if the taxpayer repays to the creditor the amount borrowed by the primary obligor, the taxpayer's amount at risk shall be increased at such time as the taxpayer has no remaining legal rights against the primary obligor. However, Prop. Reg. § 1.465-6(d) was promulgated before the development of LLCs under various state laws, and at a time when entities treated as partnerships for federal tax purposes were usually state law general partnerships and limited partnerships.
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> ….[W]e conclude that an LLC member is at risk with respect to LLC debt guaranteed by the member (where the LLC is treated as either a partnership or a disregarded entity for federal tax purposes), but only to the extent that the member has no right of contribution or reimbursement from other guarantors and is not otherwise protected against loss within the meaning of § 465(b)(4) with respect to the guaranteed amounts. Therefore, we conclude that Prop. Reg. § 1.465-6(d) is generally not applicable to situations involving bona fide guarantees of LLC debt by one or more members of the LLC that is enforceable by creditors of the LLC under local law, where the LLC is treated as either a partnership or a disregarded entity for federal tax purposes.

[1280] Based on whether the taxpayer is ultimately liable for repayment as the payor of last resort in the worst case scenario.

[1281] The IRS said that the majority view bases its determination on the "economic realities" present at the end of the taxable year and that the minority viewed bases its determination on whether the taxpayer is payor of last resort in a worst case scenario. The IRS concluded that the majority view is correct. If a taxpayer is insulated from loss with respect to a borrowed amount, based upon the facts and circumstances existing at the end of the taxable year, then the taxpayer is not at risk. However, if at some future time the taxpayer demonstrates that the taxpayer cannot recover under the loss limitation arrangement, the taxpayer will become at risk at that time.

[1282] Authored by James A. Quinn, Senior Counsel, Branch 3, Office of Associate Chief Counsel, (Passthroughs & Special Industries), to William D. Richard, Attorney (Seattle, Group 1) (Small Business/Self-Employed), October 23, 2015.

1. If a partner guarantees an obligation of the partnership and the guarantee is sufficient to cause the guaranteeing partner to bear the economic risk of loss for that obligation within the meaning of § 1.752-2(b)(1) of the Income Tax Regulations, the guaranteed debt is properly treated as recourse financing for purposes of applying the basis allocation rules of § 752. For this purpose, certain contingencies such as the partnership admitting in writing that it is insolvent or unable to pay its debts when due, its voluntary bankruptcy, or its acquiescence in an involuntary bankruptcy, after taking into account all the facts and circumstances, are not so remote a possibility that it is unlikely the obligation will ever be discharged within the meaning § 1.752-2(b)(4) that would cause the obligation to be disregarded under § 1.752-2(b)(3).[1283]

2. Where the partnership's sole business activity includes acquiring existing hotels, renovating them, installing personal property appropriate to improve the properties' utility as hotels, and holding and maintaining the premises, but does not include the hotels' day-to-day operations, the partnership is engaged in an "activity of holding real property" within the meaning of § 465(b)(6)(A).

3. When an individual partner guarantees a partnership obligation, the amount of the guaranteed debt no longer meets the definition of "qualified nonrecourse financing" under § 465(b)(6)(B), and the amount of the guaranteed debt will no longer be includible in the at-risk amount of the other non-guaranteeing partners, if the

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[1283] In support of this conclusion, the CCA reasoned:

> As a threshold matter, a bona fide guarantee that is enforceable by the lender under local law generally will be sufficient to cause the guaranteeing partner to be treated as bearing the economic risk of loss for the guaranteed partnership liability for purposes of § 1.752-2(a). For purposes of § 1.752-2, we believe it is reasonable to assume that a third-party lender will take all permissible affirmative steps to enforce its rights under a guarantee if the primary obligor defaults or threatens to default on its obligations. In this case, we view the "conditions" listed in section 1(b) of the First Guarantee as circumstances under which the lender may enforce the guarantee to collect the entire outstanding balance on the loan, beyond an actual default by X on its obligations. As such, we do not believe these "conditions" are properly viewed as conditions precedent that must occur before Y is entitled to seek repayment from C under the guarantee.[2] In addition, we believe it is reasonable to assume that one or more of these conditions, more likely than not, would be met upon a constructive liquidation of X under § 1.752-2(b)(1). Accordingly, we believe that these "conditions" do not fall within the definition of "contingencies" as intended by § 1.752-2(b)(4).
>
> > [2] According to the submission, it appears the taxpayer may assert that the various events listed in section 1(b) of the First Guarantee, upon the occurrence of which the First Guarantee will become immediately due and payable for the entire outstanding balance of the loan, are the only events under which the First Guarantee will become due and payable. It appears to us that a failure of X to repay the loan, by itself, likely would be sufficient to trigger the First Guarantee, as evidenced by the first sentence of section 1 of the First Guarantee. Assuming, arguendo, that the taxpayer's assertion is correct, we nevertheless believe that the likelihood that X or any other co-borrower will ever meet any one of these conditions, in the aggregate, is not so remote a possibility that would cause the obligation to be considered "likely to never be discharged" within the meaning of § 1.752-2(b)(4).
>
> For these reasons, we conclude that, for the purposes of §§ 704(d) and 752, and § 1.752-2(a), the promissory notes described above are recourse partnership liabilities allocable to the guaranteeing partner (C), and not to either A or B.

For regulations under Code § 752 that were changed in October 2016 and later, see part II.C.3 Allocating Liabilities (Including Debt).

guarantee is bona fide and enforceable by creditors of the partnership under local law.[1284]

[1284] After quoting from the statute and Reg. § 1.465-27(b), the CCA explained the at-risk rules as follows:

Generally, a limited partner, in a limited partnership organized under state law, who guarantees partnership debt is not at risk with respect to the guaranteed debt, because the limited partner has a right to seek reimbursement from the partnership and the general partner for any amounts that the limited partner is called upon to pay under the guarantee. The limited partner is "protected against loss" within the meaning of § 465(b)(4) unless or until the limited partner has no remaining rights against the partnership or general partner for reimbursement of any amounts paid by the limited partner. To the extent that a general partner does not have a right of contribution or reimbursement under local law against any other partner for the debts of the partnership, the general partner is at risk for such debts under § 465(b)(2). The general partner's right to subrogation, reimbursement, or indemnification from the partnership's assets (and only the partnership's assets) does not protect the general partner against loss within the meaning of § 465(b)(4).

In the case of an LLC, all members have limited liability with respect to LLC debt. In the absence of any co-guarantors or other similar arrangement, an LLC member who guarantees LLC debt becomes personally liable for the guaranteed debt and more closely resembles a general partner with respect to the guaranteed debt. If called upon to pay under the guarantee, the guaranteeing member may seek recourse only against the LLC's assets, if any. As in the case of a general partner, a right to subrogation, reimbursement, or indemnification from the LLC (and only the LLC) does not protect the guaranteeing LLC member against loss within the meaning of § 465(b)(4). Therefore, in the case of an LLC treated as a partnership or disregarded entity for federal tax purposes, we conclude that an LLC member is at risk with respect to LLC debt guaranteed by such member, but only to the extent that:

(1) the guaranteeing member has no right of contribution or reimbursement from other guarantors,
(2) the guaranteeing member is not otherwise protected against loss within the meaning of § 465(b)(4) with respect to the guaranteed amounts, and
(3) the guarantee is bona fide and enforceable by creditors of the LLC under local law.

As a general rule, LLC members may not include liabilities of the LLC in their at-risk amounts unless the members are personally liable for the debt as provided by § 465(b)(2)(A). Further, under § 465(b)(4), taxpayers are not at risk with respect to amounts protected against loss through nonrecourse financing. Section 465(b)(6)(A) creates an exception to these rules when a liability meets the definition of qualified nonrecourse financing. Under § 465(b)(6)(B)(iii), a liability is qualified nonrecourse financing only if no person is personally liable for repayment. When a member of an LLC treated as a partnership for federal tax purposes guarantees LLC qualified nonrecourse financing, the member becomes personally liable for that debt because the lender may seek to recover the amount of the debt from the personal assets of the guarantor. Because the guarantor is personally liable for the debt, the debt is no longer qualified nonrecourse financing as defined in § 465(b)(6)(B) and § 1.465-27(b)(1). Further, because the creditor may proceed against the property of the LLC securing the debt, or against any other property of the guarantor member, the debt also fails to satisfy the requirement in § 1.465-27(b)(2)(i) that qualified nonrecourse financing must be secured only by real property used in the activity of holding real property.

It should be noted that this conclusion generally will not be affected by a determination that the guarantee is a "contingent" liability within the meaning of § 1.752- 2(b)(4). Instead, the question is simply whether the guarantee is sufficient to cause the guarantor to be considered personally liable for repayment of the debt, based on all the facts and circumstances, within the meaning of § 465(b)(6)(B)(iii). In this case, we believe the First Guarantee is sufficient for this purpose.

When the debt is no longer qualified nonrecourse financing due to a guarantee of that debt, the non-guaranteeing members of the LLC who previously included a portion of the qualified

4. To the extent the guaranteeing partner has the right under the partnership operating agreement to call for the non-guaranteeing partners to make capital contributions and, if they fail to do so, treat ratable portions of the payment as loans to those partners, adjust their fractional interests in the partnership, or enter into a subsequent allocation agreement under which the risk of the guarantee would be shared among the partners, this right generally will not be sufficient to make the non-guaranteeing partners personally liable with respect to the guaranteed obligation for the purposes of §§ 752 and 465.[1285]

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nonrecourse financing in their amount at risk and who have not guaranteed any portion of the debt may no longer include any amount of the debt in determining their amount at risk. Any reduction that causes an LLC member's at-risk amount to fall below zero will trigger recapture of losses under § 465(e). The at-risk amount of the LLC member that guarantees LLC debt is increased, but only to the extent such debt was not previously taken into account by that member, the guaranteeing member has no right of contribution or reimbursement from other guarantors, the guaranteeing member is not otherwise protected against loss within the meaning of § 465(b)(4) with respect to the guaranteed amounts, and the guarantee is bona fide and enforceable by creditors of the LLC under local law.

In this case, we conclude that, for the purposes of § 465(b)(6)(B)(iii) and § 1.465- 27(b)(1)(iii), the First Guarantee described above is sufficient to cause the guaranteeing partner, C, to be considered personally liable for the guaranteed debt obligations of X. Accordingly, the guaranteed debt obligations of X will no longer qualify as "Qualified Non-Recourse Financing" within the meaning of § 465(b)(6)(B) and § 1.465-27. A and B, as non-guaranteeing members of X, will not be considered at-risk with respect to any such amounts as a consequence of the First Guarantee.

[1285] The CCA first discussed some cases:

In *Pritchett v. Comm'r*, 85 T.C. 581 (1985), *rev'd and remanded*, 827 F.2d 644 (9th Cir. 1987), the taxpayers were limited partners in an oil and gas drilling operation, and they claimed deductions for losses in excess of their cash contributions to the partnership. The taxpayers argued that under the partnership agreement, they were "at risk" for partnership liabilities held by a drilling company that was responsible for developing the oil and gas fields. Under the contract the creditor would receive a portion of profits from the drilling operation. While general partners were the only parties personally liable, under the partnership agreement the general partners were given the right to call on the limited partners to make a capital contribution if the notes issued by the partnership remained unpaid upon their maturity date. The Service argued that the liability was contingent and that the taxpayers were only at risk once general partners called upon them to make a contribution. The Tax Court agreed with this analysis. Upon appeal, the Ninth Circuit held that the contractual obligations of the limited partners under the partnership agreement made them ultimately responsible for the debt. While the Commissioner argued that the liability was contingent simply because the general partners could elect to not make the cash calls, the Ninth Circuit did not agree. The Ninth Circuit determined that the cash calls were mandatory under the partnership agreements and that "economic reality" dictated that the general partners would make the calls.

In *Melvin v. Comm'r*, 88 T.C. 63 (1987), *aff'd*, 894 F.2d 1072 (9th Cir. 1990), the general partnership in which the taxpayer was a partner invested in a limited partnership. In payment for its limited partnership interest, the general partnership paid $35,000 cash and agreed to make additional capital contributions of $70,000. The obligation to make the additional capital contributions was evidenced by a $70,000 recourse promissory note. The taxpayer's share of the note was $50,000. The limited partnership obtained a $3,500,000 recourse loan from a bank and pledged partnership assets to the bank, including the $70,000 note along with other limited partner notes, as security. These notes were subsequently physically transferred to the bank. The court concluded that the taxpayer was at risk on the $3,500,000 loan to the extent of his pro rata share thereof. In reaching it conclusion the court reasoned that "a partner will be regarded as personally liable within the meaning of § 465(b)(2)(A) if he has the ultimate liability to repay the debt obligation of the partnership in the event funds from the partnership's assets are not available for that purpose. The relevant question is who, if anyone, will ultimately be obligated to pay the partnership's recourse obligations if the partnership is unable to do so. It is not relevant that the partnership MAY be able to do so. The scenario that controls is the worst-case scenario, not the best case." *Melvin*, 88 T.C. at 75 (citations omitted).

> We believe that *Pritchett* and *Melvin* stand for the proposition that the relevant inquiries when dealing with guarantees of partnership debt, for purposes of § 465, are whether the guarantee causes the guaranteeing partner to become the "payor of last resort in a worst case scenario" for the partnership debt, given the "economic realities" of the particular situation, and whether the guarantor possesses any "mandatory" rights to contribution, reimbursement, or subordination with respect to any other parties, as a result or consequence of paying on the guarantee, that would cause these other parties to be considered the "payors of last resort in a worst case scenario" with respect to that debt.

The CCA concluded:

> It appears that the taxpayer interprets X's Operating Agreement as giving an enforceable right to require A and B to make additional contributions to X, in addition to the specific remedies provided in paragraphs (i) and (ii) of section 7.5(e) of the Operating Agreement. As noted above, we do not agree with this interpretation of the Operating Agreement. Nevertheless, even if the taxpayer's interpretation of the Operating Agreement is ultimately determined to be correct, we still conclude that the taxpayer is not allocated basis under § 752 and is not at risk under § 465 with respect to the guaranteed debt.
>
> We reach this conclusion because we view the requirement for A and B to make additional capital contributions to X as a contingent liability within the meaning of § 1.752-2(b)(4). Because C may choose alternate remedies that would not cause A or B to be viewed as bearing the ultimate economic risk of loss for the guaranteed debt of X, we believe these alternate remedies are properly viewed as contingencies that make it unlikely that any payment obligations of A or B would ever be discharged. In addition, we believe these remedies may also be viewed as future events that cause the payment obligations of A and B to be "not determinable with reasonable certainty" and cause the obligations to be ignored until A and B are actually required to make payments to X, for purposes of § 1.752-2(b)(4).[3]
>
> > [3] We believe that one or more arguments may also be made under § 1.752-2(j) in this case, depending on further factual development.
>
> In addition, for purposes of § 465, even if we view C as having an enforceable right to require A and B to make additional contributions to X in addition to the other remedies available in section 7.5(e) of X's Operating Agreement, we believe that the facts of this case would continue to be distinguishable from those in *Pritchett*. In this case, C has been provided with alternate remedies under section 7.5(e) of X's Operating Agreement if A and B choose not to make additional contributions to X under this provision. As a result, it appears that the requirement for A and B to make additional contributions under this provision is not a "mandatory" requirement, since C may elect to use these alternate remedies rather than have X enforce the Operating Agreement under the default provision of section 7.7. Therefore, it does not appear that "economic reality" would dictate that X or C must enforce the Operating Agreement under section 7.7 in a court proceeding against A and B in such circumstances. Accordingly, we conclude that A and B are not "payors of last resort in a worst case scenario", as discussed in *Pritchett* and *Melvin*, and therefore A and B are not currently at risk with respect to the guaranteed debt of X for purposes of § 465.
>
> We would further note that, to the extent that C may elect to use the remedy described in section 7.5(e)(i) of X's Operating Agreement, in which C may treat the amount of a Guaranty Contribution that a defaulting member failed to contribute as a loan to the defaulting member, such "loan" would appear to be subject to the related-party rule of § 465(b)(3)(A). Under the remedy of section 7.5(e)(i), A and B would be viewed as borrowing money from C with respect to the activity of X, at a time when C also possesses an ownership interest in the activity.

The May 2016 meeting of the American Bar Association's Section on Taxation included the following unofficial comments by the IRS:[1286] The real estate tax community loudly protested CCA 201606027. The provisions that the CCA asserted turned the debt into recourse debt were typical provisions in nonrecourse arrangements. The CCA was mainly concerned with the seventh condition listed, triggered if the insolvency was admitted. Given that the lender required financial statements, the lender could force such an admission, making the loan essentially recourse. In fact, one state trial court had stated that the financial statements showing liabilities in excess of assets constituted such as admission. However, the appellate court pointed out that the lender's request for a formal admission of insolvency were repeatedly rejected, and the court reversed, saying that insolvency was never admitted and the financial statements did not constitute such an admission.[1287]

In light of that case, AM 2016-001[1288] addresses the treatment under Code §§ 752 (allocation of liabilities) and 465 (at-risk rules of guarantee) of a partnership nonrecourse liability when the guarantee is conditioned on certain "nonrecourse carve-out" events, backing away from CCA 201606027. It concluded:

1. If a partner's guarantee of a partnership's nonrecourse obligation is conditioned on the occurrence of certain "nonrecourse carve-out" events described below, the guarantee will not cause the obligation to fail to qualify as a nonrecourse liability of the partnership under section 752 and regulations promulgated thereunder until such time as one of those events actually occurs and causes the guarantor to become personally liable for the partnership debt under local law.[1289]

> Accordingly, A and B would not be considered at risk with respect to such amounts pursuant to § 465(b)(3)(A) under this scenario.
>
> Of course, if a payment obligation does arise in the future which requires A and B to make a payment to X, A and B would properly be viewed as making contributions to X at that time, for purposes of §§ 722, 704(d) and 465(b)(1)(A).
>
> In conclusion, because A and B do not have a mandatory obligation to make additional capital contributions to the [sic] X, regardless of which interpretation of X's Operating Agreement is ultimately determined to be correct, A and B do not bear the ultimate economic risk of loss for purposes of § 752, and A and B are not the payors of last resort in a worst case scenario for purposes of § 465.

For changes to regulations under Code § 752 in October 2016, see part II.C.3 Allocating Liabilities (Including Debt).

[1286] Recording ABATX1659.

[1287] *Zwirn*, fn. 1289.

[1288] From Curt G. Wilson, Associate Chief Counsel (Passthroughs and Special Industries) (written by William Kostak), to Division Counsel (Small Business/Self-Employed), attn: Samuel Berman, Special Counsel, March 31, 2016.

[1289] The memorandum reviewed Code § 752(a), Reg. §§ 1.752-1(a), 1.752-2(a), 1.752-2(b)(1), 1.752-2(b)(3) and 1.752-2(b)(4), and *D.B. Zwirn Special Opportunities Fund, L.P. v. SCC Acquisitions, Inc.*, 902 N.Y.S.2d 93, 95 (App. Div. 2010), the latter which it characterized as a lender unsuccessfully enforcing a guarantee to be triggered by a "nonrecourse carve-out" event. In October 2016 and later, the regulations under Code § 752 changed; see part II.C.3 Allocating Liabilities (Including Debt). In arriving at the conclusion to which this footnote is appended, the memorandum reasoned:

> We think that the approach to interpreting the "nonrecourse carve-out" event relating to written admissions of insolvency that the court followed in *D.B. Zwirn* is appropriate not just for that type of carve-out, but for other typical carve-outs as well. In the commercial real estate finance industry, "nonrecourse carve-out" provisions are not intended to allow the lender to require an

2. If a partner's guarantee of a partnership's nonrecourse obligation is conditioned on the occurrence of certain "nonrecourse carve-out" events described below, the guarantee will not cause the obligation to fail to qualify as qualified nonrecourse financing for purposes of section 465(b)(6) and the regulations promulgated thereunder until such time as one of those events actually occurs and causes the guarantor to become personally liable for the partnership debt under local law.[1290]

At the ABA meeting, practitioner pointed out that the conditions in the CCA were only 7 out of about 20-30 triggers commonly found in nonrecourse financing and asked for guidance. The government spokesman unofficially provided the following bottom line: If the contingency that triggers the personal liability is within the control of the borrower or person who would be liable, then the loan is nonrecourse. On the other hand, if the lender controlled the triggers, then the loan is recourse. Court cases imposing recourse liability where the lender could force a trigger's occurrence would affect the government's view of that trigger. He also mentioned that the IRS does not revoke CCAs, so the CCA stands for that taxpayer, but AM 2016-001 represents the government's current thoroughly vetted position on triggers and is unlikely to change absent such court cases.

CCA 201805013 applied Code § 465(c)(3)(B) regarding aggregation of business activities, asserting that aggregation did not apply.[1291]

> involuntary action by the borrower or guarantor, or to place borrowers or guarantors in circumstances that would require them to involuntarily commit a "bad act." Rather, the fundamental business purpose behind such carve-outs and the intent of the parties to such agreements is to prevent actions by the borrower or guarantor that could make recovery on the debt, or acquisition of the security underlying the debt upon default, more difficult. The "nonrecourse carve-out" provisions should be interpreted consistent with that purpose and intent in mind. Consequently, because it is not in the economic interest of the borrower or the guarantor to commit the bad acts described in the typical "nonrecourse carveout" provisions, it is unlikely that the contingency (the bad act) will occur and the contingent payment obligation should be disregarded under § 1.752-2(b)(4). Therefore, unless the facts and circumstances indicate otherwise, a typical "nonrecourse carve-out" provision that allows the borrower or the guarantor to avoid committing the enumerated bad act will not cause an otherwise nonrecourse liability to be treated as recourse for purposes of section 752 and § 1.752-2(a) until such time as the contingency actually occurs.

[1290] The memorandum reviewed Code §§ 465(c)(3), 465(b)(2)(A), 465(b)(4), and 465(b)(6) and Reg. §§ 1.465-27(b)(4), (5). In arriving at the conclusion to which this footnote is appended, the memorandum reasoned:

> Therefore, for the same reasons discussed above with respect to liability under section 752, we conclude that if a partner's guarantee of a partnership's nonrecourse obligation is conditioned on the "nonrecourse carve-out" events enumerated above, the guarantee does not cause the guarantor to be treated as personally liable for the repayment of the partnership's liability, because the likelihood of any of the "nonrecourse carve-out" events occurring is such that the guarantor is effectively protected against loss until such time as one or more of the events actually occurs. Accordingly, we conclude that such guarantee will not cause the nonrecourse financing to fail to qualify as qualified nonrecourse financing under section 465(b)(6) and the regulations thereunder if such financing otherwise meets those requirements.

[1291] RIA Checkpoint summary:

> Business activities conducted through partnership and 3 separate S corps. couldn't be aggregated and treated as single activity for purposes of Code Sec. 465's at-risk rules when considering that those entities operated independently from each other in that they lacked identical ownership; sold products from different manufacturers; maintained separate franchise

The Tax Court considers the "realistic possibility" that the guarantor would ultimately be subject to "economic loss" if the guaranty is called. *Bordelon v. Commissioner*, T.C. Memo. 2020-26 reasoned:[1292]

> Accordingly, when evaluating a guarantor's loss protections (including reimbursements from primary obligors), we look at the facts and circumstances to determine not only whether there is a right to the reimbursement but whether the substance of the right is meaningful. In other words, we must consider the "realistic possibility" that the guarantor would ultimately be subject to "economic loss" if called upon to make payments on account of the guarantee. See *Levien v. Commissioner*, 103 T.C. 120, 126 (1994), *aff'd without published opinion*, 77 F.3d. 497 (11th Cir. 1996); *Miller v. Commissioner*, T.C. Memo. 2006-125, 91 T.C.M. (CCH) 1267, 1276 (2006).
>
> We note that in these cases, the realistic-possibility analysis of protection against loss under section 465(b)(4) is not contrary to or divergent from the worst-case-scenario analysis we apply for purposes of determining personal liability under section 465(b)(2)(A).[10] Indeed, the tests may intuitively run together in a two-step at-risk analysis. For example, in facts involving an individual guaranteeing debts of his solely owned business, we would first apply the section 465(b)(2)(A) analysis presuming a worst-case scenario wherein the primary obligor defaults, becomes worthless, and is unable to make payments on the debt—thus triggering payments from the guarantor. See IRS Chief Counsel Advice 201308028 (Feb. 22, 2013).[11] Second, we would consider the realistic possibility of economic loss, in which case "it would be inappropriate … to then assume that the guaranteeing member will nevertheless be able to successfully seek subrogation, reimbursement, or indemnification from the primary obligor" who defaulted and became worthless in step 1. *Id.* Accordingly, we can apply both distinct analyses congruently in cases such as Mr. Bordelon's.
>
> > [10] Among the U.S. Courts of Appeals there has been a perceived split on the appropriate framework for analyzing section 465(b)(4) - *i.e.*, whether analyzing "realistic possibility", see, *e.g.*, *Waters v. Commissioner*, 978 F.2d 1310, 1316 (2d Cir. 1992), *aff'g* T.C. Memo. 1991-462; *Young v. Commissioner*, 926 F.2d 1083, 1089 (11th Cir. 1991), *aff'g* T.C. Memo. 1988-440 and T.C. Memo. 1988-525; *Moser v. Commissioner*, 914 F.2d 1040, 1048-1049 (8th Cir. 1990), *aff'g* T.C. Memo. 1989-142; *Am. Principals Leasing Corp. v. United States*, 904 F.2d 477, 483 (9th Cir. 1990), or else analyzing "obligor of last resort" under a "worst-case scenario", see, *e.g.*, *Emershaw v. Commissioner*, 949 F.2d 841, 845 (6th Cir. 1991), *aff'g* T.C. Memo. 1990-246. These cases would presumably be appealable to the Court of Appeals for the Fifth Circuit (absent a stipulation to the contrary, see sec. 7482(b)(1)(A), (2)), and we know of no opinion of that court addressing this issue. However, the split may not really be implicated in a situation like the one in these cases. Although we acknowledge that in factually complex cases, such as those involving multi-party sale-leaseback transactions or stop-loss agreements, choosing

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agreements, financing arrangements, and books and records; operated in different regions; and shared employees only in limited circumstances. And, even if partnership could show that it actively participated in managing each S corp. for Code Sec. 465(c)(3)(B)(i) purposes, Code Sec. 465(c)(3)(B)(i) didn't allow for aggregation because partnership didn't conduct such activities directly, but rather through separate partnership or S corp.

[1292] *Bordelon* is further discussed in part II.C.3.c.ii.(a) Permanent Rules Allocating Economic Risk of Loss to Recourse Liabilities in the text accompanying fn 403.

between the tests might lead to different results, see, *e.g.*, *Thornock v. Commissioner*, 94 T.C. 439, 450 (1990), we found little distinction between the two frameworks in *Wag-A-Bag, Inc. v. Commissioner*, T.C. Memo. 1992-581, 64 T.C.M. (CCH) 948, 952 (1992), and held that either would lead to the same result in that case. In these cases we follow Wag-A-Bag and find that in the circumstances before us, both approaches would lead to the same result.

[11] A memorandum of "Chief Counsel advice" is not precedent, sec. 6110(b)(1)(A), (k)(3), and we do not cite it as such. We use it simply as an illustration of one means of applying these two tests in tandem. We do not consider the Commissioner bound by this analysis or this method.

We determined above in part I.B. that Mr. Bordelon was personally liable for purposes of section 465(b)(2)(A). In that analysis we presumed that the primary obligors (Many LLC and AHM) were worthless and unable to pay the amount owed under the Many Loan. If we maintain that presumption as to the primary obligors and turn to the question of whether there is a realistic possibility of reimbursement, it is clear that Mr. Bordelon would not be protected against loss for purposes of section 465(b)(4) because his right to reimbursement would be against the worthless entities with no means to repay him for any amounts contributed.[12]

[12] The Commissioner's position in this case suggests we ignore the presumption that AHM would be worthless and instead hold that Mr. Bordelon is not at risk because if he were required to make a payment as guarantor to the debt, then Louisiana law provided him with a right of reimbursement from AHM. However, ignoring the presumption that an obligor is worthless would be a divergence from our jurisprudence on the at-risk rules, and we are not persuaded that such divergence would be appropriate in these cases.

Mr. Bordelon executed a personal guarantee in 2008 for Many Loan. Under that guarantee, he became directly liable to Union Bank for the full amount of the debt if the obligors defaulted. There was no other guarantor on the debt, nor was there a definite or fixed right to any contribution from other members of Many LLC or from AHM on account of the debt. Indeed, Mr. Bordelon was the sole owner of these entities and the only person with unlimited liability for the Many Loan. Even if we disregard a worthlessness determination when considering Mr. Bordelon's realistic possibility of economic loss, we cannot disregard that in substance Mr. Bordelon was the only one involved with respect to the liability for the Many Loan, the corresponding promissory note, and the personal guarantee. Accordingly, we are persuaded that Mr. Bordelon was personally liable, not protected against loss, and ultimately at risk under the Many Loan during 2008 so as to be entitled to deduct the losses related to Many LLC that he claimed on the Bordelons' 2008 return.

As to the taxpayer's at risk amount in another LLC, *Bordelon v. Commissioner*, T.C. Memo. 2020-26 held:

As for Mr. Bordelon's amount at risk, the foregoing basis analysis enables us to reach easily the conclusion that his guarantee of the Kilgore Loan increased his amount at risk in Kilgore LLC for 2011. We assume that there might be a scenario in which a partner's basis could increase on account of a guarantee but in which the guarantee would not result in his being considered at risk under section 465, but this is not such a case.

> With respect to section 465(b)(2)(A), the personal guarantee in 2011 made Mr. Bordelon personally liable for the loan. He was directly liable to HFB for the underlying debt if a default occurred, and there was no right for a contribution or reimbursement from any other member of Kilgore LLC.
>
> With respect to section 465(b)(4), there was no loss protection for Mr. Bordelon on the amount guaranteed. There were no other guarantors, and no other member of Kilgore LLC was personally liable for any portion of the debt. Therefore, we find that Mr. Bordelon was at risk in 2011 for the Kilgore Loan.

II.G.4.k. Be Sure to Use Suspended Losses as Soon as They Become Available

Finally, if one's losses are suspended due to basis limitations, be sure to deduct them as soon as basis becomes sufficient. Failure to do so causes the losses to become unusable when the statute of limitations, for the year in which they should have been taken, has run.[1293]

However, that does not necessarily translate into a desire to accelerate losses. For more thoughts on this idea, see part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good.

II.G.4.l. Business Deductions and Losses

II.G.4.l.i. Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit

This part II.G.4.l.i discusses what is a "trade or business" under Code § 162, expenses from which generally would be deductible.[1294] Then it discusses what are activities for the production of income under Code § 212, expenses from which generally would be deductible.[1295] Because both provisions require a profit motive, it then discusses what Code § 183 says about profit motive.[1296]

II.G.4.l.i.(a). "Trade or Business" Under Code § 162

Subject to the various limitations provided in the preceding parts of part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner and subject to other limitations on what can be deducted, Code § 162(a) allows a taxpayer to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," even if the business sustains a loss.[1297]

[1293] *Barnes v. Commissioner*, T.C. Memo 2012-80, *aff'd* 712 F.3d 581 (D.C. Cir. 2013) (imposing penalties on taxpayer for deducting 2003 S corporation losses against basis that had been used by previously suspended losses that taxpayer had failed to deduct in 1997).
[1294] See part II.G.4.l.i.(a) "Trade or Business" Under Code § 162.
[1295] See part II.G.4.l.i.(b) Requirements for Deduction Under Code § 212.
[1296] See part II.G.4.l.i.(c) Hobby Loss Benefits of Code § 183.
[1297] Reg. § 1.162-1(a) provides:

> Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than section 162.... The full amount of the allowable deduction for ordinary and necessary expenses

Higgins v. Commissioner, 312 U.S. 212 (1941), held:[1298]

> To determine whether the activities of a taxpayer are "carrying on a business" requires an examination of the facts in each case…. The petitioner merely kept records and collected interest and dividends from his securities, through managerial attention for his investments. No matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision of the Board.

Commissioner v. Groetzinger, 408 U.S. 23 (1987), discussed various cases (footnotes in the quote below are mine):

> From these observations and decisions, we conclude (1) that, to be sure, the statutory words are broad and comprehensive (*Flint*);[1299] (2) that, however, expenses incident to caring for one's own investments, even though that endeavor is full-time, are not deductible as paid or incurred in carrying on a trade or business (*Higgins*; *City Bank*; *Pyne*);[1300] (3) that the opposite conclusion may follow for an active trader (*Snyder*)[1301]….

> in carrying on a business is deductible, even though such expenses exceed the gross income derived during the taxable year from such business.

[1298] *Higgins* dealt with the predecessor to Code § 162. Rev. Rul. 75-525 views the case as controlling in interpreting Code § 162. See fn. 3416 in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax. *Commissioner v. Groetzinger*, 408 U.S. 23 (1987), commented on *Higgins* [footnote omitted]:

> The opinion, therefore,—although devoid of analysis and not setting forth what elements, if any, in addition to profit motive and regularity, were required to render an activity a trade or business—must stand for the propositions that full-time market activity in managing and preserving one's own estate is not embraced within the phrase "carrying on a business," and that salaries and other expenses incident to the operation are not deductible as having been paid or incurred in a trade or business.

After additional commentary on the case, *Groetzinger* continued:

> Less than three months later, the Court considered the issue of the deductibility, as business expenses, of estate and trust fees. In unanimous opinions issued the same day and written by Justice Black, the Court ruled that the efforts of an estate or trust in asset conservation and maintenance did not constitute a trade or business. *City Bank Farmers Trust Co. v. Helvering*, 313 U.S. 121 (1941); *United States v. Pyne*, 313 U.S. 127 (1941). The *Higgins* case was deemed to be relevant and controlling.

[1299] *Groetzinger* referred to *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911), about which *Groetzinger* commented:

> It said: " 'Business' is a very comprehensive term and embraces everything about which a person can be employed." 220 U.S., at 171. It embraced the *Bouvier Dictionary* definition: "That which occupies the time, attention and labor of men for the purpose of a livelihood or profit." *Ibid*. See also *Helvering v. Horst*, 311 U.S. 112, 1181 (1940). And Justice Frankfurter has observed that "we assume that Congress uses common words in their popular meaning, as used in the common speech of men." Frankfurter, Some Reflections on the Reading of Statutes, 47 Colum. L. Rev. 527, 536 (1947).

[1300] See fn. 1298 for the Court's discussion of these cases.

[1301] *Groetzinger* commented:

> *Snyder v. Commissioner*, 295 U.S. 134 (1935), had to do with margin trading and capital gains, and held, in that context, that an investor, seeking merely to increase his holdings, was not engaged in a trade or business. Justice Brandeis, in his opinion for the Court, noted that the Board of Tax Appeals theretofore had ruled that a taxpayer who devoted the major portion of his time to transactions on the stock exchange for the purpose of making a livelihood could treat

> One also must acknowledge that *Higgins*, with its stress on examining the facts in each case, affords no readily helpful standard, in the usual sense, with which to decide the present case and others similar to it. The Court's cases, thus, give us results, but little general guidance.

Pointing out that the cases provide little guidance, *Groetzinger* said they provided "some helpful indicators" and reasoned:

> If a taxpayer, as Groetzinger is stipulated to have done in 1978, devotes his full-time activity to gambling, and it is his intended livelihood source, it would seem that basic concepts of fairness (if there be much of that in the income tax law) demand that his activity be regarded as a trade or business just as any other readily accepted activity, such as being a retail store proprietor or, to come closer categorically, as being a casino operator or as being an active trader on the exchanges.
>
> It is argued, however, that a full-time gambler is not offering goods or his services…. One might well feel that a full-time gambler ought to qualify as much as a full-time trader,[12] as Justice Brandeis in Snyder implied and as courts have held.[13] The Commissioner, indeed, accepts the trader result. Tr. Of Oral Arg. 17. In any event, while the offering of goods and services usually would qualify the activity as a trade or business, this factor, it seems to us, is not an absolute prerequisite.
>
> [12] "It takes a buyer to make a seller and it takes an opposing gambler to make a bet." Boyle, What is a Trade or Business?, 39 Tax Lawyer 737, 763 (1986).
>
> [13] *Levin v. United States*, 597 F.2d 760, 765 (Ct. Cl. 1979); *Commissioner v. Nubar*, 185 F.2d 584, 588 (CA4 1950), *cert. denied*, 341 U.S. 925 (1961); *Fuld v. Commissioner*, 139 F.2d 465, 468-469 (CA2 1943). See also *Moller v. United States*, 721 F.2d 810 (CA Fed. 1983), *cert. denied*, 467 U.S. 1251 (1984); *Purvis v. Commissioner*, 580 F.2d 1332, 1334 (CA9 1976).

After specifically rejecting the idea that offering goods or services is a prerequisite for engaging in a "trade or business," *Groetzinger* concluded (highlighting added):

> Of course, not every income-producing and profit-making endeavor constitutes a trade or business. The income tax law, almost from the beginning, has distinguished between a business or trade, on the one hand, and "transactions entered into for profit but not connected with ... business or trade," on the other. See Revenue Act of 1916, § 5(a) Fifth, 39 Stat. 759. Congress "distinguished the broad range of income or profit producing activities from those satisfying the narrow category of trade or business." *Whipple v. Commissioner*, 373 U.S. 193, 197 (1963). We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.

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losses incurred as having been sustained in the course of a trade or business. He went on to observe that no facts were adduced in Snyder to show that the taxpayer "might properly be characterized as a 'trader on an exchange who makes a living in buying and selling securities.' " *Id.*, at 139. These observations, thus, are dicta, but, by their use, the Court appears to have drawn a distinction between an active trader and an investor.

> It is suggested that we should defer to the position taken by the Commissioner and by the Solicitor General, but, in the absence of guidance, for over several decades now, through the medium of definitive statutes or regulations, we see little reason to do so. We would defer, instead, to the Code's normal focus on what we regard as a common-sense concept of what is a trade or business. Otherwise, as here, in the context of a minimum tax, it is not too extreme to say that the taxpayer is being taxed on his gambling losses,[15] a result distinctly out of line with the Code's focus on income.
>
> We do not overrule or cut back on the Court's holding in *Higgins* when we conclude that if one's gambling activity is pursued full time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business within the meaning of the statutes with which we are here concerned. Respondent Groetzinger satisfied that test in 1978. Constant and large-scale effort on his part was made. Skill was required and was applied. He did what he did for a livelihood, though with a less than successful result. This was not a hobby or a passing fancy or an occasional bet for amusement.
>
> We therefore adhere to the general position of the *Higgins* Court, taken 45 years ago, that resolution of this issue "requires an examination of the facts in each case." 312 U.S., at 217. This may be thought by some to be a less-than-satisfactory solution, for facts vary. See Boyle, What is a Trade or Business?, 39 Tax Lawyer 737, 767 (1986); Note, The Business of Betting: Proposals for Reforming the Taxation of Business Gamblers, 38 Tax Lawyer 759 (1985); Lopez, Defining "Trade of Business" under the Internal Revenue Code: A Survey of Relevant Cases, 11 Fla. St. L. Rev. 949 (1984). *Cf.* Comment, Continuing Vitality of the "Goods or Services" Test, 15 U. Balt. L. Rev. 108 (1985). But the difficulty rests in the Code's wide utilization in various contexts of the term "trade or business," in the absence of an all-purpose definition by statute or regulation, and in our concern that an attempt judicially to formulate and impose a test for all situations would be counterproductive, unhelpful, and even somewhat precarious for the overall integrity of the Code. We leave repair or revision, if any be needed, which we doubt, to the Congress where we feel, at this late date, the ultimate responsibility rests. *Cf*. *Flood v. Kuhn*, 407 U.S. 258, 269-285 (1972).[16]
>
> [15] "The more he lost, the more minimum tax he has to pay." Boyle, 39 Tax Lawyer, at 754. The Commissioner concedes that application of the goods-or-services-test here "visits somewhat harsh consequences" on taxpayer Groetzinger, Brief for Petitioner 36, and "points to ... perhaps unfortunate draftsmanship." *Ibid*. See also Reply Brief for Petitioner 11.
>
> [16] It is possible, of course, that our conclusion here may subject the gambler to self-employment tax, see §§ 1401-1403 of the Code, and therefore may not be an unmixed blessing for him. Federal taxes, however, rest where Congress has placed them.

Let's look at the requirement that "the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit." *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision) (footnote reproducing Code § 162(a) omitted below), seems to impose a higher standard:

> It is well settled, that in order to constitute the carrying on of a trade or business under section 162(a), the activity must "be entered into, in good faith, with the dominant hope and intent of realizing a profit, i.e., taxable income, therefrom." *Hirsch v. Commissioner*,

315 F.2d 731, 736 (9th Cir. 1963), *affg*. a Memorandum Opinion of this Court. See also *Hager v. Commissioner*, 76 T.C. 759, 784 (1981); *Golanty v. Commissioner*, 72 T.C. 411, 425 (1979), *affd*. without published opinion 647 F.2d 170 (9th Cir. 1981).

However, *Brannen* was decided before *Groetzinger* and *Groetzinger* is a higher court), so *Groetzinger* would control.

"The expectation of profit need not be reasonable, but the taxpayer must conduct the activity with the actual and honest objective of making a profit."[1302]

Brannen suggests that the regulations reproduced in part II.G.4.l.i.(c) Hobby Loss Benefits of Code § 183 are a good summary of the cases on this issue; see fn. 1316 in that part. However, no inference is to be drawn from the provisions of Code § 183 and the regulations thereunder that any activity of a C corporation is or is not a business or engaged in for profit.[1303]

Losses for 12 years, when the taxpayer was 65 years of age when starting the activity, did not disqualify the activity, in which he engaged full time, from constituting a business.[1304]

[1302] *Robison v. Commissioner*, T.C. Memo. 2018-88, citing then reasoning further:

> *Hildebrand v. Commissioner*, 28 F.3d 1024, 1026-1027 (10th Cir. 1994), *aff'g Krause v. Commissioner*, 99 T.C. 132 (1992); *Keanini v. Commissioner*, 94 T.C. 41, 46 (1990). Because petitioners were the only partners in Robison Ranch, we need not separately determine the intent at the partnership level. Greater weight is given to objective facts than to a taxpayer's self-serving statement of intent. *King v. Commissioner*, 116 T.C. 198, 205 (2001); sec. 1.183-2(a) and (b), Income Tax Regs. Evidence from years subsequent to the years in issue is relevant to the extent it creates inferences regarding a taxpayer's requisite profit objective in earlier years. See *Hoyle v. Commissioner*, T.C. Memo. 1994-592; *Smith v. Commissioner*, T.C. Memo. 1993-140.

Barker v. Commissioner, T.C. Memo. 2018-67, stated:

> To be entitled to deductions under section 162, SoBe must have entered into the music business with the "actual and honest objective of making a profit." *Osteen v. Commissioner*, 62 F.3d 356, 358 (11th Cir. 1995), *aff'g* in part, *rev'g* in part T.C. Memo. 1993-519; *Dreicer v. Commissioner*, 78 T.C. at 645; see also sec. 183(c).

[1303] Reg. § 1.183-1(a).

[1304] *Ellsworth v. Commissioner*, T.C. Memo. 1962-32, allowed the taxpayer to deduct losses. The taxpayer's testimony and corroborating expert testimony held persuade the court:

> Petitioner testified that he would not have reentered the breeding of dairy cattle in 1948 unless he "felt sure" he could make a profit, although, based on his past experience in breeding livestock, he realized that initial losses were inevitable since it would require about 10 to 15 years to develop superior strains in his Sybil cattle so that they would have substantial commercial value. Petitioner also ascribed his continuous losses from his farm enterprise in part to various causes such as climatic conditions, adverse effects on breeding establishments of artificial insemination, and economic depressions in the milk industry. Notwithstanding these latter factors, which were beyond his control, petitioner had more than a vain hope that a profit would result from his venture in the near future which would justify his expenditures.
>
> The record shows that petitioner's operation was conducted on an efficient, economical and sound scientific basis when compared to other breeding establishments; that the blood lines of his herd have been constantly improving; and that the prospects of making a profit from the sale of his cattle are considerably improved. Petitioner's expectation of realizing a profit in the very near future was corroborated by three experts in the breeding of livestock who testified, in general, as to the potential profit represented by petitioner's foundation herd, particularly in the "bull stud" market for use in artificial insemination establishments. J.F. Cavanaugh testified that

An individual who earns a living working 40 hours per week may also have a trade or business working another 30 hours per week, even if the other activity has not yet produced a product.[1305]

> petitioner's cattle "have arrived at a point where we think they would sell to good advantage." Likewise, Parodneck, another expert, testified that an individual who had a breeding herd during the taxable years involved, had "a reasonable expectancy of making a profit." We found their testimony in this respect convincing.

Although he had independent sources of income, he worked hard to minimize losses and set himself up for potential future profits:

> Admittedly, petitioner possessed an independent income and was not dependent on the success of the farm for a livelihood. He also may well have had pleasure from residing in a country home, but these facts alone do not negate his intent to operate the farm for profit. *Wilson v. Eisner*, 282 Fed. 38 (C.A. 2, 1922); *DuPont v: United States*, 28 F.Supp. 122, 124 (D. Delaware, 1939) (C.A. 2). Nor is such intent vitiated by the fact that petitioner received an annual income from dividends sufficient to offset substantial losses from his farm enterprise. No evidence was adduced that petitioner was indifferent to whether there was a loss or gain, or that the farm was an incident to the social or domestic aspects of his life. A substantial income from sources other than farming, or substantial sources of capital, was necessary as a basis for embarking on the farming project because of anticipated losses in the earlier years.
>
> We have no doubt upon the record that petitioner devoted himself assiduously to the economical operation of the farm with the reasonable hope of substantial future profits from the breeding operation. We further note that petitioner took affirmative steps to minimize losses derived in1958 by reducing his herd, terminating his lease of a neighboring farm and reducing his working area further by renting some of his acreage. We are satisfied that all of his activities at the farm were influenced by the ambition to produce a valuable strain of dairy livestock which would be commercially acceptable.
>
> That petitioner was about 65 years of age in 1948 when he commenced his selective breeding enterprise and would be 75 or 80 before he could make a profit, in our opinion, is not determinative of the issue. More significant, we believe, is the fact that he gave such attention to the farm as is usually given to a business enterprise. Apart from his annual vacation, petitioner devoted virtually all of his personal attention to supervising the farm operations, including a staff of several full time employees who assisted him. Petitioner, whose average working day on the farm was in excess of eight hours, performed all of the functions of a farm manager. During the taxable years involved, detailed records were kept of daily milk production, of statistics relating to the breeding activities of his livestock, and of income and expenses attributable to the operation of the farm. The farm was a well-equipped establishment and was operated in a businesslike manner. We find, on the whole picture, that the farm operation was not carried on for the purpose of display, social diversion, or for the gratification of a personal whim. *Samuel Riker, Jr., Executor*, 6 B.T.A. 890, 893 (1927).

The court concluded:

> Considering all of the evidence we hold that petitioner carried on his farm activities, and particularly his breeding operations, on a commercial basis with the reasonable hope of making it profitable and not for his recreation, pleasure or other personal reason. Accordingly, the expenses in question are deductible under section 162(a), *supra*.

[1305] *Snyder v. U.S.*, 674 F.2d 1359 (10th Cir. 1982), stated that the taxpayer's profit motive is only significant under Code § 162 insofar as it affords a means of *distinguishing* between an enterprise carried on in good faith as a "trade or business" and an enterprise merely carried on as a hobby. It pointed out:

> A taxpayer is clearly not engaged in a trade or business if his predominant purpose is recreation or a hobby. See, *e.g.*, *Carkhuff v. Commissioner*, 425 F.2d 1400, 1404 (6th Cir. 1970); *Schley v. Commissioner*, 375 F.2d 747, 750 (2d Cir. 1967). On the other hand, an author may be in a trade or business within the meaning of section 162 if he "participated in that endeavor with a good faith expectation of making a profit." *Stern v. United States*, No. 70-782-HP (C.D. Cal. Mar. 26, 1971), 71-1 U.S. Tax. Cas. (CCH) ¶ 9375. The business need not yield an immediate profit. *Id*.

When a taxpayer invests in a partnership, the partnership's profit motive is determinative.[1306]

It also pointed out that it is more difficult to prove a business when activity is not the taxpayer's principal means of livelihood and is of a sporting or recreational nature, citing *Imbesi v. Commissioner*, 361 F.2d 640, 645 (3d Cir. 1966). It held:

> On remand, if the trial court finds taxpayer was primarily motivated by profit, the court must then determine whether taxpayer devoted sufficient time over a substantial enough period to be in a trade or business under section 162. If the trial court finds that taxpayer was not engaged in a trade or business in the relevant years, it must then determine whether the expenses were deductible under section 212 as ordinary and necessary expenses for the production of income.

[1306] *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision), stated:

> In order for a partnership to be entitled to a deduction for expenses attributable to a trade or business in computing its taxable income (or loss) under section 703(a), it must be established that the partnership engaged in the activity with the primary purpose and intent[14] of making a profit. *Hirsch v. Commissioner*, *supra* at 736; *Golanty v. Commissioner*, *supra* at 425; *Hager v. Commissioner*, *supra* at 784. Britton Properties need not have a reasonable expectation of profit, but the partnership must have the intent and objective of realizing a profit.[15] *Hirsch v. Commissioner*, *supra*; *Hager v. Commissioner*, *supra*; *Jasionowski v. Commissioner*, 66 T.C. 312, 321 (1976); *Bessenyey v. Commissioner*, 45 T.C. 261, 274 (1965), *affd*. 379 F.2d 252 (2d Cir. 1967).
>
> [14] While it may at first appear difficult to ascribe an "intent" to an entity such as the limited partnership herein, we have previously held that "It is the intent of the partnership and not that of any specific partner which is determinative in characterizing the income for purposes of taxation." *Podell v. Commissioner*, 55 T.C. 429, 433 (1970). See also *Miller v. Commissioner*, 70 T.C. 448, 456 (1978), where we looked to the "partnership's motives." In this same context, the taxpayer in *Estate of Freeland v. Commissioner*, 393 F.2d 573, 584 (9th Cir. 1968), *affg*. a Memorandum Opinion of this Court, argued that as a limited partner, the intent of the operating partners in the partnership should not be attributed to her. In rejecting this contention, the Second Circuit stated that while the limited partnership may have been an "investment" to her, the intent of the partnership controlled in determining whether the land owned by the partnership was property described in sec. 1221(1).
>
> [15] We recognize that the standard we have used was recently reviewed in *Dreicer v. Commissioner*, 665 F.2d 1292 (D.C. Cir. 1982), *revg. and remanding* a Memorandum Opinion of this Court. In *Dreicer*, the Circuit Court, after a review of the legislative history, concluded that the applicable standard is not whether the taxpayer had "a bona fide expectation" of profit but, rather, whether he engaged in the activity with the "objective" of making a profit. The Court correctly stated that sec. 1.183-2(a), Income Tax Regs., provides that the facts must indicate that the taxpayer entered into the activity with "the objective of making a profit." The difference in the standard of "objective of making a profit" and a "bona fide expectation" of making a profit might be merely one of semantics. In any event, the Circuit Court in the *Dreicer* case recognized, as this Court has in many cases, that an activity is not engaged in for profit if the taxpayer does not have the "objective" or "intent" of making a profit, and that the "objective" or "intent" of the taxpayer is a question of fact to be decided in each case from all the evidence of record.

Barker v. Commissioner, T.C. Memo. 2018-67, stated:

> We determine the existence of such an objective at the partnership level, *Brannen v. Commissioner*, 722 F.2d 695, 703-704 (11th Cir. 1984), *aff'g* 79 T.C. 471 (1992), and "we focus on the intent of the general partner … since it is [this] individual[] who actually controlled the partnership's activities", *Fuchs v. Commissioner*, 83 T.C. 79, 98 (1984).

However, if the taxpayers are the only partners, one can look directly to their situation. See fn 1302.

Although an individual holding property for the production of income must look to Code § 212 rather than Code § 162,[1307] a corporation appears able to use Code § 162 to deduct expenses related to the production of income, as illustrated by Rev. Rul. 78-195:

> A corporation that was formed for the express purpose of investing in real property purchased a tract of unimproved, non-income-producing real property, which it held for two years and sold without having made any substantial improvements. The corporation did not make any significant efforts to sell the property and did not engage in any other transactions in real or personal property or in other commercial activities. During the period that it held the property, the corporation incurred expenses for interest, real property taxes, accounting fees, and general office costs.
>
> *Held*, the accounting fees and general office costs are expenses related to investment property of the corporation and are deductible by the corporation under section 162 of the Internal Revenue Code of 1954 in the year in which paid or incurred. The interest and real property taxes are deductible by the corporation under sections 163 and 164 of the Code, respectively. See section 266 and the Income Tax Regulations thereunder regarding amounts which may be charged to capital account.

II.G.4.l.i.(b). Requirements for Deduction Under Code § 212

Subject to the various limitations provided in the preceding parts of part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner and subject to other limitations on what can be deducted, Code § 212 allows an individual to deduct:

> all the ordinary and necessary expenses paid or incurred during the taxable year—
>
> (1) for the production or collection of income;
>
> (2) for the management, conservation, or maintenance of property held for the production of income; or
>
> (3) in connection with the determination, collection, or refund of any tax.

However, the activity need not produce a profit for the deductions to be allowable under Code § 212.[1308]

[1307] See part II.G.4.l.i.(d) Whether Managing Investments Constitutes a Trade or Business, especially fns 1342-1343.

[1308] Reg. § 1.212-1(b) provides:

> The term "income" for the purpose of section 212 includes not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. For example, if defaulted bonds, the interest from which if received would be includible in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter paid or incurred in connection with such bonds are deductible. Similarly, ordinary and necessary expenses paid or incurred in the management, conservation, or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. Expenses paid or incurred in

On the other hand, Reg. § 1.212-1(c) provides that:

> In the case of taxable years beginning before January 1, 1970, expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses. The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case. For example, consideration will be given to the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer. For provisions relating to activities not engaged in for profit applicable to taxable years beginning after December 31, 1969, see section 183 and the regulations thereunder.

Another issue is whether fees are "ordinary and necessary" expenses for investment advice allowable under Code § 212 or are nondeductible capital expenses. In resolving this issue, *Honodel v. Commissioner*, 76 T.C. 351 (1981), held:[1309]

> … we "look to the nature of the services performed" by the investment adviser rather than "their designation or treatment" by the taxpayer.[5] *Cagle v. Commissioner*, 63 T.C. 86, 96 (1974), *affd*. 539 F.2d 409 (5th Cir. 1976), and the cases cited therein. Our inquiry focuses on whether the services were performed in the process of acquisition or for investment advice. See generally *Woodward v. Commissioner*, *supra* at 577.
>
> [5] Petitioners urge us to apply the origin-of-the-claim test first specifically propounded by the Supreme Court in *United States v. Gilmore*, *supra* at 49. See *Reed v. Commissioner*, 55 T.C. 32, 39-40 (1970), and the cases cited therein. The Supreme Court in *Woodward v. Commissioner*, 397 U.S. 572, 577-578, applied the "origin" test in holding that litigation expenses incurred in connection with appraisal proceedings had their origin in the "process of acquisition" and were therefore nondeductible capital expenditures. The Court stressed that the taxpayer's motive or purpose would not be considered. Therefore, in the case at issue herein, we follow the Supreme Court's guidance in ignoring each petitioner's "motive or purpose." We adopt an inquiry consistent with that of the Supreme Court by looking at the nature of the services performed (the origin of the fee) in determining whether such services are rendered in the process of acquisition.

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managing, conserving, or maintaining property held for investment may be deductible under section 212 even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto.

[1309] The quote below refers to *Woodward v. Commissioner*, 397 U.S. 572, 575 (1970), *affg*. 410 F.2d 313 (8th Cir. 1969), which *affd*. 49 T.C. 377 (1968).

The court summarized the facts and applied this rule:

> The “nature of the services performed” by FMS for its clientele, including petitioners, may be summarized quite simply. In periodic planning sessions, FMS evaluated and analyzed each petitioner’s personal, financial, and tax status, elicited objectives and proposed investment programs in light of those objectives. Further, FMS analyzed numerous investment opportunities presented to it by outside brokers in the process of selecting the projects under our consideration. In evaluating these investments, FMS utilized the services of outside counsel for legal and tax advice. FMS, through its agents and outside contractors, negotiated the purchase of these investments and prepared the legal documentation, including the limited partnership agreement, necessary to consummate the transaction. The potential investments that met with the approval of FMS were recommended to petitioners who had the option to invest if they so desired.
>
> The complexity, or should we say perplexity, resulting from this factual web arises because of the dual nature of FMS’s function: (1) An advisory function and (2) an acquisition function. Respondent contends that the acquisition function was all encompassing in arguing as follows:
>
> > the evidence shows that Clark [FMS] identifies suitable investment projects, forms limited partnerships which he then causes to purchase the projects, and finally sells the units of limited partnership to his clients at a fixed price per unit… Accordingly, viewed from the end result and the manner in which the fees are charged, it appears they represent nothing more than part of the cost of acquiring partnership interests, or represent commissions for Clark’s services in putting the project together….
>
> We disagree with respondent because he fails to focus on the “nature of the services performed” by FMS, as required in *Cagle v. Commissioner*, *supra*. Instead, respondent incorrectly points to the end result or consequence of such services.
>
> We find that those services provided by FMS relating to (1) periodic planning sessions and (2) the evaluation of potential investments to the extent needed to formulate an opinion regarding such investments were investment advice. In addition, those services performed by FMS in communicating its recommendations to petitioners were investment advice. Conversely, those services rendered in the “process of acquisition” including, but not limited to, negotiating the purchase and creating the investment vehicle were capital in nature. See *Kimmelman v. Commissioner*, 72 T.C. 294, 304-305 (1979); section 741.
>
> FMS adopted a two-tier fee schedule: (1) A monthly retainer fee and (2) an investment fee. We now must examine the nature of each of these fees to determine if they are allocable to currently deductible investment advice or to capitalizable acquisition costs. Generally, petitioners paid a monthly retainer fee whether or not they invested in a project recommended to them by FMS. Spence Clark testified that FMS “had doctor clients pay us for two or three years, without receiving an investment and they may have … paid $5,000.00, $10,000.00, $20,000.00, $30,000.00 in fees, and still not invested.” Only those clients who decided to invest in a recommended project an took advantage of FMS’s acquisition function paid the investment fees. Those clients who chose not to invest and hence were not required to pay the investment fee received the exact same investment services as those who chose to invest. Conversely, petitioners could only participate in an investment if they paid the investment fee. Each petitioner voluntarily

could choose to invest in the projects. Each was cognizant of the fact that a decision to invest resulted in the imposition of this investment fee. This investment fee was a cost of acquiring an interest in the limited partnership projects herein.

Based upon this reasoning, we hold that the monthly retainer fees paid by petitioners are allocable to investment advice and are therefore deductible under section 212(2). Further, we find that the investment fees paid by petitioners are nondeductible capital expenditures incurred in connection with the acquisition of partnership interests and are includable in their bases.[6] See sec. 742. Our holding is consistent with that of the Court of Claims in *Picker v. United States*, 178 Ct.Cl. 445, 371 F.2d 486, 499 (1967). In *Picker*, the Court of Claims found that fees were paid for a recommendation that was not utilized in the acquisition of a capital asset. The court held that such fees were paid for investment counsel and therefore were deductible under section 212(2).

[6] We are assuming that the cattle investment and the Glendale Shopping Center investment (see table at pp. 359-360) were in partnership form. The fees paid for these investments are therefore treated consistently with the fees paid for the apartment projects. In any case, the form of the investment will not affect our result.

II.G.4.l.i.(c). Hobby Loss Benefits of Code § 183

Code § 183(a) provides:

General rule. In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

Reg. § 1.183-2(a) includes:

The determination whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case. Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit. In determining whether such an objective exists, it may be sufficient that there is a small chance of making a large profit. Thus it may be found that an investor in a wildcat oil well who incurs very substantial expenditures is in the venture for profit even though the expectation of a profit might be considered unreasonable. In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent.

Code § 183 also applies to deductions passing through a partnership.[1310]

[1310] Rev. Rul. 77-320 concluded:

Held, section 183 of the Code applies to the activities of a partnership, and the provisions of section 183 are applied at the partnership level and reflected in the partners' distributive shares.

See *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision), quoted in fn. 1339. But the Fifth Circuit may have a different view, having stated in *Copeland v. Commissioner*, 290 F.3d 326 (2002) (but correctly pointing out how Code § 183 is sometimes incorrectly referred to as disallowing deductions):

For some clues into the IRS' views, see "Activities Not Engaged in for Profit, Audit Technique Guide," Publication 5558 (9-2021) (irs.gov).

Where the taxpayer is engaged in several undertakings, each of these may be a separate activity, or several undertakings may constitute one activity.[1311] Income and deductions would be allocated between activities.[1312] Reporting activities on separate schedules (for example, one on Schedule C and another on Schedule F) is an admission that the taxpayer views the activities as separate, requiring the taxpayer to overcome a high hurdle to establish that the undertakings were a single activity.[1313]

> The Tax Court's wording to the contrary notwithstanding, however, the deductions were not actually disallowed under I.R.C. § 183, but under I.R.C. §§ 162 and 174, neither of which are limited — as is § 183 — to activities engaged in by individuals and S corporations, to the exclusion of partnerships.[26] I.R.C. § 183 provided the *Krause* court with only the factors for analysis, not statutory authority to allow or disallow deductions themselves. To say that the deductions are disallowed "under section 183" impermissibly conflates the I.R.C. sections in question and thereby glosses over this crucial distinction.
>
> [26] Even the Commissioner recognizes this limitation in his appellate brief when he states (emphasis ours): "The regulations under § 183 list a number of factors relevant to the determination of profit motive, and those factors have frequently been applied by the courts in determining whether a profit motive exists for all sorts of entities, including partnerships and corporations, *to which the limitations on deductibility of § 183 do not apply*."

[1311] Reg. § 1.183-1(d)(1), which provides further:

> In ascertaining the activity or activities of the taxpayer, all the facts and circumstances of the case must be taken into account. Generally, the most significant facts and circumstances in making this determination are the degree of organizational and economic interrelationship of various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting, and the similarity of various undertakings. Generally, the Commissioner will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities. The taxpayer's characterization will not be accepted, however, when it appears that his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case. If the taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated either in determining whether a particular activity is engaged in for profit or in applying section 183. Where land is purchased or held primarily with the intent to profit from increase in its value, and the taxpayer also engages in farming on such land, the farming and the holding of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land for its appreciation in value. Thus, the farming and holding of the land will be considered a single activity only if the income derived from farming exceeds the deductions attributable to the farming activity which are not directly attributable to the holding of the land (that is, deductions other than those directly attributable to the holding of the land such as interest on a mortgage secured by the land, annual property taxes attributable to the land and improvements, and depreciation of improvements to the land).

[1312] Reg. § 1.183-1(d)(2) provides:

> *Rules for allocation of expenses*. If the taxpayer is engaged in more than one activity, an item of deduction or income may be allocated between two or more of these activities. Where property is used in several activities, and one or more of such activities is determined not to be engaged in for profit, deductions relating to such property must be allocated between the various activities on a reasonable and consistently applied basis.

[1313] *Den Besten v. Commissioner*, T.C. Memo. 2019-154, citing for the admission issue *Topping v. Commissioner*, T.C. Memo. 2007-92, 2007 WL 1135339, at *9 (citing *Mendes v. Commissioner*, 121 T.C. 308, 312 (2003), and *Estate of Hall v. Commissioner*, 92 T.C. 312, 337-338 (1989)).

Code § 183(c) provides:[1314]

> *Activity not engaged in for profit defined*. For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

Thus, Code § 183 "is not a disallowance provision, but rather an allowance provision which operates only when the taxpayer's expenses are not allowable as deductions under section 162(a) or 212(1) and (2)," and "the profit motive analysis must be resolved *before* turning to section 183."[1315] However, courts often conflate Code §§ 162 and 183 and jump directly to whether a profit motive exists under Code § 183, presumably because a finding of profit motive under Code § 183 means that one does not need to consider a profit motive under Code § 162.

Code § 183(d) presumes an activity is engaged in for profit if it is profitable for a particular number of years. If the presumption does not apply, then Reg. § 1.183-2(b) kicks in [footnotes in the long quote below are mine, elaborating on each factor]:[1316]

> *Relevant factors*. In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account.[1317] No one factor

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[1314] Reg. § 1.183-1(a) reinforces this predicate by including:

> Whether an activity is engaged in for profit is determined under section 162 and section 212(1) and (2) except insofar as section 183(d) creates a presumption that the activity is engaged in for profit.

[1315] *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision) (emphasis in original), quoted in fn. 1339. However, courts often fail to consider Code § 162 before turning to a Code § 183 analysis; for example, *Boneparte v. Commissioner*, T.C. Memo. 2017-193, correctly contrasted the consequences of being a professional gambler with being a casual gambler and dove right into Code § 183 with even mentioning Code § 162 (but the taxpayer, who was a toll bridge operator, prepared his own returns and represented himself in Tax Court, so the lack of rigor is not surprising).

[1316] *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision), held that:

> since the regulation is not unreasonable and plainly inconsistent as it deals with a specific issue raised in section 183 which requires a determination before that section is applicable, it should be given full force and effect. See *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496 (1948). In addition, since many of the statements in the regulation, including the relevant factors listed, were derived from case law decided prior to the enactment of section 183, it is clear that the standards used in determining whether a profit motive exists for purposes of section 162 or 212 have remained the same. See *Jasionowski v. Commissioner*, *supra* at 321-322; *Benz v. Commissioner*, 63 T.C. 375, 383 (1974).

[1317] *Robison v. Commissioner*, T.C. Memo. 2018-88, stated:

> All facts and circumstances are to be taken into account, and no single factor or mathematical preponderance of factors is determinative. *Westbrook v. Commissioner*, 68 F.3d at 876; *Hildebrand v. Commissioner*, 28 F.3d at 1027. We address the most relevant factors in determining petitioners' intent.

After considering the factors in fns 1318, 1319, 1320, 1323, 1326, and 1329, the court concluded:

> This is a very close case, and our determination for the years in issue is limited to the facts found for those years. After weighing all the facts and circumstances in the light of the relevant factors, we conclude that petitioners engaged in their ranching activity for the years in issue with the requisite profit objective. Petitioners' activities cannot be characterized as a "hobby" during those years. Petitioners' efforts to reduce Robison Ranch's expenses and the resulting decrease in petitioners' net losses during the years in issue are most persuasive. Accordingly, we reject

is determinative in making this determination. In addition, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. Among the factors which should normally be taken into account are the following:

(1) *Manner in which the taxpayer carries on the activity*. The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit.[1318] Similarly,

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respondent's disallowance of the loss deductions relating to the ranching activity under section 183.

[1318] *Robison v. Commissioner*, T.C. Memo. 2018-88, included the following reasoning:

Carrying on an activity in a businesslike manner, such as by maintaining complete and accurate books and records, conducting the activity in a manner similar to other activities of the same nature that are profitable, and making changes in operations to adopt new techniques or abandon unprofitable methods, is a factor that may indicate a profit objective. Sec. 1.183-2(b)(1), Income Tax Regs. Businesslike conduct is characterized by careful and thorough investigation of the profitability of a proposed venture, monitoring of a venture in progress, and attention to problems that arise over time. See *Ronnen v. Commissioner*, 90 T.C. 74, 93 (1988); *Taube v. Commissioner*, 88 T.C. 464, 481-482 (1987).

While a taxpayer need not maintain a sophisticated cost accounting system, the taxpayer should keep records that enable the taxpayer to make informed business decisions. See *Burger v. Commissioner*, 809 F.2d 355, 359 (7th Cir. 1987), *aff'g* T.C. Memo. 1985-523. For a taxpayer's books and records to indicate a profit motive, the books and records should enable a taxpayer to cut expenses, increase profits, or evaluate the overall performance of the operation. See *Abbene v. Commissioner*, T.C. Memo. 1998-330. Petitioners kept many financial and administrative records, such as weekly meeting minutes, employment contracts, payroll tax returns, insurance policies and payments, and formal leases for employees who lived on Robison Ranch. Although petitioners' records were voluminous, respondent argues that petitioners' administrative and financial recordkeeping was more akin to a conscious attention to detail than to something used to analyze expenses or improve profitability. See *Golanty v. Commissioner*, 72 T.C. 411, 430 (1979), *aff'd*, 647 F.2d 170 (9th Cir. 1981). Petitioners contend that R. Robison used QuickBooks' profit and loss statements to monitor the ranch's finances and cut costs. We believe petitioners used them for the important purposes of cutting expenses, increasing profits, and evaluating the overall performance of the operation. See *id*. However, there is no evidence that they used them to create budgets or make income projections, which would have been advantageous and further indicative of operating in a businesslike manner. *See Keating v. Commissioner*, 544 F.3d 900, 904 (8th Cir. 2008), *aff'g* T.C. Memo. 2007-309; *Foster v. Commissioner*, T.C. Memo. 2012-207, slip op. at 14….

Respondent also argued that petitioners had no written business plan for Robison Ranch. Numerous court opinions mention that a businesslike operation often would involve a business plan. *See*, *e.g.*, *Wesinger v. Commissioner*, T.C. Memo. 1999-372. Petitioners retroactively created business plans for the years in issue, which were largely narratives of the actions petitioners took during those years. The fact that petitioners had no written business plan does not negate a profit motive, as a business plan can be evidenced by actions. *See Annuzzi v. Commissioner*, T.C. Memo. 2014-233, at *16; *Phillips v. Commissioner*, T.C. Memo. 1997-128 (stating that written financial plan not required for 32-horse farm where business plan was evidenced by action). Nevertheless, a business plan likely would have aided petitioners in creating analyses for the future financial management or planning of the activity. *See Foster v. Commissioner*, T.C. Memo. 2012-207, slip op. at 14.

Maintaining an additional bank account for the activity separate from a taxpayer's personal finances is indicative of an activity being carried on in a businesslike manner. *See Wayts v.*

> where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.[1319]

> *Commissioner*, T.C. Memo. 1992-82 (finding horse racing and breeding activity was carried on in a businesslike manner because it had a separate bank account) (citing *Pryor v. Commissioner*, T.C. Memo. 1991-109). Petitioners' separate maintenance of their personal finances and Robison Ranch's are indicative of operating in a businesslike manner.
>
> Perhaps the most important indication of whether an activity is being performed in a businesslike manner is whether the taxpayer implements methods for controlling losses, including efforts to reduce expenses and generate income. *See Dodge v. Com missioner*, T.C. Memo. 1998-89, *aff'd* without published opinion, 188 F.3d 507 (6th Cir. 1999). Petitioners contend that they made changes to their operating methods, adopted new techniques, and abandoned unprofitable methods that contributed to their losses. The record supports this contention. Petitioners made changes in their ranching activity when they realized that certain operations would not be profitable, changing Robison Ranch's operation two times - from Paint Horses, to Quarter Horses, to a registered cattle herd. *Cf. Williams v. Commissioner*, T.C. Memo. 2018-48, at *24-*25 (finding cattle operation was not carried on in a businesslike manner because taxpayer did not make changes or transition his operation for 10 years despite continued losses).

Similarly, *Den Besten v. Commissioner*, T.C. Memo. 2019-154, held that the taxpayer had a qualified business plan:

> While petitioner's plan was not formally written, it can be inferred, from his deliberate actions to achieve a narrowly focused goal, that he did have a plan.

Den Besten also held that the taxpayer's failure to maintain formal accounting records was not fatal, when the taxpayer kept sufficient receipts to substantiate his income and deductions:

> The records petitioner maintained were consistent with his business profit objective and enabled him to make educated business decisions about his cutting horse activity.

The taxpayer's advertising efforts and results also impressed the *Den Besten* court:

> A taxpayer may further exhibit his profit objective by the manner in which he advertises his business. A single form of substantial advertisement itself may not establish that a taxpayer has carried on his activity in a businesslike manner. See *McKeever v. Commissioner*, T.C. Memo. 2000-288; *Cohn v. Commissioner*, T.C. Memo. 1983-301, 1983 Tax Ct. Memo LEXIS 486, *aff'd*, 742 F.2d 1432 (2d Cir. 1984). Different kinds of advertising media may allow the taxpayer "[t]o expand … [his] potential market and to attract new individuals". *Cohn v. Commissioner*, 1983 Tax Ct. Memo LEXIS 486, at *22. Horse shows may be an effective advertising method. See *Engdahl v. Commissioner*, 72 T.C. at 662-663; *Dodge v. Commissioner*, T.C. Memo. 1998-89.
>
> Petitioner displayed banners at competition events advertising both his seed business and his cutting horse activity, and he had advertisements in printed programs and sales catalogs. Petitioner sold advertisement items such as blankets and belt buckles marked with his brand name and talked with people across the nation regarding his horses, all of which resulted in sales, breeding, and training opportunities. Petitioner marked his operation with his own unique brand. He used his brand on advertisement items, in production sales catalogs, and even on some of the horses he bred.

[1319] *Robison v. Commissioner*, T.C. Memo. 2018-88, included the following reasoning:

> Petitioners hired professionals to manage Robison Ranch, employing a full-time ranch manager and a ranch hand during the years in issue, both of whom lived on site. Petitioners also conducted weekly meetings with Robison Ranch employees. While Dahl was not an expert in registered Angus cattle ranching, nor had he managed a ranch previously, he was experienced in cattle ranching, having been raised on an unregistered cattle ranch. Further, petitioners made

(2) *The expertise of the taxpayer or his advisors*. Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices.[1320] Where a taxpayer has such preparation or procures such expert

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use of a local veterinarian who was an expert regarding brisket disease and the effects of high altitudes on cattle. This factor favors petitioners.

A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

See *Hendricks v. CIR*, 32 F3d 94, 98 (4th Cir. 1994) (physician's farm sustained losses in 20 of 21 years of operation; lack of profit motive evidenced by taxpayer's knowledge "of steps he might have taken, but failed to take, to improve the farm's profitability"); *Holmes v. CIR*, 74 TCM (CCH) 494 (1997) (farm found not to be carried on for profit because, among other things, taxpayers failed to keep records in businesslike way; negligence penalty sustained; extensive analysis); *Elliott v. CIR*, 90 TC 960, 973 (1988), *aff'd* without opinion, 899 F2d 18 (9th Cir. 1990) (Amway distributors not engaged in business for profit where they "made some small modifications in their routine social life [on entering the business], kept cursory notes about their activities, and claimed deductions for the cost of nearly everything they owned or did"; negligence penalty imposed); *Allen v. CIR*, 72 TC 28 (1979) (taxpayers operated ski lodge in businesslike manner, experimenting with different modes of operating it in hope of making profit); *Lyon v. CIR*, 36 TCM (CCH) 979 (1977) (failure to maintain records and unbusinesslike approach; activity not "engaged in for profit"); Lee, *supra* note 8, at 397–407. Compare *Rozzano v. CIR*, 94 TCM (CCH) 29 (2007) (holding horse farm was run for profit, notwithstanding large losses annually for eight years, largely because operation was carried on in business-like manner).

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974).

Den Besten v. Commissioner, T.C. Memo. 2019-154, held that the taxpayer's change of operating methods indicated a profit objective:

After his championships in 1997 and 1998, petitioner acquired and remodeled the Yellow Rose, expanding his operation. This significant acquisition enabled him to expand into hosting cutting horse competitions and production sales. It also increased his boarding and training capacities. He sold his seed business in order to increase the effort and time he needed to coordinate these efforts and to train potential foals. The Court concludes these actions are strongly indicative of petitioner's having a profit motive during this timeframe preceding the years in issue. The actions are consistent with an intent to improve profitability through new operating methods.

Even though petitioner owned and operated the Yellow Rose outside the years in issue, he recognized he had to sell it to generate time and capital to save the seed business. Petitioner reduced his operation on the basis of economic realities and entered into a winding-down period with respect to the cutting horse activity. Petitioner's realization he needed to scale down his operation is also indicative of a profit motive.

[1320] *Robison v. Commissioner*, T.C. Memo. 2018-88, included the following reasoning:

S. Robison has a family background in ranching and farming although he had never previously operated a ranch. Petitioners consulted with persons who were knowledgeable about ranching, including a ranch attorney, other ranch owners, trainers and breeders, and their veterinarian. *See Givens v. Commissioner*, T.C. Memo. 1989-529 (a profit objective was indicated where the taxpayer sought and acquired advice in all aspects of Tennessee Walking Horse breeding from experienced owners, trainers, and a veterinarian). Petitioners also sought advice regarding the business elements of starting Robison Ranch from their accountant. In the face of mounting losses, it would have been prudent to seek further business advice; however, we believe this factor favors petitioners.

Den Besten v. Commissioner, T.C. Memo. 2019-154, recognized the taxpayer's demonstrated expertise:

Petitioner has a high level of expertise in the care, training, and competing of cutting horses, including their feeding, breeding, foaling, training, competing, and selling. His efforts resulted in advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.[1321]

(3) *The time and effort expended by the taxpayer in carrying on the activity*. The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.[1322]

> two champion cutting horses and at least eight futurity prospects. His production sales attracted national attention. He offered purchases by telephone, and consignors traveled to list their horses in his production sales. In addition, he had a network of trainers to assist him. Petitioner had been a respected businessman in a related business for years.

However, *Whatley v. Commissioner*, T.C. Memo. 2021-11 required expertise to be relevant and substantial: Whatley also has no experience operating a timber farm like the one at Sheepdog Farms. We do acknowledge his argument that his foray into the business at the age of 27 should weigh in his favor. But we don't think it should weigh very much—it was over 35 years ago, and his business was different. Sheepdog Farms is reportedly a timber farm. The business Whatley ran as a young man bought and logged timber that was ready to harvest. These businesses may be in the same general field, but timber harvesting and timber growing are not similar enough for us to find that Whatley had experience in the business.[13]

> [13] Whatley also argues that he has experience in the field because he lends money to timber farmers through his bank. We are unconvinced. People don't go to a mechanic's banker to fix their cars - they go to a mechanic.

[1321] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *DeMattia v. CIR*, 75 TCM (CCH) 1903, 1906 (1998) (retired dentist's sponsorship of son's professional golf career not conducted in businesslike manner; no "goals or financial conditions," no prior investigation of profit potential, and no separate records); *Taras v. CIR*, 74 TCM (CCH) 1388, 1395 (1997) ("Petitioners initiated their activity [horse racing] without developing a business plan commensurate with that which would be expected from someone who was motivated primarily by a profit objective"); *Lucid v. CIR*, 73 TCM (CCH) 2892 (1997) (no profit motive for business of selling yachts; no business plan or training or experience in business; negligence penalty sustained); *Benz v. CIR*, 63 TC 375 (1974) (taxpayer was "relative novice"; breeding activity was hobby); Lee, *supra* note 8, at 407–412. *Taras* has been affirmed by an unpublished opinion, 187 F3d 627 (3d Cir. 1999) .

The citation to Lee is to Lee, "A Blend of Old Wines in a New Wineskin: Section 183 and Beyond," 29 Tax L. Rev. 347 (1974). *Ford v. Commissioner*, T.C. Memo. 2018-18, found no profit motive, starting its criticism of the taxpayer:

> She had no expertise in club ownership, maintained inadequate records, disregarded expert business advice, nonchalantly accepted Bell Cove's perpetual losses, and made no attempt to reduce expenses, increase revenue, or improve Bell Cove's overall performance.

[1322] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Hawkins v. CIR*, 38 TCM (CCH) 469 (1979) (publication of book of poetry not for profit; no evidence of continuous or repeated activity in literary field or intent to write with substantial

(4) *Expectation that assets used in activity may appreciate in value*. The term "profit" encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed

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> regularity); Lee, *supra* note 8, at 412–416. But see *Cornfeld v. CIR*, 797 F2d 1049, 1052 (DC Cir. 1986) ("to have an honest profit objective a taxpayer need not run the business himself or have expertise in it; it suffices that he engage those who do"); *Nickerson v. CIR*, 700 F2d 402, 407 (7th Cir. 1983) (taxpayer engaged in farming for profit even though he had another full-time job and spent only spare time on farm; taxpayer's efforts were "prodigious" and farm did not provide recreation); *Perry v. CIR*, 74 TCM (CCH) 616 (1997) (taxpayers' horse breeding operation was for profit, even though taxpayers were both employed full-time in other jobs, because they had knowledge and experience needed for success).

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974). *Ford v. Commissioner*, T.C. Memo. 2018-18, found no profit motive, concluding its criticism of the taxpayer:

> Owning Bell Cove elevated petitioner's status in the country music community, allowed her to further the careers of young performers, offered her weekly opportunities to interact with country music fans, and satiated her love promoting country music. Petitioner earnestly devoted time and energy to Bell Cove but was primarily motivated by personal pleasure, not profit, and simply used the club's losses to offset her trust and capital gain income. See *Bessenyey v. Commissioner*, 45 T.C. 261, 275 (1965), *aff'd*, 379 F.2d 252 (2d Cir. 1967); sec. 1.183-2(b)(3), (8), (9), Income Tax Regs.

Den Besten v. Commissioner, T.C. Memo. 2019-154, held that the taxpayer's efforts were ample:

> ... When evaluating the time and effort a taxpayer dedicated to horse activities, the relevant inquiry is the amount of time and effort contributed above and beyond the amount generally required to sustain a hobby. *Betts v. Commissioner*, T.C. Memo. 2010-164.
>
> During the years in issue petitioner spent a considerable amount of time breeding approximately 12 mares per season, delivering the foals, and performing veterinary work on his horses as needed. Petitioner had engaged in an extensive stallion service contracts for live cover breeding program, which required vigilance through the mares' breeding cycles and careful physical control of the stallions during mating. Petitioner's dedication to the oversight of the successful breeding program extend well beyond that of a mere hobbyist.
>
> While unforeseen events forced petitioner to scale back his activities, the Court cannot overlook the size and depth of his cutting horse activity leading up to the years in issue.

expenses of operation.[1323] See, however, paragraph (d) of § 1.183-1 for definition of an activity in this connection.[1324]

(5) *The success of the taxpayer in carrying on other similar or dissimilar activities*. The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.[1325]

[1323] *Robison v. Commissioner*, T.C. Memo. 2018-88, included the following reasoning:

> However, a profit objective may be inferred from such expected appreciation of the activity's assets only where the appreciation exceeds operating expenses and is sufficient to recoup the accumulated losses of prior years. *See Golanty v. Commissioner*, 72 T.C. at 427-428; *Hillman v. Commissioner*, T.C. Memo. 1999-255.
>
> Respondent argues that petitioners' objective must include recoupment of all of Robison Ranch's past losses. This expectation is too high. *See Welch v. Commissioner*, at *35. "An overall profit is present if net earnings and appreciation are sufficient to recoup the losses sustained in the "intervening years: between a given tax year and the time at which future profits were expected." *Helmick v. Commissioner*, T.C. Memo. 2009-220, slip op. at 27 (citing *Bessenyey v. Commissioner*, 45 T.C. 261, 274 (1965), *aff'd*, 379 F.2d 252 (2d Cir. 1967)). Therefore, the question is not whether petitioners would recoup all of Robison Ranch's losses but whether they would recoup the losses between the years in issue and the "hoped-for profitable future." *See id.* at 28.
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> Petitioners did not provide a valuation of Robison Ranch. There is not enough evidence in the record to determine the current value of or petitioners' adjusted basis in the ranch property, and we are therefore unable to determine the amount of appreciation, if any. Accordingly, this factor is neutral.

[1324] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Bolaris v. CIR*, 776 F2d 1428 (9th Cir. 1985) (depreciation and operating expense deductions allowed for former principal residence that was rented pending sale; profit motive can exist even if gain on sale qualifies for nonrecognition); *Thompson v. US*, 90-1 USTC ¶ 50,043 (D. Conn. 1989) (in determining whether horse breeding operation was carried on for profit, jury could consider possibility of appreciation in value of land used in operation); *Dickson v. CIR*, 47 TCM (CCH) 509 (1983) (expectation of profit from appreciation in value of sailboat was major factor in finding boat chartering activity was for profit); Lee, *supra* note 8, at 416–418. But see *Jasionowski v. CIR*, 66 TC 312 (1976) (taxpayer's expectation of capital gains upon eventual sale of property not sufficient to supply profit motive for current lease of the property).

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974). Another footnote in Bittker & Lokken says:

> See *Landry v. CIR*, 86 TC 1284, 1306 (1986) (rejecting IRS's argument that § 183 applies where, notwithstanding conceded expectation of profit in the long run, intention to profit during the taxable year was lacking; § 183 inapplicable if taxpayer "intended to make a profit within a reasonable time"); *Lemmen v. CIR*, 77 TC 1326 (1981) (*acq*.) (expectation of profit from herd of breeding cattle over long range established).

Ford v. Commissioner, T.C. Memo. 2018-8, at fn 7 cited this regulation to add weight to its conclusion of no profit motive, pointing out:

> Further, Bell Cove's $420,253 of accumulated losses exceeded its $383,900 of appreciation.

[1325] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), cites Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347, 418-420 (1974).

After reciting the factors in Reg. § 1.183-2(b), *Barker v. Commissioner*, T.C. Memo. 2018-67, held:

> The totality of the facts and circumstances indicate that petitioner- SoBe's CEO and managing member—operated SoBe as a trade or business with the "actual and honest objective of making

(6) *The taxpayer's history of income or losses with respect to the activity*. A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit.[1326] If losses are sustained because of unforeseen or fortuitous

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a profit." See *Osteen v. Commissioner*, 62 F.3d at 358. Petitioner had prior business successes in the music industry - he founded Peaches & Herb and co-produced a Grammy-winning song for Gladys Knight & the Pips - and he ran successful defense contracting businesses, having helped to turn one of them around after several years without a profit. Petitioner leveraged his prior experience and contacts in the music industry as he prepared for SoBe's formation and he ran SoBe in a businesslike manner, working there full time. He also devoted significant capital to make it a profitable business. While SoBe was not profitable from its founding in 2002 through 2011 - nor, indeed, through the time of trial - petitioner testified that SoBe positioned itself well to make a profit by amassing a catalog of songs that it has been able to monetize. Petitioner also convincingly testified about the turmoil in the music industry and the difficulties faced by artists and producers over the years in issue.

The fact that petitioner's son, Yannique, was one of SoBe's signed artists and that SoBe had advanced him the costs of recording, producing, and promoting his music does not mean that SoBe was merely a vehicle to fund Yannique's musical aspirations or that SoBe had no profit objective. SoBe had other artists; it did not devote most of its resources to Yannique. We also conclude that the other facts favoring characterization as a hobby, such as the fact that petitioner enjoyed the creative aspects of the music industry and had income from other sources and that SoBe had yet to make a profit as of trial, are outweighed by the facts indicating a profit motive. Thus, we conclude for years 2003 through 2011 that SoBe is a trade or business and is eligible to claim deductions under section 162.

Den Besten v. Commissioner, T.C. Memo. 2019-154, discussed how experience in one business informed his conduct of the activity in question:

A taxpayer's success in other business ventures may indicate that the taxpayer has the entrepreneurial skills and determination to succeed in subsequent endeavors. This in turn may help demonstrate that his present objective is profit. Sec. 1.183-2(b)(5), Income Tax Regs.; see also *Rabinowitz v. Commissioner*, T.C. Memo. 2005-188; *Daugherty v. Commissioner*, T.C. Memo. 1983-188. A court can infer that a taxpayer's diligence, initiative, foresight, and other qualities will generally lead to success in other business activities if he has demonstrated those qualities by starting his own business and turning that business into a relatively large and profitable enterprise. See *Daugherty v. Commissioner*, T.C. Memo. 1983-188.

Petitioner successfully operated his seed business. In 2002 he sold the business to his son for approximately $4.3 million. After his son encountered financial difficulties, petitioner returned to the seed business once again, turning it into a profitable business.

The cutting horse activity is altogether different from the seed business, but the potential consumer audience in the agricultural setting is substantially similar. Petitioner advertised both businesses to a joint audience at horse competitions. He was using the business acumen acquired from operating the seed business to grow his brand and cutting horse activity. Because petitioner was successful in the seed business, the Court finds this factor favors his having a profit objective.

[1326] *Robison v. Commissioner*, T.C. Memo. 2018-88, included the following reasoning:

Petitioners realized no profits whatsoever in 16 years of engaging in their ranching activity…. the years in issue are beyond the startup stage.

Further, despite reduced expenses and increased profits during the years in issue, petitioners produced no detailed or concrete plans as to how to further reduce their losses or as to when they expect to make a profit. The possibility of a speculative profit is insufficient to outweigh the absence of profits for a sustained period of years. *See Chandler v. Commissioner*, T.C.

circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.[1327]

(7) *The amount of occasional profits, if any, which are earned*. The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. Moreover an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.[1328]

(8) *The financial status of the taxpayer*. The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits)

Memo. 2010-92 (the possibility of a speculative profit did not outweigh more than 20 years of losses reported for the taxpayer's horse activity). This factor strongly favors respondent.

[1327] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Taras v. CIR*, 74 TCM (CCH) 1388, 1395 (1997) ("Throughout all the years of continuous losses, petitioners did not materially alter their mode of operation"); *Allen v. CIR*, 72 TC 28 (1979) (ski lodge's losses explained by market saturation, low snowfall, and gasoline shortages); Lee, *supra* note 8, at 420–428; infra ¶ 22.5.5 (presumption arising from two successful years). Taras has been affirmed by an unpublished opinion, 99-1 USTC ¶ 50,489 (3d Cir. 1999). But see *Rabinowitz v. CIR*, 90 TCM (CCH) 113, 121 (2005) (finding charter aircraft business was carried on for profit, notwithstanding 12 successive years of losses, because taxpayers "used their considerable business skills to attempt to make the business profitable" and losses for later periods resulted from unforeseen factors); *Burrus v. CIR*, 86 TCM (CCH) 429, 439 (2003) (finding "actual and honest intent to profit from" cattle raising, even though activity generated losses exceeding revenues for all of six years before court and four succeeding years; "such losses are consistent with a startup period inherent in herd building and therefore do not necessarily indicate a lack of profit motive").

The citation to Lee is to Lee, "A Blend of Old Wines in a New Wineskin: Section 183 and Beyond," 29 Tax L. Rev. 347 (1974).

[1328] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), cites Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347, 428-431 (1974).

may indicate that the activity is not engaged in for profit[1329] especially if there are personal or recreational elements involved.[1330]

(9) *Elements of personal pleasure or recreation*. The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.[1331]

Reg. § 1.183-2(c) provides:

> *Example (1)*. The taxpayer inherited a farm from her husband in an area which was becoming largely residential, and is now nearly all so. The farm had never made a profit before the taxpayer inherited it, and the farm has since had substantial losses in each

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[1329] *Robison v. Commissioner*, T.C. Memo. 2018-88, included the following reasoning:

> A taxpayer with substantial income unrelated to the activity can more readily afford a hobby . *See Wesley v. Commissioner*, T.C. Memo. 2007-78. Petitioners' substantial income from S. Robison's career has allowed them to continue their ranching activity in spite of 16 years of losses. Further, the activity has also generated tax savings in the form of net losses that offset that income, resulting in much smaller after-tax burden for the years in issue. This factor favors respondent.

[1330] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Hendricks v. CIR*, 32 F3d 94 (4th Cir. 1994) (physician's substantial income from medical practice was evidence that farm, which consistently operated at loss, was not for profit); *Jasionowski v. CIR*, 66 TC 312 (1976) (taxpayer's substantial income from other sources and other rental experience indicated that lease under which substantial losses, as distinguished from usual start-up losses, would be incurred for several years was not for profit); *Hurd v. CIR*, 37 TCM (CCH) 499 (1978) (substantial outside income enabled taxpayers to absorb large losses from ranch; held, not for profit); Lee, *supra* note 8, at 431–436. Compare *Ranciato v. CIR*, 52 F3d 23, 26 (2d Cir. 1995) (Tax Court's finding of lack of profit motive reversed because court failed to consider all relevant factors, including that taxpayer was "a solid middle-class wage earner, not an individual of wealth whose unprofitable extracurricular activities would suggest an effort to shelter unrelated income through deliberate losses").

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974). Being a trust fund baby is not helpful; see *Ford* in fn 1322.

[1331] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Allen v. CIR*, 72 TC 28 (1979) (taxpayers never used ski lodge for personal recreation); Lee, *supra* note 8, at 436–444. See *McCarthy v. CIR*, 79 TCM (CCH) 1912, 1916 (2000) ("motorcross racing activity was inherently recreational and was conducted as an activity to be shared by father and son").

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974). For an example of activity that elevated the taxpayer's social profile, see *Ford* in fn 1322.

year. The decedent from whom the taxpayer inherited the farm was a stockbroker, and he also left the taxpayer substantial stock holdings which yield large income from dividends. The taxpayer lives on an area of the farm which is set aside exclusively for living purposes. A farm manager is employed to operate the farm, but modern methods are not used in operating the farm. The taxpayer was born and raised on a farm, and expresses a strong preference for living on a farm. The taxpayer's activity of farming, based on all the facts and circumstances, could be found not to be engaged in for profit.

Example (2). The taxpayer is a wealthy individual who is greatly interested in philosophy. During the past 30 years he has written and published at his own expense several pamphlets, and he has engaged in extensive lecturing activity, advocating and disseminating his ideas. He has made a profit from these activities in only occasional years, and the profits in those years were small in relation to the amount of the losses in all other years. The taxpayer has very sizable income from securities (dividends and capital gains) which constitutes the principal source of his livelihood. The activity of lecturing, publishing pamphlets, and disseminating his ideas is not an activity engaged in by the taxpayer for profit.

Example (3). The taxpayer, very successful in the business of retailing soft drinks, raise dogs and horses. He began raising a particular breed of dog many years ago in the belief that the breed was in danger of declining, and he has raised and sold the dogs in each year since. The taxpayer recently began raising and racing thoroughbred horses. The losses from the taxpayer's dog and horse activities have increased in magnitude over the years, and he has not made a profit on these operations during any of the last 15 years. The taxpayer generally sells the dogs only to friends, does not advertise the dogs for sale, and shows the dogs only infrequently. The taxpayer races his horses only at the "prestige" tracks at which he combines his racing activities with social and recreational activities. The horse and dog operations are conducted at a large residential property on which the taxpayer also lives, which includes substantial living quarters and attractive recreational facilities for the taxpayer and his family. Since (i) the activity of raising dogs and horses and racing the horses is of a sporting and recreational nature, (ii) the taxpayer has substantial income from his business activities of retailing soft drinks, (iii) the horse and dog operations are not conducted in a businesslike manner, and (iv) such operations have a continuous record of losses, it could be determined that the horse and dog activities of the taxpayer are not engaged in for profit.

Example (4). The taxpayer inherited a farm of 65 acres from his parents when they died 6 years ago. The taxpayer moved to the farm from his house in a small nearby town, and he operates it in the same manner as his parents operated the farm before they died. The taxpayer is employed as a skilled machine operator in a nearby factory, for which he is paid approximately $8,500 per year. The farm has not been profitable for the past 15 years because of rising costs of operating farms in general, and because of the decline in the price of the produce of this farm in particular. The taxpayer consults the local agent of the State agricultural service from time-to-time, and the suggestions of the agent have generally been followed. The manner in which the farm is operated by the taxpayer is substantially similar to the manner in which farms of similar size, and which grow similar crops in the area are operated. Many of these other farms do not make profits. The taxpayer does much of the required labor around the farm himself, such as fixing fences, planting, crops, etc. The activity of farming could be found, based on all the facts and circumstances, to be engaged in by the taxpayer for profit.

> *Example (5)*. A, an independent oil and gas operator, frequently engages in the activity of searching for oil on undeveloped and unexplored land which is not near proven fields. He does so in a manner substantially similar to that of others who engage in the same activity. The changes, based on the experience of A and others who engaged in this activity, are strong that A will not find a commercially profitable oil deposit when he drills on land not established geologically to be proven oil bearing land. However, on the rare occasions that these activities do result in discovering a well, the operator generally realizes a very large return from such activity. Thus, there is a small chance that A will make a large profit from his oil exploration activity. Under these circumstances, A is engaged in the activity of oil drilling for profit.
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> *Example (6)*. C, a chemist, is employed by a large chemical company and is engaged in a wide variety of basic research projects for his employer. Although he does no work for his employer with respect to the development of new plastics, he has always been interested in such development and has outfitted a workshop in his home at his own expense which he uses to experiment in the field. He has patented several developments at his own expense but as yet has realized no income from his inventions or from such patents. C conducts his research on a regular, systematic basis, incurs fees to secure consultation on his projects from time to time, and makes extensive efforts to "market" his developments. C has devoted substantial time and expense in an effort to develop a plastic sufficiently hard, durable, and malleable that it could be used in lieu of sheet steel in many major applications, such as automobile bodies. Although there may be only a small chance that C will invent new plastics, the return from any such development would be so large that it induces C to incur the costs of his experimental work. C is sufficiently qualified by his background that there is some reasonable basis for his experimental activities. C's experimental work does not involve substantial personal or recreational aspects and is conducted in an effort to find practical applications for his work. Under these circumstances, C may be found to be engaged in the experimental activities for profit.

Den Besten v. Commissioner, T.C. Memo. 2019-154, summarized the profit motive inquiry (citations moved to footnote):[1332]

> Breeding, raising, training, and showing horses may be an activity entered into for profit pursuant to section 162. Such a determination will depend upon whether the taxpayer engaged in the activity with the primary purpose of making a profit. A reasonable expectation of profit is not required, but the facts and circumstances must indicate that the taxpayer entered into the activity or continued the activity with the actual and honest objective of making a profit. Evidence from years outside the years in issue can be relevant if it provides context to evaluate the taxpayer's overall requisite profit motive.

If a taxpayer conducts business through many entities and also conducts related business outside of those entities, the Court of Claims has held that the taxpayer may establish a "unified business enterprise" that supports finding that the outside related business has the requisite

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[1332] Citing *Engdahl v. Commissioner*, 72 T.C. 659, 665-666 (1979); *Dunn v. Commissioner*, 70 T.C. 715, 720 (1978), *aff'd*, 615 F.2d 578 (2d Cir. 1980); *Jasionowski v. Commissioner*, 66 T.C. 312, 319 (1976); Reg. § 1.183-2(a); *Dreicer v. Commissioner*, 78 T.C. 642, 645 (1982), *aff'd* without published opinion, 702 F.2d 1205 (D.C. Cir. 1983); *Feldman v. Commissioner*, T.C. Memo. 1986-287, 1986 Tax Ct. Memo LEXIS 321, at *16; *Donoghue v. Commissioner*, T.C. Memo. 2019-71, at *23; and *Smith v. Commissioner*, T.C. Memo. 1993-140 (considering profits and losses in subsequent years to have probative, although not determinative, significance).

profit motive.[1333] CCA 201747006, by Brad Poston, asserts that the Court of Claims' decision undermines the separateness of S corporations from their owners and should not be followed.[1334] I do not view that to be the case; I view the "unified business enterprise" theory as merely helping establish motive. However, expect the IRS to strongly challenge the "unified business enterprise," as it did successfully in a taxpayer's very weak case decided in 2016.[1335]

Code § 183(b) allows:

> (1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and
>
> (2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(References above and below to "this chapter" or "chapter 1" are to Code §§ 1-1400U-3.)

Reg. § 1.183-1(b)(1) elaborates on allowing deductions:

> *Manner and extent*. If an activity is not engaged in for profit, deductions are allowable under section 183(b) in the following order and only to the following extent:
>
> (i) Amounts allowable as deductions during the taxable year under chapter 1 of the Code without regard to whether the activity giving rise to such amounts was engaged in for profit are allowable to the full extent allowed by the relevant sections of the Code, determined after taking into account any limitations or exceptions with respect to the allowability of such amounts. For example, the allowability-of-interest expenses incurred with respect to activities not engaged in for profit is limited by the rules contained in section 163(d).
>
> (ii) Amounts otherwise allowable as deductions during the taxable year under chapter 1 of the Code, but only if such allowance does not result in an adjustment to the basis of property, determined as if the activity giving rise to such amounts was engaged in for profit, are allowed only to the extent the gross income attributable to such activity

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[1333] *Morton v. United States*, 98 Fed. Cl. 596 (2011). The court did not seem aware that regulations addressed how to find a profit motive under Code § 183.

[1334] The CCA opens with:

> In conference calls on 7/20/17 and 8/28/17, we discussed with your office the holding of *Peter Morton v. U.S.*, 98 Fed. Cl. 596 (2011), and its effect of excluding wholly-owned or majority owned S corporations from precedent set by *Moline Properties v. Commissioner*, 63 S.Ct. 1132 (1943). Based upon the authorities and analysis below, we conclude the Service should reject the *Morton* holding and continue to assert that *Moline Properties* is applicable to S corporations, regardless of degree of ownership.

Of course, both *Moline* and another case the CCA cited, *Deputy v. DuPont*, 308 U.S. 488 (1940), long predate the idea of an S election. However, the CCA is quite correct that one cannot simply disregard an S corporation; for example, see parts II.G.24 Taxing Entity or Individual Performing Services and II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker.

[1335] *Steinberger v. Commissioner*, T.C. Memo. 2016-104, rejecting a doctor's alleged business use of an airplane to travel in his business when his flying the airplane did not save the doctor any significant time over driving.

exceeds the deductions allowed or allowable under subdivision (i) of this subparagraph.

(iii) Amounts otherwise allowable as deductions for the taxable year under chapter 1 of the Code which result in (or if otherwise allowed would have resulted in) an adjustment to the basis of property, determined as if the activity giving rise to such deductions was engaged in for profit, are allowed only to the extent the gross income attributable to such activity exceeds the deductions allowed or allowable under subdivisions (i) and (ii) of this subparagraph. Deductions falling within this subdivision include such items as depreciation, partial losses with respect to property, partially worthless debts, amortization, and amortizable bond premium.

Special rules apply to basis adjustments for deductions allowed under Reg. § 1.183-1(b)(1)(iii).[1336]

Code § 183(b)(2) and Reg. § 1.183-1(b)(1)(ii) provide a benefit to individuals that is not available to C corporations – deducting expenses that would be business expenses if the activity had been engaged in for profit. On the other hand, all expenses under Code § 183(b)(1) and Reg. § 1.183-1(b)(1)(i) would have been allowable to a corporation anyway, and all expenses allowable to an individual under Code § 183(b) and Reg. § 1.183-1(b)(1) would be subject to the limitations described in part II.G.4.n Itemized Deductions, which might very well eliminate their benefit. Comparing the choice between C corporation and an individual (including through a partnership or S corporation):

- Both require the same profit motive to qualify under Code § 162 as a threshold inquiry.

- Code § 183 provides an additional chance for an individual to prove profit motive, which opportunity is not available to a C corporation. Whether this additional opportunity makes a difference depends on the facts and circumstances.

- Would being an entity make a difference? When testing business purpose, one would test the entity's intent[1337] rather than the individual's. When looking at an individual's business purpose, one would compare that activity to the individual's other activities. An individual

[1336] Reg. § 1.183-1(b)(2), "Rule for deductions involving basis adjustments," provides:
(i) *In general*. If deductions are allowed under subparagraph (1)(iii) of this paragraph, and such deductions are allowed with respect to more than one asset, the deduction allowed with respect to each asset shall be determined separately in accordance with the computation set forth in subdivision (ii) of this subparagraph.
(ii) *Basis adjustment fraction*. The deduction allowed under subparagraph (1)(iii) of this paragraph is computed by multiplying the amount which would have been allowed, had the activity been engaged in for profit, as a deduction with respect to each particular asset which involves a basis adjustment, by the basis adjustment fraction—
(a) The numerator of which is the total of deductions allowable under subparagraph (1)(iii) of this paragraph, and
(b) The denominator of which is the total of deductions which involve basis adjustments which would have been allowed with respect to the activity had the activity been engaged in for profit. The amount resulting from this computation is the deduction allowed under subparagraph (1)(iii) of this paragraph with respect to the particular asset. The basis of such asset is adjusted only to the extent of such deduction.

[1337] For testing a partnership's intent, see fn. 1306 in part II.G.4.l.i.(a) "Trade or Business" Under Code § 162; note that adding a service partner might complicate funding any losses. For testing an S corporation's intent, see fn. 1340; I have not looked to see the rule for Code § 162 absent Code § 183.

who is establishing a side business may consider interposing an entity that is not disregarded between the business and the individual, so that profit motive can be tested solely by reference to the entity's activities. My sense is that C corporations are tested for profit motive only when using a side deal to shelter income from their core activity and that they are not scrutinized for profit motive for their core activity; however, Code § 162 does not draw such a distinction, so one cannot rely on that distinction as a matter of law.

- If a profit motive cannot be established:
  - Code § 183(b)(1) and Reg. § 1.183-1(b)(1)(i) allows individuals to deduct whatever they could have deducted absent a profit motive, and C corporations have the same benefit. However, limitations on using itemized deductions may prevent these deduction from generating a tax benefit, whereas a C corporation does not have the same limits.
  - Code § 183(b)(2) and Reg. § 1.183-1(b)(1)(ii) provide a benefit to individuals that is not available to C corporations – deducting expenses that would be business expenses if the activity had been engaged in for profit. However, limitations on using itemized deductions may prevent these deduction from generating a tax benefit.

In applying Code § 183, gross income derived from an activity not engaged in for profit includes the total of all gains from the sale, exchange, or other disposition of property, and all other gross receipts derived from such activity.[1338]

[1338] Reg. § 1.183-1(e), which further provides:

> Such gross income shall include, for instance, capital gains, and rents received for the use of property which is held in connection with the activity. The taxpayer may determine gross income from any activity by subtracting the cost of goods sold from the gross receipts so long as he consistently does so and follows generally accepted methods of accounting in determining such gross income.

In the case of a partnership, Code § 183(b) is applied at the partnership level and can be a helpful relief valve.[1339] Also, Code § 183 is applied at the corporate level in determining the allowable deductions of an S corporation.[1340]

II.G.4.l.i.(d). Whether Managing Investments Constitutes a Trade or Business

This part II.G.4.l.i.(d) reviews whether managing one's own investments and whether managing others' investments constitutes a trade or business, expenses of which are deductible under Code § 162. However, C corporations do not appear to be subjected to these standards,[1341] so this discussion appears to apply only to other taxpayers.

"No matter how large the estate or how continuous or extended the work required may be," managing one's own portfolio of marketable securities does not constitute a trade or business. *Higgins v. Commissioner*, 312 U.S. 212 (1941).[1342]

Congress enacted Code § 212 to provide relief for taxpayers caught by *Higgins*.[1343] In denying the taxpayer a business bad debt for loans to corporations in which the taxpayer worked full-time, *Whipple v. Commissioner*, 373 U.S. 193 (1963), stated:

> Devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the

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[1339] *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision), held:

> Since the partnership is not entitled to any deductions under section 162, the activity of the partnership constitutes one "not engaged in for profit" as defined in section 183(c). We therefore turn to section 183 to determine the amount, if any, of deductions which are otherwise allowable under section 183(b). We are again faced with the question of whether the allowance provision, section 183(b), is to be applied at the partnership or partner level. For the many reasons stated above, we conclude that section 183(b) should be applied at the partnership level. See sec. 703(a); sec. 1.703-1(a), Income Tax Regs.; *Hager v. Commissioner*, *supra* at 788. Accordingly, as the partnership did not report any deductions in 1975 which are otherwise allowed without regard to whether the activity is engaged in for profit, the partnership is entitled to the deductions claimed, without inclusion in basis of the nonrecourse note in the amount of $1,400,000, but only to the extent of the gross income derived from the activity in 1975 in the amount of $679. Sec. 183(b)(2). The result of applying section 183(b)(2) is that the partnership in 1975 had income of zero; that is, it had no profit and it had no loss. Therefore, petitioner had no distributive share of income or loss from Britton Properties.[17]
>
> [17] Since petitioner's pro rata share of the partnership's income of $679 was included by respondent in his 1975 income, the result of our holding is that respondent erred in increasing petitioner's income, as reported, by $34 of partnership income but did not err in disallowing petitioner's claimed partnership loss of $15,751.

[1340] Reg. § 1.183-1(f).

[1341] See text accompanying fn 1307 in part II.G.4.l.i.(a) "Trade or Business" Under Code § 162.

[1342] See part II.G.4.l.i.(a) "Trade or Business" Under Code § 162, in which fn 1298 discusses the case's weight and continued validity.

[1343] *Whipple v. Commissioner*, 373 U.S. 193 (1963), stated:

> In response to the *Higgins* case and to give relief to *Higgins*-type taxpayers, see H.R. Rep. No. 2333, 77th Cong., 2d Sess. 46, § 23(a) was amended not by disturbing the Court's definition of "trade or business" but by following the pattern that had been established since 1916 of "[enlarging] the categories of incomes with reference to which expenses were deductible," *McDonald v. Commissioner*, 323 U.S. 57, 62; *United States v. Gilmore*, 372 U.S. 39, 45, to include expenses incurred in the production of income.

successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation. Even if the taxpayer demonstrates an independent trade or business of his own, care must be taken to distinguish bad debts losses arising from his own business and those actually arising from activities peculiar to an investor concerned with, and participating in, the conduct of the corporate business.

Managing investments for one's self, wife, and three children without compensation did not constitute a trade or business in *Beals v. Commissioner*, T.C. Memo. 1987-171. Although *Beals* acknowledged that being a day-trader may be a trade or business,[1344] the taxpayer's full-time efforts towards managing investments did not constitute day trading and therefore did not constitute a trade or business.[1345]

Whether trading commodities was a trade or business has been the subject of attempts to tax nonresident aliens, who were taxed when the trading rose to the level of a trade or business[1346]

[1344] The court noted:

> On the other hand, the Court has recognized that a full-time trader of securities may be in a trade or business. *Snyder v. Commissioner*, 295 U.S. 134, 139 (1935).
>
> In *Liang v. Commissioner*, 23 T.C. 1040 (1955), we had to distinguish between an investor and a trader; we observed:
>
> > The distinction between an investment account and a trading account is that in the former, securities are purchased to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of the securities on the daily market. In a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis. [23 T.C. at 1043.]
>
> The taxpayer's agent "never acquired any hedges; never made short sales; and never purchased any 'puts' or 'calls'." 23 T.C. at 1044. We held that the primary objective of the activity in question "was that of an investment account established to provide a reliable source of income." 23 T.C. at 1045.
>
> More recently, in *Purvis v. Commissioner*, 530 F.2d 1332 (9th Cir. 1976), *affg.* a Memorandum Opinion of this Court, the Court of Appeals for the Ninth Circuit applied the test of *Liang v. Commissioner*, *supra*, and concluded that the taxpayer was investing, not trading. The court noted:
>
> > From 1963 to 1968 petitioner engaged in only 75 sales of securities and ten short-term commodities sales. Of these, 31 involved stock which had been held for more than six months. A substantial number involved shares which petitioner admits were held as investments, or which were held for periods exceeding three years, indicating that they were investments. [530 F.2d at 1334.]

[1345] The court held:

> In the case before us, the petitioner makes no claim that he was a trader, and the evidence does not reveal any pattern of trading: his investments changed very little from year to year, and he reported only small capital transactions each year. To support his position, he relies on his investment activities. It appears that the petitioner was not a mere passive investor; he actively investigated and followed the investments made by him and his family. Nevertheless, it is well settled that the management of investments, despite the extent and scope of such activities, is not a trade or business for tax purposes. *Whipple v. Commissioner*, *supra*; *Higgins v. Commissioner*, *supra*. Consequently, we hold that the petitioner was not engaged in a trade or business during the years at issue.

[1346] *Adda v. Commissioner*, 10 T.C. 273, 277 (1948), the Official Tax Court Syllabus to which said:

and were not taxed when it didn't. *Liang v. Commissioner*, 23 T.C. 1040 (1955), stated in its Official Tax Court Syllabus:

> Petitioner, a nonresident alien whose securities were managed primarily for investment purposes by a resident commission agent, held, on facts, not subject to tax on capital gains as not being engaged in a trade or business within the United States under section 211(b), Internal Revenue Code of 1939.

The court began its description of the case:

> Petitioner, a nonresident alien, was not present in this country in 1946 nor, apparently, at any other time after he entered into the agency agreement in 1932. He left the management of his considerable account entirely to the discretion of his agent. The latter invested petitioner's funds in stocks and securities. He never acquired any hedges; never made short sales; and never purchased "puts" or "calls." His commission in excess of a fixed salary was based on total earnings of the account, regardless of source.
>
> Purchase and sale activity in the account during 1946, the year in controversy, and during 1940, which far exceeded such activity in other years, is adequately explained by transitional changes in the industries represented by the securities immediately before and after American participation in World War II, when increased trading activity was not unusual in the routine conservation and management of investment portfolios. And, in spite of increased activity, even during the year in controversy the average holding period of the securities sold was 5.8 years. More than 90 per cent of the gross gain was derived from the sale of securities held for more than 2 years; and more than 40 per cent of the gross gain was realized from the sale of securities held for more than 5 years. The absence of frequent short-term turnover in petitioner's portfolio negatives the conclusion that these securities were sold as part of a trading operation rather than as investment activity.

In finding for the taxpayer that the taxpayer had not engaged in a trade or business, the court reasoned:

> Petitioner, a nonresident alien, empowered his brother, who resided in the United States, to deal in commodity futures at his own discretion through resident brokers in the United States for petitioner's account. Petitioner's brother exercised this authority in 1940 and 1941, trading in substantial amounts. *Held*, petitioner was engaged in trade or business in the United States and is taxable as a nonresident alien so engaged; *held*, further, that the petitioner is entitled to a net short term capital loss carry-over from 1940 to 1941.

The court reasoned:

> Trading in commodities for one's own account for profit may be a "trade or business" if sufficiently extensive. *Fuld v. Commissioner*, 139 Fed.(2d) 465; *Norbert H. Wiesler*, 6 T.C. 1148; *affirmed* without discussion of this point, 161 Fed.(2d) 997. The respondent determined that the petitioner was engaged in trade or business in the United States. While the number of transactions or the total amount of money involved in them has not been stated, it is apparent that many transactions were effected through different brokers, several accounts were maintained, and gains and losses in substantial amounts were realized. This evidence shows that the trading was extensive enough to amount to a trade or business, and the petitioner does not contend, nor has he shown, that the transactions were so infrequent or inconsequential as not to amount to a trade or business.

> Whether activities undertaken in connection with investments are sufficiently extensive to constitute a trade or business is a question to be decided on the particular facts. *Higgins v. Commissioner*, 312 U.S. 212. In *Fernand C. A. Adda*, 10 T.C. 273, *affirmed* per curiam (C.A. 4) 171 F.2d 457, certiorari denied 336 U.S. 952, extensive transactions in commodities which do not pay dividends and could have resulted in profit only by means of the gains on the purchases and sales were found to constitute a trade or business. For similar reasons *Commissioner v. Nubar*, (C.A. 4) 185 F.2d 584, reversing 13 T.C. 566, certiorari denied 341 U.S. 925, held that transactions in commodities and securities where the taxpayer was himself present in the United States throughout the period were sufficient to constitute the conduct of a trade or business.

The present situation is quite different. Petitioner never having been present in the United States, it is only through the activity of his agent that he could be held to have conducted a business. For the solution of this problem we look not solely to the year in controversy but to the entire agency and particularly to the 7 years shown by the record. These figures appearing in our findings satisfy us that the primary, if not the sole objective, was that of an investment account established to provide a reliable source of income. In fact in 4 of the 7 years the capital transactions resulted in losses rather than gains and only in the year for which respondent has determined the deficiency were the gains of any considerable consequence.

Day-trading on margin, with annual transaction volume of more than half of the taxpayer's net worth,[1347] was held to be a trade or business for purposes of the Code § 166 bad debt rules.[1348]

[1347] *Levin v. U.S.*, 597 F.2d 760 (Ct. Cl. 1979), found that the taxpayer:

> … devoted virtually all his working time to the purchase and sale of securities. His initial investments made during and immediately following World War II brought him substantial profits. Although he frequently purchased heavily in the stock of one company or another, he was generally active in purchases and sales of stocks of various corporations. For instance, in 1961, the year of the indebtedness note in question, he conducted 332 transactions which represented the transfer of 112,400 shares with a total value of $3,452,125.
>
> Routinely taxpayer visited the corporations in which he was interested and talked to company officers, traveling out of town for these visits when necessary. His days were frequently spent in the brokerage houses on Wall Street; he ate lunch with brokers at the Stock Exchange Club; and he attended lectures sponsored by securities analysts when the topics were of interest. He maintained ledger sheets of all his stock transactions, attended stockholders' meetings, and generally spent his time purchasing and selling securities on his own account.
>
> It was taxpayer's practice to purchase to the extent of allowable margin. He traded with four to six brokerage houses in order to disperse his large number of shares in any one corporation, as many brokers prohibited concentrated holdings in their margin accounts. In addition, this practice avoided pressure to liquidate his entire investment in a particular company to meet a single broker's margin call. Prior to the market decline in late 969 and early 1970, taxpayer was exceedingly successful in his stock transactions. In 1968, for instance, he held stock valued at nearly $8 million with a margin debt of approximately $3 million, leaving him a net worth of about $5 million. His only other source of income was $5,000 in salary for sitting on the board of directors of a small oil-producing company.

[1348] The court held:

> Although the Supreme Court has yet to find a taxpayer properly characterized as a securities "trader," it is clear such a section 166 "businessman" exists, given the proper facts. *Higgins v. Commissioner*, 312 U.S. 212 (1941); *Snyder v. Commissioner*, 295 U.S. 134 (1935); *Commissioner v. Nubar*, 185 F.2d 584 (4th Cir. 1950). By contrast the activity of a mere "invest[or] is not a trade or business." *Whipple v. Commissioner*, 373 U.S. 193, 202 (1963). Neither the code, the regulations, nor the courts have yet provided a precise definition as to when an individual taxpayer's behavior is that of a trader rather than an investor in corporate stocks.

Averaging 15 trades per year, of which a substantial portion were long-term investments, was not a trade or business.[1349] A "taxpayer may be a dealer as to some securities and at the same time hold other securities as a trader or investor on his own account and not for resale to customers."[1350]

Moller v. U.S., 721 F.2d 810 (Fed. Cir 1983), explained:[1351]

> According to *Higgins*, a factual analysis in each case is required to determine if a particular taxpayer's securities activities rise to the level of "carrying on a business." 312 U.S. at 217. It has been ruled, however, that:
>
> > … [A] taxpayer who, for the purpose of making a livelihood, devotes the major portion of his time to speculating on the stock exchange may treat losses thus incurred as having been sustained in the course of a trade or business.… [*Snyder*, 295 U.S. at 139.]
>
> Establishing continuity of investment activity is not enough. The taxpayer must do more than "merely [keep] records and [collect] interest and dividends from his securities, through managerial attention for his investments." *Higgins*, 312 U.S. at 218; *Wilson v. United States*, 179 Ct.Cl. 725, 746, 376 F.2d 280, 293 (1967). In effect, a "trader" is an active investor in that he does not passively accumulate earnings, nor merely oversee his accounts, but manipulates his holdings in an attempt to produce the best possible yield. That is, the trader's profits are derived through the very acts of trading—direct management of purchasing and selling. *Purvis v. Commissioner*, 530 F.2d 1332 (9th Cir. 1976); *Chiang Hsiao Liang*, 23 T.C. 1040 (1955).
>
> Even absent a clear judicial demarcation between trader and investor, it is apparent that plaintiff taxpayer's securities activities place him close to the trader end of the spectrum. Aside from a small annual salary for sitting on the board of an oil-producing company, his entire and substantial income was derived from his trading. He devoted virtually his whole working day to his stock transactions, unlike the taxpayers in *Snyder* and *Wilson*. In contrast to the distant management of a portfolio portrayed in Higgins, judgments regarding purchases and sales were made directly by taxpayer, based on his personal investigation of the assets, operation and management of various corporations. In addition, the sheer quantity of transactions he conducted also supports a reasonable conclusion that this taxpayer's business was trading on his own account.
>
> Defendant urges a narrowing of this issue to consideration of whether taxpayer's activities in regard to the particular stock he held in Central Railroad alone amounted to a "trade or business." While the courts do acknowledge that a trader (and even a "dealer") may hold simultaneously certain shares for investment purposes and others to trade, *e.g.*, *Bradford v. United States*, 195 Ct.Cl. 500, 444 F.2d 1133 (1971), the question here is whether taxpayer was generally "carrying on the business" of trading for his own account. It is concluded that he was.

[1349] *Purvis v. Commissioner*, 530 F.2d 1332 (9th Cir. 1976), noted:

> From 1963 to 1968 petitioner engaged in only 75 sales of securities and ten short-term commodities sales. Of these, 31 involved stock which had been held for more than six months. A substantial number involved shares which petitioner admits were held as investments, or which were held for periods exceeding three years, indicating that they were investments.

[1350] *Bradford v. U.S.*, 444 F.2d 1133 (Ct. Cl. 1971).

[1351] The court analyzed the taxpayers' activity:

> The Claims Court concluded that taxpayers were investors and not traders because they were primarily interested in the long-term growth potential of their stocks. We agree. Mr. Moller testified that he was looking for long-term growth and the payment of dividends. In addition, the taxpayers did not derive their income from the relatively short-term turnover of stocks, nor did they derive any significant profits through the act of trading. Interest and dividend income was over 98% of taxpayers' gross income for 1976 and 1977, and in 1976 their profit from the sale of securities was only $612, while in 1977 their sales resulted in a loss of $233.
>
> The number of sales transactions made by the taxpayers also leads to the conclusion that they were not traders in securities. In the cases in which taxpayers have been held to be in the

> … in order to be a trader, a taxpayer's activities must be directed to short-term trading, not the long-term holding of investments, and income must be principally derived from the sale of securities rather than from dividends and interest paid on those securities. In determining whether a taxpayer who manages his own investments is a trader, and thus engaged in a trade or business, relevant considerations are the taxpayer's investment intent, the nature of the income to be derived from the activity, and the frequency, extent, and regularity of the taxpayer's securities transactions. See *Purvis*, 530 F.2d at 1334.

King v. Commissioner, 89 T.C. 445, 458-459 (1987), explained the differences between traders, dealers, and investors:

> … a primary distinction for Federal tax purposes between a trader and a dealer in securities or commodities is that a dealer does not hold securities or commodities as capital assets if held in connection with his trade or business, where as a trader holds securities or commodities as capital assets whether or not such assets are held in connection with his trade or business.[5] A dealer falls within an exception to capital asset treatment because he deals in property held primarily for sale to customers in the ordinary course of his trade or business. A trader, on the other hand, does not have customers and is therefore not considered to fall within an exception to capital asset treatment.
>
> [5] The same capital treatment to which traders in securities are subject has also been held applicable to traders of commodity futures. *Commissioner v. Covington*, 120 F.2d 768 (5th Cir. 1941), *affg.* on this issue 42 B.T.A. 601 (1940); *Vickers v. Commissioner*, 80 T.C. 394, 405 (1983).
>
> The distinction between a "trader" and an "investor" also turns on the nature of the activity in which the taxpayer is involved. A trader seeks profit from short-term market swings and receives income principally from selling on an exchange rather than from dividends, interest, or long-term appreciation. *Groetzinger v. Commissioner*, 771 F.2d 269, 274-275 (7th Cir. 1985), *affd.* 480 U.S. __ (1987); *Moller v. United States*, 721 F.2d 810, 813 (Fed. Cir. 1983). Further, a trader will be deemed to be engaged in a trade or business if his trading is frequent and substantial. *Groetzinger v. Commissioner*, *supra* at 275; *Fuld v. Commissioner*, 139 F.2d 465 (2d Cir. 1943), *affg.* 44 B.T.A. 1268 (1941). An investor, on the other hand, makes purchases for capital appreciation and income, usually without regard to short-term developments that would influence prices on the daily market. *Groetzinger v. Commissioner*, 82 T.C. 793, 801 (1984), *affd.* 771 F.2d 269 (7th Cir. 1985), *affd.* 480 U.S. __ (1987); *Liang v. Commissioner*, 23 T.C. 1040, 1043 (1955). No matter how extensive his activities might be, an investor is never considered to be engaged in a trade or business with respect to his investment activities. *Higgins v. Commissioner*, 312 U.S. 212, 216, 218 (1941); *Groetzinger v. Commissioner*, 771 F.2d at 275.

> business of trading in securities for their own account, the number of their transactions indicated that they were engaged in market transactions on an almost daily basis. See *Levin*, 597 F.2d at 765; *Fuld v. Commissioner*, 139 F.2d 465 (2d Cir. 1943). At most, the Mollers engaged in 83 security purchase transactions and 41 sales transactions in 1976 and 76 purchase and 30 sales transactions in 1977. [footnote omitted]
>
> Moreover, taxpayers did not "endeavor to catch the swings in the daily market movements and profit thereby on a short term basis." *Purvis*, 530 F.2d at 1334. The stocks owned by taxpayers, which they sold during 1976 and 1977, had been held for an average of over 3-1/2 and 8 years, respectively.
>
> The Mollers were investors and not traders.

The issue in *King* was whether interest expense relating to the taxpayer's trading was subject to the investment interest limitations of Code § 163(d) or was business interest. The court reasoned (at 459-460) [footnotes referred to below are in fn [1352]]:

> Petitioner clearly was in the trade or business of trading commodity futures during the years in issue.[6] Petitioner's trading was frequent and substantial but he traded solely for his own account during the years in issue and neither had customers nor performed services analogous to those performed by a merchant.[7] The parties appear to agree that petitioner was in the trade or business of trading commodities futures.[8]
>
> Based on the foregoing, we determined in our earlier opinion that certain short-term capital losses claimed by petitioner were allowable. Such losses were incurred by a commodities dealer within the meaning of sec. 108(f) (see note 6 supra), in the trading of commodities and were therefore to be treated as incurred in a trade or business for purposes of sec. 108(a). The character of such losses as capital losses, however, is not affected by their treatment as losses incurred in a trade or business for purposes of sec. 108.

[1352] Here are the footnotes that accompanied the text above:

[6] We note that in our earlier opinion, relating to petitioner's motion for partial summary judgment, we stated that the parties were in agreement that "petitioner was a dealer in commodities within the meaning of Section 108(f)" of the Tax Reform Act of 1984 (Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630), as amended by sec. 1808(d) of the Tax Reform Act of 1986. Section 108(f), as amended, provides in relevant part "For purposes of this section, the term 'commodities dealer' means any taxpayer who - (1) at any time before January 1, 1982, was an individual described in section 1402(i)(2)(B)." Sec. 1402(i)(2)(B) defines, for purposes of sec. 1402(i) a commodities dealer as "a person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission." A sec. 1256 contract is defined as including "any regulated futures contract." Sec. 1256(b)(1).

Petitioner was a registered member of the CME, a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, and was actively engaged in trading regulated futures contracts. Therefore, pursuant to sec. 108(f), petitioner was a commodities dealer for purposes of sec. 108 of the Tax Reform Act of 1984, as amended by sec. 1808(d) of the Tax Reform Act of 1986. This status as a commodities dealer, however, applies solely for purposes of section 108 and does not, for any other purpose, affect petitioner's status as a trader who is not a dealer. See H. Rept. 99-426, at 911 (1985).

[7] Until 1968, petitioner acted as a broker as well as trading for his own account. At that time, petitioner may have been a dealer with respect to futures contracts, but this is not relevant to the years in issue.

[8] We also note that sec. 108(a) and (b) of the Tax Reform Act of 1984, 98 Stat. 630, as amended by sec. 1808(d) of the Tax Reform Act of 1986, 100 Stat. 2817-2818, provides,

> SEC. 108(a). *General Rule*. For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions—
>
> (1) which are entered into before 1982 and form part of a straddle, and
>
> (2) to which the amendments made by title V of such Act do not apply, any loss from such disposition shall be allowed for the taxable year of the disposition if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business.
>
> (b) *Loss Incurred in a Trade or Business*. For purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business.

King also held that the purchase of gold was part of his trade or business of trading commodities futures, rejecting the IRS' contention that *Higgins* (fns 1342-1343) applied to segregate the purchase of gold from other activity.[1353]

After reviewing precedent,[1354] *Holsinger v. Commissioner*, T.C. Memo. 2008-191, reasoned and held:

> Petitioners argue that they were traders, trading as agents of Alpha. With the incorporation of Alpha, petitioners argue they became traders. In determining whether a taxpayer's trading activity constituted a trade or business, courts have distinguished between "traders" and "investors". *Moller v. United States*, 721 F.2d 810, 813 (Fed. Cir. 1983); see also *Levin v. United States*, 220 Ct. Cl. 197, 597 F.2d 760, 765 (1979).
>
> In determining whether a taxpayer is a trader, nonexclusive factors to consider are: (1) The taxpayer's intent, (2) the nature of the income to be derived from the activity, and (3) the frequency, extent, and regularity of the taxpayer's securities transactions. *Moller v. United States*, *supra* at 813. For a taxpayer to be a trader the trading activity must be substantial, which means "frequent, regular, and continuous enough to constitute a trade or business" as opposed to sporadic trading. *Ball v. Commissioner*, T.C. Memo. 2000-245 (quoting *Hart v. Commissioner*, T.C. Memo. 1997-11). A taxpayer's activities constitute a trade or business where both of the following requirements are met: (1) The taxpayer's trading is substantial, and (2) the taxpayer seeks to catch the swings in the

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[1353] 89 T.C. at 464-465:

> As we have stated, petitioner herein was clearly in the trade or business of trading commodities futures. Petitioner acquired the gold in issue pursuant to delivery on long gold futures contracts which he acquired in the regular course of his business. Petitioner also disposed of the gold pursuant to short gold futures contracts. While petitioner had not regularly held physical commodities for extended periods of time, petitioner did periodically, in the course of his business, take delivery of physical commodities. Further, petitioner took no affirmative action to set apart or distinguish this transaction from other transactions which were entered into in the normal course of his business. These factors strongly suggest that petitioner's gold transaction was part of his trade or business of trading commodity futures.
>
> This case is not factually similar to *Higgins* in that the transaction here in issue was integrally related to transactions which were indisputably part of petitioner's trade or business, *i.e.*, the closing of the futures contracts by which the gold was acquired and disposed. In *Higgins*, the only relationship between the taxpayer's investment activities and real estate activities was that they were directed through the same office. *Higgins* does not lead us to the conclusion that the transaction here in issue should be separated out from petitioner's trade or business.
>
> We are not aware of any case which has held that a taxpayer may hold property both as a trader of commodity futures and as an investor in commodities. Past cases have held that a taxpayer may be both a trader and a dealer with respect to securities, but these cases have not dealt with the issue of whether the taxpayer therein was a trader or investor. *Kemon v. Commissioner*, *supra* at 1033; *Carl Marks & Co. v. Commissioner*, 12 T.C. 1196 (1949).

[1354] Before addressing that the taxpayers bore the burden of proof, the court stated:

> The Internal Revenue Code does not define the term "trade or business" for purposes of section 162. *Commissioner v. Groetzinger*, 480 U.S. 23, 27 (1987); *Estate of Yaeger v. Commissioner*, 889 F.2d 29, 33 (2d Cir. 1989), affg. T.C. Memo. 1988-264. Whether activities constitute a trade or business is a question of fact. See *Higgins v. Commissioner*, 312 U.S. 212, 217 (1941); *Estate of Yaeger v. Commissioner*, *supra* at 33; *Mayer v. Commissioner*, T.C. Memo. 1994-209; *Paoli v. Commissioner*, T.C. Memo. 1991-351.

daily market movements and to profit from these short-term changes rather than to profit from the long-term holding of investments. *Mayer v. Commissioner*, *supra*.

As to the first requirement, we find petitioners' trading was not substantial. Courts consider the number of executed trades in a year and the amount of money involved in those trades when evaluating whether a taxpayer's trading activities were substantial. See, *e.g.*, *Mayer v. Commissioner*, *supra*; *Paoli v. Commissioner*, *supra*. In Paoli, the Court held trading activities were substantial when the taxpayers traded stocks or options worth approximately $9 million. In *Mayer*, the Court considered over 1,100 executed sales and purchases in each of the years at issue therein to be substantial trading activity. Trading activity was found to be insubstantial when a taxpayer executed at most 83 purchases and 41 sales in one year and 76 purchases and 30 sales in the second year. *Moller v. United States*, *supra* at 813. In 2001 petitioners executed approximately 289 trades. An analysis of petitioners' trading activity reveals that in 2001 they traded on 63 days. This total represents less than 40 percent of the trading days from April 19, 2001, the day petitioners incorporated Alpha, until December 31, 2001. In 2002 petitioners traded on 110 days and executed approximately 372 trades. This total represents less than 45 percent of the trading days in 2002. We find it doubtful whether the trades were conducted with the frequency, continuity, and regularity indicative of a business.

As to the second requirement, petitioners have failed to prove that they sought to catch the swings in the daily market movements and to profit from these short-term changes rather than to profit from the long-term holding of investments. Petitioner testified that his goal in forming Alpha was to profit from short-term swings in the market. Additionally, petitioner testified that he usually closed his account at the end of the day and tried to avoid holding stocks and options overnight. The documentary evidence, however, paints a different picture. A list of petitioners' trades shows they rarely bought and sold on the same day. Furthermore, a significant amount of petitioners' holdings was held for more than 31 days. As a result, we find that petitioners have not demonstrated that they sought to capture the daily swings in the market. We find that they were not traders, but investors. Petitioners' trading pattern is consistent with that of an investor, not of a trader.

A bad debt case, *Dagres v. Commissioner*, 136 T.C. 263, 281 (2011),[1355] noted that:[1356]

Selling one's investment expertise to others is as much a business as selling one's legal expertise or medical expertise.

[1355] For more details about the case, see fn 1175 in part II.G.4.a.iii Character of Bad Debt.

[1356] This quote followed a discussion contrasting the case from *Whipple* (see fn 1343 and accompanying text):

However, an activity that would otherwise be a business does not necessarily lose that status because it includes an investment function. Rather, the activity of "promoting, organizing, financing, and/or dealing in corporations

… for a fee or commission or with the immediate purpose of selling the corporations at a profit in the ordinary course of that business" is a business, *Deely v. Commissioner*, 73 T.C. 1081, 1093 (1980) (citing *Whipple v. Commissioner*, 373 U.S. at 202-203), supplemented by T.C. Memo. 1981-229 [¶81,229 PH Memo TC], as is "developing …

> In cases where business promotion activities are found to rise to the level of a trade or business, a common factor for distinguishing mere investment from conduct of a trade or business has been compensation other than the normal investor's return: "income received directly for his own services rather than indirectly through the corporate enterprise". *Id.* That is, if the taxpayer receives not just a return on his own investment but compensation attributable to his services, then that fact tends to show that he is in a trade or business. Although fee, commission, or other non-investor compensation is a common element, it is not a necessary element, provided the facts support the conclusion that the taxpayer is more than a passive investor. *Farrar v. Commissioner*, T.C. Memo. 1988-385; see also *Deely v. Commissioner*, 73 T.C. at 1093. Notably, in such business promotion cases, the trade-or-business characterization applies even though the taxpayer invests his own funds in, lends funds to, or guarantees the debts of the businesses he promotes. See *Farrar v. Commissioner*, *supra*.

Lender Management, LLC v. Commissioner, T.C. Memo. 2017-246, held that Lender Management, LLC ("Lender Management") carried on a trade or business under Code § 162. Tax years 2010-2012 were at issue. Lender Management reported net losses of $462,505 and $307,760 for tax years 2010 and 2011 and net income of $376,238 and $808,302 for tax years 2012 and 2013, respectively.

The court described certain relationships:

> During the tax years in issue Lender Management provided direct management services to three limited liability companies: Murray & Marvin Lender Investments, LLC (M&M), Lenco Investments, LLC (Lenco), and Lotis Equity, LLC (Lotis) (collectively, investment LLCs). Each of the investment LLCs elected to be treated as a partnership for Federal income tax purposes. Lender Management directed the investment and management of assets held by the investment LLCs for the benefit of their owners. The end-level owners with respect to M&M, Lenco, and Lotis were, in each case, all children, grandchildren, or great-grandchildren of Harry.

The court described certain arrangements:

> 1. ***Structure and Purpose***
>
> The investment LLCs were created in 2005 as part of a reorganization of Lender Management. The goals of the 2005 reorganization were to accommodate greater diversification of the managed investments and more flexible asset allocation at the individual investor level. As part of the restructuring Lender Management shifted from a cost-based office model to a profit-based model.
>
> Lender Management engaged a hedge fund specialist to help it restructure its affairs and its managed portfolio using a hedge fund, or "fund of funds", manager model. Pursuant to the restructuring strategy, Lender Management divided its managed portfolio into the three investment LLCs, each formed for the purpose of holding investments in a different

corporations as going businesses for sale to customers", *Whipple v. Commissioner*, 373 U.S. at 203. Bankers, investment bankers, financial planners, and stockbrokers all earn fees and commissions for work that includes investing or facilitating the investing of their clients' funds.[22]

[22] *Cf. InverWorld, Inc. v. Commissioner*, T.C. Memo. 1996-301 (holding that the taxpayer was in a trade or business pursuant to section 864(b); distinguishing "cases [that] did not address taxpayers who managed the investments of others").

class of assets. M&M invested in private equities, Lenco in hedge funds, and Lotis in public equities.[4] From 2005 forward, over one-half of the assets under management were invested in private equity.

[4] Lotis merged into Lenco in 2010 because Lender Management determined that Lenco's hedge fund investments held enough public equities to meet the company's asset diversification goals.

2. ***Operating Agreements***

Lender Management's operating agreement permitted it, without limitation, to engage in the business of managing the "Lender Family Office" and to provide management services to Lender family members, related entities, and "other third-party nonfamily members." The operating agreements for the investment LLCs designated Lender Management as the sole manager for each entity. Lender Management held the exclusive rights to direct the business and affairs of the investment LLCs.

Lender Management also managed downstream entities in which M&M held a controlling interest. Investors in some of these downstream entities included persons who were not members of the Lender family. It received fees for managing these entities. For the tax years in issue between 12% and 15% of M&M's net investment portfolio consisted of these downstream entities.

Members understood that they could withdraw their investments in the investment LLCs at any time, subject to liquidity constraints, if they became dissatisfied with how the investments were being managed. The operating agreements for Lenco and Lotis provided that members could withdraw all or a portion of their capital accounts on specified dates of each year or on any other date approved by the manager. The operating agreement for M&M provided that members could withdraw all or a portion of their capital accounts with the consent of the manager in the exercise of the manager's discretion.

B. ***Compensation***

Lender Management received a profits interest in each of the investment LLCs in exchange for the services it provided to the investment LLCs and their members. These profits interests were designated "Class A" interests under the operating agreements for the investment LLCs. The class A interests were structured concurrent with Lender Management's reorganization and its shift to a profit-based office model.

Under the initial terms of the operating agreements, effective August 1, 2005, Lender Management was entitled to receive for its class A interests the following percentages: (1) from Lenco, 1% of net asset value annually, plus 5% of any increase in net asset value from the prior fiscal period; (2) from M&M, 5% of gross receipts annually, plus 2% of any increase in net asset value from the prior fiscal period; and (3) from Lotis, 2% of net asset value annually, plus 5% of net trading profits.[5] Lender Management received income from the class A interests only to the extent that the investment LLCs generated profits. Net asset value was defined as the amount by which the fair market value of the investment LLC's assets exceeded its liabilities.

[5] For Lotis, class A interests were entitled to a share of the adjusted profit as defined in the operating agreement.

As of December 31, 2010, the operating agreements for M&M and Lenco were amended to provide Lender Management with increased profits interests. The class A interests for M&M and Lenco were increased to equal the aggregate of 2.5% of net asset value, plus 25% of the increase in net asset value, annually. Similar to the initial terms of the operating agreements, Lender Management received payments for its class A interests only to the extent that M&M and Lenco generated net profits. The increased profits interests were intended to more closely align Lender Management's goal of maximizing profits with that of its clients and to create greater incentive for Lender Management and its employees to perform successfully as managers of the invested portfolios. During the tax years in issue any payments that Lender Management earned from its profits interests were to be paid separately from the payments that it would otherwise receive as a minority member of each of the investment LLCs.

C. ***Lender Management Services***

During the tax years in issue Lender Management made investment decisions and executed transactions on behalf of the investment LLCs. It operated for the purpose of earning a profit, and its main objective was to earn the highest possible return on assets under management. Lender Management provided individual investors in the investment LLCs with one-on-one investment advisory and financial planning services.

Lender Management employed five employees during each of the tax years in issue. It had a total payroll for its employees of $333,200, $311,233, and $390,554 during the tax years in issue, respectively. For tax year 2011 the payroll included a $123,249 guaranteed payment to Keith. For tax year 2012 the payroll included a $206,417 guaranteed payment to Keith.

Lender Management's chief investment officer worked about 50 hours a week. The court described his activities:

As CIO, Keith retained the ultimate authority to make all investment decisions on behalf of Lender Management and the investment LLCs. Most of his time was dedicated to researching and pursuing new investment opportunities and monitoring and managing existing positions. For example, he discovered a company in Israel, and Lender Management owned an interest in and participated in the management of this company.

He reviewed personally approximately 150 private equity and hedge fund proposals per year on behalf of the investment LLCs. He met with and attended presentations of hedge fund managers, private equity managers, and investment bankers. Lender Management is not an active trader, but in a typical year the firm would enter into multiple new private equity deals and make one or two hedge fund trades.

Lender Management arranged annual business meetings, which were for all clients in the investment LLCs. These group meetings were held so that Lender Management could review face-to-face with all of its clients the performance of their investments at least once per year. The location of the annual meeting changed each year so that no single investor was repeatedly inconvenienced by having to travel a long distance. Because of conflicts Keith had difficulty getting all of Lender Management's clients to attend these meetings. He would conduct additional face-to-face meetings with clients who were more interested in the status of their financial investments at times and locations that were convenient for them.

Keith interacted directly with Lender Management's clients. He collected information from and worked with these individuals to understand their cashflow needs and their risk tolerances for investment, and Lender Management engaged in asset allocation based on these and other factors. Lender Management devised and implemented special ventures known as eligible investment options (EIOs), which allowed clients to participate in investments more directly suited to their age and risk tolerance. Keith developed and maintained a number of computer models, including a model that projected the cash needs of individual investors and a model that tracked and forecasted the cashflows associated with M&M's private equity investments.

Lender Management had other employees and outsourced certain management services:

Lender Management interviewed accounting and investment firms to provide outsourced management services beginning in 2006. It hired Harris myCFO, a division of Harris Bank, which provided both accounting and investment advice. In 2010 two of the principals of Harris myCFO formed their own firm, Pathstone Family Office, LLC (Pathstone), and Lender Management engaged Pathstone on May 6, 2010.[7] During the tax years in issue Pathstone provided Lender Management with accounting and investment advisory services.

[7] Lender Management began the process of terminating its relationship with Harris myCFO in 2009 in anticipation of its move to Pathstone. When discussing outsourced management services received by Lender Management during the tax years in issue we refer hereinafter to Pathstone, although the record is unclear as to whether Lender Management still engaged Harris myCFO in the early months of 2010.

Pathstone's accounting professionals were based in Atlanta, Georgia. Ms. Flament spoke with the accounting professionals over the phone between three and five times per week, and they exchanged between 50 and 100 emails per week. During the tax years in issue Pathstone prepared Lender Management's partnership tax returns. Pathstone also prepared quarterly financial reports for the investment LLCs.

Keith worked at the same office buildings as Pathstone's investment professionals in Englewood Cliffs, and later Fort Lee, New Jersey. He collaborated with Pathstone's principal investment adviser in selecting new investments for the investment LLCs. He presented Pathstone's advisers with his own research on investment opportunities, and he often received their advice before acting on prospective deals. Pathstone's advisers also presented him with investment opportunities. Keith exercised ultimate authority over the investment LLCs' investments and did not always follow Pathstone's advice. Pathstone did not have the authority to move cash on behalf of Lender Management or the investment LLCs.

The court reviewed the cases discussed above:

Certain activities are not considered trades or businesses. An investor is not, by virtue of his activities undertaken to manage and monitor his own investments, engaged in a trade or business. *Whipple v. Commissioner*, 373 U.S. 193 (1963); *Higgins v.*

> *Commissioner*, 312 U.S. at 218. "No matter how large the estate or how continuous or extended the work required may be", overseeing the management of one's own investments is generally[9] regarded as the work of a mere investor. *Higgins v. Commissioner*, 312 U.S. at 218. Expenses incurred by the taxpayer in trading securities or performing other investment-related activities strictly for his own account generally may not be deducted under section 162 as expenses incurred in carrying on a trade or business. See *id.*; *Beals v. Commissioner*, T.C. Memo. 1987-171. The taxpayer's activities as an investor may produce income or profit, but profit from investment is not taken as evidence that the taxpayer is engaged in a trade or business. Any profit so derived arises from the successful conduct of the trade or business of the corporation or other venture in which the taxpayer has taken a stake, rather than from the taxpayer's own activities. *Whipple v. Commissioner*, 373 U.S. at 202.
>
> [9] An exception to the general rule applies when the taxpayer is also an active trader of securities. See *Moller v. United States*, 721 F.2d 810 (Fed. Cir. 1983); *Liang v. Commissioner*, 23 T.C. 1040 (1955). Petitioners do not contend that Lender Management operated as a trader during the tax years in issue.
>
> A common factor distinguishing the conduct of a trade or business from mere investment has been the receipt by the taxpayer of compensation other than the normal investor's return. *Whipple v. Commissioner*, 373 U.S. at 202-203. Compensation other than the normal investor's return is income received by the taxpayer directly for his or her services rather than indirectly through the corporate enterprise. *Id.* At 203. If the taxpayer receives not just a return on his or her own investment but compensation attributable to his or her services provided to others, then that fact tends to show that he or she is in a trade or business. *Dagres v. Commissioner*, 136 T.C. at 281-282. The trade-or-business designation may apply even though the taxpayer invests his or her own funds alongside those that are managed for others, provided the facts otherwise support the conclusion that the taxpayer is actively engaged in providing services to others and is not just a passive investor. *Id.* at 282, 285-286.
>
> An activity that would otherwise be a business does not necessarily lose that status because it includes an investment function. *Id.* at 281. Work that includes investing or facilitating the investing of others' funds may qualify as a trade or business. *Id.* In *Dagres* we held that "[s]elling one's investment expertise to others is as much a business as selling one's legal expertise or medical expertise." Id. Investment advisory, financial planning, and other asset management services provided to others may constitute a trade or business. See *id.*

The court discussed the heightened scrutiny of this being a family business:[1357]

> Generally transactions within a family group are subjected to heightened scrutiny. *Estate of Bongard v. Commissioner*, 124 T.C. 95, 119 (2005); *Cirelli v. Commissioner*, 82 T.C. 335, 343 (1984). Where a payment is made in the context of a family relationship, we carefully scrutinize the facts to determine whether there was a bona fide business relationship and whether the payment was not made because of the familial relationship. See *Commissioner v. Culbertson*, 337 U.S. 733, 746 (1949); *Martens v. Commissioner*, T.C Memo. 1990-42, *aff'd* without published opinion, 934 F.2d 319

[1357] For *Bongard* and related cases regarding scrutiny of a family business entity for estate tax purposes, see part III.C.1 Whether Code § 2036 Applies.

(4th Cir. 1991). In *DiDonato v. Commissioner*, T.C. Memo. 2013-11, we concluded that certain payments between cousin-owned businesses were not deductible. The payments were not deductible because the record did not establish that services were actually rendered.

We find that Lender Management satisfies a review under heightened scrutiny. The end-level investors in the investment LLCs during the tax years in issue were all members of the Lender family. Lender Management's CIO, Keith, is a member of the Lender family. His father Marvin was managing member and 99%-owner of Lender Management in 2010, and Keith occupied the same position in 2011 and 2012. At all relevant times only two members of the Lender family were owners of Lender Management.

Separate from Lender Management, Marvin owned 11.47% of Lenco and 5.84% of M&M in 2010. Keith owned indirectly less than 4% of Lenco and 10% of M&M during the years he served as managing member.

There was no requirement or understanding among members of the Lender family that Lender Management would remain manager of the assets held by the investment LLCs indefinitely. Lender Management's investment choices and related activities were driven by the needs of clients, and its clients were able to withdraw their investments if they became dissatisfied with its services. Investors in Lenco and Lotis were entitled to withdraw their capital interests for any reason at least annually. Although a complete withdrawal from M&M required the manager's approval, we are satisfied on the facts before us that there was a common understanding that Lender Management would grant such approval if any investor became unhappy with how his or her funds were being managed.

Apart from what they received as returns on their respective investments, Lender Management's clients generally earned employment income. For example, Carl worked in sales for a cable communications company. Keith, like Carl, would have benefited from his membership in the investment LLCs during the tax years in issue regardless of whether he chose to work for Lender Management. Keith's position compensated him for the services that he provided to Lender Management, and it was his only full-time job during the tax years in issue. As managing member he was highly motivated to excel and to see Lender Management receive the benefit of the class A interests.

Although each investor in the investment LLCs was in some way a member of the Lender family, Lender Management's clients did not act collectively or with a single mindset. Lender Management's clients were geographically dispersed, many did not know each other, and some were in such conflict with others that they refused to attend the same business meetings. Their needs as investors did not necessarily coincide. Lender Management did not simply make investments on behalf of the Lender family group. It provided investment advisory services and managed investments for each of its clients individually, regardless of the clients' relationship to each other or to the managing member of Lender Management.

Contrasting *Higgins*,[1358] the court said:

> Lender Management was not managing its own money. Most of the assets under management were owned by members of the Lender family that had no ownership interest in Lender Management. Lender Management managed investments and did substantially more than keeping records and collecting interest and dividends.

Contrasting *Beals*,[1359] in which the taxpayer managed investments for himself, his wife, and their children, the court noted:

> In that case there was no business relationship. By contrast Lender Management had an obligation to its clients, and it tailored its investment strategy, allocated assets, and performed other related financial services specifically to meet the needs of its clients.

The court concluded:

> There is no dispute that Lender Management provided services. The profits interests were provided in exchange for services and not because Marvin and Keith were part of the Lender family. The Lender family members that participated in the investment LLCs expected Lender Management to provide them with services similar to those of a hedge fund manager. The relationship between Lender Management and the investment LLCs was a business relationship.
>
> Respondent cites no applicable attribution rules that would require us to treat Lender Management or its managing member as owning all of the interests in the investment LLCs. Lender Management carried on its operations in a continuous and businesslike manner for the purpose of earning a profit, and it provided valuable services to clients for compensation. For the tax years in issue Lender Management was carrying on a trade or business for the purpose of section 162.

Swartz v. U.S., 128 A.F.T.R.2d 2021-5251 (E.D. NY 2021), rejected a taxpayer's argument that Swartz his investment loss was a business loss. For details, see part II.G.8 Code § 165(a) Loss for Worthlessness; Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy.

Code § 475, "Mark to market accounting method for dealers in securities," may accelerate recognition of gain or treat securities as inventory when held by a "dealer in securities," which Code § 475(c)(1) defines as a taxpayer who:

> (A) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business; or
>
> (B) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.

The Syllabus to *YA Global Investments v. Commissioner*, 161 T.C. No. 11 (2023), describes the case in which the partnership was required to report $13.8 million of mark-to-market gain

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[1358] See fn 1298 in part II.G.4.l.i.(a) "Trade or Business" Under Code § 162 and text accompanying fn 1343.

[1359] See text accompanying fn 1344.

(increase in unrealized appreciation of investments and foreign currency contacts for the year) under Code § 475(a)(2) for 2008:

> PS, a partnership, provided funding to portfolio companies in exchange for stock, convertible debentures, promissory notes, and warrants. Because PS had no employees, it hired YA to manage its assets. PS could impose restrictions from time to time on the management of its assets with appropriate notice to YA. As part of the transactions in which PS acquired securities from portfolio companies, those companies paid fees to both PS and YA.
>
> For each of 2006, 2007, and 2008, PS filed Form 1065, U.S. Return of Partnership Income, but did not file Form 8804, Annual Return for Partnership Withholding Tax (Section 1446). PS was advised by the accounting firm that prepared its returns that it was not engaged in a U.S. trade or business. PS later filed suit against the accounting firm for professional malpractice and negligence.
>
> By execution of a series of Forms 872-P, Consent to Extend the Time to Assess Tax Attributable to Partnership Items, R and PS agreed to extend until March 31, 2015, for each of the years in issue, the period of limitation on the assessment of "any federal income tax attributable to the partnership items of the partnership...against any partner."
>
> On March 6, 2015, R issued notices of final partnership administrative adjustment (FPAAs) for taxable years that included 2006 through 2008. The FPAAs reflected R's determination that PS was engaged in the conduct of a trade or business in the United States during those years, that all of PS's taxable income was effectively connected with that trade or business, and that PS was liable for withholding tax under I.R.C. § 1446 on the portion of PS's effectively connected taxable income allocable to its foreign partners. R also determined that PS was a "dealer in securities" subject to the mark-to-market accounting rules provided in I.R.C. § 475.
>
> *Held*: Because Ps (PS's tax matters partners) accept that the activities of an agent can be attributed to the agent's principal for the purpose of determining whether the principal is engaged in the conduct of a U.S. trade or business, and because Ps have not established that the relationship between PS and YA was other than agency, YA's activities can be attributed to PS. PS's ability to give interim instructions to YA regarding the management of PS's account demonstrates a relationship of agent and principal rather than service provider and recipient.
>
> *Held, further*, Ps have not established that, during 2006, 2007, and 2008, PS was not engaged in a U.S. trade or business, as defined by I.R.C. § 864(b), *Commissioner v. Groetzinger*, 480 U.S. 23 (1987), and *Higgins v. Commissioner*, 312 U.S. 212 (1941). The activities that YA conducted on PS's behalf were continuous, regular, and engaged in for the primary purpose of income or profit. And Ps have not established that the fees paid by portfolio companies were additional payments for the use of capital. Therefore, they have not established that the activities that YA conducted on PS's behalf were limited to either the management of investments or trading in stocks or securities.
>
> *Held, further*, because PS "regularly [held] itself out as being willing and able to" purchase stock and debentures, the portfolio companies from which it made those purchases were its "customers," within the meaning of I.R.C. § 475(c)(1)(A). *Cf*. Treas. Reg. § 1.475(c)-1(a)(2).

Held, further, because PS "regularly purchase[d] securities from...customers in the ordinary course of a trade or business," it was a "dealer in securities," within the meaning of I.R.C. § 475(c)(1)(A), and thus subject to the mark-to-market rule provided in I.R.C. § 475(a)(2).

Held, further, to satisfy the identification requirement provided in I.R.C. § 475(b)(2), under which securities can be excepted from the mark-to-market rules of I.R.C. § 475(a), a dealer's records must explicitly state that the security in question is described in either I.R.C. § 475(b)(1)(A) or (B) or I.R.C. § 475(b)(1)(C); identification of a security in general terms as "held for investment" is insufficient to meet the requirement.

Held, further, Ps have not established that any portion of PS's taxable income was not effectively connected with its U.S. trade or business.

Held, further, a partnership's liability for withholding tax under I.R.C. § 1446 can be reduced by nonpartnership deductions of a foreign partner only if the foreign partner certifies those deductions under Treas. Reg. § 1.1446-6.

Held, further, a partnership's payment of withholding tax under I.R.C. § 1446 results in an overpayment for purposes of I.R.C. § 1464 only if the withholding tax paid exceeds the withholding tax properly due. *Jones v. Liberty Glass Co.*, 332 U.S. 524 (1947). An overpayment does not result merely because the withholding tax paid in respect of a foreign partner exceeds the foreign partner's income tax liability for the year under I.R.C. § 871(b) or 882.

Held, further, PS's filing of Form 1065 for each of 2006, 2007, and 2008 did not commence the period of limitation on the assessment of I.R.C. § 1446 withholding tax because the return did not advise R of PS's potential liability for that tax. *Commissioner v. Lane-Wells Co.*, 321 U.S. 219 (1944); *Springfield v. United States*, 88 F.3d 750 (9th Cir. 1996); *Paschall v. Commissioner*, 137 T.C. 8 (2011).

Held, further, because the tax imposed by I.R.C. § 1446 is an income tax, PS is a "partner" within the meaning of I.R.C. § 6231(a)(2). Consequently, even if the periods of limitation on the assessment of I.R.C. § 1446 withholding tax commenced with PS's filing of Forms 1065, the Forms 872-P executed for 2006 and 2007 extended the period of limitation for the assessment of that tax for each of those years so that it remained open when R issued the FPAAs.

Held, further, PS's filing of Forms 1065 did not shield it from additions to tax under I.R.C. § 6651(a)(1) for its failure to file Forms 8804. Even if a Form 1065 required to be filed by I.R.C. § 6031(a) can, in some circumstances, serve as a "return" whose filing can prevent the imposition of an addition to tax under I.R.C. § 6651(a)(1), PS's Forms 1065 cannot be accepted as defective Forms 8804 because they fail at least three of the four elements of the test prescribed in Beard v. Commissioner, 82 T.C. 766 (1984), aff'd, 793 F.2d 139 [58 AFTR 2d 86-5290] (6th Cir. 1986). Although R apparently accepts that the Forms 1065 that PS filed for 2006, 2007, and 2008 were signed under penalties of perjury, those returns did not disclose the facts relevant to the determination that PS was engaged in a U.S. trade or business, they did not purport to be Forms 8804, and they were not filed on the basis of an honest and reasonable belief that they would satisfy PS's obligations to file Forms 8804.

> *Held, further*, Ps have not met their burden of proving that PS's failure to file Forms 8804 and pay I.R.C. § 1446 withholding tax was due to reasonable cause and not willful neglect.

In providing background to its analysis concluding that the partnership was a dealer, the court explained:

> For the most part, courts have addressed on a case-by-case basis activities not within the per se rule for personal services and not covered by the trading safe harbors. Perhaps the closest any court has come to articulating a general definition of trade or business was when the Supreme Court stated, in *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987): "[N]ot every income-producing and profit-making endeavor constitutes a trade or business....We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit."
>
> But the courts have also recognized an exception to the general principle that continuous and regular activities directed at income or profit amount to a trade or business. A taxpayer whose activities are limited to investment - regardless of how continuous and regular those activities - is not engaged in a U.S. trade or business.
>
> Although the investment exception is widely recognized, its rationale is unclear. And the absence of a clear rationale for the investment exception makes it difficult to define its parameters.
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> The investment exception traces its roots back to *Higgins v. Commissioner*, 312 U.S. 212 (1941). *Higgins* involved a Paris resident who maintained a New York office where employees managed his "extensive investments in real estate, bonds and stocks." *Id*. at 213. In computing his U.S. tax liability, he sought to deduct his investment management expenses as ordinary and necessary business expenses under the predecessor of section 162. The Commissioner accepted that the expenses were ordinary and necessary. He also accepted that the taxpayer's real estate activities constituted a trade or business. But he disallowed that portion of the expenses allocable to the taxpayer's dealings in securities. While the taxpayer conceded that small investors were not engaged in a trade or business, he argued that his activities were different. Because his activities were much more extensive than those typical of small investors, he argued, his activities amounted to a trade or business. The Commissioner countered that personal investment activities, however extensive, cannot be a trade or business. The Court wrote that the determination of "whether the activities of a taxpayer are `carrying on a business' requires an examination of the facts in each case." *Id*. at 217. It added:
>
> > The Bureau of Internal Revenue has this duty of determining what is carrying on a business, subject to reexamination of the facts by the Board of Tax Appeals and ultimately to review on the law by the courts on which jurisdiction is conferred. The Commissioner and the Board appraised the evidence here as insufficient to establish [the taxpayer's] activities as those of carrying on a business. The [taxpayer] merely kept records and collected interest and dividends from his securities, through managerial attention for his investment. No matter how large the estate or how

> continuous or extended the work required may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision of the Board.
>
> *Id.* at 217-18.[19]
>
> [19] Under the law in effect for the years at issue in *Higgins*, the taxpayer could have deducted the expenses in question only as trade or business expenses under the predecessor of section 162. Section 212 now allows a deduction for expenses incurred in income-producing activities that do not rise to the level of a trade or business, but Congress did not enact the predecessor of that section until 1942, in response to the Court's opinion in *Higgins*.
>
> The *Higgins* opinion, as the Court later described it in *Commissioner v. Groetzinger*, 480 U.S. at 29-30, was "bare and brief" and "devoid of analysis." With "its stress on the facts of each case," *Higgins* "affords no readily helpful standard" for determining when a taxpayer is or is not engaged in a trade or business. *Id*. at 32. The Court in *Groetzinger* accepted that Higgins "must stand for the proposition that full-time market activity in managing and preserving one's own estate is not embraced within the phrase `carrying on a business,' and that salaries and other expenses incident to the operation are not deductible as having been paid or incurred in a trade or business." *Id*. at 30. But *Higgins* offers little or no guidance on how far the investment exception extends and whether it encompasses a taxpayer whose activities include anything beyond earning returns on invested capital.

The court then explained how it applied the law to the case:

> The issue of whether YA Global engaged in a U.S. trade or business through Yorkville Advisors during the years in issue turns on three questions. First, were the activities Yorkville Advisors conducted on behalf of YA Global continuous, regular, and engaged in for the primary purpose of income or profit? Second, were those activities limited to the management of investments? And third, were they covered by the safe harbor provided in section 864(b)(2)(A) for trading in stocks or securities? If the activities that Yorkville Advisors conducted on behalf of YA Global were continuous, regular, and directed at income or profit, went beyond the management of investments, and were not within the statutory safe harbor for securities trading, then YA Global was engaged in a U.S. trade or business as defined by section 864(b), *Groetzinger*, and *Higgins*. The appropriate label for that business would be of no moment. Regular and continuous activities directed at income or profit are, by definition, activities of a trade or business. If those activities are conducted in the United States and are outside the judicially created exception for investment and the statutory safe harbor for trading, then the activities are those of a U.S. trade or business.

After concluding that "Petitioners make no argument that Yorkville Advisors' activities were not regular, continuous, and directed at profit," the court addressed arguments that YA Global's activity was limited to the management of investments:

> Petitioners' primary argument regarding the trade or business issue is that YA Global was simply an investor. That argument stands or falls on whether, as petitioners claim, the only returns YA Global and Yorkville Advisors earned from portfolio companies were returns on capital invested in those companies.

The record does not support petitioners' claim that the fees paid by the portfolio companies were simply additional payments for the use of capital. Petitioners assert that "YA Global/Yorkville never got any fees unless the Fund closed a deal and put its capital at risk." While it may be true that a portfolio company had no obligation to pay fees to either Yorkville Advisors or YA Global unless a transaction was consummated, the payment of fees did not depend on the partnership's putting its capital at risk. Some of the commitment fees required under the terms of a SEDA were payable upon execution of the relevant agreements, before the portfolio company sought any advances.

If the fees that portfolio companies paid were simply additional compensation for capital, those fees should have been paid entirely to YA Global. The funds provided to portfolio companies came from the partnership. The record discloses no instance in which Yorkville Advisors provided capital to a portfolio company. And yet, Yorkville Advisors received cash fees from portfolio companies. The form of the transactions thus indicates that the portfolio companies received something of value from Yorkville Advisors above and beyond the capital they received from YA Global.

In objecting to proposed findings by respondent about specific types of fees, petitioners claim repeatedly that "the fees associated with transactions varied, both in name and amount." Petitioners thereby suggest that the labels applied to different fees had no real consequence. They seem to want us to believe, for example, that describing as a "structuring fee" an amount paid to Yorkville Advisors does not indicate that the fee was compensation for Yorkville Advisors' efforts in structuring the transaction. As another example, petitioners suggest that "`monitoring' fees were paid in cases where it was clear there would be nothing to monitor." Petitioners' position seems to rest on the premise that the fees Yorkville Advisors charged portfolio companies were at least misleading, if not downright deceptive.

The testimony of Messrs. Kreisler and Wright suggests that portfolio companies were relatively indifferent to whether the payments they made went to Yorkville Advisors or YA Global or whether the costs of the transaction to the companies took the form of interest, discounts, or fees given one label or another. But the characterization of fees should not have been a matter of indifference to Yorkville Advisors and YA Global's limited partners. For them, the labels given to the various fees had real economic consequences: Those designations affected whether the fees would go directly to the partnership (and thus necessarily shared among its limited partners) or instead were paid, in the first instance, to Yorkville Advisors, leaving to the latter's discretion the extent to which it would remit to the partnership any fees beyond those necessary to cover expenses.

In addition to paying at least market rates for the capital provided by YA Global,[28] the portfolio companies paid fees intended to cover the costs of the activities that Yorkville Advisors conducted on the partnership's behalf - that is, identifying, sourcing and negotiating transactions, conducting due diligence, and structuring and managing the transactions.[29] As indicated by the testimony of Messrs. Kreisler and Wright, the portfolio companies would not have entered into a transaction whose overall economics were unattractive. If the portfolio companies were willing to cover both the cost of Yorkville Advisors' activities and the cost of the capital they received, it follows that Yorkville Advisors' activities had value to the portfolio companies. If, as petitioners argue, Yorkville Advisors' activities were limited to managing YA Global's investments, the portfolio companies should have been unwilling to cover any of the costs of those activities.[30]

[28] The record provides no grounds for concluding that the terms on which YA Global provided capital to portfolio companies failed to provide the partnership with at least market-based returns. Petitioners suggest, contrary to Mr. Brokaw's testimony, that the discounts at which YA Global could acquire portfolio company stock under a SEDA were "blockage" discounts, reflecting thin trading in the stock of the portfolio companies and compensating the partnership for the risk that it would be unable to sell its shares into the market without depressing the market price. We need not resolve the dispute about whether the SEDA discounts were blockage discounts. Even if the discounts precisely compensated YA Global for the risk of being unable to sell the shares acquired without depressing their market price, the partnership would still have been paying an arm's-length price for the stock. The absence of market benchmarks for evaluating the terms of the convertible debentures makes it difficult to assess the adequacy of the stated interest rates. Those rates were presumably lower than what would have been provided in the absence of the conversion feature. But the record provides no evidence that any discount in interest rates was more than what would have been necessary to cover the value of the conversion right.

[29] While the fees that Yorkville Advisors was entitled to receive were intended to cover its expenses - and did so for 2004, and apparently for 2005 and 2006 as well - they seem not to have covered all of Yorkville Advisors' expenses for 2007 or 2008. As shown in our findings of fact, Yorkville Advisors' expenses did not decline at the same rate as the fees it received, perhaps because some of its expenses, such as office rent and at least some salaries, did not vary directly with transaction volume. Even so, the fees that Yorkville Advisors received, or was entitled to receive, covered 76.7% of expenses (as reported on Yorkville Advisors' tax return) for 2007 and 33.9% for 2008.

[30] Comparing YA Global's situation to that of the taxpayer in the "seminal" but "devoid of analysis" case on which petitioners rely, we doubt that the portfolio companies in which Mr. Higgins invested would have been favorably disposed to a request that they pay him fees sufficient to cover the costs of his New York office.

Concluding that the fees paid by portfolio companies were for benefits other than their receipt of capital does not depend on identifying specific services that the relevant agreements required Yorkville Advisors to provide. There would have been no apparent need for an agreement to impose on Yorkville Advisors the obligation to negotiate, structure, and document the transaction to which the agreement related. By the time the parties executed the agreement, the negotiating and structuring of the transaction would have been complete.

Nor is it of any moment that the fees that portfolio companies paid to Yorkville Advisors were not measured by the hours that Yorkville Advisors' employees devoted to a particular transaction. While charging a set amount per hour spent may be a common way to bill for legal and other services, parties can also agree to the provision of services in exchange for fixed fees.

More generally, the fees charged to portfolio companies were intended to cover Yorkville Advisors' variable costs and overhead. Yorkville Advisors was allowed, at its discretion, to remit to YA Global only that portion of the fees that exceeded the expenses incurred.

> We can thus infer that the amounts of the fees were set with an eye to the transaction costs incurred even if the fees were not determined by a strict hourly rate.
>
> It makes sense that the portfolio companies saw value in Yorkville Advisors' activities. The transactions in which they received needed capital would not have occurred but for Yorkville Advisors' efforts. YA Global's mere showing up on a portfolio company's doorstep with capital in hand would not have allowed the company to use that capital in its business. More had to be done. And that something more - the source of its professed competitive "edge" - was done by Yorkville Advisors.[31]
>
> > [31] As noted above, petitioners acknowledge that "[t]he `fees' paid by portfolio companies were...part of the cost they paid to gain access to YA Global's capital." Precisely. Paying to gain access to capital is not the same as paying for capital.
>
> In that respect, the activities that Yorkville Advisors conducted on behalf of YA Global can be meaningfully distinguished from those of a typical investor. Investors who purchase securities on the open market do not deal directly with the companies in which they invest. Any benefit to the issuer from the investor's purchase is negligible. The issuer receives no additional capital at that time. A given investor's market purchase increases the demand for the issuer's security and, together with other purchases, may increase the security's market price - an eventuality presumably favored by the issuer's management. But the issuer itself realizes no immediate benefit from any increase in the price at which its securities trade in the market. Even an investor who buys securities upon initial issuance provides no benefit to the issuer other than the capital provided. By contrast, when the purchaser of a security goes beyond simply deciding whether to purchase a security on the terms offered and arranges and structures the transaction in which the security is issued, the issuer realizes a benefit beyond the receipt of capital. In that circumstance, the issuer would have reason to pay for that additional benefit, as YA Global's portfolio companies apparently did in paying fees intended to cover the costs of Yorkville Advisors' activities.[32]
>
> > [32] In *Commissioner v. Groetzinger*, 480 U.S. at 30, the Court interpreted *Higgins* as "stand[ing] for the propositions that full-time market activity in managing and preserving one's own estate is not embraced within the phrase `carrying on a business.'" (Emphasis added.)

The court disposed of the taxpayers' attempted reliance on Code § 1234 regarding the termination of options. Then, in a discussion called "Trading Safe Harbor," the court explained:

> Just as the activities that Yorkville Advisors conducted on behalf of YA Global were not limited to the management of the partnership's investments, those activities were not limited to trading in stocks or securities. The reason that YA Global was not an investor during the years in issue was not that its portfolio turned over too rapidly. Instead, YA Global fails to qualify for the investment safe harbor because the income the partnership earned from portfolio companies went beyond returns on invested capital. In that respect, YA Global can be distinguished from both investors and traders. Traders, like investors, simply earn returns on the capital they invest. Because the portfolio companies compensated Yorkville Advisors and the partnership for benefits that went beyond the use of invested capital, YA Global was neither an investor nor a trader.[33] The activities that Yorkville Advisors conducted on the partnership's behalf during the years in issue were not covered by either the judicially created safe harbor for the managing of

investments or the statutory safe harbor for trading in securities provided in section 864(b)(2)(A).

> [33] YA Global would not fall within the trading safe harbor even if we were to accept that, under Treasury Regulation § 1.864-2(c)(2)(i)(c), the safe harbor covers any buying and selling of stocks or securities. The activities that Yorkville Advisors conducted on behalf of YA Global went beyond buying and selling socks or securities. Petitioners make no argument that the activities that Yorkville Advisors conducted in identifying, sourcing, and negotiating transactions - activities for which Yorkville Advisors was compensated by portfolio companies - were "closely related" to buying, selling, or trading in stocks or securities. Yorkville Advisors' activities can be readily distinguished from obtaining credit to buy, sell, or trade in stocks or securities. Yorkville Advisors' work in arranging for the issuance of stock or convertible debentures by a portfolio company could be viewed as a precondition to its purchase of that stock or those debentures. In that limited sense, Yorkville Advisors' activities could be likened to a taxpayer's obtaining the credit necessary to purchase stock or securities. But the taxpayer's obtaining of credit would not provide a benefit to the issuer of the stock or securities for which the issuer could be expected to compensate the taxpayer. As respondent observes, "Taxpayers engaged merely in trading and investment simply do not earn income designated as fees."

The court concluded:

> To sum up, the record establishes that the activities that Yorkville Advisors conducted on behalf of YA Global were continuous, regular, and directed at income or profit, went beyond the management of investments, and were not within the statutory safe harbor for securities trading. It follows that petitioners have not met their burden of proving that YA Global was not engaged in a U.S. trade or business - as defined by section 864(b), *Groetzinger*, and *Higgins* - during the years in issue.

II.G.4.l.i.(e). Family Office as a Trade or Business

This part II.G.4.l.i.(e) discusses tax issues. Part II.G.4.l.i.(f) Family Office – Securities Law Issues discusses certain regulation of family offices.

Part II.G.4.l.i.(d) Whether Managing Investments Constitutes a Trade or Business teaches:

- Managing one's own investments[1360] (or the investments of one's spouse and children)[1361] does not constitute a trade or business, unless one is a day trader or something similar.[1362]
- Managing another person's investments may constitute a trade or business, whether one's compensation is expressed as a fixed payment or a profits interest.[1363]
- However, a C corporation may deduct expenses of managing investments.[1364]

[1360] See fns 1342-1345, as well as part II.G.4.l.i.(a) "Trade or Business" Under Code § 162, especially fn 1298.
[1361] See text accompanying fns 1344-1345.
[1362] See fns 1346-1356 and the accompanying text.
[1363] See fns 1355-1359 and the accompanying text.
[1364] See text accompanying fn 1307 in part II.G.4.l.i.(a) "Trade or Business" Under Code § 162.

- Giving a C corporation that incurs investment management expenses a profits interest in an investment partnership allows the investors to deflect profits to the C corporation instead of trying to deduct investment fees themselves. However, a conservative approach of complying with proposed regulations regarding service partners adds significant complexity, making this planning complex from a financial and tax viewpoint, as described in this part II.G.4.l.i.(e). Before including a QTIP trust in such a partnership, consider parts II.H.2.c QTIP Trusts - Code § 2519 Trap and II.O.2.c Effect of Buy-Sell Agreement on Marital Deduction.

Concerned with the unfairness of disallowing deductions for activities designed to generate profit that did not rise to the level of a trade or business,[1365] Congress enacted Code § 212 to provide individuals with an itemized deduction for investment expenses.[1366] Congress even relaxed the rules if the individual could prove that the activity generated a profit in enough years or had sufficient profit motive.[1367]

However, 2017 tax reform disallowed investment expenses through December 31, 2025.[1368] Even when deductible for regular tax, they would not be deductible for alternative minimum tax purposes.[1369] Running expenses through a partnership or S corporation does not change this treatment.[1370]

Taxpayers may try to avoid these limitations by giving the investment manager a profits interest in a partnership through which they invest their taxable assets instead of paying an advisory fee. (The emphasis is on taxable investments, because one cannot deduct expenses incurred in managing tax-exempt investments.)[1371] Favorable precedent includes *Dagres*[1372] and *Lender Management*,[1373] both of which are described (*Lender Management* extensively) in part II.G.4.l.i.(d) Whether Managing Investments Constitutes a Trade or Business.

Deflecting the income to the investment management firm solves the investment partnership's owners' problem, but then one needs to consider the consequences of the investment management firm's expenses. To prevent the investment management firm from having the same problem regarding miscellaneous itemized deductions, the investment management firm needs to be engaged in a trade or business. As described in part II.G.4.l.i.(a) "Trade or Business" Under Code § 162, this inquiry depends on a variety of circumstances, and whether the investment management firm will be able to deduct the expenses is unpredictable, unless it is owned by an unrelated third party that provides services to a variety of clients. Of course, if the investment management firm is owned by third parties and one errs on the side of a higher

[1365] See fn 1343 in part II.G.4.l.i.(d) Whether Managing Investments Constitutes a Trade or Business.
[1366] See part II.G.4.n Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax, fn 1432 and part II.G.4.l.i.(b) Requirements for Deduction Under Code § 212.
[1367] See part II.G.4.l.i.(c) Hobby Loss Benefits of Code § 183. Despite its pejorative name, Code § 183 is a favorable provision that benefits individuals.
[1368] See Code § 67(g), cited in part II.G.4.n Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax.
[1369] See part II.G.4.n Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax.
[1370] Reg. § 1.67-2T(b)(1).
[1371] Code § 265.
[1372] See fns 1355-1356 and the accompanying text.
[1373] See fns 1358-1359 and the accompanying and preceding text, which started shortly after fn 1356.

profits interest (so that the firm can pay its expenses), then one risks overpaying for the services.

In *Hellman v. Commissioner*, a case that was later settled with substantial income tax payments,[1374] the Tax Court's October 1, 2018 order included the following:

> These cases involve expense deductions claimed by GF Family Management, LLC (GFM), an investment management firm owned and operated by petitioners. Petitioners are members of the same family, and GFM is a "family office" as defined by the Federal securities laws. See 17 C.F.R. 275.202(a)(11)(G)-1(b)(1) and (d)(4). Each petitioner held a 25% profits interest in GFM, and the assets managed by GFM were held by six investment partnerships. GFM held a 1% interest in each partnership, and trusts of which petitioners are the beneficiaries held (individually or collectively) the remaining 99% of each partnership….
>
> These cases appear to resemble *Lender Management* in some respects, but not in others. GFM is a family office that managed investment assets for four family members. All four family members resided in the Atlanta metropolitan area and appear to have been on good terms. GFM received performance-based compensation keyed to the success of the investments it made. One investor, Mark Graham, appears to have had authority over day-to-day investment decisions. But here, unlike in Lender Management, all of the other investors were also owners of the management company, with each investor holding a 25% profits interest in GFM.
>
> Each party contends that summary judgment may be granted in his favor on the basis of the Court's legal rulings and factual findings in *Lender Management*. From our review of the facts currently contained in the record, we do not think that opinion dictates a ruling in favor of either side as a matter of law. In *Lender Management* we relied on a variety of factors tending to prove (or disprove) the existence of a "trade or business." Besides the manner in which the family office was compensated for its services, relevant factors may include but are not necessarily limited to: (1) the nature and extent of the services provided by the family office employees; (2) the relative amounts of expertise possessed and time devoted by family office employees versus outside investment managers and consultants; (3) the individualization of investment strategies for different family members with differing investment preferences and needs; and (4) the proportionality (or lack thereof) between the share of profits inuring to each family member in his or her capacity as an owner of the family office and the share of profits inuring to that same individual in his or her capacity as an investor in the managed funds.
>
> In cases such as these, an important question is whether the owners of the family office are "actively engaged in providing services to others," *Lender Management*, at *26, or are simply providing services to themselves. *See Dagres*, 136 T.C. at 281 ("Selling one's investment expertise to others is as much a business as selling one's legal expertise."). Here, each family member had a 25% profits interest in GFM. If each family member (for example) also had an aggregate 25% interest in the assets under management, there would be perfect proportionality between the two streams of income. In that event, it would not matter how GFM was compensated, because that compensation, once

[1374] On November 9, 2018, Judge Lauber entered a decision in docket no. 8486-17, confirming agreed-upon "deficiencies in income tax due from petitioners for the taxable years 2012, 2013, and 2014 in the amounts of $98,074.00, $138,055.00, and $132,459.00, respectively."

distributed ratably to the four owners, would simply replace investment income that each person would otherwise have derived from the investment portfolios. That was not the case in *Lender Management*, where one family member had a 99% profits interest in the management company, but held only minority interests in the assets under management. The facts currently in the record do not enable the Court to assess the degree or proportionality (or lack thereof) here.

We conclude that further factual development is necessary to shed light on this and other questions. Relevant facts may include the following:

- The education and professional background of each investor-employee.

- The work schedules of each investor-employee, with descriptions of the general work performed. Ideally, this information would include approximate hours worked weekly or monthly.

- Any details pertaining to the decision process by which GFM was selected as the management company, the decision process by which Mark Graham was chosen as GFM's manager, and the identities of any other candidates considered for these two roles.

- The net asset value of each investment partnership, on a quarterly, semiannual, and/or annual basis, during the 2012-2014 tax years in question and also during 2011 and 2015.

- The aggregate percentage ownership interest that each of the four family members had in the total assets held by all the investment partnerships. Such percentage figures might be provided on a quarterly, semi-annual, and/or annual basis, for the 2012-2014 tax years in question and also for 2011 and 2015.

- Information concerning the major investments held by each investment partnership and the estimated dollar value of those investments.

- The similarities and distinctions between the investment strategies and objectives of each investment partnership. Relevant distinguishing factors might include average asset turnover, relative investment horizons, and the relative risk and nature of the investments made.

- How (if at all) the investment strategies and objectives of the partnerships were tailored to the individual needs and preferences of the four family members.

- Any additional facts the parties believe would be relevant to the "trade or business" analysis as undertaken in *Lender Management*.

The IRS attacks may seek to recharacterize the profits interest, which deflects income, as a nondeductible guaranteed payment; to defend against this attack, the investment management firm's profits interest should have real entrepreneurial risk.[1375] Here are some guidelines under the rules described in fn 1375:

- The budgeted annual profits interest should be reasonable. Consider weighing the possibility of making a gift in granting a vested interest that might exceed annual reasonable compensation[1376] against what might seem like a third party at-will relationship if the profits interest is terminable at will or is constantly being tinkered with. Ultimately, I favor allowing termination or periodic adjustments, so long as the partnership has a business reason for the investment management company's continued involvement, such as wanting a management company with a stable leadership team invested in the partnership's ongoing success, and the adjustments do not happen too frequently.

- Although a preferred profits interest is consistent with the partnership income tax rules generally, such an interest in a marketable securities partnership might be perceived to reduce entrepreneurial risk, and a cap on a profits interest might be perceived to resemble a fee. Therefore, a straight pro rata percentage of all partnership items seems safer.

- The government is concerned about a service partner being able to manipulate the annual profits to generate a steady fee. How this might play out in an investment partnership might be the service partner deciding how to time capital gains and losses. Accordingly, consider making distributions (other than tax distributions) be based on the lesser of cumulative realized net income or cumulative combined realized and unrealized net income. This introduces some complexity, in that distributions of income earned and taxed in one year might be suspended due to unrealized losses and need to be made up in a future year when any unrealized losses are reversed (through being recognized or through growth in value).

- Suppose the partnership starts off well and the investment management company receives significant distributions, then the partnership doesn't do so well but the management company keeps the money. The IRS suggested that such an arrangement would seem like a fee, rather than the management company facing an entrepreneurial risk of loss. Therefore, the preamble and proposed regulations introduced the idea of clawback – the investment management company must repay the distributions. This clawback idea does envision the investment management company keeping tax distributions, which would be only fair considering that it cannot get a refund by carrying back a net operating loss[1377] and generally a capital loss is not deducible in excess of capital gains.[1378] The preamble and proposed regulations do not specify when the repayment of distributions must occur; perhaps it could occur when the partnership terminates, but query whether it should occur much sooner to feel more "real."

Issuing a pure profits interest is a nontaxable event for income tax purposes,[1379] presumably because the holder will be earning income each year as profits are received. The structure

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[1375] See fns 524-544 in part II.C.8.a Code § 707 - Compensating a Partner for Services Performed. The paragraphs preceding and encompassing the text accompanying fns 541-544 focus on entrepreneurial risk and make structuring the profits interest somewhat tricky.
[1376] See fn 1382 and the accompanying text.
[1377] See part II.G.4.l.ii Net Operating Loss Deduction.
[1378] The rule and exceptions are described in the text accompanying fns 1550-1552 in part II.G.8 Code § 165(a) Loss for Worthlessness; Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy and fn 1423 in part II.G.4.m.i Code § 1341 Claim of Right Deduction.
[1379] See part II.M.4.f Issuing a Profits Interest to a Service Provider.

described above distributes profits to all parties out of the same pool. However, it may be desirable to distribute profits in tiers, each of which has different allocations; this is called a preferred profits interest.[1380]

If there is risk that the investment management firm may not be able to deduct its expenses, consider using a C corporation for its choice of entity. A C corporation's federal tax rate is 21%, compared to 23.8% for qualified dividends and long-term capital gains and 40.8% for other ordinary income paid to an individual in the highest federal income tax bracket. Its deductions for state income tax are not limited. Furthermore, when a C corporation receives dividends from a domestic corporation, it can exclude at least 50% of them from income. For details, see part II.E.1.g Whether a High-Bracket Taxpayer Should Hold Long-Term Investments in a C Corporation. A C corporation is also more likely than an individual to be able to deduct investment expenses under Code § 162.[1381]

I'm not a fan of C corporations, because double tax generally will apply, when the earnings come out, sooner or later, making them more expensive in the long-run (depending on the time value of money) than pass-through entities. See part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities. However, if the investment management firm is spending its income on providing investment management services, then it might not accumulate much income to distribute.

Thus, a C corporation offers reduced income tax rates on investment income and deduction of none, part, or all of the investment management expenses. A corporation that does not pay dividends may become subject to the 20% accumulated earnings tax or personal holding company income tax. See part 0 No distributions under Biden's plan:

Biden Plan	
Distributing 50% of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-36,800
Net Income after Income Tax	$63,200

So, effective tax rates under current law are 55.8% distributing all earnings, 42.8% distributing half of the earnings, and 29.8% distributing none of the earnings.

Effective tax rates under the Biden plan are 72.6% distributing all earnings, 54.7% distributing half of the earnings, and 36.8% distributing none of the earnings.

Incentives to Declare Dividends.

Now for some additional caveats:

[1380] See generally part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.
[1381] See text accompanying fn 1307 in part II.G.4.l.i.(a) "Trade or Business" Under Code § 162.

If the investment management firm is owned by family members who also own the investment partnership but is not owned in the same proportion as the investment partnership, an unexpected gift may be deemed to have been made.[1382] I expect this gift to be minimal, because the profits interest is annually renewable, but calculations under the regulations under Code § 2701 may generate gifts beyond reasonable expectations.

If the corporation provides personal services that do not relate to managing investments, be sure to charge for them. Failure to charge can constitute a constructive dividend, cause the expenses to be disallowed at the corporate level and incur a taxable dividend to the shareholder.[1383]

Furthermore, accounting for investment partnerships can be complex. A partnership needs to account for built-in gain and loss not only with respect to assets contributed to the partnership but also for assets that the partnership owns when partners come and go. See part II.P.1.a.i.(b) Special Rules for Allocations of Income in Securities Partnerships. Also, contributions of cash within two years before or after a distribution of property raises issues described in part II.Q.8.b.i.(c) Disguised Sale from Partnership to Partner, and contributions of property within two years before or after a distributions of cash raises issues described in part II.M.3.e Exception: Disguised Sale Rules.

Given all of the issues described in this part II.G.4.l.i.(e), one might not even consider this structure unless annual investment management fees exceed $200,000.

II.G.4.l.i.(f). Family Office – Securities Law Issues

I am not a securities law expert. Below is a description of the "family office" exemption from registration under the Investment Advisers Act of 1940. The Securities & Exchange Commission (SEC) explained:[1384]

> The failure of a family office to be able to meet the conditions of the rule will not preclude the office from providing advisory services to family members either collectively or individually. Rather, the family office will need to register under the Advisers Act (unless another exemption is available) or seek an exemptive order from the Commission. A number of family offices currently are registered under the Advisers Act.

A "family office," as defined in 17 C.F.R. § 275.202(a)(11)(G)-1, is not considered an "investment adviser" for purpose of the Investment Advisers Act of 1940.[1385] Certain pre-2010 persons are automatically considered "family offices" under this rule.[1386] Being excluded from

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[1382] See part III.B.7.c.ii Profits Interest in a Partnership in Which Transferor and Applicable Family Members Initially Hold Only a Profits Interest, which is part of part III.B.7.c Code § 2701 Interaction with Income Tax Planning and informed by part III.B.7.b Code § 2701 Overview.

[1383] See part II.Q.7.a.iv Dividends; Avoiding Dividend Treatment Using Redemptions under Code §§ 302 and 303.

[1384] Part II of RIN 3235-AK66, which is SEC Release No. IA-3220; File No. S7-25-10.

[1385] 17 C.F.R. § 275.202(a)(11)(G)-1(a).

[1386] 17 C.F.R. § 275.202(a)(11)(G)-1(c) provides:

> *Grandfathering*. A family office as defined in paragraph (a) of this section shall not exclude any person, who was not registered or required to be registered under the Act on January 1, 2010, solely because such person provides investment advice to, and was engaged before January 1, 2010 in providing investment advice to:

the definition of an "investment adviser" for purpose of the Investment Advisers Act of 1940 precludes state regulation.[1387]

Otherwise, for purposes of the family office exclusion:[1388]

> A family office is a company (including its directors, partners, members, managers, trustees, and employees acting within the scope of their position or employment) that:
>
> (1) Has no clients other than family clients;[1389] provided that if a person that is not a family client becomes a client of the family office as a result of the death of a family

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(1) Natural persons who, at the time of their applicable investment, are officers, directors, or employees of the family office who have invested with the family office before January 1, 2010 and are accredited investors, as defined in Regulation D under the Securities Act of 1933;

(2) Any company owned exclusively and controlled by one or more family members; or

(3) Any investment adviser registered under the Act that provides investment advice to the family office and who identifies investment opportunities to the family office, and invests in such transactions on substantially the same terms as the family office invests, but does not invest in other funds advised by the family office, and whose assets as to which the family office directly or indirectly provides investment advice represents, in the aggregate, not more than 5 percent of the value of the total assets as to which the family office provides investment advice; provided that a family office that would not be a family office but for this paragraph (c) shall be deemed to be an investment adviser for purposes of paragraphs (1), (2) and (4) of section 206 of the Act.

[1387] 15 U.S.C. § 80b-3a(b) provides:

(1) *In general*. No law of any State or political subdivision thereof requiring the registration, licensing, or qualification as an investment adviser or supervised person of an investment adviser shall apply to any person--

 (A) that is registered under section 80b-3 of this title as an investment adviser, or that is a supervised person of such person, except that a State may license, register, or otherwise qualify any investment adviser representative who has a place of business located within that State;

 (B) that is not registered under section 80b-3 of this title because that person is excepted from the definition of an investment adviser under section 80b-2(a)(11) of this title; or

 (C) that is not registered under section 80b-3 of this title because that person is exempt from registration as provided in subsection (b)(7) of such section, or is a supervised person of such person.

(2) *Limitation*. Nothing in this subsection shall prohibit the securities commission (or any agency or office performing like functions) of any State from investigating and bringing enforcement actions with respect to fraud or deceit against an investment adviser or person associated with an investment adviser.

15 U.S.C. § 80b-2(a)(11) provides:

"Investment adviser" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include … (G) any family office, as defined by rule, regulation, or order of the Commission, in accordance with the purposes of this subchapter; or (H) such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order.

[1388] 17 C.F.R. § 275.202(a)(11)(G)-1(b).

[1389] [This footnote is not from the quoted material.] For the definition of a "family client," see text accompanying fn 1394.

member[1390] or key employee[1391] or other involuntary transfer from a family member or key employee, that person shall be deemed to be a family client for purposes of this section for one year following the completion of the transfer of legal title to the assets resulting from the involuntary event;

(2) Is wholly owned by family clients and is exclusively controlled[1392] (directly or indirectly) by one or more family members and/or family entities;[1393] and

(3) Does not hold itself out to the public as an investment adviser.

The rule does not explain what a "client" is, but it does define "family client" as:[1394]

(i) Any family member;[1395]

[1390] [This footnote is not from the quoted material.] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(6) provides:

Family member means all lineal descendants (including by adoption, stepchildren, foster children, and individuals that were a minor when another family member became a legal guardian of that individual) of a common ancestor (who may be living or deceased), and such lineal descendants' spouses or spousal equivalents; provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members.

[1391] [This footnote is not from the quoted material.] For the definition of a "key employee," see text accompanying fn 1399.

[1392] [This footnote is not from the quoted material.] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(2) provides:

Control means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of being an officer of such company.

Part II of RIN 3235-AK66, which is SEC Release No. IA-3220; File No. S7-25-10.

Commenters persuaded us to expand who may own the family office from "family members" to "family clients." This change is consistent with the intent behind our proposed language (which contemplated that the family could own the family office indirectly) and more clearly allows family members to structure their ownership of the family office for tax or other reasons. We also agree with suggestions that the rule permit key employees to own a non-controlling stake in the family office to serve as part of an incentive compensation package for key employees. We remain convinced, however, that for our core policy rationale to be fulfilled - that a family office is essentially a family managing its own wealth - the family, directly or indirectly, should control the family office. Accordingly, the final rule provides that while family clients may own the family office, family members and family entities (*i.e.*, their wholly owned companies or family trusts) must control the family office.[109]

[109] We note that, as proposed, we are not limiting the exclusion to a family office that is not operated for the purpose of generating a profit. We also note that some family offices may be structured such that all or a portion of family client investment gains are distributed as dividends from the family office (when family clients own the family office) and that a not-for-profit requirement would preclude this family office structure. We were persuaded by several commenters who cautioned against limiting the exclusion for family offices to those that operate on a not-for-profit basis, arguing that it would be difficult to administer and is unnecessary given the limited clientele that a family office may advise and rely on the exclusion. *See, e.g.*, AICPA Letter; Davis Polk Letter; Kozusko Letter.

[1393] [This footnote is not from the quoted material.] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(5) provides:

Family entity means any of the trusts, estates, companies or other entities set forth in paragraphs (d)(4)(v), (vi), (vii), (viii), (ix), or (xi) of this section, but excluding key employees and their trusts from the definition of family client solely for purposes of this definition.

[1394] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(4).

[1395] [This footnote is not from the quoted material.] For the definition of a "family member," see text accompanying fn 1390.

(ii) Any former family member;[1396]

(iii) Any key employee;[1397]

(iv) Any former key employee, provided that upon the end of such individual's employment by the family office, the former key employee shall not receive investment advice from the family office (or invest additional assets with a family office-advised trust, foundation or entity) other than with respect to assets advised (directly or indirectly) by the family office immediately prior to the end of such individual's employment, except that a former key employee shall be permitted to receive investment advice from the family office with respect to additional investments that the former key employee was contractually obligated to make, and that relate to a family-office advised investment existing, in each case prior to the time the person became a former key employee.

(v) Any non-profit organization, charitable foundation, charitable trust (including charitable lead trusts and charitable remainder trusts whose only current beneficiaries[1398] are other family clients and charitable or non-profit organizations), or other charitable organization, in each case for which all the funding such foundation, trust or organization holds came exclusively from one or more other family clients;

(vi) Any estate of a family member, former family member, key employee, or, subject to the condition contained in paragraph (d)(4)(iv) of this section, former key employee;

(vii) Any irrevocable trust in which one or more other family clients are the only current beneficiaries;

(viii) Any irrevocable trust funded exclusively by one or more other family clients in which other family clients and non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations are the only current beneficiaries;

(ix) Any revocable trust of which one or more other family clients are the sole grantor;

(x) Any trust of which: Each trustee or other person authorized to make decisions with respect to the trust is a key employee; and each settlor or other person who has contributed assets to the trust is a key employee or the key employee's current

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1396 [This footnote is not from the quoted material.] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(7) provides:

> Former family member means a spouse, spousal equivalent, or stepchild that was a family member but is no longer a family member due to a divorce or other similar event.

1397 [This footnote is not from the quoted material.] For the definition of a "key employee," see text accompanying fn 1399.

1398 [This footnote is not from the quoted material.] Part II.A.1.c of RIN 3235-AK66, which is SEC Release No. IA-3220; File No. S7-25-10, explains:

> As suggested by commenters, the final rule disregards contingent beneficiaries of trusts, which commenters explained are often named in the event that all family members are deceased to prevent the trust from distributing assets to distant relatives or escheating to the state.[51] If the contingent beneficiary later becomes an actual beneficiary and is not a permitted current beneficiary of a family trust under the exclusion (such as a family friend), the rule's provisions concerning involuntary transfers allow for an orderly transition of investment advice regarding those assets away from the family office.
>
> 51 *See, e.g.*, Comment Letter of Arnold & Porter LLP (Nov. 11, 2010); Bessemer Letter.

and/or former spouse or spousal equivalent who, at the time of contribution, holds a joint, community property, or other similar shared ownership interest with the key employee; or

(xi) Any company wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more other family clients; provided that if any such entity is a pooled investment vehicle, it is excepted from the definition of "investment company" under the Investment Company Act of 1940.

The definition of "key employee" has a few components:[1399]

- A "natural person," including "any key employee's spouse or spouse equivalent[1400] who holds a joint, community property, or other similar shared ownership interest with that key employee."
- Who either:[1401]
  - Is "an executive officer,[1402] director, trustee, general partner, or person serving in a similar capacity of the family office or its affiliated family office,"[1403] or

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[1399] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(8).

[1400] [This footnote was not in the quote.] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(9) provides:

> Spousal equivalent means a cohabitant occupying a relationship generally equivalent to that of a spouse.

[1401] I wasn't quite sure of this breakdown the way that 17 C.F.R. § 275.202(a)(11)(G)-1(d)(8) reads. However, part II.A.1.f of RIN 3235-AK66, which is SEC Release No. IA-3220; File No. S7-25-10, provides:

> The final rule treats certain key employees of the family office, their estates, and certain entities through which key employees may invest as family clients so that they may receive investment advice from, and participate in investment opportunities provided by, the family office. More specifically, the final rule permits the family office to provide investment advice to any natural person (including any key employee's spouse or spousal equivalent who holds a joint, community property or other similar shared ownership interest with that key employee) who is (i) an executive officer, director, trustee, general partner, or person serving in a similar capacity at the family office or its affiliated family office or (ii) any other employee of the family office or its affiliated family office (other than an employee performing solely clerical, secretarial, or administrative functions) who, in connection with his or her regular functions or duties, participates in the investment activities of the family office or affiliated family office, provided that such employee has been performing such functions or duties for or on behalf of the family office or affiliated family office, or substantially similar functions or duties for or on behalf of another company, for at least twelve months.[79] The final rule also permits the family office to advise certain trusts of key employees, as further described below. Finally, in addition to receiving direct advice from the family office, key employees (because they are "family clients") may indirectly receive investment advice through the family office by their investment in family office-advised private funds, charitable organizations, and other family entities, as described in previous sections of this Release.
>
> [79] Rule 202(a)(11)(G)-1(d)(8).

[1402] [This footnote was not in the quote.] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(3) provides:

> Executive officer means the president, any vice president in charge of a principal business unit, division or function (such as administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions, for the family office.

[1403] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(1) provides:

- Is an "employee of the family office or its affiliated family office[1404] (other than an employee performing solely clerical, secretarial, or administrative functions with regard to the family office) who, in connection with his or her regular functions or duties, participates in the investment activities of the family office or affiliated family office, provided that such employee has been performing such functions and duties for or on behalf of the family office or affiliated family office, or substantially similar functions or duties for or on behalf of another company, for at least 12 months."

II.G.4.l.ii. Net Operating Loss Deduction (Code § 172)

If net losses from business activities cause a taxpayer to have a negative taxable income, Code § 172 may allow a taxpayer to deduct a net operating loss (NOL).[1405] Note that one does not generate an NOL until after applying limitations relating to debt-financed or other losses described in parts II.G.4.c Basis Limitations for Deducting Partnership and S Corporation Losses and II.G.4.j At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities).

This part II.G.4.l.ii is intended only to provide a broad overview of how NOLs fit into the overall scheme of loss deductions; it is not intended to teach one how to compute or efficiently use NOLs.

2017 tax reform eliminated the NOL carryback and now provides an unlimited NOL carryforward.[1406] However, the 2020 CARES Act temporarily reinstated the carryback. The Senate Finance Committee Report explained:

> Affiliated family office means a family office wholly owned by family clients of another family office and that is controlled (directly or indirectly) by one or more family members of such other family office and/or family entities affiliated with such other family office and has no clients other than family clients of such other family office.

For the definition of a "family entity," see fn 1393.

[1404] See fn 1403.

[1405] Code § 172(d)(4), "Nonbusiness deductions of taxpayers other than corporations," excludes the following from computing a net operating loss:

> In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business. For purposes of the preceding sentence -
>
> (A) any gain or loss from the sale or other disposition of -
>
> (i) property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or
>
> (ii) real property used in the trade or business,
>
> shall be treated as attributable to the trade or business;
>
> (B) the modifications specified in paragraphs (1), (2)(B), and (3) shall be taken into account;
>
> (C) any deduction for casualty or theft losses allowable under paragraph (2) or (3) of section 165(c) shall be treated as attributable to the trade or business; and
>
> (D) any deduction allowed under section 404 to the extent attributable to contributions which are made on behalf of an individual who is an employee within the meaning of section 401(c)(1) shall not be treated as attributable to the trade or business of such individual.

See also parts II.G.26.b Real Estate as a Trade or Business and II.G.4.l.i Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit.

[1406] Code § 172(a), (b).

Section 2303. Modifications for net operating losses

The provision relaxes the limitations on a company's use of losses. Net operating losses (NOL) are currently subject to a taxable-income limitation, and they cannot be carried back to reduce income in a prior tax year. The provision provides that an NOL arising in a tax year beginning in 2018, 2019, or 2020 can be carried back five years. The provision also temporarily removes the taxable income limitation to allow an NOL to fully offset income. These changes will allow companies to utilize losses and amend prior year returns, which will provide critical cash flow and liquidity during the COVID-19 emergency.

Section 2304. Modification of limitation on losses for taxpayers other than corporations

The provision modifies the loss limitation applicable to pass-through businesses and sole proprietors, so they can utilize excess business losses and access critical cash flow to maintain operations and payroll for their employees.

Note that the 2020 CARES Act provision described above and effectuated below does not provide immediate relief for 2020 losses, because 2020 NOLs will not be determined until taxpayers file their 2020 returns in the spring of 2021. However, a taxpayer owing 2019 tax might be able to get an installment agreement with the IRS and then use the NOL towards payments deferred until 2021 and future years. If an owner of a pass-through entity pledges his anticipated NOL carryback refund (offsetting income from that entity reported on prior years' returns) to secure a loan to the entity while entity is in bankruptcy, the bankruptcy court may enforce that pledge;[1407] furthermore, a refund of taxes paid with respect to one spouse's income is not tenancy-by-the-entirety property.[1408] The IRS has posted unofficial guidance as Frequently Asked Questions: Temporary procedures to fax certain Forms 1139 and 1045 due to COVID-19; if that link does not work or to get information on this and other topics regarding the 2020 CARES Act, go to Coronavirus Tax Relief and Economic Impact Payments.

Accordingly, Code § 172(a) allows "a deduction for the taxable year an amount equal to"

(1) in the case of a taxable year beginning before January 1, 2021, the aggregate of the net operating loss carryovers to such year, plus the net operating loss carrybacks to such year, and

(2) in the case of a taxable year beginning after December 31, 2020, the sum of -

(A) the aggregate amount of net operating losses arising in taxable years beginning before January 1, 2018, carried to such taxable year, plus

(B) the lesser of -

(i) the aggregate amount of net operating losses arising in taxable years beginning after December 31, 2017, carried to such taxable year, or

[1407] *In re: Somerset Regional Water Resources, LLC*, 949 F.3d 837 (3rd Cir. 2020), interpreting an ambiguous pledge agreement in favor of providing the security the lender reasonably expected.
[1408] *In re: Somerset Regional Water Resources, LLC*, 949 F.3d 837 (3rd Cir. 2020), with an extensive quote on this subject in the text accompanying fn 1145 in part II.F.7 Tenancy by the Entirety.

(ii) 80 percent of the excess (if any) of –[1409]

(I) taxable income computed without regard to the deductions under this section and sections 199A and 250, over

(II) the amount determined under subparagraph (A).

Code § 172(b), "Net operating loss carrybacks and carryovers," includes:

- (1) "Years to which loss may be carried,"
- (2) "Amount of carrybacks and carryovers," and
- (3) "Election to waive carryback."

Code § 172(b)(1)(D), "Special Rule For Losses Arising in 2018, 2019, and 2020," provides:

(i) *In General.* In the case of any net operating loss arising in a taxable year beginning after December 31, 2017, and before January 1, 2021 -

(I) such loss shall be a net operating loss carryback to each of the 5 taxable years preceding the taxable year of such loss, and

(II) subparagraphs (B) and (C)(i) shall not apply.

P.L. 116-260, § 281(a), Div. N, added § 2303(e) to P.L. 116-136, retroactively, so that P.L. 116-136, § 2303(e), "Special rules with respect to farming losses," provides:

(1) *Election to disregard application of amendments made by subsections (a) and (b)*.

(A) *In general*. If a taxpayer who has a farming loss (within the meaning of section 172(b)(1)(B)(ii) of the Internal Revenue Code of 1986) for any taxable year beginning in 2018, 2019, or 2020 makes an election under this paragraph, then -

(i) the amendments made by subsection (a) shall not apply to any taxable year beginning in 2018, 2019, or 2020, and

(ii) the amendments made by subsection (b) shall not apply to any net operating loss arising in any taxable year beginning in 2018, 2019, or 2020.

(B) *Election*.

(i) *In general*. Except as provided in clause (ii)(II), an election under this paragraph shall be made in such manner as may be prescribed by the Secretary. Such election, once made, shall be irrevocable.

[1409] [My footnote:] The 2020 CARES Act also amended Code § 172(b)(2)(C) to provide that, "For purposes of the preceding sentence, the taxable income for any such prior taxable year shall" …

(C) for taxable years beginning after December 31, 2020, be reduced by 20 percent of the excess (if any) described in subsection (a)(2)(B)(ii) for such taxable year.

(ii) *Time for making election*.

(I) *In general*. An election under this paragraph shall be made by the due date (including extensions of time) for filing the taxpayer's return for the taxpayer's first taxable year ending after the date of the enactment of the COVID-related Tax Relief Act of 2020.

(II) *Previously filed returns*. In the case of any taxable year for which the taxpayer has filed a return of Federal income tax before the date of the enactment of the COVID-related Tax Relief Act of 2020 which disregards the amendments made by subsections (a) and (b), such taxpayer shall be treated as having made an election under this paragraph unless the taxpayer amends such return to reflect such amendments by the due date (including extensions of time) for filing the taxpayer's return for the first taxable year ending after the date of the enactment of the COVID-related Tax Relief Act of 2020.

(C) *Regulations*. The Secretary of the Treasury (or the Secretary's delegate) shall issue such regulations and other guidance as may be necessary to carry out the purposes of this paragraph, including regulations and guidance relating to the application of the rules of section 172(a) of the Internal Revenue Code of 1986 (as in effect before the date of the enactment of the CARES Act) to taxpayers making an election under this paragraph.

(2) *Revocation of election to waive carryback*. The last sentence of section 172(b)(3) of the Internal Revenue Code of 1986 and the last sentence of section 172(b)(1)(B) of such Code shall not apply to any election -

(A) which was made before the date of the enactment of the COVID-related Tax Relief Act of 2020, and

(B) which relates to the carryback period provided under section 172(b)(1)(B) of such Code with respect to any net operating loss arising in taxable years beginning in 2018 or 2019."

Rev. Proc. 2021-14, Section 1.02 provides:

> Specifically, this revenue procedure prescribes when and how to make an election with regard to all NOLs of the taxpayer, regardless of whether the NOL is a Farming Loss NOL. This revenue procedure also provides that a taxpayer is treated as having made a deemed election under § 2303(e)(1) of the CARES Act if the taxpayer, before December 27, 2020, filed one or more original or amended Federal income tax returns, or applications for tentative refund, that disregard the CARES Act Amendments with regard to a Farming Loss NOL. This revenue procedure further prescribes when and how to revoke an election made under § 172(b)(1)(B)(iv) or § 172(b)(3) of the Code to waive the two-year carryback period for the farming loss portion of a Farming Loss NOL incurred in a taxable year beginning in 2018 or 2019.

More about NOL carryback procedures under Code § 172 follows after discussing the limits Code § 461(*l*) places on individuals.

IRS training on 2017 changes, "Modification of Net Operating Loss Deduction," is at https://www.irs.gov/pub/newsroom/tcja-training-provision-13302-modified-nol.pdf. The Internal Revenue Manual procedural update, "Carryback CARES Act Guidance," amended IRM subsection 21.5.9, at https://www.irs.gov/pub/foia/ig/wi/wi-21-0520-0589_redacted.pdf.

Code § 461(*l*), "Limitation on Excess Business Losses of Noncorporate Taxpayers," provides:

(1) *Limitation*. In the case of taxable year of a taxpayer other than a corporation -

(A) for any taxable year beginning after December 31, 2017, and before January 1, 2026, subsection (j) (relating to limitation on excess farm losses of certain taxpayers) shall not apply, and

(B) for any taxable year beginning after December 31, 2020, and before January 1, 2026, any excess business loss of the taxpayer for the taxable year shall not be allowed.

(2) *Disallowed Loss Carryover*. Any loss which is disallowed under paragraph (1) shall be treated as net operating loss for the taxable year for purposes of determining any net operating loss carryover under section 172(b) for subsequent taxable years.

(3) *Excess Business Loss*. For purposes of this subsection -

(A) *In General*. The term "excess business loss" means the excess (if any) of –

(i) the aggregate deductions of the taxpayer for the taxable year which are attributable to trades or businesses of such taxpayer (determined without regard to whether or not such deductions are disallowed for such taxable year under paragraph (1) and without regard to any deduction allowable under section 172 or 199A),[1410] over

(ii) the sum of –

(I) the aggregate gross income or gain of such taxpayer for the taxable year which is attributable to such trades or businesses, plus

(II) $250,000 (200 percent of such amount in the case of a joint return).

Such excess shall be determined without regard to any deductions, gross income, or gains attributable to any trade or business of performing services as an employee.

(B) *Treatment Of Capital Gains And Losses*.

(i) *Losses*. Deductions for losses from sales or exchanges of capital assets shall not be taken into account under subparagraph (A)(i).

[1410] [My footnote:] See part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income, especially fn 773 in part II.E.1.c.i.(b) Other Federal Effects of Code § 199A Deduction.

(ii) *Gains*. The amount of gains from sales or exchanges of capital assets taken into account under subparagraph (A)(ii) shall not exceed the lesser of -

(I) the capital gain net income determined by taking into account only gains and losses attributable to a trade or business, or

(II) the capital gain net income.

(C) *Adjustment for Inflation*. In the case of any taxable year beginning after December 31, 2018, the $250,000 amount in subparagraph (A)(ii)(II) shall be increased by an amount equal to -

(i) such dollar amount, multiplied by

(ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting "2017" for "2016" in subparagraph (A)(ii) thereof.

If any amount as increased under the preceding sentence is not a multiple of $1,000, such amount shall be rounded to the nearest multiple of $1,000.

(4) *Application of Subsection in Case of Partnerships and S Corporations*. In the case of a partnership or S corporation -

(A) this subsection shall be applied at the partner or shareholder level, and

(B) each partner's or shareholder's allocable share of the items of income, gain, deduction, or loss of the partnership or S corporation for any taxable year from trades or businesses attributable to the partnership or S corporation shall be taken into account by the partner or shareholder in applying this subsection to the taxable year of such partner or shareholder with or within which the taxable year of the partnership or S corporation ends.

For purposes of this paragraph, in the case of an S corporation, an allocable share shall be the shareholder's pro rata share of an item.

(5) *Additional Reporting*. The Secretary shall prescribe such additional reporting requirements as the Secretary determines necessary to carry out the purposes of this subsection.

(6) *Coordination with Section 469*. This subsection shall be applied after the application of section 469.[1411]

As to Code § 461(*l*), IRS training, "Limitation on Losses for Taxpayers other than Corporations," is at https://www.irs.gov/pub/newsroom/tcja-training-provision-11012-limits-on-losses.pdf.

I have heard uncertainty expressed regarding how alternative minimum tax (AMT) carrybacks work for C corporations, given that AMT income is no longer calculated because 2017 tax reform repealed AMT for 2018 and future years.

[1411] [My footnote:] For Code § 469, see part II.K Passive Loss Rules.

Guidance under the 2020 CARES Act helps taxpayers expedite their tentative NOL carryback refunds. Such a tentative refund generally pays the taxpayer the claimed refund (generally within 90 days of making the claim) and is subject to review, etc. after the refund. Notice 2020-26 "extends the deadline for filing an application for a tentative carryback adjustment … with respect to the carryback of an NOL that arose in any taxable year that began during calendar year 2018 and that ended on or before June 30, 2019."[1412] Rev. Proc. 2020-24 provides guidance regarding elections relating to NOL carrybacks from 2018, 2019, or 2020.[1413]

CCA 201928014 explained how its author believed a corporation computes its charitable deduction[1414] in conjunction with net operating losses:

> <u>ISSUES</u>
>
> (1) Taxpayer has both charitable contribution and net operating loss carryovers from multiple tax years available in the year at issue. Section 170(d)(2)(B) requires a reduction to a taxpayer's charitable contribution carryover to the extent an excess charitable contribution reduces modified taxable income (as computed under § 172(b)(2)) and increases an NOL carryover, so as to eliminate a double tax benefit. Is Taxpayer required to calculate the charitable contribution carryover adjustment using a year-by-year or an aggregate NOL computation under § 172(b)(2)?
>
> (2) Taxpayer has a charitable contribution carryover set to expire in the year at issue pursuant to the five-year carryover period provided in § 170(d)(2).

[1412] Notice 2020-26, Section 3, "Extension of Time to File," begins with:

> The Department of the Treasury and the IRS grant a six-month extension of time to file Form 1045 or Form 1139, as applicable, to taxpayers that have an NOL that arose in a taxable year that began during calendar year 2018 and that ended on or before June 30, 2019. This extension of time is limited to requesting a tentative refund to carry back an NOL and does not extend the time to carry back any other item.
>
> For example, in the case of an NOL that arose in a taxable year ending on December 31, 2018, a taxpayer normally would have until December 31, 2019, to file the Form 1045 or Form 1139, as applicable, but due to this relief, will now have until June 30, 2020, to file the Form 1045 or Form 1139, as applicable. For this same taxpayer, if the taxpayer is a corporation, the deadline to claim a minimum tax credit described in § 53(e)(5) is December 30, 2020, but in order to file one application for a tentative refund and claim both the NOL carryback and the minimum tax credit at the same time, the taxpayer must do so by the earlier of the two deadlines.

[1413] Rev. Proc. 2020-24, Section 1.02 provides:

> This revenue procedure prescribes when and how to file the following elections.
>
> (1) *Election to waive NOL carryback*. Section 4.01(1) of this revenue procedure provides guidance regarding an election under § 172(b)(3) to waive the carryback period for an NOL arising in a taxable year beginning after December 31, 2017, and before January 1, 2020.
>
> (2) *Election to exclude section 965 years*. Section 4.01(2) of this revenue procedure provides guidance regarding an election under § 172(b)(1)(D)(v)(I) to exclude from the carryback period for an NOL arising in a taxable year beginning after December 31, 2017, and before January 1, 2021, any taxable year in which the taxpayer has a section 965(a) inclusion, as defined in § 1.965-1(f)(37) (a section 965 year).
>
> (3) *Elections under the CARES Act special rule concerning taxable years beginning before January 1, 2018, and ending after December 31, 2017*. Section 4.04(1) of this revenue procedure provides guidance regarding elections under the special rule set forth in § 2303(d) of the CARES Act to waive any carryback period, to reduce any carryback period, or to revoke any election made under § 172(b) to waive any carryback period for a taxable year that began before January 1, 2018, and ended after December 31, 2017.

[1414] See part II.G.4.g Limitations on Deducting Charitable Contributions, especially fn 1239.

Section 170(d)(2)(B) requires a reduction to a taxpayer's charitable contribution carryover to the extent an excess charitable contribution reduces modified taxable income (as computed under § 172(b)(2)) and increases an NOL carryover. Is Taxpayer required to reduce its current year charitable contributions first or can it choose to reduce a prior year's charitable contribution carryover to prevent its expiration?

<u>CONCLUSIONS</u>

(1) Section 172(b)(2) requires Taxpayer to use a year-by-year NOL absorption computation to determine the charitable contribution carryover adjustment under § 170(d)(2)(B).

(2) Taxpayer must first reduce its current year charitable contributions by the adjustment under § 170(d)(2)(B) before reducing its earliest year's charitable contribution carryover.

CCA 201928014 provided an example:

X Corp had $1,000 of taxable income in 2017 before considering its NOL carryovers or charitable contribution deduction. X Corp had NOL carryovers of $5,000 available to use in 2017, which included $100 from 2012 and $1,500 from 2013. X Corp also had charitable carryovers available to use in 2017 of $300, which included $150 from 2012. In 2017, X Corp made charitable contributions of $120.

In this example, like in Taxpayer's case, X Corp cannot deduct any charitable contributions in 2017 because the NOL carryovers reduce taxable income for 2017 to $0. But, like Taxpayer, X Corp still must compute the 10% limit for purposes of determining modified taxable income and the amount of the NOL carryovers that are absorbed.

First, X Corp must subtract its 2012 NOL from its 2017 taxable income to determine the § 170 taxable income ($1,000-$100=$900). X Corp must then multiply its § 170 taxable income by the 10% limitation ($900x10=$90). The $90 represents the amount of the 2017 charitable contribution that is allowed for purposes of calculating modified taxable income under § 172(b)(2).

Second, because X Corp cannot deduct any charitable contributions in 2017 and it has NOL and charitable carryovers, it must determine how much of the 2017 charitable contributions it can carry over to 2018 after applying the § 170(d)(2)(B) adjustment. X Corp must reduce its 2017 charitable contributions by $90 because that amount was allowed in the modified taxable income calculation ($900-$90=$810), resulting in an increased NOL carryover to 2018 and the charitable contributions not actually being deducted. The result is that only $30 ($120-$90) of the 2017 charitable contributions is allowed to be carried over to 2018.

Lastly, X Corp must calculate the amount of the 2013 NOL carryover that is absorbed under § 172(b)(2) and the amount carried over to 2018. The 2013 NOL carryover is reduced by the amount absorbed, which is the 2017 modified taxable income, and the remainder is carried over to 2018 ($1,500-$810=$690).

II.G.4.l.iii. Code § 267 Disallowance of Related-Party Deductions or Losses

Code § 267(a) disallows certain related-party deductions or losses.[1415]

Code § 267(b) applies the following relationships for subsection (a):

(1) Members of a family, as defined in subsection (c)(4);

(2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

(3) Two corporations which are members of the same controlled group (as defined in subsection (f));

(4) A grantor and a fiduciary of any trust;

[1415] Code § 267(a) provides:

(1) *Deduction for losses disallowed*. No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b). The preceding sentence shall not apply to any loss of the distributing corporation (or the distributee) in the case of a distribution in complete liquidation.

(2) *Matching of deduction and payee income item in the case of expenses and interest*. If—

(A) by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not (unless paid) includible in the gross income of such person, and

(B) at the close of the taxable year of the taxpayer for which (but for this paragraph) the amount would be deductible under this chapter, both the taxpayer and the person to whom the payment is to be made are persons specified in any of the paragraphs of subsection (b),

then any deduction allowable under this chapter in respect of such amount shall be allowable as of the day as of which such amount is includible in the gross income of the person to whom the payment is made (or, if later, as of the day on which it would be so allowable but for this paragraph). For purposes of this paragraph, in the case of a personal service corporation (within the meaning of section 441(i)(2)), such corporation and any employee-owner (within the meaning of section 269A(b)(2), as modified by section 441(i)(2)) shall be treated as persons specified in subsection (b).

(3) *Payments to foreign persons*.

(A) *In general*. The Secretary shall by regulations apply the matching principle of paragraph (2) in cases in which the person to whom the payment is to be made is not a United States person.

(B) *Special rule for certain foreign entities*.

(i) *In general*. Notwithstanding subparagraph (A), in the case of any item payable to a controlled foreign corporation (as defined in section 957) or a passive foreign investment company (as defined in section 1297), a deduction shall be allowable to the payor with respect to such amount for any taxable year before the taxable year in which paid only to the extent that an amount attributable to such item is includible (determined without regard to properly allocable deductions and qualified deficits under section 952(c)(1)(B)) during such prior taxable year in the gross income of a United States person who owns (within the meaning of section 958(a)) stock in such corporation.

(ii) *Secretarial authority*. The Secretary may by regulation exempt transactions from the application of clause (i), including any transaction which is entered into by a payor in the ordinary course of a trade or business in which the payor is predominantly engaged and in which the payment of the accrued amounts occurs within 8½ months after accrual or within such other period as the Secretary may prescribe.

(5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

(6) A fiduciary of a trust and a beneficiary of such trust;

(7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

(8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;

(9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;

(10) A corporation and a partnership if the same persons own -

(A) more than 50 percent in value of the outstanding stock of the corporation, and

(B) more than 50 percent of the capital interest, or the profits interest, in the partnership;

(11) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;

(12) An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or

(13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

Grantor trusts are disregarded from their deemed owners for this purpose. See CCA 201343021.[1416]

Before the 1997 enactment of Code § 267(b)(13), Rev. Rul. 77-439 involved the following facts and held:

> An estate sustained a loss from the sale of property (other than stock) to the estate's executor, who was a child of the decedent.
>
> *Held*, section 267 of the Internal Revenue Code of 1954 does not disallow a deduction for the loss sustained by the estate upon its sale of the property to the executor, because the sale was not between related parties described in section 267(b) but between an estate and an individual. See *Estate of Hanna v. Commissioner*, 319 F.2d 54 [sic, 320 F.2d 54] (6th Cir. 1963).

[1416] See fn 6523 in part III.B.2.d.i.(a) General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation.

Rev. Rul. 77-439 remains important after that enactment, in case an estate sells to an executor who is not a beneficiary. Furthermore, it cited with approval *Estate of Hanna*, which reasoned and held:

> The disallowance of the loss by the Commissioner was under Section 267(b)(2) which disallows a loss resulting from a sale or exchange of property between an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual. Although the sale or exchange was between an estate and a corporation, instead of between an individual and a corporation as specified in the statute, the Commissioner contends that under Section 267(c)(1) the stock owned by the estate is considered as being owned by the beneficiaries of the estate, and under Section 267(c)(2) and (4) an individual is considered as owning the stock owned by or for his family, which includes sisters. The net result of this reasoning is that the stock was sold by a sister, who was an individual rather than an estate, and that such sister, being considered as owning the stock of the other sisters, owned more than 50 percent of the outstanding stock of the redeeming corporation. The Tax Court adopted this reasoning and interpretation of Section 267 in disallowing the deduction.
>
> We are of the opinion that this is not the correct construction of Section 267 and that the deduction should be allowed.
>
> Is it clear that under Section 267(a) and (b) losses resulting from sales or exchanges of property, otherwise deductible, are disallowed only if such sales or exchanges are between specified persons. Of the nine specified types of transactions in which losses are disallowed, no one of them by its terms covers the transactions in this case. The only one claimed by the Commissioner to be applicable is the one specified in Section 267(b)(2), namely a sale or exchange between an individual and a corporation. The sale or exchange in the present case was between an estate and a corporation. Clearly, an individual and an estate are not the same. *Estate of Charles C. Ingalls v. Commissioner*, 45 B.T.A. 787, 792; Section 7701(a)(1), Internal Revenue Code, 1954. The Commissioner does not so contend. Accordingly, unless there is some other applicable statutory provision, the deduction cannot be disallowed under Section 267(b)(2).
>
> The question is thus presented whether the provisions of Section 267(b)(2) are changed by the provisions of Section 267(c)(1), (2) and (4), as contended by the Commissioner.
>
> Section 267(c), by its title, deals with the "Constructive Ownership of Stock." It does not say that a sale by an estate is to be considered as a sale by an individual, thus enlarging the transactions barred by Section 267(b). It states the rules to be followed in determining the "ownership of stock" in applying Section 267(b)(2). Under Section 267(b)(2) the ownership of stock is a crucial item in that an individual selling to a corporation cannot take a loss as a deduction if "such individual" owns more than 50 per cent in value of the outstanding stock. In determining that question "such individual" is constructively charged with the ownership of stock by others under circumstances set out in Section 267(c). If Congress intended to disallow losses from sales by an estate in addition to losses from sales by an individual, which is the result sought by the Commissioner in this case, it could easily have done so in express language in Section 267(b)(2) where, in barring losses in sales between "An individual and a corporation" it could have simply said sales between "An individual or an estate and a corporation." Having failed to do so, we do not think we are justified in so enlarging

> Section 267(b)(2) by implications drawn from another section of the statute dealing with the constructive ownership of stock.
>
> The Commissioner and the Tax Court rely upon *Estate of Charles C. Ingalls v. Commissioner*, *supra*, 45 B.T.A. 787, affirmed by this Court, 132 F.(2) 862. The affirmance by this Court, however, is of no significance, in that the issue involved in the present case was only one of the two issues decided by the Board of Tax Appeals in that case. This issue was decided by the Board in favor of the taxpayer, of which ruling the Commissioner did not seek a review. The other issue, which is not involved in the present case, was decided adversely to the taxpayer, of which ruling the taxpayer sought a review. Our affirmance, in a very short Per Curiam, dealt with that issue only, not the issue in the present case which was not before the Court.
>
> We agree with the Tax Court, that although the ruling by the Board of Tax Appeals in the Ingalls case was in favor of the taxpayer, it was the result of a factual situation different from that in the present case, and that the rationale of the Ingalls case, if followed here, would result in an affirmance of the Tax Court. One member of the Tax Court, in a separate concurring opinion, disagreed with the rationale in the Ingalls opinion and expressed the view that we have expressed in this opinion, but felt constrained in view of the prior ruling to apply the rationale of the Ingalls opinion.
>
> We have been referred to no other case in which this question has been passed upon. We are not in accord with the rationale of the *Ingalls* case and are of the opinion that it should not be adopted in the present case.
>
> The decision of the Tax Court is reversed and the case remanded for further proceedings consistent with the views expressed herein.

Rev. Rul. 59-171 held:

> B and C are trustees of separate trusts created by the same grantor. Solely for his own account, B sold at a loss certain securities owned by him personally to C. C made the purchase for his own account, and not as a fiduciary….
>
> The legislative history of this section of the Code clearly shows that Congress intended to prevent the original grantor of certain funds from creating artificial deductions for tax avoidance purposes, choosing by artificial means the time for realizing tax losses, or otherwise exercising control over certain trust assets for such Federal tax purpose. To the same effect, Congress intended to prohibit transactions between fiduciaries acting in their capacity as fiduciaries. See House of Representatives Report No. 1546, C.B. 1939-1 (Part 2), 723. However, so long as the trustees of the common grantor are dealing with personal funds, or property not derived from the original grantor, deductions for any losses so sustained are not prohibited by section 267 of the Code.
>
> Accordingly, the deduction of the loss sustained by taxpayer B upon the sale of securities owned by him solely for his own account to the personal account of C is not prohibited by section 267 of the Code.

Rev. Rul. 56-222 held:

> Where certain stock owned by a decedent's estate is made the subject of a bona fide sale by the executor to an inter vivos trust which the decedent, as grantor, created for the benefit of his widow any loss sustained on such sale does not constitute the type of loss disallowed by section 267(a) of the Internal Revenue Code of 1954. Such loss constitutes a capital loss and is deductible from the gross income of the estate to the extent provided in section 1211(b) of the Code.

Reg. § 1.267(b)-1, "Relationships," provides:

(a) *In general*.

(1) The persons referred to in section 267(a) and § 1.267(a)-1 are specified in section 267(b).

(2) Under section 267(b)(3), it is not necessary that either of the two corporations be a personal holding company or a foreign personal holding company for the taxable year in which the sale or exchange occurs or in which the expenses or interest are properly accruable, but either one of them must be such a company for the taxable year next preceding the taxable year in which the sale or exchange occurs or in which the expenses or interest are accrued.

(3) Under section 267(b)(9), the control of certain educational and charitable organizations exempt from tax under section 501 includes any kind of control, direct or indirect, by means of which a person in fact controls such an organization, whether or not the control is legally enforceable and regardless of the method by which the control is exercised or exercisable. In the case of an individual, control possessed by the individual's family, as defined in section 267(c)(4) and paragraph (a)(4) of § 1.267(c)-1, shall be taken into account.

(b) *Partnerships*.

(1) Since section 267 does not include members of a partnership and the partnership as related persons, transactions between partners and partnerships do not come within the scope of section 267. Such transactions are governed by section 707 for the purposes of which the partnership is considered to be an entity separate from the partners. See section 707 and § 1.707-1. Any transaction described in section 267(a) between a partnership and a person other than a partner shall be considered as occurring between the other person and the members of the partnership separately. Therefore, if the other person and a partner are within any one of the relationships specified in section 267(b), no deductions with respect to such transactions between the other person and the partnership shall be allowed—

(i) To the related partner to the extent of his distributive share of partnership deductions for losses or unpaid expenses or interest resulting from such transactions, and

(ii) To the other person to the extent the related partner acquires an interest in any property sold to or exchanged with the partnership by such other person at a loss, or to the extent of the related partner's distributive share of the unpaid expenses or interest payable to the partnership by the other person as a result of such transaction.

(2) The provisions of this paragraph may be illustrated by the following examples:

Example (1). A, an equal partner in the ABC partnership, personally owns all the stock of M Corporation. B and C are not related to A. The partnership and all the partners use an accrual method of accounting, and are on a calendar year. M Corporation uses the cash receipts and disbursements method of accounting and is also on a calendar year. During 1956 the partnership borrowed money from M Corporation and also sold property to M Corporation, sustaining a loss on the sale. On December 31, 1956, the partnership accrued its interest liability to the M Corporation and on April 1, 1957 (more than 2½ months after the close of its taxable year), it paid the M Corporation the amount of such accrued interest. Applying the rules of this paragraph, the transactions are considered as occurring between M Corporation and the partners separately. The sale and interest transactions considered as occurring between A and the M Corporation fall within the scope of section 267(a) and (b), but the transactions considered as occurring between partners B and C and the M Corporation do not. The latter two partners may, therefore, deduct their distributive shares of partnership deductions for the loss and the accrued interest. However, no deduction shall be allowed to A for his distributive shares of these partnership deductions. Furthermore, A's adjusted basis for his partnership interest must be decreased by the amount of his distributive share of such deductions. See section 705(a)(2).

Example (2). Assume the same facts as in example (1) of this subparagraph except that the partnership and all the partners use the cash receipts and disbursements method of accounting, and that M Corporation uses an accrual method. Assume further, that during 1956 M Corporation borrowed money from the partnership and that on a sale of property to the partnership during that year M Corporation sustained a loss. On December 31, 1956, the M Corporation accrued its interest liability on the borrowed money and on April 1, 1957 (more than 2½ months after the close of its taxable year) it paid the accrued interest to the partnership. The corporation's deduction for the accrued interest it not allowed to the extent of A's distributive share (one-third) of such interest income. M Corporation's deduction for the loss on the sale of the property to the partnership is not allowed to the extent of A's one-third interest in the purchased property.

However, REG-131756-11 (11/27/2023) explains:

> As part of enacting the Internal Revenue Code of 1954, Public Law 83-591, ch. 736, 68A Stat. 1 (1954), Congress added section 707(b)(1) to the Code to address the sale or exchange of property between a partnership and a partner owning, directly or indirectly, more than 50 percent of the capital or profit interest in the partnership. 68A Stat. at 243. Given a lack of statutory and regulatory guidance addressing transactions between a partnership and a related person who was not a partner, the Treasury Department and the IRS issued § 1.267(b)-1(b) in 1958. See TD 6312, 23 FR 7035 (Sep. 11, 1958).

Section 1.267(b)-1(b) applies an aggregate theory of partnerships to provide that any transaction described in section 267(a) between a partnership and a person other than a partner is considered as occurring between the other person and the members of the partnership separately. Specifically, § 1.267(b)-1(b) provides that if the other person and a partner are within any of the relationships specified in section 267(b), no deductions with respect to the transaction between the other person and the partnership will be allowed: (i) to the related partner to the extent of the related partner's distributive share of partnership deductions for losses or unpaid expenses or interest resulting from the transactions, and (ii) to the other person to the extent the related partner acquires an interest in any property sold to or exchanged with the partnership by the other person at a loss, or to the extent of the related partner's distributive share of the unpaid expenses or interest payable to the partnership by the other person as a result of the transaction.

The U.S. Tax Court upheld the validity of § 1.267(b)-1(b) and its use of the aggregate theory in *Casel v. Commissioner*, 79 T.C. 424 (1982). However, subsequent statutory changes to sections 267 and 707(b) have made § 1.267(b)-1(b) inconsistent with the statute.

In 1982, Congress enacted section 3(h)(1) of the Subchapter S Revision Act of 1982, Public Law 97-354, 96 Stat. 1669, 1689 (1982) to add section 267(b)(10) to the Code to disallow a deduction resulting from a transaction between a commonly-controlled partnership and an S corporation. Specifically, section 267(b)(10) provides that an S corporation and a partnership were related persons if the same persons owned more than 50 percent of the outstanding stock of the S corporation and more than 50 percent of the capital interest or the profits interest in the partnership.

In 1984, Congress enacted section 174(b)(1) of the Tax Reform Act of 1984 (TRA 1984), Public Law 98-369, 98 Stat. 494, 705 (1984), to add section 267(e) to the Code generally to extend the matching rule of section 267(a)(2) to transactions between a partnership and a partner or a person related to a partner (within the meaning of sections 267(b) or 707(b)(1)). Congress also enacted section 174(b)(3) of the TRA 1984, 98 Stat. at 707, to amend section 267(b)(10) to include C corporations as well as S corporations.

In 1985, the Treasury Department and the IRS issued § 1.267(a)-2T(c) to provide guidance for transactions between related partnerships. Consistent with the legislative history of the TRA 1984, the regulations generally apply an aggregate theory of partnerships in deferring deductions according to the partners' aggregate interests in the payor partnership. See S. Rep. No. 98-169, 98th Cong., 2nd Sess., at 496 and n. 17 (1984); TD 7991, 49 FR 46992 (Nov. 30, 1984).

In the Tax Reform Act of 1986 (TRA 1986), Public Law 99-514, 100 Stat. 2085 (1986), Congress amended section 707(b) in two ways.[1417] First, Congress revised sections 707(b)(1)(A) and 707(b)(2)(A) to expand the application of those provisions to a person who is not a partner and modified section 707(b)(2) to reduce the thresholds described in that section from more than 80 percent of profits or capital to more than 50 percent of profits or capital for purposes of treating recognized gain between related persons as ordinary income. As amended by section 1812(c)(3) of the TRA 1986, 100

[1417] [my footnote:] Code § 707(b) is described in part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

Stat. at 2834, the loss disallowance rules of section 707(b)(1)(A) and the character of gain rules of section 707(b)(2)(A) apply to transactions between a partnership and any person (a partner or non-partner) who directly or indirectly owns more than 50 percent of the capital or profits interest in the partnership. See sections 707(b)(1)(A), (b)(2)(A), and (b)(3).

Second, in enacting section 642(a)(2) of the TRA 1986, 100 Stat. at 2284, Congress amended section 707(b)(1)(B) to provide that for purposes of the matching rule in section 267(a)(2), two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests are treated as related persons within the meaning of section 267(b). The related committee reports state that the modifications to section 707(b), and in particular to section 707(b)(1)(B), were intended to replace Questions and Answers 2 and 3 of § 1.267(a)-2T(c). See H. Rept. No. 99-426, 99th Cong., 1st Sess., at 940 and n. 7 (1986), 1986-3 C.B. Vol. 2, at 940 and n. 7; S. Rep. No. 99-313, 99th Cong., 2nd Sess., at 960 and n. 7, 1986-3 C.B. Vol. 3, 959, 960 and n. 7.

Explanation of Provisions

The statutory changes to sections 267 and 707(b) enacted since 1982 indicate that Congress intended for a partnership to be viewed as an entity, rather than as an aggregate of its partners, in applying the rules of sections 267 and 707(b). Therefore, the loss disallowance rules of sections 267(a)(1) and 707(b)(1), the gain recharacterization rules of section 707(b)(2), and the matching rule of section 267(a)(2) similarly should be applied at the partnership level and not the partner level. Accordingly, the rules relating to partnerships in § 1.267(b)-1(b) and § 1.267(a)-2T(c), Questions and Answers 2 and 3, do not conform to Congress's view of how section 267 should be applied to partnerships.

To conform the regulations under section 267 with the current statute, the proposed regulations propose: (1) to remove § 1.267(b)-1(b), (2) to amend § 1.267(a)-1 to reflect the rules in Questions and Answers 1 and 4 in § 1.267(a)-2T(c) as § 1.267(a)-1(d)(2) and (3); and (3) to amend § 1.267(a)-1 to terminate the application of Questions and Answers 2 and 3 in § 1.267(a)-2T(c). The regulations under § 1.267(a)-2T(b), which provide questions and answers applying section 267(a)(2) and (b) generally, would continue to apply. The Treasury Department and IRS are aware that some of the citations in the existing regulations under section 267 may be outdated due to subsequent legislative and regulatory changes. However, the rules in these questions and answers remain substantively accurate. For example, Question 1 under § 1.267(a)-2T(b) refers to the completed contract method under § 1.451-3(d). The substance of this answer remains correct; however, the correct citation to the completed contract method is now under § 1.460-4(d). Modifications to update incorrect citations in § 1.267(a)-2T(b) are outside the scope of these proposed regulations. Finally, these proposed regulations also revise § 1.707-1(b) to conform to the statutory changes made to sections 267 and 707(b).

Code § 267(c) applies the following rules in determining the ownership of stock subsection (b):[1418]

(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

(3) An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(5) Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

Liflans Corp. v. U.S., 390 F.2d 965 (Ct. Cl. 1968), applied Code § 267(c)(5):

> She owned no shares of plaintiff's stock; she may be considered to own constructively only the 28⅓ percent held by her husband through the application of Section 267(c)(2). She cannot be deemed to own the shares constructively owned by her husband through his partnership with Fried and Lifter, since Section 267(c)(5) provides that stock constructively owned by her husband through the application of Section 267(c)(3) "shall not be treated as owned by him for the purpose of again applying (paragraph 2) in order to make another the constructive owner of such stock".

Reg. § 1.267(c)-1, "Constructive ownership of stock," provides:

(a) *In general*.

(1) The determination of stock ownership for purposes of section 267(b) shall be in accordance with the rules in section 267(c).

(2) For an individual to be considered under section 267(c)(2) as constructively owning the stock of a corporation which is owned, directly or indirectly, by or for members of his family it is not necessary that he own stock in the corporation either directly or indirectly. On the other hand, for an individual to be considered under section 267(c)(3) as owning the stock of a corporation owned either actually, or constructively under section 267(c)(1), by or for his partner, such

[1418] Code § 267(c) also applies for attribution in certain partnership related-party transactions. See fn 5569 in part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

individual must himself actually own, or constructively own under section 267(c)(1), stock of such corporation.

(3) An individual's constructive ownership, under section 267(c)(2) or (3), of stock owned directly or indirectly by or for a member of his family, or by or for his partner, is not to be considered as actual ownership of such stock, and the individual's constructive ownership of the stock is not to be attributed to another member of his family or to another partner. However, an individual's constructive ownership, under section 267(c)(1), of stock owned directly or indirectly by or for a corporation, partnership, estate, or trust shall be considered as actual ownership of the stock, and the individual's ownership may be attributed to a member of his family or to his partner.

(4) The family of an individual shall include only his brothers and sisters, spouse, ancestors, and lineal descendants. In determining whether any of these relationships exist, full effect shall be given to a legal adoption. The term "ancestors" includes parents and grandparents, and the term "lineal descendants" includes children and grandchildren.

(b) *Examples*. The application of section 267(c) may be illustrated by the following examples:

Example (1). On July 1, 1957, A owned 75 percent, and AW, his wife, owned 25 percent, of the outstanding stock of the M Corporation. The M Corporation in turn owned 80 percent of the outstanding stock of the O Corporation. Under section 267(c)(1), A and AW are each considered as owning an amount of the O Corporation stock actually owned by M Corporation in proportion to their respective ownership of M Corporation stock. Therefore, A constructively owns 60 percent (75 percent of 80 percent) of the O Corporation stock and AW constructively owns 20 percent (25 percent of 80 percent) of such stock. Under the family ownership rule of section 267(c)(2), an individual is considered as constructively owning the stock actually owned by his spouse. A and AW, therefore, are each considered as constructively owning the M Corporation stock actually owned by the other. For the purpose of applying this family ownership rule, A's and AW's constructive ownership of O Corporation stock is considered as actual ownership under section 267(c)(5). Thus, A constructively owns the 20 percent of the O Corporation stock constructively owned by AW, and AW constructively owns the 60 percent of the O Corporation stock constructively owned by A. In addition, the family ownership rule may be applied to make AWF, AW's father, the constructive owner of the 25 percent of the M Corporation stock actually owned by AW. As noted above, AW's constructive ownership of 20 percent of the O Corporation stock is considered as actual ownership for purposes of applying the family ownership rule, and AWF is thereby considered the constructive owner of this stock also. However, AW's constructive ownership of the stock constructively and actually owned by A may not be considered as actual ownership for the purpose of again applying the family ownership rule to make AWF the constructive owner of these shares. The ownership of the stock in the M and O Corporations may be tabulated as follows:

[chart omitted because I'm too lazy]

Assuming that the M Corporation and the O Corporation make their income tax returns for calendar years, and that there was no distribution in liquidation of the M or O Corporation, and further assuming that either corporation was a personal holding company under section 542 for the calendar year 1956, no deduction is allowable with respect to losses from sales or exchanges of property made on July 1, 1957, between the two corporations. Moreover, whether or not either corporation was a personal holding company, no loss would be allowable on a sale or exchange between A or AW and either corporation. A deduction would be allowed, however, for a loss sustained in an arm's length sale or exchange between A and AWF, and between AWF and the M or O Corporation.

Example (2). On June 15, 1957, all of the stock of the N Corporation was owned in equal proportions by A and his partner, AP. Except in the case of distributions in liquidation by the N Corporation, no deduction is allowable with respect to losses from sales or exchanges of property made on June 15, 1957, between A and the N Corporation or AP and the N Corporation since each partner is considered as owning the stock owned by the other; therefore, each is considered as owning more than 50 percent in value of the outstanding stock of the N Corporation.

Example (3). On June 7, 1957, A owned no stock in X Corporation, but his wife, AW, owned 20 percent in value of the outstanding stock of X, and A's partner, AP, owned 60 percent in value of the outstanding stock of X. The partnership firm of A and AP owned no stock in X Corporation. The ownership of AW's stock is attributed to A, but not that of AP since A does not own any X Corporation stock either actually, or constructively under section 267(c)(1). A's constructive ownership of AW's stock is not the ownership required for the attribution of AP's stock. Therefore, deductions for losses from sales or exchanges of property made on June 7, 1957, between X Corporation and A or AW are allowable since neither person owned more than 50 percent in value of the outstanding stock of X, but deductions for losses from sales or exchanges between X Corporation and AP would not be allowable by section 267(a) (except for distributions in liquidation of X Corporation).

An irrevocable trust paying mandatory income to the grantor's surviving spouse, remainder to the grantor's children is not related under Code § 267(b) or 707(b)(1) with respect to grantor trusts deemed owned by the grantor's two siblings, respectively.[1419]

For how Code § 267 interacts with the Code § 351 nonrecognition rules,[1420] see Narotzki & McCoskey, "The Code Section 267 Related Party Rules: When Do They Apply to Section 351 Transactions?," *Journal of Taxation* (2/2022).

II.G.4.l.iv. Start-Up Expenditures

Code § 195(a) disallows a deduction shall be allowed for start-up expenditures, except to the extent that Code § 195(b) allows up to $5,000 to be deducted and the balance amortized over the 180-month period beginning with the month in which the active trade or business begins.

[1419] Letter Ruling 200920032.
[1420] Part II.M.2.a Initial Incorporation – Generally.

Code § 195(c)(1) provides that “start-up expenditure” means any amount, other than “any amount with respect to which a deduction is allowable under section 163(a), 164, or 174”:

(A) paid or incurred in connection with -

(i) investigating the creation or acquisition of an active trade or business, or

(ii) creating an active trade or business, or

(iii) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business, and

(B) which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction for the taxable year in which paid or incurred.

Code § 195(c)(2), “Beginning of trade or business,” provides:

(A) *In general*. Except as provided in subparagraph (B), the determination of when an active trade or business begins shall be made in accordance with such regulations as the Secretary may prescribe.

(B) *Acquired trade or business*. An acquired active trade or business shall be treated as beginning when the taxpayer acquires it.

Code § 709 provides a similar rule “for any amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such partnership.” Code § 709(b)(3) defines organizational expenses as expenditures which -

(A) are incident to the creation of the partnership;

(B) are chargeable to capital account; and

(C) are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would be amortized over such life.

Reg. § 1.709-2(a), “Organizational expenses,” elaborates:

> To satisfy the statutory requirement described in paragraph (a)(1) of this section, the expense must be incurred during the period beginning at a point which is a reasonable time before the partnership begins business and ending with the date prescribed by law for filing the partnership return (determined without regard to any extensions of time) for the taxable year the partnership begins business. In addition, the expenses must be for creation of the partnership and not for operation or starting operation of the partnership trade or business. To satisfy the statutory requirement described in paragraph (a)(3) of this section, the expense must be for an item of a nature normally expected to benefit the partnership throughout the entire life of the partnership. The following are examples of organizational expenses within the meaning of section 709 and this section: Legal fees for services incident to the organization of the partnership, such as negotiation and

> preparation of a partnership agreement; accounting fees for services incident to the organization of the partnership; and filing fees. The following are examples of expenses that are not organizational expenses within the meaning of section 709 and this section (regardless of how the partnership characterizes them): Expenses connected with acquiring assets for the partnership or transferring assets to the partnership; expenses connected with the admission or removal of partners other than at the time the partnership is first organized; expenses connected with a contract relating to the operation of the partnership trade or business (even where the contract is between the partnership and one of its members); and syndication expenses.

Reg. § 1.709-2(c), "Beginning business," provides:

> The determination of the date a partnership begins business for purposes of section 709 presents a question of fact that must be determined in each case in light of all the circumstances of the particular case. Ordinarily, a partnership begins business when it starts the business operations for which it was organized. The mere signing of a partnership agreement is not alone sufficient to show the beginning of business. If the activities of the partnership have advanced to the extent necessary to establish the nature of its business operations, it will be deemed to have begun business. Accordingly, the acquisition of operating assets which are necessary to the type of business contemplated may constitute beginning business for these purposes. The term "operating assets", as used herein, means assets that are in a state of readiness to be placed in service within a reasonable period following their acquisition.

Kellett v. Commissioner, T.C. Memo. 2022-62, explains:

> Section 162(a) permits a deduction for ordinary and necessary expenses paid or incurred during the taxable year "in carrying on any trade or business." Section 195(a), on the other hand, generally denies a deduction for start-up expenditures, which section 195(c)(1)(A)(iii) defines in pertinent part to include any amount paid or incurred in connection with "any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business." See *Hardy v. Commissioner*, 93 T.C. 684, 687 (1989) ("Start-up or pre-opening expenses are not currently deductible under section 162."). Without any regulations to tell us when an active trade or business begins,[6] we rely on a test developed by the U.S. Court of Appeals for the Fourth Circuit, the appellate venue for this case absent a stipulation by the parties. See § 7482(b); 28 U.S.C. § 41 (2018).[7] In the Fourth Circuit, a taxpayer does not begin carrying on a trade or business "until such time as the business has begun to function as a going concern and performed those activities for which it was organized." *Richmond Television Corp. v. United States*, 345 F.2d 901, 907 (4th Cir. 1965),[8] vacated and remanded per curiam on other grounds, 382 U.S. 68 (1965). The Tax Court determines when this happens on the basis of the facts and circumstances of a given case. *Madison Gas & Elec. Co. v. Commissioner*, 72 T.C. 521, 566 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980).
>
> [6] Sections 195(c)(2)(A) and 7701(a)(11)(B) direct us to determine when an active trade or business begins on the basis of regulations prescribed by the Secretary of the Treasury or his delegate, although no regulations have been promulgated.

[7] The Tax Court will follow a Court of Appeals decision which is squarely on point where appeal from our decision lies to that Court of Appeals alone. *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

[8] The same case points out that the Code prohibits a business expense deduction for capital expenditures. *Richmond Television*, 345 F.2d at 907-08; see also § 263 (denying a deduction for capital expenditures). Respondent does not argue that any portion of the claimed deduction is a section 263 capital expenditure and concedes that only section 195 is at issue as to the business-related expenditures petitioner reported on Schedule C.

The Fourth Circuit did not allow Richmond Television Corp. to deduct staff training costs incurred in 1953-55 for its new television station because the business did not begin until the station went on the air in 1956. *Richmond Television*, 345 F.2d at 903-07. A television station, like a business information website, exists to communicate information to the public, via television programming in the former case and data aggregation and analysis software in the latter. Just as a television station can have no viewers until it begins broadcasting, Vizala could have no users before the website opened. Petitioner's active trade or business could not begin until that happened.

Unlike the television station in Richmond Television, however, Vizala had no revenue until well after going live. See id. at 903–04, 909 (explaining that the station launched in 1956 and sought to carry forward its business expense deductions as net operating losses to 1956 and 1957, which indicates it had income in those years). Respondent argues that none of the expenditures petitioner reported on Schedule C, even amounts paid after the website opened, is a section 162 expense because Vizala had no revenue and no means of generating revenue in 2015. A taxpayer's effort to sell goods or services may qualify as an active trade or business even if the taxpayer makes no sales and therefore has zero gross receipts. See *Cabintaxi Corp. v. Commissioner*, 63 F.3d 614, 620 (7th Cir. 1995), *aff'g in part, rev'g in part* T.C. Memo. 1994-316. Vizala, on the other hand, made no attempt to sell anything - advertisements, access to website features, customized reports, or licensed data - until after 2015.[9]

[9] In announcing its going-concern test, the Fourth Circuit cites Justice Frankfurter's concurring opinion in *Deputy v. du Pont*, 308 U.S. 488, 499 (1940), which asserts that carrying on a trade or business "involves holding one's self out to others as engaged in the *selling* of goods or services." *Richmond Television*, 345 F.2d at 907 n.7 (emphasis added). The Supreme Court later formally rejected Justice Frankfurter's gloss on the trade or business inquiry. *Commissioner v. Groetzinger*, 480 U.S. 23, 34 (1987).

The typical case determining when an active trade or business begins contemplates a traditional business archetype: If initial operations succeed, the company should start earning revenue as soon as the active trade or business begins. For example, a grocery store will earn revenue by selling groceries as soon as it draws customers. See *Piggly Wiggly S., Inc. v. Commissioner*, 84 T.C. 739, 745-48 (1985) (allowing a store operator to deduct the cost of equipment placed in open stores, but denying the same deduction for stores not yet open), *aff'd*, 803 F.2d 1572 (11th Cir. 1986). By the same token, a company operating an apartment or office building should receive rent payments as soon as it admits tenants. See *Johnsen v. Commissioner*, 83 T.C. 103, 114-18 (1984) (denying deductions for pre-opening costs of rental property and discussing other cases reaching the same result), *rev'd on other grounds*, 794 F.2d 1157 (6th Cir. 1986).

Vizala does not fit this traditional archetype. Petitioner doubted that any of his revenue strategies could succeed until Vizala built rapport with users and advertisers. He therefore prioritized web traffic over revenue by charging no user fees and marketing the site to institutional customers. Even though petitioner made no attempt to earn revenue in 2015, his business began providing the services "for which it was organized," with an eye to long-term profit, once he opened the website. See *Richmond Television*, 345 F.2d at 907. Such activity, at least under these circumstances, constitutes an active trade or business.

The parties agree that Vizala opened to the public in or around September 2015. The burden of establishing the opening date does not shift to respondent under section 7491(a), see *supra* Part I, because petitioner has not proposed, let alone introduced credible evidence of, an opening date. We therefore err on the side of respondent by postulating. that petitioner opened the website at the end of the day on September 30, 2015.

Groetzinger, cited above, is discussed in part II.G.4.I.i.(a) "Trade or Business" Under Code § 162.

Kellett responded to the taxpayer's assertion that certain expenditures were Code § 174 research or experimental expenditures, or as costs of developing computer software under Rev. Proc. 2000-50:

A. Section 174

Section 195(c)(1) excludes from the definition of start-up expenditures any amount with respect to which a deduction is allowable under section 174. Section 174(a)(1), as in effect for 2015, allows a taxpayer to deduct "research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business."[12] Treasury Regulation § 1.174-2(a)(1) defines research or experimental expenditures as "expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense." This means the expenditures "are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product." *Id*. "Uncertainty exists," the regulation continues, "if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product." Id. Petitioner may not deduct any of his expenditures under section 174 because he did not encounter this kind of uncertainty in creating Vizala.

[12] Congress withdrew the deduction for amounts paid or incurred in tax years beginning after December 31, 2021. See Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13206, 131 Stat. 2054, 2111 (2017).

A pair of cases involving the section 41 credit for increasing research activities, which requires the taxpayer to demonstrate that expenditures may be treated as section 174 expenditures, see § 41(d)(1)(A),[13] illustrates how to understand "uncertainty" in the context of software development. In the first case the court denied taxpayer Morris Davenport a section 41 credit for wages paid to develop software that would automate and integrate the manufacturing, design, sales, accounting, and shipping aspects of his business. *United States v. Davenport*, 897 F. Supp. 2d 496, 499-501, 518

(N.D. Tex. 2012). An outside contractor created the software using a commercially available software application suite. *Id*. at 500, 510–11. After conferring with Mr. Davenport's employees to understand their needs, the contractor developed a preliminary product by following a standardized process based on "industry best practices" and resolved problems and added functionalities according to the employees' feedback. See *id*. at 510–14. Although the project consumed lots of time and effort, the record reflected a straightforward application of the tried and true development process the contractor apparently followed in service of other clients. See *id*. at 515.

[13] Congress revised section 41(d)(1)(A) effective for tax years beginning after December 31, 2021, to conform to the revision of section 174 described in the preceding note. See Tax Cuts and Jobs Act § 13206(d)(1), 131 Stat. at 2112.

At the other end of the spectrum lies Eric Suder, whose company's costs of developing a series of phone systems passed the section 174 test. See *Suder v. Commissioner*, T.C. Memo. 2014-201, at *1–30, *42–44. Although the company followed a systematic development process, neither Mr. Suder nor his team knew exactly what steps to follow to create the products they conceived or how the products would be designed. *Id*. at *8, *42-43. Each project began at the drawing board: Senior management brainstormed an idea for a new product and drafted a rudimentary diagram and specifications which their engineers used to make the idea commercially viable. *Id*. at *8–9. The company's hardware was proprietary, so employees had to create what they needed out of whole cloth using their own expertise. Id. at *10-11. Software engineers tested and retested computer code to perfect the timing of the products' components within milliseconds. *Id*. at *12. In one case the company created a softphone that allowed the user to make calls from a personal computer while traveling, which presented the challenge of developing software capable of transferring calls through hotel routers and firewalls. *Id*. at *18. When the Internal Revenue Service (IRS) expert questioned the team's failure to develop the softphone using open-source software, an employee credibly testified that this would have required significant and time-consuming changes to the product. *Id*. at *41.

Vizala followed the Davenport paradigm: Petitioner and his engineers adapted widely used software to solve a complex but familiar problem. Petitioner's project did not start from the "drawing board" in the same sense as Mr. Suder's softphone. Petitioner aimed to create a data aggregation website, which companies such as Google Finance had done before, only his website would present demographic, social, and economic data instead of the financial information available on professional-quality platforms. Whereas the softphone required Mr. Suder's team to write code from a blank slate, Vizala permitted the use of open-source software customized for petitioner's needs. Like Mr. Davenport's employees, petitioner described to his engineers how the product should work, and, as an inherent part of designing complex software, collaborated with the engineers to troubleshoot problems before launch. *Cf. id.* at *39-40 (disagreeing with the IRS's position that Mr. Suder's team encountered only the kind of uncertainty inherent in every large development effort). As in Mr. Davenport's case, we conclude that petitioner may not deduct his expenses under section 174.

B. Rev. Proc. 2000-50

Petitioner argues that he may deduct the engineer expenses on the basis of Rev. Proc. 2000-50, §§ 4, 5.01, 2000-2 C.B. at 601, which announces that the IRS will not

> disturb a taxpayer's immediate deduction of certain costs of developing computer software that the taxpayer has not treated as section 174 research or experimental expenditures. We must reject this argument because, to the extent Rev. Proc. 2000-50 purports to establish a taxpayer's entitlement to a deduction, petitioner has not demonstrated that the Code authorizes any such deduction. Rev. Proc. 2000-50 mimics the section 174 exception to the capitalization rules of sections 195 and 263. As explained *supra* Part II.A, section 162(a) permits a deduction for ordinary and necessary expenses paid or incurred during a taxable year "in carrying on any trade or business," but section 195 generally denies an immediate deduction for start-up expenditures paid or incurred before the "active trade or business" begins. Moreover, section 263(a)(1) generally denies an immediate deduction for amounts paid for permanent improvements to property, which the title of section 263 calls "capital expenditures." See *Woodward v. Commissioner*, 397 U.S. 572, 575 (1970) (explaining that a taxpayer cannot deduct a capital expenditure under section 162). The taxpayer "capitalizes" section 195 and section 263 expenditures, see § 1016(a)(1) (providing a basis adjustment for expenditures "properly chargeable to capital account"), and in some cases can deduct them over subsequent years through depreciation or amortization, *see, e.g.*, §§ 167, 195(b).
>
> As in effect for 2015, see supra note 12, section 174(a)(1) overrides these capitalization rules for research or experimental expenditures paid or incurred by the taxpayer during the taxable year "in connection with his trade or business." The taxpayer need not actually be engaged in a trade or business to incur an expenditure "in connection with his trade or business," but there must be a realistic prospect at the time of the expenditure that the taxpayer will enter a trade or business involving the technology being developed. See *Lewin v. Commissioner*, 335 F.3d 345, 347-48 (4th Cir. 2003), *aff'g per curiam* T.C. Memo. 2001-10. Such expenditures are not start-up or capital expenditures. See §§ 195(c)(1) (flush text), 263(a)(1)(B); see also § 263A(c)(2) (exempting any amount allowable as a deduction under section 174 from section 263A(a)(1), which requires that certain costs be included in inventory costs or capitalized). The taxpayer may either deduct the expenditures in the taxable year they are paid or incurred, § 174(a), or capitalize and deduct them ratably over 60 months, § 174(b).
>
> On the theory that they "so closely resemble" section 174 expenditures "as to warrant similar accounting treatment," Rev. Proc. 2000-50, §§ 4 and 5.01, purports to allow the same timing election for certain costs of developing computer software that the taxpayer has not treated as section 174 expenditures. The revenue procedure announces in pertinent part that the IRS "will not disturb" a taxpayer's deduction of these costs "in accordance with rules similar to those applicable under § 174(a)," or capitalization and recovery of the costs through amortization deductions "in accordance with rules similar to those provided by § 174(b) and the regulations thereunder" or other rules described in the revenue procedure. *Id.*; see also T.D. 9107, 2004-1 C.B. 447, 452 (preamble to regulations under section 263 directing taxpayers to rely on Rev. Proc. 2000-50 to determine when to deduct computer software development costs).

"Tax Court considers when a business becomes active for purposes of Section 195," *Journal of Taxation* (Nov. 2022), commented:

> The taxpayer alternatively argued that, if the expenditures were not deductible under Section 162, they were deductible under Section 174 as R&E expenses or Rev.

Proc. 2000-50 as software development costs. The court concluded that the taxpayer could not deduct his expenditures under Section 174 because he and the engineers simply had adapted widely used software to solve a familiar problem and did not conduct research beginning at the "drawing board." Thus, they were not dealing with uncertainty in the development of a product. The court concluded that the taxpayer could not deduct software development costs under Rev. Proc. 2000-50 because Rev. Proc. 2000-50 addressed the treatment of otherwise deductible costs and did not provide an independent basis for deduction.

II.G.4.m. Fixing Unfair Income Tax Results

See Harrington, "Retroactive Revisions and Reversals: Risks and Rewards," Chapter 4, 55TH Annual Heckerling Institute on Estate Planning (2021), parts of which discuss the ideas in this part II.G.4.m and part of which is quoted extensively in part II.P.3.g Rescissions, Including Rescinding Conversion of Entity.

II.G.4.m.i. Code § 1341 Claim of Right Deduction

Our income tax system tends to accelerate income recognition and defer deductions, absent specific provisions to the contrary (of which there are very notable provisions). If a taxpayer recognizes income that ultimately not something the taxpayer can keep, writing off that income in a future year might not do justice to the taxpayer, depending on the taxpayer's future tax posture. Accordingly, Code § 1341(a), "General rule," provides:

> If -
>
> (1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;
>
> (2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and
>
> (3) the amount of such deduction exceeds $3,000,
>
> then the tax imposed by this chapter for the taxable year shall be the lesser of the following:
>
> (4) the tax for the taxable year computed with such deduction; or
>
> (5) an amount equal to -
>
> > (A) the tax for the taxable year computed without such deduction, minus
> >
> > (B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).
>
> For purposes of paragraph (5)(B), the corresponding provisions of the Internal Revenue Code of 1939 shall be chapter 1 of such code (other than subchapter E, relating to self-employment income) and subchapter E of chapter 2 of such code.

As to the Code § 1341(a)(1) requirement that "an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item," *Mihelick v. U.S.*, 927 F.3d 1138 (11th Cir. 2019), described what "appeared" implies:

> What matters is whether Mihelick sincerely believed she had a right to Bluso's income, not the correctness of her belief. *McKinney v. United States*, 574 F.2d 1240, 1243 (5th Cir. 1978)[2] ("The language of [§] 1341(a)(1), *i.e.*[,] 'because it appeared that the taxpayer had an unrestricted right to such item,' must necessarily mean 'because it appeared (*to the taxpayer*) that (he) had an unrestricted right to such item.'" (emphasis added)). After all, if a taxpayer had to correctly believe that she had an unrestricted right to income to qualify for § 1341, then the taxpayer would have correctly paid her income taxes in the first place, and § 1341 would never come into play, since the second element of § 1341 requires a showing that the taxpayer did not, in fact, have an unrestricted right to the income. So Mihelick did not need to be right that she had an unrestricted right to Bluso's income; she just needed to sincerely believe it.[3]
>
> [2] Decisions handed down by the Fifth Circuit by the close of business on September 30, 1981, are binding on this Court.
>
> [3] The taxpayer need only subjectively believe that she was entitled to an item of income - even if some may consider her belief to be unreasonable. As stated, the object of § 1341 is "to put the taxpayer in the same position he would have been in had he not included the item as gross income in the first place." *Fla. Progress*, 348 F.3d at 957. The section does not discriminate between those who reasonably or unreasonably paid excess taxes - its aim is to return to the taxpayer excess taxes paid. And this makes good sense: no one would report and pay taxes on income to which she does not believe herself to be entitled, only to take the trouble of going through § 1341 to return herself to her starting position.

As to the Code § 1341(a)(2) requirement that "it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item," *Mihelick v. U.S.*, 927 F.3d 1138 (11th Cir. 2019), described this element:

> To make this showing, the taxpayer must demonstrate that she involuntarily gave away the relevant income because of some obligation, and the obligation had a substantive nexus to the original receipt of the income. See *Batchelor-Robjohns v. United States*, 788 F.3d 1280, 1293-94 (11th Cir. 2015). Mihelick satisfies both requirements.
>
> Mihelick involuntarily gave away $300,000 of the relevant income to which she previously believed she had an unrestricted right. We have explained that "payments made to settle a lawsuit" may constitute an involuntary obligation for § 1341 purposes. *Batchelor-Robjohns*, 788 F.3d at 1293-94 (citing *Barrett v. Commissioner*, 96 T.C. 713 (1991)).[4] In *Barrett*, two groups of securities brokers sued Barrett and several other shareholders at his brokerage firm after the Securities and Exchange Commission instituted administrative proceedings against the brokers for suspected insider-trading violations. *Barrett*, 96 T.C. at 715. At a hearing, the magistrate judge advised Barrett and his co-defendants to settle the suits to "avoid the hazards of litigation," "substantial legal fees," and "adverse trial publicity," all of which would be harmful for Barrett and his brokerage business. *Id.* Barrett heeded the magistrate judge's advice and without admitting wrongdoing, settled the civil suits for $54,000. *Id.* He then sought a tax credit through § 1341. *Id.* At 716.

> [4] In *Batchelor-Robjohns*, we adopted *Barrett*'s reasoning as to what constitutes an involuntary obligation, but we did not adopt all aspects of *Barrett*. Part of *Barrett*'s reasoning rested on the distinction between taking a tax credit and a deduction under § 1341. See *Barrett*, 96 T.C. at 718. But in *Batchelor-Robjohns*, we ruled that the "deduction/credit distinction merely determines how to account for a § 1341 repayment on one's return, nothing more." *Batchelor-Robjohns*, 788 F.3d at 1297.

> The government fought Barrett's attempt to obtain the § 1341 credit. It argued that Barrett's payment was voluntary, so he failed to establish that he did not have an unrestricted right to the $54,000 he paid to settle the suits. *Id.* at 718. In particular, the government complained that Barrett "merely settled the lawsuits" while continuing to deny his liability and "was not compelled to pay out $54,000 by a judicial decree after a trial on the merits." *Id.*

> The *Barrett* Court was unmoved by the government's arguments. It would be "ludicrous," the *Barrett* Court explained, "[t]o conclude that [Barrett] restored the $54,000 voluntarily without regard to any legal obligation." *Id.* At 719. Pointing out the risks that Barrett faced – losing his license, facing up to $10 million in liability, not knowing the type of evidence the plaintiffs wielded - and the fact that "[t]he policy of the law is to foster the peaceful settlement of disputes without litigation," *Barrett* held that the settlement was "made in good faith and at arm's length." *Id.* at 719-20. That good-faith settlement, "whether or not embodied in a judgment, established the fact and the amount of [Barrett's] legal obligation" and showed that Barrett did not have an unrestricted right to the $54,000 for § 1341 purposes. *Id*.

> Mihelick's situation is materially indistinguishable. As with Barrett, Mihelick's obligation to pay arose not from a final judgment, but from an agreement she entered in good-faith to avoid litigation. And it would be equally as "ludicrous" - as it was in *Barrett* to say that Barrett voluntarily paid his $54,000 - to conclude that Mihelick voluntarily paid $300,000 of her income without regard to any legal obligation.

> Indeed, Mihelick initially opposed paying Bluso for any liability arising from the Barnes lawsuit. Only after Bluso threatened her with litigation did she agree to be bound to do so and enter into Article 5 of her separation agreement. And even that did not occur without a battle: the parties actually negotiated Article 5 of the separation agreement - Bluso asked Mihelick to simply give him $150,000, but Mihelick turned down that offer because she judged that Barnes's lawsuit would not produce that much liability. Then, even after Bluso settled the Barnes lawsuit for $600,000 and attempted to collect $300,000 from Mihelick, she resisted paying, prompting Bluso to withhold alimony for a month.

In *Mihelick v. U.S.*, 927 F.3d 1138 (11th Cir. 2019), the taxpayer and her husband divorced, and she was forced to repay him half of the income he had returned to settle a dispute over his prior compensation that was included in a joint return. The court explained:

> The government next suggests a new requirement that the taxpayer must meet. According to the government, a taxpayer lacks an unrestricted right to an item of income only if she returned the income to the "actual owner." Although the government cites no caselaw for support, its contention is not unprecedented. See *Alcoa, Inc. v. United States*, 509 F.3d 173, 180-82 (3d Cir. 2007). Nevertheless, we decline to adopt a new requirement for this Circuit that lacks a basis in the statutory text and is inconsistent with

§ 1341's purpose—namely, returning the taxpayer who unnecessarily pays taxes on income she did not have to "the same position [s]he would have been in had [s]he not included the item as gross income in the first place." *Fla. Progress*, 348 F.3d at 957. It is sufficient on this record that Barnes effectively and reasonably claimed to be the rightful owner of the $300,000, and Bluso and Mihelick - who otherwise had a claim to be the rightful owners of the $300,000 - agreed in a legally binding way not to challenge that.

On the other hand, if funds were acquired through fraud, the taxpayer does not have "an unrestricted right" to the funds, so Code § 1341(a)(1) does not apply. Furthermore, the taxpayer needs to plead the grounds for deduction under Code § 1341(a)(2). These failures justify dismissing the claim. *Steffen v. U.S.*, 995 F.3d 1377 (Fed. Cir. 2021) (split decision).

O'Neill Trust v. Commissioner, T.C. Memo. 2022-108, gave the taxpayer no relief because the taxpayer failed to preserve its rights and because the court strictly construed which taxpayer could assert a claim of right. The case involved a compromise of estate tax liability that might have resulted in favorable income tax consequences. Facts include:[1421]

> The trust was established April 18, 1968, as a revocable trust. It became an irrevocable trust upon the death of decedent, its creator, on April 4, 2009. Before his death, decedent transferred his assets to the trust. At the time of his death, the trust held an 86.12% ownership interest in RMV Total Diversification, LLC (RMV). RMV is a limited liability company and is a partnership pursuant to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).[3] RMV sold capital gain assets during 2009 and 2010, which resulted in flowthrough income to the trust. The trust reported this income on its Forms 1041, U.S. Income Tax Return for Estates and Trusts, for 2009 and 2010.
>
> > [3] Before its repeal, TEFRA, Pub. L. No. 97 -248, §§ 401-407, 96 Stat. 324, 648-71, governed the tax treatment and audit procedures for many partnerships. TEFRA was replaced by the Bipartisan Budget Act of 2015 (BBA), Pub. L. No. 114-74, § 1101(a), (c)(1), (g), 129 Stat. 584, 625, 638. For partnership returns filed for years beginning after November 2, 2015, and before January 1, 2018, partnerships were able to elect to apply the procedures of the BBA instead of those of TEFRA. See BBA § 1101(a), 129 Stat. at 638.
>
> Following decedent's death, his estate borrowed money from RMV in the form of a *Graegin* loan on which it was charged a 9% interest rate. See *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477. The interest paid to RMV by the estate resulted in flowthrough income for the trust, which the trust reported as income. The estate timely filed Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, on June 30, 2010. The Commissioner proposed adjustments to the estate's Form 706. The estate objected to the proposed adjustments and filed a Petition with this Court.
>
> The parties reached a settlement with the IRS Appeals Office, and on February 3, 2015, this Court entered a decision in *Estate of Richard J. O'Neill, Deceased, Anthony R. Moiso, Executor v. Commissioner*, Docket No. 19822-13 (related case).[4] This decision resulted in two adjustments relevant to this case: (1) the value of the estate's interest in RMV was adjusted from $30,725,000 to $40,614,822 under section 2036 and (2) the

[1421] Below the court discusses a *Graegin* loan, which is discussed in part III.B.5.e.iii.(a) *Graegin* Loans: Tax Issues.

estate was limited to a deduction of 6% on the note (instead of the 9% claimed). The note was subsequently rewritten, resulting in a $500,538 reduction of accrued interest to the trust for 2010.

[4] On July 1, 2019, the IRS Office of Appeals was renamed the IRS Independent Office of Appeals. See Taxpayer First Act, Pub. L. No. 116-25, § 1001, 133 Stat. 981, 983 (2019). We will use the name in effect at the times relevant to this case, *i.e.*, the Office of Appeals or Appeals.

In October 2015 the trust filed a timely tentative claim for refund on Form 1045 for the 2014 tax year under a claim of right theory. The tentative claim for refund was to recover an overpayment of income tax paid by the trust for the 2009 and 2010 tax years. RMV did not file an amended partnership income tax return for 2009, 2010, 2014, or 2015. The trust did not file Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR), with respect to RMV for 2009, 2010, 2014, or 2015. Discussion Summary judgment may be granted where the pleadings and other materials show there is no genuine dispute as to any material fact and a decision may be rendered as a matter of law. Rule 121(b); *Sundstrand Corp. v. Commissioner*, 98 T.C. 518, 520 (1992), *aff'd*, 17 F.3d 965 (7th Cir. 1994). The burden is on the moving party to demonstrate that there is no genuine dispute as to any material fact and the party is entitled to judgment as a matter of law. *FPL Grp., Inc. & Subs. v. Commissioner*, 116 T.C. 73, 74-75 (2001). Both parties have moved for partial summary judgment, and they agree there exist no genuine disputes of material fact regarding the questions they have asked us to decide. After reviewing the pleadings and Motions with accompanying Exhibits, we conclude that a decision may be rendered as a matter of law.

The court rejected the trust's claim of right argument:

Claim of right under section 1341 does not apply in this case for several reasons, the first being that the trust was not the appropriate taxpayer to file a claim for refund. The trust filed a refund claim on the basis of flowthrough income it received as a partner of RMV.

Under TEFRA, treatment of partnership items must be decided at the partnership level. § 6221; Treas. Reg. § 301.6231(a)(3)-1. Partners must treat any income received from the partnership in a manner consistent with the treatment of that income at the partnership level. § 6222(a). In certain instances, a partner may seek to treat income received from a partnership in a manner inconsistent with the income item's treatment at the partnership level. § 6662(b); § 6227(a). To do so, a partner must file Form 8082. Form 8082 may also be filed by a partner as a protective claim for refund.

Both the capital gain and interest income (income items) the trust received as a partner of RMV are partnership items. See Treas. Reg. § 301.6231(a)(3)-1. RMV has not filed an amended return for 2009 or 2010. The trust did not file Form 8082 either in recognition of its inconsistent treatment of these income items or as a protective claim for refund with respect to the examination issues arising from the related case.

B. Substantive Issues

Even if there were no procedural issues with the trust's refund claim, the trust would still fail to satisfy the substantive requirements of section 1341.

In 2009 and 2010 RMV sold capital assets, resulting in capital gain allocable to the trust. The trust claims that RMV understated its basis in the sale of the capital assets, which effectively resulted in the trust's overstating its capital gain. The trust argues that this basis adjustment created a claim of right with respect to the overstated capital gain.

The parties do not dispute that RMV, and therefore the trust, had an unrestricted right in the capital assets sales proceeds. No portion of this item was repaid or otherwise restored as a result of legal or contractual disputes surrounding RMV's right to the item. RMV's unrestricted right to the sales proceeds never ceased to exist, meaning that the trust's right to the flowthrough income was also unrestricted. Because the trust's right to the income items was at all times unrestricted, section 1341 does not apply.

Additionally, section 1341 addresses issues relating to a taxpayer's right to an income item. An adjustment to basis relates to the value of an income item and is independent from a taxpayer's right to the income item. Because the trust's unrestricted right to the capital gain was unaffected by the adjustment to basis, section 1341 does not apply and the trust does not have a claim of right.

The trust's refund claim also contends that the decision in the related case created a claim of right under section 1341 with respect to the interest income paid to RMV by the estate. The decision in the related case limited the amount of interest deductible by the estate to 6%, rather than the entirety of the 9% agreed upon in the note. Following the decision in the related case, RMV and the estate voluntarily renegotiated the terms of the note, decreasing the interest paid by the estate to RMV from 9% to 6%. RMV's decision to voluntarily renegotiate the terms of the note to reflect the decision in the related case does not retroactively restrict its [*6] right to the interest income reported for the prior tax year. RMV at all relevant times had an unrestricted right to the interest income. The trust, therefore, does not have a claim of right upon which to base its claim for refund.

II. Mitigation Provisions

Sections 1311 through 1314 (mitigation provisions) allow for filing of a refund claim within one year from the date a proper determination becomes final. To claim the benefits of the mitigation provisions, a taxpayer must show that (1) there was a determination as defined by section 1313(a); (2) the determination falls within specified circumstances of adjustment set forth in section 1312; and (3) the party against whom the mitigation provisions are being invoked has maintained a position inconsistent with the challenged erroneous inclusion, exclusion, recognition , or nonrecognition of income as described by section 1311(b) . The Court of Appeals for the Ninth Circuit narrowly construes the requirements of the mitigation provisions. See *United States v. Rigdon*, 323 F.2d 446, 449 (9th Cir. 1963); *United States v. Rushlight*, 291 F.2d 508, 514 (9th Cir. 1961).

The trust's reliance on the mitigation provisions fails for procedural reasons. As with the claim of right, the mitigation provisions require that a refund claim be filed with respect to a specific year. See§ 1314(b). Because the trust is claiming it overpaid for the 2009 and 2010 tax years, it should have filed a refund claim for those years. Instead, its claim is for the 2014 tax year. As with the claim of right argument, this procedural defect is fatal to the trust's position.

Code §§ 1311-1314 are discussed in part II.G.4.m.iv Mitigation of Effect of Limitations and Other Provisions: Code §§ 1311-1314. The court also rejected the taxpayer's equitable recoupment argument.[1422]

Code § 1341(b), "Special rules," provides:

(1) If the decrease in tax ascertained under subsection (a)(5)(B) exceeds the tax imposed by this chapter for the taxable year (computed without the deduction) such excess shall be considered to be a payment of tax on the last day prescribed by law for the payment of tax for the taxable year, and shall be refunded or credited in the same manner as if it were an overpayment for such taxable year.

(2) Subsection (a) does not apply to any deduction allowable with respect to an item which was included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer (or other property of a kind which would properly have been included in the inventory of the taxpayer if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. This paragraph shall not apply if the deduction arises out of refunds or repayments with respect to rates made by a regulated public utility (as defined in section 7701(a)(33) without regard to the limitation contained in the last two sentences thereof) if such refunds or repayments are required to be made by the Government, political subdivision, agency, or instrumentality referred to in such section, or by an order of a court, or are made in settlement of litigation or under threat or imminence of litigation.

(3) If the tax imposed by this chapter for the taxable year is the amount determined under subsection (a)(5), then the deduction referred to in subsection (a)(2)shall not be taken into account for any purpose of this subtitle other than this section.

(4) For purposes of determining whether paragraph (4) or paragraph (5) of subsection (a) applies -

(A) in any case where the deduction referred to in paragraph (4) of subsection (a) results in a net operating loss, such loss shall, for purposes of computing the tax for the taxable year under such paragraph (4), be carried back to the same extent and in the same manner as is provided under section 172; and

(B) in any case where the exclusion referred to in paragraph (5)(B) of subsection (a) results in a net operating loss or capital loss for the prior taxable year (or years), such loss shall, for purposes of computing the decrease in tax for the prior taxable year (or years) under such paragraph (5)(B), be carried back and carried over to the same extent and in the same manner as is provided under section 172 or section 1212, except that no carryover beyond the taxable year shall be taken into account.

(5) For purposes of this chapter, the net operating loss described in paragraph (4)(A) of this subsection, or the net operating loss or capital loss described in paragraph (4)(B) of this subsection, as the case may be, shall (after the application of paragraph (4) or (5)(B) of

[1422] See text accompanying fn 1426 in part II.G.4.m.ii Equitable Recoupment.

subsection (a) for the taxable year) be taken into account under section 172 or 1212 for taxable years after the taxable year to the same extent and in the same manner as -

(A) a net operating loss sustained for the taxable year, if paragraph (4) of subsection (a) applied, or

(B) a net operating loss or capital loss sustained for the prior taxable year (or years), if paragraph (5)(B) of subsection (a)applied.

In response to limitations in deducting capital losses,[1423] Reg. § 1.1341-1(c), "Application to deductions which are capital in nature," provides:

> Section 1341 and this section shall also apply to a deduction which is capital in nature otherwise allowable in the taxable year. If the deduction otherwise allowable is capital in nature, the determination of whether the taxpayer is entitled to the benefits of section 1341 and this section shall be made without regard to the net capital loss limitation imposed by section 1211. For example, if a taxpayer restores $4,000 in the taxable year and such amount is a long-term capital loss, the taxpayer will, nevertheless, be considered to have met the $3,000 deduction requirement for purposes of applying this section, although the full amount of the loss might not be allowable as a deduction for the taxable year. However, if the tax for the taxable year is computed with the deduction taken into account, the deduction allowable will be subject to the limitation on capital losses provided in section 1211, and the capital loss carryover provided in section 1212.

II.G.4.m.ii. Equitable Recoupment

Code § 6214(b), "Jurisdiction over other years and quarters," provides:[1424]

> The Tax Court in redetermining a deficiency of income tax for any taxable year or of gift tax for any calendar year or calendar quarter shall consider such facts with relation to the taxes for other years or calendar quarters as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other year or calendar quarter has been overpaid or underpaid. Notwithstanding the preceding sentence, the Tax Court may apply the doctrine of equitable recoupment to the same extent that it is available in civil tax cases before the district courts of the United States and the United States Court of Federal Claims.

Estate of Jorgensen v. Commissioner, T.C. Memo. 2009-66, quoted *Menard, Inc. v. Commissioner*, 130 T.C. 54, 62-63 (2008):

[1423] See fns 1550-1552 and accompanying text in part II.G.8 Code § 165(a) Loss for Worthlessness; Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy.

[1424] In footnote 14, *Estate of Jorgensen v. Commissioner*, T.C. Memo. 2009-66, explained:

> Before the amendment to sec. 6214(b), the Courts of Appeals that considered whether we may entertain an equitable recoupment claim split on the question. Compare *Estate of Mueller v. Commissioner*, 153 F.3d 302 (6th Cir. 1998), *affg.* on other grounds 107 T.C. 189 (1996), with *Estate of Branson v. Commissioner*, 264 F.3d 904 (9th Cir. 2001), *affg.* 113 T.C. 6, 15 (1999).

Estate of Branson was a reviewed Tax Court decision, with a 12-3 vote.

> The doctrine of equitable recoupment is a judicially created doctrine that, under certain circumstances, allows a litigant to avoid the bar of an expired statutory limitation period. The doctrine prevents an inequitable windfall to a taxpayer or to the Government that would otherwise result from the inconsistent tax treatment of a single transaction, item, or event affecting the same taxpayer or a sufficiently related taxpayer. Equitable recoupment operates as a defense that may be asserted by a taxpayer to reduce the Commissioner's timely claim of a deficiency, or by the Commissioner to reduce the taxpayer's timely claim for a refund. When applied for the benefit of a taxpayer, the equitable recoupment doctrine allows a taxpayer to recoup the amount of a time-barred tax overpayment by allowing the overpayment to be applied as an offset against a deficiency if certain requirements are met.
>
> As a general rule, the party claiming the benefit of an equitable recoupment defense must establish that it applies. In order to establish that equitable recoupment applies, a party must prove the following elements: (1) The overpayment or deficiency for which recoupment is sought by way of offset is barred by an expired period of limitation; (2) the time-barred overpayment or deficiency arose out of the same transaction, item, or taxable event as the overpayment or deficiency before the Court; (3) the transaction, item, or taxable event has been inconsistently subjected to two taxes; and (4) if the transaction, item, or taxable event involves two or more taxpayers, there is sufficient identity of interest between the taxpayers subject to the two taxes that the taxpayers should be treated as one.

As to factor (2), *Estate of Jorgensen v. Commissioner*, T.C. Memo. 2009-66, explained:[1425]

> A claim of equitable recoupment will lie only where the Government has taxed a single transaction, item, or taxable event under two inconsistent theories. *Estate of Branson v. Commissioner*, 113 T.C. 6, 15 (1999), *affd.* 264 F.3d 904 (9th Cir. 2001). In *Estate of Branson*, the decedent's estate included stock in two closely held corporations. To pay applicable estate taxes, the estate sold a portion of the stock. The stock was sold for considerably more than its value reported on the estate. Under section 1014(a)(1),[16] the value of the stock tax return, as declared on the estate tax return was used as its basis for determining gain from the sale. The estate did not pay the tax on the sale but distributed the gain to the estate's residuary beneficiary, who paid the tax due. The Commissioner determined a deficiency in estate tax on the ground that the closely held corporation stock was worth substantially more than declared. In *Estate of Branson v. Commissioner*, T.C. Memo. 1999-231, we agreed with the Commissioner. Our revaluation of the stock resulted in an estate tax deficiency. Since pursuant to section 1014(a) the same valuation was used to determine the residuary beneficiary's gain on the sale of the stock, it followed that the residuary beneficiary had overpaid her income tax. *Estate of Branson v. Commissioner*, 264 F.3d at 907.
>
> > [16] Sec. 1014 generally provides a basis for property acquired from a decedent that is equal to the value placed upon the property for purposes of the Federal estate tax. See *Estate of Branson v. Commissioner*, 113 T.C. at 34-35; sec. 1.1014-1(a), Income Tax Regs.

[1425] For more on this case, see fns 5695-5696 and accompanying text in part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

O'Neill Trust v. Commissioner, T.C. Memo. 2022-108, described above,[1426] held:

> The trust argues that even if it is unable to claim a refund under claim of right or the mitigation provisions, the doctrine of equitable recoupment would still entitle it to seek a refund. Equitable recoupment is an equitable solution for situations "where the Government has taxed a single transaction, item, or taxable event under two inconsistent theories." *United States v. Dalm*, 494 U.S. 596, 605 n.5 (1990). It is not an "independent ground for reopening years now closed by the statute of limitations." *Evans Tr. v. United States*, 462 F.2d 521, 526 (Ct. Cl. 1972). A claim of equitable recoupment requires that (1) the refund for which recoupment is sought by way of offset be barred by time; (2) the time-barred offset arise out of the same transaction, item, or taxable event as the overpayment or deficiency before the Court; (3) the [*7] transaction, item, or taxable event have been inconsistently subject to two taxes; and (4) if the subject transaction, item, or taxable event involves two or more taxpayers, there be sufficiency of interest between the taxpayers so that the taxpayers should be treated as one. *Estate of Branson v. Commissioner*, 113 T.C. 6, 15 (1999), *aff'd*, 264 F.3d 904 (9th Cir. 2001).
>
> As with its claim of right and mitigation provision arguments, the trust's reliance on the doctrine of equitable recoupment fails in part because the trust is not the appropriate party to seek a refund in this case. The deficiency upon which the trust bases its claim for recoupment arises from deficiencies directly related to the estate's taxes, not the trust's.
>
> Furthermore, the requirements of equitable recoupment are not met. Respondent's determination is based on the disallowance of the trust's claimed reduction of tax liability pursuant to section 1341. This determination is not inconsistent with the trust's time-barred income tax liabilities for tax years 2009 and 2010. The liabilities for 2009 and 2010 have no transactional connection with respondent's denial under the claim of right.

When the same four individuals owned a law firm operated as a PC and another as an LLP and a payroll tax error caused the wrong entity to pay payroll taxes, a recovery of taxes against the correct entity generated equitable recoupment for taxes paid by the wrong entity. *Emery Celli Cuti Brinckerhoff & Abady v. Commissioner*, T.C. Memo. 2018-55.

II.G.4.m.iii. Tax Benefit Rule

Code § 111, "Recovery of tax benefit items," provides:

> (a) *Deductions*. Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter.
>
> (b) *Credits*.
>
> (1) *In general*. If-
>
> (A) a credit was allowable with respect to any amount for any prior taxable year, and

[1426] See text accompanying and following fn 1421 in part II.G.4.m.i Code § 1341 Claim of Right Deduction.

(B) during the taxable year there is a downward price adjustment or similar adjustment,

the tax imposed by this chapter for the taxable year shall be increased by the amount of the credit attributable to the adjustment.

(2) *Exception where credit did not reduce tax*. Paragraph (1) shall not apply to the extent that the credit allowable for the recovered amount did not reduce the amount of tax imposed by this chapter.

(3) *Exception for investment tax credit and foreign tax credit*. This subsection shall not apply with respect to the credit determined under section 46 and the foreign tax credit.

(c) *Treatment of carryovers*. For purposes of this section, an increase in a carryover which has not expired before the beginning of the taxable year in which the recovery or adjustment takes place shall be treated as reducing tax imposed by this chapter.

(d) *Special rules for accumulated earnings tax and for personal holding company tax*. In applying subsection (a) for the purpose of determining the accumulated earnings tax under section 531 or the tax under section 541 (relating to personal holding companies)-

(1) any excluded amount under subsection (a) allowed for the purposes of this subtitle (other than section 531 or section 541) shall be allowed whether or not such amount resulted in a reduction of the tax under section 531 or the tax under section 541 for the prior taxable year; and

(2) where any excluded amount under subsection (a) was not allowable as a deduction for the prior taxable year for purposes of this subtitle other than of section 531 or section 541 but was allowable for the same taxable year under section 531 or section 541, then such excluded amount shall be allowable if it did not result in a reduction of the tax under section 531 or the tax under section 541.

The companion cases of *Hillsboro Nat'l Bank v. Commissioner* and *Bliss Dairy, Inc. v. United States*, 460 U.S. 370 (1983), describe the tax benefit rule in part II of their opinion:

> The Government[7] in each case relies solely on the tax benefit rule - a judicially developed principle[8] that allays some of the inflexibilities of the annual accounting system. An annual accounting system is a practical necessity if the federal income tax is to produce revenue ascertainable and payable at regular intervals. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931). Nevertheless, strict adherence to an annual accounting system would create transactional inequities. Often an apparently completed transaction will reopen unexpectedly in a subsequent tax year, rendering the initial reporting improper. For instance, if a taxpayer held a note that became apparently uncollectible early in the taxable year, but the debtor made an unexpected financial recovery before the close of the year and paid the debt, the transaction would have no tax consequences for the taxpayer, for the repayment of the principal would be recovery of capital. If, however, the debtor's financial recovery and the resulting repayment took place after the close of the taxable year, the taxpayer would have a deduction for the apparently bad debt in the first year under § 166(a) of the Code, 26 U.S.C. § 166(a).

Without the tax benefit rule, the repayment in the second year, representing a return of capital, would not be taxable. The second transaction, then, although economically identical to the first, could, because of the differences in accounting, yield drastically different tax consequences. The Government, by allowing a deduction that it could not have known to be improper at the time, would be foreclosed[9] from recouping any of the tax saved because of the improper deduction.[10] Recognizing and seeking to avoid the possible distortions of income,[11] the courts have long required the taxpayer to recognize the repayment in the second year as income. See, *e.g.*, *Estate of Block v. Commissioner*, 39 B.T.A. 338 (1939), *aff'd sub nom. Union Trust Co. v. Commissioner*, 111 F.2d 60 (CA7), *cert. denied*, 311 U.S. 658 (1940); *South Dakota Concrete Products Co. v. Commissioner*, 26 B.T.A. 1429 (1932); Plumb, *The Tax Benefit Rule Today*, 57 Harv. L. Rev., 129, 176, 178 and n. 172 (1943) (hereinafter Plumb).[12]

[7] In No. 81-485, the Solicitor General represents the Commissioner of Internal Revenue, while in No. 81-930, he represents the United States. We refer to the Commissioner and the United States collectively as "the Government."

[8] Although the rule originated in the courts, it has the implicit approval of Congress, which enacted § 111 as a limitation on the rule. See note 12, *infra*.

[9] A rule analogous to the tax benefit rule protects the taxpayer who is required to report income received in one year under claim of right that he later ends up repaying. Under that rule, he is allowed a deduction in the subsequent year. See generally § 1341, 26 U.S.C. § 1341; 1 B. Bittker Federal Taxation of Income, Estates and Gifts § 6.3 (1981).

[10] When the event proving the deduction improper occurs after the close of the taxable year, even if the statute of limitations has not run, the Commissioner's proper remedy is to invoke the tax benefit rule and require inclusion in the later year rather than to re-open the earlier year. See *Lexmont Corp. v. Commissioner*, 20 T.C. 185 (1953); *South Dakota Concrete Products Co. v. Commissioner*, 26 B.T.A. 1429, 1432 (1932); 1 J. Mertens, Law of Federal Income Taxation § 7.34 (J. Doheny rev. ed. 1981); Bittker & Kanner, *The Tax Benefit Rule*, 26 U.C.L.A. L. Rev. 265, 266 (1978).

Much of Justice Blackmun's dissent takes issue with this well-settled rule. The inclusion of the income in the year of the deductions by amending the returns for that year is not before us in these cases, for none of the parties has suggested such a result, no doubt because the rule is so settled. It is not at all clear what would happen on the remand that Justice Blackmun desires. Neither taxpayer has ever sought to file an amended return. The statute of limitations has now run on the years to which the dissent would attribute the income, § 6501(a), and we have no indication in the record that the Government has held those years open for any other reason.

Even if the question were before us, we could not accept the view of Justice Blackmun's dissent. It is, of course, true that the tax benefit rule is not a precise way of dealing with the transactional inequities that occur as a result of the annual accounting system, *post*, at 3, 5. See note 12, *infra*. Justice Blackmun's approach, however, does not eliminate the problem; it only multiplies the number of rules. If the statute of limitations has run on the earlier year, the dissent recognizes that the rule that we now apply must apply. *Post*, at 5. Thus, under the proposed scheme, the only difference is that, if the inconsistent event fortuitously occurs between the end of the year of the deduction and the running of the statute of limitations, the Commissioner must reopen the earlier year or permit an amended return even though it is settled that the acceptance of such a return after the date for filing a return is not covered by statute but within the discretion of the Commissioner. See, *e.g.*, *Koch v. Alexander*, 561 F.2d 1115 (CA4 1977) (*per curiam*); *Miskovsky v. United States*, 414 F.2d 954 (CA3 1969). In any other situation, the income must be recognized in the later year. Surely a single rule covering all situations would be preferable to several rules that do not alleviate any of the disadvantages of the single rule.

A second flaw in Justice Blackmun's approach lies in his assertion that the practice he proposes is like any correction made after audit. Changes on audit reflect the proper tax treatment of items under the facts as they were known at the end of the taxable year. The tax benefit rule is addressed to a different problem—that of events that occur after the close of the taxable year.

In any event, whatever the merits of amending the return of the year of the improper deduction might originally have been, we think it too late in the day to change the rule. Neither the judicial origins of the rule nor the subsequent codification permit the approach suggested by Justice Blackmun.

The dissent suggests that the reason that the early cases expounding the tax benefit rule required inclusion in the later year was that the statute of limitations barred adjustment in the earlier year. *Post*, at 3, n. *. That suggestion simply does not reflect the cases cited. In *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931), the judgment of the Court of Appeals reflected Justice Blackmun's approach, holding that the amount *recovered* in the later year was not income in that year but that the taxpayer had to amend its returns for the years of the deductions. *Id*., at 362. This Court reversed, stating, "That the recovery made by respondent in 1920 was gross income *for that year* ... cannot, we think, be doubted." *Id*., at 363. (Emphasis added). Neither does *Healy v. Commissioner*, 345 U.S. 278 (1953), a case dealing with income received under claim of right, provide any support for this novel theory. On the contrary, the Court's discussion of the statute of limitations, cited by the dissent, in context, is as follows:

"A rule which required that the adjustment be made in the earlier year of receipt instead of the later year of repayment would generally be unfavorable to taxpayers, for the statute of limitations would frequently bar any adjustment of the tax liability for the earlier year. Congress has enacted an annual accounting system under which income is counted up at the end of each year. It would be disruptive of an orderly collection of the revenue to rule that the accounting must be done over again to reflect events occurring after the year for which the accounting is made, and would violate the spirit of the annual accounting system." *Id.*, at 284-285 (footnote omitted). Even the earliest cases, then, reflect the currently accepted view of the tax benefit rule.

Further, § 111, the partial codification of the tax benefit rule, see note 8, *supra*, contradicts Justice Blackmun's view. It provides that gross income for a year does not include a specified portion of a recovery of amounts earlier deducted, implying that the remainder of the recovery is to be included in gross income for that year. See, *e.g.*, S. Rep. No. 830, 88th Cong., 2d Sess. 100 (1964); S. Rep. 1631, 77th Cong., 2d Sess. 79 (1942). Even if the judicial origins of the rule supported Justice Blackmun, we would still be obliged to bow to the will of Congress.

[11] As the rule developed, a number of theories supported taxation in the later year. One explained that the taxpayer who had taken the deduction “consented” to “return” it if events proved him not entitled to it, *e.g.*, *Philadelphia National Bank v. Rothensies*, 43 F.Supp. 923, 925 (E. D. Pa. 1942), while another explained that the deduction offset income in the earlier year, which became “latent” income that might be recaptured, *e.g.*, *National Bank of Commerce v. Commissioner*, 115 F.2d 875, 876-877 (1940); Lassen, *The Tax Benefit Rule and Related Problems*, 20 Taxes 473, 476 (1942). Still a third view maintained that the later recognition of income was a balancing entry. *E.g.*, *South Dakota Concrete Products Co. v. Commissioner*, 26 B.T.A. 1429, 1431 (1932). All these views reflected that the initial accounting for the item must be corrected to present a true picture of income. While annual accounting precludes reopening the earlier year, it does not prevent a less precise correction - far superior to none - in the current year, analogous to the practice of financial accountants. See W. Meigs, A. Mosich, C. Johnson and T. Keller, *Intermediate Accounting* 109 (3d ed. 1974). This concern with more accurate measurement of income underlies the tax benefit rule and always has.

[12] Even this rule did not create complete transactional equivalence. In the second version of the transaction discussed in the text, the taxpayer might have realized no benefit from the deduction, if, for instance, he had no taxable income for that year. Application of the tax benefit rule as originally developed would require the taxpayer to recognize income on the repayment, so that the net result of the collection of the principal amount of the debt would be recognition of income. Similarly, the tax rates might change between the two years, so that a deduction and an inclusion, though equal in amount, would not produce exactly offsetting tax consequences. Congress enacted § 111 to deal with part of this problem. Although a change in the rates may still lead to differences in taxes due, see *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct.Cl. 1967), § 111 provides that the taxpayer can exclude from income the amount that did not give rise to some tax benefit. See *Dobson v. Commissioner*, 320 U.S. 489, 505-506 (1943). This exclusionary rule and the inclusionary rule described in the text are generally known together as the tax benefit rule. It is the inclusionary aspect of the rule with which we are currently concerned.

The taxpayers and the Government in these cases propose different formulations of the tax benefit rule. The taxpayers contend that the rule requires the inclusion of amounts recovered in later years, and they do not view the events in these cases as “recoveries.” The Government, on the other hand, urges that the tax benefit rule requires the inclusion of amounts previously deducted if later events are inconsistent with the deductions; it insists that no “recovery” is necessary to the application of the rule. Further, it asserts that the events in these cases are inconsistent with the deductions taken by the taxpayers. We are not in complete agreement with either view.

An examination of the purpose and accepted applications of the tax benefit rule reveals that a “recovery” will not always be necessary to invoke the tax benefit rule. The purpose of the rule is not simply to tax “recoveries.” On the contrary, it is to approximate the results produced by a tax system based on transactional rather than annual accounting. See generally Bittker and Kanner, *The Tax Benefit Rule*, 26 U.C.L.A. Rev. 265, 270 (1978); Byrne, *The Tax Benefit Rule as Applied to Corporate Liquidations and Contributions to Capital: Recent Developments*, 56 Notre Dame Law. 215, 221, 232, (1980); Tye, *The Tax Benefit Doctrine Reexamined*, 3 Tax. L. Rev. 329 (1948) (hereinafter Tye). It has long been accepted that a taxpayer using accrual accounting who accrues and deducts an expense in a tax year before it becomes payable and who for some reason eventually does not have to pay the liability must then take into income the amount of the expense earlier deducted. See, *e.g.*, *Mayfair Minerals, Inc. v. Commissioner*, 456 F.2d 622 (CA5 1972) (per curiam); *Bear Manufacturing Co. v. United States*, 430 F.2d 152 (CA7 1970), *cert. denied*, 400 U.S. 1021 (1971); *Haynsworth v. Commissioner*, 68 T.C. 703 (1977), *aff'd without op.*, 609 F.2d 1007 (CA5 1979); *G.M. Standifer Construction Corp. v. Commissioner*, 30 B.T.A. 184, 186-187 (1934), *petition for review dism'd*, 78 F.2d 285 (CA9 1935). The bookkeeping entry cancelling the liability, though it increases the balance sheet net worth of the taxpayer, does not fit within any ordinary definition of "recovery."[13] Thus, the taxpayers' formulation of the rule neither serves the purposes of the rule nor accurately reflects the cases that establish the rule. Further, the taxpayers' proposal would introduce an undesirable formalism into the application of the tax benefit rule. Lower courts have been able to stretch the definition of "recovery" to include a great variety of events. For instance, in cases of corporate liquidations, courts have viewed the corporation's receipt of its own stock as a "recovery," reasoning that, even though the instant that the corporation receives the stock it becomes worthless, the stock has value as it is turned over to the corporation, and that ephemeral value represents a recovery for the corporation. See, *e.g.*, *Tennessee-Carolina Transportation, Inc. v. Commissioner*, 582 F.2d 378, 382 (CA6 1978), *cert. denied*, 440 U.S. 909 (1979) (alternative holding). Or, payment to another party may be imputed to the taxpayer, giving rise to a recovery. See *First Trust and Savings Bank v. United States*, 614 F.2d 1142, 1146 (CA7 1980) (alternative holding). Imposition of a requirement that there be a recovery would, in many cases, simply require the Government to cast its argument in different and unnatural terminology, without adding anything to the analysis.[14]

[13] See, *e.g.*, Bittker and Kanner, *The Tax Benefit Rule*, 26 U.C.L.A. L.Rev. 265, 267 (1978); *cf.* Zysman, *Income Derived from Recovery of Deductions*, 19 Taxes 29, 30 (1941) (We are "not concerned with a theoretical or pure economic concept of income, but with gross income within the meaning of the statute.")

Although Justice Stevens insists that this situation falls within the standard meaning of "recovery," it does so only in the sense that an increase in balance sheet net worth is to be considered a recovery. *Post*, at 15, n. 26. But in Bliss, Justice Stevens asserts that there is no recovery. There, the corporation's balance sheet shows zero as the historic cost of the grain on hand, because the corporation expensed the asset upon acquisition. At the date of liquidation, the historic cost of the grain on hand was in fact greater than zero, and an accurate balance sheet would have reflected an asset account balance greater than zero. The necessary adjustment thus reflects an increase in balance sheet net worth.

[14] Despite Justice Stevens' assertion that *Tennessee-Carolina* was wrong, *post*, at 15, n. 26, the case fits what seems to be his definition of a recovery - an enhancement of the taxpayer's wealth - for the corporation in Tennessee-Carolina received stock worth more than the balance sheet book value of its assets. See note 13, supra. Thus we disagree with the assertion that the recovery rule is a bright-line rule easily applied.

The basic purpose of the tax benefit rule is to achieve rough transactional parity in tax, see note 12, supra, and to protect the Government and the taxpayer from the adverse effects of reporting a transaction on the basis of assumptions that an event in a subsequent year proves to have been erroneous. Such an event, unforeseen at the time of an earlier deduction, may in many cases require the application of the tax benefit rule. We do not, however, agree that this consequence invariably follows. Not every unforeseen event will require the taxpayer to report income in the amount of his earlier deduction. On the contrary, the tax benefit rule will "cancel out" an earlier deduction only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based.[15] That is, if that event had occurred within the same taxable year, it would have foreclosed the deduction.[16] In some cases, a subsequent recovery by the taxpayer will be the only event that would be fundamentally inconsistent with the provision granting the deduction. In such a case, only actual recovery by the taxpayer would justify application of the tax benefit rule. For example, if a calendar-year taxpayer made a rental payment on December 15 for a 30-day lease deductible in the current year under § 162(a)(3), see Treas. Reg. § 1.461-1(a)(1), 26 CFR § 1.461-1(a)(1)(1982); *e.g.*, *Zaninovich v. Commissioner*, 616 F.2d 429 (CA9 1980),[17] the tax benefit rule would not require the recognition of income if the leased premises were destroyed by fire on January 10. The resulting inability of the taxpayer to occupy the building would be an event not fundamentally inconsistent with his prior deduction as an ordinary and necessary business expense under § 162(a). The loss is attributable to the business[18] and therefore is consistent with the deduction of the rental payment as an ordinary and necessary business expense. On the other hand, had the premises not burned and, in January, the taxpayer decided to use them to house his family rather than to continue the operation of his business, he would have converted the leasehold to personal use. This would be an event fundamentally inconsistent with the business use on which the deduction was based.[19] In the case of the fire, only if the lessor—by virtue of some provision in the lease—had refunded the rental payment would the taxpayer be required under the tax benefit rule to recognize income on the subsequent destruction of the building. In other words, the subsequent recovery of the previously deducted rental payment would be the only event inconsistent with the provision allowing the deduction. It therefore is evident that the tax benefit rule must be applied on a case-by-case basis. A court must consider the facts and circumstances of each case in the light of the purpose and function of the provisions granting the deductions.

[15] Justice Stevens accuses us of creating confusion at this point in the analysis by requiring the courts to distinguish "inconsistent events" from "fundamentally inconsistent events." *Post*, at 16. That line is not the line we draw; rather, we draw the line between merely unexpected events and inconsistent events.

This approach differs from that proposed by the Government in that the Government has not attempted to explain why two events are inconsistent. Apparently, in the Government's view, any unexpected event is inconsistent with an earlier deduction. That view we cannot accept.

[16] Justice Stevens apparently disagrees with this rule, for, although he concurs in the result in *Hillsboro*, he asserts that the events there would have resulted in denial of the deduction had they all occurred in one year. *Post*, at 16. We find it difficult to believe that Congress placed such a premium on having a transaction straddle two tax years.

[17] Justice Stevens questions whether this amount was properly deductible under § 162(a)(3) and seems to suggest that if it was, Congress meant the deduction to be irrevocable. *Post*, at 13, n. 25. It is clear that § 162(a)(3) permits the deduction of prepaid expenses that will benefit the taxpayer for a short time into the next taxable

year, as in our example, rather than benefitting the taxpayer substantially beyond the taxable year. See generally 1 B. Bittker, *supra* n. 1, at ¶ 20.4.1.

The dissent's view that the preferable approach is to scrutinize the deduction more carefully in the year it is taken ignores two basic problems. First, reasons unrelated to the certainty that the taxpayer will eventually consume the asset as expected often enter into the decision when to allow the deduction. For instance, the desire to save taxpayers the burden of careful allocation of relatively small expenditures favors the allowance of the entire deduction in a single year of some business expenditures attributable to operations after the close of the taxable year. See generally *ibid*. Second, we simply cannot predict the future, no matter how carefully we scrutinize the deduction in the earlier year. For instance, in the case of the bad debt that is eventually repaid, we already require that the debt be apparently worthless in the year of deduction, see § 166(a)(1), but we often find that the future does not conform to earlier perceptions, and the taxpayer collects the debt. Then, "the deductions are practical necessities due to our inability to read the future, and the inclusion of the recovery in income is necessary to offset the deduction." *South Dakota Concrete Products Co. v. Commissioner*, 26 B.T.A. 1429, 1432 (1932).

[18] The loss is properly attributable to the business because the acceptance of the risk of loss is a reasonable business judgment that the courts ordinarily will not question. See *Welch v. Helvering*, 290 U.S. 111, 113 (1933); 1 B. Bittker, supra, n. 11, at ¶ 20.3.2.

[19] See 1 B. Bittker, supra, n. 11, ¶ 20.2.2 ("[F]ood and shelter are quintessential nondeductible personal expenses"). See also p. 25-26, *infra*.

When the later event takes place in the context of a nonrecognition provision of the Code, there will be an inherent tension between the tax benefit rule and the nonrecognition provision. See *Putoma Corp. v. Commissioner*, 601 F.2d 734, 742 (CA5 1979); *id.*, at 751 (Rubin, J., dissenting); *cf*. *Helvering v. American Dental Co.*, 318 U.S. 322 (1943) (tension between exclusion of gifts from income and treatment of cancellation of indebtedness as income). We cannot resolve that tension with a blanket rule that the tax benefit rule will always prevail. Instead, we must focus on the particular provisions of the Code at issue in any case.[20]

[20] An unreserved endorsement of the Government's formulation might dictate the results in a broad range of cases not before us. See, *e.g.*, Brief for the United States in No. 81-830 and the Commissioner in No. 81-485 at 20; Reply Brief for the Petitioner in No. 81-485 at 12; Tr. of Oral Arg. At 33. For instance, the Government's position implies that an individual proprietor who makes a gift of an expensed asset must recognize the amount of the expense as income, but *cf*. *Campbell v. Prothro*, 209 F.2d 331, 335 (CA5 1954). See generally 2A J. Rabkin & M. Johnson, Federal Income Gift and Estate Taxation § 6.01(3) (1982) (discussing Commissioner's treatment of gifts of expensed assets). Similarly, the Government's view suggests the conclusion that one who dies and leaves an expensed asset to his heirs would, in his last return, recognize income in the amount of the earlier deduction. Our decision in the cases before us now, however, will not determine the outcome in these other situations; it will only demonstrate the proper analysis. Those cases will require consideration of the treatment of gifts and legacies as well as §§ 1245(b)(1), (2), and 1250(d)(1), (2), which are a partial codification of the tax benefit rule, see O'Hare,

Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders, 27 Tax L. Rev. 215, 216 (1972), and which exempt dispositions by gift and transfers at death from the operation of the general depreciation recapture rules. Although there may be an inconsistent event in the personal use of an expensed asset, that event occurs in the context of a nonrecognition rule, see, *e.g.*, *Campbell v. Prothro*, *supra*, at 336; 1 B. Bittker, Federal Taxation of Income, Estates, and Gifts ¶ 5.21 (1981), and resolution of these cases would require a determination whether the nonrecognition rule or the tax benefit rule prevails.

The formulation that we endorse today follows clearly from the long development of the tax benefit rule. JUSTICE STEVENS' assertion that there is no suggestion in the early cases or from the early commentators that the rule could ever be applied in any case that did not involve a physical recovery, *post*, at 5 is incorrect. The early cases frequently framed the rule in terms consistent with our view and irreconcilable with that of the dissent. See *Barnett v. Commissioner*, 39 B.T.A. 864, 867 (1939) ("Finally, the present case is analogous to a number of others, where ... [w]hen some event occurs which is *inconsistent* with a deduction taken in a prior year, adjustment may have to be made by reporting a balancing item in income for the year in which the change occurs.") (emphasis added); *Estate of Block v. Commissioner*, 39 B.T.A. 338 (1939) ("When recovery or *some other event which is inconsistent* with what has been done in the past occurs, adjustment must be made in reporting income for the year in which the change occurs.") (emphasis added); *South Dakota Concrete Products Co. v. Commissioner*, 26 B.T.A. 1429, 1432 (1932) ("[W]hen an *adjustment* occurs which is inconsistent with what has been done in the past in the determination of tax liability, the adjustment should be reflected in reporting income for the year in which it occurs.") (emphasis added).[21] The reliance of the dissent on the early commentators is equally misplaced, for the articles cited in the dissent, like the early cases, often stated the rule in terms of inconsistent events.[22]

[21] Justice Stevens' attempt to discount the explicit statement in *Estate of Block* that inconsistent events would trigger the recognition of income, *post*, at 6, n. 9, is singularly unpersuasive. The Board of Tax Appeals used the word "recovery" later in the opinion because it was faced with a recovery in that case, not because it meant to repudiate hastily its discussion in the same opinion of the general rule. Similarly, the mere assertion that the broad formulation in *Barnett* followed a discussion of a Treasury regulation, *post*, at 6, n. 10, does not support the view of the dissent that the concept of inconsistent events represents a break with the early cases.

[22] "The rule requiring taxation of income from the recovery or cancellation of items previously deducted is a remedial expedient, designed to prevent the unjust enrichment of a taxpayer and to offset the benefit derived from a deduction to which, *in the light of subsequent events*, the taxpayer was not entitled." Plumb 176 (1943) (emphasis added). See also id., at 131, 178.

"In a few words, the basic idea of the Tax Benefit Rule is this: If a taxpayer has derived a benefit from a deduction by reducing his taxable income in the year of deduction, he must declare as taxable income any recovery *or other change of his status* which - *ex nunc* - makes the original deduction seem unjustified." Lassen, The Tax Benefit Rule and Related Problems, 20 Taxes 473, 473 (1942) (emphasis added).

One author saw his subject - the recovery of deductions - as an example of the broader rule: "Sometimes a subsequent event reveals the income or deductions as reported by the taxpayer to be erroneous. Thus the unexpected recovery of a portion of an amount lost and already deducted reduces the loss as originally determined. There are even cases in which items apparently finally and accurately determined have to be adjusted *on account of a subsequent event*." Zysman, Income Derived from the Recovery of Deductions, 19 Taxes 29, 29 (1941) (emphasis added).

Finally, Justice Stevens' dissent relies heavily on the codification in § 111 of the exclusionary aspect of the tax benefit rule, which requires the taxpayer to include in income only the amount of the deduction that gave rise to a tax benefit, see note 12, *supra*. That provision does, as the dissent observes, speak of a "recovery." By its terms, it only applies to bad debts, taxes, and delinquency amounts. Yet this Court has held, *Dobson v. Commissioner*, 320 U.S. 489, 505-506 (1943), and it has always been accepted since,[23] that § 111 does not limit the application of the exclusionary aspect of the tax benefit rule. On the contrary, it lists a few applications and represents a general endorsement of the exclusionary aspect of the tax benefit rule to other situations within the inclusionary part of the rule. The failure to mention inconsistent events in § 111 no more suggests that they do not trigger the application of the tax benefit rule than the failure to mention the recovery of a capital loss suggests that it does not, see *Dobson*, *supra*.

[23] See, *e.g.*, Bittker and Kanner, The Tax Benefit Rule, 26 U.C.L.A. L. Rev. 265, 266 (1978); Tye 330; Plumb 144-145.

Justice Stevens also suggests that we err in recognizing transactional equity as the reason for the tax benefit rule. It is difficult to understand why even the clearest recovery should be taxed if not for the concern with transactional equity, see *supra*, at 6-7. Nor does the concern with transactional equity entail a change in our approach to the annual accounting system. Although the tax system relies basically on annual accounting, see *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931), the tax benefit rule eliminates some of the distortions that would otherwise arise from such a system. See, *e.g.*, Bittker and Kanner, The Tax Benefit Rule, 26 U.C.L.A.L. Rev. 265, 268-270 (1978); Tye 350; Plumb 178 and n. 172. The limited nature of the rule and its effect on the annual accounting principle bears repetition: only if the occurrence of the event in the earlier year would have resulted in the disallowance of the deduction can the Commissioner require a compensating recognition of income when the event occurs in the later year.[24]

[24] Justice Stevens seems to fear that our approach to the annual accounting system is inconsistent with Sanford & Brooks in a way that will vest new power in the tax collector to ignore the annual accounting system. The fear is unfounded. In *Sanford & Brooks*, a taxpayer who had incurred a net loss on a long-term contract managed to recoup the loss in a lawsuit in a later year. The earlier net losses on the contract contributed to net losses for the business in most of the tax years during the performance of the contract. The Court rejected the taxpayer's contention that it should be able to exclude the award on the theory that the award offset the earlier net losses. This adherence to the annual accounting system is perfectly consistent with the approach we follow in the cases now before us. In situations implicating the tax benefit rule or the analogous doctrine permitting the taxpayer to take a deduction when income recognized earlier under a claim of right must be repaid, see note 9, *supra*, the

problem is that the taxpayer has mischaracterized some event. Either he has recognized income that eventually turns out not to be income, or he has taken a deduction that eventually turns out not to be a deduction. Neither of these problems arose in *Sanford & Brooks*. Instead, the problem there was that the taxpayer had properly deducted expenditures and was properly recognizing income but thought that the two should have been matched in the same year. The tax benefit rule does not permit the Commissioner or the taxpayer to rematch properly recognized income with properly deducted expenses; it merely permits a balancing entry when an apparently proper expense turns out to be improper.

Our approach today is consistent with our decision in *Nash v. United States*, 398 U.S. 1 (1970). There, we rejected the Government's argument that the tax benefit rule required a taxpayer who incorporated a partnership under § 351 to include in income the amount of the bad debt reserve of the partnership. The Government's theory was that, although § 351 provides that there will be no gain or loss on the transfer of assets to a controlled corporation in such a situation, the partnership had taken bad debt deductions to create the reserve, see § 166(c), and when the partnership terminated, it no longer needed the bad debt reserve. We noted that the receivables were transferred to the corporation along with the bad debt reserve. *Id*., at 5 and n. 5. Not only was there no "recovery," *id.*, at 4, but there was no inconsistent event of any kind. That the fair market value of the receivables was equal to the face amount less the bad debt reserve, *id*., at 4, reflected that the reserve, and the deductions that constituted it, were still an accurate estimate of the debts that would ultimately prove uncollectible, and the deduction was therefore completely consistent with the later transfer of the receivables to the incorporated business. See *Citizens' Acceptance Corp v. United States*, 320 F. Supp. 798 (D. Del. 1971), *rev'd* on other grounds, 462 F.2d 751 (CA3 1972); Rev. Rul. 78-279, 1978-2 Cum. Bull. 135; Rev. Rul. 78-278, 1978-2 Cum. Bull. 134; see generally O'Hare, Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders, 27 Tax L. Rev. 215, 219-221 (1972).[25]

[25] Justice Stevens attempts to read our prior cases as somehow inconsistent with our approach here. Nash is the only case in which we have dealt with the inclusionary aspect of the tax benefit rule, and, as we have established, there was neither a recovery nor an inconsistent event in that case. In *Dobson v. Commissioner*, 320 U.S. 489 (1943), we considered the exclusionary aspect of the rule. That case involved a recovery that was clearly inconsistent with the deduction, and the only question was whether the deduction had created a benefit. The references to "recovery" in the opinion describe the case before the Court. They do not in any way impose general requirements for inclusion, as the dissent seems to suggest.

In the cases currently before us, then, we must undertake an examination of the particular provisions of the Code that govern these transactions to determine whether the deductions taken by the taxpayers were actually inconsistent with later events and whether specific nonrecognition provisions prevail over the principle of the tax benefit rule.[26]

[26] It is worth noting that a holding requiring no recognition of income is not, as Justice BLACKMUN's dissent suggests, a conclusion that the tax benefit rule "has no application to the situation presented." *Post*, at 1. As a general principle of tax law, the rule of course applies; it simply does not require the recognition of income.

Part III of the Court's opinion discussed a provision granting a corporation a deduction for taxes imposed on its shareholders but paid by the corporation:

> In *Hillsboro*, the key provision is § 164(e).[27] That section grants the corporation a deduction for taxes imposed on its shareholders but paid by the corporation. It also denies the shareholders any deduction for the tax. In this case, the Commissioner has argued that the refund of the taxes by the state to the shareholders is the equivalent of the payment of a dividend from Hillsboro to its shareholders. If Hillsboro does not recognize income in the amount of the earlier deduction, it will have deducted a dividend. Since the general structure of the corporate tax provisions does not permit deduction of dividends, the Commissioner concludes that the payment to the shareholders must be inconsistent with the original deduction and therefore requires the inclusion of the amount of the taxes as income under the tax benefit rule.
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> > [27] The Commissioner asserts also that Hillsboro deducted the taxes as a contested liability under § 461(f), and that the legislative history of § 461(f) shows that Congress intended that the tax benefit rule apply if a taxpayer successfully contested a liability deducted under § 461(f). We do not view this argument as in any way separate from the Commissioner's argument under § 164(e). Section 461(f) does not grant deductions of its own force; the expenditure must qualify as deductible in character under some other section. See Treas. Reg. § 1.461-2(a)(1)(iv), 26 CFR § 1.461-2(a)(1)(iv) (1982). If the expenditure does qualify independently as deductible, but, because it is contested, it lacks the certainty otherwise required for deduction, § 461(f) grants the deduction, on the condition that the tax benefit rule will apply. But for the tax benefit rule to apply, there must be some event that is inconsistent with the provision granting the deduction. The question here then remains whether the deduction is appropriate under § 164(e) or whether later events are inconsistent with that deduction.
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> In evaluating this argument, it is instructive to consider what the tax consequences of the payment of a shareholder tax by the corporation would be without § 164(e) and compare them to the consequences under § 164(e). Without § 164(e), the corporation would not be entitled to a deduction, for the tax is not imposed on it. See Treas. Reg. § 1.164-1(a), 26 CFR § 1.164-1(a) (1982); *Wisconsin Gas & Electric v. United States*, 322 U.S. 526, 527-530 (1944). If the corporation has earnings and profits, the shareholder would have to recognize income in the amount of the taxes, because a payment by a corporation for the benefit of its shareholders is a constructive dividend. See §§ 301(c), 316(a); *e.g. Ireland v. United States*, 621 F.2d 731, 735 (CA5 1980); B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 7.05 (4th ed. 1979). The shareholder, however, would be entitled to a deduction since the constructive dividend is used to satisfy his tax liability. Section 164(a)(2). Thus, for the shareholder, the transaction would be a wash: he would recognize the amount of tax as income,[28] but he would have an offsetting deduction for the tax. For the corporation, there would be no tax consequences, for the payment of a dividend gives rise to neither income nor a deduction. Section 311(a).
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> > [28] There would be an exception for a shareholder who had not yet earned $200 in interest and dividend income from his stock holdings in this and other corporations during the taxable year. He would be able to exclude up to $200 received in dividend and interest income for the year. See § 116(a)(1), (b), 26 U.S.C. § 116(a)(1), (b)

(Supp. 1980). At the time of the Hillsboro transaction, the exclusion was $100. See 26 U.S.C. § 116(a).

Under § 164(e), the economics of the transaction of course remain unchanged: the corporation is still satisfying a liability of the shareholder and therefore paying a constructive dividend. The tax consequences are, however, significantly different, at least for the corporation. The transaction is still a wash for the shareholder; although § 164(e) denies him the deduction to which he would otherwise be entitled, he need not recognize income on the constructive dividend, Treas. Reg. § 1.164-7, 26 CFR § 1.164-7 (1982). But the corporation is entitled to a deduction that would not otherwise be available. In other words, the only effect of § 164(e) is to permit the corporation to deduct a dividend. Thus, we cannot agree with the Commissioner that, simply because the events here give rise to a deductible dividend, they cannot be consistent with the deduction. In at least some circumstances, a deductible dividend is within the contemplation of the Code. The question we must answer is whether § 164(e) permits a deductible dividend in these circumstances - when, the money, though initially paid into the state treasury, ultimately reaches the shareholder - or whether the deductible dividend is available, as the Commissioner urges, only when the money remains in the state treasury, as properly assessed and collected tax revenue.

Rephrased, our question now is whether Congress, in granting this special favor to corporations that paid dividends by satisfying the liability of their shareholders, was concerned with the reason the money was paid out by the corporation or with the use to which it was ultimately put. Since § 164(e) represents a break with the usual rules governing corporate distributions, the structure of the Code does not provide any guidance on the reach of the provision. This Court has described the provisions as "prompted by the plight of various banking corporations which paid and voluntarily absorbed the burden of certain local taxes imposed upon their shareholders, but were not permitted to deduct those payments from gross income*." Wisconsin Gas & Electric Co. v. United States*, 322 U.S., at 531 (footnote omitted). The section, in substantially similar form, has been part of the Code since the Revenue Act of 1921, 42 Stat. 227. The provision was added by the Senate, but its Committee Report merely mentions the deduction without discussing it, see S. Rep. No. 275, 67th Cong., 1st Sess. 19 (1921). The only discussion of the provision appears to be that between Dr. T. S. Adams and Senator Smoot at the Senate Hearings. Dr. Adams's statement explains why the states imposed the property tax on the shareholders and collected it from the banks, but it does not cast much light on the reason for the deduction. Hearings on H. R. 8245 before the Comm. on Finance, 67th Cong., 1st Sess. 250-251 (1921) (statement of Dr. T. S. Adams, tax advisor, Treasury Department). Senator Smoot's response, however, is more revealing:

> I have been a director of a bank ... for over 20 years. They have paid that tax ever since I have owned a share of stock in the bank ... I know nothing about it. I do not take 1 cent of credit for deductions, and the banks are entitled to it. *They pay it out*. *Id*., at 251 (emphasis added).

The *payment* by the corporations of a liability that Congress knew was not a tax imposed on them[29] gave rise to the entitlement to a deduction; Congress was unconcerned that the corporations took a deduction for amounts that did not satisfy their tax liability. It apparently perceived the shareholders and the corporations as independent of one another, each "know [ing] nothing about" the payments by the other. In those circumstances, it is difficult to conclude that the Congress intended that the corporation have no deduction if the state turned the tax revenues over to these independent parties. We conclude that the purpose of § 164(e) was to provide relief for the corporations making these payments, and the focus of Congress was on the act of payment rather than on the ultimate use of the funds by the state. As long as the payment itself was not negated by a refund to the corporation, the change in character of the funds in the hands of the state does not require the corporation to recognize income, and we reverse the judgment below.[30]

[29] Dr. Adams testified repeatedly that the banks paid the tax "voluntarily." Hearings on H. R. 8245 before the Comm. on Finance, 67th Cong., 1st Sess. 250 (1921) (statement of Dr. T. S. Adams, tax advisor, Treasury Department).

[30] Our examination of the legislative history thus leads us to reject Justice Blackmun's unsupported suggestion that Congress focused on the payment of a tax. Post, at 2. The theory he suggests leads to the conclusion that, even if the state had not refunded the taxes, the bank would not have been entitled to the deduction, because it had not paid a "tax." It is difficult to believe that the Congress that acted to alleviate "the plight of various banking corporations which paid and voluntarily absorbed the burden," Wisconsin Gas & Electric Co. v. United States, 322 U.S. 526, 531 [32 AFTR 368] (1944), intended the result suggested by the dissent.

Part IV discussed how the tax benefit rule interacted with a statutory tax-free liquidation of a corporation:

The problem in *Bliss* is more complicated. *Bliss* took a deduction under § 162(a), so we must begin by examining that provision. Section 162(a) permits a deduction for the "ordinary and necessary expenses" of carrying on a trade or business. The deduction is predicated on the consumption of the asset in the trade or business. See Treas. Reg. § 1.162-3, 26 CFR § 1.162-3 (1982) ("Taxpayers ... should include in expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operation in the taxable year ....") (emphasis added). If the taxpayer later sells the asset rather than consuming it in furtherance of his trade or business, it is quite clear that he would lose his deduction, for the basis of the asset would be zero, see, *e.g.*, *Spitalny v. United States*, 430 F.2d 195 (CA9 1970), so he would recognize the full amount of the proceeds on sale as gain. See § 1001(a), (c). In general, if the taxpayer converts the expensed asset to some other, non-business use, that action is inconsistent with his earlier deduction, and the tax benefit rule would require inclusion in income of the amount of the unwarranted deduction. That non-business use is inconsistent with a deduction for an ordinary and necessary business expense is clear from an examination of the Code. While § 162(a) permits a deduction for ordinary and necessary business expenses, § 262 explicitly denies a deduction for personal expenses. In the 1916 Act, the two provisions were a single section. See § 5(a)(1st), 39 Stat. 756. The provision has been uniformly interpreted as providing a deduction only for those expenses attributable to the business of the taxpayer. See, *e.g.*, *Kornhauser v. United States*, 267 [276] U.S. 145 (1928); H. Rep., 75th Cong., 3d Sess. 46 (January 14, 1938) ("a taxpayer should be granted a reasonable deduction for the direct expenses he has incurred in connection with his income") (emphasis added); see generally, 1 B. Bittker, Federal Taxation of Income, Estates and Gifts § 20.2 (1981). Thus, if a corporation turns expensed assets to the analog of personal consumption, as Bliss did here—distribution to shareholders[31] - it would seem that it should take into income the amount of the earlier deduction.[32]

[31] "Paying the dividend was the enjoyment of [the corporate] income. A body corporate can be said to enjoy its income in no other way." *Williamson v. United States*, 292 F.2d 524, 530 (Ct.Cl. 1961).

[32] Justice Stevens' dissent takes issue with this conclusion, characterizing the situation as identical to that in Nash, which he explains as a case in which we held that, although "a business asset matching a prior deduction ... would not be used up ... until it had passed to a different taxpayer," the transfer did not require the recognition of income. *Post*, at 13. What is misleading in this description is its failure to recognize that in Nash the prior deduction was reflected in the asset transferred because of the contra-asset account: uncollectible accounts. That contra-asset diminished the asset, see generally W. Meigs, A. Mosich, C. Johnson and T. Keller, Intermediate Accounting 140-141 (3d ed. 1974), and was inseparable from it. Therefore, the transfer of the notes did not establish that they were worth their face value, and there was no inconsistent event.

In *Bliss*, the taxpayers took a deduction for an expense and credited the asset account. Unlike the debit to the expense account in *Nash*, the debit to the expense account did not reflect any economic decrease in the value of the asset. When the taxpayers transferred the asset, it became clear that the economic decrease would not take place in the hands of Bliss - and possibly never would occur.

To see the difference more clearly, consider the views of a third party contemplating purchasing the asset on hand in *Nash* and one contemplating purchasing the asset on hand in *Bliss*. In *Nash*, the purchaser would be willing to pay only the face amount of the receivables less the amount in the contra-asset account—the amount earlier deducted by the taxpayer—because that is all the purchaser could expect to realize on them. In other words, the deduction reflected a real decrease in the value of the asset. In *Bliss*, on the other hand, the purchaser would be happy to pay the value of the grain, undiminished by the expense deducted by the taxpayer. The deduction and the asset remain separable, and the taxpayer can transfer one without netting out the other.

That conclusion, however, does not resolve this case, for the distribution by Bliss to its shareholders is governed by a provision of the Code that specifically shields the taxpayer from recognition of gain - § 336. We must therefore proceed to inquire whether this is the sort of gain that goes unrecognized under § 336. Our examination of the background of § 336 and its place within the framework of tax law convinces us that it does not prevent the application of the tax benefit rule.[33]

[33] We are aware that Congress considered but failed to enact a bill amending §§ 1245 and 1250 to cover any deduction of the purchase price of property. H. R. 10936, 94th Cong., 1st Sess. (1975). That bill would have settled the question here, since it is clear that § 1245 overrides § 336. Section 1245(a)(1); Treas. Reg. § 1.1245-6(b), 26 CFR § 1.1245-6(b) (1982). The failure to enact the bill does not suggest that Congress intended that deductions under § 162 not be subject to recapture. Both the House and Senate committees reported favorably on the bill, S. Rep. No. 94-1346, 94th Cong., 2d Sess. (1976); H. R. No. 94-1350, 94th Cong., 2d Sess. (1976), the

House passed it, and Congress adjourned without any action by the Senate. See Government Printing Office, Calendars of the United States House of Representatives and History of Legislation 174 (Final ed. 1977). The reports suggest that Congress focused on disposition by sale and thought the income subject to recapture in any event, but possibly at capital gains rather than ordinary income rates. S. Rep. No. 94-1346, *supra*, at 2; H. R. No. 94-1350, *supra*, at 2. Given this background, we cannot draw any inference from the failure to enact the amendment.

Section 336 was enacted as part of the 1954 Code. It codified the doctrine of *General Utilities Co. v. Helvering*, 296 U.S. 200, 206 (1935), that a corporation does not recognize gain on the distribution of appreciated property to its shareholders. Before the enactment of the statutory provision, the rule was expressed in the regulations, which provided that the corporation would not recognize gain or loss, "however [the assets] may have *appreciated or depreciated* in value since their acquisition." Income Tax Regulations 118, § 39.22(a)-20 (1953) (emphasis added). The Senate Report recognized this regulation as the source of the new § 336, S. Rep. No. 1622, 83d Cong., 2d Sess. 258 (1954). The House Report explained its version of the provision, "Thus, the fact that the property distributed has *appreciated or depreciated* in value over its adjusted basis to the distributing corporation will in no way alter the application of subsection (a) [providing nonrecognition]." H. R. No. 1337, 83d Cong., 2d Sess. at A90 (1954) (emphasis added). This background indicates that the real concern of the provision is to prevent recognition of market appreciation that has not been realized by an arm's-length transfer to an unrelated party rather than to shield all types of income that might arise from the disposition of an asset.

Despite the breadth of the nonrecognition language in § 336, the rule of nonrecognition clearly is not without exception. For instance, § 336 does not bar the recapture under §§ 1245 and 1250 of excessive depreciation taken on distributed assets. Sections 1245(a), 1250(a); Treas. Reg. §2.1245-6(b), 1.1250-1(c)(2), 26 CFR §§ 1.1245-6(b), 1.1250-1(c)(2) (1982). Even in the absence of countervailing statutory provisions, courts have never read the command of nonrecognition in § 336 as absolute. The "assignment of income" doctrine has always applied to distributions in liquidation. See, *e.g.*, *Siegel v. United States*, 464 F.2d 891 (CA9 1972), *cert. dism'd*, 410 U.S. 918 (1973); *Williamson v. United States*, 292 F.2d 524 (Ct.Cl. 1961); see also *Idaho First National Bank v. United States*, 265 F.2d 6 (CA9 1959) (decided before *General Utilities* codified in § 336). That judicial doctrine prevents taxpayers from avoiding taxation by shifting income from the person or entity that earns it to someone who pays taxes at a lower rate.[34] Since income recognized by the corporation is subject to the corporate tax and is again taxed at the individual level upon distribution to the shareholder, shifting of income from a corporation to a shareholder can be particularly attractive: it eliminates one level of taxation. Responding to that incentive, corporations have attempted to distribute to shareholders fully performed contracts or accounts receivable and then to invoke § 336 to avoid taxation on the income. In spite of the language of nonrecognition, the courts have applied the assignment of income doctrine and required the corporation to recognize the income.[35] Section 336, then clearly does not shield the taxpayer from recognition of all income on the distribution.

[34] For instance, a taxpayer cannot avoid recognizing the interest income on bonds that he owns by clipping the coupons and giving them to another party. See, *e.g.*, *Helvering v. Horst*, 311 U.S. 112 (1940); *Lucas v. Earl*, 281 U.S. 111 (1930).

[35] Indeed, the legislative history of § 336 compels such a result. Section 336 arose out of the same provision in the House bill as did § 311, which provides for nonrecognition of gain on nonliquidating distributions of appreciated property, and the Senate comment on § 311 explicitly provides for the application of the assignment of income doctrine. S. Rep. No. 1622, *supra*, at 247.

Next, we look to a companion provision - § 337, which governs sales of assets followed by distribution of the proceeds in liquidation.[36] It uses essentially the same broad language to shield the corporation from the recognition of gain on the sale of the assets. The similarity in language alone would make the construction of § 337 relevant in interpreting § 336. In addition, the function of the two provisions reveals that they should be construed in tandem. Section 337 was enacted in response to the distinction created by *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1950), and *Commissioner v. Court Holding*, 324 U.S. 331 (1945). Under those cases, a corporation that liquidated by distributing appreciated assets to its shareholders recognized no income, as now provided in § 336, even though its shareholders might sell the assets shortly after the distribution. See *Cumberland*. If the corporation sold the assets, though, it would recognize income on the sale, and a sale by the shareholders after distribution in kind might be attributed to the corporation. See *Court Holding*. To eliminate the necessarily formalistic distinctions and the uncertainties created by *Court Holding* and *Cumberland*, Congress enacted § 337, permitting the corporation to adopt a plan of liquidation, sell its assets without recognizing gain or loss at the corporate level, and distribute the proceeds to the shareholders. The very purpose of § 337 was to create the same consequences as § 336. See *Midland-Ross Corp. v. United States*, 485 F.2d 110 (CA6 1973); S. Rep. No. 1622, *supra*, at 258.

[36] In relevant part, § 337 provides:

> ("(a)) If within the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.
>
> ("(b)) (1) For purposes of subsection (a), the term "property" does not include-
>
> ("(A)) stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year, and property held by the corporation primarily for sale to customers in the ordinary course of its trade or business,
>
> ("(B)) installment obligations acquired in respect of the sale or exchange (without regard to whether such sale or exchange occurred before, on, or after the date of the adoption of the plan referred to in subsection (a)) of stock in trade or other property described in subparagraph (A) of this paragraph, and
>
> ("(C)) installment obligations acquired in respect of property (other than property described in subparagraph (A)) sold or exchanged before the date of the adoption of such plan of liquidation.

"(2) Notwithstanding paragraph (1) of this subsection, if substantially all of the property described in subparagraph (A) of such paragraph (1) which is attributable to a trade or business of the corporation is, in accordance with this section, sold or exchanged to one person in one transaction, then for purposes of subsection (a) the term "property" includes-

("(A)) such property so sold or exchanged, and

("(B)) installment obligations acquired in respect of such sale or exchange.

("(c)) (1) This section shall not apply to any sale or exchange -

("(A)) made by a collapsible corporation (as defined in section 341(b)), or

("(B)) following the adoption of a plan of complete liquidation, if section 333 applies with respect to such liquidation."

There are some specific differences between the two provisions, largely aimed at governing the period during which the liquidating corporation sells its assets, a problem that does not arise when the corporation distributes its assets to its shareholders. For instance, § 337 does not shield the income produced by the sale of inventory in the ordinary course of business; that income will be taxed at the corporate level before distribution of the proceeds to the shareholders. See § 337(b). These differences indicate that Congress did not intend to allow corporations to escape taxation on business income earned while carrying on business in the corporate form; what it did intend to shield was market appreciation.

The question whether § 337 protects the corporation from recognizing income because of unwarranted deductions has arisen frequently, and the rule is now well established that the tax benefit rule overrides the nonrecognition provision. *Connery v. United States*, 460 F.2d 1130 (CA3 1972); *Commissioner v. Anders*, 414 F.2d 1283 (CA10), *cert. denied*, 396 U.S. 958 (1969); *Krajeck v. United States*, 75-1 USTC ¶ 9492 (D. ND 1975); *S. E. Evans, Inc. v. United States*, 317 F.Supp. 423 (D. Ark. 1970), *Anders v. United States*, 462 F.2d 1147 (Ct.Cl.), *cert. denied*, 409 U.S. 1064 (1972); *Estate of Munter v. Commissioner*, 63 T.C. 663 (1975); Rev. Rul. 61-214, 1961-2 Cum. Bull. 60; Byrne, The Tax Benefit Rule as Applied to Corporate Liquidations: Recent Developments, 56 Notre Dame Law 215, 221 (1980); Note, Tax Treatment of Previously Expensed Assets in Corporate Liquidations, 80 Mich. L. Rev. 1636, 1638-39 (1982); *cf. Spitalny v. United States*, *supra*, 430 F.2d 195 (when deduction and liquidation occur within a single year, though tax benefit rule does not apply, principle does). Congress has recently undertaken major revisions of the Code, see Economic Tax Recovery Act of 1981, Pub. 97-34, 95 Stat. 172, and has made changes in the liquidation provisions, *e.g.*, Pub. 95-600, 92 Stat. 2904 (amending § 337); Pub. 95-628, 92 Stat. 3628 (same), but it did not act to change this long-standing, universally accepted rule. If the construction of the language in section 337 as permitting recognition in these circumstances has the acquiescence of Congress, *Lorillard v. Pons*, 434 U.S. 575, 580 (1978), we must conclude that Congress intended the same construction of the same language in the parallel provision in § 336.

Thus, the legislative history of § 336, the application of other general rules of tax law, and the construction of the identical language in § 337 all indicate that § 336 does not permit a liquidating corporation to avoid the tax benefit rule. Consequently, we reverse the judgment of the Court of Appeals and hold that, on liquidation, Bliss must include in income the amount of the unwarranted deduction.[37]

> [37] Some commentators have argued that the correct measure of the income that Bliss should include is the lesser of the amount it deducted or the basis that the shareholders will take in the asset. See Feld, The Tax Benefit of Bliss, 62 B. U. L. Rev. 443, 463-464 (1982); see also Rev. Rul. 74-396, 1974-2 Cum. Bull. 106. Since Bliss has not suggested that, if there is an amount taken into income, it should be less than the amount previously deducted, we need not address the point.
>
> As Justice Stevens observes, *post*, at 17 and n. 26, we do not resolve this question. His perception of ambiguities elsewhere in our discussion of the amount recognized as income is simply inaccurate. Our discussion of the tax consequences on the sale of an expensed asset, *supra*, at 25, does not suggest that the entire amount of proceeds on sale is attributable to the tax benefit rule. Instead, we illustrated that the basis rules automatically lead to inclusion of the amount attributable to the operation of the tax benefit rule. That is, the proceeds will equal the cost plus any appreciation (or less any decrease in value). The appreciation would be recognized as gain (or the decrease as loss) in the ordinary sale, regardless of whether the taxpayer had expensed the asset upon acquisition. The reduction of the basis to zero when the item is expensed ensures that if it is sold rather than consumed the unwarranted deduction will be included in income along with any appreciation, and it is this amount that the tax benefit rule requires to be recognized as income.

For the possibility of death purging post-mortem recovery of deductions taken during life, see the text accompanying fn 6593 in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System.

II.G.4.m.iv. Mitigation of Effect of Limitations and Other Provisions: Code §§ 1311-1314

Subchapter Q, "Readjustment of Tax Between Years and Special Limitations," which encompasses Code §§ 1301-1351, includes Part II, "Mitigation of Effect of Limitations and Other Provisions," consisting of Code §§ 1311-1314, in light of the repeal of Code §§ 1415-1337.

Code § 1312, "Circumstances of adjustment," explains that Code § 1311, "Correction of error," applies to the following circumstances:

(1) *Double inclusion of an item of gross income*. The determination requires the inclusion in gross income of an item which was erroneously included in the gross income of the taxpayer for another taxable year or in the gross income of a related taxpayer.

(2) *Double allowance of a deduction or credit*. The determination allows a deduction or credit which was erroneously allowed to the taxpayer for another taxable year or to a related taxpayer.

(3) *Double exclusion of an item of gross income*.

  (A) *Items included in income*. The determination requires the exclusion from gross income of an item included in a return filed by the taxpayer or with respect to which tax was paid and which was erroneously excluded or omitted from the gross income of the taxpayer for another taxable year, or from the gross income of a related taxpayer; or

(B) *Items not included in income*. The determination requires the exclusion from gross income of an item not included in a return filed by the taxpayer and with respect to which the tax was not paid but which is includible in the gross income of the taxpayer for another taxable year or in the gross income of a related taxpayer.

(4) *Double disallowance of a deduction or credit*. The determination disallows a deduction or credit which should have been allowed to, but was not allowed to, the taxpayer for another taxable year, or to a related taxpayer.

(5) *Correlative deductions and inclusions for trusts or estates and legatees, beneficiaries, or heirs*. The determination allows or disallows any of the additional deductions allowable in computing the taxable income of estates or trusts, or requires or denies any of the inclusions in the computation of taxable income of beneficiaries, heirs, or legatees, specified in subparts A to E, inclusive (secs. 641 and following, relating to estates, trusts, and beneficiaries) of part I of subchapter J of this chapter, or corresponding provisions of prior internal revenue laws, and the correlative inclusion or deduction, as the case may be, has been erroneously excluded, omitted, or included, or disallowed, omitted, or allowed, as the case may be, in respect of the related taxpayer.

(6) *Correlative deductions and credits for certain related corporations*. The determination allows or disallows a deduction (including a credit) in computing the taxable income (or, as the case may be, net income, normal tax net income, or surtax net income) of a corporation, and a correlative deduction or credit has been erroneously allowed, omitted, or disallowed, as the case may be, in respect of a related taxpayer described in section 1313(c)(7) .

(7) *Basis of property after erroneous treatment of a prior transaction*.

(A) *General rule*. The determination determines the basis of property, and in respect of any transaction on which such basis depends, or in respect of any transaction which was erroneously treated as affecting such basis, there occurred, with respect to a taxpayer described in subparagraph (B) of this paragraph , any of the errors described in subparagraph (C) of this paragraph.

(B) *Taxpayers with respect to whom the erroneous treatment occurred*. The taxpayer with respect to whom the erroneous treatment occurred must be -

(i) the taxpayer with respect to whom the determination is made,

(ii) a taxpayer who acquired title to the property in the transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, or

(iii) a taxpayer who had title to the property at the time of the transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, if the basis of the property in the hands of the taxpayer with respect to whom the determination is made is determined under section 1015(a) (relating to the basis of property acquired by gift).

(C) *Prior erroneous treatment*. With respect to a taxpayer described in subparagraph (B) of this paragraph -

(i) there was an erroneous inclusion in, or omission from, gross income,

(ii) there was an erroneous recognition, or nonrecognition, of gain or loss, or

(iii) there was an erroneous deduction of an item properly chargeable to capital account or an erroneous charge to capital account of an item properly deductible.

Urban and Bond, "Mitigation of excess gain on inherited property," *The Tax Adviser* (July 2023), explains:

> The mitigation provisions of Secs. 1311 through 1314 offer potential recourse in the above-described situations, provided the statutory requirements are met, by authorizing correction of errors that otherwise would be uncorrectable by operation of law. This item focuses on one specific context for using these rules to seek an adjustment: correcting excess gain on inherited property.
>
> First, however, a summary of the mitigation provisions' requirements may be useful. Sec. 1311 authorizes adjustments of the tax for a closed year if all the following conditions exist:
>
> - First, there must exist a "determination" as defined in Sec. 1313. This generally is a court decision (with respect to the taxpayer or a related taxpayer) that has become final, a closing agreement, or a final disposition on a claim for refund. Also, the taxpayer and the IRS can enter into an agreement on Form 2259, Agreement as Determination Pursuant to IRC 1313(a)(4), that constitutes a determination for purposes of the mitigation provisions.
> - Second, there must have been an error in the way an item was handled in a barred year that falls within one of the categories (referred to as "circumstances of adjustment") set forth in Sec. 1312.
> - Third, on the date of the determination, correction of the error is prevented by some rule of law (typically, the expiration of the period of limitation for assessment or refund under Sec. 6501 or Sec. 6511, respectively).
> - Finally, except in situations described in Sec. 1312(3)(B) and Sec. 1312(4), the position adopted by the successful party in the proceeding resulting in the determination must be inconsistent with that party's erroneous treatment in the barred year.
>
> Where mitigation applies, Sec. 1314(b) extends the applicable statute of limitation for one year from the date the determination is made, in order to allow the error to be corrected in the barred year.

After summarizing the broad categories with Code § 1312, the article continues:

> The first four circumstances of adjustment are relatively straightforward. The last three are more complicated, with Sec. 1312(7), which deals with problems involving basis, generally regarded as posing the most difficulty. This is the mitigation provision that potentially could correct excess gain on inherited property, as will be discussed. To invoke Sec. 1312(7), the asserting party must prove the existence of four additional conditions:
>
> - The relevant determination "determines the basis of property";
> - There exists a "transaction on which such basis depends" or a "transaction which was erroneously treated as affecting such basis";
> - "In respect of" the "transaction… there occurred" an error described in Sec. 1312(7)(C), which includes, for example, the erroneous recognition or nonrecognition of gain or loss or the erroneous inclusion or exclusion of gross income; and
> - The taxpayer with respect to whom the erroneous treatment occurred must fall into one of the categories listed in Sec. 1312(7)(B).

The article then reviews court cases:

> The Seventh and Fourth Circuits have disagreed as to how Sec. 1312(7) applies to the following common situation. A taxpayer receives property by bequest or inheritance and, on selling the property, determines gain or loss by using the value of the property reported on the estate tax return as basis. Later, after the year in which the sale occurred is closed for refund purposes, the IRS determines an estate tax deficiency based on a higher valuation of the property, and the taxpayer seeks to recompute the gain realized on the sale.
>
> In *O'Brien*, 766 F.2d 1038 (7th Cir. 1985), the Seventh Circuit held that no relief is available under Sec. 1312(7) in this situation. The transfer of the decedent's property at death is the transaction "on which basis depends" (i.e., the transaction that determined basis), but the miscomputation of gain on the sale of the property was not an error "in respect of " that transaction. In other words, while computing gain on the sale depends on the use of the correct basis, it is the transfer upon death that was the basis-determining transaction, and the error (i.e., the overstatement of gain on the sale) was not "in respect of " that transaction.
>
> However, three years earlier in *Chertkof*, 676 F.2d 984 (4th Cir. 1982), the Fourth Circuit described the same type of situation as "a classic example of the sort of nonculpable trap into which [a taxpayer] is all too likely to fall" and concluded that Sec. 1312(7) could provide relief. The court's opinion makes only a passing reference to the requirement that the error sought to be corrected must be in respect of a transaction on which basis depends, and its reasoning on that issue is unclear. The court possibly regarded the "error in respect of " requirement as being satisfied by its determination that the decedent's death and the related transfer of property was the transaction "on which basis depends." That is because the date-of-death valuation amount (later successfully challenged by the IRS) was "used both to calculate estate taxes, and to put the government and the taxpayer in a position to compute income taxes once a future gain

or loss is recognized," and, therefore, the error - using too low a basis when the property was sold -related back to (and was "in respect of ") the transfer-upon-death transaction.

The article didn't mention *O'Neill Trust v. Commissioner*, T.C. Memo. 2022-108, which gave the taxpayer no relief because the taxpayer failed to preserve its rights and because the court strictly construed which taxpayer could assert a claim of right. The case also discussed the Code §§ 1311-1314 mitigation provisions in denying relief. Relevant excerpts from the case are in part II.G.4.m.i Code § 1341 Claim of Right Deduction.

II.G.4.n. Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax

II.G.4.n.i. Itemized Deductions generally

For "itemized deductions," various limitations apply for regular tax and for alternative minimum tax. "Itemized deductions" are those not allowed in determining an adjusted gross income.[1427]

Deductions allowed in determining adjusted gross income that might be business expenses or incurred for the production of income include the following:

- "Deductions … attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee."[1428]

- Certain deductions that are reimbursed by an employer or are incurred by certain performing artists, governmental officials, elementary and secondary school teachers, or military reservists.[1429]

- Losses from the sale or exchange of property under Code §§ 161-199.[1430]

- The deductions allowed by Code §§ 161-199, by Code § 212,[1431] and by Code § 611 (relating to depletion) which are attributable to property held for the production of rents or royalties.[1432]

- In the case of a life tenant of property, or an income beneficiary of property held in trust, or an heir, legatee, or devisee of an estate, the deduction for depreciation allowed by Code § 167 and the deduction allowed by Code § 611 (depletion).[1433]

[1427] Code § 63(b).
[1428] Code § 62(a)(1). This includes unreimbursed business expenses as a partner. *Cristo v. Commissioner*, T.C. Memo. 2017-239 (managing member who owned 95% of an LLC.) It also includes expenses incurred by an individual taxpayer in preparing that portion of the taxpayer's return that relates to the taxpayer's business as a sole proprietor (such as profit or loss from business (Schedule C), income or loss from rentals or royalties (Part I of Schedule E, Supplemental Income and Loss), or farm income and expenses (Schedule F)), and expenses incurred in resolving asserted tax deficiencies relating to the taxpayer's business as a sole proprietor. Rev. Rul. 92-29.
[1429] Code § 62(a)(2).
[1430] Code § 62(a)(3).
[1431] See part II.G.4.l.i.(b) Requirements for Deduction Under Code § 212.
[1432] Code § 62(a)(4).
[1433] Code § 62(a)(5).

- Certain contributions to qualified retirement plans[1434] or IRAs.[1435]

Code § 63(b), (e)(1) disallows an individual's itemized deductions if the individual takes the "standard deduction."

Code § 67(a) reduces an individual's "miscellaneous itemized deductions" by 2% of the adjusted gross income, but Code § 67(g) disallows these deductions entirely for an individual for any taxable year beginning after December 31, 2017 and before January 1, 2026. Code § 67(b) defines "miscellaneous itemized deductions" as itemized deductions other than:

(1) the deduction under section 163 (relating to interest),

(2) the deduction under section 164 (relating to taxes),

(3) the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d),

(4) the deductions under section 170 (relating to charitable, etc., contributions and gifts) and section 642(c) (relating to deduction for amounts paid or permanently set aside for a charitable purpose),

(5) the deduction under section 213 (relating to medical, dental, etc., expenses),

(6) any deduction allowable for impairment-related work expenses,

(7) the deduction under section 691(c) (relating to deduction for estate tax in case of income in respect of the decedent),

(8) any deduction allowable in connection with personal property used in a short sale,

(9) the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under claim of right),

(10) the deduction under section 72(b)(3) (relating to deduction where annuity payments cease before investment recovered),[1436]

(11) the deduction under section 171 (relating to deduction for amortizable bond premium), and

(12) the deduction under section 216 (relating to deductions in connection with cooperative housing corporations).

Rev. Proc. 2019-46 discusses the interaction between this disallowance of miscellaneous itemized deductions and rules for using optional standard mileage rates in computing the deductible costs of operating an automobile for business, charitable, medical, or moving expense purposes.

[1434] Code § 62(a)(6), referring to the Code § 404 deduction allowed to self-employed individuals under Code § 401(c)(1).
[1435] Code § 62(a)(7), referring to Code § 219 IRA deductions.
[1436] [my footnote:] See text accompanying fn 3028 in part II.J.19.a.vii Loss on Sale of Annuity.

Regarding deductions of tax paid on real property, *Trans v. Commissioner*, T.C. Memo. 1999-233, held:

> Section 164 allows a deduction for certain taxes, including State and local real property taxes. In general, taxes are deductible only by the person upon whom they are imposed. See sec. 1.164-1(a), Income Tax Regs. However, the person owning the equitable or beneficial interest in real property and paying the taxes assessed against the property to protect that interest may deduct the taxes paid even though legal title is recorded in the name of another person. See *Estate of Movius v. Commissioner*, 22 T.C. 391 (1954); *Horsford v. Commissioner*, 2 T.C. 826 (1943); *Casey v. Commissioner*, T.C. Memo. 1965-282.
>
> We have concluded that petitioners were equitable owners of the Milpitas property during 1994; accordingly, we hold that they are entitled to deduct property taxes they paid on the property that year.

For any taxable year beginning after December 31, 2017 and before January 1, 2026, Code § 164(b)(6) limits an individual's deductions for state taxes to $10,000 ($5,000 for individuals who are married filing separately), but it does not apply this limit to property taxes attributable to Code § 212 trade or business (which generally would be rental real estate, if it is a trade or business).[1437] Revenue Ruling 2019-11 provides guidance to taxpayers regarding the inclusion in income of recovered state and local taxes in the current year when the taxpayer deducted state and local taxes paid in a prior year, subject to the Code § 164(b)(6) limitation.

Originally, charitable contributions that generate state tax credits were not reduced by the state tax credits that are awarded[1438] and were very helpful to those who are charitably inclined and receive a better deduction than the state income tax deduction. However, regulations may reduce the charitable deduction to account for state tax credits to be awarded; this reduction may generate a state income tax deduction relating to that credit. Reg. § 1.170A-1(h)(3), "Payments resulting in state or local tax benefits," provides:

> (i) *State or local tax credits*. Except as provided in paragraph (h)(3)(vi) of this section, if a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c), the amount of the taxpayer's charitable contribution deduction under section 170(a) is reduced by the amount of any state or local tax credit that the taxpayer receives or expects to receive in consideration for the taxpayer's payment or transfer.
>
> (ii) *State or local tax deductions*.
>
> (A) *In general*. If a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c), and the taxpayer receives or expects to receive state or local tax deductions that do not exceed the amount of the taxpayer's payment or the fair market value of the property transferred by the taxpayer to the entity, the taxpayer is not required to reduce its charitable

[1437] For more details about my comment on real estate as trade or business, see part II.E.1.e Whether Real Estate Qualifies as a Trade or Business.
[1438] CCA 201105010.

contribution deduction under section 170(a) on account of the state or local tax deductions.

(B) *Excess state or local tax deductions*. If the taxpayer receives or expects to receive a state or local tax deduction that exceeds the amount of the taxpayer's payment or the fair market value of the property transferred, the taxpayer's charitable contribution deduction under section 170(a) is reduced.

(iii) *In consideration for*. For purposes of paragraph (h)(3)(i) of this section, the term in consideration for shall have the meaning set forth in § 1.170A-13(f)(6), except that the state or local tax credit need not be provided by the donee organization.

(iv) *Amount of reduction*. For purposes of paragraph (h)(3)(i) of this section, the amount of any state or local tax credit is the maximum credit allowable that corresponds to the amount of the taxpayer's payment or transfer to the entity described in section 170(c).

(v) *State or local tax*. For purposes of paragraph (h)(3) of this section, the term state or local tax means a tax imposed by a State, a possession of the United States, or by a political subdivision of any of the foregoing, or by the District of Columbia.

(vi) *Exception*. Paragraph (h)(3)(i) of this section shall not apply to any payment or transfer of property if the total amount of the state and local tax credits received or expected to be received by the taxpayer is 15 percent or less of the taxpayer's payment, or 15 percent or less of the fair market value of the property transferred by the taxpayer.

(vii) *Examples*. The following examples illustrate the provisions of this paragraph (h)(3). The examples in paragraph (h)(6) of this section are not illustrative for purposes of this paragraph (h)(3).

(A) *Example 1*. A, an individual, makes a payment of $1,000 to X, an entity described in section 170(c). In exchange for the payment, A receives or expects to receive a state tax credit of 70 percent of the amount of A's payment to X. Under paragraph (h)(3)(i) of this section, A's charitable contribution deduction is reduced by $700 (0.70 x $1,000). This reduction occurs regardless of whether A is able to claim the state tax credit in that year. Thus, A's charitable contribution deduction for the $1,000 payment to X may not exceed $300.

(B) *Example 2*. B, an individual, transfers a painting to Y, an entity described in section 170(c). At the time of the transfer, the painting has a fair market value of $100,000. In exchange for the painting, B receives or expects to receive a state tax credit equal to 10 percent of the fair market value of the painting. Under paragraph (h)(3)(vi) of this section, B is not required to apply the general rule of paragraph (h)(3)(i) of this section because the amount of the tax credit received or expected to be received by B does not exceed 15 percent of the fair market value of the property transferred to Y. Accordingly, the amount of B's charitable contribution deduction for the transfer of the painting is not reduced under paragraph (h)(3)(i) of this section.

(C) *Example 3*. C, an individual, makes a payment of $1,000 to Z, an entity described in section 170(c). In exchange for the payment, under state M law, C is entitled to receive a state tax deduction equal to the amount paid by C to Z. Under paragraph (h)(3)(ii)(A) of this section, C's charitable contribution deduction under section 170(a) is not required to be reduced on account of C's state tax deduction for C's payment to Z.

(viii) *Effective/applicability date*. This paragraph (h)(3) applies to amounts paid or property transferred by a taxpayer after August 27, 2018.

Notice 2019-12, § 3, "Safe Harbor For Individuals," provides for post-August 27, 2018 contributions:

> The Treasury Department and the IRS take seriously the concern that the proposed regulations could create unfair consequences for individuals who (i) itemize deductions for federal income tax purposes, (ii) make a payment to a section 170(c) entity in return for a state or local tax credit, and (iii) would have been able to deduct a payment of tax to the state or local government in the amount of the credit. A safe harbor is appropriate to mitigate the consequences of the proposed regulations in the situation described above.
>
> Accordingly, the Treasury Department and the IRS intend to publish a proposed regulation amending Treasury Regulation § 1.164-3 to provide a safe harbor for certain individuals who make a payment to or for the use of an entity described in section 170(c) in return for a state or local tax credit. Under this safe harbor, an individual who itemizes deductions and who makes a payment to a section 170(c) entity in return for a state or local tax credit may treat as a payment of state or local tax for purposes of section 164 the portion of such payment for which a charitable contribution deduction under section 170 is or will be disallowed under final regulations. This treatment as a payment of state or local tax under section 164 is allowed in the taxable year in which the payment is made to the extent the resulting credit is applied, consistent with applicable state or local law, to offset the individual's state or local tax liability for such taxable year or the preceding taxable year.[1] To the extent the resulting credit is not applied to offset the individual's state or local tax liability for the taxable year of the payment or the preceding taxable year, any excess credit permitted to be carried forward may be treated as a payment of state or local tax under section 164 in the taxable year or years for which the carryover credit is applied, consistent with applicable state or local law, to offset the individual's state or local tax liability. This safe harbor shall not apply to a transfer of property.
>
> [1] Some state or local tax credit programs allow an individual to apply the state or local tax credit to offset a prior year's state or local tax liability.
>
> Nothing in this notice may be construed as permitting a taxpayer who applies this safe harbor to treat the amount of any payment as deductible under more than one provision of the Code or Treasury regulations.
>
> Nothing in this notice may be construed as permitting a taxpayer who applies this safe harbor to avoid the limitations of section 164(b)(6) for any amount paid as a tax or treated under this notice as a payment of tax.

Notice 2019-12, § 4, "Examples," provides:

> In the examples below, assume that the taxpayer's application of the state or local tax credit is consistent with applicable state or local law and that the taxpayer is an individual who itemizes deductions for federal income tax purposes.
>
> *Example 1*. In year 1, Taxpayer A makes a payment of $500 to an entity described in section 170(c). In return for the payment, A receives a dollar-for-dollar state income tax credit. Prior to application of the credit, A's state income tax liability for year 1 was $500 or more; A applies the $500 credit to A's year 1 state income tax liability. Under section 3 of this notice, A treats the $500 payment as a payment of state income tax in year 1 for purposes of section 164. To determine A's deduction amount, A must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6).
>
> *Example 2*. In year 1, Taxpayer B makes a payment of $7,000 to an entity described in section 170(c). In return for the payment, B receives a dollar-for-dollar state income tax credit, which under state law may be carried forward for three taxable years. Prior to application of the credit, B's state income tax liability for year 1 was $5,000; B applies $5,000 of the $7,000 credit to B's year 1 state income tax liability. Under section 3 of this notice, B treats $5,000 of the $7,000 payment as a payment of state income tax in year 1 for purposes of section 164. Prior to application of the remaining credit, B's state income tax liability for year 2 exceeds $2,000; B applies the excess credit of $2,000 to B's year 2 state income tax liability. For year 2, B treats the $2,000 as a payment of state income tax for purposes of section 164. To determine B's deduction amounts in years 1 and 2, B must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6).
>
> *Example 3*. In year 1, Taxpayer C makes a payment of $7,000 to an entity described in section 170(c). In return for the payment, C receives a local real property tax credit equal to 25 percent of the amount of this payment ($1,750). Prior to application of the credit, C's local real property tax liability in year 1 was $3,500; C applies the $1,750 credit to C's year 1 local real property tax liability. Under section 3 of this notice, for year 1, C treats $1,750 as a payment of local real property tax for purposes of section 164. To determine C's deduction amount, C must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6).

This recharacterization of charitable contributions that generate tax credits as state tax payments extends to tax credit contributions that generate credit against business owners' individual income tax but does not disallow recharacterize contributions when the credits are against entity level taxation.[1439]

Certain trust administrative expenses are not itemized deductions and instead are deducted in arriving at adjusted gross income (often called "above the line"); therefore, they are fully

[1439] Reg. § 1.162-15(a)(3)(iv), Examples (3), which is reproduced in part II.G.4.g.i Charitable Deduction vs. Business Expense.

deductible for regular tax and alternative minimum tax.[1440] Thus, nongrantor trusts treat these items more favorably than individuals and grantor trusts.

Among the items the alternative minimum tax disallows for noncorporate taxpayers are deductions for the following under Code § 56(b)(1)(A):

(i) for any miscellaneous itemized deduction (as defined in section 67(b)), or

(ii) for any taxes described in paragraph (1), (2), or (3) of section 164(a) or clause (ii) of section 164(b)(5)(A).

To work around the Code § 67(g) suspension of the deduction for investment expenses characterized as miscellaneous itemized deductions and the unfavorable AMT treatment after the suspension ends, see part II.G.4.l.i.(e) Family Office as a Trade or Business.

II.G.4.n.ii. Pass-Through Entity Tax (PTET)

If a partnership pays an entity-level income tax, Rev. Rul. 58-25 allows the partnership to deduct the tax against its income instead of separately stating the tax on the partner's K-1s. Notice 2020-75, § 3.01, discusses how this applies in light of the Code § 164(b)(6) limitations:

> *Purpose and scope*. The Treasury Department and the IRS intend to issue proposed regulations to provide certainty to individual owners of partnerships and S corporations in calculating their SALT deduction limitations. Based on the statutory and administrative authorities described in section 2 of this notice, the forthcoming proposed regulations will clarify that Specified Income Tax Payments (as defined in section 3.02(1) of this notice) are deductible by partnerships and S corporations in computing their non-separately stated income or loss.

Note that the PTET regime applies to partnerships and S corporations and not to sole proprietorships. Consider giving a small interest to a spouse or other family member to enable the owner to be able to apply the PTET regime.

Notice 2020-75, § 3.02, "Forthcoming regulations," describes the proposed regulations' expected concepts:

> (1) *Definition of Specified Income Tax Payment*. For purposes of section 3.02 of this notice, the term "Specified Income Tax Payment" means any amount paid by a partnership or an S corporation to a State, a political subdivision of a State, or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the partnership or the S corporation. This definition does not include income taxes imposed by U.S. territories or their political subdivisions. Thus, this definition solely includes income taxes described in section 164(b)(2) for which a deduction by a partnership is not disallowed under section 703(a)(2)(B), and such income taxes for which a deduction by an S corporation is not disallowed under section 1363(b)(2). For this purpose, a Specified Income Tax Payment includes any amount paid by a partnership or an S corporation to a Domestic Jurisdiction pursuant to a direct imposition of income tax by the Domestic Jurisdiction on the partnership or S corporation, without regard to whether

[1440] See fn 2507 and accompanying text in part II.J.3.d Who Benefits Most from Deductions.

the imposition of and liability for the income tax is the result of an election by the entity or whether the partners or shareholders receive a partial or full deduction, exclusion, credit, or other tax benefit that is based on their share of the amount paid by the partnership or S corporation to satisfy its income tax liability under the Domestic Jurisdiction's tax law and which reduces the partners' or shareholders' own individual income tax liabilities under the Domestic Jurisdiction's tax law.

(2) *Deductibility of Specified Income Tax Payments*. If a partnership or an S corporation makes a Specified Income Tax Payment during a taxable year, the partnership or S corporation is allowed a deduction for the Specified Income Tax Payment in computing its taxable income for the taxable year in which the payment is made.

(3) *Specified Income Tax Payments not separately taken into account*. Any Specified Income Tax Payment made by a partnership or an S corporation during a taxable year does not constitute an item of deduction that a partner or an S corporation shareholder takes into account separately under section 702 or section 1366 in determining the partner's or S corporation shareholder's own Federal income tax liability for the taxable year. Instead, Specified Income Tax Payments will be reflected in a partner's or an S corporation shareholder's distributive or pro-rata share of nonseparately stated income or loss reported on a Schedule K-1 (or similar form).

(4) *Specified Income Tax Payments not taken into account for SALT deduction limitation*. Any Specified Income Tax Payment made by a partnership or an S corporation is not taken into account in applying the SALT deduction limitation to any individual who is a partner in the partnership or a shareholder of the S corporation.

Notice 2020-75, § 4, "*Applicability Date*," provides:

> The proposed regulations described in this notice will apply to Specified Income Tax Payments made on or after November 9, 2020. The proposed regulations will also permit taxpayers described in section 3.02 of this notice to apply the rules described in this notice to Specified Income Tax Payments made in a taxable year of the partnership or S corporation ending after December 31, 2017, and made before November 9, 2020, provided that the Specified Income Tax Payment is made to satisfy the liability for income tax imposed on the partnership or S corporation pursuant to a law enacted prior to November 9, 2020. Prior to the issuance of the proposed regulations, taxpayers may rely on the provisions of this notice with respect to Specified Income Tax Payments as described in this section 4.

In response to owners of pass-through entities not being able to deduct state and local taxes imposed on their owners' distributive share of income, some states have imposed entity-level taxes, which tax is referred to as a pass-through entity tax (PTET) even though Notice 2020-75 refers to it as a "Specified Income Tax Payment"; the Multistate Tax Commission is looking into entity-level taxation to combat the complexity of tiered pass-through entities (especially partnerships).[1441] EY prepared a study on the different C corporation and S corporation

[1441] https://www.mtc.gov/Uniformity/Standing-Subcommittee. For more about the Multistate Tax Commission, see fn 1150 in part II.G.3 State Income Taxation.

effective tax rates.[1442] AICPA issued its own reports.[1443] Consider further the estate planning issues of this election when a material portion of the pass-through entity is owned by an irrevocable grantor trust:[1444]

- The entity paying the tax instead of the grantor paying the tax means that the trust is indirectly paying the state income tax instead of the grantor paying the state income tax. That tactic is contrary to the thought behind using such a trust. On the other hand, if the grantor plans to turn off grantor trust status once any note owed to the grantor is retired and this tactic regarding state income tax does not materially delay retiring the note, the family might prefer to save the state income tax. If the grantor reimburses the tax to the entity, then the entity has not incurred the tax and cannot deduct it, frustrating the purpose of the whole exercise. In addition to being ineffective to this extent, the reimbursement idea is problematic, given that legally the entity has no right to be reimbursed by the grantor.

- If the pass-through entity does not have a substantial non-transfer tax purpose that satisfies *Bongard*, concerns have been raised whether a trustee's authority (if any) to make this state income tax election might have transfer tax consequences.[1445] In that case, consider not authorizing the trustee of an irrevocable grantor trust to make such an election. If the entity is an S corporation, I typically advise the donor to transfer only nonvoting stock to the corporation, so the concern described above may not be an issue.[1446]

- If the trustee of an irrevocable grantor trust elects PTET, benefitting the grantor at the expense of the beneficiaries, consider that the grantor could always turn off federal grantor trust status, which would harm the beneficiaries even more. Given this dynamic, I don't view the trustee electing PTET as violating fiduciary duties; on the other hand, consider documenting that the trustee made that election to motivate the grantor not to turn of grantor trust status.

Generally, states allow pass-through entities to elect into the PTET regime and provide a credit to the owners for PTET paid. Questions to consider include:

- Is the PTET credit refundable?
    - If so, how does the tax benefit rule apply to refund of state credits by the owner?
    - If not, then an entity's payment of PTET at a higher rate may increase the owner's state income tax burden.

[1442] http://mainstreetemployers.org/wp-content/uploads/2016/03/EY-S-Corp-Association-Tax-Treatment-of-S-and-C-Corporations-2018.pdf.

[1443] 15-page position paper on state pass through entity level tax implementation issues is at https://www.aicpa.org/content/dam/aicpa/advocacy/downloadabledocuments/aicpa-paper-on-state-pass-through-entity-level-tax-issues-10-4-18.pdf, and 2-page paper is at https://www.aicpa.org/content/dam/aicpa/advocacy/downloadabledocuments/one-pager-on-aicpa-paper-on-state-pass-through-entity-level-tax-issues-10-4.pdf.

[1444] See part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

[1445] See part III.C.4 Avoiding Possible Code § 2036(a)(2) Powers, especially fn 7479.

[1446] See part II.A.2.i.i.(b) Why Nonvoting Shares Are Needed for Estate Planning.

- If a pass-through entity does business in multiple states, one must analyze how PTET works in each state.

- PTET reduces an owner's federal income tax and presumably also the owner's self-employment tax[1447] and deduction for qualified business income.[1448]

Because PTET is relatively new, I suggest that a pass-through entity develop informal procedures to be fair in allocation of PTET expense and credits. If the entity is taxed as an S corporation, do not make any formal agreements that might constitute a governing document; see parts II.A.2.i.ii Temporary Timing Differences; Other Varying Differences and II.A.2.i.iii Disproportionate Distributions (Not Temporary).

Presumably the PTET credit would be allocated between the trust and beneficiaries in the same manner as the deduction that generated that credit. For an analogy, see part II.E.1.f Trusts/Estates and the Code § 199A Deduction, especially subpart II.E.1.f.i.(a) How Qualified Business Income Flows to Beneficiaries.

In a podcast for the AICPA, "When to call an audible on the passthrough entity tax," David Kirk, CPA, CFP, LLM, Private Tax Leader, National Tax - EY, discussed some PTET issues:

- Possible S corporation distortions

- Not all states give credit for tax paid to other states when that tax is PTET

- Some states (MA and CT) don't give credit for the entire PTET

- If and to the extent that the PTE does not engage in a trade or business or a rental activity or other Code § 62(a) above-the-line activity, the related PTET is an itemized deduction that may be disallowed for regular or alternative minimum tax

- PTET undermines irrevocable grantor trust strategy; see text following fn 1444

- Check whether the credit passes through from nongrantor trust to beneficiary allow with the PTE income

- No guidance yet on how tax benefit rule applies with refund arising from PTE credit (if refundable)

Dave used the following example to illustrate certain possible S corporation distortions from PTET:

- S corporation (S), which is located in State X, earns $1,000 taxable income, of which $100 is sourced to State X

- Dave owns 75%, and April owns 25%

- Thus, State X source income is allocated $75 to Dave and $25 to April

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[1447] See part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.
[1448] See part II.E.1.c.ii.(a) Generally; List of Items Included in QBI.

- Dave resides in State X, and April resides in State Y

- State X will cause S to pay 10% tax on all of Dave's $750 of income, because Dave resides in State X. Thus, S will pay $75 State X tax on Dave's share of the income.

- Because April is not a State X resident, only her $25 State X share of income is subject to State X, so S pays only $2.50 State X tax on April's share of the income.

- Thus, S pays $75 + $2.50 = $77.50 State X tax. Of this, $58 (75%) reduces Dave's income, and $19.50 (25%) reduces April's income. However, the PTET is credited $75 to Dave and $2.50 to April.

- How would one account for the unfair $17 of expense that reduces April's share that benefits Dave?

- This is not a withholding item contemplated by the S corporation regulations.

- The concern arises only because Dave and April live in different states.

Sher, "Questions to consider before electing into a PTE tax," The Tax Adviser (9/2022), includes the following checklist:[1449]

Election issues

- Is the PTE tax statute elective or mandatory (only Connecticut's is mandatory so far)?

- What percentage of ownership is required to make the election and what is the voting procedure (remember, voting requirements/procedures may vary from state to state)?

- Is the PTE required to make estimated state tax payments?

- When are estimated payments due?

- When is the election due? Has the election or filing been extended, especially when enacted in the first year the election is available?

- What is the effective date of the election? Is the effective date retroactive?

- Is the election binding for just the current year or for multiple years?

- Is the election required to be made annually?

- When can the election be revoked?

[1449] This checklist appears to be substantially the same as *Taxpayer and Practitioner Considerations for Whether to Elect into a State Pass-Through Entity (PTE)* Tax*, AICPA, July 19, 2022.*

- What are the voting requirements/procedures and notification procedures for revocation?

- Is the PTE tax statute one that automatically sunsets if the SALT cap sunsets on Dec. 31, 2025, or does it expire on Dec. 31, 2025, regardless, or is it permanent?

- Which entities or types of owners are allowed to make the election?

- Can resident and nonresident owners make an election or consent to participate (if that is part of the state's PTE tax regime)?

- What forms need to be filed?

- What is the entity withholding tax rate?

- What is the PTE tax rate?

- What is the highest individual tax rate (relates to composite filers)?

- Is there an exclusion of income (*e.g.*, Wisconsin) or a flowthrough of income and credit for PTE tax paid (refundable or nonrefundable) (*e.g.*, the majority of the states)?

- What are the benefits to members/partners and what are potential detriments?

- How is the PTE tax credit used in sequence with other credits for owners?

- Is there any alternative minimum tax issue from using a PTE tax credit?

- Double-check the operating or partnership agreement and consider:

    - Does the agreement even permit the PTE to elect to pay a PTE tax?

    - Are the voting requirements consistent with the PTE tax statute?

    - Do the allocation provisions properly allocate any PTE tax to each partner in a way that reflects the partner's share of the economics?

    - Does the agreement allow cash distributions to nonelecting/nonconsenting/ineligible owners?

    - If there is a cash distribution provision, are distributable earnings reduced by the partner's share of any PTE tax expense?

    - Are guaranteed payments reduced by the partner's share of any PTE tax expense?

Federal issues

- How is excess PTE tax credit taxed?

- For federal income tax purposes, is the PTE tax deduction a Sec. 162 or a Sec. 212 deduction?

- Has Temp. Regs. Sec. 1.67-1T(c) been considered?

  - It provides for allocation of expenses related to both a trade or business activity and a production-of-income activity using a “reasonable basis.”

- Does the PTE tax reduce self-employment tax or net investment income tax?

- Will additional disclosures be necessary for all shareholders to properly treat the PTE tax deduction under the net investment income tax rules and passive activity rules?

- Can the entity apply a loss carry-forward from a prior year?

- Does the state election and payment sequencing create a “deposit” for federal tax purposes, such as where the payment was made in one year, but the entity cannot elect until the subsequent year when the election can be made?

- Will the IRS allow payment alone to be enough for a federal deduction (ignore deposit issues)?

- Does Notice 2020-75 allow a partnership to specially allocate the PTE tax to the consenting/eligible owners?

- How will the PTE tax deduction affect the Sec. 199A deduction? Is there a reduction in the Sec. 199A qualified business income deduction?

- What is the timing of payment when deducting for federal tax purposes (some partners will have tax effects depending on the year the distribution is made)?

- Which year does the entity take the federal deduction? The owners should consider the tax law on “deposits” and methods of accounting.

- How does the entity report any refund of the PTE tax?

- Must a refund be separately reported to the owners in order to determine the tax treatment?

- Are there any complications for S corporations related to:

  - Shareholder agreements?

  - Per share, per day allocation of income/expense?

  - Disproportionate distributions?

- One-class-of-stock issue?[1450]

State issues

- Does the PTE tax regime exclude the PTE's income from the owners' returns?
- What income and deductions will be included in the state taxable income base for the PTE tax?
  - For example, will charitable contributions reduce the base?
  - Will a sale of the entity structured for tax as an asset sale increase the base?
  - Will a sale of the entity structured for tax as a stock sale be includible in the base?
- Does the PTE tax include the distributive share of otherwise exempt owners?
- Is there nonbusiness income that will be sourced to a state if the election is made?
- Does the PTE tax payment deducted for federal tax purposes create a nondeductible item for state taxes that reduces the shareholder basis before losses and deductions?
- Does the PTE tax regime provide a full or partial credit to owners for taxes paid?
- Are there limits on the shareholders' ability to use the credit on their state returns?
- Will other states in which the PTE is doing business allow a credit for the PTE tax at the owner level?
- Is nonresident partner or shareholder withholding still required when the PTE election is made?
- Can the PTE election and payment of PTE tax at the entity level satisfy a nonresident member's state filing requirement (*i.e.*, such that a separate filing by the member is not required)?
- Can a passthrough entity still elect to file a composite return if a PTE election is made? If yes, how is the PTE credit applied/claimed?
- Can estimated composite, withholding, and/or individual estimated payments be transferred to the PTE's account to cover the PTE tax?

[1450] [my footnote:] If the governing documents do not permit disproportionate distributions, disproportionate distributions do not create a single class of stock issue. See parts II.A.2.i.ii Temporary Timing Differences; Other Varying Differences and II.A.2.i.iii Disproportionate Distributions (Not Temporary). However, the Dave Kirk S corporation example raises challenging administrative issues, and S corporations that make disproportionate distributions may be ineligible if other issues make them need relief under part II.A.2.i.xii Automatic Relief If Governing Provisions Violate Single Class of Stock Rule.

Taxpayer and tax practitioner issues

- What are the compliance costs (including CPA fees)?
- How much risk does the election create for the entity or owners, assuming that the IRS issues no more guidance?
- Does an operating agreement need to be reviewed by legal counsel and/or amended in order to optimize, or otherwise account for, an efficient election?
- Are the entity and owners “eligible” as defined under the state’s PTE tax statute?
- Who determines if qualified taxpayers (owners) consented?
- Who is charged with monitoring new state department of revenue guidance or changes in the laws of the states in which the PTE tax election has been made, or might be made, if the law or conditions changed?
- How will the election be made and documented, and what documentation is needed to prove an owner consented or not to the election?
- Is the election or vote made anonymously with respect to other partners or not? Note that the partnership and its managers (and advisers) ultimately need to know who elected.
- What are the mechanical issues involving the state PTE tax return preparation? For example, if the return must be filed through the state’s website, the tax practitioner may be required to obtain a power of attorney or a specific type of account authorization in order to be able to prepare and release returns for clients. Note that even if that is possible, the practitioner may not want to do that or may need contractual language. For example, if the practitioner’s firm is also the auditor for the taxpayer, perhaps the practitioner may need to be more careful about what information tax preparers would have if they entered into a client account.
- What is the likelihood of interest in the SALT cap workaround, assuming the entity and at least one owner are “qualified”?
- If the SALT cap is raised by Congress, does that change the willingness of qualified taxpayers (owners) to consent to (or continue) the election?
- Do owners have sufficient tax they individually owe on their share of PTE net income so that they are above the SALT cap?
- In which states should an entity with income taxed in multiple states pay the optional state PTE tax?
- How and when should amended returns and audits be handled? Like the comprehensive partnership audit rules, does the partnership/operating agreement specify who handles these?
- Does the partnership/operating agreement require a distribution to all partners?

- If the PTE tax deduction is reported on Schedule K-1 in "Other Deductions," rather than in nonseparately stated ordinary business income, will an additional disclosure be needed, since the return will not comply with the notice?

- What will the effect be on distributions to defective grantor trusts that were expected to fund installment sale payments?

- (For tax practitioners only) Conflict of interest and malpractice risks in advising owners and entities, such as:

  - How to explain unknowns to a client.

  - How to advise entities and owners who may have conflicting interests and when the law is not 100% clear.

  - How to handle a situation where not all owners consent or are eligible.

  - How to deal with issues when not all owners consent or are not all eligible to get a state tax credit, as this situation likely causes a violation of an S corporation's one-class-of-stock requirement[1451] and, for a partnership, it might violate the partnership agreement and cause other tax and legal issues for the entity and owners.

See also AICPA's "States with Enacted or Proposed Pass-Through Entity (PTE) Level Tax" (updated June 13, 2023 last time I checked).

II.G.5. Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation

II.G.5.a. Code 179 Expense

A taxpayer may expense (instead of capitalizing)[1452] $1,000,000[1453] or so[1454] of qualifying property each year.

Generally, qualifying property includes certain tangible property[1455] or certain computer software,[1456] which is Code § 1245 property[1457] and is acquired by purchase for use in the active conduct of a trade or business.[1458]

[1451] [my footnote:] See my comments disputing this leap in fn 1450.
[1452] Code § 179(a).
[1453] Code § 179(b)(1).
[1454] Code § 179(b)(6) provides for post-2018 increases for inflation.
[1455] To which Code § 168 applies.
[1456] As defined in Code § 197(e)(3)(B) and which is described in Code § 197(e)(3)(A)(i) and to which Code § 167 applies.
[1457] As defined in Code § 1245(a)(3). See part II.G.6.b Code § 1245 Property.
[1458] Code § 179(d)(1), which also expressly excludes property described in Code § 50(b) (other than Code § 50(b)(2)). Generally, Code § 50(b) refers to property used (1) predominantly outside the United States, (2) predominantly to furnish lodging or in connection with the furnishing of lodging, (3) by certain tax-exempt organizations, or (4) by governmental units or foreign persons or entities.

Reg. § 1.179-1(b), "Cost subject to expense," provides:

> The expense deduction under section 179 is allowed for the entire cost or a portion of the cost of one or more items of section 179 property. This expense deduction is subject to the limitations of section 179(b) and § 1.179-2. The taxpayer may select the properties that are subject to the election as well as the portion of each property's cost to expense.

However, a nongrantor trust cannot take Code § 179 expense,[1459] which is a little awkward when it holds S corporation stock.[1460]

Code § 179(b)(3), "Limitation based on income from trade or business," provides:

> (A) *In general*. The amount allowed as a deduction under subsection (a) for any taxable year (determined after the application of paragraphs (1) and (2)) shall not exceed the aggregate amount of taxable income of the taxpayer for such taxable year which is derived from the active conduct by the taxpayer of any trade or business during such taxable year.
>
> (B) *Carryover of disallowed deduction*. The amount allowable as a deduction under subsection (a) for any taxable year shall be increased by the lesser of -
>
> > (i) the aggregate amount disallowed under subparagraph (A) for all prior taxable years (to the extent not previously allowed as a deduction by reason of this subparagraph), or
> >
> > (ii) the excess (if any) of -
> >
> > > (I) the limitation of paragraphs (1) and (2) (or if lesser, the aggregate amount of taxable income referred to in subparagraph (A)), over
> > >
> > > (II) the amount allowable as a deduction under subsection (a) for such taxable year without regard to this subparagraph.
>
> (C) *Computation of taxable income*. For purposes of this paragraph, taxable income derived from the conduct of a trade or business shall be computed without regard to the deduction allowable under this section.

Special rules apply to changes in interests in partnerships.[1461]

II.G.5.b. Bonus Depreciation

Code § 168(k) bonus depreciation had been a nice complement to Code § 179 depreciation, but 2017 tax reform has made it perhaps the first choice for many taxpayers.

[1459] See part II.J.11.a.i Code § 179 Disallowance for Estate or Nongrantor Trust.
[1460] See fn 3892 in part II.P.1.b Allocations of Income in S Corporations.
[1461] See part III.B.2.j.iii.(e) Allocation of Specific Items, especially fn. 6942.

Bonus depreciation is a component of depreciation that provides an up-front deduction of part of qualified property and applies regular depreciation for the remaining adjusted basis in the property.[1462]

First, we will look at how powerful it is, then we'll see what property qualifies.

Code § 168(k)(6) provides bonus depreciation for qualified property as follows:

(A) *In general*. Except as otherwise provided in this paragraph, the term "applicable percentage" means-

(i) in the case of property placed in service after September 27, 2017, and before January 1, 2023, 100 percent,

(ii) in the case of property placed in service after December 31, 2022, and before January 1, 2024, 80 percent,

(iii) in the case of property placed in service after December 31, 2023, and before January 1, 2025, 60 percent,

(iv) in the case of property placed in service after December 31, 2024, and before January 1, 2026, 40 percent, and

(v) in the case of property placed in service after December 31, 2025, and before January 1, 2027, 20 percent.

(B) *Rule for property with longer 20 production periods*. In the case of property described in subparagraph (b) or (C) of paragraph (2),[1463] the term "applicable percentage" means-

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[1462] Code § 168(k)(1) provides:

Additional allowance. In the case of any qualified property—

(A) the depreciation deduction provided by section 167(a) for the taxable year in which such property is placed in service shall include an allowance equal to the applicable percentage of the adjusted basis of the qualified property, and

(B) the adjusted basis of the qualified property shall be reduced by the amount of such deduction before computing the amount otherwise allowable as a depreciation deduction under this chapter for such taxable year and any subsequent taxable year.

[1463] This is my footnote and not the statute's. Code § 168(k)(2)(B), (C) provide:

(B) Certain property having longer production periods treated as qualified property.

(i) *In general*. The term "qualified property" includes any property if such property-

(I) meets the requirements of clauses (i) and (ii) of subparagraph (A),

(II) is placed in service by the taxpayer before January 1, 2028,

(III) is acquired by the taxpayer (or acquired pursuant to a written contract entered into) before January 1, 2027,

(IV) has a recovery period of at least 10 years or is transportation property,

(V) is subject to section 263A, and

(VI) meets the requirements of clause (iii) of section 263A(f)(1)(B) (determined as if such clause also applies to property which has a long useful life (within the meaning of section 263A(f))).

(i) in the case of property placed in service after September 27, 2017, and before January 1, 2024, 100 percent,

(ii) in the case of property placed in service after December 31, 2023, and before January 1, 2025, 80 percent,

(iii) in the case of property placed in service after December 31, 2024, and before January 1, 2026, 60 percent,

(iv) in the case of property placed in service after December 31, 2025, and before January 1, 2027, 40 percent, and

(v) in the case of property placed in service after December 31, 2026, and before January 1, 2028, 20 percent.

(C) *Rule for plants bearing fruits and nuts*. In the case of a specified plant described in paragraph (5), the term ‘applicable percentage means-

(i) in the case of a plant which is planted or grafted after September 27, 2017, and before January 1, 2023, 100 percent,

(ii) in the case of a plant which is planted or grafted after December 31, 2022, and before January 1, 2024, 80 percent,

(iii) in the case of a plant which is planted or grafted after December 31, 2023, and before January 1, 2025, 60 percent,

(iv) in the case of a plant which is planted or grafted after December 31, 2024, and before January 1, 2026, 40 percent, and

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(ii) *Only pre-January 1, 2027 basis eligible for additional allowance*. In the case of property which is qualified property solely by reason of clause (i) , paragraph (1) shall apply only to the extent of the adjusted basis thereof attributable to manufacture, construction, or production before January 1, 2027.
(iii) Transportation property. For purposes of this subparagraph, the term “transportation property” means tangible personal property used in the trade or business of transporting persons or property.
(iv) *Application of subparagraph*. This subparagraph shall not apply to any property which is described in subparagraph (C).
(C) *Certain aircraft*. The term “qualified property” includes property-
(i) which meets the requirements of subparagraph (A)(ii) and subclauses (II) and (III) of subparagraph (B)(i),
(ii) which is an aircraft which is not a transportation property (as defined in subparagraph (B)(iii)) other than for agricultural or firefighting purposes,
(iii) which is purchased and on which such purchaser, at the time of the contract for purchase, has made a nonrefundable deposit of the lesser of-
(I) 10 percent of the cost, or
(II) $100,000, and
(iv) which has-
(I) an estimated production period exceeding 4 months, and
(II) a cost exceeding $200,000.

(v) in the case of a plant which is planted or grafted after December 31, 2025, and before January 1, 2027, 20 percent.

Code § 168(k)(2)(A) defines "qualified property" to be property:

(i) [intentionally blank in statute]

(I) to which this section applies which has a recovery period of 20 years or less,

(II) which is computer software (as defined in section 167(f)(1)(B)) for which a deduction is allowable under section 167(a) without regard to this subsection,

(III) which is water utility property, or

(IV) which is a qualified film or television production (as defined in subsection (d) of section 181) for which a deduction would have been allowable under section 181 without regard to subsections (a)(2) and (g) of such section or this subsection, or

(V) which is a qualified live theatrical production (as defined in subsection (e) of section 181) for which a deduction would have been allowable under section 181 without regard to subsections (a)(2) and (g) of such section or this subsection,

(ii) the original use of which begins with the taxpayer or the acquisition of which by the taxpayer meets the requirements of clause (ii) of subparagraph (E),[1464] and

(iii) which is placed in service by the taxpayer before January 1, 2027.

If the taxpayer places property in service the first taxable year ending after September 27, 2017, the taxpayer may elect to use 50% as the applicable percentage.[1465]

"Qualified property" does not include[1466] certain property used in the energy industry[1467] or property that is financed by floor plan financing indebtedness that received a special business interest deduction.[1468]

Under Code § 168(k)(7), a taxpayer may elect out of Code § 168(k) bonus depreciation "with respect to any class of property for any taxable year." Generally, the classes are the same as

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[1464] This footnote is not in the statute. Code § 168(k)(2)(E)(ii) provides:
Acquisition requirements. An acquisition of property meets the requirements of this clause if-
(I) such property was not used by the taxpayer at any time prior to such acquisition, and
(II) the acquisition of such property meets the requirements of paragraphs (2)(A), (2)(B), (2)(C), and (3) of section 179(d).

[1465] Code § 168(k)(10). Rev. Proc. 2019-33 provides procedures to make or revoke such an election.

[1466] Code § 168(k)(9).

[1467] Code § 168(k)(9)(A) refers to "any property which is primarily used in a trade or business described in clause (iv) of section 163(j)(7)(A)." See text accompanying fn 1813 in part II.G.20.a Code § 163(j) Limitation on Deducting Business Interest Expense.

[1468] Code § 168(k)(9)(B) refers to "any property used in a trade or business that has had floor plan financing indebtedness (as defined in paragraph (9) of section 163(j)), if the floor plan financing interest related to such indebtedness was taken into account under paragraph (1)(C) of such section." See text accompanying fns 1823-1825 in part II.G.20.aF Code § 163(j) Limitation on Deducting Business Interest Expense.

the classes for normal depreciation.[1469] Rev. Proc. 2019-33, § 5.01 uses the following a classes of property:

(1) Except for the property described in sections 4 and 5.01(2) of this revenue procedure, each class of property described in § 168(e) (for example, 5-year property);

(2) Water utility property as defined in § 168(e)(5) and depreciated under § 168;

(3) Computer software as defined in, and depreciated under, § 167(f)(1) and the regulations under § 167(f)(1);

(4) Qualified improvement property as defined in § 168(k)(3) as in effect on the day before amendment by § 13204(a)(4)(B) of the TCJA that: (i) is acquired by the taxpayer after September 27, 2017; (ii) is placed in service by the taxpayer after September 27, 2017, and before January 1, 2018; (iii) meets the requirements in § 168(k)(2)(A)(ii) as amended by § 13201(c)(1) of the TCJA; and (iv) is depreciated under § 168;

(5) Each separate production, as defined in § 1.181-3(b), of a qualified film or television production;

(6) Each separate production, as defined in § 181(e)(2), of a qualified live theatrical production; or

(7) A partner's basis adjustment in partnership assets under § 743(b) for each class of property described in section 4 of this revenue procedure and section 5.01(1) through (6) of this revenue procedure.

Rev. Proc. 2017-33 and Rev. Proc. 2019-33 provide procedures for making or revoking an election under Code § 168(k)(7).

Reg. § 1.168(k)-2 "provides rules for determining the additional first year depreciation deduction allowable under section 168(k) for qualified property acquired and placed in service after September 27, 2017."[1470] Reg. § 1.168(k)-2(b)(1), "In general," provides:

> Qualified property is depreciable property, as defined in § 1.168(b)-1(a)(1), that meets all the following requirements in the first taxable year in which the property is subject to depreciation by the taxpayer whether or not depreciation deductions for the property are allowable:

[1469] Reg. § 1.168(k)-1(e)(2), "Definition of class of property," defines "class of property" to mean:

(i) Except for the property described in paragraphs (e)(2)(ii) and (iv) of this section, each class of property described in section 168(e) (for example, 5-year property);
(ii) Water utility property as defined in section 168(e)(5) and depreciated under section 168;
(iii) Computer software as defined in, and depreciated under, section 167(f)(1) and the regulations thereunder; or
(iv) Qualified leasehold improvement property as defined in paragraph (c) of this section and depreciated under section 168.

[1470] Reg. § 1.168(k)-2(a)(1).

(i) The requirements in § 1.168(k)-2(b)(2) (description of qualified property);

(ii) The requirements in § 1.168(k)-2(b)(3) (original use or used property acquisition requirements);

(iii) The requirements in § 1.168(k)-2(b)(4) (placed-in-service date); and

(iv) The requirements in § 1.168(k)-2(b)(5) (acquisition of property).

Reg. § 1.168(k)-2(b)(3)(iv), "Application to partnerships," provides:

(A) *Section 704(c) remedial allocations*. Remedial allocations under section 704(c) do not satisfy the requirements of paragraph (b)(3) of this section. See § 1.704-3(d)(2).[1471]

(B) *Basis determined under section 732*. Any basis of distributed property determined under section 732 does not satisfy the requirements of paragraph (b)(3) of this section.[1472]

(C) *Section 734(b) adjustments*. Any increase in basis of depreciable property under section 734(b) does not satisfy the requirements of paragraph (b)(3) of this section.[1473]

(D) *Section 743(b) adjustments*.[1474]

(1) *In general*. For purposes of determining whether the transfer of a partnership interest meets the requirements of paragraph (b)(3)(iii)(A) of this section, each partner is treated as having a depreciable interest in the partner's proportionate share of partnership property. Any increase in basis of depreciable property under section 743(b) satisfies the requirements of paragraph (b)(3)(iii)(A) of this section if -

[1471] [my footnote:] See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations, especially parts II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000 and II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest (within the latter, see text preceding fn 4227 in the paragraph that includes fn 4227.

[1472] [my footnote:] See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations, especially part II.Q.8.e.iii.(e) Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election.

[1473] [my footnote:] See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations, especially parts II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000 and II.Q.8.e.iii.(e) Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election.

[1474] [my footnote:] See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations, especially parts II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000 and II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

(i) At any time prior to the transfer of the partnership interest that gave rise to such basis increase, neither the transferee partner nor a predecessor of the transferee partner had any depreciable interest in the portion of the property deemed acquired to which the section 743(b) adjustment is allocated under section 755 and § 1.755-1; and

(ii) The transfer of the partnership interest that gave rise to such basis increase satisfies the requirements of paragraphs (b)(3)(iii)(A)(2) and (3) of this section.

(2) *Relatedness tested at partner level*. Solely for purposes of paragraph (b)(3)(iv)(D)(1)(ii) of this section, whether the parties are related or unrelated is determined by comparing the transferor and the transferee of the transferred partnership interest.

Reg. § 1.168(k)-2(b)(3)(vii), "Examples," includes the following related to partnerships:

(M) *Example (13)*. O and P form an equal partnership, OP, in 2018. O contributes cash to OP, and P contributes equipment to OP. OP's basis in the equipment contributed by P is determined under section 723. Because OP's basis in such equipment is determined in whole or in part by reference to P's adjusted basis in such equipment, OP's acquisition of such equipment does not satisfy section 179(d)(2)(C) and § 1.179-4(c)(1)(iv) and, thus, does not satisfy the used property acquisition requirements of paragraph (b)(3)(iii) of this section. Accordingly, OP's acquisition of such equipment is not eligible for the additional first year depreciation deduction.[1475]

(N) *Example (14)*. Q, R, and S form an equal partnership, QRS, in 2019. Each partner contributes $100, which QRS uses to purchase a retail motor fuels outlet for $300. Assume this retail motor fuels outlet is QRS' only property and is qualified property under section 168(k)(2)(A)(i). QRS makes an election not to deduct the additional first year depreciation for all qualified property placed in service during 2019. QRS has a section 754 election in effect. QRS claimed depreciation of $15 for the retail motor fuels outlet for 2019. During 2020, when the retail motor fuels outlet's fair market value is $600, Q sells all of its partnership interest to T in a fully taxable transaction for $200. T never previously had a depreciable interest in the retail motor fuels outlet. T takes an outside basis of $200 in the partnership interest previously owned by Q. T's share of the partnership's previously taxed capital is $95. Accordingly, T's section 743(b) adjustment is $105 and is allocated entirely to the retail motor fuels outlet under section 755. Assuming all other requirements are met, T's section 743(b) adjustment qualifies for the additional first year depreciation deduction under this section.

(O) *Example (15)*. The facts are the same as in Example 14 of paragraph (b)(3)(vii)(N) of this section, except that Q sells his partnership interest to U, a related person within the meaning of section 179(d)(2)(A) or (B) and § 1.179-4(c). U's

[1475] [my footnote:] Because a transfer of property in exchange for a partnership interest generally is a nontaxable transaction, the transferred property has a carryover basis. See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership. Part II.M.3.a is found within part II.M.3 Buying into or Forming a Partnership, and various exceptions to part II.M.3.a follow part II.M.3.a.

section 743(b) adjustment does not qualify for the additional first year depreciation deduction.

(P) *Example (16)*. The facts are the same as in Example 14 of paragraph (b)(3)(vii)(N) of this section, except that Q dies and his partnership interest is transferred to V. V takes a basis in Q's partnership interest under section 1014. As a result, section 179(d)(2)(C)(ii) and § 1.179-4(c)(1)(iv) are not satisfied, and V's section 743(b) adjustment does not qualify for the additional first year depreciation deduction.

(Q) *Example (17)*. The facts are the same as in Example 14 of paragraph (b)(3)(vii)(N) of this section, except that QRS purchased the retail motor fuels outlet from T prior to T purchasing Q's partnership interest in QRS. T had a depreciable interest in such retail motor fuels outlet. Because T had a depreciable interest in the retail motor fuels outlet before T acquired its interest in QRS, T's section 743(b) adjustment does not qualify for the additional first year depreciation deduction.

II.G.5.c. Comparing Code § 179 to Bonus Depreciation

Let's compare part II.G.5.a Code 179 Expense to part II.G.5.b Bonus Depreciation.

Code § 179 has more limitations than bonus depreciation, in that Code § 179 does not apply to nongrantor trusts, cannot generate a loss, and is limited in availability (the latter which may or may not be relevant for any particular taxpayer).

However, bonus depreciation applies to one or more entire classes of property, whereas Code § 179 can be narrowly tailored to get the right result. After 2017, this tailoring may be more important, in that 2017 restrictions on using net operating losses make avoiding a net operating loss more important,[1476] and controlling qualified business income for the Code § 199A deduction may be important in that generating a loss means that a taxpayer's W-2 wages and UBIA for that year are wasted.[1477]

As to the net operating loss (NOL) issue, Code § 179 has its own rules regarding using any suspended Code § 179 deduction on a dollar-for-dollar basis, compared to the 80% limitation on using NOLs.

II.G.5.d. Cost Segregation Studies to Accelerate Depreciation

It is not uncommon for taxpayers to separate a building's cost into tangible property with a shorter useful life and the building with a longer life.

Note that doing so would shorten the period during which the property's unadjusted basis may be used to satisfy certain limits on the Code § 199A deduction for qualified business income.[1478]

[1476] See part II.G.4.l.ii Net Operating Loss Deduction.

[1477] See parts II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction and II.E.1.c.v.(c) Calculation When Taxable Income Exceeds the Threshold Amount.

[1478] See part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income, especially part II.E.1.c.vi.(b) Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A.

Query whether that should even be a factor for a deduction that is scheduled to expire after December 31, 2025.[1479]

II.G.6. Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business

II.G.6.a. Code § 1231 Property

The net gain for a year recognized on the sale or exchange of depreciable property used in the trade or business[1480] (referred to as section 1231 gain) constitutes long-term capital gain[1481] to the extent that the taxpayer has not previously deducted losses from the sale of that type of property (five-year lookback).[1482] This special treatment is needed because capital assets do not include "property, used in [the taxpayer's] trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in [the taxpayer's] trade or business."[1483] However, when a taxpayer attempted to buy land to improve for use in a trade or business and the land purchase did not work out, but the taxpayer profited on the ensuing litigation, the profit was long-term capital gain according to the Eleventh Circuit,[1484] overturning the Tax Court's finding of ordinary income.[1485]

Generally, the property must be held for more than one year, be used in the trade or business, and be either real property or property depreciable under Code § 167;[1486] presumably it includes property receiving a new basis under Code § 1014[1487] without regard to how long the person receiving the property from the decedent actually holds the property.[1488] It also must be held for use in such a trade or business; if it is held primarily with an intent to sell, with rental only merely a way to make the best use before sale, then the property's sale generates ordinary income as property held for sale to customers and Code § 1231 does not apply.[1489] See also

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[1479] Code § 199A(i), discussed in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

[1480] Code § 1231(a)(3)(A)(i).

[1481] Code § 1231(a)(1).

[1482] Code § 1231(c)(1) provides:

> The net section 1231 gain for any taxable year shall be treated as ordinary income to the extent such gain does not exceed the non-recaptured net section 1231 losses.

Code § 1231(c)(2) provides:

> *Non-recaptured net section 1231 losses*. For purposes of this subsection , the term "non-recaptured net section 1231 losses" means the excess of—
>
> (A) the aggregate amount of the net section 1231 losses for the 5 most recent preceding taxable years, over
>
> (B) the portion of such losses taken into account under paragraph (1) for such preceding taxable years.

[1483] Code § 1221(a)(2). Although such assets are not capital assets, they can receive a basis step-up at death. See part II.Q.4.e.i Life Insurance Basis Adjustment on the Death of an Owner Who Is Not the Insured, especially fn. 4442.

[1484] *Long v. Commissioner*, 114 A.F.T.R.2d 2014-6657.

[1485] *Long v. Commissioner*, T.C. Memo. 2013-233.

[1486] Code § 1231(c)(1). See Code § 1231(c)(2), (3), and (4) for additional qualifying assets. Gain a tenant recognizes when a landlord pays the tenant to terminate the lease may be taxed under Code § 1231; see part II.Q.1.b Leasing, especially fn. 4130.

[1487] See part II.H.2 Basis Step-Up Issues.

[1488] Code § 1223(9).

[1489] *Fargo v. Commissioner*, T.C. Memo. 2015-96 held:

parts II.E.1.e.i.(a) Whether Real Estate Activity Constitutes A Trade Or Business and II.G.26.b Real Estate as a Trade or Business.

An "amortizable section 197 intangible," such as purchased goodwill, generally qualifies for Code § 1231 treatment if used in a trade or business and held for more than one year and not sold to a controlled entity.[1490]

However, Code § 1231 property does not include inventory and certain other assets,[1491] including certain intellectual property.[1492]

Also subject to this rule is any recognized gain from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) into other property or money of either property used in the trade or business, or any capital asset which is held not only for more than one year but also in connection with a trade or business or a transaction entered into for profit.[1493]

Note, however, that generally depreciation recapture on personal property is taxed as ordinary income,[1494] and depreciation recapture on most real estate is taxed at a higher capital gain rate.[1495]

> We recognize that the La Jolla property was used as a rental property and GDLP and all related entities maintained their offices on the property. However, using the La Jolla property as rental property was not GDLP's primary purpose of holding it. We held in *Cottle v. Commissioner*, 89 T.C. 467 (1987), that section 1231 capital gain treatment was applicable to a rental property subsequently sold to liquidate the investment. That is not the case here. GDLP was making its best use of the La Jolla property as office and rental space while never abandoning its primary intention, selling it.

[1490] Reg. § 1.197-2(g)(8), which also makes goodwill subject to the ordinary income treatment described in part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).

[1491] Code § 1231(c)(1) excludes:

> (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,
>
> (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,
>
> (C) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer described in paragraph (3) of section 1221(a) , [and]
>
> (D) a publication of the United States Government (including the Congressional Record) which is received from the United States Government, or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by a taxpayer described in paragraph (5) of section 1221(a).

[1492] See fn 1681 in part II.G.18.b Sale or Exchange of Intellectual Property - Capital Gain vs. Ordinary Income.

[1493] Code § 1231(a)(3)(A)(ii).

[1494] Code § 1245(a)(1), recognizing such depreciation recapture as ordinary income; see part II.G.6.b Code § 1245 Property. The last sentence provides that this rule trumps Code § 1231:

> Such gain shall be recognized notwithstanding any other provision of this subtitle.

Reg. § 1.1245-1(e)(1) follows this rule.

[1495] Code §§ 1(h)(1)(E) (25% rate applied to unrecaptured section 1250 gain), 1(h)(6) (definition of "unrecaptured section 1250 gain"). Citing S. Rept. No. 105-174 (P.L. 105-206), p. 149, *Federal Tax Coordinator Analysis* (RIA) ¶ I-5110.8 summarized the portion subject to this tax:

Also, although generally Code § 1231 gain is taxed as capital gain, Code § 1231 losses are deducted as ordinary losses.[1496] To prevent taxpayers from playing games with the timing of sales of Code § 1231 property, net Code § 1231 gain is treated as ordinary income to the extent of prior Code § 1231 ordinary losses, with rules coordinating gain and loss on a cumulative basis.[1497]

II.G.6.b. Code § 1245 Property

Code § 1245(a) imposes ordinary income taxation on depreciation and amortization of personal or certain other property that is disposed of, overriding various nonrecognition provisions.[1498] Unless an exception or limitation under Code § 1245(b) applies (see fns. 1517-1522), gain under Code § 1245(a)(1) is recognized notwithstanding any contrary nonrecognition provision or income characterizing provision.[1499] Because Code § 1245 overrides Code § 1231 (relating to property used in the trade or business),[1500] the gain recognized under Code § 1245(a)(1) upon a disposition will be treated as ordinary income and only the remaining gain, if any, from the disposition may be considered as gain from the sale or exchange of a capital asset if Code § 1231 applies.[1501] The nonrecognition provisions of subtitle A of the Code that Code § 1245 overrides include without limitation Code §§ 267(d), 311(a), 336, 337, 501(a), 512(b)(5)[1502] and 1039,[1503] but the override is limited with respect to Code §§ 332, 351, 361, 371(a), 374(a), 721, 731, 1031, 1033, 1071, and 1081(b)(1) and (d)(1)(A).[1504] Although Reg. § 1.1245-6(d) appears to allow Code § 1245 property to be deferred under the installment method, it expressly subjects itself to Code § 453, and Code § 453(i) recaptures immediate recapture of Code § 1245(a) ordinary income before deferring the rest.[1505] Code § 1245 does

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> …unrecaptured section 1250 gain means the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if the Code Sec. 1250 real property deprecation recapture rules applied to all depreciation (rather than only to depreciation in excess of straight-line depreciation) from property held for the long-term holding period. The unrecaptured section 1250 depreciation is reduced (but not below zero) by the excess (if any) of the amount of losses taken into account in computing "28% rate gain" over the amount of gains taken into account in computing "28% rate gain".

However, part of real estate might be treated as personal property and therefore taxed at an even higher rate. Notice 2013-59.

[1496] Code § 1231(a)(2).

[1497] Code § 1231(c)(1).

[1498] Code § 1245(a)(1), (d) (the latter overriding "any other provision of this subtitle." Reg. § 1.1245-6(a) starts by saying, "The provisions of section 1245 apply notwithstanding any other provision of subtitle A of the Code."

[1499] Reg. § 1.1245-6(a).

[1500] See part II.G.6.a Code § 1231 Property.

[1501] Reg. § 1.1245-6(a), continuing, "See example (2) of paragraph (b)(2) of § 1.1245-1."

[1502] Code § 512(b)(5) is the exclusion of capital gain from taxation under part II.Q.6.d.i UBTI Related to a Partnership or Sole Proprietorship; see fns. 4685-4693 of that part.

[1503] Reg. § 1.1245-6(b).

[1504] Reg. § 1.1245-6(b), referring to Code § 1245(b); see fn. 1521.

[1505] Code § 453(i), "Recognition of recapture income in year of disposition," provides:

> (1) *In general*. In the case of any installment sale of property to which subsection (a) applies—
> > (A) notwithstanding subsection (a), any recapture income shall be recognized in the year of the disposition, and
> >
> > (B) any gain in excess of the recapture income shall be taken into account under the installment method.

not subject to tax "any income which is exempt under section 115 (relating to income of states, etc.), 892 (relating to income of foreign governments), or 894 (relating to income exempt under treaties)."[1506] Code § 1245 does not prevent gain recognition under other Code provisions.[1507]

Property to which Code § 1245 applies is "any property which is or has been property of a character subject to the allowance for depreciation provided in section 167"[1508] and is one of the following:[1509]

(A) personal property,[1510]

(B) other property (not including a building or its structural components) but only if such other property is tangible and has an adjusted basis in which there are reflected adjustments described in paragraph (2) for a period in which such property (or other property)—[1511]

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(2) *Recapture income*. For purposes of paragraph (1), the term "recapture income" means, with respect to any installment sale, the aggregate amount which would be treated as ordinary income under section 1245 or 1250 (or so much of section 751 as relates to section 1245 or 1250) for the taxable year of the disposition if all payments to be received were received in the taxable year of disposition.

For Code § 751, see part II.Q.8.b.i.(g) Code § 751 – Hot Assets.

[1506] Reg. § 1.1245-6(e).

[1507] Reg. § 1.1245-6(f) provides:

Treatment of gain not recognized under section 1245. Section 1245 does not prevent gain which is not recognized under section 1245 from being considered as gain under another provision of the Code, such as, for example, section 311(c) (relating to liability in excess of basis), section 341(f) (relating to collapsible corporations), section 357(c) (relating to liabilities in excess of basis), section 1238 (relating to amortization in excess of depreciation), or section 1239 (relating to gain from sale of depreciable property between certain related persons) . Thus, for example, if section 1245 property, which has an adjusted basis of $1,000 and a recomputed basis of $1,500, is sold for $1,750 in a transaction to which section 1239 applies, $500 of the gain would be recognized under section 1245(a)(1) and the remaining $250 of the gain would be treated as ordinary income under section 1239.

[1508] Code § 197(f)(7), treats all amortizable Code § 197 intangibles as subject to Code § 167 and is reproduced in fn 1704 in part II.G.18.d Amortization of Code § 197 Intangibles.

[1509] Code § 1245(a)(3).

[1510] Reg. § 1.1245-3(b) define "personal property" to mean:

(1) Tangible personal property (as defined in paragraph (c) of § 1.48-1, relating to the definition of "section 38 property" for purposes of the investment credit), and

(2) Intangible personal property.

[1511] [My footnote:] Reg. § 1.1245-3(c) elaborates:

(1) The term "property described in section 1245(a)(3)(B)" means tangible property of the requisite depreciable character other than personal property (and other than a building and its structural components), but only if there are adjustments reflected in the adjusted basis of the property (within the meaning of paragraph (a)(2) of § 1.1245-2) for a period during which such property (or other property)—

  (i) Was used as an integral part of manufacturing, production, or extraction, or as an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service, or

  (ii) Constituted a research or storage facility used in connection with any of the foregoing activities.

(i) was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services,

(ii) constituted a research facility used in connection with any of the activities referred to in clause (i), or

(iii) constituted a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state),

(C) so much of any real property (other than any property described in subparagraph (b)) which has an adjusted basis in which there are reflected adjustments for amortization under section 169, 179, 179B, 179C, 179D, 179E, 185, 188 (as in effect before its repeal by the Revenue Reconciliation Act of 1990), 190, 193, or 194,

(D) a single purpose agricultural or horticultural structure (as defined in section 168(i)(13)),

(E) a storage facility (not including a building or its structural components) used in connection with the distribution of petroleum or any primary product of petroleum, or

(F) any railroad grading or tunnel bore (as defined in section 168(e)(4)).

Code § 1245 property includes livestock[1512] and certain elevators and escalators.[1513] Code § 1245 property also includes leaseholds of various Code § 1245 property.[1514]

Thus, even though during the period immediately preceding its disposition the property is not used as an integral part of an activity specified in subdivision (i) of this subparagraph and does not constitute a facility specified in subdivision (ii) of this subparagraph, such property is nevertheless property described in section 1245(a)(3)(B) if, for example, there are adjustments reflected in the adjusted basis of the property for a period during which the property was used as an integral part of manufacturing by the taxpayer or another taxpayer, or for a period during which other property (which was involuntarily converted into, or exchanged in a like kind exchange for, the property) was so used by the taxpayer or another taxpayer. For rules applicable to involuntary conversions and like kind exchanges, see paragraph (d)(3) of § 1.1245-4.

(2) The language used in subparagraph (1)(i) and (ii) of this paragraph shall have the same meaning as when used in paragraph (a) of § 1.48-1, and the terms "building" and "structural components" shall have the meanings assigned to those terms in paragraph (e) of § 1.48-1.

[1512] Reg. § 1.1245-3(a)(4), which continues:

but only with respect to taxable years beginning after December 31, 1969. For purposes of section 1245, the term "livestock" includes horses, cattle, hogs, sheep, goats, and mink and other fur-bearing animals, irrespective of the use to which they are put or the purpose for which they are held.

[1513] Reg. § 1.1245-3(a)(1)(iii).

[1514] Reg. § 1.1245-3(a)(2), which provides:

If property is section 1245 property under a subdivision of subparagraph (1) of this paragraph, a leasehold of such property is also section 1245 property under such subdivision. Thus, for example, if A owns personal property which is section 1245 property under subparagraph (1)(i) of this paragraph, and if A leases the personal property to B, B's leasehold is also section 1245

The facts and circumstances of each disposition are considered in determining what is the appropriate item of Code § 1245 property.[1515] Special rules apply to multiple asset accounts.[1516]

However, Code § 1245(a) does not apply to:

- A "disposition by gift."[1517]
- A "transfer at death," except with respect to IRD assets.[1518]
- Certain substituted basis transfers involving business entities under Code § 332, 351,[1519] 361, 721,[1520] or 731.[1521]

> property under such provision. For a further example, if C owns and leases to D for a single lump-sum payment of $100,000 property consisting of land and a fully equipped factory building thereon, and if 40 per cent of the fair market value of such property is properly allocable to section 1245 property, then 40 percent of D's leasehold is also section 1245 property. A leasehold of land is not section 1245 property.

Reg. § 1.1245-3(a)(1)(i), cited in the second sentence above, cross-references Reg. § 1.1245-3(b), which is reproduced in fn. 1510.

[1515] Reg. § [1.1245-1(a)(4), which further provides:

> A taxpayer may treat any number of units of section 1245 property in any particular depreciation account (as defined in § 1.167(a)-7) as one item of section 1245 property as long as it is reasonably clear, from the best estimates obtainable on the basis of all the facts and circumstances, that the amount of gain to which section 1245(a)(1) applies is not less than the total of the gain under section 1245(a)(1) which would be computed separately for each unit. Thus, for example, if 50 units of section 1245 property X, 25 units of section 1245 property Y, and other property are accounted for in one depreciation account, and if each such unit is sold at a gain in one transaction in which the total gain realized on the sale exceeds the sum of the adjustments reflected in the adjusted basis (as defined in paragraph (a)(2) of § 1.1245-2) of each such unit on account of depreciation allowed or allowable for periods after December 31, 1961, all 75 units may be treated as one item of section 1245 property. If, however, 5 such units of section 1245 property Y were sold at a loss, then only 70 of such units (50 of X plus the 20 of Y sold at a gain) may be treated as one item of section 1245 property.

[1516] Reg. § 1.1245-6(c) provides:

> *Normal retirement of asset in multiple asset account*. Section 1245(a)(1) does not require recognition of gain upon normal retirements of section 1245 property in a multiple asset account as long as the taxpayer's method of accounting, as described in paragraph (e)(2) of § 1.167(a)-8 (relating to accounting treatment of asset retirements), does not require recognition of such gain.

[1517] Code § 1245(b)(1).

[1518] Code § 1245(b)(2). Code § 691 sets for the rules for IRD (income in respect of a decedent) assets, generally referring to property with income or gain realized and locked-in before death. See part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[1519] See part II.M.2 Buying into or Forming a Corporation.

[1520] See part II.M.3 Buying into or Forming a Partnership.

[1521] Code § 1245(b)(3) provides:

> If the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 721, or 731, then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the amount of gain recognized to the transferor on the transfer of such property (determined without regard to this section). Except as provided in paragraph (6) , this paragraph shall not apply to a disposition to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter.

Regarding Code § 731, see part II.Q.8.b.i Distribution of Property by a Partnership.

- Like kind exchanges; involuntary conversions, etc., to the extent no gain is recognized and replacement property is qualified.[1522]

"Disposition" includes a sale in a sale-and-leaseback transaction and a transfer upon the foreclosure of a security interest but does not include a mere transfer of title to a creditor upon creation of a security interest or to a debtor upon termination of a security interest.[1523]

Code § 1245 property distributed from a partnership generally retains its Code § 1245 characteristics.[1524] Also, even though property may not be depreciable in the taxpayer's hands, such property may nevertheless be Code § 1245 property if the taxpayer's basis for the property is determined by reference to its basis in the hands of a prior owner of the property and such property was depreciable in the prior owner's hands, or if the taxpayer's basis for the property is determined by reference to the basis of other property that was depreciable in the taxpayer's hands, or if the taxpayer's basis for the property is determined under Code § 1022 and such property was depreciable in the decedent's hands.[1525]

All amortizable Code § 197 intangibles are treated as one Code § 1245 asset, except for loss assets.[1526]

[1522] Code § 1245(b)(4) provides:

> If property is disposed of and gain (determined without regard to this section) is not recognized in whole or in part under section 1031 or 1033 , then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the sum of-
>
> (A) the amount of gain recognized on such disposition (determined without regard to this section), plus
>
> (B) the fair market value of property acquired which is not section 1245 property and which is not taken into account under subparagraph (A).

[1523] Reg. § 1.1245-1(a)(3), which further provides:

> Thus, for example, a disposition occurs upon a sale of property pursuant to a conditional sales contract even though the seller retains legal title to the property for purposes of security but a disposition does not occur when the seller ultimately gives up his security interest following payment by the purchaser.

[1524] See part II.G.6.b Code § 1245 Property. Code § 1245(b)(5), "Property distributed by a partnership to a partner," provides:

> (A) *In general*. For purposes of this section, the basis of section 1245 property distributed by a partnership to a partner shall be deemed to be determined by reference to the adjusted basis of such property to the partnership.
>
> (B) *Adjustments added back*. In the case of any property described in subparagraph (A) , for purposes of computing the recomputed basis of such property the amount of the adjustments added back for periods before the distribution by the partnership shall be-
>
> (i) the amount of the gain to which subsection (a) would have applied if such property had been sold by the partnership immediately before the distribution at its fair market value at such time, reduced by
>
> (ii) the amount of such gain to which section 751(b) applied.

[1525] Reg. § 1.1245-3(3), which continues:

> Thus, for example, if a father uses an automobile in his trade or business during a period after December 31, 1961, and then gives the automobile to his son as a gift for the son's personal use, the automobile is section 1245 property in the hands of the son.

[1526] Code § 1245(b)(8), "Disposition of amortizable section 197 intangibles, provides:

> (A) *In general*. If a taxpayer disposes of more than 1 amortizable section 197 intangible (as defined in section 197(c)) in a transaction or a series of related transactions, all such

Special rules apply to transfers to tax-exempt organization where property will be used in unrelated business[1527] and to transfer of timber.[1528]

Regulations should and do provide for adjustments to the basis of property to reflect gain recognized under Code § 1245(a).[1529]

II.G.7. Deferral or Partial Exclusion of Capital Gains (Even from Investment Assets) Invested in Opportunity Zones

II.G.7.a. Overview of Qualified Opportunity Zones

Code § 1400Z-2(a)(1) provides with respect to any sale or exchange before January 1, 2027:[1530]

> *Treatment of gains*. In the case of gain from the sale to, or exchange with, an unrelated person of any property held by the taxpayer, at the election of the taxpayer -
>
> (A) gross income for the taxable year shall not include so much of such gain as does not exceed the aggregate amount invested by the taxpayer in a qualified opportunity fund during the 180-day period beginning on the date of such sale or exchange,
>
> (B) the amount of gain excluded by subparagraph (A) shall be included in gross income as provided by subsection (b), and

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amortizable 197 intangibles shall be treated as 1 section 1245 property for purposes of this section.

(B) *Exception*. Subparagraph (A) shall not apply to any amortizable section 197 intangible (as so defined) with respect to which the adjusted basis exceeds the fair market value.

[1527] Code § 1245(b)(6) provides:

(A) *In general*. The second sentence of paragraph (3) shall not apply to a disposition of section 1245 property to an organization described in section 511(a)(2) or 511(b)(2) if, immediately after such disposition, such organization uses such property in an unrelated trade or business (as defined in section 513).

(B) *Later change in use*. If any property with respect to the disposition of which gain is not recognized by reason of subparagraph (A) ceases to be used in an unrelated trade or business of the organization acquiring such property, such organization shall be treated for purposes of this section as having disposed of such property on the date of such cessation.

Fn. 1521 reproduces Code § 1245(b)(3). The point of Code § 1245(b)(6) is to limit Code §1245(a) recapture when property is transferred to certain exempt organizations for use in their exempt functions. Reg. § 1.1245-6(b) provides:

> For limitation on amount of adjustments reflected in adjusted basis of property disposed of by an organization exempt from income taxes (within the meaning of section 501(a)), see paragraph (a)(8) of § 1.1245-2.

[1528] Code § 1245(b)(7) provides:

> In determining, under subsection (a)(2) , the recomputed basis of property with respect to which a deduction under section 194 was allowed for any taxable year, the taxpayer shall not take into account adjustments under section 194 to the extent such adjustments are attributable to the amortizable basis of the taxpayer acquired before the 10th taxable year preceding the taxable year in which gain with respect to the property is recognized.

[1529] Code § 1245(c). Reg. § 1.1245-6(a) cross-references Reg. § 1.1245-5 for the effect on basis.

[1530] Code § 1400Z-2(a)(2) provides that no Code § 1400Z-2(a)(1) election may be made:

(A) with respect to a sale or exchange if an election previously made with respect to such sale or exchange is in effect, or

(B) with respect to any sale or exchange after December 31, 2026.

(C) subsection (c) shall apply.

In other words, the exclusion is only a deferral to the extent that Code § 1400Z-2(b) taxes it. If the taxpayer dies, amounts recognized under Code § 1400Z-2 are includible in gross income as income in respect of a decedent (IRD) if not properly includible in the decedent's gross income.[1531]

Proposed regulations, [REG-115420-18], together with a link to comments, are at https://www.federalregister.gov/documents/2018/10/29/2018-23382/investing-in-qualified-opportunity-funds. ACTEC's comments are at https://www.actec.org/legislative-comments/actec-comments-on-proposed-regulations-on-qualified-opportunity-funds-under-code-section-1400z-2/. Final regulations are at https://www.federalregister.gov/documents/2020/01/13/2019-27846/investing-in-qualified-opportunity-funds.

IRS training, "Opportunity Zones and Qualified Opportunity Funds," is at https://www.irs.gov/pub/newsroom/tcja-training-opportunity-zones-qualfied-opportunity-funds.pdf.

Code § 1400Z-2(b), "Deferral of gain invested in opportunity zone property," provides:

(1) *Year of inclusion*. Gain to which subsection (a)(1)(B) applies shall be included in income in the taxable year which includes the earlier of -

(A) the date on which such investment is sold or exchanged, or

(B) December 31, 2026.

(2) *Amount includible*.

(A) *In general*. The amount of gain included in gross income under subsection (a)(1)(A) shall be the excess of-

(i) the lesser of the amount of gain excluded under paragraph (1) or the fair market value of the investment as determined as of the date described in paragraph (1), over

(ii) the taxpayer's basis in the investment.

(B) *Determination of basis*.

(i) *In general*. Except as otherwise provided in this clause or subsection (c), the taxpayer's basis in the investment shall be zero.

(ii) *Increase for gain recognized under subsection (a)(1)(B)*. The basis in the investment shall be increased by the amount of gain recognized by reason of subsection (a)(1)(B) with respect to such property.

(iii) *Investments held for 5 years*. In the case of any investment held for at least 5 years, the basis of such investment shall be increased by an amount equal

[1531] Code § 1400Z-2(e)(3). See part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

to 10 percent of the amount of gain deferred by reason of subsection (a)(1)(A).

(iv) *Investments held for 7 years*. In the case of any investment held by the taxpayer for at least 7 years, in addition to any adjustment made under clause (iii), the basis of such property shall be increased by an amount equal to 5 percent of the amount of gain deferred by reason of subsection (a)(1)(A).

Although Code § 1400Z-2(b)(1)(A) refers to when an investment is "sold or exchanged," Reg. § 1.1400Z2(b)-1(c)(3) triggers inclusion of deferred gain when property is transferred by gift or incident to divorce. For more discussion of triggers, see part II.G.7.b Transfers of a Qualified Opportunity Fund (QOF).

Code § 1400Z-2(c), "Special rule for investments held for at least 10 years," provides:

> In the case of any investment held by the taxpayer for at least 10 years and with respect to which the taxpayer makes an election under this clause, the basis of such property shall be equal to the fair market value of such investment on the date that the investment is sold or exchanged.

How do we determine "aggregate amount invested by the taxpayer in a qualified opportunity fund"?

"Qualified opportunity fund" means any investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90% of its assets in qualified opportunity zone property, determined by the average of the percentage of qualified opportunity zone property held in the fund.[1532] The 90% test is measured on the last day of the first 6-month period of the taxable year of the fund, and on the last day of the taxable year of the fund.[1533]

If a qualified opportunity fund fails to meet the 90% requirement, a penalty applies to the fund or its owners.[1534]

[1532] Code § 1400Z-2(d)(1),

[1533] Code § 1400Z-2(d)(1),

[1534] Code § 1400Z-2(f), "Failure of qualified opportunity fund to maintain investment standard," provides:

(1) *In general*. If a qualified opportunity fund fails to meet the 90-percent requirement of subsection (c)(1), the qualified opportunity fund shall pay a penalty for each month it fails to meet the requirement in an amount equal to the product of -
   (A) the excess of-
      (i) the amount equal to 90 percent of its aggregate assets, over
      (ii) the aggregate amount of qualified opportunity zone property held by the fund, multiplied by
   (B) the underpayment rate established under section 6621(a)(2) for such month.

(2) *Special rule for partnerships*. In the case that the qualified opportunity fund is a partnership, the penalty imposed by paragraph (1) shall be taken into account proportionately as part of the distributive share of each partner of the partnership.

(3) *Reasonable cause exception*. No penalty shall be imposed under this subsection with respect to any failure if it is shown that such failure is due to reasonable cause.

"Qualified opportunity zone property" means qualified opportunity zone stock, a qualified opportunity zone partnership interest, or qualified opportunity zone business property.[1535]

Generally,[1536] the term "qualified opportunity zone stock" means any stock in a domestic corporation if the stock is acquired by the qualified opportunity fund after December 31, 2017, at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash, as of the time that stock was issued, that corporation was a qualified opportunity zone business (or, in the case of a new corporation, that corporation was being organized for purposes of being a qualified opportunity zone business), and during substantially all of the qualified opportunity fund's holding period for such stock, such corporation qualified as a qualified opportunity zone business.[1537]

A "qualified opportunity zone partnership interest" is any capital or profits interest in a domestic partnership if:[1538]

(i) such interest is acquired by the qualified opportunity fund after December 31, 2017, from the partnership solely in exchange for cash,

(ii) as of the time such interest was acquired, such partnership was a qualified opportunity zone business (or, in the case of a new partnership, such partnership was being organized for purposes of being a qualified opportunity zone business), and

(iii) during substantially all of the qualified opportunity fund's holding period for such interest, such partnership qualified as a qualified opportunity zone business.

"Qualified opportunity zone business property" means tangible property used in a trade or business of the qualified opportunity fund if:[1539]

(I) such property was acquired by the qualified opportunity fund by purchase (as defined in section 179(d)(2))[1540] after December 31, 2017,

(II) the original use of such property in the qualified opportunity zone commences with the qualified opportunity fund or the qualified opportunity fund substantially improves the property, and

(III) during substantially all of the qualified opportunity fund's holding period for such property, substantially all of the use of such property was in a qualified opportunity zone.

1535 Code § 1400Z-2(d)(2)(A).
1536 However, Code § 1400Z-2(d)(2)(B)(ii), "Redemptions," provides that a rule similar to the rule of Code § 1202(c)(3) shall apply for purposes of Code § 1400Z-2(d)(2)(B). Code § 1202(c)(3) is described in fns 5220-5232 of part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
1537 Code § 1400Z-2(d)(2)(B)(i).
1538 Code § 1400Z-2(d)(2)(C).
1539 Code § 1400Z-2(d)(2)(D)(i).
1540 [footnote not in statute] Code § 1400Z-2(d)(2)(D)(iii) provides that the related person rule of Code § 179(d)(2) is applied pursuant to Code § 1400Z-2(d)(8) of in lieu of the application of such rule in Code § 179(d)(2)(A).

Code § 1400Z-1 provides rules for designating a "qualified opportunity zone." Notices 2018-48 and 2019-42 (7/15/2019) list the population census tracts the Secretary of the Treasury designates as qualified opportunity zones (QOZs).[1541] The IRS' Opportunity Zones Resources are at https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx, including a map of all QOZs.

Property is treated as "substantially improved" by the qualified opportunity fund only if, during any 30-month period beginning after the date of acquisition of that property, additions to basis with respect to the property in the hands of the qualified opportunity fund exceed an amount equal to the adjusted basis of the property at the beginning of that 30-month period in the hands of the qualified opportunity fund.[1542] When a qualified opportunity fund (QOF) invests in real estate in a qualified opportunity zone (QOZ), Rev. Rul. 2018-29 asserts:

(1) If a QOF purchases an existing building located on land that is wholly within a QOZ, the original use of the building in the QOZ is not considered to have commenced with the QOF for purposes of § 1400Z-2(d)(2)(D)(i), and the requirement under § 1400Z-2(d)(2)(D)(i) that the original use of tangible property in the QOZ commence with a QOF is not applicable to the land on which the building is located.

(2) If a QOF purchases a building wholly within a QOZ, under § 1400Z-2(d)(2)(D)(ii) a substantial improvement to the building is measured by the QOF's additions to the adjusted basis of the building.

(3) Under § 1400Z-2(d), measuring a substantial improvement to the building by additions to the QOF's adjusted basis of the building does not require the QOF to separately substantially improve the land upon which the building is located.

Letter Ruling 202324008 granted an extension of time "to file an amended return, or an Administrative Adjustment Request (whichever is appropriate) for Year 1, to make the election under section 1400Z-2 and section 1.1400Z2(d)-1(a)(2)(i)" on Form 8996 to self-certify as a QOF.

A "qualified opportunity zone business" [1543] is a trade or business in which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property,[1544] which satisfies certain definitional requirements of "qualified business entity" under the enterprise zone rules, and which is not a sinful business.[1545] In the prior sentence, tangible property that ceases to be a qualified opportunity zone business property continues to be treated as a qualified opportunity zone business property for the lesser of (i)5 years after the

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[1541] IRS summary: "Notice 2019-42 amplifies Notice 2018-48, 2018-28 I.R.B. 9, which lists the population census tracts that the Secretary of the Treasury designated as qualified opportunity zones. Specifically, this notice adds two additional census tracts in Puerto Rico that have been designated as qualified opportunity zones under § 1400Z-1(b)(3) of the Internal Revenue Code."
[1542] Code § 1400Z-2(d)(2)(D)(ii).
[1543] Code § 1400Z-2(d)(3)(A).
[1544] Determined by substituting "qualified opportunity zone business" for "qualified opportunity fund" each place it appears in Code § 1400Z-2(d)(2)(D).
[1545] Code § 1400Z-2(d)(3)(A)(iii) refers to Code § 144(c)(6)(B), which requires that "no portion of the proceeds of such issue is to be used to provide (including the provision of land for) any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises."

date on which that tangible property ceases to be so qualified, or (ii) the date on which that tangible property is no longer held by the qualified opportunity zone business.[1546]

If only a portion of any investment in a qualified opportunity fund consists of investments of gain to which a Code § 1400Z-2(a) election is in effect, then that investment is treated as two separate investments, consisting of one investment that only includes amounts to which the Code § 1400Z-2(a) election applies (to which Code § 1400Z-2(a), (b) and (c) apply), and a separate investment consisting of other amounts to which Code § 1400Z-2 does not apply.[1547]

In applying Code § 1400Z-2, persons are related to each other if such persons are described in Code § 267(b)[1548] or 707(b)(1),[1549] determined by substituting 20% for 50% each place it occurs there.

Part C, "Economic Analysis," of T.D. 9889 (1/17/2020) explains:

> **4. Economic Effects of Provisions Substantially Revised From the Proposed Regulations**
>
> **a. Eligible Gains From Section 1231 Property**
>
> The final regulations provide that a gain is eligible for deferral under section 1400Z-2(a) if the gain is treated as a capital gain for Federal income tax purposes. There is uncertainty, however, regarding how to treat gains arising from selling section 1231 property. Section 1231 property is certain property used in a trade or business, such as depreciable property and land, and also includes capital assets subject to an involuntary conversion, such as arising from a natural disaster or theft. Under the Code, gains from the sale or exchange of section 1231 property are characterized as capital gains if the sum of all section 1231 transactions for the taxable year is positive. If the sum of all section 1231 transactions for the year is negative, then the losses are ordinary losses.[1]
>
> [1] One source of ambiguity is determining whether gain from selling an item of section 1231 property that is potentially eligible for deferral should be included in the summation of 1231 property in the year the deferral begins or the year the deferral ends.
>
> The Treasury Department and the IRS considered two main options for the treatment of gains from section 1231 property.[2] The primary issue is whether the amount of the gains eligible for deferral is based on the sum of all sales over the taxable year or on an item-by-item basis. These approaches are also referred to as the net approach and gross approach, respectively.
>
> [2] The Treasury Department and the IRS also considered the option of not issuing specific guidance on this topic but determined that this was clearly inferior to the two main options.

[1546] Code § 1400Z-2(d)(3)(B).
[1547] Code § 1400Z-2(e)(1).
[1548] Code § 267(b) is described in part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses.
[1549] Code § 707(b) is described in part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

The statute also sets a 180-day requirement for investment in a QOF beginning on the date of the sale or exchange generating the gain, to be eligible for deferral under section 1400Z-2(a). The two options for calculating eligible section 1231 gains further determine when the 180-day requirement begins. When gains are based on the sum of sales over the taxable year, the 180-day period starts at the end of the taxable year, after it is determined whether the sum is positive or negative, and how large the net positive gain is. When gains are counted item-by-item, it is possible, although not necessary, to start the 180-day period from the date of each sale.

The proposed regulations used the net approach. Under the proposed regulations, the only gain arising from section 1231 property eligible for deferral under section 1400Z-2(a) was the amount by which the gains arising from all of a taxpayer's section 1231 property exceeded all of the taxpayer's losses from section 1231 property for a taxable year. In addition, the proposed regulations provided that the 180-day period for investment with respect to capital gain net income from section 1231 property for a taxable year began on the last day of the taxable year without regard to the date of any particular disposition of section 1231 property.

The final regulations adopt the gross approach. Under the final regulations, eligible section 1231 gains are determined on an item-by-item basis and therefore positive gains are not reduced by section 1231 losses. Furthermore, the amount of the gain is known at the time of each sale so it is not necessary for the taxpayer to wait until the end of the taxable year to determine whether any positive section 1231 sales will be offset by losses. As a consequence, the final regulations further provide that the 180-day period for investing an amount with respect to an eligible section 1231 gain for which a deferral election has been made begins on the date of the sale or exchange that gives rise to the section 1231 gain. In addition, the final regulations do not determine the character of eligible section 1231 gains, other than as gains arising from the sale or exchange of section 1231 property, until the taxable year such gains are taken into account in computing gross income pursuant to section 1231(a)(4). The treatment of section 1231 property under the gross option is essentially the same treatment provided in the final regulations for gain arising from the sale of a capital asset as defined by section 1221.

To illustrate this discussion, suppose that Corporation A sells two pieces of section 1231 property during the taxable year, one for a $100 gain early in its taxable year and the other for a $30 loss later in its taxable year. Suppose that Corporation B also sells two pieces of section 1231 property during the taxable year, one for a $20 gain, the other for a $50 loss. Neither taxpayer realizes any other capital gain during the taxable year.

Under the net approach, Corporation A's net gain is $70, which is positive. Thus, it would be able to defer up to $70 in capital gain by investing in a QOF. Corporation B has a net loss from selling section 1231 property. This net loss would be treated as ordinary and no gains would be deferrable under section 1400Z-2(a). Furthermore, although Corporation A sells the first piece of property for a gain early in its taxable year, it would not be able to make a qualifying investment in a QOF until the last day of the taxable year, because it needs to wait until the end of the tax year to determine whether it is eligible to defer any of the gain.

Under the gross approach, only the gains need to be accounted for. Corporation A would be able to defer $100 in gain and Corporation B would be able to defer $20. In this case, the amount of gain eligible for deferral increases for both taxpayers. The total amount of gain eligible for deferral increases from $70 to $120 compared to the net approach.

Although not determinative, we note that the gross approach, as adopted under the final regulations, will generally expand the pool of gains eligible for deferral under section 1400Z-2(a) relative to the net approach specified under the proposed regulations.[3] Based on recent taxpayer records, the Treasury Department and the IRS estimate that the gross option may increase the amount of eligible gains by four to eight percent compared to the net option. The increase in potentially eligible gains overstates the likely increase in investment in QOFs resulting from using the gross approach (rather than the net approach) for two different reasons. First, for many taxpayers, the amount of section 1231 gains is not likely to be a binding constraint on the amount of investment made by the taxpayer into a QOF because of the ability of the taxpayer to defer other sources of capital gains. Second, taxpayers have considerable discretion over when to realize gains, and even under the net approach taxpayers could often plan on selling section 1231 property with sufficient net gain in a taxable year to cover the amount of desired QOF investment. The Treasury Department and the IRS have not attempted to estimate the overall effect of this provision of the final regulations (relative to the proposed regulations) on either QOZ or non-QOZ investment.

[3] For a given set of section 1231 sales, positive gains for each individual taxpayer will never be lower under the gross approach than the net approach; this result follows from mathematical principles and is not specific to this example. In practice, taxpayers might choose to recognize gains differently under the two approaches. This difference complicates any projection of actual gains that would be eligible for deferral.

An additional effect of the gross option would be to minimize the tax considerations of determining the best time to sell section 1231 property, leading to a more efficient use of resources. Under the gross option, taxpayers would be less likely to delay or rush selling section 1231 property in order to achieve the desired amount of net gain that would be eligible for deferral within a particular year. Also, under the gross option, taxpayers would have more flexibility in realizing gains eligible to be invested in a QOF in calendar year 2019.

The Treasury Department and the IRS considered several variations to these two primary options. For example, one intermediate option would have required taxpayers to wait to determine the capital gain character of section 1231 property sales until summing at the end of the taxable year, but then allow the gross amount of gains to be eligible for deferral if the net is positive. Under this intermediate option, Corporation A would be eligible to defer $100 in gain, while Corporation B would not be able to defer any amount. The pool of eligible gains would be greater than under the net option, but less than the gross option. This intermediate option would also have the costs similar to the net option regarding the need for taxpayers to wait to until the end of the taxable year before investing in a QOF.

The number of taxpayers expected to be affected by this aspect of the final regulations ranges between 36,000 and 80,000 investors in QOFs.

b. Sales or Exchanges of Property by QOF Partnerships and QOF S Corporations

The Treasury Department and the IRS considered three options for how owners of QOF partnerships and QOF S corporations may exclude gains from tax on qualifying investments in the QOF held longer than 10 years. First, the Treasury Department and the IRS considered not providing a specialized rule for QOF partnerships and QOF S corporations. Under this option, owners of a QOF would need to sell or exchange their QOF ownership interest to another party in order to receive the exemption from tax on the gain. For certain business structures, this would not be the most efficient way to dispose of the assets of the QOF. For example, suppose QOF A has 20 partners and QOF A owns two commercial buildings that are qualified opportunity zone business property. If another investor B would like to purchase one of the buildings, it would generally be easier for QOF A to sell the building to investor B directly, rather than investor B buying out the partnership interests of several or all of the partners of QOF A. Under this first option, the owners of QOF A would only receive tax free gain from their investment if they are able to find an investor willing to buy their partnership interests in QOF A. This option would likely lead to relatively high negotiating costs and may reduce the pool of potential buyers for QOF assets.

Second, the May 2019 proposed regulations proposed that investors in a QOF partnership or a QOF S corporation could elect to exclude capital gains arising from the QOF selling qualified opportunity zone property from gross income. This option would provide a simpler way for owners of pass-through QOFs to receive tax-free gain, but it would apply only in certain cases. It would apply only to capital gains and not ordinary gains, such as the recapture of depreciation deductions. Also, this option would apply only to QOFs selling qualified opportunity zone property, and would not apply to qualified opportunity zone business property sold by a qualified opportunity zone business that is a subsidiary of the QOF.

Third, the final regulations allow QOF owners to elect to exclude from gross income all gains and losses of a QOF partnership or QOF S corporation (except those deriving from sales of inventory in the ordinary course of business). This would allow the gains from the sale of qualified opportunity zone business property by a qualified opportunity zone business to flow through to the owners of the QOF as excluded from income. This election can be made on an annual basis, but it must apply to all gains and losses of the QOF partnership or QOF S corporation for that taxable year. In addition, when the proceeds from the asset sales are reinvested, rather than distributed as cash, then the QOF owner’s share of the qualifying investment is reduced as the reinvested amount is deemed to be a non-qualifying investment.

These rules generally match the tax treatment that would exist for an owner of a QOF partnership or QOF S corporation after selling a qualifying investment in the QOF after it has been held at least 10 years, but would avoid the extra costs associated with negotiating the selling price of the interest in the QOF, rather than the underlying assets owned by the QOF or qualified opportunity zone business. The Treasury Department and the IRS project that this approach will lead to a reduction in transactions costs for taxpayers relative to alternative approaches (the no-action baseline and the proposed regulations), and will continue to treat similar taxpayers similarly. The number of taxpayers expected to be affected by this rule ranges between 5,000 and 11,500 QOFs, and 50,000 to 115,000 investors in QOFs.

c. Substantial Improvement of Qualified Opportunity Zone Business Property

Section 1400Z-2(d)(2)(D) requires that if tangible property was already used in a QOZ (non-original use asset) when purchased by a QOF or qualified opportunity zone business, then it needs to be substantially improved by the QOF or qualified opportunity zone business before it can become qualified opportunity zone business property. Substantial improvement, as defined by section 1400Z-2(d)(2)(D)(ii), requires the QOF or qualified opportunity zone business to more than double the adjusted basis of the property within 30 months after acquiring the property. The Treasury Department and the IRS considered two options for how to measure substantial improvement.

First, the proposed regulations provided an asset-by-asset approach. This option would require each property to be substantially improved in order to become qualified opportunity zone business property. For example, if a QOF purchases an existing commercial building, a separate determination for each piece of tangible property associated with the building would be needed, such as the structure itself, and every item of furniture and equipment within the building that is not part of the building structure.

This approach would limit the ability of taxpayers to purchase property already used within a QOZ, place that property in service in the taxpayer's business with little improvement from the previous owner, and have the property be qualified opportunity zone business property. This option would also likely encourage the purchase and substantial improvement of existing property with low existing basis; that is, property where it is easier for improvement expenditures to double the existing basis. Such properties are more likely to be older and more in need of repair and upgrades.

Second, the final regulations allow taxpayers to use an asset-by-asset approach (as provided in the proposed regulations) or a more aggregative approach. The final regulations allow purchased original use property to count towards the determination of whether non-original use property has been substantially improved if such purchased original use property improves the functionality of the non-original use property along with other conditions. Also, certain betterment expenses, such as environmental remediation or utility upgrades, which are properly chargeable to the basis of the land, may be added to the basis of a building on the land that was non-original use property for the purpose of calculating substantial improvement of that building. These rules in effect expand the definition of what expenses could be considered improvements for a particular asset. In some cases, this option could reduce compliance costs for taxpayers, as it is not always clear under the Code and regulations when expenditures should be considered an improvement of an existing property, for example a building, or be considered separate depreciable property.

These rules will make it easier for purchased non-original use property to be substantially improved compared to the proposed regulations. This will help to smooth the cliff effect that occurs with the statutory requirement that improvements need to more than double the cost basis. For example, suppose a QOF purchases a non-original use building in a QOZ for $1 million, makes $950,000 in improvements to the building that bring that building into good condition for that local market, and purchases $50,001 of furniture or equipment for use within the building. This building would not meet the substantial improvement test under the proposed regulations but it would meet it under the final regulations.

In addition, the final regulations allow a QOF or qualified opportunity zone business to aggregate multiple buildings into a single property for purposes of the substantial improvement test. The buildings must either be entirely located within a parcel of land described in a single deed, or the buildings may be on contiguous parcels of land with separate deeds if certain conditions are met that indicate the buildings are related in management or use.

This rule would expand the number of existing buildings in a QOZ that could be purchased by a QOF or a qualified opportunity zone business and be deemed to have met the substantial improvement test relative to the first option. For example, one expensive renovation project would provide excess “improvement expenses” that could be applied to other buildings. This increases the likelihood that certain substantial renovation projects would be undertaken. However, the ability to aggregate improvement of non-original use property could effectively allow a QOF or qualified opportunity zone business to purchase property already fully in use in a QOZ and count it as qualified opportunity zone business property, though use by the new owner would be qualitatively similar to the previous owner.

In summary, the Treasury Department and the IRS considered two primary options for how much aggregation to allow when determining whether purchased non-original use property satisfied the substantial improvement test. The different options would likely have different effects on the amount and distribution of non-original use property purchased by QOFs and qualified opportunity zone businesses. The proposed regulations would not allow any aggregation, and instead require each of the assets purchased under this option to receive substantial improvement. This would focus improvement expenditures on properties most in need of considerable rehabilitation to remain productive.

The final regulations allow aggregation, and will likely encourage the purchase and improvement of more non-original use property compared to the proposed regulations. The final regulations will also likely lead to a broader mix of properties purchased and improved relative to the first option. However, the final regulations also increase the likelihood that some buildings will meet the substantial improvement test when the individual building receives little to moderate improvements. Overall, the rules provided in the final regulations make it easier for a non-original use property to be substantially improved relative to the proposed regulations, which will encourage more investment through QOFs.

The Treasury Department and the IRS project that the number of taxpayers expected to be affected by this rule ranges between 5,500 and 12,000 QOFs plus 6,000 to 15,000 qualified opportunity zone businesses.

d. Vacancy

Property that is eligible for opportunity zone treatment must be “original use” or substantially improved. This statutory language leaves open the question of the conditions under which vacant property that is developed and used by an opportunity zone business might count as original use.[4] The Treasury Department and the IRS considered options of one, three, or five years for how long existing property located in a QOZ must be vacant before the purchase of such property would allow it to be considered original use property. The May 2019 proposed regulations proposed that property would need to be vacant for at least five years prior to the purchase by a QOF or qualified opportunity zone business in order to satisfy the original use requirement under section 1400Z-2(d)(2)(D)(i)(II).

[4] The Treasury Department and the IRS also considered taking no action but determined that providing a definition of vacancy and setting a time period for when vacant property could be purchased and considered original use property would be beneficial relative to providing no specific guidance.

In selecting among these options, the Treasury Department and the IRS recognize that vacant property is an underused resource to the owner and potential users of the property, and can lower the value and use of neighboring property. The Treasury Department and the IRS further recognize that property could become vacant due to economic reasons unrelated to section 1400Z-2, but also because the owner strategically let the property become or stay vacant in expectation that the property would have a higher resale value if it were eligible to be original use property under section 1400Z-2(d)(2)(D)(i)(II).

A shorter period of required vacancy provides a greater incentive for owners of vacant property to keep it vacant for purposes of later selling it for use as original use property. This incentive may also result in owners vacating property that is currently occupied. On the other hand, a longer period of required vacancy means that on average properties would remain vacant for a longer period before being sold and put into productive use, which would increase the likelihood that such property (and possibly surrounding property) would be inefficiently used.

The final regulations provide that the required time of vacancy is three years except for property that was vacant as of the date of publication of the QOZ designation notice in which the designation of the QOZ is listed, in which case the vacancy period is one year. This one-year period for vacant property at the time of designation provides an incentive for property that was vacant for economic reasons at the time of publication of the QOZ designation notice to be quickly placed back into service through sale to a new owner, thus reducing the social costs that would occur if those properties remained unused, relative to the longer three-year period. The three-year period for property that was not initially vacant makes it costly for owners to strategically limit the use of the property in order to gain a more favorable condition for selling the property in the future, relative to a shorter period. The Treasury Department and the IRS recognize, however, that even under this three-year specification, there may be situations where a property becomes vacant for a period of time due to economic reasons and the owner of that property decides to let the property remain vacant in order to receive an expected higher price upon selling after the three-year vacancy period is met.

The number of taxpayers expected to be affected by this rule ranges between 5,500 and 12,000 QOFs plus 6,000 to 15,000 qualified opportunity zone businesses.

e. Subsidiary of a Consolidated Group

The statute is silent regarding the treatment of corporate taxpayers that file consolidated returns and seek to invest in a QOF. The Treasury Department and the IRS considered two options to address this issue. Under the proposed regulations a consolidated group could invest in a corporate QOF only if the QOF would not be treated as part of the consolidated group for tax filing purposes. That is, a QOF could not be a subsidiary of a consolidated group, because of concerns of potential conflicts between the section 1400Z-2 rules and the consolidated group rules in § 1.1502. Under this approach, the gains and losses of a corporate QOF would not be shared with the consolidated group owning the QOF when determining aggregate tax liability of the consolidated group, but rather the QOF would file its own tax return, leading to a small increase in compliance burden.

This treatment could affect the choice of QOF entity for a consolidated corporate group that wanted to own a QOF, making a partnership QOF a more likely choice as tax attributes of the partnership QOF (income, deductions, credits, etc.) would flow to the member of the consolidated corporate group that owns the QOF. Sharing those tax attributes of a partnership QOF with other members of the group is subject to certain limitations. However, if the QOF is a corporate subsidiary member of the consolidated group, there is more flexibility with how tax attributes of the QOF are shared with the rest of the consolidated group. In addition, some corporate consolidated groups are likely to favor a using a corporate form due to familiarity with the corporate rules that would lead to lower organizational costs. These additional organizational or tax compliance costs are not likely to be large, but nevertheless may discourage investment in QOFs for some consolidated groups.

Therefore, the final regulations permit corporate taxpayers filing consolidated returns to own a QOF that is a subsidiary member of the consolidated group; and, as provided in the proposed regulations, a corporate QOF may be the parent member of a consolidated group. This option will reduce the limitations on the organizational structure of QOF investments that would have occurred under the proposed regulations. The final regulations permit the consolidation of a subsidiary QOF corporation only if certain conditions are satisfied. Specifically, except in very limited circumstances, the group member making the qualifying investment in the QOF member (investor member) must maintain direct equity interest of the QOF member stock. More importantly, all investor members must be wholly owned, directly or indirectly, by the common parent of the group. The final regulations also provide special rules to govern the treatment of an investment of eligible gain in the subsidiary QOF in order not to conflict with the consolidated return rules found in § 1.1502. However, these rules are not expected to be overly burdensome, because the choice of establishing the QOF as a subsidiary member of the consolidate group are elective; taxpayers would not choose to consolidate a corporate QOF subsidiary unless the benefits to the taxpayer were greater than the costs.

One drawback to allowing QOFs to be part of subsidiary member of a consolidated group is that there would be less information available regarding taxable income and loss of the QOF and its subsidiary qualified opportunity zone businesses, as that information will be reported as part of the aggregated income and deductions of the parent on the consolidated tax return.

The number of taxpayers expected to be affected by these rules ranges between 25 and 500.

5. Economic Effects of Provisions Not Substantially Revised From the Proposed Regulations

a. Definition of Substantially All

There are five uses of the term “substantially all” in section 1400Z-2 but the statute is ambiguous regarding the precise meaning of this term. The final regulations establish thresholds for all five uses of this term. The final regulations provide that “substantially all” means at least 90 percent with regard to the three holding period requirements in section 1400Z-2(d)(2) and at least 70 percent with regard to section 1400Z-2(d)(3)(A)(i) and in the context of “use” in section 1400Z-2(d)(2)(D)(i)(III). The Treasury Department and the IRS have not attempted to assess how taxpayers would have interpreted these terms in the absence of specific guidance and therefore have not projected whether these regulations will increase or decrease investment in QOZs or non-QOZ’s relative to regulatory alternatives.

In choosing what values to assign to the substantially all terms, the Treasury Department and the IRS considered the economic consequences of setting the thresholds higher or lower. Setting the threshold higher would reduce investment in QOFs but would increase the percentage of that investment that would be located within a QOZ. One reason why a higher threshold would reduce overall investment in QOFs is that it will be more difficult for businesses with diverse operations and/or multiple locations to satisfy the threshold. Setting the threshold lower would increase investment in QOFs but reduce the percentage of that investment that is located within a QOZ.

A lower threshold would further increase the likelihood that a taxpayer may receive the benefit of the preferential treatment on capital gains without placing in service more tangible property within a QOZ than would have occurred in the absence of section 1400Z-2. This effect would be magnified by the way the different requirements in section 1400Z-2 interact. For example, these final regulations imply that, in certain limited fact patterns, a QOF could satisfy the substantially all standards with as little as 40 percent of the tangible property effectively owned by the fund being used within a QOZ. This could occur if 90 percent of QOF assets are invested in a qualified opportunity zone business, in which 70 percent of the tangible assets of that business are qualified opportunity zone business property; and if, in addition, the qualified opportunity zone business property is only 70 percent in use within a QOZ, and for 90 percent of the holding period for such property. Multiplying these shares together (0.9 x 0.7 x 0.7 x 0.9 = 0.4) generates the result that a QOF could satisfy the requirements of section 1400Z-2 under the final regulations with just 40 percent of its assets effectively in use within a QOZ.

The Treasury Department and the IRS have not undertaken quantitative estimates of the volume of investment that would be placed in QOZs under the different thresholds for “substantially all” because we do not have data or models that can predict spatial patterns of investment with reasonable precision. The Treasury Department and the IRS further recognize that the specified thresholds may indirectly affect investment outside of QOZs; we have likewise not undertaken quantitative estimates of this investment effect.

The Treasury Department and the IRS have determined that the substantially all thresholds provided in the final regulations represent an appropriate balance between the ability of investors in QOFs to receive preferential capital gains treatment only for placing a consequential amount of tangible property (used in the underlying business) within a QOZ, and the flexibility provided to business operations so as not to significantly distort the types of businesses that can qualify for opportunity zone funds.

b. Treatment of Leased Property

The Treasury Department and the IRS have determined that leased property that is located in a QOZ may be treated as qualified opportunity zone business property under certain conditions. This determination means, effectively, that the value of leased property should be included in both in the numerator and the denominator of the 90-percent investment standard and the substantially all tests.[5] We project that the inclusion of leased property will enhance the efficiency of business decisions compared to other available regulatory options because leasing is a common business practice and because business decisions would be distorted if otherwise similar property (owned versus leased) were treated differently.

[5] Under the statute, the value of leased property is included in the denominator of the substantially all test. The statute is ambiguous, however, as to whether leased property should be included in the numerator.

This treatment of leased property is efficiency-enhancing (compared to alternative treatments) because of other features of the statute. For example, a start-up business that leased office space within a QOZ and owned tangible property in the form of computers and other office equipment would likely fail the substantially all test (if the office space is sufficiently valuable relative to the other tangible property) because the leased property is included in the denominator of the substantially all test; this failure to satisfy the substantially all test would occur despite all of this business's operations being located within a QOZ. This possibility may lead the business to purchase rather than lease its office property, a decision that significantly changes the nature of the business's risk and expenses.

The Treasury Department and the IRS recognize that the treatment of leased property as qualified opportunity zone business property may weaken the incentive for taxpayers to construct new real property or renovate existing real property within a QOZ, as taxpayers would be able to lease existing real property in a zone without improving it and thereby become a qualified opportunity zone business (assuming the other conditions of the statute were met). However, allowing the leasing of existing real property within a zone may encourage fuller utilization and improvement of such property and limit the abandonment or destruction of existing productive property within a QOZ when new tax-favored real property becomes available.

In summary, the Treasury Department and the IRS project that the inclusion of leased property in both the numerator and the denominator of the 90-percent investment standard and the substantially all test will increase economic activity within QOZs relative to alternative decisions including the no-action baseline. This provision will reduce potential distortions between owned and leased property that may occur under other options.

c. Valuation of Property

The final regulations provide taxpayers with a choice between two methods for determining the asset values for purposes of the 90-percent investment standard in section 1400Z-2(d)(1) for QOFs or the value of tangible property for the substantially all test in section 1400Z-2(d)(3)(A)(i) for qualified opportunity zone businesses. Under the first method (applicable financial statement valuation method), the taxpayer values owned or leased property as reported on its applicable financial statement for the reporting period. Under the alternative valuation method, the taxpayer sets the value of owned property equal to the unadjusted cost basis of the property under section 1012. The final regulations specify that the value of leased property under the alternative method equals the present value of total lease payments at the beginning of the lease. The value of the property under the alternative method for the 90-percent investment standard and substantially all test does not change over time as long as the taxpayer continues to own or lease the property.

The Treasury Department and the IRS project that the two methods will, in the majority of cases, provide similar values for leased property at the time that the lease begins because, as beginning in 2019, generally accepted accounting principles (GAAP) require public companies to calculate the present value of lease payments in order to recognize the value of leased assets on the balance sheet. However, there are situations in which the two methods may differ in the value they assign to leased property. On financial statements, the value of the leased property declines over the term of the lease. Under the alternative method, the value of the leased asset is calculated once at the beginning of the lease term and remains constant while the term of the lease is still in effect. This difference in valuation of property over time between using financial statements and the alternative method also exists for owned property. In addition, the two approaches would generally apply different discount rates, thus leading to some difference in the calculated present value under the two methods.

The Treasury Department and the IRS provide the alternative method to allow for taxpayers that either do not have applicable financial statements or do not have them available in time for the asset tests. In addition, the alternative method is simpler, thus reducing compliance costs, and provides greater certainty in projecting future compliance with the 90-percent investment standard and the substantially all test. Thus, even some taxpayers with applicable financial statements may choose to use the alternative method. One drawback to the alternative method is that it is less likely to provide accurate asset valuation over time because it does not account for depreciation or other items that may affect the value of assets after the time of purchase, and, over time, the values used for the sake of the 90-percent investment standard and the substantially all test may diverge from the actual value of the property.

Because this provision provides an election to taxpayers, the Treasury Department and the IRS project that this provision will slightly increase investment in QOFs, relative to not providing an election. The Treasury Department and the IRS have not estimated the proportion of taxpayers likely to use the alternative method nor the volume of increased investment in QOFs relative to not providing an election.

d. Gross Income Requirement of Section 1397C(b)(2)

Section 1400Z-2(d)(3)(A)(ii) incorporates the requirement of section 1397C(b)(2) that a qualified business entity must derive at least 50 percent of its total gross income during a taxable year from the active conduct of a qualified business in a zone. The final regulations provide multiple safe harbors for determining whether this standard has been satisfied.

Two of these safe harbors provide that the 50 percent of gross income standard would be satisfied if the majority of the labor input of the trade or business is located within a QOZ and provide two different methods for measuring the labor input of the trade or business. The labor input can be measured in terms of hours (hours performed test) or compensation paid (amounts paid test) of employees, independent contractors, and employees of independent contractors for the trade or business. The final regulations clarify that guaranteed payments to partners in a partnership for services provided to the trade or business are also included in the amounts paid test. The final regulations provide that if at least 50 percent of the labor input of the trade or business is located within a QOZ (as measured by one of the two provided approaches), then the section 1397C(b)(2) requirement is satisfied.

In addition, a third safe harbor (business functions test) provides that the 50-percent gross income requirement is met if the tangible property of the trade or business located in a QOZ and the management or operational functions performed in the QOZ are each necessary for the generation of at least 50 percent of the gross income of the trade or business.

The determination of the location of income for businesses that operate in multiple jurisdictions can be complex, and the rules promulgated by taxing authorities to determine the location of income are often burdensome and may distort economic activity. The provision of alternative safe harbors in the final regulations should reduce the compliance and administrative burdens associated with determining whether this statutory requirement has been met. In the absence of such safe harbors, some taxpayers may interpret the 50 percent of gross income standard to require that a majority of the sales of the entity must be located within a zone. The Treasury Department and the IRS have determined that a standard based strictly on sales would discriminate against some types of businesses (for example, manufacturing) in which the location of sales is often different from the location of the production, and thus would preclude such businesses from benefitting from the incentives provided in section 1400Z-2. Furthermore, the potential distortions introduced by the provided safe harbors would increase incentives to locate labor inputs within a QOZ. To the extent that such distortions exist, they further the statutory goal of encouraging economic activity within QOZs. Given the flexibility provided to taxpayers in choosing a safe harbor, other distortions, such as to business organizational structuring, are likely to be minimal.

e. Working Capital Safe Harbor

Section 1400Z-2 contains several rules limiting taxpayers from benefitting from the deferral and exclusion of capital gains from income offered by that section without also locating investment within a QOZ. The final regulations clarify the rules related to nonqualified financial property and what amounts can be held in cash and cash equivalents as working capital. A qualified opportunity zone business is subject to the requirements of section 1397C(b)(8), that less than 5 percent of the aggregate adjusted basis of the entity is attributable to nonqualified financial property. The final regulations establish a working capital safe harbor consistent with section 1397C(e)(1), under which a qualified opportunity zone business may hold cash or cash equivalents for a period not longer than 31 months and not violate section 1397C(b)(8). The final regulations also provide that qualified opportunity zone businesses may utilize multiple working capital safe harbors, provided that each one satisfies all of the conditions of the safe harbor provided in the final regulations. In the case where multiple working capital safe harbors applies to the same unit of tangible property, then total length of time the working capital safe harbor may last is 62 months.

The Treasury Department and the IRS expect that the establishment of the working capital safe harbors under these parameters will provide net economic benefits. Without specification of the working capital safe harbor, some taxpayers would not invest in a QOF for fear that the QOF would not be able to deploy the funds soon enough to satisfy the 90-percent asset test. Thus, this rule would generally encourage investment in QOFs by providing greater specificity to how an entity may consistently satisfy the statutory requirements for maintaining a QOF without penalty.

A longer or a shorter period could have been chosen for the working capital safe harbor. A shorter time period would minimize the ability of taxpayers to use the investment in a QOF as a way to lower taxes without actually investing in tangible assets within a QOZ, but taxpayers may also forego legitimate investments within an opportunity zone out of concern of not being able to deploy the working capital fast enough to meet the requirements. A longer period would have the opposite effects. Taxpayers could potentially invest in a QOF and receive the benefits of the tax incentive for multiple years before the money is invested into a QOZ.

f. QOF Reinvestment Rule

The final regulations provide that a QOF has 12 months from the time of the sale or disposition of qualified opportunity zone property or the return of capital from investments in qualified opportunity zone stock or qualified opportunity zone partnership interests to reinvest the proceeds in other qualified opportunity zone property before the proceeds would not be considered qualified opportunity zone property with regards to the 90-percent investment standard. This rule provides clarity and gives substantial flexibility to taxpayers in satisfying the 90-percent investment standard. The Treasury Department and the IRS have not projected the effect of this rule on the volume of investment held by QOFs compared to a no action baseline.

g. Clarity Regarding Electing Post-10-Year Gain Exclusion if Zone Designation Expires

The final regulations specify in § 1.1400Z2(c)-1 that expiration of a zone designation would not impair the ability of a taxpayer to elect the exclusion from gains for investments held for at least 10 years, provided the disposition of the investment occurs prior to January 1, 2048. The Treasury Department and the IRS considered four alternatives regarding the interaction between the expiration of the designated zones and the election to exclude gain for investments held more than 10 years. A discussion of the economic effects of the four options follows.

(i) Remaining Silent on Electing Post-10-Year Gain Exclusion

The first alternative would be for the final regulations to remain silent on this issue. Section 1400Z-2(c) permits a taxpayer to increase the basis in the property held in a QOF longer than 10 years to be equal to the fair market value of that property on the date that the investment is sold or exchanged, thus excluding post-acquisition capital gain on the investment from tax. However, the statutory expiration of the designation of QOZs on December 31, 2028, makes it unclear to what extent investments in a QOF made after 2018 would qualify for this exclusion.

In absence of the guidance provided in the final regulations, some taxpayers may have believed that only investments in a QOF made prior to January 1, 2019, would be eligible for the exclusion from gain if held greater than 10 years. Such taxpayers may have rushed to complete transactions within 2018, while others may choose to hold off indefinitely from investing in a QOF until they received clarity on the availability of the 10-year exclusion from gain for investments made later than 2018. Other taxpayers may have planned to invest in a QOF after 2018 with the expectation that future regulations would be provided or the statute would be amended to make it clear that dispositions of assets within a QOF after 2028 would be eligible for exclusion if held longer than 10 years. The ambiguity of the statute would likely lead to uneven response by different taxpayers, dependent on the taxpayer's interpretation of the statute, which may lead to an inefficient allocation of investment across QOZs.

(ii) Providing a Clear Deadline for Electing Post-10-Year Gain Exclusion

The alternative adopted by the final regulations clarifies that as long as the investment in the QOF was made with funds subject to a proper deferral election under section 1400Z-2(a), then the 10-year gain exclusion election is allowed as long as the disposition of the investment occurs before January 1, 2048. This rule would provide certainty to taxpayers regarding the timing of investments eligible for the 10-year gain exclusion. Taxpayers would have a more uniform understanding of what transactions would be eligible for the favorable treatment on capital gains. This would help taxpayers determine which investments provide a sufficient return to compensate for the extra costs and risks of investing in a QOF. This rule would likely lead to an increase in investment within QOFs compared the final regulations remaining silent on this issue.

However, setting a fixed date for the disposition of eligible QOFs investments could introduce economic inefficiencies. Some taxpayers might dispose of their investment in a QOF by the deadline in the proposed regulation primarily in order to receive the benefit of the gain exclusion, even if that selling date is not optimal for the taxpayer in terms of the portfolio of assets that the taxpayer could have chosen to invest in were there no deadline. Setting a fixed deadline may also generate an overall decline in asset values in some QOZs if many investors in QOFs seek to sell their portion of the fund within the same time period. This decline in asset values may affect the broader level of economic activity within some QOZs or affect other investors in such zones that did not invest through a QOF. In anticipation of this fixed deadline, some taxpayers may choose to dispose of QOF assets earlier than the deadline to avoid an anticipated "rush to the exits," but this would seem to conflict with the purpose of the incentives in the statute to encourage "patient" capital investment within QOZs. While the final regulations may produce these inefficiencies, by providing a long time period for which taxpayers may dispose of their investment within a QOF and still qualify for the exclusion the final regulations will lead any such inefficiencies to be minor.

(iii) Providing No Deadline for Electing Gain Exclusion

As an alternative, the final regulations could have provided no deadline for electing the 10-year gain exclusion for investments in a QOF, while still stating that the ability to make the election is not impaired solely because the designation of one or more QOZs ceases to be in effect. While this alternative would eliminate the economic inefficiencies associated with a fixed deadline and would likely lead to greater investment in QOFs, it could introduce substantial additional administrative and compliance costs. Taxpayers would also need to maintain records and make efforts to maintain compliance with the rules of section 1400Z-2 on an indefinite basis.

(iv) Providing Fair Market Value Basis Without Disposition of Investment

Another alternative considered would allow taxpayers to elect to increase the basis in their investment in the QOF if held at least 10 years to the fair market value of the investment without disposing of the property, as long as the election was made prior to January 1, 2048. (Or, the final regulations could have provided that, at the close of business of the day on which a taxpayer first has the ability to make the 10-year gain exclusion election, the basis in the investment automatically sets to the greater of current basis or the fair market value of the investment.) This alternative would minimize the economic inefficiencies of the proposed regulations resulting from taxpayers needing to dispose of their investment in the opportunity zone at a fixed date not related to any factor other than the lapse of time. However, this approach would require a method of valuing unsold assets that could raise administrative and compliance costs. It may also require the maintenance of records and trained compliance personnel for over two decades.

(v) Summary

As discussed in section V.B of the Explanation of Provisions of the October 2018 proposed regulations, the Treasury Department and the IRS have determined the ability to exclude gains for investment held at least 10 years in a QOF is integral to the TCJA's purpose of creating QOZs. The final regulations provide a uniform signal to all taxpayers on the availability of this tax incentive, which should encourage greater investment, and a more efficient distribution of investment, in QOFs than in the absence of the final regulations. The relative costs and benefits of the various alternatives are difficult to measure and compare. The final regulations would likely produce the lowest compliance and administrative costs among the alternatives and any associated economic inefficiencies are likely to be small.

Notice 2021-10 further extends deadlines that Notice 2020-39 extended as a result of the COVID-19 pandemic.

Letter Ruling 202103013 granted "an extension of time under sections 301.9100-1 and 301.9100-3 of the Income Tax Regulations to (1) make a timely election under section 1.1400Z2(a)-1(a)(2)(i) to be certified as a qualified opportunity fund (QOF), as defined in section 1400Z-2(d) of the Internal Revenue Code (Code); and (2) for the taxpayer to be treated as a QOF, effective as of the month the taxpayer was formed in Year 2 as provided under section 1400Z-2(d) of the Code and section 1.1400Z2(d)-1(a) of the Income Tax Regulations. The extension was 45 days from the date of the letter ruling to file an amended return to make the election under section 1400Z-2 and section 1.1400Z2(d)-1(a)(2)(i) and was to be made on Form 8996.

Letter Ruling 202249005 held:

> The gross income derived by Taxpayer from its sale of Parcel B, which occurs during Taxpayer's start-up period, may be treated as gross income derived from the active conduct of a trade or business in a QOZ for purposes of satisfying § 1400Z-2(d)(3)(A)(ii) and § 1397C(b)(2) of the Code, provided that Taxpayer adopts a new or revised working capital plan within 120 days of the end of the qualified disaster incident period satisfying the requirements of § 1.1400Z2(d)-1(d)(3)(v)(A) through (E) of the Regulations and that such plan utilizes the proceeds from the sale of Parcel B (net of any tax distributions) in a manner such that the completion of spending takes into account the originally allowed up to 31-month period and up-to-24 additional month period, as provided by § 1.1400Z2(d)-1(d)(3)(v)(B) of the Regulations and § 1.1400Z2(d)-1(d)(3)(v)(D) of the Proposed Regulations.

II.G.7.b. Transfers of a Qualified Opportunity Fund (QOF)

To explain the rules below and their background, see Matz, "How the Final Regulations on Qualified Opportunity Funds Come Out on Trust and Estate Related Issues – A Review of the QOF Final Regulations' Disposition of ACTEC's Comments to the U.S. Department of Treasury and the IRS," *Estate Planning Journal* (7/2020).

Reg. § 1.1400Z2(b)-1, "Inclusion of gains that have been deferred under section 1400Z-2(a)," provides when the passage of time or a transfer may cause deferred gain to be taxed.

Reg. § 1.1400Z2(b)-1(a), "Scope," provides:

> This section provides rules under section 1400Z-2(b) of the Internal Revenue Code and the section 1400Z-2 regulations (as defined in § 1.1400Z2(a)-1(b)(41)) regarding the inclusion in income of gain deferred by a QOF owner under section 1400Z-2(a)(1)(A) and the section 1400Z-2 regulations. This section applies to a QOF owner only until all of such owner's gain deferred pursuant to a deferral election has been included in income, subject to the limitations described in paragraph (e)(5) of this section, and except as otherwise provided in paragraph (c) or (d) of this section. Paragraph (b) of this section provides general rules under section 1400Z-2(b)(1) regarding the timing of the inclusion in income of the deferred gain. Paragraph (c)(1) of this section provides the general rule regarding the determination of the extent to which an event triggers the inclusion in gross income of all, or a portion, of an eligible taxpayer's deferred gain, and paragraphs (c)(2) through (16) of this section provide specific rules for certain events that are or are not treated as inclusion events. Paragraph (d) of this section provides rules regarding holding periods for qualifying investments. Paragraph (e) of this section provides rules regarding the amount of deferred gain included in gross income under section 1400Z-2(a)(1)(B) and (b), including special rules for QOF partnerships and QOF S corporations. Paragraph (f) of this section provides examples illustrating the rules of paragraphs (c), (d), and (e) of this section. Paragraph (g) of this section provides rules regarding basis adjustments under section 1400Z-2(b)(2)(B). Paragraph (h) of this section provides special reporting rules applicable to partners, partnerships, and direct

or indirect owners of QOF partnerships. Paragraph (i) is reserved. Paragraph (j) of this section provides dates of applicability.

Reg. § 1.1400Z2(b)-1(b), “General inclusion rule,” provides:

The gain to which a deferral election applies is included in gross income, to the extent provided in paragraph (e) of this section and in accordance with the rules of § 1.1400Z2(a)-1(c)(1), in the taxable year that includes the earlier of:

(1) The date of an inclusion event; or

(2) December 31, 2026.

Reg. § 1.1400Z2(b)-1(c), “Inclusion events,” provides:

(1) *In general*. Except as otherwise provided in this paragraph (c), an event is an inclusion event, if, and to the extent that -

(i) The event reduces an eligible taxpayer’s direct equity interest for Federal income tax purposes in the qualifying investment;

(ii) An eligible taxpayer receives property in the event with respect to its qualifying investment and the event is treated as a distribution for Federal income tax purposes, whether or not the receipt reduces the eligible taxpayer’s ownership of the QOF;

(iii) An eligible taxpayer claims a loss for worthless stock under section 165(g) or otherwise claims a worthlessness deduction with respect to its qualifying investment; or

(iv) A QOF in which an eligible taxpayer holds a qualifying investment loses its status as a QOF.

(2) *Termination or liquidation of QOF or QOF owner*.

(i) *Termination or liquidation of QOF*. Except as otherwise provided in this paragraph (c), an eligible taxpayer has an inclusion event with respect to all of its qualifying investment if the QOF ceases to exist for Federal income tax purposes. For example, if a QOF partnership converts to a QOF C corporation, or if a QOF C corporation converts to a QOF partnership or to an entity disregarded as separate from its owner for Federal income tax purposes, all investors in the QOF have an inclusion event with respect to all of their qualifying investments in the QOF.

(ii) *Liquidation of QOF owner* -

(A) *Portion of distribution treated as sale*. A distribution of a qualifying investment in a complete liquidation of a QOF owner is an inclusion event to the extent that section 336(a) treats the distribution as if the qualifying investment were sold to the distributee at its fair market value, without regard to section 336(d).

(B) *Distribution to 80-percent distributee*. A distribution of a qualifying investment in a complete liquidation of a QOF owner is not an inclusion event to the extent section 337(a) applies to the distribution.

(3) *Transfer of an investment in a QOF by gift or incident to divorce*.

(i) *Transfer of an investment in a QOF by gift*. Except to the extent provided in paragraph (c)(5) of this section, a taxpayer's transfer of a qualifying investment by gift, as defined for purposes of chapter 12 of subtitle B of the Code, whether outright or in trust, is an inclusion event, regardless of whether that transfer is a completed gift for Federal gift tax purposes, and regardless of the taxable or tax-exempt status of the donee of the gift.

(ii) *Transfers between spouses incident to divorce*. A transfer between spouses or incident to divorce or otherwise as provided in section 1041 of the Code is an inclusion event.

(4) *Transfer of an investment in a QOF by reason of the taxpayer's death*.

(i) *In general*. Except as provided in paragraph (c)(4)(ii) of this section, a transfer of a qualifying investment by reason of the taxpayer's death is not an inclusion event. Transfers by reason of death include, for example:

(A) A transfer by reason of death to the deceased owner's estate;

(B) A distribution of a qualifying investment by the deceased owner's estate;

(C) A distribution of a qualifying investment by the deceased owner's trust that is made by reason of the deceased owner's death;

(D) The passing of a jointly owned qualifying investment to the surviving co-owner by operation of law; and

(E) Any other transfer of a qualifying investment at death by operation of law.

(ii) *Exceptions*. The following transfers are not included as a transfer by reason of the taxpayer's death, and thus are inclusion events:

(A) A sale, exchange, or other disposition by the deceased taxpayer's estate or trust, other than a distribution described in paragraph (c)(4)(i) of this section;

(B) Any disposition by the legatee, heir, or beneficiary who received the qualifying investment by reason of the taxpayer's death; and

(C) Any disposition by the surviving joint owner or other recipient who received the qualifying investment by operation of law on the taxpayer's death.

(iii) *Liability for deferred Federal income tax*. If the owner of a qualifying investment in a QOF dies before an inclusion event and the deferred gain is not includable in the decedent's gross income, the gain that the decedent elected to defer under section 1400Z-2(a) and the section 1400Z-2 regulations will be includable in the gross income, for the taxable year in which occurs an inclusion event, of the person described in section 691(a)(1).

(iv) *Qualifying investment in the hands of the person described in section 691(a)(1)*. A qualifying investment received in a transfer by reason of death listed in paragraph (c)(4)(i) of this section continues to be a qualifying investment under § 1.1400Z2(a)-1(b)(34).

(5) *Grantor trusts*.

(i) *Contributions to grantor trusts*. If the owner of a qualifying investment contributes it to a trust and, under subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code (grantor trust rules), the contributing owner of the investment is the deemed owner of the trust (grantor trust), the contribution to the grantor trust is not an inclusion event. Similarly, a transfer of the investment by the grantor trust to the trust's deemed owner is not an inclusion event. For all purposes of the section 1400Z-2 regulations, references to the term grantor trust mean the portion of the trust that holds the qualifying investment in the QOF, and such a grantor trust, or portion of the trust, is a wholly grantor trust as to the deemed owner. Such contributions may include transfers by gift or any other type of transfer between the grantor and the grantor trust that is a nonrecognition event as a result of the application of the grantor trust rules (that is, subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code).

(ii) *Changes in grantor trust status*. In general, a change in the income tax status of an existing trust owning a qualifying investment in a QOF, whether the termination of grantor trust status or the creation of grantor trust status, is an inclusion event. Notwithstanding the previous sentence, the termination of grantor trust status as the result of the death of the owner of a qualifying investment is not an inclusion event, but the provisions of paragraph (c)(4) of this section apply to distributions or dispositions by the trust. If a qualifying investment is held in the grantor portion of an electing small business trust (ESBT), as defined in section 1361(e)(1), and the ESBT converts into a qualified subchapter S trust (QSST), as defined in section 1361(d)(3), the beneficiary of which is the deemed owner of the grantor portion of the ESBT, there has been no change in the grantor trust status because the deemed owner continues to be taxable under subtitle A of the Code on the income and gain from the qualifying investment.

(iii) *Conversions of QSSTs and ESBTs*. With regard to conversions of QSSTs and ESBTs, see paragraphs (c)(7)(i)(B) and (C) of this section. For purposes of paragraph (c)(5)(ii) of this section, if a qualifying investment is held by a QSST that converts to an ESBT, the beneficiary of the QSST is the deemed owner of the grantor portion of the ESBT that then holds the qualifying investment, and the deemed owner is not a nonresident alien for purposes of this section (and thus notwithstanding § 1.1361-1(j)(8)), there has been no change in the grantor trust status because the deemed owner continues to be taxable under subtitle A of the Code on the income and gain from the qualifying investment.

Reg. § 1.1400Z2(b)-1(c)(6)-(16) describe a variety of other events that may or may not be inclusion events.

See also Sobochan, “Disguised sale of a QOZ partnership interest,” *The Tax Adviser* (8/2023).

II.G.8. Code § 165(a) Loss for Worthlessness; Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy

Except for a small allowance for individuals[1550] and the exception provided in part II.G.4.m.i Code § 1341 Claim of Right Deduction,[1551] capital losses are deductible only against capital gain.[1552] In addition to limiting the amount of loss that any taxpayer can take, for individuals (including owners of S corporations and partnerships) this rule causes such losses to offset favorably taxed capital gain,[1553] which is not as beneficial as offsetting highly taxed ordinary income. This part II.G.8 explains that abandoning a capital asset generates an ordinary loss, which is more favorable than selling a capital asset for a capital loss, so much so that a taxpayer turned its back on $20 million cash to generate an ordinary loss deduction worth much more than that.[1554] Note that pass-through losses reduce the basis allowable as a loss on the abandonment,[1555] so the abandoning taxpayer needs to separately prove that any suspended losses are deductible; as the latter, see parts II.G.4.l Business Deductions and Losses and II.K.1.j Complete Disposition of Passive Activity.

Generally, a loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, is a Code § 165(a) deduction for the taxable year in which the loss is actually sustained.[1556] *MCM Investment Management, LLC v. Commissioner*, T.C. Memo. 2019-158, explained:

> Section 165(a) allows a deduction for any loss sustained during the tax year and not compensated for by insurance or otherwise. To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the tax year. Sec. 1.165-1(b), (d)(1), Income Tax Regs. Only a bona fide loss is deductible, and substance prevails over mere form in our analysis. *Id.* para. (b).
>
> “In most cases, a ‘closed and completed transaction’ will occur upon a sale or other disposition of the property, but this requirement also may be satisfied if the taxpayer abandons the asset or the asset becomes worthless.” *Tucker v. Commissioner*, 841 F.3d 1241, 1249 (11th Cir. 2016) (quoting *Proesel v. Commissioner*, 77 T.C. 992, 1005 (1981)), *aff’g* T.C. Memo. 2015-185. Thus, “worthlessness” is a stand-alone justification for a deduction under section 165(a), and a taxpayer may deduct a loss from an investment in a partnership if the partnership interest becomes worthless during the tax year. *Echols v. Commissioner* (*Echols I*), 935 F.2d 703, 706 (5th Cir. 1991), *rev’g* 93 T.C. 553 (1989), *rehearing denied*, *Echols v. Commissioner* (*Echols II*), 950 F.2d 209

[1550] $1,500 for married filing separately and $3,000 for all other individuals. Code § 1211(b)(1).
[1551] Especially text accompanying fn 1423.
[1552] Code § 1211.
[1553] Code § 1(h).
[1554] See fns. 1571-1572.
[1555] To zero, in *LeBlanc, Jr. v. U.S.*, 90 Fed. Cl. 186 (Ct. Fed. Cl. 2009). The taxpayer unsuccessfully argued that disallowed losses should be added to basis.
[1556] Reg. § 1.165-2(a).

> (5th Cir. 1991); see also *Forlizzo v. Commissioner*, T.C. Memo. 2018-137. The parties agree that MCMIM did not abandon its partnership interest in Companies.
>
> Therefore, we must determine whether the partnership interest became worthless in 2009, the sole remaining challenge to deductibility for that year.
>
> Whether a partnership interest is worthless is a question of fact. See *Boehm v. Commissioner*, 326 U.S. 287, 293 (1945); *Proesel v. Commissioner*, 77 T.C. at 1006. The statute's "general requirement that losses be deducted in the year in which they are sustained calls for a practical, not a legal, test." *Boehm v. Commissioner*, 326 U.S. at 292-293 (quoting *Lucas v. Am. Code Co.*, 280 U.S. 445, 449 (1930)).
>
> To prove entitlement to a section 165(a) loss deduction for worthless property, a taxpayer must demonstrate its "subjective determination of worthlessness in a given year, coupled with a showing that in such year the asset in question is in fact essentially valueless." *Echols I*, 935 F.2d at 708. The requirement that an asset be "essentially" valueless demonstrates "the de minimis rule that the taxpayer does not have to prove that a given asset is absolutely, positively without any value whatsoever." *Id.* n.2. But, "while a taxpayer need not be 'an incorrigible optimist in his determination of when property becomes worthless, a mere decline, diminution, or shrinkage in value is not sufficient to establish a loss." *Tucker v. Commissioner*, 841 F.3d at 1251 (quoting *Proesel v. Commissioner*, 77 T.C. at 1006). In sum, we must determine whether MCMIM subjectively determined that its partnership interest in Companies was worthless in 2009 and whether objective factors confirm that the interest became essentially valueless in that year. See *Echols II*, 950 F.2d at 213 ("Our opinion expressly holds that the test for worthlessness is a combination of subjective and objective indicia: a subjective determination by the taxpayer of the fact and the year of worthlessness to him, and the existence of objective factors reflecting completed transaction(s) and identifiable event(s) in the year in question[.]").

MCM Investment Management, LLC determined that MCM Investment Management, LLC (MCMIM), was entitled to a loss deduction claimed with respect to a partnership interest ("Companies")[1557] that MCMIM reported became worthless during 2009. The court held that the subjective part was satisfied, based on the taxpayer's business judgement:[1558]

[1557] "Companies" was an LLC with substantial business:

> During 2009, the year in issue, Companies was involved in three distinct lines of real estate development: single-family homebuilding, master-planned communities, and commercial development and management. Companies' business lines were operated through various wholly owned and multimember (joint venture) LLCs (project entities). Each project entity held real estate for land development and homebuilding. During 2009 Companies held investments in 73 project entities, 11 management services entities, and 3 investment-holding companies.

[1558] The court described the subjective test:

> We first consider whether MCMIM subjectively determined that its partnership interest in Companies was worthless in 2009. *Echols v. Commissioner*, 935 F.2d at 707 ("[T]he more important question of when a property is worthless for purposes of a loss deduction under … [section] 165(a) is, like beauty, largely in the eyes (more accurately, the mind) of the beholder (more accurately, the holder)."). The subjective determination of the taxpayer, while not conclusive, is entitled to great weight. *Id*. At 708; *A.J. Indus., Inc. v. United States*, 503 F.2d 660, 670 (9th Cir. 1974) ("The subjective judgment of the taxpayer (here the management) as to

> We conclude that MCMIM subjectively determined that its partnership interest in Companies was worthless by the end of 2009. First, MCMIM took the position on its tax return that the partnership interest was worthless in 2009. See *id.* at 707 (noting that taking loss deduction on tax return is manifestation of taxpayer's intent that partnership interest was worthless). Second, the owners and management of MCMIM and Companies testified credibly at trial that they believed MCMIM's interest became worthless in 2009. They based their belief, in part, on the dramatic and devastating impact of the financial crisis that began in 2007, Companies' consistent operating losses in the years leading up to and including 2009, the subordinate position of MCMIM's partnership interest to Holdings, and the overwhelming debt burden of Companies and its project entities. The owners and management took into account Companies' deteriorating cashflow projections during 2009. Those projections showed that Companies would be unable to satisfy financial obligations owed to the senior lender, the subordinate lender, or the project debt lenders. Ultimately, the McMillin family decided to wind down Companies in an orderly manner to maximize value for the creditors. These facts support our conclusion that MCMIM subjectively believed its partnership interest in Companies was worthless in 2009.

MCM Investment Management, LLC described the objective test:

> We now consider whether objective indicia confirm an absence of substantial value in 2009. See *id.* At 707 ("[P]roperty cannot be treated as worthless for tax loss purposes if at the time it, objectively, has substantial value."). Section 1.165-1(b), Income Tax Regs., requires that the reported loss be "evidenced by closed and completed transactions, fixed by identifiable events, and … actually sustained during the tax year." See also *Echols II*, 950 F.2d at 212-213 ("[I]n order to comply with … [section 1.165-1(d)(1), Income Tax Regs.,] the analysis should focus on objective events confirming the taxpayer's subjective determination that the asset was in fact worthless in the year in which the loss was claimed."); sec. 1.165-1(d)(1), Income Tax Regs.

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whether the business assets will in the future have value is entitled to great weight and a court is not justified in substituting its business judgment for a reasonable, well-founded judgment of the taxpayer."); *Oak Harbor Freight Lines, Inc. v. Commissioner*, T.C. Memo. 1999-291, 1999 WL 680132, at *2-*3 (citing *Echols II*, 950 F.2d 209, and *A.J. Indus., Inc.*, 503 F.2d 660). In *Echols I*, 935 F.2d at 708, the court emphasized the discretion a taxpayer has in claiming a loss deduction under section 165(a) for a worthless partnership interest:

> The admittedly belabored point of this analysis is that the IRS cannot disallow …[a section] 165(a) deduction by a taxpayer who can demonstrate his subjective determination of worthlessness in a given year, coupled with a showing that in such year the asset in question is in fact essentially valueless. Proof by the IRS that the asset in question may have been of virtually no value in a prior year, or that, despite being of little or no value, the asset might have been deemed worthy of continued holding by some other taxpayer, even one similarly situated, would not defeat the bona fide determination of worthlessness by the taxpayer in the year he selects. Just as a taxpayer is entitled to exercise his own investment judgment and discretion in the timing of an overt act of abandonment, he is also entitled to the same exercise of judgment and discretion in determining when an asset is worthless to him, given a reasonable showing that the asset was in fact valueless at the time selected by the taxpayer—not that its fair market value necessarily fell to or below zero in that year. [Fn. ref. omitted.]

We laid out principles for determining worthlessness in the context of equity interests in *Morton v. Commissioner*, 38 B.T.A. 1270, 1278-1279 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940):

> The ultimate value of stock, and conversely its worthlessness, will depend not only on its current liquidating value, but also on what value it may acquire in the future through the foreseeable operations of the corporation. Both factors of value must be wiped out before we can definitely fix the loss. If the assets of the corporation exceed its liabilities, the stock has a liquidating value. If its assets are less than its liabilities but there is a reasonable hope and expectation that the assets will exceed the liabilities of the corporation in the future, its stock, while having no liquidating value, has a potential value and can not be said to be worthless. The loss of potential value, if it exists, can be established ordinarily with satisfaction only by some "identifiable event" in the corporation's life which puts an end to such hope and expectation.
>
> There are, however, exceptional cases where the liabilities of a corporation are so greatly in excess of its assets and the nature of its assets and business is such that there is no reasonable hope and expectation that a continuation of the business will result in any profit to its stockholders. In such cases the stock, obviously, has no liquidating value, and since the limits of the corporation's future are fixed, the stock, likewise, can presently be said to have no potential value. Where both these factors are established, the occurrence in a later year of an "identifiable event" in the corporation's life, such as liquidation or receivership, will not, therefore, determine the worthlessness of the stock, for already "its value had become finally extinct."

Morton involved worthless corporate stock, and courts have applied these principles routinely in other cases involving securities. See, *e.g.*, *Nelson v. United States*, 131 F.2d 301 (8th Cir. 1942); *Austin Co. v. Commissioner*, 71 T.C. 955, 969-970 (1979); *Steadman v. Commissioner*, 50 T.C. 369, 376 (1968), *aff'd*, 424 F.2d 1 (6th Cir. 1970); *Flint Indus., Inc. v. Commissioner*, T.C. Memo. 2001-276, 2001 WL 1195725; *Corona v. Commissioner*, T.C. Memo. 1992-406, *aff'd*, 33 F.3d 1381 (11th Cir. 1994).

MCM Investment Management, LLC described "evidence indicating no liquidating value":

> Under *Morton v. Commissioner*, 38 B.T.A. at 1278-1279, a taxpayer claiming a worthlessness loss deduction must show that its equity interest ceased to have liquidating value during the year in issue. Generally this may be shown by an authoritative balance sheet showing liabilities in excess of assets, leaving no value for equity holders. *Steadman v. Commissioner*, 50 T.C. at 377; *Morton v. Commissioner*, 38 B.T.A. at 1282; *Flint Indus., Inc. v. Commissioner*, 2001 WL 1195725, at *17. Balance sheet insolvency at the entity level is not necessarily required when preferred equity interests are involved, however. A subordinate equity interest may become worthless if the company cannot satisfy a senior equity interest holder's preferential claim in liquidation. See *Mahler v. Commissioner*, 119 F.2d 869, 873 (2d Cir. 1941) (concluding that preferred stock and common stock of a corporation became worthless in different years); *H.K. Porter Co. v. Commissioner*, 87 T.C. 689, 694 (1986) (holding that the priority of indebtedness over preferred and common stock and of preferred stock over common stock must be respected); *Spaulding Bakeries, Inc. v. Commissioner*, 27 T.C. 684 (1957) (finding the taxpayer's common stock worthless because the corporation could not satisfy the claim of the taxpayer's preferred stock when the

corporation dissolved and nothing was distributed on account of the common stock), *aff'd*, 252 F.2d 693 (2d Cir. 1958).

In *Spaulding Bakeries, Inc. v. Commissioner*, 27 T.C. at 685-686, the taxpayer owned common stock and all the outstanding preferred stock of a corporation. The shares of preferred stock were entitled to quarterly dividends, and, on dissolution or liquidation of the corporation, the holders of preferred stock were entitled to receive the full par value of their preferred stock plus all accrued unpaid dividends before any payment whatsoever could be made upon the common stock of the corporation. *Id*. At 685. In 1950 the corporation dissolved, and all of its remaining assets were transferred to the taxpayer as holder of all of the outstanding preferred stock, but the amount transferred was less than the par value of the preferred stock. *Id*. At 686. Because the taxpayer did not receive full par value for the preferred stock and did not receive anything on account of its common stock, it claimed a worthless stock deduction for its common stock in 1950. *Id*. In recognizing the priority of preferred stock over common stock, we held that the common stock was worthless because the corporation could not satisfy the claim of the preferred stock and that the taxpayer was entitled to a loss deduction.[5] *Id*. At 688-689.

[5] The specific issue before the Court in *Spaulding Bakeries, Inc. v. Commissioner*, 27 T.C. 684 (1957), *aff'd*, 252 F.2d 693 (2d Cir. 1958), was whether the nonrecognition rule in sec. 112(b)(6) of the Internal Revenue Code of 1939, the predecessor to sec. 332, applied to bar the taxpayer, a corporation, from claiming the worthless stock deduction. That rule prevents a corporation from recognizing gain or loss upon receipt of property distributed in complete liquidation of another corporation, under certain circumstances. The Court had to decide whether the taxpayer received any property in liquidation of its common stock when the liquidating distribution the taxpayer received was insufficient to satisfy the claim of the preferred stock the taxpayer held. *Id*. at 687-688.

Thus:[1559]

In short, none of respondent's arguments can overcome the fact that MCMIM held an interest that was junior to both a $70 million senior debt obligation and a preferred

[1559] Earlier in the opinion, the court described the decision to wind down Companies:

Companies updated its cashflow forecast in December 2009. That forecast projected that Companies would have an ending cash balance of $12.3 million if it could wind down by the end of 2014 and pay off the senior debt. While Companies projected that it could achieve this positive cash balance by the end of the winddown, it also projected that it would have a cash shortfall during the winddown period in both 2012 and 2013.

Under the terms of the senior debt loan documents, Companies was required to make $32 million of principal payments in 2012 and approximately $30 million of principal payments in 2013, when the loan matured. But the December 2009 cashflow forecast showed that Companies would not have sufficient cash in 2012 and 2013 to make these required principal payments timely and cash shortfalls of approximately $14 million in 2012 and $7.4 million in 2013 would result.

Companies also prepared a liquidation analysis in 2009. The liquidation analysis showed that if Companies were to liquidate completely in 2009—as an alternative to a gradual winddown over five years—it would have only $51.6 million to pay approximately $70 million in outstanding senior debt.

> interest with an accrued preferred return that exceeded $71 million. And all of the economic data available to Companies, MCMIM, and other financial players indicated that under various scenarios MCMIM would recover nothing for its interest.

MCM Investment Management, LLC dismissed the IRS' arguments that a positive capital account indicated value:

> … In sum, even if a hypothetical liquidation in 2009 could have generated enough cash to pay off the senior debt, MCMIM would not have been entitled to liquidating distributions until after Holdings had received its preferred interest and accrued preferred return, which was highly unlikely.
>
> Respondent's argument fails in two other ways. First, the operating agreement provides for liquidating distributions in accordance with section 704(b) capital accounts. But the positive capital account balance reported on MCMIM's Schedule K-1 was its GAAP capital account, not its section 704(b) capital account. And the "0.39%" share of capital on item J of the Schedule K-1 was derived from the GAAP capital account. Because section 704(b) capital accounts can differ from GAAP capital accounts, the GAAP capital account reported on the Schedule K-1 does not necessarily reflect what liquidating distributions MCMIM would have been entitled to under section 7.3 of the operating agreement. See William S. McKee et al., *Federal Taxation of Partnerships and Partners*, para. 6.04, at 6-26 to 6-28 (4th ed. 2007).
>
> Second, since dissolution or liquidation did not occur in 2009, any capital account balances as of the end of 2009 do not reflect any adjustments that would be required

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On the basis of these financial projections Companies concluded that it could not fully repay its senior debt and project debt under the terms of their respective loan documents. And after reviewing Companies' cashflow forecasts, Companies determined that Holdings would not recover the full amount of its preferred equity interest upon liquidation and MCMIM would not receive anything with respect to its interest. Holdings' preferred equity interest and accrued cumulative preferred return would have exceeded $111 million by the end of the winddown period in 2014. Toward the end of 2009 Ceci Doty—a senior vice president of Companies responsible for the finance group—informed Companies' executive committee and managing board of its inability to satisfy its debt obligations.

Companies' continued attempts to secure additional funding during 2009 failed. One potential investor insisted that any of its investments occur outside of Companies. To address this concern, in April 2009 the McMillin family formed a new entity—the Corky McMillin Real Estate Group (MREG).

Ultimately, by the end of 2009 Companies' owners decided to wind down the entity. On the basis of its December 2009 cashflow forecast Companies believed it could complete construction of, market, and sell all of its assets in an orderly manner by the end of 2014. Companies' owners believed that an orderly liquidation over five years would be more beneficial to its lenders than a complete selloff of its assets over a shorter timeframe. Companies' owners believed widespread knowledge of this decision would damage morale for existing employees working on building out existing projects and prejudice Companies and the project entities in future debt negotiations with lenders, so it was not memorialized.

On its 2009 audited consolidated statements of operations, Companies reported a net loss of $39,316,000 for the 2009 tax year. It reported assets of $331,461,000, liabilities of $268,650,000, and members' equity of $62,811,000 as of December 31, 2009. It reported operating revenue of $254,848,000 for 2009, down from approximately $824 million in 2005 before the financial crisis. And according to Companies' 2010 audited consolidated statements of operations, Companies' operating revenue in 2010 was $162,305,000, approximately 35% lower than in 2009.

> under section 704(b) had such a dissolution or liquidation occurred in 2009. Before Companies could make liquidating distributions (if any), it would be required to take into account all section 704(b) capital account adjustments for the tax year during which dissolution occurred. Petitioner argues that a dissolution and liquidation in 2009 would have required Companies to dispose of all of its assets and immediately recognize substantial losses, which would have been allocated to MCMIM, reducing its section 704(b) capital account to zero before any liquidating distributions could be made. We find this argument persuasive, particularly in the light of the poor business conditions discussed above and the allocation provisions in the operating agreement. Thus, the GAAP capital account balance on MCMIM's 2009 Schedule K-1 is not an indication that MCMIM would have been entitled to anything had it forced Companies to liquidate in 2009.

MCM Investment Management, LLC also looked at the partnership interest's "lack of potential future value," based on the following test:

> Having determined that MCMIM's partnership interest in Companies had no liquidating value by the end of 2009, we must consider whether it also lacked potential future value then. See *Morton v. Commissioner*, 38 B.T.A. at 1278 (holding that the worthlessness of an equity interest depends "not only on its current liquidating value, but also on what value it may acquire in the future through the foreseeable operations of the … [company]"). An equity interest has potential future value when, despite the lack of liquidating value, there is still a "reasonable hope and expectation that … [the interest] will become valuable at some future time". *Id*.
>
> The hope and expectation that an equity interest may become valuable in the future can be foreclosed when certain "identifiable events" occur in the company's life that effectively destroy the potential value. *Steadman v. Commissioner*, 50 T.C. at 376-377; *Morton v. Commissioner*, 38 B.T.A. at 1278. An "identifiable event" is "an incident or occurrence that points to or indicates a loss—an evidence of a loss." *Indus. Rayon Corp. v. Commissioner*, 94 F.2d 383, 383-384 (6th Cir. 1938); see *Webster v. Commissioner*, 6 T.C. 1183, 1187 (1946). Identifiable events include, *e.g.*, bankruptcy, the cessation of business, liquidation, or the appointment of a receiver. *Steadman v. Commissioner*, 50 T.C. at 376-377; *Morton v. Commissioner*, 38 B.T.A. at 1278. The evidence "may vary according to circumstances and conditions." *Indus. Rayon Corp. v. Commissioner*, 94 F.2d at 384. In some instances a taxpayer can demonstrate that its equity interest does not have potential future value, even in the absence of an identifiable event, if the company becomes hopelessly insolvent. *Steadman v. Commissioner*, 50 T.C. at 377; *Morton v. Commissioner*, 38 B.T.A. at 1279; *Flint Indus., Inc. v. Commissioner*, 2001 WL 1195725, at *19; *Tejon Ranch Co. v. Commissioner*, T.C. Memo. 1985-207, 49 T.C.M. (CCH) 1357, 1362 (holding that a partnership's hopeless insolvency justified a deduction for a worthless partnership investment under section 165).

The court accepted some of the "identifiable events" the taxpayer suggested then rejected the IRS' attempted rebuttal:

> Respondent argues that Companies' continued operations during 2009 and the winddown period indicate that MCMIM's partnership interest must have had some potential future value. We disagree. The continued operation of a company beyond the year of claimed worthlessness does not itself prove future value in its equity interests.

See *Steadman v. Commissioner*, 50 T.C. at 378; *Rand v. Commissioner*, 40 B.T.A. 233, 240 (1939), *aff'd*, 116 F.2d 929 (8th Cir. 1941); *Frazier v. Commissioner*, T.C. Memo. 1975-220, 34 T.C.M. (CCH) 951, 966 (1975). And taxpayers have shown that their interest in a partnership is worthless in a year where the partnership did not cease its operations. See *Echols I*, 935 F.2d 703; *Tejon Ranch Co. v. Commissioner*, 49 T.C.M. (CCH) at 1362. In *Frazier v. Commissioner*, 34 T.C.M. (CCH) at 962-963, we observed that in cases involving continued operation of a company beyond the year of claimed worthlessness,

> [o]ur examination centers around whether the activities pursued during and after … [the year of claimed worthlessness] were in the nature of an attempt to salvage something for creditors, … or whether such activities were so related to a continuation of general operations that they manifest reasonable expectations of future value in the … [equity]….

After discussing various cases cited in the opinion above, the court concluded:

> In sum, *Nelson* and *Tejon Ranch Co.* illustrate the fact-intensive nature of fixing the year of an equityholder's worthlessness loss when a company declines over several years. On the record before us, respondent could only criticize each identifiable event in isolation, arguing that each alone might not be sufficient; he could not and did not direct us to affirmative evidence showing how MCMIM's partnership interest in Companies continued to have potential future value. We find that the identifiable events together confirm that the likelihood of potential future value was minimal.

The court rejected the IRS' purported foreclosure requirement:

> Respondent asserts that MCMIM's partnership interest had potential future value until foreclosure occurred with respect to each real property interest encumbered by a recourse mortgage held by Companies' project entities, citing *Tucker v. Commissioner*, T.C. Memo. 2015-185. There, we held that real property held by a taxpayer's S corporation did not become worthless before a foreclosure sale occurred because the real property was encumbered by recourse debt….
>
> *Tucker* does not preclude a finding of worthlessness in this case. In *Tucker*, the Court considered the worthlessness of the underlying real property, not the taxpayer's equity interest in Paragon, the entity that held the real property. At issue here, by contrast, is the worthlessness of the partnership interest itself, not any particular asset the partnership held. See *Echols I*, 935 F.2d at 707 ("Emphasizing again that the asset being tested for worthlessness is not the Land but the Taxpayers' 75% interest in the Partnership which owned the Land, we must determine subjectively just when it was that the Taxpayers deemed their Partnership interest worthless, then determine objectively whether that interest was valueless at such time.").
>
> A taxpayer asserting that its equity interest in a company is worthless need not prove that every asset that the company holds is worthless. *Steadman v. Commissioner*, 50 T.C. at 378 (holding that corporate stock was worthless even though the corporation held valuable assets because the taxpayer proved that corporate stock had no liquidating or potential future value); *Tejon Ranch Co. v. Commissioner*, 49 T.C.M. (CCH) at 1362 (holding that a partnership interest became worthless when the partnership became insolvent beyond hope of rehabilitation). Therefore, a taxpayer

> holding a worthless partnership interest need not delay deducting a loss under section 165(a) merely because the partnership owns real estate interests encumbered by recourse debt.

While acknowledging that expert testimony can be helpful and sometimes important, the court rejected the IRS' argument that expert testimony was required:

> Respondent did not cite any authority holding that expert valuation is required to prove worthlessness under section 165…. To the contrary we have said that "the taxpayer need not be forced to hire valuation experts where, as here, his own testimony is credible and founded upon reasonable factual premises." *Holmes v. Commissioner*, 57 T.C. 430, 439 (1971). And even if there had been expert testimony in this case, the cases respondent cites make plain that we are "not bound by the formulas or opinions proffered by expert witnesses" and we "may reach a determination of value based upon … [our] own analysis of all the evidence in the record." *Thompson v. Commissioner*, 499 F.3d at 133 (quoting *Silverman v. Commissioner*, 538 F.2d at 933). As we have explained above, we determined that MCMIM's interest in Companies had no liquidating value or potential future value on the basis of our own analysis of all the evidence in the record.

The court rejected the IRS' argument that the loss was not bona fide. The family had formed another entity, "Holdings," to acquire subordinate debt from Companies' lenders that were threatening to call the debt. When Companies got into even more financial difficulty, the subordinate debt that Holdings had acquired was converted into senior equity. The IRS complained that these intra-family transactions – intended to keep the family business going - somehow tainted MCMIM's investment in Companies in a way that would prevent a loss deduction:

> Respondent also argues that MCMIM's loss was not bona fide within the meaning of the regulations. Citing *Scully v. United States*, 840 F.2d 478, 485 (7th Cir. 1988) (quoting 7 Jacob Mertens, *Law of Federal Taxation*, sec. 28.26 (1980)), for the general proposition that a taxpayer may not "transfer assets from one pocket to another and take a loss thereby where he remains at the conclusion of the transfer the real owner of the property", respondent argues that MCMIM should not be able to claim a loss deduction because the McMillin children remained beneficial owners of Companies both before and after MCMIM's partnership interest became worthless and therefore they "experienced no loss at all." Respondent also broadly urges us to scrutinize the transactions and dealings of the McMillin entities closely because they involve related parties.
>
> Respondent failed to demonstrate that the transactions between the McMillan entities should not be respected for tax purposes.[1560]

[1560] [I moved the analysis into this footnote.] See *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-584 (1978) ("[W]here … there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties."); see also *Casebeer v. Commissioner*, 909 F.2d 1360, 1363 (9th Cir. 1990) (applying a two-part test that considers whether the taxpayer subjectively had a nontax business purpose and whether the transaction

> First, respondent objects that Companies did not itself acquire the subordinate debt at a discount. But that was beyond its control because the senior lender would not permit it. Instead the McMillin children formed Holdings to invest new capital in Companies by acquiring the subordinate debt from an unrelated lender. Moreover, Companies and its owners wanted an affiliate to purchase the debt because it ensured that a third-party owner of the debt—such as a distressed debt purchaser—would not push Companies into bankruptcy. Holdings later converted the subordinated debt to equity for a legitimate business reason: to revive Companies' balance sheet by reversing its negative net worth, thus enabling Companies to satisfy its minimum net-worth covenant and put it in a better position in restructuring negotiations with the senior lender. The debt-to-equity conversion had economic substance for the parties: Companies shed significant debt and the risk profile of Holdings' investment fundamentally changed when it traded various creditor's rights and priorities for higher upside.
>
> Second, respondent argues that MCMIM and Holdings were two pockets of the same pair of pants. We reject that analogy. The McMillin entities were separate legal entities. Respondent has not challenged their separate existence; indeed, he emphasized in his brief that "[w]hether the McMillin family entities are recognized as separate entities is not an issue in this case." The ownership of these entities was not identical because Vonnie's trust owned an interest in MCMIM but chose not to invest in M3 and Holdings.
>
> Respondent also failed to identify any actual "transfer" from MCMIM to Holdings, unlike *Scully*, where a set of family trusts sold some real estate at a loss to another set of family trusts that had the same beneficiaries. *Scully*, 840 F.2d at 486 ("[T]he purpose of the sale was to keep all the real estate in the family and to permit the trustees to operate the land in both sets of trusts as a single, integrated economic entity."). Among the transactions involving Holdings, the only "transfer" was Companies' contribution of approximately $3.9 million—which possibly, but not necessarily, came from MCMIM's capital contributions—towards the acquisition of the subordinate debt. Companies received a membership interest in M3 (which owned Holdings) in exchange, so Companies not only received value but also shared in the upside of the discounted purchase of the debt. That is, Companies invested $3.9 million for the possibility of receiving upwards of $15 million (possibly more if Companies were able to recover from the damaged state it was in at the end of 2008). Respondent asks us to engage in a hypothetical and assume away the reality that faced Companies here. And respondent identified no tax considerations that would swamp the economic reality here. The record amply illustrates that nontax considerations drove the decision to restructure the debt. And if the debt instead were held by an unrelated third party in 2009 or during the winddown period, there would be no dispute that MCMIM's interest was under water.

MCM Investment Management, LLC teaches us that a court will respect a family's attempts to keep its operating business going, including heroic efforts to prevent foreclosure by lenders, until the case becomes hopeless and any new investments are required to be held in a separate

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objectively had economic substance (citing *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 1549 (9th Cir. 1987), *aff'g* T.C. Memo. 1986-23)), *aff'g* in part, *rev'g* in part *Larsen v. Commissioner*, 89 T.C. 1229 (1987), and *aff'g Casebeer v. Commissioner*, T.C. Memo. 1987-628, *Moore v. Commissioner*, T.C. Memo. 1987-627, and *Strum v. Commissioner*, T.C. Memo. 1987-625.

structure.[1561] For when intra-family loans are legitimate, see part III.B.1.a.i.(a) Loans Must be Bona Fide.[1562]

The IRS views abandonment for purposes of claiming an ordinary loss as requiring "(1) an intention to abandon the asset, and (2) an affirmative act of abandonment."[1563] If a partnership interest subject to liabilities is abandoned, the partnership interest is treated as having being sold for the liabilities rather than abandoned.[1564]

Swartz v. U.S., 128 A.F.T.R.2d 2021-5251 (E.D. NY 2021):

> This case arises from a failed investment in the film industry. Plaintiff Jerome Swartz, a retired engineer and wealthy investor, invested a total of $4.5 million in two LLCs that financed films.[1] He claims that his investment proved worthless and that he abandoned his interests in the LLCs. Swartz sought to carry back these losses and thereby claim a refund on his previously-filed tax returns. The IRS denied the deduction, and plaintiff filed suit seeking a refund. The United States moves for summary judgment.
>
> [1] Plaintiff Starnette Watkins was added as a necessary party because she and Swartz were married and filed taxes jointly during the 2008 tax year. See Order dated July 11,

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[1561] See fn 1559, describing the decision to wind down and the formation of a new entity, MREG.

[1562] For a case holding that certain defects in documentation were not fatal because the parties' conduct showed the loans were legitimate, see *Dynamo Holdings Ltd. Partnership v. Commissioner*, T.C. Memo. 2018-61, described in the text accompanying fn 6220-6236 in part III.B.1.a.i.(a).

[1563] CCA 200637032, citing:

> A.*J. Industries, Inc. v. United States*, 503 F.2d 660, 670 (9th Cir. 1974); Rev. Rul. 93-80; Rev. Rul. 2004-58, 2004-1 C.B. 1043. *See also Echols v. Commissioner*, 935 F.2d 703, 706-08 (5th Cir. 1991) (finding both an intent to abandon and an affirmative act of abandonment when taxpayers called a partnership meeting at which they tendered their partnership interest to another partner, or anyone else, "gratis," and announced that they would contribute no further funds to the partnership), *reh'g denied*, 950 F.2d 209 (5th Cir. 1991).

Rev. Rul. 2004-58 explains what the IRS views as insufficient affirmative acts to constitute abandonment.

[1564] Rev. Rul. 93-80, Situation 1. *Watts v. Commissioner*, T.C. Memo. 2017-114, held:

> Subject to the prohibition on sales or exchanges giving rise to ordinary abandonment losses, partnership interests may be abandoned. *Echols v. Commissioner*, 935 F.2d 703 (5th Cir. 1991), *rev'g and remanding* 93 T.C. 553 (1989); *Citron v. Commissioner*, 97 T.C. at 213.
>
> When a partner is relieved of his or her share of partnership liabilities, the partner is deemed to receive a distribution of cash. Sec. 752(b). Section 731(a) requires distributions to partners to be treated as payments arising from the sale or exchange of a partnership interest. Secs. 752(b), 731(a); *Citron v. Commissioner*, 97 T.C. at 214-215 n.11. Thus, ordinary abandonment losses may arise only in a narrow circumstance where the partner: (1) was not personally liable for the partnership's recourse debts or (2) was limited in liability and otherwise not exposed to any economic risk of loss for the partnership's nonrecourse liabilities. See sec. 752(b), (d); sec. 1.752-3, Income Tax Regs.; see also *Commissioner v. Tufts*, 461 U.S. 300 (1983).
>
> Respondent determined petitioners' disposal of their Partnership interests did not fall within these narrow exceptions. Accordingly, respondent recharacterized petitioners' losses from ordinary abandonment losses to capital losses on the sale or exchange of the interests.
>
> In contesting this determination, petitioners were tasked with the burden of proving respondent's determination incorrect. Petitioners have not met this burden. Petitioners presented no documentary or testimonial evidence to establish their eligibility for an abandonment loss deduction. Petitioners failed to prove their individual shares of any Partnership liabilities, capital restoration obligations, or lack thereof, in the light of documentary evidence suggesting otherwise. Additionally, petitioners did not offer any evidence or analysis as to how their actions constituted an intentional and overt manifestation of abandoning their Partnership interests.

> 2019. Because Swartz performed all the actions relevant to this case, for simplicity's sake I refer only to him.

The court rejected Swartz's abandonment argument:

> Swartz claims that he abandoned his interests in both CT1 and Alliance Film through a call that King made to Bergstein in December 2010. ECF No. 54 ¶¶ 38-39. Swartz and King never conveyed that intent to abandon the investments to anyone else. *Id*. ¶ 39. Nor did they send written notice, even though the LLC agreements required that all communications be made in writing. *Id*. ¶¶ 9, 47. Swartz never personally communicated his intent to abandon the investments, but says that he stopped communicating with Bergstein around 2012 or 2013. ECF No. 51-6 at 3–4, 7, 11.
>
> Despite Swartz's claim that he abandoned his interests in the LLCs, he testified in 2013 that he did not file a claim in the bankruptcy proceeding because he remained "faithful to the relationship" with Bergstein and continued to believe "that [Bergstein] would work his way out of these things, and come through and take care of me, since it was a close, personal relationship." ECF No. 51-8 at 2. Swartz testified that he believed Bergstein would take care of him "even up to relatively recently, like a year or two ago" - *i.e.*, until 2011 or 2012. *Id.* That hope proved futile, and Swartz never recovered "a penny" of his $4.5 million investment. ECF No. 54 ¶ 6.

Swartz v. U.S., 128 A.F.T.R.2d 2021-5251 (E.D. NY 2021), held:

> I reject Swartz's argument that he should be considered a member of a partnership, which would in some circumstances allow him to treat his investment as a non-capital asset. See *Pilgrim's Pride Corp. v. Comm'r*, 779 F.3d 311, 314 (5th Cir. 2015); see also Rev. Rul. 93-80, 1993-2 C.B. 239. A court examining whether an entity is entitled to partnership tax status must examine "all the facts," including the entity's governing documents and the parties' conduct, statements, and relationships, as well as their "respective abilities and capital contributions," their "actual control of income and the purposes for which it is used," along with "any other facts throwing light on their true intent." *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 231-32 (2d Cir. 2006). "This test turns on the fair, objective characterization of the interest in question upon consideration of all the circumstances." *Id*. at 232.
>
> The practicalities of Swartz's relationship with the LLCs belie his assertion that he was a member of a partnership. The Second Circuit has held that a passive investor with no meaningful control over the enterprise is not entitled to partnership tax status. *Estate of Kahn v. Comm'r*, 499 F.2d 1186, 1189–90 (2d Cir. 1974). In Kahn, the Court of Appeals explained that partnership status does not flow simply from the fact that the entity's documents describe it as a partnership or that the alleged partner was entitled to a share of the profits. *Id*. at 1189. Rather, it rejected the taxpayer's theory that the entity was a partnership, because one of the "partners" in that case had the sole discretion to control and dispose of the entity's assets. Id. In light of the taxpayer's "dominant position" in the company, along with the undisputed fact that he had "sufficient legal and practical control to misappropriate" some of the company's assets, the Court of Appeals held that the company was not a bona fide partnership even though the company's owners had a profit-sharing agreement. *Id*. at 1189–90.

> Similarly here, the undisputed evidence demonstrates that Swartz was a passive investor who lacked any control over the LLCs' assets or business. Swartz admitted in the purchase agreements that he was acquiring the membership interests for "speculative" "investment purposes," and did not indicate that he was joining a partnership. ECF No. 54 ¶¶ 11, 14; see ECF Nos. 51-2, 51-3, 51-5. He "was not the manager of either entity" and lacked "any control over how" CT1 or Alliance Film "spent the money that he had invested." ECF No. 54 ¶¶ 19, 23, 26; see also ECF No. 51-6 at 15. Indeed, Swartz testified that he never received any financial reports from the LLCs and was ignorant of their financial problems until a bankruptcy petition was filed against CT1 in March 2010. ECF No. 54 ¶¶ 29–30, 36; see also ECF No. 57 ¶ 11. Nor is there any evidence that the LLCs filed tax returns as partnerships or represented themselves as partnerships to anyone else. See *TIFD III-E, Inc.*, 459 F.3d at 232 (citing *Luna v. Comm'r*, 42 T.C. 1067, 1077–78 (1964) (explaining that one factor courts may consider is "whether the parties filed Federal partnership returns or otherwise represented" that they were partnerships)). In sum, the evidence amply demonstrates that Swartz played no role in managing the LLCs and had no control over their assets. He was instead a passive investor who relied on others to pursue profit but was not a partner of the LLCs. See *Kahn*, 499 F.2d at 1189.

For *Luna* and related cases, see part II.C.10 Whether Tenancy-in-Common or other Arrangement Constitutes a Partnership.

Swartz v. U.S., 128 A.F.T.R.2d 2021-5251 (E.D. NY 2021), rejected the argument that Swartz did not invest in a business:

> Even if Swartz were permitted to treat his failed investments as ordinary losses, they were not in his trade or business. "The distinction is important because in calculating a net operating loss to be carried back to previous years, a taxpayer may take in full all of the deduction attributable to trade or business loss, whereas deductions not attributable to trade or business losses are only allowable to the extent the gross income is not derived from a trade or business. See 26 U.S.C. and § 172(c) and (d)(4)." *Chernin v. United States*, 149 F.3d 805, 811 (8th Cir. 1998); see also *Lender Mgmt., LLC v. Comm'r*, 114 T.C.M. (CCH) 638, 2017 WL 6403890, at *8 (Dec. 13, 2017) ("net operating losses may carry over under section 172 from the year in which they were incurred to another year only if the losses were the result of operating a trade or business").
>
> An individual is engaged in a trade or business only if he is "involved in the activity with continuity and regularity." *Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987). The record is clear that Swartz was not in the trade or business of making or producing films. He spent his career as an engineer with a focus on designing aircraft and computer software. ECF No. 51-7. Nevertheless, Swartz claims that, after he retired, he entered into "the business of investing in entertainment properties." ECF No. 53 at 19. The Supreme Court has held, however, that being an investor to pursue personal profit is not a trade or business for tax purposes. *Whipple v. Comm'r*, 373 U.S. 193, 202 (1963); see also *Chamberlin v. Comm'r*, 14 F. App'x 69, 71-72 (2d Cir. 2001); *Burnet v. Clark*, 287 U.S. 410, 413-15 (1932).
>
> [my comment: see part II.G.4.l.i Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit, especially subparts II.G.4.l.i.(a) "Trade

or Business" Under Code § 162, II.G.4.l.i.(d) Whether Managing Investments Constitutes a Trade or Business, and II.G.4.l.i.(e) Family Office as a Trade or Business]

Swartz nonetheless claims that his consulting agreement with CT1, along with his agreement to serve as chair of its Board of Advisers, demonstrates that he was in the trade or business of producing films, particularly given the $60,000 salary he was to be paid for the approximately three to five hours per week that he worked. ECF No. 53 at 19-20. And yet the record reflects that Swartz's role as chairman was, as he testified, "nonmeaningful" and involved no work, and that he spent little time doing any work as a consultant. ECF No. 54 ¶ 21. Indeed, Swartz admits that on his tax returns he characterized a different loan he made to CT1 as "nonbusiness" debt, which is the antithesis of an investment made in a taxpayer's trade or business. ECF No. 54 ¶ 57; see *Generes*, 405 U.S. at 95–96 (contrasting nonbusiness debt with debt incurred in a trade or business).

In any event, Swartz's losses were not "the result of operating a trade or business" with CT1 or Alliance Film. *Lender Mgmt., LL*C, 2017 WL 6403890, at *8 (emphasis added). He made his initial $1.5 million investment in CT1 seven months before he had any consulting relationship with the company, and invested the additional $2 million in CT1 on the same day he entered into the consulting agreement and became the chair of the Board of Advisers (which apparently had no other members and held no meetings). See *Garner v. Comm'r*, 987 F.2d 267, 272-73 (5th Cir. 1993) (explaining that the taxpayer's motive must be assessed at the time of his investment). Even with respect to his consulting role, the Supreme Court has explained that "furnishing management and other services to corporations for a reward not different from that flowing to an investor in those corporations is not a trade or business." *Whipple*, 373 U.S. at 202. As the United States observes, there is no evidence that Swartz was ever actually paid (or sought to collect) the $60,000 he was owed under the consulting contract, and thus any returns that he hoped to receive from CT1 were no different "from that flowing to an investor[.]" *Id*.; see ECF No. 56 at 16-17. And Swartz never had any business or consulting relationship with Alliance Film other than his investment. The undisputed facts therefore make plain that Swartz was a mere investor for personal profit and was not investing pursuant to his trade or business.

The Supreme Court has explained, in a related context, why Swartz's claim fails. In *Generes* , the Court set forth the test for how to characterize a taxpayer's losses when he was both an employee and shareholder of the company to which he made loans. The key issue in that context was whether he made the loan to protect his ability to earn an income as an employee (in which case his loss would be an ordinary loss incurred in his trade or business) or if instead the loan was intended to support his equity interest (and thus should be treated as a capital loss). 405 U.S. at 95-96, 104. The Supreme Court observed that whether the debt was incurred for business or nonbusiness reasons was directly relevant to whether the loss could be carried back as a net operating loss under § 172. *Id*. at 96.

The Generes court held that, in order to claim that the loss was made in his trade or business, the taxpayer must show that his "dominant" motive for making the loan was to protect his salary rather than to protect his equity investment in the company. 405 U.S. at 103. The Court explained that the "dominant-motivation test strengthens and is consistent with" the tax code's distinction between personal and business losses. Id. at 104-05. It held that, when determining the taxpayer's motive, courts should compare the size of the taxpayer's salary with his equity investment and access to other funds. *Id*. at 106-07. The Supreme Court concluded that the taxpayer's investment in his own company was a nonbusiness loss because his after-tax annual salary was less than 20% of his total investment. *Id*. at 106-07. There was therefore no reason to believe his "self-serving" statement that his primary motive for making the investment was to "protect [his] job" rather than earn a profit. *Id*. at 106. Indeed, the Supreme Court granted judgment to the United States notwithstanding the jury's verdict for the taxpayer. *Id*. at 106-07.

Swartz's pre-tax consulting salary was less than 2% of his total $3.5 million investment in CT1, far below the 20% of post-tax salary that the Supreme Court found to be too low in *Generes*. 405 U.S. at 106. He also had, by his estimate, a net worth in excess of $70 million and an annual income of several million dollars. As in *Generes*, it would defy belief to conclude that Swartz invested any of this money to protect his $60,000 salary rather than to engage in speculative investing.

In sum, Swartz is not entitled to carry back his losses because his investments were capital assets. Even if the investments were non-capital assets, they were not incurred in his trade or business. Thus, even if Swartz suffered the $4.5 million loss in 2010, he is unable to carry back that loss and claim refunds for 2008 and 2009.

CCA 202302011 "responds to your request for non-taxpayer specific advice regarding the applicability of section 165 of the Internal Revenue Code ("Code") to cryptocurrency that has substantially declined in value" and includes the following:

Facts

Taxpayer A is an individual who purchased units of Cryptocurrency B in 2022 at $1.00 per unit for personal investment purposes on a cryptocurrency exchange. After Taxpayer A acquired Cryptocurrency B, the per unit value of Cryptocurrency B decreased significantly, such that each unit of Cryptocurrency B was valued at less than one cent at the end of 2022. On December 31, 2022, Cryptocurrency B continued to be traded on at least one cryptocurrency exchange, and Taxpayer A maintained dominion and control over the units of Cryptocurrency B as evidenced by Taxpayer A's ability to sell, exchange, or transfer the units. Taxpayer A claimed a deduction on Taxpayer A's 2022 tax return under section 165 and took the position that the units of Cryptocurrency B were either worthless or abandoned.

Discussion

Digital assets are defined under section 6045(g)(3)(D) as digital representations of value that are recorded on a cryptographically secured distributed ledger.[1] Digital assets do not exist in physical form and include, but are not limited to, property the Service has previously referred to as convertible virtual currency and cryptocurrency. See Notice 2014-21, 2014-16 I.R.B. 938; Rev. Rul. 2019-24, 2019-44 I.R.B. 1004. Notice 2014-21 provides that convertible virtual currency is treated as property and that general tax principles applicable to property transactions apply to convertible virtual currency.

[1] The Infrastructure Investment and Jobs Act ("the Act"), Pub. L. 117-58 , div. H, title VI, section 80603(b)(1)(B), added new section 6045(g)(3)(D), which uses this

definition of a digital asset for purposes of information reporting by brokers effective January 1, 2023. The Act provides the Secretary with the authority to further define the term “digital asset.”

Cryptocurrency is a type of virtual currency that utilizes cryptography to secure transactions that are digitally recorded on a distributed ledger, such as a blockchain. Units of cryptocurrency are generally referred to as coins or tokens. Distributed ledger technology uses independent digital systems to record, share, and synchronize transactions, the details of which are recorded in multiple places at the same time with no central data store or administration functionality. See Rev. Rul. 2019-24.

Sales, exchanges, and other dispositions of digital assets may result in recognition of gain or loss. The character of a gain or loss resulting from a disposition of a cryptocurrency generally depends on whether the property is a capital asset in the hands of the taxpayer. A taxpayer not in the trade or business of dealing in cryptocurrency will generally realize capital gain or loss on the sale or exchange of a cryptocurrency. A taxpayer realizes ordinary gain or loss on the sale or exchange of property that is not held as a capital asset.

Section 165(a) of the Code provides a deduction for losses sustained during the taxable year and not compensated for by insurance or otherwise. A loss is allowed as a deduction under section 165(a) only for the taxable year in which the loss is sustained. For this purpose, a loss is treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. Treas. Reg. section 1.165-1(d)(1).

Section 165(g) provides that if any security which is a capital asset becomes worthless during the taxable year, the loss shall be treated as a loss from the sale or exchange of a capital asset. Section 165(g)(2) defines a security as a share of stock in a corporation; a right to subscribe for, or to receive, a share of stock in a corporation; or a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or a government or political subdivision thereof, with interest coupons or in registered form. Cryptocurrency B is none of the items listed in section 165(g)(2), and therefore section 165(g) does not apply.

For individual taxpayers, section 67(b)(3) characterizes section 165(a) losses, other than those from casualty, theft, and wagering, as miscellaneous itemized deductions.[2] Under current law, section 67(g) disallows all miscellaneous itemized deductions for tax years beginning after December 31, 2017, and before January 1, 2026.

[2] Special rules apply to casualty, theft, and wagering losses. See sections 67(b)(3), 165(d) and (h), 1231, and Rev. Rul. 2009-9.

Worthless Cryptocurrency

Cryptocurrency B has substantially decreased in value; however, its value was greater than zero, it continued to be traded on at least one cryptocurrency exchange, and A did not sell, exchange, or otherwise dispose of the units of Cryptocurrency B. “The mere diminution in value of property does not create a deductible loss. An economic loss in value of property must be determined by the permanent closing of a transaction with respect to the property. A decrease in value must be accompanied by some affirmative step that fixes the amount of the loss, such as abandonment, sale, or exchange." *Lakewood Assocs. v. Commissioner*, 109 T.C. 450, 459 (1997); Treas. Reg. section 1.165-1; see also *Higgins v. Smith*, 308 U.S. 473, 475 (1940) ("[D]eductions are permitted for losses 'sustained during the taxable year.' The loss is sustained when realized by a completed transaction determining its amount."); *United States v. White Dental Mfg. Co.*, 274 U.S. 398, 401 (1927) ("The statute obviously does not contemplate and the regulations forbid the deduction of losses resulting from the mere fluctuation in value of property owned by the taxpayer.") (internal citation omitted).

A loss may be sustained, however, if a cryptocurrency becomes worthless, resulting in an identifiable event that occurs during the tax year for purposes of section 165(a). Whether an asset has become worthless is a question of fact. *Boehm v. Commissioner*, 326 U.S. 287, 293 (1945). In the case of a worthless asset, it is not necessary to relinquish title where there is a "subjective determination of worthlessness in a given year, coupled with a showing that in such year the asset in question is in fact essentially valueless." *Echols v. Commissioner*, 935 F.2d 703, 708 (5th Cir. 1991). In *Morton v. Commissioner*, the Board of Tax Appeals explained that "[t]he ultimate value of stock, and conversely its worthlessness, will depend not only on its current liquidating value, but also on what value it may acquire in the future through the foreseeable operations of the corporation. Both factors of value must be wiped out before we can definitively fix the loss." 38 B.T.A. 1270, 1278 (1945).

In *MCM Investment Management, LLC v. Commissioner*, the Tax Court applied the tests articulated in Echols and Morton to determine whether a partnership interest was worthless and allowed a claimed loss deduction under section 165. T.C. Memo. 2019-158 at *26-31, *62 (citing *Echols*, 935 F.2d at 708; *Morton*, 38 B.T.A. at 1278). The Tax Court found that the petitioner subjectively determined that its partnership interest was worthless and, to determine whether there were also objective indicia of worthlessness, examined whether the partnership interest had liquidating value or any potential future value. *Id.* at *28-29, *31-32. Because the petitioner could recover nothing for its partnership interest upon liquidation of the partnership and because there was no potential future value due to the third-party subordinated debt agreements at issue, the Tax Court determined that the partnership interest was worthless. *Id.* at *58, *62.

In this case, each unit of Cryptocurrency B had liquidating value, though it was valued at less than one cent at the end of 2022.[3] Cryptocurrency B continued to be traded on at least one cryptocurrency exchange, allowing for the possibility that it may increase in value in the future. Accordingly, Cryptocurrency B was not wholly worthless during 2022 as a result of its decline in value, and Taxpayer A did not sustain a bona fide loss under section 165(a) in 2022 due to worthlessness.

[3] As of January 1, 2023, fifteen cryptocurrencies valued at less than one cent per unit were actively traded with market caps ranging from approximately $77 million to over $4.4 billion along with 24 - hour trading volume ranging from $833, 000 to $92 million. See www.coinmarketcap.com for cryptocurrency market values.

Abandoned Cryptocurrency

Under Treas. Reg. section 1.165-2(a), a taxpayer sustains a loss under section 165(a) for the obsolescence or loss of usefulness of nondepreciable property if: "(1) the loss is incurred in a business or a transaction entered for profit; (2) the loss arises from the sudden termination of usefulness in the business or transaction; and (3) the property is permanently discarded from use, or the transaction is discontinued." Franklin v. Commissioner, T.C. Memo. 2020-127 at *18 (citing Treas. Reg. section 1.165-2(a)).

Taxpayer A did not take any action to abandon and permanently discard Taxpayer A's units of Cryptocurrency B during 2022. Abandonment is proven through an evaluation of the surrounding facts and circumstances, which must show: (1) an intention to abandon the property, coupled with (2) an affirmative act of abandonment. See *Massey-Ferguson, Inc. v. Commissioner*, 59 T.C. 220, 225 (1972) (citing *Boston Elevated Railway Co. v. Commissioner*, 16 T.C. 1084, 1108 (1951), *aff'd*, 196 F.2d 923 (1st Cir. 1952)). "The mere intention alone to abandon is not, nor is non-use alone, sufficient to accomplish abandonment." *Beus v. Commissioner*, 261 F.2d 176, 180 (9th Cir. 1958), *aff'g* 28 T.C. 1133 (1957). Some express manifestation of abandonment is required when the asset is an intangible property interest. *Citron v. Commissioner*, 97 T.C. 200, 209-10, 213 (1991) (finding that taxpayer abandoned a partnership interest when the limited partners voted to dissolve the partnership, directed that a final partnership return be filed, and treated partnership property as no longer belonging to the limited partners).

In this case, Taxpayer A maintained ownership of Cryptocurrency B through the end of 2022, even though the value of each unit of the cryptocurrency as of the end of the year was less than one cent. Taxpayer A retained the ability to sell, exchange, or otherwise dispose of Cryptocurrency B during 2022. Furthermore, Taxpayer A continued to exert dominion and control over Cryptocurrency B and, regardless of intent, did not take any affirmative steps to abandon the property during 2022. Therefore, Taxpayer A did not sustain a loss pursuant to section 165(a) in 2022 due to abandonment.[4]

[4] Because Taxpayer A did not take any action to abandon and permanently discard Cryptocurrency B, we need not discuss other requirements for a section 165 loss deduction, including the first two prongs set forth in Treas. Reg. section 1.165-2(a).

Zimmernan, "Chief Counsel Advice Creates Confusion over Ordinary Loss Deduction," *Journal of Taxation* (8/2023), criticizes that CCA in light of Code § 1234A (discussed below), Rev. Rul. 2004-58, Notice 2014-21, and Form 4797 instructions.

Code § 1234A was enacted to reduce opportunities to use abandonment to deduct what otherwise would have been a capital loss (although not necessarily in the example above),[1565]

[1565] The Senate Finance Committee Report on P.L. 97-34 (ERTA 1981) explained:

Treatment of Gain or Loss From Certain Terminations

Present Law.—The definition of capital gains and losses in section 1222 requires that there be a "sale or exchange" of a capital asset. Court decisions have interpreted this requirement to mean that when a disposition is not a sale or exchange of a capital asset, for example, a lapse, cancellation, or abandonment, the disposition produces ordinary income or loss.[1] This interpretation has been applied even to dispositions which are economically equivalent to a sale or exchange of a capital asset. If a taxpayer can choose the manner of disposing of a capital asset, he may sell or exchange it, if it has appreciated in value, to realize capital gains. However, a transaction in which a taxpayer has suffered an economic loss may be terminated in a manner which produces a fully deductible ordinary loss, even though the loss in substance is the equivalent of a loss from the disposition of a capital asset.

[1] See *Leh v. Comm'r*, 260 F2d 489 (9th Cir., 1952) and *Comm'r v. Pittston Co.*, 252 F2d 344 (2d Cir., 1958), *cert. denied*, 357 U.S. 919 (1958).

but the relevant committee report focused on futures contracts.[1566] Code § 1234A taxes as a capital gain or loss the "cancellation, lapse, expiration, or other termination" of (1) certain rights or obligations[1567] "with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer," or a qualified straddle[1568] "which is a capital asset in the hands of the taxpayer." The right to a Code § 1231 asset[1569] does not qualify for Code § 1234A treatment,

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> *Reasons for Change*.—The committee believes that the change in the sale or exchange rule is necessary to prevent tax-avoidance transactions designed to create fully-deductible ordinary losses on certain dispositions of capital assets, which if sold at a gain, would produce capital gains. These transactions already cause significant losses to the Treasury.
>
> Some taxpayers and tax shelter promoters have attempted to exploit court decisions holding that ordinary income or loss results from certain dispositions of property whose sale or exchange would produce capital gain or loss. These decisions rely on the definition of capital gains and losses in section 1222 which requires that there be a sale or exchange of a capital asset.
>
> As a result of these interpretations, losses from the termination, cancellation, lapse, abandonment and other dispositions of property, which are not sales or exchanges of the property, are reported as fully deductible ordinary losses instead of as capital losses, whose deductibility is restricted. However, if such property increases in value, it is sold or exchanged so that capital gains, long-term when the holding period requirements are met, are reported.

[1566] The Senate Finance Committee Report on P.L. 97-34 (ERTA 1981) explained:

> Some of the more common of these tax-oriented ordinary loss and capital gain transactions involve cancellations of forward contracts for currency or securities.
>
> The committee considers this ordinary loss treatment inappropriate if the transaction, such as settlement of a contract to deliver a capital asset, is economically equivalent to a sale or exchange of the contract. For example, a taxpayer may simultaneously enter into a contract to buy German marks for future delivery and a contract to sell German marks for future delivery with very little risk. If the price of German marks thereafter declines, the taxpayer will assign his contract to sell marks to a bank or other institution for a gain equivalent to the excess of the contract price over the lower market price and cancel his obligation to buy marks by payment of an amount in settlement of his obligation to the other party to the contract. The taxpayer will treat the sale proceeds as capital gain and will treat the amount paid to terminate his obligation to buy as an ordinary loss.
>
> *Explanation of Provision*.—In order to insure that gains and losses from transactions economically equivalent to the sale or exchange of a capital asset obtain similar treatment, the bill adds a new section 1234A to the Code providing that gains or losses attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property which is, or which would be if acquired, a capital asset in the hands of the taxpayer shall be treated as gains or losses from the sale of a capital asset. Property subject to this rule is any personal property (other than stock) of a type which is actively traded (sec. 1092(d)(1)).

[1567] Other than a "securities futures contract," as defined in Code § 1234B. Code § 1234B(c) provides the following definition (brackets quoted from RIA Checkpoint) and then authorizes certain regulations:

> For purposes of this section, the term "securities futures contract" means any security future (as defined in section 3(a)(55)(A) of the Securities Exchange Act of 1934, as in effect on the date of the enactment [12/21/2000] of this section).

[1568] A "section 1256 contract," which § 1256(b) provides includes any "regulated futures contract," "foreign currency contract," "nonequity option," " dealer equity option," or "dealer securities futures contract" but under Code § 1256(b)(2) does not include:

> (A) any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract, or
>
> (B) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.

[1569] A Code § 1231 asset is not a capital asset. See part II.G.6.a Code § 1231 Property.

notwithstanding that the underlying asset's sale would have triggered long-term capital gain treatment.[1570]

When a taxpayer abandoned stock to obtain an ordinary loss rather than sell the stock for $20 million and have a capital loss, the Tax Court held that Code § 1234A applied to make the loss a capital loss,[1571] but the Fifth Circuit allowed an ordinary loss.[1572] The Tax Court's decision

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[1570] *CRI-Leslie, LLC v. Commissioner*, 147 T.C. 217 (2016), *aff'd* 882 F.3d 1026 (11th Cir. 2018).

[1571] *Pilgrim's Pride Corp. v. Commissioner*, 141 T.C. 533 (2013). The official Tax Court Summary is:

> P is the successor in interest to G. G was contractually obligated to purchase, and in 1999 did purchase, securities from S and T for $98.6 million. The securities were capital assets of G.
> In 2004 S offered to redeem the securities for $20 million. G's board of directors decided to abandon the securities for no consideration because a $98.6 million ordinary loss would produce tax savings greater than the $20 million offered by S. On June 24, 2004, G voluntarily surrendered the securities to S and T for no consideration. On its Federal income tax return for the tax year ending June 30, 2004, G reported a $98.6 million ordinary abandonment loss deduction under I.R.C. sec. 165(a) pursuant to sec 1.165-2(a), Income Tax Regs.
> An abandonment loss cannot be claimed on a sale or exchange of property. Sec. 1.165-2(b), Income Tax Regs. Pursuant to I.R.C. sec. 165(f) losses from sales or exchanges of capital assets are subject to the limitations on capital losses under I.R.C. secs. 1211 and 1212. I.R.C. sec. 1234A requires gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right with respect to property that is (or on acquisition would be) a capital asset in the hands of a taxpayer to be treated as gain or loss from the sale of a capital asset.
> *Held*: the securities are intangible property comprising rights that G had in the management, profits, and assets of S and T. Those rights were terminated when G surrendered the securities.
> *Held*, further, the $98.6 million loss on the surrender of the securities is attributable to the termination of G's rights with respect to the securities, which are capital assets, and pursuant to I.R.C. sec. 1234A the loss is treated as a loss from the sale or exchange of capital assets.
> *Held*, further, G is not entitled to an ordinary loss deduction for abandonment, because the loss is treated as a loss from the sale or exchange of capital assets pursuant to I.R.C. sec. 1234A. See sec. 1.165-2(b), Income Tax Regs.
> *Held*, further, pursuant to I.R.C. sec. 165(f), P's losses from the surrender of the securities, deemed to be a sale or exchange under I.R.C. sec. 1234A, are subject to the limitations on capital losses under I.R.C. secs. 1211 and 1212.

[1572] *Pilgrim's Pride Corp. v. Commissioner*, 779 F.3d 311 (5th Cir. 2015). The court held that Code § 1234A(1) did not apply:

> The primary question in this case is whether § 1234A(1) applies to a taxpayer's abandonment of a capital asset. The answer is no. By its plain terms, § 1234A(1) applies to the termination of rights or obligations with respect to capital assets (*e.g.* derivative or contractual rights to buy or sell capital assets). It does not apply to the termination of ownership of the capital asset itself. Applied to the facts of this case, Pilgrim's Pride abandoned the Securities, not a "right or obligation ... with respect to" the Securities. 26 U.S.C. § 1234A(1).
> [The court then explained why the IRS' position would have made Code § 1234A(2) meaningless.]
> For the foregoing reasons, we hold that 26 U.S.C. § 1234A(1) does not apply to Pilgrim's Pride's abandonment loss.[8]
> [8] Two administrative actions lend further support to Pilgrim's Pride's position. In Revenue Ruling 93-80, the IRS held that a taxpayer is allowed an ordinary loss on the abandonment of a partnership interest, even if the abandoned partnership interest is a capital asset. This Ruling directly contradicts the Commissioner's position in this case. Although the Commissioner asserts that Revenue Ruling 93-80 was superseded by a 1997 amendment to the statute at issue here, this begs the question presented in this case and is odd considering that the IRS never has formally revoked the Ruling and has relied on the Ruling since the statutory amendment.

seems consistent with the motivation for Code § 1234A, but the Fifth Circuit followed the statute's actual language.

When a contract right, commonly referred to as "phantom stock," passed to the employee's surviving spouse, who then contributed it to a partnership, the contribution to the partnership triggered taxation as income in respect of a decedent,[1573] converting the contract right to a capital asset in the partnership's hands; when the former employer paid on the contract, Code § 1234A applied to the proceeds.[1574] This case related to the surviving spouse's estate in *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278, which is cited in fn. 6440 in part III.B.1.g.i Private Annuities: Estate Planning Implications. The surviving spouse failed to report the contribution to the partnership on her income tax return, and it was too late to assess her return. T.C. Memo. 2008-278 held that the contract right was included in her estate directly, so the partnership received a basis step-up to its value on her estate tax return; but for Code § 2036 inclusion, the partnership would have needed to make a Code § 754 election, as described in part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000; the Code § 2036 exception is described in fn 5695.

The contract right was a capital asset because it was not excluded from the definition of capital asset. *Hurford Investments No 2, Ltd. v. Commissioner*, fn. 1574, held:

> *Section 1221*. Section 1221 defines the term "capital asset." It's a very broad section, and defines the term as all property that isn't specifically excluded by one of a list of exceptions. I.R.C. § 1221(a); 26 C.F.R. § 1.1221-1(a). Importantly, the character of property can change depending on who holds it. A car dealership's cars, for example, are inventory to the dealership, so the cars would fall into the category of non-capital assets in the hands of a car dealer. But a car becomes a capital asset in the hands of the usual car buyer because it no longer fits one of the non-capital asset definitions in section 1221. *See*, *e.g.*, *David Taylor Enters., Inc. v. Commissioner*, 89 T.C.M. (CCH) 1369 (2005). The same holds true in more complicated cases, such as inventory of a sole proprietorship which become capital assets in the hands of the business owner's estate. *Estate of Ferber v. Commissioner*, 22 T.C. 261 (1954); see also *Berry Petroleum Co. v. Commissioner*, 104 T.C. 584, 650 n. 48 (1995) (noting that the character of property for one company may be different for a successor company). HI-2's interest in the phantom stock doesn't fit into one of the exceptions listed in section 1221,[2] so it seems it's a capital asset.
>
> [2] The phantom stock is not (a) stock in trade (*i.e.*, dealer property), (b) depreciable property used in a trade or business, (c) a copyright or other similar item, (d) an account or note receivable acquired in the ordinary course of business, (e) a U.S. Government publication, (e) a commodities derivative financial instrument, (f) a hedging transaction, or (g) supplies used or consumed in the ordinary course of business. I.R.C. § 1221(a).

Furthermore, the substitute-for-ordinary-income doctrine did not apply. *Hurford Investments No 2, Ltd. v. Commissioner*, fn. 1574, held:

[1573] Code § 691(a)(2). See part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.
[1574] *Hurford Investments No 2, Ltd. v. Commissioner*, Docket No. 23017-11 (4/17/2017), https://dawson.ustaxcourt.gov/case-detail/23017-11.

> But caselaw throws another exception at us that we must consider – the substitute-for-ordinary-income doctrine. Sometimes something must be taxed as ordinary income even if it doesn't fit one of the exceptions specifically listed in section 1221. The classic example of this doctrine is the sale of a winning lottery ticket. Lump-sum payments or annuity payments for winning the lottery are taxed as ordinary income. But what if a taxpayer sells his right to future annuity payments? The IRS always argues that a sale of such property doesn't produce a capital gain. *See*, *e.g.*, *Davis v. Commissioner*, 119 T.C. 1, 5-6 (2002). The courts agree. We noted in *Davis* that the Supreme Court said "[w]hile a capital asset is defined . . . as 'property held by the taxpayer,' it is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset." *Id.* At 7 (quoting *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 134 (1960)). Should the phantom stock receive similar treatment? If Gary had lived to see the liquidation of the phantom account it would've been deferred compensation, and taxed as ordinary income. Why should that change now?
>
> The reason is that HI-2 isn't Gary Hurford and the phantom stock isn't the same as a winning lottery ticket. We've already said the character of property can change when it's transferred to another party, so the character in the hands of Gary or Thelma shouldn't automatically be applied to HI-2. In *Davis* we said that "[i]t is well established that the purpose for capital-gains treatment is 'to afford capital gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year.'" 119 T.C. at 7 n. 9 (quoting *Gillette Motor Transp.*, 364 U.S. at 134). The winning lottery ticket doesn't fit this description because it represents the right to guaranteed future payments of a set amount. The phantom stock, on the other hand, could increase or decrease in value over time, similar to ordinary stock. Once HI-2 acquired it, its value was inextricably linked to the value of Hunt Oil, which was far from set in stone. Unlike Gary, HI-2 couldn't do anything to affect its value, but rather simply held it and hoped it would appreciate in value. This distinguishing characteristic is enough for us to conclude that it is a capital asset of HI-2's.

Finally, the employer's paying the contract was a qualifying ""cancellation, lapse, expiration, or other termination." *Hurford Investments No 2, Ltd. v. Commissioner*, fn. 1574, discussed the issue:

> Winning capital-asset status is only half the battle for HI-2. To receive capital-gains rates, the income must be from a "sale or exchange" of that capital asset. I.R.C. § 1222. "The touchstone for sale or exchange treatment is consideration. If in return for assets any consideration is received, even if nominal in amount, the transaction will be classified as a sale or exchange." *LaRue v. Commissioner*, 90 T.C. 465, 483 (1988). The Commissioner argues that even if we find the phantom stock is a capital asset, HI-2 never sold or exchanged it. Instead, Hunt Oil simply fulfilled a contractual obligation. The Commissioner points us to *Pounds v. United States*, 372 F.2d 342 (5th Cir. 1967).

After discussing *Pounds*, the court noted:

> HI-2 doesn't dispute that under *Pounds* it would have a big problem. HI-2 argues instead that Founds has been superseded by a new Code section – section 1234A. Section 1234A says that "[g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of . . . a right or obligation . . . with respect to property which is . . . a

capital asset in the hands of the taxpayer . . . shall be treated as gain or loss from the sale of a capital asset." If a transaction meets the definition in section 1234A, it counts as capital gain or loss from a sale.

> HI-2 argues that when its right to participate in the phantom-stock plan ended in 2006 and Hunt Oil paid out the value of the phantom account, HI-2's interest in the phantom stock was cancelled, lapsed, expired, or was otherwise terminated. HI-2 thinks this means that there was a sale or exchange in 2006, so it should receive capital-gains treatment under section 1234A. This motion is thus affected by the Fifth Circuit's decision in *Pilgrim's Pride Corp. v. Commissioner*, 779 F.3d 311 (5th Cir. 2015), *rev'g* 141 T.C. 533 (2013).

The court then reviewed the Fifth Circuit's decision in *Pilgrim's Pride*:

> It held that section 1234A(1) applies only to the termination of rights or obligations to buy or sell capital assets, not the termination of their ownership. *Pilgrim 's Pride*, 779 F.3d at 315. So, a contractual right to buy or sell a capital asset would fall into section 1234A(1) under the Fifth Circuit's interpretation. The Fifth Circuit tells us that if there's no sale or exchange and there's no termination of a right or obligation to buy or sell, then there can't be capital-gains treatment. *Id.*

> So which category are we dealing with here--the termination of a right to buy or sell or the termination of ownership? Remember that both parties to the phantom-stock arrangement had the right to liquidate the account at any time. When Hunt Oil liquidated the phantom stock and distributed the proceeds, it ended HI-2's right to sell the phantom stock when it chose. We think that means there was a termination of a right to buy or sell a capital asset, and not an abandonment of property, under the Fifth Circuit's interpretation of 1234A(1). HI-2 still owned the rights to the phantom stock or, after the liquidation, to the cash proceeds. We therefore conclude that the transaction was a sale or exchange of a right to sell a capital asset under section 1234A(1) and HI-2 is entitled to capital-gains treatment.

TAM 200427025 asserted that Code § 1234A did not apply to the termination of a long-term power purchase agreement.

Code § 1234A, by its own terms, does not apply to "the retirement of any debt instrument (whether or not through a trust or other participation agreement)."

Code § 1234A has reportedly been used to obtain capital gain treatment on the surrender of a life insurance policy.[1575]

Code § 1234A has attracted attention in the merger and acquisition arena.[1576]

[1575] See fn. 4419, found in part II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy).

[1576] For more about Code § 1234A, see Schnee and Seago, "The Application of Section 1234A: Explanation, Revision or Expansion?" *Journal of Taxation* (4/2017), also citing *Alderson v. U.S.*, 686 F.3d 791 (9th Cir. 2012); *Patrick v. Commissioner*, 142 T.C. 124 (2014); Letter Rulings 200823012 and 201123044, FAA 20163701F; and ILM 201642035. The article concluded:

II.G.9. Tax Distributions from Partnerships and S Corporations

S corporations and partnerships generally do not pay income tax.[1577] Instead, their income is taxed to their owners, whether or not their owners receive distributions. Accordingly, it is not uncommon for their organizational documents to mandate distributions to pay income tax.[1578]

Sometimes entities pay their owners' taxes directly, as a matter of convenience, treating payments to taxing authorities as distributions to the owners followed by the owners making payments of those taxes. Requiring this payment to taxing authorities might help ensure that these payments continue if the entity later files for bankruptcy.[1579] The IRS must honor this designation of payments.[1580]

> Recently, IRS rulings and cases have considered the application of Section 1234A. They appear to have expanded its scope to include M&A transactions but limit the definition of capital assets to those that would be treated as capital based on the historic cases and rulings. This includes applying Section 1221 exactly as enacted to the extent it lists assets as non-capital assets except if the court-created narrow definitional approach applies. The application of Section 1234A to M&A transactions is very significant since corporations pay ordinary income tax on capital gains but have limited deductions for capital losses.

A panel (including governmental) at the American Bar Association Section of Taxation's January (Midyear) 2017 meeting discussed these issues, including the observation that CCA 201642035 included a footnote disagreeing with the conclusion of Letter Ruling 200823012 that a termination fee was ordinary income. Slides are saved as Thompson Coburn doc. 6555254. Panelists suggested that regulations under Code § 263(a) capitalized expenditures investigating a possible acquisition as a general intangible asset under *Indopco, Inc. v. Commissioner*, 503 U.S. 79 (1992), without identifying the intangible asset or dealing with its later being rolled into a stock purchase or being abandoned; they said that Treasury had intended to address those issues later but never got around to it.

[1577] However, S corporations that had been C corporations might pay a tax on any built-in gain (excess of value over tax basis) if property that survived the conversion is sold within 10 years after the conversion. See part II.P.3.b.ii Built-in Gain Tax.

[1578] For clients who want to spend time and money on a sophisticated tax distribution clause, consider some of the ideas in Schneider and O'Connor, "A Partnership Tax Distribution Menu: Just Say No to Phantom Income," *Business Entities*, Vol. 15, No. 1, at page 4 (January/February 2013).

[1579] *In re Kenrob Information Tech. Solutions, Inc.*, No. 09-19660-RGM (Bankr. E.D. Va. 7/10/12). However, *In re DBSI, Inc.*, 561 B.R. 97 (D. Idaho 2016) (https://goo.gl/eCva3u), distinguished the affirmative act of making an S election in *Kenrob* from the members' decision in *DBSI* not to elect taxation as a C corporation. The *DBSI* opinion did not mention whether the members affirmatively agreed not to be taxed as a C corporation in exchange for an agreement to make tax distributions; however, the operating agreement required tax distributions "if the cash position of the Company [was] sufficient to allow a distribution." The court also criticized the tax distributions being made to the IRS when they were required to made to the members; that view is nonsense, in that the members received credit from the IRS for payments made on their behalf.

[1580] *Dixon v. Commissioner*, 141 T.C. 173 (2013) (a reviewed opinion, holding that the individual taxpayers received credit as of the date of payment and not as withholding). Action on Decision 2014-001 recommended nonacquiescence, reasoning:

> The Service disagrees with the Tax Court that employment tax payments that were not withheld at the source may be designated by an employer to a specific employee's income tax liability. Pursuant to sections 3402 and 31(a), an employee may only get a credit for income taxes withheld at the source. If the income tax is not withheld at the source, a later payment by the employer of its liability for the tax it should have withheld will not result in a credit to the employee. In the absence of a statutory credit, the Dixons cannot rely on the rule allowing designation of partial voluntary payments. *See* Rev. Proc. 2002-26. Such rule only permits a taxpayer to designate a payment toward its own tax liabilities, such as where an employer

II.G.10. Distributing Profits in Excess of Tax Distributions

Generally, a business owner should withdraw as much as possible from the business so long as the business is funded in a responsible way. The idea is to expose enough to those with claims against the entity to avoid "piercing the corporate veil" (which applies to LLCs and other unincorporated limited liability entities), while not exposing any more than necessary.[1581]

Generally, any equity in an entity is exposed to the entity's creditors. If an owner loans money to an entity, that loan would compete with all other claims against the entity. Although a creditor might ask a court to use "piercing the corporate veil" theories to provide less protection to the owner who is a creditor than the protection granted other creditors, presumably an owner who withdraws money and then loans it to the company would be in a better position than an owner who simply leaves his money in the company.

S corporation owners also have tax motivations to withdraw funds and reinvest them separately. If an S corporation buys long-term investments and later decides to distribute them, the distribution would be a deemed sale[1582] – unlike a partnership, which generally can distribute assets that the partnership bought without triggering a taxable event.[1583] The owners of an S corporation might consider taking their distributions and forming an LLC taxed as a partnership, which would then be available to guarantee the S corporation's loans, own property leased to the S corporation, fund cross-purchases, start new businesses, etc. Although the LLC's operating agreement might require them to make contributions of such distributions from the S corporation, they should avoid any agreement that the IRS might argue would constitute part of the S corporation's governing documents; this is necessary to avoid an IRS argument that the LLC is essentially an owner of some S corporation stock, because a partnership is not an eligible shareholder.

If a shareholder or the LLC described above loans money to the S corporation, what would be an appropriate interest rate? My gut reaction would be the prime rate or whatever the company pays on its line of credit. Consider, however, that any interest income generated would be subject to the net investment income (NII) tax,[1584] whereas any interest deductions generated will not reduce NII if the shareholders sufficiently participate in the business and therefore business operations do not generate NII.[1585] Therefore, to minimize taxes, one might consider charging only the applicable federal rate (AFR), which might very well be short-term, which

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> designates a payment of employment taxes toward the trust fund portion of its employment tax liability. *See Wood v. United States*, 808 F.2d 411, 416 (5th Cir. 1987). Here, Tryco could not designate that its employment tax payments be applied to the income taxes of the Dixons because such income taxes were owed by the Dixons, and not Tryco.
>
> Accordingly, the Service will not follow the holding in *Dixon* that an employer can designate payments of its employment taxes to income taxes of specific employees, and effectively override the statutory limitations in the availability of a credit under section 31(a). We have, however, declined to pursue appeal of this case because due to its unique facts, Dixon has limited precedential effect.

If the taxpayer does not instruct the bank that accepts direct deposits but does not instruct the IRS, the taxpayer has not designated the payment. *Valteau, Harris, Koenig and Mayer v. Commissioner*, T.C. Memo. 2014-144.

[1581] See part II.F Asset Protection Planning.

[1582] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

[1583] See part II.Q.8.b.i Distribution of Property by a Partnership.

[1584] See part II.I.5 What is Net Investment Income Generally.

[1585] See part II.I.8 Application of 3.8% Tax to Business Income, especially parts II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax and II.I.8.g Structuring Businesses in Response to 3.8% Tax.

generally is the lowest AFR. Be sure to fully document the loan, not only to prove it bona fide but also because that can have the best tax results when an S corporation is involved.[1586]

II.G.11. Personal Service Corporations

A C corporation that is a "qualified personal service corporation" is taxed at the highest marginal corporate income tax rate.[1587] A "qualified personal service corporation" is any corporation that satisfies both of these tests:[1588]

- substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and

- substantially all of the stock of which (by value) is held directly or indirectly by employees performing services for such corporation in connection with the activities involving a field described above, retired employees who had performed such services for such corporation, the estate of any individual described above, or any other person who acquired such stock by reason of the death of an individual described above within two years after that individual's death.

Commissioned salesmen frequently describe themselves as consultants, but they are treated as salesmen and not consultants for purposes of this rule.[1589]

These types of entities are one of the few types of C corporations with more than $25 million of annual gross receipts that can use the cash receipts and disbursements method of accounting.[1590]

Generally, they also are required to file income tax returns using a calendar year.[1591]

II.G.12. Planning for C Corporation Using the Lowest Corporate Brackets and Is Owned by Taxpayer with Modest Wealth

Taxpayers in the lowest tax bracket do not pay federal income tax on qualified dividends.

Consider paying dividends when the shareholders are in the lowest tax bracket to reduce earnings and profits without incurring federal income tax.

If the corporation is not a personal service corporation[1592] for tax years beginning before January 1, 2018 or is any C corporation for tax years after that, reconsider a strategy of paying as much reasonable compensation as necessary to zero out the corporation's taxable income. Instead, consider having the corporation pay tax to the extent it is in a low bracket and pay

[1586] See part II.G.4.d.ii.(b) Consequences of Using Shareholder Debt to Deduct S Corporation Losses, especially the text accompanying fns. 1218-1220.
[1587] Code § 11(b)(2).
[1588] Code § 448(d)(2).
[1589] Reg. § 1.448-1T(e)(4)(iv), particularly clause (A) and Example (1) of clause (B).
[1590] Code § 448(b)(2). See part II.P.3.d Conversion from S Corporation to C Corporation, fns 4023-4026.
[1591] Code § 444(i)(1). Note, however, that "personal service corporation" is defined differently for these purposes. Code § 444(i)(2).
[1592] See part II.G.11 Personal Service Corporations.

nontaxable dividends to the shareholder.[1593] Make sure, however, that the employee-shareholder's compensation is not unreasonably low.[1594]

Note, however, that the corporation and shareholder may be subject to state or local income tax, which may reduce the efficacy of this idea.

When taxpayers pay tax on qualified dividends, see part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities, especially part II.E.1.a Taxes Imposed on C Corporations.

II.G.13. Loans from Entity to Employee

The IRS has attempted to recast a forgivable loan to an employee as a payment of compensation for future services, with the portion not forgiven deemed to be a liquidated damages clause for failure to complete the term of service.[1595]

II.G.14. Planning for Upcoming Sale That Is Not Imminent – Using an Installment Sale Now to Defer Tax on Upcoming Sale

If the sale is more than two years down the road, an installment sale might help fix the basis. See part II.Q.3 Installment Sales - Deferring Tax on Lump Sum Payout Expected More than Two Years in the Future, which deals with selling an interest in a business but also applies to other transactions.

Also consider using a partnership to shift basis to the property to be sold. See part II.Q.8.b.i.(e) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property.

Consider contributing the property to a charitable remainder trust, if the property would not generate unrelated business taxable income on the sale. See part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax, analysis from which has uses beyond just the built-in gain tax setting.

[1593] For how to try to get cash out of C corporations annually, see Zupanc, "Getting Cash out of a Closely Held Corporation," 92 *Practical Tax Strategies* 65 (Feb. 2014), which concluded:

> The exact amount of net tax savings or costs depends on the amount of the shareholder's (and spouse's if married filing jointly) earnings, AGI, modified AGI, taxable income, net investment income, the phase-out effect on exemptions and itemized deductions, and AMT, as well as the marginal rate of the C corporation. One general rule is that rental income from a C corporation with a corresponding deduction is usually the most advantageous choice as compared to salaries and qualified dividends for all (Alice, Basu, Claudia, and Dafir) but the highest marginal rate shareholders or when the C corporation has a 15% marginal rate. A second general rule is that the highest marginal rate shareholders (Eugenie) who are subject to the 3.8% net investment surtax will find salaries the most advantageous means to shift income, except when that C corporation is in the 15% bracket. A third general rule is that salaries are the second choice for tax-advantaged transfers to shareholders unless the C corporation is in the 15% marginal rate or the shareholder is in the 0% marginal rate for qualified dividends, which makes qualified dividends the best second choice.

I have not carefully read the article, and one should certainly use healthy skepticism, given that at the beginning of the Overview the author incorrectly referred to Code § 1411 as a Medicare contribution tax.

[1594] See part II.A.2.c Avoiding Double Taxation and Self-Employment Tax, especially fn. 79.

[1595] TAM 200040004.

II.G.15. Limitations on the Use of Installment Sales

Any depreciation recapture taxable as ordinary income under Code § 1245 or 1250 is not eligible for installment deferral, although that disallowance does not taint the rest of the gain; this includes such ordinary income taxed under Code § 751; see part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests.[1596]

Generally, deferral does not apply to any installment obligation arising out of a sale of stock or securities traded on an established securities market or, to the extent provided in regulations, property (other than stock or securities) of a kind regularly traded on an established market (although there might be a way around that rule).[1597]

Generally, if an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, the deferred gain is accelerated.[1598] Installment notes transferred outright (not in trust) to a spouse or pursuant to a divorce are not accelerated.[1599] Various business formations and liquidations might escape gain recognition.[1600] Reg. § 1.453-9(c), "Disposition from which no gain or loss is recognized," provides:

(1)

(i) Under section 453(d)(4)(A), no gain or loss shall be recognized to a distributing corporation with respect to the distribution made after November 13, 1966, of installment obligations if (a) the distribution is made pursuant to a plan for the complete liquidation of a subsidiary under section 332, and (b) the basis of such obligations in the hands of the distributee is determined under section 334(b)(1).

(ii) Under section 453(d)(4)(B), no gain or loss shall be recognized to a distributing corporation with respect to the distribution of installment obligations if the distribution is made, pursuant to a plan for the complete liquidation of a corporation which meets the requirements of section 337, under conditions whereby no gain or loss would have been recognized to the corporation had such installment obligations been sold or exchanged on the day of the distribution. The

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[1596] Code § 453(i) provides that any recapture income shall be recognized in the year of the disposition and that any gain in excess of the recapture income shall be taken into account under the installment method. as used here, "recapture income" means the amount that would be treated as ordinary income under Code §§ 1245 or 1250 (including indirectly through Code § 751) for the taxable year of the disposition and as if all payments to be received were received in the taxable year of disposition. See part II.G.6.b Code § 1245 Property.

[1597] Code § 453(k)(2), which further provides, "The Secretary may provide for the application of this subsection in whole or in part for transactions in which the rules of this subsection otherwise would be avoided through the use of related parties, pass-thru entities, or intermediaries." For opportunities that remain in light of no regulations having been promulgated, see part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests, especially fn. 5659.

[1598] Code § 453B.

[1599] Code § 453B(g), referring to Code § 1041(a).

[1600] Cross-references include Code §§ 332, 337, 351, 361, 721, and 731, with exceptions for hot assets, depreciation recapture, etc. I have not researched the effect of any apparent conflict with Code § 453B. In a Code § 351 transaction, the contributing shareholder recognizes gain based on the value of stock received in exchange for the obligation, but any excess amount on the installment note is deferred. Rev. Rul. 73-423, which would be integrated into regulations under Prop. Reg. § 1.453B-1(c). Also see part II.P.3.a From Corporations to Partnerships and Sole Proprietorships (no acceleration when corporation converts to partnership).

preceding sentence shall not apply to the extent that under section 453(d)(1) gain to the distributing corporation would be considered as gain to which section 341(f)(2), 617(d)(1), 1245(a)(1), 1250(a)(1), 1251(c)(1), 1252(a)(1), or 1254(a)(1) applies, computed under the principles of the regulations under such provisions. See paragraph (d) of § 1.1245-6, paragraph (c)(6) of § 1.1250-1, paragraph (e)(6) of § 1.1251-1, paragraph (d)(3) of § 1.1252-1, and paragraph (d) of § 1.1254-1.

(2) Where the Code provides for exceptions to the recognition of gain or loss in the case of certain dispositions, no gain or loss shall result under section 453(d) in the case of a disposition of an installment obligation. Such exceptions include: Certain transfers to corporations under sections 351 and 361; contributions of property to a partnership by a partner under section 721; and distributions by a partnership to a partner under section 731 (except as provided by section 736 and section 751).

(3) Any amount received by a person in payment or settlement of an installment obligation acquired in a transaction described in subparagraphs (1) or (2) of this paragraph (other than an amount received by a stockholder with respect to an installment obligation distributed to him pursuant to section 337) shall be considered to have the character it would have had in the hands of the person from whom such installment obligation was acquired.

Special considerations apply when installment notes are among assets of a corporation being deemed sold in a deemed asset sale when sufficiently controlling stock is being sold.[1601]

Note the exceptions for Code § 721 (subpart II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership, which is in part II.M.3 Buying into or Forming a Partnership) and Code § 731 (part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions, which is in part II.Q.8.b.i Distribution of Property by a Partnership), the latter subject to Code § 751 (part II.Q.8.b.i.(g) Code § 751 – Hot Assets), among other exceptions. Under these provisions, if one is concerned about accelerating an installment note when distributing to various beneficiaries after one's death (see below), one might contribute the note to a partnership, and after death the partnership interest can be distributed to beneficiaries. The built-in gain would be specially allocated to the person contributing the note and that person's successors in interest.[1602]

[1601] See fn 5777 in part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.

[1602] See part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value. Reg. § 1.704-3(a)(8)(ii), "Disposition in an installment sale," provides:

> If a partnership disposes of section 704(c) property in an installment sale as defined in section 453(b), the installment obligation received by the partnership is treated as the section 704(c) property with the same amount of built-in gain as the section 704(c) property disposed of by the partnership (with appropriate adjustments for any gain recognized on the installment sale). The allocation method for the installment obligation must be consistent with the allocation method chosen for the original property.

Special rules apply to installment notes includible in the holder's gross estate.[1603] As income in respect of a decedent, an installment note does not receive a basis step-up.[1604] Specifically bequeathing an installment note to the obligor accelerates income to the estate, and the bequest is not a distribution triggering the income distribution deduction[1605] (although other distributions might); however, such a bequest does not necessarily constitute a step transaction indicating an intention to forgive the note.[1606]

Transfers to[1607] or from[1608] nongrantor trusts trigger acceleration.

Also, if any person disposes of property to a related person[1609] (the "first disposition"), and the person making the first disposition receives all payments with respect to such disposition, the related person disposes of the property (the "second disposition"), then the amount realized with respect to such second disposition shall be treated as received at the time of the second disposition by the person making the first disposition.[1610] However, for property ither than

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1603 Code § 691(a)(4), (5). A transfer at death does not accelerate gain until the note is cancelled or distributed. ¶ 108.13.3 Obligations Held at Death, Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts* (WG&L), citing S. Rep. No. 1000, 96th Cong., 2d Sess., reprinted in 1980-2 C.B. 494, 508, which provides as follows:

> The bill provides that any previously unreported gain from an installment sale will be recognized by a deceased seller's estate if the obligation is transferred or transmitted by bequest, devise, or inheritance to the obligor or is cancelled by the executor. In the absence of some act of cancelling the obligation by distribution or notation which results in cancellation under the Uniform Commercial Code or other local law, the disposition will be considered to occur no later than the time the period of administration of the estate is concluded.
>
> If the cancellation occurs at the death of the holder of the obligation, the cancellation is to be treated as a transfer by the estate of the decedent. However, if the obligation were held by a person other than the decedent, such as a trust, the cancellation will be treated as a transfer immediately after the decedent's death by that person.
>
> If the decedent and the obligor were related persons (within the meaning of new Code section 453(f)(1)), the fair market value of the obligation for disposition purposes is not to be treated as less than its face amount.

For purposes of this provision, if an installment obligation becomes unenforceable, it will be treated as if it were cancelled.

See also the text accompanying fn 6425 in part III.B.1.f Self-Canceling Installment Notes.

1604 Code § 1014(c).

1605 Letter Ruling 9108027.

1606 In the *Estate of Morrissette v. Commissioner*, the Tax Court brushed aside the IRS' step transaction argument when the temporary conservator for a 94-year-old entered into a generational split-dollar agreement and amended her estate plan to bequeath the interest in the split-dollar arrangement to the other party to the agreement. This was an economic benefit transaction and not a loan transaction, so it is not directly on point to my comment about bequeathing the note. The case is discussed in fns. 4538-4540 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

1607 Rev. Rul. 67-167.

1608 Rev. Rul. 55-159.

1609 Code § 453(f)(1), "Related person," provides:

> Except for purposes of subsections (g) and (h), the term "related person" means -
>
> (A) a person whose stock would be attributed under section 318(a) (other than paragraph (4) thereof) to the person first disposing of the property, or
>
> (B) a person who bears a relationship described in section 267(b) to the person first disposing of the property.

See parts II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses and II.Q.7.a.viii Code § 318 Family Attribution under Subchapter C.

1610 Code 453(e)(1).

marketable securities, that rule applies only if the second disposition is within 2 years of the first disposition.[1611]

To avoid accelerating upon a second disposition, a taxpayer might sell to an unrelated party for a note. A deferred sale trust is a trust involving unrelated third parties who invest the sale proceeds and pay the installment note to the seller. The seller takes tremendous risk, in that the seller has no control over how the proceeds are invested and receives only a fixed interest return. The trustee and beneficiaries of the deferred sale trust are not personally liable to the seller, so they are incentivized to take risk to get return in excess of the note payments; and I have been informed of some cases where the risks resulted in the trust defaulting on the note. Quite frankly, I believe that forfeiting equity returns and taking extra risk are too great a cost; therefore, I am very skeptical when approached about deferred sale trusts. Some deferred sales promoters are sensitive to these risks and try to make arrangements that reduce this risk. CCA 202118016 argues against various less risky approaches:

> This is in response to your request for our analysis regarding "Monetized Installment Sale" transactions. Note that because there are multiple promoters/sub-promoters, there could be variations in the way transactions are structured. Some of the points below might not apply to every transaction. However, there do seem to be common features that make the transactions problematic. And we generally agree that the theory on which promoters base the arrangements is flawed. The general structure raises a number of issues including, but not limited to, the following:
>
> 1. *No genuine indebtedness*. At least one promoter contends that the seller receives the proceeds of an unsecured nonrecourse loan from a lender, but a genuine nonrecourse loan must be secured by collateral. A "borrower" who is not personally liable and has not pledged collateral would have no reason to repay a purported "loan." See *Estate of Franklin v. CIR*, 544 F.2d 1045 (9th Cir. 1976). Therefore, the loan proceeds would be income.
>
> 2. *Debt secured by escrow*. In one arrangement, the promoter states that the lender can look only to the cash escrow for payment. It appears that, in effect, the cash escrow is security for the loan to taxpayer. If so, taxpayer economically benefits from the cash escrow and should be treated as receiving payment under the "economic benefit" doctrine for purposes of section 453. *Compare Reed v. CIR*, 723 F.2d 138 (1st Cir. 1983).
>
> 3. *Debt secured by dealer note*. Alternatively, the Monetization Loan to taxpayer is secured by the right to payment from the escrow under the installment note from the dealer. This would result in deemed payment under the pledging rule, under which loan proceeds are treated as payment of the dealer note. Section 453A(d).
>
> 4. *Section 453(f)*. The intermediary does not appear to be the true buyer of the asset sold by taxpayer. Under section 453(f), only debt instruments from an "acquirer" can be excluded from the definition of payment and thus not constitute payment for purposes of section 453. Debt instruments issued by a party that is not the "acquirer" would be considered payment, requiring recognition of gain. See Rev. Rul. 77-414,

[1611] Code 453(e)(2).

1977-2 C.B. 299; Rev. Rul. 73-157, 1973-1 C.B. 213; and *Wrenn v. CIR*, 67 T.C. 576 (1976) (intermediaries ignored in a back-to-back sale situation).

5. *Cash Security*. To the extent the installment note from the intermediary to the seller is secured by a cash escrow, taxpayer is treated as receiving payment irrespective of the pledging rule. Treas. Reg. section 15a.453-1(b)(3) ("Receipt of an evidence of indebtedness which is secured directly or indirectly by cash or a cash equivalent ... will be treated as the receipt of payment.")

6. *NSAR 20123401F is distinguishable*. The case addressed in the memorandum did not involve an intermediary. Further, loans to a disregarded entity wholly owned by seller were secured by the buyer's installment notes, but the pledging rule of section 453A(d) was not applicable. There is an exception to the pledging rule for sales of farm property, which applied in the case.

The preamble to the proposed regulations, "Identification of Monetized Installment Sale Transactions as Listed Transactions," Agency/Docket Number REG-109348-22 (8/4/2023), RIN 1545-BQ69 (the "NPRM"), explains in part IV, "Tax Avoidance Using Monetized Installment Sales":

> The Treasury Department and the IRS are aware that promoters are marketing transactions that purport to convert a cash sale of appreciated property by a taxpayer (seller) to an identified buyer (buyer) into an installment sale to an intermediary (who may be the promoter) followed by a sale from the intermediary to the buyer. In a typical transaction, the intermediary issues a note or other evidence of indebtedness to the seller requiring annual interest payments and a balloon payment of principal at the maturity of the note, and then immediately or shortly thereafter, the intermediary transfers the seller's property to the buyer in a purported sale of the property for cash, completing the prearranged sale of the property by seller to buyer. In connection with the transaction, the promoter refers the seller to a third party that enters into a purported loan agreement with the seller. The intermediary generally transfers the amount it has received from the buyer, less certain fees, to an account held by or for the benefit of this third party (the account). The third party provides a purported non-recourse loan to the seller in an amount equal to the amount the seller would have received from the buyer for the sale of the property, less certain fees. The "loan" is either funded or collateralized by the amount deposited into the account. The seller's obligation to make payments on the purported loan is typically limited to the amount to be received by the seller from the intermediary pursuant to the purported installment obligation. Upon maturity of the purported installment obligation, the purported loan, and the funding note, the offsetting instruments each terminate, giving rise to a deemed payment on the purported installment obligation and triggering taxable gain to the seller purportedly deferred until that time.
>
> The promotional materials for these transactions assert that engaging in the transaction will allow the seller to defer the gain on the sale of the property under section 453 until the taxpayer receives the balloon principal payment in the year the note matures, even though the seller receives cash from the purported lender in an amount that approximates the amount paid by the buyer to the intermediary. The IRS intends to use multiple arguments to challenge the reported treatment of these transactions as installment sales to which section 453 purportedly applies, including the arguments described below.

First, the intermediary is not a bona fide purchaser of the gain property that is the subject of the purported installment sale. In these transactions, the intermediary is interposed between the seller and the buyer for no purpose other than Federal income tax avoidance, and the intermediary neither enjoys the benefits nor bears the burdens of ownership of the gain property. The interposition of the intermediary typically takes place after the seller has decided to sell the gain property to a specific buyer at a specific negotiated purchase price, and the purported resale by the intermediary to such buyer generally takes place almost simultaneously with the purported sale to the intermediary for approximately the same negotiated purchase price, less certain fees. The seller's only purpose for entering into an agreement with the intermediary is to defer recognition of the gain on the sale of the gain property to the buyer. Other than the Federal income tax deferral benefits provided by the installment method provisions of section 453, the sole economic effect of entering the monetized installment sale transaction from the perspective of the seller is to pay direct and indirect fees to the intermediary and the purported lender in an amount that is substantially less than the Federal tax savings purportedly achieved from using section 453 to defer the realized gain on the sale.

When an intermediate transaction with a third party is interposed and lacks independent substantive (non-tax) purpose, such transaction is not respected for Federal income tax purposes and the transaction is appropriately treated as a sale of the property by the seller directly to the buyer in the taxable year in which the gain property is transferred by the seller. *See Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945) ("A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress" (footnote omitted)); *Wrenn v. Commissioner*, 67 T.C. 576 (1976), (holding that a taxpayer did not engage in a bona fide installment sale when the taxpayer transferred stock to his spouse under a purported installment sale contract, followed by the spouse immediately selling the stock to a third party for a negligible gain); *Blueberry Land Co. v. Commissioner*, 361 F.2d 93, 100 (5th Cir. 1966), (holding that a corporation's transaction with an unrelated intermediary entered into solely to avoid Federal income taxes on the sale should be disregarded for Federal income tax purposes and the corporation should be taxed as if it sold the property directly to the ultimate buyer); *Enbridge Energy Co. Inc. v. United States*, 354 F. App'x 15 (5th Cir. 2009) (holding that an intermediate sale was a sham, the intermediary lacked a "bona fide role in the transaction," as its only purpose for being a party in the transaction, and indeed for existing, was to mitigate the Federal tax bill arising from the transaction, and that the transaction should be treated, for Federal tax purposes, as a sale directly from the seller to the taxpayer).

In addition, it is inappropriate to treat the intermediary in the monetized installment sale transaction described in this NPRM as the acquirer of the gain property that is the subject of the purported installment sale because the intermediary neither enjoys the benefits nor bears the burdens of ownership of the gain property that a person must possess to be considered the owner of property for Federal income tax purposes. *See Grodt & McKay Realty Inc. v. Commissioner*, 77 T.C. 1221 (1981). *See also Derr v. Commissioner*, 77 T.C. 708 (1981) and *Baird v. Commissioner*, 68 T.C. 115 (1977).

Second, in these transactions the seller is appropriately treated as having already received the full payment at the time of the sale to the buyer because (1) the purported installment obligation received by the seller is treated as the receipt of a payment by the seller under § 15a.453–1(b)(3) since it is indirectly secured by the sales proceeds, or (2) the proceeds of the purported loan are appropriately treated as a payment to the seller because the purported loan is not a bona fide loan for Federal income tax purposes, or (3) the pledging rule of section 453A(d) deems the seller to receive full payment on the purported installment obligation in the year the seller receives the loan proceeds.

Third, the transaction may be disregarded or recharacterized under the economic substance rules codified under section 7701(o) or the substance over form doctrine. The step transaction doctrine and conduit theory may also apply to recharacterize monetized installment sale transactions described in this NPRM.

The “Explanation of Provisions” part of the NPRM describes in “I. Definition of Monetized Installment Sale Transaction” the scope of transactions required to be reported:

Proposed § 1.6011–13(a) would provide that a transaction that is the same as, or substantially similar to, a monetized installment sale transaction described in proposed § 1.6011–13(b) is a listed transaction for purposes of § 1.6011–4(b)(2) and sections 6111 and 6112. “Substantially similar” is defined in § 1.6011–4(c)(4) to include any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or a similar tax strategy.

The transaction described in proposed § 1.6011–13(b) includes the following elements:

(1) A taxpayer (seller), or a person acting on the seller’s behalf, identifies a potential buyer for appreciated property (gain property), who is willing to purchase the gain property for cash or other property (buyer cash).

(2) The seller enters into an agreement to sell the gain property to a person other than the buyer (intermediary) in exchange for an installment obligation.

(3) The seller purportedly transfers the gain property to the intermediary, although the intermediary either never takes title to the gain property or takes title only briefly before transferring it to the buyer.

(4) The intermediary purportedly transfers the gain property to the buyer in a sale of the gain property in exchange for the buyer cash.

(5) The seller obtains a loan, the terms of which are such that the amount of the intermediary’s purported interest payments on the installment obligation correspond to the amount of the seller’s purported interest payments on the loan during the period. On each of the installment obligation and loan, only interest is due over identical periods, with balloon payments of all or a substantial portion of principal due at or near the end of the instruments’ terms.

(6) The sales proceeds from the buyer received by the intermediary, reduced by certain fees (including an amount set aside to fund purported interest payments on the purported installment obligation), are provided to the purported lender to fund the purported loan to the seller or transferred to an escrow or investment account of which the purported lender is a beneficiary. The lender agrees to repay these amounts to the intermediary over the course of the term of the installment obligation.

(7) On the seller's Federal income tax return for the taxable year of the purported installment sale, the seller treats the purported installment sale as an installment sale under section 453.

> A transaction may be "substantially similar" to the transaction described above even if such transaction does not include all of the elements described above. For example, a transaction would be substantially similar to a monetized installment sale if a seller transfers property to an intermediary for an installment obligation, the intermediary simultaneously or after a brief period transfers the property to a previously identified buyer for cash or other property, and in connection with the transaction, the seller receives a loan for which the cash or property from the buyer serves indirectly as collateral.

Given the many uncertainties of what might happen to trigger acceleration, consider transferring property to a partnership before selling it. The first two years of payments after forming the partnership might be interest-only, to avoid triggering the disguised sale rules.[1612] See also part II.Q.3 Installment Sales - Deferring Tax on Lump Sum Payout Expected More than Two Years in the Future. However, if the partnership later distributes the note to the obligor who is a partner, that distribution will constitute a payment of the note.[1613]

Large installment sales are subject to a charge for tax deferral.[1614]

Whereas this discussion suggests a partnership itself making an installment sale, part II.Q.8.e.ii.(c) discusses the Availability of Installment Sale Deferral for Sales of Partnership Interests.

For distributions from an estate or a nongrantor trust, see part II.J.8.d.iii Distributing a Note to the Obligor.

II.G.16. Like-Kind Exchanges

As described below, Code § 1031 disallows gain or loss on the exchange of certain property. Confirm with the client that the property has a gain; generally one does not want to defer a loss.

II.G.16.a. Post-2017 Code § 1031

Code § 1031(a)(1) provides:

> No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment.

Thus, personal property is no longer eligible for Code § 1031 treatment. For real estate, see part II.G.16.b Pre-2018 Code § 1031.

[1612] See part II.M.3.e Exception: Disguised Sale.
[1613] Reg. § 1.731-1(c)(2).
[1614] Code § 453A. Those owning an interest in a partnership or S corporation that holds an installment note should see Notice 88-81, "Application of Proportionate Disallowance Rule to Passthrough Entities."

Code § 1031(a)(2) disallows nonrecognition of “any exchange of real property held primarily for sale.”

Reg. § 1.1031(a)-3, “Definition of real property,” provides details on the distinction between real and personal property. It was adopted by T.D. 9935 (12/2/2020), which explains in its “Background,” part II, “Section 1031 After the TCJA”:

> As amended by the TCJA, section 1031(a) provides that no gain or loss is recognized on the exchange of real property held for productive use in a trade or business or for investment (relinquished real property) if the relinquished real property is exchanged solely for real property of a like kind that is to be held either for productive use in a trade or business or for investment (replacement real property). The legislative history to the TCJA amendments to section 1031 provides that Congress ‘‘intended that real property eligible for like-kind exchange treatment under present law will continue to be eligible for like-kind exchange treatment under the [amended] provision.’’ H.R. Conf. Rept. 115-466, at 396, fn. 726 (2017) (Conference Report). However, left unchanged by the TCJA, section 1031(b) provides that a taxpayer must recognize gain to the extent of money and nonlike-kind property the taxpayer receives in an exchange.

T.D. 9935 (12/2/2020) explains in its “Summary of Comments and Explanation of Revisions,” part II, “Definition of Real Property,” subheading “A. State or Local Law Definitions of Real Property”:

> 1. Approach of the Proposed Regulations
>
> Section 1031 does not provide a definition for the term ‘‘real property.’’ As noted in part II of the Background section, the Conference Report provides that Congress intended real property that was eligible for like-kind exchange treatment prior to the enactment of the TCJA to continue to be eligible for likekind exchange treatment after its enactment. See Conference Report, at 396, fn. 726. Specifically, with regard to the applicability of State law for real property determinations, the Conference Report sets forth the following example: ‘‘a like-kind exchange of real property includes an exchange of shares in a mutual ditch, reservoir, or irrigation company described in section 501(c)(12)(A) [of the Code] if at the time of the exchange such shares have been recognized by the highest court or statute of the State in which the company is organized as constituting or representing real property or an interest in real property’’ (Conference Report Example). Id. Accordingly, due to the absence of a statutory definition for the term ‘‘real property’’ in section 1031, the Treasury Department and the IRS based the proposed definition of real property upon the Conference Report Example.
>
> Under proposed § 1.1031(a)–3(a)(1), State law controls whether shares in a mutual ditch, reservoir, or irrigation company are real property for purposes of section 1031. Aside from those enumerated asset types, the proposed regulations provide that State or local law definitions were not controlling for purposes of determining whether property is real property for section 1031 purposes. See proposed § 1.1031(a)–3(a)(1). The intent of the Treasury Department and the IRS in proposing a rule that expressly applied State or local law in this manner was to provide a definition of real property for purposes of section 1031 ‘‘in a manner consistent with the scope described by Congress in the Conference Report.’’ See the preamble to the proposed regulations at 85 FR 35836.

2. Consideration of Comments and Revision of ‘‘Real Property’’ Definition

Commenters generally critiqued the apparent scope of the application of State and local law in the proposed regulations for purposes of defining real property. These commenters contended that, prior to enactment of the TCJA, State and local law classification of a property often was the determining factor in characterizing property as real or personal under section 1031. With regard to the Conference Report Example, the commenters asserted that the reference to ‘‘shares in a mutual ditch, reservoir, or irrigation company’’ merely constituted a set of examples that Congress provided to broadly indicate that real property eligible for like-kind treatment under law prior to enactment of the TCJA will continue to be eligible following the TCJA’s amendment to section 1031. Consequently, the commenters recommended that the final regulations conform to that intent by expanding the rules to rely significantly, or wholly, on State-law classifications for all assets, rather than limiting such reliance to shares in a mutual ditch, reservoir, or irrigation company. Additionally, commenters suggested that the final regulations should include multiple examples of instances in which taxpayers may rely on State or local law for purposes of classifying property as real or personal.

In light of these comments, the Treasury Department and the IRS have reconsidered the degree to which State or local law determinations of real property should be controlling for defining real property for section 1031 purposes. As a result of that reconsideration, the final regulations provide generally that property is real property for purposes of section 1031 if, on the date it is transferred in an exchange, that property is classified as real property under the law of the State or local jurisdiction in which that property is located (State and local law test). The State and local law test applies to both tangible and intangible property classifications.

However, consistent with Congressional intent that ‘‘real property eligible for like-kind exchange treatment’’ under the law in effect prior to enactment of the TCJA will continue to be eligible for like-kind exchange treatment after enactment of the TCJA, property ineligible for like-kind exchange treatment prior to enactment of the TCJA remains ineligible, including real property that was excluded from the application of section 1031. See Conference Report at 396, fn. 726. Prior to amendment by the TCJA, former section 1031(a)(2) explicitly excluded certain assets from the application of section 1031. Accordingly, the final regulations exclude from the definition of real property the intangible assets listed in section 1031(a)(2) prior to its amendment by the TCJA, regardless of the classification of the property under State or local law, because such property never was ‘‘real property *eligible* for like-kind exchange treatment’’ prior to enactment of the TCJA. Conference Report at 396, fn. 726 (emphasis added).

In summary, under the final regulations, property is classified as real property for purposes of section 1031 if the property is (i) so classified under the State and local law test, subject to certain exceptions, (ii) specifically listed as real property in the final regulations, or (iii) considered real property based on all the facts and circumstances under the various factors provided in the final regulations. A determination that property is personal property under State or local law does not preclude the conclusion that property is real property as specifically listed in § 1.1031(a)-3(a)(2)(ii) or (a)(2)(iii)(B) or under the factors listed in § 1.1031(a)-3(a)(2)(ii)(C) or (a)(2)(iii)(B).

3. Chief Counsel Advice (CCA) 201238027

Multiple commenters who objected to the scope of State and local law determinations under the proposed regulations also asserted that the approach in the proposed regulations replicated the analysis in CCA 201238027 (April 17, 2012), particularly with regard to one of the fact patterns addressed therein regarding a steam turbine (Case 3). In Case 3, the Chief Counsel Advice disregarded State law that characterized the steam turbine as real property and held that the steam turbine was not of like kind to land because it did not have the same nature or character as land. Commenters objected to this conclusion, contending that the State law classification of the steam turbine as real property should be respected and, based on that classification, the steam turbine and the undeveloped land should be considered like-kind property.

These final regulations do not address whether exchanged properties are of like kind to one another. As a consequence of expressly including the State and local law test in the final regulations, the final regulations do not adopt the reasoning of CCA 201238027 to the extent it suggests that State or local law is disregarded in determining whether property is real property under section 1031.

4. Additional Comments Regarding the Application of State and Local Law

In connection with the State and local law test under the final regulations, the Treasury Department and the IRS have considered numerous additional comments. For instance, one commenter recommended that any asset determined to be essentially the same as an asset classified as a real property for purposes of section 1031 also should automatically be treated as real property for purposes of section 1031. For example, if one asset (Property A) is classified as real property under the State or local law of State X, an asset located in a different jurisdiction (Property B) that is essentially the same as Property A also should be classified as real property for section 1031 purposes, irrespective of whether Property B is classified as real property under (i) the law of the State or local jurisdiction in which Property B is located or (ii) the real property definition and factors under the proposed regulations.

The final regulations do not adopt this suggestion. First, the Treasury Department and the IRS have determined that the ''essentially the same'' standard recommended by the commenter would be difficult for taxpayers to apply and the IRS to administer with certainty. In addition, the analysis advocated by the commenter is conceptually similar to the analysis applied by CCA 201238027, which, based on several other comments, the Treasury Department and the IRS have determined to be inconsistent with the State and local law test provided in the final regulations.

A commenter also requested that the final regulations classify as real property all property that was treated as real property for section 1031 purposes at any time between May 22, 2008, and the effective date of the TCJA. May 22, 2008, is the effective date of former section 1031(i), which treats shares in certain mutual ditch companies as real property for section 1031 purposes. The commenter reasoned that, because the treatment of mutual ditch company shares has been preserved by the proposed regulations following the enactment of the TCJA, all property classified as real property as of May 22, 2008, also should be classified as real property under the final regulations.

> The final regulations do not adopt the commenter's suggestion. The Treasury Department and the IRS have determined that a rule that fixes property classifications under State or local laws as of a date certain would add complexity as the post-enactment period of the TCJA continues to lengthen. Given that the final regulations have broadened the applicability of State and local real property classification for purposes of section 1031 qualification, the Treasury Department and the IRS have determined that the perpetually increasing complexity of such a rule would significantly outweigh any potential benefits of the commenter's suggestion.

Personal property sometimes may tag along if merely incidental to the sale of real property. Reg. § 1.1031(k)-1(c)(5), "Incidental property disregarded," provides

> (i) Solely for purposes of applying this paragraph (c), property that is incidental to a larger item of property is not treated as property that is separate from the larger item of property. Property is incidental to a larger item of property if-
>
> (A) In standard commercial transactions, the property is typically transferred together with the larger item of property, and
>
> (B) The aggregate fair market value of all of the incidental property does not exceed 15 percent of the aggregate fair market value of the larger item of property.
>
> (ii) This paragraph (c)(5) may be illustrated by the following examples.
>
> *Example (1)*. For purposes of paragraph (c) of this section, a spare tire and tool kit will not be treated as separate property from a truck with a fair market value of $10,000, if the aggregate fair market value of the spare tire and tool kit does not exceed $1,500. For purposes of the 3-property rule, the truck, spare tire, and tool kit are treated as 1 property. Moreover, for purposes of paragraph (c)(3) of this section (relating to the description of replacement property), the truck, spare tire, and tool kit are all considered to be unambiguously described if the make, model, and year of the truck are specified, even if no reference is made to the spare tire and tool kit.
>
> *Example (2)*. For purposes of paragraph (c) of this section, furniture, laundry machines, and other miscellaneous items of personal property will not be treated as separate property from an apartment building with a fair market value of $1,000,000, if the aggregate fair market value of the furniture, laundry machines, and other personal property does not exceed $150,000. For purposes of the 3-property rule, the apartment building, furniture, laundry machines, and other personal property are treated as 1 property. Moreover, for purposes of paragraph (c)(3) of this section (relating to the description of replacement property), the apartment building, furniture, laundry machines, and other personal property are all considered to be unambiguously described if the legal description, street address, or distinguishable name of the apartment building is specified, even if no reference is made to the furniture, laundry machines, and other personal property.

For additional discussion, see Cunningham and Louis Weller, "Intangible Interests in Real Property Under IRC 1031: An Examination of the Like-Kind Standard Applied to Intangible Real Property After Issuance of Treas. Reg. 1.1031(a)-3," Journal of Taxation (Jan. 2023).

Letter Ruling 202335002 involved the following facts:

> Taxpayer is a State Z limited partnership. Taxpayer holds real property directly in its own name and through a series of single-member limited liability companies that are disregarded entities for federal income tax purposes. Taxpayer uses the accrual method of accounting and a calendar taxable year.
>
> Taxpayer owns Property 1 located in City A, State Z, through one of its disregarded entities, DE 1. Taxpayer is the sole member of DE 1. Property 1 has been held for productive use in a trade or business or for investment within the meaning of § 1031 of the Code. Taxpayer intends to sell Property 1 and acquire TDRs as part of a like-kind exchange structured as a reverse exchange. Taxpayer owns Property 2 located in City B, State Z, through one of its disregarded entities, DE 2. Taxpayer is the sole member of DE 2.
>
> As part of its intended reverse exchange, DE 2 loaned funds to an exchange accommodation titleholder (EAT) to purchase the TDRs. The initial closing for the TDR acquisition occurred on Date 1, with the EAT currently holding title to the purchased TDRs. To complete the reverse exchange, DE 1 will sell Property 1 through a qualified intermediary (QI), and the QI will transfer the sale proceeds to the EAT. The TDRs will be transferred directly from the EAT to DE 2. The EAT will use the proceeds it receives to pay back the loan from DE 2. Taxpayer plans to use the TDRs to enhance Taxpayer's development project at Property 2 by increasing the floor area to an amount greater than would otherwise be permitted by zoning regulations.
>
> The TDRs originate from an MOU between City B and District, dated Date 4. ("TDR MOU"). District recorded a Covenant Restricting Use of Land and Notice of Development Restrictions dated Date 2 with the County on Date 3. The TDR MOU establishes a mechanism to accommodate the District's acquisition of three properties located in City B for development of a facility, public park, and related uses. The District will fund the acquisition and development of the property in part by the sale of transferable unutilized development rights related to the property to third party purchasers ("TDR Participants"). The TDR Participants will seek approval from City B to apply such transferred development rights to designated receiving sites to allow for additional floor area than would otherwise be permitted by zoning regulations. TDRs become permanent in the hands of the TDR Participants when a Certificate of Transfer of Development Rights is recorded.
>
> Taxpayer's pre-application was approved by the City B Council on Date 5; the City B has approved the site of the Property 2 project as eligible for the use of TDRs. The Property 2 project consists of an office building, for which Taxpayer anticipates using X TDR units from District. The agreed upon purchase price for the X TDR units is $Y. The Property 2 project, once constructed, will be held for the production of rental income by Taxpayer or by a disregarded entity owned solely by Taxpayer.
>
> Taxpayer has represented that that transferable development rights are considered an interest in real property under State Z law and has cited statutes and case law supporting its representation.

Letter Ruling 202335002 reasoned and ruled:

> Section 1031(a)(1) provides that no gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment.
>
> Treas. Reg. § 1.1031(a)-1(b) provides, in part, that the words "like kind" refer to the nature or character of the property and not to its grade or quality. One kind or class of property may not be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Properties to be exchanged tax free under § 1031 must be of the same kind or class.
>
> Treas. Reg. § 1.1031(a)-1(c) sets forth examples of properties that will be considered like kind. The relevant examples pertain to real estate and provide that a taxpayer who is not a dealer in real estate may exchange city real estate for a ranch or farm, a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate.
>
> Treas. Reg. § 1.1031(a)-3 defines the term "real property" for purposes of § 1031 and the regulations under § 1031. Under § 1.1031(a)-3(a)(1), real property includes land and improvements to land and, under § 1.1031(a)-3(a)(5), an intangible interest in real property of a type described in § 1.1031(a)-3(a)(1) is real property for purposes of § 1031. Section 1.1031(a)-3(a)(5)(i) further provides that intangible assets that are real property for purposes of § 1031 include land development rights. Finally, § 1.1031(a)-3(a)(6) provides that, with certain exceptions not relevant to Taxpayer's facts, property that is real property under State or local law is real property for purposes of § 1031.
>
> In this case, Taxpayer proposes to acquire TDRs as its replacement property and to use such rights to enhance Property 2, which Taxpayer owned prior to its acquisition of the rights, a structure similar to the one addressed in Rev. Rul. 68-394, 1968-2 C.B. 338. In Rev. Rul. 68-394, land held by a taxpayer for investment was condemned for a state freeway. The taxpayer owned adjacent land that he had leased to a second party to use and develop as a mobile trailer park site. For purposes of replacing the condemned property, the taxpayer used part of the condemnation proceeds to purchase, in an arm's length transaction, the outstanding leasehold, with 45 years remaining, on the adjacent land. After acquisition of the leasehold, the taxpayer used the land as a mobile trailer park site.
>
> Although Rev. Rul. 68-394 dealt with deferring gain under § 1033, § 1033 may apply when a taxpayer replaces condemned property with property that is of like kind, within the meaning of § 1031, to the condemned property. See § 1033(g). Since, under the § 1031 regulations, the exchange of a fee interest in real property for a leasehold interest in real property with 30 years or more to run qualifies as a like kind exchange, the ruling holds that the acquisition of a 30 year or more leasehold interest following the condemnation of unimproved real estate would likewise qualify as replacement property of like kind, even though the leasehold interest was on property already owned by the taxpayer. Consequently, in the present case, the TDRs may qualify as of like kind to Property 1 for purposes of § 1031, notwithstanding that Taxpayer intends to use the TDRs on land owned by Taxpayer prior to Taxpayer's acquisition of the TDRs. Compare

> Rev. Rul. 67-255, 1967-2 C.B. 270, holding that a taxpayer's construction on land already owned by the taxpayer did not constitute a like-kind replacement.
>
> As discussed above, Treas. Reg. §§ 1.1031(a)-3(a)(5)(i) provides that land development rights are real property for purposes of § 1031. Moreover, Taxpayer represents that transferable development rights such as TDRs are real property under the laws of State Z and that the TDRs Taxpayer intends to acquire as replacement property become permanent in the hands of the purchaser when a Certificate of Transfer of Development Rights is recorded. Therefore, based on the above authorities and the facts and representations that were submitted, we rule that the TDRs are, within the meaning of § 1.1031(a)-1(b), of like kind to Property 1.

II.G.16.b. Pre-2018 Code § 1031

Code § 1031(a)(1) provides:

> No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

Code § 1031(a)(2) excludes the following property from that favorable treatment:

> (A) stock in trade or other property held primarily for sale,
>
> (B) stocks, bonds, or notes,
>
> (C) other securities or evidences of indebtedness or interest,
>
> (D) interests in a partnership,
>
> (E) certificates of trust or beneficial interests, or
>
> (F) choses in action.

Personal property is "of like kind" as follows:

- Depreciable tangible personal property is exchanged for property of a like kind or like class.[1615] "Like class" means either[1616] within the same General Asset Class[1617] or within the same Product Class.[1618]

[1615] Reg. § 1.1031(a)-2(b)(1).
[1616] Reg. § 1.1031(a)-2(b)(1).
[1617] Reg. § 1.1031(a)-2(b)(2) describes when and how a general asset class consists of depreciable tangible personal property described in certain asset classes in Rev. Proc. 87-56.
[1618] Reg. § 1.1031(a)-2(b)(3) describes when and how a product class consists of depreciable tangible personal property that is described in the North American Industry Classification System (NAICS), set forth in Executive Office of the President, Office of Management and Budget, North American Industry Classification System, United States, 2002 (NAICS Manual), as periodically updated.

- Whether intangible personal property is of a like kind to other intangible personal property generally depends on:[1619]
    - the nature or character of the rights involved (for example, patent or a copyright), and
    - the nature or character of the underlying property to which the intangible personal property relates.

As to the latter:

- Goodwill or going concern value of a business is not of a like kind to the goodwill or going concern value of another business.[1620]
- A copyright on a novel is of like kind with a copyright on a different novel, but a copyright on a novel is not of like kind with a copyright on a song.[1621]
- Manufacturing and distribution are two distinct business activities and the rights to each would not, absent some close connection between these activities, be of a like kind; however, the close economic and unique historical connection between the manufacturing and the distribution of a particular product would make them of like kind as two aspects of a single business activity if the rights to manufacturing and distribution are contained within the same integrated agreement and any differences among the product that are relevant to manufacturing or distribution are differences in grade or quality, and not differences in nature or character.[1622] Similarly, distribution contracts were of like kind when distributed in a substantially similar manner to a largely common set of customers who resell them to end customers who, in turn, use each of the products for a substantially similar purpose, because any differences among the product relevant to distribution were differences in grade or quality, and not differences in nature or character, despite having different brand names, appearances, ingredients, packaging, manufacturing processes, and marketing strategies.[1623]

A fee title may be exchanged for a 30-year leasehold.[1624] The tenant's renewal options count toward the 30 years.[1625] Regarding a lease with less than 30 years remaining, the transfer of a

[1619] Reg. § 1.1031(a)-2(c)(1).
[1620] Reg. § 1.1031(a)-2(c)(2).
[1621] Reg. § 1.1031(a)-2(c)(3).
[1622] Letter Ruling 201531009.
[1623] Letter Ruling 201532021.
[1624] Reg. § 1.1031(a)-1(c), "Examples of exchanges of property of a 'like kind,'" provides {indenting added]:

> No gain or loss is recognized if
> (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or
> (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or
> (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

Letter Ruling 8453034 is an example of a fee interest for leasehold interests involving motels.
[1625] Rev. Rul. 78-72, reasoning:

lease and leasehold improvements in a building in return for the leaseback of a portion of the building and money was a like-kind exchange.[1626] A leasehold interest in real property with 21 years remaining was not like-kind to fee interests in real property.[1627]

> In *Century Electric Co. v. Commissioner*, 15 T.C. 581, 591 (1950), *aff'd* 192 F.2d 155 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952), the Tax Court of the United States, indicated that, for like kind exchange purposes, optional renewal periods are included in determining the length of a lease.
>
> In *R & J Furniture Co. v. Commissioner*, 20 T.C. 857, 865 (1953), *acq.*, 1954-1 C.B. 6, which involved a lease with an initial term of 5 years and ten renewal options of 5 years each, the Tax Court of the United States stated that the lease was property of a like kind and the equivalent of a fee interest in real estate under the regulations since the taxpayers had the right to possess, occupy, and use the leased property for a total of 55 years.
>
> In the instant situation, A's lease runs for an initial period of 25 years plus three optional 10-year renewal periods under the same rental terms. Thus, A has the right to possess, occupy, and use the leased property for a total of 55 years.

[1626] Rev. Rul. 76-301 reasoned:

> An exchange is considered to occur for the purposes of section 1031 of the Code if the transfers of the like kind property are reciprocal. Rev. Rul. 61-119, 1961-1 C.B. 395. Moreover, the reciprocal transfer of interests in like kind property is an exchange for the purposes of section 1031 even though the interests are in the same property. See *Century Electric Co. v. Commissioner*, 192 F.2d 155 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952), where a loss sustained on the sale of business property by a taxpayer was disallowed where it immediately leased back the same property under a long-term lease

The ruling concluded:

> … the assignment of the leasehold interest in the building in the instant case in return for an identical leasehold interest in a portion of the building qualifies as an exchange of property for like kind property and money subject to section 1031(c) of the Code.
>
> The fact that the transaction results in the disposition of the portion of the property used in one of the taxpayer's two businesses is not significant for the purposes of section 1031 of the Code. Section 1.1031(a)-1(a) of the regulations. Rather, the significant factor for the purposes of section 1031 is that the taxpayer's investment is still tied up in the same kind of property. See H. R. Rep. No. 704, 73d Cong., 2d Sess. 13 (1934), 1939-1 (Part 2) C.B. 554, 564.
>
> Accordingly, the loss of 200x dollars realized by X in the exchange of X's leasehold interest and improvements in the building in return for an identical leasehold interest in a portion of the building and money may not be recognized under the provisions of section 1031(a) and (c) of the Code.

[1627] *VIP's Industries, Inc. v. Commissioner*, T.C. Memo. 2013-157, explained:

> Petitioner contends that its leasehold interest in the Eugene property was of like kind to the fee interests in the Bridgeport and Salem properties because (1) section 1.1031(a)-1(c), Income Tax Regs., does not exclude all exchanges of leasehold interests in real property with terms of less than 30 years for fee interests in real property from receiving like-kind exchange treatment but rather provides a safe harbor for exchanges of leaseholds with terms of 30 years or more for fee interests in real property; and (2) its leasehold interest in the Eugene property was of sufficient length to be considered of like kind to the fee interests in the Bridgeport and Salem properties.
>
> Petitioner exchanged its leasehold interest in the Eugene property with a remaining term of 21 years and 4 months for fee interests in the Bridgeport and Salem properties. We previously have held that leasehold interests with similar or even longer terms than the one at issue here are not equivalent to fee interests. In *May Dep't Stores Co. v. Commissioner*, 16 T.C. at 556, we held that a 20-year leasehold was not equivalent to a fee interest. In *Standard Envelope Mfg. Co. v. Commissioner*, 15 T.C. at 48, we held that a leasehold interest with a term of 1 year and an option to renew for a term of 24 years was not equivalent to a fee interest, and we have held that options to renew are included in determining whether a leasehold interest is

Code § 1031 includes timing requirements. Amazingly, the buyer may cause a qualified intermediary (QI) to buy the replacement property, lease it from the QI, customize it for one's

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equivalent to a fee interest. See *Peabody Natural Res. Co. v. Commissioner*, 126 T.C. at 275; *Century Elec. Co. v. Commissioner*, 15 T.C. 581, 591-592 (1950), *aff'd*, 192 F.2d 155 (8th Cir. 1951).[5]

[5] Petitioner contends that *May Dep't Stores Co. v. Commissioner*, 16 T.C. 547 (1951), and *Standard Envelope Mfg. Co. v. Commissioner*, 15 T.C. 41 (1950), are distinguishable because they concern sale-leaseback transactions that may have been designed to achieve improper tax avoidance. However, these cases cannot be explained as targeting improper tax avoidance because they allowed, rather than disallowed, the respective taxpayers' claimed losses. Petitioner further contends that *May Dep't Stores* and *Standard Envelope* are distinguishable because the respective taxpayers intended for sec. 1031 not to apply and for their losses to be recognized. However, this contention also fails because the "[t]he rules of *** [sec.] 1031 apply automatically; they are not elective." *Koch v. Commissioner*, 71 T.C. 54, 64 (1978).

Petitioner's leasehold interest in the Eugene property with a term of 21 years and 4 months remaining is closer in nature to the leasehold interests that we characterized as not equivalent to a fee interest, see *May Dep't Stores Co. v. Commissioner*, 16 T.C. at 556; *Standard Envelope Mfg. Co. v. Commissioner*, 15 T.C. at 48, than to the 30-year leasehold interest that section 1.1031(a)-1(c), Income Tax Regs., recognizes as the equivalent of a fee interest. Applying our precedent, we therefore conclude that petitioner's leasehold interest was not of like kind to a fee interest under section 1031.[6]

[6] In reaching this conclusion we note that a short-term real property interest is not of like kind with a long-term real property interest irrespective of whether the short-term real property interest is a real property interest under State law. See *Peabody Natural Res. Co. v. Commissioner*, 126 T.C. 261, 275 n.11 (2006) (citing *Smalley v. Commissioner*, 116 T.C. 450, 464 n.11 (2001)).

Because we decide this case in accordance with our existing precedent, we need not decide whether section 1.1031(a)-1(c), Income Tax Regs., mechanically excludes all exchanges of leaseholds with terms of less than 30 years for fee interests from receiving like-kind exchange treatment. Compare *Peabody Natural Res. Co. v. Commissioner*, 126 T.C. at 276 (referring to "the 30-year safe harbor provisions of section 1.1031(a)-1(c), Income Tax Regs."), with *Capri, Inc. v. Commissioner*, 65 T.C. at 181 ("section 1.1031(a)-1(c), Income Tax Regs., requires a lease of real property to be 30 years in duration to constitute an interest in real property equivalent to a fee interest"), and *Standard Envelope Mfg. Co. v. Commissioner*, 15 T.C. at 48 ("The lease was for a term of less than 30 years, and, therefore, was not the equivalent of a fee under the terms of *** [the predecessor of section 1.1031(a)-1(c), Income Tax Regs.].").

own use, then sell one's existing property in a like-kind exchange for the replacement property,[1628] although the IRS does not agree.[1629]

[1628] *Bartell v. Commissioner*, 147 TC 140 (2016), the official syllabus of which stated:

In 1999, BD, a drugstore chain, entered into an agreement to purchase property L from a third party. In anticipation of structuring an exchange transaction under I.R.C. sec. 1031 to facilitate acquisition of L, BD later assigned its rights in the purchase agreement to third-party exchange facilitator EPC and entered a further agreement with EPC. That second agreement provided for EPC to purchase L and for BD to have a right to acquire L from EPC for a stated period and price. EPC so purchased L on August 1, 2000, with bank financing guaranteed by BD, acquiring title to L at that time. BD then managed the construction of a drugstore on L using proceeds from the aforementioned financing and, upon substantial completion of the construction in June 2001, leased the store from EPC from that time until title to L was transferred from EPC to BD on December 31, 2001.

In late 2001, BD contracted to sell its existing property E to a fourth party. BD next entered an exchange agreement with intermediary SS and assigned to SS its rights under the sale agreement and under the earlier agreement with EPC. SS sold E, applied the proceeds of that sale to the acquisition of L, and had the title to L transferred to BD on December 31, 2001.

Held: BD's disposition of E and acquisition of L in 2001 qualifies for nonrecognition treatment pursuant to I.R.C. sec. 1031 as a like-kind exchange, as EPC is treated as the owner of L during the period it held title to the property. *Alderson v. Commissioner*, 317 F.2d 790 (9th Cir. 1963), *rev'g* 38 T.C. 215 (1962), and *Biggs v. Commissioner*, 69 T.C. 905 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1980), followed.

[1629] Action on Decision 2017-06 nonacquiesced to *Bartell*, fn 1628:

Taxpayer, intending to engage in a like-kind exchange, entered into an agreement with Exchange Facilitator (EF) to purchase Replacement Property (RP) from Seller. EF acquired title to RP on August 1, 2000, after which Taxpayer constructed a drug store on RP and, in June of 2001, began leasing RP from EF. In December of 2001, Qualified Intermediary (QI) acquired Taxpayer's business property (RQ), sold RQ to Buyer, and used the sale proceeds to acquire RP from EF and transfer it to Taxpayer. EF held title to RP for 17 months before transferring it to QI and then to Taxpayer.

The Service asserted that Taxpayer acquired RP in August of 2000, not December of 2001, arguing that Taxpayer, not EF, acquired the benefits and burdens of ownership of RP from Seller. See *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981) (providing principles for a benefits and burdens analysis). Thus, the transaction was not a like-kind exchange; instead, Taxpayer sold RQ in a taxable sale in 2001.

The focus of the Tax Court's opinion was on case law decided before the issuance of Treas. Reg. § 1.1031(k)-1 (the deferred exchange regulations) and, in particular, on the cases that address a taxpayer's use of an accommodating party to facilitate an intended like-kind exchange. The court concluded that *Alderson v. Commissioner*, 317 F.2d 790 (9th Cir. 1963), and *Biggs v. Commissioner*, 69 T.C. 905 (1978), *aff'd* 632 F.2d 1171 (5th Cir.] 1980), establish the principle that a third-party exchange facilitator "need not assume the benefits and burdens of ownership of the replacement property in order to be treated as its owner for section 1031 purposes before the exchange." *Bartell*, 147 T.C. at 64. Consequently, the court held that the transaction was a like-kind exchange even though EF did not have the benefits and burdens of ownership of RP and held title to RP for 17 months while Taxpayer oversaw construction on RP.

Section 1031 provides that no gain or loss is recognized on an exchange of certain like-kind business or investment property. Section 1031(a)(3) allows deferred like-kind exchanges, which are exchanges in which replacement property is acquired after, but within 180 days of, the taxpayer's transfer of the relinquished property. Section 1.1031(k)-1 allows taxpayers to use qualified intermediaries and other arrangements to facilitate their deferred like-kind exchanges. Neither § 1031 nor the regulations address exchanges of the type engaged in by the taxpayers in

The "held for productive use in a trade or business or for investment" requirement is based on facts and circumstances and encourages taxpayers to hold property for long enough before and after the exchange to establish that purpose. If over 50% of the use of property is for personal purposes, the IRS asserts that the property was not held for productive use in a trade or business of for investment.[1630] Personal use of property can disqualify it as being held for

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> Bartell, in which the replacement property is acquired and "parked" with an accommodating party before the taxpayer's transfer of the relinquished property (a reverse exchange).
>
> Rev. Proc. 2000-37, 2000-2 C.B. 308, modified by Rev. Proc. 2004-51, 2004-2 C.B. 294, provides a safe harbor for taxpayers seeking to park relinquished property or replacement property with an exchange accommodation titleholder (EAT) in anticipation of a like-kind exchange. If the safe harbor requirements are met, including that the EAT cannot hold the parked property for more than 180 days, the EAT (and not the exchanging taxpayer) is considered the owner of the property held by the EAT, regardless of who has the benefits and burdens of ownership under a *Grodt & McKay* analysis. Section 3.04 of Rev. Proc. \ 2000-37 provides that, in transactions in which the requirements of the revenue procedure are not satisfied, "the determination of whether the taxpayer or the exchange accommodation titleholder is the owner of the property...., and the proper treatment of any transactions entered into by or between the parties, will be made without regard to the provisions of this revenue procedure."
>
> A taxpayer meets the requirements of § 1031 only if the taxpayer engages in an exchange of property. Thus, unless the requirements of Rev. Proc. 2000-37 are met, a taxpayer who acquires the benefits and burdens of ownership of Property 1 on Date 1 and sells Property 2 on Date 2 has not engaged in an exchange as required by § 1031. See *DeCleene v. Commissioner*, 115 T.C. 457 (2000).
>
> The case law cited in *Bartell* involves transactions that were consummated prior to the issuance of the deferred exchange regulations and Rev. Proc. 2000-37. For transactions outside the scope of the deferred exchange regulations, the Service does not follow the court opinions that take the view that for § 1031 purposes an exchange facilitator may be treated as the owner of replacement property regardless of whether it has the benefits and burdens of ownership. Similarly, in determining whether a reverse exchange outside the scope of Rev. Proc. 2000-37 meets the requirements of § 1031, the Service will not follow the principle in the court opinions that an exchange facilitator may be treated as the owner of property regardless of whether it possesses the benefits and burdens of ownership. Under Rev. Proc. 2000-37, taxpayers are permitted to use an exchange facilitator (called an accommodating party) and meet the exchange requirements of § 1031 even though, using the principles set out in *Grodt & McKay Realty, Inc.*, the taxpayer acquires the benefits and burdens of ownership of the replacement property up to 180 days before the exchange intended to qualify as a tax-deferred like-kind exchange. Taxpayers that use accommodating parties outside the scope of Rev. Proc. 2000-37 have not engaged in an exchange if the taxpayer, rather than the accommodating party, acquires the benefits and burdens of ownership of the replacement property before the taxpayer transfers the relinquished property. The Service will not follow the Tax Court's opinion in *Bartell* to the extent the opinion provides otherwise.

[1630] CCA 201605017, further stating that its analysis:

> should not be read to imply that a taxpayer whose personal use of property is less than 50 percent has met the "held for" requirement in § 1031(a) for that property. Instead, close scrutiny should be used for any property the taxpayer uses for personal purposes.

For aircraft, the CCA said that the examiner should consider:

> (1) measurement of business/investment use versus personal use based on flight hours, not just flights; (2) percentages of business/investment use versus personal for flights and flight hours for the year before the year of the exchange; and (3) which flights and flight hours were determined to be repositioning flights and the nature of the flight following the repositioning flight.

investment.[1631] Rev. Proc. 2008-16 provides a safe harbor for limited personal use[1632] referring to the vacation home rules.[1633] The vacation home rules describe personal use of a dwelling

[1631] In denying Code § 1031 treatment, *Starker v. U.S.*, 602 F.2d 1341 held:

> It has long been the rule that use of property solely as a personal residence is antithetical to its being held for investment. Losses on the sale or exchange of such property cannot be deducted for this reason, despite the general rule that losses from transactions involving trade or investment properties are deductible. Treas. Regs. § 1.165.9(a); see *Shields v. Commissioner*, 1978-120 T.C.M. (CCH) Dec. 35,064(M). A similar rule must obtain in construing the term "held for investment" in section 1031. 3 J. Mertens, *Law of Federal Income Taxation* § 20.26 (1972); see *Boesel v. Commissioner*, 65 TC 378, 389 (1975); Rev. Rul. 59-229, 1959-2 Cum. Bull. 180.

Moore v. Commissioner, T.C. Memo. 2007-134, held:

> As a preliminary matter, we accept as a fact that petitioners hoped that both the Clark Hill and Lake Lanier properties would appreciate. However, the mere hope or expectation that property may be sold at a gain cannot establish an investment intent if the taxpayer uses the property as a residence. See *Jasionowski v. Commissioner*, 66 T.C. 312, 323 (1976) ("if the anticipation of eventually selling the house at a profit were in itself sufficient to establish that the property was held with a profit-making intent, rare indeed would be the homeowner who purchased a home several years ago who could not make the same claim"). Moreover, a taxpayer cannot escape the residential status of property merely by moving out.

[1632] Section 4.02(1) provides the following safe harbor for the property to be relinquished:

> (a) The dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange (the "qualifying use period"); and
>
> (b) Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange,
>
> (i) The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and
>
> (ii) The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.
>
> For this purpose, the first 12-month period immediately preceding the exchange ends on the day before the exchange takes place (and begins 12 months prior to that day) and the second 12-month period ends on the day before the first 12-month period begins (and begins 12 months prior to that day).

Section 4.04 provides:

> Fair rental. For purposes of this revenue procedure, whether a dwelling unit is rented at a fair rental is determined based on all of the facts and circumstances that exist when the rental agreement is entered into. All rights and obligations of the parties to the rental agreement are taken into account.

[1633] Section 4.03 provides:

> *Personal use*. For purposes of this revenue procedure, personal use of a dwelling unit occurs on any day on which a taxpayer is deemed to have used the dwelling unit for personal purposes under § 280A(d)(2) (taking into account § 280A(d)(3) but not § 280A(d)(4)).

unit,[1634] rental to a family member,[1635] and rental of a principal residence (the latter which does not apply for this safe harbor).[1636] The exception for rental to a family member requires that the

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[1634] Code § 280A(d)(2) provides:

Personal use of unit. For purposes of this section, the taxpayer shall be deemed to have used a dwelling unit for personal purposes for a day if, for any part of such day, the unit is used—

(A) for personal purposes by the taxpayer or any other person who has an interest in such unit, or by any member of the family (as defined in section 267(c)(4)) of the taxpayer or such other person;

(B) by any individual who uses the unit under an arrangement which enables the taxpayer to use some other dwelling unit (whether or not a rental is charged for the use of such other unit); or

(C) by any individual (other than an employee with respect to whose use section 119 applies), unless for such day the dwelling unit is rented for a rental which, under the facts and circumstances, is fair rental.

The Secretary shall prescribe regulations with respect to the circumstances under which use of the unit for repairs and annual maintenance will not constitute personal use under this paragraph, except that if the taxpayer is engaged in repair and maintenance on a substantially full time basis for any day, such authority shall not allow the Secretary to treat a dwelling unit as being used for personal use by the taxpayer on such day merely because other individuals who are on the premises on such day are not so engaged.

Code § 267(c)(4) provides:

The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants….

[1635] Code § 280A(d)(3) provides:

Rental to family member, etc., for use as *principal residence*.

(A) *In general*. A taxpayer shall not be treated as using a dwelling unit for personal purposes by reason of a rental arrangement for any period if for such period such dwelling unit is rented, at a fair rental, to any person for use as such person's principal residence.

(B) *Special rules for rental to person having interest in unit*.

(i) *Rental must be pursuant to shared equity financing agreement*. Subparagraph (A) shall apply to a rental to a person who has an interest in the dwelling unit only if such rental is pursuant to a shared equity financing agreement.

(ii) *Determination of fair rental*. In the case of a rental pursuant to a shared equity financing agreement, fair rental shall be determined as of the time the agreement is entered into and by taking into account the occupant's qualified ownership interest.

(C) *Shared equity financing agreement*. For purposes of this paragraph, the term "shared equity financing agreement" means an agreement under which—

(i) 2 or more persons acquire qualified ownership interests in a dwelling unit, and

(ii) the person (or persons) holding 1 or more of such interests—

(I) is entitled to occupy the dwelling unit for use as a principal residence, and

(II) is required to pay rent to 1 or more other persons holding qualified ownership interests in the dwelling unit.

(D) *Qualified ownership interest*. For purposes of this paragraph, the term "qualified ownership interest" means an undivided interest for more than 50 years in the entire dwelling unit and appurtenant land being acquired in the transaction to which the shared equity financing agreement relates.

[1636] Code § 280A(d)(4), titled, "Rental of principal residence," provides:

(A) For purposes of applying subsection (c)(5) to deductions allocable to a qualified rental period, a taxpayer shall not be considered to have used a dwelling unit for personal purposes for any day during the taxable year which occurs before or after a qualified rental period described in subparagraph (B)(i), or before a qualified rental period described in subparagraph (B)(ii), if with respect to such day such unit constitutes the principal residence (within the meaning of section 121) of the taxpayer.

family member use the dwelling unit as the tenant's "principal residence."[1637] Code § 1031 may also be paired with the exercise of an option to buy real estate.[1638]

If property is a tenancy-in-common, check whether it is taxed as a partnership. If property is in a partnership and partners have different objectives, consider unwinding it well in advance of a sale. See part II.C.10 Whether Tenancy-in-Common or other Arrangement Constitutes a Partnership, especially fn. 578.

> (B) Qualified rental period. For purposes of subparagraph (A), the term "qualified rental period" means a consecutive period of—
>
> (i) 12 or more months which begins or ends in such taxable year, or
>
> (ii) less than 12 months which begins in such taxable year and at the end of which such dwelling unit is sold or exchanged, and
>
> for which such unit is rented, or is held for rental, at a fair rental.

[1637] *Kotowicz v. Commissioner*, T.C. Memo. 1991-563, declining to vary from the literal language cited in fn. 1635, even though family member paid fair rental. If the family member uses it as his or her principal residence and the family member works on the residence, the work may count as rent. *Adams v. Commissioner*, T.C. Memo. 2013-7, describing the family member's work:

> Bill and his family began working on the Eureka house in July 2004. They worked an aggregate of 60 hours per week on the property during July, August, and September 2004. They repaired mold damage, replaced broken doors, fixed holes in walls, repaired rotten subflooring, prepared floors for new carpet installation, scrubbed and repaired surfaces for painting, painted the interior of the house, renovated the kitchen, replumbed the kitchen and laundry room for gas, replaced electrical fixtures and appliances, and performed landscaping. They exterminated rats and other pests and, on one occasion, even chased away a bear. Their efforts made the house livable. For July, August, and September 2004, Adams accepted the services performed by Bill and his family in lieu of monetary rent. (Adams did not reimburse them for the labor and out-of-pocket costs of the home improvements.) The three months of services were worth $3,600.

[1638] Rev. Rul. 84-121 involved the following situation:

> A, an individual, owned a parcel of unencumbered real property that is being used in A's trade or business and that had an adjusted basis of 50x dollars. For 5x dollars, A granted to B an option to purchase A's real property for a price of 100x dollars. The option allowed B to pay the option price in cash or to transfer real property equal in value to the option price. At the time the option was granted, A's real property had a fair market value of 100x dollars. B exercised the option before the expiration of the option period, but instead of paying A 100x dollars in cash, B purchased for 100x dollars another parcel of real property with a fair market value of 100x dollars and immediately transferred that property to A. At the time B exercised the option, A's real property had a fair market value of 150x dollars. A used the property acquired form B in A's trade or business. B is neither related to A nor employed by A.

It held:

> Pursuant to section 1031(b) of the Code, A does not recognize gain or loss on the transfer of A's real property in exchange for the real property received from B, except to the extent of the 5x dollars premium paid by B to A for the option. Under section 1031(d), the adjusted basis to A in the property acquired from B is 50x dollars, that is, the adjusted basis of A's old property of 50x dollars decreased by the 5x dollars received by A and increased by the 5x dollars of gain recognized by A on the exchange.
>
> When B transfers to A the property that B had acquired in order to exercise the option, B has disposed of B's property in a taxable transaction because B has not met the requirements of section 1031. On the present facts, B has no gain or loss because the amount considered realized by B (the option price of 100x dollars) equals B's basis in the property (100x dollars). The adjusted basis to B in the property acquired from A is 105x dollars, the option price for the property that B paid to A, plus the premium for the option paid by B to A.

See also part III.B.7.c.vii Stock Options, which also applies to real estate options (see fns. 7370-7372.

II.G.16.c. Held for Investment (before and after 2017 changes)

Letter Ruling 200521002 held that a trust did not lack an investment motive for the replacement property when it placed the replacement property in an LLC and then distributed the LLC to its beneficiaries when the trust terminated.[1639] Similarly, Letter Ruling 200521002 held that a trust's termination after it acquires replacement property might not disqualify the trust on the grounds of not holding the replacement property for investment.[1640] Letter Ruling 9829025 held

[1639] Letter Ruling 200521002 reasoned:

> Your submission expresses two concerns regarding the above exchange. Your first concern is that the proposed transfer of the replacement property to LLC would violate the holding requirement of § 1031(a) (i.e., that the replacement property must be held by the taxpayer for productive use in a trade or business or for investment) as applied in Rev. Rul. 75-292 and Rev. Rul. 77-337. Your second concern is that, as a result of the Trust's terminating distribution of membership interests in LLC to multiple beneficiaries, which will then result in a de facto partnership between the beneficiaries for federal income tax purposes, the holding requirement of § 1031(a) as applied in the revenue rulings would be violated with respect to the replacement property.
>
> With respect to your first concern, you represent that the replacement property will be held by the Trust (and LLC) for investment purposes throughout the Trust's existence. You also represent that LLC will not elect to be taxed as a corporation and will remain a single member LLC until at least Date A. Therefore, LLC will be disregarded as an entity separate from the Trust, its sole owner. Consequently, the transfer by the Trust of the replacement property to LLC will also be disregarded, and the Trust will be considered the direct owner of the replacement property for federal income tax purposes. Because the Trust represents that it intends to hold the replacement property for investment purposes, the transfer by the Trust of the replacement property to LLC will not violate the holding requirement of § 1031(a).[1]
>
> [1] No ruling is requested on the factual question of whether any specific replacement property is held for a particular purpose.
>
> With respect to your second concern, the Trust represents that it will hold the replacement property for investment purposes until the Trust terminates by its own terms on Date A. Because the Trust is a testamentary trust, the termination date was fixed by Decedent and cannot be modified or changed. As a result, the Trust is not acquiring the replacement property in order to dispose of the property pursuant to a prearranged plan. The Plan of Termination has been approved by the State A probate court and will take effect without regard to whether this exchange of properties is consummated. Consequently, the like-kind exchange in this case is wholly independent from the distribution of the properties under the Plan of Termination. Thus, the facts in this ruling request are distinguishable from those in Rev. Rul. 75-292 and Rev. Rul. 77- 337.
>
> Therefore, based on the facts and representations presented above, we rule that the Trust's termination and distribution of its assets to the beneficiaries will not preclude the replacement property received by the Trust in this exchange from being considered property held either for productive use in a trade or business or investment, within the meaning of § 1031, because this like-kind exchange is independent of the impending termination.

[1640] Letter Ruling 200521002, which reasoned:

> Your submission expresses two concerns regarding the above exchange. Your first concern is that the proposed transfer of the replacement property to LLC would violate the holding requirement of § 1031(a) (i.e., that the replacement property must be held by the taxpayer for productive use in a trade or business or for investment) as applied in Rev. Rul. 75-292 and Rev. Rul. 77-337. Your second concern is that, as a result of the Trust's terminating distribution of membership interests in LLC to multiple beneficiaries, which will then result in a de facto partnership between the beneficiaries for federal income tax purposes, the holding requirement of § 1031(a) as applied in the revenue rulings would be violated with respect to the replacement property.

that Code § 1031 exchange started before death with a sale can be completed after death with a purchase.[1641] Furthermore, a gift of replacement property might not disqualify the exchange, either.[1642] *Magneson v. Commissioner*, 81 T.C. 767 (1983 reviewed case), which involved a step-transaction contribution of replacement property into a partnership called U.S. Trust (not the famed trust company), set the stage for these rules, first reviewing prior cases:

> We have previously decided that if a taxpayer holds the property received in a "like-kind" exchange for sale, the taxpayer does not hold the property for investment and, therefore, is not entitled to the benefits of nonrecognition under section 1031(a). *Regals Realty Co. v. Commissioner*, 43 B.T.A. 194 (1940), *affd.* 127 F.2d 931 (2d Cir. 1942). We have also decided that if a taxpayer holds the property received in a like-kind exchange for the

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> With respect to your first concern, you represent that the replacement property will be held by the Trust (and LLC) for investment purposes throughout the Trust's existence. You also represent that LLC will not elect to be taxed as a corporation and will remain a single member LLC until at least Date A. Therefore, LLC will be disregarded as an entity separate from the Trust, its sole owner. Consequently, the transfer by the Trust of the replacement property to LLC will also be disregarded, and the Trust will be considered the direct owner of the replacement property for federal income tax purposes. Because the Trust represents that it intends to hold the replacement property for investment purposes, the transfer by the Trust of the replacement property to LLC will not violate the holding requirement of § 1031(a).[1]
>
> [1] No ruling is requested on the factual question of whether any specific replacement property is held for a particular purpose.
>
> With respect to your second concern, the Trust represents that it will hold the replacement property for investment purposes until the Trust terminates by its own terms on Date A. Because the Trust is a testamentary trust, the termination date was fixed by Decedent and cannot be modified or changed. As a result, the Trust is not acquiring the replacement property in order to dispose of the property pursuant to a prearranged plan. The Plan of Termination has been approved by the State A probate court and will take effect without regard to whether this exchange of properties is consummated. Consequently, the like-kind exchange in this case is wholly independent from the distribution of the properties under the Plan of Termination. Thus, the facts in this ruling request are distinguishable from those in Rev. Rul. 75-292 and Rev. Rul. 77-337.
>
> Therefore, based on the facts and representations presented above, we rule that the Trust's termination and distribution of its assets to the beneficiaries will not preclude the replacement property received by the Trust in this exchange from being considered property held either for productive use in a trade or business or investment, within the meaning of § 1031, because this like-kind exchange is independent of the impending termination.

[1641]The letter ruling was extremely favorable, providing a community property basis step-up for both halves of the replacement property. The IRS takes the opposite approach with Code § 1033 condemnation cases, contrary to certain cases. Rev. Rul. 64-161; *Morris v. Commissioner*, 55 T.C. 636 (1971).

[1642] Letter Ruling 8126070, approving a like-kind exchange shortly before a trust terminated, reasoned:

> A recent tax court case, *Wagensen v. Commissioner*, 74 T.C. 653 (1980) pertains in part to an exchange of real property, a ranch, for like kind property subsequently followed by a gift of the newly acquired ranch property to taxpayer's children. The court found the exchange to be one which qualified under section 1031 of the Code. The ranch properties in question were held for use in trade or business or for investment by taxpayer both before and after the exchange.
>
> In the instant case it is represented that the trust will retain legal title to the acquired property, and continue to hold such property for use in trade or business or investment until the trust terminates as a matter of law on the date the youngest child reaches age 25.
>
> Accordingly, under the facts and circumstances as presented we conclude that the mere fact that the trust will terminate shortly after the exchange will not by itself preclude the property received by the Executor-Trustees in this exchange from being property held either for productive use in trade or business or for investment within the intendment of section 1031(a) of the Code.

> purpose of making gifts, the taxpayer is deemed not to hold it for investment and, thus, is not entitled to nonrecognition treatment under section 1031(a). *Click v. Commissioner*, 78 T.C. 225 (1982). On the other hand, we have decided that if a taxpayer holds the property for investment, even though he contemplates eventually passing it to his children, his holding under such circumstances is acceptable within the requirement of section 1031(a). *Wagensen v. Commissioner*, 74 T.C. 653 (1980).
>
> Petitioners did not hold Plaza Property for sale, personal use, or for transfer as a gift. Rather, petitioners held Plaza Property for making a nontaxable contribution of it to U.S. Trust; hence, we must decide whether such "holding" qualifies for holding as an investment.

After reviewing Reg. § 1.1002-1,[1643] the court reasoned:

> The principle embodied in the regulations, i.e., that to qualify for nonrecognition, the new property is substantially a continuation of the old investment still unliquidated, springs from the committee reports covering the predecessor of section 1031(a). H. Rept. 704, 73d Cong., 2d Sess. (1934), 1939-1 C.B. (Part 2) 554, 564. *Wagensen v. Commissioner*, *supra* at 658.
>
> In *Koch v. Commissioner*, 71 T.C. 54, 63-64 (1978), we explained:
>
>> The basic reason for allowing nonrecognition of gain or loss on the exchange of like-kind property is that the taxpayer's economic situation after the exchange is fundamentally the same as it was before the transaction occurred. "[I]f the taxpayer's money is still tied up in the same kind of property as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit…." The rules of section 1031 apply automatically; they are not elective…. The underlying assumption of section 1031(a) is that the new property is substantially a continuation of the old investment still unliquidated. ***
>
> Section 1.1031(a)-1(a), Income Tax Regs., refers to section 1.1002, Income Tax Regs. Applying the rationale of the regulations, committee reports, and case law to the instant case, the "holding question" should be resolved by deciding whether the contribution of Plaza Property to U.S. Trust was a liquidation of petitioners' investment or a continuation of the old investment unliquidated in a modified form. We conclude that it is the latter.

[1643] For Reg. § 1.1002-1(b), "Strict construction of exceptions from general rule," see fn 3010 in part II.J.18.f Commutation vs Mere Division. Reg. § 1.1002-1(c), "Certain exceptions to general rule," provides (emphasis added by court):

> Exceptions to the general rule are made, for example, by sections 351(a), 354, 361(a), 371(a)(1), 371(b)(1), 721, 1031, 1035 and 1036. These sections describe certain specific exchanges of property in which at the time of the exchange particular *differences exist between the property parted with and the property acquired, but such differences are more formal than substantial*. As to these, the Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. *The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated*; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

The contribution of Plaza Property to U.S. Trust admittedly is a nontaxable transaction under section 721 which, together with section 1031(a), is unequivocally described above in section 1.1002-1, Income Tax Regs., as representing a continuation of the old investment, not a liquidation….

As further support for the proposition that petitioners merely effected a change in the form of the ownership of their investment instead of liquidating their investment, it must be pointed out that U.S. Trust's basis in the Plaza Property for computing gain or loss is petitioners' basis, *i.e.*, their cost basis in Iowa Street.[4] U.S. Trust "tacks on" to petitioners' holding period for Plaza Property pursuant to section 1223(2), and the Commissioner has acknowledged that it is the partnership's holding period with respect to the property, rather than the partner's holding period for his partnership interest, which determines whether the gain or loss is long term or short term. Rev. Rul. 68-79, 1968-1 C.B. 310….

[4] This assumes that U.S. Trust has not availed itself of the elective provisions regarding basis.

Plaza Property was stipulated by the parties to be "commercial property." N.E.R. was organized to "acquire, own, maintain and operate" Plaza Property. If petitioners had not contributed Plaza Property to U.S. Trust, they might, nevertheless, be taxable as a partnership together with the other owners of undivided interests depending upon the level of their activity. Section 301.7701-3(a), Proced. & Admin. Regs., provides in part as follows:[1644]

> Mere co-ownership of property which is maintained, kept in repair, and rented or leased does not constitute a partnership. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a partnership thereby. Tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. For example, a partnership exists if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent.

This demonstrates that, for tax purposes, joint ownership of the property and partnership ownership of the property are merely formal differences and not substantial differences as set forth in section 1.1002(c), Income Tax Regs., and petitioners did not liquidate their investment in Plaza Property when they contributed it to U.S. Trust.

Bolker v. Commissioner, 81 T.C. 782 (1983), reasoned:

We today ruled on a very similar issue in *Magneson v. Commissioner*, 81 T.C. 767 (1983) (Court reviewed). In *Magneson*, petitioners traded property A for property B, immediately contributing property B to a partnership for a 10-percent interest. Petitioners began with an interest in real property A, ending up with an interest in a partnership that had a fractional interest in real property B. Since section 721 admittedly

[1644] [My footnote:] the regulation cited above no longer exists. Instead, it is integrated into the last part of Reg. § 301.7701-1(a)(2), "Certain joint undertakings give rise to entities for federal tax purposes," which is reproduced in fn 587 in part II.C.10 Whether Tenancy-in-Common or other Arrangement Constitutes a Partnership.

applied when property B was transferred to the partnership, the only question we confronted was whether the exchange of property A for property B was nontaxable under section 1031.

We recognized that under section 1031, both properties A and B were required to be held for investment purposes. Since property A had clearly been held for investment purposes within the meaning of section 1031, we focused on property B, stating the issue as follows: "petitioners held [property B] for making a nontaxable contribution to [the partnership]; hence we must decide whether such 'holding' qualifies for holding as an investment." Noting that petitioners did not hold property B for sale, personal use, or for transfer as a gift (see *Click v. Commissioner*, 78 T.C. 225 (1982); *Wagensen v. Commissioner*, 74 T.C. 653 (1980); *Regals Realty Co. v. Commissioner*, 43 B.T.A. 194 (1940), *affd.* 127 F.2d 931 (2d Cir. 1942)), we concluded that the holding of property B for a nontaxable contribution to a partnership under section 721 qualified as a holding for investment purposes under section 1031.

We believe *Magneson* entitles petitioner to relief herein. In both *Magneson* and the instant case, property A was exchanged for property B in a like-kind exchange, both properties being held for business or investment as opposed to personal purposes. In *Magneson*, the exchange of A for B was immediately followed by a tax-free section 721 transfer; in the instant case, the exchange of A for B was immediately preceded by a tax-free acquisition under section 333. The tax-free transaction preceded rather than followed the exchange is insufficient to produce opposite results. For, as noted, section 1031's holding for business or investment requirement is reciprocal, equally applicable to properties at both ends of an exchange. Nothing in the policy underlying section 1031 suggests that this minor variation in sequence warrants treating taxpayers dramatically different.

Even aside from *Magneson*, we believe petitioner is correct. A trade of property A for property B, both of like kind, may be preceded by a tax-free acquisition of property A at the front end, or succeeded by a tax-free transfer of property B at the back end. Considering first the tax-free acquisition of property A through a section 333 liquidation at the front end, it is appropriate to ask why gain is deferred on a liquidation. In short, where a taxpayer surrenders stock in his corporation for real estate owned by the corporation, he continues to have an economic interest in essentially the same investment, although there has been a change in the form of ownership. His basis in the real estate acquired on liquidation is equal to his basis in the stock surrendered, and the gain realized is not recognized but deferred until gain on the continuing investment is realized through a liquidating distribution. At that point, proceeds of the sale are taxed to the extent of the gain.

Similarly, Letter Ruling 200131014 held that transferring replacement property to the taxpayer's wholly-owned, single-member LLC will be disregarded and therefore will not constitute a disqualifying transfer of the replacement property.

Ultimately, all of these authorities supported the more complex Letter Ruling 200651030, which had the following facts:

Trust was established by Decedent upon his death in Year A to administer his assets. Decedent's will provided for the establishment of the Trust in order to provide an ongoing source of safe and certain income from investment returns to its beneficiaries, which included Decedent's wife and daughters. Under the terms of Decedent's will, the Trust will terminate at midnight on Date A, which is twenty years after the death of Decedent's last surviving child. Because the Trust is due to terminate, the trustees of the Trust ("Trustees") formulated a detailed Plan of Termination, which outlines a plan and mechanism for the distribution of the Trust's assets to its numerous remainder beneficiaries upon its termination.

Originally, the assets of the Trust consisted mainly of real estate holdings in State A. The submission provides that, in order to diversify the Trust's real estate holdings, increase investment returns, and generate income, the Trustees received approval from the State A probate court many years ago to conduct exchanges of real estate. The Trustees have since engaged in many such exchanges, which have been structured to qualify for nonrecognition treatment under § 1031. As a result, the assets in the Trust now include real estate holdings in State A and diversified industrial, office, and retail properties located in other states. The submission states that all of the Trust's directly-owned properties are held for investment purposes. Recently, the value of the Trust's assets approximated $X.

Under the Plan of Termination, approximately X percent of the Trust will be distributed on termination in cash to certain remainder beneficiaries. Y percent of the Trust will be distributed on termination through an in-kind distribution of one or more Trust properties to one expected remainder beneficiary. The remaining corpus (approximately Z percent) of the Trust's net asset value will be contributed by the Trustees prior to termination to LLC, a State B limited liability company, with the Trust as the single member holding all of the shares in the LLC. Upon termination of the Trust, all of the shares in LLC will be distributed among certain (but not all) remainder beneficiaries (to the extent their remainder interest is not otherwise satisfied with cash or in-kind property). LLC intends to continue the Trust's real estate investment operations in a manner consistent with past practices. It is represented that much of the current managerial and operational structure will remain in place after the Trust terminates. The Trustees submitted the Plan of Termination to the State A probate court, which approved it on Date B.

The Trustees have determined that it would be in the best interests of the Trust to exchange a few of the Trust's real estate investment properties each year in order to exercise their fiduciary duty to increase rental income. The Trust has 180 days to complete an exchange of properties by acquiring the replacement property pursuant to § 1031(a)(3)(B). Trust anticipates that, following the Trust's termination, LLC will continue to periodically conduct § 1031 exchanges. Trust has two exchanges that it expects it will be unable to close prior to its termination and, accordingly, desires to transfer its interests in these transactions to LLC for continuation post-termination. These two exchanges are the subject of this ruling request.

<u>Exchange 1</u>: On Date C, the Trust received an offer to purchase Relinquished Property 1 from Buyer 1. The acquisition price offered is $Y but is subject to negotiation. A final sale contract between the parties will condition closing of the disposition of this property on the receipt of a favorable private letter ruling in response to this request and the receipt of final subdivision approval from the local authorities. Subdivision approval is expected by Date E, which is less than 180 days from the termination date of the Trust. Accordingly, the Trust will convey Relinquished Property 1 to the LLC pursuant to the Termination Plan and will also transfer its contractual rights to continue the disposition of

Relinquished Property 1 and to acquire qualified § 1031 replacement property to LLC, which would then transact the entire exchange after Trust's termination.

Exchange 2: On Date D, the Trust entered into a non-binding Letter of Intent with Buyer 2 for the disposition of Relinquished Property 2. The acquisition price agreed to by the parties is $Z. The Letter of Intent provides that the obligation of the Trust to complete the disposition of Relinquished Property 2 is contingent on the receipt of a favorable private letter ruling in response to this request and the receipt of final subdivision approval from the local authorities. Subdivision approval for Relinquished Property 2 is also expected by Date E, which is less than 180 days from the termination date of the Trust. Accordingly, the Trust will convey Relinquished Property 2 to the LLC pursuant to the Termination Plan and will also transfer its contractual rights to continue the disposition of Relinquished Property 2 and to acquire qualified § 1031 replacement property to LLC, which would then transact the entire exchange after Trust's termination.

Relinquished Property 1 and Relinquished Property 2 (collectively "Relinquished Properties") will be subject to separate exchange transactions. However, the submission represents that they can be treated identically for purposes of this ruling request. The submission represents that for purposes of § 1031, replacement properties will be acquired (collectively "Replacement Properties"); however, these properties have not yet been identified or located for either of the exchange transactions.

As stated above, the Trust (subject to receipt of this private letter ruling) will transfer its interest in the Relinquished Properties' sale contracts (the "Disposition Contracts") to LLC for closing shortly after LLC becomes a multi-member LLC on or about the termination date of the Trust (Date A). LLC would then have the full 180 days to complete the exchanges by acquiring Replacement Properties. Consequently, pursuant to the Termination Plan, the Trustees will convey the Relinquished Properties (subject to the contractual obligations for disposition and exchange) to LLC on or before the end of the year, and will distribute all of the Trust's interests in LLC to certain of its beneficiaries on the termination date (Date A), or as soon thereafter as practicable. Prior to the terminating distribution, the Trust will be the sole member of LLC. The contribution of the Relinquished Properties and assignment of the Disposition Contracts to LLC will have no federal income tax consequences. The LLC will be taxed like a partnership when the beneficiaries receive their interests.

The two subject exchanges will be structured to qualify as "deferred exchanges" under § 1.1031(k)-1 of the Income Tax Regulations and will comply with all of the requirements of those provisions. Prior to closing, the LLC will assign all of its rights in the Disposition Contracts with respect to the Relinquished Properties to an exchange intermediary. The LLC and the exchange intermediary will enter into an exchange agreement setting forth the terms and conditions under which the intermediary will dispose of each Relinquished Property and acquire each Replacement Property identified by the LLC.

As with the Relinquished Properties, the LLC will assign its rights to the Replacement Property acquisition contract(s) to the exchange intermediary and notify all parties to the contract(s) prior to closing. At closing, the intermediary will deposit the exchange funds with an escrow company and the seller(s) will deed the replacement property directly to the LLC.

In addition, the Trust makes the following representations:

(1) The Relinquished Properties now and at all times during the Trust's ownership thereof, have been held by the Trust for investment purposes;

(2) The disposition of the Relinquished Properties and the acquisition of the Replacement Properties will be accomplished in a manner that in all respects, aside from the issues raised in this ruling request, qualify the transactions as tax-free exchanges within the meaning of § 1031 and the regulations thereunder; and

(3) The Replacement Properties will be of "like kind" to the Relinquished Properties for purposes of § 1031 and will be held by the LLC for investment purposes.

Letter Ruling 200651030 reasoned:

> In Rev. Rul. 75-292,1975-2 C.B. 333, an individual taxpayer in a prearranged transaction transferred land and buildings used in the taxpayer's trade or business to an unrelated corporation in exchange for land and an office building owned by the corporation and used in its trade or business. Immediately thereafter, the individual taxpayer transferred the land and office building to the individual's newly created corporation in exchange for the stock of the same corporation. The revenue ruling concluded that the individual taxpayer did not exchange the real estate for other real estate to be held either for productive use in a trade or business or for investment by that taxpayer but that the taxpayer acquired the replacement property for the purpose of transferring it to the new corporation. As a result, the exchange did not qualify for nonrecognition under § 1031.
>
> In Rev. Rul. 77-337, 1977-2 C.B. 305, in a prearranged plan, an individual taxpayer liquidated all the stock of a corporation and transferred the corporation's sole asset, a shopping center, to a third party in exchange for like-kind property. Rev. Rul. 77-337 noted that under Rev. Rul. 75-292, a newly created corporation's eventual productive use of property in its trade or business is not attributable to its sole shareholder. Consequently, the individual taxpayer did not hold the shopping center for use in a trade or business or for investment because the corporation's previous trade or business use could not be attributed to its sole shareholder, and the exchange did not qualify for nonrecognition of gain or loss under § 1031.
>
> Section 1031 was designed, in part, to postpone the recognition of gain or loss when property used in a trade or business or held for investment is exchanged for other property in the course of the continuing operation of that trade or business, or in the course of investment. In those circumstances, the taxpayer has not received any gain or suffered any loss in a general and economic sense, nor has the exchange of property resulted in the termination of one venture and assumption of another. The business venture operated before the exchange continues after the exchange without any real economic change or alteration, and without realization of any cash or readily liquefiable asset. See *Carlton v. United States*, 385 F.2d 238 (5th Cir. 1967); *Jordan Marsh Co. v. Commissioner*, 269 F.2d 453 (2 Cir. 1959); *cf. Portland Oil Co. v. Commissioner*, 109 F.2d 479 (1 Cir.) *cert. den.*, 310 U.S. 650 (1940). See generally § 1.1002-1(c) ("[t]he underlying assumption of these exceptions [*e.g.*, § 1031] is that the new property is substantially a continuation of the old investment still unliquidated").
>
> In this case, after the Trust's terminating distribution of membership interests in LLC to multiple beneficiaries, the resulting entity will be functionally like the Trust and will be treated as a partnership between the beneficiaries merely for federal income tax

> purposes. However, the members of LLC will be substantially identical to the Trust beneficiaries. LLC intends to continue the Trust's real estate investment operations in a manner consistent with past practices. Primarily the same managerial and operational structure will remain in place after the Trust terminates. LLC will continue the current business practices of the Trust with respect to its real estate properties. These facts distinguish this case from Rev. Rul. 77-337.
>
> Additionally, in this case, the Trust is terminating involuntarily by its own terms after many years in existence. Because the Trust is a testamentary trust, the termination date was fixed by Decedent and cannot be modified or changed. The Plan of Termination has been approved by the State A probate court and will take effect without regard to whether these exchanges involving Trust properties are consummated. According to your submission, the Trust has engaged in numerous § 1031 exchanges throughout the years. Consequently, the like-kind exchanges in this case are wholly independent from termination of the Trust and its distribution of the Relinquished Properties to the LLC, as successor entity, under the Plan of Termination. Thus, the facts in this ruling request are distinguishable from those in Rev. Rul. 75-292 and Rev. Rul. 77-337, which involve voluntary transfers of properties pursuant to prearranged plans.
>
> Accordingly, because the LLC will continue with the real estate business previously conducted by the Trust and is functionally a continuation of the Trust, and because the like-kind exchanges here are independent of the impending termination of the Trust, we rule that under the specific facts and representations presented above, the transfer of the Relinquished Properties to LLC subject to the contracts for their disposition will not violate the holding requirement of § 1031(a) with respect to the subject exchanges.

Similarly, Letter Ruling 200812012 held that the termination of an LLC resulting from the distribution of trust assets will not preclude the replacement property from being held for investment or for the productive use in a trade or business under Code § 1031(a). The facts were:

> Trust was established as a private testamentary trust by Decedent's will upon his death in Year 1 to administer his assets and to provide income to its beneficiaries. At the present time, Trust has real property assets located in numerous states. All of the Trust's directly-owned properties are held for investment purposes. Trustees of Trust created an operational structure though which Trust engaged in various real estate investment activities. This operational structure included LLC, which is owned by percent by Trust, with the remaining percentage owned by Corporation, which is itself wholly owned by Trust. The real estate investment activities carried out by LLC include like-kind exchanges of real estate investment properties.
>
> Under the terms of Decedent's will, Trust terminated at midnight on Date A. Prior to Date A, Trustees formulated a Termination Plan, which outlined a plan and mechanism for distributing Trust's assets to its remainder beneficiaries upon termination. State A Probate Court approved Termination Plan on Date B. Under Termination Plan, Trust assets equal to w percent of the remainder beneficiaries' stirpital interests were distributed in cash and through in-kind distribution to certain remainder beneficiaries. The remaining Trust assets equal to x percent of the remainder beneficiaries' stirpital interests was contributed by Trustees prior to termination to Successor Entity. The assets contributed to Successor Entity included Trust's y percent membership interest in LLC and its 100 percent stock interest in Corporation. Upon termination of Trust, all

shares of Successor Entity were distributed among certain (but not all) remainder beneficiaries. Successor Entity is intended to continue Trust's real estate investment operations on a going forward basis consistent with past practice, with much of the same managerial and operational structure remaining intact.

Trustees have determined that it is prudent for LLC to dispose of Relinquished Property in an exchange that will meet the requirements for like-kind exchange treatment under § 1031. As replacement property, it was determined that LLC should acquire a z percent interest in Replacement Property. The acquisition of Replacement Property and the disposition of the Relinquished Property were structured as a reverse like-kind exchange pursuant to Rev. Proc. 2000-37, 2 C.B. 308. On Date C, Trust entered into a contract for the purchase of Replacement Property from Seller. On Date D, Trust assigned a z percent interest in the purchase contract to LLC; LLC immediately assigned the entire z percent interest to DE, a disregarded entity whose sole member was EAT. On the same date, LLC entered into a Qualified Exchange Accommodation Agreement with EAT, pursuant to which EAT agreed to act as exchange accommodation titleholder within the meaning of Rev. Proc. 2000-37 with respect to Replacement Property. Seller transferred title to a z percent interest in Replacement Property to DE on Date D.

On Date E, LLC entered into a contract for the sale of Relinquished Property to Buyer. On Date F, LLC and EAT entered into an Exchange Agreement pursuant to which EAT agreed to act as qualified intermediary with respect to Relinquished Property. On Date G, LLC assigned its rights under the contract for sale of Relinquished Property to EAT. On Date H, LLC directly deeded Relinquished Property to Buyer. EAT then assigned the membership units in DE to LLC to complete the exchange.

The submission states that LLC has at all times intended to hold the Replacement Property solely to generate additional rental income and has no plans whatsoever to develop or construct any improvements on such property or to sell Replacement Property or any portion thereof at any time. It has continued to own this property for investment purposes and has continued to manage it in precisely the same way. There has been no change in the beneficial ownership of LLC.

On Date 1, pursuant to the Termination Plan, the Trust distributed all of its shares in Successor Entity, which then held almost all of the Trust's real estate and other investment operation assets, including its interests in LLC, to its remainder beneficiaries. Under Rev. Rul. 99-5, 1999-1 C.B. 434, the distribution of the shares to the remainder beneficiaries is treated as a distribution of Trust's assets followed by a recontribution of those assets by the remainder beneficiaries to Successor Entity. Because assets held by Successor Entity include a greater than 50 percent interest in LLC, this distribution and deemed recontribution of the shares resulted in a § 708(b)(1)(B) termination of LLC. In a § 708(b)(1)(B) termination, LLC is deemed to have contributed its assets to a new partnership in exchange for an interest in the new partnership, and then to have made a liquidating distribution of that new partnership interest to its members. Treas. Reg. § 1.708-1(b)(4).

The Trust makes the following representations:

(1) The Relinquished Property was held by LLC for investment purposes at all times during its ownership thereof;

(2) The disposition of the Relinquished Property and the acquisition of the Replacement Property was accomplished in a manner that in all respects, aside from the issues raised in this ruling request, qualify the transaction as tax-free exchange within the meaning of § 1031 and the regulations thereunder; and

(3) The Replacement Property was "like kind" to the Relinquished Property for purposes of § 1031 and was held by the LLC for investment purposes, aside from the issues raised in this ruling request. In addition, Trust represents that there was a valid "exchange" of property under the reverse exchange safe harbors of Rev. Proc. 2000-37.

After repeating various law, including the first three paragraphs quoted above from the reasoning of Letter Ruling 200651030, Letter Ruling 200812012 reasoned and held:

> In this case, Trust terminated involuntarily by its own terms after many years in existence. Because Trust was a testamentary trust, the termination date was fixed by Decedent and could not be modified or changed. The Plan of Termination was approved by the State A Probate Court and would have occurred without regard to whether this exchange of properties had been consummated. Consequently, the like-kind exchange in this case was wholly independent from termination of Trust, and thus LLC's acquisition of the Replacement Property in a reverse like-kind exchange was wholly independent of its § 708(b)(1)(B) termination. Moreover, there has been no change either in the beneficial ownership of LLC, or in the way it holds or manages the Replacement Property. It has continued to own this property for investment purposes. Thus, the facts in this ruling request are distinguishable from those in Rev. Rul. 75-292 and Rev. Rul. 77-337, which involve voluntary transfers of properties pursuant to prearranged plans.
>
> We therefore conclude that the termination of LLC under § 708(b)(1)(B) resulting from the distribution of Trust assets pursuant to the Termination Plan will not preclude the Replacement Property from being held for investment or for the productive use in a trade or business within the meaning of § 1031(a).

In light of all of the authority above, it appears that a nontaxable trust termination can occur before, during, or after a like-kind exchange, without ruining the expected Code § 1031 tax deferral, so long as the taxpayer's old and new property were/are held for investment under Code § 1031. For whether a trust termination is nontaxable, see part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.

Although partnership interests are not eligible for Code § 1031 treatment, buying all of the partnership interests at once (and holding them in a disregarded single member LLC) might constitute buying the partnership's underlying property.[1645]

[1645] Letter Ruling 200807005 analyzed Issue 1 as follows:

> Taxpayer will acquire 100 percent of the partners' interests in Partnership. Pursuant to Rev. Rul. 99-6, Partnership is considered to have terminated under § 708(b)(1)(A) and made a liquidating distribution of its real property assets to its partners, and Taxpayer is treated as having acquired such real property assets from the partners for federal tax purposes. Since Taxpayer will acquire 100 percent of the partners' interests in Partnership, Taxpayer is treated as having acquired the real property assets of Partnership rather than as having acquired partnership

Related party involvement in the exchange might trigger gain recognition.[1646]

On the other hand, related party use before the exchange might not necessarily cause problems. In light of nontax considerations involving aircraft, the IRS ruled that a partnership held relinquished aircraft and replacement aircraft "for productive use in a trade or business" under Code § 1031 even though the aircraft, which are leased to a related entity that that is owned by the same individuals who own the partnership, are the partnership's only operating assets and do not generate an economic profit for the partnership.[1647] Also, a vacation home

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> interests from the partners. Further, this transaction does not constitute an abuse of the type that Congress sought to remedy in the Deficit Reduction Act of 1984, which appears to be aimed at abuses by sellers of partnership interests. We view this transaction as a like-kind exchange under § 1031(a)(1), rather than as an exchange of partnership interests in violation of § 1031(a)(2)(D). Accordingly, Taxpayer may defer the gain on the sale of Relinquished Property under § 1031 if Taxpayer, through QI, acquires 100 percent of the interests of the partners in Partnership, which owns the Replacement Property.

The ruling then approved acquiring the partnership interests and therefore the replacement property through its wholly owned disregarded LLC.

[1646] Code § 1031(f), which Lipton explains in "Eighth Circuit Sheds Light on Like-Kind Exchanges," *Journal of Taxation* (6/2015). Letter Ruling 200920032 held that, for purposes of this rule, an irrevocable trust paying mandatary income to the grantor's surviving spouse, remainder to the grantor's children was not related under Code § 267(b) or 707(b)(1) with respect to grantor trusts deemed owned by the grantor's two siblings, respectively.

[1647] CCA 201601011, analyzing the situation as follows:

> The facts indicate that the rent P charges O for use of the relinquished property and the replacement property is insufficient for P to make an economic profit on the aircraft rental to O. However, many businesses hold and use properties in a way that, if the use of the property were viewed as an activity, do not and could not generate profit. Nevertheless, the property itself is held for productive use in that business. Thus, P's lack of intent to make an economic profit on the aircraft rental does not establish that the aircraft fails the productive use in a trade or business standard of § 1031. In addition, we agree with the field that A's and B's use of the property for personal purposes is not relevant in determining whether P holds the aircraft for productive use in a trade or business [because O included any personal use in the income of A and B].
>
> Moreover, it is important to point out that businesses, for any number of reasons, opt to hold property, especially aircraft, in a separate entity. In the present case, O, which operates a legitimate business enterprise, requires private aircraft to be available to its senior executives, both for business travel and as an employment perk. However, for business and legal reasons, the aircraft are owned not by O but by P, a related entity. If O owned the aircraft, or was the 100 percent owner of P, we doubt that the field would have raised the issue of whether the aircraft were held for productive use in a trade or business. Were we to disallow § 1031 treatment based on the entity structure presented here, businesses would be forced to structure their transactions in inefficient and potentially risky ways to achieve § 1031 treatment. Thus the entity structure in the present case should not be used as grounds that the aircraft fails to qualify as property held for productive use in a trade or business.
>
> In sum, O operates a legitimate business enterprise and requires private aircraft to be available to its senior executives. For business and legal reasons, O has structured its affairs so that the aircraft are owned through P and leased to O for an amount not intended to generate a profit for P. On these facts, the aircraft are held for productive use in a trade or business.
>
> We are sensitive to two facts raised by the field: P charges below-market rent for the replacement aircraft and A and B, rather than O, own P. While these facts do not disqualify the property from being held for productive use in a trade or business for purposes of § 1031, it may be that other tax provisions such as § 280F or 482 may apply to disallow tax benefits or impose a tax treatment different from the treatment claimed by P, O or A and B.

that is rented more than it is used for personal purposes may qualify as "property held for productive use in a trade or business or for investment."[1648]

II.G.17. Economic Substance Penalty and Doctrines

II.G.17.a. What Is the Codified Economic Substance Doctrine

Code § 7701(o) provides that income tax benefits with respect to a transaction (including a series of transactions),[1649] entered into in connection with a trade or business or an activity engaged in for the production of income,[1650] are not allowable if the transaction does not have economic substance or lacks a business purpose.[1651] The discussion below focuses on Code § 7701(o), but common law rules continue to apply as well.[1652]

Amplifying Notice 2010-62, Notice 2014-58[1653] guides us on what a "transaction" is:

> For purposes of determining whether the codified economic substance doctrine applies, " transaction" generally includes all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement; and any or all of the steps that are carried out as part of a plan. Facts and circumstances determine whether a plan's steps are aggregated or disaggregated when defining a transaction.
>
> Generally, when a plan that generated a tax benefit involves a series of interconnected steps with a common objective, the " transaction" includes all of the steps taken together

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> Finally, our analysis extends only to whether the relinquished and replacement aircraft meet the held for productive use in a trade or business requirement in § 1031(a). We do not express or imply an opinion on whether the exchange met the other requirements under § 1031 to qualify as a like-kind exchange. Nor do we express or imply an opinion regarding other tax aspects of the transaction.

[1648] Rev. Proc. 2008-16 provides details for a safe harbor.

[1649] Code § 7701(o)(5)(D).

[1650] Code § 7701(o)(5)(B).

[1651] Code § 7701(o)(5)(A). The legislative history cites *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999); *Klamath Strategic Investment Fund, LLC v. United States*, 472 F.Supp.2d 885 (E.D. Texas 2007), *aff'd* 568 F.3d 537 (5th Cir. 2009); *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), vacating and remanding 62 Fed. Cl. 716 (2004) (slip opinion at 123-124, 128); *cert. denied*, 127 S.Ct. 1261 (Mem.) (2007). *Klamath* was followed by *Robert E. Smith, III v. Commissioner*, T.C. Memo. 2017-218, which is described in fn. 5104 in part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders. An extensive relevant quote from *Coltec* is in part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership, where it was relied upon to disqualify a transaction from Code § 721. See also Lipton, "*Flextronics*, *Sundrup*, and the Application of the Economic Substance Doctrine," *Journal of Taxation* (Mar. 2011), and "In Southgate, Economic Substance, Substance Over Form, and Penalties Are a Dangerous Mix," *Journal of Taxation* (Feb. 2012) (discussing case in which penalties were not applied). For the general rule disallowing losses where economic substance is lacking, see fn. 1179. For a ruling that a partnership lacked economic substance that did not mention this penalty, see fn. 5141.

[1652] The Joint Committee on Taxation Report on P.L. 111-152 (3/30/2010) said:

> No inference is intended as to the proper application of the economic substance doctrine under present law. The provision is not intended to alter or supplant any other rule of law, including any common-law doctrine or provision of the Code or regulations or other guidance thereunder; and it is intended the provision be construed as being additive to any such other rule of law.

[1653] For analysis of Notice 2014-58, see Lipton, "New Guidance Sheds Light on Economic Substance Doctrine and Related Penalties," *Journal of Taxation* (Dec. 2014).

> – an aggregation approach. This means that every step in the series will be considered when analyzing whether the “ transaction” as a whole lacks economic substance. However, when a series of steps includes a tax-motivated step that is not necessary to achieve a non-tax objective, an aggregation approach may not be appropriate. In that case, the “ transaction” may include only the tax-motivated steps that are not necessary to accomplish the non-tax goals – a disaggregation approach.
>
> Whether the economic substance doctrine is relevant and whether a transaction should be disaggregated will be considered on a case-by-case basis, depending on the facts and circumstances of each individual case. For example, if transfers of multiple assets and liabilities occur and the transfer of a specific asset or assumption of a specific liability was tax-motivated and unnecessary to accomplish a non-tax objective, then the economic substance doctrine may be applied solely to the transfer or assumption of that specific asset or liability. Separable activities may take many forms including, for example, the use of an intermediary employed for tax benefits and whose actions or involvement was unnecessary to accomplish an overarching non-tax objective. These situations are merely examples intended to illustrate the potential application of the disaggregation approach and are not exhaustive or comprehensive.

If this doctrine is relevant, a transaction shall be treated as having economic substance only if the transaction changes in a meaningful way (apart from income tax effects) the taxpayer’s economic position, and the taxpayer has a substantial purpose (apart from income tax effects) for entering into such transaction.[1654] Income tax effects include not only federal but also state and local income effects.[1655] The Treasury Department and the IRS intend to issue regulations pursuant to Code § 7701(o)(2)(B), which directs the issuance of regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases. In the interim, the enactment of the provision does not restrict the ability of the courts to consider the appropriate treatment of foreign taxes in economic substance cases.[1656]

Achieving a financial accounting benefit is not taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.[1657]

If the taxpayer argues that the transaction has profit potential, the potential profit shall be taken into account only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.[1658] If the expected capital loss is virtually certain and the chance of economic benefits is very small, the transaction will not be respected. *Reddam v. Commissioner*, 113 AFTR.2d 2014-2549 (9th Cir. 6/13/2014). In evaluating the taxpayer’s alleged subjective motive, the court noted that the tax shelter promoter, KPMG, recommended obtaining independent counsel to review the very complex transactions, which the taxpayer failed to do, thereby undercutting the taxpayer’s alleged profit motive. Objectively evaluating the taxpayer’s motive, footnote 10 of the opinion noted an expert report:

[1654] Code § 7701(o)(1).
[1655] Code § 7701(o)(3).
[1656] Notice 2010-62.
[1657] Code § 7701(o)(4).
[1658] Code § 7701(o)(2)(A).

Dr. Miller's report states that only in highly uncommon circumstances would the OPIS transaction make any kind of profit, but that five percent of the time it could make between $3,450,000 and $6,300,000. It defies belief that an objective investor would risk $6,000,000 on a transaction that was designed to lose money at least seventy-five percent of the time, could make a nominal profit twenty percent of the time, but might, only five percent of the time, have generated profits in that range for any reason other than to garner the eight-figure tax loss the transaction was designed to generate.

The legislative history carves out some exceptions:[1659]

If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed. See, e.g., Treas. Reg. sec. 1.269-2, stating that characteristic of circumstances in which an amount otherwise constituting a

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[1659] Footnotes from this except are:

[345] The examples are illustrative and not exclusive.

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[346] *See, e.g.*, *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946) (respecting debt characterization in one case and not in the other, based on all the facts and circumstances).

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[347] *See, e.g.*, *Sam Siegel v. Commissioner*, 45. T.C. 566 (1966), *acq.* 1966-2 C.B. 3. But see *Commissioner v. Bollinger*, 485 U.S. 340 (1988) (agency principles applied to title-holding corporation under the facts and circumstances).

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[348] *See, e.g.*, 2010-1 I.R.B. 110, Secs. 3.01(38), (39),(40,) and (42) (IRS will not rule on certain matters relating to incorporations or reorganizations unless there is a "significant issue"); compare *Gregory v. Helvering*, 293 U.S. 465 (1935).

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[349] *See, e.g., National Carbide v. Commissioner*, 336 U.S. 422 (1949), *Moline Properties v. Commissioner*, 319 U.S. 435 (1943); *compare, e.g. Aiken Industries, Inc. v. Commissioner*, 56 T.C. 925 (1971), *acq.*, 1972-2 C.B. 1; *Commissioner v. Bollinger*, 485 U.S. 340 (1988); *see also* sec. 7701(l).

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[350] *See, e.g., Frank Lyon Co. v. Commissioner*, 435 U.S. 561 (1978); *Hilton v. Commissioner*, 74 T.C. 305, *aff'd*, 671 F.2d 316 (9th Cir. 1982), *cert. denied*, 459 U.S. 907 (1982); *Coltec Industries v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 127 S. Ct. 1261 (Mem) (2007); *BB&T Corporation v. United States*, 2007-1 USTC P 50,130 (M.D.N.C. 2007), *aff'd*, 523 F.3d 461 (4th Cir. 2008); *Wells Fargo & Company v. United States*, No. 06-628T, 2010 WL 94544, at *60 (Fed. Cl. Jan. 8, 2010) (distinguishing leasing case *Consolidated Edison Company of New York*, No. 06-305T, 2009 WL 3418533 (Fed. Cl. Oct. 21, 2009) by observing that "considerations of economic substance are factually specific to the transaction involved").

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[351] As examples of cases in which courts have found that a transaction does not meet the requirements for the treatment claimed by the taxpayer under the Code, or does not have economic substance, *see e.g., BB&T Corporation v. United States*, 2007-1 USTC P 50,130 (M.D.N.C. 2007) *aff'd*, 523 F.3d 461 (4th Cir. 2008); *Tribune Company and Subsidiaries v. Commissioner*, 125 T.C. 110 (2005); *H.J. Heinz Company and Subsidiaries v. United States*, 76 Fed. Cl. 570 (2007); *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied* 127 S.Ct. 1261 (Mem.) (2007); *Long Term Capital Holdings LP v. United States*, 330 F.Supp.2d 122 (D. Conn. 2004), *aff'd*, 150 Fed. Appx. 40 (2d Cir. 2005); *Klamath Strategic Investment Fund, LLC v. United States*, 472 F.Supp.2d 885 (E.D. Texas 2007); *aff'd*, 568 F.3d 537 (5th Cir. 2009); *Santa Monica Pictures LLC v. Commissioner*, 89 T.C.M. 1157 (2005).

> deduction, credit, or other allowance is not available are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate. Thus, for example, it is not intended that a tax credit (e.g., section 42 (low-income housing credit), section 45 (production tax credit), section 45D (new markets tax credit), section 47 (rehabilitation credit), section 48 (energy credit), etc.) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.[1660]
>
> The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among[345] these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity;[346] (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;[347] (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C;[348] and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.[349] Leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances.[350] As under present law, whether a particular transaction meets the requirements for specific treatment under any of these provisions is a question of facts and circumstances. Also, the fact that a transaction meets the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance.[351]

The Treasury Department and the IRS do not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply.[1661] The IRS will not issue a letter ruling regarding whether the economic substance doctrine is relevant to any transaction or whether any transaction complies with the requirements of Code § 7701(o).[1662] However, the IRS has issued guidance to examiners, including:[1663]

> The following facts and circumstances tend to show that application of the economic substance doctrine to a transaction is likely not appropriate.…
>
> - Transaction is not promoted/developed/administered by tax department or outside advisors

[1660] [my footnote:] A 2022 case, *Cross Refined Coal, LLC v. Commissioner*, rebuked the IRS for having sought to disallow partnership income taxation for a transaction structured consistently with the tax credit paradigm Congress encouraged. See generally text discussion accompanying fn 575 in part II.C.9 When Is a Partner in Form Not a Partner in Substance?
[1661] Notice 2010-62.
[1662] Notice 2010-62.
[1663] "Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties," LB&I Control No. LB&I-4-0711-015 (7/15/2011, identifying as impacted IRM 20.1.1, 20.1.5). The Guidance was applied in CCA 201515020.

- Transaction is not highly structured
- Transaction contains no unnecessary steps
- Transaction that generates targeted tax incentives is, in form and substance, consistent with Congressional intent in providing the incentives
- Transaction is at arm's length with unrelated third parties
- Transaction creates a meaningful economic change on a present value basis (pretax)
- Taxpayer's potential for gain or loss is not artificially limited
- Transaction does not accelerate a loss or duplicate a deduction
- Transaction does not generate a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset)
- Taxpayer does not hold offsetting positions that largely reduce or eliminate the economic risk of the transaction
- Transaction does not involve a tax-indifferent counterparty that recognizes substantial income
- Transaction does not result in the separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years
- Transaction has credible business purpose apart from federal tax benefits
- Transaction has meaningful potential for profit apart from tax benefits
- Transaction has significant risk of loss
- Tax benefit is not artificially generated by the transaction
- Transaction is not pre-packaged
- Transaction is not outside the taxpayer's ordinary business operations.

In addition, it is likely not appropriate to raise the economic substance doctrine if the transaction being considered is related to the following circumstances.

- The choice between capitalizing a business enterprise with debt or equity
- A U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment
- The choice to enter into a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C

- The choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied….

The following facts and circumstances tend to show that application of the economic substance doctrine may be appropriate.

- Transaction is promoted/developed/administered by tax department or outside advisors
- Transaction is highly structured
- Transaction includes unnecessary steps
- Transaction is not at arm's length with unrelated third parties
- Transaction creates no meaningful economic change on a present value basis (pretax)
- Taxpayer's potential for gain or loss is artificially limited
- Transaction accelerates a loss or duplicates a deduction
- Transaction generates a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset)
- Taxpayer holds offsetting positions that largely reduce or eliminate the economic risk of the transaction
- Transaction involves a tax-indifferent counterparty that recognizes substantial income
- Transaction results in separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years
- Transaction has no credible business purpose apart from federal tax benefits
- Transaction has no meaningful potential for profit apart from tax benefits
- Transaction has no significant risk of loss
- Tax benefit is artificially generated by the transaction
- Transaction is pre-packaged
- Transaction is outside the taxpayer's ordinary business operations.

If, after considering all of the above, the examiner wishes to pursue the case, the examiner needs to consider:

1. Is the transaction a statutory or regulatory election? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

2. Is the transaction subject to a detailed statutory or regulatory scheme? If so, and the transaction complies with this scheme, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

3. Does precedent exist (judicial or administrative) that either rejects the application of the economic substance doctrine to the type of transaction or a substantially similar transaction or upholds the transaction and makes no reference to the doctrine when considering the transaction? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

4. Does the transaction involve tax credits (e.g., low income housing credit, alternative energy credits) that are designed by Congress to encourage certain transactions that would not be undertaken but for the credits? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

5. Does another judicial doctrine (e.g., substance over form or step transaction) more appropriately address the noncompliance that is being examined? If so, those doctrines should be applied and not the economic substance doctrine. To determine whether another judicial doctrine is more appropriate to challenge a transaction, an examiner should seek the advice of the examiner's manager in consultation with local counsel.

6. Does recharacterizing a transaction (e.g., recharacterizing debt as equity, recharacterizing someone as an agent of another, recharacterizing a partnership interest as another kind of interest, or recharacterizing a collection of financial products as another kind of interest) more appropriately address the noncompliance that is being examined? If so, recharacterization should be applied and not the economic substance doctrine. To determine whether recharacterization is more appropriate to challenge a transaction, an examiner should seek the advice of the examiner's manager in consultation with local counsel.

7. In considering all the arguments available to challenge a claimed tax result, is the application of the doctrine among the strongest arguments available? If not, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel..

This LB&I Directive is not an official pronouncement of law, and cannot be used, cited, or relied upon as such.

Although we cannot rely on this guidance to examiners, many tax advisors have difficulty providing assurances to clients on this issue, so having some insight into the IRS' views, even if nonbinding views, can help tax advisors evaluate a situation.[1664]

The examiner is also directed to coordinate with Counsel.[1665] Finally, any proposal to impose a penalty regarding this doctrine at the examination level must be reviewed and approved by the appropriate Director of Field Operations before the penalty is proposed.[1666]

Notice 2014-58 discusses whether the doctrine will apply when:

> a rule or doctrine … disallows the tax benefits under subtitle A of the Code related to a transaction because:
>
> (1) the transaction does not change a taxpayer's economic position in a meaningful way (apart from Federal income tax effects); or
>
> (2) the taxpayer did not have a substantial purpose (apart from Federal income tax effects) for entering into the transaction.

Notice 2014-58 views such a transaction as a "similar rule of law." It concludes:

> The IRS will not apply a penalty under section 6662(b)(6) (or otherwise argue that a transaction is described in section 6662(b)(6)) unless it also raises section 7701(o) to support the underlying adjustments. If the IRS does not raise section 7701(o) to disallow the claimed tax benefits and instead relies upon other judicial doctrines (e.g., the substance over form or step transaction doctrines) to support the underlying adjustments, the IRS will not apply a section 6662(b)(6) penalty (or otherwise argue that a transaction is described in section 6662(b)(6)) because the IRS will not treat the transaction as failing to meet the requirements of a similar rule of law. Code sections and Treasury regulations, other than section 7701(o) and the regulations under that section, that disallow tax benefits are not similar rules of law for purposes of section 6662(b)(6).

CCA 202240019 explained:

> There is no case law on section 7701(o) relating to when a transaction was "entered into" for purposes of applying the codified doctrine. The Service did, however, issue guidance in analyzing "transaction" for the purposes of section 7701(o).
>
> Whether the codified economic substance doctrine applies to the transaction (because it was entered into after the March 30, 2010 effective date) is a factual inquiry. The codified doctrine, however, defines "transaction" to include a "series of transactions."

[1664] I am not suggesting considering audit risk in determining what the law is. We need to advise our clients on what the law is without considering risk of detection, and audit risk is a separate business issue about which clients ask so that they can weigh the economic advantages or disadvantages of taking various positions. If a client refuses to take a position consistent with the law, one should consult applicable professional and regulatory ethics requirements, particularly if the item is material.
[1665] CC-2012-008 (4/3/2012). This directive also provides that the common law economic substance doctrine and codified economic substance doctrine and related penalties require National Office review before briefs or motions are filed with the Tax Court and defense or suit letters are sent to the Department of Justice.
[1666] IDD 20140203 (2/3/2014), affecting IRM §§ 20.1.1 and 20.1.5.

I.R.C. § 7701(o)(5)(D). The facts below seem to indicate that this may be a "series of transactions" depending on how factually similar the pre-codified steps are to the steps taken in 2015.

The Service can use an aggregation or disaggregation approach to determine whether a transaction lacks economic substance under section 7701(o). See I.R.S. Notice 14-58, 2014-44 I.R.B. 746. The aggregation approach interprets "transaction" to include all of the steps taken together when a plan that generates a tax benefit involves a series of interconnected steps. *Id*. From the facts described below, it appears that the creation of the NewCap, merging OldCap into NewCap, and the issuance of new policies would be a series of interconnected steps to generate a tax benefit. Under the aggregation approach, therefore, it appears "the transaction" was entered into before the effective date of section 7701(o), as the steps are included together.

The disaggregated approach applies when a series of steps includes a tax motivated step that is not necessary to achieve a non-tax objective, the "transaction" may include only the tax-motivated steps that are not necessary to accomplish the non-tax goals. See I.R.S. Notice 14-58. The disaggregated approach may apply here. If the tax-motivated step is entering into new policies, there may be an argument that those steps can be viewed in isolation, notwithstanding what took place with OldCap and NewCap. The facts here would need to show that what occurred after 2010 is not part of a "series of transactions" and that the tax-motivated step is not necessary to obtain a non-tax goal.

It should be noted, however, that the codification of the economic substance doctrine did not supplant the common law doctrine. The common law doctrine can be applied to transactions entered into before and after March 30, 2010.

II.G.17.b. Penalty For Violating Statutory Economic Substance Doctrine

For transactions entered into after March 30, 2010:[1667] Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance or failing to meet the requirements of any similar rule of law is subject to a 20% penalty.[1668] If the relevant facts affecting the tax treatment are not adequately disclosed[1669] in the return or in a statement attached to the return,

[1667] P.L. 111-152 at §1409(e).
[1668] Code § 6662(b)(6).
[1669] The IRS annually updates what constitutes adequate disclosures for each year's tax returns. See Rev. Proc. 2016-13.

then the penalty doubles to 40%.[1670] Although reasonable cause generally is a defense to negligence and other penalties, it is not a defense to this 20% or 40% penalty.[1671]

II.G.17.c. Economic Substance, Sham Transaction, Business Purpose, and Substance Over Form Doctrines

In explaining how *Gregory v. Helvering*[1672] "spawned the economic substance, sham transaction, business purpose, and substance over form doctrines," the Tax Court reasoned:[1673]

> *Gregory*, like much of the caselaw using the economic substance, sham transaction, and other judicial doctrines in interpreting and applying tax statutes, represents an effort to reconcile two competing policy goals. On one hand, having clear, concrete rules embodied in a written Code and regulations that exclusively define a taxpayer's obligations (1) facilitates smooth operation of our voluntary compliance system, (2) helps to render that system transparent and administrable, and (3) furthers the free market economy by permitting taxpayers to know in advance the tax consequences of their transactions. On the other side of the scales, the Code's and the regulations' fiendish complexity necessarily creates space for attempts to achieve tax results that Congress and the Treasury plainly never contemplated, while nevertheless complying strictly with the letter of the rules, at the expense of the fisc (and other taxpayers).
>
> In *Gregory*, the Court confronted such an extreme result and, on the basis of equitable principles, interpreted and applied the relevant statute so as to subject Mrs. Gregory's transaction to tax. Likewise, the various other judicial doctrines applied in tax cases all represent efforts to rein in activity that, while within the technical letter of the rules,

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[1670] Code § 6662(i). Notice 2010-62 provides:

> Unless the transaction is a reportable transaction, as defined in Treas. Reg. § 1.6011-4(b), the adequate disclosure requirements of section 6662(i) will be satisfied if a taxpayer adequately discloses on a timely filed original return (determined with regard to extensions) or a qualified amended return (as defined under Treas. Reg. § 1.6664-2(c)(3)) the relevant facts affecting the tax treatment of the transaction. If a disclosure would be considered adequate for purposes of section 6662(d)(2)(B) (without regard to section 6662(d)(2)(C)) prior to the enactment of section 1409 of the Act, then it will be deemed to be adequate for purposes of section 6662(i). The disclosure will be considered adequate only if it is made on a Form 8275 or 8275-R, or as otherwise prescribed in forms, publications, or other guidance subsequently published by the IRS consistent with the instructions and other guidance associated with those subsequent forms, publications, or other guidance. Disclosures made consistent with the terms of Rev. Proc. 94-69 also will be taken into account for purposes of section 6662(i). If a transaction lacking economic substance is a reportable transaction, as defined in Treas. Reg. § 1.6011-4(b), the adequate disclosure requirement under section 6662(i)(2) will be satisfied only if the taxpayer meets the disclosure requirements described earlier in this paragraph and the disclosure requirements under the section 6011 regulations. Similarly, a taxpayer will not meet the disclosure requirements for a reportable transaction under the section 6011 regulations by only attaching Form 8275 or 8275-R to an original or qualified amended return.

[1671] Code § 6664(c)(2). The reasonable cause exception also does not apply to reportable transaction understatements that are subject to this doctrine. Code § 6664(d)(2).

[1672] 293 U.S. 465 (1935).

[1673] *CNT Investors, LLC v. Commissioner*, 144 T.C. No. 11 (2015). The case acknowledged codification of the economic substance doctrine as being a positive step in the development of the doctrines. The transaction at hand preceded the codification. However, the codification would have applied only to penalty issues, as the Tax Court viewed the economic substance doctrine as a mere subset of the larger equitable principles it applied to this case.

> deeply offends their spirit.[40] Attempts to parse and define the doctrines merely intellectualize what is, ultimately, an equitable exercise. Those who favor transparency might prefer a strictly circumscribed taxonomy of judicial doctrines, to include exclusive definitions of the circumstances in which they should be applied. Those who favor administrability, protection of the fisc, and respect for congressional purpose might prefer that courts exercise carte blanche in disallowing results of transactions perceived as abusive. *Gregory* and its progeny represent an ongoing effort to reconcile these opposing principles and methodologies. Litigants and courts employ specialized terminology to make this effort appear more rigorous, but candidly, underneath, we are simply engaged in the difficult, commonsense task of judging.
>
> [40] Such efforts lie squarely within the courts' role in interpreting the law in ways consistent with congressional intent. "[C]ourts in the interpretation of a statute have some scope for adopting a restricted rather than a literal or usual meaning of its words where acceptance of that meaning would lead to absurd results, *** or would thwart the obvious purpose of the statute[.]" *Helvering v. Hammel*, 311 U.S. 504, 510-511 (1941).

If one engages in a series of transactions designed to offset the tax consequences of the last transaction, the Tax Court held that the invalidity of the initial transactions does not give rise to an argument that the last transaction should be overlooked for tax purposes:[1674]

> Neither the sham transaction doctrine nor the step transaction doctrine nor the two combined requires us to disregard the income-producing event along with the shelter transaction designed to offset it. Such an interpretation would render the doctrines toothless and yield absurd results…..
>
> Here, the gain-producing transaction and the shelter transaction occurred pursuant to a plan, and the shelter transaction arguably preceded realization of the gains it was designed to shield. But if we were to disregard the gain-producing transaction along with the shelter transaction, we would encourage taxpayers to hedge against the audit lottery by structuring their tax shelter transactions to precede and intertwine with their income-producing activities. We will not do so. "[W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not". *Commissioner v. Nat'l Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974).

If a loan has economic substance and is properly characterized as a loan, an IRS challenge that the interest "lacked economic substance because it was overpriced" would not succeed even if the loan's motive was to avoid taxes.[1675]

In *Mazzei v. Commissioner*, 150 T.C. 138 (2018), a reviewed opinion that is summarized and explained in the text accompanying and preceding fns 1883-1884 in part II.G.22 IRA as Business Owner, the taxpayers' Roth IRAs contributed $1 each to a foreign sales corporation (FSC), a type of entity designed to achieve the goals of a specialized income tax provision that authorized shifting income from the taxpayers' corporation to the FSC. The Tax Court majority

[1674] *CNT Investors, LLC v. Commissioner*, 144 T.C. No. 11 (2015).

[1675] *The Bank of New York Mellon Corporation v. Commissioner*, 801 F.3d 104 (2nd Cir. 2015); the IRS unsuccessfully attacked an interest deduction in another tax shelter case it otherwise won - *Ad Investment 2000 Fund LLC v. Commissioner*, T.C. Memo. 2015-223, which the Tax Court reconsidered and reaffirmed in T.C. Memo. 2016-226.

agreed with the IRS that this income shifting constituted a distribution from the corporation to its owners, followed by an excess contribution to their Roth IRAs that owned the FSC. The facts were sympathetic to the government, in that the Roth IRAs contributed $1 to the FSC and received dividends from the FSC totaling $533,057 over four years. To me, the biggest problem is that the corporation that paid the FSCs had too much discretion in the contractual arrangements – so much that the court viewed the payments as voluntary. However, the majority used some disturbing language that went further than just saying that:

> Considering all the facts in the record, however, it is evident that the Roth IRAs' formal purchase of the FSC stock for $1 did not reflect the underlying reality; *i.e.*, petitioners' capacity (through Injector Co.)[39] and clear intention to direct Injector Co. to make large commission payments to the FSC. The form of the transactions the Roth IRAs entered into does not reflect the underlying related-party expectations and intentions. Petitioners' transactions attempt to utilize this mismatch between substance and form to defeat the contribution limits. We have not found any textual support in the Code or the regulations that would allow such a mismatch between the form and substance of a purchase by these Roth IRAs. We therefore disregard the purchase.
>
> [39] Petitioners' export receipts had fluctuated to some degree over the years, but they had reliable and established export receipts when they entered these transactions.
>
> Furthermore, because petitioners (through various passthrough entities) controlled every aspect of the transactions in question, we conclude that they, and not their Roth IRAs, were the owners of the FSC stock for Federal tax purposes at all relevant times.[40] The dividends from the FSC are therefore properly recharacterized as dividends from the FSC to petitioners, followed by petitioners' contributions of these amounts to their respective Roth IRAs …
>
> [40] We note that, because no income tax issues are presented in these cases, we need not and do not consider whether the FSC was owned by and through one of petitioners' passthrough entities rather than directly by petitioners.

The dissent criticized this approach:

> The majority then asks another question: Did what the Roth IRAs paid for the FSC have any relation to its future value? The majority says it didn't, which it finds is another sign that the Roth IRAs didn't own the FSC. See op. Ct. p. 45. But the Code doesn't require a founding shareholder to take as his basis what he hopes the earnings on his investment will be—it requires him to take as his basis only the cost or amount of whatever he contributed. Secs. 351, 358(a); see also sec. 1012 (basis is cost). And the Code certainly doesn't treat his corporation as a sole proprietorship if it turns out to be profitable. What the Mazzeis' Roth IRAs paid for the FSC stock is meaningless - which might be why the Commissioner didn't challenge it.
>
> Still trying to shoehorn these cases into a sale-leaseback framework, the majority then says that because Injector Co. controlled how much cash went into the FSC, an unrelated Roth IRA couldn't have expected any upside benefits from its small investment. See op. Ct. pp. 47-49. That's true, but proves too much - any commonly controlled corporations between which the owners could readjust contractual rights at any time would be in the same situation.

The majority's application of sale-leaseback analysis also misses a larger point. The Supreme Court tells us to respect a corporation for tax purposes as long as it's a real business or its purpose is the "equivalent of business activity." *Moline Props., Inc. v. Commissioner*, 319 U.S. 436, 439 (1943). And the regulations say that an FSC - a corporation - receive commissions based not on the normal transfer-pricing rules but on a statutory formula unrelated to economic reality. See, *e.g.*, sec. 925(a); sec. 1.925(a)-1T(a)(1), Temporary Income Tax Regs., 52 Fed. Reg. 6443-44 (Mar. 3, 1987). So as long as an FSC complies with the statute, we respect it as if it had a real business purpose - it doesn't do anything, but the Code and regulations give it the "equivalent of business activity." The same is essentially true for Roth IRAs - they have no nontax purpose, but the Code grants them tax benefits if they comply with certain formalities. Sec. 408A; see *Summa II*, 848 F.3d at 789 (point of Roth IRA is tax avoidance). And here the Commissioner concedes that the Mazzeis observed those formalities.

Moline Properties was about income tax, see 319 U.S. at 438, not the excise taxes at issue here, but that doesn't change anything. In *Hellweg* we held that we have to treat transactions the same way for excise tax as we do for income tax. 2011 WL 821090, at *9. There we refused to recharacterize distributions from a DISC to a Roth IRA for excise-tax purposes because the Commissioner didn't also make income-tax adjustments.[12] *Id*. So if we would respect FSCs and Roth IRAs for income-tax purposes, we also would have to respect them for excise-tax purposes.

[12] The Commissioner here also doesn't seek to redetermine income tax, but only because the statute of limitations has run - he says if it hadn't, he'd redetermine the income tax too. We previously decided this was enough of a distinction from *Hellweg* to let these cases go forward on the excise-tax issue alone. *Mazzei v. Commissioner*, T.C. Memo. 2014-55, at *12-*13.

The majority's dominion-and-control test would wreak havoc on many - perhaps hundreds of thousands - of small individually- or family-owned corporations were we ever to apply it for anything other than disposing of these cases. By the majority's reasoning, someone who created a business, incorporated it, issued himself 100% of the stock in exchange for a small capital investment, and continued to run the day-to-day operations wouldn't really own his corporation - especially if it was a success. We'd have to disregard the corporation because the initial investment was too small and didn't accurately predict the business's future earnings.

The majority replied to the last paragraph above:

This is nonsense. The dissent's hypothetical scenario would not involve a mismatch between substance and form. At the initial point of capitalization, the fair market value and the substantive economic value would be identical and equal to the capital investment. As the day-to-day operations commenced, that initial value would begin to change in concert with changing expectations regarding future cashflows. The fair market value and the substantive economic value of the stock would remain identical, whether the business was a success or not. Petitioners' situation is different because at the moment of purchase petitioners' formal characterization of the purchase did not match the underlying substantive and related-party economics.[47]

[47] The dissent, see dissenting op. pp. 100-104, attempts to contrast our approach with that of *Cottage Sav. Assoc. v. Commissioner*, 499 U.S. 554 (1991), *Gitlitz v.*

> *Commissioner*, 531 U.S. 206 (2001), *Austin v. Commissioner*, T.C. Memo. 2017-69, and *Caterpillar Tractor Co. v. United States*, 218 Ct. Cl. 517 (1978). None of these cases addresses the substance of ownership arising from a purchase in a related-party context. For example, the Commissioner did not challenge the purchase transaction in *Austin*; as the Court found, "the company funded the ESOP with a $500,000 loan … [and t]hese funds were used to purchase (on the basis of an outside appraisal) 5,000 shares of the company's common stock." *Austin v. Commissioner*, at *8. There was no dispute as to whether the ESOP owned the shares in substance. See also *Cottage Sav. Assoc. v. Commissioner*, 499 U.S. at 568 ("[T]here is no contention that the transactions in this case were not conducted at arm's length, or that Cottage Savings retained de facto ownership of the participation interests[.]").

To me, the majority is contradicting itself. On one hand, it says that the FSC was worth a lot more than the original capital contribution, because it was in line to make lots of profits from dealing with the taxpayers' corporation. On the other hand, it said that the taxpayers' corporation controlled the contracts with the FSC such that the FSC really couldn't count on anything, so the payments to the FSC were really dividends followed by Roth IRA contributions. I think this is just the Tax Court applying a smell test yet again.

The Ninth Circuit agreed with my last sentence above, reversing the Tax Court, 998 F.3d 1041 (2021):

> We join our sister circuits in concluding that, when Congress expressly departs from substance-over-form principles, the Commissioner may not invoke those principles in a way that would directly reverse that congressional judgment…
>
> As the First Circuit noted in the Benenson case, some might think that what the Mazzeis did here was too "clever," if not "unseemly." 887 F.3d at 523. But as that court noted, the substance-over-form doctrine "is not a smell test," it is "a tool of statutory interpretation." *Id*. It may have been unwise for Congress to allow taxpayers to pay reduced taxes, and pay out dividends, "through a structure that might otherwise run afoul of the Code." *Id*. at 518. But it is not our role to save the Commissioner from the inescapable logical consequence of what Congress has plainly authorized. Accordingly, to the extent that it was adverse to the Mazzeis, the judgment of the Tax Court is reversed.

II.G.18. Intellectual Property and Other Intangible Assets

II.G.18.a. Taxation of Intellectual Property Generally

One might consult a good primer on income tax planning for intellectual property generally[1676] or for universities.[1677]

[1676] See Postlewaite, Cameron & Kittle-Kamp: *Federal Income Taxation of Intellectual Properties & Intangible Assets* (WG&L). Postlewaite authors a treatise on partnership income taxation. See also Hodges & Fowler, "Tax Considerations of Acquiring Intellectual Property," *Journal of Taxation* (Oct. 2014); the authors summarized key points of that article in "Tax Considerations of Acquiring Intellectual Property," *Federal Taxes Weekly Alert Newsletter* (1/22/2015 – Vol. 61, No. 4)

[1677] Mancino and Lion, "Monetizing Colleges' And Universities' Intellectual Property," *Taxation of Exempts* (WG&L) (May/June 2015).

Whether the costs of acquiring computer software are deductible currently or capitalized depends on whether they are self-created or purchased.[1678]

II.G.18.b. Sale or Exchange of Intellectual Property - Capital Gain vs. Ordinary Income

Generally, one needs to transfer all of one's rights to an intangible asset to obtain capital gain treatment. A transfer of only some rights tends to be treated as a license, somewhat akin to renting rather than selling property.

All of the discussion in part II.G.18 Intellectual Property and Other Intangible Assets needs to consider that, for purposes of Code §§ 1-1563, "capital asset" does not include:[1679]

> a patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by -
>
> (A) a taxpayer whose personal efforts created such property,
>
> (B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or
>
> (C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B)

Similarly, after 2017 tax reform, Code § 1231 capital gain treatment[1680] does not apply to "a patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer" described in the above quote.[1681]

On the other hand, the sale of an interest in a partnership that holds the above-mentioned property may receive capital gain treatment with respect to the value attributable to that property if the property is not being amortized or if the sale is a Code § 736 redemption (or perhaps those qualifications are unnecessary).[1682] See parts II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest (capital gain treatment), II.Q.8.b.i.(g) Code § 751 – Hot Assets (exception for items ineligible for capital gain treatment, with a shorter list of ineligible items when a Code § 736 redemption is involved), and II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

[1678] Rev. Proc. 2000–50, modified by Rev. Proc. 2004-11.
[1679] Code § 1221(a)(3).
[1680] See part II.G.6.a Code § 1231 Property.
[1681] Code § 1231(b)(1)(C). From RIA Checkpoint History:
In 2017, P.L. 115-97, Sec. 13314(b), added "a patent, invention, model or design (whether or not patented), a secret formula or process," before "a copyright" in subpara. (b)(1)(C), effective for dispositions after 12/31/2017.
[1682] I am unsure whether amortizable intangibles are hot assets that trigger ordinary income tax in certain situations or whether they are never hot assets. See fn 5470 in part II.Q.8.b.i.(g) Code § 751 – Hot Assets.

In an informal internal memo, the IRS advised that the transfer of certain fishing rights did not a sale or exchange of a capital asset but rather constituted ordinary income.[1683]

The IRS reasoned that the transfer merely provided the use of an asset for a limited time, with limited rights. The IRS stated:

> As discussed above, Taxpayer only transferred the right to fish in the Area on a yearly basis. What was transferred was a time-limited interest carved out from Taxpayer's allocation rights, the remainder of which it retained. Over time, appreciation in the value of the allocation rights, including the catch history, accrued to Taxpayer, not Transferee or other temporary users. As stated in *Gillette*, the term capital asset should be construed narrowly. What Taxpayer transferred was less than the whole directed allocation right stemming from the Act, Vessel's catch history, and the cooperative agreements. "[T]he right to use is not a capital asset, but simply an incident of the underlying... property, the recompense for which is commonly regarded as rent."[1684]

However, depending on its terms, the terms of related agreements, and other factors, a license or sublicense agreement might constitute a transfer of substantially all rights in the subject property that might make the transaction eligible for capital gain treatment.[1685]

II.G.18.c. Patents

As with other intangible assets described above, whether the disposition of a patent is taxed as ordinary income or capital gain can be a challenging issue.

[1683] CCA 2011440230.

[1684] Citing *Commissioner v. Gillette Motor Transport Co.*, 364 U.S. 130, 135 (1960) (compensation for temporary seizure of business facilities is ordinary income).

[1685] *Mylan, Inc. v. Commissioner*, T.C. Memo. 2016-45, reconciling *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967), *vacating and remanding* 44 T.C. 549 (1965), with *Merck & Co. v. Smith*, 261 F.2d 162 (3d Cir. 1958), and *E.I. du Pont de Nemours & Co. v. United States*, 432 F.2d 1052 (3d Cir. 1970). The Tax Court described these cases:

> … the Court of Appeals held that the transfer of all substantial rights in a patent can result in a disposition for tax purposes qualifying the transferor for capital gains tax treatment while a transfer of anything less is called a license, with proceeds taxed at ordinary income tax rates. In both cases the Court of Appeals examined not only the terms of the contracts but also the intent of the parties and found that all substantial rights were transferred.…
>
> In *Danielson*, a taxpayer sought to change the tax consequences of a transaction by challenging the validity of the underlying contract's terms, specifically, allocation of consideration between the sale of stock and the covenant not to compete, because the taxpayer believed these terms did not reflect the agreement of the parties. In *Merck* and *E.I. du Pont de Nemours* the taxpayers did not seek to alter or challenge the agreements in question. Instead, the taxpayers disagreed with the Commissioner's interpretation of those contracts and characterization of the related payments for tax purposes…. The question presented here is a question of proper tax characterization of the proceeds of valid and enforceable contracts, and we are mindful that the Commissioner and taxpayers often disagree on this issue.[4]
>
> [4] To draw a parallel to taxation of real property transactions, we are dealing with the issue similar to whether the agreements as drafted represent a sublease or a lease assignment. See, *e.g.*, *Rochester Dev. Corp. v. Commissioner*, T.C. Memo. 1977-307 (holding that a lease in form was actually a sale for income tax purposes).

See also part II.G.33 Taxpayer Disavowing Form.

Statutory capital gain treatment applies if the seller is either (1) any individual whose efforts created such property, or (2) another individual who has acquired his or her interest in such property in exchange for consideration in money or money's worth paid to such creator before actual reduction to practice of the invention covered by the patent.[1686] However, the latter cannot be the employer of such creator or related[1687] to such creator. Thus, this treatment is best suited for someone who creates an invention on his or her own and then transfers it to an entity that then reduces the invention to practice.

For the holder to obtain capital treatment under Code § 1235, the holder must transfer "all substantial rights" to the patent.[1688] "The circumstances of the whole transaction, rather than the particular terminology used in the instrument of transfer, shall be considered in determining whether or not all substantial rights to a patent are transferred in a transaction."[1689] Retaining "a right to terminate the transfer at will" means that the transferor has not transferred "all substantial rights."[1690] The courts extend this rule to prevent the transferor from retaining control over the transferee, even if that control is not based on legal rights and does not fall within the level of control prohibited by Code § 1235(d).[1691] Code § 1235 capital gain treatment applied to

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[1686] Code § 1235(b).
[1687] As defined in Code § 1235(d).
[1688] Code § 1235(a).
[1689] Reg. § 1.1235-2(b)(1).
[1690] Reg. § 1.1235-2(b)(4).
[1691] *Cooper v. Commissioner*, 143 T.C. No. 10 (2014), finding that, although the taxpayer held a minority position in the transferee's stock and the other shareholders were not statutorily related parties to him, he controlled the transferee. The taxpayers cited *Lee v. United States*, 302 F.Supp. 945 (E.D. Wis. 1969), and *Charlson v. United States*, 525 F.2d 1046, 1053 (Ct. Cl. 1975). Although the latter held for the taxpayer, *Cooper* followed its standards and held for the IRS:

> By contrast, TLC did not exercise its rights in the subject patents according to its own discretion. Both *Lee* and *Charlson* are distinguishable because the taxpayers in those cases did not control the transferee corporations. Here, Mr. Cooper—troubled by his deteriorated business relationship with Mr. Leckrone—formed TLC with individuals he could trust and ultimately control. Ms. Coulter and Ms. Walters—the shareholders and directors of TLC (along with Ms. Cooper)—did not have the patent, engineering, or other such skills to make them particularly valuable to a small patent licensing company. Instead, they were individuals whom Mr. Cooper could trust to follow his direction on patent licensing issues. Indeed, Ms. Coulter testified that the technical negotiations regarding licensing and patent infringement were over her head and she deferred to Mr. Cooper on such issues. She further testified that she signed licensing and infringement agreements when directed to do so by TLC's attorneys and signed checks and transferred funds when directed to do so by TLC's accountants.
>
> As officers and directors of TLC, Ms. Coulter and Ms. Walters took numerous actions that are inconsistent with acting independently and in the best interest of the corporation. Among other things, Ms. Coulter and Ms. Walters approved TLC's transfer of potentially valuable patents to Mr. Cooper for no consideration. At least in one instance, Mr. Cooper almost immediately licensed one of these patents to another related corporation for which that corporation received a royalty of $120,000 in 2007. As shareholders Ms. Coulter and Ms. Walters signed a stock restriction agreement placing restrictions on their ability to transfer shares of stock in TLC to anyone other than petitioners, without receiving any consideration in exchange. The stock restriction agreement did not place similar restrictions on petitioners.
>
> Indeed, it is unclear what material decisions, if any, the officers and directors of TLC made independent of Mr. Cooper. [footnote omitted] Mr. Cooper—and not the officers or directors of TLC—provided technical assistance to the Niro firm in interpreting the subject patents and relevant technology and in formulating patent enforcement strategies. Mr. Cooper conducted all technical matters for TLC—which in substance was all or a large part of TLC's activities.

termination payments under which the seller sold all substantial rights to a patent and the buyer agreed to pay the seller based on the sales of a product; when the buyer was acquired by another party, the buyer paid the seller the termination payment in question.[1692]

Although a partnership cannot qualify for this treatment, each member of a partnership who is an individual may qualify as to his or her share of a patent owned by the partnership.[1693] If a qualified individual contributes the patent to a partnership after actual reduction to practice of the invention, the individual retains his or her eligibility for capital gain treatment under this provision as to the individual's share of gain on the partnership's disposition of the patent.[1694]

Be careful to coordinate all of the rules described in this part II.G.18.c with the denial of capital gain treatment for certain assets under 2017 tax reform described in the text accompanying fn 1679 in part II.G.18.b Sale or Exchange of Intellectual Property - Capital Gain vs. Ordinary Income.

II.G.18.d. Amortization of Code § 197 Intangibles

Code § 197, "Amortization of goodwill and certain other intangibles," allows "any amortizable section 197 intangible" to be amortized over 180 months (15 years) in lieu of any other depreciation or amortization deduction.[1695]

Generally, Code § 197(c)(1) provides that an "amortizable section 197 intangible" is any "section 197 intangible":

(A) which is acquired by the taxpayer after the date of the enactment of this section, and

(B) which is held in connection with the conduct of a trade or business or an activity described in section 212.

Code § 197 was enacted August 10, 1993.[1696] For the conduct of a trade or business or an activity described in section 212, see part II.G.4.l.i Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit, especially parts II.G.4.l.i.(a) "Trade or Business" Under Code § 162 and II.G.4.l.i.(b) Requirements for Deduction Under Code § 212.

Code § 197(d), "Section 197 intangible," provides that, for purposes of Code § 197:

(1) *In general*. Except as otherwise provided in this section, the term "section 197 intangible" means—

Furthermore, in his role as general manager of TLC and under the terms of the letter agreement, Mr. Cooper made all material decisions for TLC with respect to the IP Innovation assignment agreement and the New Medium and AV Technologies agreements.

We do not find credible any testimony by petitioners that TLC was an independent corporation that Mr. Cooper did not control. We conclude that petitioners have failed to meet their burden of establishing that they transferred all substantial rights in the subject patents to TLC pursuant to section 1235(a).

[1692] Letter Ruling 201701009.

[1693] Reg. § 1.1235-2(d)(2).

[1694] Letter Ruling 200135015.

[1695] Code § 197(a), (b).

[1696] P.L. 103-66, Sec. 13261(a).

(A) goodwill,

(B) going concern value,

(C) any of the following intangible items:

(i) workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment,

(ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers),

(iii) any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item,

(iv) any customer-based intangible,

(v) any supplier-based intangible, and

(vi) any other similar item,

(D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,

(E) any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof,[1697] and

(F) any franchise, trademark, or trade name.

(2) *Customer-based intangible*.

(A) *In general*. The term "customer-based intangible" means—

(i) composition of market,

(ii) market share, and

(iii) any other value resulting from future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers.

(B) *Special rule for financial institutions*. In the case of a financial institution, the term "customer-based intangible" includes deposit base and similar items.

[1697] [My footnote:] Code § 197(f)(3), "Treatment of amounts paid pursuant to covenants not to compete, etc.," provides, "Any amount paid or incurred pursuant to a covenant or arrangement referred to in subsection (d)(1)(E) shall be treated as an amount chargeable to capital account."

(3) *Supplier-based intangible*. The term "supplier-based intangible" means any value resulting from future acquisitions of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer.

However, Code § 197(e), "Exceptions," provides that "section 197 intangible" does not include any of the following:

(1) *Financial interests*. Any interest—

(A) in a corporation, partnership, trust, or estate, or

(B) under an existing futures contract, foreign currency contract, notional principal contract, or other similar financial contract.

(2) *Land*. Any interest in land.

(3) *Computer software*.

(A) *In general*. Any—

(i) computer software which is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified, and

(ii) other computer software which is not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.

(B) *Computer software defined*. For purposes of subparagraph (A) , the term "computer software" means any program designed to cause a computer to perform a desired function. Such term shall not include any data base or similar item unless the data base or item is in the public domain and is incidental to the operation of otherwise qualifying computer software.

(4) *Certain interests or rights acquired separately*. Any of the following not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade business or substantial portion thereof:

(A) Any interest in a film, sound recording, video tape, book, or similar property.

(B) Any right to receive tangible property or services under a contract or granted by a governmental unit or agency or instrumentality thereof.

(C) Any interest in a patent or copyright.

(D) To the extent provided in regulations, any right under a contract (or granted by a governmental unit or an agency or instrumentality thereof) if such right—

(i) has a fixed duration of less than 15 years, or

(ii) is fixed as to amount and, without regard to this section , would be recoverable under a method similar to the unit-of-production method.

(5) *Interests under leases and debt instruments*. Any interest under—

(A) an existing lease of tangible property, or

(B) except as provided in subsection (d)(2)(B), any existing indebtedness.

(6) *Mortgage servicing*. Any right to service indebtedness which is secured by residential real property unless such right is acquired in a transaction (or series of related transactions) involving the acquisition of assets (other than rights described in this paragraph) constituting a trade or business or substantial portion thereof.

(7) *Certain transaction costs*. Any fees for professional services, and any transaction costs, incurred by parties to a transaction with respect to which any portion of the gain or loss is not recognized under part III of subchapter C.

Also, Code § 197(c)(2), "Exclusion of self-created intangibles, etc.," provides that a "section 197 intangible" is not an "***amortizable*** section 197 intangible" (emphasis added) if it is not described in Code § 197(d)(1)(D), (E), or (F) and is created by the taxpayer, unless "the intangible is created in connection with a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof." When an intangible is contributed by a partner to a partnership, Reg. § 1.197-2(g)(4), "Section 704(c) allocations," provides:

(i) Allocations where the intangible is amortizable by the contributor. To the extent that the intangible was an amortizable section 197 intangible in the hands of the contributing partner, a partnership may make allocations of amortization deductions with respect to the intangible to all of its partners under any of the permissible methods described in the regulations under section 704(c). See § 1.704-3.

(ii) To the extent that the intangible was not an amortizable section 197 intangible in the hands of the contributing partner, the intangible is not amortizable under section 197 by the partnership. However, if a partner contributes a section 197 intangible to a partnership and the partnership adopts the remedial allocation method for making section 704(c) allocations of amortization deductions, the partnership generally may make remedial allocations of amortization deductions with respect to the contributed section 197 intangible in accordance with § 1.704-3(d). See paragraph (h)(12) of this section to determine the application of the anti-churning rules in the context of remedial allocations.

Remedial allocations are when a partner who contributes cash or other high-basis assets takes depreciation or amortization deductions with respect to assets contributed by another partner that otherwise would not be allowable because of insufficient basis; the partner who contributed low basis assets recognizes ordinary income to create basis to absorb the deductions as the deductions arise.[1698]

[1698] Information about remedial allocations is in fn 3825 in part II.P.1.a.i.(a) General Rules for Allocations of Income in Partnerships.

Furthermore, Code § 197(c)(3) is described in part II.Q.1.c.iv Goodwill (and other intangible) Anti-Churning Rules.

Code § 197(f)(1), "Treatment of certain dispositions, etc.," provides:[1699]

(A) *In general*. If there is a disposition of any amortizable section 197 intangible acquired in a transaction or series of related transactions (or any such intangible becomes worthless) and one or more other amortizable section 197 intangibles acquired in such transaction or series of related transactions are retained—

(i) no loss shall be recognized by reason of such disposition (or such worthlessness), and

(ii) appropriate adjustments to the adjusted bases of such retained intangibles shall be made for any loss not recognized under clause (i).

(B) *Special rule for covenants not to compete*. In the case of any section 197 intangible which is a covenant not to compete (or other arrangement) described in subsection (d)(1)(E), in no event shall such covenant or other arrangement be treated as disposed of (or becoming worthless) before the disposition of the entire interest described in such subsection in connection with which such covenant (or other arrangement) was entered into.

(C) *Special rule*. All persons treated as a single taxpayer under section 41(f)(1) shall be so treated for purposes of this paragraph .

Code § 197(f)(2), "Treatment of certain transfers," provides:

(A) *In general*. In the case of any section 197 intangible transferred in a transaction described in subparagraph (B), the transferee shall be treated as the transferor for purposes of applying this section with respect to so much of the adjusted basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor.

(B) *Transactions covered*. The transactions described in this subparagraph are—

(i) any transaction described in section 332, 351,[1700] 361, 721,[1701] 731,[1702] 1031,[1703] or 1033, and

(ii) any transaction between members of the same affiliated group during any taxable year for which a consolidated return is made by such group.

Code § 197(f)(7), "Treatment as depreciable," provides, "For purposes of this chapter, any amortizable section 197 intangible shall be treated as property which is of a character subject to

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[1699] For other rules, see part II.Q.1.c.i Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation.
[1700] [My footnote:] See part II.M.2.a Initial Incorporation – Generally.
[1701] [My footnote:] See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.
[1702] [My footnote:] See part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions, which is part of II.Q.8.b.i Distribution of Property by a Partnership.
[1703] [My footnote:] See part II.G.16 Like-Kind Exchanges.

the allowance for depreciation provided in section 167." This is critically important because it confirms the treatment of an amortizable section 197 intangible as subject to ordinary income recapture under Code § 1245(a)(3)[1704] and therefore as a "hot asset" that may make part of the gain on the sale of a partnership interest lose its capital gain treatment.

II.G.19. IRS Audits/Procedures

Generally, the tax return of the taxpayer from whom the IRS tries to collect tax is the one upon which running the statute of limitations is based.[1705]

The Taxpayer Advocate Service can be accessed locally at https://www.irs.gov/advocate/local-taxpayer-advocate.

See Willms & Davis, "Knowing the Ropes and Binding the IRS: Income & Transfer Tax Issues of Settlements and Modifications that Every Fiduciary Should Know," Texas Tech Estate Planning & Community Property Law Journal Cle & Expo (3/2/2018).

II.G.19.a. Audits of Large C Corporation Returns

Business entities that have formal financial statements are required to account for uncertain tax positions that might materially affect their financial position.

[1704] See fns 1508 in part II.G.6.b Code § 1245 Property and 5470 in part II.Q.8.b.i.(g) Code § 751 – Hot Assets.

[1705] *Lardas v. Commissioner*, 99 T.C. 490 (1992) (reviewed decision, with only one judge dissenting), holding:

> We have held that the relevant return for determining whether, at the time a deficiency notice was issued, the period for assessment had expired under section 6501(a) "is that of petitioner against whom respondent has determined a deficiency". *Fehlhaber v. Commissioner*, 94 T.C. 863, 868 (1990) (Court reviewed), *affd.* 954 F.2d 653 (11th Cir. 1992). We have maintained that position consistently, without regard to the nature of the source entity involved. See *id.*, *Bufferd v. Commissioner*, T.C. Memo. 1991-170, *affd.* 952 F.2d 675 (2d Cir. 1992), *cert. granted* 505 U.S. __, 112 S.Ct. 2990 (1992), and *Kelley v. Commissioner*, T.C. Memo. 1986-405, *revd. and remanded* 877 F.2d 756 (9th Cir. 1989) (subchapter S corporations); *Siben v. Commissioner*, T.C. Memo. 1990-435, *affd.* 930 F.2d 1034 (2d Cir. 1991) (partnerships); *Stahl v. Commissioner*, T.C. Memo. 1990-320 and 96 T.C. 798 (1991), and *Fendell v. Commissioner*, 92 T.C. 708 (1989), *revd.* 906 F.2d 362 (8th Cir. 1990) (complex trust); *Bartol v. Commissioner*, T.C. Memo. 1992-141 (grantor trust).
>
> Recently, we reaffirmed our view that " 'the relevant return for purposes of determining the statute of limitations is the return of the taxpayer against whom the tax is sought.'" *Bartol v. Commissioner*, *supra* (quoting *Bufferd v. Commissioner*, 952 F.2d 675, 678 (2d Cir. 1992), *affg.* T.C. Memo. 1991-170, *cert. granted* 505 U.S. __, 112 S.Ct. 2990 (1992)). After consideration, we continue to hold that view.[5]
>
> [5] We have set forth our reasoning on more than one occasion, see, *e.g.*, *Fehlhaber v. Commissioner*, 94 T.C. 863 (1990) (Court reviewed), *affd.* 954 F.2d 653 (11th Cir. 1992), and we need not repeat it here.

The Supreme Court unanimously affirmed *Bufferd*. See fn. 1708.

See also part III.B.2.f Triggering the Statute of Limitations for Grantor Trusts, which includes a reference to nongrantor trusts.

The IRS will require certain corporations[1706] with both uncertain tax positions and assets equal to or exceeding $10 million to file with their tax returns Schedule UTP, reporting uncertain tax positions, if they or a related party issued audited financial statements on their tax returns.[1707]

II.G.19.b. Audits of S Corporation Returns

The statute of limitations for auditing an S corporation's items runs when the statute of limitations runs for each affected shareholder.[1708] However, this coordination does not apply in determining the due date for filing the S corporation's returns – it must file its own extension and cannot rely on its shareholders filing extensions for their returns.[1709]

[1706] This would apply to corporations filing the following returns to file Schedule UTP: Form 1120, U.S. Corporation Income Tax Return; Form 1120L, U.S. Life Insurance Company Income Tax Return; Form 1120 PC, U.S. Property and Casualty Insurance Company Income Tax Return; and Form 1120F, U.S. Income Tax Return of a Foreign Corporation. Schedule UTP would not be required from any other Form 1120 series filers, pass-through entities, or tax-exempt organizations in 2010 tax years. Thus, S corporations and partnerships would be exempt.

[1707] REG-119046-10, issued 9/7/2010, proposing to add paragraphs (4) and (5) to Reg. § 1.6012-2(a).

[1708] *Bufferd v. Commissioner*, 506 U.S. 523, 71 A.F.T.R.2d 93-573 (1993) (unanimous decision). *Whitesell v. Commissioner*, T.C. Memo. 2017-84, reiterated that position, holding:

> After *Bufferd* was released, Congress enacted the Taxpayer Relief Act of 1997, Pub. L. 105-34, sec. 1284, 111 Stat. at 1038, which in part amended section 6501(a). One of its specifically intended purposes was to clarify this issue with respect to S corporations. See *Robinson v. Commissioner*, 117 T.C. at 317 (and legislative history cited thereat). The legislative history explains that the new provision is intended to clarify that the return that starts the running of the period of limitations on assessment for a taxpayer is the return of the taxpayer and not the return of another "person"[8] from whom the taxpayer has received an item of income, gain, loss, deduction, or credit. See H.R. Rept. No. 105-148, at 609-610 (1997), 1997-4 C.B. (Vol. 1) 323, 931-932; S. Rept. No. 105-33, at 277-278 (1997), 1997-4 C.B. (Vol. 2) 1067, 1357-1358; H.R. Conf. Rept. No. 105-220, at 702-703 (1997), 1997-4 C.B. (Vol. 2) 1457, 2172-2173; see also *Robinson v. Commissioner*, 117 T.C. at 317. Therefore, the controlling return for each period of limitation for assessment in this case is petitioners' respective Form 1040 — not the corresponding Forms 1120S of the related S corporations.
>
> [8] Sec. 7701(a)(1) defines "person" to mean and include "an individual, a trust, estate, partnership, association, company or corporation."

[1709] *ATL & Sons Holdings, Inc. v. Commissioner*, 152 T.C. No. 8 (2019), dismissing the corporation's plea for leniency because the S corporation had losses:

> As we have noted, the section 6699 penalty is imposed on a failure to file an S corporation return "unless it is shown that such failure is due to reasonable cause". Sec. 6699(a) (emphasis added). No regulations have been issued to elaborate on this provision; but regulations under the analogous provision of section 6651(a)(1) (imposing an addition to tax for failure to file a return) provide that a taxpayer can show reasonable cause for the failure to timely file a return if "the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time". 26 C.F.R. sec. 301.6651-1(c)(1), Proced. & Admin. Regs. ATL did not present any argument or other evidence showing that it exercised such care and prudence or that it was unable to timely file the Form 1120S.
>
> Instead, ATL argues that the reasonable cause exception should apply because ATL's two shareholders were aware of the business loss for taxable year 2012 and "no one else has been harmed" - *i.e.*, no harm, no penalty. ATL evidently conceives that the sole purpose of the Form 1120S is to give a shareholder the information that he or she needs in order to file a Form 1040 tax return; and since Mr. and Mrs. Allen knew the affairs of ATL, did eventually file their Form 1040 timely (under an extension), and did not fail to report any income, the intended purpose of the S corporation's filing requirement was accomplished and the penalty was moot.

An S corporation shareholder's return must treat a subchapter S item[1710] in a manner which is consistent with the treatment of such item on the corporate return,[1711] unless the shareholder appropriately notifies the IRS of the inconsistent treatment.[1712] Failure to follow this rule is treated a mathematical or clerical errors assessed under Code § 6213(b)(1)[1713] and may subject the taxpayer to penalties.[1714]

Because adjustments made on the S corporation's return generally[1715] have an impact only on its shareholders, when making adjustments examiners need to consider materiality when adjusting each shareholder's return.[1716]

II.G.19.c. Audits of Partnership Returns

If one holds an interest in a publicly traded partnership with nominal income and K-1s that are always issued way too late, consider reporting a good-faith estimate of income and filing Form 8082.[1717]

Part II.G.19.c.i Overview of Rules Before and After TEFRA Repeal introduces the partnership audit rules, and the rest of this part II.G.19.c discusses the rules effective for returns filed for partnership taxable years beginning after December 31, 2017.

IRS' webpage, "BBA Centralized Partnership Audit Regime," as of 3/8/2022 is at https://www.irs.gov/businesses/partnerships/bba-centralized-partnership-audit-regime. IRS Publication 5388, https://www.irs.gov/pub/irs-pdf/p5388.pdf, is a flowchart illustrating the process. Treasury Inspector General for Tax Administration Report No. 2022-30-020 (3/17/2022), "Centralized Partnership Audit Regime Rules Have Been Implemented; However, Initial No-Change Rates Are High and Measurable Goals Have Not Been Established," opened with:

> ATL cites no authority in support of its claim that the penalty should be waived on the grounds that its two shareholders were aware of the information to be shown on the return. Section 6699 does not include a condition of harm before the penalty is imposed; it simply imposes a penalty when the filing is late (without reasonable cause). A taxpayer may not disregard a filing deadline and be excused from this penalty simply because it reckons that no harm was done.

[1710] "Subchapter S item" means any item of an S corporation to the extent that regulations provide that the item is more appropriately determined at the corporation level than at the shareholder level. Code § 6037(c)(4).

[1711] Code § 6037(c)(1).

[1712] Code § 6037(c)(2). *Rubin v. U.S.*, 118 A.F.T.R.2d 2016-6235 (C.D. CA 10/14/2016), noted, "The IRS created Form 8082 to be used to notify the IRS of inconsistencies under this section. IRM 20.1.5.2.5 (Jan. 24, 2012)." The court did not address whether Form 8082 is the exclusive way to notify the IRS, although it did note other areas in which courts addressed whether Form 8082 is required. See https://www.irs.gov/uac/form-8082-notice-of-inconsistent-treatment-or-administrative-adjustment-request-aar. The Ninth Circuit reversed the decision, 904 F.3d 1081 (2018), holding that the taxpayer's amended return sufficiently identified the relevant inconsistencies. However, one should consider using the appropriate form rather than guess whether a court would accept a substitute.

[1713] Code § 6037(c)(3).

[1714] Code § 6037(c)(5).

[1715] Exception generally are in part II.P.3.b Conversion from C Corporation to S Corporation.

[1716] Internal Revenue Manual paragraph 4.22.7.2.2.

[1717] See https://www.irs.gov/uac/form-8082-notice-of-inconsistent-treatment-or-administrative-adjustment-request-aar.

What TIGTA Found

TIGTA's review of the initial examination efforts under the centralized partnership audit regime rules found that as of the end of Fiscal Year 2021, the IRS has completed a total of 480 examinations. These examinations include returns filed for Tax Years 2016 through 2019. The IRS closed 376 (approximately 78 percent) of these partnership returns as a no-change. This rate is high in comparison to the average no-change rate of 50 percent for all partnership returns for the same tax years, closed as of September 30, 2020. IRS management agreed that the no-change rate is high and believes that it is too early in the process to analyze and form conclusions about the no-change rate. However, they also confirmed that they have not determined acceptable rates or ranges they would use to measure closure types for examinations.

The IRS does not establish goals based on audit procedures such as the centralized partnership audit regime. However, the centralized partnership audit regime provides a centralized method of examining items of a partnership that should limit the burden on the IRS in both the examination and judiciary process. Therefore, the IRS should measure whether partnership examinations performed after the centralized partnership audit regime was in place are taking less overall resources to complete and administer in comparison to pre-centralized partnership audit regime results. By not having these targets, the IRS cannot measure the effectiveness of the new audit rules on taxpayer compliance.

The IRS has developed a manual compliance monitoring process to confirm adjustments to partners' returns when a partnership makes a push-out election. However, the process is not fully systemic. Without a proper systemic monitoring process, the underreporting or nonreporting of adjustments may only be detected through a cumbersome time intensive manual process.

What TIGTA Recommended

TIGTA recommended that the IRS address the centralized partnership audit regime examination no-change rates, establish goals and measures that address the expected outcomes from the implementation of the centralized partnership audit regime, and implement a fully systemic method to monitor and verify push-outs are properly reported on partners' returns.

The IRS agreed with one recommendation and plans to request the development of a systemic method to verify pushouts. The IRS disagreed with two recommendations. TIGTA believes these recommendations will help the IRS address factors contributing to high no-change rates and establish goals and measurements based on the expected outcomes from the implementation of the centralized partnership audit regime.

The partnership audit rules apply to any entity taxed as a partnership or income purposes, which includes state law partnerships and LLCs. To elect out with respect to a taxable year, among other requirements the partnership must do so on its return for that year, must issue no more than 100 K-1s, and must have only eligible partners.

Eligible partners include an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner. A trust is ineligible – even if a grantor trust (revocable or irrevocable) deemed owned solely by a person who is an eligible partner. A disregarded entity, such as a single member LLC, is also ineligible – even if treated as owned solely by a person who is an eligible partner. A partnership is not an eligible partner of another partnership.

Further details about the above – including a discussion of how ridiculous the treatment of grantor trusts and disregarded entities – are in part II.G.19.c.v.(a) Who Can Elect Out of Post-TEFRA Rules on Partnership Return; What Is the Effect of Electing Out.

However, even if a partnership is eligible to elect out, I am not a fan of electing out. The centralized partnership audit regime gives audited partnerships several choices how to handle audit adjustments:

- If the tax impact is relatively small, just pay the tax at the top rate and don't burden the partners with the effects. See part II.G.19.c.ii Partnership's Liability for Underpayment under Code § 6225.

- If and to the extent that the partners amend their prior year returns to report adjusted items, they remove those items from the partnership-level adjustments. This allows the partners to use their tax attributes - such as excess deductions, losses, or credits or simply their lower tax brackets – to blunt the severity of the audit's effects. See part II.G.19.c.iii Amended Partner Returns for Reviewed Year in Lieu of Partnership Paying Tax.

- The partnership can push the adjustments out to those who were partners in the audited year to include on their current year returns. See part II.G.19.c.iv Pushing Out Adjustments in Year of Audit in Lieu of Partnership Paying Tax.

A disadvantage to the centralized partnership audit regime is that amended returns must go through the process of an administrative adjustment request and is accountable for making sure that the partners amend their returns. However, if the partnership return is not yet due, the changed return is instead a "superseding return" and is not subject to this rule; therefore, partnerships might consider extending their returns in case they notice any mistakes before the return's due date. See Rev. Proc. 2019-32, which is discussed in part II.G.19.c.i Overview of Rules Before and After TEFRA Repeal.

The "partnership representative" has absolute authority to deal with the IRS, with partners' only recourse being against the partnership representative. I prefer for the partnership to be the partnership representative, so that the partnership agreement can control decisions. The partnership then names a "designated individual," who has absolute authority to deal with the IRS but must ministerially follow the partnership's decisions. For drafting partnership agreements and a sample LLC operating agreement clause, see part II.G.19.c.vi Drafting Partnership Agreements to Take Into Account Post-TEFRA Rules.

II.G.19.c.i. Overview of Rules Before and After TEFRA Repeal

The statute of limitations for auditing a partnership's items runs when the statute of limitations runs for the partnership's return.[1718] P.L. 114-74, § 1101, deleted this rule, effective for returns

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[1718] Code § 6229; *Summit Vineyard Holdings v. Commissioner*, T.C. Memo. 2015-140.
Under the TEFRA rules that were repealed, an entity that is disregarded for federal tax purposes, but under state law is a general partner of a partnership subject to the TEFRA partnership provisions, may be designated the tax matters partner of the partnership. Rev. Rul. 2004-88, which was cited as recently as

filed for partnership taxable years beginning after December 31, 2017; in that case, subject to certain circumstances extending the statute of limitations,[1719] the statute of limitations runs three years after the latest of:[1720]

(A) the date on which the partnership return for such taxable year was filed,

(B) the return due date for the taxable year, or

(C) the date on which the partnership filed an administrative adjustment request with respect to such year under section 6227.

Of course, the statute of limitations never runs for "a false or fraudulent partnership return with intent to evade tax"[1721] (or if a return is never filed)[1722] and is extended from three to six years for a substantial omission of income.[1723]

For later returns (or earlier if the partnership elects into the regime),[1724] Code § 6221 makes audit adjustments at the partnership level, subject to rules allowing certain partnerships with 100 or fewer partners to opt out.[1725] The rule making audit adjustments at the partnership level has the following effects:

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footnote 21 of *436, LTD v Commissioner*, T.C. Memo. 2015-28, and expressly upheld by *Seaview Trading, LLC v. Commissioner*, 119 A.F.T.R.2d 2017-2097 (9th Cir. 6/7/2017).

[1719] Code § 6235(a)(2) and (3) provide:

(2) in the case of any modification of an imputed underpayment under section 6225(c), the date that is 270 days (plus the number of days of any extension consented to by the Secretary under paragraph (7) thereof) after the date on which everything required to be submitted to the Secretary pursuant to such section is so submitted, or

(3) in the case of any notice of a proposed partnership adjustment under section 6231(a)(2), the date that is 330 days (plus the number of days of any extension consented to by the Secretary under section 6225(c)(7) after the date of such notice.

[1720] Code § 6235(a)(1). Code § 6235(b) authorizes the IRS and partnership to agree to extend the statute of limitations.

[1721] Code § 6235(c)(1).

[1722] Code § 6235(c)(3).

[1723] Code § 6235(c)(2), referring to Code § 6501(e)(1)(A).

[1724] P.L. 114-74, § 1101(g)(4) provides:

> A partnership may elect (at such time and in such form and manner as the Secretary of the Treasury may prescribe) for the amendments made by this section (other than the election under section 6221(b) of such Code (as added by this Act)) to apply to any return of the partnership filed for partnership taxable years beginning after the date of the enactment of this Act and before January 1, 2018.

Reg. § 301.9100-22 is titled "Time, form, and manner of making the election under section 1101(g)(4) of the Bipartisan Budget Act of 2015 for returns filed for partnership taxable years beginning after November 2, 2015 and before January 1, 2018" and is based on Reg. § 301.9100-22T. For an explanation of the final regulation, see T.D. 9839 (8/9/2018); for an explanation of Reg. § 301.9100-22T, see T.D. 9780 (8/4/2016).

[1725] Partnerships with partners that are partnerships or nongrantor trusts cannot opt out, unless regulations under Code § §6221(b)(2)(C) allow them to be eligible partners (and the "blue book" contemplates some leniency here). Code § 6221(b)(1) allows opting out if:

(A) the partnership elects the application of this subsection for such taxable year,

(B) for such taxable year the partnership is required to furnish 100 or fewer statements under section 6031(b) with respect to its partners,

- Partner-level defenses would not apply. However, adjustments related to partners' tax attributes may apply.

- The partnership itself would pay tax on the adjustment, and the highest rate in effect under Code § 1 or 11 would apply.[1726] See part II.G.19.c.ii Partnership's Liability for Underpayment under Code § 6225. A partnership may request modification of certain adjustments that do not result in an imputed underpayment.[1727]

- The persons who were partners in the year under audit may amend their returns for the year to move the adjustment from being taxed at the partnership level to being implemented on the partners' returns. The Consolidated Appropriations Act, 2018 amended this process to allow an equivalent method to substitute for amended partner returns. See part II.G.19.c.iii Amended Partner Returns for Reviewed Year in Lieu of Partnership Paying Tax.

- If any portion of income would be taxed at a lower rate because the taxpayer is a C corporation[1728] or because the income is a capital gain or qualified dividend allocable to an individual (directly or through an S corporation),[1729] under IRS procedures that rate would apply. See part II.G.19.c.ii Partnership's Liability for Underpayment under Code § 6225, especially fns 1748-1759.

- If the partnership is not satisfied that the above modifications to the partnership's tax liability, the partnership may require the persons who were partners in the year under audit to report those items on their current year returns, with a higher rate of interest applying to the tax that is deemed to have been deferred. See part II.G.19.c.iv Pushing Out Adjustments in Year of Audit in Lieu of Partnership Paying Tax.

If the partnership elects to pay the tax:

- The current partners essentially bear the burden of changes to tax items reported by whoever were the partners during the year being audited. Considering drafting into partnership agreements provisions allocating the burden of any tax imposed on the partnership.

- A partnership may need to include as a balance sheet liability any taxes relating to adjustments for prior years. Lenders might require partnerships to elect out of these rules to avoid having tax liabilities competing with obligations to them. On the other hand, a lender might require a partnership to adopt the push-out election for any items remaining after

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(C) each of the partners of such partnership is an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner,
(D) the election -
   (i) is made with a timely filed return for such taxable year, and
   (ii) includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each partner of such partnership, and
(E) the partnership notifies each such partner of such election in the manner prescribed by the Secretary.

[1726] Code § 6225(b)(1)(A).
[1727] Reg. § 301.6225-2(e).
[1728] Code § 6225(c)(4)(A)(i).
[1729] Code § 6225(c)(4)(A)(ii).

going through all of the procedures described above, so the partnership would not need be subject to a liability. Query whether any of this makes a difference, in that partnership agreements often require distributions to pay their partners' taxes, which would be the case before and after considering the new rules.

- States need to update their partnership income tax laws to adopt procedures to take into account federal audits.[1730]

Under Code § 6227 and the regulations thereunder, a partnership may not simply amend its return and instead must file an administrative adjustment request (AAR), following procedures for implementing the adjustment similar in some ways to the procedure for implementing audit objectives. However, a partnership that corrects its return before the due date (including extensions) may treat that correction as a "superseding return" instead of amended return and therefore is not required to follow those procedures.[1731] Also, a partnership may amend its return to obtain the benefits of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), P.L. 116-136, 134 Stat. 281 (March 27, 2020), which provides retroactive tax relief that affects partnerships, including relief for the taxable years ending in 2018, 2019, and, in some cases, 2020.[1732]

[1730] The Multistate Tax Commission ("MTC") is drafting state tax provisions in response to the new federal partnership audit rules. See http://www.mtc.gov/Uniformity/Project-Teams/Partnership-Informational-Project. For more about the MTC, see fn 1150 in part II.G.3 State Income Taxation.

[1731] Rev. Proc. 2019-32, § 2 explains:

> For calendar-year partnerships that timely request a six-month extension, the extended deadline is September 15. A partnership that files its Form 1065 and furnishes Schedules K-1 to its partners prior to the deadline for filing the Form 1065 (including extensions) may file a superseding Form 1065 and furnish corresponding Schedules K-1 to its partners prior to the deadline, including extensions. Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 2015 (March 2016) (JCT Bluebook), JCS-1-16, at 82 ("Schedules K-1 . . . may not be amended after the due date of the partnership return . . . [but] [t]he due date takes into account the permitted extension period."). A timely filed superseding Form 1065 is considered the original return of the partnership. See, *e.g.*, *Haggar Co. v. Helvering*, 308 U.S. 389, 395-96 (1940); Rev. Rul. 78-256, 1978-1 C.B. 438 (amended corporate return filed before due date including extensions is the corporation's return for that taxable year for purposes of estimated tax penalties).

In certain circumstances, Rev. Proc. 2019-32 provides an automatic extension to those who filed timely (and without applying for an extension) tax returns and K-1s and would like to file a superseding return instead of an AAR.

[1732] Rev. Proc. 2020-23, Section 3 allows partnerships to amend 2018 and 2019 returns, providing in part:

> .02 *Option to file amended return*. BBA partnerships that filed a Form 1065 and furnished all required Schedules K-1 for the taxable years beginning in 2018 or 2019 prior to the issuance of this revenue procedure may file amended partnership returns and furnish corresponding Schedules K-1 before September 30, 2020. The amended returns may take into account tax changes brought about by the CARES Act as well as any other tax attributes to which the partnership is entitled by law.
>
> .03 *Eligible BBA partnerships*. The filing and furnishing option provided in section 3.02 of this revenue procedure is available only to BBA partnerships that filed Forms 1065 and furnished Schedules K-1 for the partnership taxable years beginning in 2018 or 2019 prior to the issuance of this revenue procedure. For purposes of section 6222, the amended return replaces any prior return (including any AAR filed by the partnership) for the taxable year for purposes of determining the partnership's treatment of partnership-related items. See section 4.03 of this revenue procedure for a special rule regarding partnerships who have previously filed AARs for an affected taxable year.

Each partnership must designate a person (not necessarily a partner, which is a change from TEFRA) as the partnership representative who shall have the sole authority to act on behalf of the partnership under these rules.[1733] The person must have a substantial presence in the United States[1734] and may be an entity,[1735] but an individual must be appointed to represent that entity.[1736] The partnership must designate a partnership representative separately for each taxable year, which designation is effective only for the taxable year for which it is made.[1737] A partnership representative or designated individual may resign as partnership representative or designated individual, as applicable, for a partnership taxable year for any reason by notifying the IRS in writing of the resignation in accordance with forms, instructions, and other guidance prescribed by the IRS.[1738] A partnership may revoke a designation of a partnership representative or appointment of a designated individual for a partnership taxable year for any reason by notifying the IRS in writing of the revocation in accordance with forms, instructions, and other guidance prescribed by the IRS.[1739] If the IRS determines that a designation of a partnership representative is not in effect for a partnership taxable year, the IRS will notify the partnership, and the partnership will have 30 days to designate one, or the IRS will do so.[1740] For an explanation of the final regulation regarding the partnership representative, see T.D. 9839 (8/9/2018).

Reg. § 301.6223-2(a), "Binding nature of actions by partnership and final decision in a partnership proceeding," provides:

[1733] Code § 6223(a).

[1734] Reg. § 301.6223-1(b)(2) provides:

Substantial presence in the United States. A person must have substantial presence in the United States to be the partnership representative. A person has substantial presence in the United States for the purposes of this section if--

(i) The person makes themselves available to meet in person with the IRS in the United States at a reasonable time and place as determined by the IRS in accordance with Sec. 301.7605-1; and

(ii) The person has a United States taxpayer identification number, a street address that is in the United States and a telephone number with a United States area code.

[1735] Reg. § 301.6223-1(b)(1) provides:

In general. Any person (as defined in section 7701(a)(1)) that meets the requirements of paragraphs (b)(2) and (3) of this section, as applicable, is eligible to serve as a partnership representative, including a wholly owned entity disregarded as separate from its owner for federal tax purposes. A person designated under this section as partnership representative is deemed to be eligible to serve as the partnership representative unless and until the IRS determines that the person is ineligible. A partnership can designate itself as its own partnership representative provided it meets the requirements of paragraphs (b)(2) and (3) of this section.

[1736] Reg. § 301.6223-1(b)(3)(i) provides:

In general. A person who is not an individual may be a partnership representative only if an individual who meets the requirements of paragraph (b)(2) of this section is appointed by the partnership as the sole individual through whom the partnership representative will act for all purposes under subchapter C of chapter 63. A partnership representative meeting the requirements of this paragraph (b)(3) is an entity partnership representative, and the individual through whom such entity partnership representative acts is the designated individual. Designated individual status automatically terminates on the date that the designation of the entity partnership representative for which the designated individual was appointed is no longer in effect in accordance with paragraph (d), (e), or (f) of this section.

[1737] Reg. § 301.6223-1(c)(1).

[1738] Reg. § 301.6223-1(d)(1).

[1739] Reg. § 301.6223-1(e)(1).

[1740] Reg. § 301.6223-1(f)(1).

> The actions of the partnership and the partnership representative taken under subchapter C of chapter 63 of the Internal Revenue Code (subchapter C of chapter 63) and any final decision in a proceeding brought under subchapter C of chapter 63 with respect to the partnership bind the partnership, all partners of the partnership (including partnership-partners as defined in Sec. 301.6241-1(a)(7) that have a valid election under section 6221(b) in effect for any taxable year that ends with or within the taxable year of the partnership), and any other person whose tax liability is determined in whole or in part by taking into account directly or indirectly adjustments determined under subchapter C of chapter 63 (for example, indirect partners as defined in Sec. 301.6241-1(a)(4)). For instance, a settlement agreement entered into by the partnership representative on behalf of the partnership, a notice of final partnership adjustment (FPA) with respect to the partnership that is not contested by the partnership, or the final decision of a court with respect to the partnership if the FPA is contested, binds all persons described in the preceding sentence.

A termination of the designation of a partnership representative does not affect the validity of any action taken by that partnership representative before the termination.[1741]

Reg. § 301.6223-2(d)(1) provides:

> The partnership representative has the sole authority to act on behalf of the partnership for all purposes under subchapter C of chapter 63. In the case of an entity partnership representative, the designated individual has the sole authority to act on behalf of the partnership representative and the partnership. Except for a partner that is the partnership representative or the designated individual, no partner, or any other person, may participate in an administrative proceeding without the permission of the IRS. The failure of the partnership representative to follow any state law, partnership agreement, or other document or agreement has no effect on the authority of the partnership representative or the designated individual as described in section 6223, Sec. 301.6223-1, and this section. Nothing in this section affects, or otherwise restricts, the ability of a partnership representative to authorize a person to represent the partnership representative, in the partnership representative's capacity as the partnership representative, before the IRS under a valid power of attorney in a proceeding involving the partnership under subchapter C of chapter 63.

The AICPA has a "Partnership Audit and Adjustment Rules" resource center at http://www.aicpa.org/INTERESTAREAS/TAX/RESOURCES/REPRESENTATION/Pages/Partnership-Audit-and-Adjustment-Rules.aspx.

In IRM 1.2.2.5.40 (01-21-2021), Delegation Order 4-52, "Partnership Matters Under the Centralized Partnership Audit Regime" provides rules for the IRS to administer this regime.[1742]

II.G.19.c.ii. Partnership's Liability for Underpayment under Code § 6225

This part II.G.19.c.ii is subject to parts II.G.19.c.iii Amended Partner Returns for Reviewed Year in Lieu of Partnership Paying Tax, II.G.19.c.iv Pushing Out Adjustments and II.G.19.c.v Electing

[1741] Reg. § 301.6223-2(b). Furthermore, If the IRS issues a notice of administrative proceeding (NAP) and later withdraws the NAP, any actions taken by a partnership representative (or successor partnership representative) are binding, even though the NAP has been withdrawn and has no effect. Reg. § 301.6223-2(c).

[1742] https://www.irs.gov/irm/part1/irm_01-002-002#idm140219910256912.

Out of Post-TEFRA Rules on Partnership Return and concludes with part II.G.19.c.vi Drafting Partnership Agreements to Take Into Account Post-TEFRA Rules. Some terminology used throughout:

- "Reviewed year" is the year being audited.[1743]

- "Adjustment year" is the year in which the audit results or other changes are implemented.[1744]

Code § 6225(a)(1) provides that, if the IRS adjusts the amount of any partnership-related items with respect to any reviewed year of a partnership, generally the partnership must (1) pay any imputed underpayment with respect to such adjustment in the adjustment year and (2) if an adjustment does not result in an imputed underpayment, take into account the adjustment in the adjustment year.

Also, if an adjustment does not result in an imputed underpayment, the partnership takes into account the adjustment in the adjustment year as a reduction in non-separately stated income or an increase in non-separately stated loss (whichever is appropriate) under Code § 702(a)(8), or in the case of an item of credit, as a separately stated item.[1745]

Except as provided below, for purposes of the audit rules any imputed underpayment with respect to any partnership adjustment for any reviewed year is determined by netting all partnership adjustments and applying the highest rate of tax in effect for the reviewed year under Code § 1 or 11.[1746] If any adjustment reallocates the distributive share of any item from one partner to another, the adjustment is taken into account in the paragraph by disregarding so

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[1743] Code § 6225(d)(1) provides that, "for purposes of this subchapter" (the partnership audit rules):

> The term "reviewed year" means the partnership taxable year to which the item being adjusted relates.

[1744] Code § 6225(d)(2) provides that, "for purposes of this subchapter" (the partnership audit rules):

> The term "adjustment year" means the partnership taxable year in which -
> (A in the case of an adjustment pursuant to the decision of a court in a proceeding brought under section 6234, such decision becomes final,
> (B) in the case of an administrative adjustment request under section 6227, such administrative adjustment request is made, or
> (C) in any other case, notice of the final partnership adjustment is mailed under section 6231.

[1745] Code § 6225(a)(2).

[1746] Code § 6225(b)(1), reflecting the Consolidated Appropriations Act, 2018. Code § 6225(b)(3) provides:

> *Adjustments Separately Netted By Category*. For purposes of paragraph (1)(A), partnership adjustments for any reviewed year shall first be separately determined (and netted as appropriate) within each category of items that are required to be taken into account separately under section 702(a) or other provision of this title.

Code § 6225(b)(4) provides:

> *Limitation On Adjustments That May Be Taken Into Account*. If any adjustment would (but for this paragraph) -
> (A) result in a decrease in the amount of the imputed underpayment, and
> (B) could be subject to any additional limitation under the provisions of this title (or not allowed, in whole or in part, against ordinary income) if such adjustment were taken into account by any person,
>
> such adjustment shall not be taken into account under paragraph (1)(A) except to the extent otherwise provided by the Secretary.

much of such adjustment as results in a decrease in the amount of the imputed underpayment.[1747]

However, the IRS is required to establish procedures under which the imputed underpayment amount may be modified consistent with the requirements described in Code § 6225(c):[1748]

- The partnership must submit to the IRS any items to be considered in modifying the amount no later than the close of the 270-day period beginning on the date on which the notice of a proposed partnership adjustment is mailed under Code § 6231 unless such period is extended with the IRS' consent.[1749] Any modification resulting from any submission is made only with the IRS' approval.[1750]

- The IRS must also establish procedures under which the adjustments described in Code § 6225(a)(2) may be modified in such manner as the IRS determines appropriate.[1751]

- Those procedures must provide that, if one or more partners file returns (notwithstanding the statute of limitations for the partners' returns) for the taxable year of the partners that includes the end of the reviewed year, these returns take into account all adjustments under Code § 6225(a) properly allocable to such partners (and for any other taxable year with respect to which any tax attribute is affected by reason of such adjustments), and payment of any tax due is included with such return, then the imputed underpayment amount shall be determined without regard to the portion of the adjustments so taken into account. If an adjustment reallocates the distributive share of any item from one partner to another, the preceding sentence applies only if all partners affected by the adjustment file returns. See part II.G.19.c.iii Amended Partner Returns for Reviewed Year in Lieu of Partnership Paying Tax.

- The Consolidated Appropriations Act, 2018 amended Code § 6225(c)(2) to allow partners to use processes similar to amended returns instead of actually filing returns and also to provide rules for partners that we pass-through entities. This is referred to as a "pull-in procedure."

- These procedures must provide for determining the imputed underpayment without regard to the portion pf the adjustment that the partnership demonstrates is allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity (as defined in Code § 168(h)(2)).[1752]

- These procedures must provide for taking into account a rate of tax lower than the highest rate of tax with respect to any portion of the imputed underpayment that the partnership demonstrates is allocable to a partner which (i) is a C corporation, or (ii) in the case of a capital gain or qualified dividend, is an individual:[1753]

[1747] Code § 6225(b)(2).
[1748] Code § 6225(c)(1).
[1749] Code § 6225(c)(7).
[1750] Code § 6225(c)(8).
[1751] Code § 6225(c)(9).
[1752] Code § 6225(c)(3).
[1753] Code § 6225(c)(4)(A).

- The lower rate determined under the preceding sentence cannot be less than the highest rate in effect with respect to the income and taxpayer (C corporation or individual), as the case may be, treating an S corporation as an individual.[1754]

- Generally, the portion of the adjustment to which the lower rate applies with respect to a partner is determined by reference to the partners' distributive share of items to which the adjustment relates.[1755] However, if the imputed underpayment is attributable to the adjustment of more than one item, and any partner's distributive share of those items is not the same with respect to all of those items, then the portion of the imputed underpayment to which the lower rate applies with respect to a partner is determined referring to the amount that would have been the partner's distributive share of net gain or loss if the partnership had sold all of its assets at their fair market value as of the close of the reviewed year of the partnership.[1756]

- Reg. § 301.6225-2(d)(4) addresses these rules.[1757]

- See Form 8980, Partnership Request for Modification of Imputed Underpayments Under IRC Section 6225(c), Form 8983, Certification of Partner Tax-Exempt Status for Modification under IRC § 6225(c)(3), and Form 15028, Certification of Publicly Traded Partnership to Notify Specified Partners and Qualified Relevant Partners for Approved Modifications Under IRC § 6225(c)(5).

• Special rules apply to the Code § 469 passive losses of publicly traded partnerships.[1758]

• The government may by regulations or guidance provide for additional procedures to modify imputed underpayment amounts on the basis of such other factors as the government determines are necessary or appropriate to carry out the purposes of the modification rules.[1759]

Furthermore, no later than 45 days after the above procedures are followed and the proposed modifications result in a of final partnership adjustment, the partnership may require the reviewed year partners to pick up the adjusted items in the adjustment year rather than the partnership paying the tax. See part II.G.19.c.iv Pushing Out Adjustments in Year of Audit in Lieu of Partnership Paying Tax.

1754 Code § 6225(c)(4)(A) (flush language).
1755 Code § 6225(c)(4)(B)(i).
1756 Code § 6225(c)(4)(B)(ii).
1757 Reg. § 301.6225-2(d)(4) provides:

> *Modification based on a rate of tax lower than the highest applicable tax rate*. A partnership may request modification based on a lower rate of tax for the reviewed year with respect to adjustments that are attributable to a relevant partner that is a C corporation and adjustments with respect to capital gains or qualified dividends that are attributable to a relevant partner who is an individual. In no event may the lower rate determined under the preceding sentence be less than the highest rate in effect for the reviewed year with respect to the type of income and taxpayer. For instance, with respect to adjustments that are attributable to a C corporation, the highest rate in effect for the reviewed year with respect to all C corporations would apply to that adjustment, regardless of the rate that would apply to the C corporation based on the amount of that C corporation's taxable income. For purposes of this paragraph (d)(4), an S corporation is treated as an individual.

1758 Code § 6225(c)(5). See further below in this part II.G.19.c.ii.
1759 Code § 6225(c)(6). See further below in this part II.G.19.c.ii.

The Preamble to final regulations T.D. 9844 (2/27/2019), includes:

SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations under sections 6221 through 6241 of the Internal Revenue Code (Code) to amend the Procedure and Administration Regulations (26 CFR part 301) to implement the centralized partnership audit regime enacted by section 1101 of the Bipartisan Budget Act of 2015, Public Law 114-74 (BBA), as amended by the Protecting Americans from Tax Hikes Act of 2015, Public Law 114-113, div Q (PATH Act), and sections 201 through 207 of the Tax Technical Corrections Act of 2018, contained in Title II of Division U of the Consolidated Appropriations Act of 2018, Public Law 115-141 (TTCA).

Section 1101(a) of the BBA removed former subchapter C of chapter 63 of the Code effective for partnership taxable years beginning after December 31, 2017. Former subchapter C of chapter 63 of the Code contained the unified partnership audit and litigation rules enacted by the Tax Equity and Fiscal Responsibility Act of 1982, Public Law 97-248 (TEFRA) that were commonly referred to as the TEFRA partnership procedures or simply TEFRA. Section 1101(b) of the BBA also removed subchapter D of chapter 63 of the Code and part IV of subchapter K of chapter 1 of the Code, rules applicable to electing large partnerships, effective for partnership taxable years beginning after December 31, 2017. Section 1101(c) of the BBA replaced the TEFRA partnership procedures and the rules applicable to electing large partnerships with a centralized partnership audit regime that determines adjustments and, in general, determines, assesses, and collects tax at the partnership level. Section 1101(g) of the BBA set forth the effective dates for these statutory amendments, which are effective generally for returns filed for partnership taxable years beginning after December 31, 2017.

On December 18, 2015, section 1101 of the BBA was amended by the PATH Act. The amendments under the PATH Act are effective as if included in section 1101 of the BBA, and therefore, subject to the effective dates in section 1101(g) of the BBA.

On June 14, 2017, the Department of the Treasury (Treasury Department) and the IRS published in the Federal Register (82 FR 27334) a notice of proposed rulemaking (REG-136118-15) (June 2017 NPRM) proposing rules under section 6221 regarding the scope and election out of the centralized partnership audit regime, section 6222 regarding consistent treatment by partners, section 6223 regarding the partnership representative, section 6225 regarding partnership adjustments made by the IRS and determination of the amount of the partnership’s liability (referred to as the imputed underpayment), section 6226 regarding the alternative to payment of the imputed underpayment by the partnership, section 6227 regarding administrative adjustment requests (AARs), and section 6241 regarding definitions and special rules. The Treasury Department and the IRS received written public comments in response to the regulations proposed in the June 2017 NPRM, and a public hearing regarding the proposed regulations was held on September 18, 2017.

On November 30, 2017, the Treasury Department and the IRS published in the Federal Register (82 FR 56765) a notice of proposed rulemaking (REG-119337-17) (November

2017 NPRM) proposing rules regarding international provisions under the centralized partnership audit regime, including rules relating to the withholding of tax on foreign persons, the withholding of tax to enforce reporting on certain foreign accounts, and the treatment of creditable foreign tax expenditures of a partnership. No written comments were submitted in response to this NPRM, and no hearing was requested or held.

On December 19, 2017, the Treasury Department and the IRS published in the Federal Register (82 FR 60144) a notice of proposed rulemaking (REG-120232-17 and REG-120233-17) (December 2017 NPRM) proposing administrative and procedural rules under the centralized partnership audit regime, including rules addressing assessment and collection, penalties and interest, periods of limitations on making partnership adjustments, and judicial review of partnership adjustments. The regulations proposed in the December 2017 NPRM also provided rules addressing how pass-through partners take into account adjustments under the alternative to payment of the imputed underpayment described in section 6226 and under rules similar to section 6226 when a partnership files an AAR under section 6227. Written comments were received in response to the December 2017 NPRM. However, no hearing was requested or held.

On January 2, 2018, the Treasury Department and the IRS published in the Federal Register (82 FR 28398) final regulations under section 6221(b) providing rules for electing out of the centralized partnership audit regime.

On February 2, 2018, the Treasury Department and the IRS published in the Federal Register (83 FR 4868) a notice of proposed rulemaking (REG-118067-17) (February 2018 NPRM) proposing rules for adjusting tax attributes under the centralized partnership audit regime. Written comments were received in response to the February 2018 NPRM. However, no hearing was requested or held.

On March 23, 2018, Congress enacted the TTCA, which made a number of technical corrections to the rules under the centralized partnership audit regime. The amendments under the TTCA are effective as if included in section 1101 of the BBA, and therefore, subject to the effective dates in section 1101(g) of the BBA.

On August 9, 2018, the Treasury Department and the IRS published in the Federal Register (83 FR 39331) final regulations under section 6223 providing rules relating to partnership representatives and final regulations under § 301.9100-22 providing rules for electing into the centralized partnership audit regime for taxable years beginning on or after November 2, 2015, and before January 1, 2018. Corresponding temporary regulations under § 301.9100-22T were also withdrawn.

On August 17, 2018, the Treasury Department and the IRS published in the Federal Register (83 FR 41954) a notice of proposed rulemaking, notice of public hearing, and withdrawal and partial withdrawal of notices of proposed rulemaking (REG-136118-15) (August 2018 NPRM) that withdrew the regulations proposed in the June 2017 NPRM, the November 2017 NPRM, the December 2017 NPRM, and the February 2018 NPRM, and proposed regulations reflecting the technical corrections enacted in the TTCA as well as other changes as discussed in the preamble to the August 2018 NPRM. Written public comments were received in response to the August 2018 NPRM, and a public hearing regarding the proposed regulations was held on October 9, 2018.

In the preambles to the June 2017 NPRM and November 2017 NPRM, comments were requested regarding certain international and tax-exempt aspects of the centralized partnership audit regime. No comments were received in response to these requests, other than a comment regarding fiduciary issues under title I of the Employee Retirement Income Security Act of 1974 (ERISA), which is discussed later in section 3.B.i of the Summary of Comments and Explanation of Revisions. The Treasury Department and IRS will still consider comments on whether any issues related to international rules and tax-exempt partners warrant guidance either under the centralized partnership audit regime provisions or under the relevant provisions of the Code directly related to those areas.

After careful consideration of all written public comments received in response to the June 2017 NPRM, the December 2017 NPRM, and the August 2018 NPRM, as well as statements made during the public hearings for the June 2017 NPRM and the August 2018 NPRM, the portions of the August 2018 NPRM described in this preamble are adopted as amended by this Treasury Decision. Comments received in response to the February 2018 NPRM or that otherwise concern basis and tax attribute rules under § 301.6225-4 or § 301.6226-4 will be addressed in future guidance. For purposes of this preamble, the regulations proposed in the June 2017 NPRM, the November 2017 NPRM, and the December 2017 NPRM are collectively referred to as the "former proposed regulations." The regulations proposed in the August 2018 NPRM are referred to as the "proposed regulations."

Under "Summary of Comments and Explanation of Revisions," after describing the number of comments the preamble continued:

1. Scope of the Centralized Partnership Audit Regime

Three comments were received regarding the scope of the centralized partnership audit regime. All of the comments concerned former proposed § 301.6221(a)-1, which was issued before the TTCA was enacted. No comments were received on proposed § 301.6221(a)-1 as revised subsequent to the TTCA in the August 2018 NPRM.

Prior to amendment by the TTCA, section 6221(a) provided that any adjustment to items of income, gain, loss, deduction, or credit of a partnership shall be determined at the partnership level. Former proposed § 301.6221(a)-1(b)(1)(i) had defined the phrase "items of income, gain, loss, deduction, or credit" to mean all items and information required to be shown, or reflected, on a return of the partnership and any information contained in the partnership's books and records for the taxable year. One comment stated the definition under former proposed § 301.6221(a)-1(b)(1)(i) included items on the partnership return or in the partnership's books and records regardless of whether (i) such items or information would affect the income that the partnership reports or (ii) the particular tax characteristics of the separate partners would affect the ultimate tax liability. The comment expressed concern that, by broadly defining the scope of the centralized partnership audit regime, the proposed regulations would expand the number of partnerships and partners that encounter differences between the correct tax they would have paid if they had properly reported, and the amount of the imputed underpayment. No changes to the regulations were made in response to this comment.

The TTCA amended section 6221(a) by replacing the phrase "items of income, gain, deduction, loss or credit of a partnership for a partnership taxable year (and any partner’s distributive share thereof)” with the term “partnership-related item.” The TTCA added a definition of “partnership-related item” to section 6241(2). The August 2018 NPRM adopted the TTCA amendments to section 6221(a) and 6241 by moving the majority of the regulation text under former proposed § 301.6221(a)-1 to the definition of “partnership-related item” under proposed § 301.6241-6. Because of these changes, the comment is generally no longer applicable to this section of the regulations.

In addition, the TTCA amendments address the comment’s first concern that the scope of former proposed § 301.6221(a)-1(b)(1)(i) was overly broad in that it was delineated without regard to whether items or information adjusted at the partnership level affect the income of the partnership. Section 6241(2)(B) broadly defines a partnership-related item as any item or amount with respect to the partnership which is relevant in determining the tax liability of any person under chapter 1 of the Code and any partner’s distributive share thereof. Section 6241(2)(B). Nothing within that definition limits the term partnership-related item to income reported by the partnership. To the contrary, partnership-related items are any items with respect to the partnership that are relevant to determining any person’s chapter 1 tax, which could include partnership expenses, credits generated by partnership activity, assets and liabilities of the partnership, and any other items concerning the partnership that are relevant to someone’s chapter 1 tax, irrespective of the impact such items have on the partnership’s income.

Furthermore, the core feature of the centralized partnership audit regime is to provide a centralized method of examining items of a partnership. Adjusting items on a partnership’s return or in the partnership’s books and records, regardless of their effect on partnership income, in a centralized partnership proceeding at the partnership level is not only consistent with this centralized approach, but it also results in efficiencies because one proceeding can be conducted that will bind all partners and the partnership. See section 6223(b). Nothing in the statute requires only items that affect the partnership’s income, as reported on the partnership’s return, to be adjusted at the partnership level.

Regarding the comment’s second concern that an imputed underpayment is determined without regard to partners’ tax characteristics and that the imputed underpayment amount differs from the amount of tax the partners would have paid had the items been reported correctly, those concerns are addressed in section 3.A. of this Summary of Comments and Explanation of Revisions.

Former proposed § 301.6221(a)-1(b)(1)(i) provided as an example of an “item of income, gain, loss, deduction, or credit” any items related to transactions between a partnership and any person including disguised sales, guaranteed payments, section 704(c) allocations, and transactions to which section 707 applies. Former proposed § 301.6221(a)-1(b)(1)(i)(H). One comment suggested that this provision inappropriately included partner items such as a disguised fee under section 707(a)(2)(A) and the gain or loss a partner may realize from a disguised sale under section 707(a)(2)(B). The comment recommended revising the regulations to refer to “items of a partnership related to . . . transactions to which section 707 applies.” Similarly, another comment expressed concern about situations where a partner was not acting in the partner’s capacity as a partner, but rather as a counterparty to a transaction with the partnership. The comment suggested that the regulations clarify that a final determination of a transaction between a partnership and a partner following an examination of the partnership is not binding on any third person, including a partner not acting in its capacity as a partner and who was not a party to the examination.

These comments are addressed by the final regulations under § 301.6241-1(a)(6) regarding the definition of partnership-related item. Proposed § 301.6241-6(b)(4) and (5) defined the phrase “item or amount with respect to the partnership” to include an item or amount that relates to a transaction with the partnership by a partner acting in its capacity as a partner or by an indirect partner acting in its capacity as an indirect partner as well as an item or amount relating to a transaction that is described in section 707(a)(2), 707(b), or 707(c). Accordingly, under the proposed regulations if an item or amount related to a transaction that is described in section 707(a)(2), 707(b), or 707(c) and was relevant in determining chapter 1 tax, that item was a partnership-related item and must be determined at the partnership level.

As described more fully in section 1.B., the final regulations clarify that items or amounts relating to transactions of the partnership are items or amounts with respect to the partnership only if those items or amounts are shown, or required to be shown, on the partnership return or are required to be maintained in the partnership’s books and records. The final regulations further clarify that items or amounts shown, or required to be shown, on a return of a person other than the partnership (or in that person’s books and records) that result after application of the Code to a partnership-related item and that take into account the facts and circumstances specific to that person are not partnership-related items and, therefore, are not determined at the partnership level under the centralized partnership audit regime.

The changes in the final regulations to the definition of partnership-related item address the concerns raised by the comment. First, § 301.6241-1(a)(6) provides that only items or amounts reflected, or required to be reflected on the partnership’s return or in its books and records are with respect to the partnership. If such items are relevant to determining chapter 1 tax such items are partnership-related items. This rule applies equally to items or amounts relating to any transaction with, liability of, or basis in the partnership. Second, § 301.6241-1(a)(6) further provides that items reflected, or required to be reflected on the return of a person other than the partnership or in that person’s books and records that result after application of the Code to a partnership-related item are not with respect to a partnership and, thus, not partnership-related items. Accordingly, only items of the partnership, as suggested by the comment, are partnership-related items under § 301.6241-1(a)(6).

Proposed § 301.6221(a)-1(a) provided that any consideration necessary to make a determination at the partnership level under the centralized partnership audit regime, including the period of limitations on making partnership adjustments under section 6235 or facts necessary to calculate an imputed underpayment under section 6225 were determined at the partnership level. The final regulations under § 301.6221(a)-1(b) retain this concept, but with revised language. The final regulations provide that any legal or factual determinations underlying any adjustment or determination made under the centralized partnership audit regime are also determined at the partnership level under the centralized partnership audit regime. For instance, such determinations include the period of limitations on making adjustments under the centralized partnership audit regime and any determinations necessary to calculate the imputed underpayment or any modification of the imputed underpayment under section 6225.

After consideration, the Treasury Department and the IRS have concluded that the phrase “legal and factual determinations underlying an adjustment or determination” instead of the phrase “any consideration necessary to make a determination at the partnership level” more clearly and accurately reflects the rule that facts and legal conclusions that underlie adjustments to partnership-related items, tax, and penalties made at the partnership level are also determined at the partnership level. The revised language more clearly describes the rule and provides taxpayers with more definitive guidance regarding the items determined at the partnership level. Additionally, this language is consistent with language used in proposed § 301.6241-6(b)(8), which was removed as described in section 2 of this Summary of Comments and Explanation of Revisions.

Lastly, the final regulations remove the list of cross-references from the end of proposed § 301.6221(a)-1(a). The TTCA amended section 6221(a) to provide that adjustments to partnership-related items are determined at the partnership level “except to the extent otherwise provided in” subchapter C of chapter 63. Because the statutory language is clear that there are exceptions within subchapter C of chapter 63 to the general rule under section 6221(a) and § 301.6221(a)-1, the list of cross-references from proposed § 301.6221(a)-1(a) was no longer necessary.

A. PENALTY DEFENSES

Five comments were received with respect to former proposed § 301.6221(a)-1(c), which provided that any defense to any penalty, addition to tax, or additional amount must be raised by the partnership in a partnership-level proceeding under the centralized partnership audit regime, regardless of whether the defense relates to facts and circumstances relating to a person other than the partnership. Once the adjustments determined in the partnership-level proceeding became final, no defense to any penalty determined could be raised or taken into account. Former proposed § 301.6221(a)-1(c).

Several comments stated that the rule under former proposed § 301.6221(a)-1(c) was inequitable to partners because, among other reasons, partners had no control over whether the partnership representative would raise a partner-specific defense, especially in the case of indirect partners who are less directly connected to the partnership representative. Some comments recommended the regulations clarify how partner-level defenses would be raised in the partnership-level proceeding and how decisions regarding those penalty defenses would be communicated to partners. Other comments suggested that partners should be able to raise their own partner-level defenses. In response to these comments, former proposed § 301.6221(a)-1(c) was removed from the proposed regulations in the December 2017 NPRM. See section 3 of the preamble to the December 2017 NPRM. The December 2017 NRPM also proposed regulations under sections 6225 and 6226 (former proposed §§ 301.6225-2(d)(2)(viii) and 301.6226-3(i)) which allowed partners to raise their own partner-level defenses at the time partners took into account the partnership adjustments determined at the partnership level (either through the modification process or as part of the election under section 6226). For further discussion of the rules regarding partner-level defenses under sections 6225 and 6226, see sections 3.D. and 4.C.ii.I. of this preamble. See also section 8.A. of this preamble regarding section 6233(a).

B. PARTNERSHIP-RELATED ITEM

Proposed § 301.6241-6(a) defined the term “partnership-related item” as any item or amount with respect to the partnership which is relevant to determining the tax liability of any person under chapter 1 and any partner’s distributive share of any such item or amount. Proposed § 301.6241-6(b) provided that an item or amount is with respect to the partnership without regard to whether the item or amount appeared on the partnership return if the item or amount was described in one of eight categories. Two categories described items or amounts that are shown or reflected, or required to be shown or reflected, on a return of the partnership under section 6031 or are in the partnership’s books and records. The other categories described items or amounts relating to certain transactions with the partnership, items or amounts relating to liabilities of the partnership provided the item or amount was reported by a partner, and items or amounts relating to basis in the partnership. Imputed underpayments and any legal or factual determinations necessary to make an adjustment to items or amounts described in the other categories were also defined as items or amounts with respect to the partnership. Proposed § 301.6241-6(b)(1) through (8).

After careful consideration, the Treasury Department and the IRS have revised the definition of “item or amount with respect to the partnership.” First, the final regulations remove the language “without regard to whether or not such item or amount appears on the partnership’s return” from proposed § 301.6241-6(b). That phrase derived from the parenthetical in section 6241(2)(B)(i) that follows “item or amount with respect to the partnership.” The Treasury Department and the IRS have determined that the parenthetical language describes items or amounts that appear on the partnership return, items or amounts that were required to appear on the return but actually did not, and items or amounts that factor into the determination of items or amounts that do appear on the partnership return. The Treasury Department and the IRS have concluded that this parenthetical does not extend the concept of “with respect to the partnership” to items or amounts that are reported by third parties and that are otherwise not defined as partnership-related items in these final regulations. See § 301.6241-1(a)(6)(vi)(A) and (B).

Second, the final regulations replace the list of eight categories of items or amounts that were with respect to the partnership with a single, streamlined paragraph, § 301.6241-1(a)(6)(iii) that includes all the items and amounts from the prior list, except as described in this section of this preamble. Third, the definition of partnership-related item was moved from proposed § 301.6241-6 and placed under the definition of “partnership adjustment” in § 301.6241-1(a)(6) to more closely track the statutory structure of section 6241(2).

The final regulations under § 301.6241-1(a)(6)(iii) maintain the rule from the proposed regulations that items or amounts shown or reflected, or required to be shown or reflected, on the return of the partnership are items or amounts with respect to the partnership. The final regulations also clarify that items or amounts in the partnership’s book or records are items or amounts with respect to the partnership if those items or amounts are “required to be maintained” in the partnership’s books and records. The phrase “required to be maintained” is added to account for items that may be maintained in the partnership’s books and records on a voluntary basis. For example, a partnership may choose to maintain the outside basis of each of its partners in its books and records, even though the Code does not require this information be maintained by the partnership. The rule make clears that the voluntary recording of an item in the partnership's books is not determinative of the meaning of the phrase "item or amount with respect to the partnership." A partnership cannot convert an item or amount that is not with respect to the partnership into an item or amount that is with respect to the partnership merely by including that item or amount in the partnership's books and records. This rule provides consistency among partnerships and more certainty regarding what items in the books and records of a partnership constitute items or amounts with respect to the partnership.

The final regulations do not retain the separate categories of items relating to transactions with, liabilities of, and basis in the partnership. Instead, the final regulations adopt a streamlined approach and provide that those items are only with respect to the partnership if those items are reflected, or required to be reflected, on the partnership's return or required to be maintained in its books and records. The separate treatment under the proposed regulations for these types of items and amounts was duplicative. Items or amounts relating to transactions with, liabilities of, and basis in the partnership are items or amounts shown or reflected, or would be required to be shown or reflected, on the partnership return or required to be maintained in the partnership's books and records. Accordingly, describing separate categories for such items was unnecessary and potentially confusing.

Under § 301.6241-1(a)(6)(iii), an item or amount is with respect to the partnership only if the item or amount is shown or reflected, or required to be shown or reflected, on the partnership return or required to be maintained in the partnership's books and records. Consistent with that interpretation, the final regulations provide an item or amount relating to transactions with, liabilities of, and basis in the partnership is with respect to the partnership only if the item or amount is reported, or required to be reported, on the partnership return or is required to be maintained in the partnership's books and records.

The term partnership-related item includes a partner's distributive share of items or amounts that are with respect to the partnership which are relevant in determining the chapter 1 tax of any person. Section 6241(2)(B)(ii). In taking into account the partner's distributive share of partnership-related items, a partner must apply the provisions of the Code to each partnership-related item to compute the partner's ultimate tax liability. The application of the Code to the partner's share of partnership-related items requires taking into account facts and circumstances that are unique to a particular partner. Generally speaking, those facts and circumstances are known only by the partner, are not known by the partnership, and are based on information only within the partner's control and outside of the partnership's control.

In an examination of items on a partner's return, the IRS generally needs information pertaining to the partner's specific facts and circumstances to determine the correctness of the items. The partner whose items are at issue is normally the best source for that type of information. While a partnership may possess some information about a particular partner's facts and circumstances, obtaining information from the partnership is generally not as efficient as obtaining information from the partner. Obtaining such information from the partner also preserves the privacy interests of the partner. Therefore, from both a taxpayer and tax administration standpoint, an examination of items for which application of the Code depends on a partner's particular facts and circumstances is, in general, best performed at the partner level, rather than the partnership level.

Under the TEFRA procedures, these types of items were considered affected items and adjustments to those items were computational adjustments. The centralized partnership audit regime is intended to have a scope sufficient to address those items that would have been considered partnership items, affected items, and computational adjustments under TEFRA, including the regulations. Joint Comm. on Taxation, JCX-6-18, Technical Explanation of the Revenue Provisions of the House Amendment to the Senate Amendment to H.R. 1625 (Rules Committee Print 115-66), 37 (2018) (JCX-6-18). One way to achieve a sufficiently broad scope is to attempt to define the term "partnership-related item" to include those items that would have been partnership items, affected items, and computational adjustments under TEFRA. For the following reasons, however, this approach was not adopted.

The centralized partnership audit regime is a fundamentally distinct system from TEFRA. While under both sets of rules adjustments are made at the partnership level and those adjustments are binding on partners, the framework for assessing and collecting tax resulting from those adjustments is significantly different. Under TEFRA, tax attributable to partnership items determined at the partnership level and tax attributable to affected items was assessed against the partners of the partnership through computational adjustments made by the IRS with respect to the partner. Computational adjustments were made either by mailing a notice of deficiency to the partner if factual determinations were necessary at the partner level or by directly assessing tax against the partner. The tax was assessed with respect to the year that was audited by the IRS, and assessments were required to be made within one year of the completion of the partnership-level proceeding.

Under the centralized partnership audit regime, adjustments to partnership-related items are similarly determined at the partnership level. In stark contrast to the TEFRA procedures, however, the tax attributable to those adjustments is also assessed and collected at the partnership level in the form of an imputed underpayment determined pursuant to section 6225. An imputed underpayment is assessed as if it were a tax imposed for the adjustment year, generally the year in which the adjustments are finally determined, instead of the year that was subject to examination. Section 6225(d). The partnership, not the partners, is liable for the imputed underpayment. A partnership may elect the alternative to payment of the imputed underpayment under section 6226 and "push out" the adjustments determined at the partnership level, in which case the tax attributable to the adjustments is assessed and collected from the partnership's partners. Unlike the TEFRA procedures, however, under the push out process, assessment and collection is initiated by the partner, rather than by the IRS, by the partner taking into account the partnership adjustments and self-reporting any tax due on the partner's next filed return, alleviating both the administrative and timing issues that arose in TEFRA. See section 2.A of the preamble to the June 2017 NPRM.

When calculating an imputed underpayment based on adjustments determined at the partnership level, taxpayer favorable adjustments are generally disregarded and the highest rate of tax is applied. This formula may produce an amount that is larger than the cumulative amount of tax the partners would have paid had the partners taken the adjustments into account separately, but it also relieves the IRS of the obligation to account for specific partner facts and circumstances when initially determining the imputed underpayment amount. During the modification phase, a partnership may, at its option, request that the imputed underpayment be modified to take into account partner tax attributes and facts and circumstances. See section 3.B. for further discussion.

When taking into account adjustments under section 6226, a partner determines the increase or decrease in tax that would have occurred if the adjustments were taken into account for the partner's tax year correlating to the year that was audited. For intervening years, any year between the audited year and the current year, the partner must determine the effect on tax attributes of the adjustments and the resulting increase or decrease that would have occurred for those years as well. The partner then adjusts her tax for the current year by the aggregate tax that would have resulted had the adjustments been properly taken into account. Under TEFRA, it was the IRS's burden to determine tax at the partner level. The centralized partnership audit regime, under section 6226, shifts that burden from the IRS to the partner. As a result, it is neither necessary nor efficient for the IRS to determine at the partnership level the facts and circumstances specific to a partner in order for that partner to determine the proper amount of tax in the case of a push out.

The rules for calculating an imputed underpayment under section 6225 and the computation rules under section 6226 are sufficiently broad to ensure that the tax attributable to items that would have been partnership items, affected items, and computational adjustments under the TEFRA is collected under the centralized partnership audit regime. When the partnership pays an imputed underpayment, the application of limitations and restrictions is assumed and favorable adjustments are disregarded unless a partnership demonstrates that partner tax attributes should override those assumptions. In this way, the imputed underpayment determination, including any modifications, sufficiently accounts for those types of items that would have been affected items or computational adjustments under TEFRA. Similarly, in the case of an election under section 6226, the re-computation process necessarily involves the application of items that would have been affected items or computational adjustments.

Because both the imputed underpayment rules and the section 6226 rules sufficiently address items that would have been partnership items, affected items, and computational adjustments, it is both unnecessary and over-inclusive to define partnership-related item to encompass all of those items. Accordingly, the final regulations clarify that the term partnership-related item does not include items or amounts that would have been TEFRA affected items or computational adjustments. The final regulations do this by defining "with respect to the partnership" to exclude items or amounts shown, or required to be shown, on a return of a person other than the partnership (or in that person's books and records) that result after application of the Code to a partnership-related item and that take into account the facts and circumstances specific to that person. Because these items and amounts are not with respect to the partnership, they are not partnership-related items the IRS must adjust at the partnership level. Two examples were added to the final regulations under § 301.6241-1(a)(6)(vi) to illustrate this rule.

The definition of "with respect to the partnership," and by extension partnership-related item, under the final regulations preserves the centralized nature of the proceeding with respect to the partnership. During the partnership level proceeding under the centralized partnership audit regime, the IRS adjusts items that are germane to the partnership as an entity—that is, items reported by the partnership on its return or items in its books and records generally used for purposes of completing the return. The partnership has access to this information, and it is therefore, in general, most efficient to obtain this information from the partnership in the partnership level proceeding.

This rule also protects the tax and privacy interest of partners. Under section 6223, partners are bound by actions taken by the partnership in the partnership proceeding and by any final decision in the partnership proceeding. Unlike under TEFRA, individual partners do not have a right to participate in the partnership level administrative or judicial proceeding. If items based on the application of the Code to a particular partner based on that partner's facts and circumstances were items required to be determined at the partnership level, the partner may be unable to dispute adjustments to those items. And even if the partner were able to dispute adjustments to those items, the partner would need to divulge private information in a proceeding in which the partnership was the party, not the partner itself.

In addition, a rule that would require that such items and amounts be determined at the partnership level raises significant administrative concerns for the IRS. In general, the partnership would in most cases lack the facts necessary to determine items or amounts that depend on the facts and circumstances of the partners. By necessity, the IRS would be required to involve the partners in the examination to the extent the partner's items and amounts were at issue. Requiring the IRS to involve potentially the many partners in the entity level examination of the partnership would undermine the efficiencies of the centralized partnership audit regime's concept of the partnership representative and the binding nature of the partnership representative on the outcome of the entity level examination. Further, if the IRS did not examine all of the various items or amounts on the partners' returns during the partnership level proceeding, the IRS would, for each of the partners' items and amount that were also partnership-related items, be precluded from adjusting those items at the partner level outside of the centralized partnership audit regime. This would lead to an unnecessary expansion of partnership-level proceedings to encompass what could more simply and efficiently be resolved at the partner level for one or a small group of partners.

2. Partner's Return Must Be Consistent with Partnership Return

After describing the number of comments the preamble continued:

A. INCONSISTENT TREATMENT ON AN AMENDED RETURN AND DEFINITION OF PARTNER'S RETURN FOR PURPOSES OF § 301.6222-1

One comment recommended that the regulations clarify that a partner may file an amended return in order to take a position inconsistent with the filed partnership return as long as such amended return includes a statement identifying the inconsistent treatment. Under section 6222(a), a partner shall, on the partner's return, treat each partnership-related item in a manner that is consistent with the treatment of such item on the partnership return. Proposed § 301.6222-1(a) provided that the treatment of partnership-related items on a partner's return must be consistent with the treatment of such items on the partnership return in all respects, including the amount, timing, and characterization of such items. The term "partner's return" is not defined in either section 6222(a) or proposed § 301.6222-1(a).

Section 6222(a) and § 301.6222-1(a) are designed to ensure consistent treatment of partnership-related items on partners' returns and the partnership return filed with the IRS, except for cases where the partner notifies the IRS of the inconsistency. The requirement to be consistent with the partnership return extends to each return filed by the partner that reflects, or is required to reflect, partnership-related items. This includes both original and amended returns. Any other application of this requirement would render the requirement of consistency meaningless. For example, a partner could file a return on April 15 taking a consistent position, only to turn around on April 16 and file an amended return taking an inconsistent position.

To clarify that the consistency requirement under section 6222(a) and proposed § 301.6222-1(a) applies to each return of the partner, the final regulations provide that the term “partner’s return” for purposes of § 301.6222-1 includes any return, statement, schedule, or list, and any amendment or supplement thereto, filed by the partner with respect to any tax imposed by the Internal Revenue Code. Accordingly, pursuant to § 301.6222-1(a), a partner on either an original or an amended return must treat partnership-related items consistently with how those items were treated on the partnership return filed with the IRS.

The clarification of the term “partner’s return” also addresses the comment’s suggestion that the regulations permit inconsistent treatment on an amended return provided the IRS is notified of that inconsistent treatment. Under § 301.6222-1(c)(1), the requirement that a partner treat a partnership-related item consistently with the partnership’s treatment of that item, and the effect of inconsistent treatment, do not apply to partnership-related items identified as inconsistent (or that may be inconsistent) in a statement attached to the partner’s return on which the partnership-related item is treated inconsistently. As clarified in these final regulations, the term partner’s return for purposes of § 301.6222-1 includes any amendment to the partner’s original return. Accordingly, so long as a partner notifies the IRS of an inconsistent treatment, in the form and manner prescribed by the IRS, by attaching a statement to the partner’s return—including an amended return—on which the partnership-related item is treated inconsistently, the consistency requirement under § 301.6222-1(a), and the effect of inconsistent treatment under § 301.6222-1(b), do not apply to that partnership-related item.

I. LIMITATIONS ON FILING AMENDED RETURNS REPORTING INCONSISTENT POSITIONS

When a partner on an amended return treats a partnership-related item inconsistently with how the item was treated on the partnership return, the partner is making a request for an administrative adjustment of that partnership-related item. Accordingly, the rule under proposed § 301.6227-1(a) that provided a partner may not request an administrative adjustment of a partnership-related item was revised to account for situations in which on an amended return a partner treats a partnership-related item inconsistently with the partnership return pursuant to § 301.6222-1(c)(1).

Section 6227(c) provides that in no event may a partnership file an AAR after a notice of an administrative proceeding with respect to the taxable year is mailed under section 6231. Consistent with section 6227(c), proposed § 301.6227-1(b) provided that no AAR may be filed after a NAP has been mailed by the IRS, except as provided in § 301.6231-1(f) (regarding withdrawal of a NAP). To give effect to this rule in the context of inconsistent treatment, the final regulations under § 301.6222-1(c)(5) provide that a partner may not notify the IRS that the partner is treating an item inconsistently with the partnership return for a taxable year after a NAP with respect to such partnership taxable year has been mailed by the IRS under section 6231. This rule clarifies that once the IRS initiates an administrative proceeding with respect to a partnership taxable year, any adjustment to a partnership-related item for that year must be determined exclusively within that partnership-level proceeding in accordance with section 6221(a). Neither the partnership, through filing an AAR, nor a partner, by taking an inconsistent position, may adjust a partnership-related item outside of that proceeding. Any actions taken by the partnership and any final decision in the proceeding are binding on the partnership and all its partners. Section 6223(b).

B. INCONSISTENT TREATMENT IN THE CASE OF AN ADMINISTRATIVE ADJUSTMENT REQUEST

Proposed § 301.6222-1(c)(2) provided that the notification procedures under § 301.6222-1(c) do not apply to a partnership-related item the treatment of which is binding on the partner because of actions taken by the partnership, or because of any final decision in a proceeding with respect to the partnership, under the centralized partnership audit regime. Accordingly, under proposed § 301.6222-1(c)(2), the provisions of § 301.6222-1(c) did not apply with respect to the partner's treatment of a partnership-related item reflected on an AAR. This meant that a partner could not treat an item inconsistently with how such item was treated on an AAR. One comment recommended that the regulations under § 301.6222-1(c)(2) be revised to permit a partner to notify the IRS of an inconsistent position taken with respect to an item reported on an AAR. This comment was adopted.

Under section 6223(b), all partners are bound by actions taken by the partnership and by any final decision with respect to the partnership under the centralized partnership audit regime. In the case of an AAR, section 6223(b) binds each partner to the partnership's making of the request itself and the mechanism by which the adjustments requested are taken into account, including any election by the partnership to have the partners take into account the adjustments. Accordingly, if the partnership takes into account the adjustments by paying an imputed underpayment, the partners must follow the rules under section 6225. If there is no imputed underpayment or if the partnership elects to have the partners take into account the adjustments, the partners must follow the procedures under § 301.6227-3.

When taking into account AAR adjustments under § 301.6227-3, partners must adhere to the consistency requirements under section 6222(a). See § 301.6222-1(a)(4) (providing consistency requirement applies to the treatment of a partnership-related item on an AAR). Nothing in sections 6222, 6223(b), or 6227, however, precludes a partner from notifying the IRS the partner is taking an adjustment into account inconsistently with how the adjusted item was treated in an AAR. While section 6227 imposes certain requirements with respect to AARs, none of those requirements contradict section 6222(c)'s exception to the consistency requirement. Accordingly, the final regulations under § 301.6222-1(c)(2) remove the language stating that the provisions of § 301.6222-1(c)(1) do not apply with respect to a partner's treatment of a partnership-related item reflected on an AAR. In addition, the final regulations under § 301.6227-1 remove the rule under proposed § 301.6227-1(f) regarding the binding nature of an AAR. As a result of these changes, a partner may notify the IRS it is treating an AAR-adjusted item inconsistently in accordance with the provisions of § 301.6222-1(c).

The final regulations under § 301.6222-1(c)(2) maintain the language stating that the provisions of § 301.6222-1(c)(1) do not apply to a partner's treatment of an item reflected on a statement under section 6226 filed by the partnership with the IRS. A cross-reference to § 301.6226-1(e) was also added. In addition, the final regulations clarify that the provisions of § 301.6222-1(c)(1) do not apply to any item the treatment of which is binding on the partner because of an action taken by the partnership or because of a final decision in a proceeding under the centralized partnership audit regime with respect to the partnership. Section 6223(b). Items reflected on a statement under section 6226 filed with the IRS are an example of such items.

C. INCONSISTENT TREATMENT WHEN NO PARTNERSHIP RETURN IS FILED

Proposed § 301.6222-1(a)(3) provided that a partner's treatment of a partnership-related item attributable to a partnership that does not file a return is per se inconsistent, unless the partner files a notice of inconsistent treatment in accordance with proposed § 301.6222-1(c). One comment recommended that the regulations include an example to illustrate the outcome of the application of the rule under proposed § 301.6222-1(a)(3). The comment observed that without a return filed by the partnership, there would not be a return with which to make the partner's return consistent. To illustrate the application of § 301.6222-1(a)(3), Example 7 was added under § 301.6222-1(a)(5).

In light of the comment, the final regulations under § 301.6222-1(b)(1) include the clarification that where a partnership has failed to file a return, any treatment of a partnership-related item on a partner's return may be removed, and the IRS may determine any underpayment of tax resulting from such adjustment.

Lastly, the final regulations eliminate the phrase "unless the partner files a notice of inconsistent treatment in accordance with proposed § 301.6222-1(c)" from proposed § 301.6222-1(a)(3). This change clarifies that a partner's treatment of an item attributable to a partnership that has not filed a return is per se inconsistent, even if the partner notifies the IRS of the inconsistent treatment. The notification under § 301.6222-1(c) turns off the consistency requirement, but it does not change, as a factual matter, that the partner reported inconsistently.

D. FORM AND METHOD FOR IDENTIFYING INCONSISTENT TREATMENT OF A PARTNERSHIP-RELATED ITEM

Under proposed § 301.6222-1(c)(1), in addition to the requirement that a statement identifying an inconsistent treatment must be attached to the partner's return on which the item is treated inconsistently, the statement must be provided to the IRS according to the forms, instructions, and other guidance prescribed by the IRS. One comment asked about the form and method for providing the IRS with the statement described in proposed § 301.6222-1(c)(1) and suggested specific format guidance in the regulations would assist the public in reporting an inconsistent treatment. This comment was not adopted.

The final regulations maintain the rule that a partner must provide the statement described in § 301.6222-1(c)(1) in accordance with forms, instructions, and other guidance prescribed by the IRS. Prescribing the form and method for notifying the IRS of inconsistent treatment through forms, instructions, and other sub-regulatory guidance allows the IRS the flexibility to update its procedures for identifying an inconsistency as appropriate and necessary without the IRS having to amend the regulations. This flexibility preserves government resources and also expedites the guidance process for taxpayers to be aware of changes in IRS procedures. Accordingly, the final regulations do not provide a specific form or method for identifying inconsistent treatment.

The same comment asked whether a statement identifying inconsistent treatment can only be filed contemporaneously with the partner's tax return. Proposed § 301.6222-1(c) provided that a statement does not identify an inconsistency unless it is attached to the partner's return on which the partnership-related item is treated inconsistently. Because the plain language of proposed § 301.6222-1(c) made clear that the statement identifying inconsistent treatment must be attached to a return, no change was made in response to this comment.

E. PROCEEDING TO ADJUST AN IDENTIFIED, INCONSISTENTLY REPORTED ITEM

If a partner fails to satisfy the requirements of § 301.6222-1(a), the IRS may adjust the inconsistently reported partnership-related item on the partner's return to make it consistent with the treatment of such item on the partnership return, unless the partner provides notice of the inconsistent treatment in accordance with § 301.6222-1(c). See § 301.6222-1(b). Under proposed § 301.6222-1(c)(4)(i), if a partner notifies the IRS of an inconsistent treatment of a partnership-related item in accordance with proposed § 301.6222-1(c)(1) and the IRS disagrees with that inconsistent treatment, the IRS may adjust the identified, inconsistently reported item in a proceeding with respect to the partner. Nothing in proposed § 301.6222-1(c)(4)(i) precluded the IRS, however, from also conducting a proceeding with respect to the partnership.

One comment recommended that § 301.6222-1(c)(4)(i) provide that if the IRS does conduct a proceeding with respect to the partnership to adjust an identified, inconsistently reported item, the IRS may include within that proceeding the partner who provided notice of inconsistent treatment. The comment was concerned that the regulations provided partners who identified inconsistent treatment an automatic right to contest the IRS's adjustment through deficiency proceedings, which would result in more partner-level proceedings and which would be contrary to the intent of the centralized system. According to the comment, the recommended rule would allow the IRS to avoid conducting separate partnership and partner proceedings by allowing the IRS to include notifying partners in the partnership-level proceeding, rather than engaging such partners through deficiency procedures.

Proposed § 301.6222-1(c)(4)(i) provided that the IRS may adjust an identified, inconsistently reported item in a proceeding with respect to the partner. The IRS is not required to make that adjustment. The IRS may instead choose to make the adjustment in a proceeding with respect to the partnership. To the extent the comment was suggesting the IRS must adjust an identified, inconsistently reported item in a proceeding with respect to the partner, the comment was not correct.

If the IRS conducts a proceeding with respect to the partnership, that proceeding will include only the IRS, the partnership, and the partnership representative who is acting on behalf of the partnership. No partner, except a partner that is the partnership representative, or any other person may participate in the partnership proceeding without permission of the IRS. See § 301.6223-2(d)(1). Accordingly, while a partner is not generally included in a proceeding with respect to the partnership under the centralized partnership audit regime, the IRS has the authority under § 301.6223-2(d)(1) to allow any other person, including a partner who notified the IRS of inconsistent treatment, to participate in a partnership-level proceeding. Because that authority exists under § 301.6223-2, a separate rule within § 301.6222-1 to allow notifying partners to be included in a partnership-level proceeding is unnecessary. Therefore, the revision to proposed § 301.6222-1(c)(4) as recommended by the comment was not adopted.

All partners, including partners that have filed a notice of inconsistent treatment, are bound by the actions of the partnership and any final decision in a proceeding with respect to the partnership under the centralized partnership audit regime. See section 6223(b). To clarify the application of this rule in the case of a partnership-level proceeding to adjust an identified, inconsistently reported item, proposed § 301.6222-1(c)(4) was revised to provide that where the IRS conducts a proceeding with respect to the partnership, and there is no proceeding with respect to the partner regarding an identified, inconsistently reported partnership-related item, the partner is bound to actions by the partnership and any final decision in the partnership proceeding.

Another comment suggested that the regulations clarify what happens when the IRS conducts a proceeding with respect to the partnership under § 301.6222-1(c)(4)(i) and at the conclusion of that proceeding, the IRS accepts the partnership return as filed. The comment suggested the regulations address what procedures apply for collection of an imputed underpayment in that scenario or for collection of tax from the partner that filed inconsistently. This comment was not adopted.

First, because there is no partnership adjustment in the scenario described, there is also no imputed underpayment to collect from the partnership. Additionally, because there is no imputed underpayment, the partnership cannot make a push out election. See section 4.A.iii of this preamble. With respect to collection of tax from the partner, nothing in the regulations prevents the IRS, when it conducts a proceeding with respect to the partnership under § 301.6222-1(c)(4)(i), from also conducting a proceeding with respect to the partner to adjust an identified, inconsistently reported item. Accordingly, no changes were made in response to this comment.

F. CONSISTENT TREATMENT WITH SCHEDULE FURNISHED TO THE PARTNER BY THE PARTNERSHIP

Under proposed § 301.6222-1(d)(1), a partner is treated as having notified the IRS of treating a partnership-related item inconsistently if the partner demonstrates that the treatment of such item on the partner’s return is consistent with the treatment of that item on the statement, schedule, or other form prescribed by the IRS and furnished to the partner by the partnership, and the partner makes a valid election under proposed § 301.6222-1(d)(2). This election must be filed no later than 60 days after the date of such notice. Proposed § 301.6222-1(d)(2). One comment recommended that the regulations provide that this 60-day period may be extended with approval by the IRS. This comment was not adopted.

The IRS may assess and collect any underpayment of tax resulting from an adjustment to conform an inconsistent position in the same manner as if the underpayment were on account of a mathematical or clerical error appearing on the partner’s return, except that the procedures under section 6213(b)(2) for requesting abatement of an assessment do not apply. The 60-day period under § 301.6222-1(d)(2) is designed to allow a partner to demonstrate consistency with the information furnished to the partner by the partnership and corresponds to the 60-day period the partner would have had to request abatement if section 6213(b)(2) were applicable. Notably, section 6213(b)(2) does not provide for any extensions of time. Accordingly, the 60-day period under § 301.6222-1(d)(2) affords the partner an opportunity to contest the IRS's conforming adjustment the partner would not have otherwise had.

Additionally, the 60-day period is a reasonable amount of time for the partner to demonstrate consistency with the information it has received from the partnership. At the time the partner is notified by the IRS of the inconsistent treatment, the partner should be in possession of any statements, schedules, or forms furnished to the partner by the partnership. If the partner were permitted to request abatement, the partner would likewise only have 60 days. Furthermore, if the partnership is made aware by the partner that an item was treated incorrectly on the partnership return or the schedules furnished by the partnership, the partnership has the ability to file an AAR with respect to the partnership-related item.

Another comment suggested guidance is needed as to how the election under proposed § 301.6222-1(d)(2) is made. Proposed § 301.6222-1(d)(2)(i) provided that the election must be filed in writing with the IRS office set forth in the notice that notified the partner of the inconsistency. Proposed § 301.6222-1(d)(2)(ii) provided the election must be clearly identified as an election under section 6222(c)(2)(B); signed by the partner making the election; accompanied by a copy of the incorrect statement and IRS notice that notified the partner of the inconsistency; and include any other information required in forms, instructions, or other guidance prescribed by the IRS.

The comment did not suggest what further guidance should be provided in the regulations. Deferring further guidance to forms, instructions, and other sub-regulatory guidance allows the IRS the flexibility to update its procedures as appropriate and necessary without the IRS having to amend the regulations. As discussed earlier in this section of this preamble, this flexibility preserves government resources and also expedites the guidance process for taxpayers to be aware of changes in IRS procedures. Accordingly, proposed § 301.6222-1(d)(2) was not revised in response to this comment.

G. EFFECT OF INCONSISTENT TREATMENT WHEN PARTNER IS A PARTNERSHIP

Proposed § 301.6222-1(a)(2) provided that the rules of § 301.6222-1 apply to a partnership-partner regardless of whether the partnership-partner has made an election under section 6221(b) to elect out of the provisions of the centralized partnership audit regime. The final regulations clarify that the rules of § 301.6222-1 apply to all partners including partnership-partners that have elected out of the centralized partnership audit regime and revise the language referring to such partners to better conform to similar references in other regulation sections.

Proposed § 301.6222-1(b)(3) provided a rule regarding the effect of inconsistent treatment where the partner is itself a partnership and also provided a cross-reference to the rules under section 6232(d)(1)(B) and § 301.6232-1(d). To better conform the two sets of rules and to reduce any potential confusion between the provisions, the final regulations eliminate the rule under § 301.6222-1(b)(3) in favor of providing only a cross-reference to the rules under section 6232(d)(1)(B) and § 301.6232-1(d).

Reg. § 301.6225-2(d), “Types of modification,” includes:

(3) *Tax-exempt partners*.

(i) *In general*. A partnership may request modification of an imputed underpayment with respect to partnership adjustments that the partnership demonstrates to the satisfaction of the IRS are allocable to a relevant partner that would not owe tax by reason of its status as a tax-exempt entity (as defined in paragraph (d)(3)(ii) of this section) in the reviewed year (tax-exempt partner).

(ii) *Definition of tax-exempt entity*. For purposes of paragraph (d)(3) of this section, the term tax-exempt entity means a person or entity defined in section 168(h)(2)(A), (C), or (D).

(iii) *Modification limited to portion of partnership adjustments for which tax-exempt partner not subject to tax*. Only the portion of the partnership adjustments properly allocated to a tax-exempt partner with respect to which the partner would not be subject to tax for the reviewed year (tax-exempt portion) may form the basis of a modification of the imputed underpayment under paragraph (d)(3) of this section. A modification under paragraph (d)(3) of this section will not be approved by the IRS unless the partnership provides documentation in accordance with paragraph (c)(2) of this section to support the tax-exempt partner’s status and the tax-exempt portion of the partnership adjustment allocable to the tax-exempt partner.

(4) *Modification based on a rate of tax lower than the highest applicable tax rate*. A partnership may request modification based on a lower rate of tax for the reviewed year with respect to adjustments that are attributable to a relevant partner that is a C corporation and adjustments with respect to capital gains or qualified dividends that are attributable to a relevant partner who is an individual. In no event may the lower rate determined under the preceding sentence be less than the highest rate in effect for the reviewed year with respect to the type of income and taxpayer. For instance, with respect to adjustments that are attributable to a C corporation, the highest rate in effect for the reviewed year with respect to all C corporations would apply to that adjustment, regardless of the rate that would apply to the C corporation based on the amount of that C corporation’s taxable income. For purposes of this paragraph (d)(4), an S corporation is treated as an individual.

(5) *Certain passive losses of publicly traded partnerships*.

(i) *In general*. In the case of a publicly traded partnership (as defined in section 469(k)(2)) requesting modification under this section, an imputed underpayment is determined without regard to any adjustment that the partnership demonstrates would be reduced by a specified passive activity loss (as defined in paragraph (d)(5)(ii) of this section) which is allocable to a specified partner (as defined in paragraph (d)(5)(iii) of this section) or qualified relevant partner (as defined in paragraph (d)(5)(iv) of this section).

(ii) *Specified passive activity loss*. A specified passive activity loss carryover amount for any specified partner or qualified relevant partner of a publicly traded partnership is the lesser of the section 469(k) passive activity loss of that partner which is separately determined with respect to such partnership -

(A) At the end of the first affected year (affected year loss); or

(B) At the end of -

(1) The specified partner's taxable year in which or with which the adjustment year (as defined in §301.6241-1(a)(1)) of the partnership ends, reduced to the extent any such partner has utilized any portion of its affected year loss to offset income or gain relating to the ownership or disposition of its interest in such publicly traded partnership during either the adjustment year or any other year; or

(2) If the adjustment year has not yet been determined, the most recent year for which the publicly traded partnership has filed a return under section 6031, reduced to the extent any such partner has utilized any portion of its affected year loss to offset income or gain relating to the ownership or disposition of its interest in such publicly traded partnership during any year.

(iii) *Specified partner*. A specified partner is a person that for each taxable year beginning with the first affected year through the person's taxable year in which or with which the partnership adjustment year ends satisfies the following three requirements-

(A) The person is a partner of the publicly traded partnership requesting modification under this section;

(B) The person is an individual, estate, trust, closely held C corporation, or personal service corporation; and

(C) The person has a specified passive activity loss with respect to the publicly traded partnership.

(iv) *Qualified relevant partner*. A qualified relevant partner is a relevant partner that meets the three requirements to be a specified partner (as described in paragraphs (d)(5)(iii)(A), (B), and (C) of this section) for each year beginning with the first affected year through the year described in paragraph (d)(5)(ii)(B)(2) of this section. Notwithstanding the preceding sentence, an indirect partner of the publicly traded partnership requesting modification under this section may also be a qualified relevant partner under this paragraph (d)(5)(iv) if that indirect partner meets the requirements of paragraph (d)(5)(iii)(B) and (C) of this section for each year beginning with the first affected year through the year described in paragraph (d)(5)(ii)(B)(2) of this section.

(v) *Partner notification requirement to reduce passive losses*. If the IRS approves a modification request under paragraph (d)(5) of this section, the partnership must report, in accordance with forms, instructions, or other guidance prescribed by the IRS, to each specified partner the amount of that specified partner's reduction of its suspended passive activity loss carryovers at the end of the adjustment year to take into account the amount of any passive activity losses applied in connection with such modification request. In the case of a qualified relevant partner, the partnership must report, in accordance with forms, instructions, or other guidance prescribed by the IRS, to each qualified relevant partner the amount of that qualified relevant partner's reduction of its suspended passive activity loss carryovers at the end of the taxable year for which the partnership's next return is due to be filed under section 6031 to be taken into account by the qualified relevant partner on the partner's return for the year that includes the end of the partnership's taxable year for which the partnership's next return is due to be filed under section 6031. In the case of an indirect partner that is a qualified relevant partner, the IRS may prescribe additional guidance through forms, instructions, or other guidance to require reporting under this paragraph (d)(5)(v). The reduction in suspended passive activity loss carryovers as reported to a specified partner or qualified relevant partner under this paragraph (d)(5)(v) is a determination of the partnership under subchapter C of chapter 63 and is binding on the specified partners and qualified relevant partners under section 6223.

(6) *Modification of the number and composition of imputed underpayments*.

(i) *In general*. A partnership may request modification of the number or composition of any imputed underpayment included in the NOPPA by requesting that the IRS include one or more partnership adjustments in a particular grouping or subgrouping (as described in §301.6225-1(c) and (d)) or specific imputed underpayments (as described in §301.6225-1(g)) different from the grouping, subgrouping, or imputed underpayment set forth in the NOPPA. For example, a partnership may request under paragraph (d)(6) of this section that one or more partnership adjustments taken into account to determine a general imputed underpayment set forth in the NOPPA be taken into account to determine a specific imputed underpayment.

(ii) *Request for particular treatment regarding limitations or restrictions*. A modification request under paragraph (d)(6) of this section includes a request that one or more partnership adjustments be treated as if no limitations or restrictions under §301.6225-1(d) apply and as a result such adjustments may be subgrouped with other adjustments.

(7) *Partnerships with partners that are "qualified investment entities" described in section 860*.

(i) *In general*. A partnership may request a modification of an imputed underpayment based on the partnership adjustments allocated to a relevant partner where the modification is based on deficiency dividends distributed as described in section 860(f) by a relevant partner that is a qualified investment entity (QIE) under section 860(b) (which includes both a regulated investment company (RIC) and a real estate investment trust (REIT)). Modification under paragraph (d)(7) of this section is available only to the extent that the deficiency dividends take into account adjustments described in § 301.6225-1 that are also adjustments within the meaning of section 860(d)(1) or (d)(2) (whichever applies).

(ii) *Documentation of deficiency dividend*. The partnership must provide documentation in accordance with paragraph (c) of this section of the ‘‘determination’’ described in section 860(e). Under section 860(e)(2), § 1.860-2(b)(1)(i) of this chapter, and paragraph (d)(8) of this section, a closing agreement entered into by the QIE partner pursuant to section 7121 and paragraph (d)(8) of this section is a determination described in section 860(e), and the date of the determination is the date in which the closing agreement is approved by the IRS. In addition, under section 860(e)(4), a determination also includes a Form 8927, Determination Under Section 860(e)(4) by a Qualified Investment Entity, properly completed and filed by the RIC or REIT pursuant to section 860(e)(4). To establish the date of the determination under section 860(e)(4) and the amount of deficiency dividends actually paid, the partnership must provide a copy of Form 976, Claim for Deficiency Dividends Deductions by a Personal Holding Company, Regulated Investment Company, or Real Estate Investment Trust, properly completed by or on behalf of the QIE pursuant to section 860(g), together with a copy of each of the required attachments for Form 976.

(8) *Closing agreements*. A partnership may request modification based on a closing agreement entered into by the IRS and the partnership or any relevant partner, or both if appropriate, pursuant to section 7121. If modification under this paragraph (d)(8) is approved by the IRS, any partnership adjustment that is taken into account under such closing agreement and for which any required payment under the closing agreement is made will not be taken into account in determining the imputed underpayment under § 301.6225-1. Any required payment under the closing agreement may include amounts of tax, including tax under chapters other than chapter 1, interest, penalties, additions to tax and additional amounts. Generally, the IRS will not approve any additional modification under this section with respect to a relevant partner to which a modification under this paragraph (d)(8) has been approved.

(9) *Tax treaty modifications*. A partnership may request a modification under this paragraph (d)(9) with respect to a relevant partner’s distributive share of an adjustment to a partnership-related item if, in the reviewed year, the relevant partner was a foreign person who qualified under an income tax treaty with the United States for a reduction or exemption from tax with respect to such partnership-related item. A partnership requesting modification under this section may also request a treaty modification under this paragraph (d)(9) regardless of the treaty status of its partners if, in the reviewed year, the partnership itself was an entity eligible for such treaty benefits.

(10) *Other modifications*. A partnership may request a modification not otherwise described in paragraph (d) of this section, and the IRS will determine whether such modification is accurate and appropriate in accordance with paragraph (c)(4) of this section. Additional types of modifications and the documentation necessary to substantiate such modifications may be set forth in forms, instructions, or other guidance prescribed by the IRS.

II.G.19.c.iii. Amended Partner Returns for Reviewed Year in Lieu of Partnership Paying Tax

Code § 6225(c)(2)(A) provides that Treasury or the IRS are required to provide procedures determining the partnership's imputed underpayment amount without regard to the portion of the adjustments taken into account in a manner satisfying all of the following:

(i) one or more partners file returns (notwithstanding section 6511) [statute of limitations for claims for credit or refund of an overpayment of any tax under the Code] for the taxable year of the partners which includes the end of the reviewed year of the partnership,

(ii) such returns take into account all adjustments under subsection (a) properly allocable to such partners (and for any other taxable year with respect to which any tax attribute is affected by reason of such adjustments), and

(iii) payment of any tax due is included with such return.

Code § 6225(c)(2)(B) provides that Treasury or the IRS are required to provide pull-in procedures that are deemed to satisfy subparagraph (A) with respect to a partner if, in lieu of filing the returns described in subparagraph (A):

(i) the amounts described in subparagraph (A)(iii) are paid by the partner,

(ii) the partner agrees to take into account, in the form and manner prescribed by the Secretary, the adjustments to the tax attributes of such partner referred to in subparagraph (A)(ii), and

(iii) such partner provides, in the form and manner specified by the Secretary (including, if the Secretary so specifies, in the same form as on an amended return), such information as the Secretary may require to carry out this subparagraph.

If any adjustment by an amended return or through the pull-in procedure reallocates the distributive share of any item from one partner to another, this rule applies only if returns are filed by all partners affected by that adjustment.[1760]

The Preamble to final regulations T.D. 9844 (2/27/2019), includes:

> **III. AMENDED RETURNS**
>
> Proposed § 301.6225-2(d)(2) provided rules regarding modification with respect to amended returns filed by partners. Proposed § 301.6225-2(d)(2)(i) provided that a partnership may request modification of an imputed underpayment based on an amended return filed by a relevant partner provided all of the partnership adjustments properly allocable to such relevant partner are taken into account. One comment recommended that the regulations clarify whether modification will be allowed if a partner files an amended return taking into account adjustments that make up one imputed underpayment, while not taking into account adjustments that make up a

[1760] Code § 6225(c)(2)(C).

separate imputed underpayment which also affects that partner. This comment was not adopted because its recommendation contradicts the statute.

The requirement in proposed § 301.6225-2(d)(2)(i) that partners take into account all partnership adjustments derives from section 6225(c)(2)(A)(ii). Section 6225(c)(2)(A)(ii) states that when partners file amended returns in modification, that return must "take into account all adjustments" under section 6225(a) that are "properly allocable to such partners (and the effect of such adjustments on any tax attributes)." Section 6225(a) refers to "any adjustment by the Secretary to any partnership-related items with respect to any reviewed year of a partnership . . ." Section 6225(c)(2)(A)(ii)'s reference to "all adjustments" under section 6225(a) does not distinguish between partnership adjustments that result in an imputed underpayment and partnership adjustments that do not result in an imputed underpayment. By not distinguishing between the types of partnership adjustments, the language of section 6225(c)(2)(A)(ii) indicates that all partnership adjustments must be taken into account by partners filing modification amended returns, as opposed to only those adjustments that are associated with the imputed underpayment for which modification is requested. Consistent with section 6225(c)(2)(A)(ii), the final regulations under § 301.6225-2(d)(2)(i) require that even in the case of multiple imputed underpayments, partners filing modification amended returns must take into account all partnership adjustments, not just the adjustments associated the imputed underpayment for which modification is requested.

The comment also asked whether there are any specific requirements or limitations that apply in the case of an amended return modification request made with respect to one imputed underpayment, but not with respect to a separate imputed underpayment. Nothing in the regulations imposes specific requirements or limitations on the partnership or its partners when utilizing amended return modification with respect to only one imputed underpayment. The partnership and its partners must comply with all the requirements under § 301.6225-2(d)(2) with respect to any request for amended return modification, including a request made for only one imputed underpayment in the case of multiple imputed underpayments.

Proposed § 301.6225-2(d)(2)(ii)(A) provided that an amended return modification request will not be approved unless the partner filing the amended return has paid all tax, penalties, additions to tax, additional amounts, and interest due as a result of taking into account the adjustments at the time such return is filed with the IRS. One comment suggested that the full payment requirement under § 301.6225-2(d)(2)(ii)(A) should be satisfied if the partner is in compliance with available IRS administrative processes to make full payment, for example, an installment payment agreement. Another comment recommended that the regulations permit partners to submit requests for installment agreements or offers in compromise within the 270-day modification period. These comments were not adopted.

Section 6225(c)(2)(A)(iii) provides that if one or more partners file amended returns during modification, such returns take into account the adjustments properly allocable to such partners, and "payment of any tax due is included with such returns," the imputed underpayment is determined without regard to the adjustments so taken into account. Payment of any tax due is a statutory requirement under section 6225(c)(2)(A)(iii). Consistent with section 6225(c)(2)(A)(iii), proposed § 301.6225-2(d)(2)(ii)(A) required full payment of any tax, penalties, and interest due at the time the amended return is filed with the IRS. If payment is not included with the amended return, the IRS will not approve modification with respect to the amended return.

This rule is necessary to ensure that the IRS collects the entire amount of tax that results from the partner's share of partnership adjustments before approving the partnership's request that the imputed underpayment be calculated without regard to those adjustments. Allowing a partner to enter into an installment agreement undermines the ability of the IRS to collect tax on those adjustments both from the partnership, because the adjustments would no longer be reflected in the imputed underpayment, and from the partner that may ultimately default on the installment agreement. If a partner ultimately does not pay, the IRS may not be able to collect against that partner and likely would be outside the time period within which it must make partnership adjustments, preventing the IRS from collecting any additional imputed underpayment from the partnership. Similar concerns are presented by allowing a partner to enter into an offer in compromise. Moreover, a rule permitting partners to request installment agreements and offers in compromise as alternatives to full payment would increase the administrative burden on the IRS by requiring the IRS to evaluate whether such requests were appropriate, slowing down the modification process in general, and complicating the amended return process specifically. Accordingly, the final regulations retain the rule that full payment of any tax, penalties, and interest due as a result of taking into account the partner's allocable share of adjustments is required in order for modification to be approved with respect to a partner's amended return. In addition, the final regulations under § 301.6225-2(c)(2)(i) clarify that a failure by any person to make any payments required with respect to a modification request within the time restrictions described in § 301.6225-2(c) will result in a denial of a modification request.

Proposed § 301.6225-2(c)(3) provided that all information required under § 301.6225-2 with respect to a request for modification must be submitted on or before 270 days after the date the NOPPA is mailed, unless that period is extended with the permission of the IRS. Several comments recommended partners only be required to file amended returns or make payments on those returns after the issuance of the FPA to allow the court to review the partnership adjustments before modification is requested. One comment recommended that, to provide an adequate amount of time, partners should be allowed at least 270 days from the time of the receipt of an FPA to file amended returns. The comment further recommended that the 270-day period be tolled at any time during which a court proceeding pursuant to section 6234 is ongoing. Another comment recommended that the final regulations commit the IRS to freely grant extensions of the 270-day period and other relevant periods and allow taxpayers to seek modification of the underpayment by filing an amended return, or use the alternative procedure to filing amended returns, within 60 days after there has been a final determination in the partnership case. These comments were not adopted.

First, allowing modification requests, including amended returns, after the FPA is mailed or after there is a court decision with respect to the partnership adjustments is contrary to the statutory scheme under section 6225(c). The statutory scheme under section 6225, section 6231, and section 6235 envision a process where the IRS first mails a NOPPA to the partnership that includes the proposed partnership adjustments and proposed imputed underpayment, followed by a modification period, which is followed by the FPA. The mailing of the NOPPA starts the 270 day period within which anything required to be filed or submitted in the modification process must be filed or submitted to the IRS. After the close of this 270-day period, which may be extended with the consent of the IRS, if modification is requested, the IRS has an additional 270 days to modify the imputed underpayment as necessary to reflect approved modifications and mail the FPA, which will describe the final partnership adjustments and imputed underpayment. After the FPA is issued, there is no basis for the IRS to consider further modifications. The examination is complete and the partnership may then pay the imputed underpayment or elect the push out. The partnership may also challenge the partnership adjustments in court.

Section 6225(c)(2), which provides the procedures for filing amended returns and the alternative procedure to filing amended returns was enacted at the same time as section 6225(c)(7). The amended return modification and the alternative procedure to filing amended returns are just two of many statutory modifications. Had Congress intended for there to be an exception to the 270-day period under section 6225(c)(7) for amended return modification, as suggested by the comments, Congress could have included such an exception when enacting both statutory provisions.

Second, extending the 270-day period beyond the date of the issuance of the FPA could result in several tax administration issues for the IRS. Section 6225(c)(8) provides that any modification of the imputed underpayment amount "shall be made only upon approval of such modification by the Secretary." A request for amended return modification must therefore be approved by the IRS. If the partnership fails to comply with the requirements under the rules under § 301.6225-2, the IRS may decline to approve the request for modification. In order to adopt the comment's suggestion that amended returns and associated payments not be provided until after the FPA is issued, the IRS would need to wait to approve the modification request with respect to that amended return until after the partnership and its partners submitted what was required to be provided under the modification rules. This would prevent the IRS from including its approval or disapproval of the modification request in the FPA, delaying a determination with respect to the modification until some later date. The FPA—the notice of final partnership adjustment—is designed to be the final notice to the partnership from IRS, not an interim notice subject to further modifications or changes.

A partnership adjustment is defined under section 6241(2) as an adjustment to a partnership-related item, and a partnership-related item is defined as including an imputed underpayment. An adjustment to an imputed underpayment is, therefore, a partnership adjustment as defined in section 6241(2). The approval of a modification affects the amount of an adjustment that is taken into account in the imputed underpayment under the rules described in § 301.6225-2(b). Therefore, the IRS must approve or disapprove of a modification before the expiration of the time period for making adjustments under section 6235 or the IRS will have lost its opportunity to do so. Relatedly, and in addition to the concern about the statute of limitations, if the IRS waits until after the issuance of the FPA to make further adjustments to the imputed underpayment, modification could extend for an indefinite period of time, which would lead to uncertainty and administrative challenges for the partnership, the partners, and the IRS. This is particularly true with respect any adjustments after the mailing of the FPA because the mailing of the FPA imbues the partnership with certain rights, such as the right to petition a court for a readjustment of the partnership adjustments in the FPA and to elect the push out under section 6226 with respect to the imputed underpayment. The comment does not explain how a rule that would allow the IRS to further alter the imputed underpayment after the partnership has elected push out or petitioned a court for a readjustment would work. Such a rule would raise numerous tax administration concerns and potentially cause confusion for the partnership and its partners as to what the IRS finally determined and when.

In addition, the IRS is limited as to when it may make a partnership adjustment. According to section 6235(a)(2), “no adjustment under this subchapter for any partnership taxable year may be made after . . . in the case of any modification of an imputed underpayment under section 6225(c), the date that is 270 days [including extensions] . . . after the date on which everything required to be submitted to the Secretary pursuant to such section is so submitted.” In order to adopt the comment allowing an extension of the 270-day modification submission period beyond the issuance of the FPA, the IRS would be required to issue two FPAs. The first FPA would address the partnership adjustments and the imputed underpayment prior to consideration of modifications. The second FPA would be issued at some later date before the expiration of the period for making adjustments under section 6235. Nothing in section 6235(a)(2) prevents the IRS from mailing a second FPA; however, under section 6231(c), if the partnership petitions the original FPA under section 6234, the Secretary may not mail another notice with respect to the same taxable year in the absence of fraud, malfeasance, or misrepresentation of a material fact. In other words, in the situation contemplated by the comment, in which a partnership petitioned the FPA, in general, the IRS could not issue a second FPA to approve or deny modification issues because the IRS would be prevented from doing so under section 6231(c).

Adopting the comment’s suggestion would prevent the IRS from exercising the discretion to approve modification for which Congress provided it authority in section 6225(c)(8). The IRS needs this discretion to ensure that requests for modification are appropriate for the partnership and that the administrative proceeding process is uniform between partnerships. Partners also have other options, such as subsequent amended returns, to address some concerns regarding making payments during the modification process. Accordingly, the regulations have not adopted this comments suggestion.

Proposed § 301.6225-2(d)(2)(vii)(B) provided that if a relevant partner files an amended return for purposes of modification, such partner may not file a subsequent amended return without the permission of the IRS. One comment recommended that the regulations clarify that the restriction in proposed § 301.6225-2(d)(2)(vii)(B) relates to only those items related to a partnership adjustment. Similarly, another comment recommended that the IRS ease the restriction on the ability of a taxpayer using the amended return modification procedure to file subsequent amended returns when the subsequent amended return does not affect the items included in the partnership’s audit adjustments. The comment stated that requiring a taxpayer to request permission from the IRS before filing an amended return is an administrative burden in terms of time and resources for both the taxpayer and the IRS.

Another comment recommended that the regulations not prohibit a partner who has amended her return as part of the modification process from amending her return again without the permission of the Service. This comment suggested revising the forms for filing amended returns to (1) include a check-box asking whether the taxpayer filed a prior amended return for that same tax year that was the basis for a modification under section 6225(c) and (2) require any taxpayer who answers in the affirmative to attach to the subsequent amended return an explanatory statement and certain related documents, such as the prior amended return. Another comment recommended the regulations clarify that if a partner filed an amended return and paid tax on its share of adjustments, and modification was approved with respect to the amended return, the partner may later claim a refund of the tax paid if the partnership successfully appeals or contests the adjustment.

The final regulations clarify that the restriction under § 301.6225-2(d)(2)(vii)(B) only applies to subsequent amended returns that change the treatment of partnership adjustments previously taken into account on a prior amended return that was filed during modification or are filed with respect to an imputed underpayment that was taken into account on a prior modification amended return. The final regulations also removed the requirement that limited further amended returns filed with respect to an imputed underpayment. The final regulations provide exceptions to this rule if the modification amended return or all modifications become inapplicable to the reviewed year. For instance, a court could determine after the issuance of the FPA that the IRS's determination was erroneous in whole or in part, and there was no longer an imputed underpayment or the imputed underpayment should be reduced. In that case, the amended returns submitted during modification would have been with respect to an imputed underpayment that either no longer existed or was altered. The modifications in that case would either be wholly or partially inapplicable. Alternatively, during the modification process, after a partner files an amended return for purposes of modification, the IRS could deny modification under § 301.6225-2(c)(2)(i). In those cases, the partner may file a subsequent amended return to reverse the treatment of partnership adjustments taken into account as part of the request for modification that is no longer applicable, subject to the period of limitations under section 6511. In response to the comment, the final regulations also remove the requirement that the partners request permission before filing subsequent amended returns. The final regulations also clarify that the restrictions on amended returns also apply to other claims for refund.

One comment recommended clarification about whether and how the partner can file a request for refund if the IRS denies a modification based on a partner's filing of an amended return and payment of tax (or the use of the alternative procedure to filing amended returns) or if the partnership files a petition in court of the FPA which results in an adjustment in the partnership's favor. The same comment requested clarification on how a taxpayer who has filed an amended return or executed a closing agreement under section 6225 would receive the benefit of the reduced tax liability of the revised adjustment amount. Pursuant to section 7121, a closing agreement approved by the IRS is final and conclusive. Accordingly, as a general rule, a partner may not request a refund of amounts agreed to in, and paid with, a closing agreement, though the determination of whether a partner could file further amended returns or claims for refund with respect to a year in which a closing agreement was executed would depend on the facts and circumstances and the agreed upon terms of the closing agreement. As discussed earlier in this Summary of Comments and Explanation of Revisions, the final regulations under § 301.6225-2(d)(2)(vii) now clarify that partners may file additional amended returns with respect to partnership adjustments or imputed underpayments, including in the case of denied modification or court readjustment. To file a subsequent amended return, the partners must do so in accordance with forms, instructions, and other guidance prescribed by the IRS. A partner that modifies using the alternative procedure to filing amended returns as described in section 6225(c)(2)(B) that seeks a refund for an amount paid as part of those procedures must follow the rules of § 301.6225-2(d)(2)(vii)(B) and (C). There is no separate process for partners that modify using the alternative procedure to amended returns.

Former proposed § 301.6225-2(d)(2)(vii) provided that a pass-through partner may elect, solely for the purposes of modification, to take into account its share of the partnership adjustments and make a payment on behalf of its partners. If modification was approved with respect to the pass-through partner, the partnership was not permitted to request modification based on amended returns filed by upper-tier direct and indirect partners of the pass-through partner. Former proposed § 301.6225-2(d)(2)(vii). One comment suggested that the regulations should permit a modification of a pass-through partner's payment amount based on amended returns filed by its upper-tier owners.

This suggestion was adopted in the August 2018 NPRM revisions to § 301.6225-2(d)(2). Proposed § 301.6225-2(d)(2)(vi)(B), as revised in the August 2018 NPRM, provided that in accordance with forms, instructions, and other guidance, a pass-through partner making a payment under § 301.6225-2(d)(2)(vi)(A) may take into account modifications with respect to its direct and indirect partners to the extent that such modifications are requested by the partnership and approved by the IRS. Therefore, to the extent an upper-tier partner of the pass-through partner has filed an amended return, the partnership has requested modification with respect to that amended return, and the modification is provided, the pass-through partner may take into account that amended return in accordance with forms, instructions, or other guidance when making a payment in modification. The final regulations under § 301.6225-2(d)(2)(vi)(B) retain this rule.

Another comment recommended that the regulations provide more guidance regarding the form required for an amended return filed by a pass-through partner and the information that form will need to contain. This comment was not adopted. The form required for any amended return, including an amended return filed by a pass-through partner, and the information required on that form will be set forth in forms, instructions, and other guidance prescribed by the IRS. Setting forth this information in forms, instructions, and other guidance gives the IRS the flexibility to adapt the form and its contents without having to amend the regulations. This flexibility preserves government resources and expedites the time in which taxpayers will know of changes to the statement requirements. At the same time, the IRS recognizes the need of taxpayers to know of the information required in order to comply with the regulations. The IRS plans to develop and release drafts of forms and instructions for public inspection as they are completed.

Another comment recommended that the regulations address the situation in which a partner files an amended return but incorrectly calculates the interest amount due and subsequently receives an additional assessment from the IRS. The comment expressed concern that the incorrect calculation of interest and resulting shortfall in payment may result in an inadvertent denial of the modification request. Another comment recommended a rule that a de minimis shortfall of interest or penalties resulting from a good faith effort by a taxpayer to calculate the correct amount shall not result in a denial of a modification request.

The comment recommending a good faith de minimis rule to address situations in which a partner has a shortfall of interest or penalties was not adopted. First, allowing a good faith de minimis rule for interest or penalties is inconsistent with the centralized partnership audit regime's approach of allowing modification of the imputed underpayment if partners fully account for adjustments by taking them into account, paying any resulting amounts due as if the partnership and partners had reported correctly the first time. Because amended return modification is occurring years after any tax would have been due as a result of the partnership adjustment, partners with an underpayment must pay interest to compensate the government for the time value of money on the underpayments. Similarly, partners that owe a penalty must pay that penalty to fully take into account the adjustments and allow the partnership the benefit of modification for those adjustments. A de minimis rule that affirmatively blessed some dollar amount or percentage shortfall for either interest or penalties would encourage taxpayers to calculate their interest and penalties to fall within the allowed de minimis range to avoid disallowance but pay less than is required. It is inconsistent with the collection of amounts determined due on examination to systematically allow a collection of less than all that is due.

Second, administering a rule that allowed partners to underpay what is owed under § 301.6225-2(d)(2)(ii)(A) as long as they made a good faith effort and had only a de minimis short fall would result in untenable administrative complexities for the IRS. The IRS must review all modification requests within 270 days after the modification request has been submitted. The IRS will need to quickly ensure that all relevant partners have provided all information and payments necessary to approve modification. A rule that includes a good faith element would require the IRS to engage in a partner-specific inquiry with respect to any shortfall that might be within the de minimis range to determine whether partner made a good faith effort to comply. A rule that looks to the intent of the partner in determining the amount of interest and penalties is factually intense and would require an inquiry into the state of mind of the partner or that partner's tax advisor. In a fraction of the time it would take to make such an inquiry, the IRS could instead request and receive full payment from the partner. Therefore, it is not administrable to inject this additional, burdensome good faith de minimis shortfall rule in the final regulations, when the current requirement of full pay is both more administrable and less burdensome on the IRS and partners.

If the partnership representative becomes aware of the shortfall before expiration of the 270-day period, the partnership representative may request an extension of the 270-day period in order to allow for full payment to be made before the modification period ends. In this way, the partnership representative can take steps to ensure that all requirements under § 301.6225-2(d)(2) were satisfied.

Proposed § 301.6225-2(d)(2)(ii)(C) provided that in the case of a reallocation adjustment, all partners affected by such adjustment must file amended returns in order for the IRS to approve modification with respect to those amended returns. One comment suggested that the partners affected by the reallocation adjustment should be required to file amended returns only if there is evidence of a net underpayment of tax by the partners as a whole. The comment suggested as an alternative that the partners be allowed to attach an explanation or information statement to their adjustment year return rather than filing an amended return for the reviewed year. These suggestions were not adopted.

Section 6225(c)(2)(C) provides that in the case of a reallocation adjustment, amended return modification applies only if all the requirements of either amended return modification or the alternative procedure to filing amended returns "are satisfied with respect to all partners affected by such adjustment." The statute does not provide any exception to this rule, including an exception for situations in which there is evidence of a net underpayment of tax. Accordingly, the final regulations retain the rule that all partners affected by a reallocation adjustment must file amended returns or utilize the alternative to filing amended returns in order for modification to be approved. This rule ensures that all relevant partners affected by the reallocation adjustment take into account their appropriate shares of that adjustment and thereby ensures such partners receive the appropriate tax benefits for the taxable year subject to the adjustment.

Furthermore, payment and collection of an underpayment is not the only issue required to be resolved by the filing of modification amended returns. In some cases, the purpose of the amended returns is to take into account the tax attributes that may have effects on other modification years. Certainly, in some cases, the tax effect of adjustments taken into account in one year may be offset by tax effect of adjustments in another year or by another partner, but as described in section 3.A. of this preamble, the unmodified imputed underpayment is designed by statute to take into account only the reviewed year and it does not take into account the specific tax attributes of any partner or the effects of the partnership adjustments in modification years or intervening years. An unmodified imputed underpayment will often result in an amount that is higher than what the partners collectively would have paid had they taken the adjustments into account properly in the reviewed year. The unmodified imputed underpayment protects the IRS's interests in collecting at least the amount of tax that should have been paid by the partners without having to separately examine and track all the partners. In other words, the unmodified imputed underpayment represents a simple way to allow the partnership to pay, and the IRS to collect, as amount related to the partnership adjustments without having to delve into the specific tax attributes of each partner.

Modification, however, provides an opportunity for the partners and the partnership to demonstrate that specific tax attributes of partners should have an effect on the imputed underpayment. With respect to reallocation adjustments, if partners seek to receive the benefit of modification, each partners subject to a reallocation adjustment must follow the statutory requirement to file amended returns for all adjustments in a reallocation adjustment. It may be the case that one partner pays on modification and another partner is entitled to a refund. However, such a result is unknown until the partners demonstrate that fact through modification. More importantly, section 6225(c)(2)(C) expressly requires that all partners have taken into account all partnership adjustments and related tax attributes for the modification years and future years. This statutory mandate makes clear that the purpose of this modification is not to ensure that there is a net tax payment with respect to the partnership adjustments, but instead to ensure that the proper partners have taken the adjustments into account correctly, including in all modification years. The requirement that all partners affected by a reallocation file amended returns is a necessary condition for modification to be approved.

Similarly, the comment's suggestion that partners attach a statement to their adjustment year returns attesting to the fact that they had a net underpayment as a result of the adjustments is not workable. In an administrative proceeding, the adjustment year is the year in which the FPA is mailed under section 6231 or, if the partnership challenges the adjustments in court, the year such decision becomes final. Section 6225(d)(2). If a partner was one of the partners subject to a reallocation adjustment and failed to file an amended return, none of the other amended returns from other partners subject to the reallocation adjustments could be approved as a modification. As a result, the imputed underpayment would be determined in the FPA without reduction with respect to those adjustments. Attaching a statement on the next filed return of the partner that failed to file an amended return would have no effect on the imputed underpayment already finally determined.

Recognizing the costs and burdens this rule may create for partnerships, partners, and the IRS in cases where it is clear one partner will not owe tax on its share of a reallocation adjustment, the Treasury Department and the IRS included a rule within proposed § 301.6225-2(d)(2)(ii)(C) to mitigate the potential impact of the requirement that all partners file amended returns. Proposed § 301.6225-2(d)(2)(ii)(C) provided that modification may be approved in the case of a reallocation adjustment even if a relevant partner affected by the adjustment does not file an amended return or utilize the alternative procedure provided the partner takes into account its share of the adjustment through other modifications approved by the IRS or if a pass-through partner takes into account the relevant adjustments. For instance, in the case of an adjustment that reallocates a loss from one partner to another, the IRS may determine that the requirements of § 301.6225-2(d)(2)(ii)(C) have been satisfied if one affected relevant partner files an amended return taking into account the adjustment and the other affected relevant partner signs a closing agreement with the IRS taking into account the adjustments. Proposed § 301.6225-2(d)(2)(ii)(C).

One comment recommended that the regulations clarify whether a tax-exempt partner eligible for tax-exempt modification under § 301.6225-2(d)(3) and allocated a share of a reallocation adjustment must file an amended return to satisfy the requirements under § 301.6225-2(d)(2) in order for the IRS to approve a modification request with respect to such partner. The comment recommended adding to the regulations either an explicit statement or an example indicating that such a filing is not necessary provided the IRS is satisfied that the relevant partner qualifies as a tax-exempt entity. This comment was partially adopted by adding a sentence to § 301.6225-2(d)(2)(ii)(C) indicating the IRS may determine the amended return requirement in the context of reallocation adjustment is satisfied to the extent an affected relevant partner meets the requirements of § 301.6225-2(d)(3) regarding tax-exempt partners. The satisfaction of the requirements of § 301.6225-2(d)(2) (amended return modification and the alternative procedure) is only satisfied to the extent of the tax-exempt portion as defined in § 301.6225-2(d)(3)(iii). Therefore, if certain partnership adjustments allocable to tax-exempt partners are subject to tax, and the partner wishes to take advantage of amended return modification, the tax-exempt partner may have to file an amended return to pay tax on the portion of adjustments allocable to that partner which are subject to tax. The final regulations do not add an example to this effect because the plain language of § 301.6225-2(d)(2)(ii)(C) addresses the point raised by the comment.

One comment recommended that the regulations provide an additional modification method in the case of reallocation adjustments that would allow a partner to whom a net negative adjustment is allocated to file an amended return (or use the alternative procedure to filing amended returns) to claim a refund of tax arising from such adjustment, on the condition that the partner to whom the net positive adjustment is allocated, or the partnership, has paid the tax attributable to the net positive adjustment. Similarly, another comment recommended that the regulations permit a modification of an imputed underpayment where only the partner experiencing additional income (or less deduction, loss, or credit) as a result of a reallocation adjustment files an amended return. These comments were not adopted.

As discussed earlier in this section of this preamble, section 6225(c)(2)(C) provides that in the case of a reallocation adjustment, amended return modification applies only if all the requirements of either amended return modification or the alternative procedure to filing amended returns "are satisfied with respect to all partners affected by such adjustment.” This rule demonstrates that reallocation adjustments made by the IRS under the centralized partnership audit regime are included in the calculation of the imputed underpayment unless all partners affected by such adjustments take them into account. Section 6225(c)(2)(C) does not contain an exception to the rule that all partners take the adjustments into account. Consistent with section 6225(c)(2)(C)’s requirement that all affected partners take the reallocation adjustments into account, the IRS has exercised its discretionary authority under section 6225(c)(6) to permit modification in the case of a reallocation adjustment where a relevant partner affected by such adjustment has met the requirements of another modification method and that modification has been approved by the IRS. This regulatory exception fits squarely within the statutory framework of ensuring that all partners affected by a partnership adjustment take into account their share of that adjustment and recognize the tax effects of such adjustments. Adopting the approach suggested by the comments, one where either only the loss partner or only the income partner take the adjustments into account, would undercut the statutory framework and directly contradict the plain language of the statute. A rule that does not account for all aspects of a reallocation adjustment would run contrary to the collection mechanism of the centralized partnership audit regime with respect to reallocation adjustments. The statutory framework requires either that the partnership pay an imputed underpayment representing the additional tax effects of the reallocation adjustment in the adjustment year and take the negative adjustment aspects into account in that same year or all affected partners from the reviewed year must fully account for their share of the reallocation adjustment.

One comment recommended that the regulations clarify whether a taxpayer filing an amended return or requesting a closing agreement under section 6225 for purposes of modification is required to take into account and pay any additional taxes due under chapters 2 and 2A of the Code. This comment was adopted. The final regulations clarify that a partner filing an amended return or using the alternative procedure to filing amended returns only is required to pay tax due under chapter 1 of the Code with respect to the amended return and the alternative procedure to filing amended returns. The exception to the limitation of tax to chapter 1 tax is for a pass-through partner filing an amended return under § 301.6225-2(d)(2)(vi) because the pass-through partner, but for § 301.6225-2(d)(2)(vi), might otherwise not owe tax under chapter 1. Nothing in the final regulations limits the IRS’s authority under section 6241(9). The type of tax paid in a closing agreement, however, will depend on the terms of the closing agreement. The final regulations clarify the type of tax paid in these situations in §§ 301.6225-2(d)(2)(ii)(A) and (d)(8).

Another comment asked about the effect on the IRS’s approval of modification in the case that a partnership or partner fails to pay taxes under chapters 2 and 2A in modification. Because the final regulations clarify that a partner is only required to pay chapter 1 tax in amended return modification or in the alternative procedure to filing amended returns, the failure to pay taxes under chapters 2 and 2A is irrelevant to the approval or denial of modification. The questions asked by the comment are therefore moot, and no changes were made in response to the comment.

Section 6225(c)(2)(D) provides that section 6501 and 6511 shall not apply with respect to returns filed in modification. A comment was concerned that amended returns filed after the expiration of the time period in section 6511 would be automatically rejected by IRS Service Centers, causing confusion and uncertainty about whether the amended return has, in fact been filed, and if so, whether it was timely. The comment recommended that the IRS develop a procedure for the filing of amended returns with the IRS personnel handling the partnership's examination so that this person can make sure that the return is filed and properly processed or alternatively that the regulations directed taxpayers to include a banner on the top of the amended return stating, in red ink, "Filed Pursuant to Section 6225(c)," to alert the Service Center that this amended return should not be automatically rejected if it is otherwise untimely under section 6511. Another comment recommended that the final regulations also require that the reviewed-year partner include in the affidavit filed with the amended return modification request the partner's TIN and contact information to enable the IRS to locate easily the amended return and payment in its databases. The IRS intends to develop a process through which the partners would file their amended returns, but the regulations do not specify the details of that process. The IRS will develop forms and instructions directing the partnership and the partners as to how and where to file their amended returns submitted in modification, and the IRS intends to request the relevant partner's TIN as part of that process.

Prior to the enactment of the TTCA, section 6225(c)(2) stated that section 6511 did not apply with respect to amended return modification, but it was silent on whether section 6501 limitations on assessment applied. If a partner's period under section 6501 was closed at the time of modification, the partner might not be able to participate in amended return modification. One comment recommended that the IRS resolve this issue by allowing partners to extend the relevant section 6501 periods. This comment was received in response to the June 2017 NPRM, prior to the enactment of the TTCA. The TTCA explicitly provided that section 6501 does not apply with respect to returns filed in modification, so the need for such extensions no longer exists.

Reg. § 301.6225-2(d)(2), "Amended returns by partners," provides:

(i) *In general*. A partnership may request a modification of an imputed underpayment based on an amended return filed by a relevant partner provided all of the partnership adjustments properly allocable to such relevant partner are taken into account and any amount due is paid in accordance with paragraph (d)(2) of this section. Only adjustments to partnership-related items or adjustments to a relevant partner's tax attributes affected by adjustments to partnership-related items may be taken into account on an amended return under paragraph (d)(2) of this section. A partnership may request a modification for purposes of paragraph (d)(2) of this section by submitting a modification request based on the alternative procedure to filing amended returns as described in paragraph (d)(2)(x) of this section. The partnership may not request an additional modification of any imputed underpayment for a partnership taxable year under this section with respect to any relevant partner that files an amended return (or utilizes the alternative procedure to filing amended returns) under paragraph (d)(2) of this section or with respect to any partnership adjustment allocated to such relevant partner.

(ii) *Requirements for approval of a modification request based on amended return*. Except as otherwise provided under the alternative procedure described in paragraph (d)(2)(x) of this section, an amended return modification request under paragraph (d)(2) of this section will not be approved unless the provisions of this paragraph (d)(2)(ii) are satisfied. The partnership may satisfy the requirements of paragraph (d)(2) of this section by demonstrating in accordance with forms, instructions, and other guidance provided by the IRS that a relevant partner has previously taken into account the partnership adjustments described in paragraph (d)(2)(i) of this section, made any required adjustments to tax attributes resulting from the partnership adjustments for the years described in paragraph (d)(2)(ii)(B) of this section, and made all required payments under paragraph (d)(2)(ii)(A) of this section.

(A) *Full payment required*. An amended return modification request under paragraph (d)(2) of this section will not be approved unless the relevant partner filing the amended return has paid all tax, penalties, additions to tax, additional amounts, and interest due as a result of taking into account all partnership adjustments in the first affected year (as defined in §301.6226-3(b)(2)) and all modification years (as described in paragraph (d)(2)(ii)(B) of this section) at the time such return is filed with the IRS. Except for a pass-through partner calculating its payment amount pursuant to paragraph (d)(2)(vi) of this section, for purposes of this paragraph (d)(2)(ii)(A), the term tax means tax imposed by chapter 1 of the Internal Revenue Code (chapter 1).

(B) *Amended returns for all relevant taxable years must be filed*. Modification under paragraph (d)(2) of this section will not be approved by the IRS unless a relevant partner files an amended return for the first affected year and any modification year. A modification year is any taxable year with respect to which any tax attribute (as defined in §301.6241-1(a)(10)) of the relevant partner is affected by reason of taking into account the relevant partner's distributive share of all partnership adjustments in the first affected year. A modification year may be a taxable year before or after the first affected year, depending on the effect on the relevant partner's tax attributes of taking into account the relevant partner's distributive share of the partnership adjustments in the first affected year.

(C) *Amended returns for partnership adjustments that reallocate distributive shares*. Except as described in this paragraph (d)(2)(ii)(C), in the case of partnership adjustments that reallocate the distributive shares of any partnership-related item from one partner to another, a modification under paragraph (d)(2) of this section will be approved only if all partners affected by such adjustments file amended returns in accordance with paragraph (d)(2) of this section. The IRS may determine that the requirements of this paragraph (d)(2)(ii)(C) are satisfied even if not all relevant partners affected by such adjustments file amended returns provided any relevant partners affected by the reallocation not filing amended returns take into account their distributive share of the adjustments through other modifications approved by the IRS (including the alternative procedure to filing amended returns under paragraph (d)(2)(x) of this section) or if a pass-through partner takes into account the relevant adjustments in accordance with paragraph (d)(2)(vi) of this section. For instance, in the case of adjustments that reallocate a loss from one partner to another, the IRS may determine that the requirements of this paragraph (d)(2)(ii)(C) have been satisfied if one affected relevant partner files an amended return taking into account the adjustments and the other affected relevant partner signs a closing agreement with the IRS taking into account the adjustments. Similarly, in the case of adjustment that reallocate income from one partner to another, the IRS may determine that the requirements of this paragraph (d)(2)(ii)(C) have been satisfied to the extent an affected relevant partner meets the requirements of paragraph (d)(3) of this section (regarding tax-exempt partners) and through such modification fully takes into account all adjustments reallocated to the affected relevant partner.

(iii) *Form and manner for filing amended returns*. A relevant partner must file all amended returns required for modification under paragraph (d)(2) of this section with the IRS in accordance with forms, instructions, and other guidance prescribed by the IRS. Except as otherwise provided under the alternative procedure described in paragraph (d)(2)(x) of this section, the IRS will not approve modification under paragraph (d)(2) of this section unless prior to the expiration of the 270-day period described in paragraph (c)(3) of this section, the partnership representative provides to the IRS, in the form and manner prescribed by the IRS, an affidavit from each relevant partner signed under penalties of perjury by such partner stating that all of the amended returns required to be filed under paragraph (d)(2) of this section has been filed (including the date on which such amended returns were filed) and that the full amount of tax, penalties, additions to tax, additional amounts, and interest was paid (including the date on which such amounts were paid).

(iv) *Period of limitations*. Generally, the period of limitations under sections 6501 and 6511 do not apply to an amended return filed under paragraph (d)(2) of this section provided the amended return otherwise meets the requirements of paragraph (d)(2) of this section.

(v) *Amended returns in the case of adjustments allocated through certain pass-through partners*. A request for modification related to an amended return of a relevant partner that is an indirect partner holding its interest in the partnership (directly or indirectly) through a pass-through partner that could be subject to tax imposed by chapter 1 (chapter 1 tax) on the partnership adjustments that are properly allocated to such pass-through partner will not be approved unless the partnership -

(A) Establishes that the pass-through partner is not subject to chapter 1 tax on the adjustments that are properly allocated to such pass-through partner; or

(B) Requests modification with respect to the adjustments resulting in chapter 1 tax for the pass-through partner, including full payment of such chapter 1 tax for the first affected year and all modification years under paragraph (d)(2) of this section or in accordance with forms, instructions, or other guidance prescribed by the IRS.

(vi) *Amended returns in the case of pass-through partners -*

(A) *Pass-through partners may file amended returns*. A relevant partner that is a pass-through partner, including a partnership-partner (as defined in §301.6241-1(a)(7)) that has a valid election under section 6221(b) in effect for a partnership taxable year, may, in accordance with forms, instructions, and other guidance provided by the IRS and solely for purposes of modification under paragraph (d)(2) of this section, take into account its share of the partnership adjustments and determine and pay an amount calculated in the same manner as the amount computed under §301.6226-3(e)(4)(iii) subject to paragraph (d)(2)(vi)(B) of this section.

(B) *Modifications with respect to upper-tier partners of the pass-through partner*. In accordance with forms, instructions, and other guidance provided by the IRS, for purposes of determining and calculating the amount a pass-through partner must pay under paragraph (d)(2)(vi)(A) of this section, the pass-through partner may take into account modifications with respect to its direct and indirect partners to the extent that such modifications are requested by the partnership requesting modification and approved by the IRS under this section.

(vii) *Limitations on amended returns* -

(A) *In general*. A relevant partner may not file an amended return or claim for refund that takes into account partnership adjustments except as described in paragraph (d)(2) of this section.

(B) *Further amended returns restricted*. Except as described in paragraph (d)(2)(vii)(C) of this section, if a relevant partner files an amended return under paragraph (d)(2) of this section, or satisfies paragraph (d)(2) of this section by following the alternative procedure under paragraph (d)(2)(x) of this section (the alternative procedure), such partner may not file a subsequent amended return or claim for refund to change the treatment of partnership adjustments taken into account through amended return or the alternative procedure.

(C) *Subsequent returns in the case of changes to partnership adjustments or denial of modification*. Notwithstanding paragraph (d)(2)(vii)(B) of this section, a relevant partner that has previously filed an amended return under paragraph (d)(2) of this section, or satisfied the requirements of paragraph (d)(2) of this section through the alternative procedure, to take partnership adjustments into account may, in accordance with forms, instructions, and other guidance prescribed by the IRS, file a subsequent return or claim for refund if a determination is made by a court or by the IRS that results in a change to the partnership adjustments taken into account in modification under paragraph (d)(2) of this section or a denial of modification by the IRS under paragraph (c)(2)(i) of this section with respect to a modification request under paragraph (d)(2) of this section. Such determinations include a court decision that changes the partnership adjustments for which modification was requested or a settlement between the IRS and the partnership pursuant to which the partnership is not liable for all or a portion of the imputed underpayment for which modification was requested. Any amended return or claim for refund filed under this paragraph (d)(2)(vii) is subject to the period of limitations under section 6511.

(viii) *Penalties*. The applicability of any penalties, additions to tax, or additional amounts that relate to an adjustment to a partnership-related item is determined at the partnership level in accordance with section 6221(a). However, the amount of penalties, additions to tax, and additional amounts a relevant partner must pay under paragraph (d)(2)(ii)(A) of this section for the first affected year and for any modification year is based on the underpayment or understatement of tax, if any, reflected on the amended return filed by the relevant partner under paragraph (d)(2) of this section. For instance, if after taking into account the adjustments, the return of the relevant partner for the first affected year or any modification year reflects an underpayment or an understatement that falls below the applicable threshold for the imposition of a penalty under section 6662(d), no penalty would be due from that relevant partner for such year. Unless forms, instructions or other guidance provided by the IRS allow for an alternative procedure for raising a partner-level defense (as described in § 301.6226-3(d)(3)), a relevant partner may raise a partner-level defense by first paying the penalty, addition to tax, or additional amount with the amended return filed under paragraph (d)(2) of this section and then filing a claim for refund in accordance with forms, instructions, and other guidance.

(ix) *Effect on tax attributes binding*. Any adjustments to the tax attributes of any relevant partner which are affected by modification under paragraph (d)(2) of this section are binding on the relevant partner with respect to the first affected year and all modification years (as defined in paragraph (d)(2)(ii)(B) of this section). A failure to adjust any tax attribute in accordance with this paragraph (d)(2)(ix) is a failure to treat a partnership-related item in a manner which is consistent with the treatment of such item on the partnership return within the meaning of section 6222. The provisions of section 6222(c) and §301.6222-1(c) (regarding notification of inconsistent treatment) do not apply with respect to tax attributes under this paragraph (d)(2)(ix).

(x) *Alternative procedure to filing amended returns* -

(A) *In general*. A partnership may satisfy the requirements of paragraph (d)(2) of this section by submitting on behalf of a relevant partner, in accordance with forms, instructions, and other guidance provided by the IRS, all information and payment of any tax, penalties, additions to tax, additional amounts, and interest that would be required to be provided if the relevant partner were filing an amended return under paragraph (d)(2) of this section, except as otherwise provided in relevant forms, instructions, and other guidance provided by the IRS. A relevant partner for which the partnership seeks modification under paragraph (d)(2)(x) of this section must agree to take into account, in accordance with forms, instructions, and other guidance provided by the IRS, adjustments to any tax attributes of such relevant partner. A modification request submitted in accordance with the alternative procedure under paragraph (d)(2)(x) of this section is not a claim for refund with respect to any person.

(B) *Modifications with respect to reallocation adjustments*. A submission made in accordance with paragraph (d)(2)(x) of this section with respect to any relevant partner is treated as if such relevant partner filed an amended return for purposes of paragraph (d)(2)(ii)(C) of this section (regarding the requirement that all relevant partners affected by a reallocation must file an amended return to be eligible to for the modification under paragraph (d)(2) of this section) provided the submission is with respect to the first affected year and all modification years of such relevant partner as required under paragraph (d)(2) of this section.

II.G.19.c.iv. Pushing Out Adjustments in Year of Audit in Lieu of Partnership Paying Tax

A partnership can shift the consequences of an audit adjustment to its partners if it so elects not later than 45 days after the date of the notice of final partnership adjustment and at such time and in such manner as the government may provide, furnishes to each partner of the partnership for the reviewed year and to the IRS a statement of the partner's share of any adjustment to income, gain, loss, deduction, or credit (as determined in the notice of final partnership adjustment).[1761] This is referred to as a "push-out election."

In that case, each affected partner shall take the adjustment into account as described below.[1762]

Each partner's income tax for the taxable year which includes the date the statement was furnished (the "adjustment year") is increased by the aggregate of the adjustment amounts described below for the taxable years referred to in the statement.[1763] Consolidated Appropriations Act, 2018 amended Code § 6226(a)(2) by striking ''any adjustment to income, gain, loss, deduction, or credit'' and inserting ''any adjustment to a partnership-related item," to reflect that changes in partnership items affect items beyond just income tax.

The adjustment amounts are the sum of the following:[1764]

(A) For the taxable year of the partner which includes the end of the reviewed year, the amount by which income tax would increase or decrease if the partner's share of the corrections were taken into account for such taxable year.

(B) For any taxable year after that taxable year and before the adjustment year, the amount by which income tax would increase or decrease by reason of the corrections described in the next sentence. Any tax attribute, which would have been affected if the corrections were taken into account for the taxable year described in (A), will be appropriately adjusted for any taxable year described in (B).[1765]

Furthermore, any tax attribute, which would have been affected if the adjustments were taken into account for the taxable year described in (A), will be appropriately adjusted for any taxable year after the taxable year described in (B).[1766]

The Consolidated Appropriations Act, 2018 added Code § 6226(b)(4), relating to the treatment of partnerships and S corporations in tiered structures.

Notwithstanding the push-out election, any penalties, additions to tax, or additional amount are determined as provided under Code § 6221, and the partners of the partnership for the reviewed year are liable for any such penalty, addition to tax, or additional amount.[1767]

In the case of an imputed underpayment resulting from the push-out election, interest is determined at the partner level, from the due date of the return for the taxable year to which the increase is attributable (determined by taking into account any increases attributable to a change in tax attributes for a taxable year under Code § 6226(b)(2)), and at the underpayment rate under Code § 6621(a)(2), determined by substituting "5 percentage points" for "3 percentage points" in Code § 6621(a)(2)(B).[1768]

[1761] Code § 6226(a).
[1762] Code § 6226(a).
[1763] Code § 6226(b)(1).
[1764] Code § 6226(b)(2).
[1765] Code § 6226(b)(3)(A).
[1766] Code § 6226(b)(3)(B).
[1767] Code § 6621(c)(1).
[1768] Code § 6621(c)(2).

REG-136118-15 (6/14/2017) explains the regulations it proposed regarding the push-out election:

6. Election for the Alternative to Payment of the Imputed Underpayment

Proposed § 301.6226-1(a) provides that a partnership may elect under section 6226 to “push out” adjustments to its reviewed year partners rather than paying the imputed underpayment determined under section 6225. If a partnership makes a valid election in accordance with proposed § 301.6226-1, the partnership is no longer liable for the imputed underpayment. A partnership may make an election under this section with respect to one or more imputed underpayments identified in an FPA. For example, where the FPA includes a general imputed underpayment and one or more specific imputed underpayments, the partnership may make an election under this section with respect to any or all of the imputed underpayments.

Proposed § 301.6226-1(b)(1) provides that if a partnership makes a valid election in accordance with proposed § 301.6226-1, the reviewed year partners of the partnership are liable for tax, penalties, additions to tax, and additional amounts, as well interest on such amounts, after taking into account their share of the partnership adjustments determined in the FPA. Any modifications approved by the IRS under proposed § 301.6225-2 are also reported to the reviewed year partners. In addition, under proposed § 301.6226-1(b)(2), adjustments that do not result in an imputed underpayment described in § 301.6225-1(c)(2)(i) and (ii) are not taken into account by the partnership in the adjustment year and instead are included in the reviewed year partners’ share of the partnership adjustments reported to the reviewed year partners of the partnership.

Under proposed § 301.6226-1(c), an election under section 6226 is not valid unless the partnership complies with all the provisions for making the election under proposed § 301.6226-1 and the provisions under proposed § 301.6226-2 requiring the partnership to furnish statements to the reviewed year partners and file those statements electronically with the IRS. An election under proposed § 301.6226-1 may only be revoked with the consent of the IRS.

Proposed § 301.6226-1(c)(2) provides that if the IRS determines that an election under section 6226 is invalid, the IRS will notify the partnership and the partnership representative (within 30 days of the determination) that the election is invalid and provide the reason why the election is invalid. Proposed § 301.6226-1(c)(2) provides that a final determination that the election is invalid means that the partnership is liable for any imputed underpayment to which the election related, as well as any penalties and interest with respect to the imputed underpayment determined under section 6233. An election under proposed § 301.6226-1 is valid until the IRS determines the election is invalid.

A. Making the Election Under Section 6226

Under proposed § 301.6226-1(c)(3), a partnership may only make an election under section 6226 within 45 days of the date the FPA was mailed by the IRS. The time for filing the election may not be extended. The election must be signed by the partnership representative and filed with the IRS in accordance with forms, instructions, and other guidance. Proposed § 301.6226-1(c)(4)(i). Proposed § 301.6226-1(c)(4)(ii) provides that the election must include the name, address, and correct taxpayer identification number (TIN) of the partnership, the taxable year to which the election relates, the imputed underpayment(s) to which the election applies (if there is more than one imputed underpayment in the FPA), each reviewed year partner's name, address, and correct TIN, and any other information required under forms, instructions, and other guidance. A copy of the FPA to which the election relates must also be attached to the election.

As stated in proposed § 301.6226-1(d), an election under section 6226, which includes filing and furnishing the statements described in proposed § 301.6226-2, is an action taken by the partnership under section 6223 and the regulations thereunder. Accordingly, all reviewed year partners are bound by the election and each reviewed year partner must take the adjustments on the statement into account in accordance with section 6226(b) and report and pay additional chapter 1 tax (if any) pursuant to proposed § 301.6226-3. Therefore, a reviewed year partner may not treat items reflected on a statement described in proposed § 301.6226-2 inconsistently with how those items are treated on the statement that the partnership files with the IRS. See proposed § 301.6222-1(c)(2) (regarding items the treatment of which a partner is bound to under section 6223).

The Treasury Department and the IRS request comments from the public on whether guidance is needed on how to address potential issues arising with respect to tax-exempt entities as a result of an election under section 6226 and, if so, on possible ways to resolve such issues. For instance, if a tax exempt entity's share of the amounts under section 6226 is investment income, issues may arise regarding how a section 6226 election might affect the entity's public support calculation (if the entity is a publicly-supported organization) or the applicable net investment income tax (if the entity is a private foundation).

B. Filing Statements With the IRS and Furnishing Statements to Reviewed Year Partners

Proposed § 301.6226-2(a) provides that a partnership making an election under section 6226 must furnish statements to the reviewed year partners with respect to the partner's share of the adjustments and file those statements with the IRS in the time, form, and manner prescribed by proposed § 301.6226-2(b) and (c). Proposed § 301.6226-2(a) further provides that the statements furnished to the reviewed year partners under section 6226 are in addition to, and must be filed and furnished separate from, any other statements required to be filed with the IRS and furnished to the partners for the taxable year, including any Schedules K-1, Partner's Share of Income, Deductions, Credits, etc. Therefore, the partnership may not include the partnership adjustments that are to be taken into account by the reviewed year partners under section 6226 in any Schedule K-1 required to be furnished to the partner under section 6031(b). Similarly, the partnership must furnish separate statements for each reviewed year at issue and cannot combine multiple reviewed years (if any) into a single statement.

Under proposed § 301.6226-2(b), the statements must be furnished to the reviewed year partners no later than 60 days after the date the partnership adjustments become finally determined. The partnership adjustments become finally determined upon the later of the expiration of the time to file a petition under section 6234 or, if a petition is filed under section 6234, the date when the court's decision becomes final. Accordingly, if an FPA is mailed on June 30, 2020, and no petition is filed by the partnership, the partnership adjustments reflected in the FPA become finally determined on September 28, 2020 (at the conclusion of the 90-day petition period under section 6234). An example under proposed § 301.6226-2(b)(3) illustrates these rules.

Under proposed § 301.6226-2(b)(2), a partnership must furnish the statement to each reviewed year partner in accordance with the forms, instructions, or other guidance prescribed by the IRS. If the statements are mailed, it must mail the statements to each reviewed year partner using the current or last address for that partner that is known to the partnership. If a statement is returned to the partnership as undeliverable, a partnership must exercise reasonable due diligence to identify a correct address for the reviewed year partner to which the statement relates. Examples under proposed § 301.6226-2(b)(3) illustrate this rule. Under proposed § 301.6226-2(c), the partnership must electronically file the statements with the IRS, along with a transmittal that includes a summary of the statements and any other information required in the forms and instructions, by the date the partnership is required to furnish the statements to the reviewed year partners.

Under proposed § 301.6226-2(d), if a partnership discovers an error on a statement filed with the IRS, the partnership must correct the error within 60 days of the due date for furnishing the statements to partners and filing the statements with the IRS, as described in proposed § 301.6226-2(b) and (c). Under proposed § 301.6226-2(d)(2)(ii), if a partnership discovers an error after this 60-day period, the partnership may only correct the statements with the permission of the IRS in accordance with the forms, instructions, or other guidance prescribed by the IRS. If the IRS discovers an error in the statements, the IRS may require the partnership to correct the errors. If a partnership fails to correct an error as required by the IRS, the IRS may treat this as a failure to properly furnish statements to partners and file the statements with the IRS, and thus, allow the IRS to determine that the election under proposed § 301.6226-1 is invalid with the result that the partnership is liable for the imputed underpayment to which the election related. A partnership corrects an error in a statement by electronically filing the corrected statement with the IRS and furnishing the corrected statement to the affected reviewed year partner in accordance with the forms, instructions, and other guidance prescribed by the IRS. The adjustments contained on a corrected statement are taken into account by the reviewed year partner in accordance with proposed § 301.6226-3 for the reporting year (as defined in proposed § 301.6226-3(a)). Proposed § 301.6226-2(d)(4). Because reviewed year partners cannot file inconsistently with any statements furnished by the partnership under proposed § 301.6226-2 (see proposed § 301.6226-1(d)), this provision provides a partner a period during which the partner may notify the partnership of any errors in a statement and have the partnership furnish a corrected statement to the partner and file the corrected statement with the IRS.

i. Contents of the Statements

The statements described in proposed § 301.6226-2 must include the name and correct TIN of the reviewed year partner; the current or last address of the reviewed year partner that is known to the partnership; the reviewed year partner's share of items originally reported to the partner (taking into account any adjustments made under section 6227); the reviewed year partner's share of the partnership adjustments and any penalties, additions to tax, or additional amounts; modifications attributable to the reviewed year partner; the reviewed year partner's share of any amounts attributable to adjustments to the partnership's tax attributes in any intervening year (as defined in proposed § 301.6226-3) resulting from the partnership adjustments allocable to the partner; the reviewed year partner's safe harbor amount and interest safe harbor amount (if applicable), as determined in accordance with proposed § 301.6226-2(g); the date the statement is furnished to the partner; the partnership taxable year to which the adjustments relate; and any other information required by the forms, instructions, or other guidance prescribed by the IRS. Proposed § 301.6226-2(e).

ii. Partner's Share of Adjustments and Other Amounts

Under proposed § 301.6226-2(f), a reviewed year partner's share of the adjustments that must be taken into account by the reviewed year partner must be reported to the reviewed year partner in the same manner as originally reported on the return filed by the partnership for the reviewed year. If the adjusted item was not reflected in the partnership's reviewed year return, the adjustment must be reported in accordance with the rules that apply with respect to partnership allocations, including under the partnership agreement. However, if the adjustments, as finally determined, are allocated to a specific partner or in a specific manner, the partner's share of the adjustment must follow how the adjustment is allocated in that final determination. Proposed § 301.6226-2(f)(1). In all cases, adjustments taken into account on any amended returns or closing agreements that are approved during the modification process under proposed § 301.6225-2(d)(2) and that are disregarded in determining the imputed underpayment are ignored for purposes of determining the reviewed year partners' share of the adjustments. However, these modifications are listed separately on the statements provided to the reviewed year partners. Although modifications are ignored for purposes of reporting the adjustments to the reviewed year partners, any reviewed year partner that took an adjustment into account and paid tax through an amended return or closing agreement as part of modification with respect to that adjustment will not be taxed a second time with respect to that adjustment. This is true for two reasons. First, the partnership will inform the partner of any such adjustment in the statement furnished to that partner, per proposed § 301.6226-2(e). Therefore, the partner will know upon receipt of a statement that certain adjustments were taken into account by the partner and that those adjustments were disregarded in determining the imputed underpayment. Second, when computing the partner's tax that stems from such an adjustment (as described in proposed § 301.6226-3), the partner will account for the adjustment as part of that process, and the computation of the tax will reflect that the partner had already paid tax with respect to that adjustment during the modification phase of the audit. An example in proposed § 301.6226-3(g) illustrates this concept.

Any penalties, additions to tax, or additional amounts are reported to the reviewed year partners in the same proportion as each partner's share of the adjustments to which the penalties relate, unless the penalty, addition to tax, or additional amount is specifically allocated to a specific partner(s) or in a specific manner by a final court decision or in the FPA, if no petition is filed. Proposed § 301.6226-2(f)(2). Accordingly, if a penalty is determined with respect to a specific item or items, that penalty is reported to the reviewed year partners in the same manner as the adjustments to that specific item or items, unless otherwise provided in the FPA or a final court decision, for instance in a situation where there are partner-specific defenses to a penalty determined at the partnership level. If a penalty, addition to tax, or additional amount does not relate to a specific adjustment, each reviewed year partner's share of the penalty, addition to tax, or additional amount is determined in accordance with how such items would have been allocated under rules that apply with respect to partnership allocations, including under the partnership agreement, unless it is allocated to a specific partner in a specific manner in a final determination of the adjustments, in which case it is allocated in accordance with the final determination.

C. Computation of the Tax Resulting From Taking Adjustments Into Account

Under proposed § 301.6226-3, a reviewed year partner that is furnished a statement under proposed § 301.6226-2 is required to pay any additional chapter 1 tax (additional reporting year tax) for the partner's taxable year which includes the date the statement was furnished to the partner in accordance with proposed § 301.6226-2 (the reporting year) that results from taking into account the adjustments reflected in the statement. The additional reporting year tax is either the aggregate of the adjustment amounts, as determined in proposed § 301.6226-3(b), or, if an election is made under proposed § 301.6226-3(c), a safe harbor amount.

In addition to being liable for the additional reporting year tax, the reviewed year partner of a partnership that makes an election under section 6226 must also pay, for the reporting year, the partner's share of any penalties, additions to tax, or additional amounts reflected in the statement, and any interest on such amounts. Interest is determined in accordance with proposed § 301.6226-3(d).

i. Calculating the Aggregate of the Adjustment Amounts

Under proposed § 301.6226-3(b), the aggregate of the adjustment amounts is the aggregate of the correction amounts determined under proposed § 301.6226-3(b). There are two correction amounts for these purposes - one for the partner's taxable year which includes the reviewed year of the partnership (first affected year) and a second correction amount for the partner's taxable years after the first affected year and before the reporting year (intervening years). These correction amounts cannot be less than zero, and any amount below zero after applying the rules in proposed § 301.6226-3(b) does not reduce any correction amount, any tax in the reporting year, or any other amount.

Under proposed § 301.6226-3(b)(2), the correction amount for the first affected year is the amount by which the reviewed year partner's chapter 1 tax would increase for the first affected year by taking into account the adjustments reflected in the statement provided to the reviewed year partner under proposed § 301.6226-2. The correction amount for the first affected year is calculated by first determining the amount of chapter 1 tax that would have been imposed for the first affected year if the items as adjusted in the statement had been correctly reported in the first affected year. From that amount is subtracted the sum of the amount of chapter 1 tax shown by the partner on the return for the first affected year (which includes amounts shown on an amended return for such year, including an amended return filed under section 6225(c)(2) by the reviewed year partner) plus any amounts not shown but previously assessed (or collected without assessment) less any rebates made (as defined in § 1.6664-2(e)). In other words, the correction amount is equal to A minus (B plus C minus D). A is the amount of chapter 1 tax that would have been imposed had the items as adjusted been properly reported on the return for the first affected year. B is the amount shown as chapter 1 tax on the return for the first affected year (including amended returns filed under section 6225(c)(2) by a reviewed year partner). C represents any amounts not so shown previously assessed (or collected without assessment). D is the amount of rebates made. For purposes of applying this definition, an amount previously assessed includes an amount that was previously assessed as a result of the partner taking into account adjustments under section 6226(b) pursuant to an election made by a partnership other than the partnership making the current election.

Under proposed § 301.6226-3(b)(3), the aggregate correction amount for all intervening years is the sum of the correction amounts for each intervening year. Determining the correction amount for each intervening year is a year-by-year determination. The correction amount for each intervening year is the amount by which the reviewed year partner's chapter 1 tax would increase by taking into account any adjustments to any tax attributes. The correction amount for each intervening year is calculated by determining the amount of chapter 1 tax that would have been imposed for the intervening year if any tax attribute for the intervening year had been adjusted after taking into account the partner's share of the adjustments for the first affected year (and if any tax attribute for the intervening year had been adjusted after taking into account any adjustments to tax attributes in any prior intervening year(s)). From that amount is subtracted the sum of the amount of chapter 1 tax shown by the partner on the return for the intervening year (which includes amounts shown on an amended return for such year, including an amended return filed under section 6225(c)(2) by the reviewed year partner) plus any amounts not shown but previously assessed (or collected without assessment) less any rebates made (as defined in § 1.6664-2(e)).

For instance, if a partner had a net operating loss on his original return for the first affected year that was carried forward into the intervening years, the net operating loss (a tax attribute as defined in proposed § 301.6241-1(a)(10)) in the first intervening year after the first affected year is reduced by any portion of the net operating loss utilized to offset the adjustments in the first affected year. This reduction may not only affect the first intervening year after the first affected year, but if not fully absorbed in that intervening year, it may have a cascading effect through the intervening years as the intervening years are adjusted to reflect the adjustment to the net operating loss carryforward.

A number of comments received in response to Notice 2016-23 suggested that the Treasury Department and the IRS should permit calculation of the additional reporting year tax to account for any decreases in chapter 1 tax that may have resulted in the first affected year or any intervening year after taking into account the partner's share of the partnership adjustments. However, section 6226(b) specifically describes the correction amounts as amounts by which a partner's chapter 1 tax would increase for each respective year. Section 6226(b)(2)(A) and (B). Accordingly, the proposed regulations reflect the statute and do not permit any decreases in chapter 1 tax that would result for the first affected year or for any intervening year to factor into the calculation of the additional reporting year tax.

ii. Election To Pay the Safe Harbor Amount

Under proposed § 301.6226-3(c), a partner that is furnished a statement described in proposed § 301.6226-2 may elect under this section to pay the safe harbor amount (or the interest safe harbor amount, in the case of certain individuals) shown on the statement in lieu of the additional reporting year tax. The election is made on the partner's return for the reporting year. If a partner is furnished multiple statements described in proposed § 301.6226-2, the partner may elect to pay the safe harbor amount from some or all of the statements. For instance, if the IRS examined two partnership taxable years in the same administrative proceeding, and an election under section 6226 was made with respect to all imputed underpayments for both years, the partnership would be required to furnish separate statements to its reviewed year partners and to calculate separate safe harbor amounts for each year. A reviewed year partner could elect to pay the safe harbor amount for one taxable year, but not the other taxable year. If a partner elects to pay the safe harbor amount, the partner must report the safe harbor amount on the partner's timely-filed return (excluding extensions) for the partner's reporting year. If the partner fails to do so, the partner may not utilize the safe harbor amount, but instead must compute the additional reporting year tax under proposed § 301.6226-3(b) as if no election under proposed § 301.6226-3(c) had been made.

Proposed § 301.6226-2(g) provides rules for the partnership to compute the safe harbor amount and the interest safe harbor amount, which cannot be less than zero, for inclusion in the section 6226 statement furnished to each reviewed year partner and filed with the IRS. For purposes of calculating the safe harbor amount, all of the allocation rules of proposed § 301.6226-2(f) apply. Under proposed § 301.6226-2(g), the safe harbor amount for each reviewed year is calculated in the same manner as the imputed underpayment under proposed § 301.6225-1 except that the adjustments allocated to the partner on the statement (including any amounts attributable to adjustments to partnership tax attributes) are used instead of the adjustments that are taken into account for purposes of determining the imputed underpayment under proposed § 301.6225-1. With one exception, any approved modifications of the imputed underpayment, including a rate modification under section 6225(c)(4), has no effect on the determination of the safe harbor amount for any partner.

The one exception is where a reviewed year partner filed an amended return, or entered into a closing agreement, during the modification phase under section 6225(c)(2), and as a result, the imputed underpayment, to which an election under this section relates, was determined without regard to the adjustments taken into account on the amended return or in the closing agreement. In that case, such adjustments are not taken into account in determining that partner's safe harbor amount.

In addition to the safe harbor amount, a partnership must calculate an interest safe harbor amount for partners who are individuals and who have a calendar year taxable year. The interest safe harbor amount is calculated at the rate set forth in proposed § 301.6226-3(d)(4) from the due date (without extension) of the individual reviewed year partner's return for the first affected year until the due date (without extension) of the individual reviewed year partner's return for the reporting year.

A separate safe harbor amount (and interest safe harbor amount, if applicable) is calculated for each separate statement furnished to the partner under proposed § 301.6226-2. For example, if there are multiple reviewed years, the partner would receive a separate statement for each reviewed year, and there would be a separate safe harbor calculation and amount for each statement.

The purpose of the safe harbor amount (and the interest safe harbor amount) is to provide a simplified method for the reviewed year partner to take into account the reviewed year partner's share of the adjustments with respect to the partnership's reviewed year. Determining what the reviewed year partner's increase in chapter 1 tax would be in the partner's first affected year if the adjustments were taken into account in that year, the increase in chapter 1 tax that would have occurred as a result of any adjustment to the tax attributes for each intervening year, and interest due for the first affected year and each intervening year could be very complex. In addition, because the statute only permits adjustments to increase, but not decrease, chapter 1 tax for any taxable year, adjustments taken into account under section 6226(b) do not fully reflect the tax consequences of treating the items correctly in the reviewed year. While the safe harbor amount also does not reflect the tax consequences of treating the items correctly in the reviewed year any better than the method prescribed by the statute, it is a reasonable alternative to approximate the tax that would have been due. In some cases, many years may have lapsed between the first affected year and the last intervening year, further complicating the calculation. Accordingly, while determination of the aggregate of the correction amounts provides a close but imperfect approximation of the partner's tax that would have been due if the partnership return was correct in the reviewed year, some partners may decide that the complexity and cost of doing the calculations necessary to determine the aggregate of the correction amounts is not worth the effort given that the aggregate of the correction amounts may not be exactly what the tax due would have been if the partnership return was correct in the reviewed year.

Under the proposed regulations, the safe harbor amount is computed so that partners filing amended returns under section 6225(c)(2) or entering into closing agreements are not paying tax twice on the same adjustment. In addition, the safe harbor amount is determined by multiplying the net adjustments against the highest tax rate under section 6225(b)(1)(A). Use of a fixed rate rather than requiring the reviewed year partner to determine the rate in the first affected year and the intervening years allows the partnership to compute the safe harbor amount for the reviewed year partner, further reducing burden on the reviewed year partner.

The election under section 6226 is a partnership election and the partners are bound by the election. See section 6223(b); proposed § 301.6226-1(d). Although reviewed year partners can avoid the computation under section 6226(b) by filing an amended return (or entering into a closing agreement) and paying the tax and interest due in accordance with section 6225(c)(2) during the modification phase of the audit, not all partners are willing or able to amend their returns for the relevant year. Therefore, the Treasury Department and the IRS believe that it is important to allow partners an option to pay a simplified safe harbor amount in lieu of computing the correction amounts described under proposed § 301.6226-3(b) and a simplified interest safe harbor amount for certain individuals in lieu of computing the interest on the safe harbor amount under proposed § 301.6226-3(d)(2).

Any reviewed year partner may elect to pay the safe harbor amount, including reviewed year partners that are partnership-partners or S corporation partners.

iii. Interest

Reviewed year partners are also liable for interest on any correction amount for the first affected year and any intervening years under proposed § 301.6226-3(d)(1). If the partner elects to pay the safe harbor amount, a reviewed year partner that is an individual may also elect to pay the interest safe harbor amount. For all other partners and individuals that do not elect the safe harbor amount, interest applies under proposed § 301.6226-3(d)(2). Interest on the correction amounts and the safe harbor amount is determined at the partner level. Under proposed § 301.6226-3(d)(4), the rate of interest is calculated using the underpayment rate under section 6621(a)(2), except that when determining that rate, five percentage points are used instead of three percentage points, with the result that the underpayment rate for purposes of section 6226 is the federal short-term rate plus five percentage points.

Under proposed § 301.6226-3(d)(1), a reviewed year partner is liable for interest on any correction amount from the first affected year and any intervening years from the due date of the return (without extension) for the applicable tax year (that is, the year to which the additional tax is attributable) until the correction amount is paid. For purposes of calculating interest, the safe harbor amount and any penalties, additions to tax, or additional amounts are attributable to adjustments taken into account for the first affected year. Therefore, proposed § 301.6226-3(d)(2) and (3) provide that the reviewed year partner is liable for interest on the safe harbor amount and any penalties, additions to tax, or additional amounts from the due date of the return for the corresponding first affected year (without extension) until the reviewed year partner pays such amounts.

The Preamble to proposed regulations [REG-118067-17] (2/2/2018), includes:

3. Provisions Relating to Section 6226

A. In General

Section 6226(b) describes how partnership adjustments are taken into account by the reviewed year partners if a partnership makes an election under section 6226(a). Under section 6226(b)(1), each partner's tax imposed by chapter 1 of subtitle A of the Code (chapter 1 tax) is increased by the aggregate of the adjustment amounts as determined under section 6226(b)(2). This increase in chapter 1 tax is reported on the return for the partner's taxable year that includes the date the statement described under section 6226(a) is furnished to the partner by the partnership (reporting year). The aggregate of the adjustment amounts is the aggregate of the correction amounts. See proposed § 301.6226-3(b).

The adjustment amounts determined under section 6226(b)(2) fall into two categories. Under section 6226(b)(2)(A), in the case of the taxable year of the partner that includes the end of the partnership's reviewed year (first affected year), the adjustment amount is the amount by which the partner's chapter 1 tax would increase for the partner's first affected year if the partner's share of the adjustments were taken into account in that year. Under section 6226(b)(2)(B), in the case of any taxable year after the first affected year, and before the reporting year (that is, the intervening years), the adjustment amount is the amount by which the partner's chapter 1 tax would increase by reason of the adjustment to tax attributes determined under section 6226(b)(3) in each of the intervening years. The adjustment amounts determined under section 6226(b)(2)(A) and (B) are added together to determine the aggregate of the adjustment amounts for purposes of determining additional reporting year tax, which is the increase to the partner's chapter 1 tax in accordance with section 6226(b)(1).

Section 6226(b)(3) provides two rules regarding adjustments to tax attributes that would have been affected if the partner's share of adjustments were taken into account in the first affected year. First, under section 6226(b)(3)(A), in the case of an intervening year, any tax attribute must be appropriately adjusted for purposes of determining the adjustment amount for that intervening year in accordance with section 6226(b)(2)(B). Second, under section 6226(b)(3)(B), in the case of any subsequent taxable year (that is, a year, including the reporting year, that is subsequent to the intervening years referenced in 6226(b)(3)(A)), any tax attribute must be appropriately adjusted.

Under the June 14 NPRM, a reviewed year partner's share of the adjustments that must be taken into account by the reviewed year partner must be reported to the reviewed year partner in the same manner as originally reported on the return filed by the partnership for the reviewed year. See proposed § 301.6226-2(f). If the adjusted item was not reflected in the partnership's reviewed year return, the adjustment must be reported in accordance with the rules that apply with respect to partnership allocations, including under the partnership agreement. However, under proposed § 301.6226-2(f)(1), if the adjustments, as finally determined, are allocated to a specific partner or in a specific manner, the partner's share of the adjustment must follow how the adjustment is allocated in that final determination.

Section 301.6226-4(b) of these proposed regulations provides that the reviewed year partners or affected partners (as described in § 301.6226-3(e)(3)(i)) must take into account items of income, gain, loss, deduction or credit with respect to their share of the partnership adjustments as contained on the statements described in proposed § 301.6226-2 (pushed-out items) in the reporting year (as defined in proposed § 301.6226-3(a)). Similarly, partnerships adjust tax attributes affected by reason of a pushed-out item in the reviewed year. In the case of a reviewed year partner that disposed of its partnership interest prior to the reporting year, that partner may take into account any outside basis adjustment under these rules in an amended return to the extent otherwise allowable under the Code.

Unlike the proposed rules under section 6225 and subchapter K described in section 2 of this preamble, under section 6226, all tax attributes (as defined in proposed § 301.6241-1(a)(10)) are adjusted for pushed out items of income, gain, deduction, loss or credit.

B. Section 704(b)

Section (2)(B)(iii) of this preamble discusses the general mechanics of section 704(b). In accordance with the principles set forth in section 704(b), an allocation of a pushed-out item does not have substantial economic effect within the meaning of section 704(b)(2). However, the allocation of such an item will be deemed to be in accordance with the partners' interests in the partnership if it is allocated in the adjustment year in the manner in which the item would have been allocated under the rules of section 704(b), including § 1.704-1(b)(1)(i) (or otherwise taken into account under subtitle A) in the reviewed year (as defined in proposed § 301.6241-1(a)(8)), followed by any subsequent taxable years, concluding with the adjustment year (as defined in proposed § 301.6241-1(a)(1)). See proposed § 1.704-1(b)(4)(xiv).

C. Timing

Under the June 14 NPRM, a reviewed year partner that is furnished a statement under proposed § 301.6226-2 is required to pay any additional chapter 1 tax (additional reporting year tax) for the partner's taxable year which includes the date the statement was furnished to the partner in accordance with proposed § 301.6226-2 (the reporting year) that results from taking into account the adjustments reflected in the statement. See proposed § 301.6226-3. The additional reporting year tax is the aggregate of the adjustment amounts, as determined in proposed § 301.6226-3(b) and described in (3)(A) of this preamble.

A commenter recommended that adjustments to capital accounts and basis should be made to the reviewed year partners in the reviewed year to prevent distortions. This comment is not adopted because, in this context, section 6226 clearly applies to the adjustment year. These proposed regulations provide that adjustments to partnership-level tax attributes are calculated with respect to each year beginning with the reviewed year, followed by subsequent taxable years, concluding with the adjustment year. See proposed § 301.6226-4(b).

D. Effect of a Payment by Pass-Through Partner

These proposed regulations provide that to the extent a pass-through partner (as defined in proposed § 301.6241-1(a)(5)) makes a payment in lieu of issuing statements to its owners described in proposed § 301.6226-3(e)(4), that payment will be treated similarly to the payment of an amount under subchapter C of chapter 63 for purposes of any adjustments to bases and capital accounts, and accordingly, the rules contained in proposed § 301.6225-4 will apply to determine any appropriate adjustments to bases and capital accounts. See proposed § 301.6226-3(e). To the extent that the pass-through partner continues to push out the partnership adjustments to its partners in accordance with proposed § 301.6226-3(e)(3), the partners receiving those adjustments will adjust their bases and capital accounts in accordance with the guidance provided in proposed § 301.6226-4.

Comments are requested as to how S corporations, trusts, and estates that are pass-through partners that pay an amount under proposed § 301.6226-3(e), and their shareholders and beneficiaries, respectively, should take these payments into account and adjust tax attributes.

The Preamble to proposed regulations [REG-136118-15] (8/17/2018), includes:

SUMMARY:

This document contains proposed regulations implementing the centralized partnership audit regime. This document withdraws and reproposes certain portions of proposed regulations implementing the centralized partnership audit regime that have not been finalized to reflect the changes made by the Technical Corrections Act of 2018, contained in Title II of the Consolidated Appropriations Act of 2018 (TTCA). The proposed regulations affect partnerships with respect to partnership taxable years beginning after December 31, 2017, as well as partnerships that make the election under the Bipartisan Budget Act of 2015 (BBA),to apply the centralized partnership audit regime to partnership taxable years beginning on or after November 2, 2015 and before January 1, 2018.

….

4. Election for the Alternative to Payment of the Imputed Underpayment

Section 6226 provides an alternative to the general rule under section 6225(a)(1) that the partnership must pay an imputed underpayment. Under section 6226, the partnership may elect to have its reviewed year partners take into account adjustments made by the IRS and pay any tax due as a result of those adjustments. If this election is made, the reviewed year partners must pay any chapter 1 tax resulting from taking into account the adjustments, and the partnership is not required to pay the imputed underpayment.

Section 206(d) of TTCA amended section 6226(a) to clarify that if a partnership makes a valid election under section 6226 with respect to an imputed underpayment, no assessment of such imputed underpayment, levy, or proceeding in any court for the collection of such imputed underpayment shall be made against such partnership.

Section 206(e) of the TTCA amended section 6226(b)(1) to provide that when a partner takes into account the adjustments, the partner's chapter 1 tax is adjusted by the aggregate of the "correction amounts" determined under section 6226(b)(2). After amendment by the TTCA, the correction amounts under section 6226(b)(2) are defined as the amounts by which the partner's chapter 1 tax would increase "or decrease" for the partner's first affected year if the partner's share of the adjustments were taken into account for that year. The correction amounts are also the amount by which the partner's chapter 1 tax would increase "or decrease" by reason of the adjustment to tax attributes for any intervening years. See section 6226(b)(2).

Section 204(a) of the TTCA added to the Code section 6226(b)(4), which provides that a partnership or S corporation that receives a statement under section 6226(a)(2) must file a partnership adjustment tracking report with the IRS and furnish statements under rules similar to the rules of section 6226(a)(2). If the partnership or S corporation fails to furnish such statements, the partnership or S corporation must compute and pay an imputed underpayment under rules similar to the rules of section 6225. A partnership that is a partner must file the partnership adjustment tracking report, and furnish statements or pay an imputed underpayment, notwithstanding any election out of the centralized partnership audit regime under section 6221(b) by the partnership for the tax year that includes the end of the reviewed year of the audited partnership. The term "audited partnership" means the partnership in the chain of ownership that originally made the election under section 6226. See section 6226(b)(4)(D).

A. Proposed §§ 301.6226-1, 301.6226-2, and 301.6226-3

Proposed rules under §§ 301.6226-1, 301.6226-2, and 301.6226-3 were previously published in the Federal Register in the June 2017 NPRM (82 FR 27391-97), the November 2017 NPRM (82 FR 56778-79), and the December 2017 NPRM (82 FR 60155-61) (collectively, former proposed §§ 301.6226-1, 301.6226-2, and 301.6226-3). For an explanation of the rules under former proposed §§ 301.6226-1, 301.6226-2, and 301.6226-3, see 82 FR 27358-66, 82 FR 56769-71, and 82 FR 60148-51.

Former proposed § 301.6226-1(b)(2) provided that if a partnership makes a valid election in accordance with proposed § 301.6226-1, the partnership is not liable for the imputed underpayment to which the election relates. To reflect the statutory change to section 6226(a), language has been added to proposed § 301.6226-1(b)(2) to clarify that if a partnership makes a valid election under section 6226 with respect to an imputed underpayment, the IRS may not assess such imputed underpayment, levy, or bring a proceeding in any court for the collection of that imputed underpayment against such partnership. A similar change has also been made to proposed § 301.6226-1(c)(2) (regarding invalid elections) to clarify that if a final determination is made that a purported election under section 6226 is invalid, the IRS may assess the imputed underpayment with respect to which the election was made against the partnership without regard to the limitations under section 6232(b).

Former proposed § 301.6226-3 provided that a reviewed year partner that is furnished a statement under section 6226(a)(2) is required to pay any additional chapter 1 tax (additional reporting year tax) that results from taking into account the partnership adjustments on that statement. As mentioned above in this section of the preamble, Section 206(e) of the TTCA amended section 6226(b) to provide that decreases, as well as increases, in chapter 1 tax that result from taking into account partnership adjustments are used in computing a partner's additional reporting year tax. Section 206(e) of the TTCA also replaced the term "adjustment amount" with "correction amount." Accordingly, proposed § 301.6226-3 now refers to "correction amount" instead of "adjustment amount," as appropriate, and now provides that a reviewed year partner's chapter 1 tax for the reporting year may be increased or decreased by the additional reporting year tax. The additional reporting year tax is the sum of the correction amounts for the first affected year and any correction amounts for the intervening years. Under proposed § 301.6226-3(b)(2) and (3), the correction amounts are the amounts by which the partner's chapter 1 tax for the taxable year would be increased or decreased if the partner's taxable income for that year were recomputed by taking into account, in the case of the first affected year, the partner's share of the partnership adjustments reflected on the statement furnished to the partner or, in the case of any intervening year, any change to tax attributes of the partner resulting from the changes in the first affected year. A correction amount for the first affected year or any intervening year may be less than zero and may be used to offset any correction amounts from any other year in computing the additional reporting year tax. The examples under proposed § 301.6226-3(h) illustrate situations in which a correction amount may be less than zero.

Furthermore, the additional reporting year tax may be less than zero and may offset other taxes owed by the partner on the partner's reporting year return. Accordingly, any references to the additional reporting year tax as a "liability" have been removed from former proposed § 301.6226-3 to account for situations in which the additional reporting year tax is less than zero.

Section 6226(c)(2) provides that interest in the case of a section 6226 election is determined at the partner level, from the due date of the return for the taxable year to which the increase in chapter 1 tax is attributable, and at the underpayment rate under section 6621(a)(2) (substituting 5 percent for 3 percent). As discussed above in this section of the preamble, the TTCA amended section 6226(b) to provide that both increases and decreases in chapter 1 tax are used in computing a partner's additional reporting year tax. However, the TTCA did not similarly amend the reference to "increases" in section 6226(c)(2) with the result that interest only applies to the increases in the chapter 1 tax that would have resulted from taking into account the partnership adjustments under section 6226. No provision under the centralized partnership audit regime provides for interest in the case of a decrease in chapter 1 tax that would have resulted in the first affected year or any intervening year if the adjustments were taken into account in those years. Accordingly, proposed § 301.6226- 3(c)(1) provides that interest on the correction amounts determined under proposed § 301.6226-3(b) is only calculated for taxable years for which there is a correction amount greater than zero, that is, taxable years for which there would have been an increase in chapter 1 tax if the adjustments were taken into account.

Proposed § 301.6226-3(c)(1) further provides that for purposes of calculating interest on the correction amounts, any correction amount that is less than zero does not offset any correction amount that is greater than zero. Although those amounts may offset when determining the additional reporting year tax (as described in proposed § 301.6226-3(b)), allowing the same offset for purposes of calculating interest is inconsistent with section 6226(c)(2), which provides that interest is determined with respect to any increase determined under section 6226(b)(2).

Proposed § 301.6226-3(d)(3) has also been clarified to provide that if a partner wants to raise a partner-level defense to any penalty, addition to tax, or additional amount, a partner must first pay the penalty, addition to tax, or additional amount and file a claim for refund for the reporting year in order to raise the defense.

As discussed above in this section of the preamble, section 204(a) of the TTCA amended section 6226(b) to provide that partnerships and S corporations that are direct or indirect partners in an audited partnership and that receive statements under 6226(a)(2) must file partnership adjustment tracking reports with the IRS and furnish statements to their owners under rules similar to section 6226. If no statements are furnished, the partnership or S corporation must compute and pay an imputed underpayment.

Former proposed § 301.6226-3(e)(1) provided that a pass-through partner (as defined in proposed § 301.6241-1(a)(5)) that was furnished a statement described in proposed § 301.6226-2 (including a statement as described in former proposed § 301.6226-3(e)(3)) must take into account the adjustments reflected on that statement by either furnishing statements to its partners or by paying an amount calculated like an imputed underpayment. Any statements furnished under those provisions were treated as statements described in proposed § 301.6226-2, and any pass-through partner receiving a statement under former proposed § 301.6226-3(e)(3) was required to also take the adjustments reflected on the statement into account by furnishing statements to its own partners or paying an amount calculated like an imputed underpayment. See former proposed § 301.6226-3(e) (3)(i) and (iv).

Although the rules under former proposed § 301.6226-3(e) were largely consistent with the rules under section 6226(b)(4), some changes were needed to conform the two sets of rules. First, proposed § 301.6226-3(a)(1) now provides that the rules under proposed § 301.6226-3(a)(1) apply to a reviewed year partner except to the extent otherwise provided in proposed § 301.6226-3. Second, proposed § 301.6226-3(e) now includes a requirement that the pass-through partner must file a partnership adjustment tracking report. Third, proposed § 301.6226-3(e) provides a default rule that a pass-through partner must furnish statements to its own partners in accordance with proposed § 301.6226-3(e)(3). If a pass-through partner fails to furnish statements in accordance with proposed § 301.6226-3(e)(3), the pass-through partner must compute and pay an imputed underpayment. Additionally, language referring to a pass-through partner "taking into account" the adjustments under former proposed § 301.6226-3(e) was removed to more closely align with the statutory language in section 6226(b)(4). Fourth, proposed § 301.6226-3(e) defines and refers to the term "audited partnership," which proposed § 301.6226-3(e)(1) defines as the partnership that made the election under § 301.6226-1. See section 6226(b)(4)(D). Lastly, proposed § 301.6226-3(e)(4) provides that the amount a pass-through partner must compute and pay, if it does not furnish statements to its partners, is an "imputed underpayment." See section 6226(b)(4)(A)(ii)(II).

Because under proposed § 301.6226-3(e), pass-through partners compute and pay an "imputed underpayment," rather than calculating correction amounts under proposed § 301.6226-3(b), references in former proposed § 301.6226-3(b) to amended returns filed by indirect partners as part of modification have been deleted. Passthrough partners computing an imputed underpayment under proposed § 301.6226-3(e) may account for modifications submitted by their indirect partners, but non-pass-through partners calculating correction amounts under proposed § 301.6226-3(b) cannot. Accordingly, the references in former proposed § 301.6226-3(b) to amended returns filed by indirect partners were removed.

To reflect the change to the definition of "tax attribute" under proposed § 301.6241-1(a)(10) (see section 11.A. of this preamble), proposed §§ 301.6226-2 and 301.6226-3 now only refer to the tax attributes of the partner. For example, proposed §§ 301.6226-2(e) and 301.6226-3(e)(3)(iii) no longer require that the audited partnership report any changes to partnership tax attributes on the statements furnished to its partners under section 6226(a)(2). Therefore, when a partner computes the partner's correction amount for any intervening year, the partner calculates the amount by which the partner's chapter 1 tax for any intervening year would increase or decrease if any tax attribute of that partner (for example, a net operating loss carryover or capital loss carryover) has been adjusted after taking into account the partner's share of the adjustments in the first affected year.

Finally, references to "items" or "items of income, gain, loss, deduction, or credit" throughout former §§ 301.6226-1, 6226-2, and 6226-3 have been replaced with references to "partnership-related items."

B. Revisions to the Regulations Under Section 6226 Unrelated to the TTCA Amendments

In addition to the changes needed to conform to the amendments by the TTCA, some additional changes have been made to former proposed §§ 301.6226-1, 6226-2, and 6226-3. First, proposed § 301.6226-1(b)(2) now provides that only those adjustments that do not result in an imputed underpayment which are associated with an imputed underpayment for which an election under section 6226 is made are included in the reviewed year partner's share of the partnership adjustments reported to the partner. Any adjustments that do not result in an imputed underpayment which are not associated with an imputed underpayment for which an election under section 6226 is made are taken into account under section 6225. This change was necessary to clarify which partnership adjustments are pushed out in the case of multiple imputed underpayments where the push out election is not made with respect to all imputed underpayments. See proposed § 301.6225-1(g) for rules regarding the treatment of adjustments that do not result in an imputed underpayment in the context of specific imputed underpayments.

Second, under proposed § 301.6226-1(c)(1), an election under section 6226 is only valid if all the provisions under proposed § 301.6226-1 (regarding making the election) and § 301.6226-2 (regarding the furnishing of statements) are satisfied, and an election made under section 6226 is valid until the IRS determines that the election is invalid. The rule that an election is valid until the IRS determines it is invalid was moved from former proposed § 301.6226-1(c)(2) to proposed § 301.6226-1(c)(1) to clarify that an election that does not fully satisfy the requirements of proposed §§ 301.6226-1 and 301.6226-2 is valid unless the IRS determines that the purported election is invalid. For example, if a partnership makes an election in accordance with proposed § 301.6226-1 but fails to furnish statements to its partners, that election is valid until the IRS determines otherwise.

In addition, the word “final” was removed from before the word “determination” in proposed § 301.6226-1(c)(2) when referring to a determination made by the IRS that a purported election under section 6226 is invalid. The removal of the word “final” clarifies that the IRS may determine that an election is invalid and assess and collect the imputed underpayment to which the purported election related without first being required to make a proposed or initial determination of invalidity. Although nothing in the regulations precludes the IRS from first notifying the partnership of a potential problem with an election before determining the election is invalid, proposed § 301.6226-1(c)(2) provides that the IRS may determine that an election is invalid even if the partnership has corrected the statements required to be filed and furnished in accordance with proposed § 301.6226-2(d)(3) and also provides that the IRS is not obligated to require the correction of any errors prior to determining an election is invalid.

Third, several changes were made to clarify that the partnership must provide correct information in order to make a valid election under section 6226 and in order for statements to be properly furnished either under proposed § 301.6226-2 or proposed § 301.6226-3(e) (3). Proposed § 301.6226-1(c)(4)(ii) requires the partnership to provide correct information in its election, and proposed § 301.6226-2(e) and proposed § 301.6226-3(e)(3)(iii) require that the statements filed and furnished with the IRS include correct information. Additionally, proposed § 301.6226-2(d)(3) provides that if the IRS cannot determine whether the statements filed and furnished by the partnership are correct because of a failure by the partnership to comply with any requirements (such as filing a partnership adjustment tracking report), the IRS may, but is not obligated to, require the partnership to provide additional information to substantiate the statements. Proposed § 301.6226-2(d)(2) extends the rules governing corrections of errors in statements to statements furnished by pass-through partners under proposed § 301.6226-3(e)(3) and to provide that, if consent of the IRS is required for a correction, that corrected statements may not be furnished until the IRS provides consent.

Fourth, duplicative language regarding the definition of the extended due date for the adjustment year of the audited partnership was removed from former proposed § 301.6226-3(e)(3)(ii) and (e)(4)(ii).

Fifth, in proposed § 301.6226-3(g), the word “grantor” has been added between the words “wholly-owned” and “trusts” to clarify that “wholly-owned trusts” means “wholly-owned grantor trusts.”

Sixth, the phrase “an entity described in § 301.7701-2(c)(2)(i)” in former proposed § 301.6226-3(j) was changed to “a wholly-owned entity disregarded as separate from its owner for Federal tax purposes in the reviewed year” to conform to the definition of disregarded entity under proposed § 301.6241-1(a)(4).

Seventh, proposed § 301.6226-3(c)(2) now provides that interest on any penalties, additions to tax, or additional amounts is calculated from each applicable taxable year until the penalty, addition to tax, or additional amount is paid. Former proposed § 301.6226-3(c)(2) provided that interest was calculated from the first affected year. Under proposed § 301.6226-3(d)(2), partners calculate any penalties, additions to tax, or additional amounts that relate to the partnership adjustments at the partner level. Because the adjustments could create tax effects in more than just the first affected year (for example, as a result of changes to tax attributes in an intervening year), a penalty, addition to tax, or additional amount might likewise result in more than just the first affected year. Accordingly, proposed § 301.6226-3(c)(2) provides that interest on penalties, additions to tax, and additional amounts runs from the applicable taxable year (that is, the particular tax year to which the penalty, addition to tax, or additional amount relates).

Finally, certain errors were corrected in the examples under proposed § 301.6226-3(h). Examples 2 through 4 and 6 through 9 under former proposed § 301.6226-3(h) incorrectly listed the last day to file a petition under section 6234 as the date the adjustments became final, and examples 6 through 9 incorrectly referred to former proposed § 301.6226-1(b) as support for this rule. Under proposed § 301.6226-2(b), partnership adjustments become finally determined on the later of the expiration of the time to file a petition under section 6234 or, if a petition is filed under section 6234, the date when the court’s decision becomes final. The examples under proposed § 301.6226-3(h) now reflect that the adjustments become final on the day after the last day to file a petition under section 6234 to be consistent with the rule under § 301.6226-2(b), and incorrect references to § 301.6226-1(b) in Examples 6 through 9 under former proposed § 301.6226-3(h) have been replaced with correct references to § 301.6226-2(b).

Proposed § 301.6226-4

Proposed rules under §§ 301.6226-4 were previously published in the Federal Register in the February 2018 NPRM (83 FR 4868) (former proposed § 301.6226-4). For an explanation of the rules under former proposed § 301.6226-4, see 83 FR 4874.

Proposed § 301.6226-4 sets forth rules for adjusting reviewed year partners’ tax attributes to take into account partnership adjustments when a partnership makes an election under section 6226. To reflect the addition of section 6226(b)(4), proposed § 301.6226-3(e)(4) now provides that a reviewed year partner that is a pass-through partner must pay an imputed underpayment if the pass-through partner does not furnish statements. In addition, changes have been made throughout former proposed § 301.6226-4 to conform to the change to the definition of "tax attribute" under proposed § 301.6241-1(a)(10). See section 11.A of this preamble. These changes reflect that the adjustments to tax attributes taken into account by a partner should be consistent, regardless of whether the partner files an amended return during modification, participates in the alternative procedure to filing an amended return, or receives a statement under section 6226. Accordingly, the proposed regulations under section 6226 have been revised to refer only to the tax attributes of the partner in the intervening years. Additionally, clarifying changes were made in proposed § 301.6226-4(b) to conform to the terminology used in proposed § 301.6226-3. Lastly, an incorrect cross-reference in former proposed § 301.6226-4(c)(4)(iii) has been replaced with the correct cross-reference.

II.G.19.c.v. Electing Out of Post-TEFRA Rules on Partnership Return

For who may elect out of the centralized partnership audit regime and how to make the election, see parts II.G.19.c.v.(a) Who Can Elect Out of Post-TEFRA Rules on Partnership Return; What Is the Effect of Electing Out and II.G.19.c.v.(b) How to Elect Out of Post-TEFRA Rules on Partnership Audits; Issues to Address in a Partnership Agreement.

However, contrary to my initial impression before certain changes were made in March 2018, I am not a big fan of electing out. The only significant disadvantage to the new regime is complexity when amending partnership returns.[1769] Under the pre-TEFRA rules that apply to partnerships that opt out of the centralized partnership audit regime, the partners' returns must be amended, exposing them to scrutiny. Although that is an option under the centralized partnership audit regime, it is not the only choice:

- For amending prior returns to take advantage of the reviewed year partners' respective tax attributes, see part II.G.19.c.iii Amended Partner Returns for Reviewed Year in Lieu of Partnership Paying Tax. A nice feature is that some partners can amend, using their tax attributes and removing their share of items from the mix, while others might not do so and rely on the other options to pay the tax. Of course, the partnership would need to give those partners who amend the benefit of their actions by making the other partners bear the burden of the remaining items.

- The partnership can simply pay the tax. See part II.G.19.c.ii Partnership's Liability for Underpayment under Code § 6225.

- The reviewed year partners can apply the audit changes to their current returns, allowing them to use current tax attributes rather than amending prior year returns, but with an enhanced interest rate on the increase in tax. See part II.G.19.c.iv Pushing Out Adjustments in Year of Audit in Lieu of Partnership Paying Tax.

[1769] See text accompanying fn 1731 in part II.G.19.c.i Overview of Rules Before and After TEFRA Repeal.

II.G.19.c.v.(a). Who Can Elect Out of Post-TEFRA Rules on Partnership Return; What Is the Effect of Electing Out

The partnership may elect out of the rules on its tax return.[1770] Electing out causes the pre-TEFRA rule of Reg. § 301.6223-1(b)(3)(i) to apply.[1771] For how to elect out, see part II.G.19.c.v.(b) How to Elect Out of Post-TEFRA Rules on Partnership Audits; Issues to Address in a Partnership Agreement.

The centralized partnership audit regime does not apply with respect to any partnership for any taxable year if:[1772]

(A) the partnership elects the application of this subsection for such taxable year,

(B) for such taxable year the partnership is required to furnish 100 or fewer statements under section 6031(b) with respect to its partners,

(C) each of the partners of such partnership is an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic,[1773] an S corporation, or an estate of a deceased partner,

(D) the election—

- (i) is made with a timely filed return for such taxable year, and
- (ii) includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each partner of such partnership, and

(E) the partnership notifies each such partner of such election in the manner prescribed by the Secretary.

A "C corporation" in (C) above appears to include a tax-exempt entity organized as a corporation.[1774]

[1770] Reg. § 301.6221(b)-1(a), "In general," provides:

> The provisions of subchapter C of chapter 63 of the Internal Revenue Code (subchapter C of chapter 63) do not apply for any partnership taxable year for which an eligible partnership under paragraph (b) of this section makes a valid election in accordance with paragraph (c) of this section. For rules regarding deficiency procedures, see subchapter B of chapter 63 of the Internal Revenue Code and §§ 301.6211-1 through 301.6215-1.

[1771] See part II.G.19.c.i Overview of Rules Before and After TEFRA Repeal.

[1772] Code § 6221(b)(1). Any footnotes in the quoted material below are not from the statute itself.

[1773] [my footnote – not in the statute:] Reg. § 301.6221(b)-1(b)(3)(iii) provides:

> *Eligible foreign entity*. For purposes of this paragraph (b)(3), a foreign entity is an eligible partner if the foreign entity would be treated as a C corporation if it were a domestic entity. For purposes of the preceding sentence, a foreign entity would be treated as a C corporation if it were a domestic entity if the entity is classified as a per se corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8), is classified by default as an association taxable as a corporation under § 301.7701-3(b)(2)(i)(B), or is classified as an association taxable as a corporation in accordance with an election under § 301.7701-3(c).

[1774] See fn 1785 for a comment in the preamble suggesting this result. Reg §301.6221(b)-1(b)(3)(i) provides:

As to S corporations, a QSub[1775] would also not be an eligible partner.[1776] On a different note, if both spouses in a married couple own S corporation stock, then they count as two separate shareholder for purposes of the 100-statement limitation.[1777] However, if only one spouse holds title and the other spouse has a community property interest, then only the spouse who holds title counts.[1778]

A taxpayer counts toward the 100-statement limitation even if the taxpayer holds the partnership interest for part of the year, and a decedent and the decedent's estate count as separate taxpayers.[1779] The beneficiaries of an estate do not count toward the 100-statement limitation,

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> For purposes of paragraph (b)(1)(ii) of this section, the term eligible partner means a partner that is an individual, a C corporation (as defined by section 1361(a)(2)), an eligible foreign entity described in paragraph (b)(3)(iii) of this section, an S corporation, or an estate of a deceased partner. An S corporation is an eligible partner regardless of whether one or more shareholders of the S corporation are not an eligible partner.

Code § 1361(a)(2) provides, "For purposes of this title, the term "C corporation" means, with respect to any taxable year, a corporation which is not an S corporation for such year." This appears to include a tax-exempt corporation, consistent with the preamble.

[1775] See part II.A.2.g Qualified Subchapter S Subsidiary (QSub).

[1776] REG-123652-18 (11/24/2020), which is RIN 1545-BP01, provides:

> Although Notice 2019-06 states that the proposed regulations would have applied a rule similar to the rules for S corporations under section 6221(b)(2)(A) to partnerships with a QSub as a partner, the Treasury Department and the IRS have reconsidered that approach. Under § 301.6221(b)-1(b)(3)(ii), partnerships that have disregarded entities as partners may not elect out of the centralized partnership audit regime. QSubs are treated similarly to disregarded entities for most purposes under the Code in that both QSubs and disregarded entities do not file income tax returns but instead report their items of income and loss on the returns of the person who wholly owns the entity. Thus, as described earlier in this part and in Notice 2019-06, the Treasury Department and the IRS have determined that partnership structures with QSubs as partners present special enforcement concerns because allowing a partnership with a QSub partner to elect out of the centralized partnership audit regime would enable a partnership to elect out in situations where there are over 100 ultimate taxpayers, thereby frustrating the efficiencies the regime was intended to create. To make clear to taxpayers that a QSub cannot be used to facilitate the election out of the centralized partnership audit regime by a partnership with greater than 100 ultimate taxpayers, the Treasury Department and the IRS have determined it is necessary for the proposed regulations to address such a special enforcement concern by treating QSubs as ineligible partners for purposes of section 6221. Accordingly, proposed § 301.6221(b)-1(b)(3)(ii)(G) provides that a QSub is not an eligible partner for purposes of making an election out of the centralized partnership audit regime under section 6221(b). Therefore, if a QSub is a partner in a partnership and required to be furnished a statement by the partnership under section 6031(b), that partnership will not be eligible to make an election under section 6221(b) to elect out of the centralized partnership audit regime.

[1777] Reg. § 301.6221(b)-1(b)(2)(iii), Example (1).

[1778] Reg. § 301.6221(b)-1(b)(2)(iii), Example (2) provides:

> The facts are the same as in Example 1 of this paragraph (b)(2)(iii), except Spouse 2 does not separately own an interest in Partnership during 2020 and Spouse 1 and Spouse 2 live in a community property state, State A. Spouse 1 acquired the partnership interest in such a manner that by operation of State A law, Spouse 2 has a community property interest in Spouse 1's partnership interest. Because Spouse 2's community property interest in Spouse 1's partnership interest is not taken into account for purposes of determining the number of statements Partnership is required to furnish under section 6031(b), Partnership is required to furnish a statement to Spouse 1, but not to Spouse 2….

[1779] Reg. § 301.6221(b)-1(b)(2)(iii), Example (3) provides:

even if the estate issues them K-1s.[1780] The IRS will be watching for partnerships with more than 100 partners that purport to be separate less-than-100 partner partnerships.[1781]

The government may by regulation or other guidance identify other types of partners to whom rules similar to the special rules in the case of a partner that is an S corporation can apply.[1782]

At the beginning of 2020, Partnership, which has a taxable year ending December 31, 2020, has three partners – individuals A, B, and C. Each individual owns an interest in Partnership. On June 30, 2020, Individual A dies, and A's interest in Partnership becomes an asset of A's estate. A's estate owns the interest for the remainder of 2020. On September 1, 2020, B sells his interest in Partnership to Individual D, who holds the interest for the remainder of the year. Under section 6031(b), Partnership is required to furnish five statements for its 2020 taxable year - one each to Individual A, the estate of Individual A, Individual B, Individual C, and Individual D. Therefore, for purposes of this paragraph (b)(2), Partnership has five partners during its 2020 taxable year.

[1780] Reg. § 301.6221(b)-1(b)(2)(iii), Example (5) provides:

During its 2020 taxable year, Partnership has two partners, A, an individual, and E, an estate of a deceased partner. E has 10 beneficiaries. Under section 6031(b), Partnership is required to furnish two statements, one to A and one to E. Any statements that E may be required to furnish to its beneficiaries are not taken into account for purposes of this paragraph (b)(2). Therefore, for purposes of this paragraph (b)(2), Partnership has two partners.

[1781] The preamble to the proposed regulations, [REG-136118-15], warned:

… the IRS intends to carefully scrutinize whether two or more partnerships that have elected out should be recast under existing judicial doctrines and general federal tax principles as having formed one or more constructive or de facto partnerships for federal income tax purposes. The types of arrangements that the IRS will carefully review include those where the profits or losses of partners are determined in whole or in part by the profits or losses of partners in another partnership, and those that purport to be something other than a partnership, such as the co-ownership of property. If it is determined that two or more partnerships that have elected out of the centralized partnership audit regime have formed a constructive or de facto partnership for a particular partnership taxable year and are recast as such by the IRS, that constructive or de facto partnership will be subject to the centralized partnership audit regime because that constructive or de facto partnership will not have filed a partnership return and, therefore, will not have made a timely election out as required under section 6221(b)(1)(D)(i) and these proposed regulations. The constructive or de facto partnership may also have more than 100 partners or an ineligible partner, making it ineligible to elect out.

[1782] Code § 6221(b)(2)(C).

Although Congress expected the Treasury and IRS to make revocable trusts and various other disregarded entities eligible,[1783] the Treasury and IRS responded:[1784]

> The Treasury Department and the IRS have carefully considered all of the comments suggesting an expansion of the definition of eligible partner, but have decided not to adopt these comments at this time. In making this determination, the Treasury Department and the IRS considered the burdens of the centralized partnership audit regime on taxpayers and have concluded that the interests of efficient tax administration outweigh those potential burdens. Accordingly, the final regulations do not expand the definition of eligible partner to include entities other than those entities expressly provided in section 6221(b)(1)(C). After gaining experience with the centralized partnership audit regime, the Treasury Department and the IRS will be in a better position to reconsider any expansion of partnerships eligible to elect out of the regime…..
>
> As the Treasury Department and the IRS gain experience with the centralized partnership audit regime, the definition of eligible partner may be revisited. Section 6221(b)(2)(C) allows the Treasury Department and the IRS to expand the types of eligible partners through ''other guidance,'' which includes sub-regulatory guidance that can be more easily tailored and adapted as the Treasury Department and the IRS gain experience with the new regime. Until that time, however, the list of eligible partners will remain the list specifically set forth by Congress in section 6221(b)(1)(C).

The Treasury Department and the IRS noted the following comments but declined to act on them:[1785]

> Comments suggested that partnerships, disregarded entities, trusts (including tax-exempt trusts, revocable trusts, charitable remainder trusts, grantor trusts, and nongrantor trusts), individual retirement accounts, nominees, qualified pension plans, profit-sharing plans, and stock bonus plans should be considered eligible partners for purposes of making an election under section 6221(b). Comments specifically suggested that because certain types of entities, such as trusts, are similarly situated to

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[1783] T.D. 9829 (12/29/2017) noted:

> In addition, multiple comments suggested that the authority granted in section 6221(b)(2)(C) signified a congressional expectation that the Treasury Department and the IRS would expand the list of eligible partners under section 6221(b)(1)(C). Multiple comments also suggested that the General Explanations of Tax Legislation Enacted in 2015 prepared by the Joint Committee on Taxation supported an expansion of the section 6221(b)(1)(C) list. *See* Joint Comm. on Taxation, JCS-1-16, *General Explanation of Tax Legislation Enacted in 2015*, 59-60 (2016). Other comments observed that the differences between the election out rules under section 6221(b) and the small partnership exception under the Tax Equity and Fiscal Responsibility Act of 1982, Public Law 97-248 (TEFRA) - the increase from 10 to 100 partners and the inclusion of S corporation partners - reflected an awareness that the IRS would face additional administrative burdens as a result of the election out rules.
>
> Comments suggested that in some situations there would be minimal or no additional burdens imposed on the IRS resulting from an expansion of the definition of eligible partner. For example, comments suggested that, because there is only one additional layer of ownership beyond an entity that is disregarded as an entity separate from its owner for Federal tax purposes, adding those types of entities to the definition of eligible partner would not increase audit complexity or administrative burden for the IRS.

[1784] T.D. 9829 (12/29/2017).

[1785] T.D. 9829 (12/29/2017). See fn 1774 to see how the final sentence of this quote is implemented.

certain eligible partners, such as S corporations because those entities are audited and report items to their owners similarly, they should be included within the definition of eligible partner, and that excluding them could lead to treating similarly situated taxpayers differently. For example, one comment noted that a tax-exempt organization organized as a C corporation is an eligible partner while a tax-exempt organization organized as a trust is not an eligible partner, even though both organizations are taxed the same way.

To remove any doubt whatsoever, Reg. § 301.6221(b)-1(b)(3)(ii) provides that the following are not eligible partners:

(A) A partnership,

(B) A trust,

(C) A foreign entity that is not an eligible foreign entity described in paragraph (b)(3)(iii) of this section,

(D) A disregarded entity described in § 301.7701-2(c)(2)(i),

(E) An estate of an individual other than a deceased partner, or

(F) Any person that holds an interest in the partnership on behalf of another person.

If any person listed above as an ineligible partner holds a partnership interest during the year, the partnership may not elect out for that year.[1786]

Given that revocable trusts are not eligible partners, consider whether applicable law will allow an individual's interest to pass free from probate to that person's revocable trust:

- Some states have laws that allow one to designate a beneficiary upon death -- for example, the Missouri Nonprobate Transfers Law.[1787]

- Other states may allow such a beneficiary designation to be provided by agreement among the owners; however, one must carefully check to make sure that such an agreement does not violate the applicable state's probate laws.

Another option is to transfer the partnership interest to an S corporation:

[1786] Reg. § 301.6221(b)-1(b)(3)(iv), Example (1) (partnership ineligible to elect out because a partner was a partnership) and Example (3) (partnership ineligible to elect out because a partner was a disregarded entity, even though the disregarded entity was owned by an individual).
[1787] http://revisor.mo.gov/main/OneChapter.aspx?chapter=461.

- Although each shareholder is counted in determining the number of statements toward the 100-statement limit,[1788] a shareholder being an ineligible partner does not disqualify the S corporation as an eligible partner.[1789]

- An S corporation is an eligible partner above only if the partnership includes (in the manner prescribed by the IRS) a disclosure of the name and taxpayer identification number of each person receiving a K-1 from the S corporation.[1790]

- When a nongrantor trust holds a partnership, often <u>all</u> of the trust's distributive share of partnership income is taxed at the highest marginal income tax rate, even if the trust is a mandatory income trust. See part III.A.4 Trust Accounting Income Regarding Business Interests. However, if the trust places the partnership in an S corporation and the beneficiary makes a QSST election, all of the partnership income will be taxed at the beneficiary's rate. See parts II.J.4.g Making the Trust a Complete Grantor Trust as to the Beneficiary, III.A.3.e.i QSSTs and III.A.3.e.vi.(e) Converting Existing Trust to a QSST to Obtain Beneficiary Deemed-Owned Trust Status. If the trust has more than one current beneficiary, see part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSSTs. Conversely, if trapping all of the distributive income in the trust notwithstanding distributions is desirable, see parts II.J.4.h.i Trapping Income in Trust Notwithstanding Distributions – ESBT and III.A.3.e.ii Electing Small Business Trusts (ESBTs. If in the

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[1788] Code § 6221(b)(2)(A)(ii). Reg. § 301.6221(b)-1(b)(2)(ii) provides:

> *Special rule for S corporations*. For purposes of this paragraph (b)(2), a partnership with a partner that is an S corporation (as defined in section 1361(a)(1)) must take into account each statement required to be furnished by the S corporation to its shareholders under section 6037(b) for the taxable year of the S corporation ending with or within the partnership's taxable year.

Reg. § 301.6221(b)-1(b)(2)(ii) provides:

> *Example (4)*. During its 2020 taxable year, Partnership has 51 partners – 50 partners who are individuals and S, an S corporation. S and Partnership are both calendar year taxpayers. S has 50 shareholders during the 2020 taxable year. Under section 6031(b), Partnership is required to furnish 51 statements for the 2020 taxable year - one to S and one to each of Partnership's 50 partners who are individuals. Under section 6037(b), S is required to furnish a statement (that is, Schedule K-1 (Form 1120-S), Shareholder's Share of Income, Deductions, Credits, etc.) to each of its 50 shareholders. Under paragraph (b)(2)(ii) of this section, the number of statements required to be furnished by S under section 6037(b), which is 50, is taken into account to determine whether partnership has 100 or fewer partners. Accordingly, for purposes of this paragraph (b)(2), Partnership has a total of 101 partners (51 statements furnished by Partnership to its partners plus 50 statements furnished by S to its shareholders) and is therefore not an eligible partnership under paragraph (b)(1) of this section. Because Partnership is not an eligible partnership, it cannot make the election under paragraph (a) of this section.

[1789] Reg. § 301.6221(b)-1(b)(3)(i) includes:

> An S corporation is an eligible partner regardless of whether one or more shareholders of the S corporation are not an eligible partner.

Reg. § 301.6221(b)-1(b)(3)(iv) includes:

> *Example (2)*. During its 2020 taxable year, Partnership has four equal partners. Two partners are individuals. One partner is a C corporation. The fourth partner, S, is an S corporation. S has ten shareholders. One of S's shareholders is a disregarded entity, and one is a qualified small business trust. S is an eligible partner under paragraph (b)(3)(i) of this section even though S's shareholders would not be considered eligible partners if those shareholders held direct interests in Partnership . See paragraph (b)(3)(i) of this section. Accordingly, Partnership meets the requirements under this paragraph (b)(3) for its 2020 taxable year.

[1790] Code § 6221(b)(2)(A)(i).

planning stages for a trust to hold a partnership interest and these strategies seem of interest, see part III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.

- An S corporation that merely holds one partnership interest is not going to be able to do a tax-free division. If one considers bequests or trust terminations in favor of beneficiaries who have different objectives and keeping a single voting block is not an overriding goal, note the discussion in part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts (Whether or Not a Sale Is Made).

- When S corporation stock is sold or transferred by death, etc., the partnership interest itself would not receive a basis step-up, although careful planning may reduce or eliminate that disadvantage. See part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation; Possible Way to Attain Basis Step-Up.

Some partnerships might prohibit transfers to persons who would blow the eligibility to opt out, but that may be too prohibitive.

Thus, tenancies in common that are later found to be partnerships would not have elected out of these new rules on their returns, because the election out is required on an annual basis.

A partnership's election out does not affect its relationship to any partnership in which it is a partner.[1791]

[1791] Reg. § 301.6221(b)-1(d), "Election made by a partnership that is a partner," provides:

(1) *In general*. The fact that a partnership has made an election under this section does not affect whether the provisions of subchapter C of chapter 63 apply to any other partnership, including a partnership in which the partnership making the election is a partner. Accordingly, the provisions of subchapter C of chapter 63 that apply to partners in a partnership that has not made an election under this section apply, to the extent provided in the regulations under subchapter C of chapter 63, to partners (that are themselves partnerships that have made an election under this section) in their capacity as partners in the other partnership.

(2) *Examples*.. The following examples illustrate the rules of paragraph (d)(1) of this section. For purposes of these examples, each partnership is required to file a return under section 6031(a):

Example (1). During its 2020 taxable year, Partnership, a calendar year taxpayer, has two partners. One partner, A, is also a calendar year partnership. A files a valid election under this section with its timely filed partnership return for its 2020 taxable year. Partnership does not file an election under this section. Notwithstanding A's valid election under this section, with respect to A's interest in Partnership, A is subject to the rules applicable to partners in a partnership subject to the rules under subchapter C of chapter 63, including the consistency requirements of section 6222 and the regulations thereunder.

Example (2). The facts are the same as Example 1 of this paragraph (d)(2). The IRS mails to Partnership a notice of final partnership adjustment under section 6231 with respect to Partnership's 2020 taxable year. Partnership timely elects the alternative to payment of imputed underpayment under section 6226 and the regulations thereunder. Partnership must provide A with a statement under section 6226 reflecting A's share of the adjustments for Partnership's 2020 taxable year. A is subject to the rules applicable to partners in a partnership subject to the rules under subchapter C of chapter 63 with respect to A's interest in Partnership.

The partnership and all partners are bound by an election out unless the IRS determines that the election is invalid.[1792] If the IRS determines that an election out for a partnership taxable year is invalid, the IRS will notify the partnership in writing and the provisions of subchapter C of chapter 63 will apply to that partnership taxable year.[1793]

Any proposed or final regulations described above that were promulgated before March 23, 2018 need to be read in light of any changes made by the Consolidated Appropriations Act, 2018.

II.G.19.c.v.(b).How to Elect Out of Post-TEFRA Rules on Partnership Audits; Issues to Address in a Partnership Agreement

An election out of the new rules must be made on the eligible partnership's timely filed return, including extensions, for the taxable year to which the election applies and include all information required by the IRS in forms, instructions, or other guidance.[1794] An election is not valid unless the partnership discloses to the IRS all of the required information and, in the case of a partner that is an S corporation, the shareholders of such S corporation.[1795] An election once made may not be revoked without the IRS' consent.[1796]

An electing partnership must disclose to the IRS information about each person that was a partner at any time during the taxable year of the partnership to which the election applies, including:[1797]

- Each partner's name and correct U.S. taxpayer identification number (TIN) (or alternative form of identification required by forms, instructions, or other guidance),
- Each partner's Federal tax classification,
- An affirmative statement that the partner is an eligible partner under Reg. § 301.6221(b)-1(b)(3)(i), and
- Any other information required by the IRS in forms, instructions, or other guidance.

If a partner is an S corporation, the partnership must also disclose to the IRS information about each shareholder of the S corporation that was a shareholder at any time during the taxable year of the S corporation ending with or within the partnership's taxable year, including:[1798]

[1792] Reg. § 301.6221(b)-1(e)(1), "In general," provides:

> An election made under this section is an action taken under subchapter C of chapter 63 by the partnership for purposes of section 6223. Accordingly, the partnership and all partners are bound by an election of the partnership under this section unless the IRS determines that the election is invalid. See § 301.6223-2 for the binding nature of actions taken by a partnership under subchapter C of chapter 63.

[1793] Reg. § 301.6221(b)-1(e)(2).
[1794] Reg. § 301.6221(b)-1(c)(1).
[1795] Reg. § 301.6221(b)-1(c)(1).
[1796] Reg. § 301.6221(b)-1(c)(1).
[1797] Reg. § 301.6221(b)-1(c)(2).
[1798] Reg. § 301.6221(b)-1(c)(2).

- Each shareholder's name and correct TIN (or alternative form of identification as prescribed by forms, instructions, or other guidance),
- Each shareholder's Federal tax classification, and
- Any other information required by the IRS in forms, instructions, or other guidance.

A partnership that elects out must notify each of its partners of the election within 30 days of making the election in the form and manner determined by the partnership.[1799]

Some issues that the partnership agreement may address include:[1800]

- Provisions for the partnership to make the election to elect out for a partnership taxable year (including what vote is required).
- Provision for cooperation between the partner and the partnership.
- A requirement for the partnership to cooperate with the partner by providing access to partnership financial information, partnership records, and transactional documentation.
- A requirement for inter-partner cooperation in the audit.
- Possibly a requirement for some inter-partner information sharing in the audit.
- Possibly some arrangement between the partner and the partnership concerning audit cost sharing.
- A possible requirement for the partner to defend in audit the return positions taken by the partnership.
- An agreement by the partnership to make partnership personnel available regarding the partner audit.
- A requirement that the partner keep the partnership informed concerning the institution of the audit and the progress of the audit (including any tax litigation that may result from the audit).
- In some cases, a requirement for the partner to use advisors designated by the partnership to defend partnership issues in audit (presumably at the expense of the partnership).
- Agreement of the partner to inform the partnership of the settlement of the audit and of the general terms of the settlement as concerns partnership items.
- Notice to the partnership of filing of a petition in either Tax Court, District Court, or Court of Federal Claims.

[1799] Reg. § 301.6221(b)-1(c)(3).
[1800] These bullet points are quoted directly from "Partnership Audit Rules," by Jerald David August and Terence Floyd Cuff (8/2016).

- Agreement of the partner to inform the partnership of court resolution of partnership items.

The decision to elect out of the new audit rules is not one that should be lightly made. On one hand, electing out may very well drastically reduce the chance of the IRS examining the partnership's return (although it will probably have a program to audit whether elections out are correct). On the other hand, an audit could expose other items on a partner's return that the partner would rather not be exposed. I once saw where a partner's audit adjustment of the magnitude of $25,000 in disallowed deductions resulted in the IRS examining the individual's return, finding that an S election was not place, and disallowed approximately $800,000 in S corporation losses reported on the partner's individual return.

Any proposed or final regulations described above that were promulgated before March 23, 2018 need to be read in light of any changes made by the Consolidated Appropriations Act, 2018.

II.G.19.c.vi. Drafting Partnership Agreements to Take Into Account Post-TEFRA Rules

All references below to a partnership agreement include an LLC's operating agreement, which for federal income tax purposes is referred to as a partnership agreement.

Issues to consider include:

- See checklist in part II.G.19.c.v.(b) How to Elect Out of Post-TEFRA Rules on Partnership Audits; Issues to Address in a Partnership Agreement, text accompanying fn 1800.

- Requirement that the partnership representative notify the partners within a reasonable amount of time after received a notice of proposed partnership adjustment. The notification would explain the adjustments that each reviewed year partner would need to make to the partner's tax return reporting the reviewed year's items to avoid the partnership paying tax on the adjustments.

- Often partners are happy to let the person running the partnership handle an IRS audit when everyone's economic interests relating to the effect of an audit are substantially the same. For example, I tend to make the manager of an LLC be the partnership representative. However, if the partners want to have significant input into the audit, the partnership itself can be the partnership representative and would appoint a "designated individual" to communicate partnership decisions to the IRS.[1801]

- Procedure requiring partners to communicate intent to amend (or not amend) their returns after receiving the notice. See part II.G.19.c.iii Amended Partner Returns for Reviewed Year in Lieu of Partnership Paying Tax. Partners should have the option to take the steps below instead of it being required, so that partners do not open other parts of their returns to the IRS' scrutiny.

  - If they do not amend, the partnership may still need information from them regarding their tax attributes to minimize the tax attributable to their share of partnership items.[1802]

[1801] See Reg. § 301.6223-1(b)(3)(i), reproduced in fn 1736 in part II.G.19.c.i Overview of Rules Before and After TEFRA Repeal.
[1802] See part II.G.19.c.ii Partnership's Liability for Underpayment under Code § 6225, especially fns 1752-1759.

The partnership's procedures should provide that failure to provide the information would prevent them from complaining about their individual tax attributes not being taken into account.

- If they do amend, the partnership will need enough time to know that it will not need to work on minimizing tax due to partners' tax attributes. The partnership will also need proof of the amendment so that the partnership will not need to account for their partnership items.

- If the issue involves reallocating income from one partner to another, all of the partners affected by that reallocation need to amend their returns, to avoid the whipsaw of paying tax on the increase in income without the benefit of a reduction for the decrease in income.

- Generally, all of this must be concluded within 270 days after the IRS sends its notice of proposed adjustments.[1803]

- If not all partners amend, so that a final adjustment allocates items to the partnership, the partnership can do a push-out election or pay tax. See part II.G.19.c.iv Pushing Out Adjustments in Year of Audit in Lieu of Partnership Paying Tax. The partnership agreement might include:

  - How to make the decision whether to push-out or just have the partnership pay the tax. As far as the IRS is concerned, only the partnership representative (PR) may act, and the PR may act unilaterally. However, the partnership agreement may impose contractual or fiduciary duties on the PR.

  - Adjustments to capital accounts of those whose items required the partnership to pay tax, etc. The partnership agreement might require capital contributions to fund these payments.

Also consider requirements for partners who transfer their partnership interests. The partnership needs to know how to contact former partners to implement the above procedures. The partnership may want recourse against the transferee partner, which generally is more convenient than tracking down the former partner, and the transferee partner may want to hold part of the purchase price in escrow until the statute of limitations has run for prior years' returns. Similarly, the transferor partner may want input into how the PR handles the audit; if the issues relate to timing deductions or losses, the PR would tend to be aligned with the current partners and therefore may favor deferring deductions so that the more recent partners benefit from them.

Large partnerships require detailed procedures to protect various partners' rights, including relationships with the partnership representative, paying for audit defense, and paying any tax due at the partnership level.[1804] The partnership's management should control the partnership representative's action in whatever manner is appropriate. If the partnership representative is the same person who filed the return, the representative might have a conflict of interest. If the

[1803] See part II.G.19.c.ii Partnership's Liability for Underpayment under Code § 6225, fn 1749.
[1804] See August and Cuff, "The TEFRA Partnership Audit Rules Repeal: Partnership and Partner Impacts," ALI CLE Webcast 6/7/2016, my internal document no. 6409516. The CLE and its materials expressed concerns about fairness to taxpayers that regulations have since addressed, so the reader should focus on their comments regarding relationships between partes.

representative acts in that role for many partnerships (and perhaps is a partnership promoter) and has no skin in the game for this partnership, query whether the representative might compromise your case to settle other cases.

Below is a sample clause appointing the LLC (taxed as a partnership) as the Partnership Representative, so that the LLC's procedures are responsible for any decisions and the person dealing with the IRS – the Designated Individual – is merely effectuating the LLC's decisions. Typically, the manager will make these decisions for the LLC and serve as Designated Individual, but of course the operating agreement may provide for members to vote on any issues that the members believe important enough to address in the operating agreement. As with any sample language in this document, this is intended merely to help the reader spot issues, and the reader is responsible for exercising the reader's own professional judgment.

<u>SECTION 7.9</u> <u>TAX MATTERS</u>.

(a) <u>Appointment</u>. The Members hereby appoint (1) the Company as the "partnership representative" (as defined in Code section 6223(a)) and in any similar capacity under state or local law (the "Partnership Representative"), and (2) the Manager as "designated individual" (as defined in Treasury Regulation section 301.6223-1(b)(3)(ii)) and in any similar capacity under state or local law (the "Designated Individual"). The Designated Individual shall take such actions as directed by the Partnership Representative. The designation of the Partnership Representative and Designated Individual shall be properly made on the Company's federal income tax return (and on any similar tax return under state or local law).

(b) <u>Resignation or Removal</u>. The Partnership Representative and Designated Individual may resign at any time. The Partnership Representative or Designated Individual may be removed at any time by the Manager (or, if no Manager is serving or the Manager is also the Partnership Representative or Designated Individual, as applicable, by a vote of the Members under Section 6.5). In the event of the resignation or removal of the Partnership Representative or Designated Individual, the Manager (or, if no Manager is serving or the Manager is also the Partnership Representative or Designated Individual, as applicable, a vote of the Members under Section 6.5) shall select a replacement Partnership Representative or Designated Individual, as applicable. If the resignation or removal of the Partnership Representative or Designated Individual, as applicable, occurs before the effectiveness of the resignation or removal under applicable Treasury Regulations or other administrative guidance, (1) the resignation or removal of the Partnership Representative or Designated Individual, as applicable, shall be effective upon the earliest date provided for in such Treasury Regulations or administrative guidance, (2) the Partnership Representative that has resigned or been removed shall not take any actions in its capacity as the Partnership Representative except as directed by the Manager, and (3) the Designated Individual that has resigned or been removed shall not take any actions in its capacity as the Designated Individual except as directed by the Partnership Representative.

(c) <u>Tax Examinations and Audits</u>. The Partnership Representative is authorized and required to represent the Company (at the Company's expense) in connection with all audits, inquiries, examinations, demands or other proceedings in respect of any tax returns or taxes of the Company by any federal, state, local or foreign taxing authority, including resulting administrative and judicial proceedings (each a "Tax Contest"), and to expend Company funds for professional services and costs associated therewith. The Partnership Representative shall have sole authority to act on behalf of the Company in any such Tax Contest, and shall have exclusive right to control all proceedings and make all decisions in connection with any Tax Contest, including all decisions to (1) grant or deny any waiver or extension or (2) whether the Company (either on its own behalf or on behalf of the Members) will contest or continue to contest any Tax Contest. Each Member agrees that such Member will not independently act with respect to any Tax Contest, unless previously authorized to do so in writing by the Partnership Representative (which authorization may be withheld by the Partnership Representative in its sole and absolute discretion), and each Member consents to and agrees to become bound by all actions of the Partnership Representative, including any contest, settlement or other action or position with respect to a Tax Contest which the Partnership Representative may deem proper under the circumstances.

(d) Audit Tax Elections. The Partnership Representative may, but shall not be obligated to, cause the Company to make any available elections under the provisions of the Code related to any Tax Contest, as such provisions may be amended from time to time. The Partnership Representative may set deadlines for the Members to comply with one or more procedures intended to reduce the tax imposed on the Company or the Members, including providing information on the tax attributes of such Member, making elections, and/or filing amended tax returns. Each Member must take all actions that the Partnership Representative informs it are reasonably necessary to effect a decision of the Partnership Representative with respect to the Code, including (1) providing any information reasonably requested in connection with any Tax Contest (which information may be freely disclosed to the Internal Revenue Service or other relevant taxing authorities), (2) paying any deficiency for taxes imposed on any Member (including penalties, additions to tax or interest imposed with respect to such tax and any tax or interest imposed with respect to such tax imposed on such Member as a result of an election under Code section 6221(b) or 6226), (3) filing any amended returns that the Partnership Representative determines to be necessary or appropriate to reduce an imputed underpayment under Code section 6225(c), and/or (4) paying all liabilities associated with such an amended return; provided, however, filing an amended return shall not be subject to specific enforcement and shall not constitute a fiduciary duty but rather shall be merely subject to the following sentence. Each Member who does not comply timely and fully with the provisions of this subsection shall be responsible for the consequences of such failure. The costs and expenses incurred by a Member in connection with the preceding sentence (other than the Partnership Representative in its capacity as such) will not be treated as Company expenses and will not be reimbursed by the Company.

(e) Tax Deficiencies on the Company. The Members (and former Members) agree that, if the Company incurs any expenses or pays any deficiency for taxes, interest, and penalties (including those under Code section 6225) as a result of any Tax Contest, the Partnership Representative shall seek payment from the Members (and former Members) for the amount of such expense and such deficiency for taxes, interest, and penalties attributable to that Member (or former Member), and each such Member (or former Member) agrees to pay such amount to the Company promptly upon the request of the Company if and to the extent that the Partnership Representative, in the Partnership Representative's sole and absolute discretion, does not decide to merely debit the Member's Capital Account or reduce any obligation the Company has to the Member (or former Member), which debit or reduction the Partnership Representative shall communicate in writing to the Member (or former Member). Any such payment made by a Member (or former Member) shall not be treated as a Contribution.

(f) Survival. Notwithstanding any other provision of this Agreement to the contrary, a Member's obligation to comply with this Section 7.9 shall survive any transfer of its Company Interest or the dissolution, liquidation, winding up and termination of the Company, and, to the maximum extent not prohibited by applicable Law, for purposes of this Section 7.9, the Company shall be treated as continuing in existence. Accordingly, each Person that ceases to be a Member will, notwithstanding such transfer, dissolution, liquidation, winding up, or termination, reimburse, indemnify, and hold harmless the Company, the Managers, and their respective Affiliates from and against any liability that would be allocated to such Person under Section 7.9 if the Person were a Member at the time of determination.

(g) Liability of Partnership Representative. The Members specifically acknowledge that the Partnership Representative shall not be liable, responsible or accountable in damages or otherwise to the Company or any Member with respect to any action taken by it in its capacity as the Partnership Representative, except for gross negligence or willful misconduct. All reasonable costs and expenses incurred by the Partnership Representative in connection with an audit of a Company income tax return by any taxing authority shall be borne by the Company.

II.G.19.c.vii. Missouri Partnership Audit Procedures

RSMo § 143.425 coordinates Missouri audits with the post-TEFRA federal rules.

RIA Checkpoint Explanation ¶ 90,080 Taxation of Corporate Partners says (1/9/2021):

> Action taken by the IRS: Applicable to any adjustments to a taxpayer's federal taxable income or federal adjusted gross income with a final determination date occurring on or after January 1, 2021, taxpayers in a partnership are required to report and pay any Missouri tax due with respect to final federal adjustments arising from an audit or other action by the IRS or reported by the taxpayer on a timely filed amended federal income tax return by filing a federal adjustments report with the Missouri Department of Revenue for the reviewed year and, if applicable, paying the additional Missouri tax owed by the taxpayer no later than 180 days after the final determination date. [Mo. Rev. Stat. § 143.425(2).]
>
> Partnerships and partners also will report final federal adjustments arising from a partnership level audit or administrative adjustment request and make required payments. Partnerships will be represented in such actions by the partnership's state partnership representative, which will be the partnership's federal partnership representative unless otherwise designated in writing. Partners are prohibited from applying any deduction or credit on any amount determined to be owed under the legislation. [Mo. Rev. Stat. § 143.425(3) ; Mo. Rev. Stat. § 143.425(4) ; Mo. Rev. Stat. § 143.425(8).]
>
> The Department will assess additional tax, interest, additions to tax, and penalties due as a result of final federal adjustments arising from an audit by the IRS no later than three years after the return was filed, as provided in current law, or one year following the filing of the federal adjustments report. For taxpayers who fail to timely file the federal adjustments report, the Department will assess additional taxes, interest, additions to tax, and penalties either by three years after the return was filed, one year following the filing of the federal adjustments report, or six years after the final determination date, whichever is later. [Mo. Rev. Stat. § 143.425(10).]

> Taxpayers may make estimated payments of the Missouri tax expected to result from a pending IRS audit. Such payments will be credited against any tax liability ultimately found to be due to Missouri and limit the accrual of further interest on such amount. If the estimated payments exceed the final tax liability and interest ultimately determined to be due, the taxpayer will be entitled to a refund or credit for the excess amount, provided the taxpayer files a federal adjustments report or claim for refund or credit of tax no later than one year following the final determination date. [Mo. Rev. Stat. § 143.425(11).]

II.G.19.d. Electronic Signatures

At https://www.irs.gov/pub/foia/ig/spder/nhq-10-1121-0005.pdf is a November 18, 2021 "MEMORANDUM FOR ALL SERVICES AND ENFORCEMENT EMPLOYEES" with a subject line of "Temporary Deviation from Handwritten Signature Requirement for Limited List of Tax Forms," control number NHQ-10-1121-0005, and expiration date of 10/31/2023:

> This memorandum revises the memorandum issued on April 15, 2021 (Control Number NHQ-10-0421-0002).
>
> As part of our response to the COVID-19 situation, we have taken steps to protect employees, taxpayers and their representatives by minimizing the need for in-person contact. Taxpayer representatives have expressed concerns with securing handwritten signatures during these times for forms that are required to be filed or maintained on paper. To alleviate these concerns while promoting timely filing, we are implementing a deviation with this memorandum that allows taxpayers and representatives to use electronic or digital signatures[1] when signing certain forms that currently require a handwritten signature. The forms to which this flexibility applies can be found in the attachment to this memo. Such forms must be signed and postmarked on August 28, 2020 or later. The attachment may be updated from time to time to either add or remove applicable forms as appropriate.
>
> > [1] Electronic and digital signatures appear in many forms when printed and may be created by many different technologies. No specific technology is required for this purpose during this temporary deviation.

The Attachment was updated at https://www.irs.gov/newsroom/details-on-using-e-signatures-for-certain-forms to include the following (last reviewed or updated 3/31/3023; updated here 10/1/2023):

> Form 11-C, Occupational Tax and Registration Return for Wagering;
>
> Form 637, Application for Registration (For Certain Excise Tax Activities);
>
> Form 706, U.S. Estate (and Generation-Skipping Transfer) Tax Return;
>
> Form 706-A, U.S. Additional Estate Tax Return;
>
> Form 706-GS(D), Generation-Skipping Transfer Tax Return for Distributions;
>
> Form 706-GS(D-1), Notification of Distribution from a Generation-Skipping Trust;
>
> Form 706-GS(T), Generation-Skipping Transfer Tax Return for Terminations;

Form 706-QDT, U.S. Estate Tax Return for Qualified Domestic Trusts;

Form 706 Schedule R-1, Generation Skipping Transfer Tax;

Form 706-NA, U.S. Estate (and Generation-Skipping Transfer) Tax Return;

Form 709, U.S. Gift (and Generation-Skipping Transfer) Tax Return;

Form 730, Monthly Tax Return for Wagers;

Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons;

Form 1066, U.S. Income Tax Return for Real Estate Mortgage Investment Conduit;

Form 1120-C, U.S. Income Tax Return for Cooperative Associations;

Form 1120-FSC, U.S. Income Tax Return of a Foreign Sales Corporation;

Form 1120-H, U.S. Income Tax Return for Homeowners Associations;

Form 1120-IC DISC, Interest Charge Domestic International Sales – Corporation Return;

Form 1120-L, U.S. Life Insurance Company Income Tax Return;

Form 1120-ND, Return for Nuclear Decommissioning Funds and Certain Related Persons;

Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return;

Form 1120-REIT, U.S. Income Tax Return for Real Estate Investment Trusts;

Form 1120-RIC, U.S. Income Tax Return for Regulated Investment Companies;

Form 1120-SF, U.S. Income Tax Return for Settlement Funds (Under Section 468B);

Form 1127, Application for Extension of Time for Payment of Tax Due to Undue Hardship;

Form 1128, Application to Adopt, Change or Retain a Tax Year;

Form 2678, Employer/Payer Appointment of Agent;

Form 3115, Application for Change in Accounting Method;

Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts;

Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner;

Form 4421, Declaration – Executor's Commissions and Attorney's Fees;

Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes;

Form 8038, Information Return for Tax-Exempt Private Activity Bond Issues;

Form 8038-G, Information Return for Tax-Exempt Governmental Bonds;

Form 8038-GC, Information Return for Small Tax-Exempt Governmental Bond Issues, Leases, and Installment Sales;

Form 8283, Noncash Charitable Contributions;

Form 8453 series, Form 8878 series, and Form 8879 series regarding IRS e-file Signature Authorization Forms;

Form 8802, Application for U.S. Residency Certification;

Form 8832, Entity Classification Election;

Form 8971, Information Regarding Beneficiaries Acquiring Property from a Decedent;

Form 8973, Certified Professional Employer Organization/Customer Reporting Agreement; and

Elections made per Internal Revenue Code Section 83(b).

Details on using e-signatures for certain forms, found at https://www.irs.gov/newsroom/details-on-using-e-signatures-for-certain-forms, updated December 8, 2021 (Page Last Reviewed or Updated: 17-Dec-2021), includes:

Types of acceptable electronic signatures

The IRS will accept a wide range of electronic signatures. An electronic signature is a way to get approval on electronic documents. It can be in many forms and created by many technologies. Acceptable electronic signature methods include:

1. A typed name typed on a signature block
2. A scanned or digitized image of a handwritten signature that's attached to an electronic record
3. A handwritten signature input onto an electronic signature pad
4. A handwritten signature, mark or command input on a display screen with a stylus device
5. A signature created by a third-party software

The IRS doesn't specify what technology a taxpayer must use to capture an electronic signature. The IRS will accept images of signatures (scanned or photographed) including common file types supported by Microsoft 365 such as tiff, jpg, jpeg, pdf, Microsoft Office suite or Zip.

Electronic execution of documents is important beyond IRS concerns. See ACTEC submits Request to the National Association of Secretaries of State (NASS) for State Issuance of Electronic Apostilles (e-App) by Secretaries of State. (August 10, 2021).

Sign and Send Documents Electronically discusses how to electronically sign documents and email documents to IRS during an audit or collection interaction.

II.G.19.e. Superseding Returns

A "superseding return" is a return filed after the original return was filed and before the due date of the original return. Generally, a superseding return replaces the original return, including changing any elections that are required to made on a timely filed original return. If the superseding return is filed after the original due date but before the extended due date, it is not a superseding return with respect to any elections that must be filed with the original return and that cannot be made on an extended return. In the Internal Revenue Manual, see part 21.6.7.4.10 (03-18-2022).

CCA 202026002 concluded that the original return, not the superseding return, is "the return" that starts the statutory period under Code § 6501 for assessment of three years and under Code § 6511 for filing a claim for refund of three years. The CCA reviewed *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172 (1934); *National Paper Products Co. v. Helvering*, 293 U.S. 183 (1934); and *Haggar Co. v. Helvering*, 308 U.S. 389 (1940):

> **II. Statute of Limitations for Assessments under Section 6501**
>
> Under *Zellerbach* and *National Paper*, the original return, not the superseding return, starts the period of limitations for assessment under section 6501. In these two related cases, the issue before the Supreme Court was substantially the same, but the facts were slightly different. In both cases, new statutes were enacted after two companies had already timely filed their tax returns. Each statute affected income tax and was effective retroactively. In response to the new law, "[National Paper] filed an additional return, supplementing the original one by a statement of the additional taxes due." *Nat'l Paper*, 293 U.S. at 186. *Zellerbach Paper*, on the other hand, "did not make a new or supplemental return correcting the computation in the one on file." *Zellerbach*, 293 U.S. at 175. In both cases, the Commissioner issued a notice of deficiency after the limitation period for assessment had run from the original returns' filing date.
>
> The taxpayers argued that the notices of deficiency were untimely. The government's position was that, since the original returns did not incorporate the changes under the statute, the original return in both cases was a nullity, so the statute of limitations on assessment had not begun to run with the filing of the original returns. The Court disagreed. Discussing what is now known as the Beard test, the Court found the original returns filed by both *Zellerbach Paper Company* and *National Paper* met that test and started the statute of limitations for assessment. Thus, the notices of deficiency were untimely.
>
> The court disagreed with the government's argument that starting the period of limitation for assessment with the original return unfairly curtails the government's time for audit and assessment:

> [A] second return, reporting an additional tax, is an amendment or supplement to a return already upon the files, and being effective by relation does not toll a limitation which has once begun to run.... Supplement and correction in such circumstances will not take from a taxpayer, free from personal fault, the protection of a term of limitation already running for his benefit.

Id. at 180.[2] In coming to this conclusion, the *Zellerbach* Court deemed a loss of four months for audit insignificant, *Id*. at 181, and it apparently did not find a loss of ten months alone to be a factor that would change its decision in *National Paper*. *Nat'l Paper*, 293 U.S. at 185.

> [2] *Zellerbach* is cited for the proposition that a second return does not restart the limitations period, despite the fact that the taxpayer in *Zellerbach* did not file a second return. This is because the Court explained its reasoning on this issue in its *Zellerbach* opinion and then just referred back to that reasoning in its *National Paper* opinion. See *Nat'l Paper*, 293 U.S. at 186 (" *For reasons stated in our opinion in* [*Zellerbach*], the period of limitation began to run on the filing of the first return, and a return for additional taxes, even if filed afterwards, was an amendment or supplement which did not toll the statute.") (emphasis added).

The Court found the idea of tolling the statute due to a supervening change in the law particularly unfair to the taxpayer. Its reasoning, however, applies more broadly to all situations where an amended return is filed. For example, in *Badaracco v. Commissioner*, 464 U.S. 386 (1984),[1805] the Supreme Court held that the later filing of a non-fraudulent amended return, after the filing of a fraudulent return, cannot reinstate the general three-year limitations period and terminate the indefinite limitations period under section 6501(c)(1). *Badaracco*, 464 U.S. at 393-94 ("Thus, when Congress provided for assessment at any time in the case of a false or fraudulent 'return,' it plainly included by this language a false or fraudulent original return.... It is established that a taxpayer who submits a fraudulent return does not purge the fraud by subsequent voluntary disclosure; the fraud was committed, and the offense completed, when the original return was prepared and filed.")

In reaching its conclusion, the Court rejected the taxpayers' argument that, under *Zellerbach*, a "repentant" return terminated the indefinite limitations period, stating, "The [*Zellerbach*] Court held that an original return, despite its inaccuracy, was a 'return' for limitations purposes, so that the filing of an amended return did not start a new period of limitations running." *Badaracco*, 464 U.S. at 397. And it further noted, relying on *Zellerbach* and other cases, that "[i]t thus has been consistently held that the filing of an *amended return* in a nonfraudulent situation does not serve to extend the period within which the Commissioner may assess a deficiency." *Id*. at 393 n. 8 (emphasis added).[3]

> [3] The *Badaracco* opinion referred to, and was consistent with, an extensive body of law cited for the general proposition that an amended return is a nullity for most purposes (apart from refund claims). See, *e.g.*, *J.E. Riley Investment Co. v. Comm'r*, 311 U.S. 55 (1940) (an election required to be made on a "return" generally cannot be made or modified on an amended return); *Koch v. Alexander*, 561 F.2d 1115 (4th Cir. 1977) (A taxpayer cannot create Tax Court jurisdiction by filing an amended

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[1805] [my footnote:] For more on *Badaracco*, see part III.B.2.f Triggering the Statute of Limitations for Grantor Trusts.

return reflecting a decrease in tax); *Plunkett v. Comm'r*, 41 B.T.A. 700, (1940), *aff'd*, 118 F.2d 644 (1st Cir. 1941) (The filing of a correct amended return does not cure an earlier defective filing so as to avoid the penalty for failure to file). Because this line of cases involves amended returns, it is distinguishable from cases that involve superseding returns, like the cases at hand, and should not apply to them.

Badaracco recognized that *Zellerbach* applies to any case involving amended returns. Thus it is a natural extension that *Zellerbach* apply to superseding returns filed during an extension period as well. Nothing in the *Zellerbach* opinion limits its holding to amended returns, nor does it differentiate between second returns filed before or after the deadline for filing. Rather, the Court refers to "a second return, reporting an additional tax," that is, "an amendment or supplement to a return already upon the files," a definition that would encompass both amended returns and superseding returns.

The reasoning of *Zellerbach* also applies with equal force to superseding returns filed on extension. In both superseding- and amended-return situations, if the second return were to restart the limitations period, the taxpayer would lose the protection of the assessment statute for the period between the dates the two returns were filed. This is unfair to the taxpayer and thwarts the purpose of the statute of limitations, 4 which, in the tax context, is "to cut off rights that might otherwise be asserted ...." See *Kavanagh v. Noble*, 332 U.S. 535, 539 (1947) (citing *Rosenman v. United States*, 323 U.S. 658, 661 (1945)), *reh'g denied*, 333 U.S. 850 (1948). This purpose is served best when the original return starts the period of limitations.

The loss of time to audit the superseding return, even if the superseding return were filed at the end of a six-month automatic extension period, does not influence our conclusion that an original return, despite its inaccuracy, is the return for purposes of the statute of limitations on assessment, and the filing of a superseding return during an extension period does not restart the period of limitations. See *Zellerbach* and *National Paper* (Court was unmoved by losses of four and ten months, respectively).

Haggar Co. v. Helvering, 308 U.S. 389, (1940), does not require a different conclusion. In *Haggar*, for purposes of a new capital stock tax, the taxpayer was required to declare the value of its stock on what the statute referred to as the "first return." The taxpayer could declare any value of capital stock for its first taxable year, but the declared value for the first year was a controlling factor for the computation of excess profits tax for later years. The statute provided that the declaration once made could not be amended.

On a timely filed return, Haggar mistakenly reported the par value, as distinguished from actual value, of its issued capital stock. Before the due date, it filed a superseding return declaring the actual value. The Commissioner, refusing to accept the value of the capital stock declared in the superseding return, gave notice of a deficiency in excess profits tax calculated upon what was declared in the first return. Noting that the government was not prejudiced, that the purpose of the statute was not thwarted, and that there was a longstanding administrative practice of accepting superseding returns in other contexts, the Court observed:

> "First return" thus means a return for the first year in which the taxpayer exercises the privilege of fixing its capital stock value for tax purposes, and includes a timely amended return for that year. A timely amended return is as much a "first return" for

> the purpose of fixing the capital stock value in contradistinction to returns for subsequent years, as is a single return filed by the taxpayer for the first tax year.

Haggar, 308 U.S. at 395-96.

Over the years, *Haggar* has come to stand for the proposition that a superseding return, whether filed on extension or not, is effective for most purposes. For example, courts have held that many elections required to be made on a timely return can be made or changed on a superseding return. See, *e.g.*, *National Lead Co. v. Commissioner*, 336 F.2d 134 (2d Cir. 1964) (inventory accounting relief provision); *Charles Leich & Co. v. United States*, 329 F.2d 649 (Ct. Cl. 1964) (excess profits tax election); *Wilson v. United States*, 267 F.Supp. 89 (E.D. Mo. 1967) (partnership tax year); *Cf. J.E. Riley Investment Co. v. Comm'r*, 311 U.S. 55 (1940) ("[*Haggar*] would compel the conclusion that had the amended return been filed within the period allowed for filing the original return, it would have been a first return [for purposes of determining percentage depletion election] ....") (citations omitted).

In addition, the Service has applied *Haggar* in the penalty context. *See*, *e.g.*, Rev. Rul. 78-256, 1978-1 C.B. 438 (holding that the "tax shown on the return" refers to the amount shown on a superseding return, not the original return, for purposes of calculating the estimated tax underpayment penalty in section 6655); Rev. Rul. 83-36, 1983-1 C.B. 358 (applying *Haggar* to the estimated tax underpayment penalty for individual taxpayers in section 6654).

Nonetheless, *Haggar* does not compel a conclusion that a superseding return is "the return" for purposes of the statute of limitations. It has never been applied in that context; nor should it be because the purpose of the statute of limitations is distinct from the purpose of the statute in *Haggar* and from the purposes of the statutes covering elections and penalties to which *Haggar* has been applied. While *Haggar* has been applied to statutes aimed at determining what substantively is included in the return, the statute of limitations is a mechanical rule with the purpose of cutting off rights, as discussed above. Furthermore, *Haggar* does not conflict with *Zellerbach*. A superseding return modifies or supersedes an original return under *Haggar* and still relates back to the date of the original return for timing purposes under *Zellerbach*. *Zellerbach* recognizes that a second return, although it does not restart the limitation period, is still "an amendment or supplement to a return already upon the files, and ... [is] effective by relation." *Zellerbach*, 293 U.S. at 180; see also Wilson, 267 F. Supp. at 91 (suggesting that the question *Haggar* addresses is "whether or not an amendment is part of a first return") (emphasis added); *Barber v. Comm'r*, 64 T.C. 314, 317 (1975) (noting that if the amended return had been timely filed, then under *Haggar*, "[the amended] return might then be treated as part of the original return").

III. Statute of Limitations for Claims for Refund under Section 6511

Zellerbach and *National Paper* also support the conclusion that the original return, not the superseding return, starts the period of limitations for claims for refund under section 6511. For example, *Zellerbach* has been applied to cases involving issues of whether amended returns restart the period of limitations for claims for refunds. *See, e.g., Kaltreider Construction, Inc. v. United States*, 303 F.2d 366, 368 (3d Cir.), *cert. den.*, 371 U.S. 877 (1962) (rejecting taxpayer's argument that the statute in section 6511 began at the time the "amended return" was filed because "[t]he language of the Supreme Court

> in [*Zellerbach*] is directly in point."); Rev. Rul. 72-311, 1972-1 C.B. 398 (citing *Kaltreider* in holding that the "return" referred to in section 6511 is the original return and not an amended return); see also *Adams v. I.R.S.*, No. 2:13-CV-04525-CAS, 2014 WL 457915, at *3 (C.D. Cal. 2014); *Chaney v. United States*, 45 Fed. Cl. 309, 314-15 (1999); *Muertens v. United States*, 12 Cl. Ct. 678, 679 (1987); *but see Greene v. United States*, 191 F.3d 1341, 1343-44 (Fed. Cir. 1999) (holding the statute of limitations for seeking refund began to run upon filing of an amended return; distinguishable because the tax liability at issue was not required to be shown on the original return and could not be known until at least two years after the taxable year ended)
>
> Similar to the 6501 context, *Zellerbach* also applies when the second return filed is a superseding return filed on extension. The opinions that apply *Zellerbach* as support for holding that an amended return does not restart the limitations period under 6511 discuss the general principle that all statutes of limitations involve hardship and it is not the court's role to alleviate that hardship. See *Kaltreider*, 303 F.2d at 368-69 ("Statutes of limitation frequently involve some hardship, but alleviation of that hardship is matter of policy for Congress."); *Chaney*, 45 Fed. Cl. at 317 ("Statutes of limitations are established to cut off rights, justifiable or not, that might otherwise be asserted and they must be strictly adhered to by the judiciary.") (citations omitted).
>
> The hardship faced by taxpayers in the section 6511 refund limitation period context is the same regardless of whether the second return is an amended return or a superseding return. In both instances, the statute begins running with the original return. The Service faces the same hardship, as discussed above, in the context of the assessment statute of limitations under 6501. Enacting these sections at the same time, Congress created time periods that run concurrently, and treating superseding returns differently under each section would thwart these concurrent periods by starting the periods at different times. Thus, a court considering this issue under section 6511 would likely find that *Zellerbach* requires the statute of limitations for claims for refund to start when the original return is filed, not when the superseding return is filed.
>
> *Haggar* can again be distinguished in the same ways discussed above in the context of section 6501. A superseding return can be effective in modifying the original return by relating back to and becoming part of the original return, under *Haggar*, without tolling the period of limitations for claims for refund, in line with *Zellerbach*. Moreover, the purpose of the statute of limitations supports interpreting the ambiguous term, "the return," in section 6511 to mean the original return.

Reg 26.2632-1(b)(4)(iii), Example 1, "Modification of allocation of GST exemption," clearly allows a superseding return to change the original GST allocation:

> On December 1, 2003, T transfers $100,000 to an irrevocable GST trust described in section 2632(c)(3)(B). The transfer to the trust is not a direct skip. The date prescribed for filing the gift tax return reporting the taxable gift is April 15, 2004. On February 10, 2004, T files a Form 709 on which T properly elects out of the automatic allocation rules contained in section 2632(c)(1) with respect to the transfer in accordance with paragraph (b)(2)(iii) of this section, and allocates $50,000 of GST exemption to the trust. On April 13th of the same year, T files an additional Form 709 on which T confirms the election out of the automatic allocation rules contained in section 2632(c)(1) and allocates $100,000 of GST exemption to the trust in a manner that clearly indicates the intention to modify and supersede the prior allocation with respect to the 2003 transfer.

The allocation made on the April 13 return supersedes the prior allocation because it is made on a timely-filed Form 709 that clearly identifies the trust and the nature and extent of the modification of GST exemption allocation. The allocation of $100,000 of GST exemption to the trust is effective as of December 1, 2003. The result would be the same if the amended Form 709 decreased the amount of the GST exemption allocated to the trust.

II.G.19.f. Reliance on FAQs Issued by IRS

IR-2021-202 (10/15/2021) provides:[1806]

> WASHINGTON — Today, the Internal Revenue Service is updating its process for certain frequently asked questions (FAQs) on newly enacted tax legislation. The IRS is updating this process to address concerns regarding transparency and the potential impact on taxpayers when these FAQs are updated or revised. At the same time, the IRS is also addressing concerns regarding the potential application of penalties to taxpayers who rely on FAQs by providing clarity to taxpayers as to their ability to rely on FAQs for penalty protection.
>
> Significant FAQs on newly enacted tax legislation, as well as any later updates or revisions to these FAQs, will now be announced in a news release and posted on IRS.gov in a separate Fact Sheet. These Fact Sheet FAQs will be dated to enable taxpayers to confirm the date on which any changes to the FAQs were made. Additionally, prior versions of Fact Sheet FAQs will be maintained on IRS.gov to ensure that, if a Fact Sheet FAQ is later changed, taxpayers can locate the version they relied on if they later need to do so. In addition to significant FAQs on new legislation, the IRS may apply this updated process in other contexts, such as when FAQs address emerging issues.
>
> To address concerns about the potential application of penalties to taxpayers who rely on an FAQ, the IRS is today releasing a statement clarifying that if a taxpayer relies on any FAQ (including FAQs released before today) in good faith and that reliance is reasonable, the taxpayer will have a "reasonable cause" defense against any negligence penalty or other accuracy-related penalty if it turns out the FAQ is not a correct statement of the law as applied to the taxpayer's particular facts. For more information on taxpayer reliance, see the General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs.
>
> As part of today's revision of the FAQ process, the following legend will be added to Fact Sheet FAQs:
>
> *These FAQs are being issued to provide general information to taxpayers and tax professionals as expeditiously as possible. Accordingly, these FAQs may not address any particular taxpayer's specific facts and circumstances, and they may be updated or modified upon further review. Because these FAQs have not been published in the Internal Revenue Bulletin, they will not be relied on or used by the IRS to resolve a case. Similarly, if an FAQ turns out to be an inaccurate statement of the law as applied to a particular taxpayer's case, the law will control the taxpayer's tax liability. Nonetheless, a taxpayer who reasonably and in good faith relies on these FAQs will not be subject to a*

[1806] The web page from which I copied said, "Page Last Reviewed or Updated: 22-Nov-2021."

penalty that provides a reasonable cause standard for relief, including a negligence penalty or other accuracy-related penalty, to the extent that reliance results in an underpayment of tax. Any later updates or modifications to these FAQs will be dated to enable taxpayers to confirm the date on which any changes to the FAQs were made. Additionally, prior versions of these FAQs will be maintained on IRS.gov to ensure that taxpayers, who may have relied on a prior version, can locate that version if they later need to do so.

General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs

Guidance Published in the Internal Revenue Bulletin

The Internal Revenue Bulletin (Bulletin) is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Rulings not published in the Bulletin will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

FAQs

FAQs are a valuable alternative to guidance published in the Bulletin because they allow the IRS to more quickly communicate information to the public on topics of frequent inquiry and general applicability. FAQs typically provide responses to general inquiries rather than applying the law to taxpayer-specific facts and may not reflect various special rules or exceptions that could apply in any particular case. FAQs that have not been published in the Bulletin will not be relied on, used or cited as precedents by Service personnel in the disposition of cases. Similarly, if an FAQ turns out to be an inaccurate statement of the law as applied to a particular taxpayer's case, the law will control the taxpayer's tax liability. Only guidance that is published in the Bulletin has precedential value.

Notwithstanding the non-precedential nature of FAQs, a taxpayer's reasonable reliance on an FAQ (even one that is subsequently updated or modified) is relevant and will be considered in determining whether certain penalties apply. Taxpayers who show that they relied in good faith on an FAQ and that their reliance was reasonable based on all the facts and circumstances will have a valid reasonable cause defense and will not be subject to a negligence penalty or other accuracy-related penalty to the extent that reliance results in an underpayment of tax. See Treas. Reg. § 1.6664-4(b) for more information. In addition, FAQs that are published in a Fact Sheet that is linked to an IRS news release are considered authority for purposes of the exception to accuracy-related penalties that applies when there is substantial authority for the treatment of an item on a return. See Treas. Reg. § 1.6662-4(d) for more information.

Banoff, Lipton & Cohen, "What Happens to Old FAQs Under IRS's New FAQ Process?" *Journal of Taxation* (1/2022), includes the following:

Question 1: What is the legal effect of an FAQ?

We have previously visited the question of what is the legal effect of the IRS's answers to FAQs that are posted on the IRS website. See, *e.g.*, Shop Talk, "No News is Good News and Bad News: No New FAQs for Partnership Return Preparers," 111 JTAX 62 (July 2009) and "FAQs on Partnership Capital and Profits Interests: Are They (and Were They Ever) Reliable?," 127 JTAX 44 (July 2017). Others have wrestled with the question, also. See, e.g., Coder, "News Analysis: How Do FAQs Fit Into the Guidance Puzzle?," 2011 TNT 64-1 (April 4, 2011). Also see *Tom Reed*, TC Memo 2014-41, in which the taxpayer cited supporting FAQs, and the Tax Court simply responded that "informal guidance, such as the FAQs posted to the IRS's Web site, is not an authoritative source of Federal tax law."

The question as to whether reliance on FAQs can be used to sustain tax return reporting positions and avert penalties under Section 6662 for taxpayers is covered in the IR and the accompanying "General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs" (the "IRS FAQs Statement"). The IRS's view: FAQs are not given precedential effect in sustaining tax return reporting positions, but they may help taxpayers avert negligence and certain other tax penalties. (As discussed below, the IR and the IRS FAQs Statement are inconsistent as to exactly which penalties can be averted.)

With respect to sustaining tax return reporting positions, the IRS FAQs Statement provides: "FAQs that have not been published in the [Internal Revenue] Bulletin will not be relied on, used, or cited as precedents by Service personnel in the disposition of cases. Similarly, if an FAQ turns out to be an inaccurate statement of the law as applied to a taxpayer's case, the law will control the taxpayer's tax liability. Only guidance that is published in the Bulletin has precedential value." With respect to averting certain penalties (of the kind that arise under Section 6662), the IR states: "To address concerns about the potential application of penalties to taxpayers who rely on an FAQ, the IRS is today releasing a statement clarifying that if a taxpayer relies on an FAQ (including FAQs released before today) in good faith and that reliance is reasonable, the taxpayer will have a 'reasonable cause' defense against any negligence penalty or other accuracy-related penalty if it turns out the FAQ is not a correct statement of the law as applied to the taxpayer's particular facts."

The IRS FAQs Statement makes an important distinction (not contained in the IR) with respect to FAQs that are published in a Fact Sheet (on IRS.gov) that is linked to an IRS news release. The IRS FAQs Statement provides: "Notwithstanding the non-precedential nature of FAQs, a taxpayer's reasonable reliance on an FAQ (even one that is subsequently updated or modified) is relevant and will be considered in determining whether certain penalties apply. Taxpayers who show that they relied in good faith on an FAQ and that their reliance was reasonable based on all the facts and circumstances will have a valid reasonable cause defense and will not be subject to a negligence penalty or other accuracy-related penalty to the extent that reliance results in an underpayment of tax. See Treas. Reg. Sec. 1.6664-4(b) for more information. In addition, FAQs that are published in a Fact Sheet that is linked to an IRS news release are considered authority for purposes of the exception to accuracy-related penalties that applies when there is substantial authority for the treatment of an item on a return. See Treas. Reg. Sec. 1.6662-4(d) for more information." (emphasis added.)

Let's first analyze the new guidance with respect to the 'reasonable reliance' defense theoretically available for all FAQs (including FAQs released prior to October 15, 2021). What exactly is "reasonable reliance" on an FAQ? Does it include a taxpayer's reliance on an FAQ if the IRS withdraws the FAQ from IRS.gov after the relevant tax year ends but before the taxpayer files that year's tax return? If the answer is "no," should taxpayers who rely on FAQs file their tax returns as soon as possible, to avoid losing their 'reasonable reliance' shield to avert penalties in the event the FAQ is withdrawn or modified after the tax return filing season begins but before the taxpayer's filing deadline (including extensions)?

In a similar vein, what if the IRS deletes the FAQ from IRS.gov after a calendar year taxpayer relies on the FAQ in good faith in connection with the taxpayer's disposition on (say) February 1, 2022 of its property but the FAQ is withdrawn on December 1, 2022 (i.e., before the end of the taxpayer's relevant tax year)? Does the taxpayer lose their penalty defense under the IR because they relied on it too soon? There may be existing guidance on what constitutes "reasonable reliance" upon other types of authorities to avert penalties, albeit arising in different contexts; would that guidance prove to be relevant in answering these questions? Alternatively, in determining whether substantial authority is present for purposes of averting penalties arising under Section 6662, there is substantial authority for the tax treatment "at the time the return is filed or there was substantial authority on the last day of the taxable year to which the return relates," Reg. 1.6662-4(d)(3)(iv)(C). If that standard were applicable in determining whether there was "reasonable reliance" by our taxpayer on the FAQ, their reliance would not have been reasonable because the FAQ was withdrawn on December 1, 2022, i.e., before the end of the taxpayer's relevant tax year (which occurs on December 31, 2022). If instead the FAQ had been withdrawn (say) February 1, 2023, the taxpayer's reliance on the FAQ would not have been unreasonable solely because of the FAQ's withdrawal (coming after the end of the taxpayer's relevant tax year) even if the taxpayer did not timely file their 2022 income tax return until after February 1, 2023.

And exactly what penalty relief is provided if a taxpayer establishes the 'reasonable reliance' on FAQs' defense? Pursuant to the IR the relief is broad, as it applies to negligence penalties or other accuracy-related penalties. However, the legend that will be attached to Fact Sheet FAQs limits the relief to situations where there is an "underpayment of tax." It has been observed that the 'legendary' language would appear to prohibit reliance on FAQs to avoid information penalties, underreporting penalties, failure to file penalties, or other penalties not tied to underpayment of tax. See Jones, Monahan, and Sambur, "IRS updates process for FAQs on new tax legislation and addresses taxpayer reliance concerns," posted 11/11/21, https://www.jdsupra.com/legalnews/irs-upgrades-process-for-faqs-on-new-tax-3533917/, last visited 12/3/21.

Let's next focus on those FAQs that are published in a Fact Sheet that is linked at an IRS news release. The Service has described "IRS Fact Sheets" as being "topical information issued to the media by IRS Media Relations," see Internal Revenue Manual (IRM) 11.53.2.3.5(5)b (04-15-2015). (An archival list of Fact Sheets is maintained on the IRS's website at www.irs.gov/newsroom/news-release-and-fact-sheet-archive.) The IRS FAQs Statement, while referencing Reg. 1.6662-4(d), says those FAQs are considered "authority" for purposes of the exception to the accuracy-related penalties that applies (i.e., under Section 6662) when there is "substantial authority" for the treatment of an item on a return. Having your FAQ constitute "authority" is like a get-out-of-jail card in Monopoly; it means you don't have to prove you actually relied on the FAQ, you don't have to prove your reliance on the FAQ was reasonable (based on all of the facts and circumstances), and you don't have to prove you relied in good faith on the FAQ with respect to your return for the tax year in question.

Lastly (and importantly), neither the IR nor the IRS FAQs Statement addresses whether tax return preparers can avert potential return preparer penalties under Section 6694 if they have reasonably relied in good faith upon an FAQ in preparing a tax return. Will preparers be allowed to consider all, some, or no FAQs as being "substantial authority" under Section 6694(a)(2) without disclosure on the tax return? That question is not explicitly answered in the IR or the IRS FAQs Statement.

An analysis of issues that FAQs face under the Administrative Procedures Act ("APA") arising from the lack of notice and comment with respect to their issuance was beyond the scope of our 2021 Shop Talk article. However, we did a deep dive last August with the assistance of Joseph B. (Jud) Judkins of Baker McKenzie on that issue. See Shop Talk, "Q: Does the Administrative Procedure Act Apply to IRS FAQs? A: Now More Than Ever!," 135 JTAX 35 (August 2021). Not unexpectedly, neither the IR nor the IRS FAQs Statement addresses or provides guidance with respect to the potential application of the APA to the IRS's FAQ process.

Question 2: What is the legal effect of an FAQ after the FAQ has been withdrawn?

This was and remains a trick question. A Withdrawn FAQ has no legal effect because the FAQ while alive and well (i.e., outstanding and on point) had no legal effect, at least in the IRS's eyes, for purposes of sustaining tax return reporting positions. However, now that taxpayers seem to be able to rely upon an FAQ for certain penalty protection purposes, it would likewise seem that the Withdrawn FAQ would still be available for penalty-aversion reliance purposes for past positions (with the timing issues raised above) but would not for positions taken after the FAQ's withdrawal.

Question 3: Can a Withdrawn FAQ take on a life of its own, and if so, how?

A Withdrawn FAQ cannot easily take on a life of its own unless it is memorialized and remains relevant. One way to memorialize informal or unofficial IRS guidance is to weave it into the fabric of a contemporaneous article, as described in our 2021 Shop Talk article. Another way is for the FAQ to remain listed for all time (as a Withdrawn FAQ) on the IRS's new FAQs Fact Sheet list. Will Withdrawn FAQs be so listed or rather be expunged? We address that in Question 4, which follows.

Question 4: Are Withdrawn FAQs maintained somewhere by the IRS, so that field agents, ruling specialists, chief counsel's office, taxpayers and their tax counsel and return preparers, and the courts (if need be) can find them later on?

As described herein, there is no accessible IRS site that maintains Withdrawn FAQs, but as stated in the IR, the IRS intends to do something about that, at least on a going forward basis. As mentioned in our 2021 Shop Talk article and still true as of the day we submitted this article for publication, we can find and search *existing* FAQs in their current versions at the IRS website www.irs.gov/FAQs. But what of those FAQs that no longer grace the Service's website? We remain unaware of any official database that contains only Withdrawn FAQs. Specifically, once the IRS retires (withdraws? revokes? rescinds? terminates? liquidates? vaporizes?) an FAQ, where does it go? Do old, retired FAQs go to the Old FAQs' Home? Does Scotty beam them down in the transporter to a barren planet populated solely with Withdrawn FAQs? Are they instead laid to rest in alphabetical, chronological, and numerical order by geriatric, Dewey-decimal spouting, cross-indexing librarians in the (until now, top-secret) National FAQs Repository located outside Baltimore? We have tried to gain access to Withdrawn FAQs in all those places, without success.

In our search last year for Withdrawn FAQs, we contacted a well-respected colleague who in turn identified an IRS official with broad institutional knowledge. The official professed to not knowing any general method for finding old FAQs on government intranet sites or what the rules would be for sharing them with us non-government types. That official thought there might be a huge amount of material on those sites, albeit not organized in any useful way. The lack of a publicly available archive of FAQs has been described as "appalling." (Statement attributed to Bob Probasco, Director of the Tax Resolution Clinic, Texas A&M University School of Law, in van den Berg, "IRS Faces Pushback for Relying on FAQs for Guidance", Law360 Tax Authority (July 21, 2020).) (No disagreement from us.) We pointed out in our 2021 Shop Talk article that if one is successful at reconstructing the timeline of IRS guidance, it is possible to use the Wayback Machine (available at web.archive.org) to go to the IRS website and find withdrawn FAQs. For example, FAQ #1 of the "2008 Changes to Form 1065 - Frequently Asked Questions" (which has long been withdrawn) can be found at http://web.archive.org/web/20090201022647/http://irs.gov/businesses/partnerships/article/0,,id=186863,00.html. However, independent digital archives such as the Wayback Machine, as well as tax news services, are not maintained by the IRS or any other governmental organization (the Wayback Machine is an initiative of a 501(c)(3) non-profit known as the Internet Archive) and it is uncertain whether one could prove the authenticity of any such independent archives or tax services.

The IR professes to address these concerns regarding transparency and the potential impact on taxpayers when FAQs *on newly enacted tax legislation* are updated or revised. The IR states “significant FAQs” (an undefined term) on newly enacted tax legislation, as well as any later updates or revisions to those FAQs, will be announced in a news release and posted on IRS.gov in a separate Fact Sheet. These Fact Sheet FAQs will be dated to enable taxpayers to confirm the date on which “any changes to the FAQs” were made. Additionally, prior versions of Fact Sheet FAQs will be maintained on IRS.gov to ensure that “if a Fact Sheet FAQ is later changed,” taxpayers can locate the version they relied on if they later need to do so. Will the IRS maintain or archive the information for Withdrawn FAQs, or only those that are “changed”? Neither the IR nor the IRS FAQs Statement addresses or answers that question. The common meaning of “changed” does not seem to encumber “withdrawn”, “revoked”, “rescinded”, “retired”, “vaporized”, or any other synonym that means the FAQ has gone poof! Indeed, elsewhere in the IR, in describing the legend that will be added to Fact Sheet FAQs, the language states, “Any later updates or modifications to these FAQs will be dated” as described above, and “prior versions of these FAQs will be maintained on IRS.gov to ensure that taxpayers, who may have relied on a prior version, can locate that version if they later need to do so.”

Should a Withdrawn FAQ be expunged from the Fact Sheet FAQs? Not if transparency and the ability of taxpayers to avert penalties is to be preserved. Indeed, the IRS FAQs Statement, in discussing guidance published in the Bulletin, states, “It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, *revoke*, modify, or amend any of those previously published in the Bulletin.” (emphasis added.) The same policy should apply to FAQs, although it is not so stated in the “FAQs” portion of the IRS FAQs Statement. Hopefully, the IRS will clarify the IR to confirm that Withdrawn FAQs (and not merely those that have been changed, updated, or revised) that have been listed at IRS.gov under the new process also will be preserved at IRS.gov, unlike the IRS’s practice preceding the IR.

Will the transparency and archiving of FAQs be extended to those FAQs (future and past) that are not “significant FAQs on newly enacted legislation”? The IRS clearly thought about it and the IR leaves that open – no guarantees that it will, but no prohibition, either. The IR simply states, “In addition to significant FAQs on new legislation, the IRS may apply this updated process in other contexts, such as when FAQs address emerging issues.” The IR does not reference the significant number of historic FAQs that are designed to clarify existing law or guidance. That category also is ripe for application of the updated process. In summary: if the IRS is truly aiming to be FAQ-user friendly and helpful, it should so extend the transparency and archiving of FAQs beyond those it deems to be “significant FAQs on new legislation.” If the IRS does not now have (and does not in the future dedicate) manpower sufficient to undertake the appropriate extended application of the new FAQ process, it is unlikely to voluntarily so extend.

Will FAQs on new tax legislation that were issued prior to October 15, 2021 (the date of IR-2021-202) also be covered by this new process? Again, there is no express answer. The IR refers to FAQs released prior to October 15, 2021 only in the context of confirming that taxpayers who reasonably rely “on any FAQ (including FAQs released before today) in good faith” may have a “reasonable cause” defense against the specified penalties. However, there is no statement that the IRS intends to go back and cover the one thousand plus FAQs that have been previously issued and create an archival trail (regardless of whether those FAQs were subsequently withdrawn). If anything, the IR's discussion of Fact Sheet FAQs indicates the new process will be a prospective exercise: "Significant FAQs on newly enacted tax legislation, as well as any later updates or revisions to these FAQs, will *now* be announced in a news release and posted on IRS.gov in a separate fact sheet" (emphasis added).

Question 5: If you can no longer find them maintained online by the IRS, can you nonetheless still rely on them?

If the FAQ has been withdrawn and is no longer online, a taxpayer can expect an IRS auditor to ignore the ghost FAQ unless at a minimum as an evidentiary matter the taxpayer can produce a true and correct copy of the original FAQ. For this reason it is always prudent (and has long been suggested by commentators) for the taxpayer and its representative / return preparer / tax counsel to retain a copy of the FAQ with the date stamp that it has been downloaded or obtained from the IRS site, as back-up support for any position taken in reliance on the FAQ, should the FAQ be withdrawn or the content later be changed from the version of the FAQ that has been withdrawn. Accord: Coder, supra. The retention copy might be a hard copy reproduction or a computer-stored copy (e.g., a scan attached as a pdf/email to the firm). And even after furnishing the IRS representative with a true copy, there can be no assurance that they will "accept" or acknowledge the copy, much less give it effect, and much, much less treat it as precedential with respect to supporting a tax return position or averting a penalty.

Taxpayers and their representatives should recognize that (as described in the IR and IRS FAQs Statement) those publications' reference to FAQs (other than Fact Sheet FAQs that are linked to an IRS news release) as a defense against specified penalties will only be permitted where the taxpayer relies on the FAQ in good faith and that reliance is reasonable. There are three elements that the taxpayer must satisfy: that the taxpayer actually relied on the FAQ in question, the taxpayer so relied in good faith, and the taxpayer's reliance was "reasonable". This will necessitate creating and retaining sufficient, contemporaneous documentation that each of these requirements is met. Merely finding an FAQ to have been "on point" and outstanding at the time of the filing of the taxpayer's return with respect to the relevant event is not enough.

One last point: the IR, the IRS FAQs Statement and the new IRS FAQs Fact Sheets can themselves be withdrawn or revoked. Not being published in the Bulletin, they do not constitute authoritative guidance for purposes of reliance by taxpayers and their advisors and return preparers. Will the IRS issue guidance that will be published in the Bulletin (be it via regulation, revenue ruling, revenue procedure, or otherwise), thereby memorializing and legitimizing the IRS's new FAQ process? For example, will the regulations under Section 6662 or 6664 be revised? Or will the new program be like the airlines' award of lifetime elite status to their selected million-mile frequent flyer customers, which in the fine print effectively says, "you have lifetime elite status until we revoke it.... which we may do at any time during your lifetime, at our whim"?

In conclusion, your Shop Talk editors recognize that the IRS has long used FAQs to pre-date or augment other forms of IRS guidance, and we think the IRS is trying to get FAQ-based guidance out quickly and efficiently. Further, and more practically, without an accessible and authoritative archive of Withdrawn FAQs (including old FAQ versions), taxpayers and practitioners are at risk of relying on an IRS position which later evolves or is withdrawn without explanation, if they were ever not at risk in relying on an FAQ in the first place. The new process as announced in the IR is a step in the right direction, at least with respect to those FAQs the IRS deigns to be "significant FAQs on newly enacted tax legislation". The IRS should apply the updated process as broadly and quickly as practicable in other contexts, including FAQs that address emerging issues. That clearly will take quite some time and effort. And how will the Service educate its thousands of employees who need to know of this new penalty protection that is being provided with respect to positions taken under certain FAQs? Will the IRS add the new FAQ procedures to its Internal Revenue Manual?

II.G.19.g. Avoid Penalty by Disclosing on Original Return or Amending Return

Rev. Proc. 2022-41, § 1, "Purpose," explains generally disclosures made on returns to avoid penalties:

> This revenue procedure updates Rev. Proc. 2021-52, 2021-51 I.R.B. 883, and identifies circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or position is adequate for the purpose of reducing the understatement of income tax under section 6662(d) of the Internal Revenue Code (relating to the substantial understatement aspect of the accuracy-related penalty), and for the purpose of avoiding the tax return preparer penalty under section 6694(a) (relating to understatements due to unreasonable positions) with respect to income tax returns. This revenue procedure does not apply with respect to any other penalty provisions (including but not limited to the disregard provisions of the section 6662(b)(1) accuracy-related penalty, the section 6662(i) increased accuracy-related penalty in the case of nondisclosed noneconomic substance transactions, and the section 6662(b)(7) and (j) increased accuracy-related penalty in the case of undisclosed foreign financial asset understatements). If this revenue procedure does not include an item or position, disclosure is adequate with respect to that item or position only if made on a properly completed Form 8275 or 8275-R, as appropriate, attached to the return for the year or to a qualified amended return. See Treas. Reg. § 1.6664-2(c) for information about qualified amended returns. This revenue procedure applies to any income tax return filed on 2022 tax forms for a taxable year beginning in 2022, and to any income tax return filed in 2023 on 2022 tax forms for short taxable years beginning in 2023.

The above procedure is updated annually, and the reader should review the most recent version for guidance.

As to amended returns, Rev. Proc. 2022-39, § 1, "Purpose," provides:

> The purpose of this revenue procedure is to obsolete Rev. Proc. 94-69, 1994-2C.B. 804, and prescribe special procedures for eligible taxpayers to file a qualified amended return in accordance with § 1.6664-2(c)(4)(ii) of the Income Tax Regulations. This revenue procedure also sets forth special procedures for eligible taxpayers to show additional tax due or make adequate disclosure with respect to an item or a position on a previously filed return to avoid imposition of the accuracy-related penalties described in §§ 6662(b)(1) and 6662(b)(2) of the Internal Revenue Code (Code).

Section 3, "Scope," discusses how Rev. Proc. 2022-39 applies to taxpayers under the Coordinated Industry Case Program (CIC), the Large Corporate Compliance Program (LCC), or the Large Partnership Compliance Program (LPC) or to other taxpayers:

.01. *Eligible taxpayers*. The special procedures set forth in this revenue procedure are available to eligible taxpayers. An "eligible taxpayer" means any taxpayer selected for examination under the LCC (or successor program) if, on the date on which the IRS first contacts the taxpayer concerning an examination of an income tax return, at least four of the taxpayer's income tax returns for the five taxable years preceding the taxable year at issue are (or were) under examination under the LCC, the CIC, or a successor program. An eligible taxpayer also means any partnership selected for examination under the LPC (or successor program) if, on the date on which the IRS first contacts the partnership concerning an examination of a return of partnership income, at least four of the partnership's returns for the five taxable years preceding the taxable year at issue are (or were) under examination under the LPC (or successor program). Taxpayers selected for examination under the LCC or the LPC will be notified by the IRS if they are eligible taxpayers under this revenue procedure.

.02. *Procedures for ineligible taxpayers*. Taxpayers not eligible for, or making disclosures beyond the scope of, the special procedures set forth in this revenue procedure have the opportunity to utilize existing methods to avoid the imposition of penalties, including by filing a qualified amended return as described in and satisfying the requirements of § 1.6664-2(c)(3), or by adequately disclosing the position on a properly completed Form 8275, Form 8275-R, or Schedule UTP, Uncertain Tax Position Statement, filed with a return and satisfying the requirements of § 1.6662-3(c).

Rev. Proc. 2022-39, § 4.01 provides, among other requirements:

For purposes of avoiding the imposition of the penalty under § 6662(b)(1) for negligence or disregard of rules or regulations, and the substantial understatement penalty under § 6662(b)(2), a properly completed Form 15307, Post-Filing Disclosure for Specified Large Business Taxpayers (or successor form), is treated as a qualified amended return with respect to a particular taxable year of an eligible taxpayer if an eligible taxpayer furnished it to the IRS personnel conducting the examination after the tax return with respect to the particular taxable year has been filed but no later than 30 days (or a later date agreed to in writing by the IRS with respect to a particular taxable year) from the date of a written request to the taxpayer that Form 15307 be furnished with respect to that taxable year.

Reg. § 1.6664-2(c)(3), "Qualified amended return defined," provides:

(i) *General rule*. A qualified amended return is an amended return, or a timely request for an administrative adjustment under section' 6227, filed after the due date of the return for the taxable year (determined with regard to extensions of time to file) and before the earliest of -

(A) The date the taxpayer is first contacted by the Internal Revenue Service (IRS) concerning any examination (including a criminal investigation) with respect to the return;

(B) The date any person is first contacted by the IRS concerning an examination of that person under section 6700 (relating to the penalty for promoting abusive tax shelters) for an activity with respect to which the taxpayer claimed any tax benefit on the return directly or indirectly through the entity, plan or arrangement described in section 6700(a)(1)(A);

(C) In the case of a pass-through item (as defined in § 1.6662-4(f)(5)), the date the pass-through entity (as defined in § 1.6662-4(f)(5)) is first contacted by the IRS in connection with an examination of the return to which the pass-through item relates;

(D)

(1) The date on which the IRS serves a summons described in section 7609(f) relating to the tax liability of a person, group, or class that includes the taxpayer (or pass-through entity of which the taxpayer is a partner, shareholder, beneficiary, or holder of a residual interest in a REMIC) with respect to an activity for which the taxpayer claimed any tax benefit on the return directly or indirectly.

(2) The rule in paragraph (c)(3)(i)(D)(1) of this section applies to any return on which the taxpayer claimed a direct or indirect tax benefit from the type of activity that is the subject of the summons, regardless of whether the summons seeks the production of information for the taxable period covered by such return; and

(E) The date on which the Commissioner announces by revenue ruling, revenue procedure, notice, or announcement, to be published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter), a settlement initiative to compromise or waive penalties, in whole or in part, with respect to a listed transaction. This rule applies only to a taxpayer who participated in the listed transaction and for the taxable year(s) in which the taxpayer claimed any direct or indirect tax benefits from the listed transaction. The Commissioner may waive the requirements of this paragraph or identify a later date by which a taxpayer who participated in the listed transaction must file a qualified amended return in the published guidance announcing the listed transaction settlement initiative.

(ii) *Undisclosed listed transactions*. An undisclosed listed transaction is a transaction that is the same as, or substantially similar to, a listed transaction within the meaning of § 1.6011-4(b)(2) (regardless of whether § 1.6011-4 requires the taxpayer to disclose the transaction) and was neither previously disclosed by the taxpayer within the meaning of § 1.6011-4 or § 1.6011-4T, nor disclosed under Announcement 2002-2 (2002-1 C.B. 304), (see § 601.601(d)(2)(ii) of this chapter) by the deadline therein. In the case of an undisclosed listed transaction for which a taxpayer claims any direct or indirect tax benefits on its return (regardless of whether the transaction was a listed transaction at the time the return was filed), an amended return or request for administrative adjustment under section 6227 will not be a qualified amended return if filed on or after the earliest of -

(A) The dates described in paragraph (c)(3)(i) of this section;

(B) The date on which the IRS first contacts any person regarding an examination of that person's liability under section 6707(a) with respect to the undisclosed listed transaction of the taxpayer; or

(C) The date on which the IRS requests, from any person who made a tax statement to or for the benefit of the taxpayer or from any person who gave the taxpayer material aid, assistance, or advice as described in section 6111(b)(1)(A)(i) with respect to the taxpayer, the information required to be included on a list under section 6112 relating to a transaction that was the same as, or substantially similar to, the undisclosed listed transaction, regardless of whether the taxpayer's information is required to be included on that list.

Reg. § 1.6664-2(c)(4), "Special rules," provides:

(i) A qualified amended return includes an amended return that is filed to disclose information pursuant to § 1.6662-3(c) or § 1.6662-4(e) and (f) even though it does not report any additional tax liability. See § 1.6662-3(c), § 1.6662-4(f), and § 1.6664-4(c) for rules relating to adequate disclosure.

(ii) The Commissioner may by revenue procedure prescribe the manner in which the rules of paragraph (c) of this section regarding qualified amended returns apply to particular classes of taxpayers.

II.G.19.h. Expedited Private Letter Rulings

Rev. Proc. 2023-26 provides for a 12-week turnaround instead of a 6-month turnaround if the letter ruling request is solely under the jurisdiction of the Associate Chief Counsel (Corporate), and the requirements described in section 5 of the revenue procedure are met. Section 5.06(1) allows a taxpayer to request a ruling more urgently than that, but the business exigency must be outside the taxpayer's control, and the timing of a deal that is within the parties' control is not such an exigency.

II.G.20. Debt vs. Equity; Potential Denial of Deduction for Business Interest Expense

II.G.20.a. Code § 163(j) Limitation on Deducting Business Interest Expense

II.G.20.a.i. Generally

Although Code § 163(a) authorizes deducting "all interest paid or accrued within the taxable year on indebtedness," other parts of Code § 163 deviate from that general rule. Furthermore, loss limitations elsewhere in the Code may apply.[1807] See also part II.G.26.b Real Estate as a Trade or Business.

Among the many limitations within Code § 163 are:

- Deductions for investment interest cannot exceed the taxpayer's net investment income, all as described in Code § 163(d); "net investment income" here is very different in scope than the idea in part II.I 3.8% Tax on Excess Net Investment Income (NII).

- Personal interest is not deductible, except for qualified residence interest. Code § 163(h).

[1807] For example, see parts II.G.4.c Basis Limitations for Deducting Partnership and S Corporation Losses, II.G.4.i Passive Loss Limitations (referring to part II.K Passive Loss Rules), and II.G.4.j At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities).

- Business interest deduction limitations under Code § 163(j) were greatly expanded to need to be considered by all taxpayers incurring interest expense.

One must look to why the taxpayer incurred debt to determine in which category the debt falls. See part II.C.3.d Deducting Interest Expense on Debt Incurred by a Partnership, which generally also applies to S corporations.[1808]

IRS training on the discussion below, "Limitation on Business Interest Expense Under Section 163(j)," is at https://www.irs.gov/pub/newsroom/tcja-training-business-interest-expense-limitation-163j.pdf.

For taxable years beginning after December 31, 2017, Code § 163(j)(1) provides:

> *In general*. The amount allowed as a deduction under this chapter for any taxable year for business interest shall not exceed the sum of-
>
> (A) the business interest income of such taxpayer for such taxable year,
>
> (B) 30 percent of the adjusted taxable income of such taxpayer for such taxable year, plus
>
> (C) the floor plan financing interest of such taxpayer for such taxable year.
>
> The amount determined under subparagraph (b) shall not be less than zero.

"Business interest" means "any interest paid or accrued on indebtedness properly allocable to a trade or business;" it does not include any investment interest under Code § 163(d).[1809] Reg. § 1.163(j)-1(b)(44) looks to the Code § 162 definition of a "trade or business;" see part II.G.4.l.i.(a) "Trade or Business" Under Code § 162.

After looking at carve-outs from what is a "trade or business," we will look at each element of the items that add up to the overall limitation that applies to those businesses that are not carved out, treatment accorded partnerships.

First, small businesses are not subject to this rule.[1810] The business' average annual gross receipts of such entity for the 3-taxable-year period ending with the taxable year which precedes the taxable year cannot exceed $25 million, indexed for inflation, with related businesses aggregated and various other qualifications.[1811] Businesses that generate losses might not be

[1808] See fn 456.
[1809] Code § 163(j)(5).
[1810] Code § 163(j)(3) provides:

> *Exemption for certain small businesses*. In the case of any taxpayer (other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3)) which meets the gross receipts test of section 448(c) for any taxable year, paragraph (1) shall not apply to such taxpayer for such taxable year. In the case of any taxpayer which is not a corporation or a partnership, the gross receipts test of section 448(c) shall be applied in the same manner as if such taxpayer were a corporation or partnership.

[1811] Code § 448(c). For taxable years beginning in 2019 or 2020, the limitation is $26 million. Rev. Procs. 2018-57, § 3.31 and 2019-44, § 3.31.

eligible for this exception;[1812] this is a disadvantage of the structure I recommend in parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart.

In applying this rule, "trade or business" does not include:[1813]

(i) the trade or business of performing services as an employee,

(ii) any electing real property trade or business,

(iii) any electing farming business, or

(iv) the trade or business of the furnishing or sale of-

(I) electrical energy, water, or sewage disposal services,

(II) gas or steam through a local distribution system, or

[1812] Code § 163(j)(3), reproduced in fn 1810, excludes from the small business exception "a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3)." Code § 448(d)(3), "Tax shelter defined," provides:

> The term "tax shelter" has the meaning given such term by section 461(i)(3) (determined after application of paragraph (4) thereof). An S corporation shall not be treated as a tax shelter for purposes of this section merely by reason of being required to file a notice of exemption from registration with a State agency described in section 461(i)(3)(A), but only if there is a requirement applicable to all corporations offering securities for sale in the State that to be exempt from such registration the corporation must file such a notice.

Code § 461(i)(3), "Tax shelter defined," provides:

> For purposes of this subsection, the term "tax shelter" means -
> (A) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale,
> (B) any syndicate (within the meaning of section 1256(e)(3)(B)), and
> (C) any tax shelter (as defined in section 6662(d)(2)(C)(ii)).

Code § 461(i)(4), "Special rules for farming," provides:

> In the case of the trade or business of farming (as defined in section 464(e)), in determining whether an entity is a tax shelter, the definition of farming syndicate in subsection (k) shall be substituted for subparagraphs (A) and (B) of paragraph (3).

Code § 1256(e)(3)(B), "Syndicate defined," provides:

> For purposes of subparagraph (A), the term "syndicate" means any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs (within the meaning of section 461(k)(4)).

Code § 6662(d)(2)(C)(ii), "Reduction [in certain accuracy-related penalties] not to apply to tax shelters," provides:

> (i) *In general*. Subparagraph (B) shall not apply to any item attributable to a tax shelter.
> (ii) *Tax shelter*. For purposes of clause (i), the term "tax shelter" means -
> (I) a partnership or other entity,
> (II) any investment plan or arrangement, or
> (III) any other plan or arrangement,
> if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

[1813] Code § 163(j)(7)(A).

(III) transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.

As used above, an "electing real property trade or business" is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business that elects treatment as such:[1814]

- Any election needs to follow IRS rules regarding timing and manner and is irrevocable.[1815] An electing real property trade or business must use slower depreciation.[1816] Also, the items mentioned in clause (iv) are not eligible for bonus depreciation.[1817]

- Presumably, real estate rental could avoid the need to make an election by not qualifying as a trade or business. Such planning should consider the relationship between that reporting position and parts II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income (especially parts II.E.1.c.iii "Trade or Business" for Code § 199A and II.E.1.e Whether Real Estate Qualifies as a Trade or Business) and II.I.8 Application of 3.8% Tax to Business Income (especially part II.I.8.c Application of 3.8% Tax to Rental Income).

[1814] Code § 163(j)(7)(B). The list of businesses is from a cross-reference to Code § 469(c)(7)(C), which is further described in part II.K.1.e.iii.(a) Scope and Effect of Real Estate Professional Exception, especially fns 3203-3205 and the accompanying text. Rev. Proc. 2021-9 provides a safe harbor for a trade or business that manages or operates a qualified residential living facility, as defined in section 3.01 of the proposed revenue procedure, to be treated as a real property trade or business solely for purposes of qualifying as an electing real property trade or business under section 163(j)(7)(B).

[1815] Code § 163(j)(7)(B). Footnote 697 of the Senate report explains:

> It is intended that any such real property trade or business, including such a trade or business conducted by a corporation or real estate investment trust, be included. Because this description of a real property trade or business refers only to the section 469(c)(7)(C) description, and not to other rules of section 469 (such as the rule of section 469(c)(2) that passive activities include rental activities or the rule of section 469(a) that a passive activity loss is limited under section 469), the other rules of section 469 are not made applicable by this reference. It is further intended that a real property operation or a real property management trade or business includes the operation or management of a lodging facility.

[1816] Code § 163(j)(10)(A), referring to Code § 168(g)(1)(F), which requires certain property to use the Code § 168(g) alternative depreciation system, that property being described in Code § 168(g)(8), which described that property as:

> *Electing real property trade or business*. The property described in this paragraph shall consist of any nonresidential real property, residential rental property, and qualified improvement property held by an electing real property trade or business (as defined in 163(j)(7)(B)).

See Rev. Proc. 2019-8, sections 2.02 and 4.02.

[1817] See fn. 1467 in part II.G.5.b Bonus Depreciation.

As used above, "electing farming business" means:[1818]

(i) a farming business (as defined in section 263A(e)(4)) which makes an election under this subparagraph, or

(ii) any trade or business of a specified agricultural or horticultural cooperative (as defined in Section 199A(g)(2)) with respect to which the cooperative makes an election under this subparagraph.

Again, any election needs to follow IRS rules regarding timing and manner and is irrevocable.[1819] Rev. Proc. 2020-22 provides:

> This revenue procedure provides guidance regarding the election under section 163(j)(7)(B) of the Internal Revenue Code (Code) to be an electing real property trade or business and the election under section 163(j)(7)(C) to be an electing farming business for purposes of the business interest expense deduction limitation under section 163(j) of the Code. This revenue procedure allows certain taxpayers to make a late election, or to withdraw an election, under section 163(j)(7)(B) or 163(j)(7)(C), as applicable, on an amended Federal income tax return, an amended Form 1065, or an administrative adjustment request under section 6227 of the Code (AAR).

Letter Ruling 202348002 gave an extension to file a late Code § 163(j)(7)(B) election:

> To receive an extension of time to file a regulatory election, a taxpayer must provide evidence sufficient to establish that it acted reasonably and in good faith. Taxpayer's operating agreement indicates that Taxpayer was required to make the 163(j)(7)(B) election for the taxable year that ends Date 3. The affidavits submitted by Taxpayer indicate that Taxpayer and its Accounting Firm intended to make the election. Additionally, Taxpayer's U.S. federal income tax return for the taxable year that ends on Date 3, and the income tax returns for Year 2 and Year 3 were filed consistently with the requirements of the real property trade or business election given that Taxpayer elected the ADS depreciation method.
>
> Taxpayer has also requested relief prior to the discovery of the failure to make the election was discovered by the IRS during an examination. After exercising reasonable

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[1818] Code § 163(j)(7)(C). Footnote 698 of the Senate report provides:

> As defined in section 263A(e)(4) (*i.e.*, farming business means the trade or business of farming and includes the trade or business of operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots)). Treas. Reg. sec. 1.263A-4(a)(4) further defines a farming business as a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples of a farming business include the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals. A farming business also includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products. See Treas. Reg. sec. 1.263A-4(a)(4)(i) and (ii). A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another taxpayer, or merely buying and reselling plants or animals grown or raised by another taxpayer. See Treas. Reg. sec. 1.263A-4(a)(4)(i).

[1819] Code § 163(j)(7)(C).

> diligence (as discussed immediately above) Taxpayer relied on Accounting Firm, which is a qualified tax professional to prepare its tax return.
>
> There is nothing to indicate that Taxpayer did not act reasonably or in good faith, or is using hindsight. Based on Taxpayer's representations, the government is not prejudiced as a result of granting this ruling because granting relief will not result in Taxpayer having a lower tax liability in the aggregate for the tax years at issue than Taxpayer would have had if the election would have been made timely. Additionally, Taxpayer's tax return for the taxable year ending Date 3 was filed on Date 4, therefore, the taxable year is not closed by the period of assessment.

Also, electing farming business must use slower depreciation.[1820]

Now that we have seen which businesses are carved out, let's review the components of the limitation.

In applying the Code § 163(j)(1)(A) limitation of business interest income: "Business interest income" means "the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business."[1821] It does not include any investment income under Code § 163(d).[1822]

In applying the Code § 163(j)(1)(B) limitation of 30% of the taxpayer's adjusted taxable income: Code § 163(j)(8) provides that "adjusted taxable income" is the taxpayer's taxable income:

> (A) computed without regard to-
>
> > (i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business,
> >
> > (ii) any business interest or business interest income,
> >
> > (iii) the amount of any net operating loss deduction under section 172,
> >
> > (iv) the amount of any deduction allowed under Section 199A, and
> >
> > (v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion, and
>
> (B) computed with such other adjustments as provided by the Secretary.

In applying the Code § 163(j)(1)(C) limitation the taxpayer's floor plan financing interest: "Floor plan financing interest" means "interest paid or accrued on floor plan financing indebtedness."[1823] "Floor plan financing indebtedness" means indebtedness used to finance the

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[1820] Code § 163(j)(10)(B), referring to Code § 168(g)(1)(G), which requires certain property to use the Code § 168(g) alternative depreciation system, that property being:

> any property with a recovery period of 10 years or more which is held by an electing farming business (as defined in section 163(j)(7)(C)).

See Rev. Proc. 2019-8, sections 2.02 and 4.02.

[1821] Code § 163(j)(6).

[1822] Code § 163(j)(6).

[1823] Code § 163(j)(9)(A).

acquisition of motor vehicles[1824] held for sale or lease, and secured by the inventory so acquired.[1825]

If business interest exceeds the sum of the items described in Code § 163(j)(1), it is treated as business interest paid or accrued in the succeeding taxable year.[1826]

Notice 2018-28, "Initial Guidance Under Section 163(j) as Applicable to Taxable Years Beginning After December 31, 2017," includes the following:

- Notice § 4 provides that regulations will clarify that that, solely for purposes of Code § 163(j), as amended by the Act,[1827] all interest paid or accrued by a C corporation on indebtedness of that corporation will be business interest within the meaning of Code § 163(j)(5), and all interest on indebtedness held by the corporation that is includible in that corporation's gross income will be business interest income within the meaning of Code § 163(j)(6).
    - This protection will not apply to S corporations.
    - Regulations also will address whether and to what extent interest paid, accrued, or includible in gross income by a non-corporate entity such as a partnership in which a C corporation holds an interest is properly characterized, to that corporation, as business interest within the meaning of Code § 163(j)(5) or business interest income within the meaning of Code § 163(j)(6).
- Regulations will clarify that the disallowance and carryforward of a deduction for a C corporation's business interest expense under Code § 163(j), as amended by the Act, will not affect whether or when such business interest expense reduces that corporation's earnings and profits. Notice § 6.

For partnerships:[1828]

(i) this subsection shall be applied at the partnership level and any deduction for business interest shall be taken into account in determining the non-separately stated taxable income or loss of the partnership, and

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[1824] Code § 163(j)(9)(C) provides:

Motor vehicle. The term "motor vehicle" means a motor vehicle that is any of the following:

(i) Any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road.

(ii) A boat.

(iii) Farm machinery or equipment.

[1825] Code § 163(j)(9)(B).

[1826] Code § 163(j)(2).

[1827] Referring to:

section 163(j) of the Internal Revenue Code (Code), as amended on December 22, 2017, by "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97 (the Act).

[1828] Code § 163(j)(4)(A). To explain a term used here, Code § 163(j)(C) provides:

Excess taxable income. The term "excess taxable income" means, with respect to any partnership, the amount which bears the same ratio to the partnership's adjusted taxable income as-

(i) the excess (if any) of—

(ii) the adjusted taxable income of each partner of such partnership -

(I) shall be determined without regard to such partner's distributive share of any items of income, gain, deduction, or loss of such partnership, and

(II) shall be increased by such partner's distributive share of such partnership's excess taxable income.

For purposes of clause (ii)(II), a partner's distributive share of partnership excess taxable income shall be determined in the same manner as the partner's distributive share of nonseparately stated taxable income or loss of the partnership.

S corporations apply similar rules.[1829] Reg.§ 1.163(j)-6, "Application of the section 163(j) limitation to partnerships and subchapter S corporations," explains in subsection (a), "Overview,":

> If a deduction for business interest expense of a partnership or an S corporation is subject to the section 163(j) limitation, section 163(j)(4) provides that the section 163(j) limitation applies at the partnership or S corporation level and any deduction for business interest expense is taken into account in determining the nonseparately stated taxable income or loss of the partnership or S corporation. Once a partnership or an S corporation determines its business interest expense, business interest income, ATI, and floor plan financing interest expense, the partnership or S corporation calculates its section 163(j) limitation by applying the rules of § 1.163(j)-2(b) and this section. Paragraph (b) of this section provides definitions used in this section. Paragraph (c) of this section provides rules regarding the character of a partnership's deductible business interest expense and excess business interest expense. Paragraph (d) of this section provides rules regarding the calculation of a partnership's ATI and floor plan financing interest expense. Paragraph (e) of this section provides rules regarding a partner's ATI and business interest income. Paragraph (f) of this section provides an eleven-step computation necessary for properly allocating a partnership's deductible business interest expense and section 163(j) excess items to its partners. Paragraph (g) of this section applies carryforward rules at the partner level if a partnership has excess

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(I) the amount determined for the partnership under paragraph (1)(B), over
(II) the amount (if any) by which the business interest of the partnership, reduced by the floor plan financing interest, exceeds the business interest income of the partnership, bears to
(ii) the amount determined for the partnership under paragraph (1)(B).

The Senate report explained:

> … the limit on the amount allowed as a deduction for business interest is increased by a partner's distributive share of the partnership's excess taxable income. The excess taxable income with respect to any partnership is the amount which bears the same ratio to the partnership's adjusted taxable income as the excess (if any) of 30 percent of the adjusted taxable income of the partnership over the amount (if any) by which the business interest of the partnership, reduced by floor plan financing interest, exceeds the business interest income of the partnership bears to 30 percent of the adjusted taxable income of the partnership. This allows a partner of a partnership to deduct additional interest expense the partner may have paid or incurred to the extent the partnership could have deducted more business interest. The Senate amendment requires that excess taxable income be allocated in the same manner as nonseparately stated income and loss.

[1829] Code § 163(j)(4)(D) provides:

> *Application to S corporations*. Rules similar to the rules of subparagraphs (A) and (C) shall apply with respect to any S corporation and its shareholders.

business interest expense. Paragraph (h) of this section provides basis adjustment rules, and paragraph (k) of this section provides rules regarding investment items of a partnership. Paragraph (l) of this section provides rules regarding S corporations. Paragraph (m) of this section provides rules for partnerships and S corporations not subject to section 163(j). Paragraph (o) of this section provides examples illustrating the rules of this section.

Special rules apply for business interest from a partnership disallowed and carried forward.[1830] Code § 163(j)(4)(B), "Special rules for carryforwards," provides:

(i) *In general*. The amount of any business interest not allowed as a deduction to a partnership for any taxable year by reason of paragraph (1) for any taxable year-

(I) shall not be treated under paragraph (2) as business interest paid or accrued by the partnership in the succeeding taxable year, and

(II) shall, subject to clause (ii), be treated as excess business interest which is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership.

(ii) *Treatment of excess business interest allocated to partners*. If a partner is allocated any excess business interest from a partnership under clause (i) for any taxable year-

(I) such excess business interest shall be treated as business interest paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income from such partnership, but only to the extent of such excess taxable income, and

(II) any portion of such excess business interest remaining after the application of subclause (I) shall, subject to the limitations of subclause (I), be treated as business interest paid or accrued in succeeding taxable years.

For purposes of applying this paragraph, excess taxable income allocated to a partner from a partnership for any taxable year shall not be taken into account under

[1830] The Senate report explained:

… any business interest that is not allowed as a deduction to the partnership for the taxable year is allocated to each partner in the same manner as nonseparately stated taxable income or loss of the partnership. The partner may deduct its share of the partnership's excess business interest in any future year, but only against excess taxable income attributed to the partner by the partnership the activities of which gave rise to the excess business interest carryforward. Any such deduction requires a corresponding reduction in excess taxable income. Additionally, when excess business interest is allocated to a partner, the partner's basis in its partnership interest is reduced (but not below zero) by the amount of such allocation, even though the carryforward does not give rise to a partner deduction in the year of the basis reduction. However, the partner's deduction in a future year for interest carried forward does not reduce the partner's basis in the partnership interest. In the event the partner disposes of a partnership interest the basis of which has been so reduced, the partner's basis in such interest shall be increased, immediately before such disposition, by the amount that any such basis reductions exceed any amount of excess interest expense that has been treated as paid by the partner (*i.e.*, excess interest expense that has been deducted by the partner against excess taxable income of the same partnership). This special rule does not apply to S corporations and their shareholders.

paragraph (1)(A) with respect to any business interest other than excess business interest from the partnership until all such excess business interest for such taxable year and all preceding taxable years has been treated as paid or accrued under clause (ii).

(iii) *Basis adjustments*.

(I) *In general*. The adjusted basis of a partner in a partnership interest shall be reduced (but not below zero) by the amount of excess business interest allocated to the partner under clause (i)(II).

(II) *Special rule for dispositions*. If a partner disposes of a partnership interest, the adjusted basis of the partner in the partnership interest shall be increased immediately before the disposition by the amount of the excess (if any) of the amount of the basis reduction under subclause (I) over the portion of any excess business interest allocated to the partner under clause (i)(II) which has previously been treated under clause (ii) as business interest paid or accrued by the partner. The preceding sentence shall also apply to transfers of the partnership interest (including by reason of death) in a transaction in which gain is not recognized in whole or in part. No deduction shall be allowed to the transferor or transferee under this chapter for any excess business interest resulting in a basis increase under this subclause.

If a business owner lends to a business, the owner receives investment interest income and the business might not be able to deduct the interest. Reg. § 1.163(j)-6(n), "Treatment of self-charged lending transactions between partnerships and partners," provides some relief:

> In the case of a lending transaction between a partner (lending partner) and partnership (borrowing partnership) in which the lending partner owns a direct interest (self-charged lending transaction), any business interest expense of the borrowing partnership attributable to the self-charged lending transaction is business interest expense of the borrowing partnership for purposes of this section. If in a given taxable year the lending partner is allocated excess business interest expense from the borrowing partnership and has interest income attributable to the self-charged lending transaction (interest income), the lending partner is deemed to receive an allocation of excess business interest income from the borrowing partnership in such taxable year. The amount of the lending partner's deemed allocation of excess business interest income is the lesser of such lending partner's allocation of excess business interest expense from the borrowing partnership in such taxable year or the interest income attributable to the self-charged lending transaction in such taxable year. To prevent the double counting of business interest income, the lending partner includes interest income that was treated as excess business interest income pursuant to this paragraph (n) only once when calculating its own section 163(j) limitation. To the extent an amount of interest income received by a lending partner is attributable to a self-charged lending transaction, and is deemed to be an allocation of excess business interest income from the borrowing partnership pursuant to this paragraph (n), such an amount of interest income will not be treated as investment income for purposes of section 163(d). In cases where the lending partner is not a C corporation, to the extent that any interest income exceeds the lending partner's allocation of excess business interest expense from the borrowing partnership for the taxable year, and such interest income otherwise would be properly treated as investment income of the lending partner for purposes of section 163(d) for that year, such excess amount of interest income will continue to be treated as investment income of the lending partner for

> that year for purposes of section 163(d). See Example 26 in paragraph (o)(26) of this section.

Note that relief does not extend to S corporation owners – yet another reason to prefer partnerships to S corporations.[1831]

Notice 2018-28, § 7, "Business Interest Income and Floor Plan Financing of Partnerships, Partners, S corporations, and S corporation Shareholders," provides [all one paragraph, but I broke up for ease of reading]:

> Section 163(j)(4) requires that the annual limitation on the deduction for business interest expense be applied at the partnership level and that any deduction for business interest be taken into account in determining the non-separately stated taxable income or loss of the partnership.
>
> Although section 163(j)(4) is applied at the partnership level with respect to the partnership's indebtedness, section 163(j) may also be applied at the partner level in certain circumstances.
>
> The Treasury Department and the IRS intend to issue regulations providing that, for purposes of calculating a partner's annual deduction for business interest under section 163(j)(1), a partner cannot include the partner's share of the partnership's business interest income for the taxable year except to the extent of the partner's share of the excess of (i) the partnership's business interest income over (ii) the partnership's business interest expense (not including floor plan financing).
>
> Additionally, the Treasury Department and the IRS intend to issue regulations providing that a partner cannot include such partner's share of the partnership's floor plan financing interest in determining the partner's annual business interest expense deduction limitation under section 163(j).
>
> Such regulations are intended to prevent the double counting of business interest income and floor plan financing interest for purposes of the deduction afforded by section 163(j) and are consistent with general principles of Chapter 1 of the Code.
>
> Similar rules will apply to any S corporation and its shareholders.

II.G.20.a.ii. 2019-2020 Relief

The 2020 CARES Act provided some relief from the percent-of-adjusted-taxable-income limitation. The Senate Finance Committee explained:

> **Section 2306. Modification of limitation on business interest**
>
> The provision temporarily increases the amount of interest expense businesses are allowed to deduct on their tax returns, by increasing the 30-percent limitation to 50 percent of taxable income (with adjustments) for 2019 and 2020. As businesses look to weather the storm of the current crisis, this provision will allow them to increase

[1831] See part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons.

liquidity with a reduced cost of capital, so that they are able to continue operations and keep employees on payroll.

Accordingly, Code § 163(j)(10), "Special rule for taxable years beginning in 2019 and 2020," provides:

(A) *In general*.

(i) *In general*. Except as provided in clause (ii) or (iii), in the case of any taxable year beginning in 2019 or 2020, paragraph (1)(B) shall be applied by substituting "50 percent" for "30 percent".

(ii) *Special rule for partnerships*. In the case of a partnership -

(I) clause (i) shall not apply to any taxable year beginning in 2019, but

(II) unless a partner elects not to have this subclause apply, in the case of any excess business interest of the partnership for any taxable year beginning in 2019 which is allocated to the partner under paragraph (4)(B)(i)(II) -

(aa) 50 percent of such excess business interest shall be treated as business interest which, notwithstanding paragraph (4)(B)(ii), is paid or accrued by the partner in the partner's first taxable year beginning in 2020 and which is not subject to the limits of paragraph (1), and

(bb) 50 percent of such excess business interest shall be subject to the limitations of paragraph (4)(B)(ii) in the same manner as any other excess business interest so allocated.

(iii) *Election out*. A taxpayer may elect, at such time and in such manner as the Secretary may prescribe, not to have clause (i) apply to any taxable year. Such an election, once made, may be revoked only with the consent of the Secretary. In the case of a partnership, any such election shall be made by the partnership and may be made only for taxable years beginning in 2020.

(B) *Election to use 2019 adjusted taxable income for taxable years beginning in 2020*.

(i) *In general*. Subject to clause (ii), in the case of any taxable year beginning in 2020, the taxpayer may elect to apply this subsection by substituting the adjusted taxable income of the taxpayer for the last taxable year beginning in 2019 for the adjusted taxable income for such taxable year. In the case of a partnership, any such election shall be made by the partnership.

(ii) *Special rule for short taxable years*. If an election is made under clause (i) for a taxable year which is a short taxable year, the adjusted taxable income for the taxpayer's last taxable year beginning in 2019 which is substituted under clause (i) shall be equal to the amount which bears the same ratio to such adjusted taxable income determined without regard to this clause as the number of months in the short taxable year bears to 12.

Rev. Proc. 2020-22 "describes the time and manner in which certain taxpayers can elect (1) out of the 50% adjusted taxable income (ATI) limitation for taxable years beginning in 2019 and 2020, (2) to use the taxpayer's ATI for the last taxable year beginning in 2019 to calculate the taxpayer's section 163(j) limitation for taxable year 2020, and (3) out of deducting 50 percent of excess business interest expense (EBIE) for taxable years beginning in 2020 without limitation."

II.G.20.b. When Debt Is Recharacterized as Equity

Sometimes difficulty arises in determining whether payment obligations constitute debt or equity. For example:

- Once a C corporation becomes profitable, its owners cannot extract their original investment without paying tax.[1832]

- Perhaps one owner contributes capital and the other labor, and they want their entity to be taxed as an S corporation. Because an S corporation cannot have two classes of stock,[1833] they need to characterize as the debt the disproportionate contribution of the owner who contributes the capital.[1834]

- Sometimes a family member will loan to another to start a business without wanting to receive an equity interest.[1835]

Congress authorized the promulgation of regulations to distinguish debt from equity generally,[1836] but the effort proved unsuccessful until 2016,[1837] and what was issued in 2016 focused on foreign entities.[1838] Accordingly, one needs to look to court cases. *Pepsico Puerto Rico, Inc. v. Commissioner*, T.C. Memo. 2012-269, described the law as follows:[1839]

[1832] Code § 316.
[1833] See part II.A.2.i Single Class of Stock Rule.
[1834] Safe harbors for debt issued by an S corporation are provided by Code § 1361(c)(5) and Reg. § 1.1361-1(l)(5).
[1835] For complexity that might arise when families invest in businesses with ownership interests other than straight pro rata ownership, see parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.
[1836] Code § 385.
[1837] T.D. 7920 (1983).
[1838] See text accompanying fn. 1854.
[1839] The quote from the case does not include footnotes. *Rutter v. Commissioner*, T.C. Memo. 2017-174, which was also quoted in fns. 1158 and 1161 in part II.G.4.a.ii Bad Debt Loss – Must be Bona Fide Debt, summarized the Ninth Circuit's position:

> That court has identified 11 nonexclusive factors to determine whether an advance of funds gives rise to bona fide debt as opposed to an equity investment. See *Hardman*, 827 F.2d at 1411-1412 (citing *Bauer*, 748 F.2d at 1368); *Bell v. Commissioner*, __ F. App'x __, 2017 WL 2963547 (9th Cir. July 12, 2017) (reaffirming 11-factor test), *aff'g* T.C. Memo. 2015-111. Those factors are: (1) the labels on the documents evidencing the alleged indebtedness; (2) the presence or absence of a maturity date; (3) the source of payment; (4) the right of the alleged lender to enforce payment; (5) whether the alleged lender participates in management of the alleged borrower; (6) whether the alleged lender's status is equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) the adequacy of the alleged borrower's capitalization; (9) if the advances are made by shareholders, whether the advances are made ratably to their

A "singular defined set of standards" capable of being uniformly applied in debt-versus-equity inquiries remains elusive. See *Segel v. Commissioner*, 89 T.C. 816, 826-828 (1987). In differentiating between loans and capital investments, "It is not always easy to tell which are which, for securities can take many forms, and it is hazardous to try to find moulds into which all arrangements can certainly be poured." *Jewel Tea Co., Inc. v. United States*, 90 F.2d 451, 453 (2d Cir. 1937).

Notwithstanding the difficulty in distinguishing between debt instruments and equity instruments, the focus of a debt-versus-equity inquiry generally narrows to whether there was an intent to create a debt with a reasonable expectation of repayment and, if so, whether that intent comports with the economic reality of creating a debtor-creditor relationship. *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968); *Litton Bus. Sys., Inc. v. Commissioner*, 61 T.C. 367, 377 (1973). The key to this determination is primarily the taxpayer's actual intent, evinced by the particular circumstances of the transfer. *A. R. Lantz Co. v. United States*, 424 F.2d 1330, 1333 (9th Cir. 1970); see also *United States v. Uneco, Inc. (In re Uneco, Inc.)*, 532 F.2d at 1209 (in resolving debt-equity questions, both objective and subjective evidence of a taxpayer's intent are considered and given weight in the light of the particular circumstances of a case).

Various Courts of Appeals have identified and considered certain factors in *re Uneco, Inc.)*, 532 F.2d at 1208 (10 factors); *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972) (13 factors);[1840] *Fin Hay Realty Co. v. United States*, 398 F.2d at 697 (16 factors). This Court has articulated a list of 13 factors germane to such an analysis: (1) names or labels given to the instruments; (2) presence or absence of a fixed maturity date; (3) source of payments; (4) right to enforce payments; (5) participation in management as a result of the advances; (6) status of the advances in relation to regular corporate creditors; (7) intent of the parties; (8) identity of interest between creditor and stockholder; (9) "thinness" of capital structure in relation to debt; (10) ability of the corporation to obtain credit from outside sources; (11) use to which advances were put; (12) failure of debtor to repay; and (13) risk involved in making advances. *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 493 (1980).

> shareholdings; (10) whether interest is paid out of "dividend money"; and (11) the alleged borrower's ability to obtain loans from outside lenders. *Hardman*, 827 F.2d at 1411-1412.

As mentioned in fn 1161, *Povolny Group, Inc. v. Commissioner*, T.C. Memo. 2018-37, had a similar result to *Rutter*, only the lender was a related corporation, so the payment to the related corporation was a dividend from the payor to the shareholder, followed by a contribution to capital from the shareholder to the recipient. For dividend treatment, see part II.Q.7.a.iv Dividends; Avoiding Dividend Treatment Using Redemptions under Code §§ 302 and 303.

[1840] [this footnote not part of quote above] After this case was decided, in affirming a Tax Court decision, *DF Systems, Inc. v. Commissioner*, 112 A.F.T.R.2d 2013-7331 (5th Cir. 12/10/2013), in an unpublished *per curiam* opinion, quoted the *Mixon* factors as follows in finding a lack of bona fide debt:

> (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement.

Regarding "thinness" of capital structure in relation to debt, the court reasoned:

> The purpose of examining the debt-to-equity ratio in characterizing an advance is to determine whether a corporation is so thinly capitalized that repayment would be unlikely. *CMA Consol., Inc. v. Commissioner*, T.C. Memo. 2005-16. In such a circumstance, the advance would be indicative of venture capital rather than a loan. *Bauer v. Commissioner*, 748 F.2d 1365, 1369 (9th Cir. 1984); see also *Hubert Enters., Inc. v. Commissioner*, 125 T.C. 72, 96-97 (2005), *aff'd in part*, *vacated in part* and *remanded on other grounds* 230 Fed. Appx. 526 (6th Cir. 2007).[1841]

The court then noted how the taxpayer's debt-to-equity ratio compared to the industry's debt-to-equity ratio,[1842] accepting the taxpayer's expert's conclusion that the instrument was equity for U.S. income tax purposes. It also said the law focuses on the willingness of unrelated lenders to make a loan on the same terms or similar terms.[1843]

In *Sensenig v. Commissioner*, T.C. Memo. 2017-1, "The absence of an unconditional right to demand payment is practically conclusive that an advance is an equity investment rather than a loan for which an advancing taxpayer might be entitled to claim a deduction for a bad debt loss." "The salient fact of this case is the lack of written evidence demonstrating that there was a valid and enforceable obligation to repay on the part of any of the companies at issue that received advances from Mr. Sensenig through CLCL."[1844] "The three companies at issue were objectively risky debtors, and an unrelated prospective lender would probably have concluded that they would likely be unable to repay any proposed loan."[1845] Although an advance may be

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[1841] The court's footnote 75 here stated:

> Respondent relies on Fifth Circuit precedent which recognizes that thin capitalization is "very strong evidence" of a capital investment where: (1) the debt-to-equity ratio was initially high; (2) the parties understood that it would likely go higher; and (3) substantial portions of these funds were used for the purchase of capital assets and for meeting expenses needed to commence operations. See *Estate of Mixon*, 464 F.2d at 408 (citing *United States v. Henderson*, 375 F.2d 36, 40 (5th Cir. 1967)). Respondent contends that petitioners cannot satisfy this standard; he submits that, in particular, petitioners have not conclusively demonstrated that PGI used advances to purchase capital assets or to meet expenses needed to commence operations. However, neither this Court nor the Court of Appeals for the Second Circuit has embraced this more nuanced test for thin capitalization in a debt-versus-equity analysis. See, *e.g.*, *Nassau Lens Co. v. Commissioner*, 308 F.2d 39, 47 (2d Cir. 1962), remanding 35 T.C. 268 (1960); *Kraft Foods Co. v. Commissioner*, 232 F.2d at 127; *Hubert Enters., Inc. v. Commissioner*, 125 T.C. 72, 96 (2005); *Anchor Nat'l Life Ins. Co. v. Commissioner*, 93 T.C. 382, 401 n.16 (1989); *Recklitis v. Commissioner*, 91 T.C. 874, 903-905 (1988). Indeed, the Second Circuit has stated that the isolated debt-to-equity ratio is of "great importance in determining whether an ambiguous instrument is a debt or an equity interest." *Kraft Foods Co. v. Commissioner*, 232 F.2d at 127. Moreover, the other elements in the Fifth Circuit standard are subsumed within our larger inquiry. Accordingly, we approach the "thin capitalization" factor without addressing the additional Fifth Circuit elements.

[1842] Citing *Recklitis v. Commissioner*, 91 T.C. 874, 904 (1988).

[1843] Citing *Segel v. Commissioner*, 89 T.C. at 832, which in turn was citing *Scriptomatic, Inc. v. United States*, 555 F.2d 364, 368 (3d Cir. 1977), and *Fin Hay Realty Co. v. United States*, 398 F.2d at 697).

[1844] *Sensenig v. Commissioner*, T.C. Memo. 2017-1, supporting its statement as follows:

> (*Fin Hay* factor 11.) There is no written evidence of an enforceable obligation between CLCL and any of the companies at issue, much less a provision for a fixed maturity date or a fixed rate of interest. (*Fin Hay* factors 10 and 13.)

[1845] *Sensenig v. Commissioner*, T.C. Memo. 2017-1, further stated:

properly characterized as a loan, the substance needs to support that conclusion.[1846] The Third Circuit affirmed, rebuking the taxpayers' arguments that loans can be documented other than promissory notes: "The Tax Court noted that the purported loans were not evidenced by promissory notes, but it went on to conclude that, the handful of journal entries aside, the purported loans bore no other objective indicia of loans and the economic realities of the transactions suggested that they were intended as equity investments instead."[1847]

Keeton v. Commissioner, T.C. Memo. 2023-35, reasoned and held:

> ***A. Governing Legal Principles***
>
> Section 166(a)(1) allows as an ordinary loss deduction any bona fide debt that becomes worthless within the taxable year, except in the case of certain nonbusiness debts defined in section 166(d). A bona fide debt is a debt that arises from "a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." *Zimmerman v. United States*, 318 F.2d 611, 612 (9th Cir. 1963) (quoting Treas. Reg. § 1.166-1(c)); *Kean v. Commissioner*, 91 T.C. 575, 594 (1988); Treas. Reg. § 1.166-1(c). A contribution to capital is not considered a "debt" for purposes of section 166. *Kean*, 91 T.C. at 594.

> Mr. Sensenig emphasized that, with respect to the advances at issue here, he generated no formal written financial projections and that he did not know what those projections would be. He was satisfied to go with the "gut feel of everybody involved". He considered business plans a waste of time and emphasized the importance of being able to "turn on a dime" on the basis of the facts of the moment, unconstrained by any formal plan. We think an unrelated lender would have considered this approach too cavalier.

[1846] *Sensenig v. Commissioner*, T.C. Memo. 2017-1, further stated:

> To the same effect, an advance may have the economic substance of a loan where the funds are advanced with a reasonable expectation of repayment regardless of the success of the venture or are placed at the risk of the business. *Steiner v. Commissioner*, T.C. Memo. 1981-212. Mr. Sensenig's expectation of repayment to CLCL, however, was completely dependent on the future financial success of the companies (which were not successful). See *Scriptomatic, Inc.*, 397 F.Supp. at 764 (holding advances were not debt where repayment "can only be reasonably assured by the chance of profits or from the liquidation of the business"). Repayment of any amount advanced by CLCL to one of the companies was not anticipated until the project had been "completed". Moreover, as to WSC, any expectation of repayment was even more remote, given that CLCL's interest was necessarily subordinate to the interest of WSC's prior mortgage lender. (*Fin Hay* factor 8.)
>
> Also at odds with a conclusion that this was a genuine loan transaction is Mr. Sensenig's not charging any loan origination fees for the advances and his lack of interest in obtaining third-party audits, financial statements, or credit reports for the companies he had chosen to invest in. CLCL's advances simply do not have the appearance of loans. We believe that no reasonable third-party lender would have extended money to these companies when none of the objective attributes which denote a bona fide loan are present, including a written promise of repayment, a repayment schedule, and security for the loan.
>
> The transfers simply did not give rise to a reasonable expectation or enforceable obligation of repayment. For these reasons, we find that the relationship between Mr. Sensenig and CLCL on the one hand and the three companies on the other was not that of creditor and debtor, and we conclude that Mr. Sensenig's advances of CLCL funds were in substance equity and that the IRS properly disallowed the deduction for tax year 2005.

[1847] *Sensenig v. Commissioner*, 121 A.F.T.R.2d 2018-505 (1/23/2018), citing *Geftman v. Commissioner*, 154 F.3d 61, 68 (3d Cir. 1998). The Supreme Court denied cert. to *Sensenig* 6/4/2018.

Whether an advance of funds is treated as genuine debt "must be considered in the context of the overall transaction." *Hardman v. United States*, 827 F.2d 1409, 1411 (9th Cir. 1987). Our inquiry typically focuses on whether the taxpayer intended to create a debt with a reasonable expectation of repayment and (if so) whether that intent comports in substance with the creation of a debtor-creditor relationship. *Litton Bus. Sys., Inc. v. Commissioner*, 61 T.C. 367, 377 (1973); *Ill. Tool Works Inc. & Subs. v. Commissioner*, T.C. Memo. 2018-121, 116 T.C.M. (CCH) 124, 130–31. "The outward form of the transaction is not controlling; rather, characterization depends on the taxpayer's actual intent, as evidenced by the circumstances and conditions of the advance." *Bauer v. Commissioner*, 748 F.2d 1365, 1367–68 (9th Cir. 1984), *rev'g* T.C. Memo. 1983-120.

Absent stipulation to the contrary, appeal of this case would lie to the U.S. Court of Appeals for the Ninth Circuit. See § 7482(b)(1)(A). That court has identified 11 factors that may be relevant in determining whether a transfer to a corporation by a shareholder is a debt or a contribution to capital. No one factor is controlling or decisive, and the Ninth Circuit directs us to look to the particular circumstances of each case. *Hardman*, 827 F.2d at 1412. "The object of the inquiry is not to count factors, but to evaluate them." *Id*. (quoting *Bauer v. Commissioner*, 748 F.2d at 1368)). "The burden of establishing that the advances were loans rather than capital contributions rests with the taxpayer." *Bauer v. Commissioner*, 748 F.2d at 1368 (citing *O.H. Kruse Grain & Milling v. Commissioner*, 279 F.2d 123, 125 (9th Cir. 1960), *aff'g* T.C. Memo. 1959-110).

The Ninth Circuit in *Hardman* identified the following factors as potentially relevant to the debt-vs.-equity inquiry: (1) the names given to the certificates evidencing purported debt; (2) the presence or absence of a maturity date; (3) the source of the payments, and in particular whether they are dependent upon earnings; (4) the right to enforce payment of principal and interest; (5) whether the advances increase participation in management; (6) whether the "lender" has a status equal or inferior to that of regular creditors; (7) objective indicators of the parties' intent; (8) whether the capital structure of the "borrower" is thin or adequate; (9) the extent to which the funds advanced are proportional to the shareholder's capital interest; (10) the extent to which interest payments come from "dividend" money; and (11) the ability of the "borrower" to obtain loans from outside lending institutions. See *Hardman*, 827 F.2d at 1411–12.

B. Analysis

Our examination of the bad debt issue is greatly simplified in this case by the January 1, 2012, Unanimous Consent resolution executed by the shareholders of IWS. By that resolution all shareholder loans in existence on that date were canceled and converted to paid-in capital, *i.e.*, equity. Petitioners do not contend that they or the Riemenschneiders advanced any funds to IWS, directly or through KRLLC, after January 1, 2012. As of 2017, therefore, there existed no debt from IWS that could have gone bad….

The loans thus canceled clearly included the loans that petitioners and the Riemenschneiders extended through KRLLC….

Consistently with this analysis, IWS's balance sheet for yearend 2012 shows no notes payable to shareholders and no note payable to KRLLC. Rather, it shows $2,606,001 - the total amount of "Notes Payable to Stockholders" that appeared on the 2011 balance sheet - as having been converted to “paid in capital.” Petitioners do not contend that they or the Riemenschneiders advanced any funds to IWS, directly or through KRLLC, after January 1, 2012. As of 2017, therefore, there existed no debt from IWS for which a bad debt deduction could be claimed.

This conclusion by itself supplies a sufficient basis on which to sustain respondent’s disallowance of the $2,095,757 bad debt deduction that KRLLC claimed for 2017. For purposes of completeness, however, we will also consider whether a bona fide debt existed between IWS and KRLLC as of December 31, 2011, immediately before the debt-to-equity conversion. In so doing we consider the factors identified by the Ninth Circuit in *Hardman*. The factors with greatest salience here clearly point to characterization of KRLLC’s advances as capital contributions rather than debt.[4]

[4] Besides disputing the existence of a bona fide debt, respondent contends that petitioners have failed to prove (1) that any debt owed by KRLLC became worthless during 2017, the year for which the deduction was claimed; (2) that $2,095,757 was the correct dollar amount of any debt that became worthless; or (3) that any debt held by KRLLC was a business debt, as opposed to a nonbusiness debt qualifying for only limited deductibility under section 166(d). Given our disposition we need not consider these additional arguments.

1. Terminology Used by the Parties

Genuine indebtedness is typically indicated by the issuance of a bond, debenture, or promissory note. See *Hardman*, 827 F.2d at 1412; *Am. Offshore, Inc. v. Commissioner*, 97 T.C. 579, 602 (1991). However, where a corporate “debtor” is closely held and is related to its putative creditor, the form of the transaction and the labels the parties used may have less significance. That is because related parties are free to mold the transaction using whatever labels they wish. See *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968); *Anchor Nat’l Life Ins. Co. v. Commissioner*, 93 T.C. 382, 406-07 (1989).

KRLLC advanced funds to IWS from the mid-1990s through August 2007. During the decade in which these advances were made, there were no promissory notes, debentures, or other “certificates evidencing the indebtedness.” *Hardman*, 827 F.2d at 1412. Rather, the advances were made on open account, tracked in a QuickBooks register maintained by petitioner wife. This register was a product of KRLLC’s internal bookkeeping. It was not promissory note or other binding instrument that KRLLC could take to court to establish an enforceable promise to pay.

The terminology used in recording these advances, moreover, is hostile to the notion that they created a genuine debt. The first entry in the QuickBooks register, made on December 31, 1999, shows a credit of $3,331,093 in KRLLC’s favor. This entry was apparently designed to capture advances KRLLC had made to IWS since the latter’s inception in 1994, and it is captioned “Investment-Idaho Waste.” An entry for December 31, 2000, showing a credit of $264,372, is likewise captioned “Investment-Idaho Waste.” These entries suggest capital contributions.

Other credit entries for 1999-2001 - captioned “capital,” “capital gains,” “equipment,” and “equipment lease income” - are difficult to reconcile with debt characterization.[5] A pair of entries for 1999 and 2001, totaling $1,893,437, are captioned “loan from Wells Fargo.”

These entries do not evidence loans from KRLLC to IWS. Rather, they denote bank loans extended to KRLLC or its partners, the proceeds of which the partners contributed to IWS.

[5] Some of these entries are rather cryptic. All were yearend entries made by Mr. Holland, KRLLC's outside accountant at the time. He did not testify at trial.

The only "certificate[] evidencing the indebtedness," *Hardman*, 827 F.2d at 1412, is the October 31, 2008, document captioned "Idaho Waste Systems, Inc." In this document IWS promises to pay KRLLC "on demand" the sum of $3,222,076.89. Robert Riemenschneider signed this document in his capacity as president of IWS; there are no other signatories.

For several reasons we accord this document little weight. IWS received no funds from KRLLC in consideration of executing this document. Quite the contrary: KRLLC had ceased advancing funds to IWS in August 2007, 14 months previously. The purported promissory note thus represents an apparent effort to convert into debt, retroactively, the open-account advances that KRLLC had made to IWS on dozens of occasions during the prior decade. As explained above, there is little or no evidence that these advances constituted debt.

There are other problems with the October 31, 2008, document. The amount shown as due, $3,222,076.89, bears no discernible relationship to the "Due from IWS" QuickBooks register in which KRLLC recorded its advances. That register has no entries whatever for calendar year 2008, and the last entry for 2007 shows an alleged balance due from IWS of $7,424,926. At trial petitioner husband did not recognize the purported promissory note. He stated that he had no "knowledge or involvement about that note at the time" and "wasn't involved in it[s] being written or anything else."

Finally, the October 31, 2008, document clearly reflected a related-party transaction. Robert Riemenschneider, who signed the note for the putative obligor, owned with his wife 50% of KRLLC, the putative obligee. The labels he assigned are thus far from dispositive. See *Fin Hay Realty Co.*, 398 F.2d at 697; *Anchor Nat'l Life Ins. Co.*, 93 T.C. at 406-07. For all these reasons, we give little weight to the purported promissory note and find that the first Hardman factor strongly favors respondent.

2. Presence or Absence of Maturity Date

"[A] definite maturity date on which the principal falls due for payment, without reservation or condition, ...is a fundamental characteristic of a debt." *Monon R.R. v. Commissioner*, 55 T.C. 345, 359 (1970). On the other hand, "[t]he absence of a fixed maturity date indicates that repayment is tied to the fortunes of the business" and thus tends to support equity characterization. *Hardman*, 827 F.2d at 1413; Am. Offshore, Inc., 97 T.C. at 602.

KRLLC's advances to IWS between 1994 and 2007 were reflected in no promissory note or other debt instrument and thus necessarily lacked a fixed maturity date. The purported 2008 promissory note likewise has no fixed maturity date. It states only that IWS will repay the principal "on demand" and that interest will accrue at 9% "until paid." The document imposes no repayment schedule, stating only that "[a]ny part [of the principal] may be paid at any time." The implication of this demand note is that KRLLC would be repaid only if and when IWS was sufficiently profitable to make repayment.

Petitioners seek to explain the absence of a maturity date by characterizing KRLLC's advances as a "working line of credit." We do not find this characterization apt. A line of credit necessarily has a limit; when the limit is reached, no further borrowing is possible. There was no set limit (and no apparent limit) to KRLLC's cash advances, which continued inexorably for a decade, topping out with an alleged balance due of $7,424,926 at yearend 2007. In any event, a line of credit must be repaid at some point, and neither the pre-2008 advances nor the purported 2008 promissory note contains the remotest suggestion of a repayment date. We find that this second *Hardman* factor likewise favors equity treatment.

3. Source of Payments

A true lender is concerned with a reliable return on his investment in the form of interest and repayment of principal. *Curry v. United States*, 396 F.2d 630, 634 (5th Cir. 1968); Dev. *Corp. of Am. v. Commissioner*, T.C. Memo. 1988-127, 55 T.C.M. (CCH) 455, 483. If timely payments to the alleged lender are not made, or if they can plausibly be made only out of future earnings, an inference arises that the advances were contributions to capital. *Hardman*, 827 F.2d at 1413; *Am. Offshore, Inc.*, 97 T.C. at 602.

IWS did not make consistent payments of interest to KRLLC at any time. The QuickBooks register shows only three interest payments between 1999 and 2007: two payments totaling $18,411 at yearend 2005 and a payment of $8,390 at yearend 2007. On those dates the register showed the alleged balances due from IWS as $6,109,521 and $7,424,926, respectively. If the interest reported as paid was recorded on the alleged balance due, it would have been paid at a rate of 0.3% and 0.1%, respectively. That is a far cry from the 9% rate specified in the 2008 purported promissory note. And there is no evidence, in the QuickBooks register or elsewhere, that IWS after October 31, 2008, ever made a single interest payment on that purported note, at a rate of 9% or otherwise.

Petitioner husband testified at trial that all cash advances made by KRLLC to IWS included unstated interest at a rate of 9%. But virtually all these advances were in round numbers ($10,000, $45,000, $190,000, $460,000, etc.). Mathematically speaking, it is hard to imagine how such amounts could have included an interest charge. In any event, interest on the advances could not have been calculated ab initio because the term of the "loan" was unknowable.

Petitioners did not introduce into the record any IWS financial statements for years before 2008. But for 2008 IWS reported retained earnings of negative $5,460,671, indicating that it had suffered substantial losses in prior years. Petitioner husband admitted at trial that, during the 2007–2010 timeframe, IWS was not "in any kind of position to pay back [KRLLC] anything." Given this track record, no reasonable third-party lender could have viewed IWS as financially sound enough to make regular interest payments at a 9% rate. We thus view the third *Hardman* factor as strongly favoring equity treatment.

4. Right to Enforce Payment

The existence of a right to enforce payment of principal and interest is a further indicator of bona fide debt. Hardman, 827 F.2d at 1413; Gokey Props., Inc. v Commissioner, 34 T.C. 829, 835 (1960), aff'd, 290 F.2d 870 [7 AFTR 2d 1514] (2d Cir. 1961). KRLLC lacked any meaningful enforcement rights. The purported promissory note had no repayment schedule and no fixed maturity date. IWS's true creditors, including Premier West and Mr. Yarbrough, demanded a security interest in the landfill [*18] property, IWS's most valuable asset. KRLLC demanded from IWS no security interest of any kind. And unlike the financial institutions from which IWS sought financing in 2015 and 2016, which required guaranties from all 20% shareholders, KRLLC foreswore that enforcement mechanism as well. This factor strongly favors respondent.

5. Participation in Management

If a taxpayer's advances to a corporation entitle him to greater participation in its management, the advances are more likely to be treated as equity. *Hardman*, 827 F.2d at 1413; *Am. Offshore, Inc.*, 97 T.C. at 603. Petitioners and the Riemenschneiders, who jointly owned 100% of KRLLC, jointly owned 69% of IWS. But KRLLC's advances did not explicitly entitle them to any greater role in IWS's management. We regard this factor as neutral.

6. Status Compared to Regular Creditors

If a shareholder's rights to repayment of principal and interest are subordinated to the rights of regular creditors, then such advances are likelier to merit equity treatment. *Hardman*, 827 F.2d at 1413. Even absent an explicit subordination clause, the failure to demand timely repayment or to take collateral effectively subordinates the alleged debt to the rights of other creditors, who may receive payment or foreclose on their security in the interim. *Am. Offshore, Inc.*, 97 T.C. at 603.

According to its QuickBooks register, KRLLC advanced more than $7 million to IWS, on an unsecured basis, between 1999 and 2007. All of those advances were subordinated to the claims of IWS's later creditors. In 2007 IWS put up its landfill property as collateral for a $5 million loan from Premier West. When IWS could not repay that loan, the landfill property became security for a $4.2 million loan from Mr. Yarbrough, who ultimately foreclosed on the collateral when IWS defaulted. At no point did KRLLC secure collateral from IWS, make demand for the payment of interest or principal, or otherwise take steps to collect its alleged debt. Such behavior is wholly inconsistent with a typical debtor-creditor relationship, and this factor thus favors respondent.

7. Objective Indicators of the Parties' Intent

The parties' words and actions may supply evidence as to whether they intended cash advances to be debt or equity. *Hardman*, 827 F.2d at 1413. Because petitioners did not submit into evidence IWS's pre-2008 financial statements, the principal evidence of their intent regarding advances through August 2007 appears in the "Due from IWS" QuickBooks register. As noted *supra* pp. 14-15, several million dollars' worth of entries on that register are described as items such as "Investment-Idaho Waste," "capital," "capital gains," "equipment," and "equipment lease income." None of these descriptions favors debt treatment.

8. "Thin" or Adequate Capitalization

The purpose of examining the alleged borrower's debt-to-equity ratio is to determine whether it is so thinly capitalized that it would be unable to repay the debt if its financial condition worsened. *Bauer v. Commissioner*, 748 F.2d at 1369. A true creditor desires robust capitalization to guard against this risk. Thin capitalization thus suggests that shareholder advances to a corporation are capital contributions. *Hardman*, 827 F.2d at 1414; *Hubert Enters., Inc. v. Commissioner*, 125 T.C. 72, 96-97 (2005), aff'd in part, vacated in part, and remanded on other grounds, 230 F. App'x 526 (6th Cir. 2007).

IWS was severely undercapitalized at all times. In the absence of financial statements for years before 2008, it is impossible to calculate debt-to-equity ratios for that period. But at yearend 2008, after executing the purported promissory note to KRLLC, IWS reported liabilities of $12,615,390 and shareholder equity of negative $4,433,981. Th is computes to a debt-to-equity ratio nearing infinity. See, *e.g., Dunmire v. Commissioner*, T.C. Memo. 1981-372, 79 T.C.M. (CCH) 1769, 1774 n.24 (noting that, where shareholder equity is a negative number, the debt-to-equity ratio approaches infinity). This factor strongly favors respondent.

9. Identity of Interest

Where a stockholder owns "debt" in the same proportion to which he holds stock in the corporation, the characterization of his advances as "debt" may be suspect. *Bauer v. Commissioner*, 748 F.2d at 1370. Petitioners and the Riemenschneiders owned 100% of KRLLC, the alleged obligee. Petitioners and the Riemenschneiders owned 69% of IWS, the alleged obligor, and the Riemenschneiders' children owned another 11% of IWS. Petitioners and the Riemenschneiders thus had complete control over both entities at all times. *Cf*. § 318(a)(1) (providing that an individual is deemed to own the shares of any spouse and children for purposes of determining corporate control). While the record does not reveal an identity of interest, it reveals a strong overlapping of interest, and this factor thus offers little help to petitioners.

10. Relatedness of Payments to Profits

A true lender is concerned with reliable payment of interest. A lack of interest payments—and the alleged debtor's lack of current ability to make them—suggests that the party advancing funds is looking to the corporation's future earnings to achieve a return on his investment. *Hardman*, 827 F.2d at 1414; *Am. Offshore, Inc.*, 97 T.C. at 605. This factor, like the third *Hardman* factor, thus favors respondent. See *supra* pp. 16-17.

11. Ability to Borrow from Other Sources

If the corporation is able to borrow funds from third-party lenders on substantially the same terms as those imposed by the payor of the advance, an inference arises that the advance may be debt. *Hardman*, 827 F.2d at 1414; *Segel v. Commissioner*, 89 T.C. 816, 828 (1987); *Ill. Tool Works Inc.*, 116 T.C.M. (CCH) at 135. IWS allegedly borrowed more than $7 million from KRLLC, for a period of more than a decade, at an effective interest rate of zero, offering no collateral and no guaranties from its shareholders.

It is obvious that IWS could not have secured such terms from an unrelated third party. Although IWS sought credit from many financial institutions during this period, most

> turned it down. The two third-party lenders that did extend credit, Premier West and Mr. Yarbrough, demanded a security interest in the landfill property, which represented more than 70% of IWS's assets. And when IWS approached outside financial institutions (unsuccessfully) during 2015 and 2016, they demanded guaranties from all shareholders owning 20% or more of the company. The final Hardman factor thus favors respondent.
>
> In sum, we conclude that KRLLC's advances to IWS from inception through August 2007 did not give rise to bona fide debt, but rather constituted capital contributions on behalf of petitioners and the Riemenschneiders. Assuming arguendo that some portion of these advances constituted debt, that debt was extinguished by the Unanimous Consent resolution in January 2012, when all loans from shareholders were converted to paid-in capital. For both of these reasons, there remained no debt from IWS to KRLLC that could have become worthless in 2017, the year for which the bad debt deduction was claimed. We thus sustain the IRS's disallowance of that deduction and of the pass-through loss deduction and carryover NOL deduction claimed on petitioners' 2017 and 2018 returns, respectively.

The court upheld penalties:

> Petitioners contend that they relied in good faith on advice from their return preparer, Jennifer Werner. As a preliminary matter, we do not know what advice petitioners actually received from Ms. Werner. She did not communicate with petitioners directly; rather, she communicated with petitioners' daughter, Ms. Gilmore, in connection with preparation of the 2017 and 2018 tax returns. Petitioners did not make Ms. Gilmore available to testify about the advice she received from Ms. Werner or about the advice (if any) that she relayed to petitioners. Nor did petitioners testify about the second-hand advice (if any) that they got from Ms. Gilmore. Petitioners have thus failed to establish that they actually received and relied on professional advice.
>
> In order for reliance on professional advice to be reasonable, the professional must have "arrive[d] at that advice independently." *Neonatology Assocs., P.A.*, 115 T.C. at 98. Ms. Werner testified that she essentially transposed the $2,095,757 "bad debt" number from KRLLC's QuickBooks register to line 11 of KRLLC's 2017 tax return, without investigating the propriety of either the amount or the nature of the loss it purported to represent. Because the claimed bad debt was the product of petitioners' own bookkeeping, any advice Ms. Werner may have rendered was not "independent."
>
> To establish reasonable cause, a taxpayer must also have provided the adviser with all necessary and accurate information. Id. at 99. Petitioners did not inform Ms. Werner, at the time she prepared the 2017 tax returns, that they had executed in 2012 a Unanimous Consent resolution that converted all shareholder loans to equity. At trial Ms. Werner admitted that knowledge of this resolution would have been relevant to her analysis of whether KRLLC could properly claim a bad debt loss deduction for 2017.
>
> For these reasons, we are unable to conclude that petitioners had reasonable cause for their substantial understatements of income tax. We accordingly sustain respondent's determination of accuracy-related penalties for both years.

The Second and Fifth Circuits have spoken in a high-profile debt vs. equity case involving partnerships in the foreign arena.[1848]

If a debt instrument with a term of more than five years from issuance has original issue discount that exceeds the AFR by more than 5%, the excess may be reclassified as a dividend.[1849] Straight debt the term of which was an unknown length between 3 and 9 years was not equity even though its length might be extended to up to 15 years after issuance.[1850] Interest on indebtedness of a corporation which is payable in equity of the issuer or a related party or equity held by the issuer (or any related party) in any other person may also be nondeductible.[1851]

Although payments made within two years of a partner investing in a partnership generally are presumed to be disguised sales, payments of not more than 150% of the AFR are not presumed to be disguised sales.[1852]

See Schneider, "Is Debt vs. Equity Different in a Partnership?" *Taxes* (CCH (3/2015).[1853]

See also part II.G.4.a.ii Bad Debt Loss – Must be Bona Fide Debt, II.G.4.d.ii Using Debt to Deduct S Corporation Losses (discussing deducting S corporation losses against loans from shareholders to the corporation and the consequences of doing so), and III.B.1.a.i.(a) Loans Must be Bona Fide.

On April 8, 2016, the government issued proposed regulations under Code § 385, providing certain guidelines for recharacterizing debt as equity.[1854] Final regulations were issued October 21, 2016 as T.D. 9790. The final regulations and their preamble are lengthy. In response to comments, the final regulations narrowed the entities to which they apply, as part III of the preamble explains:

> Changes to the overall scope of the regulations:
>
> - *Exclusion of foreign issuers*. The final regulations reserve on all aspects of their application to foreign issuers; as a result, the final regulations do not apply to foreign issuers.
>
> - *Exclusion of S corporations and non-controlled RICs and REITs*. S corporations and non-controlled regulated investment companies (RICs) and real estate investment trusts (REITs) are exempt from all aspects of the final regulations.

[1848] Chiand and Du, "The Debt-Equity Debate in the *Castle Harbour* Case," *Practical Tax Strategies* (April 2013), analyzing *TIFD III-E, Inc. v. United States*, 342 F.Supp.2d 94 (D. Conn. 2004), *rev'd* 459 F.3d 220, 231 (2d Cir. 2006), *on remand* 660 F.Supp.2d 367, 395 (D. Conn. 2009), *rev'd* 666 F.3d 836 (2d Cir. 2012). See fn. 5141 for the Fifth Circuit's analysis. Note that 2015 changes to Code §§ 704(e) and 761(b) would affect the analysis.
[1849] Code § 163(e)(5).
[1850] Letter Ruling 201405005. This ruling involved a stock redemption followed by stock being issued to key employees and included number of representations.
[1851] Code § 163(*l*).
[1852] Reg. § 1.707-4(a)(3)(ii).
[1853] Saved as Thompson Coburn LLP doc. no. 6544618.
[1854] REG-108060-15, Fed. Reg. Vol. 81, No. 68, p. 20911.

- *Removal of general bifurcation rule*. The final regulations do not include a general bifurcation rule. The Treasury Department and the IRS will continue to study this issue.

Significant changes to the documentation requirements in § 1.385-2:

- *Extension of period required for timely preparation*. The final regulations eliminate the proposed regulations' 30-day timely preparation requirement, and instead treat documentation and financial analysis as timely prepared if it is prepared by the time that the issuer's federal income tax return is filed (taking into account all applicable extensions).

- *Rebuttable presumption based on compliance with documentation requirements*. The final regulations provide that, if an expanded group is otherwise generally compliant with the documentation requirements, then a rebuttable presumption, rather than per se recharacterization as stock, applies in the event of a documentation failure with respect to a purported debt instrument.

- *Delayed implementation*. The final regulations apply only to debt instruments issued on or after January 1, 2018.

Significant changes to the rules regarding distributions of debt instruments and similar transactions under § 1.385-3:

- *Exclusion of debt instruments issued by regulated financial groups and insurance entities*. The final and temporary regulations do not apply to debt instruments issued by certain specified financial entities, financial groups, and insurance companies that are subject to a specified degree of regulatory oversight regarding their capital structure.

- Treatment of cash management arrangements and other short-term debt instruments. The final and temporary regulations generally exclude from the scope of § 1.385-3 deposits pursuant to a cash management arrangement as well as certain advances that finance short-term liquidity needs.

- *Limiting certain "*cascading*" recharacterizations*. The final and temporary regulations narrow the application of the funding rule by preventing, in certain circumstances, the so-called "cascading" consequence of recharacterizing a debt instrument as stock.

- *Expanded earnings and profits exception*. The final and temporary regulations expand the earnings and profits exception to include all the earnings and profits of a corporation that were accumulated while it was a member of the same expanded group and after the day that the proposed regulations were issued.

- *Expanded access to $50 million exception*. The final and temporary regulations remove the "cliff effect" of the threshold exception under the proposed regulations, so that all taxpayers can exclude the first $50 million of indebtedness that otherwise would be recharacterized.

- *Credit for certain capital contributions*. The final and temporary regulations provide an exception pursuant to which certain contributions of property are "netted" against distributions and transactions with similar economic effect.

- *Exception for equity compensation*. The final and temporary regulations provide an exception for the acquisition of stock delivered to employees, directors, and independent contractors as consideration for the provision of services.

- *Expansion of 90-day delay for recharacterization*. The 90-day delay provided in the proposed regulations for debt instruments issued on or after April 4, 2016, but prior to the publication of final regulations, is expanded so that any debt instrument that is subject to recharacterization but that is issued on or before October 21, 2016, will not be recharacterized until immediately after October 21, 2016.

Key to much of this is multinational entities documenting loans properly.[1855] Also, transfers between related companies 36 months before or after a loan generally are deemed to be a repayment of debt rather transactions affecting equity.[1856]

Notice 2017-36, part II, described the documentation requirements and postponed their applicability until 2019:

> The Documentation Regulations in § 1.385-2 have two principal purposes. The first is to provide guidance regarding the documentation and other information that must be prepared, maintained, and provided to be used in the determination of whether an instrument subject to the Documentation Regulations will be treated as indebtedness for federal tax purposes. The second is to establish certain operating rules, presumptions, and factors to be taken into account in the making of any such determination. The Documentation Regulations, once applicable, implement these purposes by generally requiring taxpayers to prepare and maintain documentation that evidences specified "indebtedness factors" with respect to purported debt instruments subject to the regulations. Thus, compliance with the Documentation Regulations does not establish that an interest is indebtedness; it serves only to satisfy the minimum documentation for the determination to be made under general federal tax principles….
>
> In response to the concern that taxpayers have continued to raise with the application of the Documentation Regulations to interests issued on or after January 1, 2018, and in light of further actions concerning the final and temporary regulations under section 385 in connection with the review of those regulations, the Treasury Department and the IRS have determined that these concerns warrant a delay in the application of the Documentation Regulations by 12 months. Accordingly, the Treasury Department and the IRS intend to amend the Documentation Regulations to apply only to interests issued or deemed issued on or after January 1, 2019. Pending the issuance of those regulations, taxpayers may rely on the delay in application of the Documentation Regulations set forth in this notice.

[1855] See Connors, de Marigny, and Rodgers, "The Final § 385 Regulations," *TM Memorandum* (BNA) 2/20/2017, saved as Thompson Coburn doc. no. 6515888.
[1856] Reg. § 1.385-3(b)(3)(iii)(A).

T.D. 9880 (11/04/2019) repealed Reg. § 1.385-2, which it referred to as “the Documentation Regulations,” commenting:

> The Treasury Department and the IRS, however, continue to consider the issues addressed by the Documentation Regulations.
>
> After this further review, the Treasury Department and the IRS may propose a modified version of the Documentation Regulations. In any modified version, the Treasury Department and the IRS would substantially simplify and streamline the proposal to minimize taxpayer burdens, while ensuring the collection of sufficient documentation and other information necessary for tax administration purposes. The Treasury Department and the IRS welcome comments regarding approaches that would most effectively achieve that balance. Any modified version of the Documentation Regulations would be proposed with a prospective effective date to allow sufficient lead-time for taxpayers to design and implement systems to comply with those regulations.

When issuing T.D. 9880, REG-123112-19 (RIN 1545-BP51) announced:

> **Explanation of Contemplated Regulations**
>
> Pursuant to E.O. 13789, the Treasury Department and the IRS intend to issue proposed regulations modifying the Distribution Regulations. To make the Distribution Regulations more streamlined and targeted, the Treasury Department and the IRS intend to issue proposed regulations substantially modifying the funding rule, including by withdrawing the per se rule. The Treasury Department and the IRS intend that the proposed regulations would not treat a debt instrument as funding a distribution or economically similar transaction solely because of their temporal proximity; rather, the proposed regulations would apply the funding rule to a debt instrument only if its issuance has a sufficient factual connection to a distribution to a member of the taxpayer’s expanded group or an economically similar transaction (for example, when the funding transaction and distribution or economically similar transaction are pursuant to an integrated plan). Thus, under the proposed regulations, a debt instrument issued without such a connection to a distribution or similar transaction would not be treated as stock. As a result, the proposed distribution regulations would be more streamlined and targeted while continuing to deter tax-motivated uneconomic activity. As part of the intended revisions of the funding rule, the Treasury Department and the IRS also are considering substantial revisions to, or removal of, certain exceptions in the regulations, consistent with the revised standard. The proposed distribution regulations would not alter materially the definition of a covered member (defined in § 1.385-1(c)(2) as a member of an expanded group that is a domestic corporation).
>
> **Proposed Applicability Date**
>
> The Treasury Department and the IRS intend to provide that the proposed regulations would apply to taxable years beginning on or after the date of publication of the Treasury decision adopting those rules as final regulations in the Federal Register.
>
> **Reliance on the 2016 Proposed Regulations**
>
> For periods after October 13, 2019 (the expiration date of the Temporary Regulations), a taxpayer may rely on the 2016 Proposed Regulations until further notice is given,

provided that the taxpayer consistently applies the rules in the 2016 Proposed Regulations in their entirety.

Certain temporary regulations promulgated October 21, 2016 expired October 13, 2019.[1857] A taxpayer may rely on proposed regulations published October 21, 2016, if the taxpayer consistently applies the rules in the 2016 Proposed Regulations in their entirety.[1858]

The final regulations under Code § 385 do not recharacterize debt issued by a partnership as equity; instead, they treat a partnership as an aggregate and test as if the partners had made the loan or investment.[1859]

Deitch v. Commissioner, T.C. Memo. 2022-86, found that an arrangement was debt rather than equity. The court's syllabus describes the case:

> Ps were partners in the partnership WTS. In 2006 WTS purchased a commercial rental property in Georgia by financing the property with the proceeds of a loan from PLI. The integrated loan documents included an "Additional Interest Agreement" that entitled PLI to additional interest of two types - "NCF Interest" (*i.e.*, 50% of the net cashflow from the property) and "Appreciation Interest" (*i.e.*, 50% of the appreciation in the value of the property if it was ever sold or the loan was terminated). WTS owned no other real property.
>
> During the years WTS owned the commercial rental property, it made regular loan payments to PLI, which consisted of repayment of principal, stated interest at a fixed rate, and 50% of the net income from the property, all of which it characterized as interest. WTS sold the property in 2014 and, in accordance with the loan documents, paid to PLI the appreciation interest.
>
> On its partnership tax return for 2014, WTS claimed an I.R.C. § 163(a) deduction for its payment of the appreciation interest to PLI and reported a net loss in excess of $1 million on the commercial rental property. WTS reported net I.R.C. § 1231 gain of $2.6 million. Ps reported their distributive shares of income and loss of WTS on their individual income tax returns for 2014.
>
> R sent statutory notices of deficiency to Ps, determining that Ps' incomes should each be increased by $517,841, resulting from R's disallowance of the appreciation interest WTS claimed as a deductible interest expense.
>
> *Held*: Notwithstanding I.R.C. § 6221(a) and Tax Court Rule 240(c), we have jurisdiction to determine whether WTS and PLI were engaged in a joint venture constituting a partnership for federal income tax purposes, and we hold that they were not so engaged.
>
> *Held*, further, PLI did not have a "single equity interest" in its dealings with WTS that transformed WTS's loan payments on genuine indebtedness to PLI into guaranteed payments made to a partner pursuant to I.R.C. § 707(c).

[1857] Notice 2019-58.
[1858] Notice 2019-58.
[1859] See part 3, "Aggregate Treatment of Partnerships," of section Part V, "Comments and Changes to § 1.385-3—Certain Distributions of Debt Instruments and Similar Transactions," of the preamble to T.D. 9790 (10/21/2016).

> *Held*, further, in light of the facts stipulated by the parties, the appreciation interest that WTS paid to PLI was interest deductible under I.R.C. § 163, not a payment in respect of any equity interest held by PLI.

In the court's analysis, "Formation of a partnership for tax purposes," the court reasons:

> Section 761(a) defines a partnership as "includ[ing] a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not...a corporation or a trust or estate." See also § 7701(a)(2). "Partnership" for tax purposes is generally a more inclusive term than "partnership" at common law, and for tax purposes it may include entities not traditionally considered partnerships. *Dickerson v. Commissioner*, T.C. Memo. 2012-60. "A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses." *Commissioner v. Tower*, 327 U.S. 280, 286 (1946). "A partnership is, in other words, an organization for the production of income to which each partner contributes one or both of the ingredients of income-capital or services." *Commissioner v. Culbertson*, 337 U.S. 733, 740 (1949). To decide whether a partnership exists, a court must also analyze the relevant facts to determine whether "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise". *Id*. at 742.
>
> Here the Commissioner contends that WTS and PLI formed a "joint venture" that constituted a partnership under section 761(a), and we evaluate that "joint venture" contention "by reference to the same principles that govern the question of whether persons have formed a partnership which is to be accorded recognition for tax purposes". *Luna v. Commissioner*, 42 T.C. 1067, 1077 (1964) (first citing *Estate of Smith v. Commissioner*, 313 F.2d 724 (8th Cir. 1963), aff'g in part, rev'g in part and remanding 33 T.C. 465 (1959); and then citing *Beck Chem. Equip. Corp. v. Commissioner*, 27 T.C. 840, 848-49 (1957)). These principles require us to consult
>
>> [t]he following factors, none of which is conclusive...: [1] The agreement of the parties and their conduct in executing its terms; [2] the contributions, if any, which each party has made to the venture; [3] the parties' control over income and capital and the right of each to make withdrawals; [4] whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; [5] whether business was conducted in the joint names of the parties; [6] whether the parties filed Federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; [7] whether separate books of account were maintained for the venture; and [8] whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.
>
> *Id*. at 1077-78 (citations omitted).

The court pointed out that all of the documents were consistent with a secured loan with fixed stated interest and that the IRS' only complaint was that the bonus interest was based on sales proceeds:

> The Commissioner accepts that three of the agreements at issue here-the original note, the modifications, and the security agreement-constitute “genuine indebtedness” by WTS to PLI. But the fourth agreement-the Additional Interest Agreement that gave rise to WTS’s obligation to pay appreciation interest-cannot be separated from these other three agreements. Indeed, the four agreements were inextricably integrated with each other. They were simultaneously bargained for, and they cross-reference each other.
>
> WTS’s obligation to pay appreciation interest arose from the same advances, totaling $4.4 million, that gave rise to WTS’s obligation to pay the other interest components (which are concededly deductible even-the NCF interest that, like appreciation interest, was provided for in the Additional Interest Agreement). There are no other advances that PLI made that could be characterized as giving rise to the obligation to pay appreciation interest.
>
> One might still consider arguing for an allocation of the appreciation interest to a portion of the $4.4 million of advances that should be characterized as equity, but the Commissioner has affirmatively disclaimed that argument, as we now explain.

The court then explained that the IRS was essentially requiring it to determine whether the entire arrangement was debt or equity instead of being able to look at it as part debt and part equity:

> Adhering to the position of a General Counsel Memorandum (“G.C.M.”), the Commissioner here acknowledges that PLI’s “right to share in the partnership’s profits” cannot be said to be “separable from its right to repayment of its advance with interest thereon”, and acknowledges that it cannot be held “that only the right to share in profits is an equity interest”. I.R.S. G.C.M. 36,702 (Apr. 12, 1976), 1976 WL 38976, at *5. This G.C.M. was issued in response to (and in criticism of) the opinion of the Court of Appeals for the Second Circuit in the case of *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (2d Cir. 1960), aff’g T.C. Memo. 1959-93. Even though this is an argument that the Commissioner disclaims in these cases, we discuss it to explain the reason for the issues that we must decide.
>
> In *Farley* two individuals (A and B) organized a corporation (C) to purchase a building for $380,000. The seller took a first mortgage on the building for $280,000; A and B financed the remaining $100,000 with $30,000 cash and the proceeds of a $70,000 loan from another individual (Z). *Id*. at 703. Z explicitly desired to participate in the venture solely as a creditor. Id. The terms of C’s second mortgage to Z provided that Z would advance $70,000 to C for ten years in exchange for payments consisting of 15% interest for the first two years and 13% interest thereafter, as well as “50 per cent of the appreciation in the value of the property if it appreciated in value”, which was determined at such time that either C or Z extended an offer to sell or to purchase the other’s interest in the property; the $70,000 “principal” was not due until the end of the ten-year term, and repayment of the principal was expressed as “seventy per cent of the first $100,000 of the amount by which the purchase price exceeded the amount outstanding on the first mortgage”. *Id*. C made payments in accordance with the agreement. Shortly before the principal was due, and when only $583 of interest remained to be paid, Z died and his administrators sought to collect the amounts due under the agreement. *Id*. In a state court suit, C challenged the enforceability of Z’s entitlement to a 50% share in the appreciation, and the parties settled for $120,583, which represented $70,000 in principal, $583 in interest, and $50,000 for Z’s share of the appreciation. When C filed its

tax return, it claimed interest deductions totaling $50,583, and the Commissioner disallowed the $50,000 portion of the interest deduction that corresponded to Z's $50,000 appreciation payment.

The court sustained the disallowance of $50,000 of the interest deductions and held that Z's "right to share in the appreciation of petitioner's property is separable from his right to repayment of his $70,000 loan with interest thereon, and that the right to share in the property's appreciation constituted an equity interest in the property." *Id*. at 704. The court reasoned that Z's entitlement to the appreciation payment, taken separately and apart from the interest of $583, exposed Z to downside risk, was of an indefinite amount, and lacked a fixed maturity date, *id*. at 704-05, and therefore was not "interest on an indebtedness". (The court explicitly did not reach the question of whether Z's "equity interest in the property had the features of a 'joint venture'" under relevant state law, *id*. at 706, which is what the Commissioner contends occurred in these cases.)

The position that the IRS has taken on Farley-and the position that the Commissioner expressly takes in these cases-is that Farley was wrongly decided insofar as it "suggests that the taxpayer's right to share in the partnership's profits is separable from its right to repayment of its advance with interest thereon and that only the right to share in profits is an equity interest". G.C.M. 36,702, 1976 WL 38976, at *5. As the G.C.M. observes, "serious computational problems" would arise with determining that Z held an equity interest in C, if in fact all of Z's $70,000 contribution constituted a loan. *Id*. at *6. If his entire contribution was a loan, then Z "contributed neither capital nor services in his capacity as a 'partner.'...In short the Farley decision appears unsound to the extent that it holds that Z held an equity interest for which he contributed neither capital nor services". Id. at *5. Fixing this anomaly by separating the loan from the equity interest "might require computing the amount [of the advance] allocable to the loan as a portion of the contribution sufficient to establish the fixed interest as a true, arm's length return and then allocating the remaining portion to equity", *id*. at *6, an exercise that would involve "difficulty", "mak[ing] this type of allocation undesirable", *id*. at n.3.

We do not attempt here any such allocation between debt and equity because the Commissioner has not argued for it, has disclaimed it,[13] and has not put on any evidence to enable the necessary computations to make the allocation. Therefore, we cannot allocate PLI's $4.4 million advance between a loan and an equity interest.[14] This leaves the Commissioner backed into a corner: If the transaction is entirely debt, then the appreciation interest is deductible interest; but he cannot argue that only a portion of it is equity; so he argues instead that PLI's interest is all equity-to wit, its equity share of a WTS-PLI joint venture. Adjudicating that argument would require us to have jurisdiction over partnership issues of such an entity, and we must determine whether such an entity exists.

[13] For example, the Commissioner's Post-trial Answering Brief asserts "that PLI's advance to WTS was...not part equity, part debt".

[14] In the absence of stipulations to the contrary and the Commissioner's disclaimer, one might note PLI's practice of advancing 75% of the stabilized value for a conventional loan, versus PLI's practice of increasing the amount to 85% of a projected stabilized value for a participating loan (as is at issue here), and might entertain the possibility that the additional 10% was not bona fide indebtedness but was in fact capital contributed not as part of a loan advance but for a participating

> profits interest. But this we cannot do, *see* Rule 90(e) and (f), and the Commissioner does not ask us to do so.

In the next portion of the opinion, "Whether WTS established a joint venture with PLI," the court explains that the arrangement had all of the indicia of lender/borrower and was not a partnership. When reading the analysis, consider that the indicia of a partnership would have subjected the lender to joint and several liability (see part II.C.10 Whether Tenancy-in-Common or other Arrangement Constitutes a Partnership), so a lender would do its best to avoid becoming involved in a borrower's operations in a manner that would be characterized as a partnership; part II.C.10 discusses *Luna* and other fundamental case law regarding whether an arrangement constitutes a partnership. With that background, here is the court's analysis:

> The Commissioner contends, notwithstanding the ostensible loan agreement between WTS and PLI-embodied in the four documents that we find to be integrated-that the two entities in fact entered into a joint venture. He now argues that the parties' entire agreement created a "relationship between WTS and PLI...of joint venturers, not lender and borrower, and that PLI's advance was more in the nature of a capital contribution than a loan." We think that this argument must be rejected if we take at face value the parties' binding stipulation that the original note, the modifications, and the security agreement "constitute genuine indebtedness by West Town Square to Protective Life" and the Commissioner's acknowledgement that "the agreement between WTS and PLI, despite consisting of multiple documents, must be considered as a whole". Whatever else PLI might have been in this arrangement, we know it was a creditor. As we have noted, PLI advanced its entire $4.4 million as proceeds pursuant to those documents. There was no separate or additional advance that did not "constitute genuine indebtedness" and that could be characterized as giving rise to WTS's obligation to pay the appreciation interest.
>
> The Commissioner's stipulation of the existence of "genuine indebtedness", and his acceptance that the four loan documents "must be considered as a whole" and that they gave PLI a single interest, contradict the argument he now seeks to advance. Paragraph 35 of the stipulation reflects the parties' agreement that PLI held debt in WTS, and the Commissioner now accepts that PLI's advance created a single interest that must be characterized as either wholly debt or wholly equity. Consequently, the Commissioner's contention that PLI has a single interest properly characterized as equity must fail. The documents created "genuine indebtedness", and this fact precludes a finding that they created no debt but rather a single equity interest in a supposed joint venture.
>
> With the same result, we turn now to a more detailed analysis of the eight "*Luna* factors", which analysis shows that WTS and PLI did not form a joint venture that was a partnership for tax purposes.
>
> **1. The agreement of the parties and their conduct in executing its terms**
>
> The loan documents executed by WTS and PLI could hardly have been more explicit in naming their relationship. Affirmatively, the documents stated that WTS and PLI were borrower and lender. Negatively, the documents expressly stated that WTS and PLI did not form a joint venture. WTS and PLI conducted themselves in accordance with the terms of the loan documents (including the Additional Interest Agreement), and the

Commissioner does not contend that any terms of the agreement were not followed. This weighs against the existence of a joint venture.

The Commissioner asserts otherwise, stating (with record citations omitted):

> As to the first factor the agreement between PLI and WTS contemplated the purchase, operation, and eventual sale of a shopping center.... A key piece of that agreement was that PLI would share in the potential upside of the investment, both by receiving half of the operating profits but also half of the net proceeds from a sale of the shopping center.

This assertion reflects a misunderstanding of the first factor. It is true that the substance rather than the ostensible form of the transaction controls a determination of the existence of a joint venture, see *WB Acquisition, Inc. & Sub. v. Commissioner*, T.C. Memo. 2011-36, 101 T.C.M. (CCH) 1157, 1164, *aff'd sub nom. DJB Holding Corp. v. Commissioner*, 803 F.3d 1014 (9th Cir. 2015), and that the characterization reflected in a written agreement is not necessarily determinative of whether the parties entered into a joint venture. It may also sometimes be true that a "shar[ing] in the potential upside" is an indication of a possible joint venture, and there is no denying that PLI acquired-apart from its right to receive conventional interest-the right to share in the appreciated value of the shopping center. But that analysis concerns the fourth factor, discussed below. The first factor considers whether the form of the purported agreement is a joint venture and whether the parties departed from the ostensible form. In *W.B. Acquisition* we held, in examining the first factor, that an ostensible joint venture agreement was contradicted by the actual conduct of the parties, so we held that a joint venture had not been created, despite its ostensible form. Here the ostensible form-a series of integrated documents that expressly deny joint venture status and do create "genuine indebtedness"-is debt and not a joint venture, and the parties have operated according to the terms of their agreement. Therefore, the first factor continues to weigh against the existence of a joint venture. (We will proceed to address whether the other factors disclose contrary substance.)

2. The contributions, if any, which each party has made to the venture

There is no dispute that WTS contributed the services that made the operation of the Rome property a successful venture, including rehabilitating and maintaining the property and securing the tenants that produced the rental income on the property. The Commissioner argues that PLI's contribution was the capital, indicating that both were members of a joint venture.

However, the advanced funds of a lender are a loan and not a contribution to capital, so it is insufficient for the Commissioner to note the undisputed fact that PLI was the source of money for the project. One must ask in what capacity PLI provided that money; and it is fair for the Commissioner to insist that one must look past PLI's ostensible loan to ask whether perhaps the advances were not really true debt. But the answers to these questions come easily from the Commissioner's stipulation that the indebtedness evidenced by the original note and its modifications - *i.e.*, the entire $4.4 million amount of the funds advanced by PLI to WTS-was "genuine indebtedness". (As we explain below in part II.C, treatment of that amount as genuine indebtedness precludes a finding that PLI had a "single equity interest" that transformed the payments on the indebtedness into guaranteed payments made to a partner of the partnership.)

PLI contributed little of value outside of its capacity as an arm's-length lender of the entire advance to WTS. This factor weighs against finding a joint venture between WTS and PLI. See *DJB Holding Corp. v. Commissioner*, 803 F.3d at 1026 (citing *Luna*, 42 T.C. at 1077-79, and *Culbertson*, 337 U.S. at 742, for the proposition that a purported partner who contributes no value to a joint venture is not a bonafide partner in the venture).

3. The parties' control over income and capital and the right of each to make withdrawals

Other than the payments that WTS was contractually obligated to make to PLI under the loan documents, WTS controlled the income from the Rome property. PLI was contractually entitled to approximately half of the net income of the Rome property, modified by defining exclusions from "expenses" for purposes of calculating the NCF payment on terms favorable to PLI, whereas WTS was entitled to whatever net income remained after the payments to PLI (which in some years resulted in an overall loss). WTS and PLI did not have equivalent interests in the income stream from the Rome property. PLI was always guaranteed to receive what amounted to more than half of the income from the property, provided that the property was profitable. PLI was likewise not liable for any operating losses, except to the extent that they offset the quarterly amounts due to PLI under the NCF calculation at the end of the year.

PLI also exerted control over the primary capital that was the source of the income at issue, under the terms of the interest agreement and otherwise. For instance, if PLI had not repeatedly agreed to extend the term of the original note (which it was permitted, but by no means obligated, to undertake under the terms of the loan documents), PLI could have effectively forced a sale of the property, because all of the principal remaining on the loan would have been due and WTS had few other assets of value beyond the Rome property itself and its income stream, all of which were pledged to PLI as security for the loan. Moreover, the interest agreement became effective before PLI funded the loan; it was a binding contract that governed the parties' conduct "whether or not the Loan is funded and whether or not the Project is sold". Therefore, if WTS had sought junior financing or a full refinance with a different lender during the life of the loan from PLI, or even if WTS had prepaid the full amount of the principal, it would have nonetheless continued to owe PLI appreciation interest, pursuant to Article 4 of the interest agreement, based on the fair market value of the Rome property at the time that WTS exited the deal (and in certain of those instances, would have continued to owe the NCF payments). Any such actions were subject to approval by PLI or were subject to penalty of default, which likewise would not have relieved WTS of its obligation to make the additional interest payments. PLI therefore had significant control over the capital that WTS employed in its business.

PLI's economic interest under the terms of the Additional Interest Agreement, and as demonstrated by the conduct of the parties, resembles that of a holder of a preferred equity interest in the business. See *Estate of Mixon v. United States*, 464 F.2d 394, 410-11 (5th Cir. 1972)[15] (hampering ability to borrow from other creditors at the time the advance is made, using of funds to acquire capital assets, and the corporation's failure to repay on the due date weigh in favor of finding equity, not debt). Accordingly, this factor weighs in favor of finding that the parties engaged in a joint venture.

[15] Because petitioners resided in Georgia, venue for any appeal of these cases would, under section 7482(b)(1)(A), be the U.S. Court of Appeals for the Eleventh Circuit. That court has adopted as precedent decisions of the former U.S. Court of Appeals for the Fifth Circuit rendered before October 1, 1981. *Bonner v. City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981) (en banc). The Fifth and Eleventh Circuits evaluate 13 factors in a debt versus equity analysis, of which no single factor is controlling, nor are all factors entitled to equivalent significance. *Estate of Mixon*, 464 F.2d at 402. The Commissioner argues that an analysis of these 13 factors results in the conclusion that PLI's advance was made in respect of an equity interest and not debt, and petitioners urge the opposite. We find that analysis of the Luna factors is determinative of the issues in these cases, which require first that we find the existence of the relationship between WTS and PLI that could potentially give rise to an equity interest before we have occasion to characterize that interest.

4. Whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income

As we observed with respect to the third Luna factor, WTS and PLI each had an interest in the net profits of the business, but PLI was somewhat shielded from operating losses during the operation of the Rome property. The Commissioner asserts-and we agree-that the entitlement to a share of net profits is generally indicative of an equity interest in the enterprise generating those profits. See *Estate of Mixon*, 464 F.2d at 405; see also *Stevens Bros. & Miller-Hutchinson Co. v. Commissioner*, 24 T.C. 953, 956-57 (1955) (finding advance of capital from one corporation to another in exchange for a one-half share of the profits of the project was a bonafide agreement resulting in half the profits' being taxed as income to each corporation).

However, PLI did not have an obligation to share pro rata in the operating losses from the Rome property. With respect to overall loss on a final disposition of the Rome property, the Commissioner correctly observes that the operation of the Rome property was capitalized almost exclusively with debt and that the assets of WTS that were not pledged as collateral on the loan to PLI were of minimal value; and he plausibly argues that PLI was exposed to a risk of loss. If the Rome property were to decline in value, then PLI would risk losing, to the extent of that decline, the proceeds it had advanced. "Thin capitalization" of an entity is generally a factor favoring a finding that the advance that funds the venture should be viewed as an equity interest (subject to downside risk). See *Estate of Mixon*, 464 F.2d at 408 (observing that "thin capitalization is very strong evidence of a capital contribution where (1) the debt-to-equity ratio was initially high, (2) the parties realized the likelihood that it would go higher, and (3) substantial portions of these funds were used for the purchase of capital assets and for meeting expenses needed to commence operations"). But while it is true that the operation of the Rome property was capitalized almost exclusively with debt, we cannot view this factor in a vacuum. The parties stipulated that the loan from PLI to WTS was genuine indebtedness, and we do not disregard that stipulation to consider whether inadequate capitalization might be a sign of equity rather than debt.

Setting aside the Commissioner's contention with respect to the Rome property's thin capitalization, this factor weighs against finding a joint venture between WTS and PLI, because PLI did not have an obligation to share pro rata in the operating losses from the Rome property. See *WB Acquisition, Inc. & Sub.*, 101 T.C.M. (CCH) at 1167.

5. Whether business was conducted in the joint names of the parties

The Commissioner concedes that business was conducted in the name of WTS, not PLI or any other entity; and we find that this factor weighs against finding a joint venture.

6. Whether the parties filed federal partnership returns or otherwise represented to the Commissioner or to persons with whom they dealt that they were joint venturers

The Commissioner concedes that the parties did not file tax returns indicating that they were partners, and that WTS and PLI did not otherwise represent to the IRS or any other persons that they were engaged in a joint venture. Rather, WTS and PLI held themselves out as distinct entities whose relationship was solely that of borrower and lender. This factor weighs against finding that WTS and PLI engaged in a joint venture.

7. Whether separate books of account were maintained for the venture

No books of account were maintained for the Rome property other than by WTS. The Commissioner argues that “the parties agreed to the manner in which the books and records of their joint activity would be kept”, but this was solely for purposes of calculating the payments due under the interest agreement. WTS and PLI did not jointly maintain books of account that would normally be expected in the operation of a business. See *WB Acquisition, Inc. & Sub.*, 101 T.C.M. (CCH) at 1167. This factor weighs against finding a joint venture.

8. Whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise

While it is clear that PLI exercised control over the capital that it lent to WTS, most of the terms set forth in the security agreement and elsewhere are standard terms present in an arm’s-length secured commercial loan, which is consistent with the undisputed evidence that PLI used the same agreements (other than the Additional Interest Agreement) for its conventional loans. WTS exercised primary responsibility and control over the rental operations of the Rome property; and the only involvement PLI had with respect to those operations was its pre-approval of Spectrum Cauble to serve as the commercial property manager. In light of Mr. Barry’s involvement with Spectrum Cauble, this pre-approval looks much *more* like the product of an arm’s-length negotiation rather than PLI’s exerting responsibility or control over operations. We conclude that this factor weighs against finding that PLI held an equity interest in a joint venture with WTS. See *Luna*, 42 T.C. at 1078-79; see also *Estate of Mixon*, 464 F.2d at 406.

Seven of the eight *Luna* factors weigh against a finding of a joint venture, while one *Luna* factor weighs in favor. We find particularly significant the absence of any contribution by PLI to the purported joint venture, where the parties have stipulated that all of the funds it advanced to WTS were genuine indebtedness. Under the holding of *Culbertson*, 337 U.S. at 740, to the extent a partner must contribute “one or both of the ingredients of income-capital or services”, we find no basis to conclude that PLI made a contribution to an organization with WTS for the production of income. Viewing the transaction as a

> whole, and in light of our findings on all of the *Luna* factors, with no one factor being conclusive, we hold that there was no joint venture between WTS and PLI.

The court then rejected the IRS' argument that the appreciation payment was some sort of Code § 707(c) guaranteed payment, which argument was absurd in light of the lender not being a partner. Finally, the court rejected the IRS' attempt to disallow a deduction for the appreciation interest, reasoning and concluding:

> Section 163(a) provides the "general rule" that "[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness". This general rule is subject to a number of limitations imposed by the remaining paragraphs of section 163, including a general prohibition against deductions for "personal interest", see § 163(h), but neither party contends that any of these limitations apply here. Rather, the Commissioner contends that the appreciation interest payment was not interest, as petitioners have asserted.
>
> The Supreme Court has defined "interest on indebtedness" as "compensation for the use or forbearance of money". *Deputy v. du Pont*, 308 U.S. 488, 498 (1940); see also *Old Colony R.R. Co. v. Commissioner*, 284 U.S. 552, 560 (1932) ("the usual import of the term [i.e., ''interest"] is the amount which one has contracted to pay for the use of borrowed money"). We therefore must decide whether, in light of the other holdings in this Opinion, WTS's payment of the appreciation interest to PLI was compensation for the use of the funds that PLI advanced to WTS.
>
> Petitioners cite a number of precedents in support of their argument that the appreciation interest was "interest" within the meaning of section 163. In the case of *Kena, Inc. v. Commissioner*, 44 B.T.A. 217, 218 (1941), the Board of Tax Appeals (predecessor to the Tax Court) held that a payment of "money in lieu of interest" calculated as 80% of the net profits of the borrowing corporation for the duration of the loan, was in fact interest. So holding, it stated that "[i]t is not essential that interest be computed at a stated rate, but only that a sum definitely ascertainable shall be paid for the use of borrowed money, pursuant to the agreement of the lender and borrower." *Id*. at 221. Since that decision, the IRS has issued guidance concluding that sums calculated at other than a fixed rate may also constitute interest, including such sums calculated in addition to a fixed rate of interest. See Rev. Rul. 83-51, 1983-1 C.B. 48, 48-49 (concluding that home mortgage interest composed of 12% fixed interest plus 40% of the appreciation of the home during the period of the loan was "interest" under section 163); Rev. Rul. 76-413, 1976-2 C.B. 213, 213-14 (concluding that a real estate loan that charged fixed interest at 11% plus contingent interest calculated as "the greater of 1.75 percent of the gross receipts or $300 per acre from the sale of portions of the property" qualified as mortgage interest).
>
> The parties have stipulated that the full amount of the funds advanced by PLI was advanced pursuant to documents that "constituted genuine indebtedness", and we have concluded above that WTS and PLI were not engaged in a joint venture or another arrangement that could give rise to an equity interest entitling PLI to any portion of the payments at issue. Rather, WTS was obligated to pay the additional interest because WTS entered into the loan transaction structured by a series of interdependent contracts governing the terms of its indebtedness to PLI. We therefore conclude that WTS paid the appreciation interest as compensation to PLI for the use of the funds advanced, and that the appreciation interest was "interest" within the meaning of section 163.

Conclusion

> WTS's payment to PLI of the appreciation interest was a deductible payment of interest and not a payment in respect of equity.

Does this case upholding the deductibility of appreciation interest mean that this tool is a good way to structure such a financial arrangement? Consider:

- Business interest expense might not be fully deductible. See part II.G.20.a Code § 163(j) Limitation on Deducting Business Interest Expense.

- In a taxable intrafamily loan, note that interest received is ordinary income, but a large interest deduction based on a capital gain event may have the practical effect of offsetting capital gain.

- If a partnership interest is used instead of a capital appreciation loan, note the issues the IRS was trying to raise in *Deitch* regarding Code § 707© guaranteed payments. See also parts II.C.8.a Code § 707 - Compensating a Partner for Services Performed, II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A, II.H.11.c Payment of Preferred Return, II.I.2 Regulatory Framework, II.I.8.d Partnership Structuring in Light of the 3.8% Tax on Net Investment Income, II.L.2.a.i General Rules for Income Subject to Self-Employment Tax, II.L.4 Self-Employment Tax Exclusion for Limited Partners' Distributive Shares, III.B.7.b.i Code § 2701 Definitions, and III.B.7.c.i.(b) CCA 201442053 Discusses Profits Interest in a Partnership That Was a Straight-Up Partnership before the Transfer.

- I have not analyzed whether one might need to consider parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.

Banoff, Lipton, and Cohen, "Is *Deitch* the Tax Court's Most Interesting 21 Century Partnership Case?" *Journal of Taxation* (.Oct 2023), discusses hot issues in *Deitch*:

> (1) whether a loan with distinct cash-based profit sharing components will be treated for tax purposes as a unitary loan, a unitary partnership interest, or a bifurcated (part loan, part equity) instrument; (2) if bifurcation were appropriate, how a court might bifurcate the debt; (3) how large can a lender's contingent interest (the so-called "equity kicker") be, while still respecting the lender's status as a creditor rather than a partner for tax purposes; (4) what constitutes a guaranteed payment to a partner under Section 707(c) , and (5) will the IRS in litigation follow its Chief Counsel's position in a decades-old general counsel memorandum (GCM), absent any subsequent IRS or Treasury pronouncements on point. To date, the scope and potential impact of Deitch has not attracted widespread attention, but the opinion bears careful reading and analysis.

Discussing "Is the loan to the partnership a debt, an equity interest, or part debt, part equity for tax purposes?," the authors comment:

> If the borrower partnership and the lender (or the partnership's partners and the lender) are treated as tax partners, bad things could happen. There would be an allocation of a (possibly major) share of taxable income or loss to the putative lender (rather than interest expense) and, for the partnership borrower, an inability of its non-lender partners to include any part of the "loan" in the basis of their partnership interests. The granting of

the equity kicker may raise difficult questions under the original issue discount (OID) rules.[3] The payment of the equity kicker would not be deductible under Section 163.

[3] See, e.g., Banoff, "Tax Aspects of Real Estate Refinancing and Debt Restructuring: The Best and Worst of Times," 64 Taxes 926, 953 (Dec. 1986).

There are very few cases or rulings in which a loan to a partnership was tested for whether it was equity in substance. It is not clear that the same factors have been applied and given the same weights as in the corporate context.[4] In *Farley Realty*,[5] the lender received fixed interest on a loan plus the right to 50% of the appreciation in certain property (including appreciation both before and after the maturity of the loan principal). The Second Circuit Court of Appeals held the instrument to be part debt and part equity interest in the property. The Farley court apparently viewed the bifurcated equity interest as an equity interest in the borrower corporation.[6] However, it left uncertain whether the lender had an additional status as a shareholder in the borrower.

Your editors are unaware of any authorities that cited Farley for the proposition that a supposed debt instrument issued by a partnership can be bifurcated into debt and equity components.[7] Would *Deitch* be the first?

[4] See, e.g., Hambuechen, 43 TC 90 (1964). Compare Garlock, *Federal Income Taxation of Debt Instruments*, Para. 104.01[A] (VitalLaw, last viewed 8/11/23) with Schneider, "Is Debt vs. Equity Different in a Partnership?," 92 Taxes 111 (March 2015).

[5] *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (CA-2, 1960), *aff'g* TC Memo 1959-93.

[6] Garlock, note 4 supra, at para. 203.6.7.

[7] Accord: Rubinger, "Foreign Investors in U.S. Real Estate Should Consider Shared Appreciation Mortgages," 104 JTAX 235, 242 (October 2005).

In *Deitch*, the IRS chose not to follow *Farley*. Consistent with its position in GCM 36702[8] that a loan arrangement could not be bifurcated into an equity interest and a separate debt instrument, the IRS conceded in *Deitch* that PLI's advance to WTS was not part equity, part debt. As a result, the Service was forced to argue that the entire arrangement (relating to PLI's funding) constituted equity. The Tax Court, being constrained by the IRS's stipulations (concession), rejected the existence of a WTS-PLI venture and PLI having a direct equity interest in WTS. The Tax Court concluded that the loan and its interest components were (solely) debt, rather than equity, for tax purposes.

[8] GCM 36702 (Apr. 12, 1976).

Deitch is significant because the IRS there reiterated its long-standing position that a loan to a business entity (be it a corporation, as in *Farley*, or a partnership, as in GCM 36702 and *Deitch*) should not be bifurcated into part equity, part debt. Non-bifurcation, in your editors' experience, is the better position and is the one taken by taxpayers and their partnership advisors and return preparers when equity kickers are present.

Discussing “If bifurcation were under consideration, would there be an administrable, ‘correct’ approach that would be uniformly applicable?,” the authors comment:

> Bifurcation has long been rejected by the Commissioner in large part due to the administrative complexities it would create. Judge Gustafson’s dictum in Deitch reflects a bifurcation methodology that differs from that identified by the IRS in GCM 36702 . There are several other approaches that can be envisioned. Deitch provides further evidence that with no single, “correct” method of computing the bifurcation of loans to partnerships, it is administratively infeasible to put the burden on partnerships and their return preparers (both being subject to potential penalties under Sections 6662 and 6694, respectively) to speculatively attempt to compute the respective amounts attributable to a part debt, part equity bifurcation of the partnership loan. In other words, Deitch further supports the widely-held view that bifurcation of a single instrument into debt and equity components is inappropriate.

Discussing “How large can a lender’s equity kicker be, while still respecting the lender’s status as a creditor, rather than a partner, for tax purposes?” the authors comment:

> If a purported equity kicker is not treated as additional interest but, instead, is deemed to cause part or all of the debt to be treated as an equity contribution for tax purposes, the result would be that the lender and borrower would be treated as partners, thereby creating “tax pandemonium.”11
>
> The IRS and courts have provided scant guidance under the 1954 Code 12 as to the line of demarcation between bona fide contingent interest on a loan (deductible by the payor partnership, and reportable as interest income by the recipient lender) and characterization as a return on (guaranteed payment for the use of) capital. In Farley, the lender received fixed interest on a loan plus the right to 50% of the appreciation in certain property (including appreciation before and after the maturity of the principal). In Rev. Rul. 83-51, 1983-1 CB 48 , the IRS ruled a borrower could deduct under Section 163 interest payments made to a mortgage lender equal to 40% of the appreciation in value of a personal residence made under a shared appreciation mortgage (SAM). The IRS has long stated it will not issue advance rulings on the tax consequences of SAM loans where (as in Deitch) “the loan proceeds are used for commercial or business activities, or to finance a personal residence, if the facts are not similar to those described in Rev. Rul. 83-51 .” 13 The IRS has recognized that “the method of computation does not control a payment’s characterization as interest, so long as the amount in question is an ascertainable sum contracted for the use of money.” 14 Nonetheless, it seems quite likely that a court would strictly scrutinize a large loan as being disguised equity if the contingent interest were equal to say, 99% or even 95% of the partnership’s profits, or of net cash flow and net proceeds (after payment of regular interest on the loan). But what percentage of an equity kicker provides tax advisors with a level of comfort that the loan will not be recharacterized in whole or part as a partnership (equity) interest? 80%? 50%? 40%?
>
> The Tax Court held in Deitch that the Additional Interest payable to PLI is interest for federal income tax purposes. The Additional Interest was not classified for tax purposes as a return on PLI’s deemed capital contribution. It follows that Deitch illustrates a loan

can have an equity kicker of 50% of the partnership's net cash flow and 50% of the net sale and financing proceeds, while still characterized as debt for tax purposes.

Deitch may be the first tax case under the 1954 Code to recognize that such a significant equity kicker need not cause a loan to be characterized as an equity investment.

II.G.20.c. Changing from LIBOR or Other Interbank Offered Rates

T.D. 9961 (1/4/2022), "Guidance on the Transition From Interbank Offered Rates to Other Reference Rates," is generally effective March 7, 2022. Selected excerpts follow:

SUMMARY:

This document contains final regulations that provide guidance on the tax consequences of the transition away from the use of certain interbank offered rates in debt instruments, derivative contracts, and other contracts. The final regulations are necessary to address the possibility that a modification of the terms of a contract to replace such an interbank offered rate with a new reference rate could result in the realization of income, deduction, gain, or loss for Federal income tax purposes or could have other tax consequences. The final regulations will affect parties to contracts that reference certain interbank offered rates…

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under sections 860A, 860G, 1001, 1271, 1275, and 7701(l) of the Internal Revenue Code (Code) and to the Procedure and Administration Regulations (26 CFR part 301) under section 7701 of the Code.

1. Discontinuation of LIBOR and Tax Implications

On July 27, 2017, the Financial Conduct Authority, the United Kingdom regulator tasked with overseeing the London Interbank Offered Rate (LIBOR), announced that publication of all currency and term variants of LIBOR, including U.S.-dollar LIBOR (USD LIBOR), may cease after the end of 2021. The administrator of LIBOR, the ICE Benchmark Administration, announced on March 5, 2021, that publication of overnight, one-month, three-month, six-month, and 12-month USD LIBOR will cease immediately following the LIBOR publication on June 30, 2023, and that publication of all other currency and tenor variants of LIBOR will cease immediately following the LIBOR publication on December 31, 2021.

On September 29, 2021, the Financial Conduct Authority announced that it will compel the ICE Benchmark Administration to continue to publish one-month, three-month, and six-month sterling LIBOR and Japanese yen LIBOR after December 31, 2021, using a "synthetic" methodology that is not based on panel bank contributions (synthetic GBP

LIBORs and synthetic JPY LIBORs, respectively). The Financial Conduct Authority has indicated that it may also require the ICE Benchmark Administration to publish one-month, three-month, and six-month USD LIBOR after June 30, 2023, using a similar synthetic methodology (synthetic USD LIBORs). However, these synthetic GBP LIBORs, synthetic JPY LIBORs, and synthetic USD LIBORs are expected to be published for a limited period of time.

Various tax issues may arise when taxpayers modify contracts in anticipation of the discontinuation of LIBOR or another interbank offered rate (IBOR). For example, such a modification may be treated as an exchange of property for other property differing materially in kind or extent for purposes of § 1.1001-1(a), giving rise to gain or loss. Such a modification may also have consequences under the rules for integrated transactions and hedging transactions, withholding under chapter 4 of the Code, fast-pay stock, investment trusts, original issue discount, and real estate mortgage investment conduits (REMICs). To minimize potential market disruption and to facilitate an orderly transition in connection with the discontinuation of LIBOR and other IBORs, the Treasury Department and the IRS published proposed regulations (REG-118784-18) in the Federal Register (84 FR 54068) on October 9, 2019 (Proposed Regulations). The Proposed Regulations generally provide that modifying a debt instrument, derivative, or other contract in anticipation of an elimination of an IBOR is not treated as an exchange of property for other property differing materially in kind or extent for purposes of § 1.1001-1(a). The Proposed Regulations also adjust other tax rules to minimize the collateral consequences of the transition away from IBORs.

2. Rev. Proc. 2020-44

The Alternative Reference Rates Committee (ARRC), whose ex officio members include the Treasury Department, was convened by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York in 2014. To support the transition away from USD LIBOR, the ARRC has published recommended fallback language for inclusion in the terms of certain cash products, such as syndicated loans and securitizations. The ARRC has also been actively engaged in work led by the International Swaps and Derivatives Association (ISDA) to ensure that the contractual fallback provisions in derivative contracts are sufficiently robust to prevent serious market disruptions when LIBOR is discontinued or becomes unreliable. To that end, ISDA developed the ISDA 2020 IBOR Fallbacks Protocol by which the parties to certain derivative contracts can incorporate certain improved fallback provisions into the terms of those contracts.

On October 9, 2020, the Treasury Department and the IRS released Rev. Proc. 2020-44, 2020-45 I.R.B. 991, in advance of finalizing the Proposed Regulations to support the adoption of the ARRC's recommended fallback provisions and the ISDA 2020 IBOR Fallbacks Protocol. Rev. Proc. 2020-44 provides that a modification within the scope of the revenue procedure is not treated as an exchange of property for Start Printed Page 167 other property differing materially in kind or extent for purposes of § 1.1001-1(a). In addition, Rev. Proc. 2020-44 generally provides that a modification within the scope of the revenue procedure will not result in legging out of an integrated transaction or terminating either leg of a hedging transaction.

Within T.D. 9961, “Summary of Comments and Explanation of Revisions” includes:

> The Final Regulations also make use of defined terms, located in § 1.1001-6(h), to streamline references to concepts that are frequently used in the operative rules in § 1.1001-6(b) through (g). In particular, the defined term “covered modification” is the cornerstone of these rules and serves to restructure several of the fundamental rules set forth in the Proposed Regulations. For example, § 1.1001-6 of the Proposed Regulations generally provides certain beneficial tax consequences when the parties to a contract modify the contract to replace an IBOR-based rate with a “qualified rate” and make certain “associated modifications,” which may include a “one-time payment.” The Final Regulations unite these various elements of the Proposed Regulations (that is, modification of a contract, an IBOR-based rate, a qualified rate, associated modifications, and a one-time payment) in the single defined term “covered modification.” ….
>
> **1. Treatment Under Section 1001**
>
> Section 1.1001-6(a) of the Proposed Regulations generally provides rules for applying section 1001 to a contract that is modified to replace an IBOR-based rate or IBOR-based fallback provisions or to add or amend fallback provisions that would replace an IBOR-based rate. Section 1.1001-6(a) of the Proposed Regulations generally provides that such a modification is not treated as an exchange of property under section 1001 and extends this treatment to any reasonably necessary conforming modifications. When modifications that qualify for this special treatment under proposed § 1.1001-6(a) occur contemporaneously with modifications that do not qualify, the non-qualifying modifications are subject to the ordinary rules under § 1.1001-1(a) or § 1.1001-3 and the modifications that qualify for special treatment under proposed § 1.1001-6(a) are treated as part of the existing terms of the contract. Section 1.1001-6(b) of the Final Regulations provides similar rules but makes use of the defined terms “covered modification” and “noncovered modification.”

Within T.D. 9961, “BACKGROUND, NEED FOR THE FINAL REGULATIONS, AND ECONOMIC ANALYSIS OF FINAL REGULATIONS” explains:

> A very large volume of U.S. financial products and contracts include terms or conditions that reference LIBOR or, more generally, IBORs. Concern about manipulation and a decline in the volume of the funding from which LIBOR is calculated led to recommendations for the development of alternatives to LIBOR that would be based on transactions in a more robust underlying market. In addition, on July 27, 2017, the U.K. Financial Conduct Authority, the U.K. regulator tasked with overseeing LIBOR, announced that all currency and term variants of LIBOR, including USD LIBOR, may be phased out after 2021 and not be published after that timeframe. The administrator of LIBOR, the ICE Benchmark Administration, announced on March 5, 2021, that publication of overnight, one-month, three-month, six-month, and 12-month USD LIBOR will cease immediately following the LIBOR publication on June 30, 2023, and that publication of all other currency and tenor variants of LIBOR will cease immediately following the LIBOR publication on December 31, 2021.
>
> The ARRC, a group of stakeholders affected by the cessation of the publication of USD LIBOR, was convened to identify an alternative rate and to facilitate voluntary adoption of that alternative rate. The ARRC recommended SOFR as a potential replacement for

USD LIBOR. Essentially all financial products and contracts that currently contain conditions or legal provisions that rely on LIBOR and other IBORs are expected to transition to SOFR or similar alternatives in the next few years. This transition will involve changes in debt, derivatives, and other financial contracts to adopt SOFR or other alternative reference rates. The ARRC has estimated that the total exposure to USD LIBOR was close to $200 trillion in 2016, of which approximately 95 percent were in over-the-counter derivatives. ARRC further notes that USD LIBOR is also referenced in several trillion dollars of corporate loans, floating-rate mortgages, and similar financial products. In the absence of further tax guidance, the vast majority of expected changes in such contracts could lead to the recognition of gains (or losses) in these contracts for U.S. income tax purposes and to correspondingly potentially large tax liabilities for their holders. To address this issue, the final regulations provide that changes in debt instruments, derivative contracts, and other affected contracts to replace reference rates based on discontinued IBORs in a covered modification (both as defined in the final regulations) will not result in tax realization events under section 1001 and relevant regulations thereunder. For this purpose, a covered modification is generally the replacement of a discontinued IBOR with a qualified rate, provided that the replacement is not excluded under § 1.1001-6(j)(1) through (5) of these final regulations (the excluded modifications). The excluded modifications ensure that a covered modification includes only modifications to the cash flows of an IBOR-referencing contract intended to address the replacement of the IBOR-based rate in the contract and that modifications of contracts in a manner that is intended to change the amount or timing of contractual cash flows for other reasons or purposes remain subject to the general rules in section 1001 and the regulations thereunder. The final regulations also provide corresponding guidance on hedging transactions and derivatives to the effect that taxpayers may modify the components of hedged or integrated transactions to replace discontinued IBORs in a covered modification without affecting the tax treatment of the hedges or underlying transactions.

In the absence of these final regulations, parties to contracts affected by the cessation of the publication of LIBOR would either suffer tax consequences to the extent that a change to the contract results in a tax realization event under section 1001 or attempt to find alternative contracts that avoid such a tax realization event, which may be difficult as a commercial matter. Both such options would be both costly and highly disruptive to U.S. financial markets. A large number of contracts may end up being breached, which may lead to bankruptcies or other legal proceedings. The types of actions that contract holders might take in the absence of these final regulations are difficult to predict because such an event is outside recent experience in U.S. financial markets. This financial disruption would be particularly unproductive because the economic characteristics of the financial products and contracts under the new rates would be essentially unchanged. Thus, there is no underlying economic rationale for a tax realization event.

The Treasury Department and the IRS project that these final regulations would avoid this costly and unproductive disruption. The Treasury Department and the IRS further project that these final regulations, by implementing the regulatory provisions requested by ARRC and taxpayers, will help facilitate the economy’s adaptation to the cessation of LIBOR in a least-cost manner.

Changes that T.D. 9961 makes include adding Reg. § 1.1001.1-6, "Transition from certain interbank offered rates," and Reg. § 1.1275-2(m), "Transition from certain interbank offered rates."

The former is particularly relevant to part II.G.31.a Debt Modifications.

T.D. 9976, "Additional Guidance on the Transition From Interbank Offer Rates to Other Reference Rates With Respect to the Interest Rates of a Foreign Bank" (6/30/2023), summarizes its purpose:

> This document contains additional final regulations that provide guidance on the transition away from the use of interbank offer rates ("IBORs") to other reference rates. Specifically, this regulation provides the replacement rate for the IBOR presently used in the published rate election, which may be used by taxpayers to determine the amount of interest expense attributable to their excess U.S.-connected liabilities and allocable to income that is effectively connected with the conduct of a trade or business within the United States ("ECI"). The final regulations will affect foreign banks that have income that is ECI.

T.D. 9976 further explained in "Summary of Comments and Explanation of Revisions":

> **I. Appropriate Replacement Rate for 30-Day LIBOR**
>
> In response to the request for additional comments in TD 9961, one comment was received relating to the 30-day USD LIBOR replacement in § 1.882–5(d)(5)(ii)(B). The comment made three recommendations for the final regulations under § 1.882–5(d)(5)(ii)(B).
>
> **A. One-Month Term SOFR Plus a Static Spread Adjustment**
>
> First, the comment recommended finalizing the regulation using the one-month term SOFR plus static spread adjustment of 0.11448% as recommended by the ARRC (which endorsed Term SOFR rates in June of 2021 and spread adjustments in October of 2021) and codified in the LIBOR Act (enacted in December of 2021). The comment noted that the one-month term SOFR plus a fixed spread adjustment accounts for some of the differences between SOFR and LIBOR rates and implied that one-month term SOFR plus static spread adjustment of 0.11448% is a more appropriate replacement than yearly average SOFR. The published rate election provides eligible taxpayers with administrative relief from the burden of calculating their actual borrowing rate, which is based on data maintained outside the United States.
>
> The final regulations adopt this recommendation. The ARRC, whose ex officio members include the Treasury Department, has generally recommended that contracts referencing USD LIBOR adopt fallback provisions that reference the term SOFR of the same tenor, plus a static spread adjustment. The Treasury Department has supported the recommendations of the ARRC in prior guidance issued in Revenue Procedure 2020–44, 2020–45 I.R.B. 991 and the 2022 Final Regulations. In addition, contracts governed by U.S. law that have not voluntarily adopted such fallback provisions are generally required by the LIBOR Act to use the SOFR of the same tenor, plus the ARRC-recommended static spread adjustment, as a matter of law. Public Law 117–103, div. U. Accordingly, both the Treasury Department and the U.S. Congress

have endorsed, or required, the use of a term SOFR of the same tenor, plus the ARRC-recommended static spread adjustment, as a replacement for term USD LIBORs. Because the published rate election available under § 1.882–5(d)(5)(ii)(B) references 30-day LIBOR, the one-month term SOFR (plus static spread adjustment) is the most appropriate replacement rate.

B. Alternative Method Approximating Actual Rate

The comment also recommended that the final regulations allow taxpayers to use a rate that reasonably approximates the bank's actual rate and that is consistently applied from year to year. This recommendation is based on the approach taken in regulations that were in effect from 1981 through 1996. TD 7749, 46 FR 1681 (Jan. 7, 1981) (codified at former § 1.882–5(b)(3)(i)(B)). This historical regulation provided that, if information needed to calculate the taxpayer's actual interest rate could not be reasonably obtained, then the taxpayer could determine its interest rate by applying any method that reasonably approximated its actual interest rate and that was consistently applied year over year, including, for example, approximating its interest rate by reference to 30-day LIBOR. *Id.* at 1684–85. The comment expressed concern that the one-month term SOFR plus static spread adjustment may be less than the actual cost of borrowing; however, for some taxpayers it may not be worthwhile or possible for the corporation to calculate its actual borrowing rate.

The final regulations do not adopt this recommendation. An approach based on a reasonable approximation of a taxpayer's actual interest would establish a different method for determining a taxpayer's borrowing rate that does not provide the certainty, accuracy, and simplicity of a published rate election. Additionally, the IRS would face significant challenges in administering such a rule. For example, the comment did not suggest any standard by which the IRS might determine whether a taxpayer's method is a reasonable approximation of its actual borrowing rate.

Finally, data from recent filing years indicates that the actual rate calculation is not a significant burden to taxpayers. For taxable years 2020 and 2021 (the most recent years for which data is available), a majority of foreign banks with excess U.S.-connected liabilities chose to calculate their actual rate rather than use the published rate election. In both years, approximately 80% of such taxpayers opted to calculate their actual rate, while less than 20% chose to use the published rate election available under § 1.882–5(d)(5)(ii)(B).

C. Mechanism for Endorsing Additional Replacement Rates

Finally, the comment recommended that the final regulations include a mechanism for identifying additional qualified alternative reference rates via Internal Revenue Bulletin, Revenue Procedure, or another similar notice. The final regulations do not adopt this recommendation. The Treasury Department and the IRS do not anticipate a need to name additional alternative reference rates, and, if the need does arise in the future, the Treasury Department and the IRS may prefer to propose any new alternative reference rate through the regulatory process.

II. Application of the Published Rate Election by the IRS in an Examination

If a taxpayer failed to file a timely return or incorrectly determined that it did not have excess U.S.-connected liabilities, § 1.882–5(d)(5)(ii)(B) allowed the Director of Field Operations to calculate the taxpayer's interest expense with respect to excess U.S.-connected liabilities using either the taxpayer's actual rate or the published rate provided by § 1.882–5(d)(5)(ii)(B). The final regulations amend this rule to require the Director of Field Operations to use the published rate in order to reduce the administrative burden of calculating the actual rate for both the IRS and taxpayers.

III. Transitional Rule for Taxable Years Including the Date of LIBOR Cessation

For a taxable year that begins before and ends after the USD LIBOR cessation date of June 30, 2023, a taxpayer that makes the published rate election available under § 1.882–5(d)(5)(ii)(B) must calculate a blended published rate average for the taxable year which uses the 30-day USD LIBOR for the portion of its taxable year ending on June 30, 2023, and the one-month Term SOFR, plus static spread adjustment, for the portion of its taxable year beginning on July 1, 2023.

IV. Applicability Date

These final regulations apply to taxable years ending after June 30, 2023.

II.G.21. Employee Stock Ownership Plans (ESOPs) and Other Code § 401(a) Qualified Retirement Plans Investing in Businesses

Although qualified retirement plans can invest in the employer's business (with incentives to use ESOPs), the IRS has long been wary of doing so for a start-up business.[1860] Part II.G.22 IRA as Business Owner describes special issues that apply to IRAs.

Any qualified retirement plan that holds an interest in a partnership will be required to pay unrelated business income tax on its distributive share of any business income, debt-financed income, or other unrelated business income.[1861]

Any qualified retirement plan that holds an interest in an S corporation will be required to pay unrelated business income tax on its distributive share of <u>all</u> of the S corporation's income,[1862] unless the qualified retirement plan is an Employee Stock Ownership Plan (ESOP).[1863] An ESOP is a plan that invests primarily in qualifying employer securities.[1864] "Employer securities" means "common stock issued by the employer."[1865] An entity that is a partnership for tax purposes does not have "stock" and therefore does not have "qualifying employer securities;" therefore, it fails to operate as an ESOP.[1866] Thus, if the goal is to have the business owned by

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[1860] The IRS calls the latter, "Rollovers as Business Start-Ups." See Compliance Project (irs.gov).
[1861] Code §§ 511(a)(2)(A) (referring to Code § 401(a), which describes qualified retirement plans), 512. See part II.Q.7.c.i.(b) Business Income Limiting Trust Income Tax Deduction.
[1862] Code §§ 511(a)(2)(A) (referring to Code § 401(a), which describes qualified retirement plans), 512(e)(1).
[1863] Code § 512(e)(3).
[1864] Code § 4975(e)(7)(A).
[1865] Code § 409(*l*).
[1866] *K.H. Company, LLC v. Commissioner*, T.C. Memo. 2014-31.

an ESOP, then an S corporation would be ideal. See also part II.A.2.i.viii Special Price Protection for Leveraged ESOP Approved.

To avoid all of the complexity above, a qualified plan might own its business through a C corporation. Even if it can get past various ERISA hurdles, consider that a C corporation does not have favorable capital gain tax rates, which means that the sale of its business assets (including goodwill) can be much more expensive than if a partnership or S corporation sold its assets. Also, various tools used to make C corporation business sales less tax-inefficient[1867] might be unavailable or might face ERISA regulatory hurdles. Furthermore, the C corporation stock does not receive a basis step-up at death; and, whenever the C corporation sale proceeds are distributed, they are distributed as ordinary income.

Any accrued compensation payable to an employee who participates in the ESOP is not deductible until paid.[1868] If the ESOP owns 100% of an S corporation, presumably it would not pay tax and therefore this rule would not be a concern.

Many other ESOP rules are beyond the scope of my materials.

II.G.22. IRA as Business Owner

An IRA would be subject to unrelated business income tax and other tax advantages and disadvantages, as described in part II.G.21 Employee Stock Ownership Plans (ESOPs) and Other Code § 401(a) Qualified Retirement Plans Investing in Businesses.

The IRS attacks the mechanics of the rollover, and taxpayers should do their best to roll over successfully. *McGaugh v. Commissioner*, T.C. Memo. 2016-28, *aff'd* 119 A.F.T.R.2d 2017-2359 (7th Cir. 6/26/2017), finding in favor of the taxpayer, reviewed prior cases for and against taxpayers and discussed how to make the rollover work:

> If we analyze the situation for possible "constructive receipt" of the funds from Merrill Lynch by Mr. McGaugh (and constructive transfer of the funds by him to FPFC), the outcome still does not change. "It is well established that the mere receipt and possession of money does not by itself constitute gross income." *Liddy v. Commissioner*, T.C. Memo. 1985-107, *aff'd*, 808 F.2d 312 (4th Cir. 1986). "We accept as sound law the rule that a taxpayer need not treat as income moneys which he did not receive under a claim of right, which were not his to keep, and which he was required to transmit to someone else as a mere conduit." *Diamond v. Commissioner*, 56 T.C. 530, 541 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974).
>
> Thus, money received as a mere agent or conduit is not includible in gross income. *Liddy v. Commissioner*, 808 F.2d at 314; *Diamond v. Commissioner*, 56 T.C. at 541. We have held that this principle may apply in the case of a taxpayer and an IRA, see *Ancira v. Commissioner*, 119 T.C. 135, 138 (2002); and the IRS so acknowledges.[5] The question at issue here is whether, in the wire transfer and subsequent stock purchase,

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[1867] See parts II.Q.1.b Leasing, II.Q.1.c Personal Goodwill and Covenants Not to Compete, and II.Q.1.d Nonqualified Deferred Compensation.

[1868] *Petersen v. Commissioner*, 148 T.C. 463 (2017), *aff'd* 123 A.F.T.R.2d 2019-XXXX (10th Cir. 5/15/2019), holding that participants were beneficiaries of a trust under Code § 267(c) and therefore deduction deferral under Code § 267(a)(2) applied.

Mr. McGaugh acted as a conduit to or an agent of the IRA fiduciary and custodian, Merrill Lynch.

[5] As the Commissioner states in his supplemental opposition (at 7-8) to the motion for summary judgment, "if Merrill Lynch, as custodian of petitioner's IRA, purchased the shares with funds from petitioner's IRA, either through petitioner as an agent/conduit or otherwise, then there may not have been a distribution. See *Ancira v. Commissioner*, 119 T.C. 135, 137-40 (2002) (the withdrawal of funds from an IRA did not give rise to a distribution, where the withdrawal was in the form of a check that could not be negotiated by the account owner, and the funds were used by the IRA custodian to acquire stock)."

Neither the Code nor the applicable regulations provide specific guidance on whether or when an amount is considered to have been "paid or distributed out of an individual retirement plan" through the use of the beneficiary as a conduit from the custodian to the investment. This Court has, however, addressed a case involving facts similar to Mr. McGaugh's: In *Ancira v. Commissioner*, 119 T.C. at 136, the taxpayer maintained a self-directed IRA, and during the year at issue he requested that his IRA custodian purchase a particular company's stock for his IRA. While the issuing company's stock was a permissible asset that could be held by the IRA, company policy of the custodian of the account did not permit it to directly purchase stock that was not publicly traded. *Id.* The taxpayer therefore requested a check made payable to the non-public issuing company, and the custodian sent the taxpayer the requested check. *Id.* The taxpayer forwarded the check to the issuing company, and the issuing company issued the stock certificate. *Id.* at 136-137. The certificate stated that the taxpayer's IRA was the owner of the shares of the stock, and the taxpayer presumed that the issuing company had sent the stock certificate to the IRA custodian as instructed. *Id.* At 137. However, for unspecified reasons the certificate was not delivered to the custodian, and the taxpayer did not discover the mistake until after receiving a notice of deficiency from the IRS. *Id.* After learning of the error, the taxpayer directed the issuing company to send the stock certificate to him, and he then delivered it directly to the custodian. *Id.*

In *Ancira* we held that no distribution from the IRA to the taxpayer occurred when the custodian delivered the check to him. *Id.* at 139. We observed that no distribution would have occurred if the custodian had either purchased stock directly from the issuing company or sent a check to a broker who then purchased the stock for the IRA. *Id.* At 137-138. We held that the taxpayer acted as an agent or conduit for the custodian because the taxpayer arranged the purchase but was not in constructive receipt of the check and the ownership of the stock was directly assumed by the IRA. *Id.* at 138. Moreover, we determined that the delay of the delivery of the stock certificate to the custodian was a bookkeeping error, which "did not alter the ownership of the stock by the IRA and certainly did not transfer the ownership to *** [the taxpayer]." *Id.* at 140.

Like the taxpayer in *Ancira*, Mr. McGaugh wished to acquire for his IRA stock that apparently could not be purchased directly by the custodian, Merrill Lynch. Mr. McGaugh therefore arranged the purchase of FPFC stock, instructed Merrill Lynch to make the wire transfer to FPFC, and instructed FPFC to deliver the certificate directly to Merrill Lynch. Moreover, unlike the taxpayer in *Ancira*, who received a check from the IRA and delivered it to the issuing company, Mr. McGaugh never personally handled any check by which the IRA funds were transmitted to FPFC. Instead, he requested that Merrill Lynch transfer the funds via wire transfer directly to the issuing company, and that transfer was duly made without Mr. McGaugh's interposition. And unlike the stock in *Ancira*, the FPFC stock certificate was sent directly to the custodian.

The Commissioner emphasizes that "[i]t appears that petitioner is in possession of the purported stock certificate." Even if Mr. McGaugh had physical possession of the stock certificate, he was not in constructive receipt of the asset. The "essence [of constructive receipt] is that funds which are subject to a taxpayer's unfettered command and which he is free to enjoy at his option are constructively received by him whether he sees fit to enjoy them or not." *Ancira v. Commissioner*, 119 T.C. at 138 (quoting *Estate of Brooks v. Commissioner*, 50 T.C. 585, 592 (1968)). Here, the stock was issued not in Mr. McGaugh's name but in the name "Raymond McGaugh IRA FBO Raymond McGaugh". Even with physical possession of the stock certificate, Mr. McGaugh could not have realized any practical utility or benefit from the certificate in the name of the IRA. (And if Merrill Lynch's attempts to mail the IRA's stock certificates to Mr. McGaugh in "early 2012" (contrary to his instructions and intention) gave him ownership of the shares, then that was a distinct 2012 transaction that would not affect his 2011 income tax liability.)

We are not persuaded by the Commissioner's argument that Mr. McGaugh's circumstances are similar to that of the taxpayer in *Dabney v. Commissioner*, T.C. Memo. 2014-108. In *Dabney* this Court found a taxable distribution from the taxpayer's IRA when the taxpayer explicitly requested an IRA distribution (to himself) with the goal of purchasing land for his IRA but failed to return the distribution (or any other property) to the account within the 60-day rollover period of section 408(d)(3). *Id.* at *5. The policies of the custodian, Charles Schwab, did not permit real property to be an asset of its IRAs, *id.* at *4, *11, so in March 2009 Mr. Dabney requested a distribution of his IRA funds and a transfer of those funds to the title company handling the property sale. Contrary to Schwab's policies, Mr. Dabney directed the company to issue title in the name of the IRA, but it failed to do so and put the property in his name. He tried to sell the property and finally succeeded in January 2011 and wired the proceeds to Schwab as a purported "rollover contribution". We held that the transfer of the funds from the IRA to Mr. Dabney constituted a taxable distribution.

Here, by contrast, Merrill Lynch previously permitted FPFC stock as an asset to be held in Mr. McGaugh's IRA, and its subsequent correspondence seems to indicate that if the stock at issue had been received within the 60-day period, it would have been accepted. And here the stock certificate bears the name of the IRA as its owner; and it is therefore not like the real property in *Dabney* that, for more than a year, was titled in the name of the individual taxpayer. Mr. Dabney requested a distribution in order to conduct a real estate transaction not permitted by the IRA, whereas Mr. McGaugh directed the IRA to make a permissible investment. This case is not like *Dabney*.

Rather, this case resembles *Ancira*. We hold that Mr. McGaugh did not receive a distribution when Merrill Lynch made the wire transfer to FPFC; and to the extent that he had control over the wired funds, he at most acted as a conduit for the IRA custodian. Consequently, the 60-day limitation on a rollover under section 408(d)(3) does not really come into play in this case. The timing of the mailing of the shares (i.e., more than 60 days after the wire transfer) does not alter our conclusion that there was no distribution from the IRA to Mr. McGaugh. We will therefore grant Mr. McGaugh's motion for summary judgment.

In *Vandenbosch v. Commissioner*, T.C. Memo. 2016-29, the taxpayer moved money from his IRA to a joint account, moved it from the joint account into his personal account, and wired it to a borrower, in exchange for a note from the borrower payable to the taxpayer (not to his IRA). Not surprisingly, the taxpayer's claim that he was a conduit for his IRA in the same manner as in *McGaugh* got him nowhere, although he was able to avoid penalties because he had discussed the situation with his CPA income tax return preparer.

The Summary of *Estate of Caan v. Commissioner*, 161 T.C. No. 6 (2023), described the case:

> Decedent (D) held two IRAs with UBS. Both IRAs were governed by a custodial agreement between D and UBS. One of the IRAs held a partnership interest (P&A Interest) in the P&A Fund, a hedge fund. The custodial agreement between D and UBS stated that it was D's responsibility to provide UBS with the P&A Interest's yearend fair market value (FMV) every year. When D did not satisfy this responsibility for tax year 2015, UBS notified D that it had distributed the P&A Interest to him pursuant to the relevant terms of the custodial agreement. P claims such a distribution did not occur.
>
> UBS issued Form 1099-R to D, reporting a distribution. UBS valued the P&A Interest at $1,910,903, which was its 2013 FMV and the last FMV known to UBS. (R admitted in his posttrial briefs that UBS misvalued the P&A Interest.) More than a year after the notification from UBS, D's financial advisor, acting on D's behalf, liquidated the P&A Interest and contributed the cash proceeds to D's IRA at ML, an investment manager.
>
> On his 2015 income tax return, D reported an IRA distribution but claimed that it was nontaxable as a rollover contribution under I.R.C. § 408(d)(3). R disagreed and issued a notice of deficiency, determining that there was a taxable distribution. D then requested that R issue a private letter ruling to waive the 60-day period for rollover contributions. See I.R.C. § 408(d)(3)(A)(i), (I). D also filed a Petition with this Court for redetermination of his 2015 income tax deficiency. See I.R.C. § 6213(a). During the pendency of this case, R declined to issue the private letter ruling, stating that the 60-day period could not be waived because D was required to contribute the P&A Interest (not cash) to ML in order for the distribution to be nontaxable as a rollover contribution. See I.R.C. § 408(d)(3)(A)(i); *Lemishow v. Commissioner*, 110 T.C. 110, 113 (1998), supplemented by 110 T.C. 346 (1998); Treas. Reg. § 1.408-4(b)(1).
>
> *Held*: The P&A Interest was distributed to D in tax year 2015 within the meaning of I.R.C. § 408(d)(1).
>
> *Held, further*, the P&A Interest was not contributed to ML in a manner that would qualify as a rollover contribution under I.R.C. § 408(d)(3).
>
> *Held, further*, under I.R.C. § 408(d)(1), D is taxable for 2015 on the P&A Interest's value at the time of the distribution.
>
> *Held, further*, the value of the P&A Interest at the time of the distribution was $1,548,010.
>
> *Held, further*, we have jurisdiction under I.R.C. § 6213(a) to review R's denial of D's I.R.C. § 408(d)(3)(I) request for a waiver of the 60-day period for rollover contributions.
>
> *Held, further*, we review a denial of a request for a waiver under I.R.C. § 408(d)(3)(I) for abuse of discretion.

> *Held, further*, R did not abuse his discretion in denying P a waiver under I.R.C. § 408(d)(3)(I).

The IRS tends to audit Roth IRA ownership of a business, requiring certain situations to be reported as "listed transactions" on special disclosure forms.[1869] The IRS unsuccessfully tried to expand its Roth IRA attacks when a father's business was discontinued and his son's Roth IRAs started a new corporation engaging in what the IRS viewed to be a continuation of the old business.[1870]

However, the Tax Court has held that an IRA that invests in a business engages in a prohibited transaction when the business compensates the IRA's owner (even when the compensation is modest).[1871] If the business does not compensate the IRA's owner, the IRA's owner might be deemed to have received compensation and then made a contribution to the IRA. Furthermore, when an IRA's owner guarantees the IRA'S corporation's seller-financed purchase of business assets from an unrelated third party, the guarantee is a prohibited transaction that disqualifies the IRA.[1872] Thus, activities very common for start-up businesses – the owner or the owner's family working in the business and the owner guaranteeing loans – are forbidden to businesses owned by IRAs.

[1869] Notice 2004-8. *Polowniak v. Commissioner*, T.C. Memo. 2016-31, imposed a 30% penalty under Code § 6662A for 2004 on the original amount reflected in the notice of deficiency. See also *Yari v. Commissioner*, 143 T.C. 157 (2014) *aff'd* in an unpublished opinion, 118 A.F.T.R.2d 2016-6096 (9th Cir. 2016) (penalty based on original return, not amended return).

[1870] See part II.Q.7.h.v Taxpayer Win in *Bross Trucking* When IRS Asserted Corporation Distribution of Goodwill to Shareholder Followed by Gift to Shareholder of New Corporation (2014), particularly fn. 5124.

[1871] *Ellis v. Commissioner*, T.C. Memo. 2013-245:

> In essence, Mr. Ellis formulated a plan in which he would use his retirement savings as startup capital for a used car business. Mr. Ellis would operate this business and use it as his primary source of income by paying himself compensation for his role in its day-to-day operation. Mr. Ellis effected this plan by establishing the used car business as an investment of his IRA, attempting to preserve the integrity of the IRA as a qualified retirement plan. However, this is precisely the kind of self-dealing that section 4975 was enacted to prevent. For the foregoing reasons, the Court sustains respondent's determination that Mr. Ellis engaged in prohibited transactions under section 4975(c)(1)(D) and (E) when he caused CST to pay him compensation of $9,754 in tax year 2005.

The court also upheld an accuracy-related penalty. The Eighth Circuit affirmed, 787 F.3d 1213 (2015), and also rebuffed the taxpayers' argument that Code § 4975(d)(10) excluded fees for their services from being a prohibited transaction, holding that the exclusion applies only to services for the IRA and not to services performed for businesses owned by the IRA. The formation of the LLC itself did not constitute a *per se* prohibited transaction, and the court declined to address the IRS' assertion that the initial intent to engage in prohibited transactions tainted the formation, because the payment of wages that was definitely a prohibited transaction occurred in the same taxable year as the LLC's formation.

See also *Repetto v. Commissioner*, T.C. Memo. 2012-168, in which the court recharacterized service payments made to purported service corporations that were owned by Roth IRAs, holding that the agreements were designed to permit, and did permit, the taxpayer to make excessive contributions to the Roth IRAs through the disguised service payments. *Polowniak v. Commissioner*, T.C. Memo. 2016-31, had a similar result.

[1872] *Thiessen v. Commissioner*, 146 T.C. No. 7 (2016) (6-year statute of limitations applied because the issue of prohibited transaction was not disclosed anywhere), following *Peek v. Commissioner*, 140 T.C. 216 (2013).

An IRA's purchase of real estate that would tend to benefit adjoining real estate owned by the IRA's owner was a prohibited transaction.[1873]

After two false starts,[1874] the IRS successfully attacked IRAs' formation of a DISC in Tax Court, before being rebuked by the Sixth Circuit. A DISC is a statutory scheme designed to give a tax break to exporters by allowing them to deduct commissions paid to companies (even shell companies).[1875] The Tax Court held that the IRS properly recharacterized commissions as dividends to the exporter's shareholders followed by excess contributions to their Roth IRAs when the taxpayers' "sole reason for entering into the transaction at issue was to transfer money into the … Roth IRAs so that income on assets could accumulate and be distributed tax free. Petitioners had no nontax business purpose for the transactions, nor did they receive any economic benefit from the transactions."[1876] However, the Sixth Circuit pointed out, "By congressional design, DISCs are all form and no substance, making it inappropriate to tag Summa Holdings with a substance-over-form complaint with respect to its use of DISCs," further explaining, "No court has used this power to override statutory provisions whose only function is

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[1873] *Kellerman v. Rice*, 116 A.F.T.R.2d 2015-6133 (D. Ark. 2015), holding that this prohibited transaction disqualified the IRA and caused the IRA's assets to be subject to the IRA's owner's bankruptcy creditors.
[1874] *Swanson v. Commissioner*, 106 T.C. 76 (1996) (formation of DISC by traditional IRA was not a prohibited transaction; taxpayer awarded legal fees because IRS' position wasn't substantially justified); *Hellweg v. Commissioner*, T.C. Memo. 2011-58 (IRS could not challenge the substance of the transaction for income tax purposes in the absence of fraud or an illegal purpose behind the DISC transaction).
[1875] *Summa Holdings, Inc. v. Commissioner*, T.C. Memo. 2015-119, explained:

> A DISC provides a mechanism for deferral of a portion of the Federal income tax on income from exports. The DISC itself is not taxed, but instead the DISC's shareholders are currently taxed on a portion of the DISC's earnings in the form of a deemed distribution. Secs. 991, 995(b)(1). This allows for deferral of taxation on the remainder of the DISC's earnings until those earnings are actually distributed, the shareholders dispose of their DISC stock in a taxable transaction, or the corporation ceases to qualify as a DISC, Secs. 995(b)(2), 996(a)(1).
>
> A DISC sometimes does not generate the income it reports on its returns and might otherwise not be recognized as a corporate entity for tax purposes if it were not a DISC. *Addison Int'l, Inc. v. Commissioner*, 90 T.C. 1207 (1988), *aff'd*, 887 F.2d 660 (6th Cir. 1989); *Jet Research, Inc. v. Commissioner*, T.C. Memo. 1990-463; see also sec. 1.992-1(a), Income Tax Regs. "The DISC may be no more than a shell corporation, which performs no functions other than to receive commissions on foreign sales made by its parent." *Thomas Int'l Ltd. v. United States*, 773 F.2d 300, 301 (Fed. Cir. 1985); *Foley Mach. Co. v. Commissioner*, 91 T.C. 434, 438 (1988); see also *Jet Research, Inc. v. Commissioner*, T.C. Memo. 1990-463.

Polowniak v. Commissioner, T.C. Memo. 2016-31, also reallocated income, not under Code § 482 but rather allocating the income to the taxpayer who truly earned it.
[1876] *Summa Holdings, Inc. v. Commissioner*, T.C. Memo. 2015-119, also addressed arguments regarding DISCs being statutorily favored, rejecting taxpayers' arguments that *Hellweg v. Commissioner*, T.C. Memo. 2011-58, protected them:

> Petitioners argue that since Congress could have prohibited transactions involving DISCs owned by IRAs but chose not to do so, Congress was comfortable with IRAs' holding DISC stock. We rejected this argument in *Hellweg*. As we stated in *Hellweg*, this argument is logically erroneous. See *Hellweg v. Commissioner*, slip op. at 13. Congress' choice to prevent one particular abusive transaction involving DISCs and IRAs does not indicate that Congress approves of all other abusive transactions involving DISCs and IRAs. See *id*. at 13-14.
>
> Section 995(g) was enacted in 1988, almost 10 years before the enactment of the Roth IRA provisions, which were enacted as part of the Taxpayer Relief Act of 1997, sec. 302. They became effective for tax years beginning after December 31, 1997. *Id.* sec. 302(f), 111 Stat. at 829. Congress could not have been aware of the type of abusive transaction involving Roth IRAs at issue here at the time of enactment of section 995(g).

to enable tax savings, as the Commissioner seeks to do in this instance."[1877] Furthermore, "the Code authorizes investors to avoid significant taxes on capital gains and dividends by using their Roth IRAs in all manner of tax-avoiding ways, including by buying shares in promising new companies whose share prices may rise considerably over time or which may pay out large dividends over time."[1878] The Sixth Circuit pointed out that any deemed or actual dividend received from a DISC and any gain on the disposition of DISC shares received by an IRA are subject to unrelated business income tax,[1879] so Congress has addressed tax-exempt entities owning DISCs, and courts should not let the IRS override the statutory scheme.[1880] The Sixth Circuit's reversal provided the exporter with deductions for DISC commissions paid; the shareholders (the Benensons and a trust for their children) appealed to the First and Second Circuits, and the First Circuit applied logic similar to that of the Sixth Circuit in reversing the Tax Court[1881] and the Second Circuit reversed the Tax Court as well.[1882]

However, taxpayers were hit with an excise tax for excess contributions on similar deal involving a different export tax break. The official tax court syllabus of *Mazzei v. Commissioner*, 150 T.C. No. 7 (2018), summarizes:

> Ps entered into a prepackaged plan to save taxes by routing funds from their family business through a Bermuda-based foreign sales corporation (FSC) and then into Roth IRAs created for this purpose. Pursuant to this plan, in 1998 each P directly contributed $2,000, the applicable contribution limit, to his or her newly created Roth IRA, which then paid a nominal amount for stock in the FSC. From 1998 to 2002 Ps routed payments totaling $533,057 from their family business, through the FSC, and into their Roth IRAs.
>
> Ps contend that we should respect the form of these transactions as payments from Ps' business to the FSC, followed by payments of dividends by the FSC to the Roth IRAs. R contends that the payments from the FSC to Ps' Roth IRAs represented, in substance, contributions from Ps to their Roth IRAs. R contends that because these payments exceeded Ps' contribution limits for their Roth IRAs, Ps are liable for excise taxes under I.R.C. sec. 4973.
>
> *Held*: On the facts presented, Ps and not their Roth IRAs were the owners, for Federal tax purposes, of the FSC stock; in substance the FSC dividends were income to Ps, who

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[1877] *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779 (6th Cir. 2017). The taxpayer had deducted the DISC commissions, and the Tax Court had held that the taxpayer could not deduct the payments. The Sixth Circuit case applies only to this taxpayer. The other taxpayers involved - the Roth IRA owners and a trust that owned the DISC – have appealed the Tax Court's findings to the First and Second Circuits.
[1878] *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779 (6th Cir. 2017).
[1879] Code § 995(g); see ¶ D-6834 DISC dividends as unrelated trade or business income, *Federal Tax Coordinator Analysis* (RIA).
[1880] *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779 (6th Cir. 2017), concluding:

> If Congress sees DISC-Roth IRA transactions of this sort as unwise or as creating an improper loophole, it should fix the problem. Until then, the DISC will continue to provide tax savings to the owners of U.S. export companies, just as Congress intended—even if subsequent changes to the Code have increased the scale of the savings beyond Congress's original estimation. The last thing the federal courts should be doing is rewarding Congress's creation of an intricate and complicated Internal Revenue Code by closing gaps in taxation whenever that complexity creates them.

[1881] *Benenson v. Commissioner*, 121 A.F.T.R.2d ¶2018-634 (1st Cir. 4/6/2018) (IRS never argued that the shares were subscribed at too low a price).
[1882] *Benenson v. Commissioner*, 122 A.F.T.R.2d ¶2018-6897 (2nd Cir. 12/14/2018) (DISC commissions did not constitute constructive dividend to the exporter's shareholders).

contributed the funds to their Roth IRAs. *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779 (6th Cir. 2017), *rev'g* T.C. Memo. 2015-119, distinguished.

Held, further, pursuant to I.R.C. sec. 4973 Ps are liable for excise taxes on excess contributions *to* their Roth IRAs.

Held, further, R's imposition of additions to tax under I.R.C. sec. 6651(a)(1) and (2) is not sustained.

Mazzei, a reviewed decision with a spirited dissent, concluded:

> In form, petitioners' Roth IRAs purchased FSC stock for $1 and the FSC simultaneously entered into a series of contracts with Injector Co., which were executed as part of the plan of purchase. As described, the Roth IRAs effectively paid nothing for the FSC stock, put nothing at risk, and from an objective perspective, could not have expected any benefits. From that nominal initial investment, petitioners claim that their Roth IRAs earned dividends totaling $533,057 over four years.
>
> Considering all the facts in the record, however, it is evident that the Roth IRAs' formal purchase of the FSC stock for $1 did not reflect the underlying reality; *i.e.*, petitioners' capacity (through Injector Co.)[39] and clear intention to direct Injector Co. to make large commission payments to the FSC. The form of the transactions the Roth IRAs entered into does not reflect the underlying related-party expectations and intentions. Petitioners' transactions attempt to utilize this mismatch between substance and form to defeat the contribution limits. We have not found any textual support in the Code or the regulations that would allow such a mismatch between the form and substance of a purchase by these Roth IRAs. We therefore disregard the purchase.
>
> [39] Petitioners' export receipts had fluctuated to some degree over the years, but they had reliable and established export receipts when they entered these transactions.
>
> Furthermore, because petitioners (through various passthrough entities) controlled every aspect of the transactions in question, we conclude that they, and not their Roth IRAs, were the owners of the FSC stock for Federal tax purposes at all relevant times.[40] The dividends from the FSC are therefore properly recharacterized as dividends from the FSC to petitioners, followed by petitioners' contributions of these amounts to their respective Roth IRAs. All of these payments exceeded the applicable contribution limits and were therefore excess contributions. We therefore uphold respondent's determination of excise taxes under section 4973.
>
> [40] We note that, because no income tax issues are presented in these cases, we need not and do not consider whether the FSC was owned by and through one of petitioners' passthrough entities rather than directly by petitioners.

The majority noted that the case is appealable to a different court of appeals than the one that reversed the Tax Court in *Summa Holdings* and made various arguments why the cases were different; I agree with the dissent that the majority was just making excuses for not accepting the Sixth Circuit's rebuke. At any rate, DISCs replaced FSCs, so the case's true significance is in two areas: first, the majority of the Tax Court has not accepted the Sixth Circuit's rebuke; second, the majority of the Tax Court has signaled a clear warning against nominally funded entities that make profits disproportionate to the underlying investment in related party transactions.[1883] Citing contract terms that gave the exporting company complete control over how much the FSC received,[1884] the court concluded, "On these facts, no independent holder of the FSC stock could realistically have expected to receive any benefits (before or after tax) due

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[1883] The Tax Court stated:

> A "de minimis risk does not necessarily give substance to a transaction that is otherwise without risk." *John Hancock Life Ins. Co. (U.S.A.) v. Commissioner*, 141 T.C. 1, 94 (2013) (citing *ASA Investerings P'ship v. Commissioner*, 201 F.3d 505, 514-515 (D.C. Cir. 2000), *aff'g* T.C. Memo. 1998-305).

In footnote 37, the majority stated:

> The dissent asserts that under our reasoning petitioners "couldn't have owned the FSC either", because petitioners also put nothing at risk. See dissenting op. p. 91. This is incorrect; petitioners were exposed at all times to the underlying business risk, *i.e.*, that their investment in their export business would decline. The Roth IRAs were not exposed to that risk because they never made an investment (they paid only a nominal amount for the FSC stock and never capitalized the FSC) and because no fixed right to receive commission payments was ever transferred to the FSC (*i.e.*, if a fixed right to receive a portion of the export income had been transferred to the FSC, the value of the FSC stock would have varied with the export market and the Roth IRAs would have been exposed to the risk that the right to receive income held by the FSC would decline with the export market).
>
> In any event, in these cases we are examining whether the purchase transaction was sufficient to transfer substantive ownership to the Roth IRAs; risk is just one factor to be considered. Even if petitioners bore little risk with respect to the FSC, they owned the FSC because they controlled every aspect of its existence through the contractual powers retained by Injector Co. (discussed in the next section); the Roth IRAs (unlike, for example, the taxpayer in *Frank Lyon*) put nothing at risk to alter this ownership equation.

[1884] The court found:

> Injector Co. retained complete control over whether any of its export receipts would flow to the FSC in any year. The commission agreement between petitioners' business and the FSC states: "At all times … [petitioners' business] shall have the discretion as to when and how much it wishes to pay FSC and no account receivable shall ever exist between FSC and … [petitioners' business]." Consequently, no independent holder of the FSC stock would have been entitled to, or would have expected, any upside; Injector Co. retained complete control over whether any payments would ever be made.
>
> Furthermore, Injector Co.'s control over upside profits extended beyond the discretion to direct commission payments to the FSC. The commission agreement also allowed Injector Co. to reach into the FSC and take back any payments that had already been made—i.e., under the commission agreement, petitioners' business controlled any profits even after those profits had been paid to the FSC.[38]
>
> [38] More specifically, the commission agreement provided that any amount paid to the FSC by petitioners' business
>
>> shall be agreed upon by the parties and may vary from time to time by mutual agreement, so as to provide the maximum [F]ederal income tax benefits to … [petitioners' business] and [the] FSC …. [Petitioners' business] shall have the final decision as to whether [the] FSC is considered to have solicited or promoted a transaction with a customer and may prospectively or retroactively add or delete transactions entitling [the] FSC to a commission. [Emphasis added.]
>
> (Similar provisions also existed for sale, license, and lease commissions.) The duration of the power to retroactively delete transactions is not specified, but nothing in the record rules out the possibility that petitioners' business could have deleted a transaction even after the associated commission had been paid to the FSC. In other words, Injector Co. retained the power to decide—after the commissions were paid - that the FSC was not entitled to a commission with respect to a particular export transaction. Deletion of the export transaction would have had the effect of converting the associated commission payment into a loan from Injector Co. to the FSC under a section of the commission agreement detailing the treatment of overpayments.

to its formal ownership of the FSC stock; Injector Co. retained control over any benefits at all relevant times." That is what set the stage for the conclusion that the exporter was essentially distributing money to its owners, who made excess contributions to their Roth IRAs that owned the FSCs. For further discussion of this case, including the Ninth Circuit's rebuke of the Tax Court's smell test in *Mazzei*, see part II.G.17.c Economic Substance, Sham Transaction, Business Purpose, and Substance Over Form Doctrines.

If a business entity owned at least in part by a Roth IRA transacts with related parties and if somehow self-dealing issues can be avoided, be careful to document the agreements, enforce the agreements, and include staffing sufficient to operate the entity.[1885] However, none of the IRA's owner, family, or friends should be involved, because compensating them may constitute self-dealing, and not compensating them may be recharacterized as (if a family member or friend, first a gift to the owner then) an excess contribution by the owner.

For more about IRAs, consult me or check out www.ataxplan.com, the web page of IRA guru Natalie Choate, whose book I commend to all estate planning professionals and the latest version of which is available at https://www.retirementbenefitsplanning.com for $9 per month, cancelable at any time. For more on self-dealing issues that are especially risky with IRAs but can also cause problems with qualified plans, check out the web page of Texas attorney Noel Ice.[1886]

Natalie recommends that every IRA owner file Form 5329 annually to run the statute of limitations on excess contributions and other penalties involving IRAs; consider following that

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[1885] *Block Developers, LLC v. Commissioner*, T.C. Memo. 2017-142, treated as excess contributions to the LLC's Roth IRA owners distributions derived from the licensing of patents acquired in a purported sale-leaseback. Comparing the case to *Polowniak v. Commissioner*, T.C. Memo. 2016-31, the court reasoned:

> The similarities between *Polowniak* and these cases are undeniable. SR Products' sale of the Verdura Block patents to Block Developers had no substantive effect on how Jansson operated his businesses. Jansson's companies continued to produce the blocks, test the blocks, and make sure the blocks were certified. The Jansson family continued to attend trade shows and take on clients without any mention of Block Developers. And the expense of performing these tasks remained on Jansson - he was never reimbursed by Block Developers.
>
> As in *Polowniak*, there were major holes in the business dealings between the old company and the new. Block Developers did not keep consistent records, and billing statements to SR Products did not match up with payments. There is little evidence in the record detailing what services Block Developers actually performed for SR Products—not that it seems it could have without a single employee. Nor did the parties adhere to written agreements - if SR Products did not have the funds to make a royalty payment, it simply did not pay, and Block Developers did nothing about it. Block Developers' administration was no different: It did not employ anyone to perform even menial administrative tasks, and other than Maxam's testimony—which we don't believe on this point—there is no evidence to suggest that Block Developers itself ever tried to market the Verdura Block patents.
>
> Jansson's claim that Block Developers had a legitimate business purpose falls apart rather quickly after even a cursory view of the record. He says that he sold the Verdura Block patents to generate cash. This is illogical - the money Block Developers paid to SR Products in exchange for the Verdura Block patents came from SR Products, which means the sale did not actually raise new capital for SR Products. Jansson's claim that Block Developers would protect his assets is unfounded - Maxam did not take steps to protect Block Developers' interests in the patents, and there is no additional evidence or testimony to lead us to conclude that Block Developers' formation somehow protected the Janssons' assets. And, as we've already found, the record is void of any credible evidence that Block Developers tried to license the Verdura Block patents.

[1886] http://trustsandestates.net/retirement-planning.html.

advice if the IRA owns a business, otherwise engages in any activity that might possibly generate an excise tax, or is or might be required to make minimum distributions that year. The Tax Court has upheld penalties for failure to file Forms 5329 incidental to upholding the 6% excise tax on excess contributions to Roth IRAs on some of the cases described above.[1887]

However, note that disqualification of an IRA can cause it to lose its protection from creditors, so tax and penalties are not the only concern here.[1888]

II.G.23. Employee vs. Independent Contractor

Whether a service provider is an independent contractor or an employee is important for FICA (Social Security),[1889] FUTA (unemployment),[1890] and income tax withholding.[1891]

The IRS looks at 20 factors as part of a facts-and-circumstances test.[1892] The Tax Court focuses on the ones that seem to be the most relevant to the situation.[1893]

On January 10, 2024, the Department of Labor amended 29 C.F.R. Chapter 795, effective March 11, 2024, in a document titled, "Employee or Independent Contractor Classification Under the Fair Labor Standards Act."

29 C.F.R. § 795.100, "Introductory statement," provides:

> This part contains the Department of Labor's (the Department) general interpretations for determining whether workers are employees or independent contractors under the Fair Labor Standards Act (FLSA or Act). See 29 U.S.C. 201-19. These interpretations are intended to serve as a "practical guide to employers and employees" as to how the Department will seek to apply the Act. *Skidmore v. Swift & Co.*, 323 U.S. 134, 138 (1944). The Administrator of the Department's Wage and Hour Division will use these interpretations to guide the performance of their duties under the Act, unless and until the Administrator is otherwise directed by authoritative decisions of the courts or the Administrator concludes upon reexamination of an interpretation that it is incorrect. To the extent that prior administrative rulings, interpretations, practices, or enforcement policies relating to determining who is an employee or independent contractor under the Act are inconsistent or in conflict with the interpretations stated in this part, they are hereby rescinded. The interpretations stated in this part may be relied upon in accordance with section 10 of the Portal-to-Portal Act, 29 U.S.C. 251-262, notwithstanding that after any act or omission in the course of such reliance, the interpretation is modified or rescinded or is determined by judicial authority to be invalid or of no legal effect. 29 U.S.C. 259.

29 C.F.R. § 795.100, "Determining employee or independent contractor classification under the FLSA," provides:

[1887] *Mazzei v. Commissioner*, T.C. Memo. 2014-55 (passage of statute of limitations on the income tax compensation issue did not preclude IRS from assessing an excise tax for excess contribution to an IRA).
[1888] See fn. 1873.
[1889] Reg. § 31.3121(d)-1(c).
[1890] Reg. § 31.3306(i)-1.
[1891] Reg. § 31.3401(c)-1.
[1892] Rev. Rul. 87-41.
[1893] *Rahman v. Commissioner*, T.C. Summary Opinion 2014-35.

(a) *Relevance of independent contractor or employee status under the Act*. The Act's minimum wage, overtime pay, and recordkeeping obligations apply only to workers who are covered employees. Workers who are independent contractors are not covered by these protections. Labeling employees as "independent contractors" does not make these protections inapplicable. A determination of whether a worker is an employee or independent contractor under the Act focuses on the economic realities of the worker's relationship with the worker's potential employer and whether the worker is either economically dependent on the potential employer for work or in business for themself.

(b) *Economic dependence as the ultimate inquiry*. An "employee" under the Act is an individual whom an employer suffers, permits, or otherwise employs to work. 29 U.S.C. 203(e)(1), (g). "Employer" is defined to "include[ ] any person acting directly or indirectly in the interest of an employer in relation to an employee." 29 U.S.C. 203(d). The Act's definitions are meant to encompass as employees all workers who, as a matter of economic reality, are economically dependent on an employer for work. A worker is an independent contractor, as distinguished from an "employee" under the Act, if the worker is, as a matter of economic reality, in business for themself. Economic dependence does not focus on the amount of income the worker earns, or whether the worker has other sources of income.

29 C.F.R. § 795.110, "Economic reality test to determine economic dependence," provides:

(a) *Economic reality test*.

(1) In order to determine economic dependence, multiple factors assessing the economic realities of the working relationship are used. These factors are tools or guides to conduct a totality-of-the-circumstances analysis. This means that the outcome of the analysis does not depend on isolated factors but rather upon the circumstances of the whole activity to answer the question of whether the worker is economically dependent on the potential employer for work or is in business for themself.

(2) The six factors described in paragraphs (b)(1) through (6) of this section should guide an assessment of the economic realities of the working relationship and the question of economic dependence. Consistent with a totality-of-the-circumstances analysis, no one factor or subset of factors is necessarily dispositive, and the weight to give each factor may depend on the facts and circumstances of the particular relationship. Moreover, these six factors are not exhaustive. As explained in paragraph (b)(7) of this section, additional factors may be considered.

(b) *Economic reality factors*

(1) *Opportunity for profit or loss depending on managerial skill*. This factor considers whether the worker has opportunities for profit or loss based on managerial skill (including initiative or business acumen or judgment) that affect the worker's economic success or failure in performing the work. The following facts, among others, can be relevant: whether the worker determines or can meaningfully negotiate the charge or pay for the work provided; whether the worker accepts or declines jobs or chooses the order and/or time in which the jobs are performed;

whether the worker engages in marketing, advertising, or other efforts to expand their business or secure more work; and whether the worker makes decisions to hire others, purchase materials and equipment, and/or rent space. If a worker has no opportunity for a profit or loss, then this factor suggests that the worker is an employee. Some decisions by a worker that can affect the amount of pay that a worker receives, such as the decision to work more hours or take more jobs when paid a fixed rate per hour or per job, generally do not reflect the exercise of managerial skill indicating independent contractor status under this factor.

(2) *Investments by the worker and the potential employer*. This factor considers whether any investments by a worker are capital or entrepreneurial in nature. Costs to a worker of tools and equipment to perform a specific job, costs of workers' labor, and costs that the potential employer imposes unilaterally on the worker, for example, are not evidence of capital or entrepreneurial investment and indicate employee status. Investments that are capital or entrepreneurial in nature and thus indicate independent contractor status generally support an independent business and serve a business-like function, such as increasing the worker's ability to do different types of or more work, reducing costs, or extending market reach. Additionally, the worker's investments should be considered on a relative basis with the potential employer's investments in its overall business. The worker's investments need not be equal to the potential employer's investments and should not be compared only in terms of the dollar values of investments or the sizes of the worker and the potential employer. Instead, the focus should be on comparing the investments to determine whether the worker is making similar types of investments as the potential employer (even if on a smaller scale) to suggest that the worker is operating independently, which would indicate independent contractor status.

(3) *Degree of permanence of the work relationship*. This factor weighs in favor of the worker being an employee when the work relationship is indefinite in duration, continuous, or exclusive of work for other employers. This factor weighs in favor of the worker being an independent contractor when the work relationship is definite in duration, non-exclusive, project-based, or sporadic based on the worker being in business for themself and marketing their services or labor to multiple entities. This may include regularly occurring fixed periods of work, although the seasonal or temporary nature of work by itself would not necessarily indicate independent contractor classification. Where a lack of permanence is due to operational characteristics that are unique or intrinsic to particular businesses or industries and the workers they employ, this factor is not necessarily indicative of independent contractor status unless the worker is exercising their own independent business initiative.

(4) *Nature and degree of control*. This factor considers the potential employer's control, including reserved control, over the performance of the work and the economic aspects of the working relationship. Facts relevant to the potential employer's control over the worker include whether the potential employer sets the worker's schedule, supervises the performance of the work, or explicitly limits the worker's ability to work for others. Additionally, facts relevant to the potential employer's control over the worker include whether the potential employer uses technological means to supervise the performance of the work (such as by means of a device or electronically), reserves the right to supervise or discipline

workers, or places demands or restrictions on workers that do not allow them to work for others or work when they choose. Whether the potential employer controls economic aspects of the working relationship should also be considered, including control over prices or rates for services and the marketing of the services or products provided by the worker. Actions taken by the potential employer for the sole purpose of complying with a specific, applicable Federal, State, Tribal, or local law or regulation are not indicative of control. Actions taken by the potential employer that go beyond compliance with a specific, applicable Federal, State, Tribal, or local law or regulation and instead serve the potential employer's own compliance methods, safety, quality control, or contractual or customer service standards may be indicative of control. More indicia of control by the potential employer favors employee status; more indicia of control by the worker favors independent contractor status.

(5) *Extent to which the work performed is an integral part of the potential employer's business*. This factor considers whether the work performed is an integral part of the potential employer's business. This factor does not depend on whether any individual worker in particular is an integral part of the business, but rather whether the function they perform is an integral part of the business. This factor weighs in favor of the worker being an employee when the work they perform is critical, necessary, or central to the potential employer's principal business. This factor weighs in favor of the worker being an independent contractor when the work they perform is not critical, necessary, or central to the potential employer's principal business.

(6) *Skill and initiative*. This factor considers whether the worker uses specialized skills to perform the work and whether those skills contribute to business-like initiative. This factor indicates employee status where the worker does not use specialized skills in performing the work or where the worker is dependent on training from the potential employer to perform the work. Where the worker brings specialized skills to the work relationship, this fact is not itself indicative of independent contractor status because both employees and independent contractors may be skilled workers. It is the worker's use of those specialized skills in connection with business-like initiative that indicates that the worker is an independent contractor.

(7) *Additional factors*. Additional factors may be relevant in determining whether the worker is an employee or independent contractor for purposes of the FLSA, if the factors in some way indicate whether the worker is in business for themself, as opposed to being economically dependent on the potential employer for work.

29 C.F.R. § 795.115, “Severability,” provides:

> If any provision of this part is held to be invalid or unenforceable by its terms, or as applied to any person or circumstance, or stayed pending further agency action, the provision shall be construed so as to continue to give the maximum effect to the provision permitted by law, unless such holding shall be one of utter invalidity or unenforceability, in which event the provision shall be severable from this part and shall not affect the remainder thereof.

The preamble to the above discusses tax issues:

2. Tax Liabilities

As self-employed workers, independent contractors are legally obligated to pay both the employee and employer shares of the Federal Insurance Contributions Act (FICA) taxes. Thus, if workers' classifications change from independent contractors to employees, there could be a transfer in federal tax liabilities from workers to employers.[637] Although this rule only addresses whether a worker is an employee or an independent contractor under the FLSA, the Department assumes in this analysis that employers are likely to keep the status of most workers the same across all benefits and requirements, including for tax purposes.[638] These payroll taxes include the 6.2 percent employer component of the Social Security tax and the 1.45 percent employer component of the Medicare tax.[639] In sum, independent contractors are legally responsible for an additional 7.65 percent of their earnings in FICA taxes (less the applicable tax deduction for this additional payment). Some of this increased tax liability may be partially or wholly paid for by the individuals and companies that engage independent contractors, to the extent that the compensation paid to independent contractors accounts for this added tax liability. However, changes in compensation are discussed separately below. Changes in benefits, tax liability, and earnings must be considered in tandem to identify how the standard of living may change.

[637] See 86 FR 1218.

[638] Courts have noted that the FLSA has the broadest conception of employment under federal law. See, *e.g., Darden*, 503 U.S. at 326. To the extent that businesses making employment status determinations base their decisions on the most demanding federal standard, a rulemaking addressing the standard for determining classification of worker as an employee or an independent contractor under the FLSA may affect the businesses' classification decisions for purposes of benefits and legal requirements under other federal laws.

[639] Internal Revenue Service, "Publication 15, (Circular E), Employer's Tax Guide" (2023 https://www.irs.gov/publications/p15. The social security tax has a wage base limit of $160,200 in 2023. There is no wage base limit for Medicare Tax.

The Coalition to Promote Independent Entrepreneurs contended that the Department's analysis of transfers is problematic and that the claim that employers are likely to keep the status of most workers the same across all benefits and requirements is legally incorrect. In the Department's enforcement experience, employers generally classify workers as employees or independent contractors for all purposes. The Department is not making any statement regarding employers' compliance with other laws that use different standards for employee classification than the FLSA.

In addition to affecting tax liabilities for workers, this rule could have an impact on state tax revenue and budgets. Misclassification results in lost revenue and increased costs for states because states receive less tax revenue than they otherwise would from payroll taxes, and they have reduced funds to unemployment insurance, workers' compensation, and paid leave programs.[640]

[640] See, *e.g.*, Lisa Xu and Mark Erlich, Economic Consequence of Misclassification in the State of Washington, Harvard Labor and Worklife Program, 2 (2019), https://lwp.law.harvard.edu/files/lwp/files/wa_study_dec_2019_final.pdf; Karl A. Racine, Issue Brief and Economic Report, Illegal Worker Misclassification: Payroll Fraud in the District's Construction Industry, 13 (September 2019), https://oag.dc.gov/sites/default/files/2019-09/OAG-Illegal-Worker-Misclassification-Report.pdf.

Although it has not been updated more recently, the IRS conducted a comprehensive worker misclassification estimate in 1984 using data collected by auditors. At the time, the IRS found misclassification resulted in an estimated total tax loss of $1.6 billion in Social Security taxes, Medicare taxes, Federal unemployment taxes, and Federal income taxes (for Tax Year 1984).[641] [642] To the extent workers were incorrectly classified due to misapplication of the 2021 IC Rule, that could have led to reduced tax revenues.

[641] Treasury Inspector General for Tax Inspection 2013, Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings, https://www.oversight.gov/sites/default/files/oig-reports/TIGTA/201330058fr_0.pdf.

[642] Adjusted for inflation using the CPI-U, the current value of this tax loss would be $4.5 billion.

Generally, employer requirements pertaining to unemployment insurance, disability insurance, or worker's compensation are on behalf of employees, therefore independent contractors do not have access to those benefits. Reduced unemployment insurance, disability insurance, and worker's compensation contributions result in reduced disbursement capabilities. Misclassification of employees as independent contractors thus impacts the funds paid into such state programs. Even if the misclassified worker is unaffected because they need no assistance, the employer has not paid into the programs as required. As a result, the state has diminished funds for those who require the benefits.

II.G.24. Taxing Entity or Individual Performing Services

An individual performing services cannot say that payments from a third party for those services belong to an entity employing the service provider unless:[1894]

[1894] *Fleischer v. Commissioner*, T.C. Memo. 2016-238. The court mentioned that this test is consistent with the FICA test under Reg. § 31.3121(d)-1(c)(2), which provides:

> Generally such relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished.

For a similar ruling involving an attempted assignment of earnings to a limited partnership, see *Peterson v. Commissioner*, 827 F.3d 968 (11th Cir. 5/24/2016), affirming T.C. Memo. 2013-271, described in fn. 3464 in part II.L.4 Self-Employment Tax Exclusion for Limited Partner. See also *Frey v. Commissioner*, T.C. Memo. 2019-62:

> Respondent cites longstanding authorities for the rule that income is taxable to the person who earns it. *Lucas v. Earl*, 281 U.S. 111, 114-115 (1930). This rule has been applied consistently in various contexts in which taxpayers have attempted to shift the incidence of taxation to a person or entity having less or no tax liability. See, *e.g.*, *Cole v. Commissioner*, 637 F.3d 767, 777

(1) The individual providing the services is an employee of the corporation whom the corporation can direct and control in a meaningful sense; and

(2) The entity and the person using the services have a contract or similar indicium recognizing the entity's controlling position.

In *Smith v. Commissioner*, T.C. Memo. 2018-170, a married couple provided handyman services. They caused their S corporation to send invoice to third parties for services rendered. However, the corporation never had a back account; instead they deposited in their personal checking accounts checks made payable to the corporation. The corporation never entered into an employment agreement with them and never issued Forms W-2 for services performed. The court commented on services performed for one third party, Hillcrest:

> With respect to the personal services that Ms. Smith performed for Hillcrest, petitioners rely on the Hillcrest invoices that it received during 2011 and 2012 as a factor weighing in their favor in determining whether Smith Solutions in fact earned the income that it reported in its 2011 Form 1120S, its 2012 Form 1120S, and its 2013 Form 1120S. Those invoices contained the same caption. That caption showed the name "Smith Solutions, Inc." However, the name "Sheila Smith" also appeared immediately above the name "Smith Solutions, Inc." We are unable to find on the basis of the Hillcrest invoices that Hillcrest received during 2011 and 2012 that Hillcrest recognized or understood that it was contracting with Smith Solutions for certain personal services of Ms. Smith, and not with Ms. Smith in her individual capacity. Nor are we able to find from those invoices that Hillcrest recognized or understood that Smith Solutions was exercising control over Ms. Smith with respect to the personal services that she performed for it.
>
> Petitioners also rely on the Hillcrest checks that were payable to "Smith Solutions, Inc." as a factor weighing in their favor in determining whether Smith Solutions in fact earned the income that it reported in its 2011 Form 1120S, its 2012 Form 1120S, and its 2013 Form 1120S. Although those checks establish that Hillcrest was aware of the existence of Smith Solutions, they do not establish that Hillcrest recognized or understood that it was contracting with Smith Solutions for the performance of certain personal services by Ms. Smith. We are not persuaded that Hillcrest made the Hillcrest checks payable to Smith Solutions because it considered Smith Solutions as (1) the contracting party for the personal services that Ms. Smith performed for it, (2) the entity that exercised control over Ms. Smith with respect to the performance of those services, and (3) the entity that

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(7th Cir. 2011) (lawyer's attempt to assign earnings to an entity), *aff'g* T.C. Memo. 2010-31; *Parker v. Routzahn*, 56 F.2d 730 (6th Cir. 1932) (attempt to assign income to spouse); *Walker v. Commissioner*, T.C. Memo. 2012-5 (attempt to assign income to earner's children). The determination of the proper taxpayer depends upon which person or entity in fact controls the earning of the income rather than who ultimately receives the income. See *Vnuk v. Commissioner*, 621 F.2d 1318, 1320 (8th Cir. 1980), *aff'g* T.C. Memo. 1979-164.
Petitioners … claim that petitioner, in his capacity as the owner of Queen City, made a deal with himself as a sole proprietor to provide management or accounting services to the sole proprietorship equal in amount to what petitioner earned as a stockbroker. (He also suggested during his testimony that the payment was a contribution of capital to Queen City, which would not be deductible as a business expense.) Petitioners presented no evidence of the actual management or accounting services performed. There is no evidence that funds were actually transferred to Queen City. Petitioner at all times controlled the earning of the income. Petitioner's testimony is implausible and unreliable, and we give it no weight. The assignment of income in the guise of deductions for services was invalid, and no deductions are allowed.

> was entitled to compensation for those services. We believe that Hillcrest made the Hillcrest checks payable to Smith Solutions because Ms. Smith asked it to do so.

The court made similar comments about other third party service recipients and concluded:

> Based upon our examination of the entire record before us, we find that petitioners have failed to carry their burden of establishing that they did not earn the income that Smith Solutions reported as "[t]otal income" in each of its 2011 Form 1120S, 2012 Form 1120S, and 2013 Form 1120S.

In *Morowitz v. U.S.*, 123 A.F.T.R.2d 2019-1001 (D. R.I. 2019), a lawyer with an S corporation brought in a new shareholder and sought to account for pre-existing cases separately, even though the S corporation received all of the income and paid all of the expense. He tried this using Schedule C, which the court properly 'rejected. Instead, I would probably have advised the lawyers to just make compensation arrangements, so that any appropriate disparities were reflected on Forms W-2 issued the corporation, given the personal services nature of the work. If any long-term disparities are required, consider part II.A.2.j.i Using a Partnership to Avoid S Corporation Limitations on Identity or Number of Owners or to Permit Non-Pro Rata Equity Interests.

Furthermore, the Tax Court will look through a structure designed to deflect income to a tax-exempt entity, such an ESOP for the service provider, when the service provider is running the show and the arrangements were merely designed to deflect income in that manner.[1895]

[1895] *Pacific Management Group v. Commissioner*, T.C. Memo. 2018-131, holding:

> A longstanding principle of tax law is that income is taxed to the person who earns it. *United States v. Basye*, 410 U.S. 441, 450 (1973) ("[H]e who earns income may not avoid taxation through anticipatory arrangements no matter how clever or subtle[.]" (citing *Lucas v. Earl*, 281 U.S. 111, 115 (1930))). A person who earns income "cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person or entity." *Id*. at 449.
>
> Under Mr. Ryder's tax-minimization scheme, Mr. Boultinghouse remained the CFO of all four Water Companies, and he continued to provide them with exactly the same financial and accounting services he had supplied previously. But now he supplied those services as an "employee" of his S corporation, which allegedly supplied his services to PMG, which allegedly supplied his services as an "independent contractor" to the Water Companies. He signed a purported "agreement of employment" with his S corporation, but that document did not specify what position he was to hold or what duties he was to perform. , it simply recited that he would "render and perform services under the direction and designation of" his S corporation. Because his S corporation was a paper entity and functionally his alter ego, that recitation was meaningless. In reality, he performed services for the Water Companies "under the direction and designation" of himself.
>
> The "agreement of employment," like PMG's purported agreement to provide Mr. Boultinghouse's services as an "independent contractor" to the Water Companies, did not in any meaningful way change the employer-employee relationship he had with those corporations. Mr. Ryder's tax-minimization plan was a classic "assignment of income" scheme whereby Mr. Boultinghouse used a series of contractual arrangements to divert salary income that would otherwise have flowed directly to him. See *Basye*, 410 U.S. at 450. But no anticipatory arrangement can hide the fact that his share of the management fees was in substance earned by and owed to him.
>
> We recognize the principle that a corporation (including an S corporation) is a separate taxable entity. See *Moline Props., Inc. v. Commissioner*, 319 U.S. 436, 439 (1943). But the relevant question is not simply "who earned the income" but rather "who controls the earning of the

A person who performs services is taxed on the services, even if the person assigns the earnings to another person.[1896]

Also consider parts II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment and II.A.2.c Avoiding Double Taxation and Self-Employment Tax.

II.G.25. Code § 199 Deduction for Domestic Production Activities (repealed)

Code § 199 has been repealed, effective taxable years beginning after December 31, 2017, so this part II.G.25 would not apply after then.

Code § 199 provides a deduction for domestic production activities. The deduction is equal to 9% of the lesser of (1) the qualified production activities income of the taxpayer for the taxable year, or (2) taxable income (determined without regard to this section) for the taxable year.[1897] However, it cannot exceed 50% of the W-2 wages paid by the taxpayer for the taxable year.[1898] Compensation paid a partner is reported as guaranteed payments on Schedule K-1 instead of on Form W-2,[1899] so generally the Code § 199 deduction would be higher for an S corporation or a C corporation than it would be for a comparable partnership.

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income." See *Johnson v. Commissioner*, 78 T.C. 882, 891 (1982) (citing *Vercio v. Commissioner*, 73 T.C. 1246, 1254-1255 (1980)), *aff'd* without published opinion, 734 F.2d 20 (9th Cir. 1984); *Fleischer v. Commissioner*, T.C. Memo. 2016-238, 112 T.C.M. (CCH) 723, 725.

In a setting such as this, two elements are generally required before the corporation will be regarded as the party that controls the earning of the income: (1) the corporation must be able to direct and control the employee in a meaningful way and (2) "there must exist between the corporation and the person or entity using the services a contract or similar indicium recognizing the corporation's controlling position." *Johnson*, 78 T.C. at 891; see *Idaho Ambucare Ctr., Inc. v. United States*, 57 F.3d 752, 754-755 (9th Cir. 1995) (same).

We find that the first requirement is not satisfied here because Boultinghouse Inc., the S corporation, was not able to (and did not in fact) "direct and control" Mr. Boultinghouse in any meaningful way. The S corporation was a paper entity. His purported "agreement of employment" with it did not specify what position he was to hold or what duties he was to perform. And far from rendering his services under the "direction and designation of" his S corporation, he in fact supervised his own employment by directing the day-to-day activities of the Water Companies. The documents Mr. Ryder drafted were not worth the paper they were printed on. They were designed to create, and they had the effect of producing, an anticipatory assignment of Mr. Boultinghouse's income to a tax-exempt entity Mr. Ryder had created for that purpose. See *Vnuk v. Commissioner*, 621 F.2d 1318, 1320-1321 (8th Cir. 1980), *aff'g* T.C. Memo. 1979-164.

In sum, we conclude that the assignment-of-income principle is fully applicable here because Mr. Boultinghouse's S corporation was not able to (and did not in fact) "direct or control in some meaningful sense the activities of the service provider." *Idaho Ambucare Ctr., Inc.*, 57 F.3d at 754-755; *Johnson*, 78 T.C. at 891 (same).[25] Once again, we must apportion to Mr. Boultinghouse his ratable share of the $564,109 additional compensation that we have allowed the Water Companies to deduct for 2005.

[25] In view of our disposition, we need not address whether the second requirement of the Johnson test is met, viz, whether there existed a bona fide "contract or similar indicium recognizing the corporation's controlling position." *Johnson*, 78 T.C. at 891.

[1896] *Lucas v. Earl*, 281 U.S. 111 (1930).

[1897] Code § 199(a).

[1898] Code § 199(b)(1).

[1899] See fn. 551, found in part III.B.7.c.viii Creative Bonus Arrangements.

II.G.26. Real Estate Special Issues

II.G.26.a. Real Estate Dealer vs. Investor

A real estate dealer – someone who sells real estate much more frequently than an investor – must treat real estate as inventory.

A taxpayer's amount or type of real estate activity affects many aspects of tax law, including:

- Whether gain or loss from the sale of real estate is ordinary income or loss (always the case for inventory) or capital gain or loss.[1900]
- Whether ordinary income is recharacterized as capital gain and whether capital loss is recharacterized as ordinary loss under Code § 1231.[1901] Generally, this special treatment applies (a) if the taxpayer has a non-real estate trade or business and uses the real estate in that business, or (b) if the taxpayer holds the property for rental.
- Whether installment sale deferral is available for none, part, or all of the sale (inventory is not eligible).[1902]
- Whether gain is subject to self-employment tax (applies to the sale of inventory only).[1903]
- Whether the taxpayer is a real estate professional for purposes of deducting losses that might otherwise be passive losses (that might be suspended)[1904] and for purposes of avoiding treatment as passive income triggering the 3.8% tax on net investment income.[1905]
- Whether the deduction for a charitable contribution of real estate is limited to basis.[1906]

The U.S. Supreme Court held that "the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly."[1907] Whether an asset is inventory depends on:[1908]

[1900] Discussing how to obtain capital gain on pre-development appreciation and whether the taxpayer already has enough activity that investments are considered to be inventory, see part II.G.26.c Future Development of Real Estate.
[1901] See part II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business.
[1902] See part II.Q.3 Installment Sales - Deferring Tax on Lump Sum Payout Expected More than Two Years in the Future, especially the text accompanying fn. 4298.
[1903] Real estate rental income is not subject to self-employment tax. See parts II.L.2.a.ii Rental Exception to SE Tax, especially the detailed rules accompanying fn. 3428, and II.L.2.a.iii Whether Gain from Sale of Property is Subject to SE Tax, especially fn. 3438.
[1904] See part II.K.1.e.iii Real Estate Professional Converts Rental to Nonpassive Activity.
[1905] See parts II.I.8.c.ii Real Estate Classified as Nonpassive for Real Estate Professionals, II.I.8.c.iii Rental as a Trade or Business and II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.
[1906] See part II.Q.6.a General Concepts in Contributing a Business Interest to Charity.
[1907] *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955).
[1908] *Boree v. Commissioner*, 837 F.3d 1093 (11th Cir. 2016), citing:
> *United States v. Winthrop*, 417 F.2d 905, 909-10 (5th Cir. 1969); *see Sanders v. United States*, 740 F.2d 886, 889 (11th Cir. 1984) (applying the *Winthrop* factors). No factor or combination of factors is controlling. *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 415 (5th Cir. 1976) (en banc). Rather, each case must be decided on its particular facts. *Id.* Still, the "frequency

(1) the nature and purpose of the acquisition of the property and the duration of the ownership;

(2) the extent and nature of the taxpayer's efforts to sell the property;

(3) the number, extent, continuity and substantiality of the sales;

(4) the extent of subdividing, developing, and advertising to increase sales;

(5) the use of a business office for the sale of the property;

(6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and

(7) the time and effort the taxpayer habitually devoted to the sales.

Glade Creek Partners, LLC v. Commissioner, T.C. Memo. 2023-82, included:

> On its 2012 return Hawks Bluff reported that it was in business as a real estate dealer, reported the easement property as inventory, and decreased the amount of its inventory on the transfer of the easement property to Glade Creek. Statements on tax returns may generally be treated as admissions by that taxpayer. *Mendes v. Commissioner*, 121 T.C. 308, 312 (2003).

Further above in the opinion, the court had described Code § 724(b), "Contributions of inventory items," which provides:

> In the case of any property which -
>
> (1) was contributed by a partner to the partnership, and
>
> (2) was a capital asset in the hands of such partner immediately before such contribution,
>
> any loss recognized by the partnership on the disposition of such property during the 5-year period beginning on the date of such contribution shall be treated as a loss from the sale of a capital asset to the extent that, immediately before such contribution, the adjusted basis of such property in the hands of the partner exceeded the fair market value of such property.

The court commented:

> Petitioner argues that Glade Creek should not be bound by Hawks Bluff's reporting.[11] It argues that Hawks Bluff's reporting is irrelevant. But section 724(b) tells us otherwise. It is the very purpose of section 724(b) to make relevant the character of the property in

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and substantiality" of sales is the "most important" of these factors. *Id*. at 416. This is because "the presence of frequent sales ordinarily belies the contention that property is being held `for investment' rather than 'for sale.'" *Suburban Realty Co.*, 615 F.2d at 178.

When *Sugar Land Ranch Development, LLC v. Commissioner*, T.C. Memo. 2018-21, reviewed the Fifth Circuit's precedent, it cited factors similar to the list, but concluded that "frequency and substantiality of sales is the most important factor."

Hawks Bluff's hands. Congress enacted section 724 to prevent taxpayers from attempting to recharacterize ordinary income property as a capital asset by contributing the property to a newly organized partnership before the property is sold for a gain. H.R. Rep. No. 98-432, pt. 2, at 1222 (1984), as reprinted in 1984 U.S.C.C.A.N. 697, 888. While Hawks Bluff's reporting may not bind Glade Creek, petitioner has not provided a satisfactory explanation with reference to the statute as to why Hawks Bluff's reporting should not be given significant weight especially in the light of the legislative purpose of section 724. It is true, as petitioner argues, that Glade Creek did not control Hawks Bluff when Hawks Bluff filed its 2012 return, but that is the fact that is irrelevant. Nothing in section 724(b) requires that the partnership have control of the contributing partner when the contributing partner files its return.

[11] Petitioner cites only one case, *King's Court Mobile Home Park, Inc. v. Commissioner*, 98 T.C. 511 (1992), for the proposition that one taxpayer's characterization of property does not bind another taxpayer. That case does not support petitioner's argument. It involved a corporation's attempt to characterize payments to its controlling shareholder as deductible wages. The Court held that the corporation's payments were nondeductible dividends but noted that their characterization as wages or dividends had the same tax consequences to the recipient. *Id*. at 515. Thus, there was no issue relating to whether the corporation's characterization bound the recipient.

The Code gives taxpayers flexibility in how they arrange their business affairs to achieve desired tax consequences. See *Estate of Durkin v. Commissioner*, 99 T.C. 561, 571 (1992). While a taxpayer is free to organize its affairs as it chooses, once it has done so, the Commissioner may bind the taxpayer to its decision. *Bradley v. United States*, 730 F.2d 718, 720 (11th Cir. 1984);[12] see *Commissioner v. Nat'l Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974). Glade Creek and Hawks Bluff could have set out in the operating agreement that Hawks Bluff was contributing investment property or that Hawks Bluff was to report the easement property as a capital asset. See *Wray v. Commissioner*, T.C. Memo. 1978-488 (stating that partnership agreement stated that real property was held for investment). Glade Creek knew the significance of the characterization of the easement property for federal tax purposes and was aware that the easement deduction would be limited to Hawks Bluff's adjusted basis if the property was inventory in Hawks Bluff's hands immediately before the contribution. The characterization of the easement property as inventory was discussed in the PPM, and Glade Creek's tax attorney, Mr. Pollock, discussed the issue at a meeting before the easement transaction took place. Glade Creek could have negotiated with Hawks Bluff to have it report the easement property as investment property. While a taxpayer's labels are not determinative for tax purposes, because the parties failed to attach labels in the organizational documents the only evidence in the record that objectively establishes how Hawks Bluff characterized the easement property is its 2012 return.

[12] The Eleventh Circuit recognizes an exception to this principle that allows taxpayers to challenge the tax consequences of the chosen form only if they prove the existence of mistake, undue influence, fraud, duress, etc. *Bradley*, 730 F.2d at 720 (citing *Spector v. Commissioner*, 641 F.2d 376, 382 (5th Cir. Unit A Apr. 1981), *rev'g* 71 T.C. 1017 (1979)).

[my comment: see part II.G.33 Taxpayer Disavowing Form, which uses language that is not as stingy to the taxpayer as that shown above; however, the authority shown there would not have helped this taxpayer.\

Petitioner has failed to present any evidence that ILC or Hawks Bluff treated the easement property as investment property in its books and records.[13] It produced Mr. Vincent as a witness but failed to elicit testimony that ILC or Hawks Bluff held the easement property for investment purposes. In the light of section 724(b) and its purpose, we place great weight on Hawks Bluff's reporting of the easement property as inventory. Statements on a return are not conclusive, however, and we examine whether the facts otherwise support a finding that the easement property was a capital asset. *Suburban Realty*, 615 F.2d at 181.

[13] Petitioner has not requested that we reopen the record. Both parties addressed the section 170(e) issue in their posttrial briefs, and petitioner had the opportunity to present evidence at trial. Accordingly, we see no need to reopen the record. Whether to reopen the record on remand is "left to the sound discretion of the trial court." *Cambridge Univ. Press v. Albert*, 906 F.3d 1290, 1302 (11th Cir. 2018) (quoting *Jones & Laughlin Steel Corp. v. Pfeifer*, 462 U.S. 523, 551 (1983)).

III. Factor Test

A. Purpose for Holding Property

The Eleventh Circuit recognizes that a taxpayer's purpose for holding property can change over time and has indicated that the purpose at the time of sale is not determinative. *Boree v. Commissioner*, 837 F.3d at 1101 ("[T]he Fifth Circuit rejected the notion that `the decisive question is the purpose for which (the property) "primarily" was held when sold.'" (quoting *Suburban Realty*, 615 F.2d at 182)).[14] It has instructed that "a proper analysis of a taxpayer's primary purpose in holding property should take into account a reasonable period of time prior to the sale." *Id*.; see *Sanders*, 740 F.2d at 889 (considering years leading up to the sale and holding that the sale profit was ordinary income);[15] *Suburban Realty*, 615 F.2d at 183-84 (stating that the inquiry may consider "purpose over the entire course of his ownership...[and] should start at the time the property is acquired").

[14] We have stated that generally the purpose at the time of sale is determinative, but we consider earlier events to decide the purpose at the time of sale. *Cottle v. Commissioner*, 89 T.C. 467, 487 (1987).

[15] In *Boree v. Commissioner*, 837 F.3d at 1101, the Eleventh Circuit found that consistent with *Suburban Realty* "[t]he *Sanders* court also analyzed the taxpayer's activities over multiple years" leading up to the sale.

Petitioner argues that Hawks Bluff was organized to hold the easement property as an investment. It further argues that we should also consider ILC's purpose for holding the easement property while respondent focuses primarily on Hawks Bluff's holding purpose. Petitioner argues that ILC treated the easement property as investment property from the time of its acquisition or, alternatively, the easement property converted to investment property in 2009 when ILC abandoned the development project.

The first inquiry according to the Eleventh Circuit in Boree is whether Hawks Bluff was in a trade or business as a real estate dealer. Hawks Bluff reported that its business was real estate dealer on its 2012 return even though its sales had been minimal since its organization. It continued its efforts to sell lots on tract I after the easement transaction. “The taxpayer’s claim to capital gain treatment is likely to be weaker if he can point to no other business activities....” *Suburban Realty*, 615 F.2d at 179 n.24; see *Boree v. Commissioner*, 837 F.3d at 1105 (finding that taxpayer engaged in no other income-producing activity although it had no sales during years at issue). Petitioner argues that Hawks Bluff was organized to hold the ILC property for investment purposes but failed to address Hawks Bluff’s reporting that it was a dealer. Mr. Vincent did not testify that Hawks Bluff held the easement property for investment. Nor did he contest Hawks Bluff’s reporting that it was in the real estate business. He blamed the lack of sales on the economy and lack of marketing, likely because it served petitioner’s argument that residential development of the easement property was economically feasible on the easement date. As explained further below, Hawks Bluff was not organized to hold the ILC property as an investment. Accordingly, we find that it was a real estate dealer.

Petitioner argues that a real estate dealer may hold real estate for investment purposes. See *Pritchett*, 63 T.C. at 163. We find that Hawks Bluff was a real estate dealer. See *Sugar Land Ranch Dev., LLC v. Commissioner*, T.C. Memo. 2018-21 (finding that tax return statements on business activity were not conclusive because they may have been inadvertently carried over from earlier returns). When a real estate dealer holds both inventory and investment property, it must segregate investment property from its inventory. *Pritchett*, 63 T.C. at 163. The Eleventh Circuit places the burden on the taxpayer to establish that it segregated the real estate purportedly held as an investment from its inventory. *Boree v. Commissioner*, 837 F.3d at 1104. The Court of Appeals has stated that “[t]he mere lack of development activity with respect to parts of a large property does not sufficiently separate those parts from the whole to meet the taxpayer’s burden.” *Id*. (quoting *Suburban Realty*, 615 F.2d at 185). Our caselaw considers whether the taxpayer treated the property at issue differently from its other property, made improvements or subdivided the property, held the property out for sale or advertised it, and solicited the offer that led to the sale at issue. *Pritchett*, 63 T.C. at 16468; *Wray*, T.C. Memo. 1978-488. We have stated that holding title to real property in a different name or entity does not conclusively establish segregation but is a factor to consider. *Pritchett*, 63 T.C. at 164; *Paullus v. Commissioner*, T.C. Memo. 1996-419.

1. Hawks Bluff’s Purpose

On remand, petitioner argues that Hawks Bluff was organized as part of a plan to cease development, marketing, and sale activities and to develop a plan for long-term investment of all three tracts. It states that Hawks Bluff was organized in April 2010 after Mr. Vincent, Mr. Tague, and Mr. Toscano “devise[d] a new plan [for] developing a long-term investment plan for the property” and “solidified the ILC’s members’ intent in holding the property as investment property.”

Petitioner has not offered any evidence that Hawks Bluff was organized for the purpose of holding real estate for investment purposes. Its argument is speculative, not supported by the record, and contradicts Mr. Vincent’s testimony. Its argument on remand contradicts its proposed findings of fact in its posttrial briefs where it stated:

> The property was transferred to Hawks Bluff because Mr. Vincent and Mr. Teague [sic] had invested vast sums of money to fund the utilities, roads, water and infrastructure for the property. Transferring the property to Hawks Bluff provided Mr. Teague [sic] and Mr. Vincent a controlling interest over the ILC Property. This was also done to help reassure the bank, which had significant money invested in the property through loans to Mr. Vincent.

(Citations omitted.)

Mr. Vincent testified that Hawks Bluff was organized and the ILC property was transferred to it to “help reassure the bank” that funded the infrastructure loans. We do not understand this testimony to mean that Hawks Bluff was formed to hold the property for investment purposes. By petitioner’s own admission, a fundamental part of the plan was to give Mr. Vincent an ownership interest in the ILC property.

Significantly, Mr. Vincent did not testify that Hawks Bluff was organized with the intent to hold the ILC property for long-term investment. Notably, petitioner has failed to produce any evidence relating to the infrastructure loans and how ILC or Hawks Bluff represented that it held the ILC property to secure financing. We find that Hawks Bluff was organized to take over a failing real estate development with Mr. Vincent as a part owner, find a solution for the ongoing financial problems, and continue to sell the lots to customers in the ordinary course of business.

Furthermore, the evidence shows that Mr. Vincent and Mr. Tague did not want to relinquish ownership of any part of the ILC property or to do anything that might negatively affect the master-planned community for the ILC property after Hawks Bluff acquired it from ILC. They wanted to protect their ownership and the development potential. After Hawks Bluff was organized, Mr. Vincent and Mr. Tague transferred unrelated real estate as partial payment of the unpaid mortgage. Notably, they did not surrender the easement property. The primary reason Mr. Vincent chose the easement transaction was that it solved the debt problems while protecting ILC’s original vision of the vacation home community. After Hawks Bluff found the solution to its debt in the form of the easement donation, it continued its real estate business activities. Hawks Bluff did not passively hold the easement property in the hopes that it could sell it for the highest price to a third party. Under such circumstances it is difficult for us to conclude that Hawks Bluff was organized to hold the ILC property or the easement property for investment.

Petitioner produced Mr. Vincent as a witness and could have elicited testimony from him that Hawks Bluff was organized to acquire and hold the easement property as an investment but failed to do so, perhaps because it was concerned that such testimony would have adversely affected its argument that residential development was economically feasible and the highest and best use of the land. After we had agreed with petitioner that development was feasible, it conveniently changed its position on remand and argues for the first time that residential development was not feasible in 2009 to advance its argument that the easement property was investment property without having presented any evidence at trial to support the infeasibility of development in 2009.

Instead, petitioner cites Mr. Vincent’s testimony that he did not want to develop the easement property alone and did not have the finances to do so after Mr. Toscano and

Mr. Tague stopped making debt payments. However, neither statement means that Hawks Bluff was organized to hold the property for investment or requires a finding that its purpose for holding the property changed to investment As *Suburban Realty*, 615 F.2d at 182, instructs, the fact that the taxpayer is not still actively engaged in the trade or business is not determinative under the statute. “The statutory language does not demand that property actually be sold while a taxpayer is still actively engaged in its trade or business for ordinary income treatment to be required. Rather, it demands that the property have been held primarily for sale in that business.” *Id*. Hawks Bluff was organized as a real estate dealer and held itself out as such. It used the easement transaction to eliminate debt so that it could continue its business. It was actively engaged in that business after the easement transaction.

Petitioner’s argument that Hawks Bluff was organized for investment purposes is speculative and unsupported by the evidence in the record. Objective factors carry more weight than the taxpayer’s subjective statements of intent. See *Guardian Indus. Corp. v. Commissioner*, 97 T.C. 308, 316 (1991), *aff’d*, 21 F.3d 427 (6th Cir. 1994) (unpublished table decision). Accordingly, we place significant weight on Hawks Bluff’s reporting that it was a real estate dealer and held the easement property as inventory. Hawks Bluff’s organizational documents are not in the record. There is no evidence in the record that Hawks Bluff was organized because its members decided to hold the property as investment property or that it treated the ILC property as an investment. It was organized to take over a failing real estate developer to reassure a major lender and continue the residential development business albeit unsuccessfully.

2. ILC’s Purpose

Petitioner argues that ILC acquired and held the easement property as an investment. It argues the three tracts were separate assets and that ILC took specific steps to segregate the easement property from tract I to preserve the investment character of the easement property. It cites the decision not to record the platted lots and the lack of physical improvements on the easement property. To the extent that ILC’s holding purpose is relevant, we find that ILC held the easement property as inventory.

ILC was in the real estate business and acquired the land because it was suitable for development. We find petitioner’s argument that ILC purchased all three tracts for investment to be disingenuous considering the quick turnaround in development. ILC purchased all three tracts in one purchase in January 2006 after engaging Mr. Vincent to evaluate the property for a residential development. In its posttrial brief, petitioner stated:

> The purchase was made after an extensive and thorough investigation of its development potential. Specifically, ILC spent significant time and money to verify the property contained the topography and attributes suitable for a high-end, second-home development. The $9 Million was not spent on a whim. It was spent after an investigation by sophisticated land investors.

Shortly thereafter ILC engaged a licensed engineer to design a concept plan for the development of the three tracts into one master-planned community. The concept plan was completed in April 2006. Then in July 2006 ILC placed restrictive covenants on all three tracts in accordance with the concept plan. These actions are inconsistent with petitioner’s claim that ILC purchased any part of the ILC property to hold as an investment for future appreciation. See *Wray*, T.C. Memo. 1978-488 (finding that taxpayer had not made development decision at time of purchase).

By petitioner's own admission in its proposed findings of fact, ILC expanded substantial amounts of time and money to develop all three tracts. "ILC...expended millions of dollars...preparing Tracts I, II, and III for development as a master-planned community." "By March of 2007, the infrastructure (roads, underground water, electricity, utilities, soil testing, storm water plans) was in place to service all 806 lots depicted in the Concept Plan." "ILC negotiated and entered into a 25-year contract...that provided the ILC property with...enough water to cover all potential development....ILC had to build a pump station [and]...construct a mile of water mains (pipes) to service the pump station....After this process, the ILC property had the infrastructure in place to service all of the proposed 806 lots...." ILC "enjoyed huge success" with tract I sales. To support its valuation, petitioner argued that "ILC invested over $6 Million into the property obtaining approvals for the property, accessing water, utilities, roads and obtaining platted approvals for the Easement Property." On the basis of petitioner's own admissions through its proposed findings of fact, we find that ILC developed the easement property and did not segregate the easement property from tract I as investment property.

Petitioner also proposed a finding of fact that "Tracts II and III were specifically held out as `investment' property for potential future development or sale to a third-party." However, it failed to provide a reference to the record as required by Rule 151, and we have found no support for this proposed finding in the record.[16] ILC's decision to delay infrastructure improvements directly on the easement property was not based on a decision to hold it as investment property. Rather, it made a business decision to develop the ILC property in phases because of financial constraints. Mr. Vincent testified that ILC planned to develop the land in phases because it did not make business sense to develop all 806 lots and place them on the market at one time. Such a business plan does not establish that ILC segregated the easement property and held it for investment purposes especially in the light of the substantial amounts of time and money ILC expended to develop all three tracts.

[16] Rule 151(e)(3) requires that the parties' posttrial briefs contain proposed findings of fact based on the evidence and include references to the pages of the transcript, exhibits, or other sources relied on to support the findings.

Petitioner argues that ILC did not record the platted lots on the easement property because it intended to segregate the easement property and hold it as investment property. Such a position is not supported by the record. Mr. Vincent testified that ILC did not record the lots to avoid a property tax increase. He testified that normally developers would not record lots until roads and amenities were completed because recording can increase property tax. He stated that if lots were recorded the property would be appraised per lot so it is a "terrible mistake" to record the lots too early before the developer is ready to sell them. We do not understand Mr. Vincent's testimony to mean that ILC decided to hold the easement property for investment purposes. We relied on Mr. Vincent's explanation for not recording the platted lots in our decision that residential development was the highest and best use for the easement property. Respondent argued that the lack of recording weighed against that use. We stated that "ILC's decision not to record the platted lots in tracts II and III until it was ready to develop those tracts is irrelevant to their development potential. It did not record the lots to avoid a potential property tax increase." *Glade Creek*, T.C. Memo. 2020-148, at *34.

There is no testimony or other evidence that ILC decided not to record the platted lots because it planned to hold the easement property for investment. Petitioner has not presented any evidence that ILC evaluated the investment potential of the easement property including the expectation of an appreciation in value and the costs of holding the property for investment purposes. Instead, petitioner stated in its posttrial brief that "[t]he property was specifically identified and investigated by ILC in 2006 for its development potential." No witness testified that ILC treated any part of the ILC property as an investment in its books and records when it acquired it or at any time thereafter. Without more, ILC's decision not to record the lots on the easement property does not establish that ILC segregated it from tract I or held it for investment purposes.

Nor has petitioner established that ILC treated any part of the ILC property as an investment in 2009 when petitioner argues ILC abandoned its intent to develop the property because of economic conditions and lack of funding. In 2009 ILC stopped marketing the ILC property and sales decreased sharply. On remand, petitioner argues that residential development was not economically feasible in 2009. However, the character of the property does not change simply because of a change in market conditions. When a company is going out of business, it is still in that business while it winds down. See *Suburban Realty*, 615 F.2d at 182. ILC was a failed real estate developer that held the entire ILC property out for sale to customers in the ordinary course of its business as a master-planned community. ILC continued to hold the ILC property in that business when it transferred its unsold inventory to Hawks Bluff although it may not have been actively engaged in that business.

B. Sales Activities

The Eleventh Circuit has stated that frequency and substantiality of sales is the "most important" factor in determining the character of property. *Boree v. Commissioner*, 837 F.3d at 1100 (quoting *Biedenharn Realty*, 526 F.2d at 416). This is because sales are "highly relevant" to each of the three statutory inquiries for the characterization of property as a capital asset or inventory including whether the taxpayer is engaged in a trade or business and whether it held the property for sale in that business. *Suburban Realty*, 615 F.2d at 178. "[T]he presence of frequent sales ordinarily belies the contention that property is being held `for investment' rather than `for sale.'" *Id*.

As we stated above, most of the seven factors relate to sales activities. There were no lot sales on the easement property. However, the lack of sales on the easement property does not require a finding that the easement property was investment property where other facts establish otherwise. No one factor or combination thereof is controlling. *Biedenharn Realty*, 526 F.2d at 415. ILC's original plan was to develop the property in three phases and to use the cashflow from tract I sales to fund development on the easement property. In view of this plan, we place little weight on the lack of sales on the easement property. ILC did not plan to hold the easement property for investment until lots on tract I were sold out and then make a decision about whether to develop the easement property. It had a concept plan designed for a single master-planned community of the three tracts and completed significant infrastructure to enable development of all three tracts. ILC's intent was to hold the easement property as inventory for development. In the light of Hawks Bluff's reporting, ILC's development activities, and the lack of credible evidence to support petitioner's argument, we find that the lack of sales on the easement property does not require a finding that ILC or Hawks Bluff segregated the easement property and held it for investment.

C. Development Activities

Development activities are relevant to whether a taxpayer is in a real estate business and also to its purpose for holding land. *Suburban Realty*, 615 F.2d at 178-79. Lack of improvements can indicate that the property is not held primarily for sale. *Adam v. Commissioner*, 60 T.C. 996, 1000 (1973); see also *Brown v. Commissioner*, 143 F.2d 468 (5th Cir. 1944) (finding that taxpayer was a real estate dealer as it subdivided the land, installed utilities, built streets and storm sewers, and sold 20 to 30 lots a year); *Gates v. Commissioner*, 52 T.C. 898 (1969) (finding that property was dealer property where taxpayer subdivided lots, installed improvements, and sold home construction building materials); *Conner v. Commissioner*, T.C. Memo. 2018-6 (citing lack of development, finding that the taxpayer was not in the real estate business and was not entitled to business deductions), *aff'd*, 770 F. App'x 1016 (11th Cir. 2019).

On remand petitioner argues that the easement property was never improved or developed although it acknowledges that the easement property "economically benefited from the development" on tract I and that ILC's development activities "increased the likelihood of developing, subdividing, and selling lots" on the easement property. Petitioner relied on ILC's infrastructure and development activities to support its valuation of the easement property. In its posttrial briefs petitioner repeatedly stated that ILC made improvements that benefited all three tracts and added value to the easement property. It asserted that ILC spent $6 million on infrastructure related to the development of all three tracts. It criticized respondent's expert's valuation for failing to take into account the $6 million in improvements made for all 806 lots. It stated that "[a]ll three tracts...had ready-access to water, electricity, utilities, and septic tank capacity. All three tracts had paved road access. Moreover, all three tracts had obtained the required TDEC approvals, and lots were platted on all three tracts." It argued that the paved roads extending to the borders of the easement property provided the easement property with a "valuable amenity." It stated that "ILC successfully completed the steps necessary to transform the ILC Property into a fully-approved and shovel-ready 806-Lot development."

We agreed with petitioner that the highest and best use of the easement property was residential development. We relied on the fact that the easement property had platted lots, a concept plan designed by a licensed engineer, and significant infrastructure work had been completed including upgraded utility and water capacity, soil testing, approvals for septic tanks, sewage, and storm water plans. *Glade Creek*, T.C. Memo. 2020-148, at *34. We found that the easement property had been improved for development and, in this respect, agreed with petitioner. Mr. Vincent testified that ILC's development activities increased the value of the easement property, and we relied on his testimony to support our valuation. We found that Mr. Broome erred by failing to take into account "extensive development work ILC performed on the property," which contributed to the easement property's suitability for residential development. *Id*. at *32. We concluded that "[i]n the light of the improved real estate market and the significant infrastructure work and approvals previously granted, a hypothetical buyer would have reasonably purchased the property for the development of a vacation or residential community." *Id*. at *34.

We also agreed with petitioner that ILC's infrastructure and other development activities increased the fair market value of the easement property. *Id*. at *53. In our decision on the valuation, we stated:

> Mr. Vincent and ILC invested vast amounts of time and money on the development of all three tracts, spending over $6 million. Most infrastructure work took place on tract I. However, ILC had successfully completed numerous steps toward the development of all three tracts. ILC constructed a pumping station and installed upgraded pipelines to service all three tracts, upgraded electrical lines that could service residential developments on all three tracts, paved access roads leading up to tracts II and III, platted lots on the basis of a design by a licensed engineer, completed soil testing, and obtained development approvals for all three tracts. Tracts II and III clearly benefited from ILC's work even though ILC had not yet extended utilities to those tracts. Mr. Broome [respondent's valuation expert] erred by disregarding the value added to the easement property from ILC's infrastructure and approvals.

Id. at *39.

We held that the unencumbered easement property had a fair market value of approximately $9.3 million using a discounted cashflow method and found that value was supported by ILC's purchase price for the easement property and the value added by ILC's infrastructure improvements and development activities. *Id*. at *52; see *Boree v. Commissioner*, 837 F.3d at 1105 (finding that taxpayer's activities "increase[d] the value of lots in future sales"). We stated:

> We also consider ILC's $6 million investment in infrastructure and its work to obtain approvals which benefited all three tracts, including ensuring a water supply, upgrading water and electrical capacity, soil testing, Government approvals, and access roads leading to the easement property. Mr. Vincent credibly testified that ILC performed soil testing on tracts II and III. ILC's infrastructure and approval work clearly increased the fair market value of the easement property....We find it reasonable that the unencumbered easement property would have increased by $2 and $2.5 million on the basis of appreciation and ILC's infrastructure work.

Glade Creek, T.C. Memo. 2020-148, at *53.

The development activities weigh against a finding that ILC segregated the easement property from tract I to hold it for investment purposes. ILC did not treat the easement property as a passive investment. Notably, Hawks Bluff did not undertake any additional development. But we place little weight on this fact because Hawks Bluff was organized to take over ILC's failing real estate business, to give Mr. Vincent an ownership interest, and to appease the bank that financed the infrastructure. Furthermore, ILC had completed the necessary infrastructure to sell the lots on tract I, making further development by Hawks Bluff with respect to those lots unnecessary.

ILC's infrastructure improvements and development activities significantly contributed to the increase in the unencumbered easement property's value over the course of ILC's and Hawks Bluff's ownership. "[C]apital gain treatment will be proper only if the gain emanates from appreciation in value." *Boree v. Commissioner*, 837 F.3d at 1104 (quoting *Suburban R*ealty, 615 F.2d at 186); see *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 134 (1960) (stating that courts should construe capital asset narrowly "in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time"); *Jersey Land & Dev. Corp. v. United States*, 539 F.2d 311, 315 (3d Cir. 1976) (holding property to be dealer property where the gain resulted from substantial improvements made to the property by the taxpayer as opposed to long-term market appreciation). But even an increase in land value attributable more to market appreciation than to improvements does not automatically mean that the land is a capital asset, and profit from appreciation may be treated as ordinary income. *Boree v. Commissioner*, 837 F.3d at 1104.

Petitioner did not provide any expert testimony or other evidence as to the appreciation of the land over the six years of ILC's and Hawks Bluff's ownership from 2006 through 2012 in the absence of the infrastructure improvements. Instead, it argued the opposite. It argued that the real estate market was distressed beginning in 2008 but began to recover by December 2012.[17] *Glade Creek*, T.C. Memo. 2020-148, at *6, *38. It repeatedly faulted Mr. Broome's comparable sales analysis for using sales that occurred on average four years before the easement date during what petitioner called the "trough" of the recession. Petitioner has not established that the amount of the increased value of the easement property was from appreciation in the absence of the infrastructure improvements.

[17] Mr. Clark testified that a hypothetical residential development would have a seven-year absorption period for lot sales beginning in 2012 and that unsold lots would appreciate 3% to 4% annually.

IV. Conclusion

On the basis of the totality of the facts and circumstances, we find that ILC and Hawks Bluff did not segregate the easement property from tract I in a manner sufficient to meet petitioner's burden to show that the easement property was investment property. Petitioner has not presented any evidence to substantiate its argument that Hawks Bluff was organized to hold the easement property or to dispute Hawks Bluff's reporting that it held the property as inventory. ILC held the easement property as inventory and did not segregate it from tract I Petitioner's. position on remand that ILC did not develop the easement property is inconsistent with our findings of fact and petitioner's own posttrial brief. Petitioner relies on speculation that is unsupported by the record. We place significant weight on the only evidence in the record of how Hawks Bluff or ILC characterized the easement property, Hawks Bluff's 2012 return. Accordingly, Glade Creek's easement deduction is limited to the adjusted basis pursuant to sections 724(b) and 170(e).

The Syllabus of *Mill Rd. 36 Henry, LLC v. Commissioner*, T.C. Memo. 2023-129 summarized:

MRP, an LLC organized by real estate professionals and investors to buy and sell land, acquired 117 acres of undeveloped suburban land along a county road for $1.25 million (about $10,700 per acre) in December 2014. BI, an entity owned by another real estate professional, thereafter acquired from MRP a 25% undivided interest in these parcels for $315,000. MRP and BI then partitioned 40 acres of the eastern tract to create a new tract ("Tract"). MRP and BI then contributed Tract to MR36, a TEFRA partnership. MR36's only asset was Tract. MRP then sold the remainder of the 117 acres to two other entities.

In September 2016 an investment fund, IF, acquired a 97% ownership interest in MR36 for $1 million (equivalent to about $25,800 per acre). Under the control of IF, MR36

> donated by deed in December 2016 a perpetual conservation easement (constituting a "qualified real property interest" under I.R.C. § 170(h)(1)(A)) on 33 acres of Tract to SCT (a "qualified organization" under I.R.C. § 170(h)(1)(B)) for "conservation purposes" under I.R.C. § 170(h)(1)(C). Relying on a professional appraisal, MR36 claimed a charitable contribution deduction of $8,935,000 (about $270,800 for each of the 33 acres) for a "qualified conservation contribution" under I.R.C. § 170(h) on its tax return.
>
> R examined MR36's return and issued a Notice of Final Partnership Administrative Adjustment ("FPAA") determining to disallow the charitable contribution deduction. MR36's TMP filed a petition in this Court challenging the FPAA.
>
> *Held*: MR36 made a qualified conservation contribution under I.R.C. § 170(h) and attached to its return a qualified appraisal by a qualified appraiser under I.R.C. § 170(f)(11) and Treas. Reg. § 1.170A-13(c)(3).
>
> *Held, further*, the value of the easement granted on Tract is $900,000 (about $27,300 per acre) - the amount conceded by R.
>
> *Held, further*, because Tract had been inventory held for sale to customers in the ordinary course of business by MRP and BI—the partners who contributed it to MR36—the amount of MR36's deduction is limited under I.R.C. § 170(e)(1)(A) to its adjusted basis in Tract, $416,563.
>
> *Held, further*, the I.R.C. § 6663 fraud penalty is not applicable to MR36, but the I.R.C. § 6662(h) gross valuation misstatement penalty is applicable. To the extent the deduction is disallowed not because of valuation but because of the basis limitation of I.R.C. § 170(e)(1)(A), the penalty for a substantial understatement of income tax under I.R.C. § 6662(b)(2) applies, or, in the alternative, the penalty for negligence under I.R.C. § 6662(b)(1) applies.

In the part titled, "B. The Mill Road Tract as inventory," the court reasoned and held:

> The Eleventh Circuit - the appellate venue in *Glade Creek* and presumptively in this case as well - uses the following inquiries to determine whether a taxpayer holds property for sale in the ordinary course of business or as an investment: (1) whether the taxpayer was engaged in a trade or business, and if so, what business; (2) whether the taxpayer was holding the property primarily for sale in that business; and (3) whether the sales contemplated by the taxpayer were "ordinary" in the course of that business.[34] *Sanders v. United States*, 740 F.2d 886, 888-89 (11th Cir. 1984) (citing *Suburban Realty Co. v. United States*, 615 F.2d 171, 178 (5th Cir. 1980)). Mill Road Partners and Benwood Investments were the two partners who contributed the Mill Road Tract to Mill Road 36. Both entities were previously and subsequently engaged in the business of buying and selling real estate; they acquired the 117-acre parent tract that included the Mill Road Tract pursuant to their real estate business; and they contributed 40 acres of it - the Mill Road Tract - to Mill Road 36 in furtherance of their real estate business. And as we found above at page 10, after Mill Road Partners contributed 40 of the 117 acres to Mill Road 36, Mill Road Partners used the remaining acres in the ordinary course of their real estate business by selling the other parcels to Evergreen Management Group and 49 Mill Road Henry, LLC.

[34] To resolve these three inquiries, the Eleventh Circuit consults seven relevant factors:

> (1) the nature and purpose of the acquisition of the property and the duration of the ownership; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the number, extent, continuity, and substantiality of the sales; (4) the extent of subdividing, developing, and advertising to increase sales; (5) the use of a business office for the sale of the property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (7) the time and effort the taxpayer habitually devoted to the sales.

United States v. Winthrop, 417 F.2d 905, 910 (5th Cir. 1969). We need not analyze in detail each of these factors here because it is evident from the testimony of Mr. Grant that he himself, Benwood Investments, Ms. Meng, and Mr. Wang all worked together in the business of buying and selling land, and that the Mill Road Tract was both acquired and sold within the ordinary course of their real estate business operated through Mill Road 36.

The fact that 97% ownership of Mill Road 36 was then sold to MR36 Investments (after the Mill Road Tract was contributed to Mill Road 36 and before Mill Road 36 made the easement donation) does not change the fact that the Mill Road Tract was contributed to Mill Road 36 by partners (Mill Road Partners and Benwood Investments) who were real estate professionals within five years of donating the conservation easement and claiming the charitable contribution deduction.

Accordingly, pursuant to section 724(b), any proceeds from the sale of the Mill Road Tract would have been ordinary income to Mill Road 36 at the time the conservation easement was donated; and the amount of the deduction that was generated by the charitable contribution that was made (instead of a sale) is limited, by operation of section 170(e)(1)(A), to Mill Road 36's basis in the Mill Road Tract. It is undisputed that Mill Road 36's basis in the Mill Road Tract at the time of the conservation easement donation was $416,563, as it reported on its Form 8283. Mill Road 36 is therefore entitled to a charitable contribution deduction not of the almost $9 million amount it claimed on its return, nor the $6.7 million value for which it contended at trial, nor even the $900,000 value we find for the easement, but its basis of $416,563.

Tucker and Langlieb, "Tax Planning for Real Estate Ownership (With a Focus on Choice of Entity)," *TM Real Estate Journal*, January 5, 2011, Vol. 27 No. 01., point out:

> The "dealer" in real estate will encounter difficulties in segregating investment real estate from real estate held for sale. *See, e.g., Tibbals v. U.S.*, 362 F.2d 266 (Ct. Cl. 1966), and *Black v. Comr.*, 45 B.T.A. 204 (1941). *But see Cary v. Comr.*, 32 T.C.M. 913 (1973), *Adam v. Comr.*, 60 T.C. 996 (1973), and *Ridgewood Land Co. Inc. v. Comr.*, 31 T.C.M. 39 (1972), *aff'd* 477 F.2d 135 (5th Cir. 1973).

However, *Gardner v. Commissioner*, T.C. Memo. 2011-137, allowed a dealer to obtain capital gain treatment when he persuaded the Tax Court judge that he intended to hold the property and rent it. The property had been subdivided, but he had to build a road on it to give interior properties access to the nearby street. Note, however, that the taxpayer had to litigate the issue. *Pool v. Commissioner*, T.C. Memo. 2014-3, held:

> This Court and the Court of Appeals for the Ninth Circuit have identified several relevant factors for evaluating whether a taxpayer held certain properties primarily for sale to customers in the ordinary course of business. Such factors include: (1) the nature of the acquisition of the property; (2) the frequency and continuity of sales over an extended period; (3) the nature and the extent of the taxpayer's business, (4) the activity of the seller about the property; and (5) the extent and substantiality of the transactions. *Id.* at 462; *see Pritchett v. Commissioner*, 63 T.C. 149, 162-163 (1974). We must decide each case upon its particular facts, and the presence of any one or more of these factors may or may not be determinative of a particular case. *Austin v. Commissioner*, 263 F.2d at 462.

Fargo v. Commissioner, T.C. Memo. 2015-96 held:

> Whether a taxpayer held specified property primarily for sale to customers in the ordinary course of business is a question of fact. *Rockwell v. Commissioner*, 512 F.2d 882, 884 (9th Cir. 1975), *aff'g* T.C. Memo. 1972-133. The term "primarily" for purposes of section 1221(a)(1) means "of first importance" or "principally". See *Malat v. Riddell*, 383 U.S. 569, 572 (1966). This Court has identified several factors for evaluating whether a taxpayer held certain properties primarily for sale to customers in the ordinary course of business, including: (1) the purpose for which the property was initially acquired; (2) the purpose for which the property was subsequently held; (3) the extent to which improvements, if any, were made to the property by the taxpayer; (4) the frequency, number, and continuity of sales; (5) the extent and nature of the transactions involved; (6) the ordinary business of the taxpayer; (7) the extent of advertising, promotion, or other active efforts used in soliciting buyers for the sale of the property; (8) the listing of property with brokers; and (9) the purpose for which the property was held at the time of sale. *Maddux Constr. Co. v. Commissioner*, 54 T.C. 1278, 1284 (1970). We must decide each case upon its particular facts, and the presence of any one or more of these factors may or may not be determinative of a particular case. *Redwood Empire Sav. & Loan Ass'n v. Commissioner*, 628 F.2d 516, 517 (9th Cir. 1980), *aff'g* 68 T.C. 960 (1977).

Musselwhite v. Commissioner, T.C. Memo. 2022-57, looking to 4th Circuit cases, mentioned similar standards and discussed their weight:

> However, no one factor or group of factors is determinative, *id*., and not all factors may be relevant in a particular case or factors may have varying degrees of relevance depending on the facts of a particular case, *S&H, Inc. v. Commissioner*, 78 T.C. 234, 243–44 (1982). Additionally, objective factors carry more weight than the taxpayer's subjective statements of intent. See *Guardian Indus. Corp. v. Commissioner*, 97 T.C. 308, 316 (1991), *aff'd without published opinion*, 21 F.3d 427 (6th Cir. 1994).

For more cases, see ¶ I-6313, Income from real estate sales relative to other income as a factor in determining whether a taxpayer is a dealer in real estate, *Federal Tax Coordinator 2d*. See also Bittker, ¶ 31.04[6] Special Rules Relating to Real Estate, *McMahon & Zelenak: Federal Income Taxation of Individuals* (WG&L), describing when sales of real estate generate capital gain or ordinary income, including references to Code §§ 1221(a)(2), 1231, 1237 (certain activities not considered development that converts property to inventory), 1239, and 1250.

When real estate is used in a business, see part II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business; within that part, if property is bought for use in a trade or business but in never placed in service, see text accompanying fns. 1484-1485.

Although a "taxpayer may hold some property for sale in the ordinary course of business and some for investment," "the burden is on the taxpayer to establish that the parcels held primarily for investment were segregated from other properties held primarily for sale. The mere lack of development activity with respect to parts of a large property does not sufficiently separate those parts from the whole to meet the taxpayer's burden."[1909] Thus, when a taxpayer starts developing a tract of real estate and sells some property in a different manner than originally intended, the taxpayer must prove that the portion sold is not held for development the way that the rest of the real estate is.[1910] However, if the taxpayer can show why the taxpayer for several years had stopped developing the property and then sold it to another developer, which other developer engaged in its own efforts to develop and sell the property, the taxpayer was not a developer with respect to that property.[1911] In the latter case, the court was so convinced by the

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[1909] *Boree v. Commissioner*, 118 A.F.T.R.2d 2016-5742 (11th Cir. 9/12/2016), citing:

> *Suburban Realty Co.,* 615 F.2d at 185. Whether a taxpayer segregated property for investment as opposed to inventory purposes would appear to be a question of fact, just as is the taxpayer's overall primary purpose for holding the property. *See id.* at *180-81* ("[T]he question of taxpayer's purpose or purposes for holding the property is primarily factual, as is the question of which purpose predominates.").

[1910] *Boree v. Commissioner*, 118 A.F.T.R.2d 2016-5742 (11th Cir. 9/12/2016). However, in *Sugar Land Ranch Development, LLC v. Commissioner*, T.C. Memo. 2018-21, the taxpayer did prove different conduct:

> Respondent seems to suggest that we should impute to SLRD development activity which he says was performed on the eastern parcels by related parties. Respondent has not pointed us to legal authority or any evidence in support of this position. The caselaw appears to be to the contrary. See *Bramblett v. Commissioner*, 960 F.2d at 533-534 (rejecting argument that activities of corporation in selling and developing land should be attributed to partnership whose partners held ownership interests in the corporation); *Phelan v. Commissioner*, T.C. Memo. 2004-206 (similar). But even if we were to assume for the sake of argument that SLRD had substantial development activity on, or active and continuous sales from, the eastern parcels (by imputation or otherwise), nevertheless - in the absence of a connection between the eastern parcels and the TM parcels - we are not persuaded that the bulk sale of the TM parcels would have been in the ordinary course of SLRD's alleged development business, considering that all development activity had been halted on the TM parcels at least three years before the sales at issue and that the TM parcels were never developed into a subdivision by SLRD. As the Court of Appeals for the Fifth Circuit noted in *Suburban Realty*, 615 F.2d at 179 n.24, "if a taxpayer who engaged in a high volume subdivision business sold one clearly segregated tract in bulk, he might well prevail in his claim to capital gain treatment on the segregated tract." That is precisely what happened here. The TM parcels were clearly segregated from the other parcels by the levee and HLP easement and were sold in bulk to a single buyer.

[1911] *Sugar Land Ranch Development, LLC v. Commissioner*, T.C. Memo. 2018-21, held:

> The parties agree that SLRD was formed to engage in real estate development - specifically, to acquire the property and develop it into single-family residential building lots and commercial tracts. The record supports this conclusion: SLRD's tax returns, the development agreement, SLRD's formation documents, and the testimony of Messrs. Johnson and Wong all clearly show that SLRD originally intended to be in the business of selling residential and commercial lots to customers.
>
> But the evidence also clearly shows that in 2008 SLRD ceased to hold its property primarily for sale in that business and began to hold it only for investment. SLRD's partners decided not to develop the property any further, and they decided not to sell lots from those parcels. This

taxpayer's actual conduct that it decided to ignore the taxpayer's admission on its tax return that it was a developer.[1912]

Part II.I.8.c.iii Rental as a Trade or Business includes a detailed excerpt from the preamble promulgating the regulations governing net investment income tax.

II.G.26.b. Real Estate as a Trade or Business

This part II.G.26.b was inspired by Werlhof, "Significance of Trade or Business Status for Rental Real Estate," *Journal of Taxation* (9/2019), saved as Thompson Coburn LLP doc. no. 7394778.

Whether a real activity is a trade or business is important in parts:

- II.E.1.e Whether Real Estate Qualifies as a Trade or Business, which generally explores the issue of whether real estate constitutes a business for purposes of the Code § 199A deduction based on qualified business income. See generally part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

- II.G.20.a Code § 163(j) Limitation on Deducting Business Interest Expense, limiting interest deductions allocable to a trade or business but also providing special rules for real estate businesses, although those special rules have exceptions that may make the protection difficult to procure.

- II.K.1.e Rental Activities, describing how whether real estate is a trade or business can determine whether one can avoid the Code § 469 passive loss limitations, which are also

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conclusion is supported by the highly credible testimony of Messrs. Johnson and Wong and by the 2008 unanimous consent and the 2009 member resolution. In fact, from 2008 on SLRD did not develop or sell lots from those parcels (and the evidence does not suggest that SLRD ever sold even a single residential or commercial lot to a customer at any point in its existence). Respondent concedes that SLRD never subdivided the property.

More particularly, when the TM parcels were sold, they were not sold in the ordinary course of SLRD's business: SLRD did not market the parcels by advertising or other promotional activities . SLRD did not solicit purchasers for the TM parcels, nor does any evidence suggest that SLRD's managers or members devoted any time or effort to selling the property; Taylor Morrison approached SLRD. Most importantly, sale of the TM parcels was essentially a bulk sale of a single, large, and contiguous tract of land (which was clearly separated from any other properties by the HLP easement and the levee) to a single seller - clearly not a frequent occurrence in SLRD's ordinary business.

Because the Taylor Morrison parcels were held for investment and were not sold as part of the ordinary course of SLRD's business, we hold that net gains from the sales of TM-2 and TM-3 were capital in character.

[1912] *Sugar Land Ranch Development, LLC v. Commissioner*, T.C. Memo. 2018-21, held

Next, respondent points out that on its 2012 Form 1065 SLRD listed its principal business activity as "Development" and its principal product or service as "Real Estate". Although this circumstance may count against petitioners to some limited degree, we believe that these statements "are by no means conclusive of the issue." See *Suburban Realty*, 615 F.2d at 181. Considering the record as a whole, we are inclined to believe that these stock descriptions were inadvertently carried over from earlier returns.

Note also that one can be a developer with respect to some property but not with respect to other property. In *Sugar Land*, the IRS pointed out that the taxpayer appeared to have been developing other land, which the court said did not seem to be the case, but the court said was irrelevant with respect to the sold property.

important in trying to avoid the 3.8% tax on net investment income, for which real estate special rules are in part II.I.8.c Application of 3.8% Tax to Rental Income. See generally parts II.K Passive Loss Rules and II.I 3.8% Tax on Excess Net Investment Income (NII).

- III.B.5.e.ii.(a) What is a Business?, describing what is a business that can qualify for a deferral of estate taxes under Code § 6166. See generally part III.B.5.e.ii Code § 6166 Deferral.

- II.G.6.a Code § 1231 Property, which provides ordinary losses or capital gain on the sale of property used in a trade or business. However, if ordinary losses have been deducted under Code § 1231, future gains are ordinary income until the ordinary losses are recaptured. Thus, real estate being a trade or business is good for loss purposes but might be bad for gain purposes. Contrast the above to the sale of real estate that is not a trade or business, which is always a capital gain or loss. But that's not the whole story. When depreciation recapture is taxed at capital gain rates, it is taxed at 25%.[1913] When any gain is taxed as ordinary income as Code § 1231 loss recapture, it may constitute qualified business income that may generate a 20% Code § 199A deduction.[1914]

- II.G.4.l.ii Net Operating Loss Deduction (Code § 172) provides a benefit for business losses.[1915]

- II.P.3.b.iii Excess Passive Investment Income, explaining whether real estate is considered passive for purposes of determining whether an S corporation has so much passive investment income as to be hit with a supplemental tax or even lose its S election. (However, real estate does not necessarily have to be a trade or business to avoid being "passive" for that test.)

Whether real estate qualifies as a trade or business is described in parts:

- II.I.8.c.iii Rental as a Trade or Business, which is the main place where various cases are discussed.

- II.E.1.e.i.(a) Whether Real Estate Activity Constitutes A Trade Or Business, which describes the issue in the context of the Code § 199A deduction based on qualifies business income. Although that part focuses on Code § 199A, it seems to be the best source for trying to understand the IRS' views, because tax advisors complained a lot about uncertainty in this area, and the IRS promulgated a safe harbor (which isn't very helpful).

Whether any other activity qualifies as a trade or business is described in part II.G.4.l.i Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit.

Interest expense from rental real estate activity has special status. If rental is a trade or business, the interest is fully deductible, subject to the limitations described in parts II.G.20.a Code § 163(j) Limitation on Deducting Business Interest Expense, II.K Passive Loss Rules, II.G.4.c Basis Limitations for Deducting Partnership and S Corporation Losses, and II.G.4.j At Risk Rules. If rental is not from a trade or business, the same limits apply (other

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[1913] Code §§ 1(h)(1)(E), 1(h)(6).
[1914] See discussion in preambles reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.
[1915] See fn 1405 in part II.G.4.l.ii Net Operating Loss Deduction (Code § 172).

than part II.G.20.a), and the interest expense is deducted directly against the rental income,[1916] on Schedule E, part I (if conducted directly by an individual or married couple) or Form 8825 (if conducted by a partnership or an S corporation). If one borrows to buy an interest in a partnership or an S corporation, the debt is allocated among the entity's assets and interest expense treated according to how those assets are deployed.[1917]

II.G.26.c. Future Development of Real Estate

Gain[1918] on the sale of real estate is taxed as:

- Capital gain, to the extent it is held for investment,
- Ordinary income, if the seller is a dealer or subdivided the property, or
- Capital gain, to the extent it was used in the business and is not described above.

A taxpayer who holds real estate for investment (and is not a dealer) but then decides to develop it should, before preparing development plans,[1919] consider selling it to the taxpayer's wholly-owned S corporation to lock in capital gain treatment on the pre-development appreciation;[1920] however, any S corporation that holds real estate should have that (together with any ancillary cash) as its only property.[1921] A sale to a controlled partnership would be taxed as ordinary income, because the partnership's plan to act as a developer would taint the transaction.[1922] Although generally a corporation (whether S or C) is a poor choice to hold real

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[1916] See Code §§ 469(c)(2) (rental is a passive activity except for certain taxpayers carrying on a real; estate business), 163(d)(3)(B)(ii) (Code § 469 interest is not subject to the investment interest limitations of Code § 163(d)) (Code § 163(d)(3) is reproduced in fn 2295 in part II.I.6 Deductions Against NII), 163(h)(2)(C) (Code § 469 interest is not nondeductible personal interest under Code § 163(h)), 212(1) (deduction for expenses incurred "for the production or collection of income"), and 62(a)(4) (Code § 212 expenses, which are attributable to property held for the production of rents or royalties, are deductible above-the-line instead of being itemized deductions).

[1917] See fn 6112 in part III.A.3.e.vi.(a) Grantor Trust Issues Involved in a Sale of S Stock to a QSST.

[1918] For an excellent overview of expenditures that affect the adjusted basis of real estate, see Tucker and Langlieb, "Tax Planning for Real Estate Ownership (With a Focus on Choice of Entity)," *TM Real Estate Journal*, January 5, 2011, Vol. 27 No. 01.

[1919] Once the taxpayer makes plans to develop, the taxpayer might face an uphill battle in proving otherwise. See *Fargo v. Commissioner*, T.C. Memo. 2015-96.

[1920] Eustice & Kuntz, ¶2.04. Situations in Which Subchapter S Is (or Is Not) Useful - ¶ 2.04[8] Real Estate Developed for Sale, *Federal Income Taxation of S corporations* (WG&L). However, they point out that, in *Little v. Commissioner*, T.C. Memo. 1993-281, *aff'd* 106 F.3d 1445 (9th Cir. 1997), the taxpayer argued unsuccessfully that he held investment property while his S corporation held dealer property. The *Little* case involved a taxpayer who already was a dealer in real estate, so a taxpayer who clearly is not already a dealer should be able to distinguish the case. That case would tend to cause more problems when a taxpayer holds a number of real estate properties and sells to a thinly capitalized S corporation.

[1921] To maximize basis step-up possibilities, each separate real estate property should be held in its own S corporation. See part II.H.8.a Depreciable Real Estate in an S Corporation. Dividing on a tax-free basis corporations that hold real estate can be challenging. See part II.Q.7.f Corporate Division.

[1922] McKee, Nelson & Whitmire, ¶14.04. Special Rules for Transactions Between Partnerships and Partners or Related Persons, *Federal Taxation of Partnerships & Partners* (WG&L), interpreting Code § 707(b)(2)(A). For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

estate, this property is intended to be developed and sold quickly, so it really will just turn into an corporation holding cash, which can then be liquidated if an S corporation.[1923]

The sale of the investment property might be using an installment note to defer capital gain until the real estate is sold.[1924]

II.G.27. Importance of Keeping Depreciable or Amortizable Property Outside of a Corporation; Strategy for Related Party Sales

See part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation.

Also, when an S corporation sells depreciable property to a related party, which sale may include a liquidating distribution, the sale may trigger ordinary income tax for the entire gain – not just depreciation recapture.[1925] However, if it sells a partnership interest, the ordinary income portion is limited to depreciation recapture.[1926] The partnership should not be formed too close to the sale.[1927] For strategies to place corporate assets into a partnership, see part II.Q.7.h Distributing Assets; Drop-Down into Partnership.

Partnerships are subject to similar rules when selling to a related party; see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships. However, often distributions from partnerships will not constitute a sale; see part II.Q.8.b Partnership Redemption or Other Distribution.

Whether a corporation or a partnership, an entity that wants to sell to a related party might instead consider forming a preferred partnership with that related party; see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion. After waiting long enough (perhaps two but more likely seven years),[1928] the parties may decide to redeem the original transferor's retained interest; see part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

[1923] For the recommendation to liquidate, see part II.F.2 Asset Protection Benefits of Dissolving the Business Entity After Asset Sale.

[1924] The gain would be accelerated when the real estate is sold. Code § 453(e).

[1925] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).

[1926] See part II.Q.8.b.i.(g) Code § 751 – Hot Assets.

[1927] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), especially text accompanying fns. 5087-5094.

[1928] The parties should wait at least two years to avoid the disguised sale rules; see part II.M.3.e Exception: Disguised Sale. However, seven years is probably needed; see part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

II.G.28. Avoid Securing Loans with an Account Holding Muni Bonds

Code § 265(a)(2) disallows deductions for interest "on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle."[1929]

"Direct evidence of a purpose to *purchase* tax-exempt obligations exists where the proceeds of indebtedness are used for, and are directly traceable to, the purchase of tax-exempt obligations."[1930]

"Direct evidence of a purpose to *carry* tax-exempt obligations exists where tax-exempt obligations are used as collateral for indebtedness."[1931] Even where tax-exempt obligations are not used as collateral for indebtedness, they might taint loans for other purposes[1932] except where the loans are fully secured by other property.[1933]

[1929] Reg. § 1.265-1(a)(1) provides:

> No amount shall be allowed as a deduction under any provision of the Code for any expense or amount which is otherwise allowable as a deduction and which is allocable to a class or classes of exempt income other than a class or classes of exempt interest income.

Reg. § 1.265-2(a) elaborates:

> No amount shall be allowed as a deduction for interest on any indebtedness incurred or continued to purchase or carry obligations, the interest on which is wholly exempt from tax under subtitle A of the Code, such as municipal bonds….

[1930] Rev. Proc. 72-18, § 3.02 (emphasis in original), which cited and then elaborated:

> *Wynn v. United States*, 411 F.2d 614 (1969), certiorari denied 396 U.S. 1008 (1970). Section 265(2) does not apply, however, where proceeds of a bona fide business indebtedness are temporarily invested in tax-exempt obligations under circumstances similar to those set forth in Revenue Ruling 55-389, C.B. 1955-1, 276.

[1931] Rev. Proc. 72-18, § 3.03 (emphasis in original), which cited and then elaborated:

> "[O]ne who borrows to buy tax-exempts and one who borrows against tax-exempts already owned are in virtually the same economic position. Section 265(2) makes no distinction between them." *Wisconsin Cheeseman v. United States*, 338 F.2d 420, at 422 (1968).

[1932] Rev. Proc. 72-18, § 4.04 provides this example:

> Taxpayer *A*, an individual, owns common stock listed on a national securities exchange, having an adjusted basis of $200,000; he owns rental property having an adjusted basis of $200,000; he has cash of $10,000; and he owns readily marketable municipal bonds having an adjusted basis of $41,000. *A* borrows $100,000 to invest in a limited partnership interest in a real estate syndicate and pays $8,000 interest on the loan which he claims as an interest deduction for the taxable year. Under these facts and circumstances, there is a presumption that the $100,000 indebtedness which is incurred to finance A's portfolio investment is also incurred to carry A's existing investment in tax-exempt bonds since there are no additional facts or circumstances to rebut the presumption. Accordingly, a portion of the $8,000 interest payment will be disallowed under section 265(2) of the Code.

[1933] Rev. Proc. 72-18, § 4.02 provides:

> An individual taxpayer may incur a variety of indebtedness of a personal nature, ranging from short-term credit for purchases of goods and services for personal consumption to a mortgage incurred to purchase or improve a residence or other real property which is held for personal use. Generally, section 265(2) of the Code will not apply to indebtedness of this type, because the purpose to purchase or carry tax-exempt obligations cannot reasonably be inferred where a personal purpose unrelated to the tax-exempt obligations ordinarily dominates the transaction. For example, section 265(2) of the Code generally will not apply to an individual who holds salable municipal bonds and takes out a mortgage to buy a residence instead of selling his

When direct evidence establishes a purpose to purchase or carry tax-exempt obligations (either because tax-exempt obligations were used as collateral for indebtedness or the proceeds of indebtedness were directly traceable to the holding of particular tax-exempt obligations), Rev. Proc. 72-18 assets that no part of the interest paid or incurred on such indebtedness may be deducted.[1934] However, if only a fractional part of the indebtedness is directly traceable to the holding of particular tax- exempt obligations, Rev. Proc. 72-18 assets that the same fractional part of the interest paid or incurred on such indebtedness would be disallowed.[1935] In any other case where interest is disallowed under Rev. Proc. 72-18, an allocable portion of the interest on such indebtedness will be disallowed.[1936]

Investing up to 2% of one's assets in tax-exempt investments might be disregarded.[1937]

II.G.29. Missouri Income Tax Cut for Pass-Through Entities and Sole Proprietorships

RSMo. § 143.022 allows individuals to subtract from their federal adjusted gross income[1938] a portion of the income they earn as sole proprietors[1939] or as owners of partnerships or

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municipal bonds to finance the purchase price. Under such circumstances the purpose of incurring the indebtedness is so directly related to the personal purpose of acquiring a residence that no sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations may reasonably be inferred.

[1934] Section 7.01.

[1935] Section 7.01, which continues:

> For example, if *A* borrows $100,000 from a bank and invests $75,000 of the proceeds in tax-exempt obligations, 75 percent of the interest paid on the bank borrowing would be disallowed as a deduction.

[1936] Section 7.02, which continues:

> The amount of interest on such indebtedness to be disallowed shall be determined by multiplying the total interest on such indebtedness by a fraction, the numerator of which is the average amount during the taxable year of the taxpayer's tax-exempt obligations (valued at their adjusted basis) and the denominator of which is the average amount during the taxable year of the taxpayer's total assets (valued at their adjusted basis) minus the amount of any indebtedness the interest on which is not subject to disallowance to any extent under this Revenue Procedure.

[1937] Rev. Proc. 72-18, § 3.05, which provides:

> Generally, where a taxpayer's investment in tax-exempt obligations is insubstantial, the purpose to purchase or carry tax-exempt obligations will not ordinarily be inferred in the absence of direct evidence as set forth in sections 3.02 and 3.03. In the case of an individual, investment in tax-exempt obligations shall be presumed insubstantial only where during the taxable year the average amount of the tax-exempt obligations (valued at their adjusted basis) does not exceed 2 percent of the average adjusted basis of his portfolio investments (as defined in section 4.04) and any assets held in the active conduct of a trade or business. In the case of a corporation, an investment in tax-exempt obligations shall be presumed insubstantial only where during the taxable year the average amount of the tax-exempt obligations (valued at their adjusted basis) does not exceed 2 percent of the average total assets (valued at their adjusted basis) held in the active conduct of the trade or business. This paragraph shall not apply to a dealer in tax-exempt obligations.

[1938] RSMo. § 143.022.2.

[1939] RSMo. § 143.022.1(1) refers to the "total combined profit as properly reported to the Internal Revenue Service on each Schedule C, or its successor form, filed."

S corporations.[1940] The portion is expected to start at 5% in calendar year 2018[1941] and increase in 5% increments until it reaches 25% in calendar year 2022,[1942] if Missouri's revenue increases sufficiently.

The deduction applies to income reported on Form 1040, Schedule C or Schedule E, Part II. Interest and dividends from pass-through entities are reported on Schedule B and therefore do not qualify for this break. Same with gain on the sale of assets, which are reported on Schedule D (gain from the sale of capital assets and the long-term capital gain component of gain from the sale of business assets) or Form 1040, line 14 (depreciation recapture from the sale of business assets). Because gain from the sale of business assets is not eligible for this deduction, but income that is not offset by depreciation is eligible, this provision encourages business owners to consider Code § 1031 nontaxable like-kind exchanges of business assets (to the extent such a small tax cut is capable of motivating any actions).

An individual owning a single member LLC that is a disregarded entity who reports rental income on Schedule E, Part I will not get this break. By adding a member to the LLC (for example, a spouse), the LLC reports its rental income on a partnership return and the owners report their K-1 income on Schedule E, Part II, making the rental income eligible for this tax break. Note that, unless the income is large enough, this tax break does not justify the expense of filing a partnership tax return.

The subtraction is "apportioned in proportion to their share of ownership of the business as reported on the taxpayer's Schedule K-1, or its successor form, for the tax period for which such deduction is being claimed when determining the Missouri adjusted gross income" of owners of partnerships or S corporations.[1943]

II.G.30. Disclosing Owners to Financial Institutions and Governments

II.G.30.a. Rules for Disclosing Owners to Covered Financial Institutions

In addition to regulations cited below, see FIN-2018-G001, "Frequently Asked Questions Regarding Customer Due Diligence Requirements for Financial Institutions," (4/3/2018), referred to below as the FAQ.[1944] Only those aspects of the FAQ relating to ownership issues are covered below.

Covered financial institutions[1945] are required to establish and maintain written procedures that are reasonably designed to identify and verify beneficial owners of legal entity customers and to

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[1940] RSMo. § 143.022.1(2) refers to the "total partnership and S corporation income or loss properly reported to the Internal Revenue Service on Part II of Schedule E, or its successor form."

[1941] It would have started in 2017 if Missouri's revenue had increased enough for the fiscal year that ended in 2016, RSMo. § 143.022.6, but the target described in RSMo. § 143.022.5 was not reached until the fiscal year that ended in 2017.

[1942] RSMo. § 143.022.4.

[1943] RSMo. § 143.022.3.

[1944] Saved as Thompson Coburn LLP doc. no. 6734758.

[1945] 31 C.F.R. § 1010.230(f) provides:

> *Covered financial institution*. For the purposes of this section, covered financial institution has the meaning set forth in § 1010.605(e)(1) of this chapter.

31 C.F.R. § 1010.605(e)(1) provides that "covered financial institution" means, for purposes of § 1010.610 and 1010.620:

include such procedures in their anti-money laundering compliance program. 31 C.F.R. § 1010.230(f) provides:

> *Covered financial institution*. For the purposes of this section, covered financial institution has the meaning set forth in § 1010.605(e)(1) of this chapter.

31 C.F.R. § 1010.605(e)(1) provides that "covered financial institution" means, for purposes of § 1010.610 and 1010.620:

(i) An insured bank (as defined in section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. 1813(h)));

(ii) A commercial bank;

(iii) An agency or branch of a foreign bank in the United States;

(iv) A federally insured credit union;

(v) A savings association;

(vi) A corporation acting under section 25A of the Federal Reserve Act (12 U.S.C. 611 et seq.);

(vii) A trust bank or trust company that is federally regulated and is subject to an anti-money laundering program requirement;

(viii) A broker or dealer in securities registered, or required to be registered, with the Securities and Exchange Commission under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), except persons who register pursuant to section 15(b)(11) of the Securities Exchange Act of 1934;

(ix) A futures commission merchant or an introducing broker registered, or required to be registered, with the Commodity Futures Trading Commission under the

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(i) An insured bank (as defined in section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. 1813(h)));
(ii) A commercial bank;
(iii) An agency or branch of a foreign bank in the United States;
(iv) A federally insured credit union;
(v) A savings association;
(vi) A corporation acting under section 25A of the Federal Reserve Act (12 U.S.C. 611 et seq.);
(vii) A trust bank or trust company that is federally regulated and is subject to an anti-money laundering program requirement;
(viii) A broker or dealer in securities registered, or required to be registered, with the Securities and Exchange Commission under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), except persons who register pursuant to section 15(b)(11) of the Securities Exchange Act of 1934;
(ix) A futures commission merchant or an introducing broker registered, or required to be registered, with the Commodity Futures Trading Commission under the Commodity Exchange Act (7 U.S.C. 1 et seq.), except persons who register pursuant to section 4(f)(a)(2) of the Commodity Exchange Act; and
(x) A mutual fund….

Commodity Exchange Act (7 U.S.C. 1 et seq.), except persons who register pursuant to section 4(f)(a)(2) of the Commodity Exchange Act; and

(x) A mutual fund….

Other than entities excluded under 31 C.F.R. § 1010.230(e)(2),[1946] "legal entity customer" means:[1947]

> a corporation, limited liability company, or other entity that is created by the filing of a public document with a Secretary of State or similar office, a general partnership, and any similar entity formed under the laws of a foreign jurisdiction that opens an account.

[1946] 31 C.F.R. § 1010.230(e)(2) provides:

Legal entity customer does not include:

(i) A financial institution regulated by a Federal functional regulator or a bank regulated by a State bank regulator;
(ii) A person described in § 1020.315(b)(2) through (5) of this chapter;
(iii) An issuer of a class of securities registered under section 12 of the Securities Exchange Act of 934 or that is required to file reports under section 15(d) of that Act;
(iv) An investment company, as defined in section 3 of the Investment Company Act of 1940, that is registered with the Securities and Exchange Commission under that Act;
(v) An investment adviser, as defined in section 202(a)(11) of the Investment Advisers Act of 1940, that is registered with the Securities and Exchange Commission under that Act;
(vi) An exchange or clearing agency, as defined in section 3 of the Securities Exchange Act of 1934, that is registered under section 6 or 17A of that Act;
(vii) Any other entity registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934;
(viii) A registered entity, commodity pool operator, commodity trading advisor, retail foreign exchange dealer, swap dealer, or major swap participant, each as defined in section 1a of the Commodity Exchange Act, that is registered with the Commodity Futures Trading Commission;
(ix) A public accounting firm registered under section 102 of the Sarbanes-Oxley Act;
(x) A bank holding company, as defined in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841) or savings and loan holding company, as defined in section 10(n) of the Home Owners' Loan Act (12 U.S.C 1467a(n));
(xi) A pooled investment vehicle that is operated or advised by a financial institution excluded under paragraph (e)(2) of this section;
(xii) An insurance company that is regulated by a State;
(xiii) A financial market utility designated by the Financial Stability Oversight Council under Title VIII of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010;
(xiv) A foreign financial institution established in a jurisdiction where the regulator of such institution maintains beneficial ownership information regarding such institution;
(xv) A non-U.S. governmental department, agency or political subdivision that engages only in governmental rather than commercial activities; and
(xvi) Any legal entity only to the extent that it opens a private banking account subject to § 1010.620 of this chapter.

[1947] 31 C.F.R. § 1010.230(e)(1). However, 31 C.F.R. § 1010.230(e)(2) requires the following to disclose only the control prong of the beneficial ownership requirement:

(i) A pooled investment vehicle that is operated or advised by a financial institution not excluded under paragraph (e)(2) of this section; and
(ii) Any legal entity that is established as a nonprofit corporation or similar entity and has filed its organizational documents with the appropriate State authority as necessary.

Elaborating on what is a "legal entity customer," page 29412 of the Preamble[1948] explains:

> … a legal entity customer means a corporation, limited liability company, or other entity that is created by the filing of a public document with a Secretary of State or similar office, a general partnership, and any similar entity formed under the laws of a foreign jurisdiction, that opens an account. This means that ''legal entity customer'' would include, in addition to corporations and limited liability companies, limited partnerships, business trusts that are created by a filing with a state office, any other entity created in this manner, and general partnerships. (It would also include similar entities formed under the laws of other countries.) It would not include, for example, sole proprietorships or unincorporated associations even though such businesses may file with the Secretary of State in order to, for example, register a trade name or establish a tax account. This is because neither a sole proprietorship nor an unincorporated association is an entity with legal existence separate from the associated individual or individuals that in effect creates a shield permitting an individual to obscure his or her identity.[54] The definition of ''legal entity customer'' also does not include natural persons opening accounts on their own behalf. In the final rule, we remove the reference to a ''new'' account to eliminate redundancies with other paragraphs of this provision, and because this account status is not a relevant characteristic for defining a legal entity customer.
>
> [54] FinCEN notes that this is consistent with the CIP rules, which include as a customer ''an individual who opens a new account for ... (B) an entity that is not a legal person, such as a civic club.'' In such a case, the individual opening the account, rather than the civic club, is the customer. *See, e.g.*, 31 CFR 1020.100(c)(1)(ii)(B).

FAQ Question 22 explains this exclusion:

> **Are sole proprietorships formed by spouses or other unincorporated associations considered legal entity customers under the Rule?**
>
> A. No. Sole proprietorships - individual or spousal - and unincorporated associations are not legal entity customers as defined by the Rule, even though such businesses may file with the Secretary of State in order to register a trade name or establish a tax account. This is because neither a sole proprietorship nor an unincorporated association is a separate legal entity from the associated individual(s), and therefore beneficial ownership is not inherently obscured.[21]
>
> [21] See 81 FR, 29398, 29412 (May 11, 2016).

As to the exclusion for charities, non-profits or similar entities, FAQ Question 23 says:

> **Are covered financial institutions limited to the Internal Revenue Code (IRC) definitions of charities, non-profits, or similar entities when assessing their eligibility for exclusion from the definition of legal entity customer?**

[1948] These regulations were promulgated by RIN 1506-AB25, *Federal Register*, vol. 81, No. 91, pages 29398-29458, the explanatory portions being referred to in this part II.G.30 Disclosing Owners to Financial Institutions as the "Preamble."

A. No. The exclusion from the definition of legal entity customer for charities and non-profit entities is not limited to those entities that meet the definition or description of charitable, nonprofit, or similar entities under the IRC. The Rule does not rely on the tax-exempt status of an entity as described in the IRC. All nonprofit entities—whether or not tax-exempt—that are established as a nonprofit, or nonstock corporation, or similar entity that has been validly organized with the proper State authority are excluded from the ownership/equity prong of the requirement because nonprofit entities generally do not have ownership interests.[22] Financial institutions, however, are required to collect beneficial ownership information under the control prong from any such entity.[23]

[22] See 81 FR at 29412.

[23] *Id.*

A trust is not a "legal entity customer." Page 29412 of the Preamble explains:

The definition would also not include trusts (other than statutory trusts created by a filing with a Secretary of State or similar office). This is because, unlike the legal entities that are subject to the final rule, a trust is a contractual arrangement between the person who provides the funds or other assets and specifies the terms (*i.e.*, the grantor or settlor) and the person with control over the assets (*i.e.*, the trustee), for the benefit of those named in the trust deed (*i.e.*, the beneficiaries). Formation of a trust does not generally require any action by the state. As FinCEN noted in the NPRM, identifying a ''beneficial owner'' from among these parties, based on the definition in the proposed or final rule, would not be possible.

FinCEN emphasizes that this does not and should not supersede existing obligations and practices regarding trusts generally. The preamble to each of the CIP rules notes that, while financial institutions are not required to look through a trust to its beneficiaries, they "may need to take additional steps to verify the identity of a customer that is not an individual, such as obtaining information about persons with control over the account."[55] Moreover, as FinCEN noted in the proposal, it is our understanding that where trusts are direct customers of financial institutions, financial institutions generally also identify and verify the identity of trustees, because trustees will necessarily be signatories on trust accounts (which in turn provides a ready source of information for law enforcement in the event of an investigation). Furthermore, under supervisory guidance for banks, "in certain circumstances involving revocable trusts, the bank may need to gather information about the settlor, grantor, trustee, or other persons with the authority to direct the trustee, and who thus have authority or control over the account, in order to establish the true identity of the customer."[56] We reiterate our understanding that, consistent with existing obligations, financial institutions are already taking a risk-based approach to collecting information with respect to various persons associated with trusts in order to know their customer,[57] and that we expect financial institutions to continue these practices as part of their overall efforts to safeguard against money laundering and terrorist financing.[58]

[55] See, *e.g.*, "Customer Identification Programs for Broker-Dealers," 68 FR at 25116 n.32. (May 9, 2003).

[56] Federal Financial Institutions Examination Council, Bank Secrecy Act/Anti-Money Laundering Examination Manual 281 (2014) (FFIEC Manual).

[57] FinCEN also understands that in order to engage in the business of acting as a trustee, it is necessary for a trust company to be Federally- or State-chartered. Such entities are subject to BSA obligations, which reduces the AML risk of such trusts.

[58] Also not covered by the final rule are accounts in the name of a deceased individual opened by a court-appointed representative of the deceased's estate.

As to trusts with multiple trustees owning a legal entity customer, FAQ Question 19 provides:

> **When 25 percent or more of the equity interests of a legal entity customer are owned by a trust that is overseen by co-trustees (multiple trustees), are covered financial institutions required to identify and verify the identity of all co-trustees?**
>
> No. If a trust owns directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, 25 percent or more of the equity interests of a legal entity customer, the beneficial owner under the ownership/ equity prong is the trustee. Where there are multiple trustees or co-trustees, financial institutions are expected to collect and verify the identity of, at a minimum, one co-trustee of a multi-trustee trust who owns 25 percent or more of the equity interests of a legal entity customer that is not subject to an exclusion. A covered financial institution may choose to identify additional co-trustees as part of its customer due diligence, based on its risk assessment and the customer risk profile and in accordance with the institution's account opening procedures.

As to a trusts with an entity as trustee, FAQ Question 20 provides:

> **If a legal entity is the trustee (*e.g.*, law firm, bank trust department, etc.) of a trust that owns 25 percent or more of the equity interests of a legal entity customer, can that entity be identified as a beneficial owner under the ownership/equity prong or does a natural person need to be so identified?**
>
> A. If a trust owns directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise, 25 percent or more of the equity interests of a legal entity customer, the beneficial owner for purposes of the ownership/equity prong is the trustee, regardless of whether the trustee is a natural person or a legal entity.[19] In circumstances where a natural person does not exist for purposes of the ownership/equity prong, a natural person would not be identified. However, a covered institution should collect identification information on the legal entity trustee as part of its CIP, consistent with the covered institution's risk assessment and the customer risk profile. In addition to the ownership/equity prong, covered financial institutions are also required to identify and verify a natural person as the beneficial owner of the legal entity customer under the control prong to comply with the Rule.[20]
>
> The ownership/equity and control prongs, although related, are independent requirements. Thus, satisfaction of, or exclusion from, regulatory obligations under one prong does not mean a covered financial institution's obligations under the other prong are also satisfied or excluded.
>
> [19] See 31 CFR 1010.230(d)(3).
>
> [20] See 31 CFR 1010.230(d)(2).

Under 31 C.F.R. § 1010.230(d), a covered financial institution's customer due diligence procedures must enable the institution to:[1949]

(1) "Identify the beneficial owner(s) of each legal entity customer at the time a new account is opened," unless the customer is otherwise specially excluded[1950] or the account is exempted.[1951] A covered financial institution may accomplish this either by obtaining a certification in the form of part II.G.30.b from the individual opening the account on behalf of the legal entity customer, or by obtaining from the individual the information required by the form by another means, provided the individual certifies, to the best of the individual's knowledge, the accuracy of the information.

(2) "Verify the identity of each beneficial owner identified to the covered financial institution, according to risk-based procedures to the extent reasonable and practicable." These procedures must contain the elements required for verifying the identity of customers under the general rules for identifying individuals for that type of financial institution. "A covered financial institution may rely on the information supplied by the legal entity customer regarding the identity of its beneficial owner or owners, provided that it has no knowledge of facts that would reasonably call into question the reliability of such information."

Under 31 C.F.R. § 1010.230(d), "beneficial owner" means each of the following:

(1) Each individual, if any, who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, owns 25 percent or more of the equity interests of a legal entity customer; and

(2) A single individual with significant responsibility to control, manage, or direct a legal entity customer, including:

[1949] 31 C.F.R. § 1010.230(b).

[1950] See fn 1946.

[1951] 31 C.F.R. § 1010.230(h), "Exemptions," provides:

(1) Covered financial institutions are exempt from the requirements to identify and verify the identity of the beneficial owner(s) set forth in paragraphs (a) and (b)(1) and (2) of this section only to the extent the financial institution opens an account for a legal entity customer that is:
  (i) At the point-of-sale to provide credit products, including commercial private label credit cards, solely for the purchase of retail goods and/or services at these retailers, up to a limit of $50,000;
  (ii) To finance the purchase of postage and for which payments are remitted directly by the financial institution to the provider of the postage products;
  (iii) To finance insurance premiums and for which payments are remitted directly by the financial institution to the insurance provider or broker;
  (iv) To finance the purchase or leasing of equipment and for which payments are remitted directly by the financial institution to the vendor or lessor of this equipment.

(2) Limitations on Exemptions.
  (i) The exemptions identified in paragraphs (h)(1)(ii) through (iv) of this section do not apply to transaction accounts through which a legal entity customer can make payments to, or receive payments from, third parties.
  (ii) If there is the possibility of a cash refund on the account activity identified in paragraphs (h)(1)(ii) through (iv) of this section, then beneficial ownership of the legal entity customer must be identified and verified by the financial institution as required by this section, either at the time of initial remittance, or at the time such refund occurs.

(i) An executive officer or senior manager (e.g., a Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member, General Partner, President, Vice President, or Treasurer); or

(ii) Any other individual who regularly performs similar functions.

(3) If a trust owns directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, 25 percent or more of the equity interests of a legal entity customer, the beneficial owner for purposes of paragraph (d)(1) of this section shall mean the trustee. If an entity listed in paragraph (e)(2) of this section owns directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, 25 percent or more of the equity interests of a legal entity customer, no individual need be identified for purposes of paragraph (d)(1) of this section with respect to that entity's interests.

31 C.F.R. § 1010.230(d) concludes with the following note:

> The number of individuals that satisfy the definition of "beneficial owner," and therefore must be identified and verified pursuant to this section, may vary. Under paragraph (d)(1) of this section, depending on the factual circumstances, up to four individuals may need to be identified. Under paragraph (d)(2) of this section, only one individual must be identified. It is possible that in some circumstances the same person or persons might be identified pursuant to paragraphs (d)(1) and (2) of this section. A covered financial institution may also identify additional individuals as part of its customer due diligence if it deems appropriate on the basis of risk.

The final rules were effective July 11, 2016, and the "applicability date," when covered financial institutions must comply, is May 11, 2018.[1952]

Pages 29409-29410 of the Preamble explain the rules regarding beneficial owners:

> *Section 1010.230(d) Beneficial Owner*. In the NPRM, we proposed two prongs for the definition of beneficial owner: Each individual, if any, who directly or indirectly owned 25 percent of the equity interests of a legal entity customer (the ownership prong); and a single individual with significant responsibility to control, manage, or direct a legal entity customer, including an executive officer or senior manager or any other individual who regularly performs similar functions (the control prong). We noted that the number of beneficial owners identified would vary from legal entity customer to legal entity customer due to the ownership prong - there could be as few as zero and as many as four individuals who satisfy this prong. All legal entities, however, would be required to identify one beneficial owner under the control prong. We further noted that financial institutions had the discretion to identify additional beneficial owners as appropriate based on risk.
>
> Thus, in practice, the number of beneficial owners identified will vary based on the circumstances. For example:
>
> - Mr. and Mrs. Smith each hold a 50 percent equity interest in ''Mom & Pop, LLC.'' Mrs. Smith is President of Mom & Pop, LLC and Mr. Smith is its Vice President.

[1952] Preamble, p. 29398.

Mom & Pop, LLC is required to provide the personal information of both Mr. & Mrs. Smith under the ownership prong. Under the control prong, Mom & Pop, LLC is also required to provide the personal information of one individual with significant responsibility to control Mom & Pop, LLC; this individual could be either Mr. or Mrs. Smith, or a third person who otherwise satisfies the definition. Thus, in this scenario, Mom & Pop, LLC would be required to identify at least two, but up to three distinct individuals – both Mr. & Mrs. Smith under the ownership prong, and either Mr. or Mrs. Smith under the control prong, or both Mr. & Mrs. Smith under the ownership prong, and a third person with significant responsibility under the control prong.

- Acme, Inc. is a closely-held private corporation. John Roe holds a 35 percent equity stake; no other person holds a 25 percent or higher equity stake. Jane Doe is the President and Chief Executive Officer. Acme, Inc. would be required to provide John Roe's beneficial ownership information under the ownership prong, as well as Jane Doe's (or that of another control person) under the control prong.

- Quentin, Inc. is owned by the five Quentin siblings, each of whom holds a 20 percent equity stake. Its President is Benton Quentin, the eldest sibling, who is the only individual at Quentin, Inc. with significant management responsibility. Quentin, Inc. would be required to provide Benton Quentin's beneficial ownership information under the control prong, but no other beneficial ownership information under the ownership prong, because no sibling has a 25 percent stake or greater.

In section 1010.230(d), the phrase ''directly or indirectly'' intends that the financial institution's customer identify its ultimate beneficial owner or owners as defined in the rule and not their nominees or ''straw men.''[1953] A covered financial institution is not required to do a "deep dive":[1954]

> FinCEN expects that financial institutions will generally be able to rely upon information about equity ownership provided by the person opening the account, and not to affirmatively investigate whether equity holders are attempting to avoid the reporting threshold. However, financial institution staff who know, suspect, or have reason to suspect that such behavior is occurring may, depending on the circumstances, be required to file a SAR.

However, FAQ Question 3 explains:

> **When a legal entity is identified as owning 25 percent or more of a legal entity customer that is opening an account, is it necessary for a covered financial institution to request beneficial ownership information on the legal entity identified as an owner?**
>
> A. Under the Rule's beneficial ownership identification requirement, a covered institution must collect, from its legal entity customers, information about any individual(s) that are the beneficial owner(s) (unless the entity is excluded or the account is exempted). Therefore, covered financial institutions must obtain from their legal entity customers the

[1953] Page 29410 of the Preamble.
[1954] Page 29410 of the Preamble.

identities of individuals who satisfy the definition, either directly or indirectly through multiple corporate structures, as illustrated in the following example.

> For purposes of the Rule, Allan is a beneficial owner of Customer because he owns indirectly 30 percent of its equity interests through his direct ownership of Company A. Betty is also a beneficial owner of Customer because she owns indirectly 20 percent of its equity interests through her direct ownership of Company A plus $16^{2/3}$ percent through Company B for a total of indirect ownership interest of $36^{2/3}$ percent. Neither Carl nor Diane is a beneficial owner because each owns indirectly only $16^{2/3}$ percent of Customer's equity interests through their direct ownership of Company B.
>
> [A diagram shows Company A owning 50% of Customer, with Allan owning 60% and Betty owning 40% of Company A. The diagram also shows Company B owning 50% of Customer, with each of Betty, Carl and Diane owning 1/3 of Company B.]
>
> A covered financial [institution] need not independently investigate the legal entity customer's ownership structure and may accept and reasonably rely on the information regarding the status of beneficial owners presented to the financial institution by the legal entity customer's representative, provided that the institution has no knowledge of facts that would reasonably call into question the reliability of the information.

A covered financial institution may be more strict:[1955]

> We reiterate that the 25 percent threshold is the baseline regulatory benchmark, but that covered financial institutions may establish a lower percentage threshold for beneficial ownership (*i.e.*, one that regards owners of less than 25 percent of equity interests as beneficial owners) based on their own assessment of risk in appropriate circumstances. As a general matter, FinCEN does not expect covered financial institutions' compliance with this regulatory requirement to be assessed against a lower threshold. Nevertheless, consistent with the risk-based approach, FinCEN anticipates that some financial institutions may determine that they should identify and verify beneficial owners at a lower threshold in some circumstances; we believe that making this clear in the note accompanying the regulatory text will aid them in doing so with respect to their customers.

Elaborating on the last sentence above, FAQ Question 1 says:

> A covered financial institution may choose, however, to collect such information on natural persons who own a lower percentage of the equity interests of a legal entity customer as well as information on more than one individual with managerial control.

Regarding using an equity threshold lower than 25%, FAQ Question 2 advises:

> There may be circumstances where a financial institution may determine that collection and verification of beneficial ownership information at a lower threshold may be warranted, based on the financial institution's own assessment of its risk relating to its customer.

[1955] Page 29410 of the Preamble.

> Transparency in beneficial ownership, however, is only one aspect of a covered financial institution's customer due diligence obligations. A financial institution may reasonably conclude that collecting beneficial ownership information at a lower equity interest than 25 percent would not help mitigate the specific risk posed by the customer or provide information useful to the financial institution in analyzing the risk. Rather, any additional heightened risk could be mitigated by other reasonable means, such as enhanced monitoring or collecting other information, including expected account activity, in connection with the particular legal entity customer.
>
> In all cases, however, it is important that covered financial institutions establish and maintain written procedures that are reasonably designed to identify and verify the identity of beneficial owners of legal entity customers and to include such procedures in their AML compliance program.[1]
>
> [1] *See* 31 U.S.C. § 5318(h); 31 CFR 1010.230(a).

The Preamble declined to define "equity interest":[1956]

> … we deliberately avoided the use of more technical terms of art associated with the exercise of control through ownership; we did so in part based on the preferences expressed by many members of industry…. Beyond the general examples provided in the proposal, however, we are reluctant to provide additional narrower examples that could be construed to limit a definition that we intend to be broadly applicable, particularly in light of the diversity of types of legal entities formed within the United States and abroad. By the same token, we also decline to provide a formal guidance document listing the types of documents that front-line employees should rely upon to demonstrate the existence of an equity interest over the triggering threshold. We reiterate that it is generally the responsibility of the legal entity customer (and its personnel) to make this determination and to identify the beneficial owners, and not front-line employees at the financial institution, unless the employees have reason to question the accuracy of the information presented.

The Preamble focuses on each financial institution using its usual documentation and risk-based measures to comply with this rule. FAQ Question 4 elaborates:

> **What means of identity verification are sufficient to reliably confirm beneficial ownership under the CDD Rule?**
>
> A. Covered financial institutions must verify the identity of each beneficial owner according to risk-based procedures that contain, at a minimum, the same elements financial institutions are required to use to verify the identity of individual customers under applicable Customer Identification Program ("CIP") requirements. This includes the requirement to address situations in which the financial institution cannot form a reasonable belief that it knows the true identity of the legal entity customer's beneficial owners.[2] Although the CDD Rule's beneficial ownership verification procedures must contain the same elements as existing CIP procedures, they are not required to be identical to them.[3] For example, a covered financial institution's policies and procedures may state that the institution will accept photocopies of a driver's license from the legal

[1956] Page 29411 of the Preamble.

entity customer to verify the beneficial owner(s)' identity if the beneficial owner is not present, which is not permissible in the CIP rules. (See Question 6.)

A financial institution's CIP must contain procedures for verifying customer identification, including describing when the institution will use documentary, non-documentary, or a combination of both methods for identity verification.[4] Covered financial institutions may use the same methods to verify the identity of the beneficial owner of a legal entity customer. In addition, in contrast to the CIP rule, the CDD Rule expressly authorizes covered financial institutions to use photocopies or other reproduction documents for documentary verification.[5]

Documentary verification may include unexpired government-issued identification evidencing nationality or residence and bearing a photograph or similar safeguard, such as a driver's license or passport.[6] Non-documentary methods of verification may include contacting a beneficial owner; independently verifying the beneficial owner's identity through the comparison of information provided by the legal entity customer (or the beneficial owner, as appropriate) with information obtained from other sources; checking references with other financial institutions; and obtaining a financial statement.[7]

Financial institutions should conduct their own risk-based analysis to determine the appropriate method(s) of verification and the appropriate documents or types of photocopies or reproductions to accept in order to comply with the beneficial owner verification requirement.

[2] Under the CIP rules, a financial institution's CIP must include procedures for responding to circumstances in which the financial institution cannot form a reasonable belief that it knows the true identity of a customer. These procedures should describe: (1) when the institution should not open an account; (2) the terms under which a customer may use an account while the institution attempts to verify the customer's identity; (3) when it should close an account, after attempts to verify a customer's identity have failed; and (4) when it should file a Suspicious Activity Report in accordance with applicable laws and regulations. *See, e.g.*, 31 CFR 1020.220(a)(2)(iii).

[3] See 31 CFR 1020.220(a)(2); 31 CFR 1023.220(a)(2); 31 CFR 1024.220(a)(2); or 31 CFR 1026.220(a)(2).

[4] See 31 CFR 1020.220 (a)(2)(ii).

[5] See 31 CFR 1010.230(b)(2).

[6] See 31 CFR 1020.220 (a)(2)(ii)(A).

[7] See 31 CFR 1020.220 (a)(2)(ii)(B).

Various questions in the FAQ require certification of beneficial ownership for each account being opened or renewed or when the financial institution becomes aware that information has changed. However, Question 14 clarifies:

Covered financial institutions do not have an obligation to solicit or update beneficial ownership information as a matter of course during regular or periodic reviews, absent specific risk-based concerns. Financial institutions are required to develop and implement risk-based procedures for conducting ongoing customer due diligence, including regular monitoring to identify and report suspicious activity and, on a risk basis, to maintain and update customer information. Thus, periodic reviews are not by themselves a trigger to obtain or update beneficial ownership information. As stated in response to Questions 13 and 16, the obligation to obtain or update information is triggered when, in the course of normal monitoring, a financial institution becomes aware of information about a customer or an account, including a possible change of beneficial ownership information, relevant to assessing or reassessing the customer's overall risk profile. Absent such a risk-related trigger or event, collecting or updating of beneficial ownership information is at the discretion of the covered financial institution. Financial institutions may exercise this discretion to collect or update beneficial ownership information on customers as often as they deem appropriate.

II.G.30.b. Sample Form for Disclosing Owners to Covered Financial Institutions

Pages 29454-29457 of the Preamble provide the following form, which is reproduced verbatim (and which may be found online at https://www.fincen.gov/resources/filing-information):

APPENDIX A to § 1010.230 -- CERTIFICATION REGARDING BENEFICIAL OWNERS OF LEGAL ENTITY CUSTOMERS

I. GENERAL INSTRUCTIONS

<u>What is this form?</u>

To help the government fight financial crime, Federal regulation requires certain financial institutions to obtain, verify, and record information about the beneficial owners of legal entity customers. Legal entities can be abused to disguise involvement in terrorist financing, money laundering, tax evasion, corruption, fraud, and other financial crimes. Requiring the disclosure of key individuals who own or control a legal entity (i.e., the beneficial owners) helps law enforcement investigate and prosecute these crimes.

<u>Who has to complete this form?</u>

This form must be completed by the person opening a new account on behalf of a legal entity with any of the following U.S. financial institutions: (i) a bank or credit union; (ii) a broker or dealer in securities; (iii) a mutual fund; (iv) a futures commission merchant; or (v) an introducing broker in commodities.

For the purposes of this form, a **legal entity** includes a corporation, limited liability company, or other entity that is created by a filing of a public document with a Secretary of State or similar office, a general partnership, and any similar business entity formed in the United States or a foreign country. **Legal entity** does not include sole proprietorships, unincorporated associations, or natural persons opening accounts on their own behalf.

<u>What information do I have to provide?</u>

This form requires you to provide the name, address, date of birth and Social Security number (or passport number or other similar information, in the case of foreign persons) for the following individuals (*i.e.*, the **beneficial owners**):

(i) Each individual, if any, who owns, directly or indirectly, 25 percent or more of the equity interests of the legal entity customer (*e.g.*, each natural person that owns 25 percent or more of the shares of a corporation); **and**

(ii) An individual with significant responsibility for managing the legal entity customer (*e.g.*, a Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member, General Partner, President, Vice President, or Treasurer).

The number of individuals that satisfy this definition of "beneficial owner" may vary. Under section (i), depending on the factual circumstances, up to four individuals (but as few as zero) may need to be identified. Regardless of the number of individuals identified under section (i), you must provide the identifying information of one individual under section (ii). It is possible that in some circumstances the same individual might be identified under both sections (*e.g.*, the President of Acme, Inc. who also holds a 30% equity interest). Thus, a completed form will contain the identifying information of at least one individual (under section (ii)), and up to five individuals (*i.e.*, one individual under section (ii) and four 25 percent equity holders under section (i)).

The financial institution may also ask to see a copy of a driver's license or other identifying document for each beneficial owner listed on this form.

II. CERTIFICATION OF BENEFICIAL OWNER(S)

Persons opening an account on behalf of a legal entity must provide the following information:

a. *Name and Title of Natural Person Opening Account:*

____

b. *Name and Address of Legal Entity for Which the Account is Being Opened:*

____

c. *The following information for <u>each</u> individual, if any, who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, owns 25 percent or more of the equity interests of the legal entity listed above:*

Name	Date of Birth	Address (Residential or Business Street Address)	*For U.S. Persons:* Social Security Number	*For Foreign Persons:* Passport Number and Country of Issuance, or other similar identification number[1]

(If no individual meets this definition, please write "Not Applicable.")

d. *The following information for one individual with significant responsibility for managing the legal entity listed above, such as:*

☐ *An executive officer or senior manager (e.g., Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member, General Partner, President, Vice President, Treasurer); or*

☐ *Any other individual who regularly performs similar functions.*

(If appropriate, an individual listed under section (c) above may also be listed in this section (d)).

Name/ Title	Date of Birth	Address (Residential or Business Street Address)	*For U.S. Persons:* Social Security Number	*For Foreign Persons:* Passport Number and Country of Issuance, or other similar identification number[1]

I, ________________________ (*name of natural person opening account*), hereby certify, to the best of my knowledge, that the information provided above is complete and correct.

Signature: _________________________ Date ______________

[1] In lieu of a passport number, foreign persons may also provide an alien identification card number, or number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.

Legal Entity Identifier ____________________ (Optional)

II.G.30.c. Corporate Transparency Act: Disclosure to Governments

The Corporate Transparency Act, Sections 6401-6403 of the National Defense Authorization Act for Fiscal Year 2021, requires disclosure to the federal government and, in certain circumstances, other governmental entities.

See FinCEN's web page: Beneficial Ownership Information Reporting. FinCEN has prepared Frequently Asked Questions (FAQs) intended as unofficial summary of the rules. A list of exemptions that you can pass along to clients is here.

An official web page for the law, H.R. 6395 - the National Defense Authorization Act for Fiscal Year 2021, is at https://www.congress.gov/bill/116th-congress/house-bill/6395. Unofficial ACTEC resources published 1/24/2021 include Summary of Corporate Transparency Act (summarizing the law) and Future Studies Under Corporate Transparency Act and NDAA (explaining the extent to which the law remains a work in progress), as well as a podcast based on those summaries: New Corporate Transparency Act | National Defense Authorization Act (actecfoundation.org). See also Steve Leimberg's Business Entities Email Newsletter Archive Message #218, written by Jack Terrill and Michael Breslow (1/21/2021). ACTEC commentary on late 2021 developments includes:

- ACTEC submits comments pursuant to Notice of Proposed Rulemaking (NPRM), Docket Number FINCEN-2021-0005 and RIN1506-AB49 the Corporate Transparency Act FinCEN Notice of Proposed Rulemaking of Regulations for Beneficial Ownership Information Reporting Requirements Questions 15, 16, 17, 20, & 21 (February 4, 2022)

- ACTEC submits comments in response to an ANPRM RIN 1506-AB-54, by FinCEN regarding potential requirements under the Bank Secrecy Act ("BSA") regarding, broadly, the reporting of certain information by certain persons regarding certain non-financed real estate transactions (February 4, 2022)

- FATF's review of R.25 of the FATF Recommendations in relation to beneficial ownership of legal arrangements (December 2021)

Many clients with operating businesses may be exempted by 31 CFR § 1010.380(c)(2)(xxi):

Large operating company. Any Entity that:

(A) Employs more than 20 full time employees in the United States, with ''full time employee in the United States'' having the meaning provided in 26 CFR 54.4980H–1(a) and 54.4980H–3, except that the term ''United States'' as used in 26 CFR 54.4980H–1(a) and 54.4980H–3 has the meaning provided in § 1010.100(hhh);

(B) Has an operating presence at a physical office within the United States; and

(C) Filed a Federal income tax or information return in the United States for the previous year demonstrating more than $5,000,000 in gross receipts or sales, as reported as gross receipts or sales (net of returns and allowances) on the entity's IRS Form 1120, consolidated IRS Form 1120, IRS Form 1120-S, IRS Form 1065, or other applicable IRS form, excluding gross receipts or sales from sources outside the United States, as determined under Federal income tax principles. For an entity that is part of an affiliated group of corporations within the meaning of 26 U.S.C. 1504 that filed a consolidated return, the applicable amount shall be the amount reported on the consolidated return for such group.

However, this provision would not protect their separately-owned real estate LLCs.

On December 21, 2023, FinCEN issued final regulations on Beneficial Ownership Information Access and Safeguards, which it summarized in a Fact Sheet: Beneficial Ownership Information Access and Safeguards Final Rule.

My inclination would be to get a FinCEN identifier for each owner so that any change of information regarding someone who owns more than one business entity can be reported with only one filing. Given that a change of address or expiration or renewal of an individual's driver's license or other identifying document (if the unique identifying number on that document changes)[1957] needs to be reported and it may be difficult for a reporting company to monitor these changes, placing the burden on the individual seems only fair. If a reader has identified any disadvantage to this approach, please let me know.

II.G.30.c.i. Trusts and the Corporate Transparency Act

As discussed further below, the following are beneficial owners:

- Trustee
- Any other individual (if any) with the authority to dispose of trust assets, which perhaps would include a trust director/adviser of a directed trust or the holder of an inter vivos power of appointment
- The grantor of a revocable trust or any beneficiary who has the right to demand a distribution of or withdraw substantially all of the assets from the trust
- A beneficiary who is the sole permissible recipient of income and principal from the trust. This implies that being a beneficiary of a sprinkle trust does not create beneficial ownership. If a trust has separate shares (see part II.J.9.a.ii Separate Share Rule), where a separate share has a sole current permissible distributee, I would tend to err in favor of treating that distributee as a beneficial owner.

[1957] Per the Beneficial Ownership Information Reporting Filing Instructions (January 2024 - Version 1.0), identifying documents are only: "a non-expired State-issued driver's license, a non-expired State/local/Tribe-issued identification document issued for the purpose of identifying the individual, a non-expired U.S. passport, or, only if the company applicant does not have one of these identifying documents, a non-expired foreign passport."

In applying the above, if the beneficiary is a minor child, the child's parent or legal guardian is substituted for the child.

Also, merely being a remainderman would not count, given that a mere remainderman is not a permissible recipient of income or principal. This is reinforced by the exclusion for "an individual whose only interest in a reporting company is a future interest through a right of inheritance."

What if a trust divides authority, so that one trustee has authority over the trust's interest in the reporting company, and another has authority over everything else? The regulation mentioned "authority to dispose of trust assets," which captures more roles than something along the lines of authority over the trust's interest in the reporting company. So, in this example, I would treat both trustees as beneficial owners. If the client would like to avoid reporting the other trustee, consider dividing the trust and giving the trustee who has authority over the trust's interest in the reporting company plenary authority as the trustee. Although the trust that does not hold the interest in the reporting company could be a permissible distributee, it cannot be the sole distributee, because then as a beneficiary it would be a beneficial owner and the other trustee would be bootstrapped in.

"An individual whose only interest in a reporting company is a future interest through a right of inheritance" is not a beneficial owner. Part II.G.30.c.iv ACTEC/ALI-CLE Webinar January 26, 2023 speculates on when a "future interest" matures into a present interest. Consider that beneficiaries of sprinkle trusts are not considered beneficial owners. Until an interest in a reporting company can be associated with a particular beneficiary, my preliminary view is that only the fiduciary needs to be disclosed:

- Mere creditors are not beneficial owners.

- Note that a change in beneficial ownership occurs when a probate estate is "settled," which the preamble discusses: "The precise moment at which an individual acquires an ownership interest in an entity through inheritance may be subject to a variety of existing legal authorities, such as the terms of a will, the terms of a trust, applicable state laws, and other valid instruments and rules."[1958] In an estate or post-mortem revocable trust (the latter not expressly covered by the preceding sentence), my preliminary view is that one disregards creditors and those whose beneficial interest could not possibly include an interest in the reporting company. If that is correct:

    - One would ignore those beneficiaries who are entitled only to tangible personal property or a cash gift.

    - If, other than those beneficiaries, all assets go to one trust (or a trust that divides into other trusts with the same rights to current distributions), given that indirect interests count towards beneficial ownership I would be concerned that the trustee and any beneficiary described in the first paragraph of this part II.G.30.c.i may need to report. Thus, in a probate estate that pours all of interests in a reporting company to a post-mortem revocable trust, I might view the earlier of probating the will or appointing the executor/personal representative of the estate as triggering reporting the trustee of the revocable trust. In most of the documents I draft, the trustee of the revocable trust is also designated as the trustee of any downstream trusts until the primary beneficiary

[1958] For when a person's death becomes a reporting event that changes beneficial ownership, see part II.G.30.c.ii Updated Reports: Estate Planning Issues, which includes the full relevant preamble.

changes the trustee;[1959] in those documents, I would tend to look only for whether the downstream trusts have sole permissible distributees.

- What if an estate or post-mortem revocable trust has multiple downstream trusts? I would tend not to report any downstream trust that might not receive an interest in a reporting company. That view is consistent with ignoring the beneficiaries of a sprinkle trust. However, because we have no clear guidance regarding when a "future interest" has become a separate interest, I would tend to report any downstream trust that the fiduciary has determined will receive an interest in a reporting company.

- Is an estate within the scope of a "trust or similar arrangement," and is the personal representative/executor of an estate within the scope of "a trustee of the trust or other individual (if any) with the authority to dispose of trust assets" in the context of "similar arrangement" being substituted for "trust"? When Treasury made the probate exception, was that in terms of an intestate proceeding, where more than one beneficiary may have an interest and identifying who should be reporting may be problematic, or was it also thinking about orderly probate administration, where the personal representative/executor may have as much authority/control/discretion as a trustee would? When 31 CFR § 1010.380(a)(2)(iii) mentions settling estates, it refers to both intestate and testate estates, so Treasury must have realized that a personal representative/executor may be appointed but did not suggest that appointment as being a reporting trigger. The preamble said that, when the estate is settled, "the reporting company is required to file an updated report at that time, removing the deceased former beneficial owner and, to the extent appropriate, identifying any new beneficial owners."

- Arguably, for a business interest passing through probate, one could dispense with all of the analysis above until the business interest is distributed to one or more beneficiaries, because the estate is not yet "settled." However, until we get guidance from FinCEN expressly addressing these examples, one might err on the side of reporting sooner rather than later.

- Note that the estate settlement exception is an exception to reporting that the decedent is not longer an owner, rather than saying that an estate doesn't count as a beneficial owner. If an estate invests in a reporting company, the estate settlement exception does not apply, and the estate needs to be listed as a beneficial owner.

Now let's get down to the technical details:

31 CFR § 1010.380(d), "Beneficial owner," provides:

> For purposes of this section, the term ''beneficial owner,'' with respect to a reporting company, means any individual who, directly or indirectly, either exercises substantial control over such reporting company or owns or controls at least 25 percent of the ownership interests of such reporting company.

[1959] Instead of an adult child of sufficient age automatically be trustee of his or her own trust, the document requires that the child appoint himself or herself as trustee. That way, we have a chance to ask the child about coordinating trustee succession with his or her own estate plan. If (s)he can't be bothered with those questions, query whether (s)he is truly ready to be a fiduciary.

31 CFR § 1010.380(d)(2)(ii), "Ownership or control of ownership interest," provides:

> An individual may directly or indirectly own or control an ownership interest of a reporting company through any contract, arrangement, understanding, relationship, or otherwise.

31 CFR § 1010.380(d)(2)(ii)(C) discusses trust ownership or control:

> With regard to a trust or similar arrangement that holds such ownership interest:
>
> (1) As a trustee of the trust or other individual (if any) with the authority to dispose of trust assets;
>
> (2) As a beneficiary who:
>
> (i) Is the sole permissible recipient of income and principal from the trust; or
>
> (ii) Has the right to demand a distribution of or withdraw substantially all of the assets from the trust; or
>
> (3) As a grantor or settlor who has the right to revoke the trust or otherwise withdraw the assets of the trust….

ACTEC's comments on the proposed form of the above regulations explained trusts:

> The first trust structure is a "revocable trust" (also called a "living trust"). This is a trust created by an individual (called the "grantor" or "settlor") which normally also names the grantor as the initial trustee. The grantor further retains unfettered access to the assets of the trust during the grantor's lifetime, and retains the right to revoke or amend the trust in any manner during his or her lifetime. This trust is described in Prop. Reg. § 1010.380(d)(3)(ii)(C).
>
> Revocable trusts have become widely used over the last twenty or so years as the preferred instrument to provide for the distribution of assets at death (as opposed to under a Will) for the following primary reasons: (i) a revocable trust can serve as an effective vehicle for the management of assets in the event the grantor becomes incapacitated, (ii) transferring assets to a revocable trust before death allows those assets to pass outside of a court-supervised probate proceeding at death which can be time-consuming and expensive, (iii) a revocable trust may avoid the need to commence a probate court proceeding for the appointment of a successor trustee, and (iv) a revocable trust is not made public upon death whereas a Will filed in a probate court is a matter of public record.
>
> The second trust structure is a "discretionary trust". This is a trust created by an individual (called the "grantor" or "settlor") which names one or more individuals, excluding the grantor, or a corporation (such as a bank or trust company) as trustee(s). The trust is irrevocable and often intended to continue for multiple generations. The grantor designates a class of individuals (sometimes including charities) who can receive distributions from the trust at the discretion of the trustees. A common distribution clause might read, "My trustees may distribute to one or more of my descendants as much of the net income and principal of the trust as the trustees may at any time and from time to time determine in such amounts or proportions as the trustees may from time to time

> select for any purpose." It is also very common for discretionary trusts to last for the lifetime of the beneficiaries, with no specific age or milestone event triggering a binding requirement on the trustees to make a distribution or to terminate the trust. Particularly when substantial family wealth is involved, these trusts have become a prevalent since they allow for changing circumstances and provide a level of creditor protection since a trust with these terms is an unattractive target for claims by a divorcing spouse or other creditor of a descendant.
>
> It is obvious from this description of a discretionary trust that the trustee has very substantial powers over the assets held in the trust. This has led to many states enacting laws that allow for the grantor to limit the trustees' powers by dividing the powers among multiple parties (called "investment advisors", "distribution advisors" or "trust directors" among other names) and by providing for another individual (called a "trust protector") to have the power to remove and replace the trustee.
>
> Under traditional common law trust principles, trustees retained full responsibility (and liability) over how trust assets were managed, invested and distributed. More modern trust laws (enacted over the last twenty to thirty years) allow a trustee's duties, and liability for the performance or non-performance of those duties, to be allocated among the trustee and other individuals who may be more familiar with the family or better able to carry out certain trust objectives. For example, under Delaware law, a grantor can appoint a "distribution advisor" who is not the trustee but rather a trusted family member to oversee distributions from the trust, and can appoint an "investment advisor" who is not the trustee but perhaps the family financial advisor to make investment decisions. This division of the traditional roles of the trustee is very useful in situations where trusts hold concentrated investments or assets, such as a closely-held business or significant amounts of real estate. Professional trustees typically resist accepting investment responsibility for those trusts due to the specialised skills required and the potential liability associated with managing a closely held business and holding concentrated positions. Notably, trust "advisors" or "directors" are usually deemed to have the same fiduciary duties to the trust beneficiaries and exposure to liability for their actions or inactions as similarly situated trustees.

ACTEC further commented on burdens:

> As applied to situations in which a trust holds an ownership interest in a reporting company, the Proposed Regulations do not (and likely cannot) adequately address all situations in which an individual has a direct ownership or control interest, as explained in more depth in the response to Question 17(ii), below. The difficulty in complying with the Proposed Regulations when a reporting company is owned by an irrevocable discretionary trust is a function of the unique and multi-faceted nature of irrevocable discretionary trusts in the American legal system, beginning with the traditional bifurcation of beneficial enjoyment (which can take a variety of forms and structures) and control rights over trust property (which can further be divided among various parties to the trust including individual and corporate trustees, trust protectors, distribution advisors, and investment advisors, as set forth in our opening comments.
>
> Given the lack of a clear, objective rule applicable to irrevocable discretionary trusts, and the fact that reporting companies are potentially subject to sanctions, it is likely that a reporting company will assume a very significant burden to "over-comply" with the Proposed Regulations by gathering more information than is necessary or useful with

> regard to trusts which have an ownership interest in a reporting company. If there were more certainty that reporting companies are required to identify only those entities and individuals listed in Prop. Reg. § 1010.380(d)(3)(ii)(C), then the potential burden on reporting companies would be mitigated. In addition, as explained in more depth below, the potential for penalties for not reporting changes in the identities of beneficial owners within the relatively short timeframes adds to the burden on reporting companies….
>
> Prop. Reg. § 1010.380(d)(3)(ii)(C)(2) provides two clear provisions for determining which, if any, beneficiary would be considered to own or control an ownership interest of a reporting company.
>
> - Prop. Reg. § 1010.380(d)(3)(ii)(C)(2)(i) would include as a beneficial owner "a beneficiary who … [i]s the sole permissible recipient of income and principal from the trust…." As written, this provision would be easily interpreted – but we believe that the number of common law trusts that have only one beneficiary who is the sole permissible recipient of income and principal is limited. As described below, common law trusts are more likely to include multiple beneficiaries.
>
> - Prop. Reg. § 1010.380(d)(3)(ii)(C)(2)(ii) would include as a beneficial owner "a beneficiary who … [h]as the right to demand a distribution of or withdraw substantially all of the assets from the trust…." We think there are two complications with this provision.
>
>   - First, it is not clear what "substantially all" means. Would this be based upon a percentage of the assets, and if so, would a beneficiary's rights to withdraw assets over a period of years be considered on a cumulative basis?
>
>   - Second, and similar to the prior point, we believe that there are not many common law trusts that would fall into this category, other than revocable trusts and irrevocable trusts which grant a beneficiary the right to withdraw trust assets upon the occurrence of certain events, such as the beneficiary reaching a designated age, after achieving some external life milestone or after the death of other beneficiaries or individuals (which would probably be within the definition of Prop. Reg. § 1010.380(d)(3)(ii)(C)(3)(ii)).

Thus, omitting sprinkle trusts and disregarding contingent beneficiaries from being beneficial owners under these rules was done not from a lack of understanding that they exist but rather with an intent to simplify the rules.

31 CFR § 1010.380(d)(3), "Exceptions," provides:

> Notwithstanding any other provision of this paragraph (d), the term ''beneficial owner'' does not include:
>
> (i) A minor child, as defined under the law of the State or Indian tribe in which a domestic reporting company is created or a foreign reporting company is first registered, provided the reporting company reports the required information of a parent or legal guardian of the minor child as specified in paragraph (b)(2)(ii) of this section;

(ii) An individual acting as a nominee, intermediary, custodian, or agent on behalf of another individual;

(iii) An employee of a reporting company, acting solely as an employee, whose substantial control over or economic benefits from such entity are derived solely from the employment status of the employee, provided that such person is not a senior officer as defined in paragraph (f)(8) of this section;

(iv) An individual whose only interest in a reporting company is a future interest through a right of inheritance;

(v) A creditor of a reporting company. For purposes of this paragraph (d)(3)(v), a creditor is an individual who meets the requirements of paragraph (d) of this section solely through rights or interests for the payment of a predetermined sum of money, such as a debt incurred by the reporting company, or a loan covenant or other similar right associated with such right to receive payment that is intended to secure the right to receive payment or enhance the likelihood of repayment.

The exclusion for a minor children requires updating when the child attains majority as discussed in part II.G.30.c.ii Updated Reports: Estate Planning Issues.

The clause excluding agents, etc. helps advisors who are filling roles that are not discretionary. At first glance, it may seem to apply to a custodian under the Uniform Transfers to Minors Act or a similar statute, but I am less than certain that the title of "custodian" overrides the substance of that role being that of "a trustee of the trust or other individual (if any) with the authority to dispose of trust assets." Considering that a child's parent or legal guardian is substituted for the child in determining beneficial ownership, my preliminary view that a custodian of an UTMA account is more akin to the child's legal guardian. I tend to view the custodian exception as applying to the custodian of an IRA, brokerage account, or other asset that is merely being held for the true owner, as suggested by the preamble [footnote omitted]:

B. Nominees, Intermediaries, Custodians, and Agents

Proposed Rule. Proposed 31 CFR 1010.380(d)(4)(ii) reflected the exception provided in the CTA for an individual acting as a nominee, intermediary, custodian, or agent on behalf of another individual. Under this exception, reporting companies must report real parties in interest who exercise control indirectly, but not those who merely act on another individual's behalf in one of the specified capacities.

Comments Received. Multiple commenters expressed support for the proposed rule, and commenters generally did not oppose or seek clarification of this provision. However, under the rubric of proposed 31 CFR 1010.380(d)(1) (concerning what it means to exercise "substantial control" such that an individual qualifies as a beneficial owner), some commenters inquired about the treatment of certain retained professionals with an agency relationship, such as tax and legal professionals who have been designated as an agent under IRS Form 2848 (Power of Attorney and Declaration of Representative), whom these commenters viewed as exercising substantial influence in practical terms when they perform services within the scope of their duties.

Final Rule. FinCEN is adopting 31 CFR 1010.380(d)(4)(ii) as proposed but renumbered as 31 CFR 1010.380(d)(3)(ii). FinCEN emphasizes the obligation of a reporting company

> to report identifying information of the individual on whose behalf a nominee, intermediary, custodian, or agent is acting. However, as explained in Section III.C.i regarding the treatment of tax professionals and other similarly situated professionals, such a professional would not need to be reported if the individual is acting as a nominee, intermediary, custodian, or agent of an individual who is reported. Moreover, as explained in Section III.C.i regarding the application of final 31 CFR 1010.380(d)(1)(i)(C), FinCEN does not envision that the performance of ordinary, arms-length advisory or other contractual services to a reporting company would provide an individual with the power to direct or determine, or have substantial influence over, important decisions of a reporting company.

How about a corporate trustee? ACTEC expressed concern about their employees needing to report. Do they meet the "employee of a reporting company" exception?
31 CFR § 1010.380(c)(2) has many exclusions that will probably apply to a corporate trustee, so I am unsure of the answer.

As to a definition in the proposed regulation that was retained in the final regulations: "a trustee of the trust or other individual (if any) with the authority to dispose of trust assets," ACTEC expressed concern:

> Prop. Reg. § 1010.380(d)(3)(ii)(C)(1) would include as a beneficial owner "a trustee of the trust or other individual (if any) with the authority to dispose of trust assets". In many cases, the application of this provision would be straight forward, such as when one or more individuals is serving as trustee, and even in the less common situation in which an individual not serving as trustee has the authority to dispose of trust assets, such as, for example, a trust in which a beneficiary has an inter vivos power of appointment to direct the distribution of trust assets to or for a class of potential appointees. But how is this provision to be applied when an entity is serving as trustee? Would the reporting company be required to determine what individuals (such as employees) within that entity might fit within this provision? If so, what if no single individual has the authority to act on behalf of the entity serving as trustee (such as when, as an example, material distributions are only made by a committee)? How is this provision to be applied in a situation in which the ordinary roles of a trustee are divided among multiple parties, who may or may not be called "trustees," such as distribution advisors, investment direction advisors, trust protectors, etc.? In those circumstances, what does it mean to "otherwise dispose of trust assets?"

The preamble to the final regulations explains:

> The final rule also renumbers 31 CFR 1010.380(d)(2), "Direct or Indirect Exercise of Substantial Control," as 31 CFR 1010.380(d)(1)(ii) and makes certain modifications to the paragraph. First, the final rule inserts the clause "including as a trustee of a trust or similar arrangement" into the introductory text in paragraph (d)(1)(ii). This addition underscores that the trustee of a trust or similar arrangement can exercise substantial control over a reporting company through the types of relationships outlined in the paragraph. Depending on the particular facts and circumstances, trusts may serve as a mechanism for the exercise of substantial control. Furthermore, "trusts or similar arrangements" can take a wide range of forms. Accordingly, FinCEN finds it appropriate - and directly responsive to comments that requested clarification on this point - to specify that a trustee of a trust can, in fact, exercise substantial control over a reporting

> company through the exercise of his or her powers as a trustee over the corpus of the trust, for example, by exercising control rights associated with shares held in trust.

It later continues:

> After considering these comments, however, FinCEN adopts the proposed rule without change. Assets, such as the ownership interests of a reporting company, can be held in trust. The final rule identifies the trustee as an individual who will be deemed to control trust assets for the purpose of determining which individuals own or control 25 percent of the ownership interests of the reporting company. In addition to trustees, the final rule specifies that other individuals with authority to control or dispose of trust assets are considered to own or control the ownership interests in a reporting company that are held in trust. The final rule identifies circumstances in which ownership interests held in trust will be considered as owned or controlled by a beneficiary: if the beneficiary is the sole permissible recipient of income and principal from the trust, or if the beneficiary has the right to demand a distribution of, or withdraw substantially all, of the assets in the trust. In addition, trust assets will be considered as owned or controlled by a grantor or settlor who has the right to revoke the trust or withdraw its assets. One consequence of this - to confirm the reading that one comment suggested was possible and requested clarification on - is that, depending on the specifics of the trust arrangement, the ownership interests held in trust could be considered simultaneously as owned or controlled by multiple parties in a trust arrangement.[170]
>
> > [170] Such an outcome is not unique to the circumstance of trusts. For example, joint ownership of an undivided interest in ownership interests of a reporting company can result in the same assets being attributed to all of the joint owners. See 31 CFR 1010.380(d)(2)(ii)(A).

II.G.30.c.ii. Updated Reports: Estate Planning Issues

31 CFR § 1010.380(a)(2) requires updates that include:

> (iii) If an individual is a beneficial owner of a reporting company by virtue of property interests or other rights subject to transfer upon death, and such individual dies, a change with respect to required information will be deemed to occur when the estate of the deceased beneficial owner is settled, either through the operation of the intestacy laws of a jurisdiction within the United States or through a testamentary deposition. The updated report shall, to the extent appropriate, identify any new beneficial owners.
>
> (iv) If a reporting company has reported information with respect to a parent or legal guardian of a minor child pursuant to paragraphs (b)(2)(ii) and (d)(3)(i) of this section, a change with respect to required information will be deemed to occur when the minor child attains the age of majority.

The preamble addressed change in ownership by reason of death:

> Proposed 31 CFR 1010.380(a)(2)(ii) provided that if an individual is a beneficial owner of a reporting company because the individual owns at least 25 percent of the ownership interests of the reporting company, and such beneficial owner dies, a change with respect to the required information will be deemed to occur when the estate of the

deceased beneficial owner is settled. This proposed rule sought to clarify that a reporting company is not required to immediately file an updated report to notify FinCEN of the death of a beneficial owner. However, when the estate of a deceased beneficial owner is settled either through the operation of the intestacy laws of a jurisdiction within the United States or through a testamentary disposition, the reporting company is required to file an updated report at that time, removing the deceased former beneficial owner and, to the extent appropriate, identifying any new beneficial owners.

The preamble further discusses the probate delay:

D. Inheritance

Proposed Rule. Proposed 31 CFR 1010.380(d)(4)(iv) clarified that the inheritor exception in the CTA refers to a “future” interest associated with a right of inheritance, not a present interest that a person may acquire as a result of exercising such a right. The CTA's definition of “beneficial owner” excludes “an individual whose only interest” in the entity “is through a right of inheritance.”[181] In proposing this clarification to the inheritor exception, FinCEN sought to clarify that individuals who may in the future come to own ownership interests in an entity through a right of inheritance do not have ownership until the inheritance occurs. But once an ownership interest is inherited and comes to be owned by an individual, that individual has the same relationship to an entity as any other individual who has acquired an ownership interest through another means.

[181] 31 U.S.C. 5336(a)(3)(B)(iv).

Comments Received. Commenters asked that FinCEN provide more clarity with respect to the application of the inheritor exception. One commenter suggested providing a specific definition of a “right of inheritance,” which could, for example, describe situations in which the inheritor exception would apply in the probate process. Another commenter suggested outlining the mechanisms that would constitute “inheritance” under this exception.

Final Rule. The final rule adopts the proposed 31 CFR 1010.380(d)(4)(iv) without change, other than renumbering as 31 CFR 1010.380(d)(3)(iv). As stated in the proposed rule, FinCEN emphasizes that once an individual has acquired an ownership interest in an entity through inheritance, that individual owns that ownership interest and is potentially subject to the beneficial-owner reporting requirements. Individuals who may in the future come to own ownership interests in an entity through a right of inheritance do not have ownership interests until the inheritance occurs. Such a future or contingent interest may exist through wills or other probate mechanisms that solely provide a future interest in an entity. But once an ownership interest is inherited and comes to be owned by an individual, that individual has the same relationship to an entity as any other individual who acquires an ownership interest through another means.

The precise moment at which an individual acquires an ownership interest in an entity through inheritance may be subject to a variety of existing legal authorities, such as the terms of a will, the terms of a trust, applicable state laws, and other valid instruments and rules. FinCEN intends the application of the inheritor exception, and the meaning of a “right of inheritance” in this paragraph (d)(3)(iv), to conform to the governing legal

> authorities. Should those authorities not provide sufficient direction for purposes of this inheritor exception, FinCEN is prepared to consider supplemental guidance or FAQs.

When is the estate of the deceased beneficial owner "settled, either through the operation of the intestacy laws of a jurisdiction within the United States or through a testamentary deposition"? Does that mean when every single action has been taken to terminate the estate? Or does it mean when the business interest is allocated or distributed? These ideas are explored more in the text accompanying fn 1958 in part II.G.30.c.i Trusts and the Corporate Transparency Act.

ACTEC's comments on the proposed regulations expressed concern about how a reporting company could keep track of beneficiaries:

> Finally, we believe the penalties associated with the failure to report complete or updated beneficial ownership information should be revised as it pertains to information a reporting company receives from a trustee. Without the trustee providing the reporting company information, the reporting company will unlikely be able to fulfill its reporting obligations. This is similar to how a CPA receives information from a taxpayer to prepare income tax returns. For example, even if the reporting company has a copy of the trust agreement, it is often the case that beneficiaries are referred to not by name, but as a class, *e.g.*, the "settlor's descendants," to address the settlor's desire to include as beneficiaries descendants born after settlement of the trust. The reporting company will not necessarily know this information. If a reporting company receives information from a trustee as to who the beneficial owners are, and the reporting company reasonably relies on that information and submits the report based on that information that later turns out to be inaccurate or incomplete, the reporting company should not be liable or penalized as it relied on the information provided to it. Moreover, if a reporting company does not include ownership information in an initial or updated report due to its inability to obtain the necessary information from the trustee or other owners after reasonable efforts to do so, it should not be liable or penalized. The regulations should clearly state that no penalties, not even penalties for non-wilful situations, should apply in such situations. In particular, unless final regulations provide clear guidance on who must be included in the CTA report, particularly as to who is deemed to own 25% of the ownership interests in a reporting company held by a trust with multiple beneficiaries and under which the trustee has full discretion to distribute (or not) net income and principal, no penalties should be assessed, provided the reporting company acts in good faith and takes all reasonable steps to identify trust individuals who must be reported.
>
> The Proposed Regulations also include penalties for the failure to provide an updated beneficial ownership report to FinCEN within 30 days of learning of the change. In the context of a trust, this timeframe is too short to identify and report on a change at the trust level by a reporting company that may have no visibility on what is happening, at least with respect to the beneficiaries.[1] There are numerous situations that may give rise to a change in beneficial ownership, *i.e.*, a minor turns 18, a beneficiary who was a beneficial owner dies, a power under the trust is exercised to add or remove a beneficiary, etc. If any type of change must be reported within 30 days, the reporting company would need to follow up with the trustee at least every few weeks to determine if there had been any changes. In the notice of proposed rulemaking, there is a comment that to allow the reporting companies to report on an annual basis could cause significant degradation and accuracy and usefulness of the beneficial ownership information. However, if the requirement to provide updated information within 30 days is limited to changes in the trustee, FinCEN will always have a means to collect additional

information on the trust beneficiaries by simply contacting the trustee if questions arise prior to the annual report being filed. Perhaps with the exception of changes to the trustee, the reporting company should be required to report any changes through an annual filing, which would only be required if changes occurred during the prior year.

[1] We do not dispute that a change of trustee should be reported within 30 days.

We therefore suggest four modifications to the Proposed Regulations. First, if a trust owns an ownership interest in a reporting company, we believe the reporting company should be permitted to list (i) the trustee and other individual(s), if any, described in Prop. Reg. § 1010.380(d)(3)(ii)(C)(1)) as the only individual(s) who might exercise direct or indirect substantial control, (ii) beneficiaries described in Prop. Reg. § 1010.380(d)(3)(ii)(C)(2), and (iii) a grantor or settlor described in of Prop. Reg. § 1010.380(d)(3)(ii)(C)(3). In other words, the regulation should be clarified to state that the individuals identified in subparagraph (C) are exhaustive.

Second, we suggest that a reporting company that reasonably relies on information provided by a trustee as to whether any beneficiary or other individual should be included in the report shall not be subject to penalties if that information is later determined to be inaccurate or incomplete.

Third, we suggest that FinCEN lengthen the timeframe for a reporting company to report on beneficial ownership changes with respect to beneficiaries of trusts from the 30 days as currently proposed to one year for changes other than a change to the trustee.

Fourth, we suggest that if a bank or trust company is serving as trustee of a trust and has the authority to dispose of trust assets, the trustee itself and not any of its employees should be reported by the reporting company as a beneficial owner.

II.G.30.c.iii. Information about Trusts & Estates to be Gathered

Documentation of title needs to be gathered:

- For a partnership or LLC, look to the partnership or operating agreement and any documentation of transfers, such as an assignment. On rare occasions such interests are evidenced by a certificate of ownership, but the partnership or operating agreement determines what that certificate really means.

- For a corporation, look for stock certificates and stock powers transferring stock. Look for any restrictions on transfer evidenced by the stock certificate or in articles of incorporation, a shareholder agreement, or other arrangement restricting transfer.

If an individual holding a business interest dies, consider whether it might pass automatically to:

- A surviving joint owner, through joint tenancy with right of survivorship or tenancy-by-the-entirety. If held by a married couple without being specifically referring to either of the above, applicable state law might nevertheless imply such an arrangement. if none of the above, then co-ownership may be tenancy in common, in which case the decedent's business interest is a probate asset.

- A beneficiary of a nonprobate transfer, through a transfer on death (TOD) or payable on death (POD) arrangement.

If none of the above applies, then the business interest may be a probate asset. In that case, obtain a copy of:

- The decedent's will.
- A court order approving the will.
- Letters testamentary or letters of administration appointing a personal representative, executor, or administrator.
- Inventory, listing the probate estate's assets, including the business interest.
- Documentation of distributing the business interest, which may be a statement of account, agreement of or with beneficiaries, or court order.

Wills frequently direct that the residue of the estate pass to a (formerly) revocable trust.

While the grantor of a revocable trust is living, the grantor is the beneficial owner, and so is any co-trustee. When the grantor dies, one or more persons other than the grantor serve as trustee. Sometimes others have control over a trust's assets that may constitute authority to dispose of the trust's assets, and these persons are also beneficial owners. A thorough review of the instrument creating the trust – a trust agreement or declaration (or a will if the trust is created under the will) – is required to determine who is the beneficial owner. A complete copy of one or more of the following documents that may exist are required to determine the beneficial owners:

- The trust agreement/declaration, including any amendments (or will, if the trust was created under a will).
- Trustee resignation, death certificate, or other evidence of ceasing to serve
- Appointment of trustee, trust adviser, trust director, or trust protector
- Exercise of power to change trustee
- Exercise of power of appointment
- Nonjudicial settlement agreement or other agreement by or with the beneficiary(ies)

It may be advisable to obtain a trustee certification verifying who is the trustee and who else may have "authority to dispose of trust assets" under 31 CFR § 1010.380(d)(2)(ii)(C)(1). The certification could also list any beneficiary who is a beneficial owner under 31 CFR § 1010.380(d)(2)(ii)(C)(2). Most states have statutes providing formalities regarding reliance on a trustee's certification; an example is RSMo § 456.10-1013 or 760 ILCS 3/1013. Although those formalities generally do not impose a duty to update, one may ask a trustee to undertake such a duty. Consider including that as a condition of approving the transfer of a business interest to a trust.

If the business entity is taxed as an S corporation, important tax elections may be required or advisable as soon as two months and 15 days after a trust's primary beneficiary's death (although often they might not be required until 2+ years after death). See parts III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, III.A.3.c Deadlines for Trust Qualifying as S Corporation Shareholder, and III.A.3.e.i.(b) QSST Issues When Beneficiary Dies.

II.G.30.c.iv. ACTEC/ALI-CLE Webinar January 26, 2023

For Reporting Companies formed before January 1, 2024, deadline is January 1, 2025. For all other Reporting Companies, within 30 calendar days after formation. Same deadline for updating changes. Here is a link to: *Content, form, and manner of reports*.

From slides prepared by G. Fletcher, G. Fox, and R. Malviya from an ACTEC/ALI-CLE webinar January 26, 2023:

Beneficial Owner exceptions under 31 USC §5336(a)(3)(B) and 31 CFR § 1010.380(d)(3):

- Minor Children, provided the Reporting Company reports the required information of a parent or legal guardian of the minor child

- Nominee, intermediary, custodian, or agent on behalf of another individual

- Employee of Reporting Company, provided that such person is not a senior officer

- Creditors

- Right of Inheritance:

    - CTA provides that Beneficial Owner excludes "an individual whose only interest ... is through a right of inheritance."

    - Final Regulations repeat this phrase with an added clarification, stating that this exception applies to a "future" interest associated with a right of inheritance.

Right of Inheritance (Cont'd.) - FinCEN emphasizes in preamble to Final Regulations that:

- Once an individual has acquired an ownership interest in an entity through inheritance, that individual owns that ownership interest and is potentially subject to the beneficial-owner reporting requirements.

- Individuals who may in the future come to own ownership interests in an entity through a right of inheritance do not have ownership interests until the inheritance occurs. Such a future or contingent interest may exist through wills or other probate mechanisms that solely provide a future interest in an entity.

- Once an ownership interest is inherited and comes to be owned by an individual, that individual has the same relationship to an entity as any other individual who acquires an ownership interest through another means.

- The precise moment at which an individual acquires an ownership interest in an entity through inheritance may be subject to a variety of existing legal authorities, such as the terms of a will, the terms of a trust, applicable state laws, and other valid instruments and rules.

- FinCEN intends the application of the inheritor exception, and the meaning of a “right of inheritance” in 31 CFR § 1010.380(d)(3), to conform to the governing legal authorities. Should those authorities not provide sufficient direction for purposes of this inheritor exception, FinCEN is prepared to consider supplemental guidance or FAQs.

A “Company Applicant” under 31 USC §5336(a)(2) and 31 CFR § 1010.380(e) is anyone who directly files the document that:

- Creates a domestic Reporting Company;

- First registers a foreign Reporting Company; and

- Individual who is “primarily responsible” for directing or controlling such filing if more than one individual is involved in the filing of the document.

The initial report of a Reporting Company formed on or after January 1, 2024, must include the required information under the CTA for the Company Applicant (as well as for the Reporting Company itself and all Beneficial Owners) under 31 CFR § 1010.380(b)(1).

II.G.30.c.v. Beneficial Ownership Information Reporting Rule Fact Sheet

On September 29, 2022, final regulations were explained by a “Beneficial Ownership Information Reporting Rule Fact Sheet”:

> Today, the Financial Crimes Enforcement Network (FinCEN) issued a final rule implementing the bipartisan Corporate Transparency Act’s (CTA) beneficial ownership information (BOI) reporting provisions. The rule will enhance the ability of FinCEN and other agencies to protect U.S. national security and the U.S. financial system from illicit use and provide essential information to national security, intelligence, and law enforcement agencies; state, local, and Tribal officials; and financial institutions to help prevent drug traffickers, fraudsters, corrupt actors such as oligarchs, and proliferators from laundering or hiding money and other assets in the United States.
>
> The rule describes who must file a BOI report, what information must be reported, and when a report is due. Specifically, the rule requires reporting companies to file reports with FinCEN that identify two categories of individuals: (1) the beneficial owners of the entity; and (2) the company applicants of the entity….
>
> **Reporting Companies**
>
> - The rule identifies two types of **reporting companies**: domestic and foreign. A domestic reporting company is a corporation, limited liability company (LLC), or any entity created by the filing of a document with a secretary of state or any similar office under the law of a state or Indian tribe. A foreign reporting company is a corporation, LLC, or other entity formed under the law of a foreign country that is registered to do business in any state or tribal jurisdiction by the filing of a document with a secretary of state or any similar office.

Under the rule, and in keeping with the CTA, twenty-three types of entities are exempt from the definition of "reporting company."

- FinCEN expects that these definitions mean that reporting companies will include (subject to the applicability of specific exemptions) limited liability partnerships, limited liability limited partnerships, business trusts, and most limited partnerships, in addition to corporations and LLCs, because such entities are generally created by a filing with a secretary of state or similar office.

- Other types of legal entities, including certain trusts, are excluded from the definitions to the extent that they are not created by the filing of a document with a secretary of state or similar office. FinCEN recognizes that in many states the creation of most trusts typically does not involve the filing of such a formation document.

Beneficial Owners

- Under the rule, a **beneficial owner** includes any individual who, directly or indirectly, either (1) exercises substantial control over a reporting company, or (2) owns or controls at least 25 percent of the ownership interests of a reporting company. The rule defines the terms "substantial control" and "ownership interest." In keeping with the CTA, the rule exempts five types of individuals from the definition of "beneficial owner."

- In defining the contours of who has **substantial control**, the rule sets forth a range of activities that could constitute substantial control of a reporting company. This list captures anyone who is able to make important decisions on behalf of the entity. FinCEN's approach is designed to close loopholes that allow corporate structuring that obscures owners or decision-makers. This is crucial to unmasking anonymous shell companies.

- The rule provides standards and mechanisms for determining whether an individual owns or controls 25 percent of the **ownership interests** of a reporting company. Among other things, these standards and mechanisms address how a reporting company should handle a situation in which ownership interests are held in trust.

- These definitions have been drafted to account for the various ownership or control structures reporting companies may adopt. However, for reporting companies that have simple organizational structures it should be a straightforward process to identify and report their beneficial owners. FinCEN expects the majority of reporting companies will have simple ownership structures.

Company Applicants

- The rule defines a company applicant to be only two persons:
    - the individual who directly files the document that creates the entity, or in the case of a foreign reporting company, the document that first registers the entity to do business in the United States.
    - the individual who is primarily responsible for directing or controlling the filing of the relevant document by another.

- The rule, however, does not require reporting companies existing or registered at the time of the effective date of the rule to identify and report on their company applicants. In addition, reporting companies formed or registered after the effective date of the rule also do not need to update company applicant information.

Beneficial Ownership Information Reports

- When filing BOI reports with FinCEN, the rule requires a reporting company to identify itself and report four pieces of information about each of its beneficial owners: name, birthdate, address, and a unique identifying number and issuing jurisdiction from an acceptable identification document (and the image of such document). Additionally, the rule requires that reporting companies created after January 1, 2024, provide the four pieces of information and document image for company applicants.

- If an individual provides their four pieces of information to FinCEN directly, the individual may obtain a "FinCEN identifier," which can then be provided to FinCEN on a BOI report in lieu of the required information about the individual.

Timing

- The effective date for the rule is January 1, 2024.

- Reporting companies created or registered before January 1, 2024 will have one year (until January 1, 2025) to file their initial reports, while reporting companies created or registered after January 1, 2024, will have 30 days after receiving notice of their creation or registration to file their initial reports.

- Reporting companies have 30 days to report changes to the information in their previously filed reports and must correct inaccurate information in previously filed reports within 30 days of when the reporting company becomes aware or has reason to know of the inaccuracy of information in earlier reports.

Next Steps

- The BOI reporting rule is one of three rulemakings planned to implement the CTA. FinCEN will engage in additional rulemakings to (1) establish rules for who may access BOI, for what purposes, and what safeguards will be required to ensure that the information is secured and protected; and (2) revise FinCEN's customer due diligence rule following the promulgation of the BOI reporting final rule.

- In addition, FinCEN continues to develop the infrastructure to administer these requirements in accordance with the strict security and confidentiality requirements of the CTA, including the information technology system that will be used to store beneficial ownership information: the Beneficial Ownership Secure System (BOSS).

- Consistent with its obligations under the Paperwork Reduction Act, FinCEN will publish in the Federal Register for public comment the reporting forms that persons will use to comply with their obligations under the BOI reporting rule. FinCEN will publish these forms well in advance of the effective date of the BOI reporting rule.

- FinCEN will develop compliance and guidance documents to assist reporting companies in complying with this rule. Some of these materials will be aimed directly at, and made available to, reporting companies themselves. FinCEN will issue a Small Entity Compliance Guide, pursuant to section 212 of the Small Business Regulatory Enforcement Fairness Act of 1996, in order to inform small entities about their responsibilities under the rule. Other materials will be aimed at a wide range of stakeholders that are likely to receive questions about the rule, such as secretaries of state and similar offices. FinCEN also intends to conduct extensive outreach to all stakeholders, including industry associations as well as secretaries of state and similar offices to ensure the effective implementation of the rule.

II.G.30.c.vi. Statute

Section 6401 provides the Act's short title. Section 6405, "Sense of Congress," provides:

It is the sense of Congress that -

(1) more than 2,000,000 corporations and limited liability companies are being formed under the laws of the States each year;

(2) most or all States do not require information about the beneficial owners of the corporations, limited liability companies, or other similar entities formed under the laws of the State;

(3) malign actors seek to conceal their ownership of corporations, limited liability companies, or other similar entities in the United States to facilitate illicit activity, including money laundering, the financing of terrorism, proliferation financing, serious tax fraud, human and drug trafficking, counterfeiting, piracy, securities fraud, financial fraud, and acts of foreign corruption, harming the national security interests of the United States and allies of the United States;

(4) money launderers and others involved in commercial activity intentionally conduct transactions through corporate structures in order to evade detection, and may layer such structures, much like Russian nesting "Matryoshka" dolls, across various secretive jurisdictions such that each time an investigator obtains ownership records for a domestic or foreign entity, the newly identified entity is yet another corporate entity, necessitating a repeat of the same process;

(5) Federal legislation providing for the collection of beneficial ownership information for corporations, limited liability companies, or other similar entities formed under the laws of the States is needed to—

(A) set a clear, Federal standard for incorporation practices;

(B) protect vital Unites States national security interests;

(C) protect interstate and foreign commerce;

(D) better enable critical national security, intelligence, and law enforcement efforts to counter money laundering, the financing of terrorism, and other illicit activity; and

(E) bring the United States into compliance with international anti-money laundering and countering the financing of terrorism standards;

(6) beneficial ownership information collected under the amendments made by this title is sensitive information and will be directly available only to authorized government authorities, subject to effective safeguards and controls, to -

(A) facilitate important national security, intelligence, and law enforcement activities; and

(B) confirm beneficial ownership information provided to financial institutions to facilitate the compliance of the financial institutions with anti-money laundering, countering the financing of terrorism, and customer due diligence requirements under applicable law;

(7) consistent with applicable law, the Secretary of the Treasury shall -

(A) maintain the information described in paragraph (1) in a secure, nonpublic database, using information security methods and techniques that are appropriate to protect nonclassified information systems at the highest security level; and

(B) take all steps, including regular auditing, to ensure that government authorities accessing beneficial ownership information do so only for authorized purposes consistent with this title; and

(8) in prescribing regulations to provide for the reporting of beneficial ownership information, the Secretary shall, to the greatest extent practicable consistent with the purposes of this title -

(A) seek to minimize burdens on reporting companies associated with the collection of beneficial ownership information;

(B) provide clarity to reporting companies concerning the identification of their beneficial owners; and

(C) collect information in a form and manner that is reasonably designed to generate a database that is highly useful to national security, intelligence, and law enforcement agencies and Federal functional regulators.

Section 6403 of the Act, “Beneficial Ownership Information Reporting Requirements,” provides in subsection (a), “In General:”

Subchapter II of chapter 53 of title 31, United States Code, as amended by sections 6306(a)(1), 6307(a), and 6313(a) of this division, is amended by adding at the end the following:

§ 5336. Beneficial ownership information reporting requirements

(a) DEFINITIONS.—In this section:

(1) ACCEPTABLE IDENTIFICATION DOCUMENT.—The term ‘acceptable identification document’ means, with respect to an individual -

(A) a nonexpired passport issued by the United States;

(B) a nonexpired identification document issued by a State, local government, or Indian Tribe to the individual acting for the purpose of identification of that individual;

(C) a nonexpired driver's license issued by a State; or

(D) if the individual does not have a document described in subparagraph (A), (B), or (C), a nonexpired passport issued by a foreign government.

(2) APPLICANT. The term 'applicant' means any individual who -

"(A) files an application to form a corporation, limited liability company, or other similar entity under the laws of a State or Indian Tribe; or

"(B) registers or files an application to register a corporation, limited liability company, or other similar entity formed under the laws of a foreign country to do business in the United States by filing a document with the secretary of state or similar office under the laws of a State or Indian Tribe.

(3) BENEFICIAL OWNER. The term "beneficial owner" -

(A) means, with respect to an entity, an individual who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise -

(i) exercises substantial control over the entity; or

(ii) owns or controls not less than 25 percent of the ownership interests of the entity; and

(B) does not include -

(i) a minor child, as defined in the State in which the entity is formed, if the information of the parent or guardian of the minor child is reported in accordance with this section;

(ii) an individual acting as a nominee, intermediary, custodian, or agent on behalf of another individual;

(iii) an individual acting solely as an employee of a corporation, limited liability company, or other similar entity and whose control over or economic benefits from such entity is derived solely from the employment status of the person;

(iv) an individual whose only interest in a corporation, limited liability company, or other similar entity is through a right of inheritance; or

(v) a creditor of a corporation, limited liability company, or other similar entity, unless the creditor meets the requirements of subparagraph (A).

(4) DIRECTOR. The term “Director” means the Director of FinCEN.

(5) FINCEN. The term “FinCEN” means the Financial Crimes Enforcement Network of the Department of the Treasury.

(6) FINCEN IDENTIFIER. The term “FinCEN identifier” means the unique identifying number assigned by FinCEN to a person under this section.

(7) FOREIGN PERSON. The term “foreign person” means a person who is not a United States person, as defined in section 7701(a) of the Internal Revenue Code of 1986.

(8) INDIAN TRIBE. The term “Indian Tribe” has the meaning given the term “Indian tribe” in section 102 of the Federally Recognized Indian Tribe List Act of 1994 (25 U.S.C. 5130).

(9) LAWFULLY ADMITTED FOR PERMANENT RESIDENCE. The term “lawfully admitted for permanent residence” has the meaning given the term in section 101(a) of the Immigration and Nationality Act (8 U.S.C. 1101(a)).

(10) POOLED INVESTMENT VEHICLE. The term “pooled investment vehicle” means -

(A) any investment company, as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)); or

(B) any company that -

(i) would be an investment company under that section but for the exclusion provided from that definition by paragraph (1) or (7) of section 3(c) of that Act (15 U.S.C. 80a-3(c)); and

(ii) is identified by its legal name by the applicable investment adviser in its Form ADV (or successor form) filed with the Securities and Exchange Commission.

(11) REPORTING COMPANY. The term “reporting company” -

(A) means a corporation, limited liability company, or other similar entity that is -

(i) created by the filing of a document with a secretary of state or a similar office under the law of a State or Indian Tribe; or

(ii) formed under the law of a foreign country and registered to do business in the United States by the filing of a document with a secretary of state or a similar office under the laws of a State or Indian Tribe; and

(B) does not include -

(i) an issuer -

(I) of a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 781); or

(II) that is required to file supplementary and periodic information under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 780(d));

(ii) an entity -

(I) established under the laws of the United States, an Indian Tribe, a State, or a political subdivision of a State, or under an interstate compact between 2 or more States; and

(II) that exercises governmental authority on behalf of the United States or any such Indian Tribe, State, or political subdivision;

(iii) a bank, as defined in -

(I) section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813);

(II) section 2(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)); or

(III) section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a));

(iv) a Federal credit union or a State credit union (as those terms are defined in section 101 of the Federal Credit Union Act (12 U.S.C. 1752));

(v) a bank holding company (as defined in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841)) or a savings and loan holding company (as defined in section 10(a) of the Home Owners" Loan Act (12 U.S.C. 1467a(a)));

(vi) a money transmitting business registered with the Secretary of the Treasury under section 5330;

(vii) a broker or dealer (as those terms are defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)) that is registered under section 15 of that Act (15 U.S.C. 78o);

(viii) an exchange or clearing agency (as those terms are defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)) that is registered under section 6 or 17A of that Act (15 U.S.C. 78f, 78q-1);

(ix) any other entity not described in clause (i), (vii), or (viii) that is registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.);

(x) an entity that -

(I) is an investment company (as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3)) or an investment adviser (as defined in section 202 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2)); and

(II) is registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) or the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.);

(xi) an investment adviser -

(I) described in section 203(l) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(l)); and

(II) that has filed Item 10, Schedule A, and Schedule B of Part IA of Form ADV, or any successor thereto, with the Securities and Exchange Commission;

(xii) an insurance company (as defined in section 2 of the Investment Company Act of 1940 (15 U.S.C. 80a-2));

(xiii) an entity that -

(I) is an insurance producer that is authorized by a State and subject to supervision by the insurance commissioner or a similar official or agency of a State; and

(II) has an operating presence at a physical office within the United States;

(xiv) (I) a registered entity (as defined in section la of the Commodity Exchange Act (7 U.S.C. la)); or

(II) an entity that is -

(aa)(AA) a futures commission merchant, introducing broker, swap dealer, major swap participant, commodity pool operator, or commodity trading advisor (as those terms are defined in section la of the Commodity Exchange Act (7 U.S.C. la)); or

(BB) a retail foreign exchange dealer, as described in section 2(c)(2)(B) of that Act (7 U.S.C. 2(c)(2)(B)); and

(bb) registered with the Commodity Futures Trading Commission under the Commodity Exchange Act (7 U.S.C. 1 et seq.);

(xv) a public accounting firm registered in accordance with section 102 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7212);

(xvi) a public utility that provides telecommunications services, electrical power, natural gas, or water and sewer services within the United States;

(xvii) a financial market utility designated by the Financial Stability Oversight Council under section 804 of the Payment, Clearing, and Settlement Supervision Act of 2010 (12 U.S.C. 5463);

(xviii) any pooled investment vehicle that is operated or advised by a person described in clause (iii), (iv), (vii), (x), or (xi);

(xix) any -

(I) organization that is described in section 501(c) of the Internal Revenue Code of 1986 (determined without regard to section 508(a) of such Code) and exempt from tax under section 501(a) of such Code, except that in the case of any such organization that loses an exemption from tax, such organization shall be considered to be continued to be described in this subclause for the 180-day period beginning on the date of the loss of such tax-exempt status;

(II) political organization (as defined in section 527(e)(1) of such Code) that is exempt from tax under section 527(a) of such Code; or

(III) trust described in paragraph (1) or (2) of section 4947(a) of such Code;

(xx) any corporation, limited liability company, or other similar entity that -

(I) operates exclusively to provide financial assistance to, or hold governance rights over, any entity described in clause (xix);

(II) is a United States person;

(III) is beneficially owned or controlled exclusively by 1 or more United States persons that are United States citizens or lawfully admitted for permanent residence; and

(IV) derives at least a majority of its funding or revenue from 1 or more United States persons that are United States citizens or lawfully admitted for permanent residence;

(xxi) any entity that -

(I) employs more than 20 employees on a full-time basis in the United States;

(II) filed in the previous year Federal income tax returns in the United States demonstrating more than $5,000,000 in gross receipts or sales in the aggregate, including the receipts or sales of -

(aa) other entities owned by the entity; and

(bb) other entities through which the entity operates; and

(III) has an operating presence at a physical office within the United States;

(xxii) any corporation, limited liability company, or other similar entity of which the ownership interests are owned or controlled, directly or indirectly, by 1 or more entities described in clause (i), (ii), (iii), (iv), (v), (vii), (viii), (ix), (x), (xi), (xii), (xiii), (xiv), (xv), (xvi), (xvii) (xix), or (xxi);

(xxiii) any corporation, limited liability company, or other similar entity -

(I) in existence for over 1 year;

(II) that is not engaged in active business;

(III) that is not owned, directly or indirectly, by a foreign person;

(IV) that has not, in the preceding 12-month period, experienced a change in ownership or sent or received funds in an amount greater than $1,000 (including all funds sent to or received from any source through a financial account or accounts in which the entity, or an affiliate of the entity, maintains an interest); and

(V) that does not otherwise hold any kind or type of assets, including an ownership interest in any corporation, limited liability company, or other similar entity;

(xxiv) any entity or class of entities that the Secretary of the Treasury, with the written concurrence of the Attorney General and the Secretary of Homeland Security, has, by regulation, determined should be exempt from the requirements of subsection (b) because requiring beneficial ownership information from the entity or class of entities -

(I) would not serve the public interest; and

(II) would not be highly useful in national security, intelligence, and law enforcement agency efforts to detect, prevent, or prosecute money laundering, the financing of terrorism, proliferation finance, serious tax fraud, or other crimes.

(12) STATE. The term “State” means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana Islands, American Samoa, Guam, the United States Virgin Islands, and any other commonwealth, territory, or possession of the United States.

(13) UNIQUE IDENTIFYING NUMBER. The term “unique identifying number” means, with respect to an individual or an entity with a sole member, the unique identifying number from an acceptable identification document.

(14) UNITED STATES PERSON. The term “United States person” has the meaning given the term in section 7701(a) of the Internal Revenue Code of 1986.

(b) BENEFICIAL OWNERSHIP INFORMATION REPORTING.

(1) REPORTING.

(A) IN GENERAL. In accordance with regulations prescribed by the Secretary of the Treasury, each reporting company shall submit to FinCEN a report that contains the information described in paragraph (2).

(B) REPORTING OF EXISTING ENTITIES. In accordance with regulations prescribed by the Secretary of the Treasury, any reporting company that has been formed or registered before the effective date of the regulations prescribed under this subsection shall, in a timely manner, and not later than 2 years after the effective date of the regulations prescribed under this subsection, submit to FinCEN a report that contains the information described in paragraph (2).

(C) REPORTING AT TIME OF FORMATION OR REGISTRATION. In accordance with regulations prescribed by the Secretary of the Treasury, any reporting company that has been formed or registered after the effective date of the regulations promulgated under this subsection shall, at the time of formation or registration, submit to FinCEN a report that contains the information described in paragraph (2).

(D) UPDATED REPORTING FOR CHANGES IN BENEFICIAL OWNERSHIP. In accordance with regulations prescribed by the Secretary of the Treasury, a reporting company shall, in a timely manner, and not later than 1 year after the date on which there is a change with respect to any information described in paragraph (2), submit to FinCEN a report that updates the information relating to the change.

(E) TREASURY REVIEW OF UPDATED REPORTING FOR CHANGES IN BENEFICIAL OWNERSHIP. The Secretary of the Treasury, in consultation with the Attorney General and the Secretary of Homeland Security, shall conduct a review to evaluate—

(i) the necessity of a requirement for corporations, limited liability companies, or other similar entities to update the report on beneficial ownership information in paragraph (2), related to a change in ownership, within a shorter period of time than required under subparagraph (D), taking into account the updating requirements under subparagraph (D) and the information contained in the reports;

(ii) the benefit to law enforcement and national security officials that might be derived from, and the burden that a requirement to update the list of beneficial owners within a shorter period of time after a change in the list of beneficial owners would impose on corporations, limited liability companies, or other similar entities; and

(iii) not later than 2 years after the date of enactment of this section, incorporate into the regulations, as appropriate, any changes necessary to implement the findings and determinations based on the review required under this subparagraph.

(F) REGULATION REQUIREMENTS.—In promulgating the regulations required under subparagraphs (A) through (D), the Secretary of the Treasury shall, to the greatest extent practicable -

(i) establish partnerships with State, local, and Tribal governmental agencies;

(ii) collect information described in paragraph (2) through existing Federal, State, and local processes and procedures;

(iii) minimize burdens on reporting companies associated with the collection of the information described in paragraph (2), in light of the private compliance costs placed on legitimate businesses, including by identifying any steps taken to mitigate the costs relating to compliance with the collection of information; and

(iv) collect information described in paragraph (2) in a form and manner that ensures the information is highly useful in -

(I) facilitating important national security, intelligence, and law enforcement activities; and

(II) confirming beneficial ownership information provided to financial institutions to facilitate the compliance of the financial institutions with anti-money laundering, countering the financing of terrorism, and customer due diligence requirements under applicable law.

(G) REGULATORY SIMPLIFICATION. To simplify compliance with this section for reporting companies and financial institutions, the Secretary of the Treasury shall ensure that the regulations prescribed by the Secretary under this subsection are added to part 1010 of title 31, Code of Federal Regulations, or any successor thereto.

(2) REQUIRED INFORMATION.

(A) IN GENERAL. In accordance with regulations prescribed by the Secretary of the Treasury, a report delivered under paragraph (1) shall, except as provided in subparagraph (B), identify each beneficial owner of the applicable reporting company and each applicant with respect to that reporting company by -

(i) full legal name;

(ii) date of birth;

(iii) current, as of the date on which the report is delivered, residential or business street address; and

(iv) (I) unique identifying number from an acceptable identification document; or

(II) FinCEN identifier in accordance with requirements in paragraph (3).

(B) REPORTING REQUIREMENT FOR EXEMPT ENTITIES HAVING AN OWNERSHIP INTEREST. If an exempt entity described in subsection (a)(11)(B) has or will have a direct or indirect ownership interest in a reporting company, the reporting company or the applicant -

(i) shall, with respect to the exempt entity, only list the name of the exempt entity; and

(ii) shall not be required to report the information with respect to the exempt entity otherwise required under subparagraph (A).

(C) REPORTING REQUIREMENT FOR CERTAIN POOLED INVESTMENT VEHICLES. Any corporation, limited liability company, or other similar entity that is an exempt entity described in subsection (a)(11)(B)(xviii) and is formed under the laws of a foreign country shall file with FinCEN a written certification that provides identification information of an individual that exercises substantial control over the pooled investment vehicle in the same manner as required under this subsection.

(D) REPORTING REQUIREMENT FOR EXEMPT SUBSIDIARIES. In accordance with the regulations promulgated by the Secretary, any corporation, limited liability company, or other similar entity that is an exempt entity described in subsection (a)(11)(B)(xxii), shall, at the time such entity no longer meets the criteria described in subsection (a)(11)(B)(xxii), submit to FinCEN a report containing the information required under subparagraph (A).

(E) REPORTING REQUIREMENT FOR EXEMPT GRANDFATHERED ENTITIES. In accordance with the regulations promulgated by the Secretary, any corporation, limited liability company, or other similar entity that is an exempt entity described in subsection (a)(11)(B)(xxiii), shall, at the time such entity no longer meets the criteria described in subsection (a)(11)(B)(xxiii), submit to FinCEN a report containing the information required under subparagraph (A).

(3) FINCEN IDENTIFIER.

(A) ISSUANCE OF FINCEN IDENTIFIER.

(i) IN GENERAL. Upon request by an individual who has provided FinCEN with the information described in paragraph (2)(A) pertaining to the individual, or by an entity that has reported its beneficial ownership information to FinCEN in accordance with this section, FinCEN shall issue a FinCEN identifier to such individual or entity.

(ii) UPDATING OF INFORMATION. An individual or entity with a FinCEN identifier shall submit filings with FinCEN pursuant to paragraph (1) updating any information described in paragraph (2) in a timely manner consistent with paragraph (1)(D).

(iii) EXCLUSIVE IDENTIFIER. FinCEN shall not issue more than 1 FinCEN identifier to the same individual or to the same entity (including any successor entity).

(B) USE OF FINCEN IDENTIFIER FOR INDIVIDUALS. Any person required to report the information described in paragraph (2) with respect to an individual may instead report the FinCEN identifier of the individual.

(C) USE OF FINCEN IDENTIFIER FOR ENTITIES. If an individual is or may be a beneficial owner of a reporting company by an interest held by the individual in an entity that, directly or indirectly, holds an interest in the reporting company, the reporting company may report the FinCEN identifier of the entity in lieu of providing the information required by paragraph (2)(A) with respect to the individual.

(4) REGULATIONS. The Secretary of the Treasury shall -

(A) by regulation prescribe procedures and standards governing any report under paragraph (2) and any FinCEN identifier under paragraph (3); and

(B) in promulgating the regulations under subparagraph (A) to the extent practicable, consistent with the purposes of this section -

(i) minimize burdens on reporting companies associated with the collection of beneficial ownership information, including by eliminating duplicative requirements; and

(ii) ensure the beneficial ownership information reported to FinCEN is accurate, complete, and highly useful.

(5) EFFECTIVE DATE. The requirements of this subsection shall take effect on the effective date of the regulations prescribed by the Secretary of the Treasury under this subsection, which shall be promulgated not later than 1 year after the date of enactment of this section.

(6) REPORT. Not later than 1 year after the effective date described in paragraph (5), and annually thereafter for 2 years, the Secretary of the Treasury shall submit to Congress a report describing the procedures and standards prescribed to carry out paragraph (2), which shall include an assessment of—

(A) the effectiveness of those procedures and standards in minimizing reporting burdens (including through the elimination of duplicative requirements) and strengthening the accuracy of reports submitted under paragraph (2); and

(B) any alternative procedures and standards prescribed to carry out paragraph (2).

(c) RETENTION AND DISCLOSURE OF BENEFICIAL OWNERSHIP INFORMATION BY FINCEN.

(1) RETENTION OF INFORMATION. Beneficial ownership information required under subsection (b) relating to each reporting company shall be maintained by FinCEN for not fewer than 5 years after the date on which the reporting company terminates.

(2) DISCLOSURE.

(A) PROHIBITION.—Except as authorized by this subsection and the protocols promulgated under this subsection, beneficial ownership information reported under this section shall be confidential and may not be disclosed by -

(i) an officer or employee of the United States;

(ii) an officer or employee of any State, local, or Tribal agency; or

(iii) an officer or employee of any financial institution or regulatory agency receiving information under this subsection.

(B) SCOPE OF DISCLOSURE BY FINCEN. FinCEN may disclose beneficial ownership information reported pursuant to this section only upon receipt of -

(i) a request, through appropriate protocols -

(I) from a Federal agency engaged in national security, intelligence, or law enforcement activity, for use in furtherance of such activity; or

(II) from a State, local, or Tribal law enforcement agency, if a court of competent jurisdiction, including any officer of such a court, has authorized the law enforcement agency to seek the information in a criminal or civil investigation;

(ii) a request from a Federal agency on behalf of a law enforcement agency, prosecutor, or judge of another country, including a foreign central authority or competent authority (or like designation), under an international treaty, agreement, convention, or official request made by law enforcement, judicial, or prosecutorial authorities in trusted foreign countries when no treaty, agreement, or convention is available -

(I) issued in response to a request for assistance in an investigation or prosecution by such foreign country; and

(II) that -

(aa) requires compliance with the disclosure and use provisions of the treaty, agreement, or convention, publicly disclosing any beneficial ownership information received; or

(bb) limits the use of the information for any purpose other than the authorized investigation or national security or intelligence activity;

(iii) a request made by a financial institution subject to customer due diligence requirements, with the consent of the reporting company, to facilitate the compliance of the financial institution with customer due diligence requirements under applicable law; or

(iv) a request made by a Federal functional regulator or other appropriate regulatory agency consistent with the requirements of subparagraph (C).

(C) FORM AND MANNER OF DISCLOSURE TO FINANCIAL INSTITUTIONS AND REGULATORY AGENCIES. The Secretary of the Treasury shall, by regulation, prescribe the form and manner in which information shall be provided to a financial institution under subparagraph (B)(iii), which regulation shall include that the information shall also be available to a Federal functional regulator or other appropriate regulatory agency, as determined by the Secretary, if the agency -

(i) is authorized by law to assess, supervise, enforce, or otherwise determine the compliance of the financial institution with the requirements described in that subparagraph;

(ii) uses the information solely for the purpose of conducting the assessment, supervision, or authorized investigation or activity described in clause (i); and

(iii) enters into an agreement with the Secretary providing for appropriate protocols governing the safekeeping of the information.

(3) APPROPRIATE PROTOCOLS. The Secretary of the Treasury shall establish by regulation protocols described in paragraph (2)(A) that -

(A) protect the security and confidentiality of any beneficial ownership information provided directly by the Secretary;

(B) require the head of any requesting agency, on a nondelegable basis, to approve the standards and procedures utilized by the requesting agency and certify to the Secretary semiannually that such standards and procedures are in compliance with the requirements of this paragraph;

(C) require the requesting agency to establish and maintain, to the satisfaction of the Secretary, a secure system in which such beneficial ownership information provided directly by the Secretary shall be stored;

(D) require the requesting agency to furnish a report to the Secretary, at such time and containing such information as the Secretary may prescribe, that describes the procedures established and utilized by such agency to ensure the confidentiality of the beneficial ownership information provided directly by the Secretary;

(E) require a written certification for each authorized investigation or other activity described in paragraph (2) from the head of an agency described in paragraph (2)(B)(i)(I), or their designees, that -

(i) states that applicable requirements have been met, in such form and manner as the Secretary may prescribe; and

(ii) at a minimum, sets forth the specific reason or reasons why the beneficial ownership information is relevant to an authorized investigation or other activity described in paragraph (2);

(F) require the requesting agency to limit, to the greatest extent practicable, the scope of information sought, consistent with the purposes for seeking beneficial ownership information;

(G) restrict, to the satisfaction of the Secretary, access to beneficial ownership information to whom disclosure may be made under the provisions of this Section to only users at the requesting agency -

(i) who are directly engaged in the authorized investigation or activity described in paragraph (2);

(ii) whose duties or responsibilities require such access;

(iii) who -

(I) have undergone appropriate training; or

(II) use staff to access the database who have undergone appropriate training;

(iv) who use appropriate identity verification mechanisms to obtain access to the information; and

(v) who are authorized by agreement with the Secretary to access the information;

(H) require the requesting agency to establish and maintain, to the satisfaction of the Secretary, a permanent system of standardized records with respect to an auditable trail of each request for beneficial ownership information submitted to the Secretary by the agency, including the reason for the request, the name of the individual who made the request, the date of the request, any disclosure of beneficial ownership information made by or to the agency, and any other information the Secretary of the Treasury determines is appropriate;

(I) require that the requesting agency receiving beneficial ownership information from the Secretary conduct an annual audit to verify that the beneficial ownership information received from the Secretary has been accessed and used appropriately, and in a manner consistent with this paragraph and provide the results of that audit to the Secretary upon request;

(J) require the Secretary to conduct an annual audit of the adherence of the agencies to the protocols established under this paragraph to ensure that agencies are requesting and using beneficial ownership information appropriately; and

(K) provide such other safeguards which the Secretary determines (and which the Secretary prescribes in regulations) to be necessary or appropriate to protect the confidentiality of the beneficial ownership information.

(4) VIOLATION OF PROTOCOLS. Any employee or officer of a requesting agency under paragraph (2)(B) that violates the protocols described in paragraph (3), including unauthorized disclosure or use, shall be subject to criminal and civil penalties under subsection (h)(3)(B).

(5) DEPARTMENT OF THE TREASURY ACCESS.

(A) IN GENERAL.—Beneficial ownership information shall be accessible for inspection or disclosure to officers and employees of the Department of the Treasury whose official duties require such inspection or disclosure subject to procedures and safeguards prescribed by the Secretary of the Treasury.

(B) TAX ADMINISTRATION PURPOSES.—Officers and employees of the Department of the Treasury may obtain access to beneficial ownership information for tax administration purposes in accordance with this subsection.

(6) REJECTION OF REQUEST. The Secretary of the Treasury -

(A) shall reject a request not submitted in the form and manner prescribed by the Secretary under paragraph (2)(C); and

(B) may decline to provide information requested under this subsection upon finding that -

(i) the requesting agency has failed to meet any other requirement of this subsection;

(ii) the information is being requested for an unlawful purpose; or

(iii) other good cause exists to deny the request.

(7) SUSPENSION. The Secretary of the Treasury may suspend or debar a requesting agency from access for any of the grounds set forth in paragraph (6), including for repeated or serious violations of any requirement under paragraph (2).

(8) SECURITY PROTECTIONS. The Secretary of the Treasury shall maintain information security protections, including encryption, for information reported to FinCEN under subsection (b) and ensure that the protections—

(A) are consistent with standards and guidelines developed under subchapter II of chapter 35 of title 44; and

(B) incorporate Federal information system security controls for high-impact systems, excluding national security systems, consistent with applicable law to prevent the loss of confidentiality, integrity, or availability of information that may have a severe or catastrophic adverse effect.

(9) REPORT BY THE SECRETARY. Not later than 1 year after the effective date of the regulations prescribed under this subsection, and annually thereafter for 5 years, the Secretary of the Treasury shall submit to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives a report, which -

(A) may include a classified annex; and

(B) shall, with respect to each request submitted under paragraph (2)(B)(i)(II) during the period covered by the report, and consistent with protocols established by the Secretary that are necessary to protect law enforcement sensitive, tax-related, or classified information, include -

(i) the date on which the request was submitted;

(ii) the source of the request;

(iii) whether the request was accepted or rejected or is pending; and

(iv) a general description of the basis for rejecting the such request, if applicable.

(10) AUDIT BY THE COMPTROLLER GENERAL. Not later than 1 year after the effective date of the regulations prescribed under this subsection, and annually thereafter for 6 years, the Comptroller General of the United States shall -

(A) audit the procedures and safeguards established by the Secretary of the Treasury under those regulations, including duties for verification of requesting agencies systems and adherence to the protocols established under this subsection, to determine whether such safeguards and procedures meet the requirements of this subsection and that the Department of the Treasury is using beneficial ownership information appropriately in a manner consistent with this subsection; and

(B) submit to the Secretary of the Treasury, the Committee on Banking, Housing, and Urban Affairs of the Senate, and the Committee on Financial Services of the House of Representatives a report that contains the findings and determinations with respect to any audit conducted under this paragraph.

(11) DEPARTMENT OF THE TREASURY TESTIMONY.

(A) IN GENERAL. Not later than March 31 of each year for 5 years beginning in 2022, the Director shall be made available to testify before the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives, or an appropriate subcommittee thereof, regarding FinCEN issues, including, specifically, issues relating to—

(i) anticipated plans, goals, and resources necessary for operations of FinCEN in implementing the requirements of the Anti-Money Laundering Act of 2020 and the amendments made by that Act;

(ii) the adequacy of appropriations for FinCEN in the current and the previous fiscal year to -

(I) ensure that the requirements and obligations imposed upon FinCEN by the Anti-Money Laundering Act of 2020 and the amendments made by that Act are completed as efficiently, effectively, and expeditiously as possible; and

(II) provide for robust and effective implementation and enforcement of the provisions of the Anti-Money Laundering Act of 2020 and the amendments made by that Act;

(iii) strengthen FinCEN management efforts, as necessary and as identified by the Director, to meet the requirements of the Anti-Money Laundering Act of 2020 and the amendments made by that Act;

(iv) provide for the necessary public outreach to ensure the broad dissemination of information regarding any new program requirements provided for in the Anti-Money Laundering Act of 2020 and the amendments made by that Act, including -

(I) educating the business community on the goals and operations of the new beneficial ownership database; and

(II) disseminating to the governments of countries that are allies or partners of the United States information on best practices developed by FinCEN related to beneficial ownership information retention and use;

(v) any policy recommendations that could facilitate and improve communication and coordination between the private sector, FinCEN, and the Federal, State, and local agencies and entities involved in implementing innovative approaches to meet their obligations under the Anti-Money Laundering Act of 2020 and the amendments made by that Act, the Bank Secrecy Act (as defined in section 6003 of the Anti-Money Laundering Act of 2020), and other anti-money laundering compliance laws; and

(vi) any other matter that the Director determines is appropriate.

(B) TESTIMONY CLASSIFICATION. The testimony required under subparagraph (A) -

(i) shall be submitted in unclassified form; and

(ii) may include a classified portion.

(d) AGENCY COORDINATION.

(1) IN GENERAL. The Secretary of the Treasury shall, to the greatest extent practicable, update the information described in subsection (b) by working collaboratively with other relevant Federal, State, and Tribal agencies.

(2) INFORMATION FROM RELEVANT FEDERAL, STATE, AND TRIBAL AGENCIES. Relevant Federal, State, and Tribal agencies, as determined by the Secretary of the Treasury, shall, to the extent practicable, and consistent with applicable legal protections, cooperate with and provide information requested by FinCEN for purposes of maintaining an accurate, complete, and highly useful database for beneficial ownership information.

(3) REGULATIONS. The Secretary of the Treasury, in consultation with the heads of other relevant Federal agencies, may promulgate regulations as necessary to carry out this subsection.

(e) NOTIFICATION OF FEDERAL OBLIGATIONS.

(1) FEDERAL. The Secretary of the Treasury shall take reasonable steps to provide notice to persons of their obligations to report beneficial ownership information under this section, including by causing appropriate informational materials describing such obligations to be included in 1 or more forms or other informational materials regularly distributed by the Internal Revenue Service and FinCEN.

(2) STATES AND INDIAN TRIBES.

(A) IN GENERAL. As a condition of the funds made available under this section, each State and Indian Tribe shall, not later than 2 years after the effective date of the regulations promulgated under subsection (b)(4), take the following actions:

(i) The secretary of a State or a similar office in each State or Indian Tribe responsible for the formation or registration of entities created by the filing of a public document with the office under the law of the State or Indian Tribe shall periodically, including at the time of any initial formation or registration of an entity, assessment of an annual fee, or renewal of any license to do business in the United States and in connection with State or Indian Tribe corporate tax assessments or renewals -

(I) notify filers of their requirements as reporting companies under this section, including the requirements to file and update reports under paragraphs (1) and (2) of subsection (b); and

(II) provide the filers with a copy of the reporting company form created by the Secretary of the Treasury under this subsection or an internet link to that form.

(ii) The secretary of a State or a similar office in each State or Indian Tribe responsible for the formation or registration of entities created by the filing of a public document with the office under the law of the State or Indian Tribes shall update the websites, forms relating to incorporation, and physical premises of the office to notify filers of their requirements as reporting companies under this section, including providing an internet link to the reporting company form created by the Secretary of the Treasury under this section.

(B) NOTIFICATION FROM THE DEPARTMENT OF THE TREASURY.
A notification under clause (i) or (ii) of subparagraph (A) shall explicitly state that the notification is on behalf of the Department of the Treasury for the purpose of preventing money laundering, the financing of terrorism, proliferation financing, serious tax fraud, and other financial crime by requiring nonpublic registration of business entities formed or registered to do business in the United States.

(f) No BEARER SHARE CORPORATIONS OR LIMITED LIABILITY COMPANIES.
A corporation, limited liability company, or other similar entity formed under the laws of a State or Indian Tribe may not issue a certificate in bearer form evidencing either a whole or fractional interest in the entity.

(g) REGULATIONS. In promulgating regulations carrying out this section, the Director shall reach out to members of the small business community and other appropriate parties to ensure efficiency and effectiveness of the process for the entities subject to the requirements of this section.

(h) PENALTIES.

(1) REPORTING VIOLATIONS. It shall be unlawful for any person to -

(A) willfully provide, or attempt to provide, false or fraudulent beneficial ownership information, including a false or fraudulent identifying photograph or document, to FinCEN in accordance with subsection (b); or

(B) willfully fail to report complete or updated beneficial ownership information to FinCEN in accordance with subsection (b).

(2) UNAUTHORIZED DISCLOSURE OR USE. Except as authorized by this section, it shall be unlawful for any person to knowingly disclose or knowingly use the beneficial ownership information obtained by the person through -

(A) a report submitted to FinCEN under subsection (b); or

(B) a disclosure made by FinCEN under subsection (c).

(3) CRIMINAL AND CIVIL PENALTIES.

(A) REPORTING VIOLATIONS.—Any person that violates subparagraph (A) or (B) of paragraph (1) -

(i) shall be liable to the United States for a civil penalty of not more than $500 for each day that the violation continues or has not been remedied; and

(ii) may be fined not more than $10,000, imprisoned for not more than 2 years, or both.

(B) UNAUTHORIZED DISCLOSURE OR USE VIOLATIONS. Any person that violates paragraph (2) -

(i) shall be liable to the United States for a civil penalty of not more than $500 for each day that the violation continues or has not been remedied; and

(ii) (I) shall be fined not more than $250,000, or imprisoned for not more than 5 years, or both; or

(II) while violating another law of the United States or as part of a pattern of any illegal activity involving more than $100,000 in a 12-month period, shall be fined not more than $500,000, imprisoned for not more than 10 years, or both.

(C) SAFE HARBOR.

(i) SAFE HARBOR.—

(I) IN GENERAL. Except as provided in sub-clause (II), a person shall not be subject to civil or criminal penalty under subparagraph (A) if the person -

(aa) has reason to believe that any report submitted by the person in accordance with subsection (b) contains inaccurate information; and

(bb) in accordance with regulations issued by the Secretary, voluntarily and promptly, and in no case later than 90 days after the date on which the person submitted the report, submits a report containing corrected information.

(II) EXCEPTIONS. A person shall not be exempt from penalty under clause (i) if at the time the person submits the report required by subsection (b), the person -

(aa) acts for the purpose of evading the reporting requirements under subsection (b); and

(bb) has actual knowledge that any information contained in the report is inaccurate.

(ii) ASSISTANCE. FinCEN shall provide assistance to any person seeking to submit a corrected report in accordance with clause (i)(I).

(4) USER COMPLAINT PROCESS.

(A) IN GENERAL. The Inspector General of the Department of the Treasury, in coordination with the Secretary of the Treasury, shall provide public contact information to receive external comments or complaints regarding the beneficial ownership information notification and collection process or regarding the accuracy, completeness, or timeliness of such information.

(B) REPORT. The Inspector General of the Department of the Treasury shall submit to Congress a periodic report that -

(i) summarizes external comments or complaints and related investigations conducted by the Inspector General related to the collection of beneficial ownership information; and

(ii) includes recommendations, in coordination with FinCEN, to improve the form and manner of the notification, collection and updating processes of the beneficial ownership information reporting requirements to ensure the beneficial ownership information reported to FinCEN is accurate, complete, and highly useful.

(5) TREASURY OFFICE OF INSPECTOR GENERAL INVESTIGATION IN THE EVENT OF A CYBERSECURITY BREACH.

(A) IN GENERAL. In the event of a cybersecurity breach that results in substantial unauthorized access and disclosure of sensitive beneficial ownership information, the Inspector General of the Department of the Treasury shall conduct an investigation into FinCEN cybersecurity practices that, to the extent possible, determines any vulnerabilities within FinCEN information security and confidentiality protocols and provides recommendations for fixing those deficiencies.

(B) REPORT. The Inspector General of the Department of the Treasury shall submit to the Secretary of the Treasury a report on each investigation conducted under subparagraph (A).

(C) ACTIONS OF THE SECRETARY. Upon receiving a report submitted under subparagraph (B), the Secretary of the Treasury shall -

(i) determine whether the Director had any responsibility for the cybersecurity breach or whether policies, practices, or procedures implemented at the direction of the Director led to the cybersecurity breach; and

(ii) submit to Congress a written report outlining the findings of the Secretary, including a determination by the Secretary on whether to retain or dismiss the individual serving as the Director.

(6) DEFINITION. In this subsection, the term “willfully” means the voluntary, intentional violation of a known legal duty.

(i) CONTINUOUS REVIEW OF EXEMPT ENTITIES.

(1) IN GENERAL—On and after the effective date of the regulations promulgated under subsection (b)(4), if the Secretary of the Treasury makes a determination, which may be based on information contained in the report required under section 6502(c) of the Anti-Money Laundering Act of 2020 or on any other information available to the Secretary, that an entity or class of entities described in subsection (a)(11)(B) has been involved in significant abuse relating to money laundering, the financing of terrorism, proliferation finance, serious tax fraud, or any other financial crime, not later than 90 days after the date on which the Secretary makes the determination, the Secretary shall submit to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives a report that explains the reasons for the determination and any administrative or legislative recommendations to prevent such abuse.

(2) CLASSIFIED ANNEX. The report required by paragraph (1) -

(A) shall be submitted in unclassified form; and

(B) may include a classified annex.

Section 6403 of the Act, “Beneficial Ownership Information Reporting Requirements,” provides in subsection (b), “Conforming Amendments”:

Title 31, United States Code, is amended -

(1) in section 5321(a) -

(A) in paragraph (1), by striking “sections 5314 and 5315” each place that term appears and inserting “sections 5314, 5315, and 5336”; and

(B) in paragraph (6), by inserting “(except section 5336)” after “subchapter” each place that term appears;

(2) in section 5322, by striking “section 5315 or 5324” each place that term appears and inserting “section 5315, 5324, or 5336”; and

(3) in the table of sections for chapter 53, as amended by sections 6306(b)(1), 6307(b), and 6313(b) of this division, by adding at the end the following:

5336. Beneficial ownership information reporting requirements

(c) REPORTING REQUIREMENTS FOR FEDERAL CONTRACTORS.

(1) IN GENERAL. Not later than 2 years after the date of enactment of this Act, the Administrator for Federal Procurement Policy shall revise the Federal Acquisition Regulation maintained under section 1303(a)(1) of title 41, United States Code, to require any contractor or subcontractor that is subject to the requirement to disclose beneficial ownership information under section 5336 of title 31, United States Code, as added by subsection (a) of this section, to provide the information required to be disclosed under such section to the Federal Government as part of any bid or proposal for a contract with a value threshold in excess of the simplified acquisition threshold under section 134 of title 41, United States Code.

(2) APPLICABILITY. The revision required under paragraph (1) shall not apply to a covered contractor or subcontractor, as defined in section 847 of the National Defense Authorization Act for Fiscal Year 2020 (Public Law 116-92), that is subject to the beneficial ownership disclosure and review requirements under that section.

(d) REVISED DUE DILIGENCE RULEMAKING.

(1) IN GENERAL. Not later than 1 year after the effective date of the regulations promulgated under section 5336(b)(4) of title 31, United States Code, as added by subsection (a) of this section, the Secretary of the Treasury shall revise the final rule entitled “Customer Due Diligence Requirements for Financial Institutions” (81 Fed. Reg. 29397 (May 11, 2016)) to -

(A) bring the rule into conformance with this division and the amendments made by this division;

(B) account for the access of financial institutions to beneficial ownership information filed by reporting companies under section 5336, and provided in the form and manner prescribed by the Secretary, in order to confirm the beneficial ownership information provided directly to the financial institutions to facilitate the compliance of those financial institutions with anti-money laundering, countering the financing of terrorism, and customer due diligence requirements under applicable law; and

(C) reduce any burdens on financial institutions and legal entity customers that are, in light of the enactment of this division and the amendments made by this division, unnecessary or duplicative.

(2) CONFORMANCE.

(A) IN GENERAL. In carrying out paragraph (1), the Secretary of the Treasury shall rescind paragraphs (b) through (j) of section 1010.230 of title 31, Code of Federal Regulations upon the effective date of the revised rule promulgated under this subsection.

(B) RULE OF CONSTRUCTION. Nothing in this section may be construed to authorize the Secretary of the Treasury to repeal the requirement that financial institutions identify and verify beneficial owners of legal entity customers under section 1010.230(a) of title 31, Code of Federal Regulations.

(3) CONSIDERATIONS. In fulfilling the requirements under this subsection, the Secretary of the Treasury shall consider—

(A) the use of risk-based principles for requiring reports of beneficial ownership information;

(B) the degree of reliance by financial institutions on information provided by FinCEN for purposes of obtaining and updating beneficial ownership information;

(C) strategies to improve the accuracy, completeness, and timeliness of the beneficial ownership information reported to the Secretary; and

(D) any other matter that the Secretary determines is appropriate.

II.G.30.c.vii. Legislative History

H.R. Report 116-617, the Conference Report To Accompany H.R. 6395 (12/3/2020), includes:

DIVISION F—ANTI-MONEY LAUNDERING

Anti-Money Laundering Act of 2020 (secs. 6001-6511)

The House bill contained multiple provisions (sections 6001 through 7306 contained in Divisions F and G of the House bill) that would strengthen, modernize, and improve the communication, oversight, and processes of the U.S. Department of the Treasury's financial intelligence, anti-money laundering, and countering the financing of terrorism programs, and would establish beneficial ownership information reporting requirements. Division F is substantially similar to H.R. 2513, the Corporate Transparency Act of 2019, introduced by Representative Maloney of New York, and Division G is substantially similar to H.R. 2514, the Coordinating Oversight, Upgrading and Innovating Technology, and Examiner Reform Act of 2019 (COUNTER Act), introduced by Representative Cleaver of Missouri.

The Senate amendment contained no similar provision.

The Senate recedes with an amendment in the form of a single division that makes a number of additional changes to the provisions in the House bill to strengthen the provisions relating to anti-money laundering and countering the financing of terrorism programs and to establish an improved reporting system relating to beneficial ownership information, including building in further protections to ensure that sensitive information is properly used and protected. The Senate amendment builds on Divisions F & G in the House bill and draws from related bills pending in the Senate, including S. 2563, the Improving Laundering Laws and Increasing Comprehensive Information Tracking of Criminal Activity in Shell Holdings Act (ILLICIT CASH Act), introduced by Senator Warner of Virginia and Senator Cotton of Arkansas; S. 1889, the True Incorporation Transparency for Law Enforcement Act (TITLE Act), introduced by Senator Whitehouse of Rhode Island; S. 1978, the Corporate Transparency Act, introduced by Senator

Wyden of Oregon; and S. 1883, Combating Money Laundering, Terrorist Financing, and Counterfeiting Act of 2019, introduced by Senator Graham of South Carolina.

The conference agreement also includes Division L, the STIFLE Act of 2020, included in H.R. 6395 the National Defense Authorization Act for Fiscal Year 2020, as passed by the House of Representatives. This division is substantially similar to H.R. 7592, the Stopping Trafficking, Illicit Flows, Laundering, and Exploitation Act of 2020 (STIFLE Act), introduced by Representative McAdams of Utah and Representative Gonzalez of Ohio, and integrates it into the conference agreement.

The conferees note that the current Anti-Money Laundering/ Countering the Financing of Terrorism (AML/CFT) regulatory framework is an amalgamation of statutes and regulations that are grounded in the Bank Secrecy Act (BSA) (21 U.S.C. 5311 et seq.), which the Congress enacted in 1970. This decades-old regime, which has not seen comprehensive reform and modernization since its inception, is generally built on individual reporting mechanisms (i.e., currency transaction reports (CTRs) and suspicious activity reports (SARs)) and contemplates aging, decades-old technology, rather than the current, sophisticated AML compliance systems now managed by most financial institutions. The provisions of the House bill, as modified by the Senate amendment, comprehensively update the BSA for the first time in decades and provide for the establishment of a coherent set of risk-based priorities.

One overarching improvement now included in the conference agreement is to broaden the mission of the BSA to specifically safeguard national security as well as the more traditional investigatory pursuits of law enforcement. This change is reflected throughout the conference agreement, including in the priorities that will be established by the Secretary of the Treasury, in consultation with key Federal national security, law enforcement, and regulatory officials.

In particular, the conference agreement requires more routine and systemic coordination, communication, and feedback among financial institutions, regulators, and law enforcement to identify suspicious financial activities, better focusing bank resources to the AML task, which will increase the likelihood for better law enforcement outcomes.

Currently, there is no clear statutory mandate for BSA stake-holders - law enforcement, financial regulators, and financial institutions - to provide routine, standardized feedback to one another for the purpose of improving the effectiveness of BSA anti-money laundering programs. The conference agreement establishes a critical feedback loop and improved routine reporting requirements, to ensure that resources are directed effectively and that law enforcement, regulators, and financial institutions better communicate and coordinate on BSA-AML priorities, collection methods, and outcomes. Because this coordination is essential to identifying those who abuse our financial system, the conferees also examined other domestic and international models for these regulation-guided feedback loops to identify additional lessons-learned that could be adapted for this essential sector.

The conference agreement also opens avenues for more data sharing among financial institutions and within financial institutions and their affiliates, while retaining key security safeguards, so that patterns of suspicious activities will be more easily identified, tracked, and shared appropriately.

The conference agreement also provides a clear mandate for innovation, while providing for regulatory processes for financial institutions to effectively innovate, test, and adopt leading technologies, such as artificial intelligence, to track, identify, and report suspicious financial activity. It also provides for dedicated staff and multiple fora to support public-private collaboration and advancement of this issue.

This includes two new Bank Secrecy Act Advisory Group (BSAAG) subcommittees. The first focuses on confidentiality and informational security and the second on innovation and technology. A new "tech symposium" is also established whereby the U.S. Department of the Treasury is urged to convene international and domestic regulators, financial institutions, law enforcement, and technology companies to periodically demonstrate and test related innovations, all of which will introduce AML participants to the latest technology and mandate its effective incorporation into comprehensive BSA AML-CFT compliance programs.

The conference agreement further requires that the Secretary of the Treasury must consider, when imposing SAR reporting requirements, the benefits and burdens of specific requirements and whether the reporting is likely to be "highly useful" to law enforcement and national security efforts. It also calls for the potential streamlining of reporting requirements, including automated processes. The Secretary must further report to the Congress on whether to permit financial institutions to provide certain "bulk reporting" to law enforcement of low-level risks, such as Suspicious Activity Reports related to structured transactions, which could allow financial institutions to focus more time and effort on identifying and reporting higher-priority, sophisticated suspicious activity.

The conference agreement provides new whistleblower protections for those reporting BSA violations and establishes an "Anti-Money Laundering and Counter-Terrorism Financing Fund" to pay such rewards. It also establishes tough new penalties on those convicted of serious BSA violations, including additional penalties for repeat BSA violators and a prohibition against financial institution board service for individuals convicted of egregious BSA-related crimes.

The conference agreement closes significant AML-CFT gaps, including by adding the trade in antiquities to coverage under the BSA. In addition, Treasury and its law enforcement partners will further study the risks posed by the facilitation of money laundering through the trade in art.

In addition, the laundering of money through real estate transactions continues to be an issue of concern, and the conferees encourage Treasury to examine whether reporting on certain commercial, as well as certain residential, real estate transactions would be a source of highly useful information to law enforcement and the national security community. The conference agreement also requires U.S. Government-wide strategies to combat trade-based money laundering, trafficking, and Chinese money laundering activities.

The conference agreement mandates a study and strategy on de-risking to ensure that legitimate customers—whether individuals, entities, or geographic areas—are not unintentionally and unfairly excluded from access to the financial system.

The conference agreement authorizes additional support to the U.S. Department of the Treasury to accomplish these goals, and the conferees expect the Department to insist on strong accountability for results and responsiveness to congressional oversight during implementation of this measure. Recognizing the important role of the Financial Crimes Enforcement Network (FinCEN) and the need to strengthen the Bureau's management and operations, the agreement adds $10.0 million to the Bureau's authorization. The agreement also allows for special hiring authority for the Office of Terrorism and Financial Intelligence and its component parts. It further establishes a FinCEN Office of Domestic Liaison, FinCEN Foreign Financial Intelligence Unit Liaisons, and expands the number of U.S. Treasury Attaches to allow the Department a broader reach for its AML-CFT activities.

The conference agreement also addresses the critical issue of beneficial ownership. Targeting bad actors who own or control businesses that act as "fronts" or shell companies on behalf of those conducting illicit activities is essential to combating crime and safeguarding our national security.

The conference agreement requires corporations, limited liability companies, and other similar entities formed in the U.S. - or foreign entities registered to do business in the U.S. - to report their beneficial owners to the U.S. Department of the Treasury, as a means to combat the abuse of anonymous companies, which can be used to facilitate money laundering, the financing of terrorism, proliferation finance, tax evasion, human and drug trafficking, sanctions evasion, and other financial crimes.

The conference agreement requires companies to disclose their beneficial owners to the U.S. Department of the Treasury at the time the company is formed and when ownership changes. This beneficial ownership information will be kept confidential and treated as sensitive information, protected under the highest information security standards. It will be made directly available only to: (1) Authorized Government authorities upon request as set out in the measure, subject to effective safeguards, to facilitate relevant national security, intelligence, and law enforcement activities; and (2) Financial institutions, for purposes of complying with their customer due diligence requirements under applicable law and regulation.

For requests made by Federal agencies, the conference agreement requires that only the head of an agency or a designee may certify access to the beneficial ownership database for an investigation, or other authorized national security, intelligence, or law enforcement activity. The conferees expect that the process of delegating authority for designees to make a written certification under section 5403(c)(3)(E) will be consistent with the existing processes to delegate authority to designees to carry out 26 U.S.C. 6103 requests, while taking into account the unique organizational structures of each requesting agency.

Similarly, requests made by State, local, or Tribal law enforcement must be approved by a court of competent jurisdiction. "Court of competent jurisdiction," for purposes of this measure, includes an officer of such a court such as a judge, magistrate, or a Clerk of Courts. This does not include attorneys who are party to a proceeding.

The conferees note that nothing in this conference agreement is designed to undermine the requirement that financial institutions identify and verify the beneficial owners of their legal entity customers pursuant to 31 C.F.R. § 1010.230(a). The conference agreement provides that not later than 1 year after the regulations promulgated to implement the Corporate Transparency Act become effective, the Secretary of the Treasury shall revise the final rule entitled “Customer Due Diligence Requirements for Financial Institutions” (81 Fed. Reg. 29397 (May 11, 2016)) (the “CDD Rule”) to, inter alia, bring the CDD rule into conformance with the statute and reduce any burdens on financial institutions and legal entity customers that are unnecessary or duplicative.

The conference agreement further provides that paragraphs (b)-(j) of 31 C.F.R. § 1010.230 will be rescinded upon the effective date of the revised rule promulgated under this subsection. The conferees intend for the revised CDD rule, including those provisions added pursuant to section 5403(a) of this amendment, to replace appropriate provisions of the current 31 C.F.R. § 1010.230.

II.G.30.c.viii. Regulations

§ 1010.380 Reports of beneficial ownership information

(a) *Reports required; timing of reports* –

(1) *Initial report*. Each reporting company shall file an initial report in the form and manner specified in paragraph (b) of this section as follows:

(i) Any domestic reporting company created on or after January 1, 2024 shall file a report within 30 calendar days of the earlier of the date on which it receives actual notice that its creation has become effective or the date on which a secretary of state or similar office first provides public notice, such as through a publicly accessible registry, that the domestic reporting company has been created.

(ii) Any entity that becomes a foreign reporting company on or after January 1, 2024 shall file a report within 30 calendar days of the earlier of the date on which it receives actual notice that it has been registered to do business or the date on which a secretary of state or similar office first provides public notice, such as through a publicly accessible registry, that the foreign reporting company has been registered to do business.

(iii) Any domestic reporting company created before January 1, 2024 and any entity that became a foreign reporting company before January 1, 2024 shall file a report not later than January 1, 2025.

(iv) Any entity that no longer meets the criteria for any exemption under paragraph (c)(2) of this section shall file a report within 30 calendar days after the date that it no longer meets the criteria for any exemption.

(2) *Updated report*.

(i) If there is any change with respect to required information previously submitted to FinCEN concerning a reporting company or its beneficial owners, including any change with respect to who is a beneficial owner or information reported for any particular beneficial owner, the reporting company shall file an updated report in the form and manner specified in paragraph (b)(3) of this section within 30 calendar days after the date on which such change occurs.

(ii) If a reporting company meets the criteria for any exemption under paragraph (c)(2) of this section subsequent to the filing of an initial report, this change will be deemed a change with respect to information previously submitted to FinCEN, and the entity shall file an updated report.

(iii) If an individual is a beneficial owner of a reporting company by virtue of property interests or other rights subject to transfer upon death, and such individual dies, a change with respect to required information will be deemed to occur when the estate of the deceased beneficial owner is settled, either through the operation of the intestacy laws of a jurisdiction within the United States or through a testamentary deposition. The updated report shall, to the extent appropriate, identify any new beneficial owners.

(iv) If a reporting company has reported information with respect to a parent or legal guardian of a minor child pursuant to paragraphs (b)(2)(ii) and (d)(3)(i) of this section, a change with respect to required information will be deemed to occur when the minor child attains the age of majority.

(v) With respect to an image of an identifying document required to be reported pursuant to paragraph (b)(1)(ii)(E) of this section, a change with respect to required information will be deemed to occur when the name, date of birth, address, or unique identifying number on such document changes.

(3) *Corrected report*. If any report under this section was inaccurate when filed and remains inaccurate, the reporting company shall file a corrected report in the form and manner specified in paragraph (b) of this section within 30 calendar days after the date on which such reporting company becomes aware or has reason to know of the inaccuracy. A corrected report filed under this paragraph (a)(3) within this 30-day period shall be deemed to satisfy 31 U.S.C. 5336(h)(3)(C)(i)(I)(bb) if filed within 90 calendar days after the date on which the inaccurate report was filed.

(b) *Content, form, and manner of reports*. Each report or application submitted under this section shall be filed with FinCEN in the form and manner that FinCEN shall prescribe in the forms and instructions for such report or application, and each person filing such report or application shall certify that the report or application is true, correct, and complete.

(1) *Initial report*. An initial report of a reporting company shall include the following information:

(i) For the reporting company:

(A) The full legal name of the reporting company;

(B) Any trade name or ‘‘doing business as’’ name of the reporting company;

(C) A complete current address consisting of:

(1) In the case of a reporting company with a principal place of business in the United States, the street address of such principal place of business; and

(2) In all other cases, the street address of the primary location in the United States where the reporting company conducts business;

(D) The State, Tribal, or foreign jurisdiction of formation of the reporting company;

(E) For a foreign reporting company, the State or Tribal jurisdiction where such company first registers; and

(F) The Internal Revenue Service (IRS) Taxpayer Identification Number (TIN) (including an Employer Identification Number (EIN)) of the reporting company, or where a foreign reporting company has not been issued a TIN, a tax identification number issued by a foreign jurisdiction and the name of such jurisdiction;

(ii) For every individual who is a beneficial owner of such reporting company, and every individual who is a company applicant with respect to such reporting company:

(A) The full legal name of the individual;

(B) The date of birth of the individual;

(C) A complete current address consisting of:

(1) In the case of a company applicant who forms or registers an entity in the course of such company applicant's business, the street address of such business; or

(2) In any other case, the individual's residential street address;

(D) A unique identifying number and the issuing jurisdiction from one of the following documents:

(1) A non-expired passport issued to the individual by the United States government;

(2) A non-expired identification document issued to the individual by a State, local government, or Indian tribe for the purpose of identifying the individual;

(3) A non-expired driver's license issued to the individual by a State; or

(4) A non-expired passport issued by a foreign government to the individual, if the individual does not possess any of the documents

described in paragraph (b)(1)(ii)(D)(1), (b)(1)(ii)(D)(2), or (b)(1)(ii)(D)(3) of this section; and

(E) An image of the document from which the unique identifying number in paragraph (b)(1)(ii)(D) of this section was obtained.

(2) *Special rules* –

(i) *Reporting company owned by exempt entity*. If one or more exempt entities under paragraph (c)(2) of this section has or will have a direct or indirect ownership interest in a reporting company and an individual is a beneficial owner of the reporting company exclusively by virtue of the individual's ownership interest in such exempt entities, the report may include the names of the exempt entities in lieu of the information required under paragraph (b)(1) of this section with respect to such beneficial owner.

(ii) *Minor child*. If a reporting company reports the information required under paragraph (b)(1) of this section with respect to a parent or legal guardian of a minor child consistent with paragraph (d)(3)(i) of this section, then the report shall indicate that such information relates to a parent or legal guardian.

(iii) *Foreign pooled investment vehicle*. If an entity would be a reporting company but for paragraph (c)(2)(xviii) of this section, and is formed under the laws of a foreign country, such entity shall be deemed a reporting company for purposes of paragraphs (a) and (b) of this section, except the report shall include the information required under paragraph (b)(1) of this section solely with respect to an individual who exercises substantial control over the entity. If more than one individual exercises substantial control over the entity, the entity shall report information with respect to the individual who has the greatest authority over the strategic management of the entity.

(iv) *Company applicant for existing companies*. Notwithstanding paragraph (b)(1)(ii) of this section, if a reporting company was created or registered before January 1, 2024, the reporting company shall report that fact, but is not required to report information with respect to any company applicant.

(3) *Contents of updated or corrected reports* –

(i) *Updated reports—in general*. An updated report required to be filed pursuant to paragraph (a)(2) of this section shall reflect any change with respect to required information previously submitted to FinCEN concerning a reporting company or its beneficial owners.

(ii) *Updated reports—newly exempt entities*. An updated report required to be filed pursuant to paragraph (a)(2)(ii) of this section shall indicate that the filing entity is no longer a reporting company.

(iii) *Corrected reports*. A corrected report required to be filed pursuant to paragraph (a)(3) of this section shall correct all inaccuracies in the information previously reported to FinCEN.

(4) *FinCEN identifier -*

(i) *Application*.

(A) An individual may obtain a FinCEN identifier by submitting to FinCEN an application containing the information about the individual described in paragraph (b)(1) of this section.

(B) A reporting company may obtain a FinCEN identifier by submitting to FinCEN an application at or after the time that the entity submits an initial report required under paragraph (b)(1) of this section.

(C) Each FinCEN identifier shall be specific to each such individual or reporting company, and each such individual or reporting company (including any successor reporting company) may obtain only one FinCEN identifier.

(ii) *Use of the FinCEN identifier*.

(A) If an individual has obtained a FinCEN identifier and provided such FinCEN identifier to a reporting company, the reporting company may include such FinCEN identifier in its report in lieu of the information required under paragraph (b)(1) of this section with respect to such individual.

(B) A reporting company may report another entity's FinCEN identifier and full legal name in lieu of the information required under paragraph (b)(1)(ii) of this section with respect to the beneficial owners of the reporting company only if:

(1) The other entity has obtained a FinCEN identifier and provided that FinCEN identifier to the reporting company;

(2) An individual is or may be a beneficial owner of the reporting company by virtue of an interest in the reporting company that the individual holds through an ownership interest in the other entity; and

(3) The beneficial owners of the other entity and of the reporting company are the same individuals.

(iii) *Updates and corrections*.

(A) Any individual that has obtained a FinCEN identifier shall update or correct any information previously submitted to FinCEN in an application for such FinCEN identifier.

(1) If there is any change with respect to required information previously submitted to FinCEN in such application, the individual shall file an updated application reflecting such change within 30 calendar days after the date on which such change occurs.

(2) If any such application was inaccurate when filed and remains inaccurate, the individual shall file a corrected application correcting all inaccuracies within 30 calendar days after the date on which the individual becomes aware or has reason to know of the inaccuracy. A corrected application filed under this paragraph within this 30-day period will be deemed to satisfy 31 U.S.C. 5336(h)(3)(C)(i)(I)(bb) if filed within 90 calendar days after the date on which the inaccurate application was submitted.

(B) Any reporting company that has obtained a FinCEN identifier shall file an updated or corrected report to update or correct any information previously submitted to FinCEN. Such updated or corrected report shall be filed at the same time and in the same manner as updated or corrected reports filed under paragraph (a) of this section.

(c) *Reporting company* –

(1) *Definition of reporting company*. For purposes of this section, the term ''reporting company'' means either a domestic reporting company or a foreign reporting company.

(i) The term ''domestic reporting company'' means any entity that is:

(A) A corporation;

(B) A limited liability company; or

(C) Created by the filing of a document with a secretary of state or any similar office under the law of a State or Indian tribe.

(ii) The term ''foreign reporting company'' means any entity that is:

(A) A corporation, limited liability company, or other entity;

(B) Formed under the law of a foreign country; and

(C) Registered to do business in any State or tribal jurisdiction by the filing of a document with a secretary of state or any similar office under the law of a State or Indian tribe.

(2) *Exemptions*. Notwithstanding paragraph (c)(1) of this section, the term ''reporting company'' does not include:

(i) *Securities reporting issuer*. Any issuer of securities that is:

(A) An issuer of a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l); or

(B) Required to file supplementary and periodic information under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)).

(ii) *Governmental authority*. Any entity that:

(A) Is established under the laws of the United States, an Indian tribe, a State, or a political subdivision of a State, or under an interstate compact between two or more States; and

(B) Exercises governmental authority on behalf of the United States or any such Indian tribe, State, or political subdivision.

(iii) *Bank*. Any bank, as defined in:

(A) Section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813);

(B) Section 2(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)); or

(C) Section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)).

(iv) *Credit union*. Any Federal credit union or State credit union, as those terms are defined in section 101 of the Federal Credit Union Act (12 U.S.C. 1752).

(v) *Depository institution holding company*. Any bank holding company as defined in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841), or any savings and loan holding company as defined in section 10(a) of the Home Owners' Loan Act (12 U.S.C. 1467a(a)).

(vi) *Money services business*. Any money transmitting business registered with FinCEN under 31 U.S.C. 5330, and any money services business registered with FinCEN under 31 CFR 1022.380.

(vii) *Broker or dealer in securities*. Any broker or dealer, as those terms are defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), that is registered under section 15 of that Act (15 U.S.C. 78o).

(viii) *Securities exchange or clearing agency*. Any exchange or clearing agency, as those terms are defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), that is registered under sections 6 or 17A of that Act (15 U.S.C. 78f, 78q-1).

(ix) *Other Exchange Act registered entity*. Any other entity not described in paragraph (c)(2)(i), (vii), or (viii) of this section that is registered with the

Securities and Exchange Commission under the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*).

(x) *Investment company or investment adviser*. Any entity that is:

(A) An investment company as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), or is an investment adviser as defined in section 202 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2); and

(B) Registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*) or the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 *et seq.*).

(xi) *Venture capital fund adviser*. Any investment adviser that:

(A) Is described in section 203(l) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(l)); and

(B) Has filed Item 10, Schedule A, and Schedule B of Part 1A of Form ADV, or any successor thereto, with the Securities and Exchange Commission.

(xii) *Insurance company*. Any insurance company as defined in section 2 of the Investment Company Act of 1940 (15 U.S.C. 80a-2).

(xiii) *State-licensed insurance producer*. Any entity that:

(A) Is an insurance producer that is authorized by a State and subject to supervision by the insurance commissioner or a similar official or agency of a State; and

(B) Has an operating presence at a physical office within the United States.

(xiv) *Commodity Exchange Act registered entity*. Any entity that:

(A) Is a registered entity as defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a); or

(B) Is:

(1) A futures commission merchant, introducing broker, swap dealer, major swap participant, commodity pool operator, or commodity trading advisor, each as defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a), or a retail foreign exchange dealer as described in section 2(c)(2)(B) of the Commodity Exchange Act (7 U.S.C. 2(c)(2)(B); and

(2) Registered with the Commodity Futures Trading Commission under the Commodity Exchange Act.

(xv) *Accounting firm*. Any public accounting firm registered in accordance with section 102 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7212).

(xvi) *Public utility*. Any entity that is a regulated public utility as defined in 26 U.S.C. 7701(a)(33)(A) that provides telecommunications services, electrical power, natural gas, or water and sewer services within the United States.

(xvii) *Financial market utility*. Any financial market utility designated by the Financial Stability Oversight Council under section 804 of the Payment, Clearing, and Settlement Supervision Act of 2010 (12 U.S.C. 5463).

(xviii) *Pooled investment vehicle*. Any pooled investment vehicle that is operated or advised by a person described in paragraph (c)(2)(iii), (iv), (vii), (x), or (xi) of this section.

(xix) *Tax-exempt entity*. Any entity that is:

(A) An organization that is described in section 501(c) of the Internal Revenue Code of 1986 (Code) (determined without regard to section 508(a) of the Code) and exempt from tax under section 501(a) of the Code, except that in the case of any such organization that ceases to be described in section 501(c) and exempt from tax under section 501(a), such organization shall be considered to continue to be described in this paragraph (c)(1)(xix)(A) for the 180-day period beginning on the date of the loss of such tax-exempt status;

(B) A political organization, as defined in section 527(e)(1) of the Code, that is exempt from tax under section 527(a) of the Code; or

(C) A trust described in paragraph (1) or (2) of section 4947(a) of the Code.

(xx) *Entity assisting a tax-exempt entity*. Any entity that:

(A) Operates exclusively to provide financial assistance to, or hold governance rights over, any entity described in paragraph (c)(2)(xix) of this section;

(B) Is a United States person;

(C) Is beneficially owned or controlled exclusively by one or more United States persons that are United States citizens or lawfully admitted for permanent residence; and

(D) Derives at least a majority of its funding or revenue from one or more United States persons that are United States citizens or lawfully admitted for permanent residence.

(xxi) *Large operating company*. Any entity that:

(A) Employs more than 20 full time employees in the United States, with ‘‘full time employee in the United States’’ having the meaning provided in 26 CFR 54.4980H-1(a) and 54.4980H-3, except that the term ‘‘United

States'' as used in 26 CFR 54.4980H-1(a) and 54.4980H–3 has the meaning provided in § 1010.100(hhh);

(B) Has an operating presence at a physical office within the United States; and

(C) Filed a Federal income tax or information return in the United States for the previous year demonstrating more than $5,000,000 in gross receipts or sales, as reported as gross receipts or sales (net of returns and allowances) on the entity's IRS Form 1120, consolidated IRS Form 1120, IRS Form 1120–S, IRS Form 1065, or other applicable IRS form, excluding gross receipts or sales from sources outside the United States, as determined under Federal income tax principles. For an entity that is part of an affiliated group of corporations within the meaning of 26 U.S.C. 1504 that filed a consolidated return, the applicable amount shall be the amount reported on the consolidated return for such group.

(xxii) *Subsidiary of certain exempt entities*. Any entity whose ownership interests are controlled or wholly owned, directly or indirectly, by one or more entities described in paragraphs (c)(2)(i), (ii), (iii), (iv), (v), (vii), (viii), (ix), (x), (xi), (xii), (xiii), (xiv), (xv), (xvi), (xvii), (xix), or (xxi) of this section.

(xxiii) *Inactive entity*. Any entity that:

(A) Was in existence on or before January 1, 2020;

(B) Is not engaged in active business;

(C) Is not owned by a foreign person, whether directly or indirectly, wholly or partially;

(D) Has not experienced any change in ownership in the preceding twelve month period;

(E) Has not sent or received any funds in an amount greater than $1,000, either directly or through any financial account in which the entity or any affiliate of the entity had an interest, in the preceding twelve month period; and

(F) Does not otherwise hold any kind or type of assets, whether in the United States or abroad, including any ownership interest in any corporation, limited liability company, or other similar entity.

(d) *Beneficial owner*. For purposes of this section, the term ''beneficial owner,'' with respect to a reporting company, means any individual who, directly or indirectly, either exercises substantial control over such reporting company or owns or controls at least 25 percent of the ownership interests of such reporting company.

(1) *Substantial control* -

(i) *Definition of substantial control*. An individual exercises substantial control over a reporting company if the individual:

(A) Serves as a senior officer of the reporting company;

(B) Has authority over the appointment or removal of any senior officer or a majority of the board of directors (or similar body);

(C) Directs, determines, or has substantial influence over important decisions made by the reporting company, including decisions regarding:

(1) The nature, scope, and attributes of the business of the reporting company, including the sale, lease, mortgage, or other transfer of any principal assets of the reporting company;

(2) The reorganization, dissolution, or merger of the reporting company;

(3) Major expenditures or investments, issuances of any equity, incurrence of any significant debt, or approval of the operating budget of the reporting company;

(4) The selection or termination of business lines or ventures, or geographic focus, of the reporting company;

(5) Compensation schemes and incentive programs for senior officers;

(6) The entry into or termination, or the fulfillment or non-fulfillment, of significant contracts;

(7) Amendments of any substantial governance documents of the reporting company, including the articles of incorporation or similar formation documents, bylaws, and significant policies or procedures; or

(D) Has any other form of substantial control over the reporting company.

(ii) *Direct or indirect exercise of substantial control*. An individual may directly or indirectly, including as a trustee of a trust or similar arrangement, exercise substantial control over a reporting company through:

(A) Board representation;

(B) Ownership or control of a majority of the voting power or voting rights of the reporting company;

(C) Rights associated with any financing arrangement or interest in a company;

(D) Control over one or more intermediary entities that separately or collectively exercise substantial control over a reporting company;

(E) Arrangements or financial or business relationships, whether formal or informal, with other individuals or entities acting as nominees; or

(F) Any other contract, arrangement, understanding, relationship, or otherwise.

(2) *Ownership Interests* -

(i) *Definition of ownership interest*. The term ‘‘ownership interest’’ means:

(A) Any equity, stock, or similar instrument; preorganization certificate or subscription; or transferable share of, or voting trust certificate or certificate of deposit for, an equity security, interest in a joint venture, or certificate of interest in a business trust; in each such case, without regard to whether any such instrument is transferable, is classified as stock or anything similar, or confers voting power or voting rights;

(B) Any capital or profit interest in an entity;

(C) Any instrument convertible, with or without consideration, into any share or instrument described in paragraph (d)(2)(i)(A), or (B) of this section, any future on any such instrument, or any warrant or right to purchase, sell, or subscribe to a share or interest described in paragraph (d)(2)(i)(A), or (B) of this section, regardless of whether characterized as debt;

(D) Any put, call, straddle, or other option or privilege of buying or selling any of the items described in paragraph (d)(2)(i)(A), (B), or (C) of this section without being bound to do so, except to the extent that such option or privilege is created and held by a third party or third parties without the knowledge or involvement of the reporting company; or

(E) Any other instrument, contract, arrangement, understanding, relationship, or mechanism used to establish ownership.

(ii) *Ownership or control of ownership interest*. An individual may directly or indirectly own or control an ownership interest of a reporting company through any contract, arrangement, understanding, relationship, or otherwise, including:

(A) Joint ownership with one or more other persons of an undivided interest in such ownership interest;

(B) Through another individual acting as a nominee, intermediary, custodian, or agent on behalf of such individual;

(C) With regard to a trust or similar arrangement that holds such ownership interest:

(1) As a trustee of the trust or other individual (if any) with the authority to dispose of trust assets;

(2) As a beneficiary who:

(i) Is the sole permissible recipient of income and principal from the trust; or

(ii) Has the right to demand a distribution of or withdraw substantially all of the assets from the trust; or

(3) As a grantor or settlor who has the right to revoke the trust or otherwise withdraw the assets of the trust; or

(D) Through ownership or control of one or more intermediary entities, or ownership or control of the ownership interests of any such entities, that separately or collectively own or control ownership interests of the reporting company.

(iii) *Calculation of the total ownership interests of a reporting company*. In determining whether an individual owns or controls at least 25 percent of the ownership interests of a reporting company, the total ownership interests that an individual owns or controls, directly or indirectly, shall be calculated as a percentage of the total outstanding ownership interests of the reporting company as follows:

(A) Ownership interests of the individual shall be calculated at the present time, and any options or similar interests of the individual shall be treated as exercised;

(B) For reporting companies that issue capital or profit interests (including entities treated as partnerships for federal income tax purposes), the individual's ownership interests are the individual's capital and profit interests in the entity, calculated as a percentage of the total outstanding capital and profit interests of the entity;

(C) For corporations, entities treated as corporations for federal income tax purposes, and other reporting companies that issue shares of stock, the applicable percentage shall be the greater of:

(1) the total combined voting power of all classes of ownership interests of the individual as a percentage of total outstanding voting power of all classes of ownership interests entitled to vote, or

(2) the total combined value of the ownership interests of the individual as a percentage of the total outstanding value of all classes of ownership interests; and

(D) If the facts and circumstances do not permit the calculations described in either paragraph (d)(2)(iii)(B) or (C) to be performed with reasonable certainty, any individual who owns or controls 25 percent or more of any class or type of ownership interest of a reporting company shall be deemed to own or control 25 percent or more of the ownership interests of the reporting company.

(3) *Exceptions*. Notwithstanding any other provision of this paragraph (d), the term ‘‘beneficial owner’’ does not include:

(i) A minor child, as defined under the law of the State or Indian tribe in which a domestic reporting company is created or a foreign reporting company is first registered, provided the reporting company reports the required information of a parent or legal guardian of the minor child as specified in paragraph (b)(2)(ii) of this section;

(ii) An individual acting as a nominee, intermediary, custodian, or agent on behalf of another individual;

(iii) An employee of a reporting company, acting solely as an employee, whose substantial control over or economic benefits from such entity are derived solely from the employment status of the employee, provided that such person is not a senior officer as defined in paragraph (f)(8) of this section;

(iv) An individual whose only interest in a reporting company is a future interest through a right of inheritance;

(v) A creditor of a reporting company. For purposes of this paragraph (d)(3)(v), a creditor is an individual who meets the requirements of paragraph (d) of this section solely through rights or interests for the payment of a predetermined sum of money, such as a debt incurred by the reporting company, or a loan covenant or other similar right associated with such right to receive payment that is intended to secure the right to receive payment or enhance the likelihood of repayment.

(e) *Company applicant*. For purposes of this section, the term ‘‘company applicant’’ means:

(1) For a domestic reporting company, the individual who directly files the document that creates the domestic reporting company as described in paragraph (c)(1)(i) of this section;

(2) For a foreign reporting company, the individual who directly files the document that first registers the foreign reporting company as described in paragraph (c)(1)(ii) of this section; and

(3) Whether for a domestic or a foreign reporting company, the individual who is primarily responsible for directing or controlling such filing if more than one individual is involved in the filing of the document.

(f) *Definitions*. For purposes of this section, the following terms have the following meanings.

(1) *Employee*. The term ‘‘employee’’ has the meaning given the term in 26 CFR 54.4980H-1(a)(15).

(2) *FinCEN identifier*. The term ''FinCEN identifier'' means the unique identifying number assigned by FinCEN to an individual or reporting company under this section.

(3) *Foreign person*. The term ''foreign person'' means a person who is not a United States person.

(4) *Indian tribe*. The term ''Indian tribe'' has the meaning given the term ''Indian tribe'' in section 102 of the Federally Recognized Indian Tribe List Act of 1994 (25 U.S.C. 5130).

(5) *Lawfully admitted for permanent residence*. The term ''lawfully admitted for permanent residence'' has the meaning given the term in section 101(a) of the Immigration and Nationality Act (8 U.S.C. 1101(a)).

(6) *Operating presence at a physical office within the United States*. The term ''has an operating presence at a physical office within the United States'' means that an entity regularly conducts its business at a physical location in the United States that the entity owns or leases and that is physically distinct from the place of business of any other unaffiliated entity.

(7) *Pooled investment vehicle*. The term ''pooled investment vehicle'' means:

(i) Any investment company, as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)); or

(ii) Any company that:

(A) Would be an investment company under that section but for the exclusion provided from that definition by paragraph (1) or (7) of section 3(c) of that Act (15 U.S.C. 80a-3(c)); and

(B) Is identified by its legal name by the applicable investment adviser in its Form ADV (or successor form) filed with the Securities and Exchange Commission or will be so identified in the next annual updating amendment to Form ADV required to be filed by the applicable investment adviser pursuant to rule 204-1 under the Investment Advisers Act of 1940 (17 CFR 275.204-1).

(8) *Senior officer*. The term ''senior officer'' means any individual holding the position or exercising the authority of a president, chief financial officer, general counsel, chief executive officer, chief operating officer, or any other officer, regardless of official title, who performs a similar function.

(9) *State*. The term ''State'' means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana Islands, American Samoa, Guam, the United States Virgin Islands, and any other commonwealth, territory, or possession of the United States.

(10) *United States person*. The term ''United States person'' has the meaning given the term in section 7701(a)(30) of the Internal Revenue Code of 1986.

(g) *Reporting violations*. It shall be unlawful for any person to willfully provide, or attempt to provide, false or fraudulent beneficial ownership information, including a false or fraudulent identifying photograph or document, to FinCEN in accordance with this section, or to willfully fail to report complete or updated beneficial ownership information to FinCEN in accordance with this section. For purposes of this paragraph (g):

(1) The term ''person'' includes any individual, reporting company, or other entity.

(2) The term ''beneficial ownership information'' includes any information provided to FinCEN under this section.

(3) A person provides or attempts to provide beneficial ownership information to FinCEN if such person does so directly or indirectly, including by providing such information to another person for purposes of a report or application under this section.

(4) A person fails to report complete or updated beneficial ownership information to FinCEN if, with respect to an entity:

(i) such entity is required, pursuant to title 31, United States Code, section 5336, or its implementing regulations, to report information to FinCEN;

(ii) the reporting company fails to report such information to FinCEN; and

(iii) such person either causes the failure, or is a senior officer of the entity at the time of the failure.

II.G.31. Debt Modification or Forgiveness

II.G.31.a. Debt Modifications

Reg. § 1.1001-3, "Modifications of debt instruments," provides rules for determining whether a modification of the terms of a debt instrument results in an exchange for purposes of Reg. § 1.1001-1(a).[1960] also relevant is part II.G.20.c Changing from LIBOR or Other Interbank Offered Rates.

For that purpose, a significant modification of a debt instrument results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent.[1961]

[1960] Reg. § 1.1001-3(a), which continues:

> This section applies to any modification of a debt instrument, regardless of the form of the modification. For example, this section applies to an exchange of a new instrument for an existing debt instrument, or to an amendment of an existing debt instrument. This section also applies to a modification of a debt instrument that the issuer and holder accomplish indirectly through one or more transactions with third parties. This section, however, does not apply to exchanges of debt instruments between holders.

[1961] Reg. § 1.1001-3(b), which continues:

Generally, a modification of a debt instrument is any alteration of the payor's or payee's legal rights or obligations,[1962] unless that change occurs by operation of the terms of a debt instrument[1963] and is not within the list of changes that constitute a modification.[1964] Letter Ruling 202337007 involved the following facts:

> LLC 1 is a State A limited liability company that, through its subsidiaries and joint-ventures, is engaged in Business A. LLC 1 is wholly owned by LLC 2, a State A limited liability company. LLC 2 is wholly owned by LLC 3, a State A limited liability company. LLC 3 is s percent owned by LLC 4, a State A limited liability company, with the remaining interest held by a third party ("LLC 3 Investor"). For federal income tax purposes, LLC 3 is treated as a partnership, and LLC 1 and LLC 2 are entities that are disregarded as separate from LLC 3.

> A modification that is not a significant modification is not an exchange for purposes of § 1.1001-1(a). Paragraphs (c) and (d) of this section define the term modification and contain examples illustrating the application of the rule. Paragraphs (e) and (f) of this section provide rules for determining when a modification is a significant modification. Paragraph (f) of this section also provides rules for determining whether the modified instrument received in an exchange will be classified as an instrument or property right that is not debt for federal income tax purposes. Paragraph (g) of this section contains examples illustrating the application of the rules in paragraphs (e) and (f) of this section.

[1962] Reg. § 1.1001-3(c)(1)(i), "Alteration of terms," provides:

> A modification means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.

[1963] Reg. § 1.1001-3(c)(1)(ii), "Alterations occurring by operation of the terms of a debt instrument," provides:

> Except as provided in paragraph (c)(2) of this section, an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification. An alteration that occurs by operation of the terms may occur automatically (for example, an annual resetting of the interest rate based on the value of an index or a specified increase in the interest rate if the value of the collateral declines from a specified level) or may occur as a result of the exercise of an option provided to an issuer or a holder to change a term of a debt instrument.

[1964] Reg. § 1.1001-3(c)(2), "Exceptions," provides:

> The alterations described in this paragraph (c)(2) are modifications, even if the alterations occur by operation of the terms of a debt instrument.
>
> (i) *Change in obligor or nature of instrument*. An alteration that results in the substitution of a new obligor, the addition or deletion of a co-obligor, or a change (in whole or in part) in the recourse nature of the instrument (from recourse to nonrecourse or from nonrecourse to recourse) is a modification.
>
> (ii) *Property that is not debt*. An alteration that results in an instrument or property right that is not debt for Federal income tax purposes is a modification unless the alteration occurs pursuant to a holder's option under the terms of the instrument to convert the instrument into equity of the issuer (notwithstanding paragraph (c)(2)(iii) of this section). The rules of paragraph (f)(7) of this section apply to determine whether an alteration or modification results in an instrument or property right that is not debt.
>
> (iii) *Certain alterations resulting from the exercise of an option*. An alteration that results from the exercise of an option provided to an issuer or a holder to change a term of a debt instrument is a modification unless—
>
> (A) The option is unilateral (as defined in paragraph (c)(3) of this section); and
>
> (B) In the case of an option exercisable by a holder, the exercise of the option does not result in (or, in the case of a variable or contingent payment, is not reasonably expected to result in) a deferral of, or a reduction in, any scheduled payment of interest or principal.

All of the common limited liability interests of LLC 4 are owned by Subsidiary 1, a State A limited liability company that has elected, effective as of Date 1, to be taxed as a corporation. LLC 4 also has preferred limited liability company interests outstanding, all of which are owned by a third party ("LLC 4 Investor"). For federal income tax purposes, LLC 4 is treated as a partnership.

Subsidiary 1 is owned by Parent, a State B corporation that is the common parent of an affiliated group of corporations filing a consolidated federal income tax return. As of Date 1, Subsidiary 1 is a member of Parent's consolidated group.

As of Date 2, LLC 1 had outstanding, publicly-traded debt consisting of senior secured notes, three term loans (hereinafter, "Term Loan A," "Term Loan B," and "Term Loan C"), and unsecured notes (collectively referred to as the "Debt"). The Debt is held by third-parties that are not related (as determined under section 108(e)(4) of the Code) to LLC 1, LLC 2, LLC 3, LLC 4, Subsidiary 1, Parent, or any other member of Parent's consolidated group.

The senior secured notes have an aggregate principal amount of approximately $t, pay interest semi-annually at a rate of y percent, and mature on Date 3. Term Loan A has an aggregate principal amount of approximately $u, pays a variable rate of interest quarterly, and matures on Date 4. Term Loan B has an aggregate principal amount of approximately $v, pays a variable rate of interest quarterly, and matures on Date 5. Term Loan C has an aggregate principal amount of approximately $w, pays a variable rate of interest quarterly, and matures on Date 5. The unsecured notes have an aggregate principal amount of approximately $x, pay interest semi-annually at a rate of z percent, and mature on Date 6.

The Debt is recourse to LLC 1. The senior secured notes, Term Loan A, Term Loan B, and Term Loan C are (i) guaranteed by LLC 2 and by the domestic subsidiaries of LLC 1 and (ii) secured by substantially all of the assets of LLC 1 and the guarantors. None of Parent, Subsidiary 1, LLC 4, or LLC 3 is an obligor or guarantor with respect to, or has pledged any assets to support, any of the Debt.

Proposed Transaction

Parent and the entities described above intend to effect the following transaction steps (each step (1)-(3) below a "Step", and the Steps 1-3, collectively, the "Proposed Transaction").

1. LLC 3 will redeem the limited liability company interest of LLC 3 Investor for cash, as a result of which LLC 3 will become wholly-owned by LLC 4.

2. LLC 4 will redeem the preferred limited liability company interest of LLC 4 Investor for cash, as a result of which LLC 4 will become wholly-owned by Subsidiary 1.

3. LLC 1 will convert to a corporation ("Subsidiary 2") under the Act.

As a result of Step 1, for federal income tax purposes, LLC 3, LLC 2, and LLC 1 will become entities disregarded as separate from LLC 4. As a result of Step 2, for federal income tax purposes, LLC 4, LLC 3, LLC 2, and LLC 1 will become entities disregarded

> as separate from Subsidiary 1. As a result of Step 3, for federal income tax purposes, Subsidiary 2 will become a member of the Parent consolidated group.
>
> Immediately after the closing date of the Proposed Transaction, the assets and liabilities of Subsidiary 2 will be the same as the assets and liabilities of LLC 1 immediately prior to the Proposed Transaction.
>
> The Proposed Transaction, whether by operation of the terms of the Debt or otherwise, will not (i) change the yield on the Debt (as computed under section 1.1001-3(e)(2)(iii) of the Income Tax Regulations); (ii) change the specific timing of payments on the Debt; (iii) for State A law purposes, result in the addition or subtraction of co-obligors or guarantors to the Debt; (iv) change the priority of any of the Debt relative to other Debt; (v) change the collateral or security of the Debt; or (vi) otherwise alter the legal rights or obligations with respect to the Debt.
>
> Pursuant to the Act, Subsidiary 2 will remain the same legal entity as LLC 1. None of the Debt holders' rights against LLC 1, including with respect to payments and remedies, and none of LLC 1's obligations and covenants to the Debt holders will be altered in any manner by the Proposed Transaction. Following the Proposed Transaction, the Debt holders will continue to have exactly the same legal relationship with Subsidiary 2 that they previously had with LLC 1. Additionally, under State A law, the Proposed Transaction will not result in the creation of any new legal rights or obligations between the Debt holders and Subsidiary 2. There are no provisions in the original terms of the Debt that require the consent or approval of any holder of the Debt in order for LLC 4, LLC 3, and LLC 1 to effectuate the Proposed Transaction.

Letter Ruling 202337007 reviewed Code § 1001 and Reg. §§ 1.1001-1(a), 1.1001-3(b), 1.1001-3(c) and 1.1001-3(e) and ruled that the Proposed Transaction will not result in a modification of the Debt under section 1.1001-3, reasoning:

> Section 18-265(e) of the Act provides that for State A law purposes, the conversion of any entity into a domestic corporation shall not be deemed to affect any obligations or liabilities of the other entity incurred prior to its conversion to a domestic corporation or the personal liability of any person incurred prior to such conversion. Moreover, section 18-265(f) of the Act provides, inter alia, that for purposes of State A law, the domestic corporation shall be deemed to be the same entity as the converted other entity, all rights of creditors and liens upon any property of the other entity that has converted shall be preserved unimpaired, and all debts, liabilities and duties of the other entity that has converted shall remain attached to the domestic corporation and may be enforced against it to the same extent as if said debts, liabilities and duties had been incurred or contracted by it.
>
> Generally, Federal tax law looks to State law to determine the legal entitlements to property. *Aquilino v. United States*, 363 U.S. 509, 513 (1930); *Morgan v. Commissioner*, 309 U.S. 78, 82 (1940). The legal rights or obligations referred to in section 1.1001-3(c) are rights and obligations that are determined under State law. Pursuant to the Act, the conversion of LLC 1 into Subsidiary 2 will not affect the legal rights or obligations between Debt holders and LLC 1 because, as a matter of State A law, Subsidiary 2 will remain the same legal entity as LLC 1. Debt holders will continue to have exactly the same legal relationship with Subsidiary 2 that they previously had with LLC 1.

> Pursuant to the Act, Debt holders' legal rights against Subsidiary 2 with respect to payments and remedies will be the same legal rights that Debt holders had against LLC 1. The obligations and covenants from Subsidiary 2 to Debt holders will be the same as the obligations and covenants from LLC 1 to Debt holders. In these circumstances, the Proposed Transaction will not effect an alteration that results in either a change of obligor or a change in the recourse nature of the Debt for purposes of section 1.1001-3(c)(2)(i).

Generally, a modification is significant only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant.[1965]

Rules for when a change of yield are provided.[1966]

[1965] Reg. § 1.1001-3(e), "Significant modifications," provides:

> Whether the modification of a debt instrument is a significant modification is determined under the rules of this paragraph (e). Paragraph (e)(1) of this section provides a general rule for determining the significance of modifications not otherwise addressed in this paragraph (e). Paragraphs (e)(2) through (6) of this section provide specific rules for determining the significance of certain types of modifications. Paragraph (f) of this section provides rules of application, including rules for modifications that are effective on a deferred basis or upon the occurrence of a contingency.

Reg. § 1.1001-3(e)(1), "General rule," provides:

> Except as otherwise provided in paragraphs (e)(2) through (e)(6) of this section, a modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant. In making a determination under this paragraph (e)(1), all modifications to the debt instrument (other than modifications subject to paragraphs (e)(2) through (6) of this section) are considered collectively, so that a series of such modifications may be significant when considered together although each modification, if considered alone, would not be significant.

[1966] Reg. § 1.1001-3(e)(2), "Change in yield," provides:

> (i) *Scope of rule*. This paragraph (e)(2) applies to debt instruments that provide for only fixed payments, debt instruments with alternative payment schedules subject to § 1.1272-1(c), debt instruments that provide for a fixed yield subject to § 1.1272-1(d) (such as certain demand loans), and variable rate debt instruments. Whether a change in the yield of other debt instruments (for example, a contingent payment debt instrument) is a significant modification is determined under paragraph (e)(1) of this section.
>
> (ii) *In general*. A change in the yield of a debt instrument is a significant modification if the yield computed under paragraph (e)(2)(iii) of this section varies from the annual yield on the unmodified instrument (determined as of the date of the modification) by more than the greater of—
>
> (A) ¼ of one percent (25 basis points); or
>
> (B) 5 percent of the annual yield of the unmodified instrument (.05 × annual yield).
>
> (iii) *Yield of the modified instrument*.
>
> (A) *In general*. The yield computed under this paragraph (e)(2)(iii) is the annual yield of a debt instrument with—
>
> (1) an issue price equal to the adjusted issue price of the unmodified instrument on the date of the modification (increased by any accrued but unpaid interest and decreased by any accrued bond issuance premium not yet taken into account, and increased or decreased, respectively, to reflect payments made to the issuer or to the holder as consideration for the modification); and

A material deferral of scheduled payments[1967] is a significant modification unless it falls within a safe harbor.[1968]

Other rules relate to a change in obligor (which might be relevant in the context of a trust division) or security,[1969] changes in the nature of a debt instrument,[1970] and accounting or financial covenants.[1971]

II.G.31.b. Debt Forgiveness

Code § 61(a)(11) includes in income "income from discharge of indebtedness."

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(2) payments equal to the payments on the modified debt instrument from the date of the modification.

(B) *Prepayment penalty*. For purposes of this paragraph (e)(2)(iii), a commercially reasonable prepayment penalty for a pro rata prepayment (as defined in § 1.1275-2(f)) is not consideration for a modification of a debt instrument and is not taken into account in determining the yield of the modified instrument.

(iv) *Variable rate debt instruments*. For purposes of this paragraph (e)(2), the annual yield of a variable rate debt instrument is the annual yield of the equivalent fixed rate debt instrument (as defined in § 1.1275-5(e)) which is constructed based on the terms of the instrument (either modified or unmodified, whichever is applicable) as of the date of the modification.

[1967] Reg. § 1.1001-3(e)(3), "Changes in timing of payments," begins with (i), "In general," which provides:

A modification that changes the timing of payments (including any resulting change in the amount of payments) due under a debt instrument is a significant modification if it results in the material deferral of scheduled payments. The deferral may occur either through an extension of the final maturity date of an instrument or through a deferral of payments due prior to maturity. The materiality of the deferral depends on all the facts and circumstances, including the length of the deferral, the original term of the instrument, the amounts of the payments that are deferred, and the time period between the modification and the actual deferral of payments.

[1968] Reg. § 1.1001-3(e)(3)(ii), "Safe-harbor period," which provides:

The deferral of one or more scheduled payments within the safe-harbor period is not a material deferral if the deferred payments are unconditionally payable no later than at the end of the safe-harbor period. The safe-harbor period begins on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five years or 50 percent of the original term of the instrument. For purposes of this paragraph (e)(3)(ii), the term of an instrument is determined without regard to any option to extend the original maturity and deferrals of de minimis payments are ignored. If the period during which payments are deferred is less than the full safe-harbor period, the unused portion of the period remains a safe-harbor period for any subsequent deferral of payments on the instrument.

[1969] Reg. § 1.1001-3(e)(4). Generally, Reg. § 1.1001-3(e)(4)(vi)(A)(1) provides that "a change in payment expectations occurs if, as a result of a transaction":

(1) There is a substantial enhancement of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was primarily speculative prior to the modification and is adequate after the modification; or

(2) There is a substantial impairment of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was adequate prior to the modification and is primarily speculative after the modification.

Query whether a similar analysis might apply as to whether a trust division leaves each trust with the ability to make the distributions that were expected before the distribution.

[1970] Reg. § 1.1001-3(e)(5).

[1971] Reg. § 1.1001-3(e)(6).

Reg. § 1.61-12(a), "In general," provides:

> The discharge of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, the debtor realizes income in the amount of the debt as compensation for his services. A taxpayer may realize income by the payment or purchase of his obligations at less than their face value. In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.

Jacobowitz v. Commissioner, T.C. Memo. 2023-107, described timing the discharge:

> The question as to the year in which a debtor's obligation is canceled (thus giving rise to COD income) is one of fact to be determined on the basis of the evidence. *Miller Tr. v. Commissioner*, 76 T.C. 191, 195 (1981). A debt is deemed discharged (and COD income is generated) the moment it becomes clear that the debt will never have to be paid. *Cozzi v. Commissioner*, 88 T.C. 435, 445 (1987). Determining when that moment occurs requires a practical assessment of the facts and circumstances relating to the likelihood of payment. **Id**. (and cases cited thereat). "Any `identifiable event' which fixes the loss with certainty may be taken into consideration." *Id*. (citing *United States v. S.S. White Dental Mfg. Co.*, 274 U.S. 398 (1927)).
>
> Treasury Regulation § 1.6050P-1(b)(2) provides an exclusive list of seven "identifiable events" which constitute a discharge of debt for canceled debt information reporting purposes under section 6050P. The occurrence of one or more of these events triggers a creditor's obligation to send a Form 1099–C to the IRS and the debtor reporting the COD income. Treas. Reg. § 1.6050P-1(a). As relevant here, the third of the seven "identifiable events" giving rise to COD income (and thus the reporting requirement), provided in Treasury Regulation § 1.6050P-1(b)(2)(i)(C), is "[a] cancellation or extinguishment of an indebtedness upon the expiration of the statute of limitations for collection of an indebtedness, subject to the limitations described in paragraph (b)(2)(ii) of this section, or *upon the expiration of a statutory period for filing a claim or commencing a deficiency judgment proceeding*." (Emphasis added.)

Note that the statute includes in income "income from discharge of indebtedness" – not stating that the discharge of indebtedness necessarily generates income, but rather including it in income when it does generate income. The regulation says that discharge of indebtedness *may* generate income.

Code § 108 provides various exclusions from this rule, which also exclusions often translate into reductions in the basis of the debtor's assets. Before describing Code § 108 exclusions, let's dive into the consequences of debt being reduced or discharged. *Parker v. Commissioner*, T.C. Memo. 2023-104, reasoned and held in its discussion of "Tax Treatment of Debt Cancellation":

> Section 61(a) broadly defines gross income as "all income from whatever source derived." Section 61(a)(3) specifies that gross income includes "[g]ains derived from dealings in property," while section 61(a)(12) does the same for "[i]ncome from discharge of indebtedness."[5] See *Gehl v. Commissioner*, 102 T.C. 784, 789 (1994) ("[P]aragraphs (3) and (12) of section 61(a) are separate, independent, and not overlapping provisions in respect of the includability of a particular item in income."),

aff'd, 50 F.3d 12 (8th Cir. 1995). The distinction between these two subcategories of gross income - gain from property and COD income - can have significant tax consequences.

[5] After 2012, the year at issue, section 61(a)(12) was renumbered as section 61(a)(11).

When a taxpayer sells or disposes of property, the amount realized is equal to the amount of money plus the fair market value of any property received. § 1001(b). When a taxpayer sells or otherwise disposes of property encumbered by nonrecourse debt,[6] the amount of the outstanding debt is typically included in the amount realized.[7] See *Commissioner v. Tufts*, 461 U.S. 300, 317 (1983); *Crane v. Commissioner*, 331 U.S. 1, 14 (1947); *Milkovich v. United States*, 28 F.4th 1, 8 (9th Cir. 2022); Treas. Reg. § 1.1001-2(a)(1). To the extent that the amount realized exceeds the taxpayer's basis in the property, the taxpayer has gain. See § 1001(a).

[6] "Indebtedness is generally characterized as `nonrecourse' if the creditor's remedies are limited to particular collateral for the debt and as `recourse' if the creditor's remedies extend to all the debtor's assets." *Simonsen v. Commissioner*, 150 T.C. 201, 205 (2018) (quoting *Great Plains Gasification Assocs. v. Commissioner*, T.C. Memo. 2006-276, 92 T.C.M. (CCH) 534, 550).

[7] If the sold or disposed-of property instead secures recourse debt, the amount realized does not include amounts that would otherwise be COD income (i.e., debt relief in excess of the fair market value of the underlying property). *See Frazier v. Commissioner*, 111 T.C. 243, 245 (1998); Treas. Reg. § 1.1001-2(a)(2).

In contrast, a COD that is not part of a sale or exchange of property generally results in COD income, which may then be subject to certain statutory exclusions. See § 108(a)(1); see also *Estate of Delman v. Commissioner*, 73 T.C. 15, 31–32 (1979). Relevantly, section 108(a)(1)(B) allows a taxpayer who is insolvent at the time of a debt cancellation to exclude COD income from gross income. The amount of this exclusion is limited to the amount of the taxpayer's insolvency, *i.e.*, the amount by which the taxpayer's liabilities exceed the fair market value of their assets. § 108(a)(3); see *White v. Commissioner*, T.C. Memo. 2023-77, at *3.

In deciding whether debt relief results in gain or COD income, we focus on the facts and circumstances surrounding how the taxpayer debtor satisfied or extinguished the underlying debt. See *Danenberg v. Commissioner*, 73 T.C. 370, 381 (1979); *Peninsula Props. Co. v. Commissioner*, 47 B.T.A. 84, 91–92 (1942). If nonrecourse debt relief is conditioned upon a sale or exchange of property or is otherwise a part of that underlying sale or exchange, the amount of debt relief is properly included in the amount realized and is not COD income. *See Simonsen*, 150 T.C. at 211 (focusing on fact that lender's willingness to cancel mortgage debt was completely dependent on debtor's willingness to convey proceeds from sale of residence); *Sands v. Commissioner*, T.C. Memo. 1997-146, 73 T.C.M. (CCH) 2398, 2403 (rejecting taxpayer's contention that COD was "separate and distinct" from transfer of ownership in property), *aff'd without published opinion sub nom. Murphy v. Commissioner*, 164 F.3d 618 (2d Cir. 1998); Treas. Reg. § 1.1001-2(a)(1) ("[T]he amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged *as a result* of the sale or disposition." (Emphasis added.)); *see also 2925 Briarpark, Ltd. v.*

Commissioner, 163 F.3d 313, 319 (5th Cir. 1999) (concluding that debt relief "was closely intertwined" with underlying sale of property and thus included in amount realized on sale), *aff'g* T.C. Memo. 1997-298. In such an instance, it is immaterial whether debt relief takes the form of an assumption of debt by a purchaser or a cancellation by a lender. See *2925 Briarpark, Ltd. v. Commissioner*, 163 F.3d at 319; *Simonsen*, 150 T.C. at 212-13.

Respondent contends that the $2,741,399 relating to the cancellation of Loans N712A and N712B is taxable to Exterra as gain derived from the sale of the Livermore property. See § 61(a)(3). Respondent emphasizes that Loans N712A and N712B were nonrecourse to Exterra and were canceled as part of the sale of the Livermore property.

Petitioners take a rather different approach. In their briefing petitioners sidestep the threshold inquiry - whether the debt cancellation was part of the sale of the Livermore property and thus gave rise to gain - and focus on their contentions that either Exterra or petitioners themselves were insolvent at the time the debt was discharged. *Cf. Gehl*, 102 T.C. at 789 ("Only after it is determined that [section 61(a)(12)] applies does one reach the question of the impact of insolvency and therefore the applicability of section 108."); *Danenberg*, 73 T.C. at 384 (rejecting taxpayers' argument that their insolvency precluded inclusion of debt relief in amount realized). As best we can tell, much of petitioners' briefing is premised on a misconception that facts relating to Mr. Parker in his personal capacity are relevant to the question of whether there was income to Exterra in 2012 (and only then, flowthrough income to Mr. Parker as its 100% S corporation shareholder). In determining whether to sustain respondent's upward adjustment to Exterra's gross receipts (and thus the corresponding deficiency with respect to petitioners), we respect Exterra's separate corporate existence. See *Durando v. United States*, 70 F.3d 548, 552 (9th Cir. 1995) ("[I]t [is] improper to treat income earned by [an S] corporation through its trade or business as though it were earned directly by its shareholders...."); *Crook v. Commissioner*, 80 T.C. 27, 33 (1983) ("The separate existence of corporations is firmly established under the tax law, and this Court has recognized that the business of a subchapter S corporation is separate and distinct from that of its shareholders." (internal citation omitted)), *aff'd*, 747 F.2d 1463 (5th Cir. 1984). Accordingly, petitioners' observation, for instance, that Loans N712A and N712B were recourse as to Mr. Parker personally, is simply irrelevant to the issue before us.

We agree with respondent that the issue in this case is the threshold question of whether the cancellation of Loans N712A and N712B gave rise to gain or COD income for Exterra. We ultimately resolve that question in respondent's favor.

The parties have stipulated that Loans N712A and N712B were nonrecourse as to the PLF entities and Exterra. While the original loan agreements for Loans N712A and N712B are not part of the stipulated record, the parties further stipulated that Loans N712 and N712B A were each mezzanine loans. The record establishes that Loan N712A and N712B were each secured by the PLF entities' pledge of their respective membership interests in the Montevina entities. Because the PLF entities and the Montevina entities were disregarded entities for federal income tax purposes, we treat Exterra as owning the underlying assets (i.e., the Livermore property), subject to the nonrecourse mezzanine Loans N712A and N712B, before the sale.[8] See Treas. Reg. § 301.7701-2(a) ("[I]f the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner."); see also *Pierre v.*

> *Commissioner*, 133 T.C. 24, 42 (2009) (Halpern, J., dissenting) ("A sole proprietorship is generally understood to have no legal identity apart from the proprietor."), supplemented by T.C. Memo. 2010-106. In turn the sale of the PLF entities' membership interests in the Montevina entities is characterized for federal income tax purposes as a sale of the encumbered Livermore property by Exterra. See *DAF Charters, LLC v. Commissioner*, 152 T.C. 250, 260 (2019) ("[A]ny items of income and loss generated by the [disregarded] entity are directly attributable to and reported by the entity's owner for Federal tax purposes...."); see also Carter G. Bishop & Daniel S. Kleinberger, *Limited Liability Companies* § 2:83 Westlaw (database updated June 2023) ("The transfer of the interest in a disregarded entity is not treated as a transfer of the interest for federal tax purposes, but rather as a transfer of the assets of the disregarded entity.").
>
> [8] For federal income tax purposes, we characterize the mezzanine Loans N712A and N712B, which were secured by pledges of equity in the disregarded Montevina entities, as nonrecourse debt encumbering the underlying Livermore property in the hands of Exterra, the regarded entity; we note that the Commissioner has previously adopted a similar view in subregulatory guidance in a related context. *See* Rev. Proc. 2014-20, 2014-9 I.R.B. 614; I.R.S. Priv. Ltr. Rul. 09-53-005 (Dec. 31, 2009).
>
> The record is further clear that the cancellation of Loans N712A and N712B was part of the sale by Exterra (through the disregarded entities) of the Livermore property to the Buyers. As the relevant loan termination agreements between the PLF entities and NRFC WA Holdings II represented, the loan cancellation was made "[i]n connection with the proposed sale." Further, the loan termination agreements were executed on October 4, 2012 - the same date that the various other agreements effecting the sale of the Livermore property, including the consent and release agreement to which NRFC WA Holdings II was a party, were executed. The COD was part and parcel of the global agreement to convey the Livermore property, with NRFC WA Holdings II accepting new personal guaranties, a partial payment by the Buyers, and the escrowed deed to the Iowa property in consideration of that cancellation.
>
> We conclude that NRFC WA Holdings II's cancellation of Loans N712A and N712B was dependent on Exterra's sale of the Livermore property to the Buyers and was a part of the same sale transaction. *See Simonsen*, 150 T.C. at 211. Accordingly, given that Loans N712A and N712B were nonrecourse as to Exterra, the amount of debt relief was properly includible in Exterra's amount realized on the sale of the Livermore property and gave rise to gain to the extent in excess of Exterra's basis in the property. See Treas. Reg. § 1.1001-2(a)(1). In turn, that gain flowed through to petitioners' personal income tax returns via Mr. Parker's 100% shareholder interest in Exterra.

Jacobowitz v. Commissioner, T.C. Memo. 2023-107, described the discharge's character:

> Petitioner further contends that any COD income that may be attributable to him should be characterized as capital gain. In support of his contention, he relies on *L&C Springs Assocs. v. Commissioner*, 188 F.3d 866 (7th Cir. 1999), *aff'g* T.C. Memo. 1997-469, and *2925 Briarpark, Ltd. v. Commissioner*, 163 F.3d 313 (5th Cir. 1999), *aff'g* T.C. Memo. 1997-298.[8] Petitioner's contention is without merit.
>
> [8] In a footnote in his opening brief petitioner also attempts to draw support from I.R.S. Priv. Ltr. Rul. 202050014 (Dec. 12, 2020) (which he refers to as "PLR-117300-20"). A "written determination" of the IRS may not be used or cited as precedent, § 6110(k)(3),

> and written determinations are defined to include IRS private letter rulings, § 6110(b)(1)(A); see also *Plano Holding LLC v. Commissioner*, T.C. Memo. 2019-140, at *17 n.6 ("Private letter rulings have no precedential value and merely represent the Commissioner's position as to a particular set of facts.") (and cases cited thereat). In any event, I.R.S. Priv. Ltr. Rul. 202050014 is not helpful to petitioner. Like *L&C Springs Assocs.* and *2925 Briarpark, Ltd.*, as discussed above, I.R.S. Priv. Ltr. Rul. 202050014 addresses a situation factually distinct from the instant case.

> In L*&C Springs Assocs.*, the U.S. Court of Appeals for the Seventh Circuit did not opine on the nature of the income, which is the focus of the dispute here; rather, at issue in *L&C Springs Assocs.* was at what time the taxpayer abandoned certain property, thereby triggering gain from cancellation of indebtedness for purposes of section 1001. *L&C Springs Assocs.*, 188 F.3d at 868. In *2925 Briarpark, Ltd.*, the issue was whether the taxpayer-partner and the limited partnership realized gain from dealings in property under section 61(a)(3), rather than cancellation of indebtedness income under section 61(a)(12); the U.S. Court of Appeals for the Fifth Circuit did not opine on whether the gain was capital. Sagasolutions and Newtown never agreed that Sagasolutions would surrender or abandon the property that secured the line of credit in exchange for Newtown's canceling the debt, and petitioner has taken no steps to show that the resulting COD income was from the exchange of a capital asset as defined in section 1221. The COD income is ordinary income under section 61(a)(12).

Before discussing exclusions, let's briefly review partnerships. Part II.C.3.a Basic Consequences of Changes in Liability Allocations explains that partnership borrowing allocated to a partner generate tax basis as if they were cash contributions to the partnership, and reductions in liabilities allocated to a partner are treated as cash distributions to the partner. Borrowing and distributing the loan proceeds to a partner are not "found" money – when the liability allocated to the partner decreases, the partner may be taxed if the partner has insufficient basis (because the cash distributions already used the partner's basis). Part II.C.7 Maintaining Capital Accounts includes a discussion of how the IRS is tracking when such an event occurs; the income tax consequences of this deemed distribution are described in part II.Q.8.b.i Distribution of Property by a Partnership, especially parts II.Q.8.b.i.(a) Code § 731: General Rule for Distributions and II.Q.8.b.i.(c) Disguised Sale from Partnership to Partner. This reduction in allocating liabilities can arise from debt repayments, from changes in the partners' economic arrangements, or if the partner no longer owns any partnership interest. If a partnership interest is transferred, often the transferring partner should retain a partnership interest sufficient to continue to have the same liabilities allocated to himself/herself. See part II.C.3 Allocating Liabilities (Including Debt), especially part II.C.3.c Allocations of Recourse and Nonrecourse Liabilities. Then, when the partner dies and the retained partnership interest and its related liabilities are included in the partner's gross estate, a basis step-up can eliminate this issue; see part II.H.2.g Partnership Basis Adjustments. If the partner might not be able to retain this debt allocation for the rest of his/her life and most of the partnership interest was transferred to an irrevocable grantor trust, consider part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner.

Reg. § 1.108-8, "Indebtedness satisfied by partnership interest," discusses cancellation of debt ("COD"):

(a) *In general*. For purposes of determining income of a debtor from discharge of indebtedness (COD income), if a debtor partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of its recourse or nonrecourse indebtedness (a debt-for-equity exchange), the partnership is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the partnership interest.

(b) *Determination of fair market value*.

(1) *In general*. All the facts and circumstances are considered in determining the fair market value of a partnership interest transferred by a debtor partnership to a creditor in satisfaction of the debtor partnership's indebtedness (debt-for-equity interest) for purposes of paragraph (a) of this section. If the fair market value of the debt-for-equity interest does not equal the fair market value of the indebtedness exchanged, then general tax law principles shall apply to account for the difference.

(2) *Safe harbor*.

(i) *General rule*. For purposes of paragraph (a) of this section, the fair market value of a debt-for-equity interest is deemed to be equal to the liquidation value of the debt-for-equity interest, as defined in paragraph (b)(2)(iii) of this section, if the following requirements are satisfied -

(A) The creditor, debtor partnership, and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of the debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange;

(B) If, as part of the same overall transaction, the debtor partnership transfers more than one debt-for-equity interest to one or more creditors, then each creditor, debtor partnership, and its partners treat the fair market value of each debt-for-equity interest transferred by the debtor partnership to such creditors as equal to its liquidation value;

(C) The debt-for-equity exchange is a transaction that has terms that are comparable to terms that would be agreed to by unrelated parties negotiating with adverse interests; and

(D) Subsequent to the debt-for-equity exchange, the debtor partnership does not redeem the debt-for-equity interest, and no person bearing a relationship to the debtor partnership or its partners that is specified in section 267(b) or section 707(b) purchases the debt-for-equity interest, as part of a plan at the time of the debt-for-equity exchange that has as a principal purpose the avoidance of COD income by the debtor partnership.

(ii) *Tiered-partnership rule*. For purposes of this paragraph (b)(2), the liquidation value of a debt-for-equity interest in a partnership (upper-tier partnership) that directly or indirectly owns an interest in one or more partnerships (lower-tier partnership(s)) is determined by taking into account the liquidation value of such lower-tier partnership interests.

(iii) *Definition of liquidation value*. For purposes of this paragraph (b)(2), the liquidation value of a debt-for-equity interest equals the amount of cash that the creditor would receive with respect to the debt-for-equity interest if, immediately after the debt-for-equity exchange, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles) for cash equal to the fair market value of those assets and then liquidated.

(c) *Example*. The following example illustrates the provisions of this section:

Example.

(i) AB partnership has $1,000 of outstanding indebtedness owed to C. C agrees to transfer to AB partnership the $1,000 indebtedness in a debt-for-equity exchange for a debt-for-equity interest in AB partnership. The liquidation value of C's debt-for-equity interest is $700, which is the amount of cash that C would receive with respect to that interest if, immediately after the debt-for-equity exchange, AB partnership sold all of its assets for cash equal to the fair market value of those assets and then liquidated. Each of the requirements of the liquidation value safe harbor described in paragraph (b)(2) of this section is satisfied.

(ii) Because the requirements in paragraph (b)(2) of this section are satisfied, the fair market value of C's debt-for-equity interest in AB partnership for purposes of determining AB partnership's COD income is the liquidation value of C's debt-for-equity interest, or $700. Accordingly, AB partnership is treated as satisfying the $1,000 indebtedness for $700 under section 108(e)(8).

(d) *Effective/applicability date*. This section applies to debt-for-equity exchanges occurring on or after November 17, 2011.

August, "The Debt Cancellation Culture of Section 108: Tax Hurdles for Partnerships Engaged in Debt Workouts," *Corporate Taxation* (WG&L), Sep/Oct 2023 (also discussed in part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions), explains some of the Code § 108 exclusions:

> There are special provisions contained in the rule of exclusion, Section 108, which identify instances where COD income is produced as a result of a debt reduction or restructuring. Under Section 108(e)(10), where a debtor issues new debt in exchange to retire or replace old debt, COD income results to the extent that the adjusted issue price of the old instrument exceeds the issue proceeds of the new debt obligation. Where a corporation issues stock or a partnership issues a capital or profits interest in retirement of recourse or nonrecourse debt, Section 108(e)(8) provides that the borrower is treated as having satisfied the debt by a cash payment equal to the fair market value of the stock or partnership interest or stock. The entity realizes debt discharge income equal to any excess of the indebtedness satisfied over the amount of this deemed cash payment. Where other property is transferred by the debtor in repayment or in the cancellation of the debt, the transfer is a taxable sale or disposition and the amount realized will include the amount of the unpaid balance of the obligation. COD income will result where the property transferred has a FMV less than the face amount of the debt.[11] Debt-discharge

income also results where a debt is purchased by a person related to the debtor provided the previous holder of the obligation is not related as set forth in Section 108(e)(4).[12] This list of "important" portals into Section 108 should not omit reference to Section 108(e)(2), which excludes from COD income discharge of indebtedness to the extent payment of the liability would give rise to a deduction provided the debtor had not previously claimed a deduction for the cancelled obligation.[13] While this "lost deduction" exception in Section 108(e)(2) may be heavily relied upon in practice, especially with respect to cancelled interest which has not been previously expensed, its limitations have not been adequately identified.

[11] Rev. Rul. 90-16, 1990-1 CB 12 (transfer to mortgagee by insolvent taxpayer where recourse debt results in sale or exchange gain to the extent FMV of property greater than basis, and COD income for excess of liability over FMV of property; recourse debt discharge of insolvent taxpayer excludable under Section 108(a)(1)(B)); *Gehl*, 102 TC 784 (1994) (Reg. 1.1001-2 followed), *aff'd by order*, 50 F3d 12 (8th Cir.), *cert. denied,* 516 US 899 (1995); *Connell*, TC Memo 2018-213, *aff'd w/o opin.* (3d Cir. 2020). Compare *Spartan Petroleum Co.*, 437 F. Supp. 733 (DSC 1977) with *Bialock*, 35 TC 649, 661 (1961).

[12] Regs. 1.108-2(a), 1.108-2(f). The related party definitions are set forth in Sections 267(b) and 707(b) . The regulations exempt an acquisition of a related person's debt instrument from Section 108(e)(4), whether the acquisition is direct or indirect, if the instrument's stated maturity date is no more than one year after the acquisition and the instrument is actually retired no later than the maturity date. Reg. 1.108-2(e)(1) . An acquisition is also exempted if (1) the acquiring person is a securities dealer; (2) the instrument is acquired in the ordinary course of the dealer's business; (3) the instrument is accounted for as a security held for sale to customers in the ordinary course of business; (4) the instrument is held no longer than is consistent with the holding of the instrument for sale in the ordinary course of business; and (5) the instrument is not sold or transferred to a person related to the debtor (other than another dealer who meets all of the foregoing requirements). Reg. 1.108-2(e)(2) . See Rev. Rul. 91-47, 1991-2 CB 16 (corporate debtor realized discharge of indebtedness income when unrelated person formed a new corporation that acquired debtor's outstanding obligations at less than their principal amount and then sold the stock of the newly formed corporation to the debtor). See New York State Bar Ass'n Tax Section Comm. on Bankruptcy, "Acquisitions of Discount Debt by Related Parties Under the New IRC Section 108(e)(4) Regulations," 52 *Tax Notes* 211 (1991).

[13] Presumably Section 108(e)(2) overrides application of the at-risk and passive activity loss rules.

With respect to distressed real property, the compromise or release of nonrecourse mortgage indebtedness will frequently present a trap for the unwary. This is because the amount realized includes the face amount of outstanding nonrecourse debt.[14] Where the subject note's principal is reduced by compromise or negotiation, or through a significant modification of the mortgage terms, COD income may result. Where there is no accompanying foreclosure, voluntary conveyance of a deed in lieu of such foreclosure or abandonment, the mortgagor will recognize debt-discharge income taxable as ordinary income.[15] This rule also applies to the cancellation of recourse debt on a note and mortgage.

[14] Section 7701(g) (amount realized for nonrecourse indebtedness); *Tufts*, 461 US 300 (1983); *Great Plains Gasification Assocs.*, TC Memo 2006-276 (fact-finding made by trial court that partnership liability was nonrecourse and that amount realized on foreclosure therefore included entire amount of liability, regardless of property's value); Rubin, Whiteway, & Finkelstein, "Recourse or Nonrecourse: Liability Treatment for COD, Other Plans," 128 Tax Notes 1133 (9/13/2010).

[15] See, e.g., *Republic Supply Co.*, 66 TC 446 (1976).

Where mortgaged property is foreclosed, the amount of COD income depends on the type of the debt. With respect to recourse debt, where the FMV of the property exceeds basis, but less than the amount of the balance of the recourse obligation, the foreclosure results in bifurcated gain.[16] Sale or exchange treatment occurs to the extent of the FMV of the property and the taxpayer-debtor's adjusted basis, and COD income arises to the extent the called debt exceeds the FMV of the property.[17] For nonrecourse debt the entire debt cancelled must be included in the amount realized in determining gain or loss.[18]

[16] See Regs. 1.1001-2(a), -2(b) (nonrecourse debt); *Helvering v. Hamel*, 311 US 504 (1941); Rev. Rul. 90-16, 1990-1 CB 265 ; Rev. Rul. 78-164, 1978-1 CB 264 . Where the foreclosure of encumbered real property is described within Section 1038, in general no gain or loss will result to the seller on such reacquisition for the difference between the FMV of the property and the balance of the seller's debt. Section 1038 is mandatory. Section 1038 applies only where a sale of real property is secured by a note and mortgage and the seller later reacquires such real property in partial or full satisfaction of the debt. See discussion of Section 1038 in Witt and Lyons, "An Examination of the Tax Consequences of Discharge of Indebtedness," 10 Va. Tax Rev. 1 (1990); *Held*, 36 AFTR2d 75-5731 (DC Ala. 1975); *Lohman*, TC Memo 1989-141.

[17] See, e.g., *Gehl*, 102 T.C. 784 (1994), *aff'd* 50 F.3d 12 (8th Cir. 1995), *cert. den.* 516 U.S. 899 (1995).

[18] Reg. 1.1001-2; *Yarboro*, 737 F.2d 479 (1984).

With respect to the abandonment of the encumbered property by the debtor of property, a realization event does not, in general, occur until a subsequent foreclosure eliminates the debtor-taxpayer's interest in the property. Where the debtor's abandonment of the property ripens into a realization event, the taxpayer may be allowed to report a loss, and because an abandonment is not a sale or exchange of property for purposes of Sections 1222 or 1231(a), i.e., the loss is not a capital loss.[19] The abandonment loss of a partner's interest in a partnership will be realized in the year the partner evidences an intent to abandon the interest and the consummation of an overt act consistent with such intent.[20] However, with respect to the abandonment of a partnership interest which, indirectly, has a share of the liabilities of the partnership, sale or exchange treatment results. A partner who abandons a partnership interest with partnership level debt will be deemed to have a deemed distribution in cash to the extent of the liabilities the partner is deemed to be relieved.[21] However, the Eleventh Circuit, in *Weiss*, 956 F2d 242 (11th Cir. 1992), held that a partner forfeiting his partnership interest does not realize his share of partnership liabilities where he remains personally liable on the partnership debt. The Tax Court and the Fifth Circuit have held that a partner may claim an ordinary loss on the worthlessness of a partnership interest without requiring recognition of a deemed distribution under Section 752(b).[22] Still, where an act of abandonment or claim loss from the worthlessness of a partnership interest may avoid a deemed distribution by application of Section 752(b) in the year the loss is claimed and deducted, the partner is still exposed to deemed gain when the debt is ultimately cancelled.[23]

[19] See, e.g., *Green*, 126 F.2d 70 (3d Cir. 1942) (subsequent foreclosure sale after abandonment of real property encumbered by a mortgage created loss event). As to the debtor's remedy of "rescission" to unwind a prior sale, the IRS has ruled that such negate the original sale. Ltr. Rul. 7802033 ; Rev. Rul. 80-58, 1980-1 CB 181 . But see *Branum v. Campbell*, 211 F2d 147 (5th Cir. 1954).

[20] *Dezendorf*, 312 F2d 95 , 96 (5th Cir. 1963). See Bittker & Lokken, "Federal Taxation of Income, Estates, and Gifts" (WG&L) ¶25.4.3.

[21] *Pilgrim's Pride Corp.*, 141 TC 533 (2013), *rev'd* 779 F3d 311 (5th Cir. 2015); See Citron, 97 TC 200 (1991); *Echols*, 935 F2d 703 (5th Cir. 1991), *rev'g*, 93 TC 533 (1989). See *Equity Planning Corp. and Subsidiaries*, TCM 1983-57.

[22] *Echols*, 935 F2d 703, *reh'g denied per curiam*, 950 F2d 209 (5th Cir. 1991), *rev'g* 93 TC 553 (1989); *MCM Investment Management, LLC*, TC Memo 2019-158; *Tejon Ranch Co.*, TC Memo 1985-207. [my comment: see part II.G.8 Code § 165(a) Loss for Worthlessness; Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy.

[23] See McKee, Nelson & Whitmore, "Federal Taxation of Partnerships & Partners (WG&L), ¶16.06; Sowell, "Debt Workouts: the Partnership and the Partners," VII. C., PLI Publication, The Corporate Tax Practice Series 2020. See also Section 6241(7) (the cease-to-exist rule under the BBA centralized partnership audit rules). See August, "Assessments and Collection of Income Tax from Partnerships, Partners, and Former Partners under the BBA Partnership Audit Rules, Part Two: Take a Close Look at the Cease to Exist Rule!!, Corporate Taxation (WG&L) (Jul/Aug 2022).

Where seller financing is provided in the purchase of an asset and the parties subsequently agree to a reduction in the purchase price and therefore the amount owed by the purchaser, and further provided the reduction does not occur in bankruptcy or where the purchaser is insolvent, the reduction in the purchase price is not debt discharge income. This rule is set forth in Section 108(e)(5). The Service and the Tenth Circuit[24] view Section 108(e)(5) as the exclusive purchase price adjustment exception to Section 61(a)(11) . In other words, the judicial created exceptions for accord and satisfaction of debt evidenced in case law, e.g., *Hirsch*[25] and Sherman,[26] are essentially overruled where Section 108(e)(5) applies, i.e., where the purchase price reduction is between the purchaser and seller.[27]

[24] *Preslar*, 167 F3d 1323 (10th Cir. 1999).

[25] 115 F.2d 656 (7th Cir. 1940).

[26] 135 F.2d 68 (6th Cir. 1943).

[27] *Preslar*, supra, note 13.

That article later discusses "Application of Cancellation of Indebtedness Rules to Partnerships":

> Where a partnership realizes cancellation of indebtedness income, such amount is allocated among the partners in accordance with the sharing of profits in the partnership agreement as a separate item of income.[54] Any mandatory or special allocations under Section 704(b) for minimum gain and qualified income offset are taken into account. Section 108(d)(6) instructs that each partner determines whether his share of debt-discharge income qualifies under an exception for insolvency or bankruptcy under Section 108 even though the partnership is a title 11 debtor, and the partners are not.[55] The bankruptcy exclusion therefore is only available where the partner is insolvent or is under the jurisdiction of the court in a title 11 case.[56]
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> [54] Section 702(a)(8).
>
> [55] *Gracia*, TC Memo 2004-147; *Mirarchi*, TC Memo 2004-148; *Martinez*, TC Memo 2004-150.
>
> [56] Reg. 1.108-9(a).
>
> With respect to the discharge of partnership indebtedness, the determination of whether debt is considered QRPI under Section 108(c)(3) is made at the partnership level. However, the election to reduce the basis of property in lieu of recognizing discharge of indebtedness income is made at the partner level, on a partner-by-partner basis.[57] The attribute reduction rules also apply at the partner level. See prior discussion on reduction in tax attributes and special elections under Section 108(b)(5) or Section 108(c).[58]
>
> [57] Section 703(b)(1) .
>
> [58] See prior discussion, supra.
>
> Each partner allocated COD income increases his basis in his partnership interest and then decreases basis for such person's reduction in partnership liabilities under Section 752(b).[59] Where recourse debt is cancelled, the corresponding deemed distribution resulting under Section 752(b) is charged to the partner or partners allocated the liability under the economic risk of loss regulations ("EROL").[60] As noted, the bankruptcy or insolvency of the partnership does not allow a partner which is both solvent and outside a title 11 bankruptcy proceeding to exclude its pro rata share of the partnership's discharge of indebtedness income. [highlighting is mine]
>
> [59] Sections 705(a)(1)(A) , 705(a)(2), 752(b), 733(1), 731(a)(1). See Reg. 1.731-1(a)(1)(ii) . See Rev. Rul. 94-4 (deemed distribution of money from Section 752(b)/ Section 733(1) may qualify for advance or draw treatment). But the same does not apply to shareholders in S corporations allocated COD income of the S corporation. See Section 108(d)(7) , which "turns off" Section 1367 for the pass-through of COD income which, in 2002, reversed the holding of the Supreme Court's favorable decision on this issue in *Gitlitz*, 531 US 206 (2001).
>
> [60] Reg. 1.752-2; *Babin*, 23 F3d 1032 (6th Cir. 1994), aff'g TC Memo 1992-673 . See Pollack, "Does Section 108(a) Allow `Windfall' Basis Adjustments?," Tax Notes, p. 487 (7/24/1995); Lipton, "Insolvent Partner Taxed on Partnership's COD Income Despite Code Provision," 81 J Tax'n 248 (1994).

The discontinuity between the allocation of COD income based on profits ratios and the deemed distribution arising under Section 752(b) under the EROL platform seems awkward. Does the allocation of COD income have substantial economic effect?[61] This issue was the subject of Rev. Rul. 92-97, 1992-2 CB 124 . The Service held that where COD income allocations vary from the deemed distribution impacts, the allocation has substantial economic effect where: (1) the deficit restoration obligations covering any negative capital account balances resulting from the COD income allocations can be invoked to satisfy other partners' positive capital account balances, (2) the requirements of the economic effect test are otherwise met, and (3) substantiality is independently established. Where the deficit restoration obligation is not unconditional, a pro rata allocation of COD income cannot have economic effect, but the partnership may use a qualified income offset under the alternate economic effect test.[62]

[61] Regs. 1.704-1(b)(2)(ii) , 1.704-2(b)(2)(iv) . Under the "safe harbor" rule of substantial economic effect, partners must agree to maintain capital accounts in accordance with -1(b)(2)(iv) of the regulations and liquidate in accordance with positive capital account balances. Any partner with a deficit capital account must accept the obligation to restore the deficit per Reg. 1.704-1(b)(2)(ii)(b)(3) (Situation 2) or meet the requirements for the alternate economic effect test in Reg. 1.704-1(b)(2)(ii)(d).

[62] See FSA 200131013 (partnership debt discharge income should be allocated in manner consistent with allocation of all items of income, gain, loss, deduction, and credit); Rev. Rul. 92-92, 1992-2 CB 103 (for passive activity loss purposes it is appropriate to allocate COD income in the same manner at date of discharge to the allocation required under Temp. Reg. 1.163-8T).

Consider a special allocation of COD income to the partners allocated recourse debt to make the income allocation consistent with the deemed distribution under Section 733(1). A special allocation of COD income could be made, for example, to an insolvent partner with an offsetting special allocation of book loss, i.e., a "shifting allocation." In Rev. Rul. 99-43, 1999-2 CB 506 the Service held that a partnership's special allocation of debt-discharge income to an insolvent partner and a corresponding special allocation of Section 704(b) book loss were "shifting allocations" that lacked substantiality. Under the facts set forth in the ruling, book loss was produced by a revaluation of partnership assets and the special allocation of COD income reduced each partner's capital accounts to zero. The Service concluded reliance could not be made for these offsetting allocations on the "value equals basis" rule to satisfy the "substantiality" test.[63] The amendments were made after the events generating the special allocations had occurred.[64]

[63] *Ibid*. See Rev. Rul. 92-97, supra; FSA 200131013. Reg. 1.704-1(b)(5), Ex. 6 . See *Gershkowitz*, 88 T.C. 984 (1987) (amendment to partnership agreement made immediately before liquidation and specially allocating gain to partners with negative capital accounts, so-called "fill up" allocations, did not have substantial economic effect). Allocations without substantial economic effect are allocated in accordance with the partners' interests in the partnership.

[64] However, the Service stated in Rev. Rul. 99-43 , supra, that "[c]lose scrutiny would be required if the changes were made at a time when the events had not yet occurred but were likely to occur or if, under the original allocation provisions of a partnership agreement, there was a strong likelihood that a disproportionate amount of COD

income earned in the future would be allocated to any partner who is insolvent at the time of the allocation and would be offset by an increased allocation of loss or a reduced allocation of income to such partner or partners."

Minimum gain is the amount of gain that a partnership would realize upon a taxable disposition of property encumbered by a nonrecourse debt in satisfaction of the debt.[65] Accordingly, minimum gain represents each partner's share of nonrecourse deductions allocated to such partner (plus certain distributions of proceeds sourced from nonrecourse debt), less such partner's aggregate share of the net decreases in partnership minimum gain at that time.[66]

[65] Reg. 1.704-2(f)(1). See T.D. 9557, 76 Fed. Reg. 71,255 (11/17/2011).

[66] Reg. 1.704-2(g)(1).

Under the regulations, a minimum-gain chargeback requirement is based solely on the existence of a net decrease in partnership minimum gain for a partnership taxable year. Where this occurs, each partner must be allocated items of partnership income and gain for that year equal to that partner's share of the net decrease in partnership minimum gain. Chargeback is not required with respect to a partner if the net decrease is caused by a guarantee, refinancing, or other change in the debt causing it to become partially or wholly recourse or nonrecourse debt, and the partner bears the economic risk of loss under Reg. 1.752-2 for the newly guaranteed, refinanced, or otherwise changed liability.[67]

[67] See Regs. 1.704-2(f) , 1.704-2(d)(4) (capital account revaluations and minimum gain).

Treatment of nonrecourse debt of a partnership in testing for a partner's "insolvency" under Section 108(d)(3) was the subject of several rulings. Section 108(d)(3) defines "insolvent" as the excess of liabilities over the fair market value of assets. Whether a taxpayer is insolvent, and the amount by which the taxpayer is insolvent, is determined based on the taxpayer's assets and liabilities immediately before the discharge. Section 108(d)(6) provides that in the case of cancelled partnership debt, as defined in Section 108(d)(1) , the insolvency exception of Section 108(a)(1)(B) applies at the partner level. In Rev. Rul. 92-53, 1992-2 C.B. 48, the Service held that the amount that a nonrecourse debt exceeds the fair market value of the property securing the debt, i.e., excess nonrecourse debt, is treated as a liability in determining insolvency for purposes of Section 108(d)(3) to the extent that the excess nonrecourse debt is discharged. In Rev. Rul. 2012-14, 2012-24 IRB 1012 , the Service amplified Rev. Rul. 92-53 in providing that each partner is allocated excess nonrecourse debt, and that discharged excess nonrecourse debt which results in COD income must be allocated to each partner to the extent of his portion of such excess nonrecourse debt.[68]

[68] See Rev. Rul. 99-43, 1999-2 C.B. 506, and Rev. Rul. 92-97, 1992-2 C.B. 124 , regarding the application of Section 704(b) to allocations of COD income.

In the partnership area, it is quite important to identify the parties directly involved in the borrowing that is being cancelled or modified. Is the partnership the true "borrower"? Is the debt of the partnership "recourse" or "non-recourse" for purposes of Section 752 and the economic risk of loss standard contained in the regulations ("EROL")? Does an exception to the EROL rules apply?[69] In *Slavin*, TC Memo 1989-221, the issue before the Tax Court was whether the taxpayer's disposition of his 50% interest in three real estate partnerships in exchange for the assumption by the other 50% partner of the taxpayer's and his wife's liabilities on certain bank debts constituted a sale or exchange of his partnership interest, as argued by the Service, or instead, was a forgiveness of debt by the lender as the taxpayer reported. The taxpayer received no other consideration in the transaction. The transfers were made in 1978. The taxpayer claimed he was insolvent before and after the alleged forgiveness and therefore had no COD income. The government argued that neither the partnerships nor the lender regarded the petitioner as the true borrower.[70] Instead, the Service issued a notice of deficiency claiming that the petitioner sold his partnership interests under Sections 741(a), 751, and 752 and must recognize ordinary income of approximately $312,000 and long-term capital gain of $533,000 from the dispositions.[71]

[69] Parillo, "DOJ's Antiabuse Argument in Tribune Media is Off Base, Say Critics," Tax Notes Today (5/31/2023).

[70] *Plantation Patterns, Inc.*, 462 F2d 172 (5th Cir. 1972), aff'g TC Memo 1970-182 , cert. den.

[71] The transaction pre-dates the issuance of Rev. Rul. 99-5, 1999-5, 1999-1 CB 434.

II.G.32. Postponed Deadlines Due to Disaster or Military Service

Rev. Proc. 2018-58, Section 2, "Background," provides:

.01. Section 7508(a)(1) of the Code permits a postponement of certain time-sensitive acts for individuals serving in the Armed Forces of the United States, or serving in support of such Armed Forces, in an area designated by the President as a combat zone under section 112(c)(2), or serving with respect to a contingency operation (as defined in 10 U.S.C. § 101(a)(13)). Among these acts are the filing of certain returns, the payment of certain taxes, the filing of a United States Tax Court petition for redetermination of a deficiency, and the filing of a refund claim. In the event of service in a combat zone or service with respect to a contingency operation, the acts specified in section 7508(a)(1) are automatically postponed. This revenue procedure sets forth a list of such other acts that are also automatically postponed as contemplated by section 7508(a)(1)(K). In addition, the IRS may include acts not listed in this revenue procedure in any other published guidance (including an IRS News Release) related to the combat zone or contingency operation.

.02. Section 7508A provides that certain acts performed by taxpayers and the government may be postponed if the taxpayer is affected by a federally declared disaster or a terroristic or military action. Prior to 2008, section 7508A(a) referred to a "Presidentially declared disaster," defined in section 1033(h)(3). The Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (2008 Act), P.L. 110-343, Division C, § 706(a)(2)(D)(vii), amended section 7508A(a) to refer to a "federally declared disaster," defined in section 165(h)(3)(C)(i). Section 706(a)(1) of the 2008 Act amended section 165(h) to provide the definition of a "federally declared disaster." Effective December 19, 2014, the Tax Technical Corrections Act of 2014 (2014 Act), P.L. 113-295, § 221(a)(27), removed the definition of "federally declared disaster" from section 165(h)(3) and placed it in section

> 165(i)(5). However, the 2014 Act did not amend section 7508A(a) with the new cross-reference for the definition of a "federally declared disaster." Effective March 23, 2018, the Consolidated Appropriations Act, 2018, P.L. 115-141, § 401(b)(10) amended section 7508A(a) to reflect the cross-reference for the definition of a "federally declared disaster" in section 165(i)(5)(A) . However, the regulations under section 7508A have yet to be revised to change the reference to the definition of a federally declared disaster. A "terroristic or military action" is defined in section 692(c)(2). Section 301.7508A-1(d)(1) defines seven types of affected taxpayers, including any individual whose principal residence (for purposes of section 1033(h)(4)) is located in a "covered disaster area" and any business entity or sole proprietor whose principal place of business is located in a "covered disaster area." Postponements under section 7508A are not available simply because a disaster or a terroristic or military action has occurred. Generally, the IRS will publish a notice or issue other guidance (including an IRS News Release) authorizing the postponement. See section 4.01 of this revenue procedure.

Section 9.3, "Sec. 663(b) and Sec. 1.663(b)-2," refers to the time for filing the Code § 663(b) election described in part II.J.4.a Distributions after Yearend to Carry Out Income to Beneficiaries but does not seem to me to extend the 65-day deadline:

> The fiduciary of a trust or estate may elect to treat any amount properly paid or credited to a beneficiary within the first 65 days following the close of the taxable year as an amount that was properly paid or credited on the last day of such taxable year. If a return is required to be filed for the taxable year for which the election is made, the election shall be made on such return no later than the time for making such return (including extensions). If no return is required to be filed, the election shall be made in a separate statement filed with the internal revenue office with which a return would have been filed, no later than the time for making a return (including extensions).

I am unaware of any authority confirming or contradicting my reading of Rev. Proc. 2018-58, § 9.3.

Although Rev. Proc. 2018-58 lists many types of relief, the IRS is authorized to do more. See Reg. § 301.7508A-1 for additional relief one might ask the IRS to publicly declare; T.D. 9950 (6/11/2021) amended that regulation "relating to the new mandatory 60-day postponement of certain time-sensitive tax-related deadlines by reason of a federally declared disaster," and the changes "affect individuals who reside in or were killed or injured in a disaster area, businesses that have a principal place of business in a disaster area, relief workers who provide assistance in a disaster area, or any taxpayer whose tax records necessary to meet a tax deadline are located in a disaster area."

Notice 2020-23 and Notice 2021-21 extend this relief (and more) to the 2020 coronavirus pandemic, and Notice 2023-21 provides:

> *Relief for Determining the Lookback Period for Claims for Credit or Refund*. For an Affected Taxpayer with a due date postponed by Notice 2020-23, the period beginning on April 15, 2020, and ending on July 15, 2020, will be disregarded in determining the beginning of the lookback period for the purpose of determining the amount of a credit or refund under § 6511(b)(2)(A) relating to the tax for which the return filing or payment due date was postponed. In addition, for an Affected Taxpayer with a due date postponed by Notice 2021-21, the period beginning on April 15, 2021, and ending on May 17, 2021,

will be disregarded in determining the beginning of the lookback period for the purpose of determining the amount of a credit or refund under § 6511(b)(2)(A) relating to the tax for which the return filing or payment due date was postponed.

II.G.33. Taxpayer Disavowing Form

Complex Media, Inc. v. Commissioner, T.C. Memo. 2021-14, explained (highlighting added):

> At one time, this Court and its predecessor were less willing than appellate courts to allow a taxpayer, having chosen the form of a transaction, to disavow that form and argue that the tax consequences of the transaction should be determined on some other basis. For example, in *Swiss Oil Corp. v. Commissioner*, 32 B.T.A. 777, 785 (1935), *rev'd sub nom. Commissioner v. Ashland Oil & Refining Co.*, 99 F.2d 588 (6th Cir. 1938), the Board of Tax Appeals wrote: "Although courts have a tendency at times to 'look through form to substance', they nevertheless have laid down the rule that tax liability must be determined by considering what the taxpayer did, not what it intended to do, or what it might have done." And in J.*M. Turner & Co. v. Commissioner*, 26 T.C. 795 (1956), *rev'd*, 247 F.2d 370 (4th Cir. 1957), this Court, while acknowledging that the taxpayer could have achieved the tax benefit sought had it structured the transaction in issue differently, nonetheless held the taxpayer to the form of its transaction. "[I]n deciding the present controversy," we wrote, "it is necessary for us to deal with the facts and transactions as they actually existed." *Id*. at 804. In *Television Indus., Inc. v. Commissioner*, 32 T.C. 1297, 1302 (1959), *aff'd*, 284 F.2d 322 (2d Cir. 1960), we again recognized that the taxpayer could have avoided tax liability had the transaction in issue been cast in a different form. But the transaction "was not done in that [tax-favorable] way," we concluded, "and the form that the transaction took must prevail." Id. We felt ourselves bound to render our decision "upon the basis of what was actually done rather than upon what might have been done." *Id.*
>
> By contrast, in our own Opinion in *Danielson v. Commissioner*, 44 T.C. at 555, we wrote: "We are unwilling to abdicate our judicial responsibility of examining the substance of a transaction. We are not bound by its form." And in *Schmitz v. Commissioner*, 51 T.C. 306 (1968), aff'd sub nom. *Throndson v. Commissioner*, 457 F.2d 1022 (9th Cir. 1972), in addition to declining to adopt the Third Circuit's *Danielson* rule, we suggested that the substance-over-form doctrine is equally available to taxpayers and the Commissioner. We acknowledged that, in many of the cases in which the doctrine had been applied, "the Commissioner was attacking the form of the transaction". *Id*. at 317. But we also saw "no reason why we should make a distinction on this point." *Id*.; see also *Shaw v. Commissioner*, 59 T.C. 375, 383-384 (1972) ("Th[e] preference for substance over form in tax matters extends to claims of petitioner and respondent alike.").
>
> In *Estate of Rogers v. Commissioner*, T.C. Memo. 1970-192, 1970 Tax Ct. Memo LEXIS 166, *aff'd*, 445 F.2d 1020 (2d Cir. 1971), we again had occasion (as in *Danielson*) to apply Ullman's "strong proof" rule. We accepted that "a taxpayer may go beyond what appears on the face of an agreement, just as the Commissioner may do so." *Id.*, 1970 Tax Ct. Memo LEXIS 166, at *13. But, we observed, "the so-called 'two-way street' seems to run downhill for the Commissioner and uphill for the taxpayer." *Id*. at *14. "The Commissioner must be permitted to go beyond mere form to substance in order to protect the revenue", we explained, "but taxpayers have the opportunity at the outset to choose the most advantageous arrangement." *Id*.

In *Glacier State Elec. Supply Co. v. Commissioner*, 80 T.C. 1047 (1983), we suggested that the higher burden faced by a taxpayer seeking to disavow the form of its transaction might be an evidentiary one. We agreed with the taxpayer, who sought to recharacterize the transaction in issue, that "it is the substance of a transaction rather than mere form which should determine the resultant tax consequences when the form does not coincide with economic reality." *Id*. at 1053. We also accepted that "[t]he taxpayer, as well as the Commissioner, is entitled to assert the substance-over-form argument" but added that, "in such situations the taxpayer may face a higher than usual burden of proof." *Id*.

In *Glacier State Elec. Supply*, however, we did not clearly articulate just what the taxpayer should have to prove by more than a preponderance of the evidence. We ultimately rejected the taxpayer's substance-over-form argument on the grounds that "the substance of the transaction coincides with the form employed." *Id*. at 1058. We did not identify any factual questions whose resolution would have compelled a different result if the taxpayer had met a heightened standard of proof.

In *Coleman v. Commissioner*, 87 T.C. 178, we suggested that a taxpayer faces a particularly high threshold in seeking to disavow the form of a transaction chosen to allow another party tax benefits (even under foreign tax law) that are inconsistent with the treatment the taxpayer seeks before us. Coleman involved an equipment lease originally structured between counterparties in the United Kingdom with the intent that the lessor be respected as the equipment's owner and thus entitled to generous first-year depreciation allowed under U.K. tax law. The taxpayer before us was a U.S. partner in a partnership that had acquired the lessee's interest in the lease. The taxpayer argued that, under U.S. tax principles, the partnership should be treated as the owner of the equipment and thus entitled to allocate among its partners depreciation deductions in respect of the equipment. We repeated the observation we had made in *Bolger v. Commissioner*, 59 T.C. 760, 767 n.4 (1973), that "the taxpayer may have less freedom than the Commissioner to ignore the transactional form … adopted." *Coleman v. Commissioner*, 87 T.C. at 202. We then opined that "this is particularly true where … the form of the transaction was adopted … in order to achieve a bona fide, permissible tax purpose." *Id*. And the relevant analysis apparently does not turn on whether the tax purpose motivating the choice of transaction structure involves U.S. or foreign taxes. As we explained:

> The fact that the purpose underlying the form of the transactions between *** [the original lessee and lessor] was to take advantage of U.K. rather than U.S. tax laws does not, in our opinion, provide a sufficient foundation for permitting petitioners to disavow that form in order to obtain the benefits of U.S. tax laws. Similarly, we consider it irrelevant that … [the original counterparties] were apparently not subject to U.S. tax laws. Rather, we think our decision herein should be based upon the situation which would have existed had both … [of the original counterparties] been subject to U.S. tax laws … and sought to claim depreciation in respect of the Equipment.

Id. at 202-203.

In *Estate of Durkin v. Commissioner*, 99 T.C. 561 (1992), we identified other factors that tend to weigh against a taxpayer who seeks to disavow a transaction's form. The taxpayers in *Estate of Durkin* took a position contrary to their own tax reporting of the transactions in issue after the Commissioner had challenged their reporting. The taxpayers' "disavow[al] [of] their own tax return treatment", their failure to "show 'an honest and consistent respect for the substance of … [the] transaction", and their "unilateral[] attempt[]" to recast the transaction only "after it has been challenged" all weighed against our acceptance of their proposed step transaction recast. *Id*. at 574-575 (quoting *Estate of Weinert v. Commissioner*, 294 F.2d 750, 755 (5th Cir. 1961), rev'g and remanding 31 T.C. 918 (1959)). We also invoked in *Estate of Durkin* two of the three policy considerations underlying the Danielson rule:[17] "A party disavowing the form of a transaction may be unjustly enriched, particularly where the party was acting on tax advice, because the price may be influenced by tax considerations. If a party disavows the form of a transaction, the Commissioner may be whipsawed between one party claiming taxation based on the form, and the opposite party claiming taxation based on the substance." *Id*. at 575 (citation omitted).

[17] Although *Estate of Durkin v. Commissioner*, 99 T.C. 561 (1992), was appealable to the Court of Appeals for the Third Circuit, we found it unnecessary in that case to choose between that court's *Danielson* rule and the "strong proof" rule we had ourselves posited in *Glacier State Elec. Supply Co. v. Commissioner*, 80 T.C. 1047 (1983). Under either standard, we reasoned in *Estate of Durkin v. Commissioner*, 99 T.C. at 574, the taxpayers before us would not have been allowed to disavow the form of the transaction in issue.

Dyess v. Commissioner, T.C. Memo. 1993-219, 1993 WL 170147, at *10, *aff'd without published opinion*, 26 F.3d 1119 (5th Cir. 1994), similarly involved the rejection of a step transaction argument made by a taxpayer who, we concluded, had "met neither the strong proof test nor the *Danielson* test". Our conclusion rested in part on the taxpayer's failure to explain why the transaction structure employed was chosen over a considered-and-rejected alternative that would have achieved the tax results the taxpayer sought. *Dyess* involved a sale of real property between two partnerships. At issue was whether section 707(b)(2)(B) applied to recharacterize the seller's gain as ordinary income. As then in effect, the recharacterization rule would have applied if the same persons owned more than 80% of the capital and profits of both partnerships. When the sale occurred, the taxpayer and another individual (Nace) owned all of the interests in the selling partnership (Equity) and 92.5% of the interests in the buyer (Foxfire). Nonetheless, the taxpayer argued that section 707(b)(2)(B) did not apply because the sale occurred in anticipation of Foxfire's issuance of limited partner interests to new investors that reduced his and Nace's ownership of Foxfire below 80%. The whole purpose of forming a new limited partnership to acquire the property, according to the taxpayer, was to raise money from new investors in an effort to rehabilitate a failing development.

An earlier draft of Foxfire's limited partnership agreement had contemplated the issuance of 75% of the interests in the partnership to limited partners before Foxfire's acquisition of the property in question from Equity. We found no "satisfactory explanation" in the record "as to why that draft version was not used." *Dyess v. Commissioner*, 1993 WL 170147, at *10. The taxpayer, we concluded, "cannot now disavow the route he in fact followed for a different route he might have but did not take." *Id*. The taxpayer had "met neither the strong proof test nor the Danielson test".[18] *Id*. Therefore, the taxpayer could not "successfully invoke the substance over form doctrine to disavow the manner in which the Foxfire partnership was structured and the limited partnership interests sold." *Id*.

> [18] We accepted in *Dyess v. Commissioner*, T.C. Memo. 1993-219, 1993 WL 170147, at *8, *aff'd without published opinion*, 26 F.3d 1119 (5th Cir. 1994), the possibility that the Danielson rule might apply in that case because the Court of Appeals for the Fifth Circuit, to which the case was appealable, had chosen the Danielson rule over the strong proof rule in "certain situations".

> In sum, as our caselaw has evolved, it has become more hospitable to taxpayers seeking to disavow the form of their transactions. While we no longer reject those arguments out of hand, as we did in *Swiss Oil Corp., J.M. Turner & Co.*, and *Television Indus.*, we have repeatedly indicated that taxpayers may face a higher burden than the Commissioner does in challenging transactional form. On occasion, as in *Glacier State Elec. Supply*, we have suggested that the taxpayer's higher burden might be an evidentiary one. But we have not identified specific factual questions that should be subject to a higher burden than that imposed by Rule 142(a) or articulated the quantum of evidence necessary to meet that burden. Nor have we offered a clear justification for imposing on the taxpayer a higher burden to prove facts relevant to the disavowal of form than the generally applicable preponderance of the evidence standard.

> Therefore, we now conclude that the additional burden the taxpayer has to meet in disavowing transactional form relates not to the quantum of evidence but instead to its content—not how much evidence but what that evidence must show by the usual preponderance. The Commissioner can succeed in disregarding the form of a transaction by showing that the form in which the taxpayer cast the transaction does not reflect its economic substance. For the taxpayer to disavow the form it chose (or at least acquiesced to), it must make that showing and more. In particular, the taxpayer must establish that the form of the transaction was not chosen for the purpose of obtaining tax benefits (to either the taxpayer itself, as in *Estate of Durkin*, or to a counterparty, as in *Coleman*) that are inconsistent with those the taxpayer seeks through disregarding that form. When the form that the taxpayer seeks to disavow was chosen for reasons other than providing tax benefits inconsistent with those the taxpayer seeks, the policy concerns articulated in *Danielson* will not be present.

AOD 2023-2, 2023-11 I.R.B. 529, nonacquiesced in the decision:

> Issue 1:

> Nonacquiescence to the court's conclusion that the parties' failure to report the transactions fully or consistently should not be a major factor in a decision whether to allow a taxpayer to disavow the form of its transactions and also to the standard the court applied to allow petitioner to disavow its form in this case.

As to Issue 1, AOD 2023-2, 2023-11 I.R.B. 529, explained the IRS' view:[1972]

> a. *The Transactions*

> Taxpayer was incorporated by a partnership ("Partnership") to engage in a series of transactions in November 2009. The transactions were memorialized in the Agreements

[1972] For Issue 2 from the AOD, see text accompanying fn 3557 in part II.M.2.e Contributing Existing Business to a Corporation.

and were implemented consistently with the terms thereof. Based on the Agreements and as implemented, the transactions consisted of the following steps:

i. Partnership transferred the tangible and intangible assets of its publishing business ("Transferred Assets") to Taxpayer in exchange for Taxpayer common stock ("Exchange").

ii. A newly formed subsidiary of Taxpayer was merged ("Merger") into an unrelated corporation ("Target") the principal asset of which was cash. Target survived the Merger as a wholly owned subsidiary of Taxpayer; holders of Target preferred stock received Taxpayer convertible preferred stock in exchange for their Target stock; and the common stock of Target was cancelled for no consideration.

iii. Taxpayer redeemed from Partnership some of the common stock Taxpayer had issued in the Exchange ("Redemption"). The price Taxpayer paid for the redeemed stock ("Redemption Proceeds") was $2.7 million cash and a right to a $300,000 deferred payment ("Deferred Payment Right").

iv. Partnership distributed the Redemption Proceeds to one of its partners ("Liquidated Partner") in complete liquidation of his interest in Partnership.

v. Taxpayer made the deferred payment when due, 13 months after the redemption.

b. *Federal Income Tax Treatment of the Exchange, the Merger, and the Redemption*

The Service, the parties, and the court all agreed that the Exchange and the Merger should be treated, not as separate transactions, but as a single transaction in which Partnership transferred the Transferred Assets, and the holders transferred the Target preferred stock, to Taxpayer in exchange for all the stock of Taxpayer. This transaction was subject to section 351 (" Section 351 Transaction"). Thus, the transferors (Partnership and the former Target shareholders) would recognize gain only to the extent of any money or property, other than Taxpayer stock, that they received (referred to as "boot"). Under section 362(a), the basis of the transferee (Taxpayer) in the Transferred Assets was the same as Partnership's basis, increased by the amount of any gain the transferors recognized.1

The Service and the parties disagreed, however, as to the proper treatment of the Redemption. The Service's position was that, in accordance with the form of the transactions, the Redemption was a transaction separate from the Section 351 Exchange, and therefore Taxpayer's basis in the Transferred Assets was the same as Partnership's basis with no increase. Taxpayer's position was that Partnership received the Redemption Proceeds as boot in the Section 351 Transaction, so that Taxpayer was entitled to increase its basis in the Transferred Assets by the amount of the Redemption Proceeds. The court agreed with Taxpayer.

c. *Reporting of the Transactions on 2009 Federal Income Tax Returns*

i. Taxpayer

With its 2009 Form 1120, Taxpayer filed the Information Reporting Statement required by Treas. Reg. § 1.351-3 ("Taxpayer Statement"), with respect to the Section 351 Transaction. On the Taxpayer Statement, Taxpayer reported its receipt of the Transferred Assets in exchange for only Taxpayer stock, with no boot. Consistent with its reporting of the Section 351 Transaction, on its 2009 return Taxpayer reported deductions for amortization of the Transferred Assets based on carryover basis with no increase. Taxpayer did not submit any information relating to the Redemption.

ii. Partnership

With its 2009 Form 1065, Partnership filed a Statement ("Partnership Statement") reporting the Exchange. Like the Taxpayer Statement, the Partnership Statement reported its transfer of the Transferred Assets to Taxpayer as in exchange for only Taxpayer stock. Partnership did not submit any information relating to its receipt of the Redemption Proceeds. That is, Partnership did not report gain on a receipt of boot in the Section 351 Transaction, as would be required under section 351(b). Nor did it report gain or loss on the Redemption or file a statement required by § 1.302-2(b)(2) with respect to the Redemption.

iii. Liquidated Partner

On his 2009 Form 1040, Liquidated Partner reported long-term capital gain from the receipt of $2.7 million cash in liquidation of his interest in Partnership. On his 2011 Form 1040, Liquidated Partner reported the payment pursuant to the Deferred Payment Right as $300,000 of "other income" received from Taxpayer.

d. *Taxpayer's Recast and Reporting on 2010-2013 Forms 1120*

On its Forms 1120 for 2010 through 2013, Taxpayer claimed amortization deductions based on an increased basis of the Transferred Assets. In so doing, Taxpayer took a position inconsistent with its 2009 return (including the Taxpayer Statement), the Partnership Statement, and the form of the transactions as provided in the Agreements and as implemented. Neither Taxpayer nor Partnership filed an amended 2009 return or disclosed the change in position on any return or in any other manner, except Taxpayer's claimed increase in amortization deductions.

Taxpayer's post-hoc justification for the increased amortization deductions was that Partnership's transfer of the Transferred Assets to Taxpayer was in exchange for both Taxpayer stock and boot, i.e., the Redemption Proceeds, as reported by the Liquidated Partner but never by Taxpayer or Partnership. According to Taxpayer, this recast increased its basis in the Transferred Assets by $3 million (Taxpayer's understanding of the value of the purported boot) and thus increased its amortization deductions.

e. *Issue*

The main issue before the court was whether Taxpayer could disavow the transactional form it chose and reported and treat the transactions as resulting in increased basis for the Transferred Assets. The court held that Taxpayer could do so.

f. *Service Concerns*

The Service is concerned about two related aspects of the court's holding and opinion: (1) the conclusion that the parties' failure to report the transactions fully and consistently was not a major factor in determining whether Taxpayer could disavow the form of its transactions, and (2) the overall legal standard the court applied to allow this disavowal of transactional form.

i. Parties' Failure to Report the Transactions Fully and Consistently

The Service's first concern relates to the court's conclusion that the parties' failure to report the transactions fully and consistently was not a major factor in the case.

The court found that Taxpayer did not report the transactions in a manner that was inconsistent with its claimed increase in asset basis. The court concluded that the only meaningful difference between the actual form (separate Section 351 Transaction and Redemption) and Taxpayer's recast form (Section 351 Transaction with Redemption Proceeds as boot) is the increase in the basis of the Transferred Assets. The court also found that there was no whipsaw potential to the government and no conflicting interests among the parties to the transactions.

The Service continues to believe that Taxpayer's failure to report the Redemption Proceeds at all (except as a later distribution by Partnership) should have barred the recast, or at least should have been a major factor in deciding whether a recast should be allowed. Reporting requirements exist to provide the Service with the opportunity to analyze the form and substance of transactions, and the Service necessarily relies on the reported information. Consequently, compliance with reporting requirements is an essential part of tax administration.

Here, Taxpayer and Partnership were related parties, and neither of them reported the payment and receipt of the Redemption Proceeds - neither its actual form (a separate Redemption) nor Taxpayer's recast form (boot in the Section 351 Transaction) on any return. This failure to report the Redemption put the Service in the difficult position of having to discover discrepancies by comparing amortization deductions claimed on Taxpayer's 2009 return with the larger deductions claimed on its later returns. Treas. Reg. § 1.351-3 requires the parties to a section 351 transaction to attach statements describing the transaction, including identification of any property with respect to which gain was recognized. The Taxpayer Statement and the Partnership Statement both described Taxpayer's receipt of the Transferred Assets as being in exchange only for Taxpayer stock. Neither statement identified any gain recognition property. However, Taxpayer claimed amortization deductions based on an increased basis in the Transferred Assets. This claim was inconsistent with the failure to report any boot gain in the Section 351 Transaction. Allowing taxpayers to withhold vital information from the Service but still disavow the form of their transactions and reap the resulting tax benefits, as occurred in this case, is highly detrimental to administration of the revenue laws.

ii. Standard to Allow a Taxpayer to Disavow Form of Transactions

A second concern is the legal standard the court applied to allow Taxpayer to disavow the form of its transactions and recast them for tax purposes.

In *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974), the Supreme Court adopted what is sometimes referred to as the "non-disavowal principle":

> [W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, *whether contemplated or not*, . . . and may *not enjoy the benefit* of some other route he might have chosen to follow but did not.

[Emphasis added.] The Service continues to believe that the facts of this case do not support an exception to the non-disavowal principle.

The court acknowledged that, in seeking to disavow the form of its transactions, a taxpayer faces a greater burden than the Service does when it challenges the form of a transaction. But the court interpreted the non-disavowal principle as applying only in limited situations:

> [R]ead in the context of the Court's entire opinion [in *National Alfalfa*], the familiar quotation should be interpreted to mean only that a taxpayer's ability to identify an alternative path to a given end result that provides more favorable tax consequences than the path actually taken is not enough to entitle the taxpayer to the desired tax treatment.

T.C. Memo. 2021-14 (slip op.) at 48.

The court went on to state that the case law has evolved to become more hospitable to taxpayers seeking to disavow the form of their transactions. The court described the standard it applied in this case as follows:

> The Commissioner can succeed in disregarding the form of a transaction by showing that the form in which the taxpayer cast the transaction does not reflect its economic substance. For the taxpayer to disavow the form it chose (or at least acquiesced to), it must make that showing and more. In particular, the taxpayer must establish that the form of the transaction was not chosen for the purpose of obtaining tax benefits (to either the taxpayer itself, as in Estate of Durkin [99 T.C. 561 (1992)], or to a counterparty, as in Coleman [87 T.C. 178 (1986)]) that are inconsistent with those the taxpayer seeks through disregarding that form. When the form that the taxpayer seeks to disavow was chosen for reasons other than providing tax benefits inconsistent with those the taxpayer seeks, the policy concerns articulated in Danielson [378 F.2d 771 [19 AFTR 2d 1356] (3d Cir. 1967)] will not be present.

T.C. Memo. 2021-14 (slip op.) at 64.

The court found that Taxpayer's failure to adopt the recast transaction, with an increase in asset basis, resulted from an oversight - perhaps occurring to Taxpayer's accountants only when they prepared Taxpayer's 2010 return (in which Taxpayer still did not disclose a recast). Thus, under the standard described by the court, Taxpayer was allowed to recast its transactions.

This case would be appealable to the Second Circuit, which has supported strict application of the non-disavowal principle when a taxpayer changes its position on the form of its transaction. *Nestlé Holdings, Inc. v. Commissioner*, 152 F.3d 83 (2d Cir. 1998); *Consolidated Edison of New York, Inc. v. United States*, 10 F.3d 68 (2d Cir. 1993). Applying this standard here, the taxpayer would be prevented from disavowing the form of its transaction.

In the Service's view, the standard applied by the court in this case would limit the non-disavowal principle to such an extent as to produce a significant blow to tax administration. In practical terms, the Service could prevent taxpayers from disavowing the form of their transactions only if it could show purposefully conflicting tax benefits, even when, as in this case, the taxpayer withholds vital information.

g. *Conclusion*

The Service disagrees with the court's conclusion that the parties' failure to report the transactions fully or consistently should not be a major factor in a decision whether to allow a taxpayer to disavow the form of its transactions and also with the standard the court applied to allow Taxpayer to disavow its form in this case.

The Service will continue to challenge an assertion by a taxpayer that the form of a transaction, as chosen by that taxpayer, memorialized in relevant agreements, and implemented, does not bind the taxpayer for Federal tax purposes, especially if the taxpayer does not fully, properly, and consistently report the transaction.

Areas in which substance over form are discussed include:

- Part II.G.18.b Sale or Exchange of Intellectual Property - Capital Gain vs. Ordinary Income, fn 1685.

- Part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax, fn 3409, in which taxpayers argue whether payments relating to the transfer of a book of business are compensation or the sale of goodwill.

- Part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss), fn 5699, and II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest, fn 4245.

- See fn 5699 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss) and fn 230, in part II.A.2.i.i.(b) Why Nonvoting Shares Are Needed for Estate Planning, discussing a taxpayer unsuccessfully invoking Code § 2036 to get a basis step-up.

II.H. Income Tax vs. Estate and Gift Tax (Particularly for Depreciable Property)

With the estate and gift tax rate at only 40%, one might consider whether ordinary income assets are better candidates for retention and basis step-up than assets that would generate capital gain. When one considers ordinary income rates, present and future, not only federal but also state and local income tax, one might determine that obtaining a basis step-up might be more important than saving estate tax on an ordinary income asset.[1973]

Also consider that perhaps estates might use assets not protected by GST exemption to pay the estate tax, and the assets with the stepped-up basis go to GST-exempt trusts.

Paul S. Lee of Northern Trust (formerly Bernstein), in various presentations with "Venn Diagrams" in the title, discusses the continuum of assets (regarding tax rates when various assets are sold) and approaches to obtaining basis increases.

At the 2015 Heckerling Institute, John Bergner's presentation, "Oh, What a Relief It Is: Curing Estate Plans That No Longer Make Sense in Light of the American Taxpayer Relief Act of 2012," mentioned basis step-up ideas. Another good source is Yuhas & Radom, "The New Estate Planning Frontier: Increasing Basis," *Journal of Taxation* (1/2015).[1974]

II.H.1. Ordinary Income Assets

Ordinary income assets include the following depreciable property:[1975]

- Equipment, furniture, and other tangible personal property, which is even more of a concern with recently expanded opportunities for Code § 179 write-offs and bonus depreciation[1976]

- Components of buildings that have been segregated into Code § 1245 assets as a result of a cost-segregation study geared toward having faster depreciation on those components than is permitted for buildings[1977]

- Amortizable goodwill, going concern value, and other intangibles[1978]

- Real property held for one year or less

[1973] Jerome M. Hesch suggested that estates of 2010 decedents might consider paying estate tax rather than electing out of estate tax and into basis carryover. "A 2010 Estate that Holds Depreciable Property Might Benefit from Paying Estate Tax," Steve Leimberg's Estate Planning Email Newsletter (Archive Message #1771).

[1974] Saved as document number 6108884 in my system.

[1975] PPC's *1040 Deskbook*, Table T801: Depreciation Recapture. I have not verified all of this.

[1976] See part II.G.6.b Code § 1245 Property.

[1977] See part II.G.6.b Code § 1245 Property. Code § 1245(a)(3)(C) treats as Code § 1245 ordinary income recapture property "so much of any real property (other than any property described in subparagraph (B)) which has an adjusted basis in which there are reflected adjustments for amortization under section 169, 179, 179A, 179B, 179C, 179D, 179E, 185, 188 (as in effect before its repeal by the Revenue Reconciliation Act of 1990), 190, 193, or 194…." For allocations involving such real property, see Notice 2013-59.

[1978] Code § 197. Amortizable goodwill is a not a capital asset, but other goodwill is. Letter Ruling 200243002. However, amortizable goodwill may be eligible for capital gain treatment as described in part II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business, especially fn. 1490.

- Real property held for more than one year described below (dates approximate):
  - Residential real property acquired 1981-1986, to the extent depreciated faster than straight-line would have allowed
  - Nonresidential real property held more than one year, with accelerated depreciation method used under ACRS (acquired 1981-1986)[1979]
  - Certain real property bought before 1981

See part II.G.18 Intellectual Property and Other Intangible Assets.

II.H.2. Basis Step-Up Issues

Assets includible in the decedent's gross estate for estate tax purposes are subject to a Code § 1014 basis adjustment.[1980] So is property "acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent."[1981] It has been suggested that the latter applies to property held in an irrevocable trust, that is outside of the decedent's gross estate but was deemed owned by the decedent until death, because for income tax purposes the decedent is deemed to have held the assets.[1982] The IRS would argue that the basis adjustment provisions apply to transfers made for transfer tax purposes, not based on transfers made for income tax purposes.[1983]

For a 2010 decedent whose estate elected not to pay estate tax, only part receives a basis step-up. In granting an extension of time to select which assets received a basis step-up, Letter Ruling 202340016 explained:

> Section 1022(a) provides that property acquired from a decedent who died after December 31, 2009, is treated as transferred by gift, and the basis of the person acquiring the property from such a decedent is the lesser of the adjusted basis of the decedent or the fair market value of the property at the date of the decedent's death.
>
> Section 1022(b)(1) provides, in general, that the basis of property under § 1022(a) is increased by basis increase that is allocated to the property.
>
> Section 1022(b)(2)(A) provides, in general, that basis increase is the portion of the aggregate basis increase that is allocated to the property.

[1979] Code § 1245(a)(5), repealed by the Tax Reform Act of 1986 but is said to apply to future dispositions of the property for which certain depreciation methods apply.
[1980] Code § 1014(b)(9).
[1981] Code § 1014(b)(1).
[1982] Rev. Proc. 2015-37 added to the list of areas with respect to which the IRS will not rule (which will show up in the annual revenue procedure regarding issuing private letter rulings):

> *Section 1014. Basis of Property Acquired from a Decedent*. Whether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code.

[1983] See fn. 6591, citing CCA 200937028 for the proposition that Code § 1014(b)(1) would not apply; see also fn. 6532, citing a letter ruling providing that assets in a GRIT received a Code § 1015(d) basis increase for gifts tax paid.

Section 1022(b)(2)(B) and (C) provide that the aggregate basis increase is $1,300,000; and that the aggregate basis increase is increased by - (i) the sum of the amount of any capital loss carryover under § 1212(b), and the amount of any net operating loss carryover under § 172 that would (but for the decedent's death) be carried from the decedent's last taxable year to a later taxable year of the decedent, plus (ii) the sum of the amount of any losses that would have been allowable under § 165 if the property acquired from the decedent had been sold at fair market value immediately before the decedent's death.

Section 1022(c)(1) provides that in the case of property that is qualified spousal property, the basis of such property under § 1022(a) (as increased under § 1022(b)) is increased by spousal property basis increase allocated to the property.

Section 1022(c)(2)(A) provides, in general, that spousal property basis increase is the portion of the aggregate spousal property basis increase which is allocated to the property. Section 1022(c)(2)(B) provides that the aggregate spousal property basis increase is $3,000,000.

Section 1022(d)(1)(A) provides, in general, that the basis of property acquired from a decedent may be increased under § 1022(b) or (c) only if the property was owned by the decedent at the time of death. Section 1022(d)(1)(B) describes property that is considered to be owned by the decedent at the time of death.

Section 1022(d)(2) provides that the basis adjustments under §§ 1022(b) and (c) shall not increase the basis of any interest in property above its fair market value in the hands of the decedent as of the date of the decedent's death.

Section 1022(d)(3) provides, in general, that the executor is to allocate the basis adjustments under §§ 1022(b) and (c) on the return required by § 6018 and that any allocation made may be changed only as provided by the Secretary.

Section 1022(e) describes property that is considered to be acquired from the decedent for purposes of § 1022.

Subtitle A of title V of the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16 (115 Stat. 76-81), enacted § 2210, which made chapter 11 (the estate tax) inapplicable to the estate of any decedent who died in 2010 and chapter 13 (the generation skipping transfer (GST) tax) inapplicable to generation-skipping transfers made in 2010. On December 17, 2010, Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRUIRJCA), P.L. 111-312 (124 Stat. 3296), became law, and § 301(a) of TRUIRJCA retroactively reinstated the estate and GST taxes. However, § 301(c) of TRUIRJCA allows the executor of the estate of a decedent who died in 2010 to elect to apply the Code as though § 301(a) of TRUIRJCA did not apply with respect to chapter 11 and for property acquired or passing from a decedent (within the meaning of § 1014(b)). Thus, § 301(c) of TRUIRJCA allows the executor of the estate of a decedent who died in 2010 to elect not to have the provisions of chapter 11 apply to the decedent's estate, but rather, to have the provisions of § 1022 apply (the Section 1022 Election).

Notice 2011-66, 2011-35 I.R.B. 184, section I.A. provides that the executor of the estate of a decedent who died in 2010 makes the Section 1022 Election by filing a Form 8939

> on or before November 15, 2011. Notice 2011-76, 2011-40 I.R.B. 479, extended the due date of the Form 8939 and thus, the election, from November 15, 2011 to January 17, 2012.
>
> Notice 2011-66, section I.D.1, provides that the Internal Revenue Service will not grant extensions of time to file a Form 8939 and will not accept a Form 8939 filed after the due date except in four limited circumstances provided in section I.D.2. Under this section of Notice 2011-66, an executor may apply for relief under § 301.9100-3.
>
> Section 301.9100-3 provides the standards used to determine whether to grant an extension of time to make an election whose date is prescribed by a regulation (and not expressly provided by statute).
>
> Requests for relief under § 301.9100-3 will be granted when the taxpayer provides the evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the government.
>
> Section 301.9100-3(b)(1)(v) provides that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election.
>
> Based on the facts submitted and the representations made, we conclude that the requirements of § 301.9100-3 have been satisfied. Therefore, the personal representatives of Decedent's estate are granted an extension of time of 120 days from the date of this letter to make the Section 1022 Election on a Form 8939 and allocate additional basis to eligible property as provided by § 1022. A copy of this letter should be attached to the Form 8939.

Relying in part on the rule that foreign real property that is inherited by a United States citizen from a nonresident alien will receive a step-up in basis under Code § 1014(b)(1),[1984] Letter Ruling 201245006 held that Code § 1014(b)(1) applied on the termination of an irrevocable trust created by a nonresident alien who had retained the right to all of the trust's income and could receive principal distributions in the trustees' absolute discretion (the trustees being the grantor and an unrelated party). The facts were:

> Taxpayer, a citizen and resident of Country, proposes to transfer assets to Trust, an irrevocable trust subject to the laws of Country. The assets of Trust include cash and stock in Company 1 and Company 2 that are publicly traded in Country and on the New York Stock Exchange. Taxpayer and X, an unrelated party, are Trustees.
>
> Under the terms of Trust, Trustees are to pay all of the income of Trust to Taxpayer during his lifetime and may, in Trustees' absolute discretion, pay principal of Trust to Taxpayer. Article IV. Upon the death of Taxpayer, any income of Trust and any corpus remaining in Trust are to be paid or transferred to or in trust for one or more of Taxpayer's issue in such proportions as Taxpayer may appoint by deed or will. In default of appointment, corpus and accumulated income will be held in further trust for the benefit of Taxpayer's issue. Article V. Trust further provides that during Taxpayer's

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[1984] Rev. Rul. 84-139.

> lifetime no adverse party within the meaning of § 672(a) is eligible to serve as Trustee. Article XI.

The ruling reasoned:

> In this case, Taxpayer's issue will acquire, by bequest, devise, or inheritance, assets from Trust at Taxpayer's death. The assets acquired from Trust are within the description of property acquired from a decedent under § 1014(b)(1). Therefore, Trust will receive a step-up in basis in Trust assets under § 1014(a) determined by the fair market value of the property on the date of Taxpayer's death. See Rev. Rul. 84-139, 1984-2 C.B. 168 (holding that foreign real property that is inherited by a U.S. citizen from a nonresident alien will receive a step-up in basis under § 1014(a)(1) and 1014(b)(1)). This rule applies to property located outside the United States, as well as to property located inside the United States.
>
> Accordingly, based solely upon the information submitted and the representations made, we conclude that following the death of Taxpayer, the basis of the property held in Trust will be the fair market value of the property at the date of Taxpayer's death under § 1014(a).

Letter Ruling 201544002 ruled that Code § 1014 provided a basis step-up when one of the nonresident alien grantors of a joint revocable trust died:

> In this case, Trust provides that during the joint lifetimes of both Settlors the trustee is to distribute to the Deceased Spouse as much income or principal from the community property or from the Deceased Spouse's separate property as the Deceased Spouse directs. The Deceased Spouse has also reserved the right to revoke Trust with respect to community property and with respect to the Deceased Spouse's separate property at any time prior to the death of the Deceased Spouse. The Deceased Spouse's separate property and the community property are within the description of property acquired from a decedent under § 1014(b)(2). Accordingly, based solely upon the information submitted and the representations made, we conclude that upon the death of the Deceased Spouse, the Surviving Spouse will be considered as acquiring the Deceased Spouse's separate property under § 1014(b)(2) and will receive a step-up (or step-down) in basis of the Deceased Spouse's separate property equal to the fair market value of the assets as of the date of death of the Deceased Spouse. We also conclude that upon the death of the Deceased Spouse, the Surviving Spouse will be considered as acquiring the Deceased Spouse's one-half share of all community property that is part of Trust assets under § 1014(b)(2) and will receive a step-up (or step-down) in basis of the Deceased Spouse's one-half share of all community property that is part of Trust assets equal to the fair market value of the assets as of the date of death of the Deceased Spouse.

That was based on the below, which "by joint lifetimes" in Section 3.1 presumably meant while both were alive, given that Section 3.3 provided constraints on the surviving spouse:

> Section 3.1 provides, in relevant part, that during the joint lifetimes of Settlors, either Husband or Wife may revoke Trust in whole or in part with respect to community property and with respect to separate property, if any, contributed by the revoking Settlor. Revocation is to be made by written instrument delivered to the trustee and the other settlor.

> Section 3.3 provides, in relevant part, that after the death of the Deceased Spouse, the Surviving Spouse, while competent, may amend or revoke the Survivor's Trust in part or in whole, but only with the written consent of any two Individuals who are then living and competent as well as a Subordinate Party as defined in § 672(c). Any amendment or revocation pursuant to this section is to be effected by a written instrument signed by Surviving Spouse and the Subordinate Party and delivered to the trustee. Individuals are related to Husband and Wife.

However, when the surviving spouse dies:

> In this case, under section 2.4.2.1 of Trust, Surviving Spouse has a general power of appointment over the property in Survivor's Trust, exercisable by will. Accordingly, based upon the information submitted and the representations made, we conclude that the property in the Survivor's Trust fits within the description of property acquired from a decedent under § 1014(b)(4 Thus, to the extent that Surviving Spouse exercises the general power of appointment by will, upon the death of the Surviving Spouse, all of the assets owned by the Survivor's Trust will receive a step-up (or step-down) in basis pursuant to § 1014(b)(4) equal to the fair market value of the assets as of the date of death of the Surviving Spouse.

The Survivor's Trust was described as:

> Section 2.4.1.1 provides that during the lifetime of the Surviving Spouse, upon request from the Surviving Spouse, the trustee is to distribute to the Surviving Spouse an amount up to the entire net income of the Survivor's Trust.
>
> Section 2.4.2 provides, in relevant part, that on the death of the Surviving Spouse, the trustee is to consider selling any interest held directly or indirectly in any yachts, planes, boats, or real property (excluding real property described in Section 2.4.2.4 if applicable). The trustee is to distribute the Survivor's Trust as follows:
>
> Section 2.4.2.1 provides that the Surviving Spouse is to have the power to appoint the balance of the Survivor's Trust to any one or more of the creditors of the Surviving Spouse's estate (excluding any taxing authority) by a will specifically exercising this power of appointment. The trustee is to distribute the balance of the Survivor's Trust as appointed by the Surviving Spouse, to the extent this power of appointment is exercised. In addition, the trustee is to distribute the balance of the Survivor's Trust not effectively appointed pursuant to this section.

On the other hand, CCA 200937028 held:

> We strongly disagree with taxpayer's contention. In this case, the taxpayer transferred assets into a trust and reserved the power to substitute assets.
>
> Section 1014(b)(1)-(10) describes the circumstances under which property is treated as having been acquired from the decedent for purposes of the section 1014 step-up basis rule. Since the decedent transferred the property into trust, section 1014(b)(1) does not apply. Sections 1014(b)(2) and (b)(3) apply to transfers in trust, but do not apply here, because the decedent did not reserve the right to revoke or amend the trust. None of the other provisions appear to apply at all in this case.

> Quoting from section 1.1014-1(a) of the Regulations: "The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death.... Property acquired from the decedent includes, principally,... property required to be included in determining the value of the decedent's gross estate under any provision of the [Internal Revenue Code.]"
>
> Based on my reading of the statute and the regulations, it would seem that the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to section 1014, unless the property is included in the gross estate for federal estate tax purposes as per section 1014(b)(9).

A generation-skipping transfer (GST) might generate a new basis as well. If property is transferred in a taxable termination[1985] which occurs at the same time as and as a result of the death of an individual, the basis of property not protected by the allocation of GST exemption is adjusted in a manner similar to the manner provided under Code § 1014(a).[1986] For any other GST, the transferred property's basis is increased (but not above the fair market value of such property) by an amount equal to that portion of the GST tax imposed with respect to the transfer which is attributable to the excess of the fair market value of such property over its adjusted basis immediately before the transfer.[1987] This basis adjustment is applied after any Code § 1015 basis adjustment with respect to the transfer.[1988]

A taxable termination providing a basis step-up creates some powerful estate planning possibilities when the beneficiary's estate, outside of the trust, is significantly above the estate tax exemption. Not granting the beneficiary a (perhaps contingent) general power of appointment might save state estate tax (if any) and opens the door for "generation jumping." For an example of generation jumping, suppose Mom leaves a trust for Daughter that is not protected by Mom's GST exemption, Daughter has a large estate of her own, and Daughter has a nongeneral power of appointment. Daughter might choose to leave part or all of the trust to her own grandchildren or more remote descendants at Daughter's death. To the extent Daughter does that, the property incurs only one level of transfer tax even though it passed two or more generations below Daughter. Although the property is not included in Daughter's estate, it receives a new basis by reason of Daughter's death. Daughter would also have the option to direct property to her siblings or other nonskip persons, free from transfer tax but without a new basis. The main disadvantage to exposing property to GST tax instead of estate tax is that, although Code § 6166 allows deferral of estate tax on certain business interests,[1989] that deferral does not apply to GST tax. Also, the Code § 2013 credit for tax on prior transfers does not provide relief from GST tax.[1990] Giving a married beneficiary a general power of

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[1985] "Taxable termination" means the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust unless immediately after such termination, a non-skip person has an interest in such property, or at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person. Code § 2612.
[1986] Code § 2654(a)(2).
[1987] Code § 2654(a)(1).
[1988] Code § 2654(a)(1).
[1989] See part III.B.5.e.ii Code § 6166 Deferral.
[1990] Harrington, Plaine & Zaritsky, ¶ 3.06[2] No Credit for Property Previously Taxed, *Generation-Skipping Transfer Tax* (WG&L).

appointment permits a free basis step-up, but using a nongeneral power of appointment provides other benefits that one would carefully weigh.[1991]

A property's value used to determine federal estate tax when its owner dies is presumed to be the basis under Code § 1014, which presumption may be rebutted by clear and convincing evidence.[1992] However, Code § 1014 basis may not exceed the final value that has been determined for estate tax purposes,[1993] or, if not finally determined, the value shown on a statement has been furnished under Code § 6035(a) identifying the value of such property.[1994] This limitation applies only to property whose inclusion in the decedent's estate increased estate tax liability.[1995]

The cleansing effect of a basis step-up at death is a powerful planning tool. See Rev. Rul. 73-183 (no gain or loss is recognized on the decedent's final income tax return as a result of the transfer of stock – that received a basis adjustment on Code § 1014 upon death - to the executor of the decedent's estate), reasoning:

> The explanation for section 641 of the Code, relating to the imposition of tax with respect to the income of estates and trusts, as shown in Senate Report No. 1622, Eighty-third Congress, Second Session, at page 340, contains the following statement:
>
>> The mere passing of property to an executor or administrator on the death of the decedent does not constitute a taxable realization of income even though the property may have appreciated in value since the decedent acquired it.
>>
>> The transfer of the stock of the deceased taxpayer to the executor of his estate did not result in a sale or other disposition of such stock within the meaning of section 1001(a) of the Code.
>
> Accordingly, it is held in the instant case that no loss is recognized on the decedent's final income tax return as a result of the transfer of the stock to the executor of the

[1991] If the beneficiary has a general power of appointment, then estate tax is avoided at the beneficiary's death (when keeping the property in the family) only when the spouse receives a marital deduction bequest, which at a minimum entails giving the surviving spouse all of the income. If the beneficiary has a nongeneral power of appointment that includes the child's surviving spouse as an eligible appointee, the child can make the surviving spouse's interest in trust income discretionary, shift income to children and grandchildren at their presumably lower rates, make medical and tuition payments for grandchildren and other skip persons that are excluded from GST tax, and include various flexibility and protections, while still deferring GST tax on the trust property until the child's surviving spouse's death.
[1992] Rev. Rul. 54-97. This ruling has been followed, distinguished, or questioned in a variety of cases. For a discussion of any duty of consistency, see *Van Alen v. Commissioner*, T.C. Memo. 2013-235.
[1993] Code § 1014(f)(1)(A). Code § 1014(f)(3) provides that basis of property has been determined for estate tax purposes if:

(A) the value of such property is shown on a return under section 6018 and such value is not contested by the Secretary before the expiration of the time for assessing a tax under chapter 11,

(B) in a case not described in subparagraph (A), the value is specified by the Secretary and such value is not timely contested by the executor of the estate, or

(C) the value is determined by a court or pursuant to a settlement agreement with the Secretary.

[1994] Code § 1014(f)(1)(B). Code § 6035(a) requires a statement by the executor (or, under Code § 6018(b), a beneficiary, if the executor if unable to make a complete return) of an estate required to file an estate tax return.
[1995] Code § 1014(f)(2).

decedent's estate when such stock has an adjusted basis in excess of its fair market value at the date of the decedent's death. It is held further that if the fair market value of the stock at the date of the decedent's death was in excess of the adjusted basis of the stock, no gain is recognized on the decedent's final income tax return as a result of the transfer of such stock to the executor of the decedent's estate. For the treatment of a dealer in securities who regularly inventories such securities, see section 471 of the Code and the regulations thereunder.

For a discussion of the basis an owner has in an entity (outside basis) contrasted with the basis the entity has in the assets the entity owns (inside basis),[1996] see parts II.Q.8.e.iii.(a) Illustration of Inside Basis Issue and II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss), the latter including a discussion on whether a basis increase by reason of gift tax paid generates a basis step-up.[1997]

For estate planning and income tax considerations when drafting bequests of a partnership or S corporation, see parts II.O.2 Spousal Issues in Buy-Sell Agreements and Related Tax Implications, III.A.3.c.iii Deadlines for QSST and ESBT Elections, and III.A.3.e.i.(b) QSST Issues When Beneficiary Dies.

For a variety of strategies relating to basis step-up, see Bramwell & Madden, "Toggling Gross Estate Inclusion On and Off: A Powerful Strategy," *Estate Planning Journal* (3/2017), which describes strategies relevant to parts:

- II.H.2.c QTIP Trusts - Code § 2519 Trap
- III.C Code § 2036
- III.D Code § 2038.

II.H.2.a. Free Basis Step-Up When First Spouse Dies

When the first spouse dies, assets included in the first spouse's estate for estate tax purposes generate a new tax basis,[1998] but the marital deduction can be used to avoid any estate tax at that time.[1999] Using a QTIP trust (a special type of marital deduction trust)[2000] allows the

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[1996] A discussion suitable for clients is in my blog, "Tax basis: The key to reducing gain on sale or deducting asset purchases," at http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions/post/2017-01-10/tax-basis-the-key-to-reducing-gain-on-sale-or-deducting-asset-purchases.

[1997] This discussion is in fn. 5669.

[1998] Code § 1014(b)(9).

[1999] Code § 2056.

[2000] Code § 2056(b)(7)(B) provides:

Qualified terminable interest property defined. For purposes of this paragraph-

(i) *In general*. The term "qualified terminable interest property" means property-
  (I) which passes from the decedent,
  (II) in which the surviving spouse has a qualifying income interest for life, and
  (III) to which an election under this paragraph applies.

(ii) *Qualifying income interest for life*. The surviving spouse has a qualifying income interest for life if-
  (I) the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property, and

executor[2001] to choose to keep all of the trust outside of the surviving spouse's estate for estate tax purposes, include all of the trust inside the estate tax system at the surviving spouse's death, or a combination.[2002] The executor makes the election on "the last estate tax return filed by the executor on or before the due date of the return, including extensions or, if a timely return is not filed, the first estate tax return filed by the executor after the due date,"[2003] the latter suggesting that a surviving spouse might want to avoid filing an estate tax return until the surviving spouse has a better idea of whether estate tax inclusion or basis step-up would be more beneficial – even to the point of filing a late return many years after the first spouse's death. (This ability to make a late-filed QTIP election applies for estate tax purposes but not for gift tax purposes.)[2004] Some people had expressed concern that the IRS might use Rev.

> (II) no person has a power to appoint any part of the property to any person other than the surviving spouse.
>
> Subclause (II) shall not apply to a power exercisable only at or after the death of the surviving spouse. To the extent provided in regulations, an annuity shall be treated in a manner similar to an income interest in property (regardless of whether the property from which the annuity is payable can be separately identified).

Letter Ruling 8943005 approves of giving the surviving spouse an inter vivos power of appointment that the surviving spouse can exercise in favor of others, notwithstanding Code § 2056(b)(7)(B)(ii)(II).

[2001] Reg. § 20.2056(b)-7(b)(3).

[2002] Reg. § 20.2056(b)-7(b)(2) provides:

> Property for which an election may be made.
>
> (i) *In general*. The election may relate to all or any part of property that meets the requirements of section 2056(b)(7)(B)(i), provided that any partial election must be made with respect to a fractional or percentage share of the property so that the elective portion reflects its proportionate share of the increase or decrease in value of the entire property for purposes of applying sections 2044 or 2519. The fraction or percentage may be defined by formula.
>
> (ii) *Division of trusts*.
>
> (A) *In general*. A trust may be divided into separate trusts to reflect a partial election that has been made, or is to be made, if authorized under the governing instrument or otherwise permissible under local law. Any such division must be accomplished no later than the end of the period of estate administration. If, at the time of the filing of the estate tax return, the trust has not yet been divided, the intent to divide the trust must be unequivocally signified on the estate tax return.
>
> (B) *Manner of dividing and funding trust*. The division of the trust must be done on a fractional or percentage basis to reflect the partial election. However, the separate trusts do not have to be funded with a pro rata portion of each asset held by the undivided trust.
>
> (C) *Local law*. A trust may be divided only if the fiduciary is required, either by applicable local law or by the express or implied provisions of the governing instrument, to divide the trust on the basis of the fair market value of the assets of the trust at the time of the division.

[2003] Reg. § 20.2056(b)-7(b)(4)(i). However, if the estate tax return preparer put the QTIP trust on the wrong part of Schedule M, classifying it as marital deduction property not subject to a QTIP election, then the IRS might allow a supplemental estate tax return to correct that mistake. Letter Rulings 201714020, 202001012, 202229028, and 202337002 (accountant incorrectly reported property as passing outright). Letter Ruling 201943010 provided an extension of time to file a QTIP election on the first spouse's late-filed estate tax return after the surviving spouse had died and appeared to be filed solely to get a basis step-up upon the surviving spouse's death; for more details, see fn 2005.

[2004] Letter Ruling 201109012, retroactively revoking Letter Ruling 201025021:

> The time for filing the inter vivos QTIP election is expressly prescribed by § 2523(f)(4). Because § 301.9100-3 is applicable only to requests for extensions of time fixed by regulations or other published guidance, the Service does not have the discretion to grant an extension of time under § 301.9100-3 to make the QTIP election under § 2523(f)(4) for the Year 1 transfer to Trust.

Proc. 2001-38, which had allowed taxpayers to undo certain unnecessary QTIP elections made by mistake, to undo a QTIP election that the taxpayer did not need to save estate tax but is using to achieve a basis step-up. However, Rev. Proc. 2016-49 revoked Rev. Proc. 2001-38 and provided a new procedure that clearly avoids this concern. Letter Ruling 201943010 provided an extension of time to file a QTIP election on the first spouse's late-filed estate tax return after the surviving spouse had died and appeared to be filed solely to get a basis step-up upon the surviving spouse's death.[2005] Reg. § 20.2056(b)-7(c)(1) expressly allows a protective election, but it is only if you are unsure whether the property qualifies. Reg. § 20.2056(b)-7(b)(2)(i) expressly allows using a formula, which is what we use all the time if we want to use exemption on the first return but want to protect against the value being higher than we think or protect against assets we might not know about.

"Portability" allows the surviving spouse to use the first spouse's estate/gift tax exemption ("DSUE")[2006] but not the first spouse's GST exemption; to use the latter, use a QTIP marital deduction trust with a Code § 2652(a)(3) "reverse QTIP" election. Reverse QTIP planning is not an option if the surviving spouse has a general power of appointment; consider post-mortem tactics if the spouse has such a power.[2007] The executor of the estate of the first spouse to die might elect to take a marital deduction beyond that needed for estate tax purposes, so that the property will get a basis step-up at the surviving spouse's death without any estate tax being due, if the surviving spouse's taxable estate does not exceed the sum of the DSUE (if and to the extent not used) and the surviving spouse's estate tax exemption. A disadvantage of portability is keeping open until the surviving spouse's death the statute of limitations for determining the value of assets in the first spouse's estate to the extent that they determine the first spouse's unused exemption.[2008] Also, the surviving spouse would lose the DSUE if and to the extent the surviving spouse remarries, does not use the DSUE, and the new spouse predeceases the

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[2005] The facts were:

> In Year 1, Spouse received $x from the estate accounts. Spouse died on Date 3, in Year 2. Following Spouse's death, Executrix settled the administration of Decedent's estate and distributed the balance of the funds pursuant to the terms of Trust.
>
> Decedent's estate engaged legal counsel for the administration of Decedent's estate and Accountant for tax filings. Accountant recommended that Decedent's estate not file a Form 706, Federal Estate (and Generation-Skipping Transfer Tax) Return, because the estate did not exceed the filing threshold for Year 1 and did not wish to make a portability election under § 2010.
>
> Executrix requests an extension of time under § 301.9100-1 and § 301.9100-3 to make the QTIP election under § 2056(b)(7) to treat Marital Trust as QTIP property.

[2006] Code § 2010(c)(2)(B).

[2007] Letter Ruling 202152006 approved a reformation to insert the Rev. Rul. 95-58 safe harbor to allow a reverse-QTIP election to be made. For applying that safe harbor to avoid a general power of appointment, see fn. 6713 in part III.B.2.i.i Designing Trust Wholly Owned by Beneficiary from Inception. The safe harbor language in Letter Ruling 202152006 was requiring that:

> any person appointed to succeed any trustee that has been removed must be a corporation or financial institution; or an individual experienced in business, finance, or investments or who is an attorney experienced in the trust or tax fields and is "neither a 'related or subordinate to' such beneficiary" as those terms are defined in § 672(c).

[2008] Reg. § 20.2010-2(d) provides:

> *Authority to examine returns of decedent*. The IRS may examine returns of a decedent in determining the decedent's DSUE amount, regardless of whether the period of limitations on assessment has expired for that return. See § 20.2010-3(d) for additional rules relating to the IRS's authority to examine returns. See also section 7602 for the IRS's authority, when ascertaining the correctness of any return, to examine any returns that may be relevant or material to such inquiry.

surviving spouse;[2009] for strategy that may avoid that loss, see the end of part II.H.12.a Taxable Gifts of Property Included in the Donor's Estate.[2010] Later reductions in the estate tax exemption reduce the surviving spouse's estate tax exemption but do not affect the DSUE.[2011] Another possible disadvantage of portability might be loss of the state estate tax exemption of the first spouse to die, if and to the extent that the estate plan fails to use all of the first spouse's state estate tax exemption.[2012] Also, generally state death taxes do not apply portability.

Portability requires filing a timely estate tax return.[2013] However, this election is one for which the IRS may grant administrative relief.[2014] One might be able to filing an untimely request for an extension and get retroactive relief within 15 months after death, without obtaining a private letter ruling; however, for a period of time after the spring of 2016, relief without a private letter ruling was unlikely.[2015] Fortunately, Rev. Proc. 2017-34 provided an automatic extension for

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[2009] Code § 2010(c)(4)(B)(i).

[2010] Text accompanying fn 2256.

[2011] Reg. § 20.2010-1(c)(2), Examples (3) and (4).

[2012] A state death tax chart is at http://www.actec.org/resources/state-death-tax-chart. The executor files the estate tax return. Reg. § 20.2010-2(a)(6).

[2013] Code § 2010(c)(5)(A) provides, "No election may be made under this subparagraph if such return is filed after the time prescribed by law (including extensions) for filing such return."

[2014] Reg. § 20.2010-2(a)(1) provides:

> *Timely filing required*. An estate that elects portability will be considered, for purposes of subtitle B and subtitle F of the Internal Revenue Code (Code), to be required to file a return under section 6018(a). Accordingly, the due date of an estate tax return required to elect portability is nine months after the decedent's date of death or the last day of the period covered by an extension (if an extension of time for filing has been obtained). See §§ 20.6075-1 and 20.6081-1 for additional rules relating to the time for filing estate tax returns. An extension of time to elect portability under this paragraph (a) will not be granted under § 301.9100-3 of this chapter to an estate that is required to file an estate tax return under section 6018(a), as determined without regard to this paragraph (a). Such an extension, however, may be available under the procedures applicable under §§ 301.9100-1 and 301.9100-3 of this chapter to an estate that is not required to file a return under section 6018(a), as determined without regard to this paragraph (a).

Letter Ruling 201532002 allowed an extension where the sum of the gross estate and taxable gifts was less than the basic exclusion amount. No explanation for reasonable cause was listed – the ruling stated only, "The estate discovered its failure to elect portability after the due date for making the election." The ruling granted an extension until 120 days after the date of the ruling. The taxpayer sought the ruling in 2015. The IRS conditioned the relief, "If it is later determined that, based on the value of the gross estate and taking into account any taxable gifts, Decedent's estate is required to file an estate tax return pursuant to § 6018(a), the Commissioner is without authority under § 301.9100-3 to grant to Decedent's estate an extension of time to elect portability and the grant of the extension referred to in this letter is deemed null and void." Similar relief was granted in Letter Rulings 201535004 (same), 201626008 (same), 201706003 (same), 201706016 (same), and 201536002 (attorney who prepared timely filed estate tax return failed to make QTIP election; no condition based on size of estate).

[2015] Given that Reg. § 20.2010-2(a)(1) refers to Reg. § 20.6081-1, let's look at Reg. § 20.6081-1(c):

> *Extension for good cause shown*. In its discretion, the Internal Revenue Service may, upon the showing of good and sufficient cause, grant an extension of time to file the return required by section 6018 in certain situations. Such an extension may be granted to an estate that did not request an automatic extension of time to file Form 706 prior to the due date under paragraph (b) of this section, to an estate or person that is required to file forms other than Form 706, or to an executor who is abroad and is requesting an additional extension of time to file Form 706 beyond the 6-month automatic extension. Unless the executor is abroad, the extension of time may not be for more than 6 months beyond the filing date prescribed in section 6075(a). To obtain such an extension, Form 4768 must be filed in accordance with the procedures under paragraph (a) of

estates that were not required to file and did not file timely;[2016] the extension was until the later of January 2, 2018 or the second annual anniversary of the decedent's date of death.[2017] Rev. Proc. 2022-32 supersedes Rev. Proc. 2017-34. Rev. Proc. 2022-32, Section 3.01, "In General," provides:

> this section and must contain a detailed explanation of why it is impossible or impractical to file a reasonably complete return by the due date. Form 4768 should be filed sufficiently early to permit the Internal Revenue Service time to consider the matter and reply before what otherwise would be the due date of the return. Failure to file Form 4768 before that due date may indicate negligence and constitute sufficient cause for denial of the extension. If an estate did not request an automatic extension of time to file Form 706 under paragraph (b) of this section, Form 4768 must also contain an explanation showing good cause for not requesting the automatic extension.

Instructions for Form 4768 (Rev. August 2012), which have a spirit that seems more generous to the taxpayer than the tone of the regulation authorizing the extension, provide:

> **Extension for cause**. If you have not filed an application for an automatic extension for Form 706, and the time for filing such an application has passed, an extension of time to file may still be granted if good cause is shown. File Form 4768, along with explanations of why the automatic extension was not requested and why a complete return was not filed by the due date, as soon as possible.

They also say the following:

> We will contact you only if your request for extension of time to file is denied. Keep a copy of the form for your records.

Consider obtaining a transcript or other verification that the extension was approved.

An attorney reported to me filing a late Form 4768 on March 31, 2016 and on April 19, 2016 receiving a denial of the extension, with the explanation, "An error made by the office of your attorney in determining and meeting the due date of Form 4768 is not exercising ordinary business care and prudence standards." When called, the IRS responded that the denial could be appealed or they should obtain a private letter ruling. The attorney opted for the latter and received one in early October 2016, and the estate qualified for a reduced filing fee ($6,500).

[2016] Section 3.02 denies relief to timely filed returns. A governmental official pointed out that any untimely filed return needs to be re-filed with an original signature to comply with this procedure; presumably this is required by Section 4.01(1).

[2017] Section 3.01 imposes the following requirements:

> (1) The decedent:
>   (a) was survived by a spouse;
>   (b) died after December 31, 2010; and
>   (c) was a citizen or resident of the United States on the date of death.
>
> (2) The executor is not required to file an estate tax return under § 6018(a) as determined based on the value of the gross estate and adjusted taxable gifts and without regard to the need to file for portability purposes;
>
> (3) The executor did not file an estate tax return within the time required by § 20.2010-2(a)(1) for filing an estate tax return; and
>
> (4) The executor satisfies all requirements of section 4.01 of this revenue procedure.

Section 4.01 imposes the following requirements:

> (1) A person permitted to make the election on behalf of the estate of a decedent—that is, an executor described in § 20.2010-2(a)(6)—must file a complete and properly prepared Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, on or before the later of January 2, 2018, or the second annual anniversary of the decedent's date of death. The Form 706 will be considered complete and properly prepared if it is prepared in accordance with § 20.2010-2(a)(7).
>
> (2) The executor filing the Form 706 on behalf of the decedent's estate must state at the top of the Form 706 that the return is "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)."

The simplified method of this revenue procedure is available to the executor (either an appointed executor or, if none, a non-appointed executor, as provided in § 20.2010-2(a)(6)) of the estate of a decedent if:

(1) The decedent:

(a) was survived by a spouse;

(b) died after December 31, 2010; and

(c) was a citizen or resident of the United States on the date of death.

(2) The executor is not required to file an estate tax return under § 6018(a) as determined based on the value of the gross estate and adjusted taxable gifts and without regard to the need to file for portability purposes;

(3) The executor did not file an estate tax return within the time required by § 20.2010-2(a)(1) for filing an estate tax return; and

(4) The executor satisfies all requirements of section 4.01 of this revenue procedure.

Rev. Proc. 2022-32, Section 4.01, "Requirements for Relief," provides:

The requirements for relief under this revenue procedure are as follows:

(1) A person permitted to make the election on behalf of the estate of a decedent - that is, an executor described in § 20.2010-2(a)(6)--must file a complete and properly prepared Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, on or before the fifth annual anniversary of the decedent's date of death. The Form 706 will be considered complete and properly prepared if it is prepared in accordance with § 20.2010-2(a)(7).

(2) The executor filing the Form 706 on behalf of the decedent's estate must state at the top of the Form 706 that the return is "FILED PURSUANT TO REV. PROC. 2022-32 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)."

Rev. Proc. 2022-32 "is not available to the estate of a decedent whose executor filed an estate tax return within the time prescribed by § 20.2010-2(a)(1)."[2018] It also "is not available to an estate that is required to file an estate tax return under § 6018(a) (as determined based on the value of the gross estate and adjusted taxable gifts);"[2019] if, after receiving relief, it is later determined that the estate was ineligible "based on the value of the gross estate and taking into account any taxable gifts, … the grant of an extension as provided in section 4.02 of this revenue procedure is deemed null and void *ab initio*."[2020] If the estate is not disqualified for either of these reasons but simply does not qualify for Rev. Proc. 2022-32 relief, the estate

[2018] Section 3.02, which explains:

Such an executor either will have elected portability of the DSUE amount by timely filing that estate tax return or will have affirmatively opted out of portability in accordance with § 20.2010-2(a)(3)(i).

[2019] Section 3.03 explains, "As set forth in § 20.2010-2(a)(1), an extension of time to elect portability under § 301.9100-3, including through the simplified method of this revenue procedure, is not available … because, in that case, the due date of the election is prescribed by statute and not by regulation."

[2020] Section 4.03.

nevertheless "may request an extension of time to make the portability election under § 2010(c)(5)(A) by requesting a letter ruling under the provisions of § 301.9100-3."[2021]

Rev. Proc. 2022-32, Section 5 describes the impact of relief on surviving spouse.

One might also be able to obtain automatic administrative relief within six months after the original due date if one discovers that one inadvertently opted out of portability.[2022]

An estate that is not required to file an estate tax return has reduced reporting requirements regarding marital or charitable deduction property.[2023] For such property, the return is "required to report only the description, ownership, and/or beneficiary of such property, along with all other information necessary to establish the right of the estate to the" marital or charitable deduction,[2024] so long as the "the executor exercises due diligence to estimate the fair market value of the gross estate, including the property" subject to the reduced reporting requirements.[2025] The executor should include evidence that either that particular property[2026] or

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[2021] Section 3.04 directs the executor to Rev. Proc. 2022-1 or any successor revenue procedure. Letter Ruling 202351010 granted relief for an estate below the filing threshold without the ruling explaining why the estate was late, with the usual caveat:

> If it is later determined that, based on the value of the gross estate and taking into account any taxable gifts, Decedent's estate is required to file an estate tax return pursuant to § 6018(a), the Commissioner is without authority under § 301.9100-3 to grant an extension of time to elect portability and the grant of the extension referred to in this letter is deemed null and void. *See* § 20.2010-2(a)(1).

[2022] Reg. § 301.9100-2(b).

[2023] Reg. § 20.2010-2(a)(7)(ii)(A), referring to property the value of which is deductible under Code § 2056, 2056A, or 2055(a).

[2024] Reg. § 20.2010-2(a)(7)(ii)(A), referring to "§§ 20.2056(a)-1(b)(i) through (iii) and 20.2055-1(c), as applicable."

[2025] Reg. § 20.2010-2(a)(7)(ii)(B) provides:

> *Return requirements when reporting of value not required for certain property*.
> Paragraph (a)(7)(ii)(A) of this section applies only if the executor exercises due diligence to estimate the fair market value of the gross estate, including the property described in paragraph (a)(7)(ii)(A) of this section. Using the executor's best estimate of the value of properties to which paragraph (a)(7)(ii)(A) of this section applies, the executor must report on the estate tax return, under penalties of perjury, the amount corresponding to the particular range within which falls the executor's best estimate of the total gross estate, in accordance with the Instructions for Form 706.

[2026] Reg. § 20.2010-2(a)(7)(ii)(C), Example (1), provides:

> (i) *Facts*. The assets includible in H's gross estate consist of a parcel of real property and bank accounts held jointly with W with rights of survivorship, a life insurance policy payable to W, and a survivor annuity payable to W for her life. H made no taxable gifts during his lifetime.
>
> (ii) *Application*. E files an estate tax return on which these assets are identified on the proper schedule, but E provides no information on the return with regard to the date of death value of these assets in accordance with paragraph (a)(7)(ii)(A) of this section. To establish the estate's entitlement to the marital deduction in accordance with § 20.2056(a)-1(b) (except with regard to establishing the value of the property) and the instructions for the estate tax return, E includes with the estate tax return evidence to verify the title of each jointly held asset, to confirm that W is the sole beneficiary of both the life insurance policy and the survivor annuity, and to verify that the annuity is exclusively for W's life. Finally, E reports on the estate return E's best estimate, determined by exercising due diligence, of the fair market value of the gross estate in accordance with paragraph (a)(7)(ii)(B) of this section. The estate tax return is considered complete and properly prepared and E has elected portability.

the entire residue[2027] passes to the surviving spouse. However, that reduced reporting rule does not apply to marital or charitable deduction property if:[2028]

(1) The value of such property relates to, affects, or is needed to determine, the value passing from the decedent to a recipient other than the recipient of the marital or charitable deduction property;

(2) The value of such property is needed to determine the estate's eligibility for the provisions of sections 2032, 2032A, or another estate or generation-skipping transfer tax provision of the Code for which the value of such property or the value of the gross estate or adjusted gross estate must be known (not including section 1014 of the Code);

(3) Less than the entire value of an interest in property includible in the decedent's gross estate is marital deduction property or charitable deduction property; or

(4) A partial disclaimer or partial qualified terminable interest property (QTIP) election is made with respect to a bequest, devise, or transfer of property includible in the gross estate, part of which is marital deduction property or charitable deduction property.

For example, if half of the residue passes to marital deduction trust and half passes to a nonmarital trust, the residue is not eligible for the reduced reporting requirements.[2029] Thus, a formula bequest to marital deduction and nonmarital trusts would not qualify for portability. However, a one-lung plan – described below – would be eligible.

I quite often draft estate plans where the entire residue goes into a trust for the surviving spouse that is eligible for the QTIP election – sometimes called a one-lung plan. For a number of reasons, this type of plan provides significant flexibility. Extra caution is required, however, when a surviving spouse who has estate planning goals that might not necessarily be consistent

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[2027] Reg. § 20.2010-2(a)(7)(ii)(C), Example (2), provides:

(i) *Facts*. H's will, duly admitted to probate and not subject to any proceeding to challenge its validity, provides that H's entire estate is to be distributed outright to W. The non-probate assets includible in H's gross estate consist of a life insurance policy payable to H's children from a prior marriage, and H's individual retirement account (IRA) payable to W. H made no taxable gifts during his lifetime.

(ii) *Application*. E files an estate tax return on which all of the assets includible in the gross estate are identified on the proper schedule. In the case of the probate assets and the IRA, no information is provided with regard to date of death value in accordance with paragraph (a)(7)(ii)(A) of this section. However, E attaches a copy of H's will and describes each such asset and its ownership to establish the estate's entitlement to the marital deduction in accordance with the instructions for the estate tax return and § 20.2056(a)-1(b) (except with regard to establishing the value of the property). In the case of the life insurance policy payable to H's children, all of the regular return requirements, including reporting and establishing the fair market value of such asset, apply. Finally, E reports on the estate return E's best estimate, determined by exercising due diligence, of the fair market value of the gross estate in accordance with paragraph (a)(7)(ii)(B) of this section. The estate tax return is considered complete and properly prepared and E has elected portability.

[2028] Reg. § 20.2010-2(a)(7)(ii)(A).

[2029] Reg. § 20.2010-2(a)(7)(ii)(C), Example (3), reasoning:

The amount passing to the non-marital trust cannot be verified without knowledge of the full value of the property passing under the will. Therefore, the value of the property of the marital trust relates to or affects the value passing to the trust for W and the descendants of H and W.

with the first spouse's goals (for example, the surviving spouse is not a parent of the decedent's children). A trust for which a QTIP election is made is included in the surviving spouse's estate for estate tax purposes,[2030] and generally it pays estate tax equal to the excess of the amount due with inclusion over the amount due if the trust were not included in the surviving spouse's taxable estate.[2031] No law requires the surviving spouse to use the deceased spouse's estate/gift tax exemption to protect the QTIP trust's assets from estate tax. Sometimes, the first spouse to die might consider making any trust for the surviving spouse ineligible for the QTIP election to the extent that doing so will exhaust the first spouse's remaining estate/gift tax exemption; although these issues might be contractually addressed, contractual obligations might be impractical or impossible to enforce, even with excellent drafting. Situations of concern include:

- <u>Benign Neglect</u>. The surviving spouse has an estate – beyond the QTIP trust - that exceeds the surviving spouse's estate own gift/tax exemption. The first spouse's estate tax exemption will be used against the surviving spouse's bequest, leaving the QTIP with the requirement to pay estate tax.

- <u>Potentially Unfair Actions</u>. The surviving spouse uses all the first spouse's estate/gift tax exemption and the surviving spouse's estate tax exemption to make gifts to those the surviving spouse wishes to benefit. No estate/gift tax exemption remains to shelter the QTIP trust from estate tax.

Suppose, to protect against this situation, the executor decides not to make a QTIP election, but the estate has unused exemption. Is the executor required to file a return to elect portability? The Oklahoma Supreme Court affirmed a trial court's order compelling the executor to file a federal estate tax return and elect portability, notwithstanding a prenuptial agreement waiving inheritance rights (but not referring to portability).[2032]

II.H.2.b. Basis Step-Up for All Property When First Spouse Dies

Consider using community property or a marital estate trust.

II.H.2.b.i. Community Property

Community property receives a new basis for both spouse's halves when the first spouse dies.[2033] This rule applies whether the property is held as an individual or through a joint revocable trust that constitutes community property under applicable state law.[2034] Beware,

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[2030] Code § 2044.
[2031] Code § 2207A.
[2032] *Estate of Vose*, 2017 WL 167587, --- P.3d ---- (1/17/2017).
[2033] Code § 1014(b)(6).
[2034] Rev. Rul. 66-283, involving the following facts:

> H and W are husband and wife and domiciliaries of the State of California. Under California community property law a husband and wife may by agreement characterize their property as community or separate. Section 158 of the California Civil Code; *Mears v. Mears* (1960) 4 Cal. Rptr. 618; *Tomaier v. Tomaier* (1944) 146 P.2d 905. Under California law, community property may also be held by a trustee without losing its character as such. *Berniker v. Berniker* (1947) 182 P.2d 557. In 1958 H and W executed a revocable trust and transferred to it certain property held by them as community property under the laws of California. The trust instrument provides that the property transferred to the trust shall retain its character as community property. Under

however, that converting property to community property may subject it to both spouses' creditors.[2035]

If each spouse is treated as owning one-half of each asset held as community property, valuation discounts would reduce the new basis, relative to what it would have been had the property not been fractionalized.[2036] It has been suggested that, if state law or the trust

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> the terms of the trust, H and W, as long as both are alive, may at any time alter, amend or revoke the trust in whole or in part, provided that any part of the trust estate so withdrawn shall be transferred to H and W as community property. The net income from the trust is community property, and is to be paid to or applied for the benefit of the grantors.
>
> Upon the death of either H or W, the trust estate is to be divided into two equal shares, each to be held and administered as a separate trust. One share is to consist of the community interest of H, and the other of the community interest of W. During the lifetime of the survivor, the trustee is to pay to the survivor all of the net income from his or her share, and to pay to the survivor and another designated beneficiary the net income from the decedent's share. The trust consisting of the community interest of the decedent is to be irrevocable, but the trust consisting of the survivor's community interest may be altered, amended, or revoked by the survivor at any time.

It held:

> In this case, one-half of the value of the community interest in the property held in the revocable trust is includible under sections 2033, 2036(a)(1), and 2038(a)(1) of the Code in determining the value of the gross estate of the first spouse to die, because both spouses had retained for their lives the right to the income from the community property held in the trust and possessed at the date of the decedent spouse's death a power to alter, amend or revoke the trust. The property which represents the surviving spouse's one-half interest in the community property held in the revocable trust is considered under section 1014(b)(6) of the Code to have been acquired from or to have passed from the decedent and, accordingly, its basis is determined under the provisions of section 1014(a) of the Code.

[2035] See part III.B.5.e.iv.(a) Imposition of the Estate Tax Lien.

[2036] *Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982) (15% discount under California law; valuing separately was the issue – amount of discount was not challenged). In upholding the taxpayer's legal arguments that valuation discounts applied to each half, *Estate of Bright v. U.S.,* 658 F.2d 999 (5th Cir. 1981), held:

> First, the government argues that the property to be valued for estate tax purposes is an undivided one-half interest in the control block of 55% of the stock, and that the proper method of valuation would be to value the 55% control block, including a control premium, and then take one-half thereof. Both parties agree that the estate tax is an excise tax on the transfer of property at death, and that the property to be valued is the property which is actually transferred, as contrasted with the interest held by the decedent before death or the interest held by the legatee after death. *United States v. Land*, 303 F.2d 170 (5th Cir. 1962). See also *Ithaca Trust Co. v. United States*, 279 U.S. 151, 49 S.Ct. 291, 73 L.Ed. 647 (1929); *Edwards v. Slocum*, 264 U.S. 61, 44 S.Ct. 293, 68 L.Ed. 564 (1924); *Connecticut Bank and Trust Company v. United States*, 439 F.2d 931 (2nd Cir. 1971); *Walter v. United States*, 341 F.2d 182 (6th Cir. 1965); *Commissioner v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958). Both also agree that state law, Texas in this case, determines precisely what property is transferred. *Morgan v. Commissioner*, 309 U.S. 78, 60 S.Ct. 424, 84 L.Ed. 585 (1940); *Duncan v. United States*, 247 F.2d 845 (5th Cir. 1957). Both parties agree that, under Texas law, the stock at issue was the community property of Mr. and Mrs. Bright during her life, that Mrs. Bright's death dissolved the community, that upon death the community is divided equally, that each spouse can exercise testamentary disposition over only his or her own half of the community, and that "only the decedent's half is includable in his gross estate for federal tax purposes." *Commissioner v. Chase Manhattan Bank*, 259 F.2d at 239. Under Texas law, upon the division of the community at death, each spouse owns an undivided one-half interest in each item of community property. *Caddell v. Lufkin Land & Lumber Co.*, 255 S.W. 397 (Tex. Com. App., 1923).

agreement has adopted the aggregate theory of community property, one can argue that a partial interest discount does not apply.[2037] One might consider using a community property agreement to govern the rights of all community property, whether or not in trust, which property may include IRAs.[2038]

If residents of a community property state buy real property in that state using common law titling and under that state's law the property retains the community property character of the funds used to buy the property, the real property receives a new basis as to both halves; in that case, the property was titled as joint tenants with right of survivorship and received a basis equal to the property's full value (undiscounted for community property fractional interest).[2039] To avoid proof issues when that occurs,[2040] consider titling using a community property trust.

> In its brief the government argued that, because the interest to be valued was an undivided one-half interest in the full 55% control block, the proper method would be to value the whole, including its control premium, and then take one-half thereof to establish the value of the estate's undivided one-half interest. The estate points out that the government's argument overlooks the fact that the block of stock is subject to the right of partition under Texas law at the instance of either the surviving spouse or the estate of the deceased's spouse. Tex. Prob. Code Ann. § 385 (Vernon 1980). The government has not argued that partition would not be freely granted in a case involving fungible shares, such as this case. Thus, the estate has no means to prevent the conversion of its interest into shares representing a 27½% block, and we conclude that the estate's interest is the equivalent of a 27½% block of the stock. Accordingly, we reject the government's approach of valuing the 55% control block, with its control premium, and then taking one-half thereof. Accord *Estate of Lee v. Commissioner*, 69 T.C. 860 (1978).

The *Bright* dissent was troubled that the legal and not the factual valuation issues were addressed. The dissent portrayed the valuation discount as 50% for illiquidity and unmarketability of minority interest and 23% to take into account term loan agreements, guarantees and pledges that affect the stock's value, for a cumulative 73% discount.

[2037] It has been suggested that Alaska (Sec. 34.77.155), Arizona (ARS §§ 14-3916, 14-10816(22)), and Nevada have adopted the aggregate theory. It has been suggested that one read "The Modified Item Theory: An Alternative Method of Dividing Community Property Upon the Death of a Spouse," 28 Idaho L. Rev. 1047 (1991-1992), for an explanation of the item theory and aggregate theory. I invite readers to email me with citations or any other further information.

One California lawyer commented about California law:

> Technically is an item theory state, based on older case law. It was believed that two living spouses could affirmatively enter into a marital agreement opting out of item theory treatment and establishing different rules governing the division of community property at the first death.
>
> Probate Code § 100 was enacted in 1990 to confirm that this is allowed.
>
> Probate Code § 104.5 was enacted in 1999, which provides that a transfer of community property to revocable trust is presumed to be an agreement pursuant to § 100. The legislative history suggests that the agreement so presumed is that the aggregate theory applies to division, rather than the item theory; but the language in the statute is a little dodgy, stating, "an agreement, for purposes of § 100 …, that those assets retain their character in the aggregate for purposes of any division under the trust." If ability to divide using aggregate theory approach is desired (and who wouldn't want this), the best practice is to explicitly provide in trusts and Wills and not rely on § 104.5.

[2038] See Letter Ruling 199925033.

[2039] Rev. Rul. 87-98; *Estate of Wayne-Chi Young v. Commissioner*, 110 T.C. 297 (1998) (taxpayers failed in their attempt to characterize jointly held property as community property to obtain a discount for property passing to a noncitizen spouse).

[2040] Rev. Rul. 87-98, which ruled in favor of community property status, illustrated this issue:

If spouses owning community property move to a common law state, the property does not lose its community character; similarly, merely moving from a common law state to a community property state does not cause separate property to become community property.[2041]

> D and D's spouse S, residents of community property state X, purchased real property in X with community funds and took title as joint tenants with rights of survivorship. However, D and S later executed joint wills in which they declared the property to be a community asset.
>
> Although X is a community property state, under the laws of X, spouses may hold property in joint tenancy or other common law estate. Because the laws of X do not make specific provision for the coexistence of a common law estate and a community property interest, taking title in a common law estate raises the presumption that the spouses intended to terminate the community interest, effectively transmuting the property's character from community to separate. This presumption is overcome by evidence that the spouses intended for the property not to be transmuted to separate property, in such a case, the community nature of the property is preserved. Under the law of X, an express statement of such intent in joint wills precludes transmutation by reason of taking title in joint tenancy.

Rev. Rul. 87-98 deferred to the state law characterization.

[2041] *Quintana v. Ordono*, 195 So.2d 577 (Fla. App. 3rd D. 1967); Restatement (First) of Conflict of Laws § 290 (1934) ("Interests of one spouse in movables acquired by the other during the marriage are determined by the law of the domicil of the parties when the movables are acquired."); Restatement (Second) of Conflict of Laws § 259 Removal of Movables of Spouses to Another State (A marital property interest in a chattel, or right embodied in a document, which has been acquired by either or both of the spouses, is not affected by the mere removal of the chattel or document to a second state, whether or not this removal is accompanied by a change of domicil to the other state on the part of one or both of the spouses. The interest, however, may be affected by dealings with the chattel or document in the second state.") and Comments a and b thereto:

> a. *Rationale*. Considerations of fairness and convenience require that the spouses' marital property interests in a chattel or right embodied in a document should not be affected by the mere removal of the chattel or document to another state. Likewise these interests are not affected by a change of domicil to another state by one or both of the spouses. Similarly, an interest in a right not embodied in a document that was acquired by either or both of the spouses during the marriage is not affected by a subsequent change of domicil to another state by one or both of the spouses. The rule of this Section is an application of that of § 247.
>
> b. *Dealings with movable upon interests of spouses*. When a chattel or document is taken into a second state and is there exchanged for some other movable or immovable, the spouses acquire the same interests therein as they had in the original chattel or document. Thus, when a husband takes an automobile, which is his alone, from a separate property state to a community property state and then, having sold the automobile, uses the proceeds to purchase a truck, the truck will be the husband's separate property. On the other hand, if the husband had originally held the automobile in community with his wife and had exchanged it for a truck in a separate property state, the wife's interests in the truck would be the same as those she had previously had in the automobile.

Kingma, "Property Division at Divorce or Death for Married Couples Migrating Between Common Law and Community Property States," 35 ACTEC J. 74, 80 (Summer 2009), states:

> With respect to personal property acquired during marriage or coverture, courts held that the law of the marital domicile at the time the property was acquired governs the character of such property and related property rights.[56] Moving from a common law state to a community property state, or vice versa, does not change the character or interests in that property.[57] The Supreme Court of Ohio summarized this rule in Estate of Kessler:[58]
>
> > "It is generally recognized that the character of community property, even though it is personalty, does not change as to the nature of the holding, where the married couple remove themselves from a community-property state to a common-law state. The converse is

Generally, absent an agreement controlling their rights,[2042] whether property is separate property or community property depends on not where the couple was married but rather where they lived when the property was acquired.[2043] In a federal tax case, courts will look to what the governing property law says under local law without speculating whether a court might change its approach, absent a compelling showing that a court would change its approach.[2044]

Letter Ruling 202006002 held that property transferred to an incomplete gift nongrantor trust (ING) retained its community property status. Facts include:

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also true, that is, the character of property acquired in a common-law state is not altered merely by the removal of the couple to a community-property state."

[56] RESTATEMENT (SECOND) CONFLICT OF LAWS § 258 (1971); 15A Am. Jur. 2d *Community Property* §§ 16-18 (2008); A.M. Swarthout, ANNOTATION, CHANGE OF DOMICILE AS AFFECTING CHARACTER OF PROPERTY PREVIOUSLY ACQUIRED AS SEPARATE OR COMMUNITY PROPERTY, 14 A.L.R.3d 404 (2008). *See also* Estate of Crichton, 49 Misc.2d 405, 408-09 and 412-13, 267 N.Y.S.2d 706 (1966) (providing that when spouses have separate domiciles, conflict-of-law rules provide that the law of the state of domicile of the spouse who acquired the personal property controls as to the ownership of the property).

[57] RESTATEMENT (SECOND) CONFLICT OF LAWS § 259 (1971). However, marital property interests may be affected by subsequent dealings with such property in the second state. *Id.*

[58] Estate of Kessler, 177 Ohio St. 136, 138, 203 N.E.2d 221 (1964). For additional authorities regarding spouses migrating to a common law state from a community property state, *see* the treatises and case law cited in Rev. Rul. 72-443, 1972-2 C.B. 531.

[2042] *Estate of Charania v. Commissioner*, 133 T.C. 122 (2009), stated:

Although they resided in Belgium for 30 years, decedent and Mrs. Dhanani did not take the steps available under Belgian law to change their marital property regime, and there is no other evidence of their intention, before the date of death, to change the character of their property. The parties have not cited, and we have not found, any authorities that determine the nature of property without regard to intent, expressed or implied, according to the law applicable at the time of the marriage.

We conclude that under English law, applied pursuant to Belgian conflict of laws principles, all of the shares of Citigroup stock were property of decedent taxable in his estate.

[2043] *Estate of Charania v. Commissioner*, 608 F.3d 67 (1st Cir. 2010), stated:

The question of which jurisdiction's marital property regime should prevail after spouses have changed their domicile is a recurring one in conflict of laws analysis. In the United States, courts have tended to favor the doctrine of mutability. See, *e.g.*, *United States v. ITT Consumer Fin. Corp.*, 816 F.2d 487, 490 (9th Cir. 1987); *Saul v. His Creditors*, 5 Mart. (n.s.) 569 (La. 1827). The primary rationale undergirding this approach is that the jurisdiction in which a couple was domiciled at the time of the acquisition of property has the most significant interest in both the spouses and the property. See *Restatement (Second) of Conflict of Laws* § 258. In continental European countries, the doctrine of immutability is favored. See Dicey, Morris & Collins, *The Conflict of Laws* 1295 (14th ed. 2006); Friedrich K. Juenger, *Marital Property and the Conflict of Laws*, 81 Colum. L. Rev. 1061, 1061–62 (1981). Champions of the immutability doctrine tout its ease of administration and the desirability of applying a single marital property regime to the entire inventory of a couple's personal property. See, *e.g.*, Ernest G. Lorenzen, The French Rules of the Conflict of Laws, 38 Yale L.J. 165, 177 (1928); J. Thomas Oldham, What if the Beckhams Move to L.A. and Divorce?, 42 Fam. L.Q. 263, 264–65 (2008).

[2044] *Estate of Charania v. Commissioner*, 608 F.3d 67 (1st Cir. 2010), stated:

We do not presume to decide that England's highest court, if asked either to reexamine *De Nicols* or to apply it to somewhat different facts, would necessarily hold firm to the rule of immutability. That sort of prediction is beyond our proper purview. We are, however, bound to adhere to the rule of *De Nicols* absent a compelling showing that the English courts would scuttle that rule. No such showing has been made here.

> Grantors are married and reside in State 2, a community property state. Trust provides that all property transferred to Trust is community property. Moreover, any and all property transferred to Trust prior to the death of the first Grantor to die (the Predeceased Grantor) is and shall retain its character as community property…
>
> Any distribution from Trust to either Grantor prior to the death of the Predeceased Grantor will be a distribution of community property. Any distribution of income or principal from Trust to a beneficiary prior to the death of the Predeceased Grantor, whether made by the Power of Appointment Committee, the Trustee, or a Grantor's exercise of the powers retained by Grantors will be a distribution of community property.
>
> With respect to the lifetime powers of appointment retained by Grantors, prior to the death of the Predeceased Grantor, any such appointment by Grantor of the principal of Trust will be funded equally from each Grantor's share of community property. Each Grantor consents to all distributions by the other Grantor.

Letter Ruling 202006002 ruled:

> Accordingly, based on the facts submitted and the representations made, we conclude that the contribution of property to Trust by either Grantor is not a completed gift subject to federal gift tax. Any distribution from Trust to either Grantor prior to the death of the Predeceased Grantor is a distribution of community property. Any distribution from Trust to either Grantor is merely a return of each Grantor's property. Therefore, we conclude that any distribution of property from Trust by the Power of Appointment Committee to either Grantor will not be a completed gift subject to federal gift tax, by any member of the Power of Appointment Committee. Further, upon the Predeceased Grantor's death, the fair market value of the Predeceased Grantor's interest in Trust is includible in the Predeceased Grantor's gross estate for federal estate tax purposes. Moreover, upon the Surviving Grantor's death, the fair market value of the balance in Trust is includible in the Surviving Grantor's gross estate for federal estate tax purposes….
>
> Based upon the facts submitted and representations made, we conclude that any distribution of property by the Power of Appointment Committee from Trust to any beneficiary of Trust, other than Grantors, will not be a completed gift subject to federal gift tax, by any member of the Power of Appointment Committee. Further, we conclude that any distribution of property from Trust to a beneficiary other than Grantors will be a completed gift by Grantors. Trust provides that all distributions of the net income or principal prior to the death of the Predeceased Grantor, whether made by the Power of Appointment Committee, the Trustee or a Grantor's exercise of the powers retained by such Grantor, to a beneficiary is and shall be a distribution out of community property. Accordingly, distributions to beneficiaries, other than Grantors, will be gifts made one-half by each Grantor. Finally, we conclude that the powers held by the Power of Appointment Committee members are not general powers of appointment for purposes of § 2041(a)(2) and, accordingly, the possession of these powers by the Power of Appointment Committee members will not cause Trust property to be includible in any Committee member's gross estate under § 2041(a)(2)….
>
> Grantors are married and reside in State 2, a community property state. Trust provides that all transferred property to Trust is community property. Moreover, any and all property transferred to Trust prior to the death of the Predeceased Grantor shall be a distribution of community property. As concluded above, upon the death of each

> Grantor, his or her respective interest in Trust as either the Predeceased Grantor or the Surviving Grantor will be includible in his or her respective gross estate for federal estate tax purposes.
>
> Accordingly, based upon the facts submitted and representations made, we conclude that the basis of all community property in Trust on the date of death of the Predeceased Grantor will receive an adjustment in basis to the fair market value of such property at the date of death of the Predeceased Grantor.

II.H.2.b.ii. Marital Estate Trust

In a common law state, consider a marital estate trust.[2045] H creates a trust for W, with discretionary distributions to W. On W's death, the trust passes to W's estate. If H terminates the trust before W's death, the trust goes outright to W. The trust qualifies for the marital deduction because it cannot pass to anyone other than W.[2046] The gift is completed because the beneficiary is known with certainty.[2047] The trust is includible in H's estate under Code § 2038[2048] and in W's estate as an asset. Thus, it gets a new basis at the death of the first to go of H or W.[2049] Note, however, that a reverse-QTIP election[2050] would not be available to preserve H's GST exemption with respect to this trust.

To avoid probate delays, consider putting all of the trust's assets into one or more single-member, manager-managed LLCs. That way, the successor manager can step up and manage assets regardless of the timing of an executor/personal representative being appointed.

II.H.2.c. QTIP Trusts - Code § 2519 Trap

If the spouse makes a disposition of all or part of a qualifying income interest for life in a QTIP trust, he or she is treated gift and estate tax purposes as transferring all interests in property other than the qualifying income interest.[2051] Thus, the spouse is treated as making a gift under Code § 2519 of the entire trust less the qualifying income interest, and is treated for purposes of Code § 2036 "as having transferred the entire trust corpus, including that portion of the trust

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[2045] Handler and Dunn, "The Estate Trust Revival: Maximizing the Full Basis Step-Up for Spouses," *Trusts & Estates* (8/2001).
[2046] Reg. §§ 25.2523(b)-1(a)(2) (gift tax), 20.2056(b)-1(c)(1) (estate tax).
[2047] Reg. § 25.2511-2(d).
[2048] Reg. § 20.2038-1(a), which includes the following statement:

> For example, section 2038 is applicable to a power reserved by the grantor of a trust to accumulate income or distribute it to A, and to distribute corpus to A, even though the remainder is vested in A or his estate, and no other person has any beneficial interest in the trust.

Note that, because the income and principal are discretionary, the Code § 2038 power extends to both income and principal and the basis change is plenary. For more on Code § 2038, see part III.D Code § 2038.
Make the grantor's exercise of the power exercisable alone, to avoid the protection from Code § 2038 described in fn 7483 and the accompanying text in part III.D Code § 2038.
[2049] Reg. § 1.015-1(c) provides, "The date that the donee acquires an interest in property by gift is when the donor relinquishes dominion over the property and not necessarily when title to the property is acquired by the donee." Query whether the IRS might argue that H's authority to terminate the trust means that H continues to have dominion over the property, thereby triggering Code § 1014(e) on W's death, even though for gift tax purposes H has relinquished dominion and control.
Code § 1014(b)(3) is among the grounds for including it in H's estate.
[2050] Code § 2652(a)(3).
[2051] Code § 2519; Reg. § 25.2519-1(a).

corpus from which the retained income interest is payable."[2052] Bramwell and Madden, "Toggling Gross Estate Inclusion On and Off: A Powerful Strategy," *Estate Planning Journal* (3/2017),[2053] point out:

> To be sure, the surviving spouse is deemed to be the transferor of the QTIP property for estate tax purposes. Thus, if the surviving spouse is deemed to have retained (or, in the case of Section 2038, to have possessed at his or her death) any of the rights or powers described in Sections 2036 or 2038, the trust principal could be included in the surviving spouse's gross estate at death. With proper planning, however, it should be possible to avoid that result, if desired.
>
> To begin, it is well-established that a decedent's mere eligibility to receive distributions from an independent trustee, and nothing more, does not cause property transferred during lifetime to be included in the gross estate under Section 2036(a)(1) or 2038.[74] If the transferred property was subject to claims of the decedent's creditors, then the decedent is considered to have retained powers over the transferred property described in Sections 2036(a) and 2038.[75] But a transfer under Section 2519 is a deemed transfer purely for tax purposes; it is not a transfer at all for state law purposes, or a transfer in trust that might otherwise be void as against creditors. On the contrary, after a beneficiary of a QTIP trust assigns the right to income but retains a discretionary interest in principal, the spouse who created the trust remains the settlor of the trust for state law purposes.
>
> > [74] *Uhl*, 241 F.2d 867 50 A.F.T.R. 1746 (CA-7, 1957); *German*, 7 Ct. Cl. 341 55 A.F.T.R.2d 85-1577 (1985); Rev. Rul. 76-103, 1976-1 CB 293; Rev. Rul. 2004-64, 2004-2 CB 7; Ltr. Rul. 200944002.[2054]
> >
> > [75] Rev. Rul. 76-103, supra note 74; Ltr. Rul. 200944002.[2055]
>
> In other words, for tax purposes, although the surviving spouse is deemed to have transferred principal for his or her own benefit, the trust is not a self-settled trust for state law purposes and, therefore, cannot be void as against the creditors of the beneficiary spouse. Consequently, the beneficiary spouse may trigger a deemed transfer of principal under Section 2519, continue to hold a discretionary interest in principal, and have the principal protected against claims of the beneficiary's creditors under standard spendthrift provisions. Creditors' rights doctrine, therefore, does not cause the principal of the trust to be included in the spouse's gross estate under Section 2036(a)(1).
>
> Section 2036(a)(1) can also apply where there was an agreement, express or implied, that the decedent would retain the right to income or the beneficial enjoyment from the transferred property.[76] Thus, courts have found an implied understanding to exist and pulled transferred property back into a decedent's gross estate at death, where the decedent, although he or she did not retain any legal right to the property, was in actual

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[2052] Reg. § 25.2519-1(a).
[2053] Saved as Thompson Coburn LLP document no. 9993745.
[2054] [my footnote:] For *Uhl*, *German*, Rev. Rul. 76-103, and Letter Ruling 200944002, see part III.B.2.i.xi My Suggestion for Distribution Trustee – A Variation of Letter Ruling 201039010. Rev. Rul. 2004-64 is discussed in fns. 6961-6980, found in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner. Letter Ruling 200944002 is also discussed in part III.B.2.h.iii Swap Power.
[2055] See part III.B.2.c.i Completed Gift to Self-Settled Trust.

possession of, or was actually enjoying, the transferred property.[77] For a number of reasons, however, it seems that, in the case of a deemed transfer under Section 2519, it would be difficult for the IRS to establish that there was an implied understanding that the trustee would thereafter make discretionary principal distributions.

[76] Reg. 20.2036-1(c)(1)(i); see also Rev. Rul. 2004-64, supra note 74; Ltr. Rul. 200944002.[2056]

[77] *Linderme*, supra note 23;[2057] *Guynn*, 437 F.2d 1148 27 A.F.T.R.2d 71-1653b (CA-4, 1971);[2058] *Estate of Maxwell*, 3 F.3d 591 72 A.F.T.R.2d 93-6733 (CA-2, 1993);[2059] *Reichardt*, 114 TC 144 (2000);[2060] *Estate of Kerdolff*, 57 TC 643 (1972); *Paxton*, supra note 23.[2061]

For one thing, the transfer of principal under Section 2519 is purely notional. There is no actual transfer of property with respect to which an understanding, express or implied, regarding distributions could even arise. Indeed, the spouse may trigger a deemed transfer under Section 2519 without even communicating with the trustee. The deemed transfer could even occur at a time when no trustee authorized to make principal distributions is even serving. Thus, with proper planning, the risk of gross estate inclusion under Section 2036(a)(1), following a deemed transfer under Section 2519, seems to be minimal. Possibly, the spouse could receive even liberal distributions of principal without causing the QTIP trust property to be included in the spouse's gross estate at death.

In short, by incorporating toggling provisions, the couple can make it possible for the surviving spouse to be deemed to have made a taxable gift of QTIP property that, similar to the credit shelter trust, uses up the first decedent's exclusion. Just as with a credit shelter trust, the QTIP property, including appreciation after the date of the gift, should pass outside of the surviving spouse's gross estate at death. Meanwhile, the surviving spouse continues to be eligible to receive distributions of principal. The QTIP trust, after the deemed transfer under Section 2519 occurs, essentially functions like a credit shelter trust.

Toggling gross estate inclusion back on. Now suppose that, having triggered Section 2519 in order to cause QTIP trust property to pass outside of his or her gross estate, the surviving spouse decides that the trust property should be pulled back into his or her gross estate after all. For example, it may be that the combined value of the QTIP trust plus the surviving spouse's other assets is less than the surviving spouse's applicable exclusion amount (including the exclusion amount inherited from the first decedent). In that case, the surviving spouse's family may be better off obtaining a step-

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[2056] [my footnote] For the last two citations, see my fn 2054. Reg. § 20.2036-1(c)(1) is reproduced in the text accompanying fn 7473 in part III.C Code § 2036.
[2057] [my footnote] For more on *Estate of Linderme v. Commissioner*, see text accompanying fn 7466 in part III.C Code § 2036.
[2058] [my footnote] For more on *Guynn v. U.S.*, see text accompanying fn 7467 in part III.C Code § 2036.
[2059] [my footnote] The Tax Court opinion *Estate of Maxwell* is cited a couple of times in part III.B.1.a.i.(a) Loans Must be Bona Fide.
[2060] [my footnote] For more on *Estate of Reichardt v. Commissioner*, see text accompanying fn 7468 in part III.C Code § 2036.
[2061] [my footnote] For *Paxton*, see part III.B.2.i.xi My Suggestion for Distribution Trustee – A Variation of Letter Ruling 201039010.

up in basis under Section 1014(a). Another possible reason for preferring gross estate inclusion may be that, following the deemed gift under Section 2519, the value of the QTIP trust principal has declined in value. In that situation, it would be preferable, as discussed at the outset of this article, for the deemed gift to be purged from the estate tax base and for trust principal to be included in the surviving spouse's gross estate at its reduced value.[78]

> [78] It would seem that only the deemed gift of principal is purged from the estate tax base under Section 2001(b), but not the gift of income. The value of the gift of an income interest, however, may be discounted to reflect its possible divestment or curtailment, by virtue of the trustee's power to pay out principal. *Cf*. Rev. Rul. 75-550, supra note 70 (valuing an income interest at a discount to reflect all possible invasions of principal); see also Rev. Rul. 67-370, 1967-2 CB 324.[2062]

Thanks to the toggling provisions of the QTIP trust, it should be possible to turn gross estate inclusion back on. Specifically, the independent trustee can exercise a power to confer on the surviving spouse a special testamentary power of appointment. Such a power, once conferred, will cause the QTIP property to be pulled back into the surviving spouse's gross estate under Section 2038(a), as the surviving spouse is the deemed transferor of principal for estate tax purposes under Section 2519. As a result, the QTIP trust principal should be included in the surviving spouse's gross estate, the deemed Section 2519 gift should be eliminated from the transfer tax base under Section 2001(b), and the QTIP trust principal should qualify for a change in basis under Section 1014.[79]

> [79] There is some uncertainty as to whether a deemed transfer under Section 2519, followed by gross estate inclusion under one of the "string" sections of the Code, will successfully cause the property included in the gross estate to qualify for a change in basis under Section 1014(b)(9). For further discussion of this issue, see Bramwell and Socash, "Preserving Inherited Exemption: The New Planning Frontier," 50 *Real Property, Trust and Estate Law J.* 1 (Spring 2015).

Unique advantages of QTIP toggling. As discussed previously, there is some risk, with Section 2038 toggling planning, that the grantor will be deemed to hold Section 2038 powers de facto, in which case, gross estate inclusion would not be possible to avoid. But with a deemed Section 2519 transfer, the risk of the surviving spouse being treated as holding the trustee's powers is minimal, and perhaps even nonexistent. The reason, once again, is that a deemed Section 2519 transfer is purely notional. As noted above, the surviving spouse could trigger Section 2519, conceivably, without any prior communication with the independent trustee. Thus, there is little chance that the IRS would be able to infer some kind of prearrangement or informal understanding between the surviving spouse and the independent trustee.

Indeed, if anything, the opposite problem arises, namely, that the IRS will not respect the conferred special power of appointment as a valid gross estate inclusion trigger under Section 2038(a). As support for denying gross estate inclusion, the IRS could look to the decisions in cases holding that Section 2038 does not apply if the grantor made a complete disposition of his or her interest in property, and an otherwise taxable power later returned to the grantor in an unrelated transfer. In *Estate of Reed*,[80] for example,

[2062] [my footnote] Rev. Rul. 67-370 is excerpted in the text accompanying fn 6366 in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts.

the decedent had made a gift of shares to his daughter through a Uniform Gifts to Minors Act account; after the custodianship terminated, the daughter then reconveyed the property to the decedent as trustee for her benefit. The court held that Section 2038 did not apply, because the decedent made a complete disposition of property and the decedent happened to possess control over the property at death only "by a totally unrelated and fortuitous conveyance."[81]

[80] Note 40, *supra*.

[81] See also *Estate of Skifter*, 468 F.2d 699, 30 A.F.T.R.2d 72-5920 (CA-2, 1972); Rev. Rul. 84-179, 1984-2 CB 195.[2063]

Conceivably, on the strength of *Reed* and related cases, the IRS could argue that the independent trustee's decision to confer a special power of appointment on the surviving spouse is an "unrelated and fortuitous conveyance" that does not cause Section 2038 to apply, and so gross estate inclusion is not successfully toggled on. After all, the independent trustee's ability to confer a special power of appointment on the surviving spouse was not created by the surviving spouse herself but existed under the terms of a trust created by the first decedent. In this view, although the surviving spouse is deemed to be the transferor of the trust property for estate tax purposes under Section 2519, that is not enough for him or her to have set in motion the machinery that later caused the surviving spouse to have a special power of appointment at death.

As yet, it is unclear whether this argument will prevail. That said, it does seem to be contrary to the logic and intent of Section 2519. Following a disposition of a qualifying income interest for life in a QTIP trust, that section deems the spouse beneficiary to have made a transfer for all estate and gift tax purposes. Thus, if the surviving spouse retains the right to a portion of the income from the trust property, the property will be included in his or her gross estate under Section 2036(a)(1).[82] By the same logic, with QTIP toggling provisions, the surviving spouse should be deemed to have made a transfer, the terms of which make it possible for a special power to be conferred on him or her, thereby triggering Section 2038 should the special power in fact then be granted to the surviving spouse.

[82] Reg. 25.2519-2(g), Example 4.[2064]

QTIP toggling with GST tax planning. Another advantage of toggling planning with QTIP trusts is that it is compatible with GST tax planning. Specifically, the first decedent's executors may make a "reverse" QTIP election under Section 2652(a)(3) and allocate the first decedent's GST exemption to the trust. Even if the surviving spouse later toggles gross estate inclusion off by assigning the income interest, the first decedent will continue to be treated as the transferor of the QTIP principal for GST tax purposes.[83] Thus, the surviving spouse will not need to allocate any of his or her own GST exemption in order for the QTIP property to preserve its exemption from GST tax.

[2063] [my footnote] Both authorities are discussed in part II.Q.4.i.ii.(a) Trust Ownership of Policy.
[2064] [my footnote] The citation appears to be to Reg. § 25.2519-1(g), Example (4), which is reproduced below.

> [83] Reg. 26.2652-1(a)(3).[2065]
>
> In addition, although it is not certain, it seems that the first decedent rather than the surviving spouse should be considered the transferor for GST tax purposes of the income paid over to the donees of the income interest.[84] Thus, if the income interest is assigned to skip persons or to a trust for the benefit of skip persons, the income should be protected from GST tax by the first decedent's GST exemption. Even if the surviving spouse is considered the transferor of trust income for GST tax purposes, it seems that the value of the gift of the income interest would be small compared to the value of the QTIP trust as a whole. Consequently, very little of the surviving spouse's GST exemption should need to be allocated to the gift in order to protect it from GST tax.

See parts III.C Code § 2036 and III.D Code § 2038.

Reg. § 25.2519-1(g), Example (3), "Transfer of income interest in trust subject to partial election," provides:

> D's will established a trust valued for estate tax purposes at $500,000, all of the income of which is payable annually to S for life. After S's death, the principal of the trust is to be distributed to D's children. Assume that only 50 percent of the trust was treated as qualified terminable interest property. During 1995, S makes a gift of all of S's interest in the trust to D's children at which time the fair market value of the trust is $400,000 and the fair market value of S's life income interest in the trust is $100,000. Pursuant to section 2519, S makes a gift of $150,000 (the fair market value of the qualified terminable interest property, 50 percent of $400,000, less the $50,000 income interest in the qualified terminable interest property). S also makes a gift pursuant to section 2511 of $100,000 (*i.e.*, the fair market value of S's life income interest).

Reg. § 25.2519-1(g), Example (4), "Transfer of a portion of income interest in trust subject to a partial election," provides:

> The facts are the same as in Example 3 except that S makes a gift of only 40 percent of S's interest in the trust. Pursuant to section 2519, S makes a gift of $150,000 (i.e., the fair market value of the qualified terminable interest property, 50 percent of $400,000, less the $50,000 value of S's qualified income interest in the qualified terminable interest property). S also makes a gift pursuant to section 2511 of $40,000 (i.e., the fair market value of 40 percent of S's life income interest). See also section 2702 for additional rules that may affect the value of the total amount of S's gift under section 2519 to take into account the fact that S's 30 percent retained income interest attributable to the qualifying income interest is valued at zero under that section, thereby increasing the value of S's section 2519 gift to $180,000. In addition, under §25.2519-1(d), S's disposition of 40 percent of the income interest is deemed to be a transfer of a pro rata portion of the qualified terminable interest property. Thus, assuming no further lifetime dispositions by S, 30 percent (60 percent of 50 percent) of the trust property is included in S's gross estate under section 2036 and an adjustment is made to S's adjusted taxable gifts under section 2001(b)(1)(B). If S later disposes of all or a portion of the retained income interest, see § 25.2702-6.

[2065] [my footnote] Reg. § 26.2652-1(a)(3) is reproduced in the text accompanying fn 6405 in part III.B.1.d.iii Who Is the Transferor.

Code § 2702 applies in valuing the gift made by the spouse under Code § 2519.[2066] However, litigation might cause the transfer not to be a gift.[2067]

However, if a reverse QTIP election is made, the application of Code § 2519 would not change the trust's GST attributes.[2068]

Unless the spouse establishes to the contrary, Code § 2519 applies to the entire trust at the time of the disposition.[2069] One can avoid this result by dividing the trust, so that Code § 2519 applies only to the trust that was severed and is subject to that gift.[2070] To understand *Estate of Virginia V. Kite v. Commissioner*, T.C. Memo. 2013-43, a Code § 2519 case involving trust termination, one should read Steve Akers' summary.

A renunciation may be appropriate to preserve DSUE if the surviving spouse remarries or to preserve the surviving spouse's lifetime gift/estate tax exemption if it is scheduled to decrease. For advantages and disadvantages of these ideas, see part II.H.12.a Taxable Gifts of Property Included in the Donor's Estate.[2071]

The exercise by any person of a power to appoint property to the spouse is not treated as a disposition under Code § 2519, even though the spouse subsequently disposes of the appointed property.[2072] Thus, distributing the property to the spouse, free from trust, might be the only way to remove the future possible application of Code § 2519.

Rev. Rul. 98-8 held that, if a surviving spouse acquires the remainder interest in a QTIP trust by transferring property or cash to the holder of the remainder interest, the surviving spouse makes a gift equal to the greater of (i) the value of the remainder interest under Code § 2519), or (ii) the value of the property or cash transferred to the holder of the remainder interest under

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[2066] Reg. § 25.2519-1(a). Code § 2036 scenarios are discussed in Example (4) and Example (5) of Reg. § 25.2519-1(g).

[2067] FSA 199916025 described what happened when H, the surviving spouse, quarreled with S, the son of marriage to the deceased grantor:

> Although the inter vivos disposition of the qualifying income interest under section 2511 may be characterized as a transfer of property made in the ordinary course of business under Treas. Reg. § 25.2512-8, that does not affect the application of section 2519.
>
> The facts and documents provided indicate that there was animosity between H and S. Litigation was pending, pleadings were filed, temporary restraining orders were obtained, and negotiations ensued. Based on the facts presented, it appears that the transfers were free from donative intent, and the transfers may have been at arm's length and bona fide due to the acrimonious relationship. Without further factual development, we do not believe H made a gift of the qualifying income interest under section 2511 and express no opinion whether the terms of the marital trust satisfied the requirements of section 2056(b)(7)(B).

[2068] See text accompanying and following fn 6405 in part III.B.1.d.iii Who Is the Transferor.

[2069] Reg. § 25.2519-1(b).

[2070] See Letter Ruling 202116001 and 202146001 (divisions followed promptly by complete termination of spouse's interest; the latter was more thorough); see also Letter Ruling 201426016 and various others cited in Zaritsky, ¶ 6.03[3][g] Making Gifts from QTIP Funds, *Tax Planning for Family Wealth Transfers During Life: Analysis With Forms* (WG&L). See also Letter Ruling 201946009, in which a QTIP trust with a one inclusion ratio was divided and the spouse made a nonqualified disclaimer that accelerated the remaindermen. In Letter Ruling 201536010, the marital trust was divided, and the surviving spouse made a nonqualified disclaimer as a net gift that accelerated the remaindermen.

[2071] See text accompanying and following fn 2255.

[2072] Reg. § 25.2519-1(e).

Code §§ 2511 and 2512.[2073] Letter Ruling 199908033 asserted that the remaindermen's consent to terminating a QTIP trust such that the surviving spouse received all of the property without restriction, without receiving consideration for that consent, constitutes a gift of their remainder interest.

In a second marriage situation, note that any inter vivos gift by the surviving spouse would be detrimental to the surviving spouse, if the surviving spouse has a taxable estate. For example, suppose the estate and lifetime gift tax exemption is $5M, estate tax is 40%, the surviving spouse has a $5M estate of her own and a QTIP life estate in a $1M asset. Suppose the spouse considers buying the remaindermen's interest for its $400K actuarial value. If the surviving spouse had not done anything, the surviving spouse's taxable estate would have been $6M ($5M own assets pays $1M QTIP asset), generating a $400K estate tax (40% multiplied by the $1M excess of $6M estate over $5M exemption), all of which is payable out of the QTIP assets under Code § 2207A(a). If the surviving spouse buys the remaindermen's interest, then she is deemed to have made a $400K taxable gift (paying no gift tax because of her lifetime gift tax exemption)[2074] and has $5.6M assets remaining ($6M own assets plus $1M former QTIP assets minus $400K paid to remaindermen and her estate will have to pay the $400K estate tax (based on a $4.6M exemption after using up $400K of her exemption on the deemed gift, leaving her estate of $5.6M being $1M over her $4.6M exemption, which $1M excess is taxed at 40%). Thus, by buying the remainder, she has shifted $400K estate tax from the remaindermen to the beneficiaries of her estate. For income tax consequences, see part II.J.18.d Trust Commutations.

If avoiding Code § 2519 is important, one might also consider applying for relief under Rev. Proc. 2016-49 if the QTIP election was unnecessary.

II.H.2.d. Caution re: Depreciable Property Held in a Nongrantor Trust That Is Included in the Grantor's, Surviving Spouse's, or Other Beneficiary's Estate

Suppose property receives a basis adjustment because it is "acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate."[2075] If the property is acquired before the death of the decedent, that basis adjustment is reduced by the amount allowed to the taxpayer as deductions in computing taxable income for depreciation, amortization, depletion, etc. on such property before the decedent's death.[2076] Note that, if and to the extent that the trust is a grantor trust with respect to those deductions, the trust is not the taxpayer to whom the deductions are allocated, so this basis adjustment would not apply regarding those deductions.

I am uncertain how this rule might apply to marital deduction trusts when the surviving spouse dies. The property is eligible for a new basis.[2077] Presumably only the depreciation allocated to

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[2073] Rev. Rul. 98-8 is reproduced in the text accompanying fn 2978 in part II.J.18.d Trust Commutations.
[2074] If she had used up her gift tax exemption before the transaction, the remaindermen would have had to pay the gift tax. Code § 2207A(b).
[2075] Code § 1014(b)(9).
[2076] Code § 1014(b)(9). See Reg. § 1.1014-6.
[2077] Code § 1014(b)(10).

the remaindermen would be subject to this rule; that allocation occurs only if the trustee maintained a reserve for depreciation and the trust is not a grantor trust.[2078]

Reg. § 1.014-6(a)(1) provides (highlighting added):

> The basis of property described in section 1014(b)(9) which is acquired from a decedent prior to his death shall be adjusted for depreciation, obsolescence, amortization, and depletion allowed the taxpayer on such property for the period prior to the decedent's death.

Reg. § 1.014-6(c) provides (highlighting added):

> As stated in paragraph (a) of this section, section 1014(b)(9) requires a reduction in the uniform basis of property acquired from a decedent before his death for certain deductions allowed in respect of such property during the decedent's lifetime. In general, the amount of the reduction in basis required by section 1014(b)(9) shall be the aggregate of the deductions allowed in respect of the property, but shall not include deductions allowed in respect of the property to the decedent himself. In cases where, owing to the operation of the estate tax, only a part of the value of the entire property is included in the decedent's gross estate, the amount of the reduction required by section 1014(b)(9) shall be an amount which bears the same relation to the total of all deductions (described in paragraph (a) of this section) allowed in respect of the property as the value of the property included in the decedent's gross estate bears to the value of the entire property.

Reading both regulations together, if someone other than the decedent who death triggers the basis step-up is the deemed owner of a grantor trust, any reduction in basis from depreciation deductions allowed to the deemed owner would not be preserved by this rule (in other words, basis step-up eliminates the related accumulated depreciation).

II.H.2.e. IRD Assets Not Eligible for a Basis Step-Up

Property which constitutes a right to receive an item of income in respect of a decedent (IRD) under Code § 691 does not receive a basis step-up.[2079]

For whether property constitutes IRD, see part II.Q.4.e.i Life Insurance Basis Adjustment on the Death of an Owner Who Is Not the Insured, fns. 4434-4442.

Before Code § 691 was enacted,[2080] *Estate of Enright v. Helvering*, 312 U.S. 636 (1941), held that, when a partnership agreement provides for "the termination of the partnership on the death

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[2078] See part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses).

[2079] Code § 1014(c).

[2080] Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts* (WG&L), ¶ 84.1.1 Introductory (part of ¶ 84.1 Income in Respect of Decedents (IRD)), comments:

> … Congress intervened in 1934 to require a decedent's final tax return to include "amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period."[4] Congress did not define the term "amounts accrued up to the date of…death," but it did not intend to change the status of appreciated assets, which continued to get a stepped-up basis equal to their date of death values. Thus, the 1934 legislation equated cash and accrual basis

of any partner and that his estate should have his partnership percentage in the 'net monies then in the treasury of the firm, plus his like percentage in the outstanding accounts and the earned proportion of the estimated receipts from unfinished business,'" the deceased partner's final individual income tax return had to include those earnings. Presumably, any such earnings not appearing on the K-1 taxable to decedent under current law would be IRD taxable on the estate's fiduciary income tax return that reports K-1 income representing such earnings.

Willging v. United States, 474 F.2d 12 (9th Cir. 1973), which did not cite Code § 691 but addresses similar principles, is short enough to reproduce almost in full:

> Mrs. Willging and her husband were wheat farmers, owning community property, and reporting their income on the accrual basis. To determine their income for each year, they would add to the sales price of products sold during the year the value of their closing inventory and would subtract from this figure the value of their opening inventory. Treas. Reg. § 1-61-4. Inventories were valued under the "farm price" method (market price less direct costs of disposition), Treas. Reg. § 1.471-6; expenses were deducted in the year in which they were incurred. Treas. Reg. § 1.162-12.
>
> The value of the Willging's opening grain inventory for 1966 was $1,195. On November 15, 1966, Mr. Willging died. At that time the value of the grain inventory was $37,953.98. The grain had the same value at the end of the year.
>
> Mrs. Willging contends that the entire increase in the value of the 1966 crop inventories between the first of the year and November 15 escapes taxation because Int. Rev. Code of 1954, § 1014, stepped up the basis of the grain to its market value on the death of her husband. In the alternative, she argues that the half of the crop which vested in her on November 15 by virtue of the community-property laws escapes taxation.
>
> The basic thrust of Mrs. Willging's first argument is that accrual-basis farmers should be treated the same as cash-basis farmers. A cash-basis farmer who dies owning an appreciated inventory is not taxable on the unrealized appreciation. Nor does his spouse take over a potential tax liability, for she receives upon his death a stepped-up basis under § 1014(b)(1). Rev. Rul. 58-436, 1958-2 Cum. Bull. 366. If the property is owned by the community (in a community-property state) there is still no realization upon the death of one spouse. The surviving spouse is entitled to a stepped-up basis under

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taxpayers with respect to "amounts accrued" but created a fundamental disparity between items encompassed by this amorphous term and other types of property inherited from the decedent….

[4] Revenue Act of 1934, Pub. L. No. 216, § 42, 48 Stat. 680, 694.

Before the impact of *Enright's Estate* could be fully digested, Congress abandoned the accrual approach of the 1934 legislation because "hardship results in many cases from including in the income from the decedent's last taxable period amounts which ordinarily would be receivable over a period of several years."[7] Instead of restoring the status quo ante, Congress, in 1942, enacted the statutory predecessor of § 691, requiring "income in respect of decedents" - a new but undefined statutory term - to be reported by a decedent's estate or other successor in interest on collecting the claim and permitting estate tax allocable to the collected item to be deducted.[8]

[7] S. Rep. No. 1631, 77th Cong., 2d Sess., reprinted in 1942-2 CB 504, 580.

[8] Revenue Act of 1942, Pub. L. No. 753, § 134, 56 Stat. 798, 830–831. See *Richardson v. US*, 294 F2d 593 (6th Cir. 1961), *cert. denied*, 369 US 802 (1962) (rejecting claim that statutory predecessor of § 691 was unconstitutional "direct" tax on amounts that became "principal" of decedent's estate on his death).

§ 1014(b)(6) if at least one half of the whole of the community interest in such property was includable in determining the value of the decedent's gross estate.

However, because Mr. Willging elected to be taxed under the accrual method of accounting, the value of the grain was "realized" when it increased his inventory value. No sale was necessary for realization. Mr. Willging's death did not have the effect of accruing items which would not otherwise have been accrued, § 451(b), but it did serve as an occasion (the closing of his tax year) for taxing the income he had received during his last taxable year. Section 1014 does not affect the imposition of this tax. The distinction between the taxation of cash and accrual-basis farmers on death is not fortuitous, but follows directly from the method of accounting used by the respective taxpayers. We see no reason to force the Commissioner to permit all accrual-basis farmers effectively to switch to the cash basis in the year of death*. Cf. United States v. Catto*, 384 U.S. 102, 113-117 (1966).

Only half of the accrued increase in value of the inventories was taxed on the death of Mr. Willging because the other half vested in Mrs. Willging by virtue of the community property laws. Mrs. Willging contends that, even if her husband was properly taxable on his half on the inventory, she is not taxable on her half because the stepped-up basis provided by § 1014(b)(6) for community property is substituted for the beginning-of-the-year inventory value which she would normally use. Mrs. Willging points out that § 1014 applies "except as otherwise provided in this section," § 1014(a), and that the Commissioner makes no contention that the crops represent "income in respect of a decedent," which is excepted from the application of § 1014. §§ 691, 1014(c). She contends that § 1014(b)(6) entitles her to the benefit of a stepped-up basis without the disadvantage of current taxation on the increase in value, although for a noncommunity spouse of an accrual taxpayer this would be impossible. (For § 1014 to apply to a noncommunity spouse, the property is required to have been held by the decedent, and the decedent would have been taxable on the accrued increase.)

Mrs. Willging claims more for § 1014 than Congress intended. We do not rely on the failure of the regulations under which the taxpayer computed her income to refer to the "basis" of the crops involved. "Basis" is a general tax accounting term whose use cannot be so tightly circumscribed. See 85 Harv. L. Rev. 880, 884 (1972). Moreover, the Code recognizes that "basis" is a concept relevant to the computation of inventories, § 1013, and the Commissioner allows cash-basis farmers the step-up denied here although the regulations under which they compute their income make no use of the term "basis." Treas. Reg. § 1.61-4(a).

The real issue in this case is one of realization. Section 1014 operates to exempt unrealized property income from tax on the death of the owner of the property; it does not reach back to income realized before death. Income is realized under an accrual method of accounting "when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Treas. Reg. § 1.451-1(a). Because of the nature of the market for farm produce, the Commissioner allows farmers to use the increase in inventories as a realizing event. This was the method of accounting chosen by the taxpayer. It follows that § 1014 does not help Mrs. Willging, for, although it may increase her basis, it does so after the income from her crops has been realized. The time of the mechanical computation of income, at the end of the year, is irrelevant. To hold otherwise would be to make the sale of crops the determining event although the taxpayer had adopted a system of accounting which did not distinguish between sale and increase in inventory value. This would constitute a change of accounting method without the consent of the Secretary, proscribed by § 446(e).

We are reinforced in our conclusion by a consideration of the purpose of § 1014(b)(6). Given our holding that tax was due on the income accrued by Mr. Willging in the year of his death, the benefit for which Mrs. Willging contends would be peculiar to community-property taxpayers. Section 1014(b)(6) was designed to equalize the incidence of taxation between community-property and common-law states, not to provide a special benefit to community-property taxpayers. *Stanley v. C.I.R.*, 338 F.2d 434 (9th Cir. 1964); *Bath v. United States*, 211 F.Supp. 368, 370 (S.D. Tex. 1962), *aff'd per curiam*, 323 F.2d 980 (5th Cir. 1963).

The Official Tax Court Syllabus to *Rollert Residuary Trust v. Commissioner*, 80 T.C. 619 (1983), summarized at 619-620:

1. Prior to his death on Nov. 27, 1969, decedent was an executive vice president of GM. Shortly before the date of death, GM had tentatively determined to issue bonuses for 1969 to a group of employees, including decedent. However, it was not until Mar. 2, 1970 - more than 3 months after the date of death - that the bonus was formally awarded to decedent. The bonuses were paid under an established deferred compensation plan, with bonuses never having been denied to executive vice presidents and decedent's having received over $300,000 annually in bonuses during the years 1964 through 1968. *Held*, amounts paid pursuant to this postmortem bonus are income in respect of a decedent, because, under the facts of this case, decedent had a right or entitlement to the bonus payments as of the date of his death.

2. GM also awarded decedent bonuses in each of the years 1964 through 1968. These lifetime bonus awards, as well as the postmortem bonus award for 1969, were payable in annual installments, most of which became payable during years subsequent to 1969. Under decedent's will, rights to receive the bonus installments became part of the residue of the estate. The estate distributed to P, the residuary legatee, the rights to receive certain of these installments when paid in years subsequent to the year of distribution. Both the estate and P treated the distribution of the rights as a distribution of the estate's distributable net income, even though the bonus installments would constitute income in respect of a decedent when paid. In the year the rights were distributed, P reported as income under sec. 662(a), I.R.C. 1954, the date-of-distribution fair market values of the rights, and the estate took a corresponding deduction under sec. 661(a), I.R.C. 1954. Under sec. 1.661(a)-2(f), Income Tax Regs., P took the date-of-distribution values as its basis in the rights, and in the subsequent years when the bonus installments were paid to it, P reported as income only the difference between such basis and the amount received. *Held*: Sec. 691, I.R.C. 1954, requires P to report the entire amount of bonus installments paid to it as income in the year when received. P had no basis in the rights to receive income in respect of a decedent because the estate's distribution of these rights to petitioner was not a distribution subject to secs. 661 and 662, I.R.C. 1954.

The court reasoned at 636-638:

> In resolving this case, we must analyze the relationship between the rules of section 691 for the taxation of income in respect of a decedent and those of subchapter J, part I, governing the income taxation of estates. In general, the provisions of subchapter J, part I, are designed to allocate between the estate and its beneficiaries taxable income received by the estate, so that income will be taxed at only one level. For an estate that may accumulate income, such as Mr. Rollert's estate, this general allocation scheme is accomplished through the distribution rules of sections 661 through 663. Section 691 serves a totally different purpose. It is designed to deal with the problem of how to tax income that has been earned but not received by an individual as of the date of his or her death. Under section 691, income that has accrued to a decedent prior to death but has not yet been received is not included in the decedent's final income tax return, even though the right to such income may be included on the estate's estate tax return. Instead, the income is reported when received by the person who actually receives the income. See *Estate of Sidles v. Commissioner*, 65 T.C. 873, 879 (1976), affd. without published opinion 553 F.2d 102 (8th Cir. 1977).
>
> Here, petitioner used the distribution rules of section 662 in an attempt to reduce the income taxed to it under section 691. In effect, what petitioner did here was to report part of the payments of income in respect of a decedent as income under section 662, even before the payments were made by General Motors. When the payments were actually made in subsequent years, petitioner excluded the previously reported amounts from its section 691 income. Because the treatment of payments of income in respect of a decedent in this manner would completely undermine the mandate of section 691 that the recipient of such income report it for the year when received, we agree with respondent that petitioner had no right to reduce its income in respect of a decedent in the year it received the bonus payments by the amounts it had previously reported as income under section 662.
>
> Section 691(a)(1)[9] provides that the amount of all items of income in respect of a decedent shall be included in gross income, for the taxable year when received. This rule applies to income in respect of a decedent received by (A) the decedent's estate if it has acquired from the decedent the right to receive such income; (B) a person who has acquired, by reason of the decedent's death, the right to receive such income if the right to receive such income was not acquired by the decedent's estate from decedent; and (C) a person who has acquired the right to receive the amount by bequest, devise, or inheritance from the decedent, after a distribution by the decedent's estate of such right. See also sec. 1.691(a)-2(a), Income Tax Regs. In this case, subparagraph (A) required Mr. Rollert's estate to include in income amounts received with respect to those rights to bonus installments that it did not distribute to petitioner, and subparagraph (C) required petitioner to include those bonus installments that it received with respect to rights the estate had distributed to it.[10]
>
> [9] Sec. 691(a)(1) provides:
>
> (a) *Inclusion in Gross Income*.
>
> (1) *General Rule*. The amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period (including the amount of all

items of gross income in respect of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) shall be included in the gross income, for the taxable year when received, of:

(A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;

(B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or

(C) the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

[10] Sec. 691(a)(2), which requires income to be recognized upon the "transfer" of a right to receive income in respect of a decedent, does not apply to this case since "transfer" is defined specifically to exclude transfers, such as those involved in this case, to a person entitled to receive the right to income in respect of the decedent by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent.

Under section 661(a), an estate deducts in computing its taxable income (1) any amount of income required to be distributed currently and (2) "any other amounts properly paid or credited or required to be distributed for such taxable year." However, the total amount of these deductions may not exceed the estate's distributable net income.[11] Under section 662, the beneficiary to whom these distributions are made must include in gross income a corresponding amount.[12] Sections 661(b) and 662(b) are designed to assure that the character of the amounts deducted by the estate and taken into income by the beneficiary is proportionate to the character of items entering into the computation of distributable net income.

[11] Distributable net income is computed under sec. 643 by making specified adjustments to the estate's taxable income. Respondent does not challenge the correctness of the particular amounts of distributable net income reported by the estate in 1970, 1971, 1972, and 1973, the years in which rights to bonus installments were distributed.

[12] Sec. 663 lists various types of distributions that are not considered distributions subject to secs. 661 and 662, but none of the sec. 663 exclusions apply here.

Further below (at 644-645), the court reasoned:

Although the legislative history of section 691 and the regulations under that section do not specifically address the issue presented in this case, they do tend to support our conclusion that sections 661 and 662 should not be applied to an estate's distribution of rights to income in respect of a decedent. Example 1 of section 1.691(a)-2(b), Income Tax Regs., which illustrates the application of the general principle of taxing income in respect of decedent, when received, involves a fact situation quite similar to that now before us. A decedent was entitled to salary payments in five annual installments after

> his death. The estate collected the first two payments and then distributed to the residuary legatee the right to the remaining three installments. The example states that the estate must include the first two installments in its gross income and the legatee must include the subsequent three installments in his gross income. This example does not even refer to the possibility of the right to the final three installments being treated as a distribution governed by sections 661 and 662. If the distribution rules were meant to apply to distributions of rights to income in respect of a decedent, the absence of any reference to this effect in the regulation is incomprehensible.

Should assets sold after death on the date of death get a basis step-up? An ACTEC committee explored this issue, and some of its thoughts are included in Randolph, "What Is the Basis of Assets Solid on the Date of A Decedent's Death," *Probate Practice Reporter*, Vol. 29, No. 8 (8/2017). Relevant authority the article cited includes:

- Code § 1014(a)(1) provides a new basis for property passing from a decedent to a person "if not sold, exchanged, or otherwise disposed of before the decedent's death by such person."

- Code § 691(a)(1) provides who is taxed on "all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period."

- Reg. § 1.6012-3(b)(1), discussing the decedent's final income tax return, provides: "For the decedent's taxable year which ends with the date of his death, the return shall cover the period during which he was alive."

- Reg. § 1.443-1(a)(2), "Taxpayer not in existence for entire taxable year," opens, "If a taxpayer is not in existence for the entire taxable year, a return is required for the short period during which the taxpayer was in existence." After discussing mechanics of preparing a short period return, it ends with, "Although the return of a decedent is a return for the short period beginning with the first day of his last taxable year and ending with the date of his death, the filing of a return and the payment of tax for a decedent may be made as though the decedent had lived throughout his last taxable year."

- TAM 6003114710A argues, "Based upon the provision of such regulation, the provision of the first sentence of section 1.443-1(a)(2) of the income tax regulations, and the reasoning set out in I.T. 1578, C.B. II-1, 150, only the income and deductions up to the moment of a decedent's death are included in his final return since that moment terminates his taxable year. Therefore, the day of death is the last day of the period cover by a decedent's last return and the first day of the period covered by his estate's first return." The TAM concluded that, because the exact moment of death was not determinable when the decedents died from a fire, "it may, however, be administratively feasible and advisable to determine, as a fact, that the fire ended and the deaths occurred at the same moment."

- GCM 38960 (1983) took the position that the estate's taxable year begins on the date of death, without addressing how to treat activity that occurred before death on the date of death.

Publication 559, "Survivors, Executors, and Administrators," for use in preparing 2022 returns, found at About Publication 559, Survivors, Executors and Administrators (irs.gov), asserts that:

- "Form(s) 1099 reporting interest and dividends earned by the decedent before death should be received and the amounts included on the decedent's final return. A separate Form 1099 should show the interest and dividends earned after the date of the decedent's death and paid to the estate or other recipient that must include those amounts on its return."

- K-1 income from a partnership or S corporation on the date of death is included on the decedent's final income tax return.

Representatives of ACTEC discussed with the AICPA formally advocating for clarification about timing issues on the date of death. Representatives of the AICPA suggested that ACTEC not seek clarification, so as to preserve taxpayer flexibility regarding events occurring on the date of death.

See also parts III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation and III.B.2.j Tax Allocations upon Change of Interest in a Business.

The basis step-up for a partnership interest is affected by the partnership's IRD items.[2081] The basis step-up for S corporation stock is affected by the corporation's IRD items.[2082] Note that not only will the beneficiaries receiving the partnership interest or S corporation stock have a long-term capital gain of at least the amount of IRD if bought out for at least the date-of-death value, but also the remaining owners of an S corporation would pay income tax when the IRD is collected, the latter income tax which the owners of a partnership may avoid. Exploring these ideas:

- If and to the extent that the beneficiaries of the S corporation stock are shareholders when the IRD is collected, they will report ordinary income of their share of the IRD instead of the remaining shareholders reporting that income. This income increases their basis and correspondingly reduces the capital gain on the sale of the S corporation stock.[2083] Thus, the taxation of the IRD will result in additional basis to either or both of the selling or buying shareholders, the latter possibly needing to wait a long time before enjoying the benefit of that additional basis. For more on S corporation stock basis, see https://www.irs.gov/pub/int_practice_units/sco_c_53_04_01_02_02.pdf.

- For partnerships, however, the remaining owners may never be taxed on the IRD. In a cross-purchase, the remaining partners will receive inside basis for the IRD they are deemed to have bought if the partnership has a Code § 754 election in place; see parts II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000 and II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.[2084] Also, the remaining partners will receive inside basis for the IRD they are deemed to have bought in a redemption, without considering whether the partnership has a Code § 754 election in place.[2085]

[2081] See part II.H.2.g Partnership Basis Adjustments, especially the text accompanying fn. 2096.
[2082] Code § 1367(b)(4); Reg. § 1.1367-1(j). Code § 1367 is reproduced in part II.G.4.d.i Basis Limitation Generally.
[2083] See fn 4874 in part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally.
[2084] Especially Reg. § 1.755-1(a)(1), discussed in the text following fn 4242 in part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.
[2085] See fn 5529 in part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale.

Farm inputs deducted on the decedent's final returns receive a basis step-up at death and can be deducted by the surviving spouse on her return. *Estate of Backemeyer v. Commissioner*, 147 T.C. 526 (2016), holding that the tax benefit rule factors of the companion cases of *Hillsboro Nat'l Bank v. Commissioner* and *Bliss Dairy, Inc. v. United States*, 460 U.S. 370 (1983), did not cause the tax benefit rule to apply here. The court viewed Code § 1014 as so fundamental that, when applying the *Bliss Dairy* considerations, the basis step-up controlled. The Tax Court quoted *Bliss Dairy*, 460 U.S. at 386 n. 20:

> An unreserved endorsement of the Government's formulation might dictate the results in a broad range of cases not before us. For instance, the Government's position implies that an individual proprietor who makes a gift of an expensed asset must recognize the amount of the expense as income, *but cf. Campbell v. Prothro*, 209 F.2d 331, 335 (CA5 1954). Similarly, the Government's view suggests the conclusion that one who dies and leaves an expensed asset to his heirs would, in his last return, recognize income in the amount of the earlier deduction. Our decision in the cases before us now, however, will not determine the outcome in these other situations; it will only demonstrate the proper analysis. Those cases will require consideration of the treatment of gifts and legacies as well as §§ 1245(b)(1), (2), and 250(d)(1), (2), which are a partial codification of the tax benefit rule, and which exempt dispositions by gift and transfers at death from the operation of the general depreciation recapture rules. Although there may be an inconsistent event in the personal use of an expensed asset, that event occurs in the context of a nonrecognition rule, and resolution of these cases would require a determination whether the nonrecognition rule or the tax benefit rule prevails. [Some citations omitted.]

The Tax Court concluded:[2086]

> It is telling that the depreciation recapture rules, which, we are reminded, are "a partial codification of the tax benefit rule," *Bliss Dairy*, 460 U.S. at 386 n. 20, do not extend to transfers at death. The regulations bespeak this by omitting from the list of nonrecognition Code sections overridden by the depreciation recapture provisions of sections 1245 and 1250 those sections governing the treatment of a decedent's property. See secs. 1.1245-6(b), 1.1250-1(c)(2), Income Tax Regs. In *Bliss Dairy*, 460 U.S. at 398, the Supreme Court observed that depreciation recapture under sections 1245 and 1250 was an important exception to the nonrecognition statute at issue there. This is not the case with transfers at death, to which the depreciation recapture rules do not apply. Since sections 1245 and 1250 codify the tax benefit rule as it relates to depreciated property and expressly exclude transfers at death from the rule's scope, see *id.* at 386 n. 20 ("[Sections] 1245(b)(1), (2), and 1250(d)(1), (2) … are a partial codification of the tax benefit rule … [and] exempt dispositions by gift and transfers at death from the operation of the general depreciation recapture rules."), it follows that the uncodified remainder of the common law tax benefit rule, with which we are concerned in this case, operates in a similar fashion….

Reg. § 1.691(a)-2(b), Example (5) provides:

> (i) A owned and operated an apple orchard. During his lifetime, A sold and delivered 1,000 bushels of apples to X, a canning factory, but did not receive payment before

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[2086] Regarding Code § 1245 assets receiving a basis step-up, see part II.Q.4.e.i Life Insurance Basis Adjustment on the Death of an Owner Who Is Not the Insured, fn. 4442.

his death. A also entered into negotiations to sell 3,000 bushels of apples to Y, a canning factory, but did not complete the sale before his death. After A's death, the executor received payment from X. He also completed the sale to Y and transferred to Y 1,200 bushels of apples on hand at A's death and harvested and transferred an additional 1,800 bushels. The gain from the sale of apples by A to X constitutes income in respect of a decedent when received. On the other hand, the gain from the sale of apples by the executor to Y does not.

(ii) Assume that, instead of the transaction entered into with Y, A had disposed of the 1,200 bushels of harvested apples by delivering them to Z, a cooperative association, for processing and sale. Each year the association commingles the fruit received from all of its members into a pool and assigns to each member a percentage interest in the pool based on the fruit delivered by him. After the fruit is processed and the products are sold, the association distributes the net proceeds from the pool to its members in proportion to their interests in the pool. After A's death, the association made distributions to the executor with respect to A's share of the proceeds from the pool in which A had an interest. Under such circumstances, the proceeds from the disposition of the 1,200 bushels of apples constitute income in respect of a decedent.

Whether a sale is so far along at death to constitute IRD instead of the asset to be sold getting a basis step-up is the subject of several cases.[2087]

[2087] Citations from Lad Boyle from a 9/27/2021 of his treatise with Jonathan Blattmachr: *Trust Co. of Georgia v. Ross*, 262 F. Supp. 900 (N.D. Ga. 1966), *aff'd*, 392 F.2d 694 (5th Cir. 1967), *cert. denied*, 393 U.S. 830 (1968); *Keck v. Comm'r*, 415 F.2d 531 (6th Cir. 1969); See also *Estate of Ernest Napolitano v. Comm'r*, T.C. Memo. 1992-316 (contract contingency of no outstanding housing violations not met and hence no IRD…); *Estate of Bickmeyer v. Comm'r*, 84 T.C. 170 (1985) (distinguishing *Keck*); Rev. Rul. 58-436, 1958-2 C.B. 366; Treas. Reg. § 1.691(a)-2(b), ex. (5); *Comm'r v. Linde*, 213 F.2d 1 (9th Cir.), *cert. denied*, 348 U.S. 871 (1954); *Estate of Sidles v. Comm'r*, 65 T.C. 873 (1976) (proceeds of corporate liquidation), *aff'd*, 553 F.2d 102 (8th Cir. 1977), *acq*. 1976-2 C.B. 2; Priv. Ltr. Rul. 200012076 (profit derived from unexercised nonqualified stock options is IRD, but receipt of IRD by charitable beneficiary prevents imposition of income tax); *Dorsey v. Comm'r*, 49 T.C. 606 (1968) (liquidated corporation); Young, *Farmer's Inventory Problem at Death, Confused by* Linde *Decision, Clarified*, 9 J. Tax'n 355 (1958). But see Rev. Rul. 73-524, 1973-2 C.B. 307 (proceeds received on sale of securities pledged in pre-death short sale are not IRD); Priv. Ltr. Rul. 9319005 (same); *Levin v. United States*, 373 F.2d 434 (1st Cir. 1967) (does not include lender's unearned portion of note discount).

If an IRD asset is likely to appreciate after death, consider triggering income recognition under Code § 691(a)(2),[2088] so that future increases in growth may receive capital gain treatment.[2089]

II.H.2.f. Partnership Basis Shifting Opportunities

Part II.Q.8.b.i.(e) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property how to shift basis from a low basis asset to a higher basis asset.

Part II.Q.8 Exiting From or Dividing a Partnership describes partnership tax rules and explains why a person with multiple business assets outside of a corporate structure might want to form a master partnership to facilitate future basis shifting opportunities.

Part II.Q.7.h Distributing Assets; Drop-Down into Partnership discusses how to move corporate assets into a partnership structure.

II.H.2.g. Partnership Basis Adjustments

A Code § 754 election provides a basis adjustment when a partner dies.[2090] Also see parts II.Q.8.e.i Distribution of Partnership Interests and II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform), to which part III.A.6 Post-Mortem Trust and Estate Administration briefly refers.

The basis adjustment wipes out so-called "negative basis" (a technically inaccurate term describing a situation where partners would recognize what they view as "phantom income" when a partnership interest is sold).[2091]

[2088] Code § 691(a)(2) provides:

> If a right, described in paragraph (1), to receive an amount is transferred by the estate of the decedent or a person who received such right by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent, there shall be included in the gross income of the estate or such person, as the case may be, for the taxable period in which the transfer occurs, the fair market value of such right at the time of such transfer plus the amount by which any consideration for the transfer exceeds such fair market value. For purposes of this paragraph, the term "transfer" includes sale, exchange, or other disposition, or the satisfaction of an installment obligation at other than face value, but does not include transmission at death to the estate of the decedent or a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent.

[2089] *Hurford Investments No 2, Ltd. v. Commissioner*, cited in fn. 1574 in part II.G.8 Code § 165(a) Loss for Worthlessness; Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy, holding that a contribution to a partnership attained this result, without mentioning that Code § 721(a) ordinarily blocks income recognition.

[2090] For more on Code § 754 elections (and similar rules that apply without an election when the partnership has a substantial built-in loss), see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.

[2091] See Rev. Rul. 73-183 (no gain or loss is recognized on the decedent's final income tax return as a result of the transfer of stock – that received a basis adjustment on Code § 1014 upon death - to the executor of the decedent's estate) (reproduced in part II.H.2 Basis Step-Up Issues) and Reg. § 1.742-1 (basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of death, increased by the estate's share of partnership liabilities, and reduced to the extent that such

A "negative basis" situation arises as follows:

- A partnership borrows money, increasing the partners' adjusted basis.[2092] They then distribute the loan proceeds, which simply reduces the tax basis rather than triggering income.[2093] Now the partnership has liabilities without retaining the assets that triggered the liabilities. A discharge of liabilities is a deemed distribution to the partners,[2094] who already used their basis against prior distributions, so the discharge of liability can trigger income to the extent that the deemed cash distribution exceeds their remaining basis. Partners view this as an unfair result, but it really isn't, because if they simply put back the money that they had taken out then they would have enough basis to avoid the tax.[2095] As described in parts II.H.10 Extracting Equity to Fund Large Gift and II.Q.8.a.iii Examples of Using Partnership to Shift Basis, this equity stripping can be very beneficial. However, when one engages in such an approach, one needs to consider ways to trigger estate inclusion to purge possible negative income tax effects.

- Alternatively, a partnership borrows money to fund losses.

For reporting of "negative basis," see text accompanying and preceding fn 502 in part II.C.7 Maintaining Capital Accounts.

For more details on when partnership distributions trigger gain recognition and when they don't, see part II.Q.8.b.i Distribution of Property by a Partnership.

Note that partnership interests do not receive a basis step-up to the extent the underlying property constitutes income in respect of a decedent (IRD),[2096] consistent with part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

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value is attributable to IRD). Any increase in the basis of the partnership interest generates an increase in the basis of the partnership's assets other than IRD only to the extent the basis of the partnership interest is not attributable to partnership liabilities. Reg. § 1.755-1(a)(4)(i)(A), incorporated by reference by Code § 743(c) and Reg. § 1.755-1(e). For more details on Reg. § 1.742-1, see fn 5682 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss). As to IRD, see part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[2092] Code § 752(a).

[2093] Code § 731(a)(1).

[2094] Code § 752(b).

[2095] Code § 722

[2096] See fns. 5683, 4249, and 4277.

II.H.2.h. Basis Step-Up for Property Held Outside an Entity; Moving Liabilities Outside of an Entity to Maximize Deductions for Estate Tax Purposes

When property is held outside an entity,[2097] assets and associated liabilities are reported on an estate tax return as follows:[2098]

- If the debt is recourse, then the asset and its associated liability are reported on separate asset and liability schedule.

- If the debt is nonrecourse, the asset and liability are netted and reported as a net asset. For income tax purposes,[2099] in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property cannot be less than the amount of any nonrecourse indebtedness to which such property is subject.

The distinction between recourse and non-recourse debt can also be significant for nonresident aliens, when the deduction for recourse debt gets pro-rated and diluted as any other debt, making nonrecourse debt important for any U.S. real estate.

A 2006 article suggested that recourse debt provides a better fractional interest discount than nonrecourse debt, because the discount is calculated on the gross value for recourse debt but only on the net value for nonrecourse debt.[2100] For example, one's proportionate value of the underlying real estate is $1M and of the liability is $400K, for a $600K net equity. Under this theory, if a 20% discount were applied, the discount for recourse property would be $200K (20% of $1M) and for nonrecourse property would be $120K (20% of $600K). Therefore, when property is held as tenants-in-common, discounting works better for recourse than nonrecourse property.

[2097] "Entity" includes a single member LLC, which exists as a separate entity for transfer tax purposes. See fn. 4041, found in part II.P.3.f Conversions from Partnership to Sole Proprietorships and Vice Versa. Once a single-member LLC is valued, its value is allocated among its assets and liabilities to determine basis. See fns. 332-333 in part II.B Limited Liability Company (LLC).

[2098] See Reg. §§ 20.2031-1(b), 20.2053-7; *Estate of Stevens v. Commissioner*, T.C. Memo. 2000-53, *Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982); *Estate of Fung v. Commissioner*, 117 T.C. 21 (2001); Letter Ruling 8423007. Reg. § 20.2053-7 provides:

> A deduction is allowed from a decedent's gross estate of the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest which had accrued thereon to the date of death, provided the value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate. If the decedent's estate is liable for the amount of the mortgage or indebtedness, the full value of the property subject to the mortgage or indebtedness must be included as part of the value of the gross estate; the amount of the mortgage or indebtedness being in such case allowed as a deduction. But if the decedent's estate is not so liable, only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be returned as part of the value of the gross estate.

[2099] Code § 7701(g).

[2100] See Schiller, "Leveraged Tenancies in Common - The Next Great Great Planning Tool?" (subtitled "Valuation Benefits with Leveraged Co-Ownerships May Exceed Benefits of Entity-Related Valuation Adjustments for Minority Interests"), *Steve Leimberg's Estate Planning Email Newsletter* (Archive Message #1057), available at http://www.leimbergservices.com. I agreed with the article when it was written.

Note that the netting that the article suggests applies to nonrecourse liabilities applies to assets and (recourse and nonrecourse) liabilities held inside an entity. Thus, if one would like a larger deduction for liabilities, one should take the liabilities out of the entity and be subject to them directly. Of course, business issues might very well make such a suggestion a bad idea; however, if all parties are on the hook for loan guarantees, the suggestion might be more realistic.

However, the article appears wrong regarding any effect on basis that netting nonrecourse liabilities may have when the property is owned directly instead of inside a separate entity. *Crane v. Commissioner* provides that nonrecourse debt does not affect the basis of property included in the decedent's estate, even though the debt is netted for estate tax reporting purposes.[2101] Although the Code § 1014(f)(1)(A) basis consistency rule provides that basis cannot exceed the finally determined estate tax value, which might seem to conflict with *Crane* to the extent that only the net value is reported for property subject to nonrecourse debt, Prop. Reg. § 1.1014-10(a)(2) provides, "The existence of recourse or non-recourse debt secured by property at the time of the decedent's death does not affect the property's basis, whether the gross value of the property and the outstanding debt are reported separately on the estate tax return or the net value of the property is reported." Furthermore, if the property is sold, the buyer is going to buy it free and clear of the debt, so that fractional interest should not be affected by the debt's existence. Thus, valuation discounts should be the same, without regard to the recourse or nonrecourse nature of the debt.

II.H.2.i. Avoiding a Basis Step-Down

Suppose property has basis in excess of value. That property would get a reduced basis at death.

Once solution is to sell the property for a loss and obtain current income tax benefits (to the extent available). That applies not only to property held directly but also property held in a partnership. If a partnership has a built-in loss exceeding $250,000, then a partner's death (or post-mortem trust funding)[2102] generally would trigger an inside basis reduction,[2103] even if a Code § 754 election is not in place.[2104] Therefore, a partnership with a substantial built-in loss might consider selling its loss assets to avoid this unfortunate result.

Another way to avoid a basis step-down is to transfer that property by gift or sale to an irrevocable grantor trust. The donee or trust would be unable use the built-in loss if the property if the property is sold for less than its basis, but it would be able to use the full basis for purposes of determining gain on sale.[2105] However, if the donee is the donor's spouse (or perhaps former spouse), then the donee would be able to use the built-in loss.[2106]

2101 331 U.S. 1 (1947).
2102 See part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).
2103 See part II.Q.8.e.iii.(a) Illustration of Inside Basis Issue.
2104 See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.
2105 Code § 1015(a); Reg. § 1.1015-1(a)(1).
2106 Code § 1015(e).

II.H.2.j. Effect of Chapter 14 on Basis Step-Up

Chapter 14 increases the value of business entities and other arrangements for the following purposes:

- *Code § 2701 Anti-Freeze*: Any increases in value provided under part III.B.7.b Code § 2701 Overview[2107] apply solely for gift tax purposes (including whether a sale includes a gift element).[2108]

- *Code § 2703 Buy-Sell Provisions*: Any increases in value provided under part III.B.7.e Code § 2703 Overview apply solely for estate, gift, and generation-skipping transfer tax purposes.[2109]

- *Code § 2704 Restrictions on Cashing Out*: Any increases in value provided under part III.B.7.f Code § 2704 Overview apply solely for estate, gift, and generation-skipping transfer tax purposes.[2110]

Code § 1014 determines basis by referring to property's "fair market value." As noted above, Chapter 14 applies for transfer tax purposes, not for income tax purposes.

However:

- If an estate tax return is required to be filed because the gross estate exceeds the relevant threshold, the basis of certain property is determined with reference to its estate tax value.[2111]

- For other property, the value shown on an estate tax return controls.[2112]

[2107] See also part III.B.7.c Code § 2701 Interaction with Income Tax Planning.

[2108] Code § 2701(a)(1) ("Solely for purposes of determining whether a transfer … is a gift (and the value of such transfer)"); Reg. §§ 25.2701-1(a)(1), 25.2701-1(b)(1), the latter providing:

> *Completed transfers*. Section 2701 applies to determine the existence and amount of any gift, whether or not the transfer would otherwise be a taxable gift under chapter 12 of the Internal Revenue Code. For example, section 2701 applies to a transfer that would not otherwise be a gift under chapter 12 because it was a transfer for full and adequate consideration.

Note that Code §§ 2703(a)(1) and 2704(a)(1) provide "for purposes of this subtitle," so query whether Code § 2701(a)(1) not referring specifically to Chapter 12 has any significance. However, note that Reg. § 25.2701-2(a) refers to Chapter 12:

> *In general*. In determining the amount of a gift under § 25.2701-3, the value of any applicable retained interest (as defined in paragraph (b)(1) of this section) held by the transferor or by an applicable family member is determined using the rules of chapter 12, with the modifications prescribed by this section. See § 25.2701-6 regarding the indirect holding of interests.

Reg. § 25.2701-5 provides estate tax mitigation rules relating to Code § 2701 gifts.

[2109] Code § 2703(a)(1); Reg. § 25.2703-1(a)(1). See part II.Q.4.h Establishing Estate Tax Values, including a discussion that Code § 2703(b) might not apply to inter vivos transfers.

[2110] Code § 2704(a)(1).

[2111] Code § 1014(f).

[2112] Reg. § 1.1014-3(a) provides:

> *Fair market value*. For purposes of this section and § 1.1014-1, the value of property as of the date of the decedent's death as appraised for the purpose of the Federal estate tax or the alternate value as appraised for such purpose, whichever is applicable, shall be deemed to be its

Thus, to tax advantage of estate tax values inflated by Chapter 14, the subject property seems to need to be reported on an estate tax return.

II.H.2.k. Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap

Property included in one's estate for estate tax purposes receives a new basis, even if a power of appointment is the only trigger for estate inclusion. Code § 1014(b)(9) refers to "property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code of 1939." Reg. § 1.1014-2(b)(1), "In general" (meaning it is subject to subparagraphs below it), explains:[2113]

> In addition to the property described in paragraph (a) of this section, and except as otherwise provided in subparagraph (3) of this paragraph, in the case of a decedent dying after December 31, 1953, property shall also be considered to have been acquired from the decedent to the extent that both of the following conditions are met: (i) the property was acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or nonexercise of a power of appointment), and (ii) the property is includible in the decedent's gross estate under the provisions of the Internal Revenue Code of 1954, or the Internal Revenue Code of 1939, because of such acquisition. The basis of such property in the hands of the person who acquired it from the decedent shall be determined in accordance with the general rule in § 1.1014-1. See, however, § 1.1014-6 for special adjustments if such property is acquired before the death of the decedent. See also subparagraph (3) of this paragraph for a description of property not within the scope of this paragraph.

To the extent of its inclusion ratio (and therefore subject to GST tax), property subject to a taxable termination[2114] also receives a new basis based on fair market value.[2115]

> fair market value. If no estate tax return is required to be filed under section 6018 (or under section 821 or 864 of the Internal Revenue Code of 1939), the value of the property appraised as of the date of the decedent's death for the purpose of State inheritance or transmission taxes shall be deemed to be its fair market value and no alternate valuation date shall be applicable.

[2113] For more about Reg. § 1.1014-6, see part II.H.2.d Caution re: Depreciable Property Held in a Nongrantor Trust That Is Included in the Grantor's, Surviving Spouse's, or Other Beneficiary's Estate.

[2114] Code § 2612(a) provides:

(1) *General rule*. For purposes of this chapter, the term "taxable termination" means the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust unless—
   (A) immediately after such termination, a non-skip person has an interest in such property, or
   (B) at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person.

(2) *Certain partial terminations treated as taxable*. If, upon the termination of an interest in property held in trust by reason of the death of a lineal descendant of the transferor, a specified portion of the trust's assets are distributed to 1 or more skip persons (or 1 or more trusts for the exclusive benefit of such persons), such termination shall constitute a taxable termination with respect to such portion of the trust property.

[2115] Code § 2654(a)(2).

If estate tax and GST tax are repealed and Code § 1014 is not changed, presumably the above provisions would not generate a basis step-up. However, other parts of Code § 1014 may generate a basis step-up, including:

- "Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent;"[2116]
- "Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust;"[2117]
- "In the case of decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust;"[2118] and
- "Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will."[2119]

Note that, if the estate tax is repealed, the basis step-up for a general power of appointment may apply only if the decedent actually exercised the power.[2120] Similarly, for federal income tax purposes, a general power of appointment shifts the grantor, from the settlor to the person holding the power, only if exercised.[2121] If shifting the grantor for federal purposes also shifts it for state income tax purposes, consider whether shifting the grantor for state income tax purposes is desirable or undesirable.[2122] If that shift is undesirable and the estate tax is in effect, consider:

- Using the Delaware Tax Trap to trigger estate inclusion, as the Delaware Tax Trap is the exercise of a limited power of appointment in a way that triggers estate inclusion under the general power of appointment rules, or
- Planning for a taxable termination instead of using a general power of appointment. Using a taxable termination allows the decedent to exercise a power of appointment without shifting the grantor.

[2116] Code § 1014(b)(1).
[2117] Code § 1014(b)(2).
[2118] Code § 1014(b)(3).
[2119] Code § 1014(b)(4).
[2120] Code § 1014(b)(9) provides:

> In the case of decedents dying after December 31, 1953, property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code of 1939.

[2121] Reg. § 1.671-2(e)(5), which is reproduced in fn 6620 in part III.B.2.h.i Who Is the Grantor. See also part II.H.5.d Using Grantor's Parent's Exemption for Basis Step-Up.
[2122] See part II.J.3.e State and Local Income Tax.

Code § 2041(a)(3), the Delaware Tax Trap, generates estate inclusion by changing the time for vesting.[2123] The leading case is *Murphy v. Commissioner*, 71 T.C. 671 (1979), *acq. recommended* A.O.D. 1979-87, *acq.* 1979-2 C.B. 1. I find the case unhelpful and prefer to follow the statute.

If the estate tax exists, then a general power of appointment is an easy way to obtain a new basis at death. Code § 2041(b)(1), "General power of appointment," provides:

> The term "general power of appointment" means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; except that -
>
> (A) A power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent shall not be deemed a general power of appointment.
>
> (B) A power of appointment created on or before October 21, 1942, which is exercisable by the decedent only in conjunction with another person shall not be deemed a general power of appointment.
>
> (C) In the case of a power of appointment created after October 21, 1942, which is exercisable by the decedent only in conjunction with another person -
>
> (i) If the power is not exercisable by the decedent except in conjunction with the creator of the power - such power shall not be deemed a general power of appointment.
>
> (ii) If the power is not exercisable by the decedent except in conjunction with a person having a substantial interest in the property, subject to the power, which is adverse to exercise of the power in favor of the decedent - such power shall not be deemed a general power of appointment. For the purposes of this clause a person who, after the death of the decedent, may be possessed of a power of appointment (with respect to the property subject to the decedent's power) which he may exercise in his own favor shall be deemed as having an interest in the property and such interest shall be deemed adverse to such exercise of the decedent's power.
>
> (iii) If (after the application of clauses (i) and (ii)) the power is a general power of appointment and is exercisable in favor of such other person—such power shall be deemed a general power of appointment only in respect of a fractional part of the property subject to such power, such part to be determined by dividing the value of such property by the number of such persons (including the decedent) in favor of whom such power is exercisable.

[2123] Code § 2041(a)(3). For how to exercise the Delaware Tax Trap, see Trytten, Blattmachr, Davis, and Gorin, "Yes, I'll Order That Trust 'Fully Loaded,'" pages II-B-(1)-98 (100th page of PDF) through II-B-(1)-100, Special Session II-B, 51st Annual Heckerling Institute on Estate Planning (2017), which is also saved as Thompson Coburn LLP document no. 6456656.

> For purposes of clauses (ii) and (iii), a power shall be deemed to be exercisable in favor of a person if it is exercisable in favor of such person, his estate, his creditors, or the creditors of his estate.

For what is an ascertainable standard under Code § 2041(b)(1)(A), see Reg. § 20.2041-1(c)(2), "Powers limited by an ascertainable standard," which provides:[2124]

> A power to consume, invade, or appropriate income or corpus, or both, for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is, by reason of section 2041(b)(1)(A), not a general power of appointment. A power is limited by such a standard if the extent of the holder's duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them). As used in this subparagraph, the words "support" and "maintenance" are synonymous and their meaning is not limited to the bare necessities of life. A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard. Examples of powers which are limited by the requisite standard are powers exercisable for the holder's "support," "support in reasonable comfort," "maintenance in health and reasonable comfort," "support in his accustomed manner of living," "education, including college and professional education," "health," and "medical, dental, hospital and nursing expenses and expenses of invalidism." In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised.

The right to designate one of the power holder's creditors or one of the creditors of the power holder's estate constitutes a general power of appointment.[2125]

If a formula general power of appointment is vested and is based on factors within the power-holder's control, then consider whether the power-holder's actions may constitute the release of a general power of appointment. In *Estate of Kurz v. Commissioner*, 101 T.C. 44 (1993), the decedent had a 5% withdrawal right in a bypass trust, exercisable only if the marital trust had been exhausted, and the decedent also had an unlimited right to withdraw the marital trust. Thus, the decedent controlled whether the 5% withdrawal right applied. The court concluded:[2126]

[2124] For ascertainable standards in other contexts, see Reg. §§ 1.674(b)-1(b)(5)(i) (grantor trust income tax rules - see text accompanying fn 6670 in part III.B.2.h.vii.(a) Distribution Provisions Resulting from Control Causing Grantor Trust Treatment), and 25.2511-1(g)(2) (gift tax ascertainable standard – see text accompanying fn 2485 in part II.J.2.b **Trust** Provisions Authorizing Distributions).

[2125] Letter Ruling 200335015, which held that the reduction in scope of a general power did not constitute a gift when the holder still retained the right described in the text above.

[2126] The court reasoned at 58-60:

> Neither the statute (last sentence of section 2041(a)(2)) nor the pertinent regulation (section 20.2041-3(b), Estate Tax Regs.) expressly requires that the event or contingency be "beyond the decedent's control". We are not persuaded by respondent's efforts to construct such a requirement from bits and pieces of other regulations either defining a type of power of appointment[4] or governing retained powers (section 2038) rather than powers of appointment (section 2041). Since respondent added such a requirement to the retained-powers regulation (section 20.2038-1(b), Estate Tax Regs.) and at the same time failed to include that language in

the powers-of-appointment regulation (section 20.2041-3(b), Estate Tax Regs.), we decline to engraft this language into the regulation.

[4] Respondent also argues that her position is supported by section 20.2041-1(b)(1), Estate Tax Regs., which provides in part:

> A power in a donee to remove or discharge a trustee and appoint himself may be a power of appointment. For example, if under the terms of a trust instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and the decedent has the unrestricted power to remove or discharge the trustee at any time and appoint any other person including himself, the decedent is considered as having a power of appointment….

Respondent argues that the regulation attributes a general power to a decedent, even though the decedent would have been required to remove the trustee and substitute himself before he could exercise his power. Respondent thus concludes that the "regulations make clear, however, that a decedent possesses, for purposes of I.R.C. section 2041, a power of appointment notwithstanding the failure by a decedent to perform an act necessary to exercise the power if the decedent had the power to perform that act."

However, the above-quoted regulation language merely defines a particular type of general power of appointment. The particular type of general power of appointment involved in this case is the power to consume principal. There is no question that that is a general power of appointment. The only question in this case is whether that power was in existence at the time of decedent's death.

Petitioner argues that, pursuant to section 20.2041-3(b), Estate Tax Regs., because decedent's power to withdraw 5 percent of the principal from the Family Trust Fund was exercisable only upon the occurrence during decedent's lifetime of an event or a contingency (complete exhaustion of the entire principal of the Marital Trust Fund), which did not in fact occur during decedent's lifetime, the power did not exist on the date of decedent's death. Petitioner argues that the regulation requires that a condition precedent cannot be deemed to have occurred but must have in fact occurred. Petitioner concludes, therefore, that at the time of her death, decedent did not have a general power of appointment over any portion of the principal of the Family Trust Fund that would be includable in her gross estate.

Respondent counters that petitioner's interpretation of the regulation is overly broad and "does violence to the intent of the statute". We agree, but we do not accept respondent's own overbroad view that whether the event or contingency is beyond the control of the decedent is the determinative factor.

However, although we decline to read into the statute a requirement that the event or contingency must necessarily be beyond a decedent's control, the event or contingency must not be illusory and must have some significant non-tax consequence independent of the decedent's ability to exercise the power. The legislative history, however, clearly indicates that all property of which the decedent on the date of his death had practical, if not technical, ownership is to be included in his estate. We think any illusory or sham restriction placed on a power of appointment should be ignored. An event or condition that has no significant non-tax consequence independent of a decedent's power to appoint the property for his own benefit is illusory. For example, for purposes of section 2038, a power is disregarded if it becomes operational as a mere by-product of an event, the non-tax consequences of which greatly overshadow its significance for tax purposes. See Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts*, par. 126.5.4, at 126-64 (2d ed. 1984). If the power involves acts of "independent significance", whose effect on the trust is "incidental and collateral", such acts are also deemed to be beyond the decedent's control. See Rev. Rul. 80-255, 1980-2 C.B. 272 (power to bear or adopt children involves act of "independent significance", whose effect on a trust that included after-born and after-adopted children was "incidental and collateral"); see also *Estate of Tully v. United States*, 208 Ct. Cl. 596, 528 F.2d 1401, 1406 (1976) ("In reality, a man might divorce his wife, but to assume that he would fight through an entire divorce process merely to alter employee death benefits approaches the absurd."). Thus, if a power is contingent upon an event of substantial independent consequence that the decedent could, but did not, bring about, the event is deemed to be beyond the decedent's control for purposes of section 2038.

> We do not think that, where the general power of appointment is the right to withdraw principal from a trust, Congress intended that application of section 2041(a)(2) could be avoided by stacking or ordering the withdrawal powers; *i.e.*, exercising the power to withdraw a certain number of dollars before the power to withdraw the next portion comes into operation. A condition that has no significant non-tax consequence independent of a decedent's power to appoint the property for her own benefit does not prevent practical ownership; it is illusory and should be ignored. We conclude that for purposes of section 2041, although the condition does not have to be beyond the decedent's control, it must have some significant non-tax consequence independent of the decedent's power to appoint the property. Petitioner has not demonstrated that withdrawing principal from the Marital Trust Fund has any significant non-tax consequence independent of decedent's power to withdraw principal from the Family Trust Fund. Such condition is illusory and, thus, is not an event or a contingency contemplated by the section 20.2041-3(b), Estate Tax Regs.
>
> We hold that, if by its terms a general power of appointment is exercisable only upon the occurrence during the decedent's lifetime of an event or contingency that has no significant non-tax consequence independent of the decedent's ability to exercise the power, the power exists on the date of decedent's death, regardless of whether the event or contingency did in fact occur during such time. Because petitioner has failed to demonstrate any significant non-tax consequence independent of decedent's right to withdraw principal from the Family Trust Fund, we hold that, on the date of her death, decedent had a general power of appointment over 5 percent of the Family Trust Fund that causes that portion to be includable in her estate under section 2041.
>
> Decedent's power of appointment over 5 percent of the Family Trust Fund was in existence on the date of her death regardless of the fact that the principal of the Marital Trust Fund had not been completely exhausted by that date. Hence, 5 percent of the Family Trust Fund was includable in her gross estate.

In other words, if the decedent could have unilaterally determined the scope of the general power of appointment, the power existed to the extent of the maximum amount over which the power could have been exercised.[2127] Because of this issue, consider allowing a nonadverse party to revoke the power-holder's power, so that the power does not vest until death. That approach would eliminate any gift tax issues regarding whether a general power was released during life. With this idea in mind, for clients keenly interested in basis step-up planning, I may use a clause along the following lines:

> Any time a reference is made to a "Formula Power to Appoint," the primary beneficiary may Appoint (as described in subsection (a)) the Included Assets (as described in subsection (b)) to the creditors of the primary beneficiary's estate, under the following terms:
>
> (a) *Mechanism for Exercising Formula Power to Appoint*. Any exercise of the Formula Power to Appoint must specifically refer to the power, shall be effected only by a written instrument with the prior or contemporaneous written consent of the Appointment Trustee (defined below) and delivered to the trustee and shall be revocable by either the primary beneficiary or the Appointment Trustee. The

[2127] For a possible exception to this idea, see part III.B.1.i Transfers with Contingencies Based on Acts of Independent Significance.

Appointment Trustee's decision to consent to, withhold consent from, or revoke (or otherwise limit) the exercise of the primary beneficiary's power to Appoint shall be in the Appointment Trustee's sole and absolute discretion. The Appointment Trustee may, in the Appointment Trustee's sole and absolute discretion, by written instrument delivered to the trustee, reduce or eliminate the primary beneficiary's power to exercise the Formula Power to Appoint, even without an attempted exercise of such power. The trustee shall serve as the Appointment Trustee if the trustee is not the primary beneficiary and otherwise is not a Nonadverse Person. A "Nonadverse Person" is a person who is not adverse to the exercise of the power in favor of the creditors of the primary beneficiary's estate under Code section 2041(b)(1)(C)(ii) and the regulations thereunder. If the trustee is not the primary beneficiary and otherwise is not a Nonadverse Person, upon the primary beneficiary's written request the trustee shall appoint as the Appointment Trustee a Nonadverse Party who is not the primary beneficiary and is not a related or subordinate party (as described in Code section 672(c)) with respect to the primary beneficiary (an "Independent Person"). If the Appointment Trustee shall cease to serve, by resignation delivered to the trustee or for any other reason, the trustee shall appoint as the Appointment Trustee another Nonadverse Party who is an Independent Person if the primary beneficiary so requests or if the primary beneficiary has exercised the primary beneficiary's power to Appoint.

(b) *"Included Assets" Subject to Formula Power to Appoint*. This subsection is subject to subsection (c). The primary beneficiary's power to Appoint does not apply to the following assets held by the trust: (1) cash or cash equivalent accounts (such as savings accounts, certificates of deposit, money market accounts or cash on hand in any brokerage or equivalent accounts); (2) any interest in any Benefit Plan or other property that constitutes income in respect of a decedent as described in Code section 1014(c); and (3) any interest in any property that has an adjusted basis for federal income tax purposes that is greater than or equal to the fair market value of the property at the time of the primary beneficiary's death (the "Excluded Assets"). If, after eliminating from consideration the Excluded Assets, the inclusion of the value of the other assets in the trust in the primary beneficiary's taxable estate for federal estate tax purposes would not increase the federal estate tax and state death taxes payable from all sources by reason of the primary beneficiary's death, this power of appointment shall apply to all remaining assets of the trust other than the Excluded Assets (the "Included Assets"). However, if including the value of the Included Assets in the trust in the primary beneficiary's taxable estate for federal estate tax and state death tax purposes would increase the taxes so payable, the assets of the trust appointed by this Section shall be further limited as follows: The trustee shall for each of the Included Assets evaluate the ratio of the fair market value at the time of the primary beneficiary's death to the adjusted basis immediately prior to the primary beneficiary's death first (the "Gain Ratio"). The trustee shall thereafter rank the Included Assets in order of their respective Gain Ratio. The appointment shall apply first to the Included Asset with the largest Gain Ratio, and thereafter in declining order of Gain Ratio to each of the subsequent Included Assets; however, as such point that inclusion of the next in order of the Included Assets would otherwise cause an increase in the primary beneficiary's estate's federal estate tax and state death tax liability as described above, the primary beneficiary's exercise of the Formula Power to Appoint shall be limited to that fraction or percentage of that Included Asset that will not cause any federal estate tax and state death tax liability, and all lower ranked Included Assets shall be excluded from the primary beneficiary's exercise of the Formula Power to Appoint.

(c) *Appointment Trustee's Change of Included Assets*. The Appointment Trustee may, in the Appointment Trustee's sole and absolute discretion, by written instrument delivered to the trustee change the scope of Excluded Assets and Included Assets and vary the order in which assets are allocated to either category.

(d) *Terms of Appointment Trustee's Service*. The Appointment Trustee may resign in the same manner as any other trustee and shall be protected from and indemnified against liability at least as much as any individual trustee would be protected or indemnified, whether the Appointment Trustee is an individual or an entity. The Appointment Trustee shall have no duty to monitor the trust or consider any actions under this Section except to the extent requested by a trustee or the primary beneficiary. The trustee (1) shall provide the Appointment Trustee with such information as the Appointment Trustee deems necessary in making decisions about whether or how to act under this Section, (2) shall cooperate with delivering to the beneficiaries any notices or other documentation relating to this Section as the Appointment Trustee deems necessary, and (3) shall take such other actions as the Appointment Trustee deems necessary to facilitate the Appointment Trustee effectuating the Appointment Trustee's powers under this Section. The Appointment Trustee shall be entitled to reasonable compensation and expense reimbursement. The Appointment Trustee shall have no authority or duties except as provided in this Section.

I believe that it addresses the concerns some have expressed regarding *Kurz*[2128] - that a formula general power may not be capped in the way that its drafter intends - but this is still sufficiently in its developmental stages that I use it only for clients with a keen interest in basis step-up. Note that the clause can be amended even after the grantor's death to cure any defects that it may have. In contrast, one might use a simple power when the client is certain that the beneficiary will never be subject to estate tax, but that does risk a basis step-down, so it's a trade-off between (1) simplicity, client understanding, and less expensive future trust administration, and (2) trying to obtain perfect tax results. My second quarter 2019 newsletter discussed this formula in more detail, and it is verbally presented in the webinar (TCLE that is available on demand without educational credit) State Fiduciary Income Tax (Kaestner); S Corp. Ownership; Basis Step-Up Strategies.

Letter Ruling 202206008 held that adding a general power of appointment somewhat along these lines caused estate inclusion only to the extent the general power was exercised and otherwise did not blow the trust's status as grandfathered from GST tax. The trustee "has the authority in the exercise of its sole and absolute discretion to withdraw from the corpus of the trust, such sum or sums as it may deem necessary for the maintenance, education, welfare and comfort of any beneficiary or beneficiaries, and such exercise of discretion by Trustee shall be final and not subject to question by any person or persons." Then:

> A controversy arose regarding the administration of Trust B and Trustee's desire to exercise its discretion to provide Child with a power of appointment over certain assets of Trust B. Trustee asserts that the exercise of this discretionary authority is to carry out the intent of Grantor to keep trust assets in the hands of Grantor's descendants upon

[2128] See fn 2126 and accompanying text.

> Child's death and to minimize transfer taxation upon Trust B assets. However, according to Trustee, due to family dynamics, including separation and divorce, as well as changing tax laws, Grantor's intent may not be carried out.
>
> Child and the other beneficiaries of Trust B have been in negotiations regarding Trustee's proposed exercise of its discretionary authority for approximately several months. During this time, Beneficiary 1 and Beneficiary 2 (individually and as representative of his minor children) opposed the proposed exercise of Trustee's discretionary authority. Litigation was commenced, but after further negotiations, the parties were able to reach a settlement agreement. Court has approved, after a hearing on the matter, the settlement agreement in an order, dated Date 3 (Settlement Agreement), subject to a favorable private letter ruling by the Internal Revenue Service.
>
> Settlement Agreement provides that Trust B, Clause 5., Paragraph (2) is modified to grant Child a testamentary general power of appointment to appoint a "Defined Portion" of Trust B principal to Child's estate. The term "Defined Portion" means the largest portion of Trust B that could be included in Child's federal estate without increasing the total amount of the "Transfer Taxes" actually payable at Child's death over and above the amount that would have been actually payable in the absence of this provision. The term "Transfer Taxes" means all inheritance, estate, and other death taxes, plus all federal and state GST taxes, actually payable by reason of Child's death. In the event Child fails to exercise this power, and to the extent the trust property is not subject to this power, upon Child's death, Trustee shall distribute such property, per stirpes, to Child's then living descendants, if any, and if none, to the heirs at law of Spouse.

Letter Ruling 202206008 concluded that the modification qualified for the Reg. § 26.2601-1(b)(4)(i)(D) protection from blowing GST-grandfathered status provided when the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation. It also held:

> In this case, the modification of Trust B to grant Child a testamentary general power of appointment pursuant to the Court-approved Settlement Agreement will not cause Trust B property to be includible in Child's gross estate. However, the exercise by Child of Child's testamentary general power of appointment will result in the appointed property being includible in Child's gross estate under § 2041(a)(2). Accordingly, based on the facts submitted and the representations made, we conclude that the exercise by Trustee of its discretionary authority over Trust B principal upon the terms of the Settlement Agreement will result in only the trust property subject to Child's testamentary general power of appointment to be included in Child's gross estate under § 2041(a)(2).

Letter Ruling 202206008 did not address whether Child could manipulate Child's taxable estate and therefore control the scope of her general power of appointment. Therefore, I am less than enthusiastic about the formula that was described in that ruling. However, I do appreciate the ruling's tacit approval of the idea that a trustee who can distribute for a beneficiary's welfare may use that authority to grant the beneficiary a general power of appointment.[2129]

"Ed Morrow on PLR 202206008: Judicial Settlement Modification & Formula Testamentary General Powers of Appointment," Steve Leimberg's Estate Planning Email Newsletter - Archive

[2129] Letter Ruling 202206008 is briefly referred to in the text accompanying fn 6370 in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts.

Message #2946 (3/17/2022), discussed this ruling and advocated for taxpayers to use a formula to generate a basis increase. However, privately Ed agreed with me that this is a tricky area into which one should not dive without considerable thought. Ed explored these issues more seriously than he did in that article when he wrote, "The Optimal Basis Increase and Income Tax Efficiency Trust: Exploiting Opportunities to Maximize Basis, Lessen Income Taxes and Improve Asset Protection for Married Couples after ATRA (Or: Why You'll Learn to Love the Delaware Tax Trap)" (1/1/2016, lasted revised 4/28/2018), which is available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2436964. Although I differ with some of Ed's conclusions, his 2016/2018 paper is worthy of serious study and debate.

Without in any way focusing on the Wife's ability to manipulate her taxable estate and therefore to control the scope of her general power of appointment, Letter Ruling 200403094 held:

> Under article 4.5 of Trust, if Wife predeceases Husband, at her death Wife will possess a testamentary general power to appoint to Wife's estate or to or for the benefit of one or more persons or entities, Trust assets equal in value to Wife's remaining applicable exclusion amount less the value of Wife's taxable estate determined as if she did not possess this power. Accordingly, we conclude that, if Wife predeceases Husband, the value of Trust assets over which Wife holds a power of appointment under article 4.5 of Trust will be included in Wife's gross estate.

Similarly, also failing to consider *Kurz*, Letter Ruling 200604028 held:[2130]

> Under the terms of Trust 1, as amended, if Husband predeceases Wife, Husband will possess a testamentary general power of appointment over assets equal in value to Husband's remaining applicable exclusion amount less the value of Husband's taxable estate determined as if he did not possess this power. Accordingly, we conclude that, if Husband predeceases Wife, the value of Trust 1 assets over which Husband holds a testamentary general power of appointment will be included in Husband's gross estate.

Also, our form for how to exercise a power of appointment provides that even testamentary-type powers can be exercised by will or by other document delivered to the trustee and that the latter can specify whether it is revocable or irrevocable. I have some state-law-specific reasons for preferring that approach, but it also came in handy when we needed to have approvals by beneficiaries of certain actions and a beneficiary had fallen out of favor. The primary beneficiary was able to irrevocably exercise the power of appointment to remove that family member from being a remainderman, so that family member did not need to be involved.

If consent is required to exercise the power but no person is serving in the capacity to consent, does the lack of a person holding that position prevent the holder from having a general power? Generally, the answer is that incapacity does not prevent the general power from existing.[2131] In

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[2130] The facts described this power using slightly different language:

> Trust 1 provides that if Wife is living at the time of Husband's death, Husband shall have a testamentary general power of appointment equal to the amount of Husband's remaining applicable exclusion amount set forth in § 2010 of the Internal Revenue Code ("Code") minus the value of Husband's taxable estate (determined by excluding the amount of those assets subject to this power).

[2131] Zaritsky and Law, "Finding Basis – It's Not Always Where You Thought It Was" (5/18/2020), includes:

> **Decedent Need Not be Competent to Exercise the Power**

Crummey, a withdrawal right constituted a presently exercisable general power of appointment even though the holder was a minor and a conservator would have needed to be appointed to exercise the withdrawal right.[2132] The relevant clause in *Crummey* provided:

> If a child is a minor at the time of such gift of that donor for that year, or fails in legal capacity for any reason, the child's guardian may make such demand on behalf of the child. The property received pursuant to the demand shall be held by the guardian for the benefit and use of the child.

Crummey reasoned:

> As we visualize the hypothetical situation, the child would inform the trustee that he demanded his share of the additions up to $4,000. The trustee would petition the court for the appointment of a legal guardian and then turn the funds over to the guardian. It would also seem possible for the parent to make the demand as natural guardian. This would involve the acquisition of property for the child rather than the management of the property. It would then be necessary for a legal guardian to be appointed to take charge of the funds. The only time when the disability to sue would come into play, would be if the trustee disregarded the demand and committed a breach of trust. That would not, however, vitiate the demand.
>
> All this is admittedly speculative since it is highly unlikely that a demand will ever be made or that if one is made, it would be made in this fashion. However, as a technical matter, we think a minor could make the demand.

A testamentary power to appoint the subject property to one's estate or its creditors is taxed as a general power of appointment, even if the individual is, on the date of death and at all times when he or she held the power, legally incompetent to exercise it. The law taxes a powerholder on the property subject to a general power if he or she "possessed" the power on or before the date of death, not whether he or she could legally exercise it. *Fish v. United States*, 432 F.2d. 1278 (9th Cir 1970); *Estate of Alperstein v. Comm'r*, 613 F.2d 1213 (2nd Cir 1979), *cert. denied sub nom. Greenberg v. Comm'r*, 446 U.S. 918 (1980); *Williams v. United States*, 634 F.2d. 894 (5th Cir. 1981); *Boeving v. United States*, 650 F.2d. 493 (8th Cir. 1981), *rev'g* 493 F.Supp. 665 (E.D. Mo. 1980); *Estate of Gilchrist v. Comm'r*, 630 F.2d 340 (5th Cir. 1980), *rev'g* 69 T.C. 5 (1977), *acq.* 1978-2 C.B. 1 (adjudication of incompetency of holder of a general power of appointment is irrelevant to estate tax treatment, unless all exercise of the power on holder's behalf, by any person or in any capacity, is barred by the adjudication under state law); *Doyle v. United States*, 358 F.Supp. 300 (E.D. Pa 1973); *Pennsylvania Bank & Trust Co. v. United States*, 451 F.Supp. 1296 (W.D. Pa. 1978), *aff'd* 597 F.2d 382 (3rd Cir. 1979); Rev. Rul. 75-350, 1975-2 C.B. 366 (marital deduction allowed for power of appointment marital trust, even though surviving spouse was mentally ill from the time of first spouse's death until time of surviving spouse's death, and under applicable state law, incapable of exercising the power); Rev. Rul. 75-351, 1975-2 C.B. 368 (minor had a general testamentary power of appointment even though, under applicable state law, minor was legally incompetent to execute a will at the time of death). But, see also *Finley v. United States*, 404 F.Supp. 200 (S.D. Fla., 1975) vacated on jurisdictional grounds, 612 F.2d 166 (5th Cir. 1980) (decedent, from time of devise of general power of appointment until her death lacked legal capacity to exercise general testamentary power of appointment, and so did not "possess" a general power of appointment for estate tax purposes).

[2132] Citation is found in fn 5852 in part III.A.2 Liability Issues.

Crummey concluded:[2133]

> All exclusions should be allowed under the *Perkins* test or the "right to enjoy" test in *Gilmore*. Under *Perkins*, all that is necessary is to find that the demand could not be resisted. We interpret that to mean legally resisted and, going on that basis, we do not think the trustee would have any choice but to have a guardian appointed to take the property demanded.

Requiring the consent of a nonadverse party does not prevent recognition of the general power of appointment.[2134] Reg. § 20.2041-3(c)(2) provides:

> Such power is not considered a general power of appointment if it is not exercisable by the decedent except with the consent or joinder of a person having a substantial interest in the property subject to the power which is adverse to the exercise of the power in favor of the decedent, his estate, his creditors, or the creditors of his estate. An interest adverse to the exercise of a power is considered as substantial if its value in relation to the total value of the property subject to the power is not insignificant. For this purpose, the interest is to be valued in accordance with the actuarial principles set forth in § 20.2031-7 or, if it is not susceptible to valuation under those provisions, in accordance with the general principles set forth in § 20.2031-1. A taker in default of appointment

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[2133] Below the court referred to *Perkins v. Commissioner*, 27 T.C. 601 (1956), which at 604-605 held:

> The issue as to whether a gift is of a present or future interest is not one of the time of vesting, but rather whether there is any substantial barrier to the present use, possession, or enjoyment by the donee. *Commissioner v. Disston*, 325 U.S. 442; *Fondren v. Commissioner*, 324 U.S. 18; *Ryerson v. United States*, 312 U.S. 405; *United States v. Pelzer*, 312 U.S. 399; *Commissioner v. Sharp*, 153 F.2d 163 (C.A. 9). There is infinite variety in the possible terminology of trust instruments and the circumstances surrounding their creation, and each case must be decided in the light of its own trust instrument and surrounding circumstances. *Commissioner v. Kempner*, 126 F.2d 853 (C.A. 5).
>
> The trust instruments by themselves appear to have given a present interest to the beneficiaries. Each provides that notwithstanding all other provisions the beneficiary, his duly appointed guardian, or his parent may at any time demand and receive all of the income and principal. To be sure, the beneficiaries were minors and unable effectively to exercise that right, and only with respect to two gifts in 1953 to one of the seven beneficiaries was there a duly appointed guardian at the time of the making thereof. Had the power to demand income or principal been limited to the beneficiaries or their duly appointed guardians, respondent's position, at least as to all gifts other than the two aforementioned, might well be tenable; there would have been at the time such gifts were made no person who could make an effective demand for immediate use, possession, and enjoyment by the beneficiaries. *Stifel v. Commissioner*, 197 F.2d 107 (C.A. 2), affirming 17 T.C. 647. *But cf. United States v. Baker*, 236 F.2d 317 (C.A. 4); *Gilmore v. Commissioner*, 213 F.2d 520 (C.A. 6), *reversing* 20 T.C. 579; *Kieckhefer v. Commissioner*, 189 F.2d 118 (C.A. 7), *reversing* 15 T.C. 111.
>
> In the instant proceeding, however, this right was also given to the adult parents of the beneficiaries, none of whom appears to have been incompetent to exercise the power thus bestowed. Therefore, with respect to each of the gifts in question there was at all times someone who could have made an effective, binding demand for principal and income. By the terms of the trusts alone, there was no substantial bar to present use, possession, and enjoyment by the donees.
>
> Petitioners expected the trusts to continue for a substantial period and did not anticipate actual exercise by any of the parents of that power. But we do not agree with respondent that such expectation is more than precatory, or that it vitiates the clear right unmistakably given.

[2134] *Maytag v. United States*, 493 F.2d 995 (10th Cir. 1974), *aff'g* 1972 WL 3201, 31 A.F.T.R.2d 73-1357 (D. Colo. 1972).

> under a power has an interest which is adverse to an exercise of the power. A coholder of the power has no adverse interest merely because of his joint possession of the power nor merely because he is a permissible appointee under a power. However, a coholder of a power is considered as having an adverse interest where he may possess the power after the decedent's death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate. Thus, for example, if X, Y, and Z held a power jointly to appoint among a group of persons which includes themselves and if on the death of X the power will pass to Y and Z jointly, then Y and Z are considered to have interests adverse to the exercise of the power in favor of X. Similarly, if on Y's death the power will pass to Z, Z is considered to have an interest adverse to the exercise of the power in favor of Y. The application of this subparagraph may be further illustrated by the following additional examples in each of which it is assumed that the value of the interest in question is substantial:
>
> *Example (1)*. The decedent and R were trustees of a trust under the terms of which the income was to be paid to the decedent for life and then to M for life, and the remainder was to be paid to R. The trustees had power to distribute corpus to the decedent. Since R's interest was substantially adverse to an exercise of the power in favor of the decedent the latter did not have a general power of appointment. If M and the decedent were the trustees, M's interest would likewise have been adverse.
>
> *Example (2)*. The decedent and L were trustees of a trust under the terms of which the income was to be paid to L for life and then to M for life, and the remainder was to be paid to the decedent. The trustees had power to distribute corpus to the decedent during L's life. Since L's interest was adverse to an exercise of the power in favor of the decedent, the decedent did not have a general power of appointment. If the decedent and M were the trustees, M's interest would likewise have been adverse.
>
> *Example (3)*. The decedent and L were trustees of a trust under the terms of which the income was to be paid to L for life. The trustees could designate whether corpus was to be distributed to the decedent or to A after L's death. L's interest was not adverse to an exercise of the power in favor of the decedent, and the decedent therefore had a general power of appointment.

Estate of Towle v. Commissioner, 54 T.C. 368, 370 (1970), held:[2135]

[2135] At 370-371, the court cited supporting cases then listed further support:

> *Reinecke v. Smith*, 289 U.S. 172 (1933), so holds with respect to the income tax and its principles are fully applicable to the estate tax. *Northern Trust Co. v. United States*,389 F.2d 731 (C.A. 7, 1968); *New England Merchants Nat. Bank of Boston v. United States*, 384 F.2d 176 (C.A. 1, 1967); *Welch v. Terhune*, 126 F.2d 695 (C.A. 1, 1942); *William R. Steward*, 28 B.T.A. 256 (1933), vacating 27 B.T.A. 593 (1933), affirmed *sub nom. Witherbee v. Commissioner*, 70 F.2d 696 (C.A. 2, 1934). This conclusion is further supported by the following statement in the committee reports which accompanied the original enactment of the pertinent portion of section 2041, as an amendment to section 811(f) of the 1939 Code, by the Powers of Appointment Act of 1951, 65 Stat. 91:
>
> > a future joint power is totally exempt if it is not exercisable by the decedent except with the consent or joinder of a person having a substantial interest, in the property subject to the power, which is adverse to the exercise of the power in favor of the decedent, his estate, his creditors, or the creditors of his estate. A taker in default of appointment has an interest which

> As a general rule, the interest of a nonbeneficiary trustee is neither substantial nor adverse. *Reinecke v. Smith*, 289 U.S. 172 (1933), so holds with respect to the income tax and its principles are fully applicable to the estate tax.

After citing Reg. § 20.2041-3(c) and *Estate of Towle v. Commissioner*, Rev. Rul. 79-63 held:

> Under the terms of the trust in the present case the decedent could cause the trust principal to be distributed during lifetime only with the consent of A. However, in this case, the interest held by A does not amount to a substantial interest in the property subject to the power, that is adverse to exercise of the power in favor of the decedent, for purposes of section 2041(b)(1)(c)(ii).
>
> In this case, A is a taker in default not of the lifetime power in which A has a power of consent but rather of the testamentary power exercisable solely by the decedent. In such a situation A would not have necessarily been in a better economic position after the decedent's death by refusing to exercise the power in favor of the decedent during the decedent's lifetime. Thus, the fact that A might survive the decedent and receive an

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> is adverse to such an exercise. Principles developed under the income and gift taxes will be applicable in determining whether an interest is substantial and the amount of property in which the adversity exists. A coholder of the power has no adverse interest merely because of his joint possession of the power nor merely because he is a permissible appointee under a power, since neither the power nor the expectancy as appointee is an "interest" in the property.

[See H. Rept. No. 327, to accompany H.R. 2084 (Pub. L. 58), 82d Cong., 1st Sess., pp. 5-6 (1951); S. Rept. No. 382 to accompany H.R. 2084 (Pub. L. 591), 82d Cong., 1st Sess., p. 5 (1951).]

In *Reinecke v. Smith*, *supra*, the Supreme Court stated:

> In approaching the decision of the question before us it is to be borne in mind that the trustee is not a trustee of the power of revocation and owes no duty to the beneficiary to resist alteration or revocation of the trust. Of course he owes a duty to the beneficiary to protect the trust res, faithfully to administer it, and to distribute the income; but the very fact that he participates in the right of alteration or revocation negatives any fiduciary duty to the beneficiary to refrain from exercising the power.

[See 289 U.S. at 176-177.]

We think that the phrase "substantial interest in the property, subject to the power, which is adverse to exercise of the power in favor of the decedent," as used in section 2041(b)(1)(C)(ii), was intended at the very least to require that the third person have a present or future chance to obtain a personal benefit[5] from the property itself. *Cf. Latta v. Commissioner*, 212 F.2d 164, 167 (C.A. 3, 1954); *Commissioner v. Prouty*, 115 F.2d 331, 335-336 (C.A. 1, 1940), affirming in part and reversing and remanding in part 41 B.T.A. 274 (1940).[6] Compare also the provisions of section 2041(b)(1)(C)(iii), which exclude, on an allocable basis, a portion of property subject to a power which would otherwise be a general power of appointment, but which is exercisable "in favor of" a person whose consent is required.

[5] Whether such benefit includes, not only the possibility of direct realization, but also the possibility of indirect realization through a power affirmatively to dispose of an interest in the property to others is a question we are not now required to decide. See 5 Mertens, Law of Federal Gift & Estate Taxation, sec. 34.68, p. 302.

[6] The rationale of the Prouty case as to what constitutes an adverse interest has been accepted by this Court. See *Estate of Leon N. Gillette*, 7 T.C. 219, 222 (1946). See also *Strite v. McGinnes*, 330 F.2d 234, 240 (C.A. 3, 1964), affirming 215 F.Supp. 513 (E.D. Pa. 1963), where the court accepted without discussion the proposition that a corporate trustee, who was a coholder of a power of appointment, was a nonadverse party where the remaindermen were the decedent's nieces and nephews.

> interest in the property, if the decedent failed to exercise the testamentary power in favor of persons other than A, does not elevate A's interest as a consenting party of the lifetime power to a substantial adverse interest.
>
> Consequently, the decedent's power falls within the definition of a "general power of appointment" because A did not have a substantial interest in the property that was adverse to the exercise of the power in favor of the decedent. If, however, A had been the decedent's only child, A would have had a vested interest in the trust remainder that would have been substantially adverse to the exercise of the decedent's lifetime power of appointment. See *Commissioner v. Prouty*, 115 F.2d 331 (1st Cir. 1940); *Newman v. Commissioner*, 1 T.C. 921 (1943).
>
> Under section 20.2041-3(c)(3) of the regulations, quoted above, the amount includible in the decedent's gross estate is the value of property subject to the general power of appointment divided by the number of holders of the power who are also permissible appointees. In the present case A was a permissible appointee but not a coholder of the decedent's general power of appointment. The requirement that A consent to the exercise of the power held by the decedent does not raise A to the status of a coholder or joint holder of such power. Compare Rev. Rul. 76-503, 1976-2 C.B. 275 where one-third of the value of trust property was includible in the gross estate of the decedent where the decedent, along with two other coholders, had a general power of appointment. Unlike Rev. Rul. 76-503, in this case A did not have a power but could only consent to the decedent's exercise of a power, and therefore, was not a coholder of a power.
>
> Accordingly, in the present case, the total value of the trust property (as of the date of death of the decedent or appropriate alternate valuation date) is includible in the gross estate of the decedent under section 2041 of the Code as property subject to a general power of appointment.

Reading together Reg. § 20.2041-3(c), *Estate of Towle v. Commissioner*, and Rev. Rul. 79-63, a person who is not a taker in default of a power of appointment is not an adverse party, and a person who is a taker in default of a testamentary power of appointment is not, solely by reason of that status, adverse with respect to the exercise of an inter vivos power of appointment. A logical extension of Rev. Rul. 79-63 would seem to support the position that a taker in default of a testamentary power of appointment does not, solely by being a taker in default, have an adverse party with respect to distributions that are made before the death of the holder of the testamentary power of appointment.[2136]

A claim against property subject to a general power of appointment may affect its value but not a power of appointment's status as a general power.[2137]

[2136] Thus, a person who is a remainderman and not a current permissible distributee would seem not to have an adverse interest to what occurs during trust administration before the death of the holder of a power of appointment that could divest the remainderman's interest. This would seem to prevent gift tax consequences from resulting from a trust modification that affects administration before that death, perhaps curing concerns raised by part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts.

[2137] *Witkowski v. United States*, 451 F2d 1249 (5th Cir. 1971), *cert. denied*, 409 U.S. 891 (1972), reasoned:

Actually two distinct variants on the same theme are being played here. The first is the contention that Mrs. Witkowski was legally barred from conveying the property without the joinder of the sons because under State law they held what was in effect a constructive trust secured by the farm.[4] The second amounts to the theory that practically speaking the decedent could not have exercised her power alone because the sons' alleged equitable claim eliminated any realistic probability of her finding a prospective purchaser or mortgagee who would have accepted her clouded title.[5]

[4] [distinguished this case from *Faville v. Robinson*, 227 S.W. 938 (1921)]

[5] To support this contention Taxpayer introduced the expert testimony of a title attorney to the effect that the property could not have been conveyed or mortgaged without the joinder of the sons. Of course, this testimony is not conclusive on the legal issue of whether under Texas law Leo and Vernon actually held a substantial adverse interest in the farm.

Neither of these positions is tenable. Like the District Court we have serious doubts as to whether the "substantial adverse interest" contemplated by § 2041(b)(1)(C)(ii) can arise other than by the simultaneous creation of such an interest and the power in the same instrument, obviously the paradigmatic case foreseen by Congress when it carved out this exception to the definition.[6] Even assuming, however, that the holder of a general power of appointment may by his own acts estop himself from exercising it, the evidence here clearly establishes that Mrs. Witkowski's authority under Texas law was not restrained by any legally enforceable restriction.

[6] The language of § 2041(b)(1)(C) strongly suggests that the definitional exception extends only to adverse interests created concurrently with what would otherwise be a general power, rather than to those arising after its creation, but since there is apparently little authority one way or another on the subject we need not and do not decide the question here.

In the first place, neither the 1964 oral agreement between Mrs. Witkowski and her sons nor the quitclaim deed from Winifred and her husband created any present interest in the property in either Leo or Vernon. Texas courts have frequently recognized and applied the principle that oral agreements to devise or convey real property are not enforceable. "A contract to make a will to dispose of property to certain beneficiaries is a contract to convey and must conform to the Statute of Frauds." [various Texas state court citations] Since the purported agreement between the decedent and her sons was never reduced to writing, no legally enforceable interest ever arose, much less the "substantial adverse interest" required to exempt Mrs. Witkowski's authority from the statutory definition of a general power of appointment.

Nor can the appellant prevail on the alternative theory that the practical exercise of Mrs. Witkowski's power was thwarted by the sons' asserted equitable claim and its purported adverse effect on the marketability of her title. If the decedent in fact possessed the authority under the provisions of her husband's will and applicable Texas law to convey or mortgage the property without the joinder of her sons—and it is apparent that she did—the possibility that as a practical matter few if any prospective purchasers or mortgagees would be willing to take a deed or mortgage signed by her alone is totally irrelevant. The decedent's title may have been questionable for any number of reasons, apart from the putative interests of Leo and Vernon, yet such defects could not have exempted from the burden of Federal estate taxation an otherwise incontestable general power of appointment.[7] The power is taxable if it exists, even though other claimants to the property may have hindered its exercise.

[7] Of course, on these facts the appellant might have made a quite different argument—that is, that the value of the property subject to the decedent's power was something less than what otherwise would have been its fair market value because the substantial possibility of future claims by the sons might have necessitated a lower return from a sale or mortgage had Mrs. Witkowski proceeded on her own. This would go, not to taxability, but to the amount of it. However, the Commissioner's valuation of the property was never contested by Taxpayer, either in his claim for refund or in his pleading in the District Court, and we assume that he chose to stand or fall on his theory that the sons held a substantial interest adverse to the exercise of the decedent's power.

In short, the District Court correctly refused to submit the estoppel theory to the jury because the uncontested facts clearly revealed that under Texas law neither son held the necessary

When three trustees may distribute all of the trust's property, to anyone, even themselves (with no ascertainable standard), each trustee has a general power of appointment over one third of the trust, whether the trustees act unanimously[2138] or by majority vote.[2139]

Rev. Rul. 82-156 held that notice to adverse parties, who may trigger a veto power in a nonadverse party, did not prevent the power from being a general power. The facts were:

> D, the decedent, provided by will that one-half of D's adjusted gross estate be placed in a trust in which S, D's spouse, was entitled to all the income annually for life. In addition, S was granted the power, commencing at D's death and at any time during S's lifetime, to appoint trust corpus in such amounts and at such times as S chose in favor of S or S's creditors. D's will provided further that any corpus remaining in trust at S's death should pass to A and B in equal shares.
>
> The will provided that any proposed exercise of the power of appointment by S must be preceded by notice to A and B, and if either objected to a proposed exercise of the power of appointment, the matter was to be submitted for resolution to the trustee of the testamentary trust, a bank, whose decision was binding.
>
> D died in 1982. D's executor did not make an election under section 2056(b)(7) of the Code with respect to the property passing to the testamentary trust. S subsequently died in 1982.

Rev. Rul. 82-156 reasoned:[2140]

> Under the facts of the ruling, S was granted a life estate in all the trust's income coupled with a power to appoint trust corpus in favor of S or S's creditors. S's power was exercisable, in effect, either with the joint consent of A and B, or with the consent of the trustee. The consent of A and B made the consent of the trustee unnecessary, and conversely, the consent of the trustee made the consent of A and B unnecessary. Since the trustee had no adverse interest for purposes of section 2041, and since S could freely exercise the power of appointment as long as the trustee consented, S had a general power of appointment within the meaning of section 2041. S's power was not, however, exercisable "alone and in all events" for purposes of section 2056.

When a trust authorized the trustee to grant or eliminate a general power of appointment[2141] but the person serving as trustee was prohibited from exercising that power, amending the trust to

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> substantial interest in the property adverse to the exercise of the power of appointment created by the will.

[2138] Rev. Rul. 76-503.

[2139] Rev. Rul. 77-158.

[2140] Its ultimate conclusion was a double-whammy:

> Because S could not exercise the power of appointment alone and in all events, the exception to the terminable interest rule under section 2056(b)(5) of the Code does not apply and the marital deduction is not allowable. Further, because S possessed a general power within the meaning of section 2041 of the Code over the trust assets, those assets are includible in S's gross estate, on S's subsequent death.

[2141] Letter Ruling 201845006 involved a trust with the following powers that a trustee could exercise only if the trustee was not a beneficiary:

appoint a special trustee authorized to exercise that power did not have any GST[2142] or gift/estate tax[2143] consequences. However, if the power is actually turned off (or the power never existed, someone could have granted the power, but that never happened), the mere possibility of a person holding a general power should not itself constitute a general power.[2144]

Section 3.091 to create in a lineal descendant of the Grantor a testamentary general power of appointment within the meaning of IRC § 2041 [including the power the exercise of which requires the consent of the Trustee (other than any beneficiary)];

Section 3.092 to limit a general power of appointment of a lineal descendant of the Grantor, as to all or part of such principal at any time prior to the death of such lineal descendant by narrowing the class to whom the powerholder may appoint the property subject to such appointment, so as to convert such power into a special power of appointment;

Section 3.093 to eliminate such power for all or any part of such principal as to which such power was previously created

[2142] Letter Ruling 201845006 concluded as to the trust's GST status:

Pursuant to the Court's Order, under new Section 8.06, Bank 2 is named as special trustee for the limited purpose of exercising the powers given to a non-beneficiary trustee, including, but not limited to, powers set forth in Section 3.09 of Trust. The proposed modification of Trust will not result in a shift of any beneficial interest in the trust to any beneficiary who occupies a generation lower than the persons holding the beneficial interests. Further, the proposed modification of Trust will not extend the time for vesting of any beneficial interest in the modified Trust beyond the period provided for in Trust. Accordingly, based on the facts submitted and the representations made, we conclude that the proposed modification of Trust will not adversely affect Trust's GST inclusion ratio.

[2143] Letter Ruling 201845006 reasoned and concluded as to the effect for gift and estate tax purposes:

In this case, Son and Child 1 have beneficial interests in Trust and are the current Co-Trustees. Section 3.09 grants to a non-beneficiary trustee certain trustee powers, including the power to limit or eliminate Son's testamentary general power of appointment under Section 2.013. Prior to the modification, the terms of Trust did not provide a method for appointing a non-beneficiary trustee who may exercise the powers in Section 3.09 granted to only non-beneficiary trustees. The modification of Trust to add Section 8.06 to provide a method for appointing an independent special trustee who may exercise the powers set forth in Section 3.09, and to appoint Bank 2 as an independent special trustee with the authority to exercise the powers set forth in Section 3.09 of Trust, does not change or transfer the interests of Son during his lifetime, nor does it confer any new rights to any beneficiaries. Rather, the modification provides a process for the powers set forth in Section 3.09 to be administered by a non-beneficiary trustee (*i.e.*, Special Trustee). The testamentary power of appointment granted to Son in Section 2.013 occurs upon the death of Son, and is not currently exercisable by Son. Son retains the same interest in Trust, both before and after the modification.

Accordingly, based on the facts submitted and the representations made, we conclude that Bank 2's acceptance and appointment to the office of Special Trustee of Trust pursuant to the Order will not constitute the exercise or release of a general power of appointment under § 2514 so as to constitute a gift by Son for federal gift tax purposes. Further, we conclude that the exercise of trustee powers, including those delineated in Sections 3.092 and 3.093 of Trust by Bank 2, or a successor Special Trustee, to limit or eliminate Son's testamentary general power of appointment granted under Section 2.013 of Trust will not constitute the exercise or release of a general power of appointment under § 2041(a)(2), and, as a result, the Trust assets will not be included in Son's gross estate under § 2041(a)(2).

[2144] By negative implication, *Johnstone v. Commissioner*, 76 F.2d 55 (9th Cir. 1935), *cert. denied*, 296 U.S. 578 (1935), *aff'g* 29 B.T.A. 957 (1934), supports this proposition:

The contingency which would have prevented his exercise of the power did not happen, and decedent was entitled to exercise the general power of appointment given him in the several trust agreements.

Modifying a trust to add a general power of appointment may have gift/estate/GST tax consequences. For that and related issues, see part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts.

If an exercise of a power of appointment would extend the time for vesting beyond the rule against perpetuities set forth in the trust agreement and therefore be impermissible, consider clarifying the exercise to cut it back to the permitted period. Letter Ruling 202108001 held that such a clarification prevented the exercise of a general power and preventing triggering Code § 2041(a)(3) and did not affect GST grandfathering.

Now that we have discussed sophisticated provisions and various consequences, consider simplicity in the scope. If the holder's estate will never be big enough to generate estate tax, then consider making the general power plenary. However, consider whether the holder might move to a state that imposes estate tax.

One may want to require the consent of a nonadverse party if one has any concerns about the holder. The holder may be totally fine now, but anyone could lose capacity due to physical illness or may become frail and dependent on a person who is or becomes a predator. Consider requiring the consent of a corporate trustee or any substitute nonadverse party approved by family members (or appointed by the holder and not vetoed by family members after notice). Consent might be required only for the "general" aspects of the power, not for an exercise that keeps assets within the family. Also, consent would not be required to the extent exercised to pay estate tax resulting from the general power.

II.H.3. Valuation Discounts – Friend or Enemy

Adjustments for lack of control and lack of marketability are not really some magical artificial value reduction – they merely reflect proper valuation. Nevertheless, the fact that the value of an interest in an entity often is smaller than a pro rata share of the entity's underlying assets is popularly referred to as a discount, so we will reluctantly use that term here.

Although a discount might save estate taxes, it also causes a reduced basis. If the discount does not save estate tax, then it reduces the basis of a discounted asset included in one's estate. If this is unfavorable and the taxpayer wants to engage in an uphill battle to argue that Code § 2036 causes estate tax inclusion,[2145] see fn 5699 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss) and also see part III.C Code § 2036.

Same with *Keeter v. United States*, 461 F.2d 714 (5th Cir. 1972), *rev'g* 323 F.Supp. 1093 (N.D. Fl. 1971):

> A revocable power of appointment that is not revoked by the settlor becomes, upon his death, a full-fledged power of appointment. What the settlor might have done with the power that he granted is of no relevance to this case.

[2145] For when an entity is disregarded and Code § 2036 (an issue into which this document does not delve), see fn 91 in part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders.

Although partnerships work better than other entities on a few levels,[2146] having a discounted partnership interest included in one's estate can cause an unfavorable basis change in assets held in the partnership (an "inside basis"):[2147]

- if the partnership has a Code § 754 election in place, or
- if the partnership's assets (in the aggregate) have a basis that exceeds their value by more than $250,000.

This effect on inside basis depends on whether the asset has unrealized gain or loss:[2148]

- If the asset has an unrealized gain, the valuation discount can reduce or eliminate a basis increase but cannot generate a basis reduction.
- If the asset has an unrealized loss, the valuation discount can generate a basis reduction, but not below the asset's value.

Also see part III.E Fairness Within Families; Valuation.

II.H.4. How the Presence or Absence of Goodwill Affects the Desirability of Basis Step-Up in a Partnership or S corporation

Self-created goodwill (goodwill created through business entity operations rather than purchased from the seller of a business) generally has a zero tax basis yet very substantial value. A partnership structure is important to secure the basis step-up or to facilitate a tax-efficient seller-financed sale.[2149]

Some entities do not have any significant goodwill. Goodwill generally is measure by an entity's rate of return in excess of what an owner could earn investing capital in other places. An entity that is not an operating business generally would not have goodwill. Also, some businesses do not generate a high enough rate of return on their capital to have significant goodwill; they earn just enough to pay their owners and employees reasonable compensation for services provided and perhaps a very modest profit on invested capital. See parts II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees? and II.Q.7.h.v Taxpayer Win in *Bross Trucking* When IRS Asserted Corporation Distribution of Goodwill to Shareholder Followed by Gift to Shareholder of New Corporation (2014).

If a partnership or an S corporation has no significant goodwill and its other assets have values close to basis, then the basis of owner's interest in the company might be relatively close to a proportionate share of the basis and fair market value of the assets that the company owns. In that case, including the owner's interest in the company in the owner's estate might produce no

[2146] See part II.E Recommended Structure for Entities.
[2147] See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.
[2148] See part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest, especially fn. 4241.
[2149] See part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis. See also parts II.E Recommended Structure for Entities and II.Q.7.h Distributing Assets; Drop-Down into Partnership.

significant basis increase or might even produce a basis decrease when the owner dies; see part II.H.2.i Avoiding a Basis Step-Down.

Note that goodwill that is not being amortized and is held by a partnership would be eligible for a basis step if a Code § 754 election is in place.[2150]

Whether or not goodwill is being amortized, a controlled corporation's sale or distribution of goodwill might generate ordinary income.[2151] Using a partnership that essentially allows one to deduct the goodwill's value in a manner that avoids capital gain on the sale of goodwill prevents this result.[2152]

II.H.5. Irrevocable Trust Planning and Basis Issues

II.H.5.a. Irrevocable Trust Planning and Basis Issues - Generally

For various strategies involving grantor trusts, see part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.[2153] One of the problems with those techniques is that the estate tax saved might not make up for the lack of basis step-up on death, if the techniques use low-basis assets. If that is a concern, see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

Consider the following from fn 191 on page I-A-61 of Bramwell, Eastland, McCaffrey, and Morrow, "Creative Planning Techniques with Grantor and Non-Grantor Trusts," 2020 Heckerling Institute on Estate Planning:

> The following formula may be used to determine X, the amount of total investment return a transferred appreciated asset must generate to offset the potential income tax cost of the loss of basis step up under Section 1014 at the death of the transferor:
>
> $X = ((E)(V) - (I)(B)) \div (E-I)$
>
> In this formula, the letter E means the highest combined federal and state estate tax rate applicable in the year of the transferor's death to the estates of decedents who die domiciled in the transferor's state of domicile. The letter I means the highest combined federal and state income tax rate applicable to the transferee's long-term capital gains. The letter V means the value of the transferred asset as finally determined for federal gift tax purposes. The letter B means the basis of the transferred asset for federal income tax purposes. See Carlyn McCaffrey, "Tax Tuning the Estate Plan by Formula," 33rd Annual Heckerling Institute on Estate Planning ¶ 402.2 (1999).

2150 See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, fn. 5684.

2151 See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), especially fns. 5081-5085.

2152 See parts II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis and II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

2153 Especially parts III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment, III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System, and III.B.2.j Tax Allocations upon Change of Interest in a Business, especially part III.B.2.j.i Changing Grantor Trust Status.

That formula does not consider the estate savings of income tax paid by the deemed owner of an irrevocable grantor trust.[2154] Nor does it consider the effect of using lifetime gift tax exemption before a possible decrease.[2155]

If the grantor trust has high basis assets (including businesses whose assets have values that are not in excess of basis; see parts II.H.2.i Avoiding a Basis Step-Down and II.H.4 How the Presence or Absence of Goodwill Affects the Desirability of Basis Step-Up in a Partnership or S corporation), keeping them outside the estate tax system might make a lot of sense, in that the grantor is paying the income tax on each year's earnings (which earnings add to the basis in the trust's assets).

It has been suggested that one should not use one's estate tax exemption to give away assets to avoid estate tax on their appreciation. Generally, a leveraged transaction, such as a GRAT or a sale to an irrevocable grantor trust, would be better. However, if the asset has a high basis and will continue to have a high basis and the client does not want to mess with a sale, then a gift to an irrevocable grantor trust might be appropriate.

The death of the deemed owner of an irrevocable trust does not, in and of itself, trigger a new basis.[2156] To get an irrevocable grantor trust's assets included in the primary beneficiary's estate, consider giving the beneficiary a formula general power of appointment; see part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap. Because the consent of a trustee who is a nonadverse party can be required, this tool can cause estate inclusion without jeopardizing the remaindermen's interests in any practical way. In contrast, a distribution to the beneficiary exposes the assets to risks (although that may be handy to permit annual exclusion gifting if careful to avoid step transactions). In any event, be sure that whatever one does is authorized, so that it cannot be undone.[2157]

II.H.5.b. Moving Real Estate or Other Low-Basis Property from Irrevocable Trust to Grantor

This part II.H.5.b assumes one has an irrevocable grantor trust (IGT) with assets with value in excess of basis (low-basis assets) that need to be transferred to the grantor in exchange for assets with values close to basis (high-basis assets). For an explanation of IGTs, see part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

If an irrevocable trust is not a grantor trust, consider establishing an identical trust that is a grantor trust (perhaps using a swap power) and merging the nongrantor trust into the grantor trust, so that the above sale can be done.[2158] However, if the existing trust has liabilities in excess of basis, consider any income tax consequences that might result from such a merger.

If the grantor is buying the assets using debt, not everyone is comfortable using a promissory note that the grantor owes the trust, out of concern over the note's basis; if the note has a basis

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2154 See part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.
2155 See part II.H.12 Large Taxable Gifts to Lock in Lifetime Gift/Estate Tax Exemption.
2156 Rev. Rul. 2023-2, which is quoted extensively in part III.B.2.a Tax Basis Issues When Using Irrevocable Grantor Trusts.
2157 See fn 6346 in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts.
2158 See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment, especially part III.B.2.d.i Federal Income Tax and Irrevocable Grantor Trust Treatment, fn. 6533.

less than its face value, the market discount rules may treat any difference as ordinary income[2159] to any holder other than the original holder.[2160] To avoid this concern, consider having someone other than the trust loan the money to the grantor. A bank would be willing to loan 100%, if it keeps a security interest in the loan proceeds. For a full description of this strategy, see part II.H.10 Extracting Equity to Fund Large Gift; however, where part II.H.10 suggests the donor paying a guarantee fee to the donee, in this case the grantor would pay a guarantee fee to the trust.

II.H.5.c. Preferred Partnership In Conjunction with GRAT or Sale to Irrevocable Grantor Trust of an S corporation

Suppose the client has determined that an S corporation needs to be moved outside of the estate tax system using, for example, part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

Generally, the S corporation's assets do not receive an inside basis step-up on the client's death or even on the trust's sale of its stock in the S corporation. See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

Although an S corporation might in certain limited circumstances replicate an inside basis step-up upon death, that strategy does not necessarily work well. See part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation.

[2159] The IRS might argue that the note has basis equal to the basis of the common interest. Before the grantor dies, for income tax purposes the trust didn't exist. For income tax purposes, the grantor – not the trust – owned whatever property was in the trust until the grantor died. So, the grantor's death should be taken as the event that first created the trust for income tax purposes. For income tax purposes, there was no sale – simply a gift or bequest by the grantor of a note to the trust. Therefore, such an IRS argument would appear not to work. However, given that no authority directly addresses this issue, let's consider it: If the IRS were to win that argument and the Code § 1276 market discount rules were to apply, any principal payments in excess of basis would have a character similar to that of interest income.

[2160] Code § 1278(a)(1)(D) provides:

- (i) *In general*. Except as otherwise provided in this subparagraph or in regulations, the term "market discount bond" shall not include any bond acquired by the taxpayer at its original issue.
- (ii) *Treatment of bonds acquired for less than issue price*. Clause (i) shall not apply to any bond if—
  - (I) the basis of the taxpayer in such bond is determined under section 1012, and
  - (II) such basis is less than the issue price of such bond determined under subpart A of this part.
- (iii) *Bonds acquired in certain reorganizations*. Clause (i) shall not apply to any bond issued pursuant to a plan of reorganization (within the meaning of section 368(a)(1)) in exchange for another bond having market discount. Solely for purposes of section 1276, the preceding sentence shall not apply if such other bond was issued on or before July 18, 1984 (the date of the enactment [7/18/84] of section 1276) and if the bond issued pursuant to such plan of reorganization has the same term and the same interest rate as such other bond had.
- (iv) *Treatment of certain transferred basis property*. For purposes of clause (i), if the adjusted basis of any bond in the hands of the taxpayer is determined by reference to the adjusted basis of such bond in the hands of a person who acquired such bond at its original issue, such bond shall be treated as acquired by the taxpayer at its original issue.

Although the debtor changes when the grantor dies, the trust would be the original holder and presumably would receive capital gain treatment, as would any residual beneficiary of the trust who does not receive the note in a pecuniary bequest.

Therefore, in conjunction with the sale, the S corporation might form a preferred partnership.[2161] For a general explanation of preferred partnerships, see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion. For migrating into a preferred partnership, see part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure, as well as part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially part II.Q.7.h.viii Value Freeze as Conservative Alternative.

The irrevocable grantor trust would need to be funded with or borrow from a bank or a related party enough cash to contribute to invest in the 99% common interest in the partnership (the S corporation would retain a 1% common interest, perhaps as a general partner, in the partnership). See also part II.M.3 Buying into or Forming a Partnership.

Eventually, the grantor might buy the common interest from the irrevocable grantor trust, preferably borrowing from a bank in a manner similar to that described in part II.H.10 Extracting Equity to Fund Large Gift, not only to fund the grantor's purchase but also to strip the increase in equity that might occur if the property increases in value. This strategy would provide for a basis step-up at little or no estate tax cost.

II.H.5.d. Using Grantor's Parent's Exemption for Basis Step-Up

If the grantor's parent is living and does not already have a taxable estate, consider including the parent as a beneficiary of an irrevocable grantor trust that would not otherwise get a basis step-up and granting the parent a general power of appointment in favor of the parent's creditors that is effective upon death. The power would be exercisable only with the consent of an independent person and would apply only to the extent of assets that would generate a basis step-up without incurring estate tax. For how to write such a power, see text accompanying fns 2127-2128 in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.

However, if the parent is receiving means-test government benefits, such as Medicaid or SSI, consult an expert in the area whether such a trust might jeopardize these benefits.

Inclusion in the parent's estate does not change the donor's status as the grantor for purposes of the grantor trust rules except to the estate the parent actually exercises the power.[2162]

ACTEC Fellow Mickey Davis coined this idea the ""Accidentally Perfect Grantor Trust," when describing this is more detail at http://daviswillms.com/yahoo_site_admin/assets/docs/Planning_for_New_Basis_at_Death2015.68160224.pdf and elsewhere.

II.H.6. Basis Shifting Opportunities Other Than Grantor Trusts

One could simply distribute low-basis property to a partner in redemption of the low basis partnership interest of a partner with a short life expectancy, to better focus basis step-up at the partner's death or avoid the need to make a Code § 754 election.

[2161] Formation of the preferred partnership when the sale occurs is not required, but doing so would provide more efficiency in appraisal fees incurred.

[2162] Reg. § 1.671-2(e)(5), which is reproduced in fn 6620 in part III.B.2.h.i Who Is the Grantor.

See parts II.Q.8.a Partnership as a Master Entity and II.Q.8.b.i.(e) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property, which also discusses like-exchanges, for opportunities to:

- Shift basis from assets that are intended to be held for a while to assets that likely to sold in the near future, or
- Strip basis from high basis property to property that is then distributed to a partner with a short life expectancy, so that basis step-up at death is focused on targeted assets.

A gift to a person with a short life expectancy would be eligible for a basis step-up, so long as the donee does not die within one year of the gift or the gifted property does not pass back to the donor.[2163]

II.H.7. Passive Losses – When Basis Step-Up Might Not Be Favorable

A decedent's suspended passive losses are lost to the extent that the asset generating the passive losses received a basis step-up at the decedent's death.[2164]

In planning for basis step-up, consider which is more valuable - the suspended passive losses or the basis step-up.

If the former, consider using a beneficiary deemed-owned trust to hold the passive asset.[2165]

II.H.8. Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation; Possible Way to Attain Basis Step-Up

As described in part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations, S corporation assets do not receive a new basis when a shareholder dies or sells stock.

However, S corporations can sometimes replicate the equivalent of a basis step-up when the sole owner dies. For how to get property out of a corporation to enable it to receive a basis step-up without going through this analysis, see part II.Q.7.h Distributing Assets; Drop-Down into Partnership.

II.H.8.a. Depreciable Real Estate in an S Corporation – Possible Way to Replicate Effect of Basis Step-Up If the Stars Align Correctly

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[2163] Code § 1014(e). The legislative history says that a bargain sale is subject to the provision to the extent of the gift element.

[2164] See part II.K.2.d Effect of Death of an Individual or Termination of Trust on Suspended Passive Losses.

[2165] See text accompanying fn. 3360 for an explanation; see also parts III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts and III.A.3.e QSSTs and ESBTs (a QSST is a type of beneficiary grantor trust).

II.H.8.a.i. Solution That Works for Federal Income Tax Purposes (To an Extent)

II.H.8.a.i.(a). Model for Attempting to Replicate an Inside Basis Step-Up

Although a partner's share of partnership assets can obtain a basis step-up at that partner's death,[2166] no such relief is available with respect to the assets of a corporation (whether C or S).

Generally, an S corporation can replicate the basis step-up if it holds nondepreciable property in a separate entity, by liquidating after death. That is because the capital gain on the shareholder's K-1 is offset by a capital loss when the corporation is liquidated.[2167]

Sale of Depreciable Property to Third Party
or
Liquidation of Real Property
(Zero basis, $1M value)

Proceeds from sale	$ 1M
Basis of real estate	0
Gain on K-1	$ 1M
Stock basis after death	$ 1M
Gain on K-1	$ 1M
Stock basis after sale of real estate	$ 2M
Liquidation proceeds	$ 1M
Stock basis	($ 2M)
Loss on liquidation	($ 1M)
Long-term capital gain on K-1	$ 1M
Long-term capital loss on liquidation	($ 1M)
Net long-term capital gain (loss)	$ 0

II.H.8.a.i.(b). Challenging Issues When S Corporation Liquidates Holding Depreciable Property or Other Ordinary Income Property

If the property is depreciable and the corporation liquidates, then Code § 1239 might apply to convert the K-1 income to ordinary income.[2168] Being a related party transaction might also preclude capital gain treatment given patents in certain situations.[2169] Furthermore, if the taxpayer previously sold depreciable property and took an ordinary loss under Code § 1231, gains on the sale of depreciable property will be taxed as ordinary income to the extent of those prior ordinary losses (referred to as Code § 1231 recapture). Finally, the recapture of depreciation deductions taken on personal property constitutes ordinary income under Code § 1245 (see part II.H.8.b Depreciable Personal Property in an S Corporation).

[2166] For more on Code § 754 elections (and similar rules that apply without an election when the partnership has a substantial built-in loss), see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.
[2167] Letter Rulings 9218019, 9622012.
[2168] Code § 1239 is discussed at part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property.
[2169] See part II.G.18.c Patents, especially fn. 1691.

Depreciable property is not the only concern. Consider an S corporation that holds marketable securities. Depending on the nature of a security, its sale might generate ordinary income. For example, if and to the extent that gain on sale of a bond (whether or not the interest is exempt from income tax) results from basis below the bond's face amount, the gain might be taxed as ordinary income under the market discount rules.[2170]

In these cases, the K-1 would include ordinary income, which cannot be offset in any significant measure by the long-term capital loss on liquidation.

With multiple depreciable real properties in an S corporation, one might not be able to sell all the property to a third party in one year, and liquidation would cause this mismatch for the remaining properties. Thus, depreciable real estate should be spun off into a separate S corporation for each property; it's best to do the spin-off at least five years before death;[2171] even then, establishing the required business purpose for a spin-off in real estate might be challenging when

To avoid these complications for an S corporation, and to try to get some benefits for real estate currently held in a C corporation, consider getting the real estate or other assets out of the corporation into an entity taxed as a partnership, as described in part II.Q.7.h Distributing Assets; Drop-Down into Partnership.

II.H.8.a.ii. State Income Tax Disconnect

Suppose the owner of the S corporation lives in a state (the "owner's state") that is not the same as the state where the S corporation is domiciled and the property is sold (the "business state").

Generally, the business state will tax the gain on the sale of the real estate.

However, the owner's disposition of the S corporation's stock will not be considered activity in the business state, because generally only the owner's state can tax the sale of intangible personal property (and stock is intangible personal property).

In the planning stages, taxpayers might try two approaches to avoid this problem, which might or might not work:

- Change the Owner's Residence. If the owner resides in the business state, the loss will be allowed. This might not be easily solved if the owner indirectly holds real estate in many states. On the other hand, suppose the owner is a trust. The trustee could divide the trust, moving to the business state the part of the trust attributable to the property located in that state. Whether this strategy works depends on whether the business state allows a trust to be a resident trust when its grantor was not domiciled in the state when the trust was created.[2172]

- Change the Corporation's Domicile. Some states do not tax the sale of a business, even though they tax the business' operations, because the sale of the business itself is not considered in the ordinary course of business. If the corporation is not domiciled in the state

[2170] See Code § 1276.
[2171] See part II.Q.7.f Corporate Division.
[2172] See "State Income Taxation of Trustees: Some Updates," TM Memorandum (BNA), Vol. 54, No. 11 (6/3/2013) and "2013 Trust Nexus Survey," Tax Management Weekly State Tax Report (Vol. 2013, No. 34, 8/23/2013).

in which the property is located, the gain on sale of the real estate might not be taxable to the state in which the real estate is located.

Unless one wants to research all of the above issues, one might consider planning with the following assumptions:

- If one is forming a business entity to hold property in another state, one should consider forming the entity in the owner's state of residence or in a state that does not impose income tax. Depending on state law, creating domicile in the other state might give it grounds for taxation of certain transactions that might not otherwise exist.

- If the trustee of a nongrantor trust is aware of the need for the planning described in part II.H.8.a Depreciable Real Estate in an S Corporation, consider researching splitting the trust if the trust is in a different state than the business state and the real estate is in one of the states listed above. Note that splitting the trust in this manner would work best if each S corporation owns property in only one state. As mentioned above, depreciable real estate should be spun off into a separate S corporation for each property; it's best to do the spin-off at least five years before the grantor's death,[2173] even if the trust division does not occur until the sale is contemplated and before any contract is signed.

- If the S corporation formed a new partnership to hold the real estate, then the S corporation might sell its partnership interest and avoid state income tax on the sale of real estate. The partnership would probably not be formed well in advance of the transaction, because the buyer probably would not want to assume the liabilities of an ongoing entity. This in turn might cause step transaction issues at the state level.

II.H.8.b. Depreciable Personal Property in an S Corporation

The disposition of most depreciable personal property, including certain building components depreciated as personal property, will be taxed as ordinary income, whether or not sold to a related party.[2174] Thus, all the problems in part II.H.8.a, Depreciable Real Estate in an S Corporation, apply and cannot be avoided for personal property inside an S corporation.

This issue is even more of a concern with current tax laws that allow very quick write-offs on purchases of tangible personal property. Heavy equipment creates a larger concern in that it tends to retain its value for longer.

A solution might be to form an LLC taxed as a partnership that is the original purchaser and leases the equipment to the business. The LLC might even borrow from the S corporation at the AFR. When an owner dies, his or her share will receive a new basis if a Code § 754 election is in place.[2175] A disadvantage of this strategy for higher-income taxpayers is that rental might be classified as a passive activity,[2176] which means that the rental income would be

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[2173] See part II.Q.7.f Corporate Division.
[2174] See part II.G.6.b Code § 1245 Property.
[2175] For more on Code § 754 elections (and similar rules that apply without an election when the partnership has a substantial built-in loss), see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.
[2176] Code § 469(c)(2). An exception applies to active rental of real estate, not personal property. See Code § 469(c)(7).

subject to the 3.8% supplemental tax[2177] unless an exception is satisfied.[2178] This tax would not apply if the property were merely held inside the S corporation in which the taxpayer actively operates the business.

II.H.8.c. Basis Step-Up for Publicly-Traded Stock and Other Nondepreciable Property

Generally, liquidating an S corporation that holds publicly-traded stock and other nondepreciable property will provide a new basis to its assets by reason of a deemed sale (but perhaps with no taxable income generated), as described in part II.H.8.a.i.(a) Model for Attempting to Replicate an Inside Basis Step-Up, subject to the concerns described in part II.H.8.a.ii State Income Tax Disconnect, but perhaps without the concerns described in part II.H.8.a.i.(b) Challenging Issues When S Corporation Liquidates Holding Depreciable Property or Other Ordinary Income Property.

The corporation could do a formless conversion or merger into an LLC taxed as a disregarded entity or partnership, as described in part II.P.3.a From Corporations to Partnerships and Sole Proprietorships. If the entity is an LLC taxed as a corporation, it might effectuate this change retroactively for two months and 15 days by filing IRS Form 8832.

II.H.9. Basis Step-Up In S Corporations That Had Been C Corporations

An S corporation that used to be a C corporation generate dividend income to its shareholders to the extent that distributions exceed its accumulated adjustments account (AAA). See part II.P.3.b.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds.

A basis step-up does not change this result, even if it results from the S corporation receiving life insurance proceeds. See part II.Q.7.b.iv S Corporation Distributions of, or Redemptions Using, Life Insurance Proceeds.

Furthermore, some redemptions are taxed as distributions, resulting in similar dividend issues.[2179]

However, if the S corporation has never been a C corporation or otherwise does not have any C corporation earnings and profits (E&P), these concerns do not arise.[2180]

II.H.10. Extracting Equity to Fund Large Gift

II.H.10.a. General Concept of Extracting Equity to Fund Large Gift

Consider extracting the fair market value equity from depreciated property, take steps to get the extracted equity out of the estate tax system, and exposing the small net value property to the estate tax system to get a very low cost basis stepped-up. This is done in three steps:

[2177] See II.I 3.8% Tax on Excess Net Investment Income.

[2178] For whether rental constitutes a passive activity, see II.K.1.e Rental Activities. For other exceptions, see II.K.1.i Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.

[2179] See part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally, especially fns. 4874-4876.

[2180] See part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally, especially the paragraph of text accompanying fn. 4884, the latter explaining how to eliminate E&P.

(1) Borrow against the property and distribute the cash to the owner(s). The debt reduces the impact of including the property in the taxpayer's gross estate, either as a debt deduction (recourse debt)[2181] or by reason of being netted against the property's value (nonrecourse),[2182] with the secured property receiving a full basis step-up in either case.[2183] A bank might very well require loan guarantees from other entities that would post collateral. See part II.H.10.c Consider Use of Guarantee Fee. Alternatively, a related party might make the loan at the AFR.

(2) Each owner invests the proceeds in taxable income-producing property. This is important for income tax purposes. If the owner simply gives away the cash, the debt would be incurred for personal purposes and the interest would be nondeductible personal interest. The owner needs to invest first in taxable investments;[2184] tax-free investments, such as municipal bonds, would also make the interest expense nondeductible.

(3) Each owner then makes annual exclusion gifts or otherwise engages in leveraged estate planning techniques. If the plan will take some time to accomplish and the owner has an irrevocable grantor trust with low basis assets, consider using the cash to buy those low basis assets so that those assets can get a basis step-up as well.

If the real estate is in an entity taxed as a partnership and the partnership is distributing cash from the loan to a partner, beware of the disguised sale rules. Absent an exception, if the partner contributed property to the partnership within 2 years of receiving the distribution or if a partner borrows against the property within two years, a disguised sale of the contributed property is presumed to have taken place.[2185]

This strategy may also work with low basis marketable securities, which might be monetized without generating capital gain tax.[2186]

[2181] Code § 2053(a)(4).

[2182] Reg. § 20.2053-7 provides:

> A deduction is allowed from a decedent's gross estate of the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest which had accrued thereon to the date of death, provided the value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate . If the decedent's estate is liable for the amount of the mortgage or indebtedness, the full value of the property subject to the mortgage or indebtedness must be included as part of the value of the gross estate; the amount of the mortgage or indebtedness being in such case allowed as a deduction. But if the decedent's estate is not so liable, only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be returned as part of the value of the gross estate. In no case may the deduction on account of the mortgage or indebtedness exceed the liability therefor contracted bona fide and for an adequate and full consideration in money or money's worth. See § 20.2043-1. Only interest accrued to the date of the decedent's death is allowable even though the alternate valuation method under section 2032 is selected. In any case where real property situated outside the United States does not form a part of the gross estate, no deduction may be taken of any mortgage thereon or any other indebtedness in respect thereof.

[2183] *Crane v. Commissioner*, 331 U.S. 1 (1947).

[2184] Code § 163(d)(3), which is reproduced in fn. 2295, which is found in part II.I.6 Deductions Against NII.

[2185] Reg. § 1.707-3(c). See part II.M.3.e Exception: Disguised Sale.

[2186] See part II.A.1.d.ii Monetizing Founder's Remaining Shares After Going Public.

II.H.10.b. Example: Leveraging Property to Extract Equity to Fund Large Gift

Suppose property with a $10M fair market value was fully depreciated as to the value of the building, with $2M of land value remaining:

1. Borrow $9M against the building and transfer the $9M using leveraged estate planning techniques as described above (after first having invested the borrowed money in taxable investments).

2. Keep the $1M ($10M value minus $9M liabilities) until death, and pay estate tax on the $1M.

3. The $8M of building ($10M total value minus $2M land value) receives a basis step-up from zero to $8M:[2187]

   - At a 40% income rate, this basis step-up secures tax deductions worth $3.2M (40% of $8M).

   - Even if the property were later sold, the capital gain tax savings would likely be $2.4M (30%[2188] of $8M) or more.

4. Possible estate tax on $1M is a small price to pay for that income tax savings.

II.H.10.c. Consider Use of Guarantee Fee

A loan guarantee is not a gift. For gift and income tax issues related to guarantees, see part III.B.1.a.ii Loan Guarantees.

However, if the loan guarantee is from a donee, the IRS might claim that the donor has retained an interest in the gifted property and asset Code § 2036 inclusion.

Therefore, consider paying a market-rate guarantee fee so that the grantor pays adequate and full consideration for the use of the credit instead of possibly appearing to have retained the use of the gifted property. Consider the following commercial models:

- Home equity lines of credit charge no maintenance fees. They are well-secured, simple loans.

- Commercial lines of credit might involve maintenance fees. They are well-secured, complex loans.

- If the borrower has little equity or income outside of an asset that is being purchased, then the lender's or guarantor's risk increases dramatically when the loan-to-value ratio is high. If the asset being purchased is being appraised, consider asking the appraiser to also determine a reasonable guarantee fee.

[2187] If held in a partnership, a Code § 754 election would need to be made. See II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.

[2188] This example assumes that state and local income tax increases a 25% capital gain rate by 5%. Capital gain that represents the recapture of straight line depreciation is taxed at a maximum rate of 25% instead of 20%. Code § 1(h)(1)(D).

II.H.10.d. Maintaining the Security Interest in the Loan Proceeds If Using a Donee Guarantee

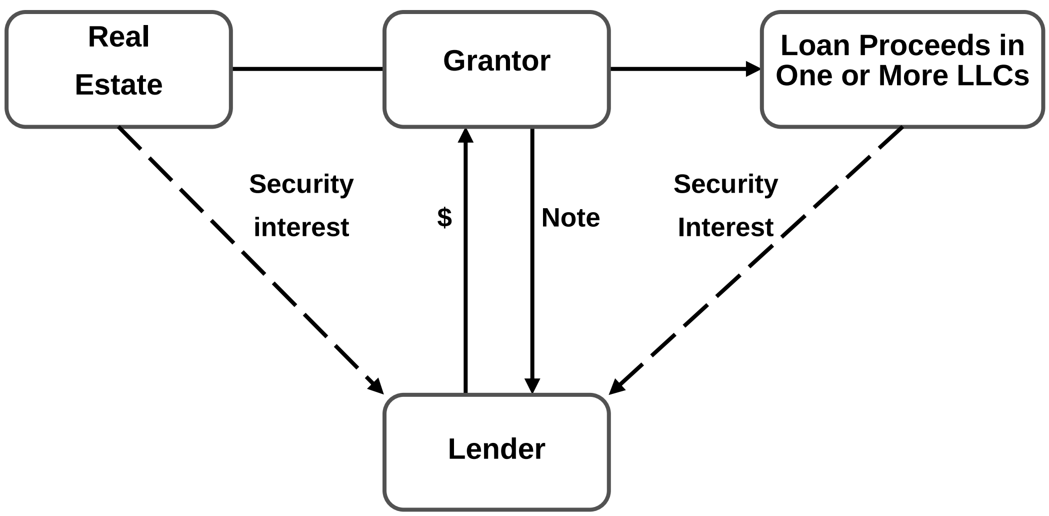
If the loan proceeds are transferred using leveraged estate planning techniques, tracking the lender's security interest might become tricky.

For example, suppose one uses a series of 2-year GRATs to transfer marketable securities, establishing a separate GRAT each year for each asset class.[2189] The number of accounts could quickly multiply. One might consider establishing an LLC to hold each asset class, so that the security interest is imposed on the LLC's account and interests in the LLC can be freely transferred among trusts to implement the strategy.[2190] Also note that an account with multiple owners might be deemed a partnership in certain situations.[2191]

II.H.10.e. Illustration of Equity Strip and Gift

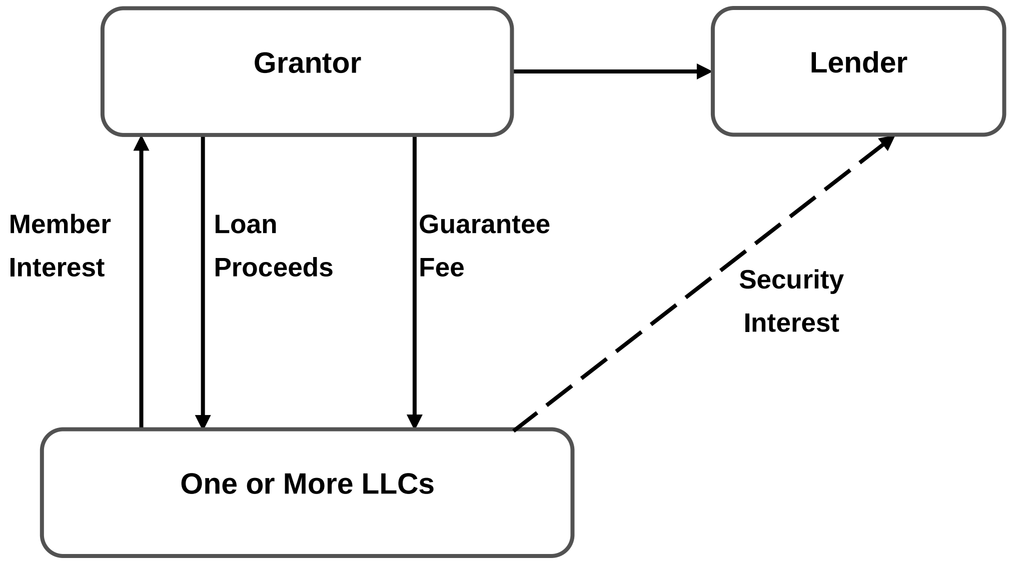
See parts II.H.10.e.i Flowchart of Equity Strip, II.H.10.e.ii Flowchart of Placing Loan Proceeds into Entity, and II.H.10.e.iii Flowchart of Transfer of Loan Proceeds.

II.H.10.e.i. Flowchart of Equity Strip

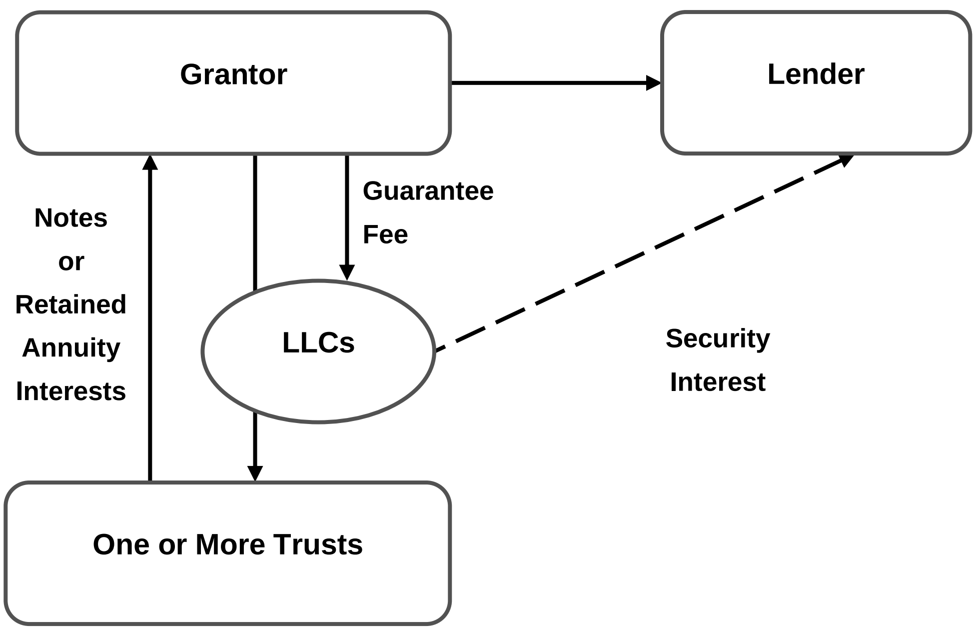


[2189] This is called a rolling, asset-splitting GRAT strategy and is described in part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust, especially the text accompanying fn. 6504.
[2190] See part II.Q.8.a Partnership as a Master Entity, especially fns. 5342-5344 and the accompanying text.
[2191] See part II.C.10 Whether Tenancy-in-Common or other Arrangement .

II.H.10.e.ii. Flowchart of Placing Loan Proceeds into Entity



II.H.10.e.iii. Flowchart of Transfer of Loan Proceeds



II.H.11. Preferred Partnership to Obtain Basis Step-Up on Retained Portion

If all of the equity has been extracted, the future growth is still an estate planning issue. Furthermore, the client might not be comfortable with extracting the equity. In either case, consider contributing the real estate to a preferred partnership, in which the client receives a preferred distribution of profits as a fixed percentage of the fair market value of the contributed property, as well as receiving a capital account equal to the fair market value of the contributed property, plus perhaps a straight 1% of the residual profits; the client then transfers the remaining residual profits – the so-called “common interest.”

If the partnership has a Code § 754 election in place, a partner's allocable share of the partnership's non-IRD assets will receive a new basis when the partner dies.[2192] Thus, a preferred partnership can be an excellent vehicle for transferring future growth while obtaining a basis step-up on the portion retained. This is particularly useful for a person whose taxable estate and adjusted taxable gifts would be less than the estate tax exemption with the current value included but would exceed the estate tax exemption if the property grows in value or generates income in excess of the preferred return.

II.H.11.a. Basics of Preferred Partnerships

In a preferred partnership, one or more partners has a preferred interest and one or more partners has a common interest. The preferred interest includes a capital account that receives a percentage return on that capital account, which preferred return is paid generally before making distributions to the partners owning the common interest. A common interest is a capital account plus a flat percentage of the profits distributed after the preferred interest receives its distributions. As described further below, the goal is to maximize the initial value of the preferred partnership interest and to minimize the initial value of the common interest.

If a partnership is recapitalized and the transferee receives common, the transferor's capital account that is attributable to the common carries over to the transferee partner;[2193] however, given that the common is entitled to only increases in value after the date of the recapitalization, the preferred stock should keep its original capital account and be allocated the first tier of book gain up to the value on the date of the transfer. Not revaluing the capital accounts and keeping the allocation of book gain is important is making sure that any nonrecourse liabilities remain allocated to the holder of the preferred interest,[2194] given that usually the senior family member usually retains the preferred interest and wants a basis step-up relating to the liabilities.[2195] However, the transferor's basis (ignoring basis relating to liabilities) is allocated between the transferor and transferee according to their respective value;[2196] allocating basis to the transferee (generally the donee) at the expense of reducing the transferor's basis (generally the donor senior family member) generates more of a basis step-up upon the senior family member's death.

The preferred interests receive operating distributions before the common interests and receive a return of their capital accounts before the common interests receive their capital accounts. The preferred returns are not guaranteed; rather they are preferred distributions of cash from operations. Because they are contingent on cash flow, they are more risky than mere loans and therefore require a higher return. See part II.H.11.c Payment of Preferred Return.

Minimizing the value of the preferred interests reduces the payment required on the capital account, reducing the pressure on the partnership to generate operating cash and leaving more cash available for the common interests:[2197]

[2192] For more on Code § 754 elections (and similar rules that apply without an election when the partnership has a substantial built-in loss), see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.
[2193] See fn 515 in part II.C.7 Maintaining Capital Accounts.
[2194] See text preceding and accompanying fn 398 in part II.C.3.c Allocations of Recourse and Nonrecourse Liabilities.
[2195] See fn 2091 in part II.H.2.g Partnership Basis Adjustments.
[2196] See fn 5633 in part II.Q.8.e.ii.(a) Unitary Basis.
[2197] See part II.H.11.d Valuing Preferred Partnership Interests.

- Usually the partnership is a limited partnership, and the preferred interest is accompanied by a 1% common interest as the controlling general partner;[2198] providing the preferred interest owner with this controlling common interest increases the likelihood of actually receiving the preferred distributions and therefore reduces risk and the required return.

- The remaining 99% common interest generally is comprised of interests as limited partners, although it might include interests as general partners that aggregate to less than 1%.

- Below is a brief discussion about how to avoid the disguised sale rule taxing the contribution of appreciated property in exchange for the preferred payments.[2199] However, the IRS can rebut the presumptions found in that discussion, and we tend to suggest that the contributing partner receive common with a value of at least 10% of the total contribution that partner made.[2200] To make the cash flows and valuations work, it is not uncommon for the contributing partner to retain 15%-20% of the common.

- If and to the extent that operating cash flow beyond the preferred return is used to repay the preferred partner's capital account, beware of tax issues. This excess operating cash flow is taxed to the common interests, because the income is allocated to them, becomes capital and only then is used to pay the preferred partner; this is an inherent part of partnership accounting. In many cases, the partnership agreement should require distributions to the common interests to pay these taxes before the excess operating cash flow is used to pay the preferred partners' capital accounts.

Forming the partnership usually does not trigger income tax.[2201] Because the right to receive preferred payments depends on cash flow and is not guaranteed, forming the partnership is presumed not to constitute a disguised sale;[2202] however, to rely on this exception, one should avoid having an intent to redeem the preferred partnership interest or cap cumulative payments under the preferred return.[2203] Although a guaranteed payment within certain limits is also presumed not be a disguised sale,[2204] using property to satisfy the obligation (because cash flow is inadequate) would probably constitute a sale and trigger income tax.[2205] The tax laws strongly encourage the preferred payment to be cumulative, meaning that make-up distributions are made in future years if current cash flow is insufficient;[2206] these rules strongly encourage payments no later than four years after the due date,[2207] and payments using property should constitute tax-free distributions.[2208]

When one creates an entity with preferred distributions and receives preferred distributions equal to the value of what one contributed, generally Code § 2036 does not include in one's

[2198] There is nothing wrong with stapling a common interest as a general partner that exceeds 1%, aside from the desire to allocate growth (the common interest) to the next generation.
[2199] Fns 2202-2205.
[2200] See part II.Q.7.h.viii Value Freeze as Conservative Alternative, especially fn 5141.
[2201] See part II.M.3 Buying into or Forming a Partnership.
[2202] See part II.M.3.e.i.(b) Distributions Presumed Not to Be Disguised Sales.
[2203] See text accompanying and following fn 3617 in part II.M.3.e.i.(b) Distributions Presumed Not to Be Disguised Sales.
[2204] See part II.M.3.e.i.(b) Distributions Presumed Not to Be Disguised Sales.
[2205] Code § 707.
[2206] See part III.B.7.b Code § 2701 Overview.
[2207] Code § 2701(d)(2)(C).
[2208] See part II.Q.8.b.i Distribution of Property by a Partnership.

estate the right to the common interest.[2209] *Hutchens Non-Marital Trust v. Commissioner*, T.C. Memo. 1993-600 (preferred stock) (Missouri case). Also, preferential liquidation rights and the right to distributions that were greatly disproportionate to that enjoyed by another class of equity, the other class of which the decedent had transferred, did not constitute a retention of rights to the transferred shares. *Boykin v. Commissioner*, T.C. Memo. 1987-134. Presumably the IRS wanted to include the transferred shares because they were voting, whereas the retained shares were nonvoting. After *Boykin* and before *Hutchens*, Congress repealed Code § 2036(c) and enacted Chapter 14 in its place. The legislative history says:

> The committee believes that an across-the-board inclusion rule is an inappropriate and unnecessary approach to the valuation problems associated with estate freezes. The committee believes that the amount of any tax on a gift should be determined at the time of the transfer and not upon the death of the transferor.

Although merely retaining a Code § 2701 preferred partnership interest should not itself cause Code § 2036 inclusion, these cases preceded *Strangi* and *Bongard*.[2210] Thus, if one does everything wrong, Code § 2036 will apply to a preferred partnership.[2211]

II.H.11.b. Preferred Partnership Compared to Sale to Irrevocable Grantor Trust

The disadvantages of a preferred partnership relative to a sale for a note are the higher required return (preferred stock generally pays dividends much higher than the AFR) and the higher equity investment required by the other owners (although Code § 2701 generally requires the common interest to be worth at least 10%, in practice appraisers require it to be 15%-20% or more).

However, the preferred partnership interest has an advantage of basis step-up. If one sells low basis assets to an irrevocable grantor trust and dies shortly thereafter, there is no growth on which estate taxes are paid, the note is included at roughly the same value as the sold asset, and the sold property does not receive a basis step-up. On the other hand, if one uses a preferred partnership, the underlying assets attributable to the preferred partnership will receive a new basis when the preferred partner dies.[2212]

[2209]

see fn 2211 for context.

[2210] See part III.C.1 Whether Code § 2036 Applies.

[2211] *Estate of Liljestrand v. Commissioner*, T.C. Memo. 2011-259, applying *Bongard* (see fn 91 in part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders):

> As part of the partnership agreement, Dr. Liljestrand was guaranteed a preferred return of 14 percent of the value of his class A limited partnership interest. Dr. Liljestrand's class A limited partnership interest was valued at $310,000, thus Dr. Liljestrand was guaranteed annual payments equal to $43,400. Moss-Adam's appraisal estimated the partnership's annual income would equal $43,000. We find this guaranteed return indicative of an agreement to retain an interest or right in the contributed property....
>
> Dr. Liljestrand received a disproportionate share of the partnership distributions, engineered a guaranteed payment equal to the partnership expected annual income and benefited from the sale of partnership assets. The objective evidence points to the fact that Dr. Liljestrand continued to enjoy the economic benefits associated with the transferred property during his lifetime.

[2212] For more on Code § 754 elections (and similar rules that apply without an election when the partnership has a substantial built-in loss), see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.

One might consider pairing the two concepts: retain the preferred interest and have an irrevocable grantor trust hold the common interest. (Consider a gift to the trust; with a preferred partnership, the common might not have enough cash flow to repay the note.) If the senior family member gets ill, (s)he buys the common interest from the trust,[2213] so that the common interest can receive a basis step-up at death.

II.H.11.c. Payment of Preferred Return

Generally, the preferred return should be paid out of operating cash flow.[2214]

Although guaranteed payments might seem attractive from a gift tax viewpoint,[2215] they are undesirable from an income tax viewpoint.[2216]

As mentioned in part II.H.11.a Basics of Preferred Partnerships, if one needs to avoid income tax on the contribution of appreciated property for the partnership interest, then avoid any plans to redeem the preferred partnership interest.[2217]

II.H.11.d. Valuing Preferred Partnership Interests

Rev. Rul. 83-120 explains how to value preferred and common stock. Presumably its concepts would apply to partnerships. Key ideas include:

- To support valuing the preferred interest at face value, the preferred distributions should exceed the interest paid to the entity's lenders.[2218] Because AFRs are based on

[2213] See fn. 2159, found in part II.H.5.b Moving Real Estate or Other Low-Basis Property from Irrevocable Trust to Grantor.
[2214] See part II.M.3.e.i.(b) Distributions Presumed Not to Be Disguised Sales.
[2215] Guaranteed payments do not trigger the special rules for family partnerships described in part III.B.7.b Code § 2701 Overview. See Code § 2701(c)(1)(B)(iii).
[2216] Guaranteed payments would generally be limited to 150% of AFR (which is much lower than market now). See part II.M.3.e.i.(b) Distributions Presumed Not to Be Disguised Sales. Also, because a guaranteed payment under Code § 707(c) is not a regular partnership distribution under Code § 731, gain or loss would be triggered on the distribution of assets in kind to satisfy that pecuniary obligation. Contrast that with a partnership distribution, which generally does not trigger gain or loss, as described in part II.Q.8.b.i Distribution of Property by a Partnership. Although it might seem common sense that a distribution out of operating cash flow would be satisfied out of cash from operations so that assets do not need to be sold, the situation for family partnerships is not so simple. Family partnerships need to make their preferred payments no later than four years after they accrue. Code § 2701(d)(2)(C). This four-year requirement should not cause problems with the disguised sale rules, which are mainly concerned about payments within two years after the preferred partner has contributed assets to the partnership. See part II.M.3.e Exception: Disguised Sale. Thus, using a preferred payment out of operating cash flow instead of a guaranteed payments not only adds helpful flexibility for partnerships generally but also is very important for family partnerships.
[2217] See fn 2203.
[2218] Rev. Rul. 83-120, § 4.02 provides:

> Whether the yield of the preferred stock supports a valuation of the stock at par value depends in part on the adequacy of the dividend rate. The adequacy of the dividend rate should be determined by comparing its dividend rate with the dividend rate of high-grade publicly traded preferred stock. A lower yield than that of high-grade preferred stock indicates a preferred stock value of less than par. If the rate of interest charged by independent creditors to the corporation on loans is higher than the rate such independent creditors charge their most credit worthy borrowers, then the yield on the preferred stock should be correspondingly higher than the yield

government bonds that are viewed as having no credit risk, the rates charged by lenders to businesses generally exceed the AFR. In other words, preferred rates exceed lenders' rate which exceed the AFR. Thus, preferred distribution rates that reflect market rates are significantly greater than the AFR. However, if a liquidation right is respected for tax purposes,[2219] that right may support valuing the preferred at face value.[2220]

- Preferred distribution rates also require sufficient coverage, which means the entity's ability to pay the preferred return. The entity needs plenty of income-generating assets to assure payment.[2221] Appraisers prefer to see the preferred interest holder have enough control over distributions to maximize the chance that distributions will actually be made. Although control tends to generate Code § 2036 concerns, the fact that a largely undiscounted preferred interest is included in the holder's estate should prevent Code § 2036 from causing problems.[2222]

- The entity needs to have ample equity to be able to pay the equity's stated liquidation right.[2223]

> on high quality preferred stock. A yield which is not correspondingly higher reduces the value of the preferred stock. In addition, whether the preferred stock has a fixed dividend rate and is nonparticipating influences the value of the preferred stock. A publicly traded preferred stock for a company having a similar business and similar assets with similar liquidation preferences, voting rights and other similar terms would be the ideal comparable for determining yield required in arm's length transactions for closely held stock. Such ideal comparables will frequently not exist. In such circumstances, the most comparable publicly-traded issues should be selected for comparison and appropriate adjustments made for differing factors.

[2219] Code § 2701 may affect valuation of a liquidation right for gift tax purposes (and also valuation of the preferred returns). See parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.

[2220] Rev. Rul. 83-120, § 4.07 provides:

> Whether the preferred stock contains a redemption privilege is another factor to be considered in determining the value of the preferred stock. The value of a redemption privilege triggered by death of the preferred shareholder will not exceed the present value of the redemption premium payable at the preferred shareholder's death (*i.e.*, the present value of the excess of the redemption price over the fair market value of the preferred stock upon its issuance). The value of the redemption privilege should be reduced to reflect any risk that the corporation may not possess sufficient assets to redeem its preferred stock at the stated redemption price. See.03 above.

[2221] Rev. Rul. 83-120, § 4.03 includes the following explanation:

> Coverage of the dividend is measured by the ratio of the sum of pre-tax and pre-interest earnings to the sum of the total interest to be paid and the pre-tax earnings needed to pay the after-tax dividends. *Standard & Poor's Ratings Guide*, 58 (1979). Inadequate coverage exists where a decline in corporate profits would be likely to jeopardize the corporation's ability to pay dividends on the preferred stock. The ratio for the preferred stock in question should be compared with the ratios for high quality preferred stock to determine whether the preferred stock has adequate coverage.

[2222] See fns 2209-2211 in part II.H.11.a Basics of Preferred Partnerships.

[2223] Rev. Rul. 83-120, § 4.04 provides:

> Whether the issuing corporation will be able to pay the full liquidation preference at liquidation must be taken into account in determining fair market value. This risk can be measured by the protection afforded by the corporation's net assets. Such protection can be measured by the ratio of the excess of the current market value of the corporation's assets over its liabilities to the aggregate liquidation preference. The protection ratio should be compared with the ratios for high

The above bullet points raise the issue of "coverage." If preferred interests are large compared to the rest of the equity, then the likelihood of making the preferred payments decreases. A decreased likelihood of payment means that a risk premium is required; in other words, the preferred distribution rate increases. Ironically, any increased preferred distribution rate increases risk, causing rates to need to be higher. To avoid this problem, capitalize the entity with more value in the common ownership.

If the partnership is a family entity, watch out for the complexities and uncertainty in valuation described in Code § 2701 later in these materials.[2224] Although the rules governing family entities generally require that the common interest have a value of at least 10% of the deal,[2225] typically it's at least 20% of the deal, so that the preferred profits distribution is kept at a reasonable rate. In a marketable securities partnership, the common is a much higher proportion, because the equity rates paid on the preferred stock often will significantly exceed the annual expected investment income on the marketable securities. Thus, practical coverage requirements tend to make the 10% minimum common value a moot issue.

A recapitalization can constitute a gift, whether under general principles[2226] or under these special rules for family partnerships.

II.H.11.e. Using Preferred Partnership that Intentionally Violates Code § 2701

Consider making placing $5M into a preferred partnership that is a family entity, retaining a $4M preferred interest with noncumulative preferred distributions redeemable at par in the holder's discretion, and giving $1M in common to the next generation.

The preferred return is a nice income stream. If the preferred holder needs more cash for unexpected spending needs, the preferred holder can require a partial redemption of the preferred's par value.

The gift and estate tax consequences are as follows:

- If the partnership violates Code § 2701, the gift of common generates a $5M taxable gift, because the preferred is valued at zero.

- If a Code § 2701 interest in existence on the date of the initial transferor's death is held by an applicable family member and therefore is not included in the gross estate of the initial transferor, the Code § 2701 interest is deemed to be transferred at the death of the initial transferor to or for the benefit of an individual other than the initial transferor or an applicable family member of the initial transferor. In such case, the transfer tax value of the interest is the value that the executor can demonstrate would be determined for gift tax purposes if the interest were transferred immediately before the initial transferor's death.[2227]

quality preferred stock to determine adequacy of coverage. Inadequate asset protection exists where any unforeseen business reverses would be likely to jeopardize the corporation's ability to pay the full liquidation preference to the holders of the preferred stock.

[2224] See part III.B.7.b Code § 2701 Overview.

[2225] See part II.M.3.e.i.(b) Distributions Presumed Not to Be Disguised Sales.

[2226] Rev. Rul. 86-39, reproduced in part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary.

[2227] Reg. § 25.2701-5(c)(3)(ii).

Code § 2701 applies "[s]olely for purposes of determining whether a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family is a gift." Thus, it does not apply for GST purposes, as described in this example from a treatise:[2228]

> Grandfather gives common stock of Family Corporation to Granddaughter, while retaining preferred stock. The gift tax under Chapter 12 will be calculated by valuing the common stock under Section 2701. The GST tax under Chapter 13 will be determined by valuing the common stock without regard to Section 2701.

So, even though the noncompliant partnership freeze can use the entire gift tax exemption, it will not use a corresponding amount of GST exemption. On the other hand, failure to take the noncumulative preferred payment may constitute a gift,[2229] which is offset by the mitigation provisions for Code § 2701(e)(6) for gift tax purposes but would not be offset for GST purposes, possibly requiring more GST exemption to be allocated. Code § 2701(e)(6) authorizes relief for gift, estate, and GST tax purposes:

> *Adjustments*. Under regulations prescribed by the Secretary, if there is any subsequent transfer, or inclusion in the gross estate, of any applicable retained interest which was valued under the rules of subsection (a), appropriate adjustments shall be made for purposes of chapter 11, 12, or 13 to reflect the increase in the amount of any prior taxable gift made by the transferor or decedent by reason of such valuation or to reflect the application of subsection (d).

Reg. § 25.2701-5, "Adjustments to mitigate double taxation," implements this authority.

Reg. § 25.2701-5(a), "Reduction of transfer tax base," provides:

> (1) *In general*. This section provides rules under which an individual (the initial transferor) making a transfer subject to section 2701 (the initial transfer) is entitled to reduce his or her taxable gifts or adjusted taxable gifts (the reduction). The amount of the reduction is determined under paragraph (b) of this section. See paragraph (e) of this section if section 2513 (split gifts) applied to the initial transfer.
>
> (2) *Federal gift tax modification*. If, during the lifetime of the initial transferor, the holder of a section 2701 interest (as defined in paragraph (a)(4) of this section) transfers the interest to or for the benefit of an individual other than the initial transferor or an applicable family member of the initial transferor in a transfer subject to Federal estate or gift tax, the initial transferor may reduce the amount on which the initial transferor's tentative tax is computed under section 2502(a). The reduction is first applied on any gift tax return required to be filed for the calendar year in which the section 2701 interest is transferred; any excess reduction is carried forward and applied in each succeeding calendar year until the reduction is exhausted. The amount of the reduction that is used in a calendar year is the amount of the initial transferor's taxable gifts for that year. Any excess reduction remaining at the death of the initial transferor may be applied by the executor of the initial transferor's estate as provided under paragraph (a)(3) of this section. See paragraph (a)(4) of this section

[2228] Zaritsky & Aucutt, ¶ 2.03[4] Scope of Section 2701, ¶ 2.03[4][a] Generation-Skipping Transfer Tax, *Structuring Estate Freezes: Analysis With Forms* (WG&L), citing the preamble to the proposed regulations, 56 Fed. Reg. § 14322 (1991).
[2229] *Snyder v. Commissioner*, 93 T.C. 529 (1989).

for the definition of a section 2701 interest. See § 25.2701-6 for rules relating to indirect ownership of equity interests transferred to trusts and other entities.

(3) *Federal estate tax modification*. Except as otherwise provided in this paragraph (a)(3), in determining the Federal estate tax with respect to an initial transferor, the executor of the initial transferor's estate may reduce the amount on which the decedent's tentative tax is computed under section 2001(b) (or section 2101(b)) by the amount of the reduction (including any excess reduction carried forward under paragraph (a)(2) of this section). The amount of the reduction under this paragraph (a)(3) is limited to the amount that results in zero Federal estate tax with respect to the estate of the initial transferor.

(4) *Section 2701 interest*. A section 2701 interest is an applicable retained interest that was valued using the special valuation rules of section 2701 at the time of the initial transfer. However, an interest is a section 2701 interest only to the extent the transfer of that interest effectively reduces the aggregate ownership of such class of interest by the initial transferor and applicable family members of the initial transferor below that held by such persons at the time of the initial transfer (or the remaining portion thereof).

Reg. § 25.2701-5(b), "Amount of reduction," provides:

Except as otherwise provided in paragraphs (c)(3)(iv) (pertaining to transfers of partial interests) and (e) (pertaining to initial split gifts) of this section, the amount of the reduction is the lesser of -

(1) The amount by which the initial transferor's taxable gifts were increased as a result of the application of section 2701 to the initial transfer; or

(2) The amount (determined under paragraph (c) of this section) duplicated in the transfer tax base at the time of the transfer of the section 2701 interest (the duplicated amount).

Reg. § 25.2701-5(c), "Duplicated amount," provides:

(1) *In general*. The duplicated amount is the amount by which the transfer tax value of the section 2701 interest at the time of the subsequent transfer exceeds the value of that interest determined under section 2701 at the time of the initial transfer. If, at the time of the initial transfer, the amount allocated to the transferred interest under § 25.2701-3(b)(3) (Step 3 of the valuation methodology) is less than the entire amount available for allocation at that time, the duplicated amount is a fraction of the amount described in the preceding sentence. The numerator of the fraction is the amount allocated to the transferred interest at the time of the initial transfer (pursuant to §2701-3(b)(3)) and the denominator of the fraction is the amount available for allocation at the time of the initial transfer (determined after application of § 25.2701-3(b)(2)).

(2) *Transfer tax value - In general*. Except as provided in paragraph (c)(3) of this section, for purposes of paragraph (c)(1) of this section the transfer tax value of a section 2701 interest is the value of that interest as finally determined for Federal transfer tax purposes under chapter 11 or chapter 12, as the case may be (including the right to

receive any distributions thereon (other than qualified payments)), reduced by the amount of any deduction allowed with respect to the section 2701 interest to the extent that the deduction would not have been allowed if the section 2701 interest were not included in the transferor's total amount of gifts for the calendar year or the transferor's gross estate, as the case may be. Rules similar to the rules of section 691(c)(2)(C) are applicable to determine the extent that a deduction would not be allowed if the section 2701 interest were not so included.

(3) *Special transfer tax value rules*.

(i) *Transfers for consideration*. Except as provided in paragraph (c)(3)(iii) of this section, if, during the life of the initial transferor, a section 2701 interest is transferred to or for the benefit of an individual other than the initial transferor or an applicable family member of the initial transferor for consideration in money or money's worth, or in a transfer that is treated as a transfer for consideration in money or money's worth, the transfer of the section 2701 interest is deemed to occur at the death of the initial transferor. In this case, the estate of the initial transferor is entitled to a reduction in the same manner as if the initial transferor's gross estate included a section 2701 interest having a chapter 11 value equal to the amount of consideration in money or money's worth received in the exchange (determined as of the time of the exchange).

(ii) *Interests held by applicable family members at date of initial transferor's death*. If a section 2701 interest in existence on the date of the initial transferor's death is held by an applicable family member and, therefore, is not included in the gross estate of the initial transferor, the section 2701 interest is deemed to be transferred at the death of the initial transferor to or for the benefit of an individual other than the initial transferor or an applicable family member of the initial transferor. In this case, the transfer tax value of that interest is the value that the executor of the initial transferor's estate can demonstrate would be determined under chapter 12 if the interest were transferred immediately prior to the death of the initial transferor.

(iii) *Nonrecognition transactions*. If an individual exchanges a section 2701 interest in a nonrecognition transaction (within the meaning of section 7701(a)(45)), the exchange is not treated as a transfer of a section 2701 interest and the transfer tax value of that interest is determined as if the interest received in exchange is the section 2701 interest.

(iv) *Transfer of less than the entire section 2701 interest*. If a transfer is a transfer of less than the entire section 2701 interest, the amount of the reduction under paragraph (a)(2) or (a)(3) of this section is reduced proportionately.

(v) *Multiple classes of section 2701 interest*. For purposes of paragraph (b) of this section, if more than one class of section 2701 interest exists, the amount of the reduction is determined separately with respect to each such class.

(vi) *Multiple initial transfers*. If an initial transferor has made more than one initial transfer, the amount of the reduction with respect to any section 2701 interest is the sum of the reductions computed under paragraph (b) of this section with respect to each such initial transfer.

However, certain anti-abuse regulations may cause these rules to change, as described in part II.H.12.a Taxable Gifts of Property Included in the Donor's Estate. Those regulations may make this strategy counterproductive if the client is trying to lock in bonus estate tax exemption.

If the donor splits gifts with the spouse, the order and manner in which the mitigation occurs depends on who dies first.[2230] Consider leaving the preferred interest in a trust for the surviving spouse and electing a QTIP marital deduction[2231] only to the extent that the mitigation provisions do not wipe out the estate inclusion.

Finally, the overall scheme of Code § 2701 requires each generation that makes a transfer to add the senior generation's interests to its own when looking at the ownership before and after making the transfer. That complexity makes me want to avoid using noncompliant partnerships in most cases.

II.H.11.f. Practical Uses of Estate Freezes

Many of the ideas discussed below are illustrated in materials put together by Stacy Eastland for 2015 Heckerling, ideas on which he has worked for many years and continues to improve.[2232] Stacy's materials contain many creative ideas not listed below, including combining leverage with preferred partnerships and GRATs; however, I am very reluctant to combine leverage with GRATs.

II.H.11.f.i. Increasing Investment Yield to Enable Owner to Transfer More Outside of Estate Tax System

The example below is for a bypass trust and the surviving spouse, but it could just as easily apply to:

- An irrevocable grantor trust created by the spouse instead of the bypass trust, or
- A partnership between a GST-exempt trust and either its beneficiary or a non-GST-exempt trust for the benefit of the GST-exempt trust's beneficiary.

A surviving spouse might engage in an estate freeze with a bypass trust created by the deceased spouse. The surviving spouse contributes assets and receives a preferred interest (with enhancements described in part II.H.11.a Basics of Preferred Partnerships), and the bypass trust contributes assets and receives a common interest. The surviving spouse receives a nice annual income flow, and the preferred interest will receive a new basis at the surviving spouse's death.

Furthermore, if the surviving spouse has some DSUE and is at risk of losing it because of remarriage, the surviving spouse might consider electing to treat the preferred interest as gifted to the bypass trust, even though the surviving spouse has not in fact gifted the interest.[2233] presumably the gifted interest would be included in the surviving spouse's estate because of

[2230] See Reg. § 25.2701-5(e).
[2231] See fn. 2000, found in part II.H.2.a Free Basis Step-Up When First Spouse Dies.
[2232] Discussions with Ellen Harrison and Stacy when preparing for our 2015 Heckerling panel have sharpened my thinking in this area. ACTEC Fellows can see some of Ellen's thoughts by looking at the Business Planning Committee materials for the 2015 Annual Meeting.
[2233] Code § 2701(c)(3)(C)(i).

actual ownership, but the amount of inclusion should be washed out, as described in part II.H.11.e Using Preferred Partnership that Intentionally Violates Code § 2701.

Although a QTIP trust could engage in a freeze transaction, Code § 2519 poses risks if the valuation is wrong. A QTIP trust might make distributions or loans to the surviving spouse so that the surviving spouse can later engage in the preferred partnership planning. Therefore, one might consider entering into the preferred partnership before the QTIP trust is funded, being wary, however, that Code § 2701 views transactions by a trust as transactions by its beneficiaries.[2234]

A portfolio of marketable securities might be a good candidate for such planning. Because the preferred return is significantly higher than general interest and dividend rates, the surviving spouse can boost the surviving spouse's annual cash return on the assets contributed. Essentially, the partnership would use the income from the bypass trust's contributed assets to make preferred payments to the surviving spouse in exchange for the growth of the surviving spouse's contributed assets. In the example below, the surviving spouse's contributed assets would need to comprise approximately 30% of the partnership to attain this result.

Suppose, for example, the surviving spouse contributed $3 million of marketable securities and the bypass trust contributed $7 million of marketable securities, each portfolio generating 2.5% cash distributions. Thus, the partnership's $10 million generates $250,000 annual cash yield. Dividing the $250,000 annual cash yield by the surviving spouse's $3 million contribution constitutes an 8.3% yield, which might be comparable to an annual cash preferred dividend. Note that the surviving spouse's income has increased from $75,000 per year to $250,000 per year. Now the surviving spouse can afford to used leveraged transfers to shift other assets outside the estate tax system. Or the surviving spouse could, in a separate transaction that was not planned until after the preferred partnership formation had seasoned sufficiently, simply sell to an irrevocable grantor trust $2 million of preferred partnership interest yielding 8.3% in exchange for a note bearing the AFR (much lower than 8.3% when this analysis was written) and retain $1 million of preferred partnership interest, earning $83,000 per year income (up from $75,000) but decreasing the amount subject to estate tax from $3 million down to $1 million (if the sale price simply goes to pay taxes on the irrevocable grantor trust). Furthermore, the $2 million capital account preferred interest would be worth less than $2 million if the surviving spouse retained the general partner interest, the control feature of which supported the value of the preferred in the surviving spouse's hands but which is not available to support the value of the $2 million preferred interest that is sold to the trust. Thus, the irrevocable grantor trust would pay less than $2 million for its preferred interest. Or, instead of doing a sale to an irrevocable grantor trust, the surviving spouse could use a GRAT, which will be guaranteed to succeed to the extent that the preferred return exceeds the Code § 7520 rate. (This example illustrates an extreme, in that the yield would likely be set at an amount lower than the partnership's annual income, to ensure coverage.)[2235]

The above strategy could be supercharged if the bypass trust contributed its partnership interest to an S corporation and the surviving spouse made a QSST election. That would cause the surviving spouse to pay the income tax on the common interest's capital gains (and other income allocable to it). If one were to use this strategy, the partnership agreement should not require distributions to pay tax on the common interests' income (contrary to the general recommendation of part II.H.11.a. Basics of Preferred Partnerships). Furthermore, one should

[2234] Reg. § 25.2701-6(a)(4).
[2235] See part II.H.11.d Valuing Preferred Partnership Interests.

consider how this approach affects the exit strategy – what happens to the bypass trust after the surviving spouse dies – described in part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts.

A simpler alternative with more modest results might be available. Consider dividing the trust, converting one portion to a unitrust and giving away another portion.[2236] The unitrust might be a higher rate of distribution than interest and dividends, allowing the surviving spouse to feel comfortable giving away that other portion.

Commercial real estate might not be a great candidate for directly engaging in increasing one's rate of cash flow return using the preferred partnership planning described above. First, the cash yield for privately managed commercial real estate tends to be close to preferred rates, making the type of leverage described in the example above difficult to achieve. (That doesn't mean that a preferred partnership is a bad idea; it simply does not create as much opportunity to enhance the surviving spouse's rate of return on retained assets.) Second, losing the basis step-up on the real estate would be quite painful. However, the leveraged planning described above could work <u>indirectly</u> for commercial real estate. Strip the real estate's equity, as described in part II.H.10 Extracting Equity to Fund Large Gift, then engage in this type of planning for the loan proceeds.

If one has an operating business in an S corporation, a preferred partnership is not available[2237] to replicate this result unless the transferor is the sole owner or the other owners have similar objective. The S corporation itself could contribute its assets to a preferred partnership in lieu of its shareholder(s) directly forming the preferred partnership.

Also note that preferred partnerships can be an excellent tool for getting future growth out of corporate solution, whether or not the corporation has an S election in place.[2238]

Also note that any freeze could be undone by switching from preferred/common to being all common, although the unrealized appreciation would need to be accounted for and the IRS might argue that the recapitalization constituted a gift. Accounting for unrealized appreciation would be a matter of determining the gain that would have been recognized if all assets had been sold for fair market value at the time of the change and specially allocating it to each partner; usually this is done by restating capital accounts to take these calculations into account – a process called booking up.[2239]

[2236] See Letter Ruling 201426016.

[2237] A partnership is not an eligible owner of a S stock. Code § 1361(b)(1)(B); see part II.A.2.e.v Relief for Late S Corporation and Entity Classification Elections for the Same Entity.

[2238] See part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially II.Q.7.h.viii Value Freeze as Conservative Alternative.

[2239] For the rules on revaluing partnership assets and adjusting capital accounts when that occurs, see part II.C.7 Maintaining Capital Accounts, especially fn. 507. The related gain allocation is called a "reverse-Code § 704(c) allocation" and is provided by fn. 5444 of part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

II.H.11.f.ii. Reverse Freeze to Guarantee Successful Sale to Irrevocable Grantor Trust

Normally one would have the transferor retain preferred and transfer common – to get the growth outside of the estate tax system. Consider doing the reverse, as described below.

Preferred partnership returns significantly exceed the AFR.[2240] The principal amount generally remains stable, because the entity needs to start with ample cushion to make sure that the stated liquidation amount will be paid.[2241] The main risk of decline in value is if interest rates increase, causing the present value of payments to decrease. However, if the holder of the preferred equity has the right to redeem for its stated value at any time, the preferred equity should hold its value.

Thus, a grantor could sell a preferred partnership interest to an irrevocable grantor trust for a note at the AFR, and the transaction would have a very high likelihood of succeeding.

I have seen this idea promoted for life insurance policies, where the preferred return is sufficient to pay not only the interest on the note to the grantor but also the life insurance premiums.

II.H.11.f.iii. Getting Business Value Out of Corporate Solution

Holding a business in an entity taxed as a partnership has several income tax advantages over holding the business in a C or S corporation; see part II.E Recommended Structure for Entities.

For how to migrate to that structure, see part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially part II.Q.7.h.viii Value Freeze as Conservative Alternative.

See also part II.H.5.c Preferred Partnership In Conjunction with GRAT or Sale to Irrevocable Grantor Trust of an S corporation.

II.H.11.f.iv. Shifting Income or Growth from High Tax State

Suppose grantor previously created an irrevocable trust while in a high tax jurisdiction and later creates (or the grantor's spouse later creates) another one in a low- or no-income tax state.

If the trust in the high tax state has low basis assets, a preferred partnership might be a way to shift growth to the other state – perhaps even after seven years[2242] getting the low basis assets outside of the high tax state altogether.

Conversely, if the trust in the high tax state has high income but expects little or no capital gain, perhaps a preferred partnership can shift the income to the other state and leave the never-to-be-taxed unrealized appreciation in the high tax state.

However, if the trust in the high tax state has high basis assets, selling the assets and lending the money to the other trust in exchange for a long-term AFR note might do the trick more simply than engaging in a preferred partnership. If the trust in the higher tax state is a credit

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[2240] See part II.H.11.d Valuing Preferred Partnership Interests, especially fn. 2218.
[2241] See part II.H.11.d Valuing Preferred Partnership Interests, especially fn. 2223.
[2242] See part II.Q.8.b.i Distribution of Property by a Partnership, especially part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

shelter trust and the surviving spouse does not need the income, the trustee could contribute the note to an S corporation and have the spouse make a QSST election so that all of the income is taxable to the surviving spouse, whether or not it is distributed; the S corporation then distributes only enough to pay the surviving spouse's income tax and invests the rest of the note payments.[2243]

II.H.11.f.v. Better Than a Charitable Lead Trust

Suppose client contributes highly appreciated property to a preferred partnership, receiving a preferred partnership interest and some significant common interest as well.[2244] The donor might then give the common to an irrevocable trust to which the donor allocates GST exemption, to get growth and future increases in income out of the estate tax system.

If, much later,[2245] the client decides to give the preferred partnership interest to a public charity, the income tax results are superior to those of a charitable lead trust. Results of giving the preferred partnership interest to a public charity:

- Income tax deduction for the fair market value of the gift.
- To the extent of the preferred return, the partnership's income is allocated to the charity,[2246] making it not taxable to the donor or the donor's family.
- The built-in gain attributable to the preferred interest is taxable to the charity when the property contributed for the preferred interest is sold.[2247]

Contrast that with a gift to an inter vivos charitable lead trust (without a partnership), in which:

- For the grantor to get an up-front charitable income tax deduction, the trust must be a grantor trust, in which case the grantor is taxed on all of the trust's income and capital gain, including amounts paid to the charity.
- Otherwise, the donor receives no charitable income tax deduction, and trust receives a charitable deduction to the extent that gross income is distributed to charity. When the underlying property is sold, the trust pays tax on all of the gain, to the extent not distributed to charity.
- The only way to assure that the remainder will have a zero inclusion ratio is to give the charity a unitrust. Assuming the property's value grows, payments to charity grow, in

[2243] See part III.A.3.e QSSTs and ESBTs, especially part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts (Whether or Not a Sale Is Made).
[2244] See text accompanying fn 2200 in part II.H.11.a Basics of Preferred Partnerships.
[2245] The preferred interest cannot have been created with an intent (at the time of creation) to give it to charity. See part II.Q.6.f.iii Charitable Partial Interest Prohibition, especially the text accompanying fns 4752-4753.
[2246] If and to the extent that the partnership generates unrelated business income, the charity will pay tax on that income. See part II.Q.6.d.i UBTI Related to a Partnership or Sole Proprietorship. If that tax is a concern, make sure the charity is a community foundation, donor advised fund, or other intermediary that distributes the income to the ultimate charitable recipient. See part II.Q.6.d.iii Charitable Deduction Against UBTI.
[2247] See part II.P.1.a.i.(a) General Rules for Allocations of Income in Partnerships, especially fns 3825-3827, 3838.

contrast to the gift to charity of a preferred partnership interest, in which payments to charity are frozen.

II.H.11.g. Need for Tax Distributions

When a partnership has any preferential distributions of operating cash flow, consider prioritizing distributions to pay taxes.

For example, suppose partnership AB provides that A is allocated and receives the first $100K of annual income, then receives the next $1M of operating cash flow to reduce A's capital account, then after that A is allocated 20% and B is allocated 80% of the profits. In the first year, AB earns $150K. A is allocated $110K of income, consisting of the first $100K plus 20% of the $50K excess; and B is allocated the remaining $40K of income ($80% of $50K). However, all distributions of operating cash flow go to A, leaving B without any cash from AB to pay B's taxes on the $40K.

Ray and Simpson, "Negotiating Partnership Preferred Equity," Tax Notes (10/30/2023),[2248] explores some nuances when some partners contribute cash and others contribute property with value in excess of basis (Code § 704(c) responsibility)[2249] or when a partnership contributes cash to a partnership holding property with value in excess of basis (reverse-Code § 704(c) responsibility).[2250]

Consider this from a form I use:

> <u>Section 4.3</u> <u>Distributions To Pay Taxes</u>. This Section is in consideration of the Members not causing the Company to be taxed as a C corporation. No later than a week before the due date of any estimated income tax payments, the Company shall distribute Cash to each Member as the Manager deems sufficient to pay the Member's share of the estimated tax due on the Company's income. To determine the estimated tax due, the Company shall apply a tax rate which is the sum of the highest rate of tax that could apply to the Company's type of income for federal income tax purposes combined with the highest rate of tax that could apply to that type of income for applicable state income tax purposes. The Manager may make this calculation using the Company's income through the end of the preceding month and annualizing as provided in Code section 6654(d)(2). Alternatively, the Manager may use the Company's income for the prior year, multiply it by the federal and state tax rate (determined above) for the prior year, and divide the product by four (4) for each quarter. In either event, no later than three (3) months after the end of the taxable year, the Manager shall calculate the distribution under this Section for such taxable year using the Company's income for the taxable year and distribute the amount calculated, less any prior distributions (whether or not under this Section) with respect to such taxable year. Without limiting the generality of the foregoing, federal income tax includes any tax

[2248] Thompson Coburn LLP doc. No. 31320322.

[2249] See parts II.P.1.a.i Allocations of Income in Partnerships (concept introduced in fn 3128) and II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

[2250] For a description of reverse-Code § 704(c) allocations of gain on sale, see part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, especially fns. 5444-5447.

imposed under Subtitle A of the Code. The amount of distributions pursuant to this Section received by a Member shall be treated as an advance on amounts otherwise distributable under Section 4.1.] [Note: Subtitle A includes self-employment tax and the tax on net investment income.]

The introductory sentence recites consideration to argue that tax distributions are an arm's-length contractual obligation rather than a mere return on investment.

II.H.12. Large Taxable Gifts to Lock in Lifetime Gift/Estate Tax Exemption

If one is concerned about a possible reduction in the lifetime gift/estate tax exemption, one may make a large taxable gift.

Part II.H.12.a Taxable Gifts of Property Included in the Donor's Estate covers the effect of:

- Taxable gifts on calculating estate tax, whether or not the gifted property is includible in the donor's gross estate.
- Using lifetime gift/estate tax exemption that exceeds the estate tax exemption otherwise allowable when the donor dies.
- Possible anti-abuse regulations attacking taxable gifts of gifted property includible in the donor's gross estate.

When reading part II.H.12.a, note that splitting large taxable gifts that are included in the grantor's estate prevents the wash effect of taxable gifts, in that:

- The consenting spouse makes taxable gifts but does not have estate inclusion.
- The grantor spouse has estate inclusion that is only offset by half of the taxable gifts.

The possibility of anti-abuse regulations may make one steer away from strategies that may be targeted. Strategies not called out for such an attack and cautions regarding using one's entire lifetime gift tax exemption (whether or not subject to the possible attack) are described in part II.H.12.b Using Lifetime Gift Tax Exemption without Estate Inclusion.

II.H.12.a. Taxable Gifts of Property Included in the Donor's Estate

The regulations governing bonus exemption may make a strategy of taxable gifts of property included in the donor's estate be counterproductive if the client is trying to lock in bonus estate tax exemption.

The preamble to proposed regulations on this topic explains in the "Background" section of the SUPPLEMENTARY INFORMATION portion:[2251]

I. Overview

In computing the amount of Federal gift tax to be paid on a gift or the amount of Federal estate tax to be paid at death, the gift and estate tax provisions of the Internal Revenue Code (Code) apply a unified rate schedule to the taxpayer's cumulative taxable gifts and taxable estate on death to arrive at a net tentative tax. The net tentative tax then is reduced by a credit based on the applicable exclusion amount (AEA), which is the sum of the basic exclusion amount (BEA) within the meaning of section 2010(c)(3) of the Code and, if applicable, the deceased spousal unused exclusion (DSUE) amount within the meaning of section 2010(c)(4). In certain cases, the AEA also includes a restored exclusion amount pursuant to Notice 2017-15, 2017-6 I.R.B. 783. Prior to January 1, 2018, for estates of decedents dying and gifts made beginning in 2011, section 2010(c)(3) provided a BEA of $5 million, indexed for inflation after 2011. The credit is applied first against the gift tax, on a cumulative basis, as taxable gifts are made. To the extent that any credit remains at death, it is applied against the estate tax.

This document contains proposed regulations to amend the Estate Tax Regulations (26 CFR part 20) under section 2010(c)(3) of the Code. The proposed regulations would update § 20.2010-1 to conform to statutory changes to the determination of the BEA enacted on December 22, 2017, by sections 11002 and 11061 of the Tax Cuts and Jobs Act, Public Law 115-97, 131 Stat. 2504 (2017) (TCJA).

II. Federal Gift Tax Computation Generally

The Federal gift tax is imposed by section 2501 of the Code on an individual's transfers by gift during each calendar year. The gift tax is determined under a seven-step computation required under sections 2502 and 2505 using the rate schedule set forth in section 2001(c) as in effect for the calendar year in which the gifts are made.

First, section 2502(a)(1) requires the determination of a tentative tax (that is, a tax unreduced by a credit amount) on the sum of all taxable gifts, whether made in the current year or in one or more prior periods (Step 1).

Second, section 2502(a)(2) requires the determination of a tentative tax on the sum of the taxable gifts made in all prior periods (Step 2).

Third, section 2502(a) requires the tentative tax determined in Step 2 to be subtracted from the tentative tax determined in Step 1 to arrive at the net tentative gift tax on the gifts made in the current year (Step 3).

Fourth, section 2505(a)(1) requires the determination of a credit equal to the applicable credit amount within the meaning of section 2010(c). The applicable credit amount is the tentative tax on the AEA determined as if the donor had died on the last day of the current calendar year. The AEA is the sum of the BEA as in effect for the year in which

[2251] REG-106706-18, RIN 1545-B072, 83 FR 59343 (11/30/2018), available at https://www.federalregister.gov/d/2018-25538 or https://www.federalregister.gov/documents/2018/11/23/2018-25538/estate-and-gift-taxes-difference-in-the-basic-exclusion-amount.

the gift was made, any DSUE amount as of the date of the gift as computed pursuant to § 25.2505-2, and any restored exclusion amount as of the date of the gift as computed pursuant to Notice 2017-15 (Step 4).

Fifth, section 2505(a)(2) and the flush language at the end of section 2505(a) require the determination of the sum of the amounts allowable as a credit to offset the gift tax on gifts made by the donor in all preceding calendar periods. For purposes of this determination, the allowable credit for each preceding calendar period is the tentative tax, computed at the tax rates in effect for the current period, on the AEA for such prior period, but not exceeding the tentative tax on the gifts actually made during such prior period. Section 2505(c). (Step 5).

Sixth, section 2505(a) requires that the total credit allowable for prior periods determined in Step 5 be subtracted from the credit for the current period determined in Step 4. (Step 6).

Finally, section 2505(a) requires that the credit amount determined in Step 6 be subtracted from the net tentative gift tax determined in Step 3 (Step 7).

III. Federal Estate Tax Computation Generally

The Federal estate tax is imposed by section 2001(a) on the transfer of a decedent's taxable estate at death. The estate tax is determined under a five-step computation required under sections 2001 and 2010 using the same rate schedule used for gift tax purposes (thus referred to as the unified rate schedule) as in effect at the decedent's death.

First, section 2001(b)(1) requires the determination of a tentative tax (again, a tax unreduced by a credit amount) on the sum of the taxable estate and the adjusted taxable gifts, defined as all taxable gifts made after 1976 other than those included in the gross estate (Step 1).

Second, section 2001(b)(2) and (g) require the determination of a hypothetical gift tax (a gift tax reduced, but not to below zero, by the credit amounts allowable in the years of the gifts) on all post-1976 taxable gifts, whether or not included in the gross estate. The credit amount allowable for each year during which a gift was made is the tentative tax, computed using the tax rates in effect at the decedent's death, on the AEA for that year, but not exceeding the tentative tax on the gifts made during that year. Section 2505(c). The AEA is the sum of the BEA as in effect for the year in which the gift was made, any DSUE amount as of the date of the gift as computed pursuant to § 25.2505-2, and any restored exclusion amount as of the date of the gift as computed pursuant to Notice 2017-15. This hypothetical gift tax is referred to as the gift tax payable (Step 2).

Third, section 2001(b) requires the gift tax payable determined in Step 2 to be subtracted from the tentative tax determined in Step 1 to arrive at the net tentative estate tax (Step 3).

Fourth, section 2010(a) and (c) require the determination of a credit equal to the tentative tax on the AEA as in effect on the date of the decedent's death. This credit may not exceed the net tentative estate tax. Section 2010(d). (Step 4).

Finally, section 2010(a) requires that the credit amount determined in Step 4 be subtracted from the net tentative estate tax determined in Step 3. (Step 5).

IV. TCJA Amendments

Section 11061 of the TCJA amended section 2010(c)(3) to provide that, for decedents dying and gifts made after December 31, 2017, and before January 1, 2026, the BEA is increased by $5 million to $10 million as adjusted for inflation (increased BEA). On January 1, 2026, the BEA will revert to $5 million. Thus, an individual or the individual's estate may utilize the increased BEA to shelter from gift and estate taxes an additional $5 million of transfers made during the eight-year period beginning on January 1, 2018, and ending on December 31, 2025 (increased BEA period).

In addition, section 11002 of the TCJA amended section 1(f)(3) of the Code to base the determination of annual cost-of-living adjustments, including those for gift and estate tax purposes, on the Chained Consumer Price Index for All Urban Consumers for all taxable years beginning after December 31, 2017. Section 11002 of the TCJA also made conforming changes in sections 2010(c)(3)(B)(ii), 2032A(a)(3)(B), and 2503(b)(2)(B).

Section 11061 of the TCJA also added section 2001(g)(2) to the Code, which, in addition to the necessary or appropriate regulatory authority granted in section 2010(c)(6) for purposes of section 2010(c), directs the Secretary to prescribe such regulations as may be necessary or appropriate to carry out section 2001 with respect to any difference between the BEA applicable at the time of the decedent's death and the BEA applicable with respect to any gifts made by the decedent.

V. Summary of Concerns Raised by Changes in BEA

1. IN GENERAL

Given the cumulative nature of the gift and estate tax computations and the differing manner in which the credit is applied against these two taxes, commenters have raised two questions regarding a potential for inconsistent tax treatment or double taxation of transfers resulting from the temporary nature of the increased BEA. First, in cases in which a taxpayer exhausted his or her BEA and paid gift tax on a pre-2018 gift, and then either makes an additional gift or dies during the increased BEA period, will the increased BEA be absorbed by the pre-2018 gift on which gift tax was paid so as to deny the taxpayer the full benefit of the increased BEA during the increased BEA period? Second, in cases in which a taxpayer made a gift during the increased BEA period that was fully sheltered from gift tax by the increased BEA but makes a gift or dies after the increased BEA period has ended, will the gift that was exempt from gift tax when made during the increased BEA period have the effect of increasing the gift or estate tax on the later transfer (in effect, subjecting the earlier gift to tax even though it was exempt from gift tax when made)?

As discussed in the remainder of this Background section, the Treasury Department and the IRS have analyzed the statutorily required steps for determining Federal gift and estate taxes in the context of several different situations that could occur either during the increased BEA period as a result of an increase in the BEA, or thereafter as a result of a decrease in the BEA. Only in the last situation discussed below was a potential problem identified, and a change intended to correct that problem is proposed in this notice of proposed rulemaking. This preamble, however, also includes a brief explanation of the reason why no potential problem is believed to exist in any of the first three situations discussed below. For the sake of simplicity, the following discussion assumes that, as may be the more usual case, the AEA includes no DSUE or restored exclusion amount and thus, refers only to the BEA.

2. EFFECT OF INCREASE IN BEA ON GIFT TAX

The first situation considered is whether, for gift tax purposes, the increased BEA available during the increased BEA period is reduced by pre-2018 gifts on which gift tax actually was paid. This issue arises for donors, who made both pre-2018 gifts exceeding the then-applicable BEA, thus making gifts that incurred a gift tax liability, and additional gifts during the increased BEA period. The concern raised is whether the gift tax computation will apply the increased BEA to the pre-2018 gifts, thus reducing the BEA otherwise available to shelter gifts made during the increased BEA period and, in effect, allocating credit to a gift on which gift tax in fact was paid.

Step 3 of the gift tax determination requires the tentative tax on all gifts from prior periods to be subtracted from the tentative tax on the donor's cumulative gifts (including the current gift). The gifts from prior periods include the pre-2018 gifts on which gift tax was paid. In this way, the full amount of the gift tax liability on the pre-2018 gifts is removed from the current year gift tax computation, regardless of whether that liability was sheltered from gift tax by the BEA and/or was satisfied by a gift tax payment. Steps 4 through 6 of the gift tax determination then require, in effect, that the BEA for the current year be reduced by the BEA allowable in prior periods against the gifts that were made by the donor in those prior periods. The increased BEA was not available in the years when the pre-2018 gifts were made and thus, was not allowable against those gifts. Accordingly, the gift tax determination appropriately reduces the increased BEA only by the amount of BEA allowable against prior period gifts, thereby ensuring that the increased BEA is not reduced by a prior gift on which gift tax in fact was paid.

3. EFFECT OF INCREASE IN BEA ON ESTATE TAX

The second situation considered is whether, for estate tax purposes, the increased BEA available during the increased BEA period is reduced by pre-2018 gifts on which gift tax actually was paid. This issue arises in the context of estates of decedents who both made pre-2018 gifts exceeding the then allowable BEA, thus making gifts that incurred a gift tax liability, and die during the increased BEA period. The concern raised is whether the estate tax computation will apply the increased BEA to the pre-2018 gifts, thus reducing the BEA otherwise available against the estate tax during the increased BEA period and, in effect, allocating credit to a gift on which gift tax in fact was paid.

Step 3 of the estate tax determination requires that the hypothetical gift tax on the decedent's post-1976 taxable gifts be subtracted from the tentative tax on the sum of the taxable estate and adjusted taxable gifts. The post-1976 taxable gifts include the pre-2018 gifts on which gift tax was paid. In this way, the full amount of the gift tax liability on the pre-2018 gifts is removed from the estate tax computation, regardless of whether that liability was sheltered from gift tax by the BEA and/or was satisfied by a gift tax payment. Step 4 of the estate tax determination then requires that a credit on the amount of the BEA for the year of the decedent's death be subtracted from the net tentative estate tax. As a result, the only time that the increased BEA enters into the computation of the estate tax is when the credit on the amount of BEA allowable in the year of the decedent's death is netted against the tentative estate tax, which in turn already has been reduced by the hypothetical gift tax on the full amount of all post-1976 taxable gifts (whether or not gift tax was paid). Thus, the increased BEA is not reduced by the portion of any prior gift on which gift tax was paid, and the full amount of the increased BEA is available to compute the credit against the estate tax.

4. EFFECT OF DECREASE IN BEA ON GIFT TAX

The third situation considered is whether the gift tax on a gift made after the increased BEA period is inflated by a theoretical gift tax on a gift made during the increased BEA period that was sheltered from gift tax when made. If so, this would effectively reverse the benefit of the increased BEA available for gifts made during the increased BEA period. This issue arises in the case of donors who both made one or more gifts during the increased BEA period that were sheltered from gift tax by the increased BEA in effect during those years, and made a post-2025 gift. The concern raised is whether the gift tax determination on the post-2025 gift will treat the gifts made during the increased BEA period as gifts not sheltered from gift tax by the credit on the BEA, given that the post-2025 gift tax determination is based on the BEA then in effect, rather than on the increased BEA.

Just as in the first situation considered in part V(2) of this Background section, Step 3 of the gift tax determination directs that the tentative tax on gifts from prior periods be subtracted from the tentative tax on the donor's cumulative gifts (including the current gift). The gift tax from prior periods includes the gift tax attributable to the gifts made during the increased BEA period. In this way, the full amount of the gift tax liability on the increased BEA period gifts is removed from the computation, regardless of whether that liability was sheltered from gift tax by the BEA or was satisfied by a gift tax payment. All that remains is the tentative gift tax on the donor's current gift. Steps 4 through 6 of the gift tax determination then require that the credit based on the BEA for the current year be reduced by such credits allowable in prior periods. Even if the sum of the credits allowable for prior periods exceeds the credit based on the BEA in the current (post-2025) year, the tax on the current gift cannot exceed the tentative tax on that gift and thus will not be improperly inflated. The gift tax determination anticipates and avoids this situation, but no credit will be available against the tentative tax on the post-2025 gift.

5. EFFECT OF DECREASE IN BEA ON ESTATE TAX

The fourth situation considered is whether, for estate tax purposes, a gift made during the increased BEA period that was sheltered from gift tax by the increased BEA inflates a post-2025 estate tax liability. This will be the case if the estate tax computation fails to treat such gifts as sheltered from gift tax, in effect reversing the benefit of the increased BEA available for those gifts. This issue arises in the case of estates of decedents who both made gifts during the increased BEA period that were sheltered from gift tax by the increased BEA in effect during those years, and die after 2025. The concern raised is whether the estate tax computation treats the gifts made during the increased BEA period as post-1976 taxable gifts not sheltered from gift tax by the credit on the BEA, given that the post-2025 estate tax computation is based on the BEA in effect at the decedent's death rather than the BEA in effect on the date of the gifts.

In this case, the statutory requirements for the computation of the estate tax, in effect, retroactively eliminate the benefit of the increased BEA that was available for gifts made during the increased BEA period. This can be illustrated by the following examples.

Example 1.

Individual A made a gift of $11 million in 2018, when the BEA was $10 million. A dies in 2026, when the BEA is $5 million, with a taxable estate of $4 million. Based on a literal application of section 2001(b), the estate tax would be approximately $3,600,000, which is equal to a 40 percent estate tax on $9 million (specifically, the $9 million being the sum of the $4 million taxable estate and $5 million of the 2018 gift sheltered from gift tax by the increased BEA). This in effect would impose estate tax on the portion of the 2018 gift that was sheltered from gift tax by the increased BEA allowable at that time.

Example 2.

The facts are the same as in Example 1, but A dies in 2026 with no taxable estate. Based on a literal application of section 2001(b), A’s estate tax is approximately $2 million, which is equal to a 40 percent tax on $5 million. Five million dollars is the amount by which, after taking into account the $1 million portion of the 2018 gift on which gift tax was paid, the 2018 gift exceeded the BEA at death. This, in effect, would impose estate tax on the portion of the 2018 gift that was sheltered from the gift tax by the excess of the 2018 BEA over the 2026 BEA.

This problem occurs as a result of the interplay between Steps 2 and 4 of the estate tax determination, and the differing amounts of BEA taken into account in those steps. Step 2 determines the credit against gift taxes payable on all post-1976 taxable gifts, whether or not included in the gross estate, using the BEA amounts allowable on the dates of the gifts but determined using date of death tax rates. Step 3 subtracts gift tax payable from the tentative tax on the sum of the taxable estate and the adjusted taxable gifts. The result is the net tentative estate tax. Step 4 determines a credit based on the BEA as in effect on the date of the decedent’s death. Step 5 then reduces the net tentative estate tax by the credit determined in Step 4. If the credit amount applied at Step 5 is less than that allowable for the decedent’s post-1976 taxable gifts at Step 2, the effect is to increase the estate tax by the difference between those two credit amounts. In this circumstance, the statutory requirements have the effect of imposing an estate tax on gifts made during the increased BEA period that were sheltered from gift tax by the increased BEA in effect when the gifts were made.

Code § 2001(g)(2), “Modifications to estate tax payable to reflect different basic exclusion amounts,” provides:

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between -

(A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent’s death, and

(B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent.

The Senate amendment, which the conference agreement followed, explained the above provision:

> As a conforming amendment to section 2010(g) (regarding computation of estate tax), the provision provides that the Secretary shall prescribe regulations as may be necessary or appropriate to carry out the purposes of the section with respect to differences between the basic exclusion amount in effect: (1) at the time of the decedent's death; and (2) at the time of any gifts made by the decedent.

The preamble to the final regulations, T.D. 9884 (11/26/2019), [2252] provides:

> **SUPPLEMENTARY INFORMATION:**
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> **Background**
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> Section 11061 of the Tax Cuts and Jobs Act, Public Law 115-97, 131 Stat. 2504 (2017) (TCJA) amended section 2010(c)(3) of the Internal Revenue Code (Code) to provide that, for decedents dying and gifts made after December 31, 2017, and before January 1, 2026, the basic exclusion amount (BEA) is increased by $5 million to $10 million as adjusted for inflation (increased BEA). On January 1, 2026, the BEA will revert to $5 million as adjusted for inflation.
>
> This document contains amendments to the Estate Tax Regulations (26 CFR part 20) relating to the BEA described in section 2010(c)(3) of the Code. On November 23, 2018, a notice of proposed rulemaking (proposed regulations) under section 2010 (REG-106706-18) was published in the Federal Register (83 FR 59343). No public hearing was requested or held. Written or electronic comments responding to the proposed regulations were received. After consideration of all the comments, this Treasury decision adopts the proposed regulations with certain revisions. Comments and revisions to the proposed regulations are discussed in the Summary of Comments and Explanation of Revisions.
>
> The final regulations adopt the special rule provided in the proposed regulations in cases where the portion of the credit against the estate tax that is based on the BEA is less than the sum of the credit amounts attributable to the BEA allowable in computing gift tax payable within the meaning of section 2001(b)(2). In that case, the rule provides that the portion of the credit against the net tentative estate tax that is attributable to the BEA is based upon the greater of those two credit amounts. The rule thus would ensure that the estate of a decedent is not inappropriately taxed with respect to gifts that were sheltered from gift tax by the increased BEA when made.
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> **Summary of Comments and Explanation of Revisions**
>
> **1. Overview**
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> Most commenters agreed that the special rule would avoid an unfair situation that otherwise could effectively vitiate the statutory increase in the BEA during the period January 1, 2018, through December 31, 2025 (increased BEA period). These

[2252] https://www.federalregister.gov/documents/2019/11/26/2019-25601/estate-and-gift-taxes-difference-in-the-basic-exclusion-amount#footnote-1-p64997 or https://www.federalregister.gov/d/2019-25601.

commenters also acknowledged that the special rule would provide important clarification for taxpayers. However, one commenter suggested an alternate approach and two others disputed the regulatory authority to adopt the special rule. Some commenters suggested technical changes. All of the other comments were requests for clarification of the interaction of the special rule with the inflation adjustments to the BEA, the deceased spousal unused exclusion (DSUE) amount, and the generation-skipping transfer (GST) tax, and requests for additional examples. These comments are discussed in this preamble.

2. Inflation Adjustments

Several commenters noted that the example in the proposed regulations does not reflect the annual inflation adjustments to the BEA, and requested clarification of the effect of those adjustments on the application of the special rule. The inflation adjustments were not included in that example for purposes of more simply illustrating the special rule. However, by definition, the term BEA refers to the amount of that exclusion as adjusted for inflation, so the Department of the Treasury (Treasury Department) and the IRS agree that examples including inflation adjustments would be appropriate. Accordingly, the examples in the final regulations reflect hypothetical inflation-adjusted BEA amounts.

One commenter requested confirmation that under the special rule a decedent does not benefit from the increased BEA, including inflation adjustments, to the extent it is in excess of the amount of gifts the decedent actually made, and agreed that this is the appropriate interpretation of the statute. Specifically, the increased BEA as adjusted for inflation is a “use or lose” benefit and is available to a decedent who survives the increased BEA period only to the extent the decedent “used” it by making gifts during the increased BEA period. The final regulations include Example 2 in § 20.2010-1(c)(2)(ii) to demonstrate that the application of the special rule is based on gifts actually made, and thus is inapplicable to a decedent who did not make gifts in excess of the date of death BEA as adjusted for inflation.

Commenters also sought confirmation that under the special rule a decedent dying after 2025 will not benefit from post-2025 inflation adjustments to the BEA to the extent the decedent made gifts in an amount sufficient to cause the total BEA allowable in the computation of gift tax payable to exceed the date of death BEA as adjusted for inflation. This is confirmed in Example 1 of § 20.2010-1(c)(2)(i) of these final regulations. In computing the estate tax, the BEA, in effect, is applied first against the decedent’s gifts as taxable gifts were made. To the extent any BEA remains at death, it is applied against the decedent’s estate. Therefore, in the case of a decedent who had made gifts in an amount sufficient to cause the total BEA allowable in the computation of gift tax payable to equal or exceed the date of death BEA as adjusted for inflation, there is no remaining BEA available to be applied to reduce the estate tax. The special rule does not change the five-step estate tax computation required under sections 2001 and 2010 of the Code or the fact that, under that computation, only the credit that remains after computing gift tax payable may be applied against the estate tax.

One commenter recommended that, where the BEA allowable in computing gift tax payable exceeds the date of death BEA including inflation adjustments, the special rule should permit the use of a BEA equal to the sum of the BEA allowable in computing gift tax payable and the post-2025 inflation adjustments. For the reasons discussed in the preceding paragraphs, this recommendation is inconsistent with the unified gift and estate tax statutes. If the BEA allowable in computing gift tax payable exceeds the date of death BEA as adjusted for inflation, under the special rule, the inflation adjustments already have been allowable against taxable gifts and it would be inconsistent with the estate tax statute to allow them again against the estate tax.

3. DSUE

Several commenters asked for confirmation that, even if the amount of BEA that is allowable under section 2010(c)(3) of the Code decreases after 2025, a DSUE amount elected during the increased BEA period will not be reduced as a result of the sunset of the increased BEA. Section 2010(c)(4) defines the DSUE amount as the lesser of the BEA or the unused portion of the deceased spouse's applicable exclusion amount (AEA) at death. The regulations in §§ 20.2010-1(d)(4) and 20.2010-2(c)(1) confirm that the reference to BEA is to the BEA in effect at the time of the deceased spouse's death, rather than the BEA in effect at the death of the surviving spouse. A DSUE election made on the deceased spouse's estate tax return allows the surviving spouse to take into account the deceased spouse's DSUE amount as part of the surviving spouse's AEA. Section 2010(c)(5); § 20.2010-2(a). AEA is the sum of the DSUE amount and the BEA. Section 2010(c)(2). A decrease in the BEA after 2025 will reduce the surviving spouse's AEA only to the extent that it is based upon the BEA, but not to the extent that it is based on the DSUE amount. Therefore, the sunset of (or any other decrease in) the increased BEA has no impact on the existing DSUE rules and the existing regulations governing DSUE continue to apply. Examples 3 and 4 of § 20.2010-1(c)(2)(iii) and (iv), respectively, of these final regulations address this situation. The examples demonstrate that, if a spouse dies during the increased BEA period, and the deceased spouse's executor makes the portability election, the surviving spouse's AEA includes the full amount of the DSUE that is based on the deceased spouse's increased BEA. This DSUE amount is available to offset the surviving spouse's transfer tax liability regardless of when the transfers are made, whether during or after the increased BEA period.

4. BEA Computations

Several commenters raised questions concerning the calculation of the credit amount solely attributable to the BEA in computing gift tax payable where the AEA upon which the credits are based consists of amounts other than the BEA. In response to these comments, the final regulations clarify how to determine the extent to which a credit allowable in computing gift tax payable is based solely on the BEA. First, the credit may not exceed that amount necessary to reduce the gift tax for that calendar period to zero. Second, any DSUE amount available to the decedent for that calendar period is deemed to be applied to the decedent's gifts before any of the decedent's BEA is applied to those gifts. This is consistent with the existing ordering rule concerning the application of DSUE to a given transfer. See §§ 20.2010-3(b) and 25.2505-2(b). Third, in a calendar period in which the AEA allowable with regard to gifts made during that period includes both DSUE and BEA, the allowable BEA may not exceed that necessary to reduce the tentative gift tax to zero after the application of the DSUE amount. Fourth, in a calendar period in which the AEA allowable with regard to gifts made during that period includes both DSUE and BEA, the portion of the credit based solely on the BEA for that period is that which corresponds to the result of dividing the BEA allocable to those gifts by the AEA allocable to those gifts. Example 4 of § 20.2010-1(c)(2)(iv) of these final regulations addresses the application of the DSUE ordering rule as well as the computation of the credit based solely on the BEA in a calendar period in which the transfer exhausts the remaining DSUE amount with the result that the BEA is also allowable.

A commenter requested an example involving a taxable estate that exceeds the available exclusion amount. Each of Examples 2, 3, and 4 of § 20.2010-1(c)(2)(ii), (iii) and (iv), respectively, of these final regulations contemplates that the decedent's estate potentially is taxable, and identifies the exclusion amounts upon which the credit against the tentative estate tax is based.

A commenter suggested that examples be provided regarding the computation of the gift tax on gifts made during the increased BEA period and after the sunset of that period. The computation of the gift tax in both situations was discussed in detail in the preamble to the proposed regulations. See part V.2., Effect of Increase in BEA on the Gift Tax, and part V.4., Effect of Decrease in BEA on the Gift Tax, in the Background section of the proposed regulations. That discussion concludes that the existing seven-step gift tax computation required under sections 2502 and 2505 of the Code appropriately applies in the case of both increases and decreases in the BEA. Accordingly, there is nothing that needs to be changed in the gift tax computation and thus, no need for gift tax examples.

Some commenters suggested a BEA ordering rule, similar to that for DSUE, under which the increase in the BEA during the increased BEA period over the BEA in effect in 2017 (base BEA) is deemed to be allowable against gifts before the base BEA. They posited that this would allow donors to utilize the increase in the BEA without being deemed to have utilized the base BEA, so that the base BEA would remain available for transfers made after 2025. Specifically, a $5 million gift made during the increased BEA period would use the temporary increase in the BEA and preserve or "bank" the base BEA of $5 million so as to be available after 2025 for either gift or estate tax purposes. This suggestion was not adopted for several reasons. First, it is inconsistent with the sunset of the increased BEA in that it, in effect, would extend the availability of the increased BEA beyond 2025. As discussed in section 2 of this Summary of Comments and Explanation of Revisions, Inflation Adjustments, the increased BEA is a "use or lose" benefit that is available only during the increased BEA period. Second, it is inconsistent with the cumulative structure of the unified transfer tax regime. Under that regime, the BEA in effect for a particular year is the exclusion allowable for cumulative purposes—that is, for all prior taxable gifts and the current gift or taxable estate. In the case of a donor or decedent who made prior gifts in an amount at least equal to the post-2025 exclusion amount in effect in the year of the current gift or death, there is no remaining BEA available to be applied. Finally, as is explained in the preamble to the proposed regulations, the existing seven-step gift tax computation required under sections 2502 and 2505 of the Code appropriately adjusts for gifts made in an earlier period during which the BEA differed from the BEA in effect for a current gift. The suggested BEA ordering rule would create the same sort of problem these final regulations are designed to correct.

5. GST Tax

Several commenters asked for confirmation that, during the increased BEA period, donors may make late allocations of the increase in GST exemption to inter vivos trusts created prior to 2018.[1] An increase in the BEA correspondingly increases the GST tax exemption, which is defined by reference to the BEA. Section 2631(c). The effect of the increased BEA on the GST tax is beyond the scope of this rulemaking.

[1] See Joint Comm. on Taxation, JCS-1-18, “General Explanation of Public Law 115-97,” 89 (2018), indicating that a late allocation of GST exemption (increased by the increase in the BEA) may be made during the increased BEA period.

A commenter requested confirmation and examples showing that allocations of the increased GST exemption made during the increased BEA period (whether to transfers made before or during that period) will not be reduced as a result of the sunset of the increased BEA. There is nothing in the statute that would indicate that the sunset of the increased BEA would have any impact on allocations of the GST exemption available during the increased BEA period. However, this request is beyond the scope of this project.

6. Anti-Abuse Rule

[reproduced further below]

7. Regulatory Authority

Two commenters suggested that the special rule would exceed the scope of the authority granted by Congress. They stated that the impact of the rule is on the estates of decedents dying after the sunset of the increased BEA period. They suggested that the rule would violate the reconciliation rules under which the TCJA was passed because it would increase the impact on the deficit beyond 2025, and therefore could not have been what Congress intended in the grant of regulatory authority. They also suggested that the avoidance of an estate tax that recaptures gift tax on sheltered gifts could not have been what Congress intended because they interpret the TCJA revenue estimates as showing that the recapture of that gift tax was contemplated. In short, these commenters suggested that Congress was concerned with the treatment of transfers made before January 1, 2026, but not with those made after December 31, 2025.

As explained in the following paragraphs, these suggestions are inconsistent with section 2001(g), which addresses the effect of changes in tax rates and exclusion amounts on the computation of the estate tax. Moreover, they are also inconsistent with the plain language of section 2001(g)(2), which addresses circumstances that can occur only after December 31, 2025.

What is now section 2001(g)(1) of the Code was added by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Public Law 111-312, 124 Stat. 3296 (2010) (TRUIRJCA). Section 302(a) of TRUIRJCA raised the exclusion amount to $5 million, as adjusted for inflation, and reduced the maximum tax rate from 45 to 35 percent. Section 302(d)(1)(B) of TRUIRJCA, “Modifications of Estate and Gift Taxes to Reflect Differences in Credit Resulting From Different Tax Rates,” added section 2001(g) to the Code. The effect of section 2001(g) is to treat the post-1976 taxable gifts and the taxable estate consistently by applying the same tax rate, regardless of whether the transfer occurred during life or at death. This consistency is achieved by using one tax rate to determine not only the gift and estate tax liabilities, but also the credit against the estate tax and against all prior gift taxes. This is the case regardless of whether rates have increased or decreased.

Section 2001(g)(2) of the Code was added by the TCJA. Section 11061 of the TCJA raised the BEA to $10 million, as adjusted for inflation, for transfers after December 31, 2017, and before January 1, 2026. The TCJA then provided that the BEA reverts to $5 million, as adjusted for inflation, for transfers after December 31, 2025. The addition of section 2001(g)(2) was a conforming amendment to the estate tax. H. Conf. Rept. 115-466, 115th Cong., 1st sess. 316 (Dec. 15, 2017). Under current law, the first change in the BEA to which section 2001(g)(2) could be applicable is the decrease to $5 million, as adjusted for inflation, on January 1, 2026.

As explained in the preamble to the proposed regulations, a decrease in the BEA has the potential to cause the imposition of estate tax on gifts that were sheltered from gift tax by the higher BEA in effect when the gifts were made. Again, under current law, this can occur only after December 31, 2025, when the BEA reverts to $5 million, as adjusted for inflation, as a result of the sunset of the increased BEA.

The impact of the sunset of the increased BEA as of January 1, 2026, was precisely the situation Congress wished to have addressed when it made the explicit grant of regulatory authority under section 2001(g)(2) and, further, the purpose of that grant was to authorize a regulatory rule to ensure that there will be no imposition of estate tax on inter vivos gifts that were sheltered from gift tax by the increased BEA in effect when the gifts were made. Indeed, prior legislative efforts to address the effect of anticipated reductions in the exclusion amount have proposed various approaches to produce the same result. See the Sensible Estate Tax Act of 2011, H.R. 3467, 112th Cong., 1st sess. section 2(c) (2011) (amending section 2001(g) to address a proposed reduction in the exclusion amount from $5 million to $1 million); and the Middle Class Tax Cut Act, S. 3393, 112th Cong., 2nd sess. section 201(b) (2012) (adding section 2001(h) to address a proposed reduction in the exclusion amount from $5 million to $3.5 million). As explained in "General Explanation of Public Law 115-97" (TCJA Bluebook),

> Because the increase in the basic exclusion amount does not apply for estates of decedents dying after December 31, 2025, it is expected that this guidance will prevent the estate tax computation under section 2001(g) from recapturing, or "clawing back," all or a portion of the benefit of the increased basic exclusion amount used to offset gift tax for certain decedents who make taxable gifts between January 1, 2018, and December 31, 2025, and die after December 31, 2025.

Joint Comm. on Taxation, JCS-1-18, "General Explanation of Public Law 115-97," 89 (2018). One commenter disputes the TCJA Bluebook explanation as an indication that the grant of regulatory authority was to prevent this "clawback" on the basis of the fact that the Bluebook was not published until almost one year after the enactment of the TCJA. The Treasury Department and the IRS consider the TCJA Bluebook's explanation of the grant of regulatory authority to be an accurate reflection of Congressional intent.

Finally, one commenter said that the special rule is based on the "flawed assumption" that such "clawback" would constitute double taxation. The commenter said that the gift and estate taxes are two different taxes, even though cumulative, and thus subjecting the same inter vivos transfer to both taxes would not be double taxation. The Treasury Department and the IRS disagree with this proposition. The gift and estate taxes are subject to a unified structure that ensures that a transfer is taxed only once, regardless of whether that transfer ultimately is treated as an inter vivos transfer or as a testamentary transfer. Indeed, the way in which the estate tax statute addresses prior gifts included in the gross estate makes it clear that a single transfer is to be taxed only once.

> In sum, section 2001(g) is directed to the consequences of changing tax rates and decreasing exclusion amounts on the computation of the estate tax. In the absence of section 2001(g)(1), a change in tax rates could subject post-1976 taxable gifts and the taxable estate to different rates, which could adversely impact the amount of credit available against the estate tax. In the absence of the special rule implementing the directions in section 2001(g)(2), a decrease in the exclusion amount could have the effect of understating the gift tax payable on post-1976 gifts, with the result that estate tax would be imposed on gifts that were sheltered from tax when made by the increased BEA. Under current law, a decrease in the exclusion amount cannot occur until after December 31, 2025. This is the period to which section 2001(g)(2) is directed. Accordingly, the special rule is well within the scope of the regulatory authority and accurately reflects the purpose of that authority.

The final regulations included Reg.§ 20.2010-1(c), "Special rule in the case of a difference between the basic exclusion amount applicable to gifts and that applicable at the donor's date of death," which provides:

> Changes in the basic exclusion amount that occur between the date of a donor's gift and the date of the donor's death may cause the basic exclusion amount allowable on the date of a gift to exceed that allowable on the date of death. If the total of the amounts allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts, within the meaning of section 2001(b)(2), to the extent such credits are based solely on the basic exclusion amount as defined and adjusted in section 2010(c)(3), exceeds the credit allowable within the meaning of section 2010(a) in computing the estate tax, again only to the extent such credit is based solely on such basic exclusion amount, in each case by applying the tax rates in effect at the decedent's death, then the portion of the credit allowable in computing the estate tax on the decedent's taxable estate that is attributable to the basic exclusion amount is the sum of the amounts attributable to the basic exclusion amount allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts.
>
> (1) *Computational rules*. For purposes of this paragraph (c):
>
> (i) In determining the amounts allowable as a credit:
>
> (A) The amount allowable as a credit in computing gift tax payable for any calendar period may not exceed the tentative tax on the gifts made during that period (section 2505(c)); and
>
> (B) The amount allowable as a credit in computing the estate tax may not exceed the net tentative tax on the taxable estate (section 2010(d)).
>
> (ii) In determining the extent to which an amount allowable as a credit in computing gift tax payable is based solely on the basic exclusion amount:
>
> (A) Any deceased spousal unused exclusion (DSUE) amount available to the decedent is deemed to be applied to gifts made by the decedent before the decedent's basic exclusion amount is applied to those gifts (see §§ 20.2010-3(b) and 25.2505-2(b));

(B) In a calendar period in which the applicable exclusion amount allowable with regard to gifts made during that period includes amounts other than the basic exclusion amount, the allowable basic exclusion amount may not exceed that necessary to reduce the tentative gift tax to zero; and

(C) In a calendar period in which the applicable exclusion amount allowable with regard to gifts made during that period includes amounts other than the basic exclusion amount, the portion of the credit based solely on the basic exclusion amount is that which corresponds to the result of dividing the basic exclusion amount allocable to those gifts by the applicable exclusion amount allocable to those gifts.

(iii) In determining the extent to which an amount allowable as a credit in computing the estate tax is based solely on the basic exclusion amount, the credit is computed as if the applicable exclusion amount were limited to the basic exclusion amount.

(2) *Examples*. All basic exclusion amounts include hypothetical inflation adjustments. Unless otherwise stated, in each example the decedent's date of death is after 2025.

(i) *Example 1*. Individual A (never married) made cumulative post-1976 taxable gifts of $9 million, all of which were sheltered from gift tax by the cumulative total of $11.4 million in basic exclusion amount allowable on the dates of the gifts. The basic exclusion amount on A's date of death is $6.8 million. A was not eligible for any restored exclusion amount pursuant to Notice 2017-15. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts (based on the $9 million of basic exclusion amount used to determine those credits) exceeds the credit based on the $6.8 million basic exclusion amount allowable on A's date of death, this paragraph (c) applies, and the credit for purposes of computing A's estate tax is based on a basic exclusion amount of $9 million, the amount used to determine the credits allowable in computing the gift tax payable on A's post-1976 gifts.

(ii) *Example 2*. Assume that the facts are the same as in Example 1 of paragraph (c)(2)(i) of this section except that A made cumulative post-1976 taxable gifts of $4 million. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts is less than the credit based on the $6.8 million basic exclusion amount allowable on A's date of death, this paragraph (c) does not apply. The credit to be applied for purposes of computing A's estate tax is based on the $6.8 million basic exclusion amount as of A's date of death, subject to the limitation of section 2010(d).

(iii) *Example 3*. Individual B's predeceased spouse, C, died before 2026, at a time when the basic exclusion amount was $11.4 million. C had made no taxable gifts and had no taxable estate. C's executor elected, pursuant to § 20.2010-2, to allow B to take into account C's $11.4 million DSUE amount. B made no taxable gifts and did not remarry. The basic exclusion amount on B's date of death is $6.8 million. Because the total of the amounts allowable as a credit in computing the gift tax payable on B's post-1976 gifts attributable to the basic exclusion amount (zero) is less than the credit based on the basic exclusion amount allowable on B's date of death, this paragraph (c) does not apply. The credit to be applied for purposes of computing B's estate tax is based on B's $18.2 million applicable exclusion amount, consisting of the $6.8 million basic exclusion amount on B's date of death plus the $11.4 million DSUE amount, subject to the limitation of section 2010(d).

(iv) *Example 4*. Assume the facts are the same as in Example 3 of paragraph (c)(2)(iii) of this section except that, after C's death and before 2026, B makes taxable gifts of $14 million in a year when the basic exclusion amount is $12 million. B is considered to apply the DSUE amount to the gifts before applying B's basic exclusion amount. The amount allowable as a credit in computing the gift tax payable on B's post-1976 gifts for that year ($5,545,800) is the tax on $14 million, consisting of $11.4 million in DSUE amount and $2.6 million in basic exclusion amount. This basic exclusion amount is 18.6 percent of the $14 million exclusion amount allocable to those gifts, with the result that $1,031,519 (0.186 × $5,545,800) of the amount allowable as a credit for that year in computing gift tax payable is based solely on the basic exclusion amount. The amount allowable as a credit based solely on the basic exclusion amount for purposes of computing B's estate tax ($2,665,800) is the tax on the $6.8 million basic exclusion amount on B's date of death. Because the portion of the credit allowable in computing the gift tax payable on B's post-1976 gifts based solely on the basic exclusion amount ($1,031,519) is less than the credit based solely on the basic exclusion amount ($2,665,800) allowable on B's date of death, this paragraph (c) does not apply. The credit to be applied for purposes of computing B's estate tax is based on B's $18.2 million applicable exclusion amount, consisting of the $6.8 million basic exclusion amount on B's date of death plus the $11.4 million DSUE amount, subject to the limitation of section 2010(d).

Reg.§ 20.2010-1(c)(3) simply says "[Reserved]," as the preamble further below described in the anti-abuse rules.

Reg.§ 20.2010-1(e)(3), "Basic exclusion amount," provides:

Except to the extent provided in paragraph (e)(3)(iii) of this section, the basic exclusion amount is the sum of the amounts described in paragraphs (e)(3)(i) and (ii) of this section.

(i) For any decedent dying in calendar year 2011 or thereafter, $5,000,000; and

(ii) For any decedent dying after calendar year 2011 and before calendar year 2018, $5,000,000 multiplied by the cost-of-living adjustment determined under section 1(f)(3) for the calendar year of the decedent's death by substituting "calendar year 2010" for "calendar year 1992" in section 1(f)(3)(B) and by rounding to the nearest multiple of $10,000. For any decedent dying after calendar year 2017, $5,000,000 multiplied by the cost-of-living adjustment determined under section 1(f)(3) for the calendar year of the decedent's death by substituting "calendar year 2010" for "calendar year 2016" in section 1(f)(3)(A)(ii) and rounded to the nearest multiple of $10,000.

(iii) For any decedent dying after calendar year 2017, and before calendar year 2026, paragraphs (e)(3)(i) and (ii) of this section will be applied by substituting "$10,000,000" for "$5,000,000."

In its “Report No. 1410 – Report on the Proposed Section 2010 Regulations,” the Tax Section of the New York State Bar Association commented on the proposed regulations.[2253] The report recommended an anti-abuse rule in part III.F, “Preservation of Basic Exclusion Amount for Gifts Pulled Back into Estate,”

> The estate and gift tax system makes it possible for a completed gift to have occurred during lifetime even though the property transferred is pulled back into the transferor’s gross estate at death. For example, an individual may make a gift of a remainder interest in property while retaining a life estate.[29] Despite the completed gift of the remainder, under Section 2036(a)(1), the entire value of the property will be included in the individual’s gross estate at death as a result of the retained right to income and enjoyment of the property.[30]
>
> > [29] See Treas. Reg. 25.2511-1(e). If the gift of the remainder is made to a member of the transferor’s family within the meaning of Section 2704(c)(2), the retained value of the life estate will be ignored for gift tax valuation purposes. I.R.C. § 2702(a).
> >
> > [30] So that the property does not count twice against applicable exclusion amount (and is not double taxed), the lifetime gift of the remainder is purged from the estate tax computation base under the Section 2001(b) estate tax computation procedures and the exclusion amount used up by the gift is effectively restored.
>
> The Proposed Regulations, in allowing a higher basic exclusion amount to a decedent whose taxable gifts used up the temporarily increased exclusion amount available before 2026, do not distinguish between gifts that pass outside of the gross estate and those that do not. On the contrary, under the Proposed Regulations, the only condition that must be satisfied in order to lock in the temporarily increased exclusion amount is that gifts use up an amount of basic exclusion that is greater than the amount available at death. Whether those gifts are included in the gross estate at death is irrelevant, under the Proposed Regulations.
>
> This result may well have been intentional. Nevertheless, we wish to bring to the Treasury’s and the Service’s attention that it would permit individuals to make relatively painless taxable gifts that lock in the increased exclusion amount, even though they retain beneficial access to the transferred property. A gift of a remainder, subject to a retained life estate, is a good example. By making a gift of a remainder interest, an individual can use up the temporarily increased exclusion amount while retaining the income and enjoyment of the property. That Section 2036(a)(1) will cause the property to be included in the gross estate does not, under the Proposed Regulations, prevent the gift from locking in the increased exclusion amount.
>
> Moreover, special valuation rules under chapter 14 of the Code, originally enacted to curb valuation abuses, can be used to increase the amount of a taxable gift artificially, thereby making it easier to lock in the increased exclusion amount. Suppose, for example, that a father makes a gift to his daughter of a remainder interest in a $10 million residence, while retaining a life estate. Under Section 2702(a), the retained life estate is valued at zero and the value of the gift is equal to the entire $10 million value of

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[2253] See https://nysba.org/NYSBA/Sections/Tax/Tax%20Section%20Reports/Tax%20Section%20Reports%202019/1410%20Report.pdf.

the residence. Thus, the gift of the remainder, though in economic terms less valuable than the undivided residence, successfully uses up $10 million of exclusion available before 2026. The father thereafter may continue to use and enjoy the residence for his lifetime, yet still, under the Proposed Regulations, cause $10 million of wealth to be shielded by the increased exclusion amount under the Act.

We recommend that Treasury and the Service consider proposing rules that would create exceptions to the favorable rule of the Proposed Regulations in the case of gifts that are included in the gross estate. Under this approach, if a decedent made a gift of property before 2026 and the gift is included in the gross estate, any increased basic exclusion amount used up by the gift is not preserved at death. As the gift would be purged from the estate tax computation base under Section 2001(b), there is no concern about claw back of tax. Further, the property would be subject to the estate tax lien[31] and the decedent's executor would normally have a right to recover the share of estate taxes attributable to the property.[32]

[31] I.R.C. § 6324(a)(1).

[32] *See*, *e.g.*, New York's Estates, Powers, and Trusts Law 2-1.8(e); *see also* I.R.C. § 2207B.

That said, Treasury and the Service may not have sufficient tools to prevent all possible planning to lock in the increased exclusion amount artificially. Deathbed planning, for example, might successfully eliminate, just before death, any rights or powers that would otherwise trigger gross estate inclusion.[33] An artificial taxable gift also could be made by making a gift of common interests in a partnership or corporation, while retaining preferred interests that intentionally run afoul of the valuation rules of Section 2701 and thereby trigger a larger taxable gift. The common interests would not be pulled back into the gross estate, yet the donor still would have the right to earnings and income of the entity through the retention of preferred interests.[34]

[33] Section 2035(a) provides that if a decedent, within three years of death, relinquished certain rights or powers over transferred property that otherwise would have caused gross estate inclusion, then the property is pulled back into the gross estate. The requirement of affirmative relinquishment, however, could be avoided by giving a third party the power to eliminate the donor's gross estate inclusion strings just before death.

[34] Treas. Reg. § 25.2701-5 provides rules to mitigate double taxation if a transfer had previously run afoul of Section 2701's valuation rules, and the holder of the Section-2701-triggering retained interest makes a subsequent transfer of that interest. In general, under these rules, the initial transferor or his or her estate may, for gift or estate tax computation purposes, reduce the value of the prior Section 2701 transfer so that it is not counted twice in the tax base. If an individual makes a Section 2701 transfer before 2026, however, the effect of the mitigation rules would be to free up, as a shield against tax on future wealth transfers, an amount of exclusion equal to the amount of any temporarily increased exclusion used up by the Section 2701 transfer. In other words, any increased basic exclusion amount used up by a Section 2701 transfer would be effectively preserved after 2025. To prevent the mitigation rules from having this effect, Treasury and the Service could propose an amendment to Treas. Reg. § 25.2701-5(b). The amendment would provide that the amount of reduction in

the value of any prior Section 2701 transfer would not include the difference between the amount of basic exclusion amount used up by the initial Section 2701 transfer and the amount of basic exclusion amount available at the time of the subsequent transfer of the Section 2701 interest. That is, the amount of the temporarily increased exclusion used up by the initial Section 2701 transfer would be subtracted from the reduction amount.

Given the difficulties of the problem, if Treasury and the Service wish to limit the benefits of locking in temporarily increased exclusion amount, we recommend that the Treasury and Service study the problem further. Final regulations could reserve space for future regulations and seek comments on this issue.

The preamble to the final regulations, T.D. 9884 (11/26/2019), [2254] responded to this comment:

6. Anti-Abuse Rule

A commenter recommended consideration of an anti-abuse provision to prevent the application of the special rule to transfers made during the increased BEA period that are not true inter vivos transfers, but rather are treated as testamentary transfers for transfer tax purposes. Examples include transfers subject to a retained life estate or other retained powers or interests, and certain transfers within the purview of chapter 14 of subtitle B of the Code. The purpose of the special rule is to ensure that bona fide inter vivos transfers are not subject to inconsistent treatment for estate tax purposes. Arguably, the possibility of inconsistent treatment does not arise with regard to transfers that are treated as part of the gross estate for estate tax purposes, rather than as adjusted taxable gifts. An anti-abuse provision could except from the application of the special rule transfers where value is included in the donor's gross estate at death. Although the Treasury Department and the IRS agree that such a provision is within the scope of the regulatory authority granted in section 2001(g)(2), such an anti-abuse provision would benefit from prior notice and comment. Accordingly, this issue will be reserved to allow further consideration of this comment.

As to the preamble's reference to "certain transfers within the purview of chapter 14 of subtitle B of the Code," see part II.H.11.e Using Preferred Partnership that Intentionally Violates Code § 2701.

As to the preamble's reference to "transfers subject to a retained life estate or other retained powers or interests," see part III.B.2.c Grantor Retained Income Trust (GRIT), which includes:

- Strategic use of a GRIT using up the grantor's remaining exemptions and a possible exit strategy if the anti-abuse regulations are issued and apply.

- How to trigger a large taxable gift whether or not Code § 2702, including arguments over power of appointment.

Another way to trigger use of lifetime gift tax exemption while retaining an interest in the property is for the income beneficiary of a QTIP trust to renounce a small part of the income. That renunciation would trigger a Code § 2519 taxable gift and may trigger Code § 2036

[2254] https://www.federalregister.gov/documents/2019/11/26/2019-25601/estate-and-gift-taxes-difference-in-the-basic-exclusion-amount#footnote-1-p64997 or https://www.federalregister.gov/d/2019-25601.

inclusion. See part II.H.2.c QTIP Trusts - Code § 2519 Trap; see fn 2052 and the text following it re Code § 2036 inclusion. If a reverse QTIP election is made, the application of Code § 2519 would not change the trust's GST attributes.[2255] Reasons to trigger a Code § 2519 taxable gift may include locking in one's lifetime gift/estate tax exemption or avoiding loss of the deceased spouse's unused exemption (DSUE). As to the latter, if the surviving spouse remarries and the new spouse predeceases the surviving spouse, the surviving spouse loses the first spouse's DSUE and instead has the new spouse's DSUE; see part II.H.2.a Free Basis Step-Up When First Spouse Dies.[2256] To avoid this risk, a surviving spouse who remarries ought to consider using DSUE as soon as possible. Because DSUE is used before the surviving spouse's own lifetime gift/estate tax exemption,[2257] triggering use of DSUE may have little downside. Query whether the anti-abuse rule would also undermine this tactic.

For more detailed discussion of the possible anti-abuse rule that preceding the proposed regulations being issued, see Lynagh, "Potential Anti-Abuse Rules May Limit Use of the Temporarily Increased Gift Tax Exclusion," *Tax Management Estates, Gifts, and Trusts Journal*, 45 EGTJ 03 (5/7/2020).

ACTEC submitted comments on the proposed regulations.

II.H.12.b. Using Lifetime Gift Tax Exemption without Estate Inclusion

One spouse might give property to a trust for the other spouse and their family members. This would give one spouse access without implicating the anti-abuse rules. Such a trust is often called a spousal limited access trust (SLAT). For transactions involving SLATs, see part III.B.2.i.xv Sale to Trust Created by Spouse: An Alternative Way to Have a Trust Benefitting Client. A donor who wants to hedge against emergencies might grant an independent party a power to appoint part or all of the trust to a trust for the benefit of the donor the if law of the state in which the trust is created does not make such a trust subject to the donor's creditors;[2258] ideally:

- To try to minimize the effectiveness of any Code § 2036 issues, the independent party would not have fiduciary duties and would not even be aware of this power until long after the donor finished making taxable gifts.
- The independent party might not be appointed at all but rather might be appointed only when the donor becomes needy; see the comment below about a power to amend possibly having grantor trust implications.
- The new trust would be governed by the law of (and administered in) a state that respects spendthrift clauses when the settlor is a beneficiary.

2255 See text accompanying and following fn 6405 in part III.B.1.d.iii Who Is the Transferor.
2256 See fn 2009.
2257 Reg. § 25.2505-2(b), "Manner in which DSUE amount is applied," provides:

> If a donor who is a surviving spouse makes a taxable gift and a DSUE amount is included in determining the surviving spouse's applicable exclusion amount under section 2010(c)(2), such surviving spouse will be considered to apply such DSUE amount to the taxable gift before the surviving spouse's own basic exclusion amount.

2258 Subjecting the trust's assets to the donor's creditors may cause the gift to be wholly incomplete. See part III.B.2.i.xi My Suggestion for Distribution Trustee – A Variation of Letter Ruling 201039010.

Consider the impact of using all of one's lifetime gift/estate exemption and GST exemption. If the donor would like to create a new irrevocable trust with different terms, the donor would not be able to use these tax attributes. Furthermore, if the donor makes outright taxable gifts because family members need funds, the donor would be required to pay gift tax. Consider the following ideas:

- Use part of that remaining lifetime exemption to create an irrevocable trust that can provide funds for family members when the need arises. If the donor is married to the other parent of the donor's children, the nondonor spouse might have a power to amend the trust; otherwise, consider granting an independent person the right to amend the trust. When drafting a power to amend, consider whether that power might interfere with the donor's ability to turn off grantor trust status; see part III.B.2.h How to Make a Trust a Grantor Trust Taxed to a U.S. Citizen or Resident, especially part III.B.2.h.vii Distribution Provisions Might Prevent Turning Off Grantor Trust Status.

- After the exemption is used, if that trust for the family's needs has not been created then perhaps use GRATs to shift assets to a trust for nonskip persons that after the grantor's death can also use the tuition/medical GST exclusion for grandchildren and other descendants while at least one child is alive. When the last child dies, include in that child's estate, pay GST tax, or distribute the remainder to a family donor-advised fund or private foundation. If the donor is married, the nondonor spouse might have a power to amend the trust.

- If the client has a living parent on good terms, ask the parent to create a beneficiary deemed-owned trust with up to $5,000 funding. See parts III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts and III.B.2.i.ii Building Up Trust. Then ask the client's parent to provide an identical trust for any bequest that the parent wishes to leave the client. The bequeathed trust could then guarantee any loans the client makes to the smaller trust needs to buy assets from the client. See parts III.B.2.i.v Sale to a Beneficiary Deemed-Owned Trust – When a Traditional Sale to an Irrevocable Grantor Trust Does Not Meet the Client's Objectives and III.B.2.i.vi.(a) General Concept of Funding with Small Gifts.

- Have one spouse use all of the exemption and have the other leave exemption in reserve for future use.

Beware that getting assets outside of the estate tax system also prevents a basis step-up. See part II.H.5 Irrevocable Trust Planning and Basis Issues; to better explore basis step-up issues, I strongly recommend reading the subpart headings within part II.H Income Tax vs. Estate and Gift Tax (Particularly for Depreciable Property) of the FULL TABLE OF CONTENTS. A formula comparing the estate tax savings of growth to the income tax savings of basis step-up is in the text preceding fn 2155 in part II.H.5.a Irrevocable Trust Planning and Basis Issues - Generally; however, that formula does not consider estate tax savings of using the lifetime gift tax exemption before a permanent reduction.

Basis step-up issues may encourage one to use strategies that result in the gifted assets being included in the donor's estate merely as a guard against a decrease in estate tax exemption and not as a way to remove growth from the estate tax system, if the benefit of removing growth from the estate tax system does not exceed the value of the lost basis step-up. Strategies that allow one to get the best of both worlds are in parts III.B.2.c Grantor Retained Income Trust (GRIT) and II.H.5.d Using Grantor's Parent's Exemption for Basis Step-Up.

II.I. 3.8% Tax on Excess Net Investment Income (NII)

For the IRS' basic overview, see http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs.

II.I.1. Taxpayers and Years Affected

For taxable years beginning after December 31, 2012,[2259] net investment income ("NII") in excess of certain thresholds is subject to a 3.8% tax.[2260] The preamble to the final regulations explains:[2261]

> Section 1402(a)(1) of the HCERA added section 1411 to a new chapter 2A of subtitle A (Income Taxes) of the Code effective for taxable years beginning after December 31, 2012. Section 1411 imposes a 3.8 percent tax on certain individuals, estates, and trusts. See section 1411(a)(1) and (a)(2). The tax does not apply to a nonresident alien or to a trust all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B). See section 1411(e).

In calculating foreign tax credit, NII tax is ignored when calculating U.S. income tax allocable to foreign income. *Toulouse v. Commissioner*, 157 T.C. 49 (2021).

II.I.2. Regulatory Framework

The preamble to the final regulations described the regulatory framework:[2262]

> On December 5, 2012, the Treasury Department and the IRS published a notice of proposed rulemaking in the Federal Register (REG-130507-11; 77 FR 72612) relating to the Net Investment Income Tax. On January 31, 2013, corrections to the proposed regulations were published in the Federal Register (78 FR 6781). The Treasury Department and the IRS received numerous comments in response to the proposed regulations. All comments are available at www.regulations.gov[2263] or upon request. The Treasury Department and the IRS held a public hearing on the proposed regulations on April 2, 2013.
>
> In addition to these final regulations, the Treasury Department and the IRS are contemporaneously publishing a notice of proposed rulemaking in the Federal Register (REG-130843-13) relating to the Net Investment Income Tax.

The preamble to the final regulations explained taxpayer reliance on proposed and final regulations:[2264]

> These regulations are effective for taxable years beginning after December 31, 2013, except that § 1.1411-3(d) applies to taxable years beginning after December 31, 2012.

[2259] P.L. 111-152, section 1402(b)(3).
[2260] Code § 1411(a).
[2261] T.D. 9644.
[2262] T.D. 9644.
[2263] A more direct link is http://www.regulations.gov/#!docketBrowser;rpp=25;po=0;dct=PS;D=IRS-2012-0049.
[2264] T.D. 9644.

> Taxpayers are reminded that section 1411 is effective for taxable years beginning after December 31, 2012.
>
> Part 12 of the preamble to the proposed regulations stated that taxpayers may rely on the proposed regulations for purposes of compliance with section 1411 until the effective date of the final regulations. Furthermore, the preamble stated that any election made in reliance on the proposed regulations will be in effect for the year of the election, and will remain in effect for subsequent taxable years. In addition, taxpayers who opt not to make an election in reliance on the proposed regulations are not precluded from making that election pursuant to these final regulations.
>
> For taxable years beginning before January 1, 2014, taxpayers may rely on either the proposed regulations or these final regulations for purposes of compliance with section 1411. See § 1.1411-1(f). However, to the extent that taxpayers take a position in a taxable year beginning before January 1, 2014 that is inconsistent with these final regulations, and such position affects the treatment of one or more items in a taxable year beginning after December 31, 2013, then such taxpayer must make reasonable adjustments to ensure that their section 1411 tax liability in the taxable years beginning after December 31, 2013, is not inappropriately distorted. For example, reasonable adjustments may be required to ensure that no item of income or deduction is taken into account in computing net investment income more than once, and that carryforwards, basis adjustments, and other similar items are adjusted appropriately.

Effective/Applicability Date

> These final regulations apply to taxable years beginning after December 31, 2013, except that § 1.1411-3(d) applies to taxable years beginning after December 31, 2012.

The final regulations were issued with additional proposed regulations, the preamble to which explained the regulatory background:[2265]

> The Treasury Department and the IRS received comments on the 2012 Proposed Regulations requesting that they address the treatment of section 707(c) guaranteed payments for capital, section 736 payments to retiring or deceased partners for section 1411 purposes, and certain capital loss carryovers. After consideration of all comments received, the Treasury Department and the IRS believe that it is appropriate to address the treatment of these items in regulations. Because such guidance had not been proposed in the 2012 Proposed Regulations, it is being issued for notice and comment in these new proposed regulations.
>
> The Treasury Department and the IRS also received comments on the simplified method for applying section 1411 to income recipients of charitable remainder trusts (CRTs) that was proposed in the 2012 Proposed Regulations. The comments recommended that the section 1411 classification incorporate the existing category and class system under section 664. These proposed regulations provide special rules for the application of the section 664 system to CRTs that derive income from controlled foreign corporations (CFCs) or passive foreign investment companies (PFICs) with respect to which an election under § 1.1411-10(g) is not in place. Specifically, these proposed regulations coordinate the application of the rules applicable to shareholders of CFCs and PFICs in

[2265] REG-130843-13.

§ 1.1411-10 with the section 664 category and class system adopted in § 1.1411-3(d)(2) of the 2013 Final Regulations.

Furthermore, these proposed regulations allow CRTs to elect to apply the section 664 system adopted in the 2013 Final Regulations or the simplified method set forth in the 2012 Proposed Regulations. Some comments responding to the 2012 Proposed Regulations requested that we provide an election. The Treasury Department and the IRS request comments with regard to whether or not taxpayers believe this election is preferable to the section 664 system adopted in the 2013 Final Regulations. If it appears that there is no significant interest in having the election, the Treasury Department and the IRS may omit it from the regulations when finalized, and the simplified method contained in the 2012 Proposed Regulations would no longer be an option.

These proposed regulations also address the net investment income tax characterization of income and deductions attributable to common trust funds (CTFs), residual interests in real estate mortgage investment conduits (REMICs), and certain notional principal contracts.

The Treasury Department and the IRS also received comments on the 2012 Proposed Regulations questioning the proposed regulation's methodology for adjusting a transferor's gain or loss on the disposition of its partnership interest or S corporation stock. In view of these comments, the 2013 Final Regulations removed § 1.1411-7 of the 2012 Proposed Regulations and reserved § 1.1411-7 in the 2013 Final Regulations.

This notice of proposed rulemaking proposes revised rules regarding the calculation of net gain from the disposition of a partnership interest or S corporation stock (each a "Passthrough Entity") to which section 1411(c)(4) may apply.

The preamble to the 2013 proposed regulations explained effective dates:[2266]

These regulations are proposed to apply for taxable years beginning after December 31, 2013, except that § 1.1411-3(d)(3) is proposed to apply to taxable years beginning after December 31, 2012.

II.I.3. Tax Based on NII in Excess of Thresholds

The preamble describes how to calculate the tax:[2267]

In the case of an individual, section 1411(a)(1) imposes a tax (in addition to any other tax imposed by subtitle A) for each taxable year equal to 3.8 percent of the lesser of: (A) the individual's net investment income for such taxable year, or (B) the excess (if any) of: (i) the individual's modified adjusted gross income for such taxable year, over (ii) the threshold amount. Section 1411(b) provides that the threshold amount is: (1) in the case of a taxpayer making a joint return under section 6013 or a surviving spouse (as defined in section 2(a)), $250,000; (2) in the case of a married taxpayer (as defined in section 7703) filing a separate return, $125,000; and (3) in the case of any other individual, $200,000. Section 1411(d) defines modified adjusted gross income as adjusted gross income increased by the excess of: (1) the amount excluded from gross

[2266] REG-130843-13.
[2267] T.D. 9644.

income under section 911(a)(1), over (2) the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amount excluded from gross income under section 911(a)(1). Section 1.1411-2 of the final regulations provides guidance on the computation of the net investment income tax for individuals.

> In the case of an estate or trust, section 1411(a)(2) imposes a tax (in addition to any other tax imposed by subtitle A) for each taxable year equal to 3.8 percent of the lesser of: (A) the estate's or trust's undistributed net investment income, or (B) the excess (if any) of: (i) the estate's or trust's adjusted gross income (as defined in section 67(e)) for such taxable year, over (ii) the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year. Section 1.1411-3 of the final regulations provides guidance on the computation of the net investment income tax for estates and trusts.

Thus, the threshold amount is not indexed for inflation for individuals but is for trusts.[2268]

Short taxable years use the full threshold,[2269] without proration,[2270] unless the short year results from a change in the annual accounting period.[2271]

II.I.4. Calculating NII - General Overview Provided by Preambles

The preamble describes how to calculate net investment income:[2272]

> Section 1411(c)(1) provides that net investment income means the excess (if any) of: (A) the sum of (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income derived in the ordinary course of a trade or business to which the tax does not apply, (ii) other gross income derived from a trade or business to which the tax applies, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply; over (B) the deductions allowed by subtitle A that are properly allocable to such gross income or net gain. Sections 1.1411-4 and 1.1411-10 of the final regulations provide guidance on the calculation of net investment income under section 1411(c)(1).

> Section 1411(c)(1)(A) defines net investment income, in part, by reference to trades or businesses described in section 1411(c)(2). A trade or business is described in section 1411(c)(2) if such trade or business is: (A) a passive activity (within the meaning of section 469) with respect to the taxpayer, or (B) a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2)).

> Section 1.1411-5 of the final regulations provides guidance on the trades or businesses described in section 1411(c)(2).

[2268] Compare Code §§ 1411(a)(1)(B)(ii) and 1411(b) (fixed dollar amounts for individuals) with Code § 1411(a)(2)(B)(ii) (referring to the annually indexed top bracket for trusts and estates).
[2269] Reg. § 1.1411-1(d)(1) sets forth the thresholds.
[2270] Reg. § 1.1411-1(d)(2).
[2271] Reg. § 1.1411-1(d)(3).
[2272] T.D. 9644.

> Section 1411(c)(3) provides that income on the investment of working capital is not treated as derived from a trade or business for purposes of section 1411(c)(1) and is subject to tax under section 1411. Section 1.1411-6 of the final regulations provides guidance on working capital under section 1411(c)(3).
>
> In the case of the disposition of an interest in a partnership or an S corporation, section 1411(c)(4) provides that gain or loss from such disposition is taken into account for purposes of section 1411(c)(1)(A)(iii) only to the extent of the net gain or net loss that would be so taken into account by the transferor if all property of the partnership or S corporation were sold at fair market value immediately before the disposition of such interest. Section 1.1411-7 of the final regulations is reserved for guidance under section 1411(c)(4). However, regulations are being proposed contemporaneously with these final regulations that address the application of section 1411(c)(4) to dispositions of interests in partnerships or S corporations.
>
> Section 1411(c)(5) provides that net investment income does not include distributions from a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A, or 457(b). Section 1.1411-8 of the final regulations provides guidance on distributions from qualified plans under section 1411(c)(5).
>
> Section 1411(c)(6) provides that net investment income also does not include any item taken into account in determining self-employment income for a taxable year on which a tax is imposed by section 1401(b). Section 1.1411-9 of the final regulations provides guidance regarding self-employment income under section 1411(c)(6).

Regarding properly allocable deductions in excess of investment income, the preamble to the final regulations provides:[2273]

> Proposed § 1.1411-4(f)(1)(ii) provided that any deductions described in § 1.1411- 4(f) in excess of gross income and net gain are not taken into account in determining net investment income in any other taxable year, except as allowed under chapter 1. Many commentators recommended that the final regulations provide that negative net investment income (when section 1411(c)(1)(B) deductions exceed section 1411(c)(1)(A) income) be carried over and become a section 1411(c)(1)(B) deduction in the subsequent year.
>
> The final regulations do not adopt this recommendation. Section 1411(c)(1)(B) provides that, in order for a deduction to be allowed, it must be: (1) allowed by subtitle A, and (2) be properly allocable to section 1411(c)(1)(A) income. Section 1411(c)(1)(B) only allows deductions allowed by other Code sections; it does not establish a basis for a deduction that does not exist elsewhere in the Code. However, as discussed in the following part of this preamble, the final regulations do permit deductions of net operating losses otherwise allowed by subtitle A that are properly allocable to section 1411(c)(1)(A) income.

[2273] T.D. 9644.

Regarding net operating losses (NOLs), the preamble to the final regulations provides:[2274]

> Proposed § 1.1411-4(f)(1)(ii) provided that, in no event, will a net operating loss (NOL) deduction allowed under section 172 be taken into account in determining net investment income for any taxable year. The proposed regulations requested comments on whether a deduction should be allowed for an NOL in determining net investment income. Several commentators argued that, for purposes of section 1411(c)(1)(B), at least some portion of an NOL deduction should be a deduction properly allocable to gross income included in net investment income and therefore allowed in determining net investment income. Three commentators recommended that taxpayers be allowed to keep track of the portions of an NOL attributable to investment income for the loss year. One commentator recommended that the IRS adopt a simple rule for determining a portion of an NOL that is attributable to a "net investment loss" for a loss year (for example, using a ratio of the portion of the loss attributable to "net investment loss" to the NOL) and allow taxpayers to take a prorated portion of the NOL deduction into account in determining net investment income for a taxable year to which the NOL is carried.
>
> The final regulations adopt a modified version of the commentator's approach in § 1.1411-4(f)(2)(iv) and (h). Because NOLs are computed and carried over year-by year, a separate ratio must be determined for each year. Thus, the final regulations provide that taxpayers may deduct a portion of an NOL deduction in determining their net investment income. The portion of an NOL deduction for a taxable year that may be deducted for section 1411 purposes is calculated by first determining the applicable portion of the NOL for each loss year. The applicable portion of the NOL is the lesser of: (1) the amount of the NOL for the loss year that the taxpayer would have incurred if only items of gross income that are used to determine net investment income and only properly allocable deductions were taken into account in determining the NOL in accordance with section 172(c) and (d), or (2) the amount of the taxpayer's NOL for the loss year. Next, the amount of the NOL carried from each loss year and deducted in the taxable year is multiplied by a fraction. The numerator of this fraction is the applicable portion of the NOL for the loss year as determined above. The denominator of the fraction is the total NOL for the loss year. A separate fraction is determined for each loss year. The result of this multiplication is the amount of the NOL deduction from the loss year that is allowed as a section 1411(c)(1)(B) deduction in the taxable year, referred to as the section 1411 NOL amount. The sum of the section 1411 NOL amounts for each NOL carried to and deducted in the taxable year, referred to as the total section 1411 NOL amount, is the amount of the NOL deduction for the taxable year that is properly allocable to net investment income.

Reg. § 1.1411-4(h) describes Code § 1411 NOLs.

See also part II.J.14 Application of 3.8% NII Tax to ESBTs.

[2274] T.D. 9644.

II.I.5. What is Net Investment Income Generally

Except as otherwise provided, all provisions that apply for Chapter 1 of the Code purposes in determining taxable income[2275] also apply in determining net investment income ("NII").[2276]

[2275] As defined in Code § 63(a)

[2276] Reg. § 1.1411-1(a). However, Code § 1411 treatment does not affect treatment under any provision of the Code other than Code § 1411. Reg. § 1.1411-1(c). Also, credits generally allowable against income tax or other taxes are not creditable against the tax on NII. Reg. § 1.1411-1(e).
To add some levity to your day, note that approximately 30 years ago NII was suggested to be a very bad word. If you don't believe me, see https://www.youtube.com/watch?v=zIV4poUZAQo (short version) or https://www.youtube.com/watch?v=QTQfGd3G6dg (long version) from *Monty Python and the Holy Grail*.

NII[2277] is the excess (if any) of:[2278]

1. The sum of:

   a. Gross income from interest,[2279] dividends,[2280] annuities,[2281] royalties,[2282] and rents,[2283] except to the extent excluded by the ordinary course of a trade or business exception;[2284]

[2277] Reg. § 1.1411-1(d)(8) provides:
The term net investment income (NII) means net investment income as defined in section 1411(c) and § 1.1411-4, as adjusted pursuant to the rules described in § 1.1411-10(c).

[2278] Reg. § 1.1411-4(a).

[2279] Reg. § 1.1411-1(d)(6) provides:
The term gross income from interest includes any item treated as interest income for purposes of chapter 1 and substitute interest that represents payments made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction.

[2280] Reg. § 1.1411-1(d)(3) provides:
The term gross income from dividends includes any item treated as a dividend for purposes of chapter 1. See also § 1.1411-10 for additional amounts that constitute gross income from dividends. The term gross income from dividends includes, but is not limited to, amounts treated as dividends--
(i) Pursuant to subchapter C that are included in gross income (including constructive dividends);
(ii) Pursuant to section 1248(a), other than as provided in § 1.1411-10;
(iii) Pursuant to § 1.367(b)-2(e)(2);
(iv) Pursuant to section 1368(c)(2); and
(v) Substitute dividends that represent payments made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction.

CCA 202118009 correctly asserted:
1) Dividend income received by an individual shareholder from a C corporation in which the shareholder is an employee is subject to tax under § 1411.
2) This conclusion is the same even if the C corporation is a closely-held corporation within the meaning of § 469(h)(1) as described in § 465(a)(1)(B).

[2281] Reg. § 1.1411-1(d)(1) provides:
The term gross income from annuities under section 1411(c)(1)(A) includes the amount received as an annuity under an annuity, endowment, or life insurance contract that is includible in gross income as a result of the application of section 72(a) and section 72(b), and an amount not received as an annuity under an annuity contract that is includible in gross income under section 72(e). In the case of a sale of an annuity, to the extent the sales price of the annuity does not exceed its surrender value, the gain recognized would be treated as gross income from an annuity within the meaning of section 1411(c)(1)(A)(i) and § 1.1411-4(a)(1)(i). However, if the sales price of the annuity exceeds its surrender value, the seller would treat the gain equal to the difference between the basis in the annuity and the surrender value as gross income from an annuity described in section 1411(c)(1)(A)(i) and § 1.1411-4(a)(1)(i) and the excess of the sales price over the surrender value as gain from the disposition of property included in section 1411(c)(1)(A)(iii) and § 1.1411-4(a)(1)(iii). The term gross income from annuities does not include amounts paid in consideration for services rendered. For example, distributions from a foreign retirement plan that are paid in the form of an annuity and include investment income that was earned by the retirement plan does not constitute income from an annuity within the meaning of section 1411(c)(1)(A)(i).

b. Other gross income derived from a passive trade or business;[2285] and

c. Net gain from the disposition of property,[2286] except to the extent attributable to property held in an active trade or business[2287] or otherwise provided,[2288]

over

2. Deductions allowable for income tax purposes that are properly allocable to such gross income or net gain.[2289]

The corollary to self-employment income being excluded from NII is that items excluded from SE income might constitute NII.[2290] Note also that wages are not among the type of income constituting NII.

[2282] Reg. § 1.1411-1(d)(11) provides:

> The term gross income from royalties includes amounts received from mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, tradebrands, franchises, and other like property.

[2283] Reg. § 1.1411-1(d)(10) provides:

> The term gross income from rents includes amounts paid or to be paid principally for the use of (or the right to use) tangible property.

[2284] See generally part II.I.8 Application of 3.8% Tax to Business Income.

[2285] See generally part II.I.8 Application of 3.8% Tax to Business Income.

[2286] Reg. § 1.1411-4(d)(1) provides:

> Definition of disposition. For purposes of section 1411 and the regulations thereunder, the term disposition means a sale, exchange, transfer, conversion, cash settlement, cancellation, termination, lapse, expiration, or other disposition (including a deemed disposition, for example, under section 877A).

Reg. § 1.1411-4(d)(2) provides:

> Limitation. The calculation of net gain may not be less than zero. Losses allowable under section 1211(b) are permitted to offset gain from the disposition of assets other than capital assets that are subject to section 1411.

Reg. § 1.1411-4(d)(3)(i) provides:

> General rule. Net gain attributable to the disposition of property is the gain described in section 61(a)(3) recognized from the disposition of property reduced, but not below zero, by losses deductible under section 165, including losses attributable to casualty, theft, and abandonment or other worthlessness. The rules in subchapter O of chapter 1 and the regulations thereunder apply. See, for example, § 1.61-6(b). For purposes of this paragraph, net gain includes, but is not limited to, gain or loss attributable to the disposition of property from the investment of working capital (as defined in § 1.1411-6); gain or loss attributable to the disposition of a life insurance contract; and gain attributable to the disposition of an annuity contract to the extent the sales price of the annuity exceeds the annuity's surrender value.

[2287] See generally part II.I.8.b 3.8% Tax Does Not Apply to Gain on Sale of Active Business Assets and also part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.

[2288] Reg. § 1.1411-4(d)(4)(ii) provides:

> Other gains and losses excluded from net investment income. Net gain, as determined under paragraph (d) of this section, does not include gains and losses excluded from net investment income by any other provision in §§ 1.1411-1 through 1.1411-10. For example, see § 1.1411-7 (certain gain or loss attributable to the disposition of certain interests in partnerships and S corporations) and § 1.1411-8(b)(4)(ii) (net unrealized appreciation attributable to employer securities realized on a disposition of those employer securities).

[2289] Reg. § 1.1411-4(f). See part II.I.6 Deductions Against NII.

[2290] Reg. § 1.1411-9(a) provides:

II.I.6. Deductions Against NII

The following deductions in determining regular adjusted gross income also apply to NII:

- Deductions allocable to gross income from rents and royalties included in NII.[2291]
- Deductions allocable to gross income from trades or businesses included in NII, to the extent the deductions have not been taken into account in determining self-employment income.[2292]
- Penalty on early withdrawal of savings.[2293]
- Net operating loss arising from NII items.[2294]

The following itemized deductions also apply to NII:

- Investment interest expense.[2295]

General rule. Except as provided in paragraph (b) of this section [income derived from a trade or business of trading in financial instruments or commodities], net investment income does not include any item taken into account in determining self-employment income that is subject to tax under section 1401(b) for such taxable year. For purposes of section 1411(c)(6) and this section, taken into account means income included and deductions allowed in determining net earnings from self-employment. However, amounts excepted in determining net earnings from self-employment under section 1402(a)(1)-(17), and thus excluded from self-employment income under section 1402(b), are not taken into account in determining self-employment income and thus may be included in net investment income if such amounts are described in § 1.1411-4. Except as provided in paragraph (b) of this section, if net earnings from self-employment consist of income or loss from more than one trade or business, all items taken into account in determining the net earnings from self-employment with respect to these trades or businesses (see § 1.1402(a)-2(c)) are considered taken into account in determining the amount of self-employment income that is subject to tax under section 1401(b) and therefore not included in net investment income.

[2291] Reg. § 1.1411-4(f)(2)(i).
[2292] Reg. § 1.1411-4(f)(2)(ii).
[2293] Reg. § 1.1411-4(f)(2)(iii).
[2294] Reg. § 1.1411-4(f)(2)(iv), cross-referencing Reg. § 1.1411-4(h).
[2295] Reg. § 1.1411-4(f)(3)(i) , cross-referencing Code § 163(d)(3), which provides:

Investment interest. For purposes of this subsection—

(A) *In general*. The term "investment interest" means any interest allowable as a deduction under this chapter (determined without regard to paragraph (1)) which is paid or accrued on indebtedness properly allocable to property held for investment.

(B) *Exceptions*. The term "investment interest" shall not include—

(i) any qualified residence interest (as defined in subsection (h)(3)), or

(ii) any interest which is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer.

(C) *Personal property used in short sale*. For purposes of this paragraph, the term "interest" includes any amount allowable as a deduction in connection with personal property used in a short sale.

Reg. § 1.163-8T provides interest tracing rules, which provide taxpayer with significant latitude to trace loan proceeds as they wish. Notice 88-74 provides guidance on various issues relating to the home mortgage interest deduction under Code § 163(h)(3).

- Investment expenses.[2296]

- State, local, and foreign income, war profits, and excess profit taxes that are allocable to net investment income.[2297]

- Deduction for unrecovered investment in an annuity in the decedent's final income tax return if the annuity was NII.[2298]

- Deductions for estate GST tax allocable to income in respect of a decedent that is NII.[2299]

- Deductions in connection with the determination, collection, or refund of any tax arising from NII.[2300]

- Amortizable bond premium on a taxable bond.[2301]

- Fiduciary expenses.[2302]

Other deductions include:

- Loss deductions.[2303]

[2296] Reg. § 1.1411-4(f)(3)(ii), cross-referencing Code § 163(d)(4)(C).
[2297] Reg. § 1.1411-4(f)(3)(iii), cross-referencing Code § 164(a)(3). For the effect of refunds of those taxes, see Reg. § 1.1411-4(g)(2).
[2298] Reg. § 1.1411-4(f)(3)(iv).
[2299] Reg. § 1.1411-4(f)(3)(v).
[2300] Reg. § 1.1411-4(f)(3)(vi) provides:

> Amounts described in section 212(3) and § 1.212-1(*l*) to the extent they are allocable to net investment income pursuant to paragraph (g)(1) of this section.

Reg. § 1.212-1(*l*) provides:

> Expenses paid or incurred by an individual in connection with the determination, collection, or refund of any tax, whether the taxing authority be Federal, State, or municipal, and whether the tax be income, estate, gift, property, or any other tax, are deductible. Thus, expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns or in connection with any proceedings involved in determining the extent of his tax liability or in contesting his tax liability are deductible.

[2301] Reg. § 1.1411-4(f)(3)(vii).
[2302] Reg. § 1.1411-4(f)(3)(viii) provides:

> In the case of an estate or trust, amounts described in § 1.212-1(i) to the extent they are allocable to net investment income pursuant to paragraph (g)(1) of this section.

Reg. § 1.212-1(i) provides:

> Reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration are deductible under section 212, notwithstanding that the estate or trust is not engaged in a trade or business, except to the extent that such expenses are allocable to the production or collection of tax-exempt income. But see section 642(g) and the regulations thereunder for disallowance of such deductions to an estate where such items are allowed as a deduction under section 2053 or 2054 in computing the net estate subject to the estate tax.

Such fees include the trust's reimbursement of legal fees paid by the beneficiaries to change the trustee and improve the investment of the trust's assets. Letter Rulings 201642027, 201642028.
[2303] Reg. § 1.1411-4(f)(4)(i) provides:

- Ordinary loss deductions for certain debt instruments.[2304]

- Other deductions not yet announced.[2305]

Generally, deductions limited for regular income tax purposes are also limited for NII purposes.[2306]

If a properly allocable deduction is allocable to both NII and taxable items of income that are not NII, the portion of the deduction that is properly allocable to net investment income may be determined by taxpayers using any reasonable method.[2307] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items. When using expenses to offset taxable items of income, consider which items of income constitute NII,[2308] as well as the overall federal and state income tax rates that apply to those items.

If a taxpayer is refunded, reimbursed, or otherwise recovers any portion of an amount deducted as a deduction against NII in a prior year, and such amount is not otherwise included in NII in the year of recovery, the amount of the recovery will reduce the taxpayer's total deductions against NII in the year of recovery (but not below zero).[2309]

General rule. Losses described in section 165, whether described in section 62 or section 63(d), are allowed as properly allocable deductions to the extent such losses exceed the amount of gain described in section 61(a)(3) and are not taken into account in computing net gain by reason of paragraph (d) of this section.

[2304] Reg. § 1.1411-4(f)(5) provides:

An amount treated as an ordinary loss by a holder of a contingent payment debt instrument under § 1.1275-4(b) or an inflation-indexed debt instrument under § 1.1275-7(f)(1).

[2305] Reg. § 1.1411-4(f)(6) provides:

Any other deduction allowed by subtitle A that is identified in published guidance in the Federal Register or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter) as properly allocable to gross income or net gain under this section.

[2306] Reg. § 1.1411-4(f)(7) provides:

Application of limitations under sections 67 and 68. Any deductions described in this paragraph (f) that are subject to section 67 (the 2-percent floor on miscellaneous itemized deductions) or section 68 (the overall limitation on itemized deductions) are allowed in determining net investment income only to the extent the items are deductible for chapter 1 purposes after the application of sections 67 and 68. For this purpose, section 67 applies before section 68. The amount of deductions subject to sections 67 and 68 that may be deducted in determining net investment income after the application of sections 67 and 68 is determined as described in paragraph (f)(7)(i) and (f)(7)(ii) of this section.

[2307] Reg. § 1.1411-4(g)(1) provides:

Deductions allocable to both net investment income and excluded income. In the case of a properly allocable deduction described in section 1411(c)(1)(B) and paragraph (f) of this section that is allocable to both net investment income and excluded income, the portion of the deduction that is properly allocable to net investment income may be determined by taxpayers using any reasonable method. Examples of reasonable methods of allocation include, but are not limited to, an allocation of the deduction based on the ratio of the amount of a taxpayer's gross income (including net gain) described in § 1.1411-4(a)(1) to the amount of the taxpayer's adjusted gross income (as defined under section 62 (or section 67(e) in the case of an estate or trust)). In the case of an estate or trust, an allocation of a deduction pursuant to rules described in § 1.652(b)-3(b) (and § 1.641(c)-1(h) in the case of an ESBT) is also a reasonable method.

[2308] See part II.I.5 What is Net Investment Income Generally.

[2309] Reg. § 1.1411-4(g)(2) provides additional details how this works.

Deductions in respect of a decedent also count against NII if they are described in any of the preceding paragraphs.[2310]

Deductions on termination of a trust or estate generally receive NII treatment consistent with their character.[2311]

Special rules apply to losses allowed in computing taxable income by reason of the rules governing former passive activities[2312] or losses allowed when a passive activity is disposed of.[2313]

[2310] Reg. § 1.1411-4(g)(3) provides:

> *Deductions described in section 691(b)*. For purposes of paragraph (f) of this section, properly allocable deductions include items of deduction described in section 691(b), provided that the item otherwise would have been deductible to the decedent under § 1.1411-4(f). For example, an estate may deduct the decedent's unpaid investment interest expense in computing its net investment income because section 691(b) specifically allows the deduction under section 163, and § 1.1411-4(f)(3)(i) allows those deductions as well. However, an estate or trust may not deduct a payment of real estate taxes on the decedent's principal residence that were unpaid at death in computing its net investment income because, although real estate taxes are deductible under section 164 and specifically are allowed by section 691(b), the real estate taxes would not have been a properly allocable deduction of the decedent under § 1.1411-4(f).

[2311] Reg. § 1.1411-4(g)(4), referring to Code § 642(h) items. See part II.J.3.i Planning for Excess Losses.

[2312] Reg. § 1.1411-4(g)(8), referring to losses under Code § 469(f)(1).

[2313] Reg. § 1.1411-4(g)(9), referring to losses under Code § 469(g)(1). Code § 469(g), the rule governing the disposition of a passive activity, is described in part II.K.1.j Complete Disposition of Passive Activity

II.I.7. Interaction of NII Tax with Fiduciary Income Tax Principles

Generally,[2314] a trust or estate is taxed on the lesser of its undistributed net investment income (UNII) or the excess (if any) of its adjusted gross income[2315] over the taxable income threshold[2316] for its highest marginal income tax bracket.[2317]

Regarding grantor trusts, the tax is imposed on the deemed owner rather than the trust:[2318]

- Thus, the beneficiary of a qualified subchapter S trust (QSST)[2319] would include the S corporation's income in the beneficiary's income and determine the applicability of the tax based on the beneficiary's tax attributes and participation in the S corporation's activity. Consider switching from an ESBT to one or more QSSTs in light of not only issues relating to the 3.8% tax but also increases in the top income tax bracket (to which all ESBT S corporation income is subject) relative to the beneficiaries' income tax rates.[2320] For more about ESBTs and QSSTs, see parts II.J.14 Application of 3.8% NII Tax to ESBTs and II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets.

- See generally part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts regarding other trusts that are deemed owned by beneficiaries rather than grantors, including

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2314 Reg. § 1.1411-3(a)(1)(i). Reg. § 1.1411-3(b)(1) exempts the following trusts from the tax:
(i) A trust or decedent's estate all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B).
(ii) A trust exempt from tax under section 501.
(iii) A charitable remainder trust described in section 664. However, see paragraph (d) of this section for special rules regarding the treatment of annuity or unitrust distributions from such a trust to persons subject to tax under section 1411.
(iv) Any other trust, fund, or account that is statutorily exempt from taxes imposed in subtitle A. For example, see sections 220(e)(1), 223(e)(1), 529(a), and 530(a).
(v) A trust, or a portion thereof, that is treated as a grantor trust under subpart E of part I of subchapter J of chapter 1. However, in the case of any such trust or portion thereof, each item of income or deduction that is included in computing taxable income of a grantor or another person under section 671 is treated as if it had been received by, or paid directly to, the grantor or other person for purposes of calculating such person's net investment income.
(vi) Electing Alaska Native Settlement Trusts subject to taxation under section 646.
(vii) Cemetery Perpetual Care Funds to which section 642(i) applies.
(viii) Foreign trusts (as defined in section 7701(a)(31)(B) and § 301.7701-7(a)(2)) (but see §§ 1.1411-3(e)(3)(ii) and 1.1411-4(e)(1)(ii) for rules related to distributions from foreign trusts to United States beneficiaries).
(ix) Foreign estates (as defined in section 7701(a)(31)(A)) (but see § 1.1411-3(e)(3)(ii) for rules related to distributions from foreign estates to United States beneficiaries).

A charitable remainder trust's beneficiaries are taxed when the CRT distributes to them NII the CRT received for all taxable years that begin after December 31, 2012. Reg. § 1.1411-3(d)(iii). Although in the past a CRT that had a huge capital gain tier would have been neutral to whether to harvest losses (because accumulated capital gain would exceed distributions whether or not the losses were taken), now one should consider the 3.8% tier as well. Thus, consider recognizing losses to offset post-12/31/2012 gains.

2315 As defined in Code § 67(e) and as adjusted under Reg. § 1.1411-10(e)(2), if applicable.

2316 Code § 1(e).

2317 Reg. § 1.1411-3(a)(1)(ii).

2318 Reg. § 1.1411-3(b)(1)(v).

2319 See part III.A.3.e.i QSSTs.

2320 See part III.A.3.e QSSTs and ESBTs, especially part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSST.

part III.B.2.i.vii Portion Owned When a Gift (discussing how to compute the portion deemed owned by the beneficiary during and after the lapse of a withdrawal right). A minor beneficiary of a trust is treated as the owner of any portion of the trust with respect to which the minor has a power to vest the corpus or income in the minor, notwithstanding that no guardian has been appointed for the minor.[2321]

- See part III.B.2.h How to Make a Trust a Grantor Trust, regarding how to make the settlor the deemed owner.

[2321] Rev. Rul. 81-6.

UNII[2322] is the estate's or trust's NII reduced by distributions of net investment income to beneficiaries[2323] and by charitable deductions[2324] (but note that the charitable deduction does not reduce DNI allocated to mandatory income beneficiaries).[2325]

To the extent that the rules governing the allocation of deductions for regular income tax purposes conflict with their NII counterparts, the regular income tax rules control.[2326] See

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[2322] Reg. § 1.1411-3(e)(2). Generally, an estate's or trust's net investment income is calculated in the same manner as that of an individual. Reg. § 1.1411-3(e)(1). Reg. § 1.1411-3(e)(5) provides examples.

[2323] Reg. § 1.1411-3(e)(3) provides:

(i) In computing the estate's or trust's undistributed net investment income, net investment income is reduced by distributions of net investment income made to beneficiaries. The deduction allowed under this paragraph (e)(3) is limited to the lesser of the amount deductible to the estate or trust under section 651 or section 661, as applicable, or the net investment income of the estate or trust. In the case of a deduction under section 651 or section 661 that consists of both net investment income and excluded income (as defined in § 1.1411-1(d)(4)), the distribution must be allocated between net investment income and excluded income in a manner similar to § 1.661(b)-1 as if net investment income constituted gross income and excluded income constituted amounts not includible in gross income. See § 1.661(c)-1 and Example 1 in paragraph (e)(5) of this section.

(ii) If one or more items of net investment income comprise all or part of a distribution for which a deduction is allowed under paragraph (e)(3)(i) of this section, such items retain their character as net investment income under section 652(b) or section 662(b), as applicable, for purposes of computing net investment income of the recipient of the distribution who is subject to tax under section 1411. The provisions of this paragraph (e)(3)(ii) also apply to distributions to United States beneficiaries of current year income described in section 652 or section 662, as applicable, from foreign estates and foreign nongrantor trusts.

[2324] Reg. § 1.1411-3(e)(4) provides:

> Deduction for amounts paid or permanently set aside for a charitable purpose. In computing the estate's or trust's undistributed net investment income, the estate or trust is allowed a deduction for amounts of net investment income that are allocated to amounts allowable under section 642(c). In the case of an estate or trust that has items of income consisting of both net investment income and excluded income, the allowable deduction under this paragraph (e)(4) must be allocated between net investment income and excluded income in accordance with § 1.642(c)-2(b) as if net investment income constituted gross income and excluded income constituted amounts not includible in gross income. For an estate or trust with deductions under both sections 642(c) and 661, see § 1.662(b)-2 and Example 2 in paragraph (e)(5) of this section.

If the trust does not sufficiently authorize distributions to charity, consider forming a partnership (which also might have benefits under part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries) that makes gifts deductible to the charity under Rev. Rul. 2004-5, which is discussed in fn. 4914, which is found in part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction. Query whether the trustee would be violating fiduciary duties in allowing the partnership to make donations to charity and whether a beneficiary who fails to object is deemed to be the donor for income tax purposes. A safer approach in planning mode would be granting the noncharitable beneficiaries an inter vivos power to appoint gross income to charity; if the trust is already in place, consider decanting to grant the beneficiary such an inter vivos power (see part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting). Letter Ruling 200906008. However, under 2017 tax reform, which was adopted after the NII regulations were finalized, Code § 642(c) does not apply to an ESBT; see fn 6055 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview and also note that fn 6054 allows an ESBT to deduct charitable contributions against its S corporation income only to the extent they are on the K-1 from the S corporation.

[2325] See fns. 2567 and 2568 in part II.J.4.c Charitable Distributions.

[2326] Reg. §§ 1.1411-1(c) (NII rules do not affect regular income rules), 1.1411-3(e)(3) (if any NII comprises all or part of a distribution for which an NII distribution deduction is allowed, such items retain their parts II.I.6 Deductions Against NII (especially the text accompanying fns. 2307-2308) and II.J.8.f.i.(a) Allocating Deductions to Various Income Items.

The beneficiary's NII includes the beneficiary's share of distributable net income (DNI) distributed to the beneficiary, as described in the rules governing inclusion in the beneficiary's income under the regular income tax rules, to the extent that the character of such income constitutes NII.[2327] The trustee may also declare a distribution and give the beneficiary the right to withdraw the declared distribution – a process known as crediting that is described, along with a planning opportunity, at part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary.

Trustee fees are not NII to the recipient and do not constitute self-employment income unless the trustee is engaging in a trade or business.[2328] Paying reasonable trustee fees[2329] to a

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character as NII for purposes of computing the recipient's NII). Reg. § 1.652(b)-3(b), reproduced in fn. 2818, controls the allocation of deductions to items comprising DNI for regular income tax purposes.

[2327] Reg. § 1.1411-4(e)(1)(i) provides:

> Net investment income includes a beneficiary's share of distributable net income, as described in sections 652(a) and 662(a), to the extent that, under sections 652(b) and 662(b), the character of such income constitutes gross income from items described in paragraphs (a)(1)(i) and (ii) of this section or net gain attributable to items described in paragraph (a)(1)(iii) of this section, with further computations consistent with the principles of this section, as provided in § 1.1411-3(e).

For how the rules of Code §§ 652 and 662 work, see the discussion in part II.J.8.f.i General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income (and General Retention of the Character of DNI Distributed to Beneficiaries).

[2328] Rev. Rul. 58-5 held:

> In order for an individual to have net earnings from self-employment, he must carry on a trade or business, either as an individual or as a member of a partnership. Whether or not a person is engaged in a trade or business is dependent upon all of the facts and circumstances in the particular case. However, the following will serve as guides in determining this question in the case of fiduciaries of decedents' estates:
>
> (1) Professional fiduciaries will always be treated as being engaged in the trade or business of being fiduciaries, regardless of the assets contained in the estate.
>
> (2) Generally, nonprofessional fiduciaries (that is, for example, persons who serve as executor or administrator in isolated instances, and then as personal representative for the estate of a deceased friend or relative) will not be treated as receiving income from a trade or business unless all of the following conditions are met:
>
> (a) There is a trade or business among the assets of the estate,
>
> (b) The executor actively participates in the operation of this trade or business,
>
> (c) The fees of the executor are related to the operation of the trade or business.

After citing some examples, including imposing self-employment tax on a trustee who manages a trade or business (see fn. 3334, found in part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues), the ruling concluded with a caveat:

> In some cases the activities of the executor of a single estate may constitute the conduct of a trade or business even though the assets of the estate do not include a trade or business as such. If, for example, an executor manages an estate which requires extensive management activities on his part over a long period of time, an examination of the facts may show that such activities are sufficient in scope and duration to constitute the carrying on of a trade or business. If doubt exists concerning the status of a fiduciary believed to be in this category, the complete facts should be transmitted to the National Office for consideration. See Rev. Rul. 54-172, C.B. 1954-1, 394.

[2329] For authority on constructive receipt of trustee fees, see Rev. Ruls. 56-472 (waiver by executor did not constitute gift or assignment of income), 64-225 (waiver after serving for many years not respected trustee who is a beneficiary would reduce NII while maintaining the same aggregate taxable income between the trust and beneficiary, subject to the following caveats:

- If the trust has tax-exempt income, some of the trustee fees will be disallowed as a deduction.[2330]

- If and to the extent that trustee fees reduce qualified dividend income or other income taxed at lower rates, the tax rate on the trustee might exceed the tax benefit of the deduction.

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when, under the circumstances, the services performed by the trustees were not intended to be rendered gratuitously), and 66-167 (waiver made six months after beginning to serve given retroactive effect); see *Breidert v. Commissioner*, 50 T.C. 844 (1968), which held:

> Not only did petitioner waive his right to executor's fees, he did not even have sufficient cash on hand in the estate after paying the claims of creditors and the expenses of administration to pay himself such fees had he desired them. In fact, the cash on hand was insufficient to cover the fees of the attorney and the accountants who rendered substantial services to the estate. There was never any point at which executor's fees in the amount of $9,100.20, or any other sum, were credited to petitioner's account, set apart for him, or otherwise made available to him either by the estate or by the legatees and devisees of the estate. See sec. 1.451-2, Income Tax Regs. Thus, there is no factual basis here for application of the doctrine of constructive receipt. See *Mott v. Commissioner*, 85 F.2d 315, 317-318 (C.A. 6), *affirming on this issue* 30 B.T.A. 1040, 1044-1045; *Estate of W. H. Kiser*, 12 T.C. 178, 180; *S.A. Wood*, 22 B.T.A. 535, 537, *Cf. Weil v. Commissioner*, 173 F.2d 805 (C.A. 2).
>
> Although the Government's principal contention is based upon "constructive receipt," a doctrine that we have found inapplicable on the facts of this case, it also suggests that petitioner must be charged with the executor's fees because he "earned" them. It does not go so far as to argue that an executor may never waive his fees so as to prevent them from being included in his gross income, but it relies upon certain revenue rulings (Rev. Rul. 66-167, 1966-1 C.B. 20; *cf.* Rev. Rul. 64-225, 1964-2 C.B. 15; Rev. Rul. 56-472, 1956-2 C.B. 21) to support its position that petitioner must in any event be accountable for the executor's fees. The precise theory of these rulings is not clear. Rev. Rul. 66-167, *supra*, appears to indicate that an executor may waive his right to compensation without incurring income tax liability, and the test is whether the waiver "will at least primarily constitute evidence of an intent to render a gratuitous service" (p. 21). Accordingly, if a waiver is made "within a reasonable time" after commencing to serve, it is regarded as "consistent with an intention to render gratuitous service" (headnote), but "if the timing, purpose, and effect of the waiver make it serve any other important objective, it may then be proper to conclude that the fiduciary has thereby enjoyed a realization of income by means of controlling the disposition thereof" (p. 21). We need not consider whether this represents sound theory, because from our appraisal of the evidence we think petitioner never had any intention to receive compensation for his services, and that the factual foundation for applying the ruling against him is absent.
>
> To be sure, the record before us contains material that is confusing and contradictory in respect of petitioner's intentions. Much of the confusion is attributable to the bungling manner in which petitioner's counsel handled the matter. But we are satisfied from the evidence as a whole, with particular reliance upon our impression of petitioner himself on the witness stand, notwithstanding contradictions in his testimony, that petitioner never in fact intended to receive any executor's fees, and that the subsequent written waiver merely formalized that intention.
>
> We hold that petitioner could render gratuitous services without subjecting himself to income tax liability therefor and that the factual basis does not exist on this unusual record to charge him with having realized income on the theory of the revenue rulings, whatever that may be.

[2330] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items, especially fn. 2817.

See also part II.J.3.a Who Is Best Taxed on Gross Income, for some strategic considerations regarding whether income is best trapped inside the trust or allocated to the beneficiaries to the extent influence by overall income tax, whether federal income tax, NII tax, or state income tax.

For a description of special NII rules governing charitable remainder trusts, see the text accompanying fn. 2265 in part II.I.2 Regulatory Framework.

II.I.8. Application of 3.8% Tax to Business Income

II.I.8.a. General Application of 3.8% Tax to Business Income

Gross income from interest,[2331] dividends, annuities, royalties,[2332] and rents is excluded from NII if it is derived in the ordinary course of a trade or business that is not a passive activity;[2333] however, any item of gross income from the investment of working capital will be treated as not derived in the ordinary course of a trade or business.[2334] Gain from the sale of an asset is

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[2331] Self-charged interest is treated as business income. Reg. § 1.1411-4(g)(5) provides:

> Gross income from interest (within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section) that is received by the taxpayer from a nonpassive activity of such taxpayer, solely for purposes of section 1411, is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5. The amount of interest income that is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5, and thus excluded from the calculation of net investment income, under this paragraph (g)(5) is limited to the amount that would have been considered passive activity gross income under the rules of § 1.469-7 if the payor was a passive activity of the taxpayer. For purposes of this rule, the term nonpassive activity does not include a trade or business described in § 1.1411-5(a)(2). However, this rule does not apply to the extent the corresponding deduction is taken into account in determining self-employment income that is subject to tax under section 1401(b).

As described in fn. 2334, other than self-charged interest described above, interest income generally will constitute NII, even if it is fully business-related, unless the business is in the nature of a bank, etc.

[2332] See part II.K.1.f Royalty as a Trade or Business. If licensing royalties does not rise to the level of a trade or business, consider obtaining a preferred profits interest in lieu of royalty income (if the owner of the property being provided is active in the business) or a structure such as described in part II.E Recommended Structure for Entities (with some extra share of profits allocated to the person who contributed the property).

[2333] Reg. § 1.1411-4(b), which provides:

> Gross income described in paragraph (a)(1)(i) of this section is excluded from net investment income if it is derived in the ordinary course of a trade or business not described in § 1.1411-5….

CCA 202118009 correctly asserted:

> As discussed above, § 1.1411-4(b) does not provide any rules for determining whether gross income derived by a shareholder of a C corporation (including a closely held C corporation) may be properly treated as derived in the ordinary course of a trade or business. C corporations, including closely held C corporations, are not passthrough entities. This analysis and conclusion do not change simply because a shareholder may be treated as materially participating, for purposes of § 469, in a trade or business activity conducted through a closely held C corporation. Accordingly, any dividend income received by a shareholder from a C corporation will be subject to tax under § 1411, irrespective of whether the C corporation is a closely held C corporation within the meaning of § 469(h)(1) or whether the shareholder is treated as materially participating in the trade or business activity of the C corporation.

[2334] Reg. § 1.1411-6(a), which also provides:

> In determining whether any item is gross income from or net gain attributable to an investment of working capital, principles similar to those described in § 1.469-2T(c)(3)(ii) apply. See § 1.1411-

excluded from NII if it is derived in the ordinary course of a trade or business that is not a passive activity;[2335] however, any net gain that is attributable to the investment of working capital will be treated as not derived in the ordinary course of a trade or business.[2336] Other gross income from a trade or business is NII if it a passive activity.[2337]

Passive income is subject to the NII tax, and Code § 469 and the regulations thereunder determine whether a trade or business is passive.[2338]

4(f) for rules regarding properly allocable deductions with respect to an investment of working capital…

Reg. § 1.469-2T(c)(3)(ii) treats only the following as gross income derived in the ordinary course of a trade or business:

(A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;
(B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;
(C) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;
(D) Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);
(E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);
(F) Amounts included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and
(G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

[2335] Reg. § 1.1411-4(a)(1)(iii).

[2336] Reg. § 1.1411-6(a), which also provides:

> In determining whether any item is gross income from or net gain attributable to an investment of working capital, principles similar to those described in § 1.469-2T(c)(3)(ii) apply. See ... § 1.1411-7 for rules relating to the adjustment to net gain on the disposition of interests in a partnership or S corporation.

It also provides an example showing how strict this rule is: The taxpayer uses an interest-bearing checking account at a local bank to make daily deposits of the restaurant's cash receipts and to pay the restaurant's recurring ordinary and necessary business expenses. The account's average daily balance is approximately $2,500, but at any given time the balance may be significantly more or less than this amount, depending on the business' short-term cash flow needs. Any interest the account generates constitutes NII.

[2337] Reg. § 1.1411-4(c).

[2338] Reg. § 1.1411-5(b)(1)(ii).

Income from a trade or business of trading in financial instruments[2339] or commodities[2340] is also subject to NII tax.[2341] This rule applies to traders – not to dealers or investors.[2342]

This tax favors (by excluding) trade or business income from partnerships and S corporations in which the taxpayer significantly or materially participates, which for many taxpayers simply means work for more than 100 hours in a year.[2343] Although a partnership's income from a

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[2339] Reg. § 1.1411-5(c)(1) provides:

> *Definition of financial instruments*. For purposes of section 1411 and the regulations thereunder, the term financial instruments includes stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, any other derivatives, or any evidence of an interest in any of the items described in this paragraph (c)(1). An evidence of an interest in any of the items described in this paragraph (c)(1) includes, but is not limited to, short positions or partial units in any of the items described in this paragraph (c)(1).

[2340] Reg. § 1.1411-5(c)(2) provides:

> *Definition of commodities*. For purposes of section 1411 and the regulations thereunder, the term commodities refers to items described in section 475(e)(2).

[2341] Code § 1411(c)(2)(B); Reg. § 1.1411-5(a)(2).

[2342] The final regulations adopted the proposed regulations. The preamble to the latter, REG-130507-11, provides:

> **C. Trading in Financial Instruments or Commodities**
>
> **i. Distinguishing Between Dealers, Traders, and Investors**
>
> Determining whether trading in financial instruments or commodities rises to the level of a section 162 trade or business is a question of fact. *Higgins v. Comm'r*, 312 U.S. 212, 217 (1941); *Estate of Yaeger v. Comm'r*, 889 F.2d 29, 33 (2d Cir. 1989). In general, section 475(c)(1) provides that the term dealer in securities means a taxpayer who (A) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (B) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. In contrast, a trader seeks profit from short-term market swings and receives income principally from selling on an exchange rather than from dividends, interest, or long-term appreciation. *Groetzinger v. Comm'r*, 771 F.2d 269, 274-275 (7th Cir. 1985), *aff'd* 480 U.S. 23 (1987); *Moller v. United States*, 721 F.2d 810, 813 (Fed. Cir. 1983). A person will be a trader, and therefore engaged in a section 162 trade or business, if his or her trading is frequent and substantial, which has been rephrased as "frequent, regular, and continuous." *Boatner v. Comm'r*, T.C. Memo. 1997-379, *aff'd* in unpublished opinion 164 F.3d 629 (9th Cir. 1998).
>
> An investor is a person who purchases and sells securities with the principal purpose of realizing investment income in the form of interest, dividends, and gains from appreciation in value over a relatively long period of time (that is, long-term appreciation). The management of one's own investments is not considered a section 162 trade or business no matter how extensive or substantial the investments might be. See *Higgins v. Comm'r*, 312 U.S. 212, 217 (1941); *King v. Comm'r*, 89 T.C. 445 (1987). Therefore, an investor is not considered to be engaged in a section 162 trade or business of investing.
>
> For purposes of section 1411(c)(2)(B), in order to determine whether gross income is derived from a section 162 trade or business of trading in financial instruments or commodities, the gross income must be derived from an activity that would constitute trading for purposes of chapter 1. Therefore, a person that is a trader in commodities or a trader in financial instruments is engaged in a trade or business for purposes of section 1411(c)(2)(B). The Treasury Department and the IRS emphasize that the proposed regulations do not change the state of the law with respect to classification of traders, dealers, or investors for purposes of chapter 1.

[2343] See part II.K.1.a Counting Work as Participation, being careful to consider part II.K.1.a.v What Does Not Count as Participation. Other than work as a mere investor, almost any type of work appears to qualify towards material participation for purposes of the Code § 1411. For the more-than-100 hours rule, see fn. 2348.

trade or business generally would be subject to self-employment tax, whereas an S corporation income from a trade or business is not,[2344] one should consider that exit strategies[2345] and basis step-up issues[2346] tend to favor partnerships over S corporations. One might consider combining a partnership for the business operations themselves with an S corporation to block self-employment income from passing through to the ultimate owners.[2347]

II.I.8.a.i. Passive Activity Recharacterization Rules

Various passive activity recharacterization rules also provide NII exclusions for trade or business activity:

- Significant participation activities (more than 100 hours of participation).[2348]

- Certain rental activities.[2349]

- To the extent that any gain from a trade or business is recharacterized as "not from a passive activity" by reason of certain rules relating to the disposition of substantially appreciated property formerly used in nonpassive activity[2350] and is not from the disposition of an interest in property that was held for investment for more than 50% of the period during which the taxpayer held that interest in property in nonpassive activities,[2351] such trade or business is a nonpassive activity solely with respect to such recharacterized gain.[2352]

- To the extent that any income or gain from a trade or business is recharacterized as a nonpassive activity and is further characterized as portfolio income under certain provisions, then such trade or business constitutes a passive activity solely with respect to such recharacterized income or gain.[2353] The relevant portfolio income provision is either:

[2344] See part II.L.1 FICA: Corporation.
[2345] See part II.Q Exiting from or Dividing a Business. However, when considering a Code § 736 redemption, see part II.I.8.d.iv Treatment of Code § 736 Redemption Payments under Code § 1411. Also see part II.G.15 Limitations on the Use of Installment Sales, but note that the suggestion in that part about forming a partnership to hold property that is to be sold would not work with an S corporation, because a partnership is not eligible to hold stock in an S corporation.
[2346] See part II.H.2 Basis Step-Up Issues.
[2347] See part II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker.
[2348] Reg. § 1.1411-5(b)(2)(i), referring to Reg. § 1.469-2T(f)(2), which is described in fn. 3255 of part II.K.1.i Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.
[2349] Reg. § 1.1411-5(b)(2)(i), referring to Reg. § 1.469-2(f)(5) or 1.469-2(f)(6), which are described in fns. 3239 and 3196, respectively, within part II.K.1.e Rental Activities.
[2350] Reg. § 1.469-2(c)(2)(iii), which provides, generally:

> If an interest in property used in an activity is substantially appreciated at the time of its disposition, any gain from the disposition shall be treated as not from a passive activity unless the interest in property was used in a passive activity for either:
>
> (1) 20 percent of the period during which the taxpayer held the interest in property; or
>
> (2) The entire 24-month period ending on the date of the disposition.

An interest in property is substantially appreciated if the fair market value of the interest in property exceeds 120% of the adjusted basis of the interest. Reg. § 1.469-2(c)(2)(iii)(C).
[2351] Reg. § 1.469-2(c)(2)(iii)(F).
[2352] Reg. § 1.1411-5(b)(2)(i).
[2353] Reg. § 1.1411-5(b)(2)(iii).

- the rental of nondepreciable property, equity-financed lending activities, and royalty income from passthrough entities,[2354] or

- the disposition of an interest in property that was held for investment for more than 50% of the period during which the taxpayer held that interest in property in nonpassive activities.[2355]

II.I.8.a.ii. Passive Activity Grouping Rules

Regarding how the Code § 469 grouping rules interact with classifying income under Code § 469, the preamble explains:[2356]

> Section 1.469-4 provides rules for defining an activity for purposes of applying the passive activity loss rules of section 469 (grouping rules). The grouping rules will apply in determining the scope of a taxpayer's trade or business in order to determine whether such trade or business is a passive activity for purposes of section 1411(c)(2)(A). However, a proper grouping under § 1.469-4(d)(1) (grouping rental activities with other trade or business activities) will not convert gross income from rents into other gross income derived from a trade or business described in proposed § 1.1411-5(a)(1).

For example, if a partner in a partnership participates in one trade or business for more than 500 hours and another trade or business for only 50 hours and the individual groups both activities as one activity in a way that qualifies both trades or businesses as nonpassive, business income from both trades or businesses is excluded from NII.[2357]

For more information about the Code § 469 grouping rules, including regrouping as a result of the NII tax, see part II.K.1.b Grouping Activities.

2354 Reg. § 1.1411-5(b)(2)(iii) refers to Reg. § 1.469-2T(f)(10), which refers to Reg. § 1.469-2(f)(10). Sutton & Howell-Smith, *Federal Income Taxation of Passive Activities* (WG&L), ¶ 7.01[2][b] Recharacterized Items, refers to Reg. § 1.469-2(f)(10) as the rental of nondepreciable property (¶ 10.05 of the treatise), equity-financed lending activities (¶ 7.03 of the treatise), and royalty income from passthrough entities (¶ 13.05 of the treatise).
2355 Reg. § 1.469-2(c)(2)(iii)(F).
2356 Part 6.B.1.(b)(4) of the preamble.
2357 Reg. § 1.1411-5(b)(3), Example (2).

II.I.8.a.iii. Qualifying Self-Charged Interest or Rent Is Not NII

Certain self-charged interest[2358] or rent[2359] received from a business are automatically deemed nonpassive trade or business income if the borrower/tenant is a nonpassive trade or business; however, self-charged interest is excluded only to the extent it is self-charged.[2360]

Note that the taxpayer must materially participate, satisfying the more-than-500-hours or similar rules,[2361] to satisfy the self-rental exception of footnote 2359:

- Although significant participation (more than 100 hours) suffices for other business income,[2362] it does not for the self-rental exception. If this contrast in treatment (between material participation and significant participation) is significant (particularly if the property is about be sold)[2363] and avoiding the NII tax on the rental income becomes important, consider using the structure depicted in part II.E.6 Recommended Partnership Structure –

[2358] Reg. § 1.1411-4(g)(5) provides:

> Treatment of self-charged interest income. Gross income from interest (within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section) that is received by the taxpayer from a nonpassive activity of such taxpayer, solely for purposes of section 1411, is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5. The amount of interest income that is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5, and thus excluded from the calculation of net investment income, under this paragraph (g)(5) is limited to the amount that would have been considered passive activity gross income under the rules of § 1.469-7 if the payor was a passive activity of the taxpayer. For purposes of this rule, the term nonpassive activity does not include a trade or business described in § 1.1411-5(a)(2). However, this rule does not apply to the extent the corresponding deduction is taken into account in determining self-employment income that is subject to tax under section 1401(b).

[2359] Reg. § 1.1411-4(f)(6)(i) provides:

> Gross income from rents. To the extent that gross rental income described in paragraph (a)(1)(i) of this section is treated as not derived from a passive activity by reason of § 1.469-2(f)(6) or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under § 1.469-4(d)(1), such gross rental income is deemed to be derived in the ordinary course of a trade or business within the meaning of paragraph (b) of this section.

See fn. 2400 regarding the interaction of Reg. § 1.469-2(f)(6) with the 3.8% tax on net investment income. See part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity for an explanation of Reg. § 1.469-2(f)(6).
See fn. 3196 for the text of Reg. § 1.469-2(f)(6).

[2360] Reg. § 1.469-7 (treatment of self-charged items of interest income and deduction), which applies "in the case of a lending transaction (including guaranteed payments for the use of capital under section 707(c)) between a taxpayer and a passthrough entity in which the taxpayer owns a direct or indirect interest, or between certain passthrough entities." Reg. § 1.469-7(a)(1). See parts II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation, II.I.8.d Partnership Structuring in Light of the 3.8% Tax on Net Investment Income, and II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736 regarding the interaction of partnership tax rules with the passive loss rules and rules governing NII.

[2361] See part II.K.1.a.ii Material Participation.

[2362] See part II.I.8.a.i Passive Activity Recharacterization Rules. If at all practical, an owner should materially participate instead of significantly participate. See part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.

[2363] See fn. 2366

Flowchart,[2364] perhaps migrating as depicted in part II.E.9 Real Estate Drop Down into Preferred Limited Partnership.

- Material participation requires ownership.[2365]

If self-charged rental is excluded from NII, gain on the sale of the rental property is also excluded.[2366]

II.I.8.a.iv. Determination of Trade or Business Status, Passive Activity Status, or Trading Status of Pass-Through Entities

If an individual, estate, or trust owns or engages in a trade or business,[2367] the determination of whether such gross income is derived in a trade or business is made at the owner's level.[2368]

If an individual, estate, or trust owns an interest in a trade or business through a partnership or S corporation:[2369]

- whether gross income is a passive trade or business activity is determined at the owner level; and

- whether gross income is derived in trade or business of a trader trading in financial instruments or commodities[2370] is determined at the entity level.

[2364] This structure often is ideal; see part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons. However, it might need to be unwound by subjecting the real estate to a long-term business lease and distributing the real estate to the client's beneficiaries not active in the business, to try to disentangle the active from the inactive beneficiaries. Note, however, that splitting up an entity taxed as a partnership generally can be done on a tax-free basis; see part II.Q.8 Exiting From or Dividing a Partnership, especially part II.Q.8.b.i Distribution of Property by a Partnership.

[2365] See fn. 3195 and part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.

[2366] Reg. § 1.1411-4(f)(6)(ii) provides:

> Gain or loss from the disposition of property. To the extent that gain or loss resulting from the disposition of property is treated as nonpassive gain or loss by reason of § 1.469-2(f)(6) or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under § 1.469-4(d)(1), then such gain or loss is deemed to be derived from property used in the ordinary course of a trade or business within the meaning of paragraph (d)(4)(i) of this section.

See fns. 2400 and 3198 regarding Reg. § 1.469-2(f)(6).

[2367] Directly or indirectly through ownership of an interest in an entity that is disregarded as an entity separate from its owner under the check-the-box rules of Reg. § 301.7701-3.

[2368] Reg. § 1.1411-4(b)(1).

[2369] Reg. § 1.1411-4(b)(2).

[2370] Reg. § 1.1411-5(c) discusses financial instruments and commodities.

II.I.8.a.v. Working Capital Is NII

II.I.8.a.v.(a). Policy of Working Capital as NII

The tax applies to interest, dividends, etc. whether inside or outside an entity, and arguments that such income was derived from working capital used to generate active business income will not help any.[2371] The preamble to the proposed regulations explains:[2372]

> Section 1411(c)(3) provides that a rule similar to the rule of section 469(e)(1)(B) applies for purposes of section 1411 (the working capital rule). Section 469(e)(1)(B) provides that, for purposes of determining whether income is treated as from a passive activity, any income or gain attributable to an investment of working capital shall be treated as not derived in the ordinary course of a trade or business.
>
> The term working capital is not defined in either section 469 or section 1411, but it generally refers to capital set aside for use in and the future needs of a trade or business. Because the capital may not be necessary for the immediate conduct of the trade or business, the amounts are often invested by businesses in income-producing liquid assets such as savings accounts, certificates of deposit, money market accounts, short-term government and commercial bonds, and other similar investments. These investment assets will usually produce portfolio-type income, such as interest. Under section 469(e)(1)(B), portfolio-type income generated by working capital is not derived in the ordinary course of a trade or business, and therefore, it is not treated as passive income. Under section 1411(c)(3), gross income from and net gain attributable to the investment of working capital is not derived in the ordinary course of a trade or business, and therefore such gross income and net gain is subject to section 1411.
>
> A taxpayer may take into account the properly allocable deductions (related to losses or deductions properly allocable to the investment of such working capital) in determining net investment income. See part 5.E of this preamble regarding properly allocable deductions.

The preamble to the final regulations simply mentions:[2373]

> Section 1411(c)(3) provides that income on the investment of working capital is not treated as derived from a trade or business for purposes of section 1411(c)(1) and is subject to tax under section 1411. Section 1.1411-6 of the final regulations provides guidance on working capital under section 1411(c)(3).

Of course, if the taxpayer does not materially participate in the business, generally all of the business' income will be NII, so the working capital exception would be moot.[2374]

[2371] Code § 1411(c)(3) provides that any income, gain, or loss which is attributable to an investment of working capital is deemed not to be derived in the ordinary course of a trade or business in applying this rule.
[2372] Part 7 of the preamble.
[2373] T.D. 9644.
[2374] Reg. § 1.1411-5(b)(3), Example (5).

II.I.8.a.v.(b). What Is Working Capital

Reg. § 1.1411-6(a) provides:[2375]

> *General rule*. For purposes of section 1411, any item of gross income from the investment of working capital will be treated as not derived in the ordinary course of a trade or business, and any net gain that is attributable to the investment of working capital will be treated as not derived in the ordinary course of a trade or business. In determining whether any item is gross income from or net gain attributable to an investment of working capital, principles similar to those described in § 1.469-2T(c)(3)(ii) apply. See § 1.1411- 4(f) for rules regarding properly allocable deductions with respect to an investment of working capital and § 1.1411-7 for rules relating to the adjustment to net gain on the disposition of interests in a partnership or S corporation.

Reg. § 1.1411-6(b) provides an example holding that cash used in daily operations constitute

> working capital under § 1.469-2T(c)(3)(ii) and, pursuant to paragraph (a) of this section, the interest generated by this working capital will not be treated as derived in the ordinary course of S's restaurant business. Accordingly, the interest income derived by S from its checking and savings accounts … constitutes gross income from interest under § 1.1411-4(a)(1)(i).

To place context on this reference to Reg. § 1.469-2T(c)(3)(ii), Reg. § 1.469-2T(c)(3)(i) excludes from passive activity gross income items of portfolio income and further provides:

> For purposes of the preceding sentence, portfolio income includes all gross income, other than income derived in the ordinary course of a trade or business (within the meaning of paragraph (c)(3)(ii) of this section), that is attributable to—
>
> (A) Interest (including amounts treated as interest under paragraph (e)(2)(ii) of this section, relating to certain payments to partners for the use of capital); annuities; royalties (including fees and other payments for the use of intangible property); dividends on C corporation stock; and income (including dividends) from a real estate investment trust (within the meaning of section 856), regulated investment company (within the meaning of section 851), real estate mortgage investment conduit (within the meaning of section 860D), common trust fund (within the meaning of section 584), controlled foreign corporation (within the meaning of section 957), qualified electing fund (within the meaning of section 1295(a)), or cooperative (within the meaning of section 1381(a));
>
> (B) Dividends on S corporation stock (within the meaning of section 1368(c)(2));
>
> (C) The disposition of property that produces income of a type described in paragraph (c)(3)(i)(A) of this section; and

[2375] Reg. § 1.1411-6(b) provides an example holding that cash used in daily operations constitute working capital under § 1.469-2T(c)(3)(ii) and, pursuant to paragraph (a) of this section, the interest generated by this working capital will not be treated as derived in the ordinary course of S's restaurant business. Accordingly, the interest income derived by S from its checking and savings accounts … constitutes gross income from interest under § 1.1411-4(a)(1)(i).

(D) The disposition of property held for investment (within the meaning of section 163(d)).

Reg. § 1.469-2T(c)(3)(ii) provides:

> *Gross income derived in the ordinary course of a trade or business*. Solely for purposes of paragraph (c)(3)(i) of this section, gross income derived in the ordinary course of a trade or business includes only—

(A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;

(B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;

(C) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;

(D) Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);

(E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);

(F) Amounts included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and

(G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

As to (G) above, it has been suggested that the IRS has informally indicated its intention to broaden the definition of mineral royalty income derived in a trade or business, but taxpayers should request a ruling to receive a proper determination.[2376] The same author said that several private letter rulings held that "float revenue, as a substitute for service fees, is derived in the ordinary course of a trade or business."[2377]

[2376] Sutton & Howell-Smith, ¶ 12.03[3][a] Royalties, *Federal Income Taxation of Passive Activities* (WG&L).

[2377] Sutton & Howell-Smith, ¶ 2.02[1][f][vii] Other income identified by the Commissioner, *Federal Income Taxation of Passive Activities* (WG&L), pointing to Letter Rulings 199924020, 199924022, and 199924023.

II.I.8.a.vi. What is a "Trade or Business"?

The preamble to the final regulations discuss what is a "trade or business" for purposes of the 3.8% tax:[2378]

> Several commentators requested guidance concerning the meaning of "trade or business." Commentators suggested that the regulations include references to relevant case law and administrative guidance. A commentator requested that the regulations expand upon existing guidance by including bright-line examples of what constitutes a trade or business to aid taxpayers in determining if income is derived in the ordinary course of a trade or business and thus is excluded from net investment income.
>
> As noted in part 6.A. of the preamble to the proposed regulations, the rules under section 162 have long existed as guidance for determining the existence of a trade or business and are applied in many circumstances. Whether an activity constitutes a trade or business for purposes of section 162 is generally a factual question. For example, in Higgins v. Commissioner, 312 U.S. 212 (1941), the Supreme Court stated that the determination of "whether the activities of a taxpayer are 'carrying on a trade or business' requires an examination of the facts in each case." 312 U.S. at 217. Except for certain clarifications made in response to the proposed regulations, further guidance concerning the definition of trade or business is beyond the scope of these regulations.
>
> In response to these commentators, § 1.1411-1(d) of the final regulations provides that the term trade or business, when used in section 1411 and the final regulations, describes a trade or business within the meaning of section 162. The section 162 reference incorporates case law and administrative guidance applicable to section 162.
>
> One commentator noted that determining whether income is earned in a section 162 trade or business under a separate entity approach, as reflected in proposed § 1.1411-4(b), will yield unexpected results that are inconsistent with section 162. For purposes of determining whether income is earned under section 162, the commentator noted that § 1.183-1(d) provides that activities are determined and their section 162 trade or business status is evaluated by aggregating undertakings in any reasonable manner determined by the taxpayer.
>
> The Treasury Department and the IRS do not believe that the determination of a trade or business under section 162 mandates the use of the definition of "activity" within the meaning of § 1.183-1(d). Section 183 disallows expenses in excess of income attributable to activities not engaged in for profit. Section 1.183-1(a) provides that section 162 and section 212 activities are not subject to section 183 limitations. The definition of activity within § 1.183-1(d) allows taxpayers latitude to combine different activities into a single activity to establish that the taxpayer is engaged in an activity for profit, and thus is not subject to the section 183 limitation. However, once the taxpayer determines that section 183 is not applicable, the taxpayer then must determine whether the activity is a section 162 trade or business or a section 212 for-profit activity. Furthermore, different definitions of "activity" can be found in sections 465 and 469. Therefore, the Treasury Department and the IRS do not believe that determining

[2378] T.D. 9644.

whether a trade or business exists using the activity determinations of Code provisions unrelated to section 162 is appropriate.

For further analysis, see part II.G.4.l.i.(a) “Trade or Business” Under Code § 162.

II.I.8.a.vii. Former Passive Activities – NII Implications

The preamble to the final regulations addressed former passive activities:[2379]

> The final regulations clarify, for section 1411 purposes, the treatment of income, deductions, gains, losses, and the use of suspended losses from former passive activities. The Treasury Department and the IRS considered three alternatives. One approach is the complete disallowance of all suspended losses once the activity is no longer a passive activity (in other words, becomes a former passive activity or a nonpassive activity). The rationale behind this approach is that the income from the activity would not be includable in net investment income, thus the suspended losses become irrelevant. Another approach is the unrestricted allowance of all suspended losses in the year in which they are allowed by section 469(f), regardless of whether the nonpassive income is included in net investment income. The rationale behind this approach is that the losses were generated during a period when the activity was a passive activity, and if such losses were allowed in full, they would have potentially reduced net investment income, and therefore the losses should continue to retain their character as net investment income deductions. The third approach is a hybrid approach that allows suspended losses from former passive activities in calculation of net investment income (as properly allocable deductions under section 1411(c)(1)(B) or in section 1411(c)(1)(A)(iii) in the case of losses) but only to the extent of the nonpassive income from such former passive activity that is included in net investment income in that year. The final regulations adopt this hybrid approach.
>
> For example, in the case of a former passive trade or business activity with suspended losses of $10,000 that generates $3,000 of net nonpassive income, section 469(c)(1)(A) allows $3,000 of the $10,000 suspended loss to offset the nonpassive income in the current year. Since the gross nonpassive income is not included in

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[2379] T.D. 9644. For general issues regarding former passive activities, see part II.K.1.k Former Passive Activities. The preamble describes the interaction of these rules with Code § 1411:

> If a taxpayer materially participates in a former passive trade or business activity, the gross income produced by that activity (and associated section 1411(c)(1)(B) properly allocable deductions) in the current year generally would not be net investment income because the activity is no longer a trade or business that is a passive activity within the meaning of section 469. However, in the case of rental income not derived in the ordinary course of a trade or business, a classification of the rental income as nonpassive for purposes of section 469 will not result automatically in the exclusion of such rental income and associated deductions from net investment income. Furthermore, it is possible that a section 469 former passive activity may still generate net investment income on its disposition to the extent the gain is included in section 1411(c)(1)(A)(iii) and not entirely excluded by, for example, section 1411(c)(4). Suspended losses that are allowed by reason of section 469(f)(1)(A) or (C) may constitute properly allocable deductions under section 1411(c)(1)(B) and § 1.1411-4(f)(2) (to the extent those losses would be described in section 62(a)(1) or 62(a)(4)) or may be included within the calculation of net gain in section 1411(c)(1)(A)(iii) and § 1.1411-4(d) (to the extent those losses would be described in section 62(a)(3) in the year they are allowed, depending on the underlying character and origin of such losses). The treatment of excess suspended losses of a former passive activity upon a fully taxable disposition is discussed in the next section of this preamble.

> section 1411(c)(1)(A)(ii) (or in section 1411(c)(1)(A)(iii) in the case of gains from the disposition of property in such trade or business), none of the deductions and losses associated with such income are properly allocable deductions under section 1411(c)(1)(B) (or in section 1411(c)(1)(A)(iii) in the case of losses from the disposition of property in such trade or business). Thus, under the facts of this example, the final regulations provide that the $3,000 is not a properly allocable deduction (or a loss included in section 1411(c)(1)(A)(iii)). However, to the extent that the remaining suspended passive loss deduction of $7,000 is allowed by section 469(f)(1)(C) to offset other net passive activity income (which is included in net investment income by reason of section 1411(c)(1)(A) less deductions allowed by section 1411(c)(1)(B)), such amounts are considered properly allocable deductions under section 1411(c)(1)(B), or as a loss included in section 1411(c)(1)(A)(iii), as appropriate.

Reg. § 1.1411-4(g)(8) provides the details described above. For more information on former passive activities, see part II.K.1.k Former Passive Activities.

II.I.8.b. 3.8% Tax Does Not Apply to Gain on Sale of Active Business Assets

Net gain from the disposition of property does not include gain or loss attributable to property held in a nonpassive[2380] trade or business.[2381]

However, this exception does not apply to the gain or loss attributable to the disposition of investments of working capital.[2382]

Although a partnership interest or S corporation stock generally is not property held in a trade or business qualifying for the exclusion,[2383] the portion of the sale proceeds attributable to business assets does qualify.[2384]

If an individual, estate, or trust owns or engages in a trade or business directly (or indirectly through a disregarded entity), the determination of whether net gain is attributable to property held in a trade or business is made at the individual, estate, or trust level.[2385] If an individual, estate, or trust that owns an interest in a passthrough entity such as a partnership or S corporation and that entity is engaged in a trade or business, the determination of whether net gain is attributable to (i) a passive activity is made at the owner level; and (ii) the trade or business of a trader trading in financial instruments or commodities is made at the entity level.[2386]

[2380] By "nonpassive" I mean not described in Reg. § 1.1411-5. See part II.I.8 Application of 3.8% Tax to Business Income, especially fn. 2338.
[2381] Reg. §§ 1.1411-4(a)(1)(iii), 1.1411-4(d)(4)(i)(A).
[2382] Reg. § 1.1411-4(d)(4)(i)(A). See Reg. § 1.1411-6 regarding working capital, which is described in part II.I.8.a.v Working Capital Is NII.
[2383] Reg. § 1.1411-4(d)(4)(i)(B)(1).
[2384] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
[2385] Reg. § 1.1411-4(d)(4)(i)(B)(2).
[2386] Reg. § 1.1411-4(d)(4)(i)(B)(3).

II.I.8.c. Application of 3.8% Tax to Rental Income

As mentioned above, rental income is NII unless it is self-rental[2387] or not only is from a trade or business but also nonpassive.[2388]

Because the self-rental exception is relatively straightforward, this part II.I.8.c focuses on whether the rental not only is from a trade or business but also is nonpassive.

II.I.8.c.i. If Not Self-Rental, Most Rental Income Is *Per Se* Passive Income and Therefore NII

Generally, rental constitutes passive income, even if it constitutes a trade or business in which the taxpayer materially participates.[2389] The NII rules elaborate on exceptions to this general rule. For example, short-term equipment leasing income is not NII,[2390] if the taxpayer materially participates.[2391]

[2387] See fn. 2359.

[2388] See fn. 2333. Note that *Erbs v. Commissioner*, T.C. Summary Opinion 2001-85, held that the material participation rules "govern whether a trade or business is passive and do not address the more fundamental question of whether an activity constitutes a trade or business." See generally "¶L-1103, Regular activity in business is required for being engaged in a trade or business—trade or business expenses," Fed. Tax. Coord.2d. See also Bittker & Lokken, "¶47.3, Property Used in a Trade or Business," *Federal Taxation of Income, Estates, and Gifts*; "¶L-1115, Renting and/or managing rental real estate as a trade or business," *Fed. Tax. Coord.2d*.

[2389] See part II.K.1.e Rental Activities.

[2390] Reg. § 1.1411-5(b)(3), Example (3) provides:

> *Application of the rental activity exceptions*. B, an unmarried individual, is a partner in PRS, which is engaged in an equipment leasing activity. The average period of customer use of the equipment is seven days or less (and therefore meets the exception in § 1.469-1T(e)(3)(ii)(A)). B materially participates in the equipment leasing activity (within the meaning of § 1.469-5T(a)). The equipment leasing activity constitutes a trade or business. In Year 1, B has modified adjusted gross income (as defined in § 1.1411-2(c)) of $300,000, all of which is derived from PRS. All of the income from PRS is derived in the ordinary course of the equipment leasing activity, and all of PRS's property is held in the equipment leasing activity. Of B's allocable share of income from PRS, $275,000 constitutes gross income from rents (within the meaning of § 1.1411-4(a)(1)(i)). While $275,000 of the gross income from the equipment leasing activity meets the definition of rents in § 1.1411-4(a)(1)(i), the activity meets one of the exceptions to rental activity in § 1.469-1T(e)(3)(ii) and B materially participates in the activity. Therefore, the trade or business is not a passive activity with respect to B for purposes of paragraph (b)(1)(ii) of this section. Because the rents are derived in the ordinary course of a trade or business not described in paragraph (a) of this section, the ordinary course of a trade or business exception in § 1.1411-4(b) applies, and the rents are not described in § 1.1411-4(a)(1)(i). Furthermore, because the equipment leasing trade or business is not a trade or business described in paragraph (a)(1) or (a)(2) of this section, the $25,000 of other gross income is not net investment income under § 1.1411-4(a)(1)(ii). However, the $25,000 of other gross income may be net investment income by reason of section 1411(c)(3) and § 1.1411-6 if it is attributable to PRS's working capital. Finally, gain or loss from the sale of the property held in the equipment leasing activity will not be subject to § 1.1411-4(a)(1)(iii) because, although it is attributable to a trade or business, it is not a trade or business to which the section 1411 tax applies.

[2391] Reg. § 1.1411-5(b)(3), Example (4) provides:

> Application of section 469 and other gross income under § 1.1411-4(a)(1)(ii). Same facts as Example 3, except B does not materially participate in the equipment leasing trade or business

II.I.8.c.ii. Real Estate Classified as Nonpassive for Real Estate Professionals

The general rule that rental is per se passive does not apply to certain real estate professionals.[2392] Therefore, if a real estate professional who meets this exceptions engages in a real estate trade or business, the rental income would not constitute NII.

Although the final regulations declined to provide broad relief for real estate professionals, the preamble informs us:[2393]

> The final regulations do, however, provide a safe harbor test for certain real estate professionals in § 1.1411-4(g)(7). The safe harbor test provides that, if a real estate professional (within the meaning of section 469(c)(7)) participates in a rental real estate activity for more than 500 hours per year, the rental income associated with that activity will be deemed to be derived in the ordinary course of a trade or business. Alternatively, if the taxpayer has participated in a rental real estate activity for more than 500 hours per year in five of the last ten taxable years (one or more of which may be taxable years prior to the effective date of section 1411), then the rental income associated with that activity will be deemed to be derived in the ordinary course of a trade or business. The safe harbor test also provides that, if the hour requirements are met, the real property is considered as used in a trade or business for purposes of calculating net gain under section 1411(c)(1)(A)(iii). The Treasury Department and the IRS recognize that some real estate professionals with substantial rental activities may derive such rental income in the ordinary course of a trade or business, even though they fail to satisfy the 500 hour requirement in the safe harbor test. As a result, the final regulations specifically provide that such failure will not preclude a taxpayer from establishing that such gross rental income and gain or loss from the disposition of real property, as applicable, is not included in net investment income.

Thus, the annual threshold is reduced from more than 750 hours under the passive loss rules to more than 500 hours.[2394]

> and therefore the trade or business is a passive activity with respect to B for purposes of paragraph (b)(1)(ii) of this section. Accordingly, the $275,000 of gross income from rents is described in § 1.1411-4(a)(1)(i) because the rents are derived from a trade or business that is a passive activity with respect to B. Furthermore, the $25,000 of other gross income from the equipment leasing trade or business is described in § 1.1411-4(a)(1)(ii) because the gross income is derived from a trade or business described in paragraph (a)(1) of this section. Finally, gain or loss from the sale of the property used in the equipment leasing trade or business is subject to § 1.1411-4(a)(1)(iii) because the trade or business is a passive activity with respect to B, as described in paragraph (b)(1)(ii) of this section.

[2392] See fns. 3187-3204.

[2393] T.D. 9655.

[2394] Reg. § 1.1411-4(g)(7) provides:

> (7) *Treatment of certain real estate professionals*
>
> > (i) *Safe Harbor*. In the case of a real estate professional (as defined in section 469(c)(7)(B)) that participates in a rental real estate activity for more than 500 hours during such year, or has participated in such real estate activities for more than 500 hours in any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year, then—

Also, Reg. § 1.1411-4(g)(7)(ii)(B) does not require that each rental activity owned by the real estate professional be a trade or business. On June 16, 2014, I informally confirmed with a drafter of the regulation that, if a real estate professional groups activities so that real estate trade or business undertakings are grouped with real estate undertakings that are not trade or business undertakings, the latter nevertheless receive treatment as not constituting NII. For example, suppose a real estate professional actively manages several real estate properties that are trade or business undertakings and also owns several properties rented using triple-net leases. If the professional groups all of those undertakings as a single activity, income from the triple-net leases does not constitute NII.

See also part II.G.26 Real Estate Special Issues.

II.I.8.c.iii. Rental as a Trade or Business

If rental activity is nonpassive under special exceptions or by reason of the taxpayer being a real estate professional, the taxpayer would apply the concepts below in conjunction with the rules of part II.I.8.a General Application of 3.8% Tax to Business Income.

Grouping passive activities will not convert gross income from rents into other gross income derived from a trade or business.[2395]

Before exploring further the issue of real estate as a trade or business, note what the characterization of real estate as such does <u>not</u> do: although generally income from a trade or business is subject to self-employment (SE) tax,[2396] see part II.L.2.a.ii Rental Exception to SE Tax.

(A) Such gross rental income from that rental activity is deemed to be derived in the ordinary course of a trade or business within the meaning of paragraph (b) of this section; and

(B) Gain or loss resulting from the disposition of property used in such rental real estate activity is deemed to be derived from property used in the ordinary course of a trade or business within the meaning of paragraph (d)(4)(i) of this section.

(ii) *Definitions*—

(A) *Participation*. For purposes of establishing participation under this paragraph (g)(7), any participation in the activity that would count towards establishing material participation under section 469 shall be considered.

(B) *Rental real estate activity*. The term rental real estate activity used in this paragraph (g)(7) is a rental activity within the meaning of § 1.469-1T(e)(3). An election to treat all rental real estate as a single rental activity under §1.469-9(g) also applies for purposes of this paragraph (g)(7). However, any rental real estate that the taxpayer grouped with a trade or business activity under § 1.469-4(d)(1)(i)(A) or (d)(1)(i)(C) is not a rental real estate activity.

(iii) *Effect of safe harbor*. The inability of a real estate professional to satisfy the safe harbor in this paragraph (g)(7) does not preclude such taxpayer from establishing that such gross rental income and gain or loss from the disposition of property, as applicable, is not included in net investment income under any other provision of section 1411.

[2395] Part 6.B.1.(b)(4) of the preamble explains:

> … a proper grouping under § 1.469-4(d)(1) (grouping rental activities with other trade or business activities) will not convert gross income from rents into other gross income derived from a trade or business described in proposed § 1.1411-5(a)(1).

[2396] See part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.

The preamble to the final regulations re NII tax explains how the IRS views rental as a trade or business (emphasis added):[2397]

> The Treasury Department and the IRS received multiple comments regarding the determination of a trade or business within the context of rental real estate. Specifically, commentators stated that Example 1 of proposed § 1.1411-5(b)(2) is inconsistent with existing case law regarding the definition of a trade or business of rental real estate. Commentators cited cases such as Fackler v. Commissioner, 45 BTA 708 (1941), *aff'd*, 133 F.2d 509 (6th Cir. 1943); Hazard v. Commissioner, 7 T.C. 372 (1946); and Lagreide v. Commissioner, 23 T.C. 508 (1954), for the proposition that the activities of a single property can rise to the level of a trade or business.
>
> The Treasury Department and the IRS agree with commentators that, in certain circumstances, the rental of a single property may require regular and continuous involvement such that the rental activity is a trade or business within the meaning of Section 162. However, the Treasury Department and the IRS do not believe that the rental of a single piece of property rises to the level of a trade or business in every case as a matter of law. For example, § 1.212-1(h) provides that the rental of real property is an example of a for-profit activity under section 212 and not a trade or business.[2398]
>
> Within the scope of a section 162 determination regarding a rental activity, key factual elements that may be relevant include, but are not limited to, the type of property (commercial real property versus a residential condominium versus personal property), the number of properties rented, the day-to-day involvement of the owner or its agent, and the type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease). Therefore, due to the large number of factual combinations that exist in determining whether a rental activity rises to the level of a section 162 trade or business, bright-line definitions are impractical and would be imprecise. The same is true wherever the section 162 trade or business standard is used and is not unique to section 1411. The Treasury Department and the IRS decline to provide guidance on the meaning of trade or business solely within the context of section 1411. However, the Treasury Department and the IRS have modified Example 1 in § 1.1411-5(b)(3) to explicitly state that the rental property in question is not a trade or business under applicable section 162 standards.
>
> In cases where other Code provisions use a trade or business standard that is the same or substantially similar to the section 162 standard adopted in these final regulations, the IRS will closely scrutinize situations where taxpayers take the position that an activity is a trade or business for purposes of section 1411, but not a trade or business for such other provisions. For example, if a taxpayer takes the position that a certain rental activity is a trade or business for purposes of section 1411, the IRS will take into account

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[2397] T.D. 9655.

[2398] This comment in the preamble seems to take out of context Reg. § 1.212-1(h), the full text of which is:

> Ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held for use as a residence by the taxpayer are not deductible. However, ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held by the taxpayer as rental property are deductible even though such property was formerly held by the taxpayer for use as a home.

That regulation does not say that rental is not a trade or business (although it appears in a regulation designed for activities that do not constitute trades or businesses. Rather, that regulation points out that property formerly held for personal use can later be used for the production or collection of income.

> the facts and circumstances surrounding the taxpayer's determination of a trade or business for other purposes, such as whether the taxpayer complies with any information reporting requirements for the rental activity imposed by section 6041.

The example cited above is as follows (emphasis added):[2399]

> Rental activity. A, an unmarried individual, rents a commercial building to B for $50,000 in Year 1. A is not involved in the activity of the commercial building on a regular and continuous basis, therefore, A's rental activity does not involve the conduct of a trade or business, and under section 469(c)(2), A's rental activity is a passive activity. Because paragraph (b)(1)(i) of this section is not satisfied, A's rental income of $50,000 is not derived from a trade or business described in paragraph (b)(1) of this section. However, A's rental income of $50,000 still constitutes gross income from rents within the meaning of § 1.1411-4(a)(1)(i) because rents are included in the determination of net investment income under § 1.1411-4(a)(1)(i) whether or not derived from a trade or business described in paragraph (b)(1) of this section.

The preamble explains how the final regulations relaxed the rules for nonpassive rental to one's business:[2400]

> With regard to grouping and recharacterizations, commentators recommended that the final regulations clarify that determining whether income is net investment income should be based solely on its recharacterized or grouped status as nonpassive under section 469 and the regulations thereunder. Although the Treasury Department and the IRS recognize the administrative simplicity of this rule, the Treasury Department and the IRS believe that this rule is too broad as it would 'deem' certain items to be derived in a trade or business when it is unlikely that a section 162 trade or business is present. For example, see §§ 1.469-1T(e)(3)(ii)(D) (rental of property incidental to an investment activity) and 1.469-2T(f)(3) (rental of nondepreciable property). Therefore, the final regulations do not adopt this broad approach.
>
> Another option advanced by some commentators is a special rule for self-charged rents similar to § 1.469-7 pertaining to self-charged interest. However, a proposed rule for self-charged rents would be more complex than the rule for self-charged interest because the amount of the net investment income exclusion must take into account the deductions allowed (depreciation, taxes, interest, etc.) that are not present in self-charged interest. A self-charged rent rule would have to exclude from gross income rents in the same way as self-charged interest, and would also exclude a share of the deductions attributable to earning the income. In addition, a rule based on § 1.469-7 would cover only rents within the context of section 1411(c)(1)(A)(i) and would not

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[2399] Reg. § 1.1411-5(b)(3), Example 1.

[2400] T.D. 9655. Reg. § 1.1411-4(g)(6)(i):

> To the extent that gross rental income described in paragraph (a)(1)(i) of this section is treated as not derived from a passive activity by reason of § 1.469-2(f)(6) or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under § 1.469-4(d)(1), such gross rental income is deemed to be derived in the ordinary course of a trade or business within the meaning of paragraph (b) of this section.

For what is a rental activity under Reg. § 1.469-2(f)(6), see part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity. No relief is provided for self-charged royalties. Consider the structure described in part II.E Recommended Structure for Entities.

> provide relief from the inclusion of the gain upon the sale of the property from net investment income. Accordingly, the final regulations do not adopt this recommendation.
>
> However, the Treasury Department and the IRS appreciate the concerns raised by the commentators. Therefore, the final regulations provide special rules for self-charged rental income. The final regulations provide that, in the case of rental income that is treated as nonpassive by reason of § 1.469-2(f)(6) (which generally recharacterizes what otherwise would be passive rental income from a taxpayer's property as nonpassive when the taxpayer rents the property for use in an activity in which the taxpayer materially participates) or because the rental activity is properly grouped with a trade or business activity under § 1.469-4(d)(1) and the grouped activity is a nonpassive activity, the gross rental income is deemed to be derived in the ordinary course of a trade or business. Furthermore, in both of these instances, the final regulations provide that any gain or loss from the assets associated with that rental activity that are treated as nonpassive gain or loss will also be treated as gain or loss attributable to the disposition of property held in a nonpassive trade or business.

It has been suggested that multiple rental properties in which the taxpayer invests considerable and regular effort should meet the standard of trade or business, even when an agent is engaged to carry out some of the responsibility to manage and maintain the properties.[2401] *Alvary v. U.S.*, 302 F.2d 790 (2nd Cir. 1962), discussed using agents:

> The rental of real estate is a trade or business if the taxpayer-lessor engages in regular and continuous activity in relation to the property, *Pinchot v. Commissioner*, 113 F.2d 718, 719 (2 Cir. 1940); *Gilford v. Commissioner*, 201 F.2d 735, 736 (2 Cir. 1953); *Grier v. United States*, 120 F. Supp. 395 (D. Conn. 1954), *aff'd per curiam*, 218 F.2d 603 (2 Cir. 1955), even if the taxpayer rents only a single piece of real estate. *Lagreide v. Commissioner*, 23 T.C. 508, 512 (1954); *Reiner v. United States*, 222 F.2d 770 (7 Cir. 1955); *Elek v. Commissioner*, 30 T.C. 731 (1958); *Schwarcz v. Commissioner*, 24 T.C. 733, 739 (1955). Of course the owner may carry on these activities through an agent as well as personally. *Pinchot v. Commissioner*, *supra*; *Gilford v. Commissioner*, *supra*; *Elek v. Commissioner*, *supra*; *Schwarcz v. Commissioner*, *supra*, at 739; *Lajtha v. Commissioner*, 20 T.C. M. 1961-273 (1961); 5 Mertens, *Federal Income Taxation*, 1961 Cum. Supp. § 29.06, at 112-13. If the taxpayer, personally or through his agent continuously operates the rental property without deviation from the planned use, the trade or business is sufficiently regular to satisfy the § 122(d)(5) requirement that it be "regularly carried on by the taxpayer." *Lagreide v. Commissioner*, *supra*, at 512; *Elek v. Commissioner*, *supra*; *Schwarcz v. Commissioner*, *supra*, at 739-40; *Daniel v. Commissioner*, 19 T.C.M. 1960-274 (1960). The taxpayer's rental activities in this case clearly satisfy these requirements.[4]

[2401] Holthouse and Ritchie, "Inoculating Real Estate Against the Obamacare Tax," *TM Memorandum* (BNA) (March 11, 2013), also appearing in the *TM Real Estate Journal* (April 3, 2013). Footnote 76 of that articles asserts:

> The fact that services were performed by agents was not detrimental in attaining trade or business status in the following cases: *Reiner v. U.S.*, 222 F.2d 770 (7th Cir. 1955); *Gilford v. Commissioner*, 201 F.2d 735 (2d Cir. 1953); *Post v. Commissioner*, 26 T.C. 1055 (1956). See, however, *Chicago Title & Trust Co. v. U.S.*, 209 F.2d 773 (7th Cir. 1954), where the operation of 25 rental properties managed by real estate firms was considered an investment, rather than a trade or business, of the taxpayer as he was not sufficiently engaged in the operation.

[4] *Elek v. Commissioner*, 30 T. C. 731 (1958); *Daniel v. Commissioner*, 19 T.C.M. 1960-274 (1960); *Lajtha v. Commissioner*, 20 T. C. M. 1961-273 (1961), are other cases in which a net operating loss carryover has been allowed for the 1952 Hungarian nationalization of rental property.

However, one of three inherited properties leased to chain stores on triple-net-leases did not constitute a trade or business. *Union National Bank of Troy v. U.S.*, 195 F.Supp. 382 (N.D. NY 1961), held:

> The record discloses that Louis Gross, the deceased taxpayer, was the distinguished Bank President of the Union National Bank in that city since 1939. It was there he gave his full energy and talent every business day from that time until his death. His one-third interest in 316 River Street came to him under his father's will upon the termination of a trust for his mother, May 29, 1946. This property was a substantial one in the business section of Troy. Like two others he similarly acquired by inheritance, it was subject to net lease of the entire property to chain stores. The lease on 316 River Street was dated March 15, 1930 and executed by his father for twenty years, to expire April 30, 1952, the lessee being F. W. Woolworth Company. The lease was a net lease, and there was no obligation at all on Gross and his family to maintain or repair. Taxes, water rents, ordinary assessments, were all the obligations of the lessee. It is undisputed in the record that Gross did not to any extent, directly or indirectly through agents, have anything at all to do with the management and operation of the property. His passive contact was to receive his share of the rents as paid. The extension of the lease was arranged by his cousin through a broker, and I am content to find that the taxpayer played no active part in the arrangement of such extension. A most significant factor in the record is that the income of Gross for all rented properties in 1953 was $7,887.49; in 1954 $3,594.06, as compared to his declared net income for those years of $80,213.92 and $81,264.06. It would crush reason to conclude in view of these facts that the rental of property was his trade or business. The government concedes in its brief that the taxpayer was not heavily involved in real estate in Troy outside of the inherited properties.

The result was the same with an inherited residential property in which the tenant was also inherited. *Grier v. U.S.*, 120 F.Supp. 395 (D. Conn. 1954), *aff'd* per curiam, 218 F.2d 603 (2d Cir. 1955), in which the trial court held:

> In this case the activities with relation to this single dwelling, although of long duration, were minimal in nature. Activity to rent and re-rent was not required. No employees were regularly engaged for maintenance or repair.
>
> Lacking the broader activity stressed in *Rogers v. U. S.*, D.C. Conn. 1946, 69 F.Supp. 8, and *Pinchot v. C.I. R.*, *Gilford v. C. I. R.* and *Fackler v. C. I. R.*, *supra*, the real estate in this case appears to partake more of the nature of property held for investment than property used in a trade or business. The property in this case, although used for the production of income should not be considered as used in the taxpayer's trade or business.

It has been further suggested that the Board of Tax Appeals and Tax Court have found the mere rental of real property sufficient to constitute a trade or business but that contrary decisions in various appeals courts would suggest that jurisdiction may be an important factor.[2402] The article that made these comments offers excellent planning tips.[2403] Additional clues regarding when rental is a trade or business might be found in the rules governing tax-free split-ups/spin-offs.[2404]

[2402] Holthouse and Ritchie, "Inoculating Real Estate Against the Obamacare Tax," *TM Memorandum* (BNA) (March 11, 2013), also appearing in the *TM Real Estate Journal* (April 3, 2013). Footnotes 77-79 cited *Fackler v. Commissioner*, 45 B.T.A. 708, 714 (1941); *Hazard v. Commissioner*, 7 T.C. 372 (1946) (former residence rented for three years prior to sale) (real estate, even a single property in appropriate circumstances, devoted to rental purposes constitutes property used in a trade or business); *Fegan v. Commissioner*, 71 T.C. 791 (1979); *Lagriede v. Commissioner*, 23 T.C. 508 (1954); *Curphey v. Commissioner*, 73 T.C. 766 (1980) (noting that the ownership and management of such properties would not necessarily, as a matter of law, constitute a trade or business, referring to *Grier v. U.S.*, 218 F.2d 603 (2d Cir. 1955), *aff'g* 120 F. Supp. 395 (D. Conn. 1954)); 561 T.M., "Capital Assets," V.D. The latter included a reference to FSA 200120036 (for purposes of the earned income credit, rental was a trade or business when the taxpayer leased the building to the corporation with continuity and regularity, and the taxpayer's primary purpose for engaging in the rental activity was for profit). Also cited by the "Capital Assets" treatise as favoring trade or business treatment when the taxpayer only holds a single parcel of real property for rent were *Post v. Commissioner*, 26 T.C. 1055 (1956), *acq.*, 1958-1 C.B. 5 (rental of a building managed by an agent was a trade or business); *Campbell v. Commissioner*, 5 T.C. 272 (1945), *acq*., 1947-1 C.B. 1 (inherited property was placed for sale or rent immediately upon being inherited); *Ohio County & Ind. Agr. Soc., Del. County Fair v. Commissioner*, 43 T.C.M. 1126 (1982) (rental property held to constitute a trade or business for Code § 513 purposes); *Crawford v. Commissioner*, 16 T.C. 678, 680-681 (1951), *acq.*, 1951-2 C.B. 2. The "Capital Assets" treatise also mentioned that the standard tends to higher for inherited property that is sold before being operated as a business. All parentheticals above in this footnote describing cases are based on these secondary sources' summaries and not the result of my reading the cases themselves. *Central States, Southeast and Southwest Areas Pension Fund v. Messina Products, LLC*, 2013 WL 466196 (7th Cir. 2013), held that rental to one's own trade or business itself constituted a trade or business for pension withdrawal liability purposes (not a tax case); the court stated that its determination was based on general "trade or business" principles as required by *Commissioner v. Groetzinger*, 480 U.S. 23 (1987). "Simply upgrading his homes with the desire to make a profit on a sale at some time in the future is not sufficient to meet the regular-and-continuous-activity test for a trade or business." *Ohana v. Commissioner*, T.C. Memo. 2014-83, which also rejected an alleged conversion from personal to business use:

> We use five factors to determine whether an individual has converted his personal residence into property held for the production of income:
>
> - the length of time the house was occupied by the individual as his home before placing it on the market for sale;
> - whether the individual permanently abandoned all further personal use of the house;
> - the character of the property;
> - offers to rent; and
> - offers to sell.
>
> *Grant v. Commissioner*, 84 T.C. 809, 825 (1985), *aff'd without published opinion*, 800 F.2d 260 (4th Cir. 1986); *Bolaris v. Commissioner*, 81 T.C. 840 (1983), *aff'd in part, rev'd in part on another issu*e, 776 F.2d 1428, 1433 (9th Cir. 1985).

[2403] Holthouse and Ritchie, "Inoculating Real Estate Against the Obamacare Tax," *TM Memorandum* (BNA) (March 11, 2013) , also appearing in the *TM Real Estate Journal* (April 3, 2013). For additional cases and commentary, see Kehl, "Passive Losses and Tax on Net Investment Income," *T.M. Real Estate Journal* (BNA), Vol. 29, No. 06 (6/5/2013).

[2404] See part II.Q.7.f.iii Active Business Requirement for Code § 355.

The Fall 2018 meeting of the Real Estate Committee of the American Bar Association's Section of Taxation included a panel, "Real Estate Trade or Business –When Does it Matter under Tax Reform?"[2405] Here are some categories of cases cited in the slides:

— *Deductions under section 162*. *Noble*, 7 T.C. 960 (1946), *acq.* 1946-2 C.B. 4.

— *Section 1231 property*.[2406] *Fackler*, 133 F.2d 509 (6th Cir. 1943); *Hazard*, 7 T.C. 372 (1946), *acq.* 1946-2 C.B. 3; *Noble*, 7 T.C. 960 (1946), *acq.* 1946-2 C.B. 3; *Grier*, 120 F.Supp. 395 (D.C. Conn. 1954), *aff'd*, 218 F.2d 603 (2nd Cir. 1955); *Bauer*, 144 Ct.Cl. 308 (1958); *Balsamo*, 54 T.C.M. (CCH) 608 (1987); G.C.M. 38779 (July 27, 1981); P.L.R. 8350008 (Aug. 23, 1983).

— *Inclusion of loss within net operating loss*. *Lagreide*, 23 T.C. 508 (1954).

— *Effectively connected income for non-U.S. taxpayers*. *Pinchot*, 113 F.2d 718 (2nd Cir. 1940); *Neill*, 46 B.T.A. 197 (1942); *Barbour*, 3 T.C.M. (CCH) 216 (1944); *The Investors' Mtge. Sec. Co.*, 4 T.C.M. (CCH) 45 (1945); *Gilford*, 201 F.2d 735 (2nd Cir. 1953); *Lewenhaupt*, 20 T.C. 151 (1953), *aff'd*, 221 F.2d 227 (9th Cir. 1955); *Herbert*, 30 T.C. 26 (1958), *acq.* 1958-2 C.B. 6; *Amodio*, 34 T.C. 894 (1960), *aff'd*, 299 F.2d 623 (3rd Cir. 1962); Rev. Rul. 73-522, 1973-2 C.B. 226.

— *Qualified real property business indebtedness under section 108(c)*. P.L.R. 9426006 (Mar. 25, 1994).

— *Disqualified income under refundable earned income credit*. F.S.A. 200120036 (Mar. 28, 2001).

— *Property eligible for section 38 credit*. *Fegan*, 71 T.C. 791 (1979), *aff'd*, 81-1 U.S.T.C. ¶ 9436 (10th Cir. 1981).

— *Home office expense under section 280A*. *Curphey*, 73 T.C. 766 (1980).

— *Extension of time for payment of estate tax under section 6166*. Rev. Rul. 2006-34, 2006-1 C.B. 1172.

— *GO Zone bonus depreciation*. Notice 2006-77, 2006-2 C.B. 590.

Although the authorities arise in a number of different contexts, courts and the IRS seem to cite the cases interchangeably in determining whether a rental real estate activity rises to the level of a trade or business for purposes of the specific context

— All seem to agree that the activities of a taxpayer's agent will be taken into account in determining whether a taxpayer is engaged in a trade or business. *See, e.g., Gilford*, 201 F.2d 735 (2nd Cir. 1953); Rev. Rul. 2006-34, 2006-1 C.B. 1172.

[2405] Slides had the name of panelists Peter Genz of King & Spalding, LLP, David Leavitt of PwC, Jim Sowell of KPMG LLP, and Tom West of the U.S. Treasury Dept. Who drafted the slides is unclear, but government officials never draft slides for bar association presentations. The slides used KPMG's logo. Peter Genz wrote a separate paper to support the slides.

[2406] [my footnote:] See part II.G.6.a Code § 1231 Property.

A helpful excerpt from Rev. Rul. 2006-34 accompanies fns 7095-7096 in part III.B.5.e.ii.(a) What is a Business?, which construes "trade or business" in the context of an automatic extension of time to pay estate tax on qualifying business interests.

Equipment rental appears to have much easier standards in qualifying as a trade or business.[2407]

Combining all of the ideas above:

- The IRS considers:
  - The type of property (commercial real property versus a residential condominium versus personal property),
  - The number of properties rented, the day-to-day involvement of the owner or its agent, and
  - The type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease).
- The IRS believes that rental of a single property may require regular and continuous involvement to constitute a trade or business, and an example in its regulations requires such participation when an individual leases a commercial property to another person. The fairest view is that, for a single property, it depends.[2408]

[2407] See fns. 3433-3434 in part II.L.2.a.ii Rental Exception to SE Tax, discussing cases in the unrelated business income area (regarding qualified retirement plans, etc.) that apply a very low threshold of activity for treating leasing tangible personal property as a trade or business, using statutory language similar to that used in determining whether income is subject to self-employment tax. I am unaware of any authority addressing the issue of leasing tangible personal property as a trade or business outside of this arena.

[2408] In analyzing the existence of a trade or business under Code § 108, Letter Ruling 9840026 reasoned:

> The rental of even a single property may constitute a trade or business under various provisions of the Code. See, *e.g.*, *Hazard v. Commissioner*, 7 T.C. 372 (1946), *acq.*, 1946-2 C.B. 3 (section 117 of the 1939 Code); *Post v. Commissioner*, 26 T.C. 1055 (1956), *acq.*, 1958-2 C.B. 7 (same); *Gilford v. Commissioner*, 201 F.2d 735 (2d Cir. 1953) (same); *Schwarcz v. Commissioner*, 24 T.C. 733 (1955), *acq.*, 1956-1 C.B. 5 (section 122 of the 1939 Code); *Elek v. Commissioner*, 30 T.C. 731 (1958), *acq.*, 1958-2 C.B. 5 (same); *Fegan v. Commissioner*, 71 T.C. 791 (1979), *aff'd*, 81-1 USTC ¶ 9436 (10th Cir. 1981) (section 482); *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940) (section 302 of 1926 Act); *Flint v. Stone Tracy Co.*, 220 U.S. 107, 171 (1911) (Corporation Tax). However, the ownership and rental of property does not always constitute a trade or business. See *Neill v. Commissioner*, 46 B.T.A. 197 (1942); Rev. Rul. 73-522, 1973-2 C.B. 226. The issue of whether the rental of property is a trade or business of a taxpayer is ultimately one of fact in which the scope of a taxpayer's activities, either personally or through agents, in connection with the property, are so extensive as to rise to the stature of a trade or business. *Bauer v. United States*, 168 F.Supp. 539, 541 (Ct. C1. 1958); *Schwarcz v. Commissioner*, 24 T.C. 733 (1955); See *Higgins v. Commissioner*, 312 U.S. 212 (1941) (management of taxpayer's own investment portfolio not a business).
>
> In Rev. Rul. 73-522, 1973-2 C.B. 226, the Service held that rental of real property under a "net lease" does not render the lessor engaged in a trade or business with respect to such property for purposes of section 871 of the Code. Section 871 provides special rules for taxation of a

Thus, in planning rental activities:

1. First consider the extent to which the rental income qualifies as self-charged rental that is excluded from NII.

2. If the self-charged rental rules do not provide sufficient protection (or if the rental is not self-charged), consider moving away from leases in which the landlord does nothing and moving towards leases in which the landlord provides significant services, such as inside and outside maintenance, repairs, etc., even if the tenant ultimately bears the burden of the expenses. However, as noted in the discussion of Reg. § 1.1411-4(g)(7)(ii)(B) in part II.I.8.c.ii Real Estate Classified as Nonpassive for Real Estate Professionals, a real estate professional might not need to take this step if the professional has enough activity that does constitute a trade or business.

3. Consider that the self-charged rules might not always apply in the same way in the future as they do today. Even if the law does not change, owner, consider that ownership of the business or ownership of the rental property might change in a way that makes the self-charged rental rules no longer apply. Because grouping elections are difficult to change, consider making grouping elections with these possible ownership changes in mind. Also, grouping elections can affect whether rental is considered self-charged.

4. Finally, consider contributing the property to the partnership and receiving a preferred profit return in lieu of rent, as well as a special allocation of any gain on the sale of the property. See part II.E Recommended Structure for Entities.

If the tax savings are significant enough, one might want to avoid the uncertainty of the rental issue and instead place the business operations and the rented property in the same umbrella.[2409]

See also part II.G.26 Real Estate Special Issues.

II.I.8.d. Partnership Structuring in Light of the 3.8% Tax on Net Investment Income

II.I.8.d.i. Interest for Use of Capital Compared with Distributive Share

Based on the principles described in this part II.I.8.d:

For operating businesses, a distributive share provides better tax treatment than a guaranteed payment of interest, if the partner is a limited partner in a partnership and materially participates.

Note, however, that, for taxpayers with modest incomes, NII tax does not apply, and self-employment (SE) tax looms large, because SE tax is at a high rate all the way up to the taxable

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nonresident alien engaged in a trade or business in the United States. Under the facts of the ruling, the taxpayer owned rental property situated in the United States that was subject to long-term leases providing for monthly payments by the lessee of real estate taxes, operating expenses, ground rent, repairs, interest and principal on existing mortgages, and insurance in connection with the leased property. See also *Neill v. Commissioner*, 46 B.T.A. 197 (1942).

For more on Rev. Rul. 73-522 and related cases regarding whether nonresident aliens holding U.S. real estate are engaging in a trade or business, see part II.E.1.e.ii Real Estate As a Trade or Business under the Effectively Connected Income (ECI) Rules.

[2409] See part II.E.9 Real Estate Drop Down into Preferred Limited Partnership.

wage base and applies to SE earnings regardless of the taxpayer's overall adjusted gross income.[2410]

For high income taxpayers, SE tax might be better than NII tax, because they can deduct 1.45% of the 2.9% or 3.8% Medicare tax.

II.I.8.d.ii. Overview of Interaction between Code § 1411 and Code §§ 707(c) and 736

The preamble to 2013 proposed regulations explain their concerns regarding certain compensation and exit strategies:[2411]

> Section 731(a) treats gain from distributions as gain from the sale or exchange of a partnership interest. In general, the section 1411 treatment of gain to a partner under section 731 is governed by the rules of section 1411(c)(1)(A)(iii). Such gain is thus generally treated as net investment income for purposes of section 1411 (other than as determined under section 1411(c)(4)). However, certain partnership payments to partners are treated as not from the sale or exchange of a partnership interest. These payments include section 707(c) guaranteed payments for services or the use of capital and certain section 736 distributions to a partner in liquidation of that partner's partnership interest. Because these payments are not treated as from the sale or exchange of a partnership interest, their treatment under section 1411 may differ from the general rule of section 1411(c)(1)(A)(iii). The proposed regulations therefore provide rules for the section 1411 treatment of these payments.

For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

II.I.8.d.iii. Treatment of Code § 707(c) Guaranteed Payments under Code § 1411

Regarding guaranteed payments, the preamble to the 2013 proposed regulations explains:[2412]

> Section 707(c) provides that a partnership payment to a partner is a "guaranteed payment" if the payment is made for services or the use of the capital, and the payment amount does not depend on partnership income. Section 1.707-1(c) provides that guaranteed payments to a partner for services are considered as made to a person who is not a partner, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, section 162(a) (relating to trade or business expenses). Section 1.704-1(b)(2)(iv)(o) provides that guaranteed payments are not part of a partner's distributive share for purposes of section 704(b).
>
> The proposed regulations' treatment of section 707(c) guaranteed payments under section 1411 depends on whether the partner receives the payment for services or the use of capital. The proposed regulations exclude all section 707(c) payments received

[2410] For self-employment tax rates and strategies, see part II.L Self-Employment Tax (FICA), especially part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax, as well as part II.Q.1.d.iii Timeline for FICA and Income Taxation of Deferred Compensation, especially fn. 4193, the latter for rates.

[2411] REG-130843-13, which would apply "to taxable years beginning after December 31, 2013. However, taxpayers may apply this section to taxable years beginning after December 31, 2012 in accordance with § 1.1411-1(f).

[2412] REG-130843-13.

> for services from net investment income, regardless of whether these payments are subject to self-employment tax, because payments for services are not included in net investment income.
>
> The Treasury Department and the IRS believe that guaranteed payments for the use of capital share many of the characteristics of substitute interest, and therefore should be included as net investment income. This treatment is consistent with existing guidance under section 707(c) and other sections of the Code in which guaranteed payments for the use of capital are treated as interest. See, for example, §§ 1.263A-9(c)(2)(iii) and 1.469-2(e)(2)(ii).

Prop. Reg. § 1.1411-4(g)(10) provides the above rules.[2413]

For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

For the self-employment consequences of guaranteed payments for services, see parts II.L.3 Self-Employment Tax: General Partner or Sole Proprietor and II.L.4 Self-Employment Tax Exclusion for Limited Partner.

II.I.8.d.iv. Treatment of Code § 736 Redemption Payments under Code § 1411

Regarding payments to a retiring partner,[2414] the preamble to the 2013 proposed regulations explains certain general ideas:[2415]

> Section 736 applies to payments made by a partnership to a retiring partner or to a deceased partner's successor in interest in liquidation of the partner's entire interest in the partnership. Section 736 does not apply to distributions made to a continuing

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[2413] The proposed regulation provides:

> Treatment of section 707(c) guaranteed payments. Net investment income does not include section 707(c) payments received for services. Except to the extent provided in paragraph (g)(11)(iii)(A) of this section, section 707(c) payments received for the use of capital are net investment income within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section.

However, I do not believe that the last sentence of the quote above ends the story; I believe that it merely suggests under what category payments for the use of capital would be tested. Prop. Reg. § 1.1411-4(g)(11)(iii)(A), described further below, applies to Code § 736(a)(2) payments for Code § 751(c) unrealized receivables and for goodwill and states that those payments are included in NII under the sale-of-business category. Prop. Reg. § 1.1411-4(g)(11)(iii)(B) coordinates with (A) and characterizes payments other than for unrealized receivables and goodwill as for services or interest. To me, this reference to treatment as NII under these buckets means merely that one tests these items under those buckets – not that they will automatically be NII; otherwise, the sale of an active business under Code § 736 would be treated less favorably than the sale of a partnership interest other than to the partnership or the sale of an interest in a sole proprietorship or S corporation, and the spirit of the preamble to the proposed regulations is to provide parity to partnership redemptions – not to place them at a disadvantage. Fn. 2418 clarifies that the Code § 1411(c)(4) exclusion from NII on the sale of a partnership interest would apply.

The self-charged interest rules apply to Code § 707(c) payments. Reg. § 1.469-7(a)(1). I believe that the "better" reading is that they apply to treat Code § 707(c) guaranteed payments for the use of capital as interest subject to the self-charged interest exclusion from NII . See fn. 2360.

[2414] See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

[2415] REG-130843-13.

> partner, distributions made in the course of liquidating a partnership entirely, or to payments received from persons other than the partnership in exchange for the partner's interest. Section 736 categorizes liquidating distributions based on the nature of the payment as in consideration for either the partner's share of partnership property or the partner's share of partnership income. Section 736(b) generally treats a payment in exchange for the retiring partner's share of partnership property as a distribution governed by section 731. Section 736(a) treats payments in exchange for past services or use of capital as either distributive share or a guaranteed payment. Section 736(a) payments also include payments to retiring general partners of service partnerships in exchange for unrealized receivables (other than receivables described in the flush language of section 751(c)) or for goodwill (other than payments for goodwill provided for in the partnership agreement) (collectively, "Section 736(a) Property").
>
> Because the application of section 1411 depends on the underlying nature of the payment received, the section 736 categorization controls whether a liquidating distribution is treated as net investment income for purposes of section 1411. Thus, the treatment of the payment for purposes of section 1411 differs depending on whether the distribution is a section 736(b) distribution in exchange for partnership property or a section 736(a) distribution in exchange for past services, use of capital, or Section 736(a) Property. Among section 736(a) payments, the proposed regulations further differentiate the treatment of payments depending on: (i) whether or not the payment amounts are determined with regard to the income of the partnership and (ii) whether the payment relates to Section 736(a) Property or relates to services or use of capital.
>
> Section 1.469-2(e)(2)(iii) contains rules pertaining to whether section 736 liquidating distributions paid to a partner will be treated as income or loss from a passive activity. Where payments to a retiring partner are made over a period of years, the composition of the assets and the status of the partner as passive or nonpassive may change. Section 1.469-2(e)(2)(iii) contains rules on the extent to which those payments are classified as passive or nonpassive for purposes of section 469. The proposed regulations generally align the section 1411 characterization of section 736 payments with the treatment of the payments as passive or nonpassive under § 1.469-2(e)(2)(iii).

These rules regarding Code § 736 payments do not apply to distributions from qualified retirement plans or self-employment earnings.[2416]

Regarding Code § 736(b) payments for partnership property, the preamble to the 2013 proposed regulations explains certain general ideas:[2417]

> Section 736(b) payments to retiring partners in exchange for partnership property (other than payments to retiring general partners of service partnerships in exchange for

[2416] Prop. Reg. § 1.1411-4(g)(11)(i) provides:

> In general. The treatment of payments received by a retiring partner or a deceased partner's successor in interest described in section 736 is determined under the rules of this paragraph (g)(11). Section 736 payments are not distributions from a plan or arrangement described in section 1411(c)(5) and § 1.1411-8 [qualified retirement plans, etc.]. To the extent that any portion of a section 736 payment is taken into account in computing a taxpayer's net earnings from self-employment (within the meaning of § 1.1411-9), then such amount is not taken into account in computing net investment income by reason of section 1411(c)(6) and § 1.1411-9.

[2417] REG-130843-13.

> Section 736(a) Property) are governed by the rules generally applicable to partnership distributions. Thus, gain or loss recognized on these distributions is treated as gain or loss from the sale or exchange of the distributee partner's partnership interest under section 731(a).
>
> The proposed regulations provide that section 736(b) payments will be taken into account as net investment income for section 1411 purposes under section 1411(c)(1)(A)(iii) as net gain or loss from the disposition of property. If the retiring partner materially participates in a partnership trade or business, then the retiring partner must also apply § 1.1411-7 of these proposed regulations to reduce appropriately the net investment income under section 1411(c)(4).[2418] Gain or loss relating to section 736(b) payments is included in net investment income under section 1411(c)(1)(A)(iii) regardless of whether the payments are classified as capital gain or ordinary income (for example, by reason of section 751).
>
> In the case of section 736(b) payments that are paid over multiple years, the proposed regulations provide that the characterization of gain or loss as passive or nonpassive is determined for all payments as though all payments were made at the time that the liquidation of the exiting partner's interest commenced and is not retested annually. The proposed regulations thus adopt for section 1411 purposes the section 469 treatment of section 736(b) payments paid over multiple years as set forth in § 1.469-2(e)(2)(iii)(A).

Thus, Code § 736(b) payments are treated as sales of partnership interests,[2419] and Code § 736(b) payments are treated as an installment sale in the year of disposition for Code § 1411 purposes[2420] even though for income tax purposes each year's payment stands alone.[2421]

Regarding Code § 736(a) payments for partnership goodwill, etc., the preamble to the 2013 proposed regulations explains certain general ideas:[2422]

> As described in part 2.B.i., section 736 provides for several different categories of liquidating distributions under section 736(a). Payments received under section 736(a) may be an amount determined with regard to the income of the partnership taxable as distributive share under section 736(a)(1) or a fixed amount taxable as a guaranteed payment under section 736(a)(2). The categorization of the payment as distributive

[2418] This sentence is key to interpreting Prop. Reg. § 1.1411-4(g)(11)(iii). One might construe Prop. Reg. § 1.1411-4(g)(11)(iii)(A) as making certain payments per se NII; this sentence instead provides the correct context – Prop. Reg. § 1.1411-4(g)(11)(iii)(A) merely described under which bucket to categorize the payment if it is NII, and then apply the Code § 1411(c)(4) exclusion from gain on sale after placing the item in the bucket.

[2419] Prop. Reg. § 1.1411-4(g)(ii)(iv) provides:

> Gain or loss attributable to section 736(b) payments is included in net investment income under section 1411(c)(1)(A)(iii) and paragraphs (a)(1)(iii) and (d) of this section as gain or loss from the disposition of a partnership interest.

[2420] Prop. Reg. § 1.1411-4(g)(ii)(iv) provides:

> A taxpayer who elects under § 1.736-1(b)(6) must apply the principles that are applied to installment sales in § 1.1411-7(d).

[2421] See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736, especially fns. 5495 and 5522 and the accompanying text.

[2422] REG-130843-13.

share or guaranteed payment will govern the treatment of the payment for purposes of section 1411.

> The determination of whether section 736(a) payments received over multiple years are characterized as passive or nonpassive depends on whether the payments are received in exchange for Section 736(a) Property. With respect to section 736(a)(1) payments in exchange for Section 736(a) Property, § 1.469-2(e)(2)(iii)(B) provides a special rule that computes a percentage of passive income that would result if the partnership sold the retiring partner's entire share of Section 736(a) Property at the time that the liquidation of the partner's interest commenced. The percentage of passive income is then applied to each payment received. See § 1.469-2(e)(2)(iii)(B)(1). These rules apply to section 736(a)(1) and section 736(a)(2) payments for Section 736(a) Property. The proposed regulations adopt this treatment as set forth in section 469 for purposes of section 1411.

When Code § 736(a) payments for partnership goodwill, etc. are taxable as a distributive share, the preamble to the 2013 proposed regulations explains:[2423]

> Section 736(a)(1) provides that if the amount of a liquidating distribution (other than a payment for partnership property described in section 736(b)) is determined with regard to the partnership's income, then the payment is treated as a distributive share of income to the retiring partner. For purposes of section 1411, the items of income, gain, loss, and deduction attributable to the distributive share are taken into account in computing net investment income under section 1411(c)(1) in a manner consistent with the item's chapter 1 character and treatment. For example, if the partner's distributive share includes income from a trade or business not described in section 1411(c)(2), that income will be excluded from net investment income. However, if the distributive share includes, for example, interest income from working capital, then that income is net investment income.
>
> The proposed regulations treat section 736(a)(1) payments unrelated to Section 736(a) Property as characterized annually as passive or nonpassive by applying the general rules of section 469 to each payment in the year received. To the extent that any payment under section 736(a)(1) is characterized as passive income under the principles of section 469, that payment also will be characterized as passive income for purposes of section 1411.

Thus, the 2013 proposed regulations treat Code § 736(a)(1) payments consistent with their character for regular income tax purposes, including their character under the passive loss rules.[2424] If a retiring partner receives a distributive share of the partnership's income in exchange for that partner's shares of the partnership's unrealized receivables and the partner materially participated in the partnership's trade or business before retiring, the distributive

[2423] REG-130843-13.

[2424] Prop. Reg. § 1.1411-4(g)(11)(ii)(A) provides:

> General rule. In the case of a payment described in section 736(a)(1) as a distributive share of partnership income, the items of income, gain, loss, and deduction attributable to such distributive share are taken into account in computing net investment income in section 1411(c) in a manner consistent with the item's character and treatment for chapter 1 purposes. See § 1.469-2(e)(2)(iii) for rules concerning the item's character and treatment for chapter 1.

See part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736. Fn. 2418 points out that the Code § 1411(c)(4) exclusion from NII on the sale of a partnership interest would apply.

share is not NII.[2425] However, payments that exceeded the partner's shares of the partnership's unrealized receivables needed to be tested annually to determine whether the distributive share of operating income and deductions would be NII, presumably because the payments (described as an incentive to retire early) were not for the partnership's underlying assets;[2426] note that a retired partner generally would not be materially participating, although it is possible that the retired partner might still have some time remaining under the rule that looks to participation in 5 of the past 10 years[2427] or if the activity were a personal service activity in which the taxpayer materially participated for any 3 years.[2428]

When Code § 736(a) payments for partnership goodwill, etc. are taxable as guaranteed payments, the preamble to the 2013 proposed regulations explains:[2429]

> Section 736(a)(2) provides that if the amount of a liquidating distribution (other than a payment for partnership property described in section 736(b)) is determined without regard to the partnership's income, then the payment is treated as a guaranteed payment as described in section 707(c). Payments under section 736(a)(2) might be in exchange for services, use of capital, or Section 736(a) Property. The section 1411 treatment of guaranteed payments for services or the use of capital follows the general rules for guaranteed payments set forth in part 2.A of this preamble. Thus, section 736(a)(2) payments for services are not included as net investment income, and section 736(a)(2) payments for the use of capital are included as net investment income.
>
> Section 736(a)(2) payments in exchange for Section 736 Property are treated as gain or loss from the disposition of a partnership interest, which is generally included in net investment income under section 1411(c)(1)(A)(iii). If the retiring partner materially participates in a partnership trade or business, then the retiring partner must also apply § 1.1411-7 of these proposed regulations to reduce appropriately the net investment income under section 1411(c)(4). To the extent that section 736(a)(2) payments exceed the fair market value of Section 736(a) Property, the proposed regulations provide that the excess will be treated as either interest income or as income in exchange for services, in a manner consistent with the treatment under § 1.469-2(e)(2)(iii).

For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

When Code § 736 payments are taxable as guaranteed payments or considered attributable to the sale of the partnership's underlying assets, the preamble to the 2013 proposed regulations explains:[2430]

> The proposed regulations provide that section 1411(c)(4) applies to section 736(a)(2) and section 736(b) payments. Thus, the inclusion of these payments as net investment

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[2425] Prop. Reg. § 1.1411-4(g)(11)(ii)(B), Example (1). However, the example did not exclude the income if it was from financial instruments and commodities.
[2426] Prop. Reg. § 1.1411-4(g)(11)(ii)(B), Example (2).
[2427] See part II.K.1.a.ii Material Participation.
[2428] See part II.K.1.a.ii Material Participation, including fn. 3065, referring to activity that involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or is a trade or business in which capital is not a material income-producing factor.
[2429] REG-130843-13.
[2430] REG-130843-13.

income may be limited if the retiring partner materially participated in all or a portion of the partnership's trade or business. The extent of any limitation is determined under the rules of § 1.1411-7.

The proposed regulations provide that, when section 736 payments are made over multiple years, the characterization of gain or loss as passive or nonpassive and the values of the partnership assets are computed for all payments as though all payments were made at the time that the liquidation of the exiting partner's interest commenced, similar to the treatment in § 1.469-2(e)(2)(iii)(A).

If a partner's net investment income is reduced pursuant to section 1411(c)(4), then the difference between the amount of gain recognized for chapter 1 and the amount includable in net investment income after the application of section 1411(c)(4) is treated as an addition to basis, in a manner similar to an installment sale for purposes of calculating the partner's net investment income attributable to these payments.

To the extent that a guaranteed payment redeeming a partner's interest is allocable to the partnership's unrealized receivables[2431] and goodwill,[2432] for NII purposes it is treated as gain from the disposition of a partnership interest.[2433] To the extent that a guaranteed payment redeeming a partner's interest is not allocable to the partnership's unrealized receivables and goodwill, for NII purposes it is treated as payment for services[2434] or the payment of interest consistent with its characterization under the passive loss rules.[2435]

To summarize testing regarding the passive or nonpassive character of income from trade or business activities:

- Code § 736(a)(2) guaranteed payments and Code § 736(b) payments are tested at the time of the disposition, even though for regular income tax purposes they are treated as separate payments each year.

- Code § 736((a)(1) payments are tested annually, which might be a disadvantage to a partner who no longer participates in the business, subject to certain favorable rules regarding prior participation.[2436]

[2431] Within the meaning of Code § 751(c).
[2432] As described and calculated in Reg. § 1.469-2(e)(2)(iii)(B). See part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736, especially fn. 3186.
[2433] Prop. Reg. § 1.1411-4(g)(11)(iii)(A).
[2434] Because this characterization is only for NII purposes (see fn. 2276), presumably it has no effect on the favorable treatment for self-employment tax of payments described in part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.
[2435] Prop. Reg. § 1.1411-4(g)(11)(iii)(B), referring to Reg. § 1.469-2(e)(2)(ii); see part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736. The provision cross-references Reg. § 1.1411-4(g)(9), which provides that losses allowed in computing taxable income by reason of Code § 469(g) (disposition of an entire interest in a passive activity) are taken into account in computing net gain under Reg. § 1.1411-4 (d) or as properly allocable deductions under Reg. § 1.1411-4(f), as applicable, in the same manner as such losses are taken into account in computing taxable income under Code § 63. Code § 469(g), the rule governing the disposition of a passive activity, is described in part II.K.1.j Complete Disposition of Passive Activity. Note that part or all of a self-charged interest component may be excluded from NII. See fn. 2360.
[2436] For the favorable rules regarding prior participation, see text accompanying fns. 2427-2428.

II.I.8.e. NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation

Part 8 of the preamble to the 2012 proposed regulations describes how Code § 1411 approaches the sale of an interest in a partnership or S corporation:

> In most cases, an interest in a partnership or S corporation is not property held in a trade or business. Therefore, gain or loss from the sale of a partnership interest or S corporation stock will be subject to section 1411(c)(1)(A)(iii). See also section 731(a) and section 1368(b)(2) (providing that the gain recognized when cash is distributed in excess of the adjusted basis of, as applicable, a partner's interest in a partnership or a shareholder's stock in an S corporation is treated as gain from the sale or exchange of such partnership interest or S corporation stock).
>
> Section 1411(c)(4)(A) provides that, in the case of a disposition of an interest in a partnership or S corporation, gain from such disposition shall be taken into account under section 1411(c)(1)(A)(iii) only to the extent of the net gain which would be so taken into account by the transferor under section 1411(c)(1)(A)(iii) if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest. Section 1411(c)(4)(B) applies a similar rule to a loss from a disposition.
>
> For purposes of section 1411, Congress intended section 1411(c)(4) to put a transferor of an interest in a partnership or S corporation in a similar position as if the partnership or S corporation had disposed of all of its properties and the accompanying gain or loss from the disposition of such properties passed through to its owners (including the transferor). However, the gain or loss upon the sale of an interest in the entity and a sale of the entity's underlying properties will not always match. First, there may be disparities between the transferor's adjusted basis in the partnership interest or S corporation stock and the transferor's share of the entity's adjusted basis in the underlying properties. See Example 2 of proposed § 1.1411-7(e). Second, the sales price of the interest may not reflect the proportionate share of the underlying properties' fair market value with respect to the interest sold.
>
> In order to achieve parity between an interest sale and an asset sale, section 1411(c)(4) must be applied on a property-by-property basis, which requires a determination of how the property was held in order to determine whether the gain or loss to the transferor from the hypothetical disposition of such property would have been gain or loss subject to section 1411(c)(1)(A)(iii). As described in proposed § 1.1411-4(a)(1)(iii) and proposed § 1.1411-4(d), section 1411(c)(1)(A)(iii) applies if the property disposed of is either not held in a trade or business, or held in a trade or business described in proposed § 1.1411-5. In other words, under the proposed regulations, the exception in section 1411(c)(4) is only applicable where the property is held in a trade or business not described in section 1411(c)(2). See JCT 2011 Explanation, at 364, fn. 976 (and accompanying text); Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patient Protection and Affordable Care Act" (JCX-18-10) (Mar. 21, 2010), at 135 fn. 286 (and accompanying text) (JCT 2010 Explanation). This means that the exception in section 1411(c)(4) does not apply where (1) there is no trade or business, (2) the trade or business is a passive activity (within the meaning of proposed § 1.1411-5(a)(1)) with respect to the transferor, or (3) where the partnership or the S corporation is

> in the trade or business of trading in financial instruments or commodities (within the meaning of proposed § 1.1411-5(a)(2)), because in these cases there would be no change in the amount of net gain determined under proposed § 1.1411-4(a)(1)(iii) upon an asset sale under section 1411(c)(4). For example, if the transferor is passive with respect to the entity's trade or business, the application of the deemed asset sale rule under section 1411(c)(4), as described in part 8.A of this preamble, would not adjust the transferor's section 1411(c)(1)(A)(iii) gain on the disposition of the interest….

Getting into the details, Reg. § 1.1411-4(a)(1)(iii) taxes as net investment income:

> Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property, except to the extent excluded by the exception described in paragraph (d)(4)(i)(A) of this section for gain or loss attributable to property held in a trade or business not described in § 1.1411-5.

Reg. § 1.1411-4(d)(4)(i)(A) provides:

> Net gain does not include gain or loss attributable to property (other than property from the investment of working capital (as described in § 1.1411-6)) held in a trade or business not described in § 1.1411-5.

Reg. § 1.1411-4(d)(4)(i)(B)(1) provides:

> A partnership interest or S corporation stock generally is not property held in a trade or business. Therefore, gain from the sale of a partnership interest or S corporation stock is generally gain described in paragraph (a)(1)(iii) of this section. However, net gain does not include certain gain or loss attributable to the disposition of certain interests in partnerships and S corporations as provided in § 1.1411-7.

Reg. § 1.1411-5(a) provides:

> *In general*. A trade or business is described in this section if such trade or business involves the conduct of a trade or business, and such trade or business is either--
>
> (1) A passive activity (within the meaning of paragraph (b) of this section) with respect to the taxpayer; or
>
> (2) The trade or business of a trader trading in financial instruments (as defined in paragraph (c)(1) of this section) or commodities (as defined in paragraph (c)(2) of this section).

For whether assets are used in a business, see part II.I.8.a.v Working Capital Is NII (as describing Reg. § 1.1411-6). However, ultimately part II.I.8.a.v.(b) What Is Working Capital provides an additional exclusion under Reg. § 1.1411-7, which needs to be addressed anyway, as described in Reg. § 1.1411-4(d)(4)(i)(B)(1) above.

Note that qualified self-created intangible assets used in a business are never passive; see part II.K.1.g Not Passive If Gain from Sale of Self-Created Intangible. (Goodwill is within the definition but is not specifically mentioned. For taxation of the sale of goodwill, see part II.Q.1.c Personal Goodwill and Covenants Not to Compete.[2437] Arguably, personal goodwill in connection with an individual's work in a C corporation is also excluded from NII.[2438]) Thus, such assets are not described in Reg. § 1.1411-5(a) and do qualify for the exception from NII under Reg. § 1.1411-4(a)(1)(iii). I do not view this as the exclusive way to protect gain from the sale of intangible assets from NII tax; I just wanted to point out this provision.

The preamble to the final regulations explains:[2439]

> In the case of the disposition of an interest in a partnership or an S corporation, section 1411(c)(4) provides that gain or loss from such disposition is taken into account for purposes of section 1411(c)(1)(A)(iii) only to the extent of the net gain or net loss that would be so taken into account by the transferor if all property of the partnership or S corporation were sold at fair market value immediately before the disposition of such interest. Section 1.1411-7 of the final regulations is reserved for guidance under section 1411(c)(4). However, regulations are being proposed contemporaneously with these final regulations that address the application of section 1411(c)(4) to dispositions of interests in partnerships or S corporations.

The preamble to the 2013 proposed regulations summarized these rules:[2440]

> 9. Calculation of Gain or Loss Attributable to the Disposition of Certain Interests in Partnerships and S corporations
>
> Section 1411(c)(4)(A) provides that, in the case of a disposition of an interest in a partnership or of stock in an S corporation (either, a "Passthrough Entity"), gain from the disposition shall be taken into account under section 1411(c)(1)(A)(iii) only to the extent of the net gain which would be taken into account by the transferor if the Passthrough Entity sold all of its property for fair market value immediately before the disposition of the interest. Section 1411(c)(4)(B) provides a similar rule for losses from dispositions.
>
> The 2012 Proposed Regulations required that a transferor of a partnership interest or S corporation stock first compute its gain (or loss) from the disposition of the interest in the Passthrough Entity to which section 1411(c)(4) may apply, and then reduce that gain (or loss) by the amount of non-passive gain (or loss) that would have been allocated to the transferor upon a hypothetical sale of all of the Passthrough Entity's assets for fair market value immediately before the transfer. The Treasury Department and the IRS received several comments questioning this approach based on the commentators' reading of section 1411(c)(4) to include gain/loss from the disposition of a partnership interest or S corporation stock only to the extent of the transferor's share of gain/loss from the Passthrough Entity's passive assets.
>
> The 2013 Final Regulations do not provide rules regarding the calculation of net gain from the disposition of an interest in a Passthrough Entity to which section 1411(c)(4) may apply. After considering the comments received, the Treasury Department and the IRS have withdrawn the 2012 Proposed Regulations implementing section 1411(c)(4) and are issuing this notice of proposed rulemaking to propose revised rules for the

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[2437] Self-created goodwill is taxed differently than purchased goodwill. See part II.Q.1.c.i Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation.

[2438] See Hesse, "Personal Goodwill and the Net Investment Income Tax," *The Tax Adviser* 5/1/2016.

[2439] T.D. 9655.

[2440] REG-130843-13.

implementation of section 1411(c)(4) adopting the commentators' suggestion. Accordingly, the 2013 Final Regulations reserve on this issue.

Proposed § 1.1411-7(b) provides a calculation to determine how much of the gain or loss that is recognized for chapter 1 purposes is attributable to property owned, directly or indirectly, by the Passthrough Entity that, if sold, would give rise to net gain within the meaning of section 1411(c)(1)(A)(iii) ("Section 1411 Property"). Section 1411 Property is any property owned by, or held through, the Passthrough Entity that, if sold, would result in net gain or loss allocable to the partner or shareholder that is includable in determining the partner or shareholder's net investment income under § 1.1411-4(a)(1)(iii). This definition recognizes that the items of property inside the Passthrough Entity that constitute Section 1411 Property might vary among transferors because a transferor may or may not be "passive" with respect to the property.

Proposed § 1.1411-7(c) provides an optional simplified reporting method that qualified transferors may use in lieu of the calculation described in proposed § 1.1411-7(b). Proposed § 1.1411-7(d) contains additional rules that apply when a transferor disposes of its interest in the Passthrough Entity in a deferred recognition transaction to which section 1411 applies. Proposed § 1.1411-7(f) provides rules for adjusting the amount of gain or loss computed under this paragraph for transferors subject to basis adjustments required by § 1.1411-10(d). Proposed § 1.1411-7(g) provides rules for information disclosures by a Passthrough Entity to transferors and for information reporting by individuals, trusts, and estates.

Net gain constituting NII does not include gain or loss attributable to property (other than property from the investment of working capital)[2441] held in a nonpassive trade or business.[2442]

Thus, to determine whether net gain is from property held in a trade or business:[2443]

1. A partnership interest or S corporation stock generally is not property held in a trade or business. Therefore, gain from the sale of a partnership interest or S corporation stock is generally NII. However, net gain constituting NII does not include certain gain or loss attributable to the disposition of certain interests in partnerships and S corporations that is attributable to their business assets, to the extent provided in Reg. § 1.1411-7.

2. In the case of an individual, estate, or trust that owns or engages in a trade or business,[2444] the determination of whether net gain that is ordinarily NII is attributable to property held in a trade or business is made at the individual, estate, or trust level.[2445]

3. In the case of an individual, estate, or trust that owns an interest in a partnership or an S corporation, and that entity is engaged in a trade or business, the determination of whether net gain that is ordinarily NII from such entity is:[2446]

[2441] As described in Reg. § 1.1411-6.
[2442] Reg. § 1.1411-4(d)(4)(i)(A).
[2443] Reg. § 1.1411-4(d)(4)(i)(B).
[2444] Whether directly or indirectly through ownership of an interest in an entity that is disregarded under the check-the-box rules under Reg. § 301.7701-3.
[2445] Reg. § 1.1411-4(d)(4)(i)(B)(3).
[2446] Reg. § 1.1411-4(d)(4)(i)(B)(3).

- from a passive trade or business activity is determined at the owner level; and
- derived in trade or business of a trader trading in financial instruments or commodities[2447] is determined at the entity level.

See also part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets.

The preamble to the final regulations explains how Code § 469(g) (the rule governing the disposition of a passive activity, which is described in part II.K.1.j Complete Disposition of Passive Activity) interacts with the 3.8% tax:[2448]

> Section 469(g)(1) provides, in relevant part, that if all gain or loss realized on a disposition is recognized, the excess of any loss from that activity for such taxable year (determined after the application of section 469(b)), over any net income or gain for that taxable year from all other passive activities (determined after the application of section 469(b)), shall be treated as a loss which is not from a passive activity. The preamble to the proposed regulations requested comments on "whether the losses triggered under section 469(g)(1) upon the disposition should be taken into account in determining the taxpayer's net gain on the disposition of the activity under section 1411(c)(1)(A)(iii) or whether the losses should be considered properly allocable deductions to gross income and net gain described in section 1411(c)(1)(A)(i) through (iii)." Because section 469(g)(1) provides that the allowed loss is treated as a loss "which is not from a passive activity," there is a question whether this language prevents the allowed losses from being treated as "properly allocable deductions" from passive activities for purposes of section 1411.
>
> Commentators recommended that losses allowed under section 469(g) be taken into account in computing net gain under section 1411(c)(1)(A)(iii), and that any net loss in section 1411(c)(1)(A)(iii) resulting from the use of such losses should be treated as a properly allocable deduction under section 1411(c)(1)(B). One commentator suggested that, to the extent a taxpayer has a net loss under section 1411(c)(1)(A)(iii) that is attributable to the allowed loss under section 469(g), the excess section 469(g) loss should continue to be suspended and carried forward to offset future gain resulting from the disposition of other passive assets subject to inclusion in section 1411(c)(1)(A)(iii).
>
> The final regulations provide that section 469(g) losses, which are treated as losses from a nonpassive activity, are taken into account for net investment income purposes in the same manner in which they are taken into account for chapter 1 purposes. As discussed in the context of section 469(f), section 469 does not alter the character or nature of the suspended passive loss. If the suspended losses allowed as a current year deduction by reason of section 469(g)(1) are attributable to operating deductions in excess of operating income, such suspended losses retain that character as, in most

[2447] Reg. § 1.1411-5(c) discusses financial instruments and commodities.

[2448] T.D. 9655. Reg. § 1.1411-4(g)(9) provides:

> *Treatment of section 469(g)(1) losses*. Losses allowed in computing taxable income by reason of section 469(g) are taken into account in computing net gain under paragraph (d) of this section or as properly allocable deductions under paragraph (f) of this section, as applicable, in the same manner as such losses are taken into account in computing taxable income (as defined in section 63).

See Reg. § 1.1411-4(g)(8)(iii), Example (2).

> cases, deductions described in section 62(a)(1) or 62(a)(4). However, to the extent the suspended losses are comprised of losses originating from the disposition of property (such as ordinary section 1231 losses or capital losses), those losses also retain their character when they are ultimately allowed by section 469. Therefore, losses that are allowed by reason of section 469(g) may constitute properly allocable deductions under section 1411(c)(1)(B) or may be included within the calculation of net gain in section 1411(c)(1)(A)(iii) in the year they are allowed, depending on the underlying character and origin of such losses. The recommendations proposed by the commentators depart from the general operating principles in chapter 1 and add additional complexity. Therefore, the final regulations do not adopt the positions advanced by commentators that section 469(g)(1) suspended losses should offset the gain first, then be allowed as a properly allocable deduction or that it should continue to be suspended and carried forward.
>
> Furthermore, section 469(g)(1) losses that are allowed by reason of a fully taxable disposition of a former passive activity are also fully taken into account for net investment income. As a result of the ordering rules in sections 469(f)(1) and (g)(1), any nonpassive gain realized on the disposition that causes passive losses to be allowed would be excluded from net investment income under the general former passive activity rules discussed in part 5.E.iv of this preamble. However, to the extent that any of the nonpassive gain is included in net investment income (for example, a portion of the gain remaining after the application of section 1411(c)(4)), the final regulations allow the same amount of suspended losses described in section 469(f)(1)(A) to be included in net investment income to offset the gain. The section 469(g)(1) losses allowed by reason of the disposition of the former passive activity are allowed in full because they relate to a period of time when the activity was a passive activity and represent true economic losses from a passive activity that do not materially differ from other section 469(g)(1) losses from non-former passive activities.

Losses allowed in computing taxable income by reason of Code § 469(g) are taken into account in computing net gain or as properly allocable deductions in the same manner as such losses are taken into account in computing Code § 63 taxable income.[2449]

I do not plan to analyze here the methods of calculating gain excluded from NII under the 2013 proposed regulations. If any reader would like to alert me to planning opportunities, I would be happy to review those ideas.

II.I.8.f. Summary of Business Activity Not Subject to 3.8% Tax

This part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax hits some of the highlights of part II.I.8 Application of 3.8% Tax to Business Income but is not intended to be comprehensive. Also consider part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, especially part II.K.3.b Maximizing Flexibility to Avoid NOLs and Use Losses in the Best Year.

[2449] Reg. § 1.1411-4(f)(9).

If a trade or business is not a long-term rental activity, then the activity is not NII if:

- During the taxable year, the owner spends more than 100 hours in the business' daily operations (a significant participation activity),[2450]
- The activity is a personal service activity, and the individual materially participated in the activity for any 3 taxable years (whether or not consecutive) preceding the taxable year,[2451] or
- For either the current year or any five out of the past ten years, the owner spent more than 500 hours in the business' daily operations (a material participation activity).[2452]

Note, however, that significant participation activities may be aggregated to constitute material participation, moving one from a significant participation paradigm to a material participation paradigm, so be sure you know which paradigm applies.[2453]

The significant participation activity exception covers many situations but is not a panacea:

- Various credits arising from significant participation activities might be suspended.[2454]
- From an income tax perspective, consider that losses from a significant participation activity offset regular income only in certain situations.[2455]
- The self-charged rental and interest exception described below apply only if the recipient materially participates in the payer activity. For example, if a taxpayer rents real estate to an S corporation in which the taxpayer materially participates, then the rental meets the self-charged rental exception. If the taxpayer's participation in the S corporation is "significant" but not "material" (see text accompanying fn. 2453 above), then the S corporation's income is nonpassive but the rental activity is passive investment income (subject to exclusions for real estate professionals).
- If a taxpayer works for more than 500 hours for five years, the activity continues to be nonpassive under the 5-out-of-the-last-10-years rule. Working for more than 100 hours but not more than 500 hours does not trigger the 5-out-of-the-last-10-years rule. The same idea also applies to the 3-year personal service activity rule.

Also, a 250-hour safe harbor applies to allow rental real estate to qualify as a business for the Code § 199A deduction for pass-through business entities. See part II.E.1.e.i.(a) Whether Real

[2450] See parts II.I.8.a.i Passive Activity Recharacterization Rules, II.K.1.i Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income, II.K.1.a.vi Proving Participation, and II.K.1.a.v What Does Not Count as Participation.

[2451] See part II.K.1.a.ii Material Participation, including fn. 3065, referring to activity that involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or is a trade or business in which capital is not a material income-producing factor.

[2452] See parts II.I.8.a General Application of 3.8% Tax to Business Income and II.K.1.a Counting Work as Participation.

[2453] See fns. 3062-3063 and accompanying text, found in part II.K.1.a.ii Material Participation.

[2454] See part II.K.1.i.i.(b) Tax Trap from Recharacterizing PIGs as Nonpassive Income.

[2455] See part II.K.1.a Counting Work as Participation.

Estate Activity Constitutes A Trade Or Business within part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

Rental income and part or all of interest income paid to an owner of a business in which the landlord or lender, respectively, materially participate is not NII.[2456]

Rental not protected by the self-rental exception is not NII under either of the following situations:

- The taxpayer is a real estate professional and the rental activity rises to the level of being a trade or business or is not a trade or business but is grouped with a rental trade business.[2457]

- Any gain from the property's sale is included in the taxpayer's income for the taxable year, the property's rental began less than 12 months before the property was sold, and the taxpayer materially participated or significantly participated for any taxable year in an activity that involved for such year the performance of services for the purpose of enhancing the property's value.[2458]

See also part II.G.26 Real Estate Special Issues.

II.I.8.g. Structuring Businesses in Response to 3.8% Tax

What might be an ideal structure for a new business entity is described in part II.E Recommended Structure for Entities.

When structuring to avoid this 3.8% tax, be careful to avoid triggering another 3.8% tax: FICA (self-employment tax). Part II.L Self-Employment Tax (FICA) describes these rules, with specific structures illustrated in parts II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker and II.L.6 SE Tax N/A to Nongrantor Trust; see also part II.E Recommended Structure for Entities. If one has to choose between the 3.8% tax on net investment income and self-employment tax, consider not only the thresholds for applying them but also the fact that the employer's 1.45% share is deductible against business income,[2459] whereas none of the 3.8% tax on net investment income is deductible.

Structuring a trust to characterize its income as nonpassive income might not be quite as easy as one might think. See part II.K.2.b Participation by an Estate or Nongrantor Trust. For other considerations regarding trusts and net investment income tax, see part II.J.3.a Who Is Best Taxed on Gross Income, especially the text accompanying fns. 2495-2499.

Note that participation by an ESBT is based on its trustee's actions, whereas participation by a QSST is based on its beneficiary's actions:

- Although switching to a QSST might facilitate participation regarding the S corporation's income, it might complicate qualifying for the self-rental exception that avoids the 3.8% tax on rental income. The self-rental exception requires the landlord to materially participate in

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[2456] See part II.I.8.a.iii Qualifying Self-Charged Interest or Rent.
[2457] See parts II.I.8.c.ii Real Estate Classified as Nonpassive for Real Estate Professionals and II.I.8.c.iii Rental as a Trade or Business.
[2458] For details and nuances, see fn. 3239 in part II.K.1.e Rental Activities.
[2459] Code § 164(f)(1).

the tenant's business.[2460] Material participation in the tenant's business includes owning an interest in the tenant's business.[2461] Suppose a nongrantor trust owns the real estate and the S corporation stock. If and to the extent that the QSST election is made, the beneficiary, not the trust, is deemed to own the stock. A solution might be to place most of the stock into a QSST, keeping some in an ESBT. The portion that is in the ESBT would qualify that trust for the self-rental exception. The governing regulations[2462] do not impose a minimum ownership requirement, so it appears that any ownership of stock by the ESBT would suffice; I leave it to the reader to decide whether leaving more than a peppercorn is advisable.

- A trust that has only one current beneficiary might be able to switch back and forth every 36 months. See part III.A.3.e.iv Flexible Trust Design.

See also part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, discussing a trade-off between NII tax and regular income if the business has enough potential for ups and downs in its taxable income that planning for a potential significant loss becomes important.

Also, one might consider selling S corporation stock to a QSST that a third party (perhaps the client's parent) creates for the client. For a discussion of how this avoids income tax on the sale but also might require the equivalent of paying for the stock twice, see part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs. After the note is repaid (or 36 months, whichever occurs last), perhaps part or all of the trust would be switched to an ESBT, as discussed in part III.A.3.e.iv Flexible Trust Design.

II.I.9. Elections or Timing Strategies to Consider to Minimize the 3.8% Tax on NII

Elections to consider to minimize the tax apply to:[2463]

- Regrouping passive activities.[2464]

- Pre-2013 installment sales that might generate net investment income in 2013 and later years.

- Controlled foreign corporation and qualified electing fund stock.

- Married taxpayers, in which one spouse is a nonresident alien. Nonresident aliens are not subject to the tax.[2465]

[2460] See part II.I.8.a.iii Qualifying Self-Charged Interest or Rent Is Not NII, especially fn. 2365, and part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity, especially fn. 3195-3196.
[2461] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.
[2462] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.
[2463] Nadeau and Ellis, "The Net Investment Income Tax: Elections to Start Thinking About Now," *T.M. Memorandum* (BNA), Vol. 54, No. 07 (4/8/2013). This article's Appendix contains a handy chart.
[2464] See parts II.K.1.b.ii Grouping Activities – General Rules and II.K.1.b.iv Regrouping Activities Transitioning into 3.8% Tax on Net Investment Income.
[2465] Code § 1411(e)(1).

Because the tax applies only if modified adjusted gross income (MAGI) exceeds various thresholds, consider accelerating next year's income or deferring the current year's income so that either this year or next year has MAGI below the threshold. For example:

- Accelerate or defer retirement plan distributions or change the mix between Roth and traditional IRA distributions, to the extent permitted without violating the rules requiring minimum distributions to be taken.[2466] Even though retirement plan distributions are not NII, income from distributions increases MAGI.

- Time capital gains and losses which might include, if spreading out the gain will keep MAGI below the threshold, engaging in installment sales.[2467]

II.J. Fiduciary Income Taxation

Generally, a "trust" is:[2468]

> an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts.

[2466] Code §§ 401(a)(9), 403(b)(10), 408(a)(6), 408(b)(3).

[2467] Code § 453, which is subject to Code §§ 453A and 453B.

[2468] Reg. § 301.7701-4(a), which further provides:

> Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

That a beneficiary provided consideration for the trust's establishment does not prevent the trust from being classified as such. *Hanover Bank v. Commissioner*, 40 T.C. 532 (1963), *acq.* 1964-2 C.B. 5, which further held:

> There does not appear to be any ambiguity in the agreement concerning the creation of the trust and, in fact, all the parties to that agreement, including Frances, have long treated the agreement as creating a valid trust. Petitioners Strong reported as trust income in 1953 and 1954 most of the amounts paid to them by the trustee. Long-standing interpretations should be given consideration and will not lightly be set aside even when there is ambiguity in the instrument, *Babette B. Israel*, 11 T.C. 1064 (1948). Furthermore, the Supreme Court of New York previously construed the agreement as creating a valid trust and the material parts of that judgment are set forth in our Findings of Fact. Judicial constructions by State courts are conclusive as to the legal extent and character of the interests created under such an agreement, *Louise Savage Knapp Trust A*, 46 B.T.A. 846 (1942).
>
> The situation here is distinguishable from cases such as *Lyeth v. Hoey*, 305 U.S. 188, and *Chase National Bank et al., Executors*, 40 B.T.A. 44 (1939). In each of those cases the taxpayer threatened to take contrary to a will and in each case compromised his claims. The Courts determined that the property received in compromise was the substitute for an inheritance. In the instant case, Frances did not contest the disposition and the amounts she received were not in compromise of any claim she may have had.

A life estate might create a relationship that rises to the level of a trust.[2469]

However, a mere agency agreement does not constitute a trust.[2470] Nor does a court-supervised guardianship or conservatorship for a minor or other incapacitated person.[2471]

See also part II.D Special Purpose Trusts.

This part II.J tends to focus on estates and nongrantor trusts and often refers to such entities when referring to trust. In many ways, estates are taxed as nongrantor trusts that are not required to distributed all of their income, so a reference to such a trust tends to apply to an estate as well; however, as with anything in these materials, a tax professional should apply independent judgment to any such inference.

For a focus on grantor trusts, see part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust, especially parts III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment and III.B.2.h How to Make a Trust a Grantor Trust.

For free oral presentations of various issues in this part II.J, go to my CPA Academy instructor page and look for courses such as:

- Fiduciary Income Tax Refresher and Latest Update
- How to Shift Income to Beneficiaries
- Pass-through Entities Held By Trusts

These webinars are free and available on demand without continuing education credit or at scheduled times with CPE credit.

II.J.1. Trust's Income Less Deductions and Exemptions Is Split Between Trust and Beneficiaries

II.J.1.a. Generally

Our fiduciary income tax system, generally computes taxable income as if the trust were an entity, then allocates taxable income between the trust and its beneficiaries.[2472]

[2469] Taxpayers sought that conclusion in fn. 5968 (found in part III.A.3.e.i QSSTs) to confirm treatment as a QSST.

[2470] Rev. Rul. 76-265 held:

> In the instant case, the bank trustee will not take title to the property for the purpose of protecting or conserving it for beneficiaries, but will be acting as an agent of the United States and in that capacity will receive moneys, hold assets, and make payments on behalf of the United States for the purposes of constructing public buildings and satisfying the obligation of the United States to holders of the participating certificates.
>
> Accordingly, the arrangement is not a trust for Federal income tax purposes, but is a security arrangement with the bank trustee acting as an agent on behalf of the United States.

Letter Ruling 200227012 followed Rev. Rul. 76-265.

[2471] Reg. § 1.6012-3(b)(3).

[2472] Technically, the trust allocates distributable net income to the trust and beneficiaries, then takes into account other items in computing the trust's taxable income. The text in the body is a convenient way to describe the system to clients.

A trust, all of the accounting income of which is required to be distributed currently to one or more noncharitable beneficiaries, deducts the lesser of its accounting income or distributable net income (DNI).[2473] It also deducts any other amounts of DNI that are "properly paid or credited or required to be distributed" for the taxable year.[2474] Thus, a mandatory income feature is simply a proxy for other distributions, without the requirement that the distribution be made during the year or within 65 days thereafter.[2475] The beneficiary includes in income the amount of the trust's deduction for DNI;[2476] CCA 201016073 requires the beneficiary to include the deductible amount in income even if the trustee chooses not to deduct that amount:

> You have requested our guidance regarding practitioner inquiries as to whether a trustee is required to take an income distribution deduction under § 661 of the Internal Revenue Code. These inquiries were based on an assumption that if the trustee chooses not to take the deduction, the result would be to shift the tax liability for distributions made to beneficiaries to the trust. Our response is that the amount potentially reportable in the gross income of the beneficiary under § 662 is unchanged by the amount of the allowable distribution deduction under § 661, even if the fiduciary chooses not to claim the § 661 deduction on the Form 1041, U.S. Income Tax Return for Estates and Trusts. Any distribution to a beneficiary described in § 661 that is properly paid, credited, or required to be distributed is considered a distribution of the trust or estate's current income to the extent of that trust or estate's distributable net income ("DNI"), as described in § 643(a), that is allocable to such beneficiary in the taxable year. Therefore, the effect of a trustee not claiming the distribution deduction would be to subject the same income to taxation at both the trust and beneficiary levels, not to shift the incidence of taxation. The legislative history surrounding the enactment of § 662 states that the effect of limiting the taxation of a beneficiary to his proportionate share of the DNI serves to avoid to the necessity for tracing of income. The House report states that "[i]nstead of determining whether a particular distribution represents amounts of current or accumulated trust income, this revision, broadly speaking, provides that any distribution is considered a distribution of the trust or estate's current income to the extent of its taxable income for the year." Committee on Ways and Means, Report on H.R. 8300 (1954) at 199.

[2473] Code § 651 and Code § 661(a)(1), (c). Code § 643(a) defines DNI, and Code § 643(b) defines accounting income. For more on accounting income, see part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law, which generally covers the area of accounting income, with extra attention paid to capital gains.

[2474] Code § 661(a)(2), (c).

[2475] Part II.J.2 Tactical Planning Shortly After Yearend describes the 65-day rule.

A beneficiary who did not actually receive the mandatory payments cannot avoid tax on them, especially when he has not disclaimed, renounced, or assigned his rights in the trust. *Seligson v. Commissioner*, T.C. Memo. 1992-320, which primarily relied on Code §§ 651 and 652 but also used constructive receipt under Reg. § 1.451-2(a) (see fns 4205-4206 in part II.Q.1.e Trying to Avoid Possible Ordinary Income on the Sale of a Partnership or S Corporation), supporting the latter:

> Thus, when income is available to a taxpayer so that he may draw upon it, so that it is his for the asking, the taxpayer is taxable on the income "constructively" received. A taxpayer recognizes taxable income when he or she has an unqualified, vested right to receive immediate payment. *Ross v. Commissioner*, 169 F.2d 483, 490 (1st Cir. 1948), *revg. on another issue* a Memorandum Opinion of this Court dated Feb. 10, 1947. This principle was applied to trust income in *Letts v. Commissioner*, 84 F.2d 760, 762 (9th Cir. 1936), *affg.* 30 B.T.A. 800 (1934) (trust income currently distributable is taxable to the beneficiary whether or not actually distributed to him).

[2476] Code §§ 651, 652.

The above framework is a simplistic explanation. Among omissions are the treatment of tax-exempt income, the separate share rule,[2477] and charitable deductions.[2478]

Some promoters market a trust structure that mistakenly interprets Code § 643 to remove certain trust income from current taxation. AM 2023-006 (8/18/2023) explains:

> ANALYSIS:
>
> Contrary to the claims of the promotors, the trust will recognize income on its capital gains and dividends, except to the extent those amounts are distributed or deemed to be distributed to its beneficiaries.
>
> The promotional materials support their claims about the tax benefits of their structure by reading subsections of § 643 out of context. The materials do not address § 641 which provides the basic rule that the trust's taxable income is computed as it is for individuals, with certain modifications. Instead, the materials look to § 643(a) for guidance as to the definition of "taxable income". In so doing, the materials fail to consider the beginning of that section, which expressly states that the section defines "distributable net income" rather than "taxable income."
>
> A non-grantor trust is considered a separate taxable entity for income tax purposes. A non-grantor trust computes its gross income in much the same manner as an individual. Most deductions and credits allowed to individuals are also allowed to estates and trusts. However, there is one primary distinction. A trust is allowed an income distribution deduction for distributions to beneficiaries. See §§ 651 and 661. A trust's deduction for distributions to beneficiaries is limited to the lesser of (1) amounts that the trust properly pays or credits to beneficiaries during the taxable year (or amounts that are required to be paid or credited to the beneficiaries during the taxable year under the trust instrument if not actually distributed) or (2) the "distributable net income" of the trust.
>
> Section 643 defines the concept of the "distributable net income" (or "DNI") of the trust. DNI not only limits the amount that the trust can deduct for distributions to beneficiaries, but it also determines the amount on which the beneficiaries can be taxed as a result of those distributions. See §§ 652 and 662. The income distribution deduction of the trust coupled with the gross income inclusion to beneficiaries ensures the income of the trust is taxed either to the entity or to the beneficiaries, but not to both.
>
> Under § 643(a), DNI is calculated by making certain modifications to the trust's taxable income. Some of these modifications include subtracting certain items of gross income from DNI that may not be distributable to beneficiaries who are entitled to receive trust "income". This, in turn, depends on the economic rights of trust beneficiaries determined under the trust instrument and applicable local law for the taxable year at issue. As background, a trustee apportions items of gross income or tax-exempt receipts of the trust between two different classes of beneficiaries, a class that is entitled to trust "income" as defined under the trust instrument and applicable local law (*i.e.*, the "accounting income" of the trust), and a class of beneficiaries (sometimes referred to as

[2477] See part II.J.9.a.ii Separate Share Rule.

[2478] As described in part II.J.4.c Charitable Distributions, Code § 642(c) generally governs charitable deductions. Among other issues, see part II.Q.7.c S Corporation Owned by a Trust Benefitting Charity, which also covers how a trust's income from business or certain other activities affects the charitable deduction.

“remainder beneficiaries”) entitled to certain amounts of gross income allocated to trust “corpus” or “principal”. Gross income that is allocated to trust principal can be accumulated by the trust for distribution in subsequent taxable years or at the time of the trust’s termination. Gross income that is allocated to trust income is either distributed to beneficiaries in the current taxable year or, depending on the terms of the trust instrument, can be accumulated by the trust for distribution in subsequent taxable years.

If a trust excludes all capital gains and extraordinary dividends from income within the meaning of § 643(b), that simply means that the trust will subtract those capital gains and extraordinary dividends from DNI under § 643(a), so long as those amounts are not actually distributed to the beneficiaries. In turn, subtracting those amounts from DNI simply means that trust has a lower threshold for the deduction that it can take for distributions to beneficiaries authorized by § 651 (for simple trusts) or § 661 (for complex trusts). If a non-grantor trust does not make (and is not required to make) any distributions to its beneficiaries, then it is not entitled to any “income distribution deduction”. Therefore, all of the income attributable to capital gains and extraordinary dividends must be reported by the non-grantor trust as income on Form 1041.

The promoters of this structure mistakenly assume that income in § 643(b) refers to the taxable income of the trust. However, the first sentence of § 643(b) provides that, within the parts of the Code encompassing §§ 641 through 668, any references to “income” without preface refers to the accounting income of the trust rather than another concept of income such as “taxable income”. References to other types of income will be denoted by their full name, such as “distributable net income” or “taxable income”. See *e.g.*, § 641 describing rules related to the computation of “taxable income”.

RECOMMENDATION:

In each case using this structure, as a threshold matter, the trust’s income tax returns should be examined to ensure that (a) the trust is reporting all of its taxable income, including capital gains and any income that is described as an extraordinary dividend, and (b) ensure that the trust is disallowed any deduction claimed with respect to such income solely because the trustee, acting in good faith, has allocated such income to the corpus of the trust.[4]

[4] Certain promotional materials include a description of tax reporting used in this structure as shown on the Form 1041. This sample From 1041 reflects that capital gains and other amounts of gross income characterized as extraordinary dividends are included as part of the trust’s “total income”, however, the sample Form 1041 shows that the trust claims a deduction on line 15a (other deductions not subject to 2% floor) in an amount that corresponds to the amount included in income. These promotional materials suggest that, in some variations, a statement is included with the return to explain this deduction.

See also part II.J.8.d Distribution in Kind; Specific Bequests, which includes subparts:

- II.J.8.d.i Distribution in Kind - Generally
- II.J.8.d.ii Specific Bequest
- II.J.8.d.iii Distributing a Note to the Obligor

A beneficiary's use of a residence generally should not constitute a deemed distribution unless the trust is a foreign trust and the beneficiary is a US person. For the latter rule, see Code § 643(i). For various cases analyzing the former issue, see *DuPont Testamentary Trust v. Commissioner*, 66 T.C. 761 (1976), *aff'd* 574 F.2d 1332 (5th Cir. 1978); *Carson v. U.S.*, 317 F.2d 370 (Ct. Cl. 1963); *Commissioner v. Plant*, 76 F.2d 8 (2nd Cir. 1935); TAM 8341005 (following *Plant* - real property taxes and the cost of the caretaker were carrying costs allocable to corpus, and income used to pay those expenses were not deemed distributed to the beneficiary who used the house; the beneficiary paid for electricity, heating and personal expenses); *Commissioner v. Lewis*, 141 F.2d 221 (3rd Cir. 1944) (carrying charges and depreciation were chargeable to trust accounting income under local law and deductible in computing amounts taxable to the mandatory income beneficiaries). *Moreell v. U.S.*, 221 F.Supp. 864 (W.D. Pa. 1963), is a sloppy, confusing, unreasoned opinion involving a mandatory income trust that was partly a grantor trust. I have not read but have seen cited *Fuller v. Commissioner*, 9 T.C. 1069 (1947), *aff'd* 171 F.2d 704 (3rd Cir. 1948); *Prince v. Commissioner*, 35 T.C. 974, 978 (1961). Also, in *Estate of Wineman v. Commissioner*, T.C. Memo. 2000-193, below-market rent constituted a taxable gift.

II.J.1.b. Foreign Trusts

I do not undertake to be an expert on the issues described in this part II.J.1.b. Rather, this part II.J.1.b consists almost entirely of quotes from the IRS LB&I International Practice Service Transaction Unit, "Defining the Entity - Foreign Trusts," DCN FEN/9434.02_01(2013)(b) (5/21/2015) (the "Process Unit").[2479]

In the Process Unit, "Issue and Transaction Overview" says:

> **What is the proper entity classification?**
>
> You are auditing a taxpayer who has been linked to a foreign entity which appears to be a trust. What audit steps should be taken? The first step is to gather information about the entity in order to determine what type of entity is involved. By correctly classifying the entity, the appropriate tax and reporting responsibilities for the entity under the United States (U.S.) tax law can be determined.
>
> This International Practice Service (IPS) Unit will focus on the classification of entities for U.S. tax purposes. It will outline information necessary to classify the entity, and the process for determining whether the entity qualifies as a trust under U.S. tax law or whether it is a business entity. For those arrangements classified as a trust, a determination must be made as to whether the trust is a domestic trust or foreign trust for U.S. tax purposes. This IPS Unit will outline the tests utilized in making those determinations.
>
> Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code (IRC), if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not

[2479] IRS Note:
This document is not an official pronouncement of law, and cannot be used, cited or relied upon as such. Further, this document may not contain a comprehensive discussion of all pertinent issues or law or the IRS's interpretation of current law.

associates in a joint enterprise for the conduct of business for profit. Foreign trusts have been used by U.S taxpayers to hide assets and income, therefore, Congress has imposed special reporting obligations for those U.S. taxpayers holding interests in foreign trusts or receiving distributions from foreign trusts.

Once it is determined the entity is a foreign trust, the next step is to determine if it is a foreign grantor trust or a foreign non-grantor trust. The type of trust is important in determining the taxability of the trust and its distributions as well as related reporting obligations. Whether a trust is a grantor trust is determined under IRC §§ 671-679, with IRC § 679 applying specifically to foreign trusts. Any trust determined not to be a grantor trust will be treated as a non-grantor trust. Practice Unit "Foreign Grantor Trust Determinations – Part I – Section 679" DCN: FEN/9434.02_02(2013) will be useful in determining if the entity is a foreign grantor trust or non-grantor trust. Practice Unit "Foreign Grantor Trusts Determinations – Part II – Sections 671-678" DCN: FEN/9434.02_07(2013) will focus on the grantor trust rules of IRC §§ 671-678. There are additional IPS units that cover other aspects of trusts, such as the taxability of trust income and distributions, and information reporting requirements. If the entity at issue is determined to be a business entity, other IPS units will assist you in determining the proper classification of such entity, such as a corporation, partnership or disregarded entity.

In the Process Unit, "Defining the Entity – Foreign Trusts" says:

What information is needed to determine the proper classification of an entity for U.S. tax purposes? If it is classified as a trust, is it a domestic trust or a foreign trust for U.S. tax purposes? This IPS unit will outline the tests utilized in making those determinations.

Fact Element	**Resources**
• The first step is to determine if the entity should be treated as a trust for U.S. tax purposes. • Background information must be gathered to determine whether the entity constitutes a trust. • Organizational documents and actual operations will control the critical determinations.	• Form 3520 • Form 3520 Instructions • Form 3520-A • Form 3520-A Instructions • Treas. Reg. §301.7701-4 • IRS AM 2009012 – Entity Classification of Lichtenstein Anstalts and Stiftungs
Items to Request: • Trust Instrument (other titles include: Declaration of Trust, Trust Deed, Trust Agreement, etc.) -- This document names the parties to the trust, establishes the duties and powers of the trustee, and establishes the rights of the beneficiaries.	• Form 3520 • Form 3520 Instructions • Form 3520-A • Form 3520-A Instructions • Treas. Reg. §301.7701-4 • IRS AM 2009012 – Entity Classification of Lichtenstein Anstalts and Stiftungs

Fact Element	Resources
-- If parties to the trust are not contained within the trust instrument, seek separate documentation to identify the settlors, trustees and beneficiaries. -- The settlor is the person who establishes the trust, also known as the grantor or creator.	
Items to Request: • Letter of Wishes -- The settlor of an offshore trust commonly provides the trustee with a non-binding "letter of wishes" or memorandum of wishes" It expresses the settlor's true intentions as to the trustee's discretionary exercise of powers such as the types of investments or the disposition of property. A letter of wishes is a separate document and not a part of the trust instrument.	• Treas. Reg. §1.679-2(a)(4)
Items to Request: • Identification of all assets held by entity – Information on how the trust assets are titled, controlled, and used, will assist in defining the entity. • Any additional agreements with respect to the trust – Question Taxpayer whether additional agreements, either written or oral, exist.	• Form 3520 • Form 3520 Instructions • Form 3520-A • Form 3520-A Instructions • Treas. Reg. §301.7701-4 • IRS AM 2009012 – Entity Classification of Lichtenstein Anstalts and Stiftungs

Issue 1

Is the entity a trust for U.S. tax purposes?

Fact Element	Resources
What is a trust? • The Regulations define a "trust" as an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of	• Treas. Reg. §301.7701-4

Fact Element	Resources
protecting or conserving it for the beneficiaries. • In a legitimate trust, the grantor transfers property to a trustee to hold and protect for the benefit of the trust beneficiaries, often pursuant to the terms of a written trust agreement. • A trust is a separate legal entity or arrangement typically used for family and estate planning purposes. Trusts allow assets to be held by an entity, other than a natural person, with an indeterminate life. Accordingly, trusts are often used to hold property and facilitate a transfer of such property to beneficiaries without the need for probate proceedings. • An arrangement will be treated as a trust if it can be shown that its purpose is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.	
What is <u>Not</u> a Trust? • An entity created to operate a business rather than to protect or conserve assets is not recognized as a trust for U.S. tax purposes. Instead, entities conducting business activities are more properly classified as business entities. If it is a business entity, other IPS Units are available to assist you in determining the proper classification, such as a corporation, partnership or disregarded entity.	• Treas. Reg. §301.7701-4(b) • Treas. Reg. §301.7701-2
ABUSIVE TRUST ARRANGEMENTS OR SHAMS: • Where a trust exists solely for tax avoidance purposes, it is an "abusive trust arrangement" or "sham" whereby the IRS may ignore the purported form for U.S. tax purposes.	• Notice 97-24 • Rev Rul 80-74 • Rev Rul 90-106 • <u>Markosian v. Commissioner</u>, 73 T.C. 1235 (1980)

Fact Element	Resources
• Factors you should consider in a sham analysis (not an exclusive list): -- Lack of Change: The relationship between the grantor and property conveyed to the trust does not materially change after conveyance to the trust. -- Retained Control: A grantor continues to use and/or exercise dominion and control over trust property as if it was his/her own. -- Retained Benefit: Property and/or income of the trust are used to benefit the Grantor -- Lack of Independent Trustee: Trustee's failure to exercise fiduciary responsibilities. The trustee merely approves actions directed by grantor, and is trustee "in name only", often due to family relationships or grantor's position of control over trustee.	• Zmuda v. Commissioner, 79 T.C. 714 (1982), aff'd 731 F. 2d 1417 (9th Cir. 1984) • Alan v. Commissioner, 767 F.2d 618 (9th Cir 1985), aff'g TC Memo 1983-249 • Able Co. v. Commissioner, TC Memo 1990-500
SHAM INDICATORS: • The identities of the parties (grantor, trustee, beneficiaries) are concealed • The sole beneficiary of the trust is another trust--particularly if the beneficiary is a foreign trust. • Beneficiaries are "discretionary" (selected by the trustee). • Beneficial interest is evidenced by "trust certificates" or "units", often transferable. • Trust instruments are vague or ambiguous. • Trust assets are commingled with those of the trustee, the grantor, or a beneficiary -- Such as a common checking account	• *Zmuda v. Commissioner*, 79 T.C. 714, 720 (1982), affd. 731 F.2d 1417 (9th Cir. 1984) • Rendel v. Commissioner, TC Memo 1995-593, aff'd 129 F.3d 127 (9th Cir 1997) • Waegemann v. Commissioner, TC Memo 1993-632 (1993) • Dahlstrom v. Commissioner, TC Memo 1991-265, aff'd w/o pub.opin. 999 F2d 1579 (5th Cir. 1993)
• If it is determined that the trust was set up for tax avoidance purposes, the facts and circumstances of your case will dictate how the trust transactions should be treated for U.S. tax purposes.	
DECISION POINT: Based on the evidence, determine if the entity should be treated as a	• Treas. Reg. §301.7701-4(a)

Fact Element	Resources
trust, a business entity or sham for U.S. tax purposes. • **Trust**: If the entity is a trust for U.S. tax purposes, then continue to Issue 2 to determine whether it is a foreign trust or a domestic trust. • **Business Entity**: Determine what type of business entity. If entity conducts a business, other IPS Units will assist in determining the proper classification (corporation, partnership or disregarded entity), taxation and filing requirements for those entities. • **Sham**: If the entity is a sham, ignore the entity for U.S. tax purposes and treat the transactions as if having occurred directly by the individual as though the entity never existed.	• Treas. Reg. §301.7701-4(b) • Rev Rul 80-74 • Rev Rul 90-106 • Notice 97-24 • Markosian v. Commissioner, 73 T.C. 1235 (1980) • Zmuda v. Commissioner, 79 T.C. 714 (1982), aff'd 731 F.2d 1417 (9th Cir. 1984)
CONSULTATION: Consult with Counsel if you have concerns about the correct entity classification.	

Issue 2

If the entity is a trust for U.S. tax purposes, is it a foreign trust or a domestic trust?

Fact Element	Resources
Is the trust foreign or domestic? • If it is determined the entity is a trust for U.S. tax purposes, the next step is to determine whether the trust is foreign or domestic. -- This classification impacts how the trust activities should be reported and taxed for U.S. tax purposes.	• Treas. Reg. §301.7701-7 • Treas. Reg. §301.7701-7(a)(1)(i) • Treas. Reg. §301.7701-7(a)(1)(ii)
Domestic Trust Tests: • A trust is considered to be a foreign trust unless it meets the following two tests:	• Treas. Reg. §301.7701-7 • Treas. Reg. §301.7701-7(a)(1)(i)

Fact Element	Resources
-- The Court Test, and -- The Control Test. • A trust meets the **<u>Court Test</u>** if: -- A court within the United States is able to exercise primary supervision over the administration of the trust". • A trust meets the **<u>Control Test</u>** if: -- One or more United States persons have the authority to control all substantial decisions of the trust with no other person having the power to veto any of the substantial decisions.	• Treas. Reg. §301.7701-7(a)(1)(ii)
The <u>COURT TEST</u> is met if: • A court within the United States is able to exercise primary supervision over the administration of the trust".	• Treas. Reg. §301.7701-7(a)(1)
COURT TEST -SAFE HARBOR: • The regulations provide that a trust satisfies the Court Test if: -- The trust instrument does not direct that the trust be administered outside of the U.S.; -- The trust is administered exclusively in the U.S.; and -- The trust is not subject to an automatic migration provision.	• Treas. Reg. §301.7701-7(c)(1)

Fact Element	Resources
The <u>CONTROL TEST</u> is met if" • One or more **<u>United States Persons</u>** have the authority to **<u>control</u>** all **<u>substantial decisions</u>** of the trust with no other person having the power to veto any of the substantial decisions. • The term "United States person" means a U.S. Person within the meaning of section IRC §7701(a)(30). -- "Substantial decisions" are fiduciary decisions authorized or required under the terms of the trust agreement and applicable law, such as those dealing with distributions, selection of beneficiaries, investment decisions and changes of trustee. -- "Control" means having the power, by vote or otherwise, to make all of the "substantial decisions" of the trust, with no other person having the power to veto any of those "substantial decisions." -- To determine whether a "United States Person" has the authority to control all substantial decisions you must consider all persons who have authority to make a substantial decision of the trust, not only the trustees. ▪ i.e. a trust protector who exercises powers traditionally held by fiduciaries or that can control the fiduciaries	• Treas. Reg. §301.7701-7(a)(1) • IRC §7701(a)(30) Definition of USP • Treas. Reg. §301.7701-7(d)(1)(ii) -Substantial decisions • Treas. Reg. §301.7701-7(d)(1)(iii) -Control
Special Rules • A trust is not considered to have met the Court Test nor the Control Test if the trust instrument contains an automatic migration provision or "flee clause." • A flee clause transfers jurisdiction and control of the trust to a different (foreign) jurisdiction under prescribed circumstances, such as: -- An attempt by a U.S. Court to assert jurisdiction or otherwise supervise the	• Treas. Reg. §301.7701-7(d)(v)(3) • Treas. Reg. §301.7701-7(c)(4)(ii)

<table>
<tr><th>Fact Element</th><th>Resources</th></tr>
<tr><td>administration of the trust absent the following exception: Treas. Reg. §301.7701-7(c)(4)(ii) will not apply if the trust instrument provides that the trust will migrate from the United States only in the case of foreign invasion of the United States or widespread confiscation or nationalization of property in the United States.
-- An attempt by any government agency or creditor to collect information from the trust
-- An attempt by any government agency or creditor to assert a claim against the trust.</td><td></td></tr>
<tr><td>DECISION POINT: Based on the evidence, determine whether the trust meets both the Control Test and the Court Test.
• If the trust meets both the Control test and the Court test, the trust is treated as a domestic trust.
• If the trust fails either the Control Test or the Court Test, the trust is treated as a foreign trust.</td><td>• Treas. Reg. §301.7701-7(c)
• Treas. Reg. §301.7701-7(d)</td></tr>
<tr><td>NEXT STEP -- Grantor Trust Rules: I.R.C §§ 671 -679
• Once a decision is made as to whether the entity is a foreign trust or a domestic trust, the next step is to determine whether the trust is:
-- A Grantor Trust or a
-- Non-Grantor Trust
• Practice Unit “Foreign Grantor Trust Determinations – Part I – Section 679” DCN: FEN/9434.02_02(2013) will assist in the proper determination of the trust as either a foreign grantor or non-grantor trust.
• Additional IPS Units will cover other aspects regarding trusts, such as the taxability of trust income and distributions, and information reporting requirements.</td><td>• IRC §671, IRC §672, IRC §673, IRC §674, IRC §675, IRC §676, IRC §677, IRC §678, IRC §679
• <u>Helvering v. Clifford</u>, 309 US 331 (1940)
• <u>Wesenberg v. Commissioner</u>, 69 TC 1005 (1978)
• Practice Unit “Foreign Grantor Trust Determinations – Part I – Section 679” DCN: FEN/9434.02_02(2013)</td></tr>
</table>

II.J.1.c. Taxation of Beneficiary of a Foreign Non-Grantor Trust

I do not undertake to be an expert on the issues described in this part II.J.1.c. Rather, this part II.J.1.c consists almost entirely of quotes from the IRS LB&I Process Unit, "Taxation of Beneficiary of a Foreign Non-Grantor Trust," DCN INT-9-253 (10/11/2023) (the "Process Unit").[2480]

In the Process Unit, "Process Overview" says:

> A trust classified as a foreign trust will be treated as either a "foreign grantor trust" or a "foreign non-grantor trust" for United States (U.S.) tax purposes. This distinction is important because it affects who is taxed on the trust income and when they are taxed. The rules administering foreign trust income taxation encompass both the domestic trust income taxation rules and the nonresident alien individual's income taxation rules. If a foreign trust is characterized as a grantor trust under Internal Revenue Code (IRC) 671–679, the grantor or another person is treated as the owner of the trust. If a U.S. person is treated as the owner of a trust for U.S. federal income tax purposes under the grantor trust rules, then generally a distribution to a beneficiary is a non-taxable transaction to the beneficiary. Any foreign trust not determined to be a grantor trust under IRC 671-679 will be treated as a foreign non-grantor trust for U.S. tax purposes. A beneficiary of a foreign non-grantor trust may be liable for U.S. tax on distributions of income (current and accumulated) from the trust. Foreign non-grantor trust corpus distributions are not taxable to a beneficiary. Therefore, the examiner must determine whether the beneficiary's distribution is income or principal (corpus). Further, the examiner must determine whether the trust is a simple trust or a complex trust in order to determine the extent and type of income distribution. This determination helps the examiner generate the beneficiary's income distribution calculation for U.S. income tax purposes which will provide the amount and type of income taxable to the beneficiary. Finally, the U.S. income tax consequences of an income distribution to the beneficiaries of a foreign non-grantor trust depend upon whether the distribution represents current income, Distributable Net Income (DNI) or accumulated income, Undistributed Net Income (UNI); whether the beneficiary is a U.S. person or a foreign person; and whether the trust's income is U.S. source or foreign source. This process unit will provide an overview of the steps needed to determine how to tax a beneficiary of a foreign non-grantor trust on distributions received from the trust. Examples of circumstances under which this process applies include:
>
> - A U.S. beneficiary receives a distribution of income from a foreign non-grantor trust. The U.S. beneficiary will generally be taxed on his or her share of DNI of the trust. The U.S. beneficiary receiving distributions from the foreign non-grantor trust is taxed similarly to a U.S. beneficiary receiving distributions from a domestic non-grantor trust, although the calculation of DNI is slightly different for a foreign trust.

[2480] IRS Note:
This document is not an official pronouncement of law, and cannot be used, cited or relied upon as such. Further, this document may not contain a comprehensive discussion of all pertinent issues or law or the IRS's interpretation of current law.

- A foreign beneficiary receives a distribution of income from a foreign non-grantor trust. The foreign beneficiary may be subject to U.S. tax on trust income from U.S. sources. The tax is based on the beneficiary's share of U.S. source DNI.

Prior to using this Practice Unit, the examiner should refer to the Practice Unit "Defining the Entity - Foreign Trusts" to determine that a foreign trust exists. Then determine whether a foreign trust is treated as a foreign grantor trust for U.S. tax purposes by referring to Practice Unit "Foreign Trust Determination -Part I -Section 679". Even if the foreign trust is not a foreign grantor trust for U.S. income tax purposes under IRC 679, in rare circumstances, the foreign trust may still be treated as a foreign grantor trust under IRC 673-678 as discussed in the Practice Unit "Foreign Grantor Trust Determination - Part II -Sections 671-678". Once these Practice Units have been reviewed and a determination is made that a foreign non-grantor trust exists, use this Practice Unit to determine the taxation of beneficiaries of a foreign non-grantor trust.

Process Steps

Determining whether a trust is a grantor or non-grantor trust is important because it affects who is taxed on the trust income and when they are taxed. Any foreign trust not determined to be a grantor trust under IRC 671-679 will be treated as a foreign non-grantor trust for U.S. tax purposes. If a trust is a foreign non-grantor trust, the trust itself is a taxable entity, and a U.S. or foreign beneficiary may be liable for U.S. tax on a distribution from the trust. The process to determine taxable income of a beneficiary of a foreign non-grantor trust is captured in the steps below.

Step 1

Determine if a foreign non-grantor trust made a distribution of trust income to a beneficiary.

Considerations	Resources
Income not distributed by a foreign non-grantor trust is taxed to the trust while income distributed to the beneficiary is taxed to the beneficiary. A foreign non-grantor trust may distribute the following income and non-income items to its beneficiary(s): • Trust income, which includes: -- Foreign sourced income, -- U.S. or foreign source income effectively connected with the conduct of a U.S. trade or business (ECI), -- Other U.S. sourced income, -- Gains from sale of U.S. real property. • Gift or bequest not paid from trust income, which includes:	• IRC 661-663 • IRC 663(a)

Considerations	Resources
-- Specific sum of money, -- Specific property. • Trust corpus -- Corpus is defined as the principal sum or capital of a trust.	• IRC 872(a) • IRC 651(b) • IRC 661(a)
• A U.S. beneficiary's share of the trust's DNI must be included in the beneficiary's income for U.S. tax purposes in the year of a distribution from the trust. In addition, if the U.S. beneficiary receives a distribution of a portion of the trust's UNI, it is taxable to the beneficiary in the year of receipt, accounting for the accumulation under the throwback tax regime. • A foreign beneficiary receiving an income distribution must include the beneficiary's share of the trust's U.S. sourced DNI. • Generally, distributions of trust corpus and gifts or bequests of specific property as specified in the trust instrument are generally not taxable to a beneficiary. However, when a foreign non-grantor trust distributes trust income, the distribution may be taxable to the beneficiary. U.S. source income and ECI not distributed by a foreign non-grantor trust is taxed to the trust. Items to review and request to aid in determining if a distribution was made from trust income include: • Form 3520: A U.S. person is required to file a Form 3520 if the person receives a distribution from a foreign trust. A distribution includes cash, non-cash property, certain loans, or the uncompensated use of trust assets credited for the beneficiary's benefit.	• IRC 667(a) • IRM 3.13.2-7 -Definition of Entities • IRM 21.7.13.5.8.1 - Definition: Trusts • IRC 662(a) • Treas. Reg. 1.679-2(a)(4)(i) • IRC 6048(c)
Net losses and capital losses of a trust cannot be distributed to a beneficiary unless it is in the termination year of a trust and even then, only certain types of unused carryover losses can be distributed according to IRC 642(h).	• IRC 643(a) • Treas. Reg. 1.643(a)-3 • IRC 642(h)

Considerations	Resources
CAUTION: Disallow losses to a beneficiary from a foreign non-grantor trust from Schedule K-1 in a non-termination year.	

Step 2

Determine if a beneficiary must use the default calculation for trust distributions.

Considerations	Resources
Trust distributions to a beneficiary can be comprised of current income and accumulated income. This information is needed to determine how the beneficiary will be taxed. A beneficiary is allowed to complete Form 3520, Part III, Schedule B, Actual Calculation of Trust Distributions, when the beneficiary has sufficient information to complete the Schedule or they can still choose to use Schedule A, Default Calculation of Trust Distributions. If completing Schedule B, the beneficiary should have marked “yes” to Form 3520, Part III, line 30 and attached a Foreign Non-grantor Trust Beneficiary Statement to the Form 3520. Many beneficiaries do not have sufficient information to complete Schedule B. Beneficiaries that do not receive a Foreign Non-grantor Trust Beneficiary Statement from the foreign trust with respect to a distribution or that do not have sufficient information to complete Form 3520, Part III, Schedule B, about the trust’s income and distributions, must use the default calculation of trust distributions to determine their ordinary and accumulation distribution income from the foreign non-grantor trust. The default calculation of trust distributions is reported on Form 3520, Part III, Schedule A. **CAUTION**: Generally, once the beneficiary uses the default calculation, they should continue to use it for all future years, with an exception in a trust termination year.	• IRC 665-668 • Form 3520 • Form 3520 Instructions

[still working on the above – you'll see more next quarter]

II.J.2. Tactical Planning Shortly After Yearend to Save Income Tax for Year That Ended

II.J.2.a. Tax Laws Supporting Tactical Planning

Code § 663(b) allows distributions in the first 65 days of the taxable year to count as distributions in the current or prior year's tax return.

Thus, the trustee can count distributions from January 1, 2020 through and including March 5, 2020 as 2019 or 2020 distributions or a combination thereof.[2481]

When in doubt, distribute more rather than less (if distributions are appropriate).[2482] The tax return, including extensions, will determine how much of the distribution counts as a distribution for the year just ended or for the year in which the distribution is made, but the distribution needs to be made within the 65-day period.

This tactic can carry out capital gains, without regard to any prior year election regarding distributing capital gains.[2483]

Code § 643(g) authorizes the trustee to use Form 1041-T to elect to treat any portion of a payment of estimated tax made by the trust for any taxable year of the trust as a payment made by a beneficiary on the last day of that taxable year. However, Form 1041-T instructions for 2020 provide:

[2481] Reg. § 1.663(b)-2(a), "Manner and time of election; irrevocability," provides:

(1) *When return is required to be filed*. If a trust return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in the appropriate place on such return. The election under this subparagraph shall be made not later than the time prescribed by law for filing such return (including extensions thereof). Such election shall become irrevocable after the last day prescribed for making it.

(2) *When no return is required to be filed*. If no return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in a statement filed with the internal revenue office with which a return by such trust would be filed if such trust were required to file a return for such taxable year. See section 6091 and the regulations thereunder for place for filing returns. The election under this subparagraph shall be made not later than the time prescribed by law for filing a return if such time prescribed by law for filing a return if such trust were required to file a return for such taxable year. Such election shall become irrevocable after the last day prescribed for making it.

In granting an extension of time to make a Code § 663(b) election, Letter Ruling 9215033 held:

> The time for filing an election under section 663(b) of the Code is fixed by section 1.663(b)-2(a)(1) of the regulations. Accordingly, the Commissioner has discretionary authority pursuant to section 301.9100-1(a) of the regulations to grant an extension of time for making the section 663(b) election provided good cause is shown and the other requirements of section 301.9100-1(a) are met.

[2482] See part II.J.3 Strategic Fiduciary Income Tax Planning for tax and nontax issues to consider in deciding whether to make distributions.

[2483] See part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary.

> You can't allocate to a beneficiary tax withheld from income, such as withholding from lottery or other gambling winnings, or from salary or pension payments reported on Form 1041. You must report this withholding on Form 1041, Schedule G, Part II, line 14.

II.J.2.b. Trust Provisions Authorizing Distributions

Drafting irrevocable trusts administered while the grantor is living is more challenging than those administered post-mortem. Distribution provisions can cause unwanted grantor trust status; see part III.B.2.h.vii Distribution Provisions Might Prevent Turning Off Grantor Trust Status, within part III.B.2.h How to Make a Trust a Grantor Trust Taxed to a U.S. Citizen or Resident.

Even when grantor trust is desirable, at some point the grantor should be able to turn off grantor trust status. I prefer to make a trust a grantor trust solely by either or both powers described in part III.B.2.h.iii Swap Power or III.B.2.h.iv Borrow Power, which the grantor can later release. If the grantor's release of those powers triggers other changes in the trust, such as changes in distribution provisions, the grantor's ability to release those powers might constitute a retained power to shift beneficial enjoyment that causes Code § 2036 estate inclusion. To avoid that concern, I draft the trust in a manner that makes it a nongrantor trust but for the swap and borrow powers. A sample savings clause for such an irrevocable trust is:

> Notwithstanding any contrary provision in this Agreement, all provisions of this Agreement shall be construed and applied so that no part of the assets composing any trust created in this Agreement shall be included in my estate for federal estate tax purposes or to cause me to be taxed as the grantor of a trust for income tax purposes, the latter determined as if I had released my powers under [swap and borrow clauses]; any provision incapable of being so construed or applied shall be inapplicable to such trust; in no event shall I, the trustee, the holder of a power to Appoint, or any other person take any action or have any power that will cause any such assets to be included in my gross estate for federal estate tax purposes or to cause me to be taxed as the grantor of a trust for income tax purposes, the latter determined as if I had released my powers under [swap and borrow clauses]; and all provisions regarding such trust shall be interpreted to conform to this directive.

Furthermore, if the trustee is a beneficiary, be careful not to trigger gift tax consequences when the trustee makes a distribution. Gift tax consequences may occur if a distribution to a beneficiary other than the trustee may reduce future distributions to a trustee who is a beneficiary.[2484] However, Reg. § 25.2511-1(g)(2) provides a safe harbor:[2485]

> If a trustee has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument. A clearly measurable standard under which the holder of a power is legally accountable is such a standard for this purpose. For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; to enable him to maintain his

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[2484] See part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts.

[2485] For what constitutes an ascertainable standard for grantor trust purposes, see text accompanying fn 6670 in part III.B.2.h.vii.(a) Distribution Provisions Resulting from Control Causing Grantor Trust Treatment.

accustomed standard of living; or to meet an emergency, would be such a standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not such a standard. The entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard. For example, if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power, the power is not limited by a reasonably definite standard. However, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no such standard exists.

Also, the authority to distribute to oneself constitutes a general power of appointment, causing estate inclusion, if it is not limited by ascertainable standards.[2486] The lapse of such a power may constitute a gift[2487] or generate estate inclusion.[2488]

For all the reasons above, ideally, if and to the extent that a distribution standard is not ascertainable, the trustee with that authority would be not the grantor, a beneficiary, or a person controlled by either of them. If the grantor has the power to change who is such a trustee or if the beneficiary appoints the trustee, consider making sure the changed trustee is independent.[2489]

Sample clauses are below. As is the case with any sample clause in this document, they should be used only by a lawyer exercising his or her independent legal judgment. A group that tries to do a better job of humanizing such drafting is https://purposefulplanninginstitute.com.

First, let's look at a clause providing an ascertainable standard:

SECTION 12.18 **SUPPORT.** Distributions for a person's "support" means distributions for a person's support and maintenance in reasonable comfort, medical care and education (including a course of instruction at an elementary school, secondary school, vocational school, art school, college, university, and graduate school, as well as private tutoring, internships and apprentice work). Distributions for the support of a beneficiary shall be based upon the standard of living to which such beneficiary shall have become accustomed. If and to the extent the power to distribute for support can be exercised to distribute assets to a new trust, the person holding this power may exercise it by modifying the existing trust rather than being required to distribute assets to a new trust.

Many variations of the above are possible and perhaps even better. For example, the grantor's goals for the beneficiary's standard of living may differ from the trustee's or beneficiary's views. However, very important is not to give the trustee "conclusive" or "sole and absolute" discretion in the clause above; an example of this caution is the next-to-the-last sentence of Reg. § 25.2511-1(g)(2) above.

With the limits of that standard lies considerable flexibility. Unless the client suggests otherwise, I include this clause:

[2486] See part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.
[2487] Which gift may be controlled by making the lapse be within the limits of Code § 2514(e), as described in part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary.
[2488] See part III.B.7.f.i Code § 2704 – Current Law.
[2489] See fn 6713 in part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.

SECTION 11.4 CONSIDERATION OF OTHER RESOURCES. In the exercise of the trustee's discretionary power to distribute income or principal of a trust for the support or welfare of any beneficiary, the trustee may consider the other income and financial resources known by the trustee to be reasonably available to such beneficiary, including the legal obligation of any other person to provide for such beneficiary's support. If the beneficiary fails to provide the information requested by the trustee, the trustee shall make such assumptions as the trustee deems appropriate. Except as specifically provided in this Agreement to the contrary, the trustee may either ignore the existence of such other income and financial resources in making the distribution or require the beneficiary to use all or any portion of such other income and financial resources as a condition to the distribution.

Thus, even if one can determine a "correct" amount of support, the trustee can determine a range of distributions by considering or ignoring the beneficiary's other resources.

An example of a clause that is the opposite of an ascertainable standard is:

SECTION 12.21 WELFARE. Distributions for a person's "welfare" means distributions for such person's comfort, welfare and best interests, all as determined in the trustee's absolute discretion. Pursuant to this standard, the trustee is authorized, in the trustee's absolute discretion, to determine that such person's welfare is enhanced by making a distribution to or for the benefit of such person of none, part or all of the trust. If and to the extent the power to distribute for welfare can be exercised to distribute assets to a new trust, the person holding this power may exercise it by modifying the existing trust rather than being required to distribute assets to a new trust.

Our Chicago office uses "best interests" instead of "welfare." "To or for the benefit of" is intended to authorize decanting; see part II.J.18.c Decanting.

Finally, to avoid the general power of appointment and related issues, consider the following clause I use for revocable trusts (which needs to be modified for irrevocable trusts to protect against inclusion in the grantor's estate), which opts out of state law protections relating to those issues and instead provides more flexibility but within established safeguards:

SECTION 11.5 NO DISCHARGE OF SUPPORT OBLIGATIONS AND OTHER LIMITATIONS. Subsections 2 through 4, inclusive, of RSMo section 456.8-814 shall not apply to any trust created in this Agreement. Notwithstanding that other provisions of this Agreement empower the trustee, in the trustee's discretion, to make distributions of income, principal or both from a trust, except as provided in the last sentence of this Section, the following provisions are limitations of the powers of the trustee (other than me) and shall not be construed as granting the trustee additional powers:

[Delete highlighted language here and at the end unless we are certain we want to force estate tax inclusion]

(a) No individual trustee shall have any voice or vote in considering whether to make any discretionary distribution of income or principal for such trustee's own benefit unless such distribution pertains to such trustee's support. No trustee who is appointed by a beneficiary may make any discretionary distribution of income or principal for such beneficiary unless either such distribution pertains to such beneficiary's support or the trustee is not a related or subordinate party (as defined in Code section 672(c)) with respect to such beneficiary.

(b) No such discretionary power, whether or not subject to standards, ascertainable or otherwise, may be exercised to effect a distribution that would discharge (in whole or in part) any legal obligation (including a support obligation) of any of the following described persons in their individual capacity, specifically excluding me: (1) any person who is then a trustee of the trust that would make the distribution; and (2) any person who is deemed to have the power of a trustee of the trust that would make the distribution (and without limiting the generality of the foregoing, an example of such a person would be a person who holds a power, then exercisable with respect to the trust that would make the distribution, to remove the trustee then serving and appoint the holder of such power as the trustee).

(c) A power the exercise of which is limited or prohibited by subsection (a) or subsection (b) may be exercised by a majority of the remaining trustee(s) whose exercise of the power is not so limited or prohibited. If the power of all trustees is so limited or prohibited, the trustees(s) may appoint a special trustee (who is otherwise not limited or prohibited from exercising the power under subsection (a) or subsection (b)) to exercise the power.

This Section shall not apply to limit distributions that any trustee of a nonexempt Life Trust (even if the beneficiary) makes for the beneficiary's welfare.

Are distributions to cover income taxes covered under the amounts allowed under the ascertainable standards, or are they the discharge of a legal obligation prohibited under Section 11.5? One way to view this question:

- First, taxes are a legal obligation, and authorizing a beneficiary-trustee to discharge his own legal obligations constitutes a general power of appointment and would move one outside of the safety of an ascertainable standard.

- However, that response is too literal. It applies more in the context a beneficiary-trustee who takes distributions to pay taxes on her income not generated by that particular trust.

- Suppose the trustee-beneficiary has $100,000 annual needs for living expenses. Suppose the trust makes a $100,000 distribution, which generates a $100,000 K-1 to the beneficiary, and the beneficiary has to pay $30,000 taxes as a result of that distribution. That means that the beneficiary has only $70,000 remaining from that distribution with which to pay living expenses. In that case, I would gross up the distribution for taxes, so that the beneficiary has enough money to fund living expenses and pay tax on the distribution. That beneficiary may need a $150,000 distribution to fund $100,000 of living expenses and $50,000 taxes on the $150,000 distribution.

- I would not hesitate to advise that trustee-beneficiary to effectuate a $150,000 distribution.

- If that same beneficiary had $200,000 in earnings outside of the trust, I would advise the beneficiary that covering the taxes on that $200,000 is not permitted.

- I would be comfortable calculating the taxes on the trust distribution by calculating their tax liability with and without the trust distribution.

- Of course, the trustee's lawyer needs to decide whether the above analysis is correct, based on the trust agreement and applicable state law. If the trustee has not consulted with a lawyer, you should insist on having a team approach, which is where your Estate Planning Council connections come in. The lawyer does not need to be involved in every decision, but receiving general guidelines for administering the trust will help keep everyone out of trouble. See also part II.J.4.j Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure.

When considering making distributions, consider the beneficiary's characteristics in relation to the trust's purposes:

- Was the trust created to save estate tax, at a time of lower exemptions? With higher exemptions, might estate inclusion and basis step-up be more helpful? See part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap. Might a distribution of assets in kind generate a future basis step-up?

- What will the beneficiary do with any extra distributions?

    - Will the beneficiary reinvest them, so that the distribution merely moves assets around while keeping them in the family?

    - Will the beneficiary's creditors yank them away, or might the beneficiary blow them on gambling, drugs, or an indolent lifestyle?

    - Will the beneficiary spend them, but in a meaningful way that enhances the family's life? Distributions to beneficiaries raising children might allow them to provide more enriching life experiences or perhaps less stressful lives than the hand-to-mouth living experience that so many people face.

Ultimately, saving income tax may be worthwhile, but not at the cost of poor use of the distributions. Income tax preparers should engage with trustees, trustee's lawyers, and trustees' investment advisors to develop a holistic approach that informs which tactics are appropriate.

This document does not delve into fiduciary duties. Here a list of suggestions by Kanyuk, "Trustee Discretion: The Better Part of Valor or Vulnerability?" *Estate Planning Journal* (WG&L), vol. 46, no. 12 (12/2019):

- Read the trust agreement, and any amendments, letters of wishes, or affidavits from the grantor regarding the grantor's intent. Prepare a concise but accurate abstract of the agreement for reference by the trust administrator and staff.

- Determine and document the standard, if any, for making discretionary distributions, including any precatory language in the trust agreement intended to guide the trustee in exercising its discretion.

- For trusts with multiple current beneficiaries, determine whether any beneficiary is the “primary beneficiary,” and, if so, determine the circumstances under which discretion might be exercised in favor of the non-primary beneficiaries.

- Keep complete, accurate, and current records of the trust assets.

- Determine whether and which resources of the beneficiary must be considered when exercising discretion, and document the procedure for requesting or otherwise obtaining information about the resources.

- Document all beneficiary requests for distributions, as well as the trustee’s response to them (*i.e.*, decision to distribute or not distribute, and the basis for the decision).

- Document whether any conditions must be satisfied in order for a distribution to be made (e.g., beneficiary must be a certain age, have attained a certain level of education, etc.).

- Coordinate the trust’s investment policy with required or anticipated distributions.

These ideas might help not only from a fiduciary duty viewpoint but also to demonstrate to the IRS that the fiduciary duties were “real” and that therefore the IRS should respect them.

II.J.3. Strategic Fiduciary Income Tax Planning

Planning for fiduciary income tax is a matter of comparing taxation at the trust level, beneficiary level, or deemed owner level, including the following issues:

- Who is best taxed on gross income?[2490]

- Who benefits most from deductions?[2491]

- Consider not only the effect of federal tax but also state and local income tax.[2492]

- Does the method of shifting the incidence of taxation undermine any material purpose of the trust?

- Do decisions made for the current taxable year affect taxation in future years?

- How much flexibility does a trustee have for currently irrevocable trusts, and can this flexibility be enhanced?

- How should one draft to provide more flexibility?

For distributing capital gain, see part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).

[2490] See parts II.J.3.a Who Is Best Taxed on Gross Income and II.J.3.b Effect of Kiddie Tax on Rates.
[2491] See part II.J.3.d Who Benefits Most from Deductions.
[2492] See part II.J.3.e State and Local Income Tax.

Also note that beneficiaries who are trustees can reduce income subject to the net investment income tax by taking reasonable trustee fees; however, this strategy is not a good idea if the trust has any significant tax-exempt income (because the deduction would be disallowed to the extent allocable to tax-exempt income,[2493] but the entire fee income would still be recognized) or if and to the extent the deduction would offset income (such as qualified dividends or long-term capital gain) taxable at a lower rate. For other aspects of the NII tax, see parts II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles and II.I.9 Elections or Timing Strategies to Consider to Minimize the 3.8% Tax on NII.

Rev. Proc. 2023-34, § 3.01 provides that the 37% top noncorporate income rate on ordinary income applies to the following taxpayers at the following 2024 taxable incomes:

• Married Individuals Filing Joint Returns and Surviving Spouses	$731,200
• Heads of Households	$609,350
• Unmarried Individuals (other than Surviving Spouses and Heads of Households)	$609,350
• Married Individuals Filing Separate Returns	$365,600
• Estates and Trusts	$ 15,200

Rev. Proc. 2023-34, § 3.02, "Unearned Income of Minor Children (the "Kiddie Tax")," provides:

> For taxable years beginning in 2024, the amount in § 1(g)(4)(A)(ii)(I), which is used to reduce the net unearned income reported on the child's return that is subject to the "kiddie tax," is $1,300. This $1,300 amount is the same as the amount provided in § 63(c)(5)(A), as adjusted for inflation. The same $1,300 amount is used for purposes of § 1(g)(7) to determine whether a parent may elect to include a child's gross income in the parent's gross income and to calculate the "kiddie tax." For example, one of the requirements for the parental election is that a child's gross income is more than the amount referenced in § 1(g)(4)(A)(ii)(I) but less than 10 times that amount; thus, a child's gross income for 2024 must be more than $1,300 but less than $13,000.

Rev. Proc. 2023-34, § 3.03, "Maximum Capital Gains Rate," provides:

> For taxable years beginning in 2024, the maximum zero rate amounts and maximum 15 percent rate amounts under § 1(j)(5)(B), as adjusted for inflation, are as follows:

Filing Status	Maximum Zero Rate Amount	Maximum 15% Rate Amount
Married Individuals Filing Joint Returns and Surviving Spouse	$94,050	$583,750
Married Individuals Filing Separate Returns	$47,025	$291,850

[2493] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items, especially fn. 2817.

Filing Status	Maximum Zero Rate Amount	Maximum 15% Rate Amount
Heads of Household	$63,000	$551,350
All Other Individuals	$47,025	$518,900
Estates and Trusts	$ 3,150	$ 15,450

Rev. Proc. 2023-34, § 3.27, "Qualified Business Income," provides that for taxable years beginning in 2024, the threshold amount under Code § 199A(e)(2) is $383,900 for married filing joint returns, $191,950 for married filing separate returns, and $191,950 for all other returns.

II.J.3.a. Who Is Best Taxed on Gross Income

Increased adjusted gross income (AGI) might cause a beneficiary to lose tax benefits, effectively increasing the beneficiary's marginal income tax rate. Therefore, even if the trust and beneficiary have the same nominal rate, the beneficiary might have a higher effective tax rate. Increased beneficiary AGI can cause the following tax detriments:

- Reduction in Particular Itemized Deductions. Itemized deductions such as medical expenses and casualty losses are reduced as AGI increases.

- Phase Out of AMT Exemption. The alternative minimum tax exemption is phased out and eventually eliminated once income exceeds certain limits.

- Net Investment Income (NII) Tax.

    - Once an individual's income exceeds certain thresholds, NII tax applies.[2494] Although a trust's income quickly becomes subject to the NII tax, the threshold for an individual is much higher.

    - NII tax applies to passive income.[2495] The trustee of a nongrantor trust might not be a suitable person to participate sufficiently to avoid the income being characterized as passive, and the rules governing whether a trustee's work constitutes participation are challenging to apply.[2496] If the trust is a grantor trust, the deemed owner's work is what counts while that person is the deemed owner,[2497] although the trustee's work might be important to set the stage for future nonpassive treatment.[2498] For a nongrantor trust,

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[2494] See part II.I.3 Tax Based on NII in Excess of Thresholds.
[2495] See part II.I.8 Application of 3.8% Tax to Business Income.
[2496] See part II.K.2.b Participation by an Estate or Nongrantor Trust.
[2497] See part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles, especially fn. 2318.
[2498] The trust will cease to be a grantor trust when the deemed owner dies, if the grantor trust powers are not turned off before then. If a QSST sells its S corporation stock, the sale is taxed to the trust rather than to the beneficiary. Consider having the trustee work in the business to try to establish participation, looking toward those events. See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax), II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets, and II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.

beneficiary's participation should count for depreciation but does not count for other items of business income.[2499]

- If the beneficiary is charitably inclined, the trust and beneficiary can avoid NII tax by the trust instead of the beneficiary making charitable contributions.[2500]

If the trust has business income, consider planning opportunities described in part II.E.1.f Trusts/Estates and the Code § 199A Deduction.

Also, consider whether the trust or the beneficiary has capital loss (or, less likely but still possible, net operating loss) carryovers against which to offset trust income.

II.J.3.b. Effect of Kiddie Tax on Rates

Code § 1(g) requires the tax of certain children, including certain students who have not attained age 24 as of the close of such calendar year, to compute their income tax based on their parents' rates.

However, no comparable rule applies to computing children's 3.8% net investment income tax.[2501]

Thus, shifting income to children subject to the kiddie tax can still result in tax savings.

II.J.3.c. Who Is Benefits the Most from Losses

See also part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, discussing a trade-off between NII tax and regular income if the business has enough potential for ups and downs in its taxable income that planning for a potential significant loss becomes important.

II.J.3.d. Who Benefits Most from Deductions

Consider that generally the fiduciary income tax system allows nongrantor trusts[2502] to net deductions against income before allocating income to beneficiaries. Thus, incurring expenses at the trust level provides benefits similar to trapping income inside trusts described in part II.J.3.a Who Is Best Taxed on Gross Income. However, depreciation deductions may pass through directly to beneficiaries, and trusts cannot use Code § 179 to expense assets but instead need to rely on bonus depreciation.[2503]

[2499] See part II.K.2.b.iv Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary; Interaction with Special Depreciation Rules.
[2500] Individuals cannot deduct charitable contributions against NII (the charitable deduction is not listed in part II.I.6 Deductions Against NII), but trusts can. See part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles, especially fn. 2324.
[2501] For thresholds, see part II.I.3 Tax Based on NII in Excess of Thresholds.
[2502] Reg. § 1.67-2T(g)(1) prevents grantor trusts from netting deductions.
[2503] Depreciation and similar deductions are an exception to this rule. See part II.J.11.a Depreciation Advantages and Disadvantages.

Note that miscellaneous itemized deductions are disallowed for any taxable year beginning after December 31, 2017 and before January 1, 2026.[2504] Reg. § 1.67-4(b)(4), "Investment advisory fees," provides that most investment advisory fees are miscellaneous itemized deductions:[2505]

> Fees for investment advice (including any related services that would be provided to any individual investor as part of an investment advisory fee) are incurred commonly or customarily by a hypothetical individual investor and therefore are subject to the 2-percent floor. However, certain incremental costs of investment advice beyond the amount that normally would be charged to an individual investor are not subject to the 2-percent floor. For this purpose, such an incremental cost is a special, additional charge that is added solely because the investment advice is rendered to a trust or estate rather than to an individual or attributable to an unusual investment objective or the need for a specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current beneficiaries and remaindermen) such that a reasonable comparison with individual investors would be improper. The portion of the investment advisory fees not subject to the 2-percent floor by reason of the preceding sentence is limited to the amount of those fees, if any, that exceeds the fees normally charged to an individual investor.

However, favorable treatment is provided deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate.[2506] Reg. § 1.67-4, "Costs paid or incurred by estates or non-grantor trusts," provides in subsection (a), "Deductions":[2507]

[2504] See part II.G.4.n Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax.

[2505] To try to get much more tax benefit from such fees, see part II.G.4.l.i.(e) Family Office as a Trade or Business

[2506] Code § 67(e)(1), which regulations narrow the definition more than one might have otherwise thought.

[2507] The preamble to T.D. 9918 (10/19/2020), explains:

> Section 67(g) was added to the Code on December 22, 2017, by section 11045(a) of Public Law 115-97, 131 Stat. 2054, 2088 (2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA). Section 67(g) prohibits individual taxpayers from claiming miscellaneous itemized deductions for any taxable year beginning after December 31, 2017, and before January 1, 2026. Prior to the TCJA, miscellaneous itemized deductions were allowable for any taxable year only to the extent that the sum of such deductions exceeded two percent of adjusted gross income. See section 67(a). Section 67(b) defines miscellaneous itemized deductions as itemized deductions other than those listed in section 67(b)(1) through (12).
>
> Section 67(e) provides that, for purposes of section 67, an estate or trust computes its adjusted gross income in the same manner as that of an individual, except that the following additional deductions are treated as allowable in arriving at adjusted gross income: (1) The deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such estate or trust, and (2) deductions allowable under section 642(b) (concerning the personal exemption of an estate or non-grantor trust), section 651 (concerning the deduction for trusts distributing current income), and section 661 (concerning the deduction for estates and trusts accumulating income). Accordingly, section 67(e) removes the deductions described in section 67(e)(1) and (2) from the definition of itemized deductions under section 63(d), and thus from the definition of miscellaneous itemized deductions under section 67(b), and treats them as deductions allowable in arriving at adjusted gross income under section 62(a). Section 67(e) further provides regulatory

(1) *Section 67(e) deductions.*

(i) *In general*. An estate or trust (including the S portion of an electing small business trust) not described in § 1.67-2T(g)(1)(i) (a non-grantor trust) must compute its adjusted gross income in the same manner as an individual, except that the following deductions (section 67(e) deductions) are allowed in arriving at adjusted gross income:

(A) Costs that are paid or incurred in connection with the administration of the estate or trust that would not have been incurred if the property were not held in such estate or trust; and

(B) Deductions allowable under section 642(b) (relating to the personal exemption) and sections 651 and 661 (relating to distributions).

(ii) *Not disallowed under section 67(g)*. Section 67(e) deductions are not itemized deductions under section 63(d) and are not miscellaneous itemized deductions under section 67(b). Therefore, section 67(e) deductions are not disallowed under section 67(g).

(2) *Deductions subject to 2-percent floor.* A cost is not a section 67(e) deduction and thus is subject to both the 2-percent floor in section 67(a) and section 67(g) to the extent that it is included in the definition of miscellaneous itemized deductions under section 67(b), is incurred by an estate or non-grantor trust (including the S portion of an electing small business trust), and commonly or customarily would be incurred by a hypothetical individual holding the same property.

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authority to make appropriate adjustments in the application of part I of subchapter J of chapter 1 of the Code to take into account the provisions of section 67.

The proposed regulations under § 1.67-4 clarify that expenses described in section 67(e) remain deductible in determining the adjusted gross income of an estate or non-grantor trust during the taxable years in which section 67(g) applies. Accordingly, section 67(g) does not deny an estate or non-grantor trust (including the S portion of an electing small business trust) a deduction for expenses described in section 67(e)(1) and (2) because such deductions are allowable in arriving at adjusted gross income and are not miscellaneous itemized deductions under section 67(b). Commenters agreed with the proposed amendments. These regulations adopt the proposed regulations under § 1.67-4 without modification.

Two commenters requested that the regulations address the treatment of deductions described in section 67(e)(1) and (2) in determining an estate or non-grantor trust's income for alternative minimum tax (AMT) purposes. The commenters suggested that such deductions are allowable as deductible in computing the AMT. The treatment of deductions described in section 67(e) for purposes of determining the AMT is outside the scope of these regulations concerning the effects of section 67(g); therefore, these regulations do not address the AMT. Further, no conclusions should be drawn from the absence of a discussion of the AMT in these regulations regarding the treatment of deductions described in section 67(e) for purposes of determining the AMT.

One commenter suggested that the Treasury Department and the IRS exercise their regulatory authority under section 67(e) to exempt cemetery trusts under section 642(i) and qualified funeral trusts (QFTs) under section 685 from the application of section 67(g)….

The Treasury Department and the IRS continue to consider these comments but providing an exemption for cemetery and funeral trusts under section 67(g) is outside the scope of these regulations.

For further explanation, T.D. 9918 (10/19/2020), the preamble to Reg. § 1.67-4(a), said:

A. Section 67

Section 67(g) was added to the Code on December 22, 2017, by section 11045(a) of Public Law 115-97, 131 Stat. 2054, 2088 (2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA). Section 67(g) prohibits individual taxpayers from claiming miscellaneous itemized deductions for any taxable year beginning after December 31, 2017, and before January 1, 2026. Prior to the TCJA, miscellaneous itemized deductions were allowable for any taxable year only to the extent that the sum of such deductions exceeded two percent of adjusted gross income. See section 67(a). Section 67(b) defines miscellaneous itemized deductions as itemized deductions other than those listed in section 67(b)(1) through (12).

Section 67(e) provides that, for purposes of section 67, an estate or trust computes its adjusted gross income in the same manner as that of an individual, except that the following additional deductions are treated as allowable in arriving at adjusted gross income: (1) The deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such estate or trust, and (2) deductions allowable under section 642(b) (concerning the personal exemption of an estate or non-grantor trust), section 651 (concerning the deduction for trusts distributing current income), and section 661 (concerning the deduction for estates and trusts accumulating income). Accordingly, section 67(e) removes the deductions described in section 67(e)(1) and (2) from the definition of itemized deductions under section 63(d), and thus from the definition of miscellaneous itemized deductions under section 67(b), and treats them as deductions allowable in arriving at adjusted gross income under section 62(a). Section 67(e) further provides regulatory authority to make appropriate adjustments in the application of part I of subchapter J of chapter 1 of the Code to take into account the provisions of section 67.

The proposed regulations under § 1.67-4 clarify that expenses described in section 67(e) remain deductible in determining the adjusted gross income of an estate or non-grantor trust during the taxable years in which section 67(g) applies. Accordingly, section 67(g) does not deny an estate or non-grantor trust (including the S portion of an electing small business trust) a deduction for expenses described in section 67(e)(1) and (2) because such deductions are allowable in arriving at adjusted gross income and are not miscellaneous itemized deductions under section 67(b). Commenters agreed with the proposed amendments. These regulations adopt the proposed regulations under § 1.67-4 without modification.

Two commenters requested that the regulations address the treatment of deductions described in section 67(e)(1) and (2) in determining an estate or non-grantor trust's income for alternative minimum tax (AMT) purposes. The commenters suggested that such deductions are allowable as deductible in computing the AMT. The treatment of deductions described in section 67(e) for purposes of determining the AMT is outside the scope of these regulations concerning the effects of section 67(g); therefore, these regulations do not address the AMT. Further, no conclusions should be drawn from the absence of a discussion of the AMT in these regulations regarding the treatment of deductions described in section 67(e) for purposes of determining the AMT.

One commenter suggested that the Treasury Department and the IRS exercise their regulatory authority under section 67(e) to exempt cemetery trusts under section 642(i) and qualified funeral trusts (QFTs) under section 685 from the application of section 67(g). The commenter stated that the primary type of expense incurred by these trusts is investment advisory expenses, the tax treatment of which differs under the Code from management expense. That is, trust management expenses generally are allowable in computing adjusted gross income under section 67(e)(1), while trust investment advisory expenses are miscellaneous itemized deductions. See § 1.67-4(b)(4). The commenter asserted that it was not the intent of Congress to disallow investment advisory expenses incurred by cemetery and funeral trusts when Congress enacted section 67(g).

The commenter suggested that exercising the regulatory authority under section 67(e) in this manner would be consistent with the exercise of regulatory authority under section 1411 to exempt section 642(i) cemetery perpetual care funds and QFTs. See § 1.1411-3(b)(1) (providing that certain types of trusts, including section 642(i) cemetery perpetual care funds, are excepted from the net investment income tax) and § 1.1411-3(b)(2) (providing a special rule for QFTs that, for purposes of calculating any tax under section 1411, section 1411 and the regulations thereunder are applied to each QFT by treating each beneficiary's interest in the trust as a separate trust). As stated in the preamble to TD 9644 (78 FR 72393), the Treasury Department and the IRS exercised their regulatory authority under section 1411 to exclude cemetery trusts from the net investment income tax because, by benefiting an operating company, such trusts are considered similar to the business trusts that are excluded from the operation of section 1411. The preamble also states that QFTs are not excluded from the application of the net income investment tax, but that the section 1411 tax is calculated consistent with the taxation of QFTs under chapter 1. The commenter noted that they advocated the treatment of each beneficiary's interest in the QFT as a separate trust because such treatment reduces the likelihood of the QFT beneficiaries being subject to the net investment income tax. The Treasury Department and the IRS continue to consider these comments but providing an exemption for cemetery and funeral trusts under section 67(g) is outside the scope of these regulations.

Unfortunately, this favorable treatment does not apply to grantor trusts.[2508]

For any taxable year beginning after December 31, 2017 and before January 1, 2026, Code § 164(b)(6) limits an individual's (and a trust's, which are the same as an individual's except as provided otherwise) deductions for state taxes to $10,000 ($5,000 for individuals who are married filing separately), but it does not apply this limit to property taxes attributable to a Code § 212 trade or business (which generally would be rental real estate, if it is a trade or business).[2509] Suppose an individual is the beneficiary of a nongrantor trust that pays $10,000 in state taxes, and the individual pays $10,000 in state taxes. The individual and trust would deduct a total of $20,000 of state taxes. However, if the trust were a grantor trust, then only one $10,000 amount – the individual's – would apply. Splitting income among multiple trusts may generate more entities with up to $10,000 state income tax deductions, but beware part II.J.9.c.i Multiple Trusts Created for Tax Avoidance.

[2508] Code § 67(c)(1), which Reg. § 1.67-2T(e)(3) applies to grantor trusts.
[2509] Income taxes attributable to a trade or business remain subject to the $10,000 limit. For more details about my comment on real estate as a trade or business, see part II.E.1.e Whether Real Estate Qualifies as a Trade or Business.

Charitable deductions often produce more benefit to a trust than to an individual.[2510]

Certain losses from the sale of small business stock[2511] are not available to nongrantor trusts,[2512] so grantor trust planning might be considered for that asset. Similarly, depreciation deductions allocated to the remaindermen of a nongrantor trust that is included in the grantor's or beneficiary's estate reduce the basis step-up; presumably this rule would not apply to a grantor trust.[2513]

II.J.3.e. State and Local Income Tax

II.J.3.e.i. Strategic State & Local Tax Issues re: Residence

Consider whether income trapped inside a trust might be taxed at a lower state and local income tax rate (or entirely exempt from such tax) than income reported on a beneficiary's income tax return.

Generally, states do not tax nonbusiness income earned by a nonresident trust. Some high income-tax states fail to tax income earned by trusts set up by their residents that are administered in other jurisdictions, which has led to the creation of incomplete gift nongrantor (ING) trusts to cause capital gain from investments to avoid state income tax.[2514] An ING trust typically uses a distribution committee that is an "adverse party" for income tax purposes, avoiding application of the Code § 674 grantor trust rules,[2515] yet for transfer tax purposes is not "adverse," causing the gift to be incomplete.[2516] Rev. Proc. 2020-3 imposes requirements on the distribution committee before the IRS will issue a private letter ruling.[2517] If a married couple

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2510 See part II.J.4.c Charitable Distributions, text accompanying fn 2572.

2511 See part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244.

2512 See part II.J.11.b Code § 1244 Treatment Not Available for Trusts.

2513 See part II.H.2.d Caution re: Depreciable Property Held in a Nongrantor Trust That Is Included in the Grantor's, Surviving Spouse's, or Other Beneficiary's Estate.

2514 "Incomplete nongrantor" is abbreviated ING, so one often hears of DING (Delaware ING) or NING (Nevada ING) trusts, even though the strategy is available for trusts established in other states (including Missouri). Private letter rulings approving such trusts treat certain trustees as adverse for income tax but not gift tax purposes without explaining how those conditions can coexist.

Now I have some silly comments to add spice to your day:

- Suppose your DING also has some asset protection features. It might be a bankruptcy avoidance trust (BAT). Being a DING-BAT, it was referred to frequently in the TV series, "All in the Family."
- Suppose you have a Missouri ING, and to the extent the grantor allocates GST exemption at death it terminates in favor of a perpetual trust. This MING Dynasty Trust might be appropriate to hold 13th century Chinese artifacts.

2515 See part III.B.2.h.vii.(a) Distribution Provisions Resulting from Control Causing Grantor Trust Treatment.

2516 *Income Taxation of Fiduciaries & Beneficiaries by Abbin*, CCH, § 1407.1.7 No Grantor Trust Status Even Though Transfer Was Incomplete Gift, citing Letter Rulings 201310002-201310006, 201410001-201410010, 201430003-201430007, 201550005-201550012, 201636027, 201650005, 201653001-201653009, 201718003-201718010, 201729009, 201742006, 201744006-201744008, and 201751001-201751003, as well as earlier rulings.

2517 Rev. Proc. 2020-3, § 3.01(93), "Section 671.—Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners," says that the IRS will not rule on the following:

> Whether any portion of the items of income, deduction, and credit against tax of the trust will be included in computing under § 671 the taxable income, deductions and credits of grantors when distributions of income or corpus are made – (A) at the direction of a committee, with or without

transfers community property to an ING and that property retains its character as community property, then that community property will receive a new basis for both halves.[2518]

Consider whether:

- The trustee could have minimized tax by moving the trust.

- By changing residence, the trustee has subjected the trust to income tax. Sometimes a trustee moves, doesn't realize that the move subjects the trust to fiduciary income tax, fails to file, then makes the trust liable for not only tax but also interest and penalties.

Consider preparing and updating a contacts list for the trust to see what contacts the trust has with which states and whether that can generate state income tax liability or whether contacts can be changed to reduce or eliminate state income tax.

Before making a Code § 645 election to treat a revocable trust as an estate, consider whether that will subject the trust (and trusts created upon its funding) to state income tax.[2519]

> the participation of the grantor, and (1) a majority or unanimous agreement of the committee over trust distributions is not required, (2) the committee consists of fewer than two persons other than a grantor and a grantor's spouse; or (3) all of the committee members are not beneficiaries (or guardians of beneficiaries) to whom all or a portion of the income and principal can be distributed at the direction of the committee or (B) at the direction of, or with the consent of, an adverse party or parties, whether named or unnamed under the trust document (unless distributions are at the direction of a committee that is not described in paragraph (A) of this section).

[2518] Letter Ruling 201850001 concluded:

> Grantors are married and reside in State 2, a community property state. Trust provides that all transferred property to Trust is community property. Moreover, any and all property transferred to Trust prior to the death of the Predeceased Grantor is and shall retain its character as community property. As concluded above, upon the death of each of Grantor, his or her respective interest in Trust as either the Predeceased Grantor or the Surviving Grantor will be includible in his or her respective gross estate for federal estate tax purposes.
>
> Accordingly, based upon the facts submitted and representations made, we conclude that the basis of all community property in Trust on the date of death of the Predeceased Grantor will receive an adjustment in basis to the fair market value of such property at the date of death of the Predeceased Grantor.

Companion rulings concluding to the same effect are Letter Rulings 201850002-201850006.

[2519]See fn. 2724, found in part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI)

Although the discussion below generally refers to trusts, generally it applies to estates as well. If a trustee has discretion to make an election regarding that trust, the election does not affect the choices available regarding other trusts the trustee manages.

I.A.1.a. Capital Gain Constitutes DNI Unless Excluded

Taxable income is DNI unless expressly excluded.

Code § 643(a)(3) provides:

> *Capital gains and losses*. Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or

(B) paid, permanently set aside, or to be used for the purposes specified in section 642(c).

Thus, to be excluded from the income of a domestic trust, the gains must:

- Arise from the sale or exchange of capital assets,
- Be allocated to corpus, and
- Not be actually or deemed to be distributed.

The rest of this part II.J.8.a Capital Gain Constitutes DNI Unless Excluded focuses on the first two prongs.

I.A.1.a.i. Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset

Only gains from the sale of capital assets are ordinarily excluded from DNI.

For example, "property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business" is not a capital asset. Therefore, the sale of such property would constitute DNI, although it would not constitute trust accounting income. Whether other real estate is a capital asset depends on various facts.

However, "any recognized gain on the sale or exchange of property used in the trade or business" often receives capital gain treatment to the extent it does not constitute certain depreciation recapture. Goodwill that has not been amortized is a capital asset, but goodwill that is being amortized is not a capital asset. Thus, because such assets are not capital assets, such capital gains generally would be included in DNI.

I.A.1.a.ii. Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus

I am unaware of any authority defining "allocated to corpus" as used in Code § 643(a)(3). Presumably it means receipts by the trust that are allocated to principal.

Does the statute mean that capital gain are automatically included in DNI unless they are affirmatively allocated to principal and certain other conditions exist? Reg. § 1.643(a)-3(a) might overrule that requirement, providing (highlighting added):

> *In general*. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

This regulation essentially has three parts:

- Reg. § 1.643(a)-6 deals with foreign trusts.

- Reg. § 1.643(a)-3(b) explains when capital gains from the sale or exchange of an asset are included in DNI and does not include a requirement that the capital gain be allocated to principal. In fact, one of the prongs discusses the treatment when capital gains are allocated to income.

- Depending on the meaning one gives to "ordinarily," this regulation might dispense with the statutory requirement that capital gains be allocated to corpus. The regulation does not explain when it says "ordinarily" what the exceptions might be, other than Reg. §§ 1.643(a)-6 and 1.643(a)-3(b). There would appear to be substantial authority for saying that an affirmative allocation of capital gains to principal is or is not required.

This issue seems to be most important for the trust's gross income that does not take the form of receipts of cash or other property. For example, a trust might invest in a partnership, S corporation, or other flow-through entity that does not distribute all of its taxable income. How should one treat capital gain from a flow-through entity's sale of a capital asset, when the entity distributes less than all of its taxable income? Should the undistributed capital gain be included in DNI?

- With respect to the accumulated capital gain, the trust has no receipts and therefore is not allocated to corpus. Arguably, the capital gain is not excluded from DNI and therefore constitutes DNI.

- On the other hand, the accumulated capital gain benefits the trust's corpus. Should it be treated as if it had been allocated to corpus? In that case, should it be trapped inside the trust, given that it was accumulated inside the entity and not distributed to the beneficiary?

- Given this uncertainty, would the trustee have discretion to take a different position each year? In Reg. § 1.643(a)-3(b), the Treasury generally agreed that the trustee would not be required to take a consistent position year-by-year, except for capital gain allocated to corpus and treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary. Given that this gross income was not allocated corpus (because it was never physically received), perhaps the trustee has discretion to vary the treatment from year to year? Another approach might be to say that, because the undistributed capital gain was not allocated to principal, the regulations might presume that the undistributed capital gain is allocated to income and can be included in DNI inconsistently from year to year under Reg. § 1.643(a)-3(b)(1).

If all of a flow-through entity's K-1 items taxable to the trust are included in DNI, then part II.J.8.c Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal might cause ordinary income to be trapped at the trust level if the flow-through entity distributes cash in an amount less than all of these K-1 items; see part II.J.8.f Consequences of Allocating Capital Gain to DNI. In light of the consequences described there, the most taxpayer-favorable reading may be that capital gain is ordinarily excluded from DNI.

I leave it to the reader to decide which approach is "better" or perhaps to make that decision on a trust-by-trust basis.

For more on using flow-through entities, see part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

I.A.1.b. Should Capital Gain Be Allocated to DNI?

Often beneficiaries have income below the thresholds that cause the 3.8% tax and the additional 5% capital gain tax to be incurred, whereas trusts start paying those taxes at relatively modest income levels. Therefore, distributing capital gains to beneficiaries might be beneficial – at least from an income tax viewpoint.

Consider various factors described in part II.J.3 Strategic Fiduciary Income Tax Planning.

I.A.1.c. Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal

Generally, gains from the sale or exchange of capital assets, net of losses, are excluded from distributable net income (DNI). But that statement belies the flexibility we are about to see.

Reg. § 1.643(a)-3(b) provides:

> *Capital gains included in distributable net income*. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law) -
>
> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));
>
> (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or
>
> (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

Note the word "or" after paragraph (2) above. That indicates capital gains are included in DNI if and to the extent that any one or more of paragraph (1) (the "Income Rule"), paragraph (2) (the "Consistent Principal Rule"), or paragraph (3) (the "Discretionary Principal Rule") applies. For more on the:

- Income Rule, see part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law

- Consistent Principal Rule, see part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary

- Discretionary Principal Rule, see part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary.

Before its amendment by T.D. 9102 (12/30/2003), Reg. § 1.643(a)-3 made it more difficult to include capital gain in DNI.

I.A.1.c.i. Income Rule: Capital Gain Allocated to Income Under State Law

Most states have adopted the Uniform Principal and Income Act, which will be referred to at UPIA for the rest of this part II.J.8.c.i, or its replacement, which is described in part II.J.5.b Uniform Fiduciary Income & Principal Act (UFIPA).

Generally, any capital gain included as the distributive share of income from a partnership or S corporation and distributed from the entity to the trust will constitute income under the Act, making the rest of this part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI) be moot.

Generally, the Act allocates capital gains to principal. The main exceptions are the power to adjust, unitrust distributions, and exceptions in the governing instrument; the power to adjust and power to convert to a unitrust followed adoption of the prudent investor rule. Following a discussion of each of these is a discussion of the respect fiduciary income tax law gives them.

I.A.1.c.i.(a). Power to Adjust

Capital gains may be reclassified as income if traditional trust accounting income principles cause insufficient receipts to be classified as income. See parts II.J.5.b.ii.(a) Power to Adjust.

I.A.1.c.i.(b). Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation

It is not uncommon for partnerships and S corporations to reinvest part of their annual income; indeed, to facilitate growth or simply a stronger capital structure (which lenders might require), many distribute only enough to pay their owners' income taxes (commonly referred to as a "tax distribution") plus a modest bonus (referred to below as a "bonus distribution").

Taxes on this reinvested income are charged against the income of a trust that owns such an entity. This is the only practical solution to the trust's obligation to pay its taxes, because the taxing authorities' claims against the trustee are much more pressing than the beneficiaries' claims. (Note that the income beneficiary of a Qualified Subchapter S Trust pays this tax – part III.A.3.e QSSTs and ESBTs – which has an effect similar to charging the trust's income.)

The Uniform Principal and Income Act includes a remedy for the income beneficiary that had to pay the tax on the entity's accumulated income that has been inherently baked into principal. Section 506(a)(3) authorizes a fiduciary to "make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from … the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary." This specific provision supplements any power to adjust that might generally apply.

Thus, when an interest in a partnership or an S corporation is sold, the trustee should consider whether to allocate some of the sale proceeds to income. However, it's not at all obvious that the trustee should make an adjustment; consider that:

- The entity made distributions specifically to pay this tax, so the trust or income beneficiary was not really "out of pocket" for this tax.

- If the entity had been a C corporation, the entity would have paid the tax itself. Its dividend would have equaled the bonus distribution, and this issue would never have arisen.

- The true issue is whether the bonus distribution was sufficient. Was the decision to accumulate income fair – a sound exercise of the business judgment of those who run the entity? Did those who control the entity promise a make-up distribution at some point because of a special project, or was the accumulation merely part of a solid plan to grow the business, which presumably would result in increased income and increased bonus distributions? Were those who control the entity running it just to benefit themselves (and, if owners, trying to extract more benefits as owners than the inactive owners received)? I have probably left out many other relevant considerations, but hopefully I have communicated why this decision is not easy.

See parts II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Trust Accounting Rules and II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets.

If the trustee is concerned that the income beneficiary might spend a perceived windfall unwisely, the trustee might consider using the power to adjust to spread distributions over an appropriate period of time. Such a spread over time might be more palatable if, instead of labelling the adjustment to sale proceeds as a tax reimbursement, the trustee labelled it as a make-up for insufficient bonus distributions, taking the position that future distributions to beneficiaries might be loosened because of a prior conservative distribution policy. The bonus distributions might have been sufficient from the viewpoint of what the entity should have distributed but might have been insufficient from the viewpoint of how much income the trustee should have tried to generate. As mentioned in part III.A.4.d.iv Advising Clients about the UPAIA § 505 Change and UFIPA § 506 (discussing conflicts with beneficiaries that might arise when an entity makes tax distributions but little or no bonus distributions), these issues have no easy answer.

See also part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Trust Accounting Rules.

I.A.1.c.i.(c). Unitrust

A unitrust is a trust that distributes fixed amounts, redetermined annually as a fixed percentage of the value of the trust's value, which value is redetermined annually but might be based on an average of values, such as the average value of the trust's assets for the past three years. See parts II.J.5.b.ii.(b) Unitrust and II.J.5.b.ii.(c) Comparing Power to Adjust to a Unitrust.

Reg. § 1.643(a)-3(e) provides the following examples regarding unitrusts:

> *Example (11)*. The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.
>
> *Example (12)*. The facts are the same as in Example 11, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire $80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.
>
> *Example (13)*. The facts are the same as in Example 11, except that neither state statutes nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

A right to income expressed initially solely as a unitrust interest may qualify for the QTIP marital deduction.

I.A.1.c.i.(d). Exceptions in the Governing Instrument

Although the Act provides general rules, it also allows trust agreements to override those rules:

> In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:
>
> (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
>
> (2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];
>
> (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and
>
> (4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

I.A.1.c.i.(e). Fiduciary Income Tax Recognition of the Trust Agreement and State Law

Code § 643(b) generally defers to the trust agreement and applicable state law. The Uniform Principal and Income Act ("UPIA") and the Uniform Fiduciary Principal & Income Act ("UFIPA") authorizes the trust agreement to override the Act.

However, Reg. § 1.643(b)-1 does not recognize trust agreements that depart too far from the usual rules:

> Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal.

Reg. § 1.643(b)-1 respects variations provided under applicable state law:

> However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually

> or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods.

Circling back to the Act's authorizing trust agreements to depart from traditional principles, Reg. § 1.643(b)-1 concludes with:

> In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.

For the "reasonable and impartial exercise" requirement in the context of the power to adjust, see part II.J.5.b.ii.(a) Power to Adjust.

I often use a clause providing that the trustee has wide discretion but must reasonably and fairly balance the interests of the income and remainder beneficiaries. That language comes from the marital deduction regulations. Generally, the trustee's authority to allocate between income and principal does not trigger grantor trust status, does not constitute a power of appointment, and does not have generation-skipping transfer tax implications. The trustee might want to consider providing accountings or other notices to the beneficiaries that would start running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile this one on top of it, which procedure might help minimize any gift tax consequences to failing to make a claim.

How does one draw the line between what departs "fundamentally from traditional principles of income and principal" and what is "a reasonable and impartial exercise of a discretionary power granted to the fiduciary" under Reg. § 1.643(b)-1?

Presumably, the trustee should be on solid ground in allocating to income capital gains such that the total amount of all receipts allocated to income does not exceed 5%, given that the regulations expressly approve unitrusts in the 3%-5% range. The trusts should also be on solid ground in allocating to income capital gains generated by a partnership that the settlor intended to distribute to the income beneficiary.

Beyond that, it's a matter of facts and circumstances and judgment. However, Reg. § 1.643(a)-3(e), Example (4) respected a mandatory allocation of capital gain to income where a trust had $5,000 of dividends and $10,000 of capital gains, and the trustee distributed $17,000 to the beneficiary.

I.A.1.c.i.(f). Conclusion Regarding Allocating Capital Gain to Income

Reg. § 1.643(a)-3(b)(1) requires a consistent practice for unitrusts. Considering that the unitrust recipient is receiving cash and presumably would have the liquidity to pay tax on any capital gains distributed to the beneficiary, in many cases it would be fair to allocate capital gain to DNI to the extent that the unitrust amount exceeds the income that would apply under the Act's general rules. Given that one provides for a unitrust when tension between the income beneficiary and remaindermen might be high, the tension created by this tax issue would be high to the same degree. Consider providing a firm rule in the trust agreement regarding the allocation of capital gain to DNI. If one is concerned that shifting tax rates might create an unfair tax result, consider providing a clause reimbursing the unitrust beneficiary for taxes paid on the unitrust and on the reimbursement; this requires cooperation between the trustee's income tax preparer and the beneficiary's income tax preparer, but the calculation should be relatively mechanical.

For trusts that are not unitrusts, Reg. § 1.643(a)-3(b)(1) provides significant flexibility, allowing the trustee discretion whether to allocate capital gain to income for fiduciary accounting purposes (if the trust agreement and state law permit) and also whether to include in DNI the capital gain that was allocated to income.

Consider the nuances for a mandatory income trust. Distributions must be made no later than 65 days after yearend to include capital gain in DNI in every other situation. In a mandatory income trust, a power to adjust might be able to retroactively include capital gain in income – perhaps as late as when the tax return is prepared. For how mandatory income trusts work, see part II.J.5 Mandatory Income Trusts. For limits on retroactivity, see part II.J.5.a Issues Arising with Mandatory Income Trusts.

I.A.1.c.ii. Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary

Reg. § 1.643(a)-3(e) helps guide our application of Reg. § 1.643(a)-3(b)(2):

> *Example (1)*. Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future

years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.

Example (2). The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.

Example (3). The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments. This treatment of capital gains is a reasonable exercise of Trustee's discretion.

The all-or-nothing approach taken by Examples (1) and (2) is not very attractive, but we need to deal with it. Let's consider some fact patterns:

1. <u>The beneficiary needs regular annual distributions that cannot be made using a power to adjust</u>. Generally, distributions in excess of what can made using a power to adjust would not be sustainable. A power to adjust typically adjusts to a 3%-5% distribution, and most models suggest that distributions in excess of that will lead to a trust being depleted. Thus, a more likely scenario is that a power to adjust is not available, because state law prevents using the power to adjust in particular situations (unless the trust agreement overrides it). In such a case, the beneficiary's federal and state/local income tax bracket for capital gains needs to be compared to the trust's federal and state/local income tax bracket for capital gains. Note that a nonresident trust would have a zero state/local income tax bracket, to the extent that the trust does not have income from a business sourced to the state/local jurisdiction.

2. <u>The beneficiary's need for distributions in excess of income is sporadic</u>. It's difficult to predict how the beneficiary's federal and state/local income tax bracket for capital gains compares to the trust's federal and state/local income tax bracket for capital gains, given that rates will change and the trust's and its beneficiaries' circumstances might change over time. In such a case, consider whether the distribution might be phrased as "allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary." If that is likely to be the case, then consider not electing to carry out capital gain automatically under (b)(2) but rather deciding to rely on (b)(3), because (b)(3) is flexible whether to allocate capital gain to income, allowing the decision to made separately each year on a case-by-case basis.

Generally, trustees would not be likely to take advantage of the discretion that Example (3) provides to allocate to income only capital gain from the sale of certain specified assets or a particular class of investments, because such an election requires additional recordkeeping.

Some people point to the word "deem" in Example (1) and emphasize the need for such authority in the trust agreement or applicable state law. Uniform Trust Code § 816 generally authorizes trustees to make tax elections, so the authority to "deem" distributions to be capital gains is inherently authorized in UTC states, as well as any other state where a trustee generally has the authority to make tax elections.

I.A.1.c.iii. Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary

Reg. § 1.643(a)-3(b)(3) might seem confusing at first, but it actually has very practical use.

First, let's look at some examples that Reg. § 1.643(a)-3(e) provides:

> Example (5). The facts are the same as in Example 1, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is $10,000, rather than $12,000. Because Trustee will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.
>
> *Example (6)*. Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to A. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

Although Reg. § 1.643(a)-3(b)(3) is viewed generally as discretionary, note that Example (6) is mandatory: if the trustee is required to distribute sale proceeds to a beneficiary, the capital gain from the sale is included in the DNI that the distribution carries out the beneficiary. Example (7) similarly requires all capital gain recognized in the trust's final taxable year to be included in the DNI that the distribution carries out the beneficiary.

The practical application is based on the ability to count as prior year distributions those distributions made in the first 65 days of the current year. For example, any distribution made on or before March 5, 2020 can be treated as a 2019 or 2020 distribution. This election applies to the greater of accounting income under Reg. § 1.643(b)-1 or DNI under Reg. §§ 1.643(a)-1 through 1.643(a)-7. By completing the line on the trust's income tax return, Form 1041, page 2, Part B, showing amounts (other than income required to be distributed currently) paid, credited, or otherwise required to be distributed and checking the Code § 663(b) box in "Other Information" at the bottom of Form 1041, page 2, the trustee decides how much of a current year distribution is allocated to the prior year; the balance would then be credited to the current year.

The practical application based on the 65-day rule would generally occur during February after the year ends and applies only if the trustee has discretion to distribute corpus. The regulations do not specify any particular trust records regarding the election, so do whatever seems best to evidence the intent. Perhaps the income tax return preparer emails the trustee recommending how much of a distribution be made to distribute income and capital gain under the 65-day rule (erring on the side of distributing too much), then the trustee makes the distribution, and the tax return carries through the intent. As long as the distribution is made timely, the tax return can treat none, part, or all of the distribution as a distribution of the taxable year's income. In a manner similar to Example (5), the trustee has referred to the capital gain itself in determining how much to distribute. Unlike Reg. § 1.643(a)-3(b)(2), Reg. § 1.643(a)-3(b)(3) allows one to carry out discretionary distributions of capital gain inconsistently from one year to another.

If the beneficiary does not require monthly or quarterly cash flow, the trustee can simply each February make a big distribution and apply it to the prior or current year for tax return preparation purposes. If the beneficiary does require monthly cash flow but is willing to accept informal constraints, the trustee makes the big distribution into an investment account that the beneficiary owns, and the account makes monthly transfers to the beneficiary's checking account. Obviously this would not work for a beneficiary who cannot exercise discipline, but there is a good segment of beneficiaries for whom it would work.

An alternative approach is to distribute an asset to a beneficiary before the asset is sold. Generally, the beneficiary will receive a carryover basis and then be taxed on the gain.

As with all tax planning, the strategies described in this part II.J.8.c.iii may be unavailable (based on the trust terms), inadvisable (based on sound financial planning), or stupid (giving money to a drug addict just to save taxes).

I.A.1.c.iv. Netting Capital Losses

Reg. § 1.643(a)-3(d), "Capital losses," provides:

> Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is distributed or required to be distributed to a particular beneficiary. See § 1.642(h)-1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

Thus, if and to the extent that Reg. § 1.643(a)-3(b)(3) includes capital gains in DNI (see part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary), capital losses are not netted against such gains. The recipient beneficiaries report all such capital gains, and the capital losses remain in the trust.

However, note that Reg. § 1.643(a)-3(b)(3) has two elements: "actually distributed to the beneficiary," which would tend to require tracing except in the case of trust termination, or "utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary," in which case the trustee would have needed to consciously decide to refer to the capital gain when making the distribution.

Unless the trustee traces or decides to refer to the gross capital gain (instead of the net capital gain) when making the distribution, the loss would be offset under Reg. § 1.643(a)-3(b)(3). Alternatively, the trustee might not trace and not refer to capital gain but rather exercise the power to adjust, which would invoke Reg. § 1.643(a)-3(b)(1) (see part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law) and include an automatic offset.

I.A.1.c.v. Conclusions Regarding the Basic Framework on Allocating Capital Gains to DNI

Often, one cannot predict whether the combination of federal, state, and local income tax rates will be higher inside or outside of the trust.

Quite frankly, I keep changing my mind regarding the best income tax elections as I encounter new situations. If the document is flexible as to distributions and distributions are appropriate, then I would lean toward:

- Flexible language allowing the trustee to allocate capital gains to income, so long as the trustee must reasonably and fairly balance the interests of the income and remainder beneficiaries.

- Using the 65-day-rule to distribute large capital gains to the beneficiary as DNI.

- Electing <u>not</u> to establish a practice of carrying out capital gain to beneficiaries under Reg. § 1.643(a)-3(b)(2) <u>unless</u> it appears that the above two approaches will not suffice to minimize overall income taxes. However, it is not uncommon for me to decide that the above. two approaches will not suffice to minimize overall income taxes. On the other hand, if the situation involves enough money, the trustee can covert capital gain that would otherwise be trapped inside the trust to trust accounting income, using the tool described in part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

Consider adding a withdrawal right of up to 5% of the trust's value. The beneficiary will be deemed to be the owner of the part that the beneficiary can withdraw and perhaps continue to be deemed the owner with respect to the lapsed portion. However, note that withdrawal rights can increase exposure to creditors to the extent of the withdrawal right and perhaps even after a lapse. For details on all of the ideas mentioned in this paragraph, see part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts. If one is concerned about the withdrawal right itself becoming a bad idea, consider using a provision along the following the lines:

> In addition to the distributions authorized by the preceding sentence, subject to the following sentence the trustee shall distribute to the beneficiary so much of the principal of the trust as the beneficiary, while at least __ years of age, may request once between February 23 and March 5 of every calendar year, on a noncumulative basis, up to five percent (5%) of the aggregate value, as of the time of such request by the beneficiary, of the principal of the trust. The trustee may, by instrument placed in the trust's records, provide that the preceding sentence shall not apply during any period (including the beneficiary's remaining life), which period shall begin no earlier than the January 1 following the date of the instrument.

This allows the trustee to turn off the withdrawal rights for any future year(s) without impeding the beneficiary's absolute right to withdraw during the current year.

I.A.1.c.vi. Fairness of Taxing Capital Gain to Beneficiaries; Need for Tax Distributions Here and Other Areas

Our income tax system taxes income to whoever receives it, subject to certain exceptions not relevant to this part II.J.8.c.vi. Therefore, it is fair to tax the beneficiaries.

However, when a distribution is made for a particular purpose and the money is spent, the beneficiary will get upset when handed a tax bill for which the beneficiary did not plan. Therefore, one might need to make a supplemental distribution to pay tax on the original distribution. The supplemental distribution would also need to be enough to pay tax on the supplemental distribution itself. This supplemental distribution is often referred to as "grossing up the distribution" to pay taxes.

This issue applies to more than just capital gains. Clients who leave residences in trust often wish to have the trust pay expenses that a life tenant would ordinarily pay. Distributions by the trust for those purposes run into the same problem – the money is spent for the intended purpose and not available to pay taxes. These distributions also need to be grossed up to pay taxes.

I.A.1.d. Distribution in Kind; Specific Bequests

I.A.1.d.i. Distribution in Kind - Generally

Except as provided below and except to the extent that it carries out DNI or constitutes a bequest of income, a distribution is a nontaxable gift (unless the recipient assumes liabilities, in which case it is taxed as a bargain sale).

When a trust distributes property to satisfy a pecuniary distribution (even if the amount is expressly authorized to be satisfied in cash or in kind), the trust recognizes gain on the deemed sale, even if the trust's residue is less than the pecuniary obligation. Such a pecuniary obligation includes an equalizing distribution (presumably unless expressed as a fractional share). This rule includes a pecuniary obligation in the form of an annuity payment to a beneficiary, and the gain recognized in paying the annuity is not included in the beneficiary's distributive net income (DNI) unless the rules for including capital gain in DNI are satisfied. If the trust's residue is less than the pecuniary obligation, the fact that all bequests are protected by Code § 663(a)(1) and therefore no residual beneficiary can pick up income under Code § 662 means that the trust will pay the tax, given that the beneficiaries of the protected bequests will not be picking up that income; note that the trustee will need to reserve for this tax before making distributions to beneficiaries and may have a mismatch for net investment income tax purposes as well. However, when a charity that was the annuity recipient was bequeathed the remainder, the resulting merger of interests and trust termination were not a taxable event. Also, if the bequest is satisfied using date-of-death values, presumably no gain or loss would be realized, but to qualify for the marital or charitable deduction the assets' value relative to date of death values must be "fairly representative of appreciation or depreciation in the value of all property thus available for distribution in satisfaction of such pecuniary bequest or transfer."

If a trust makes a non-pro rata distribution of residue without either the trust instrument or local law authorizing a non-pro rata distribution, each beneficiary may be treated as having received a pro rata distribution and exchanged it with the other beneficiaries. Otherwise, generally the trust does not recognize any gain or loss and the beneficiaries receive the same basis as the trust's; for further analysis of dividing trusts (including on termination), see part II.D.5 Severing Trusts with Multiple Grantors. However, the trust may elect to treat all property distributions during the taxable year as sales, but losses in transactions with beneficiaries and other related parties are disallowed except to the extent that they are from an estate (including a revocable trust electing to be taxed as an estate) satisfying a pecuniary bequest. The loss disallowance applies even if the distribution, taken as a whole, results in a net gain. Thus, gains are recognized and losses generally are not.

The amount deemed distributed is the lesser of the property's basis or fair market value, unless gain was recognized, in which case it is the property's value.

Distributing low basis assets will generate a new basis (often a step-up) when the beneficiary dies. However, distributed assets are subject to the beneficiary's creditors, changes in the beneficiary's estate tax posture (including not only changes in the tax law but also changes in financial situation through the beneficiary's own efforts or through marriage and change in residence to a state that imposes its own estate tax), and changes in the beneficiary's dispositive goals. To get a basis step-up, I would rather add (perhaps by decanting) a formula general power of appointment, as described in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.

Distributing an unmarketable partnership interest would carry out DNI without giving the beneficiary cash. However, valuation adjustments might depress the amount of the deemed distributions, and the beneficiary would be entitled to a proportionate share of future distributions from the partnership. However, if the trustee controls the partnership, the trustee can also control the distribution spigot.

I.A.1.d.ii. Specific Bequest

A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under Code § 661 and is not included in the gross income of a beneficiary under Code § 662, unless under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the recipient in more than three installments.

I.A.1.d.iii. Distributing a Note to the Obligor

Rev. Rul. 75-68 provides:

> The income of a testamentary trust consisting solely of interest from mortgages on the beneficiary's property was required to be distributed periodically. Although the mortgage notes held by the trust required the periodic payment of interest, it was agreed between the beneficiary and the trustees, that the beneficiary would pay no interest on the mortgages and the trustees would distribute no income from the trust.
>
> *Held*, notwithstanding the foregoing agreement, the interest income due on the mortgages held by the trust is includible in the gross income of the trust, and this same

amount, as the distributable income of the trust, is includible in the gross income of the beneficiary. Further, the beneficiary is entitled to a deduction for this interest deemed paid on the mortgages.

Below is authority consistent with this conclusion:

Reg. § 1.643(c)-1(a) treats as a beneficiary "any person with respect to an amount used to discharge or satisfy that person's legal obligation as that term is used in § 1.662(a)-4." Reg. § 1.661(a)-2(d) provides:

> The terms "income required to be distributed currently" and "any other amounts properly paid or credited or required to be distributed" also include any amount used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)-4.

Reg. § 1.662(a)-4, "Amounts used in discharge of a legal obligation," provides:

> Any amount which, pursuant to the terms of a will or trust instrument, is used in full or partial discharge or satisfaction of a legal obligation of any person is included in the gross income of such person under section 662(a)(1) or (2), whichever is applicable, as though directly distributed to him as a beneficiary, except in cases to which section 71 (relating to alimony payments) or section 682 (relating to income of a trust in case of divorce, etc.) applies. The term "legal obligation" includes a legal obligation to support another person if, and only if, the obligation is not affected by the adequacy of the dependent's own resources. For example, a parent has a "legal obligation" within the meaning of the preceding sentence to support his minor child if under local law property or income from property owned by the child cannot be used for his support so long as his parent is able to support him. On the other hand, if under local law a mother may use the resources of a child for the child's support in lieu of supporting him herself, no obligation of support exists within the meaning of this paragraph, whether or not income is actually used for support. Similarly, since under local law a child ordinarily is obligated to support his parent only if the parent's earnings and resources are insufficient for the purpose, no obligation exists whether or not the parent's earnings and resources are sufficient. In any event, the amount of trust income which is included in the gross income of a person obligated to support a dependent is limited by the extent of his legal obligation under local law. In the case of a parent's obligation to support his child, to the extent that the parent's legal obligation of support, including education, is determined under local law by the family's station in life and by the means of the parent, it is to be determined without consideration of the trust income in question.

Reg. § 1.661(a)-2(d) provides:

> The terms "income required to be distributed currently" and "any other amounts properly paid or credited or required to be distributed" also include any amount used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)-4.

I.A.1.e. Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries

Generally, K-1 income from a passthrough business entity will carry out any income (including capital) distributed to the trust and then to the trust's beneficiaries. This section focuses on nongrantor trusts holding partnerships rather than S corporations, because generally a trust can hold S corporation stock that is not a grantor trust, QSST, or ESBT only during a relatively limited amount of time. (Although the principles in this part II.J.8.e would apply to a net income with make-up charitable remainder unitrust – a NIMCRUT – the IRS has concerns about that application and might shut it down at some point.)

Also, if one elected not to carry out capital gains under Reg. § 1.643(a)-3(b)(2) and later decides that all capital gain should be included in DNI going forward (or does not want to take a risk that the IRS will not respect deviations from general rules of the Uniform Principal and Income Act, consider forming an entity taxed as a partnership. Capital gains earned through a partnership generally constitute trust accounting income.

The Uniform Principal and Income Act provides that, generally, all cash distributions from an entity (including a partnership) are considered trust accounting income. Only the following distributions from an entity are not considered trust accounting income:

- property other than money;
- money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;
- money received in total or partial liquidation of the entity; and
- money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

Thus, a partnership's capital gains recognized in the ordinary course of managing and re-balancing a portfolio would constitute fiduciary accounting income to the extent distributed from the partnership in cash and therefore would be includible in DNI under (1) above.

To keep control of the partnership, consider having the trust be a 1% general partner and 98% limited partner, and the beneficiary or someone else might contribute 1% as a limited partner. Distributing a limited partnership interest to a beneficiary can carry out income and perhaps capital gain while at the same time not giving the beneficiary cash to spend (but be sure to distribute enough cash so that the beneficiary can pay tax on the distribution). Be careful to avoid the gain on formation that applies when a contributing partner diversifies the partner's holdings by forming the partnership. If the trust holds not only marketable securities but also investments in businesses, consider setting up one partnership for the business investments and another partnership for the marketable securities, which would help facilitate allocating trust assets on termination or any other trust division. Also consider whether a state with jurisdiction over the trust might subject the partnership itself to state income tax.

Complexity might arise if a partnership distributes less than all of its taxable income to a mandatory income trust. It is unclear whether all of the trust's distributive share of capital gain is DNI. Furthermore, interrelated calculations might be required for a mandatory income trust. Generally, we should look to see whether planning under part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law or II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is sufficient before recommending a partnership solely to address the issues described in part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.

I.A.1.f. Consequences of Allocating Capital Gain to DNI

I.A.1.f.i. General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income (and General Retention of the Character of DNI Distributed to Beneficiaries)

This part II.J.8.f.i first discusses netting deductions against income then discusses allocating that income.

I.A.1.f.i.(a). Allocating Deductions to Various Income Items

Rules for allocating deductions include:

- All deductible items directly attributable to one class of income are allocated to that class. To the extent that any items of deduction which are directly attributable to a class of income exceed that class of income, they may be allocated to any other class of income (including capital gains) included in distributable net income as described above except that any excess deductions attributable to tax-exempt income may not be offset against any other class of income.

- Deductions not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing DNI, but Code § 265 requires a portion of such indirect expenses to be allocated to non-taxable income. Such indirect expenses include trustee fees, the rental of safe deposit boxes, and state income and personal property taxes. Once one has allocated expenses to tax-exempt income, how does one choose to which items of taxable income to allocate deductions? One would consider allocating to those income items that are most highly taxed, considering federal and state income tax and the 3.8% tax on net investment income. For example, interest income is taxed at the highest rates, whereas qualified dividends are taxed at long-term capital gain rates. Within interest income, consider whether the interest is from U.S. obligations exempt from state income tax. Although distributions from qualified retirement plans and IRAs are taxed at the highest regular tax rate, they are exempt from the 3.8% tax on net investment income. See part II.I.6 Deductions Against NII (especially the text accompanying fns. 2307-2308).

- If a charitable deduction under Code § 642(c) is involved, any allocations of taxable income between the charitable deduction and the beneficiaries must have substantial economic effect.

- Special rules apply to depreciation deductions.

I.A.1.f.i.(b). Allocating Income Items Among Those Receiving It

In allocating income between the trust and the beneficiary (or beneficiaries), the amounts of DNI distributed to the beneficiaries:

> shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the estate or trust as the total of each class bears to the total distributable net income of the estate or trust in the absence of the allocation of different classes of income under the specific terms of the governing instrument.

However, this proportionate rule is subject to specific provisions in the governing instrument for the allocation of different classes of income or different allocations under local law, subject to tax-exempt income being allocated in a manner that does not allow it to be deducted.

Thus, except for tax-exempt income and allocations between the charitable and noncharitable shares (and any special rules regarding depreciation deductions), it appears that a trust agreement may create ordering provisions between which items of DNI the trust retains and which items of DNI the trust distributes to beneficiaries. However, such a provision might encounter significant resistance from the IRS.

Once one decides which items of DNI the trust distributes to beneficiaries, generally distributions to each beneficiary carry out a pro rata portion of ordinary income and capital gain items allocated to the beneficiaries, and any other characteristic of the income at the trust level retains its status in the beneficiary's hands (which, among other things, is important for net investment income tax purposes). Code § 652(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary.

Code § 662(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same

> proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642(c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary. In the application of this subsection to the amount determined under paragraph (1) of subsection (a), distributable net income shall be computed without regard to any portion of the deduction under section 642(c) which is not attributable to income of the taxable year.

Reg. § 1.662(b)-1 provides:

> In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§ 1.662(a)-1 through 1.662(a)-4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For this purpose, the principles contained in § 1.652(b)-1 shall apply.

Reg. § 1.652(b)-1 provides:

> In determining the gross income of a beneficiary, the amounts includible under § 1.652(a)-1 have the same character in the hands of the beneficiary as in the hands of the trust. For example, to the extent that the amounts specified in § 1.652(a)-1 consist of income exempt from tax under section 103, such amounts are not included in the beneficiary's gross income. Similarly, dividends distributed to a beneficiary retain their original character in the beneficiary's hands for purposes of determining the availability to the beneficiary of the dividends received credit under section 34 (for dividends received on or before December 31, 1964) and the dividend exclusion under section 116…. Similarly, to the extent such amounts consist of an amount received as a part of a lump sum distribution from a qualified plan and to which the provisions of section 72(n) would apply in the hands of the trust, such amount shall be treated as subject to such section in the hands of the beneficiary except where such amount is deemed under section 666(a) to have been distributed in a preceding taxable year of the trust and the partial tax described in section 668(a)(2) is determined under section 668(b)(1)(B). The tax treatment of amounts determined under § 1.652(a)-1 depends upon the beneficiary's status with respect to them not upon the status of the trust. Thus, if a beneficiary is deemed to have received foreign income of a foreign trust, the includibility of such income in his gross income depends upon his taxable status with respect to that income.

This proportionate requirement applies "unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation."

When allocating income among beneficiaries:

> The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation.

I.A.1.f.ii. How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary

If the amount of DNI is less than the amount distributed to the beneficiary, the issues described in this part II.J.8.f.ii How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary become important.

Some income might be inadvertently trapped in the trust if the allocation rules of part II.J.8.f.i General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income apply without being modified by any special ordering rule in the trust agreement and if all of a pass-through entity's capital gain constitutes DNI under an approach described in part II.J.8.a.ii Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus That's because looking exclusively at those two factors bypasses the analysis of part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal.

For example, trust has $10,000 of interest income. Trust's distributive share of partnership's income is $20,000 of dividend income and $70,000 of long-term capital gains. If the rules described in the preceding paragraph apply, then 10% of all distributions constitute interest income, 20% constitute dividend income, and 70% constitute long-term capital gains. Trust distributes $50,000 to the beneficiary. Therefore, each of the beneficiary and the trust has $5,000 of interest income, $10,000 of dividend income, and $35,000 of long-term capital gains.

Contrast that to an approach under which the trustee is able to control how much capital gain is included in DNI, under part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal. On a year-by-year basis, the trustee can selectively include capital gain in DNI to the extent that one or both of part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary or part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is available. By including in DNI just enough capital gain to cause the DNI to match the cash distributed to the beneficiary, the trustee can ensure that all of the ordinary income is distributed to the beneficiary.

If a state that imposes income tax follows the federal rules, exercising a general power of appointment might shift the grantor.[2520] If such a shift is undesirable, see part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.

II.J.3.e.ii. When a State Can or Does Tax a Trust's Income

I do not maintain a chart of when a state asserts the right to tax a trust's income. I suggest the reader check the research service of his or her choice. You can get a quick summary created by Dick Nenno, author of the BNA Tax Management Portfolio that thoroughly covers the topic, by checking out the footnote associated with this sentence.[2521]

If and to the extent a trust's income is carried out to a beneficiary on a K-1, that beneficiary's home state taxes the income at the beneficiary level and generally the issue of the trust's residency is moot.

II.J.3.e.ii.(a). *McNeil* (Pennsylvania)

McNeil Trust v. Commonwealth of Pennsylvania, 67 A.3d 185 (Commonwealth Court of Pa. 2013), held that the Department of Revenue violated the Commerce Clause of the U.S. Constitution when it "assessed Pennsylvania Income Tax (PIT) and interest on all of the income of two inter vivos trusts, which are located in, administered in, and governed by the laws of Delaware and which had no Pennsylvania income or assets in 2007. The Department imposed the PIT because the trusts' settlor, Robert L. McNeil, Jr. (Settlor), resided in Pennsylvania when he established the trusts in 1959 and the trusts' discretionary beneficiaries are Pennsylvania residents." The facts were (citations to stipulations omitted):

> .... On January 2, 1959, Settlor, a Pennsylvania resident, executed the Trusts' Agreements and, by January 3, 1959, all of the Trusts' trustees had executed those Agreements. The Trusts' Agreements provide that the Trusts are Delaware trusts that are to be governed, administered, and construed under the laws of Delaware, and named the Wilmington Trust Company (WTC), located in Wilmington, Delaware, as the sole administrative trustee; WTC was the administrative trustee in 2007. WTC had no offices, conducted no trust affairs, and did not act as administrative trustee for the Trusts in Pennsylvania in 2007. All of the Trusts' books and records are maintained in WTC's Wilmington, Delaware office. In 2007, the Trusts' three general trustees resided outside

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I.A.1.g. Effectuating Allocation of Capital Gain to DNI

Form 1041 (Schedule D), Part III, column (1) allocates the beneficiaries' shares. Once one separates that, the rest should flow naturally.

.
[2520] Reg. § 1.671-2(e)(5), which is reproduced in fn 6620 in part III.B.2.h.i Who Is the Grantor.. For Connecticut income tax purposes, Connecticut Legal Ruling 2005-2 held:

> The residency status of an appointive trust created by the exercise of a power of appointment that is not a general power of appointment is to be determined by the residency of the donor of the power of appointment. The residency status of an appointive trust created by the exercise of a general power of appointment is to be determined by the residency of the donee of the power of appointment.

By "donor," the ruling was referring to the settlor. The ruling is my doc. no. 6517233.
[2521] The link is https://thompsoncoburn.box.com/s/m1g6r233h2sczd30r06oo3wiuxtd3g33, and the password is ZdwgPKXZ. Please be sure to note that chart's date.

of Pennsylvania and did not conduct trust affairs or act as general trustees for the Trusts in Pennsylvania.

> None of the Trusts' assets or interests in 2007 were located in Pennsylvania, and the Trusts had no income from Pennsylvania sources. All of the Trust's discretionary beneficiaries were residents of Pennsylvania in 2007. NMM Trust made no distributions to the discretionary beneficiaries in 2007. The trustees of the MVM Trust were not required to make any distributions of income or principal during 2007, but did make a distribution of $1,400,000.00 to one of its discretionary beneficiaries.
>
> As fiduciary of the NMM Trust, WTC reported that the NMM Trust had no taxable income from Pennsylvania sources and had a net Pennsylvania taxable income of zero. As fiduciary of the MVM Trust, WTC reported that the MVM Trust had taxable income from Pennsylvania sources in the amount of $1,349,817.00; however, no portion of that $1,349,817.00 was, in fact, derived from Pennsylvania sources. The MVM Trust reported the taxable income because the tax preparation software required it to report taxable income from Pennsylvania sources in order to report the distribution of $1,400,000.00. The MVM Trust claimed a deduction in the amount of $1,349,817.00 with respect to the distribution and reported its net Pennsylvania taxable income of zero.

The court held that the trusts did not have "substantial nexus" with Pennsylvania:[2522]

> … neither Settlor's residency nor the residency of the beneficiaries provides the Trusts with the requisite presence in Pennsylvania to establish a substantial nexus and, therefore, the first prong of *Complete Auto* is not met and the imposition of the PIT here violates the Commerce Clause of the U.S. Constitution. *Complete Auto*, 430 U.S. at 279 (requiring all four prongs to be satisfied for a statute to withstand constitutional scrutiny). Although we conclude that the substantial nexus prong of the *Complete Auto* test has not been met and, therefore, the imposition of the PIT on all of the Trusts' income violates the Commerce Clause, *id*., we will nevertheless address the remaining *Complete Auto* prongs the Trusts challenge.

The court also held that taxing the trusts did not constitute "fair apportionment" (citation omitted):

> Thus, the imposition of the PIT on the Trusts' income, when all of that income was derived from sources outside of Pennsylvania, is "inherently arbitrary and ha[s] no rational relationship to the [Trusts'] business activity that occurred in [Pennsylvania]." Accordingly, the imposition of the PIT here does not satisfy the fair apportionment prong of C*omplete Auto.*

The court also held that taxing the trusts was not "fairly related to the services a state provides where the taxpayer benefits directly or indirectly from the state's protections, opportunities, and services" (citations to stipulations omitted):

> In 2007, the Trusts had no physical presence in Pennsylvania, none of their income was derived from Pennsylvania sources, none of their assets or interests were located in Pennsylvania, and they were established under and were governed by Delaware law. Hence, unlike the taxpayers in Erieview Cartage and Quality Markets, the Trusts do not

[2522] Citing *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

> benefit from Pennsylvania's roadways, bridges, police, fire protection, economic markets, access to its trained workforce, courts, and laws. We recognize that the Trusts' discretionary beneficiaries almost certainly benefit from Pennsylvania's societal and legal framework because they reside in Pennsylvania; however, they are not the taxpayer in this matter and, importantly, as discretionary beneficiaries, they have no present or future right to distributions from the Trusts. Moreover, pursuant to Sections 302 and 305 [of] the Tax Code, 72 P.S. §§ 7302 and 7305, the beneficiaries will pay PIT on any distributions they do receive from the Trusts, which are fairly related to the benefits they receive from residing in Pennsylvania. Similarly, Settlor, who was deceased in TY 2007, is not the taxpayer in this matter.
>
> Thus, the Department's imposition of the PIT on the Trusts' entire income is not reasonably related to the benefits Pennsylvania provides the Trusts. Therefore, the Commonwealth's imposition of the PIT here does not satisfy the fairly related prong of *Complete Auto*.

II.J.3.e.ii.(b). *Linn* (Illinois) (Decanting)

Another important case limits Illinois' income taxation of trusts, *Linn v. Department of Revenue*.[2523] In *Linn*, the trustees of an Illinois trust exercised their limited power of appointment to create a trust that eventually came to be governed purely by Texas law and administered in Texas by Texas trustee, holding no assets in Illinois, but with concededly an Illinois grantor. The court summarized the parties' arguments:

> Plaintiff asserts the Autonomy Trust 3 has no connections to Illinois. He notes the Autonomy Trust 3 is a Texas trust that is governed by the laws of and administered in Texas. Moreover, in 2006, the Autonomy Trust 3's trustee, beneficiary, and protector were all not residents of Illinois. Without any connections to Illinois, the imposition of Illinois income tax on the Autonomy Trust 3 would be unconstitutional under the due process clause. Plaintiffs have shown no connections appear to exist with the trust in this case. However, defendants contend connections do exist because (1) the Autonomy Trust 3 owes its existence to Illinois, and (2) Illinois provides the Autonomy Trust 3's trustee and beneficiary with a panoply of legal benefits and opportunities. We note that, on appeal, defendants do not argue that, in 2006, the Autonomy Trust 3 still contained terms to be interpreted under Illinois law and that the Illinois choice of law provision in the March 1961 agreement applies to the Autonomy Trust 3.

Focusing on contacts during the tax year in question, the court dismissed Illinois' arguments that the trust "exists only because of Illinois law" and that Illinois continues to provide the trustee and beneficiary with benefits. Citing *Chase Manhattan Bank v. Gavin*, 249 Conn. 172, 733 A.2d 782 (1999), *Linn* reasoned (highlighting added):

> Defendants further argue the Autonomy Trust 3 exists only because of Illinois law. However, Autonomy Trust 3 resulted from a January 2002 exercise of the limited power of appointment by the trustee of the P.G. Linda Trust, which was provided for in the March 1961 trust agreement. Assuming arguendo, an Illinois court ruling validated a provision of the March 1961 agreement that allowed for the limited power of appointment that was later invoked to create the Autonomy Trust 3, the Autonomy Trust 3 was created by the provisions of the March 1961 agreement allowing for powers of

[2523] 2 N.E.3d 1203 (App. Ct. Ill. 4th D. 2013).

appointment and not Illinois law. Further, with income taxation, the focus of the due process analysis is on the tax year in question, which would be 2006 in this case. See *Gavin*, 733 A.2d at 802 (noting the connection for the inter vivos trust was the fact a noncontingent beneficiary was an in-state resident during the tax year in question); see also *In re Swift*, 727 S.W.2d 880, 882 (Mo. 1987) (addressing income taxation on a testamentary trust and stating, "An income tax is justified only when contemporary benefits and protections are provided the subject property or entity during the relevant taxing period"). Thus, what happened historically with the trust in Illinois courts and under Illinois law has no bearing on the 2006 tax year.

Citing *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539, 547 n. 11 (D.C. 1997), *Linn* reasoned:

> Additionally, defendants argue the State of Illinois provides the trustee and beneficiary of the Autonomy Trust 3 with a panoply of legal benefits and opportunities. In support of its assertion, it again cites case law addressing testamentary trusts. See *Gavin*, 733 A.2d at 799; District of Columbia, 689 A.2d at 544. As we have stated, this case involves an inter vivos trust, not a testamentary trust. The Autonomy Trust 3 was not in existence when A.N. Pritzker died and thus was not part of his probate case. Accordingly, no Illinois probate court has jurisdiction over the Autonomy Trust 3, unlike in the testamentary trust cases.
>
> Defendants also cite several Illinois statutory provisions and claim the Autonomy Trust 3, plaintiff, Linda, or a contingent beneficiary can seek those statutory provisions at any time. However, the parties agree that, after the November 2005 Texas reformation order, the Autonomy Trust 3 choice of law provision provided for only the application of Texas law. Further, as stated earlier, the 1977 Cook County case has no application at all to the Autonomy Trust 3 because it dealt with beneficiary powers of appointment, not trustee powers of appointment in the March 1961 trust agreement. Accordingly, we find the Autonomy Trust 3 receives the benefits and protections of Texas law, not Illinois law.

Instead, "in 2006, the Autonomy Trust 3 had nothing in and sought nothing from Illinois."[2524] *Linn* held:[2525]

> Accordingly, we find insufficient contacts exist between Illinois and the to satisfy the due process clause, and thus the income tax imposed on the Autonomy Trust 3 for the tax year 2006 was unconstitutional.

[2524] The court elaborated:

> As plaintiff notes, all of the trust's business was conducted in Texas; the trustee, protector, and the noncontingent beneficiary resided outside Illinois; and none of the trust's property was in Illinois. Moreover, the Autonomy Trust 3 meets none of the following factors that would give Illinois personal jurisdiction over the trust in a litigation: "the provisions of the trust instrument, the residence of the trustees, the residence of its beneficiaries, the location of the trust assets, and the location where the business of the trust is to be conducted." *Sullivan v. Kodsi*, 359 Ill.App.3d 1005, 1011, 296 Ill. Dec. 710, 836 N.E.2d 125, 131 (2005) (citing *People v. First National Bank of Chicago*, 364 Ill. 262, 268, 4 N.E.2d 378, 380 (1936)).

[2525] The court continued:

> Since we have found the income taxation of the Autonomy Trust 3 in 2006 violates the due process clause, we do not address plaintiff's commerce clause argument.

Thus, decanting[2526] to another jurisdiction may allow an Illinois trust to flee Illinois income taxation.

II.J.3.e.ii.(c). *Kaestner* (U.S. Supreme Court re North Carolina)

For income a trust retains, in a unanimous opinion, *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, 588 U.S. __ (2019), held that North Carolina could not tax a trust whose only ties consisted of a beneficiary who may at some point receive distributions in the trustee's "absolute discretion." The Syllabus prepared by the court reporter, which has no precedential value, summarized:

> Joseph Lee Rice III formed a trust for the benefit of his children in his home State of New York and appointed a fellow New York resident as the trustee. The trust agreement granted the trustee "absolute discretion" to distribute the trust's assets to the beneficiaries. In 1997, Rice's daughter, Kimberley Rice Kaestner, moved to North Carolina. The trustee later divided Rice's initial trust into three separate subtrusts, and North Carolina sought to tax the Kimberley Rice Kaestner 1992 Family Trust (Trust) - formed for the benefit of Kaestner and her three children - under a law authorizing the State to tax any trust income that "is for the benefit of" a state resident, N.C. Gen. Stat. Ann. § 105–160.2. The State assessed a tax of more than $1.3 million for tax years 2005 through 2008. During that period, Kaestner had no right to, and did not receive, any distributions. Nor did the Trust have a physical presence, make any direct investments, or hold any real property in the State. The trustee paid the tax under protest and then sued the taxing authority in state court, arguing that the tax as applied to the Trust violates the Fourteenth Amendment's Due Process Clause. The state courts agreed, holding that the Kaestners' in-state residence was too tenuous a link between the State and the Trust to support the tax.
>
> *Held*: The presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain to receive it. Pp. 5–16.
>
> (a) The Due Process Clause limits States to imposing only taxes that "bea[r] fiscal relation to protection, opportunities and benefits given by the state." *Wisconsin v. J. C. Penney Co.*, 311 U. S. 435, 444. Compliance with the Clause's demands "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax," and that "the 'income attributed to the State for tax purposes . . . be rationally related to "values connected with the taxing State," ' " *Quill Corp. v. North Dakota*, 504 U. S. 298, 306. That "minimum connection" inquiry is "flexible" and focuses on the reasonableness of the government's action. *Id.*, at 307. Pp. 5–6.
>
> (b) In the trust beneficiary context, the Court's due process analysis of state trust taxes focuses on the extent of the in-state beneficiary's right to control, possess, enjoy, or receive trust assets. Cases such as *Safe Deposit & Trust Co. of Baltimore v. Virginia*, 280 U.S. 83; *Brooke v. Norfolk*, 277 U.S. 27; and *Maguire v. Trefry*, 253 U. S. 12, reflect a common principle: When a State seeks to base its tax on the in-state residence of a trust beneficiary, the Due Process Clause demands a pragmatic inquiry into what exactly the beneficiary controls or possesses and how that interest relates to the object of the

[2526] See part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.

State's tax. *Safe Deposit*, 280 U. S., at 91. Similar analysis also appears in the context of taxes premised on the in-state residency of settlors and trustees. See, *e.g.*, *Curry v. McCanless*, 307 U.S. 357. Pp. 6–10.

(c) Applying these principles here, the residence of the Trust beneficiaries in North Carolina alone does not supply the minimum connection necessary to sustain the State's tax. First, the beneficiaries did not receive any income from the Trust during the years in question. Second, they had no right to demand Trust income or otherwise control, possess, or enjoy the Trust assets in the tax years at issue. Third, they also could not count on necessarily receiving any specific amount of income from the Trust in the future. Pp. 10–13.

(d) The State's counterarguments are unconvincing. First the State argues that "a trust and its constituents" are always "inextricably intertwined," and thus, because trustee residence supports state taxation, so too must beneficiary residence. The State emphasizes that beneficiaries are essential to a trust and have an equitable interest in its assets. Although a beneficiary is central to the trust relationship, the wide variation in beneficiaries' interests counsels against adopting such a categorical rule. Second, the State argues that ruling in favor of the Trust will undermine numerous state taxation regimes. But only a small handful of States rely on beneficiary residency as a sole basis for trust taxation, and an even smaller number rely on the residency of beneficiaries regardless of whether the beneficiary is certain to receive trust assets. Finally, the State urges that adopting the Trust's position will lead to opportunistic gaming of state tax systems. There is no certainty, however, that such behavior will regularly come to pass, and in any event, mere speculation about negative consequences cannot conjure the "minimum connection" missing between the State and the object of its tax. Pp. 13–16.

371 N.C. 133, 814 S.E.2d 43, affirmed.

SOTOMAYOR, J., delivered the opinion for a unanimous Court. ALITO, J., filed a concurring opinion, in which ROBERTS, C. J., and GORSUCH, J., joined.

After reviewing case law on Due Process, the Court held:

Applying these principles here, we conclude that the residence of the Kaestner Trust beneficiaries in North Carolina alone does not supply the minimum connection necessary to sustain the State's tax.

First, the beneficiaries did not receive any income from the trust during the years in question. If they had, such income would have been taxable. See *Maguire*, 253 U.S., at 17; *Guaranty Trust Co.*, 305 U. S., at 23.

Second, the beneficiaries had no right to demand trust income or otherwise control, possess, or enjoy the trust assets in the tax years at issue. The decision of when, whether, and to whom the trustee would distribute the trust's assets was left to the trustee's "absolute discretion." Art. I, § 1.2(a), App 46–47. In fact, the Trust agreement explicitly authorized the trustee to distribute funds to one beneficiary to "the exclusion of other[s]," with the effect of cutting one or more beneficiaries out of the Trust. Art. I, § 1.4, *id.*, at 50. The agreement also authorized the trustee, not the beneficiaries, to make investment decisions regarding Trust property. Art. V, § 5.2, *id.*, at 55–60. The Trust agreement prohibited the beneficiaries from assigning to another person any right they might have to the Trust property, Art. XII, *id.*, at 70–71, thus making the beneficiaries' interest less like "a potential source of wealth [that] was property in [their] hands." *Curry*, 307 U.S., at\ 370–371.[9]

[9] We do not address whether a beneficiary's ability to assign a potential interest in income from a trust would afford that beneficiary sufficient control or possession over, or enjoyment of, the property to justify taxation based solely on his or her in-state residence.

To be sure, the Kaestner Trust agreement also instructed the trustee to view the trust "as a family asset and to be liberal in the exercise of the discretion conferred," suggesting that the trustee was to make distributions generously with the goal of "meet[ing] the needs of the Beneficiaries" in various respects. Art. I, § 1.4(c), App. 51. And the trustee of a discretionary trust has a fiduciary duty not to "act in bad faith or for some purpose or motive other than to accomplish the purposes of the discretionary power." 2 Restatement (Third) of Trusts § 50, Comment c, p. 262 (2003). But by reserving sole discretion to the trustee, the Trust agreement still deprived Kaestner and her children of any entitlement to demand distributions or to direct the use of the Trust assets in their favor in the years in question.

Third, not only were Kaestner and her children unable to demand distributions in the tax years at issue, but they also could not count on necessarily receiving any specific amount of income from the Trust in the future. Although the Trust agreement provided for the Trust to terminate in 2009 (on Kaestner's 40th birthday) and to distribute assets to Kaestner, Art. I, § 1.2(c)(1), App. 47, New York law allowed the trustee to roll over the trust assets into a new trust rather than terminating it. N.Y. Est., Powers & Trusts § 10–6.6(b). Here, the trustee did just that. 371 N. C., at 135, 814 S.E.2d, at 45.[10]

[10] In light of these features, one might characterize the interests of the beneficiaries as "contingent" on the exercise of the trustee's discretion. See *Fondren v. Commissioner*, 324 U.S. 18, 21 (1945) (describing "the exercise of the trustee's discretion" as an example of a contingency); see also *United States v. O'Malley*, 383 U.S. 627, 631 (1966) (describing a grantor's power to add income to the trust principal instead of distributing it and "thereby den[y] to the beneficiaries the privilege of immediate enjoyment and conditio[n] their eventual enjoyment upon surviving the termination of the trust"); *Commissioner v. Estate of Holmes*, 326 U.S. 480, 487 (1946) (the termination of a contingency changes "the mere prospect or possibility, even the probability, that one may have [enjoyment of property] at some uncertain future time or perhaps not at all" into a "present substantial benefit"). We have no occasion to address, and thus reserve for another day, whether a different result would follow if the beneficiaries were certain to receive funds in the future. See, *e.g.*, Cal. Rev. & Tax. Code Ann. § 17742(a) (West 2019); *Commonwealth v. Stewart*, 338 Pa. 9, 16–19, 12 A.2d 444, 448–449 (1940) (upholding a tax on the equitable interest of a beneficiary who had "a right to the income from [a] trust for life"), *aff'd*, 312 U.S. 649 (1941).

Like the beneficiaries in *Safe Deposit*, then, Kaestner and her children had no right to "control or posses[s]" the trust assets "or to receive income therefrom." 280 U.S., at 91. The beneficiaries received no income from the Trust, had no right to demand income from the Trust, and had no assurance that they would eventually receive a specific share of Trust income. Given these features of the Trust, the beneficiaries' residence cannot, consistent with due process, serve as the sole basis for North Carolina's tax on trust income.[11]

> [11] Because the reasoning above resolves this case in the Trust's favor, it is unnecessary to reach the Trust's broader argument that the trustee's contacts alone determine the State's power over the Trust. Brief for Respondent 23–30. The Trust relies for this proposition on *Hanson v. Denckla*, 357 U.S. 235 (1958), which held that a Florida court lacked jurisdiction to adjudicate the validity of a trust agreement even though the trust settlor and most of the trust beneficiaries were domiciled in Florida. *Id.*, at 254. The problem was that Florida law made the trustee "an indispensable party over whom the court [had to] acquire jurisdiction" before resolving a trust's validity, and the trustee was a nonresident. *Ibid.* In deciding that the Florida courts lacked jurisdiction over the proceeding, the Court rejected the relevance of the trust beneficiaries' residence and focused instead on the "acts of the trustee" himself, which the Court found insufficient to support jurisdiction. *Ibid.* The State counters that Hanson is inapposite because the State's tax applies to the trust rather than to the trustee and because Hanson arose in the context of adjudicative jurisdiction rather than tax jurisdiction. Brief for Petitioner 21, n. 9; Reply Brief 16–17. There is no need to resolve the parties' dueling interpretations of *Hanson*. Even if beneficiary contacts - such as residence - could be sufficient in some circumstances to support North Carolina's power to impose this tax, the residence alone of the Kaestner Trust beneficiaries cannot do so for the reasons given above.

When rebuffing North Carolina's arguments, the Court discussed other states' laws:

> Second, the State argues that ruling in favor of the Trust will undermine numerous state taxation regimes. Tr. of Oral Arg. 8, 68; Brief for Petitioner 6, and n. 1. Today's ruling will have no such sweeping effect. North Carolina is one of a small handful of States that rely on beneficiary residency as a sole basis for trust taxation, and one of an even smaller number that will rely on the residency of beneficiaries regardless of whether the beneficiary is certain to receive trust assets.[12] Today's decision does not address state laws that consider the in-state residency of a beneficiary as one of a combination of factors, that turn on the residency of a settlor, or that rely only on the residency of noncontingent beneficiaries, see, *e.g.*, Cal. Rev. & Tax. Code Ann. § 17742(a).[13] We express no opinion on the validity of such taxes.
>
> [12] The State directs the Court's attention to 10 other state trust taxation statutes that also look to trust beneficiaries' in-state residency, see Brief for Petitioner 6, and n. 1, but 5 are unlike North Carolina's because they consider beneficiary residence only in combination with other factors, see Ala. Code § 40–18–1(33) (2011); Conn. Gen. Stat. § 12–701(a)(4) (2019 Cum. Supp.); Mo. Rev. Stat. §§ 143.331(2), (3) (2016); Ohio Rev. Code Ann. §5747.01(I)(3) (Lexis Supp. 2019); R.I. Gen. Laws § 44–30–5(c) (2010). Of the remaining five statutes, it is not clear that the flexible tests employed in Montana and North Dakota permit reliance on beneficiary residence alone. See Mont. Admin. Rule 42.30.101(16) (2016); N.D. Admin. Code § 81–03–02.1–04(2) (2018). Similarly, Georgia's imposition of a tax on the sole basis of beneficiary residency is disputed. See Ga. Code Ann. § 48–7–22(a)(1)(C) (2017); Brief for Respondent 52, n. 20. Tennessee will be phasing out its income tax entirely by 2021. H.B. 534, 110th Gen. Assem., Reg. Sess. (2017) (enacted); see Tenn. Code Ann. § 67–2–110(a) (2013). That leaves California, which (unlike North Carolina) applies its tax on

the basis of beneficiary residency only where the beneficiary is not contingent. Cal. Rev. & Tax. Code Ann. § 17742(a); see also n. 10, *supra*.

> [13] The Trust also raises no challenge to the practice known as throwback taxation, by which a State taxes accumulated income at the time it is actually distributed. See, *e.g.*, Cal. Rev. & Tax. Code Ann. § 17745(b).

The Court rebuffed North Carolina's concern that "adopting the Trust's position will lead to opportunistic gaming of state tax systems" (highlighting is mine):

> Though this possibility is understandably troubling to the State, it is by no means certain that it will regularly come to pass. First, the power to make distributions to Kaestner or her children resides with the trustee. When and whether to make distributions is not for Kaestner to decide, and in fact the trustee may distribute funds to Kaestner while she resides in North Carolina (or deny her distributions entirely). Second, we address only the circumstances in which a beneficiary receives no trust income, has no right to demand that income, and is uncertain necessarily to receive a specific share of that income. Settlors who create trusts in the future will have to weigh the potential tax benefits of such an arrangement against the costs to the trust beneficiaries of lesser control over trust assets. In any event, mere speculation about negative consequences cannot conjure the "minimum connection" missing between North Carolina and the object of its tax.

The highlighted text above suggests that the case protects only trusts where any future distribution to any beneficiary in the state is speculative. The Court noted in passing that the trust was to terminate when the beneficiary reached age 40, but the trustee decanted into a new trust (in a year after the taxable year being litigated), with no objection from the primary beneficiary.[2527]

At a meeting of fiduciary income tax experts at the end of June 2019, I heard the following:

- The North Carolina bar has in the past proposed a statute that would pass muster, and the legislature declined to address the issue.

- At least 400 protective claims for refunds have been filed.

- *Kaestner* has no bearing on most other states. North Carolina, Georgia, and Tennessee are the only directly affected states, and Tennessee will get rid of its income tax.

- Counsel for the state struggled to explain how state and federal income taxation are connected. He later publicly admitted that he got raked over the coals by the Supreme Court justices.

- Attendees were disappointed that the case did not grant guidance that applies to other states and that this case did not even rule on NC law outside of a purely discretionary trust where the beneficiary has not received a distribution. They speculated that the court had hoped to issue useful guidance but then found that fiduciary income tax was more complex than they realized. They speculated that, rather than admitting poor judgment in tackling an

[2527] See part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.

> issue on which it didn't have sufficient depth of understanding to set forth helpful rules, the Court decided the case narrowly then shortly thereafter declined to review *Fielding* below.

II.J.3.e.ii.(d). Contingent Beneficiary in California

Steuer v. Franchise Tax Board, 265 Cal. Rptr. 3d 216, 2020 WL 3496779 (Cal. Ct. App. 2020), reasoned and held in part II, "Contingent Beneficiary":

> Under section 17742, trust income may also be taxed based on residency, without regard to source, if there is a noncontingent California beneficiary. (§ 17742.) Where a trustee has absolute discretion to allocate net trust income to the beneficiary, the beneficiary has a contingent interest in the distribution. (*Estate of Canfield* (1947) 80 Cal.App.2d 443, 451-452, 181 P.2d 732; Cal. Franchise Tax Bd., Technical Advice Mem. 2006-0002 (Feb. 17, 2006) p. 2 ["A resident beneficiary whose interest in a trust is subject to the sole and absolute discretion of the trustee holds a contingent interest in the trust"].) "The intention of the settlor as shown by the document creating the trust is the most important single element in the determination of the rights of the trustee." *(Estate of Miller* (1964) 230 Cal.App.2d 888, 908-909, 41 Cal. Rptr. 410 (*In re Miller*).) Accordingly, we review the trust document to determine whether there are any limitations on a trustee's discretion to distribute income to a beneficiary. (See Cal. Franchise Tax Bd., Technical Advice Mem. 2006-0002 (Feb. 17, 2006) pp. 3-4 ["[t]he extent of the interest of the beneficiary of a trust depends upon the manifestation of intention of the settlor"].)
>
> Here, the Paula Trust document grants "sole absolute discretion" to the cotrustees to make distributions of trust income and principal, but that authority "shall not *require* the Trustee to make any distribution to any person." (Italics added.) Instead, the document simply authorized, rather than mandated, the trustees to distribute as much net income or principal of the trust as the trustee deemed to be in the beneficiary's best interests, but the determination of the amount to distribute was also in the trustee's sole absolute discretion.
>
> This "best interests" language does not, as FTB asserts and relying on *In re Miller*, limit the trustee's discretion. In that case, the settlor intended the trust to support one of the beneficiaries, and the trustee owed a duty "to make allowances for [the beneficiary's] support and maintenance ...." (*In re Miller*, *supra*, 230 Cal.App.2d at p. 909, 41 Cal. Rptr. 410.) The court determined the trustee abused his discretion by failing to make any distributions "sufficient to keep [the beneficiary] alive, let alone to maintain her in the condition and situation to which she was accustomed." (*Id*. at pp. 909-910, 41 Cal. Rptr. 410.)
>
> The trust's provisions here are quite distinguishable. The trustees are not required to make distributions to support Medeiros. Although the trust included various examples of distributions that would be in the best interest of the beneficiary - including permitting the beneficiary to travel for education or pleasure, purchasing a residence or investing in business - the trust expressly stated these examples were "intended solely as a precatory guide to the Trustee and shall in no way be construed to alter, limit or enlarge the discretions and powers conferred upon the Trustee by any other provision hereof nor to require the Trustee to make any distribution to any beneficiary." If anything, the decision in *In re Miller* is only relevant here for the limited and uncontroversial premise that "[e]ven where the trustee has discretion ..., the court will not permit him to abuse the

discretion." (*In re Miller*, *supra*, 230 Cal.App.2d at p. 907, 41 Cal. Rptr. 410.) Like the trial court, we find the trust instrument's plain and unambiguous terms provided the trustees with sole and absolute discretion to make distributions to Medeiros.

FTB further asserts aside from reviewing the trust instrument, there must be a factual inquiry to determine the specific nature of a beneficiary. In FTB's opinion, the facts demonstrate Medeiros's interest in the trust income is noncontingent since the trustees notified her of future distributions, she relied on those distributions in making certain financial choices, and she directed how the trustees would pay the distributions.[4]

[4] The unique circumstances presented in *Flato v. Commissioner of Internal Revenue* (5th Cir. 1952) 195 F.2d 580 - a trust in which two brothers were both trustees and beneficiaries for themselves, and a third brother beneficiary - do not help FTB's argument. (*Id.* at p. 581.) The beneficiaries in that case requested and received whatever amounts of trust income they desired, and the Fifth Circuit determined the trial court properly reviewed the " 'whole nexus of relations between the settlor, the trustee and the beneficiary' ...." (*Id.* at pp. 582-583.) However, the court limited the ruling to that particular case, noting "the beneficiaries possessed such command over the distribution of the income of the trusts, such income, whether distributed or not, is taxable to them." (Id. at p. 583 & fn. 3.)

Those actions do not change that the distributions are conditioned upon the trustee's discretion to approve or make them. (See *N.C. Dept. of Rev. v. Kimberley Rice Kaestner 1992 Family Trust* (2019) 588 U.S. ----, ----, 139 S.Ct. 2213, 2223, 204 L.Ed.2d 621 ["by reserving sole discretion to the trustee, the Trust agreement still deprived [beneficiaries] of any entitlement to demand distributions or to direct the use of the Trust assets in their favor"].) As FTB's own technical memorandum notes, a contingent beneficiary "cannot compel the trustee to give him any portion of the income where the trust gives the trustee absolute discretion as to the amounts of income to distribute." (Cal. Franchise Tax Bd., Technical Advice Mem. 2006-0002 (Feb. 17, 2006) p. 3, fn. 3.) While Medeiros could certainly request distributions or assign distributions once she received them to other trusts or various financial arrangements, she "cannot be certain that [s]he will ever enjoy any of [the] proceeds of the trust. Consequently, where the extent of the interest of the beneficiary is dependent upon the exercise of discretion by the trustee, that interest is contingent." (*Ibid*.)

The settlor intended the trustees to have absolute discretion, and we affirm the trial court's finding Medeiros is a contingent beneficiary.

II.J.3.e.ii.(e). Corporate Trustee Presence

Bank of America, N.A., trustee [of 34 trusts], v. Commissioner Of Revenue, 54 N.E.3d 13, 474 Mass. 702 (Ma. Supreme Court 2016), reasoned:

We do not share the bank's view that for the purpose of assessing the inhabitance of a corporate trustee, the board has created a formal "presence and activities" test that focuses on the corporation's general business presence in the Commonwealth. Rather, we understand the board to have evaluated the specific, agreed-upon facts presented and to have reached its conclusion that the bank qualified as an inhabitant of the Commonwealth based on those facts — facts that included that, in terms of Massachusetts-based activities, the bank both conducted general banking transactions, maintaining over 200 branch offices staffed by bank employees, and performed work as a corporate trustee of the particular trusts at issue here. With respect to the latter, the board found that the bank:

> "operated and staffed offices to fulfill some of their obligations as trustees of the [subject] Trusts; maintained relationships with the beneficiaries of the [subject] Trusts and ... decided when to make distributions of trust assets to beneficiaries; administered the assets of the [subject] Trusts; consulted with clients and prospective clients [of other trusts] about [the bank's] trust services; ... provided places for execution of [other] trusts which named [the bank or U.S. Trust] as fiduciary; and researched and discussed issues involving the [subject] Trusts and discussed such issues with grantors, beneficiaries and/or their representatives."

The bank points to the language of § 14 providing that a corporate trustee will "be subject to [the fiduciary income tax provisions of G. L. c. 62] in the same manner and under the same conditions as individual inhabitants of the commonwealth acting in similar capacities " (emphasis added). We agree with the bank that the quoted language from § 14 requires a focus on the actions within the Commonwealth of a corporation acting as a corporate trustee, including specifically acting as trustee of the trust or trusts potentially subject to fiduciary income tax liability, and not just on the corporation's general business activities. Put more generally, we interpret the three interrelated statutes that apply in this case, §§ 1 (f) (2), 10, and 14, to mean that a corporate trustee will qualify as an "inhabitant" of the Commonwealth within the meaning and for the purposes of these statutes if it: (1) maintains an established place of business in the Commonwealth at which it abides, i.e., where it conducts its business in the aggregate for more than 183 days of a taxable year; and (2) conducts trust administration activities within the Commonwealth that include, in particular, material trust activities relating specifically to the trust or trusts whose tax liability is at issue.

We conclude that the board's decision in the present case is consistent with this interpretation of statutory requirements. It concluded in effect that for a corporate trustee such as the bank to be deemed an inhabitant under § 1 (f) (2), there must be proof that the corporation has an established presence in the Commonwealth through, e.g., maintaining a permanent office or offices in Massachusetts and engaging in regular business activities here, for more than one-half of the tax year at issue. Such a presence corresponds to the presence of an individual inhabitant at a permanent place of abode for more than 183 days in a year. Certainly the agreed-upon facts establish that the bank met this requirement. But as the portion of the board's decision quoted supra shows, the board did not stop with the bank's general corporate activities within the Commonwealth. Rather, the board considered the Commonwealth-centered activities conducted by the bank in its capacity as corporate trustee, including activities that were centered on the subject trusts. And we agree with the board that the bank's activities relating to administration of the subject trusts demonstrate the bank's material and specific trust-related nexus to Massachusetts for more than 183 days of the tax year at issue.

The court declined to address constitutional issues because the bank failed to raise the issue to the Appellate Tax Board.

II.J.3.e.ii.(f). Business Income; *Fielding* (MN 2018); *Metropoulos* (CA 2022)

None of this discussion is concerned with business income. When a business operates in a state, the state taxes that business income. Generally, a trust that owns an interest in a pass-through entity such as an S corporation or partnership (including an LLC) will report income taxable to the states in which the entity does business, or the entity will pay tax on the income taxable to one or more of its owners instead of its owners reporting that income. See part II.G.3 State Income Taxation.

On June 28, 2019, the U.S. Supreme Court declined to review *Fielding v. Commissioner*, 916 N.W.2d 323 (Minn. 2018). That case involved a trust that owned shares in an S corporation. Nobody disputed Minnesota's ability to tax the trust's distributive share of the Minnesota S corporation's Minnesota source income.[2528] Rather, the dispute was taxing the other income when the trust's sole potentially meaningful contact with Minnesota regarding that other income was the grantor's residence. The Minnesota Supreme Court held that taxing the trust on that other income on that basis alone violated the Due Process Clauses of the U.S. and Minnesota Constitutions, which it view as identical to each other.

Attendees at the June 2019 meeting I attended speculated that, after *Kaestner*, the Court would have no appetite to hear other state fiduciary income tax cases.

Steuer v. Franchise Tax Board, 265 Cal. Rptr. 3d 216, 2020 WL 3496779 (Cal. Ct. App. 2020), held that California source income is taxable to a trust whether or not the trust is a California resident.

2009 Metropoulos Family Trust v. California Franchise Tax Board, 79 Cal. App.5th 245, 294 Cal. Rptr.3d 557 (Cal. Ct. App. 2022), held that nonresident trusts were taxed on their proportionate share of gain on the sale of intangible property, namely goodwill associated with the subsidiary's business located in California. Although the sale of intangible property is normally sitused to the taxpayer's residence, intangible property used in a business is sitused to where the business is conducted. The court in this case did an excellent job discussing the law in this area.

The Multistate Tax Commission's website includes at https://www.mtc.gov/Uniformity/Adopted-Uniformity-Recommendations models organized into the following general categories: Allocation and Apportionment Regulations, Business Income Tax - General, Other Income Tax, Sales and

[2528] The Minnesota court also noted (emphasis below supplied by the court):

> The Commissioner urges us to hold that the Trusts may be taxed as residents due to their connections to FFI, a Minnesota S corporation, and it is undisputed that the Trusts held interests in *intangible property*, FFI stock. Although FFI was incorporated in Minnesota and held physical property within the state, the intangible property that generated the Trusts' income was *stock* in FFI and funds held in investment accounts. These intangible assets were held outside of Minnesota, and thus do not serve as a relevant or legally significant connection with the State. *See, e.g.*, *Safe Deposit & Tr. Co.*, 280 U.S. at 92 (stating that intangible assets held by a trustee located in Maryland "did not and could not follow" the grantor and beneficiaries who were domiciled in Virginia); *In re Swift*, 727 S.W.2d 880, 881-82 (Mo. 1987) (concluding that the "creation and funding" of the trusts in Missouri with intangible assets that the trustee "held, managed and administered in Illinois" did not allow Missouri to tax the trust's income); *Mercantile-Safe Deposit & Tr. Co. v. Murphy*, 242 N.Y.S.2d 26, 28 (N.Y. App. Div. 1963) (concluding that New York, which was the grantor's domicile, could not tax the trust's income from intangible assets held in Maryland).

Use or Transaction Taxes, and Tax Administration.[2529] See also State Taxation of Partnerships - MTC. ACTEC Fellow Gray Edmondson posts updates from time to time at News - ESA Law.

If a trust owns an interest in a pass-through entity and resides in a state with no or low income tax, then any effort to minimize income tax payable to high rate states would focus on the entity hiring a state income tax expert to minimize the tax burden to the entity's owners.

All of the above assumes the underlying business assets are sold (or deemed sold). However, when a partnership interest is transferred, the buyer can get an inside basis step-up without a deemed sale of the partnership's assets; see part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

Pursuant to Article IV, Section 6(3) of the Multistate Tax Compact (as it existed in 2018), which applies pursuant to Missouri Revisor of Statutes - Revised Statutes of Missouri, RSMo Section 32.200, capital gains from the sale of intangible personal property are not taxable to a nonresident individual who does not use the intangible personal property as part of that individual's conduct of a business in Missouri.

A partnership interest is intangible personal property. Unless the state has a rule that is inconsistent with federal law, Missouri law follows federal. *Grecian Magnesite Mining v. Commissioner*, 149 T.C. 63 (2017), *aff'd* 926 F3d 819 (D.C. Cir. 2019), held that one does not look through a partnership when selling a partnership interest, unless some specific federal law says to do so.[2530] (Congress later enacted a statute overriding this rule for certain international income tax purposes, but this fundamental aspect of this holding remains.) In *Noell Industries, Inc. v. Idaho State Tax Commission*, 470 P.3d 1176 (2020), the Idaho Supreme Court held that the sale of an interest in a partnership that did business in Idaho (Blackhawk) was nonbusiness income because the owner of the partnership interest (Noell Industries) was merely a passive investor:

> In addition, while Noell Industries occupied the same role and business functions as Blackhawk prior to the 2003 reorganization, Blackhawk's creation relieved Noell Industries of those responsibilities. In the 2003 reorganization, Noell Industries effectively handed over the reins to Blackhawk to make, sell, and distribute tactical and combat gear. Noell Industries could have retained control, and oversight over Blackhawk, but it did not. Control and management of Blackhawk products passed from Noell's wholly-owned corporation to the multi-manager managed limited liability company-Blackhawk. Like in Western Phoenix, N.V., Noell Industries' sole business between 2003 and 2010 was holding its investment in Blackhawk.
>
> Because this type of gain does not meet the definition of "business income" under either the transactional test or functional test (including the unitary business test), we affirm the district court's conclusion that the gain from selling Blackhawk was nonbusiness income under Idaho Code section 63-3027.... This case clearly concerns a passive investment, the taxation of which is not apportionable to Idaho.

[2529] For more about the Multistate Tax Commission, see fn 1150 in part II.G.3 State Income Taxation.
[2530] See part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest, especially fn. 5651.

The Idaho State Tax Commission appealed the case to the U.S. Supreme Court, and the Multistate Tax Commission filed an amicus brief (2/12/2021) in support of the Idaho State Tax Commission. Certiorari was denied 2/22/2021.

Similarly, in *Vas Holdings & Investments LLC v. Commissioner of Revenue*, 186 N.E. 3d 1240 (Mass. 2022), the Supreme Judicial Court of Massachusetts, Suffolk, held:

> This case requires us to consider the constitutional constraints on the Commonwealth's ability to tax a nondomiciliary corporation on the capital gain it reaped from the sale of its fifty percent membership interest in an in-State limited liability company. The nondomiciliary corporation, VAS Holdings & Investments LLC (VASHI), maintains that the ‘‘unitary business principle’’ is the only constitutionally permissible methodology pursuant to which the Commonwealth may impose a tax on such capital gain. Under that principle, the Commonwealth may tax the capital gain only where (i) there is functional integration, centralization of management, and economies of scale between the out-of-State corporation and the in-State entity, or (ii) the investment in the in-State entity serves an operational function of the out-of-State corporation.
>
> The Commissioner of Revenue (commissioner) concedes that, under the unitary business principle as applied to the facts of this case, the capital gain is not taxable in the Commonwealth. Nevertheless, he contends that the capital gain may be taxed because it reflects the in-State entity's growth in the Commonwealth. Because the nondomiciliary corporation reaped the benefit of that growth, the commissioner maintains, the Commonwealth may impose a tax on the nondomiciliary, consistent with the due process clause and the commerce clause of the United States Constitution. The Appellate Tax Board (board) agreed, and this appeal followed.
>
> The constitutionality of the imposed taxes was the only issue raised before the board and before this court, and all parties, including the board, have a significant interest in its resolution. Because we are persuaded that the constitutional limitations on the Commonwealth's authority to tax a nondomiciliary corporation may be satisfied where, as here, the nondomiciliary corporation has reaped the financial benefits (in the form of a capital gain) from its fifty percent ownership interest in an in-State entity whose growth is tied inextricably to the protections, opportunities, and benefits afforded to it by the Commonwealth, we agree that the capital gain could be subject to the Commonwealth's tax. Before the board, the parties did not dispute the statutory authority of the commissioner to deviate from the unitary business principle. Yet, any tax beyond that which is authorized by statute is invalid; accordingly, following oral argument before this court, we asked the parties to address whether the Legislature had authorized the tax asserted by the commissioner; having reviewed the parties' postargument briefs and the pertinent statutes, we conclude that the commissioner lacked the requisite statutory authority and reverse the decision of the board.1
>
> [1] We acknowledge the amicus briefs submitted by the Multistate Tax Commission and the American College of Tax Counsel.

The Multistate Tax Commission's positions fly in the face of the Multistate Tax Compact, which it sponsors! On the other hand, if the owner of a partnership actively participates in the partnership's activities, the partnership interest might be a business asset instead of a mere investment in intangible personal property. For examples of imputing partnership business activity to a partner, see parts II.Q.7.f.iii Active Business Requirement for Code § 355 (especially parts II.Q.7.f.iii.(d) Rev. Rul. 92-17 – Participation by Partners in Rental LP and II.Q.7.f.iii.(e) Rev. Rul. 2007-42 – Level of Participation in Rental LLC) and III.B.5.e.ii Code § 6166 Deferral (especially parts III.B.5.e.ii.(a) What is a Business? and III.B.5.e.ii.(b) Tiered Structures). A partner's participation in a business may be important in other areas, such as parts II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income, II.I.8 Application of 3.8% Tax to Business Income, and II.K Passive Loss Rules.

The Multistate Tax Commission is seriously considering recommending that any investment partnership (not one that operates a business) should be disregarded and an asset sale be deemed to occur. I last saw its draft report, "State Taxation of Partnerships," as of August 22, 2022.[2531] One must research the relevant state's law as to whether the state looks through the partnership in a manner that differs from federal law and how it balances the tension described above.

Some federal exceptions nuances to the entity theory:

- Code § 751 may tax part of the gain on sale of a partnership interest as ordinary income, thereby taking it out of capital gain protection. See part II.Q.8.b.i.(g) Code § 751 – Hot Assets.

- As described in the text accompanying fn 4039 in part II.P.3.f Conversions from Partnership to Sole Proprietorships and Vice Versa, a seller of a partnership interest is taxed as selling the partnership interest, even if the buyer is treated as buying the assets.

II.J.3.e.ii.(g). Due Process and State Estate Tax – *Evans* (Oregon)

In *Estate of Evans v. Department of Revenue*, 492 P.3d 47 (Oregon 7/29/2021), the decedent, an Oregon resident, was the beneficiary of a QTIP trust created in Montana. Oregon taxed the estate based on the first spouse's QTIP election. Among the court's reasoning:

> Applying that standard to this case, we conclude that Evans had sufficient "enjoyment" of the trust principal (in addition to the enjoyment of the income generated thereby) to satisfy *Kaestner*'s requirement of "some degree of possession, control, or enjoyment" of the trust assets and thus to permit Oregon to include those trust assets in Evans's taxable estate.[5] While, under her husband's modified will, Evans could not claim a right to the whole of the trust principal or any particular portion thereof, she had a potential right to receive distributions of principal, to the extent that trust income was insufficient to satisfy her needs. No other person could receive any part of the principal during Evans's lifetime. And while the remainder beneficiaries had a right to whatever was left of the principal after Evans's death, they could not prevent her from receiving distributions of principal that would reduce or even eliminate their own ultimate shares in the remainder.
>
> > [5] "Enjoyment," in this context, appears to derive its meaning from the intransitive form of the verb "enjoy," i.e., "to have for ones use, benefit, or lot." *Merriam-Webster Dictionary*, https://www.merriam-webster.com/dictionary/enjoy (accessed July 21, 2021).

[2531] For more analysis, see Edmondson, "MTC Partnership Update" (8/9/2022).

The Oregon Supreme Court concluded:

> We have determined that Evans had sufficient enjoyment of the assets of the Gillam Trust during her lifetime that those assets cannot be dissociated from her, and that therefore, through Evans, Oregon had the minimum connection to the trust assets that due process requires before Oregon may tax the assets. And we have rejected plaintiff's additional arguments that, even if Oregon had the required minimum connection to the assets, its taxation of the assets is nonetheless unfair - and thus violates the Due Process Clause. It follows that the Tax Court did not err when it determined that Oregon's inclusion of the trust assets in Evans's Oregon estate was consistent with due process.

Lesson: before moving from a state that has no estate tax to a state that has estate tax, consider whether the surviving spouse should give up the QTIP trust (or divide the trust and renounce part of it), with the consequences described in part II.H.2.c QTIP Trusts - Code § 2519 Trap.

II.J.3.e.iii. Whether a State Recognizes Grantor Trust Status; Effect of Grantor Trust Status on a Trust's Residence

A state might ignore a trust's existence while the trust is a grantor trust.[2532] On the other hand, some states do not recognize grantor trust status of irrevocable trusts.[2533]

[2532] For example, in defining what is a trust, Illinois disregards the existence of a grantor trust. 35 ILCS 5/1501(a)(20)(D) and 86 Ill. Admin. Code § 100.3020(a)(4) refer to grantor trusts under Code §§ 671-678.

[2533] Nenno, 869 T.M. II.A. states:

> As noted above, if a trust is treated as a grantor trust for federal and for state income-tax purposes, all income (including accumulated ordinary income and capital gains) is taxed to the trustor, making planning difficult if not impossible while that status continues. Nevertheless, where the federal and state grantor-trust rules are not identical, it might be possible to structure a trust to be a grantor trust for federal purposes but to be a nongrantor trust for state purposes and to arrange matters so that the trust is not subject to that state's tax. For instance, Pennsylvania and Tennessee don't have grantor-trust rules for irrevocable trusts; Arkansas, the District of Columbia, Louisiana, and Montana tax the grantor only in limited circumstances;[21] and Massachusetts classifies a trust as a grantor trust based on §§ 671–678 only, so that a trust that falls under § 679 will be a grantor trust for federal but not for state purposes. Unfortunately, a number of those states tax individuals based on federal taxable income,[22] which captures all federal grantor-trust income,[23] making the foregoing planning option unavailable.
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> [21] Ark. Inc. Tax Reg. § 4.26-51-102; D.C. Code §§ 47-1809.08–47-1809.09; La. Rev. Stat. Ann. § 47:187; Mont. Code Ann. § 15-30-2151(5).
>
> [22] § 63.
>
> [23] § 671.

Instructions to Pennsylvania's fiduciary income tax returns explain that they respect the grantor trust rules only for revocable trusts. Michael A. Breslow on Pennsylvania Senate Bill 815: Pennsylvania Will (Finally!) Recognize Grantor Trusts, Steve Leimberg's Income Tax Planning Newsletter #251, reported:

> On December 14, 2023, Pennsylvania Governor Shapiro signed Senate Bill 815, which amended the Pennsylvania tax code by adding subparagraph (c) to 72 P.S. §7302. Beginning January 1, 2025, Pennsylvania will finally join the other forty-nine states (and the District of Columbia) in recognizing grantor trusts. Effective for tax years starting after January 1, 2025, 72 P.S. § 7302(c) provides that income received by a Pennsylvania resident trust, or by a nonresident trust from sources within Pennsylvania, that is a grantor trust for federal income tax

Given that clients often retire to jurisdictions that are not subject to income tax, keeping the trusts as grantor trusts until the clients move to those jurisdiction might mean that the state in which the trust was created will not treat the trust as a resident trust, because for income tax purposes the trust was deemed not to exist until the grantor was not a resident.

See also part II.J.15.b QSSTs and State Income Tax Issues.

II.J.3.f. Consider Trust Purposes

If shifting the incidence of taxation requires making distributions, consider whether distributions are appropriate. Consider whether distributions undermine the following nonexclusive list of concerns:

- Supplemental needs trusts designed to protect the flow of governmental benefits
- Protection from tort creditors
- Protection from business creditors
- Protection from spouses or ex-spouses
- Otherwise keeping funds inside the family
- Poor spending habits
- Inability to handle money
- Discouraging undue influence
- Funding addictive behavior
- Protecting from estate tax
- Other spendthrift concerns

II.J.3.g. Effect on Future Years

The first time a distribution of principal is made from principal without referring to or actually distributing capital gain proceeds, the trustee is essentially electing for that year and all future years whether such distributions will carry out capital gains.[2534]

Causing a trust to be taxed to the grantor can be turned on or off by the presence or absence of a swap power or other powers.[2535]

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purposes will be taxable to the grantor for Pennsylvania income tax purposes, regardless of whether income is distributed to the beneficiaries. Note that this change will not apply to trusts for the 2023 or 2024 tax years.

[2534] See part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.

[2535] See part III.B.2.h How to Make a Trust a Grantor Trust.

However, turning off the powers that make a trust deemed owned by one or more beneficiaries is more challenging.[2536] If one wants flexibility in turning on or off beneficiary deemed-owned trust treatment, consider using QSST strategies (which can cause difficulty splitting up trust assets if more than one person is a remainderman).[2537]

II.J.3.h. Drafting for Flexibility in Trust Income Taxation

When drafting using an ascertainable standard for distributions ("support" in my documents),[2538] one can give the trustee the flexibility to consider or ignore the beneficiary's other resources. If the trustee has a legal duty to support one or more beneficiaries, consider using "reasonable support and comfort"[2539] to emphasize that distributions are more than just the minimum that is required to discharge a support obligation.[2540]

I also like to include standards that are not ascertainable ("welfare" in my documents). To avoid the IRS alleging adverse estate/gift tax consequences, the trustee either cannot have been

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[2536] See generally part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.

[2537] See parts III.A.3.e.vi QSST (including part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts) and III.A.3.e.iv Flexible Trust Design.

[2538] See Reg. §§ 1.674(b)-1(b)(5)(i) (grantor trust income tax rules - see text accompanying fn 6670 in part III.B.2.h.vii.(a) Distribution Provisions Resulting from Control Causing Grantor Trust Treatment), 20.2041-1(c)(2) (exception to estate tax general power of appointment – see text accompanying fn 2124 in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap) and 25.2511-1(g)(2) (gift tax ascertainable standard – see text accompanying fn 2485 in part II.J.2.b Trust Provisions Authorizing Distributions).
Some documents include a statement that the trustee's determination is conclusive and binding on all parties. Reg. §§ 1.674(b)-1(b)(5)(i) and 25.2511-1(g)(2) take the position that such language undermines the ascertainable standard exception, but Reg. § 20.2041-1(c)(2) is silent on the issue. Those regulations were promulgated before the Uniform Trust Code ("UTC"), section 814(s) of which provides:

> Notwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of such terms as "absolute", "sole", or "uncontrolled", the trustee shall exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

UTC §§ 1002(b), 1008(a)(1) (see also the sections to which the Comments to Section 103(8) refer) provide similar references to good faith and the beneficiaries' interests in determining whether a trustee is liable. Thus, the assumption that "conclusive and binding" language makes the trustee's discretion unreviewable might be incorrect. I would not use such language in connection with trying to establish an ascertainable standard, but generally I would not urge reformation of an irrevocable trust merely for using that language. *Jennings v. Smith*, 161 F2d 74 (2nd Cir. 1947), upheld as not causing estate inclusion an ascertainable standard that included some language about the trustee's "absolution discretion."

[2539] As defined in Reg. §§ 25.2511-1(g)(2) (see text accompanying fn 2485 in part II.J.2.b **Trust** Provisions Authorizing Distributions) and 1.674(b)-1(b)(5)(i) (grantor trust income tax rules - see text accompanying fn 6670 in part III.B.2.h.vii.(a) Distribution Provisions Resulting from Control Causing Grantor Trust Treatment). See also Reg. § 20.2041-1(c)(2) (exception to estate tax general power of appointment – see text accompanying fn 2124 in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap).

[2540] Generally, a legal support obligation encompasses a much more narrow view of support than does what is permitted for an ascertainable standard, but one would want to check state law to verify. Also, if a trust makes distributions for items encompassed by a support obligation, query whether the trust has a claim against the person who has the support obligation. Finally, state laws prohibiting trustees from discharging their legal obligations, as well as any such prohibitions in the trust instrument itself, should reinforce the idea of the trust having a claim against the beneficiary. Nevertheless, many estate planners prefer to have other mechanisms for getting distributions to dependent children.

appointed by the beneficiary or was appointed by the beneficiary but is not a related or subordinate party (as defined in Code § 672(c))[2541] with respect to the beneficiary.[2542]

When drafting, consider including an annually lapsing withdrawal right to make the trust deemed owned in part by the beneficiary;[2543] one twist on the power would be giving the trustee or a trust protector the power to turn off the power for a year (or range of years) before the year starts, allowing the power to be turned off if creditors are hovering. Absent such a provision, one might convert a trust to a partial beneficiary deemed-owned trust by exercising one of the standards described above with respect to the lesser of $5,000 or 5% of the trust's assets and giving the beneficiary the power to withdraw the declared amount or portion.[2544] In either case, such treatment generally has a permanent effect.[2545]

If locking in the beneficiary as the deemed owner is unattractive, the trust can dump its assets in an S corporation, make a QSST election when taxing the beneficiary is attractive,[2546] and convert to an ESBT when trapping income in the trust (primarily when the trust is not subject to state income tax but the beneficiary is) is more attractive.[2547] However, planning using S corporations involves additional long-term planning.[2548]

Also, to promote flexibility in including capital gains in distributable net income that the trustee can elect to carry out to the beneficiaries, consider using flexible language regarding allocating receipts between income and principal.[2549]

II.J.3.i. Planning for Excess Losses

Generally, an estate or nongrantor trust cannot pass losses (other than depreciation)[2550] to beneficiaries except in the year of termination. Also consider the points made in part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good in light of planning a trust's and its beneficiaries' income and losses.

If the trust is not terminating by the end of the calendar year, consider accelerating income (perhaps selling appreciated assets, among other items) or deferring deductions if and to the extent that the trust's deductions otherwise would exceed its income.

On the final termination of an estate or a nongrantor trust, it can pass to its beneficiaries a net operating loss carryover under Code § 172, a capital loss carryover under Code § 1212, or for

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[2541] See Rev. Rul. 66-160 (director of a corporation is not an "employee" under Code § 672(c)); Letter Rulings 9842007 and 9841014.
[2542] For the latter, see fn. 6713.
[2543] See part III.B.2.i.vii.(b) Determining Portion Owned When Trust Is Only a Partial Grantor Trust.
[2544] See part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary.
[2545] For flexibility regarding beneficiary grantor trust status, see fn. 2537.
[2546] See part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs, which is part of the larger part III.A.3.e QSSTs and ESBTs.
[2547] See parts III.A.3.e.ii.(c) When ESBT Income Taxation Might Help and III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.
[2548] See part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts (Whether or Not a Sale Is Made).
[2549] See part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law, especially the text in fn. 2765.
[2550] See part II.J.11.a.ii.(b) Beneficiary's Ability to Deduct Depreciation That Generates Net Loss.

the last taxable year of the estate or trust deductions (other than the exemption and charitable deduction) in excess of gross income for such year, all to the extent provided in regulations:[2551]

- These carryovers and excess deductions are allocated among the beneficiaries succeeding to the property proportionately according to the share of each in the burden of the loss or deductions, which can include those receiving specific bequests that are abated.[2552] A person who qualified as a beneficiary succeeding to the property with respect to one amount and does not qualify with respect to another amount is a beneficiary succeeding to the property as to the amount with respect to which the beneficiary qualifies.[2553]

- Nothing in Reg. § 1.642(h)-1 expressly addresses whether Code § 1231 losses[2554] that generated a net operating loss also are reported as an informational item on the beneficiaries' K-1s. Doing so would be consistent with the principles of Code §§ 652(b) and 662(b),[2555] but those provisions deal with reporting income and do not coordinate with Code § 642(h).

- However, other than the NOL and capital loss carryover, excess deductions on termination had been miscellaneous itemized deductions in the hands of the beneficiaries, which had meant they will not receive any tax benefit for them until 2026. See parts II.G.4.n Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax and II.J.3.d Who Benefits Most from Deductions. As needed, consider recognizing gain that can be offset by these deductions before distributing assets (essentially obtaining a free basis step-up) or retaining taxable income-producing assets, the income from which can be offset by those deductions instead of being taxable to the beneficiaries (if they had been distributed to the beneficiaries). Related party sales or an election to recognize gain on distribution[2556] are ways to recognize gain while keeping assets within the family. Neither the personal exemption nor the Code § 642(c) income tax deduction for charitable contributions is included in these excess deductions.[2557]

- When an electing small business trust (ESBT)[2558] terminates, if the S portion has a net operating loss under Code § 172, a capital loss carryover under Code § 1212, or deductions in excess of gross income, then any such loss, carryover, or excess deductions are allowed as a deduction, in accordance with the regulations under Code § 642(h), to the trust, or to the beneficiaries succeeding to the property of the trust if the entire trust terminates.[2559]

2551 Code § 642(h); Reg. § 1.642(h)-2.

2552 Reg. § 1.642(h)-4, which concludes with an example:

> A decedent's will leaves $100,000 to A, and the residue of his estate equally to B and C. His estate is sufficient to pay only $90,000 to A, and nothing to B and C. There is an excess of deductions over gross income for the last taxable year of the estate or trust of $5,000, and a capital loss carryover of $15,000, to both of which section 642(h) applies. A is a beneficiary succeeding to the property of the estate to the extent of $10,000, and since the total of the excess of deductions and the loss carryover is $20,000, A is entitled to the benefit of one half of each item, and the remaining half is divided equally between B and C.

2553 Reg. § 1.642(h)-4.

2554 See part II.G.6.a Code § 1231 Property.

2555 See part II.J.8.f.i.(b) Allocating Income Items Among Those Receiving It.

2556 See part II.J.8.d.i Distribution in Kind - Generally. The election to recognize gain on distribution may have unexpected results, so read that part carefully.

2557 Code § 642(h)(2).

2558 Part III.A.3.e.ii Electing Small Business Trusts (ESBTs describes what an ESBT is and how it is taxed.

2559 Reg. § 1.641(c)-1(j).

> Now that ESBT charitable contributions are deductible under Code § 170 instead of Code § 642(c),[2560] query whether they are included as an excess deduction.

Proposed regulations [REG-113295-18] (5/11/2020) would revise rules on excess losses on termination. They are consistent with ACTEC Comments on IRS Notice 2018-61 regarding the effect of new section 67(g) of the Internal Revenue Code on the ability of the beneficiary to deduct amounts comprising the section 642(h)(2) excess deduction upon termination of a trust or estate (February 19, 2019), in which I participated. The preamble explained:

> The Treasury Department and the IRS adopt the more specific suggestion from commenters of preserving the tax character of the three categories of expenses, rather than the suggestion of grouping all non-Section 67(e) expenses together, to allow for such expenses to be separately stated and to facilitate reporting to beneficiaries. Thus, under these proposed regulations, each deduction comprising the Section 642(h)(2) excess deduction retains its separate character, specifically: As an amount allowed in arriving at adjusted gross income; a non-miscellaneous itemized deduction; or a miscellaneous itemized deduction. The character of these deductions does not change when succeeded to by a beneficiary on termination of the estate or trust. Further, these proposed regulations require that the fiduciary separately state (that is, separately identify) deductions that may be limited when claimed by the beneficiary as provided in the instructions to Form 1041, U.S. Income Tax Return for Estates and Trusts and the Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credit, etc.
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> The proposed regulations adopt the suggestion that the principles under § 1.652(b)-3 be used to allocate each item of deduction among the classes of income in the year of termination for purposes of determining the character and amount of the excess deductions under Section 642(h)(2). Section 1.652(b)-3(a) provides that deductions directly attributable to one class of income are allocated to that income. Any remaining deductions that are not directly attributable to a specific class of income, as well as any deductions that exceed the amount of directly attributable income, may be allocated to any item of income (including capital gains), but a portion must be allocated to tax-exempt income, if any. *See* § 1.652(b)-3(b) and (d). The proposed regulations provide that the character and amount of each deduction remaining after application of § 1.652(b)-3 comprises the excess deductions available to the beneficiaries succeeding to the property as provided under Section 642(h)(2).
>
> These proposed regulations incorporate a new example to illustrate the rule for determining the character of excess deductions in proposed § 1.642(h)-2. The proposed regulations also update the current example in § 1.642(h)-5 to account for changes in the Code since this example was last modified on June 16, 1965, in T.D. 6828, 1965-2 C.B. 264….
>
> Existing regulations under § 1.642(h)-4 provide that carryovers and excess deductions to which Section 642(h) applies are allocated among the beneficiaries succeeding to the property of an estate or trust proportionately according to the share of each in the burden of the loss or deduction. A person who qualifies as a beneficiary succeeding to the property of an estate or trust with respect to one amount and who does not qualify with respect to another amount is a beneficiary succeeding to the property of the estate

[2560] Code § 641(c)(2)(E), which is reproduced in fn 6055 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview.

or trust as to the amount with respect to which the beneficiary qualifies. These proposed regulations do not change the allocation method among beneficiaries set forth in § 1.642(h)-4.

One commenter asked that the Treasury Department and the IRS address the treatment of suspended deductions on the termination of a trust, such as those under Section 163(d) for investment interest, and asked that such suspended deductions be treated in the same manner as the excess **deduction** under Section 642(h). While the Treasury Department and the IRS acknowledge the comment, addressing suspended deductions under Section 163(d) and other Code sections is beyond the scope of these proposed regulations.

The preamble to the final regulations, T.D. 9918 (10/19/2020), provides:

B. Section 642(h)

1. IN GENERAL

Section 642(h) provides that if, on the termination of an estate or trust, the estate or trust has: (1) A net operating loss carryover under section 172 or a capital loss carryover under section 1212, or (2) for the last taxable year of the estate or trust, deductions (other than the deductions allowed under section 642(b) (relating to the personal exemption) or section 642(c) (relating to charitable contributions)) in excess of gross income for such year, then such carryover or excess will be allowed as a deduction, in accordance with the regulations prescribed by the Secretary of the Treasury or his delegate (Secretary), to the beneficiaries succeeding to the property of the estate or trust.

Section 1.642(h)-2(a), as articulated in the proposed regulations and these final regulations, provides that if, on termination of an estate or trust, the estate or trust has for its last taxable year deductions (other than the deductions allowed under section 642(b) or section 642(c)) in excess of gross income, the excess deductions are allowed under section 642(h)(2) as items of deduction to the beneficiaries succeeding to the property of the terminated estate or trust.

2. CHARACTER AND AMOUNT OF EXCESS DEDUCTIONS

Section 1.642(h)-2(b)(1) of the proposed regulations provides that each deduction comprising the excess deductions under section 642(h)(2) retains, in the hands of the beneficiary, its character (specifically, as allowable in arriving at adjusted gross income, as a non-miscellaneous itemized deduction, or as a miscellaneous itemized deduction) while in the estate or trust. The character of these deductions does not change when succeeded to by a beneficiary on termination of the estate or trust. Furthermore, an item of deduction succeeded to by a beneficiary remains subject to any limitation applicable under the Code in the computation of the beneficiary's tax liability.

One commenter noted that section 642(h) states that excess deductions on termination of an estate or trust are to be "allowed as a deduction, in accordance with regulations prescribed by the Secretary" and that there is no express authority to treat excess deductions as miscellaneous or non-miscellaneous itemized deductions (or tax preference items for AMT purposes). The Treasury Department and the IRS disagree with this comment. The characterization of these excess deductions as a single miscellaneous itemized deduction in the current regulations was made before the enactment of section 67(g) and served as an administrative convenience. Making a change to that characterization is now appropriate to reflect the temporary disallowance of miscellaneous itemized deductions under section 67(g) since the regulations were written and is a proper exercise of the Secretary's specific grant of regulatory authority in section 642(h).

Another commenter requested that non-miscellaneous itemized deductions included in excess deductions be fully deductible by the beneficiary and not subject to a second level of limitation applicable on the beneficiary's return, because the amounts already would have been subject to limitation on the return of the estate or trust. The commenter provided an example of a terminated trust that paid $25,000 of state income tax, for which the trust is limited to a $10,000 deduction under section 164(b)(6)(B) for taxable years beginning after December 31, 2017, and before January 1, 2026. In the commenter's example, the entire amount of the allowable $10,000 deduction was passed through to the beneficiary as an excess deduction on termination of the trust. The excess of state income tax over the $10,000 limitation ($15,000) would not pass through as an excess deduction to the beneficiaries in this circumstance because the excess amount was not deductible to the trust. Excess state income tax on termination of the estate or trust may, however, pass through to a beneficiary if the estate or trust had insufficient income to absorb the entire $10,000 of state income tax deduction. In that circumstance, the commenter opined that the limitation under section 164(b)(6)(B), having already been applied at the trust level, should not again be applied at the beneficiary level. The Treasury Department and the IRS carefully considered the comment but determined that beneficiaries remain subject to the limitation in section 164(b)(6)(B). The Treasury Department and the IRS found no authority to exempt such items from the application of any limitations applicable to the beneficiary under the Code. The excess deductions retain their character in the hands of the beneficiary on termination of the trust, and all applicable limitations apply to all of the beneficiary's items of that character, regardless of their origin.

One commenter noted that, under § 1.641(c)-1(j), if an electing small business trust (ESBT) election terminates or is revoked and the S portion has a net operating loss or capital loss carryover or deductions in excess of gross income, then any such loss, carryover or excess deductions are allowed as a deduction, in accordance with the regulations under section 642(h), to the trust or to the beneficiaries succeeding to the property of the trust if the entire trust terminates. However, the commenter also noted that under the TCJA, section 641(c)(2)(E) was amended to provide that ESBT charitable contributions are deductible under section 170, rather than under section 642(c), so that, unlike other trust charitable deductions, an ESBT's charitable deduction could constitute part of the excess deductions on termination of the trust. The commenter stated that neither the legislative history nor the explanation of the staff of the Joint Committee on Taxation addressed whether this result was intended. The Treasury Department and the IRS note that charitable contribution deductions under both sections 170 and 642(c) are non-miscellaneous itemized deductions under sections 63(d) and 67(b)(4) to the estate or trust and maintain that such character is retained in the hands of the beneficiary in these regulations. Although the Treasury Department and the IRS continue to consider the application of section 170 to ESBT charitable contributions under section 641(c)(2)(E), this issue is outside the scope of these regulations.

The above paragraph misses the point that was made by the ACTEC comments (the latter at my suggestion). Code § 642(c) charitable deductions are not *anything* in the beneficiary's hands, because Reg. § 1.642(h)-2(a)(1) expressly provides that Code § 642(c) charitable deductions are not allowed as Code § 642(h)(2) deductions. As a tax return preparer, I would interpret Reg. § 1.642(h)-2(a)(1), combined with this non-answer, as permitting an ESBT's Code § 170 deductions to be treated as excess deductions on termination.[2561]

The preamble continues:[2562]

> Another commenter requested clarification of whether an excess deduction on termination of a trust or estate that is allowed in determining the net investment income under section 1411 of the estate or trust remains deductible in the hands of the beneficiary in determining the net investment income of the beneficiary under section 1411. These final regulations provide that each excess deduction retains its separate character as a section 67(e) deduction, non-miscellaneous itemized deduction, or miscellaneous itemized deduction in the hands of the beneficiary. Whether a deduction retains its character as allowable in computing the net investment income of the beneficiary, however, is outside the scope of these regulations.
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> **3. REPORTING OF EXCESS DEDUCTIONS**
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> Section 1.642(h)-2(b)(1) of the proposed regulations provides that an item of deduction succeeded to by a beneficiary remains subject to any additional applicable limitation under the Code and must be separately stated if it could be so limited, as provided in the instructions to Form 1041, U.S. Income Tax Return for Estates and Trusts, and the Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credit, etc. Commenters requested that the Treasury Department and the IRS provide guidance on how the excess deductions are to be reported by both the terminated estate or trust and by its beneficiaries. The Treasury Department and the IRS released instructions for beneficiaries that chose to claim excess deductions on Form 1040 in the 2019 or 2018 taxable year based on the proposed regulations. In addition, the Treasury Department and the IRS plan to update the instructions for Form 1041, Schedule K-1 (Form 1041), and Form 1040, U.S. Individual Income Tax Return, for the 2020 and subsequent tax years to provide for the reporting of excess deductions that are section 67(e) expenses or non-miscellaneous itemized deductions.
>
> The Treasury Department and the IRS are aware that the income tax laws of some U.S. states do not conform to the Code with respect to section 67(g), such that beneficiaries may need information on miscellaneous itemized deductions of a terminated estate or trust. However, because miscellaneous itemized deductions are currently not allowed for Federal income tax purposes, that information is not needed for Federal income tax purposes. Therefore, it would not be appropriate to modify Federal income tax forms to require or accommodate the collection of such information while this deduction is suspended. Estates, trusts, and beneficiaries are advised to consult the relevant state

[2561] See text accompanying fn 6057 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview.
[2562] For section 67(e) deductions, see fn 2507 and accompanying text in part II.J.3.d Who Benefits Most from Deductions. Fn 2507 explains changes made 10/19/2020, which is after this NII preamble was written.

taxing authority for information about deducting miscellaneous itemized expenses on their state tax returns.

4. DETERMINATIONS OF DEDUCTIONS IN YEAR OF TERMINATION OF THE TRUST

Section 1.642(h)-2(b)(2) of the proposed regulations provides that the provisions of § 1.652(b)-3 are used to allocate each item of deduction among the classes of income in the year of termination for purposes of determining the character and amount of the excess deductions under section 642(h)(2). Accordingly, the amount of each separate deduction remaining after application of § 1.652(b)-3 comprises the excess deductions available to the beneficiaries succeeding to the property of the estate or trust as provided under section 642(h)(2). In addition, as previously explained, an item of deduction succeeded to by a beneficiary remains subject to any additional applicable limitation under the Code. Furthermore, § 1.642(h)-2(c) of the proposed regulations provides that excess deductions are allowable only in the taxable year of the beneficiary in which or with which the estate or trust terminates. That is, excess deductions of a terminated estate or trust may not carry over to a subsequent year of the beneficiary.

One commenter requested that these regulations provide an ordering rule clarifying whether excess deductions on termination of a trust allowed as a deduction to the beneficiary are claimed before, after, or ratably with the beneficiary's other deductions, particularly when the amount of the excess deductions and other deductions exceed the beneficiary's gross income. These final regulations clarify that beneficiaries may claim all or part of the excess deductions under section 642(h)(2) before, after, or together with the same character of deductions separately allowable to the beneficiary under the Code.

That commenter also requested that the final regulations include an exception for investment interest expense under section 163(d) from the general rule that excess deductions on termination of a trust or estate may be claimed only in the beneficiary's taxable year during which the trust or estate terminated. That section permits the carryforward of investment interest under section 163(d)(2) to the taxpayer's subsequent taxable years if the taxpayer is unable to deduct the investment interest in the current taxable year. The commenter stated that the disallowance of the carryover of section 642(h)(2) excess deductions should not apply to those excess deductions that are no longer treated as miscellaneous itemized deductions under the proposed regulations, and that carryover should be permitted to the extent otherwise permitted under the Code. The preamble to the proposed regulations states that addressing suspended deductions under section 163(d) is beyond the scope of the regulations and the same is true of these final regulations.

A commenter requested that the amount of a beneficiary's net operating loss carryover to a later taxable year under section 172 should include all of the beneficiary's section 642(h)(2) excess deductions that are section 67(e) deductions, as deductions that are attributable to the beneficiary's trade or business and thus deductions attributable to a trade or business under section 172(d)(4). Section 642(h) makes it clear that a net operating loss carryover under paragraph (1) of that section is separate and distinct from the excess deductions on termination described in paragraph (2) of that section. Furthermore, § 1.642(h)-2(d) provides that a deduction based upon a net operating loss carryover generally will not be allowed to beneficiaries under both paragraphs (1) and (2) of section 642(h). Therefore, an excess deduction allowable to the beneficiary under section 642(h)(2) is not a net operating loss carryover succeeded to by the beneficiary under section 642(h)(1) and (with one exception) a net operating loss carryover is not an excess deduction on termination. Moreover, these regulations provide that it is the character of the excess deductions as section 67(e) deductions, non-miscellaneous itemized deductions, and miscellaneous itemized deductions, and not the character of a deduction as attributable to a trade or business, that is retained in the hands of the beneficiary. Thus, whether section 642(h)(2) excess deductions that are section 67(e) deductions may be included in a beneficiary's net operating loss carryovers under section 172, separate from those it succeeds to from a terminated estate or trust, is beyond the scope of these regulations. Because § 1.642(h)-2(a) is clear that excess deductions on termination of an estate or trust are not carried over to future years and that such deductions are separate from a net operating loss carryover from the estate or trust, the Treasury Department and the IRS do not adopt this comment.

6. EXAMPLE 1

Section 1.642(h)-5(a), Example 1, of the proposed regulations (Example 1) updates an existing example illustrating computations under section 642(h) when there is a net operating loss. Section 1.642-5(a)(2)(ii) of Example 1 explains that the beneficiaries of the trust cannot carry back any of the net operating loss of the terminating estate that was made available to them under section 642(h)(1).

Two commenters requested that Example 1 be revised to take into account the amendments to section 172(b)(1)(D) under sec. 2302(b) of the Coronavirus Aid, Relief, and Economic Security Act, Public Law 116-136, 134 Stat. 281 (2020) (CARES Act), by allowing a beneficiary to carry back the net operating loss carryover the beneficiary succeeds to under section 642(h)(1) for net operating losses arising in taxable years beginning after December 31, 2017, and before January 1, 2021. Under section 2303 of the CARES Act, net operating losses arising in taxable years beginning after December 31, 2017, and before January 1, 2021, generally may be carried back five years before being carried forward. One of these commenters further requested confirmation that a beneficiary is allowed a carryback of the net operating loss under section 642(h)(1) for net operating losses of an estate or trust arising in taxable years ending before January 1, 2018, to the extent the beneficiary succeeds to a net operating loss carryover attributable to those net operating losses on a termination of the estate or trust between January 1, 2018, and December 31, 2020.

Unless otherwise provided under the Code, a net operating loss incurred by a taxpayer may only be used as a deduction by that taxpayer and cannot be transferred to another taxpayer for use by that other taxpayer. *Calvin v. U.S.*, 354 F.2d 202 (10th Cir. 1965), *Mellott v. U.S.*, 257 F.2d 798 (3d Cir. 1958). As an exception to this general principle, section 642(h) provides that if, on termination of an estate or trust, the estate or trust has a net operating loss carryover under section 172, then such carryover is allowed as a deduction, in accordance with the regulations prescribed by the Secretary, to the beneficiaries succeeding to the property of the estate or trust. Section 1.642(h)-1(a) provides that if, on the termination of an estate or trust, a net operating loss carryover under section 172 would be allowable to the estate or trust in a taxable year subsequent to the taxable year of termination but for the termination, a carryover is allowed under section 642(h)(1) to the beneficiaries succeeding to the property of the estate or trust. In addition, § 1.642(h)-1(b) provides that the first taxable year of the beneficiary to which the net operating loss will be carried over is the taxable year of the beneficiary in which or with which the estate or trust terminates.

Section 642(h)(1) provides a specific rule that allows the beneficiary to succeed to a net operating loss carryover of the estate or trust and deduct the amount of the net operating loss over the remaining carryover period that would have been allowable to the estate or trust but for the termination of the estate or trust. The phrase in section 642(h)(1) "the estate or trust has a net operating loss carryover' " means that the estate or trust incurred a net operating loss and either already carried it back to the earliest allowable year under section 172 or elected to waive the carryback period under section 172(b)(3), and now is limited to carrying over the remaining net operating loss. Accordingly, because the net operating loss is a carryover for the estate or trust, the beneficiary succeeding to that net operating loss may, under section 642(h)(1), only carry it forward.

The CARES Act amendments to section 172(b) mentioned by the commenters allow taxpayers a five-year carryback of certain net operating losses incurred by that taxpayer. The CARES Act amendments do not change the result that a beneficiary succeeding to the net operating loss carryover of a terminated estate or trust may only carryover that net operating loss in the same manner as the terminated estate or trust, but for the termination. Consequently, the Treasury Department and the IRS do not adopt these comments and add a citation to § 1.642(h)-1 to reference the rule that a beneficiary that succeeds to a net operating loss carryover of a terminated estate or trust may only carry forward the net operating loss.

7. EXAMPLE 2

Section § 1.642(h)-5(b), Example 2, of the proposed regulations (Example 2) demonstrates computations under section 642(h)(2). The expenses in Example 2 include rental real estate taxes in an attempt to illustrate a deduction subject to limitation under section 164(b)(6) to the beneficiary that must be separately stated as provided in § 1.642(h)-2(b)(1).

Multiple commenters noted that Example 2 raises several issues that could be potentially relevant to that example, such as whether the decedent was in a trade or business and the application of section 469 to estates and trusts. To avoid these issues, which are extraneous to the point being illustrated, one commenter suggested that the example be revised so that the entire amount of real estate expenses on rental property equals the amount of rental income. The Treasury Department and the IRS did not intend to raise such issues in the example and consider both issues to be outside the scope of these regulations. Accordingly, the Treasury Department and the IRS adopt the suggestion by the commenter and modify Example 2 to avoid these issues by having rental real estate expenses entirely offset rental income with no unused deduction.

Commenters also noted that Example 2 does not properly allocate rental real estate expenses because the example characterizes the rental real estate taxes as itemized deductions. These commenters asserted that real estate taxes on property held for the production of rental income are not itemized deductions but instead are allowed in computing gross income and cited to section 62(a)(4) as providing that ordinary and necessary expenses paid or incurred during the taxable year for the management, conservation, or maintenance of property held for the production of income under section 212(2) that are attributable to property held for the production of rents are deductible as above-the-line deductions in arriving at adjusted gross income. One commenter suggested that, if the goal of Example 2 is to illustrate state and local taxes passing through to the beneficiary, then the example should include state income taxes rather than real estate taxes on rental real estate. The Treasury Department and the IRS have revised this example in the final regulations to include personal property tax paid by the trust rather than taxes attributable to rental real estate.

Lastly, commenters noted that Example 2 does not demonstrate the broad range of trustee discretion in § 1.652(b)-3(b) and (d) for deductions that are not directly attributable to a class of income, or deductions that are, but which exceed such class of income, respectively. In response to these comments, the Treasury Department and the IRS have modified Example 2 to illustrate the application of trustee discretion as found in § 1.652(b)-3(b) and (d).

C. Applicability Dates

The proposed regulations provide that the changes to §§ 1.67-4, 1.642(h)-2, and 1.642(h)-5 apply to taxable years beginning after the date the regulations are published as final. The preamble to the proposed regulations explains that estates, non-grantor trusts, and their beneficiaries may rely on the proposed regulations under section 67 for taxable years beginning after December 31, 2017, and on or before the date these regulations are published as final. Taxpayers may also rely on the proposed regulations under section 642(h) for taxable years of beneficiaries beginning after December 31, 2017, and on or before the date the regulations are published as final, in which an estate or trust terminates.

One commenter requested that § 1.642(h)-2 of the proposed regulations be applied retroactively not only to taxable years beginning after December 31, 2017, but to all open years. The commenter asserted that the existing regulation treating excess deductions on termination of an estate as a miscellaneous itemized deduction was in error. As an example, the commenter argues that the current regulations mistakenly describe section 67(e) expenses as an exception to the rules applicable to miscellaneous itemized deductions, and therefore requested that the final regulations be applicable to all open years. The Treasury Department and the IRS have the authority to treat an excess deduction on termination of an estate or trust as a single miscellaneous itemized deduction. See section 642(h). The suspension under section 67(g) of miscellaneous itemized deductions caused the Treasury Department and the IRS to reconsider the treatment of excess deductions under section 642(h)(2) because the Treasury Department and the IRS do not interpret section 67(g) as suspending such deductions allowable under section 642(h)(2). The Treasury Department and the IRS interpret section 67(g) as not disallowing excess deductions succeeded to beneficiaries from terminated estates and trusts under section 642(h)(2). Therefore, taxpayers may rely on these regulations as of the effective date of section 67(g), but not for earlier periods.

The final regulations apply to taxable years beginning after October 19, 2020. Pursuant to section 7805(b)(7), taxpayers may choose to apply the amendments to § 1.67-4 and §§ 1.642(h)-2 and 1.642(h)-5 set forth in this Treasury decision to taxable years beginning after December 31, 2017, and on or before October 19, 2020.

On 10/18/2020 (last reviewed or updated 2/11/2020), the 2019 Instructions for Form 1041 included:

> **Box 11, Code A—Excess Deductions on Termination**
>
> If this is the final return of the estate or trust, and there are excess deductions on termination (see the instructions for line 23), enter the beneficiary's share of the excess deductions in box 11, using code A. Figure the deductions on a separate sheet and attach it to the return.
>
> Excess deductions on termination occur only during the last tax year of the trust or decedent's estate when the total deductions (excluding the charitable deduction and exemption) are greater than the gross income during that tax year.
>
> Generally, a deduction based on an NOL carryover isn't available to a beneficiary as an excess deduction. However, if the last tax year of the estate or trust is also the last year in which an NOL carryover may be taken (see section 172(b)), the NOL carryover is considered an excess deduction on the termination of the estate or trust to the extent it isn't absorbed by the estate or trust during its final tax year. For more information, see Regulations section 1.642(h)-4 for a discussion of the allocation of the carryover among the beneficiaries.
>
> Only the beneficiary of an estate or trust that succeeds to its property is allowed to deduct that entity's excess deductions on termination. A beneficiary who doesn't have enough income in that year to absorb the entire deduction can't carry the balance over to any succeeding year. An individual beneficiary must be able to itemize deductions in order to claim the excess deductions in determining taxable income.
>
> **Box 11, Codes B and C—Unused Capital Loss Carryover**
>
> Upon termination of the trust or decedent's estate, the beneficiary succeeding to the property is allowed as a deduction any unused capital loss carryover under section 1212. If the estate or trust incurs capital losses in the final year, use the Capital Loss Carryover Worksheet in the Instructions for Schedule D (Form 1041) to figure the amount of capital loss carryover to be allocated to the beneficiary.
>
> **Box 11, Codes D and E—NOL Carryover**
>
> Upon termination of a trust or decedent's estate, a beneficiary succeeding to its property is allowed to deduct any unused NOL (and any ATNOL) carryover for regular and AMT purposes if the carryover would be allowable to the estate or trust in a later tax year but for the termination. Enter in box 11, using codes D and E, the unused carryover amounts.

Reporting Excess Deductions on Termination of an Estate or Trust on Forms 1040, 1040-SR, and 1040-NR for Tax Year 2018 and Tax Year 2019 (9/19/2020) provides:

> Under Proposed Regulations 113295-18 (PDF), an excess deduction on termination of an estate or trust allowed in arriving at adjusted gross income (Internal Revenue Code (IRC) section 67(e) expenses) is reported as an adjustment to income on Forms 1040, 1040-SR, and 1040-NR; non-miscellaneous itemized deductions are reported, as

applicable, on Schedule A (Form 1040 or 1040-SR) or Schedule A (Form 1040-NR); and miscellaneous itemized deductions are not deductible. Taxpayers may rely on the proposed regulations for tax years of beneficiaries beginning after 2017 and before the final regulations are published.

For tax year 2019, an excess deduction for IRC section 67(e) expenses is reported as a write-in on Schedule 1 (Form 1040 or 1040-SR), Part II, line 22, or Form 1040-NR, line 34. On the dotted line next to line 22 or line 34 (depending on which form is filed), enter the amount of the adjustment and identify it using the code “ED67(e)”. Include the amount of the adjustment in the total amount reported on line 22 or line 34.

For tax year 2018, an excess deduction for IRC section 67(e) expenses is reported as a write-in on Schedule 1 (Form 1040), line 36, or Form 1040-NR, line 34. On the dotted line next to line 36 or line 34, (depending on which form is filed), enter the amount of the adjustment and identify it using the code “ED67(e)”. Include the amount of the adjustment in the total amount reported on line 36 or line 34.

The preamble and text of the proposed and final regulations refer to Reg. § 1.652(b)-3, which is discussed in part II.J.8.f.i.(a) Allocating Deductions to Various Income Items. Generally, expenses allocable to nontaxable items must be allocated pro rata to that income, but expenses allocable to taxable items may be applied to reduce that income in any manner the taxpayer wishes.

Reg. § 1.642(h)-2, “Excess deductions on termination of an estate or trust,” provides:

(a) Excess deductions.

(1) *In general.* If, on the termination of an estate or trust, the estate or trust has for its last taxable year deductions (other than the deductions allowed under section 642(b) (relating to the personal exemption) or section 642(c) (relating to charitable contributions)) in excess of gross income, the excess deductions as determined under paragraph (b) of this section are allowed under section 642(h)(2) as items of deduction to the beneficiaries succeeding to the property of the estate or trust.

(2) *Treatment by beneficiary*. A beneficiary may claim all or part of the amount of the deductions provided for in paragraph (a) of this section, as determined after application of paragraph (b) of this section, before, after, or together with the same character of deductions separately allowable to the beneficiary under the Internal Revenue Code for the beneficiary’s taxable year during which the estate or trust terminated as provided in paragraph (c) of this section.

(b) *Character and amount of excess deductions*

(1) *Character.* The character and amount of the excess deductions on termination of an estate or trust will be determined as provided in this paragraph (b). Each deduction comprising the excess deductions under section 642(h)(2) retains, in the hands of the beneficiary, its character (specifically, as allowable in arriving at adjusted gross income, as a non-miscellaneous itemized deduction, or as a miscellaneous itemized deduction) while in the estate or trust. An item of deduction succeeded to by a beneficiary remains subject to any additional

applicable limitation under the Internal Revenue Code and must be separately stated if it could be so limited, as provided in the instructions to Form 1041, *U.S. Income Tax Return for Estates and Trusts*, and the Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credit, etc.*, or successor forms.

(2) *Amount.* The amount of the excess deductions in the final year is determined as follows:

(i) Each deduction directly attributable to a class of income is allocated in accordance with the provisions in § 1.652(b)-3(a);

(ii) To the extent of any remaining income after application of paragraph (b)(2)(i) of this section, deductions are allocated in accordance with the provisions in § 1.652(b)-3(b) and (d); and

(iii) Deductions remaining after the application of paragraph (b)(2)(i) and (ii) of this Section comprise the excess deductions on termination of the estate or trust. These deductions are allocated to the beneficiaries succeeding to the property of the estate of or trust in accordance with § 1.642(h)-4.

(c) *Year of termination*.

(1) *In general.* The deductions provided for in paragraph (a) of this section are allowable only in the taxable year of the beneficiary in which or with which the estate or trust terminates, whether the year of termination of the estate or trust is of normal duration or is a short taxable year.

(2) *Example.* Assume that a trust distributes all its assets to B and terminates on December 31, Year X. As of that date, it has excess deductions of $18,000, all characterized as allowable in arriving at adjusted gross income under section 67(e). B, who reports on the calendar year basis, could claim the $18,000 as a deduction allowable in arriving at B's adjusted gross income for Year X. However, if the deduction (when added to other allowable deductions that B claims for the year) exceeds B's gross income, the excess may not be carried over to any year subsequent to Year X.

(d) *Net operating loss carryovers.* [same as current Reg. § 1.642(h)-2(b)]

(e) *Items included in net operating loss or capital loss carryovers.* [same as current Reg. § 1.642(h)-2(c)]

(f) *Applicability date.* Paragraphs (a) through (c) of this section apply to taxable years beginning after October 19, 2020. The rules applicable to taxable years beginning on or before October 19, 2020 are contained in § 1.642(h)-2 as in effect prior to October 19, 2020 (see 26 CFR part 1 revised as of April 1, 2020). Taxpayers may choose to apply paragraphs (a) through (c) of this section to taxable years beginning after December 31, 2017, and on or before October 19, 2020.

The most important new idea is that, instead of the excess deductions being miscellaneous itemized deductions, they are divided into three categories:

- allowable in arriving at adjusted gross income (colloquially referred to as “above-the-line”),
- non-miscellaneous itemized deduction, or
- miscellaneous itemized deduction.

Here is an example from me: Suppose the terminating trust has $5,000 income, $2,000 of tax preparation fees, and $4,000 of legal fees. Thus, excess deductions are $1,000 ($5,000 – ($2,000 + $4,000)). Note that both deductions are Code § 67(e) above-the-line deductions (in other words, deducted in arriving at gross income). Before the regulations, this $1,000 excess deduction would have been a miscellaneous itemized deduction. Under the regulations, the $1,000 excess is an above-the-line deduction.

Variation 1: same example, but the $4,000 in legal fees is replaced by $4,000 in state income tax, which is an itemized deduction. Excess deductions remain $1,000. When preparing the tax return, you choose to apply $1,000 in tax preparation fees and $4,000 in state income tax to eliminate the $5,000 income. That leaves $1,000 in tax preparation fees. Under the regulations, the $1,000 excess is an above-the-line deduction.

Variation 2: same as Variation 1, but you instead offset the income by $2,000 in tax preparation fees and $3,000 in state income tax. That leaves $1,000 in state income tax. Under the regulations, the $1,000 excess is a regular itemized deduction (not a miscellaneous itemized deduction).

We would all choose Variation 1 over Variation 2, because an above-the-line deduction is better than an itemized deduction.

Rev. Rul. 77-466 asserted:

> In the instant case, since under state law the trustees’ termination commissions were not directly allocable to any particular class of income, but instead were paid for all the activity of the trustees during the trust’s lifetime, such commissions are properly allocable to: (1) the trust’s ordinary income (including tax-exempt income) realized during its existence, (2) net realized capital gains from its inception to its termination, and (3) any net unrealized capital appreciation of the assets distributed by the trust. However, the method used by the trustees resulted in none of the commissions being allocated to tax-exempt income, even though the trust had realized tax-exempt income during the period of its existence.
>
> Accordingly, since none of the trustees’ commissions were allocated to tax-exempt income the method used is not reasonable in the light of all the facts and circumstances and, therefore, is not an appropriate method for purposes of section 265 of the Code. However, in the instant case, a reasonable and appropriate method of allocation would be one based on the ratio of tax-exempt income realized by the trust during its existence to the total of ordinary income (including tax-exempt income) realized by the trust during its existence plus the excess of capital gains realized over capital losses sustained over the life of the trust plus any net unrealized capital appreciation of the assets distributed.

Reg. § 1.642(h)-5(a), Example 1, “Computations under Section 642(h) when an estate has a net operating loss,” provides:

(1) *Facts.* On January 31, 2020, A dies leaving a will that provides for the distribution of all of A's estate equally to B and an existing trust for C. The period of administration of the estate terminates on December 31, 2020, at which time all the property of the estate is distributed to B and the trust. For tax purposes, B and the trust report income on a calendar year basis. During the period of administration, the estate has the following items of income and deductions:

TABLE 1 TO PARAGRAPH (a)(1)

Income:	
Taxable interest	$2,500
Business income	3,000
Total Income	5,500

TABLE 2 TO PARAGRAPH (a)(1)

Deductions:	
Business expenses (including administrative expense allocable to business income)	5,000
Administrative expenses not allocable to business income that would not have been incurred if property had not been held in a trust or estate (section 67(e) deductions)	9,800
Total deductions	14,800

(2) *Computation of net operating loss.* (i) The amount of the net operating loss carryover is computed as follows:

TABLE 3 TO PARAGRAPH (a)(1)

Gross income	$ 5,500
Total deductions	14,800
Less adjustment under section 172(d)(4) (allowable non-business expenses ($9,800) limited to non-business income ($2,500))	7,300
Deductions as adjusted	7,500
Net operating loss	2,000

(ii) Under section 642(h)(1), B and the trust are each allocated $1,000 of the $2,000 unused net operating loss carryover of the terminated estate in 2020, with the allowance of any net operating loss carryover to B and the trust determined under section 172. Neither B nor the trust can carry back any of the net operating loss of A's estate made available to them under section 642(h)(1). See § 1.642(h)-1(b).

(3) *Section 642(h)(2) excess deductions.* The $7,300 of non-business deductions not taken into account in determining the net operating loss of the estate are excess deductions on termination of the estate under section 642(h)(2). Under § 1.642(h)-2(b)(1), such deductions retain their character as section 67(e) deductions. Under § 1.642(h)-4, B and the trust each are allocated $3,650 of excess deductions based on B's and the trust's respective shares of the burden of each cost.

(4) *Consequences for C.* The net operating loss carryover and excess deductions are not allowable directly to C, the trust beneficiary. To the extent the distributable net income of the trust is reduced by the net operating loss carryover and excess deductions, however, C may receive an indirect benefit from the carryover and excess deductions.

Reg. § 1.642(h)-5(b), Example 2, "Computations under Section 642(h)(2)" provides:

(1) *Facts.* D dies in 2019 leaving an estate of which the residuary legatees are E (75%) and F (25%). The estate's income and deductions in its final year are as follows:

TABLE 4 TO PARAGRAPH (b)(1)

Income:	
Dividends	$3,000
Taxable Interest	500
Rent	2,000
Capital Gain	1,000
Total Income	6,500

TABLE 5 TO PARAGRAPH (b)(1)

Deductions:	
Section 62(a)(4) deductions:	
Rental real estate expenses	2,000
Section 67(e) deductions:	
Probate fees	1,500
Estate tax preparation fees	8,000
Legal fees	2,500
Total Section 67(e) deductions	12,000
Non-miscellaneous itemized deductions:	
Personal property taxes	3,500
Total deductions	17,500

(2) *Determination of character.* Pursuant to § 1.642(h)-2(b)(2), the character and amount of the excess deductions is determined by allocating the deductions among the estate's items of income as provided under § 1.652(b)-3. Under § 1.652(b)-3(a), the $2,000 of rental real estate expenses is allocated to the $2,000 of rental income. In the exercise of the executor's discretion pursuant to § 1.652(b)-3(b), D's executor allocates $3,500 of personal property taxes and $1,000 of section 67(e) deductions to the remaining income. As a result, the excess deductions on termination of the estate are $11,000, all consisting of section 67(e) deductions.

(3) *Allocations among beneficiaries.* Pursuant to § 1.642(h)-4, the excess deductions are allocated in accordance with E's (75 percent) and F's (25 percent) interests in the residuary estate. E's share of the excess deductions is $8,250, all consisting of section 67(e) deductions. F's share of the excess deductions is $2,750, also all consisting of section 67(e) deductions.

(4) *Separate statement*. If the executor instead allocated $4,500 of section 67(e) deductions to the remaining income of the estate, the excess deductions on termination of the estate would be $11,000, consisting of $7,500 of section 67(e) deductions and $3,500 of personal property taxes. The non-miscellaneous itemized deduction for personal property taxes may be subject to limitation on the returns of both B and C's trust under section 164(b)(6)(B) and would have to be separately stated as provided in § 1.642(h)-2(b)(1).

Reg. § 1.642(h)-5(c), "Applicability date" provides:

> This section is applicable to taxable years beginning after October 19, 2020. Taxpayers may choose to apply this section to taxable years beginning after December 31, 2017, and on or before October 19, 2020.

Example 2 illustrates that generally a tax return preparer should avoid allocating Code § 67(e) deductions against income and instead allocate other expenses against income so that the only excess deductions passing through to the beneficiary would be Code § 67(e) deductions. This is consistent with the comments we put together: ACTEC submits comments on Treasury Notice 85 Fed. Reg. 27693 (5/11/20): Proposed Regulations on Income Tax Regulations (26 CFR part 1) under sections 67 and 642 of the Internal Revenue Code (June 22, 2020).

Reg. § 1.641(b)-3(b)[2563] provides:

> Generally, the determination of whether a trust has terminated depends upon whether the property held in trust has been distributed to the persons entitled to succeed to the property upon termination of the trust rather than upon the technicality of whether or not the trustee has rendered his final accounting. A trust does not automatically terminate upon the happening of the event by which the duration of the trust is measured. A reasonable time is permitted after such event for the trustee to perform the duties necessary to complete the administration of the trust. Thus, if under the terms of the governing instrument, the trust is to terminate upon the death of the life beneficiary and the corpus is to be distributed to the remainderman, the trust continues after the death of the life beneficiary for a period reasonably necessary to a proper winding up of the

[2563] Reg. § 1.641(b)-3(b) is incorporated by reference by Reg. § 1.642(h)-1(a).

affairs of the trust. However, the winding up of a trust cannot be unduly postponed and if the distribution of the trust corpus is unreasonably delayed, the trust is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the trustee to complete the administration of the trust. Further, a trust will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).

II.J.4. Tips for Fiduciary Income Tax Preparers

The IRS' web page for fiduciary income tax returns is https://www.irs.gov/uac/about-form-1041.

Income tax preparers might consider the following:

II.J.4.a. Distributions after Yearend to Carry Out Income to Beneficiaries

Prepare a rough draft of the income tax return in February and compare it to the beneficiaries' income tax rates.

If distributions are appropriate, make them by March 5 or 6.

For details, see part II.J.2 Tactical Planning Shortly After Yearend to Save Income Tax for Year That Ended.

II.J.4.b. Capital Gain Elections

Tax return preparation software automatically treats capital gains as trapped in the trust.

Consider whether current or future capital gains should be shifted to the beneficiaries.[2564]

Although a prior year return might have constituted an election not to distribute capital gains under one particular option, the tax laws are much more flexible than might appear at first. See part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).

II.J.4.c. Charitable Distributions

Even more generous than the 65-day rule mentioned in part II.J.4.a Distributions after Yearend to Carry Out Income to Beneficiaries, a charitable contribution made any time in the current year can count for the current or immediately preceding year.[2565] For example, a contribution made December 31, 2017 can count as a 2016 contribution for a calendar year fiduciary taxpayer.

A nongrantor trust or estate's charitable deduction reduces adjusted gross income distributed to the beneficiaries and is the only way a charitable deduction can reduce net investment income subject to the 3.8% tax.[2566] However, the Code § 642(c) charitable deduction does not reduce

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[2564] See part II.J.3 Strategic Fiduciary Income Tax Planning.
[2565] Code § 642(c)(1); Reg. § 1.642(c)-1(b)(1); extensions of time are common, including Letter Rulings 20201013, 20201014, and 20201013. Although an estate can deduct any amounts set aside and paid any time before termination, that election can be fraught with danger. See part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI), with the caution described in fn. 2720.
[2566] See fn. 2324.

the amount of the DNI allocated to a mandatory income beneficiary.[2567] If the trust is mandatory income as to a portion and discretionary as to a portion, the beneficiary receiving discretionary distributions may benefit from the charitable deduction and may receive a windfall,[2568] but these rules may also cause more K-1 income for the mandatory income beneficiary than the trust

[2567] Code § 651(b), as explained by Reg. § 1.651(a)-4(a), prevents trusts that make charitable distributions from being treated as simple trusts. Code § 662(a)(1), which applies to trusts other than simple trusts, provides:

> *Amounts required to be distributed currently*. The amount of income for the taxable year required to be distributed currently to such beneficiary, whether distributed or not. If the amount of income required to be distributed currently to all beneficiaries exceeds the distributable net income (computed without the deduction allowed by section 642(c), relating to deduction for charitable, etc., purposes) of the estate or trust, then, in lieu of the amount provided in the preceding sentence, there shall be included in the gross income of the beneficiary an amount which bears the same ratio to distributable net income (as so computed) as the amount of income required to be distributed currently to such beneficiary bears to the amount required to be distributed currently to all beneficiaries. For purposes of this section, the phrase "the amount of income for the taxable year required to be distributed currently" includes any amount required to be paid out of income or corpus to the extent such amount is paid out of income for such taxable year.

F. Ladson Boyle & Jonathan G. Blattmachr, §3:5.2 Tier System, *Blattmachr on Income Taxation of Estates and Trusts* (PLI 16th ed. 2016), explains:

> ... trust-accounting income (required to be distributed currently) may exceed DNI. In effect, charitable distributions of income are in a middle category: available income is first treated as going to first-tier beneficiaries; then, to the extent that income is distributed to charity, there is a charitable deduction. As a result, only the residue of income is taxed to the second-tier beneficiaries.

[2568] See Code § 662(a)(1), reproduced in fn. 2567. In applying this rule, Reg. § 1.662(b)-2 provides that:

> for the purpose of allocating items of income and deductions to beneficiaries to whom income is required to be distributed currently, the amount of the charitable contributions deduction is disregarded to the extent that it exceeds the income of the trust for the taxable year reduced by amounts for the taxable year required to be distributed currently.

Reg. § 1.662(b)-2, Example (1), illustrates this rule, with paragraph (e) of the example providing the discretionary beneficiary with the windfall of receiving:

> (a) A trust instrument provides that $30,000 of its income must be distributed currently to A, and the balance may either be distributed to B, distributed to a designated charity, or accumulated. Accumulated income may be distributed to B and to the charity. The trust for its taxable year has $40,000 of taxable interest and $10,000 of tax-exempt income, with no expenses. The trustee distributed $30,000 to A, $50,000 to charity X, and $10,000 to B.
>
> (b) Distributable net income for the purpose of determining the character of the distribution to A is $30,000 (the charitable contributions deduction, for this purpose, being taken into account only to the extent of $20,000, the difference between the income of the trust for the taxable year, $50,000, and the amount required to be distributed currently, $30,000).
>
> (c) The charitable contributions deduction taken into account, $20,000, is allocated proportionately to the items of income of the trust, $16,000 to taxable interest and $4,000 to tax-exempt income.
>
> (d) Under section 662(a)(1), the amount of income required to be distributed currently to A is $30,000, which consists of the balance of these items, $24,000 of taxable interest and $6,000 of tax-exempt income.
>
> (e) In determining the amount to be included in the gross income of B under section 662 for the taxable year, however, the entire charitable contributions deduction is taken into account, with the result that there is no distributable net income and therefore no amount to be included in gross income.
>
> (f) See subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code for application of the throwback provisions to the distribution made to B.

would have had if the trust had been able to accumulate the income.[2569] I have not explored the interaction of this rule with the fact that unrelated business income generally moves the charitable deduction from Code § 642(c) to Code § 170.[2570]

For the requirement that the contribution be paid from gross income and complexity that applies when the trust has S corporation, business, or debt-financed income, see part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction. Special rules apply to electing small business trusts owning S corporations that make charitable contributions, which disallow the charitable contribution regarding any donations that the ESBT portion of the trust makes and essentially apply the individual Code § 170 contribution rules rather than Code § 642(c) to any contributions flowing through the K-1 that the ESBT receives.[2571]

But for these limitations, generally a nongrantor trust's charitable deduction is not subject to the limitations that would apply to a beneficiary. Nongrantor trusts and estates may deduct charitable contributions made during the taxable year or in the next taxable year,[2572] whereas generally individuals may deduct contributions made during the taxable year. Also note that 2017 tax reform eliminates the benefit of the charitable deduction for individuals who take the standard deduction, whereas nongrantor trusts and estates may deduct them in full, subject to

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[2569] F. Ladson Boyle & Jonathan G. Blattmachr, §3:5.2 Tier System, *Blattmachr on Income Taxation of Estates and Trusts* (PLI 16th ed. 2016), suggests:

> **Example**: A complex trust has $65,000 of taxable dividend income. Annually, the trust is required to distribute the first $10,000 of income to a qualified charity, C, and the balance of its accounting income to an individual, A. In addition, the trustee is authorized to invade principal for the benefit of a second individual, B, and distributes $10,000 to B. The trust pays $10,000 in trustee fees that are chargeable one-half to income and one-half to principal. The accounting income for the trust is $60,000 ($65,000 less $5,000 (one-half of the trustee's fee)). Thus, the amount distributable to A is $50,000 ($60,000 less $10,000 due the charity).
>
> The trust's taxable income [ignoring the distribution deduction and exemption] is $45,000 ($65,000 less $10,000 trustee fee and less $10,000 charitable deduction). The DNI for the trust is $45,000. Because distributions to A and B exceed DNI, the trust's distribution deduction is limited to $45,000.
>
> When the amount of income A must report is computed, DNI is recomputed without a charitable deduction. Thus, DNI is $55,000 for this purpose and A has $50,000 of taxable income under section 662. Note that the amount of income A must report is less than the recomputed DNI by $5,000.
>
> Nevertheless, B has no income on the distribution of principal as the DNI for purposes of the tier 2 distribution is the original $45,000 and that amount is not in excess of the tier 1 distribution to A.

B's windfall comes at the expense of A paying tax on more income ($50,000) than the net of the trust's taxable items ($45,000).

[2570] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction.

[2571] Under 2017 tax reform, Code § 642(c) does not apply to an ESBT; see fn 6055 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview and also note that fn 6054 allows an ESBT to deduct charitable contributions against its S corporation income only to the extent they are on the K-1 from the S corporation

[2572] See fn. 2565.

various limitations.[2573] Finally, nongrantor trusts and estates may deduct charitable contributions made to a foreign charity, whereas an individual cannot.[2574]

Compare and contrast part II.J.4.c.i Estate or Nongrantor Trust Contribution Deduction Requirements with part II.J.4.c.ii Individual Contribution Deduction Requirements. Estate and nongrantor trust charitable deduction rules appear to be more liberal as to who the donee is.[2575] As to the latter, note that Code § 170(c) describes who qualifies as a charitable donee, whereas Code § 642(c) refers to a contribution "paid for a purpose specified in Section 170(c) (determined without regard to section 170(c)(2)(A))."[2576]

Reg. § 1.642(c)-1(b)(1) provides that the fiduciary may elect under Code § 642(c)(1) to treat as paid during the taxable year "any amount of gross income received during such taxable year or any preceding taxable year which is otherwise deductible under such paragraph and which is paid after the close of such taxable year but on or before the last day of the next succeeding taxable year of the estate or trust."[2577] Reg. § 1.642(c)-1(b)(2) provides that this election "shall be made not later than the time, including extensions thereof, prescribed by law for filing the income tax return for the succeeding taxable year" and "shall, except as provided in subparagraph (4) of this paragraph, become irrevocable after the last day prescribed for making it." Letter Ruling 202332004 gave an extension of time to file an election that, "due to inadvertence," was not timely filed:

> This ruling is conditioned on Trust filing an income tax return (or amended return) for its Year 1 taxable year on which Trust must: (1) make the election under § 642(c)(1) to claim a deduction in Year 1 for the Contributions made by the close of Year 2, and (2) claim a deduction for such Contributions under § 642(c)(1). If necessary, Trust must

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[2573] In addition to any limits imposed by Code § 642(c), charitable contributions by nongrantor trusts and estates may be reduced if they result in state tax credits, in a manner similar to that imposed on individuals. Reg. § 1.642(c)-3(g), "Payments resulting in state or local tax benefits," provides:

> (1) *In general*. If the trust or decedent's estate makes a payment of gross income for a purpose specified in section 170(c), and the trust or decedent's estate receives or expects to receive a state or local tax benefit in consideration for such payment, § 1.170A-1(h)(3) applies in determining the charitable contribution deduction under section 642(c).
>
> (2) *Effective/applicability date*. Paragraph (g)(1) of this section applies to payments of gross income after August 27, 2018.

Reg. § 1.170A-1(h)(3) is reproduced in part II.G.4.n Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax, which also discusses the related state income effect.

[2574] Reg. § 1.642(c)-1(a)(2) provides:

> In determining whether an amount is paid for a purpose specified in section 170(c)(2) the provisions of section 170(c)(2)(A) shall not be taken into account. Thus, an amount paid to a corporation, trust, or community chest, fund, or foundation otherwise described in section 170(c)(2) shall be considered paid for a purpose specified in section 170(c) even though the corporation, trust, or community chest, fund, or foundation is not created or organized in the United States, any State, the District of Columbia, or any possession of the United States.

[2575] Code § 170(c) provides that "the term 'charitable contribution' means a contribution or gift to or for the purpose specified in section 170(c) (determined without regard to section 170(c)(2)(A))."

[2576] Code § 170(c)(2)(A) refers to a donation to a corporation, trust, or community chest, fund, or foundation "created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States."

[2577] Letter Ruling 201011001 granted an extension of time to file this election when:

> Due to an inadvertent oversight by the Trust's accountant, Trust's tax returns were filed late and Trust could not therefore make a proper § 642(c) election by including a statement with the tax return for Year1 as required under § 1.642(c)-1(b)(3) of the Income Tax Regulations.

file an income tax return (or amended return) for Trust's Year 2 taxable year to properly report the tax consequences of the Contribution in a manner consistent with the election having been made.

II.J.4.c.i. Estate or Nongrantor Trust Contribution Deduction Requirements

In addition to the rules below, see part II.G.4.g Limitations on Deducting Charitable Contributions.

However, rules requiring nongrantor trusts and estates to use gross income to make contributions can be tricky,[2578] especially when a nongrantor trust has unrelated business income.[2579] *Goldsby, Jr. v. Commissioner*, T.C. Memo. 2006-274, held that a contribution that could not possibly have come from gross income was not deductible to the contributing trust.

A trust claiming a charitable deduction must identify the "governing instrument," show that the charitable contributions were paid "pursuant to" the terms of that instrument as required by Code § 642(c)(1), and demonstrate that each contribution was paid for a charitable purpose under Code § 170(c).[2580] Trustee discretion to distribute to charity satisfies the "pursuant to" standard; however, the trustee relevant documents must authorize the distributions.

Old Colony Trust Co. v. Commissioner, 301 U.S. 379 (1937), construing the predecessor to Code § 642(c), rejecting the IRS' narrow construction and adopting a broad definition of "pursuant to":

> We are asked to hold that the words "pursuant to" mean directed or definitely enjoined. And this notwithstanding the admission that Congress intended to encourage charitable contributions by relieving them from taxation. *Lederer, Collector, v. Stockton*, 260 U.S. 3, 43 S.Ct. 5, 67 L.Ed. 99; *United States v. Provident Trust Co., Administrator*, 291 U.S. 272, 285, 54 S.Ct. 389, 392, 78 L.Ed. 793.
>
> "Pursuant to" is defined as "acting or done in consequence or in prosecution (of anything); hence, agreeable, conformable; following; according."[3]
>
> [3] *Webster's New International Dictionary, Unabridged* (2d Ed.) 1935.

In rejecting a Code § 642(c) deduction when a revocable trust distributed to a charity that was a beneficiary under the grantor-decedent's pourover will, *Love Charitable Foundation v. Commissioner*, 710 F.2d 1316 (8th Cir. 1983), reasoned:

> *Old Colony* stands for the proposition that a trust is entitled to a deduction when a trustee who is authorized but not required to make charitable contributions under the trust instrument does in fact make charitable contributions. We do not believe, however, that the *Old Colony* case and the definition of "pursuant to" given in that case should be read so broadly as to entitle a trust to a charitable deduction when a trustee, acting

[2578] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, fns. 4912-4914.
[2579] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, fns. 4927-4933, which impose individual percentage limitations in lieu of Code § 642(c) and seem to undo the benefits described above in the text accompanying fns. 2572 2575. This rule does not apply to estates. See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, fns. 4939-4940.
[2580] *Hubbell Trust v. Commissioner*, T.C. Summ. Op. 2016-67, citing *Brownstone v. United States*, 465 F.3d 525, 529 (2nd Cir. 2006).

> without any authority under the trust instrument, distributes the Trust assets to charity. Rather, as stated earlier, we believe it is necessary that a trust instrument authorize the trustee to make charitable contributions if it is to be said that the charitable contributions were made "pursuant to the terms of" the Trust instrument.

Payments an estate made to charity out of estate income attributable to that part of the estate transferred to charity, under the terms of a settlement agreement resulting from a will contest, qualify for a Code § 642(c) deduction;[2581] absent an actual dispute, the IRS has questioned the deduction.[2582] When a charitable lead annuity trust distributed more to charity than its annuity amount and that distribution was not clearly authorized, the trust received neither a charitable nor an income distribution deduction for those excess distributions.[2583]

TAM 8446007 involved the following facts:

> A is the sole surviving income beneficiary of a testamentary trust ("Trust") created under the will of D. The will requires the Trust to distribute the net income to several beneficiaries, including A, for their lives and then to the descendants of A until the youngest becomes twenty-one years old, at which time the principal is to be divided among them. The will named several charitable organizations as contingent remaindermen in the event of the death of A without descendants or the death of all of A's descendants before the youngest becomes twenty-one years old. The terms of the will do not limit the transferability of the income interests.
>
> In 1971, A irrevocably assigned 50 percent of his income interest to B, an organization described in section 170(c) of the Internal Revenue Code. A private letter ruling was issued to A with respect to this assignment which provided that the assigned income is includible in the gross income of B and not of A. The ruling also provided that a deduction against the gift tax of the present value of the income interest as of the date of the transfer would be allowed A. No ruling was requested or provided regarding whether the Trust would be entitled to deduct, in computing its taxable income, the income it would distribute to B pursuant to the assignment.

When the trust argued it should not be taxed on the income distributed to B, TAM 8446007 concluded, "The Trust is not entitled to a deduction under either section 651(a), 661(a), 642(c) nor 170(a) of the Code for amounts of income distributed to B pursuant to the assignment by A," reasoning:

> Congress created the present structure for taxing the income of a trust or estate in 1954. There is a special set of rules for simple trusts in Subchapter J, Part I, Subpart B, sections 651-652. There is a general set of rules for all others ("complex" trusts) in Subpart C, sections 661-664. A simple trust is one that by its terms provides that all of its income is required to be distributed currently and that does not provide that any amounts are to be paid, permanently set aside, or used for charitable, etc., purposes.

[2581] Rev. Rul. 59-15, which was followed by Letter Ruling 9044047 regarding the settlement of a dispute among all interested parties, including the state attorney general.
[2582] CCA 200848020.
[2583] *Crown Income Charitable Fund v. Commissioner*, 98 T.C. 327 (1992), *aff'd* 8 F.3d 571, 573 (7th Cir. 1993). In denying the income distribution deduction as an alternative when the charitable deduction was disallowed, the Tax Court referred to Reg. § 1.663(a)-2, which provides:

> Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in section 642(c).

Section 651(a). Accordingly, the statute provides no deduction for charitable distributions made by a simple trust, and moreover expressly excludes simple trusts from the section that provides such a deduction for complex trusts. Section 642(c)(1).

The Trust has taken the position that it is a simple trust within the meaning of section 651(a), while reserving the right to argue for the deduction under the complex trust rules if the Service holds the Trust to be a complex trust. Paragraph FOURTH of the will under which the Trust was created placed the residue of the estate in trust for the payment of the net trust income to the stated life beneficiaries. Although there is no express prohibition forbidding the retention of income by the trustee, the reasonable interpretation of the simple language used in the will is that all of the trust income, net of proper expenses, is required to be paid currently to the beneficiaries. Thus the first part of the definition of a simple trust is met. Section 651(a)(1). Furthermore, the will contains absolutely no mention of any beneficiary other than the named members of the testator's family and their descendants. Therefore, there is no provision in the will for the trust to pay income to a charitable beneficiary, or for the setting aside or the use of any income for charitable, etc., purposes. Thus the second part of the definition of a simple trust is met. Section 651(a)(2). Accordingly, the Trust is a simple trust within the meaning of Subchapter J, Part I, Subpart B.

Counsel for the Trust has represented that the transfer of the one-half income interest by A to B created a legal right on the part of B to receive the income thereafter which is enforceable against the trustee under local law. In effect, A has caused the Trust to acquire a charitable beneficiary by assignment. However, the Trust's counsel has represented that under local law the assignment by A does not "read into" the will B as a beneficiary under the terms of the Trust. Thus, organization B is not considered under local law a named beneficiary under the terms of the Trust.

The Trust argues that it should be entitled to an income distribution deduction under section 651(a) for the distributions to B, as it was for the distributions to A. The argument is that the conduit principle built into sections 651 and 652 causes income distributions from a simple trust to be transferred from the gross income of the trust to the gross income of the recipient, and that the assignee of a named beneficiary should be treated in this respect as standing in the shoes of the named beneficiary. The flaw in this argument is that Subchapter J contains ample evidence that Congress intended for distributions to charitable beneficiaries to be subject to special rules and limitations that do not apply to ordinary beneficiaries. Sections 642(c) and 681. The statutory provision which the Trust uses as authority for its claimed deduction, section 651, expressly excludes trusts that are designed by the grantor to make charitable distributions. The Trust's argument that the design of a beneficiary to cause the Trust to make charitable distributions should produce a statutory deduction for the Trust under this section seems to be contrary to the statutory purpose revealed in the language of section 651.

Furthermore, to allow a section 651 deduction to a simple trust for distributions to charities would establish a means for evasion of section 681. Section 681 applies only to complex trusts because it concerns charitable deductions otherwise allowable under section 642(c), which expressly excludes simple trusts. Section 1.681(a)-(1) of the Income Tax Regulations provides, in part, that the charitable contributions deduction allowable to a trust under section 642(c) is subject to the limitations under section 170 applicable to contributions by individuals to the extent the deduction is allocable to unrelated business income. This section 681 limitation, which clearly applies to a trust that makes distributions to charity pursuant to the terms of its governing instrument, could be evaded where a trust instrument is executed that provides only for a non-charitable income beneficiary, and such beneficiary then assigns its interest to a charity. This two-step procedure would effectively relieve the trust of a limitation that would have applied if the trust instrument had provided for a charitable income beneficiary.

The Trust argues that the deduction should be permitted because section 681 is not in issue since no unrelated business income is generated by the Trust, and therefore there is no tax abuse in the instant case. However, Congress intended the charitable deduction for trusts to be limited to the amounts allowable under section 681 and section 642(c), and these sections specifically do not apply to simple trusts. Therefore, to permit simple trusts to deduct charitable distributions would not only provide a benefit not allowed in the statute, it would open a loophole that could be manipulated contrary to the general rules governing the taxation of trusts. Because this scheme is subject to abuse, we think it should not be allowed despite the fact that no such abuse is present in the instant case.

The Trust argues in the alternative that it should be entitled to income tax deductions for charitable contribution distributions to B under section 170(a). This assertion is contradicted by section 1.170A-1(h)(1) of the regulations, which provides, in part, that the provisions of section 170 do not apply to a trust (other than a private foundation subject to section 642(c)(6), which does not apply to the trust in this case).

Congress excluded charitable contributions from the simple trust provisions, and in our opinion the exclusion prevents the deduction by a simple trust of any distribution made to a charitable institution. To hold otherwise would contradict the statutory structure of Subchapter J and potentially allow infringement upon its objectives.

Support for this approach can be found in section 1.663(a)-2 of the regulations, which provides, in part, that amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in section 642(c). The validity of the regulation was upheld in *Mott v. United States*, 462 F.2d 512 (Ct. Cl. 1972), *cert. denied*, 409 U.S. 1108 (1973). The *Mott* court emphasized the special treatment accorded charitable distributions by referring to "what we believe to be an implied Congressional intent to prevent all charitable distributions, whether or not deductible under Section 642(c), from entering into the operation of the distribution rules [of Sections 661 and 662]." 462 F.2d at 518.

Section 642(c) provides that the deductible amount must be paid or permanently set aside "pursuant to the terms of the governing instrument" for charitable, etc., purposes. Although there is no case law directly on assignment of a trust income interest, a number of cases are analogous. The closest case is *Weir Foundation v. United States*, 362 F.Supp. 928 (S.D.N.Y.1973), *aff'd per curiam*, 508 F.2d 894 (2d Cir. 1974), in which the surviving spouse exercised a testamentary power of appointment from the trust to charity. The trust was denied a deduction under section 642(c) on the ground that the appointment was not pursuant to the will that created the trust. See *Marquis v. United States*, 173 F.Supp. 616 (Ct. Cl. 1959); *O'Connor Estate v. Commissioner*, 69 T.C. 165 (1977), appeal dismissed (2d Cir. 1980); *cf*. *John Allan Love Charitable Foundation v. United States*, 540 F.Supp. 238 (E.D. Mo. 1982), *aff'd* 710 F.2d 1316 (8th Cir. 1983).

> The applicable principle is that for a deduction to be allowed, the charitable impulse must originate from the grantor, not the fiduciary or beneficiary. It does not require specific instruction, but there must be some indication of charitable intent in the instrument. See *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937). In the present case the trust instrument contains absolutely no authority for the payment of trust income during the lives of the designated income beneficiaries to any kind of charitable institution. On the contrary, the document is very clear as to the intent of the grantor that the income should pass to her relatives and their descendants, with the corpus passing to charitable institutions only upon the contingency that no such descendants survive as specified. Therefore, we conclude that Congress has barred the deduction of the distributions to B because they are not made pursuant to the terms of the governing instrument. The limitation that the charitable distribution must be pursuant to the terms of the estate or will in order to be deductible has been in the law long before the distinction between simple and complex trusts was enacted. 1939 I.R.C. section 162(a); Revenue Act of 1918, section 219(b). It would be a mistake to interpret the simple trust provisions of current law as bypassing this longstanding legislative policy. We think that the correct interpretation of Subchapter J as a whole is that a trust which does not within its terms allow for charitable distributions of income cannot deduct such distributions if they come into being through an assignment of an income interest by a beneficiary to a charitable organization, whether the trust is simple or complex.

The TAM's logic seems tortured to me. The assignment made B a beneficiary under state law; that the charity was not originally a beneficiary doesn't mean that the charity did not become a beneficiary. *Love Charitable Foundation* posited that the distribution to charity was not authorized, whereas in the TAM the assignment of half of A's income interest was authorized; this, *Old Colony Trust Co.* would support approving the deduction. B did become a beneficiary, preventing the simple trust rules from applying and subverting the rest of the TAM's analysis.

When a surviving spouse who had a general power of appointment over the marital trust created for her, exercised that power in favor of her estate, and left her estate to charity, the marital trust was not entitled to a charitable income tax deduction. *Brownstone v. U.S.*, 465 F.3d 525 (2nd Cir. 2006). Instead of claiming the charitable deduction, the trust should have taken an income distribution deduction and the estate then taken the charitable deduction. Thus, the court was correct to deny the charitable deduction. However, rather than saying the above, the court used the following reasoning:

> Appellant's arguments are equally unavailing. Appellant asks us to consider Ethel's power of appointment and Lucien's will together as the governing instrument, but as the district court noted on the record, the statute refers to "governing instrument" in the singular. To combine Ethel's power of appointment with Lucien's will and deem the resultant agglomeration the "governing instrument" strains the statute's text. We agree with appellant that ordinarily "governing" can imply a broader subject-object relationship than does "creating." Nevertheless, we find that the implication is neutralized by the statute's legislative history, which deems the current statute and its predecessor "comparable." We also agree with the district court that "the legislative history doesn't suggest that there is any attempt to broaden the prior law...."
>
> In construing the statute, however, we do not go so far as to equate "governing instrument" with "will or deed creating the trust." Instead, we note "[i]t is a common principle of taxation that where doubt exists, courts should resolve deductions in favor of the government: 'Whether and to what extent deductions shall be allowed depends upon

legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.'" *Holmes v. United States*, 85 F.3d 956, 961 n.3 (2d Cir. 1996) (quoting *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934)). Here, Congress has not made clear provision that an instrument subsequent to the creating instrument, such as Ethel's exercise of the power of appointment, in Article Third of her will, when combined with the "creating" deed or will, such as Lucien's will, could qualify as a "governing instrument." Under this rule of construction, because there is no such clear provision, Ethel's appointment, combined with Lucien's will, cannot qualify as a governing instrument under § 642(c)(1). Indeed, were the Tax Code to permit a trustee to agglomerate the separately manifested intents of diverse testamentary instruments so as to create a single, chimerical "governing instrument," it would greatly enhance the ability of trusts to obtain income tax deductions. For this, Congress has not made clear provision. We hold, therefore, that the governing instrument in this case is not a combination of two separate instruments. It is Lucien's will alone.

The second step in our inquiry leads us to determine whether Ethel's distribution was made "pursuant to" the governing instrument, Lucien's will. In *Old Colony*, the U.S. Supreme Court held: "'Pursuant to' is defined as 'acting or done in consequence or in prosecution (of anything); hence, agreeable; conformable; following; according.'" 301 U.S. at 383-84. This standard is permissive, but it "still conveys more than 'not in violation of'." *Weir Foundation*, 362 F.Supp. at 939. Therefore, "the instrument must be shown to possess some positive charitable intent or purpose of the settlor–not merely that the settlor did not exclude charity from all the possible beneficiaries of his bounty." *Id.* Ethel's will, in exercising the power of appointment, did not make the charitable distribution "pursuant to" the terms of Lucien's will because Lucien's will does not express sufficient charitable intent with respect to the Trust principal. In Article Seventh of his will, Lucien established the Trust for the support and maintenance of his wife. Article Seventh also gave Ethel a power of appointment that allowed her to distribute the Trust principal in any manner she saw fit. Only if she did not validly exercise that power would the Trust principal pass to a charitable organization. By the terms of Lucien's will, Ethel could have distributed the Trust principal entirely to private individuals. Just as easily, she could have distributed the Trust principal entirely to charity. But the choice was Ethel's alone, and Lucien's will expressed no preference. Indeed, Lucien's will necessarily abandoned all charitable intent with respect to the Trust principal in creating the power of appointment; if it had not, the Trust could not have taken advantage of the marital deduction. See 26 U.S.C. § 2056(b)(5). Once Ethel received the power of appointment, Lucien's will could not bind her to any course of action, charitable or otherwise. We agree with the district court: "She was not compelled to give one penny to charity. The governing instrument did not govern her free exercise of her discretion in any way, shape or form." Thus, Ethel did not make her distribution "pursuant to" the terms of the governing instrument.

The above analysis went way beyond what was necessary to resolve the case.

When a trust gave a beneficiary an inter vivos power of appointment in favor of charity that the beneficiary exercised to direct charitable distributions, Letter Ruling 201225004 allowed the charitable deduction. However, CCA 201651013 asserted no charitable deduction and no income distribution deduction when a court order gave a beneficiary an inter vivos power to appoint to charity and the beneficiary exercised it. The CCA, which was issued in the name of Brad Poston, a well-respected senior IRS official, reasoned:

> In the current case, the taxpayer makes a summary argument that the payments qualify under § 642(c) because they are pursuant to the governing instrument, citing to *Old Colony*. They do not address the authorities concerning deductions under modified trust instruments. Here there was no conflict with respect to Trust B subsequent to the division of Parent Trust. The trust terms were unambiguous. The purpose of the court order was not to resolve a conflict in Trust B but to obtain the economic benefits which the parties believe they will receive from the modification of the Parent Trust. Neither Rev. Rul. 59-15 nor *Emanuelson* hold that a modification to a governing instrument will be construed to be the governing instrument in situations where the modification does not stem from a conflict of some sort. Additionally, both *Crown* and *Brownstone* have a narrow interpretation of what qualifies as pursuant to a governing instrument. Therefore, any payments to Foundation 1 and Foundation 2 after the modification of Trust B would not be considered to be made pursuant to the governing instrument, and Trust B is not entitled to a deduction for such payments under § 642(c).

In denying the income distribution deduction, the CCA looked at Reg. § 1.663(a)-2, reproduced in fn. 2583, but took a much closer look at the issues that it said that the regulation definitively resolved. However, the CCA failed to consider Rev. Rul. 73-142, which would seem to resolve the issue in favor of the taxpayer; see part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts, giving <u>prospective</u> effect to a court modification. Following up on this and other issues, CCA 201747005 discussed Rev. Rul. 73-142; however, the CCA's arguments focused on will/trust construction cases being retroactive under *Bosch* and did not distinguish that in its reasoning from the much lower hurdle of merely needing a final court decree required for respecting court action prospectively. For example, the CCA cited *Hubbell* as favoring the CCA's position when *Hubbell* addressed only an attempt to apply a decree retroactively.

Furthermore, the "pursuant to" requirement was not met when a court modified a trust to add charities as income beneficiaries when only individuals were beneficiaries and the charities did not become beneficiaries until a later taxable year, even though the court action purported to be a construction and not a modification. *Hubbell Trust v. Commissioner*, T.C. Summ. Op. 2016-67. The probate court order stated:

> The language of the Will, as written, providing for the administration of the Trust, authorizes, and has from the inception of the Trust authorized, the Trustees of the Trust to make distributions of income and principal for charitable purposes specified in Internal Revenue Code section 170(c), or the corresponding provision of any subsequent federal tax law, both currently and upon termination of the Trust.

The Tax Court rejected the purposed construction, holding that the will did not provide for charitable contributions during that time period and that there was no ambiguity about that. Note that Rev. Rul. 73-142, referred to in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts, provides relief prospectively only.

"Estate Planning Current Developments and Hot Topics," by Steve R. Akers, Ronald D. Aucutt, and Kerri G. Nipp of Bessemer Trust, Dallas, Texas, for ALI's Estate Planning for the Family Business Owner 2023 (10/6/2023), included item 25:[2584]

[2584] The Memorandum in Support of Motion for Partial Summary Judgment and order are in Thompson Coburn LLP document number 29,992,666, starting at the 376th page of the PDF.

IRS Position Refusing to Respect Decanting and Denying Estate Tax Charitable Deduction Even Though Assets Were Actually Appointed to Charity Rejected by Tax Court, *Estate of Horvitz v. Commissioner*, T.C. Dkt. No. 20409-19 (Order dated Feb. 7, 2023)

a. **Synopsis and Basic Facts**. QTIP trusts, funded when the predeceased spouse died in 1992, were decanted in 2013 to trusts with a broadened testamentary power of appointment (that could be exercised by a signed written instrument taking effect at the surviving spouse's death) allowing the surviving spouse to appoint the assets to charity. The surviving spouse died in 2015 having appointed about $20 million to charities and her estate claimed an estate tax charitable deduction. The IRS took the position that the decanting was not appropriate, that the assets did not properly pass to the charities, and that no estate tax charitable deduction was allowed.

The Ohio decanting statute allows decanting to another trust if the trust agreement gives the trustee "absolute" authority to make principal distributions, which is defined as distributions that are not subject to an ascertainable standard. OHIO REV. CODE § 5808.18(A)(1) & (2)(a). The decanted trust can include a broadened power of appointment that includes additional potential appointees.

The original QTIP trusts had various clauses that supported the legitimacy of the decanting. The distribution standard permitted distributions for the beneficiary's "comfort or general welfare" and included within that standard were distributions that "serve estate or tax planning objectives" and transfers deemed to be in "the best interests of the beneficiary." The original trust agreement included a decanting authority, stating that any authority to make distributions to a beneficiary includes authority to "to pay principal to a trust for the benefit of the beneficiary." Despite those provisions, the IRS position was that the trustee of the original QTIP trusts had no authority to decant the assets to the second trusts.

Discovery disputes arose in the Tax Court litigation over whether certain requested information was relevant and whether it was protected from discovery by the attorney-client privilege and attorney work product doctrine. Eventually (on October 14, 2021), the estate filed a motion for summary judgment asking the court to determine that the estate tax charitable deduction was allowed, claiming that the validity of the applicability of the charitable deduction was a legal issue with no material facts in dispute. The IRS filed a motion to compel compliance with discovery requests.

Sixteen months later (on February 7, 2023) the court entered an Order generally agreeing with the estate's legal positions – factual testimony about whether the Trustee believed the decanting was permissible would not affect the outcome; even if the decanting was impermissible, no contest was asserted as to the decanting or the contributions to charities and the court knows of no authority permitting the IRS to collaterally attack the charitable contributions; the distribution standard was not an ascertainable standard; and the Order had no discussion suggesting uncertainty about whether the decanting transaction was permissible. The Order directed counsel for the parties to confer with one another within one week to consider settling the case in light of observations in the Order. *Estate of Horvitz v. Commissioner*, T.C. Dkt. No. 20409-19 (Petition filed Nov. 15, 2019; Order dated Feb. 7, 2023, Judge Gustafson).

Within that one-week period, the IRS agreed to allow a full estate tax charitable deduction for the assets that passed to charities pursuant to the exercise of the power of appointment under the decanted trust. A Stipulation of Settled Issues was filed within about two weeks, and a Stipulated Decision was entered almost two months later (on April 6, 2023) – 8 years after the decedent's death.

b. **Estate's Brief**. The estate's brief in support of the motion for summary judgment explained fundamental concepts about decanting, common law decanting, codification of decanting authority in Ohio, the effect of ascertainable standards, and the effect of the absence of ascertainable standards on decanting authority. The estate's brief emphasized (1) the language in the original QTIP trusts (including the broad distribution standard that included "comfort" and "general welfare," the ability to make transfers that serve estate or tax planning purposes or for the beneficiary's best interests, and the authority to make distributions in trust) and (2) the decanting authority under the Ohio decanting statute.

c. **IRS Position**. The IRS responded primarily that it needed more factual information to determine if material fact issues existed. The IRS did not respond in detail to the estate's legal arguments regarding the validity of the decanting other than to argue that the original trust had an ascertainable standard on distributions so the broadened power of appointment under the decanted trust was invalid. (The IRS made that argument despite the authority to make distributions for the beneficiary's comfort, general welfare, and best interests. The estate responded that the IRS's definition of an ascertainable standard ironically would mean that many very broad distribution standards in other trust instruments would not result in a beneficiary-trustee having a general power of appointment.)

d. **Observations.**

(1) **IRS's and Court's Reaction to Decanting**. The IRS was reluctant to allow an estate tax charitable deduction for charitable contributions that were made under the broadened power of appointment as a result of a decanting transaction. (It is rather surprising that the IRS chose to raise its objections to allowing an estate tax charitable deduction under a decanting transaction in a case in which about $20 million actually passed to charities.) The judge expressed no hostility to the decanting transaction or recognizing it for tax purposes. The IRS eventually conceded (and the taxpayer had good facts in the case to support the decanting authority).

Planners may experience similar IRS hostility in the future to broadened distribution authority granted in decanting transactions (for example, assets in a non-exempt trust might be decanted to a new trust giving someone a power of appointment to appoint assets to a non-skip person, who could engage in further estate planning transfers to minimize tax costs of passing assets to younger generations). Distributions pursuant to a broad authority to make distributions or a broad power of appointment rather than having to use a decanting transaction may be safer.

(2) **Significant Expense**. The dispute about the availability of an estate tax deduction for about $20 million that actually passed to charities took 8 years after the decedent's death and about 3½ years after the filing of a Tax Court petition to resolve. The litigation involved discovery disputes over "several thousand documents." The estate incurred significant litigation costs.

(3) **Recognition of Prior Transfers That Have Been Uncontested**. A paragraph in the Order questioned whether the IRS could contest the availability of a charitable deduction in a situation in which no one had complained about the decanting, the statute of limitations had passed on the ability to contest the transaction, and money had actually passed to charities. That paragraph of the Order is as follows (footnote omitted):

> As far as our record shows, there was no contest asserted as to the 2013 decanting (accomplished almost 10 years ago) or the 2015 contributions (accomplished almost 8 years ago). Presumably, a disappointed beneficiary whose interest might have been affected by either or both of these acts could have challenged them in the appropriate Ohio court, but as far as we know, none did. We know of no authority for the proposition that, in support of disallowing an estate tax deduction for a charitable contribution, the Commissioner may advance a collateral attack (not made by anyone with standing) against the propriety of the contribution. Another sort of deduction by an estate - say, for administration expenses - might be disallowed for tax purposes, even if the expense was demonstrably incurred and paid, if the expense was not “allowable by the laws of the jurisdiction”. § 2053. But we know of no such grounds for disallowance of a deduction for a charitable contribution deduction, and we would benefit from further discussion of this issue. The contribution at issue here appears to be plainly described in Section 2055(a)(2). Section 2055(e) does provide for “Disallowance of Deductions in Certain Cases”, but we do not see in that subsection the circumstances of this case.)

This argument is reminiscent of Revenue Ruling 73-142, 1973-1 C.B. 405, which addressed the tax effects of transfers pursuant to court construction actions that had become final and binding before a taxable event, even if the construction was improper. In Rev. Rul. 73-142, a settlor reserved the power to remove and replace the trustee with no express limitation on appointing himself, and the trustee held tax sensitive powers that would cause estate inclusion under §§ 2036 or 2038 if held by the grantor at his death. The settlor obtained a local court construction that the settlor only had the power to remove the trustee once and did not have the power to appoint himself as trustee. After obtaining this ruling, the settlor removed the trustee and appointed another, so the settlor no longer had the removal power.

In Revenue Ruling 73-142, the state court determination, which was binding on everyone in the world after the appropriate appeals periods ran, occurred before the taxable event, which would have been the settlor’s death. The IRS agreed that it was bound by the court’s ruling as well, “regardless of how erroneous the court’s application of the state law may have been.”

The court order must be obtained prior to the event that would otherwise have been a taxable event in order for the IRS to be bound under the analysis in Revenue Ruling 73-142.

(4) **Contrast with Trust Charitable Income Tax Deduction**. A trust is entitled to a charitable income tax deduction for amounts of gross income passing to charity “pursuant to the terms of the governing instrument.” §642(c)(1). However, no governing instrument requirement applies for the estate tax charitable deduction. That difference is another reason that the IRS’s reluctance to allow an estate tax charitable deduction for assets passing pursuant to provisions in a decanted trust is so puzzling.

> A 2016 Chief Counsel Advice refused to give effect to a court modification for purposes of whether or not charitable distributions were made "pursuant to the terms of the governing instrument" to allow a charitable income tax deduction for the trust. CCA 201651013. The trust was modified to give the beneficiary a limited power of appointment in favor of charity. The IRS concluded that if the beneficiary exercised a power of appointment to make distributions to charity, a charitable deduction would not be available under § 642(c) because the distribution would not be made pursuant to the terms of the governing instrument. A subsequent Chief Counsel Advice involving the same case similarly concluded that assets appointed to charities under a power of appointment granted in a court modification would not satisfy the "pursuant to the terms of the governing instrument" requirement. CCA 201747005 (includes extended discussion of *Bosch* and Rev. Rul. 73-142).
>
> This conclusion seems incorrect; if the governing instrument is effectively modified under state law before the transfer to charity, subsequent transfers would seem to be made pursuant to the terms of the governing instrument in the absence of guidance under § 642(c) that it looks only to the governing instrument as originally executed, without valid modifications. The case involved with that CCA was subsequently settled.

The *Horvitz* court order is reproduced in part II.J.18.c.i What Is Decanting. See also Rev. Rul. 73-142, which is reproduced in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts after fn 6352 (IRS prospective recognition even though *Bosch* would not give retroactive effect).

To avoid controversy, consider expressly authorizing the trustee to make charitable distributions or a beneficiary to exercise an inter vivos power of appointment in favor of charity. I often give a beneficiary a broad inter vivos limited power of appointment at whatever age the settlor feels is appropriate. I include a clause saying that, whenever the trust refers to all persons (with or without excluding the beneficiary, the beneficiary's estate, and the creditors of either), that expressly includes the power to appoint to charity.

Also, consider having the trust participate in a partnership that makes the donation, which may avoid needing to satisfy the "pursuant to" requirement.[2585]

A trust claiming Code § 642(c) charitable deduction may have additional filing requirements. Split-interest trusts described in Code § 4947(a)(2) have their own filing requirements.[2586] Other trusts claiming Code § 642(c) deductions have certain filing requirements (Form 1041-A)[2587] unless "all the net income for the year, determined under the applicable principles of the law of

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[2585] See fn. 4914, in part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction.

[2586] Code § 6034(a). Code § 4947(a)(2) describes:

> … a trust which is not exempt from tax under section 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which has amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522 ….

[2587] Code § 6034(b)(1).

trusts, is required to be distributed currently to the beneficiaries,"[2588] or the trust is described in Code § 4947(a)(1).[2589] Code § 4947(a)(1) describes:

> … a trust which is not exempt from taxation under section 501(a), all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and for which a deduction was allowed under section 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522 (or the corresponding provisions of prior law)….

IRM § 7.26.15.2.1 (04-08-1999), "Estates and Certain Trusts Performing Administrative Functions," as found on the IRS website https://www.irs.gov/irm/part7/irm_07-026-015 on 8/12/2019, provides:

1. An estate is not considered to be an IRC 4947(a)(1) trust during any reasonable period for administration or winding up of its affairs. Once it is terminated for federal income tax purposes or if it is considered unduly prolonged, the provisions of IRC 4947(a)(1) will apply.

2. Similarly, in the winding up of an IRC 4947(a)(2) trust, there are transitional rules that apply before the trust is considered described in IRC 4947(a)(1).

3. Examples of trusts or estates not subject to IRC 4947(a)(1) during a period of administration or settlement include the following:

    a. A split-interest trust for which a final distribution of all assets is required because its private interests have expired would not be subject to the provisions of IRC 4947(a)(1) until expiration of any reasonable period for settlement. Regs. 53.4947-1(b)(2)(iii).

    b. Another variation of the preceding example is a split interest trust where all private interests have expired and where the charitable beneficiaries are not entitled to a distribution will continue to be treated as a split-interest trust during a period of settlement. This trust is unlike the preceding trust because some or all of the charitable remainder interests remain in the trust rather than being distributed. Regs. 53.4947-1(b)(2)(iv).

    c. A revocable trust that becomes irrevocable at the creator's death and is required to make a final distribution of all its assets is not subject to IRC 4947(a)(1) during any reasonable period of settlement. Regs. 53.4947-1(b)(2)(v).

What is a reasonable period of administration for a trust depends on the circumstances, but presumably it is not less than that described in part II.J.7 Code § 645 Election to Treat a Revocable Trust as an Estate. For an estate, Reg. § 53.4947-1(b)(2)(ii)(A) provides:

> When an estate from which the executor or administrator is required to distribute all of the net assets in trust for charitable beneficiaries, or free of trust to such beneficiaries, is considered terminated for Federal income tax purposes under § 1.641(b)-3(a), then the

[2588] Code § 6034(b)(2)(A). Form 1041-A instructions refer to Code § 643(b) income. For more on Code § 643(b) income, see parts II.J.8.c.i.(a) Power to Adjust, II.J.8.c.i.(d) Exceptions in the Governing Instrument and II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.
[2589] Code § 6034(b)(2)(B)

estate will be treated as a charitable trust under section 4947(a)(1) between the date on which the estate is considered terminated under § 1.641(b)-3(a) and the date final distribution of all of the net assets is made to or for the benefit of the charitable beneficiaries. This (ii) does not affect the determination of the tax liability under subtitle A of the beneficiaries of the estates.

Reg. § 1.641(b)-3(a) is reproduced after fn 2732 in part II.J.8.

Charitable contributions are merely deductions and do not trigger issuing a K-1 to the charity.[2590]

If the charitable deduction is problematic, consider:

- Adding a Code § 501(c)(4) organization as a beneficiary. Adding the organization appears not to be subject to gift tax.[2591] The trust would get an income distribution deduction for distributions to the organization,[2592] and the organization pays no income tax.

- Adding a charitable remainder trust (CRT) as a beneficiary.[2593] Adding the CRT may be subject to gift tax, ameliorated by the charitable deduction. Generally, a CRT is not subject to income tax, but distributions to the noncharitable beneficiary are taxed to that beneficiary. However, a CRT is subject to a punitive tax on business income.[2594]

II.J.4.c.ii. Individual Contribution Deduction Requirements

Furthermore, charitable gifts from nongrantor trusts and estates do not appear to be subject to the strict substantiation and appraisal rules that apply to individuals, partnerships, and corporations. Below are the requirements that apply to these other donors.

In addition to the rules below, see part II.G.4.g Limitations on Deducting Charitable Contributions.

II.J.4.c.ii.(a). Contemporaneous Written Acknowledgement (CWA)

Code § 170(f)(8) disallows contributions under Code § 170(a) if certain substantiation requirements are not met but does so without referring to Code § 642(c). Also, Code § 642(c) says that the deduction is “in lieu of the deduction allowed by section 170(a),” further disconnecting Code § 642(c) for Code § 170(f)(8). Note also that Reg. § 1.170A-13(f)(13) provides:

> Section 170(f)(8) does not apply to a transfer of property to a trust described in section 170(f)(2)(B), a charitable remainder annuity trust (as defined in section 664(d)(1)), or a charitable remainder unitrust (as defined in section 664(d)(2) or (d)(3) or § 1.664-3(a)(1)(i)(b)). Section 170(f)(8) does apply, however, to a transfer to

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[2590] See fn 2866 in part II.J.9.a.ii Separate Share Rule.
[2591] See part II.Q.6.g Gift Tax Exclusion for Gifts to Certain Noncharitable Organizations.
[2592] See part II.J.1 Trust’s Income Less Deductions and Exemptions Is Split Between Trust and Beneficiaries, fns 2473-2475.
[2593] CRTs are described in Code § 664, which also governs income tax consequences of the taxable income they receive. Gift (Code § 2522) and estate tax (Code § 2055) charitable deductions also apply to the extent of the charitable interest. For another creative planning tool for CRTs, see part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax.
[2594] See part II.Q.6.d Unrelated Business Taxable Income (UBTI).

> a pooled income fund (as defined in section 642(c)(5)); for such a transfer, the contemporaneous written acknowledgment must state that the contribution was transferred to the donee organization's pooled income fund and indicate whether any goods or services (in addition to an income interest in the fund) were provided in exchange for the transfer. The contemporaneous written acknowledgment is not required to include a good faith estimate of the income interest.

As to how strict Code § 170(f)(8) is, *Addis v. Commissioner*, 374 F.3d 881 (9th Cir. 2004) held:

> Congress enacted section 170(f)(8) to increase compliance with the rule that "where a charity receives a quid pro quo contribution (*i.e.*, a payment made partly as a contribution and partly in consideration for goods or services furnished to the payor by the donee organization)," a charitable contribution deduction is limited to the amount exceeding the value of the consideration received. H. Rep. 103-111, at 785 (1993). Section 170(f)(8) "does not impose an information reporting requirement upon charities; rather it places the responsibility upon taxpayers ... to request ... substantiation from the charity of their contribution (and any good or service received in exchange)." H. Conf. Rep. 103-213, at 563–64 (1993).
>
> The consideration disclosure requirement in section 170(f)(8) is threefold: the receipt must (1) state whether any goods and services were given as consideration; (2) describe the consideration provided, if any; and (3) give a good-faith estimate of the value of the consideration, if any, unless it consists solely of intangible religious benefits.
>
> Goods and services that must be disclosed include "cash, property, services, benefits, and privileges ... provided in a year other than the year in which the taxpayer makes the payment to the donee organization." 26 C.F.R. § 1.170A-13(f)(5), (6). "A donee organization provides goods or services in consideration for a taxpayer's payment if, at the time the taxpayer makes the payment to the donee organization, the taxpayer receives or expects to receive goods or services in exchange for that payment." 26 C.F.R. § 1.170A-13(f)(6)….
>
> We conclude the Addises expected consideration for their payments to the NHF. The Addises' receipt did not meet any of the three disclosure requirements of section 170(f)(8).

A reviewed decision, *15 West 17th Street LLC v. Commissioner*, 147 T.C. No. 19 (2016), disallowed a $64 million charitable deduction. The charity's acknowledgement of the gift failed to recite, as required by Code § 170(f)(8)(B)(ii), whether the charity provided any goods or services to the donor. The taxpayer lost even though the charity later filed an amended Form 990 stating the gift's value. Because no regulations implement Code § 170(f)(8)(D), taxpayers cannot rely on a charity's filing with the IRS as an exception to Code § 170(f)(8)(B)(ii).

However, *Big River Development, L.P. v. Commissioner*, T.C. Memo. 2017-166, held:

> LP did not receive from the donee organization a timely letter of the sort that normally acts as a "contemporaneous written acknowledgment" (CWA) within the meaning of section 170(f)(8)(B)…. We have previously held that a deed of easement may constitute a CWA. See *310 Retail, LLC v. Commissioner*, T.C. Memo. 2017-164; *RP Golf, LLC v. Commissioner,* T.C. Memo. 2012-282, 104 T.C.M. (CCH) 413; *Averyt v. Commissioner*,

> T.C. Memo. 2012-198, 104 T.C.M. (CCH) 65. We conclude that the deed of easement in this case qualifies as a CWA under the logic of these cases.

Izen v. Commissioner, 148 T.C. 71 (2017),[2595] involved the additional CWA requirements for vehicles, including aircraft:[2596]

> Petitioner urges that we excuse these defects on the ground that he "substantially complied" with the statutory requirements. As we have repeatedly held in cases involving section 170(f)(8)(B), however, "[t]he doctrine of substantial compliance does not apply to excuse compliance with the [statute's] strict substantiation requirements." *French*, at *8. In each instance, the Code unambiguously provides that "no deduction shall be allowed" in the absence of a CWA that satisfies the statute's specific demands. Sec. 170(f)(8)(A), (12)(A)(i).
>
> In sum, we conclude that petitioner did not include with his amended 2010 return, as required by section 170(f)(12)(A)(i), "a contemporaneous written acknowledgment … by the donee organization that meets the requirements of subparagraph (B)." Congress enacted this provision after identifying serious tax compliance problems relating to charitable contributions generally and to gifts of used vehicles in particular. See H.R. Conf. Rept. No. 108-755, supra at 747-752, 2004 U.S.C.C.A.N. at 1787-1792; *cf*. H.R. Rept. No. 108-548 (Part I), at 358 (2004). Congress accordingly imposed very strict requirements and provided explicitly that "no deduction shall be allowed" unless these requirements are met. Sec. 170(f)(8)(A), (12)(A)(i). We are not at liberty to override this legislative command.

Keefer v. U.S., 130 A.F.T.R.2d 2022-5002 (N.D. TX 7/6/2022), pointed out that, in addition to the contemporaneous written acknowledgement (CWA) requirements of Code § 170(f)(8), Code § 170(f)(18) requires more when giving to a donor advised fund:

> A deduction...for any contribution to a donor advised fund...shall only be allowed if...the taxpayer obtains a [CWA](determined under rules similar to the rules of paragraph (8)(C)) from the sponsoring organization...of such donor advised fund that such organization has exclusive legal control over the assets contributed.

Keefer v. U.S., 130 A.F.T.R.2d 2022-5002 (N.D. TX 7/6/2022), held:

> Below, the Court finds the Keefers did not obtain a statutorily compliant CWA and that their charitable donation deduction was properly denied on that basis. First, the Court explains why the June 8, 2015 DAF Packet is not a CWA. Next, the Court explains why the September 9, 2015 Acknowledgment Letter cannot be supplemented by the DAF

[2595] Affirmed 38 F.4th 459 (5th Cir. 2022).

[2596] Footnote 7 of the opinion commented:

> For contributions to which section 170(f)(8) applies, Congress considered requiring taxpayers to provide TINs to donee organizations but ultimately decided not to enact this requirement. See *15 West 17th Street LLC v. Commissioner*, 147 T.C. __, __ (slip op. at 17) (Dec. 22, 2016). Under paragraph (f)(12), by contrast, taxpayers must supply TINs to donee organizations so that the latter can issue CWAs meeting the statutory requirements and satisfy their obligation to file Forms 1098-C with the Secretary. See sec. 170(f)(12)(D). Because of serious tax compliance problems in this area, Congress created a specific mechanism to enable the IRS to identify taxpayers who had made contributions of used vehicles. The statutory requirement that the CWA for such contributions include the taxpayer's TIN thus cannot be regarded as insignificant.

> Packet. Finding that the DAF Packet cannot supplement the Acknowledgment Letter, the Court does not consider whether the DAF Packet establishes that Pi had "exclusive legal control" over the donated property. Instead, because the Acknowledgment Letter alone contains nothing to prove "exclusive legal control," the Court finds that § 170(f)(18) was not satisfied….
>
> … because the Acknowledgment Letter does not reference the Keefer DAF or otherwise affirm Pi's exclusive legal control, as required by § 170(f)(18), the Keefers did not obtain a CWA satisfying each statutory requirement.

Keefer v. U.S., 130 A.F.T.R.2d 2022-5406 (N.D. TX 8/10/2022), denied the taxpayers' motion for reconsideration, holding:

> Finally, to the extent that the Keefers now appear to argue that the June 18, 2015 Assignment of Interest should be read together with the June 8, 2015 DAF Packet to create a CWA satisfying the exclusive legal control requirement of 26 I.R.C. § 170(f)(18), the Court rejects that argument. See Doc. 85, Reply, 4–6. The Keefers correctly note that under Texas law "[d]ocuments 'pertaining to the same transaction may be read together,' even if they are executed at different times and do not reference each other, and 'courts may construe all the documents as if they were part of a single, unified instrument.'" *Id*. at 5 (quoting *In re laibe Corp.*, 307 S.W.3d 314, 317 (Tex. 2010)). However, before doing so, "a court may consider whether each written agreement and instrument was 'a necessary part of the same transaction.'" *Rieder v. Woods*, 603 S.W.3d 86, 94 (Tex. 2020). And, "when construing multiple documents together, courts must do so with caution, bearing in mind that tethering documents to each other is 'simply a device for ascertaining and giving effect to the intention of the parties and cannot be applied arbitrarily and without regard to the realities of the situation.'" *Id*. at 94-95 (quoting *Miles v. Martin*, 321 S.W.2d 62, 65 (Tex. 1959)).
>
> Critically, each of the cases cited above gives the Court permission to construe multiple documents together, where appropriate under all the circumstances and to give effect to the intent of the parties. None of these cases requires the Court to do so. And here, considering the ten-day gap between the June 8, 2015 DAF Packet's signing and the June 18, 2015 Assignment of Interest's execution; that only one (Kevin) out of three signatories to the June 18, 2015 Assignment of Interest signed the June 8, 2015 DAF Packet; that neither document references the other; and that the CWA requirement requires strict (not substantial) compliance, the Court finds that the realities of the situation do not permit the documents to be read together. See Doc. 66, DAF Packet, 38; Doc. 69-5, Assignment Int., 443–44; see also *Keefer*, 2022 WL 2473369, at *16–17 (discussing cases permitting a court to consider multiple documents as forming a CWA and the strict compliance requirement).

Braen v. Commissioner, T.C. Memo. 2023-85, reasoned and held:

> Even if we were to overlook Holdings' failure to value the zoning reversion, the deduction nonetheless would be barred because of a fatal defect in the contemporaneous written acknowledgment. See I.R.C. § 170(f)(8)(A); *Triumph*, T.C. Memo. 2018–65, at *29.
>
> Section 170(f)(8) requires that the contemporaneous written acknowledgment state (1) the amount of cash and a description (but not value) of any property other than cash contributed, (2) whether the charitable organization provided any goods or services in

consideration, in whole or part, for the contributed property, and (3) a description and good-faith estimate of the value of any goods or services the taxpayer received as consideration. *Addis v. Commissioner*, 118 T.C. 528, 533–34 (2002), *aff'd*, 374 F.3d 881 (9th Cir. 2004). "A donee organization provides goods or services in consideration for a taxpayer's payment if, at the time the taxpayer makes the payment to the donee organization, the taxpayer receives or expects to receive goods or services in exchange for that payment." Treas. Reg. § 1.170A-13(f)(6). "Goods or services means cash, property, services, benefits, and privileges." *Addis*, 118 T.C. at 534 n.8; Treas. Reg. § 1.170A-13(f)(5).

The written acknowledgment and other substantiation requirements are designed to "foster disclosure of `dual payment' or quid pro quo contributions." *Viralam v. Commissioner*, 136 T.C. 151, 171 (2011). "Where the written acknowledgment of a charitable contribution by a donee organization states that the donor received no consideration and the donor actually received a benefit in exchange for the donation, the deduction is disallowed in its entirety." *Id*.

A taxpayer's failure to supply a satisfactory contemporaneous written acknowledgment bars a charitable contribution deduction. *Izen v. Commissioner*, 148 T.C. 71, 76-77 (2017), *aff'd*, 38 F.4th 459 (5th Cir. 2022); *15 W. 17th St. LLC v. Commissioner*, 147 T.C. 557, 562-63 (2016); *Albrecht*, T.C. Memo. 2022-53, at *3–4. The doctrine of substantial compliance does not apply in this context. Izen, 148 T.C. at 77; *15 W. 17th St.*, 147 T.C. at 562; *French v. Commissioner*, T.C. Memo. 2016-53, at *8 [2016 RIA TC Memo ¶2016-053]; see also Addis v. Commissioner, 374 F.3d at 881, 887 ("The deterrence value of [a] total denial of a deduction [in the case of an improper contemporaneous written acknowledgment] comports with the effective administration of a self-assessment and self-reporting system.").

The 2011 acknowledgment letter provided by the Ramapo town attorney does not satisfy section 170(f)(8). Holdings negotiated for and received the zoning change as part of the settlement and land purchase, and, to satisfy section 170(f)(8), the acknowledgment was required to both identify it as consideration and provide a good-faith valuation of it. The letter plainly did not do so, instead stating that Holdings did not receive "any goods or services, in whole or in part, as consideration" other than the $5,250,000. See *Viralam*, 136 T.C. at 171; see also *Boone*, T.C. Memo. 2013-101, at *17-21.

The Braens argue that the letter's statement that "[a] lawsuit bearing Rockland County Index No. 1752/05 was settled incident to the sale and was approved by order of Hon. Margaret Garvey, Justice of the Supreme Court, dated April 7, 2010" suffices to meet the statutory requirements. But "[n]othing in the statute or legislative history requires [the Commissioner] to look beyond the written acknowledgment when on its face the acknowledgment fails to provide the information required to substantiate a charitable contribution deduction." *Durden v. Commissioner*, T.C. Memo. 2012-140, 2012 WL 1758655, at *4. Even if we were inclined to see the reference to the settlement as sufficient to identify the rezoning as consideration, neither the letter nor the settlement agreement provides a good-faith valuation as required by section 170(f)(8). See *Boone*, T.C. Memo. 2013-101, at *21-22.

With the doctrine of substantial compliance off limits, the Braens rely on the "reasonable cause" exception of section 170(f)(11)(A)(ii)(II) to excuse the acknowledgment's shortcomings. This exception, however, does not apply to the contemporaneous written acknowledgment requirement. See *Campbell v. Commissioner*, T.C. Memo. 2020-41, at *28 n.16.

Holdings' failure to comply with requirements of section 170(f)(8) accordingly prohibits the Braens from claiming charitable contribution deductions. See *Addis*, 118 T.C. at 537; *Albrecht*, T.C. Memo. 2022-53, at *5–6; *Boone*, T.C. Memo. 2013-101, at *21–22.[10]

[10] Given the Braens' failure to establish the value of the consideration received and to supply a contemporaneous written acknowledgment, we need not address the other issues that might justify disallowance of the deductions. See *Triumph*, T.C. Memo. 2018-65, at *30; *Boone*, T.C. Memo. 2013-101, at *22.

II.J.4.c.ii.(b). Appraisal and Form 8283 Requirements

Bond v. Commissioner, 100 T.C. 32, 40-42 (1993), applied the doctrine of substantial compliance:

> Respondent contends that by not obtaining and attaching to their 1986 income tax return a written appraisal of the airships, petitioners have failed to satisfy the prerequisites to a charitable deduction under sections 1.170A-13(c)(2)(i)(A) and (3) of the regulations. On the other hand, petitioners contend that they substantially complied with the requirements of the applicable statute and, therefore, have qualified for the charitable deduction under the doctrine of substantial compliance the test for which is set forth in *Taylor v. Commissioner*, 67 TC 1071, 1077-1078 (1977), as follows:
>
>> The critical question to be answered is whether the requirements relate "to the substance or essence of the statute." *Fred J. Sperapani*, 42 TC 308, 331 (1964). If so, strict adherence to all statutory and regulatory requirements is a precondition to an effective election. *Lee R. Dunavant*, 63 TC 316 (1974). On the other hand, if the requirements are procedural or directory in that they are not of the essence of the thing to be done but are given with a view to the orderly conduct of business, they may be fulfilled by substantial, if not strict compliance. See *Lee R. Dunavant*, *supra*; *George S. Cary*, 41 TC 214 (1963); *Columbia Iron & Metal Co.*, 61 TC 5 (1973)…
>
> Under the above test we must examine section 170 to determine whether the requirements of the regulations are mandatory or directory with respect to its statutory purpose. At the outset, it is apparent that the essence of section 170 is to allow certain taxpayers a charitable deduction for contributions made to certain organizations. It is equally apparent that the reporting requirements of section 1.170A- 13, Income Tax Regs., are helpful to respondent in the processing and auditing of returns on which charitable deductions are claimed. However, the reporting requirements do not relate to the substance or essence of whether or not a charitable contribution was actually made. We conclude, therefore, that the reporting requirements are directory and not mandatory. See *Taylor v. Commissioner*, *supra* at 1078-1079.
>
> Furthermore, our conclusion is not altered by the fact that section 170(a) states that "A charitable contribution shall be allowed as a deduction only if verified under regulations prescribed by the Secretary." See *Cary v. Commissioner*, 41 TC 214 (1963), where we held that a similar provision in section 302(c)(2)(A)(iii), requiring the filing of an agreement to notify the Commissioner of reacquisitions of stock within a 10-year period of a redemption under section 302(b)(3) in the manner prescribed by an applicable

regulation, is directory rather than mandatory. The fact that a Code provision conditions the entitlement of a tax benefit upon compliance with respondent's regulation does not mean that literal as opposed to substantial compliance is mandated. *Cary v. Commissioner*, *supra*.

In the case before us there is no question that a donation of the two airships was made during the taxable year, that the subject of the donation was appraised at the amount claimed by petitioners as a charitable deduction during the taxable year by a qualified appraiser, and that the donee was qualified to receive a charitable contribution. In fact, with the exception of the excellent qualifications of the appraiser all of these facts appeared on the Form 8283 attached to the return filed by petitioners. Furthermore, the name, title, and place of employment of the appraiser also appeared on the Form 8283 together with the identification number assigned to his employer by respondent. The appraiser's qualifications were promptly furnished to respondent's agent at or near the commencement of his audit. Therefore, this is not a case where petitioners failed to obtain a timely appraisal of the donated property and thereby failed to establish its value for claiming a contribution deduction on their return. Instead, petitioners, in this case, met all of the elements required to establish the substance or essence of a charitable contribution, but merely failed to obtain and attach to their return a separate written appraisal containing the information specified in respondent's regulations even though substantially all of the specified information except the qualifications of the appraiser appeared in the Form 8283 attached to the return. The denial of a charitable deduction under these circumstances would constitute a sanction which is not warranted or justified. See *Columbia Iron & Metal Company v. Commissioner*, 61 TC 5, 10 (1973).

We conclude, therefore, that petitioners have substantially complied with section 1.170-13A, Income Tax Regs., and are entitled to the charitable deduction claimed.

Estate of Evenchik v. Commissioner, T.C. Memo. 2013-34, held:

… Instead of valuing their contributed interest in Chateau, they valued Chateau's interest in two of its own assets - the apartment complexes. That miscue goes to the essence of the information required, because without knowing the specific property contributed the Commissioner is unable to determine whether the contributed property interest was overvalued. And the problem of misvalued property is so great that Congress was quite specific about what the charitably inclined have to do to defend their deductions. See *Mohamed*, 2012 WL 1937555 at *10. Indeed, that problem arose here - the parties stipulated that the Evenchiks overvalued their partial interest in Chateau by 35%.

Moreover, as it was in *Smith*, appraising the wrong asset was far from the only error in the appraisals that the Evenchiks submitted: The appraisals also didn't state the date or expected date of the contribution or the fair market value on those dates, didn't provide a statement that the appraisal was prepared for income-tax purposes, and didn't include the terms of any agreement or understanding entered into by Harvey or FHR relating to the use of the donated property. This is not a case where the taxpayers provided most of the information but left out one insignificant datum. *Cf*. *Hewitt*, 109 T.C. at 265. This is a case where the appraisals had gaping holes of required information. These defects prevented the Commissioner from properly evaluating the property interest contributed. The Evenchiks are not, therefore, entitled to the deduction they seek.

Costello v. Commissioner, T.C. Memo. 2015-87, held:

> We have declined to apply the substantial compliance doctrine where the taxpayer's reporting fails to meet substantive requirements set forth in the regulations[6] or omits entire categories of required information.[7] Petitioners' original appraisal and Form 8283 suffer from both of these defects. Those documents omit numerous categories of important information, including an accurate description of the contributed property, the salient terms of the agreements among the parties, a signature of the donee attesting to receipt of a contribution, an explanation of the quid pro quo petitioners received, and the date of the contribution.[8]
>
> [6] See, *e.g.*, *Hewitt*, 109 T.C. at 260, 264 (the taxpayer did not "substantially comply" where he did not supply a qualified appraisal or an appraisal summary); *Estate of Evenchik v. Commissioner*, T.C. Memo. 2013-34, at *12-*15 (the taxpayer did not "substantially comply" where he submitted an appraisal of the wrong property); *Rothman v. Commissioner*, T.C. Memo. 2012-218, slip op. at 10 (the taxpayer did not "substantially comply" where the appraisal valued "a property right different from the one petitioners contributed"); *D'Arcangelo v. Commissioner*, T.C. Memo. 1994-572, 68 T.C.M. (CCH) 1223, 1230 (1994) (the taxpayer did not "substantially comply" where he obtained an appraisal from a nonqualified appraiser).
>
> [7] See, *e.g.*, *Estate of Evenchik*, at *9-*10 (the taxpayer did not "substantially comply" where the appraisal omitted an accurate description of the contributed property, the contribution date, and the terms of an agreement relating to its disposition); *Lord v. Commissioner*, T.C. Memo. 2010-196, 100 T.C.M. (CCH) 201, 202 (the taxpayer did not "substantially comply" where the appraisal omitted the contribution date, the appraisal performance date, and the fair market value as of the contribution date); *Friedman v. Commissioner*, T.C. Memo. 2010-45, 99 T.C.M. (CCH) 1175, 1177 (the taxpayer did not "substantially comply" where the appraisal omitted, *inter alia*, an adequate description of the donated property); *Smith*, 94 T.C.M. (CCH) at 585 (the taxpayer did not "substantially comply" where the appraisal omitted, *inter alia*, the contribution date and disclosure of restrictions on use of the property).
>
> [8] Because petitioners' original Form 8283 disclosed the date of the alleged contribution, the absence of that information from the appraisal would not, standing alone, be fatal. See *Zarlengo v. Commissioner*, T.C. Memo. 2014-161, at *36 (finding that taxpayers substantially complied by disclosing contribution date on appraisal summary); *Simmons v. Commissioner*, T.C. Memo. 2009-208, 98 T.C.M. (CCH) 211, 215, *aff'd*, 646 F.3d 6 (D.C. Cir. 2011) (same).

Relaxing the appraisal rules a bit, *Cave Buttes L.L.C. vs. Commissioner*, 147 T.C. No. 10 (2016), included in its official syllabus:

> *Held*: C's appraisal report substantially complied with the requirements of sec. 1.170A-13(c)(5)(iii), Income Tax Regs., by including one of the two appraisers' signatures on Form 8283, Noncash Charitable Contributions.
>
> *Held, further*, a description of the appraised property by address and characteristics is sufficient to strictly comply with sec. 1.170A-13(c)(3)(ii)(A), Income Tax Regs.

> *Held, further*, the wording in the appraisal report that it was conducted to value the property for "filing with the IRS" at least substantially, if not strictly, complied with sec. 1.170A-13(c)(3)(ii)(G), Income Tax Regs.

Presley v. Commissioner, 790 Fed. Appx. 914 (10th Cir. 2019), reasoned and held:

> The Presleys argue they substantially complied with the regulatory substantiation requirements because they obtained an appraisal and the appraisal summary on Form 8283 provided the date of contribution, the date they purchased the residence, the cost basis of the residence, the description and condition of the residence, and the identity of the donee, as required by Treas. Reg. § 1.170A-13(c)(4)(ii). They claim the only defects on Form 8283 are that the donee acknowledgment is not signed and the appraiser's declaration does not identify the appraiser. The Form 8283 defects, they argue, do not go to the essence of the issue, which they claim is whether they donated their residence to PFM during the 2012 tax year. Nor, they claim, do the defects thwart the purpose of the substantiation requirements - to "alert the Commissioner to potential overvaluations of contributed property and thus deter taxpayers from claiming excessive deductions," *RERI Holdings I, LLC v. Comm'r*, 149 T.C. 1, 14 (2017).
>
> In support of their argument, they lean heavily on *Bond v. Commissioner*, 100 T.C. 32 (1993). The Commissioner argues that *Bond* is distinguishable, and we agree. In *Bond*, the Tax Court expressed the view that the reporting requirements of Treas. Reg. § 1.170A-13 "do not relate to the substance or essence of whether or not a charitable contribution was actually made," and therefore concluded "that the reporting requirements are directory and not mandatory." *Bond*, 100 T.C. at 41. However, the only substantiation requirement the Bond taxpayers failed to comply with was to provide the appraiser's qualifications. *Id*. at 41-42. When asked for those qualifications, the taxpayers promptly furnished them. *Id*. at 42.
>
> In concluding the taxpayers in *Bond* had substantially complied with the substantiation requirements, the Tax Court stated that the case was not one where the taxpayers had "failed to obtain a timely appraisal of the donated property and thereby failed to establish its value for claiming a contribution deduction on their return." *Id*.at 42 (emphasis added). That observation suggests that a *timely appraisal*, as defined by the regulation, is necessary for substantial compliance with the substantiation requirements. And in fact the Tax Court has since stated that "nothing in *Bond* ... relieves [a taxpayer] of the requirement of obtaining a qualified appraisal," *Hewitt v. Comm'r*, 109 T.C. 258, 264 (1997), and that "late appraisals do not substantially comply with the regulations," *Mohamed v. Comm'r*, 103 T.C.M. (CCH) 1814, at *9 (2012).
>
> In the Presleys' case, the Tax Court observed that the Presleys failed not only to have Mr. Scott fill out and sign the appraiser's section of Form 8283, as required by Treas. Reg. § 1.170A-13(c)(4)(i)(C), but also to "obtain" or "receive ... a qualified appraisal" within the time limits prescribed by Treas. Reg. § 1.170A-13(c)(3)(i)(A) and (iv)(B). Aplt. App., Vol. 2 at 213. As relevant here, the appraisal had to be "*made* not ... later than the date specified in paragraph (c)(3)(iv)(B) of this section." Treas. Reg. § 1.170A-13(c)(3)(i)(A) (emphasis added). In the Presleys' case, that date was October 15, 2013, the date their 2012 return was due, including extensions. See *id*. § 1.170A-13(c)(3)(iv)(B) ("The qualified appraisal must be received by the donor before the due date (including extensions) of the return on which a deduction is first claimed ... under

> section 170 with respect to the donated property."). The Tax Court found Mr. Scott made his appraisal on the date he signed it – December 5, 2013….
>
> In sum, the Presleys have failed to show the Tax Court clearly erred in finding the appraisal was not made before their 2012 return was due, as required by Treas. Reg. § 1.170A-13(c)(3)(i)(A) and (iv)(B). That failure is fatal to their substantial-compliance argument, see *Mohamed*, 103 T.C.M. (CCH) 1814, at *9; *Bond*, 100 T.C. at 42, regardless of whether the appraisal summary substantially complied with Treas. Reg. § 1.170A-13(c)(2)(i)(B).

The substantiation rules can knock out contributions that qualify but for having timely documentation, and lack of a good appraisal may add valuation penalties[2597] even if the deduction is knocked out for other reasons. Not disclosing basis on Form 8283 is one of those reasons:

Partita Partners LLC v. U.S., 120 A.F.T.R.2d 2017-5147 (D.C. NY 7/10/2017), which is consistent with another decision issued just a week before that one, *Reri Holdings I, LLC v. Commissioner*, 149 T.C. 1 (2017), the Official Tax Court Syllabus to which states:

> PS, a partnership, paid $2.95 million in March 2002 to acquire a remainder interest in property. The agreement that created the remainder interest provided covenants intended to preserve the value of the subject property but also limited the remedy available to the holder of the remainder interest for a breach of those covenants to immediate possession of the property; in no event would the holder of the corresponding term interest be liable for damages to the holder of the remainder interest. On Aug. 27, 2003, PS assigned the remainder interest to U, a university. On its 2003 Form 1065, U.S. Return of Partnership Income, PS claimed a deduction under sec. 170(a)(1) of $33,019,000. The Form 8283, Noncash Charitable Contributions, that PS attached to its return provides the date and manner of its acquisition of the contributed remainder interest but left blank the space for the "Donor's cost or other adjusted basis".
>
> *Held*: PS' omission from its Form 8283 of its cost or other adjusted basis in the contributed remainder interest violated the substantiation requirement of sec. 1.170A-13(c)(4)(ii)(E), Income Tax Regs.
>
> *Held*, *further*, because PS' disclosure of its cost or other basis in the contributed property would have alerted R to a potential overvaluation of that property, omission of that information prevented the Form 8283 from achieving its intended purpose; the omission thus cannot be excused on the grounds of substantial compliance.
>
> *Held*, *further*, PS' failure to comply, either strictly or substantially, with the requirements of sec. 1.170A-13(c)(2), Income Tax Regs., requires denial in full of its claimed charitable contribution deduction.

[2597] See Code § 6664(c) and *Kaufman v. Commissioner*, 784 F.3d 56 (1st Cir. 2015), *aff'g* T.C. Memo. 2014-52. In affirming the imposition of penalties, the First Circuit reasoned:

> The Tax Court did not purport to equate "good faith investigation" with "exhaustive investigation." It merely required that the Kaufmans do some basic inquiry into the validity of an appraisal whose result was squarely contradicted by other available evidence glaringly in front of them.

> *Held*, *further*, because of the limitation on remedies available to the holder of the remainder interest for breaches of protective covenants, the agreement that created that interest did not provide adequate protection to its holder, for purposes of sec. 1.7520-3(b)(2)(iii), Income Tax Regs.; the standard actuarial factors provided under sec. 7520 thus do not apply in valuing the remainder interest; instead, the value of that interest is its "actual fair market value", determined without regard to sec. 7520, on the basis of all of the facts and circumstances. Sec. 1.7520-3(b)(1)(iii), Income Tax Regs.
>
> *Held*, *further*, on the basis of all of the facts and circumstances, the remainder interest that PS assigned to U on Aug. 27, 2003, had a fair market value on that date of $3,462,886.
>
> *Held*, *further*, because the $33,019,000 value that PS assigned to the remainder interest it transferred to U is more than 400% of that interest's actual fair market value, PS' claimed charitable contribution deduction resulted in a gross valuation misstatement. sec. 6662(e)(1)(A), (h)(2).
>
> *Held*, further, any underpayment resulting from the disallowance of PS' claimed charitable contribution deduction would be "attributable to" a gross valuation misstatement to the extent the underpayment relates to the disallowance of that portion of the deduction that exceeds $3,462,886. *AHG Invs., LLC v. Commissioner*, 140 T.C. 73 (2013). *885 Inv. Co. v. Commissioner*, 95 T.C. 156 (1990), overruled.
>
> *Held*, *further*, PS did not make a good-faith investigation of the value of the property subject to the remainder interest and thus did not have reasonable cause for, or act in good faith with respect to, its claim of a charitable contribution deduction that resulted in a gross valuation misstatement. sec. 6662(c)(2)(B).

As applied to each owner of the LLC (partner for income tax purposes):

> Although the liability of a particular partner for the gross valuation misstatement penalty will depend on the arithmetic threshold provided in section 6662(e)(2), no partner will be able to avoid the penalty on the basis of the reasonable cause exception provided in section 6664(c).

The Tax Court did not refer to an argument previously made about whether the donor should have listed the single-member LLC it contributed instead of the underlying assets, which argument was described in fn. 342 in part II.B Limited Liability Company (LLC).

Reri was affirmed under the name *Blau v. Commissioner*, 924 F.3d 1261 (D.C. Cir. 2019), which held that omission of basis on Form 8283 was fatal regardless of whether the appraisal substantially complied (declining to address the latter).

Omitting basis from Form 8283 also preliminarily knocked out the deduction in *Oakhill Woods, LLC v. Commissioner*, T.C. Memo. 2020-24, which reasoned:

> The required information includes "an appraisal summary" that must be attached "to the return on which such deduction is first claimed for such contribution." Deficit Reduction Act of 1984 (DEFRA), Pub. L. No. 98-369, sec. 155(a)(1), 98 Stat. at 691; see sec. 1.170A-13(c)(2), Income Tax Regs. The IRS has prescribed Form 8283 to be used as the "appraisal summary." *Jorgenson v. Commissioner*, T.C. Memo. 2000-38,

> 79 T.C.M. (CCH) 1444, 1450. Failure to comply with this requirement generally precludes a deduction. See sec. 170(a)(1) ("A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary.").
>
> In his motion for partial summary judgment, respondent contends that Oakhill's claimed deduction should be disallowed because it declined to report its "cost or adjusted basis" on Form 8283 and thus failed to attach to its return a properly completed appraisal summary. Oakhill contends that it strictly (or at least substantially) complied with the applicable regulation. We rejected that argument on virtually identical facts in *Belair Woods*, and we reject that argument again here. Accord, *Loube v. Commissioner*, T.C. Memo. 2020-3, at *17-*23.

However, *Oakhill Woods, LLC* held that reasonable cause may be a defense:

> In 2004, the year after the tax year involved in *RERI Holdings I*, Congress enacted the American Jobs Creation Act of 2004 (AJCA), Pub. L. No. 108-357, sec. 883(a), 118 Stat. at 1631. The AJCA added to the Code section 170(f)(11), which included, in subparagraph (A)(ii)(II), a new "reasonable cause" defense for failure to comply with the regulatory reporting requirements. That subparagraph excuses failure to satisfy the reporting requirements discussed above if "it is shown that the failure to meet such requirements is due to reasonable cause and not to willful neglect." This statutory "reasonable cause" defense is broader than the regulatory "reasonable cause" defense promulgated previously. As noted supra p. 12-13, the latter defense is limited to situations where the taxpayer has reasonable cause "for being unable to provide the information required." Sec. 1.170A-13(c)(4)(iv)(C)(1), Income Tax Regs.
>
> The formulation of the section 170(f)(11)(A)(ii)(II) defense - referring to the existence of "reasonable cause" and the absence of "willful neglect" - resembles that appearing in numerous Code provisions that impose penalties or additions to tax. See, *e.g.*, secs. 6039G(c) (flush language), 6704(c)(1), 6652(f)-(j), 6709(c). "Code provisions generally are to be interpreted so congressional use of the same words indicates an intent to have the same meaning apply." Elec. Arts, Inc., 118 T.C. at 241. Thus, although the section 170(f)(11)(A)(ii)(II) "reasonable cause" defense relieves the taxpayer from disallowance of a deduction rather than from imposition of a penalty, we have construed these defenses similarly. See *Alli*, 107 T.C.M. (CCH) at 1096; *Crimi v. Commissioner*, T.C. Memo. 2013-51, 105 T.C.M. (CCH) 1330, 1353.
>
> "Reasonable cause requires that the taxpayer have exercised ordinary business care and prudence as to the challenged item." *Crimi*, 105 T.C.M. (CCH) at 1353 (citing *United States v. Boyle*, 469 U.S. 241 (1985)). "The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances." Sec. 1.6664-4(b)(1), Income Tax Regs.
>
> If a taxpayer alleges reliance on the advice of a tax professional, that "advice must generally be from a competent and independent advisor unburdened with a conflict of interest and not from promoters of the investment." *Mortensen v. Commissioner*, 440 F.3d 375, 387 (6th Cir. 2006), *aff'g* T.C. Memo. 2004-279; see *Gustashaw v. Commissioner*, 696 F.3d 1124, 1139 (11th Cir. 2012), *aff'g* T.C. Memo. 2011-195. "Advice hardly qualifies as disinterested or objective if it comes from parties who actively promote or implement the transactions in question." *Stobie Creek Invs. LLC v. United*

> *States*, 608 F.3d 1366, 1382 (Fed. Cir. 2010). A taxpayer advancing a reliance-on-professional-advice defense must also show that it actually relied in good faith on the advice it received. See *Alli*, 107 T.C.M. (CCH) at 1096; see also *Neonatology Assocs., P.A. v. Commissioner*, 115 T.C. 43, 98-99 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002). This determination "is inherently a fact-intensive one." *Alli*, 107 T.C.M. (CCH) at 1096 (quoting *Crimi v. Commissioner*, 105 T.C.M. (CCH) at 1353).

One of the reasonable cause cases cited above, *Crimi v. Commissioner*, T.C. Memo. 2013-51, held:

> Reasonable cause requires that the taxpayer have exercised ordinary business care and prudence as to the challenged item. See *United States v. Boyle*, 469 U.S. 241 (1985). Thus, the inquiry is inherently a fact-intensive one, and facts and circumstances must be judged on a case-by-case basis. See *id*.; *Rothman v. Commissioner*, 103 T.C.M. (CCH) at 1874. A taxpayer's reliance on the advice of a professional, such as a certified public accountant, would constitute reasonable cause and good faith if the taxpayer could prove by a preponderance of the evidence that: (1) the taxpayer reasonably believed the professional was a competent tax adviser with sufficient expertise to justify reliance; (2) the taxpayer provided necessary and accurate information to the advising professional; (3) the taxpayer actually relied in good faith on the professional's advice. See *Rovakat, LLC v. Commissioner*, 102 T.C.M. (CCH) at 279 (citing *Neonatology Assocs., P.A. v. Commissioner*, 115 T.C. 43, 98-99 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002)); see also sec. 1.6664-4(c)(1), Income Tax Regs.
>
> Mr. Crimi had relied on Mr. LaForge and Sobel as competent tax advisers for over 20 years. Upon the filing of the returns at issue, Mr. LaForge had been a certified public accountant for over 20 years and had expertise in preparing tax returns claiming deductions for charitable contributions. Sobel was an established regional accounting firm staffed with accountants, some of whom had law degrees. During the 24 years of engagement, Mr. LaForge had become intimately familiar with Mr. Crimi's and Concrete's financial affairs. The record reveals no prior history of mishaps by Mr. LaForge or Sobel. There had also been no indication to Mr. Crimi, at least up until the instant controversy, that Mr. LaForge or Sobel had acted incompetently in his or its provision of services to Mr. Crimi and Concrete. Thus, Mr. Crimi had no reason to doubt or second guess Mr. LaForge's or Sobel's competence, or to question Mr. LaForge's request for only a dated appraisal as inadequate. See *Estate of Lee v. Commissioner*, T.C. Memo. 2009-84, 97 T.C.M. (CCH) 1435, 1438 (2009) (taxpayer may conclude on the basis of adequate due diligence that his tax adviser was competent estate tax attorney).
>
> In seeking the advice, Mr. Crimi provided all documents to Mr. LaForge. Mr. Crimi regularly apprised Mr. LaForge of the status of the contribution transaction. When Mr. LaForge requested the 2000 appraisal to prepare the 2004 tax return, Mr. Crimi gave it to him. Indeed, Mr. Crimi gave Mr. LaForge unfettered access to all documents at Mr. Crimi's home and in Concrete's office.
>
> On the facts and testimony in the record, we find Mr. Crimi actually relied on Mr. LaForge's advice in good faith. For over two decades, Mr. Crimi had relied on Mr. LaForge's expertise in Federal income tax for his accounting and tax planning. As far as we can tell from the record, this was the first time Mr. Crimi had engaged in a transfer of real property as a charitable gift. While Mr. Crimi is a sophisticated businessman

experienced in buying and selling real estate, it was not unreasonable for him not to know the specific timeliness requirement for a qualified appraisal in the context of a charitable contribution. The record reveals Mr. Crimi's as well as Mr. LaForge's good-faith belief that an updated appraisal would not yield an appraised value much different from the one provided in the 2000 appraisal. In fact, the subsequent valuation prepared by petitioners' expert produced a number much higher than the one in the 2000 appraisal. Thus, on the facts and circumstance in these cases, it was also reasonable for Mr. Crimi to believe the 2000 appraisal was not stale in substance and thus a good appraisal. And because Mr. LaForge never raised any doubt over the 2000 appraisal to Mr. Crimi, Mr. Crimi had no reason to know or to suspect the appraisal did not meet the requirements under the regulations. On the basis of the long history of competent professional services provided, as Mr. Crimi put it at trial, "I rely on them heavily to tell me what to do."

In sum, petitioners are entitled to a deduction for the charitable contribution of the subject property even if petitioners did not attach a qualified appraisal required under the Code and the regulations, because any failure to comply with the requirement is excused on the ground of reasonable cause.

One of the reasonable cause cases cited above, *Alli v Commissioner*, T.C. Memo 2014-15, held:

Petitioners argue that reasonable cause exists because they relied on Mr. Siegal, the paid preparer for their 2008 return, regarding the charitable contribution deduction. Petitioners claim that Mr. Siegal is a C.P.A. and an attorney, and further claim that he has prepared their returns for over 30 years. However, petitioners have produced no reliable evidence of Mr. Siegal's qualifications, no reliable evidence that they provided Mr. Siegal with complete information, no reliable evidence of the content of Mr. Siegal's advice, and no reliable evidence that they reasonably relied on that advice.[30]

[30] We further note that petitioners did not call Mr. Siegal as a witness, which gives rise to an adverse inference that had he been called, his testimony would not have supported petitioners' contentions. See *Wichita Terminal Elevator Co. v. Commissioner*, 6 T.C. 1158, 1165 (1946), *aff'd*, 162 F.2d 513 (10th Cir. 1947).

Petitioners further argue that reasonable cause exists because they relied on the appraisals by Mr. Sanna and Mr. Jones. However, petitioners have produced no evidence that either Mr. Sanna or Mr. Jones is a "professional" as the term is defined in *Crimi* - *i.e.*, a competent tax adviser with sufficient expertise to justify reliance. Furthermore, petitioners did not rely on either Mr. Sanna or Mr. Jones in claiming a $499,000 deduction, a figure wholly unsupported by the record.

Accordingly, petitioners do not meet their burden of establishing reasonable cause based on their alleged reliance upon professional advice.

Riverside Place LLC v. Commissioner, T.C. Memo. 2020-103, followed *RERI*, brushing aside the taxpayer's argument that the IRS didn't really need basis (which the taxpayer actually argued in a statement included in the return itself). Then the court addressed this lack-of-need argument some more:

> Finally, petitioner in its cross-motion contends that the regulation requiring disclosure of "cost or other basis" on the appraisal summary is invalid. According to petitioner, this regulation does not "give effect to the unambiguously expressed intent of Congress" and is thus invalid under *Chevron, U.S.A., Inc.*, 467 U.S. at 842-843. The taxpayer in *Oakhill Woods*, at *22-*27, made precisely the same argument and we rejected it. We do so again here. For these reasons we hold that Riverside did not comply, strictly or substantially, with the regulatory reporting requirements. Accord, *Oakhill Woods*, at *21-*22; *Loube v. Commissioner*, T.C. Memo. 2020-3, at *15-*23; *Belair Woods*, 116 T.C.M. (CCH) at 329-330. This failure supplied an independent ground for denial of its charitable contribution deduction.[8]
>
> > [8] Section 170(f)(11)(A)(ii)(II) provides that a charitable contribution deduction may be allowed, notwithstanding the taxpayer's failure to comply with the appraisal summary requirements, "if it is shown that the failure to meet such requirements is due to reasonable cause and not to willful neglect." Petitioner has not advanced a "reasonable cause" defense under this provision and has adduced no facts that would be relevant in determining its availability.

Maple Landing, LLC v. Commissioner, T.C. Memo. 2020-104, and *Englewood Place, LLC v. Commissioner*, T.C. Memo. 2020-105, had an approach similar to that of *Riverside*.

Loube v. Commissioner, T.C. Memo. 2020-3, held:

> We conclude that petitioners failed to strictly comply with DEFRA sec. 155 and the regulations thereunder because they failed to provide, among other information, the basis and the acquisition date of the contributed property on the appraisal summary. Petitioners also failed to attach to the appraisal summary an explanation of reasonable cause for their inability to provide the basis, acquisition date, or other information related to the contributed property.

In response to the taxpayers' substantial compliance argument, *Loube* responded:

> Petitioners contend that attaching the full appraisal to their return provided the necessary information such that they substantially complied. We are not swayed. While it may have been possible for the Commissioner to glean sufficient information from the purchase price and tax information listed in the appraisal, that does nothing to change the fact that Congress specifically passed DEFRA's heightened substantiation requirements so that the Commissioner could efficiently flag properties for overvaluation from the face of appraisal summaries. In so doing, Congress wanted precisely to prevent the Commissioner from having to sleuth through the footnotes of millions of returns. "The IRS reviews millions of returns each year for audit potential, and the disclosure of cost basis on the Form 8283 itself is necessary to make this process manageable. Revenue agents cannot be required to sift through dozens or hundreds of pages of complex returns looking for clues about what the taxpayer's cost basis might be." *Belair Woods, LLC v. Commissioner*, at *20. "If cost basis is not explicitly disclosed where it is required to be disclosed, the Commissioner will be handicapped in identifying suspicious charitable deductions and deterring taxpayers from 'continu[ing] to play the "audit lottery."'" *Id*. (quoting S. Prt. No. 98-169 (Vol. 1), at 444 (1984)). That is why we ruled as we did in *RERI* and *Belair Woods* and why we rule as we do now.

Brooks v. Commissioner, T.C. Memo. 2022-122, held:[2598]

> We have held that Congress specifically passed DEFRA's heightened substantiation requirements to prevent the Commissioner from having to sleuth through the footnotes of millions of returns. *Belair Woods, LLC v. Commissioner*, T.C. Memo. 2018-159, at *20. We cannot find that, in reporting roughly twice the accurate cost basis, petitioners substantially complied with DEFRA. See *Loube v. Commissioner*, T.C. Memo. 2020-3, at *22-23. Accordingly, petitioners failed to meet the requirements of Treasury Regulation § 1.170A-13(c)(2)(i), and this is also a basis on which the deduction must be disallowed.

Emanouil v. Commissioner, T.C. Memo. 2020-120, held:

> Strict compliance will necessarily satisfy the elements of a qualified appraisal. However, the taxpayer who does not strictly comply may nevertheless satisfy the elements if he has substantially complied with the requirements. That is, the above requirements are "directory" (*i.e.*, "helpful to respondent in the processing and auditing of returns on which charitable deductions are claimed") rather than "mandatory" (*i.e.*, literal compliance is required); and "[t]he fact that a Code provision conditions the entitlement of a tax benefit upon compliance with respondent's regulation does not mean that literal as opposed to substantial compliance is mandated." *Bond v. Commissioner*, 100 T.C. 32, 41 (1993); see also *Costello v. Commissioner*, T.C. Memo. 2015-87, at *22; *cf. Hewitt v. Commissioner*, 109 T.C. 258, 264 (1997) (holding that substantial compliance would not apply where the taxpayers "furnished practically none of the information required by either the statute or the regulations"), *aff'd without published opinion*, 166 F.3d 332 (4th Cir. 1998).
>
> In *Cave Buttes, L.L.C. v. Commissioner*, 147 T.C. 338 (2016), we noted the legislative history of the qualified appraisal statute and observed that its purpose was to provide the Commissioner with sufficient information to "deal more effectively with the prevalent use of overvaluations." *Id*. at 349-350 (citing S. Prt. 98-169 (Vol. I), at 444-445 (S. Comm. Print 1984), and Staff of J. Comm. on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act ["DEFRA"] of 1984 ("General Explanation"), at 505-508 (J. Comm. Print 1985)). In *Alli v. Commissioner*, T.C. Memo. 2014-15, at *56, we stated that the purpose of the appraisal requirements is to "ensur[e] that the correct values of donated property are reported". Accordingly, it would follow that if the appraisal at issue does generally provide the information required in the regulations to do just that - *i.e.*, to ensure that the correct values of donated property are reported - then the "essential requirements of the governing statute", *Estate of Evenchik v. Commissioner*, T.C. Memo. 2013-34, at *12 (quoting *Estate of Clause v. Commissioner*, 122 T.C. 115, 122 (2004)), can be satisfied despite certain defects that may not be significant in a given case.
>
> This case does not involve the abuse, mentioned in the General Explanation, arising from "tax shelter promotions".[14] But Congress was also "concerned with situations, not involving organized tax shelters, where individuals overvalue donated property … , such as interests in real estate". General Explanation at 503 (emphasis added.) The property that the Emanouils contributed was real estate, but the phrase "interests in real estate" especially connotes and implicates partial interests, such as easements. A deduction for

[2598] In sustaining penalties for gross overvaluation, beyond disallowing the deduction.

the contribution of a conservation easement is permitted by section 170(h); but such partial interests in real estate are seldom the subject of arm's-length transactions, and valuing them reliably involves special challenges, which qualified appraisal rules address. Of course, one could also overvalue an owner's entire property held in fee simple absolute, and the substantiation rules do apply to contributions of entire interests as well; but they were not the bull's eye at which DEFRA took aim.

[14] As was explained in Staff of J. Comm. on Taxation, General Explanation of the Revenue Provision of the Deficit Reduction Act of 1984, at 503 (J. Comm. Print 1985):

> Congress recognized that in recent years, opportunities to offset income through inflated valuations of donated property have been increasingly exploited by tax shelter promoters. Under typical tax shelter promotions, individuals acquire objects such as limited edition lithographs, books, gems, and the like, hold the property for at least the capital gains holding period, and then contribute the items to a museum, library, educational institution, or other qualified donee at their "appreciated" fair market value. The shelter package may include an "independent" appraisal, and the potential donor may be assured that his or her subsequent gift will be accepted by a charitable organization.

The Emanouils contributed not an easement or other partial interest but rather their entire fee simple interest in the Allie Lane parcel and in lots 2 and 3, and the valuation issue here is the garden-variety question of the fair market values of pieces of real estate. In the absence of a heightened potential for abuse, it is appropriate to recall that Congress generally favors charitable giving and that the courts have honored that legislative intent by broadly construing statutes "begotten from motives of public policy" like section 170 and similar statutes "enacted to benefit … charitable organizations". See *Helvering v. Bliss*, 293 U.S. 144, 150-151 (1934); *Estate of Crafts v. Commissioner*, 74 T.C. 1439, 1455 (1980) ("As a relief provision which inures to the benefit of charity, we believe that it should be construed liberally so that the intended charitable purposes are furthered").

The Emanouils acknowledge that they did not strictly comply with the requirements - since neither of their appraisals stated the date of contribution or stated that it was prepared for income tax purposes - but they argue that they substantially complied with the qualified appraisal requirements. Because this is not a case where the taxpayers "furnished practically none of the information] required", the substantial compliance doctrine can apply. Hewitt v. Commissioner, 109 T.C. at 264. To that end we consider whether the Emanouils provided most of the information required (they did) and whether the defects in their appraisals were so significant that they failed to establish the "substance or essence" of a "qualified appraisal" (they were not). See *Hewitt v. Commissioner*, 109 T.C. at 265; *Bond v. Commissioner*, 100 T.C. at 42.

3. Date of contribution

The Commissioner points to no specific purpose for the requirement that the date (or expected date) of contribution be included in a qualified appraisal. We have previously held that "[r]equiring an appraisal to include the actual or expected date of the contribution allows an individual (such as the Commissioner's revenue agent) to compare the appraisal and contribution dates for purposes of isolating fluctuations in the property's fair market value between those dates." *Rothman v. Commissioner*, T.C.

Memo. 2012-163], slip op. at 36 (finding no substantial compliance in a facade easement case where the appraisal failed to satisfy several substantiation requirements including the requirement to provide the date (or expected date) of the contribution), supplemented and vacated in part on other grounds by T.C. Memo. 2012-218. In this case the appraisals were dated within 30 days of the contributions, and in each instance the appraisal explicitly stated that it gave “a current market value” (emphasis added), rather than a historic value as of a previous date.

We have held that failing to include the date of contribution in the appraisal is not significant when the return includes a Form 8283 that specifies the date of contribution. See *Zarlengo v. Commissioner*, T.C. Memo. 2014-161, at *36 (finding that taxpayers substantially complied by disclosing contribution date on appraisal summary); *Simmons v. Commissioner*, T.C. Memo. 2009-208, 98 T.C.M. (CCH) 211, 215 (2009) (same), *aff'd*, 646 F.3d 6 (D.C. Cir. 2011). Because the Emanouils' returns for 2008 and 2009 included the respective Forms 8283 and disclosed the respective dates of the contributions, the absence of that information from the appraisal is not fatal in this case.

4. Income tax purpose…

In other words, the importance of providing an income tax purpose statement is to help the appraiser and the client identify the appropriate scope of work for the appraisal and the level of detail to provide in the appraisal, *i.e.*, to make sure that all the information required for relying on the appraisal - for income tax purposes - is included in the appraisal.[15] But we do not perceive that the appraisals at issue here reflect any lack of this information. Although we accept the importance of a shared understanding by appraiser and client of the purpose of an appraisal, a statement of purpose may not always be necessary to achieve substantial compliance, especially not when the appraisal otherwise includes the level of detail necessary to estimate the fair market value of the property in question. See *Consol. Inv'rs Grp. v. Commissioner*, T.C. Memo. 2009-290, slip op. at 58 (finding substantial compliance where “[t]he appraisal did lack a statement that it was prepared specifically for income tax purposes; however, we find this omission to be insubstantial”)….

> [15] The Senate Committee on Finance provided the following explanation for the requirement of stating the income tax purpose of the appraisal: “[T]he appraisal must state that it is being prepared for income tax purposes, and must be signed by the appraiser, whose tax identification number must be listed. Accordingly, the appraiser is a person to whom the civil tax penalty for aiding and abetting an understatement of tax liability (sec. 6701) could apply.” S. Prt. 98-169 (Vol. I) at 446 (S. Comm. Print 1984). The Commissioner makes no mention of this rationale from the legislative history, nor how it would affect the analysis of “substantial compliance” in this case, so we do not address this rationale further.

It is certainly true that there is no such thing as an “income tax value” distinct from fair market value. A competently performed valuation that was prepared for income tax purposes should be identical to a valuation prepared for advising a sale. The appraisals used the word “disposition”, a term broad enough to include a sale or (as was relevant) a donation. There is no reason to suppose that Ms. McKinney's valuation would have been different if its stated purpose had been “income tax”.

> We have not previously held that failing to include a statement of income tax purpose in an appraisal would by itself defeat substantial compliance for purposes of a claimed deduction for a charitable contribution. *Cf. Irby v. Commissioner*, 139 T.C. 371, 387 (2012) ("The IRS has not provided to the public a specific form for the tax purpose statement, and respondent has not proffered any instance where a suboptimal tax purpose statement, by itself, invalidated an otherwise qualified appraisal"); *Alli v. Commissioner*, T.C. Memo. 2014-15, (finding that an appraisal was not qualified because of at least five failures including the lack of a statement of an income tax purpose and, more significantly, because the appraisal was nearly 10 years old and failed to use any of the three commonly accepted approaches (capitalization, cost, or comparable sales) to determine fair market value); *Estate of Evenchik v. Commissioner*, T.C. Memo. 2013-34 (finding that an appraisal was not qualified because of numerous failures including the lack of an income tax purpose statement and, most significantly, the appraisal valued the wrong asset).
>
> In this case each appraisal valued the correct asset (a fee simple interest in real property) according to the correct standard (fair market value); each was prepared within 30 days of the date of contribution; and each used a commonly accepted approach (the income approach) to estimate fair market value for the contribution (discussed below in part III). In other words, the appraisals do not have multiple cumulative defects that we have previously held to be fatal for deducting charitable contributions.
>
> We hold that the Emanouils provided sufficient information to permit the IRS to evaluate the reported contributions and to investigate and address concerns about overvaluation and other aspects of the reported charitable contributions. The IRS did perform that investigation without any impediment arising from the two alleged defects in the appraisals, and the SNOD issued by the examination personnel did not mention the omissions (which, rather, were raised for the first time in this litigation). Thus, the Emanouils have substantially complied with the regulations for qualified appraisals.

Pankratz v. Commissioner, T.C. Memo. 2021-26, reasoned and held:

> Pankratz argues that he had reasonable cause for the position he took on his return because he reasonably relied on Meier's and Horning's advice. When a taxpayer claims to have relied on the advice of a professional, he must show that: the professional was a competent tax adviser with sufficient expertise to justify reliance, he provided necessary and accurate information to the professional who gave him advice, and he actually relied in good faith on that advice. See *Alt. Healthcare Advocates v. Commissioner*, 151 T.C. 225, 246 (2018); *Neonatology Assocs., P.A. v. Commissioner*, 115 T.C. 43, 99 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002)….
>
> Then there's the problem that Pankratz admitted that he never reviewed his return. A taxpayer's failure to review a return, though troubling, is not by itself fatal—there can be cases where even diligent taxpayers wouldn't be able to see a subtle problem in their tax returns. CNT Inv'rs, LLC, 144 T.C. at 234. That's not the case here. We first look to Pankratz's education, sophistication, and business experience. He is very well educated, with both a college degree and a doctorate. And, although he tried to represent himself as a lowly farm hand, he is a sophisticated and savvy businessman - he was able to create Grand Labs from nothing and sell it for $85 million, and he then invested his money in several different ventures in several different states. He may lack formal tax training, but we find that he possesses a sharp and sophisticated mind for business .

> Had Pankratz simply looked at Form 8283 he would have noticed that, at the very least, he likely needed to get appraisals. This makes his case unlike *CNT Investors, LLC*, because there the taxpayer met with his adviser and his review of the return would not have shown any issues. See *CNT Inv'rs, LLC*, 114 T.C. at 234.
>
> One does not have to be a tax expert to be able to read Form 8283. Had Pankratz reviewed that two-page form, he would have seen that it said "[a]n appraisal is generally required for property listed in Section B," or "you must attach a qualified appraisal of the property," or "[a]ppraised fair market value," or "Declaration of Appraiser." For a man as smart as Pankratz, this would have suggested that there was a potential major error on the return, and should have prompted him (at the very least) to ask Meier whether an appraisal was needed.[10] Instead, he just signed the return.
>
>> [10] Pankratz's excuse that he didn't review his return because he filed with only a day or so to spare and that he wasn't around when the return was filed offers no relief. Errors caused by waiting till the last minute to file are not reasonable. See sec. 1.6664-4(b)(2), Example (4), Income Tax Regs.
>
> With neither advice nor good faith reliance on that advice, we deny the deduction for Pankratz's contribution of his interests in the oil and gas fields.

Chiarelli v. Commissioner, T.C. Memo. 2021-27, reasoned and held:

> Petitioner contends that he cured his defective submissions by responding to respondent's request for additional documentation within 90 days in accordance with section 1.170A-13(c)(4)(iv)(H), Income Tax Regs. However, petitioner's position is grounded on a misreading of that regulation, which states that a deduction will not be disallowed for failure to attach an appraisal summary to a return if the donor complies with instructions to submit that document within 90 days of a request therefor. *Id.* By its terms that regulation does not apply here since petitioner did attach appraisal summaries to each of his returns. See *id.*; see also *Oakhill Woods, LLC v. Commissioner*, T.C. Memo. 2020-24, at *14-*15; *Belair Woods, LLC v. Commissioner*, at *13-*14. Further, that regulation applies only to appraisal summaries and does not afford petitioner a window to cure defects in his qualified appraisals. See *Belair Woods, LLC v. Commissioner*, at *13-*14; see also *Chrem v. Commissioner*, T.C. Memo. 2018-164, at *24 n.9; *Mohamed v. Commissioner*, 2012 WL 1937555, at *4. For all these reasons, we hold that petitioner did not comply, either strictly or substantially, with the regulatory reporting requirements for noncash charitable contributions.

Glade Creek Partner, LLC v. Commissioner, 130 A.F.T.R.2d 2022-5625 (11th Cir. 8/22/2022) (per curiam and not to be published), affirmed a penalty assessed because the appraisal was not obtained in good faith:

> As Glade Creek admits in its brief to us, Campbell understood that the goal of creating the conservation easement "was to raise enough money to repay the outstanding debt and preserve the property." And as the tax court found, Campbell "wanted an appraisal that accomplished his tax objectives for the easement transaction." By pursuing that goal single-mindedly, he did not obtain the appraisal in good faith. The court did not clearly err in finding an absence of good faith.

> Even assuming Campbell had obtained the appraisal in good faith, he was required to do more before Glade Creek could qualify for the reasonable cause exception. The exception also requires the taxpayer to make "a good faith investigation" into the property's value. I.R.C. § 6664(c)(3)(B); see also *Blau v. Comm'r*, 924 F.3d 1261, 1280 (D.C. Cir. 2019) (holding that the taxpayer had "failed to produce evidence that it conducted any investigation beyond the appraisal, let alone one that qualifies as a good faith investigation within the meaning of the statute") (quotation marks omitted); *Kaufman v. Comm'r*, 784 F.3d 56, 70 (1st Cir. 2015) (reasoning that if obtaining an appraisal were enough, it would "render the second requirement meaningless"). Glade Creek points to no evidence in the record that Campbell "made a good faith investigation" into the property's value beyond obtaining the appraisals. For this additional reason, the tax court did not clearly err in finding that Glade Creek failed to meet the requirements of the reasonable cause exception in § 6664.

Schweizer v. Commissioner, T.C. Memo. 2022-102, denied a charitable deduction when a very deficient Form 8283 was attached to the return. Before getting into the details about the tax return prepared by Mr. Kassel, consider the circumstances behind the donation:

> Shortly after assuming his position at Sotheby's, petitioner began donating works of African art to various museums. He claimed charitable contribution deductions for these gifts, all of which were reported on returns prepared by the Wasserman firm. These gifts included a work valued at $60,000 in 2007, a work valued at $100,000 in 2009, and a work valued at $5,000 in 2010.
>
> In 2011, the tax year at issue, petitioner decided to make a substantial contribution to the Minneapolis Institute of Art (MIA) to honor a colleague who was in poor health. The work he selected for donation was a Dogon sculpture that he had acquired in Paris, allegedly for $100,000, in 2003. (The Dogon people are indigenous to the central plateau region of Mali, in West Africa.)
>
> On December 6, 2011, petitioner donated the Dogon sculpture to the MIA. He anticipated claiming a charitable contribution deduction for this gift, and he received from the Internal Revenue Service (IRS) an automatic six-month extension of time, to October 15, 2012, to file his 2011 return. See § 6081(a). On June 7, 2012, he secured Mr. Kassel's assistance in requesting a Statement of Value (SOV) from the IRS with respect to the Dogon sculpture. A taxpayer may request an SOV from the IRS Art Appraisal Services (AAS) unit before filing the return on which a gift of art is to be reported, hoping to receive assurance that the IRS will accept the value as claimed. See I.R.S. Publication 561, Determining the Value of Donated Property 4 (Jan. 2022).
>
> Mr. Kassel transmitted the SOV package to the AAS unit. This package included a one-and-a-half page "appraisal" of the Dogon sculpture by Michael Oliver, a New York dealer in African art, who valued the work at $600,000. Mr. Oliver, who testified at trial, was not a certified appraiser in 2011 or at any time thereafter. He acknowledged that this was the only FMV appraisal that he had ever done.
>
> Mr. Kassel also included in the SOV package a substantially complete Form 8283, Noncash Charitable Contributions, reporting a $600,000 value for the sculpture. This document included Mr. Oliver's signature and the signature of an MIA officer attesting to receipt of the gift. Petitioner secured these signatures from Mr. Oliver and from the MIA

officer. At no time did Mr. Kassel have any contact with Mr. Oliver or with anyone at the MIA.

The taxpayer and return preparer told conflicting stories about taxpayer reliance on the preparer. Although the court did not believe the taxpayer, the court explained why such reliance would not have worked anyway:

Assuming arguendo that Mr. Kassel told petitioner that he need not include either a fully completed Form 8283 or a qualified appraisal with his 2011 return, we find no credible evidence that petitioner actually relied on such advice in good faith. A taxpayer who advances a reliance-on-professional-advice defense must establish that his “reliance was reasonable.” See *Atkinson v. Commissioner*, T.C. Memo. 2015-236, 110 T.C.M. (CCH) 550, 563 (quoting *Freytag v. Commissioner*, 89 T.C. 849, 888 (1987), *aff’d on another issue*, 904 F.2d 1011] (5th Cir. 1990), *aff’d*, 501 U.S. 868 (1991)); Treas. Reg. § 1.6664-4(b)(1).

“Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer.” Treas. Reg. § 1.6664-4(b)(1). Petitioner is a highly educated and sophisticated individual, with a law degree and five years of doctoral study. Beginning in 2007, his position at Sotheby’s enabled him to gain considerable experience in matters involving art appraisal at the highest levels. He may lack formal training in U.S. tax law, but we find that he possesses a sharp and sophisticated mind for business and dealings in fine art.

Of particular relevance to this case, petitioner was clearly familiar with Form 8283 and the section 170(f)(11) reporting requirements. He had made at least three prior tax-deductible contributions of African art, including a work valued at $60,000 in 2007, a work valued at $100,000 in 2009, and a work valued at $5,000 in 2010. He was required to secure qualified appraisals for these donations, and he was required to include (and presumably did include) a fully completed Form 8283 with each return. This was not ancient history but immediately preceded his 2011 gift.

Petitioner testified that he himself secured the signatures of Mr. Oliver and the MIA officer on the Form 8283 for the Dogon sculpture that was submitted to the AAS unit in June 2012. Mr. Kassel had no contact with either of these parties. This further establishes that petitioner was personally familiar with Form 8283 and its requirements.

We have consistently held that blind reliance on a return preparer is not a defense. Rather, the taxpayer must personally review the return and satisfy himself that it is accurate before signing and filing it. See, *e.g.*, *Metra Chem Corp. v. Commissioner*, 88 T.C. 654 (1987); *Bronson v. Commissioner*, T.C. Memo. 2002-260, 84 T.C.M. (CCH) 447; *Osborne v. Commissioner*, T.C. Memo. 2002-11, 83 T.C.M. (CCH) 1083; *Bilzerian v. Commissioner*, T.C. Memo. 2001-187 [2001 RIA TC Memo ¶2001-187], 82 T.C.M. (CCH) 295.

Petitioner knew that his 2011 return had to include a properly completed Form 8283, duly signed by the appraiser and an MIA officer, and that a qualified appraisal needed to be attached to the return. Armed with this knowledge, petitioner could not [pg. 847] have reasonably relied on contrary advice from Mr. Kassel. Such reliance would exemplify

> "willful blindness." *Cf. Jarnagin v. United States*, 134 Fed. Cl. 368, 378 (2017) (rejecting taxpayers' reasonable cause defense because failing to read or pay attention to certain lines on their tax returns "constitute[d] willful blindness to the...requirement[s]" (quoting *United States v. Williams*, 489 F. App'x 655, 659 (4th Cir. 2012))).
>
> Even if petitioner had not already been familiar with Form 8283 and its requirements, the defects were there in plain view. The Dogon sculpture was listed (incongruously) in section A of the form, where taxpayers are instructed to report donated property worth less than $5,000 and "certain publicly traded securities." On the line calling for a "[d]escription of donated property," the words "SEE ATTACHED" appeared, but there was no attachment. Section B of the form, where the gift should have been reported, was left blank, including two gaping blanks for signatures. Form 8283 explicitly says that "[a]n appraisal is generally required for property listed in Section B" but there was no, appraisal.
>
> One does not need to be a tax expert to open his eyes and read plain English. If petitioner had reviewed the Form 8283 as he testified, it would have been obvious to him that it was defective in many respects. We find it wholly implausible that a taxpayer as educated as petitioner, having devoted almost a decade to the study of law, would have acquiesced in the notion that he could properly file a tax return obviously lacking these required elements.
>
> Taxpayers have a duty to review their returns before signing and filing them, and the duty of filing accurate returns cannot be avoided by placing responsibility on a tax return preparer. *Metra Chem*, 88 T.C. at 662; *Magill v. Commissioner*, 70 T.C. 465, 479–80 (1978), *aff'd*, 651 F.2d 1233 (6th Cir. 1981). We find it most likely that petitioner did not review his 2011 return with any care at all. And if he did review it, he could not have reasonably relied on advice from Mr. Kassel that the return's blatant errors and omissions were immaterial. See *Chiarelli v. Commissioner*, T.C. Memo. 2021-27, 121 T.C.M. (CCH) 1188, 1193 (*citing Metra Chem*, 88 T.C. at 662).

Lim v. Commissioner, T.C. Memo. 2023-11, involved the following scheme:

> On December 22, 2016, Michael L. Meyer, an attorney, made a presentation to petitioners regarding a scheme he called "The Ultimate Plan: the Ultimate Tax, Estate and Charitable Plan." That same day petitioners executed an engagement agreement with Mr. Meyer. He thereby agreed to form a "Charitable Limited Liability Company" (CLLC) as a charitable giving vehicle. He agreed to create documents that would transfer assets to the CLLC, to create documents that would transfer CLLC units to a charity, and to supply an appraisal supporting the valuation claimed for the gift. He also agreed to represent petitioners before the IRS and this Court if the tax return on which petitioners reported the gift was selected by the IRS for examination.

The promoter was compensated as follows:

> The engagement letter specified that Mr. Meyer's fee would be the greater of $25,000 or an amount calculated by reference to the assets transferred to the CLLC. In the latter case, his fee was defined as 6% of the "deductible amount" of assets up to $1 million, plus 4% of the "deductible amount" of assets exceeding $1 million. The engagement letter contemplated that the assets transferred to the CLLC would be five promissory notes with an aggregate face amount of $2,008,500. Copies of the promissory notes were attached to the engagement letter.
>
> The engagement letter stated that "the total fee assessed will be USD$84,000.00, which will be payable in installments over a six month period" beginning January 2017. The agreement thus

presupposed that the "deductible amount" of assets transferred to the CLLC would be $1,600,000 (6% x $1,000,000 + 4% x $600,000 = $84,000). It is not clear how Mr. Meyer knew, on December 22, 2016, that the assets would be appraised at $1,600,000. As described below, his "appraisal" reaching that conclusion was dated January 31, 2017.

The LLC was purportedly funded by notes, and the taxpayer had little or no evidence that the LLC interest was actually transferred to the charity. Rather than try the case, the court said that the appraisal that the promoter prepared was not qualified:

> Mr. Meyer's purported appraisal has the legalistic form of an appraisal but none of the substance. Like the Foundation's supposed acknowledgment letter, it appears to be a form document into which taxpayer-specific items have been input in bold font. The appraisal is addressed to Integra, the alleged donor, at petitioners' residential address. It states (incorrectly) that ABC has "one (1) Manager," then states (ungrammatically) that the "Manager of the LLC is Helen Chu and Calvin Lim." It asserts that "LLC interests" were donated to the [*6] Foundation in 2016, but it fails to specify, anywhere in the document, how many ABC units were donated. It recites that ABC's only assets were promissory notes, but it makes no attempt to value the notes and ignores the fact that they were not due for seven years. It assumes that the Foundation owned 100% of the ABC units on the valuation date, but it incoherently applies a discount for lack of control in determining the value of those units. After many pages of legalese, Mr. Meyer opined that the deductible value of ABC units allegedly donated to the Foundation on December 31, 2016, was $1,608,808.[2]
>
> [2] Mr. Meyer evidently rounded that number down to $1,600,000 in calculating his fee, given the formula in the engagement letter. See supra p. 3.
>
> Mr. Meyer attached to his purported appraisal a one-page "certification" stating that his compensation as preparer "[was] not contingent on an action or event resulting from the analysis, opinions, or conclusions in, or the use of, this report." He averred that he had no "present or prospective interest or bias with respect to the parties involved," even though he had arranged the entire transaction for petitioners and was the registered agent for ABC. He attached a curriculum vitae stating that he was a certified public accountant (CPA), a certified valuation analyst (CVA), and a licensed attorney in Kentucky at that time.[3]
>
> [3] Respondent contends that Mr. Meyer was not a licensed attorney in Kentucky and that he had let his CPA and CVA certifications lapse as of January 31, 2017. Petitioners question the timing of the lapse of Mr. Meyer's CPA license and contend that he is (and was during 2017) an attorney in good standing in Kentucky. These factual disputes are not material in deciding whether the engagement letter provided for a "prohibited appraisal fee" under Treasury Regulation § 1.170A-13(c)(6)(i). *See* infra pp. 11–12.

Estate of Hoensheid v. Commissioner, T.C. Memo. 2023-34, involved an appraisal with several defects relating to a $3M contribution, criticizing the taxpayer's reliance:

> Petitioner is an experienced and sophisticated businessman. See Treas. Reg. § 1.6664-4(c)(1) (stating that "[a]ll facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice" and that "the taxpayer's education, sophistication and business experience will be relevant"). Petitioner made a business decision to have CSTC's transactional adviser conduct the appraisal gratis, rather than engage a national accounting firm on a paid basis. Given Mr. Dragon's admittedly limited experience and unfamiliarity with the qualified appraisal process, such a decision did not demonstrate ordinary business care and prudence. See, *e.g., Webster v. Commissioner*, T.C. Memo. 1992-538, 1992 WL 220112, at *4 (describing taxpayer's decision to engage unqualified adviser as "not a technical matter, but one calling for ordinary human wisdom and careful deliberation"). Petitioners have

> not provided credible evidence, aside from self-serving uncorroborated testimony, that they reasonably relied upon Ms. Kanski's judgment in proceeding with that unwise course of action.[25]
>
> [25] We do not ignore Ms. Kanski's email of April 16, in which she asked Mr. Hensien to inquire whether FINNEA could perform the appraisal as it "would seem to be the most efficient method." Ms. Kanski's preliminary inquiry to a colleague on behalf of petitioners does not speak to whether she ultimately exercised her judgment to advise petitioners that Mr. Dragon was qualified to conduct the appraisal nor to whether petitioners actually relied on that judgment. See, *e.g., Pankratz v. Commissioner*, T.C. Memo. 2021-26, at *26. The record is devoid of credible evidence on this point.
>
> In addition, petitioner's close involvement in the contribution and transaction requires us to cast a skeptical eye to his claim that he relied in good faith on Ms. Kanski as to the appraisal's incorrect date of contribution. The record firmly establishes that petitioner did not transfer the shares to Fidelity Charitable on June 11. The transactional documents, petitioner's contemporaneous emails, and the retention of the undated physical stock certificate strongly suggest that petitioner knew or at least should have known that the shares were not contributed to Fidelity Charitable on June 11. See Treas. Reg. § 1.6664-4(c)(1)(ii) (stating that for reliance to constitute reasonable cause "the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true"); see also *Exelon Corp. v. Commissioner*, 906 F.3d 513, 529 (7th Cir. 2018), *aff'g* 147 T.C. 230 (2016); *Blum v. Commissioner*, 737 F.3d 1303, 1318 (10th Cir. 2013), *aff'g* T.C. Memo. 2012-16. Consequently, we also conclude that petitioners have failed to establish good faith reliance on Ms. Kanski's judgment that the appraisal properly reported the required information, because petitioner knew or should have known that the date of contribution (and thus the date of valuation) was incorrect.

Braen v. Commissioner, T.C. Memo. 2023-85, discussed penalties for valuation overstatement in the context of the qualified appraisal requirement:

> Heightened requirements apply to the reasonable cause exception for valuation overstatements with respect to property for which a deduction has been claimed under section 170: (1) the value of the property must be based on a qualified appraisal made by a qualified appraiser and (2) the taxpayer must have made a good faith investigation into the value of the contributed property. I.R.C. § 6664(c)(3); *McGrady v. Commissioner*, T.C. Memo. 2016-233, at *54-55; *Costello*, T.C. Memo. 2015-87, at *35-36; *Esgar Corp. v. Commissioner*, 2012 WL 371809, at *23; . Reg. § 1.6664-4(h)(1). The qualified appraisal required for purposes of section 6664(c)(3)(A) is the same as under section 170(f)(11). I.R.C. § 6664(c)(4)(B); *Costello*, T.C. Memo. 2015-87, at *37.
>
> Treasury Regulation § 1.170A-13(c)(3)(ii) sets out the requirements for qualified appraisals. See I.R.C. § 170(f)(11)(E)(i); *Cave Buttes*, 147 T.C. at 348. Qualified appraisals must include, inter alia, the "terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the donor or donee that relates to the use, sale, or other disposition of the property contributed." Treas. Reg. § 1.170A-13(c)(3)(ii)(D). This requirement extends to any agreement that ``[r]eserves to, or confers upon anyone (other than a donee organization or an organization participating with a donee organization in cooperative fundraising) any right...to the possession of the property." *Id*. subdiv. (ii)(D)(2). This information ``enables the IRS to determine whether

the appraiser took restrictions on the disposition of the contributed property into account when appraising it." *Alli v. Commissioner*, T.C. Memo. 2014-15, at *25.

Neither appraisal on which Holdings based its valuation satisfied the qualified appraisal requirements.[18] See I.R.C. § 6664(c)(3); see also *Costello*, T.C. Memo. 2015-87, at *35-36; Treas. Reg. § 1.170A-13(c)(5)(iii) ("If the donor uses the appraisal of more than one appraiser,...each appraiser shall comply with the requirements of [Treasury Regulation § 1.170A-13(c)]...."). The appraisals failed to include the terms of either the settlement agreement or Ramapo's agreement with New York to sell three lots, both of which "relate[] to the use, sale, or other disposition of the property contributed." See Treas. Reg. § 1.170A-13(c)(3)(ii)(D).[19]

[18] The Braens contend that Holdings reasonably relied upon the advice offered by McGladrey. The Braens fail to offer convincing support for the proposition that interposing an accounting firm to offer a reconciliation of underlying appraisals insulates the appraisals from the requirements of section 6664(c)(3).

[19] We further note that the agreement between Ramapo and New York "confer[red] upon" New York a "right...to the possession of the property." See Treas. Reg. § 1.170A-13(c)(3)(ii)(D)(2). Holdings does not argue that New York was an "organization participating with a donee organization in cooperative fundraising," so we do not address that possibility. *Id.*

To be more specific, the land purchase agreement provides that "th[e zoning] lawsuit is being settled as part of the conveyance of the [p]roperty from [Holdings] to the Town of Ramapo." In a later section entitled "Subject to Court Approval and Settlement," the agreement specifies that the sale was "contingent on the settlement of" the zoning litigation "and the entry by the Court of an Order which shall include the subdivision of the property in substantial conformity with the proposed order appended hereto." Likewise, the land purchase agreement provided that Ramapo's "obligation hereunder is expressly conditioned upon the execution and all necessary approvals of the contract of sale between" Ramapo and New York and stated that it would be "null and void" if the agreement between Ramapo and New York was not executed.

"Information concerning such agreements is essential to enable the IRS to evaluate...whether the donors have received or will receive something in exchange for their gift." *Costello*, T.C. Memo. 2015-87, at *19; see also *Alli*, T.C. Memo. 2014-15, at *26. Although the cover letter to Mr. Fader's appraisal report indicates that he was provided the contract of sale between Holdings and Ramapo, the appraisal neither attached nor described the terms of the land purchase agreement, the settlement agreement, or the Ramapo-New York agreement. Mr. Zdunczyk went a bit further, including the land purchase agreement as [*37] an attachment to his appraisal. The Braens argue that this suffices as the land purchase agreement references both the settlement agreement and the agreement between Ramapo and New York, but the land purchase agreement does not set forth the terms of the other agreements and thus cannot cure the omissions in Mr. Zdunczyk's appraisal. See Treas. Reg. § 1.170-13A(c)(3)(ii)(D).

Holdings thus did not strictly comply with the qualified appraisal requirements. The Braens contend, however, that any shortcomings are excused by the substantial compliance doctrine. See *Kaufman v. Shulman*, 687 F.3d 21, 29 (1st Cir. 2012) (noting that substantial compliance can be used to "forgive minor discrepancies"), vacating in part and remanding 136 T.C. 294 (2011), and 134 T.C. 182 (2010).

The "key question" for substantial compliance "is whether the requirements [at issue] relate `to the substance or essence of the statute.'" *Loube v. Commissioner*, T.C. Memo. 2020-3, at *17 (quoting *Bond v. Commissioner*, 100 T.C. 32, 41 (1993)). If they do, "strict adherence to the statutory and regulatory requirements is mandatory," and substantial compliance does not apply. *Id*. at *17–18. This "doctrine `should not be liberally applied'" and is no "substitute for missing entire categories of content." *Costello*, T.C. Memo. 2015-87, at *23–24 (first quoting *Alli*, T.C. Memo. 2014-15, at *54; and then quoting *Hendrix v. United States*, No. 2:09-cv-132, 2010 WL 2900391, at *5 (S.D. Ohio July 21, 2010)); see *Chiarelli v. Commissioner*, T.C. Memo. 2021-27, at *17-18; *Brannan Sand & Gravel Co. v. Commissioner*, T.C. Memo. 2020-76, at *17–18. "[R]ather, it is at most a means of accepting a nearly complete effort that has simply fallen short in regard to minor procedural errors or relatively unimportant clerical oversights." *Costello*, T.C. Memo. 2015-87, at *23-24 (quoting *Hendrix*, 2010 WL 2900391, at *5).

The omissions here "were not trivial, formal, or mechanical." *Costello*, T.C. Memo. 2015-87, at *19. The requirement to set forth terms relating "to the use, sale, or other disposition of the property contributed," Treas. Reg. § 1.170A-13(c)(3)(ii)(D), goes to the IRS's evaluation of whether the taxpayer received anything of value as part of a sale, see *Costello*, T.C. Memo. 2015-87, at *19; *Smith v. Commissioner*, T.C. Memo. 2007-368, 2007 WL 4410771, at *20, *aff'd*, 364 F. App'x 317 (9th Cir. 2009); see also *RERI Holdings I, LLC v. Commissioner*, 149 T.C. 1, 16-17 (2017) (framing substantial compliance as focusing on whether the donor provided sufficient information to permit the IRS to evaluate the reported contribution), *aff'd sub nom. Blau v. Commissioner*, 924 F.3d 1261 (D.C. Cir. 2019). This issue is at the very heart of the matter. See *Hewitt v. Commissioner*, 109 T.C. 258, 265 (1997), *aff'd*, 166 F.3d 332 (4th Cir. 1998); *Bond*, 100 T.C. at 41. We thus conclude that the doctrine of substantial compliance does not apply. See I.R.C. § 6664(c)(3)(A).

The Braens finally argue that any failure to comply with the qualified appraisal requirements should be excused for reasonable cause under section 170(f)(11)(A)(ii)(II). But this defense does not apply in the context of section 6664(c)(3). See *Gorra v. Commissioner*, T.C. Memo. 2013-254, at *62. Section 6664(c)(3) provides an additional requirement applicable to substantial valuation over statements, on top of the ordinary reasonable cause requirements. See *Costello*, T.C. Memo. 2015-87, at *35-36; , Treas. Reg. § 1.6664-4(h)(1), (3). Applying the reasonable cause defense to the qualified appraisal requirement under section 6664(c)(3)(A) would thus render the additional requirement meaningless.

We therefore conclude that the Braens are liable for the substantial valuation misstatement penalties and are not entitled to the reasonable cause defense under section 6664(c)(3).

II.J.4.c.ii.(c). Conservation Easements Donated by Pass-Through Entities

For post-December 29, 2022 contributions, Code § 170(h)(7)(A), "In general," provides:

A contribution by a partnership (whether directly or as a distributive share of a contribution of another partnership) shall not be treated as a qualified conservation contribution for purposes of this section if the amount of such contribution exceeds 2.5 times the sum of each partner's relevant basis in such partnership.

Code § 170(h)(7)(F) generally applies this rule to S corporations.

REG-112916-23 (11/20/2023) proposed regulations under Code § 170(h)(7).

II.J.4.d. Possible Change in Beneficiary's Residence

A beneficiary changing residence might change the beneficiary's income tax posture and possibly the trust's residence. See part II.J.3.e State and Local Income Tax.

II.J.4.e. Material Participation for Business or Rental Activities

The 3.8% tax on net investment income[2599] applies to passive activities a trust holds.[2600] However, if the business has enough potential for ups and downs in its taxable income that planning for a potential significant loss becomes important, see part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, discussing a trade-off between NII tax and regular income.

Special rules apply to trusts when determining whether an activity is passive.[2601]

Consider how to document[2602] the trustee's participation as trustee in business activities,[2603] whether the trust should be converted to a beneficiary deemed-owned trust to use the beneficiary's work rather than the trustee's work,[2604] and the effect of the beneficiary's participation on any depreciation deductions.[2605]

II.J.4.f. Making Trust a Partial Grantor Trust as to a Beneficiary

A beneficiary may be treated as the deemed owner of a portion over which the beneficiary has - or previously had - a withdrawal right. See part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts, especially part III.B.2.i.vii Portion Owned When a Gift Over $5,000 is Made.

Generally, a nongrantor trust can offset deductions directly against income. However, generally the deemed owner of a grantor trust will report deductions as itemized deductions; note that administrative deductions are deducted against a nongrantor trust's income but are potentially

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[2599] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[2600] See part II.I.8 Application of 3.8% Tax to Business Income, especially part II.I.8.g Structuring Businesses in Response to 3.8% Tax.
[2601] See part II.K.2 Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business.
[2602] See part II.K.1.a.vi Proving Participation.
[2603] The IRS argues that the trust does not get credit for work a trustee does as an individual. See part II.K.2.b.i Participation by a Nongrantor Trust: Authority. Although the IRS has lost in court, one might consider avoiding being a test case. Accordingly, for steps one might consider to comply with the IRS' position, see part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.
[2604] See parts II.K.2.c Participation When Grantor Trusts Are Involved; Effect of Toggling and III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.
[2605] As described in part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses), depreciation deductions often pass through to the income beneficiaries, bypassing the usual fiduciary income tax filter. Therefore, the beneficiary's work is the only counted as participation in deciding whether the deductions are allowable.

disallowed on an individual deemed owner's return.[2606] Thus, being a grantor trust tends to save income tax only if the deemed owner has an overall lower federal, state, and local income tax rate than the trust; see part II.J.3.a Who Is Best Taxed on Gross Income.

In certain situations, New York may tax a trust as a resident trust if the trust has any New York source income, so consider giving one or more beneficiaries the right to withdraw New York source income; other states may have a similar approach.[2607]

If the trustee believes that a permanent change to the trust's income tax posture shifting income to the beneficiary would be helpful,[2608] the trustee might try to convert a trust to a partial beneficiary deemed-owned trust[2609] by exercising discretion to declare a distribution. Consider using this strategy to ameliorate unfavorable trust income taxation for the following:

- An interest in a partnership that does not distribute all of its K-1 income will often be taxed at the highest marginal income tax rate. See part III.A.4 Trust Accounting Income Regarding Business Interests and the example in part III.F.2 Trust Accounting and Taxation.

- ESBT taxation may be necessary for nontax reasons but unfavorable for income tax purposes: A nongrantor trust that makes an ESBT election is subject to tax at the highest marginal income tax rates and does not get a distribution deduction regarding any S corporation K-1 income it receives. The constraints placed on designing a trust taxed as a QSST may be inconsistent with the settlor's intent. See part III.A.3.e QSSTs and ESBTs for various issues regarding those types of trusts.

- After the SECURE Act, quite often IRAs and other retirement plans need to be withdrawn over 10 years instead of over the beneficiary's life expectancy. If the settlor wanted the trustee to accumulate most of those withdrawals, that income may be taxed in the top bracket.

This part II.J.4.f explains that a trustee may exercise discretion to "credit" a distribution to a beneficiary. For example, the trustee determines that it would be appropriate to distribute $50,000 for the beneficiary's support. Instead of sending the money to the beneficiary, the trustee tells the beneficiary that, upon the beneficiary's written request (for example, an email), the trustee will promptly distribute whatever portion (or all) of the $50,000 the beneficiary requests. For income tax purposes, the beneficiary is treated as having received the distribution. However, if that taxable year concludes without the beneficiary having taken out part or all of the $50,000, that unwithdrawn portion becomes a current or lapsed withdrawal right for the next taxable year.

Once part II.J.4.f explores what it means to "credit" a distribution, it then describes how to measure a lapse of a withdrawal right and what language might be used to maximize the lapse without gift tax consequences.

[2606] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment and fns 2502 and 2508 in part II.J.3.d Who Benefits Most from Deductions.
[2607] See Ed Morrow, Jonathan Blattmachr and Marty Shenkman on Using Decanting and BDOT Provisions to Avoid a Peppercorn of Income Potentially Triggering State Income Tax on a Trust's Entire Income, LISI Income Tax Planning Newsletter #204 (September 15, 2020).
[2608] See part II.J.3 Strategic Fiduciary Income Tax Planning.
[2609] See part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts, especially part III.B.2.i.vii.(b) Determining Portion Owned When Trust Is Only a Partial Grantor Trust.

Distributions include amounts required to be distributed[2610] and any other amounts properly paid, credited, or required to be distributed to such beneficiary;[2611] Code § 663(b) provides, "If within the first 65 days of any taxable year of an estate or a trust, an amount is properly paid or credited, such amount shall be considered paid or credited on the last day of the preceding taxable year." Generally, an amount is considered credited if the trustee must pay it on the beneficiary's demand (without the trustee exercising any discretion when the beneficiary makes the demand) and there is no practical or legal impediment to making the payment.[2612] *Harris v. U.S.*, 370 F.2d 887 (4th Cir. 1966), interpreted prior law:

> In *Commissioner v. Stearns*, 65 F.2d 371, 373 (2 Cir. 1933), *cert. den.* 290 U.S. 670, "distributed currently" was construed in a statute corresponding to § 162(b) to mean a distribution required by the will, and thus money to which the beneficiary is absolutely entitled, whether or not paid. Likewise, the meaning in 162(c) of "properly credited" was said to contemplate that the distributions "must be actually made, or irrevocably fixed before they become the beneficiary's as of right. ... The income must be so definitively allocated to the legatee as to be beyond recall; 'credit' for practical purposes is the equivalent of 'payment'. Therefore a mere entry on the books of the fiduciary will not serve unless made in such circumstances that it cannot be recalled." Accord, *Lynchburg Trust & Savings Bank v. Commissioner*, 68 F.2d 356, 359 (4 Cir. 1934), *cert. den.* 292 U.S. 640.

In upholding an estate's crediting of income, *Harris* held:

> Furthermore, it is noteworthy that the Eleventh clause of the will, supra, directed the executors to determine the sufficiency of the liquid assets to pay the estate taxes at the time of the testator's death. In the event such liquidity was lacking they were directed to borrow, or to sell real estate, with authorization to encumber it as necessary. This again

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[2610] Code §§ 652(a), 662(a)(1).

[2611] Code § 662(a)(2). Reg. § 1.662(a)-3(a) provides:

> There is included in the gross income of a beneficiary under section 662(a)(2) any amount properly paid, credited, or required to be distributed to the beneficiary for the taxable year, other than (1) income required to be distributed currently, as determined under § 1.662(a)-2, (2) amounts excluded under section 663(a) and the regulations thereunder, and (3) amounts in excess of distributable net income (see paragraph (c) of this section). An amount which is credited or required to be distributed is included in the gross income of a beneficiary whether or not it is actually distributed.

[2612] See *Cecelia K. Frank Trust of 1931 v. Commissioner*, 8 T.C. 368 (1947), *aff'd* 165 F.2d 992 (3d Cir. 1948); *Commissioner v. Stearns*, 65 F.2d 371 (2d Cir.), *cert. den.* 290 U.S. 670 (1933); *Weed's Estate v. United States*, 110 F.Supp. 149 (E.D. Tex. 1952); *Igoe v. Commissioner*, 19 T.C. 913 (1953); *Estate of Cohen v. Commissioner*, 8 T.C. 784 (1947); *Estate of Bruner v. Commissioner*, 3 T.C. 1051 (1944); *Estate of Hubbard v. Commissioner*, 41 B.T.A. 628 (1941); *cf. Harkness v. United States*, 469 F.2d 310 (Ct. Cl. 1972), *cert. denied* 414 U.S. 820 (1973); *Warburton v. Commissioner*, 193 F.2d 1008 (3d Cir. 1952). The author thanks Lad Boyle for providing the above citations from F. Ladson Boyle & Jonathan G. Blattmachr, *Blattmachr on Income Taxation of Estates and Trusts* (15th ed. 2008). Additional authority includes *Bohan v. U.S.*, 326 F.Supp. 1356 (W.D. Mo. 1971), *aff'd* 456 F.2d 851 (8th Cir. 1972), *nonacq.* Rev. Rul. 82-396.
Note also that Code § 643(g) provides circumstances under which a trustee may credit a beneficiary with the trust's estimated tax payments.
A similar concept is found in Reg. § 1.451-2(a), the constructive receipt doctrine, which is reproduced in the text accompanying fns 4205-4206 in part II.Q.1.e Trying to Avoid Possible Ordinary Income on the Sale of a Partnership or S Corporation.

> suggests that the executors were to look only to the liquidity of the corpus, not to the subsequent income for the payment of taxes.
>
> When the will clearly indicates, as appears in the portions to which we have adverted, that the estate income is not to be first charged with the payment of taxes, it is the law of West Virginia that the mandate of the will be followed.[2] *Cuppett v. Neilly*, 143 W.Va. 845, 105 S.E.2d 548, 563 (1958). The Federal law, IRC 1939 § 822(b), directing only that the tax be paid, leaves its impact and apportionment to the administering State. *Riggs v. del Drago*, 317 US 95 (1942). The Tax Court of the United States has so acknowledged. *Alma Igoe*, *supra*, 19 T.C. 913, 924.
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>> [2] We note that should a fiduciary pay West Virginia taxes due on property under his control, W. Va. Code § 11A-1-11, apparently unconstrued, expresses indifference as to whether he be refunded from the property or its income. Since the passage of W. Va. Code § 44-2-16a in 1959, the mandate to follow the will has been made statutory.
>
> As the money to honor the credits was available to the executors, there is no warrant for holding that they "were a sham, or were part of some device or sub rosa understanding that no distributions of income could be based upon crediting of income to the legatees". *Id.* 924. Moreover, there is no showing of a sham here, but rather an effectuation of the testamentary directions.
>
> A testamentary injunction upon executors to satisfy costs of administration, debts and taxes before distributing the estate does not, as was quite correctly conceded by the Government in argument, nullify a distribution made before satisfaction of these items. The only result is to make the personal representatives and their surety liable therefor, if the remaining estate proves insufficient to meet these items. Consequently, there can be no doubt that the credits gave the present beneficiaries good title to the moneys segregated by the entries and then in the hands of the executors. Evidently, the Government considered the sequestrations valid and effective when made in 1948, 1949 and 1950. Without objection the United States acknowledged the credits as income to the beneficiaries. No attempt was ever made to assess this income to the estate, notwithstanding a greater tax would have thereby been realized and the Government was informed by the executors of this distribution of the estate income.
>
> In short, we find there was a recognizable - and recognized - allocation of estate income among the distributees and a sustainable loan by them to the estate.

However, mere book entries on the fiduciary's records do not constitute crediting. *Estate of Johnson v. Commissioner*, 88 T.C. 225, 235-237, *aff'd* 838 F.2d 1202 (2d Cir. 1987), held:

> Next we must determine whether the crediting of income on the accountant's workpapers and the reporting of income on the fiduciary income tax returns of petitioner and of Willard's estate in 1980 and 1981 can be considered to be distributions within the meaning of section 661. Section 661(a) provides:
>
>> SEC. 661(a). Deduction.—In any taxable year there shall be allowed as a deduction in computing the taxable income of any estate or trust (other than a trust to which subpart B applies), the sum of—

(1) any amount of income for such taxable year required to be distributed currently … and

(2) any other amounts properly paid or credited or required to be distributed for such taxable year;

but such deduction shall not exceed the distributable net income of the estate or trust.

The Second Circuit has interpreted the requirement that amounts be "properly credited" as follows:

> *The income must be so definitively allocated to the legatee as to be beyond recall*; "credit" for practical purposes is the equivalent of "payment." Therefore, a mere entry on the books of the fiduciary will not serve unless made in such circumstances that it cannot be recalled. If the fiduciary's account be stated inter partes, that would probably be enough…. But the unilateral act of entering items in the account is not conclusive… [*Commissioner v. Stearns*, 65 F.2d 371, 373 (2d Cir. 1933), cert. denied sub nom. *Stearns v. Burnet*, 290 U.S. 670 (1933). Emphasis added.][7]

[7] In *Commissioner v. Stearns*, the Second Circuit interpreted section 162(c) of the Revenue Act of 1928, which provided a deduction for an estate for amounts "properly paid or credited during such year to any legatee, heir, or beneficiary." 65 F.2d at 373. The Internal Revenue Code of 1954 did not materially change the relevant language.

Harris v. United States, 370 F.2d 887, 892 (4th Cir. 1966); see *Igoe v. Commissioner*, 19 T.C. 913, 923-924 (1953).

Petitioner and Willard's estate have the same executors and accountants. In 1976 Klein, one of the executors, met with Rosenberg, a senior partner of Main Hurdman, and instructed him to make the appropriate entries each year to credit 20 percent of petitioner's income to Willard's estate. Since 1976, under the direction of Richard Stone, who was the accountant charged with reviewing tax compliance for both estates, staff members of Main Hurdman have prepared annual work papers for both estates showing the distributions. The workpapers were prepared in the ordinary course of business. The entries on the work papers do not reflect any actual exchange of money, but Willard's estate treated the amounts credited as income on its 1980 and 1981 income tax returns pursuant to section 662(a), and petitioner claimed distributions deductions for the same amounts on its 1980 and 1981 returns. See sec. 661(a)(2).

Petitioner contends that because of the identity of executors and accountants, neither formal bookkeeping entries nor actual separation of funds was necessary to credit income from petitioner to Willard's estate within the meaning of section 661(a)(2). In petitioner's view, the informal workpapers, prepared in the ordinary course of business, were sufficient to evidence a commitment to set aside funds beyond the recall of petitioner, its creditors, and its other beneficiaries. Petitioner also argues that the consistent reporting of the transfers on the income tax returns for both estates is further evidence of its intent to permanently set aside the funds for Willard's estate. Respondent contends that the workpapers did not place the amounts transferred beyond petitioner's recall and that the amounts were, therefore, not properly credited within the meaning of section 661(a)(2).

> We agree with respondent. The workpapers, which were informal documents prepared in pencil, are the only records showing the transfers of funds between the estates. Stone testified that workpapers were prepared in the ordinary course of business after the close of each taxable year, always in pencil, and kept in the files for each estate. We nonetheless cannot find that the workpapers were sufficiently permanent documents to function as the books of the estate. We are convinced that, were petitioner to make a bad investment or incur unexpected indebtedness on its large contingent liabilities, the funds credited on the workpapers to Willard's estate would not be insulated from the claims of petitioner's creditors or other beneficiaries.
>
> Petitioner chose to credit Willard's account through entries on the work papers rather than actually transferring cash specifically because of the numerous contingent liabilities and other contingencies preventing it from settling the estate. Although the consistent income tax reporting of the transfers by both estates is evidence that the amounts were intended to be permanently set aside for Willard's estate (*cf. In re Estate of O'Neil*, 68 Misc.2d 634, 327 N.Y.S.2d 725, 732 (Surr. Ct. 1972), it is not enough to meet petitioner's burden of proof. Willard's estate, as a residuary beneficiary, can receive only the residue of petitioner's assets. Thus, it was prudent for the executors not to make cash distributions until they had collected all of petitioner's assets and settled its liabilities. As one of the executors testified, "we did not make any distributions to any of the beneficiaries … we felt it would be prejudicial to them to divide the thing in five places, we felt it was our duty to stay there and settle all claims, negotiate the claims, pay our taxes, collect all the assets and dispose of the liabilities."[8]
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> [8] Transcript of trial, June 27, 1986 at 169.
>
> We do not hold that, where the representatives or accountants for estate and beneficiary are the same, funds must be physically segregated to satisfy the "properly credited" standard of section 661(a)(2). Entries on the books of the estate may be sufficient in such cases, but we do not believe that workpapers such as those prepared in this case can achieve an allocation beyond the recall of the executors, and petitioner has not shown us that New York law is otherwise. The amounts credited to Willard's estate in 1980 and 1981 were not, for Federal income tax purposes, distributions within the meaning of section 661, and petitioner is not entitled to deductions for them.

Instead of or in addition to exercising discretion by making payments to or for a beneficiary, a trustee can inform a beneficiary that the trustee is crediting a percentage (up to 5%) of the trust's assets[2613] and that, upon demand, the beneficiary may withdraw that amount for a stated reasonable period of time. The cases require that the credited amounts must be "beyond recall" by the trustee; my suggestion of lapsing after a reasonable period of time is not expressly authorized under the crediting cases but is consistent with *Crummey* and its progeny.[2614] Although that looks somewhat like a Code § 678(a)(1) withdrawal right, the process of crediting counts as a distribution rather than as a withdrawal right, because it was subject to the trustee's discretion.[2615] However, once it is credited and vests in the beneficiary, so that the beneficiary

[2613] It should be expressed as a portion of the trust's assets, rather than as a specific dollar amount. See fn 6125 in part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts (Whether or Not a Sale Is Made).
[2614] See fns 2132-2133 in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.
[2615] See part III.B.2.i.iii Can a Trust Without a Withdrawal Right Be a Code § 678 Trust?

has the unqualified right to withdraw, presumably looking forward after that taxable year one would look at the grantor trust rules as to income attributable to the beneficiary's withdrawal right and any lapses of it.[2616] If the trust instrument does have language along the lines of the text accompanying fn 2628, the trustee might substitute the following for the first sentence:

> I, the trustee, exercise my authority to distribute by declaring that, until I provide otherwise (see last sentence of this paragraph), the Primary Beneficiary shall have the right to withdraw all gross income (as defined for federal income tax purposes) accruing to the trust in each calendar year, including both ordinary income and capital gain income.

If the withdrawal right were included in the agreement instead of the crediting taking place, the beneficiary would be taxed on a portion of the trust instead of being treated as having been credited with a distribution.[2617] However, the process of crediting allows any allocable deductions to be determined at the trust level and offset directly against the trust's income,[2618] whereas any deductions allocable to the beneficiary deemed-owned trust portion are separately deducted on the deemed owner's return.[2619] Using the trust's own tax attributes may avoid various restrictions on the Code § 199A deduction for pass-through business income, state income tax, and deductions relating to managing the trust,[2620] so the crediting mechanism may provide better short-term tax benefits than having included a withdrawal right to begin with.

If the right to withdraw the credited funds lapses, the beneficiary would make a gift[2621] if and to the extent that the lapse exceeds the greater of $5,000 or 5% of the funds out of which the withdrawal could have been satisfied.[2622] The lapse of a withdrawal right does not cause the holder to become the transferor for generation-skipping transfer tax purposes except to the extent that the lapse constitutes a taxable gift. See generally part III.B.1.d Generation-Skipping Transfer (GST) Issues, including parts III.B.1.d.ii Estate Tax Inclusion Period (ETIP) and III.B.1.d.iii Who Is the Transferor (especially Reg. § 26.2652-1(a)(5), Example (5) in the latter). The ETIP rule applies only if the transferor or the transferor's spouse would have estate inclusion; see Reg. § 26.2632-1(c)(2)(i) and Code § 2642(f)(1), (4). Reg. § 26.2632-

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[2616] See part III.B.2.i.vii.(b) Determining Portion Owned When Trust Is Only a Partial Grantor Trust.
[2617] Rev. Rul. 67-241; see parts III.B.2.i.ii Building Up Trust, especially fn. 6727, and III.B.2.i.iii Can a Trust Without a Withdrawal Right Be a Code § 678 Trust?, especially fn. 6737.
[2618] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items.
[2619] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.
[2620] See part II.J.3.d Who Benefits Most from Deductions.
[2621] Reg. § 25.2514-3(a), "In general," provides:

> *In general*. The exercise, release, or lapse (except as provided in paragraph (c) of this section) of a general power of appointment created after October 21, 1942, is deemed to be a transfer of property by the individual possessing the power. The exercise of a power of appointment that is not a general power is considered to be a transfer if it is exercised to create a further power under certain circumstances (see paragraph (d) of this section). See paragraph (c) of § 25.2514-1 for the definition of various terms used in this section. See paragraph (b) of this section for the rules applicable to determine the extent to which joint powers created after October 21, 1942, are to be treated as general powers of appointment.

[2622] Code § 2514(e)(2) excludes from gift tax consequences lapses in an amount that does not exceed "5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied."

1(c)(2)(ii)(B) does attack Crummey rights held by a spouse. For a lapse in withdrawal right in excess of the 5-and-5 power, see Letter Ruling 200243026.[2623]

Be aware of circumstances under which the IRS may argue that the 5% refers to the income rather than referring to the whole trust. Code § 2514(e)(2) excludes from gift tax consequences lapses in an amount that does not exceed "5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied." Reg. If within the first 65 days of any taxable year of an estate or a trust, an amount is properly paid or credited, such amount shall be considered paid or credited on the last day of the preceding taxable year. Reg. § 25.2514-3(c)(4), "Release or lapse of power," provides:

> A release of a power of appointment need not be formal or express in character. For example, the failure to exercise a general power of appointment created after October 21, 1942, within a specified time so that the power lapses, constitutes a release of the power. In any case where the possessor of a general power of appointment is incapable of validly exercising or releasing a power, by reason of minority, or otherwise, and the power may not be validly exercised or released on his behalf, the failure to exercise or release the power is not a lapse of the power. If a trustee has in his capacity as trustee a power which is considered as a general power of appointment, his resignation or removal as trustee will cause a lapse of his power. However, section 2514(e) provides that a lapse during any calendar year is considered as a release so as to be subject to the gift tax only to the extent that the property which could have been appointed by exercise of the lapsed power of appointment exceeds the greater of (i) $5,000, or (ii) 5 percent of the aggregate value, at the time of the lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed power could be satisfied. For example, if an individual has a noncumulative right to withdraw $10,000 a year from the principal of a trust fund, the failure to exercise this right of withdrawal in a particular year will not constitute a gift if the fund at the end of the year equals or exceeds $200,000. If, however, at the end of the particular year the fund should be worth only $100,000, the failure to exercise the power will be considered a gift to the extent of $5,000, the excess of $10,000 over 5 percent of a fund of $100,000. Where the failure to exercise a power, such as a right of withdrawal, occurs in more than a single year, the value of the taxable transfer will be determined separately for each year.

Rev. Rul. 66-87 applied the corresponding estate tax provision:

> Advice has been requested whether, for purposes of the Federal estate tax, the 5-percent lapsed power exclusion from gross estate provided in section 2041(b)(2)(B) of the Internal Revenue Code of 1954 is based on trust income or the value of the trust corpus, under the circumstances described below.
>
> The decedent was the lifetime beneficiary of a testamentary trust established under the will of her husband, who died in 1953. As the beneficiary, she had the noncumulative right to withdraw the income from the trust each year. Any income not so withdrawn was to be accumulated and added to corpus. The decedent did not exercise her right during

[2623] Letter Ruling 200243026 is described in the text accompanying fn 6356 in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts. In part III.B.1.d.iii Who Is the Transferor, the effect of taxable lapses is discussed in fn 6404.

her lifetime. Each annual failure to exercise such right has been determined to constitute a lapse of a power for purposes of section 2041(b)(2) of the Code.

The issue is whether the 5-percent limitation on the lapsed power exclusion from decedent's gross estate provided by section 2041(b)(2)(B) of the Code applies to the income the decedent could have withdrawn from the trust or to the trust corpus from which the income was derived.

Section 2041(b)(2) of the Code provides that the lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. However, section 2041(b)(2) of the Code further provides that the lapse of the power during any calendar year shall be considered a release for purposes of inclusion of property in the gross estate of the individual only to the extent that the property, which could have been appointed by exercise of such lapsed power, exceeded in value the greater of $5,000 or 5 percent of the aggregate value, at the time of such lapse, "of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied."

Example (2) of section 20.2041-3(f) of the Estate Tax Regulations illustrates the application of section 2041(b)(2) of the Code in a situation substantially similar in certain important respects to that under consideration in the instant case. In that example, the donee of the power, the decedent, had the noncumulative power to distribute $10,000 of each year's income to himself, which otherwise was accumulated. The trust income for the year was $20,000. Thus, where the donee did not distribute any income to himself, there was a lapse as to $5,000 (i.e., the amount by which $10,000 exceeds $5,000).

The fact that the 5-percent exclusion is not discussed in the above example is attributable to the reason that it does not apply in the described factual situation. Five percent of $20,000 is $1,000 and, therefore, the greater exclusion of $5,000 provided for in section 2041(b)(2)(A) of the Code is the applicable exclusion in the circumstances of the example.

The 5-percent exclusion provided for in section 2041(b)(2)(B) of the Code logically relates to the "assets out of which" the property in question could have been withdrawn. The value of the fund so described is the quantity against which the exclusion is computed. This is consistent with the underlying objective of this section, which is to provide a limited exclusion from the general rule of taxability of the property over which the decedent had command by his general power of appointment. It is considered significant that the Code uses the phrase "assets out of which" rather than more commonly used terms, as principal, corpus, etc.

In the instant case, the annual trust income earned by the testamentary trust created by the decedent's husband is "the assets out of which ... the exercise of the lapsed powers could have been satisfied" within the meaning of section 2041(b)(2)(B) of the Code. Accordingly, it is held that the 5-percent exclusion from decedent's gross estate provided for in section 2041(b)(2)(B) of the Code is based on the value of the trust income rather than on the trust corpus from which the income was derived.

Fish v. U.S., 432 F.2d 1278 (9th Cir. 1970), held that Code § 2514(e) measures the lapse of a right to income by multiplying the income, rather than the trust's value, by 5%. *Fish* cited Senate Report No. 382, 82nd Cong., 1st Sess., pp. 6-7 (2 U.S. Code Congressional and

Administrative News (1951) 1530, 1535). Here is an excerpt to which it may have been referring:

> The committee amendment provides an annual exemption with respect to lapsed powers equal to $5,000 or 5 percent of the trust or fund in which the lapsed power existed, whichever is the greater. Thus, for example, if a person has a noncumulative right to withdraw $10,000 a year from the principal of a $200,000 trust fund, failure to exercise this right will not result in either estate or gift tax with respect to the power over $10,000 which lapses each year prior to the year of death. At his death there will be included in his gross estate the $10,000 which he was entitled to draw for the year in which his death occurs, less any sums which he may have taken on account thereof while he was alive during the year. However, if, in the above example, the person had had a right to withdraw $15,000 annually, failure to exercise this right in any year prior to the year of death will be considered a release of a power to the extent of the excess over 5 percent of the trust fund.

Reg. § 25.2514-3(c)(4), "Release or lapse of power," provides:

> A release of a power of appointment need not be formal or express in character. For example, the failure to exercise a general power of appointment created after October 21, 1942, within a specified time so that the power lapses, constitutes a release of the power. In any case where the possessor of a general power of appointment is incapable of validly exercising or releasing a power, by reason of minority, or otherwise, and the power may not be validly exercised or released on his behalf, the failure to exercise or release the power is not a lapse of the power. If a trustee has in his capacity as trustee a power which is considered as a general power of appointment, his resignation or removal as trustee will cause a lapse of his power. However, section 2514(e) provides that a lapse during any calendar year is considered as a release so as to be subject to the gift tax only to the extent that the property which could have been appointed by exercise of the lapsed power of appointment exceeds the greater of (i) $5,000, or (ii) 5 percent of the aggregate value, at the time of the lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed power could be satisfied. For example, if an individual has a noncumulative right to withdraw $10,000 a year from the principal of a trust fund, the failure to exercise this right of withdrawal in a particular year will not constitute a gift if the fund at the end of the year equals or exceeds $200,000. If, however, at the end of the particular year the fund should be worth only $100,000, the failure to exercise the power will be considered a gift to the extent of $5,000, the excess of $10,000 over 5 percent of a fund of $100,000. Where the failure to exercise a power, such as a right of withdrawal, occurs in more than a single year, the value of the taxable transfer will be determined separately for each year.

Rev. Rul. 85-88 describes its view of the nontaxable lapse of a withdrawal right:

> Under section 2514(e) of the Code, the lapse of a general power of appointment created after October 21, 1942, like the release of such a power, results in a transfer for federal gift tax purposes. With respect to any calendar year, however, this rule applies only to the extent the value of the property subject to the lapsed powers exceeds the greater of $5,000 or 5 percent of the aggregate value of the assets ("5 and 5 exemption") out of which the exercise of the lapsed powers could have been satisfied. See section 25.2514-3(c)(4) of the Gift Tax Regulations.

There is no indication in the legislative history of the predecessor of section 2514(e) (section 811(f)(4) of the 1939 Code) that Congress intended that the holder of multiple noncumulative general powers of appointment should receive more than one "5 and 5 exemption" in a calendar year. See S. Rep. No. 382, 82 Cong., 1st Sess. 6-7 (1951). Moreover, the language of section 2514(e), states that the exemption applies "with respect to the lapse of *powers* during any calendar year." (Emphasis added.) Thus, under these circumstances, only one 5 and 5 exemption under section 2514(e) is available for all lapses of powers of appointment in a single trust in a calendar year. Accordingly, the beneficiary is entitled to only one $5,000 exemption per calendar year.

The 5 percent test of section 2514(e) is stated in terms of "the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied." For example, where a power of appointment is limited to annual trust income, the 5 percent test is based on annual trust income, not the amount of trust corpus. *Fish v. United States*, 291 F.Supp. 59 (D. Ore. 1968), *aff'd*, 432 F.2d 1278 (9th Cir. 1970). The 5 percent test is based on the value of the assets subject to the power at the time of the lapse of the power. See section 25.2514-3(c)(4) of the Gift Tax Regulations. Where the donee has more than one noncumulative withdrawal power in the same trust that lapse in a calendar year, the 5 percent test is based on the maximum amount subject to the donee's withdrawal power on the date of lapse of any such power during the calendar year. Where the donee has noncumulative powers to withdraw property from two or more trusts, the 5 percent test is applied by aggregating the amount determined pursuant to the preceding sentence for each such trust with respect to which the withdrawal power has lapsed during the calendar year.

For example, suppose B has the power to withdraw $20,000 from the corpus of one trust, and the power lapses on June 1, when the trust corpus is worth $300,000. If B has a second noncumulative power to withdraw $20,000 from the corpus of the same trust, and such power lapses on December 1, when the value of the trust corpus has appreciated to $400,000, then the maximum amount of trust assets subject to B's withdrawal power at the time of any lapse during the calendar year would be $400,000, and the amount of B's 5-and-5 exemption for the year would be $20,000 (5% X $400,000). On the other hand, if B's second withdrawal power in the example is exercisable only with respect to a second, separate trust, B's 5-and-5 exemption for the year would be $35,000 (5% X $700,000).

In Situation 1,[2624] S's powers of withdrawal were limited to contributions to the trust. Although each contribution creates a new withdrawal power and arguably provides a separate fund for the exercise of each such withdrawal power, only a single 5-and-5

[2624] [my footnote:] Situation 1 provides:

In March 1982, G created an irrevocable trust under which S was granted the right to receive the trust income for S's life and C was granted the remainder interest. In addition, S was given the right under the trust to withdraw up to $5,000 from each contribution made by any donor to the trust.

The trust instrument required the trustee to provide S with notice immediately on receipt of a contribution. S had the right for a period of 60 days following receipt of a notice to exercise the right of withdrawal, after which the right lapsed.

G contributed $5,000 to the trust upon its creation. S was promptly notified of the contribution, but did not make a demand for withdrawal within the prescribed period. G made another $5,000 contribution in September 1982. Again, S was notified of the contribution, but the right of withdrawal subsequently lapsed within the year without S having exercised it.

exemption is available to S in 1982. Providing a separate 5-and-5 exemption for each contribution would undermine the statutory purposes to limit the exemption provided by section 2514(e). Moreover, section 2514(e) states the $5,000 and 5 percent tests in terms of the aggregate value of the assets out of which the exercise of the lapsed powers could be satisfied. Nothing is said concerning separate tests for each of the funds out of which the lapsed powers could have been exercised.

In Situation 1, $10,000 was contributed to the trust in 1982. S did not exercise the powers of withdrawal and both powers lapsed within the year. Once a power lapsed, C acquired a vested interest in the amount subject to the lapse. Therefore, C received a remainder interest in $10,000 in 1982 as a result of the lapsed powers. The gift tax does not apply to the $5,000 portion of the trust property in which C has a remainder interest and which is covered by S's 5- and-5 exemption. However, to the extent of C's remainder interest in the excess portion ($10,000 − $5,000 = $5,000) of that property, the gift tax does apply.

Accordingly, under section 2514(e) of the Code, S is treated as having made a gift to C of the excess $5,000 less the value of S's retained interest in the excess $5,000. The value of the taxable gift from S to C is computed as the difference between the $5,000 excess and the value of the right in S to receive the income for life from the excess $5,000.

In Situation 2,[2625] the statutory purpose of section 2514(e) of the Code to provide a limited exemption to the general rule that lapses of powers of appointment carry the same transfer tax consequences as releases and exercises would be thwarted if multiple exemptions were allowed. The allowance of multiple 5-and-5 exemptions would be inconsistent with the purpose of the statute. Moreover, as discussed above section 2514(e) applies the 5-and-5 exemption to the aggregate value of the assets out of which the lapsed powers could have been satisfied. Permitting separate 5-and-5 exemptions for multiple trusts would elevate form over substance by providing more favorable treatment where a transfer to a trust is restructured as multiple transfers to separate trusts.

Thus, in Situation 2, S is allowed one $5,000 exemption for the two powers that lapsed in 1982. As in Situation 1, S is considered to have made a gift to C of C's remainder interest in the $5,000 not covered by the exemption. In order to ensure that C's multiple powers are not treated less favorably than a single power in one trust fund, in Situation 2 the 5 percent test would be applied by aggregating the maximum amount in each trust subject to C's withdrawal powers with respect to such trust on the date of lapse of such powers during the calendar year.

[2625] [my footnote:] Situation 2 provides:

> In February 1982, G created two irrevocable trusts under which S was named the life income beneficiary and C was designated as the remainderman.
>
> In addition to the life income interest, S was given a power in each trust to withdraw $5,000 of the contributions made by any donor in any calendar year. The powers given S were exercisable under the same conditions as the powers in Situation 1.
>
> When the trusts were created, G contributed $5,000 to each. S was promptly notified of the contributions, but did not make a demand for withdrawal with respect to either contribution within the prescribed period. No further contributions were made to either trust in 1982. The two trusts were at all times administered in all respects as separate trusts.

HOLDINGS

In both Situations 1 and 2, S is considered to have made a transfer for federal gift tax purposes as a result of the lapse of S's power to withdraw to the extent that the aggregate amount subject to S's powers exceeds the $5,000 exemption provided in section 2514(e) of the Code. In each situation, the amount taxable is $5,000 less the value of S's retained interest in that amount.[2626]

Rev. Rul. 86-39 involved the following:

ISSUE

If the beneficiary of a trust possesses a general testamentary power of appointment over the trust corpus, if the trust holds stock of a closely held corporation, and if a recapitalization results in a shift in value from that trust to a second trust over which that beneficiary has no power of appointment, then for purposes of estate and gift taxation, is acquiescence in the recapitalization a release of the power of appointment?

FACTS

D owned 100 percent of the voting shares of X corporation. D died in 1980 and D's will provided for the creation of two testamentary trusts. Trust A provided D's spouse, S, with a lifetime income interest and a general testamentary power of appointment over the corpus. Trust A was funded with shares of X corporation common stock worth 120x dollars. Trust B provided S with a life income interest and C, D's child, with the remainder interest. Trust B was funded with shares of X corporation common stock worth 80x dollars. The trustees of Trust A and Trust B were unrelated to the decedent or the trust beneficiaries.

In 1982, the stock of X corporation was recapitalized, resulting in two new classes of stock, voting common and nonvoting preferred. Preferred stock worth 50x dollars was allocated to Trust A and common stock worth 150x dollars was allocated to Trust B. The trustees of Trust A acquiesced in the recapitalization, and S executed a release, valid under local law, in which S agreed not to challenge the trustee's action with respect to the recapitalization. S died in 1985, when the fair market value of the preferred stock held by Trust A was 55x dollars and the fair market value of the common stock held by Trust B was 225x dollars.

Citing Reg. § 25.2514-3(c)(4) and other authority, Rev. Rul. 86-39 reasoned and concluded:

Prior to the recapitalization, S, as beneficiary of Trust A, had an income interest in, and a general testamentary power of appointment over, the stock of X corporation worth 120x dollars and an income interest, as beneficiary of Trust B, in the remaining stock worth 80x dollars. As a result of the recapitalization, S, as beneficiary of Trust A, received an income interest in, and a general testamentary power of appointment over, a different class of stock worth 50x dollars and, as beneficiary of Trust B, received an income interest for life in stock worth 150x dollars. Although the total value of S's income interest in the two trusts was unchanged as a result of the recapitalization, the value of the

[2626] [my footnote:] Note that the final sentence is subject to part III.B.7.d Code § 2702 Overview.

corpus of Trust A over which S retained a general testamentary power of appointment decreased by 70x dollars, the excess of 120x dollars over 50x dollars.

By consenting to the reallocation of stock, the trustee of Trust A, accepted stock with a lesser value than the value held prior to the recapitalization. S, as the beneficiary of Trust A, could have asserted the right of a trust beneficiary under local law to prevent the trustee from permitting a loss in value of the trust assets. The execution of the release in which S agreed not to raise an objection to the trustee's conduct with respect to the recapitalization constitutes a release of a general testamentary power of appointment by S over stock worth 70x dollars.

For purposes of the gift tax, the release by S is treated as a transfer of property to C, the owner of the remainder interest in Trust B, for which S did not receive adequate and full consideration. See Rev. Rul. 84-105. The value of the gift from S to C as a result of the recapitalization of X corporation is equal to the present value of the remainder interest in 70x dollars' worth of stock that was shifted from Trust A to Trust B.

For purposes of the estate tax, the release of the general testamentary power of appointment over the remainder interest in the 70x dollars' worth of stock is treated as a transfer under which S, as the income beneficiary of Trust B, retained an income interest for life in the transferred stock. An actual transfer of such an interest would have resulted, upon S's death in 1985, in the portion of the Trust B corpus attributable to the value of the interest so transferred being includible in S's gross estate under section 2036. Thus, in this case, S's release of the power results in the inclusion of a portion of the corpus of Trust B in the gross estate under section 2041 of the Code to the same extent that the property would have been includible under section 2036 if there had been an actual transfer.

Letter Ruling 200736023 held:

In the present case, under the terms of Trust A, Daughter, during her lifetime, possesses the noncumulative right to withdraw the entire income of Trust A each year. Daughter also has a testamentary limited power to appoint Trust A corpus on her death. In addition, Daughter has the discretionary power as a co-trustee, to distribute corpus to herself for support, health, education, and maintenance. Daughter will possess the same rights and powers with respect to Trusts 1-3.

Daughter's discretionary power to distribute corpus to herself is limited by an ascertainable standard relating to her health, maintenance support and education. Therefore, this power does not constitute a general power of appointment under section 2041(b)(2). Therefore, possession of this power will not cause Trust A, or Trusts 1-3 to be included in Daughter's gross estate.

However, under Trust A, and under Trusts 1-3, Daughter does possess a noncumulative right, exercisable annually, to withdraw trust income. Trust income that is not withdrawn during the calendar year is accumulated. The accumulated income is remains subject to Daughter's testamentary limited power to appoint trust corpus. In accordance with section 2041(a)(2) and section 2041(b)(2), the net income of Trusts 1-3 over which Daughter will have a general power of appointment in the year of her death will be included in the gross estate of Daughter. In addition, a portion of the corpus of Trusts 1-3 will be includible in Daughter's gross estate to the extent the value of the property

> Daughter failed to withdraw annually with respect to Trust A and after the division, fails to withdraw annually from Trusts 1-3, exceeded (or exceeds) the greater of $5,000 or 5% of the aggregate value of the property, which could have been appointed by exercise of her lapsed powers. The portion of the corpus includible will be the portion attributable to such property. In accordance with Rev. Rul. 85-88, the 5 percent test under section 2041(b)(2) is based on the annual trust income of Trust A, and after the division, Trusts 1-3, and not the amount of trust corpus. Further, after the division, the 5 percent test is applied by aggregating the amount subject to withdrawal with respect to each trust, and only one $5000 exemption is allowed with respect to the multiple trusts.

Given *Fish*, the withdrawal right should refer to the entire trust. For example, instead of granting a $20,000 right to withdraw, the trustee grants the right to withdraw a fractional share of the trust, the numerator of which is $20,000 and the denominator of which is the value of the trust's assets. The right to withdraw would continue, lapsing each year only to the extent provided in Code § 2514(e). Because the lapse does not constitute a gift for gift tax purposes, the lapse does not cause a portion of the trust to be included in the beneficiary's estate for estate tax purposes. (The latter might be important even for QTIP marital deduction trusts that are included in the beneficiary's estate anyway, because the inclusion of such a trust's assets might be valued at a lower rate as a QTIP asset than as an incomplete gift or Code § 2036 asset.[2627]) If it is desirable to isolate the grantor trust portion from the nongrantor trust portion, see part III.B.2.i.viii Funding the Trust with a Large Initial Gift or Bequest, which is within the larger discussion of part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.

Consider language along the following lines to make the beneficiary the deemed owner of all of the gross income, taking into account the argument regarding the scope of the 5% lapse:[2628]

> The Primary Beneficiary shall have the right to withdraw all gross income (as defined for federal income tax purposes) accruing to the trust in each calendar year, including both ordinary income and capital gain income.[2629] Any income not withdrawn shall be added to principal and remain subject to withdrawal except to the extent the right of withdrawal lapses in accordance with the following sentence.[2630] On November 15 of the succeeding year and on November 15 of each subsequent year, any unexercised right of withdrawal shall lapse to the extent of 5% of the value of the trust on November 15 (or such larger amount that can lapse under section 2514(e) without being considered to be a transfer to the trust by the holder of the withdrawal right).[2631] If income accrues to the trust in a particular year that is not actually received by the trust by November 15 of the

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[2627] For the potentially lower valuation of QTIP assets, see fn. 3792.

[2628] This was drafted by Ellen Harrison and Carlyn McCaffrey, which they modified after I raised certain issues.

[2629] Having the withdrawal right be specific to income causes that income to be taxable to the beneficiary under Code § 678(a)(1).

[2630] If one attempted to lapse the withdrawal right while it was a right over income, only the income would be the base against which the lapse would be measured, as was the case in *Fish*. Converting the withdrawal right to being a right over principal the following year provides a larger base against which the lapse would be measured. Also, adding undistributed income to principal at the end of the year is pretty routine, so this sentence simply follows the natural course of action.

[2631] The 5% is Ellen's and Carlyn's language; I prefer to use only language along the lines of that found in the parenthetical. November 15 resulted from the issue pointed out in the next sentence of text, which is that the trust might receive income from a pass-through entity that might file its return on extension, so the trustee and therefore the beneficiary might not have enough information to measure the beneficiary's withdrawal right.

> succeeding year, such as from a partnership, limited liability company or subchapter S corporation, or is deemed to have been received by the trust under any other provision of the tax laws (such as section 951), the holder of the withdrawal right may direct the trustee to irrevocably assign to the holder the right to receive such income when it becomes available to the trustee or to satisfy the withdrawal right with other assets of the trust.[2632] The independent trustee may amend the trust to terminate the withdrawal right but any termination shall be prospective and shall only affect the right to withdraw income accruing after the effective date of the amendment.

Also consider modifying November 15 above to a more convenient valuation date, such as December 31.

I might edit the above clause to have the trustee credit the income to the beneficiary and get the income distribution deduction, then use the concept of the above clause to address the post-yearend hanging power. The first sentence of the sample language might be changed to say:

> I, the independent trustee, exercise my authority to distribute by declaring that, until I provide otherwise (see last sentence of this paragraph), the Primary Beneficiary shall have the right to withdraw all gross income (as defined for federal income tax purposes) accruing to the trust in each calendar year, including both ordinary income and capital gain income.

Then include the rest.

The IRS might resist applying the above clause to a pass-through entity, to the extent that the taxable income is not actually distributed to the trust. It has done so when a taxpayer asserts a charitable deduction for gross income reinvested in the pass-through entity; see *Sid W. Richardson Foundation v. U.S.*, 430 F.2d 710 (5th Cir. 1970), discussed in part II.Q.7.c.i.(a) Contribution Must Be Made from Gross Income. If the pass-through is an S corporation, consider using a QSST, as mentioned in part II.J.4.g Making the Trust a Complete Grantor Trust as to the Beneficiary. If the pass-through is a partnership, consider whether to place it in an S corporation as described in part II.J.4.g. (but when you read my discussion, you will see I mention some drawbacks to that strategy). I would tend to use that clause rather than the QSST approach primarily when the pass-through holding is small relative to the trust's other assets (such as when investing in a publicly-traded partnership).

Instead of the trustee making discretionary distributions so the beneficiary can pay taxes or otherwise enjoy the trust's income, first have the beneficiary exercise his or her withdrawal right.

As to the extent to which the continuing withdrawal right over principal or any lapses thereof make the beneficiary the deemed owner even if the withdrawal right has later been turned off, see part III.B.2.i.vii.(a) Determining Portion Owned When a Withdrawal Right Does Not Lapse in Full Before Any Income Is Earned.

Over time, the portion deemed owned by the beneficiary increases. See part III.B.2.i.vii.(b) Determining Portion Owned When Trust Is Only a Partial Grantor Trust, found within the larger discussion of part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.

[2632] This clause recognizes that pass-through entities frequently distribute to their owners less cash than the income appearing on the K-1s they issue. To give substance to the withdrawal right over the income the pass-through reinvested, the beneficiary is given the right to force the trustee to satisfy the withdrawal right with other assets.

For many more applications of the planning described in this part II.J.4.f, see Morrow, "IRC Section 678 and the Beneficiary Deemed Owner Trust (BDOT)" (5/6/2018, last revised 4/22/2021), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3165592.

A corollary to the planning described in this part II.J.4.f is to use the trustee's discretion to make distributions for welfare as a vehicle to modify the trust to grant the beneficiary a formula general power of appointment to get a basis step-up.[2633]

II.J.4.g. Making the Trust a Complete Grantor Trust as to the Beneficiary

Generally, a nongrantor trust can offset deductions directly against income. However, generally the deemed owner of a grantor trust will report deductions as itemized deductions; note that administrative deductions are deducted against a nongrantor trust's income but are potentially disallowed on an individual deemed owner's return.[2634] Thus, being a grantor trust tends to save income tax only if the deemed owner has an overall lower federal, state, and local income tax rate that the trust; see part II.J.3.a Who Is Best Taxed on Gross Income.

If the beneficiary being taxed on the trust's income is desirable, whether because of rates or a desire to accumulate funds in the trust, then consider converting the trust to a qualified subchapter S trust (QSST).[2635]

The trust forms an S corporation, the trust is modified as needed to be eligible for a QSST election, and the beneficiary makes a QSST election.

The beneficiary is taxed on the trust's distributive share of the S corporation's income.

Although the trust must distribute all of its income, income generally means distributions from the S corporation, and the trustee as the sole shareholder can control how much the S corporation distributes.[2636] Note that the trust can continue to be a discretionary trust as to income if all of the income is actually distributed.[2637] Mandatory income is safer in that it prevents a misstep in not distributing enough income, but in some cases the flexibility is more important (in a mandatory income trust, the beneficiary might pressure the trustee to distribute more from the S corporation).

Unlike the partial grantor trust strategy mentioned above, this trust's beneficiary grantor status can be toggled off, with income being accumulated in the trust.[2638]

[2633] See Letter Ruling 202206008 and related planning, as described in the text accompanying and preceding fn 2129 in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.
[2634] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment and fns 2502 and 2508 in part II.J.3.d Who Benefits Most from Deductions.
[2635] See parts III.A.3.e.i.(a) QSSTs Generally and III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs.
[2636] See part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries and III.A.4 Trust Accounting Income Regarding Business Interests.
[2637] See parts III.A.3.e.i.(a) QSSTs Generally (especially fn. 5971) and III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.
[2638] See part III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.

Before engaging in this approach, be careful to plan an exit strategy upon termination.[2639] Also consider that, if the trust is includible in the beneficiary's estate, the S corporation's assets do not get an inside basis step-up, although in some circumstances it may be possible to replicate one. See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

II.J.4.h. Trapping Income in Trust Notwithstanding Distributions

This part II.J.4.h includes not only affirmative planning opportunities (part II.J.4.h.i Trapping Income in Trust Notwithstanding Distributions – ESBT) but also warnings (part II.J.4.h.ii Final Year Income Tax Traps).

II.J.4.h.i. Trapping Income in Trust Notwithstanding Distributions – ESBT

Just as in the above strategy, the trust forms an S corporation, only this time makes an electing small business trust (ESBT) election[2640] or creates another trust.

The trust's distributive share of S corporation income is taxed to the trust, even if distributed to the beneficiary.

To better control the effect of distributions, if the trust reinvests its distributions in taxable investments then it should divide and put those assets in a separate trust.[2641]

If circumstances change, the trust could toggle to being taxed to the beneficiaries.[2642]

Before engaging in this approach, be careful to plan an exit strategy upon termination.[2643]

II.J.4.h.ii. Final Year Income Tax Traps

Many of the ideas in this part II.J.4.h.ii come from Boyle, Jones and Blattmachr, "Unexpected Income Tax Surprises for Fiduciaries," Probate Practice Reporter, Vol. 32, Nos. 10-11 (Oct. and Nov. 2020) (as used in this part II.J.4.h.ii, the "Article").

An estate may have substantial gain from satisfying pecuniary bequests, which does not carry out to the recipient of the pecuniary bequest. See part II.J.8.d.i Distribution in Kind - Generally. Sometimes pecuniary bequests exceed available assets.

Generally, a specific bequest does not carry out income, either. See part II.J.8.d.ii Specific Bequest.

A subheading of the 10/2020 Article, "Gross Income Exceeds Allowable Deductions," explains:

> If an estate has income in its final year, but also has expenses that are not income tax deductible, then the amount available to distribute to the beneficiaries may be less than

[2639] See parts III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts (Whether or Not a Sale Is Made) and III.A.3.e.i.(b) QSST Issues When Beneficiary Dies.
[2640] See part III.A.3.e.ii Electing Small Business Trusts (ESBTs.
[2641] See part III.A.3.e.ii.(c) When ESBT Income Taxation Might Help.
[2642] See part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSSTs.
[2643] See parts III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts (Whether or Not a Sale Is Made) and III.A.3.e.i.(b) QSST Issues When Beneficiary Dies.

the amount of gross income recognized on the final return. Thus, if the only assets that remain for distribution to beneficiaries are cash and property with a basis (or fair market value, if lower) that is less than the amount of DNI, the distribution deduction will not reduce the income tax liability to zero. Nondeductible expenses might include debts of the decedent (claims against the estate), liens against estate assets such as mortgages, state death taxes, or administration expenses that were elected under section 642(g) to be deducted on the estate tax return rather than on an income tax return.

Example 1: In its final year, an estate sells its sole remaining asset for $200,000. The asset has a $100,000 basis and is subject to a $100,000 mortgage. $40,000 of the proceeds of the sale are used to pay non-deductible expenses. The gain realized is $100,000, but the net cash flow is only $60,000 ($200,000 proceeds, less $100,000 mortgage, and less $40,000 of debts). In the final year, only a maximum of $60,000 of the $100,000 gain may be included in the estate's DNI because capital gain is included in DNI only when actually distributed. Therefore, a complete distribution of the net cash will provide only a $60,000 distribution deduction and the estate remains taxable on $40,000, but the fiduciary has no funds to pay the income tax.

In Example 1, the personal representative should withhold a portion of the $60,000 to pay income taxes. UPIA section 505 provides that income taxes are charged against receipts of income, so withholding a portion of the net proceeds is generally authorized by state law. This withholding has the potential to involve an "interrelated" computation because, when additional amounts of the cash are retained rather than distributed, the distribution deduction is smaller, causing the amount of the income tax due to increase. For example, if a combined 40 percent federal and state tax rate is assumed, the personal representative may distribute only $33,000 and must withhold nearly $27,000 to pay income taxes on $67,000 of net income (that is $100,000, less a $33,000 distribution deduction times 40 percent).

For more on the trustee's right to pay taxes before making mandatory distributions of income, see parts III.A.4 Trust Accounting Income Regarding Business Interests and III.F.2 Trust Accounting and Taxation. A formula for the interrelated calculation is found in part III.A.4.d.vi Appendix to 505 Discussion.

An estate may have substantial ordinary income from receiving income in respect of a decedent. See part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up. Example 2 of the 10/2020 Article explains:

An estate is about to close and the only asset remaining for distribution is the decedent's $1 million IRA. To close the estate, the personal representative of the estate withdraws $100,000 to pay nondeductible expenses. The $100,000 withdrawn from the IRA is gross income. A distribution of the remainder of the IRA (or any other rights to an IRD item of income) in-kind will not, by reason of section 643(e)(2), give rise to a section 661 distribution deduction. Therefore, the estate has $100,000 of taxable income in the final year.

A trust that distributes all of its DNI may still be subject to NII tax; see part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles.

Depreciation can pass directly to beneficiaries, leaving more taxable income than expected. See part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses).

An executor or trustee is liable if that person distributes assets before paying the estate's/trust's taxes. See generally parts III.B.5.e.iv Federal Estate Tax Liens and III.B.5.e.v Transferee Liability. When a trust/estate terminates, I tend to recommend:

- Filing Form 4810, which is described in part III.B.5.e.iv.(g) How to Avoid the Pitfalls of the Estate Tax Lien, to cut short the statute of limitations for the IRS to audit returns.

- Reserving enough cash to defend an audit and pay any tax, interest, and penalties that may be due. Retaining a cash reserve does not prevent the estate/trust from terminating for income tax purposes (although keeping it in an interest-bearing account may generate awkward fiduciary income tax returns filing requirements); see part II.J.3.i Planning for Excess Losses.[2644]

- Obtaining an agreement from the residual beneficiaries to return distributions to the extent needed to pay any tax, interest, and penalties that may be due. Usually the fiduciary would rather not have to try to collect from those beneficiaries, so that agreement is just in case the reserve is insufficient. The residual beneficiaries are also liable for any such tax, interest, and penalties; see part III.B.5.e.v Transferee Liability.

II.J.4.i. Modifying Trust to Make More Income Tax Efficient

In some states, the settlor and all beneficiaries may amend a noncharitable irrevocable trust, even if the modification or termination is inconsistent with a material purpose of the trust.[2645]

Also, depending on the distribution standard and state law, the trustee might be able to change a trust using decanting.[2646] Decanting might be done by merely amending the trust rather than by actually transferring assets to another trust.[2647] If the trust's situs has moved since inception, the trust's situs (not the substantive law of the original state) determines authority to decant through merger.[2648] If decanting is done using asset transfers to a new trust, see parts II.G.1 How and When to Obtain or Change an Employer Identification Number (EIN) and II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.

See also part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner, especially fns 6956-6958.

2644 Text accompanying fn 2563

2645 Uniform Trust Code § 401, found at http://www.uniformlaws.org/Act.aspx?title=Trust Code; R.S.Mo. § 456.4A-411, found at http://www.moga.mo.gov/mostatutes/stathtml/45604A04111.html.

2646 See part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting. Before considering decanting a QSST, see part III.A.3.e.i.(a) QSSTs Generally.

2647 For details on decanting by mere amendment, see fn. 2960, found in part II.J.18.c.i What Is Decanting.

2648 Letter Ruling 201711002, described in detail in part II.J.18.c.ii Tax Consequences of Decanting.

II.J.4.j. Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure

II.J.4.j.i. Need to Provide Notices

In Missouri and many other states, a beneficiary can sue a trustee any time before five years after the first to occur of the trustee's removal, resignation, or death of the trustee, the termination of the beneficiary's interest in the trust, or the trust's termination.[2649]

However, a beneficiary may not sue a trustee more than one year after the last to occur of the date the beneficiary or a representative of the beneficiary was sent a report that adequately disclosed the existence of a potential claim for breach of trust and the date the trustee informed the beneficiary of the time allowed for commencing a proceeding with respect to any potential claim adequately disclosed on the report.[2650]

A report adequately discloses the existence of a potential claim if it provides sufficient information so that the beneficiary or representative knows of the potential claim or should have inquired into its existence.[2651] The trustee may choose to disclose less than complete information; in that case, the trustee is protected only with respect to the information that is disclosed.

The trustee might want to consider providing accountings or other notices to the beneficiaries that would start running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile this one on top of it. Given that a beneficiary's failure to bring a claim might constitute a gift,[2652] allowing any disputes to settle annually might minimize gift tax issues.

[2649] Section 1005(c) of the Uniform Trust Code (http://www.uniformlaws.org/Act.aspx?title=Trust Code), provides:

> (c) If subsection (a) does not apply, a judicial proceeding by a beneficiary against a trustee for breach of trust must be commenced within five years after the first to occur of:
> (1) the removal, resignation, or death of the trustee;
> (2) the termination of the beneficiary's interest in the trust; or
> (3) the termination of the trust.

Missouri's version is R.S.Mo. § 456.10-1005, found at http://www.moga.mo.gov/mostatutes/stathtml/45601010051.html.

[2650] Section 1005(a) and (b) of the Uniform Trust Code (http://www.uniformlaws.org/Act.aspx?title=Trust Code), provide:

> (a) A beneficiary may not commence a proceeding against a trustee for breach of trust more than one year after the date the beneficiary or a representative of the beneficiary was sent a report that adequately disclosed the existence of a potential claim for breach of trust and informed the beneficiary of the time allowed for commencing a proceeding.
> (b) A report adequately discloses the existence of a potential claim for breach of trust if it provides sufficient information so that the beneficiary or representative knows of the potential claim or should have inquired into its existence.

Missouri's version is R.S.Mo. § 456.10-1005, found at http://www.moga.mo.gov/mostatutes/stathtml/45601010051.html.

[2651] Uniform Trust Code § 1005(b), found at http://www.uniformlaws.org/Act.aspx?title=Trust Code; R.S.Mo. § 456.10-1005.2, found at http://www.moga.mo.gov/mostatutes/stathtml/45601010051.html.

[2652] The failure to assert a claim is a gift when the right to assert the claim becomes foreclosed, Rev. Rul. 84-105, which is described in part III.B.1.b Transfers for Insufficient Consideration, Including

Each year, after a tax return preparer's peak period ends, the preparer might consider suggesting that the trustee contact counsel and obtain help in putting together an annual notice. The tax return preparer can compile the information, especially given that many preparers keep records in PDFs and can easily download them to a flash drive or memory stick. Part II.J.4.j.ii provides an example of what that might look like.

Every trustee should consider following this procedure:

- Litigious Beneficiaries. Having as few years as possible open will help reduce the stakes and make it less worthwhile for them to spend money to take legal action. Annual notices require them to state their concerns now, rather the criticizing many years in the future – put up or shut up. And, if the trustee has made a mistake (nobody's perfect), the trustee is in a better position to rectify it now than after the mistake's effects have been compounded for many years.

- One Big Happy Family. Sure, everyone's happy now. But relationships can change overnight – a beneficiary gets divorced, has a business failure, becomes addicted to drugs, is struck by physical or mental illness that changes his or her outlook on life, undergoes other financial or emotional stress, or simply starts disliking the trustee. Provide notices now, while everyone is happy and unlikely to complain. Besides, the trustee generally should be keeping beneficiaries informed anyway. Notices now can prevent a big claim later if a blow-up occurs.

Generally, a trustee may use the trust's resources to provide notices, respond to questions, provide distributions to some beneficiaries to adjust for perceived unfairness in distributions to other beneficiaries, and defend lawsuits (so long as the trustee did not engage in bad faith or reckless indifference to the beneficiaries' interests).

Countervailing this recommendation are concerns about the effect of notices on the beneficiaries themselves. The trustee might be concerned that knowing that a pool of funds is available for a beneficiary might change the beneficiary's behavior – make the beneficiary more interested in draining the trust than earning a living, generate a sense of entitlement, or encourage the beneficiary to ask the grantor or the grantor's surviving spouse for money. The trustee will need to weigh those concerns against the trustee's legal exposure and general duties to provide information and might even decide that serving as trustee is too thankless a task. Better to think about these issues now and with eyes opened than to encounter a surprise.

Restructuring Businesses or Trusts. Reg. §§ 20.2041-1(b)(1) (estate tax) and 25.2514-1(b)(1) (gift tax) provide:

> … the right in a beneficiary of a trust to assent to a periodic accounting, thereby relieving the trustee from further accountability, is not a power of appointment if the right of assent does not consist of any power or right to enlarge or shift the beneficial interest of any beneficiary therein.

If somehow the consent does somehow consist of any power or right to enlarge or shift a beneficial interest, note that a principal/income allocation generally is only a few percent, and a beneficiary's failure to object to an accounting – if somehow characterized as a lapse of a general power of appointment - might very well be less than the 5% lapse of a general power of appointment that, under Code § 2514(e), does not constitute a gift. Having an annual report may keep the grievances within the 5% range. For more details on calculating the 5% lapse, see fn 6125 in part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts (Whether or Not a Sale Is Made).

II.J.4.j.ii. Sample Notice

After this paragraph, the rest of this part II.J.4.j.ii is a shell of a notice I have used. The trustee should consult with the trustee's own legal counsel to determine the advisability and sufficiency of such a notice under the circumstances.

Re: Trustee's Notice re: [trust's name]

As you know, the [trust's name] (the "Trust") was created by the [name of trust agreement].

As a beneficiary of the Trust, and on behalf of any other current or future beneficiaries of the Trust, you have the right to request a copy of the [name of trust agreement] and to receive information about the Trust's investments and other activity.

[Disclose any related party transactions.]

The enclosed flash drive contains the following information for the Trust for the period of January 1, 20xx, through December 31, 20xx:

1. [any trust accounting regularly prepared]

2. [brokerage statements]: January 1, 20xx, through December 31, 20xx

3. 20xx Fiduciary Income Tax Return for the Trust

4. Investment policy for [brokerage account or for trust as a whole]

If you have any questions with respect to this letter and the information contained on the enclosed flash drive, or if you have any difficulty accessing the information, please contact me. If you want to make a claim that I, as trustee, have breached any duty with respect to the Trust, you have one (1) year from the last to occur of (i) the date on which you (or your representative) were sent a report that adequately disclosed the existence of potential claim for breach of trust, and (ii) the date you were informed of the time allowed for commencing a proceeding with respect to any potential claim adequately disclosed on the report.

Attached you will find an Acknowledgement confirming receipt of this information. Please sign and date the acknowledgement and return it via fax or email to my attention.

Thank you.

[closing]

[page break]

<u>ACKNOWLEDGEMENT</u>

On my behalf and on the behalf of any other current or future beneficiaries, I hereby acknowledge receipt of the Trustee's Notice to the beneficiaries of the [trust's name], which includes reports relating to the trust's activities for the period January 1, 20xx, through December 31, 20xx.

[signature line and date blank]

II.J.5. Mandatory Income Trusts

II.J.5.a. Issues Arising with Mandatory Income Trusts

The whole point to Code § 661(a)(1) or 651(a) is that fiduciary accounting income (FAI) required to be distributed – as contrasted with actually distributed – is deductible by the trust and included in income. That avoids needing to calculate FAI during the taxable year. Instead, you calculate it when doing the tax return and make any distributions that were required to be made within a reasonable amount of time (because of fiduciary duties) after FAI was calculated.

Reg. § 1.651(a)-2(a) includes:

> The fiduciary must be under a duty to distribute the income currently even if, as a matter of practical necessity, the income is not distributed until after the close of the trust's taxable year. For example: Under the terms of the trust instrument, all of the income is currently distributable to A. The trust reports on the calendar year basis and as a matter of practical necessity makes distribution to A of each quarter's income on the fifteenth day of the month following the close of the quarter. The distribution made by the trust on January 15, 1955, of the income for the fourth quarter of 1954 does not disqualify the trust from treatment in 1955 under section 651, since the income is required to be distributed currently. However, if the terms of a trust require that none of the income be distributed until after the year of its receipt by the trust, the income of the trust is not required to be distributed currently and the trust is not a simple trust.

As to the last sentence, a trust agreement never ***requires*** waiting until after yearend. Often distributions are made throughout the year based on actual income, perhaps with reserves to the extent that estimated amounts are used. I think the timing is more of a fiduciary than a tax issue, with the fiduciary communicating with the beneficiary and setting reasonable expectations for all.

Mandatory income trusts may provide additional planning options under part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI). Consider how timing under Reg. § 1.651(a)-2(a) coordinates with deciding whether to exercise a power to adjust to treat capital gain as FAI and therefore DNI, as described in part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law. Other than a nonexclusive example approving a 15-day delay, no guidance discusses the parameters for how much delay in determining income satisfies "practical necessity" under Reg. § 1.651(a)-2(a). Because FAI is reported on each fiduciary income tax return for a (nongrantor) mandatory income trust, often the tax return preparer will compute FAI and communicate with the trustee regarding the amount of FAI so that they agree on what number to use as FAI in Form 1041, page 2, Schedule B. Just as an outside CPA communicates adjusting journal entries and similar entries to an accounting client after yearend and works with a company's internal accounting staff, a tax return preparer would communicate similar information to a trustee. Absent clear guidance about how these adjustments interact with the "practical necessity" standard, I view this industry custom to provide substantial authority for adjusting FAI when the tax return preparer communicates with the trustee. Therefore, when the preparer puts together a draft of the return, the preparer may communicate with the trustee regarding FAI. The trustee may decide to exercise a power to adjust under part II.J.5.b.ii Power to Adjust or Convert to/from a Unitrust, especially part II.J.5.b.ii.(a) Power to Adjust. Any adjustment to FAI would change the amount required to be distributed. Because this timing is not coordinated with the 65-day rule under I.R.C. § 663(b), any adjustment satisfying the "practical necessity" standard could retroactively be required to be distributed.

Therefore, if the Discretionary Principal Rule could not be applied to distributions made after March 5/6 (see part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary), presumably because information was unavailable at that time, as a "practical necessity" it may be reasonable for the power to adjust to be made and the full FAI distributed sometime after the March 5/6 deadline.

For very important limitations on the use of the Code § 642(c) charitable deduction, see fns. 2567-2568 in part II.J.4.c Charitable Distributions.

Some of the interplay between entities and trusts is described in parts III.A.4 Trust Accounting Income Regarding Business Interests and III.F.2 Trust Accounting and Taxation.

Also consider what happens when a trust holds only illiquid business assets and the trust needs to pay the trustee fee. Generally, one-half of trustee fees and certain other administrative expenses is allocated to income and one-half to principal.[2653] Using the trust's income to pay trustee fees, etc. attributable to would be problematic. Consider:

- Draft into the trust agreement language flexible enough to opt out of this general rule.[2654]

- Consider exercising a power to adjust, reclassifying some of the entity's distributions from income to principal, if the income that the business generates after the adjustment fairly balances the interests of the income beneficiary and remaindermen.[2655]

- Consider that the trustee might not have any significant activities directly on behalf of the trust and might instead spend most of his or her time running the business entity. This would especially be true if the entity was formed to hold investment assets. Perhaps the business entity should pick up a large majority of the burden of compensating the trustee, so that the above two recommendations are more palatable?

- Have the entity make noncash distributions, which generally are treated as principal.[2656] The trust can then sell those assets and use the proceeds to pay trustee fees. Note that a distribution of property is a recognition event for corporations[2657] and might be a recognition event for partnerships,[2658] so consider distributing high basis assets (which the entity might need to purchase).

Also consider whether the trustee needs to sell part of the unmarketable asset or planning to avoid this issue.[2659]

[2653] Section 501 of the Uniform Principal & Income Act.
[2654] See part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law, especially the text in fn. 2765.
[2655] See part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law, especially the text in fn. 2662.
[2656] Section 401(c)(1) of the Uniform Principal & Income Act.
[2657] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.
[2658] See part II.Q.8.b.i Distribution of Property by a Partnership.
[2659] See parts III.A.4.d.iv.(b) What the Trustee Must Do to Alter the Trust's Investments If the Trust Agreement Does Not Address the Issue and III.A.4.d.iv.(c) How to Minimize Disputes About What the Trustee Should Do.

II.J.5.b. Uniform Fiduciary Income & Principal Act (UFIPA)

II.J.5.b.i. General Ideas in UFIPA

A fiduciary determines trust accounting income by analyzing the character of the trust's receipts and disbursements, which are not necessarily tied to the trust's taxable income. This part II.J.5.b refers to trusts and trustees as a shorthand for any type of fiduciary arrangement (including an estate) or fiduciary (including a personal representative/executor; UFIPA (see below) section 103 determines the scope and section 102 provides definitions of "fiduciary" and "terms of the trust" refer to other trust-like arrangements (including life estates) to which this discussion applies.

At its July 2018 annual meeting, the Uniform Law Commission approved the Uniform Fiduciary Income & Principal Act (UFIPA). The drafting committee chair was Turney Berry; the "reporter" who drafted the results of the committee's decisions was Ron Aucutt; and, as an ACTEC observer, I had significant input into the process.

UFIPA re-wrote the Uniform Principal & Income Act ("UPIA" in this part II.J.5.b), the 2008 limited changes to which I served as the reporter.

In those states that adopt UFIPA/UPIA (the "Act" in this part II.J.5.b), the Act serves as rules that apply if and to the extent that the governing instrument does not provide different results ("default rules in this part II.J.5.b). UFIPA § 201(a) provides:[2660]

> In making an allocation or determination exercising discretion under this [act], a fiduciary shall:
>
> (1) act in good faith, based on what is fair and reasonable to all the beneficiaries;
>
> (2) administer a trust or estate impartially, except to the extent terms of the trust manifest an intent that the fiduciary shall or may favor one more beneficiaries;
>
> (3) administer the trust or estate in accordance with the terms of the trust, even if there is a different provision in this [act]; and
>
> (4) administer the trust or estate in accordance with this [act], except to extent the terms of the trust provide otherwise or authorize the fiduciary to determine otherwise.

Although the terms of a trust and UFIPA describe what happens under state law, the tax laws might not respect a provision that strays too far from traditional fiduciary accounting income (FAI) principles.[2661]

II.J.5.b.ii. Power to Adjust or Convert to/from a Unitrust

Mandatory income trusts can cause conflicts between the income beneficiary, who tends to want the trustee to invest to generate current income, and the remaindermen, who tend to want the trustee to invest to generate long-term growth in principal. However, investing for long-term

[2660] For UPIA's counterpart, see fn 2762 in part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.
[2661] See part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

growth may increase long-term income, so all parties may benefit from investing for growth – especially if the trustee can count some of this growth as income.

UFIPA recognizes this solution by providing a power to adjust (see part II.J.5.b.ii.(a)) or to convert to/from a unitrust (see part II.J.5.b.ii.(b) Unitrust).

II.J.5.b.ii.(a). Power to Adjust

The power to adjust authorizes the trustee to divide the trust's total realized return, meaning income and realized gains, between income and principal. For example, if a reasonable income distribution rate is 3% and the total realized return is 8%, but traditional income included in the total realized return is only 2%, then the trustee would exercise the power to adjust by allocating 3% of the total realized return, consisting of 2% traditional income distribution rate and 1% from the realized gains. In other words, capital gains comprising 1% of the total return would be reallocated from trust accounting principal to trust accounting income. If desirable, the trustee would then be able to include that reallocated 1% capital gain to distributable net income (DNI), so that the income beneficiary would pay tax at his or her rates, rather than the capital gain possibly being taxed to the trust at its perhaps higher rates. See parts II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law and II.J.3.a Who Is Best Taxed on Gross Income.

Under UPIA, a trustee may adjust between principal and income to the extent the trustee considers necessary if:[2662]

- The trustee invests and manages trust assets as a prudent investor,
- The trust's terms describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and
- The trustee determines that the adjustment is necessary to fulfill the trustee's duty of impartiality between the beneficiaries.

The impartiality component recognizes that an income beneficiary would want the trustee to invest for income and the remaindermen want the trustee to invest for growth. A prudent investor would tend to invest for both income and growth and make fair distributions of total return to the income beneficiary. The power to adjust authorizes the trustee to invest for total return and allocate part of the growth component to the income beneficiary. If the trustee is actually distributing the capital gain to the income beneficiary as part of a fair sharing of the trust's total return, then it would seem fair to tax the income beneficiary on the capital gain that the income beneficiary receives. Depending on the overall situation, it might also be fair to include in that adjustment compensation for the taxes the income beneficiary pays on those capital gains.[2663] Often, the trustee couches the power to adjust in terms of a target percentage of the trust's value; however, the trustee might vary the target percentage as the trustee deems appropriate.

[2662] UPIA § 104(a).
[2663] See part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the .

UPIA prescribes a number of the factors the trustee should consider[2664] and circumstances that limit or prevent the exercise of this power.[2665] Illinois has a more concise power to adjust that is in some ways more flexible and in some ways less flexible than UPIA.[2666]

Under UPIA, because the adjustment must be necessary to fulfill the trustee's duty of impartiality between the beneficiaries, presumably the power to adjust would not apply when the same standards apply to the distribution of income and principal.

However, UFIPA § 203(a) requires only that the trustee determine that "the exercise of the power to adjust will assist the fiduciary to administer the trust or estate impartially." Thus, UFIPA requires only that the power to adjust will be helpful, not necessary. UFIPA also clarifies that the trustee is not liable for failing to exercise the power[2667] and provides that the trustee is not liable for any decision regarding the power made in good faith.[2668] The fiduciary has wide latitude regarding the periods to which any such adjustment applies[2669] but is subject to reporting requirements.[2670]

In deciding whether and to what extent to exercise the power to adjust, a fiduciary must consider all factors the fiduciary considers relevant, including relevant factors in UFIPA § 201(e)

[2664] UPIA § 104(b).

[2665] UPIA § 104(c).

[2666] 760 ILCS 15/3(b)(2) authorizes the trustee to use discretion in allocating receipts to income or principal:

> if the trustee in the trustee's discretion determines that application of the provisions of this Act would result in a substantial inequity to either the income beneficiaries or the remaindermen, in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as those entitled to principal.

[2667] UFIPA § 203(b) provides:

> This section does not create a duty to exercise or consider the power to adjust under subsection (a) or to inform a beneficiary about the applicability of this section.

[2668] UFIPA § 203(c) provides:

> (c) A fiduciary that in good faith exercises or fails to exercise the power to adjust under subsection (a) is not liable to a person affected by the exercise or failure to exercise.

[2669] UFIPA § 203(j) provides:

> (j) The exercise of the power to adjust under subsection (a) in any accounting period may apply to the current period, the immediately preceding period, and one or more subsequent periods.

[2670] UFIPA § 203(k) requires a description of the exercise of the power to adjust to be:

> (1) included in a report, if any, sent to beneficiaries under [Uniform Trust Code Section 813(c)]; or
>
> (2) communicated at least annually to [the qualified beneficiaries determined under [Uniform Trust Code Section 103(13)], other than [the Attorney General]][all beneficiaries that receive or are entitled to receive income from the trust or would be entitled to receive a distribution of principal if the trust were terminated at the time the notice is sent, assuming no power of appointment is exercised].

and the application of UFIPA § 401(i),[2671] 408,[2672] or 413 (the latter being a general marital deduction savings clause).[2673]

UFIPA 201(e) provides factors a fiduciary must consider in deciding whether to exercise the power to adjust under UFIPA § 203, convert an income trust to a unitrust under UFIPA § 303(a)(1), change the percentage or method used to calculate a unitrust amount under UFIPA § 303(a)(2), or convert a unitrust to an income trust under UFIPA § 303(a)(3), all of which are exercisable "if the fiduciary determines the exercise of the power will assist the fiduciary to administer the trust or estate impartially."[2674] UFIPA § 201(e) provides the following factors:

(1) the terms of the trust;

(2) the nature, distribution standards, and expected duration of the trust;

(3) the effect of the allocation rules, including specific adjustments between income and principal, under Articles 4 through 7;

(4) the desirability of liquidity and regularity of income;

(5) the desirability of the preservation and appreciation of principal;

(6) the extent to which an asset is used or may be used by a beneficiary;

(7) the increase or decrease in the value of principal assets, reasonably determined by the fiduciary;

[2671] UFIPA § 401(i) provides:

> If a fiduciary receives additional information about the application of this section to an entity distribution after the fiduciary has paid part of the entity distribution to a beneficiary, the fiduciary is not required to change or recover the payment to the beneficiary but may consider that information in determining whether to exercise the power to adjust under Section 203.

[2672] UFIPA § 408 authorizes an independent fiduciary to ignore various insubstantial allocations to income (and allocate all to principal). Subsection (b) authorizes a fiduciary to presume an allocation is insubstantial if:

(1) the amount of the allocation would increase or decrease net income in an accounting period, as determined before the allocation, by less than 10 percent; and
(2) the asset producing the receipt to be allocated has a fair market value less than 10 percent of the total fair market value of the assets owned or held by the fiduciary at the beginning of the accounting period.

In addition to restrictions on exercising this power found within UFIPA § 408, UFIPA § 203(e) restricts the exercise of the UFIPA § 408 power; see fn 2675 and accompanying text.

[2673] UFIPA § 413, "Marital Deduction Property Not Productive of Income," provides:

> If a trust received property for which a gift or estate tax marital deduction was allowed and the settlor's spouse holds a mandatory income interest in the trust, the spouse may require the trustee to make property productive of income, convert property to property productive of income within a reasonable time, or exercise the power to adjust under Section 203, to the extent the trust assets otherwise do not provide the spouse with sufficient income from or use of the trust assets to qualify for the deduction. The trustee may decide which action or combination of actions to take.

[2674] UFIPA § 201(d).

(8) whether and to what extent the terms of the trust give the fiduciary power to accumulate income or invade principal or prohibit the fiduciary from accumulating income or invading principal;

(9) the extent to which the fiduciary has accumulated income or invaded principal in preceding accounting periods;

(10) the effect of current and reasonably expected economic conditions; and

(11) the reasonably expected tax consequences of the exercise of the power.

A fiduciary may not exercise the power to adjust:[2675]

(1) if the adjustment or determination would reduce the amount payable to a current income beneficiary from a trust that qualifies for a special tax benefit, except to the extent the adjustment is made to provide for a reasonable apportionment of the total return of the trust between the current income beneficiary and successor beneficiaries;

(2) if the adjustment or determination would change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets under the terms of the trust;

(3) if the adjustment or determination would reduce an amount that is permanently set aside for a charitable purpose under the terms of the trust, unless both income and principal are set aside for the charitable purpose;

(4) if possessing or exercising the power would cause a person to be treated as the owner of all or part of the trust for federal income tax purposes;

(5) if possessing or exercising the power would cause all or part of the value of the trust assets to be included in the gross estate of an individual for federal estate tax purposes;

(6) if possessing or exercising the power would cause an individual to be treated as making a gift for federal gift tax purposes;

(7) if the fiduciary is not an independent person;[2676]

[2675] UFIPA § 203(e), which also precludes determining that an allocation is insubstantial under UFIPA § 408.

[2676] [This footnote is not in UFIPA § 203(e)(7).] UFIPA § 102(10) defines an "independent person as a parson that is not:

(A) for a trust:

(i) [a qualified beneficiary determined under [Uniform Trust Code Section 103(13)]][a beneficiary that is a distributee or permissible distributee of trust income or principal or would be a distributee or permissible distributee of trust income or principal if either the trust or the interests of the distributees or permissible distributees of trust income or principal were terminated, assuming no power of appointment is exercised];

(ii) a settlor of the trust; or

(8) if the trust is irrevocable and provides for income to be paid to the settlor and possessing or exercising the power would cause the adjusted principal or income to be considered an available resource or available income under a public-benefit program; or

(9) if the trust is a unitrust under Article 3.

However, if (4), (5), (6), or (7) above applies to a fiduciary but do not limit a co-fiduciary, the co-fiduciary may exercise the power to adjust, unless the exercise of the power by the remaining co-fiduciary or co-fiduciaries is not permitted by the terms of a trust or applicable law.[2677] If there is no such co-fiduciary, the fiduciary may appoint such a co-fiduciary, which may be a special fiduciary with limited powers, and the appointed co-fiduciary may exercise the power to adjust, unless the appointment of a co-fiduciary or the exercise of the power by a co-fiduciary is not permitted by the terms of the trust or applicable law.[2678]

Furthermore, a fiduciary may release or delegate to a co-fiduciary[2679] the power to adjust if the fiduciary determines that possessing or exercising the power to adjust will or may cause a result described in (1) through (6) or (8) above; or deprive the trust of a tax benefit or impose a tax burden not described in (1) through (6) above.[2680]

For tax issues regarding the power to adjust, see part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

Terms of a trust which deny or limit the power to adjust between income and principal do not affect the application of UFIPA § 203, unless the terms of the trust expressly deny or limit the power to adjust.[2681]

(iii) an individual whose legal obligation to support a beneficiary may be satisfied by a distribution from the trust;

(B) for an estate, a beneficiary;

(C) a spouse, parent, brother, sister, or issue of an individual described in subparagraph (A) or (B);

(D) a corporation, partnership, limited liability company, or other entity in which persons described in subparagraphs (A) through (C), in the aggregate, have voting control; or

(E) an employee of a person described in subparagraph (A), (B), (C), or (D).

[2677] UFIPA § 203(f)(1).

[2678] UFIPA § 203(f)(2).

[2679] UFIPA § 203(h) provides that such a release or delegation to a co-fiduciary of the power to adjust:

(1) must be in a record;

(2) applies to the entire power to adjust under subsection (a), unless the release or delegation in the record provides a limitation, which may be a limitation to the power to adjust:

(A) from income to principal;

(B) from principal to income;

(C) for specified property; or

(D) in specified circumstances;

(3) for a delegation, may be modified by a re-delegation under this subsection by the co-fiduciary to which the delegation is made; and

(4) subject to paragraph (3), is permanent, unless the release or delegation in the record provides a specified period, including a period measured by the life of an individual or the lives of more than one individual.

[2680] UFIPA § 203(g).

[2681] UFIPA § 203(i).

II.J.5.b.ii.(b). Unitrust

UFIPA Article 3 provides for unitrusts. Part II.J.8.c.i.(c) Unitrust describes various tax issues relating to using unitrusts.

A "unitrust" is a trust for which net income is a unitrust amount.[2682] A "unitrust amount" means an amount computed by multiplying the trust's value by a determined percentage,[2683] the percentage being referred to as the "unitrust rate."[2684] Some tax laws prevent

The terms of a trust may provide that income must or may be calculated as a unitrust amount, in which case the trust is an "express unitrust."[2685] Otherwise, a fiduciary may convert an income trust to a unitrust if the fiduciary adopts a unitrust policy.[2686] A fiduciary may modify a unitrust policy[2687] or even convert a unitrust back to a trust that is not unitrust.[2688] In changing to or from or modifying a unitrust, a fiduciary must follow certain procedures and determine "that the action will assist the fiduciary to administer a trust impartially."[2689]

A fiduciary has no duty to take or consider any of these actions or to inform a beneficiary about the possibility of taking any of these actions.[2690] Furthermore, a fiduciary that in good faith takes or fails to take an action described above is not liable to a person affected by the action or inaction.[2691]

Of course,[2692] the terms of the trust may regulate or prohibit any of the above actions.[2693]

A unitrust policy must provide:

(1) the unitrust rate or the method for determining the unitrust rate,[2694]

[2682] UFIPA § 301(5).
[2683] UFIPA § 301(6).
[2684] UFIPA § 301(8).
[2685] UFIPA § 301(2).
[2686] UFIPA § 303(a)(1).
[2687] UFIPA § 303(a)(2).
[2688] UFIPA § 303(a)(3), which refers to an "income trust," which UFIPA § 301(3) defines as "a trust that is not a unitrust."
[2689] UFIPA § 303(b).
[2690] UFIPA § 302(e).
[2691] UFIPA § 302(f).
[2692] UFIPA § 201(a)(3) provides that a fiduciary shall "(3) administer the trust or estate in accordance with the terms of the trust, even if there is a different provision in [UFIPA]." Furthermore, UFIPA § 201(a)(4) requires a fiduciary to "administer the trust or estate in accordance with [UFIPA], except to the extent the terms of the trust provide otherwise or authorize the fiduciary to determine otherwise."
[2693] UFIPA § 302(a) provides that, except as provided in subsection (b), UFIPA Article 3 applies to:

(1) an income trust, unless the terms of the trust expressly prohibit use of this [article] by a specific reference to this [article] or an explicit expression of intent that net income not be calculated as a unitrust amount; and
(2) an express unitrust, except to the extent the terms of the trust explicitly:
   (A) prohibit use of this [article] by a specific reference to this [article];
   (B) prohibit conversion to an income trust; or
   (C) limit changes to the method of calculating the unitrust amount.

[2694] UFIPA § 305(b)(1), referring to UFIPA § 306.

(2) the method for determining the applicable value,[2695] and

(3) the application of certain mandatory or permissive rules.[2696]

A unitrust policy may:[2697]

(1) provide methods and standards for:

(A) determining the timing of distributions;

(B) making distributions in cash or in kind or partly in cash and partly in kind; or

(C) correcting an underpayment or overpayment to a beneficiary based on the unitrust amount if there is an error in calculating the unitrust amount;

(2) specify sources and the order of sources, including categories of income for federal income tax purposes, from which distributions of a unitrust amount are paid; or

(3) provide other standards and rules the fiduciary determines serve the interests of the beneficiaries.

UFIPA Article 3 does not apply to a trust described in Code § 170(f)(2)(B), 642(c)(5), 664(d), 2702(a)(3)(A)(ii) or (iii), or 2702(b).[2698] Also, if a trust qualifies for a special tax benefit or a fiduciary is not an independent person, then the unitrust rate must be 3%-5%, as well as other requirements.[2699] A "special tax benefit" includes the gift tax annual exclusion because the trust's income interest qualifies as a present interest in property;[2700] the trust is or was a QSST;[2701] a marital deduction trust;[2702] or a trust grandfathered from GST or a trust with an inclusion ratio less than one, in either case if needed to avoid possible GST tax.[2703] Whether a fiduciary in independent generally is based on whether that person is a settlor or a beneficiary or is related to either.[2704]

[2695] UFIPA § 305(b)(1), referring to UFIPA § 307.
[2696] UFIPA § 305(b)(3), referring to UFIPA §§ 306-309, including mandatory rules under UFIPA §§ 307(a) and 308(a) and optional rules to the extent the fiduciary adopts them, referring to UFIPA §§ 306, 307(b), 308(b), and 309(a).
[2697] UFIPA § 309(a).
[2698] UFIPA § 302(b).
[2699] UFIPA § 309(b).
[2700] UFIPA § 102(18)(A), referring to Code § 2503(b).
[2701] UFIPA § 102(18)(B). See part III.A.3.e.i QSSTs.
[2702] UFIPA § 102(18)(C), referring to an estate or gift tax marital deduction under Code § 2056 or 2523 for a transfer to a trust, which deduction depends or depended in whole or in part on the right of the settlor's spouse to receive the trust's net income.
[2703] UFIPA § 102(18)(D), (E).
[2704] UFIPA § 102(10) provides that an "independent person" is a person who is not:

(A) for a trust:

(i) [a qualified beneficiary determined under [Uniform Trust Code Section 103(13)]][a beneficiary that is a distributee or permissible distributee of trust income or principal or would be a distributee or permissible distributee of trust income or principal if either the trust or the interests of the distributees or permissible distributees of trust income or principal were terminated, assuming no power of appointment is exercised];

II.J.5.b.ii.(c). Comparing Power to Adjust to a Unitrust

Generally, a fiduciary exercises the power to adjust annually and the power to modify a unitrust only once or occasionally. Exercising a power to adjust generally is included in annual reports, whereas adopting, modifying, or revoking unitrust provisions requires specific notice to the beneficiaries.

However, UFIPA allows a power to adjust to apply to all future periods and also authorizes frequent changes to a unitrust policy, so the above generalization about frequency is not necessarily accurate.

Computing this average adds to the trustee's recordkeeping burden, although the calculation itself might or might not be simple. For a trust holding marketable securities, the calculation might not take very long. On the other hand, for a trust with closely-held business interests or real estate, the calculation might impose additional costs on the trust; in such a case, one might draft a trust applying the unitrust only to easy-to-value assets and using either more traditional principal and income concepts or the power to adjust for difficult-to-value assets.

Providing a fixed unitrust percentage allows the trustee to avoid fights with the income beneficiary and remaindermen over what percentage to use. However, it also can cause the trust to sell assets in a down year. For example, if the trust provides a 3% unitrust and interest and dividends are 2%, the trustee needs to raise the 1% difference by selling assets. That's fine when asset values increase, but it can cause the trust to be depleted if trust values have not increased, especially if the trust has several down years. Using a power to adjust, the trustee might distribute only interest and dividends in down years and distribute capital gains in up years, perhaps making extra distributions in up years to make up for decreased distributions in down years. The problem is that the income beneficiary might rely on a particular level of distributions, and distributing less in a down year might not be acceptable. Using a unitrust based on an average of the past few years' value would help smooth fluctuations, giving the beneficiary time to adjust spending habits when notified that values are down but that the decrease will be spread over time. When assets appreciate, the trustee might consider taking some of those gains and reserving them for down years, so that a unitrust will not have to sell assets in a down market.

Satisfying a unitrust with appreciated assets appears to be a deemed sale of those assets.[2705]

The first time a unitrust payment includes amounts in excess of trust accounting income, whether or not satisfied with appreciated assets, the trustee must make an irrevocable election

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(ii) a settlor of the trust; or
(iii) an individual whose legal obligation to support a beneficiary may be satisfied by a distribution from the trust;
(B) for an estate, a beneficiary;
(C) a spouse, parent, brother, sister, or issue of an individual described in subparagraph (A) or (B);
(D) a corporation, partnership, limited liability company, or other entity in which persons described in subparagraphs (A) through (C), in the aggregate, have voting control; or
(E) an employee of a person described in subparagraph (A), (B), (C), or (D).

[2705] See part II.J.8.d.i Distribution in Kind - Generally, especially fns 2788-2789.

to treat that excess (to the extent required to satisfy the unitrust obligation) - in the current and all future years - as included in or excluded from DNI.[2706]

However, the trustee may each year separately elect to treat any distribution of capital gain pursuant to a power to adjust as included in or excluded from DNI.[2707]

Thus, to maximize income tax flexibility, I tend to prefer the power to adjust over a unitrust.

II.J.5.b.iii. Modifying a Mandatory Income Trust to Make It Discretionary Income

Modifying a mandatory income trust to allow the trustees to accumulate income and then require any accumulated income to be paid to the beneficiary's estate did not have any income, gift,[2708] or GST[2709] tax consequences.[2710] For further analysis of trust modifications, see part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting, which provides an overview and concludes with part II.J.18.f Commutation vs Mere Division.

II.J.5.b.iv. Income vs. Net Income

Although the tax laws use "income" when describing fiduciary accounting income, it must refer to "net income," given that each receipt and disbursement is allocated either to income or principal. For example, Reg. § 20.2056(b)-5(f)(1) requires that the surviving spouse be "entitled for life to ***all*** of the income" (emphasis added), and Reg. § 20.2056(b)-5(f)(3), (4) contemplate

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[2706] See part II.J.8.c.i.(c) Unitrust, found in part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law.

[2707] See part II.J.8.c.i.(a) Power to Adjust, found in part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law.

[2708] Letter Ruling 201320004 reasoned:

> In this case, the income distribution provisions will be modified to give the trustees discretion to distribute income to the primary beneficiaries or to accumulate such income. However, the accumulated income will be included in each primary beneficiary's estate upon the death of the beneficiary. Accordingly, at the time of the modification, none of the income interest will be gratuitously transferred from the primary beneficiary to any other beneficiary of Trust. The beneficial interests in the modified Trust will be substantially similar to the interests prior to the modification. Accordingly, based upon the facts submitted and representations made, we conclude that the proposed modification to Trust will not cause any beneficiary of Trust to have made a gift that is subject to gift tax under § 2501.

[2709] Letter Ruling 201320004 reasoned:

> In this case, the proposed agreement to modify Trust provides that the trustees have no duty to distribute income annually to the primary beneficiary of each separate trust share but will have the discretion to pay or apply the income for the benefit of each beneficiary. In addition, the proposed agreement to modify Trust provides that any accumulated income not distributed prior to the death of the beneficiary will be paid and distributed to the estate of the deceased beneficiary. Accordingly, the accumulated income will be included in the beneficiary's gross estate for estate tax purposes and the beneficiary will be treated as the transferor of the accumulated income for GST tax purposes. The modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Accordingly, based upon the facts submitted and the representations made, we conclude that the proposed agreement to modify Trust pursuant to Court Order will not cause Trust, as modified, to lose its GST exempt status as a result of allocating Settlor's GST exemption to Trust.

[2710] Letter Ruling 201320004.

an allocation of expenses to reduce the receipts of income, so Reg. § 20.2056(b)-5(f)(1) must mean "net income" when it says "income."

Nevertheless, below are some definitions.

Section 102 of the Uniform Fiduciary Income Principal Act (UFIPA (2018) includes:

> (9) "Income" means money or other property a fiduciary receives as current return from principal. The term includes a part of receipts from a sale, exchange, or liquidation of a principal asset, to the extent provided in [Article] 4.
>
> (10) "Income interest" means the right of a current income beneficiary to receive all or part of net income, whether the terms of the trust require the net income to be distributed or authorize the net income to be distributed in the fiduciary's discretion. The term includes the right of a current beneficiary to use property held by a fiduciary.
>
> (13) "Net income" means the total allocations during an accounting period to income under the terms of a trust and this [act] minus the disbursements during the period, other than distributions, allocated to income under the terms of the trust and this [act]. To the extent the trust is a unitrust under [Article] 3, the term means the unitrust amount determined under [Article] 3. The term includes an adjustment from principal to income under Section 203. The term does not include an adjustment from income to principal under Section 203.

Official Comments to UFIPA include:

> "**Net income**." "Net income" continues to be the term generally used in the 2018 Act to refer to what a current beneficiary must or may receive. This use is flexible enough to cover, for example, even a trust, or a special circumstance related to a trust, that requires or permits distributions of gross income, because "net income" is gross income (expressed as "the total allocations during an accounting period to income under the terms of a trust and this [act]") "minus the disbursements during the period, other than distributions, allocated to income under the terms of the trust and this [act]." To the extent the terms of a trust require or permit the distribution of gross income, there will necessarily be no "disbursements … allocated to income" – all such disbursement will necessarily be allocated to principal – and thus the definition will work even in that unusual case. In addition, the 2018 Act expands this definition to explicitly provide that in a unitrust, now provided for in new Article 3, "net income" is the unitrust amount, without deduction for any disbursements.

The Uniform Principal & Income Act defines "income" the same and in Section 102 provides:

> (8) "Net income" means the total receipts allocated to income during an accounting period minus the disbursements made from income during the period, plus or minus transfers under this [Act] to or from income during the period.

Official Comments to the Uniform Principal & Income Act include:

> "**Net income**." The reference to "transfers under this Act to or from income" means transfers made under Sections 104(a), 412(b), 502(b), 503(b), 504(a), and 506.

II.J.6. Income Allocation on Death of a Beneficiary

If income is required to be distributed currently to a beneficiary, by a trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the income is included in the gross income of the beneficiary for the beneficiary's last taxable year or in the gross income of the beneficiary's estate is determined by the computations under Code § 652 for the taxable year of the trust in which his last taxable year ends.[2711] Consider whether income should be expressly payable or not payable to the beneficiary's estate.

If an amount is paid, credited, or required to be distributed by an estate or trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the amount is included in the gross income of the beneficiary for his last taxable year or in the gross income of his estate is determined by the computations under Code § 662 for the taxable year of the estate or trust in which his last taxable year ends.[2712]

Both of these rules are subject to part II.J.9.a.ii Separate Share Rule.

II.J.7. Code § 645 Election to Treat a Revocable Trust as an Estate

An election under Code § 645, filing IRS Form 8855, causes a qualified revocable trust[2713] to be taxed as part of an estate. The form is due by the time of the first income tax return filed for the

[2711] Reg. § 1.652(c)-2, which further provides:

> Thus, the distributable net income of the taxable year of the trust determines the extent to which the income required to be distributed currently to the beneficiary is included in his gross income for his last taxable year or in the gross income of his estate. (Section 652(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)-3 with respect to separate share treatment for the periods before and after the decedent's death. If the trust does not qualify as a simple trust for the taxable year of the trust in which the last taxable year of the beneficiary ends, see section 662(c) and § 1.662(c)-2.

[2712] Reg. § 1.662(c)-2, which further provides:

> Thus, the distributable net income and the amounts paid, credited, or required to be distributed for the taxable year of the estate or trust, determine the extent to which the amounts paid, credited, or required to be distributed to the beneficiary are included in his gross income for his last taxable year or in the gross income of his estate. (Section 662(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)-3 with respect to separate share treatment for the periods before and after the death of a trust's beneficiary.

[2713] "Qualified revocable trust" means any trust treated under Code § 676 as owned by the decedent by reason of a power in the grantor, determined without regard to Code § 672(e). Code § 645(b)(1).

grantor's estate (or grantor's revocable trust, if no probate estate exists);[2714] there appears to be no relief for failing to meet that deadline, because the deadline is statutory.[2715]

An estate may elect to use a fiscal year,[2716] which can help shift income to the most suitable year, if the additional work in reconciling calendar year Forms 1099 can be justified; note that, if the estate holds a majority interest in a partnership, the partnership may be required to change to a fiscal year.[2717] Although that an estate might be able to elect a fiscal year on a late-filed return,[2718] an estate with a Code § 645 election requires a timely filing (including extensions).[2719]

[2714] Code § 645(c) provides a deadline of "not later than the time prescribed for filing the return of tax imposed by this chapter for the first taxable year of the estate (determined with regard to extensions)."
[2715] Letter Ruling 201314011 granted relief for late filing of Form 8939, which was due with the estate's first income tax return. The ruling noted:

> Estate did not make an effective election under § 645 to treat Trust as part of the estate However, Estate's first Form 1041, US Income Tax Return for Estates and Trusts, reported all of the income of Estate and Trust as if Estate had made an effective election under § 645, and set a fiscal tax year ending Date.

In granting the relief for late filing of Form 8939, the ruling held:

> This ruling is conditioned on the Estate and Trust filing amended returns consistent with their failure to make a timely and effective election under § 645.

[2716] Code § 441 generally allows the taxpayer to choose its taxable year, subject to certain limitations. Code § 644 requires trusts to use the calendar year, but estates are not so required.
[2717] Code § 706(b)(1)(B).
[2718] Reg. § 1.441-1(c)(1) provides:

> *In general*. Except as provided in paragraph (c)(2) of this section, a new taxpayer may adopt any taxable year that satisfies the requirements of section 441 and the regulations thereunder without the approval of the Commissioner. A taxable year of a new taxpayer is adopted by filing its first Federal income tax return using that taxable year. The filing of an application for automatic extension of time to file a Federal income tax return (*e.g.*, Form 7004, "Application for Automatic Extension of Time To File Corporation Income Tax Return"), the filing of an application for an employer identification number (*i.e.*, Form SS-4, "Application for Employer Identification Number"), or the payment of estimated taxes, for a particular taxable year do not constitute an adoption of that taxable year.

Although Reg. § 1.441-1(c)(2) provides exceptions, the only one of concern is that the taxpayer must keep books. Reg. § 1.441-1(c)(2)(ii) provides:

> *Taxpayers without books*. A taxpayer that must use a calendar year under section 441(g) and paragraph (f) of this section may not adopt a fiscal year without obtaining the approval of the Commissioner.

It has ben suggested that prior versions of this regulation required a timely return and that this requirement was dropped in regulations proposed in 2001 and finalized in 2002. REG-106917-99 and T.D. 8996.
[2719] Reg. § 1.645-1(c)(2)(i) provides:

> *Time and manner for filing the election*. If there is no executor for a related estate, an election to treat one or more QRTs of the decedent as an estate for purposes of subtitle A of the Internal Revenue Code is made by the trustees of each QRT joining in the election, by filing a properly completed election form, or in any other manner prescribed after December 24, 2002 by forms provided by the IRS, or by other published guidance for making the election. For the election to be valid, the election form must be filed not later than the time prescribed under section 6072 for filing the Form 1041 for the first taxable year of the trust, taking into account the trustee's election to treat the trust as an estate under section 645 (regardless of whether there is sufficient income to require the filing of that return). If an extension is granted for the filing of the Form 1041 for the first taxable year of the electing trust, the election form will be timely filed if it is filed by the time prescribed for filing the Form 1041 including the extension granted with respect to the filing of the Form 1041.

Among benefits are an unlimited charitable set-aside (which is not always beneficial)[2720] and UBTI not reducing the charitable deduction,[2721] deducting losses on funding pecuniary bequests, more favorable time deadlines for holding or making elections with respect to stock in an S corporation,[2722] and being able to deduct losses from certain active real estate rental.[2723] However, beware state income results – it might be easier for a state to claim jurisdiction over an estate than a trust, so making the Code § 645 election might convert a nonresident trust to a resident estate;[2724] note that this result might be better if the trust would be taxed in a high-tax state and the estate taxed in a low-or-no-tax state. Also, if the trust owns stock in an S corporation that makes material charitable contributions, an ESBT election may facilitate deducting the charitable contribution deduction.[2725]

This treatment expires on the "applicable date." If no estate tax return is required to be filed, the "applicable date" is two years after the date of the decedent's death;[2726] otherwise, it is six months after the date of the final determination of estate tax liability.[2727] Final determination of estate tax liability is the earliest of the following:[2728]

(A) The date that is six months after the issuance by the Internal Revenue Service of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within twelve months after the issuance of the letter;

[2720] Code § 642(c)(1) and the regulations thereunder allow trusts to deduct gross income paid to charity during the taxable year and the following taxable year. Code § 642(c)(2) and the regulations thereunder (as well as Reg. § 1.645-1(e)(2)(i) and(e)(3)(i)) authorize estates to deduct gross income permanently set aside; however, contingent claims, regardless of size, might disallow the entire set-aside deduction. *Belmont v. Commissioner*, 144 T.C. No. 6 (2015). Reg. § 1.642(c)-2(d) provides, "No amount will be considered to be permanently set aside, or to be used, for a purpose described in paragraph (a) or (b)(1) of this section unless under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside, or to be used, will not be devoted to such purpose or use is so remote as to be negligible." *Estate of John D. DiMarco v. Commissioner*, T.C. Memo. 2015-184, citing *Belmont*, concerned with the uncertainty of administrative expenses in light of litigation, disallowed the charitable set-aside, holding, "By virtue of the fact that the settlements pertaining to designation of the beneficiaries and consequential legal and administrative expenses were not finalized until after the year at issue and the estate filed its income tax return, we find that the possibility that the funds would go exclusively to noncharitable beneficiaries was not so remote as to be negligible."

[2721] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, especially fn. 4939.

[2722] See the paragraph of text accompanying fns 6857-6858 in part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest regarding allocation of K-1 income in the year of death. Fn 6858 cross-references an important footnote in part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation.

[2723] See part II.K.1.e.iv Active Rental Subject to AGI Limits, especially fn. 3237.

[2724] See part II.J.3.e.i Strategic State & Local Tax Issues re: Residence. For example, RSMo § 143.331 (http://www.moga.mo.gov/mostatutes/stathtml/14300003311.html) treats an estate as a resident merely if the decedent was domiciled in Missouri, whereas a trust is not a resident unless not only was the settlor a resident but also the trust has at least one income beneficiary who, on the last day of the taxable year, was a resident of Missouri.

[2725] See part II.Q.7.c.i.(a) Contribution Must Be Made from Gross Income, fn 4919 and the text preceding it.

[2726] Code § 645(b)(2)(A).

[2727] Code § 645(b)(2)(B).

[2728] Reg. § 1.645-1(f)(2)(ii).

(B) The date of a final disposition of a claim for refund, as defined in paragraph (f)(2)(iii) of this section, that resolves the liability for the estate tax, unless suit is instituted within six months after a final disposition of the claim;

(C) The date of execution of a settlement agreement with the Internal Revenue Service that determines the liability for the estate tax;

(D) The date of issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for the estate tax unless a notice of appeal or a petition for certiorari is filed within 90 days after the issuance of a decision, judgment, decree, or other order of a court; or

(E) The date of expiration of the period of limitations for assessment of the estate tax provided in section 6501.

The IRS might not issue a closing letter until the estate requests one, thereby extending the time that a Code § 645 might continue to apply under (A) above.[2729] Although Notice 2017-12 provides that an account transcript is the functional equivalent of a closing letter,[2730] it does not, however, state that the account transcript constitutes a "closing letter." The Notice still recognizes that a closing letter is a different procedure and does not expressly refer to Code § 645 or its regulations, so my position is that a transcript does not affect the period for the Code § 645 election. Thus, I view Notice 2017-12 as merely giving the executor the green light to make distributions without incurring personal liability re estate taxes. However, my view does not matter as much as the tax preparer's view, which is infinitely more important to the client than anything I might have to say! I think the lawyer and income tax return preparer should have this discussion and come to a mutual agreement. I am very confident in my view and believe the chance of IRS question it is quite slim, but consider mentioning to the client that one cannot guarantee the outcome. The main issue of consequence may be the timing of an ESBT election, and I would not take any risks whatsoever for that, because more important than the opinion of anyone described above would be the opinion of a strategic buyer's tax advisor, and nobody can predict that person's view.[2731]

After receiving a closing letter, the estate might try to extend the Code § 645 election by filing a claim for refund for expenses in administering the Code § 6166 election.[2732] Contrast this to an estate, for which Reg. § 1.641(b)-3(a) discusses whether administration is unduly prolonged:[2733]

[2729] See fn. 7181, found in part III.B.5.e.iv.(g).
[2730] For more about Notice 2017-12, see fn 7181 in part III.B.5.e.iv.(g) How to Avoid the Pitfalls of the Estate Tax Lien.
[2731] As to this ESBT issue, see part III.A.3.a Wholly Owned Grantor Trusts – How to Qualify, Risks, and Protective Measures, and be sure to read the various subparts under it.
[2732] Reg. § 1.645-1(f)(2)(ii). Rev. Rul. 76-23 held that, "where the sole purpose for retaining stock of a small business corporation in an estate of a deceased shareholder is to facilitate the payment of the estate tax under section 6166 of the Code, the administration of the estate will not be considered unreasonably prolonged for purposes of section 641(a)(3), and thus the estate will continue to be an eligible shareholder within the meaning of section 1371(a) for the period during which the estate complies with the provisions of section 6166." [Note that Subchapter S was overhauled for taxable years beginning after 12/31/82.]
[2733] I have been told that *Old Virginia Brock Co. Inc. v. Commissioner*, 367 F.2d 276 (4th Cir. 1966), found ownership of the S corporation's stock to be by a testamentary trust rather than the purported estate, and

> The income of an estate of a deceased person is that which is received by the estate during the period of administration or settlement. The period of administration or settlement is the period actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests, whether the period required is longer or shorter than the period specified under the applicable local law for the settlement of estates. For example, where an executor who is also named as trustee under a will fails to obtain his discharge as executor, the period of administration continues only until the duties of administration are complete and he actually assumes his duties as trustee, whether or not pursuant to a court order. However, the period of administration of an estate cannot be unduly prolonged. If the administration of an estate is unreasonably prolonged, the estate is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. Further, an estate will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary). Notwithstanding the above, if the estate has joined in making a valid election under section 645 to treat a qualified revocable trust, as defined under section 645(b)(1), as part of the estate, the estate shall not terminate under this paragraph prior to the termination of the section 645 election period. See section 645 and the regulations thereunder for rules regarding the termination of the section 645 election period.

Reg. § 601.6109-1(a)(4), "Taxpayer identification number to be used by a trust upon termination of a section 645 election," provides:[2734]

> (i) *If there is an executor*. Upon the termination of the section 645 election period, if there is an executor, the trustee of the former electing trust may need to obtain a taxpayer identification number. If § 1.645-1(g) of this chapter regarding the appointment of an executor after a section 645 election is made applies to the electing trust, the electing trust must obtain a new TIN upon termination of the election period. See the instructions to the Form 1041 for whether a new taxpayer identification number is required for other former electing trusts.
>
> (ii) *If there is no executor*. Upon termination of the section 645 election period, if there is no executor, the trustee of the former electing trust must obtain a new taxpayer identification number.
>
> (iii) *Requirement to provide taxpayer identification number to payors*. If the trustee is required to obtain a new taxpayer identification number for a former electing trust pursuant to this paragraph (a)(4), or pursuant to the instructions to the Form 1041, the trustee must furnish all payors of the trust with a completed Form W-9 or acceptable substitute Form W-9 signed under penalties of perjury by the trustee

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to also review *Hargis' Estate v. Commissioner*, 19 T.C. 842 (1953); *Estate of Farrier v. Commissioner*, 15 T.C. 277 (1950); *Roebling v. Commissioner*, 18 T.C. 788 (1952); *Miller v. Commissioner*, 39 T.C. 940 (1963); and *Maresca Trust v. Commissioner*, T.C. Memo 1983-501.

[2734] Reg. § 301.6109-1(a)(5), "Persons treated as payors," provides:

> For purposes of paragraphs (a)(2), (3), and (4) of this section, a payor is a person described in § 1.671-4(b)(4) of this chapter.

Reg. § 1.671-4(b)(4) is found in part III.B.2.e.i Grantor Trust Treatment During the Grantor's Life.

providing each payor with the name of the trust, the new taxpayer identification number, and the address of the trustee.

II.J.8. Allocating Capital Gain to Distributable Net Income (DNI)

Although the discussion below generally refers to trusts, generally it applies to estates as well. If a trustee has discretion to make an election regarding that trust, the election does not affect the choices available regarding other trusts the trustee manages.[2735]

II.J.8.a. Capital Gain Constitutes DNI Unless Excluded

Taxable income is DNI unless expressly excluded.[2736]

Code § 643(a)(3) provides:[2737]

> *Capital gains and losses*. Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c).

Thus, to be excluded from the income of a domestic trust,[2738] the gains must:

- Arise from the sale or exchange of capital assets,
- Be allocated to corpus, and
- Not be actually or deemed to be distributed.

The rest of this part II.J.8.a Capital Gain Constitutes DNI Unless Excluded focuses on the first two prongs.

II.J.8.a.i. Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset

Only gains from the sale of capital assets are ordinarily excluded from DNI.[2739]

For example, "property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or

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[2735] Reg. § 1.643(a)-3(e), Example (14).

[2736] Code § 643(a) provides:

> For purposes of this part, the term "distributable net income" means, with respect to any taxable year, the taxable income of the estate or trust computed with the following modifications….

[2737] Code § 643(a)(3) further provides:

> Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The exclusion under section 1202 shall not be taken into account.

[2738] Code § 643(a)(6)(C) provides:

> Paragraph (3) shall not apply to a foreign trust. In the case of such a trust, there shall be included gains from the sale or exchange of capital assets, reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges.

[2739] Code § 643(a)(3); Reg. § 1.643(a)-3(a).

business" is not a capital asset.[2740] Therefore, the sale of such property would constitute DNI, although it would not constitute trust accounting income.[2741] Whether other real estate is a capital asset depends on various facts.[2742]

However, "any recognized gain on the sale or exchange of property used in the trade or business" often receives capital gain treatment[2743] to the extent it does not constitute certain depreciation recapture.[2744] Goodwill that has not been amortized is a capital asset, but goodwill that is being amortized is not a capital asset.[2745] Thus, because such assets are not capital assets, such capital gains generally would be included in DNI.

II.J.8.a.ii. Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus

I am unaware of any authority defining "allocated to corpus" as used in Code § 643(a)(3). Presumably it means receipts by the trust that are allocated to principal.

Does the statute mean that capital gain are automatically included in DNI unless they are affirmatively allocated to principal and certain other conditions exist? Reg. § 1.643(a)-3(a) might overrule that requirement, providing (highlighting added):

> *In general*. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

This regulation essentially has three parts:

- Reg. § 1.643(a)-6 deals with foreign trusts.

- Reg. § 1.643(a)-3(b) explains when capital gains from the sale or exchange of an asset are included in DNI and does not include a requirement that the capital gain be allocated to

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[2740] Code § 1221(2).
[2741] Section 401(c)(1) of the Uniform Principal & Income Act.
[2742] See part II.G.26.c Future Development of Real Estate.
[2743] Code § 1231(a)(3)(A)(i). See part II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business.
[2744] Depreciation recapture on the sale of tangible personal property is taxed as ordinary income; see fn. 1494. Depreciation recapture on the sale of real property tends to be taxed as a capital gain but at a higher rate; see fn. 1495. Note that cost segregation studies might break out building components as tangible personal property, so be sure to ask about this possibility when advising on the sale of a building. For various tips under regulations that applied starting in 2014, see Wood and Abdoo, "Applying the Final Tangible Property Regulations to Tenant Fit-Ups," *TM Real Estate Journal* (BNA) (9/2/2015); Atkinson and Afeman (KPMG), "The Tangible Property Regulations: Considerations For the Real Estate Industry," *TM Memorandum* (BNA) (9/7/2015). In October 2016, the IRS made major revisions to its Cost Segregation Audit Techniques Guide, found at https://www.irs.gov/businesses/cost-segregation-audit-techniques-guide-table-of-contents.
[2745] Letter Ruling 200243002. For more discussion of goodwill, see fns. 1978, 4097, and 4137 (especially the latter).

principal.[2746] In fact, one of the prongs discusses the treatment when capital gains are allocated to income.[2747]

- Depending on the meaning one gives to "ordinarily," this regulation might dispense with the statutory requirement that capital gains be allocated to corpus. The regulation does not explain when it says "ordinarily" what the exceptions might be, other than Reg. §§ 1.643(a)-6 and 1.643(a)-3(b). There would appear to be substantial authority for saying that an affirmative allocation of capital gains to principal is or is not required.

This issue seems to be most important for the trust's gross income that does not take the form of receipts of cash or other property. For example, a trust might invest in a partnership, S corporation, or other flow-through entity that does not distribute all of its taxable income. How should one treat capital gain from a flow-through entity's sale of a capital asset, when the entity distributes less than all of its taxable income? Should the undistributed capital gain be included in DNI?

- With respect to the accumulated capital gain, the trust has no receipts and therefore is not allocated to corpus. Arguably, the capital gain is not excluded from DNI and therefore constitutes DNI.

- On the other hand, the accumulated capital gain benefits the trust's corpus. Should it be treated as if it had been allocated to corpus? In that case, should it be trapped inside the trust, given that it was accumulated inside the entity and not distributed to the beneficiary?

- Given this uncertainty, would the trustee have discretion to take a different position each year? In Reg. § 1.643(a)-3(b), the Treasury generally agreed that the trustee would not be required to take a consistent position year-by-year, except for capital gain allocated to corpus and treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary. Given that this gross income was not allocated corpus (because it was never physically received), perhaps the trustee has discretion to vary the treatment from year to year? Another approach might be to say that, because the undistributed capital gain was not allocated to principal, the regulations might presume that the undistributed capital gain is allocated to income and can be included in DNI inconsistently from year to year under Reg. § 1.643(a)-3(b)(1).

If all of a flow-through entity's K-1 items taxable to the trust are included in DNI, then part II.J.8.c Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal might cause ordinary income to be trapped at the trust level if the flow-through entity distributes cash in an amount less than all of these K-1 items; see part II.J.8.f Consequences of Allocating Capital Gain to DNI. In light of the consequences described there, the most taxpayer-favorable reading may be that capital gain is ordinarily excluded from DNI.

I leave it to the reader to decide which approach is "better" or perhaps to make that decision on a trust-by-trust basis.

[2746] See part II.J.8.c Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal, which quotes the regulation.
[2747] See part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law and the various subparts thereunder.

For more on using flow-through entities, see part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

II.J.8.b. Should Capital Gain Be Allocated to DNI?

Often beneficiaries have income below the thresholds that cause the 3.8% tax and the additional 5% capital gain tax to be incurred, whereas trusts start paying those taxes at relatively modest income levels. Therefore, distributing capital gains to beneficiaries might be beneficial – at least from an income tax viewpoint.

Consider various factors described in part II.J.3 Strategic Fiduciary Income Tax Planning.

II.J.8.c. Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal

Generally, gains from the sale or exchange of capital assets, net of losses,[2748] are excluded from distributable net income (DNI).[2749] But that statement belies the flexibility we are about to see.

Reg. § 1.643(a)-3(b) provides:

> *Capital gains included in distributable net income*. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law) -
>
> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));
>
> (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

[2748] Reg. § 1.643(a)-3(d) provides:

> *Capital losses*. Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is distributed or required to be distributed to a particular beneficiary. See § 1.642(h)-1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

See part II.J.3.i Planning for Excess Losses.

[2749] Reg. § 1.643(a)-1(a) provides:

> *In general*. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

Reg. § 1.643(a)-6 refers to DNI of a foreign trust (as defined in Code § 7701(a)(31)).

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

Note the word "or" after paragraph (2) above. That indicates capital gains are included in DNI if and to the extent that any one or more of paragraph (1) (the "Income Rule"), paragraph (2) (the "Consistent Principal Rule"), or paragraph (3) (the "Discretionary Principal Rule") applies. For more on the:

- Income Rule, see part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law
- Consistent Principal Rule, see part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary
- Discretionary Principal Rule, see part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary.

Before its amendment by T.D. 9102 (12/30/2003), Reg. § 1.643(a)-3 made it more difficult to include capital gain in DNI.[2750]

II.J.8.c.i. Income Rule: Capital Gain Allocated to Income Under State Law

Most states have adopted the Uniform Principal and Income Act,[2751] which will be referred to at UPIA for the rest of this part II.J.8.c.i, or its replacement, which is described in part II.J.5.b Uniform Fiduciary Income & Principal Act (UFIPA).

Generally, any capital gain included as the distributive share of income from a partnership or S corporation and distributed from the entity to the trust will constitute income under the Act, making the rest of this part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI) be moot.[2752]

[2750] Former Reg. § 1.643(a)-3(a) provided:

> Except as provided in § 1.643(a)-6, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income, and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary unless they are:
> (1) Allocated to income under the terms of the governing instrument or local law by the generates fiduciary on its books or by notice to the beneficiary,
> (2) Allocated to corpus and actually distributed to beneficiaries during the taxable year, or
> (3) Utilized (pursuant to the terms of the governing instrument or the practice followed by the fiduciary) in determining the amount which is distributed or required to be distributed.
> However, if capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642(c), so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income.

See Zaritsky, Lane & Danforth, ¶3.03. Capital Gains and Losses, *Federal Income Taxation of Estates and Trusts* (WG&L).

[2751] See https://www.uniformlaws.org, with the 2008 amendments to the Uniform Principal & Income Act being referred to as the "Act" in the footnotes in this part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law. However, because the 2008 amendments changed only sections 409 and 505, generally a reference to the Act in this part is the same whether it is the 2000 version or 2008 version.

[2752] See part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

Generally, the Act allocates capital gains to principal.[2753] The main exceptions are the power to adjust, unitrust distributions, and exceptions in the governing instrument; the power to adjust and power to convert to a unitrust followed adoption of the prudent investor rule.[2754] Following a discussion of each of these is a discussion of the respect fiduciary income tax law gives them.

II.J.8.c.i.(a). Power to Adjust

Capital gains may be reclassified as income if traditional trust accounting income principles cause insufficient receipts to be classified as income. See parts II.J.5.b.ii.(a) Power to Adjust.

II.J.8.c.i.(b). Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation

It is not uncommon for partnerships and S corporations to reinvest part of their annual income; indeed, to facilitate growth or simply a stronger capital structure (which lenders might require), many distribute only enough to pay their owners' income taxes (commonly referred to as a "tax distribution") plus a modest bonus (referred to below as a "bonus distribution").

Taxes on this reinvested income are charged against the income of a trust that owns such an entity.[2755] This is the only practical solution to the trust's obligation to pay its taxes, because the taxing authorities' claims against the trustee are much more pressing than the beneficiaries' claims. (Note that the income beneficiary of a Qualified Subchapter S Trust pays this tax – part III.A.3.e QSSTs and ESBTs – which has an effect similar to charging the trust's income.)

The Uniform Principal and Income Act includes a remedy for the income beneficiary that had to pay the tax on the entity's accumulated income that has been inherently baked into principal. Section 506(a)(3) authorizes a fiduciary to "make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from … the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary." This specific provision supplements any power to adjust that might generally apply.[2756]

Thus, when an interest in a partnership or an S corporation is sold, the trustee should consider whether to allocate some of the sale proceeds to income. However, it's not at all obvious that the trustee should make an adjustment; consider that:

- The entity made distributions specifically to pay this tax, so the trust or income beneficiary was not really "out of pocket" for this tax.

- If the entity had been a C corporation, the entity would have paid the tax itself. Its dividend would have equaled the bonus distribution, and this issue would never have arisen.

- The true issue is whether the bonus distribution was sufficient. Was the decision to accumulate income fair – a sound exercise of the business judgment of those who run the entity? Did those who control the entity promise a make-up distribution at some point

[2753] Act § 401.
[2754] For an analysis of how these ideas interact, see Sager, "Litigation and the Total Return Trust," *ACTEC Journal*, vol. 35, no. 3, p. 206 (Winter 2009).
[2755] See part III.A.4 Trust Accounting Income Regarding Business Interests.
[2756] See part II.J.8.c.i.(a) Power to Adjust.

> because of a special project, or was the accumulation merely part of a solid plan to grow the business, which presumably would result in increased income and increased bonus distributions? Were those who control the entity running it just to benefit themselves (and, if owners, trying to extract more benefits as owners than the inactive owners received)? I have probably left out many other relevant considerations, but hopefully I have communicated why this decision is not easy.

See parts II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Trust Accounting Rules and II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets.

If the trustee is concerned that the income beneficiary might spend a perceived windfall unwisely, the trustee might consider using the power to adjust[2757] to spread distributions over an appropriate period of time. Such a spread over time might be more palatable if, instead of labelling the adjustment to sale proceeds as a tax reimbursement, the trustee labelled it as a make-up for insufficient bonus distributions, taking the position that future distributions to beneficiaries might be loosened because of a prior conservative distribution policy.[2758] The bonus distributions might have been sufficient from the viewpoint of what the entity should have distributed but might have been insufficient from the viewpoint of how much income the trustee should have tried to generate. As mentioned in part III.A.4.d.iv Advising Clients about the UPAIA § 505 Change and UFIPA § 506 (discussing conflicts with beneficiaries that might arise when an entity makes tax distributions but little or no bonus distributions), these issues have no easy answer.

See also part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Trust Accounting Rules.

II.J.8.c.i.(c). Unitrust

A unitrust is a trust that distributes fixed amounts, redetermined annually as a fixed percentage of the value of the trust's value, which value is redetermined annually but might be based on an average of values, such as the average value of the trust's assets for the past three years. See parts II.J.5.b.ii.(b) Unitrust and II.J.5.b.ii.(c) Comparing Power to Adjust to a Unitrust.

Reg. § 1.643(a)-3(e) provides the following examples regarding unitrusts:

> *Example (11)*. The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-

[2757] Part II.J.8.c.i.(a) Power to Adjust.

[2758] "Conservative" does not necessarily equate with "stingy." Paying fixed (or inflation-adjusted) amounts that exceed net cash income can cause a trust's net asset value to decline, causing future income to decline, or might simply cause the principal not to grow sufficiently, causing the remaindermen's interests not to keep up with inflation. Using the power to adjust to make up for peaks and valleys would seem wiser than paying fixed (or inflation-adjusted) amounts. Generally, trustees should fairly and impartially balance the beneficiaries' interests under the trust agreement and might consider additional communication to those currently receiving distributions about the peaks and valleys and provide to the beneficiaries (or encourage them to obtain) advice about how to manage these peaks and valleys.

term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.

> *Example (12)*. The facts are the same as in Example 11, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire $80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.

> *Example (13)*. The facts are the same as in Example 11, except that neither state statutes nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

A right to income expressed initially solely as a unitrust interest may qualify for the QTIP marital deduction.[2759]

[2759] Letter Ruling 201117005 approved a unitrust expressly authorized by state law:

> State Statute provides that the grantor of a trust may create an express total return unitrust which will become effective as provided in the trust document without requiring a conversion of an income trust to a total return unitrust under the provisions of State Statute. An express total return unitrust created by the grantor of the trust shall be treated as a unitrust under State Statute only if the terms of the trust document contain all of the following provisions: (a) that distributions from the trust will be unitrust amounts and the manner in which the unitrust amount will be calculated and the method in which the fair market value of the trust will be determined; (b) the percentage to be used to calculate the unitrust amount, provided the percentage used is not greater than 5 percent nor less than 3 percent; (c) the method to be used in determining the fair market value of the trust; and (d) which assets, if any, are to be excluded in determining the unitrust amount.

II.J.8.c.i.(d). Exceptions in the Governing Instrument

Although the Act provides general rules, it also allows trust agreements to override those rules:[2760]

> In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:
>
> (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
>
> (2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];
>
> (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and
>
> (4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

II.J.8.c.i.(e). Fiduciary Income Tax Recognition of the Trust Agreement and State Law

Code § 643(b) generally defers to the trust agreement and applicable state law.[2761] The Uniform Principal and Income Act ("UPIA") and the Uniform Fiduciary Principal & Income Act ("UFIPA") authorizes the trust agreement to override the Act.[2762]

[2760] Act § 103(a).

[2761] Code § 643(b) provides:

> For purposes of this subpart and subparts B, C, and D, the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

[2762] Section 103(a) of UPIA provides:

> In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:
>
> (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
>
> (2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];
>
> (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and

However, Reg. § 1.643(b)-1[2763] does not recognize trust agreements that depart too far from the usual rules:

> Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal.

Reg. § 1.643(b)-1 respects variations provided under applicable state law:

> However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods.[2764]

> (4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

For UFIPA's counterpart, UFIPA § 201(a), see text preceding the text accompanying fn 2661 in part II.J.5.b Uniform Fiduciary Income & Principal Act (UFIPA).

[2763] This version of the regulation applies to taxable years of trusts and estates ending after January 2, 2004.

[2764] The regulation sets forth parameters for switching methods:

> A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries. A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of section 1001 and may result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances.

Circling back to the Act's authorizing trust agreements to depart from traditional principles, Reg. § 1.643(b)-1 concludes with:

> In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.

For the "reasonable and impartial exercise" requirement in the context of the power to adjust, see part II.J.5.b.ii.(a) Power to Adjust.

I often use a clause providing that the trustee has wide discretion but must reasonably and fairly balance the interests of the income and remainder beneficiaries.[2765] That language comes from the marital deduction regulations.[2766] Generally, the trustee's authority to allocate between income and principal does not trigger grantor trust status,[2767] does not constitute a power of appointment,[2768] and does not have generation-skipping transfer tax implications.[2769] The trustee might want to consider providing accountings or other notices to the beneficiaries that would start running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile this one on top of it, which procedure might help minimize any gift tax consequences to failing to make a claim.[2770]

How does one draw the line between what departs "fundamentally from traditional principles of income and principal" and what is "a reasonable and impartial exercise of a discretionary power granted to the fiduciary" under Reg. § 1.643(b)-1?

[2765] As with everything else, the reader must exercise independent legal judgment (or, if the reader is not an estate planning lawyer, retain one) before using the language reproduced below:

> The trustee is authorized to apportion any receipt or disbursement between principal and income, notwithstanding the apportionment that would apply under [applicable state law] apart from this provision; to determine the depletable, depreciable or amortizable interest of the principal and income in any property included among the trust estate subject to being depleted, depreciated or amortized, and to apportion the amount received from such property between principal and income; to maintain reasonable reserves for depletion, depreciation, amortization and obsolescence; to allocate to income or principal of the trust estate any gains or losses realized upon the sale or disposition of any part of the trust estate; to determine what part, if any, of the actual income received upon a wasting investment or upon any security purchased or acquired at a premium shall be returned and added to principal to prevent a diminution of principal upon exhaustion or maturity thereof; and to determine what payment, if any, should be made to any income beneficiary as compensation for losses of income due to the acquisition or retention of property returning no income or slight income; provided, however, that the trustee, in taking any action under this Section, must reasonably and fairly balance the interests of the income and remainder beneficiaries.

For an example of how the clause, "to determine what payment, if any, should be made to any income beneficiary as compensation for losses of income due to the acquisition or retention of property returning no income or slight income," can come in handy, see part II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets, especially fn. 2933.

[2766] Reg. § 20.2056(b)-5(f)(1), which governs general power of appointment marital deduction trusts under Code § 2056(b)(5), looks to whether:

> the spouse is entitled to income as determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of § 1.643(b)-1 of this chapter.

Reg. § 20.2056(b)-5(f)(4) elaborates:

> Among the powers which if subject to reasonable limitations will not disqualify the interest passing in trust are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus….

For QTIP (qualified terminable interest property) trusts, Reg. § 20.2056(b)-7(d)(1) provides:

> A power under applicable local law that permits the trustee to adjust between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries that meets the requirements of §1.643(b)-1 of this chapter will not be considered a power to appoint trust property to a person other than the surviving spouse.

Reg. § 20.2056(b)-7(d)(2) also circles back to the general power of appointment marital deduction rules:

> *Entitled for life to all income*. The principles of § 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest, or a specific portion of the entire

interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property regardless of whether the interest passing to the spouse is in trust.

[2767] Code § 674(b)(8); Reg. § 1.674(a)-1(b)(1)(iv).

[2768] Reg. §§ 20.2041-1(b)(1) (estate tax) and 25.2514-1(b)(1) (gift tax) provide:

> The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.

Although a trustee's allocations to income and principal ordinarily will not cause gift tax issues, other decisions that affect distributions might cause gift tax issues if the trustee is also a beneficiary. Reg. § 25.2511-1(g)(2) provides a safe harbor, which is reproduced in the text accompanying fn 2485 in part II.J.2.b **Trust** Provisions Authorizing Distributions. See also Reg. § 20.2041-1(c)(2) (exception to estate tax general power of appointment – see text accompanying fn 2124 in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap).

See fn. 2538 for additional authority on ascertainable standards.

Letter Ruling 8908032 recognized that Reg. §§ 20.2041-1(b)(1) generally prevents administrative powers from creating a general power of appointment:

> …. Although the amount of income that A may receive each year is generally limited, the trust provides that any income from real estate must be distributed first and that all the income from real estate be distributed to A even if such distribution exceeds the annual limitation. Thus, if the trust had substantial income from real estate, it is possible for A to receive distributions in excess of the annual limitation imposed by the trust.
>
> Where the holder of a power is not completely free from legal control or restraint in the disposition of property, a power held by the holder would not be a general power of appointment. Such legal control or restraint exists when the holder is legally accountable for its exercise. fiduciary duties imposed by local law are always subject to the control of the courts and the holder is always under a legal duty to account. See *Security-Peoples Trust Company v. United States*, 238 F.Supp. 40 (W.D. Pa. 1965). The initial step in determining whether a decedent has a general power of appointment is to determine, in light of local law, the interest conveyed to the decedent under trust; *i.e.*, the extent to which consonant with testamentary trust provisions, the decedent could invade and consume the principal. See *Morgan v. Commissioner*, 309 U.S. 78 (1940).
>
> It is necessary to look to the law of State X to determine whether A has the power to alter the beneficial interest under the trust. If A appointed herself trustee, A, as the trustee, would have the authority under the trust to sell trust assets and to invest the proceeds in real estate. Thus, A could cause trust income from real estate to exceed the limitation set forth in the trust for income distributions from other sources and, consequently, increase the total income distributions to A. Such investment policy and actions by A as the trustee would result in a shift of the beneficial interest of the trust. However, A would not have complete freedom to set investment policy for the trust. The statutory law of State X requires that a trustee consider the relative interests of both income and remainder beneficiaries in determining the prudence of any investment and imposes a duty on the trustee to administer the trust with due regard to the respective interests of income beneficiaries and remainderpersons in accordance with the terms of the trust. In addition, the highest court in State X has addressed the responsibilities of the trustee and stated that:
>
> > It is the duty of the trustees to preserve the corpus of the trust for the remaindermen and to secure the usual rate of income upon safe investments for the life tenant, and to use a sound discretion in reference to each of those objectives. They cannot postpone the yielding of income for the increase of capital, nor select a wasting or hazardous investment for the sake of greater present income.
>
> *Congdon v. Congdon*, 160 Minn. 343, 200 N.W. 76 (1924).
>
> Moreover, *In re Clarke's Will*, 204 Minn. 574, 284 N.W. 876 (1939), addressed a situation where the trustee, who was also the income beneficiary, treated trust property incorrectly as "income" rather than "capital" and made erroneous distributions to herself. The court held that the trustee-

Presumably, the trustee should be on solid ground in allocating to income capital gains such that the total amount of all receipts allocated to income does not exceed 5%, given that the regulations expressly approve unitrusts in the 3%-5% range. The trusts should also be on solid ground in allocating to income capital gains generated by a partnership that the settlor intended to distribute to the income beneficiary.[2771]

Beyond that, it's a matter of facts and circumstances and judgment. However, Reg. § 1.643(a)-3(e), Example (4) respected a mandatory allocation of capital gain to income where a trust had $5,000 of dividends and $10,000 of capital gains, and the trustee distributed $17,000 to the beneficiary.

II.J.8.c.i.(f). Conclusion Regarding Allocating Capital Gain to Income

Reg. § 1.643(a)-3(b)(1) requires a consistent practice for unitrusts. Considering that the unitrust recipient is receiving cash and presumably would have the liquidity to pay tax on any capital gains distributed to the beneficiary, in many cases it would be fair to allocate capital gain to DNI to the extent that the unitrust amount exceeds the income that would apply under the Act's general rules. Given that one provides for a unitrust when tension between the income beneficiary and remaindermen might be high, the tension created by this tax issue would be high to the same degree. Consider providing a firm rule in the trust agreement regarding the allocation of capital gain to DNI. If one is concerned that shifting tax rates might create an unfair tax result, consider providing a clause reimbursing the unitrust beneficiary for taxes paid on the unitrust and on the reimbursement; this requires cooperation between the trustee's income tax preparer and the beneficiary's income tax preparer, but the calculation should be relatively mechanical.

For trusts that are not unitrusts, Reg. § 1.643(a)-3(b)(1) provides significant flexibility, allowing the trustee discretion whether to allocate capital gain to income for fiduciary accounting

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> income beneficiary had a duty to distinguish between the rights of the life tenant and those of the remaindermen with meticulous care. The court found that, although there had been no intentional wrong, there was an invasion of the rights of the remaindermen by the trustee-income beneficiary that amounted to fraud, irrespective of intention.
>
> The law of State X clearly imposes a strong fiduciary duty on a trustee to protect the interests of all beneficiaries of the trust. While A, as the trustee, may invest trust assets in real estate that may produce sufficient income resulting in an increase in distributions to A, A cannot adopt an investment policy that would be detrimental to the interests of the remaindermen. Neither Trust 1 nor Trust 2 gives A, as the income beneficiary, any control over investment policy or income withdrawal. Due to the restrictions imposed by both the law of State X and the trust instruments, A does not have an unfettered right to change the interests of the beneficiaries.
>
> Accordingly, A's power to remove the current trustee and appoint anyone, including A, as the trustee is not a general power of appointment as described in section 2041 of the Code.

[2769] Reg. § 26.2601-1(b)(4)(i)(D)(2) provides:

> … administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1 of this chapter.

[2770] See part II.J.4.j Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure.

[2771] See fn. 2808.

purposes (if the trust agreement and state law permit) and also whether to include in DNI the capital gain that was allocated to income.

Consider the nuances for a mandatory income trust. Distributions must be made no later than 65 days after yearend to include capital gain in DNI in every other situation. In a mandatory income trust, a power to adjust might be able to retroactively include capital gain in income – perhaps as late as when the tax return is prepared. For how mandatory income trusts work, see part II.J.5 Mandatory Income Trusts. For limits on retroactivity, see part II.J.5.a Issues Arising with Mandatory Income Trusts.

II.J.8.c.ii. Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary

Reg. § 1.643(a)-3(e) helps guide our application of Reg. § 1.643(a)-3(b)(2):

> *Example (1)*. Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.
>
> *Example (2)*. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.
>
> *Example (3)*. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments. This treatment of capital gains is a reasonable exercise of Trustee's discretion.

The all-or-nothing approach taken by Examples (1) and (2) is not very attractive, but we need to deal with it. Let's consider some fact patterns:

1. <u>The beneficiary needs regular annual distributions that cannot be made using a power to adjust</u>. Generally, distributions in excess of what can made using a power to adjust would not be sustainable. A power to adjust typically adjusts to a 3%-5% distribution, and most models suggest that distributions in excess of that will lead to a trust being depleted. Thus,

a more likely scenario is that a power to adjust is not available, because state law prevents using the power to adjust in particular situations (unless the trust agreement overrides it). In such a case, the beneficiary's federal and state/local income tax bracket for capital gains needs to be compared to the trust's federal and state/local income tax bracket for capital gains. Note that a nonresident trust would have a zero state/local income tax bracket, to the extent that the trust does not have income from a business sourced to the state/local jurisdiction.

2. The beneficiary's need for distributions in excess of income is sporadic. It's difficult to predict how the beneficiary's federal and state/local income tax bracket for capital gains compares to the trust's federal and state/local income tax bracket for capital gains, given that rates will change and the trust's and its beneficiaries' circumstances might change over time. In such a case, consider whether the distribution might be phrased as "allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary." If that is likely to be the case, then consider not electing to carry out capital gain automatically under (b)(2) but rather deciding to rely on (b)(3), because (b)(3) is flexible whether to allocate capital gain to income, allowing the decision to made separately each year on a case-by-case basis.

Generally, trustees would not be likely to take advantage of the discretion that Example (3) provides to allocate to income only capital gain from the sale of certain specified assets or a particular class of investments, because such an election requires additional recordkeeping.

Some people point to the word "deem" in Example (1) and emphasize the need for such authority in the trust agreement or applicable state law. Uniform Trust Code § 816 generally authorizes trustees to make tax elections,[2772] so the authority to "deem" distributions to be capital gains is inherently authorized in UTC states, as well as any other state where a trustee generally has the authority to make tax elections.

II.J.8.c.iii. Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary

Reg. § 1.643(a)-3(b)(3) might seem confusing at first, but it actually has very practical use.

First, let's look at some examples that Reg. § 1.643(a)-3(e) provides:

> Example (5). The facts are the same as in Example 1, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is $10,000, rather than $12,000. Because Trustee will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.
>
> *Example (6)*. Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and

[2772] Paragraph (16) of that section authorizes the trustee to "exercise elections with respect to federal, state, and local taxes." The official Comment provides:

> Paragraph (16) authorizes a trustee to make elections with respect to taxes. The Uniform Trust Code leaves to other law the issue of whether the trustee, in making such elections, must make compensating adjustments in the beneficiaries' interests.

then sell it and distribute all the sales proceeds to A. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

Although Reg. § 1.643(a)-3(b)(3) is viewed generally as discretionary, note that Example (6) is mandatory: if the trustee is required to distribute sale proceeds to a beneficiary, the capital gain from the sale is included in the DNI that the distribution carries out the beneficiary. Example (7) similarly requires all capital gain recognized in the trust's final taxable year to be included in the DNI that the distribution carries out the beneficiary.

The practical application is based on the ability to count as prior year distributions those distributions made in the first 65 days of the current year.[2773] For example, any distribution made on or before March 5, 2020 can be treated as a 2019 or 2020 distribution.[2774] This election applies to the greater of accounting income under Reg. § 1.643(b)-1 or DNI under Reg. §§ 1.643(a)-1 through 1.643(a)-7.[2775] By completing the line on the trust's income tax return, Form 1041, page 2, Part B, showing amounts (other than income required to be distributed currently) paid, credited, or otherwise required to be distributed and checking the Code § 663(b) box in "Other Information" at the bottom of Form 1041, page 2, the trustee decides how much of a current year distribution is allocated to the prior year; the balance would then be credited to the current year.[2776]

The practical application based on the 65-day rule would generally occur during February after the year ends and applies only if the trustee has discretion to distribute corpus.[2777] The regulations do not specify any particular trust records regarding the election, so do whatever seems best to evidence the intent. Perhaps the income tax return preparer emails the trustee recommending how much of a distribution be made to distribute income and capital gain under the 65-day rule (erring on the side of distributing too much), then the trustee makes the distribution, and the tax return carries through the intent. As long as the distribution is made timely, the tax return can treat none, part, or all of the distribution as a distribution of the taxable year's income. In a manner similar to Example (5), the trustee has referred to the capital gain itself in determining how much to distribute. Unlike Reg. § 1.643(a)-3(b)(2), Reg. § 1.643(a)-

[2773] Code § 663(b).
[2774] In a leap year, the deadline is March 5; in other years, the deadline in March 6.
[2775] Reg. § 1.663(b)-1(a)(2)(i).
[2776] Reg. § 1.663(b)-1(a)(2)(ii). The election may be made on an extended return but not on an amended return filed after the (extended) due date. Reg. § 1.663(b)-2(a)(1). If no return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in a statement filed with the internal revenue office (under Code § 6091 and the regulations thereunder) with which a return by such trust would be filed if such trust were required to file a return for such taxable year. Reg. § 1.663(b)-2(a)(2).
[2777] The authority to distribute principal for welfare would be helpful, but the trustee should not be a related or subordinate party. See Code § 2041(b)(1), absent the application of Code § 2041(b)(1)(A) and the other exceptions, combined with Rev. Rul. 95-58 and a variety of private letter rulings applying that Rev. Rul. to Code § 2041, found in fn. 6713. Alternatively, suppose the trustee has the authority to distribute under ascertainable standards, but the trustee has the discretion to consider or ignore the beneficiary's other resources. The trustee might have considered the other resources and taken a minimalist approach to distributions throughout the year; but, when doing 65-day-rule planning, the trustee might chooses to ignore other resources and take an expansive view of the authority to make distributions.

3(b)(3) allows one to carry out discretionary distributions of capital gain inconsistently from one year to another.

If the beneficiary does not require monthly or quarterly cash flow, the trustee can simply each February make a big distribution and apply it to the prior or current year for tax return preparation purposes. If the beneficiary does require monthly cash flow but is willing to accept informal constraints, the trustee makes the big distribution into an investment account that the beneficiary owns, and the account makes monthly transfers to the beneficiary's checking account. Obviously this would not work for a beneficiary who cannot exercise discipline, but there is a good segment of beneficiaries for whom it would work.

An alternative approach is to distribute an asset to a beneficiary before the asset is sold. Generally, the beneficiary will receive a carryover basis and then be taxed on the gain.[2778]

As with all tax planning, the strategies described in this part II.J.8.c.iii may be unavailable (based on the trust terms), inadvisable (based on sound financial planning), or stupid (giving money to a drug addict just to save taxes).

II.J.8.c.iv. Netting Capital Losses

Reg. § 1.643(a)-3(d), "Capital losses," provides:

> Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is distributed or required to be distributed to a particular beneficiary. See § 1.642(h)-1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

Thus, if and to the extent that Reg. § 1.643(a)-3(b)(3) includes capital gains in DNI (see part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary), capital losses are not netted against such gains. The recipient beneficiaries report all such capital gains, and the capital losses remain in the trust.

However, note that Reg. § 1.643(a)-3(b)(3) has two elements: "actually distributed to the beneficiary," which would tend to require tracing except in the case of trust termination, or "utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary," in which case the trustee would have needed to consciously decide to refer to the capital gain when making the distribution.

Unless the trustee traces or decides to refer to the gross capital gain (instead of the net capital gain) when making the distribution, the loss would be offset under Reg. § 1.643(a)-3(b)(3). Alternatively, the trustee might not trace and not refer to capital gain but rather exercise the power to adjust, which would invoke Reg. § 1.643(a)-3(b)(1) (see part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law) and include an automatic offset.

[2778] Code § 643(e)(2).

II.J.8.c.v. Conclusions Regarding the Basic Framework on Allocating Capital Gains to DNI

Often, one cannot predict whether the combination of federal, state, and local income tax rates will be higher inside or outside of the trust.

Quite frankly, I keep changing my mind regarding the best income tax elections as I encounter new situations. If the document is flexible as to distributions and distributions are appropriate, then I would lean toward:

- Flexible language allowing the trustee to allocate capital gains to income, so long as the trustee must reasonably and fairly balance the interests of the income and remainder beneficiaries.

- Using the 65-day-rule to distribute large capital gains to the beneficiary as DNI.

- Electing not to establish a practice of carrying out capital gain to beneficiaries under Reg. § 1.643(a)-3(b)(2) unless it appears that the above two approaches will not suffice to minimize overall income taxes. However, it is not uncommon for me to decide that the above. two approaches will not suffice to minimize overall income taxes. On the other hand, if the situation involves enough money, the trustee can covert capital gain that would otherwise be trapped inside the trust to trust accounting income, using the tool described in part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

Consider adding a withdrawal right of up to 5% of the trust's value. The beneficiary will be deemed to be the owner of the part that the beneficiary can withdraw and perhaps continue to be deemed the owner with respect to the lapsed portion. However, note that withdrawal rights can increase exposure to creditors to the extent of the withdrawal right and perhaps even after a lapse. For details on all of the ideas mentioned in this paragraph, see part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts. If one is concerned about the withdrawal right itself becoming a bad idea, consider using a provision along the following the lines:

> In addition to the distributions authorized by the preceding sentence, subject to the following sentence the trustee shall distribute to the beneficiary so much of the principal of the trust as the beneficiary, while at least __ years of age, may request once between February 23 and March 5 of every calendar year, on a noncumulative basis, up to five percent (5%) of the aggregate value, as of the time of such request by the beneficiary, of the principal of the trust. The trustee may, by instrument placed in the trust's records, provide that the preceding sentence shall not apply during any period (including the beneficiary's remaining life), which period shall begin no earlier than the January 1 following the date of the instrument.

This allows the trustee to turn off the withdrawal rights for any future year(s) without impeding the beneficiary's absolute right to withdraw during the current year.

II.J.8.c.vi. Fairness of Taxing Capital Gain to Beneficiaries; Need for Tax Distributions Here and Other Areas

Our income tax system taxes income to whoever receives it, subject to certain exceptions not relevant to this part II.J.8.c.vi. Therefore, it is fair to tax the beneficiaries.

However, when a distribution is made for a particular purpose and the money is spent, the beneficiary will get upset when handed a tax bill for which the beneficiary did not plan. Therefore, one might need to make a supplemental distribution to pay tax on the original distribution. The supplemental distribution would also need to be enough to pay tax on the supplemental distribution itself. This supplemental distribution is often referred to as "grossing up the distribution" to pay taxes.

This issue applies to more than just capital gains. Clients who leave residences in trust often wish to have the trust pay expenses that a life tenant would ordinarily pay. Distributions by the trust for those purposes run into the same problem – the money is spent for the intended purpose and not available to pay taxes. These distributions also need to be grossed up to pay taxes.

II.J.8.d. Distribution in Kind; Specific Bequests

II.J.8.d.i. Distribution in Kind - Generally

Except as provided below and except to the extent that it carries out DNI[2779] or constitutes a bequest of income,[2780] a distribution is a nontaxable gift[2781] (unless the recipient assumes liabilities, in which case it is taxed as a bargain sale).[2782]

When a trust distributes property to satisfy a pecuniary distribution[2783] (even if the amount is expressly authorized to be satisfied in cash or in kind),[2784] the trust recognizes gain on the

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[2779] Reg. § 1.102-1(d).
[2780] Reg. §§ 1.102-1(b), (c) and 1.663(a)-1(b)(2)(i).
[2781] Reg. § 1.102-1(a), (d).
[2782] See part III.B.1.c.i Gifts with Consideration – Bargain Sales.
[2783] Similar logic applies to satisfying a debt. Citing Rev. Rul. 66-207 (fn 2786), Rev. Rul. 74-178 held:

> In the instant case the fair market value of the shares of stock at the time such stock was transferred to the creditor is equal to the amount of the claim satisfied ($8,000). However, since the executor did not elect the alternate valuation date, the estate's basis in the shares transferred is the fair market value of the shares at the date of the decedent's death ($7,000). Accordingly, it is held that upon such transfer the estate realized a gain of $1,000, which is the excess of the amount of the claim satisfied by the transfer over the estate's basis in the shares. Had the estate's basis in the shares of stock transferred exceeded the amount of the claim satisfied, the estate would have sustained a loss deductible to the extent allowed in sections 1211 and 1212 of the Code.

[2784] Rev. Rul. 86-105 held:

1. A bequest of "assets, in cash or in kind or partly in each," with a fair market value at date of distribution equal to a specified amount is a bequest of a "specific sum of money" under section 663(a) of the Code.
2. The bequest of unspecified property with a specified value at the date of distribution creates a right to receive a "specific dollar amount" under section 1.661(a)-2(f)(1) of the regulations. Therefore, gain or loss is realized by the estate upon a distribution in kind.

deemed sale,[2785] even if the trust's residue is less than the pecuniary obligation.[2786] Such a pecuniary obligation includes an equalizing distribution[2787] (presumably unless expressed as a

[2785] Reg. § 1.661(a)-2(f) provides:

> Gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under section 643(b) and the applicable regulations, if income is required to be distributed currently. In addition, gain or loss is realized if the trustee or executor makes the election to recognize gain or loss under section 643(e).

Reg. § 1.651(a)-2(d) provides:

> If a trust distributes property in kind as part of its requirement to distribute currently all the income as defined under section 643(b) and the applicable regulations, the trust shall be treated as having sold the property for its fair market value on the date of distribution. If no amount in excess of the amount of income as defined under section 643(b) and the applicable regulations is distributed by the trust during the year, the trust will qualify for treatment under section 651 even though property in kind was distributed as part of a distribution of all such income. This paragraph (d) applies for taxable years of trusts ending after January 2, 2004.

[2786] Rev. Rul. 66-207 included the following facts and conclusion:

> By the terms of the decedent's will he made a bequest of a specific sum of money in the amount of 250x dollars to be used to create a trust for the benefit of a designated beneficiary. After payment of all debts, costs of administration, claims, and specific bequests, other than the sum of 250x dollars, the executor finds that all he has left in the estate are assets now having a fair market value of 200x dollars and an aggregate basis to the estate of 150x dollars. Included among these assets is cash in the amount of 10x dollars. All of these assets will be transferred in trust to the designated trustee in accordance with the terms of the will….
>
> Section 1.661(a)-2(f) of the regulations provides, in part, that no gain or loss is realized by the trust or estate by reason of the distribution of property in kind unless the distribution is in satisfaction of a right to receive a distribution in a specific dollar amount. Under this provision of the regulations whenever property other than money is distributed by an estate to any beneficiary, including a trust, in satisfaction of a cash bequest the estate realizes gain or loss measured by the difference between the amount of the bequest satisfied and the basis to the estate of the property so distributed. See *William R. Kenan, Jr., et al. v. Commissioner*, 114 F.2d 217 (1940); and *Sarah P. Suisman v. Eaton*, 15 F.Supp. 113 (1935), *affirmed per curiam*, 83 F.2d 1019, *certiorari denied*, 299 U.S 573.
>
> When the executor of this estate distributes the property remaining in the estate to the designated trustee in creation of the trust the estate will realize a gain of 50x dollars. This is the difference between the amount of the bequest satisfied by distribution of property other than cash (200x dollars less 10x dollars cash, or 190x dollars) and the basis (150x dollars less 10x dollars cash or 140x dollars) to the estate of the assets other than cash distributed in satisfaction of the bequest of a specific sum of money. The effect of the distribution will be the same as if the executor sold the remaining assets of the estate and distributed the proceeds to the trustee in trust.
>
> No amount is deductible by the estate under section 661 of the Code or includible in gross income of the trust under section 662 of the Code since the distribution will be in satisfaction of a bequest of a specific sum of money, as defined by section 1.663(a)-1(b) of the regulations. Accordingly, a final distribution by the executor of an estate of appreciated property, in order to satisfy a pecuniary legacy, will result in a gain to the estate, although such distribution is of an insufficient amount to completely satisfy such bequest.

[2787] Rev. Rul. 82-4 held:

> In this case, as in Rev. Rul. 66-207, the residue equal to the value of 100,000 shares of X company stock as of date of death bequeathed to C is a "bequest of a specific sum of money," as that term is defined in section 1.663(a)-1(b)(1) of the regulations, because the amount is ascertainable under the terms of A's will as of the date of A's death. Thus, no amount is

fractional share). This rule includes a pecuniary obligation in the form of an annuity payment to a beneficiary,[2788] and the gain recognized in paying the annuity is not included in the beneficiary's distributive net income (DNI) unless the rules for including capital gain in DNI are satisfied.[2789] If the trust's residue is less than the pecuniary obligation, the fact that all bequests are protected by Code § 663(a)(1)[2790] and therefore no residual beneficiary can pick up income under Code § 662 means that the trust will pay the tax, given that the beneficiaries of the protected bequests will not be picking up that income;[2791] note that the trustee will need to

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> deductible by the estate under section 661 of the Code or includible in the gross income of B under section 662. Also, under section 1.661(a)-2(f)(1), the estate realizes a gain on the distribution in kind of appreciated property in satisfaction of C's right to receive a distribution in a specific dollar amount.
>
> **Holding**
>
> The estate realizes gain of $60,000 (date of distribution value ($180,000) less the basis of the property in the estate ($120,000)) for federal income tax purposes when the executor distributes the entire residuary estate to C to equalize to the extent possible the respective shares of total transfers received from the decedent.
>
> If in this case the value of the residuary estate had been, for example, $250,000, the property remaining after satisfaction of the $200,000 bequest to C ($50,000) would pass to B and C in equal shares. The estate would realize no gain or loss under section 1.661(a)-2(f)(1) of the regulations upon distribution of this portion of the $50,000 residue because the distribution would not be in satisfaction of the right to receive a distribution in a specific dollar amount.

[2788] Rev. Rul. 83-75, citing *Kenan v. Commissioner*, 114 F.2d 217 (2nd Cir. 1940), reasoned:

> The trustee was obligated to pay a fixed annuity to qualified charitable organizations. Under the principles of section 1.661(a)-2(f)(1) of the regulations and the case law cited, the distribution of appreciated securities causes the trust to realize gain or loss if the distribution satisfies a right to receive a distribution in a specific dollar amount. Although the trustee has authority to pay the annuity to qualified charities of the trustee's choice, the distribution satisfies a right to receive a specified dollar amount. It is not necessary or practical to identify a particular qualified charity with the right to receive a specified dollar amount. In *Kenan*, the court stated that the word "exchange" does not necessarily have the connotation of a bilateral agreement which may be said to attach to the word "sale". Thus, the distribution in this case is an exchange even though the trustee consulted with no one before satisfying the obligation to pay the annuity by using the appreciated securities.

Rev. Rul. 83-75 held:

> The distribution by the trust of corpus consisting of appreciated securities in satisfaction of its obligation to pay a fixed annuity to a qualified charitable organization is a sale or exchange of the securities that results in taxable gain to the trust.

Rev. Proc. 2007-45, § 8.02(2) says:

> *Payment requirements*. CLATs are not subject to any minimum or maximum payout requirements. The governing instrument of a CLAT must provide for the payment to a charitable organization of a fixed dollar amount or a fixed percentage of the initial net fair market value of the assets transferred to the trust. Alternatively, the governing instrument of a CLAT may provide for an annuity amount that is initially stated as a fixed dollar or fixed percentage amount but increases during the annuity period, provided that the value of the annuity amount is ascertainable at the time the trust is funded. The annuity payments may be made in cash or in kind. If the trustee distributes appreciated property in satisfaction of the required annuity payment, the donor will realize capital gain on the assets distributed to satisfy part or all of the annuity payment.

[2789] Rev. Rul. 68-392, which went through the rules that existed at that time regarding including capital gain in DNI and concluded that they did not apply. However, since then, the regulations have changed, so a different result may occur; see part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).

[2790] See part II.J.8.d.ii Specific Bequest.

[2791] Letter Ruling 9548020, citing Rev. Rul. 66-207, a relevant excerpt from which is reproduced in fn 2786.

reserve for this tax before making distributions to beneficiaries and may have a mismatch for net investment income tax purposes as well.[2792] However, when a charity that was the annuity recipient was bequeathed the remainder, the resulting merger of interests and trust termination were not a taxable event.[2793] Also, if the bequest is satisfied using date-of-death values, presumably no gain or loss would be realized, but to qualify for the marital[2794] or charitable[2795] deduction the assets' value relative to date of death values must be "fairly representative of appreciation or depreciation in the value of all property thus available for distribution in satisfaction of such pecuniary bequest or transfer."

If a trust makes a non-pro rata distribution of residue without either the trust instrument or local law authorizing a non-pro rata distribution, each beneficiary may be treated as having received a pro rata distribution and exchanged it with the other beneficiaries.[2796] Otherwise, generally the trust does not recognize any gain or loss and the beneficiaries receive the same basis as the trust's;[2797] for further analysis of dividing trusts (including on termination), see part II.D.5 Severing Trusts with Multiple Grantors. However, the trust may elect to treat all property distributions during the taxable year as sales,[2798] but losses in transactions with beneficiaries and other related parties are disallowed except to the extent that they are from an

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[2792] Deductions for regular income tax purposes limit the deduction for distributions to beneficiaries. If those same deductions do not apply for net investment income (NII) tax purposes, the trust's NII may be subjected to NII tax. See part II.I.6 Deductions Against NII within part II.I 3.8% Tax on Excess Net Investment Income (NII).
[2793] Letter Ruling 201928005, holding that Rev. Rul. 83-75 (fn 2788) did not apply.
[2794] Rev. Proc. 64-19.
[2795] Letter Ruling 8339005.
[2796] Rev. Rul. 69-486. See Zaritsky, Lane & Danforth, ¶2.19. Gain on the Division, Termination, or Reformation of a Trust, *Federal Income Taxation of Estates and Trusts* (WG&L).
[2797] Rev. Rul. 69-486. Reg. § 1.1015-2(a) provides:

(1) In the case of property acquired after December 31, 1920, by transfer in trust (other than by a transfer in trust by a gift, bequest, or devise) the basis of property so acquired is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by a transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether acquired prior to the termination of the trust and distribution of the property, or thereafter.

(2) The principles stated in paragraph (b) of § 1.1015-1 concerning the uniform basis are applicable in determining the basis of property where more than one person acquires an interest in property by transfer in trust after December 31, 1920.

[2798] Code § 643(e)(3). Letter Ruling 202239006 allowed the taxpayer to revoke its Code § 643(e)(3) election in this situation:

> On the advice of Estate's return preparer, the executors of Estate made an election under § 643(e)(3) for Estate's tax year ending Date 3 to treat the distribution as a sale of property to Y. The intended effect of the election was for Estate to recognize built-in loss in the distributed assets, and for Y, and subsequently X and Y's children, to have a basis in the assets equal to their fair market value. Estate filed its income tax return for its tax year ending Date 3 on this basis.
>
> While preparing Y and Y's children's tax income tax returns, the return preparer realized that the intended effect of the § 643(e)(3) election had not occurred because of the prohibition against deductions in transactions between related taxpayers in § 267 of the Code. The preparer advised the executors of Estate to submit a request for permission to revoke the § 643(e)(3) election. Estate has filed an amended return for its tax year ending Date 3 as though the § 643(e)(3) election is not in effect.

estate (including a revocable trust electing to be taxed as an estate)[2799] satisfying a pecuniary bequest.[2800] The loss disallowance applies even if the distribution, taken as a whole, results in a net gain. Thus, gains are recognized and losses generally are not.

[2799] See part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI)
Although the discussion below generally refers to trusts, generally it applies to estates as well. If a trustee has discretion to make an election regarding that trust, the election does not affect the choices available regarding other trusts the trustee manages.

I.A.1.h. Capital Gain Constitutes DNI Unless Excluded

Taxable income is DNI unless expressly excluded.

Code § 643(a)(3) provides:

> *Capital gains and losses*. Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c).

Thus, to be excluded from the income of a domestic trust, the gains must:

- Arise from the sale or exchange of capital assets,
- Be allocated to corpus, and
- Not be actually or deemed to be distributed.

The rest of this part II.J.8.a Capital Gain Constitutes DNI Unless Excluded focuses on the first two prongs.

I.A.1.h.i. Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset

Only gains from the sale of capital assets are ordinarily excluded from DNI.

For example, “property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business” is not a capital asset. Therefore, the sale of such property would constitute DNI, although it would not constitute trust accounting income. Whether other real estate is a capital asset depends on various facts.

However, “any recognized gain on the sale or exchange of property used in the trade or business” often receives capital gain treatment to the extent it does not constitute certain depreciation recapture. Goodwill that has not been amortized is a capital asset, but goodwill that is being amortized is not a capital asset. Thus, because such assets are not capital assets, such capital gains generally would be included in DNI.

I.A.1.h.ii. Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus

I am unaware of any authority defining "allocated to corpus" as used in Code § 643(a)(3). Presumably it means receipts by the trust that are allocated to principal.

Does the statute mean that capital gain are automatically included in DNI unless they are affirmatively allocated to principal and certain other conditions exist? Reg. § 1.643(a)-3(a) might overrule that requirement, providing (highlighting added):

> *In general*. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

This regulation essentially has three parts:

- Reg. § 1.643(a)-6 deals with foreign trusts.

- Reg. § 1.643(a)-3(b) explains when capital gains from the sale or exchange of an asset are included in DNI and does not include a requirement that the capital gain be allocated to principal. In fact, one of the prongs discusses the treatment when capital gains are allocated to income.

- Depending on the meaning one gives to "ordinarily," this regulation might dispense with the statutory requirement that capital gains be allocated to corpus. The regulation does not explain when it says "ordinarily" what the exceptions might be, other than Reg. §§ 1.643(a)-6 and 1.643(a)-3(b). There would appear to be substantial authority for saying that an affirmative allocation of capital gains to principal is or is not required.

This issue seems to be most important for the trust's gross income that does not take the form of receipts of cash or other property. For example, a trust might invest in a partnership, S corporation, or other flow-through entity that does not distribute all of its taxable income. How should one treat capital gain from a flow-through entity's sale of a capital asset, when the entity distributes less than all of its taxable income? Should the undistributed capital gain be included in DNI?

- With respect to the accumulated capital gain, the trust has no receipts and therefore is not allocated to corpus. Arguably, the capital gain is not excluded from DNI and therefore constitutes DNI.

- On the other hand, the accumulated capital gain benefits the trust's corpus. Should it be treated as if it had been allocated to corpus? In that case, should it be trapped inside the trust, given that it was accumulated inside the entity and not distributed to the beneficiary?

- Given this uncertainty, would the trustee have discretion to take a different position each year? In Reg. § 1.643(a)-3(b), the Treasury generally agreed that the trustee would not be required to take a consistent position year-by-year, except for capital gain allocated to corpus and treated consistently by the fiduciary on the trust's books, records, and tax

> returns as part of a distribution to a beneficiary. Given that this gross income was not allocated corpus (because it was never physically received), perhaps the trustee has discretion to vary the treatment from year to year? Another approach might be to say that, because the undistributed capital gain was not allocated to principal, the regulations might presume that the undistributed capital gain is allocated to income and can be included in DNI inconsistently from year to year under Reg. § 1.643(a)-3(b)(1).

If all of a flow-through entity's K-1 items taxable to the trust are included in DNI, then part II.J.8.c Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal might cause ordinary income to be trapped at the trust level if the flow-through entity distributes cash in an amount less than all of these K-1 items; see part II.J.8.f Consequences of Allocating Capital Gain to DNI. In light of the consequences described there, the most taxpayer-favorable reading may be that capital gain is ordinarily excluded from DNI.

I leave it to the reader to decide which approach is "better" or perhaps to make that decision on a trust-by-trust basis.

For more on using flow-through entities, see part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

I.A.1.i. Should Capital Gain Be Allocated to DNI?

Often beneficiaries have income below the thresholds that cause the 3.8% tax and the additional 5% capital gain tax to be incurred, whereas trusts start paying those taxes at relatively modest income levels. Therefore, distributing capital gains to beneficiaries might be beneficial – at least from an income tax viewpoint.

Consider various factors described in part II.J.3 Strategic Fiduciary Income Tax Planning.

I.A.1.j. Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal

Generally, gains from the sale or exchange of capital assets, net of losses, are excluded from distributable net income (DNI). But that statement belies the flexibility we are about to see.

Reg. § 1.643(a)-3(b) provides:

> *Capital gains included in distributable net income*. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law) -
>
> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be

greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

Note the word "or" after paragraph (2) above. That indicates capital gains are included in DNI if and to the extent that any one or more of paragraph (1) (the "Income Rule"), paragraph (2) (the "Consistent Principal Rule"), or paragraph (3) (the "Discretionary Principal Rule") applies. For more on the:

- Income Rule, see part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law

- Consistent Principal Rule, see part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary

- Discretionary Principal Rule, see part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary.

Before its amendment by T.D. 9102 (12/30/2003), Reg. § 1.643(a)-3 made it more difficult to include capital gain in DNI.

I.A.1.j.i. Income Rule: Capital Gain Allocated to Income Under State Law

Most states have adopted the Uniform Principal and Income Act, which will be referred to at UPIA for the rest of this part II.J.8.c.i, or its replacement, which is described in part II.J.5.b Uniform Fiduciary Income & Principal Act (UFIPA).

Generally, any capital gain included as the distributive share of income from a partnership or S corporation and distributed from the entity to the trust will constitute income under the Act, making the rest of this part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI) be moot.

Generally, the Act allocates capital gains to principal. The main exceptions are the power to adjust, unitrust distributions, and exceptions in the governing instrument; the power to adjust and power to convert to a unitrust followed adoption of the prudent investor rule. Following a discussion of each of these is a discussion of the respect fiduciary income tax law gives them.

I.A.1.j.i.(a). Power to Adjust

Capital gains may be reclassified as income if traditional trust accounting income principles cause insufficient receipts to be classified as income. See parts II.J.5.b.ii.(a) Power to Adjust.

I.A.1.j.i.(b). Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation

It is not uncommon for partnerships and S corporations to reinvest part of their annual income; indeed, to facilitate growth or simply a stronger capital structure (which lenders might require), many distribute only enough to pay their owners' income taxes (commonly referred to as a "tax distribution") plus a modest bonus (referred to below as a "bonus distribution").

Taxes on this reinvested income are charged against the income of a trust that owns such an entity. This is the only practical solution to the trust's obligation to pay its taxes, because the taxing authorities' claims against the trustee are much more pressing than the beneficiaries' claims. (Note that the income beneficiary of a Qualified Subchapter S Trust pays this tax – part III.A.3.e QSSTs and ESBTs – which has an effect similar to charging the trust's income.)

The Uniform Principal and Income Act includes a remedy for the income beneficiary that had to pay the tax on the entity's accumulated income that has been inherently baked into principal. Section 506(a)(3) authorizes a fiduciary to "make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from … the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary." This specific provision supplements any power to adjust that might generally apply.

Thus, when an interest in a partnership or an S corporation is sold, the trustee should consider whether to allocate some of the sale proceeds to income. However, it's not at all obvious that the trustee should make an adjustment; consider that:

- The entity made distributions specifically to pay this tax, so the trust or income beneficiary was not really "out of pocket" for this tax.

- If the entity had been a C corporation, the entity would have paid the tax itself. Its dividend would have equaled the bonus distribution, and this issue would never have arisen.

- The true issue is whether the bonus distribution was sufficient. Was the decision to accumulate income fair – a sound exercise of the business judgment of those who run the entity? Did those who control the entity promise a make-up distribution at some point because of a special project, or was the accumulation merely part of a solid plan to grow the business, which presumably would result in increased income and increased bonus distributions? Were those who control the entity running it just to benefit themselves (and, if owners, trying to extract more benefits as owners than the inactive owners received)? I have probably left out many other relevant considerations, but hopefully I have communicated why this decision is not easy.

See parts II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Trust Accounting Rules
and II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets.

If the trustee is concerned that the income beneficiary might spend a perceived windfall unwisely, the trustee might consider using the power to adjust to spread distributions over an appropriate period of time. Such a spread over time might be more palatable if, instead of labelling the adjustment to sale proceeds as a tax reimbursement, the trustee labelled it as a make-up for insufficient bonus distributions, taking the position that future distributions to beneficiaries might be loosened because of a prior conservative distribution policy. The bonus distributions might have been sufficient from the viewpoint of what the entity should have distributed but might have been insufficient from the viewpoint of how much income the trustee should have tried to generate. As mentioned in part III.A.4.d.iv Advising Clients about the UPAIA § 505 Change and UFIPA § 506 (discussing conflicts with beneficiaries that might arise when an entity makes tax distributions but little or no bonus distributions), these issues have no easy answer.

See also part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Trust Accounting Rules.

I.A.1.j.i.(c). Unitrust

A unitrust is a trust that distributes fixed amounts, redetermined annually as a fixed percentage of the value of the trust's value, which value is redetermined annually but might be based on an average of values, such as the average value of the trust's assets for the past three years. See parts II.J.5.b.ii.(b) Unitrust and II.J.5.b.ii.(c) Comparing Power to Adjust to a Unitrust.

Reg. § 1.643(a)-3(e) provides the following examples regarding unitrusts:

> *Example (11)*. The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.
>
> *Example (12)*. The facts are the same as in Example 11, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire $80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise

> of Trustee's discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.
>
> *Example (13)*. The facts are the same as in Example 11, except that neither state statutes nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

A right to income expressed initially solely as a unitrust interest may qualify for the QTIP marital deduction.

I.A.1.j.i.(d). Exceptions in the Governing Instrument

Although the Act provides general rules, it also allows trust agreements to override those rules:

> In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:
>
> (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
>
> (2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];
>
> (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and
>
> (4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

I.A.1.j.i.(e). Fiduciary Income Tax Recognition of the Trust Agreement and State Law

Code § 643(b) generally defers to the trust agreement and applicable state law. The Uniform Principal and Income Act ("UPIA") and the Uniform Fiduciary Principal & Income Act ("UFIPA") authorizes the trust agreement to override the Act.

However, Reg. § 1.643(b)-1 does not recognize trust agreements that depart too far from the usual rules:

> Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal.

Reg. § 1.643(b)-1 respects variations provided under applicable state law:

> However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods.

Circling back to the Act's authorizing trust agreements to depart from traditional principles, Reg. § 1.643(b)-1 concludes with:

> In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.

For the "reasonable and impartial exercise" requirement in the context of the power to adjust, see part II.J.5.b.ii.(a) Power to Adjust.

I often use a clause providing that the trustee has wide discretion but must reasonably and fairly balance the interests of the income and remainder beneficiaries. That language comes from the marital deduction regulations. Generally, the trustee's authority to allocate between income and principal does not trigger grantor trust status, does not constitute a power of appointment, and does not have generation-skipping transfer tax implications. The trustee might want to consider providing accountings or other notices to the beneficiaries that would start running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile this one on top of it, which procedure might help minimize any gift tax consequences to failing to make a claim.

How does one draw the line between what departs "fundamentally from traditional principles of income and principal" and what is "a reasonable and impartial exercise of a discretionary power granted to the fiduciary" under Reg. § 1.643(b)-1?

Presumably, the trustee should be on solid ground in allocating to income capital gains such that the total amount of all receipts allocated to income does not exceed 5%, given that the regulations expressly approve unitrusts in the 3%-5% range. The trusts should also be on solid ground in allocating to income capital gains generated by a partnership that the settlor intended to distribute to the income beneficiary.

Beyond that, it's a matter of facts and circumstances and judgment. However, Reg. § 1.643(a)-3(e), Example (4) respected a mandatory allocation of capital gain to income where a trust had $5,000 of dividends and $10,000 of capital gains, and the trustee distributed $17,000 to the beneficiary.

I.A.1.j.i.(f). Conclusion Regarding Allocating Capital Gain to Income

Reg. § 1.643(a)-3(b)(1) requires a consistent practice for unitrusts. Considering that the unitrust recipient is receiving cash and presumably would have the liquidity to pay tax on any capital gains distributed to the beneficiary, in many cases it would be fair to allocate capital gain to DNI to the extent that the unitrust amount exceeds the income that would apply under the Act's general rules. Given that one provides for a unitrust when tension between the income beneficiary and remaindermen might be high, the tension created by this tax issue would be high to the same degree. Consider providing a firm rule in the trust agreement regarding the allocation of capital gain to DNI. If one is concerned that shifting tax rates might create an unfair tax result, consider providing a clause reimbursing the unitrust beneficiary for taxes paid on the unitrust and on the reimbursement; this requires cooperation between the trustee's income tax preparer and the beneficiary's income tax preparer, but the calculation should be relatively mechanical.

For trusts that are not unitrusts, Reg. § 1.643(a)-3(b)(1) provides significant flexibility, allowing the trustee discretion whether to allocate capital gain to income for fiduciary accounting purposes (if the trust agreement and state law permit) and also whether to include in DNI the capital gain that was allocated to income.

Consider the nuances for a mandatory income trust. Distributions must be made no later than 65 days after yearend to include capital gain in DNI in every other situation. In a mandatory income trust, a power to adjust might be able to retroactively include capital gain in income – perhaps as late as when the tax return is prepared. For how mandatory income trusts work, see part II.J.5 Mandatory Income Trusts. For limits on retroactivity, see part II.J.5.a Issues Arising with Mandatory Income Trusts.

I.A.1.j.ii. Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary

Reg. § 1.643(a)-3(e) helps guide our application of Reg. § 1.643(a)-3(b)(2):

> *Example (1)*. Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.
>
> *Example (2)*. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.
>
> *Example (3)*. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments. This treatment of capital gains is a reasonable exercise of Trustee's discretion.

The all-or-nothing approach taken by Examples (1) and (2) is not very attractive, but we need to deal with it. Let's consider some fact patterns:

1. <u>The beneficiary needs regular annual distributions that cannot be made using a power to adjust</u>. Generally, distributions in excess of what can made using a power to adjust would not be sustainable. A power to adjust typically adjusts to a 3%-5% distribution, and most models suggest that distributions in excess of that will lead to a trust being depleted. Thus, a more likely scenario is that a power to adjust is not available, because state law prevents using the power to adjust in particular situations (unless the trust agreement overrides it). In such a case, the beneficiary's federal and state/local income tax bracket for capital gains needs to be compared to the trust's federal and state/local income tax bracket for capital gains. Note that a nonresident trust would have a zero state/local income tax bracket, to the

extent that the trust does not have income from a business sourced to the state/local jurisdiction.

2. The beneficiary's need for distributions in excess of income is sporadic. It's difficult to predict how the beneficiary's federal and state/local income tax bracket for capital gains compares to the trust's federal and state/local income tax bracket for capital gains, given that rates will change and the trust's and its beneficiaries' circumstances might change over time. In such a case, consider whether the distribution might be phrased as "allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary." If that is likely to be the case, then consider not electing to carry out capital gain automatically under (b)(2) but rather deciding to rely on (b)(3), because (b)(3) is flexible whether to allocate capital gain to income, allowing the decision to made separately each year on a case-by-case basis.

Generally, trustees would not be likely to take advantage of the discretion that Example (3) provides to allocate to income only capital gain from the sale of certain specified assets or a particular class of investments, because such an election requires additional recordkeeping.

Some people point to the word "deem" in Example (1) and emphasize the need for such authority in the trust agreement or applicable state law. Uniform Trust Code § 816 generally authorizes trustees to make tax elections, so the authority to "deem" distributions to be capital gains is inherently authorized in UTC states, as well as any other state where a trustee generally has the authority to make tax elections.

I.A.1.j.iii. Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary

Reg. § 1.643(a)-3(b)(3) might seem confusing at first, but it actually has very practical use.

First, let's look at some examples that Reg. § 1.643(a)-3(e) provides:

> Example (5). The facts are the same as in Example 1, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is $10,000, rather than $12,000. Because Trustee will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.
>
> *Example (6)*. Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to A. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

Although Reg. § 1.643(a)-3(b)(3) is viewed generally as discretionary, note that Example (6) is mandatory: if the trustee is required to distribute sale proceeds to a beneficiary, the capital gain from the sale is included in the DNI that the distribution carries out the beneficiary. Example (7) similarly requires all capital gain recognized in the trust's final taxable year to be included in the DNI that the distribution carries out the beneficiary.

The practical application is based on the ability to count as prior year distributions those distributions made in the first 65 days of the current year. For example, any distribution made on or before March 5, 2020 can be treated as a 2019 or 2020 distribution. This election applies to the greater of accounting income under Reg. § 1.643(b)-1 or DNI under Reg. §§ 1.643(a)-1 through 1.643(a)-7. By completing the line on the trust's income tax return, Form 1041, page 2, Part B, showing amounts (other than income required to be distributed currently) paid, credited, or otherwise required to be distributed and checking the Code § 663(b) box in "Other Information" at the bottom of Form 1041, page 2, the trustee decides how much of a current year distribution is allocated to the prior year; the balance would then be credited to the current year.

The practical application based on the 65-day rule would generally occur during February after the year ends and applies only if the trustee has discretion to distribute corpus. The regulations do not specify any particular trust records regarding the election, so do whatever seems best to evidence the intent. Perhaps the income tax return preparer emails the trustee recommending how much of a distribution be made to distribute income and capital gain under the 65-day rule (erring on the side of distributing too much), then the trustee makes the distribution, and the tax return carries through the intent. As long as the distribution is made timely, the tax return can treat none, part, or all of the distribution as a distribution of the taxable year's income. In a manner similar to Example (5), the trustee has referred to the capital gain itself in determining how much to distribute. Unlike Reg. § 1.643(a)-3(b)(2), Reg. § 1.643(a)-3(b)(3) allows one to carry out discretionary distributions of capital gain inconsistently from one year to another.

If the beneficiary does not require monthly or quarterly cash flow, the trustee can simply each February make a big distribution and apply it to the prior or current year for tax return preparation purposes. If the beneficiary does require monthly cash flow but is willing to accept informal constraints, the trustee makes the big distribution into an investment account that the beneficiary owns, and the account makes monthly transfers to the beneficiary's checking account. Obviously this would not work for a beneficiary who cannot exercise discipline, but there is a good segment of beneficiaries for whom it would work.

An alternative approach is to distribute an asset to a beneficiary before the asset is sold. Generally, the beneficiary will receive a carryover basis and then be taxed on the gain.

As with all tax planning, the strategies described in this part II.J.8.c.iii may be unavailable (based on the trust terms), inadvisable (based on sound financial planning), or stupid (giving money to a drug addict just to save taxes).

I.A.1.j.iv. Netting Capital Losses

Reg. § 1.643(a)-3(d), "Capital losses," provides:

> Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is

distributed or required to be distributed to a particular beneficiary. See § 1.642(h)-1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

Thus, if and to the extent that Reg. § 1.643(a)-3(b)(3) includes capital gains in DNI (see part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary), capital losses are not netted against such gains. The recipient beneficiaries report all such capital gains, and the capital losses remain in the trust.

However, note that Reg. § 1.643(a)-3(b)(3) has two elements: "actually distributed to the beneficiary," which would tend to require tracing except in the case of trust termination, or "utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary," in which case the trustee would have needed to consciously decide to refer to the capital gain when making the distribution.

Unless the trustee traces or decides to refer to the gross capital gain (instead of the net capital gain) when making the distribution, the loss would be offset under Reg. § 1.643(a)-3(b)(3). Alternatively, the trustee might not trace and not refer to capital gain but rather exercise the power to adjust, which would invoke Reg. § 1.643(a)-3(b)(1) (see part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law) and include an automatic offset.

I.A.1.j.v. Conclusions Regarding the Basic Framework on Allocating Capital Gains to DNI

Often, one cannot predict whether the combination of federal, state, and local income tax rates will be higher inside or outside of the trust.

Quite frankly, I keep changing my mind regarding the best income tax elections as I encounter new situations. If the document is flexible as to distributions and distributions are appropriate, then I would lean toward:

- Flexible language allowing the trustee to allocate capital gains to income, so long as the trustee must reasonably and fairly balance the interests of the income and remainder beneficiaries.

- Using the 65-day-rule to distribute large capital gains to the beneficiary as DNI.

- Electing <u>not</u> to establish a practice of carrying out capital gain to beneficiaries under Reg. § 1.643(a)-3(b)(2) <u>unless</u> it appears that the above two approaches will not suffice to minimize overall income taxes. However, it is not uncommon for me to decide that the above. two approaches will not suffice to minimize overall income taxes. On the other hand, if the situation involves enough money, the trustee can covert capital gain that would otherwise be trapped inside the trust to trust accounting income, using the tool described in part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

Consider adding a withdrawal right of up to 5% of the trust's value. The beneficiary will be deemed to be the owner of the part that the beneficiary can withdraw and perhaps continue to be deemed the owner with respect to the lapsed portion. However, note that withdrawal rights can increase exposure to creditors to the extent of the withdrawal right and perhaps even after a lapse. For details on all of the ideas mentioned in this paragraph, see part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts. If one is concerned about the withdrawal right itself becoming a bad idea, consider using a provision along the following the lines:

> In addition to the distributions authorized by the preceding sentence, subject to the following sentence the trustee shall distribute to the beneficiary so much of the principal of the trust as the beneficiary, while at least __ years of age, may request once between February 23 and March 5 of every calendar year, on a noncumulative basis, up to five percent (5%) of the aggregate value, as of the time of such request by the beneficiary, of the principal of the trust. The trustee may, by instrument placed in the trust's records, provide that the preceding sentence shall not apply during any period (including the beneficiary's remaining life), which period shall begin no earlier than the January 1 following the date of the instrument.

This allows the trustee to turn off the withdrawal rights for any future year(s) without impeding the beneficiary's absolute right to withdraw during the current year.

I.A.1.j.vi. Fairness of Taxing Capital Gain to Beneficiaries; Need for Tax Distributions Here and Other Areas

Our income tax system taxes income to whoever receives it, subject to certain exceptions not relevant to this part II.J.8.c.vi. Therefore, it is fair to tax the beneficiaries.

However, when a distribution is made for a particular purpose and the money is spent, the beneficiary will get upset when handed a tax bill for which the beneficiary did not plan. Therefore, one might need to make a supplemental distribution to pay tax on the original distribution. The supplemental distribution would also need to be enough to pay tax on the supplemental distribution itself. This supplemental distribution is often referred to as "grossing up the distribution" to pay taxes.

This issue applies to more than just capital gains. Clients who leave residences in trust often wish to have the trust pay expenses that a life tenant would ordinarily pay. Distributions by the trust for those purposes run into the same problem – the money is spent for the intended purpose and not available to pay taxes. These distributions also need to be grossed up to pay taxes.

I.A.1.k. Distribution in Kind; Specific Bequests

I.A.1.k.i. Distribution in Kind - Generally

Except as provided below and except to the extent that it carries out DNI or constitutes a bequest of income, a distribution is a nontaxable gift (unless the recipient assumes liabilities, in which case it is taxed as a bargain sale).

When a trust distributes property to satisfy a pecuniary distribution (even if the amount is expressly authorized to be satisfied in cash or in kind), the trust recognizes gain on the deemed sale, even if the trust's residue is less than the pecuniary obligation. Such a pecuniary obligation includes an equalizing distribution (presumably unless expressed as a fractional share). This rule includes a pecuniary obligation in the form of an annuity payment to a beneficiary, and the gain recognized in paying the annuity is not included in the beneficiary's distributive net income (DNI) unless the rules for including capital gain in DNI are satisfied. If the trust's residue is less than the pecuniary obligation, the fact that all bequests are protected by Code § 663(a)(1) and therefore no residual beneficiary can pick up income under Code § 662 means that the trust will pay the tax, given that the beneficiaries of the protected bequests will not be picking up that income; note that the trustee will need to reserve for this tax before making distributions to beneficiaries and may have a mismatch for net investment income tax purposes as well. However, when a charity that was the annuity recipient was bequeathed the remainder, the resulting merger of interests and trust termination were not a taxable event. Also, if the bequest is satisfied using date-of-death values, presumably no gain or loss would be realized, but to qualify for the marital or charitable deduction the assets' value relative to date of death values must be "fairly representative of appreciation or depreciation in the value of all property thus available for distribution in satisfaction of such pecuniary bequest or transfer."

If a trust makes a non-pro rata distribution of residue without either the trust instrument or local law authorizing a non-pro rata distribution, each beneficiary may be treated as having received a pro rata distribution and exchanged it with the other beneficiaries. Otherwise, generally the trust does not recognize any gain or loss and the beneficiaries receive the same basis as the trust's; for further analysis of dividing trusts (including on termination), see part II.D.5 Severing Trusts with Multiple Grantors. However, the trust may elect to treat all property distributions during the taxable year as sales, but losses in transactions with beneficiaries and other related parties are disallowed except to the extent that they are from an estate (including a revocable trust electing to be taxed as an estate) satisfying a pecuniary bequest. The loss disallowance applies even if the distribution, taken as a whole, results in a net gain. Thus, gains are recognized and losses generally are not.

The amount deemed distributed is the lesser of the property's basis or fair market value, unless gain was recognized, in which case it is the property's value.

Distributing low basis assets will generate a new basis (often a step-up) when the beneficiary dies. However, distributed assets are subject to the beneficiary's creditors, changes in the beneficiary's estate tax posture (including not only changes in the tax law but also changes in financial situation through the beneficiary's own efforts or through marriage and change in residence to a state that imposes its own estate tax), and changes in the beneficiary's dispositive goals. To get a basis step-up, I would rather add (perhaps by decanting) a formula general power of appointment, as described in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.

Distributing an unmarketable partnership interest would carry out DNI without giving the beneficiary cash. However, valuation adjustments might depress the amount of the deemed distributions, and the beneficiary would be entitled to a proportionate share of future distributions from the partnership. However, if the trustee controls the partnership, the trustee can also control the distribution spigot.

I.A.1.k.ii. Specific Bequest

A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under Code § 661 and is not included in the gross income of a beneficiary under Code § 662, unless under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the recipient in more than three installments.

I.A.1.k.iii. Distributing a Note to the Obligor

Rev. Rul. 75-68 provides:

> The income of a testamentary trust consisting solely of interest from mortgages on the beneficiary's property was required to be distributed periodically. Although the mortgage notes held by the trust required the periodic payment of interest, it was agreed between the beneficiary and the trustees, that the beneficiary would pay no interest on the mortgages and the trustees would distribute no income from the trust.
>
> *Held*, notwithstanding the foregoing agreement, the interest income due on the mortgages held by the trust is includible in the gross income of the trust, and this same amount, as the distributable income of the trust, is includible in the gross income of the beneficiary. Further, the beneficiary is entitled to a deduction for this interest deemed paid on the mortgages.

Below is authority consistent with this conclusion:

Reg. § 1.643(c)-1(a) treats as a beneficiary "any person with respect to an amount used to discharge or satisfy that person's legal obligation as that term is used in § 1.662(a)-4."
Reg. § 1.661(a)-2(d) provides:

> The terms "income required to be distributed currently" and "any other amounts properly paid or credited or required to be distributed" also include any amount used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)-4.

Reg. § 1.662(a)-4, "Amounts used in discharge of a legal obligation," provides:

> Any amount which, pursuant to the terms of a will or trust instrument, is used in full or partial discharge or satisfaction of a legal obligation of any person is included in the gross income of such person under section 662(a)(1) or (2), whichever is applicable, as though directly distributed to him as a beneficiary, except in cases to which section 71 (relating to alimony payments) or section 682 (relating to income of a trust in case of divorce, etc.) applies. The term "legal obligation" includes a legal obligation to support another person if, and only if, the obligation is not affected by the adequacy of the dependent's own resources. For example, a parent has a "legal obligation" within the meaning of the preceding sentence to support his minor child if under local law property or income from property owned by the child cannot be used for his support so long as his parent is able to support him. On the other hand, if under local law a mother may use the resources of a child for the child's support in lieu of supporting him herself, no

obligation of support exists within the meaning of this paragraph, whether or not income is actually used for support. Similarly, since under local law a child ordinarily is obligated to support his parent only if the parent's earnings and resources are insufficient for the purpose, no obligation exists whether or not the parent's earnings and resources are sufficient. In any event, the amount of trust income which is included in the gross income of a person obligated to support a dependent is limited by the extent of his legal obligation under local law. In the case of a parent's obligation to support his child, to the extent that the parent's legal obligation of support, including education, is determined under local law by the family's station in life and by the means of the parent, it is to be determined without consideration of the trust income in question.

Reg. § 1.661(a)-2(d) provides:

> The terms "income required to be distributed currently" and "any other amounts properly paid or credited or required to be distributed" also include any amount used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)-4.

I.A.1.l. Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries

Generally, K-1 income from a passthrough business entity will carry out any income (including capital) distributed to the trust and then to the trust's beneficiaries. This section focuses on nongrantor trusts holding partnerships rather than S corporations, because generally a trust can hold S corporation stock that is not a grantor trust, QSST, or ESBT only during a relatively limited amount of time. (Although the principles in this part II.J.8.e would apply to a net income with make-up charitable remainder unitrust – a NIMCRUT – the IRS has concerns about that application and might shut it down at some point.)

Also, if one elected not to carry out capital gains under Reg. § 1.643(a)-3(b)(2) and later decides that all capital gain should be included in DNI going forward (or does not want to take a risk that the IRS will not respect deviations from general rules of the Uniform Principal and Income Act, consider forming an entity taxed as a partnership. Capital gains earned through a partnership generally constitute trust accounting income.

The Uniform Principal and Income Act provides that, generally, all cash distributions from an entity (including a partnership) are considered trust accounting income. Only the following distributions from an entity are not considered trust accounting income:

- property other than money;
- money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;
- money received in total or partial liquidation of the entity; and
- money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

Thus, a partnership's capital gains recognized in the ordinary course of managing and re-balancing a portfolio would constitute fiduciary accounting income to the extent distributed from the partnership in cash and therefore would be includible in DNI under (1) above.

To keep control of the partnership, consider having the trust be a 1% general partner and 98% limited partner, and the beneficiary or someone else might contribute 1% as a limited partner. Distributing a limited partnership interest to a beneficiary can carry out income and perhaps capital gain while at the same time not giving the beneficiary cash to spend (but be sure to distribute enough cash so that the beneficiary can pay tax on the distribution). Be careful to avoid the gain on formation that applies when a contributing partner diversifies the partner's holdings by forming the partnership. If the trust holds not only marketable securities but also investments in businesses, consider setting up one partnership for the business investments and another partnership for the marketable securities, which would help facilitate allocating trust assets on termination or any other trust division. Also consider whether a state with jurisdiction over the trust might subject the partnership itself to state income tax.

Complexity might arise if a partnership distributes less than all of its taxable income to a mandatory income trust. It is unclear whether all of the trust's distributive share of capital gain is DNI. Furthermore, interrelated calculations might be required for a mandatory income trust. Generally, we should look to see whether planning under part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law or II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is sufficient before recommending a partnership solely to address the issues described in part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.

I.A.1.m. Consequences of Allocating Capital Gain to DNI

I.A.1.m.i. General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income (and General Retention of the Character of DNI Distributed to Beneficiaries)

This part II.J.8.f.i first discusses netting deductions against income then discusses allocating that income.

I.A.1.m.i.(a). Allocating Deductions to Various Income Items

Rules for allocating deductions include:

- All deductible items directly attributable to one class of income are allocated to that class. To the extent that any items of deduction which are directly attributable to a class of income exceed that class of income, they may be allocated to any other class of income (including capital gains) included in distributable net income as described above except that any excess deductions attributable to tax-exempt income may not be offset against any other class of income.

- Deductions not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing DNI, but Code § 265 requires a portion of such indirect expenses to be allocated to non-taxable income. Such indirect expenses include trustee fees, the rental of safe deposit boxes, and state income and personal property taxes. Once one has allocated expenses to tax-exempt income, how does one choose to which items of taxable income to allocate deductions? One would consider allocating to those income items that are most highly taxed, considering federal and state income tax and the 3.8% tax on net investment income. For example, interest income is taxed at the highest rates, whereas qualified dividends are taxed at long-term capital gain rates. Within interest income, consider whether the interest is from U.S. obligations exempt from state income tax. Although distributions from qualified retirement plans and IRAs are taxed at the highest regular tax rate, they are exempt from the 3.8% tax on net investment income. See part II.I.6 Deductions Against NII (especially the text accompanying fns. 2307-2308).

- If a charitable deduction under Code § 642(c) is involved, any allocations of taxable income between the charitable deduction and the beneficiaries must have substantial economic effect.

- Special rules apply to depreciation deductions.

I.A.1.m.i.(b). Allocating Income Items Among Those Receiving It

In allocating income between the trust and the beneficiary (or beneficiaries), the amounts of DNI distributed to the beneficiaries:

> shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the estate or trust as the total of each class bears to the total distributable net income of the estate or trust in the absence of the allocation of different classes of income under the specific terms of the governing instrument.

However, this proportionate rule is subject to specific provisions in the governing instrument for the allocation of different classes of income or different allocations under local law, subject to tax-exempt income being allocated in a manner that does not allow it to be deducted.

Thus, except for tax-exempt income and allocations between the charitable and noncharitable shares (and any special rules regarding depreciation deductions), it appears that a trust agreement may create ordering provisions between which items of DNI the trust retains and which items of DNI the trust distributes to beneficiaries. However, such a provision might encounter significant resistance from the IRS.

Once one decides which items of DNI the trust distributes to beneficiaries, generally distributions to each beneficiary carry out a pro rata portion of ordinary income and capital gain items allocated to the beneficiaries, and any other characteristic of the income at the trust level retains its status in the beneficiary's hands (which, among other things, is important for net investment income tax purposes). Code § 652(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion

of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary.

Code § 662(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642(c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary. In the application of this subsection to the amount determined under paragraph (1) of subsection (a), distributable net income shall be computed without regard to any portion of the deduction under section 642(c) which is not attributable to income of the taxable year.

Reg. § 1.662(b)-1 provides:

> In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§ 1.662(a)-1 through 1.662(a)-4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For this purpose, the principles contained in § 1.652(b)-1 shall apply.

Reg. § 1.652(b)-1 provides:

> In determining the gross income of a beneficiary, the amounts includible under § 1.652(a)-1 have the same character in the hands of the beneficiary as in the hands of the trust. For example, to the extent that the amounts specified in § 1.652(a)-1 consist of income exempt from tax under section 103, such amounts are not included in the beneficiary's gross income. Similarly, dividends distributed to a beneficiary retain their original character in the beneficiary's hands for purposes of determining the availability to the beneficiary of the dividends received credit under section 34 (for dividends received on or before December 31, 1964) and the dividend exclusion under section 116…. Similarly, to the extent such amounts consist of an amount received as a part of a lump sum distribution from a qualified plan and to which the provisions of

> section 72(n) would apply in the hands of the trust, such amount shall be treated as subject to such section in the hands of the beneficiary except where such amount is deemed under section 666(a) to have been distributed in a preceding taxable year of the trust and the partial tax described in section 668(a)(2) is determined under section 668(b)(1)(B). The tax treatment of amounts determined under § 1.652(a)-1 depends upon the beneficiary's status with respect to them not upon the status of the trust. Thus, if a beneficiary is deemed to have received foreign income of a foreign trust, the includibility of such income in his gross income depends upon his taxable status with respect to that income.

This proportionate requirement applies "unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation."

When allocating income among beneficiaries:

> The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation.

I.A.1.m.ii. How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary

If the amount of DNI is less than the amount distributed to the beneficiary, the issues described in this part II.J.8.f.ii How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary become important.

Some income might be inadvertently trapped in the trust if the allocation rules of part II.J.8.f.i General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income apply without being modified by any special ordering rule in the trust agreement and if all of a pass-through entity's capital gain constitutes DNI under an approach described in part II.J.8.a.ii Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus That's because looking exclusively at those two factors bypasses the analysis of part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal.

For example, trust has $10,000 of interest income. Trust's distributive share of partnership's income is $20,000 of dividend income and $70,000 of long-term capital gains. If the rules described in the preceding paragraph apply, then 10% of all distributions constitute interest income, 20% constitute dividend income, and 70% constitute long-term capital gains. Trust distributes $50,000 to the beneficiary. Therefore, each of the beneficiary and the trust has $5,000 of interest income, $10,000 of dividend income, and $35,000 of long-term capital gains.

Contrast that to an approach under which the trustee is able to control how much capital gain is included in DNI, under part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal. On a year-by-year basis, the trustee can selectively include capital gain in DNI to the extent that one or both of part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a

The amount deemed distributed is the lesser of the property's basis or fair market value,[2801] unless gain was recognized, in which case it is the property's value.[2802]

Distributing low basis assets will generate a new basis (often a step-up) when the beneficiary dies. However, distributed assets are subject to the beneficiary's creditors, changes in the beneficiary's estate tax posture (including not only changes in the tax law but also changes in financial situation through the beneficiary's own efforts or through marriage and change in residence to a state that imposes its own estate tax), and changes in the beneficiary's dispositive goals. To get a basis step-up, I would rather add (perhaps by decanting)[2803] a formula general power of appointment, as described in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.[2804]

Distributing an unmarketable partnership interest would carry out DNI without giving the beneficiary cash. However, valuation adjustments might depress the amount of the deemed distributions, and the beneficiary would be entitled to a proportionate share of future distributions from the partnership. However, if the trustee controls the partnership, the trustee can also control the distribution spigot.

II.J.8.d.ii. Specific Bequest

A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under Code § 661 and is not included in the gross income of a beneficiary under Code § 662, unless under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the recipient in more than three installments.[2805]

Beneficiary or part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is available. By including in DNI just enough capital gain to cause the DNI to match the cash distributed to the beneficiary, the trustee can ensure that all of the ordinary income is distributed to the beneficiary.

I.A.1.n. Effectuating Allocation of Capital Gain to DNI

Form 1041 (Schedule D), Part III, column (1) allocates the beneficiaries' shares. Once one separates that, the rest should flow naturally.

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[2800] Code § 267, especially subsections (a)(1), (b)(6) and (b)(13).
[2801] Code § 643(e)(2).
[2802] Code § 643(e)(3).
[2803] See part II.J.18.c Decanting.
[2804] Especially the text accompanying fns 2126-2128 for the formula. Part II.H.2.k also mentions that giving a nonadverse the trustee the right to veto any exercise in favor of the beneficiary's creditors generates estate inclusion even though a corporate trustee is likely to exercise that veto due to its fiduciary liability. In most states, creditors cannot reach an unexercised general power of appointment.
[2805] Reg. § 1.663(a)-1(a), which provides further:

> Thus, in order for a gift or bequest to be excludable from the gross income of the recipient, (1) it must qualify as a gift or bequest of a specific sum of money or of specific property (see

II.J.8.d.iii. Distributing a Note to the Obligor

Rev. Rul. 75-68 provides:

> The income of a testamentary trust consisting solely of interest from mortgages on the beneficiary's property was required to be distributed periodically. Although the mortgage notes held by the trust required the periodic payment of interest, it was agreed between the beneficiary and the trustees, that the beneficiary would pay no interest on the mortgages and the trustees would distribute no income from the trust.
>
> *Held*, notwithstanding the foregoing agreement, the interest income due on the mortgages held by the trust is includible in the gross income of the trust, and this same amount, as the distributable income of the trust, is includible in the gross income of the beneficiary. Further, the beneficiary is entitled to a deduction for this interest deemed paid on the mortgages.

Below is authority consistent with this conclusion:

Reg. § 1.643(c)-1(a) treats as a beneficiary "any person with respect to an amount used to discharge or satisfy that person's legal obligation as that term is used in § 1.662(a)-4." Reg. § 1.661(a)-2(d) provides:

> The terms "income required to be distributed currently" and "any other amounts properly paid or credited or required to be distributed" also include any amount used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)-4.

Reg. § 1.662(a)-4, "Amounts used in discharge of a legal obligation," provides:

> Any amount which, pursuant to the terms of a will or trust instrument, is used in full or partial discharge or satisfaction of a legal obligation of any person is included in the gross income of such person under section 662(a)(1) or (2), whichever is applicable, as though directly distributed to him as a beneficiary, except in cases to which section 71 (relating to alimony payments) or section 682 (relating to income of a trust in case of divorce, etc.) applies. The term "legal obligation" includes a legal obligation to support another person if, and only if, the obligation is not affected by the adequacy of the dependent's own resources. For example, a parent has a "legal obligation" within the meaning of the preceding sentence to support his minor child if under local law property or income from property owned by the child cannot be used for his support so long as his parent is able to support him. On the other hand, if under local law a mother may use the resources of a child for the child's support in lieu of supporting him herself, no obligation of support exists within the meaning of this paragraph, whether or not income is actually used for support. Similarly, since under local law a child ordinarily is obligated to support his parent only if the parent's earnings and resources are insufficient for the purpose, no obligation exists whether or not the parent's earnings and resources are sufficient. In any event, the amount of trust income which is included in the gross income of a person obligated to support a dependent is limited by the extent of his legal obligation under local law. In the case of a parent's obligation to support his child, to the

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> paragraph (b) of this section), and (2) the terms of the governing instrument must not provide for its payment in more than three installments (see paragraph (c) of this section). The date when the estate came into existence or the date when the trust was created is immaterial.

> extent that the parent's legal obligation of support, including education, is determined under local law by the family's station in life and by the means of the parent, it is to be determined without consideration of the trust income in question.

Reg. § 1.661(a)-2(d) provides:

> The terms "income required to be distributed currently" and "any other amounts properly paid or credited or required to be distributed" also include any amount used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)-4.

II.J.8.e. Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries

Generally, K-1 income from a passthrough business entity will carry out any income (including capital) distributed to the trust and then to the trust's beneficiaries. This section focuses on nongrantor trusts holding partnerships rather than S corporations, because generally a trust can hold S corporation stock that is not a grantor trust, QSST, or ESBT only during a relatively limited amount of time.[2806] (Although the principles in this part II.J.8.e would apply to a net income with make-up charitable remainder unitrust – a NIMCRUT – the IRS has concerns about that application and might shut it down at some point.)[2807]

[2806] See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation.

[2807] Rev. Proc. 2015-3, Section 4.01(36) identifies as an area in which rulings or determination letters will not ordinarily be issued:

> Whether a trust that will calculate the unitrust amount under § 664(d)(3) qualifies as a § 664 charitable remainder trust when a grantor, a trustee, a beneficiary, or a person related or subordinate to a grantor, a trustee, or a beneficiary can control the timing of the trust's receipt of trust income from a partnership or a deferred annuity contract to take advantage of the difference between trust income under § 643(b) and income for Federal income tax purposes for the benefit of the unitrust recipient.

Check the most recent year's Rev. Proc. 20xx-3 [where "xx" represents the last two digits of the year] to see whether this remains on the list. For further discussion, see Fox, ¶ 25.20[5] NIMCRUTs—Where Timing of Trust Income Is Controlled by Grantor, Trustee, or Related or Subordinate Person, *Charitable Giving: Taxation, Planning, and Strategies* (WG&L).

When administering any partnership, be careful to avoid any direct or indirect violation of the prohibition against counting precontribution gain as income found in Reg. § 1.664-3(a)(1)(i)(b)(3):

> For purposes of this paragraph (a)(1)(i)(b), trust income generally means income as defined under section 643(b) and the applicable regulations. However, trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property, notwithstanding any contrary provision in applicable state law. Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of their contribution to the trust. Proceeds from the sale or exchange of any assets purchased by the trust must be allocated to principal and not to trust income at least to the extent of the trust's purchase price of those assets. Except as provided in the two preceding sentences, proceeds from the sale or exchange of any assets contributed to the trust by the donor or purchased by the trust may be allocated to income, pursuant to the terms of the governing instrument, if not prohibited by applicable local law. A discretionary power to make this allocation may be granted to the trustee under the terms of the governing instrument but only to the extent that the state statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially.

Also, if one elected not to carry out capital gains under Reg. § 1.643(a)-3(b)(2) and later decides that all capital gain should be included in DNI going forward (or does not want to take a risk that the IRS will not respect deviations from general rules of the Uniform Principal and Income Act, consider forming an entity taxed as a partnership. Capital gains earned through a partnership generally constitute trust accounting income.[2808]

The Uniform Principal and Income Act provides that, generally, all cash distributions from an entity (including a partnership) are considered trust accounting income.[2809] Only the following distributions from an entity are not considered trust accounting income:[2810]

- property other than money;
- money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;
- money received in total or partial liquidation of the entity; and
- money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

Thus, a partnership's capital gains recognized in the ordinary course of managing and re-balancing a portfolio would constitute fiduciary accounting income to the extent distributed from the partnership in cash and therefore would be includible in DNI under (1) above.

To keep control of the partnership, consider having the trust be a 1% general partner and 98% limited partner, and the beneficiary or someone else might contribute 1% as a limited partner. Distributing a limited partnership interest to a beneficiary can carry out income and perhaps capital gain while at the same time not giving the beneficiary cash to spend (but be sure to distribute enough cash so that the beneficiary can pay tax on the distribution). Be careful to avoid the gain on formation that applies when a contributing partner diversifies the partner's holdings by forming the partnership.[2811] If the trust holds not only marketable securities but also investments in businesses, consider setting up one partnership for the business investments and another partnership for the marketable securities, which would help facilitate allocating trust assets on termination or any other trust division.[2812] Also consider whether a state with jurisdiction over the trust might subject the partnership itself to state income tax.[2813]

Complexity might arise if a partnership distributes less than all of its taxable income to a mandatory income trust. It is unclear whether all of the trust's distributive share of capital gain is DNI.[2814] Furthermore, interrelated calculations might be required for a mandatory income

[2808] In *Crisp v. U.S.*, 76 A.F.T.R.2d 95-6261, 34 Fed. Cl. 112 (1995), the Court of Claims held that capital gain distributed in the ordinary course of a partnership's operations was allocated to income (because the settlor intended to distribute it) and therefore was includible in DNI.
[2809] Act § 401(b).
[2810] Act § 401(c).
[2811] See part II.M.3.b Exception: Diversification of Investment Risk.
[2812] See part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions.
[2813] Although Illinois subjects partnerships to an income tax called the "replacement tax," it does not tax investment partnerships. See fn. 5385.
[2814] See part II.J.8.f.ii How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary.

trust.[2815] Generally, we should look to see whether planning under part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law or II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is sufficient before recommending a partnership solely to address the issues described in part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.

II.J.8.f. Consequences of Allocating Capital Gain to DNI

II.J.8.f.i. General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income (and General Retention of the Character of DNI Distributed to Beneficiaries)

This part II.J.8.f.i first discusses netting deductions against income then discusses allocating that income.

II.J.8.f.i.(a). Allocating Deductions to Various Income Items

Rules for allocating deductions include:

- All deductible items directly attributable to one class of income are allocated to that class.[2816] To the extent that any items of deduction which are directly attributable to a class of income exceed that class of income, they may be allocated to any other class of income (including capital gains) included in distributable net income as described above except that any excess deductions attributable to tax-exempt income may not be offset against any other class of income.[2817]

- Deductions not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing DNI, but Code § 265 requires a portion of such indirect expenses to be allocated to non-taxable income.[2818] Such indirect

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[2815] Part III.A.4 Trust Accounting Income Regarding Business Interests describes trust accounting income, income tax, and some tough fiduciary issues that arise when a mandatory income trust owns an business interest. See also part III.F.2 Trust Accounting and Taxation.

[2816] Reg. § 1.652(b)-3(a).

[2817] Reg. § 1.652(b)-3(d).

[2818] Reg. § 1.652(b)-3(b) provides:

> The deductions which are not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing distributable net income, but a portion must be allocated to non-taxable income (except dividends excluded under section 116) pursuant to section 265 and the regulations thereunder. For example, if the income of a trust is $30,000 (after direct expenses), consisting equally of $10,000 of dividends, tax-exempt interest, and rents, and income commissions amount to $3,000, one-third ($1,000) of such commissions should be allocated to tax-exempt interest, but the balance of $2,000 may be allocated to the rents or dividends in such proportions as the trustee may elect. The fact that the governing instrument or applicable local law treats certain items of deduction as attributable to corpus or to income not included in distributable net income does not affect allocation under this paragraph. For instances, if in the example set forth in this paragraph the trust also had capital gains which are allocable to corpus under the terms of the trust instrument, no part of the deductions would be allocable thereto since the capital gains are excluded from the computation of distributable net income under section 643(a)(3).

expenses include trustee fees, the rental of safe deposit boxes, and state income and personal property taxes.[2819] Once one has allocated expenses to tax-exempt income, how does one choose to which items of taxable income to allocate deductions? One would consider allocating to those income items that are most highly taxed, considering federal and state income tax and the 3.8% tax on net investment income.[2820] For example, interest income is taxed at the highest rates, whereas qualified dividends are taxed at long-term capital gain rates. Within interest income, consider whether the interest is from U.S. obligations exempt from state income tax. Although distributions from qualified retirement plans and IRAs are taxed at the highest regular tax rate, they are exempt from the 3.8% tax on net investment income. See part II.I.6 Deductions Against NII (especially the text accompanying fns. 2307-2308).

- If a charitable deduction under Code § 642(c) is involved, any allocations of taxable income between the charitable deduction and the beneficiaries must have substantial economic effect.[2821]

An expense allocated to tax-exempt income and therefore disallowed for income tax purposes may be deductible for estate tax purposes. Rev. Rul. 59-32, which Rev. Rul. 63-27 clarifies as showing just one among the acceptable methods of such a calculation.

[2819] Reg. § 1.652(b)-3(c).

[2820] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

[2821] Reg. § 1.642(c)-3(b)(2) provides:

Determination of the character of an amount deductible under section 642(c). In determining whether the amounts of income so paid, permanently set aside, or used for a purpose specified in section 642(c)(1), (2), or (3) include particular items of income of an estate or trust, whether or not included in gross income, a provision in the governing instrument or in local law that specifically provides the source out of which amounts are to be paid, permanently set aside, or used for such a purpose controls for Federal tax purposes to the extent such provision has economic effect independent of income tax consequences. See § 1.652(b)-2(b). In the absence of such specific provisions in the governing instrument or in local law, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. See § 1.643(a)-5(b) for the method of determining the allocable portion of exempt income and foreign income. This paragraph (b)(2) is illustrated by the following examples:

Example (1). A charitable lead annuity trust has the calendar year as its taxable year, and is to pay an annuity of $10,000 annually to an organization described in section 170(c). A provision in the trust governing instrument provides that the $10,000 annuity should be deemed to come first from ordinary income, second from short-term capital gain, third from fifty percent of the unrelated business taxable income, fourth from long-term capital gain, fifth from the balance of unrelated business taxable income, sixth from tax-exempt income, and seventh from principal. This provision in the governing instrument does not have economic effect independent of income tax consequences, because the amount to be paid to the charity is not dependent upon the type of income from which it is to be paid. Accordingly, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the trust as the total of each class bears to the total of all classes.

Example (2). A trust instrument provides that 100 percent of the trust's ordinary income must be distributed currently to an organization described in section 170(c) and that all remaining items of income must be distributed currently to B, a noncharitable beneficiary. This income ordering provision has economic effect independent of income tax consequences because the amount to be paid to the charitable organization each year is dependent upon the amount of ordinary income the trust earns within that taxable year. Accordingly, for purposes of section 642(c), the full amount distributed to charity is deemed to consist of ordinary income.

- Special rules apply to depreciation deductions.[2822]

II.J.8.f.i.(b). Allocating Income Items Among Those Receiving It

In allocating income between the trust and the beneficiary (or beneficiaries), the amounts of DNI distributed to the beneficiaries:[2823]

> shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the estate or trust as the total of each class bears to the total distributable net income of the estate or trust in the absence of the allocation of different classes of income under the specific terms of the governing instrument.

However, this proportionate rule is subject to specific provisions in the governing instrument for the allocation of different classes of income or different allocations under local law,[2824] subject to tax-exempt income being allocated in a manner that does not allow it to be deducted.[2825]

Thus, except for tax-exempt income and allocations between the charitable and noncharitable shares (and any special rules regarding depreciation deductions),[2826] it appears that a trust agreement may create ordering provisions between which items of DNI the trust retains and

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Reg. § 1.643(a)-5(b) provides:

> If the estate or trust is allowed a charitable contributions deduction under section 642(c), the amounts specified in paragraph (a) of this section and § 1.643(a)-6 are reduced by the portion deemed to be included in income paid, permanently set aside, or to be used for the purposes specified in section 642(c). If the governing instrument or local law specifically provides as to the source out of which amounts are paid, permanently set aside, or to be used for such charitable purposes, the specific provision controls for Federal tax purposes to the extent such provision has economic effect independent of income tax consequences. See § 1.652(b)-2(b). In the absence of such specific provisions in the governing instrument or local law, an amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. For illustrations showing the determination of the character of an amount deductible under section 642(c), see Examples 1 and 2 of § 1.662(b)-2 and § 1.662(c)-4(e).

[2822] See part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses).

[2823] Code § 661(b).

[2824] Reg. § 1.661(b)-1.

[2825] Code § 661(c). Reg. § 1.661(c)-1, which was adopted 12/19/56 and amended 12/15/64, provides:

> An estate or trust is not allowed a deduction under section 661(a) for any amount which is treated under section 661(b) as consisting of any item of distributable net income which is not included in the gross income of the estate or trust. For example, if in 1962, a trust, which reports on the calendar year basis, has distributable net income of $20,000, which is deemed to consist of $10,000 of dividends and $10,000 of tax-exempt interest, and distributes $10,000 to beneficiary A, the deduction allowable under section 661(a) (computed without regard to section 661(c)) would amount to $10,000 consisting of $5,000 of dividends and $5,000 of tax-exempt interest. The deduction actually allowable under section 661(a) as limited by section 661(c) is $4,975, since no deduction is allowable for the $5,000 of tax-exempt interest and the $25 deemed distributed out of the $50 of dividends excluded under section 116, items of distributable net income which are not included in the gross income of the estate or trust.

[2826] See fn. 2821.

which items of DNI the trust distributes to beneficiaries. However, such a provision might encounter significant resistance from the IRS.[2827]

Once one decides which items of DNI the trust distributes to beneficiaries, generally distributions to each beneficiary carry out a pro rata portion of ordinary income and capital gain items allocated to the beneficiaries, and any other characteristic of the income at the trust level retains its status in the beneficiary's hands (which, among other things, is important for net investment income tax purposes).[2828] Code § 652(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary.

Code § 662(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642(c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary. In the application of this subsection to the amount determined under paragraph (1) of subsection (a), distributable net income shall be computed without regard to any portion of the deduction under section 642(c) which is not attributable to income of the taxable year.

Reg. § 1.662(b)-1 provides:

> In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§ 1.662(a)-1 through 1.662(a)-4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class

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[2827] In adopting Reg. § 1.642(c)-3(b)(2), which is quoted in fn. 2821, T.D. 9582 rebuffed criticism of the regulation, saying:

> Permitting an ordering rule with no economic effect independent of income tax consequences to supersede the pro rata allocation rule generally applicable under Subchapter J would, in effect, permit taxpayers to deviate at will from the general rule imposed throughout Subchapter J in the case of all kinds of complex trusts.

[2828] See fn. 2327, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles.

> bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For this purpose, the principles contained in § 1.652(b)-1 shall apply.

Reg. § 1.652(b)-1 provides:

> In determining the gross income of a beneficiary, the amounts includible under § 1.652(a)-1 have the same character in the hands of the beneficiary as in the hands of the trust. For example, to the extent that the amounts specified in § 1.652(a)-1 consist of income exempt from tax under section 103, such amounts are not included in the beneficiary's gross income. Similarly, dividends distributed to a beneficiary retain their original character in the beneficiary's hands for purposes of determining the availability to the beneficiary of the dividends received credit under section 34 (for dividends received on or before December 31, 1964) and the dividend exclusion under section 116…. Similarly, to the extent such amounts consist of an amount received as a part of a lump sum distribution from a qualified plan and to which the provisions of section 72(n) would apply in the hands of the trust, such amount shall be treated as subject to such section in the hands of the beneficiary except where such amount is deemed under section 666(a) to have been distributed in a preceding taxable year of the trust and the partial tax described in section 668(a)(2) is determined under section 668(b)(1)(B). The tax treatment of amounts determined under § 1.652(a)-1 depends upon the beneficiary's status with respect to them not upon the status of the trust. Thus, if a beneficiary is deemed to have received foreign income of a foreign trust, the includibility of such income in his gross income depends upon his taxable status with respect to that income.

This proportionate requirement applies "unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation."[2829]

[2829] Reg. § 1.662(b)-1. Furthermore, Reg. § 1.652(b)-2(a) provides:

> The amounts specified in § 1.652(a)-1 which are required to be included in the gross income of a beneficiary are treated as consisting of the same proportion of each class of items entering into distributable net income of the trust (as defined in section 643(a)) as the total of each class bears to such distributable net income, unless the terms of the trust specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For example: Assume that under the terms of the governing instrument, beneficiary A is to receive currently one-half of the trust income and beneficiaries B and C are each to receive currently one-quarter, and the distributable net income of the trust (after allocation of expenses) consists of dividends of $10,000, taxable interest of $10,000 and tax-exempt interest of $4,000. A will be deemed to have received $5,000 of dividends, $5,000 of taxable interest, and $2,000 of tax-exempt interest; B and C will each be deemed to have received $2,500 of dividends, $2,500 of taxable interest, and $1,000 of tax-exempt interest. However, if the terms of the trust specifically allocate different classes of income to different beneficiaries, entirely or in part, or if local law requires such an allocation, each beneficiary will be deemed to have received those items of income specifically allocated to him.

When allocating income among beneficiaries:[2830]

> The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation.

II.J.8.f.ii. How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary

If the amount of DNI is less than the amount distributed to the beneficiary, the issues described in this part II.J.8.f.ii How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary become important.

Some income might be inadvertently trapped in the trust if the allocation rules of part II.J.8.f.i General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income apply without being modified by any special ordering rule in the trust agreement and if all of a pass-through entity's capital gain constitutes DNI under an approach described in part II.J.8.a.ii Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus That's because looking exclusively at those two factors bypasses the analysis of part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal.

For example, trust has $10,000 of interest income. Trust's distributive share of partnership's income is $20,000 of dividend income and $70,000 of long-term capital gains. If the rules described in the preceding paragraph apply, then 10% of all distributions constitute interest income, 20% constitute dividend income, and 70% constitute long-term capital gains. Trust distributes $50,000 to the beneficiary. Therefore, each of the beneficiary and the trust has $5,000 of interest income, $10,000 of dividend income, and $35,000 of long-term capital gains.

Contrast that to an approach under which the trustee is able to control how much capital gain is included in DNI, under part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal. On a year-by-year basis, the trustee can selectively include capital gain in DNI to the extent that one or both of part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary or part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is available. By including in DNI just enough capital

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[2830] Reg. § 1.652(b)-2(a). Reg. § 1.652(b)-2(b) provides the following:

(1) Allocation pursuant to a provision in a trust instrument granting the trustee discretion to allocate different classes of income to different beneficiaries is not a specific allocation by the terms of the trust.

(2) Allocation pursuant to a provision directing the trustee to pay all of one income to A, or $10,000 out of the income to A, and the balance of the income to B, but directing the trustee first to allocate a specific class of income to A's share (to the extent there is income of that class and to the extent it does not exceed A's share) is not a specific allocation by the terms of the trust.

(3) Allocation pursuant to a provision directing the trustee to pay half the class of income (whatever it may be) to A, and the balance of the income to B, is a specific allocation by the terms of the trust.

gain to cause the DNI to match the cash distributed to the beneficiary, the trustee can ensure that all of the ordinary income is distributed to the beneficiary.

II.J.8.g. Effectuating Allocation of Capital Gain to DNI

Form 1041 (Schedule D), Part III, column (1) allocates the beneficiaries' shares. Once one separates that, the rest should flow naturally.

II.J.9. Separate Share Rule; Trust Divisions; Multiple Trust Rules for Tax Avoidance

II.J.9.a. Specific Bequests; Separate Share Rule

The extent to which distributions carry out distributive net income is limited by parts II.J.9.a.i Specific Bequests and II.J.9.a.ii Separate Share Rule.

II.J.9.a.i. Specific Bequests under Code § 663(a)

Limiting what counts as distributions carrying out distributive net income ("DNI"), Code § 663(a), "Exclusions," provides:

> There shall not be included as amounts falling within section 661(a) or 662(a) -
>
> (1) *Gifts, bequests, etc.* Any amount which, under the terms of the governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or credited all at once or in not more than 3 installments. For this purpose an amount which can be paid or credited only from the income of the estate or trust shall not be considered as a gift or bequest of a specific sum of money.
>
> (2) *Charitable, etc., distributions*. Any amount paid or permanently set aside or otherwise qualifying for the deduction provided in section 642(c) (computed without regard to sections 508(d), 681, and 4948(c)(4)).
>
> (3) *Denial of double deduction*. Any amount paid, credited, or distributed in the taxable year, if section 651 or section 661 applied to such amount for a preceding taxable year of an estate or trust because credited or required to be distributed in such preceding taxable year.

Reg. § 1.663(a)-1, "Special rules applicable to sections 661 and 662; exclusions; gifts, bequests, etc.," provides:

> (a) *In general*. A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under section 661 and is not included in the gross income of a beneficiary under section 662, unless under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the recipient in more than three installments. Thus, in order for a gift or bequest to be excludable from the gross income of the recipient, (1) it must qualify as a gift or bequest of a specific sum of money or of specific property (see paragraph (b) of this section), and (2) the terms of the governing instrument must not provide for its payment in more than three installments (see

paragraph (c) of this section). The date when the estate came into existence or the date when the trust was created is immaterial.

(b) *Definition of a gift or bequest of a specific sum of money or of specific property*.

(1) In order to qualify as a gift or bequest of a specific sum of money or of specific property under section 663(a), the amount of money or the identity of the specific property must be ascertainable under the terms of a testator's will as of the date of his death, or under the terms of an inter vivos trust instrument as of the date of the inception of the trust. For example, bequests to a decedent's son of the decedent's interest in a partnership and to his daughter of a sum of money equal to the value of the partnership interest are bequests of specific property and of a specific sum of money, respectively. On the other hand, a bequest to the decedent's spouse of money or property, to be selected by the decedent's executor, equal in value to a fraction of the decedent's "adjusted gross estate" is neither a bequest of a specific sum of money or of specific property. The identity of the property and the amount of money specified in the preceding sentence are dependent both on the exercise of the executor's discretion and on the payment of administration expenses and other charges, neither of which are facts existing on the date of the decedent's death. It is immaterial that the value of the bequest is determinable after the decedent's death before the bequest is satisfied (so that gain or loss may be realized by the estate in the transfer of property in satisfaction of it).

(2) The following amounts are not considered as gifts or bequests of a sum of money or of specific property within the meaning of this paragraph:

(i) An amount which can be paid or credited only from the income of an estate or trust, whether from the income for the year of payment or crediting, or from the income accumulated from a prior year;

(ii) An annuity, or periodic gifts of specific property in lieu of or having the effect of an annuity;

(iii) A residuary estate or the corpus of a trust; or

(iv) A gift or bequest paid in a lump sum or in not more than three installments, if the gift or bequest is required to be paid in more than three installments under the terms of the governing instrument.

(3) The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples, in which it is assumed that the gift or bequest is not required to be made in more than three installments (see paragraph (c)):

Example (1). Under the terms of a will, a legacy of $5,000 was left to A, 1,000 shares of X company stock was left to W, and the balance of the estate was to be divided equally between W and B. No provision was made in the will for the disposition of income of the estate during the period of administration. The estate had income of $25,000 during the taxable year 1954, which was accumulated and added to corpus for estate accounting purposes. During the taxable year, the executor paid the legacy of $5,000 in a lump sum to A, transferred the X company stock to W, and made no other distributions to beneficiaries. The distributions to A and W qualify for the exclusion under section 663(a)(1).

Example (2). Under the terms of a will, the testator's estate was to be distributed to A. No provision was made in the will for the distribution of the estate's income during the period of administration. The estate had income of $50,000 for the taxable year. The estate distributed to A stock with a basis of $40,000 and with a fair market value of $40,000 on the date of distribution. No other distributions were made during the year. The distribution does not qualify for the exclusion under section 663(a)(1), because it is not a specific gift to A required by the terms of the will. Accordingly, the fair market value of the property ($40,000) represents a distribution within the meaning of sections 661(a) and 662(a) (see § 1.661(a)-2(c)).

Example (3). Under the terms of a trust instrument, trust income is to be accumulated for a period of 10 years. During the eleventh year, the trustee is to distribute $10,000 to B, payable from income or corpus, and $10,000 to C, payable out of accumulated income. The trustee is to distribute the balance of the accumulated income to A. Thereafter, A is to receive all the current income until the trust terminates. Only the distribution to B would qualify for the exclusion under section 663(a)(1).

(4) A gift or bequest of a specific sum of money or of specific property is not disqualified under this paragraph solely because its payment is subject to a condition. For example, provision for a payment by a trust to beneficiary A of $10,000 when he reaches age 25, and $10,000 when he reaches age 30, with payment over to B of any amount not paid to A because of his death, is a gift to A of a specific sum of money payable in two installments, within the meaning of this paragraph, even though the exact amount payable to A cannot be ascertained with certainty under the terms of the trust instrument.

(c) *Installment payments*.

(1) In determining whether a gift or bequest of a specific sum of money or of specific property, as defined in paragraph (b) of this section, is required to be paid or credited to a particular beneficiary in more than three installments—

(i) Gifts or bequests of articles for personal use (such as personal and household effects, automobiles, and the like) are disregarded.

(ii) Specifically devised real property, the title to which passes directly from the decedent to the devisee under local law, is not taken into account, since it would not constitute an amount paid, credited, or required to be distributed under section 661 (see paragraph (e) of § 1.661(a)-2).

(iii) All gifts and bequests under a decedent's will (which are not disregarded pursuant to subdivisions (i) and (ii) of this subparagraph) for which no time of payment or crediting is specified, and which are to be paid or credited in the ordinary course of administration of the decedent's estate, are considered as required to be paid or credited in a single installment.

(iv) All gifts and bequests (which are not disregarded pursuant to subdivisions (i) and (ii) of this subparagraph) payable at any one specified time under the terms of the governing instrument are taken into account as a single installment.

For purposes of determining the number of installments paid or credited to a particular beneficiary, a decedent's estate and a testamentary trust shall each be treated as a separate entity.

(2) The application of the rules stated in subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1).

(i) Under the terms of a decedent's will, $10,000 in cash, household furniture, a watch, an automobile, 100 shares of X company stock, 1,000 bushels of grain, 500 head of cattle, and a farm (title to which passed directly to A under local law) are bequeathed or devised outright to A. The will also provides for the creation of a trust for the benefit of A, under the terms of which there are required to be distributed to A, $10,000 in cash and 100 shares of Y company stock when he reaches 25 years of age, $25,000 in cash and 200 shares of Y company stock when he reaches 30 years of age, and $50,000 in cash and 300 shares of Y company stock when he reaches 35 years of age.

(ii) The furniture, watch, automobile, and the farm are excluded in determining whether any gift or bequest is required to be paid or credited to A in more than three installments. These items qualify for the exclusion under section 663(a)(1) regardless of the treatment of the other items of property bequeathed to A.

(iii) The $10,000 in cash, the shares of X company stock, the grain, the cattle and the assets required to create the trust, to be paid or credited by the estate to A and the trust are considered as required to be paid or credited in a single installment to each, regardless of the manner of payment or distribution by the executor, since no time of payment or crediting is specified in the will. The $10,000 in cash and shares of Y company stock required to be distributed by the trust to A when he is 25 years old are considered as required to be paid or distributed as one installment under the trust. Likewise, the distributions to be made by the trust to A when he is 30 and 35 years old are each considered as one installment under the trust. Since the total number of installments to be made by the estate does not exceed three, all of the items of money and property distributed by the estate qualify for the exclusion under section 663(a)(1). Similarly, the three distributions by the trust qualify.

Example (2). Assume the same facts as in example (1), except that another distribution of a specified sum of money is required to be made by the trust to A when he becomes 40 years old. This distribution would also qualify as an installment, thus making four installments in all under the trust. None of the gifts to A under the trust would qualify for the exclusion under

> section 663(a)(1). The situation as to the estate, however, would not be changed.
>
> *Example (3)* A trust instrument provides that A and B are each to receive $75,000 in installments of $25,000, to be paid in alternate years. The trustee distributes $25,000 to A in 1954, 1956, and 1958, and to B in 1955, 1957, and 1959. The gifts to A and B qualify for exclusion under section 663(a)(1), although a total of six payments is made. The gifts of $75,000 to each beneficiary are to be separately treated.

When an estate funds a pecuniary bequest to a trust before the estate terminates, the distribution receives Code § 663(a)(1) treatment.[2831]

Although Reg. § 1.663(a)-1 protects a gift or bequest of a specific sum of money or of specific property, it does not protect a combination of those. Rev. Rul. 72-295 had the following facts:

> The decedent in his will directed his executor to distribute to B, an heir, 8x dollars' worth but no more than all of the Y stock owned by the decedent at his death, the valuation to be made on the date of distribution. At the time of his death the decedent owned 300 shares of Y stock. At the time of distribution 64 shares of Y stock were required to satisfy the bequest and the executor distributed that number of the shares to B.

Rev. Rul. 72-295 reasoned and held:

> Generally, in order to qualify as specific property, the property must be identifiable both as to its kind and as to its amount. In the instant case, the bequest to B consisted of property other than money. Since only the kind of property, not the amount thereof, was ascertainable under the terms of the decedent's will as of the date of his death, it did not qualify as a bequest of specific property.
>
> Accordingly, in the instant case, since the 8x dollars' worth of Y stock received by B does not qualify as a bequest of specific property, it is not subject to the provisions of section 663(a) of the Code but is a distribution to B that comes within the meaning of the phrase "any other amounts properly paid or credited," set forth in section 661(a)(2) of the Code.
>
> … since the distribution in kind to B is not in satisfaction of a right to receive a distribution in a specific dollar amount or in specific property other than that distributed, the estate does not realize gain or loss by reason of the distribution of the shares of stock.
>
> If the estate has distributable net income, then in determining the amount deductible by the estate under section 661(a) of the Code, and includible in the gross income of B under section 662(a) of the Code the shares of Y stock will be taken into account at their fair market value at the time of distribution.
>
> In addition, the basis of the shares of Y stock in the hands of B is their fair market value at the time of distribution, to the extent such value is included in his gross income. To

[2831] Rev. Rul. 57-214. Rev. Rul. 64-307 held that Rev. Rul. 57-214 applies only to a pecuniary bequest and not to a bequest of residue and that any distribution deduction relating to the residue applies only when the bequest is actually funded.

> the extent that the value of the Y shares are not includible in B's gross income, they will retain the same basis they had to the estate.

Satisfying a bequest of specific property with other property does not affect the bequest's qualification under Code § 663(a)(1).[2832]

Apparently focusing on Reg. § 1.663(a)-1(b)(1), Letter Ruling 9218076 addressed specific bequests provided to settle a contest of the exercise of a testamentary power of appointment, holding:

> Based on the information submitted, we conclude that the amount of money and the identity of the specific property contained in the 1990 payments were not ascertainable under the terms of Trust as of the date of the inception of Trust. Therefore, the 1990 payments do not qualify as bequests of specific sums of money or property under section 663(a)(1) of the Code. Accordingly, the 1990 payments are included as amounts falling within sections 661(a) and 662(a).

However, if settlement reforms the trust as of the trust's inception as a separate taxpayer, as did Letter Ruling 9218076, I believe that the settlement payments should be eligible for Code § 663(a)(1) treatment. It has been suggested that Code § 663(a)(1) merely overlays

[2832] TAM 8220062.

> In the instant case the bequest by A of his shares in M clearly constituted a bequest of specific property. On the death of A there was no doubt as to the kind of property given. A's will made a bequest of M stock and A was possessed of M stock at the time of his death. On the death of A the amount of M stock which each of A's sons was to get was ascertainable. B was to get b shares and C was to get c shares. Unlike the case presented in Rev. Rul. 72-295 the number of shares in M which B and C were to receive was not tied into the value of the M shares on the date of their distribution. Instead, the amount of M shares which both B and C were to get was known with certainty on the day that A died. The bequest of M stock was identifiable as to its kind and amount under the terms of A's will as of the date of his death. Therefore, the bequest of M stock was a bequest of specific property. See Rev. Rul. 72-295.
>
> Although the bequest of M stock was a bequest of specific property it was satisfied, in part, with shares of N stock and not with shares of M stock. Nevertheless, the character of the property used to satisfy a bequest does not alter the nature of the bequest so satisfied. The use of money and property to satisfy a bequest of a specific sum of money is nevertheless considered a distribution in satisfaction of a bequest of a specific sum of money. Rev. Rul. 66-207. Therefore, the use of one type of property to satisfy a specific bequest of another type of property should be considered a distribution in satisfaction of a bequest of specific property.

Although the TAM did not rule on the issue, presumably the distribution of N stock was a sale or exchange.

Code § 102 principles[2833] over the fiduciary income tax system. Keeping that mind, consider *Vincent v. Commissioner*, T.C. Memo. 1992-21, which discussed Code § 102:[2834]

> Petitioners did not acquire the $390,000 payment by gift, bequest, devise, or inheritance, but instead by the settlement of a lawsuit. Whether a dispute is resolved through litigation or settlement, the nature of the underlying action determines the proper tax consequences. *Getty v. Commissioner*, *supra*; *Tribune Publishing Co. v. United States*, 836 F.2d 1176, 1177 (9th Cir. 1988). The taxability of a settlement is controlled by the

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[2833] Code § 102, "Gifts and inheritances," starts with:

(a) *General rule*. Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.

(b) *Income*. Subsection (a) shall not exclude from gross income—

  (1) the income from any property referred to in subsection (a); or

  (2) where the gift, bequest, devise, or inheritance is of income from property, the amount of such income.

  Where, under the terms of the gift, bequest, devise, or inheritance, the payment, crediting, or distribution thereof is to be made at intervals, then, to the extent that it is paid or credited or to be distributed out of income from property, it shall be treated for purposes of paragraph (2) as a gift, bequest, devise, or inheritance of income from property. Any amount included in the gross income of a beneficiary under subchapter J shall be treated for purposes of paragraph (2) as a gift, bequest, devise, or inheritance of income from property.

Reg. § 1.102-1, "Gifts and inheritances," provides:

(a) *General rule*. Property received as a gift, or received under a will or under statutes of descent and distribution, is not includible in gross income, although the income from such property is includible in gross income. An amount of principal paid under a marriage settlement is a gift. However, see section 71 and the regulations thereunder for rules relating to alimony or allowances paid upon divorce or separation. Section 102 does not apply to prizes and awards (see section 74 and § 1.74-1) nor to scholarships and fellowship grants (see section 117 and the regulations thereunder).

(b) *Income from gifts and inheritances*. The income from any property received as a gift, or under a will or statute of descent and distribution shall not be excluded from gross income under paragraph (a) of this section.

(c) *Gifts and inheritances of income*. If the gift, bequest, devise, or inheritance is of income from property, it shall not be excluded from gross income under paragraph (a) of this section. Section 102 provides a special rule for the treatment of certain gifts, bequests, devises, or inheritances which by their terms are to be paid, credited, or distributed at intervals. Except as provided in section 663(a)(1) and paragraph (d) of this section, to the extent any such gift, bequest, devise, or inheritance is paid, credited, or to be distributed out of income from property, it shall be considered a gift, bequest, devise, or inheritance of income from property. Section 102 provides the same treatment for amounts of income from property which is paid, credited, or to be distributed under a gift or bequest whether the gift or bequest is in terms of a right to payments at intervals (regardless of income) or is in terms of a right to income. To the extent the amounts in either case are paid, credited, or to be distributed at intervals out of income, they are not to be excluded under section 102 from the taxpayer's gross income.

(d) *Effect of subchapter J*. Any amount required to be included in the gross income of a beneficiary under sections 652, 662, or 668 shall be treated for purposes of this section as a gift, bequest, devise, or inheritance of income from property. On the other hand, any amount excluded from the gross income of a beneficiary under section 663(a)(1) shall be treated for purposes of this section as property acquired by gift, bequest, devise, or inheritance.

(e) *Income taxed to grantor or assignor*. Section 102 is not intended to tax a donee upon the same income which is taxed to the grantor of a trust or assignor of income under section 61 or sections 671 through 677, inclusive.

[2834] *Vincent* dealt with tax years 1980 and 1983. A cite shortcutted below referred to earlier in the case include *Getty v. Commissioner*, 913 F.2d 1486, 1490 (9th Cir. 1990), *revg*. 91 T.C. 160 (1988).

> nature of the litigation. *Raytheon Production Corp. v. Commissioner*, 144 F.2d 110, 114 (1st Cir. 1944), *affg*. 1 T.C. 952 (1943); *Victor E. Gidwitz Family Trust v. Commissioner*, 61 T.C. 664, 673 (1974). The nature of the litigation is, in turn, controlled by the origin and character of the claim which gave rise to the litigation. *United States v. Gilmore*, 372 U.S. 39 (1963); *Victor E. Gidwitz Family Trust v. Commissioner*, *supra*.
>
> In characterizing the settlement payment for tax purposes, the test to be applied is stated most simply as "In lieu of what were the damages awarded?" *Getty v. Commissioner*, *supra*; *Tribune Publishing Co. v. Commissioner*, *supra* at 1178. In the instant case, petitioner's stepmother filed a complaint to set aside the 1978 Deed to the Modoc property. Petitioner filed a cross-complaint requesting a determination of his interests in the Modoc property. Petitioner also requested that the Santa Barbara Superior Court order a partition of the property or, in the alternative, order the property be sold with the proceeds to be divided according to the parties' respective interests in the Modoc property. After 3 years of legal posturing in the property dispute, and having twice had petitioner's general demurrers sustained against her, petitioner's stepmother agreed to a settlement in the amount of $390,000….
>
> In the instant case, the origin and character of the dispute involved the validity of a gratuitous transfer of real property to petitioner by his father pursuant to the 1978 Deed. The pleadings concerning the Modoc property transfer clearly indicate that the parties disputed the validity of the 1978 Deed. Petitioner's stepmother requested the court to declare the 1978 Deed null and void. Petitioner, in his cross-complaint, requested a judicial determination of his interest in the Modoc property. The Compromise Settlement and Mutual Release stated that the covenants therein and the $390,000 payment was in lieu and instead of any inherited interest in the Modoc property. We therefore reject respondent's contention that the $390,000 payment represented a nuisance settlement based on an unrecognized claim to property. We conclude that the underlying claim arose out of a dispute as to the validity of the gratuitous transfer of the Modoc property to petitioner.
>
> Accordingly, we conclude that the settlement proceeds represented a payment for any interest that petitioner may have acquired from the purported gratuitous transfer by his father pursuant to the 1978 Deed. Therefore, we hold that the settlement payment was properly excludable from petitioners' 1983 gross income under section 102(a).

Although *Vincent* does discuss Code § 663(a)(1), the principle that Code § 102 may protect settlements from taxation undercuts Letter Ruling 9218076's idea that a settlement of rights as of the trust's inception would not be eligible for the Code § 663(a)(1) exclusion of a distribution from carrying out DNI. On the other hand, Reg. § 1.663(a)-1(b)(1), reproduced above, does require that "the amount of money or the identity of the specific property must be ascertainable under the terms of a testator's will as of the date of his death, or under the terms of an inter vivos trust instrument as of the date of the inception of the trust," so uncertainty such as that provided by a formula marital bequest (as pointed out later in the regulation)[2835] can prevent

[2835] *Lemle v. United States*, 419 F.Supp. 68 (S.D.N.Y. 1976), commented:

> The design of Section 662 is clear enough: the section as presently framed effectively eliminates the problem of tracing distributions to their source, a problem that had inevitably attended the former statutory schema. See 1954 Oscoda Cong. & Admin. News at pp. 4086-87, 4621, 4714-15, 4990 (83d Cong., 2d Sess.). It is equally clear that distributions representing an elective

Code § 663(a)(1) protection (even though satisfying with property a formula bequest of a pecuniary amount is treated as a sale of that property).[2836] Ultimately, the limits of Code § 663(a)(1) override Code § 102, which is required so that a bequest of a series of payments will carry out income.[2837] Furthermore, if a beneficiary receives a series of payments that under state law constitute income at the time but in a later taxable year settles with the estate, applying the payments towards the estate's lump-sum obligation (an elective share), that application of payments under the settlement agreement does not prevent the series of payments from being distributions that carry out DNI.[2838]

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share in the corpus of a deceased spouse's estate may be subject to the conclusive presumption raised by Section 662. See 26 U.S.C. 663 and 26 C.F.R. 1.663(a)-1(b).[5]

[5] A dower interest, in contradistinction to a surviving spouse's elective share, is excepted from Section 662 coverage. The rationale behind this difference in tax treatment is indirectly revealed in 26 C.F.R. 1.663(a)-1(b).

[2836] Rev. Rul. 60-87 provides:

Revenue Ruling 56-270, C. B. 1956-1, 325, stands for the proposition that, if a marital deduction trust comprises a fraction or percentage of the "adjusted gross estate" of a decedent, the marital trust fund is considered to have been provided for in a fixed and definite "dollar amount." Therefore, capital gain or loss is recognized upon the distribution of property to a trust…

Unlike section 1.663(a)-1(b)(1) of the regulations, Revenue Ruling 56-270, *supra*, is not concerned with the ascertainability of a specific amount at the date of death but rather whether the marital trust fund is provided for in a fixed and definite amount at the time of the distribution. Thus, to qualify for the exclusion provided for in section 663(a) of the Code, the above-quoted regulation prescribes an entirely different test from that prescribed in Revenue Ruling 56-270, which has application only for capital gain purposes. Further, the last sentence of the above-quoted regulations recognizes the fact that a different rule applies for capital gain purposes and clearly implies that the regulations are not to be considered inconsistent with that rule.

In the instant case, the marital deduction trust comprises a portion of the residue of the decedent's estate. However, instead of using a residuary formula clause, which leaves a percentage or fraction of the value of the residuary estate to the surviving spouse or trust, the will uses a pecuniary formula clause, as a Revenue Ruling 56-270, *supra*, which leaves a percentage of the "adjusted gross estate" to the surviving spouse or trust. There is a significant distinction between a marital deduction trust of the pecuniary formula type and one of the residuary formula type.

The rationale of Revenue Ruling 56-270, *supra*, is that a marital deduction trust of the pecuniary formula type provides for a trust fund in a fixed and definite amount, once the value of the adjusted gross estate is finally determined, which amount is unaffected by any appreciation or depreciation in value of the assets comprising the estate.

The difference is that under a pecuniary formula clause the trust will receive assets of a fixed and definite amount at the time of distribution, whereas under the residuary formula clause the percentage or fraction will be applied for the purpose of making distribution of the residuary estate as constituted at the time of distribution. Therefore, under a residuary formula clause, the trust will share in appreciation and depreciation of the value of the estate, which is not the case under a pecuniary formula clause. Thus, Revenue Ruling 56-270, *supra*, is not inconsistent with section 1.663(a)-1(b)(1) of the regulations.

The facts in the instant case show that the marital deduction trust comprising a portion of the residue of the estate is measured by a percentage of the value of the adjusted gross estate. Under such circumstances, the marital trust fund is considered as being provided for in a fixed and definite "dollar amount." Accordingly, gain or loss is realized by the estate measured by the difference between the fair market value of the property at the date of distribution and the value of the property determined for Federal estate tax purposes.

[2837] *Mahler v. Commissioner*, T.C. Memo. 1987-64.

[2838] *Lemle v. United States*, 579 F.2d 185 (2nd Cir. 1978).

Using property to satisfy a pecuniary bequest, although not a Code § 663(a)(1) distribution, is a deemed sale from the trust to the beneficiary.[2839] If an estate that is about to distribute specially bequeathed assets sells them at the beneficiaries' request, the executor's compliance with this request is the equivalent of a distribution of the securities to the beneficiaries, accompanied by an immediate return of the securities by the beneficiaries with instructions to the executor to sell on their behalf and is taxed directly to them.[2840] However, if an estate has legal title to property whose income is dedicated to charity, the estate reports the income and then takes a charitable deduction for the charitable set-aside.[2841] However, where the beneficiaries have only equitable rights and no legal rights to property, the income is received in trust and then distributed to the beneficiaries.[2842] On the other hand, if under applicable law a decedent's real estate passes

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[2839] Consistent with *Kenan v. Commissioner*, 40 B.T.A. 824 (1939) (taxing gain on deemed sale), *aff'd* 114 F.2d 217 (2nd Cir. 1940) (gain received capital gain treatment), Reg. § 1.661(a)-2(f) provides:

> Gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under section 643(b) and the applicable regulations, if income is required to be distributed currently. In addition, gain or loss is realized if the trustee or executor makes the election to recognize gain or loss under section 643(e). This paragraph applies for taxable years of trusts and estates ending after January 2, 2004.

[2840] Rev. Rul. 68-666 reads in its entirety:

> A decedent by will made a specific bequest of securities to three charitable organizations exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954. After all of the debts of the decedent's estate had been satisfied, and when the executor of the estate was preparing to make distribution of the specific bequest, the beneficiaries thereof requested the executor to sell the securities and to distribute the proceeds in satisfaction of the specific bequest. Held, the executor's compliance with this request is the equivalent of a distribution of the securities to the beneficiaries, accompanied by an immediate return of the securities by the beneficiaries with instructions to the executor to sell on their behalf.
>
> Accordingly, gain realized on the sale of the securities is not includible in the gross income of the decedent's estate. Such gain was not realized and received by the estate. It was realized and received by the beneficiaries as a result of sales made by the executor while acting on their behalf.

This agency argument does not apply to qualified retirement plans that sell stock before distributing it. *Clayton v. U.S.*, 33 Fed. Cl 628 (1995) (distributees argued that they received low basis stock from an ESOP and then sold it for capital gain instead of an ordinary income distribution), *aff'd* 91 F.3d 170 *Fed. Cir. 1996), *cert. denied*, 519 U.S. 1040 (1996).

[2841] Rev. Rul. 57-133.

[2842] Rev. Rul. 75-61 involved the following facts:

> A died testate in 1963. His will provided that after the payment of his just debts and funeral expenses one-third of the estate be "alloted and assigned" to his wife, B, as satisfaction of her dower interest. Real property was transferred by the executor of A's estate to B in 1964 to carry out this provision in the will. Under local law, real property and income therefrom is subject to administration.
>
> A's will further provided that the income from certain property, comprising one-third of the estate, was to be paid to his son, C, for life and at C's death, such property was to be distributed to those of C's children living at the time of his death. In the event any portion of such property should vest in any person before such person attained his or her majority, then such portion would be retained by a trustee under a power in trust to invest and reinvest the principal, to collect the income and apply the net income, or as much thereof as the trustee should in his sole discretion determine, to the support and maintenance of such person during his or her minority.
>
> C died in the year 1971 leaving only a minor child, D. Under the laws of the appropriate jurisdiction legal title to property held under a power in trust is in the beneficiaries, in this case D.

directly to the beneficiaries, the estate does not include income from the real estate, except if and to the extent that the executor takes charge of the property and uses it to pay expenses rather than distributing it to the beneficiaries.[2843]

> The final third of the estate consisted of real estate and under the will was to be held by A's daughter, E, in fee simple, with the limitation that she would have no right to sell, convey, mortgage, incumber or dispose of, in any way, the real estate or rights therein before January 1, 1971, or to control, receive, or collect income from such real estate before January 1, 1967, unless permitted to do so at an earlier date by the action of the trustee. On and after January 1, 1967, however, she could lease the real property and receive the income from it.
>
> The specific issues are whether the income derived from the property held by the executor and ultimately distributed to B is income to B or to the executor; whether the income derived from the property held subject to the power in trust is income of a trust or of C's child; and whether income derived from the property conveyed to A's daughter is her income or income of a trust.

Rev. Rul. 75-61 held:

> The will, in the instant case, passed legal title to one-third of the estate to B, one-third to D, and one-third to E. However, it is manifest that complete control over the realty conveyed to D and E was given to the trustee. D and E could not collect the rental income themselves regardless of where the bare legal title to the real estate might vest. It was A's intent that the income from the real estate held by D should be received by C, until C's death, then controlled by the trustee for the benefit of D until such time as D reached his majority, then to D. Furthermore, it was A's intent that the income from the real estate held by E should be controlled by the trustee until January 1, 1967, and the power to convey the real estate was to be withheld until January 1, 1971.
>
> Thus, the trustee of the properties of D and E is vested with the responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of the responsibility.
>
> Accordingly, it is held that the trustee must file U.S. Fiduciary Income Tax Returns (Form 1041) reporting therein the income from the property held under the power in trust for the benefit of D, for the taxable years in which he, as trustee, received such income. It is further held that the trustee must also report the income received from the real property left by A for the benefit of E for the taxable years in which such income was received by the trustee. Furthermore, it is noted that the dower interest of B has been satisfied by the transfer to her of real property of the estate by the executor, since under local law the property and income therefrom was subject to administration during that period. Rev. Rul. 57-133, 1957-1 C.B. 200. The income from such property that was received prior to the transfer to B is held to be income to the estate and reportable by the executor. After the transfer of the real estate to B, the income is held to be the personal income of B.

[2843] Rev. Rul. 59-375 reasoned and held:

> Under North Carolina law, when a person dies intestate, his real property descends directly to his heirs and is not subject to the control of the administrator. See *Alexander v. Galloway, et al.*, 80 S.E.(2d) 369; *Parker, et al., v. Porter, et al.*, 179 S.E. 28. However, under section 28-81 of the General Statutes of North Carolina, if the personal estate of the decedent should prove insufficient to pay the debts and costs of administration, the administrator may apply to the courts to sell the real property. Under section 28-57 of the General Statutes of North Carolina, all proceeds arising from such a sale are deemed personal assets in the hands of the administrator.
>
> Section 28-58 of the General Statutes of North Carolina provides, further as follows:
>
> > Surplus of proceeds of realty sold for debts is real asset.—All proceeds from the sale of real estate, as hereinafter provided, which may not be necessary to pay the debts and charges of administration, shall, notwithstanding, be considered real assets and as such shall be paid by the executor, administrator or collector to such persons as would have been entitled to the land had it not been sold.

II.J.9.a.ii. Separate Share Rule

In addition to its significance for fiduciary income tax purposes, the separate share rule can be critically important for determining a trust's eligibility for QSST treatment[2844] and for certain nonqualified deferred compensation plans.[2845]

"A separate share comes into existence upon the earliest moment that a fiduciary may reasonably determine, based upon the known facts, that a separate economic interest exists,"[2846] which really means that "distributions of the trust are to be made in substantially the

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> In the present case the income was realized from sales of property made on behalf of both the administrator and the heirs. There was a joint sale of their respective interests in the lands. Such partition of real property by sale, where it appears that the actual partition cannot be made without injury to some or all of the interested parties, is provided for under Chapter 46, Article 2 to the General Statutes of North Carolina. The sales involved here were made according to section 1-339.4 of such General Statutes which authorizes the appointment of a commissioner to hold a sale in any proceeding. In such cases, the commissioner is acting as an agent of the court on behalf of the petitioning parties. See *Ex parte Wilson*, 22 S.E.(2d) 262; and *Harrell v. Blythe*, 53 S.E. 232. Under the orders of the court, the commissioner holds the proceeds for the heirs, subject only to the actual requirements of the administrator. Thus, to the extent that the property was sold for the purpose of providing funds for the administration of the estate, the proceeds are to be considered personalty and are subject to administration. It was only to that extent that the administrator had any interest in the property. See *Linker v. Linker, et al.*, 196 S.E. 329. As only a portion of the lands was sold on behalf of the administrator, only an allocable portion of the gains from the sale is includible in the gross income of the estate.
>
> Accordingly, it is held that only that part of the gain from the sales of an intestate decedent's real estate, which is proportionate to the portion of the proceeds payable to the administrator under state law for the discharge of the debts of the estate, is required to be included in the gross income of the estate. The remainder of the gain, which arises from the partition at the suit of the heirs, does not constitute an amount "received by" the estate within the purview of section 641(a)(3) of the Code.

[2844] See part III.A.3.e.i.(a) QSSTs Generally, especially fns. 5987-5989.

[2845] Reg. § 1.404(a)-12(b)(3).

[2846] Reg. § 1.663(c)-2(a), which applies to trusts other than qualified revocable trusts within the meaning of Code § 645(b)(1). For estates and such qualified trusts:

> The applicability of the separate share rule provided by section 663(c) to estates and qualified revocable trusts within the meaning of section 645(b)(1) will generally depend upon whether the governing instrument and applicable local law create separate economic interests in one beneficiary or class of beneficiaries of such estate or trust. Ordinarily, a separate share exists if the economic interests of the beneficiary or class of beneficiaries neither affect nor are affected by the economic interests accruing to another beneficiary or class of beneficiaries.

Reg. §§ 1.663(c)-3(c) and 1.663(c)-4(c) discuss this economic interest:

> A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is separate and independent from another share in which one or more beneficiaries have an interest. Likewise, the same person may be a beneficiary of more than one separate share.

Reg. § 1.663(c)-3(b) explains how rights to distributions need to be separated:

> Separate share treatment will not be applied to a trust or portion of a trust subject to a power to:
>
> (1) Distribute, apportion, or accumulate income, or
>
> (2) Distribute corpus
>
> to or for one or more beneficiaries within a group or class of beneficiaries, unless payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other

same manner as if separate trusts had been created."[2847] If a trust (or estate) has separate and independent shares, that treatment "must prevail in all taxable years of the trust (or estate) unless an event occurs as a result of which the terms of the trust instrument and the requirements of proper administration require different treatment."[2848] This rule applies "even though separate and independent accounts are not maintained and are not required to be maintained for each share on the books of account of the trust (or estate), and even though no physical segregation of assets is made or required."[2849] Special rules apply to specific bequests,[2850] trusts with Code § 645 elections, and elective shares;[2851] also see

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> beneficiaries, or unless substantially proper adjustment must thereafter be made (under the governing instrument) so that substantially separate and independent shares exist.

Reg. § 1.663(c)-3(d) explains that remote possibilities of distributions outside the separate share's targeted beneficiaries will not ruin separate share treatment:

> Separate share treatment may be given to a trust or portion of a trust otherwise qualifying under this section if the trust or portion of a trust is subject to a power to pay out to a beneficiary of a share (of such trust or portion) an amount of corpus in excess of his proportionate share of the corpus of the trust if the possibility of exercise of the power is remote. For example, if the trust is subject to a power to invade the entire corpus for the health, education, support, or maintenance of A, separate share treatment is applied if exercise of the power requires consideration of A's other income which is so substantial as to make the possibility of exercise of the power remote. If instead it appears that A and B have separate shares in a trust, subject to a power to invade the entire corpus for the comfort, pleasure, desire, or happiness of A, separate share treatment shall not be applied.

However, such remoteness is not permitted for a QSST. See part III.A.3.e.i.(a) QSSTs Generally, fn. 5987.

[2847] Reg. § 1.663(c)-3(a), which explains:

> Thus, if an instrument directs a trustee to divide the testator's residuary estate into separate shares (which under applicable law do not constitute separate trusts) for each of the testator's children and the trustee is given discretion, with respect to each share, to distribute or accumulate income or to distribute principal or accumulated income, or to do both, separate shares will exist under section 663(c). In determining whether separate shares exist, it is immaterial whether the principal and any accumulated income of each share is ultimately distributable to the beneficiary of such share, to his descendants, to his appointees under a general or special power of appointment, or to any other beneficiaries (including a charitable organization) designated to receive his share of the trust and accumulated income upon termination of the beneficiary's interest in the share. Thus, a separate share may exist if the instrument provides that upon the death of the beneficiary of the share, the share will be added to the shares of the other beneficiaries of the trust.

[2848] Reg. § 1.663(c)-1(d).

[2849] Reg. § 1.663(c)-1(c).

[2850] See part II.J.9.a.i Specific Bequests under Code § 663(a). T.D. 8849 (12/28/1999) explained:

> The final regulations provide that bequests described in section 663(a)(1) are not separate shares. The separate share rules are applicable only to determine the distributable net income of each share when applying the distribution provisions of sections 661 and 662 to the trust or estate and its beneficiaries. Bequests described in section 663(a)(1) are not subject to the distribution provisions and therefore are not separate shares.

[2851] Reg. § 1.663(c)-4(a) provides:

> Separate shares include, for example, the income on bequeathed property if the recipient of the specific bequest is entitled to such income and a surviving spouse's elective share that under local law is entitled to income and appreciation or depreciation. Furthermore, a qualified revocable trust for which an election is made under section 645 is always a separate share of the estate and may itself contain two or more separate shares. Conversely, a gift or bequest of a specific sum of money or of property as defined in section 663(a)(1) is not a separate share.

Reg. § 1.663(c)-4(b) provides:

part III.A.3.d Special Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.

If different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts for the sole purpose of determining the amount of distributable net income (DNI) allocable to the respective beneficiaries under Code §§ 661 and 662.[2852] Any separate share's DNI is computed as if each share constituted a separate trust or estate:[2853]

- Gross income includible in DNI that is fiduciary accounting income "is allocated among the separate shares in accordance with the amount of income that each share is entitled to under the terms of the governing instrument or applicable local law."[2854]

- Gross income includible in DNI that is income in respect of a decedent under Code § 691(a) and is not fiduciary accounting income "is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount of such gross income allocated to each share is based on the relative value of each share that could potentially be funded with such amounts."[2855]

> Notwithstanding the provisions of paragraph (a) of this section, a surviving spouse's elective share that under local law is determined as of the date of the decedent's death and is not entitled to income or any appreciation or depreciation is a separate share. Similarly, notwithstanding the provisions of paragraph (a) of this section, a pecuniary formula bequest that, under the terms of the governing instrument or applicable local law, is not entitled to income or to share in appreciation or depreciation constitutes a separate share if the governing instrument does not provide that it is to be paid or credited in more than three installments.

[2852] Reg. § 1.663(c)-1(a). Rev. Rul. 74-299 (amplified by Rev. Rul. 2007-48) applied Reg. § 1.663(c)-1(a) to a Code § 402(b) nonexempt employees' trust.

Reg. § 1.663(c)-1(b) elaborates on Reg. § 1.663(c)-1(a):

> The separate share rule does not permit the treatment of separate shares as separate trusts (or estates) for any purpose other than the application of distributable net income. It does not, for instance, permit the treatment of separate shares as separate trusts (or estates) for purposes of:
> (1) The filing of returns and payment of tax,
> (2) The deduction of personal exemption under section 642(b), and
> (3) The allowance to beneficiaries succeeding to the trust (or estate) property of excess deductions and unused net operating loss and capital loss carryovers on termination of the trust (or estate) under section 642(h).

[2853] Reg. § 1.663(c)-2(b)(1), which further provides:

> Accordingly, each separate share shall calculate its distributable net income based upon its portion of gross income that is includible in distributable net income and its portion of any applicable deductions or losses.

[2854] Reg. § 1.663(c)-2(b)(2).

[2855] Reg. § 1.663(c)-2(b)(3). Reg. § 1.663(c)-5, Example (9), provides:

> The will of Testator, who dies in 2000, directs the executor to divide the residue of the estate equally between Testator's two children, A and B. The will directs the executor to fund A's share first with the proceeds of Testator's individual retirement account. The date of death value of the estate after the payment of debts, expenses, and estate taxes is $9,000,000. During 2000, the $900,000 balance in Testator's individual retirement account is distributed to the estate. The entire $900,000 is allocated to corpus under applicable local law. This amount is income in respect of a decedent within the meaning of section 691(a). The estate has two separate shares, one for the benefit of A and one for the benefit of B. If any distributions are made to either A or B

- Gross income includible in DNI "that is not attributable to cash received by the estate or trust (for example, original issue discount, a distributive share of partnership tax items, and the pro rata share of an S corporation's tax items) … is allocated among the separate shares in the same proportion as [fiduciary accounting] income from the same source would be allocated under the terms of the governing instrument or applicable local law."[2856]

- "Any deduction or any loss which is applicable solely to one separate share of the trust or estate is not available to any other share of the same trust or estate."[2857] It is unclear whether (a) this merely keeps the deduction within its share to offset its share's income but allows a net loss from a separate share might lower the trust's and therefore the other shares' tax liability, or (b) it completely prevents the loss generated by one share from reducing the amount included in the income of the other shares' beneficiaries.[2858] I believe

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during the year, then, for purposes of determining the distributable net income for each separate share, the $900,000 of income in respect of a decedent must be allocated to A's share.

The Example is troubling, in that the allocation of the IRA does not have economic effect under the actual facts. However, if the residue is less than $1.8 million, then A gets $900,000 and B gets the balance, which would be less than what A received. The fact that the estate was more than that does not change the possible economic effect, because one never knew how large the IRA or the estate would be.

[2856] Reg. § 1.663(c)-2(b)(4).

[2857] Reg. § 1.663(c)-2(b)(5).

[2858] Although the above allocations govern the allocation of DNI, Code §§ 661 and 662 govern how much income the trust can deduct and consequently include in a beneficiary's income. That amount is the lesser of DNI or the sum of income required to be distributed for a taxable year and any other amounts properly paid or credited or required to be distributed for such taxable year. Code § 661(a). These amounts are allocated to the beneficiaries and included in their income. Code § 662(a).

However, because the only mechanism for a beneficiary to deduct a loss is either depreciation deductions (see part II.J.11.a.ii.(b) Beneficiary's Ability to Deduct Depreciation That Generates Net Loss) or loss on termination (Code § 642(h)), a beneficiary cannot deduct a loss and the trust cannot carry over a loss other than one generated by a business (Code § 642(d)) or a capital loss (Code § 1212). Thus, if a separate share has a net loss, the beneficiary(ies) will not deduct that loss. See part II.J.3.i Planning for Excess Losses.

Consider the following scenario: Trust has $10,000 of taxable interest income, allocated to share A, and $10,000 of state income tax liability, attributable to taxes on the prior year's municipal bond interest earned by share B earned before the bonds were sold at no gain or loss. The trust distributes $10,000 to A and $10,000 to B, each out of her own share. The trust's taxable income, ignoring exemptions, is zero. Applying Reg. § 1.663(c)-2(b)(5) to disallow the state income tax deduction would result in A including $10,000 in income and the trust having a $10,000 loss ($10,000 interest income minus the $20,000 sum of the $10,000 income distribution deduction and the $10,000 state income tax liability). Which is correct: zero taxable income for everyone, or $10,000 taxable income to A and the trust has a $10,000 loss that benefits nobody? In other words, does the trust's overall DNI of zero control, or do A's DNI of $10,000 and B's DNI of negative $10,000 control?

Consider another scenario: share A has $10,000 of dividends and $10,000 of capital gain through a partnership that distributes $20,000 as a distribution of operating income (and not a distribution in partial liquidation), and share B has no dividends and $10,000 of capital loss through a partnership that distributes $20,000 of cash as a distribution of the prior year's operating income. On Form 1041, Schedule D, the capital gain and loss offset. We know that the separate share rule prevents B from reporting any of A's income. However, does the separate share rule tax $20,000 ($10,000 of dividends and $10,000 of capital gain) or $10,000 (dividends only, because capital gains were offset by capital loss) to A? If the former, what mechanism is there for preserving the $10,000 capital loss allocated to B? Nowhere do the Instructions for Schedule D (Form 1041) address this issue; even if one allocated share B's capital loss to the trust instead of to the beneficiaries, neither the tax return nor the Capital Loss Carryover Worksheet in the Instructions provides a mechanism that prevents netting the beneficiaries'

> that the former is the better view,[2859] although when taking that position one might attach IRS Form 8275-R because on its face that position appears to contradict Reg. § 1.663(c)-2(b)(5).[2860] If one or more separate shares benefit from the overall ceiling of tax liability, then the trustee should consider making an equitable adjustment to compensate the share that generated the loss for the benefit that the other share(s) received – especially because that loss is probably reflected in lower tax basis of assets held by the share that generated the loss. If one is doing an interim division of a trust, holding some back in the general residue but opening up a separate account within a trust to represent a separate share for each beneficiary or group of beneficiaries, one might consider raising this issue and clarifying the approach to be taken if one share generates a loss.

A specialized application of the above is in part III.A.3.d.i Various Fiduciary Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.

In making the above allocations to separate shares, "the fiduciary must use a reasonable and equitable method to make the allocations, calculations, and valuations…."[2861] For example, a principal distribution from one share that is disproportionately larger than a principal distribution from another share should affect the relative allocation of income between those shares.[2862]

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capital gain against the trust's capital loss in a manner that would generate a capital loss carryover for share B.

2859 Yu, "Deductions in a Proposed Calculation and Allocation of Distributable Net Income to the Separate Shares of a Trust or Estate," 5 Pitt. Tax Rev. 123 (2008) (saved as my document no. 6167169), reviews the two approaches to resolve the issue raised in fn. 2858 and the accompanying text and states that the view I adopted is the better approach. Footnote 93 in Yu's article cited F. Ladson Boyle & Jonathan G. Blattmachr, *Blattmachr on Income Taxation of Estates and Trusts* (15th ed. 2008), as saying on pages 3-104 to 3-105 the following about Reg. § 1.663(c)-2(b)(5):

> Notwithstanding this rule [that any deduction or loss that is applicable solely to one separate share is not available to any other share], when a net loss in one share results in the DNI of an entire trust being less than the potential DNI of a different share (computed as though it was a separate trust), the DNI of the share with net income should not exceed the DNI of the trust. The effect of limiting the DNI of the profitable, second share to the trust's DNI is to give the second share the benefit of the net loss in the first share.

Informal email conversations with Lad and Jonathan in April 2015 confirmed that they had not changed their view on this issue.

Reg. § 1.663(c)-1(a) explains the philosophy of the separate share rules, applying them to an example, and concludes, "In the absence of a separate share rule B would be taxed on income which is accumulated for A. The division of distributable net income into separate shares will limit the tax liability of B." Yu's preferred approach that I adopted does not cause any income to be shifted from one beneficiary to another; it merely limits the estate's deduction consistent with the overall DNI limitation of Code § 661(a).

2860 Such an explanation is saved as my document no. 6149985.

2861 Reg. § 1.663(c)-2(c).

2862 Reg. § 1.663(c)-5, Example (3) provides:

> The facts are the same as in Example 2, except that in 2000 the executor makes the payment to partially fund the children's trust but makes no payment to the surviving spouse. The fiduciary must use a reasonable and equitable method to allocate income and expenses to the trust's share. Therefore, depending on when the distribution is made to the trust, it may no longer be reasonable or equitable to determine the distributable net income for the trust's share by allocating to it 40% of the estate's income and expenses for the year. The computation of the distributable net income for the trust's share should take into consideration that after the partial

However, the amount the trust deducts[2863] and the amount each separate share includes in income[2864] is the lesser of the DNI allocated to[2865] or the amount actually distributed to that separate share.

The charitable deduction may reduce the amount allocable to DNI (and the charity does not receive a K-1);[2866] however, a distribution to a charitable remainder trust (CRT) generates a Code § 661 deduction and K-1 rather than a charitable income tax deduction,[2867] and be sure to use discretion regarding income and deductions to the extent possible (which is not much)[2868] to

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> distribution the relative size of the trust's separate share is reduced and the relative size of the spouse's separate share is increased.

T.D. 8849 added this example December 27, 1999, presumably superseding the approach taken in Letter Ruling 9644057, which ruling approved disproportionate distributions of principal without changing the distribution of income.

[2863] Code § 661(a).

[2864] Code § 662(a).

[2865] Code § 663(c) allocates DNI and therefore is a factor the determining, rather than the sole determinant of, the amount deducted by the trust or estate and included in the beneficiary's income.

[2866] Code § 663(a)(2) and Reg. § 1.663(a)-2 (reproduced in fn 4943 in part II.Q.7.c.i.(b) Business Income Limiting Trust Income Tax Deduction, as is Notice 2004-35), the former which is incorporated by reference into Reg. § 1.661(a)-1. Additional authority for no K-1 to charity includes Rev. Rul. 2003-123; Rev. Rul. 68-667; *U.S. Trust Company v. Internal Revenue Service*, 803 F.2d 1363 (5th Cir. 1986) (upholding the regulation as valid); *Mott v. United States*, 462 F.2d 512 (Ct. Cl. 1972) (*en banc*), *cert. denied*, 409 U.S. 1108 (1973) (same); *Estate of O'Connor v. Commissioner*, 69 T.C. 165 (1977) (same result) (reviewed); *Pullen v. United States*, 45 A.F.T.R.2d 80-381 (D. Nev. 11/30/1979), *aff'd* No. 80-1034 (8th Cir. 1980) (memo) (same result); CCAs 201651013 (thoroughly reviewing the above authorities and GCMs 33410 (1/10/67) and 33696 (11/29/67), which the CCA said resulted in TAM 6802210560A specifically and Rev. Rul. 68-667 generally, and agreeing with the result) and 201747005 (I believe that the CCAs are greatly flawed on their Code § 642(c) analysis but agree with their analysis of Code § 663(a)(2) and Reg. § 1.663(a)-2). For the charitable fiduciary income tax deduction, see part II.J.4.c Charitable Distributions.

[2867] GCM 39707 (3/14/1988) first ruled that Code § 642(c) does not apply to a distribution to a CRT, citing Reg. §§ 1.664-1(a)(5)(iii) and 1.664- 1(a)(6), Example (5), the latter providing:

> In 1973, H dies testate leaving the net residue of his estate (after payment by the estate of all debts and administration expenses) to a trust which meets the definition of a charitable remainder unitrust. For purposes of section 2055, the trust is deemed created at H's death if the requirement to pay the unitrust amount begins on H's death and is a charitable remainder trust even though the estate is obligated to pay debts and administration expenses.
>
> For purposes of section 664, the trust becomes a charitable remainder trust as soon as it is partially or completely funded. Consequently, unless the trust has unrelated business taxable income, the income of the trust is exempt from all taxes imposed by subtitle A of Code, and any distributions by the trust, even before it is completely funded, are governed by the rules of section 664. Any distributions made by H's estate, including distributions to a recipient in respect of unitrust amounts, are governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664.

The GCM concluded:

> Since we have concluded in our discussion of Issue (1) that no amounts distributed to the charitable remainder trust in this case are considered as set aside for charitable purposes within the meaning of section 642(c)(2) of the Code, the prohibition of Treas. Reg. 1.663(a)-2 on section 661 deductions for amounts paid or set aside for charitable purposes has no application in this case. Thus the estate is entitled to a deduction under section 661 of the Code for its distributions to the trust, up to the amount of the estate's distributable net income.

[2868] Part II.J.8.f.i.(b) Allocating Income Items Among Those Receiving It discusses that special allocations of income are permitted only by specific provisions in the governing instrument that have economic effect.

try to avoid allocating unrelated business income to the CRT.[2869] After separate shares are determined, the charitable deduction reduces the amount of DNI allocated to each separate share.[2870] Furthermore, generally the charitable deduction proportionately reduces the other deductions allocable to each share.[2871]

For the interaction of this part II.J.9.a.ii to the Code § 199A deduction described in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income, see part II.E.1.f.i.(d) Separate Shares.

If a beneficiary dies, to the extent that this part II.J.9.a.ii does not apply, see part II.J.6 Income Allocation on Death of a Beneficiary.

II.J.9.b. Trust Divisions

See parts II.J.18 Trust Divisions, Mergers, and Commutations; Decanting and II.D.5 Severing Trusts with Multiple Grantors.

II.J.9.c. Multiple Trusts

This part Multiple Trusts includes parts II.J.9.c.i Multiple Trusts Created for Tax Avoidance

II.J.9.c.i. Multiple Trusts Created for Tax Avoidance

For purposes of the fiduciary income tax rules under Code §§ 641-692, under Treasury regulations, two or more trusts are treated as one trust if:[2872]

> (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and
>
> (2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter.
>
> For purposes of the preceding sentence, a husband and wife shall be treated as 1 person.

Instead, try to allocate deductions to the unrelated business income; see part II.J.8.f.i.(a) Allocating Deductions to Various Income Items.

[2869] See part II.Q.6.c Possible Adverse Consequences When Contributing Partnership Interest to Charitable Remainder Trust, especially the text accompanying fns 4661-4662.

[2870] Reg. § 1.663(c)-5, Example (11) provides:

> The will of Testator, who dies in 2000, provides that after the payment of specific bequests of money, the residue of the estate is to be divided equally among the Testator's three children, A, B, and C. The will also provides that during the period of administration one-half of the income from the residue is to be paid to a designated charitable organization. After the specific bequests of money are paid, the estate initially has three equal separate shares. One share is for the benefit of the charitable organization and A, another share is for the benefit of the charitable organization and B, and the last share is for the benefit of the charitable organization and C. During the period of administration, payments of income to the charitable organization are deductible by the estate to the extent provided in section 642(c) and are not subject to the distribution provisions of sections 661 and 662.

[2871] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items, especially fn. 2821.

[2872] Code § 643(f).

1984 Committee Reports for HR 98-432, P.L. 98-369, provide:

> For example, the committee expects that the Treasury regulations would treat the trusts in the following example as one trust: A establishes, with the principal purpose for the avoidance of Federal income tax, trust 1 for the benefit of his sister S1, his brother B1, and his brother B2; trust 2 for the benefit of his sister S2, his brother B1, and his brother B2; trust 3 for the benefit of his sister S1, his sister S2, and his brother B1; and trust 4 for the benefit of his sister S1, his sister S2, and his brother B2. Under each trust instrument, the trustee is given discretion to pay any current or accumulated income to any one or more of the beneficiaries.
>
> Where there are substantial independent purposes, and tax purposes are not a principal purpose of the existence of separate trusts, the trusts will not be aggregated. The following is an example where separate trusts will not be aggregated under the committee bill: X establishes two irrevocable trusts for the benefit of X's son and daughter. Son is the income beneficiary of the first trust and the trustee (Bank of P) is required to pay all income currently to son for life. Daughter is the remainder beneficiary. X's daughter is an income beneficiary of the second trust and the trust instrument permits the trustee (Bank of D) to accumulate or to pay income, in its discretion, to daughter for her education, support and maintenance. The trustee also may pay income or corpus to son for his medical expenses. Daughter is the remainder beneficiary and will receive the trust corpus upon son's death.

However, no relevant Treasury regulations existed before 2018, so one wondered whether the provision is effective. Nevertheless, at least one taxpayer was concerned enough to include it in a private letter ruling request that focused on a trust division and received a favorable ruling (which is not surprising, considering that the trusts has different primary beneficiaries).[2873]

Proposed regulations regarding the multiple trust rule were issued in conjunction with proposed regulations interpreting Code § 199A, which has its own multiple trust rule.[2874] The preamble to the 2018 proposed regulations, REG-107892-18 (8/16/2018), explained:

> **VII. Proposed § 1.643(f)-1: Anti-avoidance Rules for Multiple Trusts**
>
> As described in section VI.B of the Explanation of Provisions, under Section 199A, the threshold amount is determined at the trust level without taking into account any distribution deductions. Therefore, taxpayers could circumvent the threshold amount by dividing assets among multiple trusts, each of which would claim its own threshold amount. This result is inappropriate and inconsistent with the purpose of Section 199A and general trust principles.
>
> To address this and other concerns regarding the abusive use of multiple trusts, proposed § 1.643(f)-1 confirms the applicability of section 643(f). As noted in part II of the Background, section 643(f) permits the Secretary to prescribe regulations to prevent taxpayers from establishing multiple non-grantor trusts or contributing additional capital to multiple existing non-grantor trusts in order to avoid Federal income tax. Proposed § 1.643(f)-1 provides that, in the case in which two or more trusts have substantially the

[2873] Letter Ruling 199912034.
[2874] Reg. § 1.199A-6(d)(3)(vii), which is reproduced in part II.E.1.f Trusts/Estates and the Code § 199A Deduction.

> same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and a principal purpose for establishing such trusts or contributing additional cash or other property to such trusts is the avoidance of Federal income tax, then such trusts will be treated as a single trust for Federal income tax purposes. For purposes of applying this rule, spouses are treated as only one person and, accordingly, multiple trusts established for a principal purpose of avoiding Federal income tax may be treated as a single trust even in cases where separate trusts are established or funded independently by each spouse. Proposed § 1.643(f)-1 further provides examples to illustrate specific situations in which multiple trusts will or will not be treated as a single trust under this rule, including a situation where multiple trusts are created with a principal purpose of avoiding the limitations of Section 199A. The application of proposed § 1.643(f)-1, however, is not limited to avoidance of the limitations under Section 199A and proposed §§ 1.199A-1 through 1.199A-6.
>
> The rule in proposed § 1.643(f)-1 would apply to any arrangement involving multiple trusts entered into or modified on or after August 16, 2018. In the case of any arrangement involving multiple trusts entered into or modified before August 16, 2018, the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) will be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f). Pending the publication of final regulations, the position of the Treasury Department and the IRS is that the rule in proposed § 1.643(f)-1 generally reflects the intent of Congress regarding the arrangements involving multiple trusts that are appropriately subject to treatment under section 643(f).

The preamble to the final regulations, T.D. 9847 (2/8/2019), part VIII, "Treatment of Multiple Trusts," retreated from this overbroad provision:

> Two commenters requested clarification regarding whether multiple trusts will be aggregated if section 643(f) requirements are met. Specifically, the commenters asked for clarification on what it means to form or fund a trust with a significant purpose of receiving a Section 199A deduction. These commenters state that trusts should not be combined simply because the Section 199A deduction is increased if a legitimate non-tax reason led to the creation of the trusts.
>
> Other commenters objected to the presumption of a tax-avoidance purpose, arguing that it will shift the focus to a requirement that there be a non-tax purpose for creating multiple trusts. The commenters also asked whether the reference to income tax includes state income tax, as the proposed rule refers to the avoidance of more than Federal income tax.
>
> Another commenter agreed with the need for the rule but asked for clarification on the definitions of primary beneficiary, significant tax benefit, principal purpose, and arrangement involving multiple trusts; the application of the substantially the same beneficiary rule; and whether trusts for different children, with other children as default beneficiaries, are the same. Another commenter noted that the use of substantial purpose rather than principal purpose is inconsistent with the statutory language.
>
> Another commenter asked for clarification of the effective date regarding modifications or contributions to pre-effective date trusts, and of the identification of trusts to which the regulation applies. Another commenter requested that final regulations address the

applicability of the rule to the conversion of grantor trusts to non-grantor trusts post enactment of the TCJA.

> One commenter requested that examples be given for each of the three requirements under section 643(f) and requested that § 1.643(f)-1, Example 2, be clarified to describe the trusts as non-grantor trusts.
>
> Based on the comments received, the Treasury Department and the IRS have removed the definition of "principal purpose" and the examples illustrating this rule that had been included in the proposed regulations, and are taking under advisement whether and how these questions should be addressed in future guidance. This includes questions of whether certain terms such as "principal purpose" and "substantially identical grantors and beneficiaries" should be defined or their meaning clarified in regulations or other guidance, along with providing illustrating examples for each of these terms. Nevertheless, the position of the Treasury Department and the IRS remains that the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) may be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f), in the case of any arrangement involving multiple trusts entered into or modified before the effective date of these final regulations.

The retreat from the overbroad proposed regulations is encouraging. However, the statute and especially the legislative history create many unanswered questions. And "taking under advisement whether and how these questions should be addressed in future guidance" indicates to me that the Treasury Department and the IRS are not working on providing clarification anytime in the near future.

Reg. § 1.643(f)-1(a), "Treatment of Multiple Trusts," provides:

> (a) *General rule*. For purposes of subchapter J of chapter 1 of subtitle A of Title 26 of the United States Code, two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing one or more of such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax. For purposes of applying this rule, spouses will be treated as one person.
>
> (b) *Effective/ applicability date*. The provisions of this section apply to taxable years ending after August 16, 2018.

The regulation merely mirrors the statute, removing the overreaching language that was in the proposed regulations and leaving uncertain many issues. The statute uses undefined terms, and the Committee Reports introduce uncertainty to how to apply its undefined terms. ACTEC's official comments to the proposed regulations criticized some overreaching terms in the proposed regulations that were removed, but its concern over undefined terms and confusing Committee Reports remains.[2875]

What is the effect of violating the rule? Suppose parents create a separate trust for each of their five children, where each child is the sole beneficiary who may or must receive

[2875] ACTEC comments on proposed regulations under Sections 199A and 643(f) (September 27, 2018).

distributions. Code § 643(f) would not try to combine them. Suppose they create a sixth trust that sprinkles among all five children and that the avoidance of Federal income tax was a principal purpose for establishing the sixth trust. Are all six trusts combined? Are the tax attributes of the sixth trust allocated to the five other trusts? We need better guidance.

Rev. Proc. 2019-3 added section 3.01(85), which continues identically in Rev. Proc. 2020-3, § 3.01(89), among the list of issues on which private letter rulings will not be issued:

> Section 643(f). - Treatment of multiple trusts. - Whether two or more trusts shall be treated as one trust for purposes of subchapter J of chapter 1.

That addition is not surprising, in that Code § 643(f) is based on a taxpayer's motivation, and the IRS ordinarily does not issue rulings in such areas. On the other hand, having "substantially the same primary beneficiary or beneficiaries" is not based on a taxpayer's motivation, and it would be nice to know when trusts are sufficiently different to avoid needing to look into the taxpayer's motivation.

Notwithstanding this prohibition, Letter Ruling 201928004, which was issued 3/21/2019 and released to the public 7/12/2019, provided a favorable Code § 643(f) ruling with respect to a trust that was grandfathered from GST tax. The trust agreement required income to be accumulated for an undisclosed period, then:[2876]

> Upon the conclusion of the x-month period, the trustee divided the principal of the trust into equal shares among the Trustors' living children, including a share to be held for the benefit of Son and his issue ("Trust"). Son has five children, Child 1, Child 2, Child 3, Child 4 and Child 5 (collectively, "Son's Children"). Bank is currently serving as trustee of Trust ("Trustee"). Trust is the subject of this ruling request.
>
> Pursuant to § 3(b)(i) of Trust Agreement, Trustee is to pay so much of the income or principal of Trust to or for the benefit of Son or his issue as Trustee deems advisable for their care, comfort, support and education, or in the case of sickness or other emergency. Upon Son's death, Trust is held in continuing trust for Son's Children until the youngest of Son's Children is age 21, at which point Trust terminates and is distributed to Son's issue, per stirpes. All of Son's Children have reached age 21.
>
> If upon Son's death, Son has no issue living, then distribution will be made to Son's brothers or sisters, per stirpes. Because Son's Children have different investment goals and distribution needs, Trustee proposes to divide Trust into five subtrusts ("Subtrust"; collectively, the "Subtrusts") for the benefit of Son and each of Son's Children and their respective issue ("Proposed Division"). Each Subtrust will be funded with one-fifth of the assets of Trust. The terms of each Subtrust will be identical and unchanged from the terms of Trust Agreement, except that each Subtrust will be held for the benefit of Son and his respective child for whom the Subtrust was created and such child's issue. Any distribution to Son from a Subtrust will be pro rata from each Subtrust.
>
> In accordance with the terms of the Trust Agreement, each Subtrust will terminate on Son's death and remaining Subtrust assets will be distributed to the then living child for whom the Subtrust was created, or, if such child is deceased, to the then living issue of

[2876] The ruling also addressed the lack of income tax consequences on the trust division itself. See text accompanying fn 2956 in part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.

> the deceased child, per stirpes. If the child dies without living issue, then the Subtrust will be distributed to Son's other living issue, per stirpes.

Letter Ruling 201928004 cited Code § 643(f), then held:[2877]

> Accordingly, based on the facts submitted and representations made, the Proposed Division of Trust will result in each Subtrust having different primary beneficiaries. We conclude that as long as each Subtrust created by the Proposed Division is separately managed and administered, they will be treated as separate trusts for federal income tax purposes.

Code § 643(f) has been the subject of various private letter rulings before 2017 tax reform, when the tax laws did not motivate multiple trusts as strongly as they do after 2017 tax reform. The most recent ruling, Letter Ruling 201722007, held:

> Taxpayer represents that each Successor Trust will have different beneficiaries. Based on the facts submitted and the representations made, we conclude that as long as the Successor Trusts are separately managed and administered, they will be treated as separate trusts for federal income tax purposes.

What an unhelpful ruling! The ruling stated the trusts' terms, so the IRS knew who the beneficiaries would be and did not need a representation that the beneficiaries would be different.

Letter Ruling 201709020 was more helpful. It actually took a position:

> The Article THIRD Trusts will each have different primary beneficiaries. We conclude that as long the Article THIRD Trusts created by the pro-rata transfer of assets from Trust are separately managed and administered, they will be treated as separate trusts for federal income tax purposes.

In the ruling, one trust for the benefit of all of the grantor's descendants was divided into separate trusts for each of the grantor's seven children before the grantor's death instead of after the grantor's death.[2878] Each new trust followed the trust's terms that would have applied after the grantor's death anyway:

[2877] Letter Ruling 202133005, Ruling 3, used similar language.

[2878] The proposed transaction was described as:

> Trust, through its trustee, proposes to create eight separate trusts governed under Article THIRD of the trust agreement for the Family Trust and each of Grantor's seven children and their descendants ("Article THIRD Trusts") and to transfer the Article ONE trust estate, other than the X stock, in equal shares to each of the Article THIRD Trusts. The trustee will allocate a pro rata portion of each and every asset transferred from Trust to the Article THIRD Trusts. Trust will retain the X stock that will continue to be governed by Article ONE of the trust agreement.
> The trustee and beneficiaries filed a petition with Court to: (i) interpret and construe the terms of the trust agreement to provide for the establishment of the Article THIRD Trusts by the trustee pursuant to the powers given under Paragraph 4.1(P) of the trust agreement, (ii) approve the creation of the Article THIRD Trusts for the Family Trust and each of Grantor's seven children and their descendants pursuant the terms of paragraph 4.1(P) of the trust agreement, and (iii) approve the transfer of the Article ONE trust estate other than the X stock in equal shares to the eight Article THIRD Trusts.

> Paragraph 3.1 of Article THIRD of the trust agreement provides that any share or part of a share which is directed to be held in accordance with the terms and conditions of Article THIRD, the trustee shall pay over or apply the net income and principal to such extent and at such time or times as the trustee, in the exercise of absolute discretion, shall determine. Any net income not so paid over or applied shall be accumulated and added to the principal of the trust at least annually and thereafter shall be held, administered and disposed as a part thereof.
>
> Paragraph 3.2 of Article THIRD provides that upon the death of the primary beneficiary, the principal of the trust shall be divided into a sufficient number of equal shares so that there shall be set aside one such share for each child of the deceased primary beneficiary who is then living and one such share for the collective descendants who are then living of any child of the deceased primary beneficiary who is not then living.

Presumably each trust had only one beneficiary to whom distributions could be made during the beneficiary's life.

One resource on Code § 199A pointed to Letter Ruling 200209008. However, it actually did not rule on whether Code § 643(f) applied:

> A primary purpose of establishing Trust A and Trust B is the need to eliminate the dispute that has arisen among the beneficiaries concerning investment strategies. It is represented that avoidance of income tax is not a primary purpose of Trust A and Trust B within the meaning of section 643(f)(2). Determining whether avoidance of income tax is a primary purpose of Trust A and Trust B is a question of fact, the determination of which must be deferred until the federal income returns of the parties involved have been examined by the office having examination jurisdiction over the income tax returns.
>
> Therefore, provided that Trust A and Trust B are separately managed and administered and it is determined that tax avoidance is not a primary purpose of Trust A and Trust B, each will be treated as a separate trust for federal income tax purposes.

That same author also cited Letter Ruling 199923004. However, Field Service Advice 199923004 did not address Code § 643(f); it involved a change in accounting method. The closest ruling in time to that was Letter Ruling 199929021, which was also unhelpful:

> Court granted such petition in a Declaratory Judgment on Date 3.

As to Paragraph 4.1(P):

> Paragraph 4.1(P) of Article FOURTH of the trust agreement gives the trustee the power to: (i) divide any trust created under Article FIRST or Article THIRD of the trust agreement into one or more separate trusts for the benefit of one or more of the beneficiaries of the trust (to the exclusion of the other beneficiaries) so divided, as the trustee, in the exercise of her absolute discretion, shall determine, but in all other respects under the same terms as set forth in Article THIRD; (ii) divide any trust created under Article SECOND hereof into one or more separate trusts for the benefit of the beneficiary but in all respects under the same terms as set forth in Article SECOND hereof; and (iii) to allocate to such divided trust some or all of the assets of the trust estate for any reason including, but not limited to, enabling any such trust or trusts to qualify as an eligible shareholder of an S corporation as described in the Code, or for any other purpose.

Article SECOND provided a QSST whenever S corporation stock was owned. See part III.A.3.e.i.(a) QSSTs Generally.

> A, B, and C represent that the primary purpose of establishing the New Trusts is the need to eliminate the impasse that has arisen among the trustees in choosing the charitable beneficiaries of Trust 1. By dividing Trust 1 into three separate trusts, A, B, and C will act independently of each other, thereby allowing each to act independently of the other in choosing the charitable beneficiaries. They further represent that avoidance of income tax is not a primary purpose of the New Trusts within the meaning of section 643(f)(2). Determining whether avoidance of income tax is a primary purpose of the New Trusts is a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved have been examined by the office of the District Director having examination jurisdiction over the tax returns. Therefore, provided that each of the Trusts is separately managed and administered and it is not determined that tax avoidance is a primary purpose of the New Trusts, each of the Trusts will be treated as a separate trust for federal income tax purposes.

Similarly, Letter Ruling 200527007 held that dividing a trust into separate trusts for siblings did not trigger Code § 643(f) as long as they are "are separately managed and administered."

I have not reviewed the more than 140 other private rulings that cited Code § 643(f).

II.J.10. Consider Extending Returns for Year of Death and Shortly Thereafter

If an estate tax audit results in higher values and therefore higher basis, the related fiduciary income tax return might need to be amended to take advantage of higher basis to reduce gain on sale of assets or increase depreciation deduction.

II.J.11. Trust Business Income Tax Nuances

II.J.11.a. Depreciation Advantages and Disadvantages

II.J.11.a.i. Code § 179 Disallowance for Estate or Nongrantor Trust

Code § 179 allows businesses to expense depreciable personal property within certain limits, which limits have become much more generous in recent years.[2879] However, a trust cannot deduct this special Code § 179 expense that flows through on its K-1 from a partnership or S corporation.[2880] The business entity does not reduce its basis in, and may depreciate, this depreciable property to the extent that this deduction is disallowed.[2881] Presumably, this complexity would be avoided by using a grantor trust.[2882]

[2879] See Stevens, "Section 179's Special Pass-Through Entity Rules," *Business Entities* (WG&L) (July/August 2010).

[2880] Code § 179(d)(4).

[2881] Reg. § 1.179-1(f)(3). Because the regulation specifically refers to S corporations, presumably this regulation overrides the general rule that all S corporation shareholders are taxed the same; the only way to give effect to this regulation would appear to make a special allocation of depreciation expense (including bonus depreciation – see part II.G.5.b Bonus Depreciation) to the trust or estate. Presumably, an S corporation or partnership would allocate the asset's inside basis, depreciation expense, and other tax attributes to the trust, including not reducing the basis of the trust's interest in the business until depreciation expense is incurred.

[2882] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment, especially fn. 6525, for the proposition that the grantor of a grantor trust is deemed to own directly any asset owned by that trust.

However, don't overlook the possibility of bonus depreciation, which under the 2017 tax reform law allows 100% deduction for most tangible personal property placed in service after September 27, 2017 and before January 1, 2023. See part II.G.5.b Bonus Depreciation.

II.J.11.a.ii. Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses)

II.J.11.a.ii.(a). Separate Reporting of Depreciation Deductions Allocable to Beneficiary

When a depreciation deduction of a trust is allocable to its beneficiaries, and where such deductions if separately taken into account by the trust would result in an income tax liability for the trust different from that which would result if the trust did not take such deductions into account separately, then the partnership's depreciation must be separately reported on the K-1 that the trust receives; a similar rule applies to depreciation allocated between a life tenant and the remaindermen or between an estate and its beneficiaries.[2883]

Code § 642(e) provides:

> An estate or trust shall be allowed the deduction for depreciation and depletion only to the extent not allowable to beneficiaries under sections 167(d) and 611(b).

Code § 167(d) provides:

> In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

Code § 167(d) was Code § 167(h) until 1990, when P.L. 101-508, Sec. 11812(a)(1), redesignated it. *Dusek v. Commissioner*, 45 T.C. 355 (1966), *aff'd* 376 F.2d 410 (10th Cir. 1967), explained why Reg. § 1.167(h)-1(b) is valid in allocating depreciation deductions to the trustee when the trustee reserves for depreciation:

[2883] Rev. Rul. 74-71. See 2017 Form 1041, Schedule K-1, line 9, "directly apportioned deductions." Code § 167(d) provides:

> *Life tenants and beneficiaries of trusts and estates*. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

For an elaboration on rules governing estates, see *Estate of Nissen v. Commissioner*, 345 F2d 230 (4th Cir. 1965), *rev'g* 41 T.C. 522 (1964); *Lamkin v. U.S.*, 533 F.2d 303 (5th Cir. 1976).

The above-quoted language of section 167(h) of the 1954 Code appeared for the first time in the Federal income tax statutes, in section 23(k) of the Revenue Act of 1928. And in the Conference Report on the bill for said Act, Congress made abundantly clear its intention as to the meaning which should be attributed to said statute. It said (H. Rept. No. 1882, 70th Cong., 1st Sess., p. 11):

> Amendment No. 30: Under existing law difficulty has been experienced in determining and allowing the deduction for depreciation in cases where property is held by one person for life with remainder to another person; *and the deduction, in the case of property held in trust, is allowable only to the trustee*. The Senate amendment provides that …. In the case of property held in trust, the allowable deduction is to be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the will, deed, or other instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income which is allocable to the trustee and the beneficiaries, respectively. For example, if the trust instrument provides that the income of the trust computed without regard to depreciation shall be distributed to a named beneficiary, such beneficiary will be entitled to the depreciation allowance to the exclusion of the trustee, *while if the instrument provides that the trustee in determining the distributable income shall first make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the allowable deduction will be granted in full to the trustee*. The bill contains similar provisions as to the deduction for depletion. *The Senate amendment provides for an equitable apportionment of the deduction in these cases; and the House recedes*. [Emphasis supplied.]

Shortly following adoption of the Revenue Act of 1928, Regs. 74 were promulgated; and in article 201 of these regulations there appeared the following statement which reflected views similar to those set forth in the above-quoted congressional report:

> If the [trust] instrument provides that the trustee in determining the distributable income shall first make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, *the allowable deduction will be granted in full to the trustee*. [Emphasis supplied.]

This provision has since been carried forward in the various Treasury regulations without substantial change for approximately 36 years; and, as above shown, it also is embodied in substance in the current regulations for the 1954 Code.

In addition, both this Court and others have given recognition to the same principle. See: *John R. Upton*, 32 T.C. 301, 309, affd. 283 F.2d 716 (C.A. 9), certiorari denied 366 U.S. 911; *Newbury v. United States*, 57 F.Supp. 168 (Ct. Cl.), certiorari denied 323 U.S. 802.

Reg. § 1.167(h)-1(b), "Trusts," provides:[2884]

> If property is held in trust, the allowable deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each, unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depreciation in any amount. In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depreciation reserve, and any part of the deduction in excess of the income set aside for the reserve shall be apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each. For example:
>
> (1) If under the trust instrument or local law the income of a trust computed without regard to depreciation is to be distributed to a named beneficiary, the beneficiary is entitled to the deduction to the exclusion of the trustee.
>
> (2) If under the trust instrument or local law the income of a trust is to be distributed to a named beneficiary, but the trustee is directed to maintain a reserve for depreciation in any amount, the deduction is allowed to the trustee (except to the extent that income set aside for the reserve is less than the allowable deduction). The same result would follow if the trustee sets aside income for a depreciation reserve pursuant to discretionary authority to do so in the governing instrument.
>
> No effect shall be given to any allocation of the depreciation deduction which gives any beneficiary or the trustee a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument, except as otherwise provided in this paragraph when the trust instrument or local law requires or permits the trustee to maintain a reserve for depreciation.

Dusek v. Commissioner, 45 T.C. 355 (1966), *aff'd* 376 F.2d 410 (10th Cir. 1967), held:

> Since in the instant case, the trust indenture required the trustee to preserve the trust corpus by establishing a reserve for depreciation, this requirement constituted in effect an allocation of the trust's depreciation deductions to the trustee. The provisions for this requirement are the "pertinent provisions of the instrument" within the meaning of section 167(h) of the 1954 Code. Accordingly, the trustee's attempt to allocate all of such depreciation deductions to the income beneficiary under the broadly worded fiduciary power contained in item (m) of Article V of the indenture, was and is not effective.

In contrast, *Tiefenbrunn v. Commissioner*, 74 T.C. 1566 (1980), held:

> The testator's will requires that a $25,000 reserve be established for "paying any extraordinary expense or capital improvements" prior to the commencement of income distributions to the beneficiaries, and this reserve had been accumulated in full prior to the beginning of the 1967 taxable year. The will does not call for any other reserve, for

[2884] Reg. § 1.167(h)-1(b) is incorporated by reference by Reg. § 1.642(e)-1, the latter of which has not yet amended to reflect changes made by P.L. 101-508, P.L. 97-34, P.L. 94-455. Reg. § 1.167(h)-1(c), "Estates," provides:

> In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of income of the estate which is allocable to each.

depreciation or any other purpose; instead, it mandates the distribution of the "remaining income" after payment of "principal and interest on mortgages, operational expenses, State, City and Federal taxes."

Based upon our examination of the foregoing provisions and the testator's will as a whole, we conclude that the testator did not intend the trust to accumulate any reserve for depreciation or any other purpose beyond those specifically provided in the will. Had he intended the creation of an additional reserve for depreciation, it seems likely that he would have so stated, given the specificity of his directions for the $25,000 reserve for "extraordinary expense or capital improvements." Moreover, since the testator's grandchildren were both the income beneficiaries and remaindermen under the trust, it would not have been unreasonable for the testator not to provide for the establishment of a depreciation reserve by the trust; if the remaindermen wished to accumulate funds to provide for the ultimate replacement of the building owned by the trust, they had discretion to do so because they were receiving the income from the trust. The testator thus might have thought that provision of a reserve for depreciation was best left to the judgment of the beneficiaries.[11]

[11] The record is in confusion as to the trustees' understanding with respect to a depreciation reserve. There is no evidence as to how they kept their books of account in this connection, and their treatment of depreciation in their returns did not follow a consistent pattern. In their 1971 return, they claimed a depreciation deduction of $9,504, the total amount of depreciation allegedly sustained in that year. In 1973 and 1974, allowable depreciation shown on the trust's returns amounted to $40,942. However, the only deduction for depreciation taken by the trust in 1973 was $7,514.11; and in 1974, the trust took no deduction for depreciation. The reasons, if any, for such disparate treatment are unexplained.

Furthermore, even if the testator's will contained no inferences as to his intent with respect to reserves for depreciation and other purposes, it is doubtful that a trustee would be permitted to establish a reserve for depreciation under Connecticut law, at least where the income beneficiaries and remaindermen are the same. The relevant Connecticut statutes provide that trust "income" includes "*All* receipts of money … paid … as rent of realty." (Emphasis added.) Conn. Gen. Stat. Ann. sec. 45-112(1) (West 1960). Although the statutes also provide for the payment of "ordinary expenses incurred in connection with the trust estate" out of income, depreciation is not mentioned as such an expense. Conn. Gen. Stat. Ann. sec. 45-119(1) (West 1960). While statutes in many States now permit trustees to provide an allowance for depreciation in determining trust income,[12] this has not been the practice of most trustees in the absence of statutory provisions,[13] and we think the Connecticut statutes cannot fairly be read to permit such an allowance in the circumstances of this case. We accordingly hold that each individual income beneficiary, and not the trust, is entitled to a deduction for depreciation in respect of the property held by the trust.

[12] See Uniform Principal and Income Act sec. 13 (1962 rev.), which has been adopted in 22 States. See 7A Uniform Laws Ann. 24 (West Supp. 1980).

[13] See 3 A. Scott, *Trusts* sec. 239.4 (3d ed. 1967); C. Dalton, "Buildings Held in Trust," 106 *Trusts & Estates* 1125 (1967); *cf*. *Edgar v. Commissioner*, 56 T.C. 717, 752-753 (1971).

In reaching our conclusion as to this issue, we must emphasize that this is the only issue argued by the parties in respect of the Commissioner's adjustments in the deficiency notices relating to depreciation. However, the deficiency notices are distressingly vague as to the precise effect resolution of this issue will have on petitioners' taxable income. Since the trust is stipulated to be a "simple testamentary trust," any depreciation deducted by the trust serves to reduce petitioners' shares of distributable net income from the trust. If the depreciation deductions are allocated in full to the beneficiaries, their shares of the trust's distributable net income are correspondingly increased, but they themselves will then be entitled to deductions for depreciation (sec. 1.167(h)-1(b), Income Tax Regs.), and those depreciation deductions will offset the increase in their shares of distributable income dollar for dollar. See secs. 651-652, I.R.C. 1954; *Kearney v. United States*, 116 F.Supp. 922, 925 (S.D.N.Y. 1953); M. Knuthe, "Depreciation & Depletion," 114 *Trusts & Estates* 146, 178 (1975). Thus, it would appear that there should not be any deficiency arising from this issue.

The entire matter may well be merely another instance of the familiar tempest in a teapot. However, in view of the confused state of the record in respect of this issue and in view of the fact that the parties have fully briefed and treated the maintenance of a depreciation reserve as the only matter to be decided, we have considered the testator's will and Connecticut law and have concluded that the beneficiaries, and not the trust, are entitled to the entire deduction for depreciation. Unless something has eluded us in this foggy record, the upshot, of course, would appear to be that there should not be any deficiency against petitioners in respect of the depreciation deductions. No issue has been presented to us for decision in respect of any other matter relating to depreciation - *e.g.*, basis, useful life, etc.

The Uniform Principal & Income Act, § 503, "Transfers from Income to Principal for Depreciation," provides:

(a) In this section, "depreciation" means a reduction in value due to wear, tear, decay, corrosion, or gradual obsolescence of a fixed asset having a useful life of more than one year.

(b) A trustee may transfer to principal a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation, but may not transfer any amount for depreciation:

  (1) of that portion of real property used or available for use by a beneficiary as a residence or of tangible personal property held or made available for the personal use or enjoyment of a beneficiary;

  (2) during the administration of a decedent's estate; or

  (3) under this section if the trustee is accounting under Section 403 for the business or activity in which the asset is used.

(c) An amount transferred to principal need not be held as a separate fund.

Official Comments include:

> The power to transfer funds from income to principal that is granted by this section is a discretionary power of administration referred to in Section 103(b), and in exercising the power a trustee must comply with Section 103(b).
>
> One purpose served by transferring cash from income to principal for depreciation is to provide funds to pay the principal of an indebtedness secured by the depreciable property. Section 504(b)(4) permits the trustee to transfer additional cash from income to principal for this purpose to the extent that the amount transferred from income to principal for depreciation is less than the amount of the principal payments.

Official Comments to the Uniform Fiduciary Income & Principal Act (UFIPA) (2018) explain:

> The 2018 Act changes “fixed” to “tangible” in the definition of depreciation in Section 503(a). The references to “a residence” and “tangible personal property” in Section 503(b)(1) are broken up into paragraphs (1) and (2), for ease of reading, and to avoid implying that the two topics are linked so that, for example, the tangible personal property described must be household furnishings. The 2018 Act also adds Section 503(b)(3)(A) to expand the exception from the depreciation rule to assets accounted for separately as liquidating assets under Section 410, as well in a business under Section 403.

Thus, UFIPA subsection (b) provides:

> (b) A fiduciary may transfer to principal a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation, but may not transfer any amount for depreciation:
>
> (1) of the part of real property used or available for use by a beneficiary as a residence;
>
> (2) of tangible personal property held or made available for the personal use or enjoyment of a beneficiary; or
>
> (3) under this section, to the extent the fiduciary accounts:
>
> (A) under Section 410 for the asset; or
>
> (B) under Section 403 for the business or other activity in which the asset is used.

Note that all of the above relate to only depreciable assets held directly by the trustee. Section 401 deals with distributions from an entity; an entity itself is intangible personal property to which § 403 would not apply; however, UFIPA §401(e)(a)(A) does allow the fiduciary to peek behind the curtains, but rarely would it be appropriate to second-guess the entity’s decision regarding reserves to recharacterize a cash distribution as principal intended to serve as a depreciation reserve by owners.

Absent a provision in the trust agreement providing otherwise, depreciation that is allocated to beneficiaries is allocated to them whether they are taxable or charitable beneficiaries.[2885]

If a trust holds mortgaged property and the trustee charges payments of mortgage principal against trust income in determining the amount to be distributed to the trust's beneficiaries, depreciation must be allocated to the trust, by multiplying the total allowable depreciation by a fraction, the numerator of which is the amount of income accumulated and the denominator of which is the total trust income computed under Code § 643(b).[2886]

Note that the apportionment is based on shares of trust accounting income, which is calculated net of deductions.[2887]

Rev. Rul. 74-530 clarifies that the trust calculates deductions and then apportions them [note, however, that Code § 167(h) then is now Code § 167(d)]:

> For purposes of section 167(h) and section 611(b) of the Code the allowable deductions described therein are the depreciation and depletion deductions attributable to properties owned by an estate or a trust. The computation of the allowable deductions is made by the estate or trust in its capacity as a separate taxable person under section 7701.
>
> Accordingly, before apportioning the deduction for depreciation under section 167(h) of the Code and the deduction for depletion under section 611(b), such deductions first must be computed by the estate or trust based on the properties it holds in its capacity as a separate taxable person.
>
> Furthermore, it is possible under section 167(h) and section 611(b) of the Code to allocate depreciation and depletion deductions between an estate and its heirs, legatees, and devisees or between a trust and its beneficiaries in amounts that are greater than their pro rata shares of the income of the estate or income of the trust. This is so because although the depreciation and depletion deductions are apportioned on the basis of the income of the estate or income of the trust allocable to each of the parties (without regard to any depreciation or depletion allocable to them), they are not limited by the amount of such income.

Thus, generally limitations on losses, such as basis and at-risk limitations,[2888] would be applied first at the trust level. However, that does not end the analysis regarding how a beneficiary deducts these directly apportioned deductions; see part II.J.11.a.ii.(b) Beneficiary's Ability to Deduct Depreciation That Generates Net Loss.

For an in-depth discussion of allocating depreciation, see Lawson, "Tax Planning for Rental Real Estate Owned by a Trust," *Estate Planning Journal* (Vol. 40, No. 9, Sept. 2013), and Ransome, "Allocating Partnership Depreciation Between Trusts and Beneficiaries," *The Tax Adviser* (7/1/2007), the latter saved as Thompson Coburn LLP doc. no. 6682178.

[2885] *Lambert Tree Trust Estate v. Commissioner*, 38 T.C. 392 (1962 re tax years 1951-1954), *acq*. 1964-2 C.B. 4, 7.
[2886] Rev. Rul. 90-82.
[2887] See part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.
[2888] See part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner.

II.J.11.a.ii.(b). Beneficiary's Ability to Deduct Depreciation That Generates Net Loss

Although the depreciation and depletion deductions are apportioned on the basis of the income of the estate or income of the trust allocable to each of the parties (without regard to any depreciation or depletion allocable to them), they are not limited by the amount of such income.[2889]

Therefore, a fiduciary might be able to allocate depreciation and depletion deductions between an estate and its heirs, legatees, and devisees or between a trust and its beneficiaries in amounts that are greater than their pro rata shares of the income of the estate or income of the trust.[2890]

For application of the Code § 469 passive loss rules to depreciation and depletion deductions, see part II.K.2.b.iv Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary.

II.J.11.a.ii.(c). Trust vs. Separately Recognized Business Entity Holding Depreciable Property

If the trust holds depreciable property through a partnership, the trustee might not be making any decision regarding depreciation reserve, if the trustee is counting on the partnership to make any appropriate reserve.[2891] In that case, presumably the depreciation deduction would be allocated solely to the beneficiaries who do or may receive current distributions. Furthermore, passing the deductions through to any beneficiaries who participate in the business would simplify any passive loss issues (if and to the extent that the passive loss rules do not supersede this part II.J.11.a.ii),[2892] because the rules for determining an individual's participation are more well-defined and easier to apply than determining a trust's participation.[2893]

If a trust holds depreciable property through an S corporation, consider the following:

- If a nongrantor trust is permitted to hold the stock without making an ESBT or a QSST election,[2894] then see the discussion above regarding partnerships.

[2889] Rev. Rul. 74-530, reproduced in part II.J.11.a.ii.(a) Separate Reporting of Depreciation Deductions Allocable to Beneficiary.
[2890] Rev. Rul. 74-530, reproduced in part II.J.11.a.ii.(a) Separate Reporting of Depreciation Deductions Allocable to Beneficiary.
[2891] Query whether the aggregate theory of partnership taxation affects this analysis any.
[2892] See part II.K.2.b.iv Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary.
[2893] See part II.K.2.b Participation by an Estate or Nongrantor Trust.
[2894] See parts III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation and III.A.3.e QSSTs and ESBTs.

- If and to the extent an ESBT is a nongrantor trust, the depreciation deductions are trapped inside the trust.[2895] (This is a bad result if the trust is included in a person's estate.)[2896]

- If and to the extent the trust is grantor trust deemed owned by the grantor or the beneficiary (the latter including QSSTs), the deemed owner (including the deemed owner of an ESBT)[2897] would be allocated the depreciation deductions, because the grantor trust rules supersede everything.

II.J.11.b. Code § 1244 Treatment Not Available for Trusts

Individuals may deduct as an ordinary a loss incurred on the first $50,000 or $100,000 on the sale of small business corporation stock under Code § 1244.[2898]

Trusts and estates are not entitled to this treatment.[2899]

Note that, for S corporations, trusts can deduct losses as the S corporation incurs them if they have sufficient basis,[2900] so that the S corporation's ordinary losses will provide current annual benefit to the trust, and the trust's basis in the stock would be correspondingly reduced, which reduces the chance of the trust having a capital loss on disposition of the S corporation stock. Therefore, this issue is much more of concern for trusts owning C corporation stock than for trusts owning S corporation stock.

[2895] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, which generally traps in a trust all items on an S corporation's K-1. Reg. § 1.641(c)-1 does not expressly discuss the depreciation issue, the only authority being Reg. § 1.641(c)-1(d)(2)(i):

> (i) *In general*. The S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Rules otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. [then discusses ESBT elections for a partial year]

The second sentence tends to suggest applying this part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses) would apply to S corporation K-1 items. However, in requiring breaking out separately stated items, Code § 1366(a)(1)(A) cross-references Code § 702(a)(4), (6), but depreciation deductions under this this part II.J.11.a.ii would fall under Code § 702(a)(7) by reason of Reg. § 1.702-1(a)(8)(ii). On the other hand, fiduciary income tax return form instructions refer to items under this part II.J.11.a.ii from a pass-through; by not specifying the type of pass-through, do these instructions suggest that S corporation items would fall under this part II.J.11.a.ii? Ultimately, the issue appears decided in favor of trapping these deductions in the trust by the language at the end of Code § 641(c)(2)(C), "…no item described in this paragraph shall be apportioned to any beneficiary," which per Code § 641(c)(2)(C)(i) includes any item described in Code § 1366.

[2896] See part II.H.2.d Caution re: Depreciable Property Held in a Nongrantor Trust That Is Included in the Grantor's, Surviving Spouse's, or Other Beneficiary's Estate.

[2897] Reg. § 1.641(c)-1(c).

[2898] Part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation.

[2899] Code § 1244(d)(4).

[2900] See part II.G.4.d Basis Limitation for Shareholders in an S Corporation.

II.J.12. Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Trust Accounting Rules

Articles by Dobris (1979)[2901] and Blattmachr (1984)[2902] seem to be the leading authority in this area. In exercising tax elections, trustees may have these duties:[2903]

(1) the duty to minimize the overall tax burden on the estate and its beneficiaries;

(2) the duty of impartiality; and

(3) the duty to abstain from self-dealing.

Harris Trust & Sav. Bank v. MacLean, 542 N.E.2d 943 (1st Dist. Ill. 1989), involved a common situation: Trust recognizes big capital gain and pays federal and state capital gain tax. Both taxes are charged to principal. However, the income beneficiaries benefitted the following year by deducting the state capital gain tax. The court held that the trustee could not reduce the beneficiaries' income account by the tax benefit they received, because a trustee should be able to make an equitable adjustment only for inequities resulting from a trustee's discretionary decisions.[2904] The court viewed the tax benefit from the deduction of state income taxes to be

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[2901] "Equitable Adjustments in Postmortem Income Tax Planning: An Unremitting Diet of Warms," 65 *Iowa L. Rev.* 103 (1979), saved as Thompson Coburn doc. no. 6174776.

[2902] "The Tax Effects of Equitable Adjustments: An Internal Revenue Code Odyssey," *18th University of Miami (Heckerling) Estate Planning Institute ¶ 1400* (1984).

[2903] *Estate of Rappaport*, 467 N.Y.S.2d 814 (N.Y. 1983), citing Carrico and Bondurant, "Equitable Adjustments: A Survey and Analysis of Precedents and Practice," 36 The Tax Lawyer, 545–6. Earlier the opinion discussed with approval Dobris, "Limits on the Doctrine of Equitable Adjustment in Sophisticated Post-mortem Tax Planning," 66 Iowa L. Rev., 273, 297–8. When administrative expenses are not needed to be deducted on an estate tax return to save estate tax, consider deducting them for income tax purposes. *Matter of Ettinger*, 564 N.Y.S.2d 691 (1990). When fiduciaries have conflicts of interest in exercising tax elections, a court may resolve the issue. *Matter of Estate of Spear*, 553 N.Y.S.2d 985 (1990).

[2904] The court reasoned and held:

> The question of whether a trustee is required to make an equitable adjustment between the trust's income and principal accounts where inequitable consequences result from the mandatory application of tax laws is one of first impression in Illinois. Several courts in other jurisdictions have addressed this issue. Some courts have suggested that an equitable adjustment should only be applied in response to a trustee's election or discretionary decision (*In re Dick's Estate* (1961), 29 Misc.2d 648, 218 N.Y.S.2d 182; *In re Kent's Estate* (1964), 23 Fla. Supp. 133), while one court has approved an adjustment to correct inequities not caused by any discretionary decision of the trustees (*Rice Estate* (1956), 8 Pa. D & C 2d 379) and another has rejected a distinction between discretionary decisions and mandatory applications (*In re Holloway's Estate* (1972), 68 Misc.2d 361, 327 N.Y.S.2d 865).
>
> We believe the better view is that equitable adjustments should be applied only in response to inequities resulting from a trustee's discretionary decisions which favor one beneficiary or class of beneficiaries over another. We agree with the trustees' position that the common law doctrine of equitable adjustments should only be employed in such circumstances because this concept is grounded in the fiduciary duty of a trustee not to be partial in making decisions or elections impacting on successive beneficiaries. (See *In re Warms' Estate* (Surr. Ct. 1955), 140 N.Y.S.2d 169; *In re Bixby's Estate* (1956), 140 Cal.App.2d 326, 295 P.2d 68.) The fiduciary should not be required to cure the inequities resulting from the application of mandatory tax laws; rather, any corrective action is more properly left for the legislature. *In re Dick's Estate*, 29 Misc.2d 648, 218 N.Y.S.2d 182; accord *In re Kent's Estate*, 23 Fla. Supp. 133.

I have been told that a Massachusetts court reached the same result.

very small compared to the sales proceeds that benefitted the principal beneficiaries, even though the benefit was probably hundreds of thousands of dollars. Blattmachr had indicated mixed results on this issue before this case was decided.[2905]

The Uniform Principal & Income Act, which has not been enacted in Illinois,[2906] takes the following approach:[2907]

Section 506. Adjustments Between Principal And Income Because Of Taxes.

(a) A fiduciary may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from:

(1) elections and decisions, other than those described in subsection (b), that the fiduciary makes from time to time regarding tax matters;

(2) an income tax or any other tax that is imposed upon the fiduciary or a beneficiary as a result of a transaction involving or a distribution from the estate or trust; or

(3) the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary.

(b) If the amount of an estate tax marital deduction or charitable contribution deduction is reduced because a fiduciary deducts an amount paid from principal for income tax purposes instead of deducting it for estate tax purposes, and as a result estate taxes paid from principal are increased and income taxes paid by an estate, trust, or beneficiary are decreased, each estate, trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal from which the increase in estate tax is paid. The total reimbursement must equal the increase in the estate tax to the extent that the principal used to pay the increase would have qualified for a marital deduction or charitable contribution deduction but for the payment. The proportionate share of the reimbursement for each estate, trust, or beneficiary whose

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[2905] See fn. 2902, ¶ 1403.3 Corpus Expenses Benefit Income and Not Corpus but Not as a Result of Fiduciary Election, fns. 30-33. A leading case he cited, *In re Holloway's Estate*, 68 Misc.2d 361, 327 N.Y.S.2d 865 (1972), held:

> It is this court's considered opinion, however, that the *Dick* case rationale lacks the requisite equitable approach. As one writer observed: "Sections of the 1954 Code dealing with estate and trusts yield other examples directly contrary to both estate and trust law and common sense. For example, subchapter J, part I, was apparently drawn by tax lawyers not entirely familiar with trust concepts or fiduciary accounting principles. *The fiduciary and the court must be free in such cases to repair the damage by equitable adjustment*" (Browning, Problems of Fiduciary Accounting, 36 N.Y.U.L.Rev. 931, p. 953 [1961]). (Italics supplied.)

[2906] However, 760 ILCS 15/3(b)(2) allows a trustee to reallocate receipts "if the trustee in the trustee's discretion determines that application of the provisions of this Act would result in a substantial inequity to either the income beneficiaries or the remaindermen, in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as those entitled to principal." The statute enacting the quoted provision was included in 1991 Ill. Legis. Serv. P.A. 87-714 (S.B. 717) (WEST).

[2907] http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008).

income taxes are reduced must be the same as its proportionate share of the total decrease in income tax. An estate or trust shall reimburse principal from income.

The official Comments include:

> **Discretionary adjustments**. Section 506(a) permits the fiduciary to make adjustments between income and principal because of tax law provisions. It would permit discretionary adjustments in situations like these: (1) A fiduciary elects to deduct administration expenses that are paid from principal on an income tax return instead of on the estate tax return; (2) a distribution of a principal asset to a trust or other beneficiary causes the taxable income of an estate or trust to be carried out to the distributee and relieves the persons who receive the income of any obligation to pay income tax on the income; or (3) a trustee realizes a capital gain on the sale of a principal asset and pays a large state income tax on the gain, but under applicable federal income tax rules the trustee may not deduct the state income tax payment from the capital gain in calculating the trust's federal capital gain tax, and the income beneficiary receives the benefit of the deduction for state income tax paid on the capital gain. See generally Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).
>
> Section 506(a)(3) applies to a qualified Subchapter S trust (QSST) whose income beneficiary is required to include a pro rata share of the S corporation's taxable income in his return. If the QSST does not receive a cash distribution from the corporation that is large enough to cover the income beneficiary's tax liability, the trustee may distribute additional cash from principal to the income beneficiary. In this case the retention of cash by the corporation benefits the trust principal. This situation could occur if the corporation's taxable income includes capital gain from the sale of a business asset and the sale proceeds are reinvested in the business instead of being distributed to shareholders.

The Uniform Fiduciary Income & Principal Act (2018) ("UFIPA"), which replaces the Uniform Principal & Income Act, renumbered section 506 as follows:

> **Section 507. Adjustment Between Income And Principal Because Of Taxes.**
>
> (a) A fiduciary may make an adjustment between income and principal to offset the shifting of economic interests or tax benefits between current income beneficiaries and successor beneficiaries which arises from:
>
> (1) an election or decision the fiduciary makes regarding a tax matter, other than a decision to claim an income tax deduction to which subsection (b) applies;
>
> (2) an income tax or other tax imposed on the fiduciary or a beneficiary as a result of a transaction involving the fiduciary or a distribution by the fiduciary; or
>
> (3) ownership by the fiduciary of an interest in an entity a part of whose taxable income, whether or not distributed, is includable in the taxable income of the fiduciary or a beneficiary.
>
> (b) If the amount of an estate tax marital or charitable deduction is reduced because a fiduciary deducts an amount paid from principal for income tax purposes instead of

deducting it for estate tax purposes and, as a result, estate taxes paid from principal are increased and income taxes paid by the fiduciary or a beneficiary are decreased, the fiduciary shall charge each beneficiary that benefits from the decrease in income tax to reimburse the principal from which the increase in estate tax is paid. The total reimbursement must equal the increase in the estate tax, to the extent the principal used to pay the increase would have qualified for a marital or charitable deduction but for the payment. The share of the reimbursement for each fiduciary or beneficiary whose income taxes are reduced must be the same as its share of the total decrease in income tax.

(c) A fiduciary that charges a beneficiary under subsection (b) may offset the charge by obtaining payment from the beneficiary, withholding an amount from future distributions to the beneficiary, or adopting another method or combination of methods.

UFIPA's official Comments include:

Mandatory adjustments. The adjustments addressed by Section 507 are derived from the history of "equitable adjustments" largely associated with New York case law. For example, *Matter of Warms*, 140 N.Y.S.2d 169 (1955), involved estate administration expenses chargeable to principal that are allowed as either estate tax deductions or income tax deductions. If the items are claimed as income tax deductions and benefit income, Warms requires income to reimburse principal for any increased estate taxes. The Warms adjustment has been codified in some states, including New York in EPTL § 11-2.1(a).

Subsection (b), which requires reimbursement of principal from income, is derived from New York's EPTL § 11-2.1(a). Unlike the New York statute, however, it limits the mandatory reimbursement to cases in which a marital or charitable deduction is reduced by the payment of additional estate taxes because of the fiduciary's income tax election. It is intended to preserve the result reached in *Estate of Britenstool v. Commissioner*, 46 T.C. 711 (1966), in which the United States Tax Court held that a reimbursement required by the predecessor of EPTL § 11-2.1(a) preserved for the estate the same charitable deduction it would have received if the administration expenses had been deducted for estate tax purposes instead of for income tax purposes. Because a fiduciary will typically elect to deduct administration expenses for income tax purposes only when the income tax reduction exceeds the estate tax reduction, the effect of this adjustment is that principal is placed in the same position it would have occupied if the fiduciary had deducted the expenses for estate tax purposes, but the income beneficiaries still receive the additional benefit of the difference in the benefit of the two deductions. For example, if the income tax benefit from the deduction is $30,000 and the estate tax benefit would have been $20,000, principal will be reimbursed by $20,000 and the net benefit to the income beneficiaries will be $10,000.

Other adjustments. A second occasion for adjustment is a "trapping distribution" – a distribution of principal that carries out income for income tax purposes. *Matter of Holloway*, 68 Misc.2d 361, 327 N.Y.S.2d 865 (1972), held that a trust that made a trapping distribution must reimburse principal for the income taxes resulting from the distribution.

> A third adjustment context arises when a trust's deductible expenses chargeable to principal reduce distributable net income and the taxable income of an income beneficiary, and the trust has taxable gains. Must income reimburse principal for the capital gains taxes that would have been saved if the expenses were used to reduce the gains? A Pennsylvania case, *Rice Estate*, 8 Pa. D&C2d 379 (1956), required an adjustment, but a New York case, *Matter of Dick*, 29 Misc.2d 648, 218 N.Y.S.2d 182 (1961), and a Massachusetts case, *New England Merchants Nat'l Bank v. Converse*, 373 Mass. 639, 369 N.E.2d 982 (1972), rejected an adjustment. A similar New York case, *Matter of Pross*, 90 Misc.2d 895, 396 N.Y.S.2d 309 (1978), required an adjustment from income to principal when a capital gain on a sale of real property resulted from a depreciation deduction that had benefitted the income beneficiary of the trust by reducing distributable net income.
>
> Subsection (a) allows adjustments in cases like these, in the fiduciary's discretion (recognizing that local case law and statutory law, other than this Act, may require the exercise of that discretion under this Act).
>
> **Changes in the 2018 Act**. Section 506(b) of the 1997 Act required that "each estate, trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal from which the increase in estate tax is paid." The 2018 Act changes this, in Section 507(b), to "the fiduciary shall charge each beneficiary that benefits from the decrease in income tax to reimburse the principal from which the increase in estate tax is paid" and adds subsection (c) to provide the fiduciary with options for accomplishing the "reimbursement" objective. One option in subsection (c) remains "obtaining payment from the beneficiary," but the possibly more practical option of withholding amounts from future distributions is also included.

See also part II.J.8.c.i.(b) Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation.

Settlement of an ambiguous provision allocating capital gain tax between income and principal should not carry with it any gift, GST, or income tax consequences (except, of course, to the extent that they modify cash distributions that carry out DNI).[2908] Similarly, when a trust erroneously reported capital gain as taxable to the beneficiary instead of to the trust, reimbursing the beneficiary for tax paid on the capital gain did not have gift, estate, or GST tax consequences.[2909]

[2908] Letter Ruling 201528024, addressing construction of a provision directing the trustee to collect all the income and out of such income pay or provide for "all proper taxes."

[2909] Letter Ruling 201735005, involving a QSST that sold its S corporation stock. For the income tax consequences of such a transaction, see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax). In the ruling:

> On or about Date 2, Trustee sold Trust's share of stock in Corporation in a transaction that resulted in capital gain to Trust for federal and state tax purposes. Pursuant to State law, the capital gains should have been allocated to Trust principal and all income taxes due on the capital gains were required to be paid from Trust principal. However, Trustee in connection with Trust's Form 1041, U.S. Fiduciary Income Tax Return, erroneously issued Daughter a K-1, Beneficiary's Share of In-come, Deductions, Credits, Etc., which treated the capital gain as a taxable distribution to Daughter for both federal and state tax purposes. As a result of receiving the K-1 Daughter reported the entire amount of the capital gain on her individual Federal and

When an estate deducted administrative expenses on its income tax return and reimbursed the principal for the income tax saved, the estate was allowed an estate tax deduction for the increased residue passing to charity (even though post-mortem actions normally do not affect the charitable deduction).[2910]

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state income tax returns which she jointly filed with Spouse. The errors on the Schedules K-1 were in Year 1. Trustee distributed $A to Daughter in Year 2 as a partial reimbursement for the income taxes erroneously paid by Daughter and Spouse. Daughter did not waive the right of recovery with respect to the erroneous payment of income taxes in Year 1.

Trustee prepared a draft of its first accounting as Trustee on Date 3. Upon receipt of the draft accounting, Daughter became aware that she was due an additional reimbursement from Trustee for the income taxes paid by Daughter and Spouse in connection with the sale of S Corporation stock.

On or about Date 4, Trustee filed a Petition for Adjudication with Court seeking judicial approval of its first intermediate accounting (Accounting) from Date 5 to Date 6. On Date 7, Daughter, through her counsel, filed an objection (Objection) to the Accounting alleging that it failed to provide for the additional reimbursement to Daughter from Trust for state income taxes in the amount of $B, together with interest on the unreimbursed taxes at a specified rate, and reimbursement of Daughter's attorney's fees incurred in connection with the Accounting and Objection.

On Date 8, Court entered an order (Order) ruling that the statute of limitations remains open for Daughter to object to any and all matters disclosed in the Accounting; and that the Accounting fails to provide for an additional reimbursement from Trust to Daughter for the unreimbursed taxes, interest and attorney's fees associated with the Accounting and Objection. Trustee intends, in accordance with the Order, to reimburse Daughter for the amount of the unreimbursed taxes, interest, and attorney's fees due for the erroneous payment of income taxes by Daughter and Spouse in Year 1.

The ruling held:

1. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with taxable income of Trust does not constitute a constructive addition by Daughter and Spouse to Trust under § 26.2601-1(b)(1)(v)(C).
2. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with taxable income of Trust and the subsequent reimbursement to them of the income taxes paid, together with interest and attorney's fees, does not cause any portion of Trust to become subject to chapter 13.
3. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with the taxable income of Trust does not constitute a gift to Trust for federal gift tax purposes where Daughter and Spouse have a right of recovery from Trust, they have exercised their rights, and Trustee, in fact, has previously reimbursed Daughter and Spouse a portion of the income taxes, and will further reimburse Daughter and Spouse the balance of income taxes together with, interest and attorney's fees.
4. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with taxable income of Trust does not cause any portion of Trust to be includible in Daughter's gross estate.

[2910] Rev. Rul. 78-445, reasoning:

In *Estate of Britenstool v. Commissioner*, 46 T.C. 711 (1966), *acq*. and *nonacq.*, page 3, this Bulletin, the decedent bequeathed a remainder interest in the residuary trust to charity. The court, in effect, concluded that a reimbursement paid pursuant to section 11-1.2(A) of the Estates, Powers and Trusts Law (which actually codified the New York case law relied upon by the court) should be included in determining the amount passing to charity for purposes of section 2055(a). The court determined that the purpose of such reimbursement (under section 11-1.2(A)) is to ensure that the amount passing to the residuary legatees in accordance with the decedent's will is not diminished by the additional estate tax payable as a result of the estate's election under

II.J.13. Applying 3.8% Tax to Trusts Owning Businesses Other than S Corporations If the Beneficiary is Active But the Trustee Is Not

A nongrantor trust's NII passes through to beneficiaries as NII.

For a nongrantor trust, the determination of whether business income is passive and therefore constitutes NII is made at the trust level.

If the beneficiary is active but the trustee is not, considering doing the following:

1. The trust contributes its interest in the partnership or sole proprietorship into one or more S corporations.

2. The trust converts into a trust eligible to be subjected to a QSST election.

3. The beneficiary makes a QSST election.

For cautions in applying this strategy, see part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts.

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section 642(g). To accomplish this, the statute requires a reimbursement, which effectively limits the amount of estate tax charged against the residue to the tax that would have been due had the administration expenses been deducted from the federal gross estate. The reimbursement is not properly characterized as an additional gift to the residuary legatees from the income recipient. Rather, the reimbursement ensures that the residuary legatees receive the amount they are otherwise entitled to receive under the terms of the decedent's will. The Service's acquiescence in Britenstool related to this issue.

Similarly, in the instant case, for purposes of section 2055(a), the value of the charitable deduction should be computed based on a residue of $825x, and not $800x. In accordance with the court's decision in Britenstool, $825x represents the amount passing to the residuary trust from D, under the terms of D's will. The $25x reimbursement, which was paid pursuant to state law, merely ensured that this $825x amount would not be diminished as a result of the executor's section 642(g) election.

Reg. § 20.2055-3(b)(2)-(4) provide:

(2) *Effect of transmission expenses*. For purposes of determining the charitable deduction, the value of the charitable share shall be reduced by the amount of the estate transmission expenses paid from the charitable share.

(3) *Effect of management expenses attributable to the charitable share*. For purposes of determining the charitable deduction, the value of the charitable share shall not be reduced by the amount of the estate management expenses attributable to and paid from the charitable share. Pursuant to section 2056(b)(9), however, the amount of the allowable charitable deduction shall be reduced by the amount of any such management expenses that are deducted under section 2053 on the decedent's federal estate tax return.

(4) Effect of management expenses not attributable to the charitable share. For purposes of determining the charitable deduction, the value of the charitable share shall be reduced by the amount of the estate management expenses paid from the charitable share but attributable to a property interest not included in the charitable share.

II.J.14. Application of 3.8% NII Tax to ESBTs

Electing small business trusts (ESBTs)[2911] are separated into S and non-S portions[2912] and subjected to the NII tax as follows:[2913]

1. The S portion and non-S portion computes each portion's undistributed net investment income as separate trusts[2914] and then combine these amounts to calculate the ESBT's undistributed net investment income.

2. The ESBT calculates the non-S portion's-adjusted gross income,[2915] increased or decreased by the S portion's net income or net loss, after taking into account all the S portion's deductions, carryovers, and loss limitations, as a single item of ordinary income (or ordinary loss).

3. The ESBT will pay tax on the lesser of (a) the ESBT's total undistributed net investment income, or (b) the excess of the ESBT's adjusted gross income[2916] over the dollar amount at which the highest fiduciary income tax bracket begins.

Beyond the 3.8% tax on NII, consider parts II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, particularly noting the IRS' position on NOLs incurred by an ESBT when the S corporation stock it owns generates losses.[2917]

II.J.15. QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items

II.J.15.a. QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax)

The preamble to the 2013 proposed regulations for net investment income tax generally explains the regular income tax treatment of sales involving QSSTs when discussing how the proposed regulations would treat the sales for net investment income tax purposes:[2918]

> H. <u>Qualified subchapter S trusts (QSSTs)</u>
>
> The preamble to the 2012 Proposed Regulations requested comments on whether special coordination rules are necessary to address dispositions of stock in an

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[2911] See part III.A.3.e.ii Electing Small Business Trusts (ESBTs.

[2912] Reg. § 1.1411-3(c)(1) provides:

> The S portion and non-S portion (as defined in § 1.641(c)-1(b)(2) and (3), respectively) of a trust that has made an ESBT election under section 1361(e)(3) and § 1.1361-1(m)(2) are treated as separate trusts for purposes of the computation of undistributed net investment income in the manner described in paragraph (e) of this section, but are treated as a single trust for purposes of determining the amount subject to tax under section 1411. If a grantor or another person is treated as the owner of a portion of the ESBT, the items of income and deduction attributable to the grantor portion (as defined in § 1.641(c)-1(b)(1)) are included in the grantor's calculation of net investment income and are not included in the ESBT's computation of tax described in paragraph (c)(1)(ii) of this section.

[2913] Reg. § 1.1411-3(c)(2). Reg. § 1.1411-3(c)(3) provides an example.

[2914] In the manner described in Reg. § 1.1361-3(e).

[2915] As defined in Reg. § 1.1361-3-(a)(1)(ii)(B)(1).

[2916] As calculated under Reg. § 1.1361-3(c)(2)(ii).

[2917] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview.

[2918] REG-130843-13.

S corporation held by a QSST. Specifically, the request for comments deals with the application of section 1411(c)(4) to the existing QSST stock disposition mechanics in § 1.1361-1(j)(8).

In general, if an income beneficiary of a trust that meets the QSST requirements under section 1361(d)(3) makes a QSST election, the income beneficiary is treated as the section 678 owner with respect to the S corporation stock held by the trust. Section 1.1361-1(j)(8), however, provides that the trust, rather than the income beneficiary, is treated as the owner of the S corporation stock in determining the income tax consequences of the disposition of the stock by the QSST. Section 1361(d)(1)(C) and the last sentence of § 1.1361-1(j)(8) provide that, solely for purposes of applying sections 465 and 469 to the income beneficiary, a disposition of S corporation stock by a QSST is treated as a disposition by the income beneficiary. However, in this special case, the QSST beneficiary, for chapter 1 purposes, does not have any passive activity gain from the disposition. Therefore, the entire suspended loss (to the extent not allowed by reason of the beneficiary's other passive net income in the disposition year) is a section 469(g)(1) loss, and is considered a loss from a nonpassive activity.

For purposes of section 1411, the inclusion of the operating income or loss of an S corporation in the beneficiary's net investment income is determined in a manner consistent with the treatment of a QSST beneficiary in chapter 1 (as explained in the preceding paragraph), which includes the determination of whether the S corporation is a passive activity of the beneficiary under section 469. However, because gain or loss resulting from the sale of S corporation stock by the QSST will be reported by the QSST and taxed to the trust by reason of § 1.1361-1(j)(8), it is not clear whether the beneficiary's section 469 status with respect to the S corporation is attributed to the trust.

One commentator recommended that the disposition of S corporation stock by a QSST should be treated as a disposition of the stock by the income beneficiary for purposes of determining material participation for purposes of section 1411. In addition, the commentator recommended that the final regulations confirm that the special rule stated in the last sentence of § 1.1361-1(j)(8) applies for purposes of section 1411 as it does for section 469 and 465.

After consideration of the comments, these proposed regulations provide that, in the case of a QSST, the application of section 1411(c)(4) is made at the trust level.

This treatment is consistent with the chapter 1 treatment of the QSST by reason of § 1.1361-1(j)(8). However, these proposed regulations do not provide any special computational rules for QSSTs within the context of section 1411(c)(4) for two reasons.

First, the treatment of the stock sale as passive or nonpassive income is determined under section 469, which involves the issue of whether there is material participation by the trust. As discussed in part 4.F of the preamble to the 2013 Final Regulations, the Treasury Department and the IRS believe that the issue of material participation by estates and trusts, including QSSTs, is more appropriately addressed under section 469.

Additionally, one commentator noted that the IRS has addressed the treatment of certain asset sales as the functional equivalent of stock sales for purposes of § 1.1361-1(j)(8) in a limited number of private letter rulings. In these cases, the private letter rulings held that gain from the sale of assets, which was followed by a liquidation, would be taxed at

> the trust level under § 1.1361-1(j)(8) rather than being taxed at the beneficiary level. The commentator recommended that an asset sale followed by a liquidation, within the context of § 1.1361-1(j)(8), should have a similar result under section 1411(c)(4). Similar to the issue of material participation by QSSTs discussed in the preceding paragraph, the Treasury Department and the IRS believe that the issue of whether an asset sale (deemed or actual) is the equivalent of a stock sale for purpose of the QSST rules should be addressed under the § 1.1361-1(j) QSST regulations, rather than in § 1.1411-7. However, the Treasury Department and the IRS believe that proposed § 1.1411-7(a)(4)(i), which provides that asset sales followed by a liquidation is a disposition of S corporation stock for purposes of section 1411(c)(4), address the commentator's QSST issue.
>
> Second, with respect to the section 1411 treatment of the disposition by the beneficiary by reason of section 1361(d)(1)(C) and the last sentence of § 1.1361-1(j)(8), the Treasury Department and the IRS believe that the general administrative principles enumerated in § 1.1411-1(a), when combined with the general treatment of section 469(g) losses within § 1.1411-4, provide an adequate framework for the treatment of QSSTs beneficiaries without the need for a special computational rule within § 1.1411-7.

Code § 469(g), the rule governing the disposition of a passive activity, is described in part II.K.1.j Complete Disposition of Passive Activity. The idea that the trust is treated as a nongrantor trust starting only at the moment of the sale, how does this instantaneous creation comport with the idea of participating over a particular period of time? I led ACTEC comments discussing this concern: https://www.actec.org/resources/recommendations-for-reg-130843-13.

For more information on the taxation of QSSTs, see parts III.A.3.e.i QSSTs[2919] and III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs.

For planning issues relating to the dispositions described in this part II.J.15.a, see part II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets.

II.J.15.b. QSSTs and State Income Tax Issues

As a grantor trust with respect to S corporation items, the trust is not subjected to state income tax on those items; instead, the beneficiary is.

A state might even treat the trust as not existing while it is a grantor trust, providing the opportunity to treat the trust as a nonresident trust if the grantor moves to another state (for example, a state with no income tax).[2920] Thus, if a QSST holds only S corporation stock, then

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[2919] Particularly the text accompanying fns. 5994-5996, dealing with sales of not only S corporation stock but also of an S corporation's business in an asset sale. For additional planning issues, see parts II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business and II.J.8.a.i Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset (discussing whether the gain is included in DNI). See also part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSSTs, especially part III.A.3.e.v.(b) Implementation and, within that, the paragraph that includes a reference to fn. 6096.

[2920] See part II.J.3.e.iii Whether a State Recognizes Grantor Trust Status; Effect of Grantor Trust Status on a Trust's Residence.

the QSST election might allow the trust's residency to be determined at a later, perhaps more favorable date.[2921]

Some trust agreements provide that any S corporation will be held in a separate QSST, leaving the original trust undisturbed as to any provisions that might be consistent with QSST status. This approach would appear to maximize the possibility of the delayed residence determination described above.

Of course, one would also want to consider the other factors mentioned in part II.J.3 Strategic Fiduciary Income Tax Planning rather than focusing exclusively on this issue.

II.J.16. Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets

Consider the following:

- The sale of ownership of a business entity is allocated to principal; however, see part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Trust Accounting Rules. Assuming the business interest is a capital asset, any capital gain is included in DNI only if certain exceptions are satisfied[2922] and any ordinary income[2923] is automatically included in DNI.[2924]

- A flow-through entity might sell its assets, or a sale of S corporation stock might be taxed to the shareholders as a sale of the entity's assets followed by the corporation liquidating.[2925] Generally, assets used in business activities do not constitute capital assets, so capital gain from their sale is included in DNI without needing to apply the special rules for gain from the sale of a capital asset,[2926] and of course any ordinary income generated by depreciation recapture is included in DNI as well. Goodwill is a capital asset unless it has been subject to any amortization.[2927] Because this gain/income is included in DNI, the allocation of such gains to principal does not cause any particular limits to be placed on shifting them to beneficiaries if they are properly paid, credited, or required to be distributed.[2928] However, if and to the extent that they are not paid or credited during the year or within 65 days

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[2921] Illinois Schedule K-1-P, which partnerships and S corporations use to report K-1 income includible in their owners' income, has a separate line, line 9b, which was "expanded to allow grantor trusts and other federally disregarded entities to identify the taxpayer that will report the income or loss shown on the Schedule K-1-P…." See Illinois Dept. of Rev. Info. Bulletin, No. FY 2013-09, 01/01/2013. That line was also on 2014 returns.
[2922] See part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).
[2923] For example, the sale of a partnership interest might generate ordinary income from the sale of "hot assets" – see part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest.
[2924] Code § 643(a).
[2925] See parts II.J.15 QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items and II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.
[2926] See part II.J.8.a Capital Gain Constitutes DNI Unless Excluded.
[2927] See fns. 4132-4137.
[2928] Code § 661(a)(1), (c).

thereafter[2929] and are not required to distributed, consider whether they can be allocated to income if the trust is a mandatory income trust.[2930]

- State and local income taxes are not deductible in determining alternative minimum tax (AMT).[2931] Often the best way to prevent these items from triggering AMT is to pay them in the year in which the income that generated them is recognized. Given that a state might allow one to use the prior year's income tax as a safe harbor or might not require estimated tax payments at all, one might easily overlook the need to pay state income tax in the year of the sale (or other major income recognition event).

Although items on a K-1 from an S corporation generally are taxed the beneficiary as if the QSST were a grantor trust, gain from sale of the stock and gain from the sale or deemed sale of the corporation's assets (even if reported on a K-1) are taxed to the trust, not as part of the grantor trust portion.[2932] However, if the beneficiary's federal and state/local income taxation (including the 3.8% tax net investment income) are more favorable than the trust's and a distribution form the trust would not frustrate the trust's objectives, consider using the ideas in the bullet points above to shift taxation on any items otherwise taxable to the trust. It is not unusual for an income tax preparer to be unfamiliar with the QSST rules regarding taxation of the sale or deemed sale of the corporation's assets and not to plan for the correct taxation, so be sensitive to this issue up front and also consider reallocating principal to income if the trust is a mandatory income trust.[2933] Although one might initially view the election to tax a stock sale as a sale of the business' assets (followed by liquidation) as merely substituting gain on the sale of assets for gain on the sale of stock, note that state income taxation might also generate surprising results; see part II.H.8.a.ii State Income Tax Disconnect.

For an ESBT, consider allocating administrative expenses and state income taxes to the S portion as much as is reasonable to do.[2934] Allocating administrative expenses to the non-S portion might create a loss that is not deductible unless the trust is terminating,[2935] making an allocation to the S portion even more desirable. In addition to that concern, allocating state

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[2929] See part II.J.2 Tactical Planning Shortly After Yearend.
[2930] See parts II.J.8.c.i.(b) Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation and II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the .
[2931] Code § 56(b)(1)(A)(ii).
[2932] See part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax). For more information on the taxation of QSSTs, see parts III.A.3.e.i QSSTs (particularly the text accompanying fns. 5994-5996, dealing with sales of not only S corporation stock but also of an S corporation's business in an asset sale) and III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs. If the corporation actually sells its assets without adopting a plan of liquidation, I am unsure of the result.
[2933] See part II.J.8.c.i.(b) Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation. In a QSST, one might be able to allocate principal to income to make up for expenses ordinarily allocated to principal that were allocated to income as an adjustment needed due to cash flow issues; see text accompanying fns. 5983-5986 in part III.A.3.e.i.(a) QSSTs Generally. For form language that might facilitate this allocation, see fn. 2765, found in part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.
[2934] For ESBT tax issues, see parts II.J.14 Application of 3.8% NII Tax to ESBTs and III.A.3.e.ii.(b) ESBT Income Taxation - Overview, the latter especially including fns. 6050-6051.
[2935] Code § 642(h). See part II.J.3.i Planning for Excess Losses.

income tax to the non-S portion might generate a large alternative minimum tax bill,[2936] which would not be owed if allocated to the S portion and paid in the year of sale.

If the trust is a QSST or if the trust is a grantor trust that would be converted to an ESBT shortly before the sale, consider making the trustee active in the business to maximize opportunities to avoid the 3.8% tax on net investment income and, in the case of a grantor trust, converting it to an ESBT far enough in advance of the sale for the trustee to accumulate sufficient hours of participation. See generally part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.

If the trustee mistakenly taxes the sale to the beneficiary, reimbursing the beneficiary should not generate any transfer tax consequences.[2937]

II.J.17. Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax

This part II.J.17 assumes that avoiding NII characterization is the most important objective. Before making that assumption, see part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good.[2938]

Making income from operations and gain on sale be nonpassive income is the key to avoiding NII characterization:

- Generally, income from a trade or business is exempt from the 3.8% tax if it is nonpassive income.[2939]

- Gain on the sale of assets used in a nonpassive trade or business (or from the part of the sale of a partnership interest or S corporation stock allocable to such assets) is exempt from the 3.8% tax.[2940]

- The taxpayer needs to sufficiently participate in a business to make it nonpassive.[2941]

Consider the following:

- In an ESBT, the trust is the taxpayer.

- In a QSST, for normal operations, the beneficiary, as deemed owner under the grantor trust rules, is the taxpayer.

- In a QSST, when the business is sold, generally the trust will be the taxpayer.[2942]

[2936] Code § 56(b)(1)(A)(ii).
[2937] See part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the , especially fn. 2909.
[2938] Particularly note the IRS' position on NOLs incurred by an electing small business trust (ESBT) when the S corporation stock it owns generates losses part III.A.3.e.ii.(b) ESBT Income Taxation - Overview.
[2939] See part II.I.8 Application of 3.8% Tax to Business Income.
[2940] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
[2941] See part II.K.1.a Counting Work as Participation.
[2942] See part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax).

- In a grantor trust, the deemed owner is the taxpayer, but the deemed owner might turn off the grantor trust powers before selling the business, generally making the trust the taxpayer, whether the trust is an ESBT or a QSST (or the business is taxed as partnership).

Thus, even when a trust is taxable to the grantor or beneficiary under the grantor trust rules, one might consider establishing the trustee's material participation at least a year before the business might be sold;[2943] whether this would count given the trust's being disregarded for income tax purposes has never been addressed, but, with rules regarding trust material participation so uncertain, these extra precautions might be worthwhile if the tax at risk is significant enough. This might require jumping through extra hoops if the entity was formed as a state law corporation, because a traditional corporate structure does not lend itself to the type of participation the IRS seeks.[2944]

For more discussion of QSSTs and ESBTs, see generally part III.A.3.e QSSTs and ESBTs, which compares and contrasts those types of trusts and discusses strategies for switching back and forth.

II.J.18. Trust Divisions, Mergers, and Commutations; Decanting

Although most trust divisions and distributions are not subject to income tax, some changes in a beneficial interest in a trust are. Two separate ideas run through the analysis of this part II.J.18:

- A beneficial interest is itself a capital asset.[2945]

- Distributions that satisfy a beneficiary's rights of something other than what is distributed are taxable events. For example, if a beneficiary has the right to a specific dollar amount (which might be a right to a specific amount of income), distributing property other than cash is considered a sale by the trust of that distributed property.[2946]

Confusion arises when trustee action is not merely a distribution but rather changes a beneficiary's rights.

Trust divisions (part II.J.18.a), mergers (part II.J.18.b), and decanting (part II.J.18.c) may be structured to avoid any income or transfer tax consequences. However, if any beneficial interest is reduced, which is more likely to be the case in a decanting than a straight division or merger (because divisions and mergers generally continue the underlying beneficial interests, and decanting may or may not do so), severe transfer tax consequences may ensue.

If the parties wish to change their beneficial interests without any transfer tax consequences, that change may constitute a commutation (part II.J.18.d), which may generate income tax consequences in that beneficial interests are themselves assets owned by the beneficiaries for income tax purposes, the sale or exchange of which is subjected to income tax.

A nice summary of the above issues is in part II.J.18.e Ed Morrow on Potential Income Tax Disasters for Early Trust Terminations. To me, the income tax question is whether a course of action is more in the nature of a nontaxable continuation of existing beneficial interests – just

[2943] See part II.K.2.b Participation by an Estate or Nongrantor Trust.
[2944] See part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.
[2945] See fn 2976 in part II.J.18.d Trust Commutations.
[2946] See part II.J.8.d Distribution in Kind; Specific Bequests

rearranged somewhat to avoid conflicts in administrative issues resulting from beneficiaries' differing goals or needs – or is a material change in beneficial interests constituting an exchange.

A settlor participating in a trust modification should not implicate Code § 2036 or 2038,[2947] so long as the settlor does not do so often enough to appear to be controlling the trust's terms.

II.J.18.a. Trust Divisions

See part II.D.5 Severing Trusts with Multiple Grantors.

Generally, a partition of jointly owned property is not a sale or other disposition of property when the co-owners of the joint property sever their joint interests.[2948]

Rev. Rul. 69-486 held the following, addressing a trustee making non-pro rata distributions to beneficiaries C and X:[2949]

[2947] See text accompanying fn 7483 in part III.D Code § 2038.

[2948] Rev. Rul. 56-437 provides:

> The conversion, for the purpose of eliminating a survivorship feature, of a joint tenancy in capital stock of a corporation into a tenancy in common is a nontaxable transaction for Federal income tax purposes. Likewise, the severance of a joint tenancy in stock of a corporation, under a partition action instituted under sections 103-1-1 to 10 of Colorado Revised Statutes, 1953, compelling partition and the issuance of two separate stock certificates in the names of each of the joint tenants, is a nontaxable transaction. In each case there was no sale or exchange and the taxpayers neither realized a taxable gain nor sustained a deductible loss. See I.T. 1761, C.B. II-2, 56 (1923), holding that although the transfer of stock from the name of an individual to the name under which the individual does business is subject to tax under the stamp tax law (Schedule A-3, Title XI of the Revenue Act of 1921), it is not a sale within the meaning of the income tax law. See also Rev. Rul. 55-77, C. B. 1955-1, 339, and Rev. Rul. 55-179, C.B. 1955-1, 340.

[2949] Rev. Rul. 69-486 posited the following facts:

> Under terms of the trust instrument, the trustee is required to distribute currently all trust income to B for her life and upon her death distribute one-half of the trust corpus to C, an individual, and one-half to X, a charitable organization exempt from tax under section 501(c)(3) of the Internal Revenue Code of 1954.
>
> B died on July 1, 1967. At the time of her death, the trust had ordinary income of 20x dollars to be reported in its current calendar year period. Subsequent to B's death the trust received no income up to its termination on August 1, 1967. The distributable net income of the trust for 1967 as defined by section 643(a) of the Code was 20x dollars. The trustee properly distributed currently 20x dollars to B's successor in interest.
>
> At the time of B's death, the trust corpus to be distributed to C and X consisted in part of notes that had been purchased by the trust and that had a total adjusted basis of 300x dollars and a total fair market value of an equal amount. The balance of the trust corpus consisted of common stock acquired by purchase with a total adjusted basis of 100x dollars and a total fair market value of 300x dollars.
>
> The trust instrument as well as local law was silent as to the authority of the trustee to make a non-pro rata distribution of property in kind.
>
> By mutual agreement, the two beneficiaries requested that the trustee distribute all of the notes to C and all of the common stock to X. The trustee complied with this request on August 1, 1967.
>
> The first issue to be decided is how the non-pro rata distribution by the trustee to C and X will be treated for Federal income tax purposes.

Since the trustee was not authorized to make a non-pro rata distribution of property in kind but did so as a result of the mutual agreement between C and X, the non-pro rata distribution by the trustee to C and X is equivalent to a distribution to C and X of the notes and common stock pro rata by the trustee, followed by an exchange between C and X of C's pro rata share of common stock for X's pro rata share of notes.

Being aware of this issue and seeking to avoid it, Uniform Trust Code ("UTC") § 816 (promulgated in 2000 and last revised or amended in 2010) provides that "a trustee may":

… (22) on distribution of trust property or the division or termination of a trust, make distributions in divided or undivided interests, allocate particular assets in proportionate or disproportionate shares, value the trust property for those purposes, and adjust for resulting differences in valuation ….

The UTC's official Comments include:

Paragraph (22) authorizes a trustee to make non-pro-rata distributions and allocate particular assets in proportionate or disproportionate shares. This power provides needed flexibility and lessens the risk that a non-pro-rata distribution will be treated as a taxable sale.

Letter Ruling 200527007 held:[2950]

The present case is distinguishable from Rev. Rul. 69-486 because it has been represented that the assets of the two initial trusts will be allocated according to their respective interests evenly among the four intermediary and two resulting, merged trusts. The assets of the original trusts will be divided fractionally and transferred to the intermediary and resulting trusts in accordance with the respective fractional interest of each of the resulting trusts. Each asset may not be transferred strictly pro rata, but the

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[see text in main body]

The second issue to be decided is the basis of the pro rata share of notes and common stock in the hands of C and X.

Rev. Rul. 69-486 reasoned and concluded:

Inasmuch as the 20x dollars of income required to be distributed currently to the estate of B is equal to the distributable net income of the trust, no amount is includible in the gross income of C and X as a result of the pro rata distribution of notes and common stock by the trustee. See section 662(a) of the Code as implemented by section 1.662(a)-2 of the regulations.

The basis of the pro rata shares of notes and common stock in the hands of C and X is the same as the adjusted basis in the hands of the trust. See section 1.1015-2(b) of the regulations.

Furthermore, C in substance exchanged his pro rata share of common stock with X for X's pro rata share of notes. The amount of recognized gain to C is determined under sections 1001 and 1002 of the Code. Since X is a charitable organization exempt from tax under section 501(c)(3) of the Code, it has no tax consequence as a result of the exchange.

[2950] Letter Ruling 200527007 also held:

In this case, the beneficiaries of the resulting trusts will have the same interests after the proposed division and merger that they had under Trust B-1 and Trust B-2 prior to the division and merger. Because the beneficial interests, rights, and expectancies of the beneficiaries are substantially similar, both before and after the proposed transaction, no transfer of property will be deemed to occur as a result of the division and merger. Accordingly, we conclude that the division of Trusts B-1 and B-2 as proposed, the merger of the resulting trusts and the allocation of assets among the resulting trusts as proposed is not a transfer, direct or indirect, of property that will be subject to the gift tax imposed by § 2501.

assets selected for each trust will be fairly representative of the appreciation, depreciation, and tax bases of the assets available for distribution. Accordingly, the proposed transaction will not be treated as a pro rata distribution followed by an exchange of assets among the beneficiaries of any of the subject trusts.

Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), concerns the issue of when a sale or exchange has taken place that results in realization of gain or loss under § 1001. In Cottage Savings, a financial institution exchanged its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans. The two groups of mortgages were considered "substantially identical" by the agency that regulated the financial institution.

The Supreme Court in *Cottage Savings* concluded that § 1.1001-1 reasonably interprets § 1001(a), and stated than an exchange of property gives rise to a realization event under § 1001 if the properties exchanged are "materially different."

In defining what constitutes a "material difference" for purposes of § 1001(a), the Court stated that properties are "different" in the sense that is "material" so long as their respective possessors enjoy legal entitlements that are different in kind or extent. *Cottage Savings*, at 564-65. In *Cottage Savings*, the Court held that mortgage loans made to different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans.

It is consistent with the Supreme Court's opinion in *Cottage Savings* to find that the interests of the beneficiaries of the four intermediary and two resulting, merged trusts will not differ materially from their interests in the original trusts. The proposed transaction will not change the interests of the beneficiaries. Instead, the beneficiaries will be entitled to the same benefits after the proposed transaction as before. The proposed transaction is similar to the kinds of transactions discussed in Rev. Rul. 56-437, since the original trusts are to be divided, but all other provisions of the trusts will remain substantially identical. Thus, the proposed transaction will not result in a material difference in the kind or extent of the legal entitlements enjoyed by any trust beneficiary.

Based upon the facts submitted and the representations made, and assuming the transaction is effectuated substantially as described, we conclude that the proposed divisions of the assets of the trusts created under the wills of Decedent and Spouse and the subsequent mergers of the resulting trusts will not constitute a distribution under § 661 or § 1.661(a)-2(f) or a sale or other taxable disposition of the assets of any of the trusts under § 1001. Thus, the proposed divisions and mergers will not result in the realization by Trust B-1 and Trust B-2, the four intermediary trusts resulting from the divisions of these trusts, or Trust D and Trust E, or by any beneficiary of any of these described trusts, of any income, gain or loss under §§ 61, 662 or 1001.

Letter Ruling 200552009, involving trust mergers followed by divisions, is discussed in part II.J.18.b Trust Mergers.

In Letter Ruling 200723014, a marital trust divided by retaining closely-held corporate stock and distributing marketable securities and cash to the spun off trust. It held:

The present case is distinguishable from Rev. Rul. 69-486 because the trust instrument allows for non-prorata distributions. Also, the two trusts will have identical terms to those set forth in the Trust Instrument, and the rights of the beneficiaries to trust assets remain unchanged. Accordingly, based on the facts submitted and representations made, we conclude that the proposed division of Marital Trust into Marital Trust A and Marital Trust B on a non-prorata basis will not constitute a distribution under § 661; and the proposed division will not result in the realization by Marital Trust, Marital Trust A, Marital Trust B, or by any beneficiary of any of these trusts, of any income under § 662. In addition, the proposed division of Marital Trust into Marital Trust A and Marital Trust B will not constitute a taxable disposition of trust assets for federal income tax purposes and the trusts and beneficiaries will not realize gain under § 1001 as a result of the division.

Reg. § 1.1001-1(h), "Severances of trusts," which was issued long after Rev. Rul. 69-486 was released, provides:[2951]

(1) *In general*. The severance of a trust (including without limitation a severance that meets the requirements of § 26.2642-6 or of § 26.2654-1(b) of this chapter) is not an exchange of property for other property differing materially either in kind or in extent if -

(i) An applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust; and

(ii) Any non-pro rata funding of the separate trusts resulting from the severance (including non-pro rata funding as described in § 26.2642-6(d)(4) or § 26.2654-1(b)(1)(ii)(C) of this chapter), whether mandatory or in the discretion of the trustee, is authorized by an applicable state statute or the governing instrument.

(2) *Effective/applicability date*. This paragraph (h) applies to severances occurring on or after August 2, 2007. Taxpayers may apply this paragraph (h) to severances occurring on or after August 24, 2004, and before August 2, 2007.

Note that the regulation applies to any severance, not just a qualified severance. Reg. § 26.2642-6(j), Example (3), "Severance based on actuarial value of beneficial interests," recognizes the following as a nonqualified severance:

In 2004, T establishes Trust, an irrevocable trust providing that income is to be paid to T's child C during C's lifetime. Upon C's death, Trust is to terminate and the assets of Trust are to be paid to GC, C's child, if living, or, if GC is not then living, to GC's estate.

[2951] Reg. § 1.1001-1(h) was promulgated as part of project to facilitate severing trusts for GST purposes. T.D. 9348 (8/2/2007) explained:

One commentator noted that § 1.1001-1(h)(1) of the proposed regulations provides favorable income tax treatment only with respect to a qualified severance. The commentator requested that the regulations also address the income tax treatment of all other trust modifications and severances. The commentator noted that the failure to address, for example, the income tax consequences of severances that are not qualified severances for GST tax purposes implies that such severances are taxable events for income tax purposes. In response to these comments, the category of severances to which § 1.1001-1(h)(1) will apply has been broadened. No inference should be drawn with respect to the income tax consequences under section 1001 of any severance that is not described in § 1.1001-1(h)(1).

> T properly elects, under section 2632(c)(5), not to have the automatic allocation rules contained in section 2632(c) apply with respect to T's transfers to Trust, and T does not otherwise allocate GST tax exemption with respect to Trust. Thus, Trust has an inclusion ratio of one. In 2009, the trustee of Trust, pursuant to applicable state law, divides Trust into two separate trusts, Trust 1 for the benefit of C (and on C's death to C's estate), and Trust 2 for the benefit of GC (and on GC's death to GC's estate). The document severing Trust directs that Trust 1 is to be funded with an amount equal to the actuarial value of C's interest in Trust prior to the severance, determined under section 7520 of the Internal Revenue Code. Similarly, Trust 2 is to be funded with an amount equal to the actuarial value of GC's interest in Trust prior to the severance, determined under section 7520. Trust 1 and Trust 2 do not provide for the same succession of interests as provided under the terms of the original trust. Therefore, the severance is not a qualified severance. Furthermore, because the severance results in no non-skip person having an interest in Trust 2, Trust 2 constitutes a skip person under section 2613 and, therefore, the severance results in a taxable termination subject to GST tax.

If a trust is divided so that each trust has the same beneficial interests but different assets and trustees, the division itself will not carry out income from one trust to the other.[2952] If a trust divides but distributes property to satisfy a pecuniary obligation to one of the beneficiaries, the latter distribution is a deemed sale, but the rest of the distribution is nontaxable.[2953] If one trust later distributes to another trust as a conduit to make distributions to the beneficiaries, the distribution will carry out DNI; however, if the distribution is just to shift funds between with the trusts without the shift being related to distributions, the shift does not carry DNI.[2954]

Whether a trust division shifts the grantor does not affect whether the division constitutes a distribution that carries out DNI.[2955]

[2952] Letter Ruling 201642028, which is described in detail in part II.J.18.c.ii Tax Consequences of Decanting. For a similar result for decanting, see part II.J.4.i Modifying Trust to Make More Income Tax Efficient.

[2953] Letter Ruling 201722007 held:

> In accordance with the conclusion that the post-equalization property divisions of Trust 1 and Trust 2 will not result in gain or loss under § 61 or § 1001, we also conclude that, based solely on the facts submitted and representations made, the proposed divisions of the post-equalization property will not result in income, gain or loss to the trusts under § 661, § 662, or § 1.661(a)-2(f). Consistent with Rev. Rul. 82-4, gain will be recognized on funding of Successor Trusts to the extent appreciated assets are used to satisfy the Equalization Distribution in kind.

Rev. Rul. 82-4 is described in fn 2787 in part II.J.8.d.i Distribution in Kind - Generally

[2954] Letter Ruling 201642028, which is described in detail in part II.J.18.c.ii Tax Consequences of Decanting.

[2955] T.D. 8831 (8/6/1999), provides:

> Commenters also questioned a provision in the proposed regulations that treated a distribution from one trust to another trust that is a beneficiary of the first trust as a gratuitous transfer, with the result that the first trust was a grantor of the second trust. Under the temporary regulations, if a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally is treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, such person is treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Code. (These rules do not affect the determination of whether or not the gratuitous transfer from the transferor trust is a distribution subject to sections 651 or 661.)

Letter Ruling 201928004 held:[2956]

> A partition of jointly owned property is not a sale or other disposition of property where the co-owners of the joint property sever their joint interests, but do not acquire a new or additional interest as a result thereof. Thus, neither gain nor loss is realized on a partition. See Rev. Rul. 56-437, 1956-2 C.B. 507 (conversion of a joint tenancy in stock to a tenancy in common in order to eliminate the survivorship feature and the partition of a joint tenancy in stock are not sales or exchanges).
>
> Similarly, divisions of trusts are also not sales or exchanges of trust interests where each asset is divided pro rata among the new trusts. See Rev. Rul. 69-486, 1969-2 C.B. 159 (pro rata distribution of trust assets not a sale or exchange).
>
> In the present case, the legal entitlements, as well as the rights and powers, of the beneficiaries will remain the same in kind and extent after the Proposed Division of Trust into the Subtrusts. Accordingly, based on the facts submitted and representations made, the Proposed Division of Trust will not result in the realization of gain or loss under § 61 and § 1001.
>
> Moreover, based on the facts submitted and representations made, we conclude that the Proposed Division is not a distribution under § 661 or § 1.661(a)-2(f). We further conclude that the Proposed Division of Trust assets among the Subtrusts will not cause Trust, the Subtrusts, or beneficiaries to recognize any income, gain, or loss under § 662.

Letter Ruling 202133005 included the following facts:

> As Grantors' family has grown in number and has become more diverse, the financial needs and objectives of the Trust 1 beneficiaries have diverged. The current beneficiaries of Trust 1 have agreed that it is in their collective best interest for Trust 1 to be divided into x separate and independent trusts, one for the benefit of each child of Grantors and that child's descendants, prior to the death of Grantor 2 (Early Division). The governing instrument of Trust 1 does not prohibit the Early Division of Trust 1.
>
> On Date 3, the trustees and current beneficiaries of Trust 1, together with other interested parties, entered into an agreement (Settlement Agreement) in which all parties agreed to take all actions necessary to accomplish the Early Division.

The parties then petitioned a court to modify the trust to provide for the Early Division. Also:

> The Partial Judgment will become effective upon entry of a final judgment, and the trustees of Trust 1 represent that Trust 1 will not be divided until Court 2 enters a final judgment. In addition, the trustees represent that Trust 1 currently has an inclusion ratio

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See parts II.D.3 Trust as Grantor or Deemed Owner of Another Trust and III.B.2.h.i Who Is the Grantor, the latter including fns. 6620-6623.

[2956] For the facts in Letter Ruling 201928004, see text following fn 2876 in part II.J.9.c.i Multiple Trusts Created for Tax Avoidance. The ruling also held:

> Based on the facts submitted and the representations made, we conclude that because § 1001 does not apply to the Proposed Division, under § 1015 the basis of the assets received by Subtrusts will be the same as the respective basis of the assets held by Trust. We further conclude that under § 1223(2) the holding period of the assets received by the Subtrusts will be the same as the holding period of the assets in Trust.

of zero for GST tax purposes, that all previous distributions from Trust 1 have been made on a pro-rata basis to each of the x family lines, and that the assets of Trust 1 are to be allocated to the newly-created trusts on a pro-rata basis. Moreover, the trustees represent that the interests of the beneficiaries of Trust 1 will not be materially altered by the division of Trust 1 into the newly-created trusts, that each newly-created trust will have different primary beneficiaries, and that each newly-created trust will be separately managed and administered.

Letter Ruling 202133005 cited *Cottage Savings*, then ruled:

> Consequently, based on the facts submitted and the representations made, the pro-rata transfer of assets from Trust 1 to the newly-created trusts will not result in a sale or exchange, or other disposition, of any property for purposes of § 1001(a), and thus no gain or loss will be recognized by the beneficiaries or the trusts on the division for purposes of § 61(a)(3) or § 1001(c). We further conclude that the pro-rata transfer of assets from Trust 1 to the newly-created trusts is not a distribution under § 661 or § 1.661(a)-2(f) and therefore not included in the gross income of any newly-created trust beneficiary under § 662. It is consistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries, after a pro-rata distribution, of the newly-created trusts do not materially differ from the interests in Trust 1.

Letter Ruling 202133005 confirmed the natural consequences of no sale or exchange:

> Based on the facts submitted and the representations made, we conclude that because § 1001 does not apply to the pro rata transfer of assets from Trust 1 into the newly-created trusts, under § 1015 the basis of the newly-created trust assets will be the same after pro-rata transfer of assets from Trust 1 as the basis of those assets before the transfer. We further conclude that each asset transferred by Trust 1 to the newly-created trusts will have the same holding period in the hands of the newly-created trusts as it had in Trust 1. Finally, we conclude that on the division of property from Trust 1 to the newly-created trusts, the newly-created trusts will succeed to and take into account, pro-rata, any net operating loss carryforward, net capital loss, and other tax attributes, including passive activity losses, credit carryforwards, and statutory depletion deductions, of Trust 1.

Letter Ruling 202133005 also ruled no change in GST inclusion ratio:

> No guidance has been issued concerning judicial modifications that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a modification that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust.
>
> In this case, the division and modifications to sections 4.1, 4.3, and 4.4 are similar to those in Example 5 of § 26.2601-1(b)(4)(i)(E). The Early Division of Trust 1 will result in x newly-created trusts, one for the family line of each child of Grantor 1 and Grantor 2. After the division and modification: (i) section 4.2, which governs distributions during the lifetime of each child and more remote descendant of Grantors, is the same as in the original Trust 1, although limited to a family line; (ii) under section 4.3, each newly-created trust (and trusts created under the terms of each newly-created trust) will terminate no later than Trust 1 terminates under its original terms; and (iii) under

section 4.4, which governs distributions at the death of a child and more remote descendants of Grantors, the distributees of property on termination of each newly-created trust (and trusts created under the terms of each newly-created trust) will be the same as the distributees of property under the original terms of Trust 1. Thus, the Early Division of Trust 1 and pro-rata allocation of Trust 1 assets among the x newly-created trusts will not shift a beneficial interest in Trust 1 to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the Early Division. In addition, the Early Division will not extend the time for the vesting of any beneficial interest in the newly-created trusts beyond the period provided for the vesting of that beneficial interest under the original terms of Trust 1.

> The modification to section 7.1 and the addition of section 7.1A resemble those in Example 10 of § 26.2601-1(b)(4)(i)(E). The modification and addition pertain to the administration of Trust 1 and do not shift a beneficial interest in Trust 1 to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification and addition. Furthermore, the modification and addition do not extend the time for vesting of any beneficial interest in Trust 1 beyond the period provided for under the original terms of Trust 1.
>
> Accordingly, based on the facts submitted and the representations made, the division of Trust 1 in accordance with Partial Judgment into the x newly-created trusts and the pro-rata allocation of Trust 1 assets will not affect the status of Trust 1 or the newly-created trusts as exempt from the GST tax. Likewise, neither the division nor the pro-rata allocation of assets will cause a distribution from, or termination of any interest in Trust 1 or any of the newly-created trusts to be subject to the GST tax.

II.J.18.b. Trust Mergers

II.J.18.b.i. Authority on Trust Mergers

For trust mergers, followed by divisions, Letter Ruling 200552009 stated:

> We also conclude that because § 1001 does not apply to the proposed division of merged Trust 4, under § 1015, the tax basis that the New Trusts have in the assets of the New Trusts immediately after the division will be the same as the tax basis of the merged Trust 4 in such assets immediately before the division. The tax basis of the historic assets in the New Trusts immediately after the division will be the same as the tax basis that the merged Trust 4 had in those assets immediately before the division. We further conclude that each asset transferred by the merged Trust 4 to the New Trusts will have the same holding period in the hands of the New Trusts immediately after the division that it had in the hands of the merged Trust 4 immediately before the division. Each historic asset of the New Trusts will have the same holding period immediately after the division that it had immediately before the division.
>
> We additionally conclude that in each of the mergers of the Family Trusts into Trust 4, the merged Trust 4 will succeed to and take into account any net operating loss carry forward (NOLCF), net capital loss, and other tax attributes, including passive activity losses and credit carryforwards, of the merging Family Trusts. Each asset transferred by the merging Family Trusts to the merged Trust 4 will have the same tax attributes immediately after the merger that it had immediately before the merger. Each historic asset of the merged Trust 4 will have the same tax attributes immediately after the

> merger that it had immediately before the merger. All NOLCFs, net capital losses, and other tax attributes, including passive activity losses and credit carryforwards, of the merging Family Trusts immediately before the mergers will survive and remain available to the merged Trust 4 after the mergers and no limitation will be imposed as a result of the proposed mergers on the merged Trust 4 's use of such tax attributes.
>
> Finally, we conclude that on the division of the merged Trust 4 into New Trusts, each of the New Trusts will succeed to and take into account c of any net operating loss carry forward (NOLCF), net capital loss, and other tax attributes, including passive activity losses and credit carryforwards, of the divided merged Trust 4. Each asset transferred by the divided merged Trust 4 to the New Trusts will have the same tax attributes immediately after the division that it had immediately before the division. Each historic asset of the New Trusts will have the same tax attributes immediately after the division that it had immediately before the division. All NOLCFs, net capital losses, and other tax attributes, including passive activity losses and credit carryforwards, of the divided merged Trust 4 immediately before the division will survive and remain available to the divided New Trusts after the division and no limitation will be imposed as a result of the proposed division on the New Trusts' use of such tax attributes.

Letter Ruling 200743019 held:

> In this case, State Statute clearly authorizes the consolidation or merger of trusts by the trustees where the merger or consolidation is in the best interests of the beneficiaries. Moreover, the terms of the trust instruments establishing the original trusts authorize the trustees to execute the necessary documents in order to carry out the powers granted the trustees with respect to the transfer of assets from the trusts. By virtue of the trust powers granted to the trustees under the State Statute and the original trust instruments, the trustees of the original trusts are authorized to merge the assets into the new trusts and to transfer trust assets from the original trusts to the new trusts. Consequently, the beneficiaries of the new trusts are acquiring their interests in the new trusts by reason of the exercise of the trustees' existing authority under state law to merge or consolidate the original trusts and to transfer the trust assets in furtherance of this merger. The beneficiaries are not therefore acquiring their interests in the new trusts as a result of the exchange of their interests in the original trusts, or as the result of an exchange of interests between themselves. Accordingly, there does not appear to be any reciprocal exchange involving the legal rights and entitlements of the beneficiaries under the trusts here. Because no "exchange" has occurred for purposes of § 1001, it is unnecessary to analyze whether the "materially different" standard has been satisfied.
>
> We therefore conclude that the proposed mergers of the original trusts into the new trusts, and the transfer of assets from the original trusts to the new trusts, will not cause the original trusts, the new trusts, or any of the income beneficiaries to recognize any gain or loss under § 1001 from a sale or other disposition of property. Because § 1001 does not apply to the division of Trust 1 assets, under § 1015 the basis of the trust assets will be the same after the proposed transaction as the basis of those assets in the original trusts. Furthermore, pursuant to § 1223(2) the holding periods of the assets in the hands of the new trusts will include the holding periods of the assets in the hands of the original trusts.

Letter Ruling 202215015 held that the following trust merger did not change the trusts' GST status:

> In this case, the beneficiaries of each trust are identical and the distribution, dispositive, and trustee power provisions of each trust are substantially similar. The termination provisions of Trust A and Trust B are identical. Under Paragraph 1.07, no trust property shall be construed to remain held in trust beyond the period permitted by applicable State law. The termination provisions of Trust WB would allow the trust to remain in existence in perpetuity. Pursuant to the merger of Trust WB and Trust B into Trust A, Trusts WB and B will terminate and the termination provisions of Trust A will apply to all property transferred from Trust WB and Trust B. Accordingly, the merger will not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

If a trust merger constitutes a transfer from one taxpayer to another taxpayer, be sure to make a timely ESBT election.[2957]

II.J.18.b.ii. Strategy for Trust Mergers

Merging trusts after the grantor dies may be attractive for administrative simplicity, but one should consider carefully various effects, even though merger itself generally does not generate income or gift tax. If any trust being merged is subject to the rule against perpetuities, then generally the shortest perpetuities period prevails, which may or may not concern the trustee.

In most cases, having multiple trusts maximizes flexibility. I tend to present the possibility and let the client and income tax return preparer run with it from a strategic viewpoint, and sometimes I'll review the projections or counsel the client further on the array of tactics that separate trusts provide.

Separate trusts often allows considering or not considering various resources for distributions for support. For example, if one has 5 trusts, has $100K documented support, and the trusts allow one to consider or ignore other resources, with 5 trusts $500K could be distributed but with only 1 all-in-merged trust only $100K could be distributed. Consider part II.J.3 Strategic Fiduciary Income Tax Planning and various subparts.

Also, generally distributions carry out various elements of income pro rata; see part II.J.8.f.i.(b) Allocating Income Items Among Those Receiving It and its companion, part II.J.8.f.i.(a) Allocating Deductions to Various Income Items. If one trust has one type of income and another has a different type of income, picking one trust for distributions allows one to isolate the type of income being distributed.

In 2023, the run-up in the brackets for each trust is worth $1,855.50 ($14,450*.37 = $5,346.50 minus $3,491) if the trust had only ordinary income.

In 2023, the first $2,900 of a trust's long-term capital gains (if the trust has no other income, which is possible if all income is qualified dividends and long-term capital gains) is free from federal tax, which is a $690 tax savings at 23.8% combined federal capital gain and NII tax.

[2957] See Letter Ruling 201941006, described in the text accompanying fn 6008 in part III.A.3.e.ii.(a) Qualification as an ESBT. See also Letter Rulings 201941003, 201941004, 201941005, and 201941007, which were companion rulings.

If a trust has qualified business income from a partnership or S corporation and 2023 taxable income of a single trust is no more than $182,100, then the full 20% deduction may be available, even if no wages and the business is a specified service trade or business.[2958]

Alternative minimum tax exemptions may also come into play.

A "net operating loss" (NOL) is specifically from a business (generally a partnership or S corporation K-1) and may be carried forward, whereas negative net taxable income not generated by business operations is totally lost if not used; see part II.J.3.i Planning for Excess Losses, but consider the nuances of parts II.J.8.c.iv Netting Capital Losses and II.J.9.a.ii Separate Share Rule. On the other hand, deferring an NOL because it is in a separate trust instead of using it right away can itself be disadvantageous.

If a trust has suspended passive losses, make sure it is the surviving trust, or the carryovers may be lost.[2959]

II.J.18.c. Decanting

II.J.18.c.i. What Is Decanting

Generally, decanting is the trustee distributing assets from one trust to another trust. For over 100 years, it has been a tool to allow a trustee to change a trust's terms in some manner – whether to facilitate administration or to change a beneficial interest.

For what decanting is, see Uniform Trust Decanting Act, found at http://www.uniformlaws.org/Act.aspx?title=Trust Decanting, with the drafting committee's work found at http://www.uniformlaws.org/Committee.aspx?title=Trust%20Decanting; R.S.Mo. § 456.4-419, found at http://www.moga.mo.gov/mostatutes/stathtml/45600404191.html. The Uniform Trust Decanting Act authorizes amending a trust without transferring assets,[2960] a power that makes decanting a QSST much more comfortable, given that a QSST may not distribute principal other than outright to the beneficiary.[2961]

A trustee's authority to make a distribution is in some ways thought of exercising a power of appointment. When a beneficiary exercises a limited power of appointment, generally that exercise relates back to the original trust and includes any of the original trust's not changed by

[2958] See part II.E.1.c.v.(a) Taxable Income "Threshold Amount".
[2959] See part II.K.2.d Effect of Death of an Individual or Termination of Trust on Suspended Passive Losses.
[2960] Uniform Trust Decanting Act § 2(23)(A), authorizes amending a trust without transferring assets. The official Comments state:

> Thus the authorized fiduciary may exercise the decanting power by modifying the first trust, in which case the "second trust" is merely the modified first trust. The decanting instrument can, when appropriate, merely identify the specific provisions in the first trust that are to be modified and set forth the modified provisions, much like an amendment to a revocable trust. If the decanting power is exercised by modifying the terms of the first trust, the trustee could either treat the second trust as a new trust or treat the second trust as a continuation of the first trust. If the second trust is treated as a continuation of the first trust, there should be no need to transfer or retitle the trust property. Further, subject to future tax guidance, if the second trust is a continuation of the first trust, there may be no need to treat the first trust as having terminated for income tax purposes and no need to obtain a new tax identification number.

[2961] See part III.A.3.e.i.(a) QSSTs Generally.

the exercise.[2962] Furthermore, a power of appointment must be a general power for its exercise to change the grantor for income tax purposes.[2963] The exercise of an inter vivos limited power of appointment may have gift tax consequences if the beneficial interest of the person exercising the power is reduced.[2964]

In *Horvitz v. Commissioner*, Tax Court Docker No. 20409-19, the IRS disputed the effectiveness of the decanting when the trust agreement provided for both ascertainable and nonascertainable distribution authority. Here is Judge Gustafson's February 7, 2023 order as it pertains to decanting:

Background

> This case involves a deduction claimed for estate tax purposes by the petitioner, the estate of Lois Horvitz, for its charitable contributions. As we understand the facts (subject to correction by the parties, which we invite), the contributions were made as follows:
>
> I. *Lois's life estate and power of appointment*
>
> Decedent's late husband Harry R. Horvitz executed a revocable living trust, which we refer to as the "HRH Trust Agreement", which was "ratif[ied] and reaffirm[ed]" as late as 1991.[1] The HRH Trust Agreement created four trusts, including two that the parties call the "First QTIP Trusts". Under the terms of the HRH Trust Agreement, each of those QTIP trusts gave to Lois a life estate (Ex. 34 at 14) and a non-general testamentary power to appoint,[2] exercisable by her will, "to and among my [Harry's] issue". Lois's power of appointment as provided in the 1971 Trust Agreement did not authorize her to appoint payments to charity.
>
> > [1] The Trust Agreement was first executed in 1971, so the parties refer to it as the "1971 Agreement" or the "1971 Trust Agreement". However, to avoid possible confusion, we do not title it and it appears that the earliest version in our record is from 1987 (Doc. 34 at 7), and that the latest modification is from 1991 (Doc. 34 at 87). Using the 1987 version and the subsequent modifications, petitioner has created for use in this case "a composite trust instrument of the Harry R. Horvitz Revocable Trust, originally established by Harry R. Horvitz on September 27, 1971, which includes a complete recitation of the terms of the trust as amended through his death." (See Doc. 35 at 3, para. 4, and Exhibit A thereto.) The Commissioner does not dispute petitioner's composite, and it appears that the terms of the various trusts are not in dispute.
> >
> > [2] We understand that Harry's estate made both a QTIP election and a reverse QTIP election, thereby establishing the "LUH QTIP Trust" and the "LUH Reverse QTIP Trust". Consequently, Lois technically had two separate life estates and was also the holder of two separate non-general powers of appointment. Because the parties refer

[2962] Spica, "Conflict of Laws and the Transitivity of the 'Relation Back' of Special Powers of Appointment," 56 *Real Property, Trust and Estate Law Journal* 333 (Fall/Winter 2021).
[2963] See part III.B.2.h.i Who Is the Grantor, especially fn 6620.
[2964] See part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts, especially the text following the text accompanying fn 6354.

to Lois's life estates and powers in the singular as if they were one life estate and one power, however, we also in this order refer to both in the singular.

II. *Trustees' powers*

As to these First QTIP Trusts in particular, Article FIRST B(2)(b) ("Federal Marital Trust") of the HRH Trust Agreement (creating the First QTIP Trusts) gave the Trustee the following power:

> [T]he Trustee may, at any time or from time to time, pay to or apply for the benefit of Lois so much or all of the principal ... as the Trustee, in its sole discretion, deems necessary or desirable for her <u>support, maintenance, health, comfort or general welfare</u>, including, without limitation, for any <u>medical emergency</u>. [Doc. 35 at 10.]

As to all four trusts, Article THIRD B ("Permissible Uses and Applications"; Doc. 35 at 19-20) of the HRH Trust Agreement described the Trustees' powers with language that was similar but that included: (1) "education", (2) an additional parenthetical elaborating on "general welfare", and (3) an authorization to "pay principal to a trust". The powers of the Trustees for all four trusts (including the QTIP trusts) are described as follows:

> Any authorization to the Trustee to pay or apply income or principal of any trust to or for the benefit of any beneficiary shall be deemed an authorization to make payments or applications of income or principal for the support, maintenance, health, <u>education</u>, comfort or general welfare of the beneficiary (including, but not limited to, payments or applications to enable the beneficiary to purchase a residence, invest in a business, make <u>transfers that serve estate or tax planning objectives</u>, or engage in any other activity deemed by the Trustee to be in the <u>best interests of the beneficiary</u>). An authorization to apply principal to or for the benefit of a beneficiary shall include <u>authority to pay principal to a trust</u> for the benefit of that beneficiary.... [Doc. 35 at 19-20.]

When Harry died in 1992, his estate funded the four trusts established under the HRH Trust Agreement, as revised and restated. As we have noted, under each of the two First QTIP Trusts, Lois had a life estate and a power of appointment ("to and among my [Harry's] issue") that did not include charitable organizations as permissible appointees.

III. *Second QTIP Trusts*

In 2013 the trustees of the "First" trusts "decanted" the assets to the "Second QTIP Trusts". The powers of the trustees of the Second QTIP Trusts (see Doc. 34 at 103, 109) were identical to those for the First QTIP Trusts (given in the two blocked quotations in Part II above).

Under the Second QTIP Trusts, Lois had, as under the First, a life estate. But under the Second trusts her power of appointment was not identical to that of the First (i.e., "to and among my [Harry's] issue") but rather was expanded: The Second QTIP Trusts gave her the power to appoint, by her will or similar instrument, the balance "to and among Harry's issue and/or charities that are qualified to receive charitable contributions that are deductible for either federal income or federal estate tax purposes."

IV. *The charitable contributions*

In 2013 Lois exercised her testamentary non-general power and directed that assets be contributed to charitable organizations upon her death. (Doc. 34 at 153-154.)

When Lois died in 2015, that exercise became effective, and the trustees made transfers to the charitable organizations.

On its estate tax return, Lois's estate claimed deductions for the charitable contributions. The IRS disallowed the deductions and issued a notice of deficiency; and the estate filed a petition in the Tax Court.

V. *Tax Court proceedings*

As this case has proceeded, the Commissioner has undertaken discovery of the facts about the decanting. He previously filed a motion (Doc. 23) for leave to take a deposition of the trustee of the QTIP trusts, in which he stated: "At issue in this case is whether the Decanting was permissible under Ohio law. … [The proposed deponent] has the requisite knowledge of and involvement with the Decanting to give testimony and produce documents or electronically stored information that are discoverable within the meaning of Rule 70(b)." We initially observed (see Doc. 25 at 3) that the motion "seems to indicate that the issue about which deposition testimony is sought is legal (i.e., 'whether the Decanting was permissible under Ohio law'). We do not see how testimony on that subject would be proper. It would seem that instead we should examine the documents for their objective import and that subjective testimony about the settlor's intentions would be irrelevant." We therefore denied that motion. (See Doc. 38.)

Petitioner filed a motion (Doc. 32) for partial summary judgment, and the Commissioner filed a motion (Doc. 47) to compel discovery, seeking, first, "all documents respecting the Decanting." Petitioner has produced documents in response to this request, but has withheld certain documents pursuant to claims of irrelevance, attorney-client privilege, and attorney work product. Petitioner produced a "log" giving information about the documents withheld, and asserting that some of the documents accounted for are in fact not responsive to the document request.

In response to the claims of privilege, the Commissioner seeks, second, "the engagement letters evidencing the existence of all claimed attorney-client relationships held by petitioner and the Trustees". That is, he disputes the existence of the attorney-client relationship. He asks us to resolve the objections by viewing in camera the several thousand documents that are in dispute, and the Commissioner expresses no objection to in camera inspection.

Discussion

We are not yet ready to rule on the Commissioner's motion to compel (nor the petitioner's motion for partial summary judgment), and we will benefit from argument by the parties on the following subjects:

VI. *Relevance of documents about the decanting*

A. *Beliefs and legal opinions*

As the parties may have anticipated from our previous orders (Docs. 25, 38), we do not understand the relevance of the documents that show opinion about the effect of the 2013 decanting. As we stated before, it seems that “we should examine the documents [i.e., the 1971 Trust Agreement and its modifications, and the Second QTIP Trusts] for their objective import”. The Commissioner argues that certain circumstances of the decanting show that “the Original Trustees [under the HRH Trust Agreement, i.e., Lois and the children of Lois and Harry] had reason to believe the Modification and Distribution [i.e., the decanting] was not permissible under ‘the trust instrument and applicable law.’” At issue, however, is the actual effect of those documents - not the individuals’ beliefs and legal opinions about the effect of the documents.

The Commissioner is correct in citing Rule 70(b) to assert that “[i]nformation is discoverable if it appears reasonably calculated to lead to discovery of admissible evidence.” (Doc. 47, para. 31.) But even when we consider relevance from this broadened perspective, the discovery still seems misdirected. If under the HRH Trust Agreement and Ohio law the decanting was not permissible, then evidence showing the Trustees’ mistaken belief that it was permissible would not change the outcome; it was simply not permissible. Or if the decanting was permissible, then evidence showing the Trustees’ doubts about its permissibility would not change the outcome; it was simply permissible. We do not see how factual testimony or other documents such as the Commissioner seeks could affect the outcome of this case. Perhaps the Commissioner can show that our tentative conclusion is in error.

B. *Intent other than the settlor’s intent*

Although the Commissioner seeks information about the 2013 decanting, he acknowledges that “the settlor’s intent is relevant to determine whether a trustee has absolute power to distribute principal” (Doc. 55, para. 24). If that is so, then it would appear that, to the extent Harry’s subjective intent is relevant, that intent must be derived from the four corners of the HRH Trust Agreement. Or perhaps, if that document reflects an ambiguity as to which Ohio law might permit parol evidence to be consulted (a legal proposition the parties have not demonstrated), then Harry’s intent would have to be divined from evidence in 1971 to 1991 – but not, it would seem, from documents generated at the time of the decanting in 2013, more than 20 years after his death.

But the Commissioner apparently does not seek documents created during or near the time that the settlor executed the HRH Trust Agreement and its modifications in 1971-1991,[3] nor at any time during his life, but rather “all documents respecting the Decanting” in 2013, i.e., 21 years after the settlor died in 1992. We do not see how this relates to discovering and proving the relevant intent.

[3] The Commissioner quotes Pack v. Osborn, 881 N.E.2d 237, 241 (Ohio 2008), which states: “When determining the settlor’s intent, an inter vivos trust ‘speaks from the date of its creation - not the date upon which the assets are distributed.’ Thus, a trust is construed according to the law in effect at the time it was created.” (Citations omitted).” (Doc. 55, para. 24.) In this case, the trust was first created in 1971, but the settlor

modified, ratified, and affirmed it multiple times through 1991, so we assume arguendo that the settlor's intent over this 20-year period might be relevant.

C. *Lois's intent*

The Commissioner may have made one particular contention about the intention of someone other than Harry that merits particular attention. Not in his motion to compel but in his opposition to the motion for partial summary judgment, the Commissioner asserts (citing and quoting a 2013 email) that there is a factual issue as to "[w]hether the Modification and Distribution was undertaken to facilitate Lois' purported desire to leave additional assets to charity" or instead "was devised to allow Lois' children to retain control over the trust assets." (Doc. 48 at 6.)

It is possible that we misunderstand this contention. There seems to be no dispute that Lois exercised her power of appointment to transfer the trust residues to charities and that, upon her death, the transfers were made, and we do not perceive any contention that Lois lacked competence to exercise the power. Instead, the contention seems to be that a charitable contribution actually made is nonetheless rendered nondeductible if it arose in conjunction with estate-planning motives. Perhaps the Commissioner can clarify this contention and can explain whether discovery is sought on the basis of it.

D. *Deductibility of an improper contribution*

More fundamentally, we do not see how even a demonstrated defect or error in the Trustees' exercise of their powers could be relevant here. For present purposes we assume arguendo (1) that the 2013 decanting was improper because it frustrated Harry's subjective intention, or violated the express terms of the HRH Trust Agreement, or exceeded the trustees' powers under Ohio law, or contradicted the best interests and entitlements of the remote beneficiaries, or all of the above, and (2) that therefore the 2015 charitable contributions should not have been made. Nonetheless, the Commissioner apparently does not dispute that the charitable contributions were made.

As far as our record shows, there was no contest asserted as to the 2013 decanting (accomplished almost 10 years ago) or the 2015 contributions (accomplished almost 8 years ago). Presumably, a disappointed beneficiary whose interest might have been affected by either or both of these acts could have challenged them in the appropriate Ohio court, but as far as we know, none did.[4]

[4] The Commissioner's filings show that Lois and Harry's three children all participated in the decanting for the purpose of facilitating the charitable contributions; and that at least one of those children communicated candidly with his own children (Harry and Lois's grandchildren) about the plan. Neither party has discussed the possibility of a contest, so neither has suggested what the statute of limitations might be for such a contest. Perhaps it is the 2-year period in Ohio Rev. Code § 5810.05 ("Limitations period for action against trustee"). If the Commissioner contends that such a challenge is still possible (or is underway) and that this might affect the allowability of the charitable contribution deduction, then we would benefit from hearing that contention.

We know of no authority for the proposition that, in support of disallowing an estate tax deduction for a charitable contribution, the Commissioner may advance a collateral attack (not made by anyone with standing) against the propriety of the contribution.

Another sort of deduction by an estate - say, for administration expenses - might be disallowed for tax purposes, even if the expense was demonstrably incurred and paid, if the expense was not “allowable by the laws of the jurisdiction”. § 2053. But we know of no such grounds for disallowance of a deduction for a charitable contribution deduction, and we would benefit from further discussion of this issue. The contribution at issue here appears to be plainly described in Section 2055(a)(2). Section 2055(e) does provide for “Disallowance of Deductions in Certain Cases”, but we do not see in that subsection the circumstances of this case.

If impropriety of a contribution is not a ground for disallowing a deduction, then it would seem that discovery undertaken to demonstrate an impropriety would be irrelevant or immaterial. If impropriety is indeed a ground for disallowing a deduction, then we would benefit from learning about this from the parties.

VII. *Privilege claims*

As we have noted, petitioner has withheld certain information from discovery, contending that it is subject to attorney-client privilege and/or attorney work product, and contending that some of the documents in dispute are “nonresponsive” to the requests (so that the information in those documents would be irrelevant). The Commissioner disputes all these contentions. Several thousand documents are at issue. We see two possible resolutions of these disputes:

First, if we persist in our tentative conclusions suggested above in Parts VI.A-D above, then presumably none of the remaining discovery would be proper and we should deny the motion to compel. If the Commissioner disputes that hypothesis (that is, if he argues for relevance even if I.A-D are confirmed), then we will benefit from his explanation of the remaining relevance.

Second, if we conclude that discovery should continue, the daunting prospect of in camera inspection of thousands of documents inclines us to attempt to resolve or narrow the dispute by the parties’ use of a “quick peek” procedure. The procedure is designed and intended to minimize the costs and delays associated with reviewing large volumes of documents that are, or might be, subject to disputed claims of privilege. Such procedure is facilitated by Federal Rule of Evidence 502(d) which provides:

> (d) <u>Controlling Effect of a Court Order</u>. A federal court may order that the privilege or protection is not waived by disclosure connected with the litigation pending before the court - in which event the disclosure is also not a waiver in any other federal or state proceeding.

This procedure might enable the Commissioner to discern many documents that are in fact of little interest to him, and the parties could then focus on the smaller number of documents that really matter. If the parties are unable to come to full agreement, then the remaining documents for the Court to consider would be a more manageable number.

The parties should consult with each other to attempt to agree on terms that they would jointly recommend to the Court. A sample of such an order can be seen online in *Guidant LLC v. Commissioner*, No. 5989-11 (Order, May 24, 2016).

VII. *Summary judgment merits arguments*

In his reply as to his motion to compel, the Commissioner argues (see Doc. 55, ¶ 23) that "Petitioner would have the court ignore the totality of the transaction." This argument concludes with petitioner's assertion (¶ 41) that "respondent's discovery bears upon material factual issues in this case". It appears, however, that these arguments pertain to the merits of petitioner's motion for summary judgment as much as (or perhaps more than) they pertain to the motion to compel. The parties disagree about whether the HRH Trust Agreement confers on the QTIP trustees a power that is subject to an ascertainable standard, as the Commissioner contends, or that instead is non-ascertainable (or "absolute"), as petitioner contends. The Commissioner seemed to reserve to his reply in support of his motion to compel his most pointed discussion on the point.

A. *Ascertainable standard*

As we understand the parties' disagreement, petitioner cites Ohio Rev. Code § 5801.01(B), which defines "ascertainable standard" as "a standard relating to an individual's health, education, support, or maintenance within the meaning of section 2041(b)(1)(A) or 2514(c)(1) of the Internal Revenue Code." Petitioner considers it significant the powers given to the QTIP trustees in the HRH Trust Agreement go beyond this list of four permissible expenditures and argues that, in so doing, the HRH Trust Agreement confers a power that exceeds the "ascertainable standard" and is therefore non-ascertainable.

The Commissioner rejoins (see Doc. 55, ¶¶ 28-31) with the position (as we understand it) that, at the time Harry was creating (and revising) the HRH Trust Agreement, a different statute was in effect: Ohio Rev Code § 1340.22(B)(2) defined (until 2007) a standard that was somewhat broader but was still an "ascertainable standard":

> Any power conferred upon a fiduciary that permits the fiduciary to make discretionary distributions of either principal or income and that is expressed in terms of a beneficiary's health, education, support, comfort, care, comfort and support, support in reasonable comfort, support in accustomed manner of living, maintenance, maintenance in health and reasonable comfort, or any combination of those factors, is a power conferred upon the fiduciary, the exercise of which is reasonably measurable in terms of, and limited by, an ascertainable standard related to the health, education, support, and maintenance of the beneficiary.

That is, if a trust confers power in addition to the conventional "HEMS" standard (health education, maintenance, or support), then under the law as it existed when Harry executed the HRH Trust Agreement, the power may nonetheless remain an "ascertainable standard" even if it adds "comfort", as the HRH Trust Agreement did.

However, "comfort" is not the only difficulty with the Commissioner's position. As we point out in Part II above, the HRH Trust Agreement conferred on the Trustee of the First QTIP Trusts not only the conventional HEMS standard plus "comfort" but also the power to make payments for "general welfare" and "payments or applications to enable the beneficiary to purchase a residence, invest in a business, make transfers that serve estate or tax planning objectives, or engage in any other activity deemed by the Trustee to be in the best interests of the beneficiary)." The addition of "general welfare" as broadly defined to include a catch-all of “best interests” seems to go well beyond the (now repealed) Ohio Rev. Code § 1340.22(B)(2).

The Commissioner also cites case law, but by his description, Finlay v. United States, 752 F.2d 246 (6th Cir. 1985), involved a surviving spouse who, because she was the sole trustee, was deemed under State law to be “limited to her support and maintenance” despite an ostensibly broader standard in the instrument. Likewise, he describes Toledo Trust Co. v. United States, unreported Case No. 86-7160 (N.D. Ohio, 1987), as following Finlay where the surviving spouse was not herself the sole trustee but had “the power to remove and replace the trustee,” which seems to be broadly equivalent to being the trustee. He also cites “see also” cases to the same effect. In each of these cases the court seems to impose an “ascertainable standard” limitation not otherwise present where the court concludes that the situation of the surviving spouse makes her, in effect, both a beneficiary and a trustee. Lois was not in that situation. We do not see, in the Commissioner’s filings, citations to statutory or case law authority that would treat as “ascertainable” the broad grants of authority in the HRH Trust Agreement for the Trustee of the First QTIP Trusts, but we invite the Commissioner’s correction or supplementation.

B. *Plural beneficiaries*

The Commissioner argues (Doc. 55, ¶ 26) that the power of the trustees of the First QTIP Trusts is constrained (not absolute) because the HRH Trust Agreement obliges the trustees to serve the best interests of “beneficiaries”, a class that, in the case of the QTIP trusts, would include not only Lois as the owner of the life interest but also the “issue” who would receive any remainder as appointees or takers in default under her power of appointment. (See Doc. 34 at 18, para. (e)(iii).) Thus, the Commissioner argues, the Trustees’ power to distribute to Lois was not absolute but was constrained by the best interests of Harry’s issue.

However, the specific plural “beneficiaries” provisions to which the Commissioner points in his reply (Doc. 55, para. 26) - i.e., “HRH Trust, Articles THIRD M(2) and FIRST B(2)(a)” - do not pertain to the Trustees’ powers to make payments for Lois’s benefit under the First QTIP Trusts (as authorized either by the QTIP provisions themselves in Article FIRST B(2)(b), or by the powers given to trustees generally in Article THIRD B, both of which are quoted above in Part II). Rather, the “beneficiaries” provisions the Commissioner cites pertain instead to the trustees’ specific power to “terminate”[5] the First QTIP Trusts (THIRD M(2), Doc. 35 at 24) and their powers under the By-Pass Trust (FIRST B(2)(a), Doc. 35 at 8). We tentatively conclude that neither of these provisions restricts the trustees’ powers (in FIRST B(2)(b) and THIRD B) to make transfers for Lois’s benefit under the First QTIP Trusts.

[5] As we understand the Commissioner, he does not argue that the 2013 decanting “terminated” the First QTIP Trusts. (As he seems to indicate, a holding of “termination” would, under § 2519, result not in estate tax liability in 2015 but in gift tax liability in 2013 - a liability for which the IRS did not issue a notice of determination.) Rather, the Commissioner evidently cites this provision simply to show that the Trustees did not have absolute power under the HRH Trust Agreement. We assume it is correct that they did not have absolute power under every aspect of the HRH Trust Agreement; but we think that the issue before us now involves the question whether the Trustees had absolute power to distribute principal to Lois during her life under the

specific provisions of the First QTIP Trusts quoted above, not the different powers in THIRD M(2) or FIRST B(2).

> Rather, the truly relevant provisions do not in fact refer to plural “beneficiaries”. Under the First QTIP Trusts, during Lois’s life the trustees have the power (under FIRST B(2)(b), Doc. 35 at 10) to make payments only “for the benefit of Lois” (i.e., “for her support, maintenance, health, comfort or general welfare”). The grant of power to the trustees includes no reference to other “beneficiaries”.
>
> As we have explained, that Trustee power is defined - under the general provisions of THIRD B (Doc. 35 at 19-20), quoted above in Part II - to include the power “to make payments or applications of income or principal for the support, maintenance, health, education, comfort or general welfare of the [singular] beneficiary (including, but not limited to, payments or applications to enable the [singular] beneficiary to ... make transfers that serve estate or tax planning objectives, or engage in any other activity deemed by the Trustee to be in the best interests of the [singular] beneficiary). An authorization to apply principal to or for the benefit of a [singular] beneficiary shall include authority to pay principal to a trust for the benefit of that [singular] beneficiary”. Lois is the sole potential beneficiary of the payment power given in FIRST B(2)(b); and the explanation of that power in THIRD B includes no reference to plural “beneficiaries” and no other reason to suppose that the trustee, when acting under FIRST B(2)(b), must take account of the interests of hypothetical potential beneficiaries who did not exist under that provision.
>
> If we misunderstand the Commissioner’s argument as to plural “beneficiaries” or if we have overlooked provisions that support it, we would benefit from his further argument.

The rest of the order was procedural. The case was settled, with the IRS dropping its arguments of an improper decanting. For a complete analysis, see the Bessemer Trust discussion reproduced in part II.J.4.c.i Estate or Nongrantor Trust Contribution Deduction Requirements. See also Rev. Rul. 73-142, which is reproduced in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts after fn 6352 (IRS prospective recognition even though *Bosch* would not give retroactive effect).

II.J.18.c.ii. Tax Consequences of Decanting

Because decanting originally took the form of distributing from one trust to another, it may be the same as or similar to a trust division. See part II.J.18.a Trust Divisions. Similarly, when a trustee decants by creating a new trust and merging the old trust into it, it can be viewed as a merger. See part II.J.18.b Trust Mergers.

Be sure to consider whether a decanting that reduces a beneficiary’s interest in a trust may be valued under Code § 2702 as a gift of the beneficiary’s entire interest in the trust, without any reduction for what the beneficiary retained. For this rule and trying to plan around it, see parts III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts (whether a trust modification may be a gift) and III.B.7.d Code § 2702 Overview (possible disproportionate consequence of beneficiary making a deemed gift in trust).[2965] What I prefer about decanting over a settlement agreement is that, in a decanting, the beneficiary is not affirmatively consenting and therefore might not be making a gift by not objecting. If a trust

[2965] The latter, especially text accompanying fns 7381-7390.

protector can get comfortable modifying a trust without the beneficiaries' consent, that would be ideal (from the viewpoint of protecting a beneficiary against gift tax for agreeing to a trust modification). In a decanting, the trustee could accompany the exercise of the decanting power with a notice of the decanting along the lines of that described in part II.J.4.j Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure, coupled with the trustee retaining the absolute right to reverse the decanting if a beneficiary objects within the time allotted for making a claim (one year under the Uniform Trust Code, but that time period varies by jurisdiction). Query whether a trust protector can feel comfortable making a modification without doing a settlement agreement, with the theory being that the beneficiaries have no practical ability to sue the trust protector and therefore cannot be making a gift by failing to take action to stop changes in their beneficial interests.

Decanting does not change who is the grantor under the grantor trust rules, even if a beneficiary is deemed to have made a gift.[2966]

ACTEC comments on decanting (http://www.actec.org/resources/comments-on-transfers-by-a-trustee) proposed a revenue ruling saying no new tax ID but do not cite authority for that conclusion. However, they mentioned that Letter Ruling 200607015 treated a decanted trust[2967] as a continuation of the original trust.[2968] On the other hand, they also referred to Letter Ruling 200736002, which involved a trust division and also treated the division as being a continuation and not a distribution,[2969] but the three successor trusts were treated as different

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[2966] See part III.B.2.h.i Who Is the Grantor, especially fn 6620.

[2967] Letter Ruling 200607015 described decanting as an inter vivos power of appointment held by a trustee:

> State 1 law permits a trustee who has absolute discretion, under the terms of a trust, to invade the principal for the benefit of one or more proper object of the exercise of the power, to exercise such discretion by appointing all or part of the principal of the trust in favor of a trustee of a trust under an instrument other than that under which the power to invade is created or under the same instrument, provided, however that the exercise of such discretion does not reduce any fixed income interest of any income beneficiary of the trust and is in favor of the proper objects of the exercise of the power. The State 1 law provides that the trustee may act without the consent of any interested person and without prior court approval. The Trustees herein represent that they will petition the appropriate court and provide notice to all interested parties.

However, section 2(17) of the Uniform Trust Decanting Act takes a different approach:

> "Power of appointment" means a power that enables a powerholder acting in a nonfiduciary capacity to designate a recipient of an ownership interest in or another power of appointment over the appointive property. The term does not include a power of attorney.

Rather, section 2(10) of the Uniform Trust Decanting Act views decanting as a fiduciary distribution:

> "Decanting power" or "the decanting power" means the power of an authorized fiduciary under this [act] to distribute property of a first trust to one or more second trusts or to modify the terms of the first trust.

[2968] Letter Ruling 200607015 held:

> Based solely on the facts and the representations submitted, we conclude that the trustees' appointment of the four Trusts into four New Trusts will not be viewed as a distribution or termination under § 661 or § 1.661(a)-2(f)(1) and should therefore not result in the realization by the Trusts, the New Trusts, or any beneficiary of any of the Trusts of any of the New Trusts, of any income, gain , or loss under §§ 661 and 662.

[2969] Letter Ruling 200736002 held:

> Based upon the facts submitted and the representations made, we conclude that because the creation of the successor trusts is a modification of Trust for Federal income tax purposes, the successor trusts are treated as a continuation of Trust. Therefore, the transfer of assets from Trust to the successor trusts will not be treated as a distribution or termination under § 661, and

trusts from each other, which means that at least two trusts needed to get new tax IDs. So I don't know how much to read into whether being considered a continuation trust would require a tax ID.

Letter Ruling 201442047 held that decanting an ESBT required a new ESBT election for the second trust.[2970] The facts were:

> Specifically, Trust1 was established as an irrevocable trust under the laws of State by A, as settlor, for the benefit of A's son, B. B was the sole beneficiary of income and principal under the trust instrument for Trust1, and no other current or contingent beneficiaries were provided for under the trust instrument. In addition, no interest in Trust1 was acquired by purchase. On Date4, A established Trust2 , an irrevocable trust under the laws of State for the benefit of B. X represents that Trust2 met all of the requirements under § 1.1361-1(m)(1) to be treated as an ESBT. B was the sole beneficiary of income and principal under the trust instrument for Trust2, and no other current or contingent beneficiaries were provided for under the trust instrument. In addition, no interest in Trust2 was acquired by purchase. X represents that, pursuant to authority provided under the trust instrument for Trust1, the shares in X held by Trust1 were transferred to Trust2 effective Date5. X further represents that each of the then shareholders of X also expressly consented to this transfer.
>
> X represents that Trust2 was established because Trust1 did not provide authority for the original trustees to designate successor trustees. Instead, pursuant to the trust instrument for Trust1, when both of the original trustees were no longer able to serve as trustees, the successor trustee would be C or C's legal successor. Because Trust1 was an irrevocable trust and its terms could not readily be amended, A established Trust2 as a new trust with the same original trustees, but with a new provision in the trust instrument for Trust2 authorizing the trustees to designate their successors as trustees.
>
> However, when the trustees transferred the X stock from Trust1 to Trust2 effective on Date5, the trustees failed to timely make the election under § 1361(c)(2)(A)(v) to treat Trust2 as an ESBT effective on Date5. X represents that X was unaware of the failure of the trustees to make this ESBT election on behalf of Trust2.
>
> X represents that X and X's shareholders have filed tax returns consistent with X being an S corporation since Date2, except for the fact that Trust2 had not filed its fiduciary income tax returns consistent with it being an ESBT. For the tax year beginning on Date5, Trust2's fiduciary income tax return incorrectly indicated that Trust2 was a "Complex Trust" rather than an ESBT. In addition, the items reported on Trust2's fiduciary income tax return were reflected on that return consistent with the treatment of Trust2 as a Complex Trust rather than as an ESBT. The same error was repeated in subsequent tax years for Trust2 until Year. X represents that once this mistake was discovered in Year, Trust2's fiduciary income tax return has been prepared and filed consistent with Trust2's treatment as an ESBT.

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will not result in the realization by Trust, the successor trusts, or by any beneficiary of Trust or the successor trusts of any income, gain, or loss.

[2970] For what an ESBT is, see part III.A.3.e.ii Electing Small Business Trusts (ESBTs.

Letter Ruling 201442047 held:

> Based solely on the facts submitted and the representations made, we conclude that the termination of X's S corporation election on Date5 was inadvertent within the meaning of § 1362(f). We further hold that, pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from Date5 and thereafter, provided that X's S corporation election was valid and provided that the election was not otherwise terminated under § 1362(d) for reasons not addressed in this letter.

Combination merger and decanting: When identical trusts merged into a new trust that was identical other than administrative trustee issues, Letter Ruling 200743022 held no change in grandfathered-GST status and:

> In this case, State Statute clearly authorizes the consolidation or merger of trusts by the trustees where the merger or consolidation is in the best interests of the beneficiaries. Moreover, the terms of the trust instruments establishing the original trusts authorize the trustees to execute the necessary documents in order to carry out the powers granted the trustees with respect to the transfer of assets from the trusts. By virtue of the trust powers granted to the trustees under the State Statute and the original trust instruments, the trustees of the original trusts are authorized to merge the assets into the new trusts and to transfer trust assets from the original trusts to the new trusts. Consequently, the beneficiaries of the new trusts are acquiring their interests in the new trusts by reason of the exercise of the trustees' existing authority under state law to merge or consolidate the original trusts and to transfer the trust assets in furtherance of this merger. The beneficiaries are not therefore acquiring their interests in the new trusts as a result of the exchange of their interests in the original trusts, or as the result of an exchange of interests between themselves. Accordingly, there does not appear to be any reciprocal exchange involving the legal rights and entitlements of the beneficiaries under the trusts here. Because no "exchange" has occurred for purposes of § 1001, it is unnecessary to analyze whether the "materially different" standard has been satisfied.
>
> We therefore conclude that the proposed mergers of the original trusts into the new trusts, and the transfer of assets from the original trusts to the new trusts, will not cause the original trusts, the new trusts, or any of the income beneficiaries to recognize any gain or loss under § 1001 from a sale or other disposition of property. Because § 1001 does not apply to the division of Trust 1 assets, under § 1015 the basis of the trust assets will be the same after the proposed transaction as the basis of those assets in the original trusts. Furthermore, pursuant to § 1223(2) the holding periods of the assets in the hands of the new trusts will include the holding periods of the assets in the hands of the original trusts.

Letter Ruling 201642028 involved the following facts:

> On Date 1, a date prior to September 25, 1985, Husband and Wife created five irrevocable trusts with substantively similar terms for different beneficiaries. Trust 1 was created for the primary benefit of Grandchild 1, Trust 2 was created for the primary benefit of Grandchild 2, Trust 3 was created for the primary benefit of Grandchild 3, Trust 4 was created for the primary benefit of Daughter, and Trust 5 was created for the primary benefit of Grandchild 4.

Article I of Trust 1 provides that the trustees are to pay to or for the benefit of Grandchild 1 so much of the net income from Trust 1 as the trustees in their sole discretion shall determine to be necessary and desirable to provide for the health, education, maintenance, and support (HEMS) of said beneficiary. In the event that net income is not sufficient to provide for the health, education, maintenance, and support of said beneficiary, then the trustees may use such part of the principal as, from time to time, in their sole discretion, they may determine to be necessary for such purposes.

Article II of Trust 1 provides that, upon the death of Grandchild 1, the trustees are to pay to or for the benefit of the issue of Grandchild 1 such part of the net income from Trust 1 as the trustees in their sole discretion shall determine to be necessary and desirable to provide for the health, education, maintenance, and support of such issue. In the event that the trustees determine that the net income is not sufficient to provide for the health, education, maintenance, and support of any one or more of such issue, then the trustees may use such part of the principal as, from time to time, in their sole discretion, they may determine to be necessary for such purposes.

Article III of Trust 1 provides that, in the event that Grandchild 1 and all issue of Grandchild 1 shall die prior to the final distribution of Trust 1 properties, the remaining Trust 1 properties, principal, and any accumulated income, shall be paid over and delivered in equal shares among the other trusts (Trust 2, Trust 3, Trust 4, and Trust 5) then in existence.

Article XII of Trust 1 provides that Trust 1 will terminate 21 years after the last to die of Grandchild 1, Grandchild 2, Grandchild 3, Daughter, or Grandchild 4. Upon termination, all of the properties remaining in Trust 1 shall be distributed to the then living beneficiaries of Trust 1, share and share alike.

Trust 1 appoints seven initial individual trustees and Article VIII of Trust 1 identifies seven successor individual trustees of Trust 1. Article VIII of Trust 1 additionally provides that when fewer than four trustees are currently serving, the remaining trustees shall have the power and authority to appoint one or more individuals as trustees, so that at least four and not more than seven individuals may serve as trustees. Further, Article VIII of Trust 1 grants the trustees then serving the power to appoint a bank as successor trustee, to serve thereafter as the sole trustee.

Grandchild 4 died in Year without issue. Pursuant to the terms of Trust 5, the assets remaining after the death of Grandchild 4 were distributed equally among Trust 1, Trust 2, Trust 3, and Trust 4.

Currently, Trust 1, Trust 2, and Trust 3 (the GC Trusts) hold limited partnership interests in LP1 and LP2 and shares of Corporation 1 and Corporation 2. Corporation 1 is a bank holding company and Corporation 2 is a closely-held corporation. Each of the GC Trusts' interests in LP2 and Corporation 2 is a significant percentage (approximately a percent) of the GC Trusts' net value, with the remaining assets consisting of cash and marketable securities.

Currently, Individual 1, Individual 2, Individual 3, Individual 4, Individual 5, and Individual 6 (the current individual trustees) serve as co-trustees of Trust 1, Trust 2, Trust 3, and Trust 4.

On Date 2, Grandchild 1 petitioned State Court, pursuant to State Statute, to modify Trust 1, specifically requesting the appointment of a corporate trustee to replace the current individual trustees. Grandchild 2, Grandchild 3, and Daughter filed similar petitions for modifications to the respective trust of which each is a beneficiary. The petitions allege that the current individual trustees failed to sufficiently communicate with the beneficiaries of the trusts concerning the investment strategies for each of the respective trusts and the respective beneficiary's needs in relation to his or her health, education, support, and maintenance. In addition, the petitions filed by Grandchild 1, Grandchild 2, and Grandchild 3 allege that the current individual trustees failed to sufficiently diversify trust assets and made questionable investments despite the potential for conflicts of interests. The current individual trustees denied the allegations in the petitions and opposed the request to appoint a corporate trustee for each trust.

After an extended period of negotiations, including mediation, Grandchild 1, Grandchild 2, Grandchild 3, Daughter, and the current individual trustees entered into Settlement Agreement, which State Court approved by order dated Date 3. Settlement Agreement is contingent on the receipt of favorable rulings from the Internal Revenue Service.

Settlement Agreement provides for similar modifications to apply to each of Trust 1, Trust 2, and Trust 3. In regard to Trust 1, Settlement Agreement provides as follows: (1) Trust 1 will be divided into Successor Trust and Trust A; (2) Bank will be appointed to serve as the sole corporate trustee of Successor Trust; (3) Individual 1, Individual 2, and Individual 3 will be appointed to serve as co-trustees of Trust A; (4) Successor Trust and Trust A will have the same beneficiaries in the same proportions as Trust 1; (4) Successor Trust will be funded with the balance of Trust 1 assets after the funding of Trust A; (5) Trust A will be funded with Trust 1's partnership interests in LP1 and LP2 and shares of Corporation 1 and Corporation 2, and $b in cash or other liquid assets; (6) Successor Trust and Trust A will be governed by the same terms found in the Trust 1 instrument, except as modified by Settlement Agreement. Trust 4 will not be divided, but Bank will be appointed to serve as the sole corporate trustee of Trust 4.

Settlement Agreement provides that the trustee provision of Trust 1 will be modified in the trust instrument governing Successor Trust to provide the "distributees" of Successor Trust, upon application to and order of State Court at State Court's discretion, the power to remove at any time and without cause any then-serving corporate trustee of Successor Trust by written notice delivered to such trustee, and the power to replace such trustee with another corporate trustee that—(1) has the power to act as a trustee under the laws of the state governing the administration of the trust; (2) has at least $c in assets under management; and (3) is not related or subordinate, within the meaning of § 672(c), to the "distributees" of Successor Trust. Further, the trustee provision of Trust 1 will be modified in the trust instrument governing Successor Trust to provide the "distributees" of Successor Trust, in the event the then-serving corporate trustee resigns or can no longer serve as trustee, the power to appoint a successor corporate trustee, without application to and approval by State Court, that— (1) has the power to act as a trustee under the laws of the state governing the administration of the trust; (2) has at least $c in assets under management; and (3) is not related or subordinate, within the meaning of § 672(c), to the "distributees" of Successor Trust. The term "distributees" refers to a majority of the competent adult beneficiaries who are at the time authorized to receive distributions of principal or income from the trust.

Settlement Agreement provides that the trustee provision of Trust 1 will be modified in the trust instrument governing Trust A so that the number of individuals serving as co-trustees of Trust A shall be three as of the date of the division of Trust 1 into Successor Trust and Trust A. Upon the first of Individual 1, Individual 2, or Individual 3, to die, resign, become incapacitated, or otherwise fail to serve, the distributees of Trust A will be empowered to select one individual to serve as successor trustee of Trust A. The trustee selected by the distributees will be subject to the approval of the other two then-serving trustees. Succession to the office of trustee for the other two trustees shall continue to be determined by the co-trustees.

Under Settlement Agreement, the beneficiaries of Trust A agree to look to, and the trustees of Trust A agree to utilize, the income and principal of Successor Trust first for the beneficiaries' HEMS distributions. Settlement Agreement provides that the governing instrument of Trust A will provide that in making distributions in accordance with the HEMS standard, the trustees are to take into consideration a beneficiary's distributions of income and principal received from Successor Trust and other sources of income.

Settlement Agreement provides that the beneficiaries of Trust A and the beneficiaries of Successor Trust are and will be the same and each beneficiary has an identical interest in Trust A as he or she has in Successor Trust. However, Settlement Agreement provides that the trustees of Trust A will make all transfers and distributions to the trustee of Successor Trust in order to satisfy any transfers or distributions the trustees of Trust A may be required to make to Successor Trust or its beneficiaries under the governing instrument of Trust A, by law, or under Settlement Agreement, so that no distributions will be made directly from Trust A to the beneficiaries.

The termination date of Successor Trust is the termination date of Trust 1, which is 21 years after the last to die of Grandchild 1, Grandchild 2, Grandchild 3, Daughter, or Grandchild 4. Settlement Agreement provides that the governing instrument of Trust A will provide for a termination date d years after the effective date of Settlement Agreement, unless trustee of Successor Trust elects, after consultation with the distributees of Successor Trust, to extend the termination date of Trust A for an additional e years. Since the sum of d years and e years is less than 21 years, and Grandchild 1, Grandchild 2, Grandchild 3, and Daughter were all alive on the effective date of Settlement Agreement, the termination date of Trust A will be before the termination date of Successor Trust. Upon termination of Trust A, the assets of Trust A will be distributed to the trustee of Successor Trust to form part of the corpus of Successor Trust.

After the modification, both Successor Trust and Trust A continue to be subject to the rule in Article III of Trust 1, which provides that in the event that Grandchild 1 and all issue of Grandchild 1 all predecease the required termination date, the remaining trust assets will be distributed equally to the other trusts (Trust 2, Trust 3, Trust 4, and Trust 5) then in existence.

Under Settlement Agreement, attorneys' fees and expenses incurred by the trustees and beneficiaries relating to the litigation and the Settlement Agreement will be paid or reimbursed by Trust 1, Trust 2, Trust 3, and Trust 4. The direct payments and reimbursements shall be made from each of Trust 1, Trust 2, Trust 3, and Trust 4, pro rata, in relation to the total value of each trust.

> Finally, Settlement Agreement includes several provisions that concern the trustees' administration of Successor Trust and Trust A, such as provisions addressing communications with beneficiaries and conflicts of interest.
>
> The current individual trustees of Trust 1 represent that no other additions have been made to Trust 1 since September 25, 1985.
>
> Under the law of State, in administering a distribution standard tied to the needs of a beneficiary, a trustee will consider all income enjoyed by the beneficiaries from any and all sources, so long as it is available for support of the beneficiary. Citation.

As to GST issues, Letter Ruling 201642028 concluded:

> With regard to the proposed modifications of Trust 1, we conclude:
>
> a The division of Trust 1 pursuant to the terms of Settlement Agreement will not shift any beneficial interest in Trust 1 to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the division. In addition, the division will not extend the time for vesting of any beneficial interest in Trust 1 beyond the period provided for in the original trust. Therefore, the two trusts resulting from the division, Successor Trust and Trust A, will not be subject to the provisions of chapter 13.
>
> b The modification of Trust 1 pursuant to the terms of Settlement Agreement to provide for a change in trustee and to modify the trustee succession procedures is viewed as pertaining to the administration of the trust, comparable to the administrative modification in Example 10 of § 26.2601-1(b)(4)(i)(E).
>
> c In addition, all other terms and trust modifications set forth in Settlement Agreement (including the trustee procedures regarding HEMS distributions, the payment of attorneys' fees, trustee communications with beneficiaries, and conflicts of interest) are viewed as administrative in nature and, under § 26.2601-1(b)(4)(i)(D)(2), will not be considered to shift a beneficial interest to a lower generation in the trust or extend the time for vesting of any beneficial interest in the trust beyond the period provided for in Trust 1.
>
> Accordingly, based upon the facts submitted and the representations made, we further conclude that after the division and modification of Trust 1 pursuant to Settlement Agreement, Trust 1, Successor Trust, and Trust A will not be subject to the provisions of chapter 13.

Letter Ruling 201642028 viewed the beneficial interests as not changing, so the modification did not have any gift or estate tax consequences. Because the trustees could make distributions only for ascertainable standards, the right to change trustees also had no estate tax consequences. As to income tax issues:

> … the division of Trust 1 into Successor Trust and Trust A pursuant to the Settlement Agreement will not result in a distribution under § 661 from Trust 1; and accordingly, will not result in gross income to Successor Trust or Trust A under § 662. Additionally, we conclude that a transfer from Trust A to Successor Trust pursuant to the Settlement Agreement that is made for a purpose other than to facilitate a HEMS distribution to a

beneficiary will not result in a distribution under § 661 from Trust A; and accordingly, will not result in gross income to Successor Trust under § 662.

> We further conclude that a transfer from Trust A to Successor Trust for an immediate HEMS distribution to a beneficiary will result in a deduction pursuant to § 661 for Trust A (to the extent of Trust A's distributable net income) and (ii) inclusion of an equivalent amount in the recipient beneficiary's gross income pursuant to § 662.

Letter Ruling 201642028 also allowed the trusts to reimburse the beneficiaries' legal fees and deduct them as Code § 212 expenses:[2971]

> Legal fees relating to the proper investment of trust assets are a function of the management of the trust property and are deductible if they are ordinary and necessary. *Trust of Bingham v. Commissioner*, 325 U.S. 365, 376 (1945). In *Herman A. Moore Trust v. Commissioner*, 49 T.C. 430 (1968), *acq*., 1968-2 C.B. 21, the Service challenged the trustee's deduction of certain attorneys' fees in computing the trust's income. These fees arose from an action brought by the testator's children to accelerate their beneficial interests in the trust. Pursuant to state law, the court ordered that the attorneys' fees for the trust, the beneficiaries and the guardian ad litem be paid from trust income. The court decided that (1) the state court decision aided the trustee in its management of the trust property, and (ii) the trust benefitted by the involvement of the beneficiaries and the guardian ad litem in the litigation. Thus, the court held that all of the litigants' attorneys' fees paid from trust income were deductible under § 212(2).
>
> In the present case, the legal fees paid by beneficiaries seeking to change the trustee of the trust are not payments to acquire, create, or facilitate the acquisition or creation of an intangible. The litigation involved only the proper administration of the trust and not the beneficiaries' ownership interests in the trust. The beneficiaries already had an ownership interest in the trust and were not seeking a redetermination of that ownership interest, but rather, merely a change in the administration of the trust. Therefore the legal fees are not subject to capitalization under § 1.263(a)-4.
>
> Based on the facts submitted and the representations made, we conclude that the purpose of the action brought by the beneficiaries of Trust 1 was to improve the investment of the assets of the trust. Further, Trust 1 benefited by the involvement of the beneficiaries in the proceedings. Thus, subject to allocations under § 1.265-1, we conclude that the attorneys' fees paid by Trust 1, Successor Trust, or Trust A to a beneficiary of Trust 1, Trust 2, Trust 3, Trust 4, or one of the resulting divided trusts pursuant to Settlement Agreement as reimbursement for the beneficiary's prior payment of attorney's fees and expenses will result in a deduction for the reimbursing trust under § 212. Since the attorney's fees and expenses are deductible under § 212, it is implicit that those expenses are not deductible under § 661 or includible by the beneficiaries under § 662.

Letter Ruling 201711002 involved the following facts:

> On Date 1, Settlor established Trust A, an irrevocable trust, for the benefit of Settlor's granddaughter (Granddaughter), Granddaughter's spouse (Spouse), and

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[2971] For Code § 212, see part II.G.4.l.i.(b) Requirements for Deduction Under Code § 212.

Granddaughter's children, GGC1 and GGC2, and Granddaughter's issue. Date 1 is a date before September 25, 1985. Trust A was governed by the laws of State 1.

Trust A provides that, during Granddaughter's life, the trustees shall distribute one-half of the net income to Granddaughter. The corporate trustee, in its absolute discretion, may direct the trustees to distribute the other one-half of the net income to Granddaughter and any of her children or issue. Further, the corporate trustee, in its absolute discretion, may direct the trustees to distribute principal to Granddaughter, Granddaughter's children or issue, but none to Granddaughter's husband, as the corporate trustee deems necessary for the support, maintenance, and education of such person.

Trust A provides that when Granddaughter dies, if Spouse predeceases her, then the corporate trustee, in its absolute discretion, may direct the trustees to distribute the entire net income to Granddaughter's children or issue.

Trust A provides that the trust will terminate (Termination Date) upon the death of the last survivor of Granddaughter, Spouse, GGC1, and GGC2 (measuring lives). Upon termination, the trust will be divided into equal shares to Granddaughter's children as are living at the death of the last survivor and to the then living issue of each child of Granddaughter who is deceased, the issue of each deceased child of Granddaughter to take per stirpes a share equal to the share which a child of Granddaughter would have taken if alive. If upon the Termination Date, there are no living children or issue of Granddaughter, then the trust estate will pass to Settlor's Grandson, and if he is deceased, to Grandson's issue, per stirpes. If none, the trust estate will pass, in equal shares, one-half to University A and one-half to University B.

After Spouse died, on Date 5, Trust A was divided, pursuant to court order and the statutes of State 1, into three separate trusts, one trust to benefit Granddaughter and her issue (Trust A1), one trust to benefit Granddaughter, GGC1 and GGC1's issue (Trust A2), and one trust to benefit Granddaughter, GGC2 and GGC2's issue (Trust A3). Trust A1 received one-half of the assets of Trust A. Trusts A2 and A3 each received one-half of the remaining assets.

Trust A1 provided that during Granddaughter's life, the trustees must pay Granddaughter all of the net income from the trust and the corporate trustee, in its sole discretion, may direct the trustees to distribute so much of the principal to Granddaughter and her issue, as the corporate trustee deems necessary for the support, maintenance, and education of such person. Upon Granddaughter's death, the remaining assets of Trust A1 would be distributed one-half to Trust A2 and one-half to Trust A3. Trust A1 retained the same Termination Date of Trust A. Upon the Termination Date, Trust A1 assets would be distributed in equal shares to Trust A2 and Trust A3. In the event, Granddaughter died without leaving children or issue, Trust A1 assets would be distributed, per stirpes, to Grandson's issue. If none, to University A and University B, in equal shares.

Trust A2 provided that the corporate trustee, in its sole discretion, may direct the trustee to distribute so much of the entire net income to Granddaughter, GGC1 and any of GGC1's issue. Any net income not distributed would be accumulated. Further, the corporate trustee, in its sole discretion, may direct the trustee to pay or expend for the benefit of Granddaughter, GGC1 and GGC1's issue any portion of the net income and so much of the principal as the corporate trustee deems necessary for the support, maintenance, and education of such person. Trust A3 contained the same provisions, except the beneficiaries included Granddaughter, GGC2 and GGC2's issue. Each trust retained the same Termination Date as Trust A. Upon the Termination Date, Trust A2 assets would be distributed to GGC1's children and to the then living issue of a deceased child, such issue to take per stirpes. Upon the Termination Date, the same provisions applied to Trust A3, except that the trust assets would be distributed to GGC2's children or issue. Trusts A2 and A3 also provided that, upon the Termination Date, in the event GGC1 or GGC2 died without leaving issue, the assets in his trust would be distributed in equal shares to his brothers' children or issue. Further, in the event, upon the Termination Date, GGC1 and GGC2 die without leaving children or issue, then the trust assets would be distributed to Grandson's issue. If none, the trust assets would be distributed, in equal shares, to University A and University B.

After Granddaughter died, on Date 6, pursuant to court order and the statutes of State 1, Trust A2 was divided into six separate trusts. Trust 1 benefits GGC1, GGGC1 and GGGC1's issue. Trust 2 benefits GGC1, GGGC2 and GGGC2's issue. Trust 3 benefits GGC1 and GGC1's children and issue. Three other trusts (Trusts X, Y, and Z) were established to benefit GGC1's other children and that child's issue. This private letter ruling pertains to Trust 1, Trust 2, and Trust 3.

Trust 1 provides that the trustees are authorized to distribute so much of the net income, as the corporate trustee determines, in its absolute discretion, to GGC1, GGGC1 and GGGC1's issue. Further, the trustees are authorized to distribute so much of the principal for the support, maintenance, and education of GGC1, GGGC1 and GGGC1's issue, as the corporate trustee, in its sole discretion, determines appropriate. Trust 2 contains the same provisions, except that the beneficiaries include GGC1, GGGC2 and GGGC2's issue. Trust 3 provides that the trustees are authorized to distribute so much of the net income, as the corporate trustee determines, in its absolute discretion, to GGC1 and GGC1's issue. Further, the trustees are authorized to distribute so much of the principal for the support, maintenance, and education of GGC1 and GGC1's issue as the corporate trustee, in its sole discretion, determines appropriate.

Trusts 1, 2, and 3 retain the same Terminate Date as Trust A. Upon the termination Date, Trust 1 assets will be distributed outright to GGGC1, if living. Trust 2 assets will be distributed outright to GGGC2, if living, and Trust 3 assets will be distributed in equal shares to Trusts 1, 2, X, Y, and Z.

On Date 2, Settlor established Trust B, a revocable trust, for the benefit of Granddaughter, GGC1, and GGC2. Trust B was amended and restated on Date 3. Trust B became irrevocable upon Settlor's death on Date 4. Dates 2, 3 and 4 are all dates prior to September 25, 1985. Trust B contains the same income and principal distribution provisions, Termination Date, and dispositive provisions as Trust A, except that Spouse was not a beneficiary or a measuring life.

On Date 5, pursuant to court order and the statutes of State 1, Trust B was divided into three separate trusts, one trust to benefit Granddaughter and her issue (Trust B1), one trust to benefit Granddaughter, GGC1 and GGC1's issue (Trust B2), and one trust to benefit Granddaughter, GGC2 and GGC2's issue (Trust B3). These trusts contain the same provisions as the three divided trusts under Trust A.

After Granddaughter died, on Date 7, pursuant to court order and the statutes of State 1, Trust B2 was divided into six separate trusts. Trust 4 benefits GGC1, GGGC1 and GGGC1's issue. Trust 5 benefits GGC1, GGGC2 and GGGC2's issue and Trust 6 benefits GGC1 and GGC1's issue. Three other trusts (Trusts L, M, and N) were established, one for each of GGC1's other children and each child's issue. This private letter ruling pertains to Trusts 4, 5, and 6.

Trusts 4 and 5 contain the same income and principal provisions, Termination Date, and dispositive provisions as Trusts 1 and 2, respectively. Trusts 6 contains the same income and principal provisions, Termination Date, and dispositive provisions as Trust 3, except that on termination Trust 6 assets will be distributed equally to Trusts 4, 5, L, M, and N. The current trustee of Trusts 1 through 6 is Trustee.

It is represented that no additions, actual or constructive, have been made to Trust A, Trust B, or Trusts 1 through 6 after September 25, 1985.

GGC1 and Trustee propose to establish six new trusts, Trusts 7 through 12, for the purpose of merging Trusts 1 through 6 into the newly established trusts. Trust 1 and Trust 4 benefit GGC1, GGGC1 and GGGC1's issue. Each of these trusts will merge into Trust 7 and Trust 10, respectively. Trusts 7 and 10 will retain the same income and principal distribution provisions as merged Trusts 1 and 4. Trusts 7 and 10 will not terminate until GGGC1 dies, as opposed to upon the death of the last to die of GGC2 and GGC1. However, Trusts 7 and 10 each grant GGGC1 a testamentary general power of appointment to appoint the trust assets of these trusts to GGGC1's issue and the creditors of GGGC1.

Trust 2 and Trust 5 benefit GGC1, GGGC2 and GGGC2's issue. Each of these trusts will merge into Trust 8 and Trust 11, respectively. Trusts 8 and 11 will retain the same income and principal distributions provisions as merged Trusts 2 and 5. Trusts 8 and 11 will terminate when GGGC2's dies, as opposed to upon the death of the last to die of GGC1 and GGC2. However, Trusts 8 and 11 each grant GGGC2 a testamentary general power of appointment to appoint the trust assets of these trusts to GGGC2's issue and the creditors of GGGC2.

Trust 3 and Trust 6 benefit GGC1 and GGC1's issue. Each of these trusts will merge into Trust 9 and Trust 12, respectively. Trusts 9 and 12 will retain the same income and principal distributions provisions as merged Trusts 3 and 6. Upon the death of the last to die of GGC1 and GGC2, Trust 9 will terminate and distribute in equal shares to Trusts 7, 8, X, Y and Z, and Trust 12 will terminate and distribute in equal shares to Trusts 10, 11, L, M, and N.

In addition, Trusts 7, 8, and 9, if not terminated earlier, will terminate on the date required by the rule against perpetuities in State 1 in effect on the date Trust A was created, and Trusts 10, 11, and 12, if not terminated earlier, will terminate on the date required by the rule against perpetuities in State 1 in effect on the date Trust B became irrevocable.

At the time Trusts 7 and 10 terminate, to the extent GGGC1 has not exercised her testamentary general power of appointment, the trustees shall distribute Trust 7 and 10 to GGGC1's then living issue, per stripes, and if no such issue is then living, then to GGC1's issue, per stirpes. Similarly, at the time Trusts 8 and 11 terminate, to the extent

GGGC2 has not exercised her testamentary general power of appointment, the trustees shall distribute Trusts 8 and 11 to GGGC2's then living issue, per stripes, and if no such issue is then living, then to GGC1's issue, per stirpes.

Trusts 7, 8, 10, and 11 each provide for the same default dispositive provisions as Trusts 1, 2, 4, and 5, respectively. To the extent GGGC1 or GGGC2 dies leaving no children or issue of a deceased child, the trust estates pass in equal shares to the trusts established to GGC1's other children. If the trusts for the other children have terminated and there are no other children or issue of deceased children of GGC1, the trust estates of Trusts 7, 8, 10, and 11 will pass to Grandson's issue, and if none, the trust estates will pass one-half to University A and one-half to University B.

It is represented that the purpose of the merger is to retain the assets of Trusts 1 through 6 in further trust after the death of GGC1 and GGC2 and to appoint successor trustees for Trusts 7 through 12. Currently, Trusts 7 through 12 are not funded and it is represented that these trusts will remain unfunded until the mergers. It is represented that all of the current and remainder beneficiaries of Trusts 1 through 6 have consented to the proposed mergers.

Statute 1 provides that a trustee may declare one or more new trusts for the purpose of merging all, or a portion, of an existing trust or trusts with and into the new trust or trusts, whether or not created by the same trustor and whether or not funded prior to the merger, to be held and administered as a single trust if such a merger would not result in a material change in the beneficial interests of the trust beneficiaries, or any of them in the trust.

Statute 2 provides that a trustee, without authorization by the court, may exercise powers conferred by the terms of the trust; and except as limited by the terms of the trust, any other powers conferred by this chapter.

Statute 3 provides that whenever a trust (a transferor trust) is merged with and into another trust (the transferee trust) the separate existence of the transferor trust shall cease and the transferee trust shall possess all of the rights and privileges, and shall be subject to all of the obligations of, the transferor trust.

Note that Trusts 8 and 11 provided earlier termination than the original trusts but grant a general power to the beneficiary whose death would trigger termination. Thus, also they accelerate distribution to the remaindermen, they make that subject to a general power of appointment, thereby diminishing the remaindermen's beneficial interest.

After reviewing the regulations governing trusts grandfathered from GST, including Reg. § 26.2601-1(b)(4)(i)(E), Example (6), Letter Ruling 201711002 held:

In the instant case, although initially administered in State 1, Trusts 1 through 6 have been administered in State 2 since the appointment of Trustee, who has its principal place of business in State 2. Therefore, State 2 law is applicable. The merger of Trusts 1 through 6 (Transferor Trusts) into Trusts 7 through 12 (Transferee Trusts), respectively, is permitted under State 2 law if such merger would not result in a material change in the beneficial interests of the trust beneficiaries. Statute 1. Statute 2 provides that a trustee may act under Statute 1 without authorization by the court. Statute 3 provides that,

> following the merger, the governing instruments of Transferee Trusts control the disposition of the property of their respective Transferor Trusts.
>
> During the lifetime of GGC1 and GGC2, the dispositive terms of the Transferor Trusts and their respective Transferee Trusts are the same. After the merger, Trusts 9 and 12 will terminate upon the death of the survivor of GGC1 and GGC2, Trusts 7 and 10 will terminate on the date of GGGC1's death, and Trusts 8 and 11 will terminate on the date of GGGC2's death. However, Trusts 7, 8, and 9, if not terminated earlier, will terminate on the date required by the rule against perpetuities in State 1 in effect on the date Trust A was created, and Trusts 10, 11, and 12, if not terminated earlier, will terminate on the date required by the rule against perpetuities in State 1 in effect on the date Trust B became irrevocable. In addition, GGGC1 is granted a general power of appointment over Trusts 7 and 10, which will cause Trusts 7 and 10 to be includible the gross estate of GGGC1 at her death under § 2041(a)(2). Further, GGGC1 will be treated as the transferor of the corpus of Trusts 7 and 10 for GST tax purposes under § 2652(a)(1). Similarly, GGGC2 is granted a general power of appointment over Trusts 8 and 11, which will cause Trusts 8 and Trust 11 to be includible in the gross estate of GGGC2 at her death under § 2041(a)(2). Further, GGGC2 will be treated as the transferor of the corpus of Trusts 8 and 11 for GST tax purposes under § 2652(a)(1).
>
> Accordingly, the terms of Trusts 7 through 12 will not extend the time for vesting of any beneficial interest in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property beyond the period provided for in the original trusts, Trust A and Trust B. Moreover, Trusts 7 through 12 will not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the trustee action.
>
> Therefore, based on the facts submitted and representations made, we conclude that upon the merger of Trust 1 into Trust 7, Trust 2 into Trust 8, Trust 3 into Trust 9, Trust 4 into Trust 10, Trust 5 into Trust 11 and Trust 6 into Trust 12, the Transferee Trusts (i.e. Trusts 7 through 12) will be exempt from GST tax under § 26.2601-1(b).

If a decanting constitutes a transfer from one taxpayer to another taxpayer, be sure to make a timely ESBT election.[2972]

II.J.18.d. Trust Commutations

Reg. § 1.1001-1(a), "General rule," begins with and then concludes with:

> Except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained…. The basis may be different depending upon whether gain or loss is being computed. For example, see section 1015(a) and the regulations thereunder. Section 1001(e) and paragraph (f) of this section prescribe the method of computing gain or loss upon the sale or other disposition of a term interest in property the adjusted basis (or a portion) of which is determined pursuant, or by reference, to section 1014 (relating to the basis of

[2972] See Letter Ruling 201941006, described in the text accompanying fn 6008 in part III.A.3.e.ii.(a) Qualification as an ESBT.

property acquired from a decedent), section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010).

Code § 1001(e), "Certain term interests," provides:[2973]

(1) *In general*. In determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.

(2) *Term interest in property defined*. For purposes of paragraph (1), the term "term interest in property" means -

(A) a life interest in property,

(B) an interest in property for a term of years, or

(C) an income interest in a trust.

(3) *Exception*. Paragraph (1) shall not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons.

In other words, under Code § 1001(e)(1), a person who sells a life interest in property, an interest in property for a term of years, or an income interest in a trust receives no basis with respect to the trust's assets and recognizes gain on the entire value. On the other hand, if all of the beneficiaries get together and simultaneously sell their interests in the trust to a third party, under Code § 1001(e)(3) they would be able to use basis. Also note that Code § 1001(e)(1) and regulations implementing it do not prevent basis from being allocated to remaindermen.

The legislative history for when Code § 1001(e) was first enacted in the Tax Reform Act of 1969 (P.L. 91-172), is as follows (excerpted from BNA):

House Committee Report

[Page 156]

6. Sales of life estates, etc. (sec. 516(a) of the bill and sec. 1001 of the code)

Present law.—Under present law, when a life estate and remainder interest in property are acquired by gift, bequest, or inheritance, a so-called "uniform basis" rule is applied with the basis of the property divided between the life estate and the remainder. (As the life estate is used up each year, its basis is reduced, and the basis of the remainder interest is increased in the same amount—hence, the combined basis of the life estate and the remainder interest remains the same from year to year.)

The life tenant is not permitted to amortize his basis over the length of the life estate because this would reduce for tax purposes the

[2973] In this part II.J.18.d, see text accompanying fn 3000 for additional explanation of Code § 1001(e).

amount of income he receives. However, where the life tenant sells his right to receive future income, his basis in the property may be used in reducing the gain he receives on the sale. In addition, such a life estate (or an estate for a term of years) is frequently treated by the courts as a capital asset, and any amount received upon its sale in excess of the adjusted basis of the life estate is treated as a capital gain. The purchaser of the life estate is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

General reasons for change.—The treatment described above has the effect of allowing a large part, and in some cases, almost all of the income from a life estate or similar interest acquired by gift, bequest, or inheritance, to avoid taxation in those situations where the life tenant sells his interest. The life tenant is not taxed on the income because he is treated as having a basis in the life estate when he sells it and, in addition, the purchaser of the life estate is not taxed on most of the income because he is allowed to reduce that income by amortizing his basis (his purchase price) in the life estate. Your committee does not believe that income should be allowed to completely escape taxation by this means.

Explanation of provision.—Your committee’s bill provides a new rule for determining the amount of gain or loss from the sale or other disposition of a life interest (or an interest for a term of years) in property or an income interest in a trust. In such a case, the bill provides that any portion of a taxpayer’s adjusted basis determined under sections 1014 or 1015 of the code (dealing with the basis of property acquired by gift, from a decedent, or by a transfer in trust) is disregarded to the extent that the adjusted basis is a portion of the entire adjusted basis of the property.

Thus, where there is a sale or other disposition of a life (or term of years) interest in property, or an income interest in a trust—which was acquired by gift, bequest, inheritance, or by a transfer in trust—there is to be no cost or other basis to offset the proceeds received from the disposition. Accordingly, the person disposing of such an interest is to be required to treat as gain the entire amount he receives from the disposition of his interest, rather than only the excess of the amount received over his basis.

The bill, however, does not change present law in the situation where there is a sale or other disposition of a life or term of years interest in property (or an income interest in trust) which is a part of a transaction in which the entire fee interest is transferred to any person or persons. Thus, where a life tenant and remainderman simultaneously sell the entire fee interest in property in a single transaction, it is to be treated in the same manner as under existing law; the gain each receives is to be measured by the excess of the proceeds received on the disposition over the adjusted basis in the life estate. Your committee believes this exception is appropriate, since in this case the purchaser acquires a single entire interest in the property and, therefore, he is not allowed to amortize the separate life interest. Thus, he is taxed on the income from the property.

Supplemental Report

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SECTION 516. OTHER CHANGES IN CAPITAL GAINS TREATMENT

(a) Sales of life estates and term interests.—Subsection (a) of section 516 of the bill adds a new subsection (e) to section 1001 of the

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code (relating to determination of amount of and recognition of gain or loss).

General rule

Paragraph (1) of new section 1001(e) provides that, in determining the gain or loss from the sale or other disposition of a “term interest in property” (as defined in new section 1001(e) (2)), that portion of the adjusted basis of such interest which is determined under section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gifts and transfers in trust) is to be disregarded to the extent that such adjusted basis is a portion of the entire adjusted basis of the property. Under this provision, a person who sells a term interest in property, such as a life interest, to which new subsection (e) applies and the basis of which is an amount computed by apportioning the basis of such property between the life interest and the remainder interest, may not reduce the amount realized by his adjusted basis in such interest.

Term interest defined

Paragraph (2) of new section 1001(e) defines the term “term interest in property” as an interest which is: (A) a life interest in property, (B) an interest in property for a term of years, or (C) an income interest in a trust.

Exception

Paragraph (3) of new section 1001(e) provides that the rules stated in paragraph (1) of new section 1001(e) do not apply to a sale or other disposition which is a part of a transaction in which a fee interest is transferred to any person or persons. For example, new subsection (e) does not apply to a case in which a life tenant and a remainderman simultaneously sell the entire fee interest in property to a third party in a single transaction.

Example.—A devises Blackacre to B for life, with the remainder to C in fee simple. The fair market value of Blackacre at A’s death is $10,000. B is considered to hold a life interest in property under new section 1001(e) (2) (A). B and C share the $10,000 basis determined pursuant to section 1014. Assume B and C each have a basis under section 1014 of $5,000 for their respective interests. If B sells his life interest in Blackacre to D for $20,000, B is treated as having gain of $20,000 since his $5,000 adjusted basis is disregarded under new section 1001(e)(1).

House Discussion

Congressional Record

(August 7, 1969)

[Page H7132]

Mr. HELSTOSKI * * * * *

23. Capital Gains. —Capital gain and loss treatment is revised in several respects. First, the alternative capital gains tax for individuals was repealed, with the result that in the case of those in the top tax brackets, the rates may rise to as much as 35 percent (or 32½ percent under the new rate structure provided by this bill); second, long-term capital losses of individuals are reduced by 50 percent before being available as an offset against ordinary income; third, the offset against ordinary income in the case of husbands and wives filing separate returns is limited to $500 for each or to the same aggregate amount as if they filed a joint return; fourth, the sale of papers by a person whose efforts created them, or by a person for whom they were produced, is to give rise to ordinary income; fifth, the holding period for capital gains is increased from 6 months to 12 months; sixth, employees' contributions to pension plans, when paid out as a part of a lump-sum distribution, is to be taxed as ordinary income; seventh, life interests are not to be accorded a cost basis when sold; eighth, casualty losses and gains are to be consolidated in determining whether they give rise to ordinary loss or to gain which is consolidated with other section 1231 gains or losses; and ninth, transfers and franchises are not to be treated as giving rise to capital gains if the transferor retains significant rights.

House Action

Summary of H.R. 13270

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6. Sales of Life Estates, Etc.

Present law.—Under present law, when a life estate and remainder interest in property are acquired by gift, by bequest, or through inheritance, the basis of the property is divided between the life estate and the remainder. The owner of the life interest is not permitted to deduct any portion of his basis over the life of his interest and thereby to reduce for tax purposes the amount of income he receives from his interest. However, where the life tenant sells his right to receive future income, his basis in the property may be used to reduce the gain he receives on the sale. The purchaser of the life estate is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

Problem.—This treatment of life estates has the effect of allowing a large portion, and in some cases, almost all of the income from a life estate or similar interest to avoid taxation in those situations where the life tenant sells his interest. This is because the life tenant is not taxed on his income to the extent of his basis and, in addition, the purchaser of this interest is not taxed on most of the income from it because he is allowed to reduce that income by amortization deductions for the purchase price which he pays for the interest. In addition, in some cases the seller's basis has exceeded the amount he received upon its sale, and he has been permitted to take a deductible loss.

House solution.—The bill provides that the entire amount received on the sale or other disposition of a life (or term-of-years) interest in property, or an income interest in a trust (which was acquired by gift, bequest, inheritance, or by a transfer in trust), is to be-taxable, rather than only the excess of the amount received over the seller's basis for his interest. This provision applies to sales or other dispositions after July 25, 1969.

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The House bill, however, does not change present law where a life interest is disposed of as part of a single transaction in which the entire fee interest is transferred (e.g., where a life tenant and remainderman simultaneously join in a sale of the entire property interest) to any person or persons. In such a case, the gain realized by the life tenant is to be measured by the excess of the proceeds received on the disposition over his adjusted basis in the property.

Argument For.—The present tax law has the effect of allowing a large part, and in some cases almost all, of the income from a life estate to avoid taxation in those situations where the life tenant sells his interest. The life tenant is not taxed on the income he receives from the sale because he will usually have a tax basis equal to, or almost equal to, the sales price. This is regarded as particularly undesirable by those who view such transactions as an anticipatory assignment of income rather than as the sale of a property interest.

Argument Against.—A sale of a property interest is involved and therefore it is appropriate in measuring the amount of gain to reduce the proceeds by the amount of the life tenant's basis.

SENATE Finance Committee

Treasury Statements

Hon. Edwin S. Cohen

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Additional changes made by the bill include a provision that life interests received by gift, bequest or inheritance, are not accorded a tax basis when sold. Under the bill, all casualty gains and losses on capital assets and section 1231 property are consolidated for the purposes of determining whether they give rise to an ordinary loss or to a gain which is consolidated with other section 1231 gains and losses. Finally, the bill provides that transfers of franchises will not give rise to capital gain treatment if the transferor retains any significant rights in connection with the transfer.

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In all other respects, we support the capital gain and loss provisions of the bill.

Committee Decisions—Compilation

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Sales of Life Estates.—The Committee also adopted the provision of the House-passed tax bill which relates to the sales of life estates. In general, this provision provides that the entire amount received on the sale or other disposition of a life (or term of years) interest in property, or income interest in trust (whether acquired by gift, bequest, inheritance, or by a transfer in trust), is to be taxable without any reduction for the taxpayer's basis. Presently, only the excess of the amount received over the seller's basis is taxed. The Committee, however, did change the effective date for the provision. Under the Senate version, this provision would become effective as to sales or other dispositions after October 9, 1969 (the House bill would have applied with respect to sales or other distributions after July 25, 1969).

Summary of Bill as Reported by Committee

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8. Sales of Life Estates, Etc.

Present law.—Under present law, when a life estate and remainder interest in property are acquired by gift, by bequest, or through inheritance, the basis of the property is divided between the life estate and the remainder. The owner of the life interest is not permitted to deduct any portion of his basis over the life of his interest and thereby to reduce for tax purposes the amount of income he receives from his interest. However, where the life tenant sells his right to receive future income, his basis in the property may be used to reduce the gain he receives on the sale. The purchaser of the life estate is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

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Problem.—This treatment of life estates has the effect of allowing a large portion, and in some cases, almost all of the income from a life estate or similar interest to avoid taxation in those situations where the life tenant sells his interest. This is because the life tenant is not taxed on his income to the extent of his basis and, in addition, the purchaser of this interest is not taxed on most of the income from it because he is allowed to reduce that income by amortization deductions for the purchase price which he pays for the interest. In addition, in some cases the seller's basis has exceeded the amount he received upon its sale, and he has been permitted to take a deductible loss.

Finance Committee decision.—The House bill and the committee amendments provide that the entire amount received on the sale or other disposition of a life (or term of years) interest in property or an income interest in a trust (which was acquired by gift, bequest, inheritance or a transfer in trust), is to be taxable, rather than only the excess of the amount received over the seller's basis for his interest.

Neither version of the bill, however, changes present law where a life interest is disposed of as a part of a single transaction in which the entire fee interest is transferred to any other persons. This occurs, for example, where a life tenant and remainderman join in the sale of the entire property interest. In such a case the gain realized by the life tenant is to be measured by the excess of the proceeds received on the sale over his basis for his interest.

The House bill would apply to sales or other dispositions after July 25, 1969. The committee amendment moves this effective date up to October 9, 1969.

Committee Report

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8. Sales of Life Estates, etc. (sec. 516(a) of the bill and sec. 1001 of the code)

Present law.—Under present law, when a life estate and remainder interest in property are acquired by gift, bequest, or inheritance, a so-called “uniform basis” rule is applied with the basis of the property being divided between the life estate and the remainder. As the life estate is used up each year, its basis is reduced, and the basis of the remainder interest is increased in the same amount—hence, the combined basis of the life estate and the remainder interest remains the same from year to year.

The life tenant is not permitted to amortize his basis over the length of the life estate and thereby reduce for tax purposes the amount of income he receives. However, where the life tenant sells his right to receive future income, his basis in the property may be used to reduce the gain he receives on the sale.

The purchaser of the life estate, however, is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

General reasons for change.—The treatment described above has the effect of allowing a large part, and in some cases, almost all of income from a life estate or similar interest acquired by gift, bequest, or inheritance, to avoid taxation in those situations where the life tenant sells his interest. The life tenant is not taxed on the income to the extent of the basis which he is treated as having in the life estate when he sells it and, in addition the purchaser of the life estate is not taxed on most of the income because he is allowed to reduce that income by amortizing his basis (his purchase price) in the life estate. In addition, in some cases the seller’s basis has exceeded the amount he received upon its sale, and he has been permitted to take a deductible

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loss. The committee agrees with the House that income should not be allowed to completely escape taxation by this means.

Explanation of provision.—The House bill and the committee amendments, in effect, generally provide that the entire amount received on the sale or other disposition of a life (or term of years) interest in property or an income interest in a trust (which was acquired by gift, bequest, inheritance or a transfer in trust) is to be taxable, rather than only the excess of the amount received over the seller’s basis for his interest.

Specifically, the bill provides that for purposes of determining the amount of gain or loss in such a case, any portion of a taxpayer’s adjusted basis determined under the provisions dealing with the basis of property acquired by gift, from a decedent, or by a transfer in trust (secs. 1014 and 1015) is to be disregarded to the extent that the adjusted basis is a portion of the entire adjusted basis of the property. Thus, there is to be no basis to be offset against the proceeds received on a disposition of this type of interest, and, accordingly, the person disposing of the interest must treat the entire amount he receives from the disposition of his interest as a gain.

Neither version of the bill, however, changes present law in the situation where there is a sale or other disposition of a life (or term of years) interest in property (or an income interest in trust) as a part of a single transaction in which the entire interest in the property is transferred to another person or to two or more other persons jointly. Thus, for example, where a life tenant and remainderman hold all of the interests in property which they simultaneously sell in a single transaction, the transaction is to be treated in the same manner as under existing law; that is, the gain realized by the life tenant is to be measured by the excess of the proceeds received on the sale over his adjusted basis in the life estate. The committee agrees with the House that this exception is appropriate, since in this case the purchaser acquires a single entire interest in the property and, therefore, he is not allowed to amortize the separate life interest. Thus, he is taxed on the income from the property.

Committee Report—Individual Views of Senator Albert Gore

[Page 324]

(3) Sales of life estates.—A fundamental rule of the tax laws is that a person cannot convert ordinary income into capital gain by transferring the right to receive the future income.

An exception to this basic rule has been permitted to develop in the case of a person who has the right to income for life from a trust or other property. Present rules permit such a person to sell his income interest and pay capital gains rates. This result is inconsistent with basic tax rules.

The House bill modified the present rule somewhat by providing that the total amount realized on the sale would be treated as capital gain; that is, there would be no reduction in the gain realized for the taxpayer's basis. This provision merely replaces one inconsistent rule with another.

The proper tax treatment of these transactions is to give the tax-payer the benefit of any basis, but to tax all gain as ordinary income under regular rules dealing with transfer of future rights to receive income. The Senate should adopt the proper rule as a substitute for the House provision.

Senate Action

Summary of Senate Amendments

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8. Sates of Life Estates, Etc.

Present law.—Under present law, when a life estate and remainder interest in property are acquired by gift, by bequest, or through inheritance, the basis of the property is divided between the life estate and the remainder. The owner of the life interest is not permitted to deduct any portion of his basis over the life of his interest and thereby to reduce for tax purposes the amount of income he receives from his interest. However, where the life tenant sells his right to receive future income, his basis in the property may be used to reduce the gain he receives on the sale. The purchaser of the life estate is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

Problem.—This treatment of life estates has the effect of allowing a large portion, and in some cases, almost all of the income from a life estate or similar interest to avoid taxation in those situations where the life tenant sells his interest. This is because the life tenant is not taxed on his income to the extent of his basis and, in addition, the purchaser of this interest is not taxed on most of the income from it because he is allowed to reduce that income by amortization deductions for the purchase price which he pays for the interest. In addition, in some cases the seller's basis has exceeded the amount he received upon its sale, and he has been permitted to take a deductible loss.

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Senate amendments.—Both versions of the bill, in effect, generally provide that the entire amount received on the sale or other disposition of a life (or term of years) interest in property or an income interest in trust (which was acquired by gift, bequest, inheritance or a transfer in trust) is to be taxable, rather than only the excess of the amount received over the seller's basis for his interest.

Neither version of the bill, however, changes present law in the situation where there is a sale or other disposition of a life (or term of years) interest property (or an income interest in trust) as a part of a single transaction in which the entire interest in the property is transferred to another person or to two or more other persons jointly.

The Finance Committee amendments, make only one change in the House bill. They apply to sales or other dispositions after October 9, 1969. The House bill is effective with respect to sales or other dispositions made after July 25, 1969.

HOUSE-SENATE CONFERENCE

Conference Action

Conference Report

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6. Sales of life estates, etc. (sec. 1001 of the code)

The House bill provides that the entire amount received on the sale or other disposition of a life (or term of years) interest in property or an income interest in trust, if such interest was acquired by gift, bequest, inheritance, or a transfer in trust, is to be taxable, rather than only the excess of the amount received over the seller's basis for his interest.

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The provision does not, however, change present law in the situation where there is a sale or other disposition of a life (or term of years) interest in property or an income interest in trust where such sale is a part of a single transaction in which the entire interest in the property is transferred to another person or to two or more other persons jointly.

The Senate amendment makes the provision applicable to sales or other dispositions after October 9, 1969, rather than with respect to sales or other dispositions made after July 25, 1969, as under the House bill.

The conference substitute (sec. 516(a) of the substitute and sec. 1001 of the code) follows the Senate amendment.

POST-ENACTMENT

Joint Committee General Explanation of The Tax Reform Act

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7. Sales of Life Estates, Etc. (sec. 516(a) of the Act and sec. 101 of the code)

Prior law.—When a life estate and remainder interest in property are acquired by gift, bequest, or inheritance, a so-called "uniform basis" rule is applied with the basis of the property being divided between the life estate and the remainder. As the life estate is used up each year, its basis is reduced, and the basis of the remainder

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interest is increased in the same amount; hence, the combined basis of the life estate and the remainder interest remains the same from year to year.

The life tenant in this case is not permitted to amortize his basis over the period of the life estate and thereby reduce for tax purposes the amount of income he reports. However, under prior law, where the life tenant sold his right to receive future income, his basis in the property at the time of sale was used to reduce the gain he received on the sale. The purchaser of the life estate, however, is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

General reasons for change.—The treatment described above had the effect of allowing a large part, and in some cases, almost all of the income from a life estate or similar interest acquired by gift, bequest, or inheritance, to avoid taxation in those situations where the life tenant sold his interest. The life tenant was not taxed on the income to the extent of the basis which he was treated as having in the life estate when he sold it. In addition, the purchaser of the life estate was not taxed on most of the income because he was allowed to reduce that income by amortizing his basis (his purchase price) in the life estate. In some cases the seller's basis even exceeded the amount he received upon its sale, and, as a result, he was permitted to take a deductible loss.

Explanation of provision.—In general, the Act provides that the entire amount received on the sale or other disposition of a life (or term of years) interest in property or an income interest in a trust (which was acquired by gift, bequest, inheritance or a transfer in trust) is taxable, rather than only the excess of the amount received over the seller's basis for his interest.

Specifically, the Act provides that for purposes of determining the amount of gain or loss in such a case, any portion of a taxpayer's adjusted basis determined under the provisions dealing with the basis of property acquired by gift, from a decedent, or by a transfer in trust (secs. 1014 and 1015) is to be disregarded to the extent that the adjusted basis is a portion of the entire adjusted basis of the property. Thus, in the type of situations considered here, there is no basis to be offset against the proceeds received on a disposition of this type of interest; and, accordingly, the person disposing of the interest must treat the entire amount he receives from the disposition of his interest as a gain.

The Act does not, however, change present law in the situation where there is a sale or other disposition of a life (or term of years) interest in property (or an income interest in trust) as a part of a single transaction in which the entire interest in the property is transferred to another person or to two or more other persons jointly. Thus, for example, where a life tenant and remainderman hold all of the interests in property which they simultaneously sell in a single transaction, the transaction is to be treated in the same manner as under existing law; that is, the gain realized by the life tenant is to be measured by the excess of the proceeds received on the sale over his adjusted basis in the life estate. This exception appeared appropriate, since in this case the purchaser acquires a single entire interest in the property and, therefore, he is not allowed to amortize the separate life interest. Thus, he is taxed on the income from the property.

Note that Code § 1001(e) refers to basis determined referring to Code § 1014 (property received by reason of death), 1015 (property received as a gift), and 1041 (property received from a spouse or former spouse). Therefore, it does not apply to the retained interest of the person who creates and transfers a split-interest. However, paragraph (c) in Examples (7) and (8) of Reg. § 1.1014-5(d) imply that the grantor was able to use basis only because all interests in the trust were sold; based on the statute's plain terms, I believe that any such an inference would constitute regulatory overreach (plus, Examples are supposed to illustrate principles set forth in the regulation, and no such inference is set forth anywhere).

Implementing this rule, Reg. § 1.1001-1(f), "Sale or other disposition of a term interest in property," which was adopted by T.D. 7142 (9/23/1971) without any explanation,[2974] provides:

(1) *General rule*. Except as otherwise provided in paragraph (f)(3) of this section, for purposes of determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in paragraph (f)(2) of this section), a taxpayer shall not take into account that portion of the adjusted basis of such interest that is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent), section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010) to the extent that such adjusted basis is a portion of the adjusted uniform basis of the entire property (as defined in § 1.1014-5). Where a term interest in property is transferred to a corporation in connection with a transaction to which section 351 applies and the adjusted basis of the term interest:

(i) Is determined pursuant to sections 1014, 1015, or 1022; and

(ii) Is also a portion of the adjusted uniform basis of the entire property, a subsequent sale or other disposition of such term interest by the corporation will be subject to the provisions of section 1001(e) and this paragraph (f) to the extent that the basis of the term interest so sold or otherwise disposed of is determined by reference to its basis in the hands of the transferor as provided by section 362(a). See paragraph (f)(2) of this section for rules relating to the characterization of stock received by the transferor of a term interest in property in connection with a transaction to which section 351 applies.[2975] That portion of the adjusted uniform basis of the entire property that is assignable to such interest at the time of its sale or other disposition shall be determined under the rules provided in § 1.1014-5. Thus, gain or loss realized from a sale or other disposition of a term interest in property shall be determined by comparing the amount of the proceeds of such sale with that part of the adjusted basis of such interest that is not a portion of the adjusted uniform basis of the entire property.

(2) *Term interest defined*. For purposes of section 1001(e) and this paragraph, a "term interest in property" means -

(i) A life interest in property,

(ii) An interest in property for a term of years, or

(iii) An income interest in a trust.

Generally, subdivisions (i), (ii), and (iii) refer to an interest, present or future, in the income from property or the right to use property which will terminate or fail on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or

[2974] Proposed regulations were published June 24, 1971 at 36 F.R. 12018-12019. They did not include any explanation, either. Reg. § 1.1001-1(f)(3) does not differ from its proposed form; I have not compared the other provisions.
[2975] [My footnote:] Code § 351 is described in part II.M.2.a Initial Incorporation – Generally, which is the beginning of part II.M.2 Buying into or Forming a Corporation.

contingency to occur. Such divisions do not refer to remainder or reversionary interests in the property itself or other interests in the property which will ripen into ownership of the entire property upon termination or failure of a preceding term interest. A "term interest in property" also includes any property received upon a sale or other disposition of a life interest in property, an interest in property for a term of years, or an income interest in a trust by the original holder of such interest, but only to the extent that the adjusted basis of the property received is determined by reference to the adjusted basis of the term interest so transferred.

(3) *Exception*. Paragraph (1) of section 1001(e) and subparagraph (1) of this paragraph shall not apply to a sale or other disposition of a term interest in property as a part of a single transaction in which the entire interest in the property is transferred to a third person or to two or more other persons, including persons who acquire such entire interest as joint tenants, tenants by the entirety, or tenants in common. See § 1.1014-5 for computation of gain or loss upon such a sale or other disposition where the property has been acquired from a decedent or by gift or transfer in trust.

(4) *Illustrations*. For examples illustrating the application of this paragraph, see paragraph (d) of § 1.1014-5.

Reg. § 1.1001-1(f)(3) requires a transfer "to a third person or to two or more other persons, including persons who acquire such entire interest as joint tenants, tenants by the entirety, or tenants in common." This narrows Code § 1001(e)(3), which requires a transfer "to any person or persons."

Although everything above in this part II.J.18.d treats a beneficial interest as an asset, what kind of asset is it? Rev. Rul. 72-243 held:[2976]

> The Internal Revenue Service will follow the decision of the United States Court of Appeals for the Second Circuit in the case of *Beulah Eaton McAllister v. Commissioner*, 157 F.2d 235 (1946), *certiorari denied*, 330 U.S. 826 (1946), which held that the proceeds received by the life tenant of a testamentary trust in consideration for the transfer of her entire interest in the trust to the remainderman, are to be treated as an amount realized from the sale or exchange of a capital asset under section 1222 of the Internal Revenue Code of 1954.

Letter Ruling 8316135 involved the following facts:

> … a ruling is requested concerning the sale of certain interests in L to M, a foreign charity not subject to United States taxation.
>
> The information provided indicates that prior to his death on January 12, 1978, A, your father, created L. It is represented that L, a foreign organization, would be taxable as a trust if it conducted activities in the United States.
>
> Article 1 of the by-laws of L provides that during his life all rights to L's assets and net income thereof belong to A. Article 3 provides that upon A's death, B, A's wife, and you

[2976] Thus, a beneficial interest itself is a capital asset belonging to the beneficiary, whereas the trust's assets are legally titled in the trustee's name and belong to the trust. See fn 2945 in the overview found in part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.

are to share L's net income as equal life beneficiaries. Articles 4 and 5 provide that upon the death of A and B, you or your children, if any, shall have all the rights to L's assets and income. Article 6 provides that the net income and assets of L shall be transferred to M in the event of the death of all other designated beneficiaries. Thus, M presently possesses a contingent remainder interest in L.

> You and B propose to sell your interests in L to M. It is represented that subsequent to this proposed sale, M will own the entire fee interest in L. It is also represented that your adjusted basis in your interests in L, and B's adjusted basis in her interest in L are determined pursuant to section 1014 of the Internal Revenue Code.

Letter Ruling 8316135 held:[2977]

> The exception in section 1001(e)(3) for the simultaneous sale of the life interest and the remainder interest in a single transaction is appropriate because "in this case the purchaser acquires a single entire interest in property and, therefore, he is not allowed to amortize the separate life interest". H. Rep. No. 91-413, 91st Cong., 1st Sess. 157 (1969), 1969-3 C.B. 200, 298.
>
> In the instant case subsequent to its purchase of your interest and B's interest in L, M will own the entire fee interest in L and, thus, would not be able to amortize any portion of this fee interest.
>
> Based upon the information submitted and representations made, we conclude as follows:
>
> 1. The amount of gain or loss you will recognize from your proposed sale of your interests in L will be measured by the difference between the amount realized on the sale of your life interest in L and your remainder interest in L and your adjusted basis in your life estate in L and your remainder interest in L.
>
> 2. The amount of gain or loss B will recognize from her proposed sale of her interest in L will be measured by the difference between the amount realized on the sale of her life interest in L and her adjusted basis in her life estate in L.

Letter Ruling 8316135 did not cite Reg. § 1.1001-1(f)(3) (which was adopted in 1971) or compare it to Code § 1001(e)(3). Implicit in its ruling is that a contingent remainderman qualifies as a "third person." Also, only the life tenants were selling their interests; the ruling was silent as to how the contingent remainderman acquired the other remaindermen's interests.

Letter Ruling 8448059 involved the following facts:

> Your late wife died testate on August 6, 1982. At the time of her death, she owned a certain parcel of improved real estate (the "Real Estate"). Pursuant to her will and codicil the Real Estate was devised and bequeathed as follows: a life estate to you (as "Life Tenant") with the remainder in equal shares to each of A, B, C, and D. Presently, you

[2977] In this part II.J.18.d, see text preceding and accompanying fn 2999 to explain the comment in the legislative history referring to amortization.

> and each of A, B, & C propose to sell your respective life estate and remainder interests to D…

Letter Ruling 8448059 reviewed Reg. § 1.1014-5 - especially Reg. § 1.1014-5(c) - Example (5)(b), and held:

> … if you consummate the proposed sale of your life estate to D, your section 1014 basis will be disregarded (you will have a zero basis for purposes of the sale); your taxable gain will be an amount equal to the sale price of the life estate; and D will have allowable amortization deductions against his basis in the life estate, which may be taken over the period of your remaining life expectancy. (Should D ever convert the property to business use, such deductions will be actually allowed.)

Letter Ruling 8948023 involved the following facts regarding charitable remainder unitrusts:

> A, B, C, and D wish to terminate the trusts. It is represented that M and N have agreed to the proposed termination. It is contemplated that one of the apartment buildings used to fund the Trusts will be sold and some of the proceeds therefrom will be distributed to M and N in satisfaction of their rights to the remainder interests in the Trusts. The balance of the cash and the other apartment building will be distributed to A, B, C, and D in satisfaction of their rights to the unitrusts amounts from the Trusts.

Letter Ruling 8948023 reviewed Reg. § 1.1014-5 – especially Reg. § 1.1014-5(c), Example (5), and held:

> In this case, A and B are selling their interests in Trust 1 to the remaindermen, M and N. C and D are selling their interests in Trust 2 and Trust 3, respectively, to the remainderman, N. Provided the cash and the property interests received by A, B, C, and D are distributed to each of them in accordance with their respective interests in the Trusts, the amount each realizes from the sale of his or her interest in the Trusts is the amount of cash and the fair market value of the property received by each.
>
> Pursuant to section 1001(e)(1) of the Code, the portion of the adjusted uniform basis assigned to the respective interests of A, B, C, and D in the Trusts is disregarded. The exception contained in section 1001(e)(3) is not applicable, because the entire interest in the Trusts' assets is not being sold, or otherwise disposed of, to a third party. A, B, C, and D have no basis in their respective interests in the Trusts.

Citing Reg. § 1.01014-5, Letter Ruling 9512002 discussed an S corporation's sale of a less-than-5% remainder interest in a nongrantor charitable lead trust to a related party:

> In the present case, Corporation's sale to S of its entire reversionary interest in Trust will be contemporaneous with its transfer of Parcels to Trust. Thus, for purposes of determining the amount of gain or loss on the sale of the reversionary interest, the basis of the reversion is computed by multiplying the uniform basis by the appropriate factor to be found in the actuarial tables issued under section 7520 of the Code.

Rev. Rul. 98-8, in addressing the gift tax consequences to the surviving spouse of the acquisition by the surviving spouse of the remainder interest in a trust subject to a QTIP election, recited the following facts:

> The decedent, D, died in 1993 survived by S, D's spouse. Under the terms of D's will, a trust (the QTIP Trust) was established under which S was to receive all of the trust income, payable at least annually, for S's life. On S's death, the remainder was to be distributed outright to C, D's adult child.
>
> S was not given a general power of appointment over the trust property.
>
> On the federal estate tax return filed for D's estate, the executor made an election under section 2056(b)(7) to treat the trust property as QTIP, and a marital deduction was allowed to D's estate for the value of the property passing from D to the QTIP Trust.
>
> Subsequently, S, C, and the trustee of the QTIP Trust entered into the following transaction: (1) S acquired C's remainder interest in the QTIP Trust; (2) S gave C a promissory note in the face amount of x dollars (the value of the remainder interest) for the remainder interest; (3) the trustee distributed all of the QTIP Trust assets (having a value of x + y dollars) to S; and (4) S thereupon paid x dollars from those assets to C in satisfaction of the promissory note.
>
> At the conclusion of the transaction, the QTIP Trust was terminated; S held QTIP Trust assets having a value of y dollars (which was equal to the value of S's life interest in the trust); and C held assets having a value of x dollars (which was equal to the value of the remainder interest in the trust). S contended that the transaction was not subject to gift tax because S received full and adequate consideration (the x dollar remainder interest in the QTIP Trust) in exchange for the x dollar promissory note given by S to C.

Inserting Code § 2519[2978] into the mix, Rev. Rul. 98-8 reasoned:

> The estate tax marital deduction provisions are intended to provide a special tax benefit that allows property to pass to the surviving spouse without the decedent's estate paying tax on its value. Tax is deferred on the transfer until the surviving spouse either dies or makes a lifetime disposition of the property. Under either circumstance, a transfer (estate or gift) tax is paid. *United States v. Stapf*, 375 U.S. 118, 128 (1963), 1964-1 (Part 1) C.B. 535, 537; *Estate of Clayton v. Commissioner*, 976 F.2d 1486, 1491 (5th Cir. 1992); *Estate of Letts v. Commissioner*, 109 T.C. 290, ___ (1997) ("It is a basic policy of the marital deduction that property that passes untaxed from a predeceasing spouse to a surviving spouse is included in the estate of the surviving spouse.")
>
> The statutory scheme of the QTIP provisions is consistent with this congressional intent. Thus, a marital deduction is allowed under section 2056(b)(7) for property passing from a decedent to a QTIP trust in which the surviving spouse possesses a lifetime income interest. Sections 2519 and 2044 act to defer the taxable event on the marital deduction

[2978] See part II.H.2.c QTIP Trusts - Code § 2519 Trap, which cites Rev. Rul. 98-8 at fn 2073. It also mentioned that Letter Ruling 199908033 asserted that the remaindermen's consent to terminating a QTIP trust such that the surviving spouse received all of the property without restriction, without receiving consideration for that consent, constitutes a gift of their remainder interest.

property only so long as the surviving spouse continues to hold the lifetime income interest.

Under section 2519, if a surviving spouse disposes of any part of the qualifying income interest, the spouse is treated as making a gift of the remainder interest in the underlying property (*i.e.*, all interests in the property other than the income interest). Correspondingly, under section 2511, the disposition of the income interest by the spouse is treated as a gift, to the extent the income interest is transferred to another for less than adequate consideration.

The term “disposition,” as used in section 2519, applies broadly to circumstances in which the surviving spouse’s right to receive the income is relinquished or otherwise terminated, by whatever means. See H. Rep. No. 201, 97th Cong., 1st Sess. 161 (1981) that states:

The bill provides that property subject to a [QTIP election] will be subject to transfer taxes at the earlier of (1) the date on which the spouse disposes (either by gift, sale, or otherwise) of all or part of the qualifying income interest, or (2) upon the spouse’s death.

A commutation, which is a proportionate division of trust property between the life beneficiary and remainderman based on the respective values of their interests is, in the context of a QTIP trust, a taxable disposition by the spouse of the qualifying income interest, resulting in a gift under section 2519 of the value of the remainder interest. The commutation of the spouse’s income interest in the QTIP trust is essentially a sale of the income interest by the spouse to the trustee (or the remainderman) in exchange for an amount equal to the value of the income interest. Sales and commutations are expressly characterized as dispositions in the applicable legislative history and regulations. section 25.2519-1(g), Example 2 (illustrating that the sale by the spouse of the spouse’s income interest to the trust remaindermen is a disposition of the income interest); section 25.2519-1(f) providing that “[T]he sale of qualified terminable interest property, followed by the payment to the donee-spouse of a portion of the proceeds equal to the value of the donee- spouse’s income interest, is considered a disposition of the qualifying income interest”. See also, *Estate of Novotny v. Commissioner*, 93 T.C. 12 (1989), in which the surviving spouse and remainderman divided the sale proceeds of QTIP property proportionately on the basis of the respective values of their interests; the court indicated that the commutation constituted a disposition by the spouse of the income interest for purposes of section 2519 and was thus subject to gift tax.

There is little distinction between the sale and commutation transactions treated as dispositions in the regulations and the transaction presented here, where S acquired the remainder interest. In both cases, after the transaction the spouse’s income interest in the trust is terminated and the spouse receives outright ownership of property having a net value equal to the value of the spouse’s income interest. Similarly, the remainderman receives ownership of property equal in value to the remainder interest. Thus, the transaction in the instant case essentially effectuates a commutation of S’s income interest in the trust, a transaction that is a disposition of S’s income interest under section 2519. Therefore, under section 2519, S is regarded as making a gift of x dollars, the value of the remainder interest in the QTIP Trust. section 25.2519-1(f).

This conclusion that S has made a gift is also supported by an additional analysis. S acquired an asset (the remainder interest in the QTIP Trust) that is already subject to inclusion in S's transfer tax base under section 2044. In analogous situations, the courts have recognized that the receipt of an asset that does not effectively increase the value of the recipient's gross estate does not constitute adequate consideration for purposes of the gift and estate tax. See *Commissioner v. Wemyss*, 324 U.S. 303, 307 (1945), 1945 C.B. 416, ("The section taxing as gifts transfers that are not made for "adequate and full [money] consideration" aims to reach those transfers which are withdrawn from the donor's estate.")

A companion case to *Commissioner v. Wemyss*, *Merrill v. Fahs*, 324 U.S. 308 (1945), 1945 C.B. 418, and the cases that preceded it, involved situations where A, an individual, transferred property to B, A's spouse (or future spouse), in exchange for B's relinquishment of marital rights in A's property. The Court held that B's relinquishment of the marital rights did not constitute adequate and full consideration for A's transfer because the assets subject to the marital rights were already includible in A's taxable estate. The property subject to dower and marital rights is clearly included in the gross estate of the property owner. Thus, to conclude that the relinquishment of dower and marital rights by the spouse of the property owner constituted adequate and full consideration for a transfer by the property owner for gift tax purposes would effectively subvert the legislative intent and statutory scheme of the gift tax provisions. *Merrill v. Fahs*, at 311-312. See also, *Commissioner v. Bristol*, 121 F.2d 129, 136 (1st Cir. 1941).

Likewise, in the present situation, property subject to the QTIP election was intended to be subject to either gift or estate tax. S's receipt of the remainder interest does not increase the value of S's taxable estate because that property is already subject to inclusion in S's taxable estate under section 2044. Rather, S's issuance of the note results in a depletion of S's taxable estate that is not offset by S's receipt of the remainder interest. Thus, for estate and gift tax purposes, S's receipt of the remainder interest cannot constitute adequate and full consideration under section 2512 for the promissory note transferred by S to C. As was the case in *Merrill v. Fahs*, any other result would subvert the legislative intent and statutory scheme underlying section 2056(b)(7). Therefore, under section 2511, S has made a gift to C equal to the value of the promissory note S gave to C.

In addition, a gift tax would be imposed under the above alternative rationales even if S acquired only a portion of C's remainder interest; *e.g.*, S acquired 60 percent of C's remainder interest. If, under applicable state law, such a transaction results in a partial termination of the trust, S would be treated as disposing of part of S's income interest in the trust, and the commutation analysis would apply. See, *e.g.*, Restatement (Second) of Trusts section 340(2) (1959). See also, section 25.2519-1(g), Example 4, (illustrating the estate and gift tax consequences of the disposition of a portion of the spouse's income interest). If the trust does not terminate, S would nonetheless be treated as making a transfer under sections 2511 and 2512 for less than adequate and full consideration to the extent of the value of the property or cash S transfers in exchange for the partial remainder interest.

Further, the conclusion of this revenue ruling would be the same if S transferred to C property or cash rather than the promissory note. The economic effect of the transaction is identical, regardless whether S uses S's own funds to finance the transaction or gives a promissory note and discharges the note using some of the QTIP Trust assets received in the transaction. Thus, the result is the same for transfer tax purposes.

Rev. Rul. 98-8 held:

> If a surviving spouse acquires the remainder interest in a trust subject to a QTIP election under section 2056(b)(7) in connection with the transfer by the surviving spouse of property or cash to the holder of the remainder interest, the surviving spouse makes a gift both under section 2519 and sections 2511 and 2512. The amount of the gift is equal to the greater of (i) the value of the remainder interest (pursuant to section 2519), or (ii) the value of the property or cash transferred to the holder of the remainder interest (pursuant to sections 2511 and 2512).

Letter Ruling 200723014, which applied Rev. Rul. 98-8 for gift tax purposes and respected a trust division to apply Code § 2519 only to the commuted trust, had a favorable income tax outcome for the commutation:[2979]

> If, under local law, the trustee is authorized to terminate Marital Trust B and distribute its assets to the remainder and life beneficiaries, the proposed termination and distribution will be by operation of law and will not be a sale or other disposition with respect to Marital Trust B. Thus, based upon the facts submitted and the representations made, and assuming the transaction is effectuated substantially as described, we conclude that the termination and distribution will not be an income recognition event for Marital Trust B under § 1001. Further, we conclude that the termination of Marital Trust B and the distribution of its property to Spouse and Child 1 is not a distribution described in § 1.661(a)-2(f) and therefore does not result in the realization of gain or loss by Marital Trust B.

Letter Ruling 200152018 held that the swap of a unitrust interest for an annuity interest was eligible for a charitable income tax deduction to the extent that the present value of the former exceeded the present value of the latter. It also held:

> In the instant case, because Taxpayer's basis in his unitrust interest is in a trust, that basis is determined pursuant to section 1015. Thus, in determining Taxpayer's basis in his unitrust interest upon his transfer of the unitrust interest to the Academy in exchange for an annuity interest from the Academy, the portion of the adjusted uniform basis assigned to Taxpayer's unitrust interest will be disregarded pursuant to section 1001(e)(1). The exception to section 1001(e)(1) in section 1001(e)(3) is not

[2979] This is consistent with the distinction I draw in part II.J.18.f Commutation vs Mere Division between trust terminations in which the trustee merely makes authorized distributions, as contrasted with a trustee changing beneficial interests with the beneficiaries' consent. Letter Ruling 200723014 applied carryover basis to the distributed assets:

> Based upon the facts submitted and the representations made, and assuming the transaction is effectuated substantially as described, we conclude that the termination of Marital Trust B and the non-prorata distribution of its cash and noncash property to Spouse and Child 1 is a distribution described in § 643(e)(1) (unless an election is made under § 643(e)(3)) and therefore the basis of such property received is the adjusted basis of such property in the hands of Marital Trust B immediately before the distribution. Spouse and Child 1 will take into their gross income their respective pro rata shares of Marital Trust B's distribution as provided by §§ 643(e)(2) and 662.

> applicable, because the remainder beneficiary is not receiving the entire interest in Trust in a single transaction.
>
> As stated above, Taxpayer's unitrust interest is a capital asset. The annuity Taxpayer will receive from Academy will be nonassignable or will be assignable only to Academy, and Taxpayer will be the only annuitant. Accordingly, upon the transfer of his unitrust interest in the Trust to the Academy in exchange for an annuity payable by the Academy, Taxpayer will have long-term capital gain in the amount of the value of the annuity, reported as provided in example (8) of section 1.1011-2(c) of the regulations.

Letter Ruling 200314021 held:

> Upon its termination, Trust proposes to distribute to Taxpayer as the income beneficiary and to Foundation as the remainder beneficiary lump sums equal to the present value of their respective interests on the date of termination. Trust represents that the values will be determined using the discount rate in effect under Section 7520 on the date of termination and using the methodology under Section 1.664-4 of the Income Tax Regulations for valuing interests in charitable remainder trusts…
>
> … Taxpayer is selling his interest in Trust to the remainderman. Provided that the money and other property received by Taxpayer are distributed to Taxpayer in accordance with his interest in Trust, the amount Taxpayer will realize from the sale of his interest in Trust is the amount of money and the fair market value of the property received by Taxpayer.
>
> Pursuant to Section 1001(e)(1), the portion of the adjusted uniform basis assigned to Taxpayer's interest in Trust is disregarded. The exception contained in Section 1001(e)(3) is not applicable, because the entire interest in Trust's assets is not being sold, or otherwise disposed of, to a third party. Accordingly, Taxpayer will be treated as though he has no basis in his interest in Trust and, therefore, Taxpayer will realize gain under Section 1001(c) in the amount received from the disposition of his interest in Trust.

Letter Ruling 200127023 was similar to Letter Ruling 200314021.

Letter Ruling 200833012, after acknowledging the rules in Code § 1001(e)(3) and Reg. § 1.1001-1(f)(3), held:

> Although the proposed transaction takes the form of a distribution of the present values of the respective interests of A, B, and the charities, in substance it is a sale of A and B's interest to the charities. The amount received by A and B as a result of the termination of Trust is an amount received from the sale or exchange of a capital asset. Under § 1015(b), A and B's basis in the life estate is a portion of the entire basis of the property, and the disposition of A and B's interest is not part of a transaction in which the entire interest in Trust is transferred to a third party. Therefore, under § 1001(e), A and B's adjusted basis in their interest is disregarded. A and B's holding period in the life interest exceeds one year. Accordingly, under § 1222(3), the entire amount realized by A and B as a result of the early termination of Trust will be long-term capital gain.
>
> This ruling is conditioned on any assets distributed in-kind from Trust being distributed on a pro-rata basis between A, B, and the charities.

Similar holdings were in Letter Rulings 200827009,[2980] 200739004,[2981] 200733014,[2982] 200727013,[2983] 200648017,[2984] 200648016,[2985] 200441024,[2986] and 200403051.[2987]

Reg. § 1.1001-1(f)(4) refers to Reg. § 1.1014-5(d), which also effectuates the rest of Reg. § 1.1014-5. Let's go through that first:

Reg. § 1.1014-5(a), "Sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent," provides:

(1) Except as provided in paragraph (b) or (c) of this section with respect to the sale or other disposition after October 9, 1969, of a term interest in property, gain or loss from a sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent is determined by comparing the amount of the proceeds with the amount of that part of the adjusted uniform basis which is

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[2980] "A is assigning A's income interest in Trust to Charity in exchange for a distribution equal to the present value of the unitrust income interest. Because the disposition of A's interest is not part of a transaction in which the entire interest in Trust is transferred to a third party, the portion of the uniform adjusted basis assigned to A's income interest is disregarded under § 1001(e)."

[2981] "Accordingly, although the proposed transaction takes the form of a distribution of the present values of the respective interests of each Beneficiary and the Charity, it is in substance a sale of each Beneficiary's unitrust interest to the Charity, the remainder beneficiary. Because the disposition of each Beneficiary's interest is not part of a transaction in which the entire interest in the Trust is transferred to a third party, the adjusted basis in each Beneficiary's interest is disregarded under § 1001(e)(1) in determining gain realized by each Beneficiary."

[2982] "In the present case, although the proposed transaction takes the form of a distribution of the present values of the respective interests of Grantors and Charity, in substance it is a sale of Grantors' interest to Charity, the remainder interest holder. The amount received by Grantors as a result of the termination of Trust is an amount realized from the sale or exchange of a capital asset. Rev. Rul. 72-243. If, as represented by Grantors, Grantors' basis in the unitrust income interest is a portion of the entire basis of the property as determined under §1015(b), Grantors' adjusted basis in their interest is disregarded under § 1001(e) because the disposition is not part of a transaction in which the entire interest in Trust is transferred to a third party. Consequently, if Grantors' adjusted basis is disregarded under § 1001(e), the entire amount realized by Grantors as a result of the early termination of Trust will be gain to Grantors."

[2983] Similar to fn 2982.

[2984] "Although the proposed transaction takes the form of a distribution of the present values of the respective interests of Granddaughter 1, A, B, C, D, and E, in substance it is a sale of Granddaughter 1, D and E's interests to A, B, and C, the remainder interest holders entitled to receive Trust 1 assets at termination under the terms of Trust 1. The amounts received by Granddaughter 1, D and E as a result of the termination of Trust 1 are amounts received from the sale or exchange of a capital asset. Rev. Rul. 72-243. Because Granddaughter 1's basis in the income interest of Trust 1 is a portion of the entire basis of the property under section 1015(b), and because the disposition of Granddaughter 1's term interest is not part of a transaction in which the entire interest in Trust 1 is transferred to a third party, Granddaughter 1's adjusted basis in Granddaughter 1's interest in Trust 1 is disregarded under section 1001(e)."

[2985] Completely or substantially the same as the quote in fn 2984.

[2986] "Although the proposed transaction takes the form of a distribution of the present values of the respective interests of X and Foundation, in substance it is a sale of X's interest to Foundation, the remainder interest holder. The amount received by X as a result of the termination of Trust is an amount received from the sale or exchange of a capital asset. Because X's basis in the unitrust income interest is a portion of the entire basis of the property under § 1015(b), and because the disposition of X's interest is not part of a transaction in which the entire interest in Trust is transferred to a third party, X's adjusted basis in X's interest is disregarded under § 1001(e)."

[2987] Similar to fn 2982.

assignable to the interest sold or otherwise disposed of. The adjusted uniform basis is the uniform basis of the entire property adjusted to the time of sale or other disposition of any such interest as required by sections 1016 and 1017. The uniform basis is the unadjusted basis of the entire property determined immediately after the decedent's death under the applicable sections of part II, subchapter O, chapter 1 of the Code.

(2) Except as provided in paragraph (b) of this section, the proper measure of gain or loss resulting from a sale or other disposition of an interest in property acquired from a decedent is so much of the increase or decrease in the value of the entire property as is reflected in such sale or other disposition. Hence, in ascertaining the basis of a life interest, remainder interest, or other interest which is sold or otherwise disposed of, the uniform basis rule contemplates that proper adjustments will be made to reflect the change in relative value of the interests on account of the passage of time.

(3) The factors set forth in the tables contained in § 20.2031-7 or, for certain prior periods, § 20.2031-7A, of Part 20 of this chapter (Estate Tax Regulations) shall be used in the manner provided therein in determining the basis of the life interest, the remainder interest, or the term certain interest in the property on the date such interest is sold. The basis of the life interest, the remainder interest, or the term certain interest is computed by multiplying the uniform basis (adjusted to the time of the sale) by the appropriate factor. In the case of the sale of a life interest or a remainder interest, the factor used is the factor (adjusted where appropriate) which appears in the life interest or the remainder interest column of the table opposite the age (on the date of the sale) of the person at whose death the life interest will terminate. In the case of the sale of a term certain interest, the factor used is the factor (adjusted where appropriate) which appears in the term certain column of the table opposite the number of years remaining (on the date of sale) before the term certain interest will terminate.

Reg. § 1.1014-5(b), "Sale or other disposition of certain term interests," provides:

(1) *In general*. In determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in § 1.1001-1(f)(2)) the adjusted basis of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent), section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010), that part of the adjusted uniform basis assignable under the rules of paragraph (a) of this section to the interest sold or otherwise disposed of shall be disregarded to the extent and in the manner provided by section 1001(e) and § 1.1001-1(f).

(2) *Effective/applicability date*. The provisions of paragraph (b)(1) of this section relating to section 1022 are effective on and after January 19, 2017. For rules before January 19, 2017, see § 1.1014-5 as contained in 26 CFR part 1 revised as of April 1, 2016.

Explaining Reg. § 1.1014-5(c) below, T.D. 9729 (8/12/2015) said:

These final regulations provide a special rule for determining the basis in certain CRT term interests in transactions to which section 1001(e)(3) applies. Such transactions are those in which the sale or other disposition of the CRT term interest is part of a transaction in which all interests in the CRT are transferred. In these cases, these final regulations provide that the basis of a term interest of a taxable beneficiary is the portion of the adjusted uniform basis assignable to that interest reduced by the portion of the sum of the following amounts assignable to that interest: (1) the amount of undistributed net ordinary income described in section 664(b)(1);and (2) the amount of undistributed net capital gain described in section 664(b)(2). These final regulations do not affect the CRT's basis in its assets but rather are for the purpose of determining a taxable beneficiary's gain arising from a transaction described in section 1001(e)(3). The rules in these final regulations are limited in application to charitable remainder annuity trusts and charitable remainder unitrusts as defined in section 664.

Reg. § 1.1014-5(c), "Sale or other disposition of a term interest in a tax-exempt trust," provides:

(1) *In general*. In the case of any sale or other disposition by a taxable beneficiary of a term interest (as defined in § 1. 1001-1(f)(2)) in a tax-exempt trust (as defined in paragraph (c)(2) of this section) to which section 1001(e)(3) applies, the taxable beneficiary's share of adjusted uniform basis, determined as of (and immediately before) the sale or disposition of that interest, is -

(i) That part of the adjusted uniform basis assignable to the term interest of the taxable beneficiary under the rules of paragraph (a) of this section reduced, but not below zero, by

(ii) An amount determined by applying the same actuarial share applied in paragraph (c)(1)(i) of this section to the sum of -

(A) The trust's undistributed net ordinary income within the meaning of section 664(b)(1) and § 1.664-1(d)(1)(ii)(a)(1) for the current and prior taxable years of the trust, if any; and

(B) The trust's undistributed net capital gains within the meaning of section 664(b)(2) and § 1.664-1(d)(1)(ii)(a)(2) for the current and prior taxable years of the trust, if any.

(2) *Tax-exempt trust defined*. For purposes of this section, the term tax-exempt trust means a charitable remainder annuity trust or a charitable remainder unitrust as defined in section 664.

(3) *Taxable beneficiary defined*. For purposes of this section, the term taxable beneficiary means any person other than an organization described in section 170(c) or exempt from taxation under section 501(a).

(4) *Effective/applicability date*. This paragraph (c) and paragraph (d) Example 7 and Example 8 of this section apply to sales and other dispositions of interests in tax-exempt trusts occurring on or after January 16, 2014, except for sales or dispositions occurring pursuant to a binding commitment entered into before January 16, 2014.

Reg. § 1.1014-5(d) provides examples for Reg. §§ 1.1001-1(f) and 1.1014-5, cross-referencing actuarial tables contained in the estate tax regulations:

Example (1). Securities worth $500,000 at the date of decedent's death on January 1, 1971 are bequeathed to his wife, W, for life, with remainder over to his son, S. W is 48 years of age when the life interest is acquired. The estate does not elect the alternate valuation allowed by section 2032. By reference to § 20.2031-7A(c), the life estate factor for age 48, female, is found to be 0.77488 and the remainder factor for such age is found to be 0.22512. Therefore, the present value of the portion of the uniform basis assigned to W's life interest is $387,440 ($500,000 × 0.77488), and the present value of the portion of the uniform basis assigned to S's remainder interest is $112,560 ($500,000 × 0.22512). W sells her life interest to her nephew, A, on February 1, 1971, for $370,000, at which time W is still 48 years of age. Pursuant to section 1001(e), W realizes no loss; her gain is $370,000, the amount realized from the sale. A has a basis of $370,000 which he can recover by amortization deductions over W's life expectancy.

Example (2). The facts are the same as in example (1) except that W retains the life interest for 12 years, until she is 60 years of age, and then sells it to A on February 1, 1983, when the fair market value of the securities has increased to $650,000. By reference to § 20.2031-7A(c), the life estate factor for age 60, female, is found to be 0.63226 and the remainder factor for such age is found to be 0.36774. Therefore, the present value on February 1, 1983, of the portion of the uniform basis assigned to W's life interest is $316,130 ($500,000 × 0.63226) and the present value on that date of the portion of the uniform basis assigned to S's remainder interest is $183,870 ($500,000 × 0.36774). W sells her life interest for $410,969, that being the commuted value of her remaining life interest in the securities as appreciated ($650,000 × 0.63226). Pursuant to section 1001(e). W's gain is $410,969, the amount realized. A has a basis of $410,969 which he can recover by amortization deductions over W's life expectancy.

Example (3). Unimproved land having a fair market value of $18,800 at the date of the decedent's death on January 1, 1970, is devised to A, a male, for life, with remainder over to B, a female. The estate does not elect the alternate valuation allowed by section 2032. On January 1, 1971, A sells his life interest to S for $12,500. S is not related to A or B. At the time of the sale, A is 39 years of age. By reference to § 20.2031-7A(c), the life estate factor for age 39, male, is found to be 0.79854. Therefore, the present value of the portion of the uniform basis assigned to A's life interest is $15,012.55 ($18,800 × 0.79854). This portion is disregarded under section 1001(e). A realizes no loss; his gain is $12,500, the amount realized. S has a basis of $12,500 which he can recover by amortization deductions over A's life expectancy.

Example (4). The facts are the same as in example (3) except that on January 1, 1971, A and B jointly sell the entire property to S for $25,000 and divide the proceeds equally between them. A and B are not related, and there is no element of gift or compensation in the transaction. By reference to § 20.2031-7A(c), the remainder factor for age 39 male, is found to be 0.20146. Therefore, the present value of the uniform basis assigned to B's remainder interest is $3,787.45 ($18,800 × 0.20146). On the sale A realizes a loss of $2,512.55 ($15,012.55 less $12,500), the portion of the uniform basis assigned to his life interest not being disregarded by reason of section 1001(e)(3). B's gain on the sale is $8,712.55 ($12,500 less $3,787.45). S has a basis in the entire property of $25,000, no part of which, however, can be recovered by amortization deductions over A's life expectancy.

Example (5).

(a) Nondepreciable property having a fair market value of $54,000 at the date of decedent's death on January 1, 1971, is devised to her husband, H, for life and, after his death, to her daughter, D, for life, with remainder over to her grandson, G. The estate does not elect the alternate valuation allowed by section 2032. On January 1, 1973, H sells his life interest to D for $32,000. At the date of the sale, H is 62 years of age, and D is 45 years of age. By reference to § 20.2031-7A(c), the life estate factor for age 62, male, is found to be 0.52321. Therefore, the present value on January 1, 1973, of the portion of the adjusted uniform basis assigned to H's life interest is $28,253 ($54,000 × 0.52321). Pursuant to section 1001(e), H realizes no loss; his gain is $32,000, the amount realized from the sale. D has a basis of $32,000 which she can recover by amortization deductions over H's life expectancy.

(b) On January 1, 1976, D sells both life estates to G for $40,000. During each of the years 1973 through 1975, D is allowed a deduction for the amortization of H's life interest. At the date of the sale H is 65 years of age, and D is 48 years of age. For purposes of determining gain or loss on the sale by D, the portion of the adjusted uniform basis assigned to H's life interest and the portion assigned to D's life interest are not taken into account under section 1001(e). However, pursuant to § 1.1001-1(f)(1), D's cost basis in H's life interest, minus deductions for the amortization of such interest, is taken into account. On the sale, D realizes gain of $40,000 minus an amount which is equal to the $32,000 cost basis (for H's life estate) reduced by amortization deductions. G is entitled to amortize over H's life expectancy that part of the $40,000 cost which is attributable to H's life interest. That part of the $40,000 cost which is attributable to D's life interest is not amortizable by G until H dies.

Example (6). Securities worth $1,000,000 at the date of decedent's death on January 1, 1971, are bequeathed to his wife, W, for life, with remainder over to his son, S. W is 48 years of age when the life interest is acquired. The estate does not elect the alternate valuation allowed by section 2032. By reference to § 20.2031-7A(c), the life estate factor for age 48, female, is found to be 0.77488, and the remainder factor for such age is found to be 0.22512. Therefore, the present value of the portion of the uniform basis assigned to W's life interest is $774,880 ($1,000,000 × 0.77488), and the present value of the portion of the uniform basis assigned to S's remainder interest is $225,120 ($1,000,000 × 0.22512). On February 1, 1971, W transfers her life interest to corporation X in exchange for all of the stock of X pursuant to a transaction in which no gain or loss is recognized by reason of section 351. On February 1, 1972, W sells all of her stock in X to S for $800,000. Pursuant to section 1001(e) and § 1.1001-1(f)(2), W realizes no loss; her gain is $800,000, the amount realized from the sale. On February 1, 1972, X sells to N for $900,000 the life interest transferred to it by W. Pursuant to section 1001(e) and § 1.1001-1(f)(1), X realizes no loss; its gain is $900,000, the amount realized from the sale. N has a basis of $900,000 which he can recover by amortization deductions over W's life expectancy.

Example (7).

(a) Grantor creates a charitable remainder unitrust (CRUT) on Date 1 in which Grantor retains a unitrust interest and irrevocably transfers the remainder interest to Charity. Grantor is an individual taxpayer subject to income tax. CRUT meets the requirements of section 664 and is exempt from income tax.

(b) Grantor's basis in the shares of X stock used to fund CRUT is $10x. On Date 2, CRUT sells the X stock for $100x. The $90x of gain is exempt from income tax under section 664(c)(1). On Date 3, CRUT uses the $100x proceeds from its sale of the X stock to purchase Y stock. On Date 4, CRUT sells the Y stock for $110x. The $10x of gain on the sale of the Y stock is exempt from income tax under section 664(c)(1). On Date 5, CRUT uses the $110x proceeds from its sale of Y stock to buy Z stock. On Date 5, CRUT's basis in its assets is $110x and CRUT's total undistributed net capital gains are $100x.

(c) Later, when the fair market value of CRUT's assets is $150x and CRUT has no undistributed net ordinary income, Grantor and Charity sell all of their interests in CRUT to a third person. Grantor receives $100x for the retained unitrust interest, and Charity receives $50x for its interest. Because the entire interest in CRUT is transferred to the third person, section 1001(e)(3) prevents section 1001(e)(1) from applying to the transaction. Therefore, Grantor's gain on the sale of the retained unitrust interest in CRUT is determined under section 1001(a), which provides that Grantor's gain on the sale of that interest is the excess of the amount realized, $100x, over Grantor's adjusted basis in the interest.

(d) Grantor's adjusted basis in the unitrust interest in CRUT is that portion of CRUT's adjusted uniform basis that is assignable to Grantor's interest under § 1.1014-5, which is Grantor's actuarial share of the adjusted uniform basis. In this case, CRUT's adjusted uniform basis in its sole asset, the Z stock, is $110x. However, paragraph (c) of this section applies to the transaction. Therefore, Grantor's actuarial share of CRUT's adjusted uniform basis (determined by applying the factors set forth in the tables contained in § 20.2031-7 of this chapter) is reduced by an amount determined by applying the same factors to the sum of CRUT's $0 of undistributed net ordinary income and its $100x of undistributed net capital gains.

(e) In determining Charity's share of the adjusted uniform basis, Charity applies the factors set forth in the tables contained in § 20.2031-7 of this chapter to the full $110x of basis.

Example (8).

(a) Grantor creates a charitable remainder annuity trust (CRAT) on Date 1 in which Grantor retains an annuity interest and irrevocably transfers the remainder interest to Charity. Grantor is an individual taxpayer subject to income tax. CRAT meets the requirements of section 664 and is exempt from income tax.

(b) Grantor funds CRAT with shares of X stock having a basis of $50x. On Date 2, CRAT sells the X stock for $150x. The $100x of gain is exempt from income tax under section 664(c)(1). On Date 3, CRAT distributes $10x to Grantor, and uses the remaining $140x of net proceeds from its sale of the X stock to purchase Y stock.

Grantor treats the $10x distribution as capital gain, so that CRAT's remaining undistributed net capital gains amount described in section 664(b)(2) and § 1.664-1(d) is $90x.

(c) On Date 4, when the fair market value of CRAT's assets, which consist entirely of the Y stock, is still $140x, Grantor and Charity sell all of their interests in CRAT to a third person. Grantor receives $126x for the retained annuity interest, and Charity receives $14x for its remainder interest. Because the entire interest in CRAT is transferred to the third person, section 1001(e)(3) prevents section 1001(e)(1) from applying to the transaction. Therefore, Grantor's gain on the sale of the retained annuity interest in CRAT is determined under section 1001(a), which provides that Grantor's gain on the sale of that interest is the excess of the amount realized, $126x, over Grantor's adjusted basis in that interest.

(d) Grantor's adjusted basis in the annuity interest in CRAT is that portion of CRAT's adjusted uniform basis that is assignable to Grantor's interest under § 1.1014-5, which is Grantor's actuarial share of the adjusted uniform basis. In this case, CRAT's adjusted uniform basis in its sole asset, the Y stock, is $140x. However, paragraph (c) of this section applies to the transaction. Therefore, Grantor's actuarial share of CRAT's adjusted uniform basis (determined by applying the factors set forth in the tables contained in § 20.2031-7 of this chapter) is reduced by an amount determined by applying the same factors to the sum of CRAT's $0 of undistributed net ordinary income and its $90x of undistributed net capital gains.

(e) In determining Charity's share of the adjusted uniform basis, Charity applies the factors set forth in the tables contained in § 20.2031-7 of this chapter to determine its actuarial share of the full $140x of basis.

Letter Ruling 200027001 analyzed a settlement involving a QTIP trust. The surviving spouse was entitled to the income, and the "trustee is authorized, in the trustee's discretion, to pay or apply additional funds from the principal of the Marital Trust to provide for Spouse's reasonable maintenance, support, comfort and welfare as the trustee deems necessary or advisable." The remainder would pass to or for the benefit of the decedent's other family members. The surviving spouse argued with the trustee over distributions and investment strategy. A settlement agreement resolved some disputes over which property belonged to the decedent and which to the surviving spouse – and:

> The agreement also directs that the trustee of the QTIP Trust pay the amount of $y to Spouse in exchange for Spouse's release of her rights to any part of the principal of the QTIP Trust. The agreement further provides that Spouse will sell her income interest in the QTIP Trust to [the remaindermen] for cash or other property valued at $z. The consideration will be paid proportionately in accordance with the respective interests of [the remaindermen] in the remainder of the QTIP Trust.
>
> The purchase price of the qualifying income interest in the QTIP Trust, $z, is equal to the actuarial value of Spouse's income interest as of Date 3, determined under section 20.2031-7 of the Estate Tax Regulations, based on the value of the corpus of the QTIP Trust as of Date 3. Until the sale of Spouse's interest in the QTIP Trust is completed, the QTIP Trust will continue to pay the income therefrom to Spouse according to the terms of the trust. However, income earned after Date 3 and paid to Spouse will reduce the purchase price, dollar-for-dollar. The settlement agreement

> recognizes that federal gift taxes will be imposed, as a result of the sale of Spouse's qualifying income interest in the QTIP Trust, under section 2519. The agreement confirms Spouse's right to recover such taxes from the persons who will receive the QTIP property, pursuant to section 2207A of the Internal Revenue Code. The settlement agreement, however, places a ceiling on Spouse's right of recovery. The settlement agreement provides that the QTIP Trust will terminate upon completion of the sale of Spouse's qualifying income interest, and the corpus will be distributed [to the remaindermen]…. The settlement agreement is contingent on court approval, which has been obtained by the parties, and favorable rulings from the Internal Revenue Service.

The surviving spouse asked the IRS to rule that any post-Date 3 income that reduced purchase price would constitute sale proceeds, making it taxable as capital gain rather than ordinary income, but the IRS declined to recharacterize the income:

> When a taxpayer receives a lump sum in exchange for the taxpayer's right to receive future income from property that does not represent a conversion of a capital investment, the taxpayer cannot characterize the transaction as a sale of property. *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958). The conversion of income already received by a beneficiary of an estate into principal was not permitted as part of a compromise agreement of a wife's claim against her deceased husband's will. *Lemle v. United States*, 579 F.2d 185 (2d Cir. 1978). This is especially the case in the present situation in which Spouse will already have received the payments from the trust at the time the sale of the income interest is consummated, and Spouse will be entitled to keep the payments whether or not the sale is consummated.
>
> The fact that the amount that will be paid for the income interest will be reduced by the amount of income that is paid by the QTIP Trust to Spouse after Date 3 and before the sale is made final does not change our conclusion.

As to taxing gain on sale, the IRS ruled:

> The sale of Spouse's interest in the principal of the QTIP Trust by Spouse constitutes a taxable sale for income tax purposes. Any gain or loss on the sale of Spouse's interest in the principal of the trust would be recognized under section 1001. The gain would be long-term capital gain, since the Decedent died on Date 1. Since section 1001(e) applies to income interests in trust, but not rights to principal, Spouse's basis in her interest in trust principal would not be disregarded.

As to gift tax consequences, the IRS reasoned and ruled:

> Section 2519 provides that any disposition of all or a part of a qualifying income interest for life in property for which an election had been made under section 2056(b)(7) is treated as the transfer of all interests in the property other than the qualifying income interest.
>
> Section 25.2519-1(c)(1) provides that the amount treated as a transfer under section 2519 upon a disposition of all or part of a qualifying income interest for life in QTIP property is equal to the fair market value of the entire property subject to the qualifying income interest, determined on the date of the disposition (including any accumulated income and not reduced by any amount excluded from total gifts under section 2503(b) with respect to the transfer creating the interest), less the value of the

qualifying income interest in the property on the date of the disposition. (The gift tax consequences of the disposition of the qualifying income interest are determined separately under section 2511 as discussed above in #5). [Ruling 5 said no gift assuming that "the sale is one made in the ordinary course of business, in that it is bona fide, at arm's length, and free from any donative intent."]

Section 25.2511-2(a) provides that the gift tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.

Section 2207A(b) provides that if a gift tax is paid with respect to any person because of a transfer made by that person under section 2519, then that person shall be entitled to recover the tax attributable to the transfer from the person receiving the property.

Rev. Rul. 75-72, 1975-1 C.B. 110, holds that gift tax imposed on a transfer that is paid by the donee may be deducted from the value of the transferred property in determining the amount of the gift, if it is established that the payment of the tax by the donee or from the property is a condition of the transfer. If, at the time of the transfer, the gift is made subject to the condition that the gift tax is to be paid by the donee or out of the transferred property, then the donor receives consideration for the transfer in the amount of the gift tax to be paid by the donee. Thus, under section 2512(b), the value of the gift is measured by the fair market value of the property passing from the donor minus the amount of the gift tax to be paid by the donee.

Rev. Rul. 81-223, 1981-2 C.B. 189, holds that, in determining the amount of the gift, the gift tax liability assumed by the donee may be deducted from the value of the transferred property, if the payment of the tax by the donee is a condition of the transfer. The donor's available unified credit must be used to reduce the tax liability that the donee has assumed to the extent the unified credit is available.

In a case like the present one, where the gift tax will be imposed as a result of a transfer under section 2519, section 2207A(b) statutorily shifts the tax burden, but not the liability, for paying the gift tax to the donee. In reimbursing the donor for the gift tax paid pursuant to the statute, the donee provides consideration for the gift. The donee's payment inures to the benefit of the donor because it reimburses the donor for gift tax that the donor was liable for and would otherwise be required to pay out of the donor's own funds.

Accordingly, we conclude that upon Spouse's disposition of Spouse's qualifying income interest for life, Spouse will be treated as making a gift under section 2519. Under section 2519, the gift tax will be imposed upon on the entire value of the QTIP Trust as of the date that the actual transfer occurs, reduced by: 1) the value of the Spouse's qualifying income interest for life on the transfer date; 2) the amount paid to Spouse for the release of her interest in trust principal under the settlement agreement; and 3) the amount of gift tax that Spouse recovers under section 2207A(b) as limited under the terms of the settlement agreement.

Note that the gift tax liability would be included in the surviving spouse's estate if she died within three years of making the deemed gift.[2988] Ordinarily, that's a wash, in that the cash used to pay the gift tax is out of the estate, so the inclusion and reduction in cash offset each other. With a net gift, however, the tax reimbursement eliminates the reduction in cash, so this type of settlement does increase the surviving spouse's estate if she dies within that three-year period. Of course, given that the remaindermen were not beneficiaries of her estate, she would rather have the cash, minus any estate tax, than not have the cash.

In Letter Ruling 200231011, Grandson was the income beneficiary (subject to floors and caps) and charities were the remaindermen.[2989] When disputes about administration arose (again), the parties entered into the following agreement to convert to a unitrust,[2990] subject to court approval:

> Under the terms of the proposed agreement, corpus of Trust in excess of Z dollars will be distributed immediately to Charity 1, Charity 2, Charity 3, and Charity 4 (or their successors) in the same proportion of their current remainder interests in Trust. Upon distribution, the charities' interest in Trust will terminate. The remaining assets of Trust will continue in trust for the benefit of Grandson. Grandson will receive at least annually an amount equal to seven percent of the net fair market value of the property held in Trust determined on a specified date in each calendar year. In addition, the trustee may distribute income or principal to provide adequately for the reasonable support of Grandson. On Grandson's death, the remaining corpus will be distributed pursuant to Grandson's exercise of a testamentary general power to appoint the remaining corpus to anyone, including his estate or the creditors of his estate. Any portion of the Trust not effectively appointed by the exercise this power will be distributed to Grandson's surviving descendants free of trust.

[2988] Code § 2035(b), "Inclusion of gift tax on gifts made during 3 years before decedent's death," provides:

> The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse during the 3-year period ending on the date of the decedent's death.

[2989] The background was:

> Decedent died testate on Date 1, prior to 1985. Pursuant to the terms of Decedent's will, a residuary testamentary trust (Trust), was established primarily for the benefit of Decedent's grandson (Grandson). Under the terms of Trust, Grandson was to receive S dollars each year during his life. Upon Grandson's death, the corpus was to be distributed as follows: 1/3 to Charity 1; 1/3 to Charity 2; 1/6 to Charity 3; and 1/6 to Charity 4. The terms of Trust provide that no beneficiary could alienate or encumber his/her interest in the income or principal and no beneficiary's interest was subject to claims of his/her creditors prior to distribution. Trust was funded with stock of Corporation with an approximate value of X dollars.
>
> In Year 1, pursuant to a court order, the investments of Trust were restructured and the dispositive provisions of Trust were modified to provide for annual income distributions to Grandson in accordance with a Performance Chart. The order required distributions to Grandson of an amount equal to the lesser of the maximum income amount set forth in the Performance Chart or the actual net income of Trust. Grandson was guaranteed a minimum income amount even if actual Trust income was less than that minimum income amount. Thus, if earnings of Trust are sufficient, Grandson would receive more than the minimum stated amounts each accounting period. In addition, Charities 1, 2, 3 and 4 received a lump sum payment. Upon Grandson's death, the remaining corpus was to be distributed to the Charity 1, Charity 2, Charity 3, and Charity 4 (or their successors) in the same proportion as set forth in Trust.

[2990] But for the floor and ceiling on income before the conversion, a unitrust conversion usually is not a taxable event. See fn 3014 and the accompanying text in part II.J.18.f Commutation vs Mere Division.

After reviewing *Cottage Savings*, Letter Ruling 200231011 held:

> The application of § 1001(a) to trust interests is illustrated by two cases. In *Evans v. Commissioner*, 30 T.C. 798 (1958), the taxpayer exchanged her income interest in a trust for an annuity, and the court concluded that this was a realization event. Taxpayer's income interest had entitled her to dividends paid by a corporation, the stock of which was owned by the trust. She transferred the income interest to her husband, who agreed in exchange to pay her fixed sums annually until her death.
>
> A contrary result was reached in *Silverstein v. United States*, 419 F.2d 999 (7th Cir. 1969). In that case, the taxpayer exchanged an interest in a trust for a right to specified annual payments from the remainderman of the trust, and the court held that taxpayer did not as a result dispose of her trust interest. After the transaction, taxpayer was to receive the same annual payments from the remainderman as she had been receiving from the trust. The court distinguished the transaction from that found to be a realization event in Evans: "the amount of Mrs. Evans' interest in the trust was not definitive. It varied with the dividend return on the trust stock. She exchanged this 'uncertainty' for definitely ascertained yearly payments from her husband." 419 F.2d. at 1003.
>
> The proposed trust modification in this case more closely resembles the situation in *Evans* than that in *Silverstein* and should be considered a realization event. Grandson currently is entitled to trust income, subject to a floor and a ceiling. Under the proposed order, he would become entitled to annual payments of seven percent of the fair market value of the trust property, with the trustee having some discretion to make additional payments under certain circumstances. Even assuming that the projected payments under the proposed order approximate those that would be made under the current terms of the trust, under the proposed order Grandson would lose the protection of the guaranteed minimum annual payments required by the Performance Chart. He also would not be limited by the Performance Chart's maximum annual payment ceilings. Finally, payments would be determined without regard to trust income. In short, Grandson's interest in the modified trust would entail legal entitlements different from those he currently possesses. This conclusion is reinforced by adding to the Taxpayer's current entitlement the general power of appointment over any trust corpus, even though this was a necessary element in a favorable GST conclusion set forth in issue #3, below.
>
> Pursuant to § 1001(e)(1), the portion of the adjusted uniform basis assigned to Grandson's interest in Trust is disregarded. The exception contained in § 1001(e)(3) is not applicable because the entire interest in Trust's assets is not being sold, or otherwise disposed of, to a third party. Accordingly, for purposes of this transaction, Grandson has no basis in his interest in Trust. Therefore, the amount of gain Grandson realizes under § 1001(c) is the amount Grandson realized from the disposition of his assets in Trust. The gain realized by Grandson from the disposition of his interest will be long term capital gain. See Rev. Rul. 72-243, 1972-1 C.B. 233, providing that a sale of an income interest in a trust is a sale of a capital asset within the meaning of §§ 1221 and 1222.

Note that this ruling was issued before Reg. § 1.1001-1(h) was issued in its current form.[2991]

[2991] Reg. § 1.1001-1(h) is reproduced in fn 2951 in this part II.J.18.

In Letter Ruling 201932001, lifetime distributions were as follows:

> On Date 1, a date prior to September 25, 1985, Settlor created an irrevocable trust, Trust, for the benefit of Son. The material purpose of Trust was to ensure that Son receive an income stream for his support. Under the terms of the Trust agreement, the trustees are required to distribute all of the net income of Trust to Son, and, upon his death, distribute the remainder to his issue, per stirpes. The Trust agreement does not authorize any distributions of principal during Son's life. Son has four living adult children (Current Remaindermen) and eight living grandchildren, four of whom are adults (Successor Remaindermen). None of Son's descendants has a predeceased child with living issue. Son and Bank are currently serving as co-trustees of Trust.

A court-approved agreement authorized the trustees to value the trust's assets, determine the appropriate distributions to be made upon the trust's termination under the agreement and terminate the trust. Upon the termination, the trustees would distribute, on a pro rata or in-kind basis, as the trustees in their sole discretion determine, all of the trust's assets to income beneficiary, immediate remaindermen and successor remaindermen according to their actuarial interests calculated as of the termination date. The ruling held that the termination did not blow the trust's grandfathering from GST tax and did not constitute a gift. However, the income tax rulings were not so innocuous:[2992]

> Although the proposed transaction takes the form of a distribution of the present values of the respective interests of Son, the Current Remaindermen, and the Successor Remaindermen, in substance it is a sale of Son's and the Successor Remaindermen's interests to the Current Remaindermen. Rev. Rul. 69-486.
>
> The amounts received by Son as a result of the termination of Trust are amounts received from the sale or exchange of a capital asset to the Current Remaindermen. Rev. Rul. 72-243. Because Son's basis in the income interest of Trust is a portion of the entire basis of the property under § 1015(b), and because the disposition of Son's term interests is not part of a transaction in which the entire interest in Trust is transferred to a third party, Son's adjusted basis in Son's interest in Trust is disregarded under § 1001(e). Son's holding period in the life interests in Trust exceeds one year. Accordingly, based on the facts submitted and representations made, the entire amount realized by Son as a result of the early termination of Trust will be long-term capital gain under § 1222(3).
>
> Similarly, the amounts received by the Successor Remaindermen as a result of the termination of Trust are amounts received from the sale or exchange of a capital asset to the Current Remaindermen. *Cf. Helvering v. Gambrill*, 313 U.S. 11, 15 (1941), 1941-1 C.B. 364 (The phrase "property held by the taxpayer" under a prior law holding period rule relating to capital gains and losses includes not only full ownership, but also any interest owned whether vested, contingent, or conditional). The Successor Remaindermen's holding period in their interests in Trust also exceeds one year.
>
> Accordingly, under § 1222(3), the gain determined under § 1001(a) by the Successor Remaindermen as a result of the early termination of Trust will be long-term capital gain.

[2992] I have heard that this ruling was procured by David Handler and that the income tax consequences, although adverse, were relatively small in that particular case.

> In addition, to the extent that a Current Remainderman exchanges property, including property deemed received from Trust, for the interests of Son and the Successor Remaindermen, the Current Remainderman will recognize gain or loss on the property exchanged. Accordingly, based on the facts submitted and representations made, for purposes of determining gain or loss, the amount realized by each Current Remainderman on the exchange of property for Trust interests held by Son and the Successor Remaindermen will be equal to amount of cash and fair market value of the trust interests received in exchange for the transferred assets. Section 1.1001-1(a) and Rev. Rul. 69-486.

Letter Ruling 201932001 is further analyzed in part II.J.18.e Ed Morrow on Potential Income Tax Disasters for Early Trust Terminations.

Letter Ruling 202016002 covered everything but some of the income tax on the commutation of an inter vivos and two testamentary QTIP trusts, whose remaindermen were charities.[2993] Nothing was surprising, but notable is no impermissible self-dealing:[2994]

> Section 53.4941(d)-1(a) of the Foundation and Similar Excise Taxes Regulations provides that the term "self-dealing" does not include a transaction between a private foundation and a disqualified person where the disqualified person status arises only as a result of such transaction. For example, the bargain sale of property to a private foundation is not a direct act of self-dealing if the seller becomes a disqualified person only by reason of his becoming a substantial contributor as a result of the bargain element of the sale.
>
> Rev. Rul. 72-243, 1972-1 C.B. 233, provides that the proceeds received by the life tenant of a trust, in consideration for the transfer of the life tenant's entire interest in the trust to the remainder beneficiary, are treated as an amount realized from the sale or exchange of a capital asset under § 1222.
>
> The transaction pursuant to the Settlement Agreement, in which Spouse will receive the present value of her life income interests in Irrevocable Trust and Marital Trust, and Charitable Trust will receive the remaining trust assets, may be regarded in substance as an indirect exchange between Spouse and Charitable Trust similar to the one described in Rev. Rul. 72-243. Charitable Trust was not funded upon Decedent's death by Decedent, and no deduction has been or will be allowed under § 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522 with respect to Charitable Trust prior to the contemplated exchange. Therefore, prior to the exchange, Charitable Trust is not a trust described in § 4947(a)(1).
>
> As discussed above, Spouse will receive a gift tax deduction under § 2522 of more than $5,000 for the property deemed transferred by her to Charitable Trust (which will exceed 2 percent of all contributions to Charitable Trust), causing Charitable Trust to be subject to § 4947(a)(1) at that time. Spouse will be a disqualified person with respect to Charitable Trust when the Settlement Agreement is executed, as a substantial contributor to Charitable Trust and as a family member of the creator of Charitable Trust. Section 53.4941(d)-1(a) provides, however, that the term "self-dealing" does not include

[2993] Companion rulings were Letter Rulings 202016003, 202016004, 202016005, and 202016006.
[2994] For more on self-dealing under Code § 4941, see text following fn 4948 in part II.Q.7.c.ii Private Foundations, Etc.

> a transaction between a private foundation and a disqualified person where the disqualified person status arises only as a result of such transaction. Accordingly, § 4941 will not apply to the indirect exchange between Spouse and Charitable Trust pursuant to the Settlement Agreement in which Spouse will receive the present value of her life income interest in Irrevocable Trust, GST Exempt Marital Trust, and GST Non-Exempt Marital Trust, and Charitable Trust will receive the remaining trust assets.

Letter Ruling 202016002 also ruled no gifts on the exchange of contingent remainder interests:

> Individual 1, Individual 2, and Individual 3 are the life beneficiaries of a trust created for his or her benefit under Revocable Trust. Pursuant to the provisions of Settlement Agreement, Spouse will disclaim under State law her interest in the remote contingent remainder interests in each Individuals' Trusts. The proposed disclaimer provides that any remainder in each Individuals' Trusts will pass directly to Charitable Trust. In exchange for the disclaimer of Spouse's interest in the remote contingent remainder interests in each Individuals' Trust, Spouse received the agreement of Charitable Trust to the terms of the Settlement Agreement. The disclaimer was a bargained for element of Settlement Agreement, which was bona fide, at arm's length and free from any donative intent, and the consideration received by Spouse for her disclaimer was adequate and full consideration in money or money's worth. See § 25.2512-8. Settlement Agreement provides a result that is within a range of reasonable settlements, that is, the interests to be received by the parties (both as to the nature of the interests and their economic value) reflect the enforceable rights of the parties. Therefore, Spouse is not deemed to have made a gift of any interest in the remote contingent remainder interests of Individual 1 Trust, Individual 2 Trust, and Individual 3 Trust because Spouse received full and adequate consideration for Spouse's disclaimer of those interests.
>
> Accordingly, based on the facts submitted and the representations made, the disclaimer by Spouse under State law of her remote contingent remainder interests in Individual 1 Trust, Individual 2 Trust, and Individual 3 Trust will not result in any gifts by Spouse.

Letter Ruling 202047005 held that a gift of an annuity interest in a charitable remainder annuity trust to its private foundation remainderman, terminating the trust and giving its assets to the foundation, was deductible (except that it concluded that the taxpayer had zero basis to deduct) and had zero adverse income or excise tax consequences. Part of the analysis:

> In *Blair v. Commissioner*, 300 U.S. 5 (1937), the United States Supreme Court held that a beneficiary of a life interest in trust income made a valid assignment of a portion of that income with a resulting shift in the tax liability on the income from the beneficiary to the assignee. Even though the beneficiary assigned for life his right to specific dollar amounts of trust income as opposed to a fixed percent of his interest, the United States Supreme Court held that, "[i]f under the law governing the trust the beneficial interest is assignable, and if it has been assigned without reservation, the assignee thus becomes the beneficiary and is entitled to the rights and remedies accordingly."
>
> Rev. Rul. 55-38, 1955-1 C.B. 389, addresses circumstances under which the assignor and assignee will be taxed on amounts paid by a trust after the lifetime income beneficiary of a testamentary trust assigns his right to receive a portion of the trust income. In Rev. Rul. 55-38, the Service determined that where a beneficiary periodically gives his consent to pay a certain portion of the trust income to another individual, the

amounts so paid will be taxable as income to the assignor, as the assignor has not parted with a substantial interest in property other than the specified payments of income. The Service held that an income beneficiary's irrevocable assignment of trust income for a period of not less than ten (10) years would be treated as "a disposition of a substantial interest in the trust property" (immunizing him or her from tax under Blair) if the assignor does not retain the type of control that would subject him or her to tax under the grantor trust rules. The ten (10) year safe harbor in the grantor trust rules existing at that time was subsequently repealed, and applied under current law, the Ruling's approach suggests that no fixed period of years is long enough to prevent taxation of a donor retaining a reversionary interest.

> The Service has ruled that a taxpayer's sale of an annuity interest in a charitable remainder trust to the remainder beneficiary will result in the taxpayer recognizing income with respect to the property received, without regard to the taxpayer's basis in such property. Additionally, a transaction in which the income interest holders and the charitable remainder beneficiary of a charitable remainder trust each receive a distribution of the present values of their respective interests in the charitable remainder trust is, in substance, a sale of the income interest to the charitable remainder beneficiary. Rev. Rul. 72-243, 1972-1 C.B. 233, provides that a sale of an income interest in a trust is a sale of a capital asset (within the meaning of sections 1221 and 1222).
>
> Taxpayer's and Spouse's situation is distinguishable from situations in which a taxpayer sells an annuity interest in a trust to the remainder beneficiary or where the taxpayer receives a distribution of the present value of the taxpayer's income interest in a trust. In this case, Taxpayer and Spouse will receive no money or property as a result of the assignment of their undivided annuity interest in Trust. Therefore, Taxpayer and Spouse are not disposing of their interest in Trust in exchange for money or property in a transaction governed by section 1001. Accordingly, no gain or loss will be recognized by Taxpayer or Spouse in accordance with section 1001.
>
> Additionally, in *Blair*, the United States Supreme Court held that future income generated by a trust subsequent to a valid assignment, without reservation, of an income interest will not be taxable to the assignor. In this case, Taxpayer and Spouse will make a valid assignment of their undivided annuity interest in Trust to Foundation, without reservation.
>
> Finally, Taxpayer's and Spouse's assignment, without reservation, of their undivided annuity interest meets the requirements set forth in Rev. Rul. 55-38. In this case, Taxpayer and Spouse propose to make an assignment of their undivided annuity interest and will not retain any reversionary interest in the annuity interest upon the assignment of their annuity interest in Trust to Foundation. Therefore, in accordance with *Blair* and Rev. Rul. 55-38, Taxpayer and Spouse would prevent income taxation with respect to any future income attributable to the annuity interest assigned to Foundation. Accordingly, no gain or loss will be recognized by Taxpayer or Spouse in accordance with section 1001.

Letter Ruling 202047005 also held that the gift of their annuity interest would be deductible only to the extent of basis and that the basis was zero under Code § 1001 et seq. The ruling did not discuss why the basis was zero under those provisions. It has been suggested that the ruling applied Code § 1001(e) but that application overlooked that the grantor would have basis because Code § 1001(e) does not apply to the donor's retained interest.

CCA 202118008, addressing the commutation of a QTIP trust, involved the following facts:

> This is a request for assistance from SB/SE Examination with regard to the examination of Year Forms 709 (United States Gift (and Generation-Skipping Transfer) Tax Return) of Spouse, Child 1, and Child 2.
>
> On Date 1, Decedent died testate, survived by Spouse and adult children, Child 1 and Child 2 (collectively, Children). Pursuant to Decedent's will, three trusts were created: Trust 1, Trust 2, and Trust 3. The assistance requested pertains to Trust 1 only.
>
> Trust 1 was funded with the residue of Decedent's estate. Trust 1 directs all income to be distributed to Spouse at least annually and authorizes principal distributions for Spouse's health, maintenance, and support in Spouse's accustomed manner of living if the income is insufficient for such purposes. Trust 1 grants Spouse a testamentary limited power of appointment in favor of Decedent's descendants. In the absence of Spouse's exercise of Spouse's testamentary limited power of appointment, Trust 1 directs the remainder to be distributed outright to Children, by right of representation.
>
> Decedent's estate timely filed a Form 706 (United States Estate (and Generation-Skipping Transfer) Tax Return). On Schedule M of Form 706, Spouse, as personal representative, elected to treat the property of Trust 1 as qualified terminable interest property (QTIP) under § 2056(b)(7). As reported on the Form 706, Trust 1 was funded with $ a of property.
>
> On Date 3, Spouse, as the current beneficiary and as the trustee of Trust 1, and Child 1 and Child 2, as remainder beneficiaries and virtual representatives of the contingent and unborn beneficiaries of Trust 1, entered into Agreement. Under the terms of Agreement, Trust 1 was commuted[1] and all of its property was distributed to Spouse. Recital H of Agreement provides that Spouse and Children agree that "Trust assets could be more effectively utilized if [Spouse] held such assets outright and free of trust." In Recital F of Agreement, the parties acknowledge that Spouse's testamentary limited power of appointment is "not operative." Paragraph 3 of Agreement provides:
>
>> By signing this Agreement and by virtue of the QTIP election for the Trust, the commutation of the Trust results in a deemed gift, for federal gift tax purposes, of the remainder interest in the Trust assets from [Spouse] to [Children] under Section 2519 of the Code. By virtue of the distribution of all of the Trust assets to [Spouse], the commutation of the Trust does not result in a deemed gift of [Spouse's] income interest in the Trust under Section 2511 of the Code. Additionally, by signing this Agreement and by virtue of the distribution of all of the Trust asset [sic] to [Spouse], the commutation of the Trust results in a gift, for federal gift tax purposes, of the remainder interest in the Trust from [Children] to [Spouse]. The deemed gift of the remainder interest from [Spouse] to [Children] and the gift from [Children] to [Spouse] results in a reciprocal gift transfer.
>
> [1] A commutation terminates a trust by distributing trust property to trust beneficiaries based on the respective values of their beneficial interests.

> Paragraph 5 of Agreement provides that (i) Agreement will have the same effect as a court decree, as described in State Statute, (ii) Agreement will become legal and effective upon the date of the last signature of the parties (Date 3), (iii) the terms of Agreement are enforceable as a nonjudicial agreement and as a contract, and (iv) Agreement "contains the entire agreement and understanding among the parties hereto with respect to the subject matter hereof."
>
> At the time of the commutation, the combined value of the property held by Trust 1 was $b, consisting of r Class A shares of Corporation, s Class B shares of Corporation, t% interest in LLC 1, u% interest in LLC 2, v% interest in LLC 3, v% interest in LLC 4, Savings Account, and Brokerage Account. After the commutation and Children's gifts of their remainder interests to Spouse, Spouse owned all of trust property outright.
>
> Also on Date 3, and with the property Spouse owned outright pursuant to Agreement, Spouse entered into a series of transactions. Spouse transferred by gift w Class B shares of Corporation (valued at $ c) to irrevocable dynasty trusts that Spouse had established on Date 2 for the collective benefit of Children and their descendants (Children's Trusts). In addition, in exchange for promissory notes with an aggregate face amount of $d, Spouse transferred to Children's Trusts (i) the entire interest in LLC 1, (ii) all of the Class A shares of Corporation, and (iii) x Class B shares of Corporation.[2]
>
> > [2] We do not address the gift and estate tax consequences of the transfers in exchange for the promissory notes.
>
> On Date 4, Spouse, Child 1, and Child 2, each filed a Form 709 for Year. Each Form 709 reported the commutation and distribution of the trust property from Spouse to Child 1 and Child 2 to be "deemed to be the same value as the property transferred from [Child 1 and Child 2] to [Spouse]" and asserted that the amounts of the gifts are zero.

CCA 202118008, "ISSUE 1: Application of § 2519 to Spouse," briefly described Code § 2519(a) and Regs. §§ 25.2519-1(a), 25.2519-1(c)(1), and 25.2519-1(f), then continued:

> In *Estate of Novotny v. Commissioner*, 93 T.C. 12 (1989), the surviving spouse and remainderman divided the sale proceeds of QTIP proportionately on the basis of the respective values of their interests; the court indicated that the commutation constituted a disposition by the spouse of the income interest for purposes of § 2519 and was thus subject to gift tax.
>
> In this case, Spouse, as personal representative of Decedent's estate, made an election under § 2056(b)(7) to treat Trust 1 as QTIP and claimed a marital deduction on Decedent's Form 706 for the value of Trust 1. Years later, on Date 3, Spouse and Children entered into Agreement. By its terms, Agreement effected the commutation of Trust 1.
>
> In a commutation, the trustee makes terminating distributions to the holders of the beneficial interests in the trust equal to the actuarial value of the interests. Each beneficiary gives up his or her respective beneficial interest in exchange for a lumpsum payment, in what is essentially a sale transaction. The commutation terminates any relationship between the beneficiary and the trust, and if all interests are commuted, the trust terminates.

> Based on the above, the commutation of Trust 1 effected by Agreement constitutes a disposition by Spouse of Spouse's qualifying income interest within the meaning of § 2519(a). Section 25.2519-1(a) and (f); *Estate of Novotny*. Accordingly, for gift tax purposes, Spouse is treated as transferring by gift all interests in Trust 1 other than the qualifying income interest.[3]
>
> > [3] Note that the commutation does not constitute a gift of Spouse's qualifying income interest under § 2511 because Spouse received adequate and full consideration for Spouse's qualifying income interest based on the distribution of all trust property to Spouse. See § 25.2519-1(g), Example 2.

CCA 202118008, "ISSUE 2: Gift by Children under § 2511," briefly described Code §§ 2501(a)(1) and 2512(b) and Regs. §§ 25.2511-2(a) and 25.2511-2(b) and reasoned:

> In this case, Child 1, Child 2, and Spouse entered into Agreement, which legally bound all persons interested in Trust 1. The effect of Agreement was to extinguish Spouse's testamentary limited power of appointment, commute Trust 1, and terminate Trust 1. As a result, Agreement vested a valuable property interest (the value of the remainder) in Children, the then remaindermen. Rather than accept a terminating distribution of the value of their beneficial interest, Child 1 and Child 2 agreed that the trust property "could be more effectively utilized" by Spouse holding the property outright. The outright distribution of all trust property to Spouse pursuant to the terms of Agreement constitutes a transfer of the value of Children's remainder interests without receipt of adequate and full consideration.[4] Accordingly, Child 1 and Child 2 each made a gift under § 2511 of the value of their respective remainder interest in Trust 1 to Spouse. Section 2512(b).
>
> > [4] Note that Spouse's transfers on the same date as Agreement to Children's Trusts are independent of Agreement. Paragraph 5 of Agreement acknowledges that Agreement "contains the entire agreement and understanding among the parties hereto with respect to the subject matter hereof."

CCA 202118008, "ISSUE 3: Reciprocal Exchange for Consideration in Commutation of QTIP Trust," explained:

> *Adequate and Full Consideration for Purposes of § 2512(b) and Reciprocal Transfers*
>
> In *Commissioner v. Wemyss*, 324 U.S. 303 (1945) and its companion case *Merrill v. Fahs*, 324 U.S. 308 (1945), the Supreme Court considered the gift tax meaning of the term "adequate and full consideration in money or money's worth" in the context of antenuptial contracts.
>
> In *Wemyss*, the donor transferred assets to his fiancé to compensate her for the loss of an income interest that would terminate upon her marriage to him. There was no dispute that both a promise of marriage and detriment to a contracting party constituted valuable consideration for purposes of the law of contracts. The Tax Court had held that if the promise of marriage was the consideration, it was not one reducible to a money value and, if the fiancé's loss of the income interest was the consideration, it did not constitute consideration in the hands of the donor. The Supreme Court stated:
>
> > If we are to isolate as an independently reviewable question of law the view of the Tax Court that money consideration must benefit the donor to relieve a transfer by

> him from being a gift, we think the Tax Court was correct…. The section taxing as gifts transfers that are not made for “adequate and full (money) consideration” aims to reach those transfers which are withdrawn from the donor’s estate.

Wemyss, 324 U.S. at 307-08. In other words, valuable contractual consideration in the hands of the donor is not sufficient; adequate and full consideration is that which replenishes, or augments, the donor’s taxable estate.

In *Merrill*, the donor transferred property to donor’s then spouse in exchange for spouse’s relinquishment of marital rights in donor’s remaining property. The Court held that spouse’s relinquishment of the marital rights did not constitute adequate and full consideration for donor’s transfer because the assets subject to the marital rights were already includible in donor’s gross estate. *Id*. at 312-13.

Rev. Rul. 69-505, 1969-2 C.B. 179, involves a transfer to a trust of joint-tenancy property that is treated as a reciprocal exchange for consideration in money or money’s worth. A and B owned the property as joint tenants and could each unilaterally sever the joint tenancy, and if not severed, the property would pass to the survivor upon the death of the other joint tenant. A and B transferred the property to a trust, reserving the right to receive one-half of the income therefrom for their joint lives and all to the survivor for life with remainder to C. Citing § 25.2511-1(e) and *U.S. v. Estate of Grace*, 395 U.S. 316 (1969), the revenue ruling holds that the transfers between A and B are treated as a reciprocal exchange for consideration in money or money’s worth. Thus, neither A nor B made a gift to the other to the extent that the transfers were of equal value. The revenue ruling concludes that since the value of the gift by B is less than the value of the gift by A, A is deemed to have made a gift to B of the difference in value of A’s and B’s transfer.

Estate of Grace is the seminal case on the reciprocal trust doctrine. The reciprocal trust doctrine uncrosses transfers of property in trust that were made pursuant to an interrelated scheme and that resulted, to the extent of like values involved, in leaving the settlors in approximately the same economic position they would have otherwise been in had they not engaged in the transaction.

Here, Paragraph 3 of Agreement provides that the “deemed gift of the remainder interest” under § 2519(a) and the gift from Children to Spouse under § 2511 result in a “reciprocal gift transfer.” This statement in Agreement is not supported by the economics of the transaction or the gift tax meaning of what constitutes “adequate and full consideration.”

Agreement characterized the transaction as a commutation of Trust 1 followed by a distribution of all trust property to Spouse. Thus, Spouse agrees to the extinguishment of Spouse’s lifetime interest in Trust 1 and Children agree to the extinguishment of their remainder interest in Trust 1 in exchange for receipt of their respective proportionate share of trust property. Also pursuant to Agreement, Children transfer their proportionate share of trust property received in the commutation to Spouse and receive no consideration from Spouse in exchange for the transfer. Absent entering into Agreement, Spouse had no right to the remainder under the terms of Trust 1 or otherwise. Therefore, from an economic perspective, the transaction resulted in a one-sided gift transfer from Children to Spouse.

It is the deemed gift transfer arising by application of § 2519(a) that is the crux of Spouse and Children's position, as stated in Agreement, that the transfers are reciprocal gift transfers. However, unlike in Rev. Rul. 69-505, Spouse's deemed transfer under § 2519(a) and Children's transfers of their remainder interests under § 2511 do not constitute offsetting exchanges of consideration. Spouse received no consideration for the deemed transfer to Children under § 2519(a). That is, because the entire value of Trust 1 was subject to inclusion in Spouse's gross estate under § 2044, the transfer of the remainder by Children to Spouse does not augment Spouse's estate and, thus, cannot constitute the receipt of adequate and full consideration for gift tax purposes. See *Commissioner v. Wemyss*; *Merrill v. Fahs*.

The fact that Spouse can receive no consideration for the deemed transfer resulting from the application of § 2519(a) does not nullify Children's transfers of their remainder interests in Trust 1. When Trust 1 was commuted, the remainder interest vested outright, equally in Children, the then remaindermen. Children then transferred their valuable property interest to Spouse and received nothing in exchange. Under § 2512(b) and Wemyss, these transfers by Children for no consideration constitute a gift. If Children were to transfer their remainder interests to a third party other than Spouse, the transfers would clearly be a gift. The result is the same if the donee is the surviving spouse beneficiary of a QTIP trust.[5] Thus, the transaction cannot be considered involving offsetting transfers for consideration within the meaning of Rev. Rul. 69-505.

[5] The gift tax consequences to remainder beneficiaries of a QTIP trust in a § 2519(a) disposition where all of the trust property is distributed to the surviving spouse is also discussed in PLR 199908033, which was referenced in *Estate of Kite v. Commissioner*, T.C. Memo. 2013-43. Note that PLRs may not be cited as precedent.

Likewise, the facts here do not support the application of the reciprocal trust doctrine enunciated in *Estate of Grace*, without regard to consideration. After entering into Agreement, Spouse and Children are not in approximately the same economic position they would have otherwise been absent entering into Agreement (*i.e.*, Children no longer have a beneficial interest in Trust 1 and Spouse then holds the trust property outright, including the actuarial value of the remainder interest).

QTIP Statutory Scheme and Legislative History

The foregoing analysis is consistent with the QTIP statutory regime, the legislative history, the rulings and the caselaw analyzing the issue of consideration in the context of deemed dispositions under § 2519(a).

Section 2056(a) provides that the value of the taxable estate shall, except as limited by § 2056(b), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property that passes or has passed from the decedent to the surviving spouse.

Section 2056(b)(1) provides in relevant part that no deduction shall be allowed for an interest passing to the surviving spouse where the interest will terminate or fail, and on such termination, the property passes to a person other than the surviving spouse or the spouse's estate.

Section 2056(b)(7) provides an exception to the “terminable interest” rule in § 2056(b)(1) and allows a deduction in the case of QTIP. Under § 2056(b)(7)(A), QTIP is treated as passing to the surviving spouse for purposes of § 2056(a), and no part of the property is treated as passing to any person other than the surviving spouse for purposes of § 2056(b)(1).

Under § 2056(b)(7)(B)(i), the term “qualified terminable interest property” generally refers to property in which the spouse receives a qualifying income interest for life, and with respect to which the executor makes an election to treat the property as QTIP.

Section 2044(a) provides that the value of the gross estate includes the value of any property described in § 2044(b) in which the decedent had a qualifying income interest for life. Section 2044(b) provides that § 2044(a) applies to any property if a deduction was allowed with respect to the transfer of the property to the decedent under § 2056(b)(7), and § 2519 did not apply with respect to a disposition by the decedent of part or all of such property.

The QTIP provisions (§§ 2056(b)(7), 2044, and 2519) were enacted in 1981, at the same time as the unlimited marital deduction. See § 403(d) of the Economic Recovery Tax Act of 1981 (ERTA), Pub. Law 97-34, 95 Stat. 172, 302-05 (August 13, 1981). Section 2056(b)(7) was enacted to provide an alternative to an outright transfer of property to the surviving spouse that would qualify for the unlimited marital deduction. See H. REP. NO. 97-201, at 159-60 (1981). Given that an income interest that terminates at death generally is not includible in a decedent’s gross estate, §§ 2044 and 2519 were added to ensure that the transfer tax deferred by § 2056(b)(7) becomes subject to tax, either on the surviving spouse’s death or after a lifetime disposition of spouse’s qualifying income interest. See H. REP. NO. 97-201, at 161-62. Thus, the QTIP statutory scheme is consistent with the policy underlying the marital deduction, that is, to allow property to pass to the surviving spouse without the decedent-spouse’s estate paying tax on its value, but only until such time as the surviving spouse either dies or makes a lifetime disposition of the property. Under either circumstance, the transfer tax is ultimately paid. See, *e.g.*, *U.S. v. Stapf*, 375 U.S. 118, 128 (1963).

In Rev. Rul. 98-8, 1998-1 C.B. 541, the surviving spouse purchased from the trust remainderman the remainder interest in a QTIP trust by issuing a promissory note equal to the actuarial value of the remainder interest to the remainderman. As a result of the purchase, the trust terminated under its terms and the entire corpus was transferred to the surviving spouse. The surviving spouse then used the proceeds to pay the remainderman the value of the remainder interest. The revenue ruling concludes that the purchase of the remainder interest, which is analogous to a commutation of the QTIP trust, is treated as a taxable disposition by the surviving spouse of the qualifying income interest, resulting in a gift of the value of the remainder interest under § 2519. Citing to Wemyss, the revenue ruling explains that the receipt of the remainder interest cannot increase the donor’s taxable estate because it is already subject to inclusion in the surviving spouse’s taxable estate under § 2044. Accordingly, the surviving spouse’s receipt of the remainder interest cannot constitute adequate and full consideration under § 2512 for the promissory note transferred. The revenue ruling notes that any other result would subvert the legislative intent and statutory scheme underlying § 2056(b)(7).

In *Estate of Kite v. Commissioner*, T.C. Memo. 2013-43, the surviving spouse was the beneficiary of two QTIP trusts. According to a prearranged plan, the QTIP trusts were terminated and all assets were distributed to the surviving spouse. Two days later, the surviving spouse sold the assets to her three children in exchange for three deferred private annuity agreements under which payments would commence ten years thereafter. In the event that the surviving spouse died within the ten-year period, her annuity interest would terminate and nothing would be payable to her estate. Based on the facts and circumstances, the court found the sale of the assets of the QTIP trusts to the children in exchange for deferred annuities constituted a bona fide sale for adequate and full consideration and treated the annuity transaction as a single integrated transaction for purposes of § 2519. Moreover, the sale of the assets of the QTIP trusts, followed by the payment to the surviving spouse of the proceeds equal to the value of her income interest, was a disposition of her qualifying income interest for purposes of § 2519. In response to petitioner's post-opinion argument that there was no gift tax deficiency for the § 2519 disposition of the surviving spouse's qualifying income interest based on the receipt of full and adequate consideration, the court stated,

> [S]ection 2519(a) treats the disposition of a qualifying income interest as a deemed transfer of the remainder interest. In other words, "the donee spouse is treated as making a gift under section 2519 of the entire trust less the qualifying income interest" (emphasis added). Sec. 25.2519-1(a), Gift Tax Regs. The term "gift" is not an accident. The remainder interest is a future interest held by the remainderman and not the donee spouse. Accordingly, the donee spouse cannot receive full and adequate consideration, or indeed any consideration, in exchange for the remainder interest. This result is supported by the intent of the marital deduction and the QTIP regime.

Estate of Kite v. Commissioner, No. 6772-08 (T.C. Oct. 25, 2013) (order and decision under Tax Court Rule 155). The court ruled that the decedent owed gift tax on the value of the deemed § 2519 gift. *Id.*

Here, the QTIP statutory scheme and legislative history support the view that Rev. Rul. 69-505 has no application and the separate transfers by Spouse and Children cannot be offset by consideration for gift tax purposes. Decedent's estate received the benefit of deferral of the estate tax liability allocable to the property of Trust 1 as a result of electing QTIP for such property under § 2056(b)(7). Because the commutation effected by Agreement constitutes a taxable disposition by Spouse within the meaning of § 2519(a) (see Issue 1), it marks the end of the deferral of the tax.

Rev. Rul. 98-8 and *Estate of Kite* illustrate that a disposition under § 2519(a) has significant tax consequences, which are appropriate in view of the QTIP statutory scheme and legislative history. Here, because the commutation of Trust 1 results in a disposition of Spouse's qualifying income interest within the meaning of § 2519(a), Spouse is treated as effectively transferring the remainder interest even though under state property law precepts the remainder interest is held by Children, not Spouse. The taxable transfer by Spouse resulting from the application of § 2519 marks the end of the deferral of estate tax on the Trust 1 property that passed untaxed from Decedent's estate, and is no longer subject to inclusion in Spouse's gross estate under § 2044(b)(2). Eliminating the taxable transfer by Spouse based on a deemed reciprocal gift transfer by the remaindermen would allow the value of the remainder of Trust 1 to escape transfer tax under both §§ 2519 and 2044, which would be contrary to the QTIP statutory scheme and legislative history.

> Based on all of the above, we conclude that the commutation of Trust 1 and the distribution of all trust property to Spouse results in separate gift transfers by Children under § 2511 and by Spouse under § 2519(a) that do not offset each other.

CCA 202118008, “ISSUE 4: Value of Spouse’s Gift under § 2519(a),” reasoned:

> Although the deemed gift under § 2519 is often referred to as a gift of the remainder interest, implying that the amount of the gift is the fair market value of the remainder interest, § 2519(a) and § 25.2519-1(a) take a different approach. Section 2519(a) and § 25.2519-1(a) and (c)(1) apply the subtractive method of valuation; the amount treated as a gift by the surviving spouse is the fair market value of all interests in the property less the value of the qualifying income interest.
>
> A qualifying income interest is defined as the right to receive “all of the income from the entire interest.” Section 20.2056(b)-7(d)(2) cross-referencing § 20.2056(b)-5(f).
>
> Section 25.2512-5(a) generally provides that except as otherwise provided in §§ 25.2512-5(b) and 25.7520-3(b) of the Procedure and Administration Regulations, the fair market value of annuities, unitrust interests, life estates, term of years, remainders, and reversions transferred by gift, is the present value of the interests determined under § 25.2512-5(d).
>
> Section 25.2512-5(d)(1) provides that the fair market value of annuities, life estates, terms of years, remainders, and reversions transferred on or after May 1, 2009, is the present value of such interests determined under § 25.2512-5(d)(2) and by use of standard or special § 7520 actuarial factors.
>
> Section 25.2512-5(d)(2)(iii) provides generally that if the interest to be valued is the right of a person to receive the income of certain property, or to use certain non-income-producing property, for the life of one individual, the present value of the interest is computed by multiplying the value of the property by the appropriate life interest actuarial factor (that corresponds to the applicable § 7520 interest rate and life interest period).
>
> Section 25.7520-1(a)(1) provides that except as otherwise provided in §§ 25.7520-1 and 25.7520-3(b), in the case of gifts made after April 30, 1989, the fair market value of annuities, interests for life or for a term of years, remainders, and reversions is their present value determined under § 25.7520-1. Section 25.7520-1(b) provides generally that valuation under § 7520 consists of an interest rate component and a mortality component. For gifts made on or after May 1, 2009, the mortality component table is contained in § 20.2031-7(d)(7).
>
> Section 25.2519-1(c)(4) provides that the amount treated as a transfer under § 25.2519-1(c)(1) is further reduced by the amount the surviving spouse is entitled to recover under § 2207A(b) (relating to the right to recover gift tax attributable to the remainder interest). Under § 25.2519-1(c)(4), if the donee spouse is entitled to recover gift tax under § 2207A(b), the amount of the gift tax recoverable and the value of the interest treated as transferred under § 2519 are determined by using the same interrelated computation applicable for other transfers in which the transferee assumes the gift tax liability. The gift tax consequences of failing to exercise the right of recovery are determined separately under § 25.2207A-1(b).

Under § 2207A(b) and § 25.2207A-1(a), a surviving spouse treated as transferring an interest in property by reason of § 2519 is entitled to recover from the "person receiving the property" the amount of gift tax attributable to that property. The right of recovery arises at the time the gift tax is actually paid by the surviving spouse subject to § 2519.

In this case, the amount of Spouse's gift under § 2519 is determined by subtracting the value of Spouse's qualifying income interest from the fair market value of the trust property as of Date 3, the date of Agreement. Section 2519(a); § 25.2519-1(a). Discretionary principal distributions and the testamentary limited power of appointment are not taken into account. A standard § 7520 income factor can be used to value the qualifying income interest, and thus, the value of Spouse's qualifying income interest is determined by multiplying the value of the trust property by the income factor of 0.09172.[6] Section 25.2512-5(d)(2)(iii); § 25.7520-1. Based on a value of the trust property of $ b, the value of Spouse's qualifying income interest is $ e. The amount of Spouse's gift under § 2519, therefore, is $ f (i.e., $ b – $ e = $ f).

[6] The income factor of 0.09172 is determined as follows: 1.000000 minus 0.90828, the § 20.2031-7(d)(7), Table S remainder factor at age y and z%, the § 7520 rate on Date 3.

To the extent Spouse is entitled to recover gift tax attributable to the remainder interest under § 2207A(b), this amount is reduced, using an interrelated calculation. Note that, under § 25.2207A-1(b), if Spouse waives or otherwise fails to exercise Spouse's right of recovery, Spouse will be treated as making an additional gift in the amount of the unrecovered tax.[7]

[7] The request for advice raises the possibility that Paragraph 5 of Agreement may constitute a written waiver of Spouse's right of recovery under state law. To the extent it does, the gift tax consequences of failing to exercise the right of recovery are determined separately under § 25.2207A-1(b) and do not factor into the computation of the amount of the gift under § 2519.

CCA 202118008, "ISSUE 5: Value of Children's Gifts of Remainder Under § 2511," cites Code § 2512(a) and Regs. §§ 25.2512-5(d)(2)(ii), 25.7520-3(b), 25.7520-3(b)(1)(ii), 25.7520-3(b)(2)(iii), and 25.7520-3(b)(1)(iii), and reasons:

Where a standard § 7520 annuity, income, or remainder factor may not be used, the actual fair market value of the interest has been determined in some instances by an actuarial determination of the present value of the interest adjusted to account for the restriction. In *Estate of Gokey v. Commissioner*, T.C. Memo 1984-665, the Tax Court determined that principal invasion for the care, comfort, support or welfare of the life interest beneficiary was likely and discounted the present value of the remainder interest accordingly, explaining "where an ascertainable standard exists, the [taxpayer] must establish with reasonable certainty the needs of the owner of the life estate for the rest of her life and the extent to which corpus might be invaded under the standard." *Id.* (citing *Lockard v. Commissioner*, 7 T.C. 1151, 1154-55 (1946), *aff'd*, 166 F. 2d 409 (1st Cir. 1948)). See also *Ithaca Trust Co. v. U.S.*, 279 U.S. 151, 154 (1929) (determining that the value of a charitable remainder interest could be derived from IRS mortality tables with no diminution in value to account for principal invasion subject to a standard for the beneficiary of the life interest because income was more than enough to satisfy the standard, making principal invasion highly unlikely).

In this case, the interests to be valued are the Children's respective remainder interests in Trust 1, determined as of Date 3. While Agreement acknowledges a commutation occurred, the terms of Agreement indicate that no computation of the value of the commuted interests in Trust 1 was performed by the trustee since all property was distributed to Spouse. Further, Child 1 and Child 2 each reported the gift of their proportionate share of the remainder interest to Spouse on Forms 709, but each reported the amount of the gift to be $0. In the absence of the trustee's or Children's computations of the actuarial value of Children's respective remainder interests in Trust 1, the Service will make its own determination.

Based on the available facts, it is appropriate to value each of Children's interests as one-half of the actuarial present value of the remainder interest, adjusting as necessary for the restrictions on the beneficial interests. The determination takes into account that the possibility of principal invasion was so remote as to be negligible, given that the combined value of the property held by Trust 1 was $b at the time of commutation and, thus, annual income of Trust 1 would have been substantial and likely sufficient for Spouse's health, maintenance, and support, even if Spouse's accustomed manner of living were extravagant.[8] Further, the determination takes into account, based on all the facts and circumstances, that the testamentary limited power of appointment would be appropriately treated as having no measurable effect on the values of these interests.

[8] This reasoning is bolstered by Spouse's sale of most of the trust property immediately after Spouse received it in exchange for promissory notes that did not provide for the payment of principal until a date after Spouse's probable life expectancy.

Accordingly, based on the available facts, we conclude that the actuarial value of Children's proportionate shares of the remainder interest is properly determined under § 7520, using a standard remainder factor. Thus, the value of each child's remainder interest under § 7520 is determined by multiplying the value of the trust property by the remainder factor of 0.90828[9] then dividing the product by 2. Section 25.2512-5(d)(2)(ii); § 25.7520-1. Based on a value of the trust property of $ b, the fair market value of each child's gift, therefore, is $g (*i.e.*, ($ b x 0.90828) ÷ 2 = $ g).

[9] The remainder factor of 0.90828 is the § 20.2031-7(d)(7) Table S remainder factor at age y and z%, the § 7520 rate on Date 3.

Boyle & Zaritsky, "Chief Counsel Advice 202118008: Tax Consequences of Distributing an Entire QTIP Trust to Spouse," *Probate Practice Reporter* vol. 33, No. 6 (6/2021), explains:

The Service's overall position in the *Chief Counsel Advice* is that the amount paid to the spouse in exchange for the acceleration of the remainder interest cannot reduce the value of the spouse's deemed gift of the remainder interest under section 2519. The gift to the remainder beneficiaries under section 2519 is not a transfer of property by the spouse as the spouse-beneficiary of a QTIP has no interest in the principal of the trust. Thus, when some portion or all of the qualifying income interest is released to trigger section 2519, there is no transfer of qualifying income interest that is transferred to trigger the section 2519 gift. Rather, the accelerated transfer of the remainder interest is a gift of property from the original grantor who created the QTIP trust. Without section 2519 there would be no reason to tax the spouse as the spouse is not transferring his or her own property as required by section 2511 for a taxable gift.

Section 2519 was added to the Code when the QTIP rules of sections 2056(b)(7) and 2523(f) were adopted in 1981. The purpose of section 2519 is to provide inter vivos taxation of property that was not subject to estate or gift tax when the QTIP trust was created. Section 2044 accomplishes the same result when the surviving spouse beneficiary dies. The purpose of all four sections is to permit the first spouse to die a deferral of estate or gift taxes on the transfer of his or her property to a spouse. That estate or gift tax deferral ends when the surviving spouse disposes of some or all of the qualifying income interest or dies, but under section 2207A it is the first spouse's property that is used to pay any gift or estate taxes due.

Reciprocal Transfers

The Service's position that the reciprocal trust doctrine is not applicable also seems valid. The children are not economically in the same position after the trust termination. Before the termination, the children held contingent remainder interests in the QTIP trust. After the termination, they were entitled to nothing.

On the other hand, the spouse owns outright the actuarial value of both the qualified income interest and the value of the remainder after the termination. For a reciprocal transfer, there should be interests in property moving both directions, to equate with the interests of the original transferors. When nothing remains for one of the transferors after the dust has settled, there is nothing that is reciprocal. See Rev. Rul. 74-533, 1974-2 C.B. 293, to calculate the amount of reciprocity.

Furthermore, application of the reciprocal trust doctrine in *Grace* concerned the application of the federal estate tax. The Supreme Court's opinion does not discuss the application of the federal gift tax as the trusts in *Grace* were created shortly before Congress adopted a gift tax. There is no reason to believe that gift tax would not have applied when the trusts in *Grace* were created under current gift tax law. The reciprocal trust doctrine has been applied in the gift tax context when related donors seek to increase the amount of annual exclusion gifts by making gifts to each other's children. See for example, *Sather v. Commissioner*, 251 F.3d 1168 (8th Cir. 2001), *aff'g in part, rev'g in part* T.C. Memo. 1999-309, discussed in the July 2001 issue of the REPORTER.

Income Tax Issues

The Chief Counsel Advice does not consider the possible income tax consequences of the transaction. It seems quite reasonable that the Service could have argued, and might still argue, that the reciprocal gifts were in fact an income taxable exchange of property. The taxpayers argued that the gifts were valued at zero because of the mutual consideration. But this position leaves open the argument that it was a bargained-for exchange - that is, the children paid the spouse to terminate the trust early. The spouse would not seem to have any basis in the remainder interest, and therefore the full amount received would be included in gross income. Treasury Regulation section 1.1015-4 provides rules to calculate gain in a transaction that is a sale in part and a gift in part when the consideration is not full and adequate.

In addition, and more onerous, is the possibility that the agreement to commute or terminate the trust was an income taxable event regardless of the gift tax issues. Howard Zaritsky, Ryan Wallace, and the author of this article published a lengthy law review article discussing the income tax consequences of terminating a trust early. See, Boyle, Zaritsky, and Wallace, *The Uniform Basis Rules and Terminating Trusts Early*, 55 REAL PROP. TR. & EST. L.J. 1 (2020).

The Service has a long-standing letter ruling position that commutation or early termination of a trust, in which the term interest holder(s) and remainder interest holder(s) receive their respective actuarial shares of the underlying assets, is a sale of the life or term interest to the remainder interest holder. As a consequence, it applies the "no-basis recovery" rule of section 1001(e)(1) to the life or term interest because all of the property is not sold to a third party. Therefore, the life or term interest holder realizes gain for the full amount received in exchange for the interest. According to the Service, the remainder interest holder does not realize gain on the exchange of the remainder interest for trust assets but may realize gain to the extent appreciated assets are used to acquire the life or term interests.

The Service applied its ruling position in 2019 in ten related letter rulings concerning the same trust. See Private Letter Rulings. 201932001-010 (Aug. 9, 2019), discussed in the September 2019 issue of the REPORTER. The Service's position is not without precedent. In particular, *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947), supports the application of section 1001 to the commutation of a trust, even though this case is not cited in the letter rulings. Thus, the spouse in the Chief Counsel Advice might well have income as a result of the commutation based on *McAllister*, section 1001(e), and other statutes and precedent discussed in the author's co-authored law review article.

A full discussion of the uniform basis rules and the possible application to the termination of a QTIP trust is beyond the scope of this article, but practitioners who advise clients about terminating trusts should carefully consider the potential for an income tax liability.

Conclusion

The Chief Counsel Advice is quite lengthy: nearly 7,000 words. The discussion of the issues above attempts to summarize the Service's position. Of special note is the fact that the Chief Counsel Advice arises in an audit of gift tax returns in which the taxpayers gave notice of the transaction but took the position that the value of the gifts was zero: returns are being audited that report transactions but no taxable gifts. A second interesting facet is that the Chief Counsel Advice would not quantify the value of a discretionary right to trust principal, but instead give it a zero value.

Children are probably better off having lost their argument regarding reciprocal transfers. If their argument had succeeded, then they would have been the true settlors of the Children's Trusts instead of Spouse being the settlor, and Children's Trusts would have been included in their gross estates under Code § 2036.[2995]

I would push back somewhat against the way in which the CCA argued the children's interest was valued. The facts were:

Trust 1 grants Spouse a testamentary limited power of appointment in favor of Decedent's descendants. In the absence of Spouse's exercise of Spouse's testamentary

[2995] See part III.C Code § 2036.

limited power of appointment, Trust 1 directs the remainder to be distributed outright to Children, by right of representation.

Because spouse could have appointed all of the remainder to grandchildren, none of Children was assured of an outright distribution. Therefore, arguably Children's remainder interest was unascertainable.[2996] You might consider advising remaindermen to file gift tax returns in such situations, using adequate disclosure, to get finality on the issue and avoid perhaps penalties and many years of interest if the IRS examines the surviving spouse's return and asks what happened to the marital trust.

One final comment about Boyle & Zaritsky's article: They refer to their article in the *RPTE Journal* on the termination of trusts. Although the latter is a good summary, it does not consider the nuances described in part II.J.18.f Commutation vs Mere Division, so consider their income tax cautions generally but apply some taxpayer-favorable skepticism. However, their warnings are right on target in CCA 202118008, because in CCA 202118008 the spouse's interest in the trust was ascertainable and the trustee did not have the discretion that part II.J.18.f suggests would be quite helpful in avoiding income tax consequences on trust termination. Again, the children are fortunate that CCA 202118008 rejected their swap argument, because otherwise CCA 202118008 may have deemed them to have sold their remainder interest.

Letter Ruling 202339008 included the following facts with a QTIP trust:

> The trust agreement of Trust ("Trust Agreement") provides that upon Decedent's death, the trustee is to divide the trust estate into two separate trusts, Marital Trust and Non-Marital Trust. Trust Agreement provides that Marital Trust is to be funded with property equal in value to that fractional share of Decedent's gross estate, the numerator of which is the marital deduction amount and the denominator of which is the value of Decedent's gross estate at its federal estate tax value after paying expenses and taxes. The marital deduction amount is defined as that amount which equals the lowest marital deduction which results in no federal estate tax being owed by reason of Decedent's death. Pursuant to Trust Agreement, the remaining portion of the trust estate was to fund Non-Marital Trust. Because Decedent had exhausted the entirety of his Basic Exclusion Amount before his death, Non-Marital Trust was not funded, and the entirety of the trust estate passed to Marital Trust.
>
> Trust Agreement requires the trustee to pay Spouse all the net income of Marital Trust for her lifetime. In addition, Trust Agreement provides that the trustee may distribute to Spouse as much principal as the trustee, in its sole discretion, deems necessary or advisable for Spouse's comfort, support, or welfare. Upon Spouse's death, the remaining principal and income of Marital Trust passes to Non-Marital Trust after payment of any taxes attributable to Marital Trust's inclusion in Spouse's estate.
>
> Trust Agreement provides that trustee must distribute all income of Non-Marital Trust between Spouse, Child 1, and Child 2. Trust Agreement further provides that trustee may distribute as much principal of Non-Marital Trust to Spouse, Child 1, or Child 2 as the trustee in its sole discretion deems necessary for their education, support, maintenance, and health. Trust Agreement provides that upon Spouse's death, Non-Marital Trust will split into separate shares for Child 1 and Child 2. The assets of each

[2996] See fn 6350 in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts.

child's separate share will be distributed outright to him or her at age x. Child 1 and Child 2 have both attained the age of x.

> Trust Agreement provides that Spouse may disclaim her right to receive income and principal from part or all of Marital Trust as Spouse specifies in a writing deposited with the trustee during Spouse's life. Trust Agreement further provides that assets disclaimed by Spouse are to be added to Non-Marital Trust.
>
> Spouse proposes to renounce her interests in Marital Trust and, in accordance with State Statute, her interest in Non-Marital Trust. After the renunciations, because both Child 1 and Child 2 have attained age x, the property of Non-Marital Trust will be distributed to Child 1 and Child 2 under the express provisions of Trust Agreement, in accordance with State Statute. Additionally, as a condition of such renunciation, Spouse, Child 1 and Child 2 intend to enter into a net gift agreement ("Net Gift Agreement") providing that gift tax imposed on Spouse's gift of her qualifying income interest under § 2511 will be paid by Child 1 and Child 2. Finally, Spouse intends to exercise her right under § 2207A to recover from Child 1 and Child 2 the gift tax attributable to Spouse's deemed gift of the remainder of Marital Trust under § 2519.

Letter Ruling 202339008 included the following analysis and ruling:

> Section 25.2519-1(c)(1) provides that the amount treated as a transfer under § 2519 upon a disposition of all or part of a qualifying income interest for life in QTIP is equal to the fair market value of the entire property subject to the qualifying income interest, determined on the date of the disposition (including any accumulated income and not reduced by any amount excluded from total gifts under § 2503(b) with respect to the transfer creating the interest), less the value of the qualifying income interest in the property on the date of the disposition. The gift tax consequences of the disposition of the qualifying income interest are determined separately under § 25.2511-2.
> Section 25.2519-1(c)(4) provides that the amount treated as a transfer under § 25.2519-1(c)(1) is further reduced by the amount the donee spouse is entitled to recover under § 2207A(b). If the donee spouse is entitled to recover gift tax under § 2207A(b), the amount of the gift tax recoverable and the value of the remainder interest treated as transferred under § 2519 are determined by using the same interrelated computation applicable for other transfers in which the transferee assumes the gift tax liability. The gift tax consequences of failing to exercise the right of recovery are determined separately under § 25.2207A-1(b).
>
> Under § 2207A(b) and § 25.2207A-1(a), if an individual is treated as transferring an interest in property by reason of § 2519, the individual is entitled to recover from the "person receiving the property" (as defined in § 25.2207A-1(e)) the amount of gift tax attributable to that property. Under § 25.2207A-1(e), if the property is in trust at the time of the transfer, the "person receiving the property" is the trustee, and any person who has received a distribution of the property prior to the expiration of the right of recovery if the property does not remain in trust. Under § 25.2207A-1(b), the failure of a person to exercise a right of recovery provided by § 2207A(b) is treated as a transfer for federal gift tax purposes of the unrecovered amounts to the persons from whom the recovery could have been obtained.
>
> Rev. Rul. 75-72, 1975-1 C.B. 310, holds that if, at the time of the transfer, a gift is made subject to a condition that the gift tax is to be paid by the donee or out of the transferred

property, then the donor receives consideration for the transfer in the amount of the gift tax to be paid by the donee. Thus, under § 2512(b), the value of the gift is the fair market value of the property passing from the donor less the amount of the gift tax to be paid by the donee or from the property itself.

Rev. Rul. 81-223, 1981-2 C.B. 189, holds that, in determining the amount of the gift tax liability that is to be subtracted from the value of the transferred property, the donor's available unified credit must be used to reduce the gift tax liability that the donee has assumed to the extent unified credit is available.

State Statute provides, in part, that a person may disclaim, in whole or in part, conditionally or unconditionally, any interest in or over property. Under State Statute, a disclaimer becomes irrevocable when any conditions to which the disclaimant has made the disclaimer are satisfied and when the disclaimer is delivered and filed in accordance with State law. Further, State Statute provides that if a donative instrument expressly provides for the distribution of property if there is a disclaimer, the property shall be distributed in accordance with the donative instrument. However, in the absence of express provisions to the contrary in the donative instrument, the property or interest in property disclaimed, and any future interest that is to take effect in possession or enjoyment at or after the termination of the interest disclaimed, shall be distributed as if the disclaimant had predeceased the decedent.

In this case, Spouse's renunciation of her interest in Marital Trust will not constitute a qualified disclaimer under § 2518 and the applicable regulations because it was not made within nine months of the creation of the interest (which in this case is Decedent's death) and Spouse has already accepted benefits from the Marital Trust. Based upon the facts submitted and the representations made, the renunciation of Spouse's interest in Marital Trust is a disposition of Spouse's qualifying income interest for life in property for which a marital deduction was allowed under § 2056(b)(7). Spouse will make a completed gift of her qualifying income interest in Marital Trust under § 2511 and will be deemed to have made a completed gift of all of the other property and other interests in property then owned by Marital Trust, other than Spouse's qualifying income interest in Marital Trust, under § 2519.

Because Spouse's renunciation of her interest in Marital Trust will result in a completed transfer to Non-Marital trust, Spouse will be considered to make an inter vivos transfer to Non-Marital Trust. Consequently, under § 2518 and the applicable regulations, the Non-Marital Trust beneficiaries' interests with respect to the property transferred from Marital Trust will be created as of the date of Spouse's renunciation of her interest in Marital Trust. Accordingly, the beneficiaries of Non-Marital Trust may disclaim their interests in the property transferred by Spouse to Non-Marital Trust within nine months of Spouse's renunciation of her interests in Marital Trust. Therefore, based on the facts submitted and the representations made, Spouse's renunciation of her interest in the property transferred to Non-Marital Trust will constitute a qualified disclaimer under § 2518 and the applicable regulations.

As a condition of the gift resulting from Spouse's renunciations of her interest in Marital Trust and Non-Marital Trust, Spouse, Child 1, and Child 2 intend to enter into Net Gift Agreement providing that gift tax imposed on Spouse's qualifying income interest under § 2511 will be paid by Child 1 and Child 2. Thus, based on the facts submitted and the

> representations made, after the renunciations, the amount of the gift will be reduced by the gift taxes paid by or recovered from Child 1 and Child 2.
>
> Furthermore, based on the facts submitted and the representations made, Spouse's gift under § 2519 will be reduced by Spouse's right under § 2207A to recover from Child 1 and Child 2 the gift tax attributable to such gift.

Letter Ruling 202339008 ruled that the gift tax tax paid by the children through the net gift would nevertheless be included in Spouse's estate if Spouse dies within three years:

> Section 2035(b) provides that the amount of the gross estate shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse during the 3-year period ending on the date of the decedent's death.
>
> In *Estate of Sachs v. Commissioner*, 856 F.2d 1158 (8th Cir. 1988), donor made a gift to trust, and, pursuant to a net gift agreement, the trustee paid the gift tax associated with the gift. When donor died within three years of making the gift, the court held that the gift tax paid was included in donor's estate even though it was actually paid by the donees. The court stated "[j]ust as the donee's tax payment must be included in the donor's taxable income, a donee's tax payment (on a gift made within three years of the donor's death) is an includable part of the donor's gross estate under [§ 2035(b)]. The fact that the Internal Revenue Service received the payment for the decedent's gift-tax liability via the donee does not make it any less a 'tax paid...by the decedent or his estate' within the meaning of [§ 2035(b)]. " *Id*. at 1164.
>
> In *Estate of Morgens v. Commissioner*, 133 T.C. 402 (2009), *aff'd*, 678 F.3d 769 (9th Cir. 2012), decedent transferred her income interest in a QTIP trust to the remainder beneficiaries and died within three years of making the gift. As a condition of the gift, the remainder beneficiaries agreed to pay the gift tax liability arising under § 2519. The court held that neither the donees' agreement to pay the gift tax nor the decedent's right of recovery under § 2207A(b) prevented the gift tax paid from being included in the decedent's estate under § 2035(b).
>
> The legislative history to § 2035(b) provides that "the gift tax paid on transfers made within 3 years of death should in all cases be included in the decedent's gross estate." H.R. Rep. No. 94-1380 at 3366.
>
> Based on the facts submitted and the representations made, all gift tax imposed on Spouse's gift of the interests in Marital Trust under §§ 2511 and 2519 will be included in Spouse's gross estate under § 2035(b) if she dies within three years of having made the gift.

Letter Ruling 202339008 discussed the income tax consequences of the net gift agreement, by which Spouse was deemed to sell her beneficial interest in exchange for gift tax paid:

> Section 1001(e)(1) provides that in determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to § 1014, § 1015, or § 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be

disregarded. Section 1001(e)(2)(C) provides that the term “term interest in property” means an income interest in a trust.

The character of the gain will depend on the nature of the asset sold. Section 1222 provides that long-term capital gain is gain from the sale or exchange of a capital asset held for more than one year. Section 1221 provides that the term “capital asset” means property held by the taxpayer, excluding certain types of property not apparently at issue in this case.

Rev. Rul. 72-243, 1972-1 C.B. 233, holds that the proceeds received by the life tenant of a testamentary trust, in consideration for the transfer of her entire interest in the trust to the remainderman, are to be treated as an amount realized from the sale or exchange of a capital asset under § 1222 and that the life tenant’s basis attributable to his life interest at the time of the sale is considered to be zero, pursuant to § 1001(e). See §§ 1.1001-1(f) and 1014-5(b) and (c) of the Income Tax Regulations.

In *Diedrich v. Commissioner*, 457 U.S. 191 (1982), the Court held that, if a donor makes a gift transfer of appreciated property that is conditioned upon the transferee’s payment of the resulting gift tax, the donor realizes gross income to the extent that the gift tax paid by the donee exceeds the donor’s adjusted basis in the transferred property. The Court reasoned that, when a donor makes a gift to a donee, a debt to the United States for the amount of the gift tax is incurred by the donor. When the donee agrees to discharge an indebtedness in consideration of the gift, the person relieved of the tax liability realizes an economic benefit.

Based on the facts submitted and the representations made, the amount realized by Spouse, under § 1001(b), will be the amount of gift tax paid or reimbursed by Child 1 and Child 2 attributable to Spouse’s gift of her income interest under § 2511 pursuant to the Net Gift Agreement. Gift tax paid or reimbursed by Child 1 and Child 2 attributable to Spouse’s gift under § 2519 of the remainder of Marital Trust is not part of the amount realized by Spouse under § 1001(b).

Because Spouse’s adjusted basis in the property she is transferring is considered to be zero under § 1001(e), the gain from Spouse’s disposition of the property will be equal to the amount realized. Accordingly, under § 1001(c), the entire amount of gain will be recognized.

Under Rev. Rul. 72-243 and *Diedrich*, Spouse’s gain from the transfer of her entire interest in Marital Trust will be treated as an amount realized from the sale or exchange of a capital asset under § 1222.

Accordingly, based on the facts submitted and the representations made, the current federal income tax imposed on Spouse as a result of the proposed transaction will be calculated by treating the amount of gift tax paid or reimbursed by Child 1 and Child 2 attributable to Spouse’s gift of her income interest under § 2511 pursuant to the Net Gift Agreement as gain from the sale of a capital asset.

Reg. § 1.1014-8 governs the basis of a remainder interest, but it has not been updated for various changes in the law.

Code § 167(e), "Certain term interests not depreciable," provides:

(1) *In general*. No depreciation deduction shall be allowed under this section (and no depreciation or amortization deduction shall be allowed under any other provision of this subtitle) to the taxpayer for any term interest in property for any period during which the remainder interest in such property is held (directly or indirectly) by a related person.

(2) *Coordination with other provisions*.

(A) *Section 273*. This subsection shall not apply to any term interest to which section 273 applies.

(B) *Section 305(e)*. This subsection shall not apply to the holder of the dividend rights which were separated from any stripped preferred stock to which section 305(e)(1) applies.

(3) *Basis adjustments*. If, but for this subsection, a depreciation or amortization deduction would be allowable to the taxpayer with respect to any term interest in property—

(A) the taxpayer's basis in such property shall be reduced by any depreciation or amortization deductions disallowed under this subsection, and

(B) the basis of the remainder interest in such property shall be increased by the amount of such disallowed deductions (properly adjusted for any depreciation deductions allowable under subsection (d) to the taxpayer).

(4) *Special rules*.

(A) *Denial of increase in basis of remainderman*. No increase in the basis of the remainder interest shall be made under paragraph (3)(B) for any disallowed deductions attributable to periods during which the term interest was held—

(i) by an organization exempt from tax under this subtitle, or

(ii) by a nonresident alien individual or foreign corporation but only if income from the term interest is not effectively connected with the conduct of a trade or business in the United States.

(B) *Coordination with subsection (d)*. If, but for this subsection, a depreciation or amortization deduction would be allowable to any person with respect to any term interest in property, the principles of subsection (d) shall apply to such person with respect to such term interest.

(5) *Definitions*. For purposes of this subsection—

(A) *Term interest in property*. The term "term interest in property" has the meaning given such term by section 1001(e)(2).

(B) *Related person*. The term "related person" means any person bearing a relationship to the taxpayer described in subsection (b) or (e) of section 267.

(6) *Regulations*. The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including regulations preventing avoidance of this subsection through cross-ownership arrangements or otherwise.

Code § 267 is described in part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses.

Code § 273, "Holders of life or terminable interest," provides:

> Amounts paid under the laws of a State, the District of Columbia, a possession of the United States, or a foreign country as income to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be reduced or diminished by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time.

The committee reports for Code § 167(e) (P L. 101-239, 12/19/89) explain:[2997]

House Explanation

Present Law.

The purchaser of a term interest in property is, for income tax purposes, entitled to amortize the cost of the interest over its expected life. The purchaser of a remainder interest in property generally does not include currently in income increases in the value of the interest.

On the other hand, a person who divides an interest in property into two parts cannot create an amortizable asset where none previously existed. Thus, a person who retains a term interest in property while transferring the remainder in that property cannot amortize the cost of the term interest.[1]

[1] See, *e.g.*, *Lomas Santa Fe, Inc. v. Commissioner*, 74 T.C. 662, 682-83 (1980); *United States v. Georgia R.R. & Banking Co.*, 348 F.2d 278, 288-89 (5th Cir. 1965), *cert. denied*, 382 U.S. 973 (1966).

Explanation of Provision.

No depreciation or amortization deduction is allowed for a term interest in property for any period during which the remainder interest in such property is held (directly or indirectly) by a related person. The provision does not affect a depreciation deduction which is not attributable to a term of years of life estate. Thus, the owner of a term interest in a building cannot amortize the term interest but may claim the depreciation deduction with respect to the underlying building allowed under present law.

The taxpayer's basis in a term interest is reduced by the deductions disallowed by the provision, and the remainderman's basis in the remainder is increased by those

[2997] Excerpted from RIA Checkpoint, USTR, "COMREP ¶1671.004 Disallowance of Depreciation for Certain Term Interests."

deductions. In the joint purchase described in the above example, the child's basis in the preferred stock would be increased in each of the six years by $72.61, the amount of the amortization deduction denied to the parent by reason of the provision.

A term interest in property is a life interest in property, an interest in property for a term of years, or an income interest in a trust. A related person is any person bearing a relationship to the taxpayer described in section 267(b) or 267(e). In determining whether persons are related, the constructive ownership rules of section 267(c) apply.

The Secretary of the Treasury shall prescribe such regulations as may be necessary to carry out the purposes of the provision, including regulations preventing avoidance of the provision through cross-ownership arrangements or otherwise. Such regulations shall prevent avoidance of the provision by one family owning a term interest in one property and a remainder interest in a second property, while another family owns a remainder interest in the first property, and a term interest in the second property. Such regulations would also prevent avoidance through the joint purchases of interests in substantially similar property. For example, a parent could not avoid the provision by purchasing a life interest in stock of a corporation while a child purchases a remainder interest in other stock of the same corporation.

The committee does not intend to change the taxation of transactions in which the remainderman is taxed on his accretion in wealth. Thus, for example, the provision does not affect the taxation of a stripped bond under section 1286 or transactions in which the lessor is imputed income under section 467(f).

Effective Date.

The provision applies to life or terminable interests acquired or created after July 27, 1989, in taxable years ending after such date.

Conference Report

Conference Agreement.

The conference agreement follows the House bill, with the following modifications. First, the remainderman's basis in the remainder is not increased for any disallowed deductions attributable to periods during which the term interest was held by (1) an organization exempt from tax under subtitle A of the Code or (2) a nonresident alien individual or foreign corporation (but only if income from the term interest is not effectively connected with the conduct of a trade or business in the United States).

Second, the holder of an interest in property for a term of years whose amortization deduction would be allowed but for the provision is permitted a depreciation deduction computed as if he were absolute owner of the property. Thus, the provision does not allow such a depreciation deduction to a person whose amortization deduction is disallowed under present law.

Third, the increase in the remainderman's basis in his interest is reduced by any depreciation allowable to the term holder with respect to the underlying property.

Fourth, the provision does not apply to any term interest to which section 273 applies.

In addition, the conferees intend that the remainderman's basis in the property is increased only if the term holder's amortization deduction would be allowed but for the provision.

The conferees intend no inference regarding the divisibility of property for tax purposes under present law. Nor do they intend any inference regarding the character of income or gain from property so divided.

Rev. Rul. 62-132 held:

The Internal Revenue Service will follow the decision of the United States Court of Appeals for the Sixth Circuit in *Commissioner v. William N. Fry, Jr., et al.*, 283 Fed.(2d) 869 (1960), and the decision of the United States Court of Appeals for the Seventh Circuit in *Laird Bell v. Harrison, et al.*, 212 Fed.(2d) 253 (1954).

These cases hold that a remainderman of a trust, the corpus of which consists of corporate stock, who purchases the interest of a life beneficiary of the trust, is entitled to recover his cost through amortization over the period of the beneficiary's life expectancy, by ratable annual deductions.

The Service had argued that the purchased life interest became merged with the remainder interest, with the result that the cost of the purchased life interest could be recouped only at the time of the sale or other disposition of the stock.

The Service noted that the transactions in these cases appeared to be bona fide and without a tax avoidance motive. These cases will be followed in the disposition of other cases in which the facts are substantially the same.

[1] Based on Technical Information Release 392, dated July 16, 1962.

Thus:

- Under Code § 273, the holder of a life or terminable interest acquired by gift, bequest, or inheritance cannot amortize its basis. Note that none of these events is a purchase, so Code § 273 does not affect purchases.

- Under Code § 167(e)(1), a taxpayer holding a term interest cannot amortize that interest when the remainder interest is held (directly or indirectly) by a related person.

- Rev. Rul. 62-132 allows the purchaser of a term interest to amortize it if Code § 167(e)(1) does not apply.

- The seller of a term interest cannot apply basis against sale proceeds unless the overly narrow Reg. § Reg. § 1.1001-1(f)(3), which requires a transfer "to a third person or to two or more other persons," applies.

In *Garvey v. U.S.*, 369 F.Supp.2d 1328 (D. Kan. 2005), in 1987 Mr. and Mrs. Garvey bought life interests and 1983 irrevocable trusts they had created bought remainder interests in interests in a newly formed partnership. A 1986 letter from their investment advisor described the plan:

> Although the initial objective was to determine if there is an opportunity by utilization of split purchases of property to transmit it to subsequent generations with no transfer tax costs, an additional objective emerged and that is as a method of extracting corporate [or partnership] assets to others without the imposition of either a dividend or capital gains tax.
>
> "It" is the split purchase of assets from unrelated parties with the older generation buying a life estate or a term of years and the younger generation purchasing the remainder interest with the cost allocated based on the actuarial tables….
>
> Upon the expiration of the term interest, the entire property, including accumulated capital gains or less accumulated capital losses, passes to the remainderman free of income, gift and estate taxes….
>
> The practical limiting factor is the availability of funds by the persons or entities to purchase the remainder interest. Simultaneous gifts of funds for the acquisition of the interest contains an element of risk in collapsing the transaction into one of being a "retained" interest rather than a "purchased" interest, in which case the favorable estate tax results do not occur. Gifts separated by time or gifts by the spouse of the purchaser of the term interest would work.
>
> There is no gift tax imposed in any point in time in the described transaction because there is no gift, *i.e.*, each party is paying the market value of its interest as determined the actuarial tables.
>
> While the term interest is in effect its holder may amortize and deduct for Federal income tax purposes the aliquot portion of the cost of the term interest although the property may otherwise be nondepreciable, *e.g.*, securities or land.
>
> Properly drafted, any capital gains realized during the time of the term interest are subjected to tax but not to either the holder of the term interest or the remainderman, but to an "implied trust" which constitutes a separate taxpayer, presumably at lower rates, with the tax paid from the proceeds of the transaction giving rise to the gain, and with the remainder of the proceeds being retained with the income therefrom, being paid to the holder of the term interest.
>
> Upon expiration of the term interest there is no income tax liability to the remainderman upon receipt of the property, with the only unfavorable factor being the remainderman's tax basis in the entire property is only his cost of the remainder interest.
>
> In a life estate, of course, upon death of the life tenant there would be no estate tax, which is a potentially significant advantage of utilizing a life estate other than a term interest.

From 1987-1996, deductions from amortizing their life estate in the partnership were $1,496,073, and their share of the partnership income was $898,475. When the IRS disallowed the amortization deductions, the taxpayers paid and sued for a refund. The *Garvey* court explained:

> Plaintiffs assert that they are entitled to a refund of the income taxes in issue because during the periods here pertinent, relevant tax law provided that to recover plaintiffs' tax

basis in the assets they contributed to Joy, an amortization deduction was available over the limited life of their interests in the partnership. They contend that the law provided that an asset (in this case a partnership interest) owned for a limited term with other related parties qualified for an amortization deduction. (See, *e.g.*, *Richard Hansen Land, Inc. v. Commissioner*, 65 T.C.M. (CCH) 2869 (1993)). Plaintiffs cite the general rule that a taxpayer who purchases a term interest in property which is used in a trade or business, or held for the production of income, is entitled to deduct ratably the cost of that interest over its expected life.[1] See, *e.g.*, Tres. Reg., 1.1014-5(c), Examples 1, 2 and 3; Rev. Rul. 62-132, 1962-2 CB 73; *Early v Commissioner*, 445 F.2nd, 166, 169 (5th Cir. 969 [sic, 1971]); *Manufacturers Hanover Trust Co., v Commissioner*, 431 F.2nd 664 (2nd Cir. 1970). Plaintiffs contend that the general rule applies to their investment in Joy.

> [1] An exception to the general rule is sec. 167(e) (as amended and in effect currently), which prohibits a taxpayer from amortizing a term interest where a related person holds the remainder interest. This section, however, applies only to term interests acquired or created after July 27, 1989. Since plaintiffs' term interests were created before that date, sec. 167(e) is inapplicable to the present case.

Defendant counters that plaintiffs formed Joy as the result of an integrated plan by which the plaintiffs transferred assets to other partners, who in turn then joined with the plaintiffs in the formation of the partnership. Defendant cites an exception to the general rule which occurs where a taxpayer, without additional investment, divides nondepreciable property into two parts, one of them being a term interest. In such a situation, amortization deductions are not allowable. See, *e.g.*, *Lomas Santa Fe, Inc. v. Commissioner*, 693 F.2nd 71 (9th Cir. 1982); *United States v Georgia R.R. & Banking Co.*, (348 F.2nd 278 (5th Cir. 1965)). Defendant contends that the exception to the general rule applies because the formation of Joy was the culmination of singular steps in an agreed-upon plan, and thus the steps can be amalgamated and treated as part of a single transaction. See, *e.g.*, *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Kornfeld v. Commissioner*, 137 F.3rd, 1231 (10th Cir. 1998).

After reviewing *Gordon v. Commissioner*, 85 T.C. 309 (1985)[2998] and *CGF Industries, Inc. v. Commissioner*, 77 T.C.M. (CCH) 1405 (1999), the court decided that the trusts were old and

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[2998] *Gordon* applied a step transaction theory to disallow the amortization, but only after commenting at 322-323:

> It is clear that a taxpayer may deduct ratably his or her cost basis in a purchased term, including a life, interest.[6] *Early v. Commissioner*, 445 F.2d 166, 169 (5th Cir. 1971), *revg.* on another ground 52 T.C. 560 (1969); *Manufacturers Hanover Trust Co. v. Commissioner*, 431 F.2d 664 (2d Cir. 1970), *affg*. a Memorandum Opinion of this Court; *Gist v. United States*, 296 F.Supp. 526, 528 (S.D. Cal. 1968), *affd*. 423 F.2d 1118 (9th Cir. 1970); *Frank MacBoyle Lewis Trust B v. Commissioner*, 83 T.C. 246, 253 n. 10 (1984); *Elrick v. Commissioner*, 56 T.C. 903, 909 (1971), *revd*. on another ground 485 F.2d 1049 (D.C. Cir. 1973); see also secs. 167(h), 62(6).[7] This is true even where the property underlying the purchased term interest is itself nondepreciable. See, *e.g.*, *Early v. Commissioner*, *supra* ; *Manufacturers Hanover Trust Co. v. Commissioner*, *supra*; *Elrick v. Commissioner*, *supra*. However, it is also clear that where a taxpayer, without additional investment, divides nondepreciable property into two parts, one of them being a term interest, amortization deductions are not allowable. *United States v. Georgia Railroad & Banking Co.*, 348 F.2d 278, 286-289 (5th Cir. 1965); *Lomas Santa Fe, Inc. v. Commissioner*, 74 T.C. 662, 681-684 (1980), *affd*. 693 F.2d 71 (9th Cir. 1982).

cold and that the taxpayers were entitled to deduct amortization of their life interests, based on these conclusions of law:

> During the relevant period, taxpayers who acquired a term interest in intangible property were allowed to amortize or depreciate the cost of the interest, even when the underlying property itself was not depreciable. Internal Revenue Code § 167(a) and Tres. Reg. 1.167(a)-3 and the cases cited herein. Thus, it was legal for Mr. and Mrs. Garvey to amortize or depreciate life estate interests in Joy.
>
> On the other hand, a taxpayer was prohibited from amortizing or depreciating the cost of term interest where, without additional investment, the taxpayer divides the nondepreciable asset into two parts, one of which is the term interest. Based upon the facts and the applicable law cited herein, the court concludes that plaintiffs have met their burden to establish that this did not occur.

Thus, on or before July 27, 1989, taxpayers could amortize life interests they purchased, if they did not themselves at the same time create the remainder interest. This rule explains Letter Ruling 8316135,[2999] which allowed the seller of a life estate to deduct basis in the life estate because the buyer was unable to amortize the life estate, given that the purchase there caused all interests in the trust to merge. So, let's take a fresh look at elements of Code § 1001(e):[3000]

- Code § 1001(e)(1), (2) disallow applying basis when selling a term interest.
- Code § 1001(e)(3) provides that this disallowance does "not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons."

According to Letter Ruling 8316135,[3001] the Code § 1001(e)(3) exception is designed simply to make sure that the buyer cannot amortize the life estate. However, now that Code § 167(e) disallows that amortization when related parties hold the remainder interest, Code § 1001(e)(1) should not apply to those situations. Rather, Code § 1001(e)(1) should apply only when

> [6] There has been considerable controversy as to whether these ratable deductions are allowable as depreciation or amortization under sec. 167 or as amortization under secs. 162 and 212. See *Sohosky v. Commissioner*, 57 T.C. 403, 409 & n. 4 (1971), *affd*. 473 F.2d 810 (8th Cir. 1973); *Early v. Commissioner*, 52 T.C. 560, 568-572 (1969) (Tannenwald, J., dissenting). For purposes of discussion herein, we simply acknowledge that ratable deductions of some nature are allowable to a purchaser of a term interest in property either used in a trade or business or held for the production of income. For convenience, we have used the term "amortization" in discussing the transactions involved herein. In this connection, we note that respondent, in his opening brief, dropped the argument that petitioners' deductions are not allowable due to sec. 265(1), which disallows deductions allocable to tax-exempt income. See *Manufacturers Hanover Trust Co. v. Commissioner*, 431 F.2d 664 (2d Cir. 1970), *affg*. a Memorandum Opinion of this Court.
>
> [7] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

[2999] In this part II.J.18.d, see text accompanying fn 2977 for details on Letter Ruling 8316135. For application of the remaining analysis of this part II.J.18.d, see fn 3009 in part II.J.18.f Commutation vs Mere Division.

[3000] Code § 1001(e) is reproduced in this part II.J.18.d in the text accompanying fn 2973.

[3001] In this part II.J.18.d, see text accompanying fn 2977.

unrelated parties hold the remainder interest. Unfortunately, the lack of coordination between Code § 167(e) and Code § 1001(e)(1) is puzzling and may undermine this reasoning.

Suppose the life tenant buys out the remaindermen. The remaindermen can use basis in such a sale. Economically, the parties are in the same position as if the remaindermen had bought out the life tenant, but with different tax results. For example, suppose the life estate is worth $400,000 and the remainder is worth $600,000, for a total of $1 million. The life tenant borrows $600,000 to buy out the remaindermen. The life tenant now has the full $1 million trust, sells enough liquid assets to repay the $600,000 loan, and has $400,000 left. Economically, that doesn't differ from the life tenant being bought out for $400,000. But the tax result is very different, and so are the logistics. If the trust has only marketable securities, the transaction may be very do-able. However, if the trust holds illiquid assets, the logistics may be quite difficult; the life tenant buys out the remaindermen and then turns around and sells the illiquid assets to them, the IRS might argue that the substance was a sale of the life estate.

II.J.18.e. Ed Morrow on Potential Income Tax Disasters for Early Trust Terminations

"Ed Morrow on Potential Income Tax Disasters for Early Trust Terminations," LISI Estate Planning Newsletter #2753 (October 9, 2019) at http://www.leimbergservices.com, reviews this ruling and its companions (201932001 to 201932010), discussing the income tax ruling.[3002] Except as otherwise indicated in footnotes, the rest of this part II.J.18.e is a direct quote, with Ed's permission; my conclusions relating to the ideas in his analysis is in part II.J.18.f Commutation vs Mere Division.

It's the third ruling on the income tax effect that should wake up practitioners, especially when considering how the gain in ruling #3 was ultimately calculated. It is dangerous trap for commutations and potentially other variations of early trust terminations – and potentially avoidable. If the IRS is correct in its rulings, the cure of terminating a trust early will often be much worse than the perceived disease of continuing it….

Therefore, G2 must pay long-term capital gains tax on the entire amount of his interest (importantly, with **no amount of basis permitted to offset gain, discussed below**), whereas G4 pays long-term capital gains tax on the amount they receive minus their share of the trust's basis as determined actuarially under the uniform basis rules. The impact on G3 is a bit confusing in the ruling, but apparently G3 only pays tax to the extent of the unrealized appreciation triggered on amounts going to G2 and G4 for their share.[2] The sole consolation is that G3 does not have to pay any tax on their share of assets received until they are later sold. In total though, this still creates a huge income tax event, *potentially worse than if the trustees had sold all of the appreciated assets*, with G2's estate being dramatically increased by the amount received net of tax even though he didn't need the income! This is a heavy price to pay to get out of a trust, like cutting off an arm to cure the itch from a mosquito bite.

[2] This is basically Kenan gain (*Kenan v. Comm.*, 114 F.2d 217 (2d Cir. 1940)), also addressed in Treas. Reg. 1.661(a)-2(f). If G3 has an obligation to pay G2 $5 million and G4 $1 million, and distributes $6 million of property with a basis of $4 million to them, $2 million of gain is triggered to G3 on transfer, no different than if you owed someone $1000 and gave them appreciated assets in kind to pay the debt. Correspondingly, G2 and G4 would have a new FMV/Cost basis.

[3002] Ed used dashes between the year and week of each PLR. I eliminated them.

There are no dollar amounts in the various PLRs of course, but with a 35+ year old trust, there had to have been substantial appreciation. Let's imagine the trust corpus in these PLRs is $20 million, with $5 million basis and the actuarial value of G2's interest is $8 million and G3's interest is $11 million and G4's interest is $1 million (G4's interest should be relatively small, since they would only receive anything if their parent predeceases their grandparent).[3] The $5 million of basis would be divided under the uniform basis rules as $2 million, $2.75 million and $250,000 respectively. G2 pays long term capital gains tax (20% + 3.8% + potentially state) on $8 million (G2 cannot use his share of $2 million basis)! G4 pays long term capital gains tax on $1 million, but is permitted to use their $250,000 share of uniform basis to offset gain, incurring $750,000 of long-term capital gain.

[3] It is not a dynastic trust and pays outright at G2/Son's death to G3. For examples of such actuarial divisions under the uniform basis rules, see examples under Treas. Reg. § 1.1014-5, with various actuarial tables at Treas. Reg. § 20.2031-7 and IRS Pub. 1457, or your favorite financial planning software.

As a deemed *buyer* rather than a seller, G3 does not pay tax on receiving their share, but this transaction does trigger tax to G3 on the $9 million of assets going to G2 and G4 to "buy out" their share, minus the $2.25 million of basis attributed to those assets ($9 million - $2.25 million = $6.75 million net long-term capital gain, assuming that those assets have been held for more than one year, which may not necessarily be the case for all of them). Thus, the total gain triggered among the family is $11.5 million ($8 million + $750,000 +$6.75 million). If we assume a 30% tax rate including state income tax on this $11.5 million of gain, that's a **$3.45 million price tag to terminate the trusts** that could have largely been avoided by waiting until son's death, or releasing an interest or amending the trust or taking another path that would not cause such a tremendous income taxable event.

By way of quick contrast, let's say there was a market downturn after funding and the basis was $30 million instead of $5 million, but all other facts the same as in our above hypothetical. *G2 would still incur $8 million of long-term capital gains and $12 million of basis would be wiped off the face of the Earth.* G4 and G3 would have a long-term capital loss, but it would probably be denied them under related party rules.[4] Thus, the spectre of a large capital gains event is present even if done immediately after death, even if the trust is entirely funded in cash.

[4] IRC §267.

Effect on Later Estate Inclusion/Basis Step Up at Son (G2)'s Death

The immediate income tax disaster is not the only negative to the commutation. If son (G2) did not otherwise have a taxable estate, he could have been granted a formula testamentary power of appointment to increase some if not all of the basis at his death.

If son *did* have a taxable estate, which is perhaps more likely based on the stipulated fact in the PLRs that son didn't need the income, the effect of the commutation is even worse, since the settlement adds his entire share (minus beaucoup taxes) to his estate to later be taxed at 40% again at his death when it otherwise would have passed to them without any estate or GST tax!

"Now I am Become § 1001(e), the Destroyer of Basis"[5]

As for the unique ruling on the destruction of G2's basis, it is a function of IRC § 1001(e)(1), which deems the sale of a trust income interest to have a *zero basis*.[6] There is an exception to this rule when the sale is part of a transaction in which the entire interest in property is transferred to any person or persons.[7] The Congressional intent of this provision was to prevent basis shifting abuse by letting remainderman continue to gradually increase their basis over time while the purchaser of an income interest still has a cost basis when a trust is not terminated.[8]

[5] A cheap reference to J. Robert Oppenheimer's quote of the Bhagavad Gita after the first successful test of nuclear bomb in New Mexico, "Now I am become Death, the destroyer of worlds.

[6] [quoting Code § 1001(e)(1)]

[7] [quoting Code § 1001(e)(13]

[8] See page 174-175 of the Joint Committee Explanation.

Arguably, since the trust will be completely terminated, this is part of a transaction "in which the entire interest in property is transferred to any person or persons" as required by IRC § 1001(e)(3). The abusive situation and rationale in passing IRC § 1001(e) is simply not present when the trust is terminated as it would be in a commutation.

Unfortunately, commutations do not fit into the wording of the statute well. Beneficiaries in a commutation are not transferring property to another in the traditional sense as much as transmuting it into a different form. Treasury regulations go beyond the code, moreover, and require a sale to a third party.[9] It seems extremely absurd to have completely different income tax treatment when parties transfer their interests to a straw man who will simply give them back the value of their interests in kind exactly as a commutation would (as the regulation appears to require). It's been a maxim for centuries of Anglo-American jurisprudence that the law does not require a futile act.[10]

[9] [quoting Reg. § 1.1001-1(f)(3)]

[10] *Lex non cogit ad inutilia*, for those readers who prefer to speak in Latin. For an example of this maxim quoted in the context of tax law, see this IRS CCM.

That said, in planning mode one should not pick a fight with the IRS armed only with common sense, especially with a regulation seemingly requiring one to abandon it. There are many PLRs ruling that a commutation does not come under the IRC § 1001(e)(3) exception, so it's best to simply play along with the charade.

If the agreement were instead to eliminate the spendthrift clause so that each party could sell all their trust interests to another party (basically allowing the new owner to terminate the trust under merger of interest doctrine), then upon joint sale the application of the IRC § 1001(e)(3) exception and compliance with Treas. Reg. § 1.1001-1(f) would be clear; G2 could use his share of uniform basis to reduce his tax upon sale, just as G3 and G4 do.

Can the Disappearing Basis Be Preserved?

Although it's relatively rare, when taxpayers purchase a trust interest, they are permitted to depreciate the cost of this purchase.[11] By being deemed to have purchased G2 and G4 shares, we'd love to think that G3 is therefore deemed to receive this basis somehow. Normally a buyer receives cost basis for what they paid for an asset.[12] Here, the IRS deems G3 to have "in substance" purchased them. Does G3 get basis for this? Probably not, since G3 did not actually pay anything. The IRS gave no indication of this in the rulings. That said, some believe that the disappearing basis should be preserved for G3 to eventually unlock on later sale of assets. I am skeptical. More likely, it is completely obliterated and G3 will probably only have a pro rata carry over basis in their remaining assets.

> [11] See, *e.g.*, Treas. Reg. § 1.1014-5(d), Examples 1, 2, 3 and 5. To quote the committee reports on why Congress passed IRC § 1001(e): "The purchaser of the life estate, however, is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it."

> [12] Treas. Reg. § 1.1012-1(a).

Is a Commutation Always a Sale, Exchange or Other Disposition?

But is a commutation (early termination) even a sale or exchange or "other disposition" at all? Generally, distributions on trust terminations are not sales or exchanges triggering income tax.[13] That an early termination ordered by a court is a sale/exchange subject to IRC § 1001 is not obvious – the parties will only receive their own pro-rata share of the trust.

> [13] *Pierson v. Comm.*, 253 F.2d 928 (3rd Cir. 1958). IRC § 643(e) generally provides that distributions in kind from a trust receive a carryover basis unless gain is triggered otherwise, such as *Kenan* gain to satisfy a pecuniary obligation, or unless a trustee makes an election to trigger gain under (e)(3).[3003]

The IRS in these PLRs assumes that a commutation is a sale by referencing a revenue ruling that concerns non-pro rata distributions: [Ed then quotes the IRS' analysis from above]

The IRS may have a very good argument that a commutation agreed to by the parties is a sale or exchange under § 1001, since all the parties are receiving substantially different property interests as a result of the transaction. But Rev. Rul. 69-486 cited above is very dubious authority for that conclusion. In that Revenue Ruling, the trustee had no authority to make non-pro rata distributions and the two beneficiaries agreed between them as to the distribution and it was deemed to be a sale between them, no different than had they exchanged the different assets between each other.

By contrast, most trusts nowadays have authority under the instrument to make non-pro rata distributions, and if they don't, most state laws, such as UTC §816, now grant such authority,[15] and if state law does not grant such authority, the wide equitable powers granted to state courts under state law probably provide such authority, as has been previously acknowledged by the IRS in prior rulings. This PLR did not involve some rogue non-judicial settlement agreement contrary to state law. A court commuted the trust pursuant to state law and there was no allegation to the contrary. Thus, it's hard to see how Rev. Rul. 69-486 even comes close to applying. In fact, the natural corollary to Rev. Rul. 69-486 should be that a pro rata distribution in kind does ***not*** constitute a sale or exchange.

[3003] [My footnote:] For Code § 643(e)(3), see text accompanying fns 2798-2802 in part II.J.8.d.i Distribution in Kind - Generally.

[15] UTC § 816(22) authorizes the trustee to "on distribution of trust property or the division or termination of a trust, make distributions in divided or undivided interests, allocate particular assets in proportionate or disproportionate shares, value the trust property for those purposes, and adjust for resulting differences in valuation." The UTC's comments to this section include: "Paragraph (22) *authorizes a trustee to make non-pro-rata distributions and allocate particular assets in proportionate or disproportionate shares. This power provides needed flexibility and lessens the risk that a non-pro-rata distribution will be treated as a taxable sale*."

Thus, the paragraph discussing non-pro rata distributions is a *red herring*. There is no indication that the parties proposed anything but a pro rata distribution and if there were pro rata distributions, this would not have changed the IRS conclusions in this PLR one iota. Even if the trust corpus were invested entirely in cash stored under the trustee's mattress, the IRS would have found that the son (G2) incurred a large capital gain equal to the value of his interest.

The more important, and dangerous, paragraph is the second one quoted above. To the IRS, it's a sale or exchange *in substance*, regardless of what authority was granted under the instrument or state law. More intriguing is the equally dubious conclusion that it's only a sale by two of the three parties. Why is this commutation in substance a sale by G2 and G4, and not G3? The IRS offers no rationale or logic for this conclusion (other than Rev. Rul. 69-486 which is inapplicable). Any student of logic could just as easily conclude that G3 and G4 are selling their shares to G2 or that G2 and G3 are selling their shares to G4 (or other permutations). Each group of beneficiaries is getting different property, not just two groups out of three as the IRS summarily concludes.

If a court-ordered commutation is a sale or exchange, it's not hard to imagine many other situations involving trust terminations to be *in substance* an exchange. *E.g.*, an agreed distribution of the trust assets to an income beneficiary followed by a gift to the remaindermen of their commuted value would probably be treated no differently, since that could *in substance* be a sale and exchange, even if the form of the transaction was a lawful distribution of corpus pursuant to the trustee's authority, followed by a gift.

The IRS has approved divisions of trusts in prior PLRs and concluded that to the extent the division was pro rata there was no taxable exchange, but to the extent the division was non-pro rata there would be deemed an exchange.[16]

[16] In PLR 200038014, the IRS acknowledged this when it found that a bifurcation of a trust into separate trusts via court order did not trigger capital gain, except to the extent the funding was non-pro rata:

"Neither the Will nor State law grants the Trustee power to make non-pro rata distributions from Trust 2. However, the court before which the petition seeking permission to divide Trust 2 is pending is a court of general jurisdiction in State with equity jurisdiction, and the court has the power to divide Trust 2 on a non-pro rata basis. ***The present case is distinguishable from Rev. Rul. 69-486 to the extent that assets of Trust 2 are divided on a pro rata basis.*** Thus, the proposed transaction will not result in a material difference in the kind or extent of the legal entitlements enjoyed by the beneficiaries. Further, to the extent that the assets are divided on a pro rata basis the distribution of the assets to the Separate Trusts will not be viewed as a pro rata distribution followed by an exchange of assets and will not give rise to a realization event as described in Rev. Rul. 69-486. As discussed above, to the extent that the assets are divided on a non-pro rata basis, the transaction will be treated in accordance with Rev. Rul. 69-486. Therefore, to the extent that the division of Trust 2 assets among the Separate Trusts is made on a pro rata basis, the division will not be considered a sale, exchange, or other disposition of property and will not cause Trust 2, the Separate Trusts, or any of the Income Beneficiaries to realize gain or loss under § 1001 and the division of Trust 2 into the Separate Trusts will not cause Trust 2, the Separate Trusts, or any of the Income Beneficiaries to realize income under § 61 or gain or loss under § 1001." Page 7 of ruling.

The PLRs did not address whether the commutation may be a tax-free *severance*. Treas. Reg. § 1.1001-1(h) provides that a severance is not an exchange if state statute or the governing instrument authorizes it and any non-pro-rata distributions. The regulation does not define "severance," however. Commutations seem to go beyond the common understanding of a severance, which implies continuation of multiple trusts.

Despite their citation to dubious authority, the IRS probably has the better argument on there being a taxable disposition. The parties bargained for and will receive fundamentally different interests in property (exchanging a trust interest for direct property interest), which is the core of IRC § 1001 as discussed in the seminal Supreme Court case of *Cottage Savings*.[17] The IRS has so ruled many times before (see below).

[17] *Cottage Savings Assn. v. Comm.*, 499 US 554 (1991). In Cottage Savings, the Supreme Court held that mortgage loans made to different obligors and secured by different homes embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged participation interests in different loans. In defining what constitutes a "material difference" for purposes of § 1001(a), the Court stated that properties are "different" in the sense that is material to the Code so long as their respective possessors *enjoy legal entitlements that are different in kind or extent*.

But then, if we are primarily examining whether the parties in these ten PLRs are receiving materially different legal entitlements, which they clearly are, *why is it that G3 did not have to recognize any gain on its share?* There is no logic to this, other than that's the [sic] way the IRS has long construed such commutations in prior PLRs. I could find no citable authority on this artificial sale to G3 idea.

Does Beneficiary Involvement or Procurement Matter?

Many readers will wonder how the IRS or court would rule if, instead of the parties agreeing to divide the trust and handing the court and IRS an agreement to be blessed, the trustees had sought and the court ordered a commutation *without such an explicit agreement among the beneficiaries*. There is no clear answer from the PLR, but this would probably make no difference whatsoever. For gift tax purposes, it should, because gift tax generally requires a voluntary action on behalf of the donor.[18] Dispositions, however, do not – just ask anyone who has ever held stock in a company that went through a taxable merger or acquisition.

[18] For a discussion of gift and estate and income tax ramifications of amendments and settlements and why unilateral trustee actions such as decanting or court petitions may be treated differently for gift tax purposes than non-judicial or court actions involving beneficiary acquiescence, see Morrow, Edwin P., *The Optimal Basis Increase and Income Tax Efficiency Trust: Exploiting Opportunities to Maximize Basis, Lessen Income Taxes and Improve Asset Protection for Married Couples after ATRA (Or: Why You'll Learn to Love the Delaware Tax Trap)*, pages 132-156. Available at SSRN: https://ssrn.com/abstract=2436964, which is an update of the Optimal Basis Increase Trust, LISI Estate Planning Newsletter #2080 (March 20, 2013).

Earlier PLRs Concerning Commutations, Including CRT Commutation PLRs

This isn't the first PLR concerning commutations that found a taxable exchange. PLRs 200209007 and 200209008 also involved a commutation, but only a partial one. The trust beneficiary whose lifetime interest was commuted was deemed to have sold their interest, which would be a capital gain, with zero basis, just as in these recent PLRs. The other beneficiaries got off scot free without the IRS finding any sale or exchange of their interest because their interest in trust essentially continued with only minor modifications.

Similarly, in PLR 200231011, the trustee and the beneficiaries had agreed that the income beneficiary would receive (i) a 7% annual unitrust payment from the trust, (ii) principal from the trust in the discretion of the trustee and (iii) a testamentary general power of appointment over the remaining trust property, while the charitable remaindermen would receive an immediate payment based on the value of their remainder interest and be thereafter removed (*i.e.* commuted). The IRS ruled that the transaction was in effect a sale or disposition under IRC § 1001(a), with the zero-basis rule applying to the sale of the son's interest, similar to the PLRs discussed in this article, even though the son's interest in trust continued in different form.[19]

[19] PLR 200231011.

There are several rulings in which the IRS deemed commutations of charitable remainder trusts (CRTs) to be sales/exchanges (by the income beneficiary to remaindermen) triggering IRC § 1001. There are compelling reasons for the IRS to have applied the zero basis rules in this manner to curb abuse in the tax-exempt context.[20] Treasury eventually issued regulations in this area to prevent such manipulations so that undistributed income and gains inside the CRT reduce the lead income beneficiary's basis even upon sale to a third party.[21]

[20] See IRS Notice 2008-99, Rev. Proc. 2008-3 where the IRS placed these on a "transaction of interest" list before Treasury issued new regulations. See Rev. Proc. 2015-3, § 3.01(68). It's abusive because if not curbed, a taxpayer could contribute a zero basis property worth $10 million, the CRT sells the property tax-free and has a basis of $10 million and if the lead income beneficiary could use their share of uniform basis in selling their interest to a third party utilizing the IRC § 1001(e)(3) exception, it would be completely evading tax on the gain.

[21] See Treas. Reg. § 1.1014-5(c) and (d), Examples 7 and 8. This is a logical way to curb such abuse, because by reducing the basis by the gains never taxed, the taxpayer is denied "free basis". The appreciation is ultimately taxed.

But the legitimate public policy rationale to prevent tax evasion shut down by those CRT sale regulations does not exist for commutations of ordinary irrevocable trusts that are not tax exempt. Arguably, the polar opposite of tax evasion occurs under the zero-basis rule when such a trust is terminated without the § 1001(e)(3) exception applying: basis is destroyed and the IRS receives a windfall.

In PLR 200127023, the IRS treated the commutation of a charitable remainder trust (CRT) as a taxable exchange and sale by the individual lead interest holder, generating capital gain with zero basis attributable under IRC § 1001(e). Regarding the exception, the IRS stated "The exception contained in § 1001(e)(3) is not applicable, because the entire interest in Trust's assets is not being sold, or otherwise disposed of, to a third party."

PLR 200733014 was substantially similar, where the commutation was ruled in substance to be a taxable sale by the income beneficiary. Regarding the commutation, the IRS noted, "In the present case, although the proposed transaction takes the form of a distribution of the present values of the respective interests of Grantors and Charity, *in substance* it is a sale of Grantors' interest to Charity, the remainder interest holder."

Decanting and Reformations as Taxable Dispositions

Reading the description of the first two PLRs from 2002 discussed above combined with these newer PLRs, readers may be nervous that commonplace reformations and decantings could be a taxable sale or disposition under § 1001. I cannot completely reassure readers on this point. While there are many PLRs that have found minor changes not to be a disposition, there is no reason that reformations and decantings cannot trigger § 1001 if the changes are material enough. In defining what constitutes a "material difference" for purposes of § 1001(a), the Supreme Court stated that "properties are 'different' in the sense that is 'material' to the Internal Revenue Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent [echoing language in Treas. Reg. § 1.1001-1(a)]. ***Under our interpretation of § 1001(a), an exchange of property gives rise to a realization event so long as the exchanged properties are "materially different" -- that is, so long as they embody legally distinct entitlements."[22]

[22] *Cottage Savings Assn. v. Comm.*, 499 US 554 (1991).

Most reformations should be safe, but not all. Administrative changes don't give beneficiaries materially different legal entitlements. However, if it's a major change in economic rights, it might. Unitrust conversions have a safe harbor.[23] Mere changes between grantor and non-grantor trust status should be safe, absent extraordinary circumstances.[24] Severances, as discussed above, are also safe, but there is no clear rules as to when a change goes beyond a mere severance. This is a very grey area. For example, if the discretionary income beneficiary gets a new 5/5 withdrawal power and the remaindermen get a restriction on the income beneficiary's testamentary power to appoint to others, that gets closer to a quid pro quo, a material change in legal entitlements, similar to PLR 200231011. Splitting a pot trust in two where the two beneficiaries keep the same rights looks like a severance, but splitting a different trust in two where one beneficiary accelerates from remainderman to current beneficiary and the other gets additional rights may go beyond the severance safe harbor.[3004]

[23] Treas. Reg. § 1.643(b)-1 "***A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries."

[24] Rev. Rul. 85-13, CCA 200923024; see Treas. Reg. § 1.1001-2(c), Example 5 and TAM 200011005 and *Madorin v. Comm.*, 84 T.C. 667 (1985) for exceptions when relief of debt in excess of basis triggers gain.

The case law that is citable authority involving commutations and reformations is sparse but leans towards substantial reformations that materially change economic interests being deemed

[3004] [my footnote:] Reg. § 1.1001-2(c), Example (5) is reproduced in fn 6591 in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System.

to be dispositions.[25] In *Evans v. Commissioner*, 30 T.C. 798 (1958), the taxpayer exchanged an income interest in trust for a more certain fixed annuity, and this was found to trigger § 1001.

[25] See the discussion of *Evans v. Commissioner*, 30 T.C. 798 (1958) and *Silverstein v. United States*, 419 F.2d 999 (7th Cir. 1969) in PLR 200231011. In *Evans*, taxpayer exchanged an income interest in trust for a more certain fixed annuity, and was found to trigger § 1001. In *Silverstein*, the trust was terminated, but the income beneficiary was to receive the exact same payments from the remaindermen rather than the trustee and the 7th Circuit found this not to be an exchange. *Silverstein* is not especially helpful, since it seems merely an assignment/change in obligors.

That said, the IRS has approved many reformations in the past that have minor changes in legal entitlements. PLRs 201702005 and 201702006 involved converting pot trusts into separate trusts, yet the IRS ruled that these changes did not trigger § 1001. More far-reaching, in recent PLR 201814005, the IRS ruled that a court reformation that converted a mandatory distribution to a discretionary distribution standard and replaced a beneficiary's rights to withdraw corpus at ages 25 and 30 with testamentary general powers of appointment ("GPOA") at that age did not trigger § 1001: "In this case, the Trust modification will result in increased trustee discretion and will not confer new rights to the beneficiaries or result in any relative shifting of interests between beneficiaries."

The IRS appears to be more sympathetic to cases such as above where the current beneficiary is arguably receiving a decrease rather than an increase in economic rights (as opposed to PLR 200231011 and *Evans*). Would the IRS have granted PL 201814005 had the requested change been reversed, *i.e.* granting a current discretionary beneficiary a mandatory distribution right, perhaps to qualify as a QSST or a BDOT? It's hard to say.

In all the PLRs discussed in this article, the local court approved the commutation or reformation. It's tempting to assume that decanting, which has spread like wildfire in recent years and is rumored to cure cancer, gets around this problem. That is questionable. If a trustee-initiated change approved by a court can be a disposition, there is no reason that an identical trustee-initiated change not approved by a court would not be. Advocates for more dramatic decanting (e.g. SD/NV proponents brag of their statutes permitting removal of mandatory distribution rights and accelerating remainder interests) claim it's completely different because decanting is framed as a distribution to another trust, but there is no clear authority for this distinction when it looks more like a substantial reformation. The IRS has been "studying" this for years and is skeptical where decantings substantially change beneficial interests.[26]

[26] IRS Notice 2011-101: The IRS "will not issue private letter rulings (PLRs) with respect to such transfers [decantings] that result in a change in beneficial interests. See Sections 5.09, 5.16, and 5.17 of Rev. Proc. 2011-3, 2011-1 I.R.B. 111. The IRS generally will continue to issue PLRs with respect to such transfers that do not result in a change to any beneficial interests and do not result in a change in the applicable rule against perpetuities period." Some state statutes, *e.g.*, the Uniform Trust Decanting Act § 19, have excellent language that may protect against decanted trusts being disqualified from various tax benefits, such as the marital deduction, designated beneficiary "see through trust" status or S corporation ownership qualification, but this is unlikely to be helpful in preventing the IRS from arguing a sale or disposition has occurred under *Cottage Savings*.

What about decanting to remove a right to receive the trust corpus at age 40 or otherwise, as in the infamous *Ferri* and *Kaestner* cases?[27] This is a favorite strategy advocated in countless tax and asset protection planning conferences in recent years. If the current beneficiaries keep a discretionary interest as sole current beneficiary coupled with a testamentary GPOA, it more closely resembles PLR 201814005 discussed above (but which, of course, is not citable precedent). Query whether beneficiaries retained a testamentary GPOA in those cases.

[27] These are discussed in prior LISI Newsletters, see *Ferri v. Powell-Ferri: Asset Protection Issues, Perils and Opportunities with Decanting*, *Ed Morrow & Steve Oshins,* LISI Asset Protection Newsletter #240*, Ed Morrow, David Berek, and Raj Malviya on the North Carolina Supreme Court's Affirmation of Kaestner and Its Impact on both North Carolina and Other States' Abilities to Tax Trust Income* LISI Income Tax Planning Newsletter #153 (August 20, 2018).

It could be quite dangerous if the IRS applied IRC § 1001 to such amendments, even if the value of the current beneficiary's interest was dramatically reduced as in cases like *Ferri* and *Kaestner*, due to the zero-basis rule of § 1001(e) and the potential effect on other beneficiaries.[28] No PLRs or cases have gone that far – yet.

[28] The one consolation would be the amount of consideration received in return, if it is merely a discretionary interest in trust with no mandatory distribution, should be valued much lower than prior to the decanting. Some attorneys believe that a discretionary interest in trust has no value whatsoever and that it would not even be considered a property interest under federal tax law, but just because Alaska or some other state says it's not a property interest does not make it so for federal tax purposes. That said, the value of such an interest should be quite low. In PLR 8535020, a lifetime limited power of appointment was exercised in a trust wherein income payments to the powerholder/beneficiary were discretionary, thus requiring the IRS to value that interest to determine the amount of the gift. The IRS cited Rev. Rul. 79-327 and stated:

"The fact that the trustee has discretion regarding distributions of income and principal to you is a factor that must be taken into account in determining the fair market value of your beneficial interest, but, as indicated by Rev. Rul. 67-370, the presence of the possibility of your receiving less than the entire income and principal does not warrant our finding that your transfer of the interest is not subject to the tax imposed by section 2501(a) of the Code."

The IRS had no further guidance on how to value a discretionary interest. The larger taxable ramifications in such decantings/reformations may therefore be to remainder beneficiaries, whose economic interest in the trust may dramatically increase. If deemed a disposition, they could use their share of uniform basis to offset such gain, but this may be phantom income if they can't access cash. In a truly dynastic trust where no one has more than a discretionary interest, many attorneys would argue that no beneficiary has any economic rights worth anything, even if the trust has $1 billion in it. Whether the IRS/courts would agree is questionable. I can cite no authority, but it's even possible that they ultimately apply a zero-sum analysis, *i.e.*, if the trust is worth $1 billion, then the collective equitable interests held by the various beneficiaries must be worth that amount so that as one beneficiary's interest decreases others must increase accordingly. The uniform basis rules have no examples of valuing discretionary interests, but consider a current discretionary interest a term interest. See Treas. Reg. § 1.1014-5(a) and § 1.1001-1(f)(2)(i).

It Could Be Much Worse…

In these PLRs, the trust had been established for over 30 years. What if the trust had been settled less than a year before the commutation? The tax rate would almost double due to short-term capital gains being taxed at ordinary income tax rates (top rate 37% v. 20% for long-term capital gains). Similarly, any assets that the trust had purchased within one year could also trigger short term capital gains as to the portion G3 is deemed to pay for G2 and G4's shares (the PLRs did not indicate whether there were any such assets).

It's unlikely that this trust contained inherited retirement plans, but many trusts do. Which bold reader wants to promise clients what the result of this would be? In compliance mode, we could argue that transferring an inherited IRA in kind from a trust to beneficiaries shouldn't trigger any income, but recall the IRS deems a commutation to be a sale by G2 and G4 to G3, with *Kenan* gain to G3 on paying off G2 and G4. The IRS does not take kindly to such transactions with inherited retirement plans involved.[29]

[29] See IRS Chief Counsel Memorandum (CCM) 200644020 regarding the *Kenan* rule applied to IRA/401(k) income in respect of a decedent funding a pecuniary obligation (which is a somewhat debatable conclusion, as IRC § 691(c)/IRD rules arguably trump this, but it's best in planning to avoid a fight).

Similarly, what if the trust was the party to an installment sale or had § 179 property or loss assets that had to fund those two shares? Related party rules could hold some nasty surprises.

Moreover, the rulings found that G3, the Current Remaindermen, did not incur any taxable sale or disposition despite turning a mere remainder interest into cold hard cash and other assets. This is hardly an inevitable conclusion under IRC § 1001. The more rational interpretation is that all three groups disposed of their shares.

Application of § 1001 to reformations and decantings that do not involve full terminations would involve even worse complications due to phantom income. In these PLRs, the beneficiaries all have liquid funds to pay the income tax, but in a reformation deemed to be a constructive disposition, they may not.

Conclusions and Solutions Around the IRC § 1001(e) Destruction of Basis

In short, these PLRs point out significant income tax dangers to early termination of trusts (and potentially, extensive reformations). Practitioners should consider the pros and cons of less drastic alternatives that may solve the perceived problems of the trust without triggering § 1001 – or worse, the zero-basis apocalypse of § 1001(e). There may be several potential solutions when the parties wish to commute a trust (remember that spendthrift provisions generally prevent transfers of trust interests, but such provisions can be removed by decanting or other reformation):[30]

[30] Some state statutes even permit a beneficiary/trustee to decant and do so, which may have significant estate tax and asset protection ramifications, see *Ed Morrow: Asset Protection Dangers When a Beneficiary Is Sole Trustee and Piercing the Third Party, Beneficiary Controlled, Irrevocable Trust*, LISI Asset Protection Planning Newsletter #339 (March 9, 2017). Simply removing a spendthrift provision should not be a material enough

change by itself to cause a sale or disposition, see, *e.g.* PLR 201136011, PLR 201026014 (both of which involved multiple related sequential PLRs), which so ruled.[3005]

Either the income beneficiary or the remaindermen could gift their interest to the other rather than sell or commute the interest. This may be acceptable in smaller trust scenarios where estate/gift tax is not an issue. In these rulings, the Son's "net worth has grown significantly, such that he does not need income from [the trust] for his support". So why didn't he simply release his interest and unilaterally make a gift? Apparently he did not care about estate/GST tax too much if he was willing to add so much to his estate through a commutation. If that would be too much and cause a gift tax, they could bifurcate the trust via qualified severance and G2 could release only the interest corresponding to the amount of potentially taxable gift desired.[31] While a gift could be construed as a disposition triggering § 1001(e), provided it was not a net gift agreement, bargain sale or trigger debt in excess of basis issues, there would be no consideration to tax as capital gain even if the basis were deemed to be $0.

[31] See Treas. Reg. § 1.1001-1(h) for qualified severances that do not trigger tax.

Similarly, Son (G2) could have gifted a portion or all of his interest to charity, sui generis or prior to a later commutation. Whether it's a zero-basis asset pursuant to § 1001(e) or not would be irrelevant (unless, perhaps if gifting to a CRT), and by longstanding case law, it's considered a capital asset, not an assignment of income.[32] This may be much better than simply gifting the income every year.

[32] *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946) *cert. denied*, 330 U.S. 826 (1947); the Service acquiesced in Rev. Rul. 72-243.

The parties could structure a sale that more clearly meets the § 1001(e)(3) exception. Neither the statute nor the regulations have a related party rule. Treas. Reg. § 1.1001-1(f)(3) states that the exception in IRC § 1001(e)(3) applies when the entire interest in property is sold or otherwise disposed of as part of a single transaction to a third person or persons. Thus, both sets of parties could sell their interest to any third party, who would then own all trust interests and merge/collapse the trust and be able to pay them each their commuted value.[33] One might fear that the IRS could argue substance over form, but here the transaction would be squarely within the statute and regulation. Congress could have easily added a related party rule as it often does, but chose not to. Who else but a related or subordinate party would want to bother?

[33] Common law doctrine of merger can be found at UTC § 402(a)(5) and *Restatement of Trusts, Third*, § 69. If an LLC is used and then holds all beneficial interests, there may be another hurdle in that state law may prohibit LLCs acting as trustees without qualification as a bank or trust company, so it may be wise to research this issue under state law before so doing or use an individual buyer.

The parties could instead divide the trust via tax-free severance. Treas. Reg. § 1.1001-1(h) provides that a severance is not a taxable exchange if state statute or the governing instrument authorizes it and any non-pro-rata funding. State law may permit such a division and non-pro-rata funding (in fact, judges would be more likely to approve than an outright termination). What if the court order had instead divided the trust into two trusts (or more) with liberal current terms for each group of beneficiaries (G2, G3, G4)? Arguably this is still a severance. However, such

[3005] [My footnote:] Those rulings involved the sale of a remainder interest, which did not implicate Code § 1001(e).

a division between generations is quite different from most traditional severances (such as dividing a pot or separate share trust), so it's still unclear whether *Cottage Savings* analysis or the severance regulation would win the day.

If the driving force was that G3 or G4 needed money for consumption, they could sell all or a portion of their remainder interest. Provided they do not both sell to G2, this would not have terminated the trust or affected G2, yet the zero-basis rule would not apply and they could use their share of uniform basis to reduce gain on sale.

They might contribute their trust share to an LLC taxed as a partnership. The LLC, just like any other purchaser, would then own all interests in the trust and it could be merged/collapsed and the LLC would own the assets and each beneficiary would thereafter own a % of the LLC in proportion to the prior value of their trust interest. For some families, this might be a great result. Investment partnership diversification rules, which are an exception to the general non-recognition rule, should be considered.[34]

> [34] IRC § 721(b), § 351. I did not fully research whether this might somehow be a diversification of the beneficiary's assets which is an exception to the general nonrecognition on contributions to partnerships rule in IRC § 721(a). The capital asset contributed to the LLC/partnership would arguably be the trust interest, not marketable securities that the Code prevents partners from diversifying. When the trust will be immediately merged/collapsed, will the IRS look through to the investments? The trust interests may represent equitable ownership in marketable securities (assuming that is how the trust is invested), but this is not a situation where the partners are diversifying their holdings in marketable securities, since all parties to the trust would be contributing shares in the same securities even if we looked through the trust. There may be other income triggering situations if the partnership/LLC made non-pro-rata distributions in kind within seven years, but it does appear that the contribution itself should be non-taxable.[3006]

If there is wide discretion to make principal distributions to the income beneficiary (not present in these PLRs), the trustees under most state decanting laws could decant to grant the income beneficiary the lifetime limited power to appoint principal to remaindermen. The powerholder could then appoint the desired value to the remaindermen (over time or lump sum) and the trustee could make a distribution of the remaining principal to the income beneficiary. This may involve a small taxable gift due to the value of the income beneficiary's interest foregone, but the annual exclusion would be available to offset such gifts.[35] It does not seem so drastic as to be a material change that would be a disposition.

> [35] Rev. Rul. 79-327, *Estate of Regester*, 83 T.C. 1 (1984), though contrary is *Self v. United States*, 142 F.Supp. 939 (1956). The IRS, in TAM 9419007, has indicated it will follow *Regester* (finding a gift) and not *Self*. The gift would not be the entire amount of the distribution. It does not necessarily affect GST exempt/grandfathered status – see *e.g.*, PLR 200243026.

Since the son (G2) didn't need the money, the parties could have simply amended the trust to grant son the power to withdraw the income instead of automatically receiving it – this is hardly a material change in the parties' rights that would be a sale or disposition, yet this would clearly

[3006] [My footnote:] The most important analysis of this issue (but not of the specific transaction Ed is describing) is in part II.M.3.b Exception: Diversification of Investment Risk. Footnote 3540 in part II.M.2.a Initial Incorporation – Generally cross-references part II.M.3.b.

shift the income taxation of such income to the son without requiring he take any of the money. This would permit the trust to grow income tax free, at least to the extent of any taxable income allocated to fiduciary accounting income, which might in many cases be all of the income (or easily could be, by change in investments or trustee allocation).[36]

> [36] For more on this concept, see *IRC § 678 and the Beneficiary Deemed Owner Trust (BDOT)*, LISI Estate Planning Newsletter #2587 (Sept 5, 2017), updated and reorganized at Morrow, Edwin P., *IRC Section 678 and the Beneficiary Deemed Owner Trust (BDOT)*. Available at SSRN: https://ssrn.com/abstract=3165592. To avoid any contribution for gift/GST purposes, amounts over IRC § 2514's 5/5 lapse protection should be withdrawn or hang. There may be compelling reasons to apply the withdrawal power over all taxable income instead of only over all accounting income, because in the latter case the 5% lapse would be calculated only on the accounting income rather than the entire corpus.[3007]

The trustees could instead petition the court to amend the trust to grant wide discretion to the trustees to distribute principal currently to both the income beneficiary and the remaindermen (a discretionary pot trust) and the trustees could thereafter use their discretion to make distributions of the proceeds to either or both. There would still be some risk here, since there is a chance of substance over form or step transaction attack, and radical modifications to a trust such as this might still be considered a disposition, as discussed previously. Moreover, whenever a party gives up a mandatory income right, there is the potential for a taxable gift to occur, even if only passively acquiesced to. Still, this stands a better chance at avoiding a disposition than a commutation.

If the driving force behind termination were to access capital for closely-held investments, they could have amended the trust to be a directed trust to permit the trust to invest in such assets (and reduce trustee fees from higher fully managed to lesser directed trust fees). This kind of change should not be a taxable event.

Similarly, depending on the driving force for termination, the trust could have been amended to permit loaning money to beneficiaries. Provided it's not a de facto termination, lending should not be a taxable event either.

There are probably many other variations on the above. Trusts with robust trust protector language may have the ability to make some of these changes without going to court or crafting a non-judicial settlement agreement.

Although not present in these PLRs, remember that for any transfer or commutation involving termination of a QTIP trust, IRC § 2519 would apply to trigger a net gift by the spouse of the remaindermen's portion of the trust (IRC § 2514 would apply to a gift involving a marital GPOA trust). This may not be a disaster, and in many cases could work out much better than had the spouse disclaimed and the estate paid estate tax instead of gift tax, but this should certainly be considered in the calculus.

In conclusion, be careful to weigh the potential income tax impact of commutations and early terminations and even dramatic amendments/reformations that materially change the economic interests of the parties (especially if a beneficiary is being removed). There is no bright line test

[3007] [My footnote:] See part III.B.2.i.vii Portion Owned When a Gift Over $5,000 is Made as to when a sale will be deemed to occur and it could be a very expensive proposition if it is later found to be so but not reported as such.

II.J.18.f. Commutation vs Mere Division

I agree with the criticism in part II.J.18.e Ed Morrow on Potential Income Tax Disasters for Early Trust Terminations that Rev. Rul. 69-486 does not support the conclusion of Letter Ruling 201932001 (and its companion rulings) and his comment that Reg. § 1.1001-1(h) prevents gain recognition when the form and substance are a distribution rather than sale of beneficial interest, especially in light of Reg. § 26.2642-6(j), Example (3).[3008]

Furthermore, when the current beneficiaries and remaindermen are related, I do not see any policy reason for Code § 1001(e)(1) to apply.[3009]

Ultimately, however, one needs to reconcile the continued existence of law on commutations in part II.J.18.d, which was not altered when Reg. § 1.1001-1(h) was adopted, with the potentially broad protection of Reg. § 1.1001-1(h) that applies to divisions under part II.J.18.a. In weighing these arguments, consider Reg. § 1.1002-1(b), "Strict construction of exceptions from general rule," which provides:[3010]

> The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

Absent Reg. § 1.1002-1(b), Reg. § 1.1001-1(h) could be broadly construed to protect most commutations. Reg. § 1.1002-1(b) informs us that we need to look deeply into the purpose of Reg. § 1.1002-1(b) and make sure it suffices to override the law of exchanges.

Ultimately, we need to see whether a beneficial interest constitutes an entitlement that one can compare to a measurable expectation of financial benefits. Certainly, an income interest or its equivalent (unitrust, annuity, etc.) can be measured. Ascertainable standards tend to constitute a measurable economic interest. For guidance in measuring beneficial interests for gift tax purposes, see part III.B.1.e.ii Valuing a Beneficial Interest in a Trust.

Transferring an entire beneficial interest to a new trust but in a modified form can trigger a Code § 2702 gift of the entire beneficial interest,[3011] so if the entire beneficial interest is transferred and the distribution rules are different then they may need to be in the form of a

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[3008] Reg. § 1.1001-1(h) and Reg. § 26.2642-6(j), Example (3), are reproduced in the text accompanying and following fn 2951.
[3009] See Code § 167(e) (particularly paragraph (1), which is reproduced in part II.J.18.d Trust Commutations.
[3010] Other parts of Reg. § 1.1002-1 are included in fn 1643 in part II.G.16.b Pre-2018 Code § 1031.
[3011] See part III.B.7.d Code § 2702 Overview.

unitrust or annuity. A trust division, where the original trust continues intact and property is transferred to a new trust, would be limited in gift tax consequence to the amount transferred and therefore less risky than reforming the entire beneficial interest. Furthermore, guidance on trust divisions in part II.J.18.a tends to show that taking a trust with multiple beneficiaries and dividing it into a separate trust for each beneficiary with the same distribution standards does not constitute a gift or an income-taxable exchange.

When is a change of an expected series of distributions material? Given the lack of concrete examples for trusts, one might see whether a change in a right to a series of payments in other areas of the law might help. Consider the rules that apply to debt modifications, which are described in part II.G.31.a Debt Modifications. Although those rules address a change of yield,[3012] consider that a trustee can have significant discretion in determining how much is allocated to income in a mandatory income trust without triggering any transfer tax consequences.[3013]

However, modifying a mandatory income trust to allow the trustees to accumulate income and then require any accumulated income to be paid to the beneficiary's estate did not have any income, gift, or GST tax consequences. See part II.J.5.b.iii Modifying a Mandatory Income Trust to Make It Discretionary Income.

Letter Ruling 200810019 held that a conversion from a straight income interest to a unitrust did not constitute an income taxable event:[3014]

> In the present case, the preliminary question is whether the trustees and beneficiaries of the Trust will have the same property interests and legal entitlements as a result of the proposed conversion. Under State Statute, a conversion to a total return trust may be made upon the court's determination that the conversion will enable the trustee to better carry out the purposes of the trust. In addition, and under the facts presented, there is to be no material change in property interests or legal entitlements for Trust, the trustees or the beneficiaries. If the conversion to a total return trust does not result in a material change in property interest or legal entitlements, there is no occasion for realizing taxable gain or loss under § 1001. Therefore, under the facts presented, the conversion will not trigger realization of gain or loss for the taxpayers for federal income tax purposes.

But a conversion from an income interest with a floor and a ceiling to a unitrust was an income taxable event.[3015]

Considering all of the sources described above, if a trust is purely discretionary (no ascertainable standards) and its remainderman are also current permissible distributees, then arguably nobody has any measurable interest, in which case the trustee may be able to divide the trust among all the beneficiaries without any income or gift tax consequences. How each

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[3012] See fn 1966.
[3013] See fns 2765-2769 and accompanying text in part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law. Also note that ascertainable standards may include significant flexibility; see fn 2538 in part II.J.3.h Drafting for Flexibility in Trust Income Taxation.
[3014] This result is strongly supported by Reg. § 26.2601-1(b)(4)(i)(E), Example (11). See text accompanying fn 6395 in part III.B.1.d.i Effect of "Additions" on Grandfathering from GST Rules.
[3015] Letter Ruling 200231011, described in fn 2989 and the accompanying text in part II.J.18.d Trust Commutations.

situation compares to this ideal and whether any beneficiary is gifting or exchanging an interest in a trust depends on the circumstances.

Letter Ruling 200723014 held that a commutation that the trustee was authorized to effectuate unilaterally had no income tax consequences.[3016]

II.J.19. Trusts Holding Life Insurance, Annuities, or Long-Term Care Policies

Relevant parts regarding life insurance include:

- II.Q.4.b Transfer for Value Rule; Basis (life insurance)
- II.Q.4.c Income Tax Issues in Transferring Life Insurance; Code § 1035
- II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy)
- II.Q.4.e Income Tax Issues When the Owner Who Is Not the Insured Dies
- II.Q.4.f Split-Dollar Arrangements
- II.Q.4.g Income Tax Trap for Business-Owned Life Insurance
- II.Q.4.i Life Insurance LLC, including part II.Q.4.i.ii Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity (especially part II.Q.4.i.ii.(a) Trust Ownership of Policy)
- III.B.2.h.v Life Insurance (within part III.B.2.h How to Make a Trust a Grantor Trust Taxed to a U.S. Citizen or Resident)

Within this part II.J.19 are parts:

- II.J.19.a Trusts Holding Annuities
- II.J.19.b Comparing Annuity to Life Insurance
- II.J.19.c Long-Term Care
- II.J.19.d Hybrid - Long-Term Care with Annuity or Life Insurance

Code § 1035 controls swapping annuity or life insurance contracts tax-free and is discussed in part II.Q.4.c Income Tax Issues in Transferring Life Insurance; Code § 1035.

II.J.19.a. Trusts Holding Annuities

Code § 72(a) defers income tax on an annuity until the owner receives a distribution. Although generally a trust cannot deduct investment management fees, an annuity contract can pay the

[3016] The income tax holding is reproduced in the text accompanying fn 2979 in part II.J.18.d Trust Commutations.

owner's investment advisor fees for advice regarding the annuity without the payment being taxed as a distribution to the owner.[3017]

First, we discuss part II.J.19.a.i Code § 72(u)(1) Requirement of Natural Person (N/A to Most Trusts).

Then the general taxation of distributions from annuity contracts is in part II.J.19.a.ii Taxation of Distributions under an Annuity Contract.

Also consider parts II.J.19.a.iii Code § 72(q) 10% Penalty for Early Distributions from Annuity Contracts and II.J.19.a.iv Code § 72(s) Required Distributions Where Holder Dies Before Entire Interest Is Distributed.

Letter Ruling 202031008 provided guidance when an annuity contract is issued to a trust. It is discussed below in parts II.J.19.a.v Annuity Contract Issued to Grantor Trust and II.J.19.a.vi Annuity Contract Issued to Nongrantor Trust.

Regarding Code § 1035 swaps of annuities for each other, Letter Ruling 201330016 involved the following facts:

> Taxpayer's mother owned Contracts 1, 2, 3, and 4, which are fixed annuity contracts issued by Company 1, and Contract 5, a variable annuity contract issued by Company 2 (collectively "Original Contracts"). Taxpayer is the beneficiary of these Original Contracts. Each Contract provides that upon the death of the owner (*i.e.*, Taxpayer's mother) before the annuity starting date, the death benefit will be paid to the beneficiary (*i.e.*, Taxpayer). The Original Contracts provide payment options consistent with § 72(s). Each Contract specifies the method to determine the amount of its death benefit.
>
> Taxpayer's mother died, and Taxpayer timely elected to receive the death benefit provided by each Contract over her life expectancy, consistent with § 72(s)(2)(B).
>
> Taxpayer perceives that she might be able to increase the amount of this payout if she can replace this payout with a payout offered by Company 3. To take advantage of this opportunity, Taxpayer applied to Company 3 for New Contract and completed both the Election Form and the Distribution Form. The value of the amounts due Taxpayer from Company 1 and Company 2 under the Original Contracts will be remitted directly to Company 3. Company 3 will then credit these amounts to New Contract. Under New Contract Taxpayer will be granted the same rights available to an owner of New Contract, except that (1) she cannot transfer ownership of New Contract and (2) she cannot make any new purchase payments to New Contract other than the assignment of the amounts due her from Company 1 and Company 2 under the Original Contracts. New Contract is nominally a deferred variable annuity contract, but by Election Form and Distribution Form, Company 3 is bound to immediately commence making payments that will continue the payouts being made by Companies 1 and 2 but in an amount determined pursuant to New Contract.

[3017] Letter Rulings 201945001, 201945002, 201945003, 201945004, 201945005, 201945006, 201945007, 201945008, and 201945009.

Letter Ruling 201330016 reasoned and ruled:

> Rev. Rul. 92-95, 1992-2 C.B. 43, cites Rev. Rul. 85-159, 1985-2 C.B. 29, in concluding that a replacement contract received in a tax free exchange of annuity contracts is not treated as an investment in a new contract. Instead, the replacement contract retains the attributes of the exchanged contract for purposes of determining when amounts are considered to have been invested in the replacement contract. The Ruling holds that for purposes of §§ 72(u)(4) and (q)(2)(I), the "date of purchase" of a contract received in a tax free exchange is the date of purchase of the annuity contract exchanged for the new annuity contract.
>
> Rev. Rul. 2003-76, 2003-2 C.B. 355, holds that in a partial exchange of annuity contracts under § 1035(a)(3), the investment in the contract and basis is allocated ratably based on the percentage of the cash value retained and transferred to purchase the new contract.
>
> Rev. Rul. 2005-30, 2005-1 C.B. 1015, holds that if the owner-annuitant of a deferred annuity contract dies before the annuity starting date, and the beneficiary receives a death benefit under the annuity contract, the amount received by the beneficiary in a lump sum in excess of the owner-annuitant's investment in the contract is includible in the beneficiary's gross income as income in respect of a decedent within the meaning of § 691. If the death benefit is instead received in the form of a series of periodic payments in accordance with § 72(s), the amounts received are likewise includible in the beneficiary's gross income (in an amount determined under § 72) as income in respect of a decedent within the meaning of § 691.
>
> Rev. Rul. 2007-24, 2007-1 C.B. 1282, holds that if a taxpayer receives a check from a life insurance company under a non-qualified annuity contract, the endorsement of the check to a second company as consideration for a second annuity contract does not qualify as a tax-free exchange under § 1035(a)(3). In other words, the transmission of funds must be directly between the life insurance companies for the transaction to qualify as a tax-free exchange under § 1035.
>
> ANALYSIS
>
> The Original Contracts provided for the distribution of the owner's (i.e., Taxpayer's mother) entire interest over the life expectancy of the beneficiary as required by § 72(s); this distribution regime is a sine qua non of an annuity contract. Accordingly, in the hands of Taxpayer's mother, the Original Contracts were annuity contracts within the meaning of § 1035(b)(2).
>
> Taxpayer became the owner of the Original Contracts upon her mother's death, subject to the performance of the Original Contracts' obligation to distribute her mother's entire interest consistent with § 72(s). This obligation was performed when Taxpayer timely elected to receive the entire interest in the Original Contracts over her life expectancy consistent with § 72(s)(2)(B).
>
> New Contract is also an annuity contract. Like the "date of purchase" for purposes of §§ 72(u)(4) and (q)(2)(I), and the allocation of investment in the contract and basis as part of a partial exchange, compliance with § 72(s) is an essential attribute of the Original Contracts that is retained by New Contract. The combination of New Contract,

Election Form and Distribution Form obligates Company 3 to pay Taxpayer the entire interest her mother had in the Original Contracts consistent with the distribution regime required of the Contracts by § 72(s)(2): namely, a continuation of the terms of Taxpayer's election to receive the interest over her life expectancy. Accordingly, the essential inherent attribute of the Original Contracts – their compliance with § 72(s) – is retained and Taxpayer will ultimately recognize the income on the Original Contracts.

The value of the Original Contracts will be transmitted directly to Company 3. Assuming Companies 1, 2, and 3 are insurance companies as contemplated by § 1035(b)(2), this transaction is an exchange of annuity contracts within the scope of § 1035(a)(3).

RULING

A direct transfer of the value of the Original Contracts to Company 3 to acquire New Contract is an exchange of annuity contracts within the scope of § 1035(a)(3).

II.J.19.a.i. Code § 72(u)(1) Requirement of Natural Person (N/A to Most Trusts)

Code § 72(u)(1) imposes ordinary income tax annually notwithstanding this rule if the annuity contract is held by "a person who is not a natural person." However, numerous private letter rulings allow nongrantor trusts to hold annuity contracts. For example, Letter Ruling 202118002 explains Code § 72(u) generally:

> Section 72(u) was enacted as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 1986-3 (Vol. 1) C.B. 1. The legislative history contains the following reasons for enacting section 72(u):
>
> > The committee believes that the present-law rules relating to deferred annuity contracts present an opportunity for employers to fund, on a tax- favored basis, significant amounts of deferred compensation for employees. This favorable tax treatment may create a disincentive for employers to provide benefits to employees under qualified pension plans, which are subject to significantly greater restrictions. In addition, because deferred annuity contracts can be provided to a limited class of employees, rather than to employees generally (as is required in the case of a qualified pension plan), the committee is concerned that the present-law treatment of deferred annuity contracts dilutes the effect of the nondiscrimination rules applicable to qualified pension plans.
>
> H.R. Rep. No. 426, 99th Cong., 1st Sess. 703 (1985), 1986-3 (Vol. 2) C.B. 1, 580.
>
> The flush language of section 72(u)(1), however, provides that holding by a trust or other entity as an agent for a natural person is not taken into account. The legislative history contains the following explanation of this flush language:
>
> > In the case of a contract the nominal owner of which is a person who is not a natural person (e.g., a corporation or a trust), but the beneficial owner of which is a natural person, the contract is treated as held by a natural person. Thus, if a group annuity contract is held by a corporation as an agent for natural persons who are the beneficial owners of the contracts, the contract is treated as an annuity contract for Federal income tax purposes. However, the committee intends that, if an employer is the nominal owner of an annuity contract, the beneficial owners of which are

employees, the contract will be treated as held by the employer. The committee intends this rule because it is concerned that the Internal Revenue Service would have difficulty monitoring compliance with the general rule that a deferred annuity is not available on a tax-favored basis, to fund nonqualified deferred compensation.

H.R. Rep. No. 426, 99th Cong., 1st Sess. 704 (1985), 1986-3 (Vol. 2) C.B. 1, 580.

After explaining that the trust was not an agent for its beneficiary, when holding that Code § 72(u)(1) did not apply, Letter Ruling 202118002 reasoned:

> A trustee generally has fiduciary obligations under trust documents and governing law that are inconsistent with it acting as an agent for the beneficiary of a trust. *See*, *e.g.*, *Restatement (Third) of Agency* section 1.01 cmt. g (2018); *Restatement (Third) of Trusts* section 5(e) & cmt. e (2003); *Restatement (Second) of Agency* section 14B (1958). This principle also applies for federal income tax purposes. *See*, *e.g.*, Rev. Rul. 69-300; *United States v. Anderson*, 132 F.2d 98 (6th Cir. 1942). Accordingly, the phrase "as an agent" in the flush language of section 72(u)(1) pertains only to "other entity." It does not pertain to "trust." Thus, for purposes of section 72(u)(1), the holding of an annuity contract by a trust is not taken into account if the contract is held for a natural person.
>
> The Trust would be the "holder" of its annuity contract within the meaning of section 72(u)(1) because the Trust would be designated in its annuity contract as the owner of the contract. The Trust is a not a grantor trust, and A is the sole beneficiary of the Trust. Thus, the Trust would be holding its annuity contract for the benefit of A. A is a natural person. Accordingly, the holding of the annuity contract by the Trust would not be taken into account for purposes of section 72(u)(1).
>
> This determination is consistent with the purpose for adopting section 72(u). Section 72(u) was adopted to encourage employers to offer benefits to employees under qualified pension plans, which are subject to certain restrictions and generally must be made available to a wide class of employees, as opposed to offering deferred compensation to a limited class of employees that is funded by deferred annuity contacts. Because the annuity contract would not be issued in an employment context, the arrangement would not provide the sort of tax-favored benefit that section 72(u) was intended to limit.

Kitces, "Owning Deferred Annuities In Trusts And Preserving Tax-Deferral Treatment" (12/25/2013), explains:

> In the context of trusts, the IRS has generally interpreted the rules in a similar manner, as evidenced by a series of Private Letter Rulings over the years. For instance, PLRs 9120024, 9204014, 9322011, 9639057, 9752035, 199905015, 199933033, and 200449017 all reviewed situations where various types of trusts would own an annuity and all the beneficiaries of the trust were natural persons; as a result, the IRS interpreted the annuities as being held by an agent for a natural person, retaining favorable tax-deferral treatment. In the case of PLR 9316018, the situation was even more straightforward - when a grantor trust owns an annuity, the contract retains tax-deferral status under IRC Section 72(u) by virtue of the grantor trust treatment alone. By contrast, in PLR 9009047, the trust's remainder beneficiary was a charitable organization and not a natural person, so the tax-deferral treatment was lost; similarly, in PLR 199944020 found that a partnership holding an annuity would not be eligible for tax-

deferral treatment, as a partnership is a business entity unto itself and not merely the nominal owner for a natural person beneficiary.

The basic conclusion from the rules - while a formal legal agency status is not required (at least based on the most recent rulings), for a trust to qualify as an “agent for a natural person” all the beneficiaries, both income and remainder, current and future, must be natural persons.

II.J.19.a.ii. Taxation of Distributions under an Annuity Contract

Once an annuity is annuitized, Code § 72(b), “Exclusion ratio,” determines how much of a payment is recovery of “investment in the contract” (which can be, but is not necessarily, the same as basis) that is nontaxable and how much is ordinary income:

(1) *In general*. Gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date).

(2) *Exclusion limited to investment*. The portion of any amount received as an annuity which is excluded from gross income under paragraph (1) shall not exceed the unrecovered investment in the contract immediately before the receipt of such amount.

(3) *Deduction where annuity payments cease before entire investment recovered*.

(A) *In general*. If -

(i) after the annuity starting date, payments as an annuity under the contract cease by reason of the death of an annuitant, and

(ii) as of the date of such cessation, there is unrecovered investment in the contract,

the amount of such unrecovered investment (in excess of any amount specified in subsection (e)(5) which was not included in gross income) shall be allowed as a deduction to the annuitant for his last taxable year.

(B) Payments to other persons. In the case of any contract which provides for payments meeting the requirements of subparagraphs (B) and (C) of subsection (c)(2) , the deduction under subparagraph (A) shall be allowed to the person entitled to such payments for the taxable year in which such payments are received.

(C) *Net operating loss deductions provided*. For purposes of section 172 , a deduction allowed under this paragraph shall be treated as if it were attributable to a trade or business of the taxpayer.

(4) *Unrecovered investment*. For purposes of this subsection, the unrecovered investment in the contract as of any date is -

(A) the investment in the contract (determined without regard to subsection (c)(2)) as of the annuity starting date, reduced by

(B) the aggregate amount received under the contract on or after such annuity starting date and before the date as of which the determination is being made, to the extent such amount was excludable from gross income under this subtitle.

Code § 72(e) governs taxation when an annuity contract has not been annuitized and also defines "investment in the contract":

(1) *Application of subsection*.

(A) *In general*. This subsection shall apply to any amount which -

(i) is received under an annuity, endowment, or life insurance contract, and

(ii) is not received as an annuity,

if no provision of this subtitle (other than this subsection) applies with respect to such amount.

(B) *Dividends*. For purposes of this section , any amount received which is in the nature of a dividend or similar distribution shall be treated as an amount not received as an annuity.

(2) *General rule*. Any amount to which this subsection applies -

(A) if received on or after the annuity starting date, shall be included in gross income, or

(B) if received before the annuity starting date -

(i) shall be included in gross income to the extent allocable to income on the contract, and

(ii) shall not be included in gross income to the extent allocable to the investment in the contract.

(3) *Allocation of amounts to income and investment*. For purposes of paragraph (2)(B) -

(A) *Allocation to income*. Any amount to which this subsection applies shall be treated as allocable to income on the contract to the extent that such amount does not exceed the excess (if any) of -

(i) the cash value of the contract (determined without regard to any surrender charge) immediately before the amount is received, over

(ii) the investment in the contract at such time.

(B) Allocation to investment. Any amount to which this subsection applies shall be treated as allocable to investment in the contract to the extent that such amount is not allocated to income under subparagraph (A).

(4) *Special rules for application of paragraph (2)(B)*. For purposes of paragraph (2)(B) -

(A) Loans treated as distributions. If, during any taxable year, an individual -

(i) receives (directly or indirectly) any amount as a loan under any contract to which this subsection applies, or

(ii) assigns or pledges (or agrees to assign or pledge) any portion of the value of any such contract,

such amount or portion shall be treated as received under the contract as an amount not received as an annuity. The preceding sentence shall not apply for purposes of determining investment in the contract, except that the investment in the contract shall be increased by any amount included in gross income by reason of the amount treated as received under the preceding sentence.

(B) Treatment of policyholder dividends. Any amount described in paragraph (1)(B) shall not be included in gross income under paragraph (2)(B)(i) to the extent such amount is retained by the insurer as a premium or other consideration paid for the contract.

(C) Treatment of transfers without adequate consideration.

(i) *In general*. If an individual who holds an annuity contract transfers it without full and adequate consideration, such individual shall be treated as receiving an amount equal to the excess of -

(I) the cash surrender value of such contract at the time of transfer, over

(II) the investment in such contract at such time,

under the contract as an amount not received as an annuity.

(ii) Exception for certain transfers between spouses or former spouses. Clause (i) shall not apply to any transfer to which section 1041(a) (relating to transfers of property between spouses or incident to divorce) applies.

(iii) *Adjustment to investment in contract of transferee*. If under clause (i) an amount is included in the gross income of the transferor of an annuity contract, the investment in the contract of the transferee in such contract shall be increased by the amount so included.

(5) *Retention of existing rules in certain cases*.

(A) *In general*. In any case to which this paragraph applies -

(i) paragraphs (2)(B) and (4)(A) shall not apply, and

(ii) if paragraph (2)(A) does not apply,

the amount shall be included in gross income, but only to the extent it exceeds the investment in the contract.

(B) *Existing contracts*. This paragraph shall apply to contracts entered into before August 14, 1982. Any amount allocable to investment in the contract after August 13, 1982, shall be treated as from a contract entered into after such date.

(C) *Certain life insurance and endowment contracts*. Except as provided in paragraph (10) and except to the extent prescribed by the Secretary by regulations, this paragraph shall apply to any amount not received as an annuity which is received under a life insurance or endowment contract.

(D) *Contracts under qualified plans*. Except as provided in paragraph (8), this paragraph shall apply to any amount received -

(i) from a trust described in section 401(a) which is exempt from tax under section 501(a),

(ii) from a contract -

(I) purchased by a trust described in clause (i),

(II) purchased as part of a plan described in section 403(a),

(III) described in section 403(b), or

(IV) provided for employees of a life insurance company under a plan described in section 818(a)(3), or

(iii) from an individual retirement account or an individual retirement annuity.

Any dividend described in section 404(k) which is received by a participant or beneficiary shall, for purposes of this subparagraph, be treated as paid under a separate contract to which clause (ii)(I) applies.

(E) *Full refunds, surrenders, redemptions, and maturities*. This paragraph shall apply to -

(i) any amount received, whether in a single sum or otherwise, under a contract in full discharge of the obligation under the contract which is in the nature of a refund of the consideration paid for the contract, and

(ii) any amount received under a contract on its complete surrender, redemption, or maturity.

In the case of any amount to which the preceding sentence applies, the rule of paragraph (2)(A) shall not apply.

(6) *Investment in the contract*. For purposes of this subsection, the investment in the contract as of any date is -

(A) the aggregate amount of premiums or other consideration paid for the contract before such date, minus

(B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

(7) *Repealed*.

(8) *Extension of paragraph (2)(B) to qualified plans*.

(A) *In general*. Notwithstanding any other provision of this subsection , in the case of any amount received before the annuity starting date from a trust or contract described in paragraph (5)(D), paragraph (2)(B) shall apply to such amounts.

(B) *Allocation of amount received*. For purposes of paragraph (2)(B) , the amount allocated to the investment in the contract shall be the portion of the amount described in subparagraph (A) which bears the same ratio to such amount as the investment in the contract bears to the account balance. The determination under the preceding sentence shall be made as of the time of the distribution or at such other time as the Secretary may prescribe.

(C) *Treatment of forfeitable rights*. If an employee does not have a nonforfeitable right to any amount under any trust or contract to which subparagraph (A) applies, such amount shall not be treated as part of the account balance.

(D) *Treatises Investment in the contract before 1987*. In the case of a plan which on May 5, 1986, permitted withdrawal of any employee contributions before separation from service, subparagraph (A) shall apply only to the extent that amounts received before the annuity starting date (when increased by amounts previously received under the contract after December 31, 1986) exceed the investment in the contract as of December 31, 1986.

(9) *Extension of paragraph (2)(B) to qualified tuition programs and Coverdell education savings accounts*. Notwithstanding any other provision of this subsection , paragraph (2)(B) shall apply to amounts received under a qualified tuition program (as defined in section 529(b)) or under a Coverdell education savings account (as defined in section 530(b)). The rule of paragraph (8)(B) shall apply for purposes of this paragraph.

(10) *Treatment of modified endowment contracts*.

(A) *In general*. Notwithstanding paragraph (5)(C) , in the case of any modified endowment contract (as defined in section 7702A) -

(i) paragraphs (2)(B) and (4)(A) shall apply, and

(ii) in applying paragraph (4)(A), “any person” shall be substituted for “an individual”.

(B) *Treatment of certain burial contracts*. Notwithstanding subparagraph (A), paragraph (4)(A) shall not apply to any assignment (or pledge) of a modified endowment contract if such assignment (or pledge) is solely to cover the payment of expenses referred to in section 7702(e)(2)(C)(iii) and if the maximum death benefit under such contract does not exceed $25,000.

(11) *Special rules for certain combination contracts providing long-term care insurance*. Notwithstanding paragraphs (2), (5)(C) , and (10), in the case of any charge against the cash value of an annuity contract or the cash surrender value of a life insurance contract made as payment for coverage under a qualified long-term care insurance contract which is part of or a rider on such annuity or life insurance contract -

(A) the investment in the contract shall be reduced (but not below zero) by such charge, and

(B) such charge shall not be includible in gross income.

(12) *Anti-abuse rules*.

(A) *In general*. For purposes of determining the amount includible in gross income under this subsection -

(i) all modified endowment contracts issued by the same company to the same policyholder during any calendar year shall be treated as 1 modified endowment contract, and

(ii) all annuity contracts issued by the same company to the same policyholder during any calendar year shall be treated as 1 annuity contract.

The preceding sentence shall not apply to any contract described in paragraph (5)(D).

(B) *Regulatory authority*. The Secretary may by regulations prescribe such additional rules as may be necessary or appropriate to prevent avoidance of the purposes of this subsection through serial purchases of contracts or otherwise.

Howard Zaritsky's Estate Planning Update (WG&L), Contingent Deferred Annuity Will Be Treated as Annuity Contract (1/1/2023), explains:

> In PLR 202250010, PLR 202250011, PLR 202250012, and PLR 202250013 (Dec. 16, 2022), the IRS stated that a nonassignable contract issued by a life insurance company to an individual would be treated as an annuity contract under Code Sec. 72, despite several variables that would ultimately determine the amount of annual payments, that certain lifetime distributions would be treated as "amounts received as an annuity," and that an investment account protected by the policy would not cause the contract to have a cash surrender value. The IRS also explained how the taxpayer's investment in the contract would be calculated, that dividends received from the assets in taxpayer's investment account will not fail to be treated as "qualified dividend income" under Code Sec. 1(h)(11)(B) merely because the taxpayer also owns the contract, and that the ownership of the contract and the account assets will not be treated as a straddle under Code Sec. 1092.

Looking just at the first of those, Letter Ruling 202250010 begins:

> Taxpayer has requested several rulings regarding whether and how § 72 of the Internal Revenue Code applies to a contingent deferred annuity contract ("the Contract") Individual plans to purchase from Taxpayer.

Letter Ruling 202250010 addressed the following situation:

> Taxpayer is a life insurance company within the meaning of § 816(a).
>
> Individual will own assets in a taxable investment account ("Account"). Taxpayer will have no legal or equitable interest in any assets owned by Individual in the Account, and Taxpayer will not treat the Account or any of the assets in the Account as Taxpayer's assets for any purpose. Individual will be free to liquidate all or any portion of the assets in the Account at any time without Taxpayer's consent.
>
> Taxpayer intends to issue the Contract to Individual. The Contract will provide certain benefits in the event the value of the Account is depleted before Individual's death. Specifically, if the Account's value reaches zero or some other minimum threshold amount for reasons other than withdrawals in excess of the prescribed limit, Taxpayer will begin making annual payments to Individual under the contract on either a fixed ("Fixed Method") or a fluctuating ("Fluctuating Method") basis (collectively, "Protected Income Payments"). The payments will continue for Individual's life or for the joint lives of Individual and Individual's spouse. Alternatively, prior to the point at which annual payments begin under the Contract, Individual can elect to liquidate the Account and transfer the proceeds to Taxpayer in exchange for fixed payments at minimum purchase rates guaranteed in the Contract ("Annuity Payments").
>
> Individual can make withdrawals from the Account. Once Individual begins making "Protected Income Withdrawals" from the Account, the maximum amount Individual may withdraw from the Account is set each year by reference to the performance of the assets in the Account. "Excess Withdrawals" in excess of the maximum amount reduce maximum withdrawal amounts going forward. Too many Excess Withdrawals can also result in termination of the Contract. The Contract may include a feature whereby unused withdrawal amounts for a given year are carried forward to subsequent years to increase the maximum withdrawal amounts in those years.
>
> Though Taxpayer's exposure to investment risk is limited due to the fluctuating limit placed on maximum withdrawals from the Account, Taxpayer also may, but does not currently plan to, restrict permissible asset holdings in the Account. For instance, certain kinds of "exotic" investments may be restricted. Exotic investments may include private securities, investments that are not priced daily, and investments that are not registered with the Securities and Exchange Commission.
>
> Unless Individual liquidates the Account and transfers the proceeds to Taxpayer in exchange for Annuity Payments, annual payments will begin under the Contract once the Account's value reaches zero or otherwise falls below a minimum threshold amount. Individual can select either fixed payments under the Fixed Method or fluctuating payments under the Fluctuating Method.

Each payment option differs in the following respects. If Individual selects the Fixed Method (which is the default option), the Contract's annual payments will commence when the Account's value is reduced to zero (for reasons other than Excess Withdrawals) and will be equal to the maximum withdrawal amount in effect as of that time. If Individual selects the Fluctuating Option before the Account falls below a minimum threshold amount (for reasons other than Excess Withdrawals), then payments will commence once the Account's value falls below a minimum threshold amount and the Contract's annual payments will initially be equal to the maximum withdrawal amount in effect as of the time that Contract payments commence but will thereafter fluctuate with investment performance.

If Individual selects the Fluctuating Option, then once the value of the Account reaches a minimum threshold amount, the remaining assets in the Account must be liquidated and the proceeds transferred to Taxpayer before payments commence. Individual may then allocate those transferred proceeds among one or more separate sub-accounts. The investment performance of the sub-account(s) that Individual selects is used solely to generate a rate of return. That rate of return is then applied to adjust the annual payouts under the Contract.

Individual will not be able to access the amounts in the sub-account(s) in any way, and the amounts will not give rise to any cash value. Any amounts allocated to the sub-account(s) are, as indicated above, used solely to generate a rate of return to use in determining annual payments under the Contract under the Fluctuating Method.

The Contract may be issued with a feature guaranteeing a payment to Individual at the age of 95 in certain circumstances ("Cumulative Income Minimum"). Specifically, if Individual reaches the age of 95 and has not had the opportunity, either through permissible withdrawals from the Account or through payments under the Contract, to recover Individual's net deposits into the Account at the time of the first Protected Income Withdrawal (proportionally reduced by any Excess Withdrawals taken after the first Protected Income Withdrawal), Taxpayer will make a one-time payment to Individual making up the difference.

Individual will periodically pay consideration for the Contract either out of the Account (on an after-tax basis) or out of other sources of after-tax funds. Additionally, as indicated above, Individual may transfer a final amount of cash proceeds to Taxpayer once the Account reaches a minimum threshold amount, which Taxpayer will treat as additional consideration for the Contract.

Amounts Individual pays for the Contract will not give rise to any cash value, and the Contract will not otherwise have any cash value accessible by Individual. The Contract is not assignable or transferable by Individual. The Contract will not serve as collateral for any loan from Taxpayer or Taxpayer's affiliates.

Individual is X years old. It is anticipated that Individual will be X years old at the time Taxpayer issues the Contract to Individual. In general, Taxpayer anticipates that Individual's age will be typical of other customers. Taxpayer intends to restrict the availability of the Cumulative Income Minimum feature to customers who are Y-Z years old at the time of Contract issuance.

> The Contract will terminate if Individual dies prior to the commencement of Annuity Payments or Protected Income Payments, unless continued by Individual's spouse pursuant to § 72(s).
>
> The Contract will be treated as an annuity contract for state law purposes and will be registered as a security with the Securities and Exchange Commission. Taxpayer will maintain reserves for its liabilities under the Contract. Taxpayer will treat the consideration Individual pays for the Contract (whether the periodic fees or any transfer of proceeds from the Account after liquidation of the Account's assets) as premiums for state premium tax purposes and will account for the consideration as annuity premiums both on its National Association of Insurance Commissioners annual statement and for federal income tax purposes.

Letter Ruling 202250010 concluded:

1. The Contract will constitute an annuity contract for purposes of § 72.

2. The Protected Income Payments that are made using the Fixed Method and the Annuity Payments will be taxable as "amounts received as an annuity" under § 72(b). In addition, a portion of each Protected Income Payment that is made using the Fluctuating Method will be treated as an "amount received as an annuity," as follows:

   (a) The portion of each such Protected Income Payment that will be treated as an amount received as an annuity will be excludable from gross income pursuant to § 72(b)(1) and §§ 1.72-2(b)(3) and 1.72-3, subject to the limitation imposed by § 72(b)(2); and

   (b) The excess (if any) of each such Protected Income Payment over the portion determined in (a) above will be treated as an amount not received as an annuity on or after the annuity starting date and will be includible in gross income as provided in § 72(e)(2)(A) and §§ 1.72-1(d), 1.72-4(a)(3), (d)(3), and 1.72-11(b)(2).

3. The Account will not cause the Contract to have a "cash value" or "cash surrender value" for purposes of § 72, and will not otherwise be part of the Contract for federal income tax purposes.

4. For purposes of § 72(c)(1) and § 72(e)(6) (each defining "investment in the contract"), the "aggregate amount of premiums or other consideration paid" for the Contract will equal the sum of all charges Individual paid under the Contract plus any proceeds Individual paid to Taxpayer upon liquidation of the Account as consideration for Protected Income Payments or Annuity Payments.

Letter Ruling 202341002 held that, when a Code § 816(a) life insurance company paid fees to a person who advised the annuity's owner on investment options, the payment of the fees was internal to the contract and not considered a distribution to the policy owner, reasoning:

> In this case, the Fees are integral to the operation of the Adviser Life Contract. During any period for which the Authorization is in effect, the Owner will receive ongoing investment advice from the Adviser with respect to the Adviser Life Contract so that the Owner may properly utilize the Adviser Life Contract. The Adviser is expected to help the

Owner select Options related to the Adviser Life Contract. Taxpayer has represented that the Fees will not serve as consideration for anything other than investment advice provided by the Adviser in relation to the Adviser Life Contract. Furthermore, Taxpayer has represented that the Fees will not exceed an annual rate of 1.5% of the Adviser Life Contract's cash surrender value based on the period in which the Fees relate. Based on Taxpayer's representations, the Fees will only be used to pay for investment advisory services relating to the Adviser Life Contract. Because the Adviser Life Contracts are designed to work with an Adviser, the Adviser Life Contract is solely liable for the Fees. The Fees do not constitute compensation to the Adviser for services related to any assets of the Owner other than the Adviser Life Contract or any services other than investment advice services with respect to the Adviser Life Contract. Therefore, the Fees are an expense of the Adviser Life Contract, not a distribution to the Owner.

II.J.19.a.iii. Code § 72(q) 10% Penalty for Early Distributions from Annuity Contracts

Code § 72(q) provides:

(1) *Imposition of penalty*. If any taxpayer receives any amount under an annuity contract, the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

(2) *Subsection not to apply to certain distributions*. Paragraph (1) shall not apply to any distribution -

(A) made on or after the date on which the taxpayer attains age 59½,

(B) made on or after the death of the holder (or, where the holder is not an individual, the death of the primary annuitant (as defined in subsection (s)(6)(B))),

(C) attributable to the taxpayer's becoming disabled within the meaning of subsection (m)(7),

(D) which is a part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his designated beneficiary,

(E) from a plan, contract, account, trust, or annuity described in subsection (e)(5)(D),[3018]

(F) allocable to investment in the contract before August 14, 1982,

(G) under a qualified funding asset (within the meaning of section 130(d), but without regard to whether there is a qualified assignment),[3019]

(H) to which subsection (t) applies (without regard to paragraph (2) thereof),[3020]

[3018] [my footnote:] Code § 72(e)(5)(D) applies to certain contracts under qualified plans.
[3019] [my footnote:] Code § 130(d) applies to certain annuities under certain personal injury assignments.
[3020] [my footnote:] Code § 72(t) applies to early distributions from qualified retirement plans.

(I) under an immediate annuity contract (within the meaning of section 72(u)(4)), or

(J) which is purchased by an employer upon the termination of a plan described in section 401(a) or 403(a) and which is held by the employer until such time as the employee separates from service.

(3) *Change in substantially equal payments*. If -

(A) paragraph (1) does not apply to a distribution by reason of paragraph (2)(D), and

(B) the series of payments under such paragraph are subsequently modified (other than by reason of death or disability) -

(i) before the close of the 5-year period beginning on the date of the first payment and after the taxpayer attains age 59½, or

(ii) before the taxpayer attains age 59½,

the taxpayer's tax for the 1st taxable year in which such modification occurs shall be increased by an amount, determined under regulations, equal to the tax which (but for paragraph (2)(D)) would have been imposed, plus interest for the deferral period (within the meaning of subsection (t)(4)(B)).

As to the Code § 72(q)(I) exception for an immediate annuity contract, one cannot qualify by engaging in a nontaxable swap of a deferred annuity for an immediate annuity. Rev. Rul. 92-95 held:

> If an annuity contract is acquired in exchange for another annuity contract in a transaction described in section 1035 of the Code, "the date of the purchase of the annuity" for purposes of section 72(u)(4) (which defines the term "immediate annuity") and section 72(q)(2)(I) (which exempts distributions under an immediate annuity from the 10 percent penalty of section 72(q)(1)) is the date of purchase of the annuity contract exchanged for the new annuity contract.

II.J.19.a.iv. Code § 72(s) Required Distributions Where Holder Dies Before Entire Interest Is Distributed

Code § 72(s) provides:

(1) *In general*. A contract shall not be treated as an annuity contract for purposes of this title unless it provides that -

(A) if any holder of such contract dies on or after the annuity starting date and before the entire interest in such contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used as of the date of his death, and

(B) if any holder of such contract dies before the annuity starting date, the entire interest in such contract will be distributed within 5 years after the death of such holder.

(2) *Exception for certain amounts payable over life of beneficiary*. If -

(A) any portion of the holder’s interest is payable to (or for the benefit of) a designated beneficiary,

(B) such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary), and

(C) such distributions begin not later than 1 year after the date of the holder’s death or such later date as the Secretary may by regulations prescribe,

then for purposes of paragraph (1), the portion referred to in subparagraph (A) shall be treated as distributed on the day on which such distributions begin.

(3) *Special rule where surviving spouse beneficiary*. If the designated beneficiary referred to in paragraph (2)(A) is the surviving spouse of the holder of the contract, paragraphs (1) and (2) shall be applied by treating such spouse as the holder of such contract.

(4) *Designated beneficiary*. For purposes of this subsection , the term “designated beneficiary” means any individual designated a beneficiary by the holder of the contract.

(5) *Exception for certain annuity contracts*. This subsection shall not apply to any annuity contract -

(A) which is provided -

(i) under a plan described in section 401(a) which includes a trust exempt from tax under section 501, or

(ii) under a plan described in section 403(a),

(B) which is described in section 403(b),

(C) which is an individual retirement annuity or provided under an individual retirement account or annuity, or,

(D) which is a qualified funding asset (as defined in section 130(d), but without regard to whether there is a qualified assignment).

(6) *Special rule where holder is corporation or other non-individual*.

(A) *In general*. For purposes of this subsection, if the holder of the contract is not an individual, the primary annuitant shall be treated as the holder of the contract.

(B) *Primary annuitant*. For purposes of subparagraph (A), the term “primary annuitant” means the individual, the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the contract.

(7) *Treatment of changes in primary annuitant where holder of contract is not an individual*. For purposes of this subsection , in the case of a holder of an annuity contract which is not an individual, if there is a change in a primary annuitant (as defined in paragraph (6)(B)), such change shall be treated as the death of the holder.

Code § 72(s)(2) looks a lot like parts of Code § 401(a)(9), but insurance company back offices do not apply the regulations under Code § 401(a)(9). If the beneficiary is not an actual individual, generally forget about stretching the payments (absent litigation against the insurance company to try to create favorable case law), notwithstanding the fact that a trust can be an individual. However, if the annuitant's surviving spouse is the beneficiary of a trust with an unlimited right to withdraw its income and principal, the surviving spouse is considered the beneficiary.[3021]

II.J.19.a.v. Annuity Contract Issued to Grantor Trust

For what is a grantor trust, see part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

Letter Ruling 202031008 involved the following:[3022]

> The Taxpayer is a life insurance company organized and operated under the laws of State. The Taxpayer is a subsidiary of the Parent and joins in the filing of a consolidated federal income tax return with the Parent on a calendar year basis using an accrual method of accounting.
>
> The Taxpayer issues nonqualified deferred annuity contracts that may be fixed, indexed, or variable contracts, that contain customary, industry standard terms, and that are considered annuity contracts in accordance with the customary practice of life insurance companies (the "Contracts"). The Taxpayer regularly issues Contracts to both grantor trusts and non-grantor trusts in situations similar to those described below. The Taxpayer has information reporting obligations under section 6047(d) with respect to distributions or payments under the Contracts.
>
> In the Grantor Trust Scenario, the Taxpayer issues a Contract to a grantor trust (*i.e.*, a trust described in subpart E of part I of subchapter J (sections 671 through 679)) (the "Grantor Trust") that was established by one individual (the "Grantor"). The beneficiaries of the Grantor Trust (each, a "Grantor Trust Beneficiary") are an individual who is not the Grantor and a charitable organization. There are no contingent beneficiaries under the Grantor Trust. The Grantor Trust is named in the Contract as the owner and beneficiary of the Contract (i.e., the person entitled to receive distributions under the Contract). The individual Grantor Trust Beneficiary is named in the Contract as the sole annuitant, the individual the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the Contract (i.e., the measuring life).

[3021] Letter Ruling 200323012, Issue 1, analyzed in the text accompanying fn 3023 in part II.J.19.a.iv Code § 72(s) Required Distributions Where Holder Dies Before Entire Interest Is Distributed. The grantor trust rules treat the surviving spouse as the deemed owner; see parts III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts and III.B.2.d.i Federal Income Tax and Irrevocable Grantor Trust Treatment.

[3022] The Non-Grantor Trust Scenario is evaluated in part II.J.19.a.vi Annuity Contract Issued to Nongrantor Trust.

In the Non-Grantor Trust Scenario, the Taxpayer issues a Contract to a trust subject to tax under section 641 (the “Non-Grantor Trust”) that was established by one individual (the “Settlor”). The sole beneficiary of the Non-Grantor Trust (the “Non-Grantor Trust Beneficiary”) is an individual who is not the Settlor and who does not have a power exercisable by himself to vest trust income or corpus in himself as described in section 678. There are no contingent beneficiaries under the Non-Grantor Trust. The Non-Grantor Trust is named in the Contract as the owner and beneficiary of the Contract (i.e., the person entitled to receive distributions under the Contract). The Non-Grantor Trust Beneficiary is named in the Contract as the sole annuitant, the individual the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the Contract (*i.e.*, the measuring life).

Letter Ruling 202031008 involved the following representations:

1. In the Grantor Trust Scenario, the Grantor will be considered the owner of the entire Grantor Trust under subpart E of part I of subchapter J.

2. In the Non-Grantor Trust Scenario, neither the Settlor nor any other person will be considered the owner of the Non-Grantor Trust under subpart E of part I of subchapter J, and the Non-Grantor Trust is a trust subject to tax under section 641.

3. Each Contract is an annuity contract under the law of the jurisdiction where issued.

4. Each Contract qualifies for treatment as an annuity contract for federal income tax purposes, including by complying with the requirements of section 72(s) and, where applicable, the requirements of section 817(h) and the “investor control” doctrine.

5. The sole annuitant named in each Contract is the “primary annuitant” within the meaning of section 72(s)(6)(B).

6. No Contract will be issued in a situation where an employer is the nominal owner of the Contract and the employer’s employees are the beneficial owners of the Contract, including as part of any arrangement to provide deferred compensation to such employees.

Letter Ruling 202031008 analyzed the Grantor Trust Scenario:

<u>Sections 72(q)(2)(A), (C), (D)</u>

Section 72(q) generally imposes an additional 10% tax on amounts received under an annuity contract that are includible in income unless certain exceptions apply. Sections 72(q)(2)(A), (C), and (D) respectively provide exceptions to the 10% additional tax if the distribution is made on or after the date the “taxpayer” attains age 59½, if the distribution is attributable to the “taxpayer’s” becoming disabled, or if the distribution is part of a series of substantially equal periodic payments made for the life of the “taxpayer” or the “taxpayer” and his or her designated beneficiary. Section 7701(a)(14) defines “taxpayer” to mean any person subject to any internal revenue tax.

Under the grantor trust rules, section 671 provides that when the grantor is treated as the owner of any portion of a trust, the grantor must include in computing his or her taxable income those items of income, deductions, and credits that are attributable to that portion of the trust. Section 1.671-3(a)(1) provides, in relevant part, that if a grantor is treated as the owner of an entire trust, the grantor takes into account in computing his or her income tax liability all items of income to which the grantor would have been entitled had the trust not been in existence during the period the grantor is treated as owner of the trust.

In the Grantor Trust Scenario, the Grantor is the owner of the Grantor Trust for federal income tax purposes. As a consequence, the Grantor is required to include in income any income arising from the receipt by the Grantor Trust of distributions under the Contract. Accordingly, the Grantor is the “taxpayer” with respect to the Contract, and references to the “taxpayer” in sections 72(q)(2)(A), (C), and (D) are references to the Grantor.

Section 72(q)(2)(B)

Section 72(q)(2)(B) provides an exception to the 10% additional tax if the distribution is made on or after the death of the “holder” or, when the “holder” is not an individual, the death of the primary annuitant (as defined in section 72(s)(6)(B)). Section 72(s)(6)(B) defines the primary annuitant as the individual the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the contract.

In the Grantor Trust Scenario, the Grantor Trust is the “holder” of the Contract because it is designated in the Contract as the owner of the Contract. The Grantor Trust is not an individual, however, so the exception provided in section 72(q)(2)(B) applies if the distribution is made on or after the death of the primary annuitant, as defined in section 72(s)(6)(B). In the Grantor Trust Scenario, the primary annuitant is the individual Grantor Trust Beneficiary. Thus, the exception provided in section 72(q)(2)(B) will apply in the Grantor Trust Scenario to distributions made on or after the death of the individual Grantor Trust Beneficiary.

Section 72(u)(1)

Section 72(u)(1) generally provides that an annuity contract is not treated as such for federal income tax purposes (other than subchapter L) if it is held by a person who is not a natural person. The flush language of section 72(u)(1), however, provides that holding by a trust or other entity as an agent for a natural person is not taken into account for this purpose.

A trustee generally has fiduciary obligations under trust documents and governing law that are inconsistent with it acting as an agent for the beneficiary of a trust. See, *e.g.*, *Restatement (Third) of Agency section* 1.01 cmt. g (2018); *Restatement (Third) of Trusts* section 5(e) & cmt. e (2003); *Restatement (Second) of Agency* section 14B (1958). This principle also applies for federal income tax purposes. See, *e.g.*, Rev. Rul. 69-300; *United States v. Anderson*, 132 F.2d 98 (6th Cir. 1942). Accordingly, the phrase “as an agent” in the flush language of section 72(u)(1) pertains only to “other entity.” It does not pertain to “trust.” Thus, for purposes of section 72(u)(1), the holding of an annuity contract by a trust is not taken into account if the contract is held for a natural person.

In the Grantor Trust Scenario, the Grantor Trust is the “holder” of the Contract within the meaning of section 72(u)(1) because it is designated in the Contract as the owner of the Contract.

> The Grantor is treated as the owner of the entire Grantor Trust, and as a consequence, the Grantor is also treated as the owner of the Contract for federal income tax purposes. See Rev. Rul. 85-13. The Grantor Trust is holding the Contract for the Contract's tax owner, the Grantor, who is a natural person. Accordingly, the holding of the Contract by the Grantor Trust is not taken into account for purposes of section 72(u)(1).
>
> This determination is consistent with the purpose for adopting section 72(u). Section 72(u) was adopted to encourage employers to offer benefits to employees under qualified pension plans, which are subject to certain restrictions and generally must be made available to a wide class of employees, as opposed to offering deferred compensation to a limited class of employees that is funded by deferred annuity contacts. Because the Contract in the Grantor Trust Scenario is not issued in the employment context, the arrangement does not provide the sort of tax-favored benefit that section 72(u) was intended to limit.

Letter Ruling 202031008 ruled on the Grantor Trust Scenario:

> (1) For purposes of section 72(q)(2), (i) the Grantor is the "taxpayer," so the exceptions in sections 72(q)(2)(A), (C), and (D) will apply based on the age, disability, and life or life expectancy, respectively, of the Grantor and (ii) the Grantor Trust is the "holder" of the Contract, so that the exception in section 72(q)(2)(B) will apply based upon the death of the primary annuitant (as defined in section 72(s)(6)(B)), who is the individual Grantor Trust Beneficiary.
>
> (2) For purposes of section 72(u)(1) and pursuant to the flush language of that section, the Contract is held by the Grantor Trust for the Grantor, so that section 72(u)(1) will not apply even though one of the Grantor Trust Beneficiaries is a charitable organization.

When a joint revocable trust owns an annuity that is transferred to the surviving spouse's revocable share on the annuitant's death, the annuity is treated as owned by the surviving spouse and may be swapped in a Code § 1035 exchange. Letter Ruling 200323012 involved the following situation:

> Taxpayers A and B were married. On Date 4, Taxpayers A and B created Trust C, a revocable, inter vivos trust. Taxpayers A and B were the grantors, co-trustees, and beneficiaries of Trust C. The trust agreement provided that the survivor of Taxpayer A and Taxpayer B would be the surviving grantor/trustee and sole beneficiary of Trust C. Subsequently, Taxpayer A transferred ownership of two deferred variable Annuities (Contracts A and B) to Trust C and named Trust C the beneficiary of Contracts A and B. Taxpayer A died on Date 5 before the starting date of the Annuities.
>
> Trust C is an A/B type trust which, upon the first death of a grantor is to be divided into two subtrusts, "Subtrust D", a survivor's trust, and "Subtrust E", a credit shelter trust. Taxpayer B, as surviving grantor/trustee, has the power of allocation between the subtrusts of Trust C and is the trustee and beneficiary of both subtrusts. With respect to Subtrust E, Taxpayer B is entitled to all net income to that trust and can invade the principal on an unascertainable standard. Further, Taxpayer B has the right to withdraw the entire or any amount of income and/or principal from Subtrust D, and this right cannot be limited by trustee discretion.

> Taxpayer B, as surviving spouse, proposes to transfer Contracts A and B from Trust C to Subtrust D and exchange Contracts A and B for a new deferred variable annuity contract (Contract C). Contract C will be issued in favor of Taxpayer B. (Taxpayer B will be both owner and beneficiary.) At no point in the exchange will Subtrust D or Taxpayer B receive any money or property other than Contract C.

Letter Ruling 200323012 concluded that "Taxpayer B is the designated beneficiary of Contracts A and B within the meaning of section 72(s)(4),"[3023] reasoning:

> In this instance, although Trust C is the named holder and beneficiary of Taxpayer A's Annuities, Taxpayer B has the right to allocate funds between Subtrust D and Subtrust E upon the division of Trust C at Taxpayer A's death, and to withdraw all of the principal of Trust C from Subtrust D. Taxpayer B thus has complete control and dominion over Trust C and Subtrusts D and E, and over the disposition of the assets of Trust C and Subtrusts D and E. Taxpayer has represented that Trust C, Subtrust D and Subtrust E are grantor trusts for purposes of the Code and Income Tax Regulations. As a result, Taxpayer B is treated as the owner of the assets of Trust C, Subtrust D, and Subtrust E (including Contracts A and B). Under section 671, Taxpayer B must take into account items of income deductions and credits attributable to the assets of the trusts (including Contracts A and B).

The representation that the surviving spouse was the deemed owner of the credit shelter trust was simply wrong.[3024] However, the credit shelter trust never owned the annuity policy; instead, the surviving spouse as trustee allocated it to the surviving spouse's revocable trust, so that representation was irrelevant (although presumably required by the IRS at that time).

Letter Ruling 200323012 ruled that, when a grantor of a joint revocable trust died, the surviving spouse's revocable trust[3025] could, tax-free under Code § 1035,[3026] exchange both contracts on her life for an annuity contract that she owned:

> Section 1.1035-1(c) of the Income Tax Regulations provides that "section 1035 does not apply to such exchanges if the policies exchanged do not relate to the same insured. The exchange, without recognition of gain or loss of an annuity contract for another annuity contract under section 1035(a)(3), is limited to cases where the same person or

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[3023] See part II.J.19.a.iv Code § 72(s) Required Distributions Where Holder Dies Before Entire Interest Is Distributed.

[3024] See part III.B.2.i.iii Can a Trust Without a Withdrawal Right Be a Code § 678 Trust?

[3025] The facts included:

> Trust C is an A/B type trust which, upon the first death of a grantor is to be divided into two subtrusts, "Subtrust D", a survivor's trust, and "Subtrust E", a credit shelter trust. Taxpayer B, as surviving grantor/trustee, has the power of allocation between the subtrusts of Trust C and is the trustee and beneficiary of both subtrusts. With respect to Subtrust E, Taxpayer B is entitled to all net income to that trust and can invade the principal on an unascertainable standard. Further, Taxpayer B has the right to withdraw the entire or any amount of income and/or principal from Subtrust D, and this right cannot be limited by trustee discretion.
>
> Taxpayer B, as surviving spouse, proposes to transfer Contracts A and B from Trust C to Subtrust D and exchange Contracts A and B for a new deferred variable annuity contract (Contract C). Contract C will be issued in favor of Taxpayer B. (Taxpayer B will be both owner and beneficiary.) At no point in the exchange will Subtrust D or Taxpayer B receive any money or property other than Contract C.

[3026] See part II.Q.4.c Income Tax Issues in Transferring Life Insurance; Code § 1035.

persons are the obligees under the contract received in the exchange as under the original contract."

In this instance, although Trust C is nominally the obligee under Contracts A and B, as explained above, Taxpayer B is the owner of Contracts A and B for tax purposes and the designated beneficiary under section 72(s)(4). Taxpayer accordingly is the obligee of Contracts A and B within the meaning of section 1.1035-1(c) of the regulations. Because Taxpayer B will also be the obligee under Contract C, the same obligee requirement of section 1.1035-1(c) will be satisfied.

The legislative history indicates that section 1035 was designed to eliminate the taxation of individuals "who merely exchanged one insurance policy for another better suited to their needs but who have actually recognized no gain." H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 81 (1954). Thus, section 1035 operates as the insurance analogue to section 1031, which relates to like-kind exchanges of certain types of property held for productive use in a trade or business or for investment. The similarity of section 1031 and section 1035 is evidenced in section 1035(c)(1), which provides that the recognition of gain or loss on an exchange that is not solely like-kind will be made under the terms of section 1031(b) and (c). In addition, section 1035(c)(2) states that section 1031(d) provides rules relating to the basis of property acquired in an exchange described in section 1035(a). Section 1031(b), (c), and (d) similarly cross-reference section 1035(a).

Section 1031 permits exchanges of one property for more than one property. See 1.1031(j)-1 (relating to exchanges of multiple properties). See also Rev. Rul. 85-135 1985-2 C.B. 181 (exchange of assets of two television stations for the assets of another television station); Rev. Rul. 73-476 1973-2 C.B. 300 (exchange of three undivided interests in three parcels of land for 100 percent ownership in one parcel).

Because section 1035(a)(3) is written in the singular, one might argue that it does not apply to exchanges of one annuity for two annuities or exchanges of two annuities for one annuity contract. However, section 7701(m)(1) cross-references Title I, section 1 of the United States Code, which provides that "in determining the meaning of any Act of Congress, unless the context indicates otherwise, words importing the singular include and apply to several persons, parties, and things." Thus, just as section 1031 applies to exchanges of multiple properties, section 1035(a)(3) applies to exchanges of multiple annuities.

II.J.19.a.vi. Annuity Contract Issued to Nongrantor Trust

Letter Ruling 202031008 involved the following:[3027]

In the Non-Grantor Trust Scenario, the Taxpayer issues a Contract to a trust subject to tax under section 641 (the "Non-Grantor Trust") that was established by one individual (the "Settlor"). The sole beneficiary of the Non-Grantor Trust (the "Non-Grantor Trust Beneficiary") is an individual who is not the Settlor and who does not have a power exercisable by himself to vest trust income or corpus in himself as described in section 678. There are no contingent beneficiaries under the Non-Grantor Trust. The Non-Grantor Trust is named in the Contract as the owner and beneficiary of the Contract

[3027] For essential background, please read fn 3022 (not just the first indented portion but also the numbered representations that follow it) in part II.J.19.a.v Annuity Contract Issued to Grantor Trust.

(*i.e.*, the person entitled to receive distributions under the Contract). The Non-Grantor Trust Beneficiary is named in the Contract as the sole annuitant, the individual the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the Contract (*i.e.*, the measuring life).

Letter Ruling 202031008 analyzed the Non-Grantor Trust Scenario:

Sections 72(q)(2)(A), (C), (D)

As discussed above, sections 72(q)(2)(A), (C), and (D) provide exceptions to the 10% additional tax imposed by section 72(q)(1) if a distribution is made on or after the date the "taxpayer" attains age 59½, if the distribution is attributable to the "taxpayer's" becoming disabled, or if the distribution is part of a series of substantially equal periodic payments made for the life of the "taxpayer" or the "taxpayer" and his or her designated beneficiary.

Unlike grantor trusts, a non-grantor trust is potentially subject to federal income tax. (Although the tax burden may be passed through to a non-grantor trust's beneficiaries, the non-grantor trust is initially subject to the tax and must claim a deduction to eliminate any income tax liability at the trust level.) In the Non-Grantor Trust Scenario, the Non-Grantor Trust is required to include in income any income arising from the receipt by the Non-Grantor Trust of distributions under the Contract. Accordingly, the Non-Grantor Trust is the "taxpayer" with respect to the Contract, and references to the "taxpayer" in sections 72(q)(2)(A), (C), and (D) are references to the Non-Grantor Trust.

The Non-Grantor Trust, however, cannot attain age 59½, become disabled, or have a life expectancy, as contemplated by sections 72(q)(2)(A), (C), and (D), respectively. Thus, the exceptions provided by these provisions are not applicable to distributions under the Contract in the Non-Grantor Trust Scenario.

Section 72(q)(2)(B)

Section 72(q)(2)(B) provides an exception to the 10% additional tax if a distribution is made on or after the death of the "holder" or, when the "holder" is not an individual, the death of the primary annuitant (as defined in section 72(s)(6)(B)). Section 72(s)(6)(B) defines the primary annuitant as the individual the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the Contract.

In the Non-Grantor Trust Scenario, the Non-Grantor Trust is the "holder" of the Contract because it is designated in the Contract as the owner of the Contract. The Non-Grantor Trust is not an individual, however, so the exception provided in section 72(q)(2)(B) applies if the distribution is made on or after the death of the primary annuitant, as defined in section 72(s)(6)(B). In the Non-Grantor Trust Scenario, the primary annuitant is the Non-Grantor Trust Beneficiary. Thus, the exception provided in section 72(q)(2)(B) will apply in the Non-Grantor Trust Scenario to distributions made on or after the death of the Non-Grantor Trust Beneficiary.

Section 72(u)(1)

As discussed above, for purposes of section 72(u)(1), the holding of an annuity contract by a trust is not taken into account if the contract is held for a natural person.

> In the Non-Grantor Trust Scenario, the Non-Grantor Trust is the "holder" of the Contract because it is designated in the Contract as the owner of the Contract.
>
> In the Non-Grantor Trust Scenario, the Non-Grantor Trust Beneficiary is the only beneficiary of the trust and the only person who will benefit from the distributions under the Contract. Thus, the Non-Grantor Trust is holding the Contract for the benefit of the Non-Grantor Trust Beneficiary, a natural person. Accordingly, the holding of the Contract by the Non-Grantor Trust is not taken into account for purposes of section 72(u)(1).
>
> This determination is consistent with the purpose for adopting section 72(u), which was discussed above. Because the Contract in the Non-Grantor Trust Scenario is not issued in the employment context, the arrangement does not provide the sort of tax-favored benefit that section 72(u) was intended to limit.

Letter Ruling 202031008 ruled on the Non-Grantor Trust Scenario:

> (1) For purposes of section 72(q)(2), (i) the Non-Grantor Trust is the "taxpayer," so that the exceptions in sections 72(q)(2)(A), (C), and (D) will not apply to any distribution from the Contract because the Non-Grantor Trust cannot attain age 59½, become disabled, or have a life or life expectancy within the meaning of such sections and (ii) the Non-Grantor Trust is the "holder" of the Contract, so that the exception in section 72(q)(2)(B) will apply based upon the death of the primary annuitant (as defined in section 72(s)(6)(B)), who is the Non-Grantor Trust Beneficiary.
>
> (2) For purposes of section 72(u)(1) and pursuant to the flush language of that section, the Contract is held by the Non-Grantor Trust for the Non-Grantor Trust Beneficiary, so that section 72(u)(1) will not apply.

In other words, in most cases the 10% penalty for early distribution under part II.J.19.a.iii Code § 72(q) 10% Penalty for Early Distributions from Annuity Contracts applies unless the contract is an immediate annuity contract or to the extent that payments are received after the sole beneficiary's death.

For post-mortem trust funding, see Letter Ruling 200323012, described in part II.J.19.a.v Annuity Contract Issued to Grantor Trust.

II.J.19.a.vii. Loss on Sale of Annuity

Rev. Rul. 61-201 addresses "the method of computing the basis of a single premium refund annuity contract for the purpose of determining the amount of loss sustained by the original purchaser upon his surrender of the annuity contract for a cash consideration." In that case:

> The taxpayer purchased a single premium refund annuity policy for 25x dollars. In 1956, he surrendered the policy for a cash consideration of 10x dollars. The annuity payments received during prior years totaled 15x dollars of which 7x dollars were excluded from gross income under the law applicable at the time of receipt.

Citing Reg. § 1.72-11(d)(1), Rev. Rul. 61-201 reasoned and held:

> It is clear that the contract under consideration is one to which section 72 of the Code applies and that the 10x dollars received by the taxpayer, upon surrender of the contract,

> was "an amount not received as an annuity" under section 72(e) of the Code. It is likewise clear that, where the transaction results in a loss, the same treatment should be afforded the taxpayer as is afforded where the transaction results in a gain. Further, the amount of 7x dollars excluded from gross income in the instant case merely represents a recovery of "basis" (investment) for which adjustment is required under section 1016(a)(1) of the Code, which provides, as far as here pertinent, that proper adjustment in respect of property shall in all cases be made for receipts properly chargeable to capital account.
>
> Accordingly, in determining the amount of loss sustained in the instant case by the original purchaser upon his surrender of a single premium refund annuity contract for a cash consideration, the basis of the contract is its cost (25x dollars) less the amounts previously received under the contract which were properly excludable from the gross income of the recipient under the law applicable at the time of receipt (7x dollars). The excess of the basis thus determined (18x dollars) over the amount received upon surrender of the contract (10x dollars) constitutes an ordinary loss (8x dollars).
>
> I.T. 3567, *supra*, is modified to remove therefrom the implication that the entire amounts of the annuity payments received by the annuitant are deducted from his cost of the annuity contract in computing the amount of loss sustained upon its surrender.
>
> Nothing in this ruling should be construed as permitting a loss deduction on the surrender of any contract other than a refund annuity.

However, Code § 72(b)(3), "Deduction where annuity payments cease before entire investment recovered," provides:[3028]

> (A) *In general*. If-
>
> > (i) after the annuity starting date, payments as an annuity under the contract cease by reason of the death of an annuitant, and
> >
> > (ii) as of the date of such cessation, there is unrecovered investment in the contract,
> >
> > the amount of such unrecovered investment (in excess of any amount specified in subsection (e)(5) which was not included in gross income) shall be allowed as a deduction to the annuitant for his last taxable year.
>
> (B) *Payments to other persons*. In the case of any contract which provides for payments meeting the requirements of subparagraphs (B) and (C) of subsection (c)(2) , the deduction under subparagraph (A) shall be allowed to the person entitled to such payments for the taxable year in which such payments are received.
>
> (C) *Net operating loss deductions provided*. For purposes of section 172 , a deduction allowed under this paragraph shall be treated as if it were attributable to a trade or business of the taxpayer.

[3028] This deduction is not a miscellaneous itemized deduction. See fn 1436 in part II.G.4.n Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax.

Both Rev. Rul. 61-201 and Code § 72(b)(3) seem to involve only dealings between the contract holder and the issuer. Presumably an annuity contract would be a capital asset, given that a life insurance contract, which is also taxed under Code § 72, is a capital asset.[3029] An annuity contract is not excluded from the definition of "capital asset" under Code § 1221.

II.J.19.b. Comparing Annuity to Life Insurance

The preceding subparts within this part II.J.19.a Trusts Holding Annuities explain that any income or growth in an annuity contract generally will be taxed at the earliest moment when the contract distributes cash, with the only recovery of basis occurring either when the annuity is annuitized, cashed out, or when all of the income has already been paid. Furthermore, a nongrantor trust will often pay a 10% penalty on distributions before the beneficiary's death; a nongrantor trust might be able to hold an annuity when it has more than one beneficiary, but whether the 10% penalty applies when a distribution is made after one beneficiary's death may be unclear. An annuity does not receive a basis step-up when passing by reason of death.[3030]

Contrast this with a life insurance contract, from which in most cases distributions are not taxable until after basis is applied to prior distributions. See part II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy). Furthermore, unless certain rules are violated, death benefits are free from income tax. See parts II.Q.4.b Transfer for Value Rule; Basis and II.Q.4.e Income Tax Issues When the Owner Who Is Not the Insured Dies.

Life insurance contracts are the only assets for which generally I'm comfortable not requiring any payments with respect to financing arrangements before maturity. See part II.Q.4.f Split-Dollar Arrangements.

As described in part II.Q.4.c Income Tax Issues in Transferring Life Insurance; Code § 1035, a life insurance contract may be swapped tax-free into another life insurance, endowment, annuity, or qualified long-term care insurance contract, but an annuity contract may be swapped tax-free only into another annuity or qualified long-term care insurance contract.

Based on a variety of rulings found in part II.Q.4.i.ii.(a) Trust Ownership of Policy (which is found within part II.Q.4.i.ii Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity):

- If a trust holds insurance on the trustee's life, the life insurance is included in the insured's taxable estate unless the trustee is screened from all incidents of ownership.

- If a trust holds insurance on a beneficiary's life, the IRS might take the position that life insurance is included in the insured's taxable estate.[3031]

- Looking instead to part II.Q.4.i.ii.(c) Partnership Ownership of Policy: If the trust invests in a partnership that owns life insurance, neither of the above concerns should be an

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[3029] Rev. Rul. 2009-13, described in fn. 4406 in part II.Q.4.c Income Tax Issues in Transferring Life Insurance; Code § 1035.
[3030] Code § 1014(b)(9)(A).
[3031] See text accompanying and preceding fn 4611 in part II.Q.4.i.ii.(a) Trust Ownership of Policy.

issue. In terms of long-term flexibility, transfers of the life insurance contract itself may raise issues,[3032] but transfers of or changes in partnership interests should not.[3033] See part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance for why and how the partnership should obtain the insured's consent to the life insurance policy. Also see part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule if the partnership transfers the policy.

Note also that an annuity contract includes an person whose life is insured; if the contract's investments are less than premiums at the insured's death, the contract boosts its value to premiums paid. I have not researched whether this feature may cause estate inclusion.

II.J.19.c. Long-Term Care

Benefits under a qualified long-term care insurance contract are excludible from income.[3034]

Such benefits must be for "necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance or personal care services, which are required by a chronically ill individual, and are provided pursuant to a plan of care prescribed by a licensed health care practitioner.[3035]

Code § 7702B(c)(2), "Chronically ill individual," provides:

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

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

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

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

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

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

(i) Eating.

(ii) Toileting.

[3032] See part II.Q.4.b Transfer for Value Rule; Basis.
[3033] See part II.Q.4.b.ii.(g) Transfer of Interest in an Entity Holding Life Insurance.
[3034] Code § 7702B(a)(2).
[3035] Code § 7702B(c)(1).

(iii) Transferring.

(iv) Bathing.

(v) Dressing.

(vi) Continence.

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

Code § 7702B(c)(2), "Maintenance or personal care services," provides:

> The term "maintenance or personal care services" means any care the primary purpose of which is the provision of needed assistance with any of the disabilities as a result of which the individual is a chronically ill individual (including the protection from threats to health and safety due to severe cognitive impairment).

Code § 7702B(d) allows a plan to provide a fixed dollar benefit for each day for which qualified services are provided, without regard to the actual expenditure. For 2022, that amount is $390.[3036]

II.J.19.d. Hybrid - Long-Term Care with Annuity or Life Insurance

In JCX-38-06 (8/3/2006), the Joint Committee on Taxation explained the Pension Protection Act:

> **4. Tax treatment of combined annuity or life insurance contracts with a long-term care insurance feature (secs. 72. 1035, and 7702B and new sec. 6050U of the Code)**
>
> *Present Law*
>
> *Annuity contracts*
>
> In general, earnings and gains on amounts invested in a deferred annuity contract held by an individual are not subject to tax during the deferral period in the hands of the holder of the contract. When payout commences under a deferred annuity contract, the tax treatment of amounts distributed depends on whether the amount is received "as an annuity" (generally, as periodic payments under contract terms) or not.
>
> For amounts received as an annuity by an individual, an "exclusion ratio" is provided for determining the taxable portion of each payment (sec. 72(b)). The portion of each payment that is attributable to recovery of the taxpayer's investment in the contract is not taxed. The taxable portion of each payment is ordinary income. The exclusion ratio is the ratio of the taxpayer's investment in the contract to the expected return under the contract, that is, the total of the payments expected to be received under the contract. The ratio is determined as of the taxpayer's annuity starting date. Once the taxpayer has recovered his or her investment in the contract, all further payments are included in

[3036] Rev. Proc. 2021-45, § 3.61.

income. If the taxpayer dies before the full investment in the contract is recovered, a deduction is allowed on the final return for the remaining investment in the contract (sec. 72(b)(3)).

Amounts not received as an annuity generally are included as ordinary income if received on or after the annuity starting date. Amounts not received as an annuity are included in income to the extent allocable to income on the contract if received before the annuity starting date, i.e., as income first (sec. 72(e)(2)). In general, loans under the annuity contract, partial withdrawals and partial surrenders are treated as amounts not received as an annuity and are subject to tax as income first (sec. 72(e)(4)). Exceptions are provided in some circumstances, such as for certain grandfathered contracts, certain life insurance and endowment contracts (other than modified endowment contracts), and contracts under qualified plans (sec. 72(e)(5)). Under these exceptions, the amount received is included in income, but only to the extent it exceeds the investment in the contract, i.e., as basis recovery first.

Long-term care insurance contracts

Tax treatment

Present law provides favorable tax treatment for qualified long-term care insurance contracts meeting the requirements of section 7702B.

A qualified long-term care insurance contract is treated as an accident and health insurance contract (sec. 7702B(a)(1)). Amounts received under the contract generally are excludable from income as amounts received for personal injuries or sickness (sec. 104(a)(3)). The excludable amount is subject to a dollar cap of $250 per day or $91,250 annually (for 2006), as indexed, on per diem contracts only (sec. 7702B(d)). If payments under such contracts exceed the dollar cap, then the excess is excludable only to the extent of costs in excess of the dollar cap that are incurred for long-term care services. Amounts in excess of the dollar cap, with respect to which no actual costs were incurred for long-term care services, are fully includable in income without regard to the rules relating to return of basis under section 72.

A plan of an employer providing coverage under a long-term care insurance contract generally is treated as an accident and health plan (benefits under which generally are excludable from the recipient's income under section 105).

Premiums paid for a qualified long-term care insurance contract are deductible as medical expenses, subject to a dollar cap on the deductible amount of the premium per year based on the insured person's age at the end of the taxable year (sec. 213(d)(10)). Medical expenses generally are allowed as a deduction only to the extent they exceed 7.5 percent of adjusted gross income (sec. 213(a)).

Unreimbursed expenses for qualified long-term care services provided to the taxpayer or the taxpayer's spouse or dependent are treated as medical expenses for purposes of the itemized deduction for medical expenses (subject to the floor of 7.5 percent of adjusted gross income). Amounts received under a qualified long-term care insurance contract (regardless of whether the contract reimburses expenses or pays benefits on a per diem or other periodic basis) are treated as reimbursement for expense actually incurred for medical care (sec. 7702B(a)(2)).

Definitions

A qualified long-term care insurance contract is defined as any insurance contract that provides only coverage of qualified long-term care services, and that meets additional requirements (sec. 7702B(b)). The contract is not permitted to provide for a cash surrender value or other money that can paid, assigned or pledged as collateral for a loan, or borrowed (and premium refunds are to be applied as a reduction in future premiums or to increase future benefits). Per diem-type and reimbursement-type contracts are permitted.

Qualified long-term care services are necessary diagnostic, preventive, therapeutic, curing treating, mitigating, and rehabilitative services, and maintenance or personal care services that are required by a chronically ill individual and that are provided pursuant to a plan of care prescribed by a licensed health care practitioner (sec. 7702B(c)(1)).

A chronically ill individual is generally one who has been certified within the previous 12 months by a licensed health care practitioner as being unable to perform (without substantial assistance) at least 2 activities of daily (ADLs) for at least 90 days due to a loss of functional capacity (or meeting other definitional requirements) (sec. 7702B(c)(2)).

Long-term care riders on life insurance contracts

In the case of long-term care insurance coverage provided by a rider on or as part of a life insurance contract, the requirements applicable to long-term care insurance contracts apply as if the portion of the contract providing such coverage were a separate contract (sec. 7702B(e)). The term "portion" means only the terms and benefits that are in addition to the terms and benefits under the life insurance contract without regard to long-term care coverage. As a result, if the applicable requirements are met by the long-term care portion of the contract, amounts received under the contract as provided by the rider are treated in the same manner as long-term care insurance benefits, whether or not the payment of such amounts causes a reduction in the contract's death benefit or cash surrender value.

The guideline premium limitation applicable under section 7702(c)(2) is increased by the sum of charges (but not premium payments) against the life insurance contract's cash surrender value, the imposition of which reduces premiums paid for the contract (within the meaning of sec. 7702(f)(1)). Thus, a policyholder can pre-fund to a greater degree a life insurance policy with a long-term care rider without causing the policy to lose its tax-favored treatment as life insurance.

No medical expense deduction generally is allowed under section 213 for charges against the life insurance contract's cash surrender value, unless such charges are includible in income because the life insurance contract is treated as a "modified endowment contract" under section 72(e)(10) and 7702A (sec. 7702B(e)((3)).

Tax-free exchanges of insurance contracts

Present law provides for the exchange of certain insurance contracts without recognition of gain or loss (sec. 1035). No gain or loss is recognized on the exchange of: (1) a life insurance contract for another life insurance contract or for an endowment or annuity contract; or (2) an endowment contract for another endowment contract (that provides for regular payments beginning no later than under the exchanged contract) or for an annuity contract; or (3) an annuity contract for an annuity contract. The basis of the contract received in the exchange generally is the same as the basis of the contract exchanged (sec. 1031(d)). Tax-free exchanges of long-term care insurance contracts are not permitted.

Capitalization of certain policy acquisition expenses of insurance companies

In the case of an insurance company, specified policy acquisition expenses for any taxable year are required to be capitalized, and are amortized generally over the 120-month period beginning with the first month in the second half of the taxable year (sec. 848). Specified policy acquisition expenses are determined as that portion of the insurance company's general deductions for the taxable year that does not exceed a specific percentage of the net premiums for the taxable year on each of three categories of insurance contracts. For annuity contracts, the percentage is 1.75; for group life insurance contracts, the percentage is 2.05; and for all other specified insurance contracts, the percentage is 7.7. With certain exceptions, a specified insurance contract is any life insurance, annuity, or noncancellable accident and health insurance contract or combination thereof.

Explanation of Provision

The provision provides tax rules for long-term care insurance that is provided by a rider on or as part of an annuity contract, and modifies the tax rules for long-term care insurance coverage provided by a rider on or as part of a life insurance contract.

Under the provision, any charge against the cash value of an annuity contract or the cash surrender value of a life insurance contract made as payment for coverage under a qualified long-term care insurance contract that is part of or a rider on the annuity or life insurance contract is not includable in income. The investment in the contract is reduced (but not below zero) by the charge.

The provision expands the rules for tax-free exchanges of certain insurance contracts. The provision provides that no gain or loss is recognized on the exchange of a life insurance contract, an endowment contract, an annuity contract, or a qualified long-term care insurance contract for a qualified long-term care insurance contract. The provision provides that a contract does not fail to be treated as an annuity contract, or as a life insurance contract, solely because a qualified long-term care insurance contract is a part of or a rider on such contract, for purposes of the rules for tax-free exchanges of certain insurance contracts.

The provision provides that, except as otherwise provided in regulations, for Federal tax purposes, in the case of a long-term care insurance contract (whether or not qualified) provided by a rider on or as part of a life insurance contract or an annuity contract, the portion of the contract providing long-term care insurance coverage is treated as a separate contract. The term "portion" means only the terms and benefits under a life insurance contract or annuity contract that are in addition to the terms and benefits under the contract without regard to long-term care coverage. As a result, if the applicable requirements are met by the long-term care portion of the contract, amounts received under the contract as provided by the rider are treated in the same manner as long-term care insurance benefits, whether or not the payment of such amounts causes a reduction in the life insurance contract's death benefit or cash surrender value or in the annuity contract's cash value.

No deduction as a medical expense is allowed for any payment made for coverage under a qualified long-term care insurance contract if the payment is made as a charge against the cash value of an annuity contract or the cash surrender value of a life insurance contract.

The provision provides that, for taxable years beginning after December 31, 2009, the guideline premium limitation is not directly increased by charges against a life insurance contract's cash surrender value for coverage under the qualified long-term care insurance portion of the contract. Rather, because such charges are not included in the holder's income by reason of new section 72(e)(11),[196] the charges reduce premiums paid under section 7702(f)(1), for purposes of the guideline premium limitation of section 7702. The amount by which premiums paid (under 7702(f)(1)) are reduced under this rule is intended to be the sum of any charges (but not premium payments) against the life insurance contract's cash surrender value (within the meaning of section 7702(f)(2)(a)) for long-term care coverage made to that date under the contract. For taxable years beginning before January 1, 2010, the present-law rule of section 7702B(e)(2) before amendment by the bill (the so-called "pay-as-you-go" rule) increases the guideline premium limitation by this same amount, reduced by charges the imposition of which reduces the premiums paid under the contract. Thus, the provision of the bill recreates the result of the "pay-as-you-go" rule (which is repealed by the provision) as a reduction in premiums paid rather than as an increase in the guideline premium limitation.

[196] Because such charges are not included in the holder's income under new section 72(e)(11), the effect would be to increase the guideline premium limitation under present-law section 7702B(e)(2)(A) by the amount of the charges and simultaneously to reduce it by the same charges under section 7702B(e)(2)(B). Such charges that are not included in income serve to reduce premiums paid under section 7702(f)(1), and therefore would cancel each other out under 7702B(e)(2)(A) and (B).

The provision provides that certain retirement-related arrangements are not treated as annuity contracts, for purposes of the provision.

The provision requires information reporting by any person who makes a charge against the cash value of an annuity contract, or the cash surrender value of a life insurance contract, that is excludible from gross income under the provision. The information required to be reported includes the amount of the aggregate of such charges against each such contract for the calendar year, the amount of the reduction in the investment in the contract by reason of the charges, and the name, address, and taxpayer identification number of the holder of the contract. A statement is required to be furnished to each individual identified in the information report. Penalties apply for failure to file the information report or furnish the statement required under the provision.

The provision modifies the application of the rules relating to capitalization of policy acquisition expenses of insurance companies. In the case of an annuity or life insurance contract that includes a qualified long-term care insurance contract as a part of or rider on the annuity or life insurance contract, the specified policy acquisition expenses that must be capitalized is determined using 7.7 percent of the net premiums for the taxable year on such contracts.

The provision clarifies that, effective as if included in the Health Insurance Portability and Accountability Act of 1996 (when section 7702B was enacted), except as otherwise provided in regulations, for Federal tax purposes (not just for purposes of section 7702B), in the case of a long-term care insurance contract (whether or not qualified) provided by a rider on or as part of a life insurance contract, the portion of the contract providing long-term care insurance coverage is treated as a separate contract.

Effective Date

The provisions are effective generally for contracts issued after December 31, 1996, but only with respect to taxable years beginning after December 31, 2009. The provisions relating to tax-free exchanges apply with respect to exchanges occurring after December 31, 2009. The provision relating to information reporting applies to charges made after December 31, 2009. The provision relating to policy acquisition expenses applies to specified policy acquisition expenses determined for taxable years beginning after December 31, 2009. The technical amendment relating to long-term care insurance coverage under section 7702B(e) is effective as if included with the underlying provisions of the Health Insurance Portability and Accountability Act of 1996.

As of January 3, 2022, Code § 7702B(e), "Treatment of coverage provided as part of a life insurance or annuity contract," had not been amended and provides in part:

Except as otherwise provided in regulations prescribed by the Secretary, in the case of any long-term care insurance coverage (whether or not qualified) provided by a rider on or as part of a life insurance contract or an annuity contract -

(1) *In general*. This title shall apply as if the portion of the contract providing such coverage is a separate contract.

(2) *Denial of deduction under section 213*. No deduction shall be allowed under section 213(a) for any payment made for coverage under a qualified long-term care insurance contract if such payment is made as a charge against the cash surrender value of a life insurance contract or the cash value of an annuity contract.

(3) *Portion defined*. For purposes of this subsection, the term "portion" means only the terms and benefits under a life insurance contract or annuity contract that are in addition to the terms and benefits under the contract without regard to long term care insurance coverage.

(4) *Annuity contracts to which paragraph (1) does not apply*. For purposes of this subsection, none of the following shall be treated as an annuity contract:

(A) A trust described in section 401(a) which is exempt from tax under section 501(a).(B) FTC A contract -

(i) purchased by a trust described in subparagraph (A)

(ii) purchased as part of a plan described in section 403(a),

(iii) described in section 403(b),

(iv) provided for employees of a life insurance company under a plan described in section 818(a)(3) , or

(v) from an individual retirement account or an individual retirement annuity.

(C) A contract purchased by an employer for the benefit of the employee (or the employee's spouse).

Any dividend described in section 404(k) which is received by a participant or beneficiary shall, for purposes of this paragraph, be treated as paid under a separate contract to which subparagraph (B)(i) applies.

Code § 72(e)(11), "Special rules for certain combination contracts providing long-term care insurance," provides:

Notwithstanding paragraphs (2), (5)(C), and (10), in the case of any charge against the cash value of an annuity contract or the cash surrender value of a life insurance contract made as payment for coverage under a qualified long-term care insurance contract which is part of or a rider on such annuity or life insurance contract -

(A) the investment in the contract shall be reduced (but not below zero) by such charge, and

(B) such charge shall not be includible in gross income.

Thus, although normally distributions from an annuity contract are income before using basis, the portion of an annuity contract used to buy long-term care insurance come from basis first.

However, generally IRAs and qualified retirement plans cannot be rolled into a qualified long-term care policy.[3037]

[3037] Code § 7702B(e)(4), "Annuity contracts to which paragraph (1) does not apply, provides:
For purposes of this subsection, none of the following shall be treated as an annuity contract:
(A) A trust described in section 401(a) which is exempt from tax under section 501(a).
(B) A contract-
(i) purchased by a trust described in subparagraph (A),
(ii) purchased as part of a plan described in section 403(a),
(iii) described in section 403(b),
(iv) provided for employees of a life insurance company under a plan described in section 818(a)(3), or
(v) from an individual retirement account or an individual retirement annuity.
(C) A contract purchased by an employer for the benefit of the employee (or the employee's spouse).
Any dividend described in section 404(k) which is received by a participant or beneficiary shall, for purposes of this paragraph, be treated as paid under a separate contract to which subparagraph (B)(i) applies.

II.J.20. Other Special Purpose Trusts

See part II.D Special Purpose Trusts, which includes parts II.D.1 Trust as a Business Entity, II.D.2 Business Entity as Grantor of Tru, II.D.3 Trust as Grantor or Deemed Owner of Another Trust, II.D.4 Disregarding Multiple Owner Trust for Income Tax Purposes, II.D.5 Severing Trusts with Multiple Grantors, II.D.6 Land Trusts, and II.D.7 Sham Trusts.

II.K. Passive Loss Rules

II.K.1. Passive Loss Rules Generally

Although owners of partnerships and S corporations generally can deduct losses, subject to various basis and at-risk limitations, a passive loss from a trade or business[3038] is deductible only against other passive income[3039] or when the activity that generated the loss is sold[3040] in full.[3041] *Williams v. Commissioner*, T.C. Memo. 2015-76, *aff'd* 637 Fed. Appx. 799 (5th Cir. 2016) ("In conclusion, we AFFIRM the decision of the Tax Court essentially for the reasons set out therein"), rejected a shareholder's argument that S corporation income is not subject to the passive losses because Code § 469 does not directly apply to S corporations, holding:

> Since S corporations and other passthrough entities do not pay tax, section 469 need not identify them as "taxpayers" to whom it applies, because the individual shareholders of an S corporation are the taxpayers to whom section 469 applies. The Court has previously recognized that income and losses from passthrough entities are subject to section 469, even though passthrough entities are not specifically included in the list of "taxpayers" to whom section 469 is applicable. See, *e.g.*, *Harnett v. Commissioner*, T.C. Memo. 2011-191 (applying section 469 to losses attributable to rental properties owned by an S corporation), *aff'd*, 496 Fed. Appx. 963 (11th Cir. 2012); *Dunn v. Commissioner*, T.C. Memo. 2010-198 (analyzing the grouping rules of section 469 with respect to various entities, including an S corporation); *Shaw v. Commissioner*, T.C. Memo. 2002-35 (applying section 469 and section 1.469-2(f)(6), Income Tax Regs., in various contexts, including the context of property leased by an S corporation); *Sidell v. Commissioner*, T.C. Memo. 1999-301 (holding income received via grantor trusts and reported as a passthrough item on taxpayers' Federal income tax returns was subject to section 469). The law is well settled in this area, and in numerous cases the Court has

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[3038] A mortgage or banking activity is a trade or business subject to the passive loss rules. INFO 2009-0229.

[3039] Code § 469(d)(1)(B).

[3040] Code § 469(g)(1), (3). Worthless stock is considered disposed of for purposes of this rule. See fn. 1182. A foreclosure on real property subject to recourse debt comprising a taxpayer's entire interest in a passive (or former passive) activity qualifies as a fully taxable disposition for purposes of Code § 469(g)(1)(A), even if the foreclosure triggers cancellation of indebtedness (COD) income that is excluded from gross income under Code § 108(a)(1)(B). CCA 201415002. However, if partnership property is foreclosed upon, the partnership lists the property as an asset on its tax returns, and the partnership is pursuing counterclaims, the foreclosure does not constitute a disposition. *Herwig v. Commissioner*, T.C. Memo. 2014-95 (accuracy-related penalties imposed when taxpayer did not introduce evidence of reasonable cause for taking the position).
Although a QSST's disposition of stock is taxable to the trust (see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets), the trust's disposition is treated as a disposition by the beneficiary for purposes of Code §§ 465 and 469. Code § 1361(d)(1)(C).

[3041] Code § 469(g)(1)(A) triggers losses only if all gain or loss on the disposition be recognized. Code § 469(g)(3) provides special rules when the entire interest is sold but when Code § 453 defers gain recognition. For more details, see part II.K.1.j Complete Disposition of Passive Activity.

applied the passive loss limitations of section 469 to individuals who receive income from passthrough entities.

Passive income does not include gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business.[3042]

The material participation rules are based on the number of hours the taxpayer participates in the activity[3043] and therefore encourage taxpayers to group businesses together as one activity (so that the hours from various activities can be aggregated to meet the necessary threshold).[3044] On the other hand, the complete allowance of a loss on the sale of an activity discourages grouping, since selling only part of the grouped activity will not be a complete disposition.

A passive income generator tends to be viewed favorably, in that it allows passive losses to be deducted. However, given the 3.8% tax on passive investment for high-income taxpayers and trusts,[3045] generating passive income in excess of losses might lead to unfavorable tax results. Thus, taxpayers might seek to transform passive income into nonpassive income, if they can do so without disallowing passive losses or triggering self-employment tax.[3046] Further below is a discussion of when passive income would be recharacterized as nonpassive income, in the IRS' efforts to minimize passive income against which passive losses can be deducted.[3047]

Conversely, although limitations on using net passive losses might not save regular income tax on nonpassive income, an abundance of passive losses can be helpful to the extent that they prevent passive business income from being subjected to the 3.8% tax on net investment income.[3048]

II.K.1.a. Counting Work as Participation in Business under the Passive Loss Rules

II.K.1.a.i. Taxpayer Must Own an Interest in the Business to Count Work in the Business

An individual needs to own an interest in an activity for the individual's work to count as participation.[3049] When counting hours that a taxpayer performs services in real property trades

[3042] Code § 469(e)(1)(A)(i)(I).
[3043] See part II.K.1.a Counting Work as Participation.
[3044] See part II.K.1.b Grouping Activities.
[3045] See part II.I 3.8% Tax on Excess Net Investment Income.
[3046] See part II.L.2.a Types of Income Subject to Self-Employment Tax.
[3047] See part II.K.1.i Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.
[3048] See generally part II.I 3.8% Tax on Excess Net Investment Income (NII).
[3049] Reg. § 1.469-5(f)(1) provides:

> *In general*. Except as otherwise provided in this paragraph (f), any work done by an individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done shall be treated for purposes of this section as participation of the individual in the activity.

Neither the final regulation nor Reg. § 1.469-5T(f) promulgate other paragraphs that qualify this rule. The parentheticals at the end of Reg. § 1.469-5T(a)(2), (3) imply that participation is done only by an owner.
To drive home the ownership requirement, Reg. § 1.469-5T(k), Example (6) provides:

> The facts are the same as in example (5), except that D does not acquire any stock in the S corporation until 1994. Under paragraph (f)(1) of this section, D is not treated as participating in

or businesses during a taxable year, personal services performed as an employee count only if the employee is a 5% owner.[3050] If an individual and a trust of which that person is the deemed owner under the grantor trust rules[3051] are the sole partners of a partnership, the partnership is disregarded[3052] and the individual is the sole taxpayer for purposes of applying Code § 469;[3053] a partnership of grantor trusts is similarly disregarded.[3054]

A taxpayer's activities include those conducted through C corporations that are subject to Code § 469, S corporations, and partnerships.[3055]

The owner in an interest in an organization may materially participate in the activities of a wholly owned subsidiary of the organization.[3056]

> the activity for any taxable year prior to 1994 because D does not own an interest in the activity for any such taxable year. Accordingly, D materially participates in the activity for only one taxable year prior to 1995, and D is not treated under paragraph (a)(5) of this section as materially participating in the activity for 1995 or subsequent taxable years.

Example (5) to which this example refers is Reg. § 1.469-5(k), Example (5):

> In 1993, D, an individual, acquires stock in an S corporation engaged in a trade or business activity (within the meaning of § 1.469-1(e)(2)). For every taxable year from 1993 through 1997, D is treated as materially participating (without regard to § 1.469-5T(a)(5)) in the activity. D retires from the activity at the beginning of 1998, and would not be treated as materially participating in the activity for 1998 and subsequent taxable years if material participation for those years were determined without regard to § 1.469-5T(a)(5). Under § 1.469-5T(a)(5) of this section, however, D is treated as materially participating in the activity for taxable years 1998 through 2003 because D materially participated in the activity (determined without regard to § 1.469-5T(a)(5) for five taxable years during the ten taxable years that immediately precede each of those years. D is not treated under § 1.469-5T(a)(5) as materially participating in the activity for taxable years beginning after 2003 because for those years D has not materially participated in the activity (determined without regard to § 1.469-5T(a)(5) for five of the last ten immediately preceding taxable years.

[3050] *Calvanico v. Commissioner*, T.C. Summary Opinion 2015-64, citing Code § 469(c)(7)(D)(ii) and Reg. § 1.469-9(c)(5), cross-referencing Code § 416(i)(1)(B). Code § 416(i)(1)(B)(i) is reproduced in fn 3204 in part II.K.1.e.iii.(a) Scope and Effect of Real Estate Professional Exception.
[3051] See part III.B.2.d.i Federal Income Tax and Irrevocable Grantor Trust Treatment.
[3052] Rev. Rul. 2004-77, discussed more in fn 330 in part II.B Limited Liability Company (LLC).
[3053] FSA 200035006.
[3054] Letter Rulings 9515006, 9515008, 9515009, and 9515013.
[3055] Reg. § 1.469-4(a). *Schwalbach v. Commissioner*, 111 T.C. 215 (1998), held that this regulation is valid and applied it to count activity through a C corporation that was subject to Code § 469 even though the regulation was promulgated in the context of grouping activities together. Presumably it reached that result because grouping of activities is mandatory to a certain extent; see Reg. § 1.469-4(d)(5)(i), which provides:

> *In general*. A C corporation subject to section 469, an S corporation, or a partnership (a section 469 entity) must group its activities under the rules of this section....

Williams v. Commissioner, T.C. Memo. 2015-76, *aff'd* 117 A.F.T.R.2d 2016-600 (5th Cir. 2/2/2016), reaffirmed the *Schwalbach* holding that Reg. § 1.469-4(a) is valid.
[3056] Letter Ruling 201029014.

II.K.1.a.ii. Material Participation

An individual shall be treated as materially participating in an activity for the taxable year if and only if:[3057]

(1) The individual participates in the activity for more than 500 hours during such year;[3058]

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year, <u>if the owner is not a limited partner</u>;[3059]

(3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year,[3060] <u>if the owner is not a limited partner</u>;[3061]

[3057] Reg. § 1.469-5T(a). *Mordkin v. Commissioner*, T.C. Memo. 1996-187, rebuffed a taxpayer's claim that the quantitative tests in the following bullet points are invalid.

[3058] Reg. § 1.469-5T(a)(1).

[3059] Reg. § 1.469-5T(a)(2). *Windham v. Commissioner*, T.C. Memo. 2017-068, found that the taxpayer satisfied this test:

> Petitioner ran her rental real estate activities by herself. She handled all aspects of the business from collecting rent to overseeing the work of repairmen. She also met prospective buyers and handled problems with utility and service companies. While petitioner did not physically perform all of the repairs that were necessary at each of those rental properties, she hired multiple contractors and repairmen to handle those repairs. With the repairs made and the number of different individuals involved in those repairs, no one individual participated in the rental real estate activities to the extent petitioner did. The Court is satisfied by petitioner's testimony and other evidence that her participation in each of those activities constituted substantially all of the participation in each.

However, that taxpayer did not fare quite as well for a vacant lot:

> The Lynn Haven property was a vacant lot in which petitioner had a 50% ownership interest. She spent approximately 12 hours meeting with an attorney and the other owner of the vacant lot discussing whether to develop or sell the vacant lot. There is nothing in the record about the participation hours of the other owner of the vacant lot. Petitioner has failed to prove that her participation constituted substantially all of the participation in the activity.

[3060] Hiring a management company undermines this test if any management company employee works more than the owner, as was the case in *Schumann v. Commissioner*, T.C. Memo. 2014-138. The taxpayer satisfied this test in *Kline v. Commissioner*, T.C. Memo. 2015-144; having a variety of employees (and documenting the hours they worked) helped assure that no employee's work exceeded the work of the taxpayer and spouse (see part II.K.1.a.iii Spousal Participation).

[3061] Reg. § 1.469-5T(a)(3).

(4) The activity is a significant participation activity[3062] for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours, if the owner is not a limited partner;[3063]

(5) The individual materially participated in the activity (determined without regard to this bullet point) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;[3064]

(6) The activity is a personal service activity, and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year;[3065] or

(7) Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during such year, if the owner is not a limited partner.[3066]

The facts and circumstances rule of (7) above is governed by Reg. § 1.469-5T(b)(2), does not specify the facts and circumstances but applies the following rules in determining the facts and circumstances: The fact that an individual satisfies the requirements of any participation standard (whether or not referred to as "material participation") under any provision other than the passive loss rules shall not be taken into account in determining whether such individual materially participates for purposes of the passive loss rules. Furthermore, an individual's services performed in the management of an activity shall not be taken into account in determining whether such individual is treated as materially participating in such activity for the taxable year under this "facts and circumstances" rule unless, for such taxable year:

[3062] Reg. § 1.469-5T(c) provides that an activity is a significant participation activity of an individual if and only if such activity is a trade or business activity (within the meaning of Reg. § 1.469-1T(e)(2)) in which the individual participates for more than 100 hours during the taxable year and would be an activity in which the individual does not materially participate for the taxable year if material participation for such year were determined without regard to the significant participation activity rules. This is elaborated on in the text accompanying and following fn 3073.

[3063] Reg. § 1.469-5T(a)(4). To better understand how to apply the significant participation test, consider the following: Assume T, an individual, has $500,000 in taxable income for the taxable year, and is the sole owner of S corporations 1, 2, and 3, which are engaged in trade or business Activities 1, 2, and 3 respectively. Business 1 has at least one full-time employee. T participates 400 hours in Activity 1, 90 hours in Activity 2, and 90 hours in Activity 3, which is the same kind of trade or business as Activity 2, but is a different business. If T does not group Activity 2 with Activity 3, then the material participation test is not satisfied, and the net income from Activity 1 is nonpassive (see part II.K.1.i Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income, particularly fns. 3255-3260) and the net loss from Activity 1 and net income or loss from Activities 2 and 3 are passive. If T groups Activity 2 with Activity 3, then the significant participation activity is satisfied, and all of the income or loss from Activities 1, 2, and 3 is nonpassive.

[3064] Reg. § 1.469-5T(a)(5).

[3065] Reg. § 1.469-5T(a)(6) refers to Reg. § 1.469-5T(d), which provides:

Personal service activity. An activity constitutes a personal service activity for purposes of paragraph (a)(6) of this section if such activity involves the performance of personal services in-

(1) The fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or

(2) Any other trade or business in which capital is not a material income-producing factor.

[3066] Reg. § 1.469-5T(a)(7).

- no person (other than such individual) who performs services in connection with the management of the activity receives prohibited compensation (wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered) in consideration for such services, and

- no individual performs services in connection with the management of the activity that exceed (by hours) the amount of such services performed by such individual.

Finally, the individual must participate in the activity for more than 100 hours during the taxable year. Grouping may push the taxpayer over this threshold. *Wade v. Commissioner*, T.C. Memo. 2014-169, is a great example of the founder letting others run the business on-site, yet continuing to participate:

> With Ashley [taxpayer's son] there to handle day-to-day management, Mr. Wade became more focused on product and customer development. He did not have to live near business operations to perform these duties, so petitioners moved to Navarre, Florida. After the move he continued to make periodic visits to the facilities in Louisiana and regularly spoke on the phone with plant personnel.
>
> In 2008 TSI and Paragon began struggling financially as prices for their products plummeted and revenues declined significantly. Mr. Wade's involvement in the businesses became crucial during this crisis. To boost employee morale, he made three trips to the companies' industrial facility in DeQuincy, Louisiana, during which he assured the employees that operations would continue. He also redoubled his research and development efforts to help TSI and Paragon recover from the financial downturn. During this time Mr. Wade invented a new technique for fireproofing polyethylene partitions, and he developed a method for treating plastics that would allow them to destroy common viruses and bacteria on contact. In addition to his research efforts, Mr. Wade ensured the companies' financial viability by securing a new line of credit. Without Mr. Wade's involvement in the companies, TSI and Paragon likely would not have survived.

Barbara v. Commissioner, T.C. Memo. 2019-50, accepted a combination of regular in-person participation at the owner's place of business (in Illinois) outside the owner's resident state and regular long-distance participation from the owner's residence (in Florida). The facts were:

> During the years 2009-12 Mr. Barbara split his time between Chicago and Florida. For each year he was in Chicago 40% of his time and in Florida 60% of his time. He worked at least 200 days in a year, proportioned between Chicago and Florida on a 40/60 basis.
>
> When in Chicago, Mr. Barbara lived either in his house in Oak Brook or his condominium on Chicago's North Side. He was in the Chicago office for about 5-3/4 hours each work day. When there he was working on the lending business. He kept a regular schedule. Therefore, he was in the Chicago office at least 460 hours per year working on the lending business, computed as follows:
>
> 200 days x 40% × 5.75 hours = 460 hours per year
>
> When in Florida, Mr. Barbara lived in a house that he had purchased in 1995. He called the Chicago office every day when it opened at 9 a.m. He also communicated with the office at other times, through telephone, fax, and e-mail. He averaged at least two hours

of work per day on the lending business while in Florida. This means that he worked at least 240 hours per year on the lending business while he lived in Florida, computed as follows:

200 days × 60% × 2 hours = 240 hours per year

The court concluded:

> For each year Mr. Barbara's total hours participating in the lending business were (1) 460 hours or more while in Chicago and (2) 240 hours or more while in Florida. Thus his total hours participating in the lending business each year were 700 or more. This exceeds the 100-hour threshold that is part of the seventh regulatory test.
>
> Both while he was in Chicago and in Florida, Mr. Barbara's participation in the lending business was regular, continuous, and substantial.
>
> The seventh regulatory test is therefore met.

Reg. § 1.469-5(j)(1), : In general," provides:

> For purposes of § 1.469-5T(a)(5) and (6), a taxpayer has materially participated in an activity for a preceding taxable year if the activity includes significant section 469 activities that are substantially the same as significant section 469 activities that were included in an activity in which the taxpayer materially participated (determined without regard to § 1.469-5T(a)(5)) for the preceding taxable year.

Referring to Reg. § 1.469-5(j)(1), *Rogerson v. Commissioner*, T.C. Memo. 2022-49, explains:

> In other words, if there is substantial similarity between the current-year activity and activities that the taxpayer materially participated in during a preceding year, then that preceding year counts as one year in applying the five of ten test to the current-year activity. See *id*. If there is substantial similarity between the current-year activity and activities that the taxpayer materially participated in for five of the last ten years, then the five of ten test is satisfied and the taxpayer is treated as materially participating in the current year-activity for the current year. See *id*.; Temp. Treas. Reg. § 1.469-5T(a)(5).
>
> The history of Treasury Regulation § 1.469-5(j)(1) confirms this interpretation. When temporary regulations first established the five of ten test in 1988, they did not initially address how the test should apply to a situation in which an individual's business activities evolve during the ten-year period. See T.D. 8175, 1988-1 C.B. at 203; see also T.D. 8253, 1989-1 C.B. 121, 122 (noting the omission). In 1989, however, the Department of the Treasury (Treasury) and the IRS[18] issued additional temporary regulations under section 469 (1989 amendments). The 1989 amendments added Temporary Treasury Regulation § 1.469-4T to define the concept of an "activity" for purposes of section 469. See T.D. 8253, 1989-1 C.B. at 122–23. The definition included the concept of an "undertaking," which was the smallest unit that could constitute an activity. *Id* at 122.
>
> [18] For simplicity, we refer to both Treasury and the IRS as "Treasury."
>
> As relevant here, the 1989 amendments also made certain changes to Temporary Treasury Regulation § 1.469-5T, including adding paragraph (j)(1), T.D. 8253, 1989-

1 C.B. at 158, the precursor to Treasury Regulation § 1.469-5(j)(1). The preamble to the 1989 amendments explained the new rule as follows:

> Under § 1.469-4T, the business and rental operations that constitute an activity may change from year to year. The existing regulations do not address how the material participation tests that are based on participation in prior years will apply in cases in which such changes occur. Accordingly, this document amends § 1.469-5T to provide that, for purposes of the material participation tests that are based on participation in prior years, a taxpayer is treated as materially participating in an activity for a prior taxable year if the activity includes an undertaking involving substantially the same operations as an undertaking that was included in an activity in which the taxpayer materially participated during such prior taxable year.

T.D. 8253, 1989-1 C.B. at 126. The text of the temporary rule tracked the preamble's explanation:

> For purposes of [the five of ten test], a taxpayer has materially participated in an activity for a preceding taxable year if such activity includes an undertaking that involves substantially the same business and rental operations as an undertaking that was included in an activity in which the taxpayer materially participated...for such preceding taxable year.

Temp. Treas. Reg. § 1.469-5T(j)(1), T.D. 8253, 1989-1 C.B. at 158. Like the current rule, therefore, the rule issued as part of the 1989 amendments required a comparison of the taxpayer's current-year activity to his preceding-year activity. If the activities were sufficiently similar - *i.e.*, if they included undertakings that involved similar business operations - and if the taxpayer materially participated in the preceding-year activity, then the taxpayer would also be treated as materially participating in the current-year activity during the preceding year. See *id*.

By 1992, Treasury determined that the 1989 definition of activity, including the concept of undertaking, was too complicated and mechanical and that a more flexible approach was required. See Limitation on Passive Activity Losses and Credits—Definition of Activity, 57 Fed. Reg. 20,802, 20,803 (proposed May 15, 1992). As a result, Treasury issued Proposed Treasury Regulation § 1.469-4, 57 Fed. Reg. at 20,804, to replace Temporary Treasury Regulation § 1.469-4T.

Simultaneously, Treasury finalized other parts of the 1989 amendments, including the clarification of the five of ten test that previously appeared at Temporary Treasury Regulation § 1.469-5T(j)(1). T.D. 8417, 1992-1 C.B. 173, 186.[19] Treasury did not, however, finalize the original temporary regulations - *i.e.*, rules that were issued in 1988 and not amended in 1989. Those regulations, which include the seven regulatory tests for determining material participation and certain related rules, continued in their temporary form. Thus, today, the five of ten test appears in a temporary regulation, while the rule explaining how the five of ten test should be applied appears in a final regulation.

[19] Treasury finalized the 1989 amendments to avoid potential disputes about whether they would expire under section 7805(e)(2), which provides that all temporary regulations expire three years after the date they are issued. See T.D. 8417, 1992-1 C.B. at 174. Section 7805(e)(2) was enacted in 1988 and applies only to temporary

regulations issued after November 20, 1988. See Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 6232, 102 Stat. 3342, 3734. Accordingly, section 7805(e)(2) potentially applied to the 1989 amendments, but not to the original temporary regulations. See T.D. 8175, 1988-1 C.B. at 233-34.

When it was finalized in 1992, the rule explaining how the five of ten test should be applied was modified slightly to its current form, essentially replacing the concept of an "undertaking" with that of a "significant section 469 activit[y]." See Treas. Reg. § 1.469-5(j)(1). In describing the change, Treasury stated:

> The final regulations generally adopt the amendments as originally proposed. They only make certain minor technical modifications to the amendments, including changes that conform them to the proposed regulations under § 1.469-4, relating to the definition of activity.

T.D. 8417, 1992-1 C.B. at 174.

Thus, the differences between the explanatory rule as originally proposed at Temporary Treasury Regulation § 1.469-5T(j)(1) and the final rule at Treasury Regulation § 1.469-5(j)(1) were not intended to be significant. And while the final rule's phrasing is somewhat convoluted, the text and regulatory history leave us with no doubt regarding its meaning. Specifically, the rule provides that even if a taxpayer's mix of activity changes over time, the taxpayer is treated as materially participating in a current-year activity if that activity substantially overlaps with activities that the taxpayer materially participated in for five of the last ten years. See Treas. Reg. § 1.469-5(j)(1); Temp. Treas. Reg. §. 1.469-5T(a)(5). As one commentator put it, "any significant overlap between activities for different tax years causes them to be treated as the same activity for purposes of the 5-out-of-10-years test." Libin Zhang, Passive Loss Rules, 549-3rd Tax Mgmt. (BNA), at IV.A.5.

The court reasoned and held:

> Mr. Rogerson's argument is foreclosed by Treasury Regulation § 1.469-5(j)(1). As discussed in detail in Opinion Part II.B.1 above, that rule does not require the taxpayer's precise activity to have existed in prior years for purposes of applying the five of ten test. Indeed, the entire point of the rule is to address situations in which circumstances change over time. The rule applies as long as the taxpayer's current-year activity (here, RAEG) "includes significant section 469 activities" (here, the RAEG product lines or RAEG as a whole) "that are substantially the same as significant section 469 activities there were included in [a preceding-year activity] in which the taxpayer materially participated" (here, the aerospace business as a whole). In other words, all that is required is substantial overlap between the current and preceding-year activities. The record here leaves no doubt that the activity conducted by RAEG in 2014, 2015, and 2016 overlaps substantially with the "single activity" reflected on RAC's prior returns - *i.e.*, the aerospace business as a whole.

Rogerson v. Commissioner, 132 A.F.T.R.2d 2023-6624 (9th Cir. 11/30/2023), affirmed:

> The tax court did not err in finding that Rogerson materially participated in Rogerson Aircraft Equipment Group ("RAEG") in 2014, 2015, and 2016 under I.R.C. § 469(h)(1). "Congress enacted Section 469 of the Internal Revenue Code to prevent taxpayers from

> applying losses from rental properties and other passive business activities to offset and shelter non-passive income, such as wages." *Beecher v. Comm'r*, 481 F.3d 717, 721 (9th Cir. 2007). Generally, "[t]he term `passive activity' means any activity - (A) which involves the conduct of any trade or business, and (B) in which the taxpayer does not materially participate." I.R.C. § 469(c)(1). A taxpayer's participation in an activity is "material" if his involvement in the operations of the activity is regular, continuous, and substantial. *Id*. § 469(h)(1).
>
> The tax court made extensive factual findings regarding Rogerson's activity as Chief Executive Officer of RAEG during the relevant years. Based on the undisputed factual record of Rogerson's involvement in RAEG, the tax court found that Rogerson materially participated in RAEG in 2014, 2015, and 2016 under I.R.C. § 469(h)(1). Rogerson's primary rebuttal to the tax court's finding is that RAEG "did not require much of [Rogerson's] time." However, the tax court rejected this argument in its reasoning:
>
>> Mr. Rogerson's ability to respond to detailed inquiries so quickly shows his detailed knowledge of every aspect of the business. Indeed, many of Mr. Rogerson's communications reflect first-hand experience with RAEG's employees, customers, and products that extends far beyond what could have been acquired by a passive investor.
>
> Moreover, I.R.C. § 469(h) does not impose a minimal-hours requirement to find that a taxpayer's participation is material, only that the participation be regular, continuous, and substantial. "Under the clearly erroneous standard, if the tax court's account of the evidence is plausible in light of the record viewed in its entirety, the court of appeals may not reverse it even though convinced that had it been sitting as the trier of fact, it would have weighed the evidence differently." *Wolf v. Comm'r*, 4 F.3d 709, 712-13 (9th Cir. 1993) (cleaned up). Accordingly, we affirm the tax court's finding that Rogerson materially participated in RAEG for 2014, 2015, and 2016 under I.R.C. § 469(h)(1).[2]
>
> [2] Since we affirm the tax court's finding that Rogerson materially participated in RAEG based on the text of I.R.C. § 469, we do not reach Rogerson's additional arguments regarding the validity, constitutionality, or the tax court's application of the 1988 temporary regulations, Temp. Treas. Reg. § 1.469-5T(a), which were not dispositive to the tax court's ruling. See *Fireman's Fund Ins. Co. v. Int'l Mkt. Place*, 773 F.2d 1068, 1070 (9th Cir. 1985) ("[A]n appellate court typically will address only those arguments that are necessary to reach its result.").

Note that some of the tests above apply only if the owner is not a limited partner.[3067] These differences arise from the statutory prohibition against limited partners being treated as materially participating except as provided in regulations.[3068] A member in an LLC is not

[3067] Reg. § 1.469-5T(e) defines a "limited partnership interest" and allows limited partners to be treated as materially participating if they qualify under Reg. § 1.469-5T(a)(1), (5), or (6).
[3068] Code § 469(h)(2).

inherently a limited partner.[3069] Proposed regulations would treat an interest in an entity as an interest in a limited partnership as a limited partner if:[3070]

- The entity in which such interest is held is classified as a partnership for Federal income tax purposes under the check-the-box regulations; and
- The holder of such interest does not have rights to manage the entity at all times during the entity's taxable year under the law of the jurisdiction in which the entity is organized and under the governing agreement.

Furthermore, an individual is not treated as holding an interest in a limited partnership as a limited partner for the individual's taxable year if that individual also holds an interest in the partnership that is not an interest as a limited partner, such as a state-law general partnership interest, at all times during the entity's taxable year;[3071] thus, being a general partner and a limited partner causes the partner's entire partnership interest to be treated as a general partner for purposes of the passive loss rules but does not *per se* subject the person's interest as a limited partner to self-employment tax.[3072]

Let's spend some time on the significant participation activity test of Reg. § 1.469-5T(c), "Significant participation activity," which provides:[3073]

(1) *In general*. For purposes of paragraph (a)(4) of this section, an activity is a significant participation activity of an individual if and only if such activity -

(i) Is a trade or business activity (within the meaning of § 1.469-1T(e)(2)) in which the individual significantly participates for the taxable year; and

(ii) Would be an activity in which the individual does not materially participate for the taxable year if material participation for such year were determined without regard to paragraph (a)(4) of this section.

(2) *Significant participation*. An individual is treated as significantly participating in an activity for a taxable year if and only if the individual participates in the activity for more than 100 hours during such year.

Reg. § 1.469-5T(a)(4) treats an individual as materially participating if "the activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year,

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[3069] A member in an LLC is not treated as a limited partner merely by reason of having limited liability. *Gregg v. U.S.*, 186 F.Supp.2d 1123 (D. Ore. 2000); *Garnett v. Commissioner*, 132 T.C. 368 (2009); *James R. Thompson v. U.S.*, 87 Fed. Cl. 728, 734 (2009), *acq.* in result only, AOD 2010-002; *Hegarty v. Commissioner*, T.C. Summary Opinion 2009-153. *Newell v. Commissioner*, T.C. Memo. 2010-23 reasoned:

> … [T]he parties stipulated that petitioner husband handled the day-to-day operations of Pasadera, including hiring and firing employees, negotiating loan agreements and other contracts, overseeing construction, administering membership programs, and reviewing, approving, and signing all checks. As the managing member of the L.L.C., petitioner husband functioned as the substantial equivalent of a general partner in a limited partnership.

[3070] Prop. Reg. § 1.469-5(e)(3)(i).
[3071] Prop. Reg. § 1.469-5(e)(3)(ii).
[3072] See part II.L.4 Self-Employment Tax Exclusion for Limited Partner, especially fn. 3462.
[3073] For context, see text accompanying fn 3062.

and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours."

TAM 202229036 asserts:

> Taxpayer's position that the language in § 1.469-5T(c)(1)(ii) provides that material participation for a taxable year is determined by disregarding whether Taxpayer satisfied § 1.469-5T(a)(4) in the tested taxable year and any other relevant year, is unsupported by the language. The language of § 1.469-5T(c)(1)(ii) specifies that the relevant inquiry is whether the taxpayer materially participated for "the taxable year" and that determination is being made "for such year" without taking § 1.469-5T(a)(4) into account. Section 1.469-5T(c)(1)(ii) does not say to disregard § 1.469-5T(a)(4) for every previous year where a taxpayer was treated as having materially participated under that test.
>
> Thus, an activity that met the requirements of § 1.469-5T(a)(4) in any five of the last ten taxable years satisfies the 5/10 test under § 1.469-5T(a)(5) for material participation in the taxable year and no longer satisfies the requirement in § 1.469-5T(c)(1)(ii). Once the activity no longer meets the 5/10 test, the activity may, provided it otherwise meets the requirements of § 1.469-5T(c)(1), again be classified as a SPA.
>
> The Service acknowledges that § 1.469-5T(c)(1)(ii) imposes an additional requirement on SPA activities, one that potentially removes an activity from being treated as a SPA in the current tax year based on participation in prior years, as is the case here. The additional requirement in § 1.469-5T(c)(1)(ii) results in a significant participation activity shifting out of the SPA test and into the 5/10 test because under § 1.469-5T(c)(1)(ii) an activity cannot be both a SPA and satisfy another material participation test. In contrast, for example, an activity that satisfies the 500 hour test also satisfies the 5/10 test in the same year because there is no similar restriction. The difference in treatment is a direct result of the SPA test having a separate qualifying section in § 1.469-5T(c)(1), where there is no such additional qualifying section for (a)(1).

Banoff, Lipton, and Cohen ("Shop Talk" column), "Significant Participation Activities under Section 469 – IRS Applies Rules With No Statutory Foundation, "Significant Participation Activities under Section 469 – IRS Applies Rules With No Statutory Foundation," *Journal of Taxation* (Oct. 2022), introduced their analysis of the TAM:

> A recent IRS National Office Technical Advice Memorandum, TAM 202229036, dated April 19, 2022, caught your editors' attention because it addressed an often-forgotten aspect of the passive loss rules – "significant participation activities" (SPAs). The TAM, issued by the Passthroughs & Special Industries Group, addressed a situation in which an individual worked in many activities, an increasingly common approach for entrepreneurs (i.e., to put their eggs in many baskets, taking a cue, perhaps, from Elon Musk and his time splitting among SpaceX, Tesla, The Boring Company, and other ventures).
>
> The TAM's authors concluded that the IRS' Examination Division ("Exam") could require the affected taxpayer to treat certain activities in which the taxpayer materially participated under the SPA rule as not satisfying that rule any longer because of the 5-out-of-10 years rule's overlap with the SPA rule – in other words, the TAM's authors effectively turned the SPA rule into a "gotcha" in order to disallow losses that were claimed by the taxpayer.

After reviewing the regulations and commenting that the SPA aspect has "absolutely no basis for it in the statute, and the IRS failed to provide notice and comment in connection with the issuance of this rule," the authors continued:

> **TAM 202229036 – illogical regulations lead to absurd results**
>
> The TAM addressed the interaction of these rules. In the TAM, an individual who participated in multiple activities for more than 100 hours but fewer than 500 hours in the taxable year reported the activities as nonpassive on the grounds that the activities were SPAs and his total participation in the SPAs in the taxable year exceeded 500 hours. The taxpayer had been involved in these SPAs for a number of years, so as a result of the application of Reg. 1.469-5T(a)(5) (the 5-out-of-10 years rule), the taxpayer also was deemed to materially participate in these activities in the taxable year. However, the 5-out-of-10-years rule did not apply to every SPA in which the taxpayer participated, and if those SPAs were taken alone, the individual's aggregate hours in those SPAs (and only those SPAs) was less than 500 hours (so the individual would not be deemed to materially participate in those activities under the SPA rules).
>
> Exam determined that the taxpayer was subject to a "gotcha" because the individual, who had been treated as materially participating in various SPAs under Reg. 1.469-5T(a)(4) in prior years only because they were SPAs in the prior years, could no longer treat any activity subject to the 5-out-of-10 years rule as a SPA because the taxpayer otherwise materially participated in such activities. This interpretation was consistent with the literal language of Reg. 1.469-5T(c)(1)(ii), which provides that an activity is a SPA only if the individual did not materially participate in such activity for the taxable year if material participation were determined without regard to Reg. 1.469-5T(a)(4).
>
> The taxpayer argued that this was an absurd result, and it was inconsistent with the intent of the regulations to use another test to prevent a taxpayer from being treated as materially participating under the SPA test. The taxpayer further argued that the purpose of the 5-out-of-10 years rule was to prevent taxpayers from being able to characterize an activity as nonpassive after the taxpayer ceases to materially participate in the activity, and not to recharacterize a SPA that was otherwise treated as nonpassive as a passive activity. The taxpayer also noted that no court decisions supported Exam's interpretation of these regulations.
>
> The National Office rejected the taxpayer's arguments, concluding that the plain language of Reg. 1.469-5T(c)(1)(ii) focuses only on the taxable year in question. If a taxpayer is treated as materially participating in an activity which otherwise would be treated as a SPA, the activity simply cannot be treated as a SPA. Here, the treatment of the individual's various trades or businesses as SPAs in prior taxable years meant that such activities could not be treated as SPAs for the current taxable year because of the 5-out-of-10 years rule, and the taxpayer was required to remove such activities from the calculation (and, therefore, could not materially participate in the remaining SPAs because total participation in such SPAs was less than 500 hours).
>
> The illogic of the IRS' position is self-evident. Assume that for the three years commencing on 1/1/20 and ending 12/31/22, Joe owns and operates ten separate trades or businesses, each of which is treated as a separate activity under Reg. 1.469-4, while on 1/1/23, Joe acquires four more trades or businesses, each of which is (also) treated as a separate activity. Joe participates for exactly 110 hours in each of these trades or businesses in every

year that he owns them. Under the IRS' interpretation of these rules, in 2023 and 2024 all 14 activities are treated as SPAs in which Joe materially participated under the aggregation rule in Reg. 1.469-5T(a)(4) , but beginning in 2025, the four additional activities cannot be treated as SPAs in which Joe materially participated because, commencing in 2025, the 5-out-of-10 years rule would apply to the original ten trades or businesses and, so, those activities would not be SPAs for purposes of applying Reg. 1.469-5T(c)(2). Thus, the four additional activities would be tested as a group under Reg. 1.469-5T(c)(2) and (having Joe's participation for only 440 hours per year) could not be treated as SPAs in which Joe materially participated beginning in 2025. Assuming no changes in Joe's participation, commencing in 2030, Joe would again be treated as materially participating in all 14 activities under the SPA rule, because the 5-out-of-10 years period would have elapsed.

This result is completely inconsistent with the purposes and legislative history of Section 469. Indeed, the entire SPA rule itself appears to conflict with Congress' stated intent in enacting Section 469, which was to treat an activity as nonpassive only if the taxpayer's participation in the activity was regular, continuous, and substantial. In Joe's example, Joe participated in the various activities on the same basis for many years, but under the regulations as applied in the TAM, the participation would not be treated as "material" for several years. This flip/flop treatment of an activity is at odds with the statutory test, which focuses on whether participation was regular, continuous, and substantial.

To add salt to the wound, as mentioned above, Reg. 1.469-2T(f)(2) provides that any income from a SPA is treated as nonpassive even if losses from the same activity would be treated as passive losses (either because the time spent on SPAs do not aggregate to 500 hours or, perhaps, because of the application of the 5-out-of-10-years rule). In other words, in the example above concerning Joe, if the four new activities which were acquired in 2023 generated losses in any year from 2025 to 2029, then under the IRS' approach those losses would be treated as passive losses, whereas any income from those activities would be treated as nonpassive income. This is a "heads we win, tails you lose" IRS-favorable rule that appears to be contrary to both the statutory language and the legislative history of Section 469, meaning that it would appear very susceptible to challenge under the Administrative Procedure Act.

The IRS issued these rules as temporary regulations, and the IRS never converted them into final regulations. By leaving the regulations in temporary form,[6] the IRS was able to ignore the comments that it received which pointed out that the rules concerning SPAs were wholly inconsistent with the statutory framework, which did not contemplate in any matter that an activity could be treated as "active" if it had income but "passive" if it had losses. (One of your editors was the author of those comments on behalf of the ABA Section of Taxation approximately 35 years ago but finding a citation decades later was a task beyond his capability.) Early on, our co-editor went on record identifying the total lack of legal authority or logic to support the SPA rules' position of 'heads the IRS wins, tails the taxpayer loses.'[7] Other treatise authors have observed that the SPA rule "is not only the most controversial, but also the least supported by the legislative history."[8]

[6] The SPA Regulations, like other temporary regulations issued under Section 469, are grandfathered from the "sunset" rules applicable to temporary regulations issued after November 20, 1988. Section 7805(e) provides that any temporary regulation shall expire (sunset) within three years after the date of issuance of such regulation. Section 7805(e) is effective with respect to regulations issued after November 20, 1988. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, Title VI, sec. 6232(b),

102 Stat. 3342, 3735. The SPA temporary regulations were promulgated earlier in 1988. (Football is a game of inches and regulations are a game of effective dates.)

[7] See Lipton, "PALs at Two: What We Know and Don't Know About Passive Activity Losses on Their Second Birthday," 66 Taxes 833 (November 1988) ("Indeed, representatives of the IRS have been able to justify this [SPA] rule only by stating that it reflects the material participation test. In effect, the IRS has established one test for material participation if an activity results in a loss (500 hours) and a different test (100 hours) if the activity results in a profit. Nothing in the Code or the legislative history of Section 469 justifies such alternating tests for material participation. Observers believe that a significant participation activity recharacterization rule is invalid, but a taxpayer takes a contrary position at a peril to his pocketbook.") Also see Lipton, "Tax Court Explores the Boundaries of Material Participation in Passive Activities," 85 JTAX 348 (Dec. 1996) ("Under Treas. Reg. 1.469-5T(f)(2) , income from significant participation activities is 'active,' but losses are 'passive' unless the taxpayer materially participates in the activity under Temp. Reg. 1.469-5T(a)(4) . Because of the differing standards (losses may be passive while income is active for a taxpayer who works the same number of hours), the validity of this rule is open to serious question.")

[8] Sutton & Howell-Smith, Federal Income Taxation of Passive Activities (WG&L), para. 9.04 (visited 8/25/22).

Likewise, as TAM 202229036 illustrates, these rules can lead to absurd situations in which an activity is treated as passive in some years and active in other years, even if the taxpayer's participation in the activity did not change an iota.

Is the taxpayer in TAM 202229036 up to the challenge?

The taxpayer who was the subject of the TAM might consider filing their tax returns inconsistent with the regulations (and file a disclosure on Form 8275R) and stating that the regulation is invalid (which, in some knowledgeable tax advisors' view, it almost certainly is), both as a substantive matter (because Congress never envisioned that a single activity could generate passive losses but active income, or could flip/flop from passive to active even though the individual's level of participation did not change[9]) and also as a result of the IRS' failure to provide taxpayers with an opportunity to provide meaningful comments with respect to these rules.

[9] "(I)t is difficult to justify the reason why a person spending two hours per week on an activity [*i.e.*, 104 hours per year] generates nonpassive income while a person spending one hour per week does not." Sutton & Howell-Smith, note 8 *supra*.

II.K.1.a.iii. Spousal Participation

Any participation by a person's spouse in an activity (without regard to whether the spouse owns an interest in the activity and without regard to whether the spouses file a joint return for the taxable year) is considered participation by that person in that activity.[3074] A taxpayer may

[3074] Reg. § 1.469-5T(f)(3), authorized under Code § 469(h)(5).

spend zero time in the activity and be deemed to participate solely by reason of the spouse's participation.[3075]

However, working to help a spouse's business does not establish the taxpayer as engaging in his own trade or business.[3076] Accordingly, consider documenting and compensating the spouse's services or making the spouse a co-owner.

Finally, although spousal attribution applies with respect to the material participation requirements even if they do not file a joint return,[3077] they do not allow for spousal attribution for purposes of meeting the other requirements to be treated as a "real estate professional" that a taxpayer perform more than one half of his or her personal services and more than 750 hours in real estate trades or businesses if they file separate returns.[3078]

II.K.1.a.iv. Period of Participation

A taxpayer's participation in a partnership or S corporation is determined for the taxable year of the entity (and not the taxpayer's taxable year).[3079]

II.K.1.a.v. What Does Not Count as Participation

However, not all work counts as participation for purposes of the material participation test:

- Work done in connection with an activity is not treated as participation in the activity if not only that work is not of a type that is customarily done by an owner of such an activity but also one of the principal purposes for the performance of such work is to avoid the disallowance, under Code § 469 and its regulations, of any loss or credit from such activity.[3080]

[3075] *Zarrinnegar v. Commissioner*, T.C. Memo. 2017-34, described in fn 3084 of part II.K.1.a.vi Proving Participation and fn. 3208 of part II.K.1.e.iii.(a) Scope and Effect of Real Estate Professional Exception.
[3076] *DeGuzman v. U.S.*, 147 F. Supp. 2d 274 (D. N.J. 2001). The husband attempted to prove that he was a real estate professional and asserted that time he spent cleaning his wife's office should count toward that. Given that neither of them owned the property (she was leasing it form an unrelated third party), his hours could not count as participation generally (see part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business); furthermore, his not having been hired by the landlord undermined his claim that his work was part of a trade or business of providing real estate services.
[3077] Reg. § 1.469-5T(f)(3), authorized under Code § 469(h)(5).
[3078] *Oderio v. Commissioner*, T.C. Memo. 2014-39. See Reg. § 1.469-9(c)(4) and the flush language at the end of Code § 469(c)(7)(B). See part II.K.1.e.iii.(a) Scope and Effect of Real Estate Professional Exception, especially fn. 3201.
[3079] Reg. § 1.469-2T(e)(1). The same test applied to determine whether a partner is treated as a general partner or a limited partner; see text accompanying fn. 3071.
[3080] Reg. §§ 1.469-5T(f)(2)(i) and 1.469-5T(k), Example (7) (work as an office receptionist did not count because that was not the type of work typically done by the owner of the business, which was a football team). Note that the regulations do not expressly exclude the work from material participation if the performance of such work is to avoid the characterization of the income as net investment income under Code § 1411. Therefore, it appears that work that is not of a type that is customarily done by an owner of such an activity does count towards material participation, even if its principal purpose is to avoid the characterization of the income as net investment income under Code § 1411, so long as no principal purpose is to avoid the passive loss rules. Reg. § 1.1411-5 refers to Reg. § 1.469-5T(a) but does not say that the application of Reg. § 1.469-5T(f)(2)(i) is to be modified.

- Work done by an individual in the individual's capacity as an investor in an activity is not treated as participation in the activity unless the individual is directly involved in the activity's day-to-day management or operations.[3081] "Investor" work includes:[3082]
    - Studying and reviewing financial statements or reports on operations;
    - Preparing or compiling summaries or analyses of the finances or operations for the individual's own use; and
    - Monitoring the finances or operations in a non-managerial capacity.
- Providing legal, tax, or accounting services as an independent contractor (or as an employee thereof), or that the taxpayer commonly provides as an independent contractor, would not ordinarily constitute material participation in an activity other than the activity of providing these services to the public. Thus, for example, a member of a law firm who provides legal services to a client regarding a general partnership engaged in research and development, is not, if he invests in such partnership, treated as materially participating in the research and development activity by reason of such legal services.[3083]

II.K.1.a.vi. Proving Participation

One needs to use reasonable means to establish participation:[3084]

- "Reasonable means" may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing

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[3081] Reg. § 1.469-5T(f)(2)(ii)(A) provides:

> *In general*. Work done by an individual in the individual's capacity as an investor in an activity shall not be treated as participation in the activity for purposes of this section unless the individual is directly involved in the day-to-day management or operations of the activity.

When an individual is involved in day-to-day management or operations, does investor work done in furtherance of such management/operations count, or does all of the investor work count, without needing to differentiate between work done purely as an investor from investor work done to conduct such management/operations? All the investor work counts, once the court finds that the individual is involved in day-to-day management or operations. *Assaf v. Commissioner*, T.C. Memo. 2005-14; *Tolin v. Commissioner*, T.C. Memo. 2014-65; and *Lamas v. Commissioner*, T.C. Memo. 2015-59.

[3082] Reg. § 1.469-5T(f)(2)(ii)(B). *Lapid v. Commissioner*, T.C. Memo. 2004-222, held:

> While Mrs. Lapid testified that she spent many hours every night studying and tracking her investments, the evidence she submitted shows that she was actually just reviewing financial statements and reports on operations. Because the regulation specifically defines such monitoring as investment activity, we cannot include that time in calculating whether she met the material participation standard in three of the safe harbors she is aiming for. This is true despite our belief that Mrs. Lapid did indeed spend a lot of time tracking her properties….
>
> Unable to count the hours that Mrs. Lapid spent on investment activity, the petitioners' claim to the loss on their hotel condos quickly collapses. Though we believe that the Lapids did at least occasionally visit the condos, the record is devoid of any evidence that they spent anywhere near 500 hours doing so. That the hotels did the routine onsite work of property management undermines the Lapids' ability to show any significant amount of time that would count as "participation" in the activity. And they completely failed to compare the time they spent with the time spent by individuals actually onsite.

[3083] Committee Reports for Senate Bill 99-313, P.L. 99-514.

[3084] Reg. § 1.469-5T(f)(4). Part VIII of T.D. 8175 provides:

such services during such period, based on appointment books, calendars, or narrative summaries.

- Although contemporaneous daily time reports, logs, or similar documents are preferable,[3085] they are not required if the extent of participation may be established by other reasonable

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H. *No Recordkeeping Requirements*

Notwithstanding the quantitative tests set forth in the regulations, § 1.469-5T(f)(4) expressly provides that taxpayers need not keep contemporaneous records of their hours of participation in each activity. The Service recognizes that, while lawyers and certain other professionals are accustomed to maintaining detailed records of how they spend their work days, most individuals do not customarily maintain such records. Accordingly, under the regulations, taxpayers will be allowed to prove the requisite number of hours by any reasonable means, including, but not limited to, appointment books, calendars, and narrative summaries.

Zarrinnegar v. Commissioner, T.C. Memo. 2017-34, shows an ideal way to prove one's case:

> To establish the hours petitioner husband spent each year on his real estate business, petitioners offered petitioner husband's testimony and logs of hours for 2010, 2011, and 2012; each log showed that petitioner husband spent more than 1,000 hours per year on real estate activities.[11] Petitioner husband testified credibly that the logs had been prepared contemporaneously. He also testified credibly and at great length about the logs' contents; he was able to recall extensive details relating to the entries. Petitioners also offered the testimony of several other witnesses, including petitioner wife. All this testimony was credible and tended to corroborate petitioner husband's logs and testimony. We therefore find that petitioner husband worked more than 1,000 hours per year at the real estate business.
>
> [11] Petitioner husband testified that throughout the years at issue he had high hopes for the brokerage side of the business, despite the financial malaise burdening the housing market. Undaunted despite earning only $8,500 in brokerage fees during the years at issue, petitioner-husband testified that he poured hundreds of hours each year into broker's tours, listing searches, open houses, property viewings, client meetings, and other related activities, likening his efforts to the early labors of Bill Gates and Mark Zuckerberg, who toiled in obscurity and relative poverty before reaping fabulous profits.

The finding of over 1,000 hours per year was important because he was also a dentist and proved that he worked less than 1,000 hours per year, the proportions being important to satisfying the real estate professional test. See part II.K.1.e.iii.(a) Scope and Effect of Real Estate Professional Exception, especially fn 3208.

However, the cases below impose a heavy burden of proof on those who do not keep contemporaneous records and impose penalties if recordkeeping is inadequate.

[3085] *Schumann v. Commissioner*, T.C. Memo. 2014-138, held that, while not necessarily required:

> … we cannot overemphasize the importance of keeping thorough, contemporaneous time records rather than making estimates after the fact.

If one reconstructs time, the reconstruction needs to include details, as that court pointed out:

> Petitioner did not keep a contemporaneous log or an appointment calendar tracking his real estate activities, but he prepared a narrative summary of his activities. The summary, however, provides a broad description of the work performed at each property rather than a detailed description of the work that petitioner performed personally.

means;[3086] however, failure to keep good records can lead to penalties.[3087] Note, however, that reconstructing participation[3088] might lead one to make serious flaws in compiling the

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[3086] *Montgomery v. Commissioner*, T.C. Memo. 2013-151. In holding for the taxpayer, *Leland v. Commissioner*, T.C. Memo. 2015-240, included the following footnote 3:

> Respondent's main objection to petitioner's reconstructed logs was that they were not prepared contemporaneously with the activity. Sec. 1.469-5T(f)(4), Temporary Income Tax Regs., 53 Fed. Reg. 5727 (Feb. 25, 1988), does not require contemporaneous records, and we are satisfied that petitioner has established material participation through other reasonable means. Respondent did not dispute petitioner's inclusion of travel time in his reconstructed logs. The facts of this case establish that petitioner's travel time was integral to the operation of the farming activity rather than incidental. *See Shaw v. Commissioner*, T.C. Memo. 2002-35. We are also satisfied that petitioner's purpose in traveling long distances to and from Turkey, Texas, was not to avoid the disallowance, under sec. 469 and the regulations thereunder, of any loss or credit from the farming activity. *See* sec. 1.469-5T(f)(2)(i), Temporary Income Tax Regs., *supra*.

Hailstock v. Commissioner, T.C. Memo. 2016-146, approved the full-time efforts of a taxpayer who did not engage in any other work, cautioning that the taxpayer should keep better records for future audits:

> Petitioner satisfies the facts and circumstances test in section 1.469-5T(a)(7), Temporary Income Tax Regs., *supra*, because of her credible testimony and the substantial amount of money and time devoted to each rental property. Petitioner testified credibly and in detail about her duties in operating her real estate rental business. We find petitioner's narrative summary convincing because she owned numerous rental properties and conducted her business as a "one-man operation" without being otherwise employed. As previously discussed, petitioner spent well in excess of 40 hours each week doing work related to numerous rental properties (i.e., researching prospective properties, maintaining properties, supervising work orders, finding tenants, securing leases, and continuing education related to rental real estate). The record before the Court indicates that petitioner received sizable amounts of rental income during the taxable years in issue and used substantial amounts of her own resources to facilitate the rental operation. Petitioner's testimony is further buttressed by respondent's concession that she "rented and incurred expenses in connection with the parcels of real property located at 1515 Ruth Avenue, 1516 Ruth Avenue, 1809-1811 Fairfax Avenue, 1805-1807 Fairfax Avenue, 1112 Race Street, 1619 Fairfax Avenue, 2541 Hemlock Street, 1923 Dana Avenue, 1517 Ruth Avenue, 140 Mulberry Avenue, 1668 California Street, 1729 Kinney Avenue, 1823 Fairfax Avenue and 1407 Race Street." Although we caution petitioner to construct contemporaneous time logs for her future real estate endeavors, we find her detailed and credible testimony to be a "reasonable means" of proof. See sec. 1.469-5T(f)(4), Temporary Income Tax Regs. On the basis of petitioner's testimony and the record as a whole, we conclude that petitioner did materially participate in each rental property reported on her reconstructed Schedule E for the taxable years in issue.[5] Because she has proven that she "materially participated" in operating each of her rental properties from 2005 to 2009, petitioner easily meets the 750-hour requirement of section 469(c)(7)(B)(ii). Accordingly, petitioner qualifies for the real estate professional exception under section 469(c)(7) for each of the taxable years in issue, and therefore her Schedule E losses are not subject to the passive loss limitations imposed by section 469.
>
> [5] As held above, 201 Mulberry Avenue and 9103 Brehm Road do not qualify as rental properties for any of the taxable years in issue and therefore are not aggregated to meet the 750-hour requirement of sec. 469(c)(7)(B)(ii).

[3087] *Williams v. Commissioner*, T.C. Memo. 2014-158 (taxpayer "made no attempt to keep contemporaneous records showing what amount of time he spent on the airplane, nor did he provide any appointment books, calendars, or narrative summaries corroborating such time"). *Schumann v. Commissioner*, T.C. Memo. 2014-138, imposed 20% negligence penalties:

> Petitioner did not call either of his tax return preparers to testify. Petitioner did not keep books and records adequate to substantiate his status as a real estate professional. We think petitioner acted without reasonable cause and did not act in good faith.

documentation.[3089] The court will not respect a "postevent 'ballpark guesstimate.'"[3090] However, reconstructing participation is acceptable when corroborated by phone records, third-party witness testimony, the parties' comprehensive stipulations of fact, and other contemporaneous materials.[3091] Furthermore, any logs should segregate investor activity, which does not count,[3092] from handling the day-to-day operations.[3093]

Hiring a management company tends to undermine one's own participation.[3094]

II.K.1.a.vi.(a). Importance of Contemporaneous Records

Not necessarily to be distinguished from part II.K.1.a.vi.(b) No Respect for a Postevent Ballpark Guesstimate, below are some cases illustrating how important contemporaneous records can be.

[3088] Reconstructing hours spent includes correcting or supplementing a log. *Flores v. Commissioner*, T.C. Memo. 2015-9, found a lack of credibility when the taxpayer admitted that various calendar entries overstated time spent. The taxpayer claimed to have a second calendar but did not produce it early enough in the proceedings to have it admitted into evidence. The court upheld a 20% accuracy-related penalty. *Ballard v. Commissioner*, T.C. Summary Opinion 2018-53, also upheld such a penalty, after finding:

> We conclude that the 2008 time logs are not trustworthy and decline to rely on them to reach the result petitioners desire. As for the documents petitioners produced for 2009 and 2010, they do not establish how many hours petitioners spent with respect to their residential rental activities. Many of the documents show that petitioners had an agent to handle the day-to-day management of their Georgia residential rental properties and that they hired numerous workers to repair and maintain all of their residential rental properties.
>
> Ms. Pu did not appear in Court at trial. And as for Mr. Ballard's testimony, we find much of it to be incredible, uncorroborated, and self-serving. Under the circumstances, "[a]s we have stated many times before, this Court is not bound to accept a taxpayer's self-serving, unverified, and undocumented testimony", *Shea v. Commissioner*, 112 T.C. 183, 189 (1999) (citing *Tokarski v. Commissioner*, 87 T.C. 74, 77 (1986)), and we do not here.

[3089] See part II.K.1.a.vi.(a) Importance of Contemporaneous Records.

[3090] See part II.K.1.a.vi.(b) No Respect for a Postevent Ballpark Guesstimate.

[3091] See part II.K.1.a.vi.(c) Reconstructing Participation Acceptable When Corroborated.

[3092] See fn 3081 in part II.K.1.a.v What Does Not Count as Participation.

[3093] In *Antonyshyn v. Commissioner*, T.C. Memo. 2018-169, *Robison v. Commissioner*, T.C. Memo. 2018-88, and *Hakkak v. Commissioner*, T.C. Memo. 2020-46, the taxpayers did not segregate investor activity from handling day-to-day operations. The court noted that a management company was hired to perform the latter and held that the taxpayer did not prove sufficient work doing the latter.

[3094] *Schumann v. Commissioner*, T.C. Memo. 2014-138 ("In addition, petitioner's use of several rental agencies to help find prospective tenants, show his properties, and market his properties suggests that he did not materially participate in the rental of his properties."). In rejecting a taxpayer's claim of material participation, *Madler v. Commissioner*, T.C. Memo. 1998-112 commented:

> Petitioners have offered no evidence to indicate that they personally approved of tenants, decided rental terms, approved of expenditures for repairs and capital improvements, or in any way participated in the management of the unit in a significant and bona fide sense. It appears that VDS, rather than petitioners, performed all significant management activities. Moreover, we do not consider petitioner's ability to terminate the contract with VDS as active participation per se; the legislative history of section 469 explains that taxpayers must themselves genuinely exercise independent discretion and judgment.

However, continuous, active marketing (including booking reservations) and spending a block of 10 days annually was enough to establish material participation for condominiums in Hawaii, even though a local property manager checked in customers and managed maid service. *Pohoski v. Commissioner*, T.C. Memo. 1998-17.

For example, a taxpayer, who claimed as a contemporaneous record a 2008 calendar printed in 2009, incurred a 20% accuracy-related penalty. *Hassanipour v. Commissioner*, T.C. Memo. 2013-88. Another taxpayer's attempt to reconstruct activity led to contradictions about when he worked where, again incurring a 20% accuracy-related penalty. *Bartlett v. Commissioner*, T.C. Memo. 2013-182, pointing out:

> While the regulations permit some flexibility with respect to the evidence required to prove material participation, we are not required to accept post-event "ballpark guesstimates," nor are we bound to accept the unverified, undocumented testimony of taxpayers. See, e.g., *Lum v. Commissioner*, T.C. Memo. 2012-103; *Estate of Stangeland v. Commissioner*, T.C. Memo. 2010-185.

Similarly, *Adeyemo v. Commissioner*, T.C. Memo. 2014-1, characterized an after-the-fact spreadsheet reconstruction of time spent as an impermissible "ballpark guesstimate":

> The first problem is that the times and activities listed in the spreadsheet are not consistent with either the Adeyemos' testimony or their documentary evidence. Mr. Adeyemo testified that the activities listed in the spreadsheet were derived from his memory as well as from documentary evidence such as receipts, phone bills, the logbook, and newspaper ads. To the extent that the spreadsheet entries are purportedly derived from documentary evidence, the record does not establish a credible link between the spreadsheet and the underlying documents. For example, most entries include a general reference to a batch of receipts or phone bills. However, the references are too vague and the receipts too disorganized for us to trust that the spreadsheet is corroborated by the underlying documents….

Harnett v. Commissioner, T.C. Memo. 2011-191, in which the taxpayer claimed to spend at least 750 hours and more than half of his time managing real estate, illustrates some issues:

> Petitioner did not maintain a contemporaneous log of time spent participating in his real estate activities. In 2008, in preparation for respondent's audit, he attempted to reconstruct the time he spent in his real estate activities. He claims to have spent months going through his records to arrive at these reconstructed estimates, but petitioners have not demonstrated the evidentiary basis or methodology for these reconstructions. At trial petitioner testified that on the basis of these reconstructions he estimated spending 1,270 hours managing his real estate properties in 2003, 1,421 hours in 2004, and 1,648 hours in 2005. As discussed in more detail below, the contemporaneous records that petitioners have offered into evidence do not credibly support these estimates....
>
> Although petitioner spent some time dealing with his various properties during the years at issue and attempting to sell some of them, primarily through agents and brokers, we are not convinced that he performed more than 750 hours of services with respect to these properties during any year at issue. By 2003 petitioner had ceased to rent these properties to any significant extent and was looking to liquidate at least some of them. He was in ill health and had important duties at the bank. The properties were widely dispersed geographically. To a great extent he relied upon various agents, brokers, lawyers, and contractors as well as his wife, Robert Goldie, and Jeana Hopkins to deal with these properties.

> Petitioners suggest that because petitioner owned so much real estate, which they say was worth over $30 million, he necessarily must have spent at least 750 hours each year managing these properties. Yet petitioner also testified that during the years at issue he spent only about 10 hours a month working at the bank. Considering that for most of this period he was both chairman of the board and CEO of the bank, with wide-ranging responsibilities and six-figure compensation, this testimony strains credibility. But if this testimony is to be believed, we see no reason to think that managing his mostly dormant real estate holdings would have required petitioner to spend anywhere near 750 hours each year. And if the testimony is not to be believed, petitioner's lack of credibility on this score further erodes his credibility about the hours he claims to have spent on his real estate activities.

Almquist v. Commissioner, T.C. Memo. 2014-40 rejected calendars allegedly compiled from an original notebook where the taxpayer could not find the original notebook:

> Petitioners contend that this Court should look past the fact that petitioners did not provide any supporting documentation of the hours Mr. Almquist worked, should ignore petitioners' calendar and first log, and should look only to the second log in determining whether Mr. Almquist is a real estate professional. We again emphasize that the Court was not provided any of the purported supporting documentation or email and was provided only petitioners' self-serving testimony.
>
> We are not required to accept such self-serving testimony, and we are not willing to rely on that testimony to establish petitioners' position. See *Tokarski v. Commissioner*, 87 T.C. 74, 76-77 (1986); see also *Chapman Glen Ltd. v. Commissioner*, 140 T.C. __ (slip op. at 45 n.24) (May 28, 2013). Without any supporting documentation, the second log, created by petitioners over a year after the work was completed, is nothing more than "a postevent 'ballpark guesstimate". See *Moss v. Commissioner*, 135 T.C. at 369.

[*Chapman Glen Ltd. v. Commissioner* is found at 140 T.C. 294.]

Makhlouf v. Commissioner, T.C. Summary Opinion 2017-1, held:

> We conclude that the hours shown on the Weston spreadsheet are inflated, duplicative, and implausible on their face. Few if any entries are supported by contemporaneous record-keeping.

Penley v. Commissioner, T.C. Memo. 2017-65, expressed the skepticism usually shown when people with full-time jobs claim that they spent more than half their working time doing real estate work (and concluding later a 20% penalty):

> Petitioners claim Mr. Penley worked 2,520 hours on his real estate activities. To do so he would have had to work a total 4,714 hours (*i.e.*, 2,194 for HHS + 2,520 on his real estate activities) in 2012. That means if he worked every day, he would need to have averaged 12.88 total hours per day (**i.e.**, 4,712 ÷ 366 = 12.88). We conclude the calendar is untrustworthy, and we will not naively accept it to reach the result petitioners seek.
>
> Virtually all of the entries are rounded to the nearest hour or half-hour, do not specify a start or end time for the work, include the time spent driving to and from the property, and do not separate out any time for meals or other breaks. See *Merino v.*

> *Commissioner*, T.C. Memo. 2013-167, at *8-*12; *Rapp v. Commissioner*, 78 T.C.M. (CCH) at 177-178 (discounting testimony that lacked specifics about time work was performed); *Pohoski v. Commissioner*, T.C. Memo. 1998-17, 75 T.C.M. (CCH) 1574, 1579 (1998) (noting that the large number of hours claimed seemed implausible, especially given that the calendar did not contain breaks for meals or leisure time with family).
>
> Corroborating evidence, such as credit card statements, phone bills, and emails relating to the purchase of Evergreen Park, demonstrates meaningful real estate activity by petitioners during 2012. However, petitioners have not provided the Court with a sufficient explanation to reconcile this documentary evidence of their activities such as a brief email, a phone call, or a hardware store purchase with the large blocks of time (often 4 hours to 14 hours) shown on the calendar. See *Hill v. Commissioner*, T.C. Memo. 2010-200, 100 T.C.M. (CCH) 220, 223 (2010) (finding that the excessive hours claimed by the taxpayer, relative to the tasks performed, diminished the credibility of the taxpayer's estimates), *aff'd*, 436 F.App'x 410 (5th Cir. 2011). We find that petitioners' calendar does not fall within the regulation's "any reasonable means". See sec. 1.469-5T(f)(4), Temporary Income Tax Regs., *supra*.

II.K.1.a.vi.(b). No Respect for a Postevent Ballpark Guesstimate

Not necessarily to be distinguished from part II.K.1.a.vi.(a) Importance of Contemporaneous Records, the following cases criticized a postevent ballpark guesstimate:

Hudzik v. Commissioner, T.C. Summary Opinion 2013-4, which also imposed penalties:

> Petitioner's counsel contended that petitioner acted with reasonable cause and in good faith by listing both properties on Schedules E, following the instructions on TurboTax, and reading and attempting to follow IRS publications. While section 469 and its regulations cover a highly complex area of the tax code, petitioner's recordkeeping seems to have greatly inflated the number of hours spent in the activity in order to satisfy the statute and the regulations. We conclude that petitioner did not act with reasonable cause and in good faith and that petitioner is liable for accuracy-related penalties under section 6662(a) for taxable years 2006, 2007, and 2008.

Calvanico v. Commissioner, T.C. Summary Opinion 2015-64 (sloppy contemporaneous notes led to reconstruction efforts that were not credible and more like ballpark estimates; penalty imposed).

Finding a ballpark estimate (and imposing penalties), *Syed v. Commissioner*, T.C. Memo. 2017-226, ruled:

> Petitioners created this list during the IRS examination or before trial with an end result in mind: to show a certain number of hours of time devoted to rental properties. We have previously found such lists unpersuasive, and our conclusion is the same here. See, *e.g.*, *Mowafi v. Commissioner*, T.C. Memo. 2001-111; *Goshorn*, T.C. Memo. 1993-578.

II.K.1.a.vi.(c). Reconstructing Participation Acceptable When Corroborated

Tolin v. Commissioner, T.C. Memo. 2014-65. In setting the stage for its ultimate conclusion that the taxpayer materially participated, the court described the taxpayer's efforts and IRS' response:

> At trial petitioner introduced a narrative summary in which he describes the work he performed in connection with the thoroughbred activity and estimates the time he spent performing such work for each of the years at issue. He prepared the summary with the assistance of his attorney in preparation for trial, using telephone records, credit card invoices, and other contemporaneous materials. For each year petitioner claims time for the following work done in connection with the thoroughbred activity: preparing and distributing promotional materials; telephone conversations with his associates, advisors, and potential customers; business trips to Louisiana; registering his horses for State and national awards; reviewing and placing mortality insurance on [the horse]; reviewing and paying bills; recordkeeping; and continuing education. [footnote omitted] Cumulatively, petitioner contends that he participated in the thoroughbred activity for 891 hours in 2002, 862 hours in 2003, and 937.5 hours in 2004.
>
> While the narrative summary is a postevent review of petitioner's claimed participation in the thoroughbred activity, the parties stipulated his performance of many of the activities described therein, and a significant amount of credible third-party witness testimony and objective evidence indicates that it is an accurate depiction of his thoroughbred activity during the years at issue. [citations omitted] Respondent primarily disputes the time petitioner claims he spent performing the activities described in his narrative summary, arguing that his estimates are unreliable because the summary was prepared solely for purposes of litigation and is based in large part on petitioner's "unreliable memory". Respondent further argues that a substantial amount of petitioner's work was undertaken in his capacity as an investor in the thoroughbred activity and thus does not qualify as participation. See sec. 1.469-5T(f)(2)(ii), Temporary Income Tax Regs., *supra*.
>
> …we conclude that petitioner participated in the thoroughbred activity for more than 500 hours in each year….
>
> The remaining hours of participation petitioner needs to satisfy the "more than 500 hours" test … are easily accounted for by his preparation and mailing of the promotional breeding packages (the voluminous contents of which were stipulated by the parties) and the miscellaneous administrative tasks he completed. See *Harrison v. Commissioner*, T.C. Memo. 1996-509.
>
> Respondent nevertheless argues that a great deal of the work upon which petitioner relies to satisfy the "more than 500 hours" test should not qualify as participation because petitioner performed it in his capacity as an investor in the thoroughbred activity. See sec. 1.469-5T(f)(2)(ii), Temporary Income Tax Regs., *supra*. We reject this argument. Petitioner was directly involved in the day-to-day management and operations of the thoroughbred activity; therefore, any investor work he completed qualifies as participation for purposes of section 469. See sec. 1.469-5T(f)(2)(ii), Temporary Income Tax Regs., *supra*; see also *Assaf v. Commissioner*, T.C. Memo. 2005-14. On the basis of his satisfaction of the more-than-500-hours test of section 1.469-5T(a)(1), Temporary Income Tax Regs., *supra*, we conclude that petitioner was a material participant in the thoroughbred activity in 2002.

Note that the tax and penalties at stake were under $60,000; it seems that the taxpayer needed to go to a lot of effort to fight that. However, the taxpayer was a practicing lawyer (1,000-1,200 hours per year) and might have needed the win to protect his credibility.

After filing the petition, the taxpayer provided additional records to the IRS that proved the taxpayer's case. T.C. Memo. 2018-29 held that the IRS had to pay the taxpayer's attorney fees for continuing to litigate after the IRS had a reasonable amount of time to review the records.

II.K.1.a.vii. State Income Tax

David Hoyal, as Trustee of Crater Lake Trust v. Department of Revenue, 2021 WL 6024316 (Or. Tax Magistrate Div.), declined to count a beneficiary's work towards a trust's material participation, applying federal standards to an Oregon state income tax case. The court looked only to work attributed to the trustee as the sole legal holder of title.

In re Cobert v. Iowa Department of Revenue, 2017 WL 6501978 (Iowa Dept. Insp. App.), state law looked to the beneficiary's participation for special tax attributes passing through to the beneficiary.

II.K.1.b. Grouping Activities

For more insight, see Hamill, "Group Passive Activities to Achieve Best Tax Treatment," *Estate Planning Journal* (Dec. 2016).

Grouping under Code § 469 is very different than the Code § 199A rules for aggregating activities.[3095]

II.K.1.b.i. What Constitutes an Activity

The undertaking is generally the smallest unit that can constitute an activity, and it may include diverse business and rental operations.[3096] Note that:

- Business and rental operations conducted at the same location and owned by the same person are generally treated as part of the same undertaking; conversely, business and rental operations generally constitute separate undertakings to the extent that they are conducted at different locations or are not owned by the same person.[3097]

- However, operations that are not conducted at any fixed place of business or that are conducted at the customer's place of business are treated as part of the undertaking with which the operations are most closely associated; and operations, that are conducted at a

[3095] See part II.E.1.c.iii.(d) Aggregating Activities for Code § 199A in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.
[3096] Reg. § 1.469-4T(a)(3)(i). Reg. § 1.469-4T(b)(2)(ii)(A) defines "business and rental operations" as all endeavors that are engaged in for profit or the production of income and satisfy one or more of the following conditions for the taxable year:
- Such endeavors involve the conduct of a trade or business (within the meaning of Code § 162) or are conducted in anticipation of such endeavors becoming a trade or business;
- Such endeavors involve making tangible property available for use by customers; or
- Research or experimental expenditures paid or incurred with respect to such endeavors are deductible research or experimental expenditures.

[3097] Reg. § 1.469-4T(a)(3)(ii).

location but do not relate to the production of property at that location or to the transaction of business with customers at that location, are treated as part of the undertaking or undertakings that the operations support.[3098]

- Furthermore, if the undertaking includes both rental and nonrental operations, the rental operations and the nonrental (including short-term rentals of real property, such as hotel-room rentals) operations generally must be treated as separate undertakings, unless more than 80% of the income of the undertaking determined under the usual rule is attributable to one class of operations (i.e., rental or nonrental) or if the rental operations would not be treated as part of a rental activity because of certain exceptions.[3099]

- Also, oil and gas wells that are subject to a certain working-interest exception as separate undertakings.[3100]

- The IRS would likely treat a portfolio of mortgages as a single trade or business activity which includes making, holding, or servicing the portfolio of mortgages, so that fact that one or more of the mortgages go into foreclosure likely will not allow the company to deduct its passive losses.[3101]

When separate entities are involved:[3102]

- A C corporation subject to Code § 469, an S corporation, or a partnership (a "section 469 entity") decides how to group its activities.

- Once the section 469 entity groups its activities, a shareholder or partner may group those activities with each other, with activities conducted directly by the shareholder or partner, and with activities conducted through other section 469 entities. For example, an owner may group an activity conducted through one entity with an activity conducted through another entity. Reg. § 1.469-4(c)(3), Example (2), provides:

  > Taxpayer B, an individual, is a partner in a business that sells non-food items to grocery stores (partnership L). B also is a partner in a partnership that owns and operates a trucking business (partnership Q). The two partnerships are under common control. The predominant portion of Q's business is transporting goods for L, and Q is the only trucking business in which B is involved. Under this section, B appropriately treats L's wholesale activity and Q's trucking activity as a single activity.

- A shareholder or partner may not treat activities grouped together by a section 469 entity as separate activities.

Although generally each undertaking in which a taxpayer owns an interest is treated as a separate activity of the taxpayer, additional rules may either require or permit the aggregation of

[3098] Reg. § 1.469-4T(a)(3)(iii).
[3099] Reg. § 1.469-4T(a)(3)(iv).
[3100] Reg. § 1.469-4T(a)(3)(v).
[3101] INFO 2009-0229.
[3102] Reg. § 1.469-4(d)(5)(i).

two or more undertakings into a single activity, if the activity is a trade or business, professional service, or rental real estate undertaking:[3103]

- Trade or business undertakings include all nonrental undertakings other than certain oil and gas undertakings and certain professional service.[3104]

- An aggregation rule treats trade or business undertakings that are both similar and controlled by the same interests as part of the same activity. However, this rule does not apply generally to small interests held by passive investors in such undertakings, unless such interests are held through the same pass-through entity.[3105] A taxpayer's interests in two or more trade or business undertakings that are similar[3106] and controlled by the same interests[3107] are treated as part of the same activity of the taxpayer for any taxable year in which the taxpayer (i) owns interests in each such undertaking through the same passthrough entity, (ii) owns a direct or substantial indirect interest[3108] in each such undertaking, or (iii) materially or significantly participates[3109] in the activity that would result if such undertakings were treated as part of the same activity.[3110]

- Undertakings are similar for purposes of this rule if more than half (by value) of their operations are in the same line of business or if the undertakings are vertically integrated.[3111]

- All the facts and circumstances are taken into account in determining whether undertakings are controlled by the same interests for purposes of the aggregation rule; however, if each member of a group of five or fewer persons owns a substantial interest in each of the undertakings, the undertakings may be rebuttably presumed to be controlled by the same interests.[3112]

- Professional service undertakings (nonrental undertakings that predominantly involve the provision of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting) must be treated as part of the same activity if they are similar, related, or controlled by the same interests.[3113] "The rules for determining whether trade or business undertakings are controlled by the same interests also apply with respect to professional service undertakings."[3114] Professional service undertakings are similar if more than 20% (by value) of their operations are in the same field.[3115] Two

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[3103] Reg. § 1.469-4T(a)(4)(i).
[3104] Reg. § 1.469-4T(a)(4)(ii)(A).
[3105] Reg. § 1.469-4T(a)(4)(ii)(B). "Pass-through entity" means a partnership, S corporation, estate, or trust. Reg. § 1.469-4T(b)(2)(i).
[3106] Within the meaning of Reg. § 1.469-4T(f)(4), "Similar undertakings," which is reproduced below.
[3107] Within the meaning of Reg. § 1.469-4T(j), which is discussed in the text accompanying fns 3137-3144 in part II.K.1.b.ii Grouping Activities – General Rules.
[3108] Within the meaning of Reg. § 1.469-4T(f)(3), "Substantial indirect interest," which is reproduced below.
[3109] Within the meaning of Reg. § 1.469-5T; see parts II.K.1.a.ii Material Participation and II.K.1.i.i.(a) Overview of Rules Recharacterizing PIGs as Nonpassive Income.
[3110] Reg. § 1.469-4T(f)(2).
[3111] Reg. § 1.469-4T(a)(4)(ii)(B).
[3112] Reg. § 1.469-4T(a)(4)(ii)(B).
[3113] Reg. § 1.469-4T(a)(4)(iii).
[3114] Reg. § 1.469-4T(a)(4)(iii).
[3115] Reg. § 1.469-4T(a)(4)(iii).

professional service undertakings are related if one of the undertakings derives more than 20% of its gross income from persons who are customers of the other undertaking.[3116]

- Also, the rules for aggregating rental real estate undertakings are generally elective, permitting taxpayers to treat any combination of rental real estate undertakings as a single activity or to divide their rental real estate undertakings and then treat portions of the undertakings as separate activities or recombine the portions into activities that include parts of different undertakings.[3117]

- Taxpayers may also elect to treat a nonrental undertaking as a separate activity even if the undertaking would be treated as part of a larger activity under the aggregation rules applicable to the undertaking, subject to certain consistency requirements; moreover, if a taxpayer elects to treat a nonrental undertaking as a separate activity, the taxpayer's level of participation (i.e., material, significant, or otherwise) in the separate activity is the same as the taxpayer's level of participation in the larger activity in which the undertaking would be included but for the election.[3118]

Reg. § 1.469-4T(f)(4), "Similar undertakings," which is key to the text accompanying fn 3106, provides:

> (i) *In general*. Except as provided in paragraph (f)(4)(iii) of this section, two undertakings are similar for purposes of this paragraph (f) if and only if -
>
> > (A) There are predominant operations in each such undertaking; and
> >
> > (B) The predominant operations of both undertakings are in the same line of business.
>
> (ii) *Predominant operations*. For purposes of paragraph (f)(4)(i)(A) of this section, there are predominant operations in an undertaking if more than 50 percent of the undertaking's gross income is attributable to operations in a single line of business.
>
> (iii) *Vertically-integrated undertakings*. If an undertaking (the "supplier undertaking") provides property or services to other undertakings (the "recipient undertakings"), the following rules apply for purposes of this paragraph (f):
>
> > (A) *Supplier undertaking similar to recipient undertaking*. If the supplier undertaking predominantly involves the provision of property and services to a recipient undertaking that is controlled by the same interests (within the meaning of paragraph (j) of this section), the supplier undertaking shall be treated as similar to the recipient undertaking. For purposes of applying the preceding sentence -
> >
> > > (1) If a supplier undertaking and two or more recipient undertakings that are similar (within the meaning of paragraph (f)(4)(i) of this section) are controlled by the same interests, such recipient undertakings shall be treated as a single undertaking; and

[3116] Reg. § 1.469-4T(a)(4)(iii).
[3117] Reg. § 1.469-4T(a)(4)(iv).
[3118] Reg. § 1.469-4T(a)(4)(v).

(2) A supplier undertaking predominantly involves the provision of property and services to a recipient undertaking for any taxable year in which such recipient undertaking obtains more than 50 percent (by value) of all property and services provided by the supplier undertaking.

(B) *Recipient undertaking similar to supplier undertaking*. If the supplier undertaking is the predominant provider of property and services to a recipient undertaking that is controlled by the same interests (within the meaning of paragraph (j) of this section), the recipient undertaking shall be treated, except as otherwise provided in paragraph (f)(4)(iii)(C) of this section, as similar to the supplier undertaking. For purposes of the preceding sentence, a supplier undertaking is the predominant provider of property and services to a recipient undertaking for any taxable year in which the supplier undertaking provides more than 50 percent (by value) of all property and services obtained by the recipient undertaking.

(C) *Coordination rules*.

(1) Paragraph (f)(4)(iii)(B) of this section does not apply if, under paragraph (f)(4)(iii)(A) of this section-

(i) The supplier undertaking is treated as an undertaking that is similar to any recipient undertaking;

(ii) The recipient undertaking is treated as a supplier undertaking that is similar to another recipient undertaking; or

(iii) Another supplier undertaking is treated as an undertaking that is similar to the recipient undertaking.

(2) If paragraph (f)(4)(iii)(A) of this section applies to a supplier undertaking, the supplier undertaking shall be treated as similar to undertakings that are similar to the recipient undertaking and shall not otherwise be treated as similar to undertakings to which the supplier undertaking would be similar without regard to paragraph (f)(4)(iii) of this section.

(3) If paragraph (f)(4)(iii)(B) of this section applies to a recipient undertaking, the recipient undertaking shall be treated as similar to undertakings that are similar to the supplier undertaking and shall not otherwise be treated as similar to undertakings to which the recipient undertaking would be similar without regard to paragraph (f)(4)(iii) of this section.

(iv) *Lines of business*. The Commissioner shall establish, by revenue procedure, lines of business for purposes of this paragraph (f)(4). Business and rental operations that are not included in the lines of business established by the Commissioner shall nonetheless be included in a line of business for purposes of this paragraph (f)(4). Such operations shall be included in a single line of business or in multiple lines of business on a basis that reasonably reflects -

(A) Similarities and differences in the property or services provided pursuant to such operations and in the markets to which such property or services are offered; and

(B) The treatment within the lines of business established by the Commissioner of operations that are comparable in their similarities and differences.

Reg. § 1.469-4T(f)(3), "Substantial indirect interest," which is key to the text accompanying fn 3108, provides:

(i) *In general*. For purposes of this paragraph (f), a taxpayer owns a substantial indirect interest in an undertaking for a taxable year if at any time during such taxable year the taxpayer's ownership percentage (determined in accordance with paragraph (j)(3) of this section) in a passthrough entity that directly owns such undertaking exceeds ten percent.

(ii) *Coordination rule*. A taxpayer shall be treated for purposes of this paragraph (f) as owning a substantial indirect interest in each of two or more undertakings for any taxable year in which –

(A) Such undertakings are treated as part of the same activity of the taxpayer under paragraph (f)(2)(i) of this section; and

(B) The taxpayer owns a substantial indirect interest (within the meaning of paragraph (f)(3)(i) of this section) in any such undertaking.

Reg. § 1.469-4T(f)(5) (in each example that does not state otherwise, the taxpayer is an individual and the facts, analysis, and conclusions relate to a single taxable year), Example (4) provides:

(i) The taxpayer owns a 5-percent interest in partnership A. Partnership A owns interests in partnerships B and C, each of which owns a single undertaking (undertakings B and C). In addition, the taxpayer is a partner in partnerships C and D and directly owns a 15-percent interest in each partnership. Partnership D also owns a single undertaking (undertaking D). Undertakings B, C, and D are trade or business undertakings (within the meaning of paragraph (f)(1)(ii) of this section) that are similar (within the meaning of paragraph (f)(4) of this section) and controlled by the same interests (within the meaning of paragraph (j) of this section). The taxpayer does not participate in undertaking B, C, or D.

(ii) Paragraph (f)(2)(i) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns interests in the undertakings through the same passthrough entity. In this case, the taxpayer owns interests in undertakings B and C through partnership A. Thus, the taxpayer's interests in undertakings B and C are treated as part of the same activity.

(iii) Paragraph (f)(2)(ii) of this section provides that trade or business undertakings that are similar and controlled by the same interests are treated as part of the same activity of the taxpayer if the taxpayer owns a direct or substantial indirect interest in each such undertaking. In this case, the taxpayer owns more than ten percent of partnerships C and D, and these partnerships directly own undertakings C and D. Thus, the taxpayer owns a substantial indirect interest in undertakings C and D (see paragraph (f)(3)(i) of this section).

(iv) The coordination rule in paragraph (f)(3)(ii) of this section applies to undertakings B and C because they are treated as part of the same activity under paragraph (f)(2)(i) of this section, and the taxpayer owns a substantial indirect interest in undertaking C. Under the coordination rule, the taxpayer is treated as owning a substantial indirect interest in undertaking B as well as undertaking C. Accordingly, the taxpayer's interests in undertakings B, C, and D are treated as part of the same activity.

For business and rental operations of consolidated groups of corporations and publicly traded partnerships, a consolidated group is treated as one taxpayer in determining its activities and those of its members, and business and rental operations owned through a publicly traded partnership cannot be aggregated with operations that are not owned through the partnership.[3119]

Subject to certain exceptions,[3120] business and rental operations that constitute a separate source of income production are required to be treated as a single undertaking that is separate from other undertakings.[3121] For this purpose, business and rental operations shall be treated as a separate source of income production if and only if such operations are conducted at the same location[3122] and are owned by the same person[3123] and income-producing operations[3124] owned by such person are conducted at such location.[3125] If the rule described in this paragraph would require treatment as a single undertaking that is separate from other undertakings, generally its rental operations[3126] and its operations other than rental operations

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[3119] Reg. § 1.469-4T(a)(5).

[3120] Notwithstanding that a taxpayer's interest in leased property would be treated as used in a single rental real estate undertaking under this rule, the taxpayer may, in certain circumstances, treat a portion of the leased property as a rental real estate undertaking that is separate from the undertaking or undertakings in which the remaining portion of the property is treated as used. Reg. § 1.469-4T(k)(2)(iii). Also, special rules apply to an oil or gas well. Reg. § 1.469-4T(e).

[3121] Reg. § 1.469-4T(c)(1).

[3122] For this purpose, Reg. § 1.469-4T(c)(2)(iii) is reproduced below.

[3123] For this purpose, Reg. § 1.469-4T(c)(2)(v) provides that business and rental operations are owned by the same person if and only if one person is the direct owner of such operations. "Person" means and includes an individual, a trust, estate, partnership, association, company or corporation.
Code § 7701(a)(1). In applying this rule, two partnerships owned by the same individuals are considered separate persons. Reg. § 1.469-4T(d)(4), Example (5)(ii).

[3124] For this purpose, Reg. § 1.469-4T(c)(2)(iv) provides that "income-producing operations" means business and rental operations that are conducted at a location and relate to (or are conducted in reasonable anticipation of):

(A) The production of property at such location;
(B) The sale of property to customers at such location;
(C) The performance of services for customers at such location;
(D) Transactions in which customers take physical possession at such location of property that is made available for their use; or
(E) Any other transactions that involve the presence of customers at such location.

[3125] Reg. § 1.469-4T(c)(2)(i).

[3126] Generally, such an undertaking's rental operations are all of the undertaking's business and rental operations that involve making tangible property available for use by customers and the provision of property and services in connection therewith. However, the undertaking's operations that involve making short-term real property available for use by customers and the provision of property and services in connection therewith are not treated as rental operations if such operations, considered as a separate activity, would not constitute a rental activity. Also, such an undertaking's operations that involve making tangible property available during defined business hours for nonexclusive use by various customers are not treated as rental operations. Reg. § 1.469-4T(d)(3).

are treated as two separate undertakings,[3127] the income and expenses that are reasonably allocable to an undertaking is taken into account in determining the income or loss from the activity or activities that include such undertaking,[3128] and an undertaking is treated as a rental undertaking if and only if such undertaking, considered as a separate activity, would constitute a rental activity.[3129]

For purposes of fn 3122, Reg. § 1.469-4T(c)(2)(iii) provides:

(A) The term "location" means, with respect to any business and rental operations, a fixed place of business at which such operations are regularly conducted;

(B) Business and rental operations are conducted at the same location if they are conducted in the same physical structure or within close proximity of one another;

(C) Business and rental operations that are not conducted at a fixed place of business or that are conducted on the customer's premises shall be treated as operations that are conducted at the location (other than the customer's premises) with which they are most closely associated;

(D) All the facts and circumstances (including, in particular, the factors listed in paragraph (c)(3) of this section) are taken into account in determining the location with which business and rental operations are most closely associated; and

(E) Oil and gas operations that are conducted for the development of a common reservoir are conducted within close proximity of one another.

In determining whether a location is the location with which business and rental operations are most closely associated for purposes of (D) above, Reg. § 1.469-4T(c)(3) provides the following relationships between operations that are conducted at such location and other operations are generally the most significant:

(i) The extent to which other persons conduct similar operations at one location;

(ii) Whether such operations are treated as a unit in the primary accounting records reflecting the results of such operations;

(iii) The extent to which other persons treat similar operations as a unit in the primary accounting records reflecting the results of such similar operations;

(iv) The extent to which such operations involve products or services that are commonly provided together;

(v) The extent to which such operations serve the same customers;

[3127] Reg. § 1.469-4T(d)(1)(i). However, this rule requiring treatment as separate undertaking does not apply for any taxable year in which the rental operations, considered as a separate activity, would not constitute a rental activity, less than 20% of the gross income of the overall undertaking is attributable to rental operations, or less than 20% of the gross income of the overall undertaking is attributable to operations other than rental operations. Reg. § 1.469-4T(d)(2).
[3128] Reg. § 1.469-4T(d)(1)(ii), which is applied after considering the text accompanying fn. 3127.
[3129] Reg. § 1.469-4T(d)(1)(iii), which is applied after considering the text accompanying fn. 3127.

(vi) The extent to which the same personnel, facilities, or equipment are used to conduct such operations;

(vii) The extent to which such operations are conducted in coordination with or reliance upon each other;

(viii) The extent to which the conduct of any such operations is incidental to the conduct of the remainder of such operations;

(ix) The extent to which such operations depend on each other for their economic success; and

(x) Whether such operations are conducted under the same trade name.

II.K.1.b.ii. Grouping Activities – General Rules

When grouping a taxpayer's trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules of Code § 469, a taxpayer's activities include those conducted through C corporations that are subject to Code § 469, S corporations, and partnerships.[3130]

To meet these participation rules, one or more trade or business activities[3131] or rental activities[3132] may be treated as a single activity if the activities constitute an appropriate

[3130] Reg. § 1.469-4(a). *Schwalbach v. Commissioner*, 111 T.C. 215 (1998), held that this regulation is valid.

[3131] Reg. § 1.469-4(b)(1) provides that, for purposes of the grouping rules, "trade or business activities" are activities, other than rental activities or activities that are treated as incidental to an activity of holding property for investment, that:

(i) Involve the conduct of a trade or business (within the meaning of section 162);
(ii) Are conducted in anticipation of the commencement of a trade or business; or
(iii) Involve research or experimental expenditures that are deductible under section 174 (or would be deductible if the taxpayer adopted the method described in section 174(a)).

For purposes of the 3.8% tax on net investment income, the IRS takes the position that grouping cannot transform an investment activity into a trade or business. See text accompanying fn. 2400.

[3132] Reg. § 1.469-4(b)(2) provides that, for purposes of the grouping rules, one refers to the definition of rental activities under Reg. § 1.469-1T(e)(3). Reg. § 1.469-1T(e)(3)(i) provides that, generally, an activity is a rental activity for a taxable year if:

(A) During such taxable year, tangible property held in connection with the activity is used by customers or held for use by customers; and
(B) The gross income attributable to the conduct of the activity during such taxable year represents (or, in the case of an activity in which property is held for use by customers, the expected gross income from the conduct of the activity will represent) amounts paid or to be paid principally for the use of such tangible property (without regard to whether the use of the property by customers is pursuant to a lease or pursuant to a service contract or other arrangement that is not denominated a lease).

However, Reg. § 1.469-1T(e)(3)(ii) provides that an activity involving the use of tangible property is not a rental activity for a taxable year if, for such taxable year:

(A) The average period of customer use for such property is seven days or less;
(B) The average period of customer use for such property is 30 days or less, and significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) are provided by or on behalf of the owner of the property in connection with making the property available for use by customers;

economic unit for the measurement of gain or loss for purposes of the passive loss rules.[3133] A taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping activities.[3134] The factors listed below, not all of which are necessary to treat more than one activity as a single activity, are given the greatest weight in determining whether activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of the passive loss rules:[3135]

- Similarities and differences in types of trades or businesses;
- The extent of common control;
- The extent of common ownership;
- Geographical location; and
- Interdependencies between or among the activities (for example, the extent to which the activities purchase or sell goods between or among themselves, involve products or

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(C) Extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are provided by or on behalf of the owner of the property in connection with making such property available for use by customers (without regard to the average period of customer use);

(D) The rental of such property is treated as incidental to a nonrental activity of the taxpayer under paragraph (e)(3)(vi) of this section;

(E) The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers; or

(F) The provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest is not a rental activity under paragraph (e)(3)(vii) of this section.

[3133] Reg. § 1.469-4(c)(1). The IRS' checklist for grouping entities is at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Exhibit-8-1-Activities-Grouping-Entities. Its Audit Techniques Guide explains the grouping rules at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Chapter-8-Activities-Grouping-Rules.

[3134] Reg. § 1.469-4(c)(2). In TAM 201634022, a surgeon did not group with his medical practice his interest in a surgical center. The TAM permitted the non-grouping:

> We conclude that the facts and circumstances of this case, as presented and analyzed under the five-factor test of § 1.469-4(c), suggest that there may be more than one reasonable method for grouping the taxpayers' activities into appropriate economic units. We also conclude that the facts and circumstances, as presented, do not support a determination that the taxpayers' grouping of the interests in X, Y, and P as separate activities is clearly inappropriate for purposes of either § 1.469-4(e)(2) or § 1.469-4(f). We further conclude that the facts as presented do not support a determination that H acquired his interest in P and treated it as a separate activity apart from X and Y with a principal purpose of circumventing the underlying purpose of § 469, for purposes of § 1.469-4(f). Therefore, we conclude that the Commissioner does not have authority to regroup the taxpayers' interests in X, Y, and P as a single activity under § 1.469-4(f) to prevent tax avoidance.

Hardy v. Commissioner, T.C. Memo. 2017-16, refused to allow the IRS to regroup the taxpayer's reasonable decision not to group; the IRS had argued that Reg. § 1.469-4(f)(2) applied. Reg. § 1.469-4(f)(2) provides that the IRS may regroup a partnership's activity leasing equipment to the partners' medical practices where the partners had passive losses. The taxpayer also successfully analogized his situation to the TAM in showing that his decision not to group was reasonable.

[3135] Reg. § 1.469-4(c)(2). *Lamas v. Commissioner*, T.C. Memo. 2015-59, held that all five factors were satisfied when two businesses with similar ownership operated from the same office.

services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).

Total lack of interdependence precludes grouping.[3136]

In determining groupings, generally all the facts and circumstances are taken into account in determining whether undertakings are controlled by the same interests; the reality of control, not its form or mode of exercise, is determinative.[3137] In applying this rule:

- Two or more undertakings of a taxpayer are part of the same common-ownership group for purposes of this rule if and only if the sum of the common-ownership percentages of any five or fewer persons (not including pass-through entities) with respect to such undertakings exceeds 50%; the common-ownership percentage of a person with respect to such undertakings is the person's smallest ownership percentage in any such undertaking.[3138]

- If, without regard to this sentence, an undertaking of a taxpayer is part of two or more common-ownership groups, any undertakings of the taxpayer that are part of any such common-ownership group shall be treated for purposes of this test as part of a single common-ownership group in determining the activities of such taxpayer.[3139]

- A person's ownership percentage in an undertaking or in a pass-through entity shall include any interest in such undertaking or pass-through entity that the person holds directly and the person's share of any interest in such undertaking or pass-through entity that is held through one or more pass-through entities (but a beneficiary does not get included by reason of a trust's ownership).[3140]

- A person's ownership percentage in a pass-through entity or in an undertaking shall be determined by treating such person as the owner of any interest that a person related person (applying Code § 267(b)[3141] or 707(b)(1))[3142] owns (determined without regard to this sentence) in such pass-through entity or in such undertaking;[3143] however, the common-ownership percentage of five or fewer persons with respect to two or more undertakings shall be determined, in any case in which, after the application of the preceding sentence,

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[3136] *Williams v. Commissioner*, T.C. Memo. 2014-158.
[3137] Reg. § 1.469-4T(j)(1).
[3138] Reg. § 1.469-4T(j)(2)(ii).
[3139] Reg. § 1.469-4T(j)(2)(iii).
[3140] Reg. § 1.469-4T(j)(3)(i). In applying this pass-through test, Reg. § 1.469-4T(j)(3)(ii) provides that:
- A partner's interest in a partnership and share of any interest in a pass-through entity or undertaking held through a partnership shall be determined on the basis of the greater of such partner's percentage interest in the capital (by value) of such partnership or such partner's largest distributive share of any item of income or gain (disregarding Code § 707(c) guaranteed payments) of such partnership.
- A shareholder's interest in an S corporation and share of any interest in a pass-through entity or undertaking held through an S corporation shall be determined on the basis of such shareholder's stock ownership.
- A beneficiary's interest in a trust or estate and share of any interest in a pass-through entity or undertaking held through a trust or estate shall not be taken into account.

[3141] Code § 267(b) is reproduced in part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses.
[3142] For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.
[3143] Reg. § 1.469-4T(j)(3)(iii)(A), (C).

two or more such persons own the same interest in any such undertaking (the "related-party owners") by treating as the only owner of such interest (or portion thereof) the related-party owner whose ownership of such interest (or a portion thereof) would result in the highest common-ownership percentage.[3144]

Grouping is subject to the following limitations:[3145]

- A rental activity may not be grouped with a trade or business activity unless the activities being grouped together constitute an appropriate economic unit and:[3146]
  - The rental activity is insubstantial in relation to the trade or business activity;
  - The trade or business activity is insubstantial in relation to the rental activity;[3147] or
  - Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which case the portion of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.[3148]
- An activity involving the rental of real property and an activity involving the rental of personal property (other than personal property provided in connection with the real property or real property provided in connection with the personal property) may not be treated as a single activity.[3149]
- Generally, a taxpayer that owns an interest as a limited partner or a limited entrepreneur,[3150] in certain activities described in the at-risk rules,[3151] may not group that activity with any

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[3144] Reg. § 1.469-4T(j)(3)(iii)(B).
[3145] Reg. § 1.469-4(d).
[3146] Reg. § 1.469-4(d)(1).
[3147] *Stanley v. U.S.*, 116 A.F.T.R.2d 2015-5419 (D. Ark. 11/12/2015), held that running golf courses provided as an amenity to apartment complexes, but open to the public for a fee, constituted an insubstantial activity, even though golf revenue might have approached 20% of revenue from operations. The golf courses facilitated apartment rentals and sometimes helped overcome neighborhood opposition to the apartments being built; see fn. 3204 for IRS' nonacquiescence to *Stanley*.
[3148] If this proportionality cannot be achieved, consider using the structure provided in part II.E Recommended Structure for Entities, especially part II.E.9 Real Estate Drop Down into Preferred Limited Partnership, assigning disproportionate preferred profits interest related to the disproportionate ownership of the real estate.
[3149] Reg. § 1.469-4(d)(2)
[3150] As used here, a limited entrepreneur is a person does not actively participate in the management of a farm. Code § 464(e)(2).
[3151] Code § 465(c)(2)(A) treats as a separate activity under the at-risk rules: film or video tape, Code § 1245 property which is leased or held for leasing, a farm, oil and gas property (as defined under Code § 614), or geothermal property (as defined under Code § 614). However, Code § 465(c)(2)(B)(i) treats as a single activity all of a partnership's or S corporation's activities with respect to Code § 1245 (generally depreciable personal property) properties that are leased or held for lease and are placed in service in any taxable year of the partnership or S corporation. Also, Code § 465(c)(2)(B)(ii) treats as a single activity a trade or business (i) in which the taxpayer actively participates, or (ii) that is carried on by a partnership or an S corporation if 65% or more of the entity's losses for the taxable year are allocable to persons who actively participate in the management of the trade or business. This is a general overview, and one needs to look to the regulations under Code § 465 for a more accurate description. See part II.G.6.b Code § 1245 Property to explain above references to Code § 1245.

other activity. A taxpayer that owns an interest as a limited partner or a limited entrepreneur in an activity described in the preceding sentence may group that activity with another activity in the same type of business if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of the passive loss rules.[3152]

- The IRS may issue additional guidance prohibiting grouping.[3153]

Finally, grouping does not help with the real estate professional test under part II.K.1.e.iii Real Estate Professional Converts Rental to Nonpassive Activity, although those rules do provide a separate aggregation election.[3154]

II.K.1.b.iii. How to Report Grouping

Generally, a taxpayer must file a written statement with its original income tax return for the first taxable year in which two or more trade or business activities or rental activities are originally grouped as a single activity.[3155] Even before the rule became effective, merely reporting an activity is nonpassive when the taxpayer has another activity that is nonpassive does not support an inference of grouping.[3156]

Rogerson v. Commissioner, T.C. Memo. 2022-49, which was primarily a case about the 5-out of-10 rule for material participation,[3157] discussed rules before and after 2014:

> The regulations Mr. Rogerson cites required RAC to perform a grouping analysis for the years before 2014. See Treas. Reg. § 1.469-4(d)(5)(i) ("[A]n S corporation...must group its activities under the rules of this section."). Mr. Rogerson concedes that, before 2014, RAC reported the consolidated results of the entire aerospace business without differentiation.[29] This approach indicates that RAC treated the aerospace business as a single activity (or as multiple activities grouped into a single activity) for purposes of section 469. Mr. Rogerson concedes as much, stating: "No position was taken on any RAC return before 2014 reflecting anything other than a single activity." Pet'r's Simultaneous Suppl. Br. 25. And Mr. Rogerson was not free to distinguish between his various aerospace activities for purposes of section 469 for any year in which RAC combined them. See Treas. Reg. § 1.469-4(d)(5)(i) (providing that a shareholder of an S corporation may not treat activities grouped together by his corporation as separate

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[3152] Reg. § 1.469-4(d)(3). The IRS audit guide at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Chapter-8-Activities-Grouping-Rules described the rule as follows (emphasis in original):

> Limited partners involved in motion pictures, videotapes, farming, exploring or exploiting oil and gas, and exploring or exploiting geothermal deposits may group with another activity **only if it is in the same line of business**.

[3153] Reg. § 1.469-4(d)(4). Rev. Proc. 2007-65, Sec. 4.09, treats certain wind farms as separate activities. The last time I checked, treatises had not mentioned any other guidance issued under this regulation.

[3154] See fns. 3203-3204.

[3155] Rev. Proc. 2010-13, Section 4.02, which further provides:

> This statement must identify the names, addresses, and employer identification numbers, if applicable, for the trade or business activities or rental activities that are being grouped as a single activity. In addition, any statement reporting a new grouping of two or more trade or business activities or rental activities as a single activity must contain a declaration that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469.

[3156] *Hardy v. Commissioner*, T.C. Memo. 2017-16.

[3157] Part II.K.1.a.ii Material Participation.

activities). Accordingly, RAC's treatment of the aerospace business as a single activity before 2014 required Mr. Rogerson to take the same approach. He did so and determined that his involvement in the overall business was active. The five of ten test requires nothing more.

> [29] Mr. Rogerson cites *Hardy v. Commissioner*, T.C. Memo. 2017-16, in which our Court concluded that taxpayers who merely report an S corporation's activity as nonpassive do not thereby group that activity with their other nonpassive activity. But that case considered whether activity reported on a Schedule K-1 had been grouped with other activity not reported on the Schedule K-1; it did not consider whether undifferentiated amounts reported on a single Schedule K-1 had been grouped together. *Id*. at *15–16. Additionally, Hardy analyzed only the grouping regulations under Treasury Regulation § 1.469-4 and did not consider the five of ten test.

If a taxpayer adds a new trade or business activity or a rental activity to an existing grouping for a taxable year, the taxpayer shall file a written statement with the taxpayer's original income tax return for that taxable year.[3158] If it is determined that the taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities.[3159] Until the taxpayer makes a change to the grouping as described in the preceding sentences of this paragraph, a taxpayer is not required to file a written statement reporting the grouping of the trade or business activities and rental activities that have been made before taxable years beginning on or after January 25, 2010.[3160]

If a taxpayer is engaged in two or more trade or business activities or rental activities and fails to report whether the activities have been grouped as a single activity as described in any of the above paragraphs, then each trade or business activity or rental activity will be treated as a separate activity.[3161] However, a timely disclosure is deemed made by a taxpayer who has filed all affected income tax returns consistent with the claimed grouping of activities and makes the required disclosure on the income tax return for the year in which the failure to disclose is first discovered by the taxpayer.[3162]

[3158] Rev. Proc. 2010-13, Section 4.03, which provides reporting requirements similar to those of Section 4.02.

[3159] Rev. Proc. 2010-13, Section 4.04, which provides reporting requirements similar to those of Section 4.02, but also provides:

> If two or more activities are regrouped into a single activity, the statement reporting a regrouping must also contain a declaration that the regrouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469. Furthermore, the statement reporting a regrouping must contain an explanation of why the taxpayer's original grouping was determined to be clearly inappropriate or the nature of the material change in the facts and circumstances that makes the original grouping clearly inappropriate.

[3160] Rev. Proc. 2010-13, Sections 4.06 and 5.

[3161] Rev. Proc. 2010-13, Section 4.07.

[3162] Rev. Proc. 2010-13, Section 4.07. Furthermore:

> If the failure to disclose is first discovered by the Service, however, the taxpayer must also have reasonable cause for not making the disclosures required by this revenue procedure. Although the default rule established by this section 4.07 will generally result in unreported activities being treated as separate activities, the Commissioner may still regroup a taxpayer's activities to prevent tax avoidance pursuant to § 1.469-4(f). This revenue procedure provides alternative relief for untimely filing of the disclosures required by this revenue procedure; therefore, relief for

Partnerships and S corporations are not subject to the above requirements:[3163]

> Instead, partnerships and S corporations must comply with the disclosure instructions for grouping activities provided for on Form 1065, U.S. Return of Partnership Income and Form 1120S, U.S. Income Tax Return for an S corporation, respectively. Generally, compliance with the applicable form requires disclosing the entity's groupings to the partner or shareholder by separately stating the amounts of income and loss for each grouping conducted by the entity on attachments to the entity's annual Schedule K-1. The partner or shareholder is not required to make a separate disclosure of the groupings disclosed by the entity under §§ 4.02, 4.03, and 4.04 of this revenue procedure unless the partner or shareholder (1) groups together any of the activities that the entity does not group together, (2) groups the entity's activities with activities conducted directly by the partner or shareholder, or (3) groups the entity's activities with activities conducted through other section 469 entities. Pursuant to § 1.469-4(d)(5)(i), a shareholder or partner may not treat activities grouped together by a section 469 entity as separate activities.

Instructions to 2022 Form 1065 provide under "Grouping Activities":

> If you group your activities under these rules for section 469 purposes, check the appropriate box in item K below the name and address block on page 1 of Form 1065.

Under "Passive Activity Reporting Requirements," those Instructions provide:

> 1. If the partnership carries on more than one activity, provide an attached statement for each activity conducted through the partnership that identifies the type of activity conducted (trade or business, rental real estate, or rental activity other than rental real estate). See Grouping Activities, earlier.
>
> 2. On the attached statement for each activity, provide a statement, using the same box numbers as shown on Schedule K-1, detailing the net income (loss), credits, and all items required to be separately stated under section 702(a) from each trade or business activity, from each rental real estate activity, from each rental activity other than a rental real estate activity, and from investments. If the partnership grouped separate activities, the attachments must identify each group. The attached group activity description must be sufficient for a partner to determine if its other activities qualify to be grouped with any groups provided by the partnership.

Instructions to 2022 Form 1120S provide under "Grouping Activities":

> If you group your activities under these rules for section 469 purposes, check the appropriate box in item J.

Under "Passive Activity Reporting Requirements," those Instructions provide:

> 1. If the corporation carries on more than one activity, provide an attached statement for each activity conducted through the corporation that identifies the type of activity

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untimely disclosures under § 301.9100 of the Procedure and Administration Regulations is not available pursuant to § 301.9100-1(d)(2).

[3163] Rev. Proc. 2010-13, Section 4.05.

conducted (trade or business, rental real estate, or rental activity other than rental real estate). See Grouping Activities, earlier.

2. The attachment(s) must identify each group. The attached group activity description must be sufficient for the shareholders to determine if their other activities qualify to be added to any groups provided by the corporation.

3. On the attached statement for each activity, provide a statement using the same box numbers as shown on Schedule K-1 and detailing the net income (loss), credits, and all items required to be separately stated under section 1366(a)(1) from each trade or business activity, from each rental real estate activity, from each rental activity other than a rental real estate activity, and from investments….

The instructions do not address the consequences of the corporation's failing to attach such a statement. Has the S corporation implicitly elected to group if it fails to attach such a statement? Or has it failed to comply with the instructions and deemed not to have grouped?[3164] An S corporation that discovers that it has not addressed this issue should be able to cure it, if it makes the required disclosure on the income tax return for the year in which the S corporation first discovers the failure to disclose.[3165]

Publication 925 (2022), "Passive Activity and At-Risk Rules," provides:

> **Disclosure Requirement**
>
> For tax years beginning after January 24, 2010, the following disclosure requirements for groupings apply. You're required to report certain changes to your groupings that occur during the tax year to the IRS. If you fail to report these changes, each trade or business activity or rental activity will be treated as a separate activity. You will be considered to have made a timely disclosure if you filed all affected income tax returns consistent with the claimed grouping and make the required disclosure on the income tax return for the year in which you first discovered the failure to disclose. If the IRS discovered the failure to disclose, you must have reasonable cause for not making the required disclosure.
>
> **New grouping**. You must file a written statement with your original income tax return for the first tax year in which two or more activities are originally grouped into a single activity. The statement must provide the names, addresses, and employer identification numbers (EINs), if applicable, for the activities being grouped as a single activity. In addition, the statement must contain a declaration that the grouped activities make up an

[3164] Rev. Proc. 2010-13, Section 4.07 provides:

> Except as provided in § 4.05, if a taxpayer is engaged in two or more trade or business activities or rental activities and fails to report whether the activities have been grouped as a single activity in accordance with this revenue procedure, then each trade or business activity or rental activity will be treated as a separate activity for purposes of applying the passive activity loss and credit limitation rules of section 469.

Section 4.05 is what provides that partnerships and S corporations must comply with the disclosure instructions for grouping activities provided for on Form 1065 or 1120S. If the partnership or S corporation does not comply with the instructions, does that kick the entity out of the safe harbor and require treatment as separate activities?

[3165] See fn. 3162.

appropriate economic unit for the measurement of gain or loss under the passive activity rules.

Addition to an existing grouping. You must file a written statement with your original income tax return for the tax year in which you add a new activity to an existing group. The statement must provide the name, address, and EIN, if applicable, for the activity that's being added and for the activities in the existing group. In addition, the statement must contain a declaration that the activities make up an appropriate economic unit for the measurement of gain or loss under the passive activity rules.

Regrouping. You must file a written statement with your original income tax return for the tax year in which you regroup the activities. The statement must provide the names, addresses, and EINs, if applicable, for the activities that are being regrouped. If two or more activities are being regrouped into a single activity, the statement must contain a declaration that the regrouped activities make up an appropriate economic unit for the measurement of gain or loss under the passive activity rules. In addition, the statement must contain an explanation of the material change in the facts and circumstances that made the original grouping clearly inappropriate.

Groupings by partnerships and S corporations. Partnerships and S corporations aren't subject to the rules for new grouping, addition to an existing grouping, or regrouping. Instead, they must comply with the disclosure instructions for grouping activities provided in their Form 1065, U.S. Return of Partnership Income, or Form 1120-S, U.S. Income Tax Return for an S Corporation, whichever is applicable.

The partner or shareholder isn't required to make a separate disclosure of the groupings disclosed by the entity unless the partner or shareholder:

- Groups together any of the activities that the entity doesn't group together,
- Groups the entity's activities with activities conducted directly by the partner or shareholder, or
- Groups an entity's activities with activities conducted through another entity.

A partner or shareholder may not treat activities grouped together by the entity as separate activities.

II.K.1.b.iv. Regrouping Activities Transitioning into 3.8% Tax on Net Investment Income

The enactment of the 3.8% tax on net investment income provides an opportunity for taxpayers to revisit their groupings. The preamble to the proposed regulations under Code § 1411 provides:[3166]

> Section 1.469-4(e)(1) provides that, except as provided in §§ 1.469-4(e)(2) and 1.469-11, once a taxpayer has grouped activities, the taxpayer may not regroup those activities in subsequent taxable years. The Treasury Department and the IRS have determined on prior occasions that taxpayers should be given a "fresh start" to redetermine their groupings. The enactment of section 1411 may cause taxpayers to reconsider their

[3166] Part 6.B.1.(b)(4) of the preamble.

> previous grouping determinations, and therefore the Treasury Department and the IRS have determined that taxpayers should be given the opportunity to regroup. Thus, the proposed regulations provide that taxpayers may regroup their activities in the first taxable year beginning after December 31, 2013, in which the taxpayer meets the applicable income threshold in proposed § 1.1411-2(d) and has net investment income (as defined in proposed § 1.1411-4). The determination in the preceding sentence is made without regard to the effect of the regrouping. Taxpayers may regroup their activities in reliance on this proposed regulation for any taxable year that begins during 2013 if section 1411 would apply to such taxpayer in such taxable year. A taxpayer may only regroup activities once pursuant to § 1.469-11(b)(3)(iv)(A), and any such regrouping will apply to the taxable year for which the regrouping is done and all subsequent years.
>
> The regrouping must comply with the existing requirements under § 1.469-4. For example, § 1.469-4(e) provides that taxpayers must comply with disclosure requirements that the Commissioner may prescribe with respect to both their original groupings and the addition and disposition of specific activities within those chosen groupings in subsequent taxable years. On January 25, 2010, the Treasury Department and the IRS published Revenue Procedure 2010-13 (2010-4 IRB 329), which requires taxpayers to report to the IRS their groupings and regroupings of activities and the addition of specific activities within their existing groupings of activities for purposes of section 469 and § 1.469-4. Thus, the disclosure requirements of § 1.469-4(e) and Revenue Procedure 2010-13 require taxpayers who regroup their activities pursuant to proposed § 1.469-11(b)(3)(iv) to report their regroupings to the IRS. See § 601.601(d)(2).

The final regulations[3167] allow an individual, estate, or trust to regroup in the first taxable year beginning after December 31, 2013, in which Code § 1411 would apply to such taxpayer, if the taxpayer has net investment income[3168] and such taxpayer's income exceeds the applicable thresholds.[3169]

The preamble to the final regulations explains:[3170]

> The final regulations retain the requirement that regrouping under § 1.469-11(b)(3)(iv) may occur only during the first taxable year beginning after December 31, 2012, in which (1) the taxpayer meets the applicable income threshold under section 1411, and (2) has net investment income. The Treasury Department and the IRS believe that the interaction between section 1411 and section 469 justifies the section 1411 regrouping rule, and that, if a taxpayer does not have a section 1411 tax liability, the reason for allowing the regrouping does not apply. The Treasury Department and the IRS acknowledge that, in the case of regrouping elections by partnerships and S corporations, one commentator's implied assertion is correct that imposition of section 1411 on a passthrough entity's owner(s) is the same change in law that

[3167] Reg. § 1.469-11(b)(3)(iv).
[3168] As defined in Reg. § 1.1411-4.
[3169] Reg. § 1.469-1(b)(3)(iv)(B) refers to the modified adjusted gross income (as defined in Reg. § 1.1411-2(c)) of an individual (as defined in Reg. § 1.1411-2(a)) exceeding the applicable threshold in Reg. § 1.1411-2(d) or the adjusted gross income of an estate or trust (as defined in Reg. § 1.1411-3(a)(1)(i)) exceeding the amount described in Reg. § 1.1411-3(a)(1)(ii)(B)(2).
[3170] T.D. 9644. The first sentence quoted here appears to be erroneous, in that, as fn. 3167 notes, the final regulations allow regrouping in the first taxable year beginning after December 31, 2013, rather than the first taxable year beginning after December 31, 2012. The mention of December 31, 2012 might have been in light of taxpayers being able to rely on the proposed regulations to regroup in their 2013 returns.

precipitated the proposed regulation's allowance of regrouping in the first instance. However, if the Treasury Department and the IRS were to expand the scope of the regulations to allow regrouping by partnerships and S corporations, then taxpayers with no tax liability under section 1411 indirectly would be allowed to regroup. Accordingly, the final regulations do not adopt this suggestion.

However, after considering the comments, the Treasury Department and the IRS agree with the commentators' concerns regarding the potential unfairness to taxpayers who become subject to section 1411 after adjustments to, for example, income or deduction items after an original return has been filed. Therefore, the final regulations allow a taxpayer to regroup under § 1.469-11(b)(3)(iv) on an amended return, but only if the taxpayer was not subject to section 1411 on his or her original return (or previously amended return), and if, because of a change to the original return, the taxpayer owed tax under section 1411 for that taxable year. This rule applies equally to changes to modified adjusted gross income or net investment income upon an IRS examination.

However, if a taxpayer regroups on an original return (or previously amended return) under these rules, and then subsequently determines that the taxpayer is not subject to section 1411 in that year, such regrouping is void in that year and all subsequent years until a valid regrouping is done. The voiding of the regrouping may cause additional changes to the taxpayer's current year return and may warrant corrections to future year returns to restore the taxpayer's original groupings. The final regulations contain two exceptions to such voided elections. First, the final regulations allow a taxpayer to adopt the voided grouping in a subsequent year without filing an amended return if the taxpayer is subject to section 1411 in such year. Second, if the taxpayer is subject to Section 1411 in a subsequent year, the taxpayer may file an amended return to regroup in a manner that differs from the previous year's voided regrouping. The final regulations provide four new examples on the amended return regrouping rules. Furthermore, § 1.1411-2(a)(2)(iii) of the final section 1411 regulations also contains a similar rule applicable to section 6013(g) elections.

The preamble quoted above acknowledges that, if a passive activity is held through a partnership or an S corporation, any grouping is done first at the entity level, and those entities are not described above.

Practice Tips:

- If a partnership has a bunch of long-term leases, consider converting the partnership into an investment trust,[3171] such as a Delaware statutory trust,[3172] so that each owner can separately engage in regrouping.

- If it is later determined that a regrouping was invalid because the NII tax would not otherwise have applied, a new election would need to be made on a subsequent return. As noted above, a taxpayer can amend such a subsequent return to make the regrouping election.[3173] Consider whether a regrouping election might be reaffirmed each year in case the initial regrouping was invalid; this would be worthwhile only if reaffirming the regrouping does not take much work.

For more about regrouping, see Kirk and Satchit, "Peeling The Onion: Passive Loss Regrouping in Light of Section 1411," *Business Entities (WG&L)* (March/April 2015).

II.K.1.b.v. Is Grouping Advisable?

Grouping undertakings together as a single activity means that an undertaking is not treated as disposed of, thereby freeing suspended losses, until all undertakings in that grouped activity are disposed of.[3174]

Also, grouping might dilute the personal service aspects of an undertaking, throwing it out of the favorable rules for material participation that apply to personal services activities.[3175]

Grouping does not help with the real estate professional test under part II.K.1.e.iii Real Estate Professional Converts Rental to Nonpassive Activity.[3176]

II.K.1.c. Attributing Material Participation from Business Entities to Their Employees and Vice Versa (Including Limited Partnership with Corporate General Partner)

When the same individual owns the corporate general partner, is the sole limited partner, and works in the partnership's business as an individual, this work can cause not only the individual but also the corporation to materially participate.[3177] Note that a special provision applying the

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[3171] See part II.D.4.a Investment Trusts. For example, all of the partners might contribute their partnership interests into an investment trust, and the partnership would dissolve as a matter of state law (if it is a general partnership) or by the entity that was a partnership filing the appropriate termination documentation. The trust itself would be a limited liability entity. However, it would have to be carefully structured so that the trust's activity does not rise to the level of a partnership. The partners would need to group that activity with other activities in which the partners engaged to satisfy the appropriate tests. When done to avoid the 3.8% tax on net investment income, this would require threading a very fine needle, in that the trust would be taking the position that it is not engaged in a trade or business (to satisfy the requirements described in part II.D.4.a Investment Trusts) and its owners would argue that their interest in the trust, when combined with their other activities, rises to the level of a trade or business (to satisfy the requirements described in part II.I.8.c Application of 3.8% Tax to Rental Income).
[3172] See fn. 688.
[3173] Reg. § 1.469-11(b)(3)(iv)(C)(2).
[3174] For more information on dispositions, see fn. 3040.
[3175] See text accompanying fn. 3065.
[3176] See fn. 3203. Real estate professionals have a separate aggregation election available.
[3177] Reg. § 1.469-5T(k), Example (1).

passive loss rules to certain C corporation owners mandates the result regarding the corporation's participation.[3178]

When an individual owns the corporate general partner, is the sole limited partner, and works in the partnership's business as an employee of the corporate general partner, this work can cause not only the corporation but also the individual to materially participate.[3179]

When an individual is the sole limited partner and works in the partnership's business as an employee of the corporate general partner, but that individual does not own the corporate general partner, this work can cause the individual to materially participate but will not affect the corporation's material participation.[3180]

These examples are consistent with the idea that an individual receives credit for participation in any capacity.[3181]

II.K.1.d. Applying Passive Loss Rules to a Retiring Partner under Code § 736

Except as described below, any Code § 707(c) payment to a partner for services or the use of capital, including any Code § 736(a)(2) payment (relating to guaranteed payments made in liquidation of the interest of a retiring or deceased partner), constitutes a payment for services or as the payment of interest, respectively, under the passive loss rules and not as a distributive share of partnership income.[3182]

If any gain or loss is taken into account by a retiring partner or a deceased partner's successor in interest as a result of a Code 736(b) payment,[3183] the gain or loss constitutes passive activity gross income or deduction only to the extent that the gain or loss would have been passive activity gross income or deduction of the retiring or deceased partner if it had been recognized at the time the liquidation of the partner's interest began.[3184]

If a Code § 736(a) payment is made in liquidation of a retiring or deceased partner's interest and that person takes into account any income as a result of the payment that is attributable to the portion (if any) of the payment that is allocable to the partnership's unrealized receivables[3185] and goodwill, the percentage of the income treated as passive shall not exceed the percentage of passive income that would be included in the income that person would have recognized if

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[3178] Code § 469(h)(4) provides:

> *Certain closely held C corporations and personal service corporations*. A closely held C corporation or personal service corporation shall be treated as materially participating in an activity only if-
> (A) 1 or more shareholders holding stock representing more than 50 percent (by value) of the outstanding stock of such corporation materially participate in such activity, or
> (B) in the case of a closely held C corporation (other than a personal service corporation), the requirements of section 465(c)(7)(C) (without regard to clause (iv)) are met with respect to such activity.

See Reg. § 1.469-1T(g).

[3179] Reg. § 1.469-5T(k), Example (2).

[3180] Reg. § 1.469-5T(k), Example (2) (variation mentioned in the final sentence).

[3181] See fn 3049.

[3182] Reg. § 1.469-2(e)(2)(ii). For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

[3183] See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

[3184] Reg. § 1.469-2(e)(2)(iii)(A).

[3185] Within the meaning of Code § 751(c).

the unrealized receivables and goodwill had been sold at the time that the liquidation of the partner's interest began.[3186]

For some background, see part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

II.K.1.e. Rental Activities

Generally, "passive activity" also includes any rental activity.[3187]

II.K.1.e.i. What Is Rental?

Generally, an activity is a rental activity for a taxable year if:[3188]

- During that taxable year, tangible property is used by customers or held for use by customers, and
- The gross income attributable to the activity during such taxable year represents (or, in the case of an activity in which property is held for use by customers, the expected gross income from the conduct of the activity will represent) amounts paid or to be paid principally for the use of such tangible property (without regard to whether the use of the property by customers is pursuant to a lease or pursuant to a service contract or other arrangement that is not denominated a lease).

However, regulations exclude from treatment as rental the use of tangible property for a taxable year if, for that taxable year:[3189]

- The average period of customer use for such property is seven days or less;[3190]

[3186] Reg. § 1.469-2(e)(2)(iii)(B)(1). For purposes of this test, calculate the portion (if any) of a Code § 736(a) payment allocable to a partnership's unrealized receivables and goodwill using the principles of Reg. § 1.736-1(b) for determining the portion of a payment made under Code § 736 treated as a distribution under Code § 736(b). Reg. § 1.469-2(e)(2)(iii)(B)(2). Reg. § 1.736-1(b)(3) provides:

> To the extent that the partnership agreement provides for a reasonable payment with respect to good will, such payments shall be treated under section 736(b) and this paragraph. Generally, the valuation placed upon good will by an arm's length agreement of the partners, whether specific in amount or determined by a formula, shall be regarded as correct.

Recognizing this exception, the Preamble to Prop. Reg. § 1.1411-7 (net investment income tax) (12/02/2013), Fed. Reg. Vol. 78, No. 231, pp. 72451 et seq., provides:

> Section 736(a) payments also include payments to retiring general partners of service partnerships in exchange for unrealized receivables (other than receivables described in the flush language of section 751(c)) or for goodwill (other than payments for goodwill provided for in the partnership agreement) (collectively, "Section 736(a) Property").

[3187] Code § 469(c)(2). An excellent article discussing how the passive loss rules apply to real estate investors and real estate professionals is Panitz and Lubin, "Higher Stakes for Tax Treatment of Rental Real Estate," *Journal of Accountancy*, at 56-62 (Dec. 2013).

[3188] Reg. § 1.469-1T(e)(3)(i).

[3189] Reg. § 1.469-1T(e)(3)(ii).

[3190] To facilitate finding a short rental period, instead of having the lease begin the date of signature or deposit, provide that lease begins with delivery and concludes with the return of the property, the latter which was successfully done in *Moreno v. U.S.*, 113 A.F.T.R.2d 2014-2149 (D. La 5/19/2014).

- The average period of customer use for such property is 30 days or less, and significant personal services are provided by or on behalf of the owner of the property in connection with making the property available for use by customers;

- Extraordinary personal services are provided by or on behalf of the owner of the property in connection with making such property available for use by customers (without regard to the average period of customer use);[3191]

- The rental of such property is treated as incidental to a nonrental activity of the taxpayer;

- The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers; or

- The provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest is not a rental activity under the following exception:[3192]

    - If the taxpayer owns an interest in a partnership, S corporation, or joint venture conducting an activity other than a rental activity, and the taxpayer provides property for use in the activity in the taxpayer's capacity as an owner of an interest in such

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Conversely, one cannot say than an average period of customer use for such property is more than seven days to avoid this exception (if being a real estate rental is desirable, which it may be for a real estate professional) by saying that a management company was continuously involved and was somehow the true customer when the taxpayer reserved use during that purported continuous rental to the management company. *Eger v. U.S.*, 405 F. Supp.3d 850 (N.D. Cal. 8/30/2019) (interpreting Reg. § 1.469-1(e)(3)(iii)(D), which determines the period of customer use).

[3191] Reg. § 1.469-1T(e)(3)(ii)(C), referring to extraordinary personal services under Reg. § 1.469-1T(e)(3)(ii)(C), which provides:

> *Extraordinary personal services*. For purposes of paragraph (e)(3)(ii)(C) of this section, extraordinary personal services are provided in connection with making property available for use by customers only if the services provided in connection with the use of the property are performed by individuals, and the use by customers of the property is incidental to their receipt of such services. For example, the use by patients of a hospital's boarding facilities generally is incidental to their receipt of the personal services provided by the hospital's medical and nursing staff. Similarly, the use by students of a boarding school's dormitories generally is incidental to their receipt of the personal services provided by the school's teaching staff.

In rejecting taxpayers' claim that they provided "extraordinary personal services" under the regulation, *Johnson v. U.S.*, 116 A.F.T.R.2d 2015-5486 (D. N.C. 2015), 117 A.F.T.R.2d 2016-947 (4th Cir. 2016), *cert. den*. 10/3/2016:

> None of the unsubstantiated evidence proffered by plaintiffs would support a finding that their rental homes in either Illinois or South Carolina offered services that were "akin to those services offered by a hospital or school, where the prime concern of the tenants is the receipt of services, whether medical, teaching, or, [this] case, legal[, financial, and psychological]." *Assaf*, 2005 WL 209726 4. The only statement provided by someone other than plaintiffs merely reveals that the "services" promised were provided; such "services" included the provision of continental breakfast items, furniture, and laundry facilities, which, as discussed above, do not constitute extraordinary personal services. The only "services" which would differentiate plaintiffs' rental homes from typical rental properties were the counseling services allegedly provided, and plaintiffs have simply failed to proffer anything more than their own conclusory statements to support a finding that the occupants' use of their property was incidental to their receipt of counseling services provided by Johnson.

[3192] Reg. § 1.469-1T(e)(3)(vii).

partnership, S corporation, or joint venture, the provision of such property is not a rental activity.

- Thus, if a partner contributes the use of property to a partnership, none of the partner's distributive share of partnership income is income from a rental activity unless the partnership is engaged in a rental activity. In addition, a partner's gross income attributable to a guaranteed payment under Code § 707(c)[3193] is not income from a rental activity under any circumstances.

- The determination of whether property used in an activity is provided by the taxpayer in the taxpayer's capacity as an owner of an interest in a partnership, S corporation, or joint venture shall be made on the basis of all of the facts and circumstances.

Rogerson v. Commissioner, T.C. Memo. 2022-49, explains:

> **a. Seven Days or Less Exception**
>
> As to the first exception, Mr. Rogerson has not requested any findings of fact or provided any evidence to allow us to conclude that his yacht activities involved charters of seven days or less during the years at issue or any other year. Mr. Rogerson claims that "[n]either TOTO nor Falcon Lair was available to be 'rented' for weeks at a time" and that "the Yacht Charter Activity was intended to provide short-term use for day trips and other short-term excursions." Pet'r's Simultaneous Opening Br. 78. But regardless of these plans, no customers chartered the yachts during 2014, 2015, or 2016. And unlike the affirmative rule for defining a rental activity, which considers a taxpayer's intended or expected use of property, the exceptions to that rule turn on what actually happened during the taxable year. *Compare* Temp. Treas. Reg. § 1.469-1T(e)(3)(i) (allowing consideration of potential customer use and expected income in identifying a rental activity), *with id*. subdiv. (ii)(A) and (B) (establishing exceptions based on the "average period of customer use"), *and* Treas. Reg. § 1.469-1(e)(3)(iii)(C) and (D) (calculating the average period of customer use based on actual customer activity). Without any customer use, it is impossible to establish (as required by the regulations) the average period of customer use for the yachts. Accordingly, Mr. Rogerson fails to qualify for the first exception.[33]
>
> [33] We express no view as to the outcome of a case in which the evidence demonstrates that one or more of the exceptions under Temporary Treasury Regulation § 1.469-1T(e)(3)(ii) had been met in prior years, but not during the years at issue. This case does not present such a scenario.
>
> **b. 30-day Exception**
>
> Mr. Rogerson's argument for the second exception falls short for the same reason. A claim in Mr. Rogerson's brief that "[n]o charter would have been for more than 30 days," Pet'r's Simultaneous Opening Br. 79, is not evidence, and again, the absence of any actual customer use of the yachts precludes us from determining that the average period of customer use was 30 days or less. Similarly, the fact that the TOTO and the Falcon Lair each had crews that conceivably could have provided services does not establish

[3193] For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

that significant personal services were in fact provided to customers. See Temp. Treas. Reg. § 1.469-1T(e)(3)(ii). Mr. Rogerson has requested no findings of fact nor produced any evidence about the kinds of services that crew members could or would provide to customers. And, more to the point, we know that no services were provided during the years at issue because the yachts were not chartered.

Mr. Rogerson has failed to establish that his yacht activities qualify under the exceptions provided in the temporary regulations. The activities therefore constituted rental activities and were per se passive during the years at issue.[34] See I.R.C. § 469(c)(2), (4), (j)(8); Temp. Treas. Reg. § 1.469-1T(e)(3)(i).[35]

[34] Mr. Rogerson's argument that he materially participated in the yacht activity would not change this conclusion, because rental activities are considered passive without regard to the taxpayer's level of participation. I.R.C. § 469(c)(2), (4). We therefore need not address it further.

[35] On January 12, 2021, just over two months before the trial of this case was scheduled to begin in March, the Commissioner filed a Motion for Leave to File an Amendment to Answer to further allege under section 183 that Mr. Rogerson did not engage in his yacht activities with an objective of realizing a profit. Mr. Rogerson objected on the ground that permitting the amendment would prejudice his preparation for trial. He further argued that the amendment came too late and essentially was designed to permit the Commissioner a "do-over" after the period for discovery had already run. After holding a status conference with the parties, the Court advised them that it intended to deny the Motion. The Court observed that permitting amendment would not be in the interest of justice in light of the procedural posture of the case, the timing of the request after the close of discovery, and the prejudice to Mr. Rogerson in preparing for trial on the existing issues, while at the same time being required to prepare for trial a different issue that turned on much different evidence. The Court also noted that the notice of deficiency specifically highlighted the issue sought to be challenged in the proposed amendment, while observing that the Commissioner had decided not to raise the issue in light of a prior resolution by IRS Appeals. The Court also advised the parties that the Motion would be formally addressed in any opinion issued in the case. Trial of this case was later postponed from March to May at the parties' request. Upon further consideration, for the reasons noted above, we will deny the Commissioner's Motion. See *Waterman v. Commissioner*, 91 T.C. 344, 349-51 (1988) (leave to amend may be denied upon a showing of prejudice to the petitioner); *Law v. Commissioner*, 84 T.C. 985, 990 (1985) (whether leave will be granted is a question falling within the discretion of the Court).

Rogerson v. Commissioner, 132 A.F.T.R.2d 2023-6624 (9th Cir. 11/30/2023), affirmed:

The tax court did not err in concluding that Rogerson's activity related to his two yachts was a rental activity under I.R.C. § 469 and Temp. Treas. Reg. § 1.469-1T(e)(3)(i). I.R.C. § 469(c)(2) provides that "the term `passive activity' includes any rental activity."[3] In turn, "[t]he term `rental activity' means any activity where payments are principally for the use of tangible property." I.R.C. § 469(j)(8).

[3] Section 469(c)(2) references an exception for real estate rental activity not at issue here. See I.R.C. § 469(c)(7).

The temporary regulations have added that an activity is generally a "rental activity" when "tangible property held in connection with the activity is used by customers or held for use by customers" and the gross income (or expected gross income) attributable to the activity represents "amounts paid or to be paid principally for the use of such tangible property." Temp. Treas. Reg. § 1.469-1T(e)(3)(i). The subsequent provision outlines several exceptions related to short-term rentals. *Id*. § 1.469-1T(e)(3)(ii).

The tax court found Rogerson's challenge to the validity of Temp. Treas. Reg. §1.469-1T untimely because he raised it for the first time in his motion for reconsideration. Similarly, we hold that Rogerson waived his challenge to the validity of Temp. Treas. Reg. § 1.469-1T by failing to raise it until after trial and an opinion on the merits. See *Ramona Equip. Rental, Inc. ex rel. U.S. v. Carolina Cas. Ins. Co.*, 755 F.3d 1063, 1070 (9th Cir. 2014) (holding an argument first raised in a post-judgment motion waived); *Beech Aircraft Corp. v. United States*, 51 F.3d 834, 841 (9th Cir. 1995) (per curiam) (same). Furthermore, as the tax court acknowledged in its denial of the motion for reconsideration, "without the temporary regulations in the picture, Mr. Rogerson's yacht activity would be covered by the general rule of the statute [I.R.C. § 469(j)(8)] and not be subject to any exception."

Rogerson next argues that the tax court applied the temporary regulation's general provision, Temp. Treas. Reg. § 1.469-1T(e)(3)(i), and the short-term rental exceptions, *id.* § 1.469-1T(e)(3)(ii), inconsistently. Specifically, Rogerson contends that the tax court erred in determining that the yachts were a rental activity under the general provision based on Rogerson's plan to charter them but considered actual charter activity (or lack thereof) to determine that neither short-term rental exception applied.

The tax court's application of the temporary regulation tracks the regulation's language. The general provision's definition of rental activity includes the holding of tangible property for future use by customers but, as the exceptions are written, actual activity, not intention, is relevant to their applicability. Compare Temp. Treas. Reg. § 1.469-1T(e)(3)(i)(A)–(B) ("[A]n activity is a rental activity...if...tangible property held in connection with the activity is...held for use by customers...[and] expected gross income from the conduct of the activity will represent[] amounts paid or to be paid principally for the use of such tangible property[.]" (emphasis added)) with id. § 1.469-1T(e)(3)(ii)(A)–(B) ("[A]n activity involving the use of tangible property is not a rental activity...if...(A) The average period of customer use for such property is seven days or less; (B) The average period of customer use for such property is 30 days or less, and significant personal services...are provided by or on behalf of the owner of the property in connection with making the property available for use by customers[.]"). As the tax court held, "[w]ithout any customer use, it is impossible to establish (as required by the regulations) the average period of customer use for the yachts."

We hold that Rogerson's argument that the yacht activity was not a rental activity as defined by I.R.C. § 469(j)(8) because it was not "principally" for the use of tangible property waived. See *Cold Mountain v. Garber*, 375 F.3d 884, 891 (9th Cir. 2004), as amended (Aug. 9, 2004) ("In general, we do not consider an issue raised for the first time on appeal.").[4] Furthermore, the record on this issue is undeveloped as Rogerson requested no findings of facts or produced any evidence about the kinds of services that crew members could or would provide to customers. *Greisen v. Hanken*, 925 F.3d 1097, 1115 (9th Cir. 2019) (holding that an argument was "inappropriate to review" where "the record is undeveloped").

> [4] Although we have discretion to hear previously unconsidered arguments under three recognized exceptions, none are applicable here. See *Cold Mountain*, 375 F.3d at 891 (recognizing three exceptions: (1) review is necessary to prevent a miscarriage of justice or to preserve the integrity of the judicial process; (2) when a new issue arises while appeal is pending because of a change in the law; or (3) the issue presented is purely one of law and either does not depend on the factual record developed below, or the pertinent record has been fully developed).

II.K.1.e.ii. Self-Rental Converts Rental to Nonpassive Activity

A taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as nonpassive if the property is rented for use in a trade or business activity in which the taxpayer[3194] materially participates[3195] for the taxable year.[3196] The rule applies to "net rental activity income" and therefore does not cause a loss to be treated as nonpassive income.[3197]

[3194] *Williams v. Commissioner*, T.C. Memo. 2015-76, *aff'd* 117 A.F.T.R.2d 2016-600 (5th Cir. 2/2/2016), held that, if a passthrough entity holds real estate, the passthrough entity's owners, not the passthrough entity itself, must materially participate.

[3195] See parts II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business and II.K.1.a Counting Work as Participation, as well as the rest of part II.K.1.a Counting Work as Participation in Business under the Passive Loss Rules. In *Schumann v. Commissioner*, T.C. Memo. 2014-138, a taxpayer who took substantial salary from his operating business could not prove that he did not materially participate in the business (because he wanted his rent to be passive income), despite his testimony that "his income tax reporting for both years was 'tax provisioning' and that he did not actively provide services to either company in exchange for the wages and payments reported on his tax returns."

[3196] Reg. § 1.469-2(f)(6) provides:

> *Property rented to a nonpassive activity*. An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as not from a passive activity if the property-
>
> (i) Is rented for use in a trade or business activity (within the meaning of paragraph (e)(2) of this section) in which the taxpayer materially participates (within the meaning of § 1.469-5T) for the taxable year; and
>
> (ii) Is not described in § 1.469-2T(f)(5).

The cross-reference to Reg. § 1.469-2(e)(2) is puzzling, because Reg. § 1.469-2(e)(2)(i) is reserved and Reg. § 1.469-2(e)(2)(ii) related to partnership redemptions. *Schwalbach v. Commissioner*, 111 T.C. 215 (1998), ignored this cross-reference when holding that Reg. § 1.469-2(f)(6) is valid and applying it in to treat rental to a professional service corporation as nonrental. *Williams v. Commissioner*, T.C. Memo. 2015-76, *aff'd* 117 A.F.T.R.2d 2016-600 (5th Cir. 2/2/2016), followed *Schwalbach* in holding that Reg. § 1.469-2(f)(6) is valid.

Reg. § 1.469-2T(f)(5) is discussed in part II.K.1.e.v Rental Income Property a Taxpayer Improves, Rents Briefly, and Then Sells Is Nonpassive.

See fns. 2359 and 2400 regarding the interaction of Reg. § 1.469-2(f)(6) with the 3.8% tax on net investment income.

[3197] Reg. § 1.469-2(f)(9)(iv) provides:

> The net rental activity income from an item of property for the taxable year is the excess, if any, of-
>
> (A) The gross rental activity income from the item of property for the taxable year; over
>
> (B) Any passive activity deductions for the taxable year (including any deduction treated as a deduction for the year under § 1.469-1(f)(4)) that are reasonably allocable to the income.

This test applies to the item of property, ignoring any grouping elections that might apply to that item of property.[3198]

"Rented for use in a trade or business activity" does not include rental to an activity that is itself rental.[3199]

II.K.1.e.iii. Real Estate Professional Converts Rental to Nonpassive Activity

Below is a discussion of the real estate professional exception, followed by certain rules in aggregating real estate activities.

II.K.1.e.iii.(a). Scope and Effect of Real Estate Professional Exception

A real estate activity is not *per se* a passive activity if the taxpayer[3200] is a real estate professional described as follows:[3201]

- more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates,[3202] <u>and</u>

[3198] *Carlos v. Commissioner*, 123 T.C. 275 (2004); *Veriha v. Commissioner*, 139 T.C. 45 (2012) (defining "item of property" for purposes of this rule); *Dirico v. Commissioner*, 139 T.C. 396 (2012); see also *Samarasinghe v. Commissioner*, T.C. Memo. 2012-23 (same result, but I'm not sure whether the taxpayer grouped the item with other rental properties or merely tried to use passive loss to offset this income).
[3199] *Dirico v. Commissioner*, 139 T.C. 396 (2012). In approving the deduction of rental losses against rental income, the Tax Court did not hold against the taxpayer the taxpayer's misreporting of rental income as ordinary business income.
[3200] Including a trust, per *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014) (rejecting the IRS' contention that only individuals - not trusts - could be real estate professionals). The petition, reply, and briefs are at http://tcinstitute.com/rv/ff0012e61ef3812cbb3202812343b05e2fbe2da8/p=3879220. CCA 201244017 had taken the position that a trust cannot be a real estate professional.
[3201] Each bullet point below requires a finding of material participation in those real property trades or businesses before adding up hours. *Windham v. Commissioner*, T.C. Memo. 2017-068. The taxpayer may use spousal participation to establish material participation in a real property trade or business so that the taxpayer can count hours in that activity, but the taxpayer does not to count spousal hours in the real estate professional test. See part II.K.1.a.iii Spousal Participation, especially fn. 3078. See also Kalfayan and Patterson, "Classifying Taxpayer Business Hours to Determine Qualification as a 'Real Estate Professional' Under the Passive Activity Loss Rules," *Journal of Taxation* (WG&L) 5/2017, saved as Thompson Coburn LLP doc. no. 6561377.
[3202] *Hakkak v. Commissioner*, T.C. Memo. 2020-46, is but one example of the difficulty in a person with a full-time job other than real estate proving that more than one-half of his time was spent in real estate.

- the taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses[3203] in which the taxpayer materially participates (and personal services do not count unless the person is a 5% owner).[3204]

CCA 201504010 held as follows, with the first holding intended to be totally positive:

1. A real estate agent who brings together buyers and sellers of real property may be engaged in a real property brokerage trade or business under § 469(c)(7)(C) [even though the licensed agent was not licensed as a broker].

2. A mortgage broker who is a broker of financial instruments is not in a real property brokerage trade or business within the meaning of § 469(c)(7)(C).

Hickam v. Commissioner, T.C. Summary Opinion 2017-66 held that neither mortgage brokerage services nor loan origination services were performed in a real property trade or business within the meaning of Code § 469(c)(7)(C).[3205]

[3203] "Real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Code § 469(c)(7)(C). A holding company that raised capital to invest in real estate projects (owned by other entities) but neither owned any rental real property nor performed any management or operations functions is not considered a Code § 469(c)(7)(C) real property trade or business. *Coastal Heart Medical Group v. Commissioner*, T.C. Memo. 2015-84, cited with approval by (but not an issue in) *Conner v. Commissioner*, T.C. Memo. 2018-6.

[3204] Code § 469(c)(7)(B). For purposes of this test, personal services performed as an employee shall not be treated as performed in real property trades or businesses unless (and when) the employee is a 5-percent owner in the employer. Code § 469(c)(7)(D)(ii); Reg. § 1.469-9(c)(5). Both of these provisions refer to Code § 416(i)(1)(B)(i), which defines 5-percent owner to mean:

(I) if the employer is a corporation, any person who owns (or is considered as owning within the meaning of section 318) more than 5 percent of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation, or

(II) if the employer is not a corporation, any person who owns more than 5 percent of the capital or profits interest in the employer.

Stanley v. U.S., 116 A.F.T.R.2d 2015-5419 (D. Ark. 11/12/2015), held:

> The Court has already set out the evidence of record substantiating Roy's ownership of the stock, and the Court does not find that the word "outstanding" imposes some additional requirement that the stock be readily transferable or not at risk of forfeiture that would operate to prevent Roy from claiming ownership for purposes of 26 U.S.C. § 469(c)(7)(D)(ii).

The IRS nonacquiesced, 2017–42 I.R.B. 311 (10/16/2017), stating in fn. 1:

> Nonacquiescence relating to the holdings that: 1) mere possession of a stock certificate, disregarding other conditions, restrictions or limitations on the possessor's rights regarding the stock, constitutes ownership for purposes of § 469(c)(7)(D)(ii); and 2) work performed by the taxpayer in a rental real estate activity for purposes of § 469(c)(7)(A) may also constitute work performed by the taxpayer in non-rental business activities of the taxpayer for other purposes of § 469.

An excellent article discussing how the passive loss rules apply to real estate investors and real estate professionals is Panitz and Lubin, "Higher Stakes for Tax Treatment of Rental Real Estate," *Journal of Accountancy*, at 56-62 (Dec. 2013). See generally Reg. § 1.469-9.

[3205] The court reasoned:

> Mr. Hickam's argument that his mortgage brokerage services and his loan origination services are performed in trades or businesses in "real property operation" because the underlying assets

Reg. § 1.469-9(b)(2) provides definitions for determining whether a trade or business is a real property trade or business for purposes of Code § 469(c)(7)(C).

Note that being a real estate professional merely treats the activity as not *per se* passive; the taxpayer's rental activity still must satisfy the usual nonrental rules for being a nonpassive activity.[3206]

The IRS often succeeds when attacking those who hold full-time jobs (a job is considered a "trade or business")[3207] who claim that they were also real estate professionals, collecting not only tax but also a 20% accuracy-related penalty.[3208] However, a taxpayer who spent her mornings on real estate and her afternoons on her investment advisory business (the latter being her more steady source of income) was able to prove being a real estate professional.[3209]

For more insight into what is a real estate trade or business, see part II.I.8.c.iii Rental as a Trade or Business, in the context of the tax on net investment income (NII), including a detailed excerpt from the preamble to the final NII regulations. Also, a 250-hour safe harbor applies to allow rental real estate to qualify as a business for the Code § 199A deduction for pass-through business entities. See part II.E.1.e.i.(a) Whether Real Estate Activity Constitutes A Trade Or Business within part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

See also parts II.G.26.b Real Estate as a Trade or Business and II.G.26 Real Estate Special Issues.

> are real property is too attenuated. His argument ignores the words "real property" that precede the specific activities listed in the statute; those words modify each of those activities, including "operation". Although the loans he brokered and originated were secured by real property, Mr. Hickam's mortgage brokerage services and his loan origination services did not involve operating the real properties that secured those loans.
>
> Further, while Mr. Hickam's mortgage brokerage services constitute a "brokerage" trade or business, they does not constitute a "real property brokerage" trade or business. Mr. Hickam did not broker real estate during either year at issue. Rather, he brokered loans between buyers and financial institutions.
>
> The legislative history of the statute supports the consequence of this distinction. Congress considered including "finance operations" in the activities listed in section 469(c)(7)(C) but specifically did not do so. See H.R. 2264, 103d Cong., sec. 13143 (1993); H.R. 1414, 102d Cong. (1991); S. 1257, 102d Cong. (1991); H.R. 3732, 101st Cong. (1989); S. 2384, 101st Cong. (1989).

[3206] *Gragg v. U.S.*, 118 A.F.T.R.2d 2016-5364 (9th Cir. 8/4/2016), citing *Perez v. Commissioner*, T.C. Memo. 2010-232, as confirming its interpretation of Reg. § 1.469-9(e)(1), which provides:

> Section 469(c)(2) does not apply to any rental real estate activity of a taxpayer for a taxable year in which the taxpayer is a qualifying taxpayer under paragraph (c) of this section. Instead, a rental real estate activity of a qualifying taxpayer is a passive activity under section 469 for the taxable year unless the taxpayer materially participates in the activity.

[3207] Reg. § 1.469-9(c)(5).

[3208] See part II.K.1.a.vi Proving Participation. *Zarrinnegar v. Commissioner*, T.C. Memo. 2017-34, was an unusual case described in fn 3084 of that part. The wife and husband shared the dental practice and real estate investments. The wife worked full-time and the husband part-time (less than 1,000 hours) in the dental practice. The wife worked none and the husband worked more than 1,000 hours in the real estate business. The wife was attributed the husband's status as a real estate professional under part II.K.1.a.iii Spousal Participation.

[3209] *Windham v. Commissioner*, T.C. Memo. 2017-068.

II.K.1.e.iii.(b). Aggregating Real Estate Activities for a Real Estate Professional

A qualifying taxpayer may elect to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity, which election may be made in any year and is binding for the taxable year in which it is made and for all future years[3210] in which the taxpayer is a qualifying taxpayer, but which does not have effect in years in which the taxpayer is not a qualifying taxpayer.[3211] Absent such an election, each building would constitute a separate activity,[3212] and it might be impossible to prove sufficient participation for each building.[3213]

To be a qualifying taxpayer, a taxpayer must own at least one interest in rental real estate and meet these requirements:[3214]

- The taxpayer must meet the requirements of section 469(c)(7)(B):[3215]
  - more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and
  - the taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates (and personal services do not count unless the person is a 5% owner).
- A taxpayer must materially participate in a real property trade or business for the personal services provided by the taxpayer in that real property trade or business to count towards meeting the above requirements.[3216]

3210 See fn. 3227.

3211 Reg. § 1.469-9(g)(1) provides:

> *In general*. A qualifying taxpayer may make an election to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity. This election is binding for the taxable year in which it is made and for all future years in which the taxpayer is a qualifying taxpayer under paragraph (c) of this section, even if there are intervening years in which the taxpayer is not a qualifying taxpayer. The election may be made in any year in which the taxpayer is a qualifying taxpayer, and the failure to make the election in one year does not preclude the taxpayer from making the election in a subsequent year. In years in which the taxpayer is not a qualifying taxpayer, the election will not have effect and the taxpayer's activities will be those determined under § 1.469-4. If there is a material change in the taxpayer's facts and circumstances, the taxpayer may revoke the election using the procedure described in paragraph (g)(3) of this section.

3212 Reg. § 1.469-9(e)(4), subparagraph (i), reproduced further below.

3213 *Syed v. Commissioner*, T.C. Memo. 2017-226, fn. 5.

3214 Reg. § 1.469-9(b)(6), (c).

3215 Reg. § 1.469-9(c)(1), referring to Code § 469(c)(7)(B), which is described (more than what is in the bullet points above) in fn. 3204 in part II.K.1.e.iii.(a) Scope and Effect of Real Estate Professional Exception. Reg. § 1.469-9(c)(2) applies special rules for taxpayers that are closely held C corporations. This requirement seems like a chicken-and-egg question – how can one prove the participation necessary to aggregate without first combining activities in some way? See fn. 3231 and the accompanying text for an answer.

3216 Reg. § 1.469-9(c)(3).

- Spouses filing a joint return are qualifying taxpayers only if one spouse separately satisfies both requirements of Code § 469(c)(7)(B).[3217]

- Work "as an employee" counts only of the taxpayer owns more than 5% of the business.[3218] Presumably (no authority on point of which I am aware), work as a partner, whether compensated directly through Code § 707(c) guaranteed payments or merely through the taxpayer's distributive share, would not be subject to this rule, but work under Code § 707(a)(2) other than as a partner may be subject to this rule.[3219] Therefore, if a partner is compensated for services, consider including the right to payment in the partnership agreement and specify that it will be reported on the partner's K-1 as a Code § 707(c) guaranteed payment; this reporting means that the income will be reported in the year for which the partnership deducts it, rather than the year in which the partner receives the payment.[3220]

A taxpayer may use any reasonable method of applying the facts and circumstances in determining the real property trades or businesses in which the taxpayer provides personal services, and a real property trade or business might consist either of one or more than one such trade or business; a taxpayer's grouping of activities under Reg. § 1.469-4 does not control the determination of the taxpayer's real property trades or businesses for purposes of this test.[3221] Once a taxpayer determines the real property trades or businesses in which personal services are provided for purposes of this test, the taxpayer may not redetermine those real property trades or businesses in subsequent taxable years unless the original determination was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original determination clearly inappropriate.[3222] If a business includes significant activities not defined as real property trades or businesses, the taxpayer will need to segregate

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[3217] Reg. § 1.469-9(c)(4), which further provides:

> In determining the real property trades or businesses in which a married taxpayer materially participates (but not for any other purpose under this paragraph (c)), work performed by the taxpayer's spouse in a trade or business is treated as work performed by the taxpayer under § 1.469-5T(f)(3), regardless of whether the spouses file a joint return for the year.

See part II.K.1.a.iii Spousal Participation, fn. 3074.

[3218] Reg. § 1.469-9(c)(5), "Employees in real property trades or businesses," provides:

> For purposes of paragraph (c)(1) of this section, personal services performed during a taxable year as an employee generally will be treated as performed in a trade or business but will not be treated as performed in a real property trade or business, unless the taxpayer is a five-percent owner (within the meaning of section 416(i)(1)(B)) in the employer. If an employee is not a five-percent owner in the employer at all times during the taxable year, only the personal services performed by the employee during the period the employee is a five-percent owner in the employer will be treated as performed in a real property trade or business.

Code § 416(i)(1)(B)(i) is reproduced in fn 3204 in part II.K.1.e.iii.(a) Scope and Effect of Real Estate Professional Exception.

[3219] See part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

[3220] See fn. 550, found in part III.B.7.c.viii Creative Bonus Arrangements.

[3221] Reg. § 1.469-9(d)(1). Failure to group under the passive loss general grouping rules constitutes an election not to group - see fns. 3161 (effect failure to group) and 3162 (possible relief) in part II.K.1.b.iii How to Report Grouping - whereas failure to aggregate real estate does not preclude a later aggregation election – see fn. 3211 in this part II.K.1.e.iii.(b).

[3222] Reg. § 1.469-9(d)(2).

the time spent on real property trades or businesses from other activities to determine whether the taxpayer satisfies this test.[3223]

This election applies to rental real estate interests held through passthrough entities.[3224] Explaining how to make the election, *Shiekh v. Commissioner*, T.C. Memo. 2010-126, pointed out:[3225]

> To make an election, a taxpayer must clearly notify the Commissioner of the taxpayer's intent to do so. See *Knight- Ridder Newspapers, Inc. v. United States*, 743 F.2d 781, 795 (11th Cir. 1984). "[T]he taxpayer must exhibit in some manner … his unequivocal agreement to accept both the benefits and burdens of the tax treatment afforded" by the law. *Young v. Commissioner*, 83 T.C. 831, 839 (1984), *affd.* 783 F.2d 1201 (5th Cir. 1986). A taxpayer makes the election to treat all interests in rental real estate as a single rental real estate activity by filing a statement with the taxpayer's original income tax return declaring that the election is under section 469(c)(7)(A). *Trask v. Commissioner*, T.C. Memo. 2010-78; sec. 1.469-9(g)(3), Income Tax Regs. A taxpayer has not made an election if it is not clear from the return that an election has been made. See *Young v. Commissioner*, 783 F.2d at 1206.
>
> We have held that aggregating losses from Schedule E on line 17 of Form 1040, U.S. Individual Income Tax Return, is insufficient notice to the Commissioner that the taxpayer intended to elect to treat all his rental properties as a single activity under section 469(c)(7). *Kosonen v. Commissioner*, T.C. Memo. 2000-107. Similarly, a taxpayer's intent to elect, without exhibiting an unequivocal agreement to accept both the benefits and the burdens of such an election, is irrelevant to making a determination of whether he or she has made an election. See *Young v. Commissioner*, 783 F.2d at 1206; *Kosonen v. Commissioner*, *supra.*

3223 Failure to segregate led to the taxpayer losing *Cantor v. Commissioner*, T.C. Summary Opinion 2014-103 (company installed glass in vehicles and residences, and residential work was not necessarily part of constructing, reconstructing, etc. a home); see also *Langille v. Commissioner*, 108 A.F.T.R.2d 2011-7254 (11th Cir. 2011) (law practice does not count as real estate professional work, and taxpayer failed to even introduce evidence that work done at law firm was real estate work rather than legal work), *aff'g* T.C. Memo. 2010-49.
3224 Reg. § 1.469-9(h)(1).
3225 See also *Schumann v. Commissioner*, T.C. Memo. 2014-138, and *Windham v. Commissioner*, T.C. Memo. 2017-68.

The deadline for making the aggregation election may be extended.[3226] An election to treat all of a taxpayer's interests in rental real estate as a single activity is binding for subsequent tax years, absent changed circumstances.[3227]

For purposes of the real estate professional rule described above, if a taxpayer elects to treat all interests in rental real estate as a single rental real estate activity and at least one interest in rental real estate is held by the taxpayer as a limited partnership interest,[3228] the combined rental real estate activity will be treated as a limited partnership interest of the taxpayer for purposes of determining material participation.[3229] However, the preceding sentence does not apply if the taxpayer's share of gross rental income from all of the taxpayer's limited partnership interests in rental real estate is less than 10% of the taxpayer's share of gross rental income from all of the taxpayer's interests in rental real estate for the taxable year.[3230]

Except for the limited partnership rule provided above, the IRS explained aggregation under the real estate professional rules as follows:[3231]

> [T]he first step here is to determine whether TP is a qualifying taxpayer under section 469(c)(7)(B). Pursuant to § 1.469-9(d), TP has reasonably determined under the particular facts and circumstances that TP has a combined real property trade or business for purposes of Treas. Reg. § 1.469-9(d) that includes Property 1, Property 2, and the real property development trade or business. Under Treas. Reg. § 1.469-5T(a)(1), because TP spends more than 500 qualifying hours on this real property trade

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[3226] Rev. Proc. 2011-34, § 4.01 may provide relief if the taxpayer meets all of the following requirements:
(1) the taxpayer failed to make an election under § 1.469-9(g) solely because the taxpayer failed to timely meet the requirements in § 1.469-9(g);
(2) the taxpayer filed consistently with having made an election under § 1.469-9(g) on any return that would have been affected if the taxpayer had timely made the election. The taxpayer must have filed all required federal income tax returns consistent with the requested aggregation for all of the years including and following the year the taxpayer intends the requested aggregation to be effective and no tax returns containing positions inconsistent with the requested aggregation may have been filed by or with respect to the taxpayer during any of the taxable years;
(3) the taxpayer timely filed each return that would have been affected by the election if it had been timely made. The taxpayer will be treated as having timely filed a required tax or information return if the return is filed within 6 months after its due date, excluding extensions;
(4) the taxpayer has reasonable cause for its failure to meet the requirements in § 1.469-9(g).

Letter Ruling 202309003 gave an extension of time to file the election because the taxpayers relied on a qualified tax professional who did not advise them that the Code § 469(c)(7) election was available to them.

[3227] *Frank Aragona Trust v. Commissioner*, 142 T.C. 165, 181 n. 17 (2014).

[3228] Referring to a limited partnership interest within the meaning of Reg. § 1.469-5T(e)(3).

[3229] Reg. § 1.469-9(f)(1), which continues the thought:

> Accordingly, the taxpayer will not be treated under this section as materially participating in the combined rental real estate activity unless the taxpayer materially participates in the activity under the tests listed in § 1.469-5T(e)(2) (dealing with the tests for determining the material participation of a limited partner).

See part II.K.1.a.ii Material Participation for a list of material participation tests, including describing which ones do not apply to limited partners.

[3230] Reg. § 1.469-9(f)(2).

[3231] CCA 201427016. For a summary of the CCA, see Miles, "Interplay of the Rental Real Estate Grouping Election and Real Estate Professional Exception," *Journal of Accountancy*, p. 62 12/1/2014. *Stanley v. U.S.*, 116 A.F.T.R.2d 2015-5419 (D. Ark. 11/12/2015), involved successful rental grouping; see fn. 3204 for IRS' nonacquiescence to *Stanley*.

or business, TP materially participates in this real property trade or business. Therefore, time spent on Property 1, Property 2, and the real property development trade or business may count towards meeting the qualifications of section 469(c)(7)(B). Because TP owns an interest in rental real estate and more than one-half of the personal services performed in trades or businesses by TP during the taxable year are performed in real property trades or businesses in which TP materially participates, and TP performs more than 750 hours of services during the taxable year in real property trades or businesses in which TP materially participates, TP is a qualifying taxpayer within the meaning of Treas. Reg. § 1.469-9(b)(6). Thus, section 469(c)(2) does not apply to any rental real estate activity of TP. Instead, a rental real estate activity of TP is not a passive activity for the taxable year if TP materially participates in the activity.

Next, once it is determined that TP is a qualifying taxpayer, we must determine whether TP materially participates in TP's rental real estate activities to determine whether these are passive activities. In accordance with section 469(c)(7)(A)(ii), because TP has not made an election under Treas. Reg. § 1.469-9(g), Property 1 and Property 2 are treated as separate rental real estate activities. Thus, TP must demonstrate material participation in Property 1 and Property 2 separately. In other words, TP must separately meet one of the tests in Treas. Reg. § 1.469-5T(a) for each of Property 1 and Property 2. Further, pursuant to Treas. Reg. § 1.469-9(e)(3), TP's participation in the real property development trade or business is disregarded in determining whether TP materially participates in Property 1 and Property 2.[3232] If, for example, TP meets one of the tests in § 1.469-5T(a) for Property 1, but not for Property 2, Property 1 will be a nonpassive activity for the taxable year, and Property 2 will be a passive activity for the taxable year.

Reg. § 1.469-9(e)(4) provides an example before and after applying Reg. § 1.469-9(e):

(i) Taxpayer B owns interests in three rental buildings, U, V and W. In 1995, B has $30,000 of disallowed passive losses allocable to Building U and $10,000 of disallowed passive losses allocable to Building V under § 1.469-1(f)(4). In 1996, B has $5,000 of net income from building U, $5,000 of net losses from building V, and $10,000 of net income from building W. Also in 1996, B is a qualifying taxpayer within the meaning of paragraph (c) of this section. Each building is treated as a separate activity of B under paragraph (e)(1) of this section, unless B makes the

[3232] [This footnote is not in the CCA.] Reg. § 1.469-9(e)(3), "Grouping rental real estate activities with other activities, provides:

(i) *In general*. For purposes of this section, a qualifying taxpayer may not group a rental real estate activity with any other activity of the taxpayer. For example, if a qualifying taxpayer develops real property, constructs buildings, and owns an interest in rental real estate, the taxpayer's interest in rental real estate may not be grouped with the taxpayer's development activity or construction activity. Thus, only the participation of the taxpayer with respect to the rental real estate may be used to determine if the taxpayer materially participates in the rental real estate activity under § 1.469-5T.

(ii) *Special rule for certain management activities*. A qualifying taxpayer may participate in a rental real estate activity through participation, within the meaning of §§ 1.469-5(f) and 5T(f), in an activity involving the management of rental real estate (even if this management activity is conducted through a separate entity). In determining whether the taxpayer materially participates in the rental real estate activity, however, work the taxpayer performs in the management activity is taken into account only to the extent it is performed in managing the taxpayer's own rental real estate interests.

election under paragraph (g) to treat the three buildings as a single rental real estate activity. If the buildings are treated as separate activities, material participation is determined separately with respect to each building. If B makes the election under paragraph (g) to treat the buildings as a single activity, all participation relating to the buildings is aggregated in determining whether B materially participates in the combined activity.

(ii) Effective beginning in 1996, B makes the election under paragraph (g) to treat the three buildings as a single rental real estate activity. B works full-time managing the three buildings and thus materially participates in the combined activity in 1996 (even if B conducts this management function through a separate entity, including a closely held C corporation). Accordingly, the combined activity is not a passive activity of B in 1996. Moreover, as a result of the election under paragraph (g), disallowed passive losses of $40,000 ($30,000 + $10,000) are allocated to the combined activity. B's net income from the activity for 1996 is $10,000 ($5,000 − $5,000 + $10,000). This net income is nonpassive income for purposes of section 469. However, under section 469(f), the net income from a former passive activity may be offset with the disallowed passive losses from the same activity. Because Buildings U, V and W are treated as one activity for all purposes of section 469 due to the election under paragraph (g), and this activity is a former passive activity under section 469(f), B may offset the $10,000 of net income from the buildings with an equal amount of disallowed passive losses allocable to the buildings, regardless of which buildings produced the income or losses. As a result, B has $30,000 ($40,000 − $10,000) of disallowed passive losses remaining from the buildings after 1996.

For more insight, see Hamill, "Group Passive Activities to Achieve Best Tax Treatment," *Estate Planning Journal* (Dec. 2016).

Aggregating real estate under Code § 469 is very different than the Code § 199A rules for aggregating activities.[3233]

II.K.1.e.iv. Active Rental Subject to AGI Limits

A natural person, with adjusted gross income within certain limits,[3234] is not subject to the passive loss rules with respect to that portion of the passive activity loss (or the deduction equivalent of the passive activity credit) for any taxable year, up to $25,000,[3235] which is attributable to all rental real estate activities with respect to which such individual actively participated in such taxable year (and if any portion of such loss or credit arose in another taxable year, in such other taxable year).[3236]

[3233] See part II.E.1.e.i.(a) Whether Real Estate Activity Constitutes A Trade Or Business, as well as parts II.E.1.c.iii.(d) Aggregating Activities for Code § 199A and II.E.1.e.i.(b) Aggregating Real Estate Businesses in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.
[3234] Code § 469(i)(3) includes the limits and which credits are not subject to them.
[3235] Code § 469(i)(2), subject to potential reduction under Code § 469(i)(4) for certain married taxpayers filing separately.
[3236] Code § 469(i)(1) , subject to potential reduction under Code § 469(i)(4) for certain married taxpayers filing separately.

An estate may receive this benefit for its taxable years ending less than two years after the date of the decedent's death,[3237] if the decedent actively participated in the year of death.[3238]

II.K.1.e.v. Rental Income Property a Taxpayer Improves, Rents Briefly, and Then Sells Is Nonpassive

A taxpayer's net rental income for the year from an item of property shall be treated as nonpassive if:[3239]

- Any gain from the sale, exchange, or other disposition of the item of property is included in the taxpayer's income for the taxable year;

- The taxpayer's use of the item of property in an activity involving the rental of the property began less than 12 months before the date of the disposition of such property;[3240] and

- The taxpayer materially participated or significantly participated for any taxable year in an activity that involved for such year the performance of services for the purpose of enhancing the value[3241] of such item of property (or any other item of property if the basis of the item of property that is sold, exchanged, or otherwise disposed of is determined in whole or in part by reference to the basis of such other item of property).

[3237] Code § 469(i)(4); Reg. § 1.645-1(e)(2)(i), (3)(i) (see part II.J.7 Code § 645 Election to Treat a Revocable Trust as an Estate).

[3238] The legislative history provides:

> The conference agreement provides that in the case of an estate of a taxpayer who, in the taxable year in which he died, owned an interest in a rental real estate activity in which he actively participated, the estate is deemed to actively participate for the two years following the death of the taxpayer. Thus, the taxpayer's estate may continue to receive the same tax treatment with respect to the rental real estate activity as did the taxpayer in the taxable year of his death. This treatment applies to the taxpayer's estate during the two taxable years of the estate following his death, to facilitate the administration of the estate without requiring the executor or fiduciary to reach decisions with respect to the appropriate disposition of the rental real property within a short period following the taxpayer's death.

[3239] Reg. § 1.469-2(f)(5), the heading to which reads, "Net income from certain property rented incidental to development activity."

[3240] Reg. § 1.469-2(f)(5)(ii) provides:

> (A) *In general*. For purposes of paragraph (f)(5)(i)(B) of this section, a taxpayer's use of an item of property in an activity involving the rental of the property commences on the first date on which-
> (1) The taxpayer owns an interest in the property;
> (2) Substantially all of the property is rented (or is held out for rent and is in a state of readiness for rental); and
> (3) No significant value-enhancing services (within the meaning of paragraph (f)(5)(ii)(B) of this section) remain to be performed.

[3241] Reg. § 1.469-2(f)(5)(iii) provides:

> *Services performed for the purpose of enhancing the value of property*. For purposes of paragraph (f)(5)(i)(C) of this section, services that are treated as performed for the purpose of enhancing the value of an item of property include but are not limited to-
> (A) Construction;
> (B) Renovation; and
> (C) Lease-up (unless more than 50 percent of the property is leased on the date that the taxpayer acquires an interest in the property).

II.K.1.f. Royalty as a Trade or Business

Royalties received by any person with respect to a license or other transfer of any rights in intangible property are considered to be derived in the ordinary course of the trade or business of licensing such property only if that person created such property or performed substantial services or incurred substantial costs with respect to the development or marketing of such property.[3242]

Generally, the determination of whether a person has performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property shall be made on the basis of all the facts and circumstances.[3243] However, a person has performed substantial services or incurred substantial costs for a taxable year with respect to the development or marketing of an item of intangible property if:[3244]

- The expenditures reasonably incurred by that person in that taxable year with respect to the development or marketing of the property exceed 50% of the gross royalties from licensing such property that are includible in that person's gross income for the taxable year; or

- The expenditures reasonably incurred by that person in that taxable year and all prior taxable years with respect to the development or marketing of the property exceed 25% of the aggregate capital expenditures (without any adjustment for amortization) made by such person with respect to the property in all such taxable years.

The consequence of failing this test is that the royalty income constitutes portfolio income.[3245]

If a taxpayer acquires an interest in an entity after the entity has created an item of intangible property or performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property, the taxpayer's gross royalty income for the taxable year from such item of property equal to the taxpayer's net royalty income (but not net royalty loss) for the year from that item of property is nonpassive.[3246]

II.K.1.g. Not Passive If Gain from Sale of Self-Created Intangible

Reg. § 1.469-2T(c)(7)(i) provides:

> Notwithstanding any other provision of the regulations under section 469, passive activity gross income does not include … gross income of an individual from intangible property, such as a patent, copyright, or literary, musical, or artistic composition, if the taxpayer's personal efforts significantly contributed to the creation of such property ….

[3242] Reg. § 1.469-2T(c)(3)(iii)(B)(1).
[3243] Reg. § 1.469-2T(c)(3)(iii)(B)(2)(i).
[3244] Reg. § 1.469-2T(c)(3)(iii)(B)(2)(ii). In applying this test, expenditures in a taxable year include amounts chargeable to capital account for such year without regard to the year or years (if any) in which any deduction for such expenditure is allowed. Reg. § 1.469-2T(c)(3)(iii)(B)(2)(ii). Also, in the case of any intangible property held by a partnership, S corporation, estate, or trust, the determination of whether royalties from such property are derived in the ordinary course of a trade or business shall be made by applying these rules to such entity and not to any holder of an interest in such entity. Reg. § 1.469-2T(c)(3)(iii)(B)(3)
[3245] Reg. § 1.469-2T(c)(3)(iv), Example (5)(ii).
[3246] Reg. § 1.469-2T(f)(7)(i).

I am unaware of rules governing whether “the taxpayer’s personal efforts significantly contributed to the creation of” intangible property. However, Reg. § 1.469-2T(c)(3)(iii)(B)(2)(ii) determines whether a taxpayer has performed substantial services for a taxable year with respect to the development of an item of intangible property,[3247] so looking there may provide a clue.

Reg. § 1.469-2T(c)(7)(i) applies to gain on sale of the intangible. For income from licensing the intangible, see part II.K.1.f Royalty as a Trade or Business.

II.K.1.h. Working Interest in Oil and Gas Property

“Passive activity” does not include any working interest in any oil or gas property which the taxpayer holds directly or through an entity[3248] which does not limit the liability of the taxpayer with respect to such interest.[3249]

If any taxpayer has any loss for any taxable year from a working interest in any oil or gas property which is treated as a nonpassive loss, then any net income from such property (or certain replacement property) for any succeeding taxable year shall be treated as nonpassive income.[3250]

The rules described above apply without regard to whether the taxpayer materially participated in the activity.[3251] On the other hand, if a taxpayer holds the working interest through a limited liability entity, then the exception does not apply, but the working interest might nevertheless be a trade or business in which the taxpayer materially participates or for some other reason is nonpassive.

“Working interest” means a working or operating mineral interest in any tract or parcel of land.[3252]

[3247] See fn 3244 and accompanying text in part II.K.1.f Royalty as a Trade or Business.

[3248] Reg. § 1.469-1T(e)(4)(v)(A) precludes holding a working interest in a limited partnership in which the taxpayer is not a general partner, a corporation, or any other entity “that, under applicable State law, limits the potential liability of a holder of such an interest for all obligations of the entity to a determinable fixed amount (for example, the sum of the taxpayer’s capital contributions),” which presumably would encompass LLCs and LLPs. Indemnification agreements inside partnership agreements don’t count; see Reg. § 1.469-1T(e)(4)(v)(C), Example (1). Being liable for a fractional portion of all liabilities suffices to provide liability, even without joint and several liability; see Reg. § 1.469-1T(e)(4)(v)(C), Example (2). A limited partner who is also a general partner is considered to have liability with respect to the interest as a limited partner as well; see Reg. § 1.469-1T(e)(4)(v)(C), Example (3).
Note that an indemnification agreement, a stop loss arrangement, insurance, or any other combination of contractual rights does not constitute a prohibited entity. Reg. § 1.469-1T(e)(4)(v)(B).

[3249] Code § 469(c)(3)(A); see Reg. § 1.469-1T(e)(4) for more details.

[3250] Code § 469(c)(3)(B); see Reg. §§ 1.469-2(c)(6) and 1.469-2T(c)(6)(iv), Example (3).

[3251] Code § 469(c)(4).

[3252] Reg. § 1.469-1(e)(4)(iv), referring to Reg. § 1.612-4(a), which addresses intangible drilling and development costs incurred by an operator but does not provide a quick explanation of what a working interest is. CCA 200952054 reasons:

> Section 1.469-1(e)(4)(iv) of the Income Tax Regulations provides that for purposes of § 469 and the regulations thereunder, the term “working interest” means a working or operating mineral interest in any tract or parcel of land (within the meaning of § 1.612-4(a)). Thus, the regulations

II.K.1.i. Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income

II.K.1.i.i.(a). Overview of Rules Recharacterizing PIGs as Nonpassive Income

Originally, passive income generators (PIGs) had the favorable characteristic of being able to be sheltered by passive losses without having any unfavorable characteristics. Now, the 3.8% tax makes PIGs unfavorable to the extent that their income exceeds passive losses.[3253] Those seeking to avoid passive income will be happy to learn that the IRS adopted rules limiting PIGs, as described below.

Although significant participation activities can be considered nonpassive, a taxpayer might not meet all of the requirements to make them nonpassive.[3254] If that's the case, but all significant participation passive activities net to become a PIG, a special rule converts the net passive income into nonpassive income for purposes of the passive loss rules[3255] and for purposes of the 3.8% tax on net investment income.[3256] "Significant participation passive activity" means any trade or business activity[3257] in which the taxpayer significantly participates[3258] for the taxable year but in which the taxpayer does not materially participate[3259] for such year.[3260]

Land rentals generally are treated as nonpassive: If less than 30% of the unadjusted basis of the property used or held for use by customers in a rental activity during the taxable year is

under § 469 define working interest in oil or gas property, for purposes of § 469(c)(3), by reference to the depletion rules set forth in §§ 611-614 and the regulations thereunder.

In general, § 611 provides for a reasonable allowance for depletion in the case of mines, oil and gas wells, and other natural deposits. Section 614 defines the term "property," for purposes of computing the allowance for depletion, as "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land." Section 1.614-1(a)(2) provides that the term "interest" means an economic interest in a mineral deposit. Mineral deposit is defined in § 1.611-1(d)(4) as referring to minerals in place. Section 1.611-1(d)(5) defines minerals to include ores of metals, coal, oil, gas, and all other natural metallic and nonmetallic deposits. That section further states that "minerals" includes all of the minerals and other natural deposits subject to depletion.

Thus, the exception provided by § 469(c)(3) for any working interest in any oil or gas property is limited to a working interest in natural deposits of oil and gas.

[3253] See part II.I 3.8% Tax on Excess Net Investment Income, especially part II.I.8 Application of 3.8% Tax to Business Income.

[3254] See fns. 3062-3063 and accompanying text, found in part II.K.1.a.ii Material Participation.

[3255] Reg. § 1.469-2T(f)(2)(i). The Example at the end of Reg. § 1.469-2T(f)(2) clarifies its application.

[3256] Reg. § 1.1411-5(2)(i).

[3257] Within the meaning of Reg. § 1.469-1T(e)(2), which cross-references to Reg. § 1.469-1(e)(2), which in turn cross-references to Reg. § 1.469-4(b)(1), which is reproduced in fn. 3131 within part II.K.1.b.ii Grouping Activities – General Rules. It all boils down to engaging or preparing to engage in a Code § 162 "trade or business" or incurring Code § 174 research or experimental expenditures, but does not include "rental activities or activities that are treated as incidental to an activity of holding property for investment."

[3258] Within the meaning of Reg. § 1.469-5T(c)(2), which defines significant participation as more than 100 hours during the taxable year.

[3259] Within the meaning of Reg. § 1.469-5T, which is described in part II.K.1.a Counting Work as Participation.

[3260] Reg. § 1.469-2T(f)(2)(ii). Reg. § 1.469-2T(f)(2)(iii) provides an example.

depreciable, an amount of the taxpayer's gross income from the activity equal to the taxpayer's net passive income from the activity shall be treated as nonpassive.[3261]

An amount of the taxpayer's gross income for the taxable year from any equity-financed lending activity shall be considered as nonpassive to the extent of the lesser of the taxpayer's equity-financed interest income[3262] from the activity for such year and the taxpayer's net passive income from the activity for such year.[3263] An activity is an equity-financed lending activity for a taxable year if the activity involves a trade or business of lending money and the average outstanding balance[3264] of the liabilities incurred in the activity[3265] for the taxable year does not exceed 80% of the average outstanding balance of the interest-bearing assets[3266] held in the activity for such year.[3267]

The amount of gross income from an activity that is treated as not from a passive activity for the taxable year under the above bullet points shall not exceed the greatest amount of gross income treated as not from a passive activity under any one of these bullet points.[3268]

Also, generally, if a taxpayer acquires an interest in a development entity after the development entity has created an item of intangible property or performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property, an amount of the taxpayer's gross royalty income for the taxable year from such item of property equal to the taxpayer's net royalty income for the year from such item of property shall be treated as nonpassive income.[3269]

[3261] Reg. § 1.469-2T(f)(3).

[3262] The taxpayer's equity-financed interest income from an activity for a taxable year is the amount of the taxpayer's net interest income from the activity for such year multiplied by the fraction obtained by dividing (a) the excess of the average outstanding balance for such year of the interest-bearing assets held in the activity over the average outstanding balance for such year of the liabilities incurred in the activity, by (b) the average outstanding balance for such year of the interest-bearing assets held in the activity. Reg. § 1.469-2T(f)(4)(iii). The net interest income from an activity for a taxable year is (a) the gross interest income from the activity for such year, reduced by (b) expenses from the activity (other than interest on liabilities used in this test) for such year that are reasonably allocable to such gross interest income. Reg. § 1.469-2T(f)(4)(iv).

[3263] Reg. § 1.469-2T(f)(4)(i).

[3264] The average outstanding balance of liabilities incurred in an activity or of the interest-bearing assets held in an activity may be computed on a daily, monthly, or quarterly basis at the option of the taxpayer. Reg. § 1.469-2T(f)(4)(vii).

[3265] Liabilities incurred in an activity include all fixed and determinable liabilities incurred in the activity that bear interest or are issued with original issue discount other than debts secured by tangible property used in the activity. Reg. § 1.469-2T(f)(4)(vi). In the case of an activity conducted by an entity in which the taxpayer owns an interest, liabilities incurred in an activity include only liabilities with respect to which the entity is the borrower. Reg. § 1.469-2T(f)(4)(vi).

[3266] Interest-bearing assets held in an activity include all assets that produce interest income, including loans to customers. Reg. § 1.469-2T(f)(4)(v).

[3267] Reg. § 1.469-2T(f)(4)(ii)(A). Liabilities incurred principally for the purpose of increasing the percentage of the average outstanding balance of the interest-bearing assets shall not be taken into account in computing such percentage. Reg. § 1.469-2T(f)(4)(ii)(B).

[3268] Reg. § 1.469-2T(f)(8).

[3269] Reg. § 1.469-2T(f)(7).

II.K.1.i.i.(b). Tax Trap from Recharacterizing PIGs as Nonpassive Income

The government appears to have whipsawed business owners whose income is recharacterized as nonpassive when the activity itself remains classified as passive. Tax credits that are subject to the passive loss rules do not appear to be creditable against such income. Below is a discussion of which credits are subject to this rule, how these rule works, and planning tips.

A credit is suspended if it "arises in connection with the conduct of an activity that is a passive activity for such taxable year"[3270] and is described in subpart D of part IV of subchapter A or in subpart B (other than Code § 27(a)) of such part IV.[3271] The regulation describing the credits omits credits enacted after the regulations were promulgated, so be careful to focus on the statutory provisions.[3272] Subpart D includes any Code section numbered 38 (general business credit) and higher but is less than 46. Subpart B includes any Code section numbered 27 and higher but is less than 31. At the time I wrote this sentence, Code § 38(b) enumerated 36 credits, so always check Code § 38 in addition to making sure the credit does not fall within Subpart B or D.

Note that the regulation refers to arising "in connection with a passive activity" and does not refer to whether the activity's income is passive. "Passive activity means "a trade or business activity … in which the taxpayer does not materially participate for such taxable year" or certain rental activities.[3273]

An enumerated credit is suspended except to the extent that it is allocable to "regular tax liability"[3274] generated "by the excess (if any) of the taxpayer's passive activity gross income for such year over the taxpayer's passive activity deductions…."[3275]

Reg. § 1.469-2T(f):

> sets forth rules that require income from certain passive activities to be treated as income that is not from a passive activity (regardless of whether such income is treated as passive activity gross income under section 469 or any other provision of the regulations thereunder).

Note that the income is recharacterized, but the classification as a "passive activity" is not altered. Thus, an enumerated credit appears to remain passive, even if its income is recharacterized as nonpassive.

[3270] Reg. § 1.469-3T(b)(1)(i)(A).
[3271] Code § 469(d)(2)(A).
[3272] Sutton & Howell-Smith, ¶ 3.01[1] Credits Subject to Limitation, *Federal Income Taxation of Passive Activities* (WG&L) (detailed commentary). For a list of credits subject to this rule, see CCH's *Tax Research Consultant*, BUSEXP: 33,252, Credits Subject to Passive Activity Limitation (simple list).
[3273] Reg. § 1.469-1T(e)(1)(i).
[3274] Reg. § 1.469-3T(d)(2) refers the definition of "regular tax liability" in Code § 26(b), which in turn refers to tax determined under Chapter 1, subject to some exceptions from Chapter 1. Chapter 1 include Code sections numbered at least 1 and less than 1401.
[3275] Reg. § 1.469-3T(d)(1)(ii). Reg. § 1.469-2T(c)(1) provides:

> Except as otherwise provided in the regulations under section 469, passive activity gross income for a taxable year includes an item of gross income if and only if such income is from a passive activity.

This observation holds true for significant participation activities (highlighting added):[3276]

> An amount of the taxpayer's gross income from each significant participation passive activity for the taxable year equal to a ratable portion of the taxpayer's net passive income from such activity for the taxable year shall be treated as not from a passive activity if the taxpayer's passive activity gross income from all significant participation passive activities for the taxable year … exceeds the taxpayer's passive activity deductions from all such activities for such year.

Thus, any enumerated credit that arises from a purely[3277] significant participation activity would appear to be a passive credit that cannot be used to offset tax on that activity's income that year.

The analysis above appears to be confirmed by reading IRS Form 8582-CR, in which one calculates allowable passive credits, allowing them only against tax on passive income shown on IRS Form 8582. The instructions to IRS Form 8582 say not to report income from significant participation activities on IRS Form 8582.

I have not found any article, treatise, or government pronouncement directly addressing this issue. Until then, I assume the analysis above is correct.

Note, however, that passive credits are suspended, not lost. If a passive credit is not allowable one year, it is suspended and carried to the next year.[3278] Consider a taxpayer with income and credits from a significant participation activity. If sufficient amounts of suspended passive credits accumulate, the taxpayer might consider intentionally flunking the significant participation test one year and paying net investment income tax but generating passive income against which current and suspended credits may be taken. Whether such a strategy would work depends on the characteristics of the particular credit and taxpayer's tax posture for that year, factors that would need to be analyzed if the situation arises. In other words, I would not suggest counting on using this strategy but would suggest exploring it when planning to obtain credits that are such to the passive activity rules.

Some credits are in lieu of a deduction. When considering the use of credits, those who run businesses subject to these rules might consider the tax characteristics of each owner to decide whether the owners can actually use the credits.

[3276] Reg. § 1.469-2T(f)(2)(i).

[3277] Note, however, that significant participation activities may be aggregated to constitute material participation. See fns. 3062-3063 and accompanying text, found in part II.K.1.a.ii Material Participation.

[3278] Code § 469(b). The suspended credit is then re-tested each year. Reg. § 1.469-3T(b)(1)(ii), referring to Reg. § 1.469-1T(f)(4), which refers to Reg. § 1.469-1(f)(4). Reg. § 1.469-1(f)(4)(i) provides:

- (i) ***In general***. In the case of an activity of a taxpayer with respect to which any deductions or credits are disallowed for a taxable year under § 1.469-1T(f)(2) or (f)(3) (the loss activity)—
  - (A) The disallowed deductions or credits is [sic] allocated among the taxpayer's activities for the succeeding taxable year in a manner that reasonably reflects the extent to which each activity continues the loss activity; and
  - (B) The disallowed deductions or credits allocated to an activity under paragraph (f)(4)(i)(A) of this section shall be treated as deductions or credits from the activity for the succeeding taxable year.

Note that materially participating would prevent these issues from arising, as well as providing other benefits.[3279] Furthermore, one who significantly participates but cannot work more than 500 hours can avoid this trap by not hiring anyone else who works for more than that person.[3280]

II.K.1.j. Complete Disposition of Passive Activity

Code § 469(g) provides:

> *Dispositions of entire interest in passive activity*. If during the taxable year a taxpayer disposes of his entire interest in any passive activity (or former passive activity), the following rules shall apply:
>
> (1) *Fully taxable transaction*.
>
> (A) *In general*. If all gain or loss realized on such disposition is recognized, the excess of—
>
> (i) any loss from such activity for such taxable year (determined after the application of subsection (b)), over
>
> (ii) any net income or gain for such taxable year from all other passive activities (determined after the application of subsection (b)),
>
> shall be treated as a loss which is not from a passive activity.
>
> (B) *Subparagraph (A) not to apply to disposition involving related party*. If the taxpayer and the person acquiring the interest bear a relationship to each other described in section 267(b) or section 707(b)(1), then subparagraph (A) shall not apply to any loss of the taxpayer until the taxable year in which such interest is acquired (in a transaction described in subparagraph (A)) by another person who does not bear such a relationship to the taxpayer.
>
> (C) *Income from prior years*. To the extent provided in regulations, income or gain from the activity for preceding taxable years shall be taken into account under subparagraph (A)(ii) for the taxable year to the extent necessary to prevent the avoidance of this section.
>
> (2) *Disposition by death*. If an interest in the activity is transferred by reason of the death of the taxpayer—
>
> (A) paragraph (1)(A) shall apply to losses described in paragraph (1)(A) to the extent such losses are greater than the excess (if any) of—
>
> (i) the basis of such property in the hands of the transferee, over

[3279] Such as allowing losses in a down year or satisfying the rule that treats as materially participating any taxpayer who participating for more than 500 hours in 5 of the most recent 10 years. See parts II.K.1.a.ii Material Participation and II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.
[3280] See part II.K.1.a.ii Material Participation, particularly fns. 3060-3061.

(ii) the adjusted basis of such property immediately before the death of the taxpayer, and

(B) any losses to the extent of the excess described in subparagraph (A) shall not be allowed as a deduction for any taxable year.

(3) *Installment sale of entire interest*. In the case of an installment sale of an entire interest in an activity to which section 453 applies, paragraph (1) shall apply to the portion of such losses for each taxable year which bears the same ratio to all such losses as the gain recognized on such sale during such taxable year bears to the gross profit from such sale (realized or to be realized when payment is completed).

For Code § 469(g)(2), see part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses and part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships, the latter being Code § 707(b). The IRS' Passive Activity Loss Audit Technique Guide (2/2005)[3281] says:

> **Verify that disposition is not to a *related party***. See IRC § 469(g)(1)(B), § 267, § 707(b). If passive activity was sold or otherwise transferred to a related party, losses stay with the taxpayer. There is not a triggering disposition. The following are related parties: Spouse, brothers, sisters, sons, daughters, grandchildren; an individual and a corporation owned more than 50 percent by the same person; a partnership and a partner who owns more than 50 percent. The IRC § 267(a) disallows losses for sales or exchanges to related parties under IRC 267(b).
>
> Be sure to look at the ownership percent on the Schedule K-1. Under IRC § 707(b)(1)(A), if a person, directly or indirectly, owns more than 50 percent of the capital interest or the profits interest of a partnership, he is a related party.

When a taxpayer disposes of a passive activity with current and suspended passive losses that exceed the gain on disposition, the net passive income and net passive losses from all of the taxpayer's other passive activities should be netted before any excess passive income is applied against the current and suspended passive losses from the disposed of activities, and any excess losses from the disposed of activity are treated as nonpassive under Code § 469(g)(1)(A).[3282] The Conference Committee Report for the Tax Reform Act of 1986 explained a disposition under Code § 469(g)(1)(A):

[3281] Downloaded from https://www.irs.gov/pub/irs-mssp/pal.pdf.

[3282] TAM 9742002, which continued:

> Please note, however, that it has been represented that the taxpayer in this case did not realize any gain on disposition of the passive activities in b. To the extent that the taxpayer may have realized any gain on disposition, however, this disposition gain must first be applied against the current and suspended losses from the disposed of activities, before section 469(g)(1)(A) is applied.

For the impact of Code § 469 on the 3.8% net investment income tax, see part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation, particularly the text accompanying fn. 2448.

Dispositions.

In general.

The conference agreement generally follows the Senate amendment with respect to dispositions of interests in passive activities which trigger the allowance of suspended losses. The conference agreement clarifies, however, that a transaction constituting a sale (or other taxable disposition) in form, to the extent not treated as a taxable disposition under general tax rules, does not give rise to the allowance of suspended deductions. For example, sham transactions, wash sales, and transfers not properly treated as sales due to the existence of a put, call, or similar right relating to repurchase, do not give rise to the allowance of suspended losses.

Related party transactions.

The conference agreement provides that the taxpayer is not treated as having disposed of an interest in a passive activity, for purposes of triggering suspended losses, if he disposes of it in an otherwise fully taxable transaction to a related party (within the meaning of section 267(b) or 707(b)(1), including applicable attribution rules). In the event of such a related party transaction, because it is not treated as a disposition for purposes of the passive loss rule, suspended losses are not triggered, but rather remain with the taxpayer. Such suspended losses may be offset by income from passive activities of the taxpayer.

When the entire interest owned by the taxpayer and the interest transferred to the related transferee in the passive activity are transferred to a party who is not related to the taxpayer (within the meaning of section 267(b) or 707(b)(1), including applicable attribution rules) in a fully taxable disposition, then to the extent the transfer would otherwise qualify as a disposition triggering suspended losses, the taxpayer may deduct the suspended losses attributable to his interest in the passive activity.

Certain insurance transactions.

Clarification is provided with respect to certain transactions involving dispositions of interests in syndicates that insure U.S. risks. Generally, when an owner of an interest in such a syndicate that is treated as a passive activity enters into a transaction whereby he disposes of his interest in the syndicate in a fully taxable closing transaction, he is treated as having made a disposition of his interest in the passive activity.

Abandonment.

The scope of a disposition triggering suspended losses under the passive loss rule includes an abandonment, constituting a fully taxable event under present law, of the taxpayer’s entire interest in a passive activity. Thus, for example, if the taxpayer owns rental property which he abandons in a taxable event which would give rise to a deduction under section 165(a) of present law, the abandonment constitutes a taxable disposition that triggers the recognition of suspended losses under the passive loss rule.

Similarly, to the extent that the event of the worthlessness of a security is treated under section 165(g) of the Code as a sale or exchange of the security, and the event otherwise represents the disposition of an entire interest in a passive activity, it is treated as a disposition. No inference is intended with respect to whether a security includes an interest in any entity other than a corporation.

Interaction with capital loss limitation.

Upon a fully taxable disposition of a taxpayer's entire interest in a passive activity, the passive loss rule provides that any deductions previously suspended with respect to that activity are allowed in full. However, to the extent that any loss recognized upon such a disposition is a loss from the sale or exchange of a capital asset, it is limited to the amount of gains from the sale or exchange of capital assets plus $3,000 (in the case of individuals). The limitation on the deductibility of capital losses is applied before the determination of the amount of losses allowable upon the disposition under the passive loss rule.

Thus, for example, if a taxpayer has a capital loss of $10,000 upon the disposition of a passive activity, and is also allowed to deduct $5,000 of previously suspended ordinary losses as a result of the disposition, the $5,000 of ordinary losses are allowed, but the capital loss deduction is limited to $3,000 for the year (assuming the taxpayer has no other gains or losses from the sale of capital assets for the year). The remainder of the capital loss from the disposition is carried forward and allowed in accordance with the provisions determining the allowance of such capital losses.

Basis adjustment for credits.

Under the conference agreement, an election is provided in the case of a fully taxable disposition of an interest in an activity in connection with which a basis adjustment was made as a result of placing in service property for which a credit was taken. Upon such a disposition, the taxpayer may elect to increase the basis of the credit property (by an amount no greater than the amount of the original basis reduction of the property) to the extent that the credit has not theretofore been allowed by reason of the passive loss rule. At the time of the basis adjustment election, the amount of the suspended credit which may thereafter be applied against tax liability is reduced by the amount of the basis adjustment. The purpose for providing this election is to permit the taxpayer to recognize economic gain or loss, taking account of the full cost of property for which no credit was allowed.

This rule may be illustrated as follows. A taxpayer places in service rehabilitation credit property generating an allowable credit of $50, and reduces the basis of the property by $50 as required by the provisions governing the rehabilitation credit, but is prevented under the passive loss rule from taking any portion of the credit. In a later year, having been allowed no portion of the credit by virtue of the passive loss rule, the taxpayer disposes of his entire interest in the activity, including the property whose basis was reduced. Immediately prior to the disposition, the taxpayer may elect to increase basis of the credit property by the amount of the original basis adjustment (to the extent of the amount of the unused credit) with respect to the property.

If the property is disposed of in a transaction that, under the passive loss rule, does not constitute a fully taxable disposition of the taxpayer's entire interest in the passive activity, then no basis adjustment may be elected at any time. To the extent the credit has been suspended by virtue of the passive loss rule, however, it may remain available to offset tax liability attributable to passive income.

Disposition of activity of limited partnership.

In general, under the passive loss rule, suspended deductions are allowed upon a taxable disposition of the taxpayer's entire interest in an activity, because it becomes possible at that time to measure the taxpayer's actual gain or loss from the activity. Under the Senate amendment, a special rule would apply to dispositions with respect to limited partnership interests. The special rule requires the taxpayer to dispose of his entire interest in the limited partnership (along with all other interests that are part of the passive activity) in order to trigger suspended deductions with respect to any activities conducted by the limited partnership.

The conferees believe that it is not appropriate to disallow a true economic loss realized upon the disposition of the taxpayer's entire interest in an activity by reason of the taxpayer's form of ownership. Therefore, the conference agreement eliminates this special rule for dispositions of limited partnership activities, and provides instead that a disposition of the taxpayer's entire interest in an activity conducted by a limited partnership, like a disposition of an activity conducted in any other form, may constitute a disposition giving rise to the allowance of suspended deductions from the activity.

The conferees do not, however, intend to change the rule that a limited partnership interest in an activity is (except as provided in Treasury regulations) treated as an interest in a passive activity. Because a limited partner generally is precluded from materially participating in the partnership's activities, losses and credits attributable to the limited partnership's activities are generally treated as from passive activities, except that items properly treated as portfolio income and personal service income are not treated as passive.

Changes in nature of activity.

The fact that the nature of an activity changes in the course of its development does not give rise to a disposition for purposes of the passive loss provision. For example, when a real estate construction activity becomes a rental activity upon the completion of construction and the commencement of renting the constructed building, the change is not treated as a disposition.

Losses disallowed by the passive loss rules are suspended and carried into future years.[3283]

The IRS' Passive Activity Loss Audit Technique Guide (2/2005)[3284] says:

FORM 8582: Dispositions with Net Gain

As indicated above, gain on the sale or other disposition generally is passive income. Gain on Form 4797 and Schedule D should first offset losses from the same activity. If any gain remains, it offsets losses from other unrelated passive activities.

On dispositions with an overall net gain, the net gain, current losses, and suspended losses are all reflected on Form 8582. Entering the gain, but not the losses, on the

[3283] IRS Publication 925 explains the passive loss and at-risk rules generally. The IRS' "Passive Activity Loss Audit Technique Guide (2/2005) is at http://www.irs.gov/pub/irs-mssp/pal.pdf.
[3284] Downloaded from https://www.irs.gov/pub/irs-mssp/pal.pdf.

Form 8582 results in unrelated passive losses being allowed in error. Any gain must first offset losses from the same activity.

The purpose of Form 8582 is purely computational. The examiner should verify that all income shown on Form 8582 line 1a or 3a is reflected elsewhere on the return, most commonly on Schedule E or Schedule D. The Form 8582 does not report income. If income shown on Form 8582 is not reflected on the return, it is unreported income!

Summary

- For current and suspended losses to be deductible, the taxpayer must sell or otherwise dispose of his entire interest in a passive activity.

- The disposition must be a fully taxable transaction. Transfers to other entities and likekind exchanges are non-qualifying dispositions. Losses remain on Form 8582.

- When a taxpayer dies, only losses in excess of the step-up in basis are allowed. Stated differently, the decedent's losses are allowed only to the extent they exceed the amount by which the beneficiary's basis in the passive activity has been increased. [citing Code § 469(g)(2)]

- On an installment sale, losses are triggered in ratio to gain reported.

- When gain and current and suspended losses are netted, if there is an overall loss, nothing should be entered on Form 8582.

- If there is an overall gain on disposition, all gains and losses should be entered on Form 8582. Any excess gain, generally is passive income which may trigger deductibility of unrelated passive losses.

The IRS' Passive Activity Loss Audit Technique Guide (2/2005)[3285] continues with some other sources:

- IRC § 469(j)(6): When a passive loss is gifted to a person or charity, losses are added to the donee's basis. They are not deductible by the taxpayer/donor.

- IRC § 469(j)(12): When an estate or trust distributes a passive activity, losses are not deductible by the estate or trust. They are added to the beneficiary's basis.[3286]

- IRC § 1398(f)(1), Reg. § 1.1398-1(d)(1): A transfer of an interest in a passive activity between an individual and a bankruptcy estate is not a qualifying disposition, which triggers deductibility of losses.

- Reg. § 1.469-2T(c)(2)(i)(A)(2): Gain on disposition generally is passive income if the activity was a passive activity in the year of disposition.

[3285] Downloaded from https://www.irs.gov/pub/irs-mssp/pal.pdf.
[3286] [My footnote:] See part II.K.2.d Effect of Death of an Individual or Termination of Trust on Suspended Passive Losses.

- Reg. § 1.469-2T(c)(2)(i)(A)(3): Gain on disposition is not passive income if the activity is not a passive activity in the taxable year of disposition.

- Reg. § 1.469-2T(f)(3): If less than 30 percent of the unadjusted basis of leased property is depreciable, gain is non-passive.

- Reg. § 1.469-2(f)(6): Gain on the sale (or rental income) of property leased to a business in which the taxpayer materially participates (i.e. where he regularly works) is non-passive.

- Reg. § 1.469-4(g): If substantially all of an activity is sold, that portion may be treated as a separate activity.

- Reg. § 1.469-6 on dispositions has not yet been written. Thus, we have no regulations on dispositions other than those mentioned above.

Code § 469(j)(6), "Special rule for gifts" (referred to above), provides:

> In the case of a disposition of any interest in a passive activity by gift—
>
> (A) the basis of such interest immediately before the transfer shall be increased by the amount of any passive activity losses allocable to such interest with respect to which a deduction has not been allowed by reason of subsection (a), and
>
> (B) such losses shall not be allowable as a deduction for any taxable year.

If the taxpayer gives less than the taxpayer's entire interest in the property, the allocable portion of his unused losses are added to the donee's basis.[3287]

Reg. § 1.469-2T(c)(2), "Treatment of gain from disposition of an interest in an activity or an interest in property used in an activity," provides the following rules generally in Reg. § 1.469-2T(c)(2)(i), "In general":

> (A) *Treatment of gain*. Except as otherwise provided in the regulations under section 469, any gain recognized upon the sale, exchange, or other disposition (a "disposition") of an interest in property used in an activity at the time of the disposition or of an interest in an activity held through a partnership or S corporation is treated in the following manner:
>
> (1) The gain is treated as gross income from such activity for the taxable year or years in which it is recognized;
>
> (2) If the activity is a passive activity of the taxpayer for the taxable year of the disposition, the gain is treated as passive activity gross income for the taxable year or years in which it is recognized; and

[3287] ¶ M-5705, "Basis adjustments under passive activity rules for dispositions by gift," *Federal Tax Coordinator*, citing S. Rept. No. 99-313 (P.L. 99-514). p. 726.

(3) If the activity is not a passive activity of the taxpayer for the taxable year of the disposition, the gain is treated as not from a passive activity.

(B) *Dispositions of partnership interests and S corporation stock*. A partnership interest or S corporation stock is not property used in an activity for purposes of this paragraph (c)(2). See paragraph (e)(3) of this section for rules treating the gain recognized upon the disposition of a partnership interest or S corporation stock as gain from the disposition of interests in the activities in which the partnership or S corporation has an interest.

(C) *Interest in property*. For purposes of applying this paragraph (c)(2) to a disposition of property—

(1) Any material portion of the property that was used, at any time before the disposition, in any activity at a time when the remainder of the property was not used in such activity shall be treated as a separate interest in property; and

(2) The amount realized from the disposition and the adjusted basis of the property must be allocated among the separate interests in a reasonable manner.

(D) *Examples*. The following examples illustrate the application of this paragraph (c)(2)(i):

Example (1). A owns an interest in a trade or business activity in which A has never materially participated. In 1987, A sells equipment that was used exclusively in the activity and realizes a gain on the sale. Under paragraph (c)(2)(i)(A)(2) of this section, the gain is passive activity gross income.

Example (2). B owns an interest in a trade or business activity in which B materially participates for 1987. In 1987, B sells a building used in the activity in an installment sale and realizes a gain on the sale. B does not materially participate in the activity for 1988 or any subsequent year. Under paragraph (c)(2)(i)(A)(3) of this section, none of B’s gain from the sale (including gain taken into account after 1987) is passive activity gross income.

Example (3). C enters into a contract to acquire property used by the seller in a rental activity. Before acquiring the property pursuant to the contract, C sells all rights under the contract and realizes a gain on the sale. Since C’s rights under the contract are not property used in a rental activity, the gain is not income from a rental activity. The result would be the same if C owned an option to acquire the property and sold the option.

Example (4). D sells a ten-floor office building. D owned the building for three years preceding the sale and at all times during that period used seven floors of the building in a trade or business activity and three floors in a rental activity. The fair market value per square foot is substantially the same throughout the building, and D not maintain a separate adjusted basis for any part of the building. Under paragraph (c)(2)(i)(C)(1) of this section, the seven floors used in the trade or business activity and the three floors used in the rental activity are treated as separate interests in property. Under paragraph (c)(2)(i)(C)(2) of this section, the amount realized and the adjusted basis of the building must be allocated between the separate interests in a reasonable manner. Under these facts, an allocation based on the square footage of the parts of the building used in each activity would be reasonable.

Example (5). The facts are the same as in example (4), except that two of the seven floors used in the trade or business activity were used in the rental activity until five months before the sale. Under paragraph (c)(2)(i)(C)(1) of this section, the five floors used exclusively in the trade or business activity and the two floors used first in the rental activity and then in the trade or business activity are treated as separate interests in property. See paragraph (c)(2)(ii) of this section for rules for allocating amount realized and adjusted basis upon a disposition of an interest in property used in more than one activity during the 12-month period ending on the date of the disposition.

Reg. § 1.469-2T(c)(2)(ii), "Disposition of property used in more than one activity in 12-month period preceding disposition," provides:

In the case of a disposition of an interest in property that is used in more than one activity during the 12-month period ending on the date of the disposition, the amount realized from the disposition and the adjusted basis of such interest must be allocated among such activities on a basis that reasonably reflects the use of such interest in property during such 12-month period. For purposes of this paragraph (c)(2)(ii), an allocation of the amount realized and adjusted basis solely to the activity in which an interest in property is predominantly used during the 12-month period ending on the date of the disposition reasonably reflects the use of such interest in property if the fair market value of such interest does not exceed the lesser of—

(A) $10,000; and

(B) 10 percent of the sum of the fair market value of such interest and the fair market value of all other property used in such activity immediately before the disposition.

The following examples illustrate the application of this paragraph (c)(2)(ii):

Example (1). The facts are the same as in example (5) of paragraph (c)(2)(i)(D) of this section. Under paragraph (c)(2)(i)(C)(2) of this section, D allocates the amount realized and adjusted basis of the building 30 percent to the three floors used exclusively in the rental activity, 50 percent to the five floors used exclusively in the trade or business activity, and 20 percent to the two floors used first in the rental activity and then in the trade or business activity. Under this paragraph (c)(2)(ii), the amount realized and adjusted basis allocated to the two floors that were used in both activities during the 12-month period ending on the date of the disposition must also be allocated between such activities. Under these facts, an allocation of 7/12 of such amounts to the rental activity and 5/12 of such amounts to the trade or business activity would reasonably reflect the use of the two floors during the 12-month period ending on the date of the disposition.

Example (2). B is a limited partner in a partnership that sells a tractor-trailer. During the 12-month period ending on the date of the sale, the tractor-trailer was used in several activities, and the partnership allocates the amount realized from the disposition and the adjusted basis of the tractor-trailer among the activities based on the number of days during the 12-month period that the partnership used the tractor-trailer in each activity. Under these facts, the partnership's allocation reasonably reflects the use of the tractor-trailer during the 12-month period ending on the date of the sale.

Example (3). C sells a personal computer for 8,000. During the 12-month period ending on the date of the sale, 70 percent of C's use of the computer was in a passive activity. Immediately before the sale, the fair market value of all property used in the passive activity (including the personal computer) was $200,000. Under these facts, the computer was predominantly used in the passive activity during the 12-month period ending on the date of the sale, and the value of the computer, as measured by its sale price ($8,000), does not exceed the lesser of (a) $10,000, and (b) 10 percent of the value of all property used in the activity immediately before the sale ($20,000). C allocates the amount realized and the adjusted basis solely to the passive activity. Under this paragraph (c)(2)(ii), C's allocation reasonably reflects the use of the computer during the 12-month period ending on the date of the sale.

Reg. § 1.469-2T(c)(2)(iii), "Disposition of substantially appreciated property formerly used in nonpassive activity," provides:

[Reserved] See § 1.469-4(c)(2)(iii) for rules relating to this paragraph.

Reg. § 1.469-2T(c)(2)(iv), "Taxable acquisitions," provides:

[Reserved] See § 1.469-2(c)(iv) for rules relating to this paragraph.

Reg. § 1.469-2T(c)(2)(v), "Property held for sale to customers, provides:

[Reserved] See § 1.469-2(c)(v) for rules relating to this paragraph.

For disposition by death, see part II.K.2.d Effect of Death of an Individual or Termination of Trust on Suspended Passive Losses.

For how this rule works in conjunction with the Code § 1411 net investment income tax, see part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.

See also part II.G.4.j At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities), relating to rules that prevent certain debt-financed debts from being deducted before considering the Code § 469 passive loss rules.

II.K.1.k. Former Passive Activities

The preamble to the final regulations governing the 3.8% tax on net investment income[3288] describes the following regarding former passive activities:[3289]

Losses disallowed by section 469 stem from (1) expenses incurred in the passive activity or (2) a sale of a portion of the passive activity or property used in the activity, in excess of passive income from any source. Section 1.469-1T(f)(2)(i) and (ii) require taxpayers to trace disallowed losses back to the activities giving effect to the deductions from the

[3288] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[3289] T.D. 9644.

> activity giving rise to the net loss. When a taxpayer disposes of a partial interest in a passive activity or disposes of assets used within a passive activity, any losses realized from the disposition are treated as arising from the passive activity and are allocated to that activity. Sections 469(b), (g), and § 1.469-1(f)(4) provide that, generally, passive losses that are disallowed in the current year carry forward to the succeeding tax year and remain suspended until the taxpayer has sufficient passive income to offset those losses or otherwise disposes of the entire activity in a fully taxable transaction with an unrelated party.
>
> In cases where a taxpayer materially participates in an activity that was formerly a passive activity, the deductions produced by the activity in the current year are not subject to section 469. However, the carryover (or "suspended") passive losses incurred in prior years when the activity was a passive activity remain disallowed passive losses subject to carryover. Section 469(f)(1)(A) allows the suspended passive losses when the former passive activity produces current-year net income (even though that income is technically from a nonpassive activity). To the extent the taxpayer has passive losses allocable to a former passive activity in excess of the current year nonpassive income from that activity (the section 469(f)(1)(A) amount), section 469(f)(1)(C) allows excess passive losses to offset net passive income from other passive activities of the taxpayer. Any suspended passive losses not allowed by section 469(f)(1)(A) or (C) remain suspended and are carried over to the following year.
>
> Section 469 does not alter the character or nature of the items that make up the suspended passive loss. If the suspended losses are attributable to operating deductions in excess of operating income, such suspended losses retain that character as deductions described in section 62(a)(1) or 62(a)(4) when ultimately allowed by section 469. To the extent the suspended losses are comprised of losses originating from the disposition of property (such as ordinary section 1231 losses or capital losses), those losses also retain their character as section 165 losses when they are ultimately allowed by section 469.

For special rules that the 3.8% tax on net investment income applies to former passive activities,[3290] see fn. 2379.

II.K.1.l. Publicly Traded Partnerships

The passive loss rules apply separately with respect to items attributable to each publicly traded partnership.[3291]

II.K.1.m. Conclusion Regarding General Rules Relating to Passive Activities

The above discussion is by no means comprehensive. These rules developed for some 20 years before part II.I 3.8% Tax on Excess Net Investment Income (NII) was enacted, and there is no substitute for consulting with a CPA who has worked with these rules in preparing tax returns. Even experts had to adjust to a paradigm shift, from PIGs being only good to now looking for a way to avoid PIG status to the extent that income from PIGs exceeds passive

[3290] See part II.I.8.a.vii Former Passive Activities.
[3291] Code § 469(k).

losses. The author would welcome comments clarifying the analysis in this part II.K.1 or suggesting any additional points.

II.K.2. Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business

II.K.2.a. Overview of Passive Loss Rules Applied to Trusts or Estates

A trust or estate participating might be important not only to prevent the passive loss rules from suspending a loss but also to prevent the 3.8% tax on net investment income from applying to the trust's business income. For details on the net investment income tax, see part II.I 3.8% Tax on Excess Net Investment Income (NII), especially part II.I.8 Application of 3.8% Tax to Business Income. See also parts II.J.13 Applying 3.8% Tax to Trusts Owning Businesses Other than S Corporations If the Beneficiary is Active But the Trustee Is Not, II.J.14 Application of 3.8% NII Tax to ESBTs, and II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.

Grantor trusts are taxed to their deemed owners and generally are not cover further in this part II.K.2. Further below are discussions of current law and how to plan for estates and nongrantor trusts in light of it.[3292] Here is an overview of regulatory developments:

From when the Code § 469 passive loss rules were enacted until when the Code § 1411 tax on net investment income (NII) was enacted, the application of the passive loss rules to estates and nongrantor trusts generally was ignored. This idea was ignored because the issues were those of timing of deductions, estates and nongrantor trusts with excess deductions could not use them, and the suspending passive losses until sales occurred generally was favorable. However, the NII tax changed the paradigm, causing taxpayers to ask the government for guidance, to which the government responded by asked for comments on what those rules should look like.

Before discussing the comments, one needs to provide context to the government's general approach. The proposed regulations under Code § 1411 initially addressed the general application of the passive loss rules (not yet focusing on trusts) in a manner biased in favor of the government: the proposed regulations would have left taxpayers with income that was nonpassive for Code § 469 but passive for Code § 1411. This approach was inconsistent with the scant legislative history of Code § 1411, and pressure was applied (in a process in which I was not involved) that caused the final regulations to back away from that approach and simply apply Code § 469 (with certain pro-taxpayer exceptions) and let the Code § 1411 consequences fall where they may.

My understanding is that the government will be looking at comments on trust participation as purely Code § 469 issues and let the Code § 1411 consequences fall where they may. It has been suggested that Code § 469 comments that tend to favor characterizing income as nonpassive in the hands of an estate, nongrantor trust, or beneficiary would be an unwarranted boon for taxpayers. However, my understanding is that the government is concerned about what might if it adopts regulations with Code § 1411 in mind, Code § 1411 later gets repealed, and the government has shot itself in the foot under Code § 469 by making it difficult to characterize income as nonpassive. Thus, regulations under Code § 1411, not Code § 469,

[3292] Part II.K.2.b Participation by an Estate or Nongrantor Trust.

would be the appropriate place to address any concerns the government might have about the impact of Code § 469 regulations on Code § 1411.

Making fair rules for how trusts can materially participate will be a complex task. Fiduciary arrangements can be grantor trusts (in which case the trust is disregarded and the deemed owner is taxed), estates, or nongrantor trusts. Trustees can be individuals or entities. A trust might have one trustee or multiple trustees. Each trustee might have different skills or knowledge of the beneficiaries' needs, leading to slicing and dicing of trustees' authority and duties. Furthermore, the level of fiduciary duties varies according to state law and the document that created the trust.

Here is a description of comments by certain major groups, all of which I participated in varying degrees:

- AICPA comments were first.[3293] They pointed to taxpayer-friendly case law.

- The ABA's Section on Taxation submitted highly technical comments, which, among other matters, explored the relationship between the passive loss and the fiduciary income tax system.[3294]

- The American College of Trust & Estate Counsel (ACTEC), whose task force I chaired, focused on the fiduciary nature of a trust and explored how the government might handle the evolving roles of trustees.[3295]

ACTEC proposed that work in a business activity be considered work attributable to a trust in determining its material participation if performed by a person who is a qualifying fiduciary. To qualify under ACTEC's proposal, the person must hold a substantial related fiduciary power and personally owe fiduciary duties to the beneficiaries with respect to the power.

One set of comments (not mentioned above) suggested varying the rules depending on who serves (and perhaps how many people serve) as trustee. Considering those factors would punish trusts that do not conform to those comments' ideas of how trusts should be administered. In contrast, ACTEC's comments treat all trustees and trust arrangements the same, focusing on whether fiduciary duties are owed with respect to the work that is performed.

ACTEC's comments mention what little law there is and recommend changes to the law. When one needs a logical framework for trusts that have more than one trustee, when distributions are made to a beneficiary, or when my planning suggestions do not work out or were not followed,

[3293] Thompson Coburn LLP document number 6252341 or http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicUrc/OGHGu+qSyFQIHlSrV/Yyi63VldeR&rh=ff0023565a83fb62ef7764e56b4689d5629036fc.

[3294] Thompson Coburn LLP document number 6252340 or http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicikIVHHCCawA0JoSeWnL+iQcx1y1EIbsot+x1JadeV10=&rh=ff0023565a83fb62ef7764e56b4689d5629036fc.

[3295] Thompson Coburn LLP document number 6252339 or http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicxjC0od0egqdZH1P8mlbZQ43UvnjYGixP&rh=ff0023565a83fb62ef7764e56b4689d5629036fc.

ACTEC's comments would form the basis for a well-reasoned argument about how the passive loss rules should be applied.

II.K.2.b. Participation by an Estate or Nongrantor Trust

II.K.2.b.i. Participation by a Nongrantor Trust: Authority

Regulations do not address participation by a nongrantor trust.[3296] The legislative history provides:[3297]

> An estate or trust is treated as materially participating in an activity (or as actively participating in a rental real estate activity) if an executor or fiduciary, in his capacity as such, is so participating.

The legislative history does not state that this is the exclusive test for how fiduciaries may participate. For planning purposes, one should consider assuming that is the exclusive test, because the IRS takes that position. For reporting purposes, however, "fiduciary" means a "guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person."[3298] The term "applies to persons who occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators. A fiduciary is a person who holds in trust an estate to which another has a beneficial interest, or receives and controls income of another" and also includes a "committee or guardian of the property of an incompetent person."[3299] A mere agent is not a fiduciary; for example, an "agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary" under this definition.[3300]

The IRS has litigated whether one should test based only on actions directly by the trustee or whether actions by others, such as an agent, should be considered.

In *Mattie K. Carter Trust v. United States*,[3301] the IRS argued that "material participation" should be based on the trustee's actions alone. However, the court agreed with the taxpayer that it should be tested by whoever participates on behalf of the trust, which in this case included two people to whom the trustee delegated functions: (1) a full-time ranch manager whose actions were subject to the trustee's approval, and (2) a beneficiary who supervised the manager and general ranch operations.

[3296] Note that participation of the activity of the deemed owner of a grantor trust would be a matter if that individual's personal participation. Thus, for example, this discussion in this section would not apply to a revocable trust. The rules for the Code § 1411 tax on passive business income expressly recognize this treatment of grantor trusts; see fn. 2318.

[3297] Committee Reports for Senate Bill 99-313, P.L. 99-514. A footnote in the legislative history provides that one looks to the participation of the deemed owner of a grantor trust rather than to the trust's participation.

[3298] Code § 7701(a)(6), which applies to Code § 469 where not otherwise distinctly expressed or manifestly incompatible with that section's intent.

[3299] Reg. § 301.7701-6(b)(1).

[3300] Reg. § 301.7701-6(b)(2).

[3301] 256 F.Supp.2d 536 (N.D. Tex. 2003).

TAM 200733023 rejected the taxpayer's reliance on *Mattie Carter* and asserted:

> What is apparent from the line of authority in this area is that a fiduciary must be vested with some degree of discretionary power to act on behalf of the trust. Although Trust represents that Special Trustees were heavily involved in the operational and management decisions of Business, Special Trustees — like the banks in Revenue Ruling 82-177 and *Anderson* — were ultimately powerless to commit Trust to any course of action or control Trust property without the express consent of Trustees. The contract between Trust and Special Trustees is explicit on this point, and Trust itself has acknowledged that Trustees retained final decision-making authority with regard to all facets of Business. The services performed by Special Trustees appear to be indistinguishable from those that would be expected of other non-fiduciary business personnel. If advisors, consultants, or general employees can be classified as fiduciaries simply by attaching different labels to them, the material participation requirement of § 469 as applied to trusts would be meaningless.

Letter Ruling 201029014 involved a trust that owned a partnership interest. The partnership interest was the sole owner of another entity, which in turn was the sole owner of the ultimate subsidiary. The ruling held that the trust may materially participate in the subsidiary's activities if the trustee is involved in the operations of the subsidiary's activities on a regular, continuous, and substantial basis. The ruling failed to mention the *Mattie K. Carter Trust* case or to address whether any formalities were needed to establish participation as the trustee rather than participation as an individual.

The IRS' Audit Technique Guide discusses the topic as follows:[3302]

> **Trusts Material Participation**
>
> If a business activity is owned by a trust, the examiner will need to determine if the material participation standard is met in order for losses to be fully deductible. Businesses may be conducted via Schedules C or Form, partnerships, S corporations or LLCs.
>
> The IRC § 469(h) requires regular, continuous and substantial participation in the operations of the business to meet material participation and for losses to be fully deductible. There is no guidance in the regulations at this time for material participation of trusts and estates.[3303]
>
> As an administrative proxy, we look to the seven tests in Reg. § 1.469-5T(a) for material participation, and generally will not raise an issue if the trustee meets one of the tests. However, as a technical matter the tests apply to individuals, not to a trust or trustee. Thus, as a legal matter, the trustee must prove he works on a regular basis in operations, on a continuous basis, and on a substantial basis in operations, i.e. rise to the requirements of IRC § 469(h).

[3302]Chapter 6, found by starting with http://www.irs.gov/pub/irs-mssp/pal.pdf or http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Chapter-6-Entity-Issues. The footnotes in the excerpt below are direct copies from the IRS' audit guide, although the footnote numbers have been changed from footnote numbers 15-19 to those used below.
[3303] Note that Reg. § 1.469-5T(g) is "Reserved".

Grantor Trusts: Since tax law does not recognize a grantor trust as a separate taxable entity, the examiner should ignore the trust entirely and look to the grantor (individual taxpayer) to determine material participation.

Qualified Subchapter S Trust[3304] **(QSST):** The QSSTs are generally grantor trusts in which the grantor is frequently a parent and the beneficiary is a child. The examiner should look to the beneficiary (child) to determine material participation.

Exceptions: There are two major exceptions to the passive loss rules:

1. Partnerships which are traders in stocks and bonds;[3305] and,

2. Working interests in oil and gas activities.[3306] Losses or income from these activities are excepted from the passive loss limitations and are not entered on Form 8582.

Issue Identification: Does the trustee materially participate in the following:

- Schedule C or F activities with losses.
- Partnership or S corporation with losses.
- Entity with an EIN and address a long distance from the trust or trustee.
- Entity in which the trust is a limited partner or the ownership percentage is low.

Examination Techniques:

- Secure the trust instrument or will and read it.
- Determine who the trustee is and what his other responsibilities are. If the trustee is a busy bank officer or attorney, material participation may be questionable in businesses or entities in which the trust owns an interest.

Documents to Request:

- Trust instrument or will including any amendments and codicils.
- Copies of Schedule K-1s from related entities.
- Detailed description of business activities conducted on Schedule C or F or by any partnerships, or S corporations.
- Explanation of the duties and responsibilities of the trustee for each business, whether conducted as a Schedule C, partnership or S corporation.

[3304] See IRC § 1361(d) where the beneficiary elects to be treated as the owner of the trust for purposes of IRC § 678.
[3305] Reg. § 1.469-1T(e)(6).
[3306] IRC § 469(c)(3), Reg. § 1.469-1T(e)(4)(v).

- Completion of the log at the end of Chapter 4 for any activity in which material participation is questioned.

Supporting Law:

- The **Senate Report**[3307] clearly provides that an estate or trust would be treated as materially participating if the executor or fiduciary/trustee materially participates.

- **Reg. § 1.469-1T(b)(2)** Passive loss rules apply to trusts other than trusts described in IRC § 671 (grantor trusts). Also see Rev. Rul. 85-13, 1986-1 CB 184.

- **QSSTs:** The General Explanation of the Tax Reform Act of 1986 by the Staff of the Joint Committee on Taxation, Note 33, page 242, explains, "Similarly, in the case of a qualified electing Subchapter S trust (§ 1361(d)(1)(B)) that is treated as a grantor trust (i.e., the beneficiary is treated as the owner for tax purposes), the material participation of the beneficiary is relevant to the determination of whether the S corporation's activity is a passive activity with respect to the beneficiary."

In its April 5, 2013 comments to the proposed regulations under Code § 1411, the American Bar Association's Section on Taxation said:[3308]

> Because of the uncertainty of current law under chapter 1, we recommend that the Service issue guidance regarding material participation for a trust or estate for purposes of section 1411. We recommend that this guidance be issued as a new proposed regulation package rather than including these rules in these final Regulations.
>
> In this regard, we recommend that the new proposed regulation package would provide that material participation by a trust or estate can be accomplished through meeting at least one of three tests:
>
>> (a) The fiduciary materially participates under the standards that apply to individuals under previously promulgated Regulations.[3309]
>>
>> (b) The fiduciary, based on all of the facts and circumstances, participates in the activity on a regular, continuous and substantial basis during the year.[3310]
>>
>> (c) The fiduciary participates in the activity on a regular, continuous, and substantial basis, either directly or through employees or contractors whose services are directly related to the conduct of the activity.[3311]

[3307] S. Rep. No. 313, 99th Cong., 2d Sess., Reprinted in 1986-3 C.B. (Vol. 3) 1, at 735.
[3308] The footnotes below use my numbering rather than the numbering used in the report. The report is at http://www.regulations.gov/contentStreamer?objectId=090000648127f7c2&disposition=attachment&contentType=pdf.
[3309] See Temp. Reg. § 1.469-5T(a)(1)-(5).
[3310] See Temp. Reg. § 1.469-5T(a)(7).
[3311] Based upon Temp. Reg. § 1.469-1T(g) (rules for C corporations). This regulation was in turn based on I.R.C. § 469(c)(7)(C).

It explained its recommendations as follows:

> The recommended alternative tests for material participation by a trust take into account the hybrid nature of a trust by allowing it to qualify based on the actions of the fiduciary (individual tests) and also those employed by the fiduciary in certain circumstances (similar to a closely held C corporation). When considering the efforts of the fiduciary, any time spent working on the activity should be considered towards meeting the material participation requirements regardless of whether the fiduciary is working on the activity as a fiduciary or in another role, for instance as an officer or an individual investor. If there are multiple fiduciaries, time spent by the fiduciaries could be aggregated for purposes of determining material participation.
>
> Applying only the standards for an individual to be a material participant in an activity would ignore the obvious differences between individuals and trusts. In what is apparently the only court case to address the issue to date, the court in *Mattie K. Carter Trust*[3312] found the trust to be analogous to a closely held C corporation and concluded that "the material participation of the Carter Trust in the ranch operations should be determined by reference to the persons who conducted the business of the ranch on Carter Trust's behalf, including [the trustee]." The Service took the position that when determining active and passive activities under section 469, only the activities of the fiduciary are to be considered when meeting the standard of regular, continuous, and substantial participation. The taxpayer argued that the participation of the trust's other employees and agents also should be included since the trust could only participate in an activity through its fiduciaries, agents and employees much like a corporation.
>
> The court held for the taxpayer, finding that a trust was most analogous to a corporation and that the acts of its agents would be deemed acts of the taxpayer. Based on the activities of the trust through its trustee, fiduciaries, employees, and agents, the material participation requirement was satisfied. The Court noted that it had studied the "snippet" of legislative history purporting to provide insight on how Congress intended section 469 to apply to a trust's participation in a business, including the Senate Finance Committee Report and the footnote in the Joint Committee on Taxation's Explanation, but did not find it helpful.
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> In private rulings, the Service has taken the position that it is appropriate in the trust context to look only to the activities of the fiduciary to determine material participation.[3313] The IRS Audit Technique Guide for Passive Activity Loss (the "ATG"), addresses

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[3312] *Mattie K. Carter Trust v. U.S.*, 256 F. Supp. 2d 536 (N.D. Tex. 2003).

[3313] In TAM 200733023 (Aug. 17, 2007), the Service took the position that a trust satisfies the material participation test only if the fiduciaries (i.e., the trustee or trustees) are involved in the operations of the trust's business activities on a regular, continuous, and substantial basis. See also PLR 201029014 (July 23, 2010). A person "required to hold and conserve the property, or the proceeds of the sale thereof, for future distribution" to others is a trustee. Rev. Rul. 61-102; see also Rev. Rul. 74-273. So is a person with "certain discretionary powers of administration and management with regard to the property ….[who] could vote at any stockholders' meeting; approve or oppose any reorganization or refinancing proposal; invest earnings in government obligations; retain counsel; exercise or sell conversion or subscription rights; hold the property in its own name or in a street name; and petition the court with respect to any other disposition concerning the property it considered to be in the best interest of the unknown owner." Rev. Rul. 69-300. A bank was not a fiduciary when it held an estate's money during litigation over the estate, paid interest, but performed no administrative duties for the estate. Rev. Rul. 82-177.

> material participation by trusts. The ATG states that the Service will generally not raise an issue if the trustee meets one of the material participation tests included in Regulation section 1.469-5T(a). We view this position as too restrictive given the hybrid nature of trusts and estates.[3314]
>
> The approach outlined above would maintain the approach outlined in private rulings requiring material participation by the fiduciary, but would also allow certain trusts which meet the requirements to be treated analogous to a closely held C corporation and apply similar standards to qualify for active treatment.

Although neither the Audit Technique Guide nor the above comments focus on whether the trustee's participation is in the trustee's fiduciary capacity, TAM 201317010 did focus on that issue, finding no material participation:

> Notwithstanding the decision in *Mattie K. Carter*, the Service believes that the standard annunciated in the legislative history is the proper standard to apply to trusts for purposes of § 469(h). Thus, the sole means for Trust A and Trust B to establish material participation in the relevant activities of Company X and Company Y is if the fiduciaries, in their capacities as fiduciaries, are involved in the operations of the relevant activities of Company X and Company Y on a regular, continuous, and substantial basis.
>
> A fiduciary must be vested with some degree of discretionary power to act on behalf of the trust. *United States v. Anderson*, 132 F.2d 98 (9th Cir. 1942). Although the Trusts represent that A was involved in the day-to-day operations and management decisions of Company X and Company Y, A's powers as Special Trustee were restricted by Article XI of the trust agreements. As Special Trustee, A lacked the power to commit Trust A and Trust B to any course of action or control trust property beyond selling or voting the stock of Company X or Company Y. The work performed by A was as an employee of Company Y and not in A's role as a fiduciary of Trust A or Trust B and, therefore, does not count for purposes of determining whether Trust A and Trust B materially participated in the trade or business activities of Company X and Company Y under § 469(h). A's time spent serving as Special Trustee voting the stock of Company X or Company Y or considering sales of stock in either company would count for purposes of determining the Trusts' material participation. However, in this case, A's time spent performing those specific functions does not rise to the level of being "regular, continuous, and substantial" within the meaning of § 469(h)(1). Trust A and Trust B represent that B, acting as Trustee, did not participate in the day-to-day operations of the relevant activities of Company X or Company Y. Accordingly, we conclude that Trust A and Trust B did not materially participate in the relevant activities of Company X or Company Y within the meaning of § 469(h) for purposes of § 56(b)(2)(D) for the tax years at issue.

Because this issue has a big impact on the 3.8% tax on net investment income,[3315] the Treasury Department and IRS are considering whether issue formal guidance at some point, even though

[3314] TAM 200733023 (Aug. 17, 2007).
[3315] See part II.I 3.8% Tax on Excess Net Investment Income (NII), particularly part II.I.8 Application of 3.8% Tax to Business Income.

they did not issue guidance when they finalized the regulations they issued in December 2012.[3316]

Meanwhile, the Tax Court held that, when a nongrantor trust created its own LLC to manage a business and the trustees themselves were paid by the LLC for managing the business, the trust was able to count the trustees' participation.[3317] However, rather than simply disregarding the LLC (which was a disregarded entity for income tax purposes) and holding that the trustees were working for the trust (for income tax purposes), instead the court focused on the trustee's duty to the trust when working for the LLC.[3318] That focus might open the door for an attack on

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[3316] The preamble to the final regulations issued in T.D. 9644 stated:

F. Material participation of estates & trusts

Several commentators noted that the enactment of section 1411 has created an additional and compelling reason for the need to determine how an estate or a trust materially participates in an activity. An estate's or a trust's income or gain from a trade or business activity in which the entity materially participates does not constitute income from a passive activity under section 469 or section 1411. One commentator noted that, in the case of estates or trusts that have not incurred losses from a passive activity, those estates and trusts previously have not had to characterize either losses or income under section 469.

Commentators stated that the legislative history of section 469 suggests that only a fiduciary's participation should control in determining whether an estate or a trust materially participates in a trade or business activity. In certain situations, case law has concluded that the participation of beneficiaries and employees also should be considered. One commentator noted that case law and IRS guidance conflict, leaving taxpayers with uncertainty in determining the material participation of a trust.

A number of commentators requested that the Treasury Department and the IRS provide guidance on material participation of estates and trusts. However, the commentators acknowledged that guidance on material participation would apply under both sections 469 and 1411, and consequently suggested the initiation of a guidance project to propose the rules for which § 1.469-5T(g) has been reserved.

The Treasury Department and the IRS believe that the commentators have raised valid concerns. The Treasury Department and the IRS considered whether the scope of these regulations should be broadened to include guidance on material participation of estates and trusts. The Treasury Department and the IRS, however, believe that this guidance would be addressed more appropriately in the section 469 regulations. Further, because the issues inherent in drafting administrable rules under section 469 regarding the material participation of estates and trusts are very complex, the Treasury Department and the IRS believe that addressing material participation of trusts and estates at this time would significantly delay the finalization of these regulations. However, the issue of material participation of estates and trusts is currently under study by the Treasury Department and the IRS and may be addressed in a separate guidance project issued under section 469 at a later date. The Treasury Department and the IRS welcome any comments concerning this issue, including recommendations on the scope of any such guidance and on specific approaches to the issue.

[3317] *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014). The petition, reply, and briefs are at http://tcinstitute.com/rv/ff0012e61ef3812cbb3202812343b05e2fbe2da8/p=3879220. CCA 201244017 had taken the position that a trust cannot be a real estate professional.

[3318] The court said:

Even if the activities of the trust's non-trustee employees should be disregarded,[15] the activities of the trustees--including their activities as employees of Holiday Enterprises, LLC--should be considered in determining whether the trust materially participated in its real-estate operations. The trustees were required by Michigan statutory law to administer the trust solely in the interests of the trust beneficiaries, because trustees have a duty to act as a prudent person would in dealing with the property of another, i.e., a beneficiary. Mich. Comp. Laws sec. 700.7302 (2001) (before amendment by 2009 Mich. Pub. Acts No. 46); see also *In re Estate of Butterfield*, the premise of TAM 201317010 that a trustee who acts as an individual is not also serving as a trustee.

Since then, the AICPA,[3319] ABA Section on Taxation,[3320] and ACTEC[3321] have made formal comments to the government.

II.K.2.b.ii. Participation by a Nongrantor Trust: Planning Issues

Some have suggested that the trustee's participation in the business will cause the trust to be taxed as a business entity. For trusts created for traditional estate planning purposes, that concern is not justified. See part II.K.2.b.iii Participating in Business Activities Does Not Convert a Trust Created by Only One Grantor into a Business Entity.[3322]

Consider giving a beneficiary who participates in the activity a role as a trustee, whose authority is limited to acting on behalf of the trust with respect to investments that need to be tested under the passive activity rules. Depending on the state, one might be able to use a nonjudicial settlement agreement to not only add a special trustee for this purpose but also protect the

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341 N.W.2d 453, 459 (Mich. 1983) (construing Mich. Comp. Laws sec. 700.813 (1979), a statute in effect from 1979 to 2000 that was a similarly-worded predecessor to Mich. Comp. Laws sec. 700.7302). Trustees are not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust. *Cf. In re Estate of Butterfield*, 341 N.W.2d at 457 ("Trustees who also happen to be directors of the corporation which is owned or controlled by the trust cannot insulate themselves from probate scrutiny [i.e., duties imposed on trustees by Michigan courts] under the guise of calling themselves corporate directors who are exercising their business judgment concerning matters of corporate policy."). Therefore their activities as employees of Holiday Enterprises, LLC, should be considered in determining whether the trust materially participated in its real-estate operations.[16]

[15]We need not and do not decide whether the activities of the trust's non-trustee employees should be disregarded.

[16]We need not consider the effect of sec. 469(c)(7)(D)(ii), which provides that for purposes of sec. 469(c)(7)(B) personal services performed as an employee are generally not treated as performed in real-property trades or businesses. This rule has no application to the resolution of this case because, as we explain *infra*, the IRS has confined its challenges to the trust's qualification for sec. 469(c)(7) treatment to two challenges: (1) that trusts are categorically barred from sec. 469(c)(7) treatment, and (2) the trust did not materially participate in real-property trades or businesses. Thus, we need not, and do not, determine how many hours of personal services were performed by the trust in real-property trades or businesses. We also note that the IRS does not cite sec. 469(c)(7)(D)(ii) in its brief.

[3319] http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicUrc/OGHGu+qSyFQIHlSrV/Yyi63VldeR&rh=ff0023c897e8a4321085e24d8c4387625763f0f4.

[3320] http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicikIVHHCCawA0JoSeWnL+iQcx1y1EIbsot+x1JadeV10=&rh=ff0023c897e8a4321085e24d8c4387625763f0f4.

[3321] http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicxjC0od0egqdZH1P8mlbZQ43UvnjYGixP&rh=ff0023c897e8a4321085e24d8c4387625763f0f4.

[3322] Particularly fn. 3340.

trustee from liability.[3323] Note that the legislative history refers to ***an*** executor or fiduciary, not ***the*** executor or fiduciary, implying that material participation by any one co-trustee will cause a trust to be treated as materially participating in an activity.

At first glance, it might seem an easy matter simply to designate as a special trustee an employee of the business. Note, however, that the special trustee must be participating on behalf of the trust and not merely on his or her own behalf. The trustee's work on behalf of the trust as an investor in an activity is not treated as participation in the activity unless the trustee is directly involved – on behalf of the trust - in the day-to-day management or operations of the activity.[3324] Consider these issues:

- What activities would an owner of that entity typically perform?

- Does the company want the individual to be protecting the trust's interests rather than the company's?[3325]

- As an active participant in running the business, the trust might have fiduciary duties to the other owners that it might not have as a passive owner. The trust might already have duties to other owners if the trust has a controlling interest, but being active in the business would tend to strengthen these duties to others. If the business entity is an LLC, these duties to other owners might be more easily reduced than perhaps for other types of entities, depending on applicable state law.

- Because the trustee is participating on behalf of the trust rather than for his or her own benefit, should the trust be compensated for the trustee's services and then pay the trustee itself, rather than the trustee receiving compensation directly from the company? If so, then the trustee needs to consider whether the trustee is an employee or independent contractor (generally the latter) and the related employment taxes and insurance.

- Because the trust itself is participating in a trade or business, it might subject itself to Form 1099 filing requirements for payments it makes.

- A very significant purpose of using a business entity is to protect its owners from liability. However, to the extent that the trust is directly involved in the business activity, it would subject itself to liability for the trustee's actions or omissions as the trust's agent. The trust may form an LLC that it wholly owns to provide those services and have the trustees provide those services through the LLC;[3326] if run in a financially responsible manner, the LLC might shield the trust from liability for managing the business.

[3323] Section 111 of the Uniform Trust Code, found at www.uniformlaws.org/shared/docs/trust_code/utc_final_rev2010.pdf; RSMo § 456.1-111. Subsection 4 authorizes a nonjudicial settlement agreement to interpret the terms of the trust, approve a trustee's report/accounting, direct a trustee to refrain from performing a particular act, grant a trustee any necessary or desirable power, accept a trustee's resignation, appoint a trustee, determine a trustee's compensation, transfer a trust's principal place of administration, and resolve the liability of a trustee for an action relating to the trust.

[3324] See part II.K.1.a.v What Does Not Count as Participation.

[3325] See part III.A.4.d.iv Advising Clients about the UPAIA § 505 Change and UFIPA § 506 regarding the trustee's fiduciary duties to beneficiaries when the trustee is active in the business.

[3326] *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014).

Additionally, consider the trust's legal rights as an owner. If the entity is a corporation, to what course of action could a trustee commit a trust with respect to stock the trust owns other than voting it and selling it? Note that the trustee's actions as an investor do not count in determining material participation.[3327]

Generally, under corporate law a shareholder cannot act on behalf of a corporation. All the shareholders can do is elect directors. Directors then make strategic decisions (often not more than 100 or 500 hours' worth) and delegate the daily running to the officers (who are by definition employees). So generally a trust as a shareholder in a corporation has no authority to participate in the business' affairs. TAM 201317010 does not seem to understand this inherent limitation and appears geared toward businesses that are wholly owned by trusts.

Given that the IRS is reading the legislative history in a manner that makes it difficult for a trust to materially participate in its role as a shareholder, one might consider the following if the entity is an S corporation:

- Many states have "close corporation" statutes or other statutes that allow shareholders to directly run a corporation, much like an LLC is run by its members.[3328] They also have built-in buy-sell provisions, some of which might protect a corporation's S election (once in place).

- Consider an LLC or limited partnership taxed as an S corporation,[3329] with an operating agreement or partnership agreement that has distributions following S corporation single-class-of-stock rules rather than capital accounts, and either a limited liability partnership registration in place to protect the general partner (making the partnership an LLLP)[3330] or having the limited partnership do business through an LLC subsidiary. Generally, for an existing corporation, a merger into the new entity (LLLP or the LP's LLC subsidiary) would be required.[3331]

In either case, if all the S corporation stock the trust has is old-and-cold nonvoting stock, do a Code § 1036 tax-free swap for voting stock, giving enough voting stock to constitute adequate and full consideration (using a formula transfer). The holder of the voting stock would file a gift tax return adequately disclosing the transaction as a non-gift.

[3327] See part II.K.1.a.v What Does Not Count as Participation.
[3328] See fn 1138 and accompanying text regarding close corporation statutes as providing protection against creditors. Such statutes are in the minority. Of the states that do not have close corporation statutes, almost all of them have buried in their corporate law provisions allowing the shareholders to bypass the board of directors and directly run part or all of the business. A chart of states in an article co-authored with Richard Barnes was published March/April 2015 in *Probate & Property*, which is reproduced at http://www.thompsoncoburn.com/Images/Newsletters/6131013_1.pdf; links supporting this chart were prepared by a summer associate in 2014 and are found in my firm's internal document number 5977514, which is reproduced at http://www.thompsoncoburn.com/Images/Newsletters/5977514_7.pdf.
[3329] As described in part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election, certain regulations might lead one to believe that an S election does not shield LLC owners from self-employment tax; however, those regulations appear to be obsolete. For those who are concerned about those regulations, a limited partnership would be the preferred state law entity, to obtain the self-employment tax exclusion available to limited partners, which is described in part II.L.4 Self-Employment Tax Exclusion for Limited Partner.
[3330] See parts II.C.12 Limited Partnership and II.C.13 Limited Liability Partnership Registration.
[3331] See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

Also, consider having the entity pay the trust for services rendered managing the business, issuing IRS Form 1099-MISC to the trust.[3332] The trust would report the management income and expense on Schedule C or C-EZ.[3333] Trusts do not pay self-employment tax. After taking a reasonable profit on the payment, the trust would compensate the trustee for services rendered. Unlike most trusts, because the trust is now engaging in a trade or business, the trust would issue IRS Form 1099-MISC to the trustee for those services, and the trustee would report the income in his/her Form 1040, Schedule C, and pay self-employment tax;[3334] however, the IRS did not object when a trust formed its own LLC (disregarded for income tax purposes) to manage the business, which LLC reported on Forms W-2 (instead of Form 1099-MISC) compensation that the LLC paid the trustees.[3335]

Does changing the individual's participation from being a direct employee to serving as a trustee affect that person's material participation as an individual? No – although the IRS takes the

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[3332] For Thompson Coburn LLP personnel – see document number 5879530.

[3333] For an ESBT, management fee income is not part of the S portion, because it is not a K-1 item. Reg. § 1.641(c)-1(d)(1), (2). The same answer applies to QSSTs. Reg. § 1.1361-1(j)(7), (8).

[3334] Generally, nonprofessional trustees do not pay self-employment tax. Rev. Rul. 58-5, reproduced in large part in fn. 2328, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles. However, the Rev. Rul. modifies that position when the trustees carry on a trade or business:

> *Example (1). Executor who receives a flat fee for administering the estate*. A, a nonprofessional fiduciary, receives a flat $10,000 for administering the estate of B. B's gross estate is valued at $150,000 and includes a trade or business which A manages for the period of time required to distribute the assets of the estate. Under the laws of the State in which B's estate is probated, an executor is entitled to a five percent commission based upon the value of the assets distributed. Since A distributed the entire estate worth $150,000 he would have been entitled to $7,500 executor's commissions, based upon the statutory five percent allowance. Inasmuch as A, pursuant to court order, actually received $10,000 instead of $7,500 in commissions, the excess, or $2,500, is regarded as being attributable to the operation of the trade or business of the estate. A must therefore treat this $2,500 as earnings from self-employment. The remaining $7,500 is regarded as being attributable to the normal fiduciary duties of marshalling the assets of the estate and should not be treated as trade or business income. On the other hand, if A's total fee for administering the estate was equal to or less than $7,500 (the statutory executor's allowance in this case), and if nothing was said in the court order with respect to allocation of the fee, the entire fee would be regarded as being attributable to A's fiduciary activities and no part of the fee would be treated as trade or business income to A.
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> *Example (2). Executrix who receives a special fee for handling the estate's business*. C, the sole executrix of the estate of her husband, operates a drugstore belonging to the estate, pending dissolution of the estate. As her commission for handling the estate, C receives, pursuant to court order, $5,125 (based upon a percentage of the value of the assets distributed) and $500, in addition, for the operation of the drugstore. Under these circumstances, only the $500 commission for the operation of the drugstore constitutes earnings from self-employment. The $5,125 commission, based upon the value of the assets distributed is not related to the operation of the trade or business, and, accordingly, does not constitute earnings from self-employment.
>
> *Example (3). Coexecutor who does not participate in the operation of the estate's business*. D and E are coexecutors of an estate which includes a trade or business. D is totally unfamiliar with the operation of the business and leaves the entire management of the business to E. Under these circumstances, D, who does not participate in the operation of the business, cannot be treated as being in a trade or business. The fees received by D do not constitute net earnings from self-employment. E, however, actively participates in the operation of the business and the compensation received by him for the management of the estate's trade or business constitutes net earnings from self-employment.

[3335] *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (2014). The court did not mention this nuance, but the facts described somewhere in the petition, reply, and briefs mentioned that Forms W-2 were issued; see http://tcinstitute.com/rv/ff0012e61ef3812cbb3202812343b05e2fbe2da8/p=3879220.

position that work a trustee's work as an individual does not count as participation by the trust, work done as a trustee apparently counts towards the trustee's participation as an individual.[3336] Consider, however, any impact on employee benefits.

Finally, to avoid the 3.8% tax on net investment income, consider converting an ESBT into one or more QSSTs[3337] if the beneficiary works for the business (or could do so in any capacity for more than 100 hours per year)[3338] and a QSST's mandatory income requirement does not do violence to the estate planning goals. However, the trustee's participation will become important again if the stock or business assets are sold.[3339] See part III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.

II.K.2.b.iii. Participating in Business Activities Does Not Convert a Trust Created by Only One Grantor into a Business Entity, But Be Wary If Multiple Grantors

If the beneficiaries are associates in a joint enterprise for the conduct of business for profit, then the trust might be characterized as a business entity. See part II.D.1 Trust as a Business Entity.

However, if the beneficiaries did not create the trust, the trust will not be considered a business entity merely because the trustee engages in business operations.[3340]

II.K.2.b.iv. Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary; Interaction with Special Depreciation Rules

Generally, income retains its character when flowing from a nongrantor trust to a beneficiary.[3341] Therefore, income's character as passive or nonpassive at the trust level also controls at the beneficiary's level.

[3336] See fn. 3049 in part II.K.1.a.ii Material Participation.
[3337] See part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSST.
[3338] Because a QSST is a grantor trust deemed owned by the beneficiary, the beneficiary's participation, not the trustee's, is what counts. See text accompanying fns. 2318-2319. Although normally participating in owner-type activities is required to avoid the passive loss rules, regulations governing the 3.8% tax do not mention this issue and therefore do not appear to impose that requirement for avoiding the 3.8% tax. See part II.K.1.a.v What Does Not Count as Participation. For more planning tips involving how to meet the participation requirements and qualify for an exclusion from the 3.8% tax, see part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.
[3339] See part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax. This is important only for net investment income tax purposes, as a complete disposition of a passive activity removes the passive loss restrictions for that activity. Code § 469(g).
[3340] I am unaware of any case addressing this issue directly interpreting the check-the-box regulations after the adoption of Reg. § 301.7701-4(a). The regulation's preamble, T.D. 8697, provides:

> The regulations provide that trusts generally do not have associates or an objective to carry on business for profit. The distinctions between trusts and business entities, although restated, are not changed by these regulations.

See part II.D.1 Trust as a Business Entity
[3341] See fn. 2327, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles, and the discussion preceding and including fn. 2828, found in part II.J.8.f.i.(b) Allocating Income Items Among Those Receiving It.

In support of this, note that private letter rulings have held that passive rental income earned by a pooled income fund was passive income in the hands of its beneficiaries.[3342]

In grouping passive activities, a beneficiary's beneficial interest in a trust's ownership of an activity cannot be grouped; all grouping is done at the trust level.[3343]

Regarding applying the passive loss rules to the beneficiary's share of directly apportionable deductions (such as depreciation, depletion, and amortization), the IRS instructs taxpayers (italics are the IRS'):[3344]

> *The limitations on passive activity losses and credits under section 469 apply to estates and trusts. Estates and trusts that distribute income to beneficiaries are allowed to apportion depreciation, depletion, and amortization deductions to the beneficiaries. These deductions are referred to as "directly apportionable deductions."*
>
> *Rules for treating a beneficiary's income and directly apportionable deductions from an estate or trust and other rules for applying the passive loss and credit limitations to beneficiaries of estates and trusts haven't yet been issued.*
>
> Any directly apportionable deduction, such as depreciation, is treated by the beneficiary as having been incurred in the same activity as incurred by the estate or trust. However, the character of such deduction may be determined as if the beneficiary incurred the deduction directly.
>
> To assist the beneficiary in figuring any applicable passive activity loss limitations, also attach a separate schedule showing the beneficiary's share of directly apportionable deductions derived from each trade or business, rental real estate, and other rental activity.

However, some commentators suggest that depreciation deductions flow through to the beneficiaries separately only to the extent allowed after applying the passive loss rules at the trust level.[3345] The best reconciliation I can come up with is the following example: Suppose the

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[3342] Letter Rulings 200608002 and 200608003 held:

> … the rental of land and buildings by the Fund to X will be a passive activity under § 469(c). Because the excess of aggregate income from all passive activities over the aggregate losses from all passive activities will enter into the computation of DNI, then the characterization rule of § 662(b) will apply. Thus, if the Fund's gross income in any year from rental of the land and buildings exceeds its losses (including a ratable portion of the Fund's indirect expenses) in that year from rental of the land and buildings, amounts distributed from the Fund that are includible in the gross income of an income beneficiary for that year will be income to that beneficiary from a passive activity, within the meaning of § 469, in the same proportion as the Fund's net income from that rental that enters into the computation of the Fund's DNI for that year bears to the Fund's entire DNI for that year.

Letter Ruling 8806065 took a similar position.

[3343] See fn. 3140.

[3344] 2019 Form 1041 Instructions, page 41, explaining how to prepare line 9 of Schedule K-1 issued to the beneficiaries. The instructions also refer to depletion and amortization. See part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses).

[3345] Sutton & Howell-Smith, ¶ 15.03 Application of Passive Loss Limitations at the Entity Level, *Federal Income Taxation of Passive Activities* (WG&L) (referring to the position the AICPA took in the late 1980s); Schmolka, "Passive Activity Losses, Trusts, and Estates: The Regulations (If I Were King)," *N.Y.U. Tax Law Review*, vol. 58, p. 191 (2005).

trust has $100 rental income before depreciation and $60 depreciation, for $40 net income; therefore, the depreciation is fully deductible under the passive loss rules applied at the trust level. The rental income and depreciation deductions are separately stated on the trust's K-1s to beneficiaries.

On the other hand, a source that CPAs often use for tax preparation states:[3346]

> When net passive income less depreciation results in a net passive loss, a PAL limitation applies at either the trust or beneficiary level, or both. If the depreciation is required to be distributed to the beneficiary, the PAL limitation occurs at the beneficiary level. If a depreciation reserve is required and maintained by the fiduciary and the depreciation allocated to the trust exceeds the passive income, the PAL limitation occurs at the trust level. If a depreciation reserve is not required and the fiduciary does not distribute all fiduciary accounting income, the PAL limitations occur at both the trust and beneficiary level if the allocated depreciation exceeds the income at both the trust and beneficiary levels.

It appears that more than one approach might be defensible. Consider the strategic consequences:

- If the beneficiary can deduct the depreciation currently, then separately applying the passive loss rules based on the beneficiary's participation seems beneficial. However, if the deduction does not offset net investment income, query whether it would have been better to deferred the deduction until it can be deducted against NII.

- If the beneficiary cannot deduct the depreciation currently, consider the effect of suspending the passive losses. When can one credit the beneficiary for a disposition of the passive activity, freeing that activity's losses from suspension?[3347] If the trust sells the asset, incurs gain because depreciation reduced the trust's basis in the property, and the gain is trapped inside the trust, then the depreciation deductions (suspended or not) do not offset the gain.[3348]

II.K.2.b.v. Electing Small Business Trusts (ESBTs) and the Passive Loss Rules

Electing small business trusts have a special tax regime that divides the trust into a grantor trust portion, a nongrantor trust S corporation portion, and a nongrantor trust non-S corporation portion.[3349]

I am unaware of any guidance directly addressing how the passive loss rules interact with these separate portions.

[3346] Key Issue 7E: Reporting Passive Activity Information to a Beneficiary, *1041 Deskbook* (PPC) (2015). See also Key Issue 7D: Passive Loss Limitations Generally Determined at the Entity Level, *1041 Deskbook* (PPC) (2015).
[3347] Code § 469(g). For more about Code § 469(g), see fn. 3040.
[3348] For further discussion of mismatches along these lines, see Abbin (WTAS), § 811 Real Estate Investment Passive Activity Concerns, *Income Taxation of Fiduciaries and Beneficiaries* (2013), arguing that passive loss rules limit the extent to which a trust passes depreciation deductions to the beneficiaries.
[3349] See part III.A.3.e.ii.(b) ESBT Income Taxation.

I believe that all portions should be combined in determining whether income or loss is active or passive. The grouping rules[3350] allow an individual and a C corporation that the individual owns to combine their participation even though they are separate taxpayers.[3351]

Because the nongrantor S corporation portion and the nongrantor non-S corporation portion are taxed as separate trusts for all income tax purpose other than administratively,[3352] they would not aggregate their income and loss in determining allowable passive losses and then disaggregate their income and loss in determining taxable income.

II.K.2.c. Participation When Grantor Trusts Are Involved; Effect of Toggling

Because grantor trusts are ignored for income tax purposes,[3353] the deemed owner's work is what counts. Complications arise with Qualified Subchapter S Trusts.[3354]

A grantor can count her work in a business for only that part of the year in which she is treated as owning an interest in the business.[3355] If, when grantor trust status terminates, she has not yet worked sufficient hours in the current year (and does not qualify for participation based on participation in prior years),[3356] then consider making sure she keeps at least some ownership in the business after turning off grantor trust status, so that she can count the hours she works later that year. If necessary, the trustee might divide the trust and leave a small portion of the trust as a grantor trust.

II.K.2.d. Effect of Death of an Individual or Termination of Trust on Suspended Passive Losses

If an interest in the activity is transferred by reason of the death of the taxpayer, losses generally are allowed to the extent such losses are greater than the excess (if any) of the basis of such property in the hands of the transferee, over the adjusted basis of such property immediately before the death of the taxpayer, but any losses to the extent of that excess are not allowed as a deduction for any taxable year.[3357] Let's turn this recitation of the Code's rule into common sense: Suspended losses reduce basis, but without the person incurring the losses receiving a benefit from that lost basis. If the owner disposes of the interest during life in a taxable disposition, the suspended losses are allowed, and the tax system has broken even. If the owner dies holding the interest, then the question is what it takes to get the basis restored on account of the suspended losses. To the extent that there is a basis step-up, the suspended losses have not caused a tax detriment, so those losses do not need to be taken to make up for lost basis; therefore, the losses are disallowed to that extent. However, if the suspended losses exceed the basis step-up, then the excess losses should be allowed.

The corollary is that losses are allowed on the decedent's final income tax return to the extent that the transferee does not receive a basis step-up at death, which would make beneficiary

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[3350] See part II.K.1.b Grouping Activities.
[3351] Reg. § 1.469-4(a), (d)(5)(ii).
[3352] See part III.A.3.e.ii.(b) ESBT Income Taxation, especially fn. 6042.
[3353] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.
[3354] See part II.J.15 QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items.
[3355] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.
[3356] See part II.K.1.a Counting Work as Participation in Business under the Passive Loss Rules, especially part II.K.1.a.ii Material Participation.
[3357] Code § 469(g)(2), reproduced in part II.K.1.j Complete Disposition of Passive Activity.

deemed-owned trusts[3358] (including QSSTs),[3359] particularly attractive; in fact, substantial triggered losses can generate a net operating loss carryback, generating income tax refunds.[3360] That also might apply to irrevocable grantor trusts taxed to the settlor[3361] - "might" because the statute requires that the interest be "transferred by reason of the death of the taxpayer;" arguably the grantor's death would qualify, but for trust deemed owned by settlor legally the transfer to the trust preceded the deemed owner's death. So, in the latter case, the trust might consider selling the interest to an otherwise identical nongrantor trust – triggering the losses and increasing the basis – to make sure that the benefits of the losses offset their detriment (in that the losses reduced basis).

Code § 469(j)(12) provides that, when an estate or trust terminates, any passive losses suspended under Code § 469 will be permanently disallowed, but, to inject some fairness, added to the basis of the interest in the relevant passive activity.

Suppose an estate is terminating, using fractional pick-and-choose funding. At first, a Code § 469(j)(12) basis increase in the partnership interest might not appear to generate a Code § 743 basis step-up because, lacking a pecuniary aspect, there is no sale or exchange, and therefore the transfer is not "by sale or exchange or upon the death of a partner." Perhaps the termination of the estate might be attributed to the partner's death? This seems uncertain, however, because the suspended passive losses generating the Code § 469(j)(12) basis increase necessarily occurred post-mortem. On the other hand, a trust's or estate's distribution of a partnership interest probably does trigger Code § 743 basis adjustments, so a Code § 743 adjustment seems to be available after all.[3362] For more thoughts on planning for Code § 469(j)(12) and evaluating its impact, see Sutton & Howell-Smith, ¶15.07. Treatment of Suspended Passive Losses Upon Distribution of Activity by an Estate or Trust, *Federal Income Taxation of Passive Activities* (WG&L).

II.K.3. NOL vs. Suspended Passive Loss - Being Passive Can Be Good

II.K.3.a. Why Being Passive Can Be Good

Particularly when significant business interests are passed to the next generation, being passive can have good results, if the business has a significant net loss.

Suppose the taxpayer has a relatively modest income, other than what the business generates. Deducting a net loss will offset income in the lower tax brackets. This is especially true if the loss is so large that it generates a net operating loss (NOL) carryover under Code § 172.[3363] Another concern is the IRS' position on NOLs incurred by an electing small business trust (ESBT) when the S corporation stock it owns generates losses.[3364]

However, in profitable years, the business income might be taxed in the highest tax bracket. The owner might save more taxes by offsetting the income in a later, high-tax-bracket year, than by deducting the loss in the lower tax brackets.

[3358] See part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.
[3359] See part III.A.3.e QSSTs and ESBTs.
[3360] FSA 200106018.
[3361] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.
[3362] See part II.Q.8.e.ii.(b) Distribution of Partnership Interests.
[3363] See part II.G.4.l.ii Net Operating Loss Deduction.
[3364] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview

If and to the extent that the loss is passive and the taxpayer does not have passive income against which to offset it, the loss is suspended and carried forward.[3365] Thus, instead of offsetting income in lower brackets in the year in which the loss is generated, it offsets income in a later year that would otherwise push the taxpayer into a higher bracket.

Furthermore, after 2017 tax reform, NOLs may offset only up to 80% of post-2020 taxable income,[3366] whereas suspended passive losses can offset 100% of any income from that activity or passive income from any other activity.

However, contrasting part II.K.2.d Effect of Death of an Individual or Termination of Trust on Suspended Passive Losses with part II.J.3.i Planning for Excess Losses,[3367] one should convert suspended losses to net operating losses before a nongrantor trust terminates.

Being passive does cause income to constitute net investment income (NII)[3368] subject to the 3.8% tax on net investment income.[3369] However, for taxpayers who have income below the NII thresholds,[3370] that impact might be small or none. If the NII tax impact is significant, compare (a) the possible income tax savings if income and loss years tend to fluctuate significantly, to (b) the extra cost of NII tax; I am not suggesting that being passive will usually be better – merely that one might consider it when planning. Furthermore, suspended passive losses that offset passive income will also offset income that generally would otherwise be subject to the NII tax.

Finally, an NOL deduction does not reduce self-employment ("SE") income subject to SE tax, whereas a freed-up suspended loss does.[3371]

II.K.3.b. Maximizing Flexibility to Avoid NOLs and Use Losses in the Best Year

One might increase planning flexibility in the planning described in part II.K.3.a Why Being Passive Can Be Good by engaging in significant participation (more than 100 hours)[3372] rather than material participation (more than 500 hours).[3373] If suspending the loss becomes important and one sees the loss coming (or perhaps is experiencing losses and expects them next year), one might cut back one's work.

Material participation might be difficult to impossible to turn off:

- One might have worked too many hours in the year before one realizes that being passive is desirable.

[3365] See the introduction to part II.K.1 Passive Loss Rules Generally.
[3366] See part II.G.4.l.ii Net Operating Loss Deduction.
[3367] Especially text accompanying fn 2551.
[3368] See part II.I.8 Application of 3.8% Tax to Business Income.
[3369] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[3370] See part II.I.3 Tax Based on NII in Excess of Thresholds.
[3371] See part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax, especially the text accompanying fn 3400 and the preceding discussion of CCA 202009024.
[3372] See part II.K.1.i Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income, especially fns. 3257-3260.
[3373] See part II.K.1.a.ii Material Participation. Although more than 500 hours (see fn. 3058) is usually what people consider, it is not the only way to materially participate.

- One might have worked too many hours in a prior year to turn it off.
    - An individual is deemed to materially participate if the individual materially participated in the activity (determined without regard to this sentence) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year.[3374]
    - An individual is deemed to materially participate if the activity is a personal service activity, and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year.[3375]

Suppose an activity is passive when it generates losses and active when it generates income. The suspended passive losses offset active income from the same activity,[3376] and the active income avoids the 3.8% NII tax.[3377]

Furthermore:

- After 2017 tax reform, net operating losses (NOLs) offset only 80% of post-2020 taxable income,[3378] whereas suspended passive losses can offset 100% of taxable income when released.
- Also see part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

If one is leaning toward using significant participation instead of material participation, consider:

- If the taxpayer stops working in the business and continues to generate business income, material participation may keep the income nonpassive for as long as five years (longer for some businesses) after the taxpayer stops working, whereas significant participation does not carry over like that. For material participation, see part II.K.1.a.ii Material Participation.[3379]
- Part II.K.1.i.i.(b) Tax Trap from Recharacterizing PIGs as Nonpassive Income.

II.L. Self-Employment Tax (FICA)

II.L.1. FICA: Corporation

For corporations, compensation, including any distributions re-characterized as salaries, is subject to income tax and FICA tax.[3380] Income retained by the corporation and not paid as

[3374] See part II.K.1.a.ii Material Participation, especially fn. 3064.
[3375] See part II.K.1.a.ii Material Participation, especially fn. 3065.
[3376] See part II.K.1.k Former Passive Activities.
[3377] See part II.I.8 Application of 3.8% Tax to Business Income.
[3378] See part II.G.4.l.ii Net Operating Loss Deduction.
[3379] Especially fns 3064 (five years) and 3065 (three years in a personal service activity leads to permanent nonpassive status).
[3380] IRS Fact Sheet 2008-25 (http://www.irs.gov/uac/Wage-Compensation-for-S-Corporation-Officers) discusses recharacterizing distributions from S corporations as compensation for this purpose.

compensation is not subject to FICA tax.[3381] For combined employer and employee rates, see the paragraph of text accompanying fns 3391-3393 in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.

If all of the remuneration to an individual from related corporations[3382] is disbursed through the common paymaster,[3383] the total amount of FICA imposed on the employer and employee is

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[3381] Rev. Rul. 59-221, which was cited with approval by *Ding v. Commissioner*, T.C. Memo. 1997-435, *aff'd* 200 F.3d 587 (9th Cir. 1999), and by *U.S. v. Asiru*, 222 Fed. Appx. 584 (9th Cir. 2007). *Ding* held that a distributive share of S corporation income was not subject to SE tax. For an excerpt from *Ding* that included an excerpt from Rev. Rul. 59-221, see fn. 3498.

[3382] Reg. § 31.3121(s)-1(b)(1) provides the following before providing examples in flush language following it:

> *Related corporations*. Corporations shall be considered related corporations for an entire calendar quarter (as defined in § 31.0-2(a)(9)) if they satisfy any one of the following four tests at any time during that calendar quarter:
>
> (i) The corporations are members of a controlled group of corporations, as defined in section 1563 of the Code, or would be members if section 1563(a)(4) and (b) did not apply and if the phrase more than 50 percent were substituted for the phrase at least 80 percent wherever it appears in section 1563(a).
>
> (ii) In the case of a corporation that does not issue stock, either fifty percent or more of the members of one corporation's board of directors (or other governing body) are members of the other corporation's board of directors (or other governing body), or the holders of fifty percent or more of the voting power to select such members are concurrently the holders of fifty percent or more of that power with respect to the other corporation.
>
> (iii) Fifty percent or more of one corporation's officers are concurrently officers of the other corporation.
>
> (iv) Thirty percent or more of one corporation's employees are concurrently employees of the other corporation.

[3383] Reg. § 31.3121(s)-1(b)(2) provides the following:

> (i) *In general*. A common paymaster of a group of related corporations is any member thereof that disburses remuneration to employees of two or more of those corporations on their behalf and that is responsible for keeping books and records for the payroll with respect to those employees. The common paymaster is not required to disburse remuneration to all the employees of those two or more related corporations, but the provisions of this section do not apply to any remuneration to an employee that is not disbursed through a common paymaster. The common paymaster may pay concurrently employed individuals under this section by one combined paycheck, drawn on a single bank account, or by separate paychecks, drawn by the common paymaster on the accounts of one or more employing corporations.
>
> (ii) *Multiple common paymasters*. A group of related corporations may have more than one common paymaster. Some of the related corporations may use one common paymaster and others of the related corporations use another common paymaster with respect to a certain class of employees. A corporation that uses a common paymaster to disburse remuneration to certain of its employees may use a different common paymaster to disburse remuneration to other employees.
>
> (iii) *Examples*. The rules of this subparagraph are illustrated by the following examples:
> *Example (1)*. S, T, U, and V are related corporations with 2,000 employees collectively. Forty of these employees are concurrently employed by two or more of the corporations, during a calendar quarter. The four corporations arrange for S to disburse remuneration to thirty of these forty employees for their services. Under these facts, S is the common paymaster of S, T, U, and V with respect to the thirty employees. S is not a common paymaster with respect to the remaining employees.
> *Example (2)*.

(a) W, X, Y, and Z are related corporations. The corporations collectively have 20,000 employees. Two hundred of the employees are top-level executives and managers, sixty of whom are concurrently employed by two or more of the corporations during a calendar quarter. Six thousand of the employees are skilled artisans, all of whom are concurrently employed by two or more of the corporations during the calendar year. The four corporations arrange for Z to disburse remuneration to the sixty executives who are concurrently employed by two or more of the corporations. W and X arrange for X to disburse remuneration to the artisans who are concurrently employed by W and X.

(b) A is an executive who is concurrently employed only by W, Y, and Z during the calendar year. Under these facts, Z is a common paymaster for W, Y, and Z with respect to A. Assuming that the other requirements of this section are met, the amount of the tax liability under sections 3102 and 3111 is determined as if Z were A's only employer for the calendar quarter.

(c) B is a skilled artisan who is concurrently employed only by W and X during the calendar year. Under these facts, X is a common paymaster for S and X with respect to B. Assuming that the other requirements of this section are met, the amount of the tax liability under sections 3102 and 3111 is determined as if X were B's only employer for the calendar quarter.

Reg. § 31.3121(s)-1(b)(3) provides the following before providing examples following it:

> *Concurrent employment*. For purposes of this section, the term concurrent employment means the contemporaneous existence of an employment relationship (within the meaning of section 3121(b)) between an individual and two or more corporations. Such a relationship contemplates the performance of services by the employee for the benefit of the employing corporation (not merely for the benefit of the group of corporations), in exchange for remuneration which, if deductible for the purposes of Federal income tax, would be deductible by the employing corporation. The contemporaneous existence of an employment relationship with each corporation is the decisive factor; if it exists, the fact that a particular employee is on leave or otherwise temporarily inactive is immaterial. However, employment is not concurrent with respect to one of the related corporations if the employee's employment relationship with that corporation is completely nonexistent during periods when the employee is not performing services for that corporation. An employment relationship is completely nonexistent if all rights and obligations of the employer and employee with respect to employment have terminated, other than those that customarily exist after employment relationships terminate. Examples of rights and obligations that customarily exist after employment relationships terminate include those with respect to remuneration not yet paid, employer's property used the employee not yet returned to the employer, severance pay, and lump-sum termination payments from a deferred compensation plan. Circumstances that suggest that an employment relationship has become completely nonexistent include unconditional termination of participation in deferred compensation plans of the employer, forfeiture of seniority claims, and forfeiture of unused fringe benefits such as vacation or sick pay. Of course, the continued existence of an employment relationship between an individual and a corporation is not necessarily established by the individual's continued participation in a deferred compensation plan, retention of seniority rights, etc., since continuation of those benefits may be attributable to employment with a second corporation related to the first corporation if the corporations have common benefits plans or if the benefits are continued as a matter of corporate reciprocity. An individual who does not perform substantial services in exchange for remuneration from a corporation is presumed not employed by that corporation. Concurrent employment need not exist for any particular length of time to meet the requirements of this section, but this section only applies to remuneration disbursed by a common paymaster to an individual who is concurrently employed by the common paymaster and at least one other related corporation at the time the individual performs the services for which the remuneration is paid. If the employment relationship is nonexistent during a quarter, that employee may not be counted towards the 30-percent test set forth in paragraph (b)(1)(iv) of this section; however, even if the employment relationship is nonexistent, section 3121(s) of the Code applies to remuneration paid to the former employee for services rendered while the employee was a common employee.

determined as though the individual has only one employer (the common paymaster).[3384] The common paymaster is responsible for filing information and tax returns and issuing Forms W-2 with respect to wages it is considered to have paid under this rule.[3385]

For S corporations, shareholders' health insurance is deductible to the S corporation and considered compensation to owners.[3386] However, it is subject to FICA only if offered in a plan that discriminates in favor of owners. The owners may deduct health insurance subject to the same rules as partners and sole proprietors.[3387]

II.L.2. Income Subject to Self-Employment Tax

II.L.2.a. Types of Income Subject to Self-Employment Tax

II.L.2.a.i. General Rules for Income Subject to Self-Employment Tax

FICA is paid one-half by the employee and one-half by the employer. If an individual is self-employed, the individual pays both halves, which combined are called self-employment (SE) tax.

Generally, all of a partnership's[3388] or sole proprietorship's[3389] income from business operations is subject to income tax and SE tax.[3390] SE tax is 15.3%[3391] (on income up to the taxable wage base (TWB) and 2.9%[3392] on all (RRA 1993 repealed the cap) income above the TWB until $200,000 (single) or $250,000 (married filing jointly), above which the tax is 3.8%.[3393] See http://www.ssa.gov/OACT/COLA/cbb.html for the current amount ($160,200 in 2023 and $168,600 in 2024). For timing, see part II.Q.1.d.iii Timeline for FICA and Income Taxation of Deferred Compensation.

Half of the SE tax is deductible for income tax purposes (which makes it less burdensome than the 3.8% tax on net investment income (NII), none of which is deducible), except that the 0.9% additional tax (that increases the 2.9% rate to 3.8%) is not considered in calculating that deduction.[3394] SE income is not subject to the 3.8% NII tax,[3395] which means that taxpayers who

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[3384] Reg. § 31.3121(s)-1(a).
[3385] Reg. § 31.3121(s)-1(a).
[3386] Rev. Rul. 91-26.
[3387] IRS Announcement 92-16, clarifying Rev. Rul. 91-26. See also IRS Notice 2005-8 (health savings accounts).
[3388] Reg. § 1.1402(a)-2(d). "Partnership" is defined in Code § 7701(a)(2) and includes a pool or joint venture whether the parties specifically elected to be excluded from the application of subchapter K, which generally governs partnership income taxation. *Methvin v. Commissioner*, T.C. Memo. 2015-81, *aff'd* 653 Fed. Appx. 616 (10th Cir. 6/24/2016).
[3389] Reg. § 1.1402(a)-2(b).
[3390] An attempt to deflect self-employment income to trusts (that do not pay self-employment tax), which distributed their income to the beneficiaries, did not succeed. *Olsen v. Commissioner*, T.C. Memo. 2008-275.
[3391] 12.4% under Code § 1401(a) plus 2.9% under Code § 1401(b).
[3392] Code § 1401(b).
[3393] Code § 1401(b)(2)(A). The thresholds are reduced (but not below zero) by wages, presumably so that a taxpayer cannot avoid this tax by splitting earned income between wages and self-employment income. Code § 1401(b)(2)(B).
[3394] Code § 164(f). A similar deduction is allowed in computing SE income; see Code § 1402(a)(12).
[3395] See fn. 2290 in part II.I.5 What is Net Investment Income Generally.

exceed the TWB each year would generally prefer to pay SE tax on the excess instead of NII tax, if they cannot qualify for exclusions from NII tax.

Specifically, Code § 1402(a) begins:

> The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member….

Note that depreciation deductions reduce net earnings from self-employment (NESE), but generally the gain generated from recapturing depreciation on the sale of an asset does not constitute NESE; see part II.L.2.a.iii Whether Gain from Sale of Property is Subject to SE Tax.

By applying for regular income tax purposes, passive loss,[3396] at-risk,[3397] and basis[3398] limitations also apply in determining SE income. CCA 202009024 explains:

> Section 1402(a) of the Code defines the term "net earnings from self-employment" as the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by subtitle A[1] which are attributable to such trade or business, plus the individual's distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member, with certain enumerated exceptions.
>
> > [1] Subtitle A of the Internal Revenue Code encapsulates §§ 1 through 1564. Section 1.1402(a)-1(a)(1) of the Income Tax Regulations more specifically references deductions allowed by chapter 1 of the Code, which includes §§ 1 through 1400Z-2.
>
> Section 1.1402(a)-2(d) of the Income Tax Regulations provides that the net earnings from self-employment of an individual include, in addition to the earnings from a trade or business carried on by him, his distributive share of the income or loss, described in section 702(a)(8), from any trade or business carried on by each partnership of which he is a member. An individual's distributive share of such income or loss of a partnership shall be determined as provided in section 704, subject to the special rules set forth in section 1402(a) and in §§ 1.1402(a)-1 to 1.1402(a)-17, inclusive, and to the exclusions provided in section 1402(c) and §§ 1.1402(c)-2 to 1.1402(c)-7, inclusive.
>
> Section 1.1402(a)-3 of the Income Tax Regulations provides that for the purpose of computing net earnings from self-employment, the gross income derived by an individual from a trade or business carried on by him, the allowable deductions attributable to such trade or business, and the individual's distributive share of the income or loss, described in section 702(a)(8), from any trade or business carried on by a partnership of which he is a member shall be computed in accordance with the special rules set forth in §§ 1.1402(a)-4 to 1.1402(a)-17, inclusive.

[3396] See part II.K Passive Loss Rules, which describes Code § 469.
[3397] See part II.G.4.j At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities).
[3398] See part II.G.4.e Basis Limitations for Partners in a Partnership.

Section 465(a) of the Code allows any loss from an activity for the taxable year only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of subsection (b)) for such activity at the close of the taxable year for individuals and C corporations that meet the stock ownership requirement under section 542(a)(2) [*i.e.*, five or less individuals owning more than 50 percent in value] engaged in an activity to which this section applies.

Section 469 of the Code disallows passive activity losses and passive activity credits for the taxable year for individuals, estates, trusts, closely-held C Corporations, and personal service corporations.

Section 1.469-1T(d)(3) of the Income Tax Regulations provides that, except as otherwise provided in regulations, a deduction that is disallowed for a taxable year under section 469 and the regulations thereunder is not taken into account as a deduction that is allowed for the taxable year in computing the amount subject to any tax imposed by subtitle A of the Internal Revenue Code.

The following example in the regulations illustrates the application of § 1.469-1T(d)(3):

> *Example*. An individual has a $5,000 passive activity loss for a taxable year, all of which is disallowed under § 1.469-1T(a)(1). All of the disallowed loss is allocated under § 1.469-1T(f) to activities that are trades or businesses (within the meaning of section 1402(c)). Such loss is not taken into account for the taxable year in computing the taxpayer's taxable income subject to tax under section 1. *In addition, such loss is not taken into account for the taxable year in computing the taxpayer's net earnings from self-employment subject to tax under section 1401.* (Emphasis added).

Section 704(d) of the Code provides that a partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

Section 707(c) of the Code provides a rule with respect to guaranteed payments made by a partnership to a member of the partnership. It provides that to the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).

Section 1.707-1(c) of the Income Tax Regulations provides that guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b) and 708(b). In addition, § 1.707-1(c) states that for purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income. Section 1.1402(a)-1(b) of the Income Tax Regulations provides that guaranteed payments are treated as gross income subject to self-employment tax.

A general partner in a partnership is subject to SECA tax on his or her self-employment income as defined in § 1402(b). The Code defines "self-employment income" as the NESE derived by an individual with certain adjustments. NESE as defined in § 1402(a) takes into account deductions that are allowed by subtitle A with regard to any trade or business carried on by the individual and includes the partner's distributive share of the income or loss from any trade or business carried on by the partnership, subject to the special rules under § 1402. If a partner incurs losses from partnership activities, there are rules or code provisions that limit the amount of losses a partner is allowed to take for general income tax purposes on the individual partner's tax return. These provisions include, in the order that applies: first, basis loss limitation under § 704(d); second, at-risk loss limitation under §465; and third, passive activity loss limitation under § 469. Since the calculation of NESE specifically incorporates the effect of subtitle A income tax provisions in determining deductions from trades or businesses carried on by the taxpayer and the partnership provisions in determining the distributive share of any loss, any loss limitation rule that applies for determining a partner's general income tax liability should also apply for determining a partner's SECA tax liability, unless a particular Code provision or regulation provides otherwise.[2]

[2] Some taxpayers have erroneously cited to Revenue Ruling 56-675, 1956-2 C.B. 459, as authority that NESE is not affected by the loss limitations under §§ 704(d), 465, and 469. It is our position that this ruling is not an authority on the application of the various loss limitations for SECA tax purposes. Rev. Rul. 56-675 stated that under § 1.1402(a)-1(a)(2) of the regulations, guaranteed payments are treated as gross income subject to SECA tax. However, where a partner's distributive share includes a loss resulting from the operation of the partnership business, including the deduction for guaranteed payments treated as a business expense under section 162, the self-employment income is the net amount computed by applying to the guaranteed payment received by that partner the distributive share of loss. Rev. Rul. 56-675 did not address the application of loss limitations for SECA tax purposes. Since basis cannot be negative, the facts implied taxpayer had sufficient basis, so the loss limitation of § 704(d) would not apply. Also, loss limitations under §§ 465 and 469 did not exist in 1956. Consequently, Rev. Rul. 56-675 is not applicable to whether and how the loss limitation rules apply in determining NESE under § 1402.

Specific guidance indicates that the basis loss limitation under § 704(d) and the passive activity loss limitation under § 469 apply to determine a general partner's NESE under § 1402 for SECA tax purposes. Stating, in part, that "[a]n individual's distributive share of such income or loss of a partnership shall be determined as provided in section 704," Treas. Reg. § 1.1402(a)-2(d) pulls in the basis loss limitation under § 704(d) into the computation of NESE.

Also, Treas. Reg. § 1.469-1T(d)(3) provides that a deduction under § 469 or the regulation is not taken into account for any subtitle A tax, which includes SECA tax imposed under §§ 1401 through 1403. Furthermore, the example under that regulation specifically articulates that "[passive activity] loss is not taken into account for the taxable year in computing the taxpayer's net earnings from self-employment subject to tax under section 1401" when the loss is not taken into account in computing a taxpayer's taxable income subject to tax under section 1. Although the example does not expressly involve a passive activity loss from a partnership, the regulation provision it illustrates makes no distinction between individuals conducting the trade or business directly and partners in a partnership conducting the trade or business.[3]

[3] TAM 9750001 (August 15, 1997) relied on § 1.469-1T(d)(3) and the example in concluding that the losses allocable to the partnership's activity in which he did not materially participate are taken into account for purposes of the calculation of NESE under § 1402, but only to the extent they are allowable for income tax purposes and are not otherwise of a character to be specifically excluded from the calculation of NESE.

Furthermore, § 465 applies in determining NESE of individuals carrying on a trade or business because § 1402(a) expressly takes into account deductions that are allowed by subtitle A (which is inclusive of the loss limitation rule of § 465) with regard to any trade or business carried on by the individual. While there is no similar guidance under § 1402 or § 465 that expressly states that the at-risk loss limitation under § 465 also applies for purposes of calculating NESE of general partners for SECA tax purposes, applying this loss limitation rule in determining a general partner's NESE under § 1402 for SECA tax purposes is consistent with considering the basis loss limitation under § 704(d) and the passive activity loss limitation under § 469 in computing NESE for a general partner. Like the application of § 469, § 465 determines the extent to which the partner's distributive share of the losses from the partnership carrying on the trade or business is taken into account in determining the partner's taxable income for the taxable year, and its effect is not limited to chapter 1 of the Code. Section 465 generally applies for purposes of the Code, including chapter 2.

Thus, if the individual share of loss from the partnership is disallowed to a partner under §§ 704(d) or 465 for the taxable year, the loss is also not taken into account in computing the partner's NESE for that taxable year for SECA tax purposes, assuming there is no SECA provision or regulation that provides otherwise (such as with excluded rental income).

Similarly, *Duffy v. Commissioner*, T.C. Memo. 2020-108, held that, if losses from one SE activity offset income (guaranteed payments) from another SE activity for regular tax purposes, they also offset it for SE tax purposes:[3399]

[3399] Fn. 16 in the opinion held:

If Mr. Duffy could be viewed as a limited partner of Impact Medical, his ordinary losses from the partnership would be excluded from his net earnings from self-employment regardless of whether those losses were deductible under sec. 704(d). See sec. 1402(a)(13). In that case, the guaranteed payments he received would be included in his net earnings from self-employment without any offsetting deduction if those payments were for services Mr. Duffy rendered to the partnership. See *id*. Because Impact Medical was a limited liability company, however, Mr. Duffy was a member and not a limited partner. Even so, he could be treated as a limited partner if his relationship to the entity was akin to that of a limited partner in a limited partnership. See generally *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011). In *Renkemeyer*, *Campbell & Weaver, LLP v. Commissioner*, 136 T.C. at 147, however, we concluded that an owner's protection from claims against an entity is not enough to qualify the owner as a limited partner for purposes of sec. 1402(a)(13). Instead, we concluded that an interest other than a limited partner interest could be treated as such for purposes of that section only if the holder is merely a passive investor in the entity who does not actively participate in the entity's business operations. *Id*.at 150. But Mr. Duffy served as Impact Medical's manager and, as such, was obliged to run the company's day-to-day operations. Therefore, we see no grounds for treating him as a limited partner of Impact Medical within the meaning of sec. 1402(a)(13).

> The text of section 1402(a) gives no indication that the individual's distributive share of a loss from a business conducted by a partnership reduces the individual's net earnings from self-employment only to the extent that the individual's outside basis in the partnership is sufficient to allow him to deduct the loss in computing his regular income tax liability.
>
> Moreover, the regulations interpreting section 1402(a) provide no apparent grounds for distinguishing between deductible partnership losses and those limited by section 704(d). Section 1.1402(a)-1(a)(2), Income Tax Regs., defines "net earnings from self-employment" to include two components, the second of which is an individual's "distributive share (whether or not distributed), as determined under section 704, of the income (or minus the loss), described in section [702(a)(8)] [8]) and as computed under section 703, from any trade or business carried on by any partnership of which is he a member." The mandate that the individual's distributive share of a partnership loss be "determined under section 704" requires consideration of section 704(d). But section 704(d) does not reduce a partner's distributive share of a partnership loss; it reduces only the portion of that loss that is allowed as a deduction in computing the partner's regular taxable income. Losses not allowed as a deduction by reason of the section 704(d) limitation remain part of the partner's distributive share of the loss (and can be deducted in future years if the partner has a sufficient outside basis).
>
> …. Because the deductible loss exceeds Mr. Duffy's guaranteed payments of $218,182 for the year, we conclude that Mr. Duffy had no net earnings from self-employment for 2013 regardless of whether his distributive share of the partnership's loss can be taken into account only to the extent that it is deductible under chapter 1….

CCA 202009024 denied SE losses suspended in the then-current year by basis or at-risk limitations from being used against SE income earned that year. The corollary from *Duffy* is that, when the restriction no longer applies, the loss would be able to be used against SE income. So, if a taxpayer has only one business generating SE income, this rule is very helpful, because the prior year loss reduces SE income, when otherwise the loss might have generated no SE tax benefit. A net operating loss (NOL) is not deductible from SE income.[3400] For similar issues regarding regular income tax, see part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good.

When applied to an individual, "To be taxable as self-employment income, an individual's income must be (1) derived, (2) from a trade or business, (3) carried on by that individual."[3401]

[3400] Code § 1402(a)(4).

[3401] *Milligan v. Commissioner*, 38 F.3d 1094 (9th Cir. 1994), which continued:

> Milligan agrees with the tax court that the trade or business and carried on requirements have been satisfied. In other words, he agrees that the Termination Payments are subject to self-employment tax if they were derived from the carrying on of his previous work as an insurance agent. *Simpson v. Commissioner*, 64 T.C. 974, 989 (1975) (self-employment tax on insurance agent's trade or business earnings, e.g., commissions, as an independent contractor); *Erickson v. Commissioner*, 64 T.C.M. (CCH) 963, 966 (1992), *aff'd without op.*, 1 F.3d 1231 (1st Cir. 1993) (self-employment tax on deferred payments of unpaid commissions and renewal commissions to former insurance agent). It is immaterial that Milligan was no longer self-employed in 1987 when he received the Termination Payments. Treas. Reg. section 1.402(a)-1(c) (as amended in 1974) (Gross income derived from a trade or business includes gross income received ... in the taxable

Applying the "derived" test, the income must arise from the taxpayer's trade or business income producing activity.[3402] "To be taxable as self-employment income, earnings must be tied to the quantity or quality of the taxpayer's prior labor, rather than the mere fact that the taxpayer worked or works for the payor."[3403] When the taxpayer was fully compensated for prior work and the payments at issue were based on others' retention of the business, termination payments did not constitute SE income.[3404] Because such trailing commissions depend on others' maintaining the business, they are not SE income, regardless of their other income tax characteristics.[3405] In a reviewed decision with a lone dissent, the Tax Court has agreed with

year even though such income may be attributable in whole or in part to services rendered or other acts performed in a prior taxable year ....); *Shumaker v. Commissioner*, 648 F.2d 1198, 1200 (9th Cir. 1981) (affirming self-employment tax on sale proceeds from wheat taxpayer grew in the past: [S]elf-employment income is determined by the source of the income, not the taxpayer's *status* at the time the income is realized.) (Emphasis added.)

[3402] *Milligan v. Commissioner*, 38 F.3d 1094 (9th Cir. 1994), reasoned:

The term "derive" requires "a nexus between the income received and a trade or business that is, or was, actually carried on." *Newberry v. Commissioner*, 76 T.C. 441, 444 (1981). By nexus, we mean that the "trade or business activity by the taxpayer *gives rise to* the income...." *Id.* (emphasis added). The income is sufficiently related to the taxpayer's trade or business activity when the business activity is its source. *Id.* at 446 ("Any income must arise from some actual ... income-producing activity of the taxpayer before such income becomes subject to ... self-employment taxes...."). See, *e.g.*, *Shumaker*, 648 F.2d at 1200 (income derived from selling wheat from prior farming activity).

[3403] *Milligan v. Commissioner*, 38 F.3d 1094 (9th Cir. 1994).

[3404] *Milligan v. Commissioner*, 38 F.3d 1094 (9th Cir. 1994), reasoned:

Because Milligan already had been fully compensated for his services, none of his business activity was the "source" of the Termination Payments. The payments did not represent deferred compensation of previously-earned commissions, *cf. Erickson*, *supra*, because none of Milligan's earnings were deferred, *i.e.*, he had no vested right to payment of an identifiable money amount. Nor were they renewal commissions on previously-generated policies, *cf. id.*; *Becker v. Tomlinson*, 9 A.F.T.R.2d 1408, 1409-10 (S.D. Fla. 1962), or retirement income tied to Milligan's years of service and overall earnings.

At most, the *amount* of the Termination Payments, not the payments themselves, actually arose from Milligan's business activity. Milligan had a contingent right to receive an uncertain amount of money or nothing, depending upon the level of his prior business activity leading to compensation in his final year as an agent. The payment amount depended upon the level of his commissions (and service compensation from State Farm-Auto) on personally-produced policies, *i.e.*, his previous value as a State Farm insurance agent.

However, in part, even the payment *amount* did not depend upon the level of Milligan's prior business activity because the Termination Payments were subject to two adjustments *unrelated* to any business activity on Milligan's part for State Farm. The State Farm companies adjusted the Termination Payments to reflect the amount of income received on Milligan's book of business during the first post-termination year, and the number of his personally-produced policies cancelled during that year. If all of Milligan's customers had cancelled their State Farm non-life policies during the first post-termination year, then Milligan would have received nothing. The adjusted payment amount depended not upon Milligan's past business activity, but upon the successor agent's future business efforts to retain Milligan's customers and to generate service compensation for State Farm. In this way too, the disputed Termination Payments did not "derive" from Milligan's prior services.

[3405] *Gump v. U.S.*, 86 F3d 1126 (Fed. Cir. 1996), commenting:

Because the payments are not "derived" from his insurance business, we need not determine the precise nature of the payments or specifically characterize them as a particular type of income. That is, we need not determine whether they represent consideration for an agreement not to compete or the purchase of his insurance franchise, including its assets and goodwill. It suffices the above analysis.[3406] However, payments tied to the quantity and quality of prior services are "derived from" those services.[3407] Congress codified this test with respect to insurance

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to hold, as we do, that they are not derived from a trade or business carried on by Gump and thus they are not taxable as self-employment income.

[3406] *Jackson v. Commissioner*, 108 T.C. 130 (1997), holding:

> In the interest of promoting uniformity, consistency, and fairness in the disposition of this issue with respect to former insurance agents who receive termination payments under similar contractual agreements, we follow the decision of the Court of Appeals for the Ninth Circuit in *Milligan v. Commissioner*, *supra*. Accordingly, upon further reflection and analysis, we hold that the termination payments petitioner received in 1990 and 1991 are not subject to self-employment tax. Because we conclude that the termination payments were not "derived" from the carrying on of petitioner's insurance business,[4] we need not decide the precise nature of the payments or specifically characterize them as a particular type of income. In other words, we need not decide in this case whether the termination payments are consideration for an agreement not to compete or the purchase of petitioner's agency, including its assets and goodwill. *Milligan v. Commissioner*, 38 F.3d at 1100.
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> [4] See, *e.g.*, *Ohio Farm Bureau Federation, Inc. v. Commissioner*, 106 T.C. 222, 236 (1996), an analogous case, in which we pointed out that the statutory language defining "unrelated business income" in sec. 512(a) is similar to that contained in sec. 1402(a). There it was held that a lump-sum payment made by Landmark, Inc., to the taxpayer, pursuant to the terms of a nonsponsorship and noncompetition clause contained in their termination agreement, did not constitute unrelated business taxable income under sec. 511(a). We applied the rationale of *Newberry v. Commissioner*, 76 T.C. at 444. The Government did not appeal our decision, and the IRS has since revoked GCM 39865, TR-45-1437-90 (Dec. 12, 1991), which reached a contrary conclusion.

Three judges would have reached the same result, viewing the payments as either for the goodwill of petitioner's former insurance business (his books of customer accounts) or for a covenant not to compete. Here are some excerpts:

> Goodwill is acquired by the purchaser of a going concern where the transfer enables the purchaser to step into the shoes of the seller. See *Decker v. Commissioner*, 864 F.2d 51, 54 (7th Cir. 1988), *affg.* T.C. Memo. 1987-388; *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 681 (5th Cir. 1971). Here the terms of the Agreement between petitioner and State Farm allowed petitioner's successor agent to step into his shoes. The successor agent continued the same business and sold insurance to the same customers….
>
> Payments attributable to a covenant not to compete are not "earned" income, *Furman v. United States*, 602 F.Supp. 444, 451 (D.S.C. 1984), *affd.* without published opinion 767 F.2d 911 (4th Cir. 1985), and they are not subject to self-employment tax. *Barrett v. Commissioner*, 58 T.C. 284 (1972); see also *Ohio Farm Bureau Federation, Inc. v. Commissioner*, 106 T.C. 222, 236 n.8 (1996).

[3407] *Schelble v. Commissioner*, 130 F.3d 1388 (10th Cir. 1997) reasoned:

> In contrast to Milligan, Mr. Schelble's payments are tied to the quantity and quality of his prior services performed for the Companies. Although the payments in *Milligan* and Mr. Schelble's payments have similar eligibility requirements such as (1) a minimum service requirement; (2) relinquishment of company records and policies; and (3) a covenant not to compete, Mr. Schelble's payments have distinguishing features related to Mr. Schelble's prior services. For example, unlike the plan in Milligan, Mr. Schelble must have 400 outstanding policies at his termination to be eligible for extended earnings payments. In addition, in contrast to Milligan, the amount of Mr. Schelble's payments was computed based on Mr. Schelble's length of service for the Companies. As an agent for the Companies for over fifteen years, Mr. Schelble's extended earnings payments were calculated using a higher percentage than if he had only been an agent for five or ten years. Furthermore, unlike the payments in Milligan, Mr. Schelble's extended earnings payments were calculated solely on the percentage applied to service fees paid to him during the twelve months preceding the Agreement's termination. No adjustments unrelated to

salesmen (see part II.L.8 Retirement Payments to Insurance Salesmen), and one court has stated, over a strong (and correct, in my view) dissent, that the line of cases described above is limited to insurance salesmen[3408] and held that payments labelled as deferred compensation in an agreement with a beauty products salesman were subject to FICA,[3409] notwithstanding one

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> Mr. Schelble's prior services were made in calculating these payments. Based on these distinguishing factors, we conclude Mr. Schelble's payments are sufficiently derived from his prior insurance business to constitute self-employment income subject to self-employment tax under 26 U.S.C. section 1401.

[3408] *Peterson v. Commissioner*, 827 F.3d 968 (11th Cir. 2016), at fn. 42, commented:

> In 1997, Congress amended 26 U.S.C. § 1402 by adding subsection (k) for the specific purpose of "codif[ying] the standard established in *Milligan* with respect to termination payments made ... to an insurance salesman." *Farnsworth v. Comm'r*, 83 T.C.M. (CCH) 1153, 1159 & n.5 (2002) (citing H.R. Rep. No. 105-220, at 458 (1997) (Conf. Rep.)). As codified in § 1402(k), the *Milligan* standard holds that self-employment tax does not apply to post-termination payments from an insurance company to its former insurance salesman, provided four requirements inapplicable to this case are satisfied. See 26 U.S.C. § 1402(k)(2), § 1402(k)(3), 1402(k)(4)(A), § 1402(k)(4)(B). The Petersons concede § 1402(k) was intended to codify the *Milligan* standard, which unambiguously applies only to contractual termination payments to former insurance agents. Appellants Br. at 19-20. By urging the application of *Milligan* in this case, the Petersons and amici invite this court to expand § 1402(k) beyond the confines of its text. Appellants Br. At 20; Amicus Curiae Br. at 9. If Congress had intended the *Milligan* standard to be applied outside the context of termination payments to insurance salesmen, it would have so stated. Instead, it unambiguously limited the standard to the context of termination payments to former insurance agents.
>
> In addition, the legislative history of § 1402(k) states "[n]o inference is intended with respect to the [self-employment] tax treatment of payments that are not described in [§ 1402(k)]." H.R. Rep. No. 105-220, at 458 (1997) (Conf. Rep.), reprinted in 1997-4 (Vol. 2) C.B. 1457, 1928; see *Ruckelshaus v. Sierra Club*, 463 U.S. 680, 686 n. 8, 103 S.Ct. 3274, 3278 n.8 (1983) ("If Congress had intended the far-reaching result urged by respondents, it plainly would have said so, as is demonstrated by Congress careful statement that a less sweeping invitation was adopted."). Moreover, if *Milligan* accurately reflected the generally applicable "derived from" standard under § 1402(a), then § 1402(k) would be superfluous. See, *e.g.*, *Nunnally v. Equifax Info. Servs., LLC*, 451 F.3d 768, 773 (11th Cir. 2006) ("It is a cardinal principle of statutory construction that a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant." (citation omitted)). We decline to expand § 1402(k) beyond its text, as the Petersons and amici urge. The dissent, however, ignores this legislative history and case law clearly limiting *Milligan* to insurance salesmen.

For Code § 1402(k), see part II.L.8 Retirement Payments to Insurance Salesmen.

[3409] *Peterson v. Commissioner*, 827 F.3d 968 (11th Cir. 2016), at fn. 42, reasoned:

> The Tax Court concluded the Petersons do not dispute the 2008 Amendments to the Family Program and the Futures Program expressly characterize them as "deferred compensation (i.e., related to Mrs. Peterson's prior labor)." *Peterson*, 106 T.C.M. (CCH) 619, *3. Under the "*Danielson* rule," that characterization is controlling for tax purposes. *Comm'r v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967) (en banc); *Spector v. Comm'r*, 641 F.2d 376, 384-86 (5th Cir. Unit A Apr. 1981) (adopting the *Danielson* rule). Our court has explained the *Danielson* rule:
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> > When a taxpayer characterizes a transaction in a certain form, the Commissioner may bind the taxpayer to that form for tax purposes. This is the rule: "a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties [to the agreement] would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, et cetera."

of the two payment plans appearing to fall within the protection of case law. Information Letter 2016-0081 argued that certain undescribed post-retirement payments were SE income. *Potter v. Commissioner*, T.C. Memo. 2018-153, held:

> … For income to be taxable as self-employment income, "there must be a nexus between the income received and a trade or business that is, or was, actually carried on." *Newberry v. Commissioner*, 76 T.C. 441, 444 (1981). For there to be a "nexus" and the income to be subject to self-employment tax, the income must arise from some actual - past, present, or future - income-producing activity of the taxpayer. *Id*. at 446. Additionally, gross income derived from a taxpayer's trade or business may be subject to self-employment tax even when it is attributable in whole or in part to services rendered in a prior taxable year. Sec. 1.1402(a)-1(c), Income Tax Regs. "[S]elf-employment income is determined by the source of the income, not the taxpayer's status at the time the income is realized." *Schelble v. Commissioner*, 130 F.3d at 1392 (alteration in original) (quoting *Shumaker v. Commissioner*, 648 F.2d 1198, 1200 (9th Cir. 1981), *aff'g in part*, *rev'g in part* T.C. Memo. 1979-71.
>
> Green Country and Mr. Potter agreed that he was an independent contractor. Additionally, petitioners and respondent stipulated that the termination payment was Mr. Potter's money, not Potter Sales'. The termination payment was calculated by

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> *Plante v. Comm'r*, 168 F.3d 1279, 1280-81 (11th Cir. 1999) (quoting *Danielson*, 378 F.2d at 775) (citation and alteration omitted). Because Peterson had signed the retirement Program Agreements respectively in 1992 and 2005 permitting Mary Kay to amend them prospectively, she necessarily had consented to the 2008 Amendments that expressly characterized the Family Program and Futures Program payments as "deferred compensation" under a nonqualified compensation plan pursuant to Section 409A of the Internal Revenue Code,[29] which makes the *Danielson* rule applicable.[30] See *Comm'r v. Nat'l Alfafa Dehydrating & Milling Co.*, 417 U.S. 134, 149, 94 S.Ct. 2129, 2137 (1974) ("This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not." (citations omitted)).[31]
> The Tax Court applied the Danielson rule and determined Peterson's 2009 distributions from the Family Program and Futures Program were "subject to self-employment tax pursuant to section 1401," because the Petersons had "failed to adduce proof sufficient to alter the construction of these unambiguous agreements or show that they were unenforceable." *Peterson*, 106 T.C.M. (CCH) 619, *3 (citing *Plante*, 168 F.3d at 1280-81; *Danielson*, 378 F.2d at 775). The Petersons do not dispute the Amendments to the Program Agreements unambiguously characterize Peterson s post-retirement payments as deferred compensation. The undisputed lack of ambiguity in the terms of the Program Agreements necessarily precludes the Petersons from "adducing proof which in an action between the parties would be admissible to alter that construction." *Plante*, 168 F.3d at 1280-81. When a contract is unambiguous, Texas law holds the parties intent must be determined from the contract terms alone. *Friendswood Dev. Co. v. McDade & Co.*, 926 S.W.2d 280, 283 (Tex. 1996); see also *Valence Operating Co. v. Dorsett*, 164 S.W.3d 656, 662 (Tex. 2005) (recognizing, under Texas law, a written contract must be construed in accordance with "the true intentions of the parties as expressed in the instrument").[32] Therefore, the *Danielson* rule requires that the Petersons are bound by the characterization of her 2009 Mary Kay, post-retirement Program payments as deferred compensation, making them subject to self-employment tax.
> [footnotes omitted]

Sherman v. Commissioner, T.C. Summary Opinion 2018-15, and *Dunlap v. Commissioner*, T.C. Summary Opinion 2020-10, reiterated the Tax Court's belief that *Peterson v. Commissioner*, T.C. Memo. 2013-271, was correct, notwithstanding the dissent in the Eleventh Circuit's opinion.
See part II.G.33 Taxpayer Disavowing Form.

> multiplying Mr. Potter's previous year's commissions by 1-1/2. Thus if Mr. Potter had earned no commissions in the previous year, the termination payment would have been zero. The termination payment was tied to the quantity and quality of Mr. Potter's work by being based on his previous year's commissions; no adjustments unrelated to his prior services were made in calculating the payment. See *Schelble v. Commissioner*, 130 F.3d at 1393. Therefore, the termination payment is subject to self-employment tax.[11]
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> > [11] The Court notes that this decision follows the U.S. Court of Appeals for the Tenth Circuit - the Circuit in which, absent an agreement between the parties otherwise, these cases are appealable, see sec. 7482(b) - and does not rely on *Jackson v. Commissioner*, 108 T.C. 130, 140 (1997), which held that "[i]n the interest of promoting uniformity, consistency, and fairness in the disposition of this issue with respect to former insurance agents who receive termination payments under similar contractual agreements, we follow the decision" in *Milligan v. Commissioner*, 38 F.3d 1094 (9th Cir. 1994), *rev'g* T.C. Memo. 1992-655. The U.S. Court of Appeals for the Ninth Circuit had reversed the Tax Court, holding that the termination payment due an insurance salesman did not derive from the quality and quantity of his work and was therefore not subject to self-employment tax. Both *Jackson* and *Milligan* were about termination payments made to insurance salesmen - and had fact patterns similar to those of many other cases concerning termination payments to insurance salesmen - and the holding in *Jackson* sought to bring uniformity to that subset of termination payment cases. That "uniformity, consistency, and fairness" does not mean that every case about termination payments must be decided under the holding in *Jackson*. See *Kennedy v. Commissioner*, T.C. Memo. 2010-206 (finding that payments received in connection with the sale of an employee benefits consulting business were not capital gain but ordinary income subject to self-employment tax). The U.S. Court of Appeals for the Tenth Circuit has also contrasted other termination payment cases from *Milligan*. See *Schelble v. Commissioner*, 130 F.3d 1388 (10th Cir. 1997), *aff'g* T.C. Memo. 1996-269; *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

The taxpayer's work can determine whether an activity is a trade or business.[3410] An author's work can bring into the ambit of SE income not only royalties from book sales but also other income from promoting her brand; *Slaughter v. Commissioner*, T.C. Memo. 2019-65, held:

> We conclude that petitioner's brand is part of her trade or business. We construe "trade or business" broadly, and, examining all of the facts, find that petitioner was engaged in developing her brand with continuity and regularity for the primary purpose of income and profit. See *Jones v. Commissioner*, T.C. Memo. 1998-354; *Dacey v. Commissioner*, T.C. Memo. 1992-187; *Hittleman v. Commissioner*, T.C. Memo. 1990-325. Petitioner set

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[3410] *Chai v. Commissioner*, T.C. Memo. 2015-42, stated:

> The term trade or business has the same meaning under section 1402(a) as under section 162. Sec. 1402(c); see *Bot v. Commissioner*, 118 T.C. 138, 146 (2002), *aff'd*, 353 F.3d 595 (8th Cir. 2003). In *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987), the Supreme Court determined that to be engaged in a trade or business under section 162 (and, in this case, section 1402(a)), the taxpayer must be involved in an activity with continuity and regularity and with the primary purpose of receiving income or profit.

In addition to citing *Groetzinger* in applying the above test, *Slaughter v. Commissioner*, T.C. Memo. 2019-65, *aff'd* 128 A.F.T.R.2d 2021-5399 (11th Cir. 8/3/2021), also cited *Hornaday v. Commissioner*, 81 T.C. 830, 834, 836-837 (1983).

out in a businesslike fashion to obtain stationery, a reputable agent, and a publishing contract. Petitioner worked with a media coach and publishers to develop a successful brand. She has spent time, including during 2010 and 2011, meeting with publishers, agents, media contacts, and others to protect and further her status as a brand author. She attended interviews and promotional events and works to develop and maintain good relationships with booksellers and librarians. Petitioner also uses social media, websites, and a newsletter to maintain her brand with her readership. Further, it is common in the publishing industry for writers to build brands and promote their work. We have held that an author's TV and radio appearances, for example, are evidence that a taxpayer is in the trade or business of writing rather than writing as a hobby. See, *e.g.*, *Dacey v. Commissioner*, T.C. Memo. 1992-187.

Petitioner contends that her brand could never be part of a trade or business because she is "not in the trade or business of being herself". Furthermore, her brand is not "tied to the quantity or quality" of her writing, and therefore it has an insufficient nexus with her trade or business as an author. We do not agree. The fact that petitioner's brand involves personal traits such as her name and likeness does not mean that it cannot form part of her trade or business. If petitioner's brand has commercial value, it can form part of her trade or business.

Petitioner also misapplies the nexus test. To satisfy the nexus test, the earnings must be tied to the quantity or quality of the taxpayer's labor. *Milligan v. Commissioner*, 38 F.3d at 1098. The question is not whether petitioner's brand is tied to the quantity or quality of her writing, but rather whether the payments for her brand are tied to the quantity or quality of her efforts in developing her brand. Petitioner herself admits she has worked to develop a brand. Royalties earned from her brand are not solely a result of her publishers' actions. Although the publishers fund the marketing plan for petitioner's books, petitioner's agent retains the authority over its development. Petitioner's and her agent's promotional activities and monitoring of sales information contribute to the sale of her books. Such sales-focused work is sufficiently routine that we consider it part of petitioner's trade or business. Petitioner's books, in turn, sell in part on the basis of her brand strength. Petitioner's brand signals to readers what content they can expect from her books. The loyalty of her readership base translates into higher sales, and her high sales then enhance her brand. Petitioner's brand and her writing combined are monetized, first, by the selling of books, and second, by providing petitioner with the leverage to negotiate for higher advances and royalty rates.

We note petitioner's treatment of her expenses as further evidence that payments for her brand derive from a trade or business…. Petitioner deducted the rent paid for the NYC apartment on her Schedule C, even though most of her writing was done in Georgia. The apartment's main purpose was to facilitate petitioner's attendance at meetings and conferences and to make connections with agents, publishers, and booksellers. Petitioner may have met with a screenwriter in the NYC apartment to collaborate on a script, but the fundamental benefit of having a presence in New York City was to develop her brand, not to write. Petitioner also deducted advertising costs, the cost of a car used, in part, to attend promotional activities around Atlanta, and gifts sent to her contacts in the publishing world. Such expenses demonstrate that petitioner's trade or business extends beyond writing to its promotion. If such promotion and brand-related expenditures are Schedule C trade or business expenses, then the income derived from the brand to which those expenses relate is also trade or business income. See sec. 1402(c).

> We turn finally to the remaining non-trade-or-business elements petitioner contends can be found in her contracts. Such elements include payments for the publisher's right to advertise in books published from petitioner's writing; access to her readership; the right to continue an existing series; the right to use characters from prior books published from her writing; and noncompete clauses. Some of the elements she identified fall squarely within her trade or business. The elements involving written series and characters are directly related to her writing activities. See *Newberry v. Commissioner*, 76 T.C. at 444. Petitioner's readership is made up of those who enjoy petitioner's writing, therefore providing a sufficient nexus. Without her writing there can be no books whose pages may be used for advertising. Further, the contracts include provisions that petitioner is, upon request, entitled to proceeds from the advertising in her books. If the contracts provide for additional and separate payment for that revenue, it follows that none of petitioner's advances or royalties are allocable to it.
>
> The remaining element petitioner explicitly identified is the amount paid for the noncompete clauses in the contracts. Income earned for not working is not subject to self-employment tax. See, *e.g.*, *Milligan v. Commissioner*, 38 F.3d 1094; *Newberry v. Commissioner*, 76 T.C. at 443. Petitioner contends that any amount allocable to noncompete clauses should similarly not be subject to self-employment tax. Upon review of petitioner's so-called noncompete clauses, however, we conclude that for the most part they do not prevent petitioner from contracting with others; they merely require that the contracted work be completed first.[8] Consequently, we hold that petitioner may not exclude any amount from her trade or business income that she alleges is from noncompete clauses.
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> [8] Petitioner also has provided no way to value the payments made for these clauses. The contracts are silent as to any allocation or cost of a breach; petitioner's expert witness testified almost exclusively as to the premium paid for a brand author and not as to any other right; and applying the calendar method used by petitioner's return preparers would be nonsensical for a noncompete provision.
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> In sum, we conclude that all of the payments to petitioner pursuant to the publishing contracts are income derived from her trade or business as an author, and such income is subject to self-employment tax.

In affirming the Tax Court, *Slaughter v. Commissioner*, 128 A.F.T.R.2d 2021-5399 (11th Cir. 8/3/2021), rejected the taxpayer's further arguments:

> Slaughter also argues that the tax court erred in finding that all of her publishing income in 2010 and 2011 was derived from her trade or business. This argument differs from her first argument: the fact that Slaughter's promotional activities were a part of her trade or business does not automatically mean that all of her publishing income was derived from her trade or business. We have held that for self-employment income to be derived from a trade or business, "there must be a nexus between the income received and a trade or business that is, or was, actually carried on." *Peterson*, 827 F.3d at 986 (cleaned up). Additionally, "the income must arise from some actual (whether present, past, or future) income-producing activity of the taxpayer before such income becomes subject to self-employment taxes." *Id*. (cleaned up). Nonetheless, "[t]he self-employment tax provisions are broadly construed to favor treatment of income as earnings from self-employment." *Id*. (quoting *Bot v. Comm'r*, 353 F.3d 595, 599 (8th Cir. 2003)).

Here, Slaughter argues that income from her intangible assets - specifically the rights to her name and likeness, access to her readership, the right to use characters from her previous books, and noncompetition agreements—is not subject to self-employment tax because there is no nexus between that income and her trade or business. In support of this argument, she cites a Ninth Circuit decision stating that the nexus test is satisfied only if the “earnings [are] tied to the quantity or quality of the taxpayer’s prior labor, rather than the mere fact that the taxpayer worked or works for the payor.” *Milligan v. Comm’r*, 38 F.3d 1094, 1098 (9th Cir. 1994).

Slaughter’s position finds no purchase in the Ninth Circuit’s test. We have declined to apply the Ninth Circuit’s quantity-or-quality test beyond the context of post-termination payments to insurance agents. See *Peterson*, 827 F.3d at 992–93 (describing Milligan as “nonbinding,” “distinguish[ing] [that] insurance case[] on at least four bases,” and concluding that “the after-termination payments of insurance salesmen” in that case were not “comparable” outside its facts). And even if the Ninth Circuit’s test did apply here, we think that all of Slaughter’s publishing income—including the portions from her intangible assets—readily satisfies it. If Slaughter ceased to write or promote her books, then her brand and success as an author would be affected. If she were not writing books, publishers would pay less—or even nothing—for her name and likeness, access to her readership, the right to use her characters, and her agreements not to compete.

Slaughter’s objections to this conclusion focus primarily on her name and likeness and her noncompetition agreements. Regarding her name and likeness, she avers that their licensing “can[not] be reasonably described as used predominantly for profit rather than as a personal right.” She then concludes that income from that licensing cannot be derived from her trade or business because trade or business activity must have the primary purpose of profit. Although she is correct that trade or business activity must be primarily profit-motivated, there is no reason to believe that Slaughter - a longtime bestselling author who has earned millions of dollars from her books - licensed her name and likeness for use on books and related materials for any purpose other than increasing her profit.

As for her noncompetition agreements, Slaughter avers that income from an agreement not to compete does not derive from a trade or business. But the supporting caselaw that Slaughter cites in fact undermines her assertion. As she correctly notes, the tax court has previously addressed “whether noncompetition under a covenant not to compete constitutes a trade or business[.]” *Ohio Farm Fed’n, Inc. v. Comm’r*, 106 T.C. 222, 234 (1996). But contrary to her suggestion, the tax court did not categorically exclude such noncompetition from being a trade or business. Instead, it held that the standard continuity-and-regularity test applied and concluded that in the case before it, “a one-time agreement not to engage in certain activities” did not constitute “the kind of continuous and regular activity characteristic of a trade or business.” *Id*. But Slaughter’s noncompetition agreements were not one-time events - noncompetition clauses appeared in every American contract that she signed. Moreover, the clauses for the most part did not prevent Slaughter from writing for other publishers - they merely required her to complete the contracted books first. Consequently, we cannot say that the tax court erred in determining that Slaughter’s income from her noncompetition agreements was derived from her trade or business.

However, if a taxpayer owns an interest in a trade or business, the taxpayer's share of business earnings is SE income, even if the taxpayer is inactive,[3411] unless the taxpayer is a limited partner.[3412]

Conversely, income from any activity that is not a trade or business, within the meaning of Code § 162,[3413] is not subject to SE tax:[3414]

- Trustee and executor fees are exempt from self-employment tax except to the extent that (a) they are attributable to the conduct of a trade or business by the trust or estate, or (b) an executor manages an estate that requires extensive management activities on the executor's part over a long period of time, in which latter case the activities might be sufficient in scope and duration to constitute the carrying on of a trade or business.[3415]

- An individual's distributive share of income from an investment club partnership does not constitute SE income.[3416]

Beware that, starting January 1, 2013, generally investment income and income from any passive activity[3417] that is not subject to SE tax would be subject to the 3.8% tax on net investment income if the taxpayer's income exceeds the relevant threshold.[3418]

[3411] See part II.L.3 Self-Employment Tax: General Partner or Sole Proprietor.

[3412] See part II.L.4 Self-Employment Tax Exclusion for Limited Partner.

[3413] Reg. § 1.1402(c)-1 provides:

> In order for an individual to have net earnings from self-employment, he must carry on a trade or business, either as an individual or as a member of a partnership. Except for the exclusions discussed in §§ 1.1402(c)-2 to 1.1402(c)-7, inclusive, the term "trade or business", for the purpose of the tax on self-employment income, shall have the same meaning as when used in section 162. An individual engaged in one of the excluded activities specified in such sections of the regulations may also be engaged in carrying on activities which constitute a trade or business for purposes of the tax on self-employment income. Whether or not he is also engaged in carrying on a trade or business will be dependent upon all of the facts and circumstances in the particular case.

See part II.G.4.l.i.(a) "Trade or Business" Under Code § 162.

[3414] Reg. § 1.1402(a)-1(b).

[3415] Rev. Rul. 58-5; see also Letter Ruling 8238055.

[3416] Rev. Rul. 75-525 held:

> In *Higgins v. Commissioner*, 312 U.S. 212 (1941), 1941-1 C.B. 339, the Supreme Court of the United States held that the conduct of investment management activities with respect to one's own account was not a trade or business within the meaning of section 23(a) of the Revenue Act of 1932, predecessor of section 162.
>
> Therefore, a partnership whose activities are limited to investment in savings certificates and collection of interest thereon with respect to its membership accounts is not engaged in a trade or business as defined in section 162 of the Code.

Higgins is quoted in the text accompanying fn. 1298 in part II.G.4.l.i.(a) "Trade or Business" Under Code § 162.

[3417] As defined in Code § 469, which generally includes rental as well as any trade or business in which the owner does not materially participate.

[3418] See part II.I 3.8% Tax on Excess Net Investment Income, particularly part II.I.8.c Application of 3.8% Tax to Rental Income.

Although interest income generally is not SE income, "other interest received in the course of any trade or business (such as interest received by a pawnbroker on his loans or interest received by a merchant on his accounts or notes receivable) is not excluded."[3419]

See also parts:

- II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner
- II.L.8 Retirement Payments to Insurance Salesmen, and
- II.Q.8.b.ii.(g) Code § 736 Payments as Retirement Income – Possible FICA and State Income Tax Benefits.

II.L.2.a.ii. Rental Exception to SE Tax

Income from real estate and from personal property leased with the real estate generally is not subject to SE tax, unless such rentals constitute certain types of farm activities[3420] or are received in the course of a trade or business as a real estate dealer.[3421]

Farm activities generate significant controversy as to what is rent and what constitutes payment for services[3422] or income from growing crops, raising livestock, etc. Payments under USDA's

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3419 Reg. § 1.1402(a)-5(b). See *Eddie Cordes, Inc. v. Commissioner*, T.C. Memo. 2002-125, subjecting to SE tax interest income on 584 notes purchased over a two-year period.

3420 Code § 1402(a)(1) provides that the rental exception:

> shall not apply to any income derived by the owner or tenant of land if (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity.

See Reg. § 1.1402(a)-4(b) and *Mizell v. Commissioner*, T.C. Memo. 1995-571 (broadly construing arrangement).

3421 Code § 1402(a)(1); Reg § 1.1402(a)-4. See Chief Counsel Advice 200816030 (Code § 761(f) active participation does not override exclusion of rental income from self-employment tax).

3422 In reversing the Tax Court, *McNamara v. Commissioner*, 236 F.3d 410 (8th Cir. 2000), *non-acq.* AOD CC-2003-003 (10/22/2003). said:

> What is missing from both the Commissioner's and the Tax Court's analyses is any mention of a nexus between the rents received by Taxpayers and the arrangement that requires the landlords' material participation. We believe this omission overlooks section 1402(a)(1)'s requirement that rents be derived under such an arrangement. That is to say, the mere existence of an arrangement requiring and resulting in material participation in agricultural production does not automatically transform rents received by the landowner into self-employment income. It is only where the payment of those rents comprise part of such an arrangement that such rents can be said to derive from the arrangement.
>
> Rents that are consistent with market rates very strongly suggest that the rental arrangement stands on its own as an independent transaction and cannot be said to be part of an arrangement for participation in agricultural production. Although the Commissioner is correct that, unlike other provisions in the Code, section 1402(a)(1) contains no explicit safe-harbor provision for fair

Conservation Reserve Program are subject to self-employment tax according to the Tax Court and IRS, but not according to the Eighth Circuit.[3423] Instead of conducting operations on one's farms and paying SE tax on all of the income, one may lease the farm to one's own S corporation for fair rental without paying SE tax on that rental, have the S corporation run

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> market value transactions, we conclude that this is the practical effect of the derived under language.
>
> At this point, the only evidence in the record is that the rents in question were at or below market rates. However, we believe the Commissioner is entitled to an opportunity to show a connection between those rents and the production arrangement it identified.

[3423] Payments under USDA's Conservation Reserve Program are subject to self-employment tax according to the Tax Court, *Morehouse v. Commissioner*, 140 T.C. 350 (unanimous reviewed decision), but not according to the Eighth Circuit, 114 A.F.T.R.2d 2014-6287 (2014); the IRS agrees with the Tax Court, A.O.D. 2015-002, IRB No. 2015-41. The *Morehouse* Tax Court opinion relied on *Timber Co. v. Commissioner*, 64 T.C. 700, 709-711 (1975), *aff'd without published opinion*, 552 F.2d 368 (5th Cir. 1977); *Webster Corp. v. Commissioner*, 25 T.C. 55, 61 (1955), *aff'd*, 240 F.2d 164 (2nd Cir. 1957); *Harding v. Commissioner*, T.C. Memo. 1970-179; and Rev. Rul. 60-32. The *Morehouse* Tax Court opinion cited *Johnson v. Commissioner*, 60 T.C. 829, 833 as holding that exception for rentals from real estate must be narrowly construed. Rev. Rul. 65-149, cited with approval in the *Morehouse* Eighth Circuit opinion, held that grain storage fees for delaying in selling grain one produced constitute income from farming and therefore net earnings from self-employment, but grain storage fees paid for the storage of a landlord's share of a crop paid to the landlord as rental income are excluded from net earnings from self-employment as rental income.

In a split opinion, the Eighth Circuit held [footnotes omitted]:

> [T]he record discloses that the government, whether by contractual right or otherwise, physically inspected the CRP properties nearly as often as Morehouse did. These entries, coupled with the significant tilling, seeding, fertilizing, and weed control work required by the CRP contracts reveal the government likely had more physical possession for its own land conservation uses than Morehouse did. Accordingly, we hold the 2006 and 2007 CRP payments were consideration paid [by the government] for use [and occupancy] of [Morehouse's] property and thus constituted rentals from real estate fully within the meaning of § 1402(a)(1).

Both the majority and dissent cited *Wuebker v. Commissioner*, 205 F.3d 897, 903-904 (6th Cir. 2000) and mentioned Notice 2006-108, without paying deference to the latter because the IRS never issued the promised Revenue Ruling (perhaps concluding that its position was not necessarily a consensus view). For a discussion of such payments generally and a brief overview of cases, see Malloy, Langstraat, and Wilkinson, "Conservation Reserve Program Payments and Self-Employment Tax: Farmers vs. Non-Farmers," *TAXES - The Tax Magazine* (8/2015).

A.O.D. 2015-002, IRB No. 2015-41, nonacquiesced to the Eighth Circuit's opinion, stating:

> We disagree with the Eighth Circuit's characterization of the revenue rulings as establishing a line of demarcation on the self-employment tax treatment of conservation reserve payments paid to farmers and nonfarmers. We also disagree with the Eighth Circuit's holding that the CRP payments were consideration paid by the government for use and occupancy of Morehouse's property and thus constituted rentals from real estate excluded from self-employment tax under section 1402(a)(1).
>
> The Eighth Circuit misinterprets Rev. Rul. 60-32 and Rev. Rul. 65-149 when it states that the rulings establish the position that CRP payments made to non-farmers constitute rentals from real estate and are excluded from the self-employment tax. *Morehouse*, 769 F.3d at 621….
>
> We recognize the precedential effect of the decision in *Morehouse* to cases appealable to the Eighth Circuit. Accordingly, we will follow *Morehouse* within the Eighth Circuit only with respect to cases in which the CRP payments at issue were both (1) paid to an individual who was not engaged in farming prior to or during the period of enrollment of his or her land in CRP and (2) paid prior to January 1, 2008 (i.e., the effective date of the 2008 amendment to section 1402(a)(1)). We will continue to litigate the IRS position in the Eighth Circuit in cases not having these specific facts. We will also continue to litigate the IRS position in all cases in other circuits.

operations and not pay SE tax on the operations, and simply take reasonable compensations for one's services to the S corporation – an arrangement that the Tax Court approved in a 2017 reviewed case.[3424] Citing an Eighth Circuit case[3425] that it decided to find persuasive in any jurisdiction, the Tax Court[3426] held:

> Regardless of a taxpayer's material participation, if the rental income is shown to be less than or equal to market value for rent, the income is presumed to be unrelated to any employment agreement. *Id*. At that point, the burden of production shifts to the Commissioner to show a nexus between the rent and the taxpayer's obligation to materially participate. Such a showing would render the lease and employment agreements part and parcel of a larger "arrangement". *Id*.

However, the Tax Court cautioned that rent payments tied to production may be recharacterized as SE income,[3427] so one should consider avoiding such an arrangement when renting to one's own S corporation.

Regulations clarify the distinction between a real estate investor and dealer:[3428]

[3424] *Martin v. Commissioner*, 149 T.C. No. 12 (9/27/2017). The Official Tax Court Syllabus (which syllabus is not precedential, but of course the text of the case is) summarized the case:

> Ps owned a farm, renting a portion of the land to wholly owned S corporation C. C contracted with unrelated entity S to raise chickens according to S' exacting specifications. Ps followed S' specific instructions to build structures designed only to raise S' chickens. C paid Ps wages for their labor and rent for the use of the farm and structures. R asserts that the rent is subject to self-employment tax pursuant to sec. 1402(a)(1).
>
> *Held*: The facts of the instant case are not materially distinguishable from the facts of *McNamara v. Commissioner*, T.C. Memo. 1999-333, *rev'd*, 236 F.3d 410 (8th Cir. 2000). The U.S. Court of Appeals for the Eighth Circuit in *McNamara* also reversed *Hennen v. Commissioner*, T.C. Memo. 1999-306, and *Bot v. Commissioner*, T.C. Memo. 1999-256. In the light of the reversals by the Court of Appeals for the Eighth Circuit, the Court reconsiders its holdings.
>
> *Held*, further, Ps established that the rent received was at or below fair market value. R failed to show a sufficient nexus between the rental income and petitioners' obligations to participate in the production or management of the production of agricultural commodities. Therefore, the rent Ps received pursuant to the lease is not includible in their net self-employment income. To the extent *McNamara v. Commissioner*, T.C. Memo. 1999-333, *Hennen v. Commissioner*, T.C. Memo. 1999-306, and *Bot v. Commissioner*, T.C. Memo. 1999-256, are inconsistent with this holding, they are not followed.

[3425] See *McNamara* in fn. 3422.

[3426] *Martin*, fn. 3424.

[3427] *Martin*, fn. 3424, noted:

> This Court has previously evaluated the nexus between the rental income and the taxpayer's production arrangement. See, *e.g.*, *Bot v. Commissioner*, 118 T.C. 138 (finding value-added payments reported as rental income includible in net self-employment income where the payments were directly related to the volume of corn acquired and delivered by taxpayers); *Solvie v. Commissioner*, T.C. Memo. 2004-55 (same when rent payments were tied directly to the number of pigs raised). But see *Johnson v. Commissioner*, T.C. Memo. 2004-56 (finding an insufficient nexus). But despite petitioners' presentation and the Court's previous application of the well-reasoned nexus requirement in *Solvie* and *Johnson*, respondent did not brief this issue.

[3428] Reg. § 1.1402(a)-4(a). *Pool v. Commissioner*, T.C. Memo. 2014-3, set forth factors deciding whether the taxpayer is a real estate dealer and held that the taxpayer had the burden of proof of disproving the IRS findings in this area. When real estate is used in a business, see part II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business; within that part, if property is bought for use in a trade or business but never placed in service, see text accompanying fns. 1484-1485.

In general, an individual who is engaged in the business of selling real estate to customers with a view to the gains and profits that may be derived from such sales is a real-estate dealer. On the other hand, an individual who merely holds real estate for investment or speculation and receives rentals therefrom is not considered a real-estate dealer. Where a real-estate dealer holds real estate for investment or speculation in addition to real estate held for sale to customers in the ordinary course of his trade or business as a real-estate dealer, only the rentals from the real estate held for sale to customers in the ordinary course of his trade or business as a real-estate dealer, and the deductions attributable thereto, are included in determining net earnings from self-employment; the rentals from the real estate held for investment or speculation, and the deductions attributable thereto, are excluded.

See also part II.G.26 Real Estate Special Issues.

Apartments that include the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, etc. fall within the rental real estate exception.[3429] However, payments for the use or occupancy of rooms or other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, or payments for the use or occupancy of space in parking lots, warehouses, or storage garages, do not qualify for this exception;[3430] neither does a university providing athletic facilities to third parties when not being used for university purposes.[3431] The real estate rental exception is narrowly construed.[3432]

CCA 202151005 involved the following scenarios:

1) The taxpayer is an individual who directly and solely owns and rents, in the course of a trade or business,[1] a fully furnished vacation property via an online rental marketplace.[2] The taxpayer is not a real estate dealer within the meaning of Treas. Reg. § 1.1402(a)-4(a).[3] The taxpayer provides linens, kitchen utensils, and all other items to make the vacation property fully habitable for each occupant. In addition, the taxpayer provides daily maid services, including delivery of individual use toiletries and other sundries, access to dedicated Wi-Fi service for the rental property, access to beach and other recreational equipment for use during the stay, and prepaid vouchers for ride-share services between the rental property and the nearest

[3429] Reg. § 1.1402(a)-4(c)(2). This regulation is similar to Reg. § 1.512(b)-1(c)(5); interpreting the latter regulation, Letter Ruling 201422027 ruled that, when local law required apartments to provide parking for tenants, extra charges for a carport constituted rental income (excluded from UBTI) because the carports were characteristic of the real property, pointing out that no services, such as a security guard, were provided and covered spots were charged only a minimal monthly amount in the set rental rate. However, the ruling held that the apartment complex providing coin-operated washers and dryers on-site for use of tenants without in-home laundry was an extra service not within the rental exclusion, because tenants could use commercial laundry and cleaning establishments off-site; the ruling did not mention whether the apartment provided any services in connection with the washers and dryers.
[3430] Reg. § 1.1402(a)-4(c)(2); Rev. Ruls. 57-108 (vacation rentals involved too many services to be excluded from SE income) and 83-139 (discussing when trailer park rentals do or do not qualify for the exclusion form SE income).
[3431] See fn. 4684 in part II.Q.6.d.i UBTI Related to a Partnership or Sole Proprietorship, which applies by analogy to SE income, as described in fns. 3435-3437 in this part II.L.2.a.ii.
[3432] *Johnson v. Commissioner*, 60 T.C. 829 (1973), denying the rental exclusion for boat sheds as part of a marina business in which the taxpayer provided many services included in the rental of the boat sheds.

business district. For the year at issue, the average period of customer use of the vacation property is seven days, and therefore the activity is not considered a rental activity for purposes of § 469 pursuant to Treas. Reg. § 1.469-1T(e)(3)(ii)(A) In addition, the taxpayer materially participates in the activity within the meaning of § 469(h)(1) and Treas. Reg. § 1.469-5T and, therefore, the activity is not a passive activity within the meaning of § 469(c).

[1] Assume, in both examples #1 and #2, sufficient other facts exist so that each example rises to the level of a § 162 trade or business. See Treas. Reg. § 1.1402(c)-1. The facts provided are not intended to be used for purposes of analysis of whether the taxpayer is engaged in a trade or business under § 162 or any other provision of the Code.

[2] Assume, in both examples #1 and #2, that the taxpayer does not use the property for "personal" purposes, as defined in § 280A(d)(2).

[3] Treas. Reg. § 1.1402-4(a) states that an individual who is engaged in the business of selling real estate to customers with a view to the gains and profits that may be derived from such sales is generally a real-estate dealer.

2) The taxpayer is an individual who directly and solely owns and rents, in the course of a trade or business, a fully furnished room and bathroom in a dwelling via an online rental marketplace. The taxpayer is not a real estate dealer. Occupants only have access to the common areas of the home to enter and exit the room and bathroom and have no access to other common areas such as the kitchen and laundry room. The taxpayer cleans the room and bathroom in between each occupant's stay. For the year at issue, the average period of customer use of the vacation property is seven days, and therefore the activity is not considered a rental activity for purposes of § 469 pursuant to Treas. Reg. § 1.469-1T(e)(3)(ii)(A). In addition, the taxpayer materially participates in the activity within the meaning of § 469(h)(1) and Treas. Reg. § 1.469-5T, and, therefore, the activity is not a passive activity within the meaning of § 469(c).

CCA 202151005 reasoned:

Section 1401 imposes tax on the self-employment income of individuals. Section 1402(b) defines self-employment income by reference to net earnings from self-employment, with certain modifications. Section 1402(a) provides that the term "net earnings from self-employment" ("NESE") means the gross income derived by individuals from any trade or business they carry on, less the deductions that are attributable to such trade or business. However, under § 1402(a)(1), rentals from real estate, together with deductions properly deductible and attributable to the rentals from real estate (collectively, "net rental income"), are excluded from NESE, unless these amounts are received in the course of a trade or business as a real estate dealer.[4]

[4] This memorandum does not address nor is intended to address arrangements between an owner or tenant and another individual which provides that the individual shall produce agricultural or horticultural commodities on the land covered, or the agricultural and horticultural exception contained in section 1402(a)(1)

Treas. Reg. § 1.1402(a)-4(c)(1) provides that rentals from living quarters, where no services are rendered for the occupants, are generally considered rentals from real estate under § 1402(a)(1), except in the case of real estate dealers. However, Treas. Reg. § 1.1402(a)-4(c)(2) provides,

> Payments for the use or occupancy of rooms or other space where services are also rendered to the occupant … are included in determining net earnings from self-employment. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.

Treas. Reg. § 1.1402(a)-4(c)(2) lists examples of situations where services are rendered for the convenience of occupants, such as hotels, boarding homes, warehouses, and storage garages.

In Rev. Rul. 57-108, 1957-1 C.B. 273, the IRS ruled that a landlord who rented furnished vacation beach dwellings and rendered services "for the comfort and convenience of his guests in connection with their recreational activities"—including maid services, swimming and fishing instruction, mail delivery, furnishing of bus schedules, and information about local churches—rendered services primarily for the occupants' convenience. Consequently, the net rental income from the vacation beach dwellings was included in the landlord's NESE because the § 1402(a)(1) exclusion did not apply.

In *Bobo v. Commissioner*, 70 T.C. 706 (1978), *acq.* 1983-2 C.B. 4, the Tax Court considered a mobile home park that provided leased trailer park units with utility hookups, sewage facilities, and laundry facilities. The Tax Court held that the net rental income from the rental of the trailer park units was excluded from the owners' NESE under § 1402(a)(1). The court relied on *Delno*, *infra*, in setting the standard for when services are considered not rendered for the occupant,

> [Section 1402(a)(1)] should be applied to exclude only payments for use of space, and, by implication, such services as are required to maintain the space in condition for occupancy. If the owner performs additional services of such substantial nature that compensation for them can be said to constitute a material part of the payment made by the tenant, the "rent" received then consists in part of income attributable to the performance of labor which is not incidental to the realization of return from passive investment.

Bobo at 709 (citing *Delno v. Celebrezze*, 347 F.2d 159, 166 (9th Cir. 1965) (relating to parallel Social Security eligibility provisions). Again relying on *Delno*, the Tax Court first determined that the phrase, "'usually or customarily rendered' … must be read with emphasis upon the closing phrase 'for occupancy only.'" *Bobo* at 710. The court reasoned that an analysis of whether services are rendered solely for the convenience of the occupants pursuant to Treas. Reg. § 1.1402(a)-4(c))(2) is a question of fact based on "whether [the services rendered] are required to maintain the space in condition for occupancy and, if not, whether [the services rendered] are substantial." *Id*. at 710-11; see also *Johnson v. Commissioner*, 60 T.C. 829, 832-33 (1973) (stating, "any service not clearly required to maintain the property in condition for occupancy be considered work performed for the tenant, and not for the conservation of invested capital," in support of a narrow construction of the exclusion from NESE for rental real estate).

Ultimately, the court determined that, even though the trailer park furnished laundry services that were "clearly rendered for the convenience of the tenant and not to maintain the property in condition for occupancy," the tenants' payments for the laundry services were not "substantial enough to classify all the tenants' [rental] payments as received for 'services to the occupants.'" *Id*. at 711 (citing Treas. Reg. § 1.1402(a)-4(c)(2)). Accordingly, the court held the payments at issue were rental from real estate excluded from NESE.

In Rev. Rul. 83-139, 1983-2 C.B. 150, the Service relied on the Tax Court's analysis in *Bobo* (as it applied the holding in *Delno*) in distinguishing between two factual situations. Situation (1) involved a trailer park owner and operator who operated a trailer park that provided similar services to those provided in Bobo. Situation (2) involved a trailer park owner and operator who provided a trailer park that provided all the services as the trailer park in Bobo, but also operated "a recreation hall, consisting of a card area, pool room, kitchen, auditorium, stage, and library." The Service determined, citing to Delno and Johnson, supra, that only situation (2) gave rise to substantial services for the convenience of the occupant, stating:

> The Service agrees with the court in *Bobo* that each case turns upon the facts presented and whether the services provided by the trailer park owner are services rendered for the convenience of the tenants as opposed to services required to maintain the space rented to tenants in condition for occupancy. When determining whether service is for the maintenance of property, the courts have emphasized that the rental exclusion must be read narrowly and that any service not clearly required to maintain the property in condition for occupancy is considered work performed for the tenant.

Rev. Rul. 83-139, 1983-2 C.B. 150. Finding that the services were of such substantial nature that the compensation for them could clearly be said to constitute a material part of the payments made by the tenants, the Service ruled that the § 1402(a)(1) exclusion for rental real estate did not apply in situation (2), and the income received was includible in computing NESE.[5]

[5] This memorandum does not address nor is intended to address arrangements between an owner or tenant and another individual which provides that the individual shall produce agricultural or horticultural commodities on the land covered, or the agricultural and horticultural exception contained in section 1402(a)(1)

In *Hopper v Commissioner*, 94 T.C. 542, 548 (1990), the Tax Court held that net rental income from storage units where the landlord also provided a soft drink machine and sold locks, packaging materials, pallets, and insurance, was excluded from the owners' NESE under § 1402(a)(1) because the services provided for the convenience of the occupants of the storage units were not substantial. Even though Treas. Reg. § 1.1402(a)-4(c)(2) uses warehouses and storage garages as examples of activities that are not rentals from real estate, the "nomenclature of the examples used" in Treas. Reg. § 1.1402(a)-4(c)(2) does not impact the analysis. *Id*. At 547. Rather, the § 1402(a)(1) analysis depends on the facts and circumstances of each specific case. See *id*. Specifically,

> Whether services are considered as rendered to the occupant within the meaning of section 1.1402(a)-4(c)(2), Income Tax Regs., raises a question of fact. This question

> can be resolved by determining whether such services are required to maintain the space in condition for occupancy. If the answer is yes, then the services are not considered as rendered to the occupant. In this regard, the services listed in section 1.1402(a)-4(c)(2), Income Tax Regs., as those which are required to maintain the space in condition for occupancy are only illustrative.

Id. at 547 (relying on *Delno*, 347 F.2d at 163, and *Bobo*, 70 T.C. at 710).

Fact Situation 1

The net rental income in Fact Situation 1 is not excluded from NESE under § 1402(a)(1) because the taxpayer provides substantial services beyond those required to maintain the space in a condition suitable for occupancy. See *Bobo*, 70 T.C. at 710; Rev. Rul. 83-139. Whether services are considered rendered for the occupant is based on the particular facts and circumstances in each case. See *Hopper*, 94 T.C. at 548 (1990). Here, the payments made to the taxpayer for these services are for the convenience of the property's occupants. The services go beyond those clearly required to maintain the space in a condition for occupancy and are of such a substantial nature that the compensation for these services can be said to constitute a material portion of the rent. Thus, the payments are not excluded under § 1402(a)(1) but rather are included in NESE.[6] The characterization of this activity as not a passive activity within the meaning of § 469(c) does not affect whether the activity is excluded from NESE under § 1402(a)(1).[7]

[6] Rev. Rul. 57-108 suggests that, in the case of vacation property, the services for the convenience of the occupants must be substantial, such as maid services, swimming and fishing instructions, and furnishing local transportation schedules. Here, similar services are provided for the convenience of the occupants. Thus, the exclusion under § 1402(a)(1) does not apply, and the net rental income is included in NESE.

[7] If the activity were a rental activity under Treas. Reg. § 1.469-1T(e)(3) and, therefore, a passive activity under § 469(c), a loss generated by this activity would still be limited for purposes of computing NESE under § 1.469-1T(d)(3).

Fact Situation 2

The net rental income from Fact Situation 2 is excluded from NESE under § 1402(a)(1) because the taxpayer does not provide substantial services beyond those required to maintain the space in a condition suitable for occupancy. See *Bobo*, 70 T.C. 706 at 710; Rev. Rul. 83-139. Services the taxpayer provides to clean and maintain the property to bring it to a suitable condition for occupancy are not relevant in applying Treas. Reg. § 1.1402(a)-4(c)(2) because such services are not furnished primarily for the convenience of the property's occupants. See *Hopper*, 94 T.C. at 547. Further, services provided for the convenience of occupants must be substantial, and whether provided services are substantial depends on the facts and circumstances of each case. See *id*. At 548. Specifically, the services provided for the convenience of the occupants must be of such a substantial nature that compensation for them can be said to constitute a material part of the payments made by the occupants. See *id*. At 546 (citing *Delno*, 347 F.2d at 166). No such services are provided in Fact Situation 2. The characterization of this activity as not a passive activity within the meaning of § 469(c) does not affect whether the activity is excluded from NESE under § 1402(a)(1).

CCA 202151005 concluded:

1) No, whether an activity is a "rental activity" under § 469(c)(2) is not determinative of whether the exclusion in § 1402(a)(1) applies.

2) In situations not involving a real estate dealer, net rental income from the rental of living quarters is considered "rentals from real estate" excluded from NESE when no services are rendered for the occupants. However, if services are rendered for the occupants and the services rendered (1) are not clearly required to maintain the space in a condition for occupancy, and (2) are of such a substantial nature that the compensation for these services can be said to constitute a material portion of the rent, then the net rental income received is not excluded under § 1402(a)(1) and is included in NESE.

How about leasing equipment or other tangible personal property not connected with real estate? Renting personal property on a short-term basis is self-employment income.[3433] Although I am unaware of any cases subjecting to self-employment tax the long-term rental of personal property, cases interpreting the tax on unrelated business income in the tax-exempt area clearly view long-term rental as a trade or business;[3434] and the rental exception for the unrelated business income tax is similar to that for SE tax,[3435] and the Tax Court has noted

[3433] *Stevenson v. Commissioner*, T.C. Memo. 1989-357, pointing out, "His work in buying, assembling, storing, renting, selling, repairing and maintaining the portable signs required him to devote a substantial amount of time on a regular and continuous basis."

[3434] Rev. Rul. 69-278 (owner of buildings also leased trucks to tenants, but the truck leases were not tied in any way to the real estate leases; truck leases did not qualify for rental exception even though the lessees were responsible for fueling, maintaining, and insuring the trucks); Rev. Rul. 60-206 (rent from long-term leases of railroad tank cars was a trade or business, even though the lessee was fully responsible for the cars' operation and maintenance of their cars, as well as replacement in case of destruction or loss); Rev. Rul. 78-144 (long-term lease of heavy machinery was a trade or business even though the lessee must provide insurance, pay any taxes, and make and pay for all repairs except those involving defects in the machine parts or workmanship; the taxpayer's only work was to find a lessee, arrange for the lease, and receive, record, and deposit the rents; did not qualify for the exception to unrelated business income tax for all work being done by volunteers because labor was not a material income-producing factor in the business); *Cooper Tire & Rubber Co. Employees' Retirement Fund v. Commissioner*, 36 T.C. 96, *aff'd* 306 F.2d 20 (6th Cir. 1962) (retirement plan's one-time purchase of twenty tire manufacturing machines and one press and long-term lease of them to the plan's employer was a business even though the plan's only activity was to lease the machinery, collect the rentals and make monthly payments on the bank note and the transaction appeared to have been done merely to avoid restriction against loans from the plan to the company). See also part II.Q.6.d Unrelated Business Taxable Income.

[3435] Compare Code § 1402(a)(1) (there shall be excluded rentals from real estate and from personal property leased with the real estate… unless such rentals are received in the course of a trade or business as a real estate dealer) with Code § 512(b)(3) (there shall be excluded all rents from real property … and all rents from personal property ... leased with such real property, if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service). Neither statute exempts rents from personal property that is not leased with real estate.

similarities between income subject to SE tax and unrelated business income tax.[3436] The 2013 Instructions to Form 1040, Schedule E generally take that position as well.[3437]

II.L.2.a.iii. Whether Gain from Sale of Property is Subject to SE Tax

Code § 1402(a)(3) excludes from SE income any gain or loss:

(A) which is considered as gain or loss from the sale or exchange of a capital asset,

(B) from the cutting of timber, or the disposal of timber, coal, or iron ore, if section 631 applies to such gain or loss, or

(C) from the sale, exchange, involuntary conversion, or other disposition of property if such property is neither-

(i) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, nor

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[3436] *Cokes v. Commissioner*, 91 T.C. 222, 234, in subjecting passive business income to SE tax, noted:

We note that the concept that the character of trade or business income is retained in the partner's hands is not unique to the self-employment taxes area. The unrelated business income tax provisions (sec. 511 et seq.) generally provide that a tax-exempt organization's distributive share of a partnership's unrelated trade or business income is subject to the unrelated trade or business income tax. Sec. 512(c). The report of the House Ways and Means Committee on the bill enacting the unrelated business income tax, reads as follows (H. Rept. 2319, 81st Cong., 2d Sess. 111-112 (1950), 1950-2 C.B. 460):

> In the event an organization to which Supplement U [the predecessor of sec. 511 et seq.] applies is a member of a partnership which is regularly engaged in a trade or business which is unrelated to the functions and purposes of the organization, the organization would include, in computing its unrelated business net income, so much of its share (whether or not distributed) of the partnership gross income as is derived from that unrelated business and its share of the deductions attributable thereto, and make the necessary adjustments for the exceptions and limitations which have been discussed above. For example, if an exempt educational institution is a silent partner in a partnership which runs a barrel factory and such institution also holds stock in a pottery manufacturing corporation, it would include in its unrelated business income its share of the barrel factory income, but not its proportionate share of any dividends received by the partnership from the pottery corporation. If the taxable year of the organization is different from that of the partnership, the amounts to be so included or deducted in computing the unrelated business net income are to be based upon the income and deductions of the partnership for any taxable year of the partnership ending within or with the taxable year of the organization.

The example in the committee report explains that the unrelated business income tax provisions draw essentially the same line as that drawn in the self-employment tax provisions. Interestingly, both statutes were enacted by the 81st Congress.

[3437] From page E-4 of the Instructions:

Personal property. Do not use Schedule E to report income and expenses from the rental of personal property, such as equipment or vehicles. Instead, use Schedule C or C-EZ if you are in the business of renting personal property. You are in the business of renting personal property if the primary purpose for renting the property is income or profit and you are involved in the rental activity with continuity and regularity.

If your rental of personal property is not a business, see the instructions for Form 1040, lines 21 and 36, to find out how to report the income and expenses.

(ii) property held primarily for sale to customers in the ordinary course of the trade or business…

In testing whether a person is a dealer in real property, courts consider numerous factors when deciding the taxpayer's primary purpose for holding property, including:[3438]

(1) the frequency and regularity of sales of real properties;

(2) the substantiality of the sales and the relative amounts of income taxpayers derived from their regular business and the sales of real properties;

(3) the length of time the taxpayers held the real properties;

(4) the nature and extent of the taxpayers' business and the relationship of the real properties to that business;

(5) the purpose for which the taxpayers acquired and held the real properties before sale;

(6) the extent of the taxpayers' efforts to sell the property by advertising or otherwise; and

(7) any improvements the taxpayers made to the real properties.

See also part II.G.26 Real Estate Special Issues.

[3438] *SI Boo, LLC v. Commissioner*, T.C. Memo. 2015-19. In that case, the court easily concluded dealer status as follows (footnote omitted):

> In 2007 and 2008 S. I. Securities sold 29 and 14 parcels of real estate, respectively, by quitclaim deed. In 2008 Sabre sold 86 parcels of real estate by quitclaim deed, of which 53 were sold to third parties and 33 were assigned to SI Boo or S. I. Securities. In 2007 and 2008 SI Boo sold 52 and 20 parcels of real estate, respectively, by quitclaim deed. The entities' own accounting records, as well as the testimony presented at trial, showed that the entities desired to dispose of the real properties quickly and frequently and with the intent to make a profit and were successful. In fact, petitioners effectively concede on brief that most of the properties S. I. Securities, Sabre, and SI Boo sold by quitclaim deed during the years at issue were sold within one year of their acquisition. On this record, we give little weight to the fact that the entities acquired more certificates of purchase of tax lien than tax deeds. In sum, the entities' sales of real properties were frequent and regular during the years at issue.

The court held:

> On the basis of our findings that the entities earned income from the proceeds of sales of real properties, which was an integral part of their respective trades or businesses, we hold that the entities should have included the income in their reported net earnings from self-employment.

It also held that the sales were not eligible for installment sale reporting. See fn. 4299, found in part II.Q.3 Installment Sales - Deferring Tax on Lump Sum Payout Expected More than Two Years in the Future.

In deciding whether sales of personal property are of property “held primarily for sale to customers in the ordinary course of a trade or business” (and therefore SE income) or if they are of property held as an investment the Tax Court looks to:[3439]

- frequency and regularity of sales;
- substantiality of sales;
- length of time the property was held;
- segregation of property from business property;
- purpose of acquisition;
- sales and advertising effort;
- time and effort spent on sales; and
- how the proceeds of the sales were used.

II.L.2.b. S corporation Subjecting to FICA Payments for Managing Real Estate, When Net Rental Income Itself Is Exempt from SE Tax

Part II.L.2.a Types of Income Subject to Self-Employment Tax explains that real estate rental income generally is not subject to self-employment (SE) tax.[3440]

However, compensating a partner for services rendered subjects a partner to SE tax.[3441] So, the key to avoiding SE tax when working in real estate is to provide some sort of interest in profits rather than expressly compensating the person.

If an S corporation holds or manages the real estate, the IRS will assert that any distributions to its owners constitute compensation to the extent of the value of the services they provide the business and that FICA is owed.[3442] In a partnership, however, a very well-drafted allocation of profits does not constitute a guaranteed payment[3443] for services that would be classified as compensation income.

Note that converting real estate rental income to SE income or FICA wages might not be a bad result. SE income and FICA wages are not subject to the 3.8% tax on net investment income,[3444] whereas real estate rental income often is. For a discussion of the latter, see

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[3439] *Ryther v. Commissioner*, T.C. Memo. 2016-56, citing *Williford v. Commissioner*, T.C. Memo. 1992-450. *Ryther* held that a taxpayer who held scrap metal left over from his dissolved business was not subject to SE tax when he surprisingly discovered it had a market where he could easily sell it whenever he needed money.
[3440] See fns. 3421-3432, noting exceptions for dealers, certain short-term rentals, etc.
[3441] See fns. 3455-3456.
[3442] See fn. 79.
[3443] See fns. 528-526, which requires the allocation to be of net profits rather than being some percentage of gross rents or other formula measurement or fixed payment.
[3444] See fn. 2290.

part II.I.8.c Application of 3.8% Tax to Rental Income. Furthermore, up to one-half of SE tax is deductible,[3445] whereas none of the 3.8% tax on NII is deductible.

II.L.3. Self-Employment Tax: General Partner or Sole Proprietor

Generally, all of a partnership's or sole proprietorship's operating income is subject to income tax and FICA (self-employment) tax.[3446] An entity that is disregarded for income tax purposes is also disregarded for self-employment tax purposes,[3447] notwithstanding that it is treated as a separate entity for payroll tax purposes;[3448] therefore, a partner in a partnership that owns a

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[3445] See text accompanying fn. 2459.

[3446] See part II.L.2 Income Subject to Self-Employment Tax.

[3447] Reg. § 301.7701-2T(c)(2)(iv)(C)(2) provides:

> Section 301.7701-2(c)(2)(i) applies to taxes imposed under subtitle A, including Chapter 2—Tax on Self-Employment Income. Thus, an entity that is treated in the same manner as a sole proprietorship under § 301.7701-2(a) is not treated as a corporation for purposes of employing its owner; instead, the entity is disregarded as an entity separate from its owner for this purpose and is not the employer of its owner. The owner will be subject to self-employment tax on self-employment income with respect to the entity's activities. Also, if a partnership is the owner of an entity that is disregarded as an entity separate from its owner for any purpose under § 301.7701-2, the entity is not treated as a corporation for purposes of employing a partner of the partnership that owns the entity; instead, the entity is disregarded as an entity separate from the partnership for this purpose and is not the employer of any partner of the partnership that owns the entity. A partner of a partnership that owns an entity that is disregarded as an entity separate from its owner for any purpose under § 301.7701-2 is subject to the same self-employment tax rules as a partner of a partnership that does not own an entity that is disregarded as an entity separate from its owner for any purpose under § 301.7701-2.

In adopting this final regulation, T.D. 9869 (7/2/2019) commented:

> As noted in the preamble to TD 9766, these regulations do not address the application of Rev. Rul. 69-184 in tiered partnership situations, but rather clarify that a disregarded entity owned by a partnership is not treated as a corporation for purposes of employing any partner of the partnership…. However, the Treasury Department and the IRS will continue to consider the application of Rev. Rul. 69-184, including the specific issue noted by the commenter [regarding publicly traded partnerships], and welcome further comments.

See text accompanying and flowchart following fn 556 in part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

[3448] Reg. § 301.7701-2(c)(2)(iv), "Special rule for employment tax purposes," provides:

> (A) *In general*. Except as provided in paragraph (c)(2)(iv)(C) of this section, paragraph (c)(2)(i) of this section (relating to certain wholly owned entities) does not apply to taxes imposed under Subtitle C—Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal Revenue Code).
>
> (B) *Treatment of entity*. Except as provided in paragraph (c)(2)(iv)(C) of this section, an entity that is disregarded as an entity separate from its owner for any purpose under this section is treated as a corporation with respect to taxes imposed under Subtitle C—Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal Revenue Code). For special rules regarding the application of certain employment tax exceptions, see §§ 31.3121(b)(3)-1(d), 31.3127-1(b), and 31.3306(c)(5)-1(d) of this chapter.
>
> (C) *Special rules*.
>
> (1) Paragraphs (c)(2)(iv)(A) and (B) of this section do not apply to withholding requirements imposed by section 3406 (backup withholding). Thus, in the case of an entity that is disregarded as an entity separate from its owner for any purpose under this section, the owner is subject to the withholding requirements imposed by section 3406 (backup withholding).
>
> (2) [see fn 3447].

disregarded entity is also treated as a partner with respect to the disregarded entity and cannot receive a Form W-2. On the other hand, a partnership that elects out of applying subchapter K remains subject to self-employment tax.[3449]

(D) *Example*. The following example illustrates the application of paragraph (c)(2)(iv) of this section:

Example.

(i) LLCA is an eligible entity owned by individual A and is generally disregarded as an entity separate from its owner for Federal tax purposes. However, LLCA is treated as an entity separate from its owner for purposes of subtitle C of the Internal Revenue Code. LLCA has employees and pays wages as defined in sections 3121(a), 3306(b), and 3401(a).

(ii) LLCA is subject to the provisions of subtitle C of the Internal Revenue Code and related provisions under 26 CFR subchapter C, Employment Taxes and Collection of Income Tax at Source, parts 31 through 39. Accordingly, LLCA is required to perform such acts as are required of an employer under those provisions of the Internal Revenue Code and regulations thereunder that apply. All provisions of law (including penalties) and the regulations prescribed in pursuance of law applicable to employers in respect of such acts are applicable to LLCA. Thus, for example, LLCA is liable for income tax withholding, Federal Insurance Contributions Act (FICA) taxes, and Federal Unemployment Tax Act (FUTA) taxes. See sections 3402 and 3403 (relating to income tax withholding); 3102(b) and 3111 (relating to FICA taxes), and 3301 (relating to FUTA taxes). In addition, LLCA must file under its name and EIN the applicable Forms in the 94X series, for example, Form 941, “Employer’s Quarterly Employment Tax Return,” Form 940, “Employer’s Annual Federal Unemployment Tax Return;” file with the Social Security Administration and furnish to LLCA’s employees statements on Forms W-2, “Wage and Tax Statement;” and make timely employment tax deposits. See §§ 31.6011(a)-1, 31.6011(a)-3, 31.6051-1, 31.6051-2, and 31.6302-1 of this chapter.

(iii) A is self-employed for purposes of subtitle A, chapter 2, Tax on Self-Employment Income, of the Internal Revenue Code. Thus, A is subject to tax under section 1401 on A’s net earnings from self-employment with respect to LLCA’s activities. A is not an employee of LLCA for purposes of subtitle C of the Internal Revenue Code. Because LLCA is treated as a sole proprietorship of A for income tax purposes, A is entitled to deduct trade or business expenses paid or incurred with respect to activities carried on through LLCA, including the employer’s share of employment taxes imposed under sections 3111 and 3301, on A’s Form 1040, Schedule C, “Profit or Loss for Business (Sole Proprietorship).”

[3449] *Cokes v. Commissioner*, 91 T.C. 222, 230-231 (1988), held:

Article XVII of the unit operating agreement, set forth in our findings, *supra*, provides that each working interest owner elects under these regulations to be excluded from subchapter K. However, in our unanimous Court-reviewed opinion in *Bryant v. Commissioner*, 46 T.C. 848 (1966), *affd.* 399 F.2d 800 (5th Cir. 1968), we concluded as follows (46 T.C. at 864):

> When Congress has subtitlized, subchapterized, and sectionized its treatment of a many threaded statutory pattern like the complex Internal Revenue Code, its clear words seem to us a safe guide to meaning. The election under section 761(a) does not operate to change the nature of the entity. A partnership remains a partnership; the exclusion simply prevents the application of subchapter K. The partnership remains intact and other sections of the Code are applicable as if no exclusion existed.

Although *Bryant* involved application of the investment credit to partnerships which had elected out of subchapter K, this Court’s above-quoted analysis (which was specifically adopted by the Court of Appeals (399 F.2d at 806-807)) is equally applicable to the self-employment taxes of chapter 2.[9]

[9] The discussion of this matter in *Madison Gas & Electric Co. v. Commissioner*, 72 T.C. 521, 559 n. 9 (1979), *affd.* 633 F.2d 512 (7th Cir. 1980), sets aside for the future how the Bryant analysis

A partner who is inactive nevertheless receives income from a trade or business subject to self-employment tax.[3450] Even very small interests that contractually are unable to participate generate SE income[3451] unless the taxpayer can qualify as a limited partner (or perhaps passive

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is to be applied where the controlling statute outside of subch. K does not specifically refer to partnerships. In the instant case, sec. 1402(a) specifically refers to partnerships; thus the instant case falls within the *Bryant* analysis and we have no need to weigh the considerations discussed in the *Madison Gas* footnote.

Accordingly, article XVII of the unit operating agreement (1) does not serve to prevent us from agreeing with respondent that the unitization agreement and the unit operating agreement created a partnership for purposes of section 1402(a), and (2) does not serve to insulate petitioner from the self-employment taxes.

[3450] *Cokes v. Commissioner*, 91 T.C. 222, 233-234 (1988), held:

Petitioner stresses her lack of control of the working interest operations because of the close relationships among the other owners and the operator. The question before us is whether petitioner was a member of a partnership or of a joint venture treated as a partnership, and petitioner's lack of control does not affect that question.[11]

[11] The report of the Committee on Ways and Means on the Social Security Act Amendments of 1949 (H. R. 6000) explained the provision as follows (H. Rept. 1300, 81st Cong., 1st Sess. 136-137 (1949), 1950-2 C.B. 294):

"The net earnings from self-employment of an individual include, in addition to the earnings from a trade or business carried on by him, his distributive share of the net income or loss from any trade or business carried on by each partnership of which he is a member. *** [A] partnership which constitutes an association taxable as a corporation *** is not recognized as a partnership for such purposes. Moreover, only the net income or loss derived by the partnership from carrying on a trade or business is taken into account. Any net income or loss of the partnership derived from sources clearly unrelated to the trade or business carried on by it is excluded in determining the net earnings from self-employment of the partners. The net earnings from self-employment of a partner include his distributive share of the net income or loss of a partnership of which he is a member, irrespective of the nature of his membership, as for example, as a limited or inactive member."

In 1977, the Congress amended sec. 1402(a) to add thereto par. (12), which excludes "the distributive share of any item of income or loss of a limited partner, as such" (sec. 313(b)(3) of the Social Security Amendments of 1977, Pub. L. 95-216, 91 Stat. 1509, 1536). (Sec. 124(c)(2) of the Social Security Amendments of 1983, Pub. L. 98-21, 97 Stat. 65, 90, redesignated par. (12) for taxable years beginning after Dec. 31, 1989.) Petitioner does not contend that the owners of the working interests constituted a limited partnership, nor that she is a limited partner . It appears that, in the words of the 1949 committee report, petitioner may fairly be described as an "inactive member", rather than a limited partner.

Petitioner contends that "The situation is analogous to a minority interest in a close-held corporation."

The problem is that petitioner (and Cokes) did not put their working interest in a corporation, and, for purposes of the self-employment taxes, the relevant statute makes receipt of distributive share of trade or business income from a partnership (defined expansively in section 7701(a)(2)) generally equivalent to the partner's engagement in a trade or business.

[3451] *Methvin v. Commissioner*, T.C. Memo. 2015-81, *aff'd* 653 Fed. Appx. 616 (10th Cir. 6/24/2016), imposed self-employment tax on the owner of working interests in several oil and gas ventures. The working interests were no more than 2%-3% in ventures that "were not part of a business organization (such as a partnership, a limited partnership, a limited liability company, or a corporation) that is registered under the laws of any State." Furthermore, "Petitioner had no right of involvement in the management or operation of the ventures." Nevertheless, the Tax Court held:

In support of his contention petitioner emphasizes his lack of active involvement in the operation of the wells, his lack of knowledge and expertise in the oil industry, and the fact that his working interests were small, minority interests in each well. The record supports petitioner's contention member of an LLC) under part II.L.4 Self-Employment Tax Exclusion for Limited Partner, which occurred in *Hardy v. Commissioner*, T.C. Memo. 2017-16, a case involving an LLC member who had management rights as an equal 1/8 owner but acted as a mere investor.[3452]

Guaranteed payments for services rendered generally are subject to SE tax.[3453] However, they are not subject to SE tax if and to the extent that the activity for which the services are rendered does not constitute a trade or business.[3454] On the other hand, an activity that is excluded from self-employment tax might constitute a trade or business for purposes of applying SE tax to guaranteed payments for services rendered.[3455]

II.L.4. Self-Employment Tax Exclusion for Limited Partners' Distributive Shares

A limited partner's income is not subject to SE tax,[3456] except for guaranteed payments for services rendered to a partnership that engages in a trade or business.[3457] Being passive in an entity is insufficient; the entity must actually be a state law limited partnership;[3458] later this

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> that his personal involvement in the day-to-day operation of the wells was minimal. However, a taxpayer who is not personally active in the management or operation of a trade or business may be liable for self-employment tax if the trade or business is carried out on his behalf through his agents or employees or constitutes his distributive share of income from a partnership in which he was a member. Sec. 1402(a); *Cokes v. Commissioner*, 91 T.C. 222 (1988); *Perry v. Commissioner*, T.C. Memo. 1994-215; *Moorhead v. Commissioner*, T.C. Memo. 1993-314; secs. 1.1402(a)-2(b), 1.1402(c)-1, Income Tax Regs.

[3452] See text accompanying fns. 3475–3482.

[3453] Rev. Rul. 55-30. Furthermore, if the IRS asserts that guaranteed payments were for services and not for capital, the IRS will succeed unless the taxpayer proves that they were for capital. *Seismic Support Services, LLC v. Commissioner*, T.C. Memo. 2014-78 (accuracy-related penalties imposed) and 2015-151 (rejecting various additional arguments by the taxpayer).

[3454] Reg. § 1.1402(a)-1(b). Guaranteed payments are not W-2 wages. See fn. 551.

[3455] Reg. § 1.1402(c)-1.

[3456] Code § 1402(a)(13). See *Hough v. Commissioner*, T.C. Memo. 1997-361 (loss from limited partnership could not offset self-employment earnings from law practice), *aff'd* 162 F.3d 1151 (3rd Cir. 1998).

[3457] Code § 1402(a)(13). See *Howell v. Commissioner*, T.C. Memo. 2012-303 (guaranteed payments from LLC were subjected to self-employment tax), initially discussed in the Shop Talk column by Banoff and Lipton, "Does *Renkemeyer*'s Legacy of Confusion Live On?" *Journal of Taxation* (February 2013).

[3458] *Perry v. Commissioner*, T.C. Memo. 1994-215, held:

> The evidence does not support petitioner's contention that he is a limited partner. State law requires that certain formalities be observed to create a limited partnership (partnership in commendam in Louisiana). Tex. Rev. Civ. Stat. Ann. art. 6132a-1 (West Supp. 1994); La. Civ. Code Ann. arts. 2836-2848 (West Supp. 1994); *Johnson v. Commissioner*, *supra*. There is no evidence of such formalities having been observed by the owners of interests in the wells.

Norwood v. Commissioner, T.C. Memo. 2000-84, followed this:

> It is undisputed that petitioner's interest in Gallant was a general partnership interest. Accordingly, his distributive share of the partnership's trade or business income is, subject to the limitations of section 1402(b), subject to the taxes imposed by section 1401 on self-employment income. *Cokes v. Commissioner*, 91 T.C. 222, 229-230 (1988); *Anderson v. Commissioner*, T.C. Memo. 1992-130. That petitioner spent a minimal amount of time engaged in the operations of Gallant is irrelevant to this determination. *Cokes v. Commissioner*, *supra* at 233; *Anderson v. Commissioner*, *supra*. The passive activity rules under section 469 have no application in this case. Petitioner's lack of participation in or control over the operations of Gallant does not turn his general partnership interest into a limited partnership interest. A limited partnership must be created in the form prescribed by State law. *Perry v. Commissioner*, T.C. Memo. 1994-215; *Johnson v. Commissioner*, T.C. Memo. 1990-461.

part II.L.4 discusses when this exception has been expanded for LLCs. One case, involving a general partnership that elect limited liability protection for its general partners, has led some commentators to suggest that the Tax Court might consider a limited partner's distributive share of income to be subject to SE tax if the limited partner performs services;[3459] I agree that the language is troublesome but disagreed with this suggestion, because that case did not involve a limited partnership and the legislative history cited in the text accompanying fn. 3462 clearly contemplates that a partner can be a general partner and a limited partner and benefit from the limited partner exclusion.

In August 2022 the Tax Court denied summary judgment on the limited partner exclusion in a state law limited partnership:[3460]

> Currently before the Court is a motion for summary judgment filed by petitioner Sirius Solutions, L.L.L.P., Sirius Solutions GP, L.L.C., Tax Matters Partner (Sirius). [Doc. 13.] Sirius contends that, as a matter of law, its limited partners' distributive shares of partnership income are excluded from self-employment tax under I.R.C. § 1402(a)(13). Both parties agree that this question turns on the ordinary meaning of the term "limited partner" as used in I.R.C. § 1402(a)(13) and whether Sirius's limited partners qualified as such during the year at issue.
>
> We will deny Sirius's motion. Genuine disputes of material fact remain regarding Sirius's operations as well as the nature of the limited partners' involvement in the business. The resolution of these factual issues likely bears on our determination whether Sirius's limited partners qualify as "limited partners" as that term is used in I.R.C. § 1402(a)(13). Given this posture, summary judgment is not appropriate.

For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

Unfortunately, *Soroban Capital Partners LP v. Commissioner*, 161 T.C. No. 12 (2023), denied a motion for summary judgment that Code § 1402(a)(13) protects a state law limited partner from SE tax. The Syllabus summarizes:

> PS, a limited partnership subject to the TEFRA audit and litigation procedures, made guaranteed payments and distributed ordinary income to its limited partners. It excluded distributions of ordinary income to its limited partners from its computation of net earnings from self-employment. R determined that the distributions of ordinary income should have been included in PS's computation of net earnings from self-employment.
>
> P, the tax matters partner of PS, filed a Motion for Summary Judgment asking the Court to hold that a limited partner's distributive share of partnership income is excluded from net earnings from self-employment. The parties cross-moved as to whether we have jurisdiction in these partnership-level proceedings to inquire into the functions and roles of PS's limited partners.

[3459] See language highlighted in fn. 3472.
[3460] *Sirius Solutions, L.L.L.P. v. Commissioner*, Docket No. 11587-20, Order dated August 8, 2022 in response to a motion filed June 4, 2021.

Held: I.R.C. § 1402(a)(13) contains a limited partner exception that excludes from net earnings from self-employment “the distributive share of any item of income or loss of a limited partner, as such.”

Held, further, the limited partner exception of I.R.C. § 1402(a)(13) does not apply to a partner who is limited in name only.

Held, further, determining whether a partner is a limited partner in name only requires an inquiry into the functions and roles of the limited partner.

Held, further, because net earnings from self-employment is a partnership item, an inquiry into the functions and roles of a limited partner is a factual determination that underlies a partnership item that is properly determined in a TEFRA proceeding. Treas. Reg. § 301.6231(a)(3)-1(b).

Held, further, P’s Motion for Summary Judgment will be denied; R’s Motion for Partial Summary Judgment will be granted.

The court reasoned in its section, “Limited Partner, As Such”:

Section 1402(a)(13) does not define the phrase “limited partner, as such.” However, legislative history and caselaw provide us with insight on Congress’s intended meaning. The limited partner exception under section 1402(a)(13) was enacted in 1977[5] to “exclude from social security coverage, the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership.”[6] Social Security Amendments of 1977, § 313(b), 91 Stat. at 1536; H.R. Rep. No. 95-702, pt. 1, at 11, as reprinted in 1977 U.S.C.C.A.N. at 4168. Essentially, it was enacted to exclude earnings that are of an investment nature. H.R. Rep. No. 95-702, pt. 1, at 11, as reprinted in 1977 U.S.C.C.A.N. at 4168.

In 1997 Treasury issued a proposed regulation seeking to define the scope of the limited partner exception. See Prop. Treas. Reg. § 1.1402(a)-2, 62 Fed. Reg. 1702 (Jan. 13, 1997). The proposed regulation provided that an individual would not be treated as a limited partner if the individual had personal liability for partnership debts, had authority to contract on behalf of the partnership, or participated in the partnership’s trade or business for more than 500 hours during the partnership’s taxable year. *Id*. para. (h)(2), 62 Fed. Reg. at 1704.

This proposal received much criticism. That criticism led Congress to issue a moratorium prohibiting Treasury from issuing any temporary or final regulation with respect to the definition of a limited partner under section 1402(a)(13) until July 1, 1998. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 935, 111 Stat. 788, 882. Congress’s reasoning behind the moratorium was that “the Senate [was] concerned that the proposed change in the treatment of individuals who are limited partners under applicable State law exceeds the regulatory authority of the Treasury Department and would effectively change the law administratively without congressional action.” Revenue Reconciliation Act of 1997, H.R. 2014, 105th Cong., 143 Cong. Rec. S6694, S6774, S6819 (1997).[7]

Since the moratorium, Congress has briefly discussed the definition of limited partner but has not defined it. See, e.g., Staff of J. Comm. on Tax’n, 110th Cong., Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I, JCX-62-07, at 35 n.64 (J. Comm. Print 2007) ("[L]imited partner status is determined under State law. Issues have arisen under present law as to the proper [self-employment] tax treatment of individuals who may be limited partners under State law but who participate in the management and operation of the partnership.").[8] Furthermore, Treasury has yet to issue any final or temporary regulation defining "limited partner" under section 1402(a)(13).

[8] Joint Committee on Taxation reports are not considered legislative history and carry persuasive weight similar to law review articles. See *Gregory v. Commissioner*, 149 T.C. 43, 55 (2017) (noting that the Joint Committee on Taxation's commentary on tax laws after Congress enacts them does "not inform the decisions of the members of Congress who vot[e] in favor of the [law]" and "[t]he Supreme Court has told us such `[p]ost-enactment legislative history...is not a legitimate tool of statutory interpretation,'" but instead is as persuasive as law review articles (alterations in original) (first quoting *United States v. Woods*, 571 U.S. 31, 48 (2013); and then quoting *Bruesewitz v. Wyeth LLC*, 562 U.S. 223, 242 (2011))).

In 2011 we were called upon to determine the scope of the limited partner exception. We applied statutory construction principles to determine whether partners in an LLP should be considered limited partners under section 1402(a)(13). See *Renkemeyer*, 136 T.C. 137. In *Renkemeyer*, 136 T.C. at 150, we analyzed the legislative history of section 1402(a)(13) and concluded that its intent "was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations...would not receive credits towards Social Security coverage." We further found that "[t]he legislative history...does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes." *Renkemeyer*, 136 T.C. at 150. Lastly, we held that the partners in that case were not limited partners for purposes of section 1402(a)(13) because their "distributive shares arose from legal services...performed on behalf of the law firm" and not "as a return on the partners' investments." *Renkemeyer*, 136 T.C. at 150.

In *Renkemeyer* we specifically applied a functional analysis test to determine whether the limited partner exception applied. But that case specifically dealt with an LLP and not a limited partnership as present here. While there have been subsequent opinions applying *Renkemeyer* to determine whether taxpayers in passthrough entities are limited partners under section 1402(a)(13), we have not addressed whether a limited partner in a state law limited partnership must satisfy a functional analysis test to be entitled to the limited partner exception.[9] See, *e.g.*, *Castigliola v. Commissioner*, T.C. Memo. 2017-62, at *7-14 finding professional LLC members not limited partners for purposes of section 1402(a)(13)).

[9] In *Joseph v. Commissioner*, T.C. Memo. 2020-65, at *60 n.9, we declined to answer whether a de jure limited partner must satisfy *Renkemeyer*'s functional analysis test to be entitled to the limited partner exclusion.

The court reasoned in its section, "Whether Soroban's Partners are Limited Partners for Purposes of Section 1402(a)(13)" (highlighting is mine):

Section 1402(a)(13) excludes from net earnings from self-employment "the distributive share of any item of income or loss of *a limited partner, as such*." (Emphasis added.) Neither section 1402(a)(13) nor applicable regulations define the phrase "limited partner, as such." Therefore, we use principles of statutory construction to ascertain Congress's intent.

For statutory interpretation, we begin with the text of the statute. See *Ross v. Blake*, 578 U.S. 632, 638 (2016). It is a well-established rule of construction that if a statute does not define a term, the term is to be given its ordinary meaning at the time of enactment. *Perrin v. United States*, 444 U.S. 37, 42 (1979); *Gates v. Commissioner*, 135 T.C. 1, 6 (2010). And the canon against surplusage helps us determine that meaning.

Under the canon against surplusage, we give effect to every clause and word of a statute. *United States v. Menasche*, 348 U.S. 528, 538-39 (1955). "When construing a statute, the Court must interpret it `so as to avoid rendering any part of the statute meaningless surplusage.'" *Growmark, Inc. & Subs. v. Commissioner*, No. 23797-14, 160 T.C., slip op. at 11 (May 16, 2023) (citing *15 W. 17th St. LLC v. Commissioner*, 147 T.C. 557, 586 (2016)); see also *Tucker v. Commissioner*, 135 T.C. 114, 154 (2010) ("[W]e decline to read words out of the statute; rather, we attempt to give meaning to every word that Congress enacted...."), *aff'd*, 676 F.3d 1129 (D.C. Cir. 2012).

Turning to the statute in question, we find that the limited partner exception does not apply to a partner who is limited in name only. If Congress had intended that limited partners be automatically excluded, it could have simply said "limited partner." By adding "as such," Congress made clear that the limited partner exception applies only to a limited partner who is functioning as a limited partner.

Petitioner's reliance on legislative history to overcome the plain meaning of the statute is unavailing. To the extent legislative history might be used to shed light on the meaning of the phrase "limited partner, as such," it confirms our conclusion. Congress enacted section 1402(a)(13) to exclude earnings from a mere investment. It intended for the phrase "limited partners, as such" used in section 1402(a)(13) to refer to passive investors.

Petitioner points to H.R. Rep. No. 95-702, pt. 1, at 11, as reprinted in 1977 U.S.C.C.A.N. at 4168, as support, noting that it states that section 1402(a)(13) was intended "to exclude for coverage purposes certain earnings which are basically of an investment nature." But Congress's express text makes clear that it was looking to the nature of the earnings. Congress intended section 1402(a)(13) to apply to partners that are passive investors.

Next petitioner cites the Sense of the Senate Resolution for support. Through that resolution, the Senate expressed its view that Treasury's attempt to define limited partner exceeded its authority. But Treasury's proposed regulation had several criteria that might have led to a limited partner's earnings' being subject to self-employment tax, even if the person was a passive investor. One such example is merely being personally liable for partnership debts. Prop. Treas. Reg. § 1.1402(a)-2(h)(2)(i), 62 Fed. Reg. at 1704. The Senate's concern was "that an individual meeting any one of these three criteria will be treated as a general partner." H.R. 2014, 105th Cong., 143 Cong. Rec.

S6694, S6774, S6819. The Senate's concern about the criteria set forth in Treasury's proposed regulation does not override the plain text of the statute.

Lastly, petitioner relies on a Joint Committee on Taxation report that states: "A special rule applies for limited partners of a partnership." Staff of J. Comm. on Tax'n, 110th Cong., Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I, JCX-62-07, at 35. In a footnote from that sentence, that report explains that "limited partner status is determined under State law." *Id*. at 35 n.64. We find this unpersuasive. The report addresses only the meaning of the words "limited partner" and not the phrase "limited partner, as such." It is those latter words that narrow the scope of the limited partner exception, which the Joint Committee Report does not address. To the extent one might read the Joint Committee on Taxation Report more broadly, it does not constitute legislative history and carries no more weight than a law review article. *Gregory*, 149 T.C. at 55.

Petitioner puts forth myriad other arguments to support its definition of limited partner, but none is persuasive. Petitioner cites section 469 and compares its rules and regulations with section 1402(a)(13), but we do not find the sections analogous. Petitioner cites dicta out of context.10 Lastly, petitioner points to the 2016 Instructions for Form 1065 at 2 and 2017 Instructions for Form 1065 at 3 as support for its definition. The instructions state: "A limited partner is a partner in a partnership formed under a state limited partnership law, whose personal liability for partnership debts is limited to the amount of money or other property that the partner contributed or is required to contribute to the partnership." But this definition is provided as part of the "General Instructions" and "Definitions." This is not, and does not purport to be, a definition for purposes of self-employment tax. In discussion of self-employment tax, the instructions state: "Generally, a limited partner's share of partnership income (loss) isn't included in net earnings (loss) from self-employment." 2016 Instructions for Form 1065 at 34; 2017 Instructions for Form 1065 at 36. Use of the qualifier "generally" makes clear that it is not always true that a limited partner's share of partnership income is excluded from net earnings from self-employment.

The phrase I highlighted above suggests that it may be impossible to avoid both SE tax and, by significantly participating, NII tax.[3461] But see soon below.

If a person is both a general partner and a limited partner, income attributable to that person's interest as a general partner is subject to SE tax, as described in the legislative history of the statute that excludes a limited partner's self-employment income:[3462]

[3461] See part II.I.8 Application of 3.8% Tax to Business Income, especially parts II.I.8.a.i Passive Activity Recharacterization Rules and II.I.8.c Application of 3.8% Tax to Rental Income.

[3462] House Report No. 95-702, Part 1 (to accompany H.R. 7346, which became PL 95-216), October 12, 1977, p. 40, which further explained its reasons on pp. 40-41:

> Your committee has become increasingly concerned about situations in which certain business organizations solicit investments in limited partnerships as a means for an investor to become insured for social security benefits. In these situations the investor in the limited partnership performs no services for the partnership and the social security coverage which results is, in fact, based on income from an investment. This situation is of course inconsistent with the basic principle of the social security program that benefits are designed to partially replace lost earnings from work.

Under present law each partner's share of partnership income is includable in his net earnings from self-employment for social security purposes, irrespective of the nature of his membership in the partnership. Under the bill the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership would be excluded from social security coverage. However, the exclusion from coverage would not extend to guaranteed payments (as described in section 707(c) of the Internal Revenue Code), such as salary and professional fees, received for services actually performed by the limited partner for the partnership. Distributive shares received as a general partner would continue to be covered. Also, if a person is both a limited partner and a general partner in the same partnership, the distributive share received as a general partner would continue to be covered under present law.

To me, this legislative history clarifies what "limited partner, as such" means: It means that a person who is both a general partner and a limited partner excludes from SE income the income earned as a limited partner, as distinguished from the income earned as a general partner. *Soroban* should have granted summary judgement regarding the limited partners' exclusion from SE income. On the other hand, the structure described in parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart can avoid NII tax,[3463] as described in part II.E.5.d Net Investment Income Tax and Passive Loss Rules Under Recommended Structure.

Assigning one's income as an independent contractor to a limited partnership does not avoid SE tax if the payor does not recognize the assignment.[3464]

These advertisements and solicitations are directed mainly toward public employees whose employment is covered by public retirement systems and not by social security. Also, these advertisements frequently emphasize the point that those who invest an amount sufficient to realize an annual net income of $400 or more (the minimum amount needed to receive social security credit in a year) will eventually gain a high return on their social security contributions. Many of those who invest in limited partnerships will qualify for minimum benefits, which are heavily weighted for the purpose of giving added protection for people who have worked under social security for many years with low earnings. The cost of paying these heavily weighted benefits to limited partners must, of course, be borne by all persons covered by the social security program. The advertising injures the social security program in the public view and causes resentment on the part of the vast majority of workers whose employment is compulsorily covered under social security, as well as those people without work income who would like to be able to become insured under the social security program but cannot afford to invest in limited partnerships.

[3463] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

[3464] *Peterson v. Commissioner*, 827 F.3d 968 (11th Cir. 5/24/2016), affirming T.C. Memo. 2013-271. For as similar holding regarding an S corporation, see part II.G.24 Taxing Entity or Individual Performing Services, especially fn. 1894. Similarly, a person who controlled a partnership and was paid directly for services lost his argument that the payments really were for a distributive share of a limited partnership and therefore were excluded under Code § 1402(a)(13), because he actually did not own an interest in the partnership. *Plotkin v. Commissioner*, T.C. Memo. 2011-260. When the taxpayer established an entity as a mere shell, *Robucci v. Commissioner*, T.C. Memo. 2011-19, disregarded the entity, and in fn. 11 declined to address the IRS' other argument:

Although it is apparently respondent's position that profit distributions to service-providing members of a multimember, professional service LLC (which is what Robucci LLC was designed to be) are never excepted from net earnings from self-employment by sec. 1402(a)(13), which so excepts distributions to a limited partner other than sec. 707(c) guaranteed payments for services

Although originally a limited partner lost liability protection by participating in the partnership's activities, that has not been the case for quite some time.[3465] In the passive loss area, being a general partner has a different effect – it converts an interest as a limited partner into an interest as a general partner when determining material participation.[3466]

> rendered, the Secretary has yet to issue definitive guidance with respect to that issue, and the law remains in a state of uncertainty. See, *e.g.*, Kalinka, 9A La. Civ. L. Treatise, Limited Liability Companies and Partnerships: A Guide to Business and Tax Planning, sec. 6.2, at 423 (3d ed. 2001); Chase, Self-Employment Tax and Choice of Entity, 34 Colo. Law. 109, 112 (Dec. 2005).

[3465] Footnotes to Bishop & Kleinberger, ¶ 11.03[1][c][ii] Distinguishing limited partnership cases, *Limited Liability Companies: Tax and Business Law* (WG&L) (viewed 9/3/2016), comment:

> The 1976 version of the RULPA provided that a limited partner risked personal liability if the partner takes part in the control of the business. See, *e.g.*, *Mursor Builders, Inc. v. Crown Mountain Apartment Assocs.*, 467 F. Supp. 1316, 1331–1332 (DC Virgin Islands 1978) (limited partners liable only for debts of the partnership incurred prior to filing certificate of limited partnership); *Antonic Rigging & Erecting of Mo., Inc. v. Foundry E. Ltd. Partnership*, 773 F.Supp. 420, 430 (SD Ga. 1991) (court held that limited partner was not liable to contractor for partnership debts on the ground that limited partner participated in management). The 1985 amendments significantly changed this provision, lengthening substantially a list of safe harbors. The newest version of the Uniform Limited Partnership Act eliminates the control rule entirely. ULPA (2001), § 303.
>
> ….
>
> As for ULPA (2001), the most modern uniform limited partnership act, in § 303, eliminates the control rule entirely: A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership.

A prior version of Willis & Postlewaite, *Partnership Taxation*, ¶2.02. Requirements of Section 704(e), stated:

> As originally written, the Uniform Limited Partnership Act provided that [a] limited partner shall not become liable as a general partner unless…he takes part in the control of the business. ULPA, § 7 (1916). The versions of the Revised Uniform Limited Partnership Act approved in 1976 and 1985 relaxed the control requirement by providing a safe harbor in the form of a lengthy list of activities deemed not to constitute participation in the control of the partnership and a limitation on a limited partner's liability for participation in activities not within the safe harbor to only those persons who transacted business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner. RULPA, § 303 (1985). Section 303 of the Uniform Limited Partnership Act approved in 2001 has eliminated the control requirement and provides that:
>
> > A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership.
>
> RULPA, § 303 (2001). According to the commentary accompanying the act, this provision is intended to provide a full, status-based liability shield for each limited partner even when the limited partner participates in the management and control of the limited partnership. The purpose is to bring limited partners into parity with the members of a limited liability company, partners in a limited liability partnership, and corporate shareholders. It is unclear how this change in state partnership law might affect the application of federal tax law in the context of family partnerships. Nevertheless, if the limited partners are to have no role in the management of the partnership, the partnership agreement should expressly provide that the limited partners have no management power.

[3466] See part II.K.1.a.ii Material Participation, especially fn. 3071.

A limited partnership[3467] may register as a limited liability limited partnership (LLLP) to limit its general partner's liability.[3468] However, rather than using an LLLP registration or perhaps to supplement the protection provided by LLLP registration,[3469] doing business through one or more LLC subsidiaries might simplify signature lines, with individuals signing as managers of each LLC rather than officers of the S corporation general partner[3470] signing on behalf of the partnership. For a comparison, see part II.E.8 Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary.

It is uncertain how this exclusion for limited partners applies to limited liability entities, with more than one member, that are not state law limited partnerships.[3471] Reasoning that "partners who performed services for a partnership in their capacity as partners (*i.e.*, acting in the manner of self-employed persons)" were not intended to be "limited partners," *Renkemeyer, Campbell and Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011), held that partners in a limited liability partnership (a general partnership that registers with the secretary of state to obtain limited liability for all partners) were subject to self-employment tax.[3472] The court pointed out that substantially:

[3467] See part II.C.12 Limited Partnership.

[3468] See part II.C.13 Limited Liability Partnership Registration.

[3469] In Missouri, failure to timely renew LLLP status creates a lapse in the general partner's protection, which lapse cannot be cured, in contrast to the many other states that allow retroactive reinstatement.

[3470] See part II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker.

[3471] See RIA's *Fed. Tax Coord.2d* ¶A-6158. Letter Ruling 9432018 held that a member's interest generally is subject to self-employment tax. Note that the fact of limited liability is not sufficient to treat a member's interest as a limited partner interest for purposes of the Code § 469 passive loss rules. See fn 3057. Courts have ruled against the IRS when it argued that an LLC member was a limited partner for purposes of the passive loss rules (see fn. 3069); query whether they would treat an LLC member as a limited partner for SE tax purposes, especially when they have ruled that exceptions from SE tax are to be narrowly construed (see *Morehouse* and *Johnson* cases cited in fn 3421).

[3472] The court cited the following legislative history:

> Under present law each partner's share of partnership income is includable in his net earnings from self-employment for social security purposes, irrespective of the nature of his membership in the partnership. The bill would exclude from social security coverage, the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership. This is to exclude for coverage purposes certain earnings which are basically of an investment nature . However, the exclusion from coverage would not extend to guaranteed payments (as described in 707(c) of the Internal Revenue Code), such as salary and professional fees, received for services actually performed by the limited partner for the partnership.

It then stated:

> The insight provided reveals that the intent of section 1402(a)(13) was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage. The legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes.

These comments were made in the context of a partner who argued that limited liability made him the equivalent of a limited partner; the court was not addressing the status of a limited partner in a limited partnership. For an in-depth discussion, see Banoff, *Renkemeyer* Compounds the Confusion in Characterizing Limited and General Partners—Part 2, *Journal of Taxation*, June 2012. Part 1 was in the December 2011 issue of the Journal. See also Banoff and Lipton, "Does *Renkemeyer*'s Legacy of Confusion Live On?" *Journal of Taxation* (February 2013). In their Shop Talk column, Who's a 'Limited

> all of the law firm's revenues were derived from legal services performed by [the partners] in their capacities as partners. [The partners] each contributed a nominal amount ($110) for their respective partnership units. Thus it is clear that the partners' distributive shares of the law firm's income did not arise as a return on the partners' investment and were not 'earnings which are basically of an investment nature.' Instead, the attorney partners' distributive shares arose from legal services they performed on behalf of the law firm.

Similarly, CCA 201436049 refused to apply the limited partner exception to an LLC, reasoning:[3473]

> Like the situation in *Renkemeyer*, Partners' earnings are not in the nature of a return on a capital investment, even though Partners paid more than a nominal amount for their Units. Rather, the earnings of each Partner from Management Company are a direct result of the services rendered on behalf of Management Company by its Partners. Similar to *Reither [*sic – *Riether]*, Management Company cannot change the character of its Partners' distributive shares by paying portions of each Partners' distributive share as amounts mislabeled as so-called "wages." Management Company is not a corporation and the "reasonable compensation" rules applicable to corporations do not apply.

However, CCA 201640014 treated an inactive member of an LLC as a limited partner, presumably consistent with the IRS' informal administrative practice of following subsections (g) through (i) of Prop. Reg. § 1.1402(a)-2:

> Franchisee owns the majority of Partnership (D percent). During the years at issue, the remaining interests in Partnership were owned by Franchisee's wife (E percent) and her irrevocable trust (F percent). Partnership's operating agreement provides for only one class of unit of ownership. Neither Franchisee's wife nor her trust are involved with

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Partner'? More Confusion Courtesy of *Renkemeyer* and *Howell*, *Journal of Taxation* (April 2013), Banoff and Lipton discussed comments, by Ronald M. Weiner, that in *Howell* (fn. 3457) the IRS merely attacked the taxpayer's characterization of guaranteed payments as not being self-employment income. They suggested that the IRS missed the boat in failing to attack as self-employment income the taxpayer's distributive share of partnership income. *Renkemeyer* involved an LLP, whereas *Howell* involved an LLC. The authors pointed out that, in *Renkemeyer*, the partners were general partners as a matter of state law, even though they had limited liability, so the *Renkemeyer* court's analysis was much more complicated than it needed to be.

[3473] *Riether* in the quote below is cited in fn. 551, found in part III.B.7.c.viii Creative Bonus Arrangements. In that case, a married couple jointly owned an LLC that operated a business. They paid themselves salary on Forms W-2 and said that the remaining income came from their employees' work, which made that income akin to being a limited partner because they did not participate in the work. The court pointed out that Rev. Rul. 69-184 required them to report compensatory payments as guaranteed payments subject to SE tax instead of on Forms W-2, said that their incorrect reporting on Forms W-2 did not somehow excuse the failure to report their distributive share of the LLC's income as SE income given that they had not proven themselves to be limited partners, and imposed an accuracy-related penalty (the latter because they had not shown that they had relied on their income tax return preparer's advice in reporting the income as not subject to SE tax.

For using a tiered partnership structure to enable a partner's salary-type compensation to be reported on Form W-2, see text accompanying and flowchart following fn 556 in part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

CCA 201436049 might very well be the same case the IRS won that is discussed further below, *Castigliola v. Commissioner*, T.C Memo. 2017-62.

> Partnership 's business operations and their status as limited partners for purposes of § 1402(a)(13) is not in dispute.

On the other hand, the CCA subjected to SE tax the entire distributive share of the majority owner of the LLC, who was active in the business, rejecting his argument that the portion of his distributive share that was not attributable to his work should be excluded from SE income:[3474]

> As discussed above, the *Renkemeyer* Court reviewed the legislative history and concluded that § 1402(a)(13) was intended to apply to those who "merely invested" rather than those who "actively participated" and "performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons)." *Renkemeyer*, 136 TC at 150 Although the *Renkemeyer* Court noted the partners' small capital contributions and service-generated income as factors influencing its decision that the partners in that case were not limited partners, *Renkemeyer* does not stand for the proposition that a capital-intensive partnership should be treated like a corporation for employment tax purposes. Instead, as the Tax Court has repeatedly held, partners who are not limited partners are subject to self-employment tax, even in cases involving capital-intensive oil and gas joint ventures where all of the work was performed by other parties. See *Cokes*, *Methvin*, and *Perry*. Under the *Renkemeyer* Court's interpretation

[3474] Preceding this conclusion, the CCA said (emphasis added):

> Partnership concedes that under the legislative history quoted above and the *Renkemeyer* opinion, service partners in a service partnership acting in the manner of self-employed persons are not limited partners. However, Partnership argues that a different analysis should apply to limited liability members which: (1) derive their income from the sale of products, (2) have made substantial capital investments, and (3) have delegated significant management responsibilities to executive-level employees. Partnership asserts that in these cases the IRS should apply substance over form principles to exclude from self-employment tax a reasonable return on capital invested.
>
> Partnership interprets the legislative history quoted above to mean that § 1402(a)(13) applies to exclude a partner's reasonable return on capital-investment in a capital-intensive LLC partnership, regardless of the extent of the partner's involvement with the partnership's business. In effect, Partnership interprets the sentence from the legislative history This is to exclude for coverage purposes certain earnings which are basically of an investment nature as instead meaning This is to exclude for coverage purposes all earnings which constitute a reasonable return on capital invested in a capital-intensive business. Essentially, Partnership argues that the self-employment tax rules for capital intensive businesses carried on by LLC partnerships are identical to the employment tax rules for corporate shareholder employees: only reasonable compensation is subject to employment tax. Under this analysis, Partnership argues that (1) Partnership's guaranteed payments to Franchisee are reasonable compensation for Franchisee's services, and (2) Franchisee's distributive share represents a reasonable return on capital investments in Partnership's business, and therefore Franchisee is not subject to self-employment tax on his distributive share. Partnership argues that it would be inconsistent with the IRS's position in the Brinks case for the IRS to assert that Franchisee is subject to self-employment tax on his distributive share from Partnership.
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> Partnership's arguments inappropriately conflate the separate statutory self-employment tax rules for partners and the statutory employment tax rules for corporate shareholder employees. ***Section 1402(a)(13) provides an exclusion for limited partners, not for a reasonable return on capital***, and does not indicate that a partner's status as a limited partner depends on the presence of a guaranteed payment or the capital-intensive nature of the partnership's business. Following the Court's analysis in *Riether*, Partnership cannot change the character of Franchisee's distributive shares by paying Franchisee guaranteed payments. Partnership is not a corporation and the wage and reasonable compensation rules which are applicable to corporations and were at issue in the Brinks case do not apply.

> of the legislative history, and consistent with the Court's holding in *Riether*, Franchisee is not a limited partner in Partnership within the meaning of § 1402(a)(13) and is subject to self-employment tax on his full distributive shares of Partnership's income described in § 702(a)(8).

Hardy v. Commissioner, T.C. Memo. 2017-16, treated as a limited partner eligible for the exclusion from SE tax a doctor who owned a 12.5% interest in an LLC, owned together with seven other doctors, that operated a professionally managed[3475] surgery center:[3476]

> Dr. Hardy has never managed MBJ, and he has no day-to-day responsibilities there. Although he meets with the other members quarterly, he does not have any input into management decisions. He generally is not involved in hiring or firing decisions. His role and participation in MBJ have not changed since he became a member.

Contrasting Dr. Hardy's work with the lawyers practicing law in *Renkemeyer*[3477] and receiving distributive shares based on those fees from practicing law, the court pointed out:

> Dr. Hardy is receiving a distribution based on the fees that patients pay to use the facility. The patients separately pay Dr. Hardy his fees as a surgeon, and they separately pay the surgical center for use of the facility in the same manner as with a hospital. Accordingly, Dr. Hardy's distributive shares are not subject to self-employment tax because he received the income in his capacity as an investor.

This last comment, about viewing Dr. Hardy as an investor, ties into other aspects of the case. Dr. Hardy claimed that the income from the surgery center was passive, so that he could deduct passive losses against it.[3478] To avoid recharacterizing the income as nonpassive, he had to prove that he spent no more than 100 hours per year on it.[3479] The Tax Court seemed to view his quarterly meetings with other members as investor time, rather than time spent as a working owner.[3480]

When I read the case, I had expected to see this set up as a manager-managed LLC, with the non-owner CEO being the manager under the operating agreement. I was very surprised to see the most recent annual report (viewed 3/1/2017), which said that each owner is a member-manager. Other documents from the secretary of state indicate that three doctors (not Dr. Hardy) were the initial managers in 2004; the annual reports for the years involved in the case, 2008-2010 do not clarify whether Dr. Hardy was a member or a member-manager, but they also

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[3475] The court pointed out:

> MBJ hires its own employees and does not share any employees with Northwest Plastic Surgery. Like hospitals, MBJ directly bills patients for facility fees. MBJ then distributes to each of its members his or her share of the earnings based on the facility fees less expenses. MBJ uses a third-party accounting firm to prepare the Schedules K-1, Partner's Share of Income, Deductions, Credits, etc., for the members. MBJ does not pay physicians for their procedures.

[3476] The IRS' post-trial brief pointed out that the members approved an employee termination at the CEO's request, but the transcript indicated that was an unusual situation and that the CEO usually took care of employment issues without consulting the members as an ownership group.

[3477] See the extensive quotes from *Renkemeyer* in fn. 3472, found in this part II.L.4.

[3478] The IRS tried to require Dr. Hardy to group his activity in his medical practice with his activity in the surgery center, but the Tax Court held that his decision not to group the two activities was reasonable. See part II.K.1.b Grouping Activities, especially fns. 3134 and 3156.

[3479] See part II.K.1.i Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.

[3480] See part II.K.1.a.v What Does Not Count as Participation.

do not list as a manager a person other than the members. Taken as a whole, the court's opinion and related documentation suggest that, in this LLC, the members together had exclusive legal authority to run the business. No member had more rights to run the business than any other. Their legal rights were not akin to the legal rights of a limited partner. Collectively, their legal rights were equal and were those of general partners.

Clearly, they delegated daily management to a non-owner and chose to oversee the business as mere investors, but that does not change the fact that the owners collectively had plenary legal rights to run the business on a daily basis. This looks to me like a general partnership in which the general partners agreed not to run the business themselves but rather agreed to hire staff to run the business. They are simply passive general partners. (Having limited liability does not cause one to be a limited partner, according to *Renkemeyer*,[3481] so the LLC's liability protection is of no consequence.) Neither the trial transcript nor the judge's opinion demonstrates any awareness of what Dr. Hardy's rights really were; they simply looked to his lack of activity. This approach appears to contradict *Methvin v. Commissioner*, T.C. Memo. 2015-81, involving an unincorporated venture in which the taxpayer had no management rights but nevertheless was subjected to self-employment tax.[3482]

Castigliola v. Commissioner, T.C Memo. 2017-62, held that three lawyers who were the only members in a law firm organized as a member-managed LLC were subject to SE tax on not only their guaranteed payments, which were comparable to salaries at other law firms, but also on their distributive share of the LLC's income. As was the case in *Hardy*, each member had an equal right to manage the LLC, and no member had a controlling interest. Unlike *Hardy* (where the members were passive investors), working for the LLC constituted the members' full-time jobs. Also unlike *Hardy*, the judge rigorously analyzed Code § 1402(a)(13) to determine what it means to be a limited partner.

Following *Renkemeyer*,[3483] *Castigliola* noted that "no statutory or regulatory authority defines 'limited partner' for the purposes of section 1402(a)(13)," and therefore "the term is to be given its ordinary meaning at the time of enactment."[3484] Because "*Renkemeyer* indicated that the meaning of 'limited partner' is not necessarily confined solely to the limited partnership context," the court first looked to "whether the person claiming the section 1402(a)(13) exemption held a position in an entity treated as a partnership for Federal tax purposes that is functionally equivalent to that of a limited partner in a limited partnership," asking whether a member of the LLC (a "professional limited liability company" or "PLLC") "is functionally equivalent to a limited partner in a limited partnership." The court pointed out:

> A limited partnership has two classes of partners, general and limited. *E.g.*, *Garnett v. Commissioner*, 132 T.C. at 375. General partners typically have management power and unlimited personal liability. 1 Bromberg & Ribstein, *Partnership*, sec. 1.01(B)(3) (2015-3 Supp.). On the other hand, limited partners typically lack management power but enjoy immunity from liability for debts of the partnership. *Id.*

[3481] See the extensive quotes from *Renkemeyer* in fn. 3472, found in this part II.L.4.
[3482] See fn. 3451, found in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.
[3483] See the extensive quotes from *Renkemeyer* in fn. 3472, found in this part II.L.4.
[3484] Citing *Gates v. Commissioner*, 135 T.C. 1, 6 (2010), and *Perrin v. United States*, 444 U.S. 37, 42 (1979).

The court noted limited partnership law when Code 1402(a)(13) was enacted in 1977 and how it has evolved since then.[3485] Applying that summary to the case at hand:

> Common to each of the definitions of "limited partner" discussed above are the primary characteristics of limited liability and lack of control of the business. In this case, the respective interests in the PLLC held by Mr. Castigliola, Mr. Banahan, and Mr. Mullen made each a member of the PLLC, which was member-managed.[9] Therefore management power over the business of the PLLC was vested in each of them through the interest each held. *See id.* sec. 79-29-302 (effective after July 1, 1994). The PLLC had no written operating agreement, nor is there any evidence to show that any member's management power was limited in any way. Furthermore, all members participated in control of the PLLC: For example, they all participated in collectively making decisions regarding their distributive shares, borrowing money, hiring, firing, and rate of pay for employees. They each supervised associate attorneys and signed checks for the PLLC. On the basis of the foregoing facts, the respective interests held by Mr. Castigliola, Mr. Banahan, and Mr. Mullen could not have been limited partnership interests under any of the limited partnership acts. Therefore, they were not limited partners under section 1402(a)(13).
>
> [9] There is no evidence to suggest that any member held a different type of interest in the PLLC or held more than one type of interest in the PLLC.

[3485] The court stated:

> More specifically, the exact meaning of "limited partner" may vary slightly from State to State. The Uniform Law Commission drafted the Uniform Limited Partnership Act in 1916 (ULPA (1916)), and the Revised Uniform Limited Partnership Act in 1976 (RULPA (1976)). Amendments were added to RULPA (1976) in 1985 (RULPA (1985)). Versions of these uniform acts have been adopted in most States, sometimes with modifications.
>
> Section 7 of ULPA (1916) states: "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." ULPA (1916) allowed limited partners a narrow set of rights but did not specifically define which activities a limited partner could perform without losing limited partner status. See *id.* sec. 10 (allowing limited partners the rights to inspect books, demand an accounting of partnership affairs, and receive a share of the profits and return of capital, and also allowing limited partners the same right as general partners to request dissolution and winding up of the partnership).
>
> Section 303(a) of RULPA (1976) provides—in terms almost identical to those of ULPA (1916)—that a "limited partner" would lose limited liability protection if "in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." With regard to the meaning of "limited partner", the essential difference between ULPA (1916) and RULPA (1976) is that RULPA (1976) enumerates certain activities that a limited partner may perform without taking part in control of the business; for example, section 303(b)(5)(i) and (ii) of RULPA (1976) explicitly permits limited partners to vote on the dissolution of the partnership or the sale of substantially all of the partnership's assets.
>
> In 1987 Mississippi adopted RULPA (1985) with some modifications. See 1987 Miss. Laws, ch. 488, sec. 303 (effective from Jan. 1, 1988); Miss. Code Ann. sec. 79-14-303 (2009). In terms almost identical to those of ULPA (1916) and RULPA (1976), the version of the limited partnership act that Mississippi adopted in 1987—and which was effective throughout the years at issue—provided that a "limited partner" would lose limited liability protection if "in addition to the exercise of his rights and powers as a limited partner, he participates in the control of the business." Miss. Code Ann. sec. 79-14-303. Like RULPA (1976), Mississippi's version provides safe harbors for various activities a limited partner may perform without losing limited liability protection. *Id.*

The court recognized that "a limited partnership must have at least one general partner"[3486] and, in reinforcing its conclusion that the members were not limited partners, reasoned:

> This is logical, because limited partners, as discussed above, cannot participate in control of the business and maintain their limited liability. Because there must be at least one partner who is in control of the business, there must be at least one general partner. The members testified that all members participated equally in all decisions and had substantially identical relationships with the PLLC. There was no PLLC operating agreement or other evidence to suggest otherwise. But since by necessity at least one of the members must have occupied a role analogous to that of a general partner in a limited partnership, and because all of the members had the same rights and responsibilities, they must all have had positions analogous to those of general partners in a limited partnership. This conclusion is affirmed by the history of the PLLC: Before the members organized the PLLC, they operated as a general partnership; and there is no evidence that organizing as a PLLC was accompanied by any change in the way they managed the business.

Thus, the court would not accept a headless entity,[3487] whereas *Hardy* implicitly accepted that idea because the members were mere investors who delegated daily running of the business to a skilled managerial employee. *Hardy* did not analyze either what it means to be a limited partner or what were the members' rights to run the LLC; it focused only on the fact that they did not run the LLC on a daily basis.

Before claiming limited partner status, the taxpayer needs to prove the type of entity involved and the taxpayer's ownership rights.[3488]

Moving on to other authority in this area: In light of the ascendancy of LLCs, subsections (g) through (i) of Prop. Reg. § 1.1402(a)-2 would define a limited partner, if ever finalized:

> **(g) Distributive share of limited partner.** An individual's net earnings from self-employment do not include the individual's distributive share of income or loss as a limited partner described in paragraph (h) of this section. However, guaranteed payments described in section 707(c) made to the individual for services actually rendered to or on behalf of the partnership engaged in a trade or business are included in the individual's net earnings from self-employment.

[3486] Citing:

> *See*, *e.g.*, Miss. Code Ann. sec. 79-14-801 (2009) ("A limited partnership is dissolved and its affairs must be wound up upon the first of the following to occur: * * * (4) An event of withdrawal of a general partner unless at the time there is at least one other general partner[.]").

[3487] *Riether*, discussed in fn. 3473, implicitly made a similar assumption when it held that a married couple that jointly owned an LLC could not claim the limited partner exclusion without proving that status.

[3488] *Joseph v. Commissioner*, T.C. Memo. 2020-65, rejected the taxpayer's claim of qualifying:

> Contrary to petitioner's assertion, we find no evidence in the record concerning GASP's nontax legal status or the nature of petitioner's interest in the entity. Petitioner made no proposed findings of fact on those points. (Indeed, contrary to the mandate of Rule 151(e)(3), his opening brief made no proposed findings of fact at all.) The parties stipulated that GASP "was a partnership for federal income tax purposes during the tax years at issue" and that petitioner "personally owned a 99% interest in GASP" during those years. But we find nothing in the stipulation of facts that identifies GASP's status under State law or the specific nature of petitioner's interest in the entity (other than its proportion in relation to other interests).

(h) Definition of limited partner.

(1) In general. Solely for purposes of section 1402(a)(13) and paragraph (g) of this section, an individual is considered to be a limited partner to the extent provided in paragraphs (h)(2), (h)(3), (h)(4), and (h)(5) of this section.

(2) Limited partner. An individual is treated as a limited partner under this paragraph (h)(2) unless the individual—

(i) Has personal liability (as defined in § 301.7701-3(b)(2)(ii) of this chapter) for the debts of or claims against the partnership by reason of being a partner;[3489]

(ii) Has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership;[3490] or

(iii) Participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year.

(3) Exception for holders of more than one class of interest. An individual holding more than one class of *interest* in the partnership who is not treated as a limited partner under paragraph (h)(2) of this section is treated as a limited partner under this paragraph (h)(3) with respect to a specific class of partnership interest held by such individual if, immediately after the individual acquires that class of interest—

(i) Limited partners within the meaning of paragraph (h)(2) of this section own a substantial, continuing interest in that specific class of partnership interest; and,

(ii) The individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by the limited partners described in paragraph (h)(3)(i) of this section.

(4) Exception for holders of only one class of interest. An individual who is not treated as a limited partner under paragraph (h)(2) of this section solely because that individual participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year is treated as a limited partner under this paragraph (h)(4) with respect to the individual's partnership interest if, immediately after the individual acquires that interest—

(i) Limited partners within the meaning of paragraph (h)(2) of this section own a substantial, continuing interest in that specific class of partnership interest; and

(ii) The individual's rights and obligations with respect to the specific class of interest are identical to the rights and obligations of the specific class of partnership interest held by the limited partners described in paragraph (h)(4)(i) of this section.

[3489] Does this mean personal liability as an inherent state law attribute of being an owner, or personal liability because lenders require all owners to guarantee loans?
[3490] Does this mean a manager-managed LLC and the limited partner is not a manager, or member-managed with voting and nonvoting interests?

(5) Exception for service partners in service partnerships. An individual who is a service partner in a service partnership may not be a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section.

(6) Additional definitions. Solely for purposes of this paragraph (h)—

(i) A *class of interest* is an interest that grants the holder specific rights and obligations. If a holder's rights and obligations from an interest are different from another holder's rights and obligations, each holder's interest belongs to a separate class of interest. An individual may hold more than one class of interest in the same partnership provided that each class grants the individual different rights or obligations. The existence of a guaranteed payment described in section 707(c) made to an individual for services rendered to or on behalf of a partnership, however, is not a factor in determining the rights and obligations of a class of interest.

(ii) A *service partner* is a partner who provides services to or on behalf of the service partnership's trade or business. A partner is not considered to be a service partner if that partner only provides a de minimis amount of services to or on behalf of the partnership.

(iii) A *service partnership* is a partnership substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.

(iv) A *substantial interest in a class of interest* is determined based on all of the relevant facts and circumstances. In all cases, however, ownership of 20 percent or more of a specific class of interest is considered substantial.

(i) Example. The following example illustrates the principles of paragraphs (g) and (h) of this section:

Example. (i) A, B, and C form LLC, a limited liability company, under the laws of State to engage in a business that is not a service partnership described in paragraph (h)(6)(iii) of this section. LLC, classified as a partnership for federal tax purposes, allocates all items of income, deduction, and credit of LLC to A, B, and C in proportion to their ownership of LLC. A and C each contribute $1x for one LLC unit. B contributes $2x for two LLC units. Each LLC unit entitles its holder to receive 25 percent of LLC's tax items, including profits. A does not perform services for LLC; however, each year B receives a guaranteed payment of $6x for 600 hours of services rendered to LLC and C receives a guaranteed payment of $10x for 1000 hours of services rendered to LLC. C also is elected LLC's manager. Under State's law, C has the authority to contract on behalf of LLC.

(ii) *Application of general rule of paragraph (h)(2) of this section*. A is treated as a limited partner in LLC under paragraph (h)(2) of this section because A is not liable personally for debts of or claims against LLC, A does not have authority to contract for LLC under State's law, and A does not participate in LLC's trade or business for more than 500 hours during the taxable year. Therefore, A's distributive share attributable to A's LLC unit is excluded from A's net earnings from self-employment under section 1402(a)(13).

(iii) *Distributive share not included in net earnings from self-employment under paragraph (h)(4) of this section*. B's guaranteed payment of $6x is included in B's net earnings from self-employment under section 1402(a)(13). B is not treated as a limited partner under paragraph (h)(2) of this section because, although B is not liable for debts of or claims against LLC and B does not have authority to contract for LLC under State's law, B does participates in LLC's trade or business for more than 500 hours during the taxable year. Further, B is not treated as a limited partner under paragraph (h)(3) of this section because B does not hold more than one class of interest in LLC. However, B is treated as a limited partner under paragraph (h)(4) of this section because B is not treated as a limited partner under paragraph (h)(2) of this section solely because B participated in LLC's business for more than 500 hours and because A is a limited partner under paragraph (h)(2) of this section who owns a substantial interest with rights and obligations that are identical to B's rights and obligations. In this example, B's distributive share is deemed to be a return on B's investment in LLC and not remuneration for B's service to LLC. Thus, B's distributive share attributable to B's two LLC units is not net earnings from self-employment under section 1402(a)(13).

(iv) *Distributive share included in net earnings from self-employment*. C's guaranteed payment of $10x is included in C's net earnings from self-employment under section 1402(a). In addition, C's distributive share attributable to C's LLC unit also is net earnings from self-employment under section 1402(a) because C is not a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section. C is not treated as a limited partner under paragraph (h)(2) of this section because C has the authority under State's law to enter into a binding contract on behalf of LLC and because C participates in LLC's trade or business for more than 500 hours during the taxable year. Further, C is not treated as a limited partner under paragraph (h)(3) of this section because C does not hold more than one class of interest in LLC. Finally, C is not treated as a limited partner under paragraph (h)(4) of this section because C has the power to bind LLC. Thus, C's guaranteed payment and distributive share both are included in C's net earnings from self-employment under section 1402(a).

Because these regulations are merely proposed, however, taxpayers may either argue that they provide a reasonable position or ignore them as not yet being effective. In using them, consider the following:

- The material participation component of these proposed regulations generally would prevent a limited partner in a trade or business from reaching the sweet spot of avoiding both SE tax and the 3.8% tax on net investment income, unless one participates for more than 100 hours and no more than 500 hours.[3491]

- Suppose one wants to argue that one's interest in an LLC has a general partner and a limited partner component:

  - (h)(3)(ii) requires that the individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by the limited partners described in (h)(3)(i).

[3491] See part II.I 3.8% Tax on Excess Net Investment Income, especially part II.I.8 Application of 3.8% Tax to Business Income, summarized at part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.

- Limited partners described in (h)(3)(i) must hold an aggregate 20% and be described in (h)(2).

- To be described in (h)(2), a member cannot:

  - Have personal liability for the debts of or claims against the LLC by reason of being a member;

  - Have authority to contract on behalf of the LLC; or

  - Participate in the partnership's trade or business for more than 500 hours during the partnership's taxable year.

Considering that owners of operating businesses frequently make loan guarantees, making sure that 20% of the owners are never on loan guarantees, never have authority to represent the LLC in any manner, and are active in the business only within the 101-500 hour sweet spot[3492] is a tall order. And *Renkemeyer* includes very strong language against granting an exclusion from self-employment tax for an active owner in an entity that is not a limited partnership, and some are concerned that *Renkemeyer* might be extended one day to prevent limited partners in a limited partnership from excluding from SE income their distributive share as limited partners.[3493] Those who are extremely concerned about the latter might advise each partner to form his or her own S corporation to hold all of his or her interest in the business, which might simply be a straight LLC, as described in parts II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker (idea that S corporations block SE income), II.L.5.c Examples of S Corporation Blockers (narrative description of alternatives), and II.L.5.e Flowchart: LLC with S Corporation as Blocker (diagram).

In many cases, using a traditional limited partnership to govern ownership, which partnership holds one or more LLC subsidiaries that are disregarded for tax purposes, would provide more long-term flexibility regarding the conduct of future business without falling out of the protection that the proposed regulations seem to provide. If a client finds a limited partnership cumbersome to operate on a daily basis, the limited partnership could do business through one or more wholly owned LLCs that are disregarded for income tax purposes.[3494]

Although administratively the IRS appears to be informally following this proposed regulation, CCA 201640014, particularly fn. 3474 and the accompanying text, makes clear that taxpayers need to use limited partnerships to maximize the possibility of refuting an IRS argument in this area. I prefer the structure described in parts II.E.5 Recommended Long-Term Structure for

[3492] See text accompanying fn. 3491 in this part II.L.4.
[3493] See highlighted language fn. 3472 in this part II.L.4. At least one tax expert whom I highly regard has expressed concern that *Renkemeyer* signals trouble for a limited partner in a state law limited partnership who is active. However, that expert concedes the language highlighted in fn. 3462 very strongly supports the exclusion for an active limited partner (but not the point that it eliminates his concern). Although I strongly disagree with that concern and feel quite confident in the structure described in part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and illustrated in part II.E.6 Recommended Partnership Structure – Flowchart, I leave it up to the reader to consider this expert's views.
[3494] See part II.B Limited Liability Company (LLC), especially the comments accompanying fns. 330-344, discussing when a single-member LLC is or is not disregarded.

Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart.

On the other hand, if the 3.8% net investment income (NII) tax is repealed and income from active businesses does not receive favorable tax treatment relative to passive businesses, investing in an LLC as a passive business owner, as in *Hardy*,[3495] may be a model that works. In that case, consider making sure that one's time spent qualifies as investor time, rather than time spent as a working owner.[3496] I would also recommend making the person who manages the LLC be the manager. However, I remain uneasy about *Hardy*, because *Methvin* involved facts that in most ways were more sympathetic to the taxpayer than *Hardy*, yet found the taxpayer subject to SE tax. Furthermore, if NII tax is not repealed and the owner is active enough to avoid NII tax, the owner might have moved away from being a mere investor and moved closer to *Renkemeyer* and *Castigliola*. So, I am not yet convinced that one should rely on *Hardy*, and I remain firmly in favor of using limited partnerships to save SE tax.

IRS LB&I Concept Unit, "Self-Employment Tax and Partners," last updated 2/13/2019,[3497] observed on page 11:

> S corporation shareholders are subject to "reasonable compensation" rules. In contrast, partnerships generally are not required to pay partners guaranteed payments. The concept of "reasonable compensation" does not exist for partnerships and partners in the same way that it does for S corporations and shareholders.

On page 19, the Concept Unit discussed Prop. Reg. § 1.1402(a)-2(h):

> The 1997 Proposed Regulations are not final. They may not be enforced on taxpayers. Instead, the applicable analysis is the statutory language, legislative history, and case law. Taxpayers, however, may rely on the 1997 proposed regulations. In other words, the IRS will respect a partner's status as a limited partner if the partner qualifies as a limited partner under the 1997 proposed regulations.

II.L.5. Self-Employment Tax: Partnership with S Corporation Blocker

II.L.5.a. S Corporation Blocker Generally

Because corporate income is not subject to self-employment (SE) tax, doing business through an S corporation avoids SE tax on the distributive share of income if and to the extent that distributions do not constitute disguised compensation payments.[3498] The corporation needs to

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[3495] In this part II.L.4, the text surrounding fn. 3475 discusses *Hardy*.

[3496] See part II.K.1.a.v What Does Not Count as Participation.

[3497] Knowledge Base – Partnerships, Book 366, Document Control Number (DCN) PST/C/366_01_01-01, found at https://www.irs.gov/pub/irs-utl/pst_c_366_01_01_01.pdf.

[3498] For corporate income not being subject to SE tax, see part II.L.1 FICA: Corporation, especially fn. 3381, citing Rev. Rul. 59-221, which was cited with approval by *Ding v. Commissioner*, T.C. Memo. 1997-435, *aff'd* 200 F.3d 587 (9th Cir. 1999). In rejecting a taxpayer's attempt to offset S corporation losses against SE income, the Tax Court in *Ding* held:

> We find the absence of any reference to S corporation pass-through items in section 1402 to be significant, and not merely a consequence of timing. The statute has been amended 34 times since the enactment of the S corporation provisions. None of the amendments address pass-through items from S corporations. We note that respondent's position on the issue here under

contract with those with whom business is conducted; the owner cannot merely transfer to the corporation income the owner receives and characterize it as income that the S corporation owned.[3499] Before deciding to do business as an S corporation, please see part II.E Recommended Structure for Entities.

If an owner wants the income tax benefits of the partnership structure but needs to avoid FICA on the business' earnings from the efforts of others or from earnings on capital, the owner might consider forming an S corporation to hold the owner's interest in the partnership, resulting in the structure depicted in part II.L.5.d Straight-Up Limited Partnership or II.L.5.e Flowchart: LLC with S Corporation as Blocker. The corporation would treat the owner as an employee with respect to reasonable compensation for services rendered.[3500] Because S corporation earnings are not

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consideration was published 38 years ago in Rev. Rul. 59-221, 1959-1 C.B. 225, which states, in part:

> it is apparent that income not resulting from the conduct of a trade or business by an individual or by a partnership of which he is a member is not includible in computing the individual's net earnings from self-employment. Amounts which must be taken into account in computing a shareholder's income tax by reason of the provisions of *** [a predecessor of section 1366] of the Code, are not derived from a trade or business carried on by such shareholder. Neither the election by a corporation as to the manner in which it will be taxed for Federal income tax purpose nor the consent thereto by the persons who are shareholders results in the consenting shareholder's being engaged in carrying on the corporation's trade or business. Accordingly, amounts which a shareholder is required to include in his gross income by reason of the provisions of *** [a predecessor of section 1366] of the Code should not be included in computing his net earnings from self-employment *** .

The revenue ruling concludes that S corporation pass-through items do not constitute net earnings from self-employment to the corporation's shareholder because such items are not derived from a trade or business carried on by the shareholder. We understand that we are not bound by the revenue ruling, *Stark v. Commissioner*, 86 T.C. 243, 250-251 (1986); however, the fact that the revenue ruling has remained in effect, unmodified, for 38 years provides a strong commentary on the validity of respondent's position. During the period the revenue ruling has been in effect, Congress has amended section 1402 approximately 30 times. If Congress had intended pass-through items from S corporations to be included in the definition of net earnings from self-employment, which would obviously be contrary to the conclusion of the revenue ruling, we expect that one of the many amendments made to the statute since its enactment would have so indicated. See generally *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939).

Furthermore, respondent's position that the pass-through items were not derived from a trade or business carried on by petitioner is supported by two firmly established principles of Federal income taxation, namely: (1) A corporation formed for legitimate business purposes and its shareholders are separate entities, *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943); and (2) the business of a corporation is separate and distinct from the business of its shareholders, *id.*; *Deputy v. du Pont*, 308 U.S. 488, 494 (1940); *Crook v. Commissioner*, 80 T.C. 27, 33 (1983), *affd.* without published opinion 747 F.2d 1463 (5th Cir. 1984).

For distributions constituting compensation subject to FICA instead of merely a disbursement of a distributive share of income not subject to SE tax, see Rev. Rul. 74-44 and part II.A.2.c Avoiding Double Taxation and Self-Employment Tax, especially fns. 79-80 (the latter discussing sanctions against a CPA for preparing a return that resulted in penalties for failure to declare reasonable compensation).

[3499] See part II.G.24 Taxing Entity or Individual Performing Services.

[3500] Rev. Rul. 73-361 (shareholder officer compensation is subject to FICA, federal income tax withholding, and FUTA). See part II.A.2.c Avoiding Double Taxation and Self-Employment Tax, which cites cases where the IRS attacked as compensation subject to FICA (and often asserted penalties regarding) payments that taxpayers characterized as distributions to shareholder-employees.

subject to FICA,[3501] no self-employment tax would be imposed on the distributive share of partnership self-employment income when it passes to the S corporation owner.[3502]

Sometimes an employee who issued a profits interest[3503] wants to remain an employee and might ask for the profits interest to be issued to an S corporation blocker. However, the IRS may assert that distributions from the S corporation to the shareholder are compensation for services rendered (after all, the profits interest was issued as incentive compensation), causing the employer share of FICA to be paid by both the partnership and the S corporation.[3504] An employee who uses such an S corporation blocker should consider reinvesting distributions from the partnership until after retirement to try to attenuate the cash flows to the shareholder from the services that the shareholder provides. However, distributions from the partnership tend to be to pay tax on the distributive share of income, and the employee-shareholders needs the distributions to pay tax. Given that such an employee would tend to earn more than the taxable wage base from the partnership, this attempt to avoid SE tax and FICA often does so only with respect to earnings over the taxable wage base, at the cost of doubling up income subject to FICA below the taxable wage base.

If these are new corporations, be sure that each corporation exercises any ownership rights it has, complying with corporate formalities in acting as a member of the LLC; having a service contract with the LLC and paying compensation to its officers or other employees would also help.[3505]

[3501] The trade or business must be carried on by the individual, either personally or through agents or employees, or by a partnership. Reg. § 1.1402(a)(2)(b), (d). The S corporation's existence as a separate taxpayer is respected for SE tax purposes, and a shareholder's K-1 income does not constitute self-employment income. See fn. 3381. However, if the S corporation is not a state law corporation, see part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election.

[3502] The effectiveness of such a blocker, when the K-1 earnings from the partnership were ultimately paid to each owner, was litigated in *Watson, P.C, v. U.S.,* 105 AFTR.2d 2010-2624 (denying the taxpayer's motion for summary judgment) and 107 AFTR.2d 2011-311 (S.D. Iowa) (finding in favor of the IRS), *aff'd* 109 AFTR.2d 2012-1059 (8th Cir.), cert. den. 10/1/2012. In 2002, the sole owner of the S corporation partner received $24K salary, $118K dividend payments, and $84K other payments. In 2003, the owner received $24K salary and $222K in dividend payments. Originally, the IRS contended that $131K of the dividend payments for 2002 and that $175K of the dividend payments for 2003 should be recharacterized as wages subject to employment taxes, assessing $49K in taxes, penalties, and interest against the corporation. Eventually, the IRS' trial position evolved to recharacterizing only $67K as compensation for each year, for a total of $91K compensation per year. Thus, the taxpayer received substantial savings from dividends that were not recharacterized by the IRS.

[3503] See part II.M.4.f Issuing a Profits Interest to a Service Provider.

[3504] See fns 732-734 in part II.E.1.b Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships.

[3505] See *Robucci v. Commissioner*, T.C. Memo. 2011-19 (psychiatrist's C corporations disregarded for self-employment tax purposes; penalty imposed; excellent example of client not understanding what the tax professional was trying to accomplish). I noticed one commentator express concern about Code § 269, acquiring control of a corporation with the principal purpose being evasion or avoidance of Federal income tax. That same commentator suggested considering the economic substance rules, which would apply to an improper avoidance of Federal income tax, and saving self-employment tax would not be a proper motive under that rule; see part II.G.17 Economic Substance. Would statutes designed to prevent Federal income tax avoidance cause a strategy designed to save self-employment tax to fail? I am unaware of any cases applying these statutes to strategies designed to save self-employment tax.

Furthermore, for business succession purposes, the owner can then transfer interests in the S corporation to family members without breaking up the single block of partnership voting rights.

On the other hand, when the owner of the S corporation blocker dies, the partnership's assets do not get an inside basis step-up.[3506] If the S corporation sells the partnership interest to an unrelated party and then liquidates in the year of sale, the deceased owner's beneficiaries might be able to replicate the inside basis step-up, although this strategy works better for federal income tax than state income tax purposes.[3507] For this reason and due to certain estate planning considerations,[3508] it might be best to have the partnership interest be the S corporation's only asset.

II.L.5.b. Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election

When an unincorporated business makes an S election (using great caution to strip any partnership tax and accounting provisions from any operating agreement or partnership agreement forms),[3509] does the S election block self-employment tax?

Reg. § 1.1402(a)-2(g) appears to provide that electing to treat a partnership as an S corporation does not preclude self-employment tax:

> *Nature of partnership interest*. In the case of a partner who is a member of a partnership with respect to which an election has been made pursuant to section 1361 and the regulations thereunder to be taxed as a domestic corporation, net earnings from self-employment include his distributive share of the income or loss, described in section 702(a)(9), from the trade or business carried on by the partnership computed without regard to the fact that the partnership has elected to be taxed as a domestic corporation.

Similarly, Reg. § 1.1402(a)-2(h) appears to provide that a sole proprietor may not avoid self-employment tax by electing to treat his or her business as an S corporation:

> *Proprietorship taxed as domestic corporation*. A proprietor of an unincorporated business enterprise with respect to which an election has been made pursuant to section 1361 and the regulations thereunder to be taxed as a domestic corporation shall compute his net earnings from self-employment without regard to the fact that such election has been made.

Thus, the above regulations appear to provide that a single member LLC that elects taxation as an S corporation will be subjected to self-employment tax as if the S election has not been made.

[3506] See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.
[3507] See part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation.
[3508] See part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts, which includes a discussion of splitting assets when a trust terminates and the beneficiaries go their separate ways.
[3509] See part II.A.2.i Single Class of Stock Rule and especially fn. 361 in part II.B Limited Liability Company (LLC).

However, those regulations were promulgated before the current subchapter S was created, and subsections (g) and (h) of Reg. § 1.1402(a)-2 appear to be obsolete.[3510]

If one remains concerned about whether subsections (g) and (h) of Reg. § 1.1402(a)-2 are valid and wants the state law benefits of an unincorporated entity and the SE tax blocking benefit of an S corporation, one should consider using a limited partnership that has limited liability protection, which is commonly known as a limited liability limited partnership (LLLP).[3511] The general partner will have limited liability and be subject to SE tax, and generally the limited partners will avoid SE tax on their distributive share of income.

II.L.5.c. Examples of S Corporation Blockers

Consider the structures described below, which seek to thread the needle between avoiding the 3.8 tax on net investment income[3512] and avoiding self-employment tax. The "Real Estate Drop Down into Preferred Limited Partnership" scenario is more complex and would tend to be more appropriate in converting existing structures. The "Straight-Up Limited Partnership" scenario has an elegant simplicity if no real estate (or other rental property) is ever held and no LLCs are required; more details are discussed earlier in this document.[3513] The "Flowchart: LLC with S Corporation as Blocker" is an excellent defense in case the IRS ever succeeds in taxing limited partners in a state law limited partnership on their distributive share of income:

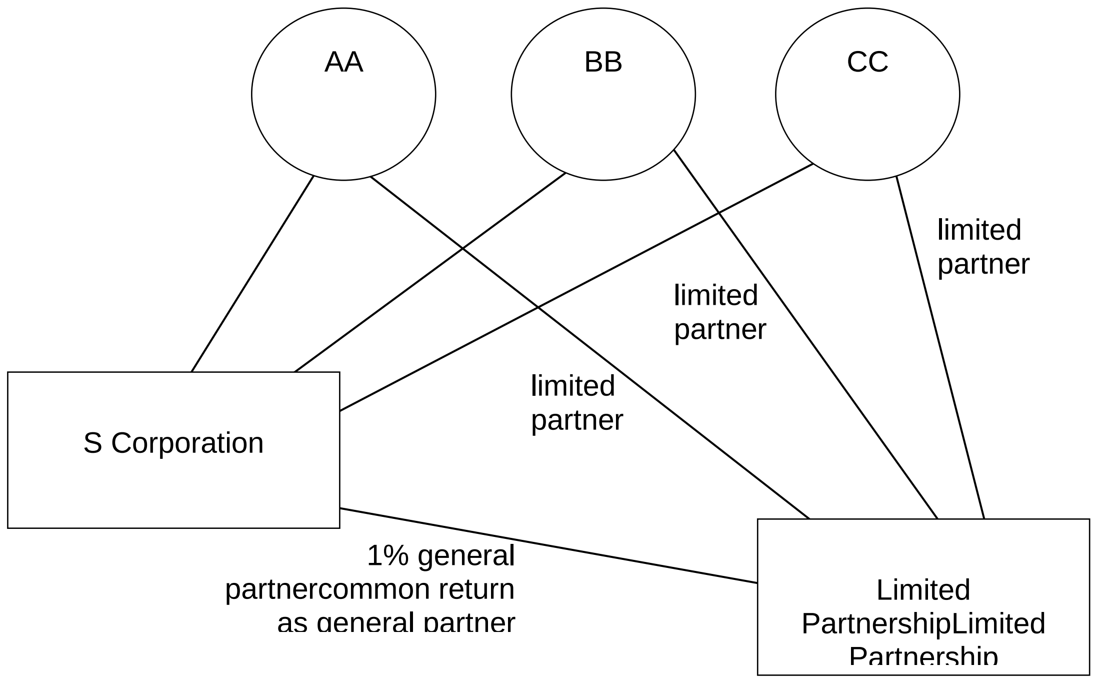
- The exit strategies in part II.Q Exiting from or Dividing a Business remain viable in that structure, although they can become more complicated.

- Basis step-up on the company's assets upon an owner's death becomes more complex and might or might not be attained.[3514] One would need to thoroughly explore the nuances of parts II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation and II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).

Note that these structures would tend to defeat a possible goal of allowing the family members who do not participate in the business to receive income from long-term leases of property used in the business, which strategy is used to provide income to the outsiders without their needing a voice in how the business is run. One might need to give up on avoiding the 3.8% tax on net investment income regarding the use of valuable property if separating outsiders from insiders is too significant an issue. See part II.E.5.d Net Investment Income Tax and Passive Loss Rules Under Recommended Structure regarding the benefits of keeping real estate under the same umbrella as the operating business.

[3510] See Banoff's and Lipton's *Shop Talk* column, Does an S Election Block Self-Employment Tax When Made By an Unincorporated Business? *Journal of Taxation* (Sep. 2014).
[3511] See parts II.C.12 Limited Partnership and II.C.13 Limited Liability Partnership Registration.
[3512] See part II.I 3.8% Tax on Excess Net Investment Income, especially part II.I.8 Application of 3.8% Tax to Business Income.
[3513] See part II.E Recommended Structure for Entities.
[3514] See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

**II.L.5.d.	Straight-Up Limited Partnership**

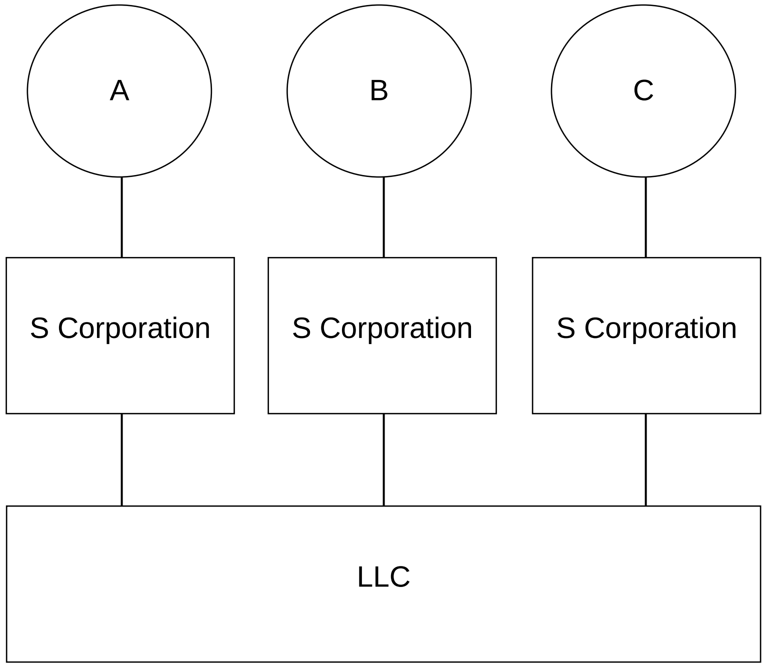


Notes:

- Assume A, B, and C are active in business (500+ hours) and receive reasonable compensation from the general partner for services rendered to the corporation as general partner of the limited partnership.
- This would not avoid self-employment tax on the limited partners if the long-ago proposed regulations defining limited partner for purposes of the self-employment tax were finalized.

Ideally, the limited partnership would hold the operating business(es) in a separate LLC (or LLCs) and any real estate in a separate LLC or LLCs. This is described more fully in part II.E Recommended Structure for Entities.

II.L.5.e. Flowchart: LLC with S Corporation as Blocker



Notes:

- Assume A, B, and C are active in business (500+ hours) and receive reasonable compensation from their respective S corporations for services rendered to the corporation as a member and manager of the LLC.
- Significant disadvantages apply to the holding real estate in this structure.

II.L.5.f. Blocker May Blow Important Tax Benefits

Unlike a partnership, an S corporation does not get a basis step-up in its underlying assets when an owner dies. See parts II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations and II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation; Possible Way to Attain Basis Step-Up.

A partner who is allocated liabilities in excess of the partner's basis faces a potential income tax disaster when the loan is repaid. However, the slate is wiped clean when the partner dies and the partnership interest is included in the partner's estate. See fn 2091 in part II.H.2.g Partnership Basis Adjustments. But, if the partnership is inside an S corporation, this slate is not wiped clean.

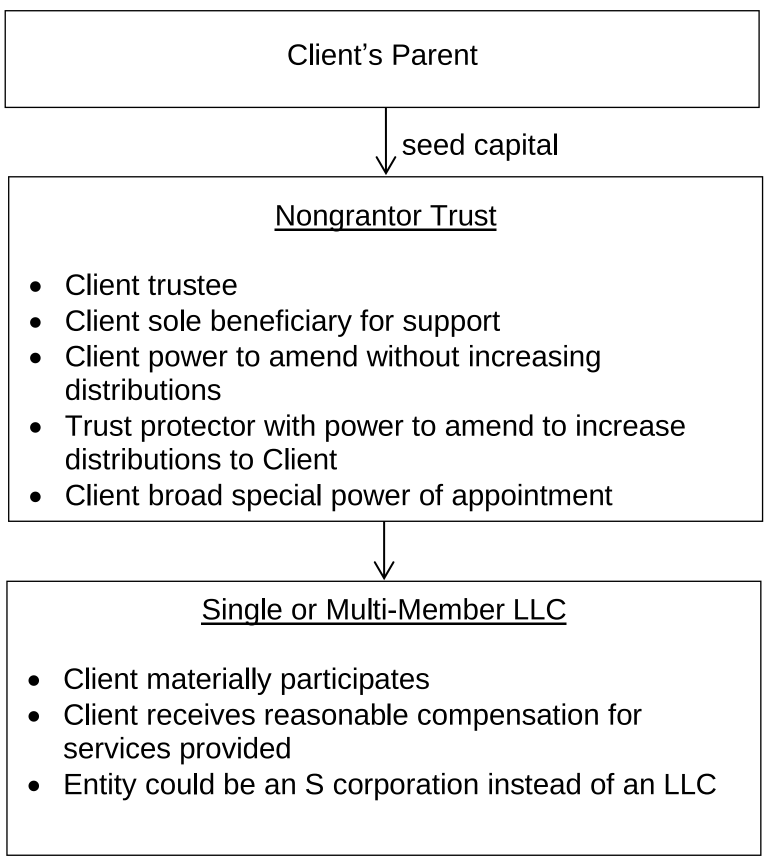
For example, a personal injury law firm is taxed as a partnership, and a partner interposes a wholly owned S corporation as a purported[3515] SE tax blocker. The partnership distributes its net winnings as soon as it receives them and borrows money to finance the costs it incurs between wins. The now-indirect partner dies between wins. His estate gets a basis step-up in the S corporation stock, but the S corporation's partnership interest does not get a basis step-

[3515] See text accompanying fn 3504 in part II.L.5.a S Corporation Blocker Generally.

up, so the problem of debt in excess of basis in the partnership's assets does not get wiped out when the now-indirect partner dies, whereas it would have been wiped out if the blocker has not used. Perhaps liquidating the S corporation immediately upon death would have replicated the basis step-up, but one has spot the issue in a timely manner, and even then the liquidation might not have the hoped-for tax results; see part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation; Possible Way to Attain Basis Step-Up.

II.L.6. SE Tax N/A to Nongrantor Trust

Self-employment tax does not apply to income earned by an estate or trust, at the trust level or at the beneficiary level.[3516] Just as the IRS will review whether distributions from an S corporation are disguised compensation,[3517] it might also consider whether individuals who are trustees and beneficiaries received reasonable and sufficient compensation for services performed for the business.[3518] If the trust is the sole member of the LLC, the trust's purpose must be to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.[3519]



[3516] Reg. § 1.1402(a)-2(b); *Huval v. Commissioner*, T.C. Memo. 1985-568.
[3517] See fn. 79 and accompanying text.
[3518] TAMs 200305001, 200305002.
[3519] See part II.D.1. Trust as a Business Entity.

II.L.7. SE Tax N/A to Qualified Retiring or Deceased Partner

Self-employment tax does not apply to amounts received by a partner pursuant to a written plan of the partnership, which satisfies IRS requirements and provides for payments on account of retirement, on a periodic basis,[3520] to partners generally or to a class or classes of partners, such payments to continue at least until such partner's death,[3521] if:[3522]

(A) such partner rendered no services with respect to any trade or business carried on by such partnership during the taxable year of such partnership, ending within or with such partner's taxable year, in which such amounts were received,[3523] and

(B) no obligation exists (as of the close of the partnership's taxable year described above) from the other partners to such partner except with respect to retirement payments under such plan, and

(C) such partner's share, if any, of the capital of the partnership has been paid to such partner in full before the close of the partnership's taxable year referred to above.

Note that such payments would likely be characterized as Code § 736(a) payments.[3524] And, although Code § 736 payments are generally excluded from the draconian Code § 409A nonqualified deferred compensation rules,[3525] payments under this provision are not excluded from Code § 409A.[3526]

3520 Payments made by a partnership retirement plan to a retired partner from current partnership earnings excepted from the term net earnings from self-employment for purposes of Code § 1402(a) even if receipt of part of the payments is deferred until shortly after the beginning of the following year. Rev. Rul. 79-34.

3521 Terminating payments before the partner's death disqualifies the payments from this exclusion. Letter Ruling 8052117.

3522 Code § 1402(a)(10); Reg. § 1.1402(a)-17.

3523 A lawyer who retired from practicing law but continued to perform arbitration services through the same law firm did not fall within this exclusion from self-employment tax. *Brandschain v. Commissioner*, 80 T.C. 746 (1983).

3524 Letter Ruling 7905032. For a general discussion of Code § 736, see part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

3525 For a general discussion of Code § 409A, see part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules. For general application (or lack thereof) of Code § 409A to partnerships, see text accompanying footnote 3736.

3526 Notice 2005-1, A-7 provides:

> The application of § 409A is not limited to arrangements between an employer and employee. Accordingly, § 409A may apply to arrangements between a partner and a partnership which provides for the deferral of compensation under a nonqualified deferred compensation plan…. [U]ntil further guidance is issued, taxpayers may treat arrangements providing for payments subject to § 736 as not being subject to § 409A, except that an arrangement providing for payments which qualify as payments to a partner under § 1402(a)(10) are subject to § 409A. Finally, § 409A may apply to payments covered by § 707(a)(1) (partner not acting in capacity as partner), if such payments otherwise would constitute a deferral of compensation under a nonqualified deferred compensation plan.

This rule continues to apply under the final regulations issued under Code § 409A. Section 4 of Notice 2007-86.

In (G.) Arrangements Between Partnerships and Partners, T.D. 9321, which promulgated final regulations under Code § 409A, provides:

If the partner has moved from the state in which the partner has provided the services, the retirement payments might escape income taxation by that state. See part II.Q.8.b.ii.(g) Code § 736 Payments as Retirement Income – Possible FICA and State Income Tax Benefits (referring back to this part II.L.7 and then discussing the state income tax exclusion under federal law).

When a partner dies during the partnership's taxable year, the portion of the partner's distributive share earned during life is subject to self-employment tax (presumably to the extent not shielded by the rule for a retired partner).[3527]

II.L.8. Retirement Payments to Insurance Salesmen

Code § 1402(k) excludes from SE income any amount received during the taxable year from an insurance company on account of services performed by such individual as an insurance salesman for such company if -

(1) such amount is received after termination of such individual's agreement to perform such services for such company,

---

Commentators raised issues concerning the application of the provision in Notice 2005-1, Q&A-7 stating that until further guidance is issued, taxpayers may treat arrangements providing for payments subject to section 736 (payments to a retiring partner or a deceased partner's successor in interest) as not being subject to section 409A, except that an arrangement providing for payments that qualify as payments to a partner under section 1402(a)(10) is subject to section 409A. Section 1402(a)(10) provides for an exception from the Self-Employment Contributions Act (SECA) tax for payments to a retired partner, provided that certain conditions are met…

Commentators questioned the appropriateness of the inclusion of such arrangements under section 409A, because neither the statute nor the legislative history refers to section 1402(a)(10). However, the Treasury Department and the IRS believe it is appropriate for such arrangements to be subject to section 409A because such arrangements are purposefully created to provide deferred compensation, and do not raise issues regarding the coordination of the provisions of section 409A with the provisions of section 736, specifically the rules governing the classification of payments to a retired partner under section 736(a) (payments considered as distributive share or guaranteed payments) and section 736(b) (payments for interest in partnership).

However, further clarification and relief is provided concerning the application of the deferral election timing rules to these payments. Until further guidance is issued, for purposes of section 409A, taxpayers may treat the legally binding right to the payments excludible from SECA tax under section 1402(a)(10) as arising on the last day of the partner's taxable year before the partner's first taxable year in which such payments are excludible from SECA tax under section 1402(a)(10), and the services for which the payments are compensation as performed in the partner's first taxable year in which such payments are excludible from SECA tax under section 1402(a)(10). Accordingly, for purposes of section 409A, the time and form of payment of such amounts generally may be established, including through an election to defer by the partner, on or before the final day of the partner's taxable year immediately preceding the partner's first taxable year in which such payments are excludible from SECA tax under section 1402(a)(10). However, this interim relief does not apply a second time where an amount paid under an arrangement in one year has been excluded from SECA tax under section 1402(a)(10), and an amount paid in a subsequent year has not been excluded from SECA tax under section 1402(a)(10) because, for example, the partner performed services in that subsequent year.

[3527] Code § 1402(f); Reg. § 1.1402(f)-1; Rev. Rul. 58-607.

(2) such individual performs no services for such company after such termination and before the close of such taxable year,

(3) such individual enters into a covenant not to compete against such company which applies to at least the 1-year period beginning on the date of such termination, and

(4) the amount of such payment-

(A) depends primarily on policies sold by or credited to the account of such individual during the last year of such agreement or the extent to which such policies remain in force for some period after such termination, or both, and

(B) does not depend to any extent on length of service or overall earnings from services performed for such company (without regard to whether eligibility for payment depends on length of service).

The taxpayer must prove that all of these elements applies.[3528]

Generally, an insurance agent receiving payments from the insurance company cannot characterize them as the sale of a capital asset.[3529]

II.M. Buying into a Business

Buying into a business includes starting a business from scratch and buying into an existing business. Each of those two issues is discussed as applied to corporations, as applied to partnerships, and as compared between the two.

II.M.1. Taxation on Formation of Entity: Comparison between Partnership and Corporation

Avoiding non-recognition of gain is much easier for a partnership than for a corporation. Assumption of liabilities generally does not cause problems with partnerships, because the partner who contributes the liability generally receives a special allocation of that liability under the partnership rules if the liability exceeds the contributing partner's basis.[3530] Neither the 80% control test nor any business purpose rule applies.

II.M.2. Buying into or Forming a Corporation

II.M.2.a. Initial Incorporation – Generally

No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation.[3531] Furthermore, regardless of the

[3528] *Geneser v. Commissioner*, T.C. Memo. 2017-110, held that the exclusion did not apply, noting: "Petitioner's commission payments credited toward his account in 2010 were dependent on his length of service at AIL." See also *Peterson v. Commissioner*, fn 3408 in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.

[3529] See fn 4152 in part II.Q.1.c.ii Consulting Agreement in Lieu of Covenant Not to Compete and fn 4155 in part II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees?

[3530] However, a shifting of liabilities might constitute a disguised sale.

[3531] Code § 351(a).

control issue, generally a contribution to capital is not income to the corporation,[3532] and the contributing shareholders get basis in their stock.[3533] Generally, when a shareholder contributes to a corporation a debt the corporation owes to that shareholder, the corporation does not recognize income.[3534] Reg. § 1.118-1 provides:

> In the case of a corporation, section 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer. Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. Section 118 also applies to contributions to capital made by persons other than shareholders. For example, the exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production. See section 362 for the basis of property acquired by a corporation through a contribution to its capital by its stockholders or by nonstockholders.

When a non-shareholder (a state) made payments to the taxpayer's affiliates, *Brokertec Holdings, Inc. v. Commissioner*, T.C. Memo. 2019-32, held:

[3532] Code § 118.

[3533] *Commissioner v. Fink*, 483 U.S. 89 (1987), explained:

> It is settled that a shareholder's voluntary contribution to the capital of the corporation has no immediate tax consequences. 26 U.S.C. § 263; 26 CFR § 1.263(a)-2(f) (1986). Instead, the shareholder is entitled to increase the basis of his shares by the amount of his basis in the property transferred to the corporation. See 26 U.S.C. § 1016(a)(1). When the shareholder later disposes of his shares, his contribution is reflected as a smaller taxable gain or a larger deductible loss. This rule applies not only to transfers of cash or tangible property, but also to a shareholder's forgiveness of a debt owed to him by the corporation. 26 CFR § 1.61-12(a) (1986). Such transfers are treated as contributions to capital even if the other shareholders make proportionately smaller contributions, or no contribution at all. See, *e.g.*, *Sackstein v. Commissioner*, 14 T.C. 566, 569 (1950).

See also Reg. § 1.118-1, which provides in part:

> In the case of a corporation, section 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer. Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company.

[3534] See fn 1223 in part II.G.4.d.ii.(b) Consequences of Using Shareholder Debt to Deduct S Corporation Losses.

> We now apply the aforementioned judicial principles to resolve the dispute before us. The evidence presented at trial shows the intent or motive of the State of New Jersey in making the payments to petitioner's affiliates. And the key to determining whether payments from a nonshareholder (here the State of New Jersey) are taxable to the recipient (here petitioner's affiliates) or nontaxable as a contribution to capital is the intent or motive of the nonshareholder donor.
>
> It is undisputed that the EDA's purpose in making the BEIP grant to petitioner's affiliates was to induce them to establish their offices in a targeted area, *i.e.*, an urban-aid municipality, not only to bring in new jobs, but also to revitalize the area. In the instant case we have clear evidence of the donor's intent, and we find that the EDA's intent and motivation for the BEIP grant was to provide a nontaxable contribution to capital. The statute enacting the BEIP stated that the purpose of the program was to develop New Jersey's economy and revitalize its cities by providing financial and technical assistance to, amongst other entities, businesses. Both witnesses from the EDA, Ms. Hassett and Ms. Butterfield, stated that their only interest in making such grants was to bring new jobs to the State. The facts in this case fall squarely within the four corners of section 1.118-1, Income Tax Regs., and are strikingly similar to those of *Brown Shoe Co.* and *McKay Prods. Corp.*, wherein the donor entities sought to induce the businesses in question to move to facilities within the donors' localities.

The Third Circuit reversed, 967 F.3d 317 (2020). First, it analyzed *Edwards v. Cuba Railroad Company*, 268 U.S. 628 (1925) and *Texas & Pacific Railway Company v. United States*, 286 U.S. 285 (1932):

> Read together, *Texas & Pacific Railway* and *Edwards* suggest that unrestricted government payments to a company reveal an intent to provide the company additional income rather than a contribution to the company's capital. Plus, calculating payments based on the company's income, rather than on the amount of some capital investment made by the company, further indicates an intent to provide income rather than a contribution to capital.

Next, the Third Circuit analyzed *Detroit Edison Co. v. Comm'r*, 319 U.S. 98, 99–103 (1943); *Commissioner v. McKay Products Corp.*, 178 F.2d 639 (3d Cir. 1949); and *Brown Shoe Co. v. Commissioner*, 339 U.S. 583 (1950). It then commented:

> In our case, the Tax Court concluded - and BrokerTec argues - that *McKay Products* and *Brown Shoe* support the position that the Incentive Program grants were contributions to BrokerTec's capital because they were relocation inducements. See *BrokerTec Holdings, Inc.*, 2019 WL 1545724, at *13–14 (concluding that the facts of *McKay Products* and *Brown Shoe* are "strikingly similar" in that in both "the localities sought to induce the taxpayers in question to move to their respective localities"); BrokerTec Br. 25-26 ("*Brown Shoe* teaches ... [that] location inducement grants like these are contributions to capital."). But, importantly, neither *McKay Products* nor *Brown Shoe* involved cash grants that were entirely unrestricted in use and calculated on the basis of wages paid rather than on the basis of the amount spent to relocate. *McKay Products* involved the contribution of a factory, rather than cash, and thus the contribution was of a capital asset. See 178 F.2d at 642. And while *Brown Shoe* involved the contribution of both land and cash without any explicit restriction on its use, the Court specifically noted that "[i]n every instance the cash received by [the company] from a community group was less than the amount expended by it for the acquisition or construction of the local

> factory building and equipment." 339 U.S. at 587. We agree with the Commissioner that this was an implicit restriction: the company in *Brown Shoe* "was effectively required to invest the funds (or a like amount) in its permanent working capital structure." Comm'r's Br. 31.
>
> In sum, the cases from which the first CB&Q characteristic was distilled - *Edwards*, *Texas & Pacific Railway*, *McKay Products*, and *Brown Shoe* - support the Commissioner's position that unrestricted cash grants, calculated on the basis of the recipient's payment of wages, are not contributions to capital but rather are supplements to the company's income.

The Third Circuit then pointed to cases in other circuits that it said were consistent with its holding here: "*AT&T, Inc. v. United States*, 629 F.3d 505 (5th Cir. 2011); *United States v. Coastal Utils.*, *Inc.*, 483 F.Supp.2d 1232 (S.D. Ga. 2007), *aff'd*, 514 F.3d 1184 (11th Cir. 2008) (per curiam adopting the district court's opinion in full). Th court then concluded:

> When viewed in light of the law as set out above, the record here permits only one resolution: New Jersey's Incentive Program grants to BrokerTec were intended as a supplement to its income rather than as a contribution to its capital. It is undisputed that New Jersey placed no restriction on how the Incentive Program grants could be used: they could be used to make capital improvements, but they could also be used for operational expenses such as paying wages, or even paying dividends to shareholders. And it also undisputed that the amount of the grants was not tied to the amount of capital improvements BrokerTec would make. Indeed, while BrokerTec indicated in its Incentive Program applications that it would make $72 million in capital investments (in the form of improvements to office space, and the acquisition of technology and furniture), the total amount of Incentive Program grants was based on a percentage of income tax withholdings generated by BrokerTec's employees and totaled approximately $170 million. In light of these facts, BrokerTec cannot show that New Jersey intended the Incentive Program payments to "become a permanent part of [BrokerTec's] working capital structure." *CB&Q*, 412 U.S. at 413.

To qualify for non-recognition of gain, the transferor(s) must control at least 80% of the shares' votes and at least 80% of each class of nonvoting stock.[3535] AM 2020-005 (issued 5/22/2020 and released 5/29/2020) confirms that, if the transferor already owns stock, the transferor does not need to be issued stock, citing:

> *Lessinger v. Commissioner*, 872 F.2d 519, 522 (2d Cir. 1989) ("[T]he exchange requirements of section 351 are met where a sole stockholder transfers property to a wholly-owned corporation even though no stock or securities are issued therefor. Issuance of new stock in this situation would be a meaningless gesture."); see Rev. Rul. 64-155, 1964-1 C.B. 138 (treating contribution of appreciated property to wholly owned corporation as exchange described in section 351 even though transferor did not receive additional stock); see also *Jackson v. Commissioner*, 708 F.2d 1402, 1405 (9th Cir. 1983) ("We assume section 351 applies [to transfer of a joint venture interest to a controlled corporation] even though no exchange of stock occurred because the transfer was to a wholly owned corporation"); *Rosen v. Commissioner*, 62 T.C. 11, 19

[3535] Code § 368(c), incorporated by reference by Code § 351(a).

(1974) (applying section 351 without discussing the fact that no stock appears to have been issued).

However, Code § 351 does not protect stock issued for services, indebtedness of the transferee corporation which is not evidenced by a security, or interest on indebtedness of the transferee corporation which accrued on or after the beginning of the transferor's holding period for the debt.[3536]

No counterpart to the above rules restrict tax-free formation of partnerships. See part II.M.3 Buying into or Forming a Partnership.

AM 2020-005 expresses concern when shareholders contribute short-term capital property to an existing corporation (which might be a shell) and then sell the corporation for a long-term capital gain. It posits the following facts:

> In each of the following situations, on January 1, Year 1, an individual ("Shareholder") contributes property with negligible value to a newly formed domestic corporation ("Corporation"), in exchange for all of Corporation's stock (the "initial transfer"). Assume that all shares of stock issued to Shareholder are capital assets in Shareholder's hands; that no transfer to Corporation is subject to section 351(d) or (e); and that section 351(g) does not apply to any stock of Corporation.
>
> After the initial transfer, each situation continues as follows.
>
> Situation 1
>
> On August 1, Year 1, Shareholder transfers a substantial amount of money to Corporation for no consideration, and Corporation invests the money in property that appreciates in value. On February 1, Year 2, Shareholder sells all of the stock in Corporation for a price that reflects the unrealized appreciation in the property, so that gain is recognized to Shareholder. Shareholder claims that all of the stock has a holding period exceeding one year (from January 1, Year 1).
>
> Situation 2
>
> On March 1, Year 1, Shareholder invests a substantial amount of money in property that appreciates in value. On August 1, Year 1, Shareholder transfers the appreciated property to Corporation for no consideration. On February 1, Year 2, Shareholder sells all of the stock in Corporation for a price that reflects the unrealized appreciation in the property, so that gain is recognized to Shareholder. Shareholder claims that all the stock has a holding period exceeding one year (from January 1, Year 1).

After reciting the analysis further above that the each subsequent contribution is a Code § 351(a) nonrecognition transaction, the IRS reasons:

> After the subsequent transfer in each Situation, Shareholder's stock in Corporation has a split basis and a split holding period to reflect the initial transfer and the subsequent transfer. Cf. Rev. Rul. 85-164, 1985-2 C.B. 117 (shares of stock received in an exchange to which section 351 applies, for property with different bases and holding

[3536] Code § 351(d).

periods, have split bases and split holding periods for purposes of determining long-term or short-term capital gain or loss); Rev. Rul. 62-140, 1962-2 C.B. 181 (shareholder has split basis and split holding period after transferring money to exercise conversion right in convertible debenture, with the portion attributable to the money having holding period dating from the transfer).

In both Situation 1 and Situation 2, the split basis and split holding period of Shareholder's stock reflect the economics of the transactions. After the subsequent transfer in each of the situations, a portion of the value of each share is attributable to the value added by the subsequent transfer, and the basis of Shareholder's stock includes the transferred money or the basis of the transferred property. Splitting the basis of each share of stock is consistent with the treatment of a section 351 exchange in which a transferor transfers several assets to a corporation, in exchange for stock and securities of the transferee corporation and other property. See Rev. Rul. 68-55, 1968-1 C.B. 140 (each asset considered transferred separately in exchange for a portion of each category of consideration received; fair market value of each category of consideration received allocated among transferred assets in proportion to their relative fair market values).[1]

[1] The same issue may arise in an acquisitive reorganization if a single shareholder owns all the stock in both the acquiring corporation and the target corporation. If no acquiring corporation stock is issued, the shareholder may designate which pre-existing shares in the acquiring corporation take their basis and holding period from the surrendered target stock and which from the pre-existing acquiring stock, so long as that designation is consistent with the terms of the reorganization. Treas. Reg. § 1.358-2(a)(2)(iii)(A), (a)(2)(vii), (c) Example (11). This designation of shares applies only to reorganizations, not to section 351 exchanges. For treatment of transactions that qualify as both reorganizations and section 351 exchanges, see Treas. Reg. § 1.358-2(a)(2)(viii).

Including the amount of the money or the basis of the transferred property in the stock's basis without a corresponding adjustment to the stock's holding period would be inconsistent with the principle that the holding period of property tracks the sources of the property's basis. See, *e.g.*, section 1223(1).

Accordingly, in Situation 1, the portion of each share attributable to the money transferred in the subsequent transfer has basis equal to the amount of the money and a holding period dating from the subsequent transfer. In Situation 2, the basis and holding period of the portion of each share attributable to the property transferred in the subsequent transfer are determined by referring to that property. Thus, in both Situation 1 and Situation 2, to the extent attributable to the subsequent transfer, Shareholder's stock has a holding period less than one year at the time of the sale of the stock on February 1, Year 2. The gain attributable to the sale of this portion of the Corporation stock is short-term capital gain.

Situations 1 and 2 illustrate two common forms of transactions that, as the Service understands it, are being recommended to taxpayers as a means of artificially extending holding periods. Depending on the facts and circumstances, the same analysis could apply to similar situations, such as transactions in which (i) Shareholder is not an individual; (ii) Shareholder initially acquires Corporation's stock in a taxable transaction; (iii) Corporation is not a domestic corporation; (iv) the relative values of the initial transfer and the subsequent transfer are different from those described in Situations 1 and 2; (v) stock of Corporation is issued in the subsequent transfer, but the value of such stock does not reflect the value of the money or property transferred to it in the subsequent transfer; (vi) Shareholder is not the sole shareholder of Corporation, but the relationship between Shareholder and other shareholders is such that the subsequent transfer for no consideration represents compensation, a gift, or another transfer of value from Shareholder to the other shareholders; or (vii) Shareholder does not dispose of all of Corporation's stock in a single transaction.

RECOMMENDATION

We recommend that the Service challenge transactions in which a shareholder's purported holding period in stock of a wholly owned corporation ignores the effect of meaningless gesture transactions. Depending on the facts and circumstances, the Service may challenge the transaction on other grounds as well, including that the transaction lacks economic substance; that the form of the transaction does not correspond to its substance; or that a purportedly tax-free transfer to a corporation lacks business purpose or constitutes an ineffective assignment of income or conduit transaction. In appropriate cases, the Service also may impose accuracy-related penalties.

Various other restrictions on favorable tax treatment may apply, depending on the situation. Among them are:

- If the shareholder in a Code § 351 transaction receives not only stock but also other property or money, then gain (if any) to such recipient is recognized, but not in excess of the amount of money received, plus the fair market value of such other property received; and no loss to such recipient shall be recognized.[3537] The cash and other property that triggers gains is commonly referred to as "boot," which is described in parts II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities, II.M.2.c Contribution of Partnership Interest to Corporation, II.M.2.d Contributing Installment Obligations, and II.M.2.e Contributing Existing Business to a Corporation. Reg. § 1.351-2, "Receipt of property," provides:

  (a) If an exchange would be within the provisions of section 351(a) if it were not for the fact that the property received in exchange consists not only of property permitted by such subsection to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property. No loss to the recipient shall be recognized.

  (b) See section 357 and the regulations pertaining to that section for applicable rules as to the treatment of liabilities as "other property" in cases subject to section 351, where another party to the exchange assumes a liability, or acquires property subject to a liability.

  (c) See sections 358 and 362 and the regulations pertaining to those sections for applicable rules with respect to the determination of the basis of stock, securities, or other property received in exchanges subject to section 351.

[3537] Code § 351(b).

(d) See part I (section 301 and following), subchapter C, chapter 1 of the Code, and the regulations thereunder for applicable rules with respect to the taxation of dividends where a distribution by a corporation of its stock or securities in connection with an exchange subject to section 351(a) has the effect of the distribution of a taxable dividend.

(e) See § 1.356-7(a) for the applicability of the definition of nonqualified preferred stock in section 351(g)(2) for stock issued prior to June 9, 1997, and for stock issued in transactions occurring after June 8, 1997, that are described in section 1014(f)(2) of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788, 921). See § 1.356-7(c) for the treatment of preferred stock received in certain exchanges for common or preferred stock described in section 351(g)(2)(C)(i)(II).

- The IRS asserts, sometime successfully and sometimes not, that a business purpose is required, but Code § 351 and the regulations do not expressly require a business purpose.[3538] Forming a corporation merely to swap the new stock for stock in another corporation prevented the stock swap from being a tax-free reorganization and instead was taxed as an exchange of the contributed assets for the other corporation's stock;[3539] note that this result was required to prevent taxpayers from avoiding the 80%-control requirement described in fn 3535.

- If shareholders contribute financial assets that are not diversified so that they can have an interest in a diversified portfolio held by the corporation, they may recognize gain.[3540]

- One who wishes to transfer assets to an unrelated corporation cannot simply form a new corporation under Code § 351 and immediately merge the new corporation into the buying corporation.[3541]

[3538] ¶ F-1002 Business purpose requirement for tax-free transfer to controlled corporation, *Fed. Tax Coord.2d*; Bittker & Eustice, ¶ 3.17[6] Business Purpose, Step Transactions, and Other Principles, *Federal Income Taxation of Corporations & Shareholders* (WG&L).

[3539] *West Coast Marketing Corporation v. Commissioner*, 46 T.C. 32, 41 (1966), noting that the corporation that was so formed "engaged in no business and served no purpose other than to hold title pending the contemplated transfer to Universal."

[3540] Code § 351(e)(1); see part II.M.3.b Exception: Diversification of Investment Risk, applying this rule to partnerships, which are much more likely to be formed by pooling financial assets than are corporations.

[3541] Rev. Rul. 70-140 involved the following facts:

> All the outstanding stock of X corporation was owned by A, an individual. A also operated a similar business in the form of a sole proprietorship on the accrual basis of reporting income. Pursuant to an agreement between A and Y, an unrelated corporation, A transferred all the assets of the sole proprietorship to X in exchange for additional shares of X stock. A then transferred all his X stock to Y solely in exchange for voting common stock of Y, which was widely held.

The ruling held:

> The two steps of the transaction described above were part of a prearranged integrated plan and may not be considered independently of each other for Federal income tax purposes. The receipt by A of the additional stock of X in exchange for the sole proprietorship assets is transitory and without substance for tax purposes since it is apparent that the assets of the sole proprietorship were transferred to X for the purpose of enabling Y to acquire such assets without the recognition of gain to A.

Also, see part II.M.3.h Reporting Real Estate Contributed to a Partnership or Corporation in a Nontaxable Transaction.

II.M.2.b. Initial Incorporation: Effect of Assumption of Liabilities

When property is contributed subject to liabilities, the contributing shareholder recognizes gain to the extent that liabilities by the corporation exceed the adjusted basis of assets contributed to the corporation.[3542] The contributing shareholder guaranteeing the loan does not prevent an assumption of liabilities;[3543] instead, the loan should be refinanced so that the shareholder is personally liable on the loan.[3544] However, at least in the Second[3545] and Ninth[3546] Circuits, a

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> Section 351 of the Code is not applicable to the transfer of the sole proprietorship assets to Y inasmuch as A was not in control of Y immediately after the transfer. The sole proprietorship cannot be a party to a reorganization within the meaning of section 368(b) of the Code. Thus, the transfer of the sole proprietorship assets to X is treated as a sale by A of the assets to Y followed by a transfer of these assets by Y to the capital of X.
>
> Accordingly, that portion of the stock of Y received by A equal to the fair market value of the sole proprietorship assets is treated as an amount received from the sale of those assets. Gain or loss is recognized to A as provided in sections 1001 and 1002 of the Code. The exchange by A of all the outstanding stock of X, solely for voting common stock of Y, other than the Y stock received in payment for the sole proprietorship assets, is a reorganization within the meaning of section 368(a)(1)(B) of the Code.

Oddly, the Revenue Ruling did not think to cite *West Coast Marketing Corporation v. Commissioner*, 46 T.C. 32 (1966), the Official Tax Court Syllabus to which says"

> T corp. owned an undivided one-fourth interest in a tract of land and C, its sole stockholder, owned an undivided one-fourth interest in two adjacent tracts. At a time when a taxable exchange of all those lands for stock in a publicly held corporation (U) was imminent, M corp. was organized by C, and both C and T transferred their interests in the land to M in exchange for stock of M. The stock of M was subsequently transferred to U in exchange for stock of U, and shortly thereafter M was dissolved. Held, M was not organized or used for any bona fide business purpose, and the exchange with U did not constitute a tax-free reorganization. The substance of the transaction was a taxable exchange of interest in land for stock of U. *Gregory v. Helvering*, 293 U.S. 465 [1935].

[3542] Code § 357(c)(1). Code § 357(c)(1) does not apply to transactions that qualify as certain types of reorganizations under Code § 368 to which Code § 351 also applies. Rev. Rul. 2007-8. See also Determining the Character of Section 357(c) Gain, *Tax Lawyer*, Vol. 62, No. 1 (Fall 2008).

[3543] *Seggerman Farms, Inc. v. Commissioner*, 308 F.3d 803 (7th Cir. 2002), *aff'g* T.C. Memo. 2001-99.

[3544] For similar issues determining whether shareholders were the true borrowers, see part II.G.4.d.ii.(a) Limitations on Using Debt to Deduct S Corporation Losses.

[3545] *Lessinger v. Commissioner*, 872 F.2d 519 (2nd Cir. 1989), *rev'g* 85 T.C. 824 (1985).

[3546] *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1998), *rev'g* T.C. Memo. 1996-191, reasoning:

> The key to solving this puzzle, then, is to ask whether bankruptcy is significant enough a contingency to confer substantial economic effect on this transaction. If the risk of bankruptcy is important enough to be recognized, Peracchi should get basis in the note: He will have increased his exposure to the risks of the business—and thus his economic investment in NAC – by $1,060,000. If bankruptcy is so remote that there is no realistic possibility it will ever occur, we can ignore the potential economic effect of the note as speculative and treat it as merely an unenforceable promise to contribute capital in the future.
>
> When the question is posed this way, the answer is clear. Peracchi's obligation on the note was not conditioned on NAC's remaining solvent. It represents a new and substantial increase in Peracchi's investment in the corporation.[14] The Code seems to recognize that economic exposure of the shareholder is the ultimate measuring rod of a shareholder's investment. *Cf.* I.R.C. section 465 (at-risk rules for partnership investments). Peracchi therefore is entitled to a step-up in basis to the extent he will be subjected to economic loss if the underlying investment

turns unprofitable. *Cf. HGA Cinema Trust v. Commissioner*, 950 F.2d 1357, 1363 (7th Cir. 1991) (examining effect of bankruptcy to determine whether long-term note contributed by partner could be included in basis). See also Treas. Reg. section 1.704-1(b)(2)(ii)(c)(1) (recognizing economic effect of promissory note contributed by partner for purposes of partner's obligation to restore deficit capital account). [My note: Reg. § 1.704-1(b)(2)(ii)(c) was revised 10/9/2019.]

[14] We confine our holding to a case such as this where the note is contributed to an operating business which is subject to a non-trivial risk of bankruptcy or receivership. NAC is not, for example, a shell corporation or a passive investment company; Peracchi got into this mess in the first place because NAC was in financial trouble and needed more assets to meet Nevada's minimum premium-to-asset ratio for insurance companies.

The economics of the transaction also support Peracchi's view of the matter. The transaction here does not differ substantively from others that would certainly give Peracchi a boost in basis. For example, Peracchi could have borrowed $1 million from a bank and contributed the cash to NAC along with the properties. Because cash has a basis equal to face value, Peracchi would not have faced any section 357(c) gain. NAC could then have purchased the note from the bank for $1 million which, assuming the bank's original assessment of Peracchi's creditworthiness was accurate, would be the fair market value of the note. In the end the corporation would hold a million dollar note from Peracchi - just like it does now - and Peracchi would face no section 357(c) gain.[15] The only economic difference between the transaction just described and the transaction Peracchi actually engaged in is the additional costs that would accompany getting a loan from the bank. Peracchi incurs a "cost" of $1 million when he promises to pay the note to the bank; the cost is not diminished here by the fact that the transferor controls the initial transferee. The experts seem to agree: "Section 357(c) can be avoided by a transfer of enough cash to eliminate any excess of liabilities over basis; and since a note given by a solvent obligor in purchasing property is routinely treated as the equivalent of cash in determining the basis of the property, it seems reasonable to give it the same treatment in determining the basis of the property transferred in a section 351 exchange." Bittker & Eustice paragraph 3.06[4][b].

[15] In a similar vein, Peracchi could have first swapped promissory notes with a third party. Assuming the bona fides of each note, Peracchi would take a cost basis in the third party note equal to the face value of the note he gave up. Peracchi could then contribute the third party note to NAC, and (thanks to the added basis) avoid any section 357(c) gain. NAC could then close the circle by giving the third party note back to the third party in exchange for Peracchi's note, leaving Peracchi and NAC in exactly the same position they occupy now.

The IRS might attack these maneuvers as step transactions, but that would beg the question: Does the contribution of a shareholder's note to his wholly-owned corporation have any real economic effect, or is it just so much window dressing? If the debt has real economic effect, it shouldn't matter how the shareholder structures the transaction.

The only substantive difference between the avoidance techniques just discussed - swapping notes or borrowing from a third party—and the case here is the valuation role implicitly performed by the third party. A bank would not give Peracchi the face value of the note unless his credit warranted it, while we have no assurance that NAC wouldn't do so. We readily acknowledge that our assumptions fall apart if the shareholder isn't creditworthy. Here, the government has stipulated that Peracchi's net worth far exceeds the value of the note, so creditworthiness is not at issue. But we limit our holding to cases where the note is in fact worth approximately its face value.

We are aware of the mischief that can result when taxpayers are permitted to calculate basis in excess of their true economic investment. See *Commissioner v. Tufts*, 461 U.S. 300 (1983). For two reasons, however, we do not believe our holding will have such pernicious effects. First, and most significantly, by increasing the taxpayer's personal exposure, the contribution of a valid, unconditional promissory note has substantial economic effects which reflect his true economic investment in the enterprise. The main problem with attributing basis to nonrecourse debt financing is that the tax benefits enjoyed as a result of increased basis do not reflect the true economic risk. Here Peracchi will have to pay the full amount of the note with after-tax dollars if NAC's economic situation heads south. Second, the tax treatment of nonrecourse debt primarily shareholder can get basis for contributing a bona fide note[3547] indebting the shareholder to a C corporation, thereby offsetting the effect of the corporation assuming the corporation's liabilities. Rev. Rul. 68-629 takes the opposite approach – not giving the shareholder basis for such a loan: "Since the taxpayer incurred no cost in making the note, its basis to him was zero" – a position the Tax Court has followed.[3548]

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creates problems in the partnership context, where the entity's loss deductions (resulting from depreciation based on basis inflated above and beyond the taxpayer's true economic investment) can be passed through to the taxpayer. It is the pass-through of losses that makes artificial increases in equity interests of particular concern. See, *e.g.*, *Levy v. Commissioner*, 732 F.2d 1435, 1437 (9th Cir. 1984). We don't have to tread quite so lightly in the C Corp context, since a C Corp doesn't funnel losses to the shareholder.[16]

[16] Our holding therefore does not extend to the partnership or S Corp context.

We find further support for Peracchi's view by looking at the alternative: What would happen if the note had a zero basis? The IRS points out that the basis of the note in the hands of the corporation is the same as it was in the hands of the taxpayer. Accordingly, if the note has a zero basis for Peracchi, so too for NAC. See I.R.C. section 362(a).[17] But what happens if NAC - perhaps facing the threat of an involuntary petition for bankruptcy - turns around and sells Peracchi's note to a third party for its fair market value? According to the IRS's theory, NAC would take a carryover basis of zero in the note and would have to recognize $1,060,000 in phantom gain on the subsequent exchange, even though the note did not appreciate in value one bit. That can't be the right result.

[17] But see *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989). In *Lessinger*, the Second Circuit analyzed a similar transaction. It agreed with the IRS's (faulty) premise that the note had a zero basis in the taxpayer's hands. But then, brushing aside the language of section 362(a), the court concluded that the note had a basis in the Corporation's hands equal to its face value. The court held that this was enough to dispel any section 357(c) gain to the taxpayer, proving that two wrongs sometimes do add up to a right.

We agree with the IRS that *Lessinger*'s approach is untenable. Section 357(c) contemplates measuring basis of the property contributed in the hands of the taxpayer, not the corporation. Section 357 appears in the midst of the Code sections dealing with the effect of capital contributions on the shareholder; sections 361 et seq., on the other hand, deal with the effect on a corporation, and section 362 defines the basis of property contributed in the hands of the corporation. Because we hold that the note has a face value basis to the shareholder for purposes of section 357(c), however, we reach the same result as *Lessinger*.

Accordingly, we hold that Peracchi has a basis of $1,060,000 in the note he wrote to NAC. The aggregate basis exceeds the liabilities of the properties transferred to NAC under section 351, and Peracchi need not recognize any section 357(c) gain.

[3547] If the note is not bona fide, it will not create basis in the issuing taxpayer. See, *e.g.*, *Owen v. U.S.*, 34 F.Supp.2d 1071 (D. Tenn. 1998) (cash basis taxpayer did not receive basis in land improvements until note repaid; court expressed concern of cash basis taxpayer getting deductions before paying cash but court expressed skepticism about whether notes would be paid).

[3548] *Alderman v. Commissioner*, 55 T.C. 662 (1971), and later Tax Court decisions cited in fns 3545 and 3546 (but reversed on appeal) followed Rev. Rul. 68-629. *Ernest S. Ryder & Associates, Inc. v. Commissioner*, T.C. Memo. 2021-88, commented;

Ryder relies on *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1998), for his argument that he had sufficient basis in RLC. Peracchi did hold that a C corporation's shareholder can get basis in his shares with the contribution of a note, but it also made clear that this holding does not apply to S corporations. *Id.* at 494 n.16. We ourselves have made completely clear that a shareholder doesn't get basis in his S corporation's stock by giving it a note until and unless he advances funds on the note. See *Perry v. Commissioner*, 54 T.C. 1293, 1295-96 (1970), *aff'd without published opinion*, 27 A.F.T.R.2d 71-1464 (8th Cir. 1971); see also *Underwood v. Commissioner*, 63 T.C. 468, 477 (1975), *aff'd*, 535 F.2d 309 (5th Cir. 1976); *Oren*, T.C. Memo. 2002-172.

Liabilities that would give rise to a deduction when paid are ignored.[3549] Thus, if a partnership interest is contributed to a corporation, accrued expenses allocated to the corporation would be ignored as liabilities, but only if the partnership uses the cash receipts and disbursements for income tax accounting. However, gain is fully recognized if the transaction's principal purpose is to avoid federal income tax.

II.M.2.c. Contribution of Partnership Interest to Corporation

Partnerships often incur liabilities, whether from money that the partnership borrows or liabilities the partnership incurs, such as accounts payable and accrued expenses. Contributing a partnership interest to a corporation often results in the corporation being allocated these liabilities[3550] and triggering gain to the extent that liabilities exceed basis.[3551]

Also, if the person contributing the partnership interest has losses suspended due to lack of basis[3552] or due to the passive loss[3553] or at-risk[3554] rules, consider whether the contribution might cause the suspended losses to be extinguished.[3555]

II.M.2.d. Contributing Installment Obligations

To the extent that a shareholder receives valuable stock for an installment obligation, gain is triggered.[3556]

II.M.2.e. Contributing Existing Business to a Corporation

The Official Tax Court Syllabus of *Complex Media, Inc. v. Commissioner*, T.C. Memo. 2021-14, describes the case:

> P, a corporation, acquired the assets of a business previously conducted by partnership PS. In exchange for the transferred assets, P issued 4,999,000 shares of its common stock. Immediately thereafter, in accordance with a prior obligation, P redeemed 1,875,000 of the common shares held by PS in exchange for $2.7 million in cash and P's obligation to make an additional payment of $300,000 a little over a year later. PS paid the cash and assigned its right to the additional payment to SG, one of its partners, in redemption of SG's interest in PS. P claimed an increased basis of $3 million in intangible assets it acquired from PS and amortized that additional basis under I.R.C. sec. 197(a). R disallowed P's claimed amortization deductions.
>
> *Held*: A taxpayer's ability to identify an alternative path to a given end result that provides more favorable tax consequences than the path actually taken is not enough to

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[3549] Code § 357(c)(3). Such liabilities do not cause a reduction in the contributing shareholder's basis. *Black & Decker v. United States*, 436 F.3d 431 (4th Cir. 2006); *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006).
[3550] Code § 752.
[3551] See part II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities.
[3552] Code § 704(d).
[3553] Code § 469. See part II.K Passive Loss Rules.
[3554] Code § 465.
[3555] See McKee, Nelson & Whitmire: *Federal Taxation of Partnerships & Partners* (WG&L), ¶ 11.05[2][c] Availability of Suspended Losses to Transferees, and T.M. 710: Partnerships — Conceptual Overview, III.D. Disposition of Partnership Interest or Partnership Business; Termination of Partnership.
[3556] See part II.G.15 Limitations on the Use of Installment Sales, especially fn. 1600.

> entitle the taxpayer to the desired tax treatment. *Commissioner v. Nat'l Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974).
>
> *Held*, further, because any tax planning involved in structuring the transactions in issue was focused on insulating PS' continuing partners from the consequences of the redemption of SG's interest and not on the achievement of a tax benefit inconsistent with allowing P increased bases in the assets it acquired from PS, P is not precluded from seeking to disavow the form of its transactions.
>
> *Held*, further, P's issuance and immediate redemption of 1,875,000 common shares had no economic substance and thus are disregarded under the step transaction doctrine, with the cash and deferred payment right treated as additional consideration for the assets P acquired from PS.
>
> *Held*, further, accepting the parties' agreement that I.R.C. sec. 351 applied to PS' transfer of assets to P, PS recognized gain in the transaction, as recharacterized, to the extent of the $2.7 million cash it received and the fair market value of its right to the additional $300,000 payment. See I.R.C. sec. 351(b). PS' recognized gain increases P's bases in the transferred assets. See I.R.C. sec. 362(a).
>
> *Held*, further, when assets transferred in an I.R.C. sec. 351 exchange with taxable "boot" constitute a trade or business, the residual method of allocation prescribed by I.R.C. sec. 1060 can appropriately be used to allocate the boot among the transferred assets. Consequently, PS' gain in amortizable section 197 intangibles, and the corresponding increase in asset bases allowed to P, is determined by subtracting from the agreed total asset value the estimated values of those assets other than amortizable section 197 intangibles.

As described in part II.G.33 Taxpayer Disavowing Form, *Complex Media* discussed the conditions under which the taxpayer can apply substance over form. The court then applied the test and concluded:

> To sum up, in considering whether to allow petitioner to disavow the form of its transactions and treat the cash and deferred payment right as boot in the section 351 exchange, we ask why the parties did not adopt that transactional form to begin with. And the parties had an obvious nontax reason for structuring the transactions as they did: Petitioner could not have paid CMH $2.7 million in cash in exchange for the assets it received from CMH because it did not have any cash until after the exchange. When petitioner acquired the assets of the transferred business, it simultaneously acquired all of the stock of OnNetworks and thus gained access to OnNetworks' remaining cash. Only then did petitioner have the wherewithal to pay CMH the cash Mr. Gerszberg apparently demanded for the redemption of his partnership interest.
>
> Achievement of the parties' business objective did not require forgoing a corporate-level step-up in basis. Petitioner could have acquired the assets of the transferred business in exchange for 3,124,000 shares of its common stock and a $3 million note. The terms of the note could have called for repayment of $2.7 million before the close of business on November 25, 2009, and payment of the remaining balance of $300,000 on January 3, 2011. Immediately after the closing of the CM & JV Agreement, petitioner could have obtained $2.7 million in cash from OnNetworks (as it, in fact, did) and used the cash to make the initial payment on the note. In that event, CMH would have

recognized its realized gain to the extent of the value of the nonstock consideration (*i.e.*, $2.7 million plus the present value of the $300,000 deferred payment), and petitioner would have been entitled to a corresponding step-up in the bases of the transferred assets.

The parties' failure to pursue a structure along those lines suggests that the prospect of a step-up in corporate asset basis was an afterthought - perhaps arising only when petitioner's accountants began preparing its 2010 return. To the extent the structuring of the transactions involved tax planning, that planning seems to have been focused on insulating CMH's continuing partners from any adverse tax consequences from the redemption of Mr. Gerszberg's interest. The circumstances give us no reason to think that the goals of the tax planning encompassed achievement of a tax benefit to any party that would be inconsistent with allowing petitioner a step-up in the bases of the assets it acquired from CMH. We therefore conclude that petitioner should be allowed to invoke the substance-over-form doctrine. Having determined that petitioner is not foreclosed from invoking that doctrine, we next consider whether its application justifies the recharacterization of the transaction that petitioner seeks.

III. Application of Step Transaction Doctrine

The question of the consequences of applying the step transaction doctrine is more easily answered than that of petitioner's right to invoke the doctrine. We have no doubt that, when applied, the doctrine requires us to disregard the issuance and immediate redemption of 1,875,000 shares of petitioner's common stock. The issuance of stock subject to an obligation that it be immediately redeemed has no economic substance. If CMH or any other party had sought a tax benefit from respecting the separate steps of the issuance and immediate redemption of those shares, we have no doubt that respondent would promptly invoke the step transaction doctrine to collapse those steps, and we would likely have upheld respondent's position. Because petitioner has met the burden it must meet for applying the doctrine in its favor, the same result should obtain. Much ink has been spilled on the question of how proximate various steps must be, in time or intention, for them to be combined under the step transaction doctrine. See, *e.g.*, *Andantech L.L.C. v. Commissioner*, T.C. Memo. 2002-97, 2002 WL 531143, at *26-*29 (describing "three alternative tests" courts have applied "in deciding whether the step transaction doctrine should be invoked in a particular situation"), *aff'd in part and remanded*, 331 F.3d 972 (D.C. Cir. 2003). But the present cases do not require us to limit the doctrine's ultimate bounds. If the step transaction doctrine has any potency, it necessarily applies to combine a first step that occurs when a preexisting obligation requires the immediate execution of a second step that undoes the first. In *Glacier State Elec. Supply Co. v. Commissioner*, 80 T.C. at 1057-1058, we rejected the taxpayer's step transaction argument because, as we explained: "[The taxpayer] is not asking us to skip, collapse, or rearrange the steps … [it] employed. … [It] is instead asking that we accept an entirely new series of steps or events that did not take place. The step transaction doctrine cannot be stretched so far."[22] In the present cases, by contrast, petitioner asks only that we collapse two offsetting steps. It is not asking that we invent new steps, or "synthesize" a transaction that did not, in fact, occur. *Cf*. *Estate of Durkin v. Commissioner*, 99 T.C. at 577. It is not even asking to rearrange steps actually taken. The step transaction doctrine has more than enough elasticity to disregard the issuance and immediate redemption of 1,875,000 shares of petitioner's common stock. Therefore, by application of that doctrine, we conclude that petitioner should be treated as having acquired the assets of the transferred business in exchange for 3,124,000 shares of its common stock, $2.7 million in cash, and an obligation to make an additional payment of $300,000 on January 3, 2011.

[22] The transactions at issue in Glacier State Elec. Supply involved two corporations that were owned by three individuals: Parsons, Reardon, and Pyle. All three individuals owned stock of the taxpayer corporation. The taxpayer owned two-thirds of the stock of a subsidiary, GSB. One of its shareholders (Pyle) owned the remaining one-third of GSB directly. Upon Parsons' death, the taxpayer was obligated to redeem the stock held by his estate. To raise the necessary funds, the taxpayer caused GSB to redeem some of the stock the taxpayer held. The Commissioner claimed that the redemption of the taxpayer's GSB stock resulted in capital gain. The taxpayer argued that it should be treated as if it had distributed the redeemed GSB stock to Parsons' estate, with GSB then treated as having redeemed the stock from the estate. (Under that recast, the taxpayer's distribution of GSB stock would have been entitled to nonrecognition treatment under the law then in effect.)

The court then reviewed the principles for allocating basis to the boot that triggered gain recognition:

IV. Petitioner's Bases in the Amortizable Section 197 Intangibles Acquired From CMH

A. Introduction

In the transaction, as recharacterized, CMH was required to recognize any gain it realized from the exchange of the transferred business assets for common stock in petitioner, cash, and the deferred payment right. See sec. 351(b)(1). CMH's recognized gain, however, was limited to the $2.7 million cash it received at closing and the fair market value of its right to receive an additional $300,000 a little over a year later. See *id*. Any gain recognized to CMH increased petitioner's bases in the assets above the carryover bases with which the corporation would otherwise have received those assets. See sec. 362(a).

Respondent claims that "[s]ection 362(a) … requires that petitioner's basis in the property received is the same as that in the hands of the transferor" because "neither CMI nor … [CMH] reported any gain in the transaction." CMH's failure to report the gain, however, did not affect petitioner's bases in the assets. By its plain terms, section 362(a) allows the transferee corporation in a section 351 exchange to increase its bases in transferred assets by "the amount of gain recognized to the transferor", without regard to whether the transferor reports that recognized gain.[23]

[23] Conversely, when the transferor in a tax-free sec. 351 exchange erroneously reports gain, the transferee corporation is not entitled to increase its bases in the transferred assets beyond their bases in the hands of the transferor. See *Truck Terminals, Inc. v. Commissioner*, 33 T.C. 876, 888 (1960), *aff'd in part, rev'd in part and remanded*, 314 F.2d 449 (9th Cir. 1963); *Gooding Amusement Co. v. Commissioner*, 23 T.C. 408, 423-424 (1954), *aff'd*, 236 F.2d 159 (6th Cir. 1956).

Because the character of any gain recognized in a section 351 exchange may differ depending on the nature of the transferred assets, a transferor who receives taxable boot in addition to stock of the transferee corporation must determine gain on an asset-by-asset basis. See *Easson v. Commissioner*, 33 T.C. 963, 975 (1960), *rev'd*, 294 F.2d 653 (9th Cir. 1961); *see also* Rev. Rul. 68-55, 1968-1 C.B. 140. The transferee corporation's basis in each asset equals the transferor's basis in the asset increased by the gain recognized by the transferor in the exchange of that asset for stock and boot. *Easson v. Commissioner*, 33 T.C. at 975. In determining the amount of recognized gain from the exchange of each asset, the Service held in Rev. Rul. 68-55, *supra*, that cash or other taxable boot should be allocated among the various assets in proportion to their relative fair market values. The transferor then must recognize gain in respect of each asset equal to the lesser of that asset's realized gain or the value of the boot allocable to the asset.

Petitioner seems to accept that, in computing the step-up in the bases of the assets of the transferred business, the value of the cash and the deferred payment right treated as boot under the step transaction recast should be allocated among those assets in proportion to their relative fair market values as prescribed by Rev. Rul. 68-55, *supra*. Respondent disputes application of that ruling not because he believes we should use a different method of allocating boot but instead because he insists that, given that "no party recognized any 'boot' or gain on the merger/reorganization transaction at issue[,] petitioner is not entitled to a step-up in basis under the provisions of section[] 351 or 362 of the Internal Revenue Code." In any event, we would look with disfavor on any effort by respondent to take a position contrary to one of his own revenue rulings. See, *e.g.*, *Rauenhorst v. Commissioner*, 119 T.C. 157, 171 (2002) (rejecting the proposition "that the Commissioner is not bound to follow his revenue rulings in Tax Court proceedings").

In *Easson*, we employed an approach to the allocation of gain recognized in a section 351 exchange that differed from that later adopted by Rev. Rul. 68-55, *supra*. *Easson* involved a taxpayer's transfer to a corporation of land and a building subject to a mortgage the exceeded the property's basis. The transaction occurred in a year governed by the Internal Revenue Code of 1939 and thus was not subject to section 357(c) of the 1954 Code, which (like the corresponding provision in the 1986 Code) required a transferor shareholder in a section 351 exchange to recognize gain to the extent that liabilities encumbering the transferred property exceed that property's basis. We viewed Congress' enactment of section 357(c) as "clarify[ing] existing law rather than … amend[ing] it", *Easson v. Commissioner*, 33 T.C. at 971, and required the shareholder to recognize gain equal to the excess of the liabilities that encumbered the transferred property over its basis. Because gain attributable to the building would have been ordinary income while gain attributable to the land would have been capital gain, we had to apportion the shareholder's recognized gain between those two assets. We did so not on the basis of their proportionate values but instead in proportion to the shareholder's realized gain in each asset. *Id*. at 975. After our decision in *Easson*, the Department of the Treasury issued regulations under section 357(c) that require gain recognized under that section to be apportioned among transferred assets in proportion to their relative values, as Rev. Rul. 68-55, *supra*, requires for the apportionment of gain attributable to taxable boot. See sec. 1.357-2(b), Income Tax Regs. Therefore, even leaving aside the reversal of our decision in Easson by the Court of Appeals for the Ninth Circuit, our Opinion in that case has little or no precedential value concerning the determination of gain attributable to specific transferred assets as a result of a shareholder's receipt of boot in a section 351 exchange.

Regardless of how we allocate boot among the transferred assets, petitioner is not entitled to the full $3 million step-up in the bases of amortizable section 197 intangibles that it claimed as a result of the exchange in which it acquired those assets. To begin with, the gain CMH was required to recognize under section 351(b) was necessarily less than $3 million: Given the time value of money, the partnership's right to receive $300,000 in a little over a year was not worth the full $300,000 future payment. See sec. 351(b)(1) (limiting amount of gain recognized to "(A) the amount of money received, plus (B) the fair market value of … other property received"). In addition, the allocation of part of the cash and the value of the deferred payment right to assets other than amortizable section 197 intangibles would reduce the gain recognized from CMH's transfer of amortizable section 197 intangibles and thus the resulting step-up in the bases of those assets.

B. Petitioner's Invocation of the Cohan Rule

Petitioner conceded (only after our request for supplemental briefs) that its accountants' "post-closing reporting of the step-up in the basis of the intangibles contributed to CMI in the CMJVA for the 'boot' left much to be desired". Petitioner now acknowledges that the accountants "did not allocate the … step up among the CMH contributed assets as required by Rev. Rul. 68-55 nor did … [they] take into consideration the potential decrease in the value of the $300,000 note" to reflect the time value of money. Petitioner also admits that "an appraisal of the transferred assets was not obtained at the time of the transaction", hindering our ability to allocate boot among the assets of the transferred business on the basis of their relative fair market values. Nonetheless, petitioner urges us to apply the "principle" established in *Cohan v. Commissioner*, 39 F.2d 540, 543-544 (2d Cir. 1930), and "make an estimate of the proper amortizable step-up in basis for the contributed assets resulting from the 'boot' payment".

The *Cohan* rule "allows us to estimate the amounts of allowable deductions when there is evidence that the taxpayer incurred deductible expenditures." *Ashkouri v. Commissioner*, T.C. Memo. 2019-95, at *31. "To do so, however, we must have some basis on which to make an estimate." *Id*. (citing *Vanicek v. Commissioner*, 85 T.C. 731, 742-743 (1985)).

Although *Cohan* itself involved a Broadway producer's claimed deductions for travel and entertainment expenses, we have applied the principle of that case in other contexts. In particular, we have relied on Cohan to estimate a taxpayer's basis in property. See, *e.g.*, *Huzella v. Commissioner*, T.C. Memo. 2017-210, at *7-*9.

In directing our predecessor, the Board of Tax Appeals, to estimate the deductible expenses incurred by the taxpayer in *Cohan v. Commissioner*, 39 F.2d at 544, the Court of Appeals for the Second Circuit allowed the Board to "bear[] heavily … upon the taxpayer whose inexactitude is of his own making." Petitioner, however, disclaims responsibility for the inadequacy of the record in the present cases. On the premise that it "was in no way at fault for the absence of a complete record", petitioner contends that the estimated allocation of basis it seeks "should not in any way be reduced or limited". Petitioner claims that, before we raised the question of the value of the deferred payment right and the allocation of any step-up in basis between amortizable and nonamortizable assets in a conference call held after the parties had submitted two rounds of briefs, "Respondent never disputed or raised any question regarding the numerical reporting by … [petitioner's accountants] either at the audit level or thereafter". In petitioner's characterization, "[t]he only position advanced by the Respondent was that there was no 'boot' received by party [sic] to the IRC § 351 transaction because the

CMJVA and the Stock Repurchase Agreement between CMI and CMH … were separate transactions.” Petitioner’s understanding of respondent’s position influenced its decisions regarding the evidence it sought to present. As petitioner explains:

> Because no question had been raised about whether the assets received were qualified intangibles or how any step up in basis should be allocated among the assets contributed by CMH, the Petitioner’s trial presentation (and the Stipulation of Facts prepared in anticipation of the trial) did not address these questions and only focused on showing that the buyout of Gerszberg was an integral and essential step in closing the CMJVA and thus establishing that the $3,000,000 paid by CMI to enable CMH to redeem Gerszberg’s interest was “boot” because it was paid by CMI to CMH as part of the consideration for CMH’s contributed assets.

Petitioner contends that “the correct amortizable step up is $2,913,652.34 rather than the $3,000,000 … [its accountants] reported.” Petitioner determined the present value of the deferred payment right by applying the applicable Federal rate (AFR) in effect for November 2009 of 0.71%, see Rev. Rul. 2009-35, 2009-44 I.R.B. 568, 569, to arrive at a present value of $297,656. Petitioner reasons that, because “the note was due, … only 13 months after the closing,” and on the premise that it was “actually paid” (as Mr. Gerszberg’s tax reporting indicates), “the note should not be subject to any valuation discount for the creditworthiness of the debtor”. Petitioner thus values the taxable boot that CMH received in the section 351 exchange at $2,997,656 ($2,700,000 + $297,656). On the premise that the shares it issued in exchange for the transferred assets and did not immediately redeem had a value of $5 million, petitioner assigns a total value to the assets of $7,997,656 ($5,000,000 + $2,997,656).[24] Next, petitioner assigns values to those assets that it acquired from CMH that it accepts were not amortizable section 197 intangibles—prepaid expenses and fixed assets. In each case, petitioner values those assets at their book values of $224,119 and $803, respectively. Petitioner thus concludes that the amortizable section 197 intangibles it received from CMH were worth $7,772,734 ($7,997,656 total value less the $224,119 value assigned to prepaid expenses and the $803 value assigned to fixed assets). Consequently, petitioner allocates $2,913,351 of the boot to amortizable section 197 intangibles ($2,997,656 × ($7,772,734 ÷ $7,997,656)). (We are unable to identify the approximately $300 discrepancy between the $2,913,652 amortizable step-up that petitioner claims and the $2,913,351 figure resulting from its detailed calculations.)

[24] Petitioner’s analysis seems to rest on the premise that CMH was entitled to receive 5 million of its common shares in exchange for the assets of the transferred business. If that were correct, and those assets had an aggregate value of $8 million, each common share would have been worth $1.60 ($8,000,000 ÷ 5,000,000), and the 3,125,000 shares that CMH retained after the redemption would have been worth $5 million (3,125,000 × $1.60). But CMH received only 4,999,000 of petitioner’s common shares in exchange for the transferred assets. In pricing the transactions in issue, the parties seem to have disregarded the 1,000 shares of petitioner’s common stock outstanding before execution of the CM & JV Agreement, as well as the prospect that the $300,000 deferred payment included imputed interest. Consequently, the per-share prices implied by the asset transfer and the redemption that immediately followed were different—the first being slightly above $1.60 and the second slightly below that amount.

The court then reviewed the taxpayer's use of the residual method of allocating basis:

> Petitioner's basic approach of assigning to section 197 intangibles any portion of the total asset value not attributable to identifiable other assets is consistent with the "residual method" of valuation that section 1060 mandates in allocating the purchase price paid in a taxable purchase and sale of a business. See sec. 1.1060-1(a)(1), Income Tax Regs. Under that approach, the assets in each of seven classes are assigned, in succession, a portion of the purchase price equal to their fair market value. See id.; sec. 1.338-6(b), Income Tax Regs. Any value not attributable to assets in the first five classes is assigned to section 197 intangibles. Sec. 1.338-6(b), Income Tax Regs. (providing that Class VII consists of goodwill and going-concern value; all other section 197 intangibles make up Class VI).
>
> By its terms, section 1060 applies to "applicable asset acquisitions[s]." Section 1060(c) defines "applicable asset acquisition" to mean "any transfer … (1) of assets which constitute a trade or business, and (2) with respect to which the transferee's basis in such assets is determined wholly by reference to the consideration paid for such assets." Despite that statutory definition, section 1.1060-1(b)(8), Income Tax Regs., provides: "A transfer may constitute an applicable asset acquisition notwithstanding the fact that no gain or loss is recognized with respect to a portion of the group of assets transferred."
>
> Regardless of whether the residual method of allocation directly applies to the transaction in which petitioner acquired the assets of the transferred business, we find the principles underlying that method useful at least by analogy. The rules serve to prevent the purchaser of a business from assigning to assets eligible for shorter cost recovery periods values that are economically attributable to goodwill or going-concern value.[26] See S. Rept. No. 99-313, at 253-254 (1986), 1986-3 C.B. (Vol. 3) 253-254. Although petitioner did not attempt to allocate any portion of its claimed step-up in asset basis to the fixed assets it acquired from CMH, other taxpayers who acquire the assets of a business in a section 351 exchange with boot might attempt to overstate the portion of the step-up in basis allowed to assets with recovery periods shorter than 15 years. Therefore, when the assets transferred in a partially taxable section 351 exchange constitute a trade or business, the allocation of the basis step-up allowed by section 362(a) implicates the concerns that led Congress to mandate the residual method of allocation in section 1060.[27] Consequently, in allocating the boot petitioner paid in the section 351 exchange among the assets it received in that exchange, we will assign to goodwill and other section 197 intangibles any excess of the $8 million agreed total value of the transferred assets over the estimated value of specifically identifiable assets that do not qualify as section 197 intangibles.[28]
>
> [26] When Congress mandated the use of the residual method in purchase price allocations with its enactment of sec. 1060 in 1986, it had not yet enacted sec. 197. Therefore, goodwill, going-concern value, and similar intangible assets were not then amortizable. It remains the case, however, that the recovery periods allowed for the costs of many tangible assets used in a business are shorter than the 15-year amortization period allowed for sec. 197 intangibles. See sec. 168(c).
>
> [27] The principles of the residual method do not conflict with the holding of Rev. Rul. 68-55, 1968-1 C.B. 140. That ruling concludes that gain recognized in a sec. 351 exchange with boot must be computed on an asset-by-asset basis and that, in making that calculation, "the fair market value of each category of consideration received must

be separately allocated to the transferred assets in proportion to the[ir] relative fair market values". *Id*., 1968-1 C.B. at 141. The ruling does not prescribe the specific mechanics to be employed in determining the relative fair market values of the transferred assets. When those assets constitute an entire trade or business, the residual method can appropriately be applied in making that determination.

[27] The circumstances of the present cases do not require us to distinguish between goodwill and going-concern value and other section 197 intangibles. That distinction can be relevant when the character of the seller's gain is at issue. Any gain attributable to goodwill and going-concern value would be capital gain. See sec. 1221(a). By contrast, value attributable to a covenant not to compete would be ordinary income. See *Ullman v. Commissioner*, 264 F.2d 305, 307 (2d Cir. 1959) ("It is well established that an amount a purchaser pays to a seller for a covenant not to compete in connection with a sale of a business is ordinary income to the covenantor[.]"),*aff'g* 29 T.C. 129 (1957). From a purchaser's perspective, however, any basis attributable to goodwill and going-concern value would be treated in the same manner as basis attributable to other amortizable section 197 intangibles. Sec. 197 allows the purchaser to amortize the basis of each of those assets over 15 years. Therefore, for purposes of the cases before us, in which the character of CMH's gain is not in issue, we can treat all section 197 intangibles as a single residual class.

When valuing a deferred payment right, the court rejected the AFR and adopted the IRS underpayment rate:

> We believe it more appropriate, under the circumstances, to value the deferred payment right by discounting it at the underpayment rate established under section 6621(a)(2) - that is, the Federal short-term rate plus 3 percentage points. Congress adopted that rate to avoid giving taxpayers an incentive "to delay paying taxes as long as possible". S. Rept. No. 99-313, at 184 (1986), 1986-3 C.B. (Vol. 3) 184. The underpayment rate is thus intended to be no less than the rate at which taxpayers could borrow money from other sources.

Subject to the caveat that the taxpayer's recordkeeping caused the court to assume the worst, the court allocated basis to prepaid expenses, furniture and fixtures, and software:

> We see no basis in the record for valuing the prepaid expenses that petitioner acquired from CMH at other than their book value of $224,119, but we disagree with petitioner that it was "logical[]" to "assume[] … that the book value of CMH's contributed furniture and fixtures … was, at best, its fair market value on the date of contribution". That assumption would treat as worthless most of the fixed assets that petitioner claims to have received from CMH…
>
> We find it implausible that most of the items of furniture and fixtures, machinery and equipment, and computer equipment that petitioner professes to have received from CMH had no value whatsoever. If those assets were worth the bother of transferring, and petitioner continued to use them in the conduct of the transferred business, they must have had some value. Bearing against petitioner, we will assume that those assets were worth their original cost of $132,993.
>
> As we understand petitioner, its position in regard to the items of computer software included among the 17 items referred to above is not that the software was worthless

when CMH transferred it to petitioner but instead that the items of software qualified as amortizable section 197 intangibles. Therefore, whatever value that software had was, in petitioner's view, appropriately included in the residual value it assigned to amortizable intangibles.

Section 197(e)(3)(A) excludes from the definition of "section 197 intangible" "[a]ny - (i) computer software which is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified, and (ii) other computer software which is not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof." The cost of software that is not covered by section 197 can be amortized over three years if the software has an ascertainable useful life. Sec. 167(f)(1)(A); secs. 1.167(a)-3, 1.167(a)-14(b)(1), Income Tax Regs.

Petitioner would apparently explain CMH's amortization over three years of the cost of the commonly reported software on the ground that the partnership did not acquire the software as part of its acquisition of a trade or business. Because petitioner did acquire the items of software as part of its acquisition of the transferred business, those items would be covered by section 197 if they were custom-developed for CMH and had not been available "off the shelf". Petitioner suggests that "the original cost of $26,036 for those three items acquired more than seven years before the instant transaction makes it unlikely that they are the type of off-the-shelf software which would be excluded from being an amortizable section 197 intangible." It is not obvious, however, how the software's age has any bearing on whether it was custom developed or whether, instead, CMH purchased it off the shelf. It might be that, the higher the cost of software, the more likely that software would be to have been custom developed. Therefore, petitioner may be suggesting that off-the-shelf software is unlikely to cost $26,036. But that amount is the aggregate cost of three items whose separate costs ranged from $7,784 to $9,690. We are unwilling to infer from the costs of those items alone that they were custom developed and thus not excluded by section 197(e)(3)(A) from the definition of section 197 intangibles. Therefore, bearing against petitioner, we will treat the items of software as covered by the section 197(e)(3)(A) exclusion so that any step-up in the bases of those assets is not eligible for amortization under section 197(a). That CMH had apparently amortized in full its cost of the software does not establish that it had no value. As with the furniture and fixtures, machinery and equipment, and computer equipment, we will assume that the three items of computer software that petitioner professes to have acquired from CMH had a value, on November 25, 2009, equal to their original cost of $26,036.

6. Additional Amortization Attributable to Increased Bases in Amortizable Section 197 Intangibles

Relying on the principles of the residual method, we will assign to section 197 intangibles the excess of the $8 million agreed value of the assets of the transferred business over the value we have assigned to prepaid expenses, furniture and fixtures, machinery and equipment, and computer equipment and software. Moreover, for the reasons explained below, we will treat all of the section 197 intangibles as amortizable section 197 intangibles.

Under section 197(c), a section 197 intangible qualifies as an amortizable section 197 intangible if the taxpayer acquired it after Congress' enactment of section 197, holds the asset in connection with a trade or business or other income-producing activity, and (in the case of assets other than governmental permits, covenants not to compete, franchises, trademarks, or trade names) did not create the asset. Petitioner acquired the assets of the transferred business in November 2009 - well after the 1993 enactment of section 197. It follows from respondent's allowance of petitioner's amortization of its carryover bases in section 197 intangibles that petitioner used those assets during the years in issue in a trade or business or other income-producing activity. Finally, even if CMH created some of the section 197 intangibles it transferred to petitioner, those assets were not self-created intangibles in petitioner's hands.

We find no evidence in the record that any of the intangible assets that petitioner acquired from CMH were ineligible for amortization under section 197. Our request for supplemental briefs gave respondent the opportunity to identify any such assets, and he declined to avail himself of that opportunity. Rather than provide us with his own estimate of the portion of any allowed step-up in basis allocable to amortizable section 197 intangibles, respondent simply maintained his puzzling insistence that CMH did not transfer any intangible assets to petitioner and his contention - contrary to the premise of our questions - that petitioner is not entitled to any step-up in basis because the cash and deferred payment right could not be treated as taxable boot in the section 351 exchange.

Treating amortizable section 197 intangibles as a single "catchall" asset category under the principles of the residual method, we value those assets at $7,616,852 ($8,000,000 agreed total asset value less the $224,119 value assigned to prepaid expenses, the $132,993 value assigned to fixed assets, and the $26,036 value assigned to computer software). Because the amortizable section 197 intangibles were worth 95.21% of the total asset value ($7,616,852 ÷ $8,000,000), we will assign to those assets the same percentage of the boot CMH received in the recharacterized section 351 exchange. Therefore, we treat $2,845,063 of the boot as allocable to amortizable section 197 intangibles ($2,988,198 total value of boot × .9521).

Under the approach adopted in Rev. Rul. 68-55, supra, CMH is treated as transferring each asset of the transferred business for the same mix of consideration, 37.4% boot ($2,988,198 ÷ $8,000,000) and 62.6% stock (1 − .374). [*102] CMH's recognized gain in each asset was the lesser of realized gain or allocable boot. Thus, the boot allocable to an asset would not be treated as a return of capital unless its basis exceeded 62.6% of its value. We will leave aside the possibility of basis recovery, even though doing so favors petitioner. We view as quite unlikely the prospect that CMH's basis in any section 197 intangible included among the transferred business assets exceeded 62.6% of the asset's value. Moreover, the carryover basis in section 197 intangibles is small enough that, even if we were to assume maximum basis recovery, it would have an immaterial effect on the amount of amortization allowed to petitioner. Therefore, we will treat CMH as having recognized gain in amortizable section 197 intangibles equal to the full $2,845,063 of boot allocable to those assets and allow petitioner a corresponding increase to the bases of those assets. We thus conclude that petitioner is allowed amortization deductions for each of the years in issue in respect of amortizable section 197 intangibles acquired from CMH of $194,479 ($4,808 + ($2,845,063 ÷ 15)).

concerns articulated in *Danielson* will not be present.

AOD 2023-2, 2023-11 I.R.B. 529, nonacquiesced in the decision:

> Issue 2:
>
> Nonacquiescence to the court's determination that the fair market value of a "Deferred Payment Right" (as described therein) for purposes of section 351(b)(1) is not equal to its issue price.

As to Issue 2, AOD 2023-2, 2023-11 I.R.B. 529, explained the IRS' view:[3557]

> Because the court ruled that Taxpayer could recast the transaction, Taxpayer is deemed to have received assets from Partnership in exchange for stock, $2.7 million of cash, and the Deferred Payment Right in a section 351 transaction.
>
> Section 1001(a) provides that gain from the sale or disposition of property shall be the excess of the amount realized over the adjusted basis. Section 1001(b) provides that the "amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received." Treas. Reg. § 1.1001-1(g) provides that "[i]f a debt instrument is issued in exchange for property, the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under § 1.1273-2 or § 1.1274-2." The regulations thus intend to treat the fair market value ("FMV") of a debt instrument as being the same as its issue price, at least in the context of a section 1001 sale or exchange. Furthermore, under Treas. Reg. § 1.1012-1(g), the issue price of a debt instrument issued in exchange for property is used to determine the buyer's basis in the property.
>
> If section 351(a) would apply to an exchange but for the fact that there is received, in addition to the property permitted to be received without recognition of gain, other property or money, then under section 351(b), gain (if any) to the recipient will be recognized, but in an amount not in excess of the sum of such money and the FMV of such other property received, and no loss to the recipient will be recognized. Section 362(a) provides that the transferee corporation's basis in the property acquired in a section 351 transaction is "the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer." The amount of a transferor's realized gain on a section 351 transaction is determined under section 1001; however, the amount of gain that a transferor recognizes on a section 351 transaction is determined under section 351(b). There is no direct authority on how to determine the FMV of a debt instrument for purposes of section 351(b)(1).
>
> Based on Taxpayer's credit risk, the court determined that the FMV of the Deferred Payment Right was $288,198 (i.e., $300,000 discounted by the Federal short-term rate plus 3 percentage points (3.71%) over 13 months). Thus, the court determined that Partnership had recognized gain of $2,988,198 on the transaction under section 351(b)(1), and Taxpayer was entitled to increase its basis in the acquired assets by $2,988,198 under section 362(a). Furthermore, the court ruled that Taxpayer would be entitled to section 197 amortization deductions to the extent that the recognized gain was allocated to section 197 intangibles. The court, however, did not address how Taxpayer should account for the $11,802 difference between the $288,198 FMV of the

[3557] For Issue 1 and more details on how the AOD described the case, see text accompanying fn 1972 in part II.G.33 Taxpayer Disavowing Form.

> Deferred Payment Right (as determined by the court) and the $300,000 payment due in 13 months.
>
> The Service's position is that the FMV of the Deferred Payment Right for purposes of section 351(b)(1) is equal to the issue price of the Deferred Payment Right. Because the Deferred Payment Right was not publicly traded and was deemed under the court's opinion to be issued in exchange for non-publicly traded property and because the Deferred Payment Right did not have adequate stated interest, the issue price of the Deferred Payment Right is $297,656 (i.e., the present value of $300,000 discounted over 13 months by the Federal short-term rate for November 2009 of 0.71%). See sections 1274(a)(2), (b), (c)(1) and (2). Had the court determined that the FMV of the Deferred Payment Right was equal to $297,656 (as argued by Taxpayer on supplemental brief with no objection by the Service), the results are clear. First, Partnership would have taken $297,656 into account in computing its recognized gain under section 351(b)(1). In addition, Taxpayer would have taken $297,656 into account when increasing its basis in the acquired assets under section 362(a). Finally, the $2,344 difference between the $300,000 due in 13 months and the $297,656 issue price is original issue discount ("OID"), which generally would be taken into account by the holder of the Deferred Payment Right as interest income and by Taxpayer as interest expense over the 13-month term of the Deferred Payment Right. See sections 163(e)(1), 1272(a)(1), and 1273(a)(1) and (2); Treas. Reg. §§ 1.163-7(a) and 1.1272-1. Treating the issue price of the Deferred Payment Right as its FMV for purposes of section 351(b)(1) allows the parties to properly account for the full $300,000 Deferred Payment Right (in the case of Taxpayer, either as an increase to the basis of the acquired assets or as an OID deduction).
>
> The court's determination that the FMV of the Deferred Payment Right is $288,198, which is less than its issue price of $297,656, leaves a gap in accounting for the $9,458 difference between the FMV of the debt instrument and its issue price, the treatment of which is unclear under current law. Treating the issue price of a debt instrument as its FMV for purposes of section 351(b)(1) allows the tax treatment of the parties to the section 351 transaction to mirror a seller's amount realized and a purchaser's basis in a fully taxable exchange involving a debt instrument, each of which is determined by reference to the debt instrument's issue price. See Treas. Reg. §§ 1.1001-1(g) and 1.1012-1(g).
>
> Accordingly, the Service will not follow *Complex Media* in determining the FMV of a debt instrument for purposes of section 351(b)(1).

Above the IRS asserts that it would have easily won on appeal, but it does not explain why it failed to appeal – how disingenuous!

II.M.3. Buying into or Forming a Partnership

Reporting requirements include parts II.M.3.h Reporting Real Estate Contributed to a Partnership or Corporation in a Nontaxable Transaction and II.M.3.i All Partners (Members) Should Sign Form W-9, etc. on Formation or Later Admission.

See also part II.P.3.f Conversions from Partnership to Sole Proprietorships and Vice Versa.

The rules in this part II.M.3 make tax-free formation much more available than the tax-free formation of a corporation under part II.M.2 Buying into or Forming a Corporation. However, that flexibility comes at the cost of complexity regarding allocation of built-in gain or loss (and depreciation or amortization) with respect to assets contributed to the partnership or built-in gain or loss on partnership assets when new partners join the partnership; see part II.P.1.a.i Allocations of Income in Partnerships.

II.M.3.a. General Rule: No Gain Or Loss on Contribution to Partnership

Subject to exceptions,[3558] when a partner contributes property (other than items constituting income in respect of a decedent)[3559] to a partnership,[3560] the partner does not recognize any gain or loss inherent in the property at the time of contribution.[3561] The prior sentence generally holds true even if the contributed property is subject to debt,[3562] because debt is allocated to built-in gain, subject to anti-abuse rules.[3563] However, the transaction still needs to be reported; see part II.M.3.h Reporting Real Estate Contributed to a Partnership or Corporation in a Nontaxable Transaction. Reg. § 1.721-1(a) provides:

> No gain or loss shall be recognized either to the partnership or to any of its partners upon a contribution of property, including installment obligations, to the partnership in exchange for a partnership interest. This rule applies whether the contribution is made to a partnership in the process of formation or to a partnership which is already formed and operating. Section 721 shall not apply to a transaction between a partnership and a partner not acting in his capacity as a partner since such a transaction is governed by section 707. Rather than contributing property to a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it. In all cases, the substance of the transaction will govern, rather than its form. See paragraph (c)(3) of § 1.731-1, Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange under section 707 rather than as a contribution under section 721. For the rules governing the treatment of liabilities to which contributed property is subject, see section 752 and § 1.752-1.

Even if an initial transfer qualifies as a Code § 721 contribution, later contributions might be characterized as something else, such as a sale when the partner does not intend to retain an economic interest in the contributed property over the long run. *Russian Recovery Fund, Ltd. v. U.S.*, 116 A.F.T.R.2d 2015-5582 (Ct. Fed. Cl. 2015). The court focused on strong evidence of

[3558] Various exceptions are included in the subsequent subparts of this part II.M.3 Buying into or Forming a Partnership. See also Willis & Postlewaite, ¶ 4.02[2] Exceptions to General Rule of Non-Recognition of Gain or Loss, *Partnership Taxation*.
[3559] See part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up, especially fns. 2088-2089.
[3560] See part II.C Partnership, especially part II.C.10 Whether Tenancy-in-Common or other Arrangement Constitutes a Partnership.
[3561] Code § 721(a). For the general lack of income recognition when a noncompensatory option to acquire a partnership interest is exercised, see Reg. § 1.721-2, adopted by T.D. 9612 (effective 2/5/2013). See also Abrams and Crnkovich, The Non-Tax Implications of The Taxation of Partnership Options, *TM Real Estate Journal* (BNA) (1/7/2015).
[3562] See fn 439 in part II.C.3.c.iii Allocating Nonrecourse (Remaining) Liabilities.
[3563] See part II.M.3.e Exception: Disguised Sale Rules.

actual intent rather than looking to the rules described in part II.M.3.e Exception: Disguised Sale. Instead, it relied on the economic substance test:

> The Court of Appeals for the Federal Circuit in *Coltec Industries, Inc. v. United States*, explained the rationale behind the economic substance test:
>
> > The economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code. From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit. In this regard, the economic substance doctrine is not unlike other canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute….
> >
> > The Supreme Court, various courts of appeals, and our predecessor court, have identified a number of different factors pertinent to the determination of whether a transaction lacks economic substance and thus should be disregarded for tax purposes. We understand the economic substance doctrine to incorporate the following principles.
> >
> > First, although the taxpayer has an unquestioned right to decrease or avoid his taxes by means which the law permits, the law does not permit the taxpayer to reap tax benefits from a transaction that lacks economic reality. This principle emerged early on in *Gregory*, where the Supreme Court disregarded intermediate transfers of stocks as falling outside the tax code because the transfers had no business or corporate purpose and performed no function other than to reduce taxes. 293 U.S. at 469....
> >
> > While the doctrine may well also apply if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance, a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance.
> >
> > Second, when the taxpayer claims a deduction, it is the taxpayer who bears the burden of proving that the transaction has economic substance. In describing the history of the economic substance doctrine, our predecessor court in *Rothschild* stated, *Gregory v. Helvering* requires that a taxpayer carry an unusually heavy burden when he attempts to demonstrate that Congress intended to give favorable tax treatment to the kind of transaction that would never occur absent the motive of tax avoidance. 407 F.2d at 411 (quoting *Diggs v. Comm'r of Internal Revenue*, 281 F.2d 326, 330 (2d Cir. 1960))....
> >
> > Third, the economic substance of a transaction must be viewed objectively rather than subjectively. The Supreme Court cases and our predecessor court's cases have repeatedly looked to the objective economic reality of the transaction in applying the economic substance doctrine. While the taxpayer's subjective motivation may be pertinent to the existence of a tax avoidance purpose, all courts have looked to the objective reality of the transaction [in] assessing its economic substance....

Fourth, the transaction to be analyzed is the one that gave rise to the alleged tax benefit.... [I]n economic substance cases, the focus is on the specific transaction whose tax consequences are in dispute, and the Second Circuit has stated that [t]he relevant inquiry is whether the transaction that generated the claimed deductions ... had economic substance, *Nicole Rose Corp. v. Comm'r of Internal Revenue*, 320 F.3d 282, 284 (2d Cir. 2003)....

Finally, arrangements with subsidiaries that do not affect the economic interest of independent third parties deserve particularly close scrutiny.

454 F.3d 1340, 1353-57 (Fed. Cir. 2006) (select citations omitted).

For more on the economic substance doctrine, see part II.G.17 Economic Substance Penalty and Doctrines, particularly the cases (including *Coltec*) cited at fn. 1651.

The *Russian Recovery* court also rebuffed the taxpayer's attempted reliance on Code § 704(e) [modified and partially renumbered as Code § 761(b) starting in 2016]:[3564]

Plaintiff makes no real effort to address the large body of case law which requires a look beyond these formalities. Instead, it relies heavily on IRC § 704(e)(1):

e) *Family partnerships*.—

(1) *Recognition of interest created by purchase or gift*.--A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

Plaintiff views this statutory provision as supporting an inquiry independent of the judicially created challenges to over-reliance on formalism. We disagree for two reasons. First, although admittedly there is some debate on the question, we believe that the provision, as its name suggests, is directed at preventing the IRS from undoing intra-familiar partnership transactions, something far afield from the Tiger-RRF transaction.[25] Second, even if the provision is of broader application, there is no reason to think Congress intended to insulate taxpayers from decades of judicial scrutiny into abusive reliance on formalism.

[25] In that respect it was a reaction to Culbertson, which did involve a family partnership. See S. Rep. 82-781, at 38-40 (1951) (noting that IRC § 704(e)(1) was intended to harmonize the rules regarding family partnerships, particularly in light of the confusion caused by *Culbertson* and its progeny).

As defendant correctly points out, the IRS has adopted regulations interpreting section 704(e)(1) that preserve the traditional inquiries into whether the creation of a partnership interest was a sham transaction. Treas. Reg. § 1.704-1(e)(1)(iii) (A ... purchaser of a capital interest in a partnership is not recognized as a partner under the principles of section 704(e)(1) unless such interest is acquired in a bona fide transaction,

[3564] The Code § 704(e) analysis might have changed since then. See part III.B.1.a.iv.(b) Income Tax Aspects of Family Partnerships.

not a mere sham for tax avoidance or evasion purposes ....). Section 704(e)(1) plainly does not insulate plaintiff from the assertions made in the FPAA.

Although gain is not recognized, any accrued interest on a note contributed to the partnership would be recognized.[3565]

When no gain or loss is recognized, the partnership's adjusted basis in the contributed property is the same as it was in the hands of the contributing partner.[3566] The partner's basis in the partnership is also equal to the partner's basis in the partner's contributed property.[3567] A partner does not get basis for contributing the partner's own promissory note to a partnership. *VisionMonitor Software, LLC v. Commissioner*, T.C. Memo. 2014-182, holding:

> The value of what a partner contributes to his partnership can be tricky when he contributes something other than cash - like the notes at issue here. VisionMonitor argues that the contribution of the promissory notes increased Mantor's and Smith's outside bases in amounts equivalent to their face value. But a partnership's basis in property contributed by a partner is the adjusted basis of that property in the hands of the contributing partner at the time of the contribution. Sec. 723. The Commissioner argues that the company's basis in the notes is zero because Mantor's and Smith's bases in them were each zero. We have to agree with the Commissioner. We have long held that the contribution of a partner's own note to his partnership isn't the equivalent of a contribution of cash, and without more, it will not increase his basis in his partnership interest. *See Dakotah Hills Offices Ltd. P'ship v. Commissioner*, T.C. Memo. 1998-134, 75 T.C.M. (CCH) 2122 (no increased basis because not cash equivalent and not property in which partner has basis); *Gemini Twin Fund III v. Commissioner*, T.C. Memo. 1991-315, 62 T.C.M (CCH) 104 (partner's outside basis not increased by contribution of promissory note), *aff'd without published opinion*, 8 F.3d 26 (9th Cir. 1993); *Oden v. Commissioner*, T.C. Memo. 1981-184, 41 T.C.M. (CCH) 1285 (partner has zero basis in own promissory note), *aff'd without published opinion*, 679 F.2d 885 (4th Cir. 1982).[5]
>
> [5] Revenue Ruling 80-235, 1980-2 C.B. 229, summarizes this corner of partnership-tax law. It states that the contribution of a note by itself does not increase a partner's outside basis because he has a zero basis in the note. His outside basis will, however, increase if and when he actually makes payments on the note. *Id.; cf.* sec. 1.704-1(b)(2)(iv)(d)(2), Income Tax Regs. (providing that a partner's capital account is not increased with respect to a note written by that partner until there is either a taxable

[3565] See Reg. §§ 1.721-1(d) and 1.721-2(e).

[3566] Code § 723. Reg. § 1.723-1 provides:

> The basis to the partnership of property contributed to it by a partner is the adjusted basis of such property to the contributing partner at the time of the contribution. Since such property has the same basis in the hands of the partnership as it had in the hands of the contributing partner, the holding period of such property for the partnership includes the period during which it was held by the partner. See section 1223(2). For elective adjustments to the basis of partnership property arising from distributions or transfers of partnership interests, see section 732(d), 734(b), and 743(b). See § 1.460-4(k)(3)(iv)(B)(2) for rules relating to adjustments to the basis of contracts accounted for using a long-term contract method of accounting that are acquired in certain contributions to which section 721(a) applies.

[3567] Code § 722.

> disposition of the note by the partnership, or the partner makes principal payments on the note).

Bussing v. Commissioner, 88 T.C. 449 (1987), held:

> A taxpayer has zero basis in an executed obligation as no cost is incurred in making the note. See *Alderman v. Commissioner*, 55 T.C. 662 (1971). For a cash-basis taxpayer, giving a note is not equivalent to giving cash. *Helvering v. Price*, 309 U.S. 409 (1940); *Menz v. Commissioner*, 80 T.C. 1174 (1983). Therefore, payments by a partner on his written obligation, representing the partner's contribution to the partnership, are added to the partner's basis in the partnership only as the payments are made.[16]

[16] See *Oden v. Commissioner*, T.C. Memo. 1981-184, affd. without published opinion 679 F.2d 885 (4th Cir. 1982).

If the partnership is mainly to hold marketable securities, using only cash to form it has certain advantages.[3568]

The substituted basis portion continues the contributing partner's depreciation schedule.[3569]

However, a contributing partner must recognize gain on the occasions described below.

II.M.3.b. Exception: Diversification of Investment Risk

Code § 721(b) requires a contributing partner to recognize built-in gain on contributed property if the partnership is equivalent to an "investment company," as defined in Code § 351. Thus, when a partner contributes property with a fair market value that is greater than its adjusted basis to an "investment company" partnership, the partner recognizes the appropriate gain.[3570] The gain recognized by the contributing partner increases the basis of not only the contributor's partnership interest,[3571] but also the partnership's basis in the property.[3572]

Below are parts II.M.3.b.i When Diversification Occurs and II.M.3.b.ii How Much Gain Triggered by Code § 721(b).

II.M.3.b.i. When Diversification Occurs

Reg. § 1.351-1(c)(1) provides that a post-6/30/1967 transfer is considered to be a transfer to an investment company if:

(i) The transfer results, directly or indirectly, in diversification of the transferors' interests, and

(ii) The transferee is (a) a regulated investment company, (b) a real estate investment trust, or (c) a corporation more than 80 percent of the value of whose assets (excluding cash and non-convertible debt obligations from consideration) are held for

[3568] See footnotes 5712-5713 and the accompanying text.
[3569] Code § 168(i)(7).
[3570] Code § 721(b).
[3571] Code § 722.
[3572] Code § 723.

> investment and are readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts.

Reg. § 1.351-1(c)(2) provides:

> The determination of whether a corporation is an investment company shall ordinarily be made by reference to the circumstances in existence immediately after the transfer in question. However, where circumstances change thereafter pursuant to a plan in existence at the time of the transfer, this determination shall be made by reference to the later circumstances.

Reg. § 1.351-1(c)(3) provides:

> Stocks and securities will be considered readily marketable if (and only if) they are part of a class of stock or securities which is traded on a securities exchange or traded or quoted regularly in the over-the-counter market. For purposes of subparagraph (1)(ii)(c) of this paragraph, the term “readily marketable stocks or securities” includes convertible debentures, convertible preferred stock, warrants, and other stock rights if the stock for which they may be converted or exchanged is readily marketable. Stocks and securities will be considered to be held for investment unless they are (i) held primarily for sale to customers in the ordinary course of business, or (ii) used in the trade or business of banking, insurance, brokerage, or a similar trade or business.

However, Code § 351(e)(1)(A) requires that, in determining whether a company is an investment company, one must take into account all stock and securities held by the company. In applying this test, Code § 351(e)(1)(B) treats as stocks and securities:

(i) money,

(ii) stocks and other equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts and derivatives,

(iii) any foreign currency,

(iv) any interest in a real estate investment trust, a common trust fund, a regulated investment company, a publicly-traded partnership (as defined in section 7704(b)) or any other equity interest (other than in a corporation) which pursuant to its terms or any other arrangement is readily convertible into, or exchangeable for, any asset described in any preceding clause, this clause or clause (v) or (viii),

(v) except to the extent provided in regulations prescribed by the Secretary, any interest in a precious metal, unless such metal is used or held in the active conduct of a trade or business after the contribution,

(vi) except as otherwise provided in regulations prescribed by the Secretary, interests in any entity if substantially all of the assets of such entity consist (directly or indirectly) of any assets described in any preceding clause or clause (viii),

(vii) to the extent provided in regulations prescribed by the Secretary, any interest in any entity not described in clause (vi), but only to the extent of the value of such interest that is attributable to assets listed in clauses (i) through (v) or clause (viii), or

(viii) any other asset specified in regulations prescribed by the Secretary.

> The Secretary may prescribe regulations that, under appropriate circumstances, treat any asset described in clauses (i) through (v)as not so listed.

Regulations have not been amended to reflect Code § 351(e), and the treatment of money as stocks and securities supersedes the regulations. Senate Report to P.L. 105-34, 8/5/97, provides:

> Other assets that count toward the 80-percent test are an interest in an entity substantially all of the assets of which are assets listed, and to the extent provided in Treasury regulations, interests in other entities, but only to the extent of the value of the interest that is attributable to assets listed.[69]
>
> [69] Until such regulations are issued, it is intended that the Treasury regulations promulgated under the similar provisions of section 731(c)(2) generally will apply. Specifically, it is intended that an entity will meet the substantially all requirement if 90 percent or more of its assets are listed assets (Treas. reg. sec. 1.731-2(c)(3)(i)). Similarly, with respect to partnerships and the non-corporate entities, it is intended that, where 20 percent or more (but less than 90 percent) of the entity's assets consist of listed assets, a *pro rata* portion of the interest in the entity will be treated as a listed asset. (Treas. reg. sec. 1.731-2(c)(3)(ii)).

Reg. § 1.731-2(c)(3)(i), (ii) are reproduced in fns. 5379-5380, respectively, which are in part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them).

Reg. § 1.351-1(c)(5) provides:

> A transfer ordinarily results in the diversification of the transferors' interests if two or more persons transfer nonidentical assets to a corporation in the exchange. For this purpose, if any transaction involves one or more transfers of nonidentical assets which, taken in the aggregate, constitute an insignificant portion of the total value of assets transferred, such transfers shall be disregarded in determining whether diversification has occurred. If there is only one transferor (or two or more transferors of identical assets) to a newly organized corporation, the transfer will generally be treated as not resulting in diversification. If a transfer is part of a plan to achieve diversification without recognition of gain, such as a plan which contemplates a subsequent transfer, however delayed, of the corporate assets (or of the stock or securities received in the earlier exchange) to an investment company in a transaction purporting to qualify for nonrecognition treatment, the original transfer will be treated as resulting in diversification.

Pre-contribution transfers between spouses may be an excellent solution.[3573]

Finally, the transferor will not attain diversification (and will not recognize gain) if the contributions of other partners are de minimis. Reg. § 1.351-1(c)(7) provides some guidelines:

[3573] Letter Rulings 9811022 and 200317011.

Example (1). Individuals A, B, and C organize a corporation with 101 shares of common stock. A and B each transfers to it $10,000 worth of the only class of stock of corporation X, listed on the New York Stock Exchange, in exchange for 50 shares of stock. C transfers $200 worth of readily marketable securities in corporation Y for one share of stock. In determining whether or not diversification has occurred, C's participation in the transaction will be disregarded. There is, therefore, no diversification, and gain or loss will not be recognized.

Example (2). A, together with 50 other transferors, organizes a corporation with 100 shares of stock. A transfers $10,000 worth of stock in corporation X, listed on the New York Stock Exchange, in exchange for 50 shares of stock. Each of the other 50 transferors transfers $200 worth of readily marketable securities in corporations other than X in exchange for one share of stock. In determining whether or not diversification has occurred, all transfers will be taken into account. Therefore, diversification is present, and gain or loss will be recognized.

Letter Ruling 200006008 applied the de minimis rule to the following facts:

X, Y, and Trust seek to contribute portfolios of stock to a newly formed limited liability company (LLC) that will be taxed as a partnership under section 301.7701-3 of the Administrative and Procedure Regulations.

Trust will contribute a portfolio of stocks to LLC with an aggregate value of $n, consisting of interests in p different stocks, v of which are stocks in regulated investment companies. X will contribute a portfolio consisting of r stocks with an aggregate value of $q, s of which are stocks in real estate investment trusts. Y will contribute a portfolio of u stocks with an aggregate value of $t, v of which are stocks in real estate investments trusts.

The taxpayer makes the following representations:

1. The sum total of all increases in value of X's, Y's and Trust's interests in each individual asset transferred to LLC does not exceed 5% of the aggregate value of LLC's assets immediately after the transfers. For purposes of this representation, the increase in value of a transferor's interest in any asset transferred to LLC is equal to the value of the transferor's indirect interest in the asset after the transfer less the value of the transferor's direct interest in the asset prior to the transfer. The value of the transferor's indirect interest in an asset is equal to the transferor's percentage ownership interest in LLC immediately after the transfer multiplied by the fair market value of the asset immediately after the transfer. The value of the transferor's direct interest in the asset it transferred is its fair market value at the time of transfer.

2. There is no plan or intention by any transferor to make any additional transfers to LLC.

3. Any other transferor who will contribute assets to LLC will not contribute assets in an amount or kind that would cause the total nonidentical assets transferred to LLC to be more than 5% of the aggregate amount of LLC's portfolio immediately after the transfer.

Letter Ruling 200006008 held:

Provided LLC is treated as a partnership for purposes of section 721, we conclude as follows:

1. The transfers of property by Trust together with the transfers of property by X and Y will not result in diversification. The transfers of nonidentical assets by the transferors, which amount to less than 5% of the total value of the assets transferred to LLC, are insignificant and therefore disregarded for purposes of determining whether diversification exists pursuant to section 1.351-1(c)(5).

2. The transfers by Trust, X, and Y to LLC are not transfers of property to a partnership that would be treated as an investment company (within the meaning of section 351) if LLC were incorporated, provided that these are the only transfers to LLC (except for transfers that would not increase the percentage of nonidentical assets contributed over 5%).

Another way to avoid investment company status would be to have each transferor contribute a portfolio of stock and securities that is already diversified.[3574] Reg. § 1.351-1(c)(6)(i) provides:

> For purposes of paragraph (c)(5) of this section, a transfer of stocks and securities will not be treated as resulting in a diversification of the transferors' interests if each transferor transfers a diversified portfolio of stocks and securities. For purposes of this paragraph (c)(6), a portfolio of stocks and securities is diversified if it satisfies the 25 and 50-percent tests of section 368(a)(2)(F)(ii), applying the relevant provisions of section 368(a)(2)(F). However, Government securities are included in total assets for purposes of the denominator of the 25 and 50-percent tests (unless the Government securities are acquired to meet the 25 and 50-percent tests), but are not treated as securities of an issuer for purposes of the numerator of the 25 and 50-percent tests.

Code § 368(a)(2)(F)(ii) provides:

> A corporation meets the requirements of this clause if not more than 25 percent of the value of its total assets is invested in the stock and securities of any one issuer and not more than 50 percent of the value of its total assets is invested in the stock and securities of 5 or fewer issuers. For purposes of this clause, all members of a controlled group of corporations (within the meaning of section 1563(a)) shall be treated as one issuer. For purposes of this clause, a person holding stock in a regulated investment company, a real estate investment trust, or an investment company which meets the requirements of this clause shall, except as provided in regulations, be treated as holding its proportionate share of the assets held by such company or trust.

"Mutual fund" is a common name for a "a regulated investment company." Code § 851(b)(3) includes among the requirements to be "a regulated investment company" that, at the close of each quarter of the taxable year:

> (A) at least 50 percent of the value of its total assets is represented by -
>
> > (i) cash and cash items (including receivables), Government securities and securities of other regulated investment companies, and
> >
> > (ii) other securities for purposes of this calculation limited, except and to the extent provided in subsection (e), in respect of any one issuer to an amount not greater in

[3574] Letter Rulings 199909045 and 199925017-199925020.

value than 5 percent of the value of the total assets of the taxpayer and to not more than 10 percent of the outstanding voting securities of such issuer, and

(B) not more than 25 percent of the value of its total assets is invested in -

(i) the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer,

(ii) the securities (other than the securities of other regulated investment companies) of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Secretary, to be engaged in the same or similar trades or businesses or related trades or businesses, or

(iii) the securities of one or more qualified publicly traded partnerships (as defined in subsection (h)).

Another approach might be to manage the situation the way one would an "exchange fund." The whole point of the rules is to avoid economic diversification – meaning shifting risk of investment results from the contributing partners to the other partners. If the partnership agreement provided for the investment results to be specifically allocated to the contributing partners, then they will not have diversified their risk. "Exchange funds" provide such an allocation for seven years (to comply with Code § 704(c)(1)(B) and 737),[3575] then they allow the partners to withdraw a diversified portfolio. I don't have any citations for private letter rulings approving this approach, but I would think that some are out there.

Reg. § 1.351-1(c)(4) provides:

In making the determination required under subparagraph (1)(ii)(c) of this paragraph, stock and securities in subsidiary corporations shall be disregarded and the parent corporation shall be deemed to own its ratable share of its subsidiaries' assets. A corporation shall be considered a subsidiary if the parent owns 50 percent or more of (i) the combined voting power of all classes of stock entitled to vote, or (ii) the total value of shares of all classes of stock outstanding.

Consistent with this rule but not citing it, Letter Ruling 201547003 involved the following facts, representations, and ruling:

Summary of Facts

X is a State A publicly-traded limited partnership. GP1, a State A limited liability company, is X's general partner. X owns the general partner interest, incentive distribution rights ("IDRs"), and a portion of the publicly traded limited partner interests in LP1. Additionally, X owns a special class of LP1 partnership interests that track a percent of the economic attributes of the general partner interest and IDRs of LP2, a State A limited partnership.

In addition to its ownership interests in LP2, LP1 also owns the general partner interest, IDRs, and limited partner interests in LP3, a publicly traded limited partnership. LP1, LP2

[3575] See part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

and LP3 are publicly traded partnerships within the meaning of §7704, and are directly involved in Business B.

Proposed Transaction

X has been engaged in acquisition discussions with GP2, the corporate general partner of Target MLP, an unrelated publicly traded limited partnership engaged in Business B. X proposes, in part, to undertake the following transaction:

(i) The members of GP1 will form a new limited liability company ("New LLC"), which will elect to be taxed as a corporation for federal income tax purposes.

(ii) GP2, the corporate general partner of Target MLP, will merge into New LLC under State A law with New LLC surviving the merger.

(iii) New LLC will contribute its newly acquired interests in Target MLP to X in exchange for limited partner interests of X (the "Exchange").

Representations

X makes the following representations:

(a) Immediately after the Exchange, the total value of X's direct ownership interests in LP1 will be more than 50 percent of the total value of all equity interests outstanding in LP1.

(b) At the time of the Exchange, there will be no plan in existence pursuant to which the total value of X's direct ownership interests in LP1 will become less than 50 percent of the total value of all equity interests outstanding in LP1.

Ruling

Based solely on the information submitted and representations set forth above, we rule as follows:

Provided that immediately after the Exchange, X's direct ownership interests in LP1 will represent 50 percent or more of the total value of all LP1 equity interests, X's LP1 equity interests will be disregarded and X will be deemed to own its ratable share of LP1's assets for purposes of determining whether X is an investment company under § 351(e).

Caveats

Except as expressly provided herein, no opinion is expressed or implied concerning the tax treatment of the Proposed Transaction under other provisions of the Code or regulations or the tax treatment of any condition existing at the time of, or effects resulting from, the Proposed Transaction that is not specifically covered by the above ruling. In particular, no opinion is expressed on (i) the merger described in step (ii) above, (ii) whether X's ownership interests in LP1 will represent 50 percent or more of the total value of all LP1 equity interests immediately after the Exchange, and (iii) whether a plan exists at the time of the Exchange pursuant to which X's direct ownership interests in LP1 will represent less than 50 percent of the total value of all of LP1's equity interests.

Letter Ruling 201633028 is very similar to Letter Ruling 201547003.

Applying the look-through rule again, C involved the following facts, representations, and rulings:

Summary of Facts

X is a publicly-traded partnership within the meaning of section 7704(b) of the Internal Revenue Code (Code) that is classified as a partnership for federal income tax purposes. GP, a limited liability company, that is classified as a partnership for federal income tax purposes, is X's general partner. As the general partner of X and owner of X common units, GP has an M% interest in X. Two individuals own all the interests in GP.

X owns the general partner interest and a portion of the limited partner interests in MLP. MLP is a publicly-traded partnership within the meaning of section 7704(b) that is classified as a partnership for federal income tax purposes. MLP is engaged directly and indirectly through various operating subsidiaries and disregarded entities, in Business A.

X has been engaged in acquisition discussions and has entered into an agreement with Target, an unrelated publicly-traded corporation engaged in Business B. Target's Business B assets, which are similar to those in one or more of MLP's existing lines of business, will expand or complement X's existing business and operations. The Proposed Transaction will result in Target becoming a wholly-owned subsidiary of X. Immediately prior to X's public announcement of this acquisition, X's equity market capitalization was approximately $N and Target's equity market capitalization was approximately $0. Also as a result of the Proposed Transaction, (1) Target is expected to own between P% and Q% of MLP common units, and (2) Target's assets are expected to make up between approximately P% and R% of MLP's assets by fair market value.

Transaction

X proposes, in part, to undertake the following transactions ("Transactions"):

(i) X will form a new limited liability company ("New LLC"), which will be disregarded as an entity separate from its owner, X, for federal income tax purposes.

(ii) New LLC will merge into Target with Target surviving the merger. In the merger, each outstanding share of Target's stock will be exchanged for common units in X and cash (with respect to the common units received in X).

(iii) Target will contribute all of its assets to MLP in exchange for units of MLP.

Representations

X makes the following representations:

(a) Immediately following the Transactions, X's direct ownership interests in MLP will represent more than 50 percent of the value (based on section 704(b) capital accounts) of all equity interests in MLP.

(b) At the time of the Transactions, there would be no plan in existence pursuant to which the total value of X's direct ownership interests in MLP will become less than 50 percent of the total value of all equity interests in MLP.

(c) Immediately after the Transactions after applying the look-through rule of Treas. Reg. § 1.351-1(c)(4), not more than 80% of (1) the fair market value of X's assets (excluding its direct interests in MLP) plus (2) X's ratable share (determined by reference to section 704(b) capital accounts) of the fair market value of MLP's assets will be attributable to assets described in section 351(e).

Ruling

Based solely on the information submitted and representations set forth above, we rule as follows:

(1) Provided that immediately after the Transactions, X's direct equity ownership interests in MLP will represent 50 percent or more of the value of all interests in MLP, X's direct equity interests in MLP will be disregarded and X will be deemed to own its ratable share (determined by reference to section 704(b) capital accounts) of MLP's assets for purposes of determining whether X would be an investment company under section 351(e) if X were incorporated.

(2) Provided that immediately after the Transactions after applying the look-through rule of Treas. Reg. § 1.351-1(c)(4), not more than 80% of (1) the fair market value of X's assets (excluding its direct interests in MLP) plus (2) X's ratable share (determined by reference to section 704(b) capital accounts) of the fair market value of MLP's assets is attributable to assets described in section 351(e), X will not be treated as an investment company (within the meaning of section 351(e)) for purposes of applying section 721(b).

Caveats

Except as expressly provided herein, no opinion is expressed or implied concerning the federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Further, no opinion is expressed with respect to any transaction other than the transfers described herein. For example, no opinion is expressed with respect to the federal tax consequences of any other transfer of property to X, including whether the control requirement in section 351(a) would be satisfied, or whether any further transfer to a lower-tier entity of X would be integrated with the transfer to X.

Letter Ruling 202016013 provides:

Summary of Facts

X is a publicly-traded partnership within the meaning of section 7704(b) of the Internal Revenue Code (Code) that is classified as a partnership for federal income tax purposes. GP, a limited liability company, that is classified as a partnership for federal income tax purposes, is X’s general partner. As the general partner of X and owner of X common units, GP has an M% interest in X. Two individuals own all the interests in GP.

X owns the general partner interest and a portion of the limited partner interests in MLP. MLP is a publicly-traded partnership within the meaning of section 7704(b) that is classified as a partnership for federal income tax purposes. MLP is engaged directly and indirectly through various operating subsidiaries and disregarded entities, in Business A.

X has been engaged in acquisition discussions and has entered into an agreement with Target, an unrelated publicly-traded corporation engaged in Business B. Target’s Business B assets, which are similar to those in one or more of MLP’s existing lines of business, will expand or complement X’s existing business and operations. The Proposed Transaction will result in Target becoming a wholly-owned subsidiary of X. Immediately prior to X’s public announcement of this acquisition, X’s equity market capitalization was approximately $N and Target’s equity market capitalization was approximately $O. Also as a result of the Proposed Transaction, (1) Target is expected to own between P% and Q% of MLP common units, and (2) Target’s assets are expected to make up between approximately P% and R% of MLP’s assets by fair market value.

Transaction

X proposes, in part, to undertake the following transactions (“Transactions”):

(i) X will form a new limited liability company (“New LLC”), which will be disregarded as an entity separate from its owner, X, for federal income tax purposes.

(ii) New LLC will merge into Target with Target surviving the merger. In the merger, each outstanding share of Target’s stock will be exchanged for common units in X and cash (with respect to the common units received in X).

(iii) Target will contribute all of its assets to MLP in exchange for units of MLP.

Representations

X makes the following representations:

(a) Immediately following the Transactions, X’s direct ownership interests in MLP will represent more than 50 percent of the value (based on section 704(b) capital accounts) of all equity interests in MLP.

(b) At the time of the Transactions, there would be no plan in existence pursuant to which the total value of X’s direct ownership interests in MLP will become less than 50 percent of the total value of all equity interests in MLP.

(c) Immediately after the Transactions after applying the look-through rule of Treas. Reg.§ 1.351-1(c)(4), not more than 80% of (1) the fair market value of X’s assets (excluding its direct interests in MLP) plus (2) X’s ratable share (determined by reference to section 704(b) capital accounts) of the fair market value of MLP’s assets will be attributable to assets described in section 351(e).

Ruling

Based solely on the information submitted and representations set forth above, we rule as follows:

(1) Provided that immediately after the Transactions, X's direct equity ownership interests in MLP will represent 50 percent or more of the value of all interests in MLP, X's direct equity interests in MLP will be disregarded and X will be deemed to own its ratable share (determined by reference to section 704(b) capital accounts) of MLP's assets for purposes of determining whether X would be an investment company under section 351(e) if X were incorporated.

(2) Provided that immediately after the Transactions after applying the look-through rule of Treas. Reg. § 1.351-1(c)(4), not more than 80% of (1) the fair market value of X's assets (excluding its direct interests in MLP) plus (2) X's ratable share (determined by reference to section 704(b) capital accounts) of the fair market value of MLP's assets is attributable to assets described in section 351(e), X will not be treated as an investment company (within the meaning of section 351(e)) for purposes of applying section 721(b).

Caveats

Except as expressly provided herein, no opinion is expressed or implied concerning the federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Further, no opinion is expressed with respect to any transaction other than the transfers described herein. For example, no opinion is expressed with respect to the federal tax consequences of any other transfer of property to X, including whether the control requirement in section 351(a) would be satisfied, or whether any further transfer to a lower-tier entity of X would be integrated with the transfer to X.

Banoff and Cohen discuss Letter Ruling 202016013:[3576]

The transaction at hand almost surely is the acquisition of SemGroup Corporation by Energy Transfer LP (see Energy Transfer LP Form S-4, filed with U.S. Securities and Exchange Commission on 10/03/2019 and amended 10/28/2019 (the S-4)) and, as such, we will discuss the transaction on that assumption.

Energy Transfer LP (ET) has limited partner common units traded on the New York Stock Exchange (NYSE). ET describes itself as being engaged in natural gas operations, including natural gas midstream and intrastate transportation and storage, interstate natural gas transportation and storage, and crude oil, natural gas liquids (NGL) and refined products transportation, terminalling services and acquisition and marketing activities, as well as NGL storage and fractionation services. ET directly owns interests in other entities through which some of these activities are conducted. Specifically, ET owns Energy Transfer Operating, L.P. (ETO), which itself has limited partner preferred units traded on the NYSE. ETO in turn owns various operating subsidiaries and interests in two other partnerships that have units traded on public exchanges (Sunoco LP and

[3576] Shop Talk column, "Section 721(b)-A Partnership Issue, a Corporate Issue, or Just a Jumble?" *Journal of Taxation* (7/2020).

USA Compression Partners, LP). ET, ETO, and the other two partnerships claim to be partnerships for U.S. federal tax purposes.

In the S-4, ET announced that it had entered into an Agreement and Plan of Merger with its wholly owned subsidiary, Nautilus Merger Sub LLC (in the ruling, New LLC) and SemGroup Corporation (SEMG; and in the ruling, Target), whose common stock traded on the NYSE (prior to SEMG's being acquired by ET on 12/05/2019). The proposed transaction, under this agreement, would merge New LLC into SEMG with SEMG surviving and with SEMG's outstanding stock being converted into cash and common units in ET, followed by the contribution by SEMG of all of its assets to ETO in exchange for ETO units.

For federal income tax purposes, the merger is characterized differently. Because New LLC is wholly owned by ET and apparently has not made a check-the-box election to be taxed as a corporation, it is disregarded as separate from ET for federal income tax purposes. Thus, the merger is treated as a contribution to ET of SEMG's stock by SEMG's shareholders in exchange for the cash and ET's units. Whether that contribution will trigger recognition of gain or loss depends entirely on Section 721. (As part of the transaction, SEMG transferred all its business assets to ETO for ETO units. That seemingly is a tax-free transfer under Section 721.)

Section 721 has its general rule of non-recognition, *i.e.*, no gain or loss is recognized by the transferor, the partnership, or any of its other partners when property is contributed to the partnership in exchange for an interest in the partnership. That general rule, however, is subject to three exceptions. Two of them, regarding transfers of intangibles and transfers by non-United States persons, are not relevant here. The third, Section 721(b), provides that the general rule does not apply "to gain realized on a transfer of property to a partnership which would be treated as an investment company (within the meaning of Section 351) if the partnership were incorporated." The scope of Section 721(b) is elusive and potentially far-reaching; it may even apply when holders of options to acquire partnership interests exercise their options and when interests in a partnership investment company are converted (*e.g.*, general partner into limited partner interests, general or limited partnership interests into LLC interests, or vice versa). See TD 9612 , 02/05/2013; Carman and Banoff, "Final Regulations on Noncompensatory Options: Worth the Wait?," 118 *JTAX* 164 (April 2013); Banoff, "Partnership Ownership Realignments in Partnership Reallocations, Legal Status Changes, Recapitalizations and Conversions: What Are the Tax Consequences?," 83 *Taxes*, No. 3 (March 2005) 105, 122.

Thus, ET was faced with the question of whether, if ET was a corporation, the transfer of SEMG's stock to ET would be a transfer to an investment company under Section 351. ET indicated in the S-4 that it was seeking a private letter ruling to determine the answer to this question. (And Ltr. Rul. 202016013, dated 01/08/2020 and released 04/17/2020, undoubtedly is that ruling.)

After reviewing the Code § 351 investment company rules, Banoff and Cohen continue discussing Letter Ruling 202016013:[3577]

> Now, let's return to the ruling at hand. The transaction in Ltr. Rul. 202016013 is a transfer of corporate stock to a partnership that owns other partnerships. In the ruling, ET represented that immediately following the proposed transaction ET's direct ownership interest in ETO represented more than 50 percent of the value (based on capital accounts) of all equity interests in ETO and that at the time of the transaction there would be no plan to have ET's direct ownership interest in ETO reduced to less than 50 percent of the total value of all equity interests in ETO. ET also represented that, immediately after the proposed transactions, "after applying the look-through rule of Treas. Reg. § 1.351-1(c)(4)," not more than 80 percent of (1) the FMV of ET's assets (excluding its direct interests in ETO) plus (2) ET's ratable share (determined by reference to Section 704(b) capital accounts) of the FMV of ETO's assets, would be assets described in Section 351(e).
>
> Thus, the ruling turns on the application of the look-through rule of Reg. 1.351-1(c)(4). Section 721(b) says to treat partnership ET as a corporation, but it does not go further (*i.e.*, it does not say to treat any entity owned by ET as a corporation). Reg. 1.351-1(c)(4) only applies to corporations. After the transaction, for purposes of the investment company rules, SEMG is a corporate subsidiary of ET and Reg. 1.351-1(c)(4) clearly applies to SEMG, but SEMG's sole asset, at that point, will be interests in ETO. The regulatory look-through rule does not appear to apply to ETO, a partnership for federal income tax purposes, or to any tax partnership owned by ETO.
>
> ET might turn to the statutory look-through rules. However, those only give you "bad" assets. The statutory provisions of Section 351(e)(1)(B)(vi) and (vii) only tell you when to treat interests in an entity as "stock and securities." They do not allow a taxpayer to truly look through interests in an entity to the assets of the entity.
>
> This raises the significant issue of whether you take at face value the reference in a statute or regulation to the classification of an entity. When a statute or regulation refers to a "corporation," does that mean only entities treated as corporations for federal income tax purposes? Or, can you apply those rules to entities treated as partnerships for federal income tax purposes, at least in a situation where the operative statute (Section 721(b)) imposes corporate tests and standards (under Section 351(e)) on partnerships?
>
> Interestingly, as noted above, Ltr. Rul. 202016013 was issued by the Corporate side of Chief Counsel's office. The ruling starts by stating that it is issued pursuant to section 6.03(2) of Rev. Proc. 2019-1, 2019-1 IRB 1, regarding one or more significant issues under Section 351 (among other provisions). Section 6.03(2) says that the IRS will not rule on the qualification of any transaction under Section 351 (among other Code sections), regardless of whether the transaction is part of an integrated transaction, but will only issue rulings on significant issues "presented in a transaction described in § 351 ...." But, looking at the entities involved, this is really a ruling on a transaction described in Section 721 that involves the application of the "investment company" rules in Section 351; it is not a "transaction described in Section 351," and therefore it is not a

[3577] Shop Talk column, "Section 721(b)-A Partnership Issue, a Corporate Issue, or Just a Jumble?" *Journal of Taxation* (7/2020).

"no ruling" transaction. We note that the application of Section 721(b) occurs if the transfer "would be" a transfer to an investment company if the transferee partnership were incorporated (and therefore subject to indirect application of Section 351(e)).

So, it may be that, only in this bizzaro world of "would be" transfers that the federal income tax classification of an entity as a corporation or a partnership is conflated. One might also think that the addition of the statutory rules that look through an entity (rather than specify a corporation or partnership), which came 30 years after the regulations were issued, should mean that the regulatory rule should be read to refer to entities generically and not solely to corporations, as Reg. 1.351-1(c)(4) says on its face. However, the 1997 Blue Book (*i.e.*, the *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97) prepared by the Joint Committee on Taxation staff (12/17/1997) that accompanied the statutory change to Section 351(e) made by The Taxpayer Relief Act of 1997) at page 184 specifically states, "the Act did not override the rule that, for purposes of determining whether a corporation or partnership is an investment company, the assets of a corporation are treated as owned proportionally by any shareholder (whether a corporation or other entity) owning 50 percent or more of its stock (Treas. Reg. sec. 1.351-1(c)(4))." This sentence itself refers to "corporation or partnership" in one place but solely "corporation" in another, implicitly indicating a conscious differentiation. (On the other hand, as your editors have previously noted over the past 30 years, the legal effect of Blue Books was, is, and perhaps always will be, unclear. See, *e.g.*, Shop Talk, "What Will the TCJA Blue Book's Legal Effect Be?," 131 *JTAX* 32 (September 2019).)

This might leave one to wonder how the IRS was able to conclude that the look-through rule in the regulations could be applied to a partnership (ETO) when testing a transaction under Section 721(b). Other respected commentators indeed have been discussing this quandary. For example, Monte Jackel, while praising the policy rationale for Ltr. Rul. 202016013, called the issuance of this ruling "lawless behavior." Jackel, "Letter Ruling on PTP Look-Through Is Illegal," 2020 *TNTF* 77-12 (04/21/2020), Tax Notes Federal, 04/27/2020, p. 647. Robert Willens responded, indicating that he believed the "would be" language of Section 721(b) should also be applied to treat partnerships owned by the partnership receiving the contribution as also being corporations. Willens, "Willens Offers Possible Explanation for PTP Look-Through Ruling," 2020 *TNTF* 81-19 (04/27/2020), Tax Notes Federal, 04/27/2020, p. 649. Benjamin Willis added that he believed that the treatment of interests in a publicly traded partnership as "stock and securities" under Section 351(e)(1)(B)(iv) means that the partnership issuing those interests itself should be considered a corporation for the regulatory look-through rule. Willis, "Taking Stock of PTP Interests," 2020 *TNTF* 86-2, *Tax Notes Federal*, 05/04/2020, p. 825. Note that the three above-named commentators and others (including us) agree that the Service has reached the correct policy answer in applying the look-through rule to subsidiary partnerships. See, *e.g.*, Willis (Arthur, not Benjamin), Postlewaite & Alexander, *Partnership Taxation* Sec. 4.02 fn. 248; Lay and Scaramella, "IRS Ruling Looking Through Lower-Tier Publicly Traded Partnership for Purposes of Determining Investment Company Status," *J. Passthrough Entities*, Vol. 19, Issue 3 (May-June 2016), pg. 7. The crux of the debate (and this article) is, how do you get there?

While we would not go so far as to call the issuance of the ruling "lawless," the statutory language relied upon by Willens and Willis does not go so far as they would hope. Section 721(b) only directs the recipient partnership to be treated as incorporated, not any subsidiary of that partnership. Section 351(e)(1)(B)(iv) only directs the interests in a publicly traded partnership to be treated as stock and securities, which does not imply the issuing partnership is a corporation for purposes of the regulations, as supported by the above-discussed sentence in the 1997 Blue Book.

Willens and Willis reference Ltr. Rul. 201547003, which Willis supplements by citing to the nearly identical Ltr. Rul. 201633028. Ltr. Rul. 201547003, which reportedly appears to be the ruling obtained in connection with the proposed acquisition of Williams by ET, involved the potential contribution of interests in a publicly traded partnership (i.e., Williams) to another partnership (**i.e.**, ET) when the recipient partnership represented that it owned 50 percent or more of the total value of a subsidiary partnership (*i.e.*, ETO) and that it had no plan whereby the recipient partnership's direct ownership interest in the subsidiary partnership would become less than 50 percent of the total value of the equity interests outstanding in the subsidiary partnership. As in Ltr. Rul. 202016013, the IRS Chief Counsel's Corporate group ruled in both Ltr. Ruls. 201547003 and 201633028 that the recipient partnership's equity interest in the subsidiary partnership would be disregarded and the recipient partnership would be deemed to own its ratable share of the subsidiary partnership's assets for determining whether the recipient partnership is an investment company under Section 351(e). Neither Ltr. Rul. 201547003 nor Ltr. Rul. 201633028 reference Reg. 1.351-1(c)(4), which is explicitly relied upon in Ltr. Rul. 202016013.

II.M.3.b.ii. How Much Gain Triggered by Code § 721(b)

The Senate Explanation to P.L. 94-455 (10/4/1976) reproduced in RUA Checkpoint ¶ 7211.10, "Exchange funds," provides:

Partnership exchange funds.

The...amendment changes the rule...relating to nonrecognition of gain or loss on a contribution of property to a partnership in exchange for an interest in the partnership (sec. 721) by making an exception where a partner transfers property to a partnership which is an "investment company." If the partnership is an investment company after the exchange, the contributing partner must recognize gain (if any) which he realizes on the exchange. The...amendment thus requires the current taxation of gains realized by investors who transfer appreciated stocks or securities (or other property) to an exchange fund operated as a partnership.

The...amendment does not change present law with regard to losses, so that a loss realized on a contribution of stock or securities (or other property) to a partnership cannot be recognized at that time.

A partnership will be treated as an "investment company," for purposes of this provision, if it satisfies the definition of an investment company under the present rules relating to corporate exchange funds (sec. 351). The latter rules are set forth in detail in the regulations under section 351. Under these regulations, a partnership will be treated as an investment company if, after the exchange, over 80 percent of the value of its assets (excluding cash and nonconvertible debt obligations) are held for investment and are readily marketable stocks or securities (or interests in regulated investment companies or real estate investment trusts). The determination of whether a partnership is an investment company under this test will ordinarily be made immediately after the transfers of property under the same plan or as part of the same transaction.

In addition, for nonrecognition treatment to be denied, the transfers of property to the partnership must be found to result, directly or indirectly, in diversification of the transferors' interests. The amount and character of the gain which a partner must recognize under the bill are to be determined under...present law.

These rules are to apply both to limited partnerships and general partnerships, regardless whether the partnership is privately formed or publicly syndicated. They also require recognition of gain by a person who transfers nonpublicly-traded stocks or securities to a partnership which, after the transfer, meets the tests of an investment company.

As under the corporate rule, the property on which gain will be recognized is not limited to appreciated stocks or securities, but includes other types of property (such as real estate or other assets) if the partnership which receives the property is an investment company after the exchange.

Under the amendment, and except as provided below, a partnership may still be an investment company despite the existence of a special allocation among the partners as to income, gain, loss, or deduction items (sec. 704). In some situations, however, it might be proper to find that no diversification has occurred if the partnership agreement allocates income and gains (or losses) from specific property to the contributing partner and requires that a withdrawing partner be returned the property which he contributed originally.

The amendment will not affect the tax treatment of an investment partnership as a partnership for tax purposes; that is, whether it will be taxable as a partnership or as a corporate-type entity. That classification question will continue to be determined under section 7701...An exchange fund which is held to be taxable as a partnership will, however, be subject to the restriction imposed by this bill under section 721 (namely, that transfers of appreciated property to the fund will require recognition of gain if the partnership is otherwise an "investment company").

Rev. Rul. 68-55 involved the following facts:[3578]

Corporation Y was organized by X and A, an individual who owned no stock in X. A transferred 20x dollars to Y in exchange for stock of Y having a fair market value of 20x dollars and X transferred to Y three separate assets and received in exchange stock of Y having a fair market value of 100x dollars plus cash of 10x dollars.

Rev. Rul. 68-55 explains:

The first question presented is how to determine the amount of gain to be recognized under section 351(b) of the Code. The general rule is that each asset transferred must be considered to have been separately exchanged. See the authorities cited in Revenue Ruling 67-192 , C.B. 1967-2, 140, and in Revenue Ruling 68-23 , page 144, this Bulletin,

[3578] Rev. Rul. 85-164 amplified Rev. Rul. 68-55 by explaining the resulting basis and holding period of the assets involved.

> which hold that there is no netting of gains and losses for purposes of applying sections 367 and 356(c) of the Code. Thus, for purposes of making computations under section 351(b) of the Code, it is not proper to total the bases of the various assets transferred and to subtract this total from the fair market value of the total consideration received in the exchange. Moreover, any treatment other than an asset-by-asset approach would have the effect of allowing losses that are specifically disallowed by section 351(b)(2) of the Code.
>
> The second question presented is how, for purposes of making computations under section 351(b) of the Code, to allocate the cash and stock received to the amount realized as to each asset transferred in the exchange. The asset-by-asset approach for computing the amount of gain realized in the exchange requires that for this purpose the fair market value of each category of consideration received must be separately allocated to the transferred assets in proportion to the relative fair market values of the transferred assets. See section 1.1245-4(c)(1) of the Income Tax Regulations which, for the same reasons, requires that for purposes of computing the amount of gain to which section 1245 of the Code applies each category of consideration received must be allocated to the properties transferred in proportion to their relative fair market values….
>
> Under section 351(b)(2) of the Code the loss of 18x dollars realized on the exchange of Asset Number I is not recognized. Such loss may not be used to offset the gains realized on the exchanges of the other assets. Under section 351(b)(1) of the Code, the gain of 13x dollars realized on the exchange of Asset Number II will be recognized as short-term capital gain in the amount of 3x dollars, the amount of cash received. Under sections 351(b)(1) and 1245(b)(3) of the Code, the gain of 30x dollars realized on the exchange of Asset Number III will be recognized as ordinary income in the amount of 5x dollars, the amount of cash received.

Thus, only the assets deemed received in exchange for the undiversified contribution trigger gain. So, a large undiversified contribution that is deemed exchanged for a small amount of other assets will trigger gain proportionate to that small amount of other assets rather than triggering gain on all of the large undiversified contribution.

This approach is consistent with the Letter Ruling 200317011, which ruled that a pre-contribution exchange to make each partner's holdings proportionate to the other partner's holdings avoided diversification. The facts of Letter Ruling 200317011 were:

> Husband individually owns assets consisting of cash, shares of the Family Partnership, residential real estate, and certain stocks and bonds (collectively, "Husband's Individually Owned Assets"). Wife individually owns assets consisting of residential real estate and certain stocks and bonds (collectively, "Wife's Individually Owned Assets").
>
> Husband and Wife also own certain residential real estate as tenants-in-common (the "Jointly Owned Property"). There are more than two partners in Family Partnership.
>
> The following transaction has been proposed regarding Husband's Individually Owned Assets, Wife's Individually Owned Assets, and the Jointly Owned Property (collectively, the "Assets"):
>
> (i) Husband will transfer part of Husband's Individually Owned Assets and part of his interest in the Jointly Owned Property to Wife, and Wife will transfer part of Wife's

Individually Owned Assets and part of her interest in the Jointly Owned Property to Husband. Following this exchange (the Exchange), Husband will own an undivided r% interest in each of the Assets, and Wife will own an undivided s% interest in each of the Assets.

(ii) After the Exchange in step (i) above, Husband and Wife will contribute their respective interests in the Assets to Partnership, a limited partnership newly-formed under the laws of State (together, the "Contributions"). Under the terms of the agreement governing Partnership, Husband and Wife will be the general partners. Initially, the limited partners will be Husband and Wife. Husband and Wife will be Partnership's only partners.

(iii) Following the Contributions described in step (ii) above, Husband and Wife will each transfer his or her limited partner interest in Partnership to their respective revocable grantor trust(s).

(iv) Husband and Wife may, in the future, make gifts of some of their interests in Partnership to their children and grandchildren.

Letter Ruling 200317011 ruled:

> Here, Husband will transfer an interest in Husband's Individually Owned Assets and part of his interest in the Jointly Owned Property to Wife, and Wife will transfer an interest in Wife's Individually Owned Assets and part of her interest in the Jointly Owned Property to Husband. Following this exchange, Husband and Wife will each own a certain undivided interest in each of the Assets. Husband and Wife will then contribute their respective interests in each of the Assets to Partnership. Husband and Wife (and later revocable trusts of which Husband and Wife will be the sole owners) will be the only partners in Partnership.
>
> Based on the foregoing, we conclude, pursuant to § 1041(a) of the Code that no gain or loss shall be recognized on the Exchange of property between Husband and Wife.
>
> Based solely on the information submitted and on the authority set forth above, and provided that Husband and Wife are co-owners of each of the Assets immediately before the Contributions, we conclude that the Contributions are not transfers of property to a partnership that would be treated as an investment company (within the meaning of § 351) if Partnership were incorporated.
>
> Based on the foregoing, we conclude that § 721(b) does not apply to the proposed transaction and, pursuant to § 721(a), no gain or loss will be recognized by Husband or Wife if the transaction is consummated.

II.M.3.c. Exception: Triggering IRD

The sale or exchange of an item of income in respect of a decedent[3579] triggers income recognition.[3580]

[3579] See part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.
[3580] See part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up, especially fns. 2088-2089.

Triggering income may convert the item to a capital asset.[3581]

II.M.3.d. Exception: Liability Shifts

Another exception to the general nonrecognition rule of Code § 721(a) can occur when a partner's share of liability in the partnership shifts. If a partner's share of liabilities increases, that increase is treated as hypothetical cash contribution and the partner's partnership interest basis is increased by that amount, but no immediate tax consequences occur.[3582] However, if the partner's share of liability decreases, then the decrease is treated as a hypothetical cash distribution, the partner's partnership interest's basis is decreased, and the partner must recognize gain to the extent the hypothetical distribution is greater than the partner's basis in such partner's partnership interest immediately before the deemed distribution.[3583] One situation that could lead to an increase or decrease in partnership liabilities is when a partner contributes to the partnership property subject to a liability. In such a case, the partner's partnership interest basis is increased to the extent of the partner's allocated share of liabilities, but is also decreased by the amount of the liability that is allocated to the other partners. The net result could be a decrease in the partner's share of partnership liabilities, which could lead to gain recognition.[3584]

August, "The Debt Cancellation Culture of Section 108: Tax Hurdles for Partnerships Engaged in Debt Workouts," *Corporate Taxation* (WG&L), Sep/Oct 2023, explains "Contribution of Encumbered Property by a Partner or Newly Admitted Partner":

> It is possible for a partnership workout to result in a partner or newly admitted partner's contribution of appreciated real property encumbered by a mortgage. Section 721 will generally protect the contributing partner from gain (or loss) and provide for a carryover of basis under Section 722 . Exception is provided for the net reduction in the transferor's liabilities as a result of applying Section 752 , resulting in the contributing partner's recognizing gain.[81] Who knows, perhaps the disguised sale rules will be applied by the Service where the transferred debt is "non-qualified."[82] Indeed, where a partnership assumes or takes property subject to a liability of the partner other than a

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[3581] See part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up, fn. 2089, cross-referencing part II.G.8 Code § 165(a) Loss for Worthlessness; Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy.

[3582] Code § 752(a); Code § 722.

[3583] Code § 752(b); Code § 731(a).

[3584] Reg. § 1.752–1(f). Generally, the allocation rules for nonrecourse liabilities will prevent the hypothetical distribution amount to the contributing partner from exceeding the basis of the contributing partner's partnership interest. Reg. § 1.752-3(a). Often, the contributing partner's Code § 704(c) responsibility will cause the contributing partner to be allocated nonrecourse debt sufficient to take care of this issue. Reg. § 1.752-3(a)(2). Additionally, if the partner contributes property subject to a recourse liability and the property remains recourse only to him, there will be no hypothetical distribution and no related recognition. Reg. § 1.752-1(g), Ex. 1. If the debt is part recourse and part nonrecourse, it is bifurcated. Reg. § 1.752-1(i). See also T.D. 9207 (5/23/2005), promulgating Reg. §§ 1.752-6 and 1.752-7 regarding certain assumptions of liability. See also Rubin, Whiteway, and Finkelstein, Recourse or Nonrecourse, That Is the Question, *TM Memorandum* (BNA) (Vol. 51, No. 17, 8/16/2010). See also Harris, I Am Not My Brother's Keeper and Other Lessons From the Related-Party Rules of Section 752, *Journal of Taxation* (Jan. 2011). For a scathing critique of proposed regulations under Code § 752, see Lipton, Proposed Regulations on Debt Allocations: Controversial, and Deservedly So, *Journal of Taxation* (WG&L), Vol. 120, No. 4 (April 2014); the proposed regulations were converted into final and temporary regulations in October 2016 (see part II.C.3 Allocating Liabilities (Including Debt)), but I have not analyzed how the changes responded to the criticism.

qualified liability, the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes or takes subject to the liability as provided in the disguised sale regulations to Section 707.

[81] Compare Section 351 in general, as well as Sections 357(c) and (d) for contributions of encumbered property to a corporation. It is also possible that Section 357(b) may be an issue.

[82] Reg. 1.707-5(a)(1). The assumption by the partnership of a "qualified liability," in contrast with non-qualified debt, will not be treated as a distribution unless the transfer is otherwise a disguised sale. See Regs. 1.707-3(b)(2), 1.707-5(a)(5) . There is also the prospect to structure the transaction as a debt-financed distribution in accordance with Reg. 1.707-5(b)(1). See *Tribune Media Co.*, TC Memo 2021-122 ; Commentary, Parillo, "Tax Pros Speculate on IRS's Appeal of Tribune Media," Tax Notes Federal, 2/6/2023, p. 905; Parillo, "DOJ's Anti-Abuse Argument in Tribune Media Is Off Base, Say Critics," Tax Notes Federal, 6/5/2023, p. 1738.

See parts II.M.2 Buying into or Forming a Corporation (including subparts discussing Code §§ 351 and 357) and II.M.3.e Exception: Disguised Sale Rules.

II.M.3.e. Exception: Disguised Sale Rules

Reg § 1.731-1(c)(3) provides:

> If there is a contribution of property to a partnership and within a short period:
>
> (i) Before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or
>
> (ii) After such contribution the contributed property is distributed to another partner,
>
> such distribution may not fall within the scope of section 731. Section 731 does not apply to a distribution of property, if, in fact, the distribution was made in order to effect an exchange of property between two or more of the partners or between the partnership and a partner. Such a transaction shall be treated as an exchange of property.

Code § 707(a)(2) provides:

> Under regulations prescribed by the Secretary—
>
> (B) *Treatment of certain property transfers*. If-
>
> (i) there is a direct or indirect transfer of money or other property by a partner to a partnership,
>
> (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and

(iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property,

such transfers shall be treated either as a transaction described in paragraph (1) or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

Together with cases and other authority, these statutes set the stage for parts:

- II.M.3.e.i Disguised Sale When Partner Who Contributes Property Receives a Distribution,
- II.M.3.e.ii Disguised Sale When One Partner Contributes Property and Another Receives a Distribution, and
- II.Q.8.b.i.(c) Disguised Sale from Partnership to Partner.

II.M.3.e.i. Disguised Sale When Partner Who Contributes Property Receives a Distribution

Another case in which a partnership contribution can lead to tax consequences is when a partner transfers property to the partnership and there is a related transfer back to the partner, which falls outside the scope of part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions. When a partner receives a direct or indirect transfer of money or other property related to a transfer that partner made to the partnership, the transfer can be treated as a sale or exchange of property between partner and the partnership;[3585] furthermore, if a partner contributes cash in connection with a distribution of property, the partnership may be treated as making a disguised

[3585] Code § 707(a)(2) and Reg. § 1.707-3(b). Reg. § 1.707-3(f), Example (1) describes the consequences of a transfer that is partly a sale and partly a transfer for a partnership interest.
For more on whether a transfer is a disguised sale, see A Tale of Two Cases: G-I Holdings and Virginia Historic Tax Credit Fund—Can They Both Be Right?, *Journal of Taxation* (Mar. 2010), discussing *In re: G-I Holdings, Inc.*, 105 AFTR.2d 2010-697 (D. N.J. 2009) and *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, T.C. Memo. 2009-295, in which the authors conclude, Taxpayers should be heartened by the court's rulings in these cases because they illustrate that partnership transactions structured with undeniable elements of risk sharing and recourse financing should be respected by the courts and the Service, but then caution that, If a taxpayer wishes to structure certain types of leveraged partnership transactions to minimize the risk of an economic substance challenge by the Service, care should be taken that any such arrangement involves the bearing of both risks and benefits—including having the loan structured as a recourse obligation of a creditworthy party. However, *Virginia Historic Tax* was reversed, 639 F.3d 129 (4th Cir. 2011); the Fourth Circuit's holding was followed in *Route 231, LLC v. Commissioner*, T.C. Memo. 2014-30, *aff'd* 810 F.3d 247 (4th Cir. 2016), and *SWF Real Estate LLC v. Commissioner*, T.C. Memo. 2015-63. See *Canal Corporation v. Commissioner*, 135 T.C. 199 (2010), characterizing a transaction as a disguised sale (transfer to partnership of assets worth $775 million, simultaneously receiving a $755 million cash distribution from the partnership) and imposing a substantial understatement penalty when the taxpayer relied on a tax opinion for which the taxpayer paid an $800,000 contingent fee, the sole contingency being the issuance of a should opinion; the court cited several cases preventing a taxpayer from relying on opinions given by promoters of various transactions. See also the anti-abuse regulations, Reg. § 1.701-2, under which transactions could be recharacterized to the extent not expressly addressed by exceptions to the disguised sale rules. For a critical analysis of *Canal Corporation v. Commissioner*, see Rubin, Whiteway, and Finkelstein, Partnership Tax Planning: Navigating the Canal, *Practical Tax Strategies*, Vol. 90, No. 5 (5/2013) (although the IRS won that case, a carefully structured leveraged partnership transaction should survive judicial scrutiny).

sale of the property to the partner.[3586] Also, TAM 9510002 asserts that, if a taxpayer merely receives consideration for agreeing to enter into a partnership and transfer property to it and that transaction is found to be separate and distinct from the subsequent transfer of property to the partnership and a later partnership distribution, the entire amount received for agreeing to enter the partnership is taxable as ordinary income in the year received.

Reg. § 1.707-3(b), "Transfers treated as a sale," provides:

(1) *In general*. A transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if based on all the facts and circumstances -

(i) The transfer of money or other consideration would not have been made but for the transfer of property; and

(ii) In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

(2) *Facts and circumstances*. The determination of whether a transfer of property by a partner to the partnership and a transfer of money or other consideration by the partnership to the partner constitute a sale, in whole or in part, under paragraph (b)(1) of this section is made based on all the facts and circumstances in each case. The weight to be given each of the facts and circumstances will depend on the particular case. Generally, the facts and circumstances existing on the date of the earliest of such transfers are the ones considered in determining whether a sale exists under paragraph (b)(1) of this section. Among the facts and circumstances that may tend to prove the existence of a sale under paragraph (b)(1) of this section are the following:

(i) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

(ii) That the transferor has a legally enforceable right to the subsequent transfer;

(iii) That the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;

(iv) That any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;

(v) That any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;

[3586] See part II.Q.8.b.i.(c) Disguised Sale from Partnership to Partner.

(vi) That the partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);

(vii) That the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);

(viii) That partnership distributions, allocations or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

(ix) That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and

(x) That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

II.M.3.e.i.(a). Distributions Presumed to Be Disguised Sales

Transfers to the contributing partner are presumed to be a sale or exchange if made within two years of one another, unless the facts and circumstances clearly establish the transfers were not a sale or exchange;[3587] however, the presumption of no disguised sale can be rebutted, particularly by step transaction principles.[3588] Among the facts and circumstances that may tend to prove the existence of a disguised sale are the following:[3589]

[3587] Reg. § 1.707-3(c)(1).

[3588] In Reg. § 1.701-2(d), Example (8), a three-year wait did not prevent a pre-arranged transaction from constituting a disguised sale.

[3589] Reg. § 1.707-3(b)(2). *Gateway Hotel Partners, LLC v. Commissioner*, T.C. Memo. 2014-5, applied this test, giving greatest weight to the first two factors under those particular circumstance, to find that no disguised sale had occurred. See Lipton, *Gateway Hotel Partners*: Decision Illustrates the Disguised Sale Quandary, *Journal of Taxation* (7/2014), offering tips in addition to analyzing the law:

> It was also interesting to observe the manner in which the court and the IRS reviewed all of the documents involved in the transaction. The IRS was essentially looking for a gotcha document to support its argument that the transaction should be subject to different tax consequences, while the taxpayer had to defend each of the relevant documents and explain some apparent inconsistencies. It probably would have been better for the taxpayer if it had entered into some type of master agreement explaining the manner in which the transaction documents should be interpreted, thereby assuring that any minor inconsistencies (such as language in resolutions) could not be used as a basis to completely alter the tax consequences of the transaction. When a transaction has numerous complex steps (as these transactions did), the language of the transaction may appear to have a plain meaning to the drafter of the transaction but ambiguities will almost certainly appear with hindsight. The court appeared to address the various ambiguities so as to reach the right result, but the taxpayer would likely have saved substantial

(i) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

(ii) That the transferor has a legally enforceable right to the subsequent transfer;

(iii) That the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;

(iv) That any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;

(v) That any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;

(vi) That the partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);

(vii) That the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);

(viii) That partnership distributions, allocations or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

(ix) That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and

(x) That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

This rule can be especially important when a partner contributes to the partnership property subject to a liability. If the partnership assumes or takes subject to the liability, the transfer may be considered a sale and some or all of the liability amount may be treated as consideration received by the contributing partner.[3590] If the liability assumed or taken subject to is considered

money (in legal fees) and have had much less heartburn if there had been an overriding document that explained how all of the various transaction documents should have been interpreted.

[3590] Reg. § 1.707-5.

a "qualified liability"[3591] (and refinancing a qualified liability - or the transfer of a liability in conjunction with the transfer of a business it historically financed - does not appear to change its character),[3592] then the liability is not treated as consideration for a sale unless some other reason exists for the transfer to be treated as such.[3593] If the liability is not a qualified liability, then the partner is treated as having received consideration for his transfer to the extent the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes or takes subject to the liability.[3594] My understanding is that liabilities that are not qualified liabilities can surprisingly change the calculations that would apply relative to involving only qualified liabilities.[3595] Generally,[3596] a partner steps in the shoes of a person for

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3591 Reg. § 1.707-5(a)(6)(i) describes qualified liabilities as:

(A) A liability that was incurred by the partner more than two years before the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property throughout that two-year period;

(B) A liability that was not incurred in anticipation of the transfer of the property to a partnership, but that was incurred by the partner within the two-year period before the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property since it was incurred (additional rules apply to a liability incurred within two years of a property transfer or of a written agreement to transfer);

(C) A liability that is allocable under the rules of Reg. § 1.163-8T to capital expenditures (as described under Reg. § 1.707-4(d)(5)) with respect to the property;

(D) A liability that was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held, but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business; or

(E) A liability that was not incurred in anticipation of the transfer of the property to a partnership, but that was incurred in connection with a trade or business in which property transferred to the partnership was used or held, but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business (additional rules apply to a liability incurred within two years of a transfer presumed to be in anticipation of the transfer)….

If the liability is a recourse liability, the amount of the liability cannot exceed the fair market value of the transferred property (less the amount of any other liabilities that are senior in priority and that either encumber such property or are certain other liabilities) at the time of the transfer. Reg. § 1.707-5(a)(6)(ii).

3592 Qualified liabilities do not lose their character as such by being transferred, along with related business assets, to a disregarded entity that is then contributed to the partnership. Letter Ruling 201714028, which (subject to various representations) held the following to constitute qualified liabilities under Reg. § 1.707-5(a)(6)(i)(E) (highlighting added):

> All of the Liabilities were incurred more than f years before the proposed Transfer. Some of the Liabilities were originally incurred to make distributions in connection with Company's formation on D1 and have been subsequently refinanced. The remaining balance of the Liabilities have been used to acquire assets, make improvements, pay expenses, and otherwise operate Company's business and that of its subsidiaries, including to refinance other liabilities incurred for the same purposes. Company has also regularly distributed cash to its members in proportion to their ownership interests. Those cash distributions, however, have been less than Company's earnings. The Liabilities (and the liabilities they refinanced) are an integral part of Company's existing and historical capital structure.

3593 Reg. § 1.707-5(a)(5)(i).

3594 Reg. § 1.707-5(a)(1).

3595 Recorded discussion of these rules at the American Bar Association Section on Taxation's Midyear (January) 2017 meeting.

3596 The exception is Reg. § 1.707-5(e)(2), which provides:

> If an interest in a partnership that has one or more liabilities (the lower-tier partnership) is transferred to another partnership (the upper-tier partnership), the upper-tier partnership's share

purposes of Reg. § 1.707-5(a) with respect to a liability the person incurred or assumed to the extent the partner assumed or took property subject to the liability from the person in a nonrecognition transaction described in Code § 351,[3597] 381(a), 721,[3598] or 731.[3599]

Reg. § 1.707-5(a)(2), "Partner's share of liability," provides that a partner's share of any liability of the partnership is determined under the following rules:

(i) *Recourse liability*. A partner's share of a recourse liability of the partnership equals the partner's share of the liability under the rules of section 752 and the regulations in this part under section 752. A partnership liability is a recourse liability to the extent that the obligation is a recourse liability under § 1.752-1(a)(1) or would be treated as a recourse liability under that section if it were treated as a partnership liability for purposes of that section.

(ii) *Nonrecourse liability*. A partner's share of a nonrecourse liability of the partnership is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under § 1.752-3(a)(3). A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability under § 1.752-1(a)(2) or would be a nonrecourse liability of the partnership under § 1.752-1(a)(2) if it were treated as a partnership liability for purposes of that section.

For Code § 752 and the regulations thereunder, see part II.C.3.c Allocations of Recourse and Nonrecourse Liabilities.

When revising Reg. § 1.707-5(a)(2) to provide as above, T.D. 9876, "Removal of Temporary Regulations on a Partner's Share of a Partnership Liability for Disguised Sale Purposes," RIN 1545-BO05 (10/9/2019), also revised the following provisions of Reg. § 1.707-5(f):

(2) *Example (2)*. *Partnership's assumption of recourse liability encumbering transferred property*.

(i) C transfers property Y to a partnership. At the time of its transfer to the partnership, property Y has a fair market value of $10,000,000 and is subject to an $8,000,000 liability that C incurred, immediately before transferring property Y to the partnership, in order to finance other expenditures. Upon the transfer of property Y to the partnership, the partnership assumed the liability encumbering

of any liability of the lower-tier partnership that is treated as a liability of the upper-tier partnership under § 1.752-4(a) is treated as a qualified liability under paragraph (a)(6)(i) of this section to the extent the liability would be a qualified liability under paragraph (a)(6)(i) of this section had the liability been assumed or taken subject to by the upper-tier partnership in connection with a transfer of all of the lower-tier partnership's property to the upper-tier partnership by the lower-tier partnership. For purposes of determining whether the liability constitutes a qualified liability under paragraphs (a)(6)(i)(B) and (E) of this section, a determination that the liability was not incurred in anticipation of the transfer of property to the upper-tier partnership is based on whether the partner in the lower-tier partnership anticipated transferring its interest in the lower-tier partnership to the upper-tier partnership at the time the liability was incurred by the lower-tier partnership.

[3597] See part II.M.2 Buying into or Forming a Corporation.

[3598] See part II.M.3 Buying into or Forming a Partnership.

[3599] Reg. § 1.707-5(a)(8). For Code § 731, see part II.Q.8.b.i Distribution of Property by a Partnership.

that property. The partnership assumed this liability solely to acquire property Y. Under section 752 and the regulations in this part under section 752, immediately after the partnership's assumption of the liability encumbering property Y, the liability is a recourse liability of the partnership and C's share of that liability is $7,000,000.

(ii) Under the facts of paragraph (f)(2)(i) of this section (Example 2), the liability encumbering property Y is not a qualified liability. Accordingly, the partnership's assumption of the liability results in a transfer of consideration to C in connection with C's transfer of property Y to the partnership in the amount of $1,000,000 (the excess of the liability assumed by the partnership ($8,000,000) over C's share of the liability immediately after the assumption ($7,000,000)). See paragraphs (a)(1) and (2) of this section.

(3) *Example (3)*. *Subsequent reduction of transferring partner's share of liability*.

(i) The facts are the same as in paragraph (f)(2) of this section (Example 2). In addition, property Y is a fully leased office building, the rental income from property Y is sufficient to meet debt service, and the remaining term of the liability is ten years. It is anticipated that, three years after the partnership's assumption of the liability, C's share of the liability under section 752 will be reduced to zero because of a shift in the allocation of partnership losses pursuant to the terms of the partnership agreement. Under the partnership agreement, this shift in the allocation of partnership losses is dependent solely on the passage of time.

(ii) Under paragraph (a)(3) of this section, if the reduction in C's share of the liability was anticipated at the time of C's transfer, was not subject to the entrepreneurial risks of partnership operations, and was part of a plan that has as one of its principal purposes minimizing the extent of sale treatment under § 1.707-3 (that is, a principal purpose of allocating a large percentage of losses to C in the first three years when losses were not likely to be realized was to minimize the extent to which C's transfer would be treated as part of a sale), C's share of the liability immediately after the assumption is treated as equal to C's reduced share.

(7) *Example (7)*. *Partnership's assumptions of liabilities encumbering properties transferred pursuant to a plan*.

(i) Pursuant to a plan, G and H transfer property 1 and property 2, respectively, to an existing partnership in exchange for interests in the partnership. At the time the properties are transferred to the partnership, property 1 has a fair market value of $10,000 and an adjusted tax basis of $6,000, and property 2 has a fair market value of $10,000 and an adjusted tax basis of $4,000. At the time properties 1 and 2 are transferred to the partnership, a $6,000 nonrecourse liability (liability 1) is secured by property 1 and a $7,000 recourse liability of F (liability 2) is secured by property 2. Properties 1 and 2 are transferred to the partnership, and the partnership takes subject to liability 1 and assumes liability 2. G and H incurred liabilities 1 and 2 immediately prior to transferring properties 1 and 2 to the partnership and used the proceeds for personal expenditures. The liabilities are not qualified liabilities. Assume that G and H are each allocated $2,000 of liability 1 in accordance with paragraph (a)(2)(ii) of this section (which determines a partner's share of a nonrecourse liability). Assume further that G's share of liability 2 is $3,500 and H's share is $0 in accordance with paragraph (a)(2)(i) of this section (which determines a partner's share of a recourse liability).

(ii) G and H transferred properties 1 and 2 to the partnership pursuant to a plan. Accordingly, the partnership's taking subject to liability 1 is treated as a transfer of only $500 of consideration to G (the amount by which liability 1 ($6,000) exceeds G's share of liabilities 1 and 2 ($5,500)), and the partnership's assumption of liability 2 is treated as a transfer of only $5,000 of consideration to H (the amount by which liability 2 ($7,000) exceeds H's share of liabilities 1 and 2 ($2,000)). G is treated under the rule in § 1.707-3 as having sold $500 of the fair market value of property 1 in exchange for the partnership's taking subject to liability 1 and H is treated as having sold $5,000 of the fair market value of property 2 in exchange for the assumption of liability 2.

(8) *Example (8*). *Partnership's assumption of liability pursuant to a plan to avoid sale treatment of partnership assumption of another liability*.

(i) The facts are the same as in paragraph (f)(7) of this section (Example 7), except that—

(A) H transferred the proceeds of liability 2 to the partnership; and

(B) H incurred liability 2 in an attempt to reduce the extent to which the partnership's taking subject to liability 1 would be treated as a transfer of consideration to G (and thereby reduce the portion of G's transfer of property 1 to the partnership that would be treated as part of a sale).

(ii) Because the partnership assumed liability 2 with a principal purpose of reducing the extent to which the partnership's taking subject to liability 1 would be treated as a transfer of consideration to G, liability 2 is ignored in applying paragraph (a)(3) of this section. Accordingly, the partnership's taking subject to liability 1 is treated as a transfer of $4,000 of consideration to G (the amount by which liability 1 ($6,000) exceeds G's share of liability 1 ($2,000)). On the other hand, the partnership's assumption of liability 2 is not treated as a transfer of any consideration to H because H's share of that liability equals $7,000 as a result of H's transfer of $7,000 in money to the partnership.

Reg. § 1.707-9(a)(4) provides effective dates for Reg § 1.707-5(a)(2) and (f)(2), (3), (7), and (8).

If within a two-year period a partner incurs certain types of liability and transfers property to a partnership or agrees in writing to transfer the property, and in connection with the transfer the partnership assumes or takes the property subject to the liability, the liability is presumed to be incurred in anticipation of the transfer unless the facts and circumstances clearly establish that the liability was not incurred in anticipation of the transfer.[3600] Liabilities to fund various preformation expenditures may be excluded from liabilities deemed to have been relieved under

[3600] Reg. § 1.707-5(a)(7)(i).

the disguised sale rules.[3601] If a partner treats a liability assumed or taken subject to by a partnership in connection with a transfer of property as a certain type of qualified liability and the partner incurred the liability within the two-year period before the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership, see part II.M.3.e.i.(c) Disclosure Requirements.

If a partner contributes property and the partnership incurs indebtedness, seeking to allocate that debt to the contributing partner to support a distribution to that partner, the IRS might argue that the debt should not have been allocated to that partner.[3602] Also, some of the rules for allocating nonrecourse debt do not apply for purposes of the disguised sale rules, leading to surprisingly unfavorable results.[3603] T.D. 9788 (10/5/2016) explained:

> … for disguised sale purposes only, it is appropriate for partners to determine their share of any partnership liability, whether recourse or nonrecourse under section 752, in the manner in which excess nonrecourse liabilities are allocated under Sec. 1.752-3(a)(3),

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[3601] Reg. § 1.707-4(d)(1) provides:

(1) *In general*. A transfer of money or other consideration by the partnership to a partner is not treated as part of a sale of property by the partner to the partnership under § 1.707-3(a) (relating to treatment of transfers as a sale) to the extent that the transfer to the partner by the partnership is made to reimburse the partner for, and does not exceed the amount of, capital expenditures that—

- (i) Are incurred during the two-year period preceding the transfer by the partner to the partnership; and
- (ii) Are incurred by the partner with respect to—
  - (A) Partnership organization and syndication costs described in section 709; or
  - (B) Property transferred to the partnership by the partner, but only to the extent the reimbursed capital expenditures do not exceed 20 percent of the fair market value of such property at the time of the transfer (the 20-percent limitation). However, the 20-percent limitation of this paragraph (d)(1)(ii)(B) does not apply if the fair market value of the transferred property does not exceed 120 percent of the partner's adjusted basis in the transferred property at the time of the transfer (the 120-percent test). This paragraph (d)(1)(ii)(B) shall be applied on a property-by-property basis, except that a partner may aggregate any of the transferred property under this paragraph (d)(1) to the extent—
    - (1) The total fair market value of such aggregated property (of which no single property's fair market value exceeds 1 percent of the total fair market value of such aggregated property) is not greater than the lesser of 10 percent of the total fair market value of all property, excluding money and marketable securities (as defined under section 731(c)), transferred by the partner to the partnership, or $1,000,000;
    - (2) The partner uses a reasonable aggregation method that is consistently applied; and
    - (3) Such aggregation of property is not part of a plan a principal purpose of which is to avoid §§ 1.707-3 through 1.707-5.
  - (C) [Reserved].

For a discussion of how this rule works, listen to recordings (primarily Part 2) of "New Partnership Regulations under Sections 707 and 752," a discussion at the January 2017 meeting of the ABA's Section on Taxation that included those who write the regulations, and see slides 15-22 in "New Partnership Regulations under Sections 707 and 752," the latter saved as Thompson Coburn LLP doc. no. 6591807. That discussion also covers the remaining paragraphs of Reg. § 1.707-4(d).

[3602] CCA 201324013.

[3603] See part II.C.3.c.iii Allocating Nonrecourse (Remaining) Liabilities, especially fn. 441 and the accompanying text.

> as limited for disguised sale purposes in the 752 Final Regulations. For purposes of the disguised sale rules, this allocation method reflects the overall economic arrangement of the partners more accurately than the current regulations or the 2014 Proposed Regulations. In most cases, a partnership will satisfy its liabilities with partnership profits, the partnership's assets do not become worthless, and the payment obligations of partners or related persons are not called upon. This is true whether: (1) A partner's liability is assumed by a partnership in connection with a transfer of property to the partnership or by a partner in connection with a transfer of property by the partnership to the partner; (2) a partnership takes property subject to a liability in connection with a transfer of property to the partnership or a partner takes property subject to a liability in connection with a transfer of property by the partnership to the partner; or (3) a liability is incurred by the partnership to make a distribution to a partner under the debt-financed distribution exception in Sec. 1.707-5(b). Accordingly, under the 707 Temporary Regulations, a partner's share of any partnership liability for disguised sale purposes is the same percentage used to determine the partner's share of the partnership's excess nonrecourse liabilities under Sec. 1.752-3(a)(3), as limited for disguised sale purposes under the 752 Final Regulations.
>
> … the 707 Temporary Regulations provide that a partner's share of a partnership liability for disguised sale purposes does not include any amount of the liability for which another partner bears the [economic risk of loss] for the partnership liability under Sec. 1.752-2.
>
> The liability allocation approach for disguised sale purposes in the 707 Temporary Regulations does not conflict with Congress's directive relating to section 752, which had been raised as a potential concern by some commenters with respect to the 2014 Proposed Regulations. Section 79 of the Deficit Reduction Act of 1984 (Pub. L. 98-369) overruled the decision in *Raphan v. United States*, 3 Cl. Ct. 457 (1983) (holding that a guarantee by a general partner of an otherwise nonrecourse liability of the partnership did not require the partner to be treated as personally liable for that liability) and directed the Secretary of the Treasury to amend the regulations under section 752 to reflect the overruling of the *Raphan* decision. At issue in the *Raphan* case was debt allocation under section 752; accordingly, Congress's directive related to regulations under section 752 only. As noted, the 707 Temporary Regulations treat all partnership liabilities, whether recourse or nonrecourse, as nonrecourse liabilities solely for purposes of section 707. Thus, the approach adopted in the 707 Temporary Regulations does not conflict with the approach directed by Congress after the *Raphan* case.

For an explanation of unfair and surprising consequences of applying this rule to nonrecourse debt guaranteed by a partner and a criticism of this rule, see Smith, "Temporary disguised-sale regulations raise concerns," *The Tax Adviser* (7/2017), saved as Thompson Coburn LLP doc. no. 6599934.

Tribune Media Company v. Commissioner, T.C. Memo. 2021-122, held that purported debt intended to reduce gain on an admitted disguised sale (as permitted by Reg. § 1.707-5(b)(1)) was really equity, applying *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 493 (1980).[3604]

For more general rules, see part II.C.3 Allocating Liabilities (Including Debt). "New Partnership Regulations under Sections 707 and 752," a discussion at the January 2017 meeting of the

[3604] See part II.G.20.b When Debt Is Recharacterized as Equity.

ABA's Section on Taxation that included those who write the regulations, discussed 2016 changes to regulations and included slides with charts explaining some key changes.[3605]

II.M.3.e.i.(b). Distributions Presumed Not to Be Disguised Sales

Certain distributions are *presumed* not to constitute disguised sales, subject to certain limitations described further below:

- 150% of AFR.[3606] If the written partnership agreement characterizes a cash distribution as a preferred return[3607] or a guaranteed payment for capital and this distribution is a payment for the use of capital in a reasonable amount,[3608] it is presumed not to be part of a sale of property to the partnership unless the facts and circumstances[3609] clearly establish that the transfer is part of a sale.[3610] A preferred return or guaranteed payment for capital is reasonable in amount if the sum of any such distributions payable for that year do not exceed the amount determined by multiplying either the partner's capital[3611] by 150% of the AFR.[3612]

  - Operating Cash Flow Distributions. An operating cash flow distribution is presumed not to be part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is part of a sale.[3613] If the partnership agreement characterizes a payment as a distribution to a partner, then the payment is an operating cash flow distribution to the extent it does not exceed the partnership's net cash flow from operations for the year multiplied by the lesser of (a) the partner's percentage

[3605] The text above references a two-part panel discussion chaired by Eric Sloan. The slides, "New Partnership Regulations under Sections 707 and 752," are saved as Thompson Coburn LLP doc. no. 6591807.
[3606] AFR refers to the applicable federal rate as defined under Code § 1274, which applies for Code § 7872 as well as in other contexts.
[3607] As used here, preferred return means a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain.
[3608] Reg. § 1.707-4(a)(3)(i).
[3609] Including the likelihood and expected timing of the subsequent allocation of income or gain to support the preferred return. Reg. § 1.707-4(a)(2).
[3610] Reg. § 1.707-4(a)(2).
[3611] Based on the partner's unreturned capital at the beginning of the year or, at the partner's option, the partner's weighted average capital balance for the year (with either amount appropriately adjusted, taking into account the relevant compounding periods, to reflect any unpaid preferred return or guaranteed payment for capital that is payable to the partner). A partner's unreturned capital equals the excess of the aggregate amount of money and the fair market value of other consideration (net of liabilities) contributed by the partner to the partnership over the aggregate amount of money and the fair market value of other consideration (net of liabilities) distributed by the partnership to the partner other than transfers of money that are presumed to be reasonable guaranteed payments for capital under Reg. § 1.707-4(a)(1)(ii), transfers of money that are reasonable preferred returns within the meaning of Reg. § 1.707-4(a)(3), and operating cash flow distributions within the meaning of Reg. § 1.707-4(b)(2) (described below). Reg. § 1.707-4(a)(3)(ii).
[3612] Reg. § 1.707-4(a)(3)(ii). The regulation refers to a safe harbor interest rate, which for a partnership's taxable year equals 150% of the highest AFR, at the appropriate compounding period or periods, in effect at any time from the time that the right to the preferred return or guaranteed payment for capital is first established pursuant to a binding, written agreement among the partners through the end of the taxable year.
[3613] Reg. § 1.707-4(b)(1). This exception is especially helpful in preferred partnerships, as described in part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

interest in overall partnership profits for that year, or (b) the partner's percentage interest in overall partnership profits for the partnership's life.[3614] The partnership's net cash flow from operations for a taxable year is an amount equal to the partnership's taxable income or loss arising in the ordinary course of the partnership's business and investment activities:[3615]

- Increased by tax exempt interest, depreciation, amortization, cost recovery allowances and other noncash charges deducted in determining such taxable income, and
- Decreased by:
  - Principal payments made on any partnership indebtedness,
  - Property replacement or contingency reserves actually established by the partnership,
  - Capital expenditures when made other than from reserves or from borrowings the proceeds of which are not included in operating cash flow, and
  - Any other cash expenditures (including preferred returns) not deducted in determining such taxable income or loss.

I tend to suggest preferred returns of operating cash flow over guaranteed payments.[3616] Unfortunately, Reg. § 1.707-4(b)(2)(i) views operating cash flow distributions as protected only "to the extent they do not exceed the product of the net cash flow of the partnership from operations for the year multiplied by the lesser of the partner's percentage interest in overall partnership profits for that year or the partner's percentage interest in overall partnership profits for the life of the partnership."[3617] Presumably, needing to look at the partner's percentage

[3614] Reg. § 1.707-4(b)(2)(i). Without limiting the choices a partner may make in applying this rule, in determining a partner's operating cash flow distributions for a taxable year the partner may use the partner's smallest percentage interest under the terms of the partnership agreement in any material item of partnership income or gain that may be realized by the partnership in the three-year period beginning with that taxable year. Reg. § 1.707-4(b)(2)(ii). In the case of tiered partnerships, the upper-tier partnership must take into account its share of the net cash flow from operations of the lower-tier partnership applying principles similar to those described in Reg. § 1.707-4(b)(2)(i), so that the amount of the upper-tier partnership's operating cash flow distributions is neither overstated nor understated. Reg. § 1.707-4(b)(2)(iii).

[3615] Reg. § 1.707-4(b)(2)(i).

[3616] See fn. 2216. See part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

[3617] Reg. § 1.707-4(b)(2)(i) continues:

> For purposes of the preceding sentence, the net cash flow of the partnership from operations for a taxable year is an amount equal to the taxable income or loss of the partnership arising in the ordinary course of the partnership's business and investment activities, increased by tax exempt interest, depreciation, amortization, cost recovery allowances and other noncash charges deducted in determining such taxable income and decreased by -
> (A) Principal payments made on any partnership indebtedness;
> (B) Property replacement or contingency reserves actually established by the partnership;
> (C) Capital expenditures when made other than from reserves or from borrowings the proceeds of which are not included in operating cash flow; and
> (D) Any other cash expenditures (including preferred returns) not deducted in determining such taxable income or loss.

interest in overall partnership profits for the life of the partnership means that, when the partnership interest is issued, there should be no intent to redeem the partnership interest or waterfalls that cap cumulative payments (the latter meaning that the percentage interest would decrease in later years).

Reg. § 1.707-4(b)(2)(i), "Operating cash flow safe harbor," explains:

> For any taxable year, in determining a partner's operating cash flow distributions for the year, the partner may use the partner's smallest percentage interest under the terms of the partnership agreement in any material item of partnership income or gain that may be realized by the partnership in the three-year period beginning with such taxable year. This provision is merely intended to provide taxpayers with a safe harbor and is not intended to preclude a taxpayer from using a different percentage under the rules of paragraph (b)(2)(i) of this section.

The partnership anti-abuse rules[3618] should not apply when one of the above safe harbors is satisfied. If the transaction is contemplated by a particular regulation, then the situation is not considered an abuse of entity treatment.[3619] However, to minimize any risk that the anti-abuse rules would apply, the seller should not be protected from loss. Looking at the larger picture, the anti-abuse rule applies only if the transaction is inconsistent with Subchapter K's intent. For this purpose, Subchapter K's intent has three prongs:[3620]

- The partnership must be bona fide, and each transaction must have a "substantial business purpose."
- The form of each transaction must be respected under substance over form principles.
- Clear reflection of income: All distributions the old owner receives is being taxed. The new owner is not being taxed on income the new owner does not receive.

II.M.3.e.i.(c). Disclosure Requirements

Certain transactions must be disclosed on Form 8275 or an appropriate statement.[3621]

The transactions requiring disclosure are referred to in:

> § 1.707-3(c)(2) (regarding certain transfers made within two years of each other),

[3618] Reg. § 1.701-2(c)(3).

[3619] Reg. § 1.701-2(e)(2)(i).

[3620] Reg. § 1.701-2(a).

[3621] Reg. § 1.707-8(b), which provides:

> *Method of providing disclosure*. Disclosure is to be made on a completed Form 8275 or on a statement attached to the return of the transferor of property for the taxable year of the transfer that includes the following:
> (1) A caption identifying the statement as disclosure under section 707;
> (2) An identification of the item (or group of items) with respect to which disclosure is made;
> (3) The amount of each item; and
> (4) The facts affecting the potential tax treatment of the item (or items) under section 707.

§ 1.707-5(a)(7)(ii) (regarding a liability incurred within two years prior to a transfer of property), and

§ 1.707-6(c) (relating to transfers of property from a partnership to a partner in situations analogous to those listed above)….

If more than one partner transfers property to a partnership pursuant to a plan, this disclosure may be made by the partnership on behalf of all the transferors rather than by each transferor separately.[3622]

II.M.3.e.ii. Disguised Sale When One Partner Contributes Property and Another Receives a Distribution

This part II.M.3.e.ii discusses whether a contribution to a partnership, followed by a distribution to another partner, constitutes a purchase by the contributing partner of the distributee partner's partnership interest.

Part II.M.3.e Exception: Disguised Sale Rules quotes Reg § 1.731-1(c)(3) and Code § 707(a)(2) as regulatory and statutory authority under the disguised sale rules, which are supplemented by case law and other authority.

Code § 707(a)(2)(B), "Treatment of certain property transfers," provides:

> If -
>
> (i) there is a direct or indirect transfer of money or other property by a partner to a partnership,
>
> (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and
>
> (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property,
>
> such transfers shall be treated either as a transaction described in paragraph (1) or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

The Senate report provides the following reason for change:

> In the case of disguised sales, the committee is concerned that taxpayers have deferred or avoided tax on sales of property (including partnership interests) by characterizing sales as contributions of property (including money) followed (or preceded) by a related partnership distribution. Although Treasury regulations provide that the substance of the transaction should govern, court decisions have allowed tax-free treatment in cases which are economically indistinguishable from sales of property to a partnership or another partner. The committee believes that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance.

[3622] Reg. § 1.707-8(c).

The Senate report explains the change disguised sale provision:

> The bill provides that when a partner transfers money or other property to a partnership which when viewed in connection with a related direct or indirect transfer of money or other property to that partner or another partner is properly characterized as a sale of property, the transaction is to [be] treated (as appropriate) as a sale between the partners of property (including partnership interests) or as a partial sale and partial contribution of the property to the partnership. The selling partner will be required to recognize gain (or loss) on the amount of the sales proceeds treated as received in the transaction. This rule is intended to prevent the parties from characterizing a sale or exchange of property as a contribution to the partnership followed by a distribution from the partnership to defer or avoid tax on the transaction.
>
> To accomplish this, the bill authorizes the Treasury Department to prescribe such regulations as may be necessary or appropriate to carry out the purposes of this provision. In prescribing these regulations, the Treasury should be mindful that the committee is concerned with transactions that attempt to disguise a sale of property and not with non-abusive transactions that reflect the various economic contributions of the partnerships. Similarly, the committee does not intend to change the general rules concerning the tax treatment of the partners under sections 721, 731, and 752 to the extent (1) contributed property is encumbered by liabilities not incurred in anticipation of the contribution, or (2) contributions to a partnership which, because of liabilities of the partnership incurred other than in anticipation of the contribution result in a deemed distribution under sec. 752(b).
>
> It is anticipated that the regulations will apply the provision when the transfer of money or property from the partnership to the partner is related to the transfer of money or other property to the partnership in such manner that, taking into account all the facts and circumstances, the transaction substantially resembles a sale or exchange of all part of the property (including an interest in the partnership). For example, when a partner contributes appreciated property to a partnership and receives a distribution of money or property within a reasonable period before or after such contribution, that is approximately equal in value to the portion of contributed property that is in effect given up to the other partner(s) the transaction will be subject to this provision. However, the distribution would not be so subject if there is a corresponding partnership allocation of income or gain, but that arrangement may instead be subject to the new provision relating to partnership payments for property or services described above. The disguised sale provision also will apply to the extent (1) the transferor partner receives the proceeds of a loan related to the property to the extent responsibility for the repayment of the loan rests, directly or indirectly, with the partnership (or its assets) or the partners, or (2) the partner has received a loan related to the property in anticipation of the transaction and responsibility for repayment of the loan is transferred, directly or indirectly, to the partnership (or its assets) or the other partners.
>
> Although the rule applies to sales of property to the partnership, the committee does not intend to prohibit a partner from receiving a partnership interest in return for contributing property which entitles him to priorities or preferences as to distributions, but is not in substance a disguised sale. Similarly, the committee generally does not intend this provision to adversely affect distributions that create deficit capital accounts (maintained in a manner consistent with Treasury regulations under section 704(b)) for which the distributee is liable, regardless of the timing of the distribution, unless such deficit capital

account is improperly understated or not expected to be made up until such a distant point in the future that its present value is small. However, if this deficit creating distribution is coupled with an allocation of income or gain, the distribution/allocation arrangement may be subject to the new provision relating to partnership payments for services or property. Similarly, the contribution of encumbered property to a partnership would not suggest a disguised sale to the extent responsibility for the debt is not shifted, directly or indirectly, to the partnership (or its assets) or to the non-contributing partners. The committee anticipates that the Treasury regulations will treat transactions to which the provision applies as a sale or property or partnership interests among the partners or as a partial sale and partial contribution of the property to the partnership, with attendant tax consequences, depending upon the underlying economic substance of the transaction. These regulations may provide for a period, such as three years, during which contributions by and distributions to the same or another partner normally will be presumed related. Finally, it is anticipated that the regulations will take into account the effect of liabilities which may accompany effective sales of property to a partnership or another partner.

> No inference regarding the tax treatment of contribution arrangements or any similar transactions under existing law should be drawn from the committee's action.

The conference agreement provides:

> The conference agreement follows the Senate amendment.
>
> The conferees wish to note that when a partner of a partnership contributes property to the partnership and that property is borrowed against, pledged as collateral for a loan, or otherwise refinanced, and the proceeds of the loan are distributed to the contributing partner, there will be no disguised sale under the provision to the extent the contributing partner, in substance, retains liability for repayment of the borrowed amounts (*i.e.*, to the extent the other partners have no direct or indirect risk of loss with respect to such amounts) since, in effect, the partner has simply borrowed through the partnership. However, to the extent the other partners directly or indirectly bear the risk of loss with respect to the borrowed amounts, this may constitute a payment to the contributing partner.

Not until 2004 were proposed regulations issued, which are discussed after reviewing cases leading up to them.

TAM 200037005 asserts that Code § 707(a)(2)(B) applies even if regulations have not been adopted.[3623]

[3623] Looking to cases in other areas, the TAM asserted:

> Although the Service has not promulgated regulations for disguised sales of partnership interests under section 707(a)(2)(B) (Income Tax Regulation Section 1.707-7 is reserved), it may enforce section 707(a)(2)(B) in the context of a disguised sale of a partnership interest in the absence of regulations. See *Pittway Corp. v. United States*, 102 F.3d 932 (7th Cir. 1996) (although the statute provided "to the extent provided in regulations" the plain language of the statue [sic] directs a single conclusion); *Estate of Neuman*, 106 T.C. 216 (1996) (regulations contemplated under section 2663(2) is not a necessary precondition to the imposition of the generation-skipping transfer tax on transfers involved in the case); Rev. Rul. 91-47 (Service enforced

Communications Satellite Corp. v. U.S., 625 F.2d 997 (Ct. Cl. 1980), held that admission of a partner followed by a related distribution to the other partners being diluted was not a disguised sale by the distributees. In that case, the distributee partners, instead of receiving full fair market value, received a proportionate share of their initial capital contribution, adjusted by income and distributions. The court held:

> The effect of the arrangements for admitting new partners was to eliminate the possibility that gains from the reduction of the existing partner's interests resulting from the admission of new partners would influence decisions on admitting new partners. Moreover, these arrangements exhibited in several important respects characteristics not commonly associated with sale transactions.
>
> There were no financial negotiations with the incoming partners by either INTELSAT or the existing partners, and there were no contracts of sale between old and new partners. Neither the partnership nor the existing partners had any control over who joined INTELSAT (other than the restriction in the agreements to members of the International Telecommunications Union) or over the terms under which the new partners joined. The entry fees—the price paid for the partnership interests—had no relationship to the actual value of the new partners' percentage interests in the partnership; there was no attempt at appraising the value of partnership interests at any time. The entry fees were determined mechanically, based not on the fair market value of the partnership or its assets but on the original capitalization of the partnership. Although the Committee had an opportunity to affect the entry fees through its role in setting the incoming quotas, this power was restricted by the requirement that the quotas reflect only the anticipated use of the system and not the business or investment goals of any partner or the partnership.
>
> Although none of these characteristics individually may establish that the transactions were not sales, their combined effect, viewed in the context of the unique and special nature and purpose of this partnership, is inconsistent with the view that the transactions by which new partners were admitted were sales by the existing partners of part of their interests. To the contrary, the receipt by the existing partners of their pro rata share of the amounts paid by new partners to the partnership were distributions of partnership property on which, under section 731, no gain is recognized.

In giving context to Reg § 1.731-1(c)(3), in fn. 6 the court noted:

> An example of the type of transaction that the regulation covers is given in Rev. Rul. 57-200, 1957-1 Cum. Bull. 205. The ruling deals with a situation in which two people each owned half of a partnership and each owned half of two corporations. Each of the partners contributed his half-interest in the two corporations to the partnership, and the partnership thereafter distributed one of the two corporations to each of the partners along with a liquidating distribution of half of the partnership itself. These transfers "constituted steps in an integral transaction entered into for the purpose of effecting an exchange of the corporate stock interests between the partners without the recognition of gain to the partners or the partnership. Accordingly, to such extent, section 731 of the

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section 108(e)(4), which applies "to the extent provided in regulations" before the regulations were issued). The plain language of the statute, as confirmed by the legislative history, imposes liability on the taxpayer in this case.

Code does not apply ... ." *Id.* At 206. See also 1 A. Willis, *Partnership Taxation* § 33.07 (2d ed. 1976).

Jupiter Corp. v. U.S.[3624] held that, when the contributing partner receives a partnership interest that is very different in nature from that of the distributee partner and both partners stay in the partnership, a disguised sale cannot have occurred.[3625]

TAM 200301004 asserts that Congress adopted Code § 707(a)(2)(B) to overturn *Jupiter Corp.* and *Communications Satellite Corp*.[3626] This assertion originated in Notice 2001-64, which also

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[3624] 2 Cl. Ct. 58 (Ct. Cl. 1983).

[3625] Describing the interests of the contributing partner, Wilkow Group, and the distributee partners, plaintiff and Empire, the court found no disguised sale:

> The uncontradicted evidence in the record establishes that plaintiff would not have considered a sale, and the Wilkow Group would not have considered a purchase, of a portion of plaintiff's general partnership interest. The economic and legal pre-requisites of plaintiff and the Wilkow Group mandated that the partnership be reorganized to admit the Wilkow Group as new limited partners.
>
> The Wilkow Group's limited partnership interest did not exist prior to the reorganization of the Venture. This newly-created limited partnership interest gave the Wilkow Group cumulative rights to monthly distributions of income which had priority over all distributions to plaintiff and Empire. Neither plaintiff nor Empire owned such a cumulative priority right to the Venture's income prior to the reorganization. The Wilkow Group's limited partnership interest created by the reorganization carried no obligation to advance money needed by the Venture beyond the initial capital contribution and loan. Plaintiff's and Empire's partnership interests imposed such an obligation, to varying extents, both before and after the reorganization. Since the Wilkow Group's limited partnership interest was unique from the partnership interests owned by plaintiff and Empire, the Wilkow Group could not have purchased this interest directly from either partner.
>
> Although plaintiff's general partnership interest was decreased from 77.5 percent to 57.5 percent after the reorganization, plaintiff remained in a more favorable position after the reorganization than it would have if it had directly sold a 20 percent general partnership interest to the Wilkow Group. Both before and after the reorganization, plaintiff remained the sole general partner with 100 percent control of the management of the Venture. Plaintiff did not want to share its management responsibilities with any other partner. Furthermore, the Wilkow Group was not interested in acquiring a share of the management responsibilities. The parties could not have accomplished these goals by a direct purchase and sale of a portion of plaintiff's general partnership interest.
>
> A further indication that this transaction was intended, and could only have been accomplished, as a reorganization of the Venture is found in a change which the amended partnership agreement made in the rights and obligations of plaintiff and Empire vis-a-vis each other. Prior to the reorganization, plaintiff and Empire were both obligated to advance all amounts which the Venture required. After the reorganization, the amended partnership agreement expressly removed Empire's obligation to advance amounts which the Venture needed to make the monthly payments to the Wilkow Group. Of course, no change in the rights between plaintiff and Empire could have been accomplished solely by a direct sale of a portion of plaintiff's general partnership interest to the Wilkow Group.

[3626] The TAM asserted:

> The legislative history of § 707(a)(2)(B) indicates that the provision was adopted as a result of Congress' concern that taxpayers were deferring or avoiding tax on sales of partnership property, including sales of partnership interests, by characterizing sales as contributions of property, including money, followed or preceded by a related partnership distribution. See S. Prt. No. 169, (Vol. I), 98th Cong., 2d Sess. 225 (1984) (hereinafter "S. Prt."); H.R. Rep. No. 432, (Pt. 2) 98th Cong., 2d Sess. 1218 (1984) (hereinafter "H.R. Rep."). Specifically, Congress was concerned about court decisions that allowed tax-free treatment in cases which were economically

announced, "Prior to the issuance of regulations, the determination of whether a transaction is a disguised sale of a partnership interest under section 707(a)(2)(B) is to be made on the basis of the statute and its legislative history."

Expressly assuming another partner's liabilities tends to make the transactions look more like a sale.[3627]

The IRS has asserted that elements of a sale from the distributee partner to the contributing partner include the contribution being the same amount as the redemption[3628] and that the continuing partners' interest did not increase proportionately upon the withdrawal of the partner.[3629]

> indistinguishable from sales of property to a partnership or another partner. See S. Prt. at 225; H.R. Rep. at 1218 (discussing *Jupiter Corp. v. United States*, No. 83-842 (Ct. Cl. 1983) and *Communications Satellite Corp. V. United States*, 223 Ct. Cl 253 (1980) both of which involved the disguised sale of a partnership interest). Congress believed that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance. See S. Prt. at 225; H.R. Rep. at 1218.

[3627] Distinguishing *Communications Satellite*, *Colonnade Condominium, Inc., v. Commissioner*, 91 T.C. 793 (1988), found a disguised sale, noting:

> The fact that the three shareholders of Colonnade expressly assumed Colonnade's liabilities, in return for partnership interests which are capital assets under section 741, is especially significant. In determining whether an actual or constructive sale or exchange took place, we note that the touchstone for sale or exchange treatment is consideration. In *LaRue v. Commissioner*, 90 T.C. 465, 483-484 (1988), we noted that where liabilities are assumed as consideration for a partnership interest a sale or exchange exists:
>
> > If, in return for assets, any consideration is received, even if nominal in amount, the transaction will be classified as a sale or exchange. *Blum v. Commissioner*, 133 F.2d 447 (2d Cir. 1943). *** When the transferee of property assumes liabilities of the transferor encumbering the property, the liability is an amount realized by the transferor. *Crane v. Commissioner*, [331 U.S. 1 (1947)]; *Commissioner v. Tufts*, [461 U.S. 300 (1983)]. Assumption of liabilities by the transferee constitutes consideration making the transaction a sale or exchange. *Wilkinson v. United States*, 177 F. Supp. 101 (S.D. Ala. 1959).
> > *** Where assets are transferred to third parties, assumption of liabilities constitutes consideration. ***
> > *** the assumption of liabilities by a third party transferee constitutes an amount realized, and this is consideration to the transferor. *Crane v. Commissioner*, [supra]; *Tufts v. Commissioner*, [supra].
>
> I am unsure why the court did not simply invoke Code § 311 to tax a distribution from the corporation to its shareholders.

[3628] FSA 200024001, citing *Jacobson v. Commissioner*, 96 T.C. 577, 587-88 (1991), *aff'd*, 963 F.2d 218 (8th Cir. 1992), asserted:

> The court, however, will look behind the chosen form of a transaction where "elements of artificiality" are present. The presence of such elements can be ascertained by looking at the business purpose for the transaction. *Jacobson*, 96 T.C. at 590. One element of artificiality is that the funds used to terminate Q's interest were derived from U, and not from P. *Jacobson*, 96 T.C. at 592. Pursuant to the Redemption Agreement, Q's entire interest in P would be redeemed for $s and certain contingent payments. Ten days before the redemption date, R and U entered into an agreement wherein U would contribute $s to fund the payment to be made to Q. The agreement also provided that U was required to make a contribution to P in an amount equal to each of the contingent payments to be made to Q.

[3629] FSA 200024001 asserted:

Proposed regulations under Code § 707(a)(2)(B) on the topic of a disguised sale from one partner to another were issued November 26, 2004 (the "Prior Prop. Regs.") and withdrawn January 21, 2009,[3630] and as of 12/16/2017 I am unaware of any having been promulgated after that. The preamble to the Prior Prop. Regs. expressed antipathy to *Communications Satellite* and *Jupiter Corp.*[3631] Although the proposed regulations have been withdrawn, one may want to consider what factors the government viewed as relevant when it issued them:[3632]

(i) That the timing and amount of all or any portion of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

(ii) That the person receiving the subsequent transfer has a legally enforceable right to the transfer or that the right to receive the transfer is secured in any manner, taking into account the period for which it is secured;

> Another element of artificiality is that the continuing partners' interest did not increase proportionately upon the withdrawal of the partner. Specifically, to the extent the interests of the continuing partners' interest does not increase proportionately upon the withdrawal of a partner, the economic substance of the transaction is generally considered a sale. *Colonnade Condominium, Inc.*, *supra* (where new general partners were admitted to a limited partnership, the interests of one pre-admission general partner decreased, and the interests of all pre-admission limited partners remain unchanged, holding that the general partner whose interest decreased sold a portion of its partnership interest to the new general partners); *Coven v. Commissioner*, 66 T.C. 295 (1976) (holding that the termination of a partner's interest was a sale of the interest to a partner rather than a liquidation because, among other things, the majority partner contributed the cash for the terminating payments and its interest increased while the minority partner's interests did not). After U's contribution of $s to P, the continuing partners' (R and U's) interest did not increase proportionately upon the withdrawal of Q. Rather, U's interest increased to z percent and R's interest remained w percent.
>
> Based on the above facts and circumstances, we conclude that a reasonable inference can be drawn that the overarching business purpose for the transaction was to sell Q's partnership interest in P to U. The substance of the transaction was a transfer of money by a partner, Q, to a partnership, P, followed by a related direct transfer of money by the partnership, P, to another partner, U. The transfers, when viewed together, are properly characterized as a sale or exchange of Q's partnership interest. Accordingly, the transfers must be treated as a transaction between two or more partners acting other than in their capacity as members of the partnership, specifically, as a sale. See I.R.C. section 707(a)(2)(B).

Colonnade is discussed in fn. 3627, and *Coven* is discussed in fn. 5491, the latter being found in part II.Q.8.b.ii.(a) Introduction to Code § 736.

[3630] FR Doc. 2009-1101, withdrawing REG-149519-03 (11/26/2004).

[3631] [REG-149519-03] stated:

> Congressional concern that taxpayers were deferring or avoiding tax on sales of partnership property, including sales of partnership interests, by characterizing sales as contributions of property, including money, followed or preceded by related partnership distributions. See H.R. Rep. No. 861, 98th Cong. 2nd Sess. 861 (1984), 1984-3 (Vol. 2) C.B. 115. Specifically, Congress was concerned about court decisions that allowed tax-free treatment in cases that were economically indistinguishable from sales of property to a partnership or another partner, and believed that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance. See H.R. Rep. No. 432, 98th Cong. 2nd Sess. 1218 (1984) (H.R. Rep.), and S. Prt. No. 169 (Vol. I), 98th Cong. 2nd Sess. 225 (1984) (S. Prt.) (discussing *Communications Satellite Corp. v. United States*, 625 F.2d 997 (Ct. Cl. 1980), and *Jupiter Corp. v. United States*, 2 Cl. Ct. 58 (1983), both of which involved disguised sales of a partnership interest).

[3632] Former Prop. Reg. § 1.707-7(b)(2).

(iii) That the same property (other than money, including marketable securities that are treated as money under section 731(c)(1)) that is transferred to the partnership by the purchasing partner is transferred to the selling partner;

(iv) That partnership distributions, allocations or control of operations are designed to effect an exchange of the benefits and burdens of ownership of transferred property (other than money, including marketable securities that are treated as money under section 731(c)(1)), including a partnership interest;

(v) That the partnership holds transferred property (other than money, including marketable securities that are treated as money under section 731(c)(1)) for a limited period of time, or during the period of time the partnership holds transferred property (other than money, including marketable securities that are treated as money under section 731(c)(1)), the risk of gain or loss associated with the property is not significant;

(vi) That the transfer of consideration by the partnership to the selling partner is disproportionately large in relationship to the selling partner's general and continuing interest in partnership profits;

(vii) That the selling partner has no obligation to return or repay the consideration to the partnership, or has an obligation to return or repay the consideration due at such a distant point in the future that the present value of that obligation is small in relation to the amount of consideration transferred by the partnership to the selling partner;

(viii) That the transfer of consideration by the purchasing partner or the transfer of consideration to the selling partner is not made pro rata;

(ix) That there were negotiations between the purchasing partner and the selling partner (or between the partnership and each of the purchasing and selling partners with each partner being aware of the negotiations with the other partner) concerning any transfer of consideration; and

(x) That the selling partner and purchasing partner enter into one or more agreements, including an amendment to the partnership agreement (other than for admitting the purchasing partner) relating to the transfers.

(Code § 731(c) is discussed in part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them).)

Prior Prop. Reg. § 1.707-7(c) provided that, "if within a two-year period a purchasing partner transfers consideration to a partnership and the partnership transfers consideration to a selling partner (without regard to the order of the transfers), the transfers are presumed to be a sale, in whole or in part, of the selling partner's interest in the partnership to the purchasing partner unless the facts and circumstances clearly establish that the transfers do not constitute a sale."

However, Prior Prop. Reg. § 1.707-7(d) presumed that distributions liquidating a partnership interest were not disguised sale to the recipient.[3633] Reg. § 1.761-1(d), "Liquidation of partner's interest," provides:[3634]

> The term "liquidation of a partner's interest" means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership. A series of distributions will come within the meaning of this term whether they are made in one year or in more than one year. Where a partner's interest is to be liquidated by a series of distributions, the interest will not be considered as liquidated until the final distribution has been made.

Furthermore, Prior Prop. Reg. § 1.707-7 would not have applied to the deemed termination of a partnership.[3635] See part II.Q.8.e.iv Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).

Also, Prior Prop. Reg. § 1.707-7 would not have applied to service partnerships,[3636] referring to the rules described in part II.G.11 Personal Service Corporations. Furthermore, operating cash

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[3633] Prior Prop. Reg. § 1.707-7(d) provided:

> *Transfers of money in liquidation of a partner's interest presumed not to be a sale*. Notwithstanding the presumption set forth in paragraph (c) of this section, for purposes of this section, if a partnership transfers money, including marketable securities that are treated as money under section 731(c)(1), to a selling partner, or is treated as transferring consideration to the selling partner under paragraph (j)(2) of this section, in liquidation of the selling partner's interest in the partnership, the transfer is presumed not to be a sale, in whole or in part, of the selling partner's interest in the partnership to the purchasing partner unless the facts and circumstances clearly establish that the transfer is part of a sale. See § 1.761-1(d) for the definition of the term liquidation of a partner's interest.

The preamble to the above explained:

> The IRS and the Treasury Department believe that the abuse that section 707(a)(2)(B) was intended to address typically is not present in situations involving complete liquidations of partners' partnership interests for money. Accordingly, the proposed regulations provide that, notwithstanding the presumption relating to transfers within two years, a transfer of money, including marketable securities that are treated as money under section 731(c)(1), to a selling partner in liquidation of that partner's entire interest in the partnership is presumed not to be part of a disguised sale of that interest. However, the IRS and the Treasury Department recognize that there are instances in which a liquidating distribution may properly be characterized as part of a disguised sale of a partnership interest, particularly when the tax consequences of a liquidating distribution are significantly different from those of a sale of a partnership interest. Accordingly, the presumption against sale treatment may be rebutted in those cases.

[3634] After the quoted language, Reg. § 1.761-1(d) continues:

> For the basis of property distributed in one liquidating distribution, or in a series of distributions in liquidation, see section 732(b). A distribution which is not in liquidation of a partner's entire interest, as defined in this paragraph, is a current distribution. Current distributions, therefore, include distributions in partial liquidation of a partner's interest, interest, and distributions of the partner's distributive share. See paragraph (a)(1)(ii) of § 1.731-1.

[3635] Prior Prop. Reg. § 1.707-7(a)(8) provided:

> *Certain transfers disregarded*. Section 707(a)(2)(B) and the rules of this section do not apply to deemed transfers resulting from a termination of a partnership under section 708(b)(1)(B) and transfers incident to the formation of a partnership. However, transfers incident to the formation of a partnership may be transfers to which § 1.707-3(a) applies.

[3636] Prior Prop. Reg. § 1.707-7(g) provided:

flow distributions and similar safe harbors, under the rules governing disguised sales from a partner to a partnership,[3637] would also have been safe harbors.[3638]

In withdrawing Prop. Reg. § 1.707-7, Ann. 2009-4 stated:

> The Treasury Department and the IRS will continue to study this area and may issue guidance in the future. Until new guidance is issued, any determination of whether transfers between a partner or partners and a partnership is a transfer of a partnership interest will be based on the statutory language, guidance provided in legislative history, and case law.

I am unaware of cases discussing the disguised sale of a partnership interest form one partner to another after the Prior Prop. Regs. were issued. One might consider looking to them as guidelines in planning to try to develop a comfort level in light of the lack of guidance beyond the cases we have toward which the IRS has expressed antipathy.

II.M.3.f. Exception: Corporate Partners

Corporate stock can be transferred to affiliated corporations or their owners in a variety of ways, some of which are tax-free. Some of this involves partnerships of corporations, which partnerships might at first glance appear to allow corporations to shift or increase basis, based on the interaction of Subchapter C and partnership rules. Although these materials touch upon various elements of Subchapter C, one should review materials that focus intensively on Subchapter C when restructuring any structure involving the interaction between more than one C or S corporation.

See part II.Q.7.j Prohibition Against Using Partnership to Circumvent Tax on Gain in Property Used to Redeem Stock.

II.M.3.g. Exception: Foreign Partner

Regulations may provide that Code § 721(a) nonrecognition shall not apply to gain realized on the transfer of property to a partnership if such gain, when recognized, will be includible in the gross income of a foreign person.[3639]

> Exception for certain transfers to and by service partnerships. Section 707(a)(2)(B) and the rules of this section do not apply to transfers of money, including marketable securities that are treated as money under section 731(c)(1), to and by a partnership that would be described in section 448(d)(2) if the partnership were a corporation. Solely for purposes of applying section 448(d)(2) to partnerships under this paragraph (g), partners are treated as employees of the partnership and "partnership interest" is substituted for "stock" in testing for ownership by the employees performing services.

[3637] See part II.M.3.e.i.(b) Distributions Presumed Not to Be Disguised Sales.

[3638] Prior Prop. Reg. § 1.707-7(f) provided:

> *Application of §1.707-4 (special rules applicable to guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures)*. Notwithstanding the presumption set forth in paragraph (c) of this section, rules similar to those provided in § 1.707-4 apply to determine the extent to which a transfer to a selling partner is treated as part of a sale of the selling partner's interest in the partnership to the purchasing partner.

[3639] Code § 721(c).

Notice 2015-54 announced detailed rules that will be integrated into regulations effective as to transfers occurring on or after August 6, 2015, as well as transfers occurring before that date that result from entity classification elections that are filed on or after that date, and that are effective on or before that date. T.D. 9814 issued temporary regulations, effective January 18, 2017. The May 2017 meeting of the American Bar Association Section of Taxation included a session with the person who worked on the regulation project. Remarks made by panelists mentioned that one needed to be concerned with foreign taxpayers who were direct or indirect owners of partnership interests and that surprising results could happen even with what seemed to be a simple situation.

II.M.3.h. Reporting Real Estate Contributed to a Partnership or Corporation in a Nontaxable Transaction

The "real estate reporting person" must file an information return (Form 1099) and provide a copy to the grantor.[3640] The person (including any attorney or title company) responsible for closing the transaction has primary responsibility for filing information returns.[3641] The person responsible for closing the transaction is:[3642]

1. If a Uniform Settlement Statement is used under RESPA, the person listed as settlement agent on the statement.

2. If no settlement agent is listed or a closing statement is used that is not a Uniform Settlement Statement, the person who prepared the closing statement.

3. If no closing statement is used or if multiple closing statements are used, then either the transferee's attorney who is present at delivery of the consideration or the transferee's attorney who prepares or reviews the deed, or if no such attorney is present then either the transferor's attorney who is present at delivery of the consideration or the transferor's attorney who prepares or reviews the deed.

The real estate reporting person may not separately charge a customer for reporting the transaction but may take the reporting requirement into account in charging a fee for the overall transaction.[3643]

Except as otherwise provided, all "sales" effected by a broker in the ordinary course of business shall be reported.[3644] Distributions from partnerships do not need to be reported if properly reported on IRS Form 1065 and Schedule(s) K-1.[3645] However, Code § 721 contributions to a partnership and Code § 351 contributions to a corporation were intentionally not excluded from reporting.[3646]

[3640] Code § 6045(e)(1). All references to the Code are to the Internal Revenue Code of 1986, as amended.
[3641] Code § 6045(e)(2)(A).
[3642] Reg. § 1.6045-4(e)(3). Reg. means a United States Treasury Regulation under the Code. Although Code § 6045(a) refers to a broker, Reg. § 1.6045-1(a)(1) defines a broker to include any person who stands ready to effect sales to be made by others.
[3643] Code § 6045(e)(3).
[3644] Reg. § 1.6045-1(c)(2).
[3645] Reg. § 1.6045-1(c)(3)(v).
[3646] Preamble to Reg. § 1.6045-1 under Treasury Decision 8323.

II.M.3.i. All Partners (Members) Should Sign Form W-9, etc. on Formation or Later Admission

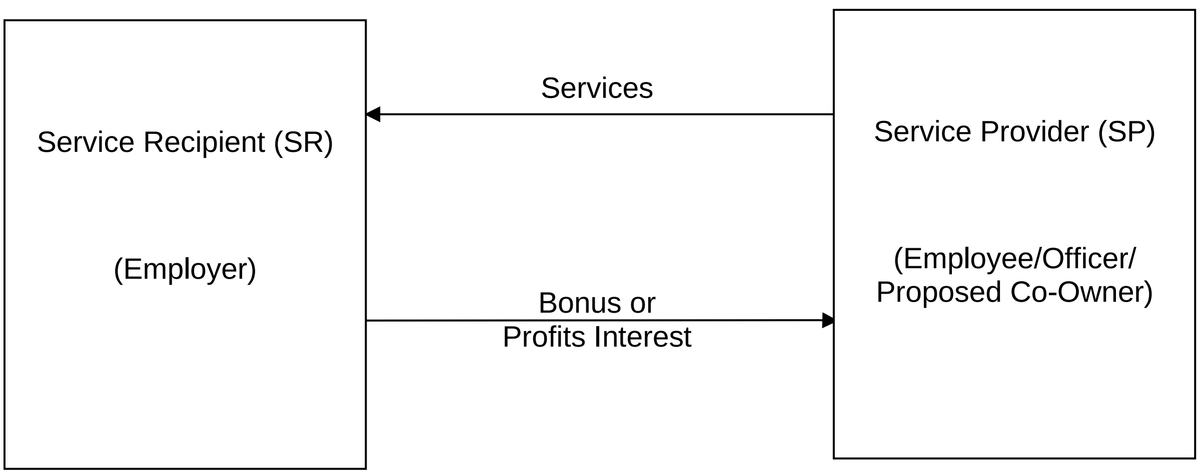
If a partnership has effectively connected taxable income (ECI)[3647] for any taxable year, and any portion of such income is allocable under Code § 704 to a foreign partner, the partnership must pay a withholding tax equal to the applicable percentage of the ECI which is so allocable.[3648]

For purposes of this rule, "foreign partner" means any partner who is not a U.S. person.[3649]

To prove that a partner is a U.S. person and therefore is not a foreign partner subject to withholding, the partner should provide the partnership with a signed Form W-9. If the partner is not a U.S. person, the partnership needs to know that, too, via the appropriate form. See Reg. § 1.1446-1(c)(1).

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

II.M.4.a. Overview



Before working in this area, consider reading part II.Q.1.d.i IRS Audit Guide for Nonqualified Deferred Compensation.

In addition to what is described in this part II.M.4, consider part II.P.3.i Common Equity for Preferred Equity and Vice Versa.

II.M.4.a.i. Bonus vs. Equity

Advantages of Bonus

- Service provider (SP) has no rights to information about the business beyond what is necessary to enforce rights to bonus.

[3647] Although Code § 1446(c) modifies the definition of ECI as used in this sentence, the base definition is in part II.E.1.c.ix QBI and Effectively Connected Income.
[3648] Code § 1446(a), (b).
[3649] Code § 1446(e).

- Don't need to worry about buying out SP upon divorce, SP's financial hardship (creditors), disability, death, or other separation from service.

Disadvantages of Bonus

- Code § 409A complicates timing of payment for performance after year-end; however, easy to get around if recognize the issue.

- Code § 409A complicates payments deferred into future as "golden handcuffs."

Advantages of Equity

- Immediate issuance of profits interest or stock often avoids all Code § 409A issues.

- SP feels like an owner and might be more motivated.

- Courts tend to accept more restrictive covenants not to compete, etc. when SP is an owner.

Disadvantages of Equity

- Complicates capital structure. Need to worry about buy-sell-related issues.

- SP might be able to demand more on separation from service, in addition to any employment issues.

- Creditors might very well require loan guarantees of SP, which might make ownership unattractive to SP. This might be more of an advantage, however, in that SP will be much less likely to abandon a sinking ship - because SP might go down with it!

- A transfer of part of the business' current value might be deemed to occur in a family business setting.[3650]

II.M.4.a.ii. Equity vs. Synthetic Equity.

What is synthetic equity?

- Bonus payments that mirror distributions to owners have the same Code § 409A issues as other bonus payments.

- Options to acquire stock or partnership interests are not subject to Code § 409A if a sufficient exercise price that makes them equivalent to profits interest.

[3650] See part III.B.7.b Code § 2701 Overview for when an entity needs to consider gift tax valuation rules when using profits interests and part III.B.7.c Code § 2701 Interaction with Income Tax Planning for planning for equity awards to those in the same family.

Profits Interest vs. Pro Rata Share of Entire Entity

- "Profits interest" means an interest in the partnership's future income, gains, deductions, and losses, with a zero beginning capital account so that, if entity dissolved at the time of transfer, the holder would receive nothing.[3651]

- "Pro rata share of entire entity" means that the owner receives not only a profits interest but also a proportionate share of the proceeds if the entity liquidates.

- Issuance of a profits interest generally is not taxable, but issuance of a pro rata share of entire entity is. Need to gross-up SP for taxes on issuance of a pro rata share of entire entity; however, SR receives an equivalent deduction and tax benefit, so long as timing is not messed up.

- Issuance of a profits interest is forward-looking, whereas issuance of a pro rata share of entire entity often has a large backward-looking component.

- Issuance of a profits interest is more conducive to golden handcuffs. SR distributes enough to pay taxes but holds the rest of the cash until agreed-upon event occurs. Undistributed cash is reflected in SP's capital account (which originally started at zero). Generally, when SP has a pro rata share of entire entity, SP receives distributions at the same time as though who provide investment capital. See S corporation example below.

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

II.M.4.b.i. Overview of Compensatory Options

II.M.4.b.i.(a). Comparison between Qualified and Nonqualified Stock Options

This chart is copied from RIA Checkpoint's *Catalyst*, paragraph 653:101 (6/8/2019):

	Nonqualified stock option (NQSO)	**Incentive stock option (ISO)**	**Employee stock purchase plan (ESPP) option**
Type of entity issuing option	Any type of corporation.	Same.	Same.
Basic requirements to be a compensatory option	(1) Right to acquire stock, (2) at a predetermined price, (3) awarded to the service provider, (4) in	Same.	Same.

[3651] This is done by valuing the partnership's assets at the time the profits interest is issued and booking up the partners' capital accounts under Reg. § 1.704-1(b)(2)(iv)(f)(5)(iii). The partners' capital accounts are adjusted as if the partnership had sold all of its assets for their fair market value, but no gain or loss is recognized and tax basis does not change as a result of that hypothetical sale and actual capital account adjustment. Reg. § 1.704-1(b)(2)(iv)(s) describes capital account rules triggered by noncompensatory options, which options are described in Reg. § 1.721-2(f).

	Nonqualified stock option (NQSO)	Incentive stock option (ISO)	Employee stock purchase plan (ESPP) option
	exchange for services, by the service recipient.		
Qualification as NQSO, ISO, or ESPP option	Any option that is not a qualified option (*e.g.*, not an ISO or ESPP option) is an NQSO.	Must meet the requirements for an ISO at IRC § 422. The key requirements are: (1) only awarded to employees; (2) exercise price must at least equal grant-date stock value; (3) for each employee, the value of stock subject to exercise is limited to $100,000 worth of stock in the first year ISO can be exercised; (4) maximum 10-year term; and (5) nontransferable, except on death.	Must meet the requirements for an ESPP option at IRC § 423. The key requirements are: (1) only awarded to employees (or employees of a related company); (2) cannot be granted to employees owning more than 5% of company stock after grant of options; (3) most employees must be covered by the ESPP plan, and all options must have the same rights and privileges; (4) the exercise price must be at least 85% of the grant-date stock value or 85% of the exercise-date stock value; (5) if the exercise price is based on the exercise-date stock value, then the option term cannot be more than five years (otherwise the term cannot be more than 27 months); (6) an employee cannot purchase stock worth more than $25,000 per year in grant-date value; and (7) nontransferable, except on death.
Taxability on option	Taxable if the NQSO has an ascertainable	Not taxable.	Not taxable.

	Nonqualified stock option (NQSO)	Incentive stock option (ISO)	Employee stock purchase plan (ESPP) option
grant	fair market value or does not meet the requirements for nontaxability in IRC § 409A.		
Taxability of stock receipt on option exercise if stock is substantially vested	Taxable as compensation income based on the value of stock received.	Not taxable.	Not taxable.
Taxability of stock receipt on option exercise if stock is substantially nonvested	Not taxable on exercise if substantially nonvested. Taxable when the stock becomes substantially vested, which is when the stock is either (1) transferable or (2) no longer subject to a substantial risk of forfeiture; however, optionee can elect under IRC § 83(b) to treat stock as substantially vested.	Not taxable.	Not taxable.
Election to defer income for up to five years under IRC § 83(i)	Applies to NQSOs.	Applies to nonqualified ISOs, converting them to NQSOs.	Applies to nonqualified ESPP options, converting them to NQSOs.
Holding period requirements for stock acquired on exercise	None.	Two years from option grant date and one year after stock received on exercise of option.	Two years from option grant date and one year after stock received on exercise of option.
Sale of stock acquired on exercise of NQSO	Capital gain or loss results from sale of stock.	N/A	N/A

	Nonqualified stock option (NQSO)	Incentive stock option (ISO)	Employee stock purchase plan (ESPP) option
Sale of stock acquired on exercise of ISO or ESPP option if a qualifying disposition (*i.e.*, holding period requirements met)	N/A	Long-term capital gain or loss.	Compensation equal to the lesser of (1) the excess of the grant-date stock value over the grant-date exercise price, or (2) the excess of the stock value on disposition over the exercise price. Remaining gain is long-term capital gain.
Sale of stock acquired on exercise of ISO or ESPP option if a disqualifying disposition (*i.e.*, holding period requirements not met)	N/A	Compensation income recognized on sale date equal to the lesser of (1) total gain recognized on sale or (2) unrecognized income on the exercise date. Any additional gain is capital gain.	Compensation income recognized on sale date equal to the unrecognized income on exercise date. Capital gain is then recognized equal to the excess of the sale price over the exercise-date value; capital loss is recognized equal to the excess of the exercise-date value over the sale price.
Effect of modification	A modification requires retesting of the option for taxability, as if it were a new option.	A modification requires retesting of the option as an ISO. In addition, a modification restarts the holding period.	A modification requires retesting of the option as an ESPP option. In addition, a modification restarts the holding period.
Employer tax accounting	An employer recognizes compensation cost in an amount equal to the compensation income recognized by the service provider. The employer recognizes cost in the same period the service provider recognizes the	Same.	Same, except that compensation income recognized by the service provider in an amount equal to the excess of the grant-date value over the grant-date exercise price is not recognized as compensation cost by the employer.

	Nonqualified stock option (NQSO)	Incentive stock option (ISO)	Employee stock purchase plan (ESPP) option
	income. The employer does not account for capital gain recognized by the service provider on sale of stock.		
Transfers of options	Transferor taxed as if option exercised on transfer date. Exceptions: • Gift transfer: no income on transfer, but transferor taxed when transferee exercises the option. • Transfer incident to divorce: no income on transfer and transferee (former spouse) recognizes ordinary income on exercise. • Transfer at death: no income on transfer by decedent, and estate or heirs have ordinary income on exercise.	An ISO can only be transferred at death. A transfer at death results in the recipient being treated the same as the decedent, except that the holding period rules do not apply.	An ESPP option can only be transferred at death. A transfer at death results in the recipient being treated the same as the decedent, except that the holding period rules do not apply.
Special rules under alternative minimum tax	None.	An ISO is treated as an NQSO for AMT purposes.	None.

II.M.4.b.i.(b). Comparison between Stock and Partnership Options

This chart is copied from RIA Checkpoint's *Catalyst*, paragraph 653:102 (6/8/2019):

	Nonqualified stock option (NQSO)	Nonqualified partnership option (NQPO)
Type of entity issuing option	Any type of corporation.	Partnership.
Basic requirements to be a compensatory option	(1) Right to acquire stock, (2) at a predetermined price, (3) awarded to the service	(1) Right to acquire partnership interest, (2) at a predetermined price,

	Nonqualified stock option (NQSO)	Nonqualified partnership option (NQPO)
	provider, (4) in exchange for services, by the service recipient.	(3) awarded to the service provider, (4) in exchange for services, by the service recipient.
Qualification as NQSO or partnership option	Any option that is not a qualified option (*e.g.*, not an ISO or ESPP option) is an NQSO.	Any option to acquire a partnership interest.
Taxability on grant	Taxable if the NQSO has a readily ascertainable fair market value or does not meet the requirements for nontaxability in IRC § 409A.	If the partnership interest is treated as stock, such as when interests in publicly traded partnerships are traded on stock exchanges, the interest would likely be taxable if the option has a readily ascertainable fair market value. Taxable if the option does not meet the requirements for nontaxability in IRC § 409A.
Taxability on exercise of option and receipt of stock or partnership interest that is substantially vested	Taxable as compensation income based on the value of stock received.	Taxable as compensation income based on the value of partnership capital interest received. May not be taxable if a partnership profits interest is received.
Taxability on exercise of option and receipt of stock or partnership interest that is not transferable and is substantially nonvested	Not taxable on exercise if substantially nonvested. Taxable when the stock becomes substantially vested, which is when the stock is either transferable or no longer subject to a substantial risk of forfeiture; however, optionee can elect under IRC § 83(b) to treat stock as substantially vested.	Capital interest not taxable on exercise. Taxable when transferable or the risk of forfeiture lapses; however, the optionee can elect under IRC § 83(b) to treat partnership capital interest as vested. Profits interest may be treated as vested or not vested.
Election to defer income for up to five years under IRC § 83(i)	Applies to NQSOs.	Does not apply.
Holding period requirements	None.	Profits interest may be taxed as capital interest if profits

	Nonqualified stock option (NQSO)	Nonqualified partnership option (NQPO)
for stock or partnership interest acquired on exercise		interest disposed of within two years.
Sale of substantially vested stock or partnership interest acquired on exercise of NQSO or partnership option	Capital gain or loss results from sale of stock.	Capital gain or loss on sale of capital interest or profits interest. However, if profits interest sold within two years of receipt, may trigger compensation (ordinary income).
Effect of modification	A modification requires retesting of the option for taxability, as if it were a new option.	Same.
Employer tax accounting	An employer recognizes compensation cost in an amount equal to the compensation income recognized by the service provider. The employer recognizes cost in the same period the service provider recognizes the income. The employer does not account for capital gain recognized by the service provider on sale of stock.	Same.
Transfers	Transferor taxed as if option exercised on date of transfer. Exceptions: • Gift transfer: no income on transfer, but transferor taxed when transferee exercises the option. • Transfer incident to divorce: no income on transfer and transferee (former spouse) recognizes ordinary income on exercise. • Transfer at death: no income on transfer by decedent, and estate or heirs have ordinary income on exercise.	No special rules.

	Nonqualified stock option (NQSO)	Nonqualified partnership option (NQPO)
Special rules under alternative minimum tax	None.	None.

II.M.4.b.ii. Income Tax Recognition Timing Rules re Equity Incentives

Property[3652] is not taxable under Code § 83(a) until it has been transferred to such person and become substantially vested in such person.[3653] For Code § 83 to apply to defer a deduction to a later date when the property was more valuable, the service recipient must show that: (1) the property was transferred in connection with the performance of services and (2) the property was subject to a substantial risk of forfeiture until that later date.[3654]

In determining whether property was transferred in connection with the performance of services, the following factors apply:[3655]

(1) whether the property right is granted at the time the employee or independent contractor signs his employment contract;

(2) whether the property restrictions are linked explicitly to the employee's or independent contractor's tenure with the employing company;

(3) whether the consideration furnished by the employee or independent contractor in exchange for the transferred property is services; and

(4) the employer's intent in transferring the property.

A transfer of property occurs when a person acquires a beneficial ownership interest in such property (disregarding certain lapse restrictions).[3656] Imposing restrictions on substantially

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[3652] Reg. § 1.83-3(e) provides:

> … the term property includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. The term also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account...

[3653] Reg. § 1.83-1(a)(1). *Qinetiq U.S. Holdings, Inc. and Subsidiaries v. Commissioner*, T.C. Memo. 2015-123, *aff'd* 119 A.F.T.R.2d 2017-330 (4th Cir. 1/6/2017), disallowed a C corporation's assertion that stock issued several years before had not vested until right before the corporation was sold. The disputed deduction was almost $118 million.

[3654] *Qinetiq U.S. Holdings, Inc. and Subsidiaries v. Commissioner*, T.C. Memo. 2015-123, *aff'd* 119 A.F.T.R.2d 2017-330 (4th Cir. 1/6/2017), the Fourth Circuit also referring to *Strom v. United States*, 641 F.3d 1051, 1055-56 (9th Cir. 2011); *United States v. Bergbauer*, 602 F.3d 569, 580 (4th Cir. 2010).

[3655] *Qinetiq U.S. Holdings, Inc. and Subsidiaries v. Commissioner*, T.C. Memo. 2015-123 (finding that the taxpayer failed to prove transfer in connection with the performance of services), *aff'd* 119 A.F.T.R.2d 2017-330 (4th Cir. 1/6/2017), the Tax Court citing as follows:

> See *Bagley v. Commissioner*, 806 F.2d at 170-171; *Alves v. Commissioner*, 734 F.2d 478, 481-482 (9th Cir. 1984), *aff'g* 79 T.C. 864 (1982); *Montelepre Systemed, Inc. v. Commissioner*, T.C. Memo. 1991-46 (citing *Centel Commc'ns Co. v. Commissioner*, 92 T.C. 612), *aff'd*, 956 F.2d 496 (5th Cir. 1992).

[3656] Reg. § 1.83-3(a)(1).

vested stock that cause the substantially vested stock to become substantially nonvested does not constitute a transfer of substantially nonvested stock subject to Code § 83.[3657]

Property is substantially vested when it is either transferable or not subject to a substantial risk of forfeiture.[3658]

Based on the facts and circumstances, a substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.[3659] The regularity of the performance of services and the time spent in performing such services tend to indicate whether services required by a condition are

[3657] Rev. Rul. 2007-49, which also held that there is a transfer of substantially nonvested stock subject to Code § 83 where (a) a service provider exchanges substantially vested stock for substantially nonvested stock in a reorganization described in Code § 368(a), or (b) a service provider exchanges substantially vested stock for substantially nonvested stock in a taxable stock acquisition.

[3658] Reg. § 1.83-3(b). *Gluckman v. Commissioner*, T.C. Memo. 2012-329, *aff'd*, 545 F. App'x 59 (2d Cir. 2013), held:

> Therefore, consistent with the Advantage Plan's provisions and the plan withdrawal procedures communicated to participating employers, at that point it appears that the underlying policies were substantially certain to be distributed to petitioners or placed within their control. Even if transfers to other welfare benefit plans were still being permitted by BISYS at that time, subsequent events demonstrate that the policies were placed within petitioners' control no later than early November 2003. After receiving the resolution, BISYS sent endorsed, partially completed change of ownership forms that lacked only the new owner information and sent blank change of beneficiary designation forms, as well as duplicate copies of the policies, to petitioner's attention. The forms and the original insurance policies also were provided to petitioners' insurance agent. These actions placed petitioners' underlying policies squarely within their control because petitioners were then free to name the policies' new owner and beneficiary, which could have been themselves or another welfare benefit plan. When a taxpayer has dominion and control over property, the value of such property generally will be included in his or her gross income. See *Cadwell v. Commissioner*, 136 T.C. 38, 52-56 (2011), *aff'd* without published opinion, 109 A.F.T.R.2d 2012-2693 (4th Cir. 2012); *Chambers v. Commissioner*, T.C. Memo. 2011-114.

O'Connor v. Commissioner, T.C. Memo. 2015-244, reaffirmed *Gluckman* and imposed penalties when the taxpayer did not give the tax advisor complete information.

[3659] Reg. § 1.83-3(c)(1), which further provides:

> Property is not transferred subject to a substantial risk of forfeiture to the extent that the employer is required to pay the fair market value of a portion of such property to the employee upon the return of such property. The risk that the value of property will decline during a certain period of time does not constitute a substantial risk of forfeiture. A nonlapse restriction, standing by itself, will not result in a substantial risk of forfeiture.

substantial.[3660] Special rules apply where the employee is a significant owner[3661] or where securities laws impose certain restrictions.[3662] When those whose stock is subject to the risk of

[3660] Reg. § 1.83-3(c)(2), which further provides:

> The fact that the person performing services has the right to decline to perform such services without forfeiture may tend to establish that services are insubstantial. Where stock is transferred to an underwriter prior to a public offering and the full enjoyment of such stock is expressly or impliedly conditioned upon the successful completion of the underwriting, the stock is subject to a substantial risk of forfeiture. Where an employee receives property from an employer subject to a requirement that it be returned if the total earnings of the employer do not increase, such property is subject to a substantial risk of forfeiture. On the other hand, requirements that the property be returned to the employer if the employee is discharged for cause or for committing a crime will not be considered to result in a substantial risk of forfeiture. An enforceable requirement that the property be returned to the employer if the employee accepts a job with a competing firm will not ordinarily be considered to result in a substantial risk of forfeiture unless the particular facts and circumstances indicate to the contrary. Factors which may be taken into account in determining whether a covenant not to compete constitutes a substantial risk of forfeiture are the age of the employee, the availability of alternative employment opportunities, the likelihood of the employee's obtaining such other employment, the degree of skill possessed by the employee, the employee's health, and the practice (if any) of the employer to enforce such covenants. Similarly, rights in property transferred to a retiring employee subject to the sole requirement that it be returned unless he renders consulting services upon the request of his former employer will not be considered subject to a substantial risk of forfeiture unless he is in fact expected to perform substantial services.

Austin v. Commissioner, 141 T.C. 551 (2013), held that the following facts might or might not support a finding of substantial risk of forfeiture based on the following definition of cause:

> A. Dishonesty, fraud, embezzlement, alcohol or substance abuse, gross negligence or other similar conduct on the part of the Employee. Upon termination of this Agreement, Employee shall be entitled to receive compensation through the date of termination.
>
> B. Failure or refusal by Employee, after 15 days written notice to Employee, to cure by faithfully and diligently performing the usual and customary duties of his employment and adhere to the provisions of this Agreement.
>
> C. Failure or refusal by Employee, after 15 days written notice to Employee, to cure by complying with the reasonable policies, standards and regulations applicable to employees which * * * [UMLIC S-Corp.] may establish from time to time.

The court looked carefully at the circumstances behind that regulation's promulgation and reasoned:

> This history of section 1.83-3(c)(2), Income Tax Regs., strongly suggests that discharge for cause, like discharge for committing a crime, refers to a narrow and serious form of employee misconduct that is very unlikely to occur and is thus properly regarded as too remote - as a matter of law - to create a substantial risk of forfeiture.

After trial, T.C. Memo. 2017-69, the court held:

> In sum, we conclude that petitioners' stock was subject to a substantial risk of forfeiture when issued to them in 1998 and remained subject to that risk until the restrictions lapsed on January 1, 2004. Neither petitioner held a controlling position in UMLIC S-Corp. If either failed to perform his duties or left the company before the earnout restriction ended, the other would have had every incentive to insist on enforcement of the forfeiture provision according to its terms. The ESOP had (if anything) even stronger economic incentives to do this. Because "the possibility of forfeiture … [was] substantial," sec. 1.83-3(c)(3), Income Tax Regs., the stock held by petitioners and their grantor trusts did not become "substantially vested" until petitioners completed their promised service through the five-year earnout period.

Austin was affirmed under the name *Estate of Kechijian v. Commissioner*, 962 F.3d 800 (4th Cir. 6/23/2020), *reh'g den.* 8/21/2020. The Fourth Circuit also recognized that basis from purchase of one block of stock cannot be applied as, basis of another block of stock that the same owner held in the same S corporation.

In *Qinetiq U.S. Holdings, Inc. and Subsidiaries v. Commissioner*, T.C. Memo. 2015-123, *aff'd* 119 A.F.T.R.2d 2017-330 (4th Cir. 1/6/2017), the Tax Court cited *Austin* (2013) when determining that a corporation failed to prove that the possibility of forfeiture was substantial.

[3661] Reg. § 1.83-3(c)(3) provides:

> In determining whether the possibility of forfeiture is substantial in the case of rights in property transferred to an employee of a corporation who owns a significant amount of the total combined voting power or value of all classes of stock of the employer corporation or of its parent corporation, there will be taken into account (i) the employee's relationship to other stockholders and the extent of their control, potential control and possible loss of control of the corporation, (ii) the position of the employee in the corporation and the extent to which he is subordinate to other employees, (iii) the employee's relationship to the officers and directors of the corporation, (iv) the person or persons who must approve the employee's discharge, and (v) past actions of the employer in enforcing the provisions of the restrictions. For example, if an employee would be considered as having received rights in property subject to a substantial risk of forfeiture, but for the fact that the employee owns 20 percent of the single class of stock in the transferor corporation, and if the remaining 80 percent of the class of stock is owned by an unrelated individual (or members of such an individual's family) so that the possibility of the corporation enforcing a restriction on such rights is substantial, then such rights are subject to a substantial risk of forfeiture. On the other hand, if 4 percent of the voting power of all the stock of a corporation is owned by the president of such corporation and the remaining stock is so diversely held by the public that the president, in effect, controls the corporation, then the possibility of the corporation enforcing a restriction on rights in property transferred to the president is not substantial, and such rights are not subject to a substantial risk of forfeiture.

In *Qinetiq U.S. Holdings, Inc. and Subsidiaries v. Commissioner*, T.C. Memo. 2015-123, *aff'd* 119 A.F.T.R.2d 2017-330 (4th Cir. 1/6/2017), the Tax Court applied these factors to determine that a corporation failed to prove that the possibility of forfeiture was substantial.

[3662] *Strom v. U.S.*, 641 F.3d 1051 (9th Cir. 2011), summarized:

> Ordinarily, when an employee is compensated with nonstatutory stock options that do not have a readily ascertainable fair market value at the time of the grant, the employee realizes income for tax purposes upon exercising the options. [Here, footnote 1 provides, Statutory stock options are compensatory options meeting criteria entitling them to special treatment under the Internal Revenue Code. See 26 U.S.C. § 422. Compensatory options that do not meet these requirements are referred to as nonstatutory. See *United States v. Tuff*, 469 F.3d 1249, 1251 n.2 (9th Cir. 2006) (citing *Cramer v. Comm'r*, 64 F.3d 1406, 1408–09 (9th Cir. 1995)).] See 26 U.S.C. § 83(e)(3)-(e)(4); 26 C.F.R. § 1.83-7(a). The taxpayer is taxed on an amount equal to the fair market value of the stock on the date of exercise minus the option price paid for the stock. See 26 C.F.R. § 1.83-1(a)(1); *id.* § 1.83-7(a). Internal Revenue Code § 83(c)(3), however, allows taxpayers to defer recognition and valuation of income so long as a profitable sale of the stock acquired through the exercise of the options could subject a person to suit under section 16(b) of the Securities Exchange Act of 1934. 26 U.S.C. § 83(c)(3). Section 16(b), in turn, forbids a corporate insider from profiting on a purchase made within six months of a sale (or a sale made within six months of a purchase) of the corporation's stock. See 15 U.S.C. § 78p(b). If a taxpayer is permitted to defer tax consequences under IRC § 83(c)(3), the taxpayer will be later taxed on an amount equal to the fair market value of the stock on the date that § 83(c)(3) no longer applies minus the option price paid for the stock. See 26 U.S.C. § 83(a); 26 C.F.R. § 1.83-1(a)(1).
>
> In this opinion, we first interpret the phrase could subject a person to suit under section 16(b) and determine what that phrase requires a taxpayer to demonstrate before she can postpone tax consequences under § 83(c)(3). We then hold that the taxpayer here has not demonstrated an entitlement to deferral of tax consequences under § 83(c)(3), and after addressing a distinct legal issue pertinent to the ultimate resolution of this case, reverse and remand for further proceedings.

forfeiture acted together to remove the restrictions without honoring their fiduciary duties in any way, *Larson v. Commissioner*, T.C. Memo. 2022-3 disregarded the restrictions.[3663]

The rights of a person in property are transferable if such person can transfer any interest in the property to any person other than the transferor of the property, but only if the rights in such property of such transferee are not subject to a substantial risk of forfeiture.[3664]

Consider planning for the contingency that a distributive share of income is allocated to a person whose interest was assumed to be vested but turned out not to be vested.[3665]

Furthermore, Code § 83(e) provides that Code § 83 does not apply to:

(1) a transaction to which section 421 applies,

(2) a transfer to or from a trust described in section 401(a) or a transfer under an annuity plan which meets the requirements of section 404(a)(2),

(3) the transfer of an option without a readily ascertainable fair market value,

(4) the transfer of property pursuant to the exercise of an option with a readily ascertainable fair market value at the date of grant, or

(5) group-term life insurance to which section 79 applies.

[3663] The first paragraph of the case presaged the result:

> Petitioner, John M. Larson, along with two other individuals, Robert A. Pfaff and David Amir Makov, promoted a fraudulent tax shelter transaction known as Bond Linked Issue Premium Structure (BLIPS). Mr. Larson was convicted of tax evasion for his involvement in BLIPS, but the central issue in this case concerns the use of a restricted stock agreement to defer recognition of income earned from these transactions.

Here’s another indication how the case would turn out:

> On September 5, 2000, the Internal Revenue Service (IRS or respondent) issued I.R.S. Notice 2000-44, 2000-2 C.B. 255, which advised that tax shelters such as BLIPS were not bona fide and that penalties might be imposed on the promoters of these transactions. On January 2, 2001, Mr. Larson, Mr. Pfaff, and Mr. Makov voted to terminate the restrictions on the Morley stock. They did not inform the members of the Morley ESOP, allow the Morley ESOP to consent to the removal of the restrictions, or resign as Morley ESOP trustees before voting to remove the restrictions.

[3664] Reg. § 1.83-3(d), which further provides:

> Accordingly, property is transferable if the person performing the services or receiving the property can sell, assign, or pledge (as collateral for a loan, or as security for the performance of an obligation, or for any other purpose) his interest in the property to any person other than the transferor of such property and if the transferee is not required to give up the property or its value in the event the substantial risk of forfeiture materializes. On the other hand, property is not considered to be transferable merely because the person performing the services or receiving the property may designate a beneficiary to receive the property in the event of his death.

[3665] See part II.M.4.f.iii What Happens If a Nonvested Partnership Interest Does Not Qualify As a Profits Interest for a similar situation.

If an employee uses existing stock to settle the exercise of a stock option, Code § 1036 may reduce the amount of gain recognized. Rev. Rul. 80-244 involved the following facts:

> A corporation, whose outstanding stock consists of a single class of common stock, has a qualified stock option plan described in section 422 of the Internal Revenue Code and a nonqualified stock option plan. An optionee who exercises an option granted under the nonqualified plan may pay for the shares (1) in cash, (2) with previously acquired shares having a fair market value equal to the option price, or (3) with cash and previously acquired shares having a fair market value less than the option price.
>
> On May 1, 1977, an employee of the corporation exercised a qualified stock option and acquired 1,000 shares of stock for 2x dollars. The fair market value of the stock steadily increased, and on July 1, 1979, when the employee exercised a nonqualified option (which was granted after April 21, 1969, and did not have a readily ascertainable fair market value when granted) for 2,000 shares of stock, the 1,000 shares of stock acquired pursuant to the qualified option had a fair market value of 6x dollars. The employee paid for the 2,000 shares of stock received pursuant to the nonqualified option with the 1,000 shares of identical stock acquired in 1977 when the employee exercised the qualified option. The nonqualified option price for the 2,000 shares of stock was 6x dollars; however, the fair market value was 12x dollars. Thus, the employee exchanged 1,000 shares of stock with a basis of 2x dollars and a fair market value of 6x dollars for 2,000 shares of stock with a fair market value of 12x dollars.

Rev. Rul. 80-244 held:

> The exercise of the nonqualified stock option caused the realization of 6x dollars of income under section 83(a) of the Code.
>
> (1) The exchange of 6x dollars in value of common stock (1,000 shares) for 6x dollars in value of common stock (1,000 shares) qualifies for nonrecognition of gain under section 1036 of the Code. Pursuant to section 1031(d), the employee-shareholder's basis in this 1,000 shares of stock received pursuant to the exercise of the nonqualified option is the same as the employee-shareholder's basis in the 1,000 shares of stock exchanged therefor (2x dollars). Therefore, a disposition within the meaning of section 425(c) did not occur because section 1036 applies to the exchange of the 1,000 shares of stock that were acquired in 1977 pursuant to the exercise of the qualified option, and the employee-shareholder did not receive income pursuant to section 1.421-8(b) of the regulations.
>
> (2) The additional 1,000 shares of common stock received by the employee-shareholder are compensation for services under section 83(a) of the Code. Accordingly, the employee-shareholder must include in gross income the fair market value (6x dollars) of the additional 1,000 shares of stock received pursuant to the exercise of the nonqualified stock option. The employee-shareholder's basis in the additional 1,000 shares of stock is the same as the amount included in gross income (6x dollars).

Rev. Rul. 80-244 is further analyzed in 383-5th T.M. III.B., "Options with Employer Stock, and IRS Position in Rev. Rul. 80-244."

Beyond the issue of forfeiture, if an employee or independent contractor (or beneficiary thereof) is granted, in connection with the performance of services, an option to which Code § 421 (relating generally to certain qualified and other options) does not apply, Code § 83(a) applies to such grant if the option has a readily ascertainable fair market value at the time the option is granted.[3666] Options have a value at the time they are granted, but that value is ordinarily not readily ascertainable unless the option is actively traded on an established market.[3667] If Code § 83(a) does not apply to the grant of an option because the option does not have a readily ascertainable fair market value at the time of grant, Code §§ 83(a) and (b) apply at the time the option is exercised or otherwise disposed of, even though the fair market value of such option may have become readily ascertainable before such time.[3668] If the option is exercised, Code §§ 83(a) and (b) apply to the transfer of property under the exercise, and the employee or independent contractor realizes compensation upon such transfer at the time and in the amount determined under Code §§ 83(a) and (b).[3669] Thus, when the service provider exercises such an option and the option is vested, the service recipient deducts the excess of value over exercise price and the service provider reports that as income.[3670]

A Generic Legal Advice Memorandum (GLAM), AM 2020-004 (5/2020), from Victoria Judson, Associate Chief Counsel (Employee Benefits, Exempt Organizations and Employment Taxes), explains in its Background:

> When a service provider exercises a stock award (such as a stock option or a stock-settled SAR) or the service recipient initiates payment under a stock award (such as a stock-settled RSU), the service recipient or a securities broker (broker) makes a request to the service recipient's transfer agent to transfer shares held in the service recipient's account with the transfer agent to the broker's account with the transfer agent. The broker then holds the shares on behalf of the service provider until the service provider decides to sell the shares. If, at the time of exercise, the service provider elects to sell shares to pay the exercise price or satisfy the tax withholding obligations, then the broker instructs the transfer agent to sell those shares.
>
> Due to Securities and Exchange Commission (SEC) regulations that apply to transfer agents and securities brokers, there is generally a short delay (settlement cycle) between the exercise of the option and settlement of the option exercise (delivery of the shares to the service provider's brokerage account or sale of the shares to cover the exercise price/withholding taxes). This same settlement cycle applies to the exercise of a stock-settled SAR as well as the payment under a stock-settled RSU. With respect to a stock-settled RSU, the short delay occurs between initiation of payment by the service recipient and delivery of the shares to the service provider's brokerage account…. A stock-settled RSU is an unsecured and unfunded promise by the service recipient to pay one or more shares of stock to the service provider at a future date following a specified vesting condition. The terms of a RSU typically provide that the payment of the stock will occur upon or within a short period of time following the satisfaction of the vesting condition. If payment occurs no later than two and a half months after the end of the taxable year in which the vesting condition was satisfied, then the payment is not

[3666] Reg. § 1.83-7(a).
[3667] Reg. § 1.83-7(b)(1).
[3668] Reg. § 1.83-7(a).
[3669] Reg. § 1.83-7(a).
[3670] Letter Ruling 201610006, dealing with warrants issued to an independent contractor that was an entity.

considered deferred compensation. See Treas. Reg. § 1.409A-1(b)(4). If the payment occurs more than two and a half months after the end of the taxable year in which the vesting condition was satisfied, then the RSU provides for a deferral compensation and is subject to the requirements of I.R.C. § 409A. See Treas. Reg. § 1.409A-1(b)(1). These facts do not contemplate or address the situation in which the RSU is settled only in cash. Not all service recipients use a transfer agent. A service recipient may act as its own transfer agent. If the stock of the service recipient is not publicly traded, then the service recipient would not typically have a transfer agent.

September 5, 2017, the settlement cycle could not exceed three days. On March 22, 2017, the SEC amended the settlement cycle regulations to provide that the settlement cycle could not exceed two days effective September 5, 2017. 17 C.F.R. § 240.15c6-1(a).

The GLAM's background then discusses various procedures regarding employment tax responsibilities upon such events. Then the GLAM discusses the tax law:

Overview of I.R.C. § 83

For purposes of I.R.C. § 83 , property includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. Treas. Reg. § 1.83-3(e). An option without a readily ascertainable fair market value is not considered property for purposes of I.R.C. § 83. Specifically, I.R.C. § 83(e)(3) provides that I.R.C. § 83 does not apply to an option without a readily ascertainable fair market value. Instead, I.R.C. § 83 applies to the transfer of property pursuant to the exercise of such an option. With respect to such options, in relevant part, Treas. Reg. § 1.83-7(a) provides that I.R.C. § 83(a) applies to the transfer of property pursuant to the exercise of the option and the service provider realizes compensation upon the transfer at the time and in the amount determined under I.R.C. § 83(a).[9]

[9] As described above, the grant of an option to purchase certain property generally does not constitute a transfer of such property. Treas. Reg. § 1.83-3(a)(2). In *Theophilos v. Comr.*, 85 F.3d 440, 445 (9th Cir. 1996), however, the Ninth Circuit held that a contractual obligation to acquire stock is property for purposes of I.R.C. § 83 and the subsequent purchase of the stock is not. In 2000, relying on *Theophilos*, CC:IT&A issued a FSA concluding that a contract to purchase shares was property for purposes of I.R.C. § 83. See FSA 200029013.

Commentators have criticized *Theophilos* . For example, "[W]e do not believe the Ninth Circuit's Theophilos decision is a correct interpretation of I.R.C. § 83." Mergers, Acquisitions, and Buyouts (Ginsburg, Levin, et al. 2016); "Where the Ninth Circuit departed from the conventional understanding of Section 83 was in its holding that an executory contract constitutes 'property.'" Paul J. Sax & Gary A. Herrmann, Ninth Circuit's Section 83 Decision May Reopen Planning Opportunities for Stock Compensation, 85 J. Tax'n 87, 88 (1996).

In a subsequent decision involving beneficial ownership outside the context of I.R.C.§ 83, the Ninth Circuit described the *Theophilos* decision as a case in which the service provider "acquired a beneficial interest in the stock not when he paid for the shares, but when the parties executed a shareholder agreement, two employee agreements, and other documents." *Pahl v. Commissioner*, 150 F.3d 1124, 1130 (9th Cir. 1998). According to the Ninth Circuit in *Pahl*, the property in *Theophilos* was the stock instead of the contractual obligation to acquire it. Regardless of the Ninth Circuit decision in *Theophilos*, prior to the actual exercise of the stock option, the terms of typical employee stock option awards do not contractually obligate service providers to purchase the underlying shares. Consequently, the facts in *Theophilos* are distinguishable from the facts covered by this GLAM.

Definition of Property for Purposes of I.R.C. § 83

Treas. Reg. § 1.83-3(a)(1) provides that, for purposes of I.R.C. § 83 , a transfer of property occurs when the service provider acquires a beneficial ownership interest in such property. A "beneficial owner" is someone who does not have legal title to property but has rights in the property which are the normal incidents of owning property. *Miller v. United States*, 345 F. Supp. 2d 1046, 1050 (N.D. Cal. 2004). Such rights include the right to receive dividends on and vote the shares, the right to dispose of the shares as the beneficial owner sees fit, and the right to use the shares as collateral. *See United States v. Tuff*, 359 F. Supp. 2d 1129, 1133 (W.D. Wash. 2005); *Miller v. United States*, *supra* at 1050. Pursuant to Treas. Reg. § 1.83-3(a)(6) , an indication that a transfer has occurred is the extent to which the service provider incurs the risk that the value of the property will decline. See also *Walter v. Commissioner*, T.C. Memo 2007-2, at 7. A service provider incurs the risk that the value of the stock will decline when the number of shares and fair market value of the stock that the service provider will receive are fixed and determinable (regardless of actual receipt of the shares),which occurs on the earliest of the service provider exercising the stock award (for example, the stock option or stock-settled SAR) or the service recipient initiating payment under the stock award (for example, the stock-settled RSU).

Overview of FICA taxes and Federal Income Tax Withholding

FICA Taxes

FICA taxes consist of the old-age, survivors, and disability insurance (social security) taxes imposed under I.R.C. §§ 3101(a) and 3111(a), the hospital insurance (Medicare) taxes imposed under I.R.C. §§ 3101(b)(1) and 3111(b), and the Additional Medicare Tax (AdMT) imposed under I.R.C. § 3101(b)(2).

FICA taxes are computed as a percentage of "wages" paid by the employer and received by the employee with respect to "employment." In general, all payments of remuneration by an employer for services performed by an employee are subject to FICA taxes, unless the payments are specifically excepted from the term "wages" or the services are specifically excepted from the term "employment."

I.R.C. § 3121(a) defines "wages," for FICA tax purposes, as all remuneration for services, with certain exceptions not applicable here. I.R.C. § 3121(a)(1) provides that the social security portion of FICA tax is only imposed on wages up to the contribution and benefit base for social security each year (social security wage base). There is no wage base for the Medicare portion of FICA tax. Effective for tax years beginning after December 31, 2012, employees are also subject to AdMT (0.9 percent) on wages paid by an employer in excess of enumerated dollar thresholds that are dependent upon each employee's filing status in a calendar year. See I.R.C.§ 3101(b)(2).

In general, the employer is required to withhold and pay to the IRS the employee share of FICA taxes from wages when paid to the employee and to pay to the IRS the employer share of FICA taxes with respect to wages when paid to the employee. In the case of AdMT, which is only imposed on the employee, an employer must withhold and pay to the IRS AdMT with respect to wages for employment performed for the employer by the employee only to the extent the employer pays wages to the employee in excess of $200,000 in a calendar year. This rule applies regardless of the employee's filing status or other income. See Treas. Reg. § 31.3102-4(a).

Treas. Reg. § 31.3121(a)-2(a) provides that wages are generally subject to FICA tax when actually or constructively received. Treas. Reg. § 31.3121(a)-2(b) provides that wages are constructively paid when they are credited to the account of or set apart for an employee so that they may be drawn upon by him at any time although not then actually reduced to possession. To constitute payment in such a case, the wages must be credited to or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that they may be drawn upon at any time, and their payment brought within his own control and disposition. Remuneration for employment that constitutes wages at the time the remuneration is actually or constructively paid is referred to as the general timing rule. See Treas. Reg. § 31.3121(a)-2(a) and Treas. Reg. § 31.3121(v)(2)-1.

I.R.C. § 3121(v)(2) provides for the FICA tax treatment of nonqualified deferred compensation (NQDC) plans.[10] Under I.R.C. § 3121(v)(2)(A) , any amount deferred under a NQDC plan must be taken into account as wages for FICA tax purposes as of the later of (1) when the services are performed, or (2) when there is no substantial risk of forfeiture of the rights to such amount. This is referred to as the special timing rule.

[10] The income tax treatment of NQDC is governed by the rules in I.R.C. §§ 451, 409A, 457(f) and 457A, as applicable. These rules are not determinative of the employment tax treatment.

Treas. Reg. § 31.3121(v)(2)-1(b)(3)(i) states that a plan provides for the deferral of compensation with respect to an employee only if, under the terms of the plan and the relevant facts and circumstances, the employee has a legally binding right during the calendar year to compensation that has not been actually or constructively received and that, pursuant to the terms of the plan, is payable to (or on behalf of) the employee in a later year.

Treas. Reg. § 31.3121(v)(2)-1(b)(4)(i) defines plans, arrangements, and benefits that do not provide for the deferral of compensation and thus are subject to the general timing rule rather than the special timing rule. Under Treas. Reg. § 31.3121(v)(2)-1(b)(4)(ii) , the grant of a stock option, stock appreciation right, or other stock value right does not constitute the deferral of compensation for purposes of I.R.C. § 3121(v)(2). In addition, amounts received as a result of the exercise of such items do not result from the deferral of compensation for purposes of I.R.C. § 3121(v)(2) if such amounts are actually or constructively received in the calendar year of exercise.

Because the grant of a stock option or a SAR does not constitute the deferral of compensation for purposes of I.R.C. § 3121(v)(2), the general timing rule under Treas.

Reg. § 31.3121(a)-2(a) applies, that is, wages generally are subject to FICA tax when actually or constructively received.

Treas. Reg. § 31.3121(v)(2)-1(b)(4)(ii) defines a stock value right as a right granted to an employee with respect to one or more shares of an employer stock that, to the extent exercised, entitles the employee to a payment for each share of stock equal to the excess, or a percentage of the excess, of the value of a share of the employer's stock on the date of exercise over a specified price (greater than zero). The term stock value right does not include a phantom stock or other arrangement under which an employee is awarded the right to receive a fixed payment equal to the value of a specific number of shares of employer stock.

An RSU award is not a stock value right and therefore provides for the deferral of compensation for purposes of I.R.C. § 3121(v). Amounts paid pursuant to the settlement of an RSU award are NQDC for FICA purposes and are subject to FICA taxes as of the later of (1) the date on which the services creating the right to the amount are performed, or (2) the date on which the right to the amount is no longer subject to a substantial risk of forfeiture.

Federal Income Tax Withholding

I.R.C. § 3401(a) generally provides, with certain enumerated exceptions, that the term "wages" for federal income tax withholding purposes means all remuneration for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash.

I.R.C. § 3402(a) provides that every employer making a payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary of the Treasury.

Treas. Reg. § 31.3402(a)-1(b) generally provides that the employer is required to collect income tax by deducting and withholding the amount thereof from the employee's wages as and when paid, either actually or constructively. Further, wages are constructively paid when they are credited to the account of or set apart for an employee so that they may be drawn upon by him at any time although not then actually reduced to possession. To constitute payment in such a case, the wages must be credited to or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that they may be drawn upon at any time, and their payment brought within his own control and disposition.

Treas. Reg. § 31.3402(a)-1(c) provides, in part, that an employer is required to deduct and withhold the tax notwithstanding the wages are paid in something other than money (for example, wages paid in stocks or bonds) and to pay over the tax in money. If wages are paid in property other than money, the employer should make the necessary arrangements to insure that the amount of the tax required to be withheld is available for payment in money.

Revenue Rulings

Rev. Rul. 67-257, 1967-2 C.B. 359, addresses whether liability is incurred by a company for the withholding of income tax under I.R.C. § 3402(a) with respect to the compensation amount in certain nonstatutory stock options allotted to its key employees. Under the plan, the company grants options to the employees to purchase shares to encourage an increase to their proprietary interest in the company. The options do not have a readily ascertainable value at time of grant. When the options allotted to the employees to buy shares of the stock are exercised, the employees have an unconditional right to receive the stock subject to the options upon payment of the option price.

The ruling holds that since the employees have an unconditional right to receive such stock upon payment of the option price, the excess of the fair market value of the stock on the date of exercise over the option price is compensation includible in the employee's gross income at the time the option is exercised. It concludes that such compensation is remuneration for services performed in the company's employ and, therefore, constitute wages subject to the withholding of income tax under I.R.C.§ 3402(a). While the ruling does not explicitly address the timing of the income tax withholding, it implies that the compensatory amount is both includible in the employee's gross income and is wages subject to income tax withholding at the time the option is exercised, since it uses fair market value on the date of exercise to measure the compensation and wage amounts.

Although the ruling does not address the timing of FICA tax treatment of the compensatory amounts as wages under I.R.C. § 3121, the timing should be the same as for the income tax withholding of wages under I.R.C.§ 3402; that is, the fair market value of the property received as wages should be determined with reference to the fair market value at the time the option is exercised. This results because both Treas. Reg. § 31.3121(a)-2(a) and Treas. Reg. § 31.3402(a)-1(b) provide the same general timing rules. Treas. Reg. § 31.3121(a)-2(a) provides that wages are generally subject to FICA tax when actually or constructively received. Treas. Reg. § 31.3402(a)-1(b) generally provides that the employer is required to collect income tax by deducting and withholding the amount thereof from the employee's wages as and when paid, either actually or constructively.

Rev. Rul. 79-305, 1979-2 C.B. 350, addresses the timing of when a transfer of stock to an employee is wages for FICA tax (I.R.C. § 3121(a)) and federal income tax withholding purposes (I.R.C. § 3401(a)), and when it is includible in gross income under I.R.C. § 83. It concludes that the fair market value of the transferred stock at the time the risk of forfeiture lapsed is includible in the employee's gross income for the year in which the risk lapses and is wages at the time the risk lapsed.[11]

[11] See also Rev. Rul. 78-185, 1978-1 C.B. 304. The Ruling discusses a company with a stock purchase plan not qualifying under I.R.C.§§ 401 or 423. At the end of each month, the company makes contributions to the plan on behalf of each participant in an amount equal to a percentage of the dollar amount of the participant's contributions into the plan for that month. On the same day, the employer then credits the employee's account with the number of whole and fractional shares of the employer's common stock that the sum of the employer's and the employee's contributions for that month would purchase based upon the average of the closing prices of that stock on

the New York Stock Exchange for each trading day of the month. There is no forfeiture provision for either the employee or employer contributions to the plan. The Ruling holds that the excess of the fair market value of the stock credited to an employee's account, on the date of the crediting of such stock to the employee's account, over the amount of the employee's contributions to the account is "wages" for purposes of FICA, FUTA, and income tax withholding.

The ruling does not address the three specific situations of this memo, but is useful for its general analysis on the timing of a payment as wages for FICA tax and federal income tax withholding purposes. In the ruling, a corporation transferred stock, subject to a substantial risk of forfeiture, to one of its employees. Prior to the lapse of the substantial risk of forfeiture, the stock was not transferable. The employee made no election pursuant to I.R.C. § 83(b) to include the fair market value of the stock in gross income in the year of transfer. The substantial risk of forfeiture lapsed in a later year, and the stock had appreciated in value from the time of the transfer to the time of the lapse of the substantial risk of forfeiture.

The ruling cites to Treas. Reg. § 31.3121(a)-(2) that, "wages are paid by an employer at the time they are actually or constructively paid…[t]o be a constructive payment, the wages must be credited to or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that they may be drawn upon at any time, and their payment brought within his own control and disposition." The ruling also cites to a similar provision Treas. Reg. § 31.3402(a)-1(b) for federal income tax withholding purposes.

Additionally, the ruling cites to Treas. Reg. § 31.3401(a)-1(a)(4) that if a corporation transfers to its employees its own stock as remuneration for services rendered, the amount of such remuneration is the fair market value of the stock at the time of transfer. The transfer of stock mentioned in Treas. Reg. § 31.3401(a)-1(a)(4) refers to the transfer of an item of noncash remuneration not subject to substantial limitations or restrictions.

The ruling holds that when the substantial risk of forfeiture lapsed, the stock was made available to the employee without any substantial limitation or restriction and was available to be used by the employee at any time. Therefore, the fair market value of the stock at the time when the substantial risk of forfeiture lapsed is wages for purposes of FICA tax and federal income tax withholding. At the time the risk of forfeiture lapsed, the fair market value of the transferred stock is also includible in the employee's gross income under I.R.C. § 83(a).

The GLAM's section titled "Law" then has explanations of "Deposit Rules for FICA Taxes and Federal Income Tax Withholding" and "Overview of the I.R.C. § 6656 FTD Penalty."

The GLAM's section titled "Analysis" explains:

Situation 1: Stock Option

An employee acquires a beneficial interest in the underlying shares of stock upon exercising a stock option. For example, in *Walter*, the Tax Court ruled that, upon the exercise of a stock option, the employee became the beneficial owner of the underlying stock because, upon exercise, the employee incurred the risk that the value of the stock would decline.[13] *Walter*, TC Memo 2007-2, at 7. Rev. Rul. 70-335, 1970-1 C.B. 111, holds that stock is considered transferred on the date the employee delivers to the grantor corporation written notice of the stock option exercise with full payment even though the plan provides that the employee has no interest in the stock until issuance of the stock certificates. In both *Walter* and Rev. Rul. 70-335, the employee incurred the risk that the value of the stock would decline and thus acquired beneficial ownership of the stock upon exercise of the stock option. When the employee exercises a stock option (thus initiating the process pursuant to which the employer transfers the stock), the number of shares and fair market value of the stock received by the employee are fixed and determinable, even though the value of the stock may decrease or increase prior to actual delivery of the shares (for example, during the period of delay between exercise and delivery of the shares to the employee's brokerage account). The employee's ability to (1) pledge the stock as collateral for a loan to exercise the option, and (2) direct the sale of shares to repay the loan or to satisfy the tax withholding obligation upon exercising the stock award are also indications of beneficial ownership. Accordingly, for purposes of I.R.C. § 83 , the transfer of shares of stock occurs on December 29, 2021, the date on which Employee exercises the stock option.

[13] In concluding that an employee acquired a beneficial ownership of shares of stock on the date of exercising the stock options, the court in *Walter* also explained that the employee's exercise of the stock options constituted an "unconditional acceptance of [the employer's] offer under the stock option grants and created a contract between [the employer] and petitioner for the sale of the exercised shares of stock." *Walter*, TC Memo 2007-2, at 6. In other words, an employee acquires a beneficial ownership in stock under a stock option when the employee is contractually obligated to purchase the underlying shares. This is consistent with the definition of transfer in Treas. Reg. § 1.83-3(a) and the Ninth Circuit's description of *Theophilos* in *Pahl*.

When an employee exercises a stock option, I.R.C. § 83 applies to the transfer of stock pursuant to the exercise and compensation is realized upon such transfer at the time and in the amount determined under I.R.C. § 83(a). See Treas. Reg. § 1.83-7(a). To determine the amount of compensation realized, I.R.C. § 83(a) provides, in relevant part, that the excess of the fair market value of the transferred property over the amount (if any) paid for such property shall be included in the gross income of the person who performed such services. In other words, the amount of compensation realized is the excess of the fair market value of the stock on the date of exercise over the exercise price. In accordance with Treas. Reg. § 1.83-7(a), such compensation is included in gross income upon exercise of the option because that is when the transfer of the underlying stock occurs for purposes of I.R.C. § 83.[14] Accordingly, on December 29, 2021, $50 [10 shares x ($15 FMV on date of exercise- $10 exercise price)] is includible in Employee's gross income.

[14] See also Rev. Rul. 67-257, 1967-2 C.B. 359, which holds that because the employees have an unconditional right to receive stock upon payment of the exercise price, the excess of the fair market value of the stock on the date of exercise over the option price is compensation includible in the employee's gross income at the time the option is exercised.

Even though the fair market value of each share is $14 on December 31, 2021 when the shares are delivered to Employee's brokerage account, the value of the shares on the delivery date is not taken into account in determining the amount of compensation income includible under I.R.C. § 83 nor the wage amount subject to FICA taxes or federal income tax withholding. At the time Employee exercised the stock option on December 29, 2021, when the fair market value of the stock was $15 per share, Employee incurred the risk that the value of the stock would decline.

On December 29, 2021, when Employee exercises the option to purchase the shares, Employee has beneficial ownership of the stock. Furthermore, when Employee exercises the option, the stock was made available to the Employee without any substantial limitation or restriction and was available to be used by the Employee at any time.[15] Therefore, on December 29, 2021, the $50 stock payment constitutes wages that have actually or constructively been received by the Employee and is subject to FICA taxes and federal income tax withholding at that time.

[15] See Rev. Rul. 67-257. *Cf*. Rev. Rul. 78-185; Rev. Rul. 79-305.

If, in conjunction with other wage payments, Employer has accumulated $100,000 or more in employment taxes upon the $50 stock payment date of December 29, 2021, then pursuant to the One-Day rule, Employer has an obligation to deposit such employment taxes by the close of the next day, December 30, 2021. If the Employer does not deposit such employment taxes by December 30, 2021, then under the Code the IRS may impose an FTD penalty upon the Employer unless it is shown that such failure is due to reasonable cause and not due to willful neglect.

Situation 2: Stock-Settled Stock Appreciation Rights (SAR's)

A stock-settled SAR is, in substance, a stock option without an exercise price. Upon exercising the stock-settled SAR, an employee acquires a beneficial ownership in the underlying shares of stock because the employee incurs the risk that the value of the stock would decline. Accordingly, the transfer of shares of stock occurs on December 29, 2021, the date on which Employee exercises the stock-settled SAR. Therefore, on December 29, 2021, $150 [10 SAR's x ($25 FMV per share on date of exercise - $10 FMV per share on date of grant)], which is the fair market value of 6 shares on the date of exercise ($150 total FMV/$25 FMV per share on date of exercise = 6 shares), is includible in Employee's gross income.

Even though the fair market value of each share is $24 on December 31, 2021 when the shares are delivered to Employee's brokerage account, the value of the shares on the delivery date is not taken into account in determining the amount of compensation income includible under I.R.C. § 83 nor the wage amount subject to FICA taxes or federal income tax withholding. At the time Employee exercised the stock option on December 29, 2021, when the fair market value of the stock was $25 per share, Employee incurred the risk that the value of the stock would decline.

On December 29, 2021, when Employee exercises the stock settled SAR, Employee has beneficial ownership of the stock. Furthermore, when Employee exercises the option, the stock was made available to the Employee without any substantial limitation or restriction and was available to be used by the Employee at any time.[16] Therefore, on December 29, 2021, the $150 stock payment constitutes wages that have been actually or constructively received by the Employee and is subject to FICA taxes and federal income tax withholding at that time.

[16] *Cf*. Rev. Rul. 67-257; Rev. Rul. 78-185; Rev. Rul. 79-305.

If, in conjunction with other wage payments, Employer has accumulated $100,000 or more in employment taxes upon the $150 stock payment date of December 29, 2021, then pursuant to the One-Day rule, Employer has an obligation to deposit such employment taxes by the close of the next day, December 30, 2021. If the Employer does not deposit such employment taxes by December 30, 2021, then under the Code the IRS may impose an FTD penalty upon the Employer unless it is shown that such failure is due to reasonable cause and not due to willful neglect.

Situation 3: Stock-Settled Restricted Stock Unit (RSU)

When the employer initiates payment under the RSU, the employee acquires a beneficial ownership in the underlying stock. When the employer initiates payment, the number of shares of stock to be transferred and the fair market value of the stock become fixed and determinable. At this time, the employee incurs the risk that the stock's fair market value may decrease or increase prior to actual delivery of the shares (for example, during the period of delay between the time the employer initiates payment and delivery of the shares to the employee's brokerage account). The employee's ability to direct the sale of stock to satisfy the tax withholding obligation is another indication of beneficial ownership. Thus, upon initiation of the payment, the employee is considered a beneficial owner of the stock and the stock is considered transferred for purposes of I.R.C. § 83. Accordingly, the transfer of shares of stock occurs on December 29, 2021, the date on which Employer initiates payment of the 10 shares of stock.[17]

[17] This analysis would also apply to a stock-settled SAR whose terms provide that the stock will be paid on a specified date and do not require the service provider to exercise the SAR.

I.R.C. § 83(a) determines the amount of compensation realized upon the transfer and provides, in relevant part, that the excess of the fair market value of the transferred property over the amount (if any) paid for such property shall be included in the gross income of the person who performed such services. If the employee did not pay for the stock issued under the RSU, then the amount of compensation included in the employee's gross income is the fair market value of the stock on the date that the employer or broker initiates the payment. Accordingly, because Employee paid nothing for the shares, on December 29, 2021, $250 (10 shares x $25 FMV on date of transfer) is includible in Employee's gross income.

Even though the fair market value of each share is $24 on December 31, 2021, when the shares are delivered to Employee's brokerage account, the value of the shares on the delivery date is not taken into account in determining the amount of compensation income includible under I.R.C. § 83. At the time Employer initiated payment on December 29, 2021, when the fair market value of the stock was $25 per share, Employee incurred the risk that the value of the stock would decline.

I.R.C. § 3121(v)(2) determines the FICA tax treatment of NQDC plans. A RSU award is not a stock value right and therefore provides for the deferral of compensation. Amounts paid pursuant to the settlement of an RSU award are NQDC for FICA purposes and are subject to FICA taxes as of the later of (1) the date on which the services creating the right to the amount are performed, or (2) the date on which the right to the amount is no longer subject to a substantial risk of forfeiture. On December 29, 2021, when Employer initiates payment, the Employee's right to the shares of stock transferred is no longer subject to a substantial risk of forfeiture. Thus, the fair market value of the shares of stock transferred in the amount of $250 is an amount paid subject to FICA taxes at that time.[18]

[18] *Cf*. Rev. Rul. 67-257; Rev. Rul. 78-185; Rev. Rul. 79-305.

As stated above, on December 29, 2021, when Employer initiates payment, Employee has beneficial ownership of the stock. Furthermore, when Employer initiates payment, the stock is made available to the Employee without any substantial limitation or restriction and was available to be used by the Employee at any time. Therefore, on December 29, 2021, the $250 stock payment constitutes wages that have been actually or constructively received by the Employee and is subject to federal income tax withholding at that time.[19]

[19] *Id.*

If, in conjunction with other wage payments, Employer has accumulated $100,000 or more in employment taxes upon the $250 stock payment date of December 29, 2021, then pursuant to the One-Day rule, Employer has an obligation to deposit such employment taxes by the close of the next day, December 30, 2021. If the Employer does not deposit such employment taxes by December 30, 2021, then under the Code the IRS may impose an FTD penalty upon the Employer unless it is shown that such failure is due to reasonable cause and not due to willful neglect.

Conclusion

In summary, the fair market value of the underlying stock is includible in the Employee's gross income as compensation when the stock is considered transferred for purposes of I.R.C. § 83 , which occurs on the earliest of (1) when the Employee exercises a stock award (such as a stock option or a stock-settled SAR) or (2) the Employer initiates payment under the stock award (such as a stock-settled RSU).

For FICA and federal income tax withholding purposes, the stock payments in the above situations are considered wages of the Employee when actually or constructively received, except that for FICA purposes in Situation 3, the settlement of an RSU award is subject to FICA taxes the later of (1) the date on which the services creating the right to the amount are performed, or (2) the date on which the right to the amount is no longer subject to a substantial risk of forfeiture.

On the date the stock payments in the above situations are considered wages for FICA and federal income tax withholding purposes, if the Employer has accumulated $100,000 or more in employment taxes, then the Employer must deposit the employment taxes by the close of the next day pursuant to the One-Day rule. If the Employer does not deposit such employment taxes by the close of the next day, an FTD penalty may be assessed.

Situation 1: Stock Option

On December 29, 2021, when Employee exercises the stock option, the transfer of shares of stock occurs for purposes of I.R.C. § 83 and $50 is includible in Employee's gross income on this date. This amount also constitutes wages subject to FICA taxes and federal income tax withholding on this date. If, in conjunction with other wage payments, the Employer accumulates $100,000 or more in employment taxes on this date, then the Employer must deposit any accumulated FICA taxes and federal income tax withholding by the close of the next day, December 30,2021.

Situation 2: Stock-Settled Stock Appreciation Rights (SAR's)

On December 29, 2021, when Employee exercises the stock-settled SAR, the transfer of shares of stock occurs for purposes of I.R.C. § 83 and $150 is includible in Employee's gross income on this date . This amount also constitutes wages subject to FICA taxes and federal income tax withholding on this date. If, in conjunction with other wage payments, the Employer accumulates $100,000 or more in employment taxes on this date, then the Employer must deposit any accumulated FICA taxes and federal income tax withholding by the close of the next day, December 30, 2021.

Situation 3: Stock-Settled Restricted Stock Unit (RSU)

On December 29, 2021, when Employer initiates the payment of shares of stock, the transfer of shares of stock occurs for purposes of I.R.C. § 83 and $250 is includible in Employee's gross income on this date. This amount also constitutes wages subject to FICA taxes and federal income tax withholding on this date. If, in conjunction with other wage payments, the Employer accumulates $100,000 or more in employment taxes on this date, then the Employer must deposit any accumulated FICA taxes and federal income tax withholding by the close of the next day, December 30, 2021.

For more details on how Code § 83 applies and the impact of a Code § 83(b) election in accelerating income, see part II.M.4.e.i Issuing Stock to an Employee - Generally; with part II.M.4.e.i, for possible deferral of income tax (but not employment tax) inclusion, see part II.M.4.e.ii Code § 83(i) Election Deferring Income Tax Inclusion.

II.M.4.b.iii. Strategic Issues re Income Tax Timing of Equity Incentives

If the employer can deduct the compensation expense at the same or a higher rate than that of the employee, then the incentive payment is tax-efficient. This can be especially important when paying key employees bonuses in connection with the sale of a company. The bonuses might even be grossed up to pay the employees' taxes – see the example in part II.M.4.e.i Issuing Stock to an Employee - Generally.

Sometime a mismatch might occur. For example, suppose a partnership or S corporation sells its assets, recognizing long-term capitals taxable at favorable rates, but has little ordinary income. In that case, the deduction benefits the employer to the extent of capital gain rates, while the income is taxed to the employee at ordinary income rates. Also, if the employer has insufficient income against which to deduct the compensation, then the compensation award is even less efficient. These mismatches might make grossing up employees for taxes be untenable.

II.M.4.c. Gifts to Employees

part II.M.4.c.i When a Gift to a Service Provider Is Compensation and Not a Gift explains that any material payment to an employee is compensation and not a gift. sometimes business owners or other business associates will make transfers to service providers, and tax litigation ensues.

Part II.M.4.c.ii Is Compensation to an Employee Better or Worse Than a Gift? explains that the service provider's income inclusion, when netted against the compensation deduction, may have little or no detriment, especially considering the gift tax consequences of making a gift.

In advising business owners on this issue, consider how any tax detriment of affirmatively declaring compensation income described in part M.4.c.ii compares to the tax risk described in part II.M.4.c.i.

Also consider whether shifting equity to employees before a sale, using various ideas described in part II.M.4 Providing Equity to Key Employees and an Introduction to Code § 409A Nonqualified Deferred Compensation Rules, might avoid the dilemma described in this part II.M.4.c.

In *Pratte v. Bardwell*, 128 A.F.T.R.2d 2021-5429 (D. Ariz. 08/04/2021), the plaintiff ("P") transferred property to the defendants (collectively, "D"), allegedly in consideration for D agreeing to provide services to P. Instead of giving D a Form 1099, P reporting the transfer as a gift on a gift tax return. When D did not perform the allegedly agreed-upon services, P sued D, seeking, among other remedies, recovery of gift tax P paid. The court held that gift tax would not be due if the transfer was not gratuitous, and any gift tax is the donor's responsibility. If P had intended to agree to pay gift tax and not impose employment tax on the parties:

> Plaintiff is not permitted to assert damages from an agreement to improperly file his taxes. See *White v. Mattox*, 127 Ariz. 181, 184, 619 P.2d 9, 12 (1980) ("Recovery will be denied if the acts to be performed under the contract are themselves illegal or contrary to public policy."); *cf. Gutierrez v. Carter Bros. Sec. Servs., LLC*, 63 F. Supp. 3d 1206, 1215 (E.D. Cal. 2014) (refusing to enforce an agreement where its apparent purpose was to avoid paying employment taxes and other benefits).

II.M.4.c.i. When a Gift to a Service Provider Is Compensation and Not a Gift

Code § 274(b), enacted in 1962, limits to $25 the deduction for business gifts.

A gift to an employee generally is considered to be compensation and not a true gift. Code § 102(c), "Employee gifts," added by the Tax Reform Act of 1986, provides:

> (1) *In general*. Subsection (a) shall not exclude from gross income any amount transferred by or for an employer to, or for the benefit of, an employee.
>
> (2) *Cross references*.
>
> For provisions excluding certain employee achievement awards from gross income, see section 74(c).

> For provisions excluding certain de minimis fringes from gross income, see section 132(e).

Absent regulations on Code § 102(c), let's look at the Senate Report that the Conference Committee followed:

> Except to the extent that the new section 74(c) exclusion or section 132(e) applies, the fair market value of an employee award (whether or not satisfying the definition of an employee achievement award) is includible in the employee's gross income under section 61, and is not excludable under section 74 (as amended by the bill) or section 102 (gifts). The fair market value of an employee award (or any portion thereof) that is not excludable from income must be included by the employer on the employee's Form W-2, as is required under present law.

Note that Code § 102(c) applies to gifts made by an employer to an employee. Below we explore whether payments made by persons other than employers constituted gifts.

When a majority stockholder of a corporation transferred some of his stock in the corporation to the employees of that corporation, the number of shares transferred to each employee being dependent on the number of years of service to the corporation, the IRS viewed the majority stockholder as benefitting economically through increased initiative in the employees resulting from their ownership of stock in their employer corporation, so Rev. Rul. 69-140 held that the transferor's intent was recognizing past services rather than "detached and disinterested generosity."

If a shareholder of a corporation transfers property to an employee of such corporation or to an independent contractor (or to a beneficiary thereof), in consideration of services performed for the corporation, the transaction is considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property as compensation paid by the corporation to the employee or independent contractor.[3671] Note that this rule applies only if the payment is "in consideration of services performed for the corporation," so this rule would not apply to a gift.

Runyon v. Commissioner, T.C. Memo. 1984-623, recognized as gifts payments made by shareholders to a former employee, following the result in *Abdella v. Commissioner*, T.C. Memo. 1983-616, which held:

> Section 61(a) provides that gross income includes all income from whatever source derived unless excluded by a specific provision of the Code. Section 102(a) excludes from gross income the value of property acquired by gift. Whether a payment is a gift under section 102(a) or gross income under section 61(a) is a factual question, and the criteria have evolved from numerous judicial determinations. In *Commissioner v. Duberstein*, 363 U.S. 278, 285-286 (1960), the Supreme Court stated the governing principles in this area:
>
>> [T]he mere absence of a legal or moral obligation to make such a payment does not establish that it is a gift.... And, importantly, if the payment proceeds primarily from "the constraining force of any moral or legal duty," or from "the incentive of

[3671] Reg. § 1.83-6(d)(1), adopted by T.D. 7554 (7/21/1978), generally effective for the transfer of property after June 30, 1969.

> anticipated benefit" of an economic nature, … it is not a gift. And, conversely, "[w]here the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it." … A gift in the statutory sense, on the other hand, proceeds from a "detached and disinterested generosity," … "out of affection, respect, admiration, charity or like impulses." … And in this regard, the most critical consideration, as the Court was agreed in the leading case here, is the transferor's "intention." … "What controls is the intention with which payment, however voluntary, has been made." [Footnotes and citations omitted.]

The intention of the transferor or donor is primarily a determination of fact "based ultimately on the application of the fact-finding tribunal's experience with the mainsprings of human conduct to the totality of the facts of each case." *Commissioner v. Duberstein*, *supra* at 289. We must make an objective inquiry into the circumstances surrounding the transfer rather than relying on the transferor's subjective characterization of the transfer. *Commissioner v. Duberstein*, *supra* at 285; *Bogardus v. Commissioner*, 302 U.S. 34, 43 (1937).

Applying the principles set forth in the case law to the facts of this case, we conclude that the payments petitioner received from Lucas and Burford were gifts within the meaning of section 102(a). We have found that Lucas and Burford were under no legal obligation to make these payments to petitioner from the stock sale proceeds.[6] Nor was there any understanding or expectation that petitioner would share in the proceeds of the sale of stock. And although Burford and Lucas testified that they felt "morally obligated" to make these payments, we find no moral obligation or duty to do so. As we read the case law, the "moral obligation" or "moral duty" contemplated by the Supreme Court in *Duberstein* involves an unenforceable promissory obligation where the recipients expect payment, or the payor expects to receive future benefits, or both. See *Pearson v. United States*, 519 F.2d 1279 (4th Cir. 1975) (payment of special death benefits to widow of deceased employee-stockholder); *Jensen v. United States*, 511 F.2d 265, 272 (5th Cir. 1975) (payment of special death benefits to widow of deceased employee-stockholder);[7] *Simpson v. United States*, 261 F.2d 497, 501 (7th Cir. 1958) (payment to widow of deceased executive); *Placko v. Commissioner*, 74 T.C. 452, 456-457 (1980) (strike benefit payments from union); *Brown v. Commissioner*, 47 T.C. 399, 408 (1967), *affd. per curiam* 398 F.2d 832 (6th Cir. 1968) (strike benefit payments from union); *Hagar v. Commissioner*, 43 T.C. 468, 484 (1965) (strike benefit payments from union).[8]

[6] The contractual nature of the payments to Little and Washburn does not diminish the significance of the noncontractual nature of the payments to petitioner, Runyon, and Phillips. This is especially true where it is likely that these contractual obligations to pay Little and Washburn were those of the corporation rather than of its shareholders, Lucas and Burford.

[7] Compare *Harper v. United States*, 454 F.2d 222 (9th Cir. 1971), involving a payment to a widow of an employee-stockholder of the Graybar Electric Company of the same type as in the *Pearson* and *Jensen* cases cited in the test, where the Ninth Circuit held that such payments were nontaxable gifts. The conflict in these cases involving the payments under the same Graybar payment plan demonstrates the differing results that may sometimes occur in analyzing the intent of the transferor, which the Supreme Court teaches us is "the most critical consideration" for the fact-finder to address in determining whether a payment constitutes a gift. *Commissioner v. Duberstein*, 363 U.S. 278, 285-286 (1960).

[8] We also note that in a different factual setting even a strike benefit paid by a union may be a nontaxable gift. *United States v. Kaiser*, 363 U.S. 299 (1960).

Although it is commendable and appropriate for investors like Lucas and Burford to share their bounty with corporate employees like petitioner, whose efforts on behalf of the corporation enhanced the value of and ultimate profit on their corporate investment, this hardly rises to the level of a moral obligation or duty. Petitioner did not expect to receive these payments, and Lucas and Burford did not expect to receive any future benefits from the payments to petitioner.[9] To find that corporate investors like Lucas and Burford were morally obligated to share their profits with corporate employees like petitioner is to impose a standard of business morality wholly alien to our economic system of free enterprise.

[9] Respondent has not argued that the payments to petitioner were compensation to induce him to greater productivity and efficiency with Burford, Inc., in order to enhance the value of the former shareholders' contingent royalty rights. See footnote 2. We do not consider this in our determination, although we note that the inclusion of former employees as recipients and the failure of McDavid and Carson, the minority shareholders, to make any such payments substantially undercut the force of any such argument.

Lucas and Burford deducted the payments to petitioner and the other employees on their individual income tax returns as compensation paid to them. Petitioner was an employee of the corporation, not of Lucas and Burford individually Some cases have viewed deduction by the payor as a factor indicating the payment was not a gift. See *Poorman v. Commissioner*, 131 F.2d 946, 949 (9th Cir. 1942), *affg*. 45 B.T.A. 73 (1941); *Willkie v. Commissioner*, 127 F.2d 953, 956 (6th Cir. 1942), *affg*. an unpublished Memorandum Opinion of this Court dated Feb. 21, 1941. Although relevant, this factor is not conclusive. See *Greentree v. United States*, 13 AFTR 2d 979, 64-1 USTC par. 9284 (E.D. Va. 1964), *affd*. 338 F.2d 946 (4th Cir. 1964). The fact that the payors improperly claimed deductions should not preclude exclusion of the payment from the recipient's income as a gift if the payment was in fact a gift. As the Supreme Court stated in *Commissioner v. Duberstein*, *supra*, 363 U.S. at 287-288:

> [I]t is doubtless relevant … that the transferor treats a payment as a business deduction... But [this inference] cannot be stated in absolute terms… The taxing statute does not make nondeductibility by the transferor a condition on the "gift" exclusion…. The conclusion whether a transfer amounts to a "gift" is one that must be reached on consideration of all the factors.

Respondent's argument that the payments represent additional compensation to petitioner because of past undercompensation is not borne out by the facts. Petitioner considered himself adequately compensated, both within his company and in comparison to persons doing comparable work for other coal companies. Although both Lucas and Burford suggested in their testimony that petitioner was undercompensated, petitioner's testimony to the contrary is supported by the objective facts. Indeed, it is notable that after Valley Industries took over Burford, Inc., it did not increase petitioner's salary. Likewise, Rehobeth Coal, owned principally by Lucas, did not increase petitioner's salary when he later left Burford, Inc., to go to work for Rehobeth Coal. Respondent's argument is also undermined by the fact that Lucas and Burford never consulted nor sought payments from the minority shareholders, Carson and McDavid, who shared proportionately the “benefits” of petitioner’s allegedly undercompensated past services. We are satisfied that petitioner was not undercompensated, and this factor militates against respondent’s argument that the payments were additional compensation. See *Bogardus v. Commissioner*, *supra*, 302 U.S. at 42.

As we see it, Lucas and Burford, after selling their Spruce Coal stock at an enormous profit on a minimal investment, chose to share some of those profits with certain employees and former employees of the corporation they, indirectly, had previously owned. The fact that the recipient (petitioner) previously performed services for a corporation (Burford, Inc.) indirectly owned and controlled by the payors (Lucas and Burford) does not necessarily make the payments compensation for past services. See and compare *Wright v. Commissioner*, 30 T.C. 392, 394-395 (1958); *Estate of McAdow v. Commissioner*, 12 T.C. 311, 318-319 (1949). See also *Bogardus v. Commissioner*, *supra*, 302 U.S. at 44.[10] And although Burford and Lucas were intensely interested in the corporation’s affairs, both as officers and as indirect shareholders, the fact remains that the business of the corporation is not the business of the shareholders. See *Whipple v. Commissioner*, 373 U.S. 193, 202 (1963). That Burford and Lucas were no longer shareholders at the time of the payments and that they also made payments to persons whose employment with the corporation had ceased five years earlier substantially undermine any compensatory element that might have been found had there been a payment from the corporation and had there been a payment to petitioner alone. Indeed, Lucas’ letter to Rosa Runyon, who had left Burford, Inc.’s employment five years before the payments, clearly expresses the payors’ intent – “to show our appreciation to you by saying ‘thanks’.” Moreover, the tone and format of the letter (“Dear Rosa” “Sincerely Edsel”) also indicated personal rather than business motivation.

[10] The world of nontaxable gifts did not, as respondent suggests, begin anew with *Commissioner v. Duberstein*, 363 U.S. 278 (1960). To the extent that pre-*Duberstein* cases seek to determine the transferor’s intention, they retain vitality. See *Jensen v. United States*, 511 F.2d 265, 269-70 (5th Cir. 1975); *Estate of Carter v. Commissioner*, 453 F.2d 61, 64-65 (2d Cir. 1971); *Poyner v. Commissioner*, 301 F.2d 287, 292 (4th Cir. 1962).

Also probative are the contemporaneous statements of Lucas and Burford (the payors) to petitioner (the recipient) that the payments were “gifts” that petitioner did not have to pay any taxes upon. We believed petitioner’s testimony as to those contemporaneous statements and found it consistent with the objective evidence in the record.[11]

[11] Conversely, we did not believe the belated attempts of Lucas and Burford at the trial to change the characterization of what had been in 1976 a nice and generous action on their part. Lucas, unversed in tax matters, relied upon Burford’s expertise. On direct examination, Burford testified as follows:

Q Did Mr. Abdella ever question you regarding the tax consequences of this $30,000 to him?

A Yes, he did.

Q And what did you tell him?

> A I told him that my state of mind and the circumstances surrounding me determined the tax consequences to me and that they had no influence on the tax consequences to him and that the circumstances surrounding him and his state of mind when he received them would determine his tax consequences.
>
> He asked me what I thought that was, and I told him in my opinion it was gift to him, but compensation by me….

> Any such legal advice by Burford would have been an astonishing error on the part of a tax lawyer. Since the Supreme Court's decision in 1960 in *Commissioner v. Duberstein*, 363 U.S. 278 (1960), if not since its decision in 1937 in *Bogardus v. Commissioner*, 302 U.S. 34 (1937), the law has been clear that the predominant factor in determining whether a payment is a gift is the intent of the payor. It is utterly incredible that Burford, a man who had attended New York University's tax school, who had practiced tax law for over 10 years, and who had taught tax law at Emory University's School of Law for three years, would advise petitioner, or direct Lucas to advise petitioner, that it was his (petitioner's) state of mind and surrounding circumstances as recipient that determined the tax consequences of the payments to him. The testimony of Burford and Lucas on this point is simply unworthy of belief, except perhaps as an expression of their rather cynical hopes that the parties to the transaction could somehow succeed in taking opposite positions for tax purposes, with only the public fisc as the loser. In any event, as the Supreme Court stated in *Commissioner v. Duberstein*, *supra*, 363 U.S. at 286: "It scarcely needs adding that the parties' expectations or hopes as to the tax treatment of their conduct in themselves have nothing to do with the matter." Thus, we disregard the subjective hopes or expectations of Lucas and Burford, and decide the case on the objective factors in the record. We are satisfied that at the time they gave the checks to petitioner, Lucas and Burford were acting from the same type of generous impulse that impelled the shareholders in Bogardus to make their gifts. It would seem that their generous impulse to make a gift was transformed by the time of the trial into a new economic impulse to save on their personal taxes. Regrettably, what was conceived and born in generosity was later debauched and disowned in avarice.

We conclude that the payments to petitioner by Lucas and Burford resulted from their generous decision to share the bounty of their enormous windfall with petitioner and other persons who, to some extent, may have helped enhance their profit on this stock sale. Such payments were motivated by "detached and disinterested generosity," "out of affection, respect, admiration or like impulses." *Commissioner v. Duberstein*, *supra*. Accordingly, such payments are gifts excludable from petitioner's gross income under section 102(a).

Kroner v. Commissioner, T.C. Memo. 2020-73, addressed payments made to a business colleague:

Gross income is income from whatever source derived unless otherwise excluded. Sec. 61(a). Gross income, however, does not include the value of property acquired by gift. Sec. 102(a). The United States Supreme Court has defined a gift under section 102 as a transfer that proceeds from a detached and disinterested generosity, out of affection, respect, admiration, charity or like impulses. *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960). In so doing, the Supreme Court stated that the most important consideration in ascertaining whether a gift has been made is the

> intention of the donor. *Id.* The donor's characterization of his action is not determinative, however, and a court must make an objective inquiry into whether what is characterized as a gift in fact meets the Duberstein definition of a gift under section 102. *Id.* at 286.
>
> The Supreme Court in *Duberstein* was careful to distinguish a common law gift from a section 102 gift. A common law gift requires only a voluntarily executed transfer without consideration. *Id.* at 285. So long as the donor had no legal obligation to pay, a transfer is a gift at common law. A section 102 gift, on the other hand, is more narrowly defined and requires more - it requires detached and disinterested generosity. *Id.* A transfer that proceeds from a moral duty or other expectation does not proceed from detached and disinterested generosity and is not a section 102 gift. *Id.* When a donee has rendered services to a donor, a payment for the services is not a gift even if the transferor had no legal compulsion to pay the remuneration. *Id.*
>
> Viewing the *Duberstein* standard through the prism of the relevant burdens of proof in this case, the ultimate issue for decision is whether petitioner has persuaded this Court that transfers totaling $24,775,000 constituted gifts from Mr. Haring within the meaning of section 102. See *id.* at 289. If petitioner cannot, he will have failed to meet his burden with regard to the determinations in the notice of deficiency and, conversely, respondent will have met his burden of proof as to the amounts asserted in his amended answer because there is no dispute as to the receipt of those amounts, only whether they are nontaxable gifts. The intention with which Mr. Haring made the transfers is the most critical factor. See *id*. at 285. Although the Court granted petitioner's motion in limine to preclude the drawing of any adverse inference from Mr. Haring's absence at trial, the Court also warned the parties on multiple occasions of the importance of hearing Mr. Haring's testimony. The Court's ruling on the motion in no way relieved petitioner of his burden of proving Mr. Haring's intention by a preponderance of credible evidence.

Part IV.B. of *Kroner*, titled, "Petitioner Has Failed To Prove That the Transfers Were Made With Disinterested Generosity," explains:

> Petitioner's story confirms that he and Mr. Haring had a business relationship starting in the early nineties and ending in 2007 with the repayment of the Avenger loan. As a result of this business relationship, petitioner would have us believe that he and Mr. Haring developed such a close personal relationship that Mr. Haring decided to give petitioner gifts of $24.775 million. We do not find petitioner's and the witnesses' testimony credible with respect to this close personal relationship. Petitioner's story is simply insufficient to prove that he and Mr. Haring had anything more than a business relationship where occasionally personal matters were discussed.
>
> Even if we were willing to find that petitioner and Mr. Haring had a close personal relationship, the record is devoid of any credible evidence to prove that Mr. Haring transferred the funds to petitioner with detached and disinterested generosity. See *Commissioner v. Duberstein*, 363 U.S. at 285-286. Additionally, when we consider our "experience with the mainsprings of human conduct" and the unconvincing record in this case, we cannot find facts that establish that Mr. Haring and petitioner had the type of relationship that would result in gifts this substantial. See *id.* at 289.

The timing of the transfers, especially the strong correlation with liquidity events experienced by Mr. Haring as a Peachtree investor, raises a question as to whether Mr. Haring acted as a nominee for an investment by petitioner in Peachtree. On Monday, February 7, 2005, the first liquidity event was reported in a Philadelphia banking and financial services publication. Just a few days earlier, on Friday, February 4, 2005, petitioner received the first transfer of $2.6 million from Mr. Haring. In March 2006 Peachtree went public and in April 2006 petitioner received a $6 million transfer from Mr. Haring. Finally, in November 2006 Credit Suisse acquired Peachtree and in December 2006 petitioner received an $8.75 million transfer from Mr. Haring.

The question of whether Mr. Haring acted as a nominee for petitioner becomes even more compelling when certain aspects of petitioner's story are considered. At the time of the Peachtree investment petitioner was barred by a noncompete agreement from participating or investing directly in Peachtree. Moreover, at the time of Mr. Haring's investment in Peachtree, petitioner held assets belonging to Mr. Haring in a nominee account and a nominee trust, suggesting a willingness on their parts to participate in nominee arrangements. We need not answer the question, however; suffice it to say that petitioner failed to meet his burden of proving that the transfers were gifts under section 102.[11] Accordingly, he has failed to meet his burden regarding the determinations in the notice, and respondent has met his burden regarding the increases asserted in his amended answer.

[11] Additionally, even if we believed parts of petitioner's story, we would view the series of transfers and their abrupt end as odd. Many transfers were made within days of each other. Petitioner repaid a loan from Mr. Haring with the proceeds of the "gifts". If Mr. Haring had truly wished to provide financially for petitioner, why did he not begin by forgiving the outstanding Avenger loan rather than making transfers far exceeding the loan balance and then expecting repayment of the loan? While this may be consistent with Mr. Haring's past behavior, the record is simply devoid of credible evidence for us to draw any conclusions.

Petitioner cites *Bogardus v. Commissioner*, 302 U.S. 34 (1937), *Runyon v. Commissioner*, T.C. Memo. 1984-623, *Abdella v. Commissioner*, T.C. Memo. 1983-616, and *Brimm v. Commissioner*, T.C. Memo. 1968-231, to support his position that the transfers from Mr. Haring should be excluded as gifts under section 102. Although the Court in those cases concluded that payments the taxpayer received were gifts, those cases are distinguishable.

In *Bogardus v. Commissioner*, 302 U.S. at 38, the parties stipulated that funds the taxpayer received were not intended to be payment or compensation for any services rendered or to be rendered. No such stipulation is present here. In two of the other cases petitioner cites, the donors appeared before the Court and provided credible testimony evincing their donative intent. It was on the basis of the donors' testimony, not present in this case, that the Court found that the transfers in those cases were gifts.[12] In contrast, we did not hear from Mr. Haring, which is surprising given his alleged close relationship with petitioner, and we cannot find other credible evidence in the record to determine his intentions.[13]

[12] In *Brimm v. Commissioner*, T.C. Memo. 1968-231, the donor was a school, and a member of the board of trustees executive committee credibly testified regarding the school's intention. In *Abdella v. Commissioner*, T.C. Memo. 1983-616, the donors

were shareholders of a corporation that employed the taxpayer. The donors told the taxpayer that the payment was a gift to him, but then later claimed a deduction for the payment as compensation. Nonetheless, the donors testified at trial that it was their intent to give the taxpayer a gift because they had sold the corporation, and the Court concluded that the objective facts indicated that the transfer was a gift when made. *Id.* The donors in *Runyon v. Commissioner*, T.C. Memo. 1984-623, were the same donors involved in *Abdella*. While the opinion in *Runyon* is not clear as to whether the donors testified, the Court relied on its opinion in *Abdella* in reaching its conclusion.

> [13] The Court granted petitioner's motion in limine, see *supra* p. 9, to preclude the drawing of any adverse inference from Mr. Haring's absence at trial, see *Wichita Terminal Elevator Co. v. Commissioner*, 6 T.C. 1158 (1946), *aff'd*, 162 F.2d 513 (10th Cir. 1947). In reaching our conclusion, we draw no adverse inference against petitioner as a result of Mr. Haring's absence. We conclude, however, that the evidence petitioner presented is insufficient for us to find that Mr. Haring's transfers during the years at issue were gifts. While petitioner could have proved Mr. Haring's intent with indirect, inferential evidence of intent if the evidence was convincing and credible, see *Alhadi v. Commissioner*, T.C. Memo. 2016-74, the record does not contain sufficient credible evidence for us to conclude that Mr. Haring's transfers were the result of detached and disinterested generosity, see *Commissioner v. Duberstein*, 363 U.S. at 285.

The record consists largely of unsubstantiated and self-serving testimony that we do not find credible. The record suffers from factual gaps and a noteworthy lack of documentation regarding the story told by petitioner and his witnesses. Because petitioner bears the burden of persuading this Court that the transfers were gifts and not income, and has failed to carry that burden, the deficiencies determined in the notice of deficiency are sustained. Moreover, because petitioner does not dispute the receipt or amount of the 2006 transfer and has failed to prove that it was a gift, respondent has met his burden of proof as to as the increases asserted in his amended answer,[14] which are sustained.

> [14] Petitioner does not dispute the increased December 20, 2006, transfer amount that resulted in the increased deficiency and penalty in respondent's amended answer. See *supra* p. 7.

On the other hand, when a parent transferred stock to a grantor retained income trust that passed to children if the parent lived ten years, past work from time to time was considered incidental to donative intent: the children were full-time students when the trust was created, no mention was made of future work for the company, and the survivorship requirement persuaded the IRS that the transfer was purely a gift.[3672]

Larsen v. Commissioner, T.C. Memo. 2008-73, held:

> PCI's issuance of a Form 1099-MISC reporting the $160,000 payment indicates that PCI did not intend this payment to be a gift.[6] Petitioner reported the $160,000 payment as income under the category "Services & Other Activities" on her State tax return and paid

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[3672] Letter Ruling 9109027, which is further described in fn. 6532 in part III.B.2.d.i.(a) General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation.

the State tax on the additional income. Mr. Skone, the same accountant who purportedly advised Mr. Pettegrove that the payment was a gift, prepared that return.

Petitioner has failed to establish that the $160,000 payment was a gift.[7] Accordingly, we hold that respondent's determination that the $160,000 payment to petitioner was includable in income was not in error.

[6] While petitioner and respondent had approximately 2 years from the time that the petition was filed to the start of trial, both failed to produce relevant information about PCI's tax returns that would have been helpful to the Court. Although the parties stipulated that PCI did not deduct the payment in 2001, the parties did not present evidence regarding which accounting method PCI used. A donor's characterization of his action, however, is not determinative of its tax treatment in the hands of the recipient. *Duberstein v. Commissioner*, 363 U.S. 278, 286-288 (1960).

[7] Petitioner also inaptly argued that the duty of consistency doctrine precludes respondent from asserting that the $160,000 payment is income to petitioner. Petitioner's argument is premised upon respondent's stipulation that the income to petitioner is either wage income or a gift and that it was not self-employment income. Petitioner's counsel suggests that this is inconsistent with PCI's treatment of the payment because PCI did not pay employment taxes on that payment. The duty of consistency doctrine estops a taxpayer from adopting a position in an open year that is inconsistent with a position that the taxpayer took during a different year after the period of limitations has expired for the earlier year. *Estate of Ashman v. Commissioner*, 231 F.3d 541, 543 (9th Cir. 2000), *affg*. T.C. Memo. 1998-145. Estoppel and the duty of consistency are to be applied against the Commissioner with the utmost caution and restraint, if at all, and only in compelling situations where the result otherwise would be unwarrantable or unconscionable. *Estate of Emerson v. Commissioner*, 67 T.C. 612, 617 (1977). Petitioner's argument must fail as there is no inconsistent treatment or position asserted or taken by respondent.

IRS Fact Sheet 2022-20 (3/2022) includes:

Tax Treatment of Money Raised Through Crowdfunding

Under federal tax law, gross income includes all income from whatever source derived unless it is specifically excluded from gross income by law. In most cases, property received as a gift is not includible in the gross income of the person receiving the gift.

If a crowdfunding organizer solicits contributions on behalf of others, distributions of the money raised to the organizer may not be includible in the organizer's gross income if the organizer further distributes the money raised to those for whom the crowdfunding campaign was organized.

If crowdfunding contributions are made as a result of the contributors' detached and disinterested generosity, and without the contributors receiving or expecting to receive anything in return, the amounts may be gifts and therefore may not be includible in the gross income of those for whom the campaign was organized. Contributions to crowdfunding campaigns are not necessarily a result of detached and disinterested generosity, and therefore may not be gifts. Additionally, contributions to crowdfunding

> campaigns by an employer to, or for the benefit of, an employee are generally includible in the employee's gross income.

In *Fields v. Commissioner*, T.C. Summary Opinion 2022-22, when the taxpayer separated from service, her employer forgave her loans and issued her Form 1099-MISC. The taxpayer asserted that the amount was nontaxable because it was a gift – an argument that the court rejected. After citing *Duberstein*, the court reasoned:

> There is a strong presumption that payments made beyond an employee's salary are compensation for services and not gifts. See *Van Dusen v. Commissioner*, 166 F.2d 647 (9th Cir. 1948), *aff'g* 8 T.C. 388 (1947). A payment between an employer and an employee may be a gift when the relationship between the employer and the employee is personal and unrelated to work. *Caglia v. Commissioner*, T.C. Memo. 1989-143; *Harrington v. Commissioner*, T.C. Memo. 1958-194.Petitioner offered testimony as to her personal relationship with Mr. Menke. In support of her assertion of a personal relationship and Mr. Menke's intent to make a gift, petitioner produced emails, text messages, and an unsigned draft severance agreement that removed the text pertaining to the $79,581 being written off as an employee advance.
>
> The communications presented consist of an email with Mr. Menke's administrator scheduling dinner in 2017, a meeting scheduling email with Paragon stakeholders in 2019, and unverified text messages from petitioner to Mr. Menke. While petitioner and Mr. Menke[6] corresponded after her separation from Paragon, their communications do not demonstrate that the payments were intended to be a gift. While petitioner and Mr. Menke reached an oral compromise regarding the terms of separation, the second, revised draft severance agreement was not signed. Even considering the revised agreement and a relevant provision, it is ambiguous at best. The text of the revised draft severance agreement does not necessarily support petitioner's position that the employer intended a gift to petitioner. At best, it reflects petitioner's attempt to recharacterize the payments as a gift, which apparently neither Mr. Menke nor Paragon agreed to. There is no evidence in the record from which the Court could conclude that Mr. Menke or Paragon intended to make a gift to petitioner. The payments were made from Paragon to petitioner and recorded as accounts receivables in Paragon's accounting records. Paragon's inclusion of the disputed amount in the signed and executed severance agreement and the subsequent issuance of a Form 1099-MISC indicates that the payments were not intended to be a gift.
>
> We find petitioner's testimony that she had a personal relationship with Mr. Menke is insufficient to support her contention that the payments were a gift.

The court upheld penalties:

> While they were assisted in preparing their tax return and timely filed their return, petitioners were aware of the provisions of the Paragon Severance agreement and the subsequently issued Form 1099-MISC. Also, they conceded that the taxable wages of $6,413 attributable to LTF were required to be included in their income for the year in issue and did not provide any further explanation as to why that amount was not reported in their return. Petitioners have not established they acted in good faith to properly report their tax liability and accordingly have not established that they had reasonable cause for the underpayment.

II.M.4.c.ii. Is Compensation to an Employee Better or Worse Than a Gift?

An employer may deduct reasonable compensation for services rendered in carrying out the employer's activity for profit.[3673]

The employer's deduction might offset the detriment of the employee's inclusion in income. For example, suppose each of the employer and employee have a 40% marginal tax rate and the employer wanted to get $100 to the employee, net of tax. The employer could award $167 of compensation, consisting of $100 cash to the employee and $67 (40% of $167) withholding to the government. The employer's $167 deduction generates a $67 tax saving (40% of $167), effectively reimbursing the employer for the $67 withholding paid to the government.

The actual math is not quite so tidy as illustrated above. For example, the employer and employee need to pay FICA tax on the compensation.[3674] The employer and employee might not be in the same bracket, which might cause a windfall or detriment to one party. If the payment is very large, the deduction might very well push the employer into a lower bracket and the employee into a higher bracket. When sharing with employees proceeds from the sale of a business, consider whether the employer might be taxed at capital gain rates, whereas employee compensation is taxed as ordinary income (plus FICA).

From a gift tax perspective, a gift is preferable if the donor has much more estate/gift tax exemption than assets. On the other hand, if the donor has a taxable estate, a 40% federal estate tax, without any corresponding tax savings, might represent a much larger net tax to the parties than a compensation scenario.

Often the buyer of the business will retain employees so that their relationships and know-how stay in the business. The new owner may seek to reduce its purchase price to devote funds to incentivize key employees to assure success after the purchase. To the extent that these key employees are participating in the sale directly, see part II.Q.1.c Personal Goodwill and Covenants Not to Compete. Another way to shift sale proceeds is to award equity more than one year before the sale; see parts II.M.4.e Issuing Stock to an Employee and II.M.4.f Issuing a Profits Interest to a Service Provider, as well as part II.M.4.b When is an Award or Transfer to an Employee Includible in the Employee's Income. However, owners of private businesses are often less comfortable with these awards, in that they may be reluctant to be accountable to their employees as fellow owners and may feel uncertain that the purchase price might not be enough that they can afford to share it. As to the latter, consider the following:

- Based on risk factors associated with private businesses, a $1 million business may earn $200,000-$300,000 in annual profit, which might be distributed to its owners every year.

- However, after paying capital gain tax, those owners might have $700,000 to reinvest, earning perhaps $14,000-$21,000 (2%-3%) in dividends from the stock market.

- Facing such a precipitous decline in income, the owners may resist selling the business and might not feel like sharing any of the sale proceeds, either.

[3673] Code § 162(a)(1). Code § 162(m) is among the authority for not deducting excessive compensation.
[3674] See part II.L.1 FICA: Corporation.

So, while setting up various plans before a sale may be a good idea in some cases, in others it gets delayed until a business sale is on the table.

II.M.4.c.iii. FICA On Amounts Paid After Death, Including Death Benefits

Any taxable payment made by an employer to a survivor or the estate of a former employee after the calendar year in which such employee died is not subject to FICA.[3675] This includes amounts that would have been payable even if the employee had lived.[3676]

Payments made in the calendar year of death are exempted from FICA by reason of the employee's death only if they:[3677]

- Are made under a plan established by the employer which makes provision for employees generally or a class or classes of his employees (or for such employees or class or classes of employees and their dependents), and

- Would not have been paid if the employee had not died.

For more information, see Zaritsky & Leimberg, ¶ 6.06[2][a][ii] Income tax treatment of the beneficiaries, *Tax Planning with Life Insurance: Analysis With Forms* (WG&L).

II.M.4.d. Introduction to Code § 409A Nonqualified Deferred Compensation Rules

Before working in this area, consider reading part II.Q.1.d.i IRS Audit Guide for Nonqualified Deferred Compensation. Also consider part II.P.3.i Common Equity for Preferred Equity and Vice Versa, where a retiring owner/employee might have their equity rearranged.

Enacted by the American Jobs Creation Act of 2004,[3678] Code § 409A imprints a layer of rules that supplements previously existing rules on taxing deferred compensation.[3679] It punishes service providers (employees and independent contractors) who receive deferred compensation without complying with its terms; it is so broad that even public school teachers need to be careful![3680]

The service provider must pay a penalty of 20% of the deferred compensation when it is includible in gross income.[3681] At the same time, the service provider must also pay interest to the IRS on the deferred tax, measured from the taxable year that is the later of when compensation was earned or when it was not subject to a substantial risk of forfeiture.[3682]

[3675] Code §3121(a)(14).
[3676] Letter Ruling 8321051.
[3677] Code §3121(a)(13).
[3678] Although the statute became effective January 1, 2005, existing plans did not need to be modified until December 31, 2008. Notice 2007-86.
[3679] Constructive receipt, Code § 83, Code § 457(f), etc.
[3680] Notice 2008-62.
[3681] Code § 409A(a)(1)(B)(i)(I); Prop. Reg. § 1.409A-4.
[3682] Code § 409A(a)(1)(B)(i)(II); Prop. Reg. § 1.409A-4.

However, these rules do not apply to compensation payments that are taxed when earned but paid in a later year.[3683]

Permissible triggering events for payments under Code § 409A include separation from service, disability, death, a specified time or fixed schedule, a change in control of the service recipient, or an unforeseeable emergency.[3684] Special rules apply to split-dollar life insurance arrangements that were entered into before 2005.[3685] These materials are not intended to provide a thorough knowledge of Code § 409A. The discussion below focuses on satisfying exceptions to Code § 409A with respect to equity and substitutes for equity.[3686]

Note, however, that the present value of a deferred compensation obligation is an expense on the business's income statement and a liability on its balance sheet. See part II.Q.1.d.ii.(b) Balance Sheet Effects of Deferred Compensation. Deferred compensation may help with a stock sale that but can backfire in an asset sale.[3687]

Also note that, to be exempt from ERISA, a plan needs to be a "top hat" plan for the benefit of a person or select group of persons with bargaining power.[3688] The employer must notify the Department of Labor that such a plan exists.[3689]

In *Keels v. Commissioner*, T.C. Memo. 2020-25, the IRS raised Code § 409A for the first time in a post-trial brief, causing the IRS to have the burden of proof. The Tax Court reasoned and held:

> To prevail under section 409A, a taxpayer must show all three of the following: first, that distributions from the plan may not occur before the taxpayer's separation from service, disability, death, an unforeseen emergency, or a change in ownership of the corporation, sec. 409A(a)(2)(A)(i)-(vi); second, that the plan does not permit acceleration of benefits except to the extent provided by regulations, sec. 409A(a)(3); and third, that the election to deferred compensation must be timely made, sec. 409A(a)(4)(B)(i). These requirements do not apply if the benefits are subject to substantial risk of forfeiture or were previously taxable. Sec. 409A(a)(1)(A)(i).
>
> For respondent to meet the burden of proof respondent must show that the plan fails to include any one of the three requirements above, that petitioner does not have a substantial risk of forfeiture, and that petitioner was not previously taxed on the deferred

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[3683] See Rev. Rul. 2007-48 (treatment of amounts vested 1/1/2009 in the scenario that is used in the ruling), stating, Under § 1.409A-1(b)(6)(i), a right to compensation income that will be required to be included in income under § 402(b)(4) is not a deferral of compensation for purposes of § 409A.

[3684] The regulations and various IRS pronouncements provide very detailed rules on how to apply these concepts. The author always works with employee benefits practitioners in his firm who know these rules better than he does.

[3685] Notice 2007-34. See part II.Q.4.f Split-Dollar Arrangements.

[3686] For benefits of using profits interests, see part II.M.4.f.i Overview of Profits Interest; Contrast with Code § 409A.

[3687] See fn 5771 in part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold. See also part II.Q.1.d Nonqualified Deferred Compensation.

[3688] 'Top-Hat' Plans, part XI.C. of Deferred Compensation Arrangements, T.M. 385.

[3689] The simplest way might be a letter under 29 C.F.R. § 2520.104-23. For some relief for failure to send the letter, see https://www.irs.gov/retirement-plans/irs-penalty-relief-for-dol-dfvc-filers-of-late-annual-reports and https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/correction-programs/dfvcp.

> compensation. The record does not show whether petitioner's plan with State Farm meets the requirements of section 409A. The plan document probably provides these details, but it is not in the record; neither is any Form 1099-MISC sent to petitioner by State Farm. The State Farm letter does not include those details. Thus, respondent has not shown that the plan fails to meet at least one of the requirements of section 409A or whether there is a substantial risk of forfeiture. Therefore, respondent did not meet the burden of proving that section 409A applies, and on this record petitioner is not taxable on the yearend balances of his termination and extended termination accounts for the years at issue.

For a tax trap regarding to deferred compensation when a business is sold, see fn 5771 in part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.

II.M.4.d.i. Performance Bonuses

Performance bonuses that are due March 15 after a calendar year-end can have excellent motivational effects. Because the date is fixed no later than 2.5 months after yearend, paying compensation after that fixed date would not cause the payment to violate Code § 409A if the payment is made during the calendar year including the fixed date.[3690] One glitch is that it is possible that the information needed to determine the bonus might not be available until after March 15. To avoid this, require the employee to work at least one day in the next year. For example, suppose a bonus relates to 2010 performance. Require the employee to work at least one day in 2011. Imposing this requirement means that the payment is not vested until 2011, so the payment date could be fixed at a date on or before March 15, 2012. Of course, for motivational reasons, the payment should be made in 2011 as soon as the information is available to ensure that the employee does not have to wait too long, but the important point is that the deadline for the bonus relating to 2010 work can be after March 15, 2011, to take into account practical business exigencies.

Be sure that, when a performance bonus is added to other compensation, the service provider's total compensation remains reasonable.

Performance bonuses based on profits should not constitute an equity interest under Code § 2701 if the service provider does not have any other equity interest, the service provider is not identified to the IRS or third parties as being an owner, and the service provider does not share in any losses.

II.M.4.d.ii. Pushing Back a Scheduled Retirement Date

After a plan has been set up, the employee cannot elect to postpone a scheduled payment unless the election is at least 12 months before the scheduled payment date and the payment is deferred at least 5 years.[3691] (Postponing previously deferred payments is often referred to as re-deferral.)

However, that rule might not be as big an obstacle as it seems. Suppose an employee makes $150K per year and is scheduled to receive $100K annual retirement payments from 2020-

[3690] Reg. §§ 1.409A-1(b)(4)(i), 1.409A-3(b), (d).
[3691] Code § 409A(a)(4)(C).

2029. Suppose that 2019 comes along, and the parties agree that employee should continue working. In that case:

- In 2019, the employee agrees to receive his $150K in compensation for 2020 over two periods: $50K in 2020 and $100K in 2030.

- The employee receives $150K in 2020, of which $100K is the originally scheduled deferred compensation and $50K that is earned for 2020 work.

- Thus, the employee receives $150K in 2020 and earns an additional payment of $100K to be paid in 2030, the year after the $100K retirement payments were scheduled to end.

The employee has effectively pushed back retirement by one year. However, the original payment stream of $100K per year from 2020-2029 remains intact. Thus, the Code § 409A rules on postponing a stream of payments have not been violated. The above plan not only offers flexibility but also avoids the strict deadlines that apply to re-deferral.

Setting a fixed payment upon attaining a particular age would satisfy Code § 409A without causing Code § 2701 or other income or estate tax problems, and that could be coupled with disability and death benefits to provide financial security.[3692]

II.M.4.d.iii. Change in Control as a Permitted Triggering Event under Code § 409A

Change in the entity's control is an event that can trigger payment of deferred compensation without the harsh consequences of Code § 409A.[3693] Generally, such a change in control in a corporation occurs when any one person, or more than one person acting as a group, acquires ownership of stock of the corporation that, together with stock held by such person or group, constitutes more than 50% of the total fair market value or total voting power of the stock of such corporation.[3694] Similar rules apply to partnerships.[3695] Using principles that apply to other forms of performance-based compensation, Code § 2701 should not apply to compensation awarded upon change of control.

[3692] See part III.B.7.c.vi, Code § 2701 Interaction with Income Tax Planning.
[3693] In order to cover earn-out provisions where the acquirer in a change of control contracts to make an immediate payment at the closing of the transaction with additional amounts payable at a later date, delayed payments may meet the requirements for a payment at a specified time or pursuant to a fixed schedule if they are paid on the same schedule and under the same terms and conditions as payments to shareholders generally pursuant to the change in control event to the extent paid not later than five years after the change in control event. Reg. § 1.409A-3(i)(5)(iv).
[3694] Reg. § 1.409A-3(i)(5)(v)(A). This applies to a change in the ownership of the corporation, a change in effective control of the corporation, or a change in the ownership of a substantial portion of the assets of the corporation. Reg. § 1.409A-3(i)(5)(i).
[3695] Third paragraph of Part VI.E. to the Preamble to the Prop. Regs., allowing taxpayers to rely on similar rules until further guidance is issued for a partnership setting. This continues to apply under section III.G. of the preamble to the final regulations.

II.M.4.e. Issuing Stock to an Employee

II.M.4.e.i. Issuing Stock to an Employee - Generally

For the fundamental rules underlying this part II.M.4.e.i, see part II.M.4.b.ii Income Tax Recognition Timing Rules re Equity Incentives.

An employee who receives stock as compensation for services must pay tax on that stock.[3696] For possible deferral of income tax (but not employment tax) inclusion, see part II.M.4.e.ii Code § 83(i) Election Deferring Income Tax Inclusion.

Rev. Proc. 2012-29 explains the consequences of nonvested or nontransferable stock:[3697]

> Section 83(a) provides generally that if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of the property (determined without regard to any restriction other than a restriction which by its terms will never lapse) as of the first time that the transferee's rights in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over the amount (if any) paid for the property is included in the service provider's gross income for the taxable year which includes such time.[3698]
>
> Under § 1.83-3(f) of the Income Tax Regulations, property is transferred in connection with the performance of services if it is transferred to an employee or independent contractor (or beneficiary thereof) in recognition of the performance of services, or refraining from performance of services. The existence of other persons entitled to buy stock on the same terms and conditions as an employee, whether pursuant to a public or private offering may, however, indicate that in such circumstance a transfer to the employee is not in recognition of the performance of, or refraining from performance of, services. The transfer of property is subject to § 83 whether such transfer is in respect of past, present, or future services.[3699]
>
> Section 83(b) and § 1.83-2(a) permit the service provider to elect to include in gross income the excess (if any) of the fair market value of the property at the time of transfer over the amount (if any) paid for the property, as compensation for services.[3700]
>
> Under § 83(e)(3) and § 1.83-7(b), § 83 does not apply to the transfer of an option without a readily ascertainable fair market value at the time the option is granted. As a result, a § 83(b) election may only be made with respect to the transfer of an option that has a readily ascertainable fair market value (as defined in § 1.83-7(b)), at the time the option is granted and that is substantially nonvested (as defined in § 1.83-3(b)). If substantially nonvested property is received upon exercise of an option without a readily ascertainable fair market value at grant, a service provider is permitted to make a

[3696] Code § 83. Letter Ruling 201405005 is a good example of a simultaneous exit of two owners and entrance of key employees with restricted stock in an S corporation.
[3697] Footnotes below are mine and are not in the Rev Proc.
[3698] Rev. Proc. 2012-29, § 2.01.
[3699] Rev. Proc. 2012-29, § 2.02.
[3700] Rev. Proc. 2012-29, § 2.03.

§ 83(b) election with respect to the transfer of such property upon the exercise of the option.[3701]

Under § 1.83-2(a), if property is transferred in connection with the performance of services, the person performing such services may elect to include in gross income under § 83(b) the excess (if any) of the fair market value of the property at the time of transfer (determined without regard to any lapse restriction, as defined in § 1.83-3(i)) over the amount (if any) paid for such property, as compensation for services. If this election is made, the substantial vesting rules of § 83(a) and the regulations thereunder do not apply with respect to such property, and except as otherwise provided in § 83(d)(2) and the regulations thereunder (relating to the cancellation of a nonlapse restriction), any subsequent appreciation in the value of the property is not taxable as compensation to the person who performed the services. Thus, the value of property with respect to which this election is made is included in gross income as of the time of transfer, even though such property is substantially nonvested (as defined in § 1.83-3(b)) at the time of transfer, and no compensation will be includible in gross income when such property becomes substantially vested.[3702]

In computing the gain or loss from a subsequent sale or exchange of property for which a § 83(b) election was filed, § 1.83-2(a) provides that the basis of such property shall be the amount paid for the property (if any) increased by the amount included in gross income under § 83(b).[3703]

If property for which a § 83(b) election was filed is forfeited while substantially nonvested, § 83(b)(1) provides that no deduction shall be allowed with respect to such forfeiture. Section 1.83-2(a) further provides that such forfeiture shall be treated as a sale or exchange upon which there is realized a loss equal to the excess (if any) of (1) the amount paid (if any) for such property, over (2) the amount realized (if any) upon such forfeiture. If such property is a capital asset in the hands of the taxpayer, such loss shall be a capital loss.[3704]

The Rev. Proc. provided a sample form for making a Code § 83(b) election.[3705]

When stock is transferred to the employee that is subject to a substantial risk of forfeiture[3706] and is not transferable,[3707] the employee recognizes income and treated as owning the stock if the employee makes a Code § 83(b) election.[3708] Conversely, if the corporation awards nonvested stock, then the employee does not recognize compensation until the stock vests, unless the employee makes a Code § 83(b) election no later than 30 days after the award.[3709]

[3701] Rev. Proc. 2012-29, § 2.04.
[3702] Rev. Proc. 2012-29, § 4.01.
[3703] Rev. Proc. 2012-29, § 4.02.
[3704] Rev. Proc. 2012-29, § 4.03.
[3705] Reg. § 1.83-2(e) sets forth the requirements for the election's contents, and Rev. Proc. 2012-29 provides a way to satisfy those requirements.
[3706] Within the meaning of Code § 83(c)(1).
[3707] Within the meaning of Code § 83(c)(2).
[3708] Rev. Rul. 83-22.
[3709] Code § 83(b)(2). Letter Rulings 201405008 and 201528001 excused failure to file with the taxpayer's individual tax return a copy of a timely Code § 83(b) election; T.D. 9779 finalized without changes REG-

Similarly, in determining who is a shareholder of an S corporation: Stock that is issued in connection with the performance of services[3710] and that is substantially nonvested[3711] is not treated as outstanding stock of the corporation, and the holder of that stock is not treated as a shareholder solely by reason of holding the stock, unless the holder makes a Code § 83(b) election with respect to the stock.[3712] In the event of such an election, the stock is treated as outstanding stock of the corporation, and the holder of the stock is treated as a shareholder for purposes of subchapter S.[3713] Substantially nonvested stock with respect to which a Code § 83(b) election has been made is taken into account in determining whether a corporation has a second class of stock, and such stock is not treated as a second class of stock if the stock confers rights to distribution and liquidation proceeds that are identical,[3714] to the rights conferred by the other outstanding shares of stock.[3715] See part II.A.2.i Single Class of Stock Rule, especially part II.A.2.i.iv Providing Equity-Type Incentives without Violating the Single Class of Stock Rules.

135524-14, Property Transferred in Connection with the Performance of Services, 7/16/2015, amending Reg. § 1.83-2(c) to remove this requirement, effective for property transferred on or after January 1, 2016, the latter per Reg. § 1.83-2(g). T.D. 9779 also revoked Rev. Proc. 2012-29, in part, to the extent it requires, inconsistent with the final regulations, a taxpayer to submit a copy of a Code § 83(b) election with his or her income tax return. Note that Code § 83(b)(2) requires only the initial filing to make the election; the requirement to file the election with one's individual return appeared to be merely an administrative requirement for preparing a complete return – a requirement that the IRS appears to have abandoned as of January 1, 2015, although this apparent abandonment for 2015 was done in a peculiar way.

[3710] Within the meaning of Reg. § 1.83-3(f).

[3711] Within the meaning of Reg. § 1.83-3(b).

[3712] Reg. § 1.1361-1(b)(3), "Treatment of restricted stock," provides:

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

[3713] Reg. § 1.1361-1(b)(3), which is reproduced in fn 3712.

[3714] Within the meaning of Reg. § 1.1361-1(*l*)(1), which is reproduced in fn 226 in part II.A.2.i.i.(a) Nonvoting Stock Permitted for S Corporations.

[3715] Reg. § 1.1361-1(*l*)(3), "Stock taken into account," which provides:

> Except as provided in paragraphs (b)(3), (4), and (5) of this section (relating to restricted stock, deferred compensation plans, and straight debt), in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account. For example, substantially nonvested stock with respect to which an election under section 83(b) has been made is taken into account in determining whether a corporation has a second class of stock, and such stock is not treated as a second class of stock if the stock confers rights to distribution and liquidation proceeds that are identical, within the meaning of paragraph (*l*)(1) of this section, to the rights conferred by the other outstanding shares of stock.

Reg. § 1.1361-1(b)(3) is reproduced in fn 3712 in part II.M.4.e.i Issuing Stock to an Employee - Generally.
Reg. § 1.1361-1(b)(4) is reproduced in the text accompanying fn 265 in part II.A.2.i.iv Providing Equity-Type Incentives without Violating the Single Class of Stock Rules.
Reg. § 1.1361-1(b)(5) is reproduced in fn 290 in part II.A.2.i.x Straight Debt.

Rev Proc. 2012-29, Section 5, provides various examples, the tax results of which “do not depend on whether or not the stock transferred to the employee is traded on an established securities market”:

> *Example 1*. Company A is a privately held corporation and no stock in Company A is traded on an established securities market. On April 1, 2012, in connection with the performance of services, Company A transfers to E, its employee, 25,000 shares of substantially nonvested stock in Company A. In exchange for the stock, E pays Company A $25,000, representing the fair market value of the shares at the time of the transfer. The restricted stock agreement provides that if E ceases to provide services to Company A as an employee prior to April 1, 2014, Company A will repurchase the stock from E for the lesser of the then current fair market value or the original purchase price of $25,000. E’s ownership of the 25,000 shares of stock will not be treated as substantially vested until April 1, 2014 and will only be treated as substantially vested if E continues to provide services to Company A as an employee until April 1, 2014. On April 1, 2012, E makes a valid election under § 83(b) with respect to the 25,000 shares of Company A stock. Because the excess of the fair market value of the property ($25,000) over the amount E paid for the property ($25,000) is $0, E includes $0 in gross income for 2012 as a result of the stock transfer and related § 83(b) election. The 25,000 shares of stock become substantially vested on April 1, 2014 when the fair market value of the shares is $40,000. No compensation is includible in E’s gross income when the shares become substantially vested on April 1, 2014. In 2015, E sells the stock for $60,000. As a result of the sale, E realizes $35,000 ($60,000 sale price - $25,000 basis) of gain, which is a capital gain.
>
> *Example 2*. The facts are the same as in Example 1 above, except that E does not make an election under § 83(b). Under § 83(a), E includes $0 in gross income in 2012 as a result of the transfer of stock from Company A because the stock is not substantially vested. When the shares become substantially vested on April 1, 2014, E includes $15,000 ($40,000 fair market value less $25,000 purchase price) of compensation in gross income. E’s basis in the stock as of April 1, 2014 is $40,000 ($25,000 paid for the stock and $15,000 included in income under § 83(a)). As a result of the 2015 sale of the stock for $60,000, E realizes $20,000 ($60,000 sale price - $40,000 basis) of gain, which is a capital gain.
>
> *Example 3*. The facts are the same as in Example 1 above, except that E terminates employment with Company A on August 1, 2013 before the shares become substantially vested. Because the excess of the fair market value of the property ($25,000) over the amount E paid for the property ($25,000) is $0, E includes $0 in gross income for 2012 as a result of the stock transfer and related § 83(b) election. When E terminates employment on August 1, 2013, the fair market value of the stock is $30,000 but Company A purchases the stock from E for $25,000 pursuant to the terms of the restricted stock agreement. As a result of the 2013 sale of the stock for $25,000, E realizes $0 in gain ($25,000 sale price - $25,000 basis).
>
> *Example 4*. Company B is a publicly held corporation and Company B stock is traded on an established securities market. On April 1, 2012, in connection with the performance of services, Company B transfers to F, its employee, 25,000 shares of substantially nonvested stock in Company B. At the time of the transfer, the shares have an aggregate fair market value of $25,000. F is not required to pay Company B any consideration in exchange for the stock. The restricted stock agreement provides that if

F ceases to provide services to Company B as an employee prior to April 1, 2014, F will forfeit the stock back to Company B. F's ownership of the 25,000 shares of stock will not be treated as substantially vested until April 1, 2014 and will only be treated as substantially vested if F continues to provide services to Company B as an employee until April 1, 2014. On April 1, 2012, F makes a valid election under § 83(b) with respect to the 25,000 shares of Company B stock. Because the excess of the fair market value of the property ($25,000) over the amount F paid for the property ($0) is $25,000, F includes $25,000 of compensation in gross income for 2012 as a result of the stock transfer and related § 83(b) election. The 25,000 shares of stock become substantially vested on April 1, 2014 when the fair market value of the shares is $40,000. No compensation is includible in F's gross income when the shares become substantially vested on April 1, 2014. In 2015, F sells the stock for $60,000. As a result of the sale, F realizes $35,000 ($60,000 sale price - $25,000 basis) in gain, which is a capital gain.

Example 5. The facts are the same as in Example 4 above, except that F does not make an election under § 83(b). Under § 83(a), F includes $0 in gross income in 2012 as a result of the transfer of stock from Company B because the stock is not substantially vested. When the shares become substantially vested on April 1, 2014, F includes $40,000 ($40,000 fair market value less $0 purchase price) of compensation in gross income. F's basis in the stock as of April 1, 2014 is $40,000 ($0 paid for the stock and $40,000 included in income under § 83(a)). As a result of the 2015 sale of the stock for $60,000, F realizes $20,000 ($60,000 sale price - $40,000 basis) of gain, which is a capital gain.

Example 6. The facts are the same as in Example 4 above, except that F terminates employment with Company B on August 1, 2013 and forfeits the shares before the shares become substantially vested. Because the excess of the fair market value of the property ($25,000) over the amount F paid for the property ($0) is $25,000, F includes $25,000 of compensation in gross income for 2012 as a result of the stock transfer and related § 83(b) election. In the year F terminates employment, F forfeits the 25,000 shares back to Company B and such forfeiture is treated as a sale of the shares in exchange for no consideration. Pursuant to § 1.83-2(a), F realizes no loss as the result of such sale. F is not entitled to a deduction or credit for taxes paid as the result of filing the § 83(b) election or the subsequent forfeiture of the property.

Note the unfairness in Example 6: F included an amount in income for stock F received but got no deduction – not even a capital loss – when F forfeited the stock with respect to that amount included (but would have received a deduction for any out-of-pocket purchase price)[3716]. Presumably, if F does not receive a deduction, Company B will not recognize income on account of F forfeiting the shares. Note that the result would have been different if Company B had separately bonused $25,000 cash and F had paid $25,000 cash for the stock, so long as the bonus and the payment were not tied together.

Often the corporation will "gross-up" the employee's pay by paying the employee's taxes on that compensation. If the corporation and employee are in the same income tax bracket, this arrangement will not cost anyone any income tax. For example, suppose everyone is in a 40% income tax bracket (federal and state) and $100 of stock is issued:

[3716] Although the Example cited a regulation, Code § 83(b)(1) mandates the position the regulation takes.

- The corporation receives $167 compensation deduction, consisting of $100 stock and $67 income tax withholding.

- The corporation saves $67 income tax (40% of $167). That $67 income tax savings offsets the $67 cash out-of-pocket for the withholding. Therefore, the corporation has no net cash expenditure.

- The employee incurs $67 of income tax liability (40% of the $167 compensation income). However, the $67 income tax withholding offsets that liability.

- Note that the above analysis ignores FICA.

- Note that lower corporate rates and the Code § 199A qualified business income deduction[3717] may make the employer's deduction worth less than the income tax that the service provider.

- For an S corporation, the compensation deduction benefits the shareholders, not the corporation, although the corporation indirectly benefits by reducing the need to make distributions to pay the shareholders' income tax. Note the new shareholder will benefit from this deduction, because all items are allocated pro rata, per share per day owned regardless of the timing of ownership, except to the extent that an election is made to close the books as of the date of the transfer.[3718] The election to close the books can be made only if issuance is at least 25% of the previously outstanding stock to one or more new shareholders.[3719]

Consider timing the issuance to coincide with taxable years in which the employer has sufficient ordinary income to absorb the deduction and provide a tax benefit at a sufficiently high income tax rate. Note also that, if an S corporation issues stock to its key employees in the year of the sale of the business, the deduction (if high enough) might wind up offsetting capital gain income, which is taxed at a lower rate – often too low to take advantage of the income tax dynamics described above.

Compare these concepts to the income tax dynamics of part II.Q.1.a, Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis, and more fully explored in part II.Q.1.d, Nonqualified Deferred Compensation.

Nonvested stock options provide the least complication when the exercise price is no less than the amount of the underlying stock's value. This approach avoids the forfeiture described above. It also avoids the need to comply with the restrictions that Code § 409A imposes on nonqualified deferred compensation.[3720]

[3717] See part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.
[3718] See part III.B.2.j Tax Allocations upon Change of Interest, particularly III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.
[3719] Reg. § 1.1361-1(g)(2)(i)(C).
[3720] See footnote 3762.

If an employee is upset about stock being diluted when other investors enter and the buyer pays the employee the amount necessary to make up for the dilution, the payments in excess of a pro-rata purchase price that the buyer designates as being compensation is taxed as such.[3721]

Also, a corporation cannot treat a person as a shareholder with the same rights as the other shareholder and then claim that the stock was not yet vested to try to obtain a deduction at a later time when the stock was more valuable.[3722]

II.M.4.e.ii. Code § 83(i) Election Deferring Income Tax Inclusion

Notice 2018-97 explains this provision of the 2017 tax law changes:

> Section 83 generally provides for the federal income tax treatment of property transferred in connection with the performance of services. Section 13603 of the Act amended section 83 by adding section 83(i) to allow certain employees to defer recognition of income attributable to the receipt or vesting of qualified stock.

Notice 2018-97, part III.B, "Employment Taxes (including Income Tax Withholding)," explains in subpart 1, "General,":

> Employment taxes under Subtitle C of the Code include Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Tax Act (FUTA) tax, and federal income tax withholding. The Act made no amendments to FICA and FUTA taxation with respect to deferral stock. Thus, the FICA and FUTA taxation of deferral stock is unaffected by the Act. See H.R. Rep. No. 115-466, at 501 (2017).[1]
>
> [1] See H.R. Rep. No. 115-466, pages 496-497 for a discussion of FICA and FUTA taxation.
>
> The Act did amend the income tax withholding provisions in the Code with respect to deferral stock. Specifically, section 13603(b) of the Act amended the income tax withholding provisions, as described below, to conform the income tax withholding provisions in section 3401 and section 3402 to the income taxation of deferral stock. The remainder of the discussion of employment taxes concerns only federal income tax withholding.
>
> Section 3402(a) provides that, except as otherwise provided in section 3402, every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary. The term "wages" is defined in section 3401(a) for income tax withholding purposes as including all remuneration for services performed by an employee for his or her employer including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain specific exceptions.

[3721] *Brinkley v. Commissioner*, T.C. Memo. 2014-227, *aff'd* 808 F.3d 657 (5th Cir. 2015) (penalties assessed for the manner in which the taxpayer engaged in self-help merely through tax return positions rather than by negotiating a better deal with the company).

[3722] *Qinetiq U.S. Holdings, Inc. and Subsidiaries v. Commissioner*, T.C. Memo. 2015-123, *aff'd* 119 A.F.T.R.2d 2017-330 (4th Cir. 1/6/2017). See part II.M.4.b When is an Award or Transfer to an Employee Includible in the Employee's Income.

Section 3401(i), as added by section 13603(b)(1) of the Act, provides that for purposes of section 3401(a), qualified stock (as defined in section 83(i)) with respect to which an election is made under section 83(i) is treated as wages (1) received on the earliest date described in section 83(i)(1)(B), and (2) in an amount equal to the amount included in income under section 83 for the taxable year which includes such date. Thus, under section 3401(i), the amount of the deferral stock included in gross income is treated as wages subject to federal income tax withholding on the earliest date described in section 83(i)(1)(B), which sets forth the end date of the applicable deferral period.

Section 3402(t), which was added by section 13603(b)(2) of the Act, provides that, in the case of any qualified stock with respect to which an election is made under section 83(i), (1) the rate of tax under section 3402(a) must not be less than the maximum rate in effect under section 1 (37% in 2018), and (2) such stock is treated for purposes of section 3501(b) in the same manner as a noncash fringe benefit. Section 3501(b) provides that the taxes imposed by Subtitle C with respect to noncash fringe benefits must be collected (or paid) by the employer at the time and in the manner prescribed by the Secretary by regulations. Questions and Answers 5 and 6 of § 31.3501(a)-1T provide that the employer is liable for the payment of the tax with respect to a noncash fringe benefit regardless of whether the benefit is paid by another entity.

Noncash fringe benefits that fall within section 3501(b) generally are subject to the provisions of Announcement 85-113, 1985-31 I.R.B. 31, which provides guidelines for withholding, paying, and reporting employment tax on taxable noncash fringe benefits. Announcement 85-113 provides generally that taxpayers may rely on the guidelines in the announcement until the issuance of regulations that supersede the temporary and proposed regulations under section 3501(b). No regulations have been issued under section 3501(b) that supersede the announcement. Thus, Announcement 85-113 generally is applicable to current payments of noncash fringe benefits, and until further regulatory guidance is issued, it applies to deferral stock, except as limited by the specific rules of section 3401(i) and the terms of the announcement itself, as discussed further below.

Section 2 of Announcement 85-113 sets out the general income tax and accounting rule, which provides, in relevant part, that employers must withhold the applicable income tax on the date the benefits are paid and must deposit the withheld taxes under the regular rules for tax deposits. The employer may make a reasonable estimate of the value of the fringe benefit on the date the fringe benefit is paid for purposes of meeting the timely deposit requirements. The actual value of the fringe benefit must be determined by January 31 of the following year and reported on Form W-2, Wage and Tax Statement, and Form 941, Employer's Quarterly Federal Tax Return (or Form 944, Employer's Annual Federal Tax Return, if applicable instead of Form 941).

Announcement 85-113 states that if the employer underestimates the value of the fringe benefit and as a result deposits less than the amount required to be deposited (that is, the amount the employer would be required to deposit if the employer had correctly withheld the applicable taxes), the employer may be subject to the failure to deposit penalty under section 6656. Under Announcement 85-113, if the employer overestimates the value and deposits more than the amount required, the employer may claim a refund or elect to have the overpayment applied to the employer's next Form 941 (or other employment tax return).

Generally, under § 31.6205-1(d)(2), if an employer collects less than the correct amount of income tax required to be withheld from wages during a calendar year, the employer must collect the amount of the undercollection on or before the last day of the year by deducting the amount from remuneration of the employee. Under § 31.6205-1(d)(2),[2] if such a deduction is not made, the obligation of the employee to the employer with respect to the undercollection is a matter for settlement between the employee and the employer within the calendar year. However, in the case of noncash fringe benefits, Announcement 85-113 permits the employer to recover the undercollection of income tax withholding from the employee after the end of the calendar year during which the wage payment is made, as long as the recovery occurs prior to April 1 of the year following the year in which the benefits are paid. This rule in Announcement 85-113 applies to the amount included in wages under section 3401(i). Thus, with regard to any income tax withholding that the employer deposits for deferral stock included in wages under section 3401(i) that has not been collected from the employee, the employer may recover the income tax from the employee prior to April 1 of the year following the year in which the inclusion in wages under section 3401(i) occurs.

[2] The reference in Announcement 85-113 is to the section of the regulations (§ 31.6205-1(c)(4)) setting forth the same principle in the section 6205 regulations before amendments to the regulations after 1985. See T.D. 9405, 72 FR 37376 (July 1, 2008).

Section 3401(i) provides the specific date on which deferral stock must be treated as wages for income tax withholding purposes and the special rules for timing of inclusion in income under Announcement 85-113 available with respect to certain noncash fringe benefits do not apply.[3] The withholding rates described in section 2 of Announcement 85-113 also do not apply to deferral stock because, under section 3402(t)(1), the income tax withholding rate under section 3402(a) “shall not be less than the maximum rate of tax in effect under section 1.” The Treasury Department and the IRS expect that proposed regulations providing further guidance on section 83(i) will provide that the rate of withholding under section 3402(t)(1) on deferral stock is the maximum rate of tax in effect under section 1 and will provide that withholding is applied (1) without reference to any payment of regular wages, (2) without allowance for the number of allowances or other dollar amounts claimed by the employee on Form W-4, Employee’s Withholding Allowance Certificate, (3) without regard to whether the employee has requested additional withholding, and (4) without regard to the withholding method used by the employer. Thus, under the anticipated proposed regulations, only one rate, the maximum rate of tax under section 1, would be used in withholding on deferral stock under section 3402(t), and employers would not be able to increase or decrease the rate at the request of the employee. Under Code section 3402(t) and this notice and unless and until superseding guidance is issued, with respect to wages resulting from deferral stock under section 3402(t), employers must withhold taxes at the maximum rate of income tax under section 1 without regard to whether the employee has requested additional withholding and without regard to any withholding allowances or dollar amounts entered on the employee’s Form W-4.

[3] Announcement 85-113 provides two rules applicable to the date of payment of some noncash fringe benefits that do not apply to deferral stock. The first rule allows payors of certain noncash fringe benefits to treat the benefits as paid on any day(s) during the year so long as they treat benefits provided in a calendar year as paid not later than December 31 of the calendar year. The second rule allows employers to treat certain

benefits paid during the last two months of the year (or any shorter period) as paid during the subsequent calendar year. However, Announcement 85-113 provides that neither of these two rules applies when the fringe benefit is the transfer of personal property (either tangible or intangible) of a kind normally held for investment or the transfer of real property. Because deferral stock is personal property of a kind normally held for investment, neither of these rules may be used with respect to deferral stock.

In summary, deferral stock constitutes wages under section 3401(i) and is treated as received on the earliest date described in section 83(i)(1)(B) in an amount equal to the amount included in income under section 83 for the taxable year that includes such date. When the wages are treated as paid under section 3401(i), the employer must make a reasonable estimate of the value of the stock and make deposits of the amount of income tax withholding liability based on that estimate. The wages included under section 3401(i) are subject to withholding at the maximum rate of tax in effect under section 1, and withholding is determined without regard to the employee's Form W-4. By January 31 of the following year, the employer must determine the actual value of the deferral stock on the date it is includible in the employee's income and report that amount and the withholding on Form W-2 and Form 941. With respect to income tax withholding for the deferral stock that the employer pays from its own funds, the employer may recover that income tax withholding from the employee until April 1 of the year following the calendar year in which the wages were paid.

An employer that fails to deduct and withhold federal income tax under section 3402 is liable for the payment of the tax whether or not the employer collects it from the employee, unless section 3402(d) applies.[4] Section 3402(d) provides that if the employer fails to deduct and withhold the correct amount of income tax withholding, and thereafter the income tax against which the tax under section 3402 may be credited is paid, the tax imposed under section 3402(a) shall not be collected from the employer. Section 3402(d) does not relieve the employer from liability for any penalties in respect of the failure to deduct and withhold.

[4] Section 3403, Section 31.3403-1.

Code § 83(i)(1) provides:[3723]

In general. For purposes of this subtitle—

(A) *Timing of inclusion*. If qualified stock is transferred to a qualified employee who makes an election with respect to such stock under this subsection, subsection (a) shall be applied by including the amount determined under such subsection with respect to such stock in income of the employee in the taxable year determined under subparagraph (B) in lieu of the taxable year described in subsection (a).

(B) *Taxable year determined*. The taxable year determined under this subparagraph is the taxable year of the employee which includes the earliest of—

(i) the first date such qualified stock becomes transferable (including, solely for purposes of this clause, becoming transferable to the employer),

[3723] Subtitle A consists of Code §§ 1-1563.

(ii) the date the employee first becomes an excluded employee,

(iii) the first date on which any stock of the corporation which issued the qualified stock becomes readily tradable on an established securities market (as determined by the Secretary, but not including any market unless such market is recognized as an established securities market by the Secretary for purposes of a provision of this title other than this subsection),

(iv) the date that is 5 years after the first date the rights of the employee in such stock are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, or

(v) the date on which the employee revokes (at such time and in such manner as the Secretary provides) the election under this subsection with respect to such stock.

The Conference Agreement to P.L. 115-97 (12/22/2017) provides:

> … it is intended that the limited circumstances outlined in section 83(c)(3) and applicable regulations apply with respect to the determination of when stock first becomes transferrable or is no longer subject to a substantial risk of forfeiture. For example, income inclusion cannot be delayed due to a lock-up period as a result of an initial public offering. Finally, it is intended that the transition rule provided with respect to compliance with the 80-percent and employer notice requirements not be expanded beyond these specific items.

The principles of Code § 83(c)(3) are in part II.M.4.b.ii Income Tax Recognition Timing Rules re Equity Incentives.

Note that the amount of income inclusion is determined (and realized) under the normal rules of Code § 83(a); all Code § 83(i) does is defer taxation (recognition) of that income – perhaps to a taxable year in which the stock's value is less than that on which the Code § 83(a) taxation is based. The employee is treated as the owner for purposes of any activity relating to that stock, including allocating S corporation income if applicable.[3724]

Code § 83(i)(2), "Qualified stock," provides:

(A) *In general*. For purposes of this subsection, the term "qualified stock" means, with respect to any qualified employee, any stock in a corporation which is the employer of such employee, if—

(i) such stock is received—

(I) in connection with the exercise of an option, or

(II) in settlement of a restricted stock unit, and

(ii) such option or restricted stock unit was granted by the corporation—

[3724] See Eustice, Kuntz & Bogdanski, *Federal Income Taxation of S Corporations* (WG&L), particularly ¶¶ 3.03[21][c] Deferral Election, 11.03[2] Stock Options.

(I) in connection with the performance of services as an employee, and

(II) during a calendar year in which such corporation was an eligible corporation.

(B) *Limitation*. The term "qualified stock" shall not include any stock if the employee may sell such stock to, or otherwise receive cash in lieu of stock from, the corporation at the time that the rights of the employee in such stock first become transferable or not subject to a substantial risk of forfeiture.

(C) *Eligible corporation*. For purposes of subparagraph (A)(ii)(II)—

(i) *In general*. The term "eligible corporation" means, with respect to any calendar year, any corporation if—

(I) no stock of such corporation (or any predecessor of such corporation) is readily tradable on an established securities market (as determined under paragraph (1)(B)(iii)) during any preceding calendar year, and

(II) such corporation has a written plan under which, in such calendar year, not less than 80 percent of all employees who provide services to such corporation in the United States (or any possession of the United States) are granted stock options, or are granted restricted stock units, with the same rights and privileges to receive qualified stock.

(ii) *Same rights and privileges*. For purposes of clause (i)(II)—

(I) except as provided in subclauses (II) and (III), the determination of rights and privileges with respect to stock shall be made in a similar manner as under section 423(b)(5),

(II) employees shall not fail to be treated as having the same rights and privileges to receive qualified stock solely because the number of shares available to all employees is not equal in amount, so long as the number of shares available to each employee is more than a de minimis amount, and

(III) rights and privileges with respect to the exercise of an option shall not be treated as the same as rights and privileges with respect to the settlement of a restricted stock unit.

(iii) *Employee*. For purposes of clause (i)(II), the term "employee" shall not include any employee described in section 4980E(d)(4) or any excluded employee.

(iv) *Special rule for calendar years before 2018*. In the case of any calendar year beginning before January 1, 2018, clause (i)(II) shall be applied without regard to whether the rights and privileges with respect to the qualified stock are the same.

"Restricted stock unit" is explained below.[3725]

[3725] See text accompanying fn 3727.

Notice 2018-97, part III.A, “Application of the 80% Requirement,” provides:

> As described above, section 83(i)(2)(C) defines an “eligible corporation,” in relevant part, as, with respect to any calendar year, any corporation that has a written plan under which, in such calendar year, not less than 80% of all employees who provide services to the corporation in the United States (or any possession of the United States) are granted stock options, or are granted RSUs, with the same rights and privileges to receive qualified stock. Stakeholders have asked whether the 80% requirement of section 83(i)(2)(C)(i)(II) with respect to a calendar year is applied on a cumulative basis that takes into account stock options or RSUs granted in prior calendar years.
>
> The determination of whether a corporation qualifies as an eligible corporation is made “with respect to any calendar year.” Furthermore, to meet the 80% requirement, the corporation must have granted “in such calendar year” stock options to 80% of its employees or RSUs to 80% of its employees. Therefore, the determination that the corporation is an eligible corporation must be made on a calendar year basis, and whether the corporation has satisfied the 80% requirement is based solely on the stock options or the RSUs granted in that calendar year to employees who provide services to the corporation in the United States (or any possession of the United States). In calculating whether the 80% requirement is satisfied, the corporation must take into account the total number of individuals employed at any time during the year in question as well as the total number of employees receiving grants during the year (in each case, without regard to excluded employees or part-time employees described in section 4980E(d)(4)), regardless of whether the employees were employed by the corporation at the beginning of the calendar year or the end of the calendar year.
>
> The Treasury Department and the IRS have determined that interpreting the 80% requirement of section 83(i)(2)(C)(i)(II) with respect to a calendar year on a cumulative basis that takes into account stock options or RSUs granted in prior calendar years is contrary to the language of the statute and is not a reasonable good faith interpretation of the 80% requirement. Accordingly, the transition rule in section 13603(g) of the Act does not apply to such an interpretation.

Code § 83(i)(3) provides:

> *Qualified employee; excluded employee*. For purposes of this subsection—
>
> (A) *In general*. The term “qualified employee” means any individual who—
>
> > (i) is not an excluded employee, and
> >
> > (ii) agrees in the election made under this subsection to meet such requirements as are determined by the Secretary to be necessary to ensure that the withholding requirements of the corporation under chapter 24 with respect to the qualified stock are met.
>
> (B) *Excluded employee*. The term “excluded employee” means, with respect to any corporation, any individual—

(i) who is a 1-percent owner (within the meaning of section 416(i)(1)(B)(ii))[3726] at any time during the calendar year or who was such a 1 percent owner at any time during the 10 preceding calendar years,

(ii) who is or has been at any prior time—

(I) the chief executive officer of such corporation or an individual acting in such a capacity, or

(II) the chief financial officer of such corporation or an individual acting in such a capacity,

(iii) who bears a relationship described in section 318(a)(1) to any individual described in subclause (I) or (II) of clause (ii), or

(iv) who is one of the 4 highest compensated officers of such corporation for the taxable year, or was one of the 4 highest compensated officers of such corporation for any of the 10 preceding taxable years, determined with respect to each such taxable year on the basis of the shareholder disclosure rules for compensation under the Securities Exchange Act of 1934 (as if such rules applied to such corporation).

For Code § 318(a), see part II.Q.7.a.viii Code § 318 Family Attribution under Subchapter C.

The Conference Agreement to P.L. 115-97 (12/22/2017) provides:

> It is intended that the requirement that 80 percent of all applicable employees be granted stock options or be granted restricted stock units apply consistently to eligible employees, whether they are new hires or existing employees.

Notice 2018-97, part III.B, "Employment Taxes (including Income Tax Withholding)," explains in subpart 2, "Escrow Arrangement,":

> Section 83(i)(3)(A)(ii) provides the Secretary with authority to impose any requirements as the Secretary determines to be necessary to ensure that the withholding requirements of the corporation under chapter 24 with respect to the qualified stock are met. In order to be a qualified employee, an employee making an election under section 83(i) must agree in the election to these requirements.
>
> Pursuant to the authority provided to the Secretary under section 83(i)(3)(A)(ii), in order to be a qualified employee an employee making a section 83(i) election with respect to qualified stock must agree in the election that all deferral stock will be held in an escrow arrangement, the terms of which are consistent with the following requirements:

[3726] [footnote not in statute]: Code § 416(i)(1)(B)(ii), "1-Percent Owner," provides:

> For purposes of this paragraph, the term "1-percent owner" means any person who would be described in clause (i) if "1 percent" were substituted for "5 percent" each place it appears in clause (i).

Code § 416(i)(1)(B)(i) is reproduced in fn 3204 in part II.K.1.e.iii.(a) Scope and Effect of Real Estate Professional Exception.

(i) The deferral stock must be deposited into escrow before the end of the calendar year during which the section 83(i) election is made and must remain in escrow until removed in accordance with clause (ii) or the corporation has otherwise recovered from the employee an amount equal to the corresponding income tax withholding obligation under section 3401(i) for the taxable year determined in accordance with section 83(i)(1)(B).

(ii) At any time between the date of income inclusion under section 83(i)(1)(B) and March 31 of the following calendar year, the corporation may remove from escrow and retain the number of shares of deferral stock with a fair market value equal to the income tax withholding obligation that has not been recovered from the employee by other means. The fair market value of the shares must be determined pursuant to the rules in § 1.409A-1(b)(5)(iv). The fair market value used for purposes of this calculation is the fair market value of the shares at the time the corporation retains shares held in escrow to satisfy the income tax withholding obligation.

(iii) Any remaining shares held in escrow after the corporation's income tax withholding obligation has been met, whether by retention of shares in accordance with clause (ii) or otherwise, must be delivered to the employee as soon as reasonably practicable thereafter.

The Treasury Department and the IRS have concluded that the escrow arrangement described above adequately ensures the statutory income tax withholding requirements of the corporation will be met and that this approach is less burdensome than alternatives that would require a cash outlay by the corporation or the employee before the due date for the relevant withholding, and thus allow less flexibility with respect to resource allocation. If the corporation and the employee do not agree to deposit the deferral stock into an escrow arrangement consistent with the terms outlined above, the employee is not a "qualified employee" within the meaning of section 83(i)(3). The Treasury Department and the IRS are aware that this has the effect of allowing a corporation to preclude its employees from making section 83(i) elections by declining to establish an escrow arrangement consistent with the terms outlined above.

Future guidance on section 83(i)(3)(A)(ii) may establish alternative or substitute mechanisms to ensure a corporation's income tax withholding requirements are satisfied. Such mechanisms may be more restrictive than the above described escrow arrangement.

Code § 83(i)(4), "Election," provides:

(A) *Time for making election*. An election with respect to qualified stock shall be made under this subsection no later than 30 days after the first date the rights of the employee in such stock are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, and shall be made in a manner similar to the manner in which an election is made under subsection (b).

(B) *Limitations*. No election may be made under this section with respect to any qualified stock if—

(i) the qualified employee has made an election under subsection (b) with respect to such qualified stock,

(ii) any stock of the corporation which issued the qualified stock is readily tradable on an established securities market (as determined under paragraph (1)(B)(iii)) at any time before the election is made, or

(iii) such corporation purchased any of its outstanding stock in the calendar year preceding the calendar year which includes the first date the rights of the employee in such stock are transferable or are not subject to a substantial risk of forfeiture, unless—

(I) not less than 25 percent of the total dollar amount of the stock so purchased is deferral stock, and

(II) the determination of which individuals from whom deferral stock is purchased is made on a reasonable basis.

(C) *Definitions and special rules related to limitation on stock redemptions*.

(i) *Deferral stock*. For purposes of this paragraph, the term "deferral stock" means stock with respect to which an election is in effect under this subsection.

(ii) *Deferral stock with respect to any individual not taken into account if individual holds deferral stock with longer deferral period*. Stock purchased by a corporation from any individual shall not be treated as deferral stock for purposes of subparagraph (B)(iii) if such individual (immediately after such purchase) holds any deferral stock with respect to which an election has been in effect under this subsection for a longer period than the election with respect to the stock so purchased.

(iii) *Purchase of all outstanding deferral stock*. The requirements of subclauses (I) and (II) of subparagraph (B)(iii) shall be treated as met if the stock so purchased includes all of the corporation's outstanding deferral stock.

(iv) *Reporting*. Any corporation which has outstanding deferral stock as of the beginning of any calendar year and which purchases any of its outstanding stock during such calendar year shall include on its return of tax for the taxable year in which, or with which, such calendar year ends the total dollar amount of its outstanding stock so purchased during such calendar year and such other information as the Secretary requires for purposes of administering this paragraph.

Code § 83(i)(5), "Controlled groups," provides:

For purposes of this subsection, all persons treated as a single employer under section 414(b) shall be treated as 1 corporation.

Code § 83(i)(6) provides:

Notice requirement. Any corporation which transfers qualified stock to a qualified employee shall, at the time that (or a reasonable period before) an amount attributable to such stock would (but for this subsection) first be includible in the gross income of such employee—

(A) certify to such employee that such stock is qualified stock, and

(B) notify such employee—

(i) that the employee may be eligible to elect to defer income on such stock under this subsection, and

(ii) that, if the employee makes such an election—

(I) the amount of income recognized at the end of the deferral period will be based on the value of the stock at the time at which the rights of the employee in such stock first become transferable or not subject to substantial risk of forfeiture, notwithstanding whether the value of the stock has declined during the deferral period,

(II) the amount of such income recognized at the end of the deferral period will be subject to withholding under section 3401(i) at the rate determined under section 3402(t), and

(III) the responsibilities of the employee (as determined by the Secretary under paragraph (3)(A)(ii)) with respect to such withholding.

Notice 2018-97, part III.C, “Designation of Stock as Not Eligible for Section 83(i) Election,” provides:

As described above, section 83(i) imposes a number of requirements and limitations that must be met for a section 83(i) election to be allowed. Although the election, if allowed, may be made by an employee, the corporation is responsible for creating the conditions that would allow an employee to make the election. Stakeholders have indicated that a corporation may wish to compensate its employees with equity-based compensation for which no section 83(i) election may be made. As noted above, a corporation can preclude its employees from making section 83(i) elections by declining to establish an escrow arrangement as described in Section III.B.2 of this notice. As a result, a corporation need not be concerned that it would inadvertently create the requisite conditions for its employees to make section 83(i) elections or be required to comply with the notice requirement of section 83(i)(6). If a corporation does not intend to deposit qualified stock into an escrow arrangement (as described in Section III.B.2 of this notice) or otherwise create the conditions that would allow an employee to make the section 83(i) election, the terms of a stock option or RSU may provide that no election under section 83(i) will be available with respect to stock received upon the exercise of the stock option or settlement of the RSU. This designation would inform employees that no section 83(i) election may be made with respect to stock received upon exercise of the option or settlement of the RSU even if the stock is qualified stock.

Code § 83(i)(7), “Restricted stock units,” provides:

This section (other than this subsection), including any election under subsection (b), shall not apply to restricted stock units.

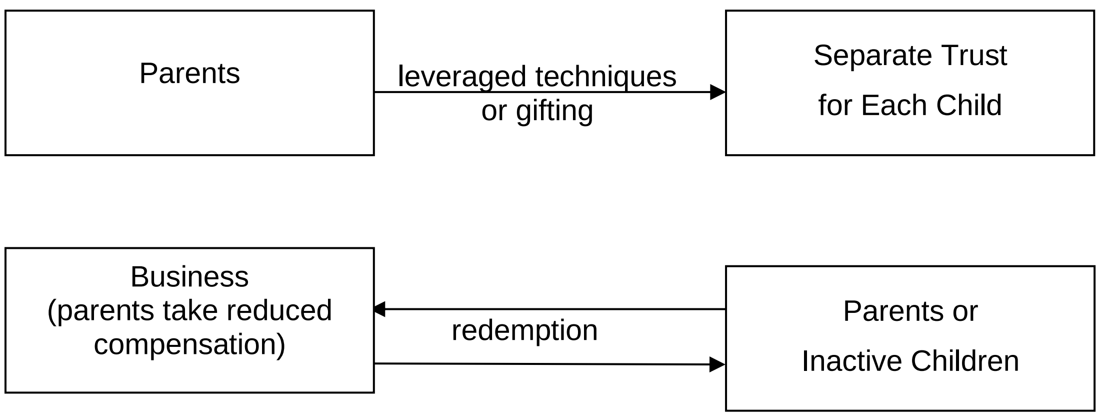
The Conference Agreement to P.L. 115-97 (12/22/2017) describes restricted stock units:[3727]

> A restricted stock unit (“RSU”) is a term used for an arrangement under which an employee has the right to receive at a specified time in the future an amount determined by reference to the value of one or more shares of employer stock. An employee’s right to receive the future amount may be subject to a condition, such as continued employment for a certain period or the attainment of certain performance goals. The payment to the employee of the amount due under the arrangement is referred to as settlement of the RSU . The arrangement may provide for the settlement amount to be paid in cash or as a transfer of employer stock (or either). An arrangement providing RSUs is generally considered a nonqualified deferred compensation plan and is subject to the rules, including the limits, of section 409A.

The Conference Agreement explains why Code § 83(i) does not apply to RSUs:

> The provision does not apply to income with respect to nonvested stock that is includible as a result of a section 83(b) election. The provision clarifies that Section 83 (other than the provision), including subsection (b), shall not apply to RSUs. Therefore, RSUs are not eligible for a section 83(b) election. This is the case because, absent this provision, RSUs are nonqualified deferred compensation and therefore subject to the rules that apply to nonqualified deferred compensation.

II.M.4.e.iii. Succession Planning Using Redemptions When Parent is Living



Leveraged Techniques of Gifting

The first chart represents the concept that leveraged techniques, such as GRATs and sales to irrevocable grantor trusts, result in all of the next generation having an equal interest in the business. See part III.B.1, Transfers During Life.

This might be through one trust that later splits through the trustee’s power to divide or a family agreement or through separate trusts created from inception.

[3727] “Restricted stock unit” is also important to understand for Code § 83(i)(2), defining “Qualified stock.” See text preceding fn 3725.

Reducing or Eliminating Parents or Inactive Owners

Inactive owners generally wish to maximize their return through distributions and by keeping compensation down.

Active owners typically wish to reinvest earnings to grow the business and wish to have incentive compensation.

The business entity might redeem the inactive owners to minimize future conflict.

If the older generation is still working in the business, then the older generation might agree to take less compensation. This might have income tax consequences to partnerships[3728] or S corporations,[3729] but it would not have gift tax consequences.

If the entity is an S corporation, then a partial redemption that the tax law treats as a distribution rather than a redemption might actually be favorable if it can be made out of AAA. See part II.Q.7.b Redemptions or Distributions Involving S Corporations.

The corporation might use a promissory note to redeem a parent's interest in a corporation.[3730]

[3728] Code § 704(e).

[3729] Code § 1366(e).

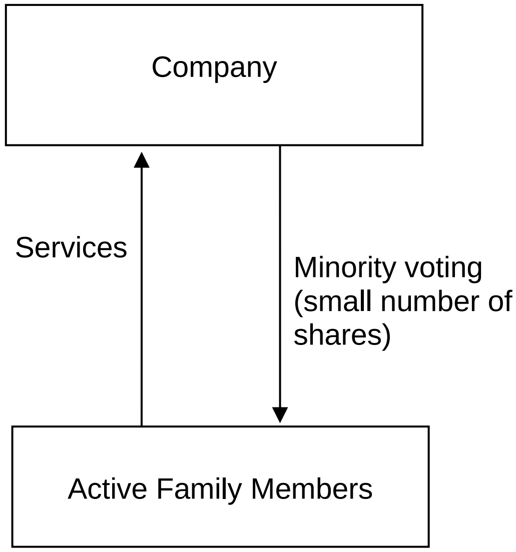
[3730] Letter Ruling 9408018, which held:

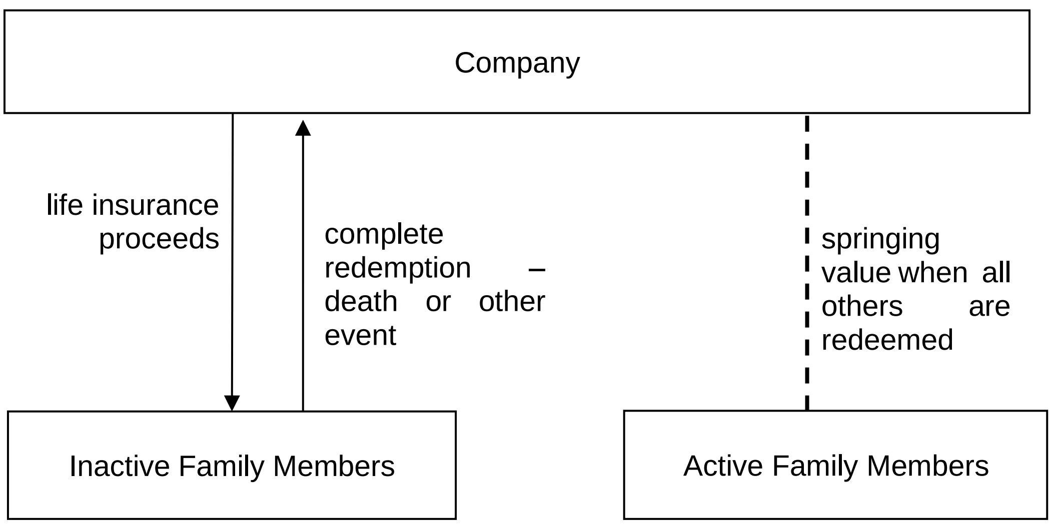
> The execution, as described above, of Notes A and B by Company with a stated annual interest rate that is the greater of either (i) 120 percent of the applicable federal mid-term rate on the date the redemption agreement is executed or (ii) the rate that is sufficient to provide the promissory note with "adequate stated interest" within the meaning of section 1274(c)(2) of the Code, will not result in a gift subject to gift tax. The interest rate that will be stated in the notes will be at least equal to the applicable federal long-term rate under section 1274(d)(1)(A) for the month during which the notes are executed. Therefore, for federal gift tax purposes, the fair market value of Note A and Note B will be the principal amount stated in each note. This ruling (number (11)) is conditioned on both of the following assumptions being met (i) there is no indication that the notes will not be paid according to their terms and (ii) the corporation's ability to pay the notes is not otherwise in doubt.

See also fn 7067 in part III.B.5.b Promissory Notes.

II.M.4.e.iv. Succession Planning Using Redemptions Funded by Life Insurance

Consider the following business succession strategy:





From a tax perspective, this structure can help solve the problem of inactive owners want to maintain their equity position, but key employees need entrepreneurial incentive to run and grow the business.

Below are some issues:

1. If a C corporation, make an S election. This will enable the profits to be distributed to the inactive owners using only one level of tax.

2. Grant incentive compensation to key employees based on formula.

3. Recapitalize into voting and nonvoting, for example, by issuing 19 shares of nonvoting for every share of voting stock; a similar idea would apply to an LLC or other entity taxed as a partnership.

4. Issue voting stock to key employees as compensation for services so that:

    - Key employees and inactive owners have an appropriate balance of voting power.

    - Key employees receive compensation increases or bonuses only if part of the agreements made when restructuring or if approved by inactive owners. Similarly, key employee compensation decreases only if part of the agreements made when restructuring or if approved by key employees.

    - Distributions are made according to a set formula and can be increased only if approved by key employees. Similarly, distributions decrease only if part of the agreements made when restructuring or if approved by inactive owners.

5. Life insurance funds a buy-sell agreement.

    - When all of the inactive owners' interests are redeemed, the only ownership remaining is held by the key employees. Thus, their small ownership suddenly blossoms into sole ownership.

    - If a cross-purchase (each owner holds insurance on the lives of the other owners and uses the proceeds to buy stock at death) is used rather than a redemption, then the key employees' ownership might increase more quickly, depending on how the cross-purchase is structured.

    - A cross-purchase is generally better from a tax perspective.

        - It is less risky from an estate tax perspective. Redemption agreements typically exclude the life insurance from the calculated purchase price. The IRS might be able to persuade a court to disregard that exclusion and count the life insurance as part of the business' value for estate tax purposes. See II.Q.4.h Establishing Estate Tax Values.

        - C corporations might be subjected to alternative minimum tax on the death benefit.

        - If a redemption is used, S corporations and partnerships might experience income tax basis distortions,[3731] and S corporations that have significant accumulated E&P from when they were C corporations would lose AAA.[3732]

[3731] See part II.Q.7.b.iii S Corporation Receipt of Life Insurance Proceeds, which discusses the impact on S corporations, but the same principles would seem to apply to partnerships.

[3732] Part II.Q.7.b.iv S Corporation Distributions of, or Redemptions Using, Life Insurance Proceeds. Although life insurance adds to each shareholder's stock basis, it adds to the other adjustments account rather than to AAA.

- However, if one owner leaves the business and a policy (or interest in a policy) is transferred to another owner, beware of the transfer-for-value rules, which might subject the death benefit to income tax.[3733]

- Cross-purchases and redemptions entail various nontax risks. Neither is perfect. Probably the safest method, which is a little complicated, is the life insurance LLC:

  - The owners of the main company are also members of the LLC. Each owner is specially allocated the responsibility for paying premiums on the other owners and the benefit of the associated life insurance death benefit.

  - A corporate trustee (or other independent deep pocket) serves as the manager and may be removed only by consent of all the members.

  - The manager's only job is to hold policies, collect premiums, and hold proceeds until all parties agree on implementation of the buy-sell agreement.

  - This avoids various business and tax risks, including the transfer for value rule that might apply when owners come and go.[3734]

  - For details, see part II.Q.4.i Life Insurance LLC.

If one expects to sell a business interest for all cash in a few years and would like to defer capital gain on the sale of a business interest, consider selling the business interest in an installment sale to a nongrantor trust. The note might be interest-only for a few years, with principal payments beginning sometime after the business interest is expected to be sold. The trust receives basis for the full amount of the promissory and can sell the business interest tax-free to the extent of that basis.

Similar principles apply to the sale of land or other property that is not depreciable or amortizable.

Potential pitfalls include the following:

- If the trust is a related person (which usually is the case) and it re-sells the business interest within two years, the original seller's deferred gain is accelerated.

- The original seller's death will not generate a basis step-up in the note. If the original seller had simply held the business interest until death, part or all of the gain would be eliminated by basis step-up. Consider buying term insurance against the risk of loss of the financial benefit of the basis step-up.

- Be sensitive to possible acceleration of the deferred gain if the original seller later transfers the installment note, including by gift (or transfer to or from a nongrantor trust), or pledges the note.

[3733] Code § 101(a)(2).
[3734] See part II.Q.4.b Transfer for Value Rule; Basis.

- Beware of the possible need to pay interest on the deferred tax liability if the sale exceeds $5 million.[3735]

- The part of the gain on the sale of a partnership interest attributable to "hot assets" is not eligible for installment sale treatment.

- The direct or indirect sale of depreciable or amortizable assets to a related party (the nongrantor trust) might trigger ordinary income tax.

II.M.4.f. Issuing a Profits Interest to a Service Provider

II.M.4.f.i. Overview of Profits Interest; Contrast with Code § 409A

Issuing a profits interest usually makes more sense than issuing stock to the employee, in that a service provider usually is interested more in sharing the fruits of the business' future success than in buying its existing assets. Awarding a profits interest is also less expensive, because it does not require buying any of the business' current value.

Code § 409A does not apply to the issuance of a profits interest.[3736] The profits interest could turn into golden handcuffs that avoid the strict rules on timing that Code § 409A imposes. For

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[3735] Code § 453A(b)(2).

[3736] Notice 2005-1, Q&A 7 (third sentence). For a general discussion of the broader topic, see, The Proper Tax Treatment of the Transfer of a Compensatory Partnership Interest and also Finding the Right Balance: A Critical Analysis of the Major Proposals to Reform the Taxation of Carried Interests in Private Equity, both in *Tax Lawyer*, Vol. 62, No. 1 (Fall 2008). This Notice continued to apply under section III.G of the preamble to the final regulations under Code § 409A and still applies under the final regulations pursuant to Section 4 of Notice 2007-86. Reg. § 1.409A-1(b)(7) has the following text: Arrangements between partnerships and partners. [Reserved.] The preamble to the final regulations, T.D. 9321, provides:

> (G.) Arrangements Between Partnerships and Partners
>
> The proposed regulations did not address the application of section 409A to arrangements between partnerships and partners, and these final regulations also do not address such arrangements. The statute and the legislative history of section 409A do not specifically address arrangements between partnerships and partners providing services to a partnership and do not explicitly exclude such arrangements from the application of section 409A. Commentators raised a number of issues, relating both to the scope of the arrangements subject to section 409A and the coordination of the provisions of subchapter K and section 409A with respect to those arrangements that are subject to section 409A. The Treasury Department and the IRS are continuing to analyze the issues raised in this area. Notice 2005-1, Q&A-7 provides interim guidance regarding the application of section 409A to arrangements between partnerships and partners. Until further guidance is issued, taxpayers may continue to rely on Notice 2005-1, Q&A-7 and sections II.E. and VI.E. of the preamble to the proposed regulations.
>
> Notice 2005-1, Q&A-7 provided that until further guidance is issued for purposes of section 409A, taxpayers may treat the issuance of a partnership interest (including a profits interest) or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock. For this purpose, taxpayers may apply the principles applicable to stock options or stock appreciation rights under these final regulations, as effective and applicable, to equivalent rights with respect to partnership interests.
>
> Taxpayers also may continue to rely upon the explanation in the preamble to the proposed regulations regarding the application of section 409A to guaranteed payments for services

example, a partnership distributes enough of the service partner's share of profits to pay the service partner's income taxes. The rest of the service partner's share of profits is accumulated in the service partner's capital account and may be subject to any timing rules the parties choose. Because the service partner has already paid income tax on this accumulated income, this deferral does not offend the principles of Code § 409A, which are concerned about the timing of taxation. For more on Code § 409A, see part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

Profits interests have Code § 2701 consequences for family-controlled businesses, so the transferor either prepares to be treated as making a gift of the capital account that would ordinarily be associated with the profits interest or retains preferred payments that help reduce the impact of Code § 2701. For a discussion of how Code § 2701 might apply, see part III.B.7.c Code § 2701 Interaction with Income Tax Planning.

Also, receiving a profits interest causes the service provider to be taxed as a partner for all of that person's compensation, because bona fide members of a partnership are not employees for tax purposes.[3737]

II.M.4.f.ii. Tax Effects of Profits Interests

Below we discuss that issuing a profits interest generally does not have an <u>income</u> tax consequence.

As mentioned above, profits interests have gift/estate tax effects even though they don't have an income tax effect; see part III.B.7.c Code § 2701 Interaction with Income Tax Planning. I don't believe that the IRS is conceding for even a nanosecond that a profits interest is worth zero for income tax purposes. Rather, the issue is a matter of income tax accounting. If for income tax accounting purposes one recognizes the value of a profits interest, the partner would need to be awarded a capital account equal to that value. That capital account would not reflect a share of the partnership's assets, because reflecting such a share would be contrary to the very definition of a profits interest. Rather, that capital account would be a right to future profits that should be amortized over the period for which the profits were assumed in the valuation. This would generate amortization deduction based on the valuation assumptions, which of course are subject to dispute. Thus, initially the other partners get a compensation deduction (and reduced capital accounts) and the profits interest partner would recognize income, and then the profits interest partner would have an amortization deduction to offset future profits. This alternative paradigm would be quite messy and generate significant valuation disputes along the way. To avoid this partnership income tax accounting mess, the IRS decided to make administrability of the partnership income tax system supersede the theory behind Code § 83. The simplifying assumption of zero value for the income tax accounting treatment of profits interests makes the system more practical to use and avoids valuation fights.

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described in section 707(c). As stated in that preamble, until further guidance is issued, section 409A will apply to guaranteed payments described in section 707(c) (and rights to receive such guaranteed payments in the future), only in cases where the guaranteed payment is for services and the partner providing services does not include the payment in income by the 15th day of the third month following the end of the taxable year of the partner in which the partner obtained a legally binding right to the guaranteed payment or, if later, the taxable year in which the right to the guaranteed payment is first no longer subject to a substantial risk of forfeiture.

[3737] See note 551. For self-employment tax on guaranteed payments, see text accompanying notes 3454-3455.

After discussing income taxation of issuing profits interests, we discuss that certain sales of compensatory partnership interests are recharacterized from long-term to short-term capital gains.

II.M.4.f.ii.(a). Tax Effects of Issuing a Profits Interest

The issuance of a profits interest to a new partner, discussed in this part II.M.4.f.ii.(a), tends to be distinguished from shifting interests in profits among existing partners, the latter which is discussed in part II.C.6 Shifting Rights to Future Profits.

Reg. § 1.721-1(b)(1) provides (highlighting added):

> Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest. To the extent that an interest in capital representing compensation for services rendered by the decedent prior to his death is transferred after his death to the decedent's successor in interest, the fair market value of such interest is income in respect of a decedent under section 691.

Under Rev. Proc. 93-27, if a person receives a profits interest[3738] for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner,

[3738] Under the Rev. Proc., a profits interest is a partnership interest other than a capital interest. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest. For the rules on revaluing partnership assets and adjusting capital accounts when that occurs, see part II.C.7 Maintaining Capital Accounts, especially fn. 507.
See *Mark IV Pictures, Inc. v. Commissioner*, T.C. Memo. 1990-571, which held:

> Deciding whether a partner's interest in a partnership is a capital interest, rather than a mere profits interest, turns on whether that partner has the right to receive a share of the partnership's assets upon a hypothetical winding up and liquidation immediately following acquisition of the interest, rather than the mere right to share in future partnership earnings or profits. Here, a fair reading of paragraphs 2.4 and 9.2 of the Articles indicates that the general partners had the *right to receive* a specified share of the partnerships' liquidation proceeds (assets). Thus, even if no partnership proceeds remained to be distributed to the general partners after distributing the liquidating proceeds in accordance with section 545.42, they nevertheless had the *right to receive* a share of the partnerships' assets.
>
> Based on the foregoing, we conclude that the general partners received a capital interest in their respective limited partnerships. See sec. 1.721-1(b)(1), Income Tax Regs.

generally the IRS will not treat the receipt of such an interest as a taxable event for the partner or the partnership. However, that safe harbor does not apply:

(1) If the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;

(2) If within two years of receipt, the partner disposes of the profits interest; or

(3) If the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of Code § 7704(b).

If Rev. Proc. 93-27 applies, the profits interest is treated as a capital asset when the service provider sells it.

Rev. Proc. 2001-43 applies Rev. Proc. 93-27 to the grant of a partnership profits interest that is substantially nonvested for the provision of services to or for the benefit of the partnership. Under Section 4 of Rev. Proc. 2001-43, the service provider will be treated as receiving the interest on the date of its grant, and a Code § 83(b) election will not be required, if:

> .01 The partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest;
>
> .02 Upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and
>
> .03 All other conditions of Rev. Proc. 93-27 are satisfied.

If Rev. Proc. 2001-43 does not apply to the grant of a substantially nonvested partnership profits interest and if case law[3739] does not provide otherwise, then the service provider recognizes ordinary income (and the partnership is deemed to have paid compensation) when the profits interest vests. The holding period for a later sale of the profits interest would be based on the date of vesting, rather than the date of grant.

A similar result was *Hensel Phelps Construction Co. v. Commissioner*, 74 T.C. 939 (1980), *aff'd* 703 F2d 485 (10th Cir. 1983).

[3739] *Diamond v. Commissioner*, 56 T.C. 530 (1971 reviewed decision) (taxing service partner on issuance of profits interest), *aff'd* 492 F.2d 286 (7th Cir. 1974); *Campbell v. Commissioner*, T.C. Memo. 1990-162 (finding taxation on issuance), *rev'd* 943 F.2d 815 (8th Cir. 1991) (finding no taxation on issuance); *St. John v. U.S.*, 53 A.F.T.R.2d 84-718 (C.D. Ill. 1983) (no taxation because partnership's success was undetermined and speculative); *Kenroy, Inc. v. Commissioner,* T.C. Memo. 1984-232 (no taxation because partnership's liabilities exceeded assets); *United States v. Frazell*, 339 F.2d 885 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965) (taxation on capital shift even though original partners held a preferred profits interest). The Eighth Circuit in *Campbell* cited an earlier version (that has since been updated) of McKee, Nelson & Whitmire, ¶5.02 Distinguishing Taxable From Nontaxable Service-Connected Transfers of Partnership Interests: Is There a Difference Between Capital and Profits Interests? *Federal Taxation of Partnerships & Partners* (WG&L), and of Willis & Postlewaite, ¶4.06 Partnership Profits Interest Received in Exchange for Services, *Partnership Taxation*.

The IRS has proposed regulations[3740] that would change these rules for profits interests, effective only when the regulations are finalized. Under the proposed regulations, a service provider would be required to recognize income upon receipt of a vested profits interest. A Code § 83(b) election would be required to treat a substantially nonvested profits interest as if it were vested. At any rate, determining the value of the profits interest generally would require an appraisal and complicate future accounting on many levels. IRS Notice 2005-43 proposes a Rev. Proc. to allow taxpayers to elect to determine the value based on the awarded partnership interest's liquidation value determined immediately after the grant of the partnership interest. If the partnership interest is merely a profits interest, the liquidation value would be zero. The proposed Rev. Proc. would supersede Rev. Proc. 93-27 and Rev. Proc. 2001-43; however, until the proposed Rev. Proc. is finalized, taxpayers may continue to rely on Rev. Proc. 93-27 and Rev. Proc. 2001-43.

Furthermore, the preamble to subsequent proposed regulations[3741] announced:

> The Treasury Department and the IRS are aware of transactions in which one party provides services and another party receives a seemingly associated allocation and distribution of partnership income or gain. For example, a management company that provides services to a fund in exchange for a fee may waive that fee, while a party related to the management company receives an interest in future partnership profits the value of which approximates the amount of the waived fee. The Treasury Department and the IRS have determined that Rev. Proc. 93-27 does not apply to such transactions because they would not satisfy the requirement that receipt of an interest in partnership profits be for the provision of services to or for the benefit of the partnership in a partner capacity or in anticipation of being a partner, and because the service provider would effectively have disposed of the partnership interest (through a constructive transfer to the related party) within two years of receipt.

Returning to the law when this portion was written, should one file a Code § 83(b) election, to preserve future capital gain treatment on the profits interest holder's future sale of the profits

[3740] REG-105346-03, proposing changes to Reg. §§1.83-3, 1.83-6, 1.704-1, 1.706-3, 1.707-1, 1.721-1, and 1.761-1. Over the past several years, various proposals to tax hedge fund managers on the sale of their profits interests have had a chilling effect on the progress of these proposed regulations, particularly since the safeguards needed to make those proposals effective would cause radical changes in this area of tax law, well beyond the scope of taxing hedge fund managers.

[3741] REG-115452-14 (7/22/2015), which continued:

> Further, the Treasury Department and the IRS plan to issue a revenue procedure providing an additional exception to the safe harbor in Rev. Proc. 93-27 in conjunction with the publication of these regulations in final form. The additional exception will apply to a profits interest issued in conjunction with a partner forgoing payment of an amount that is substantially fixed (including a substantially fixed amount determined by formula, such as a fee based on a percentage of partner capital commitments) for the performance of services, including a guaranteed payment under section 707(c) or a payment in a non-partner capacity under section 707(a).
> In conjunction with the issuance of proposed regulations (REG-105346-03; 70 FR 29675-01; 2005-1 C.B. 1244) relating to the tax treatment of certain transfers of partnership equity in connection with the performance of services, the Treasury Department and the IRS issued Notice 2005-43, 2005-24 I.R.B. 1221. Notice 2005-43 includes a proposed revenue procedure regarding partnership interests transferred in connection with the performance of services. In the event that the proposed revenue procedure provided for in Notice 2005-43 is finalized, it will include the additional exception referenced.

For an in-depth discussion of proposed regulations under REG-115452-14, see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

interest due to any noncompliance with the Revenue Procedures, either by the structure or by subsequent events within two years after the grant? If the profits interest's issuance is determined to be like the issuance a capital interest (for example, if it is determined that the book-up[3742] on issuance of the profits interest undervalued the partnership's assets), then filing a Code § 83(b) election would trigger income on issuance. Consider, however, that the tax economics if capital gain treatment were disallowed are not necessarily so bad, if certain tax indemnification agreements are in place:

Example

Suppose the basis at the time of the subsequent sale is zero (all profits have been paid out), the fair market value is $100x, the federal and state capital rate is 20%, and the federal and state income tax rate is 40%.

If the profits interest is given capital gain treatment, the holder of the profits interest pays $20x tax on the sale.

If the profits interest is deemed not to have been property until the sale (due to lack of vesting, etc.), then the following should occur:

- The holder receives $100x from the sale, which is deemed compensation income.
- The partners pay $67x withholding to the federal and state taxing authorities, covering the tax on the $100x and the $67x (40% of $167x is $67x). This is also deemed income to the holder of the profits interest.
- The partners deduct $167x compensation, saving $67x of tax, assuming they have basis for this deduction.
- The $67x tax savings to the partners pays for $67x withholding they paid.
- Except as described below, nobody pays anything out-of-pocket on the holder's receipt of the $100x sale proceeds.
- The partners pay capital gain tax on the sale proceeds they are deemed to have received.
- An appropriate adjustment needs to be made to the allocations set forth above so that the holder reimburses the partners for their capital gain tax paid on the sale, which capital gain tax the parties had originally assumed the holder would have paid.

Articles explain some of the nuances and practical implications of profits interests[3743] and some prominent authors' reconsideration of their position that a taxable issuance of a profits interest might not be a big deal.[3744]

[3742] See footnote 3651.
[3743] Schippel, Should My CEO Be My Partner? A Practical Approach to Dealing with LLC and Partnership Equity Compensation, *TM Memorandum*, Vol. 53, No. 5 (2/27/2012).
[3744] Banoff & Lipton's Shop Talk column, "So You Received a Taxable Profits Interest-Maybe You *Should* Care!" *Journal of Taxation* (2/2016), reconsidering their 11/2015 column.

In *ES NPA Holding, LLC v. Commissioner*, T.C. Memo. 2023-55, the following occurred:

> Before October 14, 2011, Joshus[3] Landy owned 100% of the outstanding shares or membership units in NPA, Inc., Community Credit Services, Inc. (CCS), National Opportunities Unlimited, Inc. (NOU), and American Consumer Credit, LLC (ACC). Those entities conducted consumer loan businesses. Mr. Landy desired to dispose of a portion of his consumer loan businesses (NPA, Inc., CCS, NOU, and ACC) in 2011. Monu Joseph and Amit Raizada, who would later become ES NPA's principals, became aware of an opportunity to acquire an interest in an existing online consumer finance business that was fully licensed in Delaware. Messrs. Joseph and Raizada contacted Mr. Landy with regard to his desire to dispose of a portion of his consumer loan businesses.
>
> [3] Joshus Landy is referenced throughout the record with various spellings of his first name (e.g., Joshus, Joshua, and Josh). We do not find any indication that these spellings represent separate individuals.
>
> Messrs. Landy, Joseph, and Raizada discussed a potential sale for several weeks; and on June 25, 2011, one of Mr. Joseph's businesses, Emerald Crest Capital (ECC), sent a letter (term sheet) to Mr. Landy in which ECC offered to purchase 70% of Mr. Landy's consumer loan businesses for $20.59 million, which was based on a 2.3× multiple of earnings before interest, taxes, depreciation, and amortization (EBITDA) for the most recent 12-month period.
>
> The term sheet specified contingencies such as that a new entity would be formed by the principals of ECC, its affiliates, or its investors to acquire the 70% interest in Mr. Landy's consumer loan businesses and stated that ECC did not "currently have sufficient information to determine the most efficient structure for the [a]cquisition." The term sheet also stated that ECC might bring in various parties as part of its purchase group to fund the purchase of an interest in Mr. Landy's businesses. Mr. Landy signed the term sheet on July 5, 2011.
>
> Thereafter Mr. Landy retained the law firm Bryan Cave LLP to represent him with respect to the preparation of the transaction documents that would effect the sale of his businesses. Meanwhile, ECC provided a 60-page acquisition due diligence memorandum to prospective investors to facilitate the purchase of a controlling interest in Mr. Landy's businesses. The memorandum discussed a "contemplated transaction" that involved "a purchase of 39.2% of" Mr. Landy's businesses.
>
> Article 6.2 of the NPA, LLC operating agreement provides that "[e]ach Member has made an initial Capital Contribution to the Company in such amounts and under such terms as were agreed by the Member and approved by the Company as a condition to the issuance of Units to the Member. The initial Capital Contribution with respect to each Member and Class of Units is set forth in Exhibit B."
>
> NPA, LLC operating agreement § 13.3 provides that, after the payment of liabilities, the liquidation proceeds of NPA, LLC are to be distributed 30% to class B unit holders, 40% to class A unit holders, and
>
>> 30 percent to the Members who hold Class C Units; provided however, that, if the sum of all distributions made to the Members who hold Class A Units pursuant to [§] 9.2 and this [§] 13.3(c) is less than the total Capital Contributions of such

> Members, the distributions to the Members who hold Class C Units shall be reduced and the distribution to the Members who hold Class A Units shall be increased, by an amount equal to the lesser of (i) the distribution to the Members who hold Class C Units pursuant to this [§] 13.3(c)(ii), and (ii) the difference between the total Capital Contributions of the Members who hold Class A Units and the sum of all distributions previously made to the Members who hold Class A Units pursuant to [§] 9.2 and the distribution that would be made to the Class A Members pursuant to [§] 13.3(c)(iii).

The sale of Mr. Landy's businesses was arranged through the following transactions, which took place on September 27, October 13, and October 14, 2011. On September 27, 2011, NPA, Inc. formed two LLCs: IDS and NPA, LLC. IDS had two classes of membership units: class B and class C. NPA, LLC had three classes of units: class A, class B, and class C. Per Articles 9.2 and 13.3 of the IDS first amended and restated limited liability company agreement, the class B and class C units in IDS track the class B and class C units in NPA, LLC, respectively, in that the owner of IDS class B units was entitled to 100% of the payments received by IDS because of its ownership of NPA, LLC class B units and the owner of IDS class C units was entitled to 100% of the payments received by IDS because of its ownership of NPA, LLC class C units.

On October 13, 2011, NPA, Inc. contributed substantially all of its business assets to NPA, LLC in exchange for all three classes of units (classes A, B, and C) in NPA, LLC. NPA, Inc. then contributed all three classes of units (classes A, B, and C) in NPA, LLC to IDS as a capital contribution to IDS. At the end of the day on October 13, 2011, the relevant aspects of the entity ownership structure were as follows:

[chart showing Mr. Landy owning NPA, Inc., which owned IDS, which in turn owned NPA, LLC]

On October 14, 2011, NPA, LLC entered into revenue-sharing agreements with the other consumer loan businesses, CCS, NOU, and ACC, respectively. An entity named NPA Investors, LP (NPA Investors), purchased all of NPA, LLC's class [pg. 441] A units from IDS in exchange for $14,502,436. Also on October 14, 2011, ES NPA exercised a call option granted by NPA, Inc., and pursuant thereto acquired all of the IDS class C units in exchange for ES NPA's payment to NPA, Inc. of $100,000 and services provided or to be provided.

The "Whereas" clause of the call option agreement states that ES NPA agreed to provide the following services to NPA, Inc. in exchange for the option to pay $100,000 to NPA, Inc. to acquire all of the class C units in IDS (which reflected an indirect interest in the class C units of NPA, LLC): "strategic advice for the purpose of enhancing the performance of [NPA Inc.'s] business and to assemble an investor group that would purchase 40 [sic] percent of [NPA Inc.'s] business for approximately $21 million." The call option agreement also provides that ES NPA is hereby given "an option...to purchase all of the Class C Units...from [IDS]" and is dated October 14, 2011….

At the end of the day on October 14, 2011, (i) the class A units held by NPA Investors had a capital contribution of $20,985,509, (ii) the class B units held by IDS had a capital contribution of $8,993,790, and (iii) the class C units held by IDS had a capital contribution of zero.

Part II.C of the court's opinion, "Receipt of a Partnership Interest in Exchange for Services," explains:

> Section 721(a) provides that "[n]o gain or loss shall be recognized to a...partner[] in the case of a contribution of property to the partnership in exchange for an interest in the partnership." However, where a person receives a partnership interest in exchange for a contribution of services, nonrecognition is not always guaranteed. See Treas. Reg. § 1.721-1(b)(1). Under that regulation the "receipt of a partnership capital interest in exchange for services is taxable to the service provider." *Crescent Holdings, LLC*, 141 T.C. at 488; see I.R.C. § 83(a) (generally dictating the recipient's tax treatment of property received in connection with services performed); Treas. Reg. § 1.61-2(d) (stating property received as compensation must be included in income). Under longstanding principles services are not "property" for purposes of section 721; therefore, the receipt of a partnership capital interest in exchange for services does not receive section 721 treatment.
>
> Treasury Regulation § 1.721-1(b)(1) states in part:
>
>> To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.
>
> The foregoing parenthetical reference to a profits interest in the above regulation has been read as intending to exempt the receipt of a profits interest for services from taxation. *See* Charles H. Egerton, *Rev. Proc. 93-27 Provides Limited Relief on Receipt of Profits Interest for Services*, 79 J. Tax'n 132, 132 (1993). This view was also acknowledged by this Court. *See Hale v. Commissioner*, T.C. Memo. 1965-274, 1965 WL 1045, n.3.
>
> We previously held that the receipt of a profits interest in a partnership in exchange for the performance of services was a taxable event. *Diamond v. Commissioner*, 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974). Then in *Campbell v. Commissioner*, T.C. Memo. 1990-162, *aff'd* in part, *rev'd* in part, 943 F.2d 815 (8th Cir. 1991), we again determined the receipt to be a taxable event regardless of whether the transferee partner would receive anything upon a theoretical liquidation. The U.S. Court of Appeals for the Eighth Circuit, however, reversed our decision in Campbell, finding that the receipt of a profits interest was not taxable since the value received was speculative. *Campbell v. Commissioner*, 943 F.2d 815.[5]
>
>> [5] Absent stipulation to the contrary this case is appealable to the Eighth Circuit, and we thus follow its precedent. See *Golsen v. Commissioner*, 54 T.C. 742, 756-57 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971); see also I.R.C. § 7482(b)(1)(E).
>
> Ultimately the IRS addressed the issue when it promulgated Revenue Procedure 93-27, publishing guidance on the treatment of the receipt of a profits interest for services provided to or for the benefit of the partnership.[6] *Id*. § 1, 1993-2 C.B. at 343. In this revenue procedure the IRS cites Treasury Regulation § 1.721-1(b)(1) and acknowledges that the receipt of a capital interest for services is taxable as compensation, Rev.

Proc. 93-27, § 3, 1993-2 C.B. at 343, while on the other hand, it will not treat the receipt of a profits interest as a taxable event, *id*. § 4.01, 1993-2 C.B. at 344.[7]

[6] The IRS addressed the receipt of a partnership interest in exchange for services in a proposed ruling attached to a General Counsel Memorandum (GCM). I.R.S. G.C.M. 36,346 (July 23, 1975). In the GCM, the IRS acknowledged a conflict between our holding in Diamond and Treasury Regulation § 1.721-1(b). In the GCM, the IRS declined to follow our holding in Diamond "to the extent that it holds that the receipt by a partner of an interest in future partnership profits as compensation for services results in taxable income." The GCM also recognized that because "the receipt of a 'profits['] interest is not taxable, the proposed revenue ruling is limited to interests that give the holder no rights to existing partnership assets upon the liquidation of his interest."

[7] Followed by clarification in Revenue Procedure 2001-43, 2001-2 C.B. 191, intended to ensure that the receipt of a profits interest will achieve the recipient's goal of not having an immediate recognition of tax upon his or her joining of the partnership, the IRS seems to view the receipt of a profits interest as a type of deferred compensation arrangement.

Part III.A of the court's opinion, "Definition of a Profits Interest," explains:

Revenue Procedure 93-27[8] defines a profits interest as a partnership interest "other than a capital interest," *id*. § 2.02, 1993-2 C.B. at 343, and a capital interest is, in turn, an interest that would "give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership," *id*. § 2.01. This theoretical liquidation is to occur "at the time of receipt of the partnership interest," *id*., which the parties referred to throughout the case as "immediately" after the transaction. Under Revenue Procedure 93-27 such a profits interest is not treated as income upon its acquisition if a person receives it "for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner." *Id*. § 4.01.[9]

[8] Revenue Procedure 93-27 is amplified by Revenue Procedure 2001-43, which acknowledges the time and valuation rules of section 83.

[9] In Revenue Procedure 2001-43, § 2, 2001-2 C.B. at 191, the IRS further clarified Revenue Procedure 93-27 by providing that the determination of whether the interest granted is a profits interest is tested at the time of grant.

Part III.B.1 of the court's opinion, "Is Revenue Procedure 93-27 Applicable?" explains:

As a threshold matter, it is uncontroverted that ES NPA provided services to NPA, Inc. in exchange for the class C units in IDS. It is also undisputed that ES NPA's interests in the class C units in IDS are identical in all respects to the interests in class C units in NPA, LLC. Respondent contends Revenue Procedure 93-27 has no application since it applies only when "a partnership profits interest for services provided to or for the benefit of the partnership," *id*. § 1, and in this case ES NPA received an interest in IDS in exchange for services it provided to NPA, Inc.-not NPA, LLC.[10] We disagree with respondent and find his reading of this revenue procedure and views of the transaction at issue to be unreasonably narrow.

> [10] Proposed Treasury regulations under section 83 reject the concept that the receipt of a partnership interest in connection with services is not a realization event. In conjunction with the issuance of these proposed regulations, the IRS issued I.R.S. Notice 2005-43, 2005-1 C.B. 1221, which explains that Revenue Procedures 93-27 and 2001-43 will become obsolete upon the finalization of these proposed regulations, but that until then taxpayers are permitted to rely upon Revenue Procedure 93-27.

> While respondent has accurately stated the introductory purpose set out in Revenue Procedure 93-27, § 1,[11] the revenue procedure later states and further explains that "if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the [IRS] will not treat the receipt of such an interest as a taxable event for the partner or the partnership." See *id*. at § 4.01. We find Revenue Procedure 93-27 § 4, entitled "Application," to set the intended parameters of the revenue procedure's application.

> [11] Revenue Procedure 93-27 does not apply: (1) if the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) if within two years of receipt, the partner disposes of the profits interest; or (3) if the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of section 7704(b). See Rev. Proc. 93-27, § 4.02, 1993-2 C.B. at 344. Respondent does not assert that ES NPA triggered any of these three elements. Therefore, we will not consider this issue and deem it to be waived.

> On brief, respondent implies that Revenue Procedure 93-27 is a "safe harbor" with limited application. We do not view Revenue Procedure 93-27 in such a restricted manner, but rather view it as administrative guidance on the treatment of the receipt of a partnership profits interest for services. See William S. McKee et al., *Federal Taxation of Partnerships and Partners* ¶ 5.02[2] (2022) (referring to Revenue Procedure 93-27 as a "broad, taxpayer-friendly safe harbor" subject only to tightly defined exceptions).

> Considering the text of Revenue Procedure 93-27 § 4, the evidence supports a finding that ES NPA directly (or through its principals), before and after formation, provided services to or for the benefit of the partnership in a partner capacity or in anticipation of being a partner. It is undisputed that the material assets of this partnership are held in NPA, LLC, and the activities ES NPA performed were to and for the benefit of the future partnership. It is of no material consequence that ES NPA's interest in NPA, LLC is held indirectly through IDS, which is a mere conduit since the liquidation rights in the class C units in both IDS and NPA, LLC are identical. This partnership came about only through ES NPA and NPA, Inc.'s joint ownership of IDS and their ownership interest in NPA, LLC. Other relevant elements here evidencing that the application of Revenue Procedure 93-27 is proper are the presence of entrepreneurial risk and the receipt of a profits interest in the capacity as a partner. Thus, it is entirely reasonable to conclude that ES NPA's receipt of the class C units meets the intended parameters of Revenue Procedure 93-27 § 4.

Part III.B.2 of the court's opinion, "Has ES NPA Satisfied the Requirements of Revenue Procedure 93-27?" reasons:

> Since we conclude ES NPA's receipt of the class C units qualifies under Revenue Procedure 93-27, the question now becomes whether ES NPA has satisfied the

underlying requirements of the revenue procedure; namely, whether the received class C units are a profits interest. To answer this question Revenue Procedure 93-27 § 2 directs us to determine whether ES NPA would receive a distribution upon a hypothetical liquidation at the time of receipt.

On October 14, 2011, the class A units held by NPA Investors had a capital account of $20,985,509, the class B units held by IDS had a capital account of $8,993,790, and the class C units held by IDS had a capital account of zero. NPA, LLC operating agreement § 13.3 provides that after the payment of liabilities, the NPA, LLC liquidation proceeds are to be distributed 30% to class B unit holders and 40% to class A unit holders, with the remaining 30% to the members who hold class C units, provided, however, that the sum of all distributions made to the members who hold class A units had first been satisfied. In other words, the class A and B unit holders have a preferred return on their capital, and the class C units would receive anything in a hypothetical liquidation only after all capital accounts were first satisfied in full. The parties, and their respective experts, agree, under the terms of the operating agreement, that if the fair market value of NPA, LLC was $29,979,299 as reflected in NPA, LLC's capital account, then there would be no distribution to the class C unit holders upon a hypothetical liquidation.[12]

[12] This $29 million figure would be the book value of NPA, LLC at its formation. See Treas. Reg. § 1.704-3(a)(3). Respondent essentially disputes the book value assigned to the partnership assets and partners' capital accounts and contends that the market value of the newly formed partnership is substantially greater, upon a hypothetical liquidation the class C units would be worth in excess of $12 million, and therefore the receipt of these units was in fact a capital interest in NPA, LLC (rather than a future profits interest as petitioner contends).

To answer the question regarding hypothetical liquidation of the partnership, we must decide the largely subjective question of fair market value. Fair market value is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. *United States v. Cartwright*, 411 U.S. 546, 550-51 (1973); see also Treas. Reg. § 20.2031-1(b); Rev. Rul. 59-60, § 2.2, 1959-1 CB 237, 237.

Respondent contends that in the opinion of his retained expert witness the fair market value of NPA, LLC as of the transaction date was $52,463,722. Respondent disputes the testimony of petitioner's expert and further avers that Mr. Landy lacked knowledge of the value of his business, performed minimal due diligence, and did not understand the terms of the transaction. Essentially, respondent disputes that the transaction was an arm's-length transaction and contends that it should not be relied upon to determine the fair market value of NPA, LLC.

Petitioner contends that the actual terms of the sale, namely the acquisition of the class A units by NPA Investors for $20,985,509, is the best evidence of the overall fair market value of $29,979,299. Petitioner further avers-on the basis of the testimony of Messrs. Landy and Joseph-that the sale was a bona fide arm's-length transaction reflecting the sale of a 70% interest in NPA, LLC. In the alternative, petitioner argues, on the basis of its expert witness testimony, that the fair market value of $29,979,299 is supported by a market analysis approach using a direct capitalization of earnings. Finally, petitioner, on the basis of its expert rebuttal report, disputes respondent's expert witness valuation since it erroneously assumes Mr. Landy sold 40% of his interest in NPA, LLC for approximately $21 million.

The parties agree that the best evidence of fair market value is actual arm's-length sales involving that property. Indeed, this Court has repeatedly affirmed that actual arm's-length sales occurring sufficiently close to the valuation date are the best evidence of value, and typically dispositive, over other valuation methods. See, *e.g.*, *Rubber Rsch., Inc. v. Commissioner*, 422 F.2d 1402, 1405-06 (8th Cir. 1970), *aff'g* T.C. Memo. 1969-24; *Estate of Fitts v. Commissioner*, 237 F.2d 729, 731 (8th Cir. 1956), *aff'g* T.C. Memo. 1955-269; *Wortmann v. Commissioner*, T.C. Memo. 2005-227, 2005 WL 2387487, at *5 (collecting cases and noting that "evidence of what property sold for within a reasonable time before the valuation date generally is competent, substantial, and persuasive evidence of its fair market value" and that "[a]ctual sales between a willing buyer and a willing seller are generally more reliable than estimates and approximations and indicate what a hypothetical buyer and seller may agree on"). Here, there was an actual sale of the subject property-that is, Mr. Landy's internet-based consumer lending businesses-immediately before the hypothetical liquidation of NPA, LLC. That sale of a 70% interest implies an overall fair market value of $29,979,299.

In deciding valuation issues courts often receive into evidence and consider the opinions of expert witnesses. *Helvering v. Nat'l Grocery Co.*, 304 U.S. 282, 295 (1938). Where experts offer competing estimates of fair market value, we determine how to weigh those estimates by, inter alia, examining the factors they considered in reaching their conclusions. *See Casey v. Commissioner*, 38 T.C. 357, 381 (1962). Contrary to the Commissioner's current position that a "formal" appraisal is required, this Court and others have frequently adopted the proposition that an actual sale is more persuasive evidence of fair market value than an appraisal, so the proposition that an appraisal is necessary to validate a sale clearly cannot be correct. See, *e.g.*, *Gaggero v. Commissioner*, T.C. Memo. 2012-331, at *34 (giving "considerably more weight" to the "actual sales price" than an appraisal), *aff'd*, 795 F. App'x 1005 (9th Cir. 2020); *Hollis v. Commissioner*, B.T.A.M. (P-H) P 37,133 (1937) ("The best evidence of value is a sale made between willing parties under no compulsion, and where, in valuing property at a given date, we must choose between opinion evidence based on appraisals and an actual sale or sales between willing parties, the established rule is that the selling price is the better evidence of value.").

In his reply brief respondent argues that the transaction was not for fair market value and should be disregarded since Mr. Landy was pressured to sell, failed to obtain a formal appraisal, and lacked sophistication and education. There is nothing in the record that indicates that Mr. Landy was under any duress or compulsion to sell, and in fact his trial testimony reflects the contrary. At trial Mr. Landy testified how he wanted a "liquidity event" and he understood that he would retain 30% of his businesses. He also testified that he was under no financial compulsion or other need to sell, as his businesses were in fact profitable. The parties to the transaction entered into a letter of intent whereby Mr. Landy agreed to effect the sale of 70% of his consumer loan businesses for a 2.3× multiple of EBITDA. Mr. Landy was represented by legal counsel, and after months of due diligence, the sale occurred with investors paying $14,502,436 for "good will" and $6,483,073 for the existing book of loans for a total price of $20,985,509.[13]

[13] Mr. Landy (through NPA, Inc.) contributed substantially all of his interests in his consumer loan businesses to NPA, LLC before the sale; so to say Mr. Landy sold 70% of his consumer loan businesses, compared to what third-party investors paid to acquire class A units in NPA, LLC, is referring to the same transaction.

Respondent retained an expert witness to provide a retrospective opinion of NPA, LLC's fair market value. This expert was also retained to provide his opinion as to the proceeds ES NPA would receive upon a hypothetical liquidation of NPA, LLC. Respondent's expert performed a market approach analysis through examining comparable businesses and determined an overall fair market value of $52,463,772. It was respondent's expert's opinion that ES NPA would receive $12,269,000 upon a hypothetical liquidation.

Respondent's expert, however, was not aware when he prepared his original report that Mr. Landy had sold 70% of his consumer loan businesses for approximately $21 million. Therefore, respondent's expert performed no analysis with respect to the transaction in his original report. On rebuttal, respondent's expert acknowledged that the transaction provides the best indicator of NPA, LLC's value; however, he conducted additional analysis using an income approach to test the reasonableness of the transaction. In his rebuttal report respondent's expert opined, using an income approach and a 4.7× multiple of EBITDA, that NPA, LLC had an overall fair market value of $48,480,500, resulting in ES NPA's receiving a distribution upon a hypothetical liquidation.

Determining credibility is the province of the Court, and we find the testimony of Mr. Landy, a neutral third-party regarding the nature of the transaction at issue, to be credible and unbiased. We find nothing in the record to dispute a finding that the transaction was arm's-length and bona fide. We decline to adopt respondent's expert's opinion of value. See *Parker v. Commissioner*, 86 T.C. 547, 561 (1986). Rather, we rely upon the arm's-length and bona fide transaction in which Mr. Landy sold a 70% interest in his consumer loan businesses for approximately $21 million, resulting in an overall fair market value in NPA, LLC of $29,979,299.

Therefore, we determine ES NPA's class C units are a profits interest as defined under Revenue Procedure 93-27 since, applying a fair market value of $29,979,299 to NPA, LLC at the time of receipt, ES NPA would not receive a share of the proceeds upon a hypothetical liquidation of the partnership.[14] Further, on the basis of the conflicting expert witness testimony, we determine any fair market value in excess of $29,979,299 to be speculative. See *Campbell v. Commissioner*, 943 F.2d at 823.

[14] The foregoing facts are distinguishable from those in *Crescent Holdings, LLC*, 141 T.C. at 493, where, unlike here, we found that upon a hypothetical liquidation the taxpayer would have received a share of the proceeds.

Lipton and Gruen, "*ES NPA Holding, LLC*: Tax Court Upholds Properly Structured Profits Interest under Rev. Proc. 93-27," *Journal of Taxation* (WG&L) (8/2023), comments:

Analysis

As noted by the Tax Court, Revenue Procedure 93-27 is not a "safe harbor with limited application." The IRS issued the revenue procedure in response to its loss in *Campbell*.[26] If a taxpayer falls outside of the scope of Revenue Procedure 93-27 , there is still favorable case law to treat the receipt of a profits interest for services as a nontaxable event.[27] In other words, *Campbell* is broader than Revenue Procedure 93-27, in that it does not require black-and-white qualifications (e.g., no dispositions within two years of receipt). Your authors believe the Tax Court correctly viewed the revenue procedure as “administrative guidance” on the treatment of the receipt of a partnership profits interest for services.

[26] *See* Mincey, Sloan and Banoff, *Rev. Proc. 2001-43, Section 83 (b), and Unvested Profits Interests - the Final Facet of Diamond?*, 95 JTAX 4 (Oct. 2001) (“The Eighth Circuit’s opinion in Campbell left substantial uncertainty as to the taxation of compensatory profits interests. In response, the IRS issued Rev. Proc. 93-27, which carefully recited the litany of relevant statutes and judicial authority but pledged its allegiance to none. Nonetheless, the Procedure has been a practical success and remains the basis of most tax planning involving vested profits interests.” (citations omitted)).

[27] *Cf.* 857(b)(6)(C) (safe harbor for REIT prohibited transactions).

The Tax Court also correctly ignores any speculative value associated with the class C units at the time of issuance. The relevant determination for purposes of applying Revenue Procedure 93-27 is whether the holder of the profits interest is entitled to a share of the proceeds if the partnership’s assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. The fact that a profits interest may be worth something to a willing buyer on day one is irrelevant - most profits interests are; hence, their issuance in the first place.

The IRS agreed in ES NPA that if the fair market value of NPA, LLC was $29,979,299 as reflected in NPA, LLC’s capital account, then there would be no distribution to the class C unit holders upon a hypothetical liquidation. The IRS steered off course when it tried to assert a $52,463,722 valuation for NPA, LLC - a figure determined by its retained expert witness - rather than using the actual sales price from the arm’s-length and bona fide transaction entered into immediately before such hypothetical liquidation. In other words, the IRS was trying to use an appraisal to supplant an actual sale price, which the court appropriately rejected. Even if Mr. Landy was not completely aware of all of the relevant facts, an actual sale between unrelated parties must be given significant weight. The IRS’ attempt to use an appraisal seems like the IRS was grasping at straws to support its position.

Often times, however, a profits interest is not granted in connection with a recent sale of the underlying partnership. In that situation, it is important for the partnership to book up its partners’ capital accounts to reflect the fair market value of partnership property immediately prior to the issuance of the profits interest.[28] This is clearly contemplated under Treasury Regulations section 1.704-1(b)(2)(iv)(f)(5)(iii), which provides that a revaluation is permitted if made principally for a substantial non-tax business purpose “[i]n connection with the grant of an interest in the partnership (other than a de minimis interest) on or after May 6, 2004, as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner.”[29]

[28] Parillo, *Tax Court Decision on Profits Interest Isn’t Full Story*, 179 TAX NOTES FEDERAL 1216 (May 15, 2023). (“‘There is a lesson from [the *ES NPA*] case -

something we've been saying for years - that if you're going to be granting a partnership profits interest, you really ought to do a proper book-up,' [Clifford Warren of the IRS Office of Associate Chief Counsel (Passthroughs and Special Industries)] said"); Sheppard, *Defining Partnership Profits Interest*, 179 TAX NOTES FEDERAL 1103 (May 15, 2023) ("Make sure you're valuing the assets as of the date the person comes in. How do we know that the person is not getting a piece of already-established profits if we don't book-up and put everything at fair market value?" quoting Warren).

[29] Prior to the promulgation of this regulatory provision, one of your authors raised this issue in Shop Talk, *"Booking Up" for Partnership Profits Interests*, 84 JTAX 1 (Jan. 1996) ("Thus, in light of [prior] Reg. 1.704-1(b)(2)(iv) (f), it is not clear how the partnership can book up the partners' capital accounts under the Regulations on the issuance of a profits interest...On the other hand, if the partnership does not book up when the service provider receives a partnership interest, the transfer will likely not be subject to Rev. Proc. 93-27 because the service provider would have an interest in the capital of the partnership...Thus, a book-up is required as a practical matter when a profits interest is granted, but it is questionable whether the book-up is permitted under the Regulations.").

In determining whether Revenue Procedure 93-27 applied in *ES NPA*, the Tax Court considered the entirety of the double-tiered structure of ES NPA's profits interest holding, rather than looking at the upper-tier partnership in isolation. The Tax Court correctly found it to be of no material consequence that ES NPA's interest in NPA, LLC was held indirectly through IDS, which was a mere conduit since the liquidation rights in the class C units in both IDS and NPA, LLC were identical. Often times, profits interests are issued through a tiered structure (*e.g.*, in the case of an aggregator vehicle for profits interests issued to key employees of a company). This does not take away from the fact that the profits interests are granted for the provision of services to or for the benefit of the issuing partnership. As pointed out by the Tax Court, such a reading of the revenue procedure would be "unreasonably narrow."

The Tax Court was comfortable reaching this conclusion because ES NPA's interests in the class C units in IDS were "identical in all respects" to the interests in class C units in NPA, LLC. However, even if that were not the case, the services provided by ES NPA to NPA, LLC also benefited IDS (given its sole holding was an interest in NPA, LLC) even if not performed directly to IDS. The Tax Court failed to highlight that Revenue Procedure 93-27 applies if services are provided "to *or for the benefit of*" a partnership. Thus, in your authors' view, identical tracking is not required, as long as the services provided at the lower level benefit the upper-tier partnership issuing the profits interest.

The Tax Court's decision in *ES NPA* does not discuss the specific services performed in exchange for the profits interest, other than a statement in the facts that the "Whereas" clause of the call option agreement stated that ES NPA agreed to provide the following services to NPA, Inc. in exchange for the option to pay $100,000 to NPA, Inc. to acquire all of the class C units in IDS: "strategic advice for the purpose of enhancing the performance of [NPA Inc.'s] business and to assemble an investor group that would purchase 40 [sic] percent of [NPA Inc.'s] business for approximately $21 million." In your authors' view, it would have been prudent to set forth these services in the partnership agreement or a standalone agreement with the service provider, given their importance in satisfying Revenue Procedure 93-27.

Conclusion

The Tax Court's decision in *ES NPA* was rightly decided. The profits interest at issue complied with all of the requirements of Revenue Procedure 93-27, administrative guidance on which taxpayers and practitioners have been relying for the past thirty years. This decision gives added comfort that services do not need to be provided directly to the partnership issuing the profits interest, as long as the issuing partnership benefits from the services being provided by the profits interest holder. ES NPA also affirms the long-standing principle that fair market value is best determined by an actual arm's-length sale occurring sufficiently close to the valuation date, if available, and that in all situations, partnerships should book up capital accounts prior to issuing profits interests to avoid running afoul of the hypothetical liquidation test.

II.M.4.f.ii.(b). Code § 1061 - Certain Sales of Compensatory Partnership Interests Recharacterized from Long-Term to Short-Term Gains

Effective for taxable years beginning after December 31, 2017, special rules apply when a taxpayer transfers certain compensatory partnership interests, with surprising results when transferring to a related party.

Subject to exceptions, Code § 1061 targets an "applicable partnership interest," which is:[3745]

> any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business.

The House report, which was accepted by the Conference Committee, elaborated:

> It is intended that partnership interests shall not fail to be treated as transferred or held in connection with the performance of services merely because the taxpayer also made contributions to the partnership, and the Treasury Department is directed to provide guidance implementing this intent.

However, an "applicable partnership interest," does not include "an interest held by a person who is employed by another entity that is conducting a trade or business (other than an applicable trade or business) and only provides services to such other entity."[3746]

Before getting into which businesses are being targeted, let's focus on the type of equity interest being targeted. Code § 1061(c)(4) provides:

> *Exceptions*. The term "applicable partnership interest" shall not include-
>
> (A) any interest in a partnership directly or indirectly held by a corporation, or
>
> (B) any capital interest in the partnership which provides the taxpayer with a right to share in partnership capital commensurate with-

[3745] Code § 1061(c)(1).
[3746] Code § 1061(c)(1).

(i) the amount of capital contributed (determined at the time of receipt of such partnership interest), or

(ii) the value of such interest subject to tax under section 83 upon the receipt or vesting of such interest.

Thus, if a corporation provides services and receives a partnership interest of any kind, Code § 1061 does not apply. The House report, which was accepted by the Conference Committee, elaborated:

> For example, if two corporations form a partnership to conduct a joint venture for developing and marketing a pharmaceutical product, the partnership interests held by the two corporations are not applicable partnership interests.

However, Notice 2018-18 announced that regulations would provide retroactively that this exception applies to C corporations, not S corporations, which rule is now in Reg. §§ 1.1061-3(b)(2) and 1.1061-3(f)(2).

The other exception above is the right to share in partnership capital commensurate with the partner's capital contribution or the actually taxed value of services provided.[3747] The House report, which was accepted by the Conference Committee, elaborated:

> An applicable partnership interest does not include any capital interest in a partnership giving the taxpayer a right to share in partnership capital commensurate with the amount of capital contributed (as of the time the partnership interest was received), or commensurate with the value of the partnership interest that is taxed under section 83 on receipt or vesting of the partnership interest. For example, in the case of a partner who holds a capital interest in the partnership with respect to capital he or she contributed to the partnership, if the partnership agreement provides that the partner's share of partnership capital is commensurate with the amount of capital he or she contributed (as of the time the partnership interest was received) compared to total partnership capital, the partnership interest is not an applicable partnership interest to that extent.

Thus the provision is directly targeting nontaxable issuances of profits interests described in part II.M.4.f.ii.(a) Tax Effects of Issuing a Profits Interest. Consider, however, what happens if the partnership is not a straight pro-rata deal. What if the partnership involves preferred returns? How about multiple tiers of preferred returns – commonly referred to as waterfalls? What does it mean for the right to share in partnership capital to be commensurate with the partner's capital contribution?

Now, on to the targeted businesses:

Code § 1061(c)(1) provides:

> *Applicable trade or business*. The term "applicable trade or business" means any activity conducted on a regular, continuous, and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of-

[3747] Code § 1061(c)(4)(B).

(A) raising or returning capital, and

(B) either-

(i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or

(ii) developing specified assets.

"Specified asset" means securities,[3748] commodities,[3749] real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing.[3750] The House report, which was accepted by the Conference Committee, elaborated:

> Developing specified assets takes place, for example, if it is represented to investors, lenders, regulators, or others that the value, price, or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider or of others acting in concert with or at the direction of a service provider. Services performed as an employee of an applicable trade or business are treated as performed in an applicable trade or business for purposes of this rule. Merely voting shares owned does not amount to development; for example, a mutual fund that merely votes proxies received with respect to shares of stock it holds is not engaged in development.
>
> *Specified assets*
>
> Under the provision, specified assets means securities (generally as defined under rules for mark-to-market accounting for securities dealers), commodities (as defined under rules for mark-to-market accounting for commodities dealers), real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to such securities, commodities, real estate, cash or cash equivalents, as well as an interest in a partnership to the extent of the partnership's proportionate interest in the foregoing. A security for this purpose means any (1) share of corporate stock, (2) partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust, (3) note, bond, debenture, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contract, (5) interest in, or derivative financial instrument in, any such security or any currency (regardless of whether section 1256 applies to the contract), and (6) position that is not such a security and is a hedge with respect to such a security and is clearly identified. A commodity for this purpose means any (1) commodity that is actively traded, (2) notional principal contract with respect to such a commodity, (3) interest in, or derivative financial instrument in, such a commodity or notional principal contract, or (4) position that is not such a commodity and is a hedge with respect to such a commodity and is clearly

[3748] As defined in Code § 475(c)(2) without regard to its last sentence. Reg. § 1.1061-1(a) includes "interests in partnerships qualifying as securities (as defined in section 475(c)(2) without regard to the last sentence thereof)."
[3749] As defined in Code § 475(e)(2).
[3750] Code § 1061(c)(3). Reg. § 1.1061-1(a) includes in the definition of "Specified Assets" looking through partnerships to the extent described in Reg. § 1.1061-2(b)(1)(iii) and also includes "options or derivative contracts with respect to any of" the items described above as "Specified Assets."

identified. For purposes of the provision, real estate held for rental or investment does not include, for example, real estate on which the holder operates an active farm.

> A partnership interest, for purposes of determining the proportionate interest of a partnership in any specified asset, includes any partnership interest that is not otherwise treated as a security for purposes of the provision (for example, an interest in a partnership that is not widely held or publicly traded). For example, assume that a hedge fund acquires an interest in an operating business conducted in the form of a non-publicly traded partnership that is not widely held; the partnership interest is a specified asset for purposes of the provision.

Suppose we have a compensatory partnership interest, that shares in capital disproportionately to the contribution, and a targeted business, all as described above, so that the taxpayer has an "applicable partnership interest." What are the consequences?

Code § 1061(a) treats as a short-term capital gain the excess, if any, of the taxpayer's (A) net long-term capital gain with respect to applicable partnership interests for a taxable year, over (B) the taxpayer's net long-term capital gain with respect to such interests for such taxable year computed by using a more-than-three-year holding period in determining whether a gain or loss is long-term.[3751] Thus, if the taxpayer's applicable partnership interests held for more than one year but not more than three years are sold at a net loss, Code § 1061(a) does not recharacterize the character of the loss. Here's how Code § 83 interacts with the holding period rule, according to the Conference Committee report:

> The conferees wish to clarify the interaction of section 83 with the provision's three-year holding requirement, which applies notwithstanding the rules of section 83 or any election in effect under section 83(b). Under the provision, the fact that an individual may have included an amount in income upon acquisition of the applicable partnership interest, or that an individual may have made a section 83(b) election with respect to an applicable partnership interest, does not change the three-year holding period requirement for long-term capital gain treatment with respect to the applicable partnership interest.

[3751] Code § 1061(a) provides:

> *In general*. If one or more applicable partnership interests are held by a taxpayer at any time during the taxable year, the excess (if any) of-
>
> (1) the taxpayer's net long-term capital gain with respect to such interests for such taxable year, over
>
> (2) the taxpayer's net long-term capital gain with respect to such interests for such taxable year computed by applying paragraphs (3) and (4) of sections 1222 by substituting "3 years" for "1 year",
>
> shall be treated as short-term capital gain, notwithstanding section 83 or any election in effect under section 83(b).

The Conference Committee report concludes:

> Thus, the provision treats as short-term capital gain taxed at ordinary income rates the amount of the taxpayer's net long-term capital gain with respect to an applicable partnership interest for the taxable year that exceeds the amount of such gain calculated as if a three-year (not one-year) holding period applies. In making this calculation, the provision takes account of long-term capital losses calculated as if a three-year holding period applies.

Explaining the exception to this rule in Code §§ 1061(b)[3752] and (c)(5),[3753] the House report, which was followed by the Conference Committee on this issue, said:

> A special rule provides that, as provided in regulations or other guidance issued by the Secretary, this rule does not apply to income or gain attributable to any asset that is not held for portfolio investment on behalf of third party investors. Third party investor means a person (1) who holds an interest in the partnership that is not property held in connection with an applicable trade or business (defined below) with respect to that person, and (2) who is not and has not been actively engaged in directly or indirectly providing substantial services for the partnership or any applicable trade or business (and is (or was) not related to a person so engaged). A related person for this purpose is a family member (within the meaning of attribution rules[833]) or colleague, that is a person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.
> [833] Sec. 318(a)(1).

In addition to related party transfers not qualifying for this exception, they also do not qualify for the netting of gains and losses that Code § 1061(a) allows regarding the sale of applicable partnership interests held for more than one year but not more than three years. The House Report explains Code § 1061(d):[3754]

> *Transfer of applicable partnership interest to related person*
>
> If a taxpayer transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer, then the taxpayer includes in gross income as short-term

[3752] Which provides:

> *Special rule*. To the extent provided by the Secretary, subsection (a) shall not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors.

[3753] Which provides:

> *Third party investor*. The term "third party investor" means a person who-
> (A) holds an interest in the partnership which does not constitute property held in connection with an applicable trade or business; and
> (B) is not (and has not been) actively engaged, and is (and was) not related to a person so engaged, in (directly or indirectly) providing substantial services described in paragraph (1) for such partnership or any applicable trade or business.

[3754] Code § 1061(d), "Transfer of applicable partnership interest to related person," provides:

> (1) *In general*. If a taxpayer transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer, the taxpayer shall include in gross income (as short term capital gain) the excess (if any) of-
> (A) so much of the taxpayer's long-term capital gains with respect to such interest for such taxable year attributable to the sale or exchange of any asset held for not more than 3 years as is allocable to such interest, over
> (B) any amount treated as short term capital gain under subsection (a) with respect to the transfer of such interest.
> (2) *Related person*. For purposes of this paragraph, a person is related to the taxpayer if-
> (A) the person is a member of the taxpayer's family within the meaning of section 318(a)(1), or
> (B) the person performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

For Code § 318(a)(1), see part II.Q.7.a.viii Code § 318 Family Attribution under Subchapter C.

> capital gain so much of the taxpayer's net long-term capital gain attributable to the sale or exchange of an asset held for not more than three years as is allocable to the interest. The amount included as short-term capital gain on the transfer is reduced by the amount treated as short-term capital gain on the transfer for the taxable year under the general rule of the provision (that is, amounts are not double-counted). A related person for this purpose is a family member (within the meaning of attribution rules[834]) or colleague, that is a person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.
> [834] Sec. 318(a)(1).

For Code § 318(a)(1), see part II.Q.7.a.viii Code § 318 Family Attribution under Subchapter C.

The government must require appropriate reporting[3755] and issue regulations or other guidance as is necessary or appropriate to carry out the purposes of Code § 1061.[3756]

T.D. 9945 (1/13/2021) provides final regulations explaining Code § 1061. Schreiber, "Carried interests regulations are finalized," *The Tax Adviser* (1/8/2021), explains:

> Because the application of the Sec. 1061 carried interest rules requires a clear determination of the holding period of a partnership interest that is, in whole or in part, an [applicable partnership interest], the final regulations also provide clarifying amendments to Regs. Sec. 1.1223-3, which governs partnership-interest holding periods. The regulations also make clarifying amendments to Regs. Sec. 1.702-1(a)(2), regarding partners' distributive shares of partnership capital gains and losses, and Regs. Sec. 1.704-3(e), providing that a method for aggregating gains and losses by a securities partnership will not be considered reasonable unless it takes into account the application of Sec. 1061.
>
> The regulations generally apply to tax years of owner-taxpayers and passthrough entities beginning on or after the date they are published in the Federal Register. (The regulations have been submitted to the Office of the Federal Register, but a publication date has not yet been scheduled.) Regs. Sec. 1.1061-3(b)(2)(i) (regarding an S corporation for which an election under Sec. 1362(a) is in effect) applies to tax years beginning after Dec. 31, 2017.
>
> Regs. Sec. 1.1061-3(b)(2)(ii) (regarding a passive foreign investment company with a qualifying electing fund election in effect) applies to tax years beginning after Aug. 14, 2020.
>
> Owner-taxpayers or passthrough entities may choose to apply the final regulations in their entirety to a tax year beginning after Dec. 31, 2017, if they consistently and entirely apply the final regulations to that year and all later years.

IRS provided additional guidance through News Release IR-2021-215 and https://www.irs.gov/businesses/partnerships/section-1061-reporting-guidance-faqs.

[3755] Code § 1061(e).
[3756] Code § 1061(f).

II.M.4.f.iii. What Happens If a Nonvested Partnership Interest Does Not Qualify As a Profits Interest

Crescent Holdings, LLC v. Commissioner[3757] determined the tax consequences of an unvested interest in partnership capital and profits:

- The taxpayer's partnership interest was conditioned upon his future performance of substantial services. In other words, it wasn't vested.

- If the partnership had liquidated immediately after the unvested partnership interest was awarded, the agreement would have allocated liquidation proceeds to the taxpayer. Therefore, the unvested partnership interest was not a pure profits interest and was subject to Code § 83 income taxation.

- The Tax Court held that, under Code § 83, the taxpayer did not own the partnership interest for tax purposes and was taxed on only the cash that was distributed to him. Instead, the unvested, undistributed profits were taxable to those who would have received them if he had terminated employment.

- Furthermore, if the taxpayer were to become vested (no requirement to perform future substantial services), he would be taxable on the fair market value of the partnership interest at the time of vesting.

This case illustrates the big swing that can occur when awarding a partnership interest without making sure it is a pure profits interest. Until this case, most tax lawyers assumed that the only tax consequence to not having a pure profits interest was possible inclusion of the fair market value of the profits interest in the recipient's income. The remaining partners would get a corresponding deduction, and presumably they could use the taxes saved from the deduction to pay the recipient's taxes. Now the stakes are higher: if the recipient has a falling out with the partnership and challenges the income tax treatment, the income allocated to the recipient might instead be taxed to the other partners; however, the tax distribution was made to the recipient and might not be available to the remaining partners.

In light of this case, consider the following measures:

- When including in the partnership agreement a reference to the parties' intent that the partnership interest be a profits interest described in Rev. Procs. 93-27 and 2001-43, add language along the lines of: "Without limiting the generality of the foregoing, if the [partnership] were to liquidate immediately after granting [the profits interest], holders of [the profits interest]would receive no payment in respect of [the profits interest]."

- Include a savings clause that, if the IRS does find that we didn't have a good profits interest and this reallocation occurs, the recipient shall refund any tax distributions. That would remove a terminated employee's incentive to challenge the K-1 and hopefully provide cash to pay the partners' taxes.

[3757] 141 T.C. 477 (2013). For an exhaustive analysis, see Carman and Banoff, "*Crescent Holdings*: Unvested Capital Partner Avoids Income Allocations, But Many Questions Remain," *Journal of Taxation* (WG&L), Vol. 120, No. 4 (April 2014).

II.M.4.f.iv. Alternative If a Prospective Partner Wants a Capital Interest Instead of a Profits Interest

Profits interests are great because they are forward-looking. Sometimes, however, the prospective partner insists on having a share of the existing business. The easiest, most certain way to do that is to give the new partner a share of capital and report granting the partnership interest as compensation, much as when one would issue corporate stock.[3758]

An alternative approach might work - if the insistent partner is willing to take some risk. The partnership agreement could allocate net income to the new partner until the new partner's capital account increases to the desired level. That approach would not generate the desired results if the partnership does not earn enough income to increase the partner's capital account sufficiently. Also, if the income allocated to the partner is ordinary income, the partner risks having this ordinary income generate a capital loss if the partner is unable to sell the partnership interest for enough in the future (plus the fact that the basis acquired by this ordinary income would tend to offset future capital gain).

Some partnerships allocate gross income to generate this result, leading to more certainty of the partner's capital account attaining the desired level. However, if the IRS views the allocation of gross income as being certain, the IRS might assert that the agreement to allocate gross income generates compensation immediately, so one might want to take that possibility into account when considering the effect of the agreement.

II.M.4.g. Options to Acquire Equity (Stock Options, etc.)

Options to acquire equity do not constitute an equity interest in a corporate setting and, if the service provider is not a partner, do not constitute an equity interest in a partnership interest.[3759] Thus, they should not be subject to Code § 2701. However, they are subject to Code § 2703 in a family-controlled business, so they must be binding during life and after death and must satisfy the comparability test. The rest of these materials focus on the requirements to exclude stock options from Code § 409A; satisfying these tests is likely to bring a taxpayer into compliance (or least close to compliance) under the Code § 2703(b) comparability test under the *Amlie* case.[3760]

The Treasury and IRS have not issued guidance on options to acquire partnership interests, other than to provide that such options are subject to rules similar to those governing corporate stock options.[3761] If the stock option's exercise price is never less than the underlying stock's fair market value on the date the option is granted, then generally the stock option does not constitute deferred compensation.[3762] Thus, the key to a successful stock option is determining the value on the date that the option is granted.

[3758] See part II.M.4.e.i Issuing Stock to an Employee - Generally.
[3759] A partner's option to acquire a partnership interest might or might not constitute an equity interest. See part III.B.7.c.vii Stock Options.
[3760] The *Amlie* case is described in the text accompanying footnote 4591.
[3761] Notice 2005-1, Q&A-7. This continues to be the case under section III.G. of the preamble to the final regulations. Reg. § 1.409A-1(b)(7) is a placeholder for future regulations on arrangements between partnerships and partners.
[3762] Reg. § 1.409A-1(b)(5)(i)(A).

For stock options issued on or after January 1, 2005 and before the effective date of final regulations, taxpayers have the following ways to determine fair market value:[3763]

- Notice 2005-1, Q&A-4(d)(ii) provides that for purposes of determining the value of the underlying stock upon the grant of a nonstatutory stock option, "any reasonable valuation method may be used." This includes estate tax valuation under Reg. § 20.2031-2. Taxpayers may rely on Notice 2005-1 for stock rights issued on or after January 1, 2005 but before January 1, 2008.[3764]

- Prop. Reg. § 1.409A-1(b)(5)(iv)(B) provided additional details in response to commentators' assertions that the above Notice is too vague. Taxpayers may rely on either the proposed regulations or the final regulations for stock rights issued any date before January 1, 2008.[3765]

- Reg. § 1.409A-1(b)(5)(iv)(B) provides the following for stock that is not readily tradable on an established securities market:[3766]

[3763] Notice 2006-4. Final regulations were effective generally January 1, 2008. Notice 2006-79.
[3764] Section XII.C. of the Preamble to the final regulations.
[3765] Section XII.C. of the Preamble to the final regulations.
[3766] CCA 201521013 provides:

> Section 1.409A-1(k) provides that, for purposes of section 409A, the term established securities market means an established securities market as defined under § 1.897-1(m).
> Section 1.409A-1(b)(5)(vi)(G) provides that, for purposes of section 409A, stock is treated as readily tradable if it is regularly quoted by brokers or dealers making a market in the stock. In explaining § 1.409A-1(b)(5)(vi)(G), the preamble to the final section 409A regulations (72 Fed. Reg. 19,234, 19,240 (April 17, 2007)) states that the rule was intended to adopt the same standard as that set forth under § 1.280G-1, Q&A-6(e). Section 1.280G-1, Q&A-6(e) provides that, for purposes of section 280G, stock is treated as readily tradable if it is regularly quoted by brokers or dealers making a market in the stock. Section 1.280G-1, Q&A-6(f) provides that, for purposes of section 280G, the term established securities market means an established securities market as defined under § 1.897-1(m).
> Section 1.897-1(m) provides that the term established securities market means (1) a national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f), (2) a foreign national securities exchange which is officially recognized, sanctioned, or supervised by governmental authority, and (3) any over-the-counter market. An over-the-counter market is any market reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets which are prepared and distributed by a broker or dealer in the regular course of business and which contain only quotations of such broker or dealer.
> It is a common practice for new issues of publicly traded stocks and bonds to be traded on a when, as and if issued (commonly called a when issued) basis days prior to when the issuer actually issues and distributes the security to holders. A when-issued trade is made between a seller and a buyer contingent on actual issuance of the security, after which settlement of the trade is made.
> A when-issued market for a security yet to be issued may occur on an over-the-counter market or any other established securities market as defined under § 1.897-1(m). Section 703.02 (part 1) of the New York Stock Exchange's Listed Company Manual provides guidelines applicable to when-issued trading on the Exchange of a security expected to be issued as a stock dividend:
> Normally, the Exchange will initiate when issued trading when the percentage of additional stock distributed is 25% or more of the outstanding. There is no fixed date for the commencement of

(B) Stock not readily tradable on an established securities market.

(1) In general. For purposes of paragraph (b)(5)(i) of this section, in the case of service recipient stock that is not readily tradable on an established securities market, the fair market value of the stock as of a valuation date means a value determined by the reasonable application of a reasonable valuation method. The determination of whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, is made based on the facts and circumstances as of the valuation date. Factors to be considered under a reasonable valuation method include, as applicable, the value of tangible and intangible assets of the corporation, the present value of anticipated future cash-flows of the corporation, the market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged in by the corporation the stock of which is to be valued, the value of which can be readily determined through nondiscretionary, objective means (such as through trading prices on an established securities market or an amount paid in an arm's length private transaction), recent arm's length transactions involving the sale or transfer of such stock or equity

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when issued trading, but the Exchange will usually wait until such time as all corporate and official action requisite to the issuance of shares has been taken.

The Tax Court held that a when-issued trading price on an over-the-counter market indicates the fair market value of a security prior to its issuance. *Frizzelle Farms, Inc. v. Comm.*, 61 T.C. 737 (1974), *aff'd* 511 F.2d 1009 (4 Cir., 1975).

CCA 201603025, the IRS' response to the taxpayer's assertion that the stock was not readily tradable so that the taxpayer's valuation should be used, included the following:

Under § 1.409A-1(b)(5)(vi)(G), stock is treated as readily tradable if it is regularly quoted by brokers or dealers making a market in such stock. Therefore, a stock is readily tradable if brokers or dealers make the stock available to trade by listing it on an established securities market. The readily tradable standard therefore requires only the ability to buy and sell the stock through a third party….

Taxpayers argue that there were therefore no actual transactions in the Common Stock as reported by the over-the-counter market for purposes of determining the fair market value of the Common Stock under § 1.409A- 1(b)(5)(iv)(A) on the Grant Date.[2] However, the rule does not require that the Common Stock must actually exchange hands on the trading date, but rather only that there are actual transactions in such stock on the trading date. Transactions in stock generally mean either the sale or transfer of stock. Even assuming that only contracts to purchase the Common Stock were actually purchased on the Grant Date, the contracts provided for the transfer of the Common Stock. The buyers were contractually obligated to complete their when-issued purchases of the Common Stock if [a certain condition] occurred. The [condition] had already occurred… on the Grant Date before the over-the-counter market opened for that trading date. Moreover, the buyers were contractually obligated to pay the auction price that applied at the time that they purchased the Common Stock on the Grant Date regardless of the auction prices of the Common Stock on the settlement date. Thus, there is no basis for treating the when-issued purchases of the Common Stock as anything other than actual transactions in such stock reported by the established securities market.

[2] The cases cited by Taxpayers do not support Taxpayers' position. The *Stavisky* court assumed that contracts to purchase stock when issued reflect the fair market value of the stock on the date the contract is entered into: In the case at bar the performance of the original contract—that is, the purchase of the shares—at the price fixed— remained what it had been. *Stavisky v. Comm'r*, 291 F.2d 48, 49 (2d Cir. 1961). Furthermore, the *Stavisky* holding applied to a transaction that occurred before the enactment of section 1233. Section 1233(e)(2)(A) treats stock traded on a when-issued basis the same as the stock. Under Example 6 of § 1.1233-1(c)(6), the price contracted to sell stock when issued applies for purposes of determining the applicable gain or loss when the stock is actually issued.

interests, and other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the service recipient, its stockholders or its creditors. The use of a valuation method is not reasonable if such valuation method does not take into consideration in applying its methodology, all available information material to the value of the corporation. Similarly, the use of a value previously calculated under a valuation method is not reasonable as of a later date if such calculation fails to reflect information available after the date of the calculation that may materially affect the value of the corporation (for example, the resolution of material litigation or the issuance of a patent) or the value was calculated with respect to a date that is more than 12 months earlier than the date for which the valuation is being used. The service recipient's consistent use of a valuation method to determine the value of its stock or assets for other purposes, including for purposes unrelated to compensation of service providers, is also a factor supporting the reasonableness of such valuation method.

(2) Presumption of reasonableness. For purposes of this paragraph (b)(5)(iv)(B), the use of any of the following methods of valuation is presumed to result in a reasonable valuation, provided that the Commissioner may rebut such a presumption upon a showing that either the valuation method or the application of such method was grossly unreasonable:

(i) A valuation of a class of stock determined by an independent appraisal that meets the requirements of section 401(a)(28)(C) and the regulations as of a date that is no more than 12 months before the relevant transaction to which the valuation is applied (for example, the date of grant of a stock option).

(ii) A valuation based upon a formula that, if used as part of a nonlapse restriction (as defined in § 1.83-3(h)) with respect to the stock, would be considered to be the fair market value of the stock pursuant to § 1.83-5, provided that such stock is valued in the same manner for purposes of any nonlapse restriction applicable to the transfer of any shares of such class of stock (or any substantially similar class of stock) to the issuer or any person that owns stock possessing more than 10 percent of the total combined voting power of all classes of stock of the issuer (applying the stock attribution rules of § 1.424-1(d)), other than an arm's length transaction involving the sale of all or substantially all of the outstanding stock of the issuer, and such valuation method is used consistently for all such purposes, and provided further that this paragraph (b)(5)(iv)(B)(2)(ii) does not apply with respect to stock subject to a stock right payable in stock, where the stock acquired pursuant to the exercise of the stock right is transferable other than through the operation of a nonlapse restriction.

(iii) A valuation, made reasonably and in good faith and evidenced by a written report that takes into account the relevant factors described in paragraph (b)(5)(iv)(B)(1) of this section, of illiquid stock of a start-up corporation. For this purpose, illiquid stock of a start-up corporation means service recipient stock of a corporation that has no material trade or business that it or any predecessor to it has conducted for a period of 10 years or more and has no class of equity securities that are traded on an established securities market (as defined in paragraph (k) of this section), where such stock is not subject to any put, call, or other right or obligation of the service recipient or other person to purchase such stock (other than a right of first refusal upon an offer to purchase by a third party that is unrelated to the service recipient or service provider and other than a right or obligation that constitutes a lapse restriction as defined in § 1.83-3(i)), and provided that this paragraph (b)(5)(iv)(B)(2)(iii) does not apply to the valuation of any stock if the service recipient or service provider may reasonably anticipate, as of the time the valuation is applied, that the service recipient will undergo a change in control event as described in § 1.409A-3(i)(5)(v) or § 1.409A-3(i)(5)(vii) within the 90 days following the action to which the valuation is applied, or make a public offering of securities within the 180 days following the action to which the valuation is applied. For purposes of this paragraph (b)(5)(iv)(B)(2)(iii), a valuation will not be treated as made reasonably and in good faith unless the valuation is performed by a person or persons that the corporation reasonably determines is qualified to perform such a valuation based on the person's or persons' significant knowledge, experience, education, or training. Generally, a person will be qualified to perform such a valuation if a reasonable individual, upon being apprised of such knowledge, experience, education, and training, would reasonably rely on the advice of such person with respect to valuation in deciding whether to accept an offer to purchase or sell the stock being valued. For this purpose, significant experience generally means at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the service recipient operates.

(3) Use of alternative methods. For purposes of this paragraph (b)(5), a different valuation method may be used for each separate action for which a valuation is relevant, provided that a single valuation method is used for each separate action and, once used, may not retroactively be altered. For example, one valuation method may be used to establish the exercise price of a stock option, and a different valuation method may be used to determine the value at the date of the repurchase of stock pursuant to a put or call right. However, once an exercise price or amount to be paid has been established, the exercise price or amount to be paid may not be changed through the retroactive use of another valuation method. In addition, notwithstanding the foregoing, where after the date of grant, but before the date of exercise or transfer, of the stock right, the service recipient stock to which the stock right relates becomes readily tradable on an established securities market, the service recipient must use the valuation method set forth in paragraph (b)(5)(iv)(A) of this section for purposes of determining the payment at the date of exercise or the purchase of the stock, as applicable.

If value is off, consider whether relief provisions might be available.[3767]

For gift, estate, and generation-skipping transfer tax purposes, Rev. Proc. 98-34 provides a safe harbor for valuing nonpublicly traded stock options that are granted in connection with the performance of services (including stock options that are subject to the provisions of Code § 421), which options are granted on stock that is publicly traded on an established securities market.

[3767] Notice 2008-113, as modified by Notice 2010-6 and Notice 2010-80.

A form of compensation similar to stock options is a stock appreciation right (SAR). An SAR is like a stock option, except that the employee never buys the stock. In many cases involving stock options, an employee borrows to exercise the stock option, repays the exercise price by selling the shares, and then keeps the remaining stock. An SAR gives the employee the same cash the employee would have received if the employee had borrowed to exercise the option, sold all of the stock immediately, and repaid the loan, without making the employee go through all of those steps and without the employee ever owning any of the underlying stock. If properly structured, an SAR would receive Code § 409A treatment similar to an option.[3768] An SAR is likely have few, if any, Chapter 14 implications because the employee never receives any equity in the company.

Finally, awards of restricted stock could work well. Code § 409A does not apply merely because property is not includable income in the year of receipt by reason of the property being nontransferable and subject to a substantial risk of forfeiture under Code § 83 or is includable in income solely due to a valid election under Code § 83(b).[3769] The service provider should receive actual shares of stock subject to forfeiture; a promise to transfer stock in the future may be subject to Code § 409A,[3770] although it could be excluded from Code § 409A for other reasons. However, the IRS takes the position that a gift of a stock option that is not exercisable until after the performance of services is an incomplete gift until exercise of the option is no longer conditioned on the performance of services by the transferor;[3771] presumably, this attitude would also apply to restricted stock. The author disagrees with the IRS' position regarding incomplete gifts but cautions planners to consider whatever litigation risks the IRS' position might entail when making transfers of property conditioned on the performance of services by the transferor.

[3768] Reg. § 1.409A-1(b)(5)(i)(B). An SAR that complies with this regulation is also exempt from Code § 457A (which taxes deferred compensation from certain types of foreign entities when vested). Rev. Rul. 2014-18. In AM 2016-003, the IRS was asked:

> May a service provider making an overall accounting method change under section 446(e) of the Code —from the cash receipts and disbursements method of accounting to an accrual method of accounting —include in its adjustment under section 481(a) (section 481(a) adjustment) vested deferred compensation under a plan of a nonqualified entity that would have been includible under section 457A had the services not been performed before January 1, 2009, resulting in some of the vested deferred compensation being included in income later than the service provider's last taxable year beginning before 2018?

Reasoning that the statute regarding deferral overrode otherwise applicable principles, it asserted:

> To the extent the section 481(a) adjustment relates to vested deferred compensation that is attributable to services performed before January 1, 2009, under a plan of a nonqualified entity, the service provider may not take the adjustment into account later than the service provider's last taxable year beginning before 2018.

[3769] Reg. §§ 1.409A-1(b)(6)(i), 1.83-3(b). If an important goal is to convert nonvested restricted stock to deductible compensation upon the transfer of an interest in the business to the holder, a Code § 83(b) election should not be made.

[3770] Reg. § 1.409A-1(b)(6)(ii).

[3771] Rev. Rul. 98-21, reversing the IRS' prior Letter Ruling position. Rev. Rul. 98-21 is wrong; see text accompanying fn 6331 in part III.B.1.a.v Sending Business or Performing Services.

II.N. Shareholder Agreements and Operating Agreements

II.N.1. Comparison of Ability to Specify Future Actions

In a corporation, generally each member of a board of directors has certain fiduciary duties that cannot be waived on a blanket basis by the organizational documents,[3772] and the way to enforce actions promised in shareholder agreements is to remove a noncompliant board and replace it with directors who will carry out the shareholders' wishes. However, depending on state law, a corporation can be organized as a statutory close corporation that functions more like a limited liability company.[3773]

A limited liability company's operating agreement can dictate specific actions. The drafting lawyer might consider whether to relieve managers and members of various fiduciary duties. Some states, such as Illinois, do not allow fiduciary duties to be negated by contract; other states, such as Missouri, allow any arrangement to which the parties agree. The absence of fiduciary duties generally is not recommended for estate planning purposes. If one wants (and is permitted) to negate fiduciary duties, consider including the duties of good faith that generally apply to commercial contracts. Some cases have held lawyers liable to the injured party (who is not the lawyers' client) for advising clients to breach fiduciary duties, whereas lawyers generally are not liable for advising clients to breach contract duties.

II.N.2. Retroactivity of Amendment to Partnership Agreement (Including Operating Agreement)

For purposes of the partnership income tax rules, a partnership agreement includes any modifications of the partnership agreement made before, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.[3774] A partnership agreement or modifications can be oral or written; as to any matter on which the partnership agreement, or any modification thereof, is silent, the provisions of local law are part of the agreement.[3775]

When a partnership agreement did not have a fixed method to determine the current and future allocations of profits or losses and instead allocates them based on the determinations of an executive committee, an agreement to determine the allocation of then-currently unrealized profits and losses arising from many years of operations did not give rise to an analysis of how much profit and loss might have been allocated to the partners before the amendment.[3776]

II.O. Buy-Sell Agreements

II.O.1. General Buy-Sell Concepts

A buy sell agreement is a contract between owners and/or the entity that provides for the sale of an owner's interest upon the occurrence of a triggering event such as disability, retirement, or death. The three types of buy-sell agreements are: (1) redemption agreements; (2) cross-

[3772] See How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors, *The Business Lawyer*, Vol. 63, No. 3, May 2008.
[3773] See fn. 1138.
[3774] Code § 761(c); Reg. § 1.761-1(c).
[3775] Reg. § 1.761-1(c).
[3776] Letter Ruling 9821051, described in part II.C.6 Shifting Rights to Future Profits.

purchase agreements; and (3) a combination of redemption and cross-purchase. Deciding which type to use requires consideration of a number of factors including the number and ages of the shareholders involved and the weighing of tax consequences for each type of agreement.

These agreements determine the price and payment terms and restrict who can own an interest in the business. In a limited liability company (LLC), the buy-sell agreement is integrated into the operating agreement. In a partnership, the buy-sell agreement is integrated into the partnership agreement. In a corporation, whether a C corporation or an S corporation, the buy-sell agreement is integrated into a shareholders' agreement.

Key circumstances triggering a buy-sell agreement include the owner's divorce, bankruptcy, incapacity, or death. Special considerations may apply to an owner who works in the business, especially if the ownership interest was granted as an employment incentive. Also, owners like to choose their partners, so frequently the buy-sell provisions restrict transfers to outsiders.

In LLCs and partnerships, voting and management rights are not transferred automatically when ownership is transferred. An owner without voting and management rights is called an assignee. LLC and partnership buy-sell provisions specify whether a transferee is an assignee or has voting and management rights.[3777]

An S corporation may revert to a C corporation if too many shareholders own stock or if stock is transferred to an ineligible shareholder. Special buy-sell provisions are required to preserve the S election.

Reg. § 20.2031-3, "Valuation of interests in businesses" (last amended 1/28/1992), provides:

> The fair market value of any interest of a decedent in a business, whether a partnership or a proprietorship, is the net amount which a willing purchaser, whether an individual or a corporation, would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The net value is determined on the basis of all relevant factors including -
>
> (a) A fair appraisal as of the applicable valuation date of all the assets of the business, tangible and intangible, including good will;
>
> (b) The demonstrated earning capacity of the business; and
>
> (c) The other factors set forth in paragraphs (f) and (h) of §20.2031-2 relating to the valuation of corporate stock, to the extent applicable.
>
> Special attention should be given to determining an adequate value of the good will of the business in all cases in which the decedent has not agreed, for an adequate and full consideration in money or money's worth, that his interest passes at his death to, for example, his surviving partner or partners. Complete financial and other data upon which the valuation is based should be submitted with the return, including copies of reports of examinations of the business made by accountants, engineers, or any technical experts as of or near the applicable valuation date. See section 2701 and the regulations at

[3777] A Delaware Court of Chancery held that an assignee's admission as a member must be done formally and that an assignee who is not a creditor could assert rights in equity without being admitted as a member. *In re Carlisle Etcetera LLC*, C.A. No. 10280-VCL (4/30/2015), found at https://casetext.com/case/in-re-carlisle-etcetera-llc.

§ 25.2701 of this chapter for special rules for valuing the transfer of an interest in a partnership and for the treatment of unpaid qualified payments that the death of the transferor or an applicable family member. See section 2703 and the regulations at § 25.2703 of this chapter for special rules involving options and agreements (including contracts to purchase) entered into (or substantially modified after) October 8, 1990. See section 2704(b) and the regulations at § 25.2704-2 of this chapter for special valuation rules involving certain restrictions on liquidation rights created after October 8, 1990.

The Business Planning Committee of the American College of Trust & Estate Counsel has put together a model shareholder agreement and related outline of technical issues.

II.O.2. Spousal Issues in Buy-Sell Agreements and Related Tax Implications

Generally speaking, it is usually best to have a spouse hold a business interest through a trust, rather than through outright ownership. The trust can protect the property from creditors and from new spouses if the surviving spouse remarries. A trust also allows the decedent to choose to have a third party involved in the management and investment of the property, if desirable. Additionally, a trust allows the decedent to designate who the remainder interest in the property passes to upon the spouse's death and might enable the decedent to devise property to successive generations without incurring estate tax. Finally, the trust form will allow the donor to structure the estate plan to take advantage of any potential minority discounts or control premiums that may apply.

II.O.2.a. Spouses and Buy-Sell Agreements – State Law Issues

A number of issues can arise related to spouses holding interests in closely-held businesses. If these issues are not addressed, closely-held business owners could end up in losing a portion of their business to an ex-spouse, or an owner's estate could lose part or all of the marital deduction.

Some courts have held a business owner's buy-sell agreement not binding on the spouse, so spousal consent should be considered necessary to ensure enforcement of buy-sell agreements. First, such consent can prevent a divorce proceeding or elective share from causing an ex-spouse to be involved in the business. It also prevents a spouse from leaving her community property interest in the business to a third party. Finally, it protects the spouse from claiming a community property interest in the business upon the business owner's death.

However, even if the spouse consents by signing the buy-sell agreement, a court might rule that the spouse did not truly consent to the agreement because the spouse did not fully understand the agreement.[3778] Preferably, the spouse would be represented by his or her own counsel. Be sure to update spousal consent when amending the buy-sell agreement.

II.O.2.b. Divorce – Income Tax Issues Relating to Buy-Sell Agreements

In order to accomplish its objectives, a buy-sell agreement needs to specifically address transfers incident to divorce. If an agreement focuses on voluntary transfers, it is possible a court would not apply the restriction in the case of an involuntary transfer, such as a divorce transfer.

[3778] See, e.g. *Suther v. Suther*, 627 P.2d 110 (Wash. App. 1981).

When a business interest is transferred to a spouse pursuant to a divorce agreement and the stock is then redeemed by the business for cash pursuant to the buy-sell agreement, the non-recognition rules for spousal transfers and the stock redemption rules collide. Before tax regulations addressed this situation, there was some question as to whether the transferring spouse should be taxed on the redemption or the spouse receiving the interest should be taxed. Reg. § 1.1041-2(c) addresses this question and states that the spouses may chose who will be taxed on the redemption.[3779]

In another setting indirectly involving a transfer of a business interest, Letter Ruling 201024005 held that the transfer of qualified replacement property (QRP) to a divorcing spouse is not subject to income tax. Under Code § 1042, QRP is certain stock purchased with the proceeds of a sale of stock to an employee stock ownership plan (ESOP); this purchase allows the seller to defer gain on the sale, which deferred gain reduces the QRP's basis. Code § 1042(e) requires the deferred gain to be recognized if the seller later disposes of the QRP. Code § 1042(e)(3)(C) provides that a gift does not count as a Code § 1042(e) disposition. Code § 1041(b)(1) and its legislative history provide that a transfer in a divorce counts as a gift for income tax purposes, so the ruling held that a transfer of QRP by divorce was not subject to Code § 1042(e) recapture. Letter Ruling 202206009 held that a transfer to a grantor trust deemed owned by the transferor will not constitute a disposition of the QRP under Code § 1042(e), nor will transfers of QRP that occur pursuant to the terms of that trust after the grantor's death.

For more details on Code § 1041 nonrecognition, see part III.B.6.d Divorce as an Opportunity to Transfer.

II.O.2.c. Effect of Buy-Sell Agreement on Marital Deduction

The buy-sell agreement price can have a significant effect on the estate tax marital deduction. If stock held in a marital trust is subject to a bargain buy-sell agreement, the marital deduction might be totally disallowed.[3780] Such a provision might run afoul of Code § 2056(b)(5), which allows a marital deduction only if no other person has the power to appoint any portion of the interest to anyone except the surviving spouse, and Code § 2056(b)(7), which requires that the spouse be the only beneficiary. TAM 9147065 reasoned:

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3780 See *Estate of Rinaldi v. U.S.*, 38 Fed. Cl. 341 (1997); *Estate of McCabe v. U.S.*, 475 F.2d 1142 (Ct. Cl. 1973); TAM 9147065. See also TAM 8843004. The IRS took a similar position (without citing these cases) and lost in *Alan Baer Revocable Trust v. U.S.*, 105 A.F.T.R.2d 2010-1544 (D.C. Neb.), when the court disregarded a contingent distribution to beneficiaries because the possibility that the transfer to the contingent beneficiaries would ever come to fruition was so remote that it is negligible. The IRS acquiesced in result only in AOD 2012-001, arguing that any possibility whatsoever of others receiving the trust's possibility violated the Code § 2056(b)(7)(B)(ii)(II) prohibition against any person having the power to appoint any part of the property to any person other than the surviving spouse. The IRS claimed that Reg. § 20.2056(b)-7(d)(6) supports its position. That regulation provides that, if the surviving spouse is legally bound to transfer the distributed property to another person without full and adequate consideration in money or money's worth, the requirement of section 2056(b)(7)(B)(ii)(II) is not satisfied. Although generally I would want to avoid arguing with the IRS over this issue in a buy-sell agreement, perhaps some sort of formula adjustment clause (see part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers) might work if one can find no other way to plan around this issue?

In the present case, no marital deduction can be allowed with respect to the portion of the spouse's trust that is required to be funded with the Company stock.

First, by giving his sons an option to purchase the Company stock at $1,000 a share, the decedent effectively divided the value of the stock between his sons and the spouse's trust. At the decedent's death, the fair market value of the stock was $11,000 per share. This was nearly 11 times the option price. The fair market value during the 24 months after the decedent's death could be expected to change due to a variety of factors. There was almost no possibility as of the date of decedent's death that the fair market value of the stock would equal the option price when the option was exercised. (Indeed, there must be presumed to be a greater likelihood of exercise where the fair market value exceeds the option price.) Thus, VIEWED AS OF THE DECEDENT'S DEATH, each son held a right, exercisable during the spouse's life, to make a bargain purchase of the Company stock. The effect of the bargain purchase would be to substantially deplete the value of the trust corpus.[1]

[1] As discussed below, even if the option had specified a strike price that happened to equal fair market value on the date of death, the marital deduction would still be disallowed, since the option price does not constitute a "specific portion" of the trust corpus.

Each son's option right is, effectively, a right to appoint to himself the excess of the fair market value of a share on the option exercise date over the option price. The sons' rights to purchase Company stock confers upon them a power to withdraw property with a substantial value from the spouse's trust for less than adequate and full consideration. This right is a "power in any other person to appoint any part of the interest, or such specific portion, to any person other than the surviving spouse" as that phrase is used in section 2056(b)(5) of the Code. Because of this power, the amount of the marital deduction for the property passing to the spouse's trust must be reduced by the value of the stock passing to the trust.

In this regard, at the decedent's death, it was not certain that the spouse's trust would receive even $1,000 upon the exercise of an option. The will entitled a son to pay the option price with a note bearing annual interest of nine percent. At decedent's death, the date that an option might be exercised certainly could not be predicted nor could the applicable interest rates for most of the 24- month period. If the rate of interest prescribed under section 7872 of the Code on the date of exercise is below nine percent, the trust would actually receive value GREATER THAN the $1,000 face amount of the nine percent note. (But a son would presumably not borrow from the trust at a rate that was higher than otherwise available from other sources.) Conversely, if the section 7872 rate exceeds nine percent, the trust would receive LESS THAN the equivalent of $1,000 on the nine percent note. In view of this financing arrangement prescribed by the will, at the decedent's death no minimum value that the trust would receive upon a son's exercise of his option can be determined. Therefore, for purposes of the marital deduction, we cannot attach even a $1,000 per share minimum value to the stock.

Further, the sons' powers cannot be construed as conferring upon the spouse the right to income from, and a power of appointment over, "a specific portion" of the stock under section 2056(b)(5) of the Code. In the present case, the amount (attributable to the Company stock) remaining in the trust after the purchase of the Company stock by the sons -- that interest in the trust corpus in which the spouse would continue having a right to income and over which she would continue having a power of appointment -- was not an ascertainable part of the trust corpus or the stock at the decedent's death. As discussed above, there was no way to predict the value of any note paid in purchase of the stock under an option, or what relationship the option price paid would bear to the fair market value of the stock in the trust at that time. Therefore, the spouse's right to the income from the option purchase price and power to appoint the option price are not rights over a specific portion of the stock or trust corpus, determinable at the decedent's death. Consequently, the marital deduction must be disallowed for the total value of the Company stock in the trust and any proceeds in the trust from the exercise of the options on the 29.746 shares.

Even if the sons did not have the power to appoint the value of the Company stock to themselves, the marital deduction would nevertheless be disallowed due to the nature of the spouse's income interest in the stock. As noted above, section 2056(b)(5) of the Code requires that the spouse be "entitled for life to all the income" from an interest in property or a specific portion of the interest. Under the will, the spouse is to be paid the trust income at least quarterly and may receive principal payments, in the trustee's discretion. However, the Company stock has been unproductive property for at least five consecutive years, including the year of the decedent's death and the two following years and is not certain to become productive property.

In addition, even if the Company had paid a level of dividends commensurate with the standards for a productive trust under local law, there would have been no assurance at decedent's death that the son authorized as voting manager of the Company would continue a practice of paying dividends. The managing son's exclusive voting right gives him, alone, the power to accumulate Company profits and withhold payment of dividends. If this son planned to exercise his option to purchase Company stock near the end of the 24-month option period, he would have a personal incentive to withhold all dividends during the life of the spouse and prior to the exercise of the purchase option. Doing so would tend to increase the fair market value of the Company stock subject to his fixed price option during the 24-month option period. Thus, under section 20.2056(b)-5(f)(4), the spouse's income interest in the Company stock is disqualified unless the rules for administering the trust require the trustee to convert the Company stock to income producing property, or permit the spouse to compel this conversion.

Under the will, unproductive property generally cannot be held for more than a reasonable time during the spouse's life without her written consent. However, the will expressly prohibits the trustee from selling the Company stock, unless so directed by the son authorized to sell it (except if a son exercises his option). Thus, effectively, neither the spouse nor the trustee have any legal right to establish an adequate income flow for the spouse from the Company stock. Consequently, under section 20.2056(b)-5(f)(4) of the regulations, the spouse is not entitled to "all the income for life" from the stock.

The spouse has a qualifying power of appointment over and income interest in a specific portion of the spouse's trust, the portion funded with miscellaneous assets of about $1 million in value, and this portion qualifies for a marital deduction under section 2056(b)(5) of the Code. However, we cannot conclude that she has a qualifying income interest in the trust viewed as a whole, because of the relatively large value of the nonproductive portion of the trust funded with the Company stock. Although the productive assets may be used to purchase a wasting asset that would produce a sufficient level of income for the entire trust on a TEMPORARY basis, these assets would eventually erode and, so, would no longer sustain the entire trust.[2]

> [2] Finally, even if the spouse's interest in the trust otherwise qualified under section 2056(b)(5) of the Code, the marital deduction allowable for the stock passing to the trust would nonetheless have to be reduced to reflect the fact the decedent bifurcated the value of the stock by passing only a truncated interest in the stock to the trust, and passing the voting rights in the stock directly to his son. See *Ahmanson Foundation v. U.S.*, 674 F.2d 761 (9th Cir. 1981), in which the decedent's revocable trust owned 100 percent of the stock of a closely-held corporation consisting of one voting share and 99 nonvoting shares. Under the terms of the trust, the voting share remained in the trust and the nonvoting shares passed to a charitable foundation. The court held that, for purposes of determining the value of the stock includible in the gross estate, the voting and nonvoting stock must be valued as one single controlling block. However, in determining the amount of the charitable deduction, the value of the 99 nonvoting shares passing to charity must be discounted to reflect their reduced value when severed from the voting share. Thus, in the present case, the value of the Company stock distributed to the spouse's trust would have had to have been limited to reflect its nonvoting characteristic if any deduction had been allowable for the value of the Company stock.

Consider the following:

- Provide that, if the property passes to a marital deduction trust, the agreement provide that the sale price shall be adjusted up as necessary to be no less than the fair market value, as finally determined for estate tax purposes. Alternatively, consider providing that, if the IRS determines that a fixed price redemption as of date of death is below fair market value as of date of death, the estate can rescind the sale.[3781]

- Bequeath the business interest to a marital deduction trust that is separate from other marital deduction trust assets, so that the marital deduction for those other assets is not jeopardized.[3782]

- Suppose one of the client's children receiving the benefit of a bargain is too important not to make allowances for, and a bequest to that child at the client's death is not practical. Consider requiring that any excess of fair market value over the agreed-upon price will be

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[3781] *Estate of Dickinson v. Commissioner*, 63 T.C. 771 (1975), rejecting the IRS' reliance on *Procter*, prevented the IRS from nailing the taxpayer with circular marital and charitable deduction disallowances. See fn 7044 and accompanying and following text in part III.B.3.o *Procter* and Other Cases.

[3782] The trustee might divide the marital trust on the estate tax return if the trust agreement does not so provide. Although I believe that the suggestion in this bullet point is prudent, a reasonable person could argue that it is overkill, in that TAM 9147065 held:

> That portion of the spouse's trust that is funded with the Company stock (and the proceeds of Company stock sold pursuant to the exercise of the option) does not qualify for the marital deduction under section 2056(b)(5) of the Code. Viewed as of the date of the decedent's death, a person other than the spouse has power to appoint trust corpus, the spouse has no right to income from or a power of appointment over that portion of the trust represented by the value of the Company stock. Further, the spouse's income interest attributable to the value of the Company stock fails to satisfy the requisite standard under section 2056(b)(5). Therefore, the marital deduction is allowable only with respect to the specific portion of the spouse's trust that is represented by the trust assets other than the Company stock.

> held in a separate QTIP trust, with the surviving spouse getting only the income and the principal passing to that child on the spouse's death. One might even require the other QTIP trusts to pay any estate tax on this separate QTIP trust's assets on the surviving spouse's death.

On the other hand, FSA 200018020[3783] stated that directing stock to be sold for a bargain price before funding the QTIP Trust did not disqualify the QTIP trust; it simply affected the amount available for the marital deduction. The FSA distinguished the *Rinaldi* case cited in fn. 3780. If a bargain sale before funding the marital trust is not directed by the estate plan but rather is done as part of estate administration, then the marital deduction should be allowed in full and the surviving spouse is treated as making a gift.[3784]

Also, generally, giving the surviving spouse a choice between various bequests does not violate the terminable interest rule.[3785] In determining the deadline for an election, one might consider the 9 month disclaimer deadline under Code § 2518 or the 6 month survival requirement that may be imposed under Code § 2056(b)(3) without making the interest terminable. Rev. Rul. 82-184 approved a six-month simple election procedure but rejected an election that was conditioned on the surviving spouse's "performance of significant acts and upon events beyond mere procedural requirements." Rev. Rul. 82-184 included the following facts:

> D died on February 2, 1982. Under the terms of D's will, a trust was established in which D's surviving spouse, A, received a life income interest. However, under the will A could elect to take an outright bequest of $50,000 in lieu of the life income interest. The election was to be made by the spouse by filing written notice to the executor within six months of D's death. The will also provided that if A was at any time to buy a new house, A could receive on demand from the trustee the amount needed to buy a house, up to $200,000. A timely elected the cash bequest and sometime later demanded $200,000 for the purchase of a new home. D's executor deducted both the $50,000 cash bequest and the $200,000 distribution as bequests qualifying for the marital deduction under section 2056 of the Code.

Rev. Rul. 82-184 held:

> A cash bequest in lieu of a life estate, payable unconditionally at the election of the surviving spouse within a reasonable time after the decedent's death qualifies for the estate tax marital deduction under section 2056 of the Code.

[3783] FSA 200018020 was approved by Melissa Liquerman, who has had a long and successful career with the IRS and I believe is very well-regarded.

[3784] See Rev. Rul. 84-105, which is found in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts.

[3785] See, *e.g.*, *Mackie v. Commissioner*, 64 T.C. 308 (1975), *aff'd per curiam* 545 F.2d 883 (4th Cir. 1976), which approved the following clause:

> My said wife shall have, however, the right to elect whether to accept this devise, bequest and appointment, or to reject it, or to accept it in part and reject it in part, which election she shall make by a statement in writing to that effect delivered to my executrix within four months from the date of my death. The failure of my said wife to deliver such statement to my executrix within such time shall be deemed an election by her to reject this devise, bequest and appointment in full.

See also Reg. § 20-2056(c)-2(c), regarding elective shares.

Rev. Rul. 82-184 reasoned:

> Section 2056(b)(1) provides that the marital deduction is not allowed for certain interests passing to the surviving spouse that will terminate or fail on the occurrence or nonoccurrence of an event or contingency where an interest in the property also passes to another person, who may enjoy the property after the surviving spouse's interest has terminated.
>
> In *Estate of Tompkins v. Commissioner*, 68 T.C. 912 (1977), *acq.*, 1982-1 C.B. 1, the spouse was given alternative bequests of a life income interest in a trust or an option to take $40,000 in cash outright. The election to take the $40,000 in lieu of the income interest was to be made within 60 days after the qualification of the executor. The decedent's spouse timely elected the cash bequest. The court held that for purposes of section 2056 of the Code, the surviving spouse had not received a terminable interest, but received, at the decedent's date of death, an absolute right to take outright a specific portion of the decedent's estate. The court considered the requirement that the spouse must make a timely election of the alternative bequest a mere procedural requirement, and thus not a contingency within the meaning of section 2056(b)(1), as long as the interest was otherwise nonterminable. The court noted that there is no substantial difference between an elective testamentary bequest of a non- terminable interest and a spouse's election against a will under state law. See section 20.2056(e)-2 of the Estate Tax Regulations. See also *Estate of Neugass v. Commissioner*, 555 F.2d 322 (2d Cir. 1977), *rev'g*, 65 T.C. 188 (1975).
>
> Similarly, in *Mackie v. Commissioner*, 64 T.C. 308 (1975), *acq.*, 1982-1 C.B. 1, *aff'd per curiam*, 545 F.2d 883 (4th Cir. 1976), it was held that a spouse's right to select any property out of the estate in an amount equal to the maximum marital deduction, was an absolute right to take outright a specified portion of the estate.

Rev. Rul. 82-184 also held:

> However, a cash bequest payable on the condition that the spouse purchase a new home is a nondeductible terminable interest for purposes of section 2056.

Rev. Rul. 82-184 continued:

> In *Estate of Edmonds v. Commissioner*, 72 T.C. 970 (1979), the decedent's spouse was bequeathed a life estate in the decedent's house and, in addition, if the decedent's spouse purchased another residence, the spouse was entitled to receive the amount necessary to do so, up to $100,000. The $100,000 was payable to the spouse upon notice to the executor and demand of the trustee. Approximately three years subsequent to the decedent's death, the spouse demanded and received $100,000 for a new residence. The court held that the estate could not deduct the distribution because, unlike the situations in Mackie and Tompkins, the spouse was not given an absolute right to take outright a specified portion of the decedent's estate. The requirement that the distribution be made only if the spouse relinquished the life tenancy and purchased a new house was considered a significant condition precedent to the spouse's enjoyment of the property. There was no way of ascertaining at the time of the decedent's death whether the surviving spouse would purchase a new home, or how much of the $100,000 would be needed to effect the purchase. Consequently, the bequest was a

> terminable interest for purposes of section 2056 of the Code. See also *Allen v. United States*, 359 F.2d 151 (2nd Cir. 1966), *cert. denied*, 385 U.S. 832 (1966).

In the present case, the optional bequest of $50,000 A received at the time of D's death was an absolute right to a specific portion of D's estate, and A made the election within a reasonable time for purposes of section 2056 of the Code. Since A timely elected to take the alternate bequest, D's estate can deduct the $50,000 bequest under section 2056. However, the bequest of the $200,000 is a terminable interest under section 2056(b) because it was conditioned upon A's performance of significant acts and upon events beyond mere procedural requirements. As is the case in *Edmonds*, there is no way of knowing at the time of D's death whether A would exercise the demand right or how much of the funds will be paid over. Because the residuary trust beneficiaries would benefit upon the failure of A to purchase a new home, D's bequest of the $200,000 is a nondeductible terminable interest under section 2056(b).

Letter Ruling 201410011 approved a 180-day election procedure in conjunction with a prenuptial agreement, with the QTIP trust funded with preferred partnership interest.[3786] Letter Ruling 201410011 approved a revocable trust while the grantor was living. Part of its provisions resulted from a prenuptial agreement. Key terms included:

> Section 3A(7) of Revocable Trust provides that, if Spouse survives Taxpayer and if Taxpayer and Spouse are married and living together at the time of Taxpayer's death, the trustee will allocate and make distributions to Spouse as provided in Section 3A(7)(a). However, if Spouse makes a timely election as provided in Section 3A(7)(b), then the trustee will allocate and make distributions to Spouse as provided in that section (Elective Marital Portion).
>
> Section 3A(7)(a) provides that Spouse will take under the terms of Antenuptial Agreement, and that the trustee will make any distributions to Marital Trust, to be added to the principal of Marital Trust, and to be held and distributed as may be required by the Antenuptial Agreement. The terms of Revocable Trust specify that the trustee has the discretion to satisfy any distribution to Marital Trust under the Antenuptial Agreement with LLC preferred units (Preferred Units).
>
> Section 3A(7)(b) provides that if, within 180 days following Taxpayer's death, Spouse elects pursuant to Section 3A(7)(b) to receive the Elective Marital Portion in lieu and instead of any distributions under Antenuptial Agreement, the trustee will distribute to Spouse outright the sum of $w and will distribute those property interests specified in Section 3(A)(7)(b), to be added to the principal of Marital Trust, and to be held and distributed as may be required by the Marital Trust agreement. If Spouse elects to receive the Elective Marital Portion Marital Trust will still be funded in part with Preferred Units.

Letter Ruling 201410011 started its reasoning:

> In Rev. Rul. 54-446, 1954-2 C.B. 303, a decedent and his wife were parties to an antenuptial agreement in which the wife relinquished any marital rights she might acquire in the decedent's property or estate by reason of their marriage. The decedent's will bequeathed property to his wife that was different from and of a greater value than the amount due to her under the antenuptial agreement. The will specifically provided

[3786] See text accompanying fn. 3789.

> that the bequests to wife were in lieu of any rights she might have under the antenuptial agreement. The revenue ruling determined that the amount bequeathed to the wife under the will "passed from the decedent to his surviving spouse" and therefore qualified for the estate tax marital deduction.
>
> In Rev. Rul. 68-271, 1968-1 C.B. 409, a decedent and his wife entered into an antenuptial agreement pursuant to which wife renounced and relinquished any marital rights she might acquire in his property or estate by reason of their marriage, in return for a stated sum from his estate, provided she survived him. Following the decedent's death, the estate paid the required sum to the widow pursuant to a claim filed by her. Decedent's will did not mention wife, and there was no will contest. The revenue ruling determined that the value of the interest transferred to the surviving spouse pursuant to the antenuptial agreement "passed from the decedent to his surviving spouse" and therefore qualified for the estate tax marital deduction.

Then Letter Ruling 201410011 cited *Tompkins* and Rev. Rul. 82-184. After that, it said:

> In the instant case, Spouse will receive certain property interests under the terms of the Antenuptial Agreement pursuant to Section 3A(7)(a) of Revocable Trust unless, within 180 days following Taxpayer's death, Spouse elects pursuant to Section 3A(7)(b) of Revocable Trust to receive certain other property interests (Elective Marital Portion). In each event, Spouse will have an absolute right to any property passing outright to her as well as an absolute right to the income from any property passing to Marital Trust. Therefore, the property interest passing outright to Spouse will be a nonterminable interest and the property interest passing to Marital Trust will be treated as a nonterminable interest if it otherwise satisfies the requirements of § 2056(b)(7). The requirement that Spouse make a timely election is "a mere procedural formality" *Tompkins*, 68 T.C. at 917, and is not a contingency within the meaning of § 2056(b)(1).
>
> Consequently, based on the facts submitted and the representations made, we conclude that Spouse's right to elect under section 3A(7) of Revocable Trust is not a "contingency" within the meaning of § 2056(b)(1). The Revocable Trust property actually distributed outright to Spouse and to Marital Trust (if it otherwise satisfies the requirements of § 2056(b)(7)) will be "property which passes from the decedent to his surviving spouse," for purposes of § 2056(a).

Letter Ruling 8735003 held that a no-contest clause did not preclude the marital deduction. Letter Ruling 8735003 involved the following provision:

> I hereby direct and expressly provide that it shall be a condition precedent to the taking, vesting, receiving or enjoyment of any property, benefit, or thing whatsoever under and by virtue of this Will, that no such devisee or legatee shall in any manner contest the probate thereof, or question or contest the same, or any part or clause thereof, in any judicial proceeding, and I further will and provide that, should any such devisee or legatee so contest or question, or in any manner aid in such contesting or questioning, such devisee or legatee shall thereupon lose and forfeit all right to any benefit and all right or title to any property or thing herein directly or indirectly devised or bequeathed to said devisee and legatee, and same shall thereupon vest in such of my devisees or legatees herein as do not so question or contest, or give aid in such questioning or contesting of, this Will or the probate or any clause or provision thereof, in the same proportion as to value in which they otherwise take in value of my estate under this Will.

Letter Ruling 8735003 cited Reg. § 20.2056(e)-2(c), *Tompkins*, Rev. Rul. 82-184, and *Mackie*. After that, it said:

> Under local law, forfeiture provisions in a will are strictly construed and a forfeiture of property interests will be avoided by the Texas courts unless the acts of the parties come strictly within the express terms of the forfeiture clause. Accordingly, the local courts have generally held that an action or proceeding for the construction of a will in which a beneficiary participates does not bring the beneficiary within the provision of a forfeiture provision. See, for example, the following cases where a state court held that a forfeiture clause was not applicable (1) where the decedent's granddaughter sued to obtain a fee simple title to property devised by will and the court held that the suit was brought to construe the decedent's will [*Roberts v. Chisum*, 238 S.W.2d 822 (Tex. Civ. App., 1951)]; and (2) where beneficiaries under a will sued to have provisions of the decedent's will devising real estate among four persons construed to ascertain the decedent's intent [*Reed v. Reed*, 569 S.W.2d 645 (Tex. Civ. App., 1978)].
>
> In the present case, C could either (1) accept the terms of B's will, or (2) contest the provisions of B's will. C chose the former course of action. Although under Texas law a will contest by C might result in a forfeiture of the assets C would otherwise receive under B's will, the existence of this option does not convert what are otherwise fee property interests into nondeductible terminable interests. The court in *Tompkins*, *supra*, found no substantial difference between an elective testamentary bequest of a nonterminable interest which relates back to the testator's date of death and a spouse's election against a will under state law. Similarly, we see no reason to distinguish a situation where a surviving spouse has a choice between accepting a testamentary bequest or challenging the provision of her husband's will in order to obtain her statutory share. In each situation, the beneficiary has a choice between two groups of assets. Furthermore, all interests that C received under B's will were in all respects nonterminable interests, that is, they were fee interests in property that C could transfer by gift or by will. Accordingly, the principles described in *Tompkins*, *Mackie*, section 20.2056(e)-2(c) of the regulations, and Rev. Rul. 82-184 are applicable to this case. Thus the value of the assets that C received under Articles III and VI of B's will are deductible under section 2056(a) of the Code.

A right of first refusal to buy at fair market value stock that a QTIP Trust sells upon the surviving spouse's demand did not disqualify a QTIP trust.[3787] A thirty day period in which to exercise a right of first refusal is not an unreasonable burden on a spouse's right to make a QTIP trust productive.[3788]

[3787] Letter Ruling 199951029 held:

> If Spouse requests the trustee to convert the stock into income producing property, Grantor's children have the right of first refusal to purchase the stock at its fair market value as determined by an independent appraisal and under such terms and conditions as would be agreed upon by parties dealing at arm's length. This restriction does not prevent the trust from receiving full value for the stock if the stock is sold to the children, nor does it restrict the trustees' ability to sell the stock.

[3788] Letter Ruling 8931005 held:

> Given the fact that Corporation is a closely-held entity and the Children's Trust (owner of the controlling interest) is one of the most likely purchasers of the minority interest held by the Marital Trust, we do not consider the thirty day right of first refusal to place an undue burden on the ability of Spouse to require that the trust corpus be made productive.

Here is an example of another business interest that qualified:[3789]

> The surrounding circumstances also manifest Taxpayer's intention that, after his death, Marital Trust should produce for Spouse during her life that degree of beneficial enjoyment of the LLC Preferred Units which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust. Under the terms of Operating Agreement, as the owner of LLC Preferred Units, Marital Trust will be entitled to an eight percent return on the aggregate face value of its LLC Preferred Units, payable no less often than annually. LLC cannot redeem Marital Trust's LLC Preferred Units for less than the greater of their face value or fair market value. In addition, without the affirmative vote or consent of all of the Preferred Members, LLC's Voting Common Members cannot amend, restate, alter or repeal Operating Agreement whether by merger, consolidation or otherwise so as to directly materially and adversely affect any right or preference of the Preferred Units or Preferred Unit holders.
>
> Moreover, the sale of LLC Preferred Units is not unreasonably restricted. At the written request of Spouse, the trustee of Marital Trust may sell the LLC Preferred Units to permitted purchasers without the consent of other LLC Members. Subject only to reasonable administrative restrictions, these purchasers will become substitute Preferred Members. The permitted purchases are other Members of LLC, Taxpayer's children, and Qualified Institutional Investors (as defined by Operating Agreement). Taxpayer has demonstrated that a substantial number of Qualified Institutional Investors currently own interests in B and that they are common purchasers of REITs. With respect to the actual receipt of income from an investment in B, an indirect owner of interests in B who owns LLC Preferred Units is in a similar position as a direct owner of interests in B because LLC is required to distribute an eight percent preferred return annually to owners of LLC Preferred Units.

In contrast to concerns about a buy-sell agreement reducing the marital deduction, an agreement benefitting the surviving spouse may qualify for the marital deduction. In *Estate of Lauder v. Commissioner*, T.C. Memo. 1994-527, the court largely disregarded a buy-sell agreement in valuing stock for purposes of estate inclusion and significantly increased the value. The court held:

> We agree with respondent that, in light of our holding in *Estate of Lauder v. Commissioner*, T.C. Memo. 1992-736, it would be anomalous if particular portions of the shareholder agreement are now deemed relevant to the question of the fair market value of decedent's stock. At the risk of belaboring the point, our responsibility is to determine the fair market value of decedent's stock on the date of his death. In our prior opinion, we resolved that the formula price was intended to serve a testamentary purpose, and thus would not be respected for Federal estate tax purposes. It is worth noting at this point that we have not had the opportunity to address the validity of each and every aspect of the shareholder agreement. Nonetheless, we repeat the observation made earlier in these proceedings that there is no evidence in the record that the Lauders engaged in arm's-length negotiations with respect to any aspect of the shareholder agreement. Absent proof on the point, we presume that all aspects of the agreement, particularly those tending to depress the value of the stock, are tainted with the same testamentary objectives rendering the formula price invalid.[24]

[3789] Letter Ruling 201410011.

[24] We note with interest Lehman Brothers' conclusion that neither EJL nor the Lauders would qualify for the "Aa" credit rating used under article 6.3 of the shareholder agreement to set the interest rate to be paid on the 20-year debentures described therein. See *supra* note 19. While the Lauders certainly were free to adopt any rate of their choosing, the fact remains that the record is devoid of any evidence that the Lauders negotiated with respect to this aspect of the shareholder agreement. Shutzer testified that he did not inquire how the Lauders arrived at that credit rating. Given the state of the record, and consistent with our holdings in *Estate of Lauder v. Commissioner*, 1992-736, we will not permit petitioner to cite that aspect of the agreement as a factor depressing the value of decedent's stock.

In light of our holding in *Estate of Lauder v. Commissioner*, T.C. Memo. 1992-736, we hold that the specific provisions of the shareholder agreement are not relevant to the question of the fair market value of decedent's stock on the valuation date. Simply put, the willing buyer/willing seller analysis that we undertake in this case would be distorted if elements of such testamentary origin are injected into the determination.

Petitioner attempts to breathe new life into the shareholder agreement by pointing out that we declined to declare the agreement invalid per se in our most recent Memorandum Opinion. Petitioner's reliance on this aspect of our prior opinion is misplaced. Simply put, whether a particular shareholder agreement constitutes a binding contract between the parties to the agreement begs the purely legal question of whether the agreement, or any of its provisions, will be respected in determining the fair market value of the affected stock for purposes of the Federal estate tax. See, *e.g.*, *St. Louis County Bank v. United States*, 674 F.2d 1207, 1210 (8th Cir. 1982). As indicated above, we cannot agree that particular aspects of such an agreement can be employed to depress the fair market value of the subject stock (and thereby avoid Federal estate tax) where it is evident that the agreement was adopted primarily as a testamentary device. Further, it is on this basis that we distinguish *Estate of Hall v. Commissioner*, 92 T.C. 312, 335 (1989), the case relied upon by petitioner to support its contention that the shareholder agreement is relevant to the question of fair market value.

This is not to say, however, that the existence of the 1976 shareholder agreement can be completely ignored or written out of the record. our perspective, the shareholder agreement affirmatively demonstrates the Lauders' commitment to maintain family control over EJL. This element is properly accounted for below as a component of the discount applied to reflect the lack of a public market for EJL stock.

The court also held that, because the surviving spouse was entitled to the benefit of this increased value under the buy-sell agreement, the estate received a marital deduction for it (highlighting toward the end added to support a comment following the quote):

We likewise must consider petitioner's second alternative contention that the estate is entitled to a marital deduction under section 2056(a).[28] Petitioner argues that a marital deduction is warranted on the theory that decedent indirectly passed a valuable property interest to his wife, Estee, by virtue of the transfer of his stock to EJL at a price below fair market value. Estee owned 10,230 shares of EJL common stock on the date of decedent's death. Focusing on the enhanced value of Estee's stock following the transfer of decedent's stock to EJL, petitioner asserts that the estate is entitled to a marital deduction equal to 39.26 percent of $21,443,544 — the difference between

$50,494,344 (the fair market value of decedent's stock as determined by this Court) and $29,050,800 (the value of the stock as reported on the estate tax return.[29]

[28] Sec. 2056(a) and (c) provides in pertinent part:

(a) Allowance of Marital Deduction. — For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsection (b) [relating to terminable interests], be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate. ***

(c) Definition. — For purposes of this section, an interest in property shall be considered as passing from the decedent to any person if and only if —

(1) such interest is bequeathed or devised to such person by the decedent;

(2) such interest is inherited by such person from the decedent; ***

(4) such interest has been transferred to such person by the decedent at any time;

[29] The 39.26 percent figure that petitioner uses in this computation represents Estee's share of all outstanding EJL common stock (both voting and nonvoting) following decedent's death.

Petitioner is unable to cite any authority directly supporting its marital deduction argument. Rather, petitioner relies on Federal gift tax cases analyzing the impact of an inter vivos transfer of assets to a corporation for less than an adequate and full consideration. See *Kincaid v. United States*, 682 F.2d 1220 (5th Cir. 1982); *Ketteman Trust v. Commissioner*, 86 T.C. 91 (1986); see also sec. 25.2511-1(h), Gift Tax Regs; Rev. Rul. 71-443, 1971-2 C.B. 338 (where the Commissioner determined that a *section 2523*(a) gift tax marital deduction would be available under somewhat analogous circumstances). Citing the rule of statutory construction that the Federal estate and gift tax provisions are interpreted in pari materia, see *Estate of Sanford v. Commissioner*, 308 U.S. 39, 44 (1939), petitioner concludes that an interest in property passed to Estee such that the estate is entitled to a marital deduction under section 2056(a).[30]

[30] Petitioner also argues that a marital deduction is warranted to avoid the possibility of double taxation to the extent the amount in question will be included in both decedent's Federal gross estate and in Estee's gross estate upon her death.

Respondent maintains that petitioner is attempting to extend the marital deduction provision beyond its intended scope. Respondent reasons that petitioner's argument should be denied on the theory that, because Estee will eventually be required to offer her stock to EJL at the formula price, any property interest purportedly passing to her is illusory. In conjunction with the foregoing, respondent concludes that the interest in question is a terminable interest under section 2056(b).

> Section 2056(a) provides that the taxable estate shall be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate and excepting any terminable interest as described in section 2056(b). While we recognize that the marital deduction is strictly construed, see *Commissioner v. Estate of Bosch*, 387 U.S. 456, 464 (1967), we nevertheless agree with petitioner that the estate is entitled to a marital deduction under the circumstances presented.
>
> To briefly recapitulate, we determined that the fair market value of decedent's EJL stock exceeded the value assigned to the stock by petitioner on its Federal estate tax return. Because the difference, $21,443,544, will be included in decedent's gross estate, it follows that the first element required for the deduction under section 2056(a) is satisfied.
>
> Additionally, we are persuaded by petitioner's argument that an interest in property passed (albeit indirectly) from decedent to his surviving spouse, Estee, as a result of the transfer of decedent's stock to EJL at the formula price. We first note that there is no requirement in section 2056 that an interest must pass directly to the surviving spouse in order to qualify for the marital deduction. See sec. 2056(c); *Harter v. Commissioner*, 39 T.C. 511 (1962); Stephens et al., *Federal Estate and Gift Taxation*, para. 5.06[3][a], at 5-71 (6th ed. 1991). Further, we agree with petitioner that Federal gift tax cases such as *Ketteman Trust v. Commissioner*, *supra*, are sufficiently analogous to lend support to their argument that an interest in property passed to Estee and the remaining shareholders. Respondent has not convinced us otherwise. We likewise find it significant that respondent has permitted a marital deduction for purposes of the Federal gift tax under comparable circumstances. See *Estate of Higgins v. Commissioner*, T.C. Memo. 1991-47; Rev. Rul. 71-443, supra.
>
> Thus, we are left with respondent's argument that the estate should be denied the marital deduction on the ground that any property interest deemed to have passed to Estee constitutes a terminable interest under section 2056(b). Although Estee agreed to offer her EJL stock to the company under the shareholder agreement, the fact remains that Estee generally will be subject to a Federal transfer tax should she or her estate transfer the stock for less than an adequate and full consideration. We cannot agree that such an interest is a terminable interest.
>
> In sum, we are convinced that the technical requirements of section 2056(a) are satisfied. We are also persuaded that allowing a marital deduction under the circumstances presented is compatible with the policies underlying the provision.

In the text highlighted above, note the court's view that, if a shareholder agreement is testamentary in nature, a bargain sale required under the agreement would constitute a gift.[3790]

An earlier case also successfully sought to protect the marital deduction. In *Dickinson v. Commissioner*, 63 T.C. 771 (1975), the Official Tax Court Syllabus summarized the case:

> D, who owned most of the stock of C, entered into an agreement providing that his estate would sell such stock to C and that C would purchase it at its book value.

[3790] See fn 4585 in part II.Q.4.h Establishing Estate Tax Values.

> Subsequently, D entered into a second agreement with the other shareholders of C providing that if the Commissioner of Internal Revenue disregarded the book value of the stock for estate tax valuation purposes, they would release the estate from the first agreement, if requested to do so. The Commissioner has taken the position, and the estate agrees, that the stock of C should be includable in the estate at its fair market value, and not its book value. *Held*, the second agreement is to be given effect in administering the estate, and the parties are released from the obligations under the first agreement.

Dickinson is quoted more fully in the text following fn 7044 part III.B.3.o *Procter* and Other Cases.

II.O.2.d. Marital Trusts - S Corporations

When a business passes to a surviving spouse in a trust, a QSST or an ESBT election must be made.

Testamentary QTIP trusts generally qualify as QSSTs, and QSSTs often have more favorable income tax effects than ESBTs.

See parts III.A.3.c.iii Deadlines for QSST and ESBT Elections and III.A.3.e QSSTs and ESBTs (including part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies).

II.O.2.e. Marital Deduction Trusts - Discount Planning

Much of the discussion below assumes that valuation reduction is good. That is not necessarily the case; see part II.H Income Tax vs. Estate and Gift Tax (Particularly for Depreciable Property), including part II.H.3 Valuation Discounts – Friend or Enemy. Accordingly, consider whether to plan to avoid valuation discounts, as needed.

Minority and fractional discounts for closely-held businesses and marital trusts need to be considered in estate planning as well. When spouses together own a majority in a business under community property laws, they will be considered to own one-half of that interest, and thus will be entitled to discounts for lack of control in determining their estate value.[3791] Additionally, fractional interest discounts may come into play when property interests are divided between a QTIP trust and a spouse. For example, if the surviving spouse owns 60% of a business and the remaining 40% is held in a QTIP trust, one might assume discounts for lack of control will not come into play when the second spouse dies. However, courts have held that the spouse's estate will be entitled to a discount for lack of control by disaggregating the QTIP trust from the spouse's other assets (in this example, providing a discount for lack of control for the QTIP stock).[3792] However, this disaggregation would not apply to a general power of appointment marital trust (Code § 2056(b)(5)).[3793]

Another issue arises when a business owner has a controlling interest in the company and bequeaths some portion of that interest to his spouse. Upon the owner's death, the full controlling interest value must be included in determining the owner's gross estate, and the estate will be entitled to some marital deduction for the portion passing to the spouse. However,

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[3791] See *Estate of Bright v. U.S.*, 658 F.2d 999 (5th Cir. 1981).
[3792] See *Estate of Bonner v. U.S.*, 84 F.3d 196 (5th Cir. 1996); *Estate of Mellinger v. Commissioner*, 112 T.C. 26 (1999); *Nowell v. Commissioner*, T.C. Memo. 1999-15.
[3793] *Estate of Fontana v. Commissioner*, 118 T.C. 318, 322 (2002).

that deduction is based on what passes to the spouse, not what is included in the estate. In *Estate of Chenoweth v. Commissioner*,[3794] the decedent owned 100% of a business and left his spouse a 51% interest. The IRS claimed the highest marital deduction the estate could take was 51% of the full value of the business included in the gross estate, but the estate claimed it should be entitled to increase the deduction by some control premium. The court ruled that the estate should be entitled to attempt to prove the increased value and that no rule required that the marital deduction amount equal the value the property was assigned when included in the gross estate. While this holding can lead to a potential tax advantage for an estate, it also has a potentially negative effect. What if the decedent owned a controlling interest but passed a minority interest to the spouse? In this case, the marital deduction will be based on the value of the minority interest, even though the full value of the interest will be used in calculating the gross estate.[3795] This same result can occur in the charitable contribution deduction context, when a decedent leaves a minority interest in stock to a charity.[3796] Thus, estate planners need to be aware of this whipsaw effect when determining how the estate will be divided.[3797] For

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[3794] 88 T.C. 1577 (1987).

[3795] TAM 9403005. In *Estate of Frank M. DiSanto v. Commissioner*, T.C. Memo 1999-421, the decedent had a controlling interest and a non-controlling interest passed to the surviving spouse, creating a mismatch between inclusion and deduction.

[3796] See generally *Estate of Schwan v. Commissioner*, T.C. Memo 2001-174 (taking into account post-mortem transformations occurring in funding a charitable bequest).

[3797] Steve Akers of Bessemer Trust has a post-mortem outline that, as of 2/8/2014, included the following as possible solutions:

> * Have the executor to fund the marital bequest with a note. The residuary estate would then be burdened with the note as a liability that would be distributed along with the residuary assets to the residuary beneficiaries.
>
> A strategy that may have worked previously: Have someone purchase a minority interest from the estate within the first six months, and elect the alternate valuation date. If the remaining interest is a minority interest, the alternate valuation date values would reflect minority interest values in the estate. Alternatively, consider merely distributing minority block of stock, and value the block distributed (minority interest) and the remaining block of stock in the estate at the end of the six month period (which might also be a minority interest). See Treas. Reg. § 20.2032-1(c)(1)(phrase distributed, sold, exchanged or otherwise disposed of includes surrender of stock in complete or partial liquidation of a corporation but not mere changes in form such as a transfer of assets to a corporation in a manner that no gain or loss is recognizable under § 351); *Kohler v. Comm'r*, T.C. Memo 2006-152, nonacq. AOD 2008-001 (tax-free reorganization is not a disposition that accelerates alternate valuation date). Proposed regulations prohibit this strategy, with an effective date of when the regulation is finalized. Prop. Treas. Reg. § 20.2032-1(h).
>
> * For fractional interests in real estate, use a co-ownership agreement at the first spouse's death that will eliminate the discount, by providing that either co-tenant can sell the property and distribute the proceeds pro rata.
>
> * For stock, use a pro rata funding but have a shareholder agreement that will eliminate the discount (by giving the marital legatee the right to liquidate the company or otherwise have control).
>
> * Sell the majority interest to a Family Trust for a note, then fund the Marital Trust with a part of the note, and fund the Family Trust with the balance of the note (which the Family Trust would then owe to itself).
>
> * Distribute a majority interest in an asset (that exceeds the marital bequest amount) to the Marital Trust, and have the Marital Trust give the estate back a note for the excess value. (For example, assume there is a $2MM Family Trust and a $8MM Marital Trust and the only asset is a 51% interest in a closely held company that is worth $10MM. If the Marital Trust is funded with 8/10 of the 51% interest, it will not be worth $8MM. Fund the Marital Trust with the entire 51% controlling interest, and have the Marital Trust give a note back to the estate for $2MM. The

example, if a controlling interest is to be divided among charities, with each receiving a minority interest, the IRS might argue that the bequest to each receives a minority discount; instead, consider (a) bequeathing the controlling interest to a private foundation for the benefit of those charities, or (b) including a direction to sell the business interest and distribute the proceeds, perhaps giving the charities an option to take in kind.

II.O.3. Effect of Buy-Sell on Charitable Estate Tax Deduction

If a decedent owns voting and nonvoting shares, the shares are valued together as a single block; however, if the charitable bequest is a specific bequest of stock that is less than the combined block, the charitable deduction is based on the block it actually received. *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981). In that case, the sole share of voting stock was specifically bequeathed to a noncharitable beneficiary, and ninety-nine shares of nonvoting stock were specifically bequeathed to charity. The court reasoned:

> The Foundation argues that it makes no difference if we conclude, as we did in section II, that the gross estate should include the value of the 600 HFA shares in the hands of Ahmanson, because the 99 nonvoting shares must have the same value for the charitable deduction as they have in the gross estate. The Foundation argues that inconsistent valuations, for these two purposes, would be incompatible with the orderly administration and application of the estate tax law. There is, certainly, an initial plausibility to the suggestion that fairness dictates that the same method of valuation be used in computing the gross estate and the charitable deduction. This initial plausibility, however, does not survive a close second look.
>
> The statute does not ordain equal valuation as between an item in the gross estate and the same item under the charitable deduction. Instead, it states that the value of the charitable deduction shall not exceed the value of the transferred property required to be included in the gross estate. 26 U.S.C. § 2055(d). Moreover, the statutory scheme specifically requires a lower valuation for the charitable deduction than for the same item within the gross estate under certain circumstances. If the alternate valuation date is used and the property becomes more valuable by virtue of a contingency occurring between the date of death and the alternate valuation date, the higher value is included in the gross estate, but the lower value is used in computing the charitable deduction. 26 U.S.C. § 2032(b).
>
> In light of the purpose of the charitable deduction to encourage gifts to charity, it seems doubtful that Congress intended to give as great a charitable deduction when the testamentary plan diminishes the value of the charitable property as it would when the testamentary plan conveys the full value of the property to the charity intact. That is, the intent of encouraging charitable gifts suggests the further policy of encouraging greater rather than lesser charitable gifts. By severing the voting power of the stock from its economic entitlement, and giving only the economic entitlement to charity, Ahmanson

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Marital Trust might later end up paying off the $2MM note with an interest in the company (which would be valued at a discount, thus requiring more shares than if there were no discount).

* Fund the bequest using a defined value formula conveyance. For example, a pecuniary bypass trust bequest could be funded by a conveyance having a defined value—reduced only by the amount necessary that will not result in an increased estate tax.

* To avoid the valuation problem on funding marital bequests, make the marital gifts during lifetime. In that event, there would not be a mismatch between the amount of the gift and the allowed marital deduction. (But lifetime gifts would lose the benefit of a basis step-up at death.)

> reduced the value of the stock to the charity. In the present case, the district judge found that the reduction in value was relatively small. Under other circumstances, however, the reduction in value might be substantial. The proper administration of the charitable deduction cannot ignore such differences in the value actually received by the charity.
>
> Thus there are compelling considerations in conflict with the initially plausible suggestion that valuation for purposes of the gross estate must always be the same as valuation for purposes of the charitable deduction. When the valuation would be different depending on whether an asset is held in conjunction with other assets, the gross estate must be computed considering the assets in the estate as a block. Otherwise, as discussed above, the testator would be able to produce an artificially low valuation by manipulatively disbursing complimentary assets into the hands of different beneficiaries—only to have those beneficiaries recombine the assets in their more valuable arrangements at some later time. The valuation of these same sorts of assets for the purpose of the charitable deduction, however, is subject to the principle that the testator may only be allowed a deduction for estate tax purposes for what is actually received by the charity—a principle required by the purpose of the charitable deduction.
>
> Therefore the district judge erred in concluding that the valuation of the 99 nonvoting shares of Ahmanco stock would be the same for the purpose of the charitable deduction and for purpose of the gross estate. The district judge should recompute the taxable estate, beginning with a value in the gross estate equal to the 100 shares of Ahmanco undiminished by the 3 percent reduction for the nonvoting status of the 99 shares. The charitable deduction should then be computed on the basis of that 3 percent decrease in value that resulted from the severance of the voting rights from these 99 shares.

Similarly, in *Estate of Warne v. Commissioner*, T.C. Memo. 2021-17:

> Upon her death, Miriam Warne's estate donated 75% of Royal Gardens to the Foundation and 25% to the Church. The Commissioner asserts that we should apply discounts for lack of control and marketability to the charitable contribution deductions attributable to the estate's donations to the Church and the Foundation. The Commissioner argues that the value of the deduction should reflect the benefit received by the respective donees.
>
> The estate insists that discounts are inappropriate and would subvert the public policy of motivating charitable donations. It claims that because 100% of Royal Gardens was included in the estate and the estate donated 100% of Royal Gardens to charities, the estate is entitled to a deduction of 100% of Royal Gardens' value. We disagree.
>
> Both parties cite *Ahmanson Foundation v. United States* for support.[39] In *Ahmanson*, the decedent owned (through a revocable trust) a corporation that had 100 shares. Only one of those shares was a voting share; the remaining 99 shares were nonvoting. The decedent bequeathed the one voting share to his son and the 99 nonvoting shares to a charitable foundation.[40] The Court of Appeals for the Ninth Circuit in *Ahmanson* stated that "[t]here is nothing in the statutes or in the case law that suggests that valuation of the gross estate should take into account that the assets will come to rest in several hands rather than one."[41] In other words, when valuing an asset as part of an estate, we value the entire interest held by the estate, without regard to the later disposition of that asset.

[39] *Ahmanson Found. v. United States*, 674 F.2d 761 (9th Cir. 1981). Because these cases are appealable to the Court of Appeals for the Ninth Circuit, we follow its approach. *Golsen v. Commissioner*, 54 T.C. 742, 756 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

[40] *Ahmanson Found.*, 674 F.2d at 765-766.

[41] *Ahmanson Found.*, 674 F.2d at 768.

But when property is split as part of a charitable contribution, a different principle applies. "The valuation of these same sorts of assets for the purpose of the charitable deduction, however, is subject to the principle that the testator may only be allowed a deduction for estate tax purposes for what is actually received by the charity—a principle required by the purpose of the charitable deduction."[42] In short, when valuing charitable contributions, we do not value what an estate contributed; we value what the charitable organizations received.

[42] *Ahmanson Found.*, 674 F.2d at 772.

Taking these two principles together, the estate must include 100% of the value of Royal Gardens in the value of the estate, but the estate may deduct only the 25% and 75% interests received by the respective charities.

In its opinion, the Court of Appeals in *Ahmanson* cited section 2055(d), which provides that an estate's charitable contribution deduction for transferred property may not exceed that property's value in the gross estate.[43] It concluded that the estate's deduction attributable to the donation of the 99 nonvoting shares necessitated a 3% discount to account for the foundation's lack of voting rights.[44]

[43] *Ahmanson Found.*, 674 F.2d at 772.

[44] *Ahmanson Found.*, 674 F.2d at 772.

The estate asks us to distinguish its donation from the one in *Ahmanson*. It emphasizes that the voting share in Ahmanson went to the decedent's son and not a charitable organization. It claims that because Miriam Warne donated 100% of Royal Gardens' value to charitable organizations, a discount should not apply. However, whether a charitable organization or an individual received the 75% interest in Royal Gardens does not affect the value of the Church's interest, and it is the value of the property received by the donee that determines the amount of the deduction available to the donor.

A discount applies to the charitable contribution deduction for the estate's donation of Royal Gardens. The parties stipulated that a 27.385% discount is appropriate for the 25% interest. Likewise, the parties stipulated that a 4% discount also applies to the estate's 75% donation to the Foundation.

The decedent should have bequeathed all of her interest these LLCs to a donor-advised fund or other charity that directed distribution to her desired charities.

When the trustee caused controlling stock bequeathed to charity to be redeemed for a value based on discounts for lack of control, the charitable deduction was correspondingly reduced, and the estate was assessed penalties.[3798]

Also, consider providing that, if the IRS determines that a fixed price redemption as of date of death is below fair market value as of date of death, the estate can rescind the sale.[3799]

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

In recharacterizing deductible compensation as nondeductible dividends, the Tax Court in 2016 held that an independent investor[3800] would have demanded a return on investment as a shareholder.[3801]

In that particular case, the net book value, determined on a cash basis, was sufficient to justify the IRS' conclusion that a particular portion of distributions constituted dividends. Consider, however, that a buy-sell agreement might constitute evidence of a company's value that might support an IRS attack asserting that the corporation's value is higher and that therefore distributions taxable as nondeductible dividends should be higher:

- Generally, a business is worth the present value of its future profits, as they are distributed annually or upon liquidation.[3802]

[3798] *Estate of Dieringer v. Commissioner*, 146 T.C. No. 8 (2016), reasoning:

> We do not believe that Congress intended to allow as great a charitable contribution deduction where persons divert a decedent's charitable contribution, ultimately reducing the value of property transferred to a charitable organization. This conclusion comports with the principle that if a trustee is empowered to divert the property … to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed … the deduction will be limited to that portion, if any, of the property, or fund which is exempt from an exercise of the power. Sec. 20.2055-2(b)(1), Estate Tax Regs. Eugene and his brothers thwarted decedent's testamentary plan by altering the date-of-death value of decedent's intended donation through the redemption of a majority interest as a minority interest.
>
> The trust did not transfer decedent's bequeathed shares nor the value of the bequeathed shares to the foundation. Accordingly, we hold that the estate is not entitled to the full amount of its claimed charitable contribution deduction.

In sustaining the penalty, the court reasoned:

> DPI's lawyer's advice regarding the charitable contribution deduction was based on an errant appraisal. The date-of-death appraisal and the redemption appraisal--performed only seven months apart--differed substantially in value. The estate knew that a significant percentage of the value of decedent's bequeathed shares was not passing to the foundation and that Eugene and his brothers were acquiring a majority interest in DPI at a discount.

[3799] *Estate of Dickinson v. Commissioner*, 63 T.C. 771 (1975), rejecting the IRS' reliance on *Procter*, prevented the IRS from nailing the taxpayer with circular marital and charitable deduction disallowances. See fn 7044 and accompanying and following text in part III.B.3.o *Procter* and Other Cases.

[3800] Many cases have looked to the independent investor test in determining reasonable compensation. See fn. 31.

[3801] *Brinks Gilson & Lione A Professional Corporation v. Commissioner*, T.C. Memo. 2016-20, discussed in fn. 31.

[3802] See part III.E Fairness Within Families; Valuation.

- Therefore, if a company has no profits, it has no value. Conversely, if a company has value but does not report profits, then presumably either the value is based on expected future profits based on efforts that have not yet generated results or the expenses are overstated.

- Appraisals of controlling interests in business often adjust compensation to what the appraisers believe is reasonable. These appraisals might be dangerous to a C corporation, that does not want its compensation deductions to be denied.

C corporation owners often assert that compensation to zero out income is reasonable, yet the business has value to an investor. The IRS might asset that the latter is an admission of value on which dividends should be paid. An advisor might consider addressing this issue very directly with the client and revisiting choice of entity in light of a possible intellectual inconsistency that might come back to bite the taxpayer in the long run.

A seller-financed buyout is best done using a partnership,[3803] so consider converting to a partnership to avoid these issues,[3804] which does not necessarily mean paying otherwise avoidable self-employment tax.[3805] If converting to a partnership is not acceptable, consider making an S election.[3806]

II.P. Operations

Taxation of operations focuses on whether income from operations is taxed to the entity or to its owner(s), effect of contributed property on taxation of operations, to what extent are FICA taxes imposed, and miscellaneous issues.

II.P.1. Income Taxation of Operations

II.P.1.a. Allocations of Income in Partnerships and S Corporations

Partnership income taxation of owners is more complex but more flexible than S corporation income taxation of owners. Defining the ownership in a partnership can be challenging.[3807] Although receiving K-1s after the original due date of a return is aggravating, a taxpayer who uses estimates rather than actual K-1 amounts can be penalized.[3808]

Also see part III.B.2.j Tax Allocations upon Change of Interest.

[3803] See part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis.
[3804] See part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure.
[3805] See parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart. See the paragraph that includes fn. 1064 for avoiding self-employment tax and when one might not want to avoid self-employment tax.
[3806] See parts II.A.2.b Existing Corporation - Paying Retired Shareholder-Officers and II.P.3.b Conversion from C Corporation to S Corporation.
[3807] See Banoff, FAQ-Filled Guidance on Computing a Partner's Interest in Profits, Losses, and Capital, *Journal of Taxation*, April and May 2009 (two-part article). See also Banoff, "Identifying Partners' Interests in Profits and Capital: Uncertainties, Opportunities and Traps," *Taxes* (CCH) 3/1/2007.
[3808] *Sampson v. Commissioner*, T.C. Memo. 2013-212.

II.P.1.a.i. Allocations of Income in Partnerships

II.P.1.a.i.(a). General Rules for Allocations of Income in Partnerships

Allocation of income, gain, loss, deductions and credits among partners are governed by Code § 704(b) and Reg. § 1.704-1. These provisions set up a rule that requires the allocation of such income, gain, loss, deduction, or credit to have substantial economic effect or to be in accordance with the partner's interest in the partnership. These rules are set up to ensure that, when a partner is allocated income, the partner is able to enjoy the economic benefit associated with that income, or that when he is allocated economic loss, the partner suffers the burden of that loss. This allocation is usually achieved through the use of partner capital accounts, that, in most basic terms, are increased by a partner's contributions or share of income and are decreased by distributions or the partner's share of a loss.[3809] The goal of the capital account is to track the distribution amount a partner would receive if the partnership sold all of its assets at book value, paid off all liabilities, and then distributed any remaining cash to the partners in liquidation of the partnership.

Allocations of gross income in preferred partnerships would tend to be based on the ratio of a partnership's overall distributive share of profit for the year, divided by all partners' distributive share of profit for the year, unless special allocations with substantial economic effect provide otherwise.[3810]

Losses that generate or exacerbate a negative capital account complicate the issue. If a partner has a deficit balance in the partner's capital account following the liquidation of the partner's interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which the liquidation occurs (other than those made pursuant to this sentence and the following sentence), the partner is unconditionally obligated to restore the amount of the deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances (in accordance with

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[3809] Reg. § 1.704-1(b)(2)(iv). A partner's capital account is increased by the fair market value, not basis, of assets that partner contributes. Reg. § 1.704-1(b)(2)(iv)(d). The fair market value assigned to property contributed to a partnership, property distributed by a partnership, or property otherwise revalued by a partnership, will be regarded as correct, provided that (1) such value is reasonably agreed to among the partners in arm's-length negotiations, and (2) the partners have sufficiently adverse interests. Reg. § 1.704-1(b)(2)(iv)(h)(1). In calculating book-tax differences under Code § 704(c), A partnership may use different methods with respect to different items of contributed property, provided that the partnership and the partners consistently apply a single reasonable method for each item of contributed property and that the overall method or combination of methods are reasonable based on the facts and circumstances and consistent with the purpose of Code § 704(c). Reg. § 1.704-3(a)(2). For events causing accounts to be revalued, see part II.C.7 Maintaining Capital Accounts, especially fn. 507.

[3810] See Banoff, FAQ-Filled Guidance on Computing a Partner's Interest in Profits, Losses, and Capital, *Journal of Taxation*, April 2009 (part one of two-part article) (see discussion of IRS FAQ1); see also Banoff, Identifying Partners' Interests in Profits and Capital: Uncertainties, Opportunities and Traps, *TAXES - The Tax Magazine* (3/1/2007).

Reg. § 1.704-1(b)(2)(ii)(b)(2)[3811]).[3812] Notwithstanding the partnership agreement, an obligation to restore a deficit balance in a partner's capital account, including an obligation described in Reg. § 1.704-1(b)(2)(ii)(c)(1),[3813] will not be respected for purposes of Reg. § 1.704-1 to the extent the obligation is disregarded under Reg. § 1.704-1(b)(2)(ii)(c)(4).[3814]

Reg. § 1.704-1(b)(2)(ii)(b)(4) provides:

> For purposes of paragraphs (b)(2)(ii)(b)(1) through (3) of this section, a partnership taxable year shall be determined without regard to section 706(c)(2)(A).

Reg. § 1.704-1(b)(2)(ii)(b)(5) provides:[3815]

> The requirements in paragraphs (b)(2)(ii)(b)(2) and (3) of this section are not violated if all or part of the partnership interest of one or more partners is purchased (other than in connection with the liquidation of the partnership) by the partnership or by one or more partners (or one or more persons related, within the meaning of section 267(b) (without modification by section 267(e)(1)) or section 707(b)(1), to a partner) pursuant to an agreement negotiated at arm's length by persons who at the time such agreement is entered into have materially adverse interests and if a principal purpose of such purchase and sale is not to avoid the principles of the second sentence of paragraph (b)(2)(ii)(a) of this section.

Reg. § 1.704-1(b)(2)(ii)(b)(6) provides:

> The requirement in paragraph (b)(2)(ii)(b)(2) of this section is not violated if, upon the liquidation of the partnership, the capital accounts of the partners are increased or decreased pursuant to paragraph (b)(2)(iv)(f) of this section as of the date of such liquidation and the partnership makes liquidating distributions within the time set out in the requirement in paragraph (b)(2)(ii)(b)(2) of this section in the ratios of the partners' positive capital accounts, except that it does not distribute reserves reasonably required

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[3811] Reg. § 1.704-1(b)(2)(ii)(b)(2) provides:

> Upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (2) and requirement (3) of this paragraph (b)(2)(ii)(b)), by the end of such taxable year (or, if later, within 90 days after the date of such liquidation).

[3812] Reg. § 1.704-1(b)(2)(ii)(b)(3).

[3813] Reg. § 1.704-1(b)(2)(ii)(c)(1), "Other arrangements treated as obligations to restore deficits," provides:

> If a partner is not expressly obligated to restore the deficit balance in such partner's capital account, such partner nevertheless will be treated as obligated to restore the deficit balance in his capital account (in accordance with the requirement in paragraph (b)(2)(ii)(b)(3) of this section and subject to paragraph (b)(2)(ii)(c)(2) of this section) to the extent of—
>
> (A) The outstanding principal balance of any promissory note (of which such partner is the maker) contributed to the partnership by such partner (other than a promissory note that is readily tradable on an established securities market), and
>
> (B) The amount of any unconditional obligation of such partner (whether imposed by the partnership agreement or by state or local law) to make subsequent contributions to the partnership (other than pursuant to a promissory note of which such partner is the maker).

[3814] Reg. § 1.704-1(b)(2)(ii)(b)(3)

[3815] Code § 267(b), referred to below, is described in part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses.

to provide for liabilities (contingent or otherwise) of the partnership and installment obligations owed to the partnership, so long as such withheld amounts are distributed as soon as practicable and in the ratios of the partners' positive capital account balances.

Reg. § 1.704-1(b)(2)(ii)(b)(7) provides:

See Examples 1.(i) and (ii), 4.(i), 8.(i), and 16.(i) of paragraph (b)(5) of this section for issues concerning paragraph (b)(2)(ii)(b) of this section.

Reg. § 1.704-1(b)(2)(ii)(c), "Obligation to restore deficit," provides:

(1) *Other arrangements treated as obligations to restore deficits*. If a partner is not expressly obligated to restore the deficit balance in such partner's capital account, such partner nevertheless will be treated as obligated to restore the deficit balance in his capital account (in accordance with the requirement in paragraph (b)(2)(ii)(b)(3) of this section and subject to paragraph (b)(2)(ii)(c)(2) of this section) to the extent of—

(A) The outstanding principal balance of any promissory note (of which such partner is the maker) contributed to the partnership by such partner (other than a promissory note that is readily tradable on an established securities market), and

(B) The amount of any unconditional obligation of such partner (whether imposed by the partnership agreement or by state or local law) to make subsequent contributions to the partnership (other than pursuant to a promissory note of which such partner is the maker).

(2) *Satisfaction requirement*. For purposes of paragraph (b)(2)(ii)(c)(1) of this section, a promissory note or unconditional obligation is taken into account only if it is required to be satisfied at a time no later than the end of the partnership taxable year in which such partner's interest is liquidated (or, if later, within 90 days after the date of such liquidation). If a promissory note referred to in paragraph (b)(2)(ii)(c)(1) of this section is negotiable, a partner will be considered required to satisfy such note within the time period specified in this paragraph (b)(2)(ii)(c)(2) if the partnership agreement provides that, in lieu of actual satisfaction, the partnership will retain such note and such partner will contribute to the partnership the excess, if any, of the outstanding principal balance of such note over its fair market value at the time of liquidation. See paragraph (b)(2)(iv)(d)(2) of this section. See Examples 1.(ix) and (x) of paragraph (b)(5) of this section.

(3) *Related party notes*. For purposes of paragraph (b)(2) of this section, if a partner contributes a promissory note to the partnership during a partnership taxable year beginning after December 29, 1988, and the maker of such note is a person related to such partner (within the meaning of § 1.752-4(b)(1)), then such promissory note shall be treated as a promissory note of which such partner is the maker.

(4) *Obligations disregarded*.

(A) *General rule*. A partner in no event will be considered obligated to restore the deficit balance in his capital account to the partnership (in accordance with the requirement in paragraph (b)(2)(ii)(b)(3) of this section) to the extent such partner's obligation is a bottom dollar payment obligation that is not recognized under § 1.752-2(b)(3) or is not legally enforceable, or the facts and circumstances otherwise indicate a plan to circumvent or avoid such obligation. See paragraphs (b)(2)(ii)(f), (b)(2)(ii)(h), and (b)(4)(vi) of this section for other rules regarding such obligation. To the extent a partner is not considered obligated to restore the deficit balance in the partner's capital account to the partnership (in accordance with the requirement in paragraph (b)(2)(ii)(b)(3) of this section), the obligation is disregarded and paragraph (b)(2) of this section and § 1.752-2 are applied as if the obligation did not exist.

(B) *Factors indicating plan to circumvent or avoid obligation*. In the case of an obligation to restore a deficit balance in a partner's capital account upon liquidation of a partnership, paragraphs (b)(2)(ii)(c)(4)(B)(i) through (iv) of this section provide a non-exclusive list of factors that may indicate a plan to circumvent or avoid the obligation. For purposes of making determinations under this paragraph (b)(2)(ii)(c)(4), the weight to be given to any particular factor depends on the particular case and the presence or absence of any particular factor is not, in itself, necessarily indicative of whether or not the obligation is respected. The following factors are taken into consideration for purposes of this paragraph (b)(2):

(i) The partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation.

(ii) The partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership.

(iii) The obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account as provided in § 1.704-1(b)(2)(iv) is negative other than when a transferee partner assumes the obligation.

(iv) The terms of the obligation are not provided to all the partners in the partnership in a timely manner.

The rules about losses that generate or exacerbate a negative capital account are coordinated with those described in part II.C.3.c.ii.(a) Permanent Rules Allocating Economic Risk of Loss to Recourse Liabilities.

In most cases, however, those wanting partnership income taxation use a limited liability company or other entity that blocks personal liability and do not wish to have such a deficit restoration obligation (DRO). Instead of a DRO, a partnership agreement may contain a "qualified income offset."[3816] A "qualified income offset" is a provision that a partner who unexpectedly receives an adjustment, allocation, or distribution described in Reg. § 1.704-

[3816] Reg. § 1.704-1(b)(2)(ii)(d)(3).

1(b)(2)(ii)(d)(4),[3817] (5),[3818] or (6)[3819] will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible.[3820] (However, I am unsure that there is a consensus about what it means to unexpectedly receive such an adjustment, allocation, or distribution.) Allocations of items of income and gain made pursuant to the qualified income offset are deemed to be made in accordance with the partners' interests in the partnership if the partnership determines and maintains capital accounts under Reg. § 1.704-1(b)(2)(iv)[3821] and liquidating distributions are made in accordance with the positive capital account balances of the partners, as determined after taking into account various capital account adjustments[3822] for the partnership taxable year during which such liquidation occurs.[3823] (Once a loss is allocated, the partner also needs to satisfy various other rules to deduct the loss.[3824])

Special allocation rules govern contributions of property and the income, gain, loss, and deductions associated with contributed property. Under Code § 704(c), a contributed property's income, gain, loss, and deductions[3825] are allocated to all partners to account for differences between the partnership's basis in the property and the fair market value of the property at the

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[3817] Reg. § 1.704-1(b)(2)(ii)(d)(4) provides for:

> Adjustments that, as of the end of such year, reasonably are expected to be made to such partner's capital account under paragraph (b)(2)(iv)(k) of this section for depletion allowances with respect to oil and gas properties of the partnership.

[3818] Reg. § 1.704-1(b)(2)(ii)(d)(5) provides for:

> Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to section 704(e)(2), section 706(d), and paragraph (b)(2)(ii) of § 1.751-1.

[3819] Reg. § 1.704-1(b)(2)(ii)(d)(6) provides for:

> Distributions that, as of the end of such year, reasonably are expected to be made to such partner to the extent they exceed offsetting increases to such partner's capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made (other than increases pursuant to a minimum gain chargeback under paragraph (b)(4)(iv)(e) of this section or under § 1.704-2(f); however, increases to a partner's capital account pursuant to a minimum gain chargeback requirement are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain.

[3820] Reg. § 1.704-1(b)(2)(ii)(d)(6).

[3821] Reg. § 1.704-1(b)(2)(ii)(b)(1).

[3822] Reg. § 1.704-1(b)(2)(ii)(b)(2).

[3823] Reg. § 1.704-1(b)(2)(ii)(d)(6).

[3824] See generally part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner.

[3825] Regarding book-tax depreciation differences, see Reg. §§ 1.704-1(b)(2)(iv)(g)(3) (book depreciation) and 1.704-3 (accounting for book-tax differences). Amoni and Schmalz, Section 704(c): The Disparity Offset Method Provides Answers to Difficult Questions, *Journal of Taxation* (WG&L), Vol. 114, No. 4 (Apr. 2011), suggests a way to apply the mechanics of existing regulations in this area. For the impact on allocating depreciation deductions and a basic overview of some tax planning flexibility on that issue, see Lawson, Using Curative and Remedial Allocations to Enhance the Tax Benefits of FLPs, 36 *Estate Planning*, No. 8, 12 (August 2009); however, note that remedial allocations might be attacked under Reg. § 1.701-2(b) or under Reg § 1.704-3(a)(1), the latter added by T.D. 9485 (6/8/2010). Note also that special allocations for book purposes might raise Code § 2701 issues, an issue that is not discussed in that article, which focuses on allocations for income tax purposes. See III.B.7.b Code § 2701 Overview, and III.B.7.c, Code § 2701 Interaction with Income Tax Planning, for a discussion of Code § 2701.

time of its contribution.[3826] This allocation ensures that the right person, the contributing partner, will realize any net pre-contribution gain or loss.[3827]

Except for personal property included in the same general asset account of the contributing partner and the partnership under Code § 168,[3828] personal property with a basis equal to zero,[3829] certain inventory,[3830] and a securities partnership making certain reverse-Code § 704(c) allocations[3831] to gains and losses from qualified financial assets,[3832] Code § 704(c) and Reg. § 1.704-3 apply on a property-by-property basis.[3833] A partnership may use different methods with respect to different items of contributed property, provided that the partnership and the partners consistently apply a single reasonable method for each item of contributed property and that the overall method or combination of methods are reasonable based on the facts and circumstances and consistent with the purpose of Code § 704(c).[3834] Using one method for appreciated property and another method for depreciated property may

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[3826] Code § 704(c)(1)(A).

[3827] The purpose of Code § 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Reg. § 1.704-3(a)(1), which further provides:

> Under section 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution. Notwithstanding any other provision of this section, the allocations must be made using a reasonable method that is consistent with the purpose of section 704(c). For this purpose, an allocation method includes the application of all of the rules of this section (*e.g.*, aggregation rules). An allocation method is not necessarily unreasonable merely because another allocation method would result in a higher aggregate tax liability. Paragraphs (b), (c), and (d) of this section describe allocation methods that are generally reasonable. Other methods may be reasonable in appropriate circumstances. Nevertheless, in the absence of specific published guidance, it is not reasonable to use an allocation method in which the basis of property contributed to the partnership is increased (or decreased) to reflect built-in gain (or loss), or a method under which the partnership creates tax allocations of income, gain, loss, or deduction independent of allocations affecting book capital accounts. See § 1.704-3(d). Paragraph (e) of this section contains special rules and exceptions. The principles of this paragraph (a)(1), together with the methods described in paragraphs (b), (c) and (d) of this section, apply only to contributions of property that are otherwise respected. See for example § 1.701-2. Accordingly, even though a partnership's allocation method may be described in the literal language of paragraphs (b), (c) or (d) of this section, based on the particular facts and circumstances, the Commissioner can recast the contribution as appropriate to avoid tax results inconsistent with the intent of subchapter K. One factor that may be considered by the Commissioner is the use of the remedial allocation method by related partners in which allocations of remedial items of income, gain, loss or deduction are made to one partner and the allocations of offsetting remedial items are made to a related partner.

[3828] Reg. § 1.704-3(e)(2)(i).

[3829] Reg. § 1.704-3(e)(2)(ii).

[3830] Reg. § 1.704-3(e)(2)(iii) excludes:

> For partnerships that do not use a specific identification method of accounting, each item of inventory, other than qualified financial assets (as defined in paragraph (e)(3)(ii) of this section.).

[3831] For a description of reverse-Code § 704(c) allocations of gain on sale, see part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, especially fns. 5444-5447.

[3832] See part II.P.1.a.i.(b) Special Rules for Allocations of Income in Securities Partnerships.

[3833] Reg. § 1.704-3(a)(2).

[3834] Reg. § 1.704-3(a)(2).

be unreasonable.[3835] A new partnership formed as the result of the termination of a partnership under Code § 708(b)(1)(B) is not required to use the same method as the terminated partnership with respect to Code § 704(c) property deemed contributed to the new partnership by the terminated partnership under Reg. § 1.708-1(b)(1)(iv).[3836]

Code § 704(c)(1)(B) prevents a partner from avoiding Code § 704(c) gain or loss by contributing property and having the partnership turn around and distribute it to another partner.[3837]

A partner cannot erase the Code § 704(c) taint by transferring the partner's interest to a third party. When a partnership interest is transferred, any tax attributes associated with the interest travel from the old partner to the new partner, and the new partner becomes the "contributing partner."[3838]

In addition to allocating gain or loss, Code § 704(c) also requires allocations of depreciation and amortization related to contributed property.

Partnerships may revalue assets for book purposes when certain events occur, so that partners' capital accounts better reflect the partners' economic interests at the time of those events. The events may include: [3839]

- a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership,
- the liquidation of the partnership,
- a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership, or
- the grant of an interest in the partnership (other than a de minimis interest), as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner.[3840]

When the partnership adjusts capital accounts to reflect such an event:[3841]

- The adjustments must be based on the fair market value of partnership property on the date of adjustment.
- The adjustments must reflect the manner in which the unrealized income, gain, loss, or deduction inherent in such property (that has not been reflected in the capital accounts

[3835] Reg. § 1.704-3(a)(2).
[3836] Reg. § 1.704-3(a)(2).
[3837] See part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.
[3838] Reg. § 1.704-4(d)(2).
[3839] Reg. § 1.704-1(b)(2)(iv)(f)(5). See part II.C.7 Maintaining Capital Accounts, especially fn. 507.
[3840] This last bullet point generally refers to the issuance of a profits interest, as discussed in II.M.1 Taxation on Formation of Entity: Comparison between Partnership and Corporation.
[3841] Reg. § 1.704-1(b)(2)(iv)(f), which is reproduced in fn. 507 in part II.C.7 Maintaining Capital Accounts.

previously) would be allocated among the partners if there were a taxable disposition of such property for such fair market value on that date.

- The partnership agreement must require that the partners' capital accounts be adjusted (as provided in regulations) for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property.

- The partnership agreement must require that the partners' distributive shares of depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to such property be determined so as to take account of the variation between the adjusted tax basis and book value of such property in the same manner as under Code § 704(c).

- The adjustments must be made principally for a substantial non-tax business purpose on account of one of the events described above.

When this revaluation occurs, book-tax differences arise, not necessarily because of the contribution of property, but rather because the book value of the partnership's property has changed. Allocating the responsibility for these new book-tax differences is called a reverse-Code § 704(c) allocation.[3842] Partnerships are not required to use the same allocation method for reverse-Code § 704(c) allocations as for contributed property, even if at the time of revaluation the property is already subject to Code § 704(c) and Reg. § 1.704-3(a).[3843] In addition, partnerships are not required to use the same allocation method for reverse-Code § 704(c) allocations each time the partnership revalues its property.[3844] A partnership that makes allocations with respect to revalued property must use a reasonable method that is consistent with the purposes of Code § 704(b), (c).[3845] A partnership making adjustments under Reg. § 1.743-1(b) or 1.751-1(a)(2) must use Reg. § 1.704-3 to account for built-in gain or loss under Code § 704(c).[3846] Special rules apply to such allocations when goodwill or similar assets

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[3842] Reg. § 1.704-3(a)(6)(i) provides:

> The principles of this section apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to § 1.704-1(b)(2)(iv)(f) or 1.704-1(b)(2)(iv)(s) (reverse section 704(c) allocations).

For a description of reverse-Code § 704(c) allocations of gain on sale, see part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, especially fns. 5444-5447.

[3843] Reg. § 1.704-3(a)(6)(i).

[3844] Reg. § 1.704-3(a)(6)(i).

[3845] Reg. § 1.704-3(a)(6)(i).

[3846] Reg. § 1.704-3(a)(6)(ii).

are being amortized.[3847] Beware that a book-up resulting from a revaluation may shift nonrecourse liabilities,[3848] which can generate income tax.[3849]

Reg. § 1.704-1(b)(1)(vii), "Bottom line allocations," provides:

> Section 704(b) and this paragraph are applicable to allocations of income, gain, loss, deduction, and credit, allocations of specific items of income, gain, loss, deduction, and credit, and allocations of partnership net or "bottom line" taxable income and loss. An allocation to a partner of a share of partnership net or "bottom line" taxable income or loss shall be treated as an allocation to such partner of the same share of each item of income, gain, loss, and deduction that is taken into account in computing such net or "bottom line" taxable income or loss. See example (15)(i) of paragraph (b)(5) of this section.

Reg. § 1.704-1(b)(5), Example (15)(i), provides:

> JB and DK form a limited partnership for the purpose of purchasing residential real estate to lease. JB, the limited partner, contributes $13,500, and DK, the general partner, contributes $1,500. The partnership, which uses the cash receipts and disbursements method of accounting, purchases a building for $100,000 (on leased land), incurring a recourse mortgage of $85,000 that requires the payment of interest only for a period of 3 years. The partnership agreement provides that partnership net taxable income and loss will be allocated 90 percent to JB and 10 percent to DK, the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances (as set forth in paragraph (b)(2)(ii)(b)(2) of this section), and JB is not required to restore any deficit balance in his capital account, but DK is so required. The partnership agreement contains a qualified income offset (as defined in paragraph (b)(2)(ii)(d) of this section). As of the end of each of the partnership's first 3 taxable years, the items described in paragraphs (b)(2)(ii)(d)(4), (5), and (6) of this section are not reasonably expected to cause or increase a deficit balance in JB's capital account: In the partnership's first taxable year, it has rental income of $10,000, operating expenses of $2,000, interest expense of $8,000, and cost recovery deductions of $12,000. Under the partnership agreement JB and DK are allocated $10,800 and $1,200, respectively, of the $12,000 net taxable loss incurred in the partnership's first taxable year.

[3847] Rev. Rul. 2004-49 held:

> If, pursuant to § 1.704-1(b)(2)(iv)(f), a partnership revalues a section 197 intangible that was amortizable in the hands of the partnership, then the § 197 anti-churning rules do not apply and the partnership may make reverse § 704(c) allocations (including curative and remedial allocations) of amortization to take into account the built-in gain or loss from the revaluation of the intangible. If the revalued section 197 intangible was not amortizable in the hands of the partnership, then the partnership may make remedial, but not traditional or curative, allocations of amortization to take into account the built-in gain or loss from the revaluation of the intangible, provided that such allocations are not limited by § 1.197-2(h)(12)(vii)(B).

[3848] See text preceding and accompanying fn 398 in part II.C.3.c Allocations of Recourse and Nonrecourse Liabilities.

[3849] See part II.C.3.a Basic Consequences of Changes in Liability Allocations.

	JB	DK
Capital account upon formation	$13,500	$1,500
Less year 1 net loss	(10,800)	(1,200)
Capital account at end of year 1	$ 2,700	$ 300

The alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section is satisfied as of the end of the partnership's first taxable year. Thus, the allocation made in the partnership's first taxable year has economic effect.

If one partner transfers a partnership interest to another person, the transferee receives the transferor's capital account. Also see part III.B.2.j.iii Allocations upon Change of Interest in a Partnership.

Because of very complicated estate and gift tax rules governing family businesses,[3850] generally family partnerships should be set up with one class of partnership interests. In other words, each partner's capital account is proportionate to that partner's percentage in interest in profits and losses.[3851] However, businesses not involving family members can be more flexible, allocating different tiers of income as rewards for each partner's relative contributions of capital or services. In any event, the tax allocations need to be consistent with the economic arrangements; the tax jargon is that tax allocations must have a "substantial economic effect."

Whether the partnership has one or multiple classes of equity, issues arise when a partner contributes property whose value exceeds its basis. This excess value is known as Code § 704(c) responsibility. When contributed property is subjected to depreciation or amortization or is later sold, the contributing partner receives a special allocation to properly take into account that partner's Code § 704(c) responsibility. Beware if the contribution and corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the direct and indirect partners' aggregate tax liability.[3852]

Hedge funds are complicated partnership tax structures.[3853]

II.P.1.a.i.(b). Special Rules for Allocations of Income in Securities Partnerships

Below is a discussion about allocating income in securities partnerships. This discussion focuses on a subset of allocations described in part II.P.1.a.i.(a) General Rules for Allocations of Income in Partnerships, which upon any distribution from a partnership may have the tax consequences described in part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not

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[3850] See parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.
[3851] See part III.B.7.b.ii Certain Exclusions from Code § 2701, fns. 7315-7316.
[3852] Reg. § 1.704-3(a)(10), added by T.D. 9485 (6/8/2010). For the regulation's text, see fn. 3860 in part II.P.1.a.i.(b) Special Rules for Allocations of Income in Securities Partnerships.
[3853] Miller and Bertrand, "Federal Income Tax Treatment of Hedge Funds, Their Investors, and Their Managers," *Tax Lawyer*, pp. 309-397, Vol. 65, No. 2 (Winter 2002).

Equal to Fair Market Value. If securities partnerships have money flowing and out, they should consider not only those rules but also the rules described in parts II.M.3.e Exception: Disguised Sale (exception to the general idea that the formation of a partnership is not a taxable event) and II.Q.8.b.i.(c) Disguised Sale from Partnership to Partner, as well concerns that distributions of securities from a partnership to a partner may be treated as cash distributions, as described in part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them). The disguised sale rules generally look to entrepreneurial risk, and the risk of disguised sales from a partnership with many investors may be smaller than that with many investors; however, in any event, a contribution of cash or property and a distribution of cash or property that occur within two years tends to trigger a disguised sale reporting requirement, even if the transaction does not constitute a disguised sale.[3854]

Reverse-Code § 704(c) responsibility means tracking the built-in gain or loss of the partnership's property when partnership interests change (which is common when a new partner is admitted to an existing partnership).[3855]

Tracking Code § 704(c) and reverse-Code § 704(c) responsibility often is administratively cumbersome. Rev. Proc. 2007-59, § 2 points out:

> .01. To prevent the shifting of tax consequences among partners with respect to precontribution gain or loss, section 704(c) requires partnerships to allocate income, gain, loss, and deductions with respect to property contributed by a partner so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of the contribution. These allocations must be made using a reasonable method that is consistent with the purpose of section 704(c). Section 1.704-3(a)(6) provides that similar rules apply to differences between book value and tax basis that are created by a revaluation of partnership assets pursuant to § 1.704-1(b)(2)(iv)(f) (reverse section 704(c) allocations).
>
> .02. Section 1.704-3(a)(2) provides that section 704(c) allocations are generally made on a property-by-property basis. Therefore, built-in gains and losses from different items of contributed or revalued property generally cannot be aggregated.

See part II.C.7 Maintaining Capital Accounts, especially fn. 507 (quoting the regulation governing revaluations).

For purposes of making reverse-Code § 704(c) allocations, a securities partnership may aggregate gains and losses from qualified financial assets using any reasonable approach that is consistent with the purpose of Code § 704(c).[3856] Once a partnership adopts an aggregate approach, that partnership must apply the same aggregate approach to all of its qualified financial assets for all taxable years in which the partnership qualifies as a securities partnership.[3857] Further below are approaches for aggregating reverse-Code § 704(c) gains and

[3854] See part II.M.3.e.i.(c) Disclosure Requirements, incorporated by reference by parts II.M.3.e Exception: Disguised Sale and II.Q.8.b.i.(c) Disguised Sale from Partnership to Partner.
[3855] For a description of reverse-Code § 704(c) allocations of gain on sale, see part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, especially fns. 5444-5447.
[3856] Reg. § 1.704-3(e)(3)(i).
[3857] Reg. § 1.704-3(e)(3)(i), expressly overriding Reg. § 1.704-3(a)(2) and (a)(6)(i).

losses that are generally reasonable.[3858] Other approaches may be reasonable in appropriate circumstances.[3859] In some circumstances, various Code § 704(c) methods, including the aggregate approaches described further below, are not reasonable.[3860] A partnership using an aggregate approach must separately account for any built-in gain or loss from contributed property.[3861]

When getting into details on the two aggregate approaches below, one finds that they limit the assets that can be aggregated and require one to go to an asset-by-asset approach if one later fails to qualify. Consider using one of the approaches without formally adopting it. For example, one might use an aggregate approach in practice for marketable securities and an asset-by-asset approach for unmarketable assets. Given that Reg. § 1.704-3(e)(3)(i) permits using any reasonable approach and given that the IRS views an aggregate approach as reasonable for marketable securities (or it would not have provided it), such a hybrid approach would seem to allow one to comply with the regulations without hamstringing one with the artificial rules that are imposed on using an aggregate method as a safe harbor. As a practical matter, given that using an aggregate method is intended as a reasonable shortcut to avoid laborious asset-by-asset tracking, an IRS examiner might need to do laborious asset-by-asset tracking to show that this method is unreasonable, going into such an ordeal with no reason to believe it would be productive.

A "qualified financial asset" is any personal property (including stock) that is actively traded.[3862] For a management company, it includes various additional assets, even if not actively

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[3858] Reg. § 1.704-3(e)(3)(i), referring to Reg. § 1.704-3(e)(3)(iv) and (v).
[3859] Reg. § 1.704-3(e)(3)(i).
[3860] Reg. § 1.704-3(e)(3)(i), referring to Reg. § 1.704-3(a)(10), titled, "Anti-abuse rule," which provides:

> (i) *In general*. An allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability. For purposes of this paragraph (a)(10), all references to the partners shall include both direct and indirect partners.
>
> (ii) *Definition of indirect partner*. An indirect partner is any direct or indirect owner of a partnership, S corporation, or controlled foreign corporation (as defined in section 957(a) or 953(c)), or direct or indirect beneficiary of a trust or estate, that is a partner in the partnership, and any consolidated group of which the partner in the partnership is a member (within the meaning of § 1.1502-1(h))…. [The rest provides details on controlled foreign corporations and Code § 951(a).]

[3861] Reg. § 1.704-3(e)(3)(i).
[3862] Reg. § 1.704-3(e)(3)(ii)(A), which continues:

> Actively traded means actively traded as defined in § 1.1092(d)-1 (defining actively traded property for purposes of the straddle rules).

Reg. § 1.1092(d)-1(a) provides:

> *Actively traded*. Actively traded personal property includes any personal property for which there is an established financial market.

Reg. § 1.1092(d)-1(b)(1) provides:

> *In general*. For purposes of this section, an established financial market includes—
>
> (i) A national securities exchange that is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f);
>
> (ii) An interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Exchange Act of 1934;

traded.[3863] A "qualified financial asset" does not include a partnership interest, but a partnership (upper-tier partnership) that holds an interest in a securities partnership (lower-tier partnership) must take into account the lower-tier partnership's assets and qualified financial assets.[3864]

A partnership is a securities partnership if the partnership is either a management company that is registered with the SEC[3865] or an investment partnership, and the partnership makes all of its book allocations in proportion to the partners' relative book capital accounts (except for reasonable special allocations to a partner that provides management services or investment advisory services to the partnership).[3866] A partnership is an investment partnership if:[3867]

(i) On the date of each capital account restatement, the partnership holds qualified financial assets that constitute at least 90% of the fair market value of the partnership's non-cash assets; and

(ii) The partnership reasonably expects, as of the end of the first taxable year in which the partnership adopts an aggregate approach under Reg. § 1.704-3(e)(3), to make revaluations at least annually.

A partnership that establishes appropriate accounts for each partner for the purpose of taking into account each partner's share of the book gains and losses and determining each partner's

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(iii) A domestic board of trade designated as a contract market by the Commodities Futures Trading Commission;
(iv) A foreign securities exchange or board of trade that satisfies analogous regulatory requirements under the law of the jurisdiction in which it is organized (such as the London International Financial Futures Exchange, the Marche a Terme International de France, the International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited, the Frankfurt Stock Exchange, and the Tokyo Stock Exchange);
(v) An interbank market;
(vi) An interdealer market (as defined in paragraph (b)(2)(i) of this section); and
(vii) Solely with respect to a debt instrument, a debt market (as defined in paragraph (b)(2)(ii) of this section).

Reg. § 1.1092(d)-1(b)(2) defines various terms above. Reg. § 1.1092(d)-1(c) discusses notional principal contracts, and Reg. § 1.1092(d)-1(d) discusses debt linked to the value of personal property and may be part pf a straddle.

[3863] Reg. § 1.704-3(e)(3)(ii)(B), which lists those additional assets as:
notes, bonds, debentures, or other evidences of indebtedness; interest rate, currency, or equity notional principal contracts; evidences of an interest in, or derivative financial instruments in, any security, currency, or commodity, including any option, forward or futures contract, or short position; or any similar financial instrument.

[3864] Reg. § 1.704-3(e)(3)(ii)(C), which continues:
(1) In determining whether the upper-tier partnership qualifies as an investment partnership, the upper-tier partnership must treat its proportionate share of the lower-tier securities partnership's assets as assets of the upper-tier partnership; and
(2) If the upper-tier partnership adopts an aggregate approach under this paragraph (e)(3), the upper-tier partnership must aggregate the gains and losses from its directly held qualified financial assets with its distributive share of the gains and losses from the qualified financial assets of the lower-tier securities partnership.

[3865] Reg. § 1.704-3(e)(3)(iii)(B)(1), provides:
Management company. A partnership is a management company if it is registered with the Securities and Exchange Commission as a management company under the Investment Company Act of 1940, as amended (15 U.S.C. 80a).

[3866] Reg. § 1.704-3(e)(3)(iii)(A).

[3867] Reg. § 1.704-3(e)(3)(iii)(B)(2).

share of the tax gains and losses may adopt the partial netting approach of making reverse-Code § 704(c) allocations.[3868] Reg. § 1.704-3(e)(3)(iv) further provides:

> Under the partial netting approach, on the date of each capital account restatement, the partnership:
>
> (A) Nets its book gains and book losses from qualified financial assets since the last capital account restatement and allocates the net amount to its partners;
>
> (B) Separately aggregates all tax gains and all tax losses from qualified financial assets since the last capital account restatement; and
>
> (C) Separately allocates the aggregate tax gain and aggregate tax loss to the partners in a manner that reduces the disparity between the book capital account balances and the tax capital account balances (book-tax disparities) of the individual partners.

Reg. § 1.704-3(e)(3)(ix), Example (1), illustrates the following under the partial netting approach:

- Each partner has a single revaluation account that shows a net positive or negative book-tax difference.

- Recognized gains and recognized losses are accounted for separately in each of the next two bullet points.

- Recognized gains are allocated only to the partners with positive revaluation accounts, until the positive accounts are exhausted. After that, recognized gains are allocated in proportion to partnership interests.

- Recognized losses are allocated only to the partners with negative revaluation accounts, until the negative accounts are exhausted. After that, recognized losses are allocated in proportion to partnership interests.

A partnership that establishes appropriate accounts for each partner for the purpose of taking into account each partner's share of the book gains and losses and determining each partner's share of the tax gains and losses may also adopt the full netting approach of making reverse-Code § 704(c) allocations.[3869] Reg. § 1.704-3(e)(3)(v) further provides:

> Under the full netting approach, on the date of each capital account restatement, the partnership:
>
> (A) Nets its book gains and book losses from qualified financial assets since the last capital account restatement and allocates the net amount to its partners;

[3868] Reg. § 1.704-3(e)(3)(iv). Letter Ruling 201421001 (described more fully in fn. 372 in part II.B Limited Liability Company (LLC)) approved separate partnerships investing in equities or in fixed income funds using this method to track not only Code § 704(c) allocations but also reverse-Code § 704(c) allocations:

> provided that a contribution or revaluation of property and the corresponding allocation of tax items with respect to the property are not made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

[3869] Reg. § 1.704-3(e)(3)(v).

(B) Nets tax gains and tax losses from qualified financial assets since the last capital account restatement; and

(C) Allocates the net tax gain (or net tax loss) to the partners in a manner that reduces the book-tax disparities of the individual partners.

The character and other tax attributes of gain or loss allocated to the partners under these approaches must:[3870]

(A) Preserve the tax attributes of each item of gain or loss realized by the partnership;

(B) Be determined under an approach that is consistently applied; and

(C) Not be determined with a view to reducing substantially the present value of the partners' aggregate tax liability.

Reg. § 1.704-3(e)(3)(ix), Example (2), illustrates the following under the full netting approach:

- Each partner has a single revaluation account that shows a net positive or negative book-tax difference.

- Recognized gains and losses are netted against each other.

- If the net is a gain, then this net recognized gains in allocated only to the partners with positive revaluation accounts, until the positive accounts are exhausted. After that, the recognized gain is allocated in proportion to partnership interests.

- If the net is a loss, then the recognized loss is allocated only to the partners with negative revaluation accounts, until the negative accounts are exhausted. After that, the recognized loss is allocated in proportion to partnership interests.

If a securities partnership adopts an aggregate approach under these rules and later fails to qualify as a securities partnership, it must make reverse-Code § 704(c) allocations on an asset-by-asset basis after the date of disqualification.[3871] However, it is not required to disaggregate the book gain or book loss from qualified asset revaluations before the date of disqualification when making reverse-Code § 704(c) allocations on or after the date of disqualification.[3872] A securities partnership revaluing its qualified financial assets pursuant to Reg. § 1.704-1(b)(2)(iv)(f) on or after the effective date of these rules may use any reasonable approach to coordinate with revaluations that occurred before these rules' effective date.[3873]

The IRS may, by published guidance or by letter ruling, permit aggregation of properties other than those described above, partnerships and partners not described above to aggregate gain and loss from qualified financial assets, and aggregation of qualified financial assets for purposes of making Code § 704(c) allocations in the same manner as that described above.[3874]

[3870] Reg. § 1.704-3(e)(3)(vi).
[3871] Reg. § 1.704-3(e)(3)(vii).
[3872] Reg. § 1.704-3(e)(3)(vii).
[3873] Reg. § 1.704-3(e)(3)(viii).
[3874] Reg. § 1.704-3(e)(4).

Letter Rulings have approved:

- Two separate partnerships, one holding equities and another holding fixed income, created on trust termination.[3875]

[3875] In Letter Ruling 201421001, a trust used two series LLCs – one invested in equities (X) and the other in fixed income securities (Y) – to distribute its investment assets to remaindermen. The IRS ruled:

(1) Before the distribution of interests in X and Y to the remainder beneficiaries, X and Y will be disregarded entities as long as they remain single member series of a single-member limited liability company (wholly-owned by trust) and items of income, deduction, credit, gains and losses with respect to assets held within X and Y should be reported directly on the trust's federal income tax returns (as if Trust continued to hold X and Y assets directly).

(2) Upon the distribution of interests in X and Y to the remainder beneficiaries, X and Y will be converted from disregarded entities to partnerships for federal tax purposes, and distribution of X and Y interests by the trust shall be treated as (i) a non-taxable pro rata distribution of X and Y assets (subject to any related liabilities) to the remainder beneficiaries (in accordance with the fractional share of Trust residue to which each remainder beneficiary, respectively, is entitled), as if such assets had been distributed outright from Trust to the remainder beneficiaries; followed by (ii) a deemed capital contribution of those same assets by the remainder beneficiaries to X and Y in a non-taxable exchange for interests in X and Y.

(3) Once X and Y become partnerships for federal tax purposes, to avoid taxation under Code § 721(b) any later in-kind trust distribution of a diversified portfolio of stocks and securities that is transferred as an addition to X or Y on behalf of some or all remainder beneficiaries who hold or thereby acquire membership interests in X or Y shall be treated as: (i) a non-taxable pro rata distribution of such trust assets (subject to any related liabilities) to the remainder beneficiaries holding or thereby acquiring membership interests in X or Y (in accordance with the proportionate fractional share of the trust residue to which each remainder beneficiary, respectively, is entitled), as if such assets had been distributed outright from the trust to such remainder beneficiaries; followed by (ii) a deemed capital contribution of those same assets by such remainder beneficiaries to X or Y in a non-taxable exchange for membership interests in X or Y. See part II.M.3 Buying into or Forming a Partnership.

(4) X's and Y's use of the partial netting approach as defined in Reg. § 1.704-3(e)(3)(iv) for aggregating gains and losses from qualified financial assets for the purpose of making reverse-Code § 704(c) allocations is reasonable within the meaning of Reg. § 1.704-3(e)(3).[3875]

(5) X and Y have permission to aggregate built-in gains and losses from qualified financial assets contributed to X and Y by a partner with built-in gains and built-in losses from revaluations of qualified financial assets held by X and Y for purposes of making allocations under Code § 704(c)(1)(A) and Reg. § 1.704-3(a)(6). See parts II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, especially fns. 5444-5447 (describing reverse-Code § 704(c) allocations, which is where a partner makes a disproportionate contribution or receives a disproportionate distribution when the partner has assets with values not equal to basis, which book-tax difference needs to be accounted for) and II.P.1.a.i.(b) Special Rules for Allocations of Income in Securities Partnerships.

(6) After X and Y become partnerships for federal tax purposes, in-kind distributions of qualified financial assets from X and Y to one or more of its members will not be deemed a distribution of money under Code § 731(c). As a result, an in-kind distribution will not be treated as a "sale or exchange" and the distributee member should not recognize any gain or loss in connection therewith. Further, both (i) the "aggregate built-in gain or loss" at the partnership level, and (ii) the portion of such "aggregate built-in gain or loss" allocable to the partner receiving such distribution, may be adjusted by the full amount of net unrealized gain or loss in the assets so distributed.

See part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions. For rules on revaluing capital accounts on certain events, see part II.C.7 Maintaining Capital Accounts, especially fn. 507.

- Partnerships between a voluntary employees' beneficiary association (VEBA) and plans providing for pension and welfare benefits of a common employer and its current and former subsidiaries.[3876]

- A partnership was allowed to apply this rule to Code § 704(c) allocations when applying the usual Code § 704(c) rules would have been two cumbersome, if a contribution or revaluation of the property and the corresponding allocation of tax items with respect to the property are not made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.[3877]

- Use of the partial netting approach when three partnerships merged.[3878]

Rev. Proc. 2007-59 allows certain partnerships to aggregate gains and losses from an expanded class of qualified financial assets in applying the above rules. It provides special rules for a "Qualified Partnership," which is a partnership that satisfies the following requirements:[3879]

(1) the partnership makes all of its book allocations in proportion to the partners' relative book capital accounts (except for reasonable special allocations to a partner that provides management services or investment advisory services to the partnership);

[3876] Letter Rulings 201028016 and 201028017.
[3877] Letter Ruling 201032003.
[3878] Letter Ruling 201710008 held:

> … Surviving Partnership's use of the partial netting approach for making reverse § 704(c) allocations is a reasonable approach within the meaning of § 1.704-3(e)(3), provided that a contribution or revaluation of property and the corresponding allocation of tax items with respect to the property are not made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability….
>
> … if Surviving Partnership uses the partial netting approach to make § 704(c) allocations, including reverse § 704(c) allocations, this will be a reasonable method within the meaning of § 1.704-3(a)(1), and is permitted by the Commissioner under § 1.704-3(e)(4)(iii), provided that a contribution or revaluation of property and the corresponding allocation of tax items with respect to the property are not made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.
>
> This ruling is limited to allocations of gain or loss from the sale or other disposition of qualified financial assets made under § 704(b), § 704(c)(1)(A), and § 1.704-3(a)(6). Specifically, no opinion is expressed concerning allocations of items other than items of gain or loss from the sale or other disposition of qualified financial assets, or the aggregation of built-in gains and losses from qualified financial assets contributed to Surviving Partnership by any person other than Terminating Partnership A and Terminating Partnership B. Surviving Partnership must maintain sufficient records to enable it and its partners to comply with § 704(c)(1)(B) and § 737. Additionally, this ruling applies only to the contributions to Surviving Partnership made in connection with the mergers of Terminating Partnership A and Terminating Partnership B into Surviving Partnership and not to any other contributions or any other future partner.

Letter Ruling 201710007 seemed to be the same as Letter Ruling 201710008.
[3879] § 3.01.

(2) the partnership reasonably expects, as of the end of the first taxable year in which the partnership adopts an aggregate approach under this revenue procedure, to make revaluations of qualified financial assets at least four times annually;

(3) on the date of each capital account restatement during the taxable year, the partnership holds qualified financial assets that constitute at least 90 percent of the partnership's non-cash assets;

(4) the partnership reasonably expects, as of the first day of each taxable year for which the partnership seeks to aggregate under this revenue procedure, that the partnership

(a) will have at least 10 unrelated partners at all times during the taxable year; and

(b) will make at least 200 trades of qualified financial assets during the taxable year, the aggregate value of which will comprise at least 50% of the book value of the partnership's assets (including cash) as of the first day of the taxable year; and

(5) the application of the aggregation method to reverse section 704(c) allocations under this revenue procedure is not made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

In applying the above definition, "partners are treated as related if they are related within the meaning of sections 267(b)[3880] or 707(b)."[3881]

In applying Rev. Proc. 2007-59, "qualified financial assets" are:[3882]

(1) those assets described in § 1.704-3(e)(3)(ii)(A) and (B);

(2) any interest in a partnership that is traded on an established securities market or readily tradable on a secondary market or the substantial equivalent thereof within the meaning of § 1.7704-1(c); and

(3) any interest owned by the partnership (the upper-tier partnership) in a partnership (the lower-tier partnership) that represents it is a securities partnership or a Qualified Partnership, provided that such interest is

(i) less than 10 percent of the capital and profits of the lower-tier partnership and that the upper-tier partnership does not actively or materially participate in the management or operations of the lower-tier partnership; and

(ii) less than 5 percent of the total book value of the upper-tier partnership's assets (including cash) as of the first day of the taxable year.

[3880] Code § 267(b) is reproduced in part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses.
[3881] § 3.01. For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.
[3882] § 3.02.

Rev. Proc. 2007-59 grants permission to any Qualified Partnership to aggregate built-in gains and losses from qualified financial assets for purposes of making reverse-Code § 704(c) allocations under Reg. § 1.704-3(e)(3).[3883] Once a partnership adopts an aggregate approach under this revenue procedure, that partnership must apply the same aggregate approach to all of its qualified financial assets for all taxable years in which the partnership qualifies as a Qualified Partnership.[3884] However, a partnership may choose not to aggregate all of the partnership's qualified financial assets if such qualified assets do not exceed in the aggregate 30% of the book value of the partnership's non-cash assets at the time any such qualified financial assets is acquired.[3885]

A Qualified Partnership that adopts an aggregate approach under Rev. Proc. 2007-59 and later fails to qualify as a Qualified Partnership must make reverse-Code § 704(c) allocations on an asset-by-asset basis after the date of disqualification.[3886] The partnership, however, is not required to disaggregate the book gain or book loss from qualified asset revaluations before the date of disqualification when making reverse-Code § 704(c) allocations on or after the date of disqualification.[3887]

Rev. Proc. 2001-36 grants automatic permission for certain securities partnerships to aggregate contributed property for purposes of making Code § 704(c) allocations.[3888] Rev. Proc. 2001-36[3889] provides that a Qualified Master-Feeder Structure (QMFS) may "aggregate built-in gains and losses from contributed qualified financial assets for purposes of making section 704(c) and reverse section 704(c) allocations."[3890] Section 4.02 provides:

[3883] § 4.01.
[3884] § 4.01, citing Reg. § 1.704-3(e)(3)(i).
[3885] § 4.01.
[3886] § 4.02.
[3887] § 4.02.
[3888] It also described the information that must be included with ruling requests for permission to aggregate contributed property for purposes of making Code § 704(c) allocations submitted by partnerships that do not qualify for automatic permission, but Rev. Proc. 2002-3, § 6.06, titled "Section 704(c)," superseded that part, providing that private letter rulings will not ordinarily be issued regarding:

> Contributed Property-Requests from Qualified Master-Feeder Structures, as described in section 4.02 of Rev. Proc. 2001-36, 2001-23 I.R.B. 1326, for permission to aggregate built-in gains and losses from contributed qualified financial assets for purposes of making § 704(c) and reverse § 704(c) allocations.

[3889] §§ 2.07 and 2.08 describe the Rev. Proc.'s purpose:

> .07. In a typical Master-Feeder Structure, two or more Feeder Funds or one or more Feeder Funds and an investment advisor, principal underwriter, or manager contribute their assets, consisting primarily of cash or financial investments, to a single Master Portfolio in exchange for beneficial interests in the Master Portfolio. In these cases, each Feeder Fund and the Master Portfolio is registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (1940 Act). The shares of these Feeder Funds are typically publicly offered and widely held by individuals, corporations, and institutional investors. Generally, each Feeder Fund is an open-end mutual fund, which continuously offers to sell new shares or redeem existing shares for a price equal to the net asset value of their proportionate interest in the portfolio.
>
> .08. The IRS and Treasury Department have determined that it is in the best interest of sound tax administration to reduce the burden on taxpayers of submitting ruling requests by granting to certain Master-Feeder Structures automatic permission to aggregate built-in gains and losses from contributed securities.

[3890] § 4.01.

A QMFS is created where two or more investors contribute cash or qualified financial assets to a Master Portfolio in exchange for beneficial interests in the Master Portfolio. To qualify as a QMFS, the following requirements must be met:

(1) Each partner in the Master Portfolio is a Feeder Fund, or an investment advisor, principal underwriter, or manager of the Master Portfolio;

(2) Each Feeder Fund contributes only cash and/or a portfolio of diversified stocks and securities that satisfies the 25 and 50 percent tests of section 368(a)(2)(F)(ii) in exchange for beneficial interests in the Master Portfolio;

(3) Each partner in the Master Portfolio that is an investment advisor, principal underwriter, or manager, contributes only cash and/or services in exchange for beneficial interests in the Master Portfolio;

(4) The Master Portfolio is treated as a partnership for federal tax purposes and qualifies as a securities partnership under section 1.704-3(e)(3)(iii);

(5) Each Feeder Fund is a publicly offered regulated investment company, as defined in section 67(c)(2)(B) and section 1.67-2T(g)(3)(iii);

(6) The Master Portfolio is registered as an investment company under the 1940 Act.

(7) The Master Portfolio makes section 704(c) and reverse section 704(c) allocations under the partial netting approach or the full netting approach as described in section 1.704-3(e)(3)(iv) or section 1.704-3(e)(3)(v), respectively, and;

(8) The contributions to the Master Portfolio and the corresponding allocations of tax items with respect to the property contributed to the Master Portfolio are not made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

II.P.1.b. Allocations of Income in S Corporations

As described further below, S corporations generally must have a single class of stock. Income is always allocated in proportion to stock ownership.[3891] Special allocations of profits are not permitted, and Code § 704(c) responsibility does not exist. However, trusts cannot use the Code § 179 expensing of equipment, etc., so if the corporation reports Code § 179 expense and has a nongrantor trust shareholder then the corporation will need to separately track as an asset the trust's share of Code § 179 expense and specially allocate to the trust depreciation from that asset.[3892]

Also described further below are ways to creatively compensate employees, providing incentive that is the same as, or similar to, the results one can attain from partnerships.

[3891] Code § 1377(a)(1). For allocations of income when ownership changes, see part III.B.2.j Tax Allocations upon Change of Interest, particularly III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.
[3892] See part II.J.11.a.i Code § 179 Disallowance for Estate or Nongrantor Trust.

S corporations are superior to C corporations in that undistributed S corporation income adds to the basis of the shareholders' stock.

Also see part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

II.P.1.c. Schedules K-2 and K-3 for Pass-Throughs

IRS resources include:

- Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865) | Internal Revenue Service (irs.gov)

- Schedules K-2 and K-3: Interim Electronic Filing for Tax Year 2021 | Internal Revenue Service (irs.gov)

- Notice 2021-39, Transition Period Penalty Relief for New Schedules K-2 and K-3 for Forms 1065, 1120-S and 8865

AICPA resources are at IRS Schedules K-2 and K-3 guidance and resources | AICPA (aicpa-cima.com).

II.P.1.d. Advantages of C and S Corporation Reporting of Owners' Compensation on Forms W-2

C and S corporations must withhold taxes and file quarterly forms 941 and annual Forms W-2 for owners' compensation, whereas partnerships and sole proprietorships are not involved in withholding taxes regarding owner compensation.

Timely filing Forms W-2 helps support the 20% deduction for qualified business income ("QBI") for owners of partnerships,[3893] but W-2 income itself does not constitute QBI.[3894]

Filing W-2 forms for owners provides some minor benefits:

(a) Unless the employee elects otherwise, federal income tax withheld is deemed paid evenly throughout the year. If the owner falls behind during the year, the owner may withhold large amounts at year-end, which generally will be deemed paid evenly throughout the year.

(b) Qualified retirement plans have a cap on compensation that can be considered in allocating contributions to the plans. Owners of corporations could adjust their W-2 income to reduce their compensation in good years and increase it in bad years to plan around this cap. Partners and sole proprietors do not have this flexibility. Of course, all businesses on the cash basis could delay or accelerate billings or disbursements.

(c) Providing a better base for the special deduction for domestic manufacturing.[3895]

[3893] See part II.E.1.c.vi.(a) W-2 wages under Code § 199A.
[3894] See parts II.E.1.c.ii.(b) Trade or Business of Being an Employee (Excluded from QBI) and II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.
[3895] Note the W-2 limitation mentioned in part II.G.25 Code § 199 Deduction for Domestic Production Activities especially fn. 1898.

II.P.2. C Corporation Advantage Regarding Fringe Benefits

Only a C corporation may deduct the following items without including them in the recipient's income:

(a) Dependent care (child care) assistance payments for owners subject to a dollar cap (generally $5,000).

(b) The owners' meals and lodging for the employer's convenience without including them in the owner's income.[3896]

(c) Non-discriminatory premiums for up to $50,000 in group-term life insurance covering the owners without including them in the owner's income.[3897]

Partners' fringe benefits are summarized by McKee, Nelson & Whitmire;[3898] RIA has prepared summaries of fringe benefits that partners and S corporation shareholders can and cannot claim.[3899] Any partner who performs services for a partnership is considered employed by the

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[3896] Code § 119. See Campbell and Mitchell, The Exclusion for Meals and Lodging, *The Tax Adviser* (April 2015) (also discussing the partnership issue described below), saved as doc. no. 6206076. However, this exclusion might apply beyond the C corporation context. See McKee, Nelson & Whitmire, ¶14.02. Partners Acting in Nonpartner Capacities: Section 707(a) Transactions, *Federal Taxation of Partnerships & Partners* (WG&L), citing a Fifth Circuit case looking with favor on the Code § 119 exclusion for a partner:

> *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968) (remanding for determination whether partner was in fact employee of his partnership, and therefore entitled to exclude under § 119 value of meals and lodging furnished by the partnership). *Contra Wilson v. United States*, 376 F.2d 280 (Ct. Cl. 1967). The courts generally applied aggregate principles under the 1939 Code. See *Commissioner v. Doak*, 234 F.2d 704 (4th Cir. 1956) (partner may not be employee of his partnership); *Commissioner v. Moran*, 236 F.2d 595 (8th Cir. 1956) (same); *Commissioner v. Robinson*, 273 F.2d 503 (3d Cir. 1959) (cert. denied) (same); Rev. Rul. 53-80, 1953-1 CB 62 (same). See also *George A. Papineau*, 16 T.C. 130 (1951) (nonacq.); Tech. Adv. Mem. 9134003 (May 6, 1991) (incorporation of farming business; shareholder/employees claim benefits of § 119; § 269 not applicable because same benefits available if partnership had been formed). But *cf. Dilts v. United States*, 845 F.Supp. 1505 (D. Wyo. 1994) (§ 119 not available to shareholders of family-owned S corporation; result of *Armstrong v. Phinney* justified on grounds that taxpayer only 5 percent partner).

For more on *Armstrong v. Phinney* and when a partner may be considered as being compensated for services not in his or her capacity as a partner under Code § 707(a)(2), as contrasted as compensation for services rendered in his or her capacity as a partner under Code § 707(c), see fns. 551, 528 in part III.B.7.c.viii Creative Bonus Arrangements. Reg. § 1.707-1(c) provides that "partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d)."

[3897] The arrangement must truly be group term and not some bundled package of various separate life insurance policies. See part II.Q.4.f Split-Dollar Arrangements, especially fn. 4447.

[3898] Federal Taxation of Partnerships & Partners (WG&L), ¶2.04 Qualified Plans and Other Fringe Benefits.

[3899] See "Fringe benefits partners and more-than-2% S shareholder employees can and can't claim," *Federal Taxes Weekly Alert Newsletter* (RIA) (5/25/2017) and *Pension & Benefits Week Newsletter* (RIA) (7/3/2017), the latter saved as Thompson Coburn doc. no. 6591733. See also part II.P.1.d Advantages of C and S Corporation Reporting of Owners' Compensation on Forms W-2. For a discussion of "fringe benefits" under Code § 1372, applying partnership rules to those owning at least 2% of an S corporation, see text accompanying fn 4472 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit **Arrangement under Reg. § 1.61-22**, describing a unanimous Tax Court reviewed opinion.

partnership for purposes of Code § 132(a)(1) (relating to no-additional-cost services) and Code § 132(a)(2) (relating to qualified employee discounts),[3900] as well as Code § 132(a)(3) (relating to working condition fringes)[3901] and Code § 132(h)(5) (relating to on-premises athletic facilities).[3902] Partners are eligible for educational assistance programs under Code § 127.[3903] Qualified transportation fringe benefits under Code § 132(f) are available to partners only if they are entirely below the limits for the working condition and de minimis fringe exclusions under Code § 132(a)(3), (4).[3904]

Code § 162(*l*), "Special rules for health insurance costs of self-employed individuals," provides:

(1) *Allowance of deduction*. In the case of a taxpayer who is an employee within the meaning of section 401(c)(1) , there shall be allowed as a deduction under this section an amount equal to the amount paid during the taxable year for insurance which constitutes medical care for -

(A) the taxpayer,

(B) the taxpayer's spouse,

(C) the taxpayer's dependents, and

(D) any child (as defined in section 152(f)(1)) of the taxpayer who as of the end of the taxable year has not attained age 27.

(2) *Limitations*.

(A) *Dollar amount*. No deduction shall be allowed under paragraph (1) to the extent that the amount of such deduction exceeds the taxpayer's earned income (within the meaning of section 401(c)) derived by the taxpayer from the trade or business with respect to which the plan providing the medical care coverage is established.

(B) *Other coverage*. Paragraph (1) shall not apply to any taxpayer for any calendar month for which the taxpayer is eligible to participate in any subsidized health plan maintained by any employer of the taxpayer or of the spouse of, or any dependent, or individual described in subparagraph (d) of paragraph (1) with respect to, the taxpayer. The preceding sentence shall be applied separately with respect to -

(i) plans which include coverage for qualified long-term care services (as defined in section 7702B(c)) or are qualified long-term care insurance contracts (as defined in section 7702B(b)), and

(ii) plans which do not include such coverage and are not such contracts.

[3900] Reg. § 1.132-1(b)(1).
[3901] Reg. § 1.132-1(b)(2)(ii).
[3902] Reg. § 1.132-1(b)(3).
[3903] Code § 127(c)(2), (3).
[3904] Reg. § 1.132-9, A-24 (adopted in 2001 and amended in 2006); see Notice 94-3, Q-5(b).

(C) *Long-term care premiums*. In the case of a qualified long-term care insurance contract (as defined in section 7702B(b)), only eligible long-term care premiums (as defined in section 213(d)(10)) shall be taken into account under paragraph (1).

(3) *Coordination with medical deduction*. Any amount paid by a taxpayer for insurance to which paragraph (1) applies shall not be taken into account in computing the amount allowable to the taxpayer as a deduction under section 213(a).

(4) *Deduction not allowed for self-employment tax purposes*. The deduction allowable by reason of this subsection shall not be taken into account in determining an individual's net earnings from self-employment (within the meaning of section 1402(a)) for purposes of chapter 2 for taxable years beginning before January 1, 2010, or after December 31, 2010.

(5) *Treatment of certain S corporation shareholders*. This subsection shall apply in the case of any individual treated as a partner under section 1372(a), except that -

(A) for purposes of this subsection, such individual's wages (as defined in section 3121) from the S corporation shall be treated as such individual's earned income (within the meaning of section 401(c)(1)), and

(B) there shall be such adjustments in the application of this subsection as the Secretary may by regulations prescribe.

An individual who is a 2-percent shareholder of an S corporation pursuant to the attribution of ownership rules under Code § 318 is entitled to the deduction under Code § 162(*l*) for amounts that are paid by the S corporation under a group health plan for all employees and included in the individual's gross income, if the individual otherwise meets the requirements of Code § 162(*l*).[3905]

II.P.3. Conversions

Conversion to a C corporation is less taxing than conversion from a C corporation. Often, start-up businesses open as a pass-through entity (partnership or S corporation) to enable the owner to deduct initial losses, and then convert to a C corporation when they become profitable. To the extent that timing is discussed below, it is when changes in entity arise from check-the-box elections, which elections generally may be effective up to 75 days before the date of filing.[3906]

[3905] CCA 201912001.

[3906] Reg. § 301.7701-3(c)(1)(iii) provides:

Effective date of election. An election made under paragraph (c)(1)(i) of this section will be effective on the date specified by the entity on Form 8832 or on the date filed if no such date is specified on the election form. The effective date specified on Form 8832 can not be more than 75 days prior to the date on which the election is filed and can not be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 75 days prior to the date on which the election is filed, it will be effective 75 days prior to the date it was filed. If an election specifies an effective date more than 12 months from the date on which the election is filed, it will be effective 12 months after the date it was filed. If an election specifies an effective date before January 1, 1997, it will be effective as of January 1, 1997. If a purchasing corporation makes an election under section 338 regarding an acquired subsidiary, an election

For structural changes to partnerships, see parts II.C.5 Converting from One Entity Taxed as a Partnership to Another and II.C.6 Shifting Rights to Future Profits.

An eligible entity may elect to be classified other than its default classification or to change its classification, by filing Form 8832.[3907] If an eligible entity makes an election under the preceding sentence to change its classification (other than an election made by an existing entity to change its classification as of the effective date of this section), the entity cannot change its classification by election again during the 60 months succeeding the effective date of the election.[3908] However, the IRS may permit the entity to change its classification by election within the sixty months if more than 50% of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of the entity's prior election.[3909] An election by a newly formed eligible entity that is effective on the date of formation is not considered a change for purposes of the 60-month rule.[3910]

Regarding taxpayer identification numbers, Reg. § 301.6109-1(h), "Special rules for certain entities under § 301.7701-3," provides:

> (1) *General rule*. Any entity that has an employer identification number (EIN) will retain that EIN if its federal tax classification changes under § 301.7701-3.
>
> (2) *Special rules for entities that are disregarded as entities separate from their owners*.
>
> > (i) *When an entity becomes disregarded as an entity separate from its owner*. Except as otherwise provided in regulations or other guidance, a single owner entity that is disregarded as an entity separate from its owner under § 301.7701-3, must use its owner's taxpayer identifying number (TIN) for federal tax purposes.
> >
> > (ii) *When an entity that was disregarded as an entity separate from its owner becomes recognized as a separate entity*. If a single owner entity's classification changes so that it is recognized as a separate entity for federal tax purposes,

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> under paragraph (c)(1)(i) of this section for the acquired subsidiary can be effective no earlier than the day after the acquisition date (within the meaning of section 338(h)(2)).

[3907] Reg. § 301.7701-3(c)(1)(i).

[3908] Reg. § 301.7701-3(c)(1)(iv). T.D. 8697 (12/18/1996) provides:

> The sixty month limitation only applies to a change in classification by election; the limitation does not apply if the organization's business is actually transferred to another entity.

The preamble to the proposed regulations, PS-43-95 (5/1996), followed a sentence similar to the above with:

> For example, an organization could liquidate into its parent, terminate and reform as another entity (e.g., by merger), or contribute its business to another organization without restriction.

[3909] Reg. § 301.7701-3(c)(1)(iv).

[3910] Reg. § 301.7701-3(c)(1)(iv). The preamble to the proposed regulations, PS-43-95 (5/1996), commented:

> The sixty month limitation only applies to a change in classification by election. Thus, if a new eligible entity elects out of its default classification effective from its inception, that election is not a change in the entity's classification.

Letter Ruling 201516034 confirmed that electing out of default classification is not a change in the entity's classification. The ruling permitted corporate subsidiaries to convert to LLCs under their original state law and for those LLCs to elect corporation taxation, after which the LLCs converted to LLCs governed by a different state's laws, and the newest LLCs were also permitted to elect corporation taxation.

and that entity had an EIN, then the entity must use that EIN and not the TIN of the single owner. If the entity did not already have its own EIN, then the entity must acquire an EIN and not use the TIN of the single owner.

(3) *Effective date*. The rules of this paragraph (h) are applicable as of January 1, 1997.

II.P.3.a. From Corporations to Partnerships and Sole Proprietorships

If an entity that elected taxation as a corporation that has more than one owner elects under Reg. § 301.7701-3(c)(1)(i) to be classified as a partnership, the corporation is deemed to distribute all of its assets and liabilities to its owners, who immediately contribute all of the distributed assets and liabilities to the partnership.[3911] The deemed transactions are treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification is effective on January 1, the deemed transactions are treated as occurring immediately before the close of December 31 and must be reported as of December 31. Thus, the last day of the corporation's taxable year will be December 31 and the first day of the partnership's taxable year will be January 1.[3912]

If an entity that elected taxation as a corporation that has only one owner elects under Reg. § 301.7701-3(c)(1)(i) to be classified as a disregarded entity, the corporation is deemed to distribute all of its assets and liabilities to its single owner in liquidation of the corporation;[3913] when a subsidiary is deemed to have liquidated into its parent due to such an election, "the surviving parent corporation is considered as having been engaged in the liquidated subsidiary's preliquidation trade or business, with the result that the assets of that trade or business are deemed assets used in the surviving parent's trade or business at the time of receipt."[3914] The deemed transaction is treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification is effective on January 1, the deemed transaction is treated as occurring immediately before the close of December 31 and must be reported as of December 31. Thus, the last day of the corporation's taxable year will be December 31 and the first day of the individual's taxable year regarding the activity will be January 1.[3915] If a parent corporation converts a wholly-owned subsidiary corporation to a single member LLC that is disregarded for tax purposes, the conversion constituted a tax free liquidation of the subsidiary under Code § 332.[3916]

The liquidation of a corporation is a taxable event.[3917] The corporation (or its shareholders through K-1s if it is an S corporation) is taxed on the extent by which any asset's fair market value (FMV) exceeds its basis.[3918] Each shareholder generally realizes capital gain or loss on the difference between the FMV received and the stock's adjusted basis. This double tax can be expensive.[3919]

[3911] Reg. § 301.7701-3(g)(1)(ii).
[3912] Reg. § 301.7701-3(g)(3).
[3913] Reg. § 301.7701-3(g)(1)(iii).
[3914] *Dover Corporation and Subsidiaries v. Commissioner*, 122 T.C. 324 (2004).
[3915] Reg. § 301.7701-3(g)(3).
[3916] Letter Ruling 201452016.
[3917] See Code §§ 336 and 337.
[3918] Contributing property with a built-in loss within 2 years of liquidation so as to avoid gain on liquidation generally would not work. Code § 336(d)(2).
[3919] See, *e.g.*, Everett, Hennig, and Raabe, Converting a C corporation into an LLC: Quantifying the Tax Costs and Benefits, *Journal of Taxation* (Aug. 2010).

What if the conversion is not a formless check-the-box conversion? Rev. Rul. 69-534 provides:

> A corporation was liquidated and its business was thereafter conducted as a partnership by the three individuals who had owned all of the stock of the corporation and who acquired the same relative interests in the partnership that they had previously held in the corporation.
>
> The account of each partner was credited on the books of the partnership with his share of the equity of the corporation, but no amount was actually distributed to the individuals.
>
> *Held*, the credit given to each shareholder on the books of the partnership that succeeded the corporation was equivalent to a distribution of such assets to the partners since upon the dissolution of the corporation each of its three shareholders became entitled to his proportionate share of its entire net assets. Accordingly, gain or loss is recognized to each shareholder measured by the difference between his aliquot portion of the fair market value of the assets of the corporation distributed in liquidation and the cost or other basis of his stock as provided by section 331 of the Internal Revenue Code of 1954.

Hackett, "Liquidating a controlled subsidiary tax-free," The Tax Adviser (9/2023), discusses "Avoiding recognition of gain or loss":

> Nonrecognition of gain or loss by a parent corporation and its subsidiary on the liquidation of the subsidiary is mandatory if the following requirements are met (Secs. 332 and 337):
>
> - The parent owns at least 80% of the voting stock of the subsidiary and at least 80% of the total value of all the subsidiary's stock (Secs. 332(b)(1), 337(c), and 1504(a)(2)). Sometimes, liquidating distributions are made over a number of years rather than at one point in time. In that instance, the parent corporation must own at least 80% of the subsidiary's stock beginning on the date of adoption of the plan of liquidation; that ownership must continue until all property has been distributed. If the parent's ownership falls below the required 80% at any time during this period, this requirement will not be met, and the nonrecognition provisions will not apply to any distribution (Regs. Sec. 1.332-2(a)). A resolution by the shareholders to distribute all the subsidiary's assets in complete cancellation or redemption of all the subsidiary's stock is an adoption of a plan of liquidation, even if the date to complete the property transfer is not identified (Sec. 332(b)(2)). However, when liquidating distributions are made in more than one tax year of the subsidiary, the plan must specify the period during which the property transfer to the parent will be completed (Regs. Sec. 1.332-4(a)(1)).
>
> - The distribution must be in complete cancellation or redemption of all the subsidiary's stock, and the transfer of property must occur within the tax year. Or the distribution must be one in a series of distributions in complete cancellation or redemption of the stock in accordance with a plan of liquidation under which the distributions of the property must occur within three years from the close of the tax year in which the first distribution occurred (Secs. 332(b)(2) and (3)).
>
> - The subsidiary must be solvent (Regs. Sec. 1.332-2(b)). This means that the Sec. 332 rules do not apply when an insolvent subsidiary liquidates because there is

> nothing to distribute in cancellation or redemption of the subsidiary's stock. If the parent receives nothing for the stock, the liquidation is not treated as a tax-free liquidation. Instead, the parent may be able to claim a worthless stock loss under Sec. 165(g).

Under "Obtaining other tax benefits," the article discusses NOL carryovers, capital loss carryovers, earnings and profits, business credit carryovers, and suspended business interest. Nonrecognition on complete liquidation also applies to cancellation of indebtedness income (again, if the subsidiary is solvent). Special rules apply to intercompany items of the liquidating corporation, making liquidating distributions to minority shareholders (given that the subsidiary can have up to 20% minority owners), and distributions from subsidiaries of tax-exempt entities.

If a corporation sells assets in a tax-deferred installment sale and the corporation liquidates into a partnership, the deemed distribution from the corporation to its shareholders does not trigger gain,[3920] and the deemed contribution to the partnership does not trigger gain.[3921]

II.P.3.b. Conversion from C Corporation to S Corporation

Converting from a C corporation to an S corporation can trigger LIFO recapture for companies that carry an inventory[3922] or built-in gain tax when assets are sold with a certain number of years after the S election.[3923]

Any S corporations that have not cleansed themselves of C corporation earnings and profits encounter constraints regarding too much investment income[3924] and reduced benefits from tax-exempt interest.[3925]

II.P.3.b.i. LIFO Recapture

If a C corporation inventoried goods under the LIFO method immediately before making an S election, it shall include in income the LIFO recapture amount in its last taxable year as a C corporation (for which its inventory then receives appropriate basis adjustments.[3926]

The corporation pays tax imposed on this conversion in its last C year and first three S years.[3927]

[3920] Reg. § 1.453-9(c)(1)(ii).
[3921] Reg. § 1.453-9(c)(2), (3).
[3922] See part II.P.3.b.i LIFO Recapture.
[3923] See part II.P.3.b.ii Built-in Gain Tax.
[3924] See part II.P.3.b.iii Excess Passive Investment Income.
[3925] See part II.P.3.b.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds.
[3926] Code § 1363(d)(1).
[3927] Code § 1361(d)(2). FSA 20153001F discussed the treatment of a consolidated group with a C corporation parent being acquired by an S corporation and became a Qualified Subchapter S Subsidiary. The FSA included the following clarification:

> The recapture date is the day before the effective date of the S election. Treas. Reg. § 1.1363-2(c)(1). However, with reference to transactions described in § 1.1363-2(a)(2) (including Qsub elections), there appears to be a typo in the regulations. Treas. Reg. § 1.1363-2(c)(1) states that for a nonrecognition transaction described in § 1.1363-2(a)(2) or (b)(2), the recapture date is the date of the transfer of the partnership interest to the S corporation. However, only section (b)(2) refers to a transfer of a partnership interest, (a)(2) refers to transfers of LIFO inventory assets by

Considering that any inventory on hand is likely to be sold during the recognition period for the built-in gain tax, this recapture avoids double taxation. On the other hand, the corporation might have been able to maintain its old layer of inventory for tax purposes during the entire built-in gain recognition period, and this might be viewed as an additional tax burden.

II.P.3.b.ii. Built-in Gain Tax on Former C Corporations under Code § 1374

II.P.3.b.ii.(a). Explanation of Built-in Gain Tax on Former C Corporations under Code § 1374

When any asset is disposed of within 5 years of the S election,[3928] generally double taxation applies - normal taxation as a flow-through entity, plus a separate corporate level tax imposed on the lesser of the gain on disposition or the unrealized gain on the effective date of the S election.[3929] The corporation must disclose its unrealized built-in gain annually.[3930]

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the C corporation to an S corporation. The LIFO recapture amount is determined as of the end of the recapture date for S corporation elections described in § 1.1363-2(a)(1), and as of the moment before the transfer occurs for nonrecognition transactions (including Qsub elections) described in 1.1363-2(a)(2). Treas. Reg. § 1.1363-2(c)(2).

[3928] Code § 1374(d)(7) generally provides a 5-year recognition period, which was 7 years for a sale in 2009 or 2010 or 10 years for a sale before then. Code § 1374(d)(7) describes the recognition period as follows:

(A) *In general*. The term 'recognition period' means the 5-year period beginning with the 1st day of the 1st taxable year for which the corporation was an S corporation. For purposes of applying this section to any amount includible in income by reason of distributions to shareholders pursuant to section 593(e), the preceding sentence shall be applied without regard to the phrase '5-year'.

(B) *Installment sales*. If an S corporation sells an asset and reports the income from the sale using the installment method under section 453, the treatment of all payments received shall be governed by the provisions of this paragraph applicable to the taxable year in which such sale was made.

Letter Ruling 201150023 includes some nuances as the 2011 transition rules related to an installment sale. The ABA Section of Taxation S corporations Committee meeting in May 2015 discussed various nuances to Code § 1374(d)(7) before the Protecting Americans from Tax Hikes Act of 2015 enacted the language quoted above; see Thompson Coburn document no. 6214396.

[3929] Code § 1374. For ways to minimize this tax using a charitable remainder trust, see part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax. Also, see generally, Dealing with the S corporation Built-In Gains Tax, Parts 1 and 2, *Journal of Taxation* (April and May 2008). Reg. § 1.1374-2(a) provides that an S corporation is taxed is the lesser of:

(1) Its taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover (pre-limitation amount);
(2) Its taxable income determined by using all rules applying to C corporations as modified by section 1375(b)(1)(B) (taxable income limitation); and
(3) The amount by which its net unrealized built-in gain exceeds its net recognized built-in gain for all prior taxable years (net unrealized built-in gain limitation).

[3930] Form 1120S (2014), page 2, Schedule B, question 8. To avoid an understatement penalty, the taxpayer might consider hiring an appraiser to value the more significant items that have value that differs from basis. For a taxpayer to rely on a professional's advice, Reg. § 1.6664-4(c)(1)(i) provides;

All facts and circumstances considered. The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes)

Generally, any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been properly included in gross income before the beginning of the recognition period by an accrual method taxpayer.[3931] Assets subject to this tax include inventory (but see part II.P.3.b.i LIFO Recapture) and a cash basis taxpayer's accounts receivable,[3932] as well as goodwill;[3933] however, an accrual taxpayer's the receipt of franchise fees not constituting a sale or exchange of a capital asset under Code § 1253(a) are not subject to built-in gain tax.[3934] If a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method during or after the recognition period, that income is subject to built-in gain tax.[3935]

> for entering into a transaction and for structuring a transaction in a particular manner. In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.

If the taxpayer obtains more than one opinion of value, the taxpayer does not need to provide the tax return preparer with an earlier appraisal if a later appraisal was obtained to correct errors and incorporate more current data. *The Ringgold Telephone Company v. Commissioner*, T.C. Memo. 2010-103 (no penalty assessed for underpayment of built-in gain tax). The court also rejected the IRS' criticism of the taxpayer's failure to give the tax return preparer a copy of a memorandum suggesting a value, because the memorandum was prepared primarily as a marketing tool, not as an objective valuation.

[3931] Reg. § 1.1374-4(b)(1). This determination disregards any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation. Reg. § 1.1374-4(b)(3), Example (4) discusses deferred prepayment income, and Example (5) discusses changes in accounting methods. For further discussion of various items of built-in gain, see McMahon and Simmons, Where Subchapter S Meets Subchapter C, *Tax Lawyer*, vol. 67, No. 2 (Winter 2014), saved as Thompson Coburn LLP doc. no. 6177833.

[3932] For accounts receivable, the S corporation takes them account in full when it collects them, but it takes into account no more than their fair market value at the time of the S election if it sells them to a third party instead. Reg. § 1.1374-4(b)(3), Example (1). For long-term contracts accounted for under the completed contract method, income that would have been earned before the S election under the percentage of completion method is built-in gain. Reg. § 1.1374-4(g).

[3933] Reg. § 1.1374-3(c), Example (1).

[3934] Letter Ruling 200411015 involved the following situation:

> Franchisees pay [taxpayer] a license fee upon grant of the license and monthly royalty fees which are composed of a fixed fee portion and a variable fee portion. Except for the limited use allowed by the Agreements, [taxpayer] retains a significant power, right, or continuing interest in the franchise and terminates any Agreement in violation of the terms and conditions of the license grant. The grant or transfer of franchise rights pursuant to an Agreement does not constitute a sale or exchange of a capital asset under section 1253(a).

The ruling held:

> The income of [taxpayer] with respect to the receipt of the license fees and royalty fees from franchisees after the Conversion Date will not be treated as recognized built-in gain within the meaning of section 1374(d).
>
> We express no opinion about the tax treatment of the license fees or royalty fees under other provisions of the Code and regulations or the tax treatment of any conditions existing at the time of, or the effects resulting from, the license fees and royalty fees that are not specifically covered by the above ruling. We also express no opinion about the tax treatment under 1374 of any income or gain that may be realized by [taxpayer] during the recognition period except as specifically provided above.

[3935] Reg. § 1.1374-4(h). Also watch out for acceleration as described in part II.G.15 Limitations on the Use of Installment Sales

This gain can be offset by built-in losses,[3936] such as a cash basis taxpayer's accounts payable.[3937] Thus, a cash basis taxpayer with accounts receivable at the time of the S election should be able to offset that built-in gain by its board of directors declaring a bonus, constituting reasonable compensation, before the S election, which bonus is payable while an S corporation.[3938]

An accrual taxpayer's deductions deferred by reason of the economic performance rules count as built-in losses.[3939]

Regulations prevent avoiding this tax merely by dropping assets into a partnership.[3940] However, if the corporation owns the partnership at the time of the S election, valuation discounts might reduce the amount of built-in gain. A charitably inclined business might consider part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax.

[3936] Reg. § 1.1374-2(a)(1).

[3937] Reg. § 1.1374-4(b)(2) provides that, generally:

> …any item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period to an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation).

Under an accrual method of accounting, a liability is incurred and generally is taken into account in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Reg. § 1.461-1(a)(2)(i). For example, if the corporation is involved in a lawsuit at the time of the S election, amounts paid as a result of the lawsuit are built-in losses only if a judgement had been awarded at the time of the S election. Reg. § 1.1374-4(b)(3), Examples (2) and (3). If an accrual method taxpayer would have been able to deduct amounts owed to related parties before making the S election and Code § 267(a)(2) suspended the deduction until after the S election was made, those expenses might be built-in losses under Reg. § 1.1374-4(c)(1). A similar rule applies to compensation appropriately accrued before the S election but suspended under Code § 404(a)(5) until after the S election was made. Reg. § 1.1374-4(c)(2). For a tax trap regarding to such compensation when a business is sold, see fn 5771 in part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.

[3938] S. Rep. No. 445, 100th Cong., 2d Sess. 65 (1988), states:

> As an example of these built-in gain and loss provisions, in the case of a cash basis personal service corporation that converts to S status and that has receivables at the time of the conversion, the receivables, when received, are built-in gain items. At the same time, built-in losses would include otherwise deductible compensation paid after the conversion to the persons who performed the services that produced the receivables, to the extent such compensation is attributable to such pre-conversion services. To the extent such built-in loss items offset the built-in gains from the receivables, there would be no amount subject to the built-in gains tax.

Eustice & Kuntz, ¶ 7.06[4][f] Computation of Tax; Use of Certain Losses and Deductions to Reduce Tax Base, Federal Income Taxation of S corporations, views this as an accurate statement of current law.

[3939] Reg. § 1.1374-4(b)(2) provides that:

> In determining whether an item would have been properly allowed as a deduction against gross income by an accrual method taxpayer for purposes of this paragraph, section 461(h)(2)(C) and § 1.461-4(g) (relating to liabilities for tort, worker's compensation, breach of contract, violation of law, rebates, refunds, awards, prizes, jackpots, insurance contracts, warranty contracts, service contracts, taxes, and other liabilities) do not apply.

[3940] Reg. § 1.1374-4(i).

II.P.3.b.ii.(b). Consider S Election Even If Plan to Sell Within 5 Years

Even if one plans to sell the corporation within five years, one might find an S election useful and then revert back to a C corporation if the sale does occur during that time, if all of the following are present:

- The corporate stock is not eligible for the exclusion from gain on sale of the stock under Code § 1202 described in part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation. Being an S corporation for any significant period would blow the exclusion.[3941]

- The company does not have too much inventory subject to tax under part II.P.3.b.i LIFO Recapture. Note that any tax imposed on LIFO recapture is spread over several years.

- The company does not expect to dispose of significant assets subject to built-in gain tax.[3942] If the company reports on the cash receipts and disbursements method, then its accounts receivable and other accrued income in excess of its accounts payable and other accrued expenses would be subject to built-in gain tax; however, if it is on the accrual method, the income would already have been recognized and the built-in gain tax would not apply.[3943]

Making the S election would allow the shareholders to extract earnings during that period income-tax free, whether those earnings are extracted through distributions or when selling their stock.

If stock in the company is sold as just a straight stock sale, then either the buyer keeps the S election going (and benefits from to) or terminates the S election. If the buyer requires a basis step-up on the corporation's assets as described in part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold, then the seller might need to revoke the S election to avoid the built-in gain tax. Either way, terminating the S election might very well be relatively straightforward so that this process of turning on and then off the S election might have few bad tax effects (if the three bullet points above work out) and are advantageous while the election is in effect. See parts II.P.3.d Conversion from S Corporation to C Corporation and II.A.2.k Terminating an S Election.

II.P.3.b.iii. Excess Passive Investment Income

If a C corporation with accumulated earnings and profits (E&P)[3944] elects S status, it might be subject to a supplemental tax and lose its S status if it has excess passive investment income.[3945] The corporation can avoid this treatment by carefully planning its gross receipts or

[3941] See fn. 5233.
[3942] See part II.P.3.b.ii.(a) Explanation of Built-in Gain Tax on Former C Corporations under Code § 1374.
[3943] See fns. 3931-3939.
[3944] Reg. § 1.1375-1(b)(4) refers to Code § 1362(d)(3) and the regulations thereunder in determining E&P. E&P is based on C corporation principles under Code § 312 and taxed by Code § 316 when distributed. Code § 1371(c). E&P are the earnings and profits of any corporation, including the S corporation or an acquired or predecessor corporation, for any period with respect to which an S election was not in effect. Reg. § 1.1362-2(c)(3).
[3945] Code §§ 1362(d)(3), 1375. Certain S corporations may disregard pre-1983 earnings and profits. 2007 Small Business Act P.L. 110-28, Sec. 8235.

by distributing its E&P.[3946] Inadvertent termination relief may be available if the corporation distributes its E&P after violating the excess passive investment income test.[3947]

Some points on planning gross receipts to avoid excess passive investment income treatment include:

- Although the statute defines rent as tainted income,[3948] that characterization does not apply if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental activity.[3949] For this purpose, "rent" does not include

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[3946] Planning before the conversion might also help. Starr and Sobol, *S corporations: Operations*, T.M. 731-2nd, suggests at IV.B:

> Comment: When a C corporation converts to an S corporation, accumulated E&P is likely to be overstated, since timing differences originating in C status will tend to reverse while in S corporation status. As a result, excessive dividend distributions will be necessary to fully deplete the account. Conversely, when an S corporation converts to a C corporation, these timing differences may prove advantageous in that the accumulated E&P would reflect the reversal in C status while not being affected by the origination of the item in S status.
>
> Instances where timing differences come into play when switching from C to S or S to C status include:
>
> - accelerated cost recovery deductions for taxable income, but straight-line for accumulated E&P;
> - installment method elected for taxable income, but not allowed for accumulated E&P; and
> - special LIFO inventory adjustments required for accumulated E&P, but generally not required for taxable income.

[3947] Letter Ruling 201710013.

[3948] Code § 1362(d)(3)(C)(i).

[3949] Reg. § 1.1362-2(c)(5)(ii)(B)(2), which provides:

> *Rents derived in the active trade or business of renting property*. Rents does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

When describing net leases, the regulation did not clarify whether it was referring to leases in which the tenant does everything to rather leases in which the tenant reimburses the landlord for expenses the landlord incurs. If the taxpayer has very significant concern about this issue, consider making the lease a fixed annual rent that is enough to cover annual expenses – which may or may not be acceptable to the landlord in that the landlord assumes the risk of unexpected expenses.

Rev. Rul. 81-197 addressed leasing aircraft. Reimbursing the renter's expenses under a one-year lease, where the tenant does all of the work, did not make rental be active. However, chartering aircraft was active, where (a) the owner provides all pilots, fuel, catering, and operating supplies, and pays for all hull and liability insurance, landing and parking fees, taxes, and governmental fees and charges, (b) pilots who are its employees have primary authority for the safety and actual operation of the aircraft, and (c) it enters into a management agreement with the aircraft manufacturer to secure assistance in maintaining the aircraft.

A corporation did not provide significant services or incur substantial costs when it provided furniture for the bungalows (used as vacation homes) and a recreation area maintained by the corporation, as well as tables and cards use in that area, sponsored bingo games for the adults and parties for the children at which small prizes were given, and sponsored parties for the adults, providing food and entertainment, all of which cost approximately 0.15% of revenue. *Feingold v. Commissioner*, 49 T.C. 461(1968).

> “income realized by a landowner under a share-farming arrangement where the landowner participates to a material degree in the production of farm commodities through physical work or management decisions, or a combination of both,”[3950] but the payment of costs may

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Performing decorating, repair, maintenance and cleaning services at the lessee’s separate expense did not make active the rental of stadium suites active, but income from concessions, stadium club membership fees and dues, and electronic scoreboard advertising was active. Letter Ruling 8247052 (GCM 38915 apparently provided the underlying analysis).

Letter Ruling 201725022 held that the following medical office lease was active:

> X contracts with an independent leasing agent to assist in soliciting prospective tenants for M, negotiating leases and renewals, and overseeing post-leasing activities such as build-outs and renovations of suite space. X, with the assistance of the independent leasing agent, drafts, proposes, presents, and negotiates letters of intent to lease available suite spaces. Negotiation for leasing regularly requires the use of an independent space planner to design and tailor the spaces for prospective tenants. Once letters of intent are accepted, X, with the assistance of the independent leasing agent, prepares, finalizes, and executes the lease agreements with prospective tenants. Renewals of leases are similarly handled by X, which are often complicated by requests for concessions and renegotiation of the leasing rate. Renewals often require significant time and attention by X.
>
> X, through its employees, its agents, and the agents’ employees, provides certain services in maintaining and repairing of the buildings, common areas, and grounds of M. X utilizes a standard lease agreement for its tenants, and under the lease agreements X has the obligation to provide certain services with respect to the leasing of space within M and to maintain or repair the following items: the heat and air conditioning systems, plumbing, hot water heaters, exterior lighting, signs, lawn care and gardening, roofs and exterior walls, exterior walkways, courtyards, parking areas, electricity, water and sewer, drainage, and garbage pickup.
>
> In addition, the following specific services are provided to M and its tenants by an employee or independent contractor/worker of X: daily walk-through inspections of M to report on water breaks, lighting outage, vandalism, damage to building exteriors and certain interior spaces; sweeping, cleaning and maintaining the common areas of M such as sideways, walkways, and parking lot; routine periodic inspection of building exteriors and interiors, including foundations, roofs, exterior lighting, grounds, and parking lot and engaging in maintenance and repairs as needed; treating the roofs of the buildings for moss growth yearly; recoating and resurfacing the parking lot; routine and periodic maintenance of the numerous heating and air conditioning units; renovating vacant suites for leasing; routine and periodic maintenance of the plumbing and sewer lines, and their repair and replacement as needed; maintenance, repair and replacement of exterior lighting and selected interior lighting; janitorial services for selected units and common areas; exterior window washing; regular maintenance of grounds and lawn care, and landscaping services when necessary; seasonal snow removal and ice control; weekly trash removal; periodic pest and vermin control; and emergency response and property access for public safety.

Additional authority is in *United States Tax Reporter* ANN ¶ 13,799.27 Rents; Bittker & Eustice, ¶ 6.04. Events Terminating Election, *Federal Income Taxation of Corporations & Shareholders* (WG&L); Eustice, Kuntz & Bogdanski, ¶ 5.04[2][b] Rents, *Federal Income Taxation of S Corporations*; Christian & Grant, ¶ 11.03 Rents, *Subchapter S Taxation* (WG&L).

[3950] Rev. Rul. 61-112. See Letter Rulings 8927039, 9003056, 9514005, 200002033, 200217045, and 200739008, all cited in Thompson Coburn LLP doc. no. 6513203 (which would need to be sanitized before sharing), which is the background for Letter Ruling 201812003 (which approved S corporation status and an ESBT election when the trust that was the sole shareholder was required to cause the corporation to distribute real estate to charity, facts that were present but were not discernible from the ruling). *Kennedy v. Commissioner*, T.C. Memo. 1974-149, held that crop-sharing was passive rental when the corporation furnished nothing except the use of the land and the tenant furnished all the management, labor, supplies, etc.

Citing Rev. Rul. 61-112, Rev. Rul. 67-423 held that, when a corporation owns farmland it leases to a tenant under a crop-sharing arrangement that generates government payments under acreage reserve be sufficient to cause a farm arrangement to be nonpassive under this test.[3951] See also part II.G.26.b Real Estate as a Trade or Business.

- Gross receipts (rather than net income) of nonpassive income from partnerships in which the corporation is invested may be counted;[3952] some income from controlled foreign corporations might also count as nonpassive income.[3953] Investing in oil and gas partnerships frequently helps generate sufficient nonpassive gross receipts.[3954] Any gross

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and conservation reserve programs and the landlord materially participates in the management of the farm production, the payments which the landlord receives under the foregoing programs are not "rents" for personal holding company income tax purposes. TAM 6211239430A, which also cited Rev. Rul. 61-112, held that crop-sharing payments were "rents" for personal holding company income tax purposes where the corporation did nothing and the tenant furnishes all of the equipment and performs all of the work.

GCM 35957 (1974) cited Rev. Rul. 61-112, among other authority, in analyzing whether crop-sharing constituted unrelated business taxable income.

GCM 35247 (1973) cited Rev. Rul. 61-112, among other authority, in analyzing whether crop-sharing constituted a business for purposes of estate tax deferral under Code § 6166.

[3951] Letter Ruling 201722019 approved as nonpassive both of the following:

> X is engaged in the business of farming and owns n acres in State. X has leased the land for sharecropping (Sharecropping Lease Arrangement) continuously beginning in Date 3. Beginning in Year, the land was leased to Y. Pursuant to the Sharecropping Lease Arrangement, all taxes, assessments or charges levied or assessed on products of the land must be paid by X and Y based in proportion to the percentage of crops to which X and Y are entitled. X and Y each pay one half of the actual cost of fertilizer and soil conditioner. X pays the cost of the power and fuel necessary to operate the drainage pumping plants as well as the cost of maintaining the irrigation and drainage canals and irrigation pipe line. X is also responsible for paying box rent and the grower's share of the state inspection fee. Any processing expenses incurred with the preparation of crops for sale, which are related to X's share of the crops, are paid by X. X also determines the percentage of Property to be farmed and the types of crops to be planted. Further, X is at risk for crop yields and marketing.
>
> In Year, X signed a new lease agreement (Rental Lease Arrangement) with Y for lease of Property. Under the lease, X's expenses are between o% and p% of X's rental income. X is responsible for providing and maintaining insurance on all improvements and fixtures owned by X. Further, X pays the costs and expenses associated with the repair, maintenance and replacement of the irrigation drainage pumps as well as the insurance, water reclamation tax, water rights fees, water coalition dues and property taxes.

[3952] Rev. Rul. 71-455; see also Reg. § 1.702-1(a)(8)(ii).

[3953] CCA 201030024.

[3954] For a summary of the issue, see 723 T.M. III.D.7.b.; see also part II.P.1.a.i Allocations of Income in Partnerships. Specific examples include Letter Rulings 200005012 (publicly traded partnership engaged in the purchasing, gathering, transporting, storage and resale of crude oil, refined petroleum products, and natural gas liquids, as well as some related activities), 200027037 (publicly traded limited partnerships engaged in the business of purchasing, gathering, transporting, trading, storage, and resale of crude oil, refined petroleum, and other chemical products), 200147034 (one publicly traded partnership's business consisted of purchasing, gathering, transporting, trading, storage and resale of crude oil and refined petroleum products and related activities, and the other's consisted of interstate and intrastate crude oil transportation, terminalling and storage, as well as crude oil gathering and marketing activities), 200240043 (publicly traded partnerships engaged in the business of purchasing, gathering, transporting, trading, storing, and reselling crude oil and refined petroleum products), 200309021 (publicly traded partnership engaged in the purchasing, gathering, transporting, trading, storage, and resale of crude oil, refined petroleum, and other mineral or natural resources), 200327004 (publicly traded partnership engaged in the purchasing, gathering, transporting, trading, marketing, storing, and reselling of crude oil, refined petroleum products, and natural gas liquids), and 200928024 (publicly traded receipts separately stated on such a K-1 would be reflected only in a worksheet provided in the Instructions for Form 1120S.[3955]

- In the case of sales or exchanges of stock or securities, gross receipts shall be taken into account only to the extent of the gains, without deduction for losses.[3956] For other capital assets, losses are netted against gains.[3957]

The corporation can distribute its E&P. Generally, distributions from an S corporation come first as generally[3958] nontaxable distributions of its accumulated adjustments account (AAA), then are treated as dividends to the extent of E&P, and then as a return of basis and gain on sale.[3959] However, an S corporation may, with the consent of all of its affected shareholders, elect to ignore AAA with respect to all distributions made during the taxable year for which the election is made.[3960]

Generally, a distribution of E&P must be effected using a distribution of money or other property.[3961] For these purposes, a distribution is taken into account on the date the corporation makes the distribution, regardless of when the distribution is treated as received by the shareholder.[3962] AAA at the close of the taxable year is applied to distributions during the taxable and pro-rated among them if they exceed AAA.[3963]

"Property" means money, securities, and any other property, but does not include stock in the corporation making the distribution (or rights to acquire such stock).[3964] However, no distribution of property is required if an S corporation elects to distribute all or part of its E&P through a deemed dividend, in which case: [3965]

- The corporation will be considered to have elected to bypass AAA for that year.

- The deemed dividend may not exceed the E&P on the last day of the taxable year, reduced by any actual distributions of E&P made during the taxable year.

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partnerships engaged in the active trade of purchasing, gathering, transporting, trading, storage and/or resale of crude oil and refined petroleum products and related activities). It is best to document that the corporation's investment strategy is to provide for liquidity and also to diversify its investment risk.

[3955] The 2016 Instructions provide a worksheet to compute the excess net passive income tax for line 22a. The schedule computing the excess net passive income items includes+:

> *Income and deductions on lines 1, 2, and 5 are from total operations for the tax year. This includes applicable income and expenses from page 1, Form 1120S, as well as those imported separately on Schedule K.

[3956] Code § 1362(d)(3)(B)(ii).
[3957] Code § 1362(d)(3)(B)(i).
[3958] If and to the extent that the basis of a shareholder's stock is less than the shareholder's allocable AAA, the distribution of AAA would be taxed as a capital gain. Code § 1368(c)(1), (b)(2).
[3959] Code § 1368(c).
[3960] Code § 1368(e)(3)(A). Affected shareholder means any shareholder to whom a distribution is made by the S corporation during the taxable year. Code § 1368(e)(3)(B).
[3961] Code § 316(a). See Reg. § 1.1368-1(c).
[3962] Reg. § 1.1368-1(b).
[3963] Reg. § 1.1368-1(b), (c).
[3964] Code § 317(a).
[3965] Reg. § 1.1368-1(f)(3).

- The amount of the deemed dividend is considered, for all tax purposes,[3966] as if it were distributed in money to the shareholders in proportion to their stock ownership, received by the shareholders, and immediately contributed by the shareholders to the corporation, all on the last day of the corporation's taxable year.

A corporation makes an election for a taxable year by attaching a statement to a timely filed (including extensions) original or amended return required to be filed for that taxable year, which statement must include the amount of the deemed dividend that is distributed to each shareholder,[3967] as well as consent by each affected shareholder.[3968]

A deemed dividend might be attractive when dividend tax rates are low, if one expects to need to take distributions in excess of AAA is a future year. However, if the shareholder might later sell the stock to a third party or wait to have the stock redeemed until it obtains a basis step-up on death, then it's possible that distributions will never exceed AAA. In that case, investing in assets that generate nonpassive gross receipts might be a lot less painful than paying tax on a deemed dividend. If the majority shareholder does not want to mess with a closely-held business or active rental, then my experience has been that investing 1-3% of the corporation's assets in oil and gas partnerships will be sufficient to generate sufficient nonpassive gross receipts.[3969]

If a corporation does not know about the possible loss of its S election under the excess passive investment income rules and terminates its S election as a result of these rules, consider applying for inadvertent termination relief in which the corporation and shareholders agree to a retroactive deemed dividend described above.[3970]

II.P.3.b.iv. Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds

Tax-exempt income does not increase AAA.[3971]

Therefore, any tax-exempt income, although not taxable to the shareholders when earned, would be taxable dividends when distributed to the shareholders to the extent that the corporation has no remaining AAA but has E&P.

Even if the corporation has plenty of AAA, a need for AAA might later arise, such as tax-free redemptions of part of a shareholder's stock.[3972]

[3966] However, the dividend deemed distributed to a qualified subchapter S trust does not constitute trust accounting income and therefore is not required to be distributed to the beneficiary. Letter Ruling 200446007.

[3967] Reg. § 1.1368-1(f)(5)(iii).

[3968] Reg. § 1.1368-1(f)(5)(ii).

[3969] See footnote 3954.

[3970] Letter Rulings 201351013, 201629001.

[3971] Code § 1368(e)(1)(A). This includes tax-free receipts beyond just municipal bonds. See part II.Q.7.b.iv.(a) S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations and Letter Ruling 201440013.

[3972] If a state law redemption is treated as a distribution under Code § 302(b)(2) or (3) and Code § 302(c), then it is a tax-free distribution to the extent of AAA. See part II.Q.7.b. Redemptions or Distributions Involving S Corporations.

These issues are spelled out more in part II.Q.7.b.iv.(a) S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations.

II.P.3.b.v. Conversion from S Corporation to C Corporation then Back to S Corporation

CCA 201446021 asserted that, when an S election terminates, its accumulated adjustments account (AAA) is wiped out. Therefore, the IRS reasoned, if the corporation later becomes an S corporation, its AAA starts from scratch.

However, any distribution of ***money***[3973] by a corporation with respect to its stock during a post-termination transition period (generally, the first C corporation year after the S election terminate) is applied against and reduce the adjusted basis of the stock, to the extent that the amount of the distribution does not exceed AAA.[3974] Rev. Rul. 2019-13 clarifies that this treatment applies if and to the extent that a redemption if recharacterized as a Code § 301 distribution.[3975]

Thus, if the S corporation status is terminated, one should consider promptly distributing earnings as cash; although one might loan them back to the corporation if it needs the cash, the IRS may treat that as a step transaction that is a note distribution that does not qualify as a distribution of money.[3976] If one is planning a termination, consider distributing on the last day of

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[3973] The law refers to "money," and the 2017 legislative history refers to "distributions of cash."

[3974] Code § 1371(e)(1). Code § 1377(b)(1) and Reg. § 1.1377-2(b) determine the post-termination transition period.

[3975] See parts II.Q.7.a.iii Redemption Taxed Either as Sale of Stock or Distribution; Which Is Better When and II.Q.7.b Redemptions or Distributions Involving S Corporations. The facts of Rev. Rul. 2019-13 are:

> X is a corporation that once was a C corporation and later elected to be an S corporation under § 1362(a) of the Code. X's S election terminated under § 1362(d), such that it is now a C corporation. A, an individual, owns all 100 shares of the outstanding stock of X. X is a calendar-year taxpayer. At the time of its conversion to an S corporation, X had accumulated earnings and profits (E&P) of $600x and no current E&P. At the time of the termination of its S election, X's AAA was $800x and its accumulated E&P was still $600x. During X's post-termination transition period, X redeems 50 of A's 100 shares of X stock for $1,000x. X makes no other distributions during the post-termination transition period. Pursuant to § 302(d) of the Code, the redemption is characterized as a distribution subject to § 301. For the taxable period that includes the redemption, X has current E&P of $400x.

Rev. Rul. 2019-13 holds:

> If, during a former S corporation's post-termination transition period, the corporation distributes cash in redemption of a shareholder's stock, which is characterized as a distribution subject to § 301, the corporation should reduce its AAA to the extent of the proceeds of the redemption pursuant to § 1368. The redemption of 50 of A's 100 shares of X stock for $1,000x is characterized as a reduction of X's $800x of AAA with the remaining $200x characterized as a dividend under § 301(c)(1).

[3976] See *McKelvy v. United States*, 478 F.2d 1217 (Ct. Cl. 1973); *DeTreville v. United States*, 445 F.2d 1306 (4th Cir. 1971); *Fountain v. Commissioner*, 59 T.C. 696 (1973); and *Roesel v. Commissioner*, 56 T.C. 14 (1971). In the first three cases, the corporation did not have cash on hand to honor the checks, and the loan or other transaction was needed to avoid bouncing checks. In *Roesel*, 56 T.C. at 26, the court noted, "The conversations which were had between Milling's president or comptroller and the shareholders with respect to the purported loans, the degree of correspondence between the book overdrafts created by Milling's distributions and the amounts purportedly loaned back by its shareholders, the close proximity in time of the purported loans and the issuance of checks by Milling, and the correlation between the amounts purportedly loaned by each shareholder and his interest in Milling, all serve to establish that the purported distributions and loans were but parts of interrelated transactions which must be viewed as such for tax purposes."

the last S corporation taxable year a formula note equal to AAA as of that date. See part II.P.3.d Conversion from S Corporation to C Corporation for discussion about additional opportunities for former S corporations whose owners at the time of revocation are the same as those on December 22, 2017.

A better strategy might be for the S corporation to do a tax-free "F" reorganization,[3977] in which the existing S corporation becomes a wholly-owned subsidiary of a new parent S corporation, which parent is owned by the original S corporation's shareholders immediately before the reorganization. The parent makes an S election, and the subsidiary elects taxation as a Qualified Subchapter S Subsidiary (QSub).[3978] The original S corporation initially is disregarded from the parent, giving the parent all of the subsidiary's AAA.[3979] Later, the subsidiary's QSub election is revoked, keeping the AAA intact at the parent level, notwithstanding that the subsidiary is now taxed as a C corporation. That way, if the subsidiary later becomes a QSub, the AAA remain to help carry out distributions to the shareholders.

This strategy also might allow a faster conversion back to taxation as an S corporation, because the S election was never terminated and therefore the five year waiting period[3980] would appear not to apply.[3981] Because the QSub is wholly owned, the deemed liquidation when the QSub election is made again generally would be nontaxable.[3982]

Another alternative would be for the S corporation to transfer one or more businesses to one or more C corporations (or to separate LLCs, which elect C corporation treatment once the transfers are complete).

However, an S corporation may want to issue a promissory note before converting to C corporation, so that it can make payments to shareholders after the C corporation conversion without those payments being taxable dividends; this strategy seems appealing but may have some disadvantages relating to the related interest income and expense.[3983] The only way this accomplishes the intended result is if the C corporation subsidiary is the borrower. Unfortunately, the deemed issuance of a promissory note upon the deemed Code § 351 transaction may constitute "boot" that triggers income tax on formation.[3984] The corporation may try to borrow from a third party immediately before the conversion and distribute its AAA to its shareholders, followed by them loaning back to the corporation after it becomes a C corporation to repay the debt; however, this solution is subject to two caveats (among others referred to in fn 3984). First, liabilities in excess of debt on the deemed Code § 351 formation of the C corporation may trigger income tax on that excess; see part II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities. Second, consider whether such a tight sequence may constitute a step transaction, along the lines noted in fn 3976.

The "F" reorganization strategy is especially important when converting to a C corporation the stock of which generally would qualify for the exclusion described in part II.Q.7.k. Although a corporation that had been an S corporation cannot qualify for the exclusion, the S corporation

[3977] See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.
[3978] See part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[3979] Reg. § 1.1368-2(d)(2).
[3980] See fn 318 in part II.A.2.k Terminating an S Election.
[3981] See fns 197-199 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[3982] See fn 204 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[3983] See part II.E.2.b Converting from S Corporation to C Corporation.
[3984] See fn 3537 and accompanying text in part II.M.2.a Initial Incorporation – Generally.

can form a C corporation whose stock does qualify for the exclusion,[3985] which generally requires a transfer of assets and liabilities to a new entity. This reorganization strategy facilitates a seamless transition as a matter of state law – the old corporation turns into a new C corporation for income tax purposes. However, if the old corporation becomes a C corporation directly, it retains its old tax ID,[3986] which will show a history of having been an S corporation. That history may lead the IRS to question whether the deemed brand-new C corporation is, in fact, a prior S corporation, even though the QSub regulations clearly say it is. To avoid such questions, the cumbersome asset/liability transfer may be the better way to go. Query whether one might convert the old corporation into an LLC on a tax-free and seamless state law basis, then the parent transfers the LLC into a new C corporation (or do some other equivalent seamless conversion).

Finally, consider the built-in gain tax described in part II.P.3.b.ii Built-in Gain Tax on Former C Corporations under Code § 1374. That tax is imposed when as asset with unrecognized built-in gain when the corporation converts from C to S is sold within five years. This can be pernicious when an S corporation converts to C and then back to S again. For example, an asset has a zero basis and a $1 million value before the corporation revokes its S election. The asset grows to be worth $1.3 million before the corporation switches back from C to S. The full $1.3 million of unrealized gain constitutes built-in gain, even though only $300,000 of the appreciation occurs while taxed as a C corporation.

To avoid the problem described in the preceding paragraph, consider not simply revoking the S election when first converting to C corporation. Instead, leave behind in an S corporation parent any highly appreciated assets and lease them to the C corporation, while contributing the rest of the business to a C corporation.

II.P.3.c. Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations

Transfers from a sole proprietorship to a corporation, including a disregarded LLC electing corporate taxation,[3987] are generally nontaxable.[3988]

However, shifting from a partnership to a corporation might cause the partners to recognize gain or lose their suspended losses.[3989]

Consider what adjustments might be required to convert a partnership interest, which might have capital accounts disproportionate to profit and loss sharing and might have profit in loss sharing that is not "straight-up," into shares, generally would have identical distribution and liquidation rights (and must have such rights in the case of an S corporation).

II.P.3.c.i. Formless Conversion

When an entity taxed as a partnership elects taxation as a corporation, the partnership is deemed to contribute all of its assets and liabilities to the corporation in exchange for stock in the corporation; and, immediately thereafter, the partnership liquidates by distributing the stock

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[3985] See fns 5233-5235 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[3986] Reg. § 301.6109-1(i)(3), reproduced in full in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[3987] Reg. § 301.7701-3(g)(1)(iv).
[3988] See part II.M.2.a. Initial Incorporation – Generally.
[3989] See part II.M.2.c Contribution of Partnership Interest to Corporation.

of the corporation to its partners.[3990] The deemed transactions are treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification is effective on January 1, the deemed transactions are treated as occurring immediately before the close of December 31 and must be reported by the owners of the entity on December 31. Thus, the last day of the partnership's taxable year will be December 31 and the first day of the corporation's taxable year will be January 1.[3991]

Rev. Rul. 2004-59 held, "If an unincorporated state law entity that is classified as a partnership for federal tax purposes converts into a state law corporation under a state law formless conversion statute, the following is deemed to occur: the partnership contributes all its assets and liabilities to the corporation in exchange for stock in such corporation, and immediately thereafter, the partnership liquidates distributing the stock of the corporation to its partners." It said that Rev. Rul. 84-111 does not apply to that situation. Rev. Rul. 84-111 is described in part II.P.3.c.ii Transfer of Partnership Assets and Liabilities to a Newly Formed Corporation in Exchange for All of its Stock.

A partnership can be converted directly into an S corporation; the corporation is not deemed formed until the partnership is deemed to have distributed its assets to the corporation:[3992]

- Suppose that, on January 1, 2009, X, a calendar year taxpayer, is taxed as a partnership. X elects to be taxed as a corporation for federal tax purposes, effective January 1, 2010. On February 1, 2010, X files an S election, effective January 1, 2010. Each person who held stock in X on January 1, 2010 also holds stock at the time the S election is made. When X elects to be taxed as a corporation, the following steps are deemed to occur: X contributes all of its assets and liabilities to the corporation in exchange for stock in the corporation, and immediately thereafter X liquidates by distributing the stock of the association to its partners. These deemed steps are treated as occurring immediately before the close of the day before the election is effective.[3993] Thus, the partnership's taxable year ends on December 31, 2009, and the corporation's first taxable year begins on January 1, 2010. Therefore, the partnership will not be deemed to own the stock of the corporation during any portion of the association's first taxable year beginning January 1, 2010, and X is eligible to elect to be an S corporation effective January 1, 2010. Additionally, because the partnership's taxable year ends immediately before the close of the day on December 31, 2009, and the corporation's first taxable year begins at the start of the day on January 1, 2010, the deemed steps will not cause X to have an intervening short taxable year in which it was a C corporation.

- On January 1, 2009, Y, a calendar year taxpayer, is taxed as a partnership. Y converts into a corporation under a state law formless conversion statute, effective January 1, 2010. As a result of the conversion, Y is classified as a corporation for federal tax purposes. On February 1, 2010, Y files an S election, effective January 1, 2010. Each person who held

[3990] Reg. § 301.7701-3(g)(1)(i). Under Rev. Rul. 2004-59, when a formless conversion occurs under state law, Rev. Rul. 84-111 does not apply. Rev. Rul. 84-111 describes the differences in the basis and holding periods of the various assets received by the corporation and the basis and holding periods of the stock received by the former partners provided the steps described are actually undertaken and the underlying assumptions and purposes for the conclusions in the revenue ruling are applicable. Except to the extent inconsistent with the above, see the text accompanying footnotes 5358-5452 for tax effects of liquidating a partnership.
[3991] Reg. § 301.770l-3(g)(3).
[3992] Rev. Rul. 2009-15.
[3993] Reg. § 301.7701-3(g)(3)(i).

stock in Y on January 1, 2010 also holds stock at the time the S election is made. The result is the same as above.

Of course, the simplest way would be just to make the S election, by the partnership filing IRS Form 2553.[3994]

Because S corporations can have only a single class of stock,[3995] capital accounts need to be made proportionate to interests in profits and losses before converting to an S corporation.[3996]

II.P.3.c.ii. Transfer of Partnership Assets and Liabilities to a Newly Formed Corporation in Exchange for All of its Stock

If the conversion is not described in part II.P.3.c.i Formless Conversion, Rev. Rul. 84-111 provides for three scenarios. In each situation, the steps the partners and partnerships take are parts of a plan to transfer the partnership operations to a corporation organized for valid business reasons in exchange for its stock and were not devices to avoid or evade recognition of gain. Because the federal income tax consequences of the three situations are the same, each partnership is considered to make a nontaxable contribution of its assets and liabilities to a corporation in exchange for its stock,[3997] followed by a distribution of the stock to the partners in liquidation of the partnership.[3998]

In the first situation, the partnership transfers all of its assets to newly-formed corporation in exchange for all the outstanding stock of the corporation and the assumption by the corporation of the partnership's liabilities. The partnership then terminates by distributing all the stock of the corporation to the partners in proportion to their partnership interests. The tax results are:

- No gain or loss is recognized by the partnership when it transfers all of its assets to the corporation in exchange for the corporation's stock and the assumption by the corporation of the partnership's liabilities.[3999]

- The corporation's basis in the assets received from the partnership equals their basis to the partnership immediately before their transfer to the corporation.[4000]

- The partnership's basis of the stock received from the corporation is the same as the partnership's basis in the assets transferred to the corporation, reduced by the liabilities assumed by the corporation, which assumption is treated as a payment of money to the partnership.[4001]

[3994] See fn. 359.
[3995] See II.A.2.i Single Class of Stock Rule, for a description of the single class of stock rules and those rules' surprising flexibility.
[3996] See fn 361 in part II.B Limited Liability Company (LLC).
[3997] Code § 351.
[3998] Rev. Rul. 70-239.
[3999] Code § 351.
[4000] Code § 362(a). However, Reg. § 1.362-3 reduces the basis of property acquired in loss importation transaction.
[4001] Code § 358.

- The corporation's assumption of the partnership's liabilities decreases each partner's share of the partnership liabilities, thus, decreasing the basis of each partner's partnership interest.[4002]

- On distribution of the stock to the partners, the partnership terminates.[4003]

- The basis of the stock distributed to the partners in liquidation of their partnership interests is, with respect to each partner, equal to the adjusted basis of the partner's interest in the partnership.[4004]

- The partnership's holding period for the stock received in the exchange includes its holding period in the capital assets and Code § 1231 assets transferred (to the extent that the stock was received in exchange for such assets).[4005]

- To the extent the stock was received in exchange for neither capital nor Code § 1231 assets, the partnership's holding period for such stock begins on the day following the date of the exchange.[4006]

- The corporation's holding period in the assets transferred to it includes the partnership's holding period.[4007]

- When the partnership distributes the stock to its partners, the partners' holding periods includes the partnership's holding period of the stock.[4008]

In the second situation, the partnership distributes all of its assets and liabilities to its partners in proportion to their partnership interests, terminating the partnership. The partners then transfer all the assets received from the partnership to a new corporation in exchange for all the corporation's outstanding stock and the corporation's assumption of the partnership's liabilities that had been assumed by the partners. The tax results are:

- On the transfer of all of the partnership's assets to its partners:

  - The partnership terminates.[4009]

  - The basis of the assets (other than money) distributed to the partners in liquidation of their partnership interests is, with respect to each partner, equal to the adjusted basis of the partner's interest, reduced by the money distributed.[4010]

- The decrease in the partnership's liabilities resulting from the transfer to its partners was offset by the partners' corresponding assumption of such liabilities, so that the net effect on

[4002] See Code §§ 752 and 733.
[4003] Code § 708(b)(1)(A).
[4004] Code § 732(b),
[4005] Code § 1223(1).
[4006] See Rev. Rul. 70-598.
[4007] Code § 1223(2).
[4008] Code §§ 735(b) and 1223. Furthermore, such distribution will not violate the Code § 368(c) control requirement.
[4009] Code § 708(b)(1)(A).
[4010] Code § 732(b).

the basis of each partner's interest in the partnership, with respect to the liabilities transferred, was zero.[4011]

- No gain or loss is recognized by the partnership's former partners when the partnership transfers its assets and liabilities to the corporation in exchange for its stock.[4012]

- The (former) partners' basis in the corporation's stock is the same as their basis in the assets received in the partnership's liquidation and the transfer to the corporation, reduced by the liabilities assumed by the corporation, which assumption is treated as a payment of money to the partners.[4013]

- The corporation's basis in the assets received from the (former) partners equals the (former) partners' basis immediately before the transfer to the corporation.[4014]

- The partners' holding periods for the assets the partnership distributes to them includes the partnership's holding period.[4015]

- The partners' holding periods for the stock received in the exchange includes the partners' holding periods in the capital assets and Code § 1231 assets transferred to the corporation (to the extent that the stock was received in exchange for such assets).[4016]

- However, to the extent that the stock received was in exchange for neither capital nor Code § 1231 assets, the holding period of the stock begins on the day following the date of the exchange.

- The corporation's holding period of the partnership's assets received in the exchange includes the partners' holding periods.[4017]

In the third situation, the partners transfer their partnership interests to a newly-formed corporation in exchange for all the corporation's outstanding stock. This exchange terminates the partnership, and all of its assets and liabilities became assets and liabilities of the corporation. The tax result is:

- No gain or loss is recognized by the partners on the transfer of the partnership interests to the corporation in exchange for the corporation's stock.[4018]

- When the transfer partners transfer their partnership interests to the corporation, the partnership terminates.[4019]

- The partners' basis of the stock received from the corporation in exchange for their partnership interests equals the basis of their partnership interests transferred to the

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[4011] Code § 752.
[4012] Code § 351.
[4013] Code §§ 358(a) and 732(b).
[4014] Code §§ 362(a) and 732(c). However, Reg. § 1.362-3 reduces the basis of property acquired in loss importation transaction.
[4015] Code § 735(b).
[4016] Code § section 1223(1).
[4017] Code § 1223(2).
[4018] Code § 351.
[4019] Code § 708(b)(1)(A).

corporation, reduced by the partnership's liabilities assumed by the corporation, the release from which is treated as a payment of money to the partners.[4020]

- The corporation's basis for the assets received in the exchange equals the basis of the partners in their partnership interests.[4021]
- The corporation's holding period includes the partnership's holding period in the assets.
- The holding period of the stock received by the former partners includes each respective partner's holding period for the partnership interest transferred,[4022] except that the holding period of the stock that was received by the partners in exchange for their interests in any unrealized receivables, inventory, or various depreciable or amortizable assets of the partnership that are neither capital assets nor Code § 1231 assets begins on the day following the date of the exchange.

II.P.3.d. Conversion from S Corporation to C Corporation

Before discussing the consequences of such a conversion, consider forming an S corporation parent before converting an S corporation directly into a C corporation, or a similar transaction, for the reasons described in fns 3977-3985 in part II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation and the closing comments in that part II.P.3.b.v.

See part II.A.2.k Terminating an S Election, which includes the fact that conversion from S status to C status requires an additional tax return if done mid-year and precludes an S election for 5 years.

Converting from an S corporation to a C corporation may require the corporation to switch from the cash receipts and disbursements method of accounting to the accrual method. Generally, a C corporation cannot use the cash method,[4023] unless the corporation conducts a qualified

[4020] Code §§ 358 and 752(d).
[4021] Allocated under Code § 732(c).
[4022] Code § 1223(1).
[4023] Code § 448(a)(1).

farming business,[4024] is a qualified personal service corporation,[4025] or has gross receipts that are no more than $25 million (after 2018 adjusted for inflation).[4026]

If a corporation was an S corporation on or before December 21, 2017, during the 2-year period beginning on December 22, 2017 revokes its S election, and the owners of the stock of which, determined on the date the revocation is made, are the same owners (and in identical proportions) as on December 22, 2017 (an "eligible terminated S corporation"), then any adjustment required by a change in accounting method under Code § 481(a)(2) which is attributable to that revocation is taken into account ratably during the 6-taxable year period beginning with the year of change.[4027] A taxpayer may also apply this rule if is not required to change from cash to accrual but does anyway.[4028]

Note that S corporation earnings might be extracted in cash tax-free in the first C corporation taxable period after the final S corporation yearend.[4029] Converting the corporation into a QSub before converting it to a C corporation might also be used to preserve the AAA of a corporation whose S election is revoked.[4030]

Additionally, after that first C Corporation taxable period, an eligible terminated S corporation's distribution is chargeable to accumulated earnings and profits, in the same ratio as the amount of such AAA bears to the amount of such accumulated earnings and profits.[4031] The preamble to final regulations, T.D. 9914 (10/20/2020), explains:

[4024] Code § 448(d)(1), "Farming business," provides that a "qualified personal service corporation" is any corporation:

(A) *In general*. The term "farming business" means the trade or business of farming (within the meaning of section 263A(e)(4)).

(B) *Timber and ornamental trees*. The term "farming business" includes the raising, harvesting, or growing of trees to which section 263A(c)(5) applies.

[4025] Code § 448(d)(2), "Qualified personal service corporation," provides:

(A) substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and

(B) substantially all of the stock of which (by value) is held directly (or indirectly through 1 or more partnerships, S corporations, or qualified personal service corporations not described in paragraph (2) or (3) of subsection (a)) by-

   (i) employees performing services for such corporation in connection with the activities involving a field referred to in subparagraph (A),

   (ii) retired employees who had performed such services for such corporation,

   (iii) the estate of any individual described in clause (i) or (ii), or

   (iv) any other person who acquired such stock by reason of the death of an individual described in clause (i) or (ii) (but only for the 2-year period beginning on the date of the death of such individual).

To the extent provided in regulations which shall be prescribed by the Secretary, indirect holdings through a trust shall be taken into account under subparagraph (B).

[4026] Code § 448(b), (c).

[4027] Code § 481(d).

[4028] Rev. Proc. 2018-44, modifying Rev. Proc. 2018-31, § 15.01(3).

[4029] See fn. 3974, found in part II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation.

[4030] See part II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation, especially fns. 3977-3979.

[4031] Code § 1371(f).

Background

In the case of an S corporation, as defined in section 1361(a)(1) of the Internal Revenue Code (Code), having accumulated earnings and profits (as described in section 316(a)(1) of the Code (AE&P)) that makes a distribution of property to which section 301 would otherwise apply, section 1368(c)(1) of the Code generally treats the amount of the distribution not in excess of the S corporation's accumulated adjustments account (as defined in § 1.1368-2(a)(1) (AAA)) or the recipient shareholder's adjusted basis in such S corporation's stock as excluded from the shareholder's gross income. Section 1368(c)(2) provides that the remaining portion of the distribution is treated as a dividend (as defined in section 316(a)) to the extent of the S corporation's AE&P. Finally, section 1368(c)(3) provides that any amount of the distribution in excess of the S corporation's AAA and AE&P is applied against the shareholder's remaining adjusted basis in the stock, with any amount exceeding that adjusted basis treated as gain from the sale or exchange of property.

Generally, a distribution by a C corporation to its shareholders with respect to their stock ownership is treated as a taxable dividend to the extent of the corporation's earnings and profits. See sections 301(c) and 316(a). However, following the termination of a corporation's S election made under section 1362 of the Code (S election), section 1371(e) of the Code allows shareholders of the resulting C corporation to benefit from the corporation's former status as an S corporation with respect to distributions of money during the corporation's post-termination transition period (PTTP), which is generally the one-year period after the corporation terminates its S election. Specifically, during the PTTP, a distribution of money by the C corporation is characterized as a distribution from the corporation's AAA. The receipt of such a distribution is tax-free to the extent of the recipient shareholder's basis in its stock and the corporation's AAA balance. If the distribution exceeds the recipient shareholder's basis in its stock, but not the corporation's AAA, then the distribution is tax-free to the extent of the recipient shareholder's basis, with the remainder treated as gain from the sale of property. If the distribution exceeds the corporation's AAA, then the excess is taxed as a dividend from current earnings and profits (as described in section 316(a)(2) (CE&P)) or any AE&P from the corporation's previous existence as a corporation taxed under subchapter C. Without section 1371(e), shareholders of the former S corporation would be precluded from receiving distributions allocable to AAA.

Section 13543(a) and (b) of Public Law 115-97, 131 Stat. 2054, 2155 (2017), commonly referred to as the Tax Cuts and Jobs Act (TJCA), amended the Code by adding new sections 481(d) and 1371(f), effective as of December 22, 2017, the date of enactment of the TCJA.

Section 481(d)(1) of the Code permits a corporation that qualifies as an eligible terminated S corporation (ETSC) to take into account any 481 adjustments (as defined in part II. C of the Summary of Comments and Explanation of Revisions) which are attributable to the revocation of an S election over the section 481(d) inclusion period, which is the six-taxable-year-period beginning with the year of change (as defined in part II. C of the Summary of Comments and Explanation of Revisions). Section 481(d)(2) defines an ETSC as a C corporation meeting the following three requirements: (i) The corporation was an S corporation on December 21, 2017; (ii) the S corporation revoked its election under section 1362(a) to be an S corporation (that is, the S election) during the two-year period beginning on December 22, 2017 (revocation requirement); and (iii) the owners of the stock of the corporation, determined on the date the corporation made a revocation of its S election, are the same owners (and own identical proportions of the corporation's stock) as on December 22, 2017 (shareholder identity requirement).

Section 1371(f) extends the period during which shareholders of an ETSC can benefit from its AAA generated during the corporation's former status as an S corporation (ETSC period) by providing that, in the case of distributions of money following the PTTP, (i) the distributing ETSC's AAA is allocated to a distribution of money to which section 301 would otherwise apply (qualified distribution), and (ii) the qualified distribution is chargeable to AE&P in the same ratio as the amount of such AAA bears to the amount of such AE&P. In enacting section 1371(f), Congress determined that "it is important to provide rules to ease the transition from S corporation to C corporation for the affected taxpayers" because, based on the TCJA's revisions to the Code, "taxpayers that previously elected to be taxed as S corporations may prefer instead to be taxed as C corporations." H. Rept. 115-409, 115th Cong., 1st Sess., at 245 (Nov. 14, 2017) (House Report).

On November 7, 2019, the Department of the Treasury (Treasury Department) and the IRS published a notice of proposed rulemaking (REG-131071-18) in the Federal Register (84 FR 60011) containing proposed regulations under section 1371 and proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 481 and 1377 (proposed regulations). The Treasury Department and the IRS received 16 written or electronic comments responding to the proposed regulations. All comments received on the proposed regulations are available at http://www.regulations.gov or upon request. As no request for a public hearing was received, no hearing was held. After full consideration of the comments received, this Treasury decision adopts generally the proposed regulations with certain modifications in response to the comments received, as described in the Summary of Comments and Explanation of Revisions.

Summary of Comments and Explanation of Revisions

I. Overview

The final regulations retain the approach and structure of the proposed regulations, with certain revisions. This Summary of Comments and Explanation of Revisions discusses those revisions, as well as the comments received in response to the proposed regulations.

II. Comments on Qualification as an Eligible Terminated S Corporation

A. Significance of Date of Revocation of S Election

To qualify as an ETSC under section 481(d)(2), a corporation must satisfy the revocation requirement by making a revocation of its S election during the two-year period beginning on December 22, 2017 (two-year period). See section 481(d)(2)(A)(ii) (setting forth the revocation requirement); proposed § 1.481-5(b)(2) (same). In addition, the shareholder identity requirement must be satisfied by the same shareholders owning identical proportions of the corporation's stock on two dates: December 22, 2017, and the date on which the corporation made a revocation of its S election. See section 481(d)(2)(B) (setting forth the shareholder identity requirement); proposed § 1.481-5(b)(3) (same). But see proposed § 1.481-5(c)(1) (identifying five categories of share transfers that do not result in a change in shareholder ownership for purposes of section 481(d)(2)(B)). Consequently, the date on which a corporation makes a revocation of its S election is critical for determining ETSC qualification.

A corporation can allow the effective date of its S election revocation to occur automatically by operation of section 1362(d)(1)(C), or it can specify an effective date under section 1362(d)(1)(D). For example, a revocation made before the 16th day of the third month of an S corporation's taxable year generally is effective retroactively on the first day of that taxable year. See section 1362(d)(1)(C)(i); § 1.1362-2(a)(2)(i). In contrast, a revocation made after the 15th day of the third month of a corporation's taxable year generally is effective prospectively on the first day of the corporation's following taxable year. See section 1362(d)(1)(C)(ii); § 1.1362-2(a)(2)(i). Alternatively, the corporation may specify an immediate or prospective effective date for a revocation by expressing a date (in terms of a stated day, month, and year) that occurs on or after the date on which the revocation is made. See section 1362(d)(1)(D); § 1.1362-2(a)(2)(ii).

1. Retroactive Effective Date of the Revocation Determines ETSC Status

One commenter suggested that the final regulations revise proposed § 1.481-5(b)(2) to confirm that, in the case of a revocation with a retroactive effective date pursuant to section 1362(d)(1)(C)(i), the revocation may be treated as occurring on the retroactive effective date for purposes of ETSC qualification. Based on the stated congressional goal of facilitating the transition from S corporation status to C corporation status, the commenter contended that taxpayers reasonably could have interpreted the statute to indicate that compliance with the shareholder identity requirement would be tested on the retroactive revocation's effective date. In support of this contention, the commenter correctly noted that, in the absence of such an interpretation, a corporation would not satisfy the shareholder identity requirement for qualifying as an ETSC in proposed § 1.481-5(b)(2) and (3) if the corporation (i) had the same shareholders (and in identical proportions) on both December 22, 2017, and the retroactive effective date of the revocation, but (ii) experienced a change in shareholder ownership during the period between the retroactive effective date of the revocation and the date on which the revocation was made.

The Treasury Department and the IRS agree with the commenter's interpretation. Proposed § 1.481-5(b)(2) and (3) directly address revocations with prospective effective dates, which can be specified with significant flexibility in the revocation. A retroactive effective date for a revocation results solely by operation of section 1362(d)(1)(C)(i) and § 1.1362-2(a)(2)(i) and, in such instance, is always effective on the first day of the corporation's taxable year. To confirm the commenter's interpretation, § 1.481-5(c)(2) of the final regulations provides that, solely with regard to revocations with retroactive effective dates, a revocation may be treated as having been made on the effective date of such revocation. Accordingly, for purposes of § 1.481-5(b)(2) and (3), a corporation may test compliance with the revocation requirement and the shareholder identity requirement on either the date the revocation was made or, in the case of a revocation with a retroactive effective date, the date the revocation was effective.

2. Application of Section 7503 to a Revocation of an S Election

As discussed in part II. A of this Summary of Comments and Explanation of Revisions, the revocation requirement of section 481(d)(2)(A)(ii) requires that a corporation must make a revocation during the two-year period to qualify as an ETSC. Section 7503 provides that, "when the last day prescribed under authority of the internal revenue laws for performing any act falls on Saturday, Sunday, or a legal holiday, the performance of such act shall be considered timely if it is performed on the next succeeding day which is not a Saturday, Sunday, or a legal holiday." Because a revocation is an act made under authority of the internal revenue laws (that is, section 1362 of the Code), section 7503 applies for purposes of determining whether the revocation was made within the required two-year period. As a result of the application of section 7503 in conjunction with section 1362 and § 1.1362-2(a)(2), December 23, 2019 (a Monday), is the last day of the two-year period. Therefore, a revocation made on that date would be treated as made within the two-year period. Without the application of section 7503, December 21, 2019 (a Saturday), would have been the last day of the two-year period.

To avoid any doubt, these final regulations clarify the text of § 1.1362-2(a)(2) to provide explicitly that section 7503 applies where the last day prescribed for making a revocation occurs on a Saturday, Sunday, or legal holiday. Therefore, a revocation made on December 23, 2019, will be treated as made during the two-year period.

B. Applicability of PTTP and ETSC Period to S Corporations With No AE&P

Following the termination of an S election, section 1371(e) permits shareholders of the resulting C corporation to benefit from the corporation's former status as an S corporation with respect to distributions of money during the corporation's PTTP, which generally is the one-year period after the corporation terminates its S election. Specifically, during the PTTP, a distribution of money by the C corporation is characterized as a distribution from the corporation's AAA. The receipt of such a distribution is tax-free to the extent of the recipient shareholder's basis in the stock with respect to which the shareholder received the distribution, and is taxed as gain from the sale of property to the extent the distribution exceeds the shareholder's basis in that stock. See section 1371(e)(1). If the corporation exhausts its AAA during the PTTP, subsequent distributions are subject to treatment under section 301.

A commenter requested confirmation that the rules regarding distributions made during the PTTP, including section 1371(e) and § 1.1377-2, apply if the corporation did not have AE&P at the time that it terminated its S election. Section 1371(e)(1) provides special treatment to distributions made by a corporation during the PTTP if such distributions (i) consist of money and (ii) are made with respect to the corporation's stock. Those two conditions would be satisfied regardless of whether the distributing corporation had AE&P. Therefore, the Treasury Department and the IRS agree with the commenter's interpretation of section 1371(e) and § 1.1377-2, but have determined that no clarifying revisions to the regulations are necessary in this regard.

The commenter also requested confirmation that the rules regarding distributions made during the ETSC period would apply if the distributing corporation did not have AE&P as of the effective date of the revocation. Example 1 of proposed § 1.1371-1(d) illustrates that, if an ETSC has no AE&P as of the beginning of the day on which the revocation is effective, its historical AE&P is zero. Pursuant to proposed § 1.1371-1(a)(2)(ix) and (x), such a corporation would enter its ETSC period with a AAA ratio of 1 and an AE&P ratio of zero. Therefore, each qualified distribution would be characterized as a distribution of AAA. Based on the guidance provided in Example 1, as well as the definition of the “AAA ratio” set forth in proposed § 1.1371-1(a)(ii), the Treasury Department and the IRS have determined that no clarifying revisions to the regulations are necessary in this regard.

C. Application of Section 481(d) to Qualified Subchapter S Subsidiaries

If an S corporation wholly owns the stock of a domestic C corporation that is not an ineligible corporation described in section 1361(b)(2), the S corporation may elect under section 1361(b)(3)(B)(ii) and § 1.1361-3 to treat the C corporation as a qualified subchapter S subsidiary (QSub) such that (i) the QSub will no longer be treated as a separate corporation and (ii) all of the QSub’s assets, liabilities, and items of income, deduction, and credit will be treated as assets, liabilities, and such items (as the case may be) of the S corporation parent. If the requirements of section 1361(b)(3)(B) cease to be satisfied with respect to a QSub, including by reason of the revocation of the parent’s S election, section 1361(b)(3)(C)(i) and § 1.1361-5(b)(1)(i) provide that the corporation’s QSub election is terminated such that the QSub is treated, for purposes of the Code, as (i) a newly formed C corporation subsidiary separate from the parent and (ii) acquiring all of its assets (and assuming all of its liabilities) from the parent through an exchange to which section 351 of the Code applies (deemed section 351 exchange).

If the taxable income of any taxpayer, including a corporation, for the current year (year of change) is computed under a method of accounting that is different from the method of accounting used by the taxpayer in the preceding year (accounting method change), section 481 requires that the taxpayer must take into account those adjustments that are determined to be necessary solely by reason of the accounting method change to prevent items of income or expense from being duplicated or omitted (481 adjustments). Section 481(a). The 481 adjustments are generally taken into account in computing the taxpayer’s taxable income in the year of change. However, section 481(c) permits a taxpayer, in such manner and subject to such conditions prescribed in regulations by the Secretary of the Treasury or his delegate (Secretary), to take 481 adjustments into account in computing taxable income for the taxable year or years permitted under such regulations. As noted earlier, section 481(d)(1) permits an ETSC to take into account any 481 adjustments that are attributable to the revocation of an S election over a six-taxable year period beginning with the year of change (that is, the section 481(d) inclusion period).

Commenters have correctly observed that section 481(a) and (d) do not apply to an ETSC’s newly formed C corporation subsidiary (ETSC corporate subsidiary) that operated as a QSub prior to the revocation of its parent’s S election. Upon such a revocation, the ETSC corporate subsidiary is treated as acquiring all of its assets and assuming all of its liabilities from the ETSC in a deemed section 351 exchange. See section 1361(b)(3)(C)(i); § 1.1361-5(b)(1)(i). A corporation formed for a business purpose is a taxpayer separate from its shareholder(s). See generally *Moline Properties v. Commissioner*, 319 U.S. 436 (1943). As a result of the ETSC corporate subsidiary’s status as a new C corporation with no prior taxable year (rather than, for example, as a successor under section 381(a) of the Code), commenters have noted that the ETSC corporate subsidiary lacks any historical method of accounting from which to change. Compare § 1.446-1(e)(1) (providing that a taxpayer filing its first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return) with section 381(c)(4) (providing that, in general, a successor corporation must use the method of accounting used by the predecessor corporation as of the date of the section 381(a) transaction).

Notwithstanding those observations of the law, commenters have requested that the final regulations extend the section 481(d) inclusion period to an accrual method ETSC corporate subsidiary that operated as a cash method QSub of a cash method S corporation prior to the revocation of the parent’s S election. These commenters highlighted that, in the deemed section 351 exchange required by section 1361(b)(3)(C)(i) and § 1.1361-5(b)(1)(i) that results from the revocation of the parent’s S election, the accounts receivable of a former cash method QSub would be deemed transferred to the accrual method ETSC corporate subsidiary with a zero basis. See generally *Raich v. Commissioner*, 46 T.C. 604 (1966) (holding that trade accounts receivable of a cash method transferor received by an accrual basis transferee in a section 351 exchange had a zero basis). Therefore, the ETSC corporate subsidiary would recognize income as it collects amounts on the transferred receivables. In the case where the ETSC corporate subsidiary collects the entire amount of the transferred receivables during its first taxable year, commenters contended that the ETSC corporate subsidiary’s inability to include the amount received over the six-year section 481(d) inclusion period would inappropriately disadvantage the former QSub as compared to its former S corporation parent.

The Treasury Department and the IRS understand the commenters’ concerns regarding the statutorily limited application of section 481(d) and observe that the commenters’ request is not unique to the application of section 481(d), but rather addresses the longstanding treatment of former S corporations and QSubs under section 481 with regard to a deemed section 351 exchange. Throughout the nearly 25-year period since the 1996 enactment of the QSub provisions under section 1361, section 481(a)(2) and any inclusion period for a 481 adjustment have not applied with respect to former QSubs. See section 1308 of the Small Business Job Protection Act of 1996, Public Law 104-188, 110 Stat. 1755, 1782-3 (August 20, 1996). See also Rev. Proc. 97-27, 1997-1 C.B. 680, section 5.02(3)(a) (providing a four-year amortization period solely to taxpayers that have a 481 adjustment); Rev. Proc. 2015-13, 2015-5 I.R.B. 419, section 7.03(1) (same). After considering the commenters’ analysis and the explicit reference in section 481(d) to section 481(a)(2), the Treasury Department and the IRS have determined that section 481(d) does not apply to ETSC corporate subsidiaries, but rather maintains the longstanding application of section 481(a) solely to taxpayers that make an accounting method change. Accordingly, there is no authority under section 481(d) to extend the section 481(d) inclusion period to ETSC corporate subsidiaries.

Commenters also contended that the Treasury Department and the IRS could override the limited scope of section 481(d) through special QSub regulations issued under the authority provided by section 481(c), which, in the case of a taxpayer making an accounting method change, authorizes regulations permitting a taxpayer to take any 481 adjustment into account in computing taxable income for the taxable year or years permitted under such regulations. For example, commenters suggested that the final regulations permit an accrual method ETSC corporate subsidiary to elect to treat the assets received (and liabilities assumed) by the ETSC corporate subsidiary in the deemed section 351 exchange as though the subsidiary had owned such assets (and had such liabilities) in a prior taxable year, thereby creating an accounting method change upon the revocation. However, this approach contradicts the explicit text of section 1362(b)(3)(C)(i), which provides that, “[f]or purposes of this title” (that is, for purposes of all of the provisions of the Code), an ETSC corporate subsidiary “shall be treated as a new corporation.”

In the alternative, commenters suggested that the final regulations could permit taxpayers to treat the assets received (and liabilities assumed) by an ETSC corporate subsidiary as though still owned by the former S corporation on the date on which the former S corporation becomes an ETSC. Under this approach, the ETSC’s 481 adjustment would be computed as if the ETSC owned such assets and was subject to such liabilities. For support, these commenters highlighted anti-abuse regulations issued under section 263A of the Code (UNICAP anti-abuse regulations) that utilized this alternative approach. See § 1.263A-7(c)(4)(ii) (providing an anti-abuse rule regarding the use of section 351 exchanges to avoid application of section 263A). However, the UNICAP anti-abuse regulations were issued under the authority of section 263A(h)(1) rather than the authority granted the Secretary under section 481(c). See 52 FR 10052, 10059 (March 30, 1987). Section 263A(h)(1) requires the Secretary to “prescribe rules to carry out the purpose of section 263A, including regulations to prevent the use of related parties, pass-thru entities, or intermediaries to avoid the application of this section.” Section 263A(j)(1).

The Treasury Department and the IRS have considered the commenters’ suggested approaches for extending the section 481(d) inclusion period to ETSC corporate subsidiaries but have determined that section 481(c) would not support either approach. Section 481(c) and § 1.481-1(c)(2) provide the general rule that the 481 adjustment is taken into account in computing taxable income in the year of change, unless the Commissioner prescribes a different taxable year or years to take the 481 adjustment into account under §§ 1.446-1(e)(3) and 1.481-4. Any regulations issued under section 481(c) can apply only “[i]n the case of any change described in [section 481](a)” with regard to “adjustments required by [section 481](a)(2).” As acknowledged by the commenters, section 481(a) does not apply to an ETSC corporate subsidiary because such entity is newly formed and therefore could not have had a prior accounting method to potentially change.

Based on the foregoing, the final regulations do not adopt either of the commenters’ alternative suggestions or provide any inclusion period for ETSC corporate subsidiaries under section 481. The Treasury Department and the IRS, however, note that TCJA amendments to section 448(c) of the Code have significantly expanded the applicability of the cash method to C corporations, including ETSC corporate subsidiaries. As amended by section 13102(a) of the TCJA (131 Stat. 2054, 2102-3), section 448(c) provides that a C corporation may use the cash method if the corporation has average annual gross receipts not exceeding $25 million (adjusted for inflation) for its three prior taxable years. Prior to the TCJA, the gross receipts threshold under section 448(c) was $5 million. As a result, fewer ETSC corporate subsidiaries will be required to adopt the accrual method as their permissible method of accounting for their first tax return than if the section 448(c) gross receipts threshold had not been increased from $5 million to $25 million.

III. Comments Regarding the Post-Termination Transition Period

The last sentence of § 1.1377-2(b), as in effect prior to the effective date of these final regulations (no-newcomer rule), limited the special treatment provided under section 1371(e)(1) (with respect to distributions of money during a corporation's PTTP) solely to those shareholders who were shareholders of the corporation at the time that it terminated or revoked its S election (collectively, legacy shareholders). Because the rules pertaining to the PTTP and to the ETSC period serve a similar objective of easing the transition from S corporation to C corporation status, the Treasury Department and the IRS determined that the rules regarding newcomers (that is, non-legacy shareholders) should be consistent. See preamble to the proposed regulations, Explanation of Provisions, part IV. Therefore, based on the rationale for rejecting a no-newcomer rule with respect to the ETSC period, as set forth in part II. A of the Explanation of Provisions of the preamble to the proposed regulations, the Treasury Department and the IRS determined that such a rule should also not apply with respect to the PTTP and proposed the removal of the no-newcomer rule in § 1.1377-2(b). See *Id.*

A. Reliance on the § 1.1377-2(b) No-Newcomer Rule

One commenter expressed concern that elimination of the no-newcomer rule in § 1.1377-2(b) could alter bargained-for economic results if a legacy shareholder had transferred less than all of its shares prior to November 7, 2019 (that is, the publication date of the proposed regulations) or after that date but pursuant to a binding agreement entered into before that date. In particular, the commenter contended that legacy shareholders who transferred less than all of their shares would have expected that only legacy shareholders could receive distributions of AAA during the PTTP, and perhaps even during the ETSC period. According to the commenter, this expectation would have reduced the bargained-for price for the transferred shares to reflect the tax benefit of the future tax-free distributions.

The commenter provided an example in which a sole shareholder of an ETSC sold 40 percent of its stock to a third-party. The sale price was set prior to November 7, 2019, and the parties assumed that the no-newcomer rule would limit distributions of AAA to the legacy shareholder during the PTTP, and that a similar rule would apply during the ETSC period. Under the proposed elimination of the no-newcomer rule in § 1.1377-2(b), however, the newcomer, and not the legacy shareholder, would be eligible to receive 40 percent of any AAA distributed during the PTTP or ETSC period. The commenter observed that the newcomer's accession to a 40 percent interest in the corporation's AAA during the PTTP and ETSC period amounts to a transfer of a tax benefit from the legacy shareholder to the newcomer for no consideration, contrary to the parties' expectations. Therefore, the commenter recommended that the final regulations include an additional transition rule. Under this rule, if shares of a former S corporation were transferred to a newcomer pursuant to a binding agreement entered into before the applicability date of the final regulations, then, except upon unanimous agreement of current shareholders of a corporation that are legacy shareholders, the no-newcomer rule would apply during the PTTP, and a similar rule would apply during the ETSC period.

The Treasury Department and the IRS understand the concern underlying the commenter's recommendation. However, the Treasury Department and the IRS intended the applicability date provisions in the proposed regulations, and as adopted in these final regulations, to afford corporations transition flexibility in applying § 1.1377-2(b) with regard to the PTTP. Section 1.1377-2(b), as revised by the final regulations to eliminate the no-newcomer rule for special treatment under section 1371(e)(1) of distributions of money by a corporation with respect to its stock during the post-termination transition period applies to a corporation's taxable years beginning after the date of publication of the final regulations. In the case of a corporation using the calendar year as its annual accounting period, newcomers are not entitled to receive distributions of AAA before January 1, 2021, unless the corporation chooses to apply § 1.1377-2(b) before January 1, 2021. Corporations to which the commenter's transition rule would have applied generally will thus have completed their PTTPs prior to the applicability of § 1.1377-2(b). Distributions of AAA during those PTTPs would have been limited to legacy shareholders. Additionally, the commenter's proposed transition rule would add complexity in administering these rules. Accordingly, the Treasury Department and the IRS have determined that the applicability date provisions, as set forth in the proposed regulations and adopted in these final regulations, balance appropriately the protection of legacy taxpayers' expectations with the goal of the Treasury Department and the IRS to minimize complexity and administrative difficulties for S corporations, their shareholders, and the IRS.

With regard to the ETSC period, as discussed in part II. A of the Explanation of Provisions of the preamble to the proposed regulations, section 1371(f) does not contain a no-newcomer rule similar to § 1.1377-2(b), and the Treasury Department and the IRS have concluded that it is inappropriate to adopt one. Corporations may have applied a similar analysis of section 1371(f) and made distributions of AAA to newcomers during their respective ETSC periods. Providing an alternate rule in these final regulations for the ETSC period could unexpectedly alter taxpayers' bargained-for economic results. Therefore, the Treasury Department and the IRS have determined that the best way to address this situation is to allow but not require corporations to apply the final regulations addressing distributions made during the ETSC period to taxable years beginning on or before the date that these final regulations are published in the Federal Register.

B. Consideration of Request for an Additional 120-Day PTTP

A commenter recommended that the final regulations provide a new 120-day PTTP that would begin on the applicability date of the final regulations. The commenter noted that this new PTTP would create an opportunity for any C corporation with undistributed AAA that expired at the end of its PTTP to restore and distribute such AAA pursuant to section 1371(e)(1) and § 1.1377-2. The commenter contended that the elimination of the no-newcomer rule only for terminations that occur after the issuance of the proposed regulations disadvantages corporations that terminated their S election more than one year prior to issuance of the proposed regulations, as compared to corporations that terminated their S election after the issuance of the proposed regulations.

The Code sets forth a statutory definition of the PTTP that includes detailed limits on its duration. Specifically, section 1377(b)(1)(A), (B), and (C) provide three separate durations for the PTTP, the respective applicability of which depends upon particular events. While the Treasury Department and the IRS acknowledge the concerns raised by the commenter, the final regulations do not adopt the commenter's recommendation because (i) section 1377(b) provides specific, detailed, and unambiguous guidance on the duration of a PTTP, and (ii) the recommended revision to § 1.1377-2 exceeds the scope of the authority granted to prescribe regulations under sections 1371 or 1377.

IV. Consideration of Comment Regarding Treatment of ETSC Status and AAA as Section 381 Items

In the case of certain asset acquisitions, section 381(a) generally requires the acquiring corporation to succeed to and take into account the tax items described in section 381(c) of the distributor or transferor corporation. See section 381(a) (describing distributions to which section 332 of the Code applies and transfers to which section 361 of the Code applies that are carried out in connection with certain reorganizations described in section 368(a)(1) of the Code); section 381(c) (enumerating tax items of the distributor or transferor corporation that the acquiring corporation succeeds to and takes into account under section 381(a)).

A commenter requested that the final regulations confirm that ETSC status and AAA constitute tax items that an acquiring corporation would succeed to or take into account under section 381(a). The Treasury Department and the IRS have considered the issue raised by the commenter but have determined that further study would be required to promulgate the appropriate rule. In addition, the Treasury Department and the IRS have concluded that this issue exceeds the scope of the final regulations because whether AAA constitutes a tax item to which a successor may succeed under section 381 is not limited to the ETSC context. Therefore, the final regulations do not address the commenter's request.

Applicability Dates

These regulations generally apply to taxable years beginning after October 20, 2020. See §§ 1.481-6(b), 1.1371-1(e), 1.1371-2(d), and 1.1377-3(c). However, a corporation may choose to apply the rules set forth in §§ 1.481-5, 1.1371-1, and 1.1371-2 in their entirety to taxable years beginning on or before October 20, 2020. If a corporation makes the choice described in the previous sentence, all shareholders of the corporation must report consistently, and the corporation must continue to apply the rules in §§ 1.481-5, 1.1371-1, and 1.1371-2 in their entirety for the corporation's subsequent taxable years.

In addition, a corporation generally may choose to not apply the no-newcomer rule in § 1.1377-2(b) to taxable years beginning on or before October 20, 2020 and with respect to which the period described in section 6501(a) as applied to that corporation has not expired. If a corporation makes the choice described in the previous sentence, all shareholders of the corporation must report consistently, and the corporation must adopt §§ 1.481-5, 1.1371-1, 1.1371-2 (if an ETSC), and § 1.1377-2(b) in their entirety and continue to apply those rules in their entirety for the corporation's subsequent taxable years.

II.P.3.e. Conversion from Qualified Subchapter S Subsidiary to Single Member LLC

The merger of a Qualified Subchapter S Subsidiary ("QSub") into an LLC wholly owned by the QSub's parent has no income tax consequences.[4032]

[4032] Reg. § 1.1361-5(b)(3), Example (2). See fn. 139 for details.

II.P.3.f. Conversions from Partnership to Sole Proprietorships and Vice Versa

When a sole proprietorship organized as an LLC adds a member, it becomes a partnership. If the original member sells part his or her interest in the LLC to a new member, then he or she is deemed to have sold a corresponding portion of the LLC's assets to the new member,[4033] as follows:[4034]

> In this situation, the LLC, which, for federal tax purposes, is disregarded as an entity separate from its owner, is converted to a partnership when the new member, B, purchases an interest in the disregarded entity from the owner, A. B's purchase of 50% of A's ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets, which are treated as held directly by A for federal tax purposes. Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.
>
> Under section 1001, A recognizes gain or loss from the deemed sale of the 50% interest in each asset of the LLC to B.
>
> Under section 721(a), no gain or loss is recognized by A or B as a result of the conversion of the disregarded entity to a partnership.
>
> Under section 722, B's basis in the partnership interest is equal to $5,000, the amount paid by B to A for the assets which B is deemed to contribute to the newly-created partnership. A's basis in the partnership interest is equal to A's basis in A's 50% share of the assets of the LLC.
>
> Under section 723, the basis of the property treated as contributed to the partnership by A and B is the adjusted basis of that property in A's and B's hands immediately after the deemed sale.
>
> Under section 1223(1), A's holding period for the partnership interest received includes A's holding period in the capital assets and property described in section 1231 held by the LLC when it converted from an entity that was disregarded as an entity separate from A to a partnership. B's holding period for the partnership interest begins on the day following the date of B's purchase of the LLC interest from A. See Rev. Rul. 66-7, 1966-1 C.B. 188, which provides that the holding period of a purchased asset is computed by excluding the date on which the asset is acquired. Under section 1223(2), the partnership's holding period for the assets deemed transferred to it includes A's and B's holding periods for such assets.

[4033] See T.D. 8844 (preamble to regulations on entity conversions) (11/29/99) and Rev. Rul. 99-5. See Rev. Rul. 2001-61 and CCA 201351018 regarding retention of employer identification number. See also The Treatment of Liabilities In Rev. Rul. 99-5 and Rev. Rul. 99-6 Situations *TM Memorandum* (BNA) (3/16/2009), and AICPA Comments to IRS on Rev. Rul. 99-5 on Disregarded Entities (6/5/2013), found at http://www.aicpa.org/advocacy/tax/partnerships/downloadabledocuments/comments-on-rev-ruling-99-5-v-6-5-13submit.pdf.

[4034] Rev. Rul. 99-5, Situation 1.

However, if the new member pays the LLC for a member interest, then the old and new member are deemed to have formed a partnership, which generally qualifies as a nontaxable transaction,[4035] as follows:[4036]

> In this situation, the LLC is converted from an entity that is disregarded as an entity separate from its owner to a partnership when a new member, B, contributes cash to the LLC. B's contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to the partnership in exchange for a partnership interest.
>
> Under section 721(a), no gain or loss is recognized by A or B as a result of the conversion of the disregarded entity to a partnership.
>
> Under section 722, B's basis in the partnership interest is equal to $10,000, the amount of cash contributed to the partnership. A's basis in the partnership interest is equal to A's basis in the assets of the LLC which A was treated as contributing to the newly-created partnership.
>
> Under section 723, the basis of the property contributed to the partnership by A is the adjusted basis of that property in A's hands. The basis of the property contributed to the partnership by B is $10,000, the amount of cash contributed to the partnership.
>
> Under section 1223(1), A's holding period for the partnership interest received includes A's holding period in the capital and section 1231 assets deemed contributed when the disregarded entity converted to a partnership. B's holding period for the partnership interest begins on the day following the date of B's contribution of money to the LLC. Under section 1223(2), the partnership's holding period for the assets transferred to it includes A's holding period.

Thus, the parties can control whether the original owner is taxed and the new owner gets an inside basis step-up, or the original owner is not taxed and the new owner does not get an inside basis step-up.[4037] However, the parties can have their cake and eat it, too: in the latter case, the new owner can transfer the partnership interest to another partnership (or corporation) in a tax-free transaction and get an inside basis step-up.[4038]

[4035] See T.D. 8844 (preamble to regulations on entity conversions) (11/29/99), Rev. Rul. 99-5, and part II.M.3 Buying into or Forming a Partnership (especially part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership). See Rev. Rul. 2001-61 and CCA 201351018 regarding retention of employer identification number. Letter Ruling 200633019 discusses a large variety of tax issues when a trust contributes a diversified portfolio of marketable securities to a single-member LLC and then distributes LLC interests to the remaindermen; Letter Ruling 201628008 includes a more abbreviated discussion of such a transaction. See also The Treatment of Liabilities In Rev. Rul. 99-5 and Rev. Rul. 99-6 Situations 201351018 (BNA) (3/16/2009).

[4036] Rev. Rul. 99-5, Situation 2.

[4037] See part II.Q.8.e.iii.(a) Illustration of Inside Basis Issue.

[4038] See parts II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss), II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000 and II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

When an LLC with more than one member is taxed as a partnership, and the number of members later is reduced to one, it becomes a sole proprietorship for tax purposes. When one member buys out the other(s), the selling member(s) is(are) taxed based on the rules for selling a partnership interest, and the remaining member (essentially the new sole proprietor) is deemed to have bought all of the LLC's assets on that date, with no tacking of holding period for any portion of the assets.[4039] Furthermore, payments that would have been deductible by a partnership had it continued in existence are deductible by the successors to the partnership.[4040]

Pierre v. Commissioner[4041] was a reviewed opinion (12-6 vote) holding that gifts and sales of interests in a single-member limited liability company (LLC) be treated for gift tax purposes as transfers of interests in an entity rather than transfers of the underlying assets.

Initially, the transferor was the LLC's sole owner. Some LLC interests were gifted, and the rest were sold. The IRS asserted that the transfers were of the LLC's underlying assets, not interests in the LLC. It tried to apply the principles of Rev. Rul. 99-5, Situation 1, which provides:

> In this situation, the LLC, which, for federal tax purposes, is disregarded as an entity separate from its owner, is converted to a partnership when the new member, B, purchases an interest in the disregarded entity from the owner, A. B's purchase of 50% of A's ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets, which are treated as held directly by A for federal tax purposes. Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

The Tax Court majority rejected the application of the check-the-box rules[4042] to this gift. Those provisions apply only "where not otherwise distinctly expressed or manifestly incompatible with the intent" of other provisions in the tax law.[4043] Fundamental gift tax precepts require that one look to the bundle of rights transferred. The Tax Court held that, under state law, an LLC interest (not an interest in the underlying assets) was transferred; applying the check-the-box regulations would be manifestly incompatible with fundamental gift tax precepts. *Pierre* is quoted in length in part III.B.1.e Valuation Issues.

The court distinguished between classifying the entity and describing the nature of the assets that were transferred. This fine line might breed litigation in the transfer tax area.

4039 Rev. Rul. 99-6; see also part II.Q.8 Exiting From or Dividing a Partnership; see Letter Ruling 201723009 when such a transaction is done inside a consolidated group. See Rev. Rul. 2001-61 and CCA 201351018 regarding retention of employer identification number. See also "The Treatment of Liabilities In Rev. Rul. 99-5 and Rev. Rul. 99-6 Situations," *TM Memorandum* (BNA) (3/16/2009). For a myriad of tax issues raised in this situation, criticizing Rev. Rul. 99-6, see AICPA Comments on Revenue Ruling 99-6 on Conversions from Partnerships to Disregarded Entities (10/1/2013), found at http://www.aicpa.org/advocacy/tax/partnerships/downloadabledocuments/comments-on-rev-ruling-99-6-submit.pdf. The AICPA points to very different results when a purchaser buys 99% instead of 100%.
4040 Rev. Rul. 75-154.
4041 133 T.C. 24 (2009). For income tax treatment of a gift of the entire interest in a single member LLC, see fn. 342.
4042 Reg. §§ 301.7701-1 through 301.7701-3.
4043 Code § 7701(a) (introductory language).

II.P.3.g. Rescissions, Including Rescinding Conversion of Entity

The IRS often respects rescissions for income tax purposes[4044] when a transaction is reversed in the same taxable year. The IRS explains:[4045]

> The legal concept of rescission refers to the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.
>
> The annual accounting concept requires that one must look at the transaction on an annual basis using the facts as they exist at the end of the year. That is, each taxable year is a separate unit for tax accounting purposes…..
>
> In Situation 1 the rescission of the sale … placed A and B at the end of the taxable year in the same positions as they were prior to the sale. Thus, … the original sale is to be disregarded for federal income tax purposes because the rescission extinguished any taxable income for that year with regard to that transaction…..
>
> In Situation 2, as in Situation 1, there was a completed sale in 1978. However, unlike Situation 1, because only the sale and not the rescission occurred in 1978, at the end of 1978 A and B were not in the same positions as they were prior to the sale….[T]he rescission in 1979 is disregarded with respect to the taxable events occurring in 1978.
>
> In both situations, the annual accounting period principle requires the determination of income at the close of the taxable year without regard to subsequent events.

Gateway Hotel Partners, LLC v. Commissioner[4046] upheld the requirement that the transaction cannot qualify for rescission unless undone by the end of the taxable year. *Blagaich v.*

[4044] The IRS does not have a clear policy for estate and gift tax law. However, *Neal v. U.S.*, 187 F.3d 626 (3rd Cir. 1999) allowed a rescission under Pennsylvania law and considered the gift incomplete because of it.

[4045] Rev. Rul. 80-58. Although the ruling is old, it is still viable. Rev. Proc. 2013-3, Section 5.02(1) indicated that the IRS was considering its position in the rescission area. Rev. Proc. 2014-3, Section 1.02(6) mentioned that Section 5.02(1) was deleted and that Section 3.02(8) was added, the latter providing that whether a completed transaction can be rescinded for Federal income tax purposes is an issue on which the IRS will not issue a private letter ruling. At the May 2014 meeting of the Sales, Exchanges & Basis Committee of the American Bar Association's Section of Taxation, a government representative informally stated that withdrawing its study of the area indicates that the IRS has reaffirmed its commitment to Rev. Rul. 80-58. Materials for that meeting prepared by Section practitioner members are saved as Thompson Coburn document 6044351. For more on Rev. Rul. 80-58, see New York State Bar Association Tax Section Report on the Rescission Doctrine (Report No. 1216) (8/11/2010) at www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1216-Report.pdf, citing Sheldon I. Banoff, Unwinding or Rescinding a Transaction: Good Tax Planning or Tax Fraud, *Taxes – The Tax Magazine* (Dec. 1984) at 942; and David H. Schnabel, Revisionist History: Retroactive Federal Tax Planning (2009) (unpublished manuscript), mentioning that an earlier version is published at 60 *Tax Lawyer* 685 (2007).

[4046] T.C. Memo. 2014-5.

Commissioner[4047] also refused to apply rescission to a payment that the taxpayer returned over three years later after payment, when she did so only after being order by a court to do so. However, in another case, a taxpayer was permitted to rescind a disclaimer based on erroneous tax advice, more than two years after the disclaimer, after joining the IRS as a party to a legal action to rescind.[4048]

[4047] T.C. Memo. 2016-2, holding:

> … In general, the annual accounting period principle reflected in section 451, considered in the light of the judicially articulated claim-of-right doctrine, limits application of the rescission exception such that, without regard to subsequent events, income received by the taxpayer under a claim of right and retained by her at the close of the taxable year must be included in gross income for that year. See [*Penn v. Robertson*, 115 F.2d 167, 175 (4th Cir. 1940)]; Rev. Rul. 80-58, Situation 2, 1980-1 C.B. at 182.
>
> ….
>
> The facts show that, in 2010, petitioner took possession of the whole amount in question, $400,000, without any substantial limitations or restrictions as to its disposition. She recognized no liability and made no provision to repay that amount until nearly three years later. None of the cases petitioner cites as allowing a relaxation of the same-year requirement for rescission is factually comparable to her own, and they provide no rationale for departing from the general rule.
>
> With respect to the equitable concerns petitioner raised in her motion—The equities in this case simply do not support strict adherence to the one-year guideline in the rescission doctrine.—we note only that our statutory mandate does not permit us to decide this case on the basis of general principles of equity. See *Knapp v. Commissioner*, 90 T.C. 430, 440 (1988) (citations omitted) (The Tax Court is a court of limited jurisdiction. *** We have only the powers expressly conferred on us by Congress, and may not apply equitable principles to expand our jurisdiction beyond the limits of section 7442.), *aff'd*, 867 F.2d 749 (2d Cir. 1989).

The court rejected the taxpayer's reliance on *Hope v. Commissioner*, 55 T.C. 1020, 1030 (1971), *aff'd*, 471 F.2d 738 (3d Cir. 1973), which the court said:

> suggests that the rescission doctrine may apply even when repayment of a gain does not formally occur in the year of receipt, but only if, before the end of the year, [the] taxpayer recognizes his liability under an existing and fixed obligation to repay the amount received and makes provisions for repayment.

The court rejected the taxpayer's reliance on *Guffey v. United States*, 339 F.2d 759 (9th Cir. 1964), which case the court described:

> In *Guffey*, the installment purchasers of the Guffeys' home sued to rescind the sale contract when, in the following year, they discovered dry rot, moved out, and refused to make further payments. A settlement was reached under which the purchasers' suit was dismissed and the Guffeys obtained a quitclaim deed and retained the previously received payments as rent.…While the Court of Appeals did state that it can fairly be said that the settlement with the *** original purchasers was, in substance, a reduction in the purchase price, *id.*, the Guffeys returned nothing to the original purchasers, the original purchasers apparently agreeing that the payments could be kept as rent. The sort of passive unwinding of the agreement that occurred in *Guffey* did not and could not occur in the case at bar; the only way Mr. Burns could be restored to status quo ante was if petitioner returned the $400,000.

[4048] *Breakiron v. Gudonis*, 106 A.F.T.R.2d 2010-5999 (D. Mass. 2010). The IRS was joined as a party when it attempted to collect gift tax. In another disclaimer case, the court dismissed the IRS as a party. *Van Vliet v. Van Vliet*, 115 A.F.T.R.2d 2015-803 (E.D. Va. 2015).

When I discussed *Breakiron* on a list-serve, one of the lawyers who represented Breakiron responded on 12/30/2022:

> Legally, *Breakiron* relied primarily on an incomplete gift theory (building on *Dodge*, *Berger*, etc.) – in theory, if the gift really is incomplete because the donor has a state law right to rescind the transaction on grounds of mistake, it remains incomplete for so long as that right remains

The IRS approved a rescission of a conversion from partnership to corporation where everything happened in one year and the taxpayer had a good nontax reason.[4049] The IRS has also allowed a taxpayer to rescind a restructuring involving a subsidiary to reverse unintended adverse Federal income tax consequences.[4050] However, the IRS will not issue any more letter rulings in this area.[4051]

A taxpayer cannot unilaterally recast a transaction merely because the taxpayer decides that documenting it differently would have produced a better tax result.[4052]

For the rescission to be effective, both parties must be put back in their original positions.[4053] A January 2005 article further analyzes the rescission doctrine.[4054]

> outstanding (at some point you'd no longer be able to enforce it because of limitations periods, laches, etc., which would render the gift complete at that time).
> Practically, it mattered significantly that the case was decided in federal court (both the underlying question of whether state law allowed a rescission in that particular case, and the question of that rescission's effect on federal tax law), allowing the judge to set aside the issues around collusion, etc. in the *Van den Wymelenberg* series of cases, and of course (unlike state court actions generally) making the state law determination regarding the mistake binding on the IRS as a party. We'd originally filed the action in state court, going the *Bosch* route, naming the government as a party but expecting them to ignore us, but to our surprise the DOJ removed the case to federal court. Once they did that, we realized what a lucky result that was, as (assuming we won on the merits) we'd have a binding ruling and wouldn't have to worry about whether and to what extent a state court action would solve the problem. I don't know whether anyone else has seen a case like this removed to federal court by the government, but (judging from the *Van Vliet* case that Steve cited) I suspect they decided after that to let things stay in state court, and deflect attempts to bring actions in federal court where they could, and then choose to fight instead over the extent to which those state court decisions affect federal tax liabilities.

[4049] Letter Ruling 200952036.
[4050] Letter Ruling 201008033.
[4051] Rev. Proc. 2017-3, Section 3.02(8), listed as a no-rule area "whether a completed transaction can be rescinded for Federal income tax purposes."
[4052] *Makric Enterprises, Inc. v. Commissioner*, TC Memo 2016-44, *aff'd* 119 A.F.T.R.2d ¶ 2017-580 (5th Cir. 3/27/2017).
[4053] Citing *Hutcheson v. Commissioner*, T.C. Memo. 1996-127 for that proposition, *Fitch v. Commissioner*, T.C. Memo. 2012-358, rebuffed IRS arguments in favor of rescinding a sale of a CPA practice, which was followed by a repurchase shortly thereafter when the original buyer's health deteriorated unexpectedly:

> The repurchase agreement, by its own terms, effected a sale of the C.P.A. practice from Mr. Gronke to Mr. Fitch and not an unwinding of the earlier sale. There is no evidence that Mr. Fitch and Mr. Gronke intended to abrogate, cancel, or void the sale agreement. Furthermore, we do not believe that the repurchase agreement returned them to their original positions. The C.P.A. practice continued as a dynamic, ongoing enterprise for approximately 4-1/2 months after the sale transaction, and we cannot say that Mr. Fitch received the C.P.A. practice back in the exact same condition in which he had sold it. Accordingly, we find that the sale and repurchase transactions were not rescinded.

Query whether the court was just being sympathetic to the seriously ill parties and really would set such a high bar if the taxpayers had sought to rescind the agreement.
[4054] Morehouse, The Rescission Doctrine: Tax Do-Overs, Another Roll of the Dice, *TM Real Estate Journal* (BNA) (1/7/2015).

An S election may be rescinded until the last day on which the election could have been timely made.[4055] The IRS will not permit a revocation that is more retroactive than that.[4056] A corporation may rescind such a revocation at any time before the revocation becomes effective, but only with the consent of each person who consented to the revocation and each person who became a shareholder of the corporation within the period beginning on the first day after the date the revocation was made and ending on the date on which the rescission is made.[4057]

For various state law grounds for rescission or reformation (retroactive), see Harrington, "Retroactive Revisions and Reversals: Risks and Rewards," Chapter 4, 55TH Annual Heckerling Institute on Estate Planning (2021).

As to tax issues, *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), held:

> First, the Commissioner was not made a party to either of the proceedings here and neither had the effect of res judicata, *Freuler v. Helvering*, *supra*, nor did the principle of collateral estoppel apply. It can hardly be denied that both state proceedings were brought for the purpose of directly affecting federal estate tax liability. Next, it must be remembered that it was a federal taxing statute that the Congress enacted and upon which we are here passing. Therefore, in construing it, we must look to the legislative history surrounding it. We find that the report of the Senate Finance Committee recommending enactment of the marital deduction used very guarded language in referring to the very question involved here. It said that "proper regard," not finality, "should be given to interpretation of the will" by state courts and then only when entered by a court "in a bona fide adversary proceeding." S. Rep. No. 1013, Pt. 2, 80th Cong., 2d Sess., p. 4. We cannot say that the authors of this directive intended that the decrees of state trial courts were to be conclusive and binding on the computation of the federal estate tax as levied by the Congress. If the Congress had intended state trial court determinations to have that effect on the federal actions, it certainly would have said so—which it did not do. On the contrary, we believe it intended the marital deduction to be strictly construed and applied. Not only did it indicate that only "proper regard" was to be accorded state decrees but it placed specific limitations on the allowance of the deduction as set out in §§ 2056(b), (c), and (d). These restrictive limitations clearly indicate the great care that Congress exercised in the drawing of the Act and indicate also a definite concern with the elimination of loopholes and escape hatches that might jeopardize the federal revenue. This also is in keeping with the long-established policy of the Congress, as expressed in the Rules of Decision Act, 28 U.S.C. § 1652. There it is provided that in the absence of federal requirements such as the Constitution or Acts of Congress, the "laws of the several states ... shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply." This Court has held that judicial decisions are "laws of the ... state" within the section. *Erie R. Co. v. Tompkins*, *supra*; *Cohen v. Beneficial Loan Corp.*, 337 U. S. 541 (1949); *King v. Order of Travelers*, 333 U.S. 153 (1948). Moreover, even in diversity cases this Court has further held that while the decrees of "lower state courts" should be "attributed some weight ... the decision [is] not controlling ..." where the highest court of the State has not spoken on the point. *King v. Order of Travelers*, *supra*, at 161. And in *West v. A. T. & T. Co.*, 311 U.S. 223 (1940), this Court further held that "an intermediate appellate state court ...

[4055] Reg. § 1.1362-2(a)(2)(i).
[4056] Christian & Grant, ¶32.02. Revocation, *Subchapter S Taxation* (WG&L), cites varies IRS correspondence to that effect.
[4057] Reg. § 1.1362-2(a)(4).

is a datum for ascertaining state law which is not to be disregarded by a federal court unless it is convinced by other persuasive data that the highest court of the state would decide otherwise." At 237. Thus, under some conditions, federal authority may not be bound even by an intermediate state appellate court ruling. It follows here then, that when the application of a federal statute is involved, the decision of a state trial court as to an underlying issue of state law should *a fortiori* not be controlling. This is but an application of the rule of *Erie R. Co. v. Tompkins*, *supra*, where state law as announced by the highest court of the State is to be followed. This is not a diversity case but the same principle may be applied for the same reasons, *viz.*, the underlying substantive rule involved is based on state law and the State's highest court is the best authority on its own law. If there be no decision by that court then federal authority must apply what it finds to be the state law after giving "proper regard" to relevant rulings of other courts of the State. In this respect, it may be said to be, in effect, sitting as a state court. *Bernhardt v. Polygraphic Co.*, 350 U.S. 198 (1955).

We believe that this would avoid much of the uncertainty that would result from the "non-adversary" approach and at the same time would be fair to the taxpayer and protect the federal revenue as well.

Harrington's 2021 *Heckelring* article cited above explained various gift/estate tax recognitions of attempts to undo various transactions:

C. Gifts: Reformation for Scrivener's Error. Some relevant federal tax cases:

1. *Kraus Est. v. Comr.*, T.C. Memo 1988-154, *aff'd in part and rev'd in part*, 875 F.2d 597 (7th Cir. 1989), *on remand*, T.C. Memo 1990-399. Clear and convincing proof existed of scrivener's error in omitting general power of appointment for trust intended to qualify for marital deduction; court reformation given effect for federal estate tax purposes.

2. *Rapp v. Comm'r*, 140 F.3d 1211 (9th Cir. 1998). Marital deduction denied because all income was not required to be paid to spouse. No evidence of mistake or intention to qualify for marital deduction introduced. Court held that the state court order reforming the trust with consent of all parties did not operate to allow the marital deduction.

3. *Marguerita Touche v. Comm'rs*, 58 T.C. 565 (1972), *acq*. 1972-2 CB 3. Incorrect percentage interest in property recited in deed. Corrected deed recorded after attorney learned of mistake from IRS letter. Held that there was no completed gift as to the portion conveyed by mistake.

4. In *Dodge v. U.S.*, 413 F.2d 1239 (5th Cir 1969), taxpayer meant to transfer a 1/5 undivided interest in real estate to charity. Instead, the deed conveyed her entire interest. The deed was reformed to correct the mistake. The IRS rejected a charitable deduction for a subsequent transfer in the same property, concluding that taxpayer had already conveyed all of her interest. The Fifth Circuit affirmed the District Court's decision that the gift of all of her interest was incomplete as to the fraction erroneously conveyed, and the reformation was respected.

5. *Harris v Comm'r*, 461 F.2d 554 (5th Cir. 1972). Taxpayers created a trust for their child that did not qualify for the annual exclusion as a present interest. Donors

amended the trust and claimed the inadvertent omission by the typist of the crucial provisions. The court held that the donors failed to prove that their intent at the time of the gift was to include the missing language. The drafting lawyer stated in his opening statement that the omitted language was a typing error but did not testify, and this gave rise to inference that his testimony would not be favorable.

6. Rev. Rul. 71-416, 1971-2 CB 83, gives retroactive correction of a divorce decree where the mistake was computational rather than based on a misunderstanding of federal tax law.

7. There are many private rulings that address reformations to correct a scrivener's error. Some recent examples are PLRs 201941023 and 201837009. In both of these rulings, the applicable state law require clear and convincing evidence of the error. The rulings do not provide any specific details as to what the proof entailed but merely state that "an examination of the relevant trust instruments, affidavits, and representations of the parties" indicated that the original trust terms resulting from scrivener's error were contrary to the settlor's intent.

D. Gifts: Retroactive Reformation for Other Mistakes.

1. *Berger v. U.S.*, 487 F. Supp. 49 (W.D. 1980). Settlor Berger believed that he needed to transfer most of his assets to an irrevocable trust to comply with ethics rules for a high level government job. Berger did not receive the job but also learned that his transfer would not have been necessary had he received the position. The Pennsylvania Orphans Court reformed the trusts to be revocable based on state law allowing reformation for mistake of law or fact. District Court held that trust was revocable and taxpayer received a gift tax refund.

2. *Flitcroft v. Comr.*, 328 F.2d 449 (9th Cir. 1964). A provision making the trust irrevocable was inadvertently left out, which under state law made the trust revocable; trust was reformed in state court to be clearly irrevocable, which was held to be effective for federal gift and income tax purposes.

3. *Neal v. U.S.*, 82 AFTR 2d 98-5429, 98-2 USTC ¶60318 (DC PA 1998), *aff'd* 187 F3d 626 (3rd Cir. 1999). Taxpayer created a grantor retained income trust ("GRIT") in 1988. In 1989, the IRS issued Notice 89-99 that disqualified her GRIT under then existing IRC § 2036(c) because it included a reversionary interest worth more than 25% of the trust value. To comply with the Notice, taxpayer released her contingent reversion and paid a gift tax. After retroactive repeal of Sec 2036(c), taxpayer rescinded her release and claimed a refund of the gift tax. The Third Circuit affirmed the lower court's holding that taxpayer's release was based on a mistake and her gift tax paid should be refunded. But see *Lange v. U.S.*, 78 AFTR 2d 96-6553 (DC IN 1996), with same basic facts as *Neal*.

4. In *Breakiron v Gudonis*, 106 AFTR 2d 2010-5999, (DC MA 2010), parent created a QPRT for 10 years with the real estate to pass equally to two children at the end of the term. The son of the parent attempted to disclaim his interest so all would pass to his sister but did so more than 9 months after the creation of the QPRT because his lawyer had incorrectly advised him that he had until 9 months after the QPRT terminated to disclaim without gift tax consequences. Gift tax of

$2.3 million was imposed on the nonqualified disclaimer. Son sought rescission of his disclaimer in state court and the IRS removed to federal court. The District Court applied Massachusetts law and found that a written instrument may be reformed or rescinded in equity on grounds of mistake if there is full, clear and decisive proof of the mistake and that in *Kaufman v. Richard*, 442 Mass. 1010, 811 NE 2d 987 (2004), the state court recognized that a disclaimer could be reformed or rescinded where the intent was to minimize tax consequences for disclaimant's children. The son's disclaimers stated that they were intended to be qualified disclaimers under federal law. Rescission was granted effective as of the date of the disclaimer.

5. A number of private letter rulings have recognized that when a state's substantive law permits reformation to conform an instrument to the grantor's original intent, the changes will be given retroactive effect for federal tax purposes, even if the mistake is not a scrivener's error. See, *e.g.*, Private Letter Rulings 200423006, 200450033, 200311020, 200201020, 200143019 and 200147028, 200144018. For example, in PLR 200423006, the taxpayer's attorney gave wrong advice when he told the client that the trust income had to be distributed to the grantor's great-grandchildren when the great-grandchildren reached age 21. The grantor's great-grandchildren were unborn when the trust was created and the attorney apparently incorrectly advised the taxpayer that accumulating income past age 21 violated the local rule against accumulations. The taxpayer signed a trust instrument that reflected this incorrect advice. The grantor had signed four other trusts drafted at the same time for his grandchildren, in which mandatory income was not payable until age 35. The IRS ruled that a reformation based on the attorney's erroneous advice was a mistake of law and a scrivener's error, and that correcting it did not affect the effective date GST exempt status of the trust.

E. Gifts: Reformation Not Recognized Retroactively for Mistake.

1. *Van Den Wymelenberg v. U.S.*, 397 F.2d 443 (7th Cir. 1968), *cert. denied*, 393 U.S. 953 (1968). Taxpayer intended gifts to a trust to qualify for the gift tax annual exclusion. The trust did not qualify due to lawyer's error, but was later amended by taxpayer. The court held that the amendment had no retroactive effect and that reformation may relate back to original transfer as to the parties, but does not change rights of government.

2. Several cases have held that the reformation did not relate back to the date of the transfer to affect tax consequences. See, *M.T. Straight Trust v. Comm'r*, 245 F.2d 327 (8th Cir. 1957); *Sinopoulo v. Jones*, 154 F.2d 648 (10th Cir. 1946); *American Nurserymen Publishing Co. v. Comm'r*, 75 T.C. 271 (1980), *aff'd*. 673 F.2d 1333 (7th Cir. 1981); *Estate of Starkey v. U.S.*, 58 F.Supp.2d 939 (DC IN 1999); *Lange v. U.S.*, 78 AFTR 2d 96-6553 (DC IN 1996) (with same basic facts as *Neal* regarding IRC §2036(c), *supra*).

F. Failure to Qualify for Charitable Deduction--Special Rules.

1. Secs. 2055(e)(3) and 2522(c)(4) recognize retroactive to date of transfer "qualified reformations" as defined in IRC §2055(e)(3)(B).

2. For estate tax purposes, the complete termination of a disqualifying power to consume, invade or appropriate property for the benefit of an individual before the due date including extensions for filing the federal estate tax return due to the death of that individual before such power has been exercised is treated the same as a qualified disclaimer. IRC §2055(a), flush language at end, Treas. Reg. § 20.2055-2(c)(ii).

Harrington's 2021 *Heckelring* article cited above explained the rescission doctrine for income tax purposes:

> Rev. Rul. 80-58 addresses the rescission doctrine and concludes that when a real estate sale is rescinded in the same reporting period the sale is ignored for income tax purposes. However, the ruling also states (without discussing IRC § 1341, discussed below) that if the real estate sale is rescinded in the year after the sale, the seller reacquires the real estate with its basis being the amount that the seller repays.
>
> The ruling essentially recognizes a rescission under the facts described as retroactive if in the same taxable year and treats the rescission as a second independent transaction if it occurs in a subsequent year. However, the IRS also has required that parties be restored to their original positions for the doctrine to apply. There has been no requirement that an underlying legal basis exists for the rescission so that the agreement of the parties alone is an acceptable basis for the rescission.
>
> 1. The taxpayer's intent or motivation may not matter. In PLR 201211009, adverse tax consequences seemed to be the sole reason for the rescission. In that ruling, a stock sale was rescinded in the same taxable year as the sale and the transaction was redone later with a new buyer to be able to make an election under a IRC § 338(h)(10) where the buyer in the first transaction did not qualify for the election. In *Davis v. U.S.*, 378 F. Supp. 579 (ND TX 1974), a transfer that was intended as a gift by a mistake of the accountant was structured as a sale. The sale was reversed in the same tax year and redone as a gift, and the court held that there was no taxable sale. Other rulings allow rescission in the same year to nullify tax consequences where economic conditions have changed. See, *e.g.*, Rev. Rul. 74-501, 1974-2 CB 98; PLRs 200613027; 200923010.
>
> 2. The IRS currently has a no rule policy on whether a completed transaction may be rescinded for federal income tax purposes, in place since 2012 when it announced that it is studying the issues with rescissions. Rev. Proc. 2012-3, 2012-1 IRB 113, 5.02.02. However, William Alexander, IRS associate chief counsel (corporate), said at the New York State Bar Association Tax Section summer meeting in July 2013 that no such guidance will be coming out and that the rescission no-rule will stay in place for the indefinite future, where it remains at this time. 2013 TNT 127-1 (July 2, 2013); Rev. Proc. 2021-3, 2021-1 IRB 140, 3.02(8).

For income tax purposes, the focus is on correction within the same taxable year, to preserve the concept of annual accounting periods. When issues involve more than one taxable year, see part II.G.4.m Fixing Unfair Income Tax Results.

II.P.3.h. Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization

When transferring a corporation's business to a new partnership, consider doing the following:

1. The shareholders form a new corporation with ownership identical to the old corporation's ownership.

2. The shareholders contribute their stock of the old corporation to the new corporation, making the old corporation a wholly owned subsidiary of the new corporation. If the old corporation is an S corporation, the new corporation files Form 8869 to make the old corporation a disregarded entity.[4058]

3. The day after making a Qsub election (if an S corporation is involved),[4059] the old corporation converts or is merged into a limited liability company that is a disregarded entity. Consider filing Form 8832 to ensure that the converted limited liability company does not automatically convert from a QSub back into a tax corporation, like it was treated before the Code § 368(a)(1)(F) reorganization.[4060]

4. Optional: Either the new corporation then transfers its member interest in the LLC to a limited partnership, or the LLC itself admits one or more additional members to convert the LLC to an entity taxed as a partnership.

5. Prepare the statement described in Reg. § 1.368-3 that needs to be filed with relevant tax returns.

To qualify as an F reorganization[4061] nontaxable for federal income tax purposes (always check state income tax rules), this or any other transaction must result in a mere change in identity, form, or place of organization of one corporation.[4062] A transaction involving an actual or deemed transfer is a mere change only if:

- Immediately after the reorganization, all the stock of the resulting corporation, including any stock of the resulting corporation issued before the reorganization, must have been distributed (or deemed distributed) in exchange for stock of the transferor corporation;[4063]

[4058] See fn. 4078.
[4059] See fn. 192 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[4060] I don't view this as necessary, but others recommend it, and I don't mind filing Form 8832 to make others happy.
[4061] Code § 368(a)(1)(F).
[4062] Reg. § 1.368-2(m)(1). For an analysis of the background to this regulation and its impact, see Kliegman and Chen, Some Ado About a Nothing: Final F Reorganization Regulations, *TM Memorandum* (BNA) (4/4/2016). The article suggests that Rev. Rul. 68-349 appears to violate the requirements of the text accompanying fns. 4063-4064; it has been suggested that informal comments at the January 2016 meeting of the American Bar Association's Section of Taxation indicate that the government might not have considered the regulations' impact on that ruling.
[4063] However, a de minimis amount of stock issued by the resulting corporation other than in respect of stock of the transferor corporation to facilitate the organization of the resulting corporation or maintain its legal existence is disregarded. Reg. § 1.368-2(m)(1)(i).

- The same person or persons must own all of the stock of the transferor corporation, determined immediately before the reorganization, and of the resulting corporation, determined immediately after the reorganization, in identical proportions;[4064]

- The resulting corporation does not hold any property or have any tax attributes[4065] immediately before the reorganization;[4066]

- The transferring corporation completely liquidates, for federal income tax purposes, in the reorganization;[4067]

- Immediately after the reorganization, no corporation other than the resulting corporation holds property that was held by the transferor corporation immediately before the reorganization, if such other corporation would, as a result, succeed to and take into account the items of the transferor corporation described in Code § 381(c);[4068] and

- Immediately after the reorganization, the resulting corporation does not hold property acquired from a corporation other than the transferor corporation if the resulting corporation would, as a result, succeed to and take into account the items of such other corporation described in Code § 381(c).[4069]

The last two bullet points emphasize that tax attributes cannot change in an F reorganization.[4070] Thus, when a corporation engages in an F reorganization, the part of the tax year before the reorganization and the part after constitute a single tax year,[4071] and the

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[4064] However, this requirement is not violated if one or more holders of stock in the transferor corporation exchange stock in the transferor corporation for stock of equivalent value in the resulting corporation, but having different terms from those of the stock in the transferor corporation, or receive a distribution of money or other property from either the transferor corporation or the resulting corporation, whether or not in exchange for stock in the transferor corporation or the resulting corporation. Reg. § 1.368-2(m)(1)(ii).
[4065] Including those specified in Code § 381(c).
[4066] However, this requirement is not violated if the resulting corporation holds or has held a de minimis amount of assets to facilitate its organization or maintain its legal existence, and has tax attributes related to holding those assets, or holds the proceeds of borrowings undertaken in connection with the potential F reorganization. Reg. § 1.368-2(m)(1)(iii).
[4067] However, the transferor corporation is not required to dissolve under applicable law and may retain a de minimis amount of assets for the sole purpose of preserving its legal existence. Reg. § 1.368-2(m)(1)(iv).
[4068] Reg. § 1.368-2(m)(1)(v). The preamble, T.D. 9739, explains:

> Thus, a transaction that divides the property or tax attributes of a Transferor Corporation between or among acquiring corporations, or that leads to potential competing claims to such tax attributes, will not qualify as a Mere Change.

[4069] Reg. § 1.368-2(m)(1)(vi). The preamble, T.D. 9739, explains:

> Thus, a transaction that involves simultaneous acquisitions of property and tax attributes from multiple transferor corporations (such as the transaction described in Rev. Rul. 58-422, 1958-2 CB 145) will not qualify as a Mere Change.

[4070] The preamble, T.D. 9739, says:

> From a federal income tax perspective, F reorganizations are generally neutral, involving no change in ownership or assets, no end to the taxable year, and inheritance of the tax attributes described in section 381(c) without a limitation on the carryback of losses. See, for example, Rev. Rul. 96-29 (discussed in section 3.B.ii. of the Background); § 1.381(b)-1(a)(2).

[4071] Reg. § 1.381(b)-1(a)(2) provides:

resulting corporation must file a single full-year return using the same EIN;[4072] however, if the old corporation was domestic and the new one is foreign, the F reorganization does close the tax year.[4073] In a purely domestic F reorganization, the new corporation's filing a tax return runs the statute of limitations for the old corporation's activity that was reported on the new corporation's return.[4074]

Continuity of the business enterprise and a continuity of interest are not required to qualify as an F reorganization.[4075]

Subject to certain limitations, an F reorganization might consist of a series of related transactions that together result in a mere change of one corporation.[4076]

> *Reorganizations under section 368(a)(1)(F)*. In the case of a reorganization qualifying under section 368(a)(1)(F) (whether or not such reorganization also qualifies under any other provision of section 368(a)(1)), the acquiring corporation shall be treated (for purposes of section 381) just as the transferor corporation would have been treated if there had been no reorganization. Thus, the taxable year of the transferor corporation shall not end on the date of transfer merely because of the transfer; a net operating loss of the acquiring corporation for any taxable year ending after the date of transfer shall be carried back in accordance with section 172(b) in computing the taxable income of the transferor corporation for a taxable year ending before the date of transfer; and the tax attributes of the transferor corporation enumerated in section 381(c) shall be taken into account by the acquiring corporation as if there had been no reorganization.

[4072] Rev. Rul. 73-526, Situation (3) described these facts:

> Corporation R was chartered in state X. It reincorporated in state Y as corporation S, a new corporate entity under the laws of state Y. The assets and liabilities of R were transferred to corporation S. Prior to the reincorporation, corporation R had been assigned an identifying number. Except for the technical difference of forming a new corporate entity chartered in state Y, the surviving corporation, S, is the same corporation as the transferor corporation, R. The same business with the same assets and the same stockholders is continued in the newly chartered entity. Consequently, the reincorporation constitutes a reorganization within the meaning of section 368(a)(1)(F) of the Internal Revenue Code of 1954. Under section 1.381(b)-1(a)(2) of the Income Tax Regulations, the acquiring corporation is treated just as the transferor corporation would have been treated in the absence of a reorganization, and the taxable year of the transferor does not close on the date of transfer. Thus, a final return is not required of corporation R in this transaction.

Rev. Rul. 73-526 concluded:

> Since the surviving corporation, S, is for Federal income tax purposes treated as the same corporation as the transferor corporation, R, the identifying number assigned to corporation R should be continued in use by corporation S after the transaction.

[4073] Reg. § 1.367(a)-1(e).

[4074] *New Capital Fire, Inc. v. Commissioner*, T.C. Memo. 2017-177, rejecting the IRS' contention that failing to file a return for the old corporation kept the statute of limitations open. The new corporation's return properly disclosed the F reorganization. The court held:

> New Capital's 2002 return purported to and did include Old Capital's income from January 1 through December 4, 2002. Respondent has not alleged, and we do not find, that New Capital's 2002 return was false or fraudulent with intent to evade tax as it pertains to Old Capital. It was respondent's duty to determine, within the period of limitations provided by section 6501(a), whether New Capital's 2002 return, as it pertains to Old Capital, was erroneous in any respect. The exception under section 6501(c)(3) does not apply. Accordingly, assessment of the determined deficiency and additions to tax is barred by the statute of limitations.

[4075] Reg. § 1.368-2(m)(2).

[4076] Reg. § 1.368-2(m)(3), which provides:

It has been suggested that substantive changes of ownership that were not allowed before these regulations are now allowed:[4077]

- Exchanging stock for stock of equivalent value but with different terms, or

- Either the old or new corporations distributing cash or other property.

Sometimes a conversion generally involves a direct or indirect merger of a corporation into an unincorporated entity taxed as a corporation.[4078] For example, an LLC that is taxed as an

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> *Series of transactions*. A potential F reorganization consisting of a series of related transactions that together result in a mere change of one corporation may qualify as a reorganization under section 368(a)(1)(F), whether or not certain steps in the series, viewed in isolation, could be subject to other Code provisions, such as sections 304(a), 331, 332, or 351. However, see paragraph (k) of this section for transactions that qualify as reorganizations under section 368(a) and will not be recharacterized as a mere change as a result of one or more subsequent transfers of assets or stock.

The preamble, T.D. 9739, explains:

> In some cases, business or legal considerations may require extra steps to complete a transaction that is intended to qualify as a Mere Change. As discussed in section 3.B.i. of the Background, the Treasury Department and the IRS concluded that the words however effected in the statutory definition of F reorganization reflect a Congressional intent to treat a series of transactions that together result in a Mere Change as an F reorganization, even if the transfer (or deemed transfer) of property from the Transferor Corporation to the Resulting Corporation occurs indirectly. The Final Regulations confirm this conclusion by providing that a Potential F Reorganization consisting of a series of related transactions that together result in a Mere Change may qualify as an F reorganization, whether or not certain steps in the series, viewed in isolation, might, for example, be treated as a redemption under section 304(a), as a complete liquidation under section 331 or section 332, or as a transfer of property under section 351. For example, the first step in an F reorganization of a corporation owned by individual shareholders could be a dissolution of the Transferor Corporation, so long as this step is followed by a transfer of all the assets of the Transferor Corporation to a Resulting Corporation. However, see § 1.368-2(k) for completed reorganizations that will not be recharacterized as a Mere Change as a result of one or more subsequent transfers of assets or stock, such as where a Transferor Corporation transfers all of its assets to its parent corporation in liquidation, followed by the parent corporation's retransfer of those assets to a new corporation. See also Rev. Rul. 69-617, 1969-2 CB 57 (an upstream merger followed by a contribution of all the target assets to a new subsidiary corporation is a reorganization under sections 368(a)(1)(A) and 368(a)(2)(C)).

The preamble further discussed such a reorganization's role in a larger transaction:

> As discussed in section 3.B.ii. of the Background, the Treasury Department and the IRS recognized that an F reorganization may be a step, or a series of steps, before, within, or after other transactions that effect more than a Mere Change, even if the Resulting Corporation has only a transitory existence following the Mere Change. In some cases an F reorganization sets the stage for later transactions by alleviating non-tax impediments to a transfer of assets. In other cases, prior transactions may tailor the assets and shareholders of the Transferor Corporation before the commencement of the F reorganization. Although an F reorganization may facilitate another transaction that is part of the same plan, the Treasury Department and the IRS have concluded that step transaction principles generally should not recharacterize F reorganizations because F reorganizations involve only one corporation and do not resemble sales of assets.

[4077] McMahon, Recent Developments in Federal Income Taxation of Corporations and Partnerships, 64th Annual Montana Tax Institute (10/14/2016).

[4078] A direct approach is found Reg. § 1.368-2(m)(4), Example (8), and the logistics are explained in Letter Ruling 200839017. See Riser, Hiding Your Stuff in Plain Sight (Without Trusts): Dr. Funbundle (or How I Learned to Stop Worrying and Love Sec. 368(a)(1)(F)), American Bar Association Section of Real

S corporation can move assets comprising one line of business into a new parent LLC taxed as an S corporation that assumes its tax attributes and then under Code § 355 distribute assets comprising another line of business into another LLC taxed as an S corporation.[4079] Generally,

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Property, Trust & Estate Law, 2009 Spring Symposia, discussing Letter Ruling 200701017. See also Rev. Ruls. 64-250, 73-256, and 2008-18 and Letter Rulings 200528021, 200622025, and 200719005. See also Kalinka, Transfer of an Interest in an LLC Taxed As an S corporation Raises Many Questions, p. 23 *Taxes-The Tax Magazine* (October 2007); Christian & Grant, ¶ 29.07. 'F' Reorganizations, *Subchapter S Taxation* (WG&L); and Gassman, Crotty, and O'Leary, The Estate Planner's Guide to New Parent F Reorganizations, *Estate Planning Journal* (WG&L), May 2008. These issues were discussed at the Fall 2009 Asset Protection Committee meeting of the American College of Trust & Estate Counsel (ACTEC) in, which included some practical materials for LLCs taxed as S corporations that are available to ACTEC Fellows. For whether a new employer identification number (IRS tax ID) is needed, see fns 188-191 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub). Although Rev. Rul. 2008-18 says that the new entity retains the new entity's S election, I had suggested that the new entity file IRS Form 2553. However, Form 8869, line 14 asks, "Is this election being made in combination with a section 368(a)(1)(F) reorganization described in Rev. Rul. 2008-18, where the subsidiary was an S corporation immediately before the election and a newly formed holding company will be the subsidiary's parent?" and provides the following instructions:

> This box should be checked "Yes" if this election is being made pursuant to a reorganization under section 368(a)(1)(F) and Rev. Rul. 2008-18. This occurs when a newly formed parent holding company holds the stock of the subsidiary that was an S corporation immediately before the transaction and the transaction otherwise qualifies as a reorganization under section 368(a)(1)(F). No Form 2553, Election by a Small Business Corporation, is required to be filed by the parent. See Rev. Rul. 2008-18, 2008-13 I.R.B. 674, for details.

Letter Ruling 199947034, found in fn. 7284, ruled that Code § 2701 did not apply to such a reorganization.

See fn. 359 in part II.B Limited Liability Company (LLC) if the new entity is an LLC electing taxation as an S corporation and fn. 192 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub) regarding the timing of an LLC electing S corporation status before acquiring a QSub.

[4079] Letter Ruling 201638004. The facts were:

(1) The X members will contribute all of their X equity units to Y, a newly formed-State X limited liability company, in exchange for all of the Y equity units.
(2) X will elect to become, or by default will become, a disregarded entity or qualified subchapter S subsidiary for Federal tax purposes. After this step, Y expects to continue X's S corporation election.
(3) X will distribute the assets comprising the Retained Business to Y in a transaction that it expects to be disregarded for Federal income tax purposes. After this step, X would continue to hold the assets comprising the Distributed Business.
(4) Y will transfer all of the equity units of X to Z, a newly-formed State X limited liability company, solely in exchange for all of the Z equity units. After this step, Z will hold only the equity units in X, which continues to hold the assets comprising the Distributed Business.
(5) Y will distribute pro rata all of the equity units of Z to Y's members in a transaction intended to qualify under section 355 of the Internal Revenue Code (the Distribution).

After reciting various representations, the ruling held:

(1) For purposes of determining whether Steps 1 and 2, viewed together, result in the realization of gain or loss under section 1001 (see *Weiss v. Stearn*, 265 U.S. 242 (1924)), or a reorganization under section 368(a)(1)(F) (see Rev. Rul. 72-206, 1972-1 C.B. 104), Steps 3 through 5 shall be disregarded.
(2) For U.S. Federal income tax purposes, Steps 3 through 5 will be treated as a direct transfer of the Distributed Business by Y to Z in exchange for all of the equity units of Z and the assumption of associated liabilities, followed by the pro rata distribution by Y of all of the equity units of Z to Y's members.
(3) X's S election will not terminate as a result of the completion of Steps 1 and 2, but continues for Y.

for an S corporation, I recommend that the LLC file a new Form 2553, election to be taxed as an S corporation, which converts the LLC to a corporation and makes an S election at the same time;[4080] however, when an existing S corporation passes its S corporation tax attributes to a new parent through a Code § 368(a)(1)(F) reorganization in which the old corporation becomes a qualified subchapter S subsidiary (QSub), only a QSub election is made, which results in the parent becoming an S corporation, as described in fn 4078. Query whether one wants to file Form 2553 for the new parent anyway, in case the Code § 368(a)(1)(F) reorganization is somehow deficient. Regarding tax IDs of those involved in Code § 368(a)(1)(F) reorganizations, see fns 4078-4080 and parts II.G.1 How and When to Obtain or Change an Employer Identification Number (EIN) and II.P.3 Conversions.

Letter Ruling 202102007 involved the following facts and rulings:

> **Summary of Facts**
>
> Oldco, prior to the Completed Transaction, was a publicly traded State A corporation and the common parent of an affiliated group of corporations that filed a consolidated federal income tax return (the "Oldco Group"). Oldco owned all the stock of Sub 1, which in turn held substantially all of the assets and operations of the Oldco Group.
>
> Oldco formerly operated a business that generated Historic Liabilities. Prior to the Completed Transaction, the Historic Liabilities were obligations of Oldco for state law purposes. Oldco undertook the Completed Transaction (described below) in order to separate its core business operations from the Historic Liabilities and to better manage the Historic Liabilities.
>
> **Completed Transaction**
>
> The Completed Transaction has been completed as of the date of this ruling, but either the tax return has not yet been filed for the year in which the transaction was completed or the tax return was filed for the year in which the transaction was completed, but this ruling request was filed prior to the filing of the tax return.
>
> The steps of the Completed Transaction are set forth below:
>
> (i) On Date 1, Oldco formed Newco, a State A corporation.
>
> (ii) On Date 2, Newco formed LLC, a State A limited liability company that will be treated as a disregarded entity for federal income tax purposes.
>
> (iii) On Date 3, Oldco merged with and into LLC, with LLC as the surviving entity. In the merger, the Oldco shareholders exchanged their shares of Oldco stock for shares of Newco stock. Steps (i) through (iii), collectively, are referred to as the "Potential Reorganization."
>
> Newco shareholders held no economic interest in LLC following the Potential Reorganization, except by reason of their ownership of Newco stock. At all times before

[4080] See fn. 359 and the accompanying and following text. Also consider what happens if there is some defect in Form 2553 that might make its filing invalid. Is converting into a partnership or a C corporation the lesser of two evils? If the latter, consider filing Form 8832 before Form 2553.

and following the Potential Reorganization, Newco had the sole authority to appoint LLC's board of directors.

(iv) On Date 4, Newco and LLC entered into the Support Agreement, whereby Newco agreed to contribute funds to LLC in order to ensure LLC's ongoing solvency.

(v) On Date 4, LLC distributed the stock of Sub 1 to Newco.

Representations

The taxpayer makes the following representations with respect to the Completed Transaction:

a) LLC is a domestic eligible entity under Treas. Reg. § 301.7701-3(a).

b) For all tax, accounting, financial statement, books, records, and corporate purposes, Newco and LLC have reported and will consistently report and treat Newco as the sole member and sole owner of LLC immediately before and immediately after the Potential Reorganization.

c) Except for the issue of the Shareholder Rights included in the LLC Agreement, the Potential Reorganization will qualify as a reorganization under section 368(a)(1)(F).

Rulings

Based solely on the information provided and the representations set forth above, we rule as follows regarding the Completed Transaction:

1) At the time of and immediately after the Potential Reorganization, LLC was an entity disregarded as separate from Newco under Treas. Reg. § 301.7701-3(b)(1)(ii) for federal income tax purposes.

2) The Shareholder Rights included in the LLC Agreement will not preclude the Potential Reorganization from otherwise qualifying as a reorganization under section 368(a)(1)(F).

Consider a different approach when the corporation has sold all of its business assets. See part II.F.2 Asset Protection Benefits of Dissolving the Business Entity After Asset Sale.

Nonrecognition treatment does not necessarily apply if foreign connections exist. *TBL Licensing LLC v. Commissioner*, 158 T.C. No. 1 (2022), explained:

> The rules of section 367 provide an overlay to the corporate nonrecognition provisions found in subchapter C of subtitle A, chapter 1 of the Code. When one of the parties to a transaction is a foreign corporation, affording the transaction the same nonrecognition treatment it would receive if the parties were domestic could lead to inappropriate results. When foreign corporations are involved, property can move in and out of the U.S. tax jurisdiction. Reflecting those changes in status requires adjustments to the normal nonrecognition rules. In particular, a U.S. person who makes an "outbound" transfer of property to a foreign corporation might be required to recognize gain even if, had the transfer been made to a U.S. corporation, it would have been entitled to

nonrecognition treatment. Section 367(a), which applies to outbound transfers of most types of property, achieves that result by providing, subject to significant exceptions, that the foreign corporation that receives the property is not treated as a corporation. Outbound transfers of intangible property are not covered by section 367(a) but are instead addressed by section 367(d). Section 367(d) generally requires the U.S. transferor of intangible property to recognize gain in the form of ordinary income, but the timing of that income recognition varies depending on the circumstances….

Letter Ruling 202339009 involved the following facts and conclusions:

Summary of Facts

Parent, a Country A corporation, is the foreign parent of a worldwide group (collectively, the "Parent Group"). Parent has a single class of voting common stock outstanding that is owned by the public (the "Shareholders") and publicly traded. Parent's stock is primarily listed on Exchange Y.

Parent owns all of the stock of FSub, a foreign corporation organized under the laws of Country C. FSub, through its subsidiaries, owns and operates all of the Parent Group's foreign business operations.

Parent owns all of the stock of US Sub, a U.S. corporation organized under the laws of State D. US Sub is the common parent of an affiliated group of corporations that files a consolidated return for federal income tax purposes. Prior to the Proposed Transaction, Parent will contribute all of the stock of US Sub to FSub.

Proposed Transaction

For what are represented to be valid business purposes, Parent intends to redomicile in Country B through the following steps (collectively, the "Proposed Transaction"):

1. Parent will form Resulting, a Country B corporation. Parent will own a nominal amount of shares of Resulting.

2. Parent will subscribe for additional shares of Resulting for nominal consideration and instruct Resulting to issue such shares for the benefit of the Shareholders on its behalf, in the same ratio as their ownership in Parent. The nominal amount of shares of Resulting held by Parent will be cancelled.

3. Parent will sell all of the shares of FSub to Resulting pursuant to the laws of Country A in exchange for promissory notes. The notes will be non-interest bearing, demand notes with a face value equal to the fair market value of FSub's shares.

4. The Shareholders will exchange all of their Parent stock for Resulting stock (the "Resulting Exchange").

5. Resulting's shares will be listed on and begin trading on Exchange Z.

6. Parent will file a notice of amendment to convert into a Country A private limited company (an eligible entity for purposes of Treas. Reg. § 301.7701-3).

Approximately *a* days after the Resulting Exchange and during which time Resulting's shares will be traded on Exchange Z, Parent will convert.

7. Effective as of the date of the conversion, Parent will make an election to be classified as disregarded from its owner for federal income tax purposes (the "Election").

Representations

1. Step 3 will be structured as a sale transaction solely for Country A purposes.

2. No planned purchase or sale of stock of Resulting during the period of time between the Resulting Exchange and the Election will be included as part of the Plan of Reorganization.

Rulings

Based solely on the information submitted and representations made, we rule as follows:

1. For federal income tax purposes, Steps 2, 3, 4, 6, and 7 of the Proposed Transaction will be treated as if 100 percent of the stock of Parent was contributed to Resulting and, subsequently, Parent made an election to be classified as disregarded from its owner for federal income tax purposes.

2. The period of time between the Resulting Exchange and the Election will not prevent the Proposed Transaction from qualifying as a reorganization under section 368(a)(1)(F).

3. Sales or exchanges of Resulting stock during the period of time between the Resulting Exchange and the Election will not prevent the Proposed Transaction from qualifying as a reorganization under section 368(a)(1)(F). Treas. Reg. § 1.368-2(m)(1)(ii).

II.P.3.i. Common Equity for Preferred Equity and Vice Versa

In the C corporation arena, Rev. Rul. 77-238 provides that converting common stock to preferred and vice versa may be nontaxable. Pay particular attention to Situation 1, because further below we will discuss arrangements with similar ideas in other entities. Rev. Rul. 77-238 involved the following situations:

Situation 1.

Corporation X is engaged in a manufacturing business and has shares of voting common stock and shares of <Page 116>nonvoting preferred stock outstanding. All the common stock is owned by employees of X. The certificate of incorporation requires that the shareholders of X convert their common stock into preferred stock at a specified exchange rate upon their retirement from X, or have the stock redeemed for cash. The taxpayer, a retiring employee of X, exchanged the X common stock for X preferred stock of equal value pursuant to the conversion privilege. The purpose of the conversion privilege is to eliminate common stock ownership by retiring employees and to reduce the cash expenditures by X that would otherwise result if the common stock of retiring employees were redeemed for cash.

Situation 2.

Corporation Y is engaged in a manufacturing business and has shares of voting common stock and shares of nonvoting preferred stock outstanding. The certificate of incorporation gives the shareholders of Y the right to convert their preferred stock into common stock at a specified exchange rate. The taxpayer, pursuant to the conversion privilege, exchanged preferred stock for Y common stock of equal value. The purpose of the conversion privilege is to encourage the conversion of preferred stock into common stock in order to simplify the capital structure of the corporation by eliminating the preferred stock.

Rev. Rul. 77-238 recited the law and provided the analysis and holding below:

Section 368(a)(1) of the Internal Revenue Code of 1954, in defining the term “reorganization,” includes a recapitalization as one of the kinds of transactions so defined.

Section 1.368-2(e) of the Income Tax Regulations provides, in part, that a transaction involving the exchange of common stock for preferred stock of the same corporation and a transaction involving the exchange of preferred stock for common stock are recapitalizations within the meaning of section 368(a)(1)(E) of the Code.

Section 354(a)(1) of the Code provides, in part, that no gain or loss will be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of a plan of reorganization, exchanged solely for stock or securities in a corporation a party to the same reorganization.

Section 1.368-1(c) of the regulations provides that the nonrecognition provisions of the Code relating to exchanges pursuant to reorganizations defined in section 368(a)(1) of the Code are not applicable unless the exchanges are in pursuance of a plan of reorganization.

Section 1.368-2(g) of the regulations provides that the transaction embraced in a plan of reorganization must not only come within the specific language of section 368(a) of the Code, but the readjustments involved in the exchange or distributions effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization.

The conversions of stock in Situation 1 were in furtherance of a corporate business purpose to encourage the conversion of common stock into preferred stock thereby permitting the corporation to use the cash that would otherwise be expended to redeem the common stock for other business purposes, and were pursuant to a continuing plan of reorganization represented by the conversion privilege embodied in the certificate of incorporation. Likewise, the conversions of stock in Situation 2 were in furtherance of a corporate business purpose to simplify the capital structure, and were in pursuance of a plan of reorganization. See Rev. Rul. 56-179, 1956-1 C.B. 187.

> Accordingly, the exchanges of stock in Situation 1 and Situation 2 pursuant to the conversion privileges involved are reorganizations within the meaning of section 368(a)(1)(E) of the Code. Under section 354(a)(1), no gain or loss is recognized to the taxpayers involved upon the exchanges of stock pursuant to the conversion privileges.
>
> Compare Rev. Rul. 72-265, 1972-1 C.B. 222, regarding the exercise of the conversion privilege provided for in a corporate debenture.[4081]

Note that dividend payments are required to achieve the desired objectives, making this strategy less desirable for a C corporation than for a partnership or an S corporation. See part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities, especially subparts II.E.1.a Taxes Imposed on C Corporations and II.E.1.b Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships.

The goals of Situation 1 are easily attained in a partnership structure – and without the requirements for a corporation referred to above but not necessarily more easily. First, a partnership can rearrange profits interests so long as the partners' rights to existing capital are not changed; see part II.C.6 Shifting Rights to Future Profits. This restructuring may require appraising the partnership's assets as if a liquidation had occurred, so as to preserve the partners' rights to existing capital. The resulting structure is described in part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion – especially part II.H.11.a Basics of Preferred Partnerships. A redemption of the preferred partnership interest may also be done on a generally more favorable basis than is available for corporation stock; see part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736 – especially subpart II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale – and consider the restrictions against continued corporate employment in certain situations described in part II.Q.7.a.iv Dividends; Avoiding Dividend Treatment Using Redemptions under Code §§ 302 and 303.

An S corporation cannot have two classes of equity that differ and to distribution or liquidation rights; see part II.A.2.i Single Class of Stock Rule. However, an S corporation can reorganize and form an LLC subsidiary; see part II.A.2.j.i Using a Partnership to Avoid S Corporation Limitations on Identity or Number of Owners or to Permit Non-Pro Rata Equity Interests. Then the LLC subsidiary can issue a profits interest to one or more key employees; see part II.M.4.f Issuing a Profits Interest to a Service Provider. If the key employee is also a shareholder, consider getting an expert opinion that the profits interest is reasonable compensation for past, current, or future services rather than a distribution, because a distribution can have serious tax consequences, as described in parts II.Q.7.h.ii Taxation of Shareholders When Corporation Distributes Cash or Other Property and II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders (in an S corporation, the corporate taxation would be reported on K-1s to shareholders instead of paid by the corporation); also note in a family business part III.B.7.c Code § 2701 Interaction with Income Tax Planning, the subparts to which explore various avenues to consider pursuing.

[4081] Rev. Rul. 72-265 held that the exchange of a convertible debenture for stock under the embedded conversion option was not a realization event, except if the debenture was an installment note (Rev. Rul. 72-264 providing that exception).

II.Q. Exiting from or Dividing a Business

If selling less than all of a corporation's assets, see part II.Q.7.o Reorganizing to Sell a Business That Is Less Than All of a Corporation's Assets.

II.Q.1. General Principles When Selling Ownership of a Business

A business' value is the present value of the expected future cash flows to its owners. A buyer uses these cash flows to pay the purchase price:

- ***Third-Party Financing***. A third-party lender provides cash to pay the purchase price in a lump sum. Business risk is shared between the buyer and the third-party lender, with the buyer assuming substantially all of the risk. Because the seller receives all cash up-front, the seller's risk is minimal.

- ***Seller Financing***. A series of payments from the buyer to the seller is evidenced through a promissory note. From a technical legal viewpoint, the buyer has all of the risk. However, as a practical matter, the seller is subject to business risk because the buyer is much less likely to pay if the business' cash flow is insufficient to service this debt. At any given point in time, the buyer is likely to withhold part or all of the remaining payments if the business' cash flow is less than expected. From an income tax viewpoint, the seller might be able to use the installment method to defer income tax on the gain on sale,[4082] subject to limitations if and to the extent that the business interest sold is a partnership interest with "hot assets,"[4083] as well as acceleration in various events.[4084]

- ***Equity Financing***. The seller receives payments based on the business' performance over a short period of time following the transfer, or the timing of buyer's payments depends on the business' profitability. The taxation of contingent sales proceeds in the corporate arena[4085] is more uncertain than in the partnership arena.[4086]

[4082] Even though stock was generally listed on the stock market, taxpayers who were affiliates as defined in Rule 144 under the 1933 Act and could not sell their unregistered shares of stock in Company on the Market, except pursuant to the volume limitations and other restrictions imposed by Rule 144 could sell their shares on the installment method. Letter Ruling 9803021. Furthermore, stock in an S corporation was eligible for installment sale treatment even though it held marketable securities. Letter Ruling 9306003 reasoned:

> Application of section 453(k)(2) to the S Common Stock is inappropriate. The flush language of section 453(k) provides the Secretary with the authority to provide for the application of section 453(k) in whole or in part for transactions in which the rules of the section would be avoided through use of related parties, pass-thru entities, or intermediaries. Because the Secretary has not issued regulations pursuant to this authority, however, the flush language may not be applied to the sale of the S Common Stock. Thus, because the S Common Stock is neither traded on an established securities market nor convertible into such publicly traded property, section 453(k)(2) does not apply to the sale of the S Common Stock.

However, the legislative history to the Tax Reform Act of 1986, PL 99-514, authorized the issuance of retroactive regulations disallowing the avoidance of the rules regarding publicly traded stock through use of related parties or other intermediaries.

[4083] See part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests.

[4084] See part II.G.15 Limitations on the Use of Installment Sales.

[4085] Skinner, Earn-Outs in Public Company Acquisitions: New CVRs Raise Unsettled Tax Issues, Journal of Taxation (Dec 2010).

[4086] See part II.Q.8.b.ii, Partnership Redemption – Complete Withdrawal Using Code § 736.

When the buyer uses debt to pay for the business, two layers of tax are imposed:

- First, the buyer pays income tax on the earnings used to repay the debt.
  - For a partnership or S corporation, if owners are taxed on income from operations at a 34.6%-45.8% ordinary federal and state income tax rate, the business must earn $153-185 of profits to fund a $100 principal payment on the debt.[4087]
  - A C corporation structure exacerbates this. If dividends are taxed at a 28.8% combined federal and state income rate, a $140 dividend generates $100 after tax. To distribute $140 to its shareholders, a C corporation that is subject to taxes on income from operations at a 26% ordinary federal and state income tax rate must generate over $189 of income. Thus, over $189 of business earnings are required to fund a $100 principal payment on the debt.
  - The interest component is easier to finance, assuming the interest is fully deductible.[4088] For a partnership or S corporation, only $100 of earnings is necessary to make a $100 interest payment. However, for a C corporation that is subject to taxes on income from operations at a 26% ordinary federal and state income tax rate, earnings of $189 are required to pay a $100 dividend.[4089]
- The seller pays tax on the sale. For example, if the seller has a combined 30% federal and state income tax rate, the seller nets $70 on every $100 of purchase price that constitutes capital gain. However, the seller would pay ordinary income tax on any interest component, so that $100 of interest payments would net only $50 to a seller subject to taxes on income from operations at a 50% ordinary federal and state income tax rate. Note that, although capital gain rates apply to the sale of stock in a C corporation or an S corporation, ordinary income tax rates apply to the portion of the sale of a partnership interest attributable to "hot assets."[4090]

[4087] However, if the owner is a partner who must pay self-employment tax on the earnings, additional earnings are required to pay the self-employment tax. Holding the partnership interest through an S corporation should avoid this issue.

[4088] See part II.G.20.a Code § 163(j) Limitation on Deducting Business Interest Expense. Also see part III.A.3 Trusts Holding Stock in S Corporations, for a discussion of various types of trusts that can hold stock in an S corporation, including part III.A.3.e.iii Comparing QSSTs to ESBTs, which addresses deducting interest on a loan to buy such stock in footnotes 6133-6076.

[4089] If an individual buyer/shareholder itemizes deductions, the buyer would deduct the interest as investment interest expense. Investment interest expense is deductible to the extent of net investment income. Code § 163(d). Preferably, the buyer would have ordinary interest or nonqualified dividends sufficient to generate this net investment income. Otherwise, the qualified dividends would need to be taxed at ordinary rates to constitute investment income; however, investment interest deducted at ordinary income tax rates generally would offset dividend income taxed using ordinary income tax rates. This comparison is not totally accurate, however, in that the dividend income is included in adjusted gross income (AGI) and can result in reduced itemized deductions and have other adverse AGI-related tax effects. If the buyer is a C corporation, these concerns are not present, and the corporation may also benefit from a dividends received deduction that can reduce or eliminate the tax on the dividends; however, the buyer's own shareholders would be taxed when the buyer distributes whatever return it receives on its investment.

[4090] See part II.Q.8.e.ii.(b) Character of Gain.

From these examples, some principles emerge:

- ***Paying Principal***. Principal payments can require from $153[4091]-$189[4092] of income to be generated to provide the seller with $71[4093]-$100[4094] after tax. Thus, the tax cost of principal payments represents 35%-62% of the earnings.

- ***Paying Interest***. Interest payments provide a deduction, which is less expensive for the buyer to pay than principal.

- ***Efficiency of Entity***. The tax cost is lowest for:

    - Interest or other deductible payments on the sale of a partnership or S corporation, or

    - Principal payments to the extent of the seller's basis.

    - Reinvested earnings increase the basis of S corporation stock or a partnership interest but not increase the basis of C corporation stock.[4095]

One may defer or avoid gain on the sale of a business using tools in parts II.G.7 Deferral or Partial Exclusion of Capital Gains (Even from Investment Assets) Invested in Opportunity Zones, II.Q.7.m Deferring Gain on Sale of Marketable Securities by Investing in a Specialized Small Business Investment Company, or II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation. However, because buyers prefer to get a basis step-in in the business' property, always consider parts II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations, II.Q.1.e Trying to Avoid Possible Ordinary Income on the Sale of a Partnership or S Corporation, II.Q.1.f Code § 1060 Allocation Rule When Selling Business, and II.Q.1.g Partnership Basis Adjustments. An important point gleaned from these parts is that gain on the sale of an S corporation's assets increases the business interest's basis and avoids gain on the sale of the S corporation stock itself. Conversely, the sale of an interest in a business taxed as a partnership is taxable but generates a basis increase in the business' assets; furthermore, depending on the jurisdiction, the sale of a partnership interest may avoid state income tax on the deemed asset sale, as described in *Vas Holdings & Investments LLC v. Commissioner of Revenue*, 186 N.E. 3d 1240 (Mass. 2022), which is discussed in part II.J.3.e.ii.(f) Business Income; *Fielding* (MN 2018); *Metropoulos* (CA 2022). The need to generate higher basis in the business' assets reduces the benefit of a tax-free sale of stock that does not generate that increased inside basis.

Some taxpayers consider deferring gain using the Code § 453 installment sale rules. See parts II.Q.3 Installment Sales - Deferring Tax on Lump Sum Payout Expected More than Two Years in the Future and II.G.15 Limitations on the Use of Installment Sales. However, redeeming a partnership interest tends to help a seller even more than an installment sale. See part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale.

[4091] $153-$185 for a partnership or S corporation.
[4092] For a C corporation.
[4093] For the gain component of principal payments, net of capital gain tax.
[4094] For the portion of principal payments representing a return of basis.
[4095] See part II.E.2.a Transferring the Business, especially fns 1024-1025 regarding basis increases for partnerships and S corporations.

II.Q.1.a. Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis

To minimize a sale's tax bite illustrated below, as discussed in the discussion after the illustrations tax planners seek structures with characteristics similar to interest or other deductible payments on the sale of a partnership or S corporation.[4096] The discussion below shows that seller-financed sales of partnership interests can avoid capital gain tax relative to a sale of stock in an S corporation (or a C corporation). Furthermore, the partnership sale structure allows goodwill to be sold later subject to capital gain rates, whereas a sale of goodwill generates slow deductions and may cause disadvantages for the future sale of that goodwill.[4097]

As noted earlier, reinvested earnings increase the basis of S corporation stock or a partnership interest but not increase the basis of C corporation stock.[4098] Thus, the gain component for a C corporation is likely to be much larger than that for a sale of S corporation stock or a partnership interest. Note, however, that some or all of up to $10 million of the gain on the sale of C corporation stock might be excluded from taxable income under part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation; this exclusion is increased to ten times the greater of the adjusted basis or fair market value of property contributed with respect to original issue stock.[4099] Thus, starting as a partnership and later converting to a C corporation may increase this exclusion, but the partnership cannot be worth more than $50 million when converted.[4100]

Further below is a discussion of special opportunities to shift towards a partnership structure,[4101] which generally is the best overall structure, the structure of which[4102] and a summary of ways to shift[4103] were described earlier in these materials.

For now, let's focus on ways to extract value that any entity can try to use.

4096 This is a little simplistic, in that partnerships also have unique benefits (earlier use of basis in installment sales; if considering such a sale, see part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests) and detriments (look at partnership's underlying assets to determine the character of gain on sale). See II.Q.8 Exiting From or Dividing a Partnership, especially II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736 and II.Q.8.e.ii Transfer of Partnership Interests: Effect on Transferring Partner.

4097 For more details, see part II.Q.1.c.i Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation.

4098 See part II.E.2.a Transferring the Business, especially fns 1024-1025 regarding basis increases for partnerships and S corporations.

4099 Code § 1202(b)(1). For this purpose, basis includes the fair market value of property contributed. See fns 5190-5033 of part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

4100 See fns 5238-5242 of part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

4101 See II.Q.8.b.iii Partnership Alternative to Seller-Financed Sale of Goodwill, regarding how a corporation might shift future appreciation to a partnership.

4102 See parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart.

4103 See part II.E.7 Migrating into Partnership Structure.

II.Q.1.a.i. Scenario for Moderate State Tax

Consider the portion of the business' equity representing internally generated goodwill, and assume the following tax rates, which might or might not be attained:

An individual in a top bracket might be taxed at a rate of 34.6%-45.8%, consisting of:

- 29.6%-37% ordinary income tax (depending on whether the Code § 199A 20% deduction is available)
- zero-3.8% net investment income tax (working in the business may avoid this tax, and exceptions to SE tax may apply as well), and
- 5% state income tax.

The individual in a top bracket is assumed taxed at a rate of 28.8%, consisting of 20% capital gain tax, 3.8% net investment income tax, and 5% state income tax.

Sale of Goodwill - Assumptions

C corp. income tax rate:	26.0%	federal and state
Individual capital gain rate:	20.0%	federal
	5.0%	state
	3.8%	NII tax
	28.8%	
Pass-through income rate:	29.6%-37%	federal income tax
	5.0%	state
	Zero-3.8%	NII or SE tax
	34.6%-45.8%	

The capital gain rate for individuals might be overstated when a person sells stock in an S corporation, because the 3.8% tax on net investment income would not apply with respect to the business assets allocable to that stock when a shareholder who is active in the business sells the stock.[4104] The partnership income tax rate might be overstated, either if the partner is a limited partner not subject to self-employment tax[4105] or if the payment is neither self-employment income[4106] nor attributable to business assets allocable to the partnership interest when a partner who is active in the business sells the partnership interest.[4107]

The scenario in the left column below assumes that the buyer uses after-tax dollars to buy the seller's interest in the business. The tax to the buyer in the left column is based on the ordinary

[4104] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
[4105] See part II.L.4 Self-Employment Tax Exclusion for Limited Partner, which one might apply to avoid self-employment tax using the structure described in part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and illustrated in part II.E.6 Recommended Partnership Structure – Flowchart.
[4106] See part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.
[4107] See parts II.I.8.d Partnership Structuring in Light of the 3.8% Tax on Net Investment Income and II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.

income rates, because the buyer is using income generated by operations to fund the payments to the seller. The seller is receiving income at capital gain rates.

	Capital Gain to Seller	Ordinary Income to Seller
Profit	$ 153-185	$109-131
Tax to Buyer	-(53-85)	-0
	$ 100	$109-131
Tax to Seller	- 29	38-60
Net to Seller	$ 71	$ 71

The tax in the right-hand column assumes that the buyer deducts payments to the seller, which is essentially what happens when one pays off a seller by allocating current partnership income to the seller.

The following pages illustrate this concept, showing that it takes a C corporation $189 in earnings to do a cross-purchase (one owner sells to another)[4108] and $135 to do either a redemption (entity buys from seller)[4109] or a cross-purchase using an exclusion that applies to the sale of certain stock,[4110] an S corporation $153-185 in earnings,[4111] and a partnership only $109-131 in earnings[4112] to get $71 to the seller.

[4108] See part II.Q.1.a.i.(a) C Corporation Triple Taxation

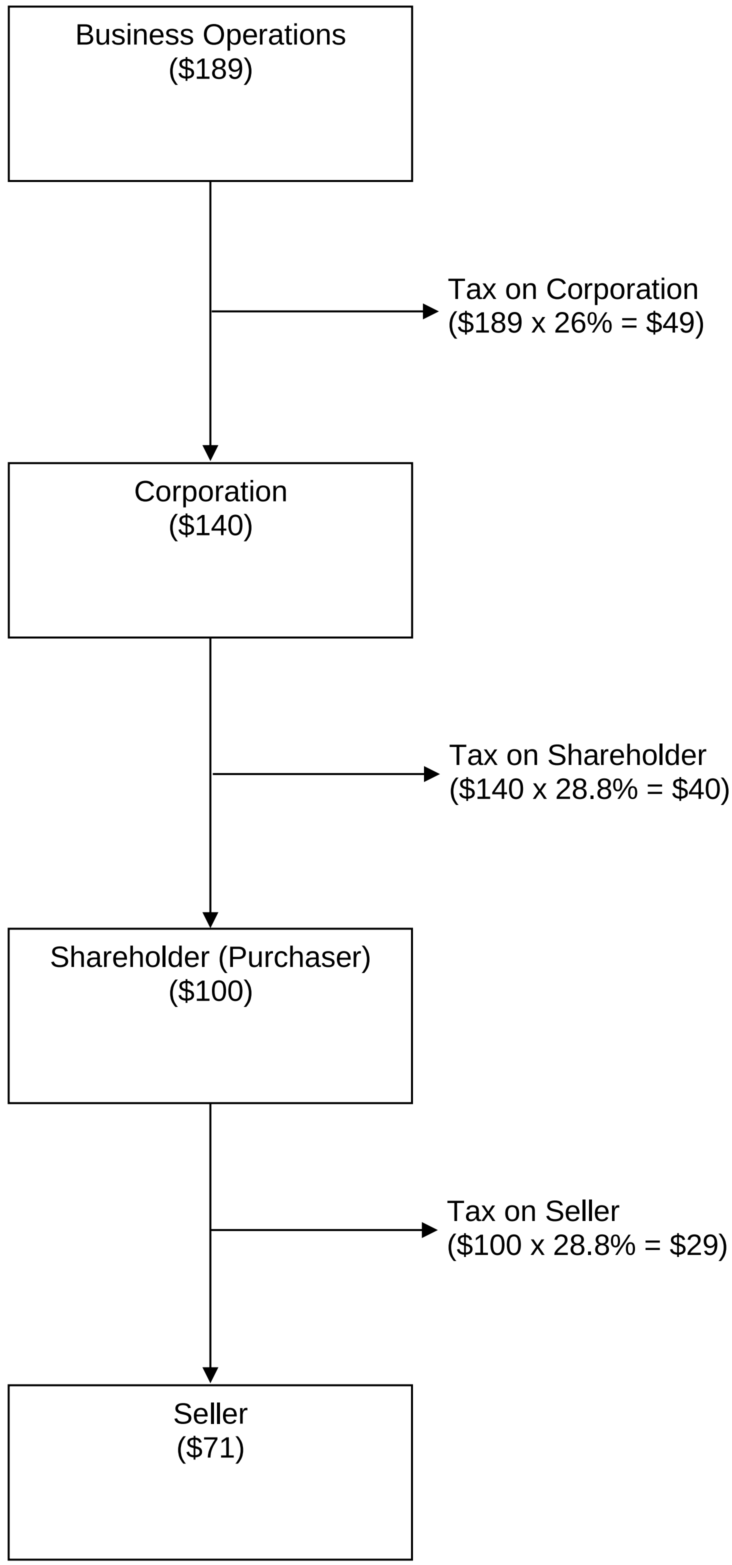
[4109] See part II.Q.1.a.i.(b) C Corporation Redemption. Redeeming the seller entirely might work if buying out one owner and increasing the other owners' interests in proportion to each other. However, if the sole owner is selling, or if the remaining owners are not increased in proportion to each other, then a cross-purchase or a stock issuance is needed to get the remaining owners' interests in the correct proportion, followed by the redemption. For approval of combining a cross-purchase with a redemption, see part II.Q.7.a.ii Hybrid Between Redemption and Cross-Purchase When Selling to New Shareholder or Other Shareholders.

[4110] See part II.Q.1.a.i.(c) C Corporation Double Taxation Under Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation.

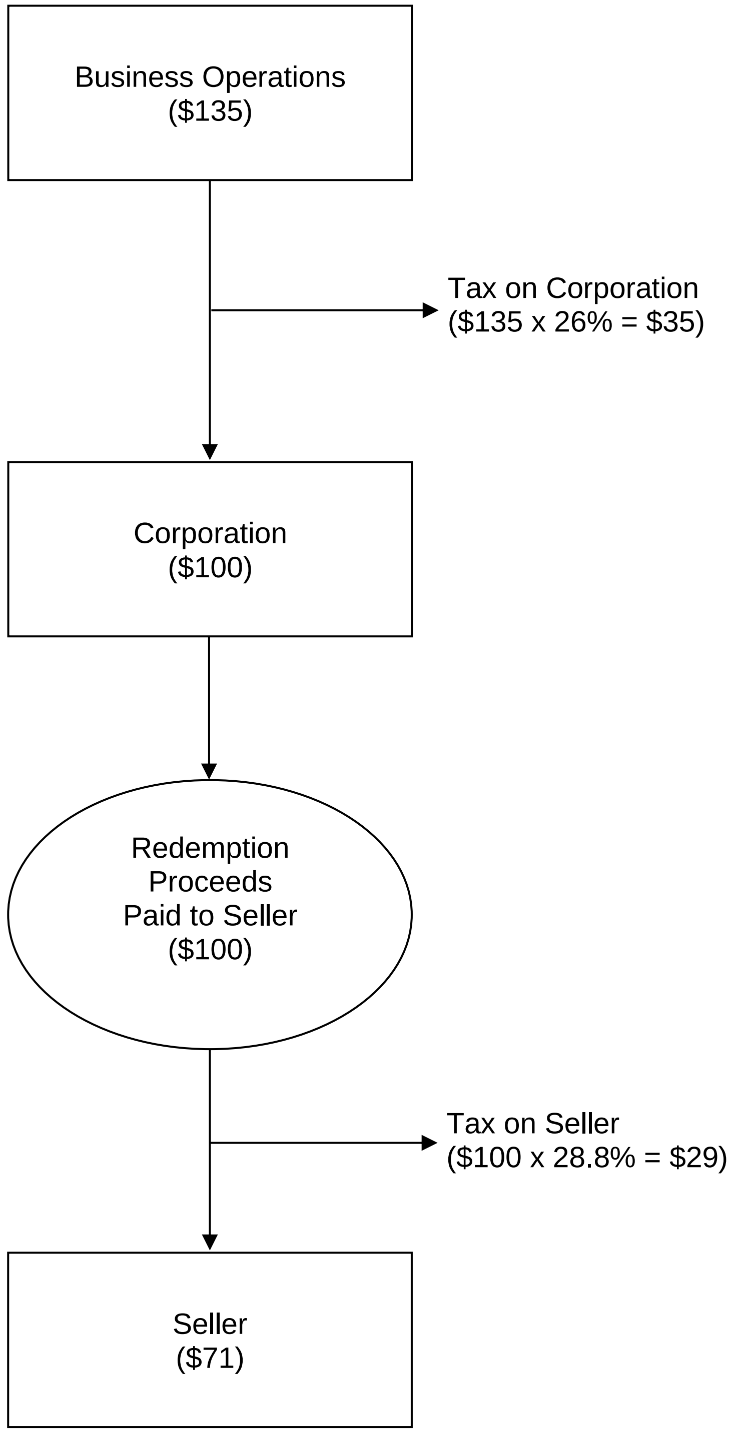
[4111] See part II.Q.1.a.i.(d) S Corporation Double Taxation.

[4112] See part II.Q.1.a.i.(e) Partnership Single Taxation of Goodwill.

II.Q.1.a.i.(a). C Corporation Triple Taxation

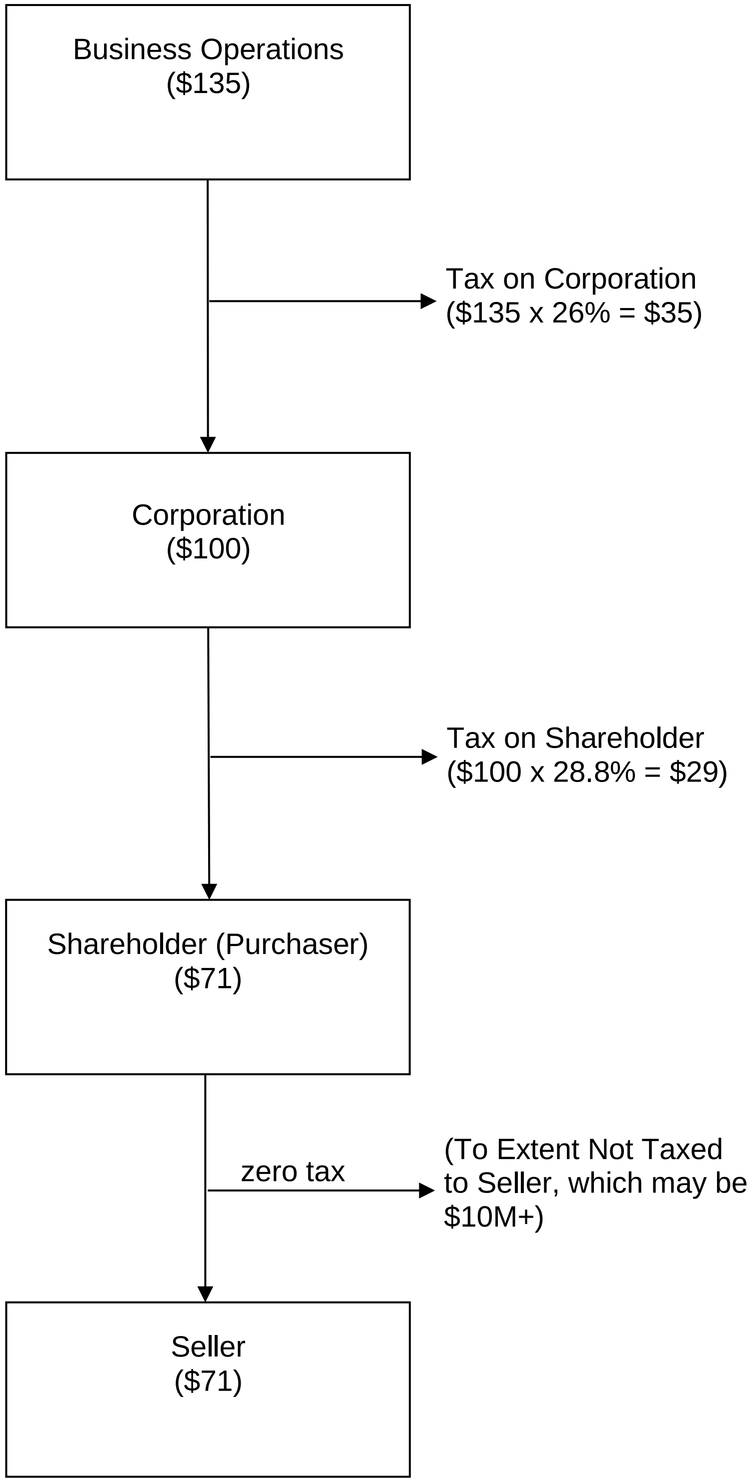


II.Q.1.a.i.(b). C Corporation Redemption



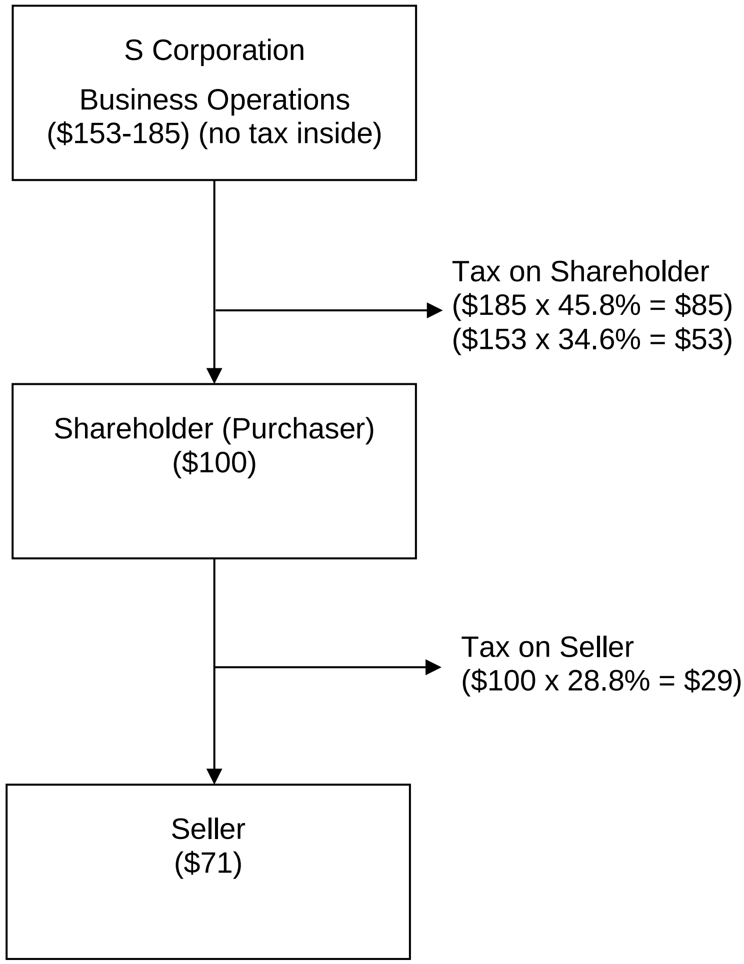
See part II.Q.7.a.ii Hybrid Between Redemption and Cross-Purchase When Selling to New Shareholder or Other Shareholders. The buyer may benefit more from buyer's future sale if buys from corporation more than two years before the seller is redeemed. See part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation.

II.Q.1.a.i.(c). C Corporation Double Taxation Under Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation



This structure may be required to avoid the anti-redemption rules described in the text accompanying and preceding fn 5226 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

II.Q.1.a.i.(d). S Corporation Double Taxation



Notes:

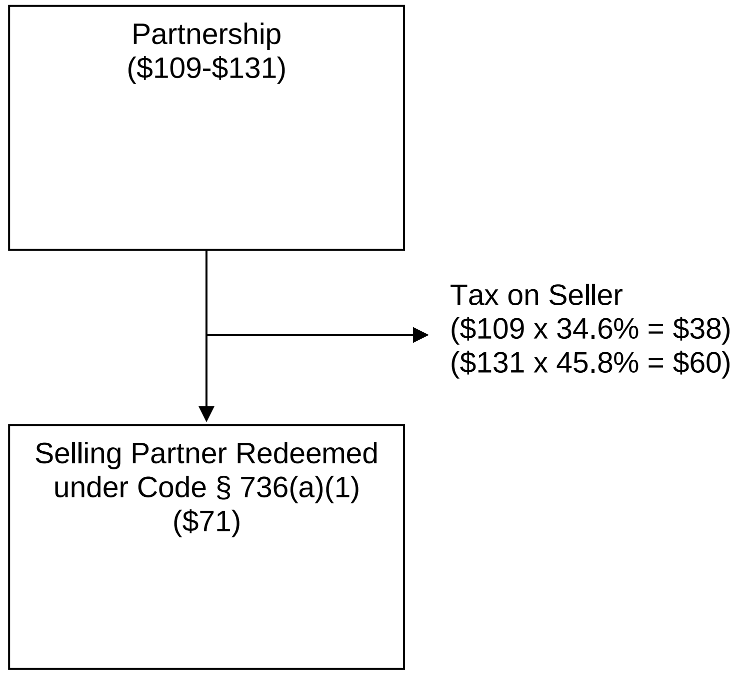
The buyers might very well have lower income tax rates than the seller, resulting in a decreased amount of earnings needed to buy out the seller. For example, a 40% income tax rate would require only $167 of earnings (40% of $167 is $67 tax).

Although an S corporation buyout might be perceived as the same as a Code § 736(b) buyout, it is not. Each year's Code § 736(b) payment creates a new goodwill asset that can amortized over 15 years. This option is not available to S corporations.

This scenario assumes corporate goodwill. Personal goodwill can be dealt with more effectively than corporate goodwill.

If and to the extent sale price is based on accumulated earnings rather than goodwill, sale price is not taxable and exclusion under part II.Q.1.a.i.(c) is not more favorable.

II.Q.1.a.i.(e). Partnership Single Taxation of Goodwill



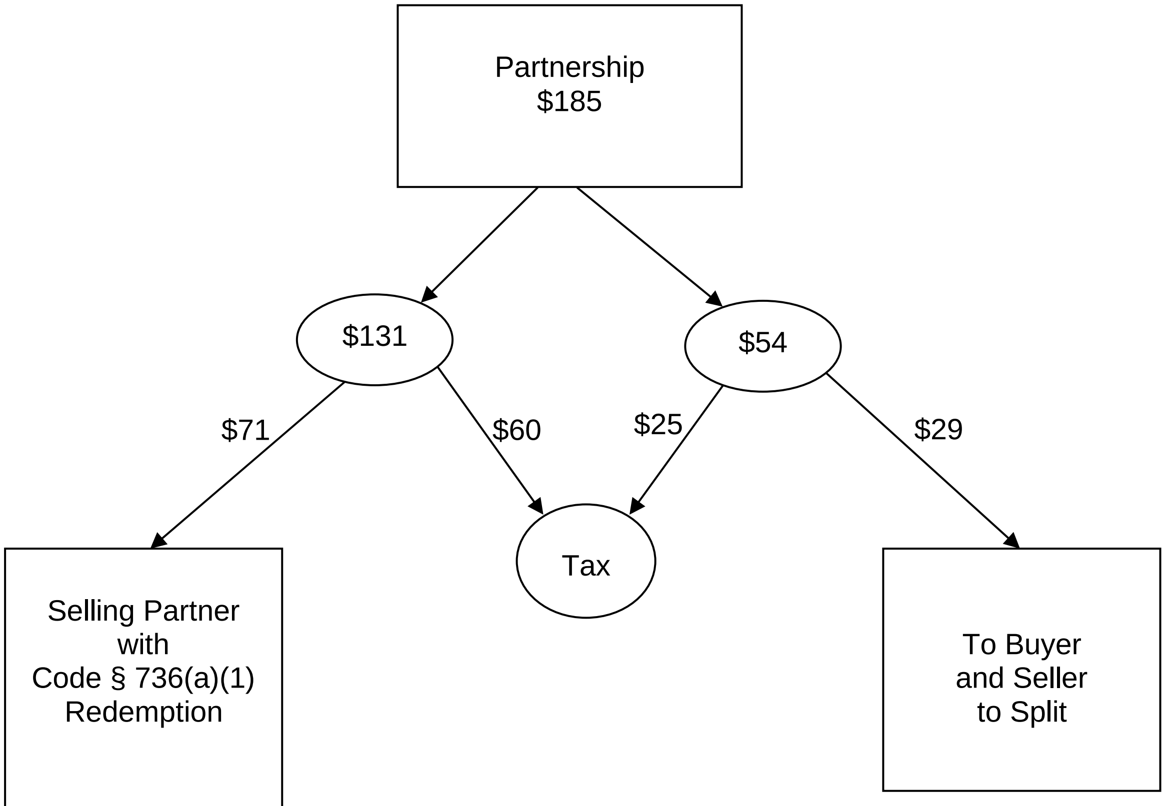
For more details on the tax and nontax benefits of this structure, see part II.Q.8.b.iii Partnership Alternative to Seller-Financed Sale of Goodwill, as well as part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736, which includes allowing income to be taxed to the seller under Code § 736(a).

See part II.Q.8.b.ii.(b) Flexibility in Choosing between Code § 736(a) and (b) Payments (including in fns. 5502-5504 the requirement that, to obtain Code § 736(a) treatment with respect to unrealized receivables and goodwill, a retiring partner must be a general partner and capital cannot be a material income-producing factor).

If the partnership is not a service partnership, one might need to use a preferred profits interest instead of Code § 736(a) payments. However, consider whether such a reallocation of profits might constitute a shifting of goodwill that should be reflected in capital accounts and therefore might constitute a taxable shift of a capital account.[4113]

[4113] See fn. 486 in part II.C.6 Shifting Rights to Future Profits.

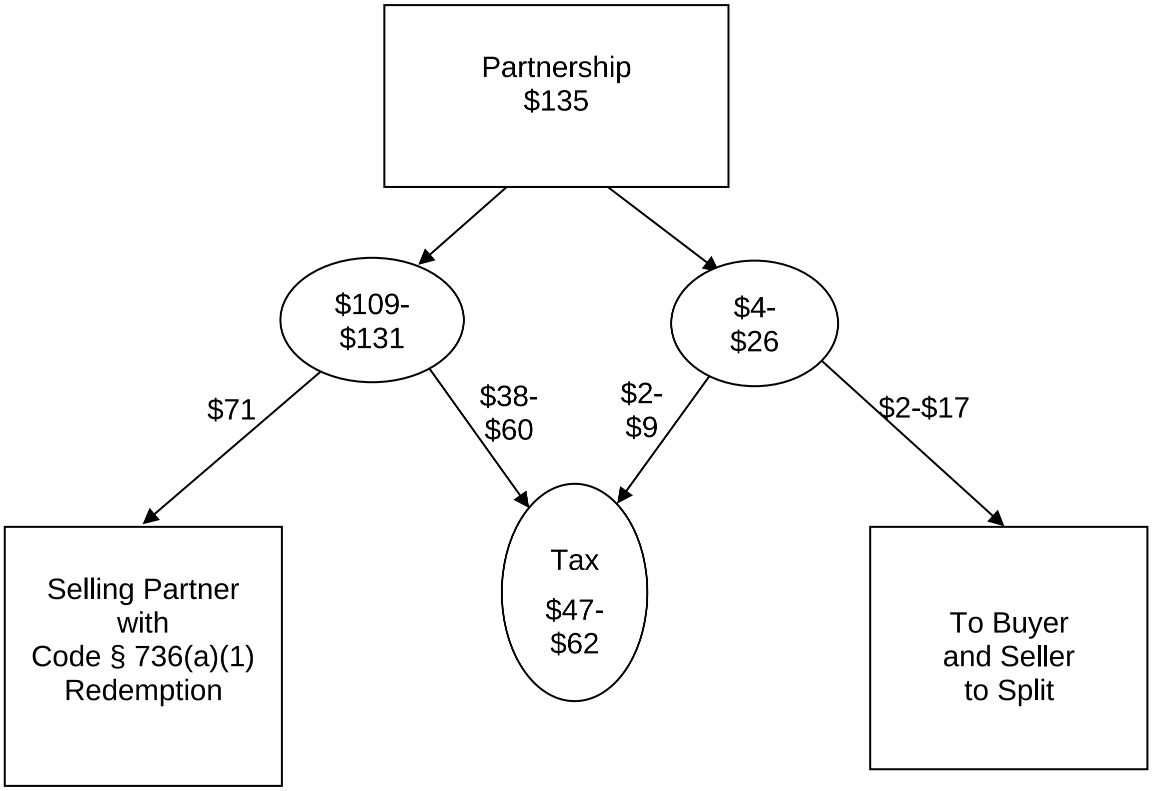
II.Q.1.a.i.(f). Partnership Use of Same Earnings as S Corporation in Sale of Goodwill



Notes:

- This scenario uses the income from the scenario II.Q.1.a.i.(d) S Corporation Double Taxation and applies the concepts from part II.Q.1.a.i.(e) Partnership Single Taxation of Goodwill. The left side of the flowchart duplicates the partnership scenario, with $131 of earnings and $71 of tax. The right side of the flowchart takes the $185 from the S corporation double taxation scenario and subtracts from it the $131 from the partnership scenario, resulting in $54 extra earnings in the partnership scenario not needed to generate $71 for the seller. However, these $54 of extra earnings are subject to $25 of income tax, so that only $29 is left, net after-tax.
- The $29 net after-tax is based on an original $100 purchase price, meaning that the partnership scenario nets 29% after-tax dollars that the parties can allocate.
- In either scenario, $185 is subjected to ordinary income tax.

II.Q.1.a.i.(g). Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill



Notes:

- This scenario uses the income ($135) from the scenario in in part II.Q.1.a.i.(b) C Corporation Redemption or part II.Q.1.a.i.(c) C Corporation Double Taxation Under Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation and applies the concepts from part II.Q.1.a.i.(e) Partnership Single Taxation of Goodwill. The left side of the flowchart duplicates the partnership scenario, with $109-$131 of earnings and $38-$60 of tax. The right side of the flowchart takes the $135 from the C corporation scenario and subtracts from it the $109-$131 from the partnership scenario, resulting in $4-$26 extra earnings in the partnership scenario not needed to generate $70 for the seller. However, these $4-$26 of extra earnings are subject to $2-$9 of income tax, so that only $2-$17 is left, net after-tax.
- The $2-$17 net after-tax is based on an original $100 purchase price, meaning that the partnership scenario nets 4%-17% after-tax dollars that the parties can allocate.
- In either scenario, $135 is subjected to ordinary income tax.

II.Q.1.a.ii. California Scenarios

See assumptions in part II.Q.1.a.i Scenario for Moderate State Tax. Consider the portion of the business' equity representing internally generated goodwill, and assume the following top marginal income tax rates, which might or might not be attained:

<u>Sale of Goodwill - Assumptions</u>

C corp. income tax rate:	21.0%	federal
	8.8%	state (really 8.84%)
	29.8%	
Individual capital gain rate:	20.0%	federal
	13.3%	state
	3.8%	net investment income (NII) tax
	37.1%	
S corporation income rate:	29.6%-37%	federal
	13.3%	state individual
	1.5%	state entity
	zero-3.8%	NII tax
	44.4%-55.6%	
Partnership income rate:	29.6%-37%	federal
	13.3%	state
	zero-3.8%	NII or SE tax
	42.9%-54.1%	

The capital gain rate for individuals might be overstated when a person sells stock in an S corporation, because the 3.8% tax on net investment income would not apply with respect to the business assets allocable to that stock when a shareholder who is active in the business sells the stock.[4114] The partnership income tax rate might be overstated, either if the partner is a limited partner not subject to self-employment tax[4115] or if the payment is neither self-employment income[4116] nor attributable to business assets allocable to the partnership interest when a partner who is active in the business sells the partnership interest.[4117]

The scenario in the left column below assumes that the buyer uses after-tax dollars to buy the seller's interest in the business. The tax to the buyer in the left column is based on the ordinary income rates, because the buyer is using income generated by operations to fund the payments to the seller. The seller is receiving income at capital gain rates.

[4114] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
[4115] See part II.L.4 Self-Employment Tax Exclusion for Limited Partner.
[4116] See part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.
[4117] See parts II.I.8.d Partnership Structuring in Light of the 3.8% Tax on Net Investment Income and II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.

	Capital Gain to Seller	Ordinary Income to Seller
Profit	$ 175-218	$ 110-137
Tax to Buyer	- (75-118)	- 0
	$ 100	$ 110-137
Tax to Seller	- 37	- (47-74)
Net to Seller	$ 63	$ 63

The tax in the right-hand column assumes that the buyer deducts payments to the seller, which is essentially what happens when one pays off a seller by allocating current partnership income to the seller.

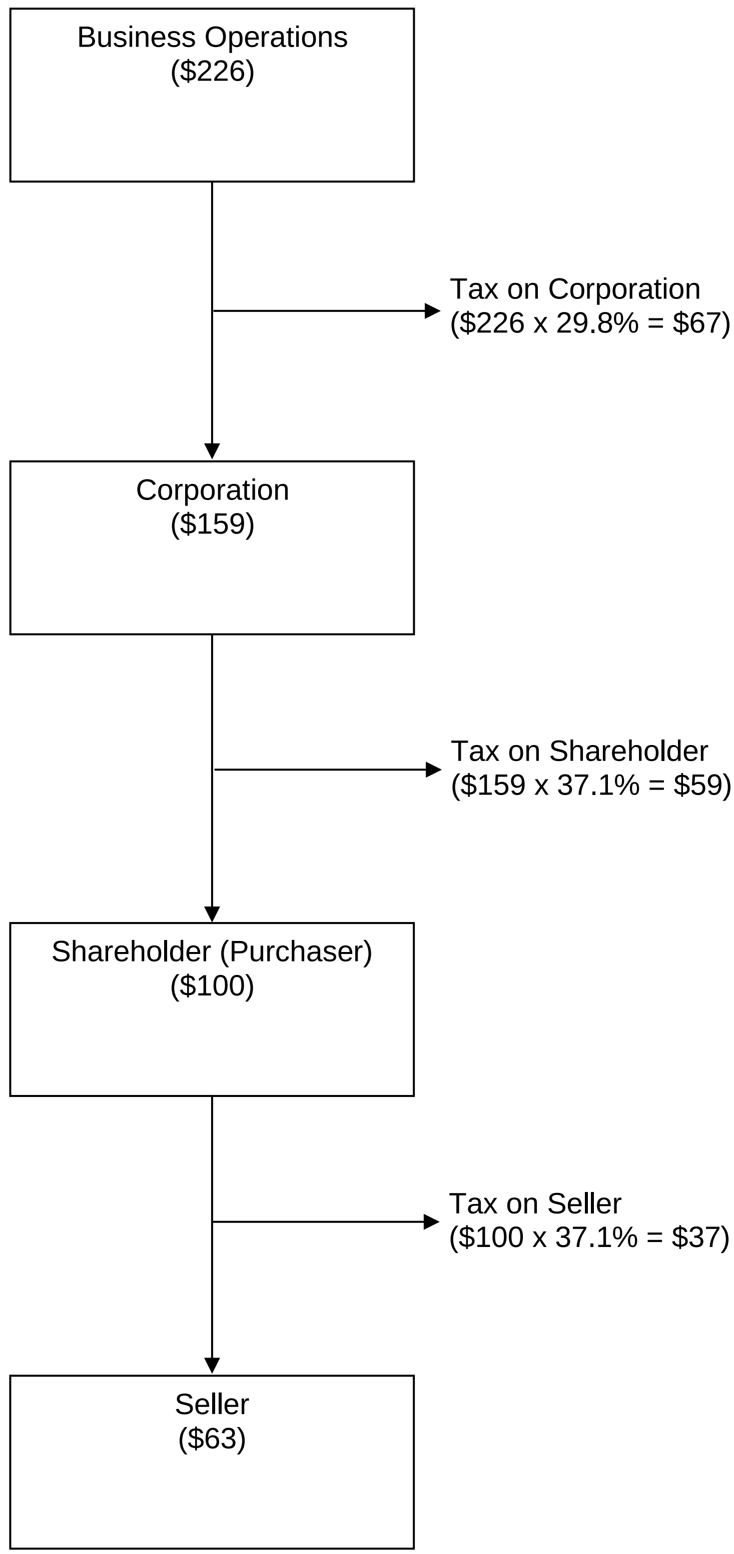
The illustrations ignore the California LLC fee (gross receipts tax) of up to nearly $12K that applies to an LLC taxed as a partnership. If the partnership uses the structure recommended in part II.E.6 Recommended Partnership Structure – Flowchart:

- This fee of up to nearly $12K would be imposed on each LLC subsidiary annually,
- Self-employment tax would not apply, and
- California's 1.5% entity-level tax on S corporations would apply to the general partner's 1% annual income and any profit from its management fee in excess of salaries paid to the owners.

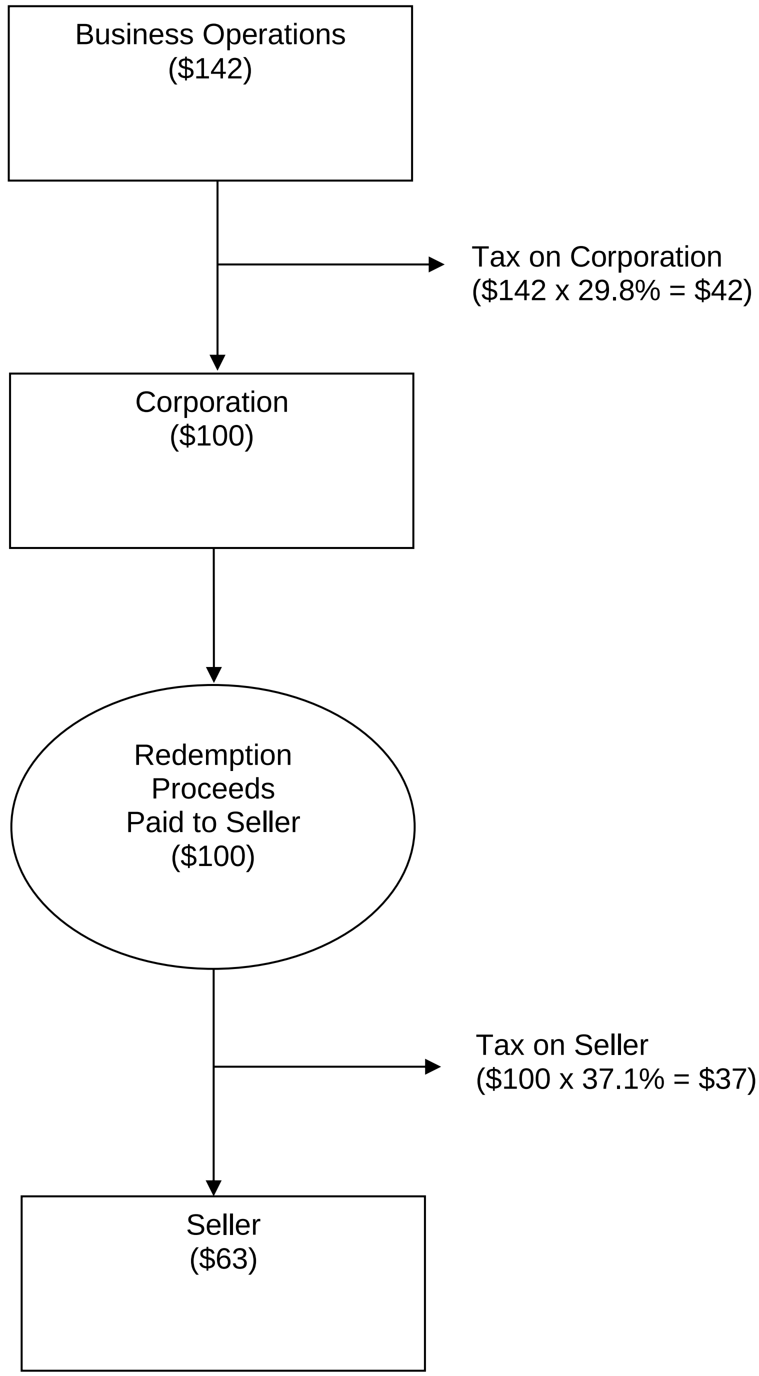
The following pages illustrate this concept, showing that it takes a C corporation $288 in earnings to do a cross-purchase (one owner sells to another)[4118] and $225 to do either a redemption (entity buys from seller)[4119] or a cross-purchase using an exclusion that applies to the sale of certain stock,[4120] an S corporation $218 in earnings,[4121] and a partnership only $147 in earnings[4122] to get $62 to the seller.

[4118] See part II.Q.1.a.ii.(a) C Corporation Triple Taxation (California).
[4119] See part II.Q.1.a.ii.(b) C Corporation Redemption (California). Redeeming the seller entirely might work if buying out one owner and increasing the other owners' interests in proportion to each other. However, if the sole owner is selling, or if the remaining owners are not increased in proportion to each other, then a cross-purchase or a stock issuance is needed to get the remaining owners' interests in the correct proportion, followed by the redemption. For approval of combining a cross-purchase with a redemption, see part II.Q.7.a.ii Hybrid Between Redemption and Cross-Purchase When Selling to New Shareholder or Other Shareholders.
[4120] See part II.Q.1.a.ii.(c) C Corporation Triple Taxation Under Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation (California).
[4121] See part II.Q.1.a.ii.(d) S Corporation Double Taxation (California).
[4122] See part II.Q.1.a.ii.(e) Partnership Single Taxation of Goodwill (California).

II.Q.1.a.ii.(a). C Corporation Triple Taxation (California)

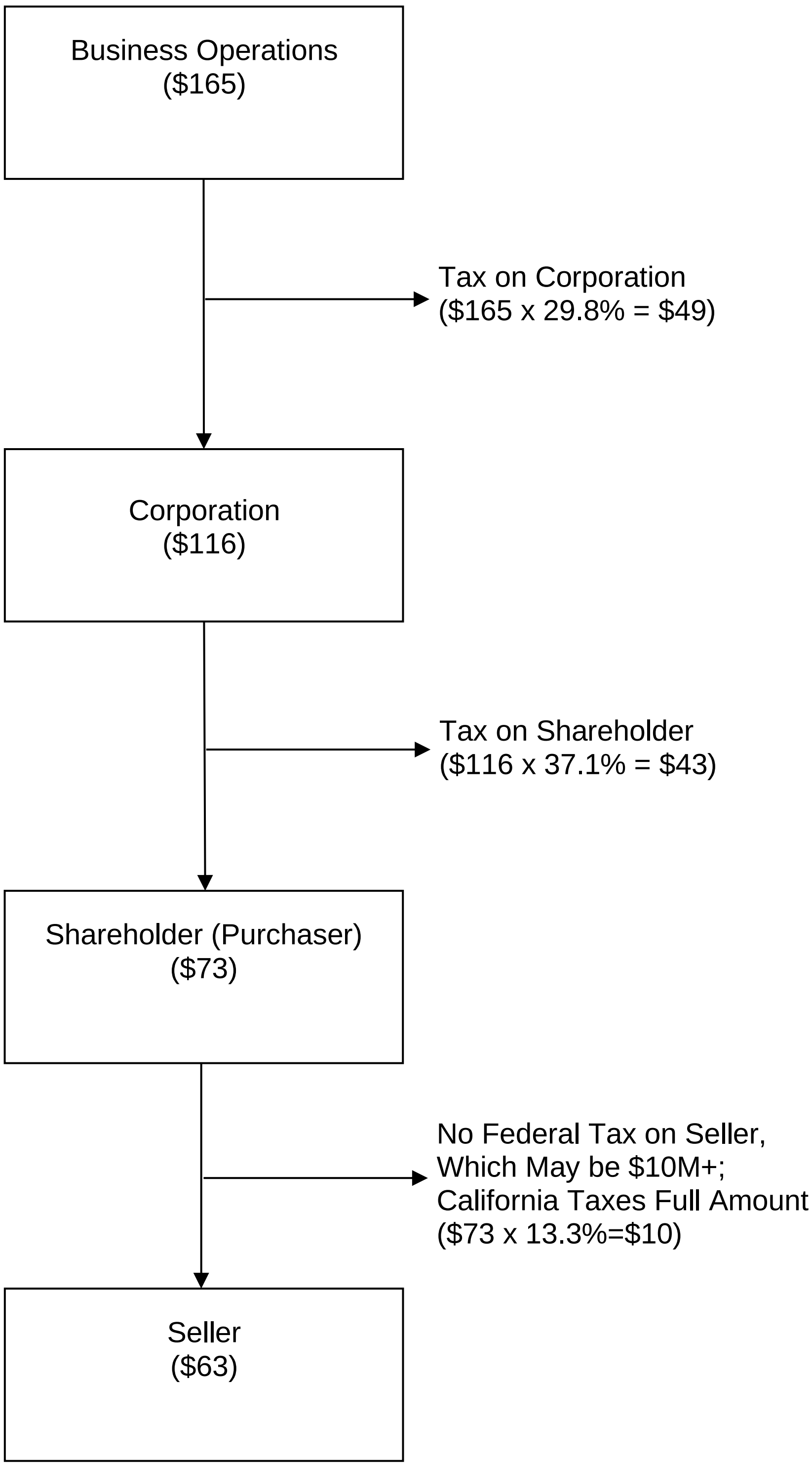


II.Q.1.a.ii.(b). C Corporation Redemption (California)

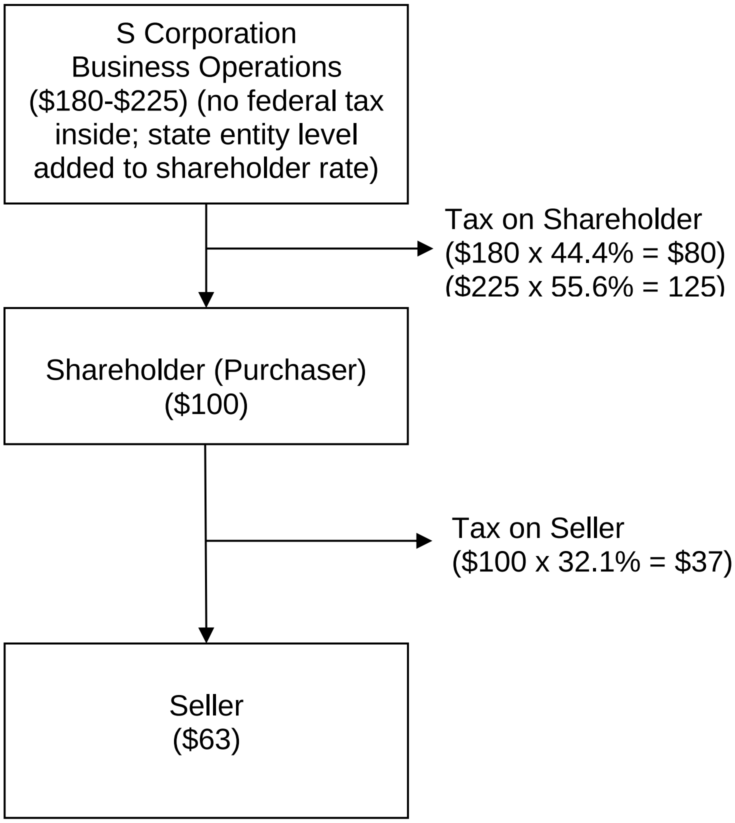


See part II.Q.7.a.ii Hybrid Between Redemption and Cross-Purchase When Selling to New Shareholder or Other Shareholders. The buyer may benefit more from buyer's future sale if buys from corporation more than two years before the seller is redeemed. See part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation.

II.Q.1.a.ii.(c). C Corporation Triple Taxation Under Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation (California)



II.Q.1.a.ii.(d). S Corporation Double Taxation (California)



<u>Notes</u>:

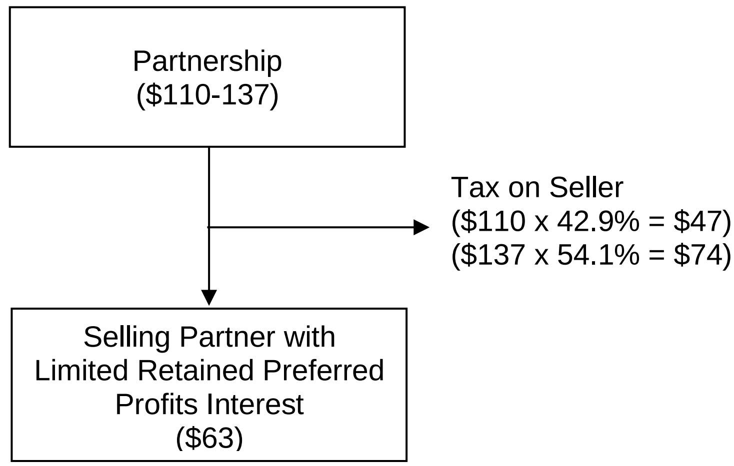
The buyers might very well have lower income tax rates than the seller, resulting in a decreased amount of earnings needed to buy out the seller.

Although an S corporation buyout might be perceived as the same as a Code § 736(b) buyout, it is not. Each year's Code § 736(b) payment creates a new goodwill asset that can amortized over 15 years. This option is not available to S corporations.

This scenario assumes corporate goodwill. Personal goodwill can be dealt with more effectively than corporate goodwill.

If and to the extent sale price is based on accumulated earnings rather than goodwill, sale price is not taxable and exclusion under part II.Q.1.a.ii.(c) is not more favorable.

II.Q.1.a.ii.(e). Partnership Single Taxation of Goodwill (California)



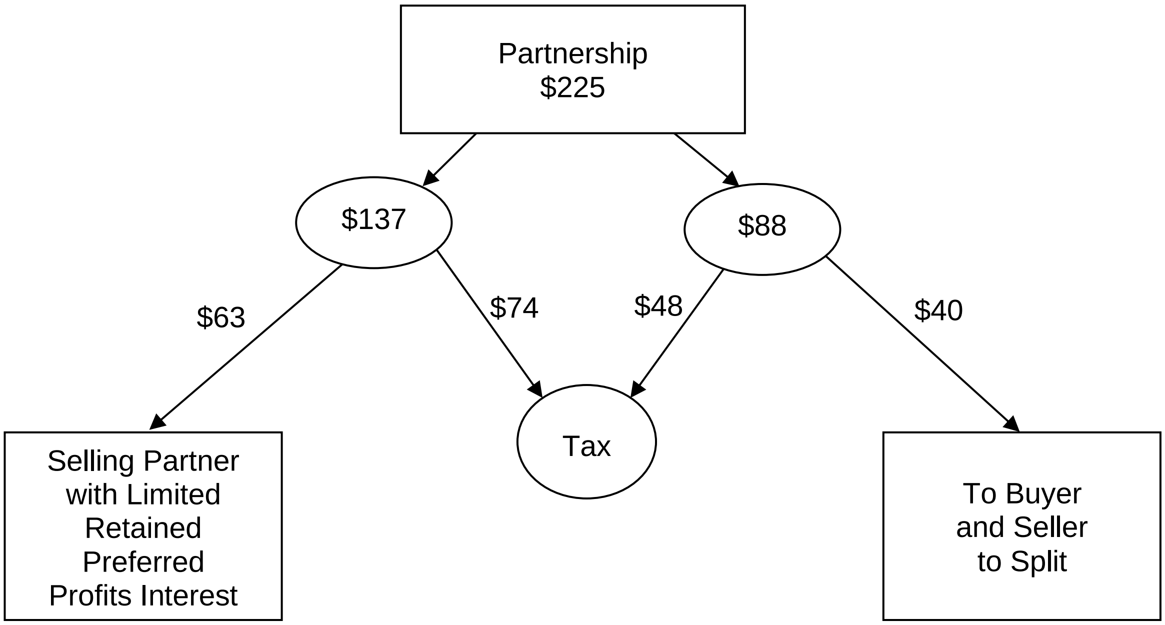
For more details on the tax and nontax benefits of this structure, see part II.Q.8.b.iii Partnership Alternative to Seller-Financed Sale of Goodwill, as well as part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736, which includes allowing income to be taxed to the seller under Code § 736(a).

See part II.Q.8.b.ii.(b) Flexibility in Choosing between Code § 736(a) and (b) Payments (including in fns. 5502-5504 the requirement that, to obtain Code § 736(a) treatment with respect to unrealized receivables and goodwill, a retiring partner must be a general partner and capital cannot be a material income-producing factor).

If the partnership is not a service partnership, one might need to use a preferred profits interest instead of Code § 736(a) payments. However, consider whether such a reallocation of profits might constitute a shifting of goodwill that should be reflected in capital accounts and therefore might constitute a taxable shift of a capital account.[4123]

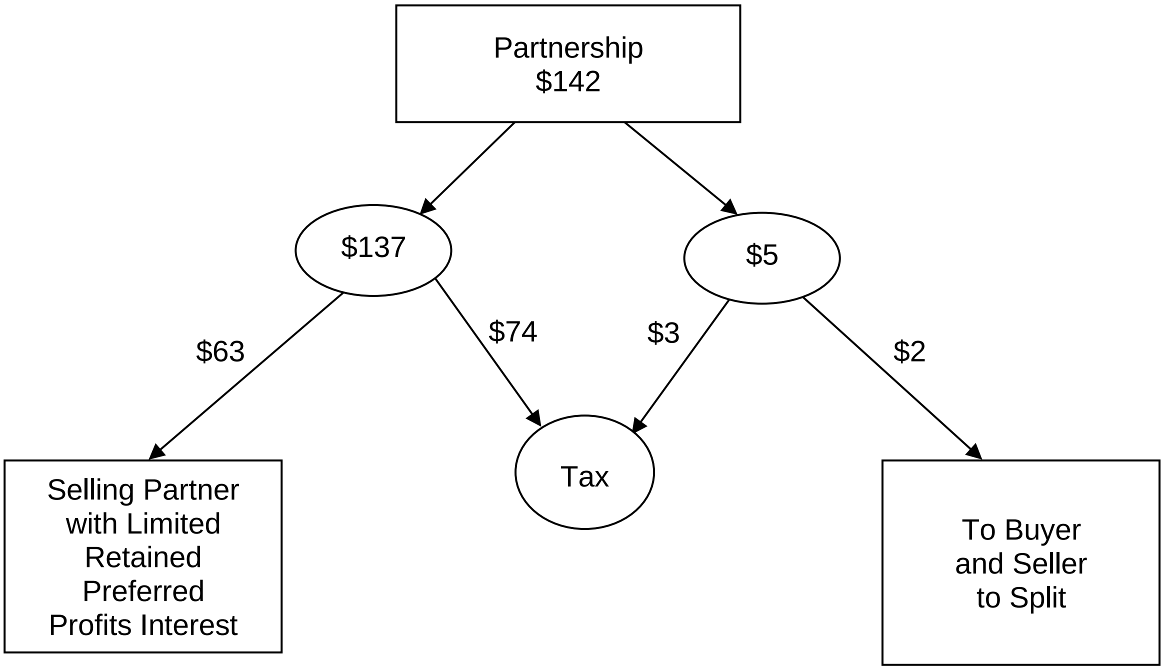
[4123] See fn. 486 in part II.C.6 Shifting Rights to Future Profits.

II.Q.1.a.ii.(f). Partnership Use of Same Earnings as S Corporation in Sale of Goodwill (California)



- This scenario uses the income from the scenario in part II.Q.1.a.ii.(d) S Corporation Double Taxation (California) and applies the concepts from part II.Q.1.a.ii.(e) Partnership Single Taxation of Goodwill (California). The left side of the flowchart duplicates the partnership scenario, with $137 of earnings and $74 of tax. The right side of the flowchart takes the $225 from the S corporation double taxation scenario and subtracts from it the $137 from the partnership scenario, resulting in $88 extra earnings in the partnership scenario not needed to generate $63 for the seller. However, these $88 of extra earnings are subject to $48 of income tax, so that only $40 is left, net after-tax.
- The $40 net after-tax is based on an original $100 purchase price, meaning that the partnership scenario nets 40% after-tax dollars that the parties can allocate. The $40 savings consists of $37 capital gain tax and $3 entity level tax (1.5% of $225 S corporation earnings).
- In either scenario, $225 is subjected to ordinary income tax.
- If the buyers are in a lower tax bracket than the seller, then not as much money is required in the S corporation scenario and the $40 net-after-tax amount can be reduced or eliminated.

II.Q.1.a.ii.(g). Partnership Use of Same Earnings as C Corporation – Redemption (California)

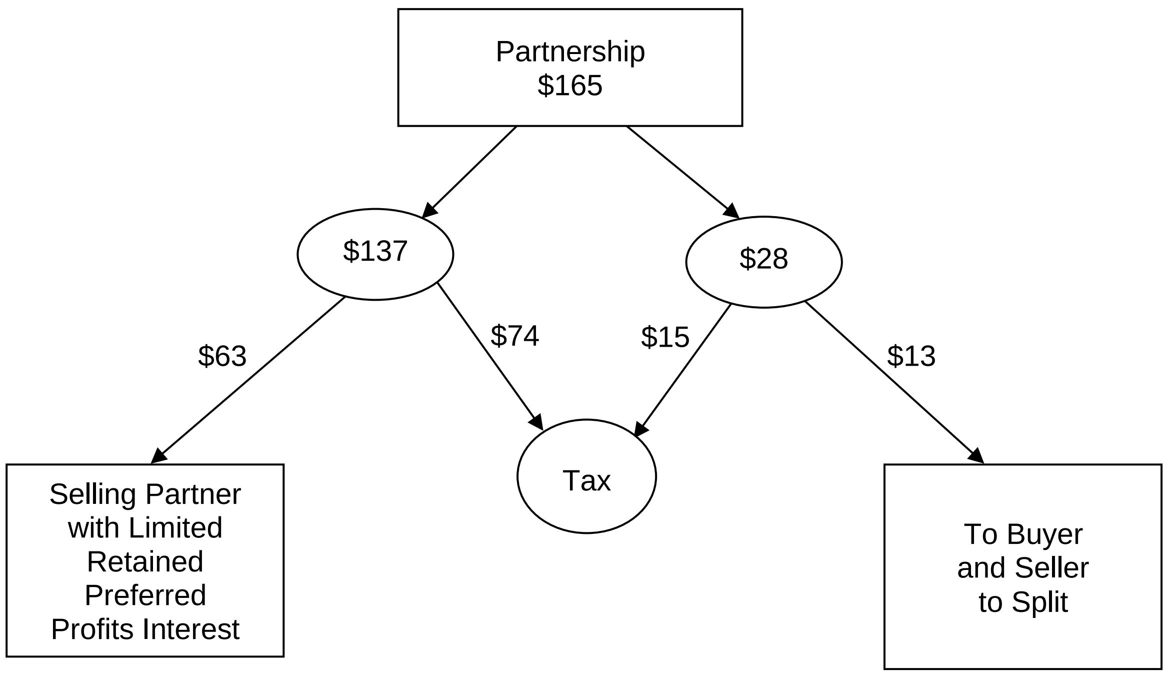


Notes:

- This scenario uses the income from the scenario in part II.Q.1.a.ii.(b) C Corporation Redemption (California) and applies the concepts from part II.Q.1.a.ii.(e) Partnership Single Taxation of Goodwill (California). The left side of the flowchart duplicates the partnership scenario, with $137 of earnings and $74 of tax. The right side of the flowchart takes the $142 from the C corporation double tax scenario and subtracts from it the $137 from the partnership scenario, resulting in $5 extra earnings in the partnership scenario not needed to generate $63 for the seller. However, these $5 of extra earnings are subject to $3 of income tax, so that only $2 is left, net after-tax.
- The $2 net after-tax is based on an original $100 purchase price, meaning that the partnership scenario nets 2% after-tax dollars that the parties can allocate.

In either scenario, $142 is subjected to ordinary income tax.

II.Q.1.a.ii.(h). Partnership Use of Same Earnings as C Corporation – No Federal Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation in Sale of Goodwill (California)



Notes:

- This scenario uses the income from the scenario in part II.Q.1.a.ii.(c) C Corporation Triple Taxation Under Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation (California) and applies the concepts from part II.Q.1.a.ii.(e) Partnership Single Taxation of Goodwill (California). The left side of the flowchart duplicates the partnership scenario, with $137 of earnings and $74 of tax. The right side of the flowchart takes the $165 from the C corporation double tax scenario and subtracts from it the $137 from the partnership scenario, resulting in $28 extra earnings in the partnership scenario not needed to generate $63 for the seller. However, these $28 of extra earnings are subject to $15 of income tax, so that only $13 is left, net after-tax.
- The $13 net after-tax is based on an original $100 purchase price, meaning that the partnership scenario nets 13% after-tax dollars that the parties can allocate.

In either scenario, $165 is subjected to ordinary income tax.

II.Q.1.a.iii. Migrating to a Partnership Structure

For what might be an ideal partnership structure, see part II.E Recommended Structure for Entities, especially parts II.E.3 Recommended Structure for Start-Ups, II.E.4 Reaping C Corporation Annual Taxation Benefits Using Hybrid Structure, II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons, and II.E.6 Recommended Partnership Structure – Flowchart.

Parts II.E.7 Migrating into Partnership Structure and II.E.9 Real Estate Drop Down into Preferred Limited Partnership explain how to get there.

II.Q.1.b. Leasing

Some assets used in a business might be held outside of the business and then leased to the business. The buyer continues to lease these assets from the seller. Such lease payments are deductible to the buyer and taxable to the seller, and the seller is not necessarily at risk in that the seller might be able to sell the property to a third party. If a partnership holds the business, the partnership that conducts business operations can save its owners self-employment (SE) tax by leasing real estate instead of owning it;[4124] However, equipment leasing generally would be subject to SE tax.[4125] Also note that Florida and perhaps other states impose a tax on gross rents.

If a long-term lease provides rent above the property's fair rental value, a lease termination payment is deductible as an ordinary business expense, even if the tenant buys the property;[4126] however, be prepared for a fight with the IRS and to go to District Court, because the Tax Court will require the taxpayer to capitalize the lease termination fee outside of the Sixth Circuit.[4127] On the other hand, amounts a lessee receives for the cancellation of a lease are considered as amounts received in exchange for that lease;[4128] although this exchange treatment does not affect whether the lease is a capital asset as to the lessee,[4129] it very well may be.[4130]

[4124] Real estate rental income received on a long-term basis is not subject to self-employment tax, Reg. § 1.1402(a)-4(a) (see part II.L.2.a.ii Rental Exception to SE Tax, especially fn. 3428), whereas the rent deduction would reduce self-employment income, if any, of the operating business. In early years of owning the real estate, rent deductions might not produce much saving relative to depreciation, interest expense, insurance and taxes; in later years, however, the saving might be significant. Although rental income generally is subject to the 3.8% tax on net investment income (NII), rental to a business with sufficient common ownership is not NII. See part II.I.8.c Application of 3.8% Tax to Rental Income.

[4125] See part II.L.2.a.ii Rental Exception to SE Tax, fns 3433-3437.

[4126] *ABC Beverage Corporation v. U.S.*, 756 F.3d 438 (6th Cir. 2014) (of $9M purchase price, $6.25M allocated to lease termination expense).

[4127] *Union Carbide Foreign Sales Corp. v. Commissioner*, 115 T.C. 423 (1993) (holding that Code § 167(c)(2) compelled that result). Code § 167(c)(2) provides:

> If any property is acquired subject to a lease-
> (A) no portion of the adjusted basis shall be allocated to the leasehold interest, and
> (B) the entire adjusted basis shall be taken into account in determining the depreciation deduction (if any) with respect to the property subject to the lease.

The Sixth Circuit's opinion in fn. 4126 pointed out that the purchase extinguished the lease; because the lease did not continue after the purchase, the property was not acquired subject to the lease.

[4128] Code § 1241.

[4129] Reg. § 1.1241-1(a).

[4130] In Letter Ruling 200045019, the tenant entered into a commercial lease, then later claimed that the rent that it paid was too high because it used the property primarily for residential purposes. After stating that the local housing authority ruled in the tenant's favor, the Ruling continued:

> City's rent control law gives a tenant the right to continued possession of a property and establishes the maximum rent that may be charged. This right of possession is for an indefinite time period. The landlord may evict such a tenant only under specific circumstances as listed in the Statute.
>
> As a result of the determination that the Premises were subject to the rent control law, the landlord agreed to pay Taxpayer $s in return for Taxpayer surrendering all lease and statutory rights to the Premises. This agreed sum represents $m plus $n to cover estimated taxes. The estimated tax amount was determined under the assumption that Taxpayer's gains from the transaction would be treated as capital gains. Further, the landlord agreed to pay an additional amount, up to $u, plus interest and penalties, if the Internal Revenue Service determines that the

gain is ordinary. Finally, the landlord agreed to pay $v to a law firm to cover Taxpayer's legal fees.

In finding that the lease termination payment was capital gain, the Ruling reasoned:

> We note that section 1231, rather than section 1221, may apply to the instant case because the facts indicate that Taxpayer's leasehold may have been used in part, or for a portion of the lease period, for the conduct of Taxpayer's business. Business use of real property precludes that property from receiving capital asset treatment under section 1221(2). However, we do not need to determine whether the leasehold is excluded under section 1221(2) because it will either be a section 1221 capital asset or a section 1231 asset. In either case, the gain recognized on the exchange of the leasehold will be capital, rather than ordinary.
>
> In Rev. Rul. 72-85, 1972-1 C.B. 234, the Service determined that a leasehold of land used in a trade or business is section 1231 property, even if it is of indefinite duration. This revenue ruling clarified Rev. Rul. 56-531, 1956-2 C.B. 983, which holds, in part, that the Service acquiesces in *McCue Bros. & Drummond, Inc. v. Commissioner*, 19 T.C. 667 (1953), *acq.* 1956-2 C.B. 7, *aff'd*, 210 F.2d 752 (2d Cir. 1954), *cert. denied*, 348 U.S. 829 (1954).
>
> The petitioner in *McCue Bros.* leased a hat shop in New York City. For a portion of his occupancy, the petitioner held the property under a written lease. However, after the lease expired, the petitioner continued to occupy the property under a "statutory tenancy" by virtue of the New York rent control laws that had taken effect shortly before the end of the written lease. In affirming the Tax Court in *McCue Bros.*, the Second Circuit stated that it was immaterial whether the petitioner held the property under a lease or through the rent control laws. The court stated, "we think the right of possession under a lease or otherwise, is a ...substantial property right which does not lose its existence when transferred. If it is sold by the tenant to a third person, the gain derived therefrom is a capital gain." 210 F.2d at 753. The court further stated that the holding period began when the statutory right of possession attached. *Id.* at 754.
>
> In *Stotis v. Commissioner*, T.C. Memo. 1996-431, the Tax Court came to a similar result in the case of a residential leasehold. Mr. Stotis, the petitioner, leased space in an apartment building that he used as a residence. The landlord, desiring to use the real estate for other purposes, entered into a surrender agreement with the petitioner whereby the petitioner exchanged his right in the property for a cash payment. The Tax Court held that the petitioner's leasehold interest in a residence was a capital asset, and that the petitioner's sale of the leasehold interest constituted a sale or exchange, taxable as capital gain.
>
> The facts of this case are not clear as to whether the property in question is properly treated as real property used in the trade or business for purposes of sections 1221 and 1231. If it is not real property used in the trade or business, the leasehold interest is a capital asset under section 1221. If it is real property used in the trade or business, any gain attributable to the sale or exchange of the leasehold interest is treated as long-term capital gain under section 1231. Taxpayer's holding period began with the vesting of the statutory right of occupancy on c. Therefore, Taxpayer held the property for more than one year. Additionally, under Rev. Rul. 72-85, the fact that Taxpayer's leasehold interest under the rent control laws was for an indefinite period does not preclude section 1231 long-term capital gain treatment.
>
> Under section 1241, amounts received by a lessee for the cancellation of a lease, or by a distributor of goods for the cancellation of a distributor's agreement (if the distributor has a substantial capital investment in the distributorship), are considered as amounts received in exchange for such lease or agreement.
>
> Based on the foregoing, we conclude that the amounts received by Taxpayer are considered amounts received in exchange for Taxpayer's leasehold interest in the Premises. Further, we conclude that Taxpayer realized long-term capital gain on the sale of the leasehold interest. Taxpayer's interest in the Premises is either a capital asset under section 1221 or real property used in the trade or business under section 1231. In either event, gain realized from the sale of the leasehold interest is treated as long-term capital gain. Payments of the legal fees and income taxes are part of the purchase price to the extent that such payments are given in exchange for Taxpayer's leasehold interest and not for Taxpayer abandoning some other legal right or property not related to the transaction in question.

Reg. § 1.162-11(a), "Acquisition of a leasehold," provides:

> If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. For disallowance of deduction for income taxes paid by a lessee corporation pursuant to a lease arrangement with the lessor corporation, see section 110 and the regulations thereunder. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in amortizing the costs incurred after July 28, 1958, of acquiring a lease. See § 1.197-2 for rules governing the amortization of costs to acquire limited interests in section 197 intangibles.

Generally, real property should not be held in the entity that conducts the business. As discussed above, for self-employment tax purposes it should not be owned by a partnership that has business operations. Because appreciated real estate cannot be distributed from a corporation without triggering either premature (in the case of an S corporation) or double (in the case of a C corporation) taxation under Code § 311,[4131] usually real estate should not be held in a corporation (see footnote 367 for some of the issues, including basis step-up issues, involved in whether real estate should be in a corporation).

II.Q.1.c. Personal Goodwill and Covenants Not to Compete

II.Q.1.c.i. Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation

If the business entity does not require its key employees to agree not to compete, the key employees might leave and take their contacts with them. Thus, in such situations the key employees really "own" the business' goodwill. When the business is sold, the buyer would buy goodwill from the person who owns the goodwill, pay key employees not to compete, pay the key employees to work in the business, or a combination of any of these.

Note, however, that, gain from the sale of a Code § 1231 asset may be different than gain from the sale of a capital asset. If the taxpayer had Code § 1231 losses in a prior year, those losses may have converted the gain to ordinary income. See part II.G.6.a Code § 1231 Property, especially fns. 1496-1497.

[4131] Code § 311 provides that, when a corporation distributes property, the distribution constitutes a sale or exchange by the corporation. See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders. Together with the rules governing income taxation of shareholders:

- For an S corporation, generally this means that the shareholders are taxed on the exchange (with favorable capital gain rates often available), receive an increased tax basis in their stock equal to the gain reported, reduce the basis of their stock to the extent of the value of the property that was distributed, and adjust to fair market value the basis of the property that was distributed.
- For a C corporation, generally this means that the corporation pays income tax (with favorable capital gain rates <u>not</u> available) and the shareholders are taxed on the distribution as a dividend, thus generating two layers of tax. However, as with an S corporation, the distributed property's basis is adjusted to fair market value.

When self-created goodwill is sold, generally the seller receives favorable capital gain treatment and the buyer deducts over 15 years the sum of the payments;[4132] furthermore, that capital gain may qualify for an exclusion from the 3.8% tax on net investment income.[4133] (Also goodwill that is not being amortized and is held by a partnership would be eligible for a basis step if a Code § 754 election is in place.[4134]) This capital gain treatment may incentivize taxpayers to allocate proceeds from sales of intangibles to goodwill, because the sale of some intangibles generates ordinary income instead of capital gain, as described in part II.G.18.b Sale or Exchange of Intellectual Property - Capital Gain vs. Ordinary Income. However, ordinary income treatment applies to the sale to a related party,[4135] which applies whether or not the goodwill was being amortized.[4136] Furthermore, the amortization of goodwill causes it to lose its status as a capital asset, which in some circumstances can cause part or all of the gain on sale to lose capital treatment.[4137] Additional rules are described in the text accompanying fn 1699 in part II.G.18.d Amortization of Code § 197 Intangibles.

[4132] *Horton v. Commissioner*, 13 T.C. 143 (1949) (income from the sale of goodwill is capital gain, whereas income from a noncompete agreement is ordinary income); Code § 197(a), (d)(1)(A) (deduction for amortizing goodwill). Although Reg. § 1.197-2(d)(2) disallows amortization deductions for self-created goodwill, it allows amortization when the taxpayer buys the goodwill (including from someone who bought it from the taxpayer). *Fitch v. Commissioner*, T.C. Memo. 2012-358 rebuffed an IRS attack on repurchased goodwill using a very simple contract. But for Code § 197, goodwill is not amortizable. Reg. § 1.167(a)-3(a).

[4133] See text accompanying and preceding fn 2437 in part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.

[4134] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, fn. 5684. For an example of the effect of a Code § 754 election on goodwill that is being amortized, see fn. 5795 in part II.Q.8.e.iv Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).

[4135] See parts II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), which applies to sale of an S corporation's goodwill, and II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

[4136] See text accompanying fn. 5084.

[4137] Letter Ruling 200243002 ruled that the sale of goodwill that has not been amortized is taxed as a capital gain, but goodwill that is being amortized is not a capital asset and therefore was subject to tax at ordinary income rates. However, amortizable goodwill may be eligible for capital gain treatment as described in part II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business, especially fn. 1490. Because capital gain treatment in that situation arises solely by reason of Code § 1231, any Code § 1231 gain is taxed as ordinary income if and to the extent the taxpayer has unrecaptured Code § 1231 losses. Code § 1231 losses are ordinary losses generated by the sale of Code § 1231 property (property used in a trade or business).

Elaborating on the above, Letter Ruling 200243002 reasoned:

> It is well settled that prior to enactment of § 197, goodwill and going concern value were considered to be intangible and nonamortizable capital assets within the meaning of § 1221, by both the Service and the courts. Rev. Rul. 65-180, 1965-2 C.B. 279; Rev. Rul. 55-79, 1955-1 C.B. 370; *UFE, Inc. v. Commissioner*, 92 T.C. 1314, 1323 (1989) ("going-concern value is an intangible, nonamortizable capital asset that is often considered to be part of goodwill"); *Patterson v. Commissioner*, 810 F.2d 562, 569 (6th Cir. 1987) (stating that "any amount paid for goodwill, since it does not waste, becomes a nonamortizable capital asset," and "amounts received by a seller for the goodwill or going concern value of the business are taxed at the more favorable capital gains rates"); *Better Beverages, Inc. v. United States*, 619 F.2d 424, 425 n. 2 (5th Cir. 1980) ("goodwill is a capital asset"); *Dixie Finance Co. v. United States*, 474 F.2d 501, 506 n. 5 (5th Cir. 1973) (goodwill is a capital asset and amounts received therefor in excess of the

For an exception to capital gain treatment when a partnership distributes a client-based intangible asset, such as a customer list or book of business, see part II.Q.8.b.i.(d) Capital Accounting May Trigger Ordinary Income.

Also, the sale and subsequent amortization of goodwill turns it into a "hot" asset, reducing opportunities for deferral on its sale.[4138] Whether or not goodwill is being amortized, a controlled corporation's sale or distribution of goodwill might generate ordinary income,[4139] as would a sale involving a partnership.[4140]

When a covenant not to compete is involved, generally the seller receives ordinary income treatment and the buyer deducts the present value of the payments over 15 years.[4141]

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seller's basis are treated as capital gains, but represent a nonamortizable capital investment resulting in no corresponding deduction for the purchaser); *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963) ("[i]t is settled that goodwill, as a distinct property right, is a capital asset under the tax laws "); *Michaels v. Commissioner*, 12 T.C. 17 (1949) ("[w]e entertain no doubt that goodwill and such related items as customers' lists are capital assets").

Prior to enactment of § 197, goodwill and going concern value were not considered property used in the trade or business of a character which is subject to the allowance for depreciation provided in § 167, and thus were not excluded from the definition of capital asset by reason of § 1221(a)(2) of the Code. Under § 197, an amortizable section 197 intangible is treated as property of a character which is subject to the allowance for depreciation under § 167. Thus, goodwill and going concern value which are amortizable section 197 intangibles are not capital assets for purposes of § 1221, but if used in a trade or business and held for more than one year, gain or loss upon their disposition generally qualifies as § 1231 gain or loss. Taxpayer has questioned whether enactment of § 197 has changed the treatment of goodwill and going concern value as capital assets for goodwill and going concern value that do not qualify as amortizable section 197 intangibles.

In this case, Taxpayer represents that at the time of each sale of the c, the Goodwill is either self-created Goodwill of the selling entity (or a subsidiary of the selling entity acquired by the selling entity in a stock transaction) or Goodwill acquired by the selling entity (or a subsidiary of the selling entity acquired by the selling entity in a stock transaction) from third parties prior to August 11, 1993. While it is possible that a selling entity acquired the Goodwill after July 25, 1991, and prior to August 11, 1993, Taxpayer also represents that no retroactive election was made under § 1.197-1T. These representations are material representations. Based solely on Taxpayer's representations with respect to the Goodwill, we conclude that the Goodwill is not an amortizable section 197 intangible, and furthermore is not subject to depreciation under § 167. Thus, the Goodwill is not property that is of a character subject to the allowance for depreciation provided in § 167.

Because we conclude the Goodwill is not an amortizable section 197 intangible and is not property that is of a character subject to the allowance for depreciation provided in § 167, we further conclude that the Goodwill sold by Taxpayer qualifies as a capital asset under § 1221. Although § 197 now provides that goodwill and going concern value that is an amortizable section 197 intangible are not capital assets for purposes of § 1221, it does not address the treatment of goodwill and going concern value that is not an amortizable section 197 intangible, nor does it change prior law treatment of goodwill and going concern value.

[4138] See part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests, especially fn. 5654, referring to part II.Q.8.b.i.(g) Code § 751 – Hot Assets.

[4139] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), especially fns. 5081-5085.

[4140] See part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

[4141] Code § 197(a), (d)(1)(E), (f)(3) (buyer's deduction) (see fn 1697 and the rest of part II.G.18.d Amortization of Code § 197 Intangibles); Rev. Rul. 69-643 (seller's income); *Kinney v.*

Thus, compensation for current services, which is deductible in full when paid, is much more beneficial to buyers than either of the above alternatives. Taxpayers tend to assign consideration in a sale to whatever produces the fastest deduction – ongoing services, office equipment, etc. Note that assigning a low value to goodwill or a non-compete agreement can have very practical effect – reducing or eliminating damages[4142] – if the agreement is broken, so the buyer is trading deductions for economic risk.

Even if goodwill is taxed to the seller at capital gain rates, deferred compensation[4143] is more tax-efficient than a payment for goodwill; however, the deferred compensation agreement constitutes a liability on the company's balance sheet that might impair its ability to obtain credit. The benefit of the immediate deduction for compensation for personal services is likely to be of so much benefit to the buyer that the buyer should be willing to pay extra to the seller so that the seller's proceeds after ordinary income tax exceed what the seller would have received for goodwill net of capital gain tax. For example, suppose the seller receives $100 for zero basis goodwill. If the seller's combined federal and state capital gain rate is 20%, the seller receives $80 net of tax. If the buyer pays 40% federal and state tax, the buyer must generate $167 of ordinary income to pay the $100 that it pays the seller. Thus, the buyer needs to earn $167 so that the seller receives $80 net of tax. However, if the buyer and seller both have 40% combined federal and state income taxes, then the seller would need just over $133 in ordinary income to net the same $80 after taxes. Thus, with a compensation payment of $134-$166, both the seller and buyer are better off (ignoring the deduction[4144] the buyer receives for capitalized goodwill in a purchase-of-goodwill scenario). A seller needs "strong proof" that a payment is for goodwill taxable as capital gain rather than a covenant not to compete taxable as ordinary income.[4145]

Commissioner, 58 T.C. 1038 (1972); *Coleman v. Commissioner*, T.C. Memo. 2004-126. *Recovery Group Inc. v. Commissioner*, T.C. Memo. 2010-76, held that payments under a one-year covenant not to compete agreed to in connection with the redemption of an employee's stock were deductible over 15 years. The IRS and taxpayer contested the meaning of entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof. The court agreed with the IRS that "thereof" modifies "trade or business," and that "interest" means an ownership interest of any percentage, large or small. The court held alternatively that the employee's 23% stock ownership was substantial.

4142 A result reported to have happened in *Healthcase v. Orr*, 2016 Cal. App. Unpub. LEXIS 440 (1/20/2016) per *Business Valuation Update*, vol. 22, no. 4 (4/2016).

4143 Before working in this area, consider reading part II.Q.1.d Nonqualified Deferred Compensation, especially part II.Q.1.d.i IRS Audit Guide for Nonqualified Deferred Compensation..

4144 Although the deduction is valuable, the discounted present value is relatively small, considering that discount rates are high when the sale of a closely-held business is involved. For example, if $100 were capitalized and deducted over 15 years with a 40% tax saving, the extra tax benefit would be $2.67 per year, compared with an immediate tax saving of $20 in not having capital gain on the sale of goodwill. At a 20% discount rate, the present value of these deductions would be $12.48; at a 33% discount rate, the present value would be $7.98.

4145 *Muskat v. United States*, 554 F.3d 183 (1st Cir. 2009); *Kinney*, fn. 4141. For more on *Muskat*, see fn 5557 in part II.Q.8.b.iii Partnership Alternative to Seller-Financed Sale of Goodwill. *Dunlap v. Commissioner*, T.C. Summary Opinion 2020-10 held:

> There was no agreement between Mary Kay and Ms. Dunlap with respect to any sale of a business or goodwill. Other than the reference to goodwill in the preamble to some documents, there is no evidence in the record that would support a sale of a business interest. The payments under the FSP are calculated on the basis of sales and commissions and are being paid at a rate of 60% of a high average tiered sales activity. Lastly, Ms. Dunlap had no rights or legal

II.Q.1.c.ii. Consulting Agreement in Lieu of Covenant Not to Compete

Given that a seller needs "strong proof"[4146] that a payment is for goodwill[4147] and that payments are amortizable over 15 years if for goodwill or covenants not to compete,[4148] consider retaining the seller on a consulting agreement.[4149] The buyer might very well need the seller's cooperation to transition employees, customers, and vendors. If the purchase is amicable, hiring the seller to a lucrative consulting contract can provide not only valuable business benefits but also immediate income tax deductions.

Beware, however, that a consulting contract might very well prevent the seller from having a separation from service that might be needed under Code § 409A. Although that provision is generally viewed as applying to deferred compensation, various payments or noncash benefits triggered by a change in job status might constitute deferred compensation that might require a "separation from service" to avoid imposition of the harsh consequences of Code § 409A.[4150]

Furthermore, when a property right concerns the contractual right to perform a service and receive compensation for the service, a payment made to terminate the contract cannot be considered a capital asset unless the contract confers something more than the right to perform services or receive compensation for services performed.[4151] When an insurance company

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relationship with the consultants and sales directors in her tiered Mary Kay activity. Accordingly, her goodwill argument does not change the outcome of this case.

4146 Because the "strong proof" rule "drives at the contracting parties' intentions," conflicting testimony as to that intent precludes summary judgment from being granted. *Cotto-Vázquez v. U.S.*, 127 A.F.T.R.2d 2021-1182 (D. P.R. 3/11/2021).

4147 See fn. 4145.

4148 See part II.Q.1.c.i Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation.

4149 For whether a consultant is an employee, independent contractor, or partner, see *Thoma v. Commissioner*, T.C. Memo. 2020-67.

4150 See parts II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules and II.Q.1.d Nonqualified Deferred Compensation.

4151 *Trantina v. U.S.*, 512 F.3d 567 (9th Cir. 2008), held:

> The parties spend considerable time in the briefs discussing cases involving the question of whether a contractual right qualifies as a capital asset. These cases demonstrate that, when the property right asserted concerns the contractual right to perform a service and receive compensation for the service, a payment made to terminate the contract cannot be considered a capital asset unless the contract confers something more than the right to perform services or receive compensation for services performed. See, *e.g.*, *Furrer*, 566 F.2d at 1117; *Vaaler v. United States*, 454 F.2d 1120, 1122 (8th Cir. 1972) ("[T]he courts have quite uniformly held that contracts for the performance of personal services are not capital assets and that the proceeds from their transfer or termination will not be accorded capital gains treatment but will be considered to be ordinary income."); *Md. Coal & Coke Co. v. McGinnes*, 350 F.2d 293, 294 (3d Cir. 1965) (per curiam) (finding a contract giving the taxpayer an exclusive sales agency not to be a capital asset because it did not confer on the taxpayer "some interest or estate in or encumbrance upon some property with which the contract is concerned"); *United States v. Dresser Indus., Inc.*, 324 F.2d 56, 60–61 (5th Cir. 1963) (finding that the exclusive right to practice a patent did constitute a capital asset); *Nelson Weaver Realty Co. v. Comm'r*, 307 F.2d 897, 899–901 (5th Cir. 1962) (finding sale of mortgage servicing contract along with files, ledgers, and records to be a capital asset); *Dorman v. United States*, 296 F.2d 27, 29 (9th Cir. 1961) (finding that an option to become a full partner in a business venture constituted a capital asset); *Brown v. Comm'r*, 28 T.C.M. (CCH) 1330, 1332 (T.C. 1969) ("A payment in discharge of [the right to receive commissions on policies], unlinked to the policies themselves by any proprietary interest, is simply a substitute for ordinary income.").

retains all rights regarding a policies an agent sold, termination payments made to the agent cannot be considered a sale of rights with respect to those policies.[4152]

II.Q.1.c.iii. Does Goodwill Belong to the Business or to Its Owners or Employees?

For purposes of valuing a business:[4153]

> In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the

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> The question in the present case is thus whether the Corporate Agreement conferred on Trantina some right or interest beyond the right to perform the services required by the agreement or to receive compensation for the services performed under the agreement….
>
> We adopt the reasoning of the Seventh Circuit. A precondition to realizing a long-term capital gain is the ownership of a capital asset. Yet under the express terms of Trantina's Corporate Agreement with State Farm, Trantina simply had no property that could be sold or exchanged. The Corporate Agreement contains a provision nearly identical to the one that the *Baker* court found to be controlling. Trantina's Corporate Agreement states:
>
>> Information regarding names, addresses, and ages of policyholders of the Companies; the description and location of insured property; and expiration or renewal dates of State Farm policies acquired or coming into the Agent's possession during the effective period of this Agreement, or any prior agreement, except information and records of policyholders insured by the Companies pursuant to any governmental or insurance industry plan or facility, are trade secrets wholly owned by the Companies. forms and other materials, whether furnished by State Farm or purchased by the Agent, upon which this information is recorded shall be the sole and exclusive property of the Companies.
>
> Given this blanket reservation of all property rights to State Farm, it is unclear exactly what Trantina could have sold or exchanged. Trantina could not sell back to State Farm something that it already owned.

[4152] *Baker v. Commissioner*, 338 F3d 789 (7th Cir. 2003), held:

> Fundamentally, in order to have the ability to sell something, one must own it. Because Warren Baker did not own any property related to the policies, he could not sell anything. Section D of the Agreement provides:
>
>> Information regarding names, addresses, and ages of policyholders of the Companies; the description and location of insured property; and expiration or renewal dates of State Farm policies ... *are trade secrets wholly owned by the Companies*. All forms and other materials, whether furnished by State Farm or purchased by you, upon which this information is recorded *shall be the sole and exclusive property of the Companies*.
>
> (emphasis added). Thus, according to the terms of the Agreement, Warren Baker did not own anything related to the policies.
>
> As the Tax Court noted, Baker returned everything used in the daily course of business to State Farm. He returned the books, records, and customer lists because the Agreement designated them as the "sole and exclusive property" of State Farm.

Baker also dismissed the insurance agent's argument that he sold goodwill; see fn 4155 in part II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees? This reasoning was also applied in *Pexa v. U.S.*, 121 AFTR.2d 2018-XXXX (D. CA 5/8/2018).

[4153] Rev. Rul. 59-60, Section 4.02(f).

amount by which the appraised value of the tangible assets exceeds the net book value of such assets.

"Goodwill is often defined as the expectation of continued patronage by existing customers."[4154] (However, in the insurance industry, policy records and policyholder information are the goodwill, and payments to agents tend to be for covenants not to compete.)[4155] Generally, if a business subjects its owners or employees to a covenant not to compete, the business owns the related goodwill; otherwise, generally the owners or employees own the goodwill.[4156]

[4154] *Estate of Adell v. Commissioner*, T.C. Memo. 2014-155, citing *Network Morning Ledger Co. v. United States*, 507 U.S. 546, 572-573 (1993).

[4155] *Baker v. Commissioner*, 338 F3d 789 (7th Cir. 2003) (highlighting added):

> Goodwill is the expectation of continued patronage. *Newark Morning Ledger Co. v. United States*, 507 U.S. 546, 555 (1993). Goodwill enables a purchaser to step into the shoes of the seller. *Decker v. Commissioner*, 864 F.2d 51, 54 (7th Cir. 1988) (quoting *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 681 (5th Cir. 1971)). Courts have recognized that the insurance industry treats policy records and policyholder information as goodwill. *Schelble v. Commissioner*, 130 F.3d 1388, 1394 (10th Cir. 1997); *Marsh & McLennan, Inc. v. Commissioner*, 420 F.2d 667, 669–70 (3d Cir. 1969).
>
> As noted above, Baker did not own any assets related to the business. Goodwill cannot be transferred apart from the business with which it is connected. 38 Am.Jur.2d Goodwill § 10. We find reliance for our position in *Schelble v. Commissioner*, 130 F.3d 1388 (10th Cir. 1997) and *Vaaler v. United States*, 454 F.2d 1120 (8th Cir. 1972). In , the taxpayer argued that "extended earnings" payments made to him after terminating his position as an insurance agent constituted proceeds from the sale of goodwill . The court rejected the taxpayer's argument, finding that no sale of vendible assets occurred. *Schelble*, 130 F.3d at 1394. Citing *Elliott v. United States*, 431 F.2d 1149, 1154 (10th Cir. 1970), the court noted that for tax purposes, a sale of goodwill takes place "only when the business or a part of it, to which the goodwill attaches is sold." *Id.* at 1394. In *Vaaler v. United States*, the Eighth Circuit rejected a similar argument made by the taxpayer. It also cited *Elliott* for the same proposition, adding that as a general agent, the taxpayer built up goodwill for the insurance company, which belonged to the company. *Vaaler*, 454 F.2d at 1123; see also *Webster Investors, Inc. v. Commissioner*, 291 F.2d 192, 195 (2d Cir. 1961).
>
> While Baker built the insurance agency; the tools he used were on loan from State Farm. State Farm's termination payments were not for the sale of a business where a buyer was able to step into the seller's shoes. Baker owned nothing. Thus, he could sell no assets, including goodwill. We agree that goodwill was developed during Baker's tenure; however, it was not his to sell. Since Baker has failed to establish that the payments were consideration for the sale or exchange of a capital asset, the Commissioner's deficiency determination is upheld. One final point we briefly address: Baker asks if the purpose for the payments are not in consideration for goodwill, what are they? We agree with the Tax Court's conclusion that (a portion of) State Farm's payments were for a covenant not to compete. See, *e.g.*, *Clark v. Commissioner*, 67 T.C.M. 3105 (1994); *Foxe v. Commissioner*, 53 T.C. 21 (1969). The Agreement provides that Baker would not induce any State Farm policyholder to change coverage or solicit coverage through a competitor for one year. The tax consequences of such language are settled: the consideration a buyer pays a seller for a covenant not to compete is taxable as ordinary income. *Patterson v. Commissioner*, 810 F.2d 562, 569 (6th Cir. 1987); *Sonnleitner v. Commissioner*, 598 F.2d 464, 466 (5th Cir. 1979).

Baker similarly rejected an insurance agent's assertion that the agent sold other contractual rights for a capital gain; see fn 4152 in part II.Q.1.c.ii Consulting Agreement in Lieu of Covenant Not to Compete.

[4156] Shin, Lightened Taxpayer Burdens in the Sale of Personal Goodwill After *H&M, Inc. v. Commissioner*, *Tax Lawyer*, Vol. 67, No. 2 (Winter 2014), saved as Thompson Coburn LLP doc. no. 6177834; *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998); *Norwalk v. Commissioner*, T.C. Memo. 1998-279; *Bross Trucking, Inc.. v. Commissioner*, T.C. Memo. 2014-107 (lack of non-compete precluded corporate

Personal goodwill reflects the owners' relationships with customers; to prove that these relationships had value, the purchasing business should hire the sellers and not just sign a covenant not to compete with them.[4157] Generally, a sale of goodwill is recognized only if paired with the sale of a business; . *Potter v. Commissioner*, T.C. Memo. 2018-153, held:

> The questions of whether goodwill existed and was transferred are questions of fact. *Butler v. Commissioner,* 46 T.C. 280, 287 (1966). Petitioners scream for *Martin Ice Cream Co. v. Commissioner* (Martin Ice Cream), 110 T.C. 189 (1998), to rule the day because what Mr. Potter "sold" were his relationships with the various buyers of Green Country's products. In *Martin Ice Cream*, 110 T.C. at 207-208, the Court held that the benefits of the relationships with supermarket chains that a shareholder, Arnold Strassberg, cultivated were not the corporation's assets; Mr. Strassberg was the owner and seller of those assets. Thus, the corporation - *Martin Ice Cream Co.* - was not liable for tax due on payments for the shareholder's assets. The Court decided that the goodwill was not a corporate asset in Martin Ice Cream and did not address how the individual shareholder—Mr. Strassberg - should be taxed on the payments. See

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goodwill regarding owner-officer's relationships; owner's sons developed relationships with owner's customers when owner shut down owner's business due to regulatory hassles and sons started new corporation; workforce intangible not deemed transferred when only 50% of the employees of the old corporation worked for the new corporation); *Estate of Adell v. Commissioner*, T.C. Memo. 2014-155 (lack of non-compete precluded corporate goodwill regarding owner-officer's relationships; customers did business with owner's son because they trusted the son personally; son was qualified to run the business). Conversely, goodwill generated while a covenant not to compete is in place is owned by the business entity, even though it was generated by the professional who was the sole owner of a personal service corporation. *Howard v. U.S.*, 106 A.F.T.R.2d 2010-5533 (E.D. Wash. 2010), *aff'd* 108 AFTR.2d 2011-5993 (9th Cir. 2011); *Kennedy v. Commissioner*, T.C. Memo. 2010-206 (payments were consideration for services rather than goodwill; payments varied based on success of seller's efforts to transition customers to buyer; part of payments were for non-compete; taxpayer failed to prove economics of allocation, the court finding that goodwill was a tax-motivated afterthought that occurred late in the negotiations) (distinguished from *Martin Ice Cream*) (self-employment tax imposed; reliance on tax advisor avoided negligence penalty); *H & M, Inc. v. Commissioner*, T.C. Memo. 2012-290 (insurance agent's name and talents were more highly valued than his incorporated insurance agency's name, so compensation payments to agent were not disguised payments to his agency followed by dividends to him; characterization as goodwill or compensation was not raised). See Kliegman and Turkenich, Goodwill Games: Determining the Existence And Ownership of Goodwill In a Closely Held Business, *T.M. Memorandum* (BNA) (9/22/2014).
For more details on sending business as a gift, see fn., part III.B.1.a.v Sending Business.

[4157] *Solomon v. Commissioner*, T.C. Memo. 2008-102, held:

> The *Martin Ice Cream* case is distinguishable from this case. First, the record does not persuade us, nor do we find as a fact, that the value of Solomon Colors in the market was attributable to the quality of service and customer relationships developed by Robert Solomon or Richard Solomon. Rather, the record reflects our finding that Solomon Colors, as a business of processing, manufacturing, and sale, rather than one of personal services, did not depend entirely on the goodwill of its employees for its success. See *Schilbach v. Commissioner*, T.C. Memo. 1991-556; *cf. Longo v. Commissioner*, T.C. Memo. 1968-217. Second, unlike the founder of Haagen-Dazs in *Martin Ice Cream*, who signed an agreement with Strassberg in his personal capacity, Robert Solomon and Richard Solomon were not named as the sellers of any asset but were included in the sale in their individual capacities solely to guarantee that they would not compete with Prince. Third, the fact that Prince required noncompete agreements, but not employment or consulting agreements, of Robert Solomon and Richard Solomon makes it unlikely that Prince was purchasing the personal goodwill of these individuals.

> *Kennedy v. Commissioner*, T.C. Memo. 2010-206, 100 T.C.M. (CCH) 268, 274-275 (2010). Thus, *Martin Ice Cream* is not controlling here.
>
> What is controlling is the fact that Mr. Potter did not sell a trade or business. See *Baker v. Commissioner*, 118 T.C. 452 (2002) (holding that the taxpayer did not sell a trade or business to which goodwill could attach), *aff'd*, 338 F.3d 789 (7th Cir. 2003). "To qualify as the sale of goodwill, the taxpayer must demonstrate that he sold 'the business or a part of it, to which the goodwill attaches." *Id*. at 465 (quoting *Schelble v. Commissioner*, 130 F.3d 1388, 1394 (10th Cir. 1997), *aff'g* T.C. Memo. 1996-269). Although a party to the asset purchase agreement between Oldcastle and Green Country, Mr. Potter did not sell any assets to Oldcastle or to Green Country. The word "sale" means "a transfer of property for a fixed price in money or its equivalent". *Schelble v. Commissioner*, 130 F.3d at 1394 (quoting *Iowa v. McFarland*, 110 U.S. 471, 478 (1884)); see also *Commissioner v. Brown*, 380 U.S. 563, 571 (1965). Potter Sales' office furniture, computers, and vehicles were included in the assets Oldcastle acquired when it purchased Green Country's assets, but it paid nothing for them.[10] Additionally, Potter Sales had only one client, Green Country. The relationships that Mr. Potter fostered were with Green Country's clients; the client contacts were not his to sell. See *Foxe v. Commissioner*, 53 T.C. 21, 26 (1969) (finding that an insurance salesman's personal contacts with customers did not amount to goodwill because the insurance company owned the customer contacts). Therefore, the 2010 termination payment was for Mr. Potter's right to service Green Country's clients and receive ordinary income; it was not for the sale of Mr. Potter's goodwill, because the client contacts were not his to sell.
>
> [10] Nor did Mr. Potter "exchange" property for another property that was materially different in either kind or extent. See sec. 1.1001-1(a), Income Tax Regs.

Sometimes a variety of factors reduce a company's goodwill, and having the next generation start a new company without so much baggage creates a viable company without making a gift of goodwill.[4158]

If the business is inside an entity taxed as a C or an S corporation, paying for the business' going concern value (of which goodwill tends to be a very significant part) results in short-term double or triple taxation.[4159] If the entity has only one owner, one can set the stage for a more tax-advantaged exit strategy by ***not*** subjecting the owner to a covenant not to compete. For a multiple-owner entity, the business reasons might trump the tax issues, so one might more strongly consider migrating to the ideal business structure[4160] so that one can put these protections in place as soon as possible without complicated issues. The problem with migrating from a corporation to a pass-through entity is that the IRS will argue that goodwill is being distributed from the corporation to the owners and then into the new entity, and a distribution from a corporation to its owners is a taxable event.[4161] If the owners of the new

[4158] See part II.Q.7.h.v Taxpayer Win in *Bross Trucking* When IRS Asserted Corporation Distribution of Goodwill to Shareholder Followed by Gift to Shareholder of New Corporation (2014).
[4159] See part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis.
[4160] See parts II.E Recommended Structure for Entities, II.Q.7.h Distributing Assets; Drop-Down into Partnership and II.Q.8.b.iii Partnership Alternative to Seller-Financed Sale of Goodwill.
[4161] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

entity are different from but are the natural objects of the bounty of the owners of the original entity, the IRS might also argue that the deemed distribution and transfer constitute a gift.[4162]

A sole proprietorship or partnership does not face these concerns. A sole proprietorship can convert into a partnership tax free by granting the new owner a profits interest in the partnership.[4163] The partnership can then engage in a redemption that obtains the most income tax-efficient result. Thus, a sole proprietorship or partnership is free to enter into covenants not to compete without complicating income tax exit strategies.

II.Q.1.c.iv. Goodwill (and other intangible) Anti-Churning Rules

Generally, an anti-churning rule provides that goodwill and going concern value are not amortizable if:[4164]

1. The intangible was held or used at any time on or after July 25, 1991, and on or before such date of enactment by the taxpayer or a related person,

2. The intangible was acquired from a person who held such intangible at any time on or after July 25, 1991, and on or before such date of enactment, and, as part of the transaction, the user of such intangible does not change, or

3. The taxpayer grants the right to use such intangible to a person (or a person related to such person) who held or used such intangible at any time on or after July 25, 1991, and on or before such date of enactment.

If the business did not exist on July 25, 1991, the anti-churning would not apply because the goodwill did not yet exist.[4165]

For purposes of these rules, a person is "related" to any person only if the related person bears a relationship to such person specified in Code § 267(b)[4166] or 707(b)(1),[4167] or the related person and such person are engaged in trades or businesses under common control.[4168] In applying Code § 267(b) or 707(b)(1) to this test, use 20% instead of 50%.[4169] A person shall be treated as related to another person if such relationship exists immediately before or immediately after the acquisition of the intangible involved.[4170]

4162 See part III.B.1.a.v Sending Business. Taxpayers won, but it cost them significant legal fees.
4163 See part II.M.4.f Issuing a Profits Interest to a Service Provider. The new owner can also contribute capital to the new business, which generally is tax-free (see part II.M.3 Buying into or Forming a Partnership), but be wary of part II.M.3.e Exception: Disguised Sale.
4164 Code § 197(f)(9)(A).
4165 Letter Ruling 200551018, which noted the following representations:

> … Taxpayer represents that Taxpayer began operations during 1994. Furthermore, Taxpayer represents that none of the assets used in the formation of Taxpayer constituted a previous trade or business. Thus, Taxpayer's goodwill asset did not exist during the section 197(f)(9) transition period, and the anti-churning rules of section 197(f)(9) do not apply.

4166 Code § 267(b) is reproduced in part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses.
4167 For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.
4168 Code § 197(f)(9)(C)(i). The common control test used is that provided in Code § 41(f)(1)(A) and (B).
4169 Code § 197(f)(9)(C)(i).
4170 Code § 197(f)(9)(C)(ii).

However, if the anti-churning rule applies only because the related party's ownership is more than 20% instead of more than 50%, then this rule is subject to an exception.[4171] To qualify for the exception, the person from whom the taxpayer acquired the intangible must elect to recognize gain on the disposition of the intangible and to pay a tax on such gain which, when added to any other income tax on such gain under this title, equals such gain multiplied by the highest income tax rate applicable to such person.[4172] If this exception applies, then the goodwill or concern value is prevented from being amortized only to the extent that the taxpayer's adjusted basis in the intangible exceeds the gain recognized.[4173]

Also, the anti-churning rule does not apply to the acquisition of any property by the taxpayer if the basis of the property in the taxpayer's hands is determined under Code § 1014(a) (basis adjustment by reason of death).[4174]

Code § 197 also does not permit amortization of any intangible acquired in a transaction, one of the principal purposes of which is to avoid the anti-churning rules.[4175]

Reorganizing a tiered structure using nontaxable contributions under Code § 721[4176] and nontaxable distributions under Code § 731[4177] may avoid triggering the anti-churning rules so as to allow the pre-transaction amortization of post-1993 intangibles to continue.[4178]

With respect to any increase in the basis of partnership property under Code § 732, 734, or 743, determinations under the anti-churning rules are made at the partner level, and each partner shall be treated as having owned and used such partner's proportionate share of the partnership assets.[4179] See part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

Letter Ruling 201906002 sets forth applicable rules and reasoning for partnerships:[4180]

> Section 197(f)(9)(E) provides that with respect to any increase in the basis of partnership property under §§ 732, 734, or 743, determinations under § 197(f)(9) shall be made at the partner level and each partner shall be treated as having owned and used such partner's proportionate share of the partnership assets.

[4171] Code § 197(f)(9)(B)(i).
[4172] Code § 197(f)(9)(B)(ii).
[4173] Code § 197(f)(9)(B).
[4174] Code § 197(f)(9)(D).
[4175] Code § 197(f)(9)(E). This provision also prevents amortization of any asset acquired in a transaction that was postponed to avoid the requirement that the intangible be acquired after the date of the enactment of Code § 197.
[4176] See part II.M.3 Buying into or Forming a Partnership, especially part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.
[4177] See part II.Q.8.b.i Distribution of Property by a Partnership, especially part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions.
[4178] Letter Ruling 201709003.
[4179] Code § 197(f)(9)(E). For details, see Reg. § 1.197-2(h)(12); see also fn. 3847, found in part II.P.1.a.i Allocations of Income in Partnerships. For an example of the effect of a Code § 754 election on goodwill that is being amortized, see fn. 5795 in part II.Q.8.e.iv Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).
[4180] See also text accompanying and preceding fn 5676 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

Section 1.197-2(g)(3) provides that any increase in the adjusted basis of a § 197 intangible under...§ 743(b) (relating to the optional adjustment to the basis of partnership property after transfer of a partnership interest) is treated as a separate § 197 intangible. For purposes of determining the amortization period under § 197 with respect to the basis increase, the intangible is treated as having been acquired at the time of the transaction that causes the basis increase, except as provided in § 1.743-1(j)(4)(i)(B)(2) (dealing with an increase in the basis of the item of the partnership's recovery property under § 743(b) that is attributable to § 704(c) built-in gain when the partnership elects to use the remedial allocation method).

Section 1.197-2(h)(1)(i) provides that this paragraph (h) applies to § 197(f)(9) intangibles. For this purpose, § 197(f)(9) intangibles are goodwill and going concern value that was held or used at any time during the transition period and any other § 197 intangible that was held or used at any time during the transition period and was not depreciable or amortizable under prior law.

Section 1.197-2(h)(1)(ii) provides that the purpose of the anti-churning rules of § 197(f)(9) and § 1.197-2(h) is to prevent the amortization of § 197(f)(9) intangibles unless they are transferred after the applicable effective date in a transaction giving rise to a significant change in ownership or use. Special rules apply for purposes of determining whether transactions involving partnerships give rise to a significant change in ownership or use. See § 1.197-2(h)(12). The anti-churning rules are to be applied in a manner that carries out their purpose.

Section 1.197-2(h)(6)(i) provides, in pertinent part, that a person is related to another person for purposes of § 1.197-2(h) if the person bears a relationship to that person that would be specified (A) in § 267(b) (determined without regard to § 267(e)), and by substitution, § 267(f)(1), if those sections were amended by substituting 20 percent for 50 percent or (B) in § 707(b)(1) if that section were amended by substituting 20 percent for 50 percent.

Section 1.197-2(h)(6)(ii) provides that a person is treated as related to another person for purposes of § 1.197-2(h) if the relationship exists, in the case of a single transaction, immediately before or immediately after the transaction in which the intangible is acquired.

Section 1.197-2(h)(12)(i) provides that in determining whether the anti-churning rules apply to any increase in the basis of a § 197(f)(9) intangible under § 743(b), the determinations are made at the partner level and each partner is treated as having owned and used the partner's proportionate share of partnership property. In determining whether the anti-churning rules apply to any transaction under another section of the Internal Revenue Code, the determinations are made at the partnership level, unless under § 1.701-2(e) the Commissioner determines that the partner level is more appropriate.

Section 1.197-2(h)(12)(v)(A) provides, generally, that the anti-churning rules do not apply to an increase in the basis of a § 197 intangible under § 743(b) if the person acquiring the partnership interest is not related to the person transferring the partnership interest. In addition, the anti-churning rules do not apply to an increase in the basis of a § 197 intangible under § 743(b) to the extent that ...

(2) The partnership interest being transferred was acquired after the partnership acquired the § 197(f)(9) intangible, provided -

(i) The § 197(f)(9) intangible was acquired by the partnership after August 10, 1993, and is not amortizable with respect to the partnership;

(ii) The partnership interest being transferred was held after the partnership acquired the § 197 intangible by a person or persons (the post-contribution person or persons) other than the person transferring the partnership interest or persons who were related to the person transferring the partnership interest; and

(iii) The acquisition of such interest by the post-contribution person or persons was not part of a transaction or series of related transactions in which the person transferring the partnership interest or persons related to the person transferring the partnership interest acquired such interest.

Section 1.197-2(h)(12)(v)(B) provides that, solely for purposes of § 1.197-2(h)(12)(v)(A)(1) and (2), a partner who acquires an interest in a partnership in exchange for a contribution of property to the partnership is deemed to acquire a pro rata portion of that interest in the partnership from each person who is a partner in the partnership at the time of contribution based on each such partner's proportionate interest in the partnership.

Rev. Rul. 87-115, 1987-2 C.B. 163, states that when an upper-tier partnership has a § 754 election in effect, the transfer of an interest in the upper-tier partnership is treated as a transfer of an interest in the upper-tier partnership's interest in the lower-tier partnership for purposes of § 743. Such an election shall apply with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year when such election was filed and all subsequent years, unless revoked by the partnership, subject to § 1.754-1(c).

Section 754 provides that if a partnership files an election in accordance with regulations prescribed by the Secretary, the basis of partnership property shall be adjusted ...in the case of a transfer of a partnership interest, in the manner provided in § 743. Such an election shall apply with respect to all distributions by the property by the partnership and to all transfers of interests in the partnership during the taxable year when such election was filed and all subsequent years, unless revoked by the partnership, subject to § 1.754-1(c).

Section 743(b) provides, in part, that in the case of a transfer of an interest in a partnership by sale or exchange, a partnership with respect to which the election provided in § 754 is in effect shall increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property.

Of the requirements for amortization under § 197, only the anti-churning rules are in question in this case. Special rules are provided for partnerships in § 1.197-2(h)(12), and specific rules for § 743(b) basis adjustments are provided in § 1.197-2(h)(12)(v).

Rev. Rul. 87-115 is described in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

Letter Ruling 201906002 reasoned:[4181]

> On Date1 (after August 10, 1993), Partnership3 was formed by Partnership5 and Partnership1 in a transaction that qualified for non-recognition under § 721(a). Partnership5 contributed the Intangible Asset to Partnership3 in exchange for its interest in Partnership3, and Partnership1 contributed cash and other assets in exchange for its interest in Partnership3. Partnership3 has used the Intangible Asset since then in its trade or business. Under § 1.197-2(h)(12)(v)(B), each of the partners of Partnership3 was deemed to acquire their interest in Partnership3 from the other, and each was deemed to acquire a proportional interest in the assets of Partnership3. Since the Intangible Asset was not amortizable in Partnership5's hands, it is also not amortizable in the hands of Partnership3. Section 197(f)(2) and § 1.197-2(g)(2). This will continue to be true after the transactions subject to this ruling occur.
>
> This ruling addresses the § 743(b) adjustments that are allocable to the Intangible Asset that result from the transfer of Partnership2 and Partnership3 interests to NewCo2, a newly formed corporation in a non-taxable transaction. Each § 743(b) adjustment results in a separate intangible asset that is analyzed under § 1.197-2(h)(12)(v) at the partner level. Sections 1.197-2(g)(3) and 1.197-2(h)(12)(i). Partners are treated as directly owning and using their proportionate share of partnership assets. Section 197(f)(9)(E).
>
> In this case, the anti-churning rules do not apply to a § 743(b) adjustment if one of two tests is met, either (i) the transferee is not related to the transferor or (ii) the requirements of § 1.197-2(h)(12)(v)(A)(2) are met. The basis adjustments do not satisfy the first test because the transferor and the transferee of any actual or deemed transfer of Partnership3 interests as a result of the Transaction will be related within the meaning of § 197(f)(9)(C)(i) and § 1.197-2(h)(6) immediately before and after the Transaction. Thus, any transferee entitled to a basis adjustment will be related to the transferor for purposes of the anti-churning rules. Therefore, the basis adjustments will be amortizable under § 197(a) only if the requirements of § 1.197-2(h)(12)(v)(A)(2) are met.
>
> *Principals Transactions*
>
> In the case of the interests in Partnership3 that Partnership1 and Partnership2 acquired in the Principals transactions, the Partnership3 interests that are transferred to NewCo2 were originally owned by Partnership5 and distributed to the exercising Principal through a series of non-recognition transactions. Taxpayer has represented that no Principal exercised their D in connection with, or as part of a plan that included, the formation of Partnership3.
>
> With respect to the interests in Partnership3 acquired by Partnership1 and Partnership2 from the Principals, the requirements of § 1.197-2(h)(12)(v)(A)(2) are met because:
>
> (i) The Principals transactions occurred after Partnership3 acquired the Intangible Asset and, therefore, the interests in Partnership3 that Partnership1 and Partnership2 acquired in the Principals transactions occurred after Partnership3 acquired the Intangible Asset. Also, Partnership3 acquired the Intangible Asset

[4181] See also text accompanying and preceding fn 5676 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

after August 10, 1993, and the Intangible Asset is not amortizable in the hands of Partnership3;

(ii) The Principals' interests in Partnership3 that are being transferred were held after Partnership3 acquired the Intangible Asset by Partnership5, a person other than Partnership1 or Partnership2. Further, Taxpayer has represented that Partnership5 has never been related to Partnership1 or its predecessor, or Partnership2, within the meaning of § 197(f)(9)(C)(i) and § 1.197-2(h)(6); and

(iii) The acquisition of the interests in Partnership3 by Partnership5 was not part of a transaction or series of related transactions in which Partnership1 and Partnership2 acquired its Partnership3 interest from the Principals. That is, the exercise of the D occurred in transactions independent from the formation of Partnership3.

Public Trading

With respect to the interests in Partnership3 acquired by Partnership1 upon the formation of Partnership3 on Date1, the requirements of § 1.197-2(h)(12)(v)(A)(2) are met because:

(i) Partnership1 acquired its interest in Partnership3 after Partnership3 acquired the Intangible Asset. Also, Partnership3 acquired the Intangible Asset after August 10, 1993, and the Intangible Asset is not amortizable in the hands of Partnership3; and

(ii) In its letter dated July 31, 2018, Taxpayer represents, subject to confirmation by ongoing diligence, Taxpayer reasonably estimates that as of Date3, through public trading and issuances of limited partnership interests, [Redacted Text] percent or more of the economic interests in Partnership1 have changed ownership since Partnership1 acquired its interests in Partnership3 in Year1.

As stated in Rev. Rul. 87-115, when an upper-tier partnership has a § 754 election in effect, any § 743(b) adjustment resulting from the deemed transfer is segregated and allocated solely to the transferee of the upper-tier partnership interest.

Further, with respect to any increase in the basis of partnership property under § 743, a partnership is treated as an aggregate of its owners under the anti-churning rules. Section 197(f)(9)(E).

Applying § 1.197-2(h)(12)(i), for purposes of § 1.197-2(h)(12)(v)(A)(2)(iii), the public owners of Partnership1 are treated as acquiring interests in Partnership3 when each public owner purchased an interest in Partnership1, subsequent to the formation of Partnership3 in Year1. Because the public owners of Partnership1 acquired interests in Partnership3 after those interests were held by unrelated owners in transactions independent from the formation of Partnership3, § 1.197-2(h)(12)(v)(A)(2)(ii) and (iii) are satisfied for those acquisitions.

Based on Taxpayer's representation in a letter dated July 31, 2018 that, Taxpayer reasonably estimates that as of Date3, which is one business day before Date 4, through public trading and issuances of limited partnership interests, [Redacted Text] percent or more of the economic interests in Partnership1 have changed ownership since Partnership1 acquired its interests in Partnership3 in Year1, the increases to the tax basis of the Intangible Asset for the benefit of Newco2 or Partnership2 under § 743(b) resulting from Partnership1's transfer of interests in Partnership3 to Newco2 are amortizable under § 197(a) to the extent those interests were treated as previously acquired by public investors since the formation of Partnership3 on Date1.

CONCLUSIONS

Based solely on the facts and representations submitted and the law and analysis as set forth above, we rule that the increases to the tax basis of the Intangible Asset, a § 197(f)(9) intangible, under § 743(b) for the benefit of NewCo2 or Partnership2, that result from the Transaction will be amortizable under § 197(a) to the extent those basis adjustments relate to interests that (i) were previously acquired from the Principals or (ii) were treated as previously acquired by public investors subsequent to the formation of Partnership3 on Date1.

Except as expressly set forth above, no opinion is expressed or implied concerning the federal tax consequences of the facts described above under any other provision of the Code or regulations. Specifically, no opinion is expressed or implied concerning the federal income tax treatment of any transactions described in this letter, including the Transaction that Taxpayer represents occurred on Date4.

This letter ruling is conditioned upon Taxpayer demonstrating the extent that the ownership of Partnership1's interests changed between Date1 and Date3.

II.Q.1.d. Nonqualified Deferred Compensation

For draconian measures that can apply to compensation paid in a year different from the year is which it was earned (as well as detrimental balance sheet effects), see part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

II.Q.1.d.i. IRS Audit Guide for Nonqualified Deferred Compensation and Other Noncash Compensation (other than fringe benefits)

In "Nonqualified Deferred Compensation Audit Techniques Guide (June 2015)," the IRS explained its view on deferred compensation and similar tools and described audit techniques.[4182]

II.Q.1.d.ii. Using Nonqualified Deferred Compensation to Facilitate a Sale

II.Q.1.d.ii.(a). Income Tax Issues when Using Nonqualified Deferred Compensation to Facilitate a Sale

A common tactic had been to pay the seller compensation for past services rendered. The theory was that, during its formative years, the business did not have the financial ability to compensate the owner for all that the owner did to develop the business into the successful operation it is today. When the business would be sold, finally the business would have

[4182] LB&I-04-0615-005, found at http://www.irs.gov/Businesses/Corporations/Nonqualified-Deferred-Compensation-Audit-Techniques-Guide.

sufficient resources to express its gratitude for the owner's past services. The business might pay the owner all at once; or, it might pay this bonus over time to provide the owner with a nice stream of retirement income. This compensation could be paid by the buyer or the seller. If the buyer makes the payments, it deducts them as it makes them and reduces the purchase price to take into account the present value of the payments. If the seller makes the payments, the seller would want to deduct the payments against the sale proceeds or against the interest or income equity component of any deferred sale proceeds.[4183]

Deferred compensation may help with a stock sale that is not treated as an asset sale. Deferred compensation can backfire in an asset sale.[4184]

Under 2017 tax reform, the service recipient may have a lower rate as a C corporation or as a pass-through entity than the service provider. See part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities. This has always been a problem when the compensation paid exceeds ordinary taxable income, but now it may apply regarding most or all of the deferred compensation payments.

Also, under Code § 409A, one is required to have a written plan in place as soon as a legally binding right to nonqualified deferred compensation exists.[4185] Thus, if at the time of sale compensating the owner for past services is reasonable and necessary,[4186] and the entity can show that a legally binding right to compensation for past services did not exist until that time, then the strategy described in the preceding paragraph may be used. Absent a prior written plan, however, convincing a court that the owner was undercompensated might be very difficult.[4187]

[4183] The seller would not want to liquidate the entity that owned the business until after these payments are made. Otherwise, the payments would constitute an additional capital loss or reduction of capital gain rather than a deduction against ordinary income. *Arrowsmith, Exec. v. Commissioner*, 344 U.S. 6 (1952).

[4184] See fn 5771 in part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.

[4185] A plan is any arrangement or agreement providing for a deferral of compensation. Code § 409A(d)(1), (3). If the payment is reasonable because it relates to past services, then it constitutes deferred compensation, and its material terms must be documented in writing to satisfy Code § 409A. Reg. § 1.409A-1(c)(3)(i). The written plan must be in place when the service provider obtains a legally binding right to the compensations. Reg. § 1.409A-1(a)(1). One might argue that compensation was earned in a prior year, but there was no legally binding right to payments based on that service, and now it is necessary and reasonable to pay for those past services to retain the employee. *Aries Communications Inc. v. Commissioner*, T.C. Memo. 2013-97 (comparing actual amounts paid in prior years against what was shown to have been higher reasonable compensation for those years), following the factors in *Elliotts* in fn. 31 as well the independent investor test of *Metro Leasing & Dev. Corp. v. Commissioner*, 376 F.3d 1015, 1019 (9th Cir. 2004), *aff'g* 119 T.C. 8 (2002). Although the author would make such an argument regarding past services on audit, the author would prefer to have more certainty when planning in light of Code § 409A's expansive reach. See part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

[4186] See part II.A.1.b.i Compensating Individuals, especially fn. 31.

[4187] *PK Ventures, Inc. v. Commissioner*, T.C. Memo. 2006-36, *aff'd sub nom. Rose v. Commissioner*, 101 A.F.T.R.2d 2008-1888 (11th Cir. 2008), disallowed deductions for such deferred compensation beyond what the IRS conceded. *Thousand Oaks Residential Care Home I, Inc. v. Commissioner*, T.C. Memo. 2013-10, found credible testimony that compensation was intended as catchup compensation – payment of back salaries that were not paid in prior years due to insufficient cash flow. However, the court applied the independent investor test (see fn. 31) to determine that the catch-up compensation was unreasonably high.

A more conservative approach would be to have a plan in place when the business is doing well but is not yet sold, which plan vests over time. That strategy is described later.[4188] Alternatively, consider paying an immediate lump sum if a plan is not already in place and the payor has enough income to absorb the deduction.[4189] An immediate lump sum payment often is very unattractive to the buyer (who has cash flow issues and might not need that much deduction in a single year) or seller (who might rather receive payments over time to avoid accelerating income tax if adequate safeguards are in place to protect the payment).

Deferred compensation in an S corporation will not raise second-class of stock issues unless a principal purpose of the agreement is to circumvent the single class of stock rules.[4190]

II.Q.1.d.ii.(b). Balance Sheet Effects of Deferred Compensation

Before establishing a deferred compensation agreement, ask the company's outside CPA to determine what the balance sheet effect is going to be.

Then have the client take that information to the company's lenders to discuss the impact on balance sheet loan covenants. Same with any companies that provide construction bonds, etc., if the company is in such a line of business.

I have seen the balance sheet liability cause deferred compensation agreements to be killed.

[4188] See part III.B.7.c.vi Deferred Compensation.

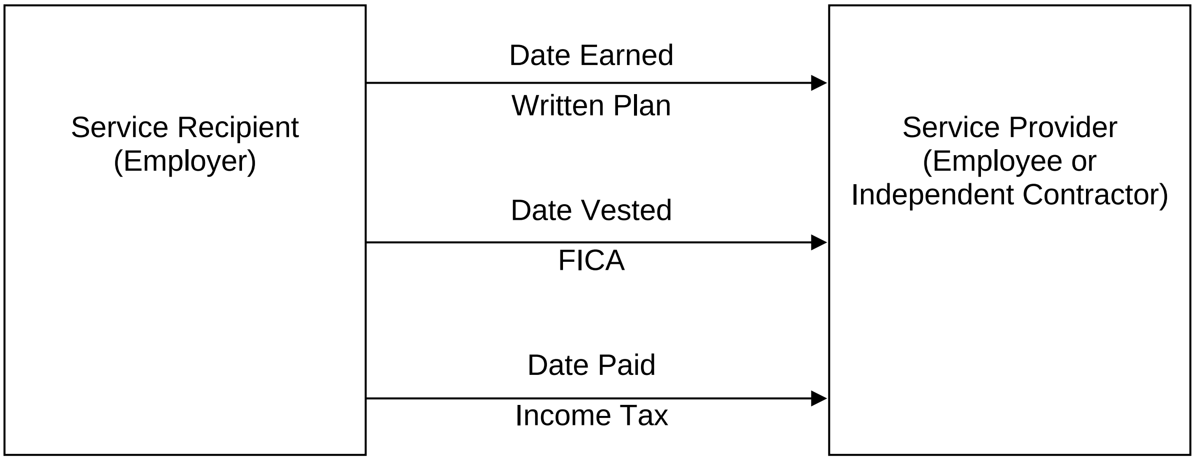
[4189] A special exception to Code § 409A applies to payments that occur immediately after the payment becomes vested if the taxpayer can prove that the payment was contingent on continuing to provide services from the date the service had been performed until the date that occurred during the current year. Reg. § 1.409A-1(b)(4)(i). The preamble to the final regulations, T.D. 9321, rejected cross-referencing existing rules:

> The final regulations generally adopt the definition of substantial risk of forfeiture set forth in the proposed regulations. Several commentators requested that the definition of substantial risk of forfeiture be the same as the definition of substantial risk of forfeiture in § 1.83-3(c). However, the definition of substantial risk of forfeiture for purposes of compensatory transfers of property under section 83 reflects different policy concerns from those involved in section 409A, and there are also practical differences between transfers of restricted property and promises to pay deferred compensation. This is reflected in the provisions of section 409A(e)(5), directing the Secretary of the Treasury Department to issue regulations disregarding a substantial risk of forfeiture in cases where necessary to carry out the purposes of section 409A. Accordingly, the final regulations do not adopt this suggestion.

[4190] See part II.A.2.i.iv Providing Equity-Type Incentives without Violating the Single Class of Stock Rules, especially fns. 266-267.

II.Q.1.d.iii. Timeline for FICA and Income Taxation of Deferred Compensation

Here is a timeline for FICA and income taxation of deferred compensation when the service recipient is not a tax-exempt entity:



Date Earned. Need to have written plan in place before service provider obtains legally enforceable rights – either required or best practice to be in place before performing service.

Date Vested. "Vested" corresponds to no further obligation to perform services. FICA will be due on present value[4191] and will not be due when the benefits are paid.[4192] This vesting is often beneficial when employee's compensation, for the year in vesting occurs, exceeds the taxable wage base ($160,200 in 2023 and $168,600 in 2024) because it is taxed at 2.9% (1.45% x 2) or 3.8% (for compensation in excess of $200,000 for a single person or $250,000 for a married person filing jointly) instead of 15.3% (7.65% x 2).[4193] The employer and employee can negotiate whether the employer should pay the employee an additional bonus to cover the additional FICA withholding in the year of vesting. On one hand, the employee might not have the cash flow to pay the FICA, since the employee has not been paid this deferred amount. On the other hand, the employee's share of FICA is properly taxed to the employee, and it is taxed at a lower rate than it would be if the plan had not been in effect, so it's only fair for the employee to pay this additional FICA. Note, however, that the FICA deferred compensation regulations do not provide a discount for the credit risk (that the employer might not be able to

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[4191] Reg. § 31.3121(v)(2)-1(c)(2).

[4192] Code § 3121(v)(2)(B). Reg. § 31.3121(v)(2)-1(d)(2) provides how much income on this initially taxed amount is also excluded from FICA wages when paid.

[4193] FICA tax (for employer and employee combined, or for self-employment tax purposes) is 15.3% on annual income up to the taxable wage base (TWB) and 2.9% on all annual income above the TWB until $200,000 (single) or $250,000 (married), above which it is 3.8%. FICA consists of Old-Age, Survivors, and Disability Insurance benefits (OASDI) and Medicare's Hospital Insurance program (HI). The OASDI tax is 6.2% for employer and 6.2% for employee, for a total of 12.4%, imposed only up to the TWB. The HI tax is 1.45% for employer and 1.45% for employee, imposed on all FICA wages. See http://www.ssa.gov/OACT/COLA/cbb.html for the past and current TWB; see also part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax. Most of the FICA tax on the present value will be at the lower 2.9% or 3.8% rate. When payments are made in future years, they will not be subject to FICA tax. This could save around $15,959 of FICA tax each year ($128,700 TWB for 2018, multiplied by the 12.4% spread between 15.3% and 2.9%; if wages were taxed at 3.8% the savings would be $14,801). The savings is slightly less than indicated, because it does not consider that the employer receives a deduction for the employer's one-half portion of FICA.

pay) that the employee assumes,[4194] and the employee cannot get the FICA back if the employer defaults.[4195]

Date Paid. Income tax is due when paid or constructively received, but FICA is not due since that was already paid.[4196] Code § 409A places strict limits on events that accelerate payment and events that delay payment.

[4194] Reg. § 31.3121(v)(2)-1(c)(2)(ii) provides:

> For purposes of this section, the present value must be determined as of the date the amount deferred is required to be taken into account as wages under paragraph (e) of this section using actuarial assumptions and methods that are reasonable as of that date. For this purpose, a discount for the probability that an employee will die before commencement of benefit payments is permitted, but only to the extent that benefits will be forfeited upon death. In addition, the present value cannot be discounted for the probability that payments will not be made (or will be reduced) because of the unfunded status of the plan, the risk associated with any deemed or actual investment of amounts deferred under the plan, the risk that the employer, the trustee, or another party will be unwilling or unable to pay, the possibility of future plan amendments, the possibility of a future change in the law, or similar risks or contingencies. Nor is the present value affected by the possibility that some of the payments due under the plan will be eligible for one of the exclusions from wages in section 3121(a).

[4195] *Balestra v. U.S.*, 803 F.3d 1363 (Ct. Fed. Cl. 2014), holding:

> Sections 3101(b) and 3121(v)(2) required these benefits to be calculated and taxed when he retired, but do not require the use of a risk-adjusted discount rate nor a refund corresponding to the benefits plaintiff never received.

The Federal Circuit, at 803 F.3d 1363 (2015), affirmed the Court of Claims, validating Reg. § 31.3121(v)(2)-(1)(c)(2)(ii):

> Treasury's path to calculating the amount deferred in terms of the compensation's present value without consideration of an employer's financial condition is reasonably discernable. Treasury explained that it sought simple, workable, and flexible rules when valuing future benefits. It devised a regulation that satisfied these goals while comporting with the governing statute. This is neither arbitrary nor capricious. It may seem unfair in a specific instance such as this, but in balancing the desire for simplicity against the ideal of ultimate comprehensiveness, the agency must be allowed a reasonable degree of discretion. We cannot say that this one example of consequent unfairness by the agency results in invalidating the rule-making.

[4196] However, if an amount deferred is required to be taken into account in a particular year, but the employer fails to pay the additional FICA tax resulting from that amount, then the amount deferred and the income attributable to that amount must be included as wages when actually or constructively paid. Reg. § 31.3121(v)(2)-1(d)(1)(ii)(A). An employer that fails to withhold upfront and then causes the employees to pay more FICA when they retire is liable to the employees. *Davidson v. Henkel Corporation*, 115 A.F.T.R.2d ¶ 2015-321 (D. Mich. 2015). AM 2017-001 clamps down to an extent when employers do not follow the rules:

> As noted above, § 31.3121(v)(2)-1(d)(1)(ii) describes the steps to be taken if an employer fails to use the special timing rule as required for part or all of the amounts an employee defers under a NQDC plan. If an employer fails to pay FICA tax on amounts deferred as required under § 3121(v)(2), the employer is required to adjust its employment tax returns for any years for which the period of limitations has not expired to report and pay the additional FICA tax attributable to the amounts deferred and required to be included under the special timing rule. See § 6205 and § 31.6205-1(a) and (b) of the regulations with regard to making interest-free adjustments of underpayments. If the employer does so, the nonduplication rule will apply to the payment of the deferred compensation. However, the general timing rule will apply to any amounts deferred and income attributable to those amounts deferred for closed years that cannot be adjusted.
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> Upon discovery that they have not correctly applied the special timing rule under § 3121(v) to pay FICA tax when required under the regulations, some employers have requested a closing

One might also consider whether FICA tax rates might increase in the future as Social Security and Medicare payments for the Baby Boomers increase.

Furthermore, the state in which the service provider worked may not subject the deferred compensation to tax except to the extent paid to the service provider while he or she is a resident of that state.[4197]

Because various tax-exempt entities have no incentive to accelerate income, the present value of the future payments is taxed when vested instead of when paid.[4198] Such an employer includes a State, political subdivision of a State, and any agency or instrumentality of a State or political subdivision of a State, and any other organization (other than a governmental unit) exempt from income tax.[4199] When the employee receives the deferred payments, the payments are exempt from FICA (as described above)[4200] but, to the extent of the interest component arising from the present value calculation, would be subject to income tax.[4201] If deferring payments is important to the employer, then the employer should consider paying up-front enough to pay for the employee's up-front taxes and deferring most or all of the rest. Note that the arrangement saves FICA relative to what otherwise might have been the parties' expectations,[4202] so they might want to consider that savings when negotiating the deferred compensation arrangement.

II.Q.1.e. Trying to Avoid Possible Ordinary Income on the Sale of a Partnership or S Corporation

My law partner Mariquita Barbieri contributed substantially to this part II.Q.1.e., which focuses on ordinary income that a sale of a business may generate when it involves an actual or deemed sale of the business' assets. As described below, ordinary income can be generated when the business uses the cash method or has Code § 1245 property. These issues also

agreement to permit them to pay FICA tax in a subsequent year that is prior to the year of payment in order to reduce the amount of total FICA taxes that would otherwise be due under the general timing rule if FICA tax was applied at the time of payment of the wages. The employer may also want to avoid application of the allocation rule in § 31.3121(v)(2)-1(d)(1)(ii)(B) that imposes FICA tax on a portion of each payment if the employer took some portion (but not all) of the NQDC into account for FICA tax under the special timing rule.

Because the applicable regulations provide the mechanism for the payment of FICA taxes in the case of NQDC which is not timely taken into account under the special timing rule in § 31.3121(v)(2)-1(a)(2), as a policy matter, a closing agreement should not be entered into if it that has the effect of avoiding application of this regulatory mechanism. The existence of the special transition rule in the regulations for years for which the period of limitations had expired at the time the regulations were finalized reinforces the importance of adhering to the rules contained in § 31.3121(v)(2)-1(d)(1)(ii) for determining the FICA tax due upon payment of amounts that were deferred in prior years and that should have been taken into account under § 3121(v)(2) in such prior years but for which the period of limitations has since expired.

[4197] See part II.Q.8.b.ii.(g) Code § 736 Payments as Retirement Income – Possible FICA and State Income Tax Benefits, fns. 5550-5553.

[4198] Code § 457(f)(1)(A), which applies to payments made by an eligible employer.

[4199] Code § 457(e)(1).

[4200] See fn. 4192.

[4201] Code § 457(f)(1)(B).

[4202] See discussion accompanying fns. 4191-4195.

inform the comparison between the often-overblown benefits of the exclusion of gain on the sale of Code § 1202 stock with the sale of an S corporation.[4203]

Many small businesses choose their initial accounting method to most benefit their owners, in light of the business industry. For many small businesses, the cash receipts and disbursements method of accounting (the "cash method") is most beneficial, as the company – or, ultimately, the owner in a company taxed as a partnership or as an S corporation – recognizes gain or loss in the tax year in which the company actually or constructively received the item of income, whether in the form of cash, property or services, and take deductions for the tax in which expenditures are actually made.[4204] Constructive receipt occurs in the year in which the taxpayer has unfettered access to income.[4205] Reg. § 1.451-2(a), "General rule," begins with:[4206]

> Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.

The cash method gives taxpayers more control over the timing of income recognition and the deductibility of expenses than under the accrual method of accounting, which is a key reason many small businesses strive to use the cash method.

The accrual method is another common accounting method. Generally, the accrual method taxpayer recognizes income in the tax year when all events have occurred that establish the legal right to receive income and the amount of such income is able to be determined with reasonable accuracy. Reg. § 1.451-1(a) includes:[4207]

[4203] See text accompanying fns 5177-5178 in part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation.

[4204] For limits on a C corporation using the cash method, see fns 4023-4026 in part II.P.3.d Conversion from S Corporation to C Corporation.

[4205] For the Tax Court's reluctance to invoke constructive receipt except when clearly justifiable, see text accompanying fn 4731 in part II.Q.6.e Assignment of Income on Property Being Sold. For a beneficiary's inability to avoid taxation on mandatory distributions, see fn 2475 in part II.J.1 Trust's Income Less Deductions and Exemptions Is Split Between Trust and Beneficiaries; also, a trustee may effectuate a distribution by "crediting" the beneficiary (giving the beneficiary the equivalent of constructive receipt), as described in the text before and after fn 2612 in part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary. Letter Ruling 9413023 analyzed the timing of the employees recognizing income under the constructive receipt rule and is reproduced in part in the text accompanying fn 282 in part II.A.2.i.iv Providing Equity-Type Incentives without Violating the Single Class of Stock Rules.

[4206] The rest of subsection (a) discusses interest, dividends, or other earnings (whether or not credited) payable in respect of any deposit or account in a bank or similar institution. Subsection (b) provides some examples relating to dividends or interest.

[4207] Within Reg. § 1.451-1, subsections (b) and (c) provide:

> (b) *Timing of income inclusion for accrual method taxpayers with an applicable financial statement*. For the timing of income inclusion for taxpayers that have an applicable financial statement, as

> Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy (all events test). Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made.

In the same way, an expense is incurred and is, generally, deductible in the tax year in which all events occurred that establish the liability, the amount of the liability is able to be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Reg. § 1.461-1(a)(2), "Taxpayer using an accrual method," provides:

> (i) *In general*. Under an accrual method of accounting, a liability (as defined in § 1.446-1(c)(1)(ii)(B)) is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. (See paragraph (a)(2)(iii)(A) of this section for examples of liabilities that may not be taken into account until a taxable year subsequent to the taxable year incurred, and see §§ 1.461-4 through 1.461-6 for rules relating to economic performance.) Applicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account. For example, section 162 provides that the deductible liability generally is taken into account in the taxable year incurred through a deduction from gross income. As a further example, under section 263 or 263A, a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization (within the meaning of § 1.263A-1(c)(3)), and may later affect the computation of taxable income through depreciation or otherwise over a period including subsequent taxable years, in accordance with applicable Internal Revenue Code sections and guidance published by the Secretary. The principles of this paragraph (a)(2) also apply in the calculation of earnings and profits and accumulated earnings and profits.
>
> (ii) *Uncertainty as to the amount of a liability*. While no liability shall be taken into account before economic performance and all of the events that fix the liability have occurred, the fact that the exact amount of the liability cannot be determined does not prevent a taxpayer from taking into account that portion of the amount of the liability which can be computed with reasonable accuracy within the taxable year. For example, A renders services to B during the taxable year for which A charges $10,000. B admits a liability to A for $6,000 but contests the remainder. B may take into account only $6,000 as an expense for the taxable year in which the services were rendered.

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defined in § 1.451-3(b)(1), and that use an accrual method of accounting, see section 451(b) and § 1.451-3.

(c) *Special rule for timing of income inclusion from advance payments*. For the timing of income inclusion for taxpayers that receive advance payments, as defined in § 1.451-8(a)(1), and that use an accrual method of accounting, see section 451(c) and § 1.451-8.

(iii) *Alternative timing rules*.

(A) If any provision of the Code requires a liability to be taken into account in a taxable year later than the taxable year provided in paragraph (a)(2)(i) of this section, the liability is taken into account as prescribed in that Code provision. See, for example, section 267 (transactions between related parties) and section 464 (farming syndicates).

(B) If the liability of a taxpayer is subject to section 170 (charitable contributions), section 192 (black lung benefit trusts), section 194A (employer liability trusts), section 468 (mining and solid waste disposal reclamation and closing costs), or section 468A (certain nuclear decommissioning costs), the liability is taken into account as determined under that section and not under section 461 or the regulations thereunder. For special rules relating to certain loss deductions, see sections 165(e), 165(i), and 165(l), relating to theft losses, disaster losses, and losses from certain deposits in qualified financial institutions.

(C) Section 461 and the regulations thereunder do not apply to any amount allowable under a provision of the Code as a deduction for a reserve for estimated expenses.

(D) Except as otherwise provided in any Internal Revenue regulations, revenue procedure, or revenue ruling, the economic performance requirement of section 461(h) and the regulations thereunder is satisfied to the extent that any amount is otherwise deductible under section 404 (employer contributions to a plan of deferred compensation), section 404A (certain foreign deferred compensation plans), or section 419 (welfare benefit funds). See § 1.461-4(d)(2)(iii).

(E) Except as otherwise provided by regulations or other published guidance issued by the Commissioner (See §601.601(b)(2) of this chapter), in the case of a liability arising out of the use of property pursuant to a section 467 rental agreement, the all events test (including economic performance) is considered met in the taxable year in which the liability is to be taken into account under section 467 and the regulations thereunder.

A taxpayer can also adopt a hybrid method of accounting – using a combination of the accrual and cash methods – if the method clearly reflects income and is consistently used.[4208] For

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[4208] Reg. § 1.446-1(c)(1)(iv), "Combinations of the foregoing methods," provides:

(a) In accordance with the following rules, any combination of the foregoing methods of accounting will be permitted in connection with a trade or business if such combination clearly reflects income and is consistently used. Where a combination of methods of accounting includes any special methods, such as those referred to in subdivision (iii) of this subparagraph, the taxpayer must comply with the requirements relating to such special methods. A taxpayer using an accrual method of accounting with respect to purchases and sales may use the cash method in computing all other items of income and expense. However, a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business. Similarly, a taxpayer who uses an accrual method of accounting in computing business expenses shall use an accrual method in computing items affecting gross income from his trade or business.

business that maintain inventories, the accrual method of accounting is typically required.[4209] The IRS can also mandate the accrual method if it more accurately reflects the income of the business than does the cash method of accounting.[4210]

Code § 448 allows a taxpayer, including without limitation a C corporation or a partnership which has a C corporation as a partner, but not including a tax shelter, to use the cash method if and to the extent it engages in a farming business, is a qualified personal service corporation, or has average annual gross receipts for the 3-taxable-year period (ending with the taxable year which precedes such taxable year) that do not exceed $25 million, which is indexed for inflation.

As a business grows, it can still establish that the business is appropriately using the cash method of accounting, but the goal to maintain the use of the cash method can backfire for a company when it comes time to sell the business. Today, many private equity and venture capital acquirers also require a selling corporation to modify its tax structure to that of a partnership (through a tax-free reorganization) so that the buyer receives additional tax benefits from the acquisition of the seller's assets. When a cash basis taxpayer that is a corporation changes into a tax basis taxpayer that is a partnership or S corporation, the backfire of being a cash basis taxpayer occurs.

When a business is sold, for tax purposes, it is selling a collection of assets. Some of these are tangible (such as real estate, machinery, inventory) and some are intangible (such as goodwill, accounts receivable, a trade name). Unless the business is incorporated and it is selling the stock in a straightforward stock purchase and sale transaction (with no pre-closing reorganization and no deemed sale of the business' assets[4211]), the purchase price must be allocated among the assets that are being transferred. The IRS requires the buyer and seller to use the same allocation,[4212] so the allocation will have to be negotiated and put in writing as part of the purchase and sale agreement.

If the selling business is a C corporation or an S corporation, the gain on the sale of the stock of the company will – almost entirely if not entirely – be taxed at capital gain tax rates, the lowest tax rates. Thus, sellers of a C corporation and of an S corporation want the transaction to be a straightforward stock sale. But, often, buyers do not want to purchase the stock, both for tax and liability reasons. If the selling business is a partnership, the gain on the sale of the equity of a partnership is taxed at capital gains rates, but also subject to taxation at ordinary income tax

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(b) A taxpayer using one method of accounting in computing items of income and deductions of his trade or business may compute other items of income and deductions not connected with his trade or business under a different method of accounting.

[4209] Reg. § 1.446-1(c)(2)(i).

[4210] Reg. § 1.446-1(a)(2) provides:

It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

[4211] See part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.

[4212] Code § 1060.

rates on depreciated equipment and, if the seller is a cash basis taxpayer, accounts receivable.[4213]

If the transaction is structured as an asset purchase and sale transaction, selling the collection of assets of the company and not the underlying equity of the company, for a seller that is a C corporation (with no pre-closing reorganization), the C corporation asset seller will pay tax on any gains on the sale inside the company at corporate tax rates, then again when the company liquidates and net gain is paid to the company's shareholders, resulting in double taxation.[4214] If the selling business is an S corporation selling its assets, then the transaction to the S corporation seller is taxed in part at ordinary income tax rates and in part at capital gains tax rates, based on an allocation of the purchase price among the assets, which is impacted further by the S corporation being a cash basis taxpayer.[4215] Note:

- Usually, equipment is fully depreciated for tax purposes[4216] so a purchase price allocation to equipment generates ordinary income.[4217]

- Rather than allocating purchase price to equipment's value, the parties might allocate purchase price to equipment's basis. This gives the buyer less basis but also prevents arguing over who should bear the burden of the seller's ordinary income recognition.

For an example of a statement seeking to minimize taxation as ordinary income, see the chart in part II.Q.1.f Code § 1060 Allocation Rule When Selling Business.

The key consequences to a seller company that is a cash method taxpayer are as follows:

- Accounts receivable are taxed at ordinary income rates for cash basis taxpayers. An accrual basis taxpayer does not pay taxes on the portion of the purchase price related to the company's accounts receivable that have already been recognized as income. Accumulated depreciation on equipment is normally taxed at ordinary income tax rates.

- If the buyer requests a tax-free reorganization mechanism be used prior to closing to change the tax structure of the selling company, usually by use of an "F" reorganization,[4218] the selling shareholders wind up holding a parent company with the same tax attributes as the original corporation, with the parent company then owning a limited liability company,

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4213 See part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest.

4214 If one considers the buyer paying tax on the income used pay down a loan used to by the business, often triple taxation is really occurring. See part II.Q.1 General Principles When Selling Ownership of a Business, especially part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis, which is illustrated in flowcharts in parts II.Q.1.a.i.(a) C Corporation Triple Taxation and II.Q.1.a.ii.(a) C Corporation Triple Taxation (California).

4215 If one considers the buyer paying tax on the income used pay down a loan used to by the business, often double taxation is really occurring. See part II.Q.1 General Principles When Selling Ownership of a Business, especially part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis, which is illustrated in flowcharts in parts II.Q.1.a.i.(d) S Corporation Double Taxation and II.Q.1.a.ii.(d) S Corporation Double Taxation (California).

4216 For an immediate expensing of part or all of the purchase price, see part II.G.5 Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation.

4217 See part II.G.6.b Code § 1245 Property.

4218 See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

which is a disregarded entity for tax purposes.[4219] Selling the disregarded entity LLC is treated the same as a straight sale of assets by the corporation, such that the gain will be in part ordinary and in part capital based on the purchase price allocation. The F reorganization does not change the seller's method of accounting, so the issues regarding accounts receivable remain for a taxpayer using the cash method.

Options for the selling company to avoid the negative impact of being a cash basis taxpayer at the time of sale are to (i) consider changing to an accrual method taxpayer as it prepares to enter the market to sell its business; (ii) use a "drop down" limited liability structure; (iii) make the payment of the portion of the purchase price be contingent on the selling company's collection of accounts receivable.

The seller can make a Code § 481 election to change its method of accounting; however, the seller might pay taxes because of making the Code § 481 election to account for income not yet actually received but included in income because the legal right to receive the income is established and the amount of such income is able to be determined with reasonable accuracy. The potential tax impact incurred for changing the method of accounting, however, should be calculated against the impact of keeping the seller's cash method and proceeding with the F reorganization as a cash basis taxpayer. The ordinary income taxes paid as a cash basis taxpayer might be less than, or equal to, the taxes owed if the seller makes the Code § 481 election. The seller might also negotiate with the buyer to have the buyer gross up the purchase price to account for the ordinary income tax amount paid by the seller, covering the difference between the capital gains tax amount the seller would have paid in a traditional stock transaction and the amount paid at ordinary income rates resulting from the F reorganization. However, be wary that a buyer will remind the cash basis seller that the seller benefitted from being a cash basis taxpayer for years before the cash basis method "caught up with it" at the time of sale. Changing methods of accounting might also take time and requires excellent bookkeeping and accounting records to recharacterize income if needed to establish the new accounting method.

The parties to a purchase and sale transaction can also determine if the use of a "drop down" limited liability company structure would be beneficial. If possible, the seller could form a subsidiary company, taxed as a partnership for tax purposes, contributing the buyer-desired assets into the new subsidiary, likely carving out depreciated equipment and accounts receivable, with the buyer purchasing the new subsidiary's equity or the buyer contributing cash in exchange for the new subsidiary's equity. It is still possible for the seller to pay taxes at both capital gains rates and ordinary income rates, depending on the other assets subject to the transaction.

The parties could also consider adding a contingency to the purchase price to defer a portion of proceeds and tax payments until the contingency of collection of accounts receivable occurs; however, this is a partial potential solution, as it does not change the ordinary income treatment of depreciated equipment for the partnership or S corporation cash basis taxpayer.

[4219] See part II.E.7.c.i.(b) Use F Reorganization to Form LLC (which is within part II.E.7 Migrating into Partnership Structure). For an S corporation, see also part II.A.2.g Qualified Subchapter S Subsidiary (QSub), especially fn. 193. For long-term planning preceding a sale, see part II.Q.7.h.viii Value Freeze as Conservative Alternative, in case seller-financing is used (buyout by management or next generation of owners), to take advantage of part II.Q.1.a.i.(e) Partnership Single Taxation of Goodwill, which contrasts with double or triple taxation in S or C corporation scenarios; see generally part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis and its various subparts.

Overall, the impact of being a cash basis taxpayer for a selling S corporation or partnership are often discovered "too late" as the parties are on the precipice of a transaction, making any option to mitigate or change the impact of being a cash basis taxpayer no longer viable. Even if a potential solution might be timed prior to a selling business going out for bid, the seller must calculate the tax impact if it elects to change its accounting method prior to sale, and that amount might not be one that the seller can justify before it knows the purchase price and requirements of the buyer to achieve the closing of the transaction. Knowing the impact of being a cash basis taxpayer by the seller is, at least, good awareness to have to avoid the surprise of unexpected tax treatment at ordinary income tax rates for certain assets at the time of sale, if the seller, mistakenly, believed that the entire purchase price proceeds would be taxed at capital gains rates.

II.Q.1.f. Code § 1060 Allocation Rule When Selling Business

Code § 1060, "Special allocation rules for certain asset acquisitions," starts with subsection (a), "General rule," which provides:

> In the case of any applicable asset acquisition, for purposes of determining both -
>
> (1) the transferee's basis in such assets, and
>
> (2) the gain or loss of the transferor with respect to such acquisition,
>
> the consideration received for such assets shall be allocated among such assets acquired in such acquisition in the same manner as amounts are allocated to assets under section 338(b)(5). If in connection with an applicable asset acquisition, the transferee and transferor agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and transferor unless the Secretary determines that such allocation (or fair market value) is not appropriate.

Code § 1060(c), "Applicable asset acquisition," provides:

> For purposes of this section, the term "applicable asset acquisition" means any transfer (whether directly or indirectly) -
>
> (1) of assets which constitute a trade or business, and
>
> (2) with respect to which the transferee's basis in such assets is determined wholly by reference to the consideration paid for such assets.
>
> A transfer shall not be treated as failing to be an applicable asset acquisition merely because section 1031 applies to a portion of the assets transferred.

Reg. § 1.1060-1(b), "Applicable asset acquisition," elaborates:

> (1) *In general*. An applicable asset acquisition is any transfer, whether direct or indirect, of a group of assets if the assets transferred constitute a trade or business in the hands of either the seller or the purchaser and, except as provided in paragraph (b)(8) of this section, the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration.

(2) *Assets constituting a trade or business*.

(i) *In general*. For purposes of this section, a group of assets constitutes a trade or business if -

(A) The use of such assets would constitute an active trade or business under section 355; or[4220]

(B) Its character is such that goodwill or going concern value could under any circumstances attach to such group.

(ii) *Goodwill or going concern value*. Goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor. Going concern value is the additional value that attaches to property because of its existence as an integral part of an ongoing business activity. Going concern value includes the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership. It also includes the value that is attributable to the immediate use or availability of an acquired trade or business, such as, for example, the use of the revenues or net earnings that otherwise would not be received during any period if the acquired trade or business were not available or operational.

(iii) *Factors indicating goodwill or going concern value*. In making the determination in this paragraph (b)(2), all the facts and circumstances surrounding the transaction are taken into account. Whether sufficient consideration is available to allocate to goodwill or going concern value after the residual method is applied is not relevant in determining whether goodwill or going concern value could attach to a group of assets. Factors to be considered include -

(A) The presence of any intangible assets (whether or not those assets are section 197 intangibles), provided, however, that the transfer of such an asset in the absence of other assets will not be a trade or business for purposes of section 1060;

(B) The existence of an excess of the total consideration over the aggregate book value of the tangible and intangible assets purchased (other than goodwill and going concern value) as shown in the financial accounting books and records of the purchaser; and

(C) Related transactions, including lease agreements, licenses, or other similar agreements between the purchaser and seller (or managers, directors, owners, or employees of the seller) in connection with the transfer.

(3) *Examples*. The following examples illustrate paragraphs (b)(1) and (2) of this section:

Example (1). S is a high grade machine shop that manufactures microwave connectors in limited quantities. It is a successful company with a reputation within the industry

[4220] [my footnote]: See part II.Q.7.f.iii Active Business Requirement for Code § 355.

and among its customers for manufacturing unique, high quality products. Its tangible assets consist primarily of ordinary machinery for working metal and plating. It has no secret formulas or patented drawings of value. P is a company that designs, manufactures, and markets electronic components. It wants to establish an immediate presence in the microwave industry, an area in which it previously has not been engaged. P is acquiring assets of a number of smaller companies and hopes that these assets will collectively allow it to offer a broad product mix. P acquires the assets of S in order to augment its product mix and to promote its presence in the microwave industry. P will not use the assets acquired from S to manufacture microwave connectors. The assets transferred are assets that constitute a trade or business in the hands of the seller. Thus, P's purchase of S's assets is an applicable asset acquisition. The fact that P will not use the assets acquired from S to continue the business of S does not affect this conclusion.

Example (2). S, a sole proprietor who operates a car wash, both leases the building housing the car wash and sells all of the car wash equipment to P. S's use of the building and the car wash equipment constitute a trade or business. P begins operating a car wash in the building it leases from S. Because the assets transferred together with the asset leased are assets which constitute a trade or business, P's purchase of S's assets is an applicable asset acquisition.

Example (3). S, a corporation, owns a retail store business in State X and conducts activities in connection with that business enterprise that meet the active trade or business requirement of section 355. P is a minority shareholder of S. S distributes to P all the assets of S used in S's retail business in State X in complete redemption of P's stock in S held by P. The distribution of S's assets in redemption of P's stock is treated as a sale or exchange under sections 302(a) and 302(b)(3), and P's basis in the assets distributed to it is determined wholly by reference to the consideration paid, the S stock. Thus, S's distribution of assets constituting a trade or business to P is an applicable asset acquisition.

Example (4). S is a manufacturing company with an internal financial bookkeeping department. P is in the business of providing a financial bookkeeping service on a contract basis. As part of an agreement for P to begin providing financial bookkeeping services to S, P agrees to buy all of the assets associated with S's internal bookkeeping operations and provide employment to any of S's bookkeeping department employees who choose to accept a position with P. In addition to selling P the assets associated with its bookkeeping operation, S will enter into a long term contract with P for bookkeeping services. Because assets transferred from S to P, along with the related contract for bookkeeping services, are a trade or business in the hands of P, the sale of the bookkeeping assets from S to P is an applicable asset acquisition.

(4) *Asymmetrical transfers of assets*. A purchaser is subject to section 1060 if -

(i) Under general principles of tax law, the seller is not treated as transferring the same assets as the purchaser is treated as acquiring;

(ii) The assets acquired by the purchaser constitute a trade or business; and

(iii) Except as provided in paragraph (b)(8) of this section, the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration.

(5) *Related transactions*. Whether the assets transferred constitute a trade or business is determined by aggregating all transfers from the seller to the purchaser in a series of related transactions. Except as provided in paragraph (b)(8) of this section, all assets transferred from the seller to the purchaser in a series of related transactions are included in the group of assets among which the consideration paid or received in such series is allocated under the residual method. The principles of § 1.338-1(c) are also applied in determining which assets are included in the group of assets among which the consideration paid or received is allocated under the residual method.

(6) *More than a single trade or business*. If the assets transferred from a seller to a purchaser include more than one trade or business, then, in applying this section, all of the assets transferred (whether or not transferred in one transaction or a series of related transactions and whether or not part of a trade or business) are treated as a single trade or business.

(7) *Covenant entered into by the seller*. If, in connection with an applicable asset acquisition, the seller enters into a covenant (e.g., a covenant not to compete) with the purchaser, that covenant is treated as an asset transferred as part of a trade or business.

(8) *Partial non-recognition exchanges*. A transfer may constitute an applicable asset acquisition notwithstanding the fact that no gain or loss is recognized with respect to a portion of the group of assets transferred. All of the assets transferred, including the non-recognition assets, are taken into account in determining whether the group of assets constitutes a trade or business. The allocation of consideration under paragraph (c) of this section is done without taking into account either the non-recognition assets or the amount of money or other property that is treated as transferred in exchange for the non-recognition assets (together, the non-recognition exchange property). The basis in and gain or loss recognized with respect to the non-recognition exchange property are determined under such rules as would otherwise apply to an exchange of such property. The amount of the money and other property treated as exchanged for non-recognition assets is the amount by which the fair market value of the non-recognition assets transferred by one party exceeds the fair market value of the non-recognition assets transferred by the other (to the extent of the money and the fair market value of property transferred in the exchange). The money and other property that are treated as transferred in exchange for the non-recognition assets (and which are not included among the assets to which section 1060 applies) are considered to come from the following assets in the following order: first from Class I assets, then from Class II assets, then from Class III assets, then from Class IV assets, then from Class V assets, then from Class VI assets, and then from Class VII assets. For this purpose, liabilities assumed (or to which a non-recognition exchange property is subject) are treated as Class I assets. See Example 1 in paragraph (d) of this section for an example of the application of section 1060 to a single transaction which is, in part, a non-recognition exchange.

(9) *Insurance business*. The mere reinsurance of insurance contracts by an insurance company is not an applicable asset acquisition, even if it enables the reinsurer to establish a customer relationship with the owners of the reinsured contracts. However, a transfer of an insurance business is an applicable asset acquisition if the purchaser acquires significant business assets, in addition to insurance contracts, to which goodwill and going concern value could attach. For rules regarding the treatment of an applicable asset acquisition of an insurance business, see paragraph (c)(5) of this section.

Code § 1060(d), "Treatment of certain partnership transactions," provides:

In the case of a distribution of partnership property or a transfer of an interest in a partnership -

(1) the rules of subsection (a) shall apply but only for purposes of determining the value of section 197 intangibles for purposes of applying section 755, and

(2) if section 755 applies, such distribution or transfer (as the case may be) shall be treated as an applicable asset acquisition for purposes of subsection (b).

See part II.Q.1.g.ii Code § 755 Allocation to Inside Basis under Code § 743(b).

Reg. § 1.1060-1(c), "Allocation of consideration among assets under the residual method," provides:

(1) *Consideration*. The seller's consideration is the amount, in the aggregate, realized from selling the assets in the applicable asset acquisition under section 1001(b). The purchaser's consideration is the amount, in the aggregate, of its cost of purchasing the assets in the applicable asset acquisition that is properly taken into account in basis.

(2) *Allocation of consideration among assets*. For purposes of determining the seller's amount realized for each of the assets sold in an applicable asset acquisition, the seller allocates consideration to all the assets sold by using the residual method under §§ 1.338-6 and 1.338-7, substituting consideration for ADSP. For purposes of determining the purchaser's basis in each of the assets purchased in an applicable asset acquisition, the purchaser allocates consideration to all the assets purchased by using the residual method under §§ 1.338-6 and 1.338-7, substituting consideration for AGUB. In allocating consideration, the rules set forth in paragraphs (c)(3) and (4) of this section apply in addition to the rules in §§ 1.338-6 and 1.338-7.

(3) *Certain costs*. The seller and purchaser each adjusts the amount allocated to an individual asset to take into account the specific identifiable costs incurred in transferring that asset in connection with the applicable asset acquisition (*e.g.*, real estate transfer costs or security interest perfection costs). Costs so allocated increase, or decrease, as appropriate, the total consideration that is allocated under the residual method. No adjustment is made to the amount allocated to an individual asset for general costs associated with the applicable asset acquisition as a whole or with groups of assets included therein (e.g., non-specific appraisal fees or accounting fees). These latter amounts are taken into account only indirectly through

their effect on the total consideration to be allocated. If an election described in § 1.338-6(c)(5) is made with respect to an applicable asset acquisition, any allocation of costs pursuant to this paragraph (c)(3) shall be made as if such election had not been made. The preceding sentence applies to applicable asset acquisitions occurring on or after September 11, 2007. For applicable asset acquisitions occurring before September 11, 2007, and on or after September 15, 2004, see § 1.1060-1T as contained in 26 CFR Part 1 in effect on April 1, 2007. For applicable asset acquisitions occurring before September 15, 2004, see §§ 1.338-6 and 1.1060-1 as contained in 26 CFR Part 1 in effect on April 1, 2004.

(4) *Effect of agreement between parties*. If, in connection with an applicable asset acquisition, the seller and purchaser agree in writing as to the allocation of any amount of consideration to, or as to the fair market value of, any of the assets, such agreement is binding on them to the extent provided in this paragraph (c)(4). Nothing in this paragraph (c)(4) restricts the Commissioner's authority to challenge the allocations or values arrived at in an allocation agreement. This paragraph (c)(4) does not apply if the parties are able to refute the allocation or valuation under the standards set forth in *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967) (a party wishing to challenge the tax consequences of an agreement as construed by the Commissioner must offer proof that, in an action between the parties to the agreement, would be admissible to alter that construction or show its unenforceability because of mistake, undue influence, fraud, duress, etc.).

(5) *Insurance business*. If the trade or business transferred is an insurance business, the rules of this paragraph (c) are modified by the principles of § 1.338-11(a) through (d). However, in transactions governed by section 1060, such principles apply even if the transfer of the trade or business is effected in whole or in part through indemnity reinsurance rather than assumption reinsurance, and, for the insurer or reinsurer, an insurance contract (including an annuity or reinsurance contract) is a Class VI asset regardless of whether it is a section 197 intangible. In addition, the principles of § 1.338-11(f) through (h) apply if the transfer occurs in connection with the complete liquidation of the transferor.

Here is an example of a statement seeking to minimize taxation as ordinary income:

Asset Class	**Methodology for Determining Fair Market Value**
Cash and cash equivalents	Cash value.
Inventory, accounts receivable and other current assets	The amount assigned to such assets in the calculation of Working Capital; however, if any such asset is not subject to inclusion in the determination of Working Capital, then the net book value of such asset for financial accounting purposes as of immediately before the Closing.

Asset Class	Methodology for Determining Fair Market Value
Property, equipment, and other tangible and intangible assets (other than those assets that are set forth above or are Code Section 197 assets)	The tax basis of such assets as of immediately before the Closing.
Goodwill and going concern value and other Code Section 197 assets	The remainder of the Merger Consideration and any other relevant items in excess of the amount allocated to the assets set forth above; however, no amount will be allocated to any covenant not to compete or any similar covenant.

II.Q.1.g. Partnership Basis Adjustments

This part II.Q.1.g effectuates the basis adjustments triggered as described in part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

II.Q.1.g.i. Effect of Basis Adjustments

The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of death, increased by the estate's share of partnership liabilities, and reduced to the extent that such value is attributable to IRD.[4221] Thus, the basis increase has two effects:

- Restoring Basis Arising from Liabilities. To the extent a partner assumes a liability, that partner is deemed to have contributed cash equal to the liabilities that person is allocated. To the extent a partner's allocable share of liabilities is reduced, that person is deemed to have received a cash distribution, reducing basis or triggering gain if and to the extent basis is insufficient to absorb the distribution. During life, distributions or losses might have reduced or eliminated basis generated by the assumption of liabilities. By passing through a decedent's estate, a partnership interest's basis due to allocated liabilities is fully restored.

- Basis Adjustment Due to Value. The partnership interest's value, which includes appropriate reductions for the balance sheet effect of liabilities and appropriate increases or decreases for control or lack thereof, reductions for lack of marketability, and any other features, is added to the amount of allocable liabilities.

[4221] Reg. § 1.742-1. For more details on Reg. § 1.742-1, see fn 5682 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

In implementing the Code § 743(b) adjustments:[4222]

> No adjustment is made to the common basis of partnership property. Thus, for purposes of calculating income, deduction, gain, and loss, the transferee will have a special basis for those partnership properties the bases of which are adjusted under section 743(b) and this section. The adjustment to the basis of partnership property under section 743(b) has no effect on the partnership's computation of any item under section 703.

In other words, the partnership keeps two or more separate sets of books for transferee partner: one that applies to all partners based on the partnership's transactions and is reflected in their capital accounts, and one or more than applies to each partner separately based on that partner's events that affect outside basis (that do not involve transfers of the partnership's assets) and is reflected in the partnership's basis records specially allocated to the applicable partners. (However, if the Code § 743(b) basis adjustment remains when the partnership interest is liquidated, instead of being wasted it may cause an inside basis adjustment and perhaps even a capital account adjustment.)[4223] When a partnership interest is transferred, the transferor's capital account attributable to the transferred interest (which might be part or all of the transferor's capital account, depending on what portion is transferred) shifts to the transferee.[4224]

The amount of any positive basis adjustment that is recovered by the transferee in any year is added to the transferee's distributive share of the partnership's depreciation or amortization deductions for the year, which deductions also reduce the basis adjustment.[4225] Reg. § 1.743-1(j)(4)(i)(B), "Recovery period," provides:[4226]

[4222] Reg. § 1.743-1(j)(1). Reg. § 1.743-1(j)(2) provides more details:

> *Computation of partner's distributive share of partnership items*. The partnership first computes its items of income, deduction, gain, or loss at the partnership level under section 703. The partnership then allocates the partnership items among the partners, including the transferee, in accordance with section 704, and adjusts the partners' capital accounts accordingly. The partnership then adjusts the transferee's distributive share of the items of partnership income, deduction, gain, or loss, in accordance with paragraphs (j)(3) and (4) of this section, to reflect the effects of the transferee's basis adjustment under section 743(b). These adjustments to the transferee's distributive shares must be reflected on Schedules K and K-1 of the partnership's return (Form 1065). These adjustments to the transferee's distributive shares do not affect the transferee's capital account. [additional references re: accounting for long-term contracts]

CCA 201726012 (under the signature of David R. Haglund) stated:

> Adjustments to the adjusted tax basis of partnership property under § 743 are not reflected in the capital account of the transferee partner or on the books of the partnership. § 1.704-1(b)(2)(iv)(m)(2). No adjustment is made to the common basis of partnership property, and the § 743(b) adjustment has no effect on the partnership's computation of any item under § 703. § 1.743-1(j)(1). Section 743(b) adjustments are personal to the transferee partners and are not subject to reallocation under § 704(b).

Reg. 1.704-1(b)(2)(iv)(m)(2), which includes exceptions to the proposition for which it is quoted above, is reproduced in fn 519 in part II.C.7 Maintaining Capital Accounts.

[4223] See fns 515-519 in part II.C.7 Maintaining Capital Accounts.

[4224] Reg. § 1.704-1(b)(2)(iv)(*l*). See also Reg. § 1.704-1(b)(5), Ex. (13).

[4225] Reg. § 1.743-1(j)(4)(i)(A).

[4226] Reg. § 1.743-1(*l*), "Effective/applicability date," includes:

(1) *In general*. Except as provided in paragraph (j)(4)(i)(B)(2) of this section, for purposes of section 168, if the basis of a partnership's recovery property is increased as a result of the transfer of a partnership interest, then the increased portion of the basis is taken into account as if it were newly-purchased recovery property placed in service when the transfer occurs. Consequently, any applicable recovery period and method may be used to determine the recovery allowance with respect to the increased portion of the basis. However, no change is made for purposes of determining the recovery allowance under section 168 for the portion of the basis for which there is no increase. The partnership is allowed to deduct the additional first year depreciation under section 168(k) and § 1.168(k)-2 for an increase in the basis of qualified property, as defined in section 168(k) and § 1.168(k)-2, under section 743(b) in a class of property, as defined in § 1.168(k)-2(f)(1)(ii)(A) through (F), even if the partnership made the election under section 168(k)(7) and § 1.168(k)-2(f)(1) not to deduct the additional first year depreciation for all other qualified property of the partnership in the same class of property, as defined in § 1.168(k)-2(f)(1)(ii)(A) through (F), and placed in service in the same taxable year, provided the section 743(b) basis adjustment meets all requirements of section 168(k) and § 1.168(k)-2. Further, the partnership may make an election under section 168(k)(7) and § 1.168(k)-2(f)(1) not to deduct the additional first year depreciation for an increase in the basis of qualified property, as defined in section 168(k) and § 1.168(k)-2, under section 743(b) in a class of property, as defined in § 1.168(k)-2(f)(1)(ii)(A) through (F), and placed in service in the same taxable year, even if the partnership does not make that election for all other qualified property of the partnership in the same class of property, as defined in § 1.168(k)-2(f)(1)(ii)(A) through (F), and placed in service in the same taxable year. In this case, the section 743(b) basis adjustment must be recovered under a reasonable method.

Special rules apply if the partnership uses the remedial allocation method.[4227] Bonus depreciation does not apply to adjustments due to the remedial allocation method,[4228] does

The last three sentences of paragraph (j)(4)(i)(B)(1) of this section, and the last sentence of paragraph (j)(4)(i)(B)(2) of this section, apply to transfers of partnership interests that occur on or after September 24, 2019. However, a partnership may choose to apply the last three sentences in paragraph (j)(4)(i)(B)(1) of this section, and the last sentence of paragraph (j)(4)(i)(B)(2) of this section, for transfers of partnership interests that occur on or after September 28, 2017. A partnership may rely on the last three sentences in paragraph (j)(4)(i)(B)(1) of this section in regulation project REG-104397-18 (2018-41 I.R.B. 558) (see § 601.601(d)(2)(ii)(b) of this chapter) for transfers of partnership interests that occur on or after September 28, 2017, and ending before September 24, 2019.

[4227] Reg. § 1.743-1(j)(4)(i)(B)(2) provides:

Remedial allocation method. If a partnership elects to use the remedial allocation method described in § 1.704-3(d) with respect to an item of the partnership's recovery property, then the portion of any increase in the basis of the item of the partnership's recovery property under section 743(b) that is attributable to section 704(c) built-in gain is recovered over the remaining recovery period for the partnership's excess book basis in the property as determined in the final sentence of § 1.704-3(d)(2). Any remaining portion of the basis increase is recovered under paragraph (j)(4)(i)(B)(1) of this section. The first sentence of this paragraph (j)(4)(i)(B)(2) does not apply to a partnership that is not a publicly traded partnership within the meaning of section 7704(b) with respect to any basis increase under section 743(b) that is recovered using the additional first year depreciation deduction under section 168(k).

See fn 4226 re effective date.

[4228] See text accompanying fn 1471 in part II.G.5.b Bonus Depreciation.

apply in most cases when a new partner buys into a partnership,[4229] and does not apply when a partnership interest is transferred by reason of death.[4230]

Reg. § 1.1245-1(e)(3) recaptures depreciation/amortization on the disposition of the property to which the Code § 743(b) adjustment applies:

(i) If (a) a partner had a special basis adjustment under section 743(b) in respect of section 1245 property, or (b) on the date he acquired his partnership interest by way of a sale or exchange (or upon death of another partner) the partnership owned section 1245 property and an election under section 754 (relating to optional adjustment to basis of partnership property) was in effect with respect to the partnership, then the amount of gain recognized under section 1245(a)(1) by him upon a disposition by the partnership of such property shall be determined under this subparagraph.

(ii) There shall be allocated to such partner, in the same proportion as the partnership's total gain is allocated to him as his distributive share under section 704, a portion of (a) the common partnership adjusted basis for the property, and (b) the amount realized by the partnership upon the disposition, or, if nothing is realized, the fair market value of the property. There shall also be allocated to him, in the same proportion as the partnership's gain recognized under section 1245(a)(1) is allocated under subparagraph (2) of this paragraph as his distributive share of such gain, a portion of "the adjustments reflected in the adjusted basis" (as defined in paragraph (a)(2) of § 1.1245-2) of such property. If on the date he acquired his partnership interest by way of a sale or exchange the partnership owned such property and an election under section 754 was in effect, then for purposes of the preceding sentence the amount of the adjustments reflected in the adjusted basis of such property on such date shall be deemed to be zero. For special rules relating to the amount of adjustments reflected in the adjusted basis of property after partnership transactions, see paragraph (c)(6) of § 1.1245-2.

(iii) The partner's adjusted basis in respect of the property shall be deemed to be (a) the portion of the partnership's adjusted basis for the property allocated to the partner under subdivision (ii) of this subparagraph, (b) increased by the amount of any special basis adjustment described in section 743(b)(1) (or decreased by the amount of any special basis adjustment described in section 743(b)(2)) which the partner may have in respect of the property on the date the partnership disposed of the property.

(iv) The partner's recomputed basis in respect of the property shall be deemed to be (a) the sum of the partner's adjusted basis for the property, as determined in subdivision (iii) of this subparagraph, plus the amount of "the adjustments reflected in the adjusted basis" (as defined in paragraph (a)(2) of § 1.1245-2) for the property allocated to the partner under subdivision (ii) of this subparagraph, (b) increased by the amount by which any special basis adjustment described in section 743(b)(1) (or

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[4229] See text accompanying fn 1474 in part II.G.5.b Bonus Depreciation. Following that, see Reg. § 1.168(k)-2(b)(3)(vii), Examples (14), (15), and (17) for when bonus depreciation does or does not apply.
[4230] Following the text accompanying fn 1474 in part II.G.5.b Bonus Depreciation, see Reg. § 1.168(k)-2(b)(3)(vii)(P), Example (16).

decreased by the amount by which any special basis adjustment described in section 743(b)(2)) in respect of the property was reduced, but only to the extent such amount was applied to adjust the amount of the deductions allowed or allowable to the partner for depreciation or amortization of section 1245 property attributable to periods referred to in paragraph (a)(2) of § 1.1245-2. The terms “allowed or allowable,” “depreciation or amortization,” and “attributable to periods” shall have the meanings assigned to these terms in paragraph (a) of § 1.1245-2.

(4) The application of subparagraph (3) of this paragraph may be illustrated by the following example:

Example. A, B, and C each hold a one-third interest in calendar year partnership ABC. On December 31, 1962, the firm holds section 1245 property which has an adjusted basis of $30,000 and a recomputed basis of $33,000. Depreciation deductions in respect of the property for 1962 were $3,000. On January 1, 1963, when D purchases C’s partnership interest, the election under section 754 is in effect and a $5,000 special basis adjustment is made in respect of D to his one-third share of the common partnership adjusted basis for the property. For 1963 and 1964 the partnership deducts $6,000 as depreciation in respect of the property, thereby reducing its adjusted basis to $24,000, and D deducts $2,800, *i.e.*, his distributive share of partnership depreciation ($2,000) plus depreciation in respect of his special basis adjustment ($800). On March 15, 1965, the partnership sells the property for $48,000. Since the partnership’s recomputed basis for the property ($33,000, *i.e.*, $24,000 adjusted basis plus $9,000 in depreciation deductions) is lower than the amount realized upon the sale ($48,000), the excess of recomputed basis over adjusted basis, or $9,000, is treated as partnership gain under section 1245(a)(1). D’s distributive share of such gain is $3,000⅓ of $9,000). However, the amount of gain recognized by D under section 1245(a)(1) is only $2,800, determined as follows:

(1) Adjusted basis:		
D’s portion of partnership adjusted basis (⅓ of $24,000)	$8,000	
D’s special basis adjustment as of December 31, 1964 ($5,000 minus $800)	4,200	
D’s adjusted basis		$12,200
(2) Recomputed basis:		
D’s adjusted basis	12,200	
D’s portion of partnership depreciation for 1963 and 1964, *i.e.*, for periods after he acquired his partnership interest (⅓ of $6,000)	2,000	
Depreciation for 1963 and 1964 in respect of D’s special basis adjustment	800	
D’s recomputed basis		15,000
(3) D’s portion of amount realize by partnership (⅓ of $48,000)		16,000

(4) Gain recognized to D under section 1245(a)(1), *i.e.*, the lower of (2) or (3), minus (1) 2,800

CCA 201726012 (under the signature of David R. Haglund) asserted that Reg. § 1.1502-13 did not permit increased deductions for depreciation and amortization that are attributable to Code § 743(b) adjustments arising from the transfer of a partnership interest in an intercompany reorganization to which Code § 368 applies and from the distribution of a partnership interest in an intercompany liquidation to which Code § 332(a) applies. It also asserted that the basis adjustment provisions of Code § 743(b) do not conflict with the carryover basis provisions of Code § 362(a) when a partnership interest is transferred in an intercompany reorganization to which Code § 368 applies or with the carryover basis provisions of Code § 334(b)(1) when a partnership interest is distributed in an intercompany liquidation to which Code § 332(a) applies.[4231]

For basis decreases, however, Reg. § 1.743-1(j)(4)(ii)(A) provides:

> *Reduced deduction*. The amount of any negative basis adjustment allocated to an item of depreciable or amortizable property that is recovered in any year first decreases the transferee's distributive share of the partnership's depreciation or amortization deductions from that item of property for the year. If the amount of the basis adjustment recovered in any year exceeds the transferee's distributive share of the partnership's depreciation or amortization deductions from the item of property, then the transferee's distributive share of the partnership's depreciation or amortization deductions from other items of partnership property is decreased. The transferee then recognizes ordinary income to the extent of the excess, if any, of the amount of the basis adjustment recovered in any year over the transferee's distributive share of the partnership's depreciation or amortization deductions from all items of property.

For purposes of Code § 168, the decrease is recovered over the remaining useful life of the item of the partnership's recovery property, using the following formula:[4232]

> The portion of the decrease that is recovered in any year during the recovery period is equal to the product of-

[4231] CCA 201726012 reasoned:

> In the case of property transferred in a reorganization to which § 368 applies, in which no gain or loss is recognized, the basis of such property in the hands of the transferee generally is the same as it would be in the hands of the transferor under § 362(a). Similarly, in the case of property distributed to a corporate parent from a subsidiary in a complete liquidation to which § 332(a) applies, in which no gain or loss is recognized, the basis of such property in the hands of the distributee generally is the same as it would be in the hands of the distributor under § 334(b)(1). Thus, with respect to the transfer of the Partnership1 interest from SubsidiaryH to SubsidiaryF in the Reorganization (to which § 368 applies), and the distribution of the Partnership1 interest from SubsidiaryC to SubsidiaryE in the Liquidation (to which § 332 applies), the transferee's and distributee's basis in their Partnership1 interest is the same as it would be in the hands of the respective transferor and distributor.
>
> Application of § 743(b), by contrast, has no effect on the basis of a *partnership interest* transferred in a reorganization or distributed in a complete liquidation. Rather, in such cases, if the partnership has a § 754 election in effect, § 743(b) provides for an increase or decrease in the adjusted basis of *partnership property*.

[4232] Reg. § 1.743-1(j)(4)(ii)(B). Reg. § 1.743-1(j)(4)(ii)(C) provides examples.

(1) The amount of the decrease to the item's adjusted basis (determined as of the date of the transfer); multiplied by

(2) A fraction, the numerator of which is the portion of the adjusted basis of the item recovered by the partnership in that year, and the denominator of which is the adjusted basis of the item on the date of the transfer (determined prior to any basis adjustments).

Also, Reg. § 1.743-1(j)(5) provides:

> *Depletion*. Where an adjustment is made under section 743(b) to the basis of partnership property subject to depletion, any depletion allowance is determined separately for each partner, including the transferee partner, based on the partner's interest in such property. See § 1.702-1(a)(8). For partnerships that hold oil and gas properties that are depleted at the partner level under section 613A(c)(7)(D), the transferee partner (and not the partnership) must make the basis adjustments, if any, required under section 743(b) with respect to such properties. See § 1.613A-3(e)(6)(iv).

II.Q.1.g.ii. Code § 755 Allocation to Inside Basis under Code § 743(b)

The partnership increases the adjusted basis of its property by the excess of the basis to the transferee partner of the partner's interest in the partnership over the partner's proportionate share of the adjusted basis of the partnership property.[4233] Consistent with the rule for outside basis stated above, a transferee's share of the adjusted basis to the partnership of partnership property is equal to the sum of the transferee's interest as a partner in the partnership's previously taxed capital, plus the transferee's share of partnership liabilities.[4234] Generally, a transferee's interest as a partner in the partnership's previously taxed capital is equal to:[4235]

- The amount of cash that the transferee would receive on a liquidation of the partnership following a certain hypothetical transaction, to the extent attributable to the acquired partnership interest; increased by

- The amount of tax loss,[4236] that would be allocated to the transferee from the hypothetical transaction (to the extent attributable to the acquired partnership interest); and decreased by

- The amount of tax gain, [4237] that would be allocated to the transferee from the hypothetical transaction (to the extent attributable to the acquired partnership interest).

The hypothetical transaction referred to the bullet points above means the disposition by the partnership of all of the partnership's assets, immediately after the transfer of the partnership interest, in a fully taxable transaction for cash equal to the fair market value of the assets.[4238] TAM 201929019 asserted that an assets-over merger[4239] constitutes a Code § 761(e) transfer, as described in the text following fn 5623 in part II.Q.8.e.i Distribution of Partnership Interests,

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[4233] Code § 743(b).
[4234] Reg. § 1.743-1(d)(1).
[4235] Reg. § 1.743-1(d)(1).
[4236] Including any remedial allocations under Reg. § 1.704-3(d).
[4237] Including any remedial allocations under Reg. § 1.704-3(d).
[4238] Reg. § 1.743-1(d)(2).
[4239] See part II.Q.8.e.v Partnership Mergers, especially the text accompanying fns 5816 and 5824 (describing an "assets-over" merger).

and calculated a basis step-down as described later in this part II.Q.8.e.iii.(d). Next, TAM 201929019 asserted its view on how to account for gain or loss in this hypothetical transaction:

> A transferee partner's share of the adjusted basis of partnership property under § 1.743-1(d)(1) equals the sum of the transferee's interest as a partner in the partnership's previously taxed capital plus the transferee's share of partnership liabilities. In determining a transferee's interest as a partner in the partnership's previously taxed capital, the amount of tax gain and loss (including any remedial allocations under § 1.704-3(d)), that would be allocated to the transferee from a hypothetical transaction described in § 1.743-1(d)(2) (to the extent attributable to the acquired partnership interest) is taken into account. In this case, the amount of tax loss that would be allocated to A from a hypothetical disposition of Y's assets would be $N17. A argues that, as a result of the § 1.743-1(d)(2) hypothetical transaction, A should also be allocated "tax gain" equal to A's share of X's deferred COD income under § 108(i) ("deferred COD income") of $N9, for purposes of calculating A's share of Y's previously taxed capital under § 1.743-1(d)(1). The crux of A's argument is that this amount of deferred COD income is (or should be treated as) equivalent to "tax gain" within the meaning of § 1.743-1(d)(1)(iii) that would be attributable to the transferred interest in Y that X receives in the merger transaction and that, in certain cases, disparities between inside/outside basis may be created by not including the deferred COD income as tax gain.
>
> We disagree. Deferred COD income is not "tax gain" for purposes of determining the transferee partner's interest in previously taxed capital. This income is not "tax gain" that would arise upon the disposition of partnership assets within the meaning and for the intent and purposes of § 1.743-1(d)(1)(iii) because it does not arise as a result of a disposition of partnership assets or property at fair market value for cash. The hypothetical transaction described in § 1.743-1(d)(2) is only concerned with determining the amount of partnership tax gain or loss that would result from the disposition of partnership assets at fair market value for cash, for purposes of determining an inside basis adjustment to partnership property. Deferred COD income is not and does not relate to partnership assets or property for purposes of the hypothetical transaction described in § 1.743-1(d)(2), but is simply an item of deferred income that does not have or attract basis, is not transferrable or marketable, and has no fair market value.[16]
>
> [16] A argues that the deferred COD income should be treated as gain like recognized COD income is treated as gain for purposes of §§ 338, 382, and 1374, citing Notice 2003-65, 2003-2 C.B. 747, and § 1.1374-4(f). Those Code sections, however, are corporate-level tax provisions that do not apply to partnerships. In addition, the policy rationale for treating recognized COD income as gain for purposes of §§ 338, 382, and 1374 is not relevant for determining whether deferred COD income should be included in calculating a partner's share of previously taxed capital of a partnership for purposes of § 743(b).
>
> Although § 1.755-1(b)(1)(ii) allocates the basis adjustment under § 743(b) between classes of property and among items of property within each class based on allocations of tax gain and income that would result from a hypothetical sale of all of the partnership property for cash in an amount equal to the fair market value of such property (emphasis added), any ordinary income amounts must still relate to partnership property that can be valued, such as accounts receivable or recapture property. COD income does not

relate to any partnership asset that can be assigned a value under the § 755 regulations and, therefore, should not be treated or otherwise taken into consideration as "tax gain" under § 1.743-1(d)(1)(iii).[17] Accordingly, deferred COD income should play no role in determining Y's previously taxed capital for determining A's inside basis in Y under § 743(b).

[17] See, generally, Rev. Rul. 91-31, 1991-1 C.B. 19, holding that the reduction of the principal amount of an under-secured nonrecourse debt by the holder of a debt who was not the seller of the property securing the debt results in the realization of discharge of indebtedness income under § 61(a)(12) and does not result in the reduction to the basis of the property securing the debt.

Moreover, treating deferred COD income as "tax gain" frustrates the purpose of § 743(b) and perpetuates the disparity between the transferee partner's inside and outside basis. Treating deferred COD income as tax gain actually reduces the § 743(b) adjustment that is required to treat the transferee partner as though the transferee partner directly purchased its share of the partnership's assets and, thus, perpetuates the difference between the transferee partner's inside and outside basis. We also disagree with A's argument that it is appropriate to preserve the "status quo ante" when § 743(b) applies to a sale or exchange. The purpose of § 743(b) when it applies to a transaction is to reduce the disparities between the partner's inside basis and outside basis, not to maintain the status quo by perpetuating inside/outside basis disparities.

A points out, not incorrectly, that in a hypothetical situation[18] where the partner has sufficient outside basis in the partnership interest at the time of discharge, the deemed distribution under § 752(b) resulting from the reduction in liabilities will occur immediately under § 108(i)(6) even though the recognition of the § 108(i) amount is deferred. In such a situation, A argues that the failure to treat the deferred COD income as "tax gain" for purposes of calculating the partner's interest in previously taxed capital under § 1.743-1(d)(1) will lead to a permanent disparity between inside and outside basis, which is counter to the intent and purposes of § 743(b). While we acknowledge this point, we disagree with A's argument that this means that deferred COD income must be treated as "tax gain" in computing the partner's interest in previously taxed capital as a matter of policy in every case. We note that doing so would lead to permanent disparities in cases such as this one where the partner has a deferred § 752 amount. Accordingly, to address the concern raised by A's hypothetical situation in which a partner has sufficient outside basis at the time of the discharge to absorb at least a portion of the deemed distribution under § 752(b), it would be appropriate solely for purposes of computing the transferee partner's § 743(b) adjustment to adjust the transferee partner's basis in the transferred partnership interest under § 705 by the amount of the deferred COD income that equals the amount of the deemed distribution under § 752(b) previously taken into account. This adjustment would compensate for the difference in timing created under § 108(i) in taking into account the two related items. Adjusting a transferee partner's basis in its partnership interest in this manner in the hypothetical situation would obviate the need to make any adjustment to the transferee partner's interest in the resulting partnership's previously taxed capital in such a situation. Therefore, we conclude that A's share of Y's previously taxed capital equals the amount of tax loss that would be allocated to A from a hypothetical disposition of Y's assets, or $N17, and does not include A's deferred COD income of $N9.

[18] Field Counsel and A currently disagree as to whether this hypothetical situation may apply, in part, to the actual facts of this case.

> In summary, taking into account the conclusions reached in this technical advice memorandum, the downward inside-basis adjustment under § 743(b) with respect to A is $N13 ($N13 (A's share of the adjusted basis to the partnership of Y's property ($N17 (tax loss) plus $N14 (A's share of Y's liabilities)) over $N15 (A's basis in the transferred Y interest)). A asserts that this basis adjustment is inconsistent with the purpose of § 743(b) because it not only eliminates the "true built-in loss" (based on A's legal position that A's $N14 share of Y's liabilities should be $N15 and A's $N9 deferred COD income should reduce A's interest in Y's previously taxed capital when applying the § 743(b) calculation), but it inappropriately creates gain for A. Although A does not specify the amount of gain created, presumably it is the gain that A would recognize upon a sale or exchange of Y's property after the proposed basis adjustments (reduced by the amount of A's asserted "true built-in loss"). In any event, we disagree that our position inappropriately creates gain for A. This ordinary loss deduction of $N3 reduced A's basis in A's partnership interest in X to $N15. However, the bases in X's assets were not reduced by the ordinary loss deduction, and A continued to hold an interest in X and operate X in Year3 and Year4. The downward inside-basis adjustment of $N13 for A is the logical, necessary, and appropriate consequence of the prior reduction of A's outside basis to $N15 as a result of the § 165(a) ordinary loss deduction in Year2 when § 743(b) applies to a subsequent transaction (in this case, the assets-over merger). The downward inside-basis adjustment of $N13 does not inappropriately create gain for A but carries out the purpose of § 743(b) by correctly applying the rules in § 1.743-1 to reduce A's inside basis in Y and thereby eliminate additional losses or deductions for A in subsequent tax years with respect to the partnership property transferred from X to Y in Year4.

Note that the basis adjustment does not refer to the basis change that triggered the adjustment. Rather, the basis adjustment seeks to reconcile the cumulative effect of anything that changed inside and outside basis.

Code § 755 and the regulations thereunder determine the allocation of the Code § 743(b) basis adjustment among the individual items of partnership property.[4240] Generally, any Code § 743(b) change in the adjusted basis of partnership property will be allocated in a manner which has the effect of reducing the difference between the fair market value in any other manner permitted by regulations.[4241]

In applying this rule, changes in the adjusted basis of property consisting of capital assets and Code § 1231(b) property (property used in a trade or business), or any other property of the

[4240] Code § 743(c); Reg. § 1.743-1(e).

[4241] Code § 755(a), which the regulations follow by allocating according to gain or loss arising from a hypothetical sale. This concept prevents an outside basis decrease due to valuation discounts from reducing the basis of assets with unrealized gain (although such a discount may reduce any basis increase); see part II.H.3 Valuation Discounts – Friend or Enemy, especially fn. 2148. Similarly, a distribution shifting basis to distributed assets under Code § 732 that ordinarily would reduce inside basis cannot reduce the basis of assets with unrealized gain; see parts II.H.2.f Partnership Basis Shifting Opportunities and II.Q.8.b.i.(e) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property (with fn. 5401 referring to this footnote).

partnership, is allocated to partnership property of a like character, except that the basis of any such partnership property is not reduced below zero.[4242] Reg. § 1.755-1(a)(1) provides:

- First, the partnership determines the value of each of its assets.

- Second, the basis adjustment is allocated between the two classes of property consisting of capital assets and Code § 1231(b) property (capital gain property), and any other property of the partnership (ordinary income property). Furthermore, properties and potential gain treated as unrealized receivables under Code § 751(c) and the regulations thereunder are treated as separate assets that are ordinary income property. References to "capital gain" or "ordinary income" property appear to disregard whether there is an unrealized gain or loss.

- Third, the portion of the basis adjustment allocated to each class is allocated among the items within the class.

TAM 201929019 asserted that an assets-over merger constitutes a Code § 761(e) transfer, as described in the text following fn 5623 in part II.Q.8.e.i Distribution of Partnership Interests. The TAM asserted a basis step-down, calculated as follows (and applied as described in the text following fn 4238 earlier in this part II.Q.8.e.iii.(d)):

> Section 1.743-1 sets forth a mathematical formula for calculating the mandatory downward basis adjustment to partnership property when § 743(b) applies to a transaction.[10, 11] Notwithstanding the complications, the formula can be applied to achieve the correct basis adjustment consistent with the purpose of § 743(b), § 752, and subchapter K generally.
>
> > [10] When Congress amended § 743(b) in 2004 to mandatorily apply to substantial built-in loss cases, the mathematical formula was in § 1.743-1(d), which was amended in 1999 to apply to transfers of partnership interests occurring on or after December 15, 1999. Accordingly, Congress was aware that any basis adjustment under § 743(b) would not only take into account the transferee partner's share of built-in gain and built-in loss in determining the partner's share of previously taxed capital but would also take into account the partner's share of partnership liabilities.
> >
> > [11] [blank]
>
> In applying the formula to the facts of this case and for purposes of computing A's adjusted basis in the transferred Y interest under § 1.743-1(c) and A's share of the adjusted basis to the partnership of Y's property under § 1.743-1(d)(1), any net decrease in A's share of X's liabilities that are assumed by Y in Step 1 of the assets-over merger under § 1.708-1(c)(3)(i) must be taken into account to carry out the mandatory basis adjustment of § 743(b). When X is deemed to contribute all of its assets and liabilities to Y in exchange for an interest in Y under § 1.708-1(c)(3)(i), X's (and consequently A's) share of those liabilities decreases under § 752(b) when Y assumes the liabilities. In addition, A, as a momentary indirect partner in Y, is allocated a share of Y's liabilities under § 1.752-3(a)(3).[12] Because A's profit share in Y with respect to its momentary indirect interest in Y is N15, A's share of Y's liabilities under § 1.752-3(a)(3) is $N15. Because the decrease in A's share of X's liabilities of $N14 exceeds A's share of Y's

[4242] Code § 755(b).

liabilities through X after Step 1 of the merger, A would be treated as receiving a distribution of money under § 752(b) after Step 1 of the merger absent the netting rule in § 1.752-1(f). Immediately before the deemed distribution under § 752(b), A's adjusted basis in X is $N15. Therefore, without the netting rule in § 1.752-1(f), A would recognize gain under § 731 after Step 1 of the merger to the extent that the distribution under § 752(b) exceeds A's adjusted basis in X.

[12] Section 1.752-3(a)(1) and (a)(2) do not apply to the facts of this case.

A's unrecognized gain under § 731 represents the net decrease in A's share of X's liabilities that are assumed by Y after Step 1 of the assets-over merger. To carry out the mandatory downward basis adjustment of § 743(b) when there is a disparity between a transferee partner's basis in a resulting partnership and the transferee's share of the adjusted basis to the partnership of the resulting partnership's property, we must account for this decrease in liabilities by respecting the steps of the assets-over merger in § 1.708-1(c)(3)(i) and by taking into account the effect of the netting rule under § 1.752-1(f) in determining the basis adjustments under § 743(b). Therefore, when a net decrease in liabilities under § 752(b) as a result of a deemed contribution of liabilities in Step 1 in an assets-over merger is greater than the transferee partner's outside basis in the terminating partnership, the transferee partner (as a momentary indirect partner in the resulting partnership) must be allocated enough liabilities of the resulting partnership under § 752(a) to avoid recognizing § 731 gain,[13] and/or recognize § 731 gain to the extent that the transferee partner is not allocated a sufficient amount of the liabilities of the resulting partnership.

[13] Allocating enough liabilities to avoid gain recognition under § 731 will also prevent negative basis consequences, which are not recognized under federal tax law. See *Tufts v. Comm'r*, 461 U.S. 300, 310.

Those liabilities of the resulting partnership that are allocated to the transferee partner are included in determining the transferee partner's adjusted basis in the transferred resulting partnership interest under § 1.743-1(c) and the transferee partner's share of the resulting partnership's liabilities for purposes of computing the transferee partner's share of the adjusted basis to the partnership of the resulting partnership's property under § 1.743-1(d)(1). The intended parity of § 743(b) when there is a substantial built-in loss is achieved by taking into account those allocated liabilities in determining the transferee partner's § 743(b) adjustment. Therefore, for purposes of determining A's basis in the transferred Y interest under § 1.743-1(c) and A's share of Y's liabilities for purposes of determining A's share of the adjusted basis to the partnership of Y's property under § 1.743-1(d)(1), A's share of Y's liabilities under § 752(a) after Step 1 of the assets-over merger is $N14, representing the amount of gain that A would recognize under § 731 after Step 1 of the assets-over merger absent the netting rule in § 1.752-1(f).

The netting rule in § 1.752-1(f) determines the effect of a merger under § 752 with respect to a partner. While the netting rule reflects and implements a "single transaction/unitary basis" approach to prevent gain upon a merger, this does not imply that the steps of a merger should be ignored and a net decrease in liabilities after Step 1 of a merger should not be taken into account in determining adjustments under § 743(b). A's § 743(b) adjustment can be computed irrespective of whether the netting rule in § 1.752-1(f) applies by respecting the steps of a merger and accounting for the net decrease in liabilities under § 752.[14] Any other rule or result would have the effect of frustrating the clear intent of § 743(b), which strives to achieve parity between inside basis of partnership property and outside basis of transferred partnership interests when the transfers are subject to that rule. Further, by not making a § 743(b) adjustment, A could be allocated losses or depreciation deductions from Y in subsequent years with respect to any depreciable built-in loss property that X contributed to Y in the assets-over merger which conflicts with Congressional intent in amending § 743(b) to apply in cases where there is a substantial built-in loss.[15] There is no reason why § 743(b) should be prevented from achieving its intended purpose in this case.

[14] For example, when applying the separate/bifurcated approach of § 743(b) to the facts from Example 2 of § 1.752-1(g) assuming a § 754 election is in effect and accounting for B's net decrease in liabilities under § 752, B has no adjustment under § 743. This is correct because before the merger, the inside and outside bases of B in partnership T and partnership S are equal. For simplicity, B's share of partnership liabilities in partnership T and partnership S is determined under § 1.752-3(a)(3). When partnership T merges into partnership S and transfers its assets ($600 of adjusted basis and value of $1,000) and liabilities ($900) to partnership T, B's share of partnership T's liabilities decreases by $630. B's share of partnership S's liabilities, as a momentary indirect partner in partnership S, is $70 (7% of $1,000). Under the netting rule in § 1.752-1(f), B does not recognize any gain under § 731. Absent the netting rule, B would recognize $140 of gain under § 731.

For purposes of determining B's § 743(b) adjustment, B's outside basis in partnership S (transferred partnership interest) is $0 ($420 (B's outside basis in partnership T before the merger) less $630 (decrease in B's share of partnership T's liabilities) plus $70 (B's share of partnership S's liabilities under § 1.752-3(a)(3) as a momentary indirect partner in partnership S) plus $140 of additional liabilities of partnership S (representing the amount of gain under § 731 that B does not recognize as a result of the netting rule in § 1.752-1(f))). B's share of the adjusted basis to the partnership of partnership S's property is $0 (negative $210 (B's interest as a partner in partnership S's previously taxed capital ($70 of cash under § 1.743-1(d)(1)(i) less $280 of tax gain under § 1.743-1(d)(1)(iii))) plus $210 (B's share of partnership S's liabilities, which is the same amount of liabilities used to compute B's outside basis in partnership S)). Therefore, because B's outside basis in partnership S with respect to the transferred partnership interest ($0) over B's share of the adjusted basis to the partnership of partnership S's property ($0) equals $0, there is no § 743 adjustment for B.

The separate/bifurcated approach of § 743(b) also reaches the correct result when applied to the same modified facts from Example 2 of § 1.752-1(g) assuming that another partner, A, in partnership T recognizes gain under § 731. Suppose that prior to the merger, A owns a 30% interest in partnership T, but does not own an interest in partnership S, and Z owns an 80% interest in partnership S. A's adjusted basis in its partnership T interest is $180 and A's share of partnership T's liabilities is $270. Z's share of partnership S's liabilities is $80. After the merger, A has a 3% interest in partnership S, B has a 25% interest in partnership S, and Z has a 72% interest in partnership S. When partnership T merges into partnership S and transfers its assets ($600 of adjusted basis and value of $1,000) and liabilities ($900) to partnership T, A's share of partnership T's liabilities decreases by $270 and Z's share of partnership S's liabilities increases by $640. A's share of partnership S's liabilities, as a momentary indirect partner in partnership S, is $30 (3% of $1,000). Under the netting rule in

§ 1.752-1(f), A will be treated as receiving a distribution under § 752(b) of $240 ($270 decrease in A's share of partnership T's liabilities less $30 increase in A's share of partnership S's liabilities). A's adjusted basis in its partnership S interest before the deemed distribution is $180 ($180 + $0). Because the $240 distribution exceeds A's adjusted basis in its partnership S interest by $60 ($240 - $180), A will recognize $60 of gain under § 731. After the merger, A's adjusted basis in its partnership S interest is $0 and includes A's $30 share of partnership S's liabilities. Z's share of partnership S's liabilities after the merger is $720 ($80 + $640, or 72% of $1,000).

For purposes of determining A's § 743(b) adjustment, A's outside basis in partnership S (transferred partnership interest) is $0 ($180 (A's outside basis in partnership T before the merger) less $270 (decrease in B's share of partnership T's liabilities) plus $30 (B's share of partnership S's liabilities under § 1.752-3(a)(3) as a momentary indirect partner in partnership S) plus $60 (amount of gain A recognizes under § 731)). A's share of the adjusted basis to the partnership of partnership S's property is $0 (negative $30 (A's interest as a partner in partnership S's previously taxed capital ($30 of cash under § 1.743-1(d)(1)(i) less $60 of tax gain under § 1.743-1(d)(1)(iii) adjusted to take into account A's $60 of § 731 gain)) plus $30 (A's share of partnership S's liabilities, which is the same amount of liabilities used to compute A's outside basis in partnership S)). Therefore, because A's outside basis in partnership S with respect to the transferred partnership interest ($0) over A's share of the adjusted basis to the partnership of partnership S's property ($0) equals $0, there is no § 743 adjustment for A.

[15] See footnote 5, *supra*.

[5] In 2004, Congress amended § 743 to mandate a downward inside-basis adjustment to partnership property with respect to a transferee partner in cases where there is a substantial built-in loss in the partnership. Under prior law, these adjustments would only be required in cases where the partnership had an election under § 754 in effect. Congress was concerned that, under those rules, built-in loss at the partnership level could be transferred to a transferee partner who would then be allocated a share of the loss when the partnership disposes of (or depreciates) the property. See H.R. Rep. No. 108-755, at 622 (2004) (Conf. Rep.).

A argues that the Service's interpretation of §§ 743(b) and 752 in the context of an assets-over merger creates a rule that is not in the regulations. We disagree. Although the regulations do not provide a specific example illustrating the analysis for an assets-over merger when § 743(b) applies, the regulations provide the rules necessary to perform the correct analysis consistent with the clear purpose of § 743(b) described above. The Service's position applies the rules in § 1.708-1(c), § 1.743-1(c) and (d)(1), § 1.752-1(f), and § 1.752-3 in an integrated, logical manner that effectuates Congressional intent consistent with the relevant statutes. In contrast, A seeks to apply the rules in § 1.752-3 in a mechanical manner that fails to give proper consideration to how the effect of the netting rule in § 1.752-1(f) must be taken into account to reach the correct results when § 743(b) applies to an assets-over merger. A's partial, mechanical application of the rules in the regulations reaches an erroneous basis adjustment that would allow the transfer of built-in loss assets to the resulting partnership and fails to achieve parity between A's inside/outside basis amounts contrary to § 743(b).

Valuation issues include:

- If the assets of the partnership constitute a trade or business,[4243] then the partnership is required to use the residual method to assign values to the partnership's section 197 intangibles (goodwill, etc.).[4244] The IRS is not bound by the parties' allocation of purchase price, even if the parties are bound by a statement required to be filed with the IRS.[4245]

- Except for certain Code § 743(b) basis adjustments resulting from substituted basis transactions,[4246] partnership gross value generally is equal to the amount that, if assigned to all partnership property, would result in a liquidating distribution to the partner equal to the transferee's basis in the transferred partnership interest immediately following the relevant transfer (reduced by the amount, if any, of such basis that is attributable to partnership

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[4243] As defined in Reg. § 1.1060-1(b)(2), which provides that a group of assets constitutes a trade or business if:

> (A) The use of such assets would constitute an active trade or business under section 355; or
> (B) Its character is such that goodwill or going concern value could under any circumstances attach to such group.

See part II.Q.7.f.iii Active Business Requirement for Code § 355.

[4244] Reg. § 1.755-1(a)(2), which further provides:

> To do so, the partnership must, first, determine the value of partnership assets other than section 197 intangibles under paragraph (a)(3) of this section. The partnership then must determine partnership gross value under paragraph (a)(4) of this section. Last, the partnership must assign values to the partnership's section 197 intangibles under paragraph (a)(5) of this section. For purposes of this section, the term section 197 intangibles includes all section 197 intangibles (as defined in section 197), as well as any goodwill or going concern value that would not qualify as a section 197 intangible under section 197.

Reg. § 1.755-1(a)(3) provides:

> For purposes of this section, the fair market value of each item of partnership property other than section 197 intangibles shall be determined on the basis of all the facts and circumstances, taking into account section 7701(g).

Code § 7701(g) provides:

> *Clarification of fair market value in the case of nonrecourse indebtedness*. For purposes of subtitle A, in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject.

[4245] Reg. § 1.1060-1(c)(4) provides:

> *Effect of agreement between parties*. If, in connection with an applicable asset acquisition, the seller and purchaser agree in writing as to the allocation of any amount of consideration to, or as to the fair market value of, any of the assets, such agreement is binding on them to the extent provided in this paragraph (c)(4). Nothing in this paragraph (c)(4) restricts the Commissioner's authority to challenge the allocations or values arrived at in an allocation agreement. This paragraph (c)(4) does not apply if the parties are able to refute the allocation or valuation under the standards set forth in *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967) (a party wishing to challenge the tax consequences of an agreement as construed by the Commissioner must offer proof that, in an action between the parties to the agreement, would be admissible to alter that construction or show its unenforceability because of mistake, undue influence, fraud, duress, etc.).

[4246] Reg. § 1.755-1(a)(4)(ii):

> applies to basis adjustments under section 743(b) that result from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in the interest or to the basis of other property held at any time by the transferee (substituted basis transactions). In the case of a substituted basis transaction, partnership gross value equals the value of the entire partnership as a going concern, increased by the amount of partnership liabilities at the time of the exchange giving rise to the basis adjustment.

liabilities).[4247] However, in certain circumstances, such as where income or loss with respect to particular section 197 intangibles are allocated differently among partners, partnership gross value may vary depending on the values of particular section 197 intangibles the partnership held.[4248] Also, where a partnership interest is transferred as a result of the death of a partner, the transferee's basis in its partnership interest is determined without regard to Code § 1014(c), and is deemed to be adjusted for that portion of the interest, if any, that is attributable to items representing income in respect of a decedent under Code § 691.[4249]

If the aggregate value of partnership property other than section 197 intangibles[4250] is equal to or greater than partnership gross value,[4251] then all section 197 intangibles are deemed to have a value of zero for purposes of this allocation.[4252] Otherwise, the aggregate value of the partnership's section 197 intangibles (the residual section 197 intangibles value) is deemed to equal the excess of partnership gross value over the aggregate value of partnership property other than section 197 intangibles.[4253] The residual section 197 intangibles value must be

[4247] Reg. § 1.755-1(a)(4)(i)(A).

[4248] Reg. § 1.755-1(a)(4)(i)(B), which further provides:

> In these special situations, the partnership must assign value, first, among section 197 intangibles (other than goodwill and going concern value) in a reasonable manner that is consistent with the ordering rule in paragraph (a)(5) of this section and would cause the appropriate liquidating distribution under paragraph (a)(4)(i)(A) of this section. If the actual fair market values, determined on the basis of all the facts and circumstances, of all section 197 intangibles (other than goodwill and going concern value) is not sufficient to cause the appropriate liquidating distribution, then the fair market value of goodwill and going concern value shall be presumed to equal an amount that if assigned to goodwill and going concern value would cause the appropriate liquidating distribution.

[4249] Reg. § 1.755-1(a)(4)(i)(C).

[4250] Reg. § 1.755-1(a)(3) provides:

> For purposes of this section, the fair market value of each item of partnership property other than section 197 intangibles shall be determined on the basis of all the facts and circumstances, taking into account section 7701(g).

[4251] Gross value as determined in Reg. § 1.755-1(a)(4).

[4252] Reg. § 1.755-1(a)(5)(i).

[4253] Reg. § 1.755-1(a)(5)(i).

allocated first among section 197 intangibles other than goodwill and going concern value[4254] and then to goodwill and going concern value.[4255]

Substituted basis transactions and other transactions have different methodologies.[4256] Subject to certain exceptions for substituted basis transaction:[4257]

- The portion of the basis adjustment allocated to one class of property may be an increase while the portion allocated to the other class is a decrease. This would be the case even though the total amount of the basis adjustment is zero.

- The portion of the basis adjustment allocated to one item of property within a class may be an increase while the portion allocated to another is a decrease. This would be the case even though the basis adjustment allocated to the class is zero.

If the Code § 743(b) basis adjustment does not result from a substituted basis transaction, then the allocation of that adjustment between the classes of property and among the items of property within each class are made based on the allocations of income, gain, or loss[4258] that the transferee partner would receive (to the extent attributable to the acquired partnership interest) if, immediately after the transfer of the partnership interest, all of the partnership's

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[4254] Reg. § 1.755-1(a)(5)(ii) provides:

> *Values assigned to section 197 intangibles other than goodwill and going concern value*. The fair market value assigned to a section 197 intangible (other than goodwill and going concern value) shall not exceed the actual fair market value (determined on the basis of all the facts and circumstances) of that asset on the date of the relevant transfer. If the residual section 197 intangibles value is less than the sum of the actual fair market values (determined on the basis of all the facts and circumstances) of all section 197 intangibles (other than goodwill and going concern value) held by the partnership, then the residual section 197 intangibles value must be allocated among the individual section 197 intangibles (other than goodwill and going concern value) as follows. The residual section 197 intangibles value is assigned first to any section 197 intangibles (other than goodwill and going concern value) having potential gain that would be treated as unrealized receivables under the flush language of section 751(c) (flush language receivables) to the extent of the basis of those section 197 intangibles and the amount of income arising from the flush language receivables that the partnership would recognize if the section 197 intangibles were sold for their actual fair market values (determined based on all the facts and circumstances) (collectively, the flush language receivables value). If the value assigned to section 197 intangibles (other than goodwill and going concern value) is less than the flush language receivables value, then the assigned value is allocated among the properties giving rise to the flush language receivables in proportion to the flush language receivables value in those properties. Any remaining residual section 197 intangibles value is allocated among the remaining portions of the section 197 intangibles (other than goodwill and going concern value) in proportion to the actual fair market values of such portions (determined based on all the facts and circumstances).

[4255] Reg. § 1.755-1(a)(5)(i), (iii).

[4256] Reg. § 1.755-1(b)(1)(i) provides:

> For basis adjustments under section 743(b) resulting from substituted basis transactions, paragraph (b)(5) of this section shall apply. For basis adjustments under section 743(b) resulting from all other transfers, paragraphs (b)(2) through (4) of this section shall apply.

[4257] Reg. § 1.755-1(b)(1)(i).

[4258] Including remedial allocations under Reg. § 1.704-3(d).

property were disposed of in a fully taxable transaction for cash in an amount equal to the fair market value of such property (the hypothetical transaction):[4259]

1. The amount of the basis adjustment allocated to the class of ordinary income property is equal to the total amount of income, gain, or loss[4260] that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the sale of all ordinary income property in the hypothetical transaction.[4261] The amount of the basis adjustment to each item of property within the class of ordinary income property is equal to:

   A. The amount of income, gain, or loss[4262] that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of the item;[4263] reduced by

   B. The product of:[4264]

      - Any decrease to the amount of the basis adjustment to ordinary income property required pursuant to fn 4276; multiplied by

      - A fraction, the numerator of which is the fair market value of the item of property to the partnership and the denominator of which is the total fair market value of all of the partnership's items of ordinary income property.

2. The amount of the basis adjustment to capital gain property is equal to the total amount of the basis adjustment under Code § 743(b) minus he amount of the basis adjustment allocated to ordinary income property.[4265] The amount of the basis adjustment to each item of property within the class of capital gain property is equal to:[4266]

   A. The amount of income, gain, or loss[4267] that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of the item;[4268] minus

   B. The product of:[4269]

      - The total amount of gain or loss[4270] that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all items of capital gain property, minus the amount of the positive basis adjustment

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[4259] Reg. § 1.755-1(b)(1)(ii), which further provides:

> See § 1.460-4(k)(3)(v)(B) for a rule relating to the computation of income or loss that would be allocated to the transferee from a contract accounted for under a long-term contract method of accounting as a result of the hypothetical transaction.

[4260] Including any remedial allocations under Reg. § 1.704-3(d).
[4261] Reg. § 1.755-1(b)(2)(i).
[4262] Including remedial allocations under Reg. § 1.704-3(d).
[4263] Reg. § 1.755-1(b)(3)(i)(A).
[4264] Reg. § 1.755-1(b)(3)(i)(B).
[4265] Reg. § 1.755-1(b)(2)(i).
[4266] Reg. § 1.755-1(b)(3)(ii).
[4267] Including remedial allocations under Reg. § 1.704-3(d).
[4268] Reg. § 1.755-1(b)(3)(ii)(A).
[4269] Reg. § 1.755-1(b)(3)(ii)(B).
[4270] Including remedial allocations under Reg. § 1.704-3(d).

to all items of capital gain property or plus the amount of the negative basis adjustment to capital gain property; multiplied by

- A fraction, the numerator of which is the fair market value of the item of property to the partnership, and the denominator of which is the fair market value of all of the partnership's items of capital gain property.

An asset with respect to which the transferee partner has no interest in income, gain, losses, or deductions shall not be taken into account in calculating this product.[4271] Furthermore, the amount of any decrease in basis allocated to an item of capital gain property above[4272] may not exceed the partnership's adjusted basis in that item; if a decrease in basis allocated above to an item of capital gain property would otherwise exceed the partnership's adjusted basis in that item, the excess must be applied to reduce the remaining basis, if any, of other capital gain assets pro rata in proportion to the bases of such assets (as adjusted under these rules).[4273]

3. In no event may the amount of any decrease in basis allocated to capital gain property exceed the partnership's basis[4274] in capital gain property.[4275] If a decrease in basis allocated to capital gain property would otherwise exceed the partnership's basis in capital gain property, the excess must be applied to reduce the basis of ordinary income property.[4276]

4. Where a partnership interest is transferred as a result of the death of a partner, under Code § 1014(c) the transferee's basis in its partnership interest is not adjusted for that portion of the interest, if any, which is attributable to items representing income in respect of a decedent under Code § 691.[4277]

Next we discuss substituted basis transactions.[4278] Initially, this was limited to Code § 743(b) basis adjustments resulting from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in that interest.[4279] For exchanges on or after June 9, 2003, it also applies to Code § 743(b) basis adjustments that result from exchanges in which the transferee's basis in the partnership interest is determined by reference to other property held at any time by the transferee, including when a partnership interest:[4280]

- Is contributed to a corporation in a Code § 351 transaction,

[4271] Reg. § 1.755-1(b)(3)(iii)(A).
[4272] In the case of property subject to the remedial allocation method, the transferee's share of any remedial loss under Reg. § 1.704-3(d) from the hypothetical transaction.
[4273] Reg. § 1.755-1(b)(3)(iii)(B)
[4274] In the case of property subject to the remedial allocation method, the transferee's share of any remedial loss under Reg. § 1.704-3(d) from the hypothetical transaction.
[4275] Reg. § 1.755-1(b)(2)(i)(B).
[4276] Reg. § 1.755-1(b)(2)(i).
[4277] Reg. § 1.755-1(b)(4)(i), referring to Reg. § 1.742-1. For more details on Reg. § 1.742-1, see fn 5682 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).
[4278] Reg. § 1.755-1(b)(5).
[4279] Reg. § 1.755-1(b)(5)(i).
[4280] Reg. § 1.755-1(b)(5)(i).

- Is contributed to a partnership in a Code § 721(a) transaction, or
- Is distributed by a partnership in a Code § 731(a) transaction.

The substituted basis transaction's effect depends on whether the Code § 743(b) basis adjustment is zero, positive, or negative:[4281]

- If the overall Code § 743(b) basis adjustment is zero, then no adjustment to the basis of partnership property will be made.
- If the overall Code § 743(b) basis adjustment is positive, the increase is allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss[4282] that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all such property would result in a net gain or net income, as the case may be, to the transferee. If an increase in basis may be allocated to both capital gain assets and ordinary income assets, the increase is allocated to each class in proportion to the net gain or net income, respectively, which would be allocated to the transferee from the sale of all assets in each class.
- If the overall Code § 743(b) basis adjustment is negative, the decrease is allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss[4283] that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all such property would result in a net loss to the transferee. If a decrease in basis may be allocated to both capital gain assets and ordinary income assets, the decrease is allocated to each class in proportion to the net loss that would be allocated to the transferee from the sale of all assets in each class.

Any substituted basis increase within a class is allocated in the following order:[4284]

1. To properties with unrealized appreciation in proportion to the transferee's share of the respective amounts of unrealized appreciation before such increase (but only to the extent of the transferee's share of each property's unrealized appreciation), then any remaining increase
2. In proportion to the transferee's share of the amount that would be realized by the partnership upon the hypothetical sale of each asset in the class.

Any substituted basis decrease within a class is allocated in the following order:[4285]

1. To properties with unrealized depreciation in proportion to the transferee's shares of the respective amounts of unrealized depreciation before such decrease (but only to the extent of the transferee's share of each property's unrealized depreciation), then any remaining decrease

[4281] Reg. § 1.755-1(b)(5)(ii).
[4282] Including any remedial allocations under Reg. § 1.704-3(d).
[4283] Including any remedial allocations under Reg. § 1.704-3(d).
[4284] Reg. § 1.755-1(b)(5)(iii)(A).
[4285] Reg. § 1.755-1(b)(5)(iii)(B).

2. In proportion to the transferee's shares of their adjusted bases (as adjusted under the preceding sentence).

However, if a substituted basis decrease must be allocated to capital gain assets, ordinary income assets, or both, and the amount of the decrease otherwise allocable to a particular class exceeds the transferee's share of the adjusted basis to the partnership of all depreciated assets in that class, the transferee's negative basis adjustment is limited to the transferee's share of the partnership's adjusted basis in all depreciated assets in that class.[4286] Also, if a Code § 743(b) transferee's negative basis adjustment cannot be allocated to any asset, because the adjustment exceeds the transferee's share of the adjusted basis to the partnership of all depreciated assets in a particular class, the adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made.[4287]

II.Q.2. Consequences of IRS Audit Exposure for Prior Years' Activities

Consider the impact of part II.G.19 IRS Audits and whether the buyers might want a price adjustment if such audits occur:

- C Corporation. An audit changing a prior year's tax position results in the new shareholders paying the tax.

- S corporation. An audit changing a prior year's tax position results in the former shareholders paying the tax, except to the extent that the change relates to C corporation years,[4288] built-in gain tax,[4289] tax on excess net passive income,[4290] or any other taxes or penalties (for example, payroll taxes) imposed on the entity itself.

- Partnership. Depending on the situation, tax imposed by reason an audit changing a prior year's tax position might be paid by the partnership or by the former partners. Of course, taxes or penalties (for example, payroll taxes) other than income tax might be imposed on the entity itself.

II.Q.3. Installment Sales - Deferring Tax on Lump Sum Payout Expected More than Two Years in the Future

If one expects to sell a business interest for all cash in a few years and would like to defer capital gain on the sale of a business interest, consider selling the business interest in an installment sale to a nongrantor trust. The note might be interest-only for a few years, with principal payments beginning sometime after the business interest is expected to be sold. The trust receives basis for the full amount of the promissory note and can sell the business interest tax-free to the extent of that basis. Similar principles apply to the sale of land or other property that is not depreciable or amortizable.

[4286] Reg. § 1.755-1(b)(5)(iii)(C).
[4287] Reg. § 1.755-1(b)(5)(iii)(D).
[4288] Changes to C corporation years might result not only in more tax but also more earnings & profits (E&P); for the latter, see part II.Q.7.b Redemptions or Distributions Involving S Corporations (effect of E&P on taxation of distributions).
[4289] See part II.P.3.b.ii Built-in Gain Tax on Former C Corporations under Code § 1374.
[4290] See part II.P.3.b.iii Excess Passive Investment Income.

The preamble to the proposed regulations, "Identification of Monetized Installment Sale Transactions as Listed Transactions," Agency/Docket Number REG-109348-22 (8/4/2023), RIN 1545-BQ69, explains in part III, "Installment Sales":

> Section 61(a)(3) provides that a taxpayer's gross income includes gains from dealings in property. Under section 1001(a), a taxpayer's gain on a sale of property is equal to the excess of the amount realized on the sale over the taxpayer's adjusted basis in the property and, generally, a taxpayer must recognize the gain in the taxable year of the sale. The taxpayer's amount realized generally includes cash actually or constructively received, plus the fair market value of any property received or, in the case of a debt instrument issued in exchange for property, the issue price of the debt instrument. See § 1.1001–1 of the Income Tax Regulations.
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> Section 453 provides an exception to the general rule that gain from the sale of property must be recognized in the year of sale. Section 453(a) provides, in general, that income from an installment sale is accounted for under the installment method. Under section 453(b), an installment sale is one in which a taxpayer disposes of property and at least one payment is to be received after the close of the taxable year of the disposition. The installment method, as described in section 453(c), requires a taxpayer to recognize income from a disposition as payments are actually or constructively received, in an amount equal to the proportion of the payment received that the gross profit (realized or to be realized when payment is completed) bears to the total contract price.
>
> Under section 453(f)(3) and 26 CFR 15a.453–1(b)(3) (Temporary Income Tax Regulations Under the Installment Sales Revision Act), a taxpayer generally does not receive a "payment," as such term is used in section 453(b), to the extent the taxpayer receives evidence of indebtedness "of the person acquiring the property" (installment obligation). As a result, notwithstanding that a taxpayer has received an installment obligation from the buyer evidencing the buyer's obligation to pay an amount equal to the purchase price, the taxpayer is not treated as having received full payment in the year in which the taxpayer received the installment obligation. Instead, the taxpayer is treated as receiving payments when the taxpayer receives (or constructively receives) payments under the installment obligation.
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> However, to the extent that the taxpayer receives a note or other evidence of indebtedness in the year of sale from a person other than "the person acquiring the property," section 453(f)(3) is inapplicable. A note or other evidence of indebtedness received in the year of sale issued by a person other than the person acquiring the property is, under § 15a.453-1(b)(3), the receipt of a payment for purposes of section 453. Likewise, under § 15a.453-1(b)(3), the taxpayer's receipt of a note or other evidence of indebtedness that is secured directly or indirectly by cash or a cash equivalent is treated as the receipt of payment for purposes of section 453.
>
> Section 453A(d) provides rules relating to certain installment obligations arising from a disposition of property, the sales price of which is more than $150,000. Under section 453A(d), if any indebtedness is secured by an installment obligation to which section 453A applies, the net proceeds of the secured indebtedness are treated as a payment received on the installment obligation as of the later of the time the indebtedness becomes secured by the installment obligation or the time the taxpayer receives the proceeds of the indebtedness (the pledging rule). To the extent installment

payments are received after the date payment is treated as received under section 453A(d), the tax on such payments is treated as having already been paid.

Potential pitfalls include the following:

- If the trust is a related person (which usually is the case) and it re-sells the business interest within two years, the original seller's deferred gain is accelerated.[4291]

- The original seller's death will not generate a basis step-up in the note.[4292] If the original seller had simply held the business interest until death, part or all of the gain would be eliminated by basis step-up. Consider buying term insurance against the risk of loss of the financial benefit of the basis step-up.

- Be sensitive to possible acceleration of the deferred gain if the original seller later transfers the installment note, including by gift (or transfer to or from a nongrantor trust),[4293] or pledges the note.[4294]

- Beware of the possible need to pay interest on the deferred tax liability if the sale exceeds $5 million.[4295]

- The part of the gain on the sale of a partnership interest attributable to "hot assets" is not eligible for installment sale treatment.[4296]

- The direct or indirect sale of depreciable or amortizable assets to a related party (the nongrantor trust) might trigger ordinary income tax.[4297]

Dealers cannot use the installment method with respect to:[4298]

(A) *Personal property*. Any disposition of personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan.

(B) *Real property*. Any disposition of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.

When entities disposed of real properties that were held for sale to customers in the ordinary course of their trades or businesses, they were not permitted to use the installment method to account for their sales of real properties made by contract for deed.[4299]

[4291] Code § 453(e).
[4292] Code § 1014(c).
[4293] See part II.G.15 Limitations on the Use of Installment Sales for that or other accelerating events.
[4294] Code § 453A(d).
[4295] Code § 453A(c)(4).
[4296] See part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests.
[4297] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).
[4298] Code § 453(b)(2)(A). The quoted language is from Code § 453(*l*)(1) and is subject to exceptions in Code § 453(*l*)(2).
[4299] See *SI Boo, LLC v. Commissioner*, T.C. Memo. 2015-19; see fn. 3438 and the accompanying text for this case's facts and analysis.

See also part II.G.26 Real Estate Special Issues.

II.Q.4. Consequences of Buy-Sell Agreements Not Dependent on Choice of Entity

This part II.Q.4.g begins with practical issues of part II.Q.4.a Funding the Buy-Sell.

Because life insurance is so commonly used to fund buy-sell agreements, it then delves into various life insurance issues in parts:

- II.Q.4.b Transfer for Value Rule; Basis
- II.Q.4.c Income Tax Issues in Transferring Life Insurance; Code § 1035
- II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy)
- II.Q.4.e Income Tax Issues When the Owner Who Is Not the Insured Dies
- II.Q.4.f Split-Dollar Arrangements
- II.Q.4.g Income Tax Trap for Business-Owned Life Insurance

The next issue is part II.Q.4.h Establishing Estate Tax Values, which includes not only gift/estate tax issues in transferring a business interest but also estate tax issues caused by life insurance held by a business to redeem the insured's business interest.

To avoid the latter, the owners might agree to buy each other's interest on death (a "cross purchase"). A solution to several issues raised by a cross purchase is in part II.Q.4.i Life Insurance LLC.

II.Q.4.a. Funding the Buy-Sell

Insurance is by far the most common method by which a buy-sell agreement is funded, whichever form of agreement is used. Special rules apply if the beneficiary is two generations (or the equivalent) younger than the insured.[4300] If a business owner has a parent with an

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[4300] If the policy proceeds are $250,000 or more, the life insurance company will need to verify with the beneficiary that the beneficiary is not a skip person receiving a payment subject to generation-skipping transfer (GST) tax; otherwise the insurance company might need to file relevant forms reporting and paying GST tax. Reg. § 26.2662-1(c)(2)(vi) explains:

> *Example (1)*. *Insurance proceeds less than $250,000*. On August 1, 1997, T, the insured under an insurance policy, died. The proceeds ($200,000) were includible in T's gross estate for Federal estate tax purposes. T's grandchild, GC, was named the sole beneficiary of the policy. The insurance policy is treated as a trust under section 2652(b)(1), and the payment of the proceeds to GC is a transfer from a trust for purposes of chapter 13. Therefore, the payment of the proceeds to GC is a direct skip. Since the proceeds from the policy ($200,000) are less than $250,000, the executor is liable for the tax imposed by chapter 13 and is required to file Form 706.
>
> *Example (2)*. *Aggregate insurance proceeds of $250,000 or more*. Assume the same facts as in Example 1, except T is the insured under two insurance policies issued by the same insurance company. The proceeds ($150,000) from each policy are includible in T's gross estate for Federal estate tax purposes. T's grandchild, GC1, was named the sole beneficiary of Policy 1, and T's other grandchild, GC2, was named the sole beneficiary of Policy 2. GC1 and GC2 are

estate tax problem, that parent's estate tax problem might lend itself to a special opportunity to pay for the policies that fund the buy-sell.[4301]

Not enough attention is focused on disability insurance, which can protect the business' cash flow due to the interruption caused and might also help fund buyouts. To the extent disability is to benefit the disabled person, one should avoid the draconian Code § 409A rules,[4302] which have a stringent disability provision,[4303] and instead pay the key employee compensation sufficient for that person to buy his or her own disability policy.

Having life insurance proceeds paid directly to the selling shareholder does not make the sale tax-free; rather, the payment is treated just as would be any other payment to a seller[4304] (which might be tax-free if the seller has sufficient basis, for example because of a basis step-up in the business interest).

Funding with life insurance under a cross-purchase plan will require that each shareholder own a life insurance policy on the life of every other shareholder. If there are more than three owners, however, policy ownership can become complicated and a stock redemption agreement may make better sense. One alternative to a stock redemption agreement may be a trusteed agreement whereby the trustee would act as custodian of the policies and purchase one life insurance policy for each shareholder. This avoids the need for multiple policies when there are more than two shareholders. If a stock redemption arrangement is employed, the

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skip persons (as defined in section 2613). Therefore, the payments of the proceeds are direct skips. Since the total value of the policies ($300,000) exceeds $250,000, the insurance company is liable for the tax imposed by chapter 13 and is required to file Schedule R-1 of Form 706.
Example (3). *Insurance proceeds of $250,000 or more held by insurance company*. On August 1, 1997, T, the insured under an insurance policy, dies. The policy provides that the insurance company shall make monthly payments of $750 to GC, T's grandchild, for life with the remainder payable to T's great grandchild, GGC. The face value of the policy is $300,000. Since the proceeds continue to be held by the insurance company (the trustee), the proceeds are treated as if they were transferred to a trust for purposes of chapter 13. The trust is a skip person (as defined in section 2613(a)(2)) and the transfer is a direct skip. Since the total value of the policy ($300,000) exceeds $250,000, the insurance company is liable for the tax imposed by chapter 13 and is required to file Schedule R-1 of Form 706.
Example (4). *Insurance proceeds less than $250,000 held by insurance company*. Assume the same facts as in Example 3, except the policy provides that the insurance company shall make monthly payments of $500 to GC and that the face value of the policy is $200,000. The transfer is a transfer to a trust for purposes of chapter 13. However, since the total value of the policy ($200,000) is less than $250,000, the executor is liable for the tax imposed by chapter 13 and is required to file Form 706.
Example (5). On August 1, 1997, A, the insured under a life insurance policy, dies. The insurance proceeds on A's life that are payable under policies issued by Company X are in the aggregate amount of $200,000 and are includible in A's gross estate. Because the proceeds are includible in A's gross estate, the generation-skipping transfer that occurs upon A's death, if any, will be a direct skip rather than a taxable distribution or a taxable termination. Accordingly, because the aggregate amount of insurance proceeds with respect to Company X is less than $250,000, Company X may pay the proceeds without regard to whether the beneficiary is a skip person in relation to the decedent-transferor.

[4301] This tool, generational split-dollar, is described as it was approved in fns. 4538-4540 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4302] See part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

[4303] See part III.B.7.c.vi Deferred Compensation, especially fn. 7362.

[4304] For an analogous situation, see Rev. Rul. 70-254, which is based on *Landfield Finance Company v. U.S.*, 418 F. 2d 172 (7th Cir. 1969), which in turn is based on Reg. § 1.101-1(b)(4).

corporation purchases a life insurance policy on each shareholder. Upon the shareholder's death, the beneficiary then uses the proceeds to purchase the decedent's shares. Similarly, as described in a Letter Ruling, the shareholders could form a limited liability company to own life insurance on each other, with the manager of the LLC retaining the proceeds until the parties agree on proper application of the proceeds.[4305] Also note that split-dollar life insurance arrangements[4306] are subject to Code § 409A rules restricting the events upon which deferred compensation can be paid, the violation of which trigger significant tax, penalties, and interest.[4307] When drafting a shareholder agreement using life insurance, consider authorizing transfers of the policy to the insured for fair market value to avoid Code § 409A risks; defining the value as cash surrender value might not be sufficient, particularly because features, such as no-lapse guarantees (which is the equivalent of prepaid insurance that is not revealed on annual insurance policy statements), provide additional value that is tracked through the life insurance company's internal "shadow account" that can provide surprising results when the insurance company issues IRS Form 712.[4308] Also, make sure that any rights an insured might have to purchase a policy others hold on his life arise only as a collateral consequence of acts or events of independent significance,[4309] so that they do not constitute an incident of ownership.[4310]

[4305] See part II.Q.4.i Life Insurance LLC.

[4306] Split-dollar is a cash value life insurance financing arrangement described in Reg. §§ 1.61-22 and 1.7872-15, with cross-references found in Reg. §§ 1.83-6(a)(5) (income tax treatment on rollout of employee split-dollar), 1.301-1(q) (shareholder arrangements), and 1.1402(a)-18 (self-employment tax issues). See part II.Q.4.f Split-Dollar Arrangements, especially part II.Q.4.i.ii.(b) Corporate Ownership of Policy, including *Machacek v. Commissioner*, where the Sixth Circuit, reversing the Tax Court and ignoring the parties' briefs, held that Reg. § 1.301-1(q) caused economic benefits under even compensatory split-dollar agreements to be treated as distributions and not compensation income to an employee-shareholder.

[4307] Notice 2007-34 sets forth transition rules. See part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules, for a discussion of Code § 409A, including the permissible triggering events. Events that terminate pre-2005 split-dollar agreements often do not comply with these permissible triggering events, so a review of pre-2005 split-dollar agreements is a good idea. See Zaritsky, Aghdami & Mancini, ¶8.02. Life Insurance Funding, *Structuring Buy-Sell Agreements: Analysis With Forms*.

[4308] In the case of a split-dollar arrangement entered into on or before September 17, 2003, and which is not materially modified after that date, only the cash surrender value of the contract is considered to be property. Reg. § 1.83-3(e). Reg. §§ 20.2031-8 and 25.2512-6 determine the value for estate and gift tax purposes - based primarily on interpolated terminal reserve as a measure of the replacement value.

[4309] See part III.B.1.i Transfers with Contingencies Based on Acts of Independent Significance.

[4310] Letter Ruling 8049002 held that no incidents of ownership existed when a shareholder agreement gave the decedent the option to purchase policies at a price equal to the transfer value (cash surrender value), which option was exercisable only if decedent terminated his shareholder relationship with the corporation by offering all stock to the corporation and/or the other principal. This first-refusal option would become operative when a shareholder receives a bona fide offer, a shareholder terminates employment, or a shareholder becomes totally and permanently incapacitated. At date of death, although the option was still outstanding, the decedent had not terminated his shareholder relationship or acted in any way to exercise his option with respect to the insurance policies. The ruling was based on Rev. Ruls. 72-307, 75-50, and 79-46, from which the IRS gleaned an absence of incidents of ownership because the decedent could not independently initiate the events which would enable him to gain control over the policies (except, perhaps, by terminating employment, and, even then, he would not control the corporation's decision to repurchase). Thus, he lacked not only the practical ability to exercise any power with respect to these policies but also any power over the policies. Letter Ruling 9233006 also found no incidents of ownership when shareholders could buy policies on their respective lives and, thus, prevent cancellation of these policies only if the corporation redeems their stock interests in the event that the

If a shareholder is uninsurable, a sinking fund may be used to accumulate funds for premium payments or at least to provide a down payment. The remainder of the purchase price can be subject to an installment agreement whereby the payments can be spread out over a long time period.

When using life insurance, make sure the beneficiary is the owner. Otherwise, when the insured dies, the owner is deemed to have transferred the death benefit to the beneficiary.[4311]

In a redemption agreement, the value of the insurance on the decedent's life will not be includable in the decedent's gross estate for federal estate tax purposes if the corporation is the owner and beneficiary of the policy,[4312] and the insurance proceeds received by the corporation will not be subject to income tax.[4313] Unless a valid agreement that satisfies Code § 2703[4314] provides otherwise, the insurance proceeds will, however, be considered in valuing the decedent's interest in the business,[4315] but perhaps offset by the buy-sell obligation.[4316]

Insurance premiums used to fund the agreement are not deductible by the corporation.[4317] Same with "any interest paid or accrued on any indebtedness with respect to 1 or more life insurance policies owned by the taxpayer covering the life of any individual, or any endowment

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insured is disabled for a prescribed period of time, the insured declines to participate in the sale of the corporation to a third party, or the insured declines to participate in a public offering of the corporation's stock. Thus, the right to acquire the insurance policies and thus, prevent cancellation would arise as a collateral consequence of acts or events of independent significance. That ruling also cited Rev. Ruls. 84-130 and 80-255. The ability to cancel a death benefit by divorcing one's spouse does not generate Code § 2038(a)(1) inclusion; see part III.D Code § 2038.

[4311] *Goodman v. Commissioner of Internal Revenue*, 156 F.2d 218 (2nd Cir. 1946).

[4312] Rev. Rul. 82-85, relying on Reg. § 20.2042-1(c)(6), which is reproduced in part II.Q.4.i.ii.(b) Corporate Ownership of Policy. If the decedent controls the entity that owns the policy and the insurance proceeds are not payable to the corporation or otherwise used for a valid business purpose (such as in satisfaction of a business debt of the corporation) so that the net worth of the corporation is increased by the amount of such proceeds, then the proceeds are includible in the decedent's estate. Reg. § 20.2042-1(c)(6). For purposes of determining whether a decedent controlled stock, the decedent will not be attributed ownership of a trust that the decedent did not create with respect to which the decedent was not the deemed owner under the grantor trust income tax rules. Letter Rulings 9808024 (decedent not deemed owner of trust and therefore not attributed stock ownership), 9511046 (decedent attributed stock ownership as deemed owner of QSST). Also, Code § 2035 causes inclusion if the life insurance proceeds are payable to a third party for other than a Reg. § 20.2042-1(c)(6) business purpose and: (a) the corporation, for less than adequate and full consideration, assigns an insurance policy on the stockholder's life and the stockholder then disposes of control of the corporation, or (b) within three years of death the stockholder had a controlling interest in a corporation that owns a life insurance policy on the stockholder's life. Rev. Rul. 90-21. Situation (2) of Rev. Rul. 90-21 reasoned that a shareholder who holds a non-controlling interest would not hold incidents of ownership; however, the facts did not indicate whether the shareholder had any authority to exercise any control over the policy.

[4313] Code § 101(a)(1). However, the death benefit might trigger significant alternative minimum tax (AMT), because book-tax differences generate an AMT preference. See part II.Q.7.a.v Redemptions and Alternative Minimum Tax.

[4314] See part II.Q.4.h Establishing Estate Tax Values.

[4315] Reg. § 20.2031-2(f); *Newell v. Commissioner*, 66 F.2d 102 (7th Cir. 1933).

[4316] In the *Blount* case, cited in footnote 4584, the Tax Court included the life insurance in the business' value, but the 11th Circuit reversed, holding that the buy-sell obligation offset the inclusion in the company's value.

[4317] Code § 264(a)(1).

or annuity contracts owned by the taxpayer covering any individual."[4318] This rule disallowing interest does "not apply to any interest paid or accrued on any indebtedness with respect to policies or contracts covering an individual who is a key person to the extent that the aggregate amount of such indebtedness with respect to policies and contracts covering such individual does not exceed $50,000."[4319] In this context, "key person" means an officer or 20% owner, except that the number of individuals who may be treated as key persons with respect to any taxpayer cannot exceed the greater of (A) five individuals, or (B) the lesser of 5% of the total officers and employees of the taxpayer or 20 individuals.[4320] In this context, a "20% owner" means any person who owns directly 20% or more of the outstanding stock of a corporation, stock possessing 20% or more of the total combined voting power of all stock of a corporation, or 20% or more of the capital or profits interest in a partnership.[4321] For purposes of determining stock ownership and applying the $50,000 debt limit, all members of a controlled group are treated as one taxpayer, and this limitation shall be allocated among the members of such group in such manner as the Treasury/IRS may prescribe.[4322]

A cross-purchase generally would constitute a taxable sale, treated as a capital gain.[4323] In many cases, a cross-purchase or a redemption that is paid over time can qualify for tax deferral as an installment sale.[4324] However, tax deferral on installment sales can be limited,[4325] so do not assume that it is available without our first having the rules thoroughly researched.

In a cross-purchase arrangement, the value of life insurance owned on the decedent's life by a surviving shareholder will not be included in the decedent's estate for federal estate tax purposes, but the decedent's gross estate will include the value of life insurance the decedent owned on the lives of the surviving shareholders. Premiums paid by the shareholders to fund the agreement are not deductible by the shareholders, and the insurance proceeds paid to the surviving shareholders will not be subject to income tax. Generally, a transferred policy would be valued for income tax purposes at its fair market value, rather than its Form 712 value. *Matthies v. Commissioner*, 134 T.C. 141 (2010 regarding tax years 2000 and 2001), rejected the taxpayer's attempt to used interpolated terminal reserve for income tax purposes, although the rejection appears to have responded to the taxpayer's failure to prove value when engaging in what many people call a pension rescue plan that the court considered to be a scheme. The case also held that, if and to the extent that cash surrender value is used, the value does not consider charges imposed on a surrender of the policy. Rev. Proc. 2005-25 applies generally in the context of valuing compensation under Code §§ 79, 83 and 402. Except for split-dollar arrangements and except for employee trusts and annuity plans subject to Code §§ 402(b) and 403(c), Reg. § 1.83-3(e) provides:

[4318] Code § 264(a)(4). However, such interest reduces earnings and profits if the payor is a C corporation. Rev. Rul. 2009-25.

[4319] Code § 264(e)(1). However, Code § 264(e)(2) may limit the interest deduction to a particular rate.

[4320] Code § 264(e)(3).

[4321] Code § 264(e)(4).

[4322] Code § 264(e)(5)(A). Code § 264(e)(5)(B), "Controlled group," provides:

> For purposes of this paragraph, all persons treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414 shall be treated as members of a controlled group.

[4323] However, in a partnership, part of the sale might constitute ordinary income under Code § 751. See part II.Q.8.e.ii Transfer of Partnership Interests: Effect on Transferring Partner.

[4324] Code § 453.

[4325] Code § 453A.

> In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any undivided interest therein, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than current life insurance protection, are treated as property for purposes of this section.

For qualified retirement plan purposes, see Reg. § 1.402(a)-1(a)(2), the preamble to which is T.D. 9223, which does a good job of explaining how that rule changed. Reg. § 1.402(a)-1(a)(2) requires that surrender charges be ignored in calculating the amount of a distribution from a qualified retirement plan. However, for a nonexempt employee trust (a trust established to fund payments of compensation to be made in the future), surrender charges are considered. *Schwab v. Commissioner*, 136 T.C. 120 (2011) (when surrender charges exceeded cash value, policies valued based on prepaid death benefit when no other evidence of value was introduced), *aff'd* 715 F.3d 1169 (9th Cir. 2013), and *Lowe v. Commissioner*, T.C. Memo. 2011-106. *Lowe* summarized the holding of the Schwab Tax Court opinion, contrasting the qualified retirement plan concept of entire cash value against the nonexempt employee trust concept of entire value:

> We concluded that while the entire cash value of a life insurance policy is determined without regard to surrender charges, the entire value of a life insurance policy is determined by its fair market value, which may include surrender charges. We thus rejected the simple proposition that surrender charges should never count or that they should always count, instead reading section 402(b) to require a court to consider the payment of surrender charges as part of a more general inquiry into the policy's fair market value.

Lowe pointed out that the Tax Court denied the IRS' motion for reconsideration of *Schwab*. In denying the IRS' motion for summary judgment, the *Lowe* court held:

> The facts of the instant case are virtually identical to those presented in *Schwab*. The policies were variable universal life insurance policies with steep premiums, and both were distributed from nonexempt employee trusts in late 2003. Both policies carried surrender charges that rendered the accumulated value of the policy zero or less than zero. In Schwab we decided that the fair market values of the policies the taxpayers received were less than their accumulated values. Here, we are unable to determine the fair market value of Mr. Lowe's policy because the record does not allow us to do so.

Thus, the Tax Court appears to heavily weigh surrender charges in determining the value of a policy for income tax purposes, if a specific rule does not apply to override that. Specific rules to the contrary include qualified retirement plans (discussed above) and split-dollar arrangements (Reg. § 1.61-22(d)(4)(i)). Reg. § 1.83-3(e) provides further:

However, in the case of the transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, which was part of a split-dollar arrangement (as defined in § 1.61-22(b)) entered into (as defined in § 1.61-22(j)) on or before September 17, 2003, and which is not materially modified (as defined in § 1.61-22(j)(2)) after September 17, 2003, only the cash surrender value of the contract is considered to be property. Where rights in a contract providing life insurance protection are substantially nonvested, see § 1.83-1(a)(2) for rules relating to taxation of the cost of life insurance protection.

For estate and gift tax purposes, the IRS Form 712 value is usually, but not always, appropriate. Reg. § 25.2512-6(a) provides:

> The value of a life insurance contract or of a contract for the payment of an annuity issued by a company regularly engaged in the selling of contracts of that character is established through the sale of the particular contract by the company, or through the sale by the company of comparable contracts. As valuation of an insurance policy through sale of comparable contracts is not readily ascertainable when the gift is of a contract which has been in force for some time and on which further premium payments are to be made, the value may be approximated by adding to the interpolated terminal reserve at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date. If, however, because of the unusual nature of the contract such approximation is not reasonably close to the full value, this method may not be used.

Dematteo v. Commissioner, Tax Court Docket 3634-21 (7/21/2022), declined the request for "a determination that a particular method of valuation of certain life insurance policies may be used by petitioner for gift tax purposes." The court refused to choose between Form 712 and another method, saying that the answer:

> [Depends] on the evidence of the nature of the policies and the quality of the respective valuations. Both must be approximations that are reasonable and reliable….

Reg. § 20.2031-8(a)(1), (2) provide:

> (1) The value of a contract for the payment of an annuity, or an insurance policy on the life of a person other than the decedent, issued by a company regularly engaged in the selling of contracts of that character is established through the sale by that company of comparable contracts. An annuity payable under a combination annuity contract and life insurance policy on the decedent's life (e.g., a retirement income policy with death benefit) under which there was no insurance element at the time of the decedent's death (see paragraph (d) of § 20.2039-1) is treated like a contract for the payment of an annuity for purposes of this section.
>
> (2) As valuation of an insurance policy through sale of comparable contracts is not readily ascertainable when, at the date of the decedent's death, the contract has been in force for some time and further premium payments are to be made, the value may be approximate by adding to the interpolated terminal reserve at the date of the decedent's death the proportionate part of the gross premium last paid before the date of the decedent's death which covers the period extending beyond that date. If, however, because of the unusual nature of the contract such an approximation is not reasonably close to the full value of the contract, this method may not be used.

Rev. Rul. 78-137 held:

> In general, the replacement cost of a single premium policy will determine the value of the policy for gift tax purposes. *United States v. Ryerson*, 312 U.S. 260 (1941), Ct. D. 1488, 1941-1 C.B. 447. The replacement cost is based upon the single premium cost of a comparable policy. *Candler v. Allen*, 43 F.Supp. 435 (M.D. Ga. 1942). Generally, the estate tax and gift tax provisions are in *pari materia*. *Sanford Estate v. Commissioner*, 308 U.S. 39 (1939), Ct. D. 426, 1939-2 C.B. 340.

> In order for an insurance policy to qualify as a comparable contract within the meaning of section 20.2031-8(a), the policy must provide the same economic benefits as the policy owned by the decedent. *Candler v. Allen*, above at 437. The economic benefits of a single premium life insurance policy consist of an entire bundle of rights including the right to surrender the policy, the right to retain it for investment virtues, the right to borrow the cash surrender value of the policy and the right to payment of the face amount on the death of the insured. *Guggenheim v. Rasquin*, 312 U.S. 254 (1941), Ct. D. 1487, 1941-1 C.B. 445; *Candler v. Allen*, above at 437. All of the economic benefits of the decedent's policy must be taken into consideration. To single out one economic benefit of the decedent's policy and to disregard the others is, in effect, to substitute a different property interest for the one that was owned by the decedent. *Cf. Guggenheim v. Rasquin*, above at 257.
>
> Since the cash surrender value of the replacement policy is less than the cash surrender value of the decedent's policy, the replacement policy does not reflect all of the economic benefits of the policy owned by the decedent. Therefore, the replacement policy is not a comparable contract within the meaning of section 20.2031-8(a) of the regulations. Accordingly, in the present case, the value of the policy owned by A on the life of A's child shall be determined, for Federal estate tax purposes, by reference to a comparable contract that reflects all of the economic benefits of the decedent's policy. If, however, information pertaining to a comparable contract is not obtainable, the value of the policy shall be determined by reference to the interpolated terminal reserve value of the policy pursuant to section 20.2031-8(a)(2) of the regulations, quoted above.

¶ 3.02[2][a][iii] of Zaritsky & Leimberg, *Tax Planning with Life Insurance: Analysis With Forms* (WG&L), provides an interesting discussion. Also see Anoia, Mendelsohn, and Slane, Complexities of Life Insurance Policy Valuation, *Estate Planning Journal* (June 2014), especially for some insightful analysis of valuing no-lapse guarantee policies.

In a cross purchase funded by life insurance, consider not only the transfer for value but also income tax rules when an owner enters or exits the ownership group. How will policies on the existing owners be transferred to the new owner? How will policies that a departing owner owns be transferred when that person leaves, and how will policies on that person's life be transferred from the other owners? Consider not only income tax but also Code § 409A nonqualified deferred compensation issues. One might use a Life Insurance LLC to minimize these potentially adverse tax consequences – particularly when new insurance can be obtained.[4326]

Using split-dollar arrangements[4327] to fund a cross-purchase might also help when unwinding the arrangement. The insured pays the premiums and is deemed the policy owner under the split-dollar regulations,[4328] but the other business owners are entitled to the term insurance component of the death benefit and hold title and all other incidents of ownership with respect to the policy.[4329] If the insured leaves the business, the policy is transferred to the insured (or, preferably, an irrevocable grantor trust established by the insured); the transfer of the policy to the insured is not deemed a transfer for income tax purposes because the insured was already deemed to be the owner.

[4326] See part II.Q.4.i, Life Insurance LLC.
[4327] See part II.Q.4.f Split-Dollar Arrangements.
[4328] Reg. § 1.61-22(c).
[4329] To avoid estate tax inclusion under Code § 2042.

II.Q.4.b. Transfer for Value Rule; Basis

II.Q.4.b.i. Transfer for Value Rule Generally

If life insurance policies can be transferred among the shareholders or from the corporation to the shareholders, the transfer for value rules must be examined. The transfer-for-value rule states that, if consideration is given for the transfer of an insurance policy, then the proceeds of the policy will be taxed as income to the owner-beneficiary upon the insured's death.[4330] Specifically:[4331]

> A transfer for valuable consideration means any transfer of an interest in a life insurance contract for cash or other consideration reducible to a money value.

Under prior regulations,[4332] the IRS had taken the position that, when an insured transfers a policy on his life to his business co-owner, and his co-owner does the same, the transfer for value rules apply, and the death proceeds will be exempt only to the extent of the new premiums paid after the transfer, with the balance of the proceeds being taxed as ordinary income;[4333] given that T.D. 9879 (10/31/2019) changed the regulation to require "cash or other

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[4330] Code § 101(a)(2) provides, subject to certain exceptions:

> In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee.

Code § 101(a)(1) is the general rule that death benefits are not taxable.

[4331] Reg. § 1.101-1(f)(5).

[4332] Before T.D. 9879 (10/31/2019) was issued, Reg. § 1.101-1(b)(4) provided:

> … a "transfer for a valuable consideration" is any absolute transfer for value of a right to receive all or a part of the proceeds of a life insurance policy. Thus, the creation, for value, of an enforceable contractual right to receive all or a part of the proceeds of a policy may constitute a transfer for a valuable consideration of the policy or an interest therein. On the other hand, the pledging or assignment of a policy as collateral security is not a transfer for a valuable consideration of such policy or an interest therein, and section 101 is inapplicable to any amounts received by the pledgee or assignee.

Rev. Rul. 74-76 held no transfer for value when an employee-participant assigned a life insurance directly to a profit-sharing trust as a voluntary employee contribution.

[4333] Letter Ruling 7734048, reasoning:

> In the case of *Monroe v. Patterson*, 197 F.Supp. 146 (N.D. Ala. 1961), two policies were purchased on the life of an officer-stockholder, one by the insured and the other by the corporation. Subsequently insured entered into an agreement with two key employees for the purchase of his stock at his death. The policies were transferred to a trustee for use in partially financing the agreement and the key employees took over the payment of premiums. Upon insured's death, the proceeds were applied to the purchase of his stock. The Court held, the employees were transferees for value even though they had paid no purchase price for the policies. Their agreement to make the premium payments and to purchase the stock constituted a valuable consideration. Consequently the employees were taxed on the difference between the premiums they had paid and the proceeds applied toward their purchase of the insured's stock.

For additional discussion of the transfer for value rules, see Zaritsky & Leimberg, ¶2.07. The Transfer-For-Value Rule Causing the Loss of Tax-Free Status, *Tax Planning With Life Insurance: Analysis With Forms* (WG&L).

consideration reducible to a money value," that position should no longer apply. A policy without cash value is subject to these rules.[4334]

Reg. § 1.101-1(g)(9), Example (9)(i) treats a nontaxable exchange – a contribution to a partnership in exchange for a partnership interest under Code § 721(a)[4335] – as a transfer for valuable consideration. Also, Reg. § 1.101-1(g)(10), Example 10 assumes that a transfer to a corporation is a transfer for value.

The transfer for value rule does not apply to transfers made to the insured, a corporation in which the insured is an officer or stockholder, a partner of the insured,[4336] a partnership in which the insured is a partner, or where the new owner's basis is determined in whole or in part by reference to the transferor's basis.[4337] This exception looks at the deemed owner of a grantor trust.[4338] A gift subject to a policy loan that is not in excess of basis is a substituted basis

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4334 *James F. Waters, Inc. v. Commissioner*, 160 F.2d 596 (9th Cir. 1947) (prior version of this statute).

4335 See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.

4336 Not surprisingly, Letter Ruling 200120007 treated an LLC as a partnership in applying this rule. That LLC was formed to hold stock in a C corporation. The ruling also treated as having no adverse transfer-for-value effects:

- The transfer of a second-to-die policy to a trust deemed owned by one of the insureds.
- The transfer of a policy from a trust deemed owned by husband to a trust deemed owned by wife (due to Code § 1041 make it a substituted basis transaction).

Letter Ruling 9347016 applied this exception when shareholders bought a policy from a corporation (to facilitate a future cross-purchase of that corporation), triggering the transfer-for-value rule, but the investment partnership the shareholders owned triggered the exception. Same with Letter Ruling 9045004, which had the following facts:

> Corp. X, a C corporation, sells musical instruments. The stock of Corp. X is owned by A (42.85%), B (7.15%), C (42.85%), and D (7.15%). A, B, C, and D also are partners in Partnership. Partnership is involved in rental real estate activities and oil and gas production. A and C each have a 49% interest and B and D each have a 1% interest in Partnership. Corp. X is the owner and beneficiary of two life insurance policies on each of the lives of A and C. Premiums for the policies are paid for by Corp. X.
>
> Corp. X proposes to transfer the ownership and change the beneficiaries on the policies it owns as follows. The two policies currently insuring A will be transferred to B with B as the primary beneficiary and C and D as secondary beneficiaries.
>
> The two policies currently insuring C will be transferred to D with D as the primary beneficiary and A and B as secondary beneficiaries. It is represented that the secondary beneficiaries would be the beneficiaries should the primary beneficiary predecease the insured. It is further represented that Corp. X will retain the cash value portion of the policies and will continue to pay the premiums for that portion representing the cash value. The new owners of the policies will pay the premiums representing the life insurance portion of the policies.
>
> It is represented that the purpose of the transaction is to facilitate a buy-sell agreement. Upon the death of one or more of the insureds of the insurance policies, the financial means will be available for the remaining shareholders to secure control of Corp. X by purchasing the decedent's share from his estate.

4337 Code § 101(a)(2)(A), (B).

4338 Rev. Rul. 2007-13 posited the following situations:

> Situation 1. TR1 and TR2 are grantor trusts, both of which are treated as wholly owned by G under subpart E of Part I of subchapter J of the Internal Revenue Code. TR2 owns a life insurance contract upon the life of G. TR2 transfers the life insurance contract to TR1 in exchange for cash.
>
> Situation 2. The facts are the same as in Situation 1, except that TR2 is not a grantor trust.

It held:

transaction that does not trigger the transfer-for-value rule.[4339] A transfer of an interest in a partnership that owns a life insurance policy is not subject to the transfer for value rules if the

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> The grantor who is treated for federal income tax purposes as the owner of a trust that owns a life insurance contract on the grantor's life is treated as the owner of the contract for purposes of applying the transfer for value limitations of § 101(a)(2). Accordingly, in Situation 1, the transfer of a life insurance contract between two grantor trusts that are treated as wholly owned by the same grantor is not a transfer for a valuable consideration within the meaning of § 101(a)(2); in Situation 2, the transfer of a life insurance contract to a grantor trust that is treated as wholly owned by the insured is a transfer to the insured within the meaning of § 101(a)(2)(B) and is therefore excepted from the transfer for value limitations under § 101(a)(2).

Note that Rev. Proc. 2019-3, Section 3.01(14) states that the IRS will not issue letter rulings on:

> Section 101.—Certain Death Benefits.—Whether there has been a transfer for value for purposes of § 101(a) in situations involving a grantor and a trust when (i) substantially all of the trust corpus consists or will consist of insurance policies on the life of the grantor or the grantor's spouse, (ii) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (iii) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, and (iv) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under §§ 673 to 677.

However, that did not stop the IRS from issuing Letter Ruling 201423009, which including the following facts and conclusions:

> Individual A and his spouse, Individual B, are the grantors of the AC Trust. The AC Trust, as amended, is represented to be a grantor trust for federal income tax purposes owned by Individual A and Individual B. The AC Trust, as amended, owns and is currently the beneficiary of Number Y life insurance contracts on the joint lives of Individual A and Individual B and the Number X policy on Individual B (collectively, the life insurance contracts which total Number Z policies).
>
> The movement of the life insurance contracts from the AC Trust to the AB Trust has two aspects. The first aspect is that, pursuant to the rationale of Rev. Rul. 85-13, Individual A, as a grantor of the AC Trust, as amended, proposes to transfer the life insurance contracts to the AB Trust of which Individual A is the grantor. Thus, this aspect of the transaction cannot be recognized as a sale or exchange for tax purposes because Individual A is treated for income tax purposes as owning the purported consideration both before and after the transaction. The second aspect of the transaction is that Individual B's interest in the AC Trust (in which she is a grantor) is being moved to the AB Trust in which Individual B's husband, Individual A, is the grantor. This action has the result, under § 1041(a), as being treated as a gift to her husband, Individual A, who pursuant to § 1041(b) receives a carryover basis in the life insurance contracts from his wife, Individual B.

[4339] Rev. Rul. 69-187 involved the following facts:

> *A* was the owner of a life insurance policy on his life under which his estate was designated as the beneficiary. The policy was in the face amount of 2,000x dollars, and had a value of approximately 860x dollars. Approximately 845x dollars had been advanced to *A* as a policy loan, on the security of the value of the policy and without personal liability on the part of *A*. *A* transferred the policy, subject to the indebtedness, to his wife, *B*. The transfer was made by the execution by *A* of a form that designated the new owner as *B*, and on her death, then to the executors, administrators, or assigns of *B*. *B* did not assume any personal liability with respect to the indebtedness.

Rev. Rul. 69-187 held:

> In the instant case the transferee's interest in the life insurance policy was acquired in part for a valuable consideration and in part by gift. Thus, upon the insured's death the insurance proceeds will be received under a policy that has a basis with respect to the transferee determinable in part by reference to the basis of the policy in the hands of the transferor. Accordingly, the limitation

transfer does not constitute a termination of the partnership.[4340] Similarly, contributing a life insurance policy to a partnership in a Code § 721 nontaxable transfer[4341] is a substituted basis transaction that is not subject to the original transfer for value rules[4342] but may need to be checked under the reportable policy sale rule under part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

II.Q.4.b.ii. The Impact of Reportable Policy Sale on Transfer for Value Rule

Special rules apply to a "reportable policy sale," which is "the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract."[4343] "Indirectly" includes "the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract."[4344] Special rules for a reportable policy sale include:

- The exceptions to the transfer for value rule described above, all of which are Code § 101(a)(2)(A) or (B), do not apply.[4345] Thus, the death benefit generally is taxable, to the extent described in fn 4330.

- Various reporting requirements apply when the death benefit is paid.[4346]

The relevant committee report provides:

> **In general**
>
> The provision imposes reporting requirements in the case of the purchase of an existing life insurance contract in a reportable policy sale and imposes reporting requirements on the payor in the case of the payment of reportable death benefits. The provision sets forth rules for determining the basis of a life insurance or annuity contract. Lastly, the

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> provided in section 101(a)(2) of the Code is not applicable. Upon the death of the insured, the proceeds of the policy are paid to *B* solely by reason of the death of the insured and are excludable from her gross income, as provided in section 101(a)(1) of the Code, except to the extent that section 101(d) of the Code is applicable by reason of payment of the proceeds at a date later than the death of the insured.

See also Letter Rulings 8628007 and 8951056, the latter pointing out that the transaction was substituted basis because basis exceeded debt.

[4340] Letter Ruling 200826009. Note, however, that Rev. Proc. 2011-3, Section 3.01(8) states that the IRS will not issue letter rulings on:

> Sections 101, 761, and 7701.—Definitions. — Whether, in connection with the transfer of a life insurance policy to an unincorporated organization, (i) the organization will be treated as a partnership under §§ 761 and 7701, or (ii) the transfer of the life insurance policy to the organization will be exempt from the transfer for value rules of § 101, when substantially all of the organization's assets consists or will consist of life insurance policies on the lives of the members.

[4341] See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.

[4342] Letter Ruling 201308019.

[4343] Code § 101(a)(3)(B).

[4344] Code § 101(a)(3)(B).

[4345] Code § 101(a)(3)(A).

[4346] Code § 6050Y, which is reproduced in part II.Q.4.b.ii.(f) Reporting Requirements for Reportable Policy Sales.

provision modifies the transfer for value rules in a transfer of an interest in a life insurance contract in a reportable policy sale.

Reporting requirements for acquisitions of life insurance contracts

Reporting upon acquisition of life insurance contract

The reporting requirement applies to every person who acquires a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale during the taxable year. A reportable policy sale means the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured (apart from the acquirer's interest in the life insurance contract). An indirect acquisition includes the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract.

Under the reporting requirement, the buyer reports information about the purchase to the IRS, to the insurance company that issued the contract, and to the seller. The information reported by the buyer about the purchase is (1) the buyer's name, address, and taxpayer identification number ("TIN"), (2) the name, address, and TIN of each recipient of payment in the reportable policy sale, (3) the date of the sale, (4) the name of the issuer, and (5) the amount of each payment. The statement the buyer provides to any issuer of a life insurance contract is not required to include the amount of the payment or payments for the purchase of the contract.

Reporting of seller's basis in the life insurance contract

On receipt of a report described above, or on any notice of the transfer of a life insurance contract to a foreign person, the issuer is required to report to the IRS and to the seller (1) the name, address, and TIN of the seller or the transferor to a foreign person, (2) the basis of the contract (*i.e.*, the investment in the contract within the meaning of section 72(e)(6)), and (3) the policy number of the contract. Notice of the transfer of a life insurance contract to a foreign person is intended to include any sort of notice, including information provided for nontax purposes such as change of address notices for purposes of sending statements or for other purposes, or information relating to loans, premiums, or death benefits with respect to the contract.

Reporting with respect to reportable death benefits

When a reportable death benefit is paid under a life insurance contract, the payor insurance company is required to report information about the payment to the IRS and to the payee. Under this reporting requirement, the payor reports (1) the name, address and TIN of the person making the payment, (2) the name, address, and TIN of each recipient of a payment, (3) the date of each such payment, (4) the gross amount of the payment, and (5) the payor's estimate of the buyer's basis in the contract. A reportable death benefit means an amount paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale.

For purposes of these reporting requirements, a payment means the amount of cash and the fair market value of any consideration transferred in a reportable policy sale…

> **Scope of transfer for value rules**
>
> The provision provides that the exceptions to the transfer for value rules do not apply in the case of a transfer of a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale. Thus, some portion of the death benefit ultimately payable under such a contract may be includable in income.

The last paragraph above, consistent with the statutory language, does not say that a reportable policy sale is an additional type of transfer that is subject to the transfer for value rule; rather, it says that the exceptions to the transfer for value rule do not apply when the transfer is also a reportable policy sale. Notwithstanding this lack of income tax effect of a reportable policy sale that is not a transfer for value, a reportable policy may be subject to additional reporting obligations, which are purely informational.[4347]

II.Q.4.b.ii.(a). Income Tax Effect of a Reportable Policy Sale

Below is a discussion of Reg. § 1.101-1, overhauled by REG-103083-18.

Part 6 of the preamble to the proposed regulations, REG-103083-18 (3/25/2019), "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death," explains:

> Generally, amounts received under a life insurance contract that are paid by reason of the death of the insured are excluded from federal income tax under section 101(a)(1). However, if a life insurance contract is sold or otherwise transferred for valuable consideration, the "transfer for value rule" set forth in section 101(a)(2) limits the excludable portion of the amount paid by reason of the death of the insured. Section 101(a)(2) provides that the excludable amount following a transfer for valuable consideration generally may not exceed the sum of (1) The actual value of the consideration paid by the transferee to acquire the life insurance contract and (2) the premiums and other amounts subsequently paid by the transferee. Section 101(a)(2) provides two exceptions to this transfer for value rule. Specifically, the limitation set forth in section 101(a)(2) does not apply if (1) The transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis in the contract or (2) the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.
>
> Section 13522 of the Act added section 101(a)(3) to the Code. Section 101(a)(3)(A) provides that these two exceptions shall not apply in the case of a transfer of a life insurance contract, or any interest therein, that is a reportable policy sale. Section 101(a)(3)(B) defines the term "reportable policy sale" to mean the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract. For purposes of the preceding sentence, the term "indirectly" applies to the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract.

[4347] For more about these nuances, see part II.Q.4.b.ii.(g) Transfer of Interest in an Entity Holding Life Insurance, especially fn 4395.

> The proposed regulations update § 1.101-1(a)(1) of the existing regulations to reflect the repeal of section 101(b) (treatment of employees' death benefits) in 1996, and the addition of section 7702 (definition of life insurance contract) in 1984, section 101(j) (treatment of certain employer-owned life insurance contracts) in 2006, and section 101(a)(3) (exception to valuable consideration rules for reportable policy sales) in 2017. The proposed regulations remove the second and third sentences of § 1.101-1(a)(1) of the existing regulations and add a sentence at the end of § 1.101-1(a)(1) to address the earlier changes in law. To address the changes in law made by the Act, the proposed regulations under section 101 provide updated rules for determining the amount of death benefits excluded from gross income following a transfer for value or gratuitous transfer, including a reportable policy sale, and provide definitions applicable under section 101. The proposed regulations under section 6050Y adopt the relevant definitions by cross-reference.

Part 6 of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Comments and Changes Relating to § 1.101-1(a) of the Proposed Regulations," explains:

> The proposed regulations would remove the second sentence of § 1.101-1(a)(1) of the existing regulations, which states: "Death benefit payments having the characteristics of life insurance proceeds payable by reason of death under contracts, such as workmen's compensation insurance contracts, endowment contracts, or accident and health insurance contracts, are covered by this provision." As noted in the preamble to the proposed regulations, this update reflects the addition of section 7702 to the Code in 1984. See 84 FR 11015.
>
> One commenter stated that it is important that no changes be made with respect to the second sentence because the benefits described therein were written into older policies, some of which are still in effect, and changing the rules would negatively impact policyholders who have long relied on the appropriate exclusion of these death benefits from income. The commenter further stated that there is a longstanding and extensive body of court decisions and IRS rulings that establish the conditions under which such benefits qualify for treatment as life insurance proceeds.
>
> In response to these comments, the final regulations revise, rather than remove, the second sentence of § 1.101-1(a)(1) of the existing regulations to clarify that the sentence only applies to contracts issued on or before December 31, 1984, the effective date of section 7702.

Reg. § 1.101-1(a)(1) was changed by "Revising the second sentence of paragraph (a)(1), removing the third sentence of paragraph (a)(1), and adding a sentence at the end of paragraph (a)(1), as follows:

> … Death benefit payments having the characteristics of life insurance proceeds payable by reason of death under contracts, such as workmen's compensation insurance contracts, endowment contracts, or accident and health insurance contracts, issued on or before December 31, 1984, are covered by this provision…. If the life insurance contract is an employer-owned life insurance contract within the definition of section 101(j)(3), the amount to be excluded from gross income may be affected by the provisions of section 101(j).

Thus, Reg. § 1.101-1(a) now reads:

(1) *In general*. Section 101(a)(1) states the general rule that the proceeds of life insurance policies, if paid by reason of the death of the insured, are excluded from the gross income of the recipient. Death benefit payments having the characteristics of life insurance proceeds payable by reason of death under contracts, such as workmen's compensation insurance contracts, endowment contracts, or accident and health insurance contracts, issued on or before December 31, 1984, are covered by this provision. For provisions relating to death benefits paid by or on behalf of employers, see section 101(b) and § 1.101-2. The exclusion from gross income allowed by section 101(a) applies whether payment is made to the estate of the insured or to any beneficiary (individual, corporation, or partnership) and whether it is made directly or in trust. The extent to which this exclusion applies in cases where life insurance policies have been transferred for a valuable consideration is stated in section 101(a)(2) and in paragraph (b) of this section. In cases where the proceeds of a life insurance policy, payable by reason of the death of the insured, are paid other than in a single sum at the time of such death, the amounts to be excluded from gross income may be affected by the provisions of section 101(c) (relating to amounts held under agreements to pay interest) or section 101(d) (relating to amounts payable at a date later than death). See §§ 1.101-3 and 1.101-4. However, neither section 101(c) nor section 101(d) applies to a single sum payment which does not exceed the amount payable at the time of death even though such amount is actually paid at a date later than death. If the life insurance contract is an employer-owned life insurance contract within the definition of section 101(j)(3), the amount to be excluded from gross income may be affected by the provisions of section 101(j).[4348]

(2) *Cross references*. For rules governing the taxability of insurance proceeds constituting benefits payable on the death of an employee -

(i) Under pension, profit-sharing, or stock bonus plans described in section 401(a) and exempt from tax under section 501(a), or under annuity plans described in section 403(a), see section 72(m)(3) and paragraph (c) of § 1.72-16;

(ii) Under annuity contracts to which § 1.403(b)-3 applies, see § 1.403(b)-7. For the definition of a life insurance company, see section 801; or

(iii) Under eligible State deferred compensation plans described in section 457(b), see paragraph (c) of § 1.457-1.

Part 1.B. of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Applicability Date for Section 101 Regulations," explains:

> Section 1.101-6(b) of the proposed regulations provides that, for purposes of section 6050Y, § 1.101-1(b), (c), (d), (e), (f), and (g) apply to reportable policy sales made after December 31, 2017, and to reportable death benefits paid after December 31, 2017. Section 1.101-6(b) of the proposed regulations further provides that, for any other purpose, § 1.101-1(b), (c), (d), (e), (f), and (g) apply to transfers of life

[4348] [my footnote:] For Code § 101(j), see part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

> insurance contracts, or interests therein, made after the date the Treasury decision adopting the proposed regulations as final regulations is published in the Federal Register.
>
> Several commenters requested clarification regarding the applicability dates set forth in § 1.101-6(b) of the proposed regulations. Two of these commenters requested that the Treasury Department and the IRS clarify that the rules issued with respect to section 101(a)(3) apply to all transfers of life insurance contracts, or interests therein, made after December 31, 2017, or alternatively, that the Treasury Department and the IRS allow taxpayers to rely upon the rules in § 1.101-1 of the proposed regulations for transactions undertaken after December 31, 2017, and before the date that the Treasury Department adopts final rules. Another commenter recommended that application of the rules under section 101 (as well as the reporting obligations under section 6050Y) be delayed until 60 days after the date the final regulations are published in the Federal Register, but suggested that language should be included in the preamble to the final regulations to provide that taxpayers may rely on the proposed regulations for the period prior to the effective date of the final regulations.
>
> Because the final regulations provide that the reporting obligations under section 6050Y apply to reportable policy sales and payments of reportable death benefits occurring after December 31, 2018, for purposes of determining whether a transfer of an interest in a life insurance contract is a reportable policy sale or a payment of death benefits is a payment of reportable death benefits subject to the reporting requirements of section 6050Y and §§ 1.6050Y-1 through 1.6050Y-4 of the final regulations, the definitions and rules set forth in § 1.101-1(b) through (g) of the final regulations apply to reportable policy sales made after December 31, 2018, and to reportable death benefits paid after December 31, 2018. See §§ 1.101-6(b) and 1.6050Y-1(b) of the final regulations.
>
> The final regulations provide that, for other purposes, specifically for purposes of determining the amount of the proceeds of life insurance contracts payable by reason of death excluded from gross income under section 101, § 1.101-1(b) through (g) of the final regulations apply to amounts paid by reason of the death of the insured under a life insurance contract, or interest therein, transferred after October 31, 2019. However, under section 7805(b)(7), a taxpayer may apply the rules set forth in § 1.101-1(b) through (g) of the final regulations, in their entirety, with respect to all amounts paid by reason of the death of the insured under a life insurance contract, or interest therein, transferred after December 31, 2017, and on or before October 31, 2019.

Reg. § 1.101-6(b) provides:

> Notwithstanding paragraph (a) of this section, for purposes of determining whether a transfer of an interest in a life insurance contract is a reportable policy sale or a payment of death benefits is a payment of reportable death benefits subject to the reporting requirements of section 6050Y and §§ 1.6050Y-1 through 1.6050Y-4, § 1.1011(b) through (g) apply to reportable policy sales made after December 31, 2018, and to reportable death benefits paid after December 31, 2018. For any other purpose, including for purposes of determining the amount of the proceeds of life insurance contracts payable by reason of death excluded from gross income under section 101, § 1.101-1(b) through (g) apply to amounts paid by reason of the death of the insured under a life insurance contract, or interest therein, transferred after October 31, 2019.

> However, under section 7805(b)(7), a taxpayer may apply the rules set forth in § 1.101-1(b) through (g) of the final regulations, in their entirety, with respect to all amounts paid by reason of the death of the insured under a life insurance contract, or interest therein, transferred after December 31, 2017, and on or before October 31, 2019.

Reg. § 1.101-1(b)(1)(i), "In general," (under (b)(1), "Transfer of an interest in a life insurance contract for valuable consideration") provides:

> In the case of a transfer of an interest in a life insurance contract for valuable consideration, including a reportable policy sale for valuable consideration, the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited under section 101(a)(2) to the sum of the actual value of the consideration for the transfer paid by the transferee and the premiums and other amounts subsequently paid by the transferee with respect to the interest. For exceptions to this general rule for certain transfers for valuable consideration that are not reportable policy sales, see paragraph (b)(1)(ii) of this section. The application of section 101(d), (f) or (j), which is not addressed in paragraph (b) of this section, may further limit the amount of the proceeds excludable from gross income.

Before getting into the exceptions to the transfer-for-value rule, let's address the last sentence of Reg. § 1.101-1(b)(1)(i). Code § 101(d) provides that payments other than simply the death benefit on the date of death will be taxable. Code § 101(f) relates to "a flexible premium life insurance contract issued before January 1, 1985." Code § 101(j) relates to a policy owned by an employer of or business entity owned by an insured; see part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

Part 1.B.2 of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Comments and Changes Relating to § 1.101-1(b) of the Proposed Regulations," explains:

> Generally, amounts received under a life insurance contract that are paid by reason of the death of the insured are excluded from gross income for Federal income tax purposes under section 101(a)(1). However, if a life insurance contract or interest therein is sold or otherwise transferred for valuable consideration, the "transfer for value rule" set forth in section 101(a)(2) limits the excludable portion of the amount received by reason of the death of the insured to the sum of the consideration paid for the contract or interest therein and any premiums and other amounts subsequently paid by the transferee with respect to the contract or interest therein. Section 101(a)(2)(A) and (B) provide two exceptions to this transfer for value rule. One exception (the "certain person exception") applies to transfers to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer ("certain persons"). See section 101(a)(2)(B). The other exception (the "carryover basis exception") applies if the transferee's basis for determining gain or loss in the life insurance contract or interest therein is determined in whole or in part by reference to the transferor's basis in the contract or interest therein. See section 101(a)(2)(A). Under section 101(a)(3), which was added by section 13522 of the TCJA, neither of these exceptions to the transfer for value rule apply in the case of a transfer of a life insurance contract, or any interest therein, that is a reportable policy sale.
>
> Section 1.101-1(b)(1)(i) of the proposed regulations provides the general transfer for value rule set forth in section 101(a)(2). Section 1.101-1(b)(1)(ii) of the proposed regulations sets forth the exceptions from this general rule for transfers for valuable

consideration that are not reportable policy sales (the certain person exception and carryover basis exception provided in section 101(a)(2)). Section 1.101-1(b)(2) of the proposed regulations provides rules regarding gratuitous transfers of interests in life insurance contracts, as well as transfers of only a part of an interest in a life insurance contract and bargain sales of an interest in a life insurance contract (that is, transfers that are in part gratuitous and in part transfers for valuable consideration). This section of this Summary of Comments and Explanation of Revisions discusses comments received on § 1.101-1(b) of the proposed regulations.

A. Transfers to certain persons

One commenter on the proposed regulations described a life insurance policy subject to the section 101(a)(2) transfer for value rule as "tainted," in that death benefits paid under the policy are no longer fully excluded from income under section 101(a)(1). The commenter asked that the final regulations provide for removal of the "taint" by a transfer to the insured, as was permitted before the TCJA, and asked for clarification regarding whether a transfer of a policy to the insured must be a sale for fair market value to remove the "taint" of a transfer for valuable consideration. The commenter suggested that mistakes happen, including the mistake of not seeking tax advice from a professional who knows the section 101 rules, and that taxpayers should be able to take corrective measures to remove this "taint." The commenter noted that the insured may no longer have a business or other need for the current transferee to own the policy and may wish to hold the policy to protect the insured's family, or the insured may regret selling the policy and wish to buy the policy back after the policy was transferred in a reportable policy sale. The commenter pointed out that § 1.101-1(b)(3)(ii) of the existing regulations (not yet revised to reflect TCJA changes to section 101) currently provides such a corrective measure, allowing the "taint" to be removed by a transfer of the policy to certain persons. However, § 1.101-1(b)(1)(ii)(B)(2) of the proposed regulations makes this corrective measure unavailable to the extent that the transfer to those certain persons was preceded by a transfer of the policy for valuable consideration in a reportable policy sale. The commenter also noted that § 1.101-1(b)(3)(ii) of the existing regulations does not require the corrective transfer to be a sale for fair market value, and that § 1.101-1(b)(1)(ii)(B)(/) of the proposed regulations does not impose such a requirement. The commenter suggested that Example 1, Example 2, and Example 3 in § 1.101-1(g)(1), (2), and (3) of the proposed regulations, read together, however, appear to require that the transfer to the insured be a sale for fair market value to clear the "taint" of a prior transfer for valuable consideration. The commenter asked for clarification on this point. The commenter suggested that the transfer to the insured be available as a corrective measure even if that transfer was preceded by a reportable policy sale, and, to prevent any possible abuse, that the insured be required to pay fair market value if the policy previously had been transferred in a reportable policy sale.[4349]

Section 1.101-1(b)(1)(ii)(B)(/) of the proposed regulations does not explicitly require that the valuable consideration for a transfer of an interest in a life insurance contract be equal to the interest's fair market value, but, in the case of a bargain sale, the rules implementing the provisions of section 101 are applied separately to the sale and gift portions of the transferred interest. Under § 1.101-1(b)(2)(iii) of the proposed regulations, part of the transfer in a bargain sale is treated as a gratuitous transfer subject to § 1.101-1(b)(2)(i) of the proposed regulations. Example 1, Example 2, and Example 3 in § 1.101-

[4349] [My footnote:] I was that commenter.

1(g)(1), (2), and (3) of the proposed regulations are intended to illustrate the application of the rules implementing the changes made by the TCJA. For the sake of simplicity, the consideration in these examples equals fair market value, so the bargain sale rules do not apply. The final regulations include an example that illustrates the application of the bargain sale rules. See Example 7 in § 1.101-1(g)(7) of the final regulations.

In response to the comments received, the final regulations provide for a fresh start with respect to an interest gratuitously transferred to the insured, provided the interest has not previously been transferred for value in a reportable policy sale. See § 1.101-1(b)(2)(i) of the final regulations. Example 2 in § 1.101-1(g)(2) of the final regulations illustrates the application of this rule. The final regulations also provide for a fresh start with respect to an interest (or portion thereof) that is transferred to the insured following a reportable policy sale of the interest for valuable consideration, but only to the extent that the insured pays fair market value for the interest and only with respect to the interest (or relevant portion thereof) transferred to the insured that is not subsequently transferred in a transfer for valuable consideration or in a reportable policy sale. See § 1.101-1(b)(1)(ii)(B)(3) of the final regulations. The application of this rule is illustrated in revised Example 6, new Example 7, new Example 8, and new Example 9 in § 1.101-1(g)(6), (g)(7), (g)(8), and (g)(9) of the final regulations.

B. Gratuitous Transfers

Under § 1.101-1(b)(2)(i) of the proposed regulations, the amount of the policy proceeds attributable to a gratuitously transferred interest in a life insurance policy that is excludable from gross income under section 101(a)(1) is limited to the sum of the amount attributable to the gratuitously transferred interest that would have been excludable by the transferor if the transfer had not occurred, and the premiums and other amounts subsequently paid by the transferee with respect to the interest. Unlike the existing regulations, the proposed regulations do not provide a special rule for a gratuitous transfer made by or to certain persons.[1] As explained in the preamble to the proposed regulations, such a rule is not required by section 101(a), and a special rule for these transfers could be subject to abuse. *See* 84 FR 11009, 11017.

[1] Under § 1.101-1(b)(2) of the existing regulations, in the case of a gratuitous transfer, by assignment or otherwise, of a life insurance policy or any interest therein, the amount of the proceeds attributable to such policy or interest that is excludable from the transferee's gross income under section 101(a) is, as a general rule, limited to the sum of the amount which would have been excludable by the transferor if no such transfer had taken place and any premiums and other amounts subsequently paid by the transferee with respect to the interest. However, if the gratuitous transfer in question is made by or to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer, the entire amount of the proceeds attributable to the policy or interest transferred is excludable from the transferee's gross income.

Section 1.101-1(b)(2)(i) of the proposed regulations applies to any gratuitous transfer of an interest in a life insurance contract, "including a reportable policy sale that is not for valuable consideration." One commenter requested that this language be deleted, asserting that including gratuitous transfers within the definition of reportable policy sales is not consistent with section 101.[2] The commenter noted that the title of section 101(a)(3) is "Exception to valuable consideration rules for commercial transactions," which the commenter asserted makes clear that a reportable policy sale can occur only if there has been a transfer for valuable consideration. The commenter further asserted that the provisions of section 101(a)(3)(A) and (B) limit the relevance of reportable policy sales to those situations in which a taxpayer needs to determine whether one of the section 101(a)(2) exceptions applies and, because those exceptions are never relevant for gratuitous transfers, reportable policy sales are never relevant for gratuitous transfers.

[2] The commenter also asserted that this language creates unnecessary and confusing reporting requirements under section 6050Y for gift transfers and is inconsistent with the statutory language, which, according to the commenter, indicates that a reportable policy sale must be a transfer for value. The commenter's concerns about reporting are discussed in section 10.A of this Summary of Comments and Explanation of Revisions.

The TCJA added section 101(a)(3)(A) to provide that the two pre-existing exceptions to the transfer for value rules no longer apply if the transfer is a reportable policy sale. Section 101(a)(3)(B) defines a reportable policy sale as any acquisition of an interest in a life insurance contract in the absence of the described relationship between the acquirer and insured. Although the availability of exceptions from the transfer for value rules is not directly relevant to a gratuitous transfer standing alone, the acquisition of an interest in a contract by an acquirer that does not have the described relationship with the insured, including a gratuitous transfer, may affect the exclusion of the policy proceeds from gross income under section 101(a) and the regulations thereunder if there are subsequent transfers. Consistent with the statutory language, the definition of a reportable policy sale in the final regulations does not exclude gratuitous transfers.

Reg. § 1.101-1(b)(2), "Other transfers," provides:

(i) *Gratuitous transfer of an interest in a life insurance contract*. To the extent that a transfer of an interest in a life insurance contract is gratuitous, including a reportable policy sale that is not for valuable consideration, the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited to the sum of the amount of the proceeds attributable to the gratuitously transferred interest that would have been excludable by the transferor if the transfer had not occurred and the premiums and other amounts subsequently paid by the transferee with respect to the interest. However, if an interest in a life insurance contract is transferred gratuitously to the insured, and that interest has not previously been transferred for value in a reportable policy sale, the entire amount of the proceeds attributable to the interest transferred to the insured is excludable from gross income.

(ii) *Partial transfers*. When only part of an interest in a life insurance contract is transferred, the transferor's exclusion is ratably apportioned between or among the several parts. If multiple parts of an interest are transferred, the transfer of each part is treated as a separate transaction, with each transaction subject to the rule under paragraph (b) of this section that is applicable to the type of transfer involved.

(iii) *Bargain sales*. When the transfer of an interest in a life insurance contract is in part a transfer for valuable consideration and in part a gratuitous transfer, the transfer of each part is treated as a separate transaction for purposes of determining the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1). Each separate transaction is subject to the rule under paragraph (b) of this section that is applicable to the type of transfer involved.

"Gratuitous" is not defined anywhere, but the context of Reg. § 1.101-1(b)(2) suggests that it means any transfer that is not for valuable consideration. Reg. § 1.101-1(f)(5), reproduced in the text accompanying fn 4331, refers to "cash or other consideration reducible to a money value." Reg. § 1.101-1(g)(9), Example (9)(i) treats a nontaxable exchange – a contribution to a partnership in exchange for a partnership interest under Code § 721(a)[4350] – as a transfer for valuable consideration.

The last sentence of Reg. § 1.101-1(b)(2)(i) is an important cleansing rule that the final regulations added after I asked for it. See part II.Q.4.b.ii.(e) Cleansing by Transfer Back to Insured.[4351]

Reg. § 1.101-1(b)(3), "Determination of amounts paid by the transferee," provides:

> For purposes of paragraphs (b)(1) and (2) of this section, in determining the amounts, if any, of consideration paid by the transferee for the transfer of an interest in a life insurance contract and premiums and other amounts subsequently paid by the transferee with respect to that interest, the amounts paid by the transferee are reduced, but not below zero, by amounts received by the transferee under the life insurance contract that are not received as an annuity, to the extent excludable from gross income under section 72(e).

II.Q.4.b.ii.(b). Interest in a Life Insurance Contract

The preamble to the proposed regulations explains:[4352]

> The proposed regulations provide that any transfer of an interest in a life insurance contract for cash or other consideration reducible to a money value is a transfer for valuable consideration. See § 1.101-1(f)(5) of the proposed regulations; see also § 25.2512-8 ("[a] consideration not reducible to a value in money or money's worth, as love and affection, promise of marriage, etc., is to be wholly disregarded"). An interest in a life insurance contract (also referred to as a life insurance policy) is held by any person that has taken title to or possession of the life insurance contract, in whole or part, for state law purposes, including any person that has taken title or possession as nominee for another person, or by any person that has an enforceable right to receive all or a part of the proceeds of the life insurance contract or to any other economic benefits of the insurance policy as described in § 20.2042-1(c)(2). See § 1.101-1(e)(1) of the proposed regulations. The enforceable right to designate a contract beneficiary is an interest in a life insurance contract. *Id.* Any person named as the owner in a life insurance contract generally is the owner (or an owner) of the contract and holds an interest in the contract. *Id.*

4350 See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.
4351 Especially text accompanying fn 4390, as well as Example (2) that is discussed in the text accompanying fn 4384.
4352 Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

> The transfer of an interest in a life insurance contract includes the transfer of any interest in the life insurance contract as well as any transfer of the life insurance contract itself (meaning a transfer of title to, possession of, or legal or beneficial ownership of the life insurance contract). See § 1.101-1(e)(2) of the proposed regulations. For instance, the creation of an enforceable right to receive all or a part of the proceeds of a life insurance contract constitutes the transfer of an interest in the life insurance contract. *Id.* However, the revocable designation of a beneficiary of the policy proceeds does not constitute a transfer of an interest in a life insurance contract to the beneficiary until the designation becomes irrevocable other than by reason of the death of the insured. *Id.* For purposes of this rule, a beneficiary designation is not revocable if the person with the right to designate the beneficiary of the contract has an enforceable contractual obligation to designate a particular contract beneficiary. The pledging or assignment of a policy as collateral security also is not a transfer of an interest in a life insurance contract. *Id.* In response to comments received on Notice 2018-41 suggesting that the initial owner of a life insurance contract should not be considered an "acquirer" for purposes of section 6050Y(a), § 1.101-1(e)(2) of the proposed regulations clarifies that the issuance of a life insurance contract to a policyholder, other than the issuance of a policy in an exchange pursuant to section 1035, is not a transfer of an interest in a life insurance contract.

Part 1.B.4 of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Comments and Changes Relating to § 1.101-1(e) of the Proposed Regulations," explains:

> Section 1.101-1(e) of the proposed regulations defines the terms used to determine whether there has been an acquisition of an interest in a life insurance contract. This section of this Summary of Comments and Explanation of Revisions discusses comments that generally relate to the definitions in § 1.101-1(e) of the proposed regulations.
>
> **A. Interest in a Life Insurance Contract**
>
> Under § 1.101-1(e)(1) of the proposed regulations, an "interest in a life insurance contract" is generally defined as the interest held by any person that has taken title to or possession of the life insurance contract, in whole or part, for state law purposes, and the interest held by any person that has an enforceable right to receive all or a part of the proceeds of the life insurance contract or to any other economic benefits of the policy as described in § 20.2042-1(c)(2). Section 1.101-1(e)(2) of the proposed regulations provides that the term "transfer of an interest in a life insurance contract" means the transfer of any interest in the life insurance contract, including any transfer of title to, possession of, or legal or beneficial ownership of the life insurance contract itself. Under § 1.101-1(e)(3) of the proposed regulations, the acquisition of an interest in a life insurance contract may be direct or indirect, as described in § 1.101-1(e)(3)(i) (defining "direct acquisition of an interest in a life insurance contract") and (ii) (defining "indirect acquisition of an interest in a life insurance contract").
>
> One commenter on the proposed regulations suggested that, in a life settlement transaction in which a securities intermediary holds legal title to the acquired life insurance contract as nominee for the new beneficial owner of the life insurance contract pursuant to a securities account agreement, the new beneficial owner does not acquire an interest in the life insurance contract under § 1.101-1(e)(3) of the proposed regulations, even though the new beneficial owner controls and enjoys all of the benefits

of the life insurance policy, because the new beneficial owner neither acquires legal title to the life insurance policy nor holds an ownership interest in the securities intermediary holding legal title. However, under the proposed regulations, the new beneficial owner acquires an interest in the life insurance contract because it acquires control of all of the benefits of the life insurance policy. Any person that acquires an enforceable right to receive all or a part of the proceeds of the life insurance contract or to any other economic benefits of the policy as described in § 20.2042-1(c)(2) acquires an interest in the life insurance contract under § 1.101-1(e)(1) of the proposed regulations. In the situation described in the comment, after the life settlement transaction, there are two persons who have an interest in the life insurance contract at issue: the legal title holder and the new beneficial owner. Example 16 of § 1.101-1(g)(16) of the final regulations illustrates a reportable policy sale in which one acquirer acquires legal title and another acquires beneficial ownership.

B. Section 1035 Exchanges[4353]

Section 1.101-1(e)(2) of the proposed regulations provides that the issuance of a life insurance contract to a policyholder, other than the issuance of a policy in an exchange pursuant to section 1035, is not a transfer of an interest in a life insurance contract. The preamble to the proposed regulations requests comments on whether the proposed regulations should include additional provisions regarding the treatment of section 1035 exchanges of life insurance contracts. *See* 84 FR 11009, 11019.

One commenter on the proposed regulations recommended that no additional provisions be added to the proposed regulations for this circumstance. The commenter stated that the acquirer of a life insurance contract in a reportable policy sale would be unlikely to meet the requirements for an insurable interest in the insured and, consequently, would not be able to make a section 1035 exchange. In support of this position, the commenter explained that, in order for an exchange of policies to qualify as a section 1035 exchange, the owner of the new contract must be the same person who owned the old contract at the time of the exchange. The commenter also stated that an insurer can issue a new policy only when that new policy will meet state insurance laws requiring an insurable interest in the insured, and an insurable interest is generally based on a close familial relationship with the insured or a lawful and substantial financial interest in the continued life of the insured.

Another commenter recommended that the statement in § 1.101-1(e)(2) of the proposed regulations regarding section 1035 exchanges be deleted or amended to eliminate any suggestion that such transactions, by themselves, can lead to reportable policy sales. The commenter indicated that the statement suggests that the mere issuance of a new life insurance policy in a section 1035 exchange could (or perhaps would) give rise to a reportable policy sale and asserted that such treatment is unnecessary and would be inappropriate.

In support of this position, the commenter explained that, mechanically, a section 1035 exchange typically involves the assignment by the policyholder of the existing policy to the carrier, followed by the surrender of the policy and the application of the cash proceeds as a premium under a new policy issued to the same owner on the same

[4353] [My footnote – not in the preamble:] For why this exception may be perceived to be too narrow, see text accompanying fn 4364 in part II.Q.4.b.ii.(c) “Reportable Policy Sale”.

insured's life. The commenter remarked that, although the new carrier acquires an interest in the old policy, that interest is immediately extinguished. The commenter also remarked that treating the exchange as a reportable policy sale is not necessary to serve any information collection purpose in the case of an exchange involving a new, different carrier, because the exchange must be reported to the IRS and the policyholder on a Form 1099-R. Additionally, the commenter suggested that, even if an exchange were viewed as potentially meeting the definition of a reportable policy sale, the new carrier should be viewed as having a substantial business or financial relationship with the insured, considering that the carrier just issued a new policy on that individual's life.

The commenter suggested that, if there are specific transactions involving section 1035 exchanges that fall outside the normal situation described by the commenter, and the Treasury Department and the IRS determine that such atypical scenarios might give rise to reportable policy sales, the scope of any provision addressing those transactions should be limited to those particular transactions, so that doubt will not be cast on everyday policy exchanges.

The reference in § 1.101-1(e)(2) of the proposed regulations to section 1035 exchanges was not intended to imply that the transfer of a policy to an insurance company in a section 1035 exchange would be a reportable policy sale. In response to the comments received on section 1035 exchanges, § 1.101-1(c)(2)(iv) of the final regulations provides that the acquisition of a life insurance contract by an insurance company in an exchange pursuant to section 1035 (such as the acquisition that would result from the assignment by the policyholder of the existing policy to the insurance company in exchange for the issuance of a new life insurance contract) is not a reportable policy sale.

The concern prompting the reference in § 1.101-1(e)(2) of the proposed regulations to section 1035 exchanges related to the possibility that a policy transferred in a reportable policy sale subsequently could be exchanged for a new policy in an exchange pursuant to section 1035 and that, absent the reference in § 1.101-1(e)(2), the death benefits paid under the new policy might not be reported under section 6050Y(c). Under the final regulations, which adopt § 1.101-1(e)(2) of the proposed regulations as proposed, the issuance of a new life insurance contract to a policyholder in an exchange pursuant to section 1035 is a transfer of an interest in a life insurance contract (the newly issued life insurance contract) to the policyholder, which results in a direct acquisition of an interest in a life insurance contract (the newly issued life insurance contract) by the policyholder. *See* § 1.101-1(e)(2) and (3)(i) of the final regulations. The tax treatment of the newly issued life insurance contract under section 101 is not affected by the tax treatment of the policy for which it was exchanged. However, if the policyholder's acquisition of the newly issued contract constitutes a reportable policy sale, the rules generally applicable to reportable policy sales under section 101 and the regulations thereunder apply to determine the effect of the reportable policy sale on the tax treatment of the newly issued policy under section 101, and the rules generally applicable to reportable policy sales under section 6050Y and the regulations thereunder apply to determine whether section 6050Y reporting is required with respect to the reportable policy sale. The final regulations provide that the acquisition of a newly issued life insurance contract by a policyholder in an exchange pursuant to section 1035 is not a reportable policy sale, if the policyholder has a substantial family, business, or financial relationship with the insured, apart from its interest in the life insurance contract, at the time of the exchange. *See* § 1.101-1(c)(2)(v) of the final regulations. If no such relationship exists at the time of the section 1035 exchange, the exchange is a reportable policy sale under § 1.101-

1(c)(1) of the final regulations. The Treasury Department and the IRS have determined that no exception from the definition of reportable policy sale should apply in this situation. Based on comments received, this situation should rarely arise due to state law insurable interest requirements.

Should this situation arise, however, the policyholder, as an acquirer, must furnish the statement to the issuer required by section 6050Y(a)(2) and § 1.6050Y-2(d)(2) of the final regulations (the reportable policy sale statement or "RPSS"). *See* § 1.6050Y-2(f)(3) of the final regulations. In this case, the statement must be furnished to the issuer that issues the new life insurance contract. *See* § 1.6050Y-1(8)(ii) of the final regulations. However, the policyholder is not required to file the information return required by section 6050Y(a)(1) and § 1.6050Y-2(a) of the final regulations. *See* § 1.6050Y-2(f)(3). Also, because the policyholder is not only the acquirer, but is also the reportable policy sale payment recipient and the seller with respect to the reportable policy sale, the policyholder is not required to furnish the statement generally required to be furnished to the reportable policy sale payment recipient under § 1.6050Y-2(d)(1) of the final regulations. See § 1.6050Y-1(a)(15), (16), and (18) of the final regulations; § 1.6050Y-2(f)(3) of the final regulations. Additionally, although the issuer that issues the new life insurance contract receives an RPSS, it is not required to file a return or furnish a statement to the seller under section 6050Y(b) and § 1.6050Y-3 because the seller does not need the information that would be provided on the statement to properly report a section 1035 exchange. See § 1.6050Y-3(f)(3) of the final regulations.

However, if the issuer makes a payment of reportable death benefits under the newly issued life insurance contract, the issuer must report that payment under section 6050Y(c) and § 1.6050Y-4 of the final regulations, unless an exception under § 1.6050Y-4 applies.

C. Ordinary Course Trade or Business Acquisitions

Several commenters on Notice 2018-41 suggested that acquisitions of life insurance contracts, or interests therein, in ordinary course business transactions in which one trade or business acquires another trade or business that owns life insurance on the lives of former employees or directors should not be reportable policy sales. The proposed regulations include provisions that exclude certain of these transactions from the definition of reportable policy sales. These provisions include the definition of substantial business relationship in § 1.101-1(d)(2) of the proposed regulations, the special rule for indirect acquisitions in § 1.101-1(d)(4)(i) of the proposed regulations, and the definition of the term "indirect acquisition of an interest in a life insurance contract" in § 1.101-1(e)(3)(ii) of the proposed regulations.

Two commenters on the proposed regulations suggested that ordinary course business transactions (such as mergers or acquisitions) involving businesses that own life insurance contracts were not intended by Congress to fall within the meaning of a reportable policy sale and noted that the rules describing a reportable policy sale in the proposed regulations are very helpful in confirming that narrow intent. Another commenter stated that, although the legislative history does not elaborate on the intent of section 101(a)(3)(A) (which limits the carryover basis exception to transfers for value that fall outside the definition of reportable policy sale in section 101(a)(3)(B)), it is widely understood to be aimed at ensuring enforcement of the transfer for value rule with respect to newer forms of speculative transfers involving life insurance policies, rather than imposing new restrictions on legitimate business uses of life insurance. The commenter asserted that the preamble to the proposed regulations implicitly acknowledges this by stating that some provisions are meant to ensure that “certain ordinary course business transactions” will not be treated as reportable policy sales. In response to these comments supporting the ordinary course exclusions from the definition of reportable policy sales in the proposed regulations, those provisions are retained in the final regulations.

One commenter on the proposed regulations requested that the proposed regulations be revised to provide that any transfer of an interest in a life insurance contract as part of a tax-free reorganization conducted in the ordinary course of business is eligible for an exception to being treated as a reportable policy sale under section 101(a)(3)(B), regardless of whether the target survives the reorganization transaction. In this regard, the commenter recommended revising § 1.101-1(e)(3)(ii) of the proposed regulations, which defines the term “indirect acquisition of an interest in a life insurance contract,” to specifically cover all transactions involving the acquisition of a C corporation that qualify for tax-free reorganization treatment unless, immediately prior to the acquisition, more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts. The commenter also recommended adding an example to illustrate this point. The commenter concluded that § 1.101-1(e)(3)(ii) of the proposed regulations applies in the case of acquisition transactions in which the corporate existence of the target survives the acquisition (for instance, a taxable stock sale with no section 338 election, a reverse subsidiary merger structured to qualify as a tax-free reorganization under section 368(a)(2)(E), or a tax-free reorganization under section 368(a)(1)(B)) and appears not to apply in the case of acquisition transactions in which the target corporation is merged with and into the acquiring corporation and the target’s separate corporate existence is terminated as of the merger date (for instance, a tax-free reorganization under section 368(a)(1)(A), (C), or (D) or section 368(a)(2)(D)).

Under § 1.101-1(e)(3)(ii) of the proposed regulations, an indirect acquisition of an interest in a life insurance contract occurs when a person (acquirer) becomes a beneficial owner of a partnership, trust, or other entity that holds (whether directly or indirectly) the interest in the life insurance contract. However, for this purpose, the term “other entity” does not include a C corporation, unless more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts immediately before the indirect acquisition. Accordingly, the acquisition of ownership of a C corporation that owns an interest in a life insurance contract is not an indirect acquisition of such an interest, and therefore is not a reportable policy sale, if no more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts. The commenter thus is correct that § 1.101-1(e)(3)(ii) of the proposed regulations applies only in the case of indirect acquisitions of life insurance contracts (which include a tax-free reorganization in which the corporate existence of the target that holds an interest in a life insurance contract survives the acquisition), and not direct acquisitions of life insurance contracts (which include a tax-free reorganization in which the separate corporate existence of a target that holds an interest in a life insurance contract is terminated).

The commenter asserted that this disparate treatment (between policies transferred directly in tax-free asset reorganizations and indirectly in stock reorganizations) is inappropriate and not warranted as a matter of good tax policy. The commenter further asserted that all tax-free reorganizations should be eligible for an exception similar to the exception provided in § 1.101-1(e)(3)(ii) of the proposed regulations. The commenter noted that the proposed regulations provide certain exceptions that could apply to tax-free mergers in which the target goes out of existence and the surviving corporation continues to hold the life insurance contract, but asserted that having to determine in these types of tax-free mergers whether a particular exception applies on a contract-by-contract basis is unduly complex and a trap for the unwary. The commenter further asserted that this burdensome exercise does not appear to serve the purpose of the change in the statute, which is to address abusive transactions and a failure to report income when appropriate.

The final regulations do not adopt the commenters recommendation regarding amendments to § 1.101-1(e)(3)(ii). The exception in § 1.101-1(e)(3)(ii) of the proposed regulations is not targeted to acquisitions of C corporation stock in tax-free reorganizations, but instead is a relatively broad exception that applies to the acquisition of any interest in a C corporation, provided that no more than 50 percent of the C corporation’s gross asset value consists of life insurance contracts. This exception is one of a number of exceptions in the proposed regulations intended to provide relief for indirect acquisitions in which acquisition of the underlying life insurance contract interest likely was not a significant motivating factor for the acquisition. The final regulations preserve the different results for stock and asset reorganizations because there are significant differences between these two types of reorganizations, and the Treasury Department and the IRS have concluded that those distinctions justify different treatment for purposes of sections 101 and 6050Y. In addition, no exception is provided in the final regulations that excludes reorganizations from the definition of a reportable policy sale. Rather, there are exclusions based on the application of the definitions of substantial relationships as mandated by the statute and exceptions for certain indirect acquisitions that may produce different results in different types of reorganizations.

One reason for treating indirect and direct acquisitions of life insurance contract interests differently is that an acquirer of an interest in an entity may have limited ability to determine what types of assets an entity owns, or to obtain from the entity information necessary to report on the entity’s assets. Thus, for example, the proposed regulations provide a reportable policy sale exception for the acquisition of a small (five percent or less) interest in any entity, unless more than 50 percent of the entity’s gross asset value consists of life insurance contracts. See § 1.101-1(c)(2)(iii)(B) of the proposed regulations. In addition, in the case of a C corporation, a corporate level income tax applies to corporate earnings in addition to income tax on distributions at the shareholder level. As a result, C corporations are not frequently used as vehicles for investing in life insurance contracts covering insureds with respect to which the corporation does not have a substantial business, financial, or family relationship at the time the contract is issued. For this reason, the proposed regulations provide a more generous exception for acquisitions of interests in a C corporation, provided that no more than 50 percent of the C corporation’s gross asset value consists of life insurance contracts, as determined under § 1.101-1(f)(4) of the proposed regulations. *See* § 1.101-1(e)(3)(ii) of the proposed regulations.[4]

[4] Section 1.101-1(f)(4) of the final regulations clarifies that the gross value of assets means, with respect to any entity, the fair market value of the entity’s assets, including assets beneficially owned by the entity under § 1.101-1(f)(1) of the final regulations as a beneficial owner of a partnership, trust, or other entity. Accordingly, the 50 percent test in § 1.101-1(e)(3)(ii) of the final regulations applies to a C corporation’s assets and

the assets held by any partnership, trust, or other entity beneficially owned by the C corporation.

After the TCJA amendments to section 101, the fact that the transfer of a life insurance contract occurs in a carryover basis transaction qualifying under section 101(a)(2)(A) (such as a tax-free reorganization) is no longer sufficient to avoid the limit on the amount of life insurance policy proceeds that are excludable from gross income under the section 101(a)(1) transfer for value rule. Rather, Congress provided that the carryover basis exception in section 101(a)(2)(A) does not apply unless the transferee also has a substantial family, business, or financial relationship with the insured. Under the proposed regulations, in the case of life insurance contracts transferred in an asset reorganization, the surviving corporation could, for example, establish that a substantial business relationship exists by determining that the life insurance policies transferred in the reorganization cover insureds who are key persons of, or materially participate in, an active trade or business of the acquirer as owners, employees, or contractors. *See* § 1.101-1(d)(2)(i) of the proposed regulations. The surviving corporation could also establish that a substantial business relationship exists by determining that the life insurance contracts cover insureds who either (i) are officers, directors or employees of the business being acquired immediately before the acquisition or (ii) previously were directors, highly compensated employees or highly compensated individuals within the meaning of section 101(j)(2)(A)(ii) and the surviving corporation will have ongoing financial obligations with respect to these individuals after the acquisition (such as retirement obligations). *See* § 1.101-1(d)(2)(ii) of the proposed regulations. Corporations must track this data annually for purposes of section 101(j) corporate owned life insurance (COLI) reporting obligations and related recordkeeping, so it should not be overly burdensome to obtain this information. Additionally, in an asset reorganization, it would in any case be necessary to review the life insurance contracts directly acquired on a contract-by-contract basis in order to update insurance contract ownership and beneficiary information with the relevant insurance company.

It is possible that an asset acquisition could result in the loss of the complete exclusion of death benefits from income with respect to some COLI policies that cover insureds who are not employed by the target immediately before the acquisition or employed by the acquirer after the acquisition and with respect to whom the acquirer has no ongoing obligations to pay retirement or other benefits. However, the Treasury Department and the IRS have not identified any clear policy reason why that tax benefit should carry over when ownership of the insurance policy is transferred. The indirect transfer exceptions in the proposed regulations that could permit COLI benefits to be retained with respect to some policies covering no-longer-connected officers, directors, and employees apply only when ownership of the insurance policy is not transferred, such as in a stock reorganization. These exceptions reflect a weighing by the Treasury Department and the IRS of information collection burdens versus potential for abuse in indirect acquisition scenarios.

The commenter also recommended modifying the language in Example 8 of § 1.101-1(g)(8) of the proposed regulations to clarify that the example is intended only to illustrate application of the rule under § 1.101-1(d) of the proposed regulations and is not intended to imply that, without the insured’s current employment by the acquired corporation, the transaction would be treated as a reportable policy sale. Example 8 of § 1.101-1(g)(8) of the proposed regulations describes a tax-free reorganization in which a corporation transfers to an acquiring corporation its active trade or business and a life insurance policy on the life of a current employee that was acquired from the employee. The example concludes that, because the insured was an employee of the target corporation at the time of the tax-free reorganization, and the acquiring corporation carries on the acquired trade or business, the transfer in the tax-free reorganization is not a reportable policy sale because the acquirer has a substantial business relationship with the insured under § 1.101-1(d)(2)(ii) of the proposed regulations. The commenter observed that the example suggests that the transfer of the policy as part of the tax-free reorganization described in the example would not have qualified for an exception from being treated as a reportable policy sale under the proposed regulations absent the existence of the substantial business relationship. The commenter's understanding of the example is correct. The substantial business relationship is necessary for the tax-free reorganization in the example to avoid being treated as a reportable policy sale. As discussed in this section of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS have not adopted the commenter's recommendation regarding amendments to § 1.101-1(e)(3)(ii), and therefore have not revised the example in the final regulations.

This commenter also recommended a related change to § 1.101-1(d)(4)(i) of the proposed regulations. Under § 1.101-1(d)(4)(i) of the proposed regulations, an indirect acquirer is deemed to have a substantial business or financial relationship with the insured if the direct holder of the interest in the life insurance contract has a substantial business or financial relationship with the insured immediately before and after the date the indirect acquirer acquires its interest. Section 1.101-1(d)(4)(i) of the proposed regulations provides relief for acquirers who do not hold their interest in the relevant life insurance contracts directly, when the direct holder of those interests has a substantial business or financial relationship with the insured before and after the acquisition. The Department of Treasury and the IRS have determined that it is not appropriate to treat an indirect acquisition of an interest in a life insurance contract as a reportable policy sale when the direct owner of the interest in the life insurance contract does not change and the direct owner has a substantial family, business, or financial relationship with the insured. The commenter recommended modification of § 1.101-1(d)(4)(i) of the proposed regulations to eliminate what the commenter describes as disparate treatment that arises depending on the type of merger transaction the acquirer undertakes or whether after the merger the insured remains with the company or retains the right to retirement or other post-employment benefits.

First, the commenter observed that, in a tax-free merger in which the target goes out of existence, the direct holder of the life insurance contract no longer exists, and therefore would no longer have any relationship with the insured. Accordingly, the acquirer cannot be deemed to have a substantial business or financial relationship with the insured under § 1.101-1(d)(4)(i) of the proposed regulations. However, in a tax-free merger in which the target does not survive, § 1.101-1(d)(4)(i) of the proposed regulations would not apply because the acquirer would own the insurance contract directly. An acquirer that holds its interest in the relevant life insurance contract directly must determine whether it has a substantial family, business, or financial relationship with the insured under § 1.101-1(d) of the proposed regulations at the time of the acquisition.

Second, the commenter suggested that there are situations in which the insured's employment with the target company is terminated as a result of a merger or acquisition, and the insured has no continuing relationship with the surviving company that retains the life insurance contract. The commenter observed that, in such cases, the "after the date of the acquisition" prong of § 1.101-1(d)(4)(i) of the proposed regulations cannot be satisfied. The commenter recommended modifying § 1.101-1(d)(4)(i) of the proposed regulations to provide that the acquirer of an interest in a life insurance contract in a tax-free merger is deemed to have a substantial business or financial relationship with the insured if the target has a substantial business or financial relationship with the insured immediately prior to the merger, provided the acquirer does not otherwise transfer any interest in the life insurance contract in a transaction treated as a reportable policy sale. The commenter also recommended that the rule specifically state that the fact that the surviving company continues to hold, after the merger, the contract on the life of an individual with whom the target had a substantial financial or business relationship is the determinative factor under this modified rule.

The proposed modification is not adopted because, although § 1.101-1(d)(4)(i) of the proposed regulations generally would not apply to the situations referenced by the commenter, the proposed regulations already include exceptions that may apply in the situations referenced by the commenter. In a tax-free merger in which the target does not survive, § 1.101-1(d)(4)(i) of the proposed regulations would not apply because the acquirer would have a direct acquisition of any interest in a life insurance contract acquired from the target. However, the acquirer does not have a reportable policy sale if the acquirer has a substantial family, business, or financial relationship with the insured. Under § 1.101-1(d)(2)(ii) of the proposed regulations, the surviving company has a substantial business relationship with the insured, and therefore has not acquired its interest in the life insurance contract on the insured's life in a reportable policy sale, if: (1) the insured is an employee within the meaning of section 101(j)(5)(A) of the acquired trade or business immediately preceding the acquisition, and (2) the surviving company either carries on the acquired trade or business or uses a significant portion of the acquired business assets in an active trade or business that does not include investing in interests in life insurance contracts. Accordingly, the proposed regulations already include a rule similar to the one requested by the commenter that is applicable to direct acquisitions of interests in life insurance contracts (such as acquisitions resulting from tax-free mergers in which the target does not survive).

REG-108054-21, Information Reporting and Transfer for Valuable Consideration Rules for Section 1035 Exchanges of Life Insurance and Certain Other Life Insurance Contract Transactions (5/09/2023) describes how the regulations it proposes softens the approach to Code § 1035 exchanges:

Explanation of Provisions

Section 1035 Exchanges

As stated in the preamble to the final regulations, the concern prompting the references to section 1035 exchanges in the 2019 proposed regulations and the final regulations related to the possibility that a policy transferred in a reportable policy sale subsequently could be exchanged for a new policy in an exchange pursuant to section 1035 and that the death benefits paid under the new policy might not be reported under section 6050Y(c). See 84 FR 58460, 58465. The section 1035 exchange provisions were not intended to change the treatment under section 101 of the policyholder's new contract if the policyholder's old contract was never transferred in a reportable policy sale.

However, the Treasury Department and the IRS have determined that such a change was inadvertently effected by the final regulations. Prior to the issuance of the final regulations, the transfer for value rule of section 101(a)(2) did not apply as the result of a section 1035 exchange of a life insurance contract by the original policyholder of the contract. However, under § 1.101-1(e)(2) of the final regulations, the issuance of a new policy in a section 1035 exchange is a transfer of an interest in a life insurance contract. Because the new policy is issued in exchange for an old policy, the exchange is a transfer for valuable consideration under § 1.101-1(f)(5) of the final regulations. Therefore, the new policy is subject to the transfer for value rule of section 101(a)(2), unless one of the exceptions in section 101(a)(2)(A) and (B) applies. For either exception to apply, there must be a substantial business, family, or financial relationship between the insured and the acquirer of the new policy. The Treasury Department and the IRS have determined that the carryover basis exception of section 101(a)(2)(A) would not apply in this case.[5] Therefore, the application of the transfer for value rule would generally limit the amount of death benefits excludable under section 101(a)(1), even in the absence of a reportable policy sale, unless one of the section 101(a)(2)(B) exceptions applies (that is, the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer). The Treasury Department and the IRS have determined that this result is inconsistent with the prior treatment of new policies issued in section 1035 exchanges.

[5] The Code recognizes two categories of substituted basis property: transferred basis property and exchanged basis property. See section 7701(a)(42). Property has a "transferred basis" for Federal tax purposes when the same property is transferred from one person to another but keeps the same basis. See section 7701(a)(43). Property has an "exchanged basis" for Federal tax purposes when a person's basis in new property is determined by reference to other property held by that same person. See section 7701(a)(44). The section 101(a)(2) "carryover basis" exception applies to a transfer if the transferred life insurance contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor. That is, the exception applies if the contract is transferred basis property. However, the basis of a new policy issued in a section 1035 exchange to the same taxpayer is the same as the basis of the old policy held by that taxpayer, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. See sections 1035(d)(2) and 1031(d). The new policy is thus exchanged basis property, not transferred basis property. It is therefore ineligible for the carryover basis exception of section 101(a)(2)(A).

Accordingly, the proposed regulations are intended to correct the unintended change effected by the final regulations to the treatment under section 101 of a life insurance contract issued to a policyholder in a section 1035 exchange, while continuing to address the concern that the reporting of death benefits paid under section 6050Y(c) could be avoided by exchanging a policy transferred in a reportable policy sale for a new policy in a section 1035 exchange, as well as the concern that a policyholder could attempt to avoid the limitation on the excludability of death benefits resulting from the application of the transfer for value rule through a section 1035 exchange. The proposed regulations would accomplish these objectives by revising the final regulations in four ways.

1. Modify definition of a transfer of an interest in a life insurance contract

First, proposed § 1.101-1(e)(2) would revise the definition of a transfer of an interest in a life insurance contract in § 1.101-1(e)(2) of the final regulations to exclude the issuance of a life insurance contract to a policyholder, without qualification. As such, any issuance of a life insurance contract to a policyholder, including in a section 1035 exchange, is not a transfer of an interest in a life insurance contract and therefore cannot be a reportable policy sale under § 1.101-1(c)(1) of the final regulations. The Treasury Department and the IRS do not view this position as inconsistent with the purpose of section 101(j). See Public Law 109-280, §863(d), 120 Stat. 780, 1024 (2006) (providing that section 101(j) generally applies to life insurance contracts issued after August 17, 2006, “except for a contract issued after such date pursuant to an exchange described in section 1035...for a contract issued on or prior to that date”); Notice 2009- 48, 2009-1 C.B. 1085 (providing that further notice and consent is not required by section 101(j) with regard to a contract received in a section 1035 exchange for an employer-owned life insurance contract issued after August 17, 2006, for which the notice and consent requirements were previously satisfied if either (1) the existing consent remains valid, or (2) the exchange does not result in a material change in the death benefit or other material change in the contract).

The proposed regulations make conforming changes to remove the exception in § 1.101-1(c)(2)(v) of the final regulations (providing that the acquisition of a life insurance contract by a policyholder in a section 1035 exchange is not a reportable policy sale if the policyholder has a substantial family, business, or financial relationship with the insured, apart from its interest in the life insurance contract, at the time of the exchange); to remove §§ 1.6050Y-2(f)(3) and 1.6050Y-3(f)(3) of the final regulations (providing certain reporting requirement exceptions related to section 1035 exchanges that are no longer necessary); and to remove § 1.6050Y-1(a)(8)(ii) of the final regulations (providing a definitional rule related to section 1035 exchanges that is no longer necessary).

2. New rule addressing section 1035 exchanges

Second, proposed § 1.101-1(b)(2)(iv) provides a new rule that would apply to the exchange of an interest in a life insurance contract (old interest) in a section 1035 exchange for an interest in a newly issued life insurance contract (new interest) and provides guidance on how to determine the amount of the proceeds attributable to the new interest that is excludable from gross income under section 101(a), provided the new interest is not subsequently transferred or exchanged. If the new interest is subsequently transferred or exchanged, the amount excludable from gross income under section 101(a) would be determined under the rule in § 1.101-1(b) applicable to the type of transfer or exchange involved. The limitation (or lack of any limitation) on the amount of the proceeds attributable to the old interest that is excludable from gross income applies under proposed § 1.101-1(b)(2)(iv) to the new interest for which it is exchanged, just as the basis of the old interest applies to the new interest. See sections 1031(d) and 1035(d)(2) (providing that a contract acquired in a section 1035 exchange has the same basis as the contract for which it was exchanged). The IRS has previously treated certain attributes of contracts exchanged in section 1035 exchanges as applying to the new contracts acquired. See, e.g., Rev. Rul. 92-95, 1992-2 C.B. 43 (for purposes of section 72(q)(2)(I) and 72(u)(4), the “date of purchase” of an annuity contract acquired in a section 1035 exchange for another annuity contract is the date of purchase of the annuity contract that was exchanged for the new contract). See also section 7702A(a)(2) (defining a modified endowment contract to include any contract exchanged for a contract that is a modified endowment contract under section 7702A(a)(1)).

Proposed § 1.101-1(b)(2)(iv) ensures that the acquirer of an interest in a life insurance contract in a reportable policy sale cannot avoid any limit imposed by section 101(a)(2) and (a)(3) on the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) by simply exchanging the interest for a new life insurance contract. Under proposed § 1.101-1(b)(2)(iv)(A), if the entire amount of the proceeds attributable to the old interest would have been excludable from gross income under section 101(a) at the time of the section 1035 exchange, the entire amount of the proceeds attributable to the new interest is excludable from gross income. Under proposed § 1.101-1(b)(2)(iv)(B), if less than the entire amount of the proceeds attributable to the old interest would have been excludable from gross income under section 101(a) at the time of the section 1035 exchange, the amount of the proceeds attributable to the new interest that is excludable from gross income is limited to the sum of the amount of the proceeds attributable to the old interest that would have been excludable at the time of the section 1035 exchange, and the premiums and other amounts subsequently paid with respect to the new interest by the policyholder. Proposed § 1.101-1(b)(2)(iv)(B) also provides that, when determining the premiums and other amounts subsequently paid by the policyholder with respect to the new interest, the amounts paid by the policyholder are reduced, but not below zero, by amounts received by the policyholder under the new life insurance contract that are not received as an annuity, to the extent excludable from gross income under section 72(e). The proposed regulations also make conforming changes to § 1.101-1(a)(1) of the final regulations and the headings of § 1.101-1(b) and (b)(2) of the final regulations to reflect the addition of proposed § 1.101-1(b)(2)(iv). The proposed regulations also add two examples to illustrate the application of the rules set forth in proposed § 1.101-1(b)(2)(iv). See proposed § 1.101-1(g)(17) and (18).

3. Modification to definition of reportable policy sale

Third, the proposed regulations would modify the definition of “reportable policy sale” to address section 1035 exchanges. Specifically, proposed § 1.101-1(c)(3) addresses situations in which an old interest is exchanged in a section 1035 exchange for a new interest, and the old interest was previously transferred for valuable consideration in a reportable policy sale or is treated, under proposed § 1.101-1(c)(3), as an interest in a life insurance contract that was previously transferred for valuable consideration in a reportable policy sale. In such cases, the new interest is treated, for purposes of § 1.101-1, as an interest in a life insurance contract that was previously transferred for valuable consideration in a reportable policy sale. Under the proposed rule, the old interest’s attribute of having been previously transferred for valuable consideration in a reportable policy sale applies to the new interest acquired in a section 1035 exchange. Whether or not an interest in a life insurance policy was previously transferred in a reportable policy sale is relevant for the purpose of determining the applicability of certain provisions in the final regulations. See, e.g., § 1.101-1(b)(1)(ii)(B)(1) of the final regulations (applies only if the interest was not previously transferred for valuable consideration in a reportable policy sale); § 1.101- 1(b)(1)(ii)(B)(2) and (3) of the final regulations (apply if the interest was previously transferred for valuable consideration in a reportable policy sale); § 1.101-1(b)(2)(i) of the final regulations (includes a special rule for interests that have not previously been transferred for value in a reportable policy sale). The Treasury Department and the IRS have previously treated (and continue to treat) other attributes of contracts exchanged in section 1035 exchanges as applying to the new contracts acquired, so the new contract is treated the same as the old contract. See, e.g., Rev. Rul. 92-95. Similarly, the proposed rule ensures that the new interest is treated the same as the old interest when applying rules that consider whether an interest in a life insurance contract was previously transferred in a reportable policy sale. See proposed § 1.101-1(c)(3). Proposed § 1.101-1(c)(3) also provides that, for purposes of §§ 1.6050Y-3 and 1.6050Y-4, the section 1035 exchange is treated as the transfer of an interest in the life insurance contract in a reportable policy sale if the old interest previously was transferred for valuable consideration in a reportable policy sale (or is treated, under proposed § 1.101-1(c)(3), as an interest in a life insurance contract that previously was transferred for valuable consideration in a reportable policy sale). Accordingly, the designation of death benefits as reportable death benefits is an attribute that transfers from the old interest to the new interest in a section 1035 exchange. See also proposed § 1.6050Y-1(a)(12). The Treasury Department and the IRS previously have treated other attributes of contracts exchanged in section 1035 exchanges as transferring to the new contracts acquired. In this case, the proposed rule ensures that death benefits under the new interest are treated the same as under the old interest for purposes of reporting under section 6050Y(c) and § 1.6050Y-4. These rules are necessary to ensure that the acquirer of an interest in a life insurance contract in a reportable policy sale cannot avoid the designation of the death benefits as reportable death benefits and the associated reporting of the payment of the reportable death benefits by simply exchanging the interest for a new life insurance contract. The proposed regulations also make conforming changes to § 1.101-1(c)(1) of the final regulations to reflect the addition of proposed § 1.101-1(c)(3).

The preamble explains that taxpayers can choose to rely on the proposed regulations – possibly even retroactively to when the reportable policy sale rule first became effective:

Applicability Dates

Proposed §§ 1.101-1(b)(2)(iv) and (c)(3) are proposed to apply to section 1035 exchanges occurring on or after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register, and proposed § 1.101-1(c)(2)(v) is proposed to apply to any acquisition of an interest in a life insurance contract occurring on or after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. See proposed § 1.101-6(c). However, it is proposed that a taxpayer may choose to apply § 1.101-1(b)(2)(iv), (c)(2)(v), and (c)(3) of the regulations set forth in the Treasury decision adopting these regulations as final regulations to all section 1035 exchanges and acquisitions occurring after December 31, 2017, and before the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register. See section 7805(b)(7) of the Code. Alternatively, a taxpayer may rely on proposed § 1.101- 1(b)(2)(iv), (c)(2)(v), and (c)(3) for all section 1035 exchanges and acquisitions occurring after December 31, 2017, and before the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.

The reporting obligations under proposed § 1.6050Y-3 are proposed to apply to any section 1035 exchange treated as a reportable policy sale under proposed § 1.101-1(c)(3) if the exchange occurs on or after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. See proposed § 1.6050Y-1(b)(2). The reporting obligations under proposed § 1.6050Y-4 are proposed

> to apply to reportable death benefits paid with respect to an interest in a life insurance contract issued in a section 1035 exchange treated as a reportable policy sale under proposed § 1.101-1(c)(3) if the exchange occurs on or after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. See proposed § 1.6050Y-1(b)(2). Any person with a reporting obligation under proposed § 1.6050Y-3 or proposed § 1.6050Y-4 may, however, rely on the proposed regulations with respect to all section 1035 exchanges occurring after May 10, 2023, and before the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.

Reg. § 1.101-1(e)(1), "Definition," provides:[4354]

> For purposes of this section and section 6050Y, the term interest in a life insurance contract means the interest held by any person that has taken title to or possession of the life insurance contract (also referred to as a life insurance policy), in whole or part, for state law purposes, including any person that has taken title or possession as nominee for another person, and the interest held by any person that has an enforceable right to receive all or a part of the proceeds of a life insurance contract or to any other economic benefits of the policy as described in § 20.2042-1(c)(2) of this chapter, such as the enforceable right to designate a contract beneficiary. Any person named as the owner in the life insurance contract generally is the owner (or an owner) of the contract and holds an interest in the contract.

Reg. § 20.2042-1(c)(2) is reproduced in part II.Q.4.i.ii Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity.

What happens when more than one person is named in a contract/policy as holding title or has possession? How does one define each person's interest? Presumably, one would review part II.Q.4.f Split-Dollar Arrangements.

Reg. § 1.101-1(e)(2), "Transfer of an interest in a life insurance contract," provides:

> For purposes of this section and section 6050Y, the term transfer of an interest in a life insurance contract means the transfer of any interest in the life insurance contract, including any transfer of title to, possession of, or legal or beneficial ownership of the life insurance contract itself. The creation of an enforceable right to receive all or a part of the proceeds of a life insurance contract constitutes the transfer of an interest in the life insurance contract. The following events are not a transfer of an interest in a life insurance contract: the revocable designation of a beneficiary of the policy proceeds (until the designation becomes irrevocable other than by reason of the death of the insured); the pledging or assignment of a policy as collateral security; and the issuance of a life insurance contract to a policyholder, other than the issuance of a policy in an exchange pursuant to section 1035.

[4354] Part II.Q.4.b.ii.(g) Transfer of Interest in an Entity Holding Life Insurance discusses an interest in a life insurance contact under Reg. § 1.101-1(e)(1) in the text accompanying fn 4394.

The preamble to the proposed regulations explains:[4355]

> Under § 1.101-1(e)(3)(i) of the proposed regulations, the transfer of an interest in a life insurance contract results in the direct acquisition of the interest by the transferee (acquirer). Under § 1.101-1(e)(3)(ii) of the proposed regulations, an indirect acquisition of an interest in a life insurance contract occurs when a person (acquirer) becomes a beneficial owner of a partnership, trust, or other entity that holds (directly or indirectly) an interest in the life insurance contract. For this purpose, the term "other entity" does not include a C corporation (as that term is defined in section 1361(a)(2)), unless more than 50 percent of the gross value of the assets of the C corporation (as determined under § 1.101-1(f)(4)) consists of life insurance contracts immediately before the indirect acquisition. Under § 1.101-1(f)(1) of the proposed regulations, a "beneficial owner" of a partnership, trust, or other entity is an individual or C corporation with an ownership interest in that partnership, trust, or other entity. The beneficial owner's interest may be held directly or indirectly, through one or more other partnerships, trusts, or other entities.
>
> Accordingly, under § 1.101-1(e)(3)(ii) of the proposed regulations, persons that acquire shares in a C corporation that holds an interest in a life insurance contract generally will not be considered to have an indirect acquisition of an interest in such contract. However, if the C corporation primarily owns life insurance contracts (or interests therein), any person that acquires shares in the C corporation will be considered to have an indirect acquisition of an interest in any life insurance contract held by the C corporation.

Reg. § 1.101-1(e)(3), "Acquisition of an interest in a life insurance contract," provides:[4356]

> For purposes of this section and section 6050Y, the acquisition of an interest in a life insurance contract may be direct or indirect.
>
> (i) *Direct acquisition of an interest in a life insurance contract*. For purposes of this section and section 6050Y, the transfer of an interest in a life insurance contract results in the direct acquisition of the interest by the transferee (acquirer).
>
> (ii) *Indirect acquisition of an interest in a life insurance contract*. For purposes of this section and section 6050Y, an indirect acquisition of an interest in a life insurance contract occurs when a person (acquirer) becomes a beneficial owner of a partnership, trust, or other entity that holds (whether directly or indirectly) the interest (whether legal or beneficial) in the life insurance contract. For purposes of this paragraph (e)(3)(ii), the term other entity does not include a C corporation, unless more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts (as determined under paragraph (f)(4) of this section) immediately before the indirect acquisition.

[4355] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."
[4356] For the significance of indirect acquisitions under Reg. § 1.101-1(e)(3)(ii), see text accompanying fn 4396 in part II.Q.4.b.ii.(g) Transfer of Interest in an Entity Holding Life Insurance. Certain indirect acquisitions that are not treated as reportable policy sales are described in Reg. § 1.101-1(c)(2)(iii), which is reproduced in the text accompanying fn 4363 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.

Elaborating on clause (ii) above, the preamble to the proposed regulations explains:[4357]

> Finally, in response to comments received on Notice 2018-41, certain indirect acquisitions of life insurance contracts, or interests in life insurance contracts, are excepted from the definition of a reportable policy sale. The limited definition of "indirect acquisition" under § 1.101-1(e)(3)(ii) of the proposed regulations means that shareholders acquiring an interest in a C corporation that holds an interest in one or more life insurance contracts will not be considered to have an indirect acquisition or reportable policy sale unless the C corporation primarily owns life insurance contracts (or interests therein). The proposed regulations also provide an exception from the definition of a reportable policy sale for an indirect acquisition of an interest in a life insurance contract if the direct holder of the interest acquired the interest in a reportable policy sale and reported the acquisition in compliance with section 6050Y(a) and § 1.6050Y-2 of the proposed regulations. See § 1.101-1(c)(2)(iii)(A) of the proposed regulations. Also, the indirect acquisition of an interest in a life insurance contract is not a reportable policy sale if (1) Immediately before the acquisition, no more than 50 percent of the gross value of the assets of the entity that directly holds the interest in the life insurance contract consists of life insurance contracts, and (2) the acquirer and his or her family members own five percent or less of the ownership interests in the entity that directly holds the interest in the life insurance contract. See § 1.101-1(c)(2)(iii)(B) of the proposed regulations. Section 1.101-1(f)(4) of the proposed regulations provides rules regarding the determination of the gross value of assets for this purpose.

Reg. § 1.101-1(f)(2), "C corporation," provides:

> The term C corporation has the meaning given to it in section 1361(a)(2).

Code § 1361(a)(2) is reproduced in fn 1774.

Reg. § 1.101-1(f)(4), "Gross value of assets," provides:

> (i) *Determination of gross value of assets*. Except as provided in paragraph (f)(4)(ii) or (iii) of this section, for purposes of paragraphs (c)(2)(iii)(B) and (e)(3)(ii) of this section, the term gross value of assets means, with respect to any entity, the fair market value of the entity's assets, including assets beneficially owned by the entity under paragraph (f)(1) of this section as a beneficial owner of a partnership, trust, or other entity.
>
> (ii) *Determination of gross value of assets of publicly traded entity*. For purposes of determining the gross value of assets of an entity that is publicly traded, if the entity's annual Form 10-K filed with the United States Securities and Exchange Commission (or equivalent annual filing if the entity is publicly traded in a non-U.S. jurisdiction) for the period immediately preceding a person's acquisition of an ownership interest in the entity does not contain information demonstrating that more than 50 percent of the gross value of the entity's assets consist of life insurance contracts, that person may assume that no more than 50 percent of the gross value of the entity's assets consists of life insurance contracts, unless that person has actual knowledge or

[4357] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

reason to know that more than 50 percent of the gross value of the entity's assets consists of life insurance contracts.

(iii) *Safe harbor definition of gross value of assets*. An entity may choose to determine the gross value of all the entity's assets for purposes of this section using the following alternative definition of gross value of assets:

(A) In the case of assets that are life insurance policies or annuity or endowment contracts that have cash values, the cash surrender value as defined in section 7702(f)(2)(A); and

(B) In the case of assets not described in paragraph (f)(4)(iii)(A) of this section, the adjusted bases (within the meaning of section 1016) of such assets.

II.Q.4.b.ii.(c). "Reportable Policy Sale" Defined

What is a "reportable policy sale" is important to determine whether a transfer for valuable consideration will cause a policy's death benefit to lose its income tax exclusion[4358] and for whether certain reporting must be done.[4359]

The preamble to the proposed regulations explains:[4360]

> Section 1.101-1(c) of the proposed regulations defines the term "reportable policy sale," which was introduced in section 101(a)(3). The proposed regulations provide that, as a general matter, any direct or indirect acquisition of an interest in a life insurance contract is a "reportable policy sale" if the acquirer has, at the time of the acquisition, no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in that life insurance contract. See § 1.101-1(c)(1) of the proposed regulations.

Reg. § 1.101-1(c) describes what is a reportable policy sale.

Reg. § 1.101-1(c)(1), "In general," provides:[4361]

> Except as provided in paragraph (c)(2) of this section, a reportable policy sale for purposes of this section and section 6050Y is any direct or indirect acquisition of an interest in a life insurance contract if the acquirer has, at the time of the acquisition, no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in the life insurance contract.

[4358] See part II.Q.4.b.ii.(a) Income Tax Effect of a Reportable Policy Sale, as well as most of the rest of this part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.
[4359] See part II.Q.4.b.ii.(f) Reporting Requirements for Reportable Policy Sales.
[4360] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."
[4361] Reg. § 1.101-1(e)(3)(ii) defines "indirect acquisition" and is reproduced in the text accompanying fn 4356 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.

The preamble to the proposed regulations explains exceptions:[4362]

> The proposed regulations also provide several exceptions from the definition of reportable policy sale. The proposed regulations provide that the transfer of an interest in a life insurance contract between certain related entities is not a reportable policy sale. Specifically, a transfer between entities with the same beneficial owners is not a reportable policy sale if the ownership interest of each beneficial owner in each entity does not vary by more than a 20 percent ownership interest. See § 1.101-1(c)(2)(i) and (g)(10) of the proposed regulations. Also, a transfer between corporations that are members of an affiliated group (as defined in section 1504(a)) that files a consolidated U.S. tax return for the taxable year in which the transfer occurs is not a reportable policy sale. See § 1.101-1(c)(2)(ii) of the proposed regulations.

Part 1.B.3 of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Comments and Changes Relating to § 1.101-1(c) of the Proposed Regulations," explains:

> Under section 101(a)(3)(B) and § 1.101-1(c)(1) of the proposed regulations, a reportable policy sale is, as a general matter, any direct or indirect acquisition of an interest in a life insurance contract if the acquirer has, at the time of the acquisition, no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in the life insurance contract. Exceptions to the definition of reportable policy sale for transfers between certain related entities are provided in § 1.101-1(c)(2)(i) and (ii) of the proposed regulations. Section 1.101-1(c)(2)(iii) of the proposed regulations sets forth exceptions from the definition of reportable policy sales for certain indirect acquisitions. This section of this Summary of Comments and Explanation of Revisions discusses comments received on § 1.101-1(c) of the proposed regulations.
>
> **A. Pre-TCJA Acquisitions**
>
> Two commenters on the proposed regulations requested clarification regarding the application of § 1.101-1(c)(2)(iii)(A) with respect to the indirect acquisition of an interest in a life insurance contract if the entity that directly holds the interest acquired the interest before January 1, 2018 (that is, before the existence of any reporting requirements under section 6050Y(a)). Both commenters recommended that an exception from the definition of reportable policy sale be provided with respect to the indirect acquisition of an interest in a life insurance contract by a person if the partnership, trust, or other entity that directly holds the interest in the life insurance contract acquired the interest before January 1, 2018. One commenter recommended that, if the requested exception is not provided, the partnership, trust, or other entity in which the investment interest is purchased should be permitted to undertake the applicable reporting, instead of requiring the investor to navigate the complexities of the reporting requirements. This commenter also suggested that, if the requested exception is provided, the partnership, trust, or other entity could file an information return with the IRS for its portfolio of policies acquired prior to January 1, 2018, as a transition solution. However, the other commenter suggested that the partnership, trust, or other entity may not have tracked or retained information sufficient to satisfy the reporting requirements under section 6050Y with respect to interests acquired before January 1, 2018.

[4362] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

In response to these comments, § 1.101-1(c)(2)(iii)(A) of the final regulations provides an exception from the definition of reportable policy sale with respect to the indirect acquisition of an interest in a life insurance contract by a person if a partnership, trust, or other entity in which an ownership interest is being acquired directly or indirectly holds the interest in the life insurance contract and acquired that interest before January 1, 2019, or acquired that interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2.[3]

[3] As discussed in section 1.A of this Summary of Comments and Explanation of Revisions, the final regulations provide that the reporting obligations under section 6050Y apply to reportable policy sales and payments of reportable death benefits occurring after December 31, 2018. See § 1.6050Y-1(b) of the final regulations. Section 3.B of this Summary of Comments and Explanation of Revisions describes changes adopted in § 1.101-1(c)(2)(iii)(A) of the final regulations in response to other comments requesting expanded indirect acquisition exceptions.

B. Additional Requests for Expanded Indirect Acquisition Exceptions

One commenter on the proposed regulations identified the existence of a possible technical issue with § 1.101-1(c)(2)(iii)(A) of the proposed regulations, which provides an exception from reportable policy sale status for certain indirect acquisitions. The commenter noted that, under this provision, the indirect acquisition of an interest in a life insurance contract is not a reportable policy sale if the partnership, trust, or other entity that directly holds the interest in the life insurance contract acquired the interest in a reportable policy sale that was reported in compliance with section 6050Y(a) and the regulations thereunder. The commenter described a fact pattern in which legal title to a life insurance contract is held by a nominee (for example, a securities intermediary) on behalf of a partnership, trust, or other entity (for example, an investment fund). The commenter concluded that, in this fact pattern, the exception in § 1.101-1(c)(2)(iii)(A) of the proposed regulations cannot apply to an investor in the partnership, trust, or other entity because the investor's ownership interest is in the partnership, trust, or other entity (which does not hold a direct interest in the life insurance contract), not in the nominee (which directly holds the legal interest in the life insurance contract). The commenter also recommended that § 1.101-1(c)(2)(iii)(A) be revised to clarify that the exception applies if reporting under section 6050Y is done by either the legal owner of the life insurance contract (such as a securities intermediary holding legal title as a nominee) or the beneficial owner of the life insurance policy that controls the life insurance contract under a securities account agreement (such as an investment fund).

In the fact pattern described in the comment letter, the partnership, trust, or other entity in which the investor acquires an ownership interest holds an interest in the life insurance contract. An interest in a life insurance contract is not limited to legal ownership of the contract. Instead, any person that acquires an enforceable right to receive all or a part of the proceeds of the life insurance contract or acquires the right to any other economic benefits of the policy as described in § 20.2042-1(c)(2) acquires an interest in the life insurance contract under § 1.101-1(e)(1) of the proposed regulations.

The partnership, trust, or other entity described by the commenter presumably would hold such an interest directly, even though legal title to the life insurance contract is held by a nominee or other intermediary. By acquiring an interest in the partnership, trust, or other entity, the investor indirectly would acquire a beneficial interest in the life insurance contract. The exception in § 1.101-1(c)(2)(iii)(A) of the proposed regulations would apply to this indirect acquisition if the partnership, trust, or other entity reported its acquisition of the beneficial interest in the contract in compliance with section 6050Y(a). The commenter's recommended revision to § 1.101-1(c)(2)(iii)(A) of the proposed regulations therefore is not adopted in the final regulations.

The commenter also proposed that § 1.101-1(c)(2)(iii)(A) of the proposed regulations be modified to apply if "the partnership, trust, or other entity that directly or indirectly holds the interest in the life insurance contract acquired that interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2."

This change is adopted in the final regulations, which also clarify that the partnership, trust, or other entity must be a partnership, trust, or other entity in which an ownership interest is being acquired. As modified, the exception applies to the indirect acquisition of an interest in a life insurance contract by a person acquiring an ownership interest in a partnership, trust, or other entity that holds the interest in the life insurance contract, regardless of whether the person's ownership interest in the partnership, trust, or other entity that reported its acquisition of the interest in the life insurance contract is direct or indirect and regardless of whether that partnership, trust, or other entity acquired its interest in a direct or indirect acquisition, provided the partnership, trust, or other entity acquired its interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2 or, as discussed in section 3.A of this Summary of Comments and Explanation, acquired its interest before January 1, 2019.

One commenter on the proposed regulations reiterated its previous request, made in comments on Notice 2018-41, that an exception from the reporting requirements of section 6050Y be provided with respect to an indirect acquisition of an interest in a life insurance contract by any investor that acquires a 5 percent or less economic and voting interest in an investment vehicle that holds, directly or indirectly, life insurance policies, with the added proviso that the investor must not be an officer or director of the investment vehicle. Section 1.101-1(c)(2)(iii)(B) of the proposed regulations provides that the indirect acquisition of an interest in a life insurance contract is not a reportable policy sale if the acquirer and his or her family members own, in the aggregate, 5 percent or less of the partnership, trust, or other entity that directly holds the interest in the life insurance contract, but this exception applies only if, immediately before the acquisition, no more than 50 percent of the gross value of the assets of the partnership, trust, or other entity that directly holds the interest in the life insurance contract consists of life insurance contracts.

The final regulations do not adopt the proposed change because, if more than 50 percent of an entity's asset value is life insurance contracts, investment in life insurance contracts is likely the entity's primary business activity, and it is reasonable to expect even small investors to be able to determine the primary activity of the business they are investing in, regardless of whether they are also officers or directors of the entity. In addition, any investor that does not qualify for the exception set forth in § 1.101-1(c)(2)(iii)(B) of the final regulations because more than 50 percent of the gross value of the assets of the partnership, trust, or other entity that directly holds the interest in the life insurance contract consists of life insurance contracts may still qualify for the exception set forth in § 1.101-1(c)(2)(iii)(A) of the final regulations if a partnership, trust, or other entity that directly or indirectly holds the interest in the life insurance contract acquired the interest before January 1, 2019, or acquired that interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2.

> Separately, § 1.101-1(c)(2)(iii)(B) of the final regulations clarifies that, if the partnership, trust, or other entity in which the acquirer is directly acquiring an ownership interest indirectly holds an interest in one or more life insurance contracts, (i) the assets of the partnership, trust, or other entity in which the ownership interest is being acquired are tested to determine whether more than 50 percent of the gross value of the assets of that partnership, trust, or other entity consists of life insurance contracts, and (ii) the ownership interest in that partnership, trust, or other entity held by the acquirer and his or her family members after the acquisition is tested to determine whether they hold more than a 5 percent ownership interest in the entity. The assets of the partnership, trust, or other entity that directly holds the interest in the life insurance contract and the interest in that partnership, trust, or other entity held by the acquirer and his or her family member are tested only if the acquirer is directly acquiring an ownership interest in that partnership, trust, or other entity.

Reg. § 1.101-1(c)(2), "Exceptions," provides:

> None of the following transactions is a reportable policy sale:[4363]
>
> (i) A transfer of an interest in a life insurance contract between entities with the same beneficial owners, if the ownership interest of each beneficial owner in the transferor entity does not vary by more than a 20 percent ownership interest from that beneficial owner's ownership interest in the transferee entity. In a series of transfers, the prior sentence is applied by comparing the beneficial owners' ownership interest in the first transferor entity and the last transferee entity. For purposes of this paragraph (c)(2)(i), each beneficial owner of a trust is deemed to have an ownership interest determined by the broadest possible exercise of a trustee's discretion in that beneficial owner's favor. Paragraph (g)(13) (Example 13) of this section provides an illustration of the application of this paragraph (c)(2)(i).
>
> (ii) A transfer between corporations that are members of an affiliated group (as defined in section 1504(a)) that files a consolidated U.S. income tax return for the taxable year in which the transfer occurs.
>
> (iii) The indirect acquisition of an interest in a life insurance contract by a person if—
>
> > (A) A partnership, trust, or other entity in which an ownership interest is being acquired directly or indirectly holds the interest in the life insurance contract and acquired that interest before January 1, 2019, or acquired that interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2; or
> >
> > (B) Immediately before the acquisition, no more than 50 percent of the gross value of the assets (as determined under paragraph (f)(4) of this section) of the partnership, trust, or other entity that directly or indirectly holds the interest in the life insurance contract, and in which an ownership interest is being directly

[4363] Reg. § 1.101-1(e)(3)(ii) defines "indirect acquisition" and is reproduced in the text accompanying fn 4356 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.

acquired, consists of life insurance contracts, provided that, after the acquisition, with respect to that partnership, trust, or other entity, the person indirectly acquiring the interest in the life insurance contract and his or her family members own, in the aggregate-

(1) With respect to an S corporation, stock possessing 5 percent or less of the total combined voting power of all classes of stock entitled to vote and 5 percent or less of the total value of shares of all classes of stock of the S corporation;

(2) With respect to a trust or decedent's estate, 5 percent or less of the corpus and 5 percent or less of the annual income (taking into account, for the purpose of determining any person's ownership interest, the maximum amount of income and corpus that could be distributed to or held for the benefit of that person); or

(3) With respect to a partnership or other entity that is not a corporation or a trust, 5 percent or less of the capital interest and 5 percent or less of the profits interest.

(iv) The acquisition of a life insurance contract by an insurance company that issues a life insurance contract in an exchange pursuant to section 1035.

(v) The acquisition of a life insurance contract by a policyholder in an exchange pursuant to section 1035, if the policyholder has a substantial family, business, or financial relationship with the insured, apart from its interest in the life insurance contract, at the time of the exchange.

Reg. § 1.101-1(c)(2)(v) requires the holder of a policy on the insured who does a Code § 1035 exchange for a replacement policy on the insured to have a substantial family, business, or financial relationship with the insured or risk its interest in the replacement policy being tainted as having been transferred in a reportable policy sale.[4364] This creates concerns when an employer uses a cash value life insurance policy to fund its payments of post-retirement benefits for a living former employee. (It would not create a concern when funding the post-mortem purchase of the retiree's interest in the employer or any other obligations that mature by reason of the employee's death.)[4365]

Reg. § 1.101-1(c)(2)(i) refers to Reg. § 1.101-1(g)(13),[4366] which provides:

Example 13. Partnership X and Partnership Y are owned by individuals A, B, and C. A holds 40% of the capital and profits interest of Partnership X and 20% of the capital and profits interest of Partnership Y. B holds 35% of the capital and profits interest of

[4364] For the preamble discussing this issue, see fn 4353 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.
[4365] See Reg. § 1.101-1(d)(2)(ii).
[4366] Reg. § 1.101-1(g), "Examples," begins with:

The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

Partnership X and 40% of the capital and profits interest of Partnership Y. C holds 25% of the capital and profits interest of Partnership X and 40% of the capital and profits interest of Partnership Y. Partnership X is the initial policyholder of a $100,000 insurance policy on the life of A. Partnership Y purchases the policy from Partnership X. Under paragraph (c)(2)(i) of this section, this transfer is not a reportable policy sale because the ownership interest of each beneficial owner in Partnership X does not vary from that owner's interest in Partnership Y by more than a 20% ownership interest. A's ownership varies by a 20% interest, B's ownership varies by a 5% interest, and C's ownership varies by a 15% interest.

Reg. § 1.101-1(g)(15)[4367] elaborates on Reg. § 1.101-1(c)(2)(iii)(B), providing:

> *Example 15*. The facts are the same as in Example 14[4368] in paragraph (g)(14) of this section, except that A is no longer an employee of Partnership X, and Partnership X has no substantial family, business, or financial relationship with A, when B acquires the profits interest in Partnership X. Also, B acquires only a 5% profits interest in exchange for a cash payment of $500,000. Partnership X does not own an interest in any other life insurance policies, and the gross value of its assets is $10 million. Although neither Partnership X nor B has a substantial family, business, or financial relationship with A at the time of B's indirect acquisition of an interest in the policy covering A's life, because B's profits interest in Partnership X does not exceed 5%, and because no more than 50% of Partnership X's asset value consists of life insurance contracts, the exception in paragraph (c)(2)(iii)(B) of this section applies, and B's indirect acquisition of an interest in the policy covering A's life is not a reportable policy sale.

Reg. § 1.101-1(c)(1) above stated that a reportable policy sale can apply only if, at the time of the acquisition, the acquirer has "no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in the life insurance contract." Reg. § 1.101-1(d) describes these substantial relationships.

The preamble to the proposed regulations explains:[4369]

> Section 1.101-1(d) of the proposed regulations defines the terms "substantial family relationship," "substantial business relationship," and "substantial financial relationship." Under section 1.101-1(d)(1) of the proposed regulations, a "substantial family relationship" is the relationship between an individual and any family member of that individual as defined in § 1.101-1(f)(3) of the proposed regulations. A substantial family relationship also exists between an individual and his or her former spouse with regard to a transfer of an interest in a life insurance contract to (or in trust for the benefit of) that former spouse incident to divorce. See § 1.101-1(d)(1) of the proposed regulations. Additionally, a substantial family relationship exists between the insured and an entity if

[4367] Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

[4368] [Not in the regulation - click to go to:] Example 14.

[4369] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

all of the entity's beneficial owners have a substantial family relationship with the insured. *Id.*

Section 1.101-1(d)(2) describes the two situations in which a substantial business relationship exists between the acquirer and insured: (1) The insured is a key person (as defined in section 264) of, or materially participates (as defined in section 469 and the corresponding regulations) in, an active trade or business as an owner, employee, or contractor, and at least 80% of that trade or business is owned (directly or indirectly, through one or more partnerships, trusts, or other entities) by the acquirer or the beneficial owners of the acquirer, and (2) the acquirer acquires an active trade or business and acquires the interest in the life insurance contract either as part of that acquisition or from a person owning significant property leased to the acquired trade or business or life insurance policies held to facilitate the succession of the ownership of the business, if certain requirements are met. See § 1.101-1(d)(2)(i) and (ii) of the proposed regulations.

Comments received on Notice 2018-41 suggested that acquisitions of life insurance contracts, or interests therein, in certain ordinary course business transactions involving the acquisition of a trade or business should not be considered reportable policy sales, including ordinary course business transactions whereby one trade or business acquires another trade or business that owns life insurance on the lives of former employees or directors. The definition of substantial business relationship in § 1.101-1(d)(2) of the proposed regulations, as well as certain other provisions in the proposed regulations, are intended to exclude certain of these transactions from the definition of reportable policy sales.

Section 1.101-1(d)(3) of the proposed regulations describes the three situations in which a substantial financial relationship exists between the insured and the acquirer: (1) The acquirer (directly or indirectly, through one or more partnerships, trusts, or other entities of which it is a beneficial owner) has, or the beneficial owners of the acquirer have, a common investment (other than the interest in the life insurance contract) with the insured and a buy-out of the insured's interest in the common investment by the co-investor(s) after the insured's death is reasonably foreseeable; (2) the acquirer maintains the life insurance contract on the life of the insured to provide funds to purchase assets or satisfy liabilities following the death of the insured; or (3) the acquirer is an organization described in sections 170(c), 2055(a), and 2522(a) that previously received financial support in a substantial amount or significant volunteer support from the insured. See § 1.101-1(d)(3)(i) through (iii) of the proposed regulations.

The proposed regulations also specify that the fact that an acquirer is a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer (all relationships that are covered by an exception from the transfer for value rule) is not sufficient to establish a substantial business or financial relationship, nor is such status required to establish a substantial business or financial relationship. See § 1.101-1(d)(4)(ii) of the proposed regulations. The proposed regulations also clarify that, for purposes of determining whether the acquirer in an indirect acquisition of an interest in a life insurance contract has a substantial business or financial relationship with the insured, the acquirer will be deemed to have a substantial business or financial relationship with the insured if the direct holder of the interest in the life insurance contract has a substantial business or financial relationship with the insured immediately before and after the date the acquirer acquires its interest.

> See § 1.101-1(d)(4)(i) of the proposed regulations. Accordingly, the acquirer in an indirect acquisition may establish a substantial business or financial relationship with the insured based on the acquirer's own relationship with the insured or the relationship between the insured and the direct holder of the interest in the life insurance contract.

Part 1.B.3 of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Comments and Changes Relating to § 1.101-1(d) of the Proposed Regulations," explains:

> Section 1.101-1(d) of the proposed regulations defines the terms substantial family relationship, substantial business relationship, and substantial financial relationship, and provides special rules for applying these definitions. This section of this Summary of Comments and Explanation of Revisions discusses comments that generally relate to the definitions and special rules in § 1.101-1(d) of the proposed regulations.
>
> **A. Beneficial Owners With a Combination of Substantial Relationships**
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> Under § 1.101-1(d)(1) of the proposed regulations, a substantial family relationship exists between the insured and a partnership, trust, or other entity if all of the beneficial owners of that partnership, trust, or other entity have a substantial family relationship with the insured. A partnership, trust, or other entity may itself have a substantial business or financial relationship with the insured under § 1.101-1(d)(2) or (3) of the proposed regulations.
>
> One commenter on the proposed regulations recommended that a transfer to a trust, partnership, or other entity not be a reportable policy sale within the meaning of section 101(a)(3) if all of the beneficial owners of the trust, partnership, or other entity have a substantial family, business, or financial relationship with the insured.[4370] The Treasury Department and the IRS have determined it would be appropriate to expand the definition of substantial family, business, or financial relationship to include the relationship between the insured and a trust, partnership, or other entity, every beneficial owner of which has a substantial family, business, or financial relationship with the insured. Accordingly, § 1.101-1(d)(4)(iii) of the final regulations provides this expanded definition.
>
> The commenter also suggested that the definition of "family member" under § 1.101-1(f)(3) should include charities to which the insured has given substantial financial support or significant volunteer support. Another commenter suggested that a trust with beneficiaries that include both individual family members and a charity with a substantial financial relationship to the insured should qualify as a "family member."[4371] Under § 1.101-1(d)(3)(iii) of the proposed regulations, a substantial financial relationship exists between the insured and acquirer if the acquirer is an organization described in sections 170(c), 2055(a), and 2522(a) that previously received financial support in a substantial amount or significant volunteer support from the insured. Under either of the approaches suggested by the commenters, the acquisition of an interest in a life insurance contract by a trust with beneficiaries that include both individuals who are

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[4370] [my footnote:] I was that commenter (one of only 12 comments submitted); see https://www.thompsoncoburn.com/docs/default-source/blog-documents/gorin-transfer-for-value-comments.pdf. Discussing with ACTEC Fellow Michael Van Cise's the comment he was making below got me thinking more about this issue.

[4371] [my footnote:] ACTEC Fellow Michael Van Cise was that commenter.

family members of the insured and a charity described in § 1.101-1(d)(3)(iii) of the proposed regulations would not be a reportable policy sale. The Treasury Department and the IRS agree that the existence of a trust beneficiary that is a charity described in § 1.101-1(d)(3)(iii) of the proposed regulations should not cause a transfer to that trust to be a reportable policy sale. However, rather than expanding the definition of "family member" under § 1.101-1(f)(3) of the proposed regulations as suggested by the commenters, the Treasury Department and the IRS have adopted a more direct and expansive approach to address the commenters' concerns by adding a new rule in the final regulations providing that any combination of the described substantial relationships between a trust's beneficiaries and the insured is sufficient to qualify the transfer to that trust for the reportable policy sale exclusion. See § 1.101-1(d)(4)(iii) of the final regulations. As a result, under the final regulations, there is no need to also expressly treat a trust established and maintained for the primary benefit of the insured or one or more of the insured's family members as a family member of the insured. Therefore, the final regulations do not include such a trust in the definition of family member.

B. Substantial Financial Relationships With Charities

Under § 1.101-1(d)(3)(iii) of the proposed regulations, the acquirer of an interest in a life insurance contract has a substantial financial relationship with the insured if the acquirer is an organization described in sections 170(c), 2055(a), and 2522(a) that previously received financial support in a substantial amount or significant volunteer support from the insured. One commenter on the proposed regulations suggested that this provision be expanded to include any other such organization with which the insured has substantial personal ties, such as the donor or a family member having benefitted from the charitable organization's services in some manner.[4372] The commenter stated that it is not uncommon for a donor to both (i) contribute very modestly, if at all, to a charity during life because the donor is concerned about having sufficient retirement income, and (ii) want to benefit the charity when the donor no longer needs to preserve retirement income sources. The commenter also stated that donors often benefit charities through either a split interest trust described in section 170(f)(2) or a bargain sale described in § 1.1011-2.

The Treasury Department and IRS have not adopted this suggestion in the final regulations because it would be challenging to determine when personal ties with a charity are substantial enough to constitute a substantial financial relationship with the insured, in the absence of a significant donation of time or property. Also, there generally will be little detriment to a charity as a result of an acquisition (whether gratuitous or for value) of an interest in a life insurance contract in a reportable policy sale. Nevertheless, as discussed later in this section, the final regulations provide that the category of charities considered to have a substantial financial relationship with an insured may be expanded in the future in guidance published in the Internal Revenue Bulletin.

Treating a gratuitous transfer of an interest in a life insurance contract (or the part of the transfer that is gratuitous, in the case of a bargain sale) as a reportable policy sale does not affect the amount of proceeds excludable by the gratuitous transferee.
Section 1.101-1(b)(2)(i) of the final regulations applies to all gratuitous transfers of interests in life insurance contracts and generally provides that the transferee in a gratuitous transfer of an interest in a life insurance contract steps into the shoes of the

[4372] [my footnote:] I was that commenter; see fn 4370.

transferor and may exclude death benefits paid under the contract from gross income to the same extent that the transferor would have been able to exclude the benefits, in addition to the premiums and other amounts paid by the transferee. Furthermore, treatment of a gratuitous transfer as a reportable policy sale does not result in reporting obligations for the gratuitous transferee because the gratuitous transferor is not a reportable policy sale payment recipient. See §§ 1.6050Y-1(a)(16) and 1.6050Y-2(a) of the final regulations.

Even if a charity purchased some or all of its interest in a life insurance contract for valuable consideration, a charity generally is not subject to Federal income tax on its income (including insurance policy proceeds) unless the income arises from an unrelated trade or business. Thus, the charity's obligation in case of a purchase generally would be limited to acquirer reporting under § 1.6050Y-2, which merely requires providing on Form 1099-LS information that should be readily available to the charity. This reporting provides important information regarding the sale to reportable policy sale payment recipients and the IRS.

In response to the commenters concerns, however, the final regulations provide that the IRS may publish guidance in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) describing other situations in which a substantial financial relationship exists between the insured and an acquirer that is an organization described in sections 170(c), 2055(a), and 2522(a). See § 1.101-1(d)(3)(iii) of the final regulations.

C. Substantial Financial Relationships and BOLI Pooling Transactions

One commenter on the proposed regulations requested confirmation that a reportable policy sale will not arise when a life insurance policy is involved in a transaction that pools bank-owned life insurance (BOLI). The commenter explained that businesses, such as banks, commonly promise certain pre-and post-retirement benefits to their employees, such as retiree health care benefits, which can result in substantial liabilities for the businesses that must be reflected on their financial statements. The commenter described BOLI as permanent, cash value life insurance coverage on the lives of a bank's officers, directors, and employees purchased by the bank to fund such obligations informally and to establish assets on its financial statements to offset liabilities for the promised benefits. The commenter stated that BOLI owners typically hold the policies until the death benefits become payable and use the benefits to fund the costs of the employee benefits or to recover such costs after the fact. The commenter described BOLI pooling transactions as transactions that pool the BOLI policies of multiple banks for the continued purpose of funding each bank's employee benefits, but in a more effective, centralized way. The commenter described the initial step of a BOLI pooling transaction as the transfer by multiple unrelated banks of their pre-existing BOLI policies to a partnership, in return for which each bank receives a partnership interest proportional to the value of its contributed policies. The commenter explained that the partnership holds and manages the contributed policies and distributes death benefits among the bank-partners pro rata based on their respective partnership interests, which is expected to help normalize cash flows from the policies.

The commenter asserted that BOLI pooling transactions are ordinary course business transactions that should not be treated as reportable policy sales because they are not speculative and can be distinguished from sales of policies to third parties because the intent and result is to pool the policies among all the original policyholders for the continued purpose of funding their employee benefit liabilities. The commenter noted that the IRS has issued private letter rulings that confirm, directly or indirectly, that the carryover basis exception to the transfer for value rule in section 101(a)(2) applies to a bank's contribution of BOLI policies to the partnership in a BOLI pooling transaction, thereby preserving the tax-free character of the death benefits when paid to the partnership. These rulings pre-date the addition of section 101(a)(3) to the Code. The reportable policy sale rules of section 101(a)(3) are in addition to the carryover basis exception of section 101(a)(2). As a result, policy transfers are ineligible for the carryover basis exception if no substantial family, business, or financial relationship exists between the acquirer of an interest in a life insurance contract and the insured under that contract at the time of the acquisition.

The commenter asserted that the proposed regulations support the requested treatment of BOLI pooling transactions because a substantial financial relationship exists between the acquirer and insured. A substantial financial relationship exists under § 1.101-1(d)(3)(ii) of the proposed regulations if the acquirer maintains the life insurance contract on the life of the insured to provide funds to purchase assets or satisfy liabilities following the death of the insured. The commenter asserted that this provision applies in BOLI pooling transactions with respect to both the bank and the partnership as follows: (1) the partnership has a direct acquisition of life insurance policies, which it maintains to satisfy liabilities following the death of the insured, namely, the employee benefit liabilities of the bank-partners for which they originally purchased the policies; (2) the bank has an indirect acquisition of life insurance policies contributed by other banks to the partnership; and (3) the bank maintains its indirect interest in those policies to continue funding the same employee benefit liabilities. The commenter recommended clarification of the regulations to confirm this treatment, either by adding additional language to the definition of substantial financial relationship, or by adding an example that applies that provision to the BOLI pooling transaction. Alternatively, the commenter suggested a separate exception to the reportable policy sale definition.

The final regulations do not adopt the commenters requested changes because the changes would be inconsistent with the statute. The proposed regulations do not support, and were not intended to support, the requested treatment of BOLI pooling transactions.

First, the partnership described by the commenter does not have a substantial family, business, or financial relationship with the insureds under the proposed regulations. Specifically, it does not have a substantial financial relationship with any insured under § 1.101-1(d)(3)(ii) of the proposed regulations because it does not maintain the life insurance contract on the life of the insured to provide funds for the partnership to purchase assets or satisfy liabilities following the insured's death. As described by the commenter, the partnership maintains the life insurance contracts to provide its partners, the banks, with funds to satisfy the banks' employee benefit liabilities. Accordingly, the partnership's acquisition of the life insurance contracts in the circumstances described is a reportable policy sale that must be reported under section 6050Y and § 1.6050Y-2 of the proposed regulations.

Second, the definition of a substantial financial relationship in § 1.101-1(d)(3)(ii) of the proposed regulations was not intended to cover relationships as tenuous as those existing between the indirect acquirers (the banks) and the insureds in the BOLI pooling transactions described by the commenter. Section 1.101-1(d)(3)(ii) of the proposed regulations was intended to cover situations in which the life insurance contract is held to provide funds to purchase assets or satisfy liabilities, when the need for the asset purchases or liability payments results from the insured's death. In the situation described by the commenter, a bank does not have this kind of relationship with the insureds under life insurance contracts contributed to the partnership by other banks. However, in the circumstances described, because the partnership acquires the life insurance contracts in a reportable policy sale that must be reported under section 6050Y(a) and § 1.6050Y-2 of the proposed regulations, the bank's indirect acquisition of the life insurance contracts is not a reportable policy sale, provided the partnership complies with the reporting requirements. See § 1.101-1(c)(2)(iii)(A) of the proposed regulations.

D. Substantial Financial Relationships Under § 1.101-1(d)(3)(ii)

A substantial financial relationship exists under § 1.101-1(d)(3)(ii) of the proposed regulations if the acquirer maintains the life insurance contract on the life of the insured to provide funds to purchase assets or satisfy liabilities following the death of the insured. As described in section 5.0 of this Summary of Comments and Explanation of Revisions, this definition was intended to apply in situations in which the life insurance contract is held to provide funds to purchase assets or satisfy liabilities following the death of the insured, when the need for the asset purchases or liability payments results from the insured's death. Accordingly, § 1.101-1(d)(3)(ii) of the final regulations revises the definition to provide that a substantial financial relationship exists between the acquirer and insured if the acquirer maintains the life insurance contract on the life of the insured to provide funds to purchase assets of or to satisfy liabilities of the insured or the insured's estate, heirs, legatees, or other successors in interest, or to satisfy other liabilities arising upon or by reason of the death of the insured.

Reg. § 1.101-1(d)(1), "Substantial family relationship," provides:

For purposes of this section, a substantial family relationship means the relationship between an individual and any family member of that individual as defined in paragraph (f)(3) of this section. In addition, a substantial family relationship exists between an individual and his or her former spouse with regard to the transfer of an interest in a life insurance contract to (or in trust for the benefit of) that former spouse incident to divorce.

Reg. § 1.101-1(f)(3), "Family member," provides:

With respect to any individual, the term family member refers to any person described in paragraphs (f)(3)(i) through (vi) of this section. For purposes of this paragraph (f)(3), full effect is given to a legal adoption, and a step-child is deemed to be a descendant. The family members of an individual include:

(i) The individual;

(ii) The individual's spouse or a person with whom the individual is in a registered domestic partnership, civil union, or other similar relationship established under state law;

(iii) Any parent, grandparent, or great-grandparent of the individual or of the person described in paragraph (f)(3)(ii) of this section and any spouse of such parent, grandparent, or great-grandparent, or person with whom the parent, grandparent, or great-grandparent is in a registered domestic partnership, civil union, or other similar relationship established under state law;

(iv) Any lineal descendant of the individual or of any person described in paragraph (f)(3)(ii) or (iii) of this section;

(v) Any spouse of a lineal descendant described in paragraph (f)(3)(iv) of this section and any person with whom such a lineal descendant is in a registered domestic partnership, civil union, or other similar relationship established under state law; and

(vi) Any lineal descendant of a person described in paragraph (f)(3)(v) of this section.

Reg. § 1.101-1(d)(2), “Substantial business relationship,” provides:

For purposes of this section, a substantial business relationship between the insured and the acquirer exists in each of the following situations:

(i) The insured is a key person (as defined in section 264) of, or materially participates (within the meaning of section 469) in, an active trade or business as an owner, employee, or contractor, and at least 80 percent of that trade or business is owned (directly or indirectly, through one or more partnerships, trusts, or other entities) by the acquirer or the beneficial owners of the acquirer.

(ii) The acquirer acquires an active trade or business and acquires the interest in the life insurance contract either as part of that acquisition or from a person owning significant property leased to the acquired trade or business or life insurance policies held to facilitate the succession of the ownership of the business if--

(A) The insured—

(1) Is an employee within the meaning of section 101(j)(5)(A) of the acquired trade or business immediately preceding the acquisition; or

(2) Was a director, highly compensated employee, or highly compensated individual within the meaning of section 101(j)(2)(A)(ii) of the acquired trade or business, and the acquirer, immediately after the acquisition, has ongoing financial obligations to the insured with respect to the insured’s employment by the trade or business (for example, the life insurance contract is maintained by the acquirer to fund current or future retirement, pension, or survivorship obligations based on the insured’s relationship with the entity or to fund a buy-out of the insured’s interest in the acquired trade or business); and

(B) The acquirer either carries on the acquired trade or business or uses a significant portion of the acquired business assets in an active trade or business that does not include investing in interests in life insurance contracts.

For the above references to Code § 264, see fns 4320-4322 in part II.Q.4.a Funding the Buy-Sell. Under that provision, generally a key person is an officer or 20% owner, but the number of individuals who may be treated as key persons may be as few as five people.

For the above references to material participation under Code § 469, see part II.K.1.a.ii Material Participation and various other discussion in part II.K.1 Passive Loss Rules Generally.

For the above references to Code § 101(j), see part II.Q.4.g.i Analysis of Code § 101(j).

Reg. § 1.101-1(d)(2), "Substantial financial relationship," provides:

> For purposes of this section, a substantial financial relationship between the insured and the acquirer exists in each of the following situations:
>
> (i) The acquirer (directly or indirectly, through one or more partnerships, trusts, or other entities of which it is a beneficial owner) has, or the beneficial owners of the acquirer have, a common investment (other than the interest in the life insurance contract) with the insured and a buy-out of the insured's interest in the common investment by the co-investor(s) after the insured's death is reasonably foreseeable.
>
> (ii) The acquirer maintains the life insurance contract on the life of the insured to provide funds to purchase assets of or to satisfy liabilities of the insured or the insured's estate, heirs, legatees, or other successors in interest, or to satisfy other liabilities arising upon or by reason of the death of the insured.
>
> (iii) The acquirer is an organization described in sections 170(c), 2055(a), and 2522(a) that previously received from the insured either financial support in a substantial amount or significant volunteer support or that meets other requirements prescribed in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) for establishing that a substantial financial relationship exists between the insured and the organization.

Neither the proposed regulations nor their preamble defines "common investment." Presumably this provides full latitude for buy-sell agreements among owners of a business entity.

Reg. § 1.101-1(d)(4), "Special rules," provides:

> Paragraphs (d)(4)(i), (ii), and (iii) of this section apply for purposes of determining whether a substantial relationship (whether family, business, or financial) exists under paragraph (d)(1), (2), or (3) of this section, respectively.
>
> (i) *Indirect acquisitions*. The acquirer of an interest in a life insurance contract in an indirect acquisition is deemed to have a substantial business or financial relationship with the insured if the direct holder of the interest in the life insurance contract has a substantial business or financial relationship with the insured immediately before and after the date the acquirer acquires its interest.
>
> (ii) *Acquisitions by certain persons*. The sole fact that an acquirer is a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer, is not sufficient to establish a substantial business or financial relationship with the insured. In addition, an acquirer need not be a

partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer to have a substantial business or financial relationship with the insured.

(iii) *Acquisitions by those with differing types of substantial relationships*. A substantial family, business, or financial relationship exists between the insured and a partnership, trust, or other entity if each beneficial owner of that partnership, trust, or other entity has a substantial family, business, or financial relationship with the insured. For example, a substantial family, business, or financial relationship exists between the insured and a trust if each trust beneficiary is a family member of the insured or an organization described in paragraph (d)(3)(iii) of this section.

Reg. § 1.101-1(f)(1), "Beneficial owner," provides:

> A beneficial owner of a partnership, trust, or other entity is an individual or C corporation with an ownership interest in that entity. The interest may be held directly or indirectly, through one or more other partnerships, trusts, or other entities. For instance, an individual that directly owns an interest in a partnership (P1), which directly owns an interest in another partnership (P2), is an indirect beneficial owner of P2 and any assets or other entities owned by P2 directly or indirectly. For purposes of this paragraph (f)(1), the beneficial owners of a trust include those who may receive current distributions of trust income or corpus and those who could receive distributions if the trust were to terminate currently.

Note that the beneficial owners of a trust ***include*** those persons named above [emphasis added]. My understanding is that, in federal tax regulations, "includes" means "includes without limitation." Query whether that expansion of the definition means that one or more persons beyond the current potential distributees and immediate remaindermen need to be considered.

Reg. § 1.101-1(g)(14)[4373] elaborates on Reg. § 1.101-1(d)(4), providing:

> *Example 14*. Partnership X conducts an active trade or business and is the initial policyholder of a $100,000 insurance policy on the life of its full-time employee, A. A materially participates in Partnership X's active trade or business in A's capacity as an employee. Individual B acquires a 10% profits interest in Partnership X in exchange for a cash payment of $1,000,000. Under paragraphs (d)(1) through (3) of this section, B does not have a substantial family, business, or financial relationship with A. Under paragraph (d)(4)(i) of this section, however, B is deemed to have a substantial business relationship with A because, under paragraph (d)(2)(i) of this section, Partnership X (the direct policyholder) has a substantial business relationship with A. Accordingly, although the acquisition of the 10% partnership interest by B is an indirect acquisition of a 10% interest in the insurance policy covering A's life, the acquisition is not a reportable policy sale.

[4373] Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

Reg. § 1.101-1(g)(16)[4374] elaborates on Reg. § 1.101-1(d), providing:

> *Example 16*. A is the initial policyholder of a $100,000 insurance policy on A's life. A sells the policy for its fair market value. As a result of the sale, Bank X holds legal title to the life insurance contract as the nominee of Partnership B, and Partnership B has the enforceable right to designate the contract beneficiary. Under paragraphs (d)(1) through (4) of this section, neither Bank X nor Partnership B has a substantial family, business, or financial relationship with the insured, A, at the time of the sale. Accordingly, the transfer of legal title to the policy to Bank X is a reportable policy sale under paragraph (c)(1) of this section, unless an exception set forth in paragraph (c)(2) of this section applies. The same is true of the transfer of the economic benefits of the policy to Partnership B. At a later date, Partnership B sells its economic interest in the policy to Partnership C for fair market value. Bank X continues to hold legal title to the life insurance contract, but now holds it as Partnership C's nominee. Partnership C has no substantial family, business, or financial relationship with the insured, A, under paragraphs (d)(1) through (4) of this section at the time of the transfer. Accordingly, Partnership C's acquisition of the economic interest in the policy from Partnership B is a reportable policy sale under paragraph (c)(1) of this section, unless an exception set forth in paragraph (c)(2) of this section applies.

Prop. Reg. § 1.101-1(g)(17)[4375] elaborates on Prop. Reg. § 1.101-1(b)(2)(iv), providing:

> *Example 17*. The facts are the same as in Example 4 in paragraph (g)(4) of this section except that, before A's death, C exchanges the policy on A's life for a new policy on A's life in a section 1035 exchange. The amount of the proceeds C may exclude from C's gross income under this section is limited under paragraph (b)(2)(iv)(B) of this section to $6,000 plus any premiums and other amounts paid by C with respect to the original policy subsequent to the transfer and any premiums and other amounts paid by C with respect to the new policy subsequent to the exchange.

Prop. Reg. § 1.101-1(g)(18)[4376] elaborates on Prop. Reg. § 1.101-1(b)(2)(iv), providing:

> *Example 18*. The facts are the same as in Example 17 in paragraph (g)(17) of this section except that, before A's death, C sells the new policy to A for fair market value.

[4374] Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

[4375] See retroactivity provided in Applicability Dates of the proposed regulations. Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

[4376] See retroactivity provided in Applicability Dates of the proposed regulations. Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the

A’s estate receives the proceeds of $100,000 on A’s death. Under paragraph (b)(1)(ii)(B)(3)(i) of this section, the amount of the proceeds A’s estate may exclude from gross income is not limited by paragraph (b) of this section.

Prop. Reg. § 1.101-1(g)(19)[4377] provides:

> *Example 19*. A is the initial policyholder of a $100,000 insurance policy on A’s life. A transfers the policy for $6,000, its fair market value, to an individual, C, who does not have a substantial family, business, or financial relationship with A at the time of the transfer. The transfer from A to C is a reportable policy sale. C also is the initial policyholder of a $200,000 insurance policy on A’s life. Before A’s death, C exchanges the two policies on A’s life for a single new policy on A’s life in a section 1035 exchange. C receives the proceeds from the new policy on A’s death. The entire amount of the proceeds attributable to the interest in the new policy that was issued in exchange for the policy originally issued to C is excludable from gross income under paragraph (b)(2)(iv)(A) of this section. The amount of the proceeds attributable to the interest in the new policy that was issued in exchange for the policy originally issued to A that is excludable from gross income is limited under paragraph (b)(2)(iv)(B) of this section to $6,000 plus any premiums and other amounts paid by C with respect to the policy originally issued to A subsequent to the transfer and any premiums and other amounts paid by C with respect to the interest in the new policy that was issued in exchange for the policy originally issued to A.

II.Q.4.b.ii.(d). Transfer With Substituted Basis or To Permitted Transferee When Not a Reportable Policy Sale

Code § 101(a)(2) provides that the transfer for value rule does not apply:

> (A) if such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor, or
>
> (B) if such transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.

Thus, either the substituted basis rule of Code § 101(a)(2)(A) or the permitted transferee rule of Code § 101(a)(2)(B) suffices to exclude from the transfer for value rules any transfer that is not a reportable policy sale.

> amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

[4377] See retroactivity provided in Applicability Dates of the proposed regulations. Reg. § 1.101-1(g), “Examples,” begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

The preamble to the proposed regulations explains:[4378]

> Section 1.101-1(b)(1)(i) of the proposed regulations provides that, in the case of a transfer of an interest in a life insurance contract for valuable consideration, the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited under section 101(a)(2) to the sum of the actual value of the consideration for the transfer paid by the transferee and the premiums and other amounts subsequently paid by the transferee with respect to that interest. Consistent with section 101(a)(3), this general rule applies to all transfers of interests in life insurance contracts for valuable consideration that are reportable policy sales. Consistent with section 101(a)(2), this general rule also continues to apply to transfers of interests in life insurance contracts for valuable consideration that are not reportable policy sales, unless an exception set forth in section 101(a)(2) applies. See § 1.101-1(b)(1)(i) and (ii) of the proposed regulations. Section 1.101-1(b)(1)(ii)(A) of the proposed regulations applies to carryover basis transfers that are not also subject to § 1.101-1(b)(1)(ii)(B) of the proposed regulations. Section 1.101-1(b)(1)(ii)(B) of the proposed regulations applies to transfers to certain persons.
>
> Under § 1.101-1(b)(1)(ii)(A) of the proposed regulations, the limitation described in section 101(a)(2) and § 1.101-1(b)(1)(i) of the proposed regulations does not apply to the transfer of an interest in a life insurance contract for valuable consideration if (1) The transfer is not a reportable policy sale, (2) the basis of the interest transferred, for the purpose of determining gain or loss with respect to the transferee, is determinable in whole or in part by reference to the basis of that interest in the hands of the transferor, and (3) § 1.101-1(b)(1)(ii)(B) of the proposed regulations does not apply to the transfer. The amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is, however, limited to the sum of (1) The amount that would have been excludable by the transferor, and (2) the premiums and other amounts subsequently paid by the transferee.
>
> This limitation applies without regard to whether the interest previously has been transferred or to the nature of any prior transfer of the interest. For instance, it is irrelevant whether a prior transfer was gratuitous or for value, whether section 101(a)(2)(A) or (B) applied to a prior transfer, whether any prior transfer was a reportable policy sale, or whether the prior transfer was of the same interest or a larger interest in a life insurance contract that included the same interest. If the full amount of the proceeds would have been excludable by the transferor, as would generally be the case if the original policyholder is the transferor, § 1.101-1(b)(1)(ii)(A) of the proposed regulations will, as a practical matter, impose no limitation on the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1).
>
> Under § 1.101-1(b)(1)(ii)(B)(1) of the proposed regulations, the limitation on the excludable amount of the proceeds described in section 101(a)(2) and § 1.101-1(b)(1)(i) of the proposed regulations will not apply to an interest in a life insurance contract that is transferred for valuable consideration if (1) The transfer is not a reportable policy sale and the interest was not previously transferred for valuable consideration in a reportable policy sale, and (2) the transfer is to the insured, a partner of the insured, a partnership

[4378] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

> in which the insured is a partner, or a corporation in which the insured is a shareholder or officer (a (B)(1) person).
>
> Under § 1.101-1(b)(1)(ii)(B)(2) of the proposed regulations, if a transfer of an interest in a life insurance contract to a (B)(1) person follows a transfer for valuable consideration in a reportable policy sale (whether in the immediately preceding transfer or an earlier transfer), the amount of the proceeds attributable to that interest that is excludable from gross income under section 101(a)(1) is limited to the sum of (1) The higher of the amount that would have been excludable by the transferor if the transfer to the (B)(1) person had not occurred or the actual value of the consideration for the transfer to the (B)(1) person paid by the (B)(1) person, and (2) the premiums and other amounts subsequently paid by the transferee. Thus, in determining the excludable amount of the proceeds attributable to an interest in a life insurance contract that is transferred to a (B)(1) person in a transfer that is not a reportable policy sale, the limitation described in section 101(a)(2) and § 1.101-1(b)(1)(i) of the proposed regulations is inapplicable unless the interest previously had been transferred in a reportable policy sale. Additionally, because of the alternative in the formula for computing the limitation, a (B)(1) person will not be subject to a less favorable limitation than the limitation applicable to a transferee in a carryover basis transfer eligible for the exception set forth in § 1.101-1(b)(1)(ii)(A) of the proposed regulations.
>
> The proposed regulations provide a single rule applicable to all gratuitous transfers of interests in life insurance contracts, including reportable policy sales that are not for valuable consideration: the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited to the sum of (1) The amount of the proceeds attributable to the gratuitously transferred interest that would have been excludable by the transferor if the transfer had not occurred, and (2) the premiums and other amounts subsequently paid by the transferee. See § 1.101-1(b)(2)(i) of the proposed regulations. Although § 1.101-1(b)(2) of the existing regulations provides a special rule for gratuitous transfers made by or to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer, such a rule is not required by section 101(a), and the proposed regulations do not contain a special rule for these transfers because it could be subject to abuse.
>
> Section 1.101-1(b)(3) of the proposed regulations clarifies that, for purposes of § 1.101-1(b)(1) and (2) of the proposed regulations, in determining the amounts, if any, of consideration paid by the transferee for the transfer of an interest in a life insurance contract and premiums and other amounts subsequently paid by the transferee with respect to that interest, the amounts paid by the transferee are reduced, but not below zero, by amounts received by the transferee under the life insurance contract that are not received as an annuity, to the extent excludable from gross income under section 72(e). This provision is necessary to prevent an exclusion from gross income based on a double-counting of consideration paid.

Reg. § 1.101-1(b)(1)(ii), "Exceptions," explains in (A), "Exception for carryover basis transfers," when the substituted basis rule of Code § 101(a)(2)(A) causes the transfer for value rule under Code § 101(a)(2) not to apply:

> The limitation described in paragraph (b)(1)(i) of this section does not apply to the transfer of an interest in a life insurance contract for valuable consideration if each of the

following requirements are satisfied. First, the transfer is not a reportable policy sale. Second, the basis of the interest, for the purpose of determining gain or loss with respect to the transferee, is determinable in whole or in part by reference to the basis of the interest in the hands of the transferor (see section 101(a)(2)(A)). Third, paragraph (b)(1)(ii)(B) of this section does not apply. In the case of a transfer described in this paragraph (b)(1)(ii)(A), the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited to the sum of the amount that would have been excludable by the transferor if the transfer had not occurred and the premiums and other amounts subsequently paid by the transferee with respect to the interest. The preceding sentence applies without regard to whether the interest previously has been transferred and the nature of any prior transfer of the interest.

Thus, the substituted basis rule of Code § 101(a)(2)(A) applies when the permitted transferee rule of Code § 101(a)(2)(B), which is elaborated upon in Reg. § 1.101-1(b)(1)(ii)(B), does not apply. Reg. § 1.101-1(b)(1)(ii)(B), "Exception for transfers to certain persons," provides:

(1) *In general*. The limitation described in paragraph (b)(1)(i) of this section does not apply to the transfer of an interest in a life insurance contract for valuable consideration if both of the following requirements are satisfied. First, the transfer is not a reportable policy sale and the interest was not previously transferred for valuable consideration in a reportable policy sale. Second, the interest is transferred to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer (see section 101(a)(2)(B)).

(2) *Transfers to certain persons subsequent to a reportable policy sale*. Except as provided in paragraph (b)(1)(ii)(B)(3) of this section, if a transfer of an interest in a life insurance contract would be described in paragraph (b)(1)(ii)(B)(/) of this section, but for the fact that the interest previously was transferred for valuable consideration in a reportable policy sale (whether in the immediately preceding transfer or an earlier transfer), then the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited to the sum of -

(i) The higher of the amount that would have been excludable by the transferor if the transfer had not occurred or the actual value of the consideration for the transfer paid by the transferee; and

(ii) The premiums and other amounts subsequently paid by the transferee with respect to the interest.

(3) *Transfers to the insured subsequent to a reportable policy sale*.

(i) Except as provided in paragraph (b)(1)(ii)(B)(3)(ii) of this section, to the extent that an interest (or portion of an interest) in a life insurance contract that was transferred for valuable consideration in a reportable policy sale subsequently is transferred to the insured for valuable consideration, the limitations described in paragraph (b)(1)(i) of this section and paragraph (b)(1)(ii)(B)(2) of this section do not apply. To the extent that fair market value is not paid by the insured for the transferred interest, the transfer of the portion of the interest with a value in excess of the consideration paid will be treated as a gift under the bargain sale rule in paragraph (b)(2)(iii) of this section.

(ii) This paragraph (b)(1)(ii)(B)(3)(ii) applies with respect to an interest described in paragraph (b)(1)(ii)(B)(3)(i) of this section (or portion of such an interest) that subsequently is transferred by the insured to any other person. If all subsequent transfers of the interest (or portion of the interest) are gratuitous transfers that are not reportable policy sales, the amount of the proceeds excluded from gross income is determined under paragraph (b)(2)(i) of this section, taking into account the application of paragraph (b)(1)(ii)(B)(3)(i) of this section to the insured's acquisition of the interest. If any subsequent transfer of the interest (or portion of the interest) is for valuable consideration or is a reportable policy sale, the amount of the policy proceeds excludable from gross income is determined in accordance with paragraph (b) of this section; if the amount that would have been excludable from gross income by the insured following the transaction described in paragraph (b)(1)(ii)(B)(3)(i) of this section if no subsequent transfer had occurred is relevant, that amount is determined under paragraph (b)(1)(ii)(B)(2) of this section. Paragraph (g)(8) (Example 8) of this section and paragraph (g)(9) (Example 9) of this section illustrate the application of this paragraph (b)(1)(ii)(B)(3)(ii).

Reg. § 1.101-1(b)(1)(ii)(B)(1) above continues the policy of the prior regulations that a transfer to a permitted transferee cleanses a prior transfer for value, but it adds in the requirement that the transfer not be a reportable policy and removes the requirement that the transfer be the final transfer before the insured's death.[4379]

Reg. § 1.101-1(b)(1)(ii)(B)(3) was added in response to my comments requesting cleansing if the insured buys the policy after a reportable policy sale. See part II.Q.4.b.ii.(e) Cleansing by Transfer Back to Insured.[4380]

Examples (10) through (12) in Reg. § 1.101-1(g)(10) through(12)[4381] shed some light on this rule (other than the cleansing aspects, which are discussed later:

(10) *Example 10*. A is the initial policyholder of a $100,000 insurance policy on A's life. A contributes the policy to Corporation X in exchange for stock. Corporation X's basis in the policy is determinable in whole or in part by reference to A's basis in the policy. Corporation X conducts an active trade or business that it wholly owns, and A materially participates in that active trade or business as an employee of Corporation X. Corporation X receives the proceeds of $100,000 on A's death. A's contribution of the policy to Corporation X is not a reportable policy sale because Corporation X has a substantial business relationship with A under paragraph (d)(2)(i) of this section. Although Corporation X's basis in the policy is

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[4379] Reg. § 1.101-1(b)(1)(ii)(B)(1) is applied is Example (3), which is discussed in the text accompanying fn 4385 in part II.Q.4.b.ii.(e) Cleansing by Transfer Back to Insured.

[4380] Especially text accompanying fn 4389.

[4381] Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

determinable in whole or in part by reference to A's basis in the policy, paragraph (b)(1)(ii)(A) of this section does not apply because the insured, A, is a shareholder of Corporation X and the other requirements under paragraph (b)(1)(ii)(B) of this section are satisfied. Accordingly, paragraph (b)(1)(ii)(B) of this section applies, and paragraph (b)(1)(ii)(A) of this section is inapplicable. Under paragraph (b)(1)(ii)(B)(/) of this section, Corporation X's exclusion is not limited by paragraph (b) of this section.

(11) *Example 11*. The facts are the same as in Example 10 in paragraph (g)(10) of this section, except that Corporation X transfers its active trade or business and the policy on A's life to Corporation Y in a tax-free reorganization at a time when A is still employed by Corporation X, but is no longer a shareholder of Corporation X. Corporation Y's basis in the policy is determinable in whole or in part by reference to Corporation X's basis in the policy, and Corporation Y carries on the trade or business acquired from Corporation X. Corporation Y receives the proceeds of $100,000 on A's death. The transfer from Corporation X to Corporation Y is not a reportable policy sale because Corporation Y has a substantial business relationship with A under paragraph (d)(2)(ii) of this section. The amount of the proceeds that Corporation Y may exclude from gross income is limited under paragraph (b)(1)(ii)(A) of this section to the sum of the amount that would have been excludable by Corporation X had the transfer to Corporation Y not occurred, plus any premiums and other amounts paid by Corporation Y with respect to the policy subsequent to the transfer. Accordingly, because Corporation X's exclusion is not limited by paragraph (b) of this section, as described in Example 10 in paragraph (g)(10) of this section, Corporation Y's exclusion is not limited by paragraph (b) of this section.

(12) *Example 12*. A is the initial policyholder of a $100,000 insurance policy on A's life. A contributes the policy to a C corporation, Corporation W, in exchange for stock. After the acquisition, A owns less than 20% of the outstanding stock of Corporation W and owns stock possessing less than 20 % of the total combined voting power of all stock of Corporation W and is therefore not a key person with respect to Corporation W under section 264(e)(3). Corporation W's basis in the policy is determinable in whole or in part by reference to A's basis in the policy. However, no substantial family, business, or financial relationship exists between A and Corporation W, so A's contribution of the policy to Corporation W is a reportable policy sale. Corporation W receives the proceeds of $100,000 on A's death. Under paragraph (b)(1)(i) of this section, the amount of the proceeds Corporation W may exclude from gross income is limited to the actual value of the stock exchanged for the policy, plus any premiums and other amounts paid by Corporation W with respect to the policy subsequent to the transfer. The exceptions in paragraph (b)(1)(ii) of this section do not apply because the transfer to Corporation W is a reportable policy sale.

Example (10) meets each element of the 3-prong test of Reg. § 1.101-1(b)(1)(ii). Example (11) meets the substituted basis and not-a-reportable-sale elements but not the qualified transferee element. However, Example (11) concludes that, because the transferor would have excluded the proceeds from gross income, the substituted-basis transferee may also do so. Thus, Reg. § 1.101-1(b)(1) is essentially imprinting on to the substituted basis rule of Code § 101(a)(2)(A) the idea that a policy's taint under the transfer-for-value rule continues when the policy is transferred in a substituted basis transaction without being cleansed.

Conventional wisdom had been that a transfer to the insured would cleanse the taint. However, Reg. § 1.101-1 seems to suggest limitations on which transfers to the insured would cleanse the taint; see part II.Q.4.b.ii.(e) Cleansing by Transfer Back to Insured.

Example (12) points out that a substituted basis transfer that is a reportable policy sale is subject to the transfer-for-value rules, which is consistent with Code § 101(a)(3).

II.Q.4.b.ii.(e). Cleansing by Transfer Back to Insured or Permitted Transferee

For a sale that is ***not*** a reportable policy sale, Examples (1), (2) and (3) in Reg. § 1.101-1(g)(1), (2), and (3)[4382] describe how to cleanse a policy:

(1) *Example 1*. A is the initial policyholder of a $100,000 insurance policy on A's life. A sells the policy to B, A's child, for $6,000, its fair market value. B is not a partner in a partnership in which A is a partner. B receives the proceeds of $100,000 upon the death of A. Because the transfer to B was for valuable consideration, and none of the exceptions in paragraph (b)(1)(ii) of this section applies, the amount of the proceeds B may exclude from B's gross income under this section is limited under paragraph (b)(1)(i) of this section to $6,000 plus any premiums and other amounts paid by B with respect to the policy subsequent to the transfer.

(2) *Example 2*. The facts are the same as in Example 1 in paragraph (g)(1) of this section except that, before A's death, B gratuitously transfers the policy back to A. A's estate receives the proceeds of $100,000 on A's death. Because the transfer from B to A is a gratuitous transfer to the insured, and the preceding transfer from A to B was not a reportable policy sale, the amount of the proceeds A's estate may exclude from gross income under this section is not limited by paragraph (b)(2)(i) of this section.

(3) *Example 3*. The facts are the same as in Example 1 in paragraph (g)(1) of this section except that, before A's death, B sells the policy back to A for its fair market value. A's estate receives the proceeds of $100,000 on A's death. The transfer from A to B is not a reportable policy sale because the acquirer B has a substantial family relationship with the insured, A. The transfer from B to A also is not a reportable policy sale because the acquirer A has a substantial family relationship with the insured, A. Accordingly, paragraph (b)(1)(ii)(B)(*l*) of this section applies to the transfer to A, and the amount of the proceeds A's estate may exclude from gross income is not limited by paragraph (b) of this section.

Before discussing cleansing, let's discuss Example (1). If A had given the policy to B, then the gift would have qualified for the substituted basis exception to the transfer for value rule. If A had sold the policy to an irrevocable grantor trust that A had previously established for B, the sale would have been disregarded and the rule would not have applied.[4383]

[4382] Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

[4383] See Rev. Rul. 2007-13, reproduced in fn 4338 in part II.Q.4.b.i Transfer for Value Rule Generally.

Example (2) cleansed the policy by a gratuitous transfer to the insured under Reg. § 1.101-1(b)(2)(i).[4384]

Example (3) applies the exception for a transfer for valuable consideration to a permitted transferee in Reg. § 1.101-1(b)(1)(ii)(B)(1).[4385] Unlike Example (2), it was a transfer for valuable consideration, so it also had to avoid being a reportable policy sale.

For a sale that ***<u>is</u>*** a reportable policy sale, the Examples in Reg. § 1.101-1(g)(4), (5), and (6)[4386] in the proposed regulations asserted that no transfer back to the insured will cleanse the policy from the transfer for value rules, but the final regulations allow a fair market value sale to the insured to cleanse the policy:

(4) *Example 4*. A is the initial policyholder of a $100,000 insurance policy on A's life. A transfers the policy for $6,000, its fair market value, to an individual, C, who does not have a substantial family, business, or financial relationship with A. The transfer from A to C is a reportable policy sale. C receives the proceeds of $100,000 on A's death. The amount of the proceeds C may exclude from C's gross income under this section is limited under paragraph (b)(1)(i) of this section to $6,000 plus any premiums and other amounts paid by C with respect to the policy subsequent to the transfer.

(5) *Example 5*. The facts are the same as in Example 4 in paragraph (g)(4) of this section, except that before A's death, C transfers the policy to D, a partner of A who co-owns real property with A, for $8,000, the policy's fair market value. D receives the proceeds of $100,000 on A's death. The transfer from C to D is not a reportable policy sale because the acquirer D has a substantial financial relationship with the insured, A. However, because that transfer follows a reportable policy sale (the transfer from A to C), the amount of the proceeds that D may exclude from gross income under this section is limited by paragraph (b)(1)(ii)(B)(2) of this section to the sum of--

(i) The higher of the amount C could have excluded had the transfer to D not occurred ($6,000 plus any premiums and other amounts paid by C with respect to the policy subsequent to the transfer to C, as described in Example 4 in paragraph (g)(4) of this section) or the actual value of the consideration for that transfer paid by D ($8,000); and

(ii) Any premiums and other amounts paid by D with respect to the policy subsequent to the transfer to D.

[4384] Fn 4390 reproduces the relevant part of . § 1.101-1(b)(2)(i), and Reg. § 1.101-1(b)(2) is reproduced in the text preceding fn 4351 in part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

[4385] See text accompanying and preceding fn 4379 in part II.Q.4.b.ii.(d) Transfer With Substituted Basis or To Permitted Transferee When Not a Reportable Policy Sale.

[4386] Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

(6) *Example 6*. The facts are the same as in Example 4 in paragraph (g)(4) of this section, except that before A's death, C transfers the policy back to A for $8,000, its fair market value. A's estate receives the proceeds of $100,000 on A's death. The transfer from C to A is not a reportable policy sale because the acquirer A has a substantial family relationship with the insured, A. Although the transfer follows a reportable policy sale (the initial transfer from A to C), A's estate may exclude all of the policy proceeds from gross income because paragraph (b)(1)(ii)(B)(3)(i) of this section applies and, therefore, the amount of the proceeds that A may exclude from gross income is not limited by paragraph (b)(1)(i) of this section or (b)(1)(ii)(B)(2) of this section.

Reg. § 1.101-1(g)(7), Example (7)[4387] applies the bargain sale rule to Example (6):

(7) *Example 7*. The facts are the same as in Example 6 in paragraph (g)(6) of this section, except that C transfers the policy back to A for $4,000, rather than its fair market value of $8,000. A's estate receives the proceeds of $100,000 on A's death. Because A did not pay fair market value for the policy, the transfer is bifurcated and treated as a bargain sale under paragraph (b)(2)(iii) of this section. A therefore is treated as having purchased 50% of the policy interest for valuable consideration equal to fair market value and as having received 50% of the policy interest in a gratuitous transfer. The transfer from C to A is not a reportable policy sale because the acquirer, A, has a substantial family relationship with the insured, A, but the transfer from C to A follows a reportable policy sale (the transfer from A to C).

(i) *Treatment of policy interest purchased by A*. A's estate may exclude from income all of the policy proceeds related to the 50% policy interest transferred for valuable consideration ($50,000) because, under paragraph (b)(1)(ii)(B)(3)(i) of this section, the amount of the proceeds that may be excluded from gross income is not limited by paragraph (b)(1)(i) of this section or (b)(1)(ii)(B)(2) of this section.

(ii) *Treatment of policy interest gratuitously transferred to A*. The amount of the policy proceeds related to the 50% policy interest transferred gratuitously that A's estate may exclude from income is limited under paragraph (b)(2)(i) of this section to the sum of the amount C could have excluded with respect to 50% of the policy had the transfer back to A not occurred (that is, 50% of the $6,000 that C paid A for the policy, plus 50% of any premiums and other amounts paid by C with respect to the policy subsequent to the transfer to C), plus 50% of any premiums and other amounts paid by A with respect to the policy subsequent to the transfer to A.

[4387] Reg. § 1.101-1(g), "Examples," begins with:

The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

Additional cleansing examples are in Reg. § 1.101-1(g)(8) and (9), Examples (8) and (9)[4388]:

(8) *Example 8*. The facts are the same as in Example 6 in paragraph (g)(6) of this section, except that, before A's death, A gratuitously transfers 50% of the policy interest to B, A's child, and sells 50% of the policy interest for its fair market value to an individual, E, who does not have a substantial family, business, or financial relationship with A. B and E each receive $50,000 of the proceeds on A's death. Paragraph (b)(1)(ii)(B)(3)(ii) of this section applies to determine the amount of the proceeds that B and E may exclude from gross income because the policy interests transferred to B and E were first transferred for valuable consideration in a reportable policy sale (the transfer by A to C) and then transferred to the insured, A, for fair market value.

(i) *Treatment of policy interest transferred to B*. With respect to the portion of the policy interest transferred to B, because the transfer to B was the only transfer subsequent to the transfer to A and the transfer to B was gratuitous and not a reportable policy sale, under paragraph (b)(1)(ii)(B)(3)(ii) of this section, the amount of the policy proceeds excludable from gross income by B is determined under paragraph (b)(2)(i) of this section, taking into account the application of paragraph (b)(1)(ii)(B)(3)(i) of this section to A's acquisition of the interest. Under paragraph (b)(2)(i) of this section, the amount of the proceeds B may exclude is limited to the sum of the amount A could have excluded had the transfer to B not occurred, and any premiums and other amounts paid by B with respect to the policy subsequent to the transfer to B. As described in Example 6 in paragraph (g)(6) of this section, under paragraph (b)(1)(ii)(B)(3)(i) of this section, the amount of the proceeds that A may exclude from gross income is not limited by paragraph (b)(1)(i) of this section or (b)(1)(ii)(B)(2) of this section. Accordingly, the amount of the proceeds that B may exclude from gross income is not limited by paragraph (b) of this section.

(ii) *Treatment of policy interest transferred to E*. With respect to the portion of the policy interest transferred to E, because the transfer to E was not gratuitous and was a reportable policy sale, under paragraph (b)(1)(ii)(B)(3)(ii) of this section, the amount of the policy proceeds excludable from gross income by E is determined in accordance with paragraph (b) of this section. Accordingly, because the transfer to E was for valuable consideration, the amount excludable from gross income by E is limited by paragraph (b)(1)(i) of this section unless an exception in paragraph (b)(1)(ii) of this section applies. Because the transfer from A to E is a reportable policy sale, none of the exceptions in paragraph (b)(1)(ii) of this section apply. Therefore, the amount of the proceeds E may exclude from gross income under this section is limited by paragraph (b)(1)(i) of this section to the sum of the consideration paid by E and the premiums and other amounts paid by E with respect to the policy subsequent to the transfer to E.

[4388] Reg. § 1.101-1(g), "Examples," begins with:

The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

(9) *Example 9*. The facts are the same as in Example 8 in paragraph (g)(8) of this section, except that, before A's death, B transfers B's policy interest to Partnership F, whose partners are A and other family members of A, in exchange for a partnership interest in Partnership F. Partnership F receives $50,000 of the proceeds on A's death. With respect to the policy interest transferred to Partnership F, paragraph (b)(1)(ii)(B)(3)(ii) of this section applies to determine the amount of the proceeds that Partnership F may exclude from gross income for the reasons described in Example 8 in paragraph (g)(8) of this section.

(i) *Treatment of policy interest transferred to Partnership F*. The transfer to Partnership F was not a reportable policy sale. However, because the transfer to Partnership F was not gratuitous, the amount of the policy proceeds excludable from gross income by Partnership F is determined in accordance with paragraph (b) of this section as if the amount that would have been excludable from gross income by A following the transfer to A, if no subsequent transfer had occurred, was determined under paragraph (b)(1)(ii)(B)(2) of this section. Because B's transfer to Partnership F was a transfer for valuable consideration to a partnership in which the insured is a partner that was preceded by a reportable policy sale (the transfer to C), the amount of the proceeds Partnership F may exclude from gross income under this section is limited under paragraph (b)(1)(ii)(B)(2) of this section to the higher of the amount that would have been excludable by B if the transfer to Partnership F had not occurred or the actual value of the consideration for the policy paid by Partnership F, plus any premiums and other amounts paid by Partnership F with respect to the policy subsequent to the transfer to Partnership F.

(ii) *Amount that B could have excluded*. Because the transfer from A to B was a gratuitous transfer, the amount of the proceeds B could have excluded from gross income under this section if the transfer to Partnership F had not occurred is limited under paragraph (b)(2)(i) of this section to the sum of the amount A could have excluded had the transfer to B not occurred, and any premiums and other amounts paid by B with respect to the policy subsequent to the transfer to B.

(iii) *Amount that A could have excluded*. As described in paragraph (g)(9)(i) of this section, the amount of the proceeds A could have excluded under this section if the transfer to B had not occurred must be determined under paragraph (b)(1)(ii)(B)(2) of this section in accordance with paragraph (b)(1)(ii)(B)(3)(ii) of this section. Under paragraph (b)(1)(ii)(B)(2) of this section, the amount that would have been excludable by A is limited to the higher of the amount that would have been excludable by C if the transfer to A had not occurred ($6,000 plus premiums and other amounts subsequently paid by C) or the actual value of the consideration for the policy paid by A ($8,000), plus any premiums and other amounts paid by A with respect to the policy subsequent to the transfer to A.

These Examples helpfully illustrate that reportable policy sale can be completely cleansed through a sale to the insured for fair market value, and a subsequent transferee may (if appropriate) inherit the policy's cleansed status.[4389] A bargain sale is broken into its separate

[4389] Reg. § 1.101-1(b)(1)(ii)(B)(3) is reproduced in the text preceding fn 4380.

components of a sale plus a gratuitous transfer. A gratuitous transfer back to the insured does not cleanse the policy after a reportable policy sale. Furthermore, Reg. § 1.101-1(b)(2) also provides cleansing: “if an interest in a life insurance contract is transferred gratuitously to the insured, and that interest has not previously been transferred for value in a reportable policy sale, the entire amount of the proceeds attributable to the interest transferred to the insured is excludable from gross income.”[4390] And that cleansing can apply to subsequent transferees, when appropriate. I am delighted that, in response my comments, the final regulations provide both of these cleansing opportunities.

Contrast this to what was in effect before the reportable policy sale rules were enacted, Reg. § 1.101-1(b)(3), which had provided:

> In the case of a series of transfers, if the last transfer of a life insurance policy or an interest therein is for a valuable consideration -
>
> (i) The general rule is that the final transferee shall exclude from gross income, with respect to the proceeds of such policy or interest therein, only the sum of—
>
> (a) The actual value of the consideration paid by him, and
>
> (b) The premiums and other amounts subsequently paid by him;
>
> (ii) If the final transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer, the final transferee shall exclude the entire amount of the proceeds from gross income;
>
> (iii) Except where subdivision (ii) of this subparagraph applies, if the basis of the policy or interest transferred, for the purpose of determining gain or loss with respect to the final transferee, is determinable, in whole or in part, by reference to the basis of such policy or interest therein in the hands of the transferor, the amount of the proceeds which is excludable by the final transferee is limited to the sum of—
>
> (a) The amount which would have been excludable by his transferor if no such transfer had taken place, and
>
> (b) Any premiums and other amounts subsequently paid by the final transferee himself.

Thus, under prior regulations, cleansing applied only to a transfer to the insured for valuable consideration and then only if the insured or a permitted transferee was the final transferee. The prior regulations were much narrower than what the 2019 regulations adopted.

II.Q.4.b.ii.(f). Reporting Requirements for Reportable Policy Sales

See “About Form 1099-LS, Reportable Life Insurance Sale,” at https://www.irs.gov/forms-pubs/about-form-1099-ls.

[4390] Reg. § 1.101-1(b)(2) is reproduced in the text preceding fn 4351 in part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

Code § 6050Y, “Returns relating to certain life insurance contract transactions,” starts with subsection (a), “Requirements of reporting of certain payments”:

(1) *In general*. Every person who acquires a life insurance contract or any interest in a life insurance contract in a reportable policy sale during any taxable year shall make a return for such taxable year (at such time and in such manner as the Secretary shall prescribe) setting forth—

(A) the name, address, and TIN of such person,

(B) the name, address, and TIN of each recipient of payment in the reportable policy sale,

(C) the date of such sale,

(D) the name of the issuer of the life insurance contract sold and the policy number of such contract, and

(E) the amount of each payment.

(2) *Statement to be furnished to persons with respect to whom information is required*. Every person required to make a return under this subsection shall furnish to each person whose name is required to be set forth in such return a written statement showing—

(A) the name, address, and phone number of the information contact of the person required to make such return, and

(B) the information required to be shown on such return with respect to such person, except that in the case of an issuer of a life insurance contract, such statement is not required to include the information specified in paragraph (1)(E).

Code § 6050Y(b), “Requirement of reporting of seller’s basis in life insurance contracts,” provides:

(1) *In general*. Upon receipt of the statement required under subsection (a)(2) or upon notice of a transfer of a life insurance contract to a foreign person, each issuer of a life insurance contract shall make a return (at such time and in such manner as the Secretary shall prescribe) setting forth—

(A) the name, address, and TIN of the seller who transfers any interest in such contract in such sale,

(B) the investment in the contract (as defined in section 72(e)(6)) with respect to such seller, and

(C) the policy number of such contract.

(2) *Statement to be furnished to persons with respect to whom information is required*. Every person required to make a return under this subsection shall furnish to each

person whose name is required to be set forth in such return a written statement showing—

(A) the name, address, and phone number of the information contact of the person required to make such return, and

(B) the information required to be shown on such return with respect to each seller whose name is required to be set forth in such return.

Code § 6050Y(c), "Requirement of reporting with respect to reportable death benefits," provides:

(1) In general. Every person who makes a payment of reportable death benefits during any taxable year shall make a return for such taxable year (at such time and in such manner as the Secretary shall prescribe) setting forth—

(A) the name, address, and TIN of the person making such payment,

(B) the name, address, and TIN of each recipient of such payment,

(C) the date of each such payment,

(D) the gross amount of each such payment, and

(E) such person's estimate of the investment in the contract (as defined in section 72(e)(6)) with respect to the buyer.

(2) Statement to be furnished to persons with respect to whom information is required. Every person required to make a return under this subsection shall furnish to each person whose name is required to be set forth in such return a written statement showing—

(A) the name, address, and phone number of the information contact of the person required to make such return, and

(B) the information required to be shown on such return with respect to each recipient of payment whose name is required to be set forth in such return.

Code § 6050Y(d), "Definitions," provides that, for purposes of Code § 6050Y:

(1) *Payment*. The term "payment" means, with respect to any reportable policy sale, the amount of cash and the fair market value of any consideration transferred in the sale.

(2) *Reportable policy sale*. The term "reportable policy sale" has the meaning given such term in section 101(a)(3)(B).

(3) *Issuer*. The term "issuer" means any life insurance company that bears the risk with respect to a life insurance contract on the date any return or statement is required to be made under this section.

(4) *Reportable death benefits*. The term "reportable death benefits" means amounts paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale.

For details on the definition of “reportable policy sale” in Code § 101(a)(3)(B), see part II.Q.4.b.ii.(c) “Reportable Policy Sale”.

Part 1.A.3 of the preamble to the final regulations, T.D. 9879 (10/31/2019), “Applicability Date for Section 6050Y Regulations,” explains:

> Section 1.6050Y-1 of the proposed regulations provides that the rules in § 1.6050Y-1 through 1.6050Y-4 of the proposed regulations apply to reportable policy sales made and reportable death benefits paid after December 31, 2017, and provides transition relief with respect to reporting required on reportable policy sales and payments of reportable death benefits occurring after December 31, 2017, and before the date final regulations under section 6050Y are published in the Federal Register.
>
> One commenter recommended that reporting obligations under section 6050Y (as well as application of the rules under section 101 relating to section 6050Y) be delayed until 60 days after the date the final regulations are published in the Federal Register. Informal comments also were received requesting transition relief (such as delayed reporting) or permanent relief with respect to the reporting obligations under section 6050Y for reportable policy sales and payments of reportable death benefits occurring after December 31, 2017, and before January 1, 2019 (such as waiving the reporting obligations for this period). One commenter requested that at least an additional 30 days be added to the 90-day relief period provided in § 1.6050Y-1(b)(2) and (3) of the proposed regulations for filing returns and furnishing statements required under section 6050Y(b) and (c) and § 1.6050Y-3 and 1.6050Y-4 of the proposed regulations, to give issuers at least 60 days to complete their reporting after the 60-day extension period provided to acquirers of an interest in a life insurance contract under § 1.6050Y-1(b)(1) of the proposed regulations. The commenter asserted that issuers require significantly more time than the 30 days effectively provided to complete Forms 1099-SB, “Seller’s Investment in Life Insurance Contract,” and 1099-R “Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.”, and to add new forms (such as Form 1099-SB) to their systems. The commenter stated that issuers must identify policies that are subject to reporting once the Forms 1099-LS, “Reportable Life Insurance Sale,” are received as well as enhance systems to track these policies over their life and transmit data between various systems in order to accurately report under sections 6050Y(b) and (c).
>
> In response to these comments, and to give acquirers and issuers ample time to develop and implement reporting systems, the final regulations provide that the rules in §§ 1.6050Y-1 through 1.6050Y-4 of the final regulations apply to reportable policy sales made and reportable death benefits paid after December 31, 2018. See § 1.6050Y-1(b) of the final regulations. As a result, no reporting is required under section 6050Y for reportable policy sales made and reportable death benefits paid after December 31, 2017, and before January 1, 2019.
>
> Section 1.6050Y-1(a)(12) of the final regulations defines “reportable death benefits” as “amounts paid by reason of the death of the insured under a life insurance contract that are attributable to an interest in the contract that was transferred in a reportable policy sale.” Accordingly, because the definition of “reportable policy sale” under § 1.6050Y-1(a)(14) of the final regulations applies only to transfers of interests in life insurance contracts made after December 31, 2018, death benefits are “reportable death benefits” under § 1.6050Y-1(a)(12) of the final regulations and are subject to the reporting

> requirements of § 1.6050Y-4 of the final regulations only if the death benefits are paid by reason of the death of the insured under a life insurance contract transferred after December 31, 2018, in a reportable policy sale.
>
> The final regulations also provide transition relief as set forth in the proposed regulations with two modifications. First, the transition relief applies with respect to reportable policy sales made and reportable death benefits paid after December 31, 2018, and on or before October 31, 2019. Second, as requested by one of the commenters, § 1.6050Y-1(b)(3), (4), and (5) of the final regulations provide issuers with at least 120 days after the final regulations are published in the Federal Register to file returns and furnish statements under section 6050Y(b) and (c) and §§ 1.6050Y-3 and 1.6050Y-4 of the final regulations. These features of the final regulations are intended to give acquirers and issuers ample time to develop and implement reporting systems.
>
> Noting that 250 or more information returns of a single taxpayer must be filed electronically, one commenter requested waivers from electronic filing for 2018 and 2019 issuer reporting under section 6050Y(b) and (c). The Treasury Department and the IRS have determined not to provide the requested waiver in the final regulations under section 6050Y because procedures already exist for any person required to file 250 or more returns during the calendar year to request a waiver from the requirement to file electronically by showing hardship. See § 301.6011-2(c).

Part 7 of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Comments and Changes Relating to Sec. 1.6050Y-1 of the Proposed Regulations," explains:

> Section 1.6050Y-1 of the proposed regulations provides that the rules in § 1.6050Y-1 through 1.6050Y-4 of the proposed regulations apply to reportable policy sales made and reportable death benefits paid after December 31, 2017, and provides transition relief with respect to reporting required on reportable policy sales and payments of reportable death benefits occurring after December 31, 2017, and before the date final regulations under section 6050Y are published in the Federal Register.

I have not reproduced the rest of the preamble explaining various changes to these regulations.

Reg. § 1.6050Y-2, "Information reporting by acquirers for reportable policy sale payments," provides:

> (a) *Requirement of reporting*. Except as provided in paragraph (f) of this section, every person that is an acquirer in a reportable policy sale during any calendar year must file a separate information return with the Internal Revenue Service (IRS) in the form and manner as required by the IRS for each reportable policy sale payment recipient, including any seller that is a reportable policy sale payment recipient. Each return must include the following information with respect to the seller or other reportable policy sale payment recipient to which the return relates:
>
> (1) The name, address, and taxpayer identification number (TIN) of the acquirer;
>
> (2) The name, address, and TIN of the seller or other reportable policy sale payment recipient to which the return relates;
>
> (3) The date of the reportable policy sale;

(4) The name of the 6050Y(a) issuer of the life insurance contract acquired and the policy number of the life insurance contract;

(5) The aggregate amount of reportable policy sale payments made, or to be made, to the seller or other reportable policy sale payment recipient to which the return relates with respect to the reportable policy sale; and

(6) Any other information that is required by the form or its instructions.

(b) *Unified reporting*. The information reporting requirement of paragraph (a) of this section applies to each acquirer in a series of prearranged transfers of an interest in a life insurance contract, as well as each acquirer in a simultaneous transfer of different interests in a single life insurance contract. In either case, an acquirer's reporting obligation is deemed satisfied if the information required by paragraph (a) of this section with respect to that acquirer is timely reported on behalf of that acquirer in a manner that is consistent with forms, instructions, and other IRS guidance by one or more other acquirers or by a third party information reporting contractor.

(c) *Time and place for filing*. Returns required to be made under paragraph (a) of this section must be filed with the Internal Revenue Service Center designated on the prescribed form or in its instructions on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the reportable policy sale occurred. However, see § 1.6050Y-1(b)(5) for transition rules.

(d) *Requirement of and time for furnishing statements*.

(1) *Statements to reportable policy sale payment recipients*.

(i) *Requirement of furnishing statement*. Every person required to file an information return under paragraph (a) of this section with respect to a reportable policy sale payment recipient must furnish in the form and manner prescribed by the IRS to the reportable policy sale payment recipient whose name is set forth in that return a written statement showing the information required by paragraph (a) of this section with respect to the reportable policy sale payment recipient and the name, address, and phone number of the information contact of the person furnishing the written statement. The contact information of the person furnishing the written statement must provide direct access to a person that can answer questions about the statement. The statement is not required to include information with respect to any other reportable policy sale payment recipient in the reportable policy sale or information about reportable policy sale payments to any other reportable policy sale payment recipient.

(ii) *Time for furnishing statement*. Each statement required by paragraph (d)(1)(i) of this section to be furnished to any reportable policy sale payment recipient must be furnished on or before February 15 of the year following the calendar year in which the reportable policy sale occurred. However, see § 1.6050Y-1(b)(2) for transition rules.

(2) *Statements to 6050Y(a) issuers*.

(i) *Requirement of furnishing RPSS*.

(A) *In general*. Except as provided in paragraph (d)(2)(i)(B) of this section, every person required to file a return under paragraph (a) of this section must furnish in the form and manner prescribed by the IRS to the 6050Y(a) issuer whose name is required to be set forth in the return an RPSS with respect to each reportable policy sale payment recipient that is also a seller. Each RPSS must show the information required by paragraph (a) of this section with respect to the seller named therein, except that the RPSS is not required to set forth the amount of any reportable policy sale payment. Each RPSS must also show the name, address, and phone number of the information contact of the person furnishing the RPSS. This contact information must provide direct access to a person that can answer questions about the RPSS.

(B) *Exception from reporting*. An RPSS is not required to be furnished to the 6050Y(a) issuer by an acquirer acquiring an interest in a life insurance contract in an indirect acquisition.

(ii) *Time for furnishing RPSS*. Except as provided in this paragraph (d)(2)(ii), each RPSS required by paragraph (d)(2)(i) of this section to be furnished to a 6050Y(a) issuer must be furnished by the later of 20 calendar days after the reportable policy sale, or 5 calendar days after the end of the applicable state law rescission period. However, if the later date is after January 15 of the year following the calendar year in which the reportable policy sale occurred, the RPSS must be furnished by January 15 of the year following the calendar year in which the reportable policy sale occurred. However, see § 1.6050Y-1(b)(1) for transition rules.

(3) *Unified reporting*. The information reporting requirements of paragraphs (d)(1)(i) and (d)(2)(i) of this section apply to each acquirer in a series of prearranged transfers of an interest in a life insurance contract, as well as each acquirer in a simultaneous transfer of different interests in a single life insurance contract, as described in paragraph (b) of this section. In either case, an acquirer's obligation to furnish statements is deemed satisfied if the information required by paragraphs (d)(1)(i) and (d)(2)(i) of this section with respect to that acquirer is timely reported on behalf of that acquirer consistent with forms, instructions, and other IRS guidance by one or more other acquirers or by a third party information reporting contractor.

(e) *Notice of rescission of a reportable policy sale*. Any person that has filed a return required by section 6050Y(a)(1) and this section with respect to a reportable policy sale must file a corrected return within 15 calendar days of the receipt of notice of the rescission of the reportable policy sale. Any person that has furnished a written statement under section 6050Y(a)(2) and this section with respect to the reportable policy sale must furnish the recipient of that statement with a corrected statement within 15 calendar days of the receipt of notice of the rescission of the reportable policy sale.

(f) *Exceptions to requirement to file*.

(1) An acquirer that is a foreign person is not required to file an information return under paragraph (a) of this section with respect to a reportable policy sale unless -

(i) The life insurance contract (or interest therein) transferred in the sale is on the life of an insured who is a United States person at the time of the sale; or

(ii) The sale is subject to the laws of one or more States of the United States that pertain to acquisitions or sales of life insurance contracts (or interests therein).

(2) An acquirer is not required to file an information return under paragraph (a) of this section with respect to a reportable policy sale payment to a reportable policy sale payment recipient other than the seller if the reportable policy sale payment is reported by the acquirer under section 6041 or 6041A.

(3) An acquirer is not required to file an information return under paragraph (a) of this section with respect to the issuance of a life insurance contract in an exchange pursuant to section 1035. However, the acquirer is required to furnish the 6050Y(a) issuer with the statement required under paragraph (d)(2) of this section as if the acquirer were required to file an information return under paragraph (a) of this section.

(g) *Cross-reference to penalty provisions*.

(1) *Failure to file correct information return*. For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6050Y(a)(1) and this section, see section 6721 and § 301.6721-1 of this chapter. See section 6724(a) and § 301.6724-1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(2) *Failure to furnish correct statement*. For provisions relating to the penalty provided for failure to furnish timely a correct statement to identified persons under section 6050Y(a)(2) and this section, see section 6722 and § 301.6722-1 of this chapter. See section 6724(a) and § 301.6724-1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

Reg. § 1.6050Y-6, "Information reporting by 6050Y(b) issuers for reportable policy sales and transfers of life insurance contracts to foreign persons," provides:

(a) *Requirement of reporting*. Except as provided in paragraph (f) of this section, each 6050Y(b) issuer that receives an RPSS or any notice of a transfer to a foreign person must file an information return with the Internal Revenue Service (IRS) with respect to each seller in the form and manner prescribed by the IRS. The return must include the following information with respect to the seller:

(1) The name, address, and taxpayer identification number (TIN) of the seller;

(2) The investment in the contract with respect to the seller;

(3) The amount the seller would have received if the seller had surrendered the life insurance contract on the date of the reportable policy sale or the transfer of the contract to a foreign person, or if the date of the transfer to a foreign person is not known to the 6050Y(b) issuer, the date the 6050Y(b) issuer received notice of the transfer; and

(4) Any other information that is required by the form or its instructions.

(b) *Unified reporting*. Each 6050Y(b) issuer subject to the information reporting requirement of paragraph (a) of this section must satisfy that requirement, but a 6050Y(b) issuer's reporting obligation is deemed satisfied if the information required by paragraph (a) of this section with respect to that 6050Y(b) issuer is timely reported on behalf of that 6050Y(b) issuer in a manner that is consistent with forms, instructions, and other IRS guidance by one or more other 6050Y(b) issuers or by a third party information reporting contractor.

(c) *Time and place for filing*. Except as provided in this paragraph (c), returns required to be made under paragraph (a) of this section must be filed with the Internal Revenue Service Center designated on the prescribed form or in its instructions on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the reportable policy sale or the transfer to a foreign person occurred. If the 6050Y(b) issuer does not receive notice of a transfer to a foreign person until after January 31 of the calendar year following the year in which the transfer occurred, returns required to be made under paragraph (a) of this section must be filed by the later of February 28 (March 31 if filed electronically) of the calendar year following the year in which the transfer occurred or thirty days after the date notice is received. However, see § 1.6050Y-1(b)(5) for transition rules.

(d) *Requirement of and time for furnishing statements*.

(1) *Requirement of furnishing statement*. Every 6050Y(b) issuer filing a return required by paragraph (a) of this section must furnish to each seller that is a reportable policy sale payment recipient or makes a transfer to a foreign person and whose name is required to be set forth in the return a written statement showing the information required by paragraph (a) of this section with respect to that seller and the name, address, and phone number of the information contact of the person filing the return. This contact information must provide direct access to a person that can answer questions about the statement.

(2) *Time for furnishing statement*. Except as provided in this paragraph (d)(2), each statement required by paragraph (d)(1) of this section to be furnished to any seller must be furnished on or before February 15 of the year following the calendar year in which the reportable policy sale or transfer to a foreign person occurred. If a 6050Y(b) issuer does not receive notice of a transfer to a foreign person until after January 31 of the calendar year following the year in which the transfer occurred, each statement required to be made under paragraph (d) of this section must be furnished by the date thirty days after the date notice is received. However, see § 1.6050Y-1(b)(3) for transition rules.

(3) *Unified reporting*. Each 6050Y(b) issuer subject to the information reporting requirement of paragraph (d)(1) of this section must satisfy that requirement, but a 6050Y(b) issuer's reporting obligation is deemed satisfied if the information required by paragraph (d)(1) of this section with respect to that 6050Y(b) issuer is timely reported on behalf of that 6050Y(b) issuer consistent with forms, instructions, and other IRS guidance by one or more other 6050Y(b) issuers or by a third party information reporting contractor.

(e) *Notice of rescission of a reportable policy sale or transfer of an insurance contract to a foreign person*. Any 6050Y(b) issuer that has filed a return required by section 6050Y(b)(1) and this section with respect to a reportable policy sale or transfer of an insurance contract to a foreign person must file a corrected return within 15 calendar days of the receipt of notice of the rescission of the reportable policy sale or transfer of the insurance contract to a foreign person. Any 6050Y(b) issuer that has furnished a written statement under section 6050Y(b)(2) and this section with respect to the reportable policy sale or transfer of the insurance contract to a foreign person must furnish the recipient of that statement with a corrected statement within 15 calendar days of the receipt of notice of the rescission of the reportable policy sale or transfer of the insurance contract to a foreign person.

(f) *Exceptions to requirement to file*. A 6050Y(b) issuer is not required to file an information return under paragraph (a) of this section if paragraph (f)(1), (2), or (3) of this section applies.

(1) Except as provided in this paragraph (f)(1), the 6050Y(b) issuer obtains documentation upon which it may rely to treat a seller of a life insurance contract or interest therein as a foreign beneficial owner in accordance with § 1.1441-1(e)(1)(ii), applying in such case the provisions of § 1.1441-1 by substituting the term "6050Y(b) issuer" for the term "withholding agent" and without regard to the fact that that these provisions apply only to amounts subject to withholding under chapter 3 of subtitle A of the Internal Revenue Code. A 6050Y(b) issuer may also obtain from a seller that is a partnership or trust, in addition to documentation establishing the entity's foreign status, a written certification from the entity that no beneficial owner of any portion of the proceeds of the sale is a United States person. In such a case, the issuer may rely upon the written certification to treat the partnership or trust as a foreign beneficial owner for purposes of this paragraph (f)(1) provided that the seller does not have actual knowledge that a United States person is the beneficial owner of all or a portion of the proceeds of the sale. See § 1.1441-1(c)(6)(ii) for the definition of beneficial owner that applies for purposes of this paragraph (f)(1). Additionally, for certifying its status as a foreign beneficial owner (as applicable) for purposes of this paragraph (f)(1), a seller that is required to report any of the income from the sale as effectively connected with the conduct of a trade or business in the United States under section 864(b) is required to provide to the 6050Y(b) issuer a Form W-8ECI, Certificate of Foreign Person's Claim that Income is Effectively Connected with the Conduct of a Trade or Business in the United States. If a 6050Y(b) issuer obtains a Form W-8ECI from a seller with respect to the sale or has reason to know that income from the sale is effectively connected with the conduct of a trade or business in the United States under section 864(b), the exception to reporting described in this paragraph (f)(1) does not apply.

(2) The 6050Y(b) issuer receives notice of a transfer to a foreign person, but does not receive an RPSS with respect to the transfer, provided that, at the time the notice is received -

(i) The 6050Y(b) issuer is not a United States person;

(ii) The life insurance contract (or interest therein) transferred is not on the life of a United States person; and

(iii) The 6050Y(b) issuer has not classified the seller as a United States person in its books and records.

(3) The RPSS received by the 6050Y(b) issuer is with respect to the 6050Y(b) issuer's issuance of a life insurance contract to a policyholder in an exchange pursuant to section 1035.

(g) *Cross-reference to penalty provisions*.

(1) *Failure to file correct information return*. For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6050Y(b)(1) and this section, see section 6721 and § 301.6721-1 of this chapter. See section 6724(a) and § 301.6724-1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(2) *Failure to furnish correct statement*. For provisions relating to the penalty provided for failure to furnish timely a correct statement to identified persons under section 6050Y(b)(2) and this section, see section 6722 and § 301.6722-1 of this chapter. See section 6724(a) and § 301.6724-1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

Reg. § 1.6050Y-7, "Information reporting by payors for reportable death benefits," provides:

(a) *Requirement of reporting*. Except as provided in paragraph (e) of this section, every person that is a payor of reportable death benefits during any calendar year must file a separate information return for such calendar year with the Internal Revenue Service (IRS) for each reportable death benefits payment recipient in the form and manner prescribed by the IRS. The return must include the following information with respect to the reportable death benefits payment recipient to which the return relates:

(1) The name, address, and taxpayer identification number (TIN) of the payor;

(2) The name, address, and TIN of the reportable death benefits payment recipient;

(3) The date of the payment;

(4) The gross amount of reportable death benefits paid to the reportable death benefits payment recipient during the taxable year;

(5) The payor's estimate of investment in the contract with respect to the buyer, limited to the payor's estimate of the buyer's investment in the contract with

respect to the interest for which the reportable death benefits payment recipient was paid; and

(6) Any other information that is required by the form or its instructions.

(b) *Time and place for filing*. Returns required to be made under this section must be filed with the Internal Revenue Service Center designated in the instructions for the form on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the payment of reportable death benefits was made. However, see § 1.6050Y-1(b)(5) for transition rules.

(c) *Requirement of and time for furnishing statements*.

(1) *Requirement of furnishing statement*. Every person required to file an information return under paragraph (a) of this section must furnish to each reportable death benefits payment recipient whose name is required to be set forth in that return a written statement showing the information required by paragraph (a) of this section with respect to that reportable death benefits payment recipient and the name, address, and phone number of the information contact of the payor. This contact information must provide direct access to a person that can answer questions about the statement.

(2) *Time for furnishing statement*. Each statement required by paragraph (c)(1) of this section to be furnished to any reportable death benefits payment recipient must be furnished on or before January 31 of the year following the calendar year in which the payment of reportable death benefits was made. However, see § 1.6050Y-1(b)(4) for transition rules.

(d) *Notice of rescission of a reportable policy sale*. Any person that has filed a return required by section 6050Y(c) and this section with respect to a payment of reportable death benefits must file a corrected return within 15 calendar days of recovering any portion of the reportable death benefits payment from the reportable death benefits payment recipient as a result of the rescission of the reportable policy sale. Any person that has furnished a written statement under section 6050Y(c)(2) and this section with respect to a payment of reportable death benefits must furnish the recipient of that statement with a corrected statement within 15 calendar days of recovering any portion of the reportable death benefits payment from the reportable death benefits payment recipient as a result of the rescission of the reportable policy sale.

(e) *Exceptions to requirement to file*. A payor is not required to file an information return under paragraph (a) of this section with respect to a payment of reportable death benefits if paragraph (e)(1), (2), or (3) of this section applies.

(1) Except as provided in this paragraph (e)(1), the payor obtains documentation in accordance with § 1.1441-1(e)(1)(ii) upon which it may rely to treat the reportable death benefits payment recipient as a foreign beneficial owner of the reportable death benefits, applying in such case the provisions of § 1.1441-1 by substituting the term “payor” for the term “withholding agent” and without regard to the fact that the provisions apply only to amounts subject to withholding under chapter 3 of subtitle A of the Internal Revenue Code. A payor may also obtain from a

partnership or trust that is a reportable death benefits recipient, in addition to documentation establishing the entity's foreign status, a written certification from the entity that no beneficial owner of any portion of the reportable death benefits payment is a United States person. In such a case, a payor may rely upon the written certification to treat the partnership or trust as a foreign beneficial owner for purposes of this paragraph (e)(1) provided that the payor does not have actual knowledge that a United States person is the beneficial owner of all or a portion of the reportable death benefits payment. See § 1.1441-1(c)(6)(ii) for the definition of beneficial owner that applies for purposes of this paragraph (e)(1). Other due diligence or reporting requirements may, however, apply to a payor that relies on the exception set forth in this paragraph (e)(1). See § 1.1441-5(c) and (e) (determination of payees of foreign partnerships and certain foreign trusts for amounts subject to withholding under § 1.1441-2(a)) and § 1.1461-1(b) and (c) (amounts subject to reporting for chapter 3 purposes).

(2) The buyer obtained the life insurance contract (or interest therein) under which reportable death benefits are paid in a reportable policy sale to which the exception to reporting described in § 1.6050Y-3(f)(2) applies.

(3) The payor never received, and has no knowledge of any issuer having received, an RPSS with respect to the interest in a life insurance contract with respect to which the reportable death benefits are paid.

(f) *Cross-reference to penalty provisions*.

(1) *Failure to file correct information return*. For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6050Y(c)(1) and this section, see section 6721 and § 301.6721-1 of this chapter. See section 6724(a) and § 301.6724-1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(2) *Failure to furnish correct statement*. For provisions relating to the penalty provided for failure to furnish timely a correct statement to identified persons under section 6050Y(c)(2) and this section, see section 6722 and § 301.6722-1 of this chapter. See section 6724(a) and § 301.6724-1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

II.Q.4.b.ii.(g). Transfer of Interest in an Entity Holding Life Insurance

Under pre-2018 law, a transfer of an interest in an entity did not constitute a transfer of the entity's life insurance under the transfer for value rule. Letter Ruling 9410039, involving a general partnership, held:

> … the admittance of new partners to Taxpayer and/or the withdrawal of partners from Taxpayer will not result in a transfer for valuable consideration under section 101(a)(2) of the life insurance contract on Managing Director, provided there is no termination of the partnership under section 708(b). We express no opinion about the application of

> section 101(a)(2) in the event that there is a termination of the partnership under section 708(b).[4391]

For an LLC taxed as a partnership, Letter Ruling 200826009 similarly ruled:

> … the sale or exchange of membership interests in X either by N or any of the Investors will not result in a transfer for a "valuable consideration" under § 101(a)(2), provided there is no termination of the partnership under § 708(b)(1)(B).[4392]

2017 tax reform did not change the language that what triggers the transfer for value rules is "a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein."[4393] Code § 101(a)(3)(A) added that the permitted transfer and permitted transferee exceptions to the transfer for value rule "shall not apply in the case of a transfer of a life insurance contract, or any interest therein, which is a reportable policy sale." Code § 101(a)(3)(B) defines a "reportable policy sale" as "the acquisition of an interest in a life insurance contract, directly or indirectly," if the acquirer does not have a required connection to the insured.

As described in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract, Reg. § 1.101-1(e)(1), "Definition,"[4394] an "interest" refers to taking "title to or possession of the life insurance contract (also referred to as a life insurance policy), in whole or part, for state law purposes," as well as holding "an enforceable right to receive all or a part of the proceeds of a life insurance contract or to any other economic benefits of the policy" as described in Reg. § 20.2042-1(c)(2) (incidents of ownership).

Applying the above definition of an "interest" in a contract, it appears that for purposes of testing whether a transfer for value has occurred that may affect the exclusion of a death benefit from income, direct ownership of a policy (in whole or in part) must be subjected to a "transfer for a valuable consideration."[4395] Therefore, the conclusion of Letter Rulings 9410039 and 200826009 - that a transfer of a partnership interest does not constitute a deemed transfer of the partnership's insurance policies - would seem to continue to apply. Presumably the same analysis would apply to the transfer of an interest in any other type of entity.

Through this lens, let's consider that a transfer of an interest in an entity may cause the acquirer to have an "indirect acquisition" that constitutes a reportable policy sale.[4396] Although such a transfer does not appear to trigger the transfer for value rule's income taxation of death benefits, it may trigger reporting requirements, given that the rules in part II.Q.4.b.ii.(f) Reporting

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4391 [My footnote:] See part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).

4392 [My footnote:] See part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).

4393 Code § 101(a)(2).

4394 Reg. § 1.101-1(e)(1) is reproduced in the text accompanying fn 4354.

4395 For a discussion of legislative history supporting this idea, see fn 4347 in part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

4396 Reg. § 1.101-1(e)(3)(ii) defines "indirect acquisition" and is reproduced in the text accompanying fn 4356 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract. Certain indirect acquisitions that are not treated as reportable policy sales are described in Reg. § 1.101-1(c)(2)(iii), which is reproduced in the text accompanying fn 4363 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.

Requirements for Reportable Policy Sales refer to the definition in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.

If the required connection with the insured exists, one does not need to worry about an "indirect acquisition." Also, the "indirect acquisition" rule does not apply if:[4397]

> A partnership, trust, or other entity in which an ownership interest is being acquired directly or indirectly holds the interest in the life insurance contract and acquired that interest before January 1, 2019, or acquired that interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2.

So, if the entity acquired each life insurance contract before January 1, 2019, one does not need worry about the transfer of any interest in the entity (but, for policies issued after August 17, 2006, see part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance). One also need not worry when dealing with an interest of no more than 5%, if the entity does not hold mainly life insurance contracts.[4398] Otherwise, one may need to file Form 1099-LS for each policy, to qualify for the exception for a reportable policy sale reported in compliance with Code § 6050Y(a) and Reg. § 1.6050Y-2.

Although I feel comfortable taking the position that the rule regarding indirect acquisitions does not cause the transfer of an interest in a business entity to be a transfer for value, the IRS might assert that such a position makes the reportable policy sale rule toothless for income tax purposes, because all one needs to do to protect a life insurance contract from the income tax consequences is to put the life insurance in a partnership wrapper. Thus, the IRS' might argue that an "indirect acquisition" constitutes a "a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein."[4399]

Therefore, when in doubt regarding whether the transfer of an interest in a business entity might constitute an "indirect acquisition," one should consider reporting on Form 1099-LS any policy where the requisite relationship with the insured might not exist, to avoid any argument by the IRS that the policy's death benefit might be subjected to income tax.

REG-108054-21, Information Reporting and Transfer for Valuable Consideration Rules for Section 1035 Exchanges of Life Insurance and Certain Other Life Insurance Contract Transactions (5/09/2023) describes how the regulations it proposes softens the approach to corporation reorganizations:[4400]

> *Ordinary Course Trade or Business Acquisitions*
>
> As noted in the preamble to the final regulations, C corporations are not frequently used as vehicles for investing in life insurance contracts covering insureds with respect to which the corporation does not have a substantial business, financial, or family relationship at the time the contract is issued because a corporate level income tax applies to corporate earnings in addition to income tax on distributions at the shareholder level. See 84 FR 58460, 58467. After consideration of the comments and

[4397] Reg. § 1.101-1(c)(2)(iii)(A), which is reproduced along with the rest of Reg. § 1.101-1(c)(2) in the text accompanying fn 4363 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.
[4398] Reg. § 1.101-1(c)(2)(iii)(B), which is reproduced along with the rest of Reg. § 1.101-1(c)(2) in the text accompanying fn 4363 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.
[4399] Code § 101(a)(2).
[4400] **Applicability Dates** are found in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.

letter received on the 2019 proposed regulations and the final regulations, respectively, regarding ordinary course trade or business acquisitions, the Treasury Department and the IRS are proposing an exception for certain direct acquisitions of interests in life insurance contracts from a C corporation.

> Proposed § 1.101-1(c)(2)(v) provides that the direct acquisition of an interest in a life insurance contract from a C corporation by a C corporation is not a reportable policy sale if (1) the acquisition results from a transaction that qualifies as a reorganization under section 368(a); (2) immediately before the acquisition, (i) the interest is held by a C corporation that conducts an active trade or business within the meaning of § 1.367(a)-2(d)(2) and (3), (ii) the C corporation does not engage in a trade or business of investing in interests in life insurance contracts, and (iii) no more than 5 percent of the gross value of the assets of the C corporation consists of life insurance contracts; and (3) immediately after the acquisition, (i) the acquiring C corporation does not engage in a trade or business of investing in interests in life insurance contracts, and (ii) not more than 5 percent of the gross value of the assets of the C corporation consists of life insurance contracts. This exception would provide relief from the reportable policy sale rules for acquisitions of interests in life insurance contracts through certain ordinary course trade or business acquisitions while preserving different treatment for direct and indirect acquisitions of interests in life insurance contracts in other cases. The proposed regulations modify Example 11 in § 1.101-1(g)(11) of the final regulations to reflect the addition of the exception in proposed § 1.101-1(c)(2)(v). See proposed § 1.101-1(g)(11).

II.Q.4.b.iii. Basis in Purchased Life Insurance Contract

Rev. Rul. 2009-13 took the position that the basis of a policy that is sold to a person other than the issuer is not equal to the premiums paid.[4401] Effective for transactions entered into after August 25, 2009 (coinciding with the effective date of the IRS' position), section 13521 of the 2017 tax reform act reversed the IRS' position,[4402] adding Code § 1016(a)(1)(B), which provides:

> Proper adjustment in respect of the property shall in all cases be made for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made for mortality, expense, or other reasonable charges incurred under an annuity or life insurance contract.

Rev. Rul. 2020-5 modifies Rev. Ruls. 2009-13 and 2009-14 to effectuate Code § 1016(a)(1)(B).[4403]

For basis step-up when an owner who is not the insured dies and for an analysis of "investment in the contract" (which governs distributions from a policy) generally, see part II.Q.4.e Income Tax Issues When the Owner Who Is Not the Insured Dies.

[4401] See Rev. Ruls. 2009-13 and 2009-14. Commentators disagreed with the IRS' position.

[4402] The Senate report stated:

> The provision provides that in determining the basis of a life insurance or annuity contract, no adjustment is made for mortality, expense, or other reasonable charges incurred under the contract (known as "cost of insurance"). This reverses the position of the IRS in Revenue Ruling 2009-13 that on sale of a cash value life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance.

[4403] For details on Rev. Rul. 2020-5, see text accompanying fn 4408.

II.Q.4.c. Income Tax Issues in Transferring Life Insurance; Code § 1035

Generally, income tax applies when buying, selling, or swapping policies. However, Code § 1035, "Certain exchanges of insurance policies," provides:

(a) *General rules*. No gain or loss shall be recognized on the exchange of -

(1) a contract of life insurance for another contract of life insurance or for an endowment or annuity contract or for a qualified long-term care insurance contract;

(2) a contract of endowment insurance (A) for another contract of endowment insurance which provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or (B) for an annuity contract, or (C) for a qualified long-term care insurance contract;

(3) an annuity contract for an annuity contract or for a qualified long-term care insurance contract; or

(4) a qualified long-term care insurance contract for a qualified long-term care insurance contract.

(b) *Definitions*. For the purpose of this section -

(1) *Endowment contract*. A contract of endowment insurance is a contract with an insurance company which depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during his life.

(2) *Annuity contract*. An annuity contract is a contract to which paragraph (1) applies but which may be payable during the life of the annuitant only in installments. For purposes of the preceding sentence, a contract shall not fail to be treated as an annuity contract solely because a qualified long-term care insurance contract is a part of or a rider on such contract.

(3) *Life insurance contract*. A contract of life insurance is a contract to which paragraph (1) applies but which is not ordinarily payable in full during the life of the insured. For purposes of the preceding sentence, a contract shall not fail to be treated as a life insurance contract solely because a qualified long-term care insurance contract is a part of or a rider on such contract.

(c) *Exchanges involving foreign persons*. To the extent provided in regulations, subsection (a) shall not apply to any exchange having the effect of transferring property to any person other than a United States person.

(d) *Cross references*.

(1) For rules relating to recognition of gain or loss where an exchange is not solely in kind, see subsections (b) and (c) of section 1031.

(2) For rules relating to the basis of property acquired in an exchange described in subsection (a), see subsection (d) of section 1031.

Reg. § 1.1035-1(c) provides, "section 1035 does not apply to such exchanges if the policies exchanged do not relate to the same insured."[4404] Rev. Rul. 90-109 examined a contract that allowed the insured to change (highlighting added):

> A change in contractual terms effected through an option provided in the original contract is treated as an exchange under section 1001 if there is a sufficiently fundamental or material change that the substance of the original contract is altered through the exercise of the option. Under such circumstances, the old contract is treated as if it were actually exchanged for a new one. *Cf.* Rev. Rul. 69-135, 1969-1 C.B. 198 (recognition of realized gain or loss under former section 1002 where bonds of one corporation are converted into stock of another corporation pursuant to an option contained in the bonds). See also Rev. Rul. 79-155, 1979-1 C.B. 153 (addition of new parent as obligor is a change which, together with other changes, constitutes a material change for purposes of section 1001).
>
> In the present situation, X exercised an option in its key person insurance policy that permitted it to change the insured from A, the original insured under the policy, to B, the new insured. This resulted in a change in the fundamental substance of the original contract because the essence of a life insurance contract is the life that is insured under the contract. Thus, X's exercise of the change-of-insureds option is substantively the same as an actual exchange of contracts and is a sale or other disposition for purposes of section 1001.
>
> Section 1.1035-1 of the regulations expressly excludes from the application of section 1035 exchanges of policies that do not relate to the same insured and thus prevents policy owners from deferring indefinitely recognition of gain with respect to the policy value. Had X actually assigned a life insurance policy on A to the insurance company as consideration for a new life insurance policy on B, any gain realized on the exchange would have been ineligible for nonrecognition treatment under section 1035 of the Code. X cannot avoid the same-insured limitations of section 1035 simply by placing terms in its original documents that obviate the need for an actual exchange but nevertheless effect a de facto exchange of the original contract for a new contract on a different insured. For example, the result would be the same if X insured a person holding a particular position and, thus, no formal substitution is made when a new person occupies that position.

It held:

> The exercise of an option in an insurance policy to change the insured constitutes a sale or other disposition under section 1001 of the Code, and this disposition does not qualify as a tax-free exchange of insurance policies under section 1035.

A taxpayer may roll over part of a policy into another policy. Notice 2011-68, § 2.05 states:

> In *Conway v. Commissioner*, 111 T.C. 350 (1998), *acq.*, 1999-2 C.B. xvi, the Tax Court held that the direct exchange by an insurance company of a portion of an existing annuity contract to an unrelated insurance company for a new annuity contract was a tax-free exchange under § 1035. Such a transaction is sometimes referred to as a

[4404] Some tax research services make this clause look like part of subsection (c) only, but T.D. 6211 (11/14/56) clearly indents (a), (b), and (c) without indenting this part.

> "partial exchange." See also Rev. Rul. 2003-76, 2003-2 C.B. 355 (direct transfer of a portion of an annuity contract for a new annuity contract treated as a tax-free exchange under § 1035); Rev. Rul. 2002-75, 2002-2 C.B. 812 (assignment of an entire annuity contract for deposit into a preexisting annuity contract treated as a tax-free exchange under § 1035).

Similarly, Rev. Rul. 92-43 held that a taxpayer's exchange of an annuity contract issued by a life insurance company that has become subject to a rehabilitation, conservatorship, or similar state proceeding, for an annuity contract issued by another life insurance company qualify as tax-free under Code § 1035 if the new contract is funded by a series of two or more payments from the old annuity contract, even in the case of serial funding of a new life insurance contract. Its facts were:

> L1 is a life insurance company within the meaning of section 816(a) of the Code. L1 is domiciled in state O. A owns an annuity contract (Old Contract) issued by L1.
>
> L1 is subject to a O rehabilitation, conservatorship, or similar state proceeding under the jurisdiction and control of the O insurance commissioner and a O court. Under the terms imposed by any O authorities pursuant to the proceeding, L1 is permitted to distribute no more than X percent of the full cash value of the annuity contract. A wishes to terminate all of A's rights in Old Contract and acquire a new annuity contract (New Contract) from L2. L2 is a life insurance company within the meaning of section 816(a) of the Code.
>
> A assigns Old Contract to L2 in exchange for a New Contract. Pursuant to the assignment, L1 pays cash to L2 in an amount that represents X percent of the cash value of Old Contract, and is required to pay L2 an amount equal to any residual value of Old Contract when it is permitted to do so by the O authorities. L2 must credit to New Contract all amounts received from L1.

Rev. Rul. 92-43 reasoned:

> Section 1035(a)(3) of the Code provides that no gain or loss is recognized on the exchange of one annuity contract solely for another annuity contract. Neither the statute nor the regulations contain a time limit for completion of the exchange. In addition, nonrecognition treatment under section 1035 is not expressly conditioned upon the relative policy values of the contracts exchanged, so long as no other property or cash is distributed as part of the exchange.
>
> Under the facts described, A has effected an exchange of annuity contracts. Because section 1035(a)(3) of the Code does not require that an exchange be completed concurrently where the issuer is precluded from distributing the full cash value of the contract, the transaction is a nontaxable exchange of an annuity contract for an annuity contract under that section.

Rev. Rul. 92-43 held:

> Under section 1035 of the Code, A does not recognize gain or loss on the exchange of Old Contract for New Contract even though New Contract will be funded through a series of payments from L1 that may extend over a period of time. The same holding

applies in the case of serial funding of an exchange of a life insurance contract for a life insurance, endowment, or annuity contract.

Letter Ruling 200323012 held that a revocable trust could swap tax-free under Code § 1035 two annuity contracts it owned on the life of its deemed owner for one annuity contract that owner owned on her life.[4405]

A life insurance contract may be swapped into another life insurance, endowment, annuity, or qualified long-term care insurance contract. Notice 2011-68, § 3 describes certain changes made by the Pension Protection Act of 2006, P.L. 109-280 (the "PPA"):

> .04. Section 844(b) of the PPA expanded the categories of exchanges that are treated as tax-free under § 1035 to include certain exchanges that involve a qualified long-term care insurance contract. Accordingly, § 1035 now applies to the exchange of a life insurance contract for another life insurance, endowment, annuity, or qualified long-term care insurance contract; an endowment contract for another endowment, annuity, or qualified long-term care insurance contract; an annuity contract for another annuity or qualified long-term care insurance contract; or a qualified long-term care insurance contract for another qualified long-term care insurance contract. The PPA also amended § 1035(b)(2) and (3) to provide that, for purposes of § 1035, a contract does not fail to be treated as a life insurance contract or an annuity contract solely because a qualified long-term care insurance contract is a part of or a rider on the contract.
>
> .05. Just as the direct transfer of a portion of the cash surrender value of an existing deferred annuity contract for a second annuity contract may be treated as a tax-free exchange under § 1035, the direct transfer of a portion of the cash surrender value of an existing deferred annuity contract for a qualified long-term care insurance contract may be treated as a tax-free exchange, provided the requirements of § 1035 are otherwise met. See, *e.g.*, Rev. Proc. 2011-38, 2011-30 I.R.B. 66 (setting forth conditions under which such a transfer will be treated as a tax-free exchange under § 1035); but see, Rev. Rul. 2007-24, 2007-21 I.R.B. 1282 (receipt of a check under a nonqualified annuity contract and endorsement of the check to a second company as consideration for a second annuity contract treated as a distribution under § 72(e), rather than as a tax-free exchange under § 1035).
>
> .06. Although § 7702B(b)(1)(D) and (E) limit the extent to which a qualified long-term care insurance contract may have a cash value or premium refund feature, § 7702B(b)(2)(C) permits the refund of premiums in the event of a complete surrender or cancellation of the contract, provided the amount does not exceed the aggregate premiums paid under the contract. Such a refund is includible in gross income to the extent that any deduction or exclusion was allowable with respect to the premiums. Moreover, § 1031(d) provides that if property is acquired in an exchange described in § 1035(a), then the acquired property's adjusted basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. Accordingly, Treasury and the IRS believe that, under § 1031(d), the adjusted basis of a qualified long-term care insurance contract received in a tax-free exchange under § 1035(a) generally carries over from the life

[4405] Letter Ruling 200323012 is discussed (including large excerpts) in part II.J.19.a.v Annuity Contract Issued to Grantor Trust in the text before and after fn 3026.

> insurance, endowment, annuity, or qualified long-term care insurance contract exchanged.

If one insured in a second-to-die policy has died, Code § 1035 may apply to the exchange of that policy for a policy on the life of only the surviving insured. Consistent with Letter Ruling 9248013, Letter Ruling 9330040 reasoned and held:

> The legislative history of section 1035 of the Code indicates that Congress viewed nonrecognition treatment as appropriate for "individuals who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain." See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 81 (1954).
>
> Trust's proposed assignment of Policy to the issuer of New Policy and its receipt of New Policy will qualify as an exchange of one contract of life insurance for another contract of life insurance under section 1035(a)(1) of the Code. At the time of the proposed exchange, the sole remaining insured on Policy will be A. The sole insured on New Policy will also be A. Therefore, the proposed exchange does not involve a change of insured, which would disqualify the transaction from nonrecognition treatment under section 1035.
>
> Accordingly, under section 1035 of the Code no gain or loss will be recognized by Trust upon the exchange of Policy solely for New Policy. Further, the basis of New Policy in the hands of Trust will, as provided in section 1031(d), be the same as Trust's basis in Policy.
>
> We express no opinion on whether section 1035 of the Code applies to the exchange of a survivorship or "second to die" life insurance contract for a single life insurance contract prior to the death of either of the insureds under the survivorship contract. We also express no opinion on whether Policy or New Policy qualifies as a life insurance contract under section 7702(a).

However, Code § 1035 does not apply to changing from having two insureds under a second-to-die policy to one insured under a policy or from one insured under a policy to two insureds under a second-to-die policy. Letter Ruling 9542037 rejected the application of Code § 1035 in all of the following situations:

> Taxpayer has inquired as to several situations involving exchanges by Taxpayer's policyholders who are spouses. In Situation 1, Spouse A exchanges a life insurance contract insuring solely his own life for a second-to-die life insurance contract covering the lives of both Spouse A and Spouse B. In Situation 2, Spouse A exchanges two life insurance contracts, one of which insures the life of Spouse A and one of which insures the life of Spouse B, for a second-to-die life insurance contract which covers the lives of both Spouse A and Spouse B. In Situation 3, Spouse A and Spouse B jointly exchange separate life insurance contracts each of which insures solely the life of one spouse for a jointly owned second-to-die life insurance contract which covers the lives of both Spouse A and Spouse B. In Situations 4A and 4B respectively, the facts are the same as in Situations 1 and 2 except that a trust is the owner and exchanger of the life insurance contracts involved. In none of the Situations do Spouse A, Spouse B or the trust receive any money or other property not permitted to be transferred without the recognition of gain or loss.

It held:

> In each of the Situations described above, the individual insured under each contract given up in the exchange is not the sole individual insured under the contract received in the exchange. As the contracts do not relate to the same insured, any gain realized on the exchange is ineligible for nonrecognition under section 1035 of the Code.

The transfer for value rule might cause the death benefit to be subject to income tax. see part II.Q.4.a Funding the Buy-Sell.

When life insurance is sold in a taxable transaction, the IRS' position was that:[4406]

[4406] Rev. Rul. 2009-13, Situation 2 provides the following facts and analysis, which works from Situation 1:

> **Situation 1**
>
> On January 1 of Year 1, A, an individual, entered into a life insurance contract (as defined in § 7702 of the Internal Revenue Code (Code)) with cash value. Under the contract, A was the insured, and the named beneficiary was a member of A's family. A had the right to change the beneficiary, take out a policy loan, or surrender the contract for its cash surrender value. The contract in A's hands was not property described in § 1221(a)(1)-(8).
>
> On June 15 of Year 8, A surrendered the contract for its $78,000 cash surrender value, which reflected the subtraction of $10,000 of cost-of-insurance charges collected by the issuer for periods ending on or before the surrender of the contract. Through that date, A had paid premiums totaling $64,000 with regard to the life insurance contract. A had neither received any distributions under the contract nor borrowed against the contract's cash surrender value.
>
> A determines taxable income using the cash method of accounting and files income tax returns on a calendar year basis. As of June 15 of Year 8, A was not a terminally ill individual, nor a chronically ill individual, within the meaning of § 101(g)(4).
>
> **Situation 2**
>
> The facts are the same as in Situation 1, except that on June 15 of Year 8, A sold the life insurance contract for $80,000 to B, a person unrelated to A and who would suffer no economic loss upon A's death.
>
> ….
>
> **Law and Analysis**
>
> ….
>
> In Situation 2, A paid total premiums of $64,000 under the life insurance contract through the date of sale, and $10,000 was subtracted from the contract's cash surrender value as cost-of-insurance charges. Accordingly, A's adjusted basis in the contract as of the date of sale under §§ 1011 and 1012 and the authorities cited above was $54,000 ($64,000 premiums paid less $10,000 expended as cost of insurance).
>
> Accordingly, A must recognize $26,000 on the sale of the life insurance contract to B, which is the excess of the amount realized on the sale ($80,000) over A's adjusted basis of the contract ($54,000).
>
> [above two paragraphs were superseded by Rev. Rul. 2020-5, as described in fn 4408.]
>
> **Character of income recognized on sale of the life insurance contract**
>
> Unlike Situation 1, which involves the surrender of the life insurance contract to the issuer of the contract, Situation 2 involves an actual sale of the contract. Nevertheless some or all of the gain on the sale of the contract may be ordinary if the substitute for ordinary income doctrine applies. The Supreme Court has held, under the so-called substitute for ordinary income doctrine, that property within the meaning of § 1221 does not include claims or rights to ordinary income. Instead, the Court has consistently construed 'capital asset' to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income. *United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965). *See also Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958) (consideration received on the sale of a working interest in

1. The taxpayer's gain is:

    - Ordinary income to the extent that it does not exceed the excess of the policy's cash value over the taxpayer's "investment in the contract" (this excess referred to later as the "inside build-up"),[4407] and

    - Capital gain to the extent of the balance.

2. The selling taxpayer's basis is reduced by the cost of insurance.

However, as mentioned above, Congress retroactively repealed the IRS' position that the selling taxpayer's basis is reduced by the cost of insurance.[4408]

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an oil well represented a substitute for what would have been received in the future as ordinary income, therefore taxable as ordinary income and not capital gain); *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 217, n. 5 (1988) (noting that the substitute for ordinary income doctrine had no application to that case). Thus, ordinary income that has been earned but not recognized by a taxpayer cannot be converted into capital gain by a sale or exchange. *See also Prebola v. Commissioner*, 482 F.3d 610 (2d Cir. 2007); *United States v. Maginnis*, 356 F.3d 1179 (9th Cir. 2004); *Davis v. Commissioner*, 119 T.C. 1 (2002) (applying the substitute for ordinary income doctrine after the Arkansas Best decision).

The substitute for ordinary income doctrine has been applied to characterize the profit on a sale of an annuity contract or life insurance contract as ordinary income. For example, in *Gallun*, 327 F.2d 809, 811 (7th Cir. 1964), the court stated:

> The question presented has been considered by other courts. Uniformly, they have held that the assignment of income doctrine . . . should be applied and the profits realized from the sale or the surrender value of an annuity or life insurance contract should be treated as ordinary income rather than capital gain. These cases are: *First Nat'l Bank of Kansas City v. Commissioner*, 309 F.2d 587 (8th Cir. 1962); *Rolf v. Commissioner*, 304 F.2d 450 (3d Cir. 1962); *Commissioner v. Phillips*, 275 F.2d 33 (4th Cir. 1960); *Arnfeld v. United States*, 163 F.Supp. 865, 143 Ct. Cl. 277 (1958).

Application of the substitute for ordinary income doctrine is limited to the amount that would be recognized as ordinary income if the contract were surrendered (i.e., to the inside build-up under the contract). Hence, if the income recognized on the sale or exchange of a life insurance contract exceeds the inside build-up under the contract, the excess may qualify as gain from the sale or exchange of a capital asset. *See*, *e.g.*, *Commissioner v. Phillips*, 275 F.2d 33, 36 n. 3 (4th Cir. 1960).

In Situation 2, the inside build-up under A's life insurance contract immediately prior to the sale to B was $14,000 ($78,000 cash surrender value less $64,000 aggregate premiums paid). Hence, $14,000 of the $26,000 of income that A must recognize on the sale of the contract is ordinary income under the substitute for ordinary income doctrine. Because the life insurance contract in A's hands was not property described in § 1221(a)(1)-(8) and was held by A for more than one year, the remaining $12,000 of income is long-term capital gain within the meaning of § 1222(3).

[4407] Although the IRS did not expressly say so, this policy result is required to preserve the integrity of the system described in part II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy), which also explains why this policy result is required in the text preceding fn. 4423.

[4408] See text accompanying fn 4403 in part II.Q.4.b.iii Basis in Purchased Life Insurance Contract. Thus, Rev. Rul. 2020-5 modifies the analysis of fn 4406:

> In Situations 2 and 3 in Rev. Rul. 2009-13, under § 1016(a)(1)(B), as added by the TCJA, A is not required to reduce A's basis in the contract by the cost of insurance. Accordingly, in Situation 2 of Rev. Rul. 2009-13, A's adjusted basis in the contract equals the premiums paid. A must recognize $16,000 of income on the sale of the contract ($80,000 amount realized on sale less

If the policy is a term policy, then the IRS asserts that the basis is any unexpired premiums and the gain is purely capital gain.[4409] Rev. Rul. 2009-14 discusses tax consequences to the purchaser of a term life insurance policy but must be read in light of the modification to Situation 2 made by Rv. Rul. 2020-5.

Using a life insurance LLC might solve most or all of these issues.[4410]

II.Q.4.d. Income Tax on Distributions or Loans from Contract (Including Surrender of Policy)

To the extent that the distributions are nontaxable death benefits,[4411] the rules described below do not apply.[4412]

Generally, distributions (other than tax-free death benefits) from life insurance contracts are not taxable "the extent allocable to the investment in the contract."[4413] Dividends used to pay premiums are not taxable.[4414] Furthermore, loans generally are also not subject to income tax (without reference to the investment in the contract) while the borrower continues to hold the policy[4415] and are treated as distributions when those exceptions apply.[4416] However, distributions and loans generally are taxable if the policy is a "modified endowment contract," which generally applies when a policy's premiums are paid too quickly in its initial years.[4417]

Furthermore, gifts or trust distributions may trigger income taxation. Code § 72(e)(4)(C), "Treatment of transfers without adequate consideration," provides:

> $64,000 adjusted basis). In Situation 3 of Rev. Rul. 2009-13, A's adjusted basis in the contract equals the premiums paid. A will recognize a $25,000 loss on the sale of the contract ($20,000 amount realized on the sale less $45,000 adjusted basis). A will not be permitted to deduct the loss unless the loss is incurred under § 165(c)(1) or (2).

However, Rev. Rul. 2020-5, fn 1 provides:

> Section 13521 of the TCJA only applies to determine a taxpayer's adjusted basis in a life insurance contract under § 1016. Section 13521 of the TCJA does not affect the analysis in Situations 2 and 3 of Rev. Rul. 2009-13 and Situation 2 of Rev. Rul. 2009-14 with respect to the character of any income or loss recognized by a taxpayer on the sale of a life insurance contract.

[4409] Rev. Rul. 2009-13, Situation 1.

[4410] See parts II.Q.4.i Life Insurance LLC, II.M.3 Buying into or Forming a Partnership, and II.Q.8 Exiting From or Dividing a Partnership.

[4411] Code § 101(a)(1).

[4412] Reg. § 1.72-2(b)(1)(i) provides:

> In general, the amounts to which section 72 applies are any amounts received under the contracts described in paragraph (a)(1) of this section. However, if such amounts are specifically excluded from gross income under other provisions of chapter 1 of the Code, section 72 shall not apply for the purpose of including such amounts in gross income. For example, section 72 does not apply to amounts received under a life insurance contract if such amounts are paid by reason of the death of the insured and are excludable from gross income under section 101(a). See also sections 101(d), relating to proceeds of life insurance paid at a date later than death, and 104(a)(4), relating to compensation for injuries or sickness.

[4413] Code § 72(e)(5)(C) applies the Code § 72(e)(5)(A) rule of nontaxable recovery of investment coming first.

[4414] Code § 72(e)(4)(B).

[4415] Code § 72(e)(4)(A) includes various exceptions.

[4416] Code § 72(e)(4)(A) includes various exceptions.

[4417] Code § 72(e)(10), using the definition of modified endowment contract in Code § 7702A.

(i) *In general*. If an individual who holds an annuity contract transfers it without full and adequate consideration, such individual shall be treated as receiving an amount equal to the excess of -

(I) the cash surrender value of such contract at the time of transfer, over

(II) the investment in such contract at such time,

under the contract as an amount not received as an annuity.

(ii) *Exception for certain transfers between spouses or former spouses*. Clause (i) shall not apply to any transfer to which section 1041(a) (relating to transfers of property between spouses or incident to divorce) applies.

(iii) *Adjustment to investment in contract of transferee*. If under clause (i) an amount is included in the gross income of the transferor of an annuity contract, the investment in the contract of the transferee in such contract shall be increased by the amount so included.

Consider whether turning off grantor trust status, whether voluntarily or by reason of death, might trigger Code § 72(e)(4)(C) income taxation.

Kitces, "Owning Deferred Annuities In Trusts And Preserving Tax-Deferral Treatment" (12/25/2013), explains:

> Ironically, in situations where an annuity is transferred out of a trust, the transaction also does not trigger IRC Section 72(e)(4)(C), as the IRS reads the provision literally, and since it states that it must be "an individual who holds an annuity..." a trust that owns the annuity in the first place isn't an individual and therefore cannot trigger tax treatment by transferring the contract. Thus, in PLR 201124008, where an annuity was distributed in-kind by a bypass trust to its trust natural person trust beneficiary, the transfer was not taxable at the time.
>
> However, in situations where the annuity is being transferred as a (taxable) gift to a trust, the situation is less clear. If the trust is not a grantor trust and the transfer is a gift, IRC Section 72(e)(4)(C) will clearly be triggered, even if all the beneficiaries are natural persons such that subsequent gains may again be tax-deferred once the trust owns the annuity. Perhaps the most confusing situation is when an annuity is transferred to an Intentionally Defective Grantor Trust (IDGT), which is a grantor trust for income tax purposes but outside of the individual's estate for gift and estate tax purposes. While some have contended that the transfer of the annuity to the IDGT should not trigger taxation upon transfer - it certainly wouldn't face ongoing under 72(u) since it's a grantor trust - it's difficult to claim that the annuity was not "a transfer without full and adequate consideration" when the grantor has to file a gift tax return to report the transfer in the first place! Notably, while popular Revenue Ruling 85-13 has indicated that a sale of property to a grantor trust should not trigger gain, as one cannot have a sale between a grantor and the grantor's trust, in this case the problem is actually that the annuity was not sold but gifted as a gratuitous transfer (without full and adequate consideration). Ironically, this suggests that while a sale of an annuity to an IDGT might avoid gains treatment, the gratuitous gift transfer of an annuity to an IDGT may trigger gain. Unfortunately, though, neither situation has been directed address on point in a Tax Court case or even via a Private Letter Ruling.

Any distributions in excess of "investment in the contract" constitute ordinary income.[4418] However, Code § 1234A might be used to argue that income on surrender should be all capital gain.[4419]

"Investment in the contract":[4420]

> as of any date is-
>
> (A) the aggregate amount of premiums or other consideration paid for the contract before such date, minus
>
> (B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

However, charges relating to a long-term insurance component of a policy may reduce "investment in the contract."[4421]

What constitutes "other consideration paid for the contract"? Code § 72(g) tells us what to do when the policy is sold:

> (g) **Rules for transferee where transfer was for value**. Where any contract (or any interest therein) is transferred (by assignment or otherwise) for a valuable consideration, to the extent that the contract (or interest therein) does not, in the

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[4418] Code § 72(e)(2).

[4419] At the 2015 Heckerling Institute, Larry Brody reported having settled a Tax Court case on this basis. See part II.G.8 Code § 165(a) Loss for Worthlessness; Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy. Rev. Rul. 2009-13 asserted, without explanation, that Code § 1234A does not apply to a surrender.

[4420] Code § 72(e)(6).

[4421] Notice 2011-68, § 3 describes certain changes made by the Pension Protection Act of 2006, P.L. 109-280 (the "PPA"):

> .02. Section 844(a) of the PPA amended § 72(e) by adding a new paragraph, § 72(e)(11). Section 72(e)(11) provides that a charge against the cash value of an annuity contract or the cash surrender value of a life insurance contract made as payment for coverage under a qualified long-term care insurance contract that is part of or a rider on the annuity or life insurance contract is not includible in income. The investment in the contract is reduced (but not below zero) by the charge.
>
> .03. The PPA did not otherwise amend the definition of "investment in the contract" in § 72(c)(1) and 72(e)(6). Accordingly, the Treasury Department and the IRS believe that all premiums paid for a combination contract that is an annuity and also provides long-term care insurance are generally included in investment in the contract under § 72 if (i) the premiums are credited to the contract's cash value (rather than directly to the long-term care insurance contract that is part of or a rider to the contract), and (ii) coverage under the long-term care insurance contract is paid for by charges against the cash value of the contract. Consistently, a waiver of premiums under such a contract, such as on account of disability or because the annuitant has become chronically ill, should be accounted for in the same manner as a waiver of premiums under other contracts for which "investment in the contract" is determined under § 72(c)(1) or 72(e)(6). See, *e.g.*, *Estate of Wong Wing Non v. Commissioner*, 18 T.C. 205 (1952) (waived premiums not treated as constructively received as disability benefits, and therefore not included as part of premium paid for endowment life insurance policy).

hands of the transferee, have a basis which is determined by reference to the basis in the hands of the transferor, then—

(1) for purposes of this section, only the actual value of such consideration, plus the amount of the premiums and other consideration paid by the transferee after the transfer, shall be taken into account in computing the aggregate amount of the premiums or other consideration paid for the contract;

(2) for purposes of subsection (c)(1)(B), there shall be taken into account only the aggregate amount received under the contract by the transferee before the annuity starting date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws; and

(3) the annuity starting date is January 1, 1954, or the first day of the first period for which the transferee received an amount under the contract as an annuity, whichever is the later.

For purposes of this subsection, the term “transferee” includes a beneficiary of, or the estate of, the transferee.

Code § 72(g)(2) does not apply, because our income is based on Code § 72(e)(6), not Code § 72(c)(1)(B).

Consider the following potential abuse:

1. Policy owner sells the policy and receives capital gain treatment.

2. Buyer receives a new “investment in the contract” under Code § 72(g).

3. Buyer cashes in the policy, tax-free.

Given that the buyer has no risk, a policy owner could easily find a straw man to help the policy owner cash in the policy and receive capital gain treatment, avoiding the ordinary income treatment provided by Code § 72(e)(1). Rev. Rul. 2009-13,[4422] Situation 2,[4423] prevents this potential abuse.

Thus, if one sells a policy in a taxable transaction:

1. If and to the extent one has gain, the first tier of this gain is ordinary income.[4424]

2. All of the gain on the sale translates into increased “investment in the contract” against which distributions can be taken tax-free.

3. Be careful to fit within an exception to the transfer for value rules[4425] if the buyer expects to receive death benefit in excess of investment in the contract.

[4422] See fn 4402 in part II.Q.4.b Transfer for Value Rule; Basis for the fact that Rev. Rul. 2009-13 does not apply to basis determinations.
[4423] See fn. 4406.
[4424] See text accompanying fn. 4406.
[4425] Code § 101(a)(2).

II.Q.4.e. Income Tax Issues When the Owner Who Is Not the Insured Dies

Generally, property an individual owns (including indirectly through a partnership[4426]) receives a new tax basis when that individual dies if that property is included in that individual's estate for estate tax purposes.[4427]

The discussion below focuses on if and the extent to which a life insurance might not get a basis adjustment on the death of an owner who is not insured and then explores practical issues in implementing any basis adjustment that is available.

II.Q.4.e.i. Life Insurance Basis Adjustment on the Death of an Owner Who Is Not the Insured

"Annuities described in section 72" do not receive a new basis.[4428] Although Code § 72 governs distributions from life insurance companies to policy owners, this provision appears to be aimed at annuity contracts and not life insurance contracts.

Of greater concern is whether the internal build-up in a cash value life insurance contract constitutes "income in respect of a decedent" (IRD) ineligible for a basis adjustment; see part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up. Reg. § 1.691(a)-1(b) provides:

> **General definition.** In general, the term "income in respect of a decedent" refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent. See the regulations under section 451. Thus, the term includes-
>
> (1) All accrued income of a decedent who reported his income by use of the cash receipts and disbursements method;
>
> (2) Income accrued solely by reason of the decedent's death in case of a decedent who reports his income by use of an accrual method of accounting; and
>
> (3) Income to which the decedent had a contingent claim at the time of his death.

Income is "accrued" when "all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."[4429] 2017 tax

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[4426] Generally, the partnership need to have a Code § 754 election in place for the partnership's taxable year in which the individual dies or in certain situations when that person's interest in the partnership is later transferred. See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.
[4427] Code § 1014, which applies to more than just what this sentence describes.
[4428] Code § 1014(b)(9); Reg. § 1.1014-2(b)(3)(i).
[4429] Reg. § 1.451-1(a). On the deduction side, see *U.S. v. General Dynamics Corp.*, 481 U.S. 239 (1987); U*.S. v. Hughes Properties, Inc.*, 476 U.S. 593 (1986); Rev. Rul. 78-212; *Giant Eagle, Inc. v. Commissioner*, 822 F.3d 666 (3rd Cir. 2016), *rev'g* T.C. Memo. 2014-146. In addition to the all events test, the Code § 461(h) economic performance rules may defer deductions.

reform modified this test; a brief explanation is in the "SUPPLEMENTARY INFORMATION" portion of the preamble to T.D. 9941 (1/6/2021):[4430]

> **Background**
>
> This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 451(b) and (c) of the Internal Revenue Code (Code).
>
> On December 22, 2017, section 451(b) and (c) were amended by section 13221 of Public Law 115-97 (131 Stat. 2054), commonly referred to as the Tax Cuts and Jobs Act (TCJA). Section 451(b) was amended to provide that, for a taxpayer using an accrual method of accounting (accrual method taxpayer), the all events test for an item of gross income, or portion thereof, is met no later than when the item, or portion thereof, is included in revenue for financial accounting purposes on an applicable financial statement (AFS). Section 451(c) was amended to provide that an accrual method taxpayer may use the deferral method of accounting provided in section 451(c) for advance payments. Unless otherwise indicated, all references to section 451(b) and section 451(c) hereinafter are references to section 451(b) and section 451(c), as amended by the TCJA.
>
> **I. Section 451(b)**
>
> In general, section 451(a) provides that the amount of any item of gross income is included in gross income for the taxable year in which it is received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period. Under § 1.451-1(a), accrual method taxpayers generally include items of income in gross income in the taxable year when all the events occur that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy (all events test). All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens first. Revenue Ruling 2003-10, 2003-1 C.B. 288; Revenue Ruling 84-31, 1984-1 C.B. 127; Revenue Ruling 80-308, 1980-2 C.B. 162.
>
> Section 451(b)(1)(A) provides that, for an accrual method taxpayer, the all events test for an item of gross income, or portion thereof, is met no later than when the item, or portion thereof, is included as revenue in an AFS (AFS Income Inclusion Rule).
>
> Section 451(b)(1)(B) lists exceptions to the AFS Income Inclusion Rule. The AFS Income Inclusion Rule does not apply to taxpayers that do not have an AFS for a taxable year or to any item of gross income from a mortgage servicing contract.
>
> Section 451(b)(1)(C) codifies the all events test, stating that the all events test is met for any item of gross income if all the events have occurred which fix the right to receive such income and the amount of such income can be determined with reasonable accuracy.

[4430] One provision makes death trigger income tax regarding inventory; see part III.A.6 Post-Mortem Trust and Estate Administration.

Section 451(b)(2) provides that the AFS Income Inclusion Rule does not apply for any item of gross income the recognition of which is determined using a special method of accounting, “other than any provision of part V of subchapter P (except as provided in clause (ii) of paragraph (1)(B)).”

Section 451(b)(3) defines an AFS, as referenced in section 451(b)(1)(A)(i), by providing a hierarchical list of financial statements.

Section 451(b)(4) provides that for purposes of section 451(b), in the case of a contract which contains multiple performance obligations, the allocation of the transaction price to each performance obligation is equal to the amount allocated to each performance obligation for purposes of including such item in revenue in the taxpayer’s AFS.

Section 451(b)(5) provides that, if the financial results of a taxpayer are reported on the AFS for a group of entities, the group’s financial statement shall be treated as the AFS of the taxpayer.

II. Section 451(c)

Section 451(c) provides special rules for the treatment of advance payments. Section 451(c)(1)(A) provides the general rule requiring an accrual method taxpayer to include an advance payment in gross income in the taxable year of receipt. However, section 451(c)(1)(B) permits a taxpayer to elect to include any portion of the advance payment in gross income in the taxable year following the year of receipt to the extent income is not included in revenue in the AFS in the year of receipt. Section 451(c)(1)(B) generally codifies Revenue Procedure 2004-34, 2004-22 I.R.B. 991, which provided for a similar deferral period.

Section 451(c)(2)(A) provides the Secretary of the Treasury or his delegate (Secretary) with the authority to provide the time, form and manner for making the election under section 451(c)(1)(B), and the categories of advance payments for which an election can be made. Under section 451(c)(2)(B), the election is effective for the taxable year that it is first made and for all subsequent taxable years, unless the taxpayer receives the consent of the Secretary to revoke the election. Section 451(c)(3) provides that the deferral election does not apply to advance payments received in the taxable year that the taxpayer ceases to exist.

Section 451(c)(4)(A) defines advance payment for purposes of section 451(c). Under section 451(c)(4)(A), the term advance payment means any payment that meets the following three requirements: (1) The full inclusion of the payment in gross income in the year of receipt is a permissible method of accounting; (2) any portion of the advance payment is included in revenue in an AFS for a subsequent tax year; and (3) the advance payment is for goods, services, or such other items that the Secretary has identified. Section 451(c)(4)(B) lists certain payments that are excluded from the definition of advance payment and gives the Secretary the authority to identify other payments to be excluded from the definition. Section 451(c)(4)(C) provides a special definition of the term “receipt” for purposes of the definition of advance payment, and section 451(c)(4)(D) states that rules similar to those for allocating the transaction price among performance obligations in section 451(b)(4) also apply for purposes of section 451(c).

IRD does not include “items which are excluded from gross income under subtitle A.”[4431]

When the owner who is not the insured dies, we do not know whether the policy’s value in excess of “investment in the contract” (such excess, the “inside build-up”) is going to be includible in income (if taken out before the insured dies)[4432] or excluded from income (if received as a nontaxable death benefit).[4433] In other words, it is not true that “all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.” Therefore, the inside build-up has not “accrued” upon that owner’s death and cannot constitute IRD.

This analysis is consistent with a test the Tax Court formulated for determining whether proceeds from a sale contract are IRD. The test considers:[4434]

[4431] Reg. § 1.691(a)-1(c).

[4432] Code § 72(e).

[4433] See fns. 4411-4412.

[4434] *Estate of Peterson v. Commissioner*, 667 F.2d 675 (8th Cir. 1981), summarizing the Tax Court’s holding. Although the Eighth Circuit agreed with the Tax Court’s holding and pointed out that the IRS agreed with the test when it appealed, it held that lack of delivery of the sold goods sufficed to prevent IRD treatment:

> Here, the task remaining to be performed by the estate was performance of the contract. We agree with the conclusion of the Tax Court that performance of the contract, which, under the circumstances, involved care and feeding of livestock and delivery, cannot be characterized as a ministerial or minor act. However, we think that characterization of the tasks which remain after the death of the decedent should not necessarily depend upon the nature of the subject matter of the sales transaction. For example, the subject matter of the sales transaction in the present case was livestock, which obviously required care and feeding. What if the subject matter was not livestock but logs or refrigerators? It would still be the task of the decedent’s transferee to deliver or otherwise dispose of the logs or refrigerators, even though that type of property does not require the care that livestock does.
>
> We recognize that the analysis followed by the Tax Court emphasizes delivery or disposal of the subject matter of the sales transaction and, to a certain degree, discounts the significance of the sales contract. Compare Gordon, Income in Respect of a Decedent and Sales Transactions, 1961 Wash. U.L.Q. 30, 37-38 (proposing that §691 should apply to sales proceeds if the contract of sale is incomplete at death “only as to delivery of the res and receipt of the purchase price”). Nonetheless, this analysis is not inconsistent with *Trust Co. v. Ross*, *supra*, 392 F.2d at 697, where the contract of sale was executed and the stock was placed in escrow before the death of the decedent and the tasks remaining for the estate were “minor,” and *Commissioner v. Linde*, *supra*, 213 F.2d at 4-8, where the decedent had delivered the property before death to the marketing cooperative, thus “converting” the property into a right to receive income. Moreover, “while the death of a decedent can be a fortuitous event tax-wise, it is certainly hard to visualize death as a tax avoidance scheme.” Note, Sales Transactions and Income in Respect of a Decedent, *supra*, 3 Ga. L. Rev. at 615. After all, the decedent in a sales case does not prearrange his death in order to shift the responsibility for delivering the subject matter of the sale transaction to his executor or to take advantage of the fair market value basis rule of § 1014(a) and thus avoid the reach of § 691.

However, the IRS does not appear to agree with the Eighth Circuit’s emphasis on delivery. Rev. Rul. 82-1 involved the following facts:

> A taxpayer, who used the cash receipts and disbursements method of accounting, held title to a personal residence solely in the taxpayer’s name. The taxpayer met all the age, use, and holding requirements of section 121 of the Code relating to the treatment of gain from sale or exchange of a principal residence by an individual who has attained age 55. The taxpayer had not previously made an election under section 121 with respect to any prior sale.

(1) whether the decedent entered into a legally significant arrangement regarding the subject matter of the sale,[5]

(2) whether the decedent performed the substantive (nonministerial) acts required as preconditions to the sale,[6]

(3) whether there existed at the time of the decedent's death any economically material contingencies which might have disrupted the sale,[7] and

(4) whether the decedent would have eventually received the sale proceeds if he or she had lived.[8]

74 T.C. at 639-41.

[5] As noted by the Tax Court, "[t]his arrangement may take a variety of forms: an express executory contract of sale [as in *Trust Co. v. Ross*, *supra*, 392 F.2d 694]; an implied contract for sale [A delivers apples to Y, Y accepts the apples, A dies before Y can pay for them]; or a contractual arrangement with a cooperative marketing association [as in *Commissioner v. Linde*, *supra*, 213 F.2d 1 (no contract or sale, just delivery of grapes to marketing cooperative; proceeds held income in respect of a decedent when received)]." *Estate of Peterson v. Commissioner*, 74 T.C. 630, 639 (1980) (parentheticals substituted and expanded). *See also Halliday v. United States*, 655 F.2d 68, 72 (5th Cir. 1981) (the right to income need not be legally enforceable).

[6] "One indicium of whether a decedent has performed the applicable substantive acts is whether he has delivered, or somehow placed, the subject matter of the sale beyond his control prior to his death." *Estate of Peterson v. Commissioner*, *supra*, 74 T.C. at 640. *Compare* M. Ferguson, J. Freeland & R. Stephens, *Federal Income Taxation of Estates*

> The taxpayer entered into a binding executory contract to sell the residence and accepted a down payment. The terms of the contract called for delivery of the deed and possession of the property upon receipt of the balance of the purchase price. After substantial fulfillment of the prerequisites to consummation of the sale and with only ministerial obligations remaining to be performed under the contract, but prior to closing the sale, the taxpayer died and the sale was completed when the executor of the taxpayer's estate received payment in full and delivered the deed.

Rev. Rul. 82-1 held:

> Consistent with the extension of rights and privileges accorded a fiduciary under section 6903, the executor may "stand in the shoes" of the decedent for purposes of making the election under section 121, with respect to the sale of the residence described herein. However, if the executor chooses not to make the election under section 121, or to the extent that the gain exceeds the amount excludable under section 121, the provisions of section 691(a), relating to income in respect of a decedent, will apply. Rev. Rul. 78-32.

In *Trust Co. of Ga. v. Ross*, 392 F.2d 694 (5th Cir. 1967), *aff'g* 262 F.Supp. 900 (N.D. Ga. 1966), cert. denied 393 U.S. 830 (1968), the decedent had fully performed, but the buyer had not met financing contingencies and other contingencies out of the decedent's control remained. The Fifth Circuit found IRD:

> When the facts in these cases are all viewed, it is readily apparent that the proceeds in issue were realized as a consequence of negotiations and an enforceable contract made by Mr. Dinkler, Sr., during his lifetime, and not the result of any material acts or activities by the estate. The right to the proceeds was acquired by the plaintiffs solely by virtue of the death of the decedent and not through their own efforts. Had Mr. Dinkler lived through the closing date, the proceeds would have been income to him and, consequently, they constitute income in respect of a decedent when received by the estate.

> *and Beneficiaries*, *supra*, 180-84 ("[E]vend where the property has been made the subject of a binding, executory contract of sale, if the benefits and hazards of ownership are still possessed by the decedent at his death, the property is entitled to a § 1014(a) basis in the hands of his estate, and his negotiated profit will not be taxed to his estate (or to anyone) under § 691 when the sale is completed after his death.") (footnote omitted), with Gordon, Income in Respect of a Decedent and Sales Transactions, 1961 *Wash. U.L.Q.* 30, 37 (§ 691 should apply to sale proceeds from sales which at the time of the decedent's death are incomplete "only as to delivery of the *res* and receipt of the purchase price").
>
> [7] *Cf. Keck v. Commissioner*, *supra* 415 F.2d at 534 (sale of stock was contingent upon Interstate Commerce Commission approval; proceeds held not income in respect of decedent where ICC approval not granted at time of the decedent's death).
>
> [8] *See* 26 C.F.R. § 1.691(a)-2(b) (Ex. 4) (buy-sell agreement effective at date of death; proceeds not income in respect of a decedent because the decedent could not have received the proceeds if he had lived).

The Tax Court in that case held:[4435]

> Although three of the four requirements tend to support a conclusion opposite to the one reached, all four elements are necessary to support a finding that the decedent possessed a right to the sale proceeds as of his date of death. [fn. omitted] Accordingly, the absence of one of these requirements precludes the applicability of section 691.

In analyzing the requirement that was missing, the Tax Court said:[4436]

> The fourth requirement is that the decedent, himself, would have eventually received (actually or constructively) the sale proceeds if he had lived. This situation may be best exemplified by a typical date-of-death buy-sell agreement between a decedent and his corporation; since, by its terms, the sale is only effective upon the decedent's death, the decedent could not have received the sale proceeds if he had lived. Therefore, the proceeds from such a sale are not income in respect of a decedent.

(Related to this is the "open transaction" doctrine. See part II.A.1.d.ii Monetizing Founder's Remaining Shares After Going Public, discussing the prepaid variable forward Tax Court case of *Estate of Andrew J. McKelvey v. Commissioner*). Also, the IRS has unsuccessfully attempted to use the tax benefit rule (see part II.G.4.m.iii Tax Benefit Rule) to circumvent any protection provided above.[4437]

Applying the Tax Court's fourth requirement to the insurance policy analysis, would the decedent have received taxable income from the policy if the decedent/policy owner had lived? The answer is not necessarily – if the insured died while the policy owner was living, the policy owner would have received a tax-free death benefit. The answer would be different if the policy

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[4435] 74 T.C. at 643-44.
[4436] 74 T.C. at 641. In a case involving a similar issue, farm inputs deducted on the decedent's final returns received a basis step-up at death and could be deducted by his widow on her return, even though their expected use was obvious. See *Backemeyer*, discussed in part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.
[4437] See text accompanying fn 6593 in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System.

owner had submitted the appropriate forms to cash out the policy before the policy owner died and the insurance company simply had not cut the check before the policy owner died. Thus, if the policy owner has not, before the policy owner's death, submitted whatever documentation is required to cash in the policy, then the events fixing the policy's tax consequences have not occurred before the policy owner's death and the internal cash build-up obtains a basis step-up because it does not constitute IRD.

Insurance companies remain concerned because they view the inside build-up as vested untaxed earnings. Although this argument seems untenable for contracts whose cash value might later decrease, for fully paid whole-life they understandably view it as absolute earnings that will never decrease. Rev. Rul. 2009-13[4438] took the position that, on the sale of a life insurance contract, the gain on sale is ordinary income to the extent that it does not exceed the inside build-up.[4439] The substitute-for-income doctrine, under which the IRS states that the asset is not a capital asset to the extent that the doctrine applies, makes them view the inside build-up as IRD. What they do not take into account is that assets that generate ordinary income on sale, such as inventory (which is not a capital asset),[4440] do not constitute IRD unless actually sold before death; an asset's character as an ordinary income asset has nothing to do with IRD characterization unless the income is "accrued"[4441] or is a specified class of assets subject to IRD, neither of which applies to a life insurance contract. If and to the extent that a policy might not constitute a capital asset, that classification is irrelevant, because the Code § 1014 basis step-up rules apply to more than just capital assets.[4442] Furthermore, Rev.

[4438] See fn 4402 in part II.Q.4.b Transfer for Value Rule; Basis for the fact that Rev. Rul. 2009-13 does not apply to basis determinations.

[4439] See fn. 4406.

[4440] Code § 1221(a)(1) provides:

> For purposes of this subtitle, the term capital asset means property held by the taxpayer (whether or not connected with his trade or business), but does not include … stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Note that real estate might or might not constitute inventory. See part II.G.26.c Future Development of Real Estate.

[4441] Rev. Rul. 58-436. However, crop shares or livestock received as rent by a decedent, who had employed the cash method of accounting, before the decedent's death, and owned by the decedent at the time of the decedent's death, as well as crop shares or livestock which the decedent had a right to receive as rent at the time of the decedent's death for economic activities occurring before the decedent's death, constitute income in respect of a decedent which is required to be included in gross income, for Federal income tax purposes, in the year in which the crop shares or livestock are sold, or otherwise disposed of. Rev. Rul. 64-289. *Friedman v. Commissioner*, 41 T.C. 428 (1965), *aff'd* 346 F.2d 506 (6th Cir. 1965) and Rev. Rul. 69-102 were disturbed when a taxpayer sought a charitable deduction for the full value of life insurance policies and therefore taxed the taxpayer on ordinary income on the policies' inside build-up based on a combination of the assignment-of-income principle and the taxpayers realizing a benefit (charitable deduction) for that income; Code § 170(e) and Reg. § 1.170A-4(a) address this issue by not permitting a deduction on the portion of the policy that would constitute ordinary income if the policy were sold, so presumably these authorities are obsolete in light of Rev. Rul. 2009-13. Rev. Rul. 69-102 involved an endowment policy, which typically provides for a payout of the accrued income on a specified maturity date, so before the gift all events had occurred that would require the payout of the inside build-up. Once a policy has been annuitized, an assignment triggers the assignment of income doctrine, *Jones v U.S.*, 395 F.2d 938 (6th Cir. 1968), but that should not apply to a policy passing by reason of death to the extent that the policy had not been annuitized.

[4442] For example, nobody has ever suggested that a depreciable building used in a business is not eligible for a new basis under Code § 1014, even though Code § 1221(a)(2) provides that such a building is not a

Rul. 2009-13 did not say that inside build-up creates gain; it merely said that inside build-up recharacterizes part or all of the gain on sale of the policy as ordinary income. Of course, Rev. Rul. 2009-13 has been retroactively repealed, [4443] so my mention of it simply provides context in which to analyze these issues.

Thus, although the potential ordinary income taxation of inside build-up might make one inclined to view it as IRD, that view has no basis in the law, although I found one probably irrelevant and unsound source that the IRS might try to seize upon in the event of an audit.[4444]

II.Q.4.e.ii. Practical Issues In Implementing Any Basis Adjustment On the Death of an Owner Who Is Not the Insured

The only direct immediate practical use of a stepped-up basis is avoiding gain on sale. After all, the death benefit is tax-free if one avoids the transfer for value rules (see part II.Q.4.a Funding the Buy-Sell). The remaining big question is any effect on distributions of inside build-up, the taxation of which depends on the "investment in the contract" under Code § 72(g).

The estate of the decedent who is not the insured does not appear to receive a new "investment in the contract" because the contract was not transferred to it "for a valuable consideration." However, if that estate later sold the policy for full value to a different taxpayer:

- The estate would have a stepped-up basis.
- The transferee would have a new "investment in the contract."
- The transferee would need to make sure that the "transfer for value" rules[4445] do not make the death benefit taxable.[4446]

Before buying a cash value policy to be includible in the estate of a person who is not the insured or that might be transferred in a taxable sale (perhaps one that avoids the transfer for value rules), consider asking the insurance company its procedures in this area. Results from that inquiry include the following:

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capital asset. See, *e.g.*, Reg. §§ 1.1245-2(c)(1)(iv) and 1.1250-3(b)(2)(i), providing that Code § 1014 can wipe out depreciation recapture when such property is included in the deceased owner's estate. See also the quotes from the U.S. Supreme Court and Tax Court in the text accompanying fn. 2086, found in part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[4443] See fn 4402 in part II.Q.4.b Transfer for Value Rule; Basis for the fact that Rev. Rul. 2009-13 does not apply to basis determinations.

[4444] Rev. Rul. 75-125 (which the Rev. Rul. 92-47 cited as being good law) took the position that stock, which has net unrealized appreciation (NUA) that was not taxed when distributed from a qualified retirement plan, does not receive a basis step-up at death to the extent of that NUA. This ruling preceded *Peterson* (fn. 4434), and I believe it is simply wrong in light of *Peterson*, because there is no assurance that the gain will ever be realized, and the ruling did not cite any particular support in reaching the conclusion it did. It is also philosophically inconsistent with the IRS' failure to assert assignment of income principles or otherwise impose any taint when NUA property was given to charitable remainder trusts in Letter Rulings 200038050, 200202078, 200215032, 200302048, and 200335017.

[4445] See part II.Q.4.a Funding the Buy-Sell, especially fns. 4330-4342.

[4446] Nothing in Code § 72(g) or Reg. § 1.72-10 suggests that an exception to the transfer for value rules (other than a substituted basis transaction) would make the contract not transferred for a valuable consideration.

- "We never undertake to make a Code § 72(g) adjustment, because we don't want to be bothered with it." If the insurance company answers that way, ask whether they will honor a request to check the box "taxable amount not determined" so that the taxpayer is not required to disprove what otherwise would be an incorrect Form 1099.

- "We don't want to undertake to make a Code § 72(g) adjustment, but we will do it if a sale violates the transfer for value rules; in that case, we need to tell the IRS the taxable amount at death, so it is worth it to track this." To obtain that Form 1099 reporting, the policy owner's estate might sell the policy in a transaction that violates the transfer for value rules. One might follow that transfer by a transfer to the insured, which would cleanse the transfer for value taint (perhaps other cleansing opportunities are available as well). For example, Dad owns policy on Daughter's life. Dad dies. Dad's estate sells the policy to Son, violating the transfer for value rules (unless an exception applies) and triggering the insurance company tracking the new "investment in the contract." Then Son sells the policy to Daughter (the insured); this transaction would not generate any gain to the extent of Son's basis due to his purchase from Dad's estate, and Daughter's purchase cleanses the transfer-for-value taint because she is the insured. However, one might decide that taking all these steps is not worth the effort and simply ask whether the insurance company will honor a request to check the box "taxable amount not determined."

II.Q.4.f. Split-Dollar Arrangements

II.Q.4.f.i. Split-Dollar Generally

A split-dollar arrangement is an arrangement in which one party pays part or all of the premiums and one or more of the economic rights to the policy (cash value, death benefits, etc.) are divided. An employer cannot bundle together a number of such arrangements and call them deductible welfare benefit plans; doing so subjects the employer to penalties.[4447] If an employer buys insurance on an employee's life and allows the employee to designate the beneficiary, that arrangement may constitute an ERISA plan.[4448] The IRS has an audit techniques guide on split-dollar arrangements.[4449]

The IRS created split-dollar rules before the U.S. Supreme Court found that interest could be imputed on loans and before Code § 7872 was enacted. During that period, the employer would retain the premiums it paid when the arrangement terminated (whether by death or by unwinding the arrangement – the latter referred to as a "rollout"), and the employee's beneficiary

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[4447] *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015). This case involved seven taxpayers, and the parties in approximately 40 other cases agreed to be bound by the result of this case. Notice 2007-83 announced that the IRS would target welfare benefit plans funded by life insurance. Notice 2007-84 announced that the IRS would target certain multi-employer welfare benefit plans. Program Manager Technical Advice 2015-11 explains how to apply the 30% accuracy-related penalty under Code § 6662A(c), to taxpayers who didn't follow the requirement of Notice 2007-83 to disclose participation in a listed transaction that used cash value life insurance policies to provide welfare benefits in a purported Code § 419 plan. The IRS successfully penalized Keller Tank Services II, Inc., one of the employers in the *Our Country Home Enterprises* case, for failure to report its participation in the plan as a "listed transaction" on its tax return. *Keller Tank Services II, Inc. v. Commissioner*, 854 F3d 1192 (10th Cir. 2017).

[4448] And it did in *Alberth v. Southern Lakes Plumbing & Heating, Inc.*, 2020 WL 1082775, 2020 Employee Benefits Cas. 84,566 (E.D. Wis. 3/6/2020) (Docket No. 19-CV-62).

[4449] See http://www.irs.gov/Businesses/Corporations/Split-Dollar-Life-Insurance-Audit-Technique-Guide-(03-2005) and www.irs.gov/businesses/corporations/article/0,id=136548,00.html.

(or employee on rollout) would receive the death benefit (or cash value in the case of a rollout) after reimbursing the premiums paid.[4450] It needed a mechanism to tax long-term interest-free loans, which is what split-dollar was essentially at that time, but without a promissory note. Under that system, the employer was treated as owning the policy and providing taxable economic benefits to the employee each year equal to the value of one year of life insurance protection. This treatment applied whether the employer or employee owned the policy. To avoid estate tax on the death benefit, an irrevocable life insurance trust ("ILIT") would own the policy, so that each year's imputed income to the employee was also a gift to the trust. Eventually, the arrangement would be undone before the employee's death, whether because the annual life insurance protection became too high as the employee got older, because the parties wanted to simplify the arrangement, or termination of employment. Often, the policy's cash value exceeded the premiums paid; and some taxpayers took the position that receipt of the life insurance policy, which had a cash value in excess of the premiums reimbursed to the employer on rollout, was not a taxable event, because the employee (or life insurance trust) already had legal title to the policy. The government was not happy with the taxpayer using the tax fiction of the employer owning the policy before rollout and then ignoring that tax fiction at rollout and responded by promulgating the regulatory regime described below.

Now split-dollar arrangements are governed by Reg. § 1.7872-15, under which premium payments generally are treated as loans, or Reg. § 1.61-22, the "economic benefit regime," under which generally one person is treated as owning all of the policy's cash value and the other person pays, or is treated as paying, for one-year term life insurance to the extent of the death benefit not allocated to the owner or deemed owner.

In the economic benefit regime, generally the owner and non-owner receive tax-free death benefits. The owner applies Code § 72 to any distributions that are not death benefits; even a deemed owner is treated as the real owner under Code § 72. See part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement. The other version involves the premium payor being treated as making loans to the policy owner. Generally, interest is actually paid when the insured dies but treated as paid every year,[4451] and the parties need to make an election to give effect to the loan for income and gift tax purposes.[4452] See part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

For the treatment of the economic benefit regime before Reg. § 1.61-22 was promulgated, agreements entered into on or before September 17, 2003 are instead subject to IRS Notices 2001-10 and 2002-8[4453] and Rev. Rul. 2003-105, so long as they are not "materially

[4450] The reimbursement obligation was nonrecourse – paid only out of the policy and not personally by the employee.

[4451] Stated interest that is not payable annually triggers the Code § 1272 original issue discount (OID) rules. See text accompanying fns 4501-4506 in part Split-Dollar Loans under Reg. § 1.7872-15.

[4452] See text accompanying fns 4515-4516 in part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

[4453] Notice 2002-8 discusses the extent to which changes in the IRS' view might affect arrangements then in effect:

> **VI. Effect On Other Documents**
> Notice 2001-10 is revoked. Notwithstanding that revocation, Rev. Rul. 55-747 remains revoked, and Rev. Rul. 64-328, 1964-2 C.B. 11, and Rev. Rul. 66-110 remain modified to the extent that those rulings indicate that an employer's premium payments under a split-dollar life insurance arrangement may not be treated as loans.
> Except for Part III (Revised Standards for Valuing Current Life Insurance Protection), no inference should be drawn from this notice regarding the appropriate Federal income, employment and gift

modified." Reg. § 1.61-22(j) lists some unenlightening safe harbors for what does not constitute a material modification. "Material modification" for this purpose includes changes that would not constitute a material modification under Code § 101(j) (employer-owned life insurance)[4454] or 264(f) (limiting deductions for interest expense allocable to unborrowed policy cash value).[4455]

The economic benefit regime might also trigger the harsh nonqualified deferred compensation rules of Code § 409A.[4456] Although the Code § 409A risk described in fn. 4456 is much smaller under Reg. § 1.61-22 than under prior law, be careful to consider it in either case.[4457]

All split-dollar arrangements require an exit strategy. For the loan regime, somehow the loans must be repaid; however, they do not need to be repaid until the insured's death, so the exit strategy might be easy. For the economic benefit regime, the deemed term portion becomes prohibitively expensive when the insured reaches a certain age, and it is not unusual for the parties not to have planned for how the non-owner obtains ownership for tax purposes (even though they should have). For split-dollar agreements entered into on or before September 17, 2003, when the policy is rolled out with the non-owner merely repaying the premiums:

- The equity (excess of policy value over amount owed the owner) may be taxable, but the no-inference language in fn 4453 supports a reasonable basis argument that lets one take a tax return reporting position that the equity is not taxable, so a taxpayer can take the position, file Form 8275, and see what happens. *Neff v. Commissioner*, T.C. Memo. 2012-244, accepted the IRS' position that the taxpayer had taxable income to the extent that the amount the taxpayer owed the employer on rollout exceeded the amount the employee paid the employer (rather than the employee's argument that the present value of the amount payable at death was the proper measure). It appears that nobody considered whether the

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> tax treatment of split-dollar life insurance arrangements entered into before the date of publication of final regulations. However, taxpayers may rely on this notice (including a reasonable application of the rules to be proposed as described in Part II) or Notice 2001-10 for split-dollar life insurance arrangements entered into before the date of publication of final regulations.

I am aware of a taxpayer who took the position of no income or gift on rollout, filed Form 8275, received a brief question from the IRS, and then heard nothing before the statute of limitations passed. See Thompson Coburn doc. 6348842 (email from an outside lawyer to that effect).

[4454] See part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance, especially part II.Q.4.g.i Analysis of Code § 101(j).

[4455] Notice 2008-42.

[4456] See text accompanying fns. 4307-4308.

[4457] Reg. § 1.409A-1(b)(1) provides:

> A legally binding right to an amount that will be excluded from income when and if received does not constitute a deferral of compensation, unless the service provider has received the right in exchange for, or has the right to exchange the right for, an amount that will be includible in income….

Generally, for post-2003 split-dollar agreements, the employee will have to pay for the policy's value under part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22; however, one might want to clarify that the employee will need to pay the greater of the amount provided under the regulations or the policy's fair market value, which as a practical matter would likely to be the value on Form 712. For pre-2003 agreements that are not materially modified, the employee paying the cash surrender value would suffice. Given that these older arrangements might not require the employee to pay the cash surrender value, one should look to Notice 2007-34 to try to make the policy qualify for being grandfathered from Reg. § 1.61-22 and comply with Code § 409A.

employee should have been taxable on the policy's value, which exceeded the amount owed to the employer.

- However, if I can find a way to avoid doing that, I will. For example, if the employer can use the deduction (or is a pass-through entity whose owners can use the deduction), then the employer can afford to gross them up for taxes, because the employer is saving taxes by taking that reporting position. A classic example: Employer and employee are both in the federal and state combined 40% bracket, and the amount of equity is $100. The employer pays the employee a $67 bonus so that the employee can pay the employee's taxes. The employee's taxes are $67, which is 40% of $167, the latter being the sum of the $100 policy value and the $67 bonus. The employer saves $67 taxes by reporting the same $167 compensation value, so the employer is not out-of-pocket anything.

- I successfully use the above strategy most of the time. However, the paradigm falls apart when the employer's tax benefit is less than the employee's tax cost, which often happens when the employer has little taxable income from operations against which to use the deduction. And my solution does not address estate/gift tax issues. So sometimes we need to fall back to the taxpayer taking the position that the equity is not taxable. And I have not heard any war stories about the IRS auditing this issue.

The loan regime can be somewhat unwieldy, in that each year's premium requires a separate loan. Furthermore, the economic benefit regime tends to be most beneficial to the non-owner in the policy's early years, in which the premiums paid tend to exceed the policy's cash value. Considering these issues, one might consider starting with the economic benefit regime and the switching to the loan regime when cash value approaches premium paid. This switching approach avoids administering and accruing interest on multiple loans in the policy's early years and allow cash value increases after that point to benefit the party that originally was the non-owner. By the time the switch occurs, the policy might very well be earning enough dividends to pay premiums, perhaps avoiding the need to administer multiple loans to pay for those future premiums. If the original non-owner is an irrevocable trust, during the economic benefit phase (and of course later) the grantor can make annual exclusion gifts to the trust and perhaps even use leveraged estate planning techniques[4458] to grow the trust so that the trust can afford to pay future premiums and perhaps even retire the split-dollar loans.

II.Q.4.f.ii. Technical Details of the Split-Dollar Economic Benefit Regime

II.Q.4.f.ii.(a). Is the Arrangement a Split-Dollar Arrangement?

Generally, in the split-dollar economic benefit regime, the idea is giving only pure term protection to the "non-owner" and all other right to the actual or deemed "owner."

Reg. § 1.61-22(b)(1) provides:

> *In general*. A split-dollar life insurance arrangement is any arrangement between an owner and a non-owner of a life insurance contract that satisfies the following criteria -

[4458] See part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust.

(i) Either party to the arrangement pays, directly or indirectly, all or any portion of the premiums on the life insurance contract, including a payment by means of a loan to the other party that is secured by the life insurance contract;

(ii) At least one of the parties to the arrangement paying premiums under paragraph (b)(1)(i) of this section is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract; and

(iii) The arrangement is not part of a group-term life insurance plan described in section 79 unless the group-term life insurance plan provides permanent benefits to employees (as defined in § 1.79-0).

Even if the above requirements are not met, any arrangement between an owner and a non-owner of a life insurance contract is treated as a split-dollar life insurance arrangement if it qualifies as a certain compensatory arrangement or shareholder arrangement.[4459]

Reg. § 1.61-22(b)(2)(ii) provides that the following constitutes a split-dollar compensatory arrangement:

(A) The arrangement is entered into in connection with the performance of services and is not part of a group-term life insurance plan described in section 79;

(B) The employer or service recipient pays, directly or indirectly, all or any portion of the premiums; and

(C) Either-

(1) The beneficiary of all or any portion of the death benefit is designated by the employee or service provider or is any person whom the employee or service provider would reasonably be expected to designate as the beneficiary; or

(2) The employee or service provider has any interest in the policy cash value of the life insurance contract.

As to Reg. § 1.61-22(b)(2)(ii)(A), *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015), discussed this requirement in depth, including the requirement of Reg. § 1.79-1(a)(4) that a group term arrangement not involve individual selection:

> Guardian and Minnesota Life required that the Our Country and Environmental shareholder/employees tender information on their health, traveling tendencies, and/or driving traits. The need to submit that type of personal information as a condition to receiving the insurance strongly suggests, and we find, that the insurers were exercising underwriting judgment with respect to at least the Our Country and Environmental shareholder/employees in connection with the issuance of the life insurance related to them. This finding is further strengthened by the fact that, in the case of Guardian at least, Guardian specifically rated each of Our Country's participating employees for purposes of setting the premiums payable on their policies and offered to try to find a way to reduce the premium attributable to the Blake policy. The mere fact that an

[4459] Reg. § 1.61-22(b)(2)(i).

insurer such as Guardian or Minnesota Life may add up the premiums that apply to separate policies that it sells on a specific group of insureds and then tender the total as the amount due on a group policy does not necessarily recharacterize the separate policies as part of a single group term life insurance plan. Instead, as we have stated, the exercise of underwriting judgment with respect to the specific persons in a group is indicative of the issuance of individual insurance policies rather than group policies. We hold that the insurance policies at hand are not group term life insurance policies for Federal income tax purposes.

De Los Santos v. Commissioner, T.C. Memo. 2018-155, followed *Our Country Home*. In contrast, if a group-term policy allows employees to buy additional pure term insurance on an after-tax basis without any such purchases affecting the employer-provided group plan, the employees' independent choices do not affect the employer-provided group plan's qualification as such. Letter Ruling 201542003.

As to Reg. § 1.61-22(b)(2)(ii)(C)(1), *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015), discussed this requirement in depth:

The shareholder/employees named the beneficiaries of the death benefits payable under their insurance policies by designating through the Sterling Plan the individuals who would receive the death benefits under the plan, which, in turn were the death benefits under the policy. In addition, those shareholder/employees were assured that their designated beneficiaries would receive any death benefits payable on those policies to the extent that the shareholder/employees died while participants in the plan. Petitioners seek a contrary holding essentially by looking at the life insurance policies through the wider end of a telescope towards its narrower end and seeing that the Sterling Plan is named as the beneficiary on the policies. They conclude from this view that none of the individuals who the participating employees designate to receive the death benefits payable by the Sterling Plan is [t]he beneficiary of all or any portion on the death benefit for purposes of section 1.61-22(b)(2)(ii)(C), Income Tax Regs. We, on the other hand, look telescopically at the life insurance benefit from the narrower end towards the wider end, as one commonly does, and see the ultimate recipient of the death proceeds as the person designated by the shareholder/employees. The fact that the death proceeds from the life insurance policies are funneled through the Sterling Plan to each of the ultimate recipients does not blur our view (or our conclusion) that each of those recipients is the beneficiary of the death benefit for purposes of section 1.61-22(b)(2)(ii)(C), Income Tax Regs. *Cf. Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945) (To permit the true nature of a transaction to be disguised by mere formalisms *** would seriously impair the effective administration of the tax policies of Congress.); *Minn. Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) (A given result at the end of a straight path is not made a different result because reached by following a devious path.). The light at the end of the tunnel brightly illuminates our conclusion, given that the Sterling Plan would pay no death benefit were it not for the life insurance policies, and the employee to whom a policy relates, rather than the Sterling Plan, is assured of receiving the entire amount that is payable under the terms of the policy.

As to Reg. § 1.61-22(b)(2)(ii)(C)(1), *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015), discussed this requirement in depth:

We also conclude that the shareholder/employees of Our Country and Environmental had interests in the their life insurance policies and the cash values thereof. This conclusion is supported by at least five facts. First, each life insurance policy and any funds related thereto were intended to be received by the corresponding employee or his or her designee(s) and no one else, and those employees were the only ones who had the right to receive or otherwise to redirect to someone else the cash value of the life insurance policies related to them. Second, the employees could elect to receive their policies upon retiring from employment with the employer. Third, the funds in the Sterling Plan could not be accessed by either the employer or by the employer's creditors, and Our Country and the Environmental employees, upon retiring or alternatively upon their employers' ceasing participation in the Sterling Plan, were certain to get those funds in the form of the policies that then passed to the employees. Fourth, a participating employee, before actually receiving the funds in his or her account, could be allowed to direct the investment of those funds and thus enjoy the benefit of any investment gain or suffer the detriment of any investment loss. Fifth, if the participating employee were to die while his or her insurance policy was in force, then the death benefit under that policy would ultimately be paid to his or her beneficiary in accordance with the terms of the policy.

> We also find important to our just-stated conclusion that the plan benefits were set to be fully vested either when a shareholder/employee satisfied the vesting requirements that he or she chose (or possibly could choose) in the name of the employer or when the employer terminated the plan. And as to vesting, the shareholder/employees were not necessarily bound by the vesting requirements that were initially set in their plans. Instead, at their whim they could accelerate or otherwise change the vesting requirements to their preference. In the case of Mr. Blake, for example, he executed an adoption agreement on July 30, 2006, retroactive to January 1, 2005, that lowered the normal retirement age for the employee participants in the Our Country plan and accelerated his complete vesting to the then-present time.

If an employer funds a split-dollar arrangement using a Code § 419(e) welfare benefit fund, the employer and employee retain their status as such under the split-dollar arrangement notwithstanding the fund's role and notwithstanding any delay in the fund remitting premiums to the insurance company.[4460]

The following constitutes a split-dollar shareholder arrangement:[4461]

(A) The arrangement is entered into between a corporation and another person in that person's capacity as a shareholder in the corporation;

(B) The corporation pays, directly or indirectly, all or any portion of the premiums; and

(C) Either-

(1) The beneficiary of all or any portion of the death benefit is designated by the shareholder or is any person whom the shareholder would reasonably be expected to designate as the beneficiary; or

[4460] *De Los Santos v. Commissioner*, T.C. Memo. 2018-155.
[4461] Reg. § 1.61-22(b)(2)(iii).

(2) The shareholder has any interest in the policy cash value of the life insurance contract.

Mcgowan v. U.S., 132 A.F.T.R.2d 2023-5955 (N.D. OH 9/25/2023),[4462] held that an employer-funded life insurance arrangement was split dollar. First, it discussed Reg. § 1.61-22(b)(2)(ii):

> Plaintiffs do not dispute that the arrangement was "entered into in connection with the performance of services." Additionally, the Restricted Property Trust was a whole life insurance policy, not a group-term life insurance plan. The requirement of subparagraph A is therefore satisfied. Plaintiffs concede that the premiums were paid by the Company (the employer), which satisfies subparagraph B. And according to the terms of the Benefits Trust Agreement, upon Dr. McGowan's death, the death benefit would be paid by the RPT subtrust to Dr. McGowan's designee. His designee was his wife, Michelle McGowan. The parties primarily disagree over whether this case meets the overarching criteria that the transaction was between an owner and non-owner of the policy, which would require the Company to be treated as the policy owner.
>
> **Policy Ownership**
>
> The insurance policy was owned during the five-year Restricted Property Trust term by the DBT subtrust, which was owned by trustee Aligned Partners Trust Company. Plaintiffs contend this means the split-dollar regulation is inapplicable. Defendant responds that "in the case of a compensatory split-dollar arrangement, the employer is treated as the owner if the owner is an employee trust or welfare benefit fund."

The court quoted from Reg. § 1.61-22(c)(1)(iii), "Attribution rules for compensatory arrangements," which provides:

> For purposes of this section, if a split-dollar life insurance arrangement is entered into in connection with the performance of services, the employer or service recipient is treated as the owner of the life insurance contract if the owner (within the meaning of paragraph (c)(1)(i) of this section) of the life insurance contract under the split-dollar life insurance arrangement is -
>
> (A) A trust described in section 402(b);
>
> (B) A trust that is treated as owned (within the meaning of sections 671 through 677) by the employer or the service recipient;
>
> (C) A welfare benefit fund within the meaning of section 419(e)(1); or
>
> (D) A member of the employer or service recipient's controlled group (within the meaning of section 414(b)) or a trade or business that is under common control with the employer or service recipient (within the meaning of section 414(c)).

The court continued:

> Section 419(e)(1) defines a welfare benefit fund as any fund "which is part of a plan of an employer, and...through which the employer provides welfare benefits to employees

[4462] In discussing this case, court citations to locations of evidence are omitted from all of my quotations.

or their beneficiaries." 26 U.S.C. §§ 419(e)(1). The DBT was devised for the purpose of providing benefits from the Company to Dr. McGowan. ("through this Trust Agreement, ...[the] Corporation desires to provide certain financial benefits to each employee designated on Schedule A as an incentive to remain with the Corporation and as compensation for prior valuable services rendered"). Additionally, Plaintiffs admit the DBT is a welfare benefit fund. The tax courts have previously held a corporate employer is the owner of a life insurance policy owned by a fund or trust under the split-dollar regulation. See *Our Country Home Enters., Inc. v. Comm'r of Internal Revenue*, 145 T.C. 1, 40 (2015). This Court finds that the Company is correctly treated as the owner of the policy under the regulation.

Because the transaction meets the requirements of the split-dollar regulation, the taxation rules of the regulation are applicable.

II.Q.4.f.ii.(b). Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22

The rules below apply for purposes of the income tax, the gift tax, the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), the Railroad Retirement Tax Act (RRTA), and the Self-Employment Contributions Act of 1954 (SECA).[4463] Generally, the split-dollar economic benefit regime[4464] applies to any arrangement that is not subject to the split-dollar loan regime.[4465] It also applies to a loan arrangement if the following requirements of Reg. § 1.61-22(b)(3)(ii) apply:

(A) The arrangement is entered into in connection with the performance of services, and the employer or service recipient is the owner of the life insurance contract (or is treated as the owner of the contract under paragraph (c)(1)(ii)(A)(1) of this section); or

(B) The arrangement is entered into between a donor and a donee (for example, a life insurance trust) and the donor is the owner of the life insurance contract (or is treated as the owner of the contract under paragraph (c)(1)(ii)(A)(2) of this section).

[4463] Reg. § 1.61-22(a)(1) provides:

> *In general*. This section provides rules for the taxation of a split-dollar life insurance arrangement for purposes of the income tax, the gift tax, the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), the Railroad Retirement Tax Act (RRTA), and the Self-Employment Contributions Act of 1954 (SECA). For the Collection of Income Tax at Source on Wages, this section also provides rules for the taxation of a split-dollar life insurance arrangement, other than a payment under a split-dollar life insurance arrangement that is a split-dollar loan under § 1.7872-15(b)(1). A split-dollar life insurance arrangement (as defined in paragraph (b) of this section) is subject to the rules of paragraphs (d) through (g) of this section, § 1.7872-15, or general tax rules. For rules to determine which rules apply to a split-dollar life insurance arrangement, see paragraph (b)(3) of this section.

Noticeably absent from the list in the first sentence is estate tax, the consequences of which are provided in part II.Q.4.f.v Estate Tax Consequences of Split-Dollar Agreements.

[4464] The regulatory framework for the split-dollar economic benefit regime is valid. *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015).

[4465] Reg. § 1.61-22(b)(3)(i).

Generally, “with respect to a life insurance contract, the person named as the policy owner of such contract generally is the owner of such contract.[4466]

However:[4467]

(1) An employer or service recipient is treated as the owner of a life insurance contract under a split-dollar life insurance arrangement that is entered into in connection with the performance of services if, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in paragraph (d)(3) of this section; and

(2) A donor is treated as the owner of a life insurance contract under a split-dollar life insurance arrangement that is entered into between a donor and a donee (for example, a life insurance trust) if, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in paragraph (d)(3) of this section.

Note that (1) above does not prevent an employee from setting up an endorsement arrangement with the employer, in which the employee owns the policy (including cash surrender value) and pays the premiums and the employer pays for some current life insurance protection. In such an arrangement, the employee’s interest in the cash value means that current life insurance protection is not the employee’s only interest in the policy; therefore, the employee’s being named as the policy owner also makes the employee the owner for tax purposes.

Similarly, in a donor-donee economic benefit split-dollar agreement, if the donee is designated the owner of the life insurance policy, then the donee will be treated as the owner for tax purposes if the donee has any interest other than current life insurance protection. Although the donee having actual ownership of the policy would seem risky for this reason, such an arrangement might save estate tax if the donor is not the insured, as described in part II.Q.4.f.v Estate Tax Consequences of Split-Dollar Agreements.[4468]

Rev. Rul. 81-198 involved the following facts:

> The donor, D, is an employee of X, a corporation. In 1974, D and X entered into a “split-dollar” arrangement to purchase a whole life insurance policy on the life of D.
>
> Under the arrangement, X pays that portion of the annual premium that is equal to the amount of the increase in the cash surrender value of the policy during the year. D pays the balance.

[4466] Reg. § 1.61-22(c)(1)(i), which further provides:

> If two or more persons are named as policy owners of a life insurance contract and each person has, at all times, all the incidents of ownership with respect to an undivided interest in the contract, each person is treated as the owner of a separate contract to the extent of such person’s undivided interest. If two or more persons are named as policy owners of a life insurance contract but each person does not have, at all times, all the incidents of ownership with respect to an undivided interest in the contract, the person who is the first-named policy owner is treated as the owner of the entire contract.

[4467] Reg. § 1.61-22(c)(1)(ii)(A).

[4468] Especially fns. 4538-4540.

> Upon D's death, X will be entitled to receive out of the proceeds of the policy an amount equal to the funds it provided for premium payments. D has the right to name the beneficiary of the balance of the insurance proceeds.
>
> X was designated as owner of the policy. However, X could not cancel, surrender or assign the policy without D's approval. Neither X nor D had an obligation to continue making premium payments.
>
> On April 1, 1981, D executed a trust agreement for the benefit of D's child, assigning all of D's rights in the policy to the trustee. However, D was to continue to pay the portion of the premium allocated to D. At that time, the total of premiums previously paid by X was $8,590. The interpolated terminal reserve and proportionate part of the last premium paid before the date of the assignment which covers the period extending beyond the date totaled $12,583.

Rev. Rul. 81-198 held:

> Since the policy had been in force for some time and further premium payments were to be made after the date of the gift, the value of the transferred interest, for purposes of section 2512 of the Code, is $3,993, the interpolated terminal reserve plus the proportionate part of the gross premium paid before the date of the gift, $12,583, reduced by the amount of funds provided by X for premiums, which is the corporation's interest in the policy, $8,590. Regarding the gift tax consequences with respect to the payment of annual premiums on the policy after the transfer. D's annual premium payment is a transfer by D for purposes of section 2511 of the Code. See section 25.2511-1(h)(3) of the regulations. Further, the value of the life insurance protection provided by the corporation, which is included in the income of D, is deemed to be transferred by D for purposes of section 2511 of the Code. See Rev. Rul. 78-420, 1978-2 C.B. 67.

The preamble to the split-dollar regulations, T.D. 9092 (9/11/2003), commented:

> The gift tax consequences of the transfer of an interest in a life insurance contract to a third party will continue to be determined under established gift tax principles notwithstanding who is treated as the owner of the life insurance contract under the final regulations. See, for example, Rev. Rul. 81-198 (1981-2 C.B. 188). Similarly, for estate tax purposes, regardless of who is treated as the owner of a life insurance contract under the final regulations, the inclusion of the policy proceeds in a decedent's gross estate will continue to be determined under section 2042. Thus, the policy proceeds will be included in the decedent's gross estate under section 2042(1) if receivable by the decedent's executor, or under section 2042(2) if the policy proceeds are receivable by a beneficiary other than the decedent's estate and the decedent possessed any incidents of ownership with respect to the policy. One commentator requested that these regulations address the extent to which a decedent's interest in a co-owned policy is included in that decedent's gross estate under section 2042, but the IRS and Treasury believe that issue is beyond the scope of these regulations and may be addressed in future guidance.

For purposes of measuring current life insurance protection, Reg. § 1.61-22(d)(3)(i) provides:

> the amount of the current life insurance protection provided to the non-owner for a taxable year (or any portion thereof in the case of the first year or the last year of the arrangement) equals the excess of the death benefit of the life insurance contract (including paid-up additions thereto) over the total amount payable to the owner (including any outstanding policy loans that offset amounts otherwise payable to the owner) under the split-dollar life insurance arrangement, less the portion of the policy cash value actually taken into account under paragraph (d)(1) of this section or paid for by the non-owner under paragraph (d)(1) of this section for the current taxable year or any prior taxable year.

Reg. § 1.61-22(d)(1) provides:

> In the case of a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section, economic benefits are treated as being provided to the non-owner of the life insurance contract. The non-owner (and the owner for gift and employment tax purposes) must take into account the full value of all economic benefits described in paragraph (d)(2) of this section, reduced by the consideration paid directly or indirectly by the non-owner to the owner for those economic benefits. Depending on the relationship between the owner and the non-owner, the economic benefits may constitute a payment of compensation, a distribution under section 301, a contribution to capital, a gift, or a transfer having a different tax character. Further, depending on the relationship between or among a non-owner and one or more other persons (including a non-owner or non-owners), the economic benefits may be treated as provided from the owner to the non-owner and as separately provided from the non-owner to such other person or persons (for example, as a payment of compensation from an employer to an employee and as a gift from the employee to the employee's child).

Letter Ruling 200910002 involved the following facts:

> Settlor A and Settlor B who are married, created an irrevocable trust (Trust) on Date. Trustees were named as trustees of the trust. Under the terms of Trust, the trustee is required to distribute trust income annually to a class of beneficiaries consisting of the Settlors' living issue (but excluding their children). Each member of the class has a noncumulative power to withdraw their share of any contributions to the trust. The trustee also has the discretion to distribute corpus to a member of the class to provide for the beneficiary's health, education, support, and maintenance. If a member of the class dies survived by issue, the surviving issue become members of the class. Trust will terminate on the later of the death of the last surviving Settlor, or when the number of class members equals 40. In no event may any trust established under the Trust instrument extend beyond the applicable rule against perpetuities. Upon termination, the corpus will be divided into as many equal shares as there are then living children of the Settlors and deceased children of the Settlors who have left issue then surviving.
>
> Each share created on account of a living or deceased child of the Settlors shall be further divided into as many equal shares as there are then living children of the said child and deceased grandchildren who have left issue then surviving. Each share created for a grandchild that is age 35 at termination will be distributed outright. If a grandchild is not age 35, then the share will continue in trust for the grandchild. If a

> deceased grandchild is survived by issue, then the grandchild's share is to be distributed outright, per stirpes.
>
> The terms of the Trust specifically preclude either Settlor from acting as trustee. Further, the Settlors have retained no powers or authority over the Trust, Trust property, or the administration of the Trust.
>
> The Trust has purchased a second-to-die life insurance policy on the lives of Settlor A and Settlor B and proposes to entered into a split-dollar life insurance agreement (Agreement) with Settlors. Under the agreement, the Trust will continue to own the policy and will pay during the joint lives of the Settlors an amount equal to the insurance company's current published premium rate for annually renewable term insurance generally available for standard risks. After the death of the first Settlor, the Trust will pay an amount equal to the lesser of: (1) the applicable amount provided in § Notice 2001-10, 2001-1 C.B. 549, or subsequent IRS guidance; or (2) the insurer's current published premium rate for annually renewable term insurance generally available for standard risks. The Settlors will pay the balance of the premiums.
>
> Under the Agreement, the Trust will collaterally assign the following rights to the Settlors: (1) if the Agreement terminates on the death of the survivor of Settlor A and Settlor B, then upon the death of the survivor, the right of the survivor's estate to receive the greater of the cash surrender value of the policy or the cumulative premiums paid by the Settlors; and (2) if the Agreement terminates during the lifetime of Settlor A and Settlor B, or the lifetime of the survivor, then within 60 days of termination, the right to receive from Trust an amount equal to the greater of the cash surrender value of the policy, or the premiums paid by Settlor A and Settlor B, to the extent Trust has other assets. Under the Agreement, all incidents of ownership over the policy (including the sole right to surrender or cancel the policy, and the sole right to borrow or withdraw against the policy) are vested in the Trustees of Trust.

Letter Ruling 200910002 reasoned and concluded:

> In the present case, under section 1.61-22(c)(1)(ii)(A)(2), A and B will be treated as the owners of Policy, because under the terms of the Agreement, the only economic benefit that will be provided under the split-dollar arrangement is current life insurance protection. Under the terms of the Agreement, Trust will pay the portion of the premium equal to the cost of current life insurance protection and Settlor A and B will pay the balance of the premium. Settlor A and/or B (or the estate of the survivor) will be entitled to receive an amount equal to the greater of the policy cash surrender value or premiums paid on early termination or at the death of the survivor. We conclude that the payment of the premiums by Settlors A and B, pursuant to the terms of the Agreement, will not result in a gift by Settlor A and B under § section 2511, provided that the amounts paid by the Trust for the life insurance benefit that the Trust receives under the Agreement is at least equal to the amount prescribed under § Notice 2001-10
>
> We also conclude that, if some or all of the cash surrender value is used (either directly, or indirectly through loans) to fund the Trust's obligation to pay premiums, Settlor A and B will be treated as making a gift at that time….
>
> In the present case, under Agreement and the collateral assignment, neither Settlor A nor B will hold any incidents of ownership in Policy. As noted above, all incidents of

> ownership in the policies, including the power to change the beneficiary, the power to surrender or cancel the policy, the power to assign the policy or to revoke an assignment, and the power to pledge the policy for a loan or to obtain from the insurer are vested in the Trustee of Trust. Accordingly, we conclude that the proceeds of the policy payable to the Trust will not be included in the gross estate of the second to die of A and B under § section 2042(2). The portion of the proceeds payable to the estate of the survivor of A and B will be includible under § section 2042(1). See, *e.g.*, Rev. Rul. 79-129, 1979-1 C.B. 306.

Machacek v. Commissioner, T.C. Memo. 2016-55, held that a split-dollar agreement benefitting a shareholder-employee was a compensatory plan, causing income inclusion to the shareholder-employee. The Sixth Circuit reversed, 906 F.3d 429 (2018),[4469] ignoring both parties' briefs and instead citing Reg. § 1.301-1(q)(1), "Split-dollar life insurance arrangements," which provides:

> (i) *Distribution of economic benefits*. The provision by a corporation to its shareholder pursuant to a split-dollar life insurance arrangement, as defined in § 1.61-22(b)(1) or (2), of economic benefits described in § 1.61-22(d) or of amounts described in § 1.61-22(e) is treated as a distribution of property, the amount of which is determined under § 1.61-22(d) and (e), respectively.
>
> (ii) *Distribution of entire contract or undivided interest therein*. A transfer (within the meaning of § 1.61-22(c)(3)) of the ownership of a life insurance contract (or an undivided interest therein) that is part of a split-dollar life insurance arrangement is a distribution of property, the amount of which is determined pursuant to § 1.61-22(g)(1) and (2).

The Sixth Circuit stated that Reg. § 1.301-1(q)(1)(i) did not differentiate between compensatory and non-compensatory split-dollar arrangements and noted that this was not inconsistent with Reg. § 1.61-22(d)(1), which specifically contemplates that Code § 301 may apply to a split-dollar arrangement. Although such a disproportionate distribution should be cured if an S election is in place, it almost never will cause the corporation to violate the single-class-of-stock rule.[4470]

However, in a unanimous reviewed decision, *De Los Santos v. Commissioner*, 156 T.C. No. 9 (2021), refused to accept this reversal outside the Sixth Circuit,[4471] commenting on the enactment of Code § 301(a):

> This provision, Congress explained, "has applicability only to distributions of property to shareholders in their capacity as such." S. Rept. No. 83-1622, at 231 (1954), 1954 U.S.C.C.A.N. 4621, 4868. "For example, a distribution of property to a shareholder who is a creditor of the corporation in satisfaction of his claim against the corporation is not within the scope of section 301." *Ibid.*
>
> The regulations issued under section 301 must (and can) be interpreted to be consistent with this statutory mandate. Section 1.301-1(a) describes the statute as setting forth "the general rule for treatment of distributions … by a corporation to a shareholder with

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[4469] The Sixth Circuit denied the Government's petition for rehearing on December 9, 2020.
[4470] See part II.A.2.i Single Class of Stock Rule, especially parts II.A.2.i.ii Temporary Timing Differences; Other Varying Differences (especially fn 252, citing Reg. § 1.1361-1(l)(2)(i)) and II.A.2.i.iii Disproportionate Distributions.
[4471] The Sixth Circuit consists of MI, OH, KY, and TN.

respect to its stock." Section 1.301-1(c) states that "[s]ection 301 is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such."

These general rules, unambiguously stated at the outset of the section 301 regulations, necessarily apply to (and limit) the subsequent, more granular provisions. Those subsequent provisions often refer to "distributions to shareholders" or "property transferred by a corporation to a shareholder," without explicitly saying-each and every time-that the distribution or transfer is being made to the shareholder "in his capacity as such."[5] But there was no need for Treasury to include that verbiage in these more granular provisions because the general rules stated at the outset limit the scope of the regulations to distributions by a corporation with respect to its stock.

[5] *See, e.g.*, sec. 1.301-1(b), Income Tax Regs. (specifying time for inclusion in gross income of "[a] distribution made by a corporation to its shareholders," without specifically stating that the distribution was made to shareholders in their capacity as such); *id*. para. (d)(3) (specifying consequences for "a distribution of property … by a foreign corporation to a shareholder," without specifically stating that the distribution was made to the shareholder in its capacity as such); *id*. para. (f), Examples (1), (2), and (3) (specifying consequences of various distributions to stockholders, without specifically stating that the distributions were made to them in their capacity as such); *id*. para. (j) (specifying consequences where "property is transferred by a corporation to a shareholder which is not a corporation for an amount less than its fair market value in a sale or exchange," without specifically stating that the distribution was made to a shareholder in his capacity as such); id. para. (m) (providing that "[t]he cancellation of indebtedness of a shareholder by a corporation shall be treated as a distribution of property," without specifically stating that this benefit is conferred on the shareholder in his capacity as such).

The same analysis applies to section 1.301-1(q)(1)(i), Income Tax Regs. It says that "[t]he provision by a corporation to its shareholder pursuant to a split-dollar life insurance arrangement ... of economic benefits … is treated as a distribution of property." *Ibid*. This sentence necessarily applies only to the provision of economic benefits to a shareholder "in his capacity as such," because that is the only type of transfer to which section 301 applies. Interpreting "shareholder" to mean "shareholder in his capacity as such" - when used here and in comparable paragraphs of the regulation-is not only justified but is required by the statutory text and by the regulation's introductory provisions.[6]

[6] The Sixth Circuit suggested that there was "no alternative interpretation that gives meaning to the inclusion of compensatory arrangements in § 1.301-1(q)(1)(i)." *Machacek*, 906 F.3d at 436. Again we respectfully disagree. The "alternative interpretation" that renders this provision consistent with the statute and the rest of the regulation is to interpret "to its shareholder," as used in sec. 1.301-1(q)(1)(i), to mean "to its shareholder in his capacity as such." That is the clear meaning of this phrase throughout sec. 1.301-1, Income Tax Regs. See supra note 5.

When proposing and finalizing the split-dollar regulations, Treasury made clear that the manner in which economic benefits are taxed depends on whether the arrangement is a compensatory arrangement or a shareholder arrangement. "[I]f the arrangement were in a compensatory context," Treasury advised, "the employee … would account for the amount as compensation." Sec. 1.61-22, Proposed Income Tax Regs., 67 Fed.

Reg. 45417 (July 9, 2002). The final regulations similarly state that the manner in which economic benefits are taxed "[d]epend[s] on the relationship between the owner and the non-owner." Sec. 1.61-22(d)(1), Income Tax Regs. Depending on the capacity in which the non-owner receives the transfer, it "may constitute a payment of compensation, a distribution under section 301, a contribution to capital, a gift, or a transfer having a different tax character." *Ibid*. Under the Sixth Circuit's approach in *Machacek*, economic benefits received by a shareholder would invariably constitute a distribution under section 301, regardless of the relationship that accounts for the payment. We are unable to reconcile that approach either with the text of section 301(a) or with the split-dollar regulations.

Notably, the split-dollar regulations govern the taxation of such arrangements, not only for income and gift tax purposes, but also for employment tax purposes. See sec. 1.61-22(a)(1), Income Tax Regs. ("This section provides rules for the taxation of a split-dollar life insurance arrangement for purposes of … the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), … and the Self-Employment Contributions Act[.]"). It is well established that an S corporation "cannot avoid Federal employment taxes by characterizing compensation … as distributions of the corporation's net income." *Veterinary Surgical Consultants, P.C. v. Commissioner*, 117 T.C. 141, 145-146 (2001), *aff'd sub nom. Yeagle Drywall Co. v. Commissioner*, 54 F. App'x 100 (3d Cir. 2002).

But if a corporate employer could characterize benefits paid to employees under compensatory arrangements as section 301 "distributions," the employer could avoid paying a substantial amount of taxes that fund programs like Medicare and Social Security. An S corporation might even offer its rank-and-file employees a few shares of stock. By converting each employee into a "shareholder," the employer could avoid paying employment taxes on split-dollar insurance benefits, contrary to Treasury's evident purpose in promulgating these rules.

For these reasons, we conclude that the economic benefits received by petitioner husband under the split-dollar arrangement cannot be characterized as "distributions" under section 301. In the notice of deficiency respondent determined that these benefits, having been received under a compensatory arrangement, are taxable as "compensation for services" under section 61(a)(1) and thus as ordinary income. Although we agree that the benefits are taxable as ordinary income, we think the path to that conclusion requires a few additional steps.

Subchapter S governs the tax treatment of S corporations and their shareholders. Section 1372, one of its provisions, is captioned "Partnership Rules to Apply for Fringe Benefit Purposes." Section 1372(a) provides that, "[f]or purposes of applying the provisions of this subtitle [*viz*., subtitle A, dealing with income taxes] which relate to employee fringe benefits - (1) the S corporation shall be treated as a partnership, and (2) any 2-percent shareholder of the S corporation shall be treated as a partner of such partnership." A "2-percent shareholder" is defined to include "any person who owns … more than 2 percent of the outstanding stock of such corporation." Sec. 1372(b).

In *Our Country Home Enterprises*, 145 T.C. at 51, we ruled that an employer's provision of economic benefits to its employees under a compensatory split-dollar arrangement "generally is deemed to be the payment of compensation." But we noted that this general rule is subject to an exception "where the employer is an S corporation that

> provides the benefits to a 2% shareholder in consideration for services rendered." Ibid. "In the case of such an S corporation," we reasoned, "the 2% shareholder is treated as a partner for purposes of applying the employee fringe benefit rules, the economic benefits are categorized as guaranteed payments under section 707(c), and the 2% shareholder must recognize the amount of the guaranteed payments as gross income under section 61(a)." *Ibid*.; see *Hurst v. Commissioner*, 124 T.C. 16, 35 (2005) (treating an S corporation's payment of insurance premiums on behalf of a 2% shareholder as "guaranteed payments" under section 707(c)).
>
> Petitioner husband owned 100% of the S Corp.'s stock at all relevant times. Under section 1372(a), the S Corp. is treated as a partnership, and he is treated as a partner, for purposes of determining the taxation of employee fringe benefits. The life insurance benefits petitioner husband received under the split-dollar arrangement are "employee fringe benefits" within the meaning of section 1372. *Our Country Home Enters., Inc.*, 145 T.C. at 51; see *Hurst*, 124 T.C. at 35. Those economic benefits are thus taxed to petitioner husband as "guaranteed payments" under section 707(c) and hence as ordinary income under section 61.

The Tax Court explained its interpretation of "fringe benefit" for the purposes of Code § 1372:[4472]

> The term "fringe benefit" is commonly understood to mean "any form of employee compensation provided in addition to wages or base salary, as a pension, insurance coverage, vacation time, etc." Webster's New World Collegiate Dictionary 568 (4th ed. 2010); see Black's Law Dictionary (11th ed. 2019) (defining "fringe benefit" as a "benefit (other than direct salary or compensation) received by an employee from an employer, such as insurance"); see also Internal Revenue Manual pt. 4.23.5.15(1) (Nov. 22, 2017) (defining "fringe benefit" as a benefit "that an employee receives in addition to regular taxable wages").
>
> Although the term "fringe benefit" is not defined in the Code, all available evidence suggests that Congress intended to adopt the common understanding of this term, *i.e.*, that a "fringe benefit" includes any employer-provided benefit that supplements an employee's salary, specifically including life insurance benefits. Because the Code "is broad enough to include in taxable income any … benefit conferred on the employee as compensation," *Commissioner v. Smith*, 324 U.S. 177, 181 (1945), any fringe benefit is taxable unless "excluded by § 132 or some other explicit exclusionary rule," Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Employee Compensation*, para. 5.1, at *1 (2020), Westlaw WGL-COMP. Section 132, captioned "Certain fringe benefits," specifically excludes from gross income eight types of fringe benefits, but split-dollar insurance benefits are not among those so excluded.
>
> Congress codified section 1372 as part of the Subchapter S Revision Act of 1982 (Act), Pub. L. No. 97-354, 96 Stat. at 1682. In the section of the Act governing effective dates Congress provided that, in the case of "existing fringe benefits," section 1372 shall apply "only with respect to taxable years beginning after December 31, 1987." Act sec. 6(d)(1), 96 Stat. at 1699. Congress defined "existing fringe benefit" to mean "any employee fringe benefit of a type which the corporation provided to its employees as of

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[4472] Code § 132 is referred to in the paragraph accompanying fn 3899 in part II.P.2 C Corporation Advantage Regarding Fringe Benefits.

September 28, 1982." *Id*. para. (3). By referring to "any employee fringe benefit," Congress evidently intended to give this term broad scope.

The Act's legislative history expressed Congress' understanding that "fringe benefits" within the meaning of section 1372 included various insurance benefits, such as death benefits, group term life insurance benefits, and benefits received under accident and health plans. See S. Rept. No. 97-640, at 22 (1982), 1982-2 C.B. 718, 728; H.R. Rept. No. 97-826, at 21 (1982), 1982-2 C.B. 730, 739. Both reports state, without exceptions, that "the treatment of fringe benefits of any person owning more than two percent of the stock of the corporation will be treated in the same manner as a partner in partnership." Ibid. Petitioners offer no plausible explanation why the death benefits they received under the Legacy Plan, unlike all other employer-provided insurance benefits, should be excluded from "fringe benefits" that are subject to this rule.[7]

[7] Notably, the IRS has consistently characterized split-dollar life insurance benefits as "fringe benefits" for purposes of subchapter S. See Priv. Ltr. Rul. 200441023 (Oct. 8, 2004); Priv. Ltr. Rul. 9248019 (Nov. 27, 1992). Petitioners seek to differentiate such benefits from other insurance benefits on the theory that "split-dollar arrangements represent more of a co-ownership of an asset for income tax purposes which benefits both parties." This statement is factually incorrect, at least as applied to the Legacy Plan: The Trust owned the Policy, and the S Corp. was simply deemed "the owner" for purposes of the split-dollar regulations. See sec. 1.61-22(c)(1)(ii)(A)(1), Income Tax Regs. In any event all employee benefit programs may be said to "benefit both parties." Otherwise employers presumably would not offer them to their employees.

Besides pointing us to the correct technical analysis, section 1372 confirms the error of petitioners' reliance on section 1.301-1(q), Income Tax Regs. For purposes of taxing the economic benefits at issue here, section 1372 requires that the S Corp. be treated as a partnership. Although partnerships can distribute property, see secs. 731-737, they cannot make "distributions" covered by section 301, see sec. 301(a) (specifying taxability of distributions of property "made by a corporation to a shareholder"). The regulation on which petitioners rely accordingly has no application to this case. See sec. 1.301-1(q)(1)(i), Income Tax Regs. (addressing the provision of economic benefits "by a corporation to its share-holder"). Thus, even if petitioners were correct in contending that split-dollar insurance benefits received by an employee-shareholder of a C corporation would necessarily be treated as a distribution under section 301, sections 1372 and 707(c) dictate that the result is different for an employee-shareholder of an S corporation who owns 2% or more of its stock. These provisions therefore supply a distinct and independently sufficient basis for denying petitioners' motion for partial summary judgment.[8]

[8] Although the employer in *Machacek*, 906 F.3d at 430, was an S corporation, the Sixth Circuit in its opinion did not address sec. 1372, and neither party appears to have brought that provision to the court's attention.

The opinion says that the compensation is taxable as a Code § 707(c) guaranteed payment. Presumably the IRS will use the logic of Rev. Rul. 91-26 and Announcement 92-16 (both reaffirmed in Notice 2005-8) and reported on Form W-2.

In AOD 2021-02 (5/24/2021), the IRS announced its position:[4473]

> The Service's position is that these benefits must be "taken into account based on their character." *Split-Dollar Life Insurance Arrangements*, T.D. 9092, 68 Fed. Reg. 54,336, 54,339 (Sept. 17, 2003). Payments that arise from an employer-employee relationship, like those in Machacek, are compensation, not distributions subject to section 301. Treas. Reg. § 1.301-1(q) applies only to split-dollar life insurance arrangements between a corporation and a shareholder in his or her capacity as such. See also *De Los Santos v. Commissioner*, 156 T.C. No. 9 at 16-20 (Apr. 12, 2021) (declining to follow the Sixth Circuit's reasoning and conclusion in *Machacek* in a case appealable to a different circuit).
>
> Although the Service disagrees with the decision of the court in *Machacek*, we recognize the precedential effect of the decision to cases appealable to the Sixth Circuit. Therefore, the Service will follow it in cases within that circuit if the opinion cannot be meaningfully distinguished. The Service does not, however, acquiesce in the opinion, and we will continue to litigate our position in cases in other circuits.
>
> In cases appealable to the Sixth Circuit, the Service's position is that taxpayers must adopt consistent reporting positions in light of the opinion in *Machacek*, which may result in unfavorable consequences for some taxpayers. For example, if the economic benefits of a split-dollar life insurance arrangement are treated as distributions, the costs of the arrangement will never be deductible as compensation under Treas. Reg. § 1.83-6(a)(5) or otherwise. Additionally, the Service's position is that adoption of a split-dollar life insurance arrangement by a corporation will terminate the corporation's S election (or invalidate a subsequent S election) if the arrangement provides some shareholders with superior rights to distribution proceeds. See section 1361(b)(1)(D); Treas. Reg. § 1.1361-1(*l*).

When the IRS says, "if the economic benefits of a split-dollar life insurance arrangement are treated as distributions," my best guess is that the AOD applies only if the taxpayer chooses to treat the economic benefits in that manner. However, to be safe, corporations in the Sixth Circuit should consider treating the economic benefits as distributions and giving make-up distributions to the other shareholders.

Mcgowan v. U.S., 132 A.F.T.R.2d 2023-5955 (N.D. OH 9/25/2023),[4474] in "Deductions by the Company," viewed the situation as similar to *Machacek*:

> In addition to imposing tax consequences upon Dr. McGowan, the policy's fulfillment of the split-dollar regulation requirements imposes consequences upon the Company; namely: "No premium...is deductible by the owner." 26 C.F.R. § 1.61-22(f)(2)(ii). Plaintiffs attempted to deduct the Company's premium payments as a transfer to a trust subject to substantial risk of forfeiture, pursuant to 26 U.S.C. §§ 83, and as contribution to a welfare benefit trust for an employee's benefit, pursuant to 26 U.S.C. and §§ 162 and 419. But under 26 C.F.R. § 1.301-1, economic benefits flowing from split-dollar life insurance arrangements are "treated as a distribution of property", not as the

[4473] See part II.A.2.i.iv Providing Equity-Type Incentives without Violating the Single Class of Stock Rules, especially text accompanying and preceding fn 269.
[4474] In discussing this case, court citations to locations of evidence are omitted from all of my quotations.

> transactions under which Plaintiffs could have deducted the income. *Machacek v. Comm'r of Internal Revenue*, 906 F.3d 429, 434 (6th Cir. 2018).
>
> Despite Plaintiffs' assertions to the contrary, the facts relevant to Plaintiffs' deductions are similar to those in *Machacek*, where a company provided the premiums for its shareholder-employee's life insurance policy and deducted those premiums; the shareholder-employee included neither those premiums nor the "economic benefits flowing from the increase in value of the life insurance policy" on his tax return as individual income. *Id*. at 431. While the shareholder-employee in that case appeared to argue that the tax regulations "do not carry sufficient weight to overcome Congress' unambiguous standards expressed in [the tax code]" - as Plaintiffs here argue there is "no authority for the proposition that the IRS's interpretive regulation, 26 C.F.R. § 1.61-22, can supersede Congressionally enacted statutes" - the regulations help determine which statutes of the tax code apply. And "[26 C.F.R. §] 1.301-1 treats economic benefits provided to a shareholder pursuant to any split-dollar arrangement as a distribution of property...and are thus deemed to have been paid to the shareholder in his capacity as a shareholder." *Machacek*, 906 F.3d at 436. Because the policy value ought to have been included in Dr. McGowan's income, and because the Company was not permitted to deduct the premium payments, the IRS calculations of tax liability in the Notices of Deficiency are correct, and Defendant is entitled to summary judgment on these issues.

Below are some letter rulings issued before the split-dollar regulations were promulgated:

Letter Ruling 9248019 held:

> Like the payment of accident and health insurance premiums described in Rev. Rul. 91-26, X's payment of premiums under the split-dollar life insurance agreement is a fringe benefit to employees, not a vehicle for the circumvention of the one class of stock requirement. Therefore, based solely on the representations made and the information submitted, it is held that X's split-dollar life insurance agreement with its employees and their spouses will not create more than one class of stock within the meaning of section 1361(b)(1)(D) of the Internal Revenue Code.

Letter Ruling 9318007 held:

> Because the arrangement provides that, at the time X pays the premiums, A, or the irrevocable trust established by A, must reimburse X to the extent the payment confers an economic benefit to that shareholder, X's split-dollar arrangement does not alter rights to distribution and liquidation proceeds. Therefore, based solely on the representations made and the information submitted, it is held that X's split-dollar life insurance agreement with the irrevocable trust established by A will not create more than one class of stock within the meaning of section 1361(b)(1)(D) of the Code.

Letter Ruling 9331009 held:

> Because the agreement provides that each of the shareholders or their trusts must reimburse X to the extent the payment confers an economic benefit to the shareholder, X's split-dollar arrangement does not alter rights to distribution and liquidation proceeds. Therefore, based solely on the representations made and the information submitted, it is

> held that X's split-dollar life insurance agreement with its shareholders will not create more than one class of stock within the meaning of section 1361(b)(1)(D) of the Code.

Letter Ruling 9413023 held:

> Like the payment of accident and health insurance premiums described in Rev. Rul. 91-26, X's payment of premiums under the split-dollar life insurance agreement is a fringe benefit to B, not a vehicle for the circumvention of the one class of stock requirement. Therefore, the agreement will be disregarded in determining whether X's shares of stock confer identical distribution and liquidation rights.

Letter Ruling 9651017 held:

> Because the arrangement provides that, at the time X pays the premiums, either (1) H, W, or the irrevocable trust established by H and W must reimburse X to the extent of the economic benefit of the life insurance protection, or (2) if H is an employee of X, X may treat the economic benefit as compensation to H during the taxable year, X's split-dollar arrangement does not alter rights to distribution and liquidation proceeds. Therefore, based solely on the representations made and the information submitted, we hold that X's split-dollar life insurance agreement with the irrevocable trust established by H and W will not create more than one class of stock within the meaning of section 1361(b)(1)(D).

Letter Ruling 9709027 held:

> Because the arrangement provides that, at the time X pays the premiums, H, through a contribution to the Trust, and payment by the Trust to X, will reimburse X to the extent of the economic benefit of the life insurance protection, the split-dollar agreement between Trust and X does not alter rights to distribution and liquidation proceeds. Therefore, based solely on the representations made and the information submitted, we hold that X's split-dollar life insurance agreement with Trust will not create more than one class of stock within the meaning of section 1361(b)(1)(D).

Letter Ruling 9735006 held:

> Because the agreements in this case provide that, at the time Company pays the premiums, the Trusts, or their settlors or beneficiaries, must reimburse Company to the extent the payments confer an economic benefit to the Trusts, Company's split-dollar life insurance agreements do not alter rights to distribution and liquidation proceeds. Therefore, based solely on the facts submitted and the representations made, we conclude that Company's split-dollar life insurance agreements will not create more than one class of stock within the meaning of section 1361(b)(1)(D).

Letter Ruling 200441023, which was issued after the split-dollar regulations, held:

> Because the agreements in this case provide that, at the time Company pays the premiums, the Recipients, must reimburse Company to the extent the payments confer an economic benefit to the Recipients, Company's split-dollar life insurance agreements do not alter rights to distribution and liquidation proceeds.

TD 9954 (9/22/2021) "adopts the 2019 proposed regulations as final regulations with no substantive changes and with certain non-substantive changes for purposes of clarity and readability," so that Reg § 1.301-1(m), "Split-dollar and other life insurance arrangements," provides:

(1) *Split-dollar life insurance arrangements*

(i) *Distribution of economic benefits*. The provision by a corporation to its shareholder pursuant to a split-dollar life insurance arrangement, as defined in § 1.61-22(b)(1) or (2), of economic benefits described in § 1.61-22(d), or of amounts described in § 1.61-22(e), is treated as a distribution of property, the amount of which is determined under § 1.61-22(d) and (e), respectively.

(ii) *Distribution of entire contract or undivided interest therein*. A transfer (within the meaning of § 1.61-22(c)(3)) of the ownership of a life insurance contract (or an undivided interest therein) that is part of a split-dollar life insurance arrangement is a distribution of property, the amount of which is determined pursuant to § 1.61-22(g)(1) and (2).

(2) *Other life insurance arrangements*. A payment by a corporation on behalf of a shareholder of premiums on a life insurance contract or an undivided interest therein that is owned by the shareholder constitutes a distribution of property, even if such payment is not part of a split-dollar life insurance arrangement under § 1.61-22(b).

(3) *When distribution is made*

(i) *In general*. Except as provided in paragraph (m)(3)(ii) of this section, paragraph (c) of this section applies to determine when a distribution described in paragraph (m)(1) or (2) of this section is taken into account by a shareholder.

(ii) *Exception*. Notwithstanding paragraph (c) of this section, a distribution described in paragraph (m)(1)(ii) of this section is treated as made by a corporation to its shareholder at the time that the life insurance contract, or an undivided interest therein, is transferred (within the meaning of § 1.61-22(c)(3)) to the shareholder.

(4) *Applicability date*

(i) *General rule*. This paragraph (m) applies to split-dollar and other life insurance arrangements entered into after September 17, 2003. For purposes of this paragraph (m)(4), a split-dollar life insurance arrangement is entered into as determined under § 1.61-22(j)(1)(ii).

(ii) *Modified arrangements treated as new arrangements*. If a split-dollar life insurance arrangement entered into on or before September 17, 2003, is materially modified (within the meaning of § 1.61-22(j)(2)) after September 17, 2003, the arrangement is treated as a new arrangement entered into on the date of the modification.

I do not view this finalization of regulations as changing anything but included it for the sake of completeness.

The requirement that the non-owner receive only current life insurance protection means that the non-owner cannot have any other economic benefits, such as current or future access to cash value. Reg. § 1.61-22(d)(2) provides:

> *Value of economic benefits*. The value of the economic benefits provided to a non-owner for a taxable year under the arrangement equals -
>
> (i) The cost of current life insurance protection provided to the non-owner as determined under paragraph (d)(3) of this section;
>
> (ii) The amount of policy cash value to which the non-owner has current access within the meaning of paragraph (d)(4)(ii) of this section (to the extent that such amount was not actually taken into account for a prior taxable year); and
>
> (iii) The value of any economic benefits not described in paragraph (d)(2)(i) or (ii) of this section provided to the non-owner (to the extent not actually taken into account for a prior taxable year).

McGowan v. U.S., 132 A.F.T.R.2d 2023-5955 (N.D. OH 9/25/2023),[4475] applied that regulation in its discussion, "Current Access to Cash Value":

> The Benefits Trust Agreement states Dr. McGowan had no "interest or right in or to" the policy while it was owned by the DBT, as it was in 2014 and 2015. But the split-dollar regulation defines "current access" in a perhaps counterintuitive way: "a non-owner has current access to that portion of the policy cash value...[t]o which, under the arrangement, the non-owner has a current or future right; and...[t]hat currently is directly or indirectly accessible by the non-owner, *inaccessible to the owner*, or inaccessible to the owner's general creditors." 26 C.F.R. § 1.61-22(d)(4)(ii) (emphasis added).
>
> Plaintiffs argue "the cash value could not be accessed by anyone." This fact does not, however, mean that Dr. McGowan did not have "current access" to the cash value as that term is defined under the regulation. A non-owner has "current access" when he has "future right" to cash value inaccessible to the owner, and Dr. McGowan had "a `future right' to the [p]olicy cash value because [he had] the exclusive right to designate who would receive death benefits under the [p]olicy." *De Los Santos v. Comm'r of Internal Revenue*, 116 T.C.M. (CCH) 304, at *8 (2018).
>
> Plaintiffs appear to argue that because the death benefits were subject to a "substantial risk of forfeiture" (referring to the provision that if the Company stopped paying the premiums during the policy term, the cash value of the policy would be distributed to a charity of Dr. McGowan's choosing), Dr. McGowan did not have the exclusive right to designate who would receive the benefit and thus did not have "current access".[1] The regulation makes no reference to whether a non-owner's future right to the policy value may be construed as "current access" where that future right is contingent.
>
> [1] The Court notes as an aside that Dr. McGowan designated the charity himself, just as he designated Michelle McGowan as the beneficiary in the event of his death,

[4475] In discussing this case, citations to locations of evidence are omitted from all of my quotations.

which in this Court's view means that even in the event of forfeiture, he had the right to designate who would receive the policy's value.

Plaintiffs contend this contingency excludes the policy's cash value from the total value of economic benefits under the regulation by contrasting it to the facts of another split-dollar regulation case, where "the facts therein are clearly and significantly distinguishable": "`The Court has repeatedly held [that the regulation] does not allow an employer to deduct its payments to a purported welfare benefit plan *where the participating employees could receive the value reflected in insurance policies purchased by those plans*." (quoting *Our Country Home*, 145 T.C. at 48 (emphasis added by Plaintiffs)). The Court is not convinced that the emphasized portions are substantially different from the facts of this case. Plaintiffs seem to believe that the word "purported" means "sham" or "fictitious" (see Doc. 103, at 21); rather, it means "imputed" or "alleged". Even so, the split-dollar regulation expressly states that it applies to welfare benefit plans. 26 C.F.R. § 1.61-22(c)(1)(iii)(C). Additionally, this *is* a case where the participating employee (Dr. McGowan) could receive the value reflected in the insurance policy (by declining to renew the Restricted Property Trust transaction after the five-year term, as he did).

Defendant argues that "a contingent right is still a right", and that the split-dollar regulation makes no exception for a contingent right. While Plaintiffs argue that such a contingency being "[n]oticeably absent from the Treasury Regulation" implies that it makes the regulation inapplicable, this Court finds that the regulation's plain language, including the absence of an exception for any "substantial forfeiture" provision in a policy, indicates that the regulation includes such contingent rights. Additionally, this Court notes that no insurance policy's benefit is conferred if its premiums are not paid; if potential cancellation of an insurance policy due to failure to pay premiums were enough to negate a future right to the policy's value or benefits, there is likely no case in which paragraph (d)(2)(ii) would apply. *Cf. United States v. Henry*, 983 F.3d 214, 218 (6th Cir. 2020) ("When interpreting a statute, we begin with the plain meaning of the statutory language. This requires that we look at the specific statutory language as well as the language and design of the statute as a whole.").

The Court therefore finds that Dr. McGowan had "current access" to the policy cash value as defined by the split-dollar regulation, and it should have been included as part of the value of economic benefits provided to Dr. McGowan and taxed accordingly. 26 C.F.R. § 1.61-22(d)(2).

Policy cash value excludes surrender charges or other similar charges or reductions and includes policy cash value attributable to paid-up additions.[4476] A non-owner has current access to that portion of the policy cash value (A) to which the non-owner has a current or future right and (B) that currently is directly or indirectly accessible by the non-owner, inaccessible to the owner, or inaccessible to the owner's general creditors.[4477] Note that the policy's being

[4476] Reg. § 1.61-22(d)(4)(i).

[4477] Reg. § 1.61-22(d)(4)(ii). *De Los Santos v. Commissioner*, T.C. Memo. 2018-155, held: Petitioners had a "future right" to the Policy cash value because they had the exclusive right to designate who would receive death benefits under the Policy. *See Our Country Home Enters.*, Inc., 145 T.C. at 45-46, 53-54. Moreover, once a participating employer had made contributions to the Legacy/Flex Trust, those contributions were irrevocable and were inaccessible to the employer and its creditors. Employers and their creditors likewise had no access to the income inaccessible to the owner is not enough to attribute cash value to the non-owner; the non-owner must also have a current or future right to the cash value.[4478] Thus, as *McGowan* points out, the

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or assets (including insurance contracts) held by the Legacy/Flex Trust. Thus, although petitioners during 2011-2012 could not withdraw funds from the Policy or the Legacy/Flex Plan, the Policy cash value, in its entirety, was "inaccessible to the owner" (*i.e.*, the S Corp.) and was "inaccessible to the owner's general creditors." See sec. 1.61-22(d)(4)(ii)(B), Income Tax Regs.[4]

[4] Petitioners insist that they enjoyed no economic benefit beyond the cost of current insurance protection - i.e., $178 for 2011 and $213 for 2012 - because they could not withdraw cash from the Policy or from the Legacy/Flex Plan currently. This argument ignores the governing regulation, which explicitly states that a non-owner possessing future rights "has current access to that portion of the policy cash value" that is "inaccessible to the owner" or "inaccessible to the owner's general creditors." Sec. 1.61-22(d)(4)(ii)(B), Income Tax Regs.

Although the Legacy/Flex Plan documents make clear that the Policy cash value was not subject to the claims of any participating employer or its creditors, petitioners assert that a clawback provision in the bankruptcy code could lead to a different outcome. Under 11 U.S.C. sec. 548(e)(1) (2012), a bankruptcy trustee may claw back any transfers made by a debtor within 10 years of the petition date if the transfer (among other things) was made to a self-settled trust or to a similar device whose beneficiary was the debtor. This provision is irrelevant here. The Legacy and Flex Trusts were not self-settled trusts. And the S Corp., the debtor in the scenario petitioners imagine, was not a beneficiary of the Legacy or Flex Trust. We accordingly hold that petitioners had "current access" to the entire cash value of the Policy during 2011 and 2012.

[4478] See fns. 4538-4540, in which the cash value seemed to be as inaccessible to the donor as it could possibly be, and the court dismissed out-of-hand arguments about inaccessibility because the non-owner had no current or future right to any part of the cash value. The split-dollar agreement provided:

Section 2.01. <u>Policy Ownership</u>.

(a) The Trust be the sole and absolute owner of the Policy. and may exercise all ownership rights granted to the owner thereof under the term of the Policy, except as otherwise provided in and limited by this Agreement.

(b) It is the intention of the parties to this Agreement and the purpose of the Collateral Assignment that the Trust shall retain all rights that the Policy grants to the owner thereof, except as otherwise provided in and provided by this Agreement. The sole right of the Donor under this Agreement and under the Collateral Assignment shall be to be repaid the amount due to Donor under this Agreement. Specifically, but without limitation, the Donor shall neither have nor exercise any right as collateral assignee of the Policy that could in any way defeat or impair the Trust's right to receive the Policy Cash Value or the death benefit of the Policy in excess of the total amount due to the Donor under this Agreement. All provisions of this Agreement and of the Collateral Assignment shall be construed so as to carry out such intention and purpose.

Section 2.02. <u>Dividends</u>. All dividends declared and paid on the Policy shall be applied as the Trust shall deem appropriate.

Section 6.01 of the split-dollar agreement said that the agreement is to be interpreted such that the only economic benefit is the current life insurance protection. Query whether the IRs and court assumed that this savings clause meant that the dividends could not be paid to the trust – rather that the trust merely had discretion how to apply the dividends to the policy's cash value; I do not recall them addressing the issue. Note that the trust having a right to be receive dividends itself would have violated the Reg. § 1.61-22(c)(1)(ii)(A)(2) rule that the only right to the policy be current life insurance protection and the consequence of violating that rule would have been that the trust would be deemed the owner for gift tax purposes.

Paragraph 2 of the collateral assignment (also not mentioned in the court's opinion) provided as follows:

2. It is expressly agreed that the Assignee's interest in the Policy under and by virtue of this Assignment shall be limited to die following specific rights, and no others: (a) the right to be paid the amount due to the Assignee under the Agreement by recovering said amount directly from the Insurer out of the net death proceeds of the Policy; upon the death of the Insured; and (b) the

owner needs to have the right to designate a beneficiary with respect to the death benefit consisting of at least the cash value; if not, the non-owner is treated as having received the cash value.

Now that we have established that the non-owner receives only the term portion and the owner receives everything else, let's discuss how to treat money received with respect to the subject life insurance contract.

For death benefits (noting that Code § 101(a) exempts death benefits from income taxation except to the extent that the transfer for value or rules apply, if at all, or to the extent that the policy's issuance violates the employer-owned life insurance rules):[4479]

(i) *Death benefit proceeds to beneficiary (other than the owner)*. Any amount paid to a beneficiary (other than the owner) by reason of the death of the insured is excluded from gross income by such beneficiary under section 101(a) as an amount received under a life insurance contract to the extent such amount is allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account pursuant to paragraph (d)(1) of this section.

(ii) *Death benefit proceeds to owner as beneficiary*. Any amount paid or payable to an owner in its capacity as a beneficiary by reason of the death of the insured is

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right to be paid the amount due to the Assignee under the Agreement by recovering said amount from the Assignor out of the Policy Cash Value (as defined in the Agreement), in the event the Policy is surrendered or cancelled by the Assignor or m the event the Agreement is terminated during the Insured's lifetime. The Assignee shall have no other rights or powers in and to the Policy as a result of the assignment of the Policy to the Assignee hereunder, and specifically shall not have the right or power to borrow against or obtain loans or advances on the Policy, make withdrawals from the Policy, nor cancel or surrender the Policy.

3. Except as otherwise provided in this Assignment and the Agreement, the Assignor shall specifically retain all incidents of ownership in and to the Policy, including, but not limited to: (a) the sole right to cancel or surrender the Policy at any time provided by the terms of the Policy and at such other times as the Insurer may allow; (b) the sole right to collect and receive all distributions or shares of surplus, dividend deposits or additions to the Policy now or hereafter made or apportioned thereto, and to exercise any and all options contained in the Policy with respect thereto; (c) the sole right to exercise all non-forfeiture rights permitted by the return of the Policy or allowed by the Insurer and to receive all benefits and advantages derived therefrom; (d) the sole right to designate and change the beneficiary of the Policy (for any amount in excess of the amount to the .Assignee under the Agreement); (e) the sole right to elect any optional mode of settlement permitted by the Policy or allowed by the Insurer; and (c) the sole right to collect directly from the Insurer that portion of the net death proceeds of the Policy in excess of those proceeds payable to the Assignee under the Agreement; *provided, however,* in no event shall the Assignor possess the right or power to receive loans or other advances respecting the Policy from the Insurer or any other lender; *provided, further,* all of the foregoing rights retained by the Assignor in the Policy hereunder shall be subject to the terms and conditions of the Agreement.

I view the collateral assignment as being limited by the split-dollar agreement.

Notwithstanding any of the above possible interpretations, I recommend making it clear that the donee is not entitled to dividends. This particular policy was variable life insurance but paid dividends presumably because it was a mutual insurance company.

[4479] Reg. § 1.61-22(f)(3). These exceptions are found in parts II.Q.4.b Transfer for Value Rule; Basis and II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

excluded from gross income of the owner under section 101(a) as an amount received under a life insurance contract to the extent such amount is not allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account pursuant to paragraph (d)(1) of this section.

Except for death benefits:[4480]

> Any amount received under a life insurance contract that is part of a split-dollar life insurance arrangement … is treated, to the extent provided directly or indirectly to a non-owner of the life insurance contract, as though such amount had been paid to the owner of the life insurance contract and then paid by the owner to the non-owner. The amount received is taxable to the owner in accordance with the rules of section 72. The non-owner (and the owner for gift tax and employment tax purposes) must take the amount described in paragraph (e)(3) of this section into account as a payment of compensation, a distribution [from a corporation],[4481] a contribution to capital, a gift, or other transfer depending on the relationship between the owner and the non-owner.

The owner is the only party who is credited with "investment in the contract" under Code § 72(e)(6).[4482]

If the employee or donee is provided only current life insurance protection so that a policy owned by the that person for state law purposes is treated as owned by the employer or donor for income tax purposes,[4483] then any modification that causes the employer or donor not to be treated as the donor for income tax purposes has the following consequences:[4484]

(1) If, immediately after such modification, the employer, service recipient, or donor is the owner of the life insurance contract under the split-dollar life insurance arrangement (determined without regard to paragraph (c)(1)(ii)(A) of this section), the employer, service recipient, or donor continues to be treated as the owner of the life insurance contract.

(2) If, immediately after such modification, the employer, service recipient, or donor is not the owner of the life insurance contract under the split-dollar life insurance arrangement (determined without regard to paragraph (c)(1)(ii)(A) of this section), the

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4480 Reg. § 1.61-22(e)(1).
4481 The actual text refers to Code § 301.
4482 Reg. § 1.61-22(f)(2)(ii) provides:

> *To owner*. Any premium paid by an owner under a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section is included in the owner's investment in the contract under section 72(e)(6). No premium or amount described in paragraph (d) of this section is deductible by the owner (except as otherwise provided in § 1.83-6(a)(5)). Any amount paid by a non-owner, directly or indirectly, to the owner of the life insurance contract for current life insurance protection or for any other economic benefit under the life insurance contract is included in the owner's gross income and is included in the owner's investment in the life insurance contract for purposes of section 72(e)(6) (but only to the extent not otherwise so included by reason of having been paid by the owner as a premium or other consideration for the contract).

4483 Reg. § 1.61-22(c)(1)(ii)(A), reproduced in the text accompanying fn 4467.
4484 Reg. § 1.61-22(c)(1)(ii)(B).

employer, service recipient, or donor is treated as having made a transfer of the entire life insurance contract to the employee, service provider, or donee under the rules of paragraph (g) of this section as of the date of such modification.

(3) For purposes of this paragraph (c)(1)(ii)(B), entering into a successor split-dollar life insurance arrangement that has the effect of providing any economic benefit in addition to that described in paragraph (d)(3) of this section is treated as a modification of the prior split-dollar life insurance arrangement.

A transfer of the ownership of a life insurance contract (or an undivided interest in such contract) that is part of a split-dollar life insurance arrangement occurs on the date that a non-owner becomes the owner (within the meaning of Reg. § 1.61-22(c)(1)) of the entire contract or of an undivided interest in the contract.[4485] After a transfer of an entire life insurance contract,[4486] the transferee generally becomes the owner for Federal income, employment, and gift tax purposes, including for purposes of Reg. § 1.61-22.[4487]

Reg. § 1.61-22(g) provides rules for unwinding the arrangement so that the non-owner becomes the owner. Unwinding the agreement before the insured's death would have the following consequences:

1. If the non-owner buys the policy (outside of an employment setting – see footnote):[4488]

   - The buyer (and the seller for gift tax and employment tax purposes) takes into account the excess of the life insurance contract's fair market value at that time over the sum of:[4489]

     - The amount the buyer pays to the seller; and

[4485] Reg. § 1.61-22(c)(3).
[4486] Reg. § 1.61-22(c)(4), "Undivided interest," provides:

> An undivided interest in a life insurance contract consists of an identical fractional or percentage interest or share in each right, benefit, and obligation with respect to the contract. In the case of any arrangement purporting to create undivided interests where, in substance, the rights, benefits or obligations are shared to any extent among the holders of such interests, the arrangement will be treated as a split-dollar life insurance arrangement.

[4487] Preamble to T.D. 9092, which further explains:

> Thus, if the transferor pays premiums after the transfer, the payment of those premiums may be includible in the transferee's gross income if the payments are not split-dollar loans under § 1.7872-15. Alternatively, the arrangement will be subject to the loan regime if the payments constitute split-dollar loans under § 1.7872-15.

[4488] Reg. § 1.61-22(g)(3) provides:

> *Exception for certain transfers in connection with the performance of services*. To the extent the ownership of a life insurance contract (or undivided interest in such contract) is transferred in connection with the performance of services, paragraph (g)(1) of this section does not apply until such contract (or undivided interest in such contract) is taxable under section 83. For purposes of paragraph (g)(1) of this section, fair market value is determined disregarding any lapse restrictions and at the time the transfer of such contract (or undivided interest in such contract) is taxable under section 83.

[4489] Reg. § 1.61-22(g)(1).

- The amount of all economic benefits (cash value and other policy features other than term insurance protection)[4490] actually taken into account by the buyer (and the seller for gift tax and employment tax purposes), plus certain consideration[4491] paid or treated as having been paid by the buyer for such economic benefits, to the extent that it was not previously applied to such economic benefits.[4492]

The life insurance contract's fair market value used above is the policy's cash value and the value of all other rights under the contract (including any supplemental agreements thereto and whether or not guaranteed), other than the value of current life insurance protection; however, a life insurance contract's fair market value for gift tax purposes is determined under Reg. § 25.2512-6(a).

- Presumably, for income tax purposes the transferor treats the transaction as a sale (to the extent of sale proceeds) or a gift. The transferor's basis would be the fair market value of the split-dollar receivable at the original owner's death plus any premiums paid by the current owner.[4493] The IRS' position is that any part of the gain attributable to cash value inside the policy is ordinary income and the rest of the gain would be capital gain.[4494]

- After a transfer of an life insurance contract (except when such transfer is in connection with the performance of services and the transfer is not yet taxable under Code § 83), the buyer is treated as the owner of such contract for all purposes.[4495] Furthermore, the buyer's investment in the contract[4496] treats as premiums paid the greater of the fair market value of the contract or certain amounts accounted for under the split-dollar

[4490] Referring to benefits described in Reg. § 1.61-22(d)(2)(ii) and (iii), which are reproduced in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.
[4491] Referring to consideration described in Reg. § 1.61-22(d)(1), which is reproduced in the text following fn 4468 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.
[4492] Referring to accounting for benefits under Reg. § 1.61-22(e)(3)(ii) or (g)(1)(ii).
[4493] See part II.Q.4.e.i Life Insurance Basis Adjustment on the Death of an Owner Who Is Not the Insured.
[4494] See fn 4406 in part II.Q.4.c Income Tax Issues in Transferring Life Insurance; Code § 1035.
[4495] Reg. § 1.61-22(g)(4)(i), which applies to a transfer of an entire policy, referring to Reg. §§ 1.61-22(b) and 1.61-2(d)(2)(ii)(A), and continues:

> After the transfer of an undivided interest in a life insurance contract (or, if later, at the time such transfer is taxable under section 83), the person who previously had been the non-owner is treated as the owner of a separate contract consisting of that interest for all purposes, including for purposes of paragraph (b) of this section and for purposes of § 1.61-2(d)(2)(ii)(A).

[4496] For the significance of the "investment in the contract," see part II.Q.4.e.ii Practical Issues In Implementing Any Basis Adjustment On the Death of an Owner Who Is Not the Insured.

rules.[4497] Generally, the buyer does not get credit toward "investment in the contract" for the economic benefit of any term portion previously taken into account.[4498]

[4497] Reg. § 1.61-22(g)(4)(ii), "Investment in the contract after transfer," provides:

(A) *In general*. The amount treated as consideration paid to acquire the contract under section 72(g)(1), in order to determine the aggregate premiums paid by the transferee for purposes of section 72(e)(6)(A) after the transfer (or, if later, at the time such transfer is taxable under section 83), equals the greater of the fair market value of the contract or the sum of the amounts determined under paragraphs (g)(1)(i) and (ii) of this section.

(B) *Transfers between a donor and a donee*. In the case of a transfer of a contract between a donor and a donee, the amount treated as consideration paid by the transferee to acquire the contract under section 72(g)(1), in order to determine the aggregate premiums paid by the transferee for purposes of section 72(e)(6)(A) after the transfer, equals the sum of the amounts determined under paragraphs (g)(1)(i) and (ii) of this section except that—

(1) The amount determined under paragraph (g)(1)(i) of this section includes the aggregate of premiums or other consideration paid or deemed to have been paid by the transferor; and

(2) The amount of all economic benefits determined under paragraph (g)(1)(ii) of this section actually taken into account by the transferee does not include such benefits to the extent such benefits were excludable from the transferee's gross income at the time of receipt.

(C) *Transfers of an undivided interest in a contract*. If a portion of a contract is transferred to the transferee, then the amount to be included as consideration paid to acquire the contract is determined by multiplying the amount determined under paragraph (g)(4)(ii)(A) of this section (as modified by paragraph (g)(4)(ii)(B) of this section, if the transfer is between a donor and a donee) by a fraction, the numerator of which is the fair market value of the portion transferred and the denominator of which is the fair market value of the entire contract.

(D) *Example*. The following example illustrates the rules of this paragraph (g)(4)(ii):

(i) In year 1, donor D and donee E enter into a split-dollar life insurance arrangement as defined in paragraph (b)(1) of this section. D is the owner of the life insurance contract under paragraph (c)(1) of this section. The life insurance contract is not a modified endowment contract as defined in section 7702A. In year 5, D gratuitously transfers the contract, within the meaning of paragraph (c)(3) of this section, to E. At the time of the transfer, the fair market value of the contract is $200,000 and D had paid $50,000 in premiums under the arrangement. In addition, by the time of the transfer, E had current access to $80,000 of policy cash value which was excludable from E's gross income under section 102.

(ii) E's investment in the contract is $50,000, consisting of the $50,000 of premiums paid by D. The $80,000 of policy cash value to which E had current access is not included in E's investment in the contract because such amount was excludable from E's gross income when E had current access to that policy cash value.

[4498] Reg. § 1.61-22(g)(4)(ii), "No investment in the contract for current life insurance protection," provides:

Except as provided in paragraph (g)(4)(ii)(B) of this section, no amount allocable to current life insurance protection provided to the transferee (the cost of which was paid by the transferee or the value of which was provided to the transferee) is treated as consideration paid to acquire the contract under section 72(g)(1) to determine the aggregate premiums paid by the transferee for purposes of determining the transferee's investment in the contract under section 72(e) after the transfer.

The above preceded the 2017 enactment of Code § 1016(a)(1)(B), which is described in the text accompanying fn 4402 in part II.Q.4.b.iii Basis in Purchased Life Insurance Contract, which perhaps might affect the regulation's validity? However, the regulation discusses "investment in the contract," whereas the statutory change address basis.

2. If the owner cashes in the policy. The owner reports ordinary income to the extent that the cash received exceeds the premiums paid, without regard to basis, so long as the policy has not been sold (including transfer by pecuniary bequest).[4499]

Reg. § 1.61-22(g), "Examples," provides:

> The following examples illustrate the rules of this section. Except as otherwise provided, each of the examples assumes that the employer (R) is the owner (as defined in paragraph (c)(1) of this section) of a life insurance contract that is part of a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section, that the employee (E) is not provided any economic benefits described in paragraph (d)(2)(iii) of this section, that the life insurance contract is not a modified endowment contract under section 7702A, that the compensation paid to E is reasonable, and that E makes no premium payments. The examples are as follows:
>
> *Example (1)*.
>
> (i) In year 1, R purchases a life insurance contract on the life of E. R is named as the policy owner of the contract. R and E enter into an arrangement under which R will pay all the premiums on the life insurance contract until the termination of the arrangement or E's death. Upon termination of the arrangement or E's death, R is entitled to receive the greater of the aggregate premiums or the policy cash value of the contract. The balance of the death benefit will be paid to a beneficiary designated by E.
>
> (ii) Because R is designated as the policy owner of the contract, R is the owner of the contract under paragraph (c)(1)(i) of this section. In addition, R would be treated as the owner of the contract regardless of whether R were designated as the policy owner under paragraph (c)(1)(i) of this section because the split-dollar life insurance arrangement is described in paragraph (c)(1)(ii)(A)(1) of this section. E is a non-owner of the contract. Under the arrangement between R and E, a portion of the death benefit is payable to a beneficiary designated by E. The arrangement is a split-dollar life insurance arrangement under paragraph (b)(1) or (2) of this section. Because R pays all the premiums on the life insurance contract, R provides to E the entire amount of the current life insurance protection E receives under the arrangement. Therefore, for each year that the split-dollar life insurance arrangement is in effect, E must include in gross income under paragraph (d)(1) of

[4499] See part II.Q.4.e.ii Practical Issues In Implementing Any Basis Adjustment On the Death of an Owner Who Is Not the Insured. Reg. § 1.61-22(f)(2)(ii) provides:

> *To owner*. Any premium paid by an owner under a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section is included in the owner's investment in the contract under section 72(e)(6). No premium or amount described in paragraph (d) of this section is deductible by the owner (except as otherwise provided in § 1.83-6(a)(5)). Any amount paid by a non-owner, directly or indirectly, to the owner of the life insurance contract for current life insurance protection or for any other economic benefit under the life insurance contract is included in the owner's gross income and is included in the owner's investment in the life insurance contract for purposes of section 72(e)(6) (but only to the extent not otherwise so included by reason of having been paid by the owner as a premium or other consideration for the contract).

this section the value of current life insurance protection described in paragraph (d)(2)(i) of this section provided to E in each year.

Example (2).

(i) The facts are the same as in Example 1 except that, upon termination of the arrangement or E’s death, R is entitled to receive the lesser of the aggregate premiums or the policy cash value of the contract. Under the terms of the arrangement and applicable state law, the policy cash value is fully accessible by R and R’s creditors but E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R.

(ii) Because R is designated as the policy owner, R is the owner of the contract under paragraph (c)(1)(i) of this section. E is a non-owner of the contract. For each year that the split-dollar life insurance arrangement is in effect, E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R. Thus, under paragraph (d)(4)(ii) of this section, E has current access to such portion of the policy cash value for each year that the arrangement is in effect. In addition, because R pays all the premiums on the life insurance contract, R provides to E all the economic benefits that E receives under the arrangement. Therefore, for each year that the split-dollar life insurance arrangement is in effect, E must include in gross income under paragraph (d)(1) of this section, the value of all economic benefits described in paragraph (d)(2)(i) and (ii) of this section provided to E in each year.

Example (3).

(i) The facts are the same as in Example 1 except that in year 5, R and E modify the split-dollar life insurance arrangement to provide that, upon termination of the arrangement or E’s death, R is entitled to receive the greater of the aggregate premiums or one-half the policy cash value of the contract. Under the terms of the modified arrangement and applicable state law, the policy cash value is fully accessible by R and R’s creditors but E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R.

(ii) For each year that the split-dollar life insurance arrangement is in effect, E must include in gross income under paragraph (d)(1) of this section the value of the economic benefits described in paragraph (d)(2)(i) of this section provided to E under the arrangement during that year. In year 5 (and subsequent years), E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R. Thus, under paragraph (d)(4)(ii) of this section, E has current access to such portion of the policy cash value. Thus, in year 5 (and each subsequent year), E must also include in gross income under paragraph (d)(1) of this section the value of the economic benefits described in paragraph (d)(2)(ii) of this section provided to E in each year.

(iii) The arrangement is not described in paragraph (c)(1)(ii)(A)(1) of this section after it is modified in year 5. Because R is the designated owner of the life insurance contract, R continues to be treated as the owner of the contract under paragraph (c)(1)(ii)(B)(1) of this section after the arrangement is modified. In addition, because the modification made by R and E in year 5 does not involve the transfer (within the meaning of paragraph (c)(3) of this section) of an undivided interest in the life insurance contract from R to E, the modification is not a transfer for purposes of paragraph (g) of this section.

Example (4).

(i) The facts are the same as in Example 2 except that in year 7, R and E modify the split-dollar life insurance arrangement to provide that, upon termination of the arrangement or E's death, R will be paid the lesser of 80 percent of the aggregate premiums or the policy cash value of the contract. Under the terms of the modified arrangement and applicable state law, the policy cash value is fully accessible by R and R's creditors but E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the lesser of 80 percent of the aggregate premiums paid by R or the policy cash value of the contract.

(ii) Commencing in year 7 (and in each subsequent year), E must include in gross income the economic benefits described in paragraph (d)(2)(ii) of this section as provided in this Example 4(ii) rather than as provided in Example 2(ii). Thus, in year 7 (and in each subsequent year) E must include in gross income under paragraph (d) of this section, the excess of the policy cash value over the lesser of 80 percent of the aggregate premiums paid by R or the policy cash value of the contract (to the extent E did not actually include such amounts in gross income for a prior taxable year). In addition, in year 7 (and each subsequent year) E must also include in gross income the value of the economic benefits described in paragraph (d)(2)(i) of this section provided to E under the arrangement in each such year.

Example (5).

(i) The facts are the same as in Example 3 except that in year 7, E is designated as the policy owner. At that time, E's rights to the contract are substantially vested as defined in § 1.83-3(b).

(ii) In year 7, R is treated as having made a transfer (within the meaning of paragraph (c)(3) of this section) of the life insurance contract to E. E must include in gross income the amount determined under paragraph (g)(1) of this section.

(iii) After the transfer of the contract to E, E is the owner of the contract and any premium payments by R will be included in E's income under paragraph (b)(5) of this section and § 1.61-2(d)(2)(ii)(A) (unless R's payments are split-dollar loans as defined in § 1.7872-15(b)(1)).

Example (6).

(i) In year 1, E and R enter into a split-dollar life insurance arrangement as defined in paragraph (b)(2) of this section. Under the arrangement, R is required to make annual premium payments of $10,000 and E is required to make annual premium payments of $500. In year 5, a $500 policy owner dividend payable to E is declared by the insurance company. E directs the insurance company to use the $500 as E's premium payment for year 5.

(ii) For each year the arrangement is in effect, E must include in gross income the value of the economic benefits provided during the year, as required by paragraph (d)(2) of this section, over the $500 premium payments paid by E. In year 5, E must also include in gross income as compensation the excess, if any, of the $500 distributed to E from the proceeds of the policy owner dividend over the amount determined under paragraph (e)(3)(ii) of this section.

(iii) R must include in income the premiums paid by E during the years the split-dollar life insurance arrangement is in effect, including the $500 of the premium E paid in year 5 with proceeds of the policy owner dividend. R's investment in the contract is increased in an amount equal to the premiums paid by E, including the $500 of the premium paid by E in year 5 from the proceeds of the policy owner dividend. In year 5, R is treated as receiving a $500 distribution under the contract, which is taxed pursuant to section 72.

Example (7).

(i) The facts are the same as in Example 2 except that in year 10, E withdraws $100,000 from the cash value of the contract.

(ii) In year 10, R is treated as receiving a $100,000 distribution from the insurance company. This amount is treated as an amount received by R under the contract and taxed pursuant to section 72. This amount reduces R's investment in the contract under section 72(e). R is treated as paying the $100,000 to E as cash compensation, and E must include that amount in gross income less any amounts determined under paragraph (e)(3)(ii) of this section.

Example (8).

(i) The facts are the same as in Example 7 except E receives the proceeds of a $100,000 specified policy loan directly from the insurance company.

(ii) The transfer of the proceeds of the specified policy loan to E is treated as a loan by the insurance company to R. Under the rules of section 72(e), the $100,000 loan is not included in R's income and does not reduce R's investment in the contract. R is treated as paying the $100,000 of loan proceeds to E as cash compensation. E must include that amount in gross income less any amounts determined under paragraph (e)(3)(ii) of this section.

II.Q.4.f.iii. Split-Dollar Loans under Reg. § 1.7872-15

For purposes of Reg. § 1.7872-15, "split-dollar life insurance arrangement," "owner," and "non-owner" have the same meanings as provided in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.[4500]

Reg. § 1.7872-15(a)(2) provides:[4501]

[4500] Reg. § 1.7872-15(b), referring to Reg. § 1.61-22(b) and (c).
[4501] Reg. § 1.7872-15(a)(1) provides, "This section applies to split-dollar loans as defined in paragraph (b)(1) of this section." Reg. § 1.7872-15(b)(1) provides, "A split-dollar loan is a loan described in paragraph (a)(2)(i) of this section." Thus, Reg. § 1.7872-15(a)(2)(i) is our starting point.

(i) *General rule*. A payment made pursuant to a split-dollar life insurance arrangement is treated as a loan for Federal tax purposes, and the owner and non-owner are treated, respectively, as the borrower and the lender, if—

(A) The payment is made either directly or indirectly by the non-owner to the owner (including a premium payment made by the non-owner directly or indirectly to the insurance company with respect to the policy held by the owner);

(B) The payment is a loan under general principles of Federal tax law or, if it is not a loan under general principles of Federal tax law (for example, because of the nonrecourse nature of the obligation or otherwise), a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner (whether with or without interest); and

(C) The repayment is to be made from, or is secured by, the policy's death benefit proceeds, the policy's cash surrender value, or both.

(ii) *Payments that are only partially repayable*. For purposes of § 1.61-22 and this section, if a non-owner makes a payment pursuant to a split-dollar life insurance arrangement and the non-owner is entitled to repayment of some but not all of the payment, the payment is treated as two payments: one that is repayable and one that is not. Thus, paragraph (a)(2)(i) of this section refers to the repayable payment.

(iii) *Treatment of payments that are not split-dollar loans*. See § 1.61-22(b)(5) for the treatment of payments by a non-owner that are not split-dollar loans.

(iv) *Examples*. The provisions of this paragraph (a)(2) are illustrated by the following examples:

Example (1). Assume an employee owns a life insurance policy under a split-dollar life insurance arrangement, the employer makes premium payments on this policy, there is a reasonable expectation that the payments will be repaid, and the repayments are secured by the policy. Under paragraph (a)(2)(i) of this section, each premium payment is a loan for Federal tax purposes.

Example (2).

(i) Assume an employee owns a life insurance policy under a split-dollar life insurance arrangement and the employer makes premium payments on this policy. The employer is entitled to be repaid 80 percent of each premium payment, and the repayments are secured by the policy. Under paragraph (a)(2)(ii) of this section, the taxation of 20 percent of each premium payment is governed by § 1.61-22(b)(5). If there is a reasonable expectation that the remaining 80 percent of a payment will be repaid in full, then, under paragraph (a)(2)(i) of this section, the 80 percent is a loan for Federal tax purposes.

(ii) If less than 80 percent of a premium payment is reasonably expected to be repaid, then this paragraph (a)(2) does not cause any of the payment to be a loan for Federal tax purposes. If the payment is not a loan under general principles of Federal tax law, the taxation of the entire premium payment is governed by § 1.61-22(b)(5).

Reg. § 1.7872-15(a)(1) provides:

> If a split-dollar loan is not a below-market loan, then, except as provided in this section, the loan is governed by the general rules for debt instruments (including the rules for original issue discount (OID) under sections 1271 through 1275 and the regulations thereunder). If a split-dollar loan is a below-market loan, then, except as provided in this section, the loan is governed by section 7872. The timing, amount, and characterization of the imputed transfers between the lender and borrower of a below-market split-dollar loan depend upon the relationship between the parties and upon whether the loan is a demand loan or a term loan. For additional rules relating to the treatment of split-dollar life insurance arrangements, see § 1.61-22.

The OID rules referred to above provide that, if adequate stated interest is not paid annually, payments will be deemed made from the borrower to the lender each year, generating interest income[4502] and generally nondeductible interest,[4503] even though no cash changes hands.[4504] If the split-dollar agreement is between a donor and a donee, consider making the donee be an irrevocable grantor trust, so that no interest income is recognized while the trust is deemed owned by the donor.[4505] Presumably any accrued interest at the time that grantor trust treatment is turned off will be considered principal for income tax purposes; perhaps the promissory note might be drafted so that any accrued but unpaid interest is added to principal on the note's anniversary to further support that treatment.

[4502] Code § 1272.

[4503] Reg. § 1.7872-15(c) provides:

> *Interest deductions for split-dollar loans*. The borrower may not deduct any qualified stated interest, OID, or imputed interest on a split-dollar loan. See sections 163(h) and 264(a). In certain circumstances, an indirect participant may be allowed to deduct qualified stated interest, OID, or imputed interest on a deemed loan. See paragraph (e)(2)(iii) of this section (relating to indirect loans).

[4504] Reg. § 1.7872-15(f), "Treatment of stated interest and OID for split-dollar loans," provides:

> (1) *In general*. If a split-dollar loan provides for stated interest or OID, the loan is subject to this paragraph (f), regardless of whether the split-dollar loan has sufficient interest. Except as otherwise provided in this section, split-dollar loans are subject to the same Internal Revenue Code and regulatory provisions for stated interest and OID as other loans. For example, the lender of a split-dollar loan that provides for stated interest must account for any qualified stated interest (as defined in § 1.1273-1(c)) under its regular method of accounting (for example, an accrual method or the cash receipts and disbursements method). See § 1.446-2 to determine the amount of qualified stated interest that accrues during an accrual period. In addition, the lender must account under § 1.1272-1 for any OID on a split-dollar loan. However, § 1.1272-1(c) does not apply to any split-dollar loan. See paragraph (h) of this section for a subsequent waiver, cancellation, or forgiveness of stated interest on a split-dollar loan.
>
> (2) *Term, payment schedule, and yield*. The term of a split-dollar term loan determined under paragraph (e)(4)(iii) of this section (other than paragraph (e)(4)(iii)(C) of this section) applies to determine the split-dollar loan's term, payment schedule, and yield for all purposes of this section.

[4505] Rev. Rul. 85-13, referred to in part III.B.2.d.i.(a) General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation.

Generally, a split-dollar loan will bear and accrue interest at the long-term applicable federal rate, so that making the loan does not constitute a gift in a donor-donee setting or compensation in an employer-employee setting. This accrued interest can be ignored for two reasons (in addition to possibly being ignored under general tax principals. First, Reg. § 1.7872-15(a)(4), "Certain interest provisions disregarded," provides:

(i) *In general*. If a split-dollar loan provides for the payment of interest and all or a portion of the interest is to be paid directly or indirectly by the lender (or a person related to the lender), then the requirement to pay the interest (or portion thereof) is disregarded for purposes of this section. All of the facts and circumstances determine whether a payment to be made by the lender (or a person related to the lender) is sufficiently independent from the split-dollar loan for the payment to not be an indirect payment of the interest (or a portion thereof) by the lender (or a person related to the lender).

(ii) *Examples*. The provisions of this paragraph (a)(4) are illustrated by the following examples:

Example (1).

(i) On January 1, 2009, Employee B issues a split-dollar term loan to Employer Y. The split-dollar term loan provides for five percent interest, compounded annually. Interest and principal on the split-dollar term loan are due at maturity. On January 1, 2009, B and Y also enter into a fully vested non-qualified deferred compensation arrangement that will provide a payment to B in an amount equal to the accrued but unpaid interest due at the maturity of the split-dollar term loan.

(ii) Under paragraph (a)(4)(i) of this section, B's requirement to pay interest on the split-dollar term loan is disregarded for purposes of this section, and the split-dollar term loan is treated as a loan that does not provide for interest for purposes of this section.

Example (2).

(i) On January 1, 2004, Employee B and Employer Y enter into a fully vested non-qualified deferred compensation arrangement that will provide a payment to B equal to B's salary in the three years preceding the retirement of B. On January 1, 2009, B and Y enter into a split-dollar life insurance arrangement and, under the arrangement, B issues a split-dollar term loan to Y on that date . The split-dollar term loan provides for five percent interest, compounded annually. Interest and principal on the split-dollar term loan are due at maturity. Over the period in which the non-qualified deferred compensation arrangement is effective, the terms and conditions of B's non-qualified deferred compensation arrangement do not change in a way that indicates that the payment of the non-qualified deferred compensation is related to B's requirement to pay interest on the split-dollar term loan. No other facts and circumstances exist to indicate that the payment of the non-qualified deferred compensation is related to B's requirement to pay interest on the split-dollar term loan.

(ii) The facts and circumstances indicate that the payment by Y of non-qualified deferred compensation is independent from B's requirement to pay interest under the split-dollar term loan. Under paragraph (a)(4)(i) of this section, the fully vested non-qualified deferred compensation does not cause B's requirement to pay interest on the split-dollar term loan to be disregarded for purposes of this section. For purposes of this section, the split-dollar term loan is treated as a loan that provides for stated interest of five percent, compounded annually.

Thus, one should avoid bequeathing the split-dollar note receivable until long after the funds are advanced.[4506]

Second, interest (or any other payment) needs to be reasonably expected to be repaid or must be deemed expected to be repaid. As mentioned above,[4507] to be a split-dollar loan, among other requirements the payment of premiums must be "a loan under general principles of Federal tax law or, if it is not a loan under general principles of Federal tax law (for example, because of the nonrecourse nature of the obligation or otherwise), a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner (whether with or without interest)." Split-dollar loans are commonly nonrecourse, and if the policy does not perform then typically the lender eats the loss. Reg. § 1.7872-15(d), (j) discuss nonrecourse or contingent payments.[4508]

Reg. § 1.7872-15(j) controls over the usual rules governing contingent payments in making loans at the applicable federal rate (AFR).[4509] The lender puts together a projected payment schedule, which everyone directly or indirectly involved in the loan must use.[4510] The term of a split-dollar loan payable on the death of an individual is the individual's life expectancy as determined under the appropriate table in Reg. § 1.72-9 on the day the loan is made;[4511] if the

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[4506] See text accompanying fns 4532-4533 in part II.Q.4.f.iv.(b) Loan Regime After Initial Owner Has Died.

[4507] Reg. § 1.7872-15(a)(2)(i)(B), quoted in full in the text accompanying fn 4501.

[4508] Reg. § 1.7872-15(d)(1) provides:

(1) *In general*. Except as provided in paragraph (d)(2) of this section, if a payment on a split-dollar loan is nonrecourse to the borrower, the payment is a contingent payment for purposes of this section. See paragraph (j) of this section for the treatment of a split-dollar loan that provides for one or more contingent payments.

[4509] Reg. § 1.7872-15(j)(1) provides:

(1) *In general*. Except as provided in paragraph (j)(2) of this section, this paragraph (j) provides rules for a split-dollar loan that provides for one or more contingent payments. This paragraph (j), rather than § 1.1275-4, applies to split-dollar loans that provide for one or more contingent payments.

[4510] Reg. § 1.7872-15(j)(3)(ii)(E) provides:

Borrower/lender consistency. Contrary to § 1.1275-4(b)(4)(iv), the lender rather than the borrower is required to determine the projected payment schedule and to provide the schedule to the borrower and to any indirect participant as described in paragraph (e)(2) of this section. The lender's projected payment schedule is used by the lender, the borrower, and any indirect participant to compute interest accruals and adjustments.

[4511] Reg. § 1.7872-15(e)(5)(ii)(C), which further provides:

If a split-dollar loan is payable on the earlier of the individual's death or another term determined under paragraph (e)(4)(iii) of this section, the term of the loan is whichever term is shorter.

If the split-dollar loan is payable on the later of the individual's death or a term certain, the term certain is used. Reg. § 1.7872-15(e)(5)(v)(A), (B)(2).

The contingent payment rules look to the above regulations. Reg. § 1.7872-15(j)(3)(ii)(B) provides:

Split-dollar term loans payable upon the death of an individual. If a split-dollar term loan described in paragraph (e)(5)(ii)(A) or (v)(A)(1) of this section provides for one or more contingent insured outlives his or her life expectancy, the split-dollar loan is treated as retired and reissued as a split-dollar demand loan at that time for an amount of cash equal to the loan's adjusted issue price on that date.[4512] Although a payment is not contingent merely because of the possibility of impairment by insolvency, default, or similar circumstances, if any payment on a split-dollar loan is nonrecourse to the borrower, the payment is a contingent payment for purposes unless the parties to the arrangement make the written representation provided for in Reg. § 1.7872-15(d)(2).[4513] Treating a nonrecourse payment as contingent may cause that payment to assigned a zero value,[4514] which would mean that the usual nonrecourse split dollar loan would be assigned a zero value.

Thus, the written representation provided for in Reg. § 1.7872-15(d)(2) is critically important in making sure that a nonrecourse loan is respected. An otherwise noncontingent payment on a split-dollar loan that is nonrecourse to the borrower is not deemed a contingent payment if the parties to the split-dollar life insurance arrangement represent in writing that a reasonable person would expect that all payments under the loan will be made.[4515] Unless the IRS provides otherwise, "both the borrower and the lender must sign the representation not later than the last day (including extensions) for filing the Federal income tax return of the borrower or lender, whichever is earlier, for the taxable year in which the lender makes the first split-dollar loan under the split-dollar life insurance arrangement."[4516] If the interest actually paid on the split-dollar loan is less than the interest required to be accrued on the split-dollar loan according to the representation, "the excess of the interest required to be accrued over the interest actually paid is treated as waived, cancelled, or forgiven by the lender."[4517]

> payments, the projected payment schedule is determined based on the term of the loan as determined under paragraph (e)(5)(ii)(C) or (v)(B)(2) of this section, whichever is applicable.

Closing the loop, Reg. § 1.7872-15(e)(5)(ii)(A) provides:

> *Applicability*. This paragraph (e)(5)(ii) applies to a split-dollar term loan payable not later than the death of an individual.

[4512] Reg. § 1.7872-15(e)(5)(ii)(D), which further provides:

> However, the loan is not retested at that time to determine whether the loan provides for sufficient interest. For purposes of determining forgone interest under paragraph (e)(5)(ii)(B) of this section, the appropriate AFR for the reissued loan is the AFR determined under paragraph (e)(5)(ii)(B) of this section on the day the loan was originally made.

[4513] Reg. § 1.7872-15(j)(2)(ii).

[4514] When the lender determines the projected payment schedule, Reg. § 1.7872-15(j)(3)(ii)(A) provides:

> The projected payment for a contingent payment is the lowest possible value of the payment. The projected payment schedule, however, must produce a yield that is not less than zero. If the projected payment schedule produces a negative yield, the schedule must be reasonably adjusted to produce a yield of zero.

[4515] Reg. § 1.7872-15(d)(2)(i).

[4516] Reg. § 1.7872-15(d)(2)(ii), which further provides:

> This representation must include the names, addresses, and taxpayer identification numbers of the borrower, lender, and any indirect participants. Unless otherwise stated therein, this representation applies to all subsequent split-dollar loans made pursuant to the split-dollar life insurance arrangement. Each party should retain an original of the representation as part of its books and records and should attach a copy of this representation to its Federal income tax return for any taxable year in which the lender makes a loan to which the representation applies.

Letter Rulings 200923002, 201041006, and 202336013 granted an extension of time to make the election.

[4517] Reg, § 1.7872-15(h)(1)(iv).

Once we have figured out the payment schedule that the IRS will respect, Reg. § 1.7872-15(k) applies a payment made by the borrower on all direct and indirect split-dollar loans in the following order:

(1) A payment of interest to the extent of accrued but unpaid interest (including any OID) on all outstanding split-dollar loans in the order the interest accrued;

(2) A payment of principal on the outstanding split-dollar loans in the order in which the loans were made;

(3) A payment of amounts previously paid by a non-owner pursuant to a split-dollar life insurance arrangement that were not reasonably expected to be repaid by the owner; and

(4) Any other payment with respect to a split-dollar life insurance arrangement, other than a payment taken into account under ... (1), (2), and (3) ….

Reg. § 1.7872-15(m) describes what happens when the insurance company pays the lender:

> *Repayments received by a lender*. Any amount received by a lender under a life insurance contract that is part of a split-dollar life insurance arrangement is treated as though the amount had been paid to the borrower and then paid by the borrower to the lender. Any amount treated as received by the borrower under this paragraph (m) is subject to other provisions of the Internal Revenue Code as applicable (for example, sections 72 and 101(a)). The lender must take the amount into account as a payment received with respect to a split-dollar loan, in accordance with paragraph (k) of this section. No amount received by a lender with respect to a split-dollar loan is treated as an amount received by reason of the death of the insured.

II.Q.4.f.iv. Income Taxation of Split-Dollar Agreement After Premium Payor Dies When Life Insurance Not on the Owner's Life

When the premium payor dies holding a split-dollar receivable on the payor's life, the receivable is repaid immediately and correspondingly has a basis equal to the amount of the receivable, generating no income taxation.

However, if the split-dollar receivable is not on the premium payor's life, the receivable would be valued based on when the receivable is collected. The split-dollar arrangement's long-term nature may cause the receivable to be valued at significantly less than its face amount, leading to a step-down in basis; see the cases in part II.Q.4.f.v Estate Tax Consequences of Split-Dollar Agreements.

The rest of this discussion, from part II.Q.4.f.iv, assumes that the initial owner has died and refers to the successor owner as the owner.

II.Q.4.f.iv.(a). Economic Benefit Model After Initial Owner Has Died

In the economic benefit model described in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22, the economic benefit of current life insurance protection is considered a payment from the owner to the non-owner.[4518] The payment's nature depends on the relationship between the owner and non-owner.[4519] As the insured gets older, the amount of this payment increases and may become exorbitant, and the arrangement might need to be terminated. If the insurance company distributes the cash value, the holder of the split-dollar receivable recognizes ordinary income to the extent that the amount received exceeds the holder's "investment in the contract," the latter which is described in part II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy). Under those rules, the change in basis by reason of death does not affect the "investment in the contract." If the policy's ownership is considered transferred from the owner to the non-owner, then the transfer may be a sale (taxable to the extent that proceeds exceed basis), a gift, a distribution, or some other appropriate arrangement.[4520] An advantage of just cashing out the policy with the insurance company is that the investment in the contract, which would generally exceed the stepped-down basis on the date of the original owner's death, would reduce income relative to the gain on sale, which the IRS would assert (not necessarily successfully)[4521] is ordinary income anyway.

If the arrangement stays in place until the insured's death, then:

- Generally, the owner's death benefit is nontaxable under Code § 101(a).[4522]

- Generally, the non-owner's death benefit is nontaxable under Code § 101(a), if the non-owner paid for or properly took into account the value of the economic benefit of the life insurance protection.[4523]

[4518] Reg. § 1.61-22(d)(1), quoted in the text following fn 4468 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4519] The part of § 1.61-22(d)(1) that follows fn 4468 in part 1.61-22(d)(1) provides:

> Depending on the relationship between the owner and the non-owner, the economic benefits may constitute a payment of compensation, a distribution under section 301, a contribution to capital, a gift, or a transfer having a different tax character. Further, depending on the relationship between or among a non-owner and one or more other persons (including a non-owner or non-owners), the economic benefits may be treated as provided from the owner to the non-owner and as separately provided from the non-owner to such other person or persons (for example, as a payment of compensation from an employer to an employee and as a gift from the employee to the employee's child).

[4520] See fns 4480 and 4488-4494 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4521] See fn 4419 in part II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy).

[4522] Reg. § 1.61-22(f)(3)(ii) provides:

> *Death benefit proceeds to owner as beneficiary*. Any amount paid or payable to an owner in its capacity as a beneficiary by reason of the death of the insured is excluded from gross income of the owner under section 101(a) as an amount received under a life insurance contract to the extent such amount is not allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account pursuant to paragraph (d)(1) of this section.

[4523] Reg. § 1.61-22(f)(3)(i) provides:

> *Death benefit proceeds to beneficiary (other than the owner)*. Any amount paid to a beneficiary (other than the owner) by reason of the death of the insured is excluded from gross income by such beneficiary under section 101(a) as an amount received under a life insurance contract to the

- Generally, any death benefit not described above is taxable.[4524]

If the insured was employed by or owned at least 5% of the original owner when the policy was issued, special requirements apply to obtain the Code § 101(a) exclusion. See part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance. Also, to obtain the Code § 101(a) exclusion, any transfer from the original owner to a successor owner needs to qualify for an exception from the transfer-for-value rules,[4525] which means that any distribution from a trust or estate should be pick-and-choose fractional instead of pecuniary.[4526]

II.Q.4.f.iv.(b). Loan Regime After Initial Owner Has Died

Suppose a $1 million split-dollar loan under Code § 1.7872-15 is worth $150,000 at the death of the owner who is not the insured. This valuation spread is realistic, because commercial lenders do not make long-term loans except for real estate, and even then they tend to require significant equity. Unlike other loans, payment of annual interest is not required in a split-dollar loan.[4527] A split-dollar loan does not require any equity, and the lender cannot accelerate the loan if the underlying collateral starts to lose value or otherwise fail to perform. Furthermore, a cash value life insurance policy loses value immediately, due to commissions and other start-up costs the insurance company incurs that are allocated to the policy. Commercial lenders who finance life insurance tend to require some combination of equity or outside collateral, use floating interest rates, and impose loan maturities much shorter than the insured's life expectancy.

Let's look at the character of the note repayment:

- Any payment from the life insurer to repay the note is treated as a payment from the insurer to the borrower and then from the borrower to the lender.[4528]

- To the extent of any accrued interest, the payment would have that character.[4529]

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extent such amount is allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account pursuant to paragraph (d)(1) of this section.

[4524] Reg. § 1.61-22(f)(3)(iii) provides:

Transfers of death benefit proceeds. Death benefit proceeds paid to a party to a split-dollar life insurance arrangement (or the estate or beneficiary of that party) that are not excludable from that party's income under section 101(a) to the extent provided in paragraph (f)(3)(i) or (ii) of this section, are treated as transferred to that party in a separate transaction. The death benefit proceeds treated as so transferred will be taxed in a manner similar to other transfers. For example, if death benefit proceeds paid to an employee, the employee's estate, or the employee's beneficiary are not excludable from the employee's gross income under section 101(a) to the extent provided in paragraph (f)(3)(i) of this section, then such payment is treated as a payment of compensation by the employer to the employee.

[4525] See part II.Q.4.b Transfer for Value Rule; Basis.

[4526] See part II.J.8.d Distribution in Kind; Specific Bequests.

[4527] See part II.Q.4.f.i Split-Dollar Generally, especially the text accompanying fns 4451-4452.

[4528] See Reg. § 1.7872-15(m), reproduced in full near the end of part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

[4529] See Reg. § 1.7872-15(k), reproduced in full near the end of part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15, provides that accrued interest is deemed paid first.

- To the extent that a payment is principal and the payment exceeds basis, the payment would probably be taxed as capital gain to the original holder of the note or to a substituted basis transferee or ordinary income for any other holder.[4530] Thus, if the decedent's estate is considered to be the issuer, then the estate and any beneficiary (except the recipient of a pecuniary bequest) should have capital gain. Otherwise, the gain would be taxed as ordinary income.

Many commentators have suggested that, because one misstep can cause the economic benefit split-dollar regime (described in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit **Arrangement under Reg. § 1.61-22**) to be unwound, resulting in potentially huge income and gift tax consequences, the loan regime is safer.[4531] However, consider *Morrissette*, in which the split-dollar receivable's owner bequeathed the receivable to the split-dollar obligor.[4532] If the arrangement had been a split-dollar loan, that bequest might have violated Reg. § 1.7872-15(a)(4) (especially Example (1)), causing the interest expected to be paid under the loan to be disregarded, eviscerating most of the loan's value for gift tax purposes.[4533]

On the other hand, the economic benefit regime would let the successor owner cash in the policy using the investment in the contract (generally premiums paid) instead of the basis that was greatly reduced when the original owner died.[4534] Furthermore, if the insured dies before the economic benefit regime is unwound and the transfer-for-value and related rules have not been violated, all benefits to everyone are received tax-free.[4535]

II.Q.4.f.v. Estate Tax Consequences of Split-Dollar Agreements

Rev. Rul. 79-129 involved the following facts:

> In 1973, D obtained an ordinary life insurance policy on D's life. The policy had a face amount of $150,000. Simultaneously, D created an irrevocable funded insurance trust and named the X Trust Company as trustee.
>
> The insurance policy designated the trustee of the insurance trust as owner of the policy. Under the terms of the policy, D possessed the right to borrow against the cash surrender value in an amount not to exceed the total amount of the policy premiums paid by D. However, the policy had no cash surrender value during the first year.
>
> The policy designated D's estate as the beneficiary of the policy proceeds to the extent of an amount equal to the cash surrender value of the policy immediately prior to D's death, less any outstanding indebtedness against the policy. The policy designated the

[4530] See fns 2159-2160 (especially the latter) in part II.H.5.b Moving Real Estate or Other Low-Basis Property from Irrevocable Trust to Grantor, discussing what if an irrevocable grantor trust sold assets to the decedent in exchange for a note from the decedent.
[4531] See fn 4478 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.
[4532] See fns 4538-4541 in part II.Q.4.f.v Estate Tax Consequences of Split-Dollar Agreements.
[4533] Reg. § 1.7872-15(a)(4) is reproduced in full in text preceding the sentence that includes fn 4506 in part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.
[4534] See text accompanying fns 4520-4521 in part II.Q.4.f.iv.(a) Economic Benefit Model After Initial Owner Has Died.
[4535] See fn 4479 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

> X Trust Company, as trustee of the insurance trust, as the beneficiary of the balance of the proceeds.
>
> With the exception of D's right to borrow against the cash surrender value, noted above, all other contract rights with respect to the policy were exercisable by the trustee of the insurance trust, as owner of the policy. These contract rights included the right to assign and surrender the policy, to elect paid up insurance, and to change the beneficiary of the policy proceeds to the extent they exceeded the cash surrender value, which was payable to D's estate.
>
> The terms of the trust provide that on D's death, the trustee is to hold the insurance proceeds for the benefit of D's spouse and children. The trust agreement further provides that D would be responsible for payment of the portion of the annual premium that is equal to the increase in the cash surrender value of the policy during the year. The trustee would be responsible for the payment of the balance of the annual premium.
>
> D died in 1977, more than three years after D obtained the insurance policy and created the insurance trust. Between 1973 and 1977, D paid a total of $12,000 in premiums on the policy, in accordance with D's obligations under the terms of the trust agreement. During the period, D did not exercise the power to borrow against the cash surrender value. At the time of D's death, the cash surrender value of the policy was $12,000. Consequently, $12,000 of the policy proceeds was paid to D's estate. The balance of the proceeds, $138,000, was paid to the X Trust Company in accordance with the terms of the policy.
>
> On the Federal estate tax return filed for D's estate, the executor included the $12,000 in policy proceeds payable to the decedent's estate under section 2042(1) of the Code. The executor excluded the $138,000 balance of the proceeds, which was payable to a beneficiary other than the decedent's estate, on the ground that this portion of the proceeds was not includible under section 2042(2) of the Code, because the incidents of ownership in the policy possessed by D could not be exercised to affect this portion of the policy proceeds.

Rev. Rul. 79-129 held that $12K of proceeds were includible in the decedent's estate and the balance was not, based on the following reasoning:

> Section 20.2042-1(c)(2) of the Estate Tax Regulations describes "incidents of ownership" as follows:
>
> > For purposes of this paragraph, the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc. ...."
>
> The right of an insured to obtain a loan against the surrender value of the policy is specified in the regulations as an incident of ownership. The courts have recognized that this power furnishes grounds for including the entire policy proceeds in the gross estate, even in situations where the decedent's power to borrow is limited to the amount of the

policy premiums. *Estate of Neuberger v. Hickey*, Civil No. 836 (N.D. N.Y. August 13, 1942); *Estate of McCoy v. Commissioner*, T.C. Memo. 1961-40.

In the situation presented in the instant case, $12,000 in policy proceeds were paid to D's estate, under the terms of the policy. Since this $12,000 in proceeds is payable to D's estate, this amount is includible in D's gross estate pursuant to section 2042(1) of the Code.

The balance of the proceeds, $138,000, was paid to the X Trust Company, a beneficiary other than the decedent's estate. Consequently, the estate taxation of these proceeds is governed by section 2042(2) of the Code.

Under the terms of the insurance contract, D possessed the right to borrow against the cash surrender value of the policy to the extent of the premiums paid by D and not recovered. In accordance with section 20.2042-1(c)(2) of the regulations, and the courts' decisions in *Neuberger* and *McCoy*, cited above, this power qualifies as an incident of ownership for purposes of section 2042(2), even though the amount D could borrow against the surrender value was limited. If the decedent possessed an incident of ownership in the policy, then the entire policy proceeds payable to a beneficiary other than the decedent's estate are includible in the decedent's gross estate regardless of the fact that a portion of the proceeds subject to inclusion could not be affected by the exercise of the incident of ownership.

Letter Ruling 9745019 involved the following facts:

You represent that the taxpayers, husband and wife, reside in a community property state. The taxpayers have three children: child A, child B, and child C. The taxpayers created an irrevocable trust in October 1996. Child A was named trustee. The terms of the trust specifically preclude the taxpayers from acting as trustees. The trust is irrevocable and the taxpayers have retained no powers or authority over either the trust or the trust property or the administration thereof.

The trust instrument provides that, during the lifetime of the taxpayers, the net income of the trust is to be paid in equal shares quarter-annually to child A, child B, and child C. Upon the death of the last to die of the taxpayers, the trust is to be divided into as many shares as there are children of the taxpayers then living and children of the taxpayers then deceased leaving issue then living (except no share is to be established for the issue of child B). Each share is to comprise a separate subtrust. The net income of each subtrust is to be paid quarter-annually for the benefit of the child for whom the subtrust was created. The principal of each subtrust may be distributed, at the discretion of the trustee, for the respective child's health, education, maintenance, or support. At the death of either child A or child C with both taxpayers deceased, the trustee of the subtrust for such deceased child is to distribute the remaining corpus of the subtrust to the issue of the deceased child by right of representation. Upon the death of child B with both taxpayers deceased, the remaining corpus of the subtrust for child B is to be distributed to the taxpayers' issue by right of representation except that no distributions are to be made to the issue of child B.

The taxpayers initially funded the primary trust with a cash gift. With this initial contribution the trustee purchased, and paid the first premium on, a second-to-die life insurance policy covering the lives of the taxpayers. The irrevocable trust was named the owner and beneficiary of the policy. The taxpayers and the trustee propose to enter into a collateral assignment split-dollar agreement with respect to any policies held by the trust.

Under the collateral assignment split-dollar agreement, the trustee is designated the owner of the policy. During the joint lives of the taxpayers, the trustee will pay that portion of the annual policy premiums equal to the insurer's current published premium rate for annually renewable term insurance generally available for standard risks. After the death of the first taxpayer to die, the trustee will pay that portion of the annual policy premiums equal to the lesser of 1) the applicable amount provided in the P.S. 58 tables set forth in Rev. Rul. 55-747, 1955-2 C.B. 228, or 2) the insurer's current published premium rate for annually renewable term insurance generally available for standard risks. The taxpayers will pay the remaining portion of the annual premium. The entire premium may be remitted by the taxpayers, and, if the taxpayers remit the total premium, the trustee is obligated to reimburse the taxpayers within 30 days for the trustee's portion of the premium.

The split-dollar agreement may be terminated at will by either the trustee or the taxpayers if the value of the assets held by the trust, excluding the value of the insurance policy, but including the loan value of the policy, equal or exceed the amount that is to be paid to the taxpayers upon termination as set forth below. In all other cases, the split-dollar agreement may be terminated only through the mutual consent of the trustee and the taxpayers. The agreement will also terminate upon the bankruptcy of the taxpayers, the failure of the trustee to timely reimburse the taxpayers, the failure of the taxpayers to pay the premiums, or the death of the survivor of the taxpayers.

If the agreement is terminated prior to the death of the survivor of the taxpayers, the survivor of the taxpayers will be entitled to receive an amount equal to the cash surrender value of the policy (net of the cash surrender value at the end of the initial policy year). For a 60-day period after the date of termination the owner has the option of obtaining a release from the collateral assignment by returning to the insureds (taxpayers) or the survivor an amount equal to the then cash surrender value of the policy less the cash surrender value at the end of the initial policy year. If the owner fails to exercise this option, the insureds or the survivor have the right to surrender the policy and obtain the cash surrender value less the cash surrender value at the end of the initial policy year.

If the agreement is terminated as a result of the death of the survivor of the taxpayers, the estate of the survivor of the taxpayers (or its designated beneficiaries) will be entitled to receive an amount equal to the cash surrender value of the policy immediately prior to the death of the survivor of the taxpayers less the cash surrender value at the end of the initial policy year.

In order to secure the taxpayers' interest (or the interest of the estate of the survivor) in the policy, the trustee will assign to the taxpayers, under a collateral assignment agreement, certain rights in the policy. Under the agreement, the following rights are assigned to the taxpayers: 1) the right to receive a portion of the proceeds payable on the survivor's death equal to the taxpayers' interest under the split-dollar agreement; and 2) the right to receive the cash value of the policy if the policy is surrendered by the trustee, less the cash surrender value amount at the end of the initial policy year. All

> other rights with respect to the policy are reserved to the trustee and all such rights may be exercised solely by the trustee subject to the taxpayer's security interest.

Letter Ruling 9745019 summarized Code § 2042(2) and Reg. § 20.2042-1(c)(2)[4536] and then reasoned and ruled:

> In the present case, the taxpayers have retained no incidents of ownership in the second-to-die life insurance policy on their lives. In the event that the trust includes assets (other than the insurance policy) such that these assets when added to the loan value of the policy would allow the trustee to pay the specified amount upon termination and the taxpayer(s) elects to cancel the agreement, the trustee could pay the taxpayer(s) an amount equal to the cash surrender value of the policy (net of the cash surrender value at the end of the initial policy year). The taxpayer(s) cannot, thus, force the cancellation of the policy.
>
> We conclude that the insurance proceeds payable to the trust pursuant to the split-dollar agreement from the second-to-die life insurance policy held by the irrevocable trust will not be includible in the gross estate of the last taxpayer to die under section 2042.

Letter Ruling 9809032 involved the following facts:

> On May 7, 1982, Decedent created an irrevocable trust (Trust) and transferred certain life insurance policies to the trust. Individual and Corporation were appointed trustees of the Trust and continue to serve as trustees.
>
> Paragraph C of Article FIRST of Trust provides that the trustees are vested with all right, title, and interest in and to the policies of insurance that were transferred to the trust and any additional policies of insurance assigned to the trust by any person. Paragraph C also authorizes the trustees to exercise all options, benefits, rights, elections, privileges, and other powers under the policies, including the right to borrow upon the policy or policies, to pledge any for a loan, to surrender any policy for the cash surrender value, and to convert a policy into other forms of insurance.
>
> Paragraph E of Article FIRST authorizes the trustees to receive all payments on insurance policies.
>
> Paragraph (4) of Article SECOND provides that, at the death of Decedent and if his wife predeceases him, the trustees shall pay $1,000,000 to Individual, if he survives decedent or, if not, to Individual's issue that survive Decedent. If the $1,000,000 amount is more than five percent of the Decedent's gross estate including the principal held by the Trustees, the amount shall be reduced so that it is no greater than five percent of Decedent's gross estate. The balance of the remaining principal shall be paid to the issue of the Decedent.
>
> Article THIRD provides that Trust's principal shall be divided into equal shares, one for each of Decedent's children who is then living and each of his children who has died leaving issue.

[4536] Reg. § 20.2042-1(c)(2) is reproduced in part II.Q.4.i.ii Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity.

> Article THIRTEENTH provides that, during Decedent's life, the trustees shall receive compensation for their services as fiduciaries as is determined by Decedent. Individual is granted the authority to name a successor trustee provided any such successor trustee is a partner of Individual's law firm.
>
> Decedent died on October 27, 1996, survived by his three children, A, B, and C. During Decedent's life, the trustees borrowed from the Decedent amounts that were documented with promissory notes. The amounts borrowed were used to pay premiums on the insurance policies and, at his death, five of the notes were outstanding. The terms of the notes are substantially identical except for the amount borrowed and the interest rate prevailing at the time each note was executed. The executor has represented that the Decedent owned and controlled the notes through a revocable trust and that the notes are includible in Decedent's gross estate for federal estate tax purposes.

Letter Ruling 9809032 ruled:

> In this case, Decedent transferred insurance policies to Trust during his life. Trust was irrevocable and authorized the trustees to exercise all options, benefits, rights, elections, privileges, and other powers under the policies, including the right to borrow upon the policy or policies, to pledge any for a loan, to surrender any policy for the cash surrender value, and to convert a policy into other forms of insurance. The trustees were Individual and Corporation. Under these circumstances, Decedent did not have the incidents of ownership in the policies as that term is defined in section 20.2042-1(c)(2).
>
> In addition, the trustees borrowed from Decedent amounts that were used to pay premiums on the insurance policies. At Decedent's death, five of the notes were outstanding. Under section 2042, the payment of premiums is irrelevant in determining whether a decedent retained any incidents of ownership in the policy proceeds. *Estate of Leder v. Commissioner of Internal Revenue*, 893 F.2d 237 (10 Cir. 1989); *Estate of Headrick v. Commissioner of Internal Revenue*, 918 F.2d 1263 (6th Cir. 1990).
>
> Accordingly, based on the facts submitted and the representations made, we rule … the decedent did not possess any incidents of ownership in the policy under section 2042(2) as a result of loaning the amounts for payments of life insurance premiums to the trust.

The split-dollar economic benefit regime regulations do not apply for estate tax purposes.[4537]

Apparently taking advantage of this gap, *Estate of Morrissette v. Commissioner*[4538] held that a taxpayer's entering into a heavily discounted generational split-dollar agreement[4539] did not

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[4537] See fn 4463 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.
[4538] 146 T.C. 171 (2016). For a complete discussion, see S. Gorin & H. Zaritsky, Tax Court Approves Some Key Issues with Intergenerational Split-Dollar Arrangements, 28 Probate Practice Reporter 1 (June 2016). For a link to various selected documents filed with the Tax Court, including the split dollar agreement and appraisal the IRS viewed as representative of the arrangements, see http://tcinstitute.com/rv/ff002894cb41394cda173f9fe7469759eae604bd. In *Estate of Levine v. Commissioner*, Tax Court docket no. 9345-15, a July 13, 2016 order granted summary judgment to the taxpayer because the parties agreed that *Morrissette* controlled, with the IRS preserving its right to appeal, indicating that it continued to disagree with *Morrissette*.
[4539] Under the split-dollar rules, the decedent was the deemed owner of policies on younger insureds. Such an arrangement is referred to as generational because the insured is expected to outlive the

constitute a gift, even though the decedent bequeathed her interest to the other party in the split-dollar arrangement.[4540] In that case, the mother funded life insurance owned by irrevocable life insurance trusts ("ILITs") to fund cross purchase buy-sell obligations that her children had to each other. Because the mother had to wait until her children died to receive cash on the split-dollar receivables and the ILITs had full control over the policies, the mother's estate tax return reported that her right to receive the almost $30 million she invested was worth only approximately $7.5 million. Because the split-dollar receivable would have a low basis, repayment would have generated significant income tax; by bequeathing the receivable to the

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decedent by a significant number of years. That the decedent's estate has to wait for many years to collect what it is owed and must also continue to expend funds during that time might cause the value of the decedent's economic rights to be discounted. However, the decedent's estate would benefit from the growth in the policy's cash value and would not bear the mortality charge (except to the extent that the mortality charge exceeded the rates under the IRS' Table 2001 rates), so it is unclear how much the policy should be discounted.

[4540] The IRS apparently argued that bequeathing the decedent's split-dollar interest to the other party to the contract made the restrictions illusory. From the opinion:

> Respondent argues that the Dynasty Trusts had a direct or indirect right in the cash values of the insurance policies by virtue of the terms of the 2006 Amendment to the CMM Trust. Under that amendment, the CMM Trust's interest in the cash values of the policies would pass to the Dynasty Trusts or directly to Mrs. Morrissette's sons or their heirs upon her death. However, because the CMM Trust was a revocable trust with respect to Mrs. Morrissette, she retained an absolute right to alter the CMM Trust throughout her lifetime. Accordingly, the Dynasty Trusts did not have a legally enforceable right to the cash values of the policies during the lifetime of the grantor. Furthermore, the split-dollar life insurance arrangements did not require the CMM Trust to distribute the receivables to the Dynasty Trusts. Rather, Mrs. Morrissette retained the right to receipt of the receivables.

The decedent's ability to amend her revocable trust was pure legal fiction, which legal fiction this case takes to the extreme. From the finding of facts:

> [The decedent's sons] Arthur, Donald, and Kenneth petitioned the Circuit Court of Fairfax County, Virginia (Fairfax court) for appointment of a conservator for Mrs. Morrissette's estate and asked the conservator to transfer additional assets to the CMM Trust. On August 18, 2006, the court found Mrs. Morrissette to be permanently incapacitated and appointed Cathleen A. Hatfield, an employee of the Interstate Group, to serve as the conservator. The Fairfax court granted Ms. Hatfield broad authority to act on Mrs. Morrissette's behalf. The conservatorship expired on October 20, 2006.

The conservator did the following during that 2-month period:

1. Established Dynasty Trusts,
2. Amended the revocable trust to authorize entering into the split-dollar agreements and bequeathing the revocable trust's interest in each split-dollar agreement to the other party to the split-dollar agreement, and
3. Entered into a buy-sell agreement requiring the life insurance.

Then, the Dynasty Trusts bought the policies and, together with the revocable trust (of which the sons were co-trustees), entered into the split-dollar agreements.

The idea that this arrangement would ever be modified was ludicrous, given that the sons orchestrated this entire transaction for their benefit, using as the conservator an employee of the company that they directly or beneficially owned, to set up a multi-million dollar transaction in a compressed period of time.

The following facts might have helped the estate's case:

- The purchase of the policies was for a legitimate and significant nontax reason [my assumption that the *Bongard* test might have been in the court's mind - see fn 91 in part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders] – to fund a buy-sell agreement.
- The donor lived 4 years after the arrangement was made.
- The gift tax returns used the IRS' Table 2001 rates instead of any alternative term rates provided by the insurance company.

other party the agreement, the mother might have prevented that result.[4541] However, in a similar situation, *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84, held that Code §§ 2036, 2038, and 2703[4542] may very well apply, probably not qualifying for the exception for a sale for adequate and full consideration that would prevent the former two[4543] from applying because the split dollar receivable was only a small fraction of the amount of money the decedent contributed to the agreement.[4544] The court failed to address Reg. § 20.2038-

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[4541] Presumably the bequest of the receivable or even a note under the loan regime would not generate income tax. Bequeathing a note (other than a note received in an installment sale) does not trigger cancellation of indebtedness income to the debtor; see fn. 7075, found in part III.B.5.b Promissory Notes. However, if *Morrissette* had used the loan regime, bequeathing the note may have caused the loan to be disregarded for gift tax purposes, which would have made the whole amount advanced constitute a gift. See fn 4506 in part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

[4542] The court held:

> On the basis of the undisputed facts, we conclude that under section 2703(a)(1) the split-dollar agreements, and specifically the provisions that prevent decedent from immediately withdrawing his investment, are agreements to acquire or use property at a price less than fair market value. The estate claims that decedent paid $10 million to the insurance companies for the benefit of MB Trust and in return received certain rights, namely, the termination rights (which the estate claims are worthless) and decedent's death benefit rights (which, according to the estate's valuation theory, are worth less than 2% of the cash surrender value). MB Trust, meanwhile, paid nothing into this arrangement and received MB Trust's death benefit rights. As best we understand the estate's valuation theory, MB Trust's death benefit rights are allegedly worth at least the cash surrender value minus the value of decedent's death benefit rights (*i.e.*, $9,611,624 – (allegedly) $183,700 = $9,427,924). Nothing in the parties' filings suggests that MB Trust ever paid, or was obligated to pay, any interest or other amount to compensate decedent for MB Trust's acquisition and use of this amount….
>
> Next, it is clear that under section 2703(a)(2) the split-dollar agreements, and specifically MB Trust's ability to prevent termination, also significantly restrict decedent's right to use the termination rights. The split-dollar agreements, taken as a whole, clearly restrict decedent's right to terminate the agreements and withdraw his investment from these arrangements.

[4543] The court held:

> … the rights to terminate and recover at least the cash surrender value were clearly rights, held in conjunction with another person (MB Trust), both to designate the persons who would possess or enjoy the transferred property under section 2036(a)(2) and to alter, amend, revoke, or terminate the transfer under section 2038(a)(1).

[4544] The court noted:

> Whether a transfer was for adequate and full consideration is a question of value; *i.e.*, did what decedent transferred roughly equal the value of what he received in return? See, *e.g.*, *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278. On the basis of the undisputed facts presently before us, we conclude that it was not.
>
> According to the estate, at decedent's date of death MB Trust's ability to veto decedent's termination of the agreements rendered the termination rights valueless. Additionally, the estate alleges that decedent's death benefit rights are worth less than 2% of the cash surrender value (i.e., $183,700 ÷ $9,611,624 < 2%). But MB Trust's veto power existed from the moment decedent entered into these split-dollar agreements, and nothing in the undisputed facts presently before us suggests that the terms of the split-dollar agreements were altered between execution of the agreements and decedent's date of death; consequently, this alleged 98% discount must have been present from the execution of these agreements. Therefore, *according to the estate's valuation theory*, the initial transfer of $10 million in value cannot have been in exchange for property worth that amount; *i.e.*, under the estate's argument, what decedent received was necessarily worth at least 98% less than what he transferred (even without taking into account the amounts used to pay commissions and fees to the insurance company). Consequently, at least according to the estate's valuation theory, the value of what decedent received (allegedly, something close to $183,700) was not even roughly equal to the $10 million decedent paid.

1(a)(2), which prevents Code § 2038 from applying "if the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law."[4545] On December 12, 2018, the parties settled the case, with the estate paying $2,123,508 in estate tax and $424,702 in Code § 6662(h) penalties (but no Code § 6662(a) penalties).

In an order entered June 21, 2018, the *Morrissette* Tax Court denied the taxpayer's motion for partial summary judgment on grounds similar to *Cahill*.[4546] On February 19, 2019, the court

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[4545] That exception is an alternative to the exception to which the court alluded, Reg. § 20.2038-1(a)(1), which prevents Code § 2038 from applying, "to the extent that the transfer was for an adequate and full consideration in money or money's worth (see §20.2043-1)."

[4546] The court reasoned and ruled (Docket No. 4415-14):

> Petitioners argue that the decedent's only right under the split-dollar arrangements was the death benefit and that right was without restriction. They argue that the property being valued is the death benefit, the death benefit is free of any restriction as defined in section 2703(a)(2), and accordingly section 2703(a) does not apply to the valuation of the split-dollar arrangements. They argue that the split-dollar arrangements did not contain any restrictions on the decedent's rights for purposes of section 2703(a)(2). They state, without further analysis, that the termination restriction, *i.e.*, that neither party had the unilateral right to terminate the split-dollar arrangements, is not a restriction for purposes of section 2703(a)(2).
>
> Respondent argues that the decedent's rights also include the termination right and receipt of a payout upon termination. He argues that the termination right were restricted by the split-dollar arrangements and that section 2703(a)(2) applies to disregard the termination restrictions. He also argues the decedent had rights under collateral assignment agreements. He contends that the CMM Trust and the Dynasty Trusts entered into agreements in which the Dynasty Trusts assigned the insurance policies to the CMM Trust as collateral for its $30 million premium prepayment, and the collateral assignments contained a restriction that should be disregarded under section 2703(a)(2). He argues that neither the termination restriction nor the collateral assignment restriction is inherent or necessary to a split-dollar agreement. See *Estate of Strangi v. Commissioner*, 115 T.C. 478, 488-489 (2000), *aff'd* in part, *rev'd* on another issue, 293 F.3d 279 (5th Cir. 2002) (holding that section 2703 did not apply to disregard partnership entity to cause partnership assets to be included in the estate); *cf. Estate of Elkins v. Commissioner*, 140 T.C. 86 (2013), *aff'd* in part, *rev'd* in part, 767 F.3d 443 (5th Cir. 2014) (applying section 2703(a) to disregard restriction on decedent's right to institute a partition action for undivided fractional interests in art work); *Holman v. Commissioner*, 130 T.C. 170 (2008) (applying section 2703 to disregard restrictions in partnership agreement on partner's right to transfer her partnership interest). He argues that we should deny summary judgment in petitioners' favor because genuine issues of material fact exist. He argues that the Court should find that section 2703 applies to the decedent's rights under the split-dollar arrangements as a matter of law, but he did not file a cross-motion for summary judgment on this issue. If section 2703 applies, respondent argues that we should disregard the termination restrictions pursuant to section 2703 and value the decedent's rights under the split-dollar arrangement as if she had the right to unilaterally terminate the agreements. He does not seek to disregard the split dollar arrangements in their entirety.
>
> The restriction on the decedent's termination rights is a restriction for purposes of section 2703(a)(2). *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84, at *23-28. In *Estate of Cahill*, we denied the estate's motion for partial summary judgment that section 2703(a) is inapplicable to split-dollar arrangements with termination restrictions similar to those at issue here where the parties to the arrangements could mutually agree to terminate the arrangement but neither party could unilaterally terminate the arrangements. *Id.* Here the CMM Trust and the respective Dynasty Trust could mutually agree to terminate the split-dollar arrangement, but neither party could unilaterally terminate the agreement. Respondent has asserted alternative arguments that the split-dollar arrangements are includible in the decedent's gross estate

denied the IRS motion for summary judgment under Code §§ 2036(a)(2) and 2038(a)(1) and (2), finding that "there is a material factual dispute concerning the issue of full and adequate consideration" and denied the IRS motion for summary judgment under Code § 2703, stating that Code § 2703 "will apply unless the requirements of the section 2703(b) exception are satisfied" but that "there is a genuine dispute of material fact of whether the transfers were a device to transfer property to members of decedent's family for less than full an adequate consideration in money or money's worth." Ultimately, however, T.C. Memo 2021-60 held that Code § 2036 did not apply:[4547]

> Taking into account the totality of the facts and circumstances, the CMM trust had legitimate and significant nontax purposes for entering into the split-dollar agreements and funding payment of the premiums in exchange for repayment plus interest in the form of inside buildup. An important purpose of the transfer was to promote the management succession and efficiency and to protect corporate profits for the accumulation of capital to develop the business. On the basis of the record before us, we find that unrelated parties would have agreed to similar terms. Respondent has not argued otherwise….
>
> To qualify for the bona fide sale exceptions, the transfer must have been made for adequate and full consideration in money or money's worth….
>
> Compliance with the economic benefit regime does not mean that the adequate and full consideration requirement is met. *Estate of Cahill v. Commissioner*, at *33. Under the plain text of the regulations, the economic benefit regime does not apply for estate tax purposes. The regime is set out in the income tax regulations, and the regulations state that the regime applies for income, gift, employment, and self-employment tax purposes. Sec. 1.61-22(a), Income Tax Regs. Estate tax is not listed. The economic benefit regime does not use the phrase "adequate and full consideration" or otherwise invoke the concept of adequate and full consideration….
>
> We hold that the CMM trust received adequate and full consideration on the basis of the split-dollar agreements' repayment terms that included interest earned in the form of inside buildup of the insurance policies. The minimum interest rates and the actual appreciation in the policies' cash values were higher than the interest rates that the CMM trust had been earning on the money. Respondent does not argue that the repayment terms were inadequate. The split-dollar agreements also provide the additional benefit of deferral of tax on the policies' inside buildup and the tax-exempt payout of the death benefits to the beneficiaries.

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pursuant to sections 2036 and 2038 relating to inter vivos transfers, which petitioners have not been addressed in their summary judgment motions and remain at issue for trial. See *Estate of Cahill v Commissioner*, T.C. Memo. 2018-84, at *15-*16 (holding the estate retained rights under the split-dollar arrangements as defined in sections 2036(a) and 2038(a) and denying summary judgment to the estate that those sections are inapplicable). As there may be facts or theories not yet presented, we decline to treat respondent's response to petitioners' motion for partial summary judgment as a cross-motion for partial summary judgment.

Accordingly, it is ORDERED that petitioners' motion for partial summary judgment, filed December 5, 2016, relating to the issue of the applicability of section 2703 is denied.

[4547] These are strategic excerpts from the full analysis that is reproduced in the text following fn 7470 in part III.C.1 Whether Code § 2036 Applies.

> Estate tax saving was not achieved through execution of the split-dollar agreements alone but rather through the undervaluation of the split-dollar rights….

The court held that Code § 2703 did not apply,[4548] which is not surprising given that it bought into the bona fide arguments for Code § 2036. However, the court did not buy into the estate's valuation, holding the split-dollar agreement would be unwound much earlier than its stated termination (thereby undermining the effect of various discounts):

> Petitioners argue that there was no prearranged plan to terminate the split-dollar agreements when the agreements were executed. We are not convinced. When the 2006 plan was implemented, the CMM trust agreement was amended to distribute the split-dollar rights to the respective dynasty trusts that owned the underlying policies. Such a distribution indicates an intent to give the dynasty trusts full control over the policies once the distribution occurred. Such control makes it appropriate to apply a maturity date, and we apply a maturity date of December 31, 2013. That is the date that respondent seeks. Accordingly, we do not apply an earlier one. We acknowledge that Ken testified that he did not intend to cancel the policies. While we find him credible, the brothers were free to choose to cancel the policies after the agreements were distributed to the dynasty trusts. From the outset, the plan was to give the dynasty trusts complete control after Mrs. Morrissette's death, and the CMM trust agreement was so amended. Respondent points to other facts to support a December 31, 2013, maturity date including the decision to purchase policies with high premiums and modest death benefits and July 2010 emails between Don, Mr. Meltzer, and Mr. McNair that discuss the possibility of canceling certain policies. Mr. McNair responded to Don that he insisted that the policies not be canceled until the three-year period of limitations on the estate return had expired. This is the basis for respondent's choosing December 31, 2013, as the maturity date. Petitioners raise valid objections to the emails including that Ken and Buddy were not involved and the discussion started out about the effect of cancellation of the policies on Mr. Meltzer's future commissions. However, on our review of all the facts and circumstances, the key factor in setting the December 31, 2013, maturity date is the brothers' complete control over the split-dollar agreements. As stated above, there are grounds for setting an earlier maturity date, but we will use respondent's date.

The court imposed an undervaluation penalty:

> When considering reliance on an appraisal as a defense to a valuation penalty, we consider the methodology and assumptions underlying the appraisal, the appraised value, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayer. *Estate of Richmond v. Commissioner*, T.C. Memo. 2014-26, at *48. In this case we place the most weight on the appraised value, less than $7.5 million. Mr. Stephanson's opined value was not reasonable, and the brothers should have known that. The brothers had the CMM trust pay $30 million and turned it into $7.5 million for estate tax reporting purposes. They should have known that the claimed value was unreasonable and not supported by the facts.
>
> While the brothers credibly testified to the business and nontax purposes for entering into the split-dollar agreements, they also knew that Mr. Meltzer and Mr. McNair were marketing the agreements as an estate tax saving strategy. Mr. Meltzer and Mr. McNair made it clear that the tax benefits of the split-dollar agreements would be obtained

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[4548] See text accompanying fn 7400 in part III.B.7.e Code § 2703 Overview.

> through the undervaluation of the split-dollar agreements, and the brothers knew from the time they decided to enter into the split-dollar agreements that any estate tax saving depended on valuing the split-dollar rights at a substantial discount from the premiums that the CMM trust paid. In July 2010, before the return's filing, Mr. McNair warned Don that the IRS would likely see problems with the values of the split-dollar rights that the estate had planned to report on the return. Nevertheless, the brothers had the estate report substantially discounted values on the return.
>
> Mrs. Morrissette had significant, nontax reasons for entering into the split-dollar agreements. However, the only purpose for the substantially discounted values of the split-dollar rights as compared to the $30 million that the CMM trust paid is estate tax saving. Knowing that any estate tax saving would be from the undervaluation of the split-dollar rights, the brothers engaged an appraiser that Mr. McNair recommended. Mr. McNair reviewed a draft of Mr. Stephanson's appraisal and asked Mr. Stephanson to make changes that reduced his opined values.
>
> Mr. Stephanson's appraisal was not reasonable, and petitioners did not rely on it in good faith. Accordingly, the estate is not entitled to rely on Mr. Stephanson's appraisal as a reasonable cause defense. The estate did not act reasonably or in good faith in the valuation of the split-dollar rights. The estate is liable for the 40% penalty for the gross valuation misstatement of the split-dollar rights.

On the other hand, the taxpayer won *Estate of Levine v. Commissioner*, 158 T.C. No. 2 (2/28/2022). The Syllabus summarized the facts:

> D, the deceased, entered into split-dollar life-insurance arrangements which required her revocable trust to pay premiums for life-insurance policies taken out on the lives of her daughter and son-in-law. When the arrangements terminate, D's revocable trust has the right to be paid the greater of the premiums paid or the cash surrender value of the policies. An irrevocable life-insurance trust was the owner of these policies. D's children and grandchildren were the beneficiaries of the irrevocable trust, and F, a family friend who was substantially involved in the family's businesses, was the sole member of the investment committee that managed the irrevocable trust. F and two of D's children also acted as D's attorneys-in-fact and as the revocable trust's successor cotrustees. As the sole member of the irrevocable trust's investment committee, only F had the right to prematurely terminate the life-insurance policies: the arrangements gave D and the other two attorneys-in-fact no rights to terminate the policies or the arrangement itself.

Levine reviewed the general rules of estate inclusion when the life insurance is not on the life of the person advancing the premiums:

> On this we have precedent. In *Morrissette I*, we held that a split-dollar arrangement much like this one fell under the economic-benefit regime for gift-tax purposes. But we also noted in *Morrissette I*, 146 T.C. at 172 n.2, that "we [were] not deciding whether the estate's valuation of the receivables...in the gross estate [was] correct." And section 1.61-22(a)(1) seems not to cover the estate-tax consequences of split-dollar arrangements at all.21 The final regulations do make one reference to estate tax in their preamble, which states "[f]or estate tax purposes, regardless of who is treated as the owner of a life insurance contract under the final regulations, the inclusion of the policy proceeds in a decedent's gross estate will continue to be determined under section 2042." T.D. 9092, § 5, 2003-2 C.B. 1055, 1063. But the express terms of section

> 2042 limit its applicability to life-insurance policies on a decedent's own life, not split-dollar arrangements where policies are taken out on the lives of others. See § 2042(1); Treas. Reg. § 20.2042-1(a)(2) ("[S]ection 2042 has no application to the inclusion in the gross estate of the value of rights in an insurance policy on the life of a person other than the decedent"). From this we conclude that neither the regulation nor section 2042 governs our valuation of the split-dollar arrangement we have to analyze.

Levine rebuffed the IRS' Code §§ 2036, 2038 attacks, first comparing Code § 2036(a)(2) inclusion in *Estate of Strangi*, T.C. Memo. 2003-145, and *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017), to the taxpayer's win in *United States v. Byrum*, 408 U.S. 125 (1972):

> In *Byrum*, the Supreme Court held that a decedent's right to vote shares of stock in three corporations that he had transferred to a trust for the benefit of his children did not cause those shares to be included in his estate under section 2036(a)(2). The Court noted that any powers the decedent might have had were subject to a number of different "economic and legal constraints" that prevented those powers from being equivalent to the right to designate a person to enjoy trust income. *Id*. at 144. One of these constraints was that the decedent, as the controlling shareholder of each corporation whose stock was transferred into the trust, owed fiduciary duties to minority shareholders that limited his influence over the corporations' dividend policies. *Id*. at 142-43. The Supreme Court also noted that an independent corporate trustee alone had the right under the trust agreement to pay out or withhold income, *id*. at 137, so the decedent had no way of compelling the trustee to pay out or accumulate that income, *id*. at 144. That the decedent had fiduciary duties to these minority shareholders - duties that were legally enforceable - was important to the Supreme Court's analysis. *Id*. at 141-42.
>
> We have been careful to distinguish *Byrum* in later cases when we see something behind a transaction's facade that suggests appearance doesn't match reality. *Estate of Strangi*, 85 T.C.M. (CCH) at 1333-34, featured a decedent who could act with others to dissolve a family limited partnership to which he had transferred property in exchange for a 99% limited-partner interest. The decedent in *Estate of Strangi* - through his son-in-law—also had the right to determine the amount and timing of partnership distributions. *Id*. at 1337. This led us to distinguish *Byrum*, because in *Byrum* the son-in-law had fiduciary duties to other members of the family limited partnership; in *Estate of Strangi*, the son-in-law's potential fiduciary duties - as the decedent's attorney-in-fact and 99% owner of the family limited partnership - were duties he owed "essentially to himself." *Id.* at 1343.
>
> We decided *Estate of Powell* on essentially the same grounds as *Estate of Strangi*. In *Estate of Powell*, 148 T.C. at 394-95, a fiduciary also owed duties to the decedent both as his attorney-in-fact and as partner in a family limited partnership. We found that there was nothing in the record of that case to suggest that as a fiduciary he "would have exercised his responsibility as a general partner of [the family limited partnership] in ways that would have prejudiced decedent's interests." *Id*. at 404. And we again determined that whatever duties were owed were duties that "he owed almost exclusively to decedent herself." *Id.*
>
> Here's where the Commissioner makes his thrust. He contends that Levine - through her attorneys-in-fact - stood on both sides of these transactions and therefore could unwind the split-dollar transactions at will. This meant that she - again through the attorneys-in-fact - had the power to surrender the policies at any time for their cash-surrender values.

(Remember that, under the terms of the split-dollar arrangements, if the Insurance Trust surrendered the policies before the deaths of both Nancy and her husband, it would immediately owe the Revocable Trust the full cash-surrender values of the policies.) The Commissioner argues that these powers constitute the right to possession and enjoyment of, or the right to income from, the split-dollar receivable under section 2036(a)(1). If he's right, we would have to value the receivable at the policies' cash-surrender values.

We agree that Robert, Nancy, and Larson - as Levine's attorneys-in-fact - stood in the shoes of Levine for this split-dollar arrangement. That is the point of giving someone a power of attorney. The Revocable Trust is the entity that paid the $6.5 million, and its cotrustees are Nancy, Larry, and Larson. The Insurance Trust, however, owns the life-insurance policies, and its trustee is South Dakota Trust. South Dakota Trust is directed by the investment committee, and the investment committee's only member is Larson. This, however, means that the only person that stood on both sides of the transaction is Larson -in his role as the investment committee and as one of Levine's attorneys-in-fact.

We therefore must look at each of Larson's roles in this transaction to consider how to apply sections 2036(a) and 2038. Under the 1996 power of attorney and Minnesota law, all actions taken by Larson as an attorney-in-fact are considered to be actions of Levine. See Minn. Stat. § 523.12 (2008).[25] The Insurance Trust's instrument, however, states that the Insurance Trust is irrevocable. We have no reason to doubt that this means what it says. And the consequence is that Levine irrevocably surrendered her interest in the Insurance Trust and had no right to change, modify, amend, or revoke its terms. Once it was created, Levine had no legal power over its assets. Levine did not have the power to surrender the policies by herself. Since Larson - in his role as an attorney-in-fact - could not take any action which Levine could not take herself, we find that he could not surrender the policies in his capacity as attorney-in-fact. This means that even if we treat the Insurance Trust, the policies, or that Trust's rights under the split-dollar deal as the "property transferred" (and thus the property whose value we look for) under section 2036, Levine did not retain any right to possession or enjoyment of the property transferred.

[25] The Minnesota statute states: "Any action taken by the attorney in-fact-pursuant to the power-of-attorney binds the principal, the principal's heirs and assigns, and the representative of the estate of the principal *in the same manner as though the action was taken by the principal* ...." (Emphasis added.)

To get around these problems, the Commissioner has to argue that Larson has the right to designate who shall possess or enjoy the cash-surrender value of the policies, either by surrendering them or by terminating the entire arrangement. See *Estate of Cahill*, 115 T.C.M. (CCH) at 1467. For example, in Estate of Cahill, we found that section 2036(a)(2) applied when the decedent jointly held the right to terminate the split-dollar life-insurance policy with the irrevocable trust that held the policies. *Id*. We think that's the only way the Commissioner can include the combined cash-surrender values of the life-insurance policies in Levine's estate under section 2036(a)(2) or section 2038.

But we also think that this argument fails to consider the fiduciary obligations Larson owes to the beneficiaries of the Insurance Trust—obligations that would prevent him from surrendering the policies. The Commissioner first questions the validity and existence of these duties. He notes that "Larson was not compensated for his role as the sole member of the Investment Committee despite the fact that petitioner has taken the position that he assumed significant fiduciary responsibilities under this role." But we don't think that matters. There is no requirement under either South Dakota law[26] or general trust law[27] that a trustee or trust adviser be compensated to have fiduciary obligations. The terms of the Insurance Trust expressly state that Larson—in his role as the single-member investment committee - shall be considered to be acting in a fiduciary capacity. Therefore we do find that Larson was under fiduciary obligations in his role as the sole member of the investment committee.

[26] S.D. Codified Laws § 55-1B-4 (2008) provides:

> If one or more trust advisors are given authority by terms of the governing instrument to direct, consent to, or disapprove a fiduciary's investment decisions, or proposed investment decisions, *such trust advisors shall be considered to be fiduciaries when exercising such authority unless the governing instrument provides otherwise*''

(Emphasis added).

And S.D. Codified Laws § 55-2-1 (2008) provides that "[i]n all matters connected with his trust a trustee is bound to act in the highest good faith toward his beneficiary . . . ."

[27] *Restatement (Third) of Trusts* § 70, cmt. d(1) (Am. L. Inst. 2007) states that "[w]hether or not a person receives compensation for serving as trustee, the person is subject to a duty to administer the trust in accordance with its terms . . . with prudence . . . and in good faith and conformity with other fiduciary duties referred to in Clause (b)."

Larson's duties in his role for the Insurance Trust required him, however, to look out for the interests of that Trust's beneficiaries. And here is where the Commissioner makes a different and subtler argument. He contends that, since Nancy and Robert are beneficiaries of the Insurance Trust, they stand to benefit under the split-dollar arrangement regardless of whether the life-insurance policies remain in place or are surrendered during their lifetime. This means, he says, that Larson would not violate his fiduciary duties to the beneficiaries of the Insurance Trust if he either surrendered, or didn't surrender, the policies because Nancy and Robert would benefit no matter what. If Larson immediately terminated the split-dollar arrangement, surrendered the policies, and sent the money out of the Insurance Trust to the Estate and then to Levine's children, he'd just be benefiting the children in a different capacity.

To this subtle thrust, the Estate has a blunt parry: Levine's children are not the only beneficiaries under the Insurance Trust. Her grandchildren are also beneficiaries, and Larson has fiduciary obligations to them as well. According to the terms of the Insurance Trust, Levine's grandchildren would receive nothing if the life-insurance policies were surrendered. Left unmentioned is the final step in this argument - that Larson has no right to violate his fiduciary obligations by looting the Insurance Trust for the benefit of only some of its beneficiaries.

The Commissioner counters by arguing that the Insurance Trust itself allows Nancy and Robert to extinguish their children's interests in it. This means, he says, that Nancy and Robert are the only real beneficiaries, and stand to benefit regardless of whether the life insurance policies stay in effect.

This misinterprets the way that "extinguishment" works under the provisions of the Insurance Trust, however. The Trust plainly states that "the special testamentary power of appointment hereby granted to said Beneficiary shall not be exercisable in favor of or for the benefit of the Beneficiary ..."—i.e. they can't extinguish another beneficiary's interest in favor of themselves. The Insurance Trust also states that extinguishment of a beneficiary's interest can occur only by will and cannot take place until the death of the beneficiary doing the extinguishing (which in this case would be Nancy or Robert). So if Nancy and Larry hoped to extinguish the interests of their own children, they couldn't do so until they themselves directly named some other beneficiary to take their place. This means that during the lives of Nancy and Robert, their children will remain beneficiaries of the Insurance Trust, and a decision by Larson to surrender the policies would mean the grandchildren would receive nothing. This would breach his fiduciary duties to them.

Levine's case is thus distinguishable from *Estate of Strangi* and *Estate of Powell*. Many of the same "economic and legal constraints" that existed in *Byrum* exist here. First, the fiduciary obligations that Larson owed were not duties that he "essentially owed to himself." His fiduciary obligations are owed to all the beneficiaries of the Insurance Trust, which include not just Levine's children, but her grandchildren. As we've already discussed, if Larson surrendered the life insurance-policies, those grandchildren would receive nothing as beneficiaries. That makes these fiduciary obligations more analogous to the duties owed to the minority shareholders in *Byrum*, which like them are duties that do limit the powers of the person who holds them. They are also legally enforceable duties, established by South Dakota state law, *see, e.g.*, S.D. Codified Laws §§ 55-2-1, 55-1B-4 (2008), and if Larson breached these duties or was put in a position where he was forced to do so, he would be required under S.D. Codified Law § 55-2-6 (2008) to inform all of the beneficiaries of the Insurance Trust, and he could be removed. He could also be subject to liability under South Dakota law for breach of his duty. *See, e.g.*, *Matter of Heupel Fam. Revocable Tr.*, 914 N.W.2d 571 (S.D. 2018) (trustee breaching fiduciary duties removed and required to personally reimburse trust).

We stress that the fiduciary duties that Larson owed to the beneficiaries of the Insurance Trust do not conflict with the fiduciary duties that he owed Levine as one of her attorneys-in-fact. In both *Estate of Strangi* and *Estate of Powell* we held that the fiduciary's role as the attorney-in-fact would potentially require him to go against his duties as a trustee. *Estate of Strangi*, 85 T.C.M. (CCH) at 1343; *Estate of Powell*, 148 T.C. at 404. This is not the case here: Under Minnesota law, whenever Larson and the other attorneys-in-fact exercise their powers, they are to do so "in the same manner as an ordinarily prudent person of discretion and intelligence would exercise in the management of the person's own affairs and shall have the interests of the principal utmost in mind." Minn. Stat. § 523.21 (1992). And Larson, Nancy, and Robert all credibly testified that one of the reasons for this split-dollar arrangement was that Levine wished to provide for her grandchildren and keep this arrangement in effect until the insureds died. So not only did Larson's role as an attorney-in-fact not require him to go against his duties as a trustee, the two roles reinforced each other and pushed him to fulfill Levine's stated purpose in her estate planning. They made it more likely that he would not want to cancel the life-insurance policies.

We therefore find it more likely than not that the fiduciary duties that limit Larson's ability to cancel the life-insurance policies were not "illusory". It also persuades us that we cannot characterize his ability to unload the policies and realize their cash-surrender values as a right retained by Levine, either alone or in conjunction with Larson, to designate who shall possess or enjoy the property transferred or the income from it.

We conclude that this precludes the inclusion of the cash-surrender values of the life-insurance policies in Levine's estate under section 2036(a)(2).[28]

[28] Section 2036(a) also excepts from its sweep transfers that are bona fide sales for adequate and full consideration. We need not determine whether this exception applies.

Section 2038 focuses on a decedent's power to "alter, amend, revoke, or terminate" the enjoyment of the property in question. The Commissioner's argument under section 2038 mirrors his argument under section 2036 - that the attorneys-in-fact have controlled the entirety of Levine's affairs since 1996, and that this control includes the ability to "alter, amend, revoke or terminate" any aspect of the split-dollar arrangements. He argues again that the termination of the split-dollar arrangements would provide Levine - through her attorneys-in-fact - with complete control over the cash-surrender values of the policies, and the power to do this would fall within section 2038(a)(1). He argues that it applies to section 2038(a)(1) for the same reasons that he argues it applies to section 2036. We disagree for the same reasons and need not repeat them.

The cash-surrender values of the insurance policies are not includible under section 2038(a)(1) either. The cash-surrender values of the insurance policies are not includible under section 2038(a)(1) either.[29]

[29] Section 2038 also includes an exception for a "*bonafide* sale for an adequate and full consideration in money or money's worth." We need not decide whether this exception applies here.

Levine rebuffed the IRS' Code § 2703 argument that the split-dollar agreement was a restriction on the estate's property:

We disagree. Section 2703 does refer to "any property." But the "any property" it refers to is property of an estate, not some other entity's property. Our caselaw confirms the plain meaning of the Code, and tells us to confine section 2703's valuation rule to property held by a decedent at the time of her death*. See, e.g., Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), aff'd in part, rev'd in part, 293 F.3d 279 (5th Cir. 2002). The district court in *Church v. United States*, 85 A.F.T.R.2d 2000-804 (W.D. Tex. 2000), aff'd without published opinion, 268 F.3d 1063 (5th Cir. 2001), rejected precisely this argument when it held that "property" in section 2703 consideration does not include assets that a decedent contributed to a partnership before her death, but only the partnership interest she got in exchange. *See also Estate of Strangi*, 115 T.C. at 488 ("Congress 'wanted to value property interests more accurately when they transferred, instead of including previously transferred property in the transferor's gross estate'" (citing *Kerr v. Commissioner*, 113 T.C. 449 (1999), aff'd, 292 F.3d 490 (5th Cir. 2002))).

The property we have to value here is the property in Levine's estate, which is the split-dollar receivable she held at the time of her death. There were no restrictions on that property. She could do with the receivable what she wanted. She was free to sell it or transfer it as she wished. One needs to remember that what the Estate valued on its return was the receivable owned by Levine in her Revocable Trust. Section 2703 is not

> relevant to the valuation of the receivable because Levine had unrestricted control of it. Section 2703 therefore does not apply.
>
> The only property left in the Estate after this arrangement was done was the split-dollar receivable. It is the value of that property that must be included in the gross estate, and the parties have agreed that its value is $2,282,195. The Estate having almost entirely prevailed, no accuracy-related penalties apply.

Also consider potential estate tax inclusion when the insured controls an employer that is a party to the split-dollar agreement. Because part of the death benefit is not payable to the employer,[4549] the IRS might argue that the insured has incidents of ownership over the policy that is subjected to the split-dollar arrangement. To avoid such an argument, the split-dollar agreement and any collateral assignments might limit the employer's rights to just those provided in the split-dollar agreement.[4550] Although that approach would work for the split-dollar loan regime, it might not work so well for the economic benefit regime. The economic benefit regime provides that the non-owner is deemed to have current access to that portion of the policy cash value to which the non-owner has a current or future right and that currently is

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[4549] If all of the death benefit is payable to the employer or used for the employer's business purpose, the insurance policy is not included in the insured's estate by reasons of incidents of ownership, although the death benefit might very well affect the employer's value that is included in its deceased owner's estate. See part II.Q.4.a Funding the Buy-Sell, especially fn. 4312.

[4550] For example, Letter Ruling 9651017 held:

> Under the split-dollar agreement in the present case, X is expressly prohibited from borrowing against any part of the policy. In addition, the power to change the beneficiary, the power to surrender or cancel the policy, the power to assign the policy or to revoke an assignment, and the power to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy are vested in the trustee of Trust. Accordingly, we conclude, that X will possess no incidents of ownership in the policy acquired by the Trust. See Rev. Rul. 76-274, 1976-2 C.B. 278, modified by Rev. Rul. 82-145, 1982-2 C.B. 213.

Letter Ruling 9651030 had the same or similar language. Letter Ruling 9511046 elaborated:

> Under the split-dollar agreement in the present case, the corporation will, however, hold no incidents of ownership. The corporation will have no defacto ability to force the trustee to borrow against the policy because the corporation is required to make the necessary premium payments for the duration of the trust. The power to change the beneficiary, the power to surrender or cancel the policy, the power to assign the policy or to revoke an assignment, and the power to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy are vested in the third party trustee of the irrevocable trust and are not attributable to the corporation. Accordingly, although the surviving spouse will hold control of the corporation for purposes of section 20.2042-1(c)(6), the corporation will hold no incidents of ownership in the second-to-die life insurance policy, and, thus, no incidents of ownership in the policy will be attributable to the surviving spouse. Reg. § 20.2042-1(c)(6) is reproduced in part II.Q.4.i.ii.(b) Corporate Ownership of Policy.

Letter Ruling 9348009 held:

> The facts in this case indicate that the Company's economic interest in the policy is limited to that of irrevocably designated beneficiary of that portion of the proceeds that is equal to the cash surrender of the policy. Additionally, we assume that no agreement or other factors exist that would cause the value of the decedent's stock holdings in the corporation not to be taken into account for purposes of section 2031. Under these circumstance, because the Company possesses no rights the exercise of which would impact that portion of the proceeds payable to a beneficiary other than the Company, the Company cannot be said to possess any incidents of ownership in the policy of the type that would be attributable to the surviving spouse under section 20.2042-1(6) of the regulations.

inaccessible to the owner.[4551] In other words, if the employer is generally the deemed owner but cannot access the cash value, the other party to the split-dollar agreement is deemed to benefit from that cash value if the other party has a current or future right to part of the cash value. Thus, the approach suggested in fn. 4550 risks being recharacterized as being owned by the employee (and therefore the employer's premium being considered paid to the employee to the extent not attributable to the employer's retained rights to absolutely control cash value) unless the split-dollar agreement is absolutely tight about the employer being entitled to the full cash value. For those less than absolutely confident that the agreement, when using the economic benefit regime consider making the case that the entire arrangement is for the employer's business purpose – the employer receives the employer's portion of the death benefit, and the balance of the death benefit was provided through reasonable compensation for valuable services that the insured provided to the employer or through sharing the premium. However, *Morrissette*'s approval of a split-dollar policy as being solely owned by the premium payer (other than current life insurance protection) will boost the confidence of practitioners regarding the ability to draft agreements without risking the named owner being treated as the owner for income and gift tax purposes; see fn. 4538.

For donor-donee arrangements on the life of the insured, naming the donor as owner is not available. If the donor is the insured, one must draw up an absolutely tightly woven split-dollar agreement preventing the donor from having incidents of ownership, if using the economic regime (as in fn. 4538); those who are risk averse should use the loan regime. If the donor is not the insured, preventing the donor from having incidents of ownership is not important; one can then either name the donor as owner to take a conservative approach or, using a tightly woven split-dollar to try to secure valuation discounts,[4552] name the donee as the owner.

Letter Ruling 200728015 involved the following facts:

> Taxpayers A and B, husband and wife, have four adult children. On Date 1, Taxpayers' four children each established an irrevocable trust, Trusts 1-4 (collectively "Trusts"), for the sole benefit of each child's respective descendants. Taxpayers A and B have no beneficial interest in the Trusts. An unrelated third party is the current trustee of the Trusts. In addition, each Taxpayer has renounced the right to serve as trustee of the Trusts.
>
> On Date 2, a trust created under the will of Decedent for the benefit of Taxpayer A loaned $X to each Trust. The Taxpayers represent that they have made no contributions to the Trusts and will make no contributions to the Trusts in the future.
>
> The Trusts purchased a second-to-die life insurance policy (Policy) on the lives of Taxpayers A and B. The Policy lists the Trusts as joint owners and each trust is designated as the beneficiary of 25 percent of the policy proceeds.
>
> On Date 3, Taxpayers and trustees of the Trusts formed a limited partnership under State law (Partnership). The Taxpayers each own a 1% general partnership interest and a 47% limited partnership interest. The Trusts each own a 1% limited partnership interest. On Date 4, prior to January 28, 2002, the Partnership and the Trusts entered into a collateral assignment split-dollar life insurance agreement (Agreement). Under the Agreement, during the joint lives of Taxpayers A and B, the Trusts will pay that portion of

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[4551] Reg. § 1.61-22(d)(2)(ii) - see fn. 4477 for text of the relevant regulations.
[4552] See fns. 4538-4540.

the annual premium due equal to the insurer's current published premium rate for annually renewable term insurance generally available for standard risks. After the death of the first insured to die, the Trusts will pay the portion of the annual premium equal to the lesser of (i) the applicable amount provided in the P.S. 58 tables set forth in Rev. Rul. 55-747, 1955-2 C.B. 228 or (ii) the insurer's current published premium rate for annually renewable term insurance generally available for standard risks. The Partnership will pay the balance of any premium amount. The Agreement further provides that upon the death of the last to die of Taxpayer A and Taxpayer B, Partnership is to be paid from the Policy proceeds an amount equal to the greater of (i) the cash surrender value of the Policy immediately prior to the death of the survivor of the last to die of Taxpayer A and Taxpayer B, or (ii) the net premiums paid by the Partnership. In the event the Agreement is terminated prior to death of the last to die of Taxpayer A and Taxpayer B, then the Partnership is entitled to receive an amount equal to the cash surrender value of the Policy.

To secure the Partnership's right to repayment, the Trusts executed a collateral assignment of the Policy to the Partnership. The collateral assignment provides that the Trusts shall retain and possess all incidents of ownership, including, the sole and exclusive right to surrender or cancel the policy for its cash surrender value; the right to designate and change the beneficiary of the death benefits; the right to elect and exercise any optional mode of settlement or dividend payment permitted by the Policy; and the sole right to obtain loans secured by the Policy or make withdrawals from the Policy.

It is further represented that on Date 5, a date after September 17, 2003, while Taxpayer A and Taxpayer B were alive, the Agreement was terminated. At the time Agreement was terminated, the Policy had a cash surrender value of zero. Immediately after the Agreement was terminated, as part of a negotiated agreement with the insurance company, the insurance company waived the surrender charges with respect to the Policy, and the Policy was exchanged by the life insurance company for a new policy (Policy 2), a fully paid up policy but with a significantly lower death benefit. The Trusts are listed as the joint owners of Policy 2 and each Trust is listed as the designated beneficiary of 25% of the proceeds.

As to estate tax issues, Letter Ruling 200728015 reasoned and ruled:

Any incidents of ownership in a life insurance policy held by the partnership are effectively held by the partners as individuals. Rev. Rul. 83-147,1983-2 C.B. 158.

In the instant case, Taxpayers did not retain any interests in the Trusts that would cause the corpus of the respective trusts to be included in the Taxpayers' gross estates under section 2036. Further, the Partnership held no incidents of ownership in the Policy under the terms of the Agreement, as described above. See, Rev. Rul. 79-129, 1979-1 C.B. 306. Thus, no incidents of ownership in the Policy or Policy 2 will be attributed to Taxpayers as a result of their ownership interest in the Partnership, nor would Taxpayers be treated as relinquishing any incidents of ownership in the Policy or Policy 2 for purposes of section 2035, if either Taxpayer was to die within three years of the termination of the Agreement on Date 5. No portion of Policy or Policy 2 will be includible in the gross estate of the second to die of Taxpayer A or Taxpayer B.

The collateral assignment that secured the Taxpayers' interest in Letter Ruling 200728015 gave all of the incidents of ownership to the Partnership, other than securing the Taxpayers' interest. This is referred to as a "bare bones" collateral assignment. I have been told that other "bare bones" collateral assignments were in Letter Rulings 9204041, 9511046, 9651030, 9709027, 9808024, 9848011, and 9318009.

Lee Slavutin suggests the following guidelines for drafting generational split dollar agreements:[4553]

1. Clearly state that the purpose of the split dollar agreement is to "fund a permanent life insurance policy for estate liquidity or business succession, for example."

2. Add a preliminary recital that the agreement is intended to qualify as an economic benefit arrangement under Reg. § 1.61-22 and that the ONLY benefit intended to be provided to the "donee" trust is life insurance protection.

3. Do NOT give the donee trust the right to borrow against the cash value.

4. At termination or death, make sure that the donor gets the GREATER of cash value or premiums paid.

5. The donor should be REQUIRED to pay all premiums. The donee has no obligation to pay premiums. If premiums are prepaid, there will be no additional benefit to the donee trust.

6. Do not mention the disposition of the receivable at death. Otherwise, it might be construed as an additional benefit to the donee trust.

II.Q.4.g. Income Tax Trap for Business-Owned Life Insurance

II.Q.4.g.i. Analysis of Code § 101(j)

Beware that an employer-owned life insurance contract might not qualify for the usual exclusion from regular income tax.[4554] An "employer-owned life insurance contract" (a term that applies to much more than one would think) does not receive the exclusion unless certain notice and consent requirements are met.[4555]

An "employer-owned life insurance contract" is a life insurance contract that (i) is owned by a person engaged in a trade or business and under which such person (or certain related party) is directly or indirectly a beneficiary under the contract, and (ii) covers the life of an insured who is an employee with respect to the trade or business of the applicable policyholder on the date the contract is issued.[4556] An "applicable policyholder" means, with respect to any employer-owned

[4553] A Post-*Morrissette* Roadmap for Drafting Intergenerational Split Dollar Agreements, *Steve Leimberg's Estate Planning Email Newsletter* - Archive Message #2414 (5/12/2016).
[4554] Code § 101(j).
[4555] Code § 101(j)(1), (2).
[4556] Code § 101(j)(3)(A).

life insurance contract, the person described in the preceding sentence who owns the contract[4557] at the time it is issued.[4558]

"Employee" includes a "highly compensated employee" under Code § 414(q),[4559] and Code § 414(q)(1)(A) pulls in people who own at least 5% of the company.[4560] Thus, an owner who is not an employee is an "employee" for purposes of this rule by being a 5% owner.[4561]

The notice and consent requirements are met if, before the issuance of the contract, the employee (A) is notified in writing that the applicable policyholder intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the contract was issued, (B) provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment, and (C) is informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable upon the death of the employee.[4562] The only way that this requirement makes any sense is if the policy was issued to the person treated as the insured's employer under these rules - this requirement would be impossible to satisfy if it was issued to the insured or someone else because the person treated as an employer might not even know about the policy. Thus, "applicable policyholder" should mean the person to whom the policy is issued when the insured is an "employee" of that person.[4563]

In addition to the notice and consent requirements, either the insured must have a qualifying relationship with the company or the death benefit must be put to certain uses:

[4557] Code § 101(j)(3)(B)(i).

[4558] The qualification at the time it is issued is not mentioned in any particular authority but appears to be implicit in the statutory scheme. See the text accompanying fn. 4563.

[4559] Code § 101(j)(5).

[4560] Code § 414(q)(1), "In general," provides:

> The term "highly compensated employee" means any employee who -
> (A) was a 5-percent owner at any time during the year or the preceding year, or
> (B) for the preceding year -
> (i) had compensation from the employer in excess of $80,000, and
> (ii) if the employer elects the application of this clause for such preceding year, was in the top-paid group of employees for such preceding year.
>
> The Secretary shall adjust the $80,000 amount under subparagraph (B) at the same time and in the same manner as under section 415(d), except that the base period shall be the calendar quarter ending September 30, 1996.

Notice 2018-83 provides that the $80,000 amount is $125,000 for 2019.

[4561] Notice 2009-48, A-8 provides:

> Section 101(j)(4) provides no exception that would excuse a wholly-owned corporation and its employee-owner from the notice and consent requirements that otherwise apply, nor can actual knowledge alone substitute for the statutory requirement that notice and consent be 'written.' Moreover, the requirement that notice and consent be written avoids factual controversies that otherwise could result where, for example, the sole owner of a corporation delegates financial matters to an employee.

[4562] Code § 101(j)(4).

[4563] Notice 2009-48, A-1, further below, clarifies that the person to whom this sentence refers generally is the entity that employs the insured rather than an owner of the entity and that the entity is treated as owning a policy owned by a grantor trust with respect to which the entity is the deemed owner.

- A qualifying relationship includes the insured being an employee, director, or 5% owner at any time during the 12-month period before the insured's death.[4564]

- Another qualifying relationship is if, when the contract is issued, the insured is a director, certain highly compensated employees, or a 5% owner.[4565] (Note that Code § 101(j) does not apply unless the insured is an employee with respect to the trade or business of the applicable policyholder when the contract is issued, so the concern for the qualifying relationship or qualifying use applies only when the insured is an employee who does not satisfy this bullet point when the contract is issued.)[4566]

- A qualifying use is being paid to a member of the family of the insured, any individual who is the designated beneficiary of the insured under the contract (other than the applicable policyholder), a trust established for the benefit of any such member of the family or designated beneficiary, or the estate of the insured.[4567]

- Another qualifying use is the purchase of an equity (or capital or profits) interest in the applicable policyholder from any person described in the preceding bullet point.[4568] Beware of the proceeds exceeding this use.

A life insurance-funded buy-sell agreement might be structured to comply with these rules, in case the parties forget to do the required notice and consent.[4569] It also would guard against

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[4564] Code § 101(j)(2)(A)(i). The reference to director comes from Code § 101(j)(5), and a 5% owner is described in the text accompanying fns. 4559-4561.

[4565] Code § 101(j)(2)(A)(ii). The reference to a 5% owner is described in the text accompanying fns. 4559-4561. The highly compensated employees are those described in Code § 414(q) (without regard to Code § 414(q)(1)(B)(ii)) or Code § 105(h)(5) (except that 35% is substituted for "25 percent" in Code § 105(h)(5)(C). Code § 414(q)(1) is reproduced in fn 4560 in part II.Q.4.g.i Analysis of Code § 101(j).

[4566] See text accompanying fns. 4556-4558.

[4567] Code § 101(j)(2)(B)(i). "Family member" refers to Code § 267(b)(4).

[4568] Code § 101(j)(2)(B)(ii).

[4569] One might consider provisions such as that found in part II.Q.4.g.ii Consent Integrated into Operating Agreement. The sample is an attempt to be a catch-all in case clients do not follow the recommended procedure. Letter Ruling 201217017 approved what appears to have been a similar provision in a corporate buy-sell agreement:

> … the Agreement provides that Taxpayer will obtain life insurance on the life of each Shareholder, and that Taxpayer will be the owner and beneficiary of such life insurance. If the Agreement is terminated, or a Shareholder disposes of his interest in Taxpayer as allowed by the Agreement, a Shareholder has the right to purchase from Taxpayer any Taxpayer-owned life insurance covering his life. If the life insurance was not purchased, Taxpayer retained the right to surrender or otherwise dispose of the life insurance.

The ruling concluded:

> …considering all of Taxpayer's documentation as a whole, for the Contracts listed in the Appendix, all of the requirements of § 101(j)(4) were met before the issuance of the Contracts:
>
> a) through the Agreement and the Application, each Shareholder was notified in writing that Taxpayer intended to insure the Shareholder's life;
>
> b) through the Application, each Shareholder was notified in writing of the maximum face amount for which the Shareholder could be insured at the time the Contract was issued, in dollars;
>
> c) by signing both the Agreement and the Application, each Shareholder consented to being insured under the Contract;

error in my suggestion that "applicable policyholder" is limited to being the person to whom the policy is issued when the insured is an "employee" of that person.

These rules impose various notice and other requirements that in most cases will not be a practical obstacle to implementing buy-sell agreements if signed before the application is signed.[4570] The employer might be able to cure a failure before the due date of its return for the year in which the policy was issued if the insured has not died yet.[4571] Another cure would be to transfer the policy to the insured, then the insured transfers the policy back to the company (generally, transfers from the insured to the company are not subject to the rule, except with respect to increases in coverage);[4572] step transaction concerns might suggest that the insured transfer the policy into a life insurance LLC[4573] instead of waiting long enough (whatever that means) to avoid an assertion of the step transaction doctrine.

The proposed policy owner should obtain the insured's written consent before the life insurance application is signed.

Consider having the maximum face amount in that consent provide a cushion in excess of the largest amount that the parties can conceive of that death benefit being (including increased death benefits due to investing the cash value very successfully).

An insurance agent might provide such a consent form, which counsel should consider reviewing, or counsel could provide his/her own consent form to the client. Although some agents understand these issues, many agents do not know (or think they know but actually

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d) by signing the Agreement, each Shareholder consented that such coverage may continue after the Shareholder terminates employment; and

e) through the Agreement and the Application, each Shareholder was informed in writing that Taxpayer will be a beneficiary of any proceeds payable upon the death of the Shareholder.

[4570] Leimberg and Zaritsky, IRS Provides New and Substantial Guidance on Employer-Owned Life Insurance, 36 *Estate Planning*, No. 8, 3 (August 2009).

[4571] Notice 2009-48, A-13 provides:

> Section 101(j) does not contain a provision for correcting an inadvertent failure to satisfy the notice and consent requirements of § 101(j)(4). The Service will not, however, challenge the applicability of an exception under § 101(j)(2) based on an inadvertent failure to satisfy the notice and consent requirements if the following conditions are met: (1) the applicable policyholder made a good faith effort to satisfy those requirements, such as by maintaining a formal system for providing notice and securing consents from new employees; (2) the failure to satisfy the requirements was inadvertent; and (3) the failure to obtain the requisite notice and consent was discovered and corrected no later than the due date of the tax return for the taxable year of the applicable policyholder in which the employer-owned life insurance contract was issued. Because § 101(j)(4)(B) requires that the employee's consent be written, failure to obtain such consent cannot be corrected after the insured employee has died.

[4572] Notice 2009-48, Q/A-8 provides:

> Q-8. Is notice and consent required with regard to an existing life insurance contract that an employee irrevocably transfers to an employer?
>
> A-8. No. The actual transfer of an existing life insurance contract by an employee to an employer is sufficient to satisfy the requirements that the employee be notified in writing of the intention to insure and the maximum face amount of insurance, that written consent be secured, and that the employee be notified that the employer will be a beneficiary upon his or her death. In the event the employer subsequently increases the face amount of the contract, however, written notice and consent must be secured to establish the requisite notice to the employee and consent to the new face amount.

[4573] See part II.Q.4.i Life Insurance LLC.

misunderstand) these rules. Accordingly, tax advisors should consider warning their clients that the tax advisors need to be involved <u>before</u> any policy is issued.

Every applicable policyholder owning one or more employer-owned life insurance contracts issued after August 17, 2006 is required to file IRS Form 8925 each year.[4574] "Applicable policyholder" and "employer-owned life insurance contract" are defined for purposes of this reporting rule the same way they are for determining whether a policy is subject to the notice and consent rules.[4575]

These rules for life insurance contracts issued or materially changed after August 17, 2006.[4576] Notice 2009-48 elaborates on the rules described above, as well as providing rules for what constitutes a material modification,[4577] including guidance on tax-free exchanges.[4578]

As to buy-sell agreements, Notice 2009-48 provides that a contract that is owned by the owner of an entity engaged in a trade or business (such as for purposes of financing the purchase of an equity interest of another owner – in other words, a cross-purchase - is not subject to these rules.[4579] However, if the business owns it,[4580] the following rules apply (emphasis added):[4581]

[4574] Code § 6039I(a) is the general reporting requirement, and Reg. § 1.6039I-1 specifies the form.

[4575] Code § 6039I(c).

[4576] P.L. 109-280, Sec. 863(a). Changing a split-dollar agreement without changing the underlying policy will not constitute a material modification under Code § 101(j), although it might very well affect other tax treatment. Notice 2008-42, discussed in part II.Q.4.f.i Split-Dollar Generally, especially the text accompanying fns. 4455-4457.

[4577] Notice 2009-48, A-14 provides:

> The following changes are not treated as material changes for purposes of determining whether an existing contract is treated as a new contract for purposes of § 101(j): (1) increases in death benefit that occur as a result of either the operation of § 7702 or the terms of the existing contract (provided the insurer's consent to the increase is not required); (2) administrative changes; (3) changes from general account to separate account or from separate account to general account; or (4) changes as a result of the exercise of an option or right granted under the contract as originally issued. Thus, for example, a death benefit increase does not cause a contract to be treated as a new contract if the increase is necessary to keep the contract in compliance with § 7702, or if the increase results from the application of policyholder dividends to purchase paid-up additions, or if the increase is the result of market performance or contract design with regard to a variable contract. Notice and consent are required if a contract is treated as a new contract by reason of a material increase in death benefit or other material change, unless a valid consent remains in effect with regard to the insured.

[4578] Notice 2009-48, A-15 provides:

> Section 863(d) of the PPA provides that § 101(j) generally does not apply to a contract issued after August 17, 2006 in an exchange described in § 1035 for a contract issued on or before that date. Section 863(d) also provides that, for purposes of determining when a contract is issued, a material increase in the death benefit or other material change generally causes the contract to be treated as a new contract. A § 1035 exchange that results in a material increase in death benefit or other material change (other than a change in issuer) is treated as the issuance of a new contract after August 17, 2006 for purposes of determining whether § 101(j) applies to the contract.

[4579] A-1.

[4580] Including through a grantor trust that the business established, per A-1.

[4581] After A-3 and before Q-4.

Exceptions to the Application of § 101(j)(1)

Section 101(j)(2) provides several exceptions to the application of § 101(j)(1), ***provided the notice and consent requirements of § 101(j)(4) are met***. Specifically, under § 101(j)(2)(A), § 101(j)(1) does not apply if the insured either was an employee at any time during the 12-month period before death, or was a director, highly compensated employee or highly compensated individual, as defined, at the time the contract was issued. Under § 101(j)(2)(B), § 101(j)(1) does not apply to any amount received by reason of the death of an insured to the extent the amount is paid to or used to purchase an equity (or capital or profits) interest from a family member of the insured, an individual who is a designated beneficiary, a trust established for the benefit of a family member or designated beneficiary, or the estate of the insured.

If plans do change, the Notice allows consent to be given before the death benefit exceeds the amount shown in the consent. The Notice also provides for a change in the employer.

The Notice further provides:

Q-1. Can a contract be an employer-owned life insurance contract if it is owned not by a person engaged in a trade or business, but by a related person who is not engaged in a trade or business?

A-1. No. A contract is an employer-owned life insurance contract only if it is owned by a person engaged in a trade or business and is otherwise described in § 101(j)(3). Thus, a contract that is owned by the owner of an entity engaged in a trade or business (such as for purposes of financing the purchase of an equity interest of another owner), or by a qualified plan or VEBA that is sponsored by an entity engaged in a trade or business, is not an employer-owned life insurance contract. A contract, however, that is owned by a grantor trust (such as a rabbi trust), assets of which are treated as assets of a grantor that is engaged in a trade or business, is an employer-owned life insurance contract if the contract is otherwise described in § 101(j)(3).

Q-2. Can a contract be an employer-owned life insurance contract if it is subject to a split dollar arrangement?

A-2. Yes. A contract that is subject to a split dollar arrangement is an employer-owned life insurance contract if the contract is owned by a person engaged in a trade or business and is otherwise described in § 101(j)(3). See § 1.61-22(c)(1) (defining the owner of a contract subject to a split dollar arrangement to be the person named as the policy owner of the contract). Under § 101(j)(2)(B), however, the general rule of § 101(j)(1) does not apply to the extent any amount received by reason of the death of the insured is paid to a family member of the insured, an individual who is a designated beneficiary, a trust established for the benefit of a family member or designated beneficiary.

Q-3. Is a contract an employer-owned life insurance contract if it is owned by a partnership or sole proprietorship that is engaged in a trade or business; the partnership or sole proprietorship is directly or indirectly a beneficiary under the contract; and, the contract covers the life of an insured who is an employee with respect to the trade or business on the date the contract is issued?

A-3. Yes. If a life insurance contract is otherwise described in § 101(j)(3), ownership of the contract by a partnership or sole proprietorship does not prevent the contract from being treated as an employer-owned life insurance contract. A life insurance contract that is owned by a sole proprietor on his or her own life is not, however, an employer-owned life insurance contract.

Q-4. Under § 101(j)(2)(A) and (j)(4), when is a contract treated as "issued" for purposes of determining whether the notice and consent are timely, or whether the insured is a director, a highly compensated employee, or a highly compensated individual at the time the contract is issued?

A-4. Generally, the issue date of a contract is the date on the policy assigned by the insurance company, which is on or after the date the application was signed. Solely for purposes of § 101(j)(2)(A) and (j)(4), an employer-owned life insurance contract is treated as "issued" on the later of (1) the date of application for coverage, (2) the effective date of coverage, or (3) the formal issuance of the contract. Thus, if an employer-owned life insurance contract is effective for a limited period of time before formal issuance of the contract (such as to complete underwriting), the notice and consent requirements may be satisfied during the period between the effective date of coverage and formal issuance of the contract. In addition, an employer-owned life insurance contract may be treated as a new contract, and thus newly "issued," by reason of a material increase in death benefit or other material change in the contract. See A-14, this Notice.

Q-5. For purposes of § 101(j), is the term "employee" limited to common law employees?

A-5. No. Section 101(j)(5)(A) provides that the term "employee" includes an officer, director, and highly compensated employee (within the meaning of § 414(q)). A director is an independent contractor in his or her capacity as a director.

Section 414(q) contains special rules relating to certain former employees and self-employed individuals. For example, a former employee is treated as a highly compensated employee (within the meaning of § 414(q)) if the individual was a highly compensated employee when he separated from service, or was a highly compensated employee at any time after attaining age 55. In addition, the term "employee" for purposes of § 414(q) includes an individual who is a self-employed individual who is treated as an employee pursuant to § 401(c)(1).

Although policies used to fund redemptions are subject to the notice and consent rules if the insured is either an employee or holds at least 5% ownership, an exception applies if and to the extent that the company uses the policy to redeem the insured's stock shortly after death:

A-6. In order to know whether an amount received as a death benefit under an employer-owned life insurance contract is eligible for exclusion from gross income under § 101(a), or is ineligible for exclusion under the general rule of § 101(j)(1), it is necessary to determine the availability of the exception for amounts used to purchase an equity (or capital or profits) interest in the applicable policyholder. Accordingly, an amount must be so paid or used by the due date, including extensions, of the tax return for the taxable year of the applicable policyholder in which the applicable policyholder is treated as receiving a death benefit under the contract.

I insist on notice and consent - even for redemption arrangements - because the purchase might not be completed within that deadline, the parties might later all agree that the money would be better used in the business, or the death benefit might exceed the purchase price.

II.Q.4.g.ii. Consent Integrated into Operating Agreement

As with any sample, consultation with a qualified tax advisor and a lawyer are required before using the sample below. See fn. 4569 for authority for relying on such a provision; however, I recommend obtaining a separate notice and consent for more direct evidence to show the IRS. The rest of this part II.Q.4.g.ii is the sample:

The Company or Members may from time to time obtain life insurance policies on the lives of the Members. In the event those policies fall within the definition of "employer-owned life insurance policies" as defined in Code section 101(j), it is intended that the policies qualify for an exclusion from those rules (and thus the proceeds will be income tax-free) and that this Operating Agreement comply with the notice and consent requirements necessary to obtain that exclusion. Therefore, each Member is hereby given written notice that the Company or Members intend to insure his or her life by purchasing life insurance policy(ies) in the maximum face amount of $___________, and that the Company or Members will be the owner and beneficiary of that policy and of any proceeds payable on such Member's death. Each Member (by signing this Operating Agreement) hereby gives advance written consent to being insured under such policy(ies) and to the continuation of the policy(ies) after such Member ceases to have an Interest in the Company or otherwise terminates employment (as defined in Code section 101(j)(4)(B)) with the Company (and no inference is intended that a Member is an "employee" for any purposes other than the possible application of Code section 101(j)). The Members also agree to enter into a specific notice and consent containing these terms with regard to each policy obtained before the issuance of that policy.

II.Q.4.g.iii. Consent for Owner Who Is Not an Employee

As mentioned in part II.Q.4.g.i, a person owning at least 5% of a company is treated as an employee for purposes of this rule, even if that person not an employee. The rest of this part II.Q.4.g.iii is a sample. As with any sample, consultation with a qualified tax advisor and a lawyer are required before using the sample below.

Notice and Consent

For _____ Owner

Under I.R.C. Section 101(j)(4)

I acknowledge notification that ______________ (the "Employer") intends to obtain a policy insuring my life with a maximum face amount of $_______. Although the Employer does not employ me, I understand that my ownership in the Employer makes me considered an "employee" for purposes of I.R.C. Section 101(j). Therefore:

(A) I acknowledge that the Employer intends to insure my life regarding the death benefits listed in the attached schedule.

(B) I consent to being insured under these contracts and that such coverage may continue after I no longer own an interest in the Employer or otherwise terminate employment.

(C) I understand that the Employer will be a beneficiary of any proceeds payable upon my death.

[add signature line and date, dated on before policy issuance]

II.Q.4.g.iv. Consent for an Employee

The rest of this part II.Q.4.g.iv is a sample. As with any sample, consultation with a qualified tax advisor and a lawyer are required before using the sample below.

Notice and Consent

For _______ Employee

Under I.R.C. Section 101(j)(4)

I acknowledge notification that ____________ (the "Employer") intends to obtain a policy insuring my life with a maximum face amount of $_______, and:

(A) I acknowledge that the Employer intends to insure my life regarding the death benefits listed in the attached schedule.

(B) I consent to being insured under these contracts and that such coverage may continue after I terminate employment.

(C) I understand that the Employer will be a beneficiary of any proceeds payable upon my death.

[add signature line and date, dated on before policy issuance]

II.Q.4.h. Establishing Estate Tax Values

For estate tax purposes, fair market value is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[4582] If a decedent owns voting and nonvoting shares, the shares are valued together as a single block.[4583]

Suppose a company is worth $4M and A owns 75% of the company. Perhaps A's estate would want to be bought out for $3M, which is 75% of $4M.

Suppose the company then buys a $3M policy insuring A's life, so it could buy A's interest when A dies. On A's death, however, the company is worth $7M – the sum of its $4M normal value and $3M of life insurance. Should the company have to pay 75% of $7M for A's interest, because of this life insurance? That higher price certainly would not honor the parties' intent. If

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[4582] Reg. § 20.2031-1(b). Rev. Rul. 59-60 and its progeny discuss valuation principles.
[4583] *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981).

the parties agree that A's estate gets $3M instead of 75% of $7M, does that mean that A has bequeathed the difference to the company's other owners? Imposing estate tax on A's estate for money that the estate will never receive is certainly an unfair result. On the other hand, if the company's other owner was A's son or some other natural object of A's bounty, then perhaps A's goal was essentially to bequeath the difference to that other owner. In the latter case, A's estate should pay estate tax on the difference and – depending on A's intent – perhaps recover the extra estate tax from that other owner.

How does the estate tax system differentiate between these situations? Regarding buy-sell agreements, Reg. § 20.2031-2(h), "Securities subject to an option or contract to purchase," provides:

> Another person may hold an option or a contract to purchase securities owned by a decedent at the time of his death. The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime. Such is the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death. Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. See section 2703 and the regulations at § 25.2703 of this chapter for special rules involving options and agreements (including contracts to purchase) entered into (or substantially modified after) October 8, 1990.

Thus, a buy-sell or similar agreement must apply during a decedent's life as well as after death before it might be given effect. Recent cases have reaffirmed this requirement.[4584] If a buy-sell agreement is held to have testamentary intent rather than a legitimate business purpose, a bargain sale may constitute a gift.[4585]

Reg. § 20.2031-2(h) is not the only hurdle. For purposes of gift, estate and GST tax, Code § 2703(a) provides that the value of any property shall be determined without regard to:

[4584] *True v. Commissioner*, 390 F.3d 1210 (10th Cir. 2004); *Estate of Blount*, T.C. Memo. 2004-116, *aff'd* in part, *rev'd* in part, 428 F.3d 1338 (11th Cir. 2005) (life insurance included in valuing company, but the Eleventh Circuit treated the buy-sell obligation as offsetting the inclusion); *Smith III v. U.S.*, 96 A.F.T.R.2d 2005-6549 (W.D. Pa. 2005). In a case citing *True* but taking an unusual tack, in *Huber v. Commissioner*, T.C. Memo. 2006-96, the IRS tried to use a buy-sell agreement against a taxpayer, but Judge Goeke ruled that a right of first refusal in the agreement did not increase the value of the subject stock. Not mentioned in the Huber opinion is that, according to one of the taxpayer's counsel, prior gift tax audits had accepted the taxpayer's appraisals or settled very close to it, so the IRS' posture was radically different than before. In *Estate of Cartwright v. Commissioner*, 183 F.3d 1034 (9th Cir. 1999), *aff'g* in part and *rev'g* in part T.C. Memo. 1996-286, life insurance proceeds did not increase the value of the decedent's interest in the law firm to which he had belonged, except as necessary to take into account advanced client costs and work in process pursuant to the buy-sell agreement.

[4585] See quote from *Estate of Lauder v. Commissioner*, T.C. Memo. 1994-527, in the text preceding fn 3790 in part II.O.2.c Effect of Buy-Sell Agreement on Marital Deduction.

(1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or

(2) any restriction on the right to sell or use such property.

Thus, when a parent transfers an equity interest to a child pursuant to a legally binding stock option or buy-sell agreement, generally for gift, estate and GST tax purposes the parent is deemed to make a taxable transfer to the extent that the equity interest's value exceeds the payment under that agreement. Reg. § 25.2703-1(a)(3) provides:

> A right or restriction may be contained in a partnership agreement, articles of incorporation, corporate bylaws, a shareholders' agreement, or any other agreement. A right or restriction may be implicit in the capital structure of an entity.

A waiver of the right to partition art was disregarded under Code § 2703(a)(2).[4586]

However, Code § 2703(b) provides that Code § 2703(a) does not apply to any option, agreement, right, or restriction which meets each of the following requirements:

(1) It is a bona fide business arrangement.[4587]

[4586] *Elkins v. Commissioner*, 140 T.C. No. 5 (2013).

[4587] *Holman v. Commissioner*, 130 T.C. 170 (2008) held:

> We believe that [the transfer restrictions] were designed principally to discourage dissipation by the children of the wealth that Tom and Kim had transferred to them by way of the gifts. The meaning of the term bona fide business arrangement in section 2703(b)(1) is not self-apparent. As discussed supra, in *Estate of Amlie v. Commissioner*, T.C. Memo. 2006-76, we interpreted the term bona fide business arrangement to encompass value-fixing arrangements made by a conservator seeking to exercise prudent management of his ward's minority stock investment in a bank consistent with his fiduciary obligations to the ward and to provide for the expected liquidity needs of her estate. Those are not the purposes of [the transfer restrictions]. There was no closely held business here to protect, nor are the reasons set forth in the Committee on Finance report as justifying buy-sell agreements consistent with petitioners' goals of educating their children as to wealth management and disincentivizing them from getting rid of Dell shares, spending the wealth represented by the Dell shares, or feeling entitled to the Dell shares.

The court had cited this portion of the legislative history (an informal report of the Senate Committee on Finance):

> [Buy-sell agreements] are common business planning arrangements … that … generally are entered into for legitimate business reasons…. Buy-sell agreements are commonly used to control the transfer of ownership in a closely held business, to avoid expensive appraisals in determining purchase price, to prevent the transfer to an unrelated party, to provide a market for the equity interest, and to allow owners to plan for future liquidity needs in advance….

The Eighth Circuit affirmed, 601 F.3d 763 (2010):

> Here that context shows that the Tax Court correctly assessed the personal and testamentary nature of the transfer restrictions. Simply put, in the present case, there was and is no business, active or otherwise. The donors have not presented any argument or asserted any facts to distinguish their situation from the use of a similar partnership structure to hold a passbook savings account, an interest-bearing checking account, government bonds, or cash. We and other courts have held that maintenance of family ownership and control of [a] business may be a bona fide business purpose. *St. Louis County Bank*, 674 F.2d at 1207; see also *Estate of Bischoff v. Commissioner*, 69 T.C. 32,

39–40 (1977). We have not so held, however, in the absence of a business. [footnote described below]

That is not to say we necessarily believe it will always be easy to apply § 2703(b)(1) or that investment-related activities cannot satisfy the subsection (b)(1) test. When the restrictions at issue, however, apply to a partnership that holds only an insignificant fraction of stock in a highly liquid and easily valued company with no stated intention to retain that stock or invest according to any particular strategy, we do not view this determination as difficult. See, e.g., *Higgins v. Commissioner*, 312 U.S. 212, 217–18 (1941) (holding in another context that merely keeping records and collecting interest and dividends did not amount to carrying on a business); *Estate of Thompson v. Commissioner*, 382 F.3d 367, 380 (3d Cir. 2004) (Other than favorable estate tax treatment resulting from the change in form, it is difficult to see what benefit could be derived from holding an untraded portfolio of securities in this family limited partnership with no ongoing business operations.).

In footnote 3 discussing the *St. Louis County Ban*k case, 674 F.2d 1207 (8th Cir. 1982), the court pointed out:

In *St. Louis County Bank*, for example, the transferred interests were shares in a family company that had started out as a moving, storage, and parcel-delivery business and evolved into a real estate management company. *St. Louis Bank*, 674 F.2d at 1208–09. When engaged in the moving and storage business, the company had created a stock-purchase agreement based on a valuation formula keyed to income. *Id*. At 1209. Later, the family exited the moving and storage business but kept the business structure as a vehicle for renting real estate. *Id*. With this new activity, the formula resulted in a dramatically lower value. *Id*. We stated, We have no problem with the District Court's findings that the stock-purchase agreement provided for a reasonable price at the time of its adoption, and that the agreement had a bona fide business purpose—the maintenance of family ownership and control of the business. Courts have recognized the validity of such a purpose. *Id*. at 1210.

Judge Beam offered a strong dissent:

Here, the Tax Court made the express factual determination that the partnership agreement restrictions were designed principally to protect family assets from dissipation by the Holman daughters. *Holman*, 130 T.C. at 195 (emphasis added). In other words, the Tax Court determined that the restrictions were designed primarily to serve a non-tax purpose. Notably, the Tax Court did not find that the Holmans merely paid lip service to legitimate business purposes for the restrictions while, in reality, using the restrictions for the primary purpose of avoiding taxes. [footnote omitted] Additionally, the Tax Court did not find that the restrictions failed to match the partnership's legitimate, non-tax goals. [footnote omitted] The underlying purposes of § 2703 are not served where, as here, the bona fide business arrangement test is applied in a manner that discourages partners in family partnerships from creating restrictions principally to achieve non-tax, economic goals. Thus, I would hold that the Holman partnership agreement restrictions are bona fide business arrangements because they were not created for the primary purpose of avoiding taxes, and they served the following legitimate business purposes: (1) maintaining family control over the right to participate as a limited partner; (2) maintaining family control over the right to receive income from the partnership's investment assets; (3) protecting partnership assets from creditors and potential future ex-spouses; and (4) preserving the partners' fundamental right to choose who may become a partner.

…Under § 2703(b)(3)'s comparable terms test, the Holman partnership restrictions' terms must be comparable to similar arrangements entered into by persons in an arms' length transaction. While the Tax Court did not decide whether the restrictions satisfied the comparable terms test, it noted that both parties' experts agree that transfer restrictions comparable to those found in [the Holman partnership agreement] are common in agreements entered into at arm's length. [footnote omitted] Holman, 130 T.C. at 198–99. The Tax Court explained that this would seem to be all that [the Holmans] need to show to satisfy section 2703(b)(3). Id. at 199. I agree, and I would hold that the Holman partnership restrictions satisfy § 2703(b)(3)'s comparable terms test. Thus, because the partnership restrictions satisfy all three of § 2703(b)'s tests, I would reverse and remand to the Tax Court for a valuation of the limited partnership interests that does not disregard the partnership restrictions.

The U.S. District Court for the Southern District of Indiana, following *Holman*, held that holding undeveloped land did not constitute a business that could qualify for the Code § 2703 safe harbor. *Fisher*

(2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.[4588]

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v. U.S., 106 A.F.T.R.2d 2010-6144. The court later ruled that the taxpayer could not introduce into evidence the discounts that the IRS had used on audit, ruling that the IRS' audit determination was irrelevant to determining the actual value. 106 A.F.T.R.2d 2010-6144.

For an in-depth discussion of the facts of some of these cases, see Aghdami, Mancini, & Zaritsky, *Structuring Buy-Sell Agreements*, ¶ 6.02[4] Restriction on Lifetime Transfer.

[4588] Judge Beam's dissent in *Holman v. Commissioner*, 601 F.3d 763 (2010), argued that "decedent" in Code § 2703(b)(2) means it does not apply to gifts:

> Having determined that the partnership restrictions satisfy § 2703(b)(1), I now turn to § 2703(b)(2)'s device test. Under this test, the Holman partnership restrictions must not be a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth. I.R.C. § 2703(b)(2) (emphasis added). Treasury Regulation § 25.2703-1(b)(1)(ii) excises the phrase members of the decedent's family found in § 2703(b)(2) and substitutes in its place the phrase natural objects of the transferor's bounty, apparently because the Secretary of the Treasury interprets § 2703(b)(2) to apply to both inter vivos transfers and transfers at death. Holman, 130 T.C. at 195–96. Applying this regulation, the Tax Court held that the Holman partnership restrictions operate as a device to transfer property to the natural objects of the Holmans' bounty. The Holmans argue that Treasury Regulation § 25.2703-1(b)(1)(ii) is invalid because it fails to give effect to § 2703(b)(2)'s plain language. I agree. [discusses Chevron deference] The parties primarily dispute whether § 2703(b)(2) is ambiguous. The Holmans assert that the term decedent unambiguously refers to a deceased person and, therefore, § 2703(b)(2) asks only whether restrictions operate as a device to transfer property to family members at death. The Holmans point out that only the term decedent, not the broader term transferor, is used throughout § 2703(b)(2)'s legislative history. Conversely, the Commissioner argues that the term decedent is ambiguous due to § 2703's location in the Internal Revenue Code. Specifically, § 2703 is located in Subtitle B of the Code, which includes three transfer taxes—the estate, gift and generation-skipping transfer taxes. More precisely, § 2703 is located in Subtitle B, Chapter 14. In Chapter 14, § 2703 joins a set of special valuation rules targeting transfer tax avoidance schemes. It is clear that the phrase members of the decedent's family unambiguously limits § 2703(b)(2)'s application to transfers at death. First, the term decedent is itself unambiguous. *Black's Law Dictionary* 465 (9th ed. 2009) plainly defines decedent as [a] dead person. Moreover, the phrase members of decedent's family is not ambiguous when read in the greater context of Chapter 14. While Congress used the term decedent in § 2703(b)(2), it used the broader term transferor in Chapter 14's other valuation statutes. See I.R.C. §§ 2701(a)(1) & 2702(a)(1). And, as the Holmans point out, the term decedent consistently appears in § 2703(b)(2)'s legislative history. Finally, I find it telling that members of Congress have failed in their attempts to amend § 2703(b)(2) by substituting the legislative phrase members of the decedent's family with the Commissioner's phrase natural objects of the transferor's bounty. See *Smith v. United States*, No. C.A. 02-264 ERIE, 2004 WL 1879212, at 6 n.3 (W.D. Pa. June 30, 2004). Thus, although Congress enacted Chapter 14 to generally address transfer tax avoidance schemes, § 2703(b)(2) applies specifically to transfers at death. Therefore, Treasury Regulation § 25.2703-1(b)(1)(ii) is invalid because it does not give effect to the plain language of § 2703(b)(2). Since the Holmans are living persons, they are, by definition, not decedents and § 2703(b)(2)'s device test is satisfied.

Kress v. U.S., 123 AFTR 2d 2019-1224 (E.D. Wis. 3/26/2019), held that Code § 2703(b)(2) does not apply to gifts (highlighting added):

> Under the second requirement, the Restriction cannot be "a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth." § 2703(b)(2). Citing Treasury Regulation § 25.2703–1, the Government contends that this second requirement applies not only to transfers at death but also to inter vivos transfers. See 26 C.F.R. § 25.2703–1(b)(1)(ii) ("The right or restriction is not a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration in money or money's worth."). The Government argues that the term "decedent" in § 2703(b)(2) is ambiguous in

(3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

One way to satisfy this exception is if the entity is not family owned, using Code § 2701 principles:[4589]

> A right or restriction is considered to meet each of the three requirements … if more than 50 percent by value of the property subject to the right or restriction is owned directly or indirectly (within the meaning of § 25.2701-6) by individuals who are not members of the transferor's family. In order to meet this exception, the property owned by those individuals must be subject to the right or restriction to the same extent as the property owned by the transferor. For purposes of this section, members of the transferor's family include the persons described in § 25.2701-2(b)(5) and any other individual who is a natural object of the transferor's bounty. Any property held by a member of the transferor's family under the rules of § 25.2701-6 (without regard to § 25.2701-6(a)(5)) is treated as held only by a member of the transferor's family.

If the entity does not satisfy this non-family-controlled test, then one must satisfy each of the above three exceptions separately. The Code § 2703(b)(3) comparability test, which is the main test that Code § 2703 added to pre-1990 law, uses the following principles:[4590]

(i) In general. A right or restriction is treated as comparable to similar arrangements entered into by persons in an arm's length transaction if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm's length. A right or restriction is considered a fair bargain among unrelated parties in the same business if it conforms with the general practice of unrelated parties under negotiated agreements in the same

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light of the statute's place within Subtitle B, Chapter 14 of the Internal Revenue Code, which includes other valuation rules targeting transfer avoidance schemes, and thus the court should defer to the agency's interpretation of the statute.…

Although Chapter 14 is intended to generally address transfer tax avoidance schemes, it is clear from the statute itself that the phrase "members of the decedent's family" unambiguously limits its application to transfers at death. See Black's Law Dictionary (10th ed. 2014) (defining "decedent" as a "dead person, especially one who has died recently"); see also *Smith v. United States*, No. C.A. 02-264 ERIE, 2004 WL 1879212, at *6 (W.D. Pa. June 30, 2004) (noting that "one of Congress's primary concerns [in enacting § 2703(b)(2)] was the free passage of wealth to family members through a device that is testamentary in nature"). Although Congress has attempted to amend § 2703(b)(2) to conform with the agency regulations, no such legislation has been enacted. See *Smith*, 2004 WL 1879212, at *6 n.3 (citing HR Conf. Rep. 1555, 102d Cong., 1st Sess. (1991); The Revenue Bill of 1992, HR Conf. Rep. 11, 102d Cong., 2d Sess. (1992)); see also *Holman*, 601 F.3d at 781 (Bean, J., dissenting) ("I find it telling that members of Congress have failed in their attempts to amend § 2703(b)(2) by substituting the legislative phrase `members of the decedent's family' with the Commissioner's phrase `natural objects of the transferor's bounty.'").

In short, I find that Congress has spoken unambiguously to the precise question at issue: § 2703(b)(2) applies specifically to transfers at death. Because Plaintiffs gifted their shares to their family members as living persons, they are, by definition, not decedents. Therefore, § 2703(b)(2) is satisfied. But even were I to conclude that § 2703(b)(2) does apply to inter vivos transfers, this would not change the result. For as noted above, the family transfer restrictions serve the bona fide purpose of maintaining family ownership and control of the business, and were not intended as a tax avoidance device.

[4589] Reg. § 25.2703-1(b)(3).

[4590] Reg. § 25.2703-1(b)(4).

business. This determination generally will entail consideration of such factors as the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the arrangement, and the adequacy of any consideration given in exchange for the rights granted.

(ii) Evidence of general business practice. Evidence of general business practice is not met by showing isolated comparables. If more than one valuation method is commonly used in a business, a right or restriction does not fail to evidence general business practice merely because it uses only one of the recognized methods. It is not necessary that the terms of a right or restriction parallel the terms of any particular agreement. If comparables are difficult to find because the business is unique, comparables from similar businesses may be used.

The Tax Court, convinced that the taxpayer's buy-sell agreement was arrived upon in a manner intended to arrive at fair market value, applied the comparability test in *Estate of Amlie*:[4591]

> For the reasons discussed below, we conclude that the estate has satisfied section 2703(b)(3). By its terms, the statute requires only a showing that the agreement's terms are "comparable" to similar arrangements entered at arm's length. While the regulations caution against using "isolated comparables", we believe that in context the regulations delineate more of a safe harbor than an absolute requirement that multiple comparables be shown.

Even if the above rules are not complied with, obligations do tend to affect a stock's marketability,[4592] in that they cloud the business' future operations.[4593] In reversing the Tax Court,[4594] *Estate of Blount*, 428 F.3d 1338 (11th Cir. 2005) held:

> To establish the fair market value of BCC, the Tax Court blended the analyses of the experts to arrive at a value of $6.75 million. The IRS and the Taxpayer, albeit alternatively, agree that this is the base value for the assets and liabilities of BCC as of the date of Blount's death. We accept the accuracy of this value as not clearly erroneous. The Tax Court then added the insurance proceeds that BCC would receive on Blount's death to the value of the company, concluding that the value of BCC would have been $9.85 million. In doing so, the Tax Court erred.
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> In valuing the corporate stock, "consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent that such nonoperating assets have not been taken into account in the determination of net worth." Treas. Reg. § 20.2031-2(f)(2). The limiting phrase, "to the extent that such nonoperating assets have not been taken into account," however, precludes the inclusion of the insurance proceeds in this case. In *Cartwright v. Commissioner*, the Ninth Circuit approved deducting the insurance proceeds from the value of the organization when they were offset by an obligation to pay those proceeds

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[4591] T.C. Memo. 2006-76.

[4592] Rev. Rul. 77-287 explains valuation adjustments due to stock being restricted from resale pursuant to Federal securities laws.

[4593] *True v. Commissioner*, 390 F.3d 1210 (10th Cir. 2004), citing *Estate of Lauder v. Commissioner*, T.C. Memo. 1994-527, for the concept that, even if a provision does not bind the IRS as to estate tax value, it can still affect its value.

[4594] T.C. Memo. 2004-116.

to the estate in a stock buyout. 183 F.3d 1034, 1038] (9th Cir. 1999)[5] ; see also *Huntsman v. Comm'r*, 66 T.C. 861, 875 (1976)[6].

[5] The Ninth Circuit observed that the Tax Court "properly determined that [the] insurance policy would not necessarily affect what a willing buyer would pay for the firm's stock because it was offset dollar-for-dollar by [the] obligation to pay out the entirety of the policy benefit's to [the] estate." *Cartwright*, 183 F.3d at 1038.

[6] The Tax Court focused on the word "consideration" to make its judgment about including life insurance proceeds: "The Commissioner argues that our interpretation of section 20.2031-2(f), Estate Tax Regs., frustrates the clear intent of Congress to include corporate-owned life insurance in the estate of its sole shareholder. See H. Rept. No. 2333, 77th Cong., 1st Sess. (1942), 1942-2 C.B. 372, 491; S. Rept. No. 1631, 77th Cong., 2d Sess. (1942) 1942-2 C.B. 504, 677. However, the statements in the legislative history relied upon by the Commissioner indicate only that Congress believed that a sole shareholder was deemed to have the incidents of ownership possessed by his corporation on insurance policies on his life. The regulations now provide that the incidents of ownership held by a corporation are not to be attributed to its shareholder, and no indication is included in the committee reports that Congress intended property owned by a decedent to be includable in his gross estate at other than its fair market value. Consequently, our interpretation of such section does not frustrate a congressional intent. In accordance with section 20.2031-2(f), Estate Tax Regs., we must determine the fair market value of the decedent's stock in the two corporations by applying the customary principles of valuation and by giving "consideration" to the insurance proceeds." *Huntsman*, 66 T.C. at 875–76.

The rationale in *Cartwright* is persuasive and consistent with common business sense. BCC acquired the insurance policy for the sole purpose of funding its obligation to purchase Blount's shares in accordance with the stock-purchase agreement. Even when a stock-purchase agreement is inoperative for purposes of establishing the value of the company for tax purposes, the agreement remains an enforceable liability against the valued company, if state law fixes such an obligation.[7] Here the law of Georgia required such a purchase.

[7] Other courts have found - when the restrictive agreement is an attempt to effect a testamentary transfer and avoid the estate tax - that honoring a restrictive element in determining fair market value would be improper. See *True v. Comm'r*, 390 F.3d 1210, 1239-41 (10th Cir. 2004) (listing cases that honor restrictive clauses in determining value and cases that do not honor such restrictive clauses). The IRS urges us to adopt the broadest rule that, when an agreement is ignored for valuation purposes, the agreement plays no role in determining the fair market value. We decline to do so because, as proved by this case, such a rule is overinclusive and represents a manifest departure from common business (i.e., market) sense.

Thus, we conclude that the insurance proceeds are not the kind of ordinary nonoperating asset that should be included in the value of BCC under the treasury regulations. To the extent that the $3.1 million insurance proceeds cover only a portion of the Taxpayer's 83% interest in the $6.75 million company, the insurance proceeds are offset dollar-for-dollar by BCC's obligation to satisfy its contract with the decedent's estate. We conclude that such nonoperating "assets" should not be included in the fair market valuation of a company where, as here, there is an enforceable contractual obligation that offsets such

> assets. To suggest that a reasonably competent business person, interested in acquiring a company, would ignore a $3 million liability strains credulity and defies any sensible construct of fair market value.
>
> **III. CONCLUSION**
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> The Tax Court properly determined that the 1981 agreement, as amended by the 1996 agreement, had no effect for purposes of determining the value of the BCC shares in Blount's estate and that the fair market value of the corporation was the proper basis for tax assessment. The Tax Court erred when it ignored the amended agreement's creation of a contractual liability for BCC, which the insurance proceeds were committed to satisfy. We reject the Tax Court's inclusion of the insurance proceeds paid upon the death of the insured shareholder as properly included in the computation of the company's fair market value. We remand for disposition consistent with this opinion.

I cannot reconcile the Eleventh Circuit's opinion with the regulations. I believe that the Eleventh Circuit stretched to do justice, in that the benefit of the reduced purchase price went to an ESOP that generally was not for the benefit of the decedent's family. Reviewing footnote 7 above, the court acknowledged that "when the restrictive agreement is an attempt to effect a testamentary transfer and avoid the estate tax … honoring a restrictive element in determining fair market value would be improper," but added that such a result would defy common sense in this case.

Connelly v. U.S., 128 A.F.T.R.2d 2021-5955 (E.D. MO 9/21/2021), agreed with the Tax Court's reasoning and disagreed with the Eleventh Circuit's opinion in *Blount*:

> The Estate urges that the fair market value of Crown C does not include the $3 million in life-insurance proceeds at issue because those proceeds "were off-set dollar for dollar by the obligation to redeem [Michael's] shares" under the Stock Agreement. Doc. 65. According to the Estate, a hypothetical "willing buyer" of Crown C would have to account for substantial liabilities like Crown C's redemption obligation. See, *e.g.*, *Estate of Dunn v. C.I.R.*, 301 F.3d 339, 352 (5th Cir. 2002) (the value of a corporation's assets is discounted by the corporation's capital-gains liability); *Eisenberg v. Comm'r*, 155 F.3d 50, 57 (2d Cir. 1998) (a hypothetical buyer would pay less for shares in a corporation because of the buyer's "inability to eliminate the contingent tax liability"). The Estate emphasizes that a willing buyer would pay less for a company encumbered with a stock-purchase agreement, to account for the company's future decrease in assets when fulfilling the contractual obligation. See *Estate of Blount*, 428 F.3d at 1346.
>
> The parties agree that the facts of this case present the same fair-market-value issue as *Estate of Blount*, 2004 WL 1059517, at *26 (T.C. 2004), *aff'd in part*, *rev'd in part*, 428 F.3d 1338 (11th Cir. 2005). Doc. 52 at 12; Doc. 46 at 6–7. In *Estate of Blount*, a closely-held family company entered into a stock purchase agreement with its shareholders, intending that the company would use life-insurance proceeds to redeem a key shareholder's shares upon his death. 428 F.3d at 1340. When one of the shareholders died, his estate argued that the life-insurance proceeds should not be included in the value of the company, for purposes of determining fair market value of the redeemed shares, because of the company's offsetting contractual obligation to redeem those shares from the estate. *Id*. at 1345.
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> The Tax Court in *Estate of Blount* included the life-insurance proceeds in the value of the company and the shareholders' shares, determining that the redemption obligation was

not like an ordinary liability because the redemption involved the very same shares being valued. 2004 WL 1059517, at *26. The Eleventh Circuit reversed on this issue, holding that the fair market value of the closely-held corporation did not include life-insurance proceeds used to redeem the shares of the deceased shareholder under a stock purchase agreement. *Estate of Blount*, 428 F.3d at 1346. The Eleventh Circuit reasoned that the stock-purchase agreement created a contractual liability for the company, offsetting the life-insurance proceeds. *Id*. at 1345-46. The Eleventh Circuit concluded that the insurance proceeds were "not the kind of ordinary nonoperating asset that should be included in the value of [the company] under the treasury regulations" because they were "offset dollar-for-dollar by [the company's] obligation to satisfy its contract with the decedent's estate." *Id*. at 1346 (citing 26 C.F.R. § 20.2031-2(f)(2)).

The IRS urges the Court to reject the Eleventh Circuit's holding in *Estate of Blount* and apply the Tax Court's reasoning. Doc. 52 at 12–14. The IRS contends that the Eleventh Circuit's approach violates customary valuation principles, resulting in a below-market valuation for Crown C and a windfall for Thomas at the expense of Michael's estate. *Id*. According to the IRS, a willing buyer and seller would value Crown C at approximately $6.86 million, rather than $3.86 million, because on the date of Michael's death, Crown C possessed the $3 million in life-insurance proceeds that were later used to redeem Michael's shares. *Id*. at 19. This, in turn, would make Michael's 77.18% interest in Crown C worth about $5.3 million. *Id*. The Estate disagrees, somewhat reflexively arguing that under the Eleventh Circuit's holding in *Estate of Blount*, the Court should not include the $3 million in life-insurance proceeds in the valuation of Crown C because of the redemption obligation in the Stock Agreement. Doc. 46 at p. 6. But other than citing the Eleventh Circuit's holding and its own expert opinions (which essentially say that holding controls), the Estate does not really explain why it believes the Eleventh Circuit's holding is correct. *Id.*

Life-insurance proceeds are nonoperating assets that generally increase the value of a company. 26 C.F.R. § 20.2031-2(f)(2); *Estate of Huntsman*, 66 T.C. at 874. Here, the parties agree that the proceeds are a nonoperating asset that would have increased Crown C's value, but they dispute whether Crown C's redemption obligation was a liability that offset the proceeds for valuation purposes. Doc. 52 at pp. 14-15; Doc. 46 at pp. 5-6. Therefore, to determine the fair market value of Michael's shares as of the date of his death, the Court analyzes whether Crown C's outstanding redemption obligation was a corporate liability that reduced the fair market value of Crown C.

Under the willing-buyer-willing-seller principle, a redemption obligation does not reduce the value of a company as a whole or the value of the shares being redeemed. A redemption obligation requires a company to buy its own shares from a shareholder, and just like any other contractual obligation, a redemption obligation expends company resources. But as the Tax Court observed in *Estate of Blount*, a redemption obligation is not a "value-depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued." 2004 WL 1059517, at *25.

Consider what a hypothetical "willing buyer" would pay for a company subject to a redemption obligation. See 26 C.F.R. § 20.2031-1(b). The willing buyer would not factor the company's redemption obligation into the value of the company, because with the purchase of the entire company, the buyer would thereby acquire all of the shares that would be redeemed under the redemption obligation; in other words the buyer would pay all of the shareholders the fair market value for all of their shares. The company, under the buyer's new ownership, would then be obligated to redeem shares that the buyer now holds. Since the buyer would receive the payment from the stock redemption, the buyer would not consider the obligation to himself as a liability that lowers the value of the company to him. See *Estate of Blount*, 2004 WL 1059517, at *25 (T.C. 2004) ("To treat the corporation's obligation to redeem the very shares that are being valued as a liability that reduces the value of the corporate entity thus distorts the nature of the ownership interest represented by those shares.").

A willing buyer purchasing Crown C on the date of Michael's death would not demand a reduced purchase price because of the redemption obligation in the Stock Agreement, as Crown C's fair market value would remain the same regardless. The willing buyer would buy all 500 of Crown C's outstanding shares (from Michael's Estate and Thomas) for $6.86 million, acquiring Crown C's $3.86 million in estimated value plus the $3 million in life-insurance proceeds at issue. If Crown C had no redemption obligation, the willing buyer would then own 100% of a company worth $6.86 million.

But even with a redemption obligation, Crown C's fair market value remains the same. Once the buyer owned Crown C outright, the buyer could either: 1) cancel the redemption obligation to himself and own 100% of a company worth $6.86 million, or 2) let Crown C redeem Michael's former shares - the buyer (and not Michael's Estate) would receive roughly $5.3 million in cash and then own 100% of a company worth the remaining value of about $1.56 million, leaving the buyer with a total of $6.86 million in assets. Therefore, with or without the redemption obligation, the fair market value of Crown C on the date of Michael's death was $6.86 million.

The Estate urges the Court to follow the Eleventh Circuit's reasoning in *Estate of Blount*, which declared that "nonoperating assets should not be included in the fair market valuation of a company where, as here, there is an enforceable contractual obligation that offsets such assets." 428 F.3d at 1346 (quotation marks omitted). But as the IRS points out, the Court must determine the fair market value of Crown C on the date of Michael's death, not the value in its post-redemption configuration. See 26 U.S.C. § 2031. Excluding the insurance proceeds from Crown C's value impermissibly treats Michael's shares as both outstanding and redeemed at the same time, reducing Crown C's value by the redemption price of the very shares whose value is at issue. This approach ignores the ownership interest represented by Michael's shares; construing a redemption obligation as a corporate liability only values Crown C post redemption (*i.e.*, excluding Michael's shares), not the value of Crown C on the date of death (i.e. including Michael's shares).

Demonstrating this point, exclusion of the insurance proceeds from the fair market value of Crown C and valuing Michael's shares at $3 million results in drastically different share prices for Michael's shares compared to Thomas's. If on the date of his death, Michael's 77.18% interest was worth only $3 million ($7,774/share), that would make Thomas's 22.82% interest worth $3.86 million ($33,863/share) because Thomas owned all other outstanding shares and the residual value of Crown C was $3.86 million. See Doc. 53-19 at ¶ 61. The residual value of Crown C is the value of the company apart from the $3 million of insurance proceeds at issue. The parties have agreed that this value was $3.8 million. Doc. 48 at ¶¶ 1–3; Doc. 58 at ¶¶ 43, 79–81. Because Thomas was the only other shareholder of Crown C, his ownership interest must therefore equal the residual value of Crown C: $3.8 million. This outcome violates customary valuation principles because Thomas's shares would be worth 336% more than Michael's at the exact same time. See Doc. 53-19 at ¶ 61. A willing seller of Michael's shares would not accept this bargain, as it creates a windfall for the buyer (Crown C of which Thomas would now have 100% control), while undervaluing Michael's shares in comparison.

Only by including the insurance proceeds in the fair market value of Crown C do Michael's and Thomas's shares hold an equal value on the date of Michael's death. Michael's 77.18% interest in a $6.86 million company would be worth $5.3 million ($13,782/share) and Thomas's 22.82% interest would be worth $1.56 million ($13,782/share). This outcome tracks customary valuation principles, because the brothers' shares have the same value-per-share. A willing seller of Michael's shares would only accept this outcome, because it assigns the same value to Michael's shares as to Thomas's and neither party's economic position changes through the transaction.

The Eleventh Circuit declared in *Estate of Blount* that 26 C.F.R. § 20.2031-2(f)(2) precludes the inclusion of insurance proceeds in the corporate value when the proceeds are used for a redemption obligation. 428 F.3d at 1345 ("The limiting phrase, 'to the extent that such nonoperating assets have not been taken into account,' however, precludes the inclusion of the insurance proceeds in this case." (citing 26 C.F.R. § 20.2031-2(f)(2))). But, 26 C.F.R. § 20.2031-2(f)(2) begins with a discussion of the factors considered in determining the fair market value of a closely-held corporation, including "the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors." The regulation goes on to state that "[i]n addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth." *Id.*

While in *Estate of Huntsman* the Tax Court ultimately rejected the Commissioner's valuation as not following customary valuation principles, the court found this regulation to mean that the court "must determine the fair market value of the decedent's stock...by applying customary principles of valuation and by giving 'consideration' to the [life-]insurance proceeds." 66 T.C. at 875. The Eleventh Circuit's holding in *Estate of Blount* notwithstanding, the text of the regulation does not indicate that the very presence of an offsetting liability means that the life-insurance proceeds have already been "taken into account in the determination of a company's net worth." See 26 C.F.R. § 20.2031-2(f)(2). By its plain terms, the regulation means that the proceeds should be considered in the same manner as any other nonoperating asset in the calculation of the fair market value of a company's stock. See id. And as already discussed, a redemption obligation is not the same as an ordinary corporate liability. See supra at pp. 29–31.

The Eleventh Circuit's opinion in *Estate of Blount* relied heavily on *Estate of Cartwright*, 183 F.3d 1034, 1037 (9th Cir. 1999), which excluded insurance proceeds from the fair market value of a company when the proceeds were offset by an obligation to pay those proceeds to a shareholder's estate. *Estate of Blount*, 428 F.3d at 1345. But *Estate of Cartwright* is distinguishable. As the Tax Court in *Estate of Blount* explained about *Estate of Cartwright*:

> The lion's share of the corporate liabilities in that case which were found to offset the insurance proceeds were *not obligations of the corporation to redeem its own stock*. Rather, we determined that approximately $4 million of the $5 million liability of the corporation was to compensate the decedent shareholder for services; *i.e.*, for his

> interest in work in progress. Thus, a substantial portion of the liability was no different from any third-party liability of the corporation that would be netted against assets, including insurance proceeds, to ascertain net assets.

2004 WL 1059517, at *27 (emphasis added). Unlike in *Estate of Cartwright*, Crown C's redemption obligation simply bought Michael's shares. See *id*. The redemption did not compensate Michael for his past work, so it was not an ordinary corporate liability. See *Estate of Blount*, 2004 WL 1059517, at *27 (T.C. 2004). While some of the life-insurance proceeds in *Estate of Cartwright* were used for a stock redemption, *Estate of Cartwright* mainly discussed how the insurance proceeds compensated the shareholder for past work, not for his shares in the company. See *Estate of Cartwright* , 1996 WL 337301, at *7-8 (T.C. 1996), *aff'd in part, rev'd in part by*, 183 F.3d 1034, 1037-38 (9th Cir. 1999). And to the extent that *Estate of Cartwright* excluded some of the life-insurance proceeds from the company's fair market value because of an offsetting redemption obligation, the opinion contains the same analytical flaw as *Estate of Blount*, 183 F.3d at 1037, *i.e*. considering a redemption obligation to be a corporate liability that depresses a company's value by ignoring the ownership interest represented by the redeemed shares.

The Court finds the Tax Court's reasoning in *Estate of Blount* persuasive. *Estate of Blount*, 2004 WL 1059517, at *24-27; *see also* Adam S. Chodorow, *Valuing Corporations for Estate Tax Purposes: A Blount Reappraisal*, 3 Hastings Business Law Journal 1, 25 (2006) ("Taking redemption obligations into account leads the court to value the wrong property...redemption obligations are different from other types of corporate obligations in that a redemption obligation both shrinks the corporate assets and changes its ownership structure."). A redemption obligation is not an ordinary corporate liability - a stock redemption involves a change in the ownership structure of the company, where the company buys a shareholder's interest - so a redemption obligation does not change the value of the company as a whole before the shares are redeemed. Nor can a redemption obligation diminish the value of the same shares being redeemed; the shareholder is essentially "cashing out" his share of ownership in the company and its assets. Moreover, a stock redemption results in the company (and more specifically its remaining shareholder(s)) getting something of equal value for the cash spent, *i.e.* the decedent's share of ownership in the company; the exchange increases the ownership interest for each of the company's outstanding shares, *i.e.* the surviving shareholders' shares.

For these reasons, the Court respectfully finds that the Eleventh Circuit's opinion in *Estate of Blount* is "demonstrably erroneous" and there are "cogent reasons for rejecting [it]." *Keasler v. United States*, 766 F.2d 1227, 1233 (8th Cir. 1985) ("[T]he tax decisions of other circuits should be followed unless they are demonstrably erroneous or there appear cogent reasons for rejecting them." (internal quotation marks and citation omitted)). Accordingly, the Court holds that the $3 million in life-insurance proceeds used to redeem Michael's shares must be included in the fair market value of Crown C and of Michael's shares.

Connelly hypothesized that a buyer would buy 100% before buying the decedent's interest. Hypothesizing a strategic buyer is reversible error, unless that part of the opinion can be disregarded and the rest of the opinion holds together. Query how the court will value the decedent's stock. If the buy-sell agreement is disregarded, will the resulting liquidity also be disregarded? In that case, the stock needs to be valued based on lack of marketability and how much control a hypothetical willing buyer of the company's stock would have over the company.

In affirming the District Court, among its reasons the Eighth Circuit, 70 F.4th 412 (2023) reasoned:

> We now consider the fair market value of Michael's shares. The key question is whether the life insurance proceeds received by Crown and intended for redemption should be taken into account when determining the corporation's value at the time of Michael's death.[4] Two principles guide the analysis. The first deals with valuing property in general, and the second addresses companies whose stock prices cannot be readily determined from an exchange, as is the case with closely held corporations.
>
> [4] We focus on this moment in time - after Michael's death but before his shares are redeemed. See *Bright's Est. v. United States*, 658 F.2d 999, 1006 (5th Cir. 1981) (en banc) ("[T]he estate tax is an excise tax on the transfer of property at death and accordingly ... the valuation is to be made as of the moment of death and is to be measured by the interest that passes, as contrasted with the interest held by the decedent before death or the interest held by the legatee after death."). Regardless of the timing, no one argues that the proceeds were ever in doubt. Crown expected to receive $3.5 million from the policy, most of which would be used to buy Michael's shares.
>
> Generally, the value of property in the gross estate is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." 26 C.F.R. § 20.2031-1(b); see also *United States v. Cartwright*, 411 U.S. 546, 551 (1973) ("The willing buyer-willing seller test of fair market value is nearly as old as the federal income, estate, and gifts taxes themselves ... .").
>
> To this end, for closely held corporations, the share value "shall be determined by taking into consideration, in addition to all other factors, the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange." 26 U.S.C. § 2031(b). Treasury regulations have interpreted this as a "fair market value" analysis. 26 C.F.R. § 20.2031-2(a). The fair market value depends on the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors like "the good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; [and] the degree of control of the business represented by the block of stock to be valued." 26 C.F.R. § 20.2031-2(f)(2); see also *Est. of Huntsman v. Comm'r*, 66 T.C. 861, 876 (1976) ("[W]e ... determine the fair market value of the decedent's stock ... by applying the customary principles of valuation ... ."). Setting aside for the moment the life insurance proceeds used to redeem Michael's shares, so far as Crown's operations, revenue streams, and capital are concerned, we know its value - about $3.86 million. See supra n.2.
>
> But in valuing a closely held corporation, "consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity." 26 C.F.R. § 20.2031-2(f)(2). This need to "take[] into account" life

insurance proceeds appears again in a nearby regulation, 26 C.F.R. § 20.2042-1(c)(6). That regulation clarifies 26 U.S.C. § 2042, which has to do with life insurance proceeds that go to beneficiaries other than the decedent's estate. Understanding the relationship between § 2031 (defining the gross estate) and § 2042, along with their corresponding regulations, helps further illuminate what it means to "take[] into account" life insurance proceeds.

Section 2042 says that the value of a decedent's gross estate includes life insurance proceeds received directly by the estate as well as proceeds received by other beneficiaries under insurance policies in which the decedent "possessed at his death any of the incidents of ownership." For example, if Michael obtained a life insurance policy for the benefit of Crown, the value of that policy's proceeds would be included in Michael's gross estate. See § 2042(2). Yet here, Crown obtained the policy for its own benefit.

Now, there might be a plausible argument that under § 2042 Michael possessed "incidents of ownership" in the life insurance policy through his controlling-shareholder status. If that were the case, then § 2042 would require that Michael's gross estate include the proceeds used for his stock redemption. But that is not the case. Treasury regulation § 20.2042-1(c)(6) clarifies that a decedent does not possess the "incidents of ownership" described in § 2042 merely by virtue of being a controlling shareholder in a corporation that owns and benefits from the policy.

Still, although § 2042 does not require that the proceeds be included here, it does not exclude them either. We are cautioned to "[s]ee § 20.2031-2(f) for a rule providing that the proceeds of certain life insurance policies shall be considered in determining the value of the decedent's stock." 26 C.F.R. § 20.2042-1(c)(6). Thus, although the life insurance proceeds intended for redemption do not directly augment Michael's gross estate by way of § 2042, they may well do so indirectly through a proper valuation of Crown. Indeed, the $500,000 of proceeds not used to redeem shares and which simply went into Crown's coffers undisputedly increased Crown's value according to the principles in § 2031 and 26 C.F.R. § 20.2031-2(f)(2).

We must therefore consider the value of the life insurance proceeds intended for redemption insofar as they have not already been taken into account in Crown's valuation and in light of the willing buyer/seller test. In this sense, the parties agree that this case presents the same fair-market-value issue as *Estate of Blount v. Commissioner*, 428 F.3d at 1345-46, from the Eleventh Circuit. But they disagree on whether *Blount* was correctly decided. Like here, *Blount* involved a stock-purchase agreement for a closely held corporation. Although the court referenced the requirement in 26 C.F.R. § 20.2031-2(f)(2) that proceeds be "taken into account," it concluded that the life insurance proceeds had been accounted for by the redemption obligation, which a willing buyer would consider. 428 F.3d at 1345. In balance-sheet terms, the court viewed the life insurance proceeds as an "asset" directly offset by the "liability" to redeem shares, yielding zero effect on the company's value.[5] The court summarized its conclusion with an appeal to the willing buyer/seller concept: "To suggest that a reasonably competent business person, interested in acquiring a company, would ignore a $3 million liability strains credulity and defies any sensible construct of fair market value." Id. at 1346.

[5] *Blount* cited favorably the Ninth Circuit's decision in *Estate of Cartwright v. Commissioner*, 183 F.3d 1034, 1038 (9th Cir. 1999), which employed similar reasoning. Like the Eleventh Circuit in *Blount*, the Ninth Circuit's analysis was limited - one paragraph citing 26 C.F.R. § 20.2031-2(f)(2) and the tax-court decision in *Estate of Huntsman v. Commissioner*, 66 T.C. at 875, which merely emphasized that life insurance proceeds are to be considered according to § 20.2031-2(f)(2).

Like the estate in *Blount*, Thomas argues that life insurance proceeds do not augment a company's value where they are offset by a redemption liability. In his view, the money is just passing through and a willing buyer and seller would not account for it. The IRS counters that this assumption defies common sense and customary valuation principles, as reflected in Treasury regulations.

The IRS has the better argument. *Blount*'s flaw lies in its premise. An obligation to redeem shares is not a liability in the ordinary business sense. See 6A Fletcher Cyclopedia of the Law of Corporations § 2859 (Sept. 2022 update) ("The redemption of stock is a reduction of surplus, not the satisfaction of a liability."). Treating it so "distorts the nature of the ownership interest represented by those shares." See Est. of Blount v. Comm'r, 87 T.C.M. (CCH) 1303, 1319 [2004 RIA TC Memo ¶2004-116] (2004), aff'd in part and rev'd in part, 428 F.3d at 1338 [96 AFTR 2d 2005-6795]. Consider the willing buyer at the time of Michael's death. To own Crown outright, the buyer must obtain all its shares. At that point, he could then extinguish the stock-purchase agreement or redeem the shares from himself. This is just like moving money from one pocket to another. There is no liability to be considered - the buyer controls the life insurance proceeds. A buyer of Crown would therefore pay up to $6.86 million, having "taken into account" the life insurance proceeds, and extinguish or redeem as desired. See 26 C.F.R. § 20.2031-2(f)(2). On the flip side, a hypothetical willing seller of Crown holding all 500 shares would not accept only $3.86 million knowing that the company was about to receive $3 million in life insurance proceeds, even if those proceeds were intended to redeem a portion of the seller's own shares. To accept $3.86 million would be to ignore, instead of "take[] into account," the anticipated life insurance proceeds. See *id*.

To further see the illogic of the estate's position, consider the resulting windfall to Thomas. If we accept the estate's view and look to Crown's value exclusive of the life insurance proceeds intended for redemption, then upon Michael's death, each share was worth $7,720 before redemption.[6] After redemption, Michael's interest is extinguished, but Thomas still has 114.1 shares giving him full control of Crown's $3.86 million value. Those shares are now worth about $33,800 each.[7] Overnight and without any material change to the company, Thomas's shares would have quadrupled in value.[8] This view of the world contradicts the estate's position that the proceeds were offset dollar-by-dollar by a "liability." A true offset would leave the value of Thomas's shares undisturbed. See Cox & Hazen, supra, § 21:2 ("When a corporation purchases its own stock, it has depleted its assets by whatever amount of money or property it gave in exchange for the stock. There is, however, an increase in the proportional interest of the nonselling shareholders in the remaining assets of the corporation."). In sum, the brothers' arrangement had nothing to do with corporate liabilities. The proceeds were simply an asset that increased shareholders' equity. A fair market value of Michael's shares must account for that reality.

[6] $3.86 million divided by 500 shares.

[7] $3.86 million divided by 114.1 shares.

[8] No one has argued that Michael's death and Thomas's subsequent sole ownership of Crown accounts for such an increase. *Cf. Huntsman*, 66 T.C. at 879 ("The decedent was the dominant force in both businesses, and his untimely death obviously reduced the value of the stock in the two corporations.").

For background on the court's Code § 2042 analysis, see part II.Q.4.i.ii.(b) Corporate Ownership of Policy.

Keeping a pre-1990 agreement outside of the application of Code § 2703 would avoid the statute's imposition of the comparability test. Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in a significant change to the quality, value, or timing of the rights of any party with respect to property that is subject to the right or restriction is a substantial modification that's would subject it to this test.[4595] If the terms of the right or restriction require periodic updating, the failure to update is presumed to substantially modify the right or restriction unless updating would not have resulted in a substantial modification.[4596] Adding any family member as a party to a right or restriction is a substantial modification unless either the terms of the right or restriction require the addition or the added family member is assigned to a generation no lower than the lowest generation occupied by individuals already party to the right or restriction.[4597] However, a substantial modification does not include a modification required by the terms of a right or restriction, a discretionary modification of an agreement conferring a right or restriction if the modification does not change the right or restriction, a modification of a capitalization rate used with respect to a right or restriction if the rate is modified in a manner that bears a fixed relationship to a specified market interest rate, or a modification that results in an option price that more closely approximates fair market value.[4598] Amending an agreement to extend the number of years of payment, to clarify that the prime rate is to be established semi-annually, and to update the name of the banking institution from the original bank's name to its successor's name was not a substantial modification.[4599] Issuing nonvoting shares proportionately to the owners of voting stock in an S corporation was not a substantial modification.[4600]

Letter Ruling 202014006, approving certain actions and amendments as not ruining grandfathering. Facts included:

[4595] Reg. § 25.2703-1(c)(1).
[4596] Reg. § 25.2703-1(c)(1).
[4597] Reg. § 25.2703-1(c)(1).
[4598] Reg. § 25.2703-1(c)(2).
[4599] Letter Ruling 201313001.
[4600] Letter Ruling 201536009, reasoning:

> In this case, the stock split and amendment to the Articles will apply to all of the common shares (whether voting or nonvoting). Because each shareholder will receive c shares for every common share he or she currently holds, the beneficial interests in Company will not be affected by the stock split, amendment, and share dividend.
>
> Likewise, because the number of authorized voting shares will continue to be x, the shareholders' voting rights will remain unchanged.
>
> Consequently, the stock split, amendment to the Articles, and share dividend will not affect the quality, value or timing of any rights under the Articles, and the changes will not be a substantial modification of the Articles for purposes of § 25.2703-1(c). Accordingly, the Articles will remain exempt from the application of chapter 14.

As a result of the transfers of shares of Company stock since the Agreement date, Date 1, Company is now owned by Daughters, C, D, and E, six living grandchildren F, G, H, J, K, and L, as well as six GST Trusts created by C on Date 9.

The Board of Directors of Company proposes to cancel all shares of Company common stock held in treasury and to recapitalize Company so that newly issued voting stock in Company can thereafter be primarily held by shareholders who are active in the management of Company. To accomplish this, Company will amend its Articles to increase the number of common shares and to immediately convert each outstanding common share into one share of Class A voting common stock and x shares of Class B nonvoting common stock. After adoption of the foregoing amended capital structure, the Articles and the Agreement will be amended to reflect the common stock split and the addition of the Class B nonvoting common stock (Plan of Recapitalization).

In addition and as indicated above, after approval of the changes to the corporate structure, C, D and E propose to transfer shares of her Class B nonvoting common stock to the GST Trusts created by her on Date 9 (with respect to C) and Date 10 (with respect to each of D and E).

Letter Ruling 202014006 held:

Ruling #1

The individuals and trusts who were parties to the Agreement as of Date 1 are A, B, C, D, E, the Daughters' Trust, and the six Grandchildren's' Trusts (excluding L's Trust). Under § 2651, A and B, as parents and grandparents of the other parties to the Agreement, are assigned to the eldest generation, which will be referred to as the First Generation. C, D and E, as children of A and B, are assigned to the generation immediately below the First Generation and will be referred to as the Second Generation. The Daughters' Trusts are also assigned to the Second Generation because C, D and E are the only current beneficiaries of the Daughters' Trusts. The six Grandchildren's' Trusts (excluding L's Trust) are assigned to the Third Generation, as each trust benefits only a grandchild of A and B.

There are nine transactions or events after October 8, 1990, in which new parties were treated as having been added to the Agreement. The nine events occurred as follows: (i) on Date 3 with the addition of A's estate upon the death of A; (ii) through (vii) through the addition of F, G, H, J, K, and L, on the date each respective Grandchild's Trust distributed shares of Company stock subject to the Agreement to each such Grandchild, outright and free of trust; (viii) on Date 5 with the addition of B's estate upon the death of B, and (ix) on Date 9 when C transferred shares of her Company stock to the GST Trusts C created, each benefiting a niece or nephew of C.

On Date 2, a date after Date 1 but prior to October 8, 1990, A and B created and funded with shares of Company stock a seventh Grandchild's Trust for L (L's Trust), a newly-born descendant. Since L's Trust was not in existence on Date 1, L's Trust was not a party to the Agreement. However, L's Trust was treated as having been added to the Agreement when it received the shares of Company stock from A and B. Pursuant to Paragraph 1 of the Agreement, the gifted shares were subject to the terms of the Agreement and to the obligations of the transferors thereunder and L's Trust was prohibited from transferring such shares except in accordance with the Agreement.

Pursuant to Paragraph 8 of the Agreement, the Endorsement appeared on the certificates issued to L's Trust. Accordingly, the addition is mandatory under the terms of the right or restriction within the meaning of § 25.2703-1(c)(1). Further, under § 2651(f)(2), L's Trust is assigned to the same generation as the sole beneficiary, L, a grandchild of A and B. Therefore, L's Trust is assigned to the Third Generation of family members already parties to the Agreement. Accordingly, L's Trust is assigned to a generation no lower than the lowest generation occupied by individuals already party to the right or restriction, within the meaning of § 25.2703-1(c).

On Date 3, A died, survived by his spouse, B, and his Daughters, C, D, and E, and his grandchildren. Pursuant to A's will, B, C, D, and E were the beneficiaries of A's estate. Accordingly, pursuant to § 2651(f)(1) and (2), A 's estate was assigned to the Second Generation of shareholders already parties to the Agreement. Accordingly, the addition of A's estate to the Agreement was the addition of a family member of no lower a generational assignment than the family members already party to the Agreement on Date 1.

On Date 4, and subsequently, the trustee of the Grandchildren's Trusts benefiting F, G, H, J, K, and L distributed shares of Company stock subject to the Agreement to the grandchild for whom a Grandchild's Trust was held, outright and free of trust. The foregoing transfers for J, K and L included shares of Company stock received from Grandchild's Trust for I upon I's death. F , G, H, J, K, and L were treated as having been added to the Agreement when shares of Company stock were distributed to them, outright and free of trust. Pursuant to § 2651(f)(2), each Grandchild's Trust was assigned to the same generational assignment as its sole beneficiary, a grandchild of A and B. Therefore, the addition of the beneficiary of each Grandchild's Trust to the Agreement was the addition of a family member of no lower a generational assignment than the individuals already party to the Agreement as of Date 1.

On Date 5, B died, survived by her Daughters, C, D, and E, and her grandchildren. B's estate is treated as a new party to the Agreement. Pursuant to B's will, C, D , and E were the beneficiaries of B's estate. C, D, and E executed partial disclaimers which resulted in F, G, H, I, J, K , and L acquiring beneficial interests in B's estate. Pursuant to § 2651(f)(1) and (2), B 's estate is treated as being assigned to the Third Generation of shareholders. Therefore, the addition of B's estate to the Agreement was the addition of a family member of no lower than the generational assignment of the individuals already party to the Agreement as of Date 1.

On Date 9, C created and funded six GST Trusts with shares of Company stock for the initial benefit of each of her six living nieces and nephews. A niece or nephew of C, each of whom is also a grandchild of A and B, is the sole beneficiary of each GST Trust for and during the lifetime of each such beneficiary. There are no other permissible distributees from any such GST Trust during such time. Therefore, pursuant to § 2651(f)(1), each GST Trust is treated as being assigned to the Third Generation. Accordingly, a transfer of shares of Company stock subjecting the GST Trust to the Agreement is treated as a transfer to a family member of no lower than the generational assignment of the parties already subject to the Agreement on Date 1. The Agreement was adopted before October 8, 1990 and, consequently is exempt from the application of § 2703, provided the Agreement is not substantially modified as set forth in § 25.2703-1(c). No family member which is treated as having been added to the Agreement after October 8, 1990 is assigned to a lower generational assignment than the parties already subject to the Agreement on Date 1. Accordingly, based upon the information submitted and representations made, we conclude that none of the transfers of shares of Company stock subject to the Agreement after October 8, 1990, constitute substantial modifications within the meaning of § 25.2703-1(c). Consequently, the Agreement continues to be grandfathered for purposes of chapter 14.

Ruling #2

On Date 7, a date after October 8, 1990, Company amended the Articles to change its name to the current name. On Date 8, Company amended and restated the Articles. Also on Date 8, Company amended and restated the Bylaws that included administrative changes such as name change, indemnification, and number of members constituting the Board of Directors.

Based upon the facts submitted and representations made, we conclude that none of the amendments to the Articles on Date 7, the amendments and restatement of the Articles on Date 8, and the amendment and restatement of the Bylaws on Date 8 constitute substantial modifications of any right or restriction in the Articles, the Bylaws, or the Agreement within the meaning of § 25.2703-1(c). Consequently, we conclude that the Articles, the Bylaws, and the Agreement continue to be grandfathered for purposes of chapter 14.

Ruling #3

The proposed Plan of Recapitalization includes a stock split of one share of Company common stock into one share of Class A voting common stock and x shares of Class B nonvoting common stock. The Articles and Agreement will be amended to reflect the stock split and the addition of Class B nonvoting common stock to the capital structure. The issuance of the Class B nonvoting common stock does not change the terms and conditions to which the shareholders are already subject. In addition, the beneficial interest in the Company will not be affected by the stock split because each shareholder of common stock will receive x shares of Class B nonvoting common stock for every share of common stock held prior to the recapitalization. Accordingly, we conclude that the recapitalization does not affect the quality, value, or timing of any rights of the parties to the Agreement.

Based upon the facts submitted and representations made, we conclude that the proposed Plan of Recapitalization, the proposed amendments to the Articles and Agreement to reflect the stock split and the addition of Class B nonvoting common stock to the capital structure, and the issuance of Class B nonvoting common stock, will not constitute substantial modifications of the Agreement or the Articles within the meaning of § 25.2703-1(c). Further, we conclude that the proposed Plan of Recapitalization and the proposed amendments, described above, will not cause § 2703 to apply to transfers of shares of Company stock subject to the Agreement, as amended.

Ruling #4

C, D and E propose to transfer shares of Class B nonvoting stock in the Company to the GST Trusts created by each. Each GST Trust is assigned to the Third Generation of family members subject to the Agreement. We concluded under Ruling 1 that the prior transfers by C of shares of Company stock to C's GST Trusts do not cause a substantial modification of the Agreement. We likewise conclude that the proposed transfers of shares of Company stock by C to her GST Trusts do not cause a substantial modification to the Agreement. Similarly, the proposed transfers by D and E of shares of Company stock to D's and E's GST Trusts, respectively, do not cause a substantial modification of the Agreement.

> Accordingly, based upon the facts submitted and representations made, we conclude the proposed transfers of shares of Company stock by C, D and E to the GST Trusts created by each will not constitute substantial modifications of the Agreement within the meaning of § 25.2703-1(c). Further, we conclude that the proposed transfers of shares of Company stock by C, D and E to the GST Trusts created by each will not cause § 2703 to apply to the transfer of shares of Company stock subject to the Agreement, as amended.

Letter Rulings 202014007, 202014008, 202014009, and 202014010 are reported to be companion rulings to Letter Ruling 202014006. Letter Rulings 202015004-202015013 also appear to be companion rulings.

BNA Daily Tax Report (4/24/2020) described ten letter rulings:[4601]

> In 10 similar ruling letters, the IRS concluded that certain events occurring after October 8, 1990 (the date defining whether tax code Section 2703 applies), subject to an agreement that "Company" shareholders (individuals and trusts in a family lineage) entered into before that date, don't constitute substantial modifications of the Agreement or other applicable documents within the meaning of Treasury Regulations Section 25.2703-1(c) such that would cause application of these sections. The events are: (rulings 1,2) transfers of Company shares and additions of new parties to the Agreement - including the estates of first-generation individuals (a husband and wife) upon their deaths, and new generation-skipping transfer (GST) tax-exempt trusts for additional or newly born family members none of whom are assigned to a lower generation than those already subject to the Agreement - as well as amendment and restatement of Company's Articles of Incorporation (including name change); consequently grandfathering continues on all the applicable documents for purposes of Chapter 14 (Special Valuation Rules) of the tax code; (ruling 3) proposed amendments to the Articles and Agreement to reflect Company's plan of recapitalization, including a stock split into voting and nonvoting common shares, deemed as not affecting the quality, value, or timing of any rights of the parties to the Agreement; and (ruling 4) proposed transfers of Company shares by second-generation trust beneficiaries to GST trusts for third-generation beneficiaries.

Finally, many of the buy-sell restrictions in partnership agreements are no more restrictive than would otherwise apply under state law, so the application of Code § 2703 would not have a significant impact on the valuation. Yet the IRS makes a big deal of these issues on audit and acts as if some of the cases cited above give it a major advantage. Consider asking the appraiser to expressly state that (s)he is ignoring any provisions in the agreement that are more restrictive than otherwise applicable state law. That way, when the IRS makes a big deal about

[4601] Letter Rulings 202017001, 202017002, 202017003, 202017004, 202017005, 202017006, 202017011, 202017012, 202017013, 202017014.

Code § 2703, one might respond that one has already assumed that Code § 2703 applied, so that issue is off the table.

II.Q.4.i. Life Insurance LLC

Wouldn't it be nice to avoid using a lot of policies, minimize life insurance income tax consequences to owners coming and going,[4602] and keep the life insurance policies in a safer environment? One solution is to place the policies in a limited liability company (LLC) taxed as a partnership. The owners of the business entity also would be the members (owners) of the LLC. A trust company could serve as manager, taking charge of the policies and ensuring that the proceeds are used as intended. Each owner would have an interest in policies insuring the other partners' lives. I obtained Letter Ruling 200747002, which approved such a strategy.

Before reviewing that, as background consider that Letter Ruling 9309021 involved the following facts:

> A and B are shareholders of Corporation X and Corporation Y (Corporations) and also will be partners in Partnership. A represents that Corporations own life insurance policies (the Policies) on the lives of A and B, the proceeds of which are dedicated to the purchase of common stock under stock purchase agreements of Corporations. A and B plan to form Partnership and thereafter, Corporations will transfer the Policies to Partnership in consideration of payment to Corporations by Partnership of the interpolated reserve value of the Policies at the time of the transfer.
>
> After the transfer, Partnership will own the Policies and will change the beneficiary of the policies from Corporations to itself. Partnership will pay all premiums due on the Policies after the transfers. A represents that the business purpose for the proposed transfer is to facilitate a cross-purchase agreement between A and B for the stock of Corporations in the event of the death of either A or B.
>
> Partnership will be formed under State's Uniform Partnership Act (the Act). The Act provides in part that all partners are jointly liable for all debts and obligations of Partnership. In addition, the partnership agreement provides that the management and authority of Partnership is equally vested in each of the partners. Partnership will engage in the purchase and acquisition of life insurance policies on the lives of its partners. Partnership will have ownership rights in the Policies and will manage a portfolio of insurance policies.

Letter Ruling 9309021 included the following reasoning/conclusions:

> Under the proposed transaction, Partnership will transfer cash to Corporations, the current owners of the Policies, and will receive in exchange ownership of the Policies on the lives of A and B, the insureds. Under section 1.101-1(b)(4) of the regulations, a transfer for valuable consideration is "any absolute transfer for value of a right to receive all or a part of the proceeds of a life insurance Policy." Corporations' transfers of the Policies to partnership in exchange for payment of a sum equal to the interpolated

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[4602] See text accompanying fns. 4340-4342 in part II.Q.4.b.i Transfer for Value Rule Generally regarding certain transfers involving partnerships. Distributions from partnerships generally are tax-free, as described in part II.Q.8.b.i Distribution of Property by a Partnership; and, as described in fn 5372, a life insurance contract is not targeted by part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them).

> reserve value of the Policies is a transfer for valuable consideration under section 101(a)(2) of the Code and section 1.101-1(b)(4) of the regulations.
>
> When the Corporations transfer the Policies to Partnership, the insureds, A and B, are partner of Partnership. Since the insureds are partners in the partnership to which the Policies are transferred, the transfer for valuable consideration of the Policies from Corporation to partnership is covered by section 101(a)(2)(B) of the Code and as such, the exclusion limitation of section 101(a)(2) does not apply….
>
> Provided that the life insurance proceeds are exempt from gross income under section 101(a) of the Code, the proceeds will be reflected in the partner's distributive share under section 702 as tax-exempt income. The partner's basis in their respective partnership interests will increase under section 705(a)(1)(B) due to their distributive shares of tax-exempt income. Under section 731, distributions from a partnership to a partner are generally nontaxable to the extent that any money distributed does not exceed the adjusted basis of the partner's interest in the partnership immediately before the distribution. Accordingly, any proceeds of the life insurance policies distributed to A are not taxable to A to the extent that the distribution does not exceed the adjusted basis of A's partnership interest immediately before the distribution.

II.Q.4.i.i. The Facts of Letter Ruling 200747002

The flowcharts in the Appendices A and B illustrate the situation. Appendix A illustrates trusts that were set up. Appendix B explains the Insurance LLC's structure. Appendix C illustrates some creative planning described below.

In this case, an S corporation had three shareholders: Child A (Brother), Child B (Sister), and BA. BA was an unrelated shareholder. Although the ruling does not disclose the percentage ownership, in fact BA owned 5% of the stock, and Brother and Sister owned the rest in roughly equal amounts. The buy-sell agreement was funded by term life insurance policies.

The grantor, parent of Brother and Sister, set up an irrevocable trust, Trust 2A, for Brother ("Brother's Irrevocable Trust"). This was a typical flexible generation-skipping trust. Brother was trustee and could make distributions under an ascertainable standard to Brother and Brother's descendants. Brother also had the power to appoint Brother's Irrevocable Trust's assets at Brother's death to anyone except to Brother, Brother's creditors, Brother's estate or the creditors of Brother's estate. The grantor had allocated GST exemption to Brother's Irrevocable Trust, and Brother's Irrevocable Trust was not subject to the rule against perpetuities. Thus, Brother's Irrevocable Trust provides Brother with flexibility to use its assets during life and pass them to practically anyone at death. The grantor also set up Trust 2B for Sister with similar terms ("Sister's Irrevocable Trust").

Under a buy-sell agreement, Brother would buy Sister's and BA's stock at their deaths. Brother owned policies on their lives to fund this purchase. Brother also had the right to assign Brother's purchase rights and obligations to Brother's Irrevocable Trust or other trusts controlled by Brother. Brother would then transfer these policies to the LLC. Brother and Brother's Irrevocable Trust would contribute premiums to the LLC and receive the right to death benefits from Policies on Sister's and BA's lives in proportion to the premiums that Brother and Brother's Irrevocable Trust made these premium contributions. The goal was to maximize Brother's Irrevocable Trust's proportion of contributions, because Brother's Irrevocable Trust and any trusts created under it are excluded from the estate tax system. However, given the uncertainties of cash flow and the impracticality of frequently changing beneficiary designations, being flexible in sharing premiums was important and the LLC's use of partnership accounting seemed to be the best way to accomplish that. Brother and Sister had virtually identical goals regarding the buy-sell arrangement.

The LLC had some other features. The manager was a corporate trustee. Using a corporate trustee as manager provided security to ensure that no party to the buy-sell agreement would use the life insurance proceeds improperly. The manager was instructed to retain all life insurance proceeds until the parties agreed on their application toward the cross-purchase. Thus, the manager's roles were essentially the equivalent of a combination of trustee of an irrevocable life insurance trust before a shareholder's death and escrow agent for the buy-sell agreement after a shareholder's death.

The LLC's activity required special partnership accounting provisions. Each member had a separate capital account for each policy the member owned on a shareholder. Also, the members needed to contribute cash to pay the LLC's administrative expenses, requiring an additional set of capital accounts.

II.Q.4.i.ii. Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity

Code § 2042(2) provides that an insured's gross estate includes the value of all property "to the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person."[4603]

Code § 2035(a) provides:

> If—
>
> (1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and
>
> (2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036 , 2037, 2038, or 2042 if such transferred

[4603] It continues:

> For purposes of the preceding sentence, the term "incident of ownership" includes a reversionary interest (whether arising by the express terms of the policy or other instrument or by operation of law) only if the value of such reversionary interest exceeded 5 percent of the value of the policy immediately before the death of the decedent. As used in this paragraph, the term "reversionary interest" includes a possibility that the policy, or the proceeds of the policy, may return to the decedent or his estate, or may be subject to a power of disposition by him. The value of a reversionary interest at any time shall be determined (without regard to the fact of the decedent's death) by usual methods of valuation, including the use of tables of mortality and actuarial principles, pursuant to regulations prescribed by the Secretary. In determining the value of a possibility that the policy or proceeds thereof may be subject to a power of disposition by the decedent, such possibility shall be valued as if it were a possibility that such policy or proceeds may return to the decedent or his estate.

> > interest or relinquished power had been retained by the decedent on the date of his death,
>
> the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.

Reg. 20.2042-1(c)(1) begins with:

> Section 2042 requires the inclusion in the gross estate of the proceeds of insurance on the decedent's life not receivable by or for the benefit of the estate if the decedent possessed at the date of his death any of the incidents of ownership in the policy, exercisable either alone or in conjunction with any other person.

Then it continues by pointing out inclusion when incidents of ownership are transferred too soon to death, which is now covered by Code § 2035.

Reg. 20.2042-1(c)(2) provides:

> For purposes of this paragraph, the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc. See subparagraph (6) of this paragraph for rules relating to the circumstances under which incidents of ownership held by a corporation are attributable to a decedent through his stock ownership.

Reg. 20.2042-1(c)(3) discusses reversionary interests:

> The term "incidents of ownership" also includes a reversionary interest in the policy or its proceeds, whether arising by the express terms of the policy or other instrument or by operation of law, but only if the value of the reversionary interest immediately before the death of the decedent exceeded 5 percent of the value of the policy. As used in this subparagraph, the term "reversionary interest" includes a possibility that the policy or its proceeds may return to the decedent or his estate and a possibility that the policy or its proceeds may become subject to a power of disposition by him. In order to determine whether or not the value of a reversionary interest immediately before the death of the decedent exceeded 5 percent of the value of the policy, the principles contained in paragraph (c)(3) and (4) of § 20.2037-1, insofar as applicable, shall be followed under this subparagraph. In that connection, there must be specifically taken into consideration any incidents of ownership held by others immediately before the decedent's death which would affect the value of the reversionary interest. For example, the decedent would not be considered to have a reversionary interest in the policy of a value in excess of 5 percent if the power to obtain the cash surrender value existed in some other person immediately before the decedent's death and was exercisable by such other person alone and in all events. The terms "reversionary interest" and "incidents of ownership" do not include the possibility that the decedent might receive a policy or its proceeds by inheritance through the estate of another person, or as a surviving spouse under a statutory right of election or a similar right.

Reg. 20.2042-1(c)(4) is reproduced in part II.Q.4.i.ii.(a) Trust Ownership of Policy.

Reg. 20.2042-1(c)(5) discusses the impact of state law property rights:

> As an additional step in determining whether or not a decedent possessed any incidents of ownership in a policy or any part of a policy, regard must be given to the effect of the State or other applicable law upon the terms of the policy. For example, assume that the decedent purchased a policy of insurance on his life with funds held by him and his surviving wife as community property, designating their son as beneficiary but retaining the right to surrender the policy. Under the local law, the proceeds upon surrender would have inured to the marital community. Assuming that the policy is not surrendered and that the son receives the proceeds on the decedent's death, the wife's transfer of her one-half interest in the policy was not considered absolute before the decedent's death. Upon the wife's prior death, one-half of the value of the policy would have been included in her gross estate. Under these circumstances, the power of surrender possessed by the decedent as agent for his wife with respect to one-half of the policy is not, for purposes of this section, an "incident of ownership", and the decedent is, therefore, deemed to possess an incident of ownership in only one-half of the policy.

Reg. 20.2042-1(c)(6) is reproduced in part II.Q.4.i.ii.(b) Corporate Ownership of Policy.

Simple cross-purchase agreements avoid these issues. Rev. Rul. 56-397 ruled that when each of two business associates owns, is the beneficiary of and pays all premiums for an insurance policy on the other business associate, neither of the business associates possesses incidents of ownership in the policy on his or her respective life.

TAM 9349002 asserted incidents of ownership in the following situation:

> On December 31, 1985, the stockholders of the Company entered into the STOCKHOLDERS AGREEMENT, (the "buy-sell agreement") culminating a series of agreements and contracts dated 1980, 1982, 1984, and July 1985. Under the terms of the buy-sell agreement the purchase price of shares purchased pursuant to the agreement was to be determined by a formula increasing the book value of the Company by a weighted income factor. On January 31, 1987, the FIRST AMENDMENT TO STOCKHOLDER'S AGREEMENT modified the applicable date for computation of book value of the Company.
>
> On May 16, 1988, the SECOND AMENDMENT TO STOCKHOLDERS AGREEMENT --
>
> (1) Deleted a right held by B to acquire shares held by Decedent;
>
> (2) Required the Company to redeem Decedent's shares at the end of the 1991 fiscal year (or at any prior date determined by Decedent) unless they had previously been redeemed under the terms of the agreement;
>
> (3) Modified the method of computing book value; and
>
> (4) Made other miscellaneous changes to the buy-sell agreement.
>
> On November 5, 1988, the THIRD AMENDMENT TO SHAREHOLDER'S AGREEMENT was executed. At the time of the third amendment the Decedent held 49.5 percent of the

outstanding shares of stock in the Company. While the majority of the remaining shares were held by B, four other employees also held shares in the Company. No single individual held a majority interest in the Company.

After the Third amendment, the buy-sell agreement provided that, if either Decedent or B survived the other by thirty days, the Company stock held by the first to die of Decedent or B would be acquired by the surviving shareholders to the extent insurance proceeds were available. To the extent such proceeds were not available, or if neither survived the other by thirty days, the Company was to redeem the stock. The amount to be paid on the purchase or redemption of the stock was the greater of (1) the amount of insurance proceeds available, or (2) the amount otherwise calculated under the agreement. Any amount in excess of the insurance proceeds was to be paid by the Company over a period of four years pursuant to a promissory note containing the terms set forth in the agreement. Information submitted by the taxpayer indicates that the application of the formula as of June 30, 1989, would have resulted in a promissory note in the amount of $490,000.

The amended buy-sell agreement named a corporate trustee to be the applicant, owner, and beneficiary of policies of insurance on the lives of each of Decedent and B except that the Company was to be the owner to the extent of the each policy's cash surrender value. The trustee was precluded from exercising any powers of ownership by canceling a policy, assigning ownership, changing the name of the beneficiary, borrowing against a policy, or otherwise changing the nature or value of any policy.

The amended buy-sell agreement provided that, upon termination of tile trust, any unmatured policy was to be transferred to the Company subject to the right of the insured to purchase the policy for the then interpolated terminal reserve (cash surrender value). The trust was to terminate upon the first to occur of --

(1) the death of the first to die of Decedent or B,

(2) the completion of the redemption of Decedent's shares, or

(3) the completion of the redemption of B's shares.

Subparagraph 6 (I) of the amended buy-sell agreement provided, in part --

> If [a] redeeming shareholder dies prior to the completion of [the] redemption, the Trustee shall collect the insurance proceeds and ... pay the balance remaining due for said redemption to the deceased Shareholder1s estate and pay the balance of the insurance proceeds pro rata to the remaining Shareholders of record on the date of death. If any Shareholder sells his shares during his lifetime pursuant to the terms of the Agreement or upon termination of this Amendment, such Shareholder(s) shall have the right to purchase the policy or policies upon his life owned by the Trustee, but only after all monies being paid to the redeeming Shareholder have been paid in full. This purchase shall be upon the same terms and conditions as set forth . . . for the purchase of such policy or policies by the surviving shareholder from the corporation.

On February 7, 1989, when Decedent was age 54, the trust acquired an increasing premium term policy of insurance on Decedent's life ($500,000 face value) using funds furnished by the Company to pay the initial premium on the policy. Under the terms of the policy there would be “no cash values until after insured’s age 71.”

On November 10, 1989, Decedent, and three of the small shareholders entered into a “STOCK PURCHASE AND REDEMPTION AGREEMENT” (the “redemption agreement”) wherein it was agreed that the Company would purchase Decedent’s shares by delivery of a promissory note having a face value of $300,000 payable over a thirty month period. The agreement also provided that Decedent would receive a cash payment of $150,000 at closing in exchange for her covenant not to compete for a period of two years. The agreement, signed by B as President, was contingent on the execution by B of a repurchase agreement with respect to B’s shares in another jointly owned company engaged in a similar line of business. No insurance policies were involved with respect to the repurchase of B’s shares in the other company.

Paragraph 10 of the redemption agreement provides that, after full payment of the promissory note, Decedent would have the right to purchase any company owned policies insuring Decedent’s life at the policies’ then cash surrender value plus the amount of the pro-rated annual premium.

The redemption agreement contains a recital that it supersedes all prior understandings and written agreements specifically including the amended buy-sell agreement. We note that one individual holding a small number of shares did not execute the repurchase agreement.

On December 15, 1989, Decedent surrendered her shares to Company in exchange for a promissory note in the amount of $300,000. The note provided for 30 equal monthly payments of principal and interest with the final payment due on June 15, 1992.

Decedent died on September 27, 1991, at age 55 (age 56 as of her nearest birthday) when the balance due under the promissory note was $96,231.47. Upon the death of Decedent the trustee distributed a portion of the insurance proceeds to the estate (in an amount equal to the balance due on the promissory note) and the balance to B and the other shareholders.

The probability that a person aged 56 will survive for a period of nine months exceeds 99 percent.

TAM 9349002 asserted that the above facts supported the following conclusions:

1. At the time the life insurance arrangement was created, the Decedent’s stock was to be redeemed by Company within thirty-eight months and that final payment of the promissory note would have occurred within sixty-eight months.

2. The insurance policies were acquired with Company earnings that would otherwise have accrued to the benefit of the shareholders.

3. Neither the Company nor the trustee could exercise any of the incidents of ownership that existed with respect to the insurance policy during the term of the trust (except as directed by the shareholders through modification of the agreement). The “trustee,” holding no independent authority, functioned solely as an agent for the shareholders ([sic] accepting and forwarding the premiums on the insurance policies

and collecting and disbursing the proceeds, if any, received with respect to each policy.

4. The policy was structured so that its cash surrender value would be zero until several years after the trust terminated. Thus, the Decedent would have been able to acquire the policy by paying the then unexpired (pro-rata) portion of the annual premium regardless of the actual value of the policy at the completion of the redemption.

TAM 9349002 agreed with the estate "that the Decedent did not possess more than 50 percent of the combined voting power of the corporation; thus, the incidents of ownership in the policy held by the Company, if any, are not attributed to the Decedent under the indirect control rationale of section 20.2042-1(c)(6)." However, the IRS disagreed regarding Reg. 20.2042-1(c)(3):

> Taxpayer argues that the Decedent did not have a reversionary interest in the policy immediately prior to death. Taxpayer contends that a reversion cannot exist in property that was never held by the Decedent and, even if it could, no reversion exists in this case because the policy would not have automatically returned to the Decedent.
>
> Taxpayer relies on *Estate of Leder v. Commissioner*, 893 F.2d 237 (10th Cir. 1989), *Estate of Headrick v. Commissioner*, 918 F.2d 1263 (6th Cir. 1990), and *Estate of Perry v. Commissioner*, 927 F.2d 209 (5th Cir. 1991), for the proposition that Decedent did not "transfer" a policy of insurance on Decedent's life. We believe taxpayer's reliance is misplaced. While those cases did reject a "constructive", (or "beamed") transfer doctrine in the application of section 2035(d)(2), they did not deny the validity of that doctrine.
>
> In *Leder* for example, the court recognized the existence of a transfer, stating, in part:
>
>> The typical example of a constructive transfer is where the decedent purchases a life insurance policy on himself or herself, pays all the premiums, and designates his or her children or spouse as the owners and beneficiaries. In these situations courts construing section 2035(a) view the decedent's actions as acts of transfer, because the decedent "beamed" the policy proceeds to the children or spouse by paying the policy premiums and creating in the children or spouse all of the contractual rights to the insurance benefits. [*Bel*, 452 F.2d 683 (5th Cir. 1971), *cert. denied*, 406 U.S. 919 (1972)].
>
> It is clear that in *Leder*, as in the other cases cited by the taxpayer, the decision did not hinge on whether the insured had transferred a policy of insurance but on the technical issue of whether the insured had transferred an interest in the policy that would have caused inclusion of the proceeds under section 2042 of the Code if the interest had not been transferred. In addition, in those cases the trustee or other third party transferee who purchased the policy ostensibly had a much greater degree of independence in the selection and acquisition of trust assets.
>
> In this case the Decedent, along with the other shareholders, caused the Company to transfer assets to the trustee who was directed to acquire a policy of insurance on the life of each of the two major shareholders. Whether the arrangement is viewed as a transfer of the assets or as an interest free loan, the result is a constructive transfer of an insurance policy.

Similarly, we disagree with the taxpayer’s analysis of the Decedent’s potential right to re-acquire the policy.

Taxpayer, citing *Estate of Smith*, 73 T.C. 307 (1979), *acq. in result only*, 1981-1 C.B. 2, suggests that no reversion exists if return of the policy is contingent on events over which the insured has no control. We believe the absence of control is relevant only with respect to the VALUE of the insured’s right (the PROBABILITY of reverter) and has no relevance with respect to the EXISTENCE of that right (the POSSIBILITY of reverter).

In *Smith* the insured possessed the right to acquire an employer- owned policy only if the employer elected to discontinue the policies either through nonpayment of premiums or by surrender of the policies. At the date of death the contingencies under which the insured could acquire the policy had not occurred and the issue before the court was whether the insured’s veto power (over the cancelation of the policies) was a sufficient incident of ownership to cause inclusion in the gross estate.

We do not believe that *Smith* is relevant here. The issue as framed by the court in *Smith* was whether the insured, acting alone or in conjunction with the employer could have exercised any of the incidents of ownership or if the insured could have prevented the exercise by the employer of any incidents of ownership. We can find no discussion as to whether the insured’s contingent right to acquire the policies constituted a reversionary interest as contemplated in section 20.2042-1(a)(6) of the regulations. We assume that the issue was not discussed because the value of the insured’s possibility of reverter would not have exceeded five percent of the value of the policies immediately before the death of the insured.

Taxpayer further argues that the Decedent possessed no reversionary interest in the policy because her right to acquire the policy was contingent on the final payment of the promissory note, “an event over which [the Decedent] had no control”. We can find no indication in the file that the promissory note was not enforceable at the time of the Decedent’s death and taxpayer has furnished no information that would suggest that the Decedent could not have required the Company to make the final payment as contemplated therein. If such evidence does exist, we believe it would be relevant solely for purposes of determining the value of Decedent’s reversionary interest immediately before the Decedent’s death.

Finally, taxpayer argues that no reversion existed because the only way the Decedent could have acquired the policy was to purchase it. Again, we believe that taxpayer raises an issue going to the valuation of the insured’s interest rather than the existence of that interest. We note that in this case the purchase price contemplated in the arrangement did not require the Decedent to pay an amount equal to the replacement cost of the policy; *i.e.*, the arrangement did not require the Decedent to pay an amount equal to the cost of a similar policy under the then existent facts.

We would also note that this arrangement did not involve the cross-purchase of life insurance policies. In this case, prior to the redemption, the amended buy-sell agreement essentially created a “winner take all” arrangement. If the Decedent had survived B by more than 30 days, the Decedent would have acquired over ninety percent of the stock in the Company and, thus, would have indirectly owned more than ninety percent of the policy on the her life (with the additional option of acquiring the entire policy).

TAM 9349002 also asserted incidents of ownership under Reg. § 20.2042-1(c)(4):

> When the insured cannot initiate the acts associated with the incidents of ownership but can only consent to or veto the exercise of the incidents of ownership by another, the courts have held that the veto power itself constitutes an incident of ownership over the policy. The Second Circuit held that where the insured must consent before the actions of others effectively alter a revocable trust, the insured holds incidents of ownership in a life insurance policy held by the trust. *Estate of Karagheusian v. Commissioner*, 233 F.2d 197 (2d Cir. 1956). Similarly, the Court of Claims held that where the beneficiary/owner of an insurance policy had the power to change the beneficiary, but the power could be exercised only with the consent of the insured, the insured held incidents of ownership in the policy for federal estate tax purposes. *Estate of Goldstein v. United States*, 122 F.Supp 677 (Ct. Cl. 1954). It is immaterial whether the decedent may initiate changes, or whether he must merely consent to them. It is the power and not the substantiality of the power that we must look to. *Schwager v. Commissioner*, 64 T.C. 781 (1975).
>
> Taxpayer argues that the insurance policy at issue was purchased for a valid business purpose and is not, therefore, includible in the insured's gross estate. In support of this position taxpayer cites *Estate of Bert L. Fuchs*, 47 T.C. 199 (1966) and *Estate of Howard F. Infante*, 29 T.C. Memo 1970-206. Additionally, taxpayer cites *Estate of Smith*, *supra*, and Rev. Rul. 84-130, 1984-2 C.B. 194.
>
> In *Fuchs* the partners agreed to acquire insurance on the lives of the other partners to fund a buy-sell agreement. The partners each acquired insurance on the lives of the other partners pursuant to an agreement which the court characterized as creating an "informal relationship of a quasi-trust nature which obligated the partners to deal with each policy in a manner conforming to the terms of the agreement. Under the "policy facts", the incidents of ownership were vested in the owner. The court stated that any power held by the insured with respect to those incidents was held in a fiduciary capacity similar to that imposed on a trustee.
>
> The facts in *Infante* were similar to those in *Fuchs*, except that the partnership originally acquired the policies, which were then reissued naming each partner absolute owner and beneficiary of the policy on the other partner's life. The court noted that the veto right held by the insured arose from the partnership agreement and as such could only be exercised in conformance with the limitations imposed by the that agreement. Citing *Fuchs*, the court held that the insured did not possess the true incidents of ownership in the policy.
>
> We note that the court in *Infante* recognized that policy facts do not always control and that side agreements can create incidents of ownership. With respect to *Karagheusian*, *supra*., the court stated, in part:
>
>> Decedent had no direct ownership interest in the policy and held none of the powers granted by the terms of the policy itself. His veto power derived exclusively from the trust instrument.
>>
>> While the "incident of ownership" was created exclusively by the collateral contract (the trust instrument), the contract substantially impinged upon the terms of the policy itself. Through the trust, and in conjunction with his wife, he could have

> exercised all rights of ownership. In addition, there were no restrictions on the decedent as to the purposes for which he could have used the proceeds of the funds. Hence, through a merely formalistic change of ownership, decedent was able to reserve all rights of ownership without being the owner of record.

The court found the decedent's power to be an "incident of ownership" in the policy for purposes of section 2042(2). In reaching this conclusion, the court analogized the trust situation to the [Estate Tax Regs.] example of indirect ownership of a policy through a corporation as an "incident of ownership" and held that the decedent had obtained an "incident of ownership" (his veto power) through his indirect ownership of the policy.

Rev. Rul. 84-130, 1984-2 C.B. 194, provides that the decedent does not hold incidents of ownership in a group term life insurance policy where the only right the decedent held over a noncontributory group term policy on the decedent's life was the right to convert the policy to an individual policy should the individual cease employment. The ruling notes that the powers mentioned in section 20.2042-1(c)(2) of the regulations are powers that directly affect the insurance policy rather than powers that arise as collateral consequences of independent actions of the insured. As an example of a power exercisable as a result of an independent action and, thus, not an incident of ownership, the ruling cites the power to cancel coverage under a group term policy by terminating employment. See Rev. Rul. 72-307, 1972-1 C.B. 307. The power of cancelation is considered a collateral consequence of the power that every employee holds to terminate employment. See also Rev. Rul. 80-255, 1908-2 C.B. 272.

Both Rev. Rul. 84-130 and *Estate of Smith*, *supra*., involved an employee's rights with respect to employer owned insurance. Neither case involved the insured's rights with respect to a policy of insurance held by a trust created by the insured.

Based on the above we conclude that, under the terms of the amended buy-sell agreement, the Decedent-insured, through her ability to withhold consent to the exercise of the policy rights effectively acquired the incidents of ownership in the life *insurance* policy held by the "trustee". See *Estate of Raragheusian v. Commissioner*, supra. Similarly, because the economic rights with respect to the policy could only be changed by modification of the trust arrangement, and because that arrangement could not be modified without her consent, it seems Clear that the Decedent-insured, in conjunction with the other shareholders, possessed the incidents of ownership in the policy at the date of death.

Analysis of the terms of the amended buy-sell agreement indicates that the duties of the "trustee" thereunder are limited to acquiring the policies of insurance on the lives of B and the Decedent; receiving premium payments from the Company and forwarding those payments to the insuror, and distributing any proceeds paid under the policies to the actual beneficiaries thereof. In as much as the "trustee" was precluded from exercising any of the "powers of ownership" of the policy, it is apparent that the "trustee" acted more as an agent for the shareholders rather than as an independent trustee.

On brief taxpayer has argued that inclusion of the insurance proceeds along with inclusion of the balance on the promissory note would result in double taxation.

In most cases when the issue of double taxation has been before the court, the owner and beneficiary of the insurance policy was the business entity involved. In those cases

> the question before the court involved indirect ownership of the proceeds through the insured's ownership in the entity.
>
> In this case no portion of the value of the proceeds is indirectly included in the value of the Decedent's gross estate. The fact that the trustee paid a portion of the proceeds to the Company (rather than to the new owners of the Company) would be relevant if the value of the company (as affected by those proceeds) were relevant in determining the value of the Decedent's gross estate.

II.Q.4.i.ii.(a). Trust Ownership of Policy

Reg. § 20.2042-1(c)(4) provides:

> A decedent is considered to have an "incident of ownership" in an insurance policy on his life held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust. Moreover, assuming the decedent created the trust, such a power may result in the inclusion in the decedent's gross estate under section 2036 or 2038 of other property transferred by the decedent to the trust if, for example, the decedent has the power to surrender the insurance policy and if the income otherwise used to pay premiums on the policy would become currently payable to a beneficiary of the trust in the event that the policy were surrendered.

Letter Ruling 9622036 discussed the following scenario:

> You represent that A, B, and C are the shareholders of Corporation X, a "subchapter C" corporation. Shareholder A owns 43 percent of the stock of the corporation; shareholder B owns 14 percent of the stock, and shareholder C owns 43 percent of the stock. Shareholder A is the father of shareholder C. Shareholder B is not related to shareholder A or C.
>
> The corporation and the three shareholders have entered into a stock restriction agreement. It is represented that the agreement was contracted on a bona fide basis for full and adequate consideration. The agreement is legally binding and enforceable against the shareholders and their estates under state law. The agreement provides for the transfer of a shareholder's corporate stock in the event of the death, disability, retirement, or termination of employment of that shareholder. At a shareholder's death, the shareholder (or his estate) is obligated to sell, and the surviving shareholders are obligated to buy, his shares at a price specified in the agreement. The agreement requires that the shareholders purchase life insurance on the lives of the other shareholders to ensure payment of the purchase price. The policies that are purchased must be made expressly subject to the agreement. Each shareholder, in signing the agreement, agrees that he will not exercise any of the rights, privileges, or benefits accruing under the policies owned by him and that he will not assign, encumber, borrow against, or otherwise dispose of the policies without the prior written consent of all other shareholders.
>
> Pursuant to the agreement, two life insurance policies have been purchased by the shareholders. Policy 1 is a first-to-die life insurance policy which designates A and C as

the insureds and B or his estate as the owner. At the death of the first-to-die of A or C, the survivor of A or C is named the beneficiary of 75 percent of the proceeds of the policy and B is named the beneficiary of the remaining 25 percent.

A second policy, Policy 2, is a life insurance policy on the life of B that is owned by shareholders A and C. Shareholders A and C are each beneficiaries of 50 percent of the proceeds of Policy 2. The premiums on Policies 1 and 2 are paid by the corporation under a collateral assignment split dollar agreement.

Upon the death of a shareholder, the stock restriction agreement requires that the surviving shareholders purchase, on a pro rata basis, such shares of the corporation owned by the decedent as may be purchased for cash with the proceeds of the life insurance policy. The estate of the decedent is obligated to sell such shares. The purchase price under the agreement is to be redetermined annually at the end of each fiscal year by the unanimous agreement of the shareholders. If the shareholders fail to redetermine the value of the shares, the fair market value of the stock is to be determined by an independent certified public accountant. In the event that the insurance proceeds are not sufficient to purchase all of the deceased shareholder's shares, the corporation is obligated to purchase the balance of the shares. The party that has the obligation to purchase the stock of a deceased shareholder may retain any policy proceeds that are in excess of the amount necessary to purchase the stock. The agreement is made expressly binding upon all shareholders and their respective heirs, executors and administrators, successors and assigns.

The shareholders propose to create an irrevocable trust and transfer Policy 1 and Policy 2 to the trust. The trustee of the trust will be a third party unrelated to A, B, or C, and will at no time be a shareholder of the corporation. The trust will be named the beneficiary of the proceeds of each policy and all "policy rights" will be transferred to the trustee of the trust. The "policy rights" include all of the right, title, interest, ownership, control, and incidents of ownership in any and all insurance policies that become subject to the terms of the trust, and in any insurance provided under such policies, together with any additions to such insurance. The "policy rights" are also defined to include any conversion privilege, waiver of premium benefit and accidental death benefit, the right to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy, and the right to assign, pledge, sell or otherwise dispose of any and all right, title, interest, ownership, option, election, privilege, or benefit under the policy.

Upon receipt of any proceeds under either policy, the trustee is obligated to distribute such proceeds to the surviving shareholders who, pursuant to the agreement, are obligated to purchase the decedent's shares. The proceeds are to be distributed in proportion to the percentage of stock held by each surviving shareholder (excluding the stock owned by the deceased shareholder). In the event that a shareholder's shares are purchased by the other shareholders pursuant to the terms of the agreement for any reason other than the shareholder's death, the trustee is obligated to distribute any policy in which the selling shareholder is a named insured to the purchasing shareholders in proportion to the stock ownership of the purchasing shareholders (excluding the shares of stock being purchased from the selling shareholder). In the event of a liquidation of the corporation, the entire trust corpus must be distributed to the shareholders in proportion to their respective percentage stock ownership in the corporation.

Letter Ruling 9622036 ruled that each insured did not hold incidents of ownership:

> In the present case, shareholders A, B, and C, have entered into a binding stock restriction agreement with respect to their corporate stock. The agreement is funded, in part, by a first-to-die life insurance policy, Policy 1, on the lives of shareholders A and C. A portion of the proceeds from Policy 1 is payable to the survivor of A and C, and a portion is payable to B. The beneficiaries must use the policy proceeds to purchase the decedent's stock in the corporation.
>
> The agreement is also funded by a second policy, Policy 2, which insures the life of shareholder B. The proceeds of Policy 2 are payable equally to shareholders A and C. The beneficiaries must use the policy proceeds to purchase the decedent's stock in the corporation.
>
> The shareholders propose to transfer Policy 1 and Policy 2 to an irrevocable trust. The trustee of the trust will be a third party, unrelated to A, B, or C, who will not be a shareholder in the corporation. The trust will be named the beneficiary of the proceeds of each policy and all "policy rights" will be transferred to the trustee of the trust.
>
> We conclude that the proceeds of Policy 1 will not be includible in the gross estate of the first to die of shareholder A or shareholder C under section 2042(2), after the proposed transfer of the policy to the irrevocable trust. Similarly, the proceeds of Policy 2 will not be includible in the gross estate of shareholder B under section 2042(2), after the proposed transfer of the policy to the irrevocable trust.

Zaritsky & Leimberg, ¶7.04. Life Insurance Funding for Buy-Sell Agreements, *Tax Planning with Life Insurance: Analysis With Forms* (WG&L), commented on Letter Ruling 9622036:

> The Service ruled that the shareholders did not have incidents of ownership over the policies held by the trust. Although this ruling appears to be favorable, there are several issues that the Service did not address. For example, it is unclear whether one of the shareholders (and which one) must report as taxable income the economic benefit of the policies, since it cannot be known whom the survivor of the father and son will be. In this regard, it is unclear whether 75 percent of the economic benefit should be allocated to or between father and son (the survivor of whom will receive 75 percent of the proceeds) and whether the remaining 25 percent of the economic benefit should be allocated to the unrelated shareholder, who will receive the 25 percent balance of the proceeds. Similarly, it is unclear how the parties should measure the annual economic benefit, as there is no official IRS table for measuring the value of coverage under a first-to-die contract. Furthermore, it is unclear whether there has been a transfer for value, and whether, if neither father nor son reports any annual economic benefit, whether the proceeds payable to the survivor should be subjected to ordinary income tax treatment.
>
> Policy 2 in the ruling was owned by the father and son and insured the life of the unrelated shareholder. When the unrelated shareholder died, the proceeds would be split equally between father and son. The Service could argue that neither father nor son would have allowed the other to be an automatic surviving owner had the other not allowed the same. That reciprocity could provide the consideration required to invoke the transfer-for-value rules. Because of the underlying business reasons for the insurance coverage, it may be difficult to argue that the "transfer" between father and son qualifies under the "gift" exception to the transfer-for-value rule, despite the family relationship. If

father and son owned the policy on the unrelated shareholder as tenants-in-common (rather than as joint tenants with rights of survivorship) and one of them died, the decedent's interest in the policy on the unrelated shareholder's life would vest in the decedent-policy owner's estate. It is unclear how the surviving owner would acquire the interest from the deceased's estate without creating a transfer for value.

The ruling was requested because the shareholders wanted to create an irrevocable trust with an independent trustee and transfer both policies to that trust. The trust is to be the beneficiary of the proceeds of Policy 1 and Policy 2 and also hold all policy rights. The taxpayers' letter indicated that those policy rights encompass every right that might be considered an incident of ownership. When the trust receives policy proceeds, it must pay out the money to the surviving shareholders who are obligated to buy a decedent's shares—in proportion to the percentage of stock held by the surviving shareholders (without counting stock owned by the estate of the deceased shareholder).

If a shareholder's stock were bought on an event other than death, the trustee must distribute the policy on the selling shareholder's life to the buying shareholders in proportion to their percentage ownership (without counting stock owned by the selling shareholder). If the corporation were liquidated while the shareholders were alive, any policy or other asset in the trust must be distributed to the shareholders in proportion to their respective stock ownership in the corporation. In other words, policy ownership will never revert to the insured. The Service stated that, after the policies are transferred to the trust, the proceeds from Policy 1 and Policy 2 will not be includable in the insured's estate. That favorable outcome was based on the belief that all ownership rights were to be held by the trust, and that there would be no "reversion" of ownership or beneficial interest to the insured. Although it is not totally clear from the facts, it appears that at the death of any shareholder, his interest in the life insurance on the lives of the other shareholders shifts to the surviving shareholder(s). This would be a transfer of an interest in a policy for valuable consideration (*i.e.*, each shareholder tacitly has agreed to allow the interest he owns in a policy to shift to the others in return for their agreement to reciprocate). As noted previously, in the event of a corporate liquidation while all three shareholders are alive, the policies will be distributed in proportion to their respective stock ownership. Were the first-to-die policy to be distributed, father and son (the insureds) would be among the "purchasing" shareholders (together with the unrelated party), and part of the policy will be distributed to father and son, or both. If so, it is unclear what percentage of the assets should be distributed to each of the beneficiaries—in an unsigned document, the decedent could possibly resolve all the potential transfer-for-value problems by making the shareholders legitimate partners in a bona fide partnership, one actually engaged in a business or investment enterprise that meets state and federal law partnership requirements. This brings all three shareholders into a safe harbor exception to the transfer-for-value rule and assures that the life insurance proceeds will be income tax free.

The intent in the arrangement in this ruling was to fund a cross-purchase plan with a minimum number of policies and reduce administration. The ruling seems to bless this approach by stating that neither policy would be includable in the insured's estate. However, planners should consider income as well as estate tax implications. Any transfer for value that were made before the transfer of the policies to the trust would, however, remain, because of the arrangements. Thus, the death proceeds may to be treated as ordinary income taxable to the beneficiaries.

For details on the income issues that concerned Zaritsky & Leimberg, see part II.Q.4.b Transfer for Value Rule; Basis.

Further below are authorities when the insured is a trustee or a beneficiary.

The Official Tax Court Syllabus for *Estate of. Fruehauf v. Commissioner*, 50 T.C. 915 (reviewed 1968), summarized:

> Decedent's wife owned several insurance policies taken out on the life of her husband. She died 14 months before her husband. In the wife's will it was provided that the policies were to go to a trust of which decedent was cotrustee and income beneficiary. The trustees were given broad powers to retain policies as long as they desired, to assign some of the policies to obtain money to pay premiums, to designate themselves as beneficiaries, and to sell or convert policies for cash surrender value. Held, the proceeds of the policies were correctly included in decedent's estate and he held incidents of ownership over the policies within sec. 2042, I.R.C. 1954, and the fact that his powers, affecting the beneficiaries' enjoyment of the proceeds, were held by him in his capacity as trustee, was immaterial.

The majority reasoned and held:

> There is no merit in petitioners' argument. The right of the insured or his estate to the economic benefits of the policy is merely one of the several incidents of ownership. The argument advanced by petitioners was rejected in *United States v. Rhode Island Hospital Trust Co.*, 355 F.2d 7 (C.A. 1, 1966), where the court said:
>
>> Plaintiffs seize on Section 20.2042-1(c)(2) of the Treasury Regulations on Estate Tax, which says "… the term 'incidents of ownership' is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy." Plaintiffs urge that there must be "a real control over the economic benefits". To this there are two answers. First, it is clear that the reference to ownership in the "technical legal sense" is not abandoned and supplanted by reference to "economic benefits". Second, the regulation goes on to list illustrative powers referred to by Congress in its reports. All of these are powers which may or may not enrich decedent's estate, but which can affect the transfer of the policy proceeds…..
>
> In *United States v. Rhode Island Hospital Trust Co.*, *supra*, the court said the relevant question to ask with respect to this statute is: "Did he [decedent] have a capacity to do something to affect the disposition of the policy if he had wanted to?" It cannot be said the capacity to do something to affect the disposition of the policy is lacking merely because it is held in a fiduciary capacity.
>
> It is no answer to say that decedent as trustee owed a duty to the beneficiary to faithfully administer the trust and the beneficiary could have had his actions with respect to the trust corpus reviewed in an action at law or in equity. *Cf. Reinecke v. Smith*, 289 U.S. 172 (1933). As stated in *United States v. Rhode Island Hospital Trust Co.*, *supra*, it is the existence of "powers" that renders the proceeds of the policies taxable as distinguished from the existence of "rights" or duties owed to others.

In the last-cited case, in answer to the same argument with respect to decedent's power over the property being limited because of trustee duties and responsibilities, the court said:

> For decedent had some powers—perhaps not rights, but powers—which could, if exercised alone or in conjunction with another, affect the disposition of some or all of the proceeds of the policy.

There is no doubt at all but that sections 2038 and 2042 are parts of a tax pattern to make includable in the gross estate property over which the decedent held various powers affecting beneficial enjoyment. Since case law makes immaterial for purposes of section 2038 the capacity in which the powers are held, it is not logical to make capacity a significant factor as far as section 2042 is concerned.

In spite of the fact that there is language expressing a contrary view in some of our prior cases, we now hold that the fact the powers over the policies were held by decedent in a fiduciary capacity is no bar to their constituting incidents of ownership under section 2042.

The Sixth Circuit affirmed, 427 F.2d 80 (1970), while disagreeing with the breadth of the Tax Court's reasoning:

> While the opinion of the Tax Court clearly related the holding to the facts of this case, certain language in that opinion is susceptible to interpretation as a broad per se rule that possession by a decedent of powers constituting incidents of ownership in insurance policies on his life, regardless of the capacity in which they are held, always requires inclusion of the proceeds of the policies in the decedent's gross estate. In reasoning to this conclusion the Tax Court placed heavy reliance on a number of cases[2] which arose under § 2038 (and its predecessor sections) of the Code. Section 2038 charges a decedent's gross estate with any property of which he made an inter vivos transfer if, at the date of his death, he possessed the power to "alter, amend, revoke, or terminate" the transfer. The statute also provides that the existence of the power is to be determined "without regard to when or from what source the decedent acquired the power." Thus, the Tax Court reasoned:
>
> > "There is no doubt at all but that sections 2038 and 2042 are parts of a tax pattern to make includable in the gross estate property over which the decedent held various powers affecting beneficial enjoyment. Since case law makes immaterial for purposes of section 2038 the capacity in which the powers are held, it is not logical to make capacity a significant factor as far as section 2042 is concerned."
>
> and held that:
>
> > "[T]he fact the powers over the policies were held by decedent in a fiduciary capacity is no bar to their constituting incidents of ownership under section 2042." 50 T.C. at 926.
>
> [2] *E.g.*, *Van Beuren v. McLoughlin*, 262 F.2d 315; (1st Cir. 1958), *cert. denied* (359 U.S. 991 (1959); *Estate of Loughridge v. Commissioner*, 183 F.2d 294 (10th Cir. 1950), *cert. denied*, 340 U.S. 830 (1950); *Union Trust Company of Pittsburgh v.*

> *Driscoll*, 138 F.2d 152 (3rd Cir. 1943), *cert. denied*, 321 U.S. 764 (1944); *Welch v. Terhune*, 126 F.2d 695 (1st Cir. 1942).

We must disagree with the Tax Court's broad per se rule. We believe that there is a distinction between the issues arising under § 2038 where the decedent, as transferor of certain property, possesses at his death the power, even though in a fiduciary capacity, to revoke or change the transfer, and the issues in a case arising under § 2042 where the decedent is the transferee, in a fiduciary capacity, of powers constituting incidents of ownership in the insurance policies on his life. Where a decedent holds the requisite powers over policies on his life solely because he is a transferee, in a fiduciary capacity, of those powers, with no beneficial interest therein, such arrangement can hardly be construed as a substitute for testamentary disposition on decedent's part. *Cf*. *Porter v. Commissioner*, 288 U.S. 436, 444 (1933); *Commissioner v. Chase National Bank*, 82 F.2d 157, 158 (2d Cir. 1936).

Moreover, the Tax Court has previously held that where the decedent himself procured the policies on his life and transferred them to a trust, while retaining certain powers over the policies in a fiduciary capacity, the proceeds of the policies were not includible in the decedent's gross estate. In *Estate of Newcomb Carlton*, 34 T.C. 988 (1960), *rev'd on other grounds*, 298 F.2d 415 (2d Cir. 1962), the decedent originally procured 21 insurance policies on his life. He then transferred them to a trust, together with certain securities, with instructions to use the net income from the securities to pay the premiums on the life insurance policies. The decedent originally retained certain powers over the policies, but by a subsequent instrument he relinquished all rights over the trust except the right to the income from the trust in excess of that necessary to pay the premiums on the life insurance policies, and the right to appoint a co-trustee, including himself, for a co-trustee who had resigned. Decedent never exercised the power to appoint himself as co-trustee, but he retained that power until his death. Had he appointed himself as co-trustee he would have had, in conjunction with the other co-trustees, broad powers to borrow on the insurance policies or surrender them for their cash surrender value, powers which would constitute incidents of ownership in the policies. The Tax Court stated, however:

> "Any control that decedent would have acquired over the insurance policies had he appointed himself co-trustee would have been control over the policies jointly with the corporate trustee as trustee only and such control would be solely for the benefit of the trust. Such control as trustee would not constitute incidents of ownership in the insurance policies in decedent except in his capacity as trustee for the benefit of the trust." 34 T.C. at 996.

In *Estate of Bert L. Fuchs*, 47 T.C. 199 (1966), the decedent was one of three business partners who funded a partnership purchase agreement with insurance policies on the lives of the respective partners. The purchase agreement provided that the beneficiaries would be the owners of the policies, that the beneficiaries would pay the premiums on the policies, and that the insureds would have no right, title or interest in the policies on their respective lives. Through inadvertence on the part of the insurance agent, the policies showed ownership to be in the insured rather than in the beneficiaries, thereby giving the insured the right under the policy to change the beneficiary and to surrender or assign the policies. Nevertheless the Tax Court held that the insured decedent did not possess any incidents of ownership in the policies on his life at the date of his death. While that determination was based on a finding that the insurance policies were subject to the provisions in the partnership purchase agreement, the Tax Court clearly recognized the nature of the fiduciary relationship:

> "Assuming, arguendo, that the insured of each policy herein possessed the naked power to change beneficiaries or make an assignment, we cannot say, in view of the partners' agreement regarding the policies, that the insured herein should be treated in any way differently than a common trustee. Each insured herein was under no less of a legal duty to respect the terms of the partners' agreement than a common trustee legally obligated to respect the terms of a trust indenture. Decedent merely had the same type of power over the ... policies as a trustee's power to affect trust proceeds. We do not believe that this type of naked power alone is sufficient to bring the insurance proceeds within decedent's gross estate." 47 T.C. at 204.

We believe that the Tax Court in this case ignored what it had clearly recognized in these prior cases, *i.e.*, the fundamental nature of the fiduciary relationship. Accordingly, we decline to hold that mere possession by a decedent of any powers in the nature of incidents of ownership in a fiduciary capacity invariably requires inclusion of the proceeds of the policies on the decedent's life in his gross estate.

Our rejection of the per se rule of the Tax Court majority opinion does not dispose of the case, however. In an opinion in which three other judges joined, Judge Simpson of the Tax Court similarly rejected the per se rule of the majority opinion but concurred in the result because of the special facts of this case. Judge Simpson viewed the powers held by decedent in his fiduciary capacity as broad enough to permit their exercise for his individual benefit. Specifically, the concurring opinion concluded that decedent had the power as trustee under paragraph Eighth of his wife's will to surrender the insurance policies for their cash surrender values. The amounts so received could then have been added to the corpus of the trust, thereby increasing the income receivable from the trust by decedent as income beneficiary.

The estate's first response to this analysis of the facts is that decedent did not actually have any powers as trustee or any right to receive any increased income which would result from a surrender of the insurance policies because, at the date of his death, no distribution of assets had been made to the trust, and neither decedent nor any of the other co-trustees had been formally appointed as trustees of the testamentary trust by the state probate court. In support of this argument the estate contends that the normal period for the administration of decedents' estates in Michigan is eighteen months, and since decedent's death here occurred only fourteen months after his wife's death the testamentary trust could not reasonably have been created.

It appears, however, that eighteen months is the maximum period allowable by a Michigan probate court for the administration of an estate before the accrual of interest on pecuniary bequests begins. See *In re Howlett's Estate*, 275 Mich. 596, 602, 267 N.W. 743, 745 (1936). It does not appear that swifter administration of an estate is impossible. Decedent here had the power to become both trustee and life income beneficiary of the testamentary trust through the exercise of his powers as executor of the will. We believe that it is the existence of that power, not its exercise, which is determinative. Merely because decedent had not performed certain acts necessary to enable [pg. 70-1627] him to become trustee-beneficiary of the trust does not detract from his power to do so. Moreover, under the terms of paragraph Eighth of his wife's will decedent had the power in his capacity as executor as well as trustee to surrender the policies for their cash

> value. Accordingly, he could have surrendered the policies for their cash value while he was executor thereby enlarging the income producing ability of the corpus available for distribution in due course to the testamentary trust. We therefore do not consider it significant that decedent had not been formally appointed trustee by the probate court.
>
> The estate's second line of argument is that the fiduciary duty of loyalty imposed upon decedent in his capacity as executor and trustee would have prevented him from exercising any of the powers granted to him in any manner which would benefit himself to the detriment of the remainderman; that any powers granted to decedent which would appear to give him authority to perform acts which would benefit himself to the detriment of the remainderman were void as a matter of law.
>
> It is a well-established rule of law that a fiduciary cannot use his position to benefit himself in his individual capacity. See *e.g.*, *Michigan Trust Co. v. Luton*, 267 Mich. 547, 554, 255 N.W. 351, 353-54 (1934); *Chambers v. Chambers*, 207 Mich. 129, 136, 173 N.W. 367, 369-70 (1919); *Sloan v. Silberstein*, 2 Mich. App. 660, 673, 141 N.W.2d 332, 338 (1966); Bogert, *Trusts and Trustees* § 129 (2d ed. 1965); II *Scott on Trusts* § 170.23 (3rd ed. 1967). There is, however, an equally well established countervailing rule of law that a fiduciary may be authorized by the terms of the instrument creating his powers to do that which in the absence of such provision would be a violation of his fiduciary duty of loyalty. II *Scott on Trusts* § 170.9 (3rd ed. 1967). Michigan courts have recognized this rule. See *Waddell v. Waddell*, 335 Mich. 498, 506-7, 56 N.W.2d 257, 260-61 (1953).
>
> Under the provisions of paragraph Eighth of decedent's wife's will, decedent was authorized, both as executor and as trustee, to surrender the policies on his life for their cash value. If this had been done the policies would have been transformed from non-income producing assets designed to benefit primarily the ultimate beneficiary of the trust into income producing assets (since it must be assumed that such proceeds would not remain idle), which would benefit decedent when he assumed his capacity as trustee and income beneficiary of the trust. We must therefore hold that under the facts of this case decedent could exercise powers in the nature of incidents of ownership in the policies to his individual benefit, and that therefore the proceeds of the policies were includible in his gross estate.

Does being the trustee of a trust containing an insurance policy on the trustee's life, with the trustee having no beneficial interest in the trust, result in estate tax inclusion under Code § 2042? *Estate of Skifter v. Commissioner*, 468 F. 2d 699 (2d Cir. 1972) held that the insured as trustee would not have an includable incident of ownership unless the insured had transferred the policy to the trust, implying this requirement into the regulation, which otherwise would not have complied with the statute:

> Although this legislative history is hardly conclusive on the matter, we feel that there is sufficient support to justify our conclusion that Congress intended § 2042 to parallel the statutory scheme governing the interests and powers that will cause other types of property to be included in a decedent's estate. This conclusion is reinforced by the types of interests and powers that Congress indicated were exemplary of what it meant to be included within the scope of "incidents of ownership." The interests there listed are interests that would cause other types of property to be included in a decedent's estate under § 2036 or § 2037; and the powers that Congress discussed are also powers that would result in the property being included in the decedent's estate under § 2038 or

§ 2041.[4604] Therefore, in ruling on the Commissioner's contention that the fiduciary power here involved is an "incident of ownership," a question that has not been considered under § 2042, we feel that we should look to the experience under the statutory scheme governing the application of the estate tax to other types of property. Indeed, the Commissioner, in making his contention before us, relies on numerous analogies to decisions under these other statutory provisions.

The core of the controversy here centers on the decedent's power, as trustee, to prefer the current income beneficiary over the remainderman and all later income beneficiaries through payment of the entire trust corpus. He did not have the power to alter or revoke the trust for his own benefit and he could not name new, additional, or alternative beneficiaries. In this regard, Reg. § 20.2042-1(c)(4) provides:

> A decedent is considered to have an "incident of ownership" in an insurance policy on his life held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

The Commissioner contends that this regulation requires that the proceeds of the policies here be included in decedent's estate.

The Tax Court declined to interpret that regulation so as to make it applicable here, but concluded that, since the power could not be exercised to benefit the decedent or his estate, it would not cause the proceeds to be included in his estate. If the power had been exercisable for the benefit of decedent, or for the benefit of whomever the decedent selected, it would have been necessary to include the proceeds in the estate; for there would be a powerful argument that this was an incident of ownership since he would have had the equivalent of a power of appointment, which under § 2041 would cause other types of property to be included in the estate of the holder of such a power. This distinction causes us to concur in the Tax Court's conclusion that the Commissioner's reliance on our decision in *Commissioner v. Karagheusian's Estate*, 233 F.2d 197 (2d Cir. 1956), is misplaced.

The power that the decedent possessed was over the entire trust corpus, which included property other than the insurance policies. But there is no serious doubt that this power did not result in this other property being in decedent's estate for tax purposes. This type of power would fall under both § 2036 and § 2038. The former provision is clearly not triggered in this case because it only applies to a power retained by the grantor over the income from property when he transferred it to another. Thus, for purposes of § 2036, it would not matter that the decedent effectively had the power to deprive later income beneficiaries of the income from the corpus in favor of an earlier income beneficiary. However, the latter provision, § 2038, would apply because decedent had the power "to alter, amend ..., or terminate" the trust. The Commissioner has pointed to many cases holding that such a power would result in the property interest over which the power could be exercised being included in the estate of the holder of the power. See *e.g.*

[4604] [my footnote:] See parts III.C.1 Whether Code § 2036 Applies, III.D Code § 2038, and II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap, the latter of which covers Code § 2041. Code § 2038 cases often cite *Skifter*.

Lober v. United States, 346 U.S. 335 (1953); *United States v. O'Malley*, 383 U.S. 627 (1966) (decided under § 2036); *Commissioner v. Newbold's Estate*, 158 F.2d 694 (2d Cir. 1946). Therefore, he argues, this power must be an incident of ownership for § 2042 purposes also.

But the Commissioner's reliance on § 2038 cases exposes the fatal flaw in his position. The cases he cites dealt with powers that were retained by the transferor or settlor of a trust. That is not what we have here; the power the decedent had was given to him long after he had divested himself of all interest in the policies—it was not reserved by him at the time of the transfer. This difference between powers retained by a decedent and powers that devolved upon him at a time subsequent to the assignment is not merely formal, but has considerable substance. A taxpayer planning the disposition of his estate can select the powers that he reserves and those that he transfers in order to implement an overall scheme of testamentary disposition; however, a trustee, unless there is agreement by the settlor and/or beneficiaries, can only act within the powers he is granted. When the decedent is the transferee of such a power and holds it in a fiduciary capacity, with no beneficial interest therein, it is difficult to construe this arrangement as a substitute for a testamentary disposition by the decedent. *Cf. Porter v. Commissioner*, 288 U.S. 436, 444 (1933); *Commissioner v. Chase National Bank*, 82 F.2d 157, 158 (2d Cir. 1936).

Accordingly, we conclude that, although such a power might well constitute an incident of ownership if retained by the assignor of the policies, it is not an incident of ownership within the intended scope of § 2042, when it has been conveyed to the decedent long after he had divested himself of all interest in the policies and when he cannot exercise the power for his own benefit. We justify this interpretation of "incidents of ownership" on the apparent intent of Congress that § 2042 was not to operate in such a manner as to discriminate against life insurance, with regard to estate tax treatment, as compared with other types of property. We also note that our conclusion comports with the views expressed by the Sixth Circuit in *Estate of Fruehauf v. Commissioner*, 427 F.2d 80, 84-85 (6th Cir. 1970). Therefore, we must reject the contention of the Commissioner that the language of § 2042 requires that it be given a broader scope of operation than the statutes covering other types of property.

Until now, the discussion has assumed that § 2038 only applies when the power possessed by the decedent was reserved by him at the time he divested himself of all interest in the property (other than life insurance) subject to the power. This necessitates a brief discussion of the language of § 2038, which provides in pertinent part:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer ..., by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) ... *without regard to when or from what source the decedent acquired such power*), to alter, amend, revoke, or terminate ... (emphasis added).

The emphasized language would appear to indicate that § 2038 would apply even when the power was acquired under circumstances such as are present here. However, there is no indication that the Commissioner has ever made such an argument and we have been able to find no case applying § 2038 in this manner.

> The noted language was added to the predecessor of § 2038 in 1936 in response to the decision in *White v. Poor*, 296 U.S. 98 (1935). In that case, the decedent had created an inter vivos trust and conferred on the trustee the power jointly to terminate the trust. Subsequently, the decedent was appointed a successor trustee. Therefore, at death decedent possessed this power to terminate and the Commissioner attempted to apply the predecessor to § 2038; but the Supreme Court held this was impermissible because decedent had not retained the power at the time of transfer but had received it later. It was for the purpose of changing this result that Congress added the emphasized language. However, this language appears never to have been applied to a power other than one that the decedent created at the time of transfer in someone else and that later devolved upon him before his death. In essence, the language has been applied strictly to change the result in *White v. Poor*.
>
> We need not here consider the reasons for applying § 2038 to powers such as that involved in *White v. Poor*. Nor need we speculate whether or not such a power would trigger § 2042, for that question is not before us. What is significant for our purposes is that § 2038 has not been applied when the power possessed by decedent was created and conferred on him by someone else long after he had divested himself of all interest in the property subject to the power. Therefore, because of our view that Congress did not intend § 2042 to produce divergent estate tax treatment between life insurance and other types of property, we conclude that the fiduciary power that Skifter possessed at his death did not constitute an "incident of ownership" under § 2042; hence, that provision does not require that the life insurance proceeds at issue be included in Skifter's estate.
>
> The Tax Court was thus correct in holding that Reg. § 20.2042-1(a)(4) must be read to apply to "reservations of powers by the transferor as trustee" and not to powers such as that in issue. Accordingly, the decision of the Tax Court is affirmed.

GCM 39317 followed *Skifter*. However, *Rose v. U.S.*, 511 F.2d 259 (5th Cir. 1975) held that there was no transfer requirement.

Rev. Rul. 84-179 reasoned:

> The legislative history of section 2042 indicates that Congress intended section 2042 to parallel the statutory scheme governing those powers that would cause other types of property to be included in a decedent's gross estate under other Code sections, particularly sections 2036 and 2038. S. Rep. No. 1622, 83rd Cong., 2d Sess. 124 (1954). See *Estate of Skifter v. Commissioner*, 468 F. 2d 699 (2d Cir. 1972).
>
> Sections 2036(a)(2) and 2038(a)(1) concern lifetime transfers made by the decedent. Under these sections, it is the decedent's power to affect the beneficial interests in, or enjoyment of, the transferred property that required inclusion of the property in the gross estate. Section 2036 is directed at those powers retained by the decedent in connection with the transfer. See, for example, *United States v. O'Malley*, 383 U.S. 627 (1966), 1966-2 C.B. 526. Section 2038(a)(1) is directed at situations where the transferor-decedent sets the machinery in motion that purposefully allows fiduciary powers over the property interest to subsequently return to the transferor-decedent, such as by an incomplete transfer. See *Estate of Reed v. United States*, Civil No. 74-543 (M.D. Fla., May 7, 1975); *Estate of Skifter v. Commissioner*, above cited, at 703-05.

> In accordance with the legislative history of section 2042(2), a decedent will not be deemed to have incidents of ownership over an insurance policy on decedent's life where decedent's powers are held in a fiduciary capacity, and are not exercisable for decedent's personal benefit, where the decedent did not transfer the policy or any of the consideration for purchasing or maintaining the policy to the trust from personal assets, and the devolution of the powers on decedent was not part of a prearranged plan involving the participation of decedent. This position is consistent with decisions by several courts of appeal. See *Estate of Skifter*; *Estate of Fruehauf v. Commissioner*, 427 F.2d 80 (6th Cir. 1970); *Hunter v. United States*, 624 F.2d 833 (8th Cir. 1980). But see *Terriberry v. United States*, 517 F.2d 286 (5th Cir. 1975), *cert. denied*, 424 U.S. 977 (1976); *Rose v. United States*, 511 F.2d 259 (5th Cir. 1975), which are to the contrary. Section 20.2042-1(c)(4) will be read in accordance with the position adopted herein.
>
> The decedent will be deemed to have incidents of ownership over an insurance policy on the decedent's life where decedent's powers are held in a fiduciary capacity and the decedent has transferred the policy or any of the consideration for purchasing and maintaining the policy to the trust. Also, where the decedent's powers could have been exercised for decedent's benefit, they will constitute incidents of ownership in the policy, without regard to how those powers were acquired and without consideration of whether the decedent transferred to property to the trust. *Estate of Fruehauf*; *Estate of Skifter*, above cited at 703. Thus, if the decedent reacquires powers over insurance policies in an individual capacity, the powers will constitute incidents of ownership even though the decedent is a transferee.
>
> In the present situation, D completely relinquished all interest in the insurance policy on D's life. The powers over the policy devolved on D as a fiduciary, through an independent transaction, and were not exercisable for D's own benefit. Also, D did not transfer property to the trust. Thus, D did not possess incidents of ownership over the policy for purposes of section 2042(2) of the Code.

Rev. Rul. 84-179 held:

> An insured decedent who transferred all incidents of ownership in a policy to another person, who in an unrelated transaction transferred powers over the policy in trust to the decedent, will not be considered to possess incidents of ownership in the policy for purposes of section 2042(2) of the Code, provided that the decedent did not furnish consideration for maintaining the policy and could not exercise the powers for personal benefit. The result is the same where the decedent, as trustee, purchased the policy with trust assets, did not contribute assets to the trust or maintain the policy with personal assets, and could not exercise the powers for personal benefit.

Citing Rev. Rul. 84-179 with approval, Letter Ruling 9602010 reasoned and held:

> In the present case, the Indenture of Trust vests the trustees of the separate trusts with all rights, title, and interest in and to the policies and prohibits the trustees from distributing any portion of a life insurance policy or its proceeds to the insured daughter. In addition, neither A nor B can serve as a trustee under the Indenture of Trust. Therefore, we need not address specifically the problems concerning the application of 2042(2) where the insured holds powers over the life insurance policies in a fiduciary capacity. Instead, we must consider A and B's powers over the maintenance and distribution of the assets held in their separate trusts. The ability to control these assets

may indirectly give A and B or their estates powers over the economic benefits of the life insurance policies.

Although A and B are the income beneficiaries of their respective separate trusts and each has the right to receive distributions of principal, their rights to distributions of principal are subject to the trustees absolute discretion. Neither A nor B can direct corpus to be distributed to themselves.

Under the Indenture of Trusts, the separate trusts were created by A and B's father. The annual premiums on the life insurance policies will be paid from the principal of the separate trusts. Neither A nor B can transfer assets to their separate trusts. Therefore, neither A nor B can maintain any life insurance policies held by their separate trusts with personal assets.

Although both A and B have special powers of appointment to cause the trustees of their separate trusts to distribute principal of their separate trusts to such beneficiaries (other than the daughter, her creditors, her estate, or the creditors of her estate) as they designate, these powers of appointment are effective only when there are no life insurance policies on the life of the beneficiary included in trust assets. Generally, an inter vivos exercise of a special power of appointment could reduce the principal of a trust so that there are insufficient funds to pay the premiums on the life insurance policies. In addition, a testamentary exercise of a special power of appointment could result in a reversionary interest in the life insurance policies. In this case, the special powers of appointment are not effective when insurance policies on the life of the beneficiary-daughter are among trust assets. Therefore, A and B cannot exercise their special powers of appointment to gain any economic benefits of the life insurance policies.

Based on the facts and representations made in your request for rulings and your subsequent submissions, we conclude that neither A nor B will possess any incidents of ownership over life insurance policies on their lives held by the trustees of their irrevocable trusts and that the proceeds of the policies will not be includible in their gross estates under section 2042(2).

We express no opinion at this time with respect to the gift tax consequences to A or B where the trustees of their separate trusts invest in a nonincome-producing life insurance policy on their lives.

Letter Ruling 9111028 involved the following facts:

A is a trustee of the Trust. The Trust, a family trust, was originally part of a revocable trust, which, on B's death, was divided into the Trust and a marital trust. The trustee of the Trust is to pay to or apply for the benefit of A (B's surviving spouse) and B's descendants as much of the net income and principal of the Trust as the trustee deems necessary or advisable for their education, health, maintenance, and support, provided that no distribution to the descendants will operate to discharge or relieve A of any legal support obligation. Any income not distributed is accumulated and added to principal. Distributions of principal from the Trust to A are to be made only after exhaustion of the marital trust principal.

> A has a limited power to appoint, at any time, all or any portion of the principal of the Trust, other than any insurance policy on her life, to or for the benefit of B's descendants, in such amounts and proportions, and terms as A may elect. A may remove a trustee without reason by written notice at any time.
>
> The Trust provides that any trustee with an interest in the trust is excluded from decisions to distribute income or principal to such trustee except as limited by an ascertainable standard. In addition, the trustee is excluded from making any decisions with respect to distributions to any person the trustee is legally obligated to support. Any individual trustee whose life is insured by a policy held as trust property is prohibited from exercising any power conferred on the owner of such policy.

Letter Ruling 9111028 reasoned and held:

> In the present case, distributions of income and principal of the Trust can only be made to A or B's descendants when the trustees deem it necessary or advisable for their education, health, maintenance, and support. A, as a trustee whose life is insured by a policy held by the Trust, is specifically prohibited from exercising any power normally conferred on the owner of a policy. In addition, although A has a special power of appointment over the Trust principal, any insurance policies on A's life are specifically excluded from the scope of that power. Therefore, A does not possess any incidents of ownership over the policies on A's life held by the Trust that would cause inclusion of the policies in A's gross estate at A's death.

Letter Ruling 9434028 involved the following facts:

> You represent that, in 1975, the taxpayer's father created an irrevocable trust for the benefit of the taxpayer. The taxpayer is the life income beneficiary of the Trust and is currently serving as trustee. As trustee, she may also distribute principal to herself under an ascertainable standard relating to her maintenance. During the taxpayer's lifetime, she has the power to appoint all or any portion of the Trust principal to, or for the benefit of any one or more of her issue. Upon her death, the Trust assets will be distributed to her issue, per stirpes. Under the laws of the state in which the Trust was created, the powers granted to the trustee of the Trust include the power to invest and reinvest, as the fiduciary deems advisable, in insurance contracts on the life of any beneficiary or of any person in whom a beneficiary has an insurable interest, and generally in such property as the fiduciary shall deem advisable, even though such investment shall not be of the character approved by applicable law but for this provision.
>
> The taxpayer proposes to resign as trustee of the Trust. The terms of the Trust provide for a specified successor third-party trustee if the trustee should resign or fail to serve for any reason. If this third-party trustee should fail to serve, a corporate bank is named as trustee. You represent that the successor trustee proposes to purchase a life insurance policy on the life of the taxpayer. It is represented that the annual premium on the policy will be paid from Trust principal. On the taxpayer's death, the insurance proceeds will be paid to the Trust and will be allocated to principal, which will be distributed as set forth in the trust instrument.

Letter Ruling 9434028 reasoned and held:

> In the present case, the taxpayer is currently trustee and income beneficiary of the Trust and has the right to receive discretionary distributions of corpus for her maintenance. The taxpayer proposes to resign as trustee of the Trust. A third-party named in the Trust instrument will become successor trustee. It is represented that the successor trustee, after being named trustee, proposes to purchase a life insurance policy on the life of the taxpayer. The Trust was created and funded by the taxpayer's father during his lifetime and the taxpayer has not transferred any assets to the Trust. The annual premiums on the policy will be paid from the principal of the Trust and the taxpayer will not maintain the policy with personal assets.
>
> We express no opinion at this time with respect to the gift tax consequences to the taxpayer/income beneficiary where the trustee invests in a nonincome-producing life insurance policy on the taxpayer's life.
>
> We conclude that the taxpayer will not possess incidents of ownership over a life insurance policy on her life that is purchased by the successor trustee of an irrevocable trust where the taxpayer is the former trustee. Therefore, the proceeds of the policy will not be includible in the taxpayer's gross estate at her death under section 2042(2), assuming that the taxpayer is not reinstated as trustee and serving in that capacity at the time of her death or, after being reinstated, subsequently resigns as trustee within three years of her death. See *Estate of Fruehauf* and Rev. Rul. 84-179.

Letter Ruling 9602010 involved the following facts:

> The Grantor proposes to execute an Indenture of Trust. Under the Indenture of Trust, the Grantor will establish two separate irrevocable trusts, one for the benefit of each of his two daughters, A and B. Under the terms of the Indenture of Trust, trust assets include the property listed in "Schedule A" of the Indenture of Trust. In addition, the trustees shall accept any other property which may be transferred to them by the Grantor or others by will or other instrument. Neither the Grantor nor his daughters may serve as trustees.
>
> During each daughter's lifetime, the net income of her separate trust is to be distributed to the daughter in convenient periodic installments. The trustees, also, may distribute to each daughter principal of their separate trust. The amount of principal distributable is the amount the trustees, in their absolute discretion, deem advisable and is not limited otherwise.
>
> Generally, during a daughter's lifetime, the trustees must distribute principal of the daughter's separate trust to any beneficiary (other than the daughter, her creditors, her estate, or the creditors of her estate) the daughter designates in writing. This power of appointment, however, is not effective if the daughter's separate trust holds any insurance policies on the life of the daughter.
>
> Upon a daughter's death, the balance of the principal of the daughter's separate trust is distributable to any beneficiary (other than the daughter, her creditors, her estate, or the creditors of her estate) the daughter appoints by will or other written instrument delivered to the trustees during her lifetime. This power of appointment, however, is not effective if,

at the time of the daughter’s death or immediately prior to her death, the daughter’s separate trust holds any insurance policies on the life of the daughter.

To the extent that a daughter fails to exercise her power of appointment or cannot exercise her power of appointment prior to or upon her death, the remaining principal of her separate trust will be distributed to her issue then living, per stirpes. If there is no such issue, the trust assets shall be divided among the Grantor’s issue then living, per stirpes. Any share attributable to A or B shall be added to such daughter’s separate trust established under the Indenture of Trust. In the case of a share attributable to a child of the Grantor born subsequent to the date of the Indenture of Trust, that child’s share shall be added to a trust established under another indenture of trust with terms identical to the terms in the Indenture of Trust. Each share attributable to a grandchild of the grantor shall be held in a separate trust for the benefit of such grandchild.

Section VI of the Indenture of Trust gives the trustees of each separate trust the power to purchase life insurance policies on the life of the beneficiary of the separate trust. In addition, section VII indicates that life insurance policies may be among the assets transferred to the separate trusts. Under section VII of the Indenture of Trust, the trustees are vested with all rights, title, and interest in and to the policies. In addition, the trustees of each separate trust may not distribute to the beneficiary all or any portion of a policy of insurance on the life of the beneficiary.

It is represented that the annual premiums on any life insurance policies on the life of the beneficiaries will be paid from principal of the separate trusts. On the death of A or B, the insurance proceeds of the life insurance policies will be paid to their respective separate trust and will be allocated to principal, which will be distributed as set forth in the trust instrument.

Letter Ruling 9602010 reasoned and held:

Under the facts presented in the ruling, the decedent transferred the policy to the spouse and subsequently, in an unrelated transaction, reacquired incidents of ownership over the policy in a fiduciary capacity. The ruling holds that under these circumstances, the decedent will not be considered to possess incidents of ownership in the policy for purposes of section 2042(2), provided the decedent did not furnish consideration for maintaining the policy and could not exercise the powers for the decedent’s personal benefit. The ruling further provides that the result would be the same if the decedent acting as trustee purchased a policy as a trust asset. The ruling states, however, that where the decedent’s powers over the policy could have been exercised for the decedent’s benefit, they would constitute incidents of ownership in the policy without regard to how those powers were acquired and without consideration of whether or not the decedent was the source of the funds used to pay the premiums. See *Estate of Fruehauf v. Commissioner*, 427 F.2d 80 (6th Cir. 1970).

In the present case, the Indenture of Trust vests the trustees of the separate trusts with all rights, title, and interest in and to the policies and prohibits the trustees from distributing any portion of a life insurance policy or its proceeds to the insured daughter. In addition, neither A nor B can serve as a trustee under the Indenture of Trust. Therefore, we need not address specifically the problems concerning the application of 2042(2) where the insured holds powers over the life insurance policies in a fiduciary capacity. Instead, we must consider A and B’s powers over the maintenance and distribution of the assets held in their separate trusts. The ability to control these assets may indirectly give A and B or their estates powers over the economic benefits of the life insurance policies.

Although A and B are the income beneficiaries of their respective separate trusts and each has the right to receive distributions of principal, their rights to distributions of principal are subject to the trustees absolute discretion. Neither A nor B can direct corpus to be distributed to themselves.

Under the Indenture of Trusts, the separate trusts were created by A and B's father. The annual premiums on the life insurance policies will be paid from the principal of the separate trusts. Neither A nor B can transfer assets to their separate trusts. Therefore, neither A nor B can maintain any life insurance policies held by their separate trusts with personal assets.

Although both A and B have special powers of appointment to cause the trustees of their separate trusts to distribute principal of their separate trusts to such beneficiaries (other than the daughter, her creditors, her estate, or the creditors of her estate) as they designate, these powers of appointment are effective only when there are no life insurance policies on the life of the beneficiary included in trust assets. Generally, an inter vivos exercise of a special power of appointment could reduce the principal of a trust so that there are insufficient funds to pay the premiums on the life insurance policies. In addition, a testamentary exercise of a special power of appointment could result in a reversionary interest in the life insurance policies. In this case, the special powers of appointment are not effective when insurance policies on the life of the beneficiary-daughter are among trust assets. Therefore, A and B cannot exercise their special powers of appointment to gain any economic benefits of the life insurance policies.

Based on the facts and representations made in your request for rulings and your subsequent submissions, we conclude that neither A nor B will possess any incidents of ownership over life insurance policies on their lives held by the trustees of their irrevocable trusts and that the proceeds of the policies will not be includible in their gross estates under section 2042(2).

We express no opinion at this time with respect to the gift tax consequences to A or B where the trustees of their separate trusts invest in a nonincome-producing life insurance policy on their lives.

Letter Ruling 9748020 involved the following facts:

Decedent's Spouse is the current beneficiary and was one of three co-trustees of Trust B. During her life, the trustees of Trust B are to distribute all of the net income of the trust to Decedent's Spouse. If the income is insufficient to provide for Decedent's Spouse's health, support, and maintenance in accordance with the standard of living she enjoyed at the time of Decedent's death, the trustees are authorized to distribute principal. Decedent's Spouse has no power of appointment over the assets in Trust B. Decedent's children and grandchildren are contingent beneficiaries. Decedent's Spouse resigned as a co-trustee of Trust B on Date 2. The Trust instrument provides that no successor trustee is to be appointed and the remaining trustees will serve as co-trustees.

> Trustees of Trust B propose to purchase a policy of insurance on the life of Decedent's Spouse. Trustees request a ruling that Decedent's Spouse will not possess any incidents of ownership over the life insurance policy on her life held by the trustees of Trust B and that the proceeds of the policy will not be includible in her gross estate under sections 2036 and 2042(2).

Letter Ruling 9748020 cited Reg. §§ 20.2042-1(c)(2)[4605] and 20.2042-1(c)(4) and Rev. Rul. 84-179 and reasoned and held:

> In this case, Decedent's Spouse is the current beneficiary of Trust B. During her life, the trustees of Trust B are to distribute all of the net income of the trust to Decedent's Spouse. If the income is insufficient to provide for Decedent's Spouse's health, support, and maintenance in accordance with the standard of living she enjoyed at the time of Decedent's death, the trustees are authorized to distribute principal. Decedent's children and grandchildren are contingent beneficiaries of Trust B.
>
> Because Decedent's Spouse resigned as a trustee of Trust B, Decedent's Spouse will not possess any incidents of ownership over a life insurance policy on her life purchased by the remaining trustees of Trust B and held as an asset of Trust B. Therefore, proceeds of a life insurance policy on her life purchased by the trustees of Trust B and held as an asset of Trust B will not be included in Decedent's Spouse's gross estate provided that (1) she has not transferred any assets to Trust B, (2) the premiums on the policy are paid from the principal of Trust B, (3) she does not maintain the policy with personal assets, and (4) she is not reinstated as a trustee of Trust B.

Letter Ruling 9748029 involved the following facts:

> On May 7, 1990, A, established an irrevocable trust, Trust, for the benefit of his spouse, B, and his children. The Trust was funded with a second to die life insurance policy on the lives of A and B. The trustees of Trust are A's two children. Under the terms of the Trust, any contribution to the Trust may be withdrawn by B, provided the amount of withdrawal cannot exceed $5,000 for any calendar year. A's children have the right to withdraw a proportionate amount of any contribution not withdrawn by B, not to exceed $5,000. Each withdrawal right lapses on the earlier of (a) the last of the year in which the contribution was made, or (b) 60 days after the contribution. During A's lifetime, the trustee is authorized to use some or all of the trust income to pay premiums on policies of life insurance on the lives of A and B. After paying any insurance premium, the trustees may distribute to or for the benefit of B and the children so much of the trust income and principal as the trustees deem appropriate.
>
> After A's death, the trustees are to pay to or for the benefit of B and the children so much of the Trust's income and principal, as the trustees deem appropriate for the comfort and general welfare of those beneficiaries. Upon B's death, the trustees have discretion to pay B's burial expenses, expenses of her last illness, and death and succession taxes. Any remaining corpus is to be divided into separate shares with a separate share to be distributed to each living child and a share to be distributed per stripes to the living descendants of a deceased child.

[4605] Reg. § 20.2042-1(c)(2) is reproduced in part II.Q.4.i.ii Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity.

> A transferred property to Trust, and Trust applied for a second to die life insurance policy on the lives of A and B. Trust has owned the policy at all times. The trustees possess all incidents of ownership in the policy. A died on January 26, 1996, survived by B. B has made no transfers to Trust. The trustees have continued to pay the premiums on the insurance policy from trust funds.
>
> Although a bank is named successor trustee, the trustees have the ability to name additional co-trustees. The trust instrument does not prohibit B from being added as an additional co-trustee.

First, the ruling cited a variety of rules, including Reg. § 20.2042-1(b), which provides:

> (1) Section 2042 requires the inclusion in the gross estate of the proceeds of insurance on the decedent's life receivable by the executor or administrator, or payable to the decedent's estate. It makes no difference whether or not the estate is specifically named as the beneficiary under the terms of the policy. Thus, if under the terms of an insurance policy the proceeds are receivable by another beneficiary but are subject to an obligation, legally binding upon the other beneficiary, to pay taxes, debts, or other charges enforceable against the estate, then the amount of such proceeds required for the payment in full (to the extent of the beneficiary's obligation) of such taxes, debts, or other charges is includible in the gross estate. Similarly, if the decedent purchased an insurance policy in favor of another person or a corporation as collateral security for a loan or other accommodation, its proceeds are considered to be receivable for the benefit of the estate. The amount of the loan outstanding at the date of the decedent's death, with interest accrued to that date, will be deductible in determining the taxable estate. See § 20.2053-4.
>
> (2) If the proceeds of an insurance policy made payable to the decedent's estate are community assets under the local community property law and, as a result, one-half of the proceeds belongs to the decedent's spouse, then only one-half of the proceeds is considered to be receivable by or for the benefit of the decedent's estate.

Letter Ruling 9748029 reasoned and held:

> In the present case, A created and funded the Trust in 1990 and made all transfers to the Trust. B has made no direct contributions nor indirect contributions by reason of the lapse of the $5,000 withdrawal right. See section 2514(e). Under the terms of the Trust, B does not possess any rights within the meaning of sections 2036 or 2038. Assuming B is not named as an additional trustee, B will not have any incidents of ownership in the policy by reason of section 20.2042-1(c)(4). Assuming B does not make any contributions to the Trust (either directly or indirectly) we conclude that the Trust and insurance policy will not be included under sections 2036, 2038, and 2042(2) in B's gross estate upon her death.
>
> However, we express no opinion regarding the application of section 2042(1) which is dependent on facts presented at the spouse's death; for example, whether the trustee

> will be legally bound to pay B's burial expenses, expenses of her last illness, and death and succession taxes at that time. See Rev. Rul. 77-157, 1977-1 C.B. 279.[4606]

Note that the surviving spouse in Letter Ruling 9748029 was not a trustee, did not have any power of appointment, and could not receive any distributions until after the insurance premiums were paid. If a policy on only one spouse can use decent mortality charges and the premium savings from a second-to-die policy is mainly due to a longer time to fund the death benefit, consider whether that timing of premium payments is really worth sacrificing giving the surviving spouse the control that a surviving spouse often has over a spousal limited access trust.

Letter Ruling 200314009 found no incidents of ownership where a grantor had the power to name as a successor trustee anyone except himself or any party related or subordinate to the grantor when the two designated trustees are unavailable to act as trustee or are removed; however, the grounds for removal were not spelled out. The IRS pointed out that Reg. § 20.2042-1(c)(4) provides that:

> A decedent is considered to have an incident of ownership in an insurance policy on his life held in trust if, under the terms of the policy, the decedent, (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

The IRS looked to Rev. Rul. 77-182 (no Code § 2036 inclusion where decedent could appoint a successor corporate trustee if the original trustee resigned or was removed by judicial process) and Rev. Rul. 95-58 (no Code § 2036 inclusion where decedent could remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent).[4607]

In Letter Rulings 201919002-201919003, the settlor established an irrevocable trust for the benefit of Child 1 and Child 1's descendants, with the trustee being Child 1. When the trustee planned to buy life insurance, the trustee petitioned to have the trust modified so that Child 2 (presumably Child 1/s sibling) would serve as special trustee over insurance, holding all incidents of ownership, and Child 1 would have no power of appointment over the life insurance policy. However, Child 1 had the power to change trustees, so long Child 1 did not appoint a person related to or subordinate to Child 1, within the meaning of Code § 672(c), as successor insurance trustee. Citing Rev. Rul. 84-179 but not Rev. Rul. 95-58, the ruling held:

> In this case, Child 1's powers, in the capacity as Trustee and beneficiary were eliminated prior to the acquisition of the life insurance policy on Child 1's life. Trust is the owner and beneficiary of the policy. Accordingly, when the Insurance Trustee purchased a life insurance policy on Child 1's life, Child 1 did not possess and did not have the power to exercise, any incidents of ownership in the policy acquired by Trust. Child 1 will not relinquish or transfer any incidents of ownership in the policy as a result of the modification prior to the acquisition of the policy.

[4606] Rev. Rul. 77-157 ruled as to Code § 2039(c), which has since been repealed; therefore, Rev. Rul. 88-85 obsoleted Rev. Rul. 77-157.

[4607] "Related or subordinate" looked to Code § 672(c) – see fn. 2541 in part II.J.3.h Drafting for Flexibility in Trust Income Taxation.

> Accordingly, based on the facts submitted and the representations made, we conclude that Child 1 does not and will not possess any incidents of ownership over any life insurance policy on Child 1's life acquired by Trust, as amended, and that the proceeds of any policy on Child 1's life will not be includible in Child 1's gross estate under § 2042(2). The above conclusions assume that Child 1 is not serving as Insurance Trustee at the time of Child 1's death, or Trust is modified such that Child 1 regains fiduciary powers over life insurance on Child 1's life.

A decedent's right to veto a change in the transfer of a policy, where the decedent could gain no economic benefits from the veto power, did not constitute incidents of ownership.[4608]

Letter Ruling 200404013 involved the following facts:

> On Date 1, A created and funded an irrevocable trust, Trust. Under the terms of Trust, the co-trustees (B, A's spouse, and Corporate Trustee) have absolute discretion to distribute income and corpus to A's children and their descendants for such person's care, health, education, maintenance, support, purchase or improvement of home, to establish a professional practice, or acquire an interest in a business. Upon the death of A, or earlier if the Trust fails to qualify as a grantor trust for federal income tax purposes, the trustees are to segregate any shares of stock of a corporation which is an S corporation for federal income tax purposes. The segregated stock is to be held in separate trusts (hereinafter referred to as separate trusts), one trust for each child or deceased child of A. The remainder of any Trust assets are to be held in trusts (hereinafter referred to as remainder trusts), one trust for each child or deceased child of A.
>
> Under the terms of the separate trusts, the net income is to be paid quarterly to the designated child (or in the case of a trust created for a deceased child, the child's descendants). The trustees also have absolute discretion to distribute corpus to such child (or child's descendants as the case may be) for care, health, education, maintenance, support, purchase or improvement of home, to establish a professional practice, or acquire an interest in a business. Upon the death of a child, any remaining corpus that has not been appointed pursuant to a testamentary special power of appointment, is to be held in further trust, under terms and conditions described above, for the child's descendants.
>
> Under the terms of the remainder trusts, the trustees have absolute discretion to distribute income and corpus to A's child and that child's descendants for such person's care, health, education, maintenance, support, purchase or improvement of home, to establish a professional practice, or acquire an interest in a business. Upon the death of a child, any remaining corpus that has not been appointed pursuant to a testamentary special power of appointment, is to be held in further trust, under terms and conditions described above, for the child's descendants.
>
> In the case of the Trust, separate trusts, and remainder trusts, no income or principal may be distributed for support or maintenance of a beneficiary if A or B is legally obligated to support such beneficiary.

[4608] *Estate of Rockwell v. Commissioner*, 779 F.2d 931 (3rd Cir. 1985).

> Under the terms of Trust, the Corporate Trustee may be replaced by the vote of three designated advisors. Under Article XVII, a trustee, by written instrument, may renounce in whole or in part any one or more powers, authorities or discretion given by Trust or by law to that trustee. Under Article XXIV, A may not be appointed trustee, nor may A remove a trustee or appoint a successor trustee.
>
> Trust purchased a joint and survivor life insurance policy on the lives of A and B. It is represented that Trust will make ten annual premium payments and that the Trust should have adequate income each year to fully pay the annual premium. B, as trustee, also executed a written instrument renouncing her right as trustee to: (1) change the beneficiary of the policy; (2) revoke any change of beneficiary; (3) assign the policy; (4) revoke any assignment of the policy; In addition, B has renounced any right to make contributions to Trust and to appoint a successor advisor.
>
> It is represented that A funded Trust, but that B has consented to treat the gift as made one-half by A and one-half by B under § 2513. Further, it is represented that sufficient GST exemption under § 2631 was allocated to Trust, such that Trust has a zero inclusion ratio for GST tax purposes.

Letter Ruling 200404013 reasoned and held:

> In the present case, neither A or B have any beneficial interest in Trust. Trust has purchased the life insurance policy using funds held in trust. Further, it is represented that neither A nor B will make any additional transfers to Trust for the purpose of paying premiums on the policy. Under these circumstances, we conclude that the purchase by Trust of the life policy with Trust assets will not be a treated as a gift by A or B.
>
> In the present case, Trust purchased and owns the life insurance policy. Trust is also the designated beneficiary of the policy proceeds and Trust will also make all future premium payments from Trust assets. Accordingly, we conclude that A will not possess any incidents of ownership, under § 2042(2) and § 20.2042-1(c)(2), in the policies owned by Trust. Further, we conclude that the proceeds of the policies payable to the trustee of Trust will not be includible, under § 2042(2) in the gross estate of A. Further, in the present case, it is represented that B has not transferred any property to Trust, nor will B make any transfers to Trust in the future to maintain the policy. Accordingly, notwithstanding that B is a trustee of Trust, we conclude that B will not possess any incidents of ownership, under § 2042(2) and § 20.2042-1(c)(2), in the policies owned by Trust and the proceeds of the policies payable to the trustee of Trust will not be includible, under § 2042(2) in the gross estate of B. Rev. Rul. 84-179.
>
> In the present case, A and B have treated A's transfer to Trust, as made one-half by each under § 2513. Under § 2652(a)(2), if the requirements for signifying consent under § 2513(b) were satisfied, A and B are each deemed the transferor for Federal GST tax purposes of one-half of A's gift to Trust. It is represented that A and B have each allocated sufficient GST exemption to the Trust such that Trust will have an inclusion ratio of zero for GST tax purposes. As noted above, it is represented that the insurance policy was purchased with current trust assets and all future premium payments will be paid from Trust assets. Accordingly we conclude that the purchase of the insurance policy by Trust, will not affect the identity of the transferors of Trust for GST tax purposes, nor will the purchase effect the inclusion ratio with respect to Trust.

Letter Ruling 200518005 involved the following facts:

> Trust A and Trust B were not established by Taxpayer. Pursuant to the terms of each trust, Taxpayer is to receive the net income of each trust for her life. Upon her death, the principal of each trust is to be divided into equal shares for the benefit of Taxpayer's children. Taxpayer was a co-trustee of Trust A and Trust B, but on Date 1, she renounced all of her rights as co-trustee of Trust A and Trust B in connection with life insurance policies on her life. Life insurance policies on Taxpayer's life were purchased by Trusts A and B using trust corpus subsequent to Taxpayer's renunciation. Taxpayer resigned as co-trustee of Trust A and Trust B on Date 2 and Date 3, respectively. Trustee A and Trustee B are the current co-trustees of both trusts.

Letter Ruling 200518005 reasoned and held:

> In the present case, Taxpayer is the current income beneficiary of Trust A and Trust B. During her life, the trustees of Trust A and Trust B are to distribute all of the net income of each trust to Taxpayer. Upon Taxpayer's death, the trust is to be divided into equal shares for Taxpayer's issue. It has been represented that Taxpayer will not contribute assets to Trust A or Trust B, or maintain the life insurance policies held as assets of Trust A and Trust B with Taxpayer's personal assets.
>
> Based on the foregoing, Taxpayer will not possess any incidents of ownership over the life insurance policies held as assets of Trust A and Trust B because Taxpayer renounced her rights as co-trustee of Trust A and Trust B in connection with the life insurance policies and ultimately resigned as co-trustee of the trusts. Therefore, we conclude that the proceeds of the life insurance policies held as assets of Trust A and Trust B will not be included in Taxpayer's gross estate under § 2042(2) or 2035, provided the premiums for the policies are not paid from the income of Trust A or Trust B.

Letter Ruling 200617008 involved the following facts:

> The Trustees are to pay Wife the entire net income and so much of the principal of Trust A as the trustees in their absolute discretion determine. Trust A is to terminate upon the death of Wife, and the balance of the Trust A corpus is to be paid to Husband's then living issue, per stirpes. The balance of the Trust corpus (after providing for the funding of Trust A) is to be paid to husband's then living issue, per stirpes, provided that any property payable to a child of Husband who had not attained the age of 29 is to be held in further trust for the benefit of the child.
>
> Article Fifth (I) of the Trust Agreement provides that if any person currently eligible to receive any principal or income from any trust created under the terms of Trust is acting as a trustee, then such trustee shall have no power whatsoever to make or participate in making decisions affecting in any way the disposition of the income or principal of such trust to himself or herself, including determining how much income or principal should be distributed and whether the trust should be terminated.
>
> … Wife and Father are currently serving as co-trustees of Trust A.
>
> Wife proposes to resign as co-trustee of Trust A. Subsequent to Wife's resignation, Father, as trustee of Trust A, will apply for and purchase a policy of insurance on Wife's

> life. Trust A will be the owner and beneficiary of the policy. It is represented that the principal of Trust A will be used to pay the premiums on the policy and that the annual premiums will be less than Q% of the principal of Trust A. Wife will not pay any premiums with respect to the policy or otherwise contribute towards the maintenance of the policy. All the income of Trust A will continue to be paid to Wife.

Letter Ruling 200617008 reasoned and held:

> In the present case, Wife will resign as co-trustee of Trust A prior to the acquisition by Trust A of the life insurance policy on Wife's life. Trust A will be the owner and beneficiary of the policy. Accordingly, because Wife is resigning as co-trustee prior to the acquisition of the policy, Wife will never possess, or have the power to exercise, any incidents of ownership in the policy to be acquired by Trust A, nor will she relinquish or transfer any incidents of ownership in the policy by resigning as co-trustee prior to the acquisition of the policy. Further, it is represented that only trust principal will be used to pay the premiums on the policy and the annual premiums will be less than Q% of the Trust A principal. All the income of Trust A will continue to be paid to Wife. In addition, Wife has not transferred, nor will she transfer any assets to Trust A, and she will not pay any premiums with respect to the policy to be held as an asset of Trust A.
>
> Based on the foregoing, we conclude that the proceeds of the life insurance policy to be acquired by Trust A, as described above, will not be includible in Wife's gross estate under section 2042(2). Further, the policy proceeds will not be includible under section 2035(a), if Wife dies within three years of resigning as co-trustee of Trust A. The above conclusions assume that Wife is not reinstated as co-trustee and is not serving as co-trustee at the time of her death, or after being reinstated, subsequently resigns within three years of death. See Rev. Rul. 84-179.

Letter Ruling 201327010 involved the following facts:

> Over a period of years, Taxpayer s spouse, Decedent, purchased several life insurance policies naming Taxpayer as the insured and Decedent s estate as the beneficiary. It is represented that Taxpayer paid none of the premiums on the policies and, as well, that Taxpayer anticipates that no further premiums will be due on the policies.
>
> Decedent died on Date 1. Under Decedent s will ownership of the policies passed to Family Trust. Under the terms of Family Trust, income and principal is distributable to Taxpayer and Decedent s descendants in the discretion of the trustee. The remainder is payable to such persons, other than Taxpayer, Taxpayer s estate, Taxpayer s creditors, or the creditors of Taxpayer s estate, as Taxpayer shall appoint by will, and in default of appointment, to certain takers in default. Taxpayer is named the trustee of Family Trust, as well as the protector of Family Trust, with the power to remove and replace trustees. As trustee, Taxpayer possessed the incidents of ownership in the policies.
>
> On Date 2, pursuant to its terms, Family Trust was divided into two trusts, Family Trust 1 and Family Trust 2. Family Trust 1 was funded with the insurance policies, while Family Trust 2 was funded with the remaining assets. Concurrent with the division of Family Trust, Taxpayer relinquished his roles as trustee and protector of Family Trust 1, his ability to be reappointed as trustee of Family Trust 1, and his power of appointment over the assets of Family Trust 1. Taxpayer retained his beneficial interest in Family Trust 1 as a permissible distributee of trust income and principal.

Letter Ruling 201327010 reasoned and held:

> Here, prior to the Date 2 transaction, Family Trust held policies of insurance on Taxpayer's life. Under the terms of Decedent s will, Taxpayer possessed trustee powers over the Family Trust assets, a beneficial interest in Family Trust, and a testamentary power of appointment over the Family Trust assets. Taxpayer could exercise in a fiduciary capacity the trustee powers over the incidents of ownership in the policies of insurance on Taxpayer's life for Taxpayer's own benefit, and could exercise in his individual capacity the power of appointment over the proceeds of the policies. On these facts, both the fiduciary powers and individually held powers constitute incidents of ownership in the policies, without regard to how those powers were acquired and without consideration of whether Taxpayer transferred property to Family Trust. Section 20.2042-1(c)(4). After the Date 2 transactions, however, with regard to Family Trust 1, Taxpayer held only a beneficial interest as a permissible distributee of income and corpus, but no powers over the policies or their proceeds, and thus, no incidents of ownership for purposes of § 2042(2). Assuming that Taxpayer survives the three-year period of § 2035, the proceeds of the policies will not be includible in Taxpayer s gross estate. Section 20.2042-1(c)(1).

The mere right to the dividends, by itself, is not an incident of ownership that would cause the value of the insurance proceeds to be included in Decedent's gross estate under Code § 2042(2).[4609] This conclusion was based on the view that dividends represent a return of premiums[4610] and did not address whether dividends in excess of premiums would be treated differently.

Letter Ruling 201919002 involved the following facts:

> On Date 1, Settlor established an irrevocable trust, Trust, for the benefit of Child 1 and Child 1's descendants. The Trustee of Trust is Child 1. Settlor predeceased Child 1. It is represented that Child 1 has not made any contributions to Trust and does not intend to make any contributions to Trust.
>
> Section 2.1 of Trust provides that the Trustee is expressly granted the power to own and acquire life insurance and to pay the premiums on existing life insurance on the life of any person in which the trust or its beneficiaries may have an insurable interest. The ownership of any and all policies of insurance applied for and purchased by the Trustee or transferred and assigned to the Trustee is irrevocably vested in the Trustee.
>
> Under Section 2.4, the Trustee is vested with all rights, powers, options, elections, privileges and incidents of ownership in all insurance policies owned by Trust.
>
> Section 2.5 provides that the Trustee shall have the power to use all or any part of the net income or corpus of Trust to pay all or any part of any premiums or other charges due on any insurance policies held in trust. Provided, however, notwithstanding any contrary provision in this paragraph, in the event the Trust owns any life insurance on

[4609] CCA 201328030.

[4610] CCA 201328030 cited *Estate of Bowers v. Commissioner*, 23 T.C. 911, 917 (1955) (the right to dividends, which may be applied against a current premium, is nothing more than a reduction in the amount of premiums paid rather than a right to the income of the policy) and *Estate of Jordahl v. Commissioner*, 65 T.C. 92, 99 (1975) (since dividends are merely a reduction in the amount of premiums paid, the right to dividends is not an incident of ownership).

the life of Settlor, premium payments shall only be made out of corpus, and not out of income (as determined for federal income tax purposes under Subpart E of Part I, Subchapter J, Chapter 1, Subtitle A of the Internal Revenue Code (Code)).

Under Article III, during Child 1's lifetime, the Trustee shall have the power to distribute net income and corpus of Trust as Trustee may determine to be appropriate to provide for the health, support, maintenance and education of Child 1 and Child 1's descendants. Any undistributed net income shall be accumulated and added to the corpus of Trust.

Section 6.1 provides that upon the death of Child 1, Child 1 shall have a testamentary special power of appointment over the remaining assets of Trust limited to the class consisting of Child 1's descendants. To the extent Child 1 does not exercise or ineffectively exercises Child 1's testamentary special power of appointment, then the Trustee shall apportion the property of Trust into separate equal trusts, one for the benefit of each of Child 1's then living children (Child's Trust) and one trust for the benefit of the descendants (Descendant's Trust), taken collectively, of each child of Child 1 who is then deceased leaving descendants then surviving. Moreover, Sections 6.2 and 6.3 grant a testamentary special power of appointment to the primary beneficiary of a Child's Trust or a Descendant's Trust.

Under Section 7.2, Child 1 shall have the power to appoint one or more persons, individual or corporate, to serve as Co-Trustee or sole Trustee of Trust or the separate trusts created hereunder and shall have the power to remove or replace any Co-Trustee or sole Trustee whether named in Trust or appointed pursuant to Article VII. If Child 1 should die, resign or be unable or unwilling to serve as Trustee for any reason, or fail to appoint a successor, then Settlor appoints Child 1's spouse, Spouse, as Trustee. If Spouse is unable to serve for any reason, then Settlor appoints Child 2. Upon the death of Child 1, if Child 1 has not appointed a trustee to succeed upon Child 1's death, Settlor appoints each child of Child 1 as sole Trustee of any separate trust created for his or her benefit.

Section 7.12 provides that Settlor does not intend that the Trustee have any power over trust property that, if held by the Trustee in a fiduciary capacity, would result in inclusion of trust assets in the estate of the Trustee for federal estate tax purposes. To this end, the Settlor appoints the Co-Trustee or, if none, the next Successor Trustee named or appointed under Article VII who is qualified to serve as Trustee and who does not suffer the same disability, as Special Co-Trustee during any period in which a trust governed by this agreement provides for current distribution to beneficiaries to whom the primary Trustee owes a legal obligation of support or contains property over which the primary Trustee's powers would result in such inclusion.

Section 7.12(a) provides that a Special Co-Trustee shall be appointed if a trust governed under this agreement owns or otherwise possesses any incidents of ownership over any life insurance policies on the life of the primary Trustee within the meaning of § 2042.

Section 7.12(c) provides that a Special Co-Trustee shall be appointed if a trust governed under this agreement provides for current distributions to beneficiaries to whom the primary Trustee has a legal obligation of support. The Special Co-Trustee shall have the sole power to determine the amount and timing of any discretionary distribution to a beneficiary to whom the primary Trustee has a legal obligation of support. The primary

Trustee's powers at such times shall be limited to management of trust assets and distributions to beneficiaries to whom the primary Trustee owes no legal support obligation.

In Year 1, Trustee proposed to purchase a life insurance policy on the joint lives of Child 1 and Spouse. However, Section 6.1 of Trust provides Child 1 with a testamentary special power of appointment over all assets contained in Trust. As a result, if Trust owned a life insurance policy on the life of Child 1, there is a risk that the life insurance death benefit proceeds will be included in Child 1's gross estate for federal estate tax purposes upon Child 1's death.

Accordingly, Child 1, in the capacity of Trustee of Trust, petitioned Court to modify the terms of Trust to remove Child 1's testamentary special power of appointment over any life insurance policy on Child 1's life or the proceeds of such policy; to add an Insurance Trustee, who will have sole authority over any insurance policies on the life of Child 1 purchased by Trust; and to modify Trust to require that premium payments on life insurance policies on Child 1 must be paid out of Trust corpus. On Date 2, in Year 1, a Final Judgment of Modification was issued by Court approving the modification of Trust.

Pursuant to the Final Judgment of Modification, Trust is modified as follows: Section 2.5, as modified, provides that if Trust owns any life insurance on the life of Settlor, a beneficiary, or a trustee, premium payments shall only be made out of corpus, and not out of income (as determined for federal income tax purposes under Subpart E of Part I, Subchapter J, Chapter 1, Subtitle A of the Internal Revenue Code (Code)).

Sections 6.1, 6.2 and 6.3, as modified, provide that a holder of a testamentary special power of appointment under the terms of Trust, Child's Trust or Descendant's Trust is excluded from exercising the power over any life insurance policy on such beneficiary's life or proceeds of such policy on such beneficiary's life.

Section 7.12(a) of Trust, as modified, is deleted and replaced with the following:

> Notwithstanding the foregoing procedure, [Child 2] is appointed as Insurance Trustee (hereinafter referred to as "Insurance Trustee") if a trust governed by this Agreement intends to purchase, purchases, owns or otherwise possesses any incidents of ownership over any life insurance policies on the life of the primary Trustee within the meaning of § 2042 of the Internal Revenue Code. [Child 1] shall have the power to: (i) change the Insurance Trustee succession herein, (ii) appoint one or more persons, individual or corporate, excluding [Child 1], to serve as Insurance Trustee or Co-Trustees of this trust or any trust created hereunder, and (iii) remove such persons appointed, whether now serving or appointed to serve in the future. Provided, however, [Child 1] shall not have the power to appoint a person related to or subordinate to [Child 1], within the meaning of § 672(c) of the Internal Revenue Code, as successor Insurance Trustee. The Insurance Trustee shall have the power to maintain the policies in which the applicable trust has an ownership interest and pay the trust's proportionate share of the premiums thereon. If for any reason there are not sufficient funds to pay the premiums and maintain the policies in force, the Insurance Trustee shall have authority to accept paid-up insurance for the policies. Additionally, if necessary for the health, support or maintenance of the beneficiary of that trust, the Insurance Trustee shall have complete authority to surrender the said policies, or borrow on them, and to utilize the proceeds for the benefit of that trust

beneficiary. The Insurance Trustee shall not be liable to any beneficiary by virtue of its decision in exercising its discretion and in carrying out these instructions. If [Child 2] should die, resign or be unable or unwilling to exercise the power described in this subparagraph, unless [Child 1] has otherwise named a successor Insurance Trustee, then a majority of the beneficiaries then entitled or permitted to receive income from each separate trust hereunder, per stirpes and not per capita, who are at least twenty-one (21) years of age, shall have the authority to appoint a successor Insurance Trustee, other than Settlor.

Statute provides, in pertinent part, that on the petition of a trustee or a beneficiary, a court may order that the terms of the trust be modified if because of circumstances not known to or anticipated by the settlor, the order will further the purposes of the trust; modification of administrative, non-dispositive terms of the trust is necessary or appropriate to prevent waste or avoid impairment of the trust's administration; the order is necessary or appropriate to achieve the settlor's tax objectives and is not contrary to the settlor's intentions; or the order is not inconsistent with the material purpose of the trust and all beneficiaries of the trust have consented or are deemed to have consented to the order.

In Year 2, subsequent to the Court's Final Judgment, Child 2, in the capacity of Insurance Trustee, purchased a second-to-die policy on the lives of Child 1 and Spouse.

Letter Ruling 201919002 reasoned and held:

In the present case, prior to the modifications of Trust, Section 2.1 of Trust expressly granted the Trustee the power to own and acquire life insurance and to pay the premiums on existing life insurance on the life of any person in which the trust or its beneficiaries may have an insurable interest. The ownership of any and all policies of insurance applied for and purchased by the Trustee or transferred and assigned to the Trustee is irrevocably vested in the Trustee. Under Section 2.4, Child 1, as the Trustee, is vested with all rights, powers, options, elections, privileges and incidents of ownership in all insurance policies owned by Trust. Accordingly, prior to the modifications, Child 1 possessed all incidents of ownership in any life insurance policy on Child 1's life that the Trust may acquire.

The modifications to Trust relinquished Trustee's powers with respect to any life insurance policy on Child 1's life acquired by Trust and granted such powers to an Insurance Trustee. Under Section 7.12(a), as modified, Child 2 is appointed as Insurance Trustee with power to maintain and pay premiums on a life insurance policy on the life of Child 1. Child 2 shall have complete authority to surrender policies, borrow on them, or utilize the proceeds for the benefit of the beneficiary if necessary for the health, support or maintenance of the beneficiary. Accordingly, Trustee is precluded from exercising any power normally conferred on the owner of a policy.

Child 1 retains a beneficial interest in income and principal of Trust, subject to an ascertainable standard. However, under Section 2.5, as modified, premium payments will only be made out of corpus and not income. In addition, Child 1 has not made any contributions to Trust and further represents that Child 1 will not make any contributions to Trust.

Further, prior to the modifications of Trust, Child 1 possessed a testamentary special power of appointment over the Trust principal, which would include any proceeds from life insurance on the life of Child 1 that Trust may hold. This power gave Child 1 the power to change the beneficial ownership of the proceeds. However, the modifications to Trust restrict Child 1's testamentary special power of appointment. Under Section 6.1, as modified, Child 1 may not exercise Child 1's testamentary special power of appointment over any life insurance policies on the life of Child 1. Accordingly, Child 1 may not exercise Child 1's testamentary special power of appointment to change the beneficial interests in the proceeds of the life insurance policy on Child 1's life.

In this case, Child 1's powers, in the capacity as Trustee and beneficiary were eliminated prior to the acquisition of the life insurance policy on Child 1's life. Trust is the owner and beneficiary of the policy. Accordingly, when the Insurance Trustee purchased a life insurance policy on Child 1's life, Child 1 did not possess and did not have the power to exercise, any incidents of ownership in the policy acquired by Trust. Child 1 will not relinquish or transfer any incidents of ownership in the policy as a result of the modification prior to the acquisition of the policy.

Accordingly, based on the facts submitted and the representations made, we conclude that Child 1 does not and will not possess any incidents of ownership over any life insurance policy on Child 1's life acquired by Trust, as amended, and that the proceeds of any policy on Child 1's life will not be includible in Child 1's gross estate under § 2042(2). The above conclusions assume that Child 1 is not serving as Insurance Trustee at the time of Child 1's death, or Trust is modified such that Child 1 regains fiduciary powers over life insurance on Child 1's life.

We neither express nor imply any opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

Reviewing various authorities cited above, Mezzullo, T.M. 826-3rd, *Life Insurance*, Detailed Analysis Part I.D., "Special Issues in Trust-Owned Insurance: Application of Incidents of Ownership Test," subpart 1, "What Are Consequences of Decedent Serving as Trustee of Trust Holding Insurance Policy on Decedent's Life?" point e, "Practical Application of Rules," suggests:

- The most cautious approach is for the insured not to serve as a trustee of a trust that holds insurance policies on his or her life, whether or not he or she is the transferor.

- If the insured is to serve as a trustee in a *Estate of Skifter v. Commissioner*[94] situation (that is, where the trust is created by someone other than the insured), certain precautions should be taken. First, the insured should not have a beneficial interest in the trust. If the insured's spouse or children are trust beneficiaries, language should be used precluding trust distributions that may satisfy the insured's obligation of support to the spouse and children. Second, there should be a source for premium payments other than the insured because, under Rev. Rul. 84-179, the insured's powers as trustee may result in the inclusion of the insurance policies in his or her gross estate, if the insured furnished "consideration for maintaining the policies." Thus, it will probably be necessary for the trust holding the insurance policies to hold other assets that can be used to pay premiums.

- If there is a plan for a trust to acquire a policy of insurance on the life of a trustee who is a beneficiary of the trust, the trustee should, before the policy is acquired, either renounce all powers that may affect the policy or resign as trustee.

- Notwithstanding the result in *Estate of Bloch v. Commissioner*,[95] the insured/trustee should not use the trust property for his own benefit in contravention of the terms of the trust. At some point, a court may conclude that the transaction is a sham. Moreover, the planning objective is to avoid, rather than encourage, litigation with the IRS.

- Where a question of inclusion in the decedent's gross estate of the proceeds of an insurance policy on the decedent's life is raised not in a planning context, but as a fait accompli, it should not be assumed that inclusion is inevitable, even if the decedent is transferor, trustee, and beneficiary. As in *Estate of Jordahl v. Commissioner*,[96] the powers of the decedent (under the terms of the relevant document and based on the actual facts) should be analyzed closely in determining whether, in fact, the decedent possessed any incidents of ownership.

- [94] 468 F.2d 699 (2d Cir. 1972).

- [95] 78 T.C. 850 (1982).

- [96] 65 T.C. 92 (1975), *acq.*, 1977-1 C.B. 1.

Reviewing various authorities cited above, Mezzullo, T.M. 826-3rd, *Life Insurance*, Detailed Analysis Part I.D., "Special Issues in Trust-Owned Insurance: Application of Incidents of Ownership Test," subpart 2, "What Are Consequences if Decedent Is Beneficiary of Trust Holding Insurance Policy on Decedent's Life?" point g, "Guidelines," suggests:

> There are no definitive answers, but the following thoughts are offered as possible guidelines in the insured/beneficiary arena:

- In a number of rulings, the IRS has ruled favorably where the insured/beneficiary was entitled to the income. However, if the insured has the right, as income beneficiary, to demand that the policy be converted to income-producing assets, there is a significant risk that (1) this could create a § 2042 problem under the reasoning of *Estate of Fruehauf v. Commissioner*[99] and/or (2) the failure to exercise the right could have adverse gift and estate tax consequences.

  [99] 427 F.2d 80 (6th Cir. 1970).

- If the insured is entitled to income, the trust should provide that all premium payments will be made from principal, although this will have the effect of reducing the income in the future.

- If distributions to the beneficiary/insured are permitted with no reference to a standard, the insured has no right to the economic benefit of the policy and § 2042 should not apply.

- If distributions can be made to the insured only in accordance with a standard and the standard is not satisfied, § 2042 should not apply because no distribution could be made to the beneficiary.

- If distributions are required to be made to the insured only in accordance with a standard and the standard is satisfied, § 2042 should not apply. Even though the beneficiary has a right to distributions (which right, if not enforced, may create estate and gift tax issues in and of itself), the beneficiary should have no § 2042 economic benefit in the policy if he or she has no right to demand distribution of the policy itself.

- If distributions are permitted (but not required) to be made to the insured only in accordance with a standard and the standard is satisfied, possible § 2042 includibility is even more remote than in the bullet point immediately above.

- All of the above assumes that the insured has not made contributions to the trust. While it may well be that contributions by the insured should have no relevance in the § 2042 context (or at least in this aspect of § 2042), the fact that the favorable result in Rev. Rul. 84-179 (and in each of the private rulings discussed above) is contingent on the no-contribution condition raises a significant concern.

- All of the above assumes that the insured is not a trustee of the trust (or at least has no distribution powers as trustee). While PLR 9111028 shows that it may be possible for the insured/beneficiary to serve as trustee, *Fruehauf* points out the potential danger. A fair inference from the private letter rulings discussed above is that the renunciations and resignations were a prerequisite to the favorable rulings.

- The beneficiary/insured should not hold any power of appointment (inter vivos or testamentary) over the insurance policy.

- *Bottom* Line: The taxpayer may want to consider requesting a private letter ruling. While there are certainly trusts with other terms that should be outside the scope of § 2042, a conservative approach is to draft a trust in which (1) the only permissible distributions to the insured are in the discretion of the trustee (without a standard), (2) distribution to the insured of any insurance policy on his or her life is prohibited, and (3) the insured has no power of appointment over any such policies.

To me, the focus seems to be whether the beneficiary might have been able to make a claim on the money used to pay premiums because the trustee diverted to the policy money that should have been distributed to the beneficiary. I think that this emphasis is misplaced, in that the beneficiary cannot control the trustee's actions and should not be imputed incidents of ownership unless the beneficiary actually obtains authority to exercise incidents of ownership; however, the IRS' and courts' opinion is much more important than my view. To avoid these concerns, the trustee might consider forming a partnership to hold the policy.[4611]

II.Q.4.i.ii.(b). Corporate Ownership of Policy

However, redemptions require further analysis, as do arrangements for cross-purchase agreements when all of the parties hold policies on each other through an entity. If a decedent

[4611] See text accompanying fns 3032-3033 in part II.J.19.b Comparing Annuity to Life Insurance.

is the sole or controlling shareholder of a corporation that owns an insurance policy on the decedent's life, then the decedent will not be deemed to possess incidents of ownership as a result of the decedent's stock ownership so long as the proceeds of the policy are payable to the corporation.

Reg. 20.2042-1(c)(6) provides:

> In the case of economic benefits of a life insurance policy on the decedent's life that are reserved to a corporation of which the decedent is the sole or controlling stockholder, the corporation's incidents of ownership will not be attributed to the decedent through his stock ownership to the extent the proceeds of the policy are payable to the corporation. Any proceeds payable to a third party for a valid business purpose, such as in satisfaction of a business debt of the corporation, so that the net worth of the corporation is increased by the amount of such proceeds, shall be deemed to be payable to the corporation for purposes of the preceding sentence. See § 20.2031-2(f) for a rule providing that the proceeds of certain life insurance policies shall be considered in determining the value of the decedent's stock. Except as hereinafter provided with respect to a group-term life insurance policy, if any part of the proceeds of the policy are not payable to or for the benefit of the corporation, and thus are not taken into account in valuing the decedent's stock holdings in the corporation for purposes of section 2031, any incidents of ownership held by the corporation as to that part of the proceeds will be attributed to the decedent through his stock ownership where the decedent is the sole or controlling stockholder. Thus, for example, if the decedent is the controlling stockholder in a corporation, and the corporation owns a life insurance policy on his life, the proceeds of which are payable to the decedent's spouse, the incidents of ownership held by the corporation will be attributed to the decedent through his stock ownership and the proceeds will be included in his gross estate under section 2042. If in this example the policy proceeds had been payable 40 percent to decedent's spouse and 60 percent to the corporation, only 40 percent of the proceeds would be included in decedent's gross estate under section 2042. For purposes of this subparagraph, the decedent will not be deemed to be the controlling stockholder of a corporation unless, at the time of his death, he owned stock possessing more than 50 percent of the total combined voting power of the corporation. Solely for purposes of the preceding sentence, a decedent shall be considered to be the owner of only the stock with respect to which legal title was held, at the time of his death, by (i) the decedent (or his agent or nominee); (ii) the decedent and another person jointly (but only the proportionate number of shares which corresponds to the portion of the total consideration which is considered to be furnished by the decedent for purposes of section 2040 and the regulations thereunder); and (iii) by a trustee of a voting trust (to the extent of the decedent's beneficial interest therein) or any other trust with respect to which the decedent was treated as an owner under subpart E, part I, subchapter J, chapter 1 of the Code immediately prior to his death. In the case of group-term life insurance, as defined in the regulations under section 79, the power to surrender or cancel a policy held by a corporation shall not be attributed to any decedent through his stock ownership.

Letter Ruling 9511009 involved a transfer from corporations of policies on the lives of both shareholders, with each shareholder receiving the policies on the other's life to facilitate a cross-purchase:

> B1 and B2 together own 100% of the stock of Corporation 1 and Corporation 2 (Corporations). B1 and B2 also together own 100% interests in Partnership 1 and

> Partnership 2 (Partnerships). Corporations currently own various life insurance policies on the lives of Partners. Corporations are the beneficiaries of these policies and make all of the premium payments.
>
> Under the terms of the shareholder's agreement currently in force, on the death of a shareholder, the surviving shareholder is required to purchase, and the estate of the deceased shareholder is required to sell, the deceased shareholder's stock.
>
> Separately, all of the parties mentioned herein have now entered into a Stock Purchase Agreement and Partnership Interest Purchase Agreement (Stock Purchase Agreement) which supersedes the earlier Stock Purchase Agreement and Amended Stock Transfer Restriction Agreement regarding how the stock or partnership interests will be purchased on the death of either Partner.
>
> Corporations propose to distribute the life insurance policies to Partners for cash surrender value. Partners will receive the policies insuring the life of the other partner/shareholder. Contemporaneously, Partners will assign the policies to Trust. Trust will be the beneficiary of the policies and the trustee will be an unrelated third party. Partners represent that Trust is a grantor trust under sections 671-677 of the Code. Partners will make payments to Trust in the amount of the premiums necessary to maintain the policies.
>
> The terms of Trust require that, after the death of the first of Partners to die, the trustee will distribute the proceeds of the policies to the decedent's estate on behalf of the surviving Partner in payment of the purchase price of the stock of Corporations the survivor is required to purchase. If the purchase price of the stock as set forth in the partner's/shareholder's agreement is less than the amount of the proceeds, any excess insurance proceeds will be distributed to the surviving partner/shareholder.

Letter Ruling 9511009 reasoned:

> In the present case, Partners will assign the polices to an irrevocable life insurance trust (Trust). The beneficiary of the policies at the death of the first Partner to die will be Trust. The trustee of Trust and not Partners will hold all incidents of ownership on the polices. Accordingly, neither Partners will hold incidents of ownership in the policies on their lives during the time the policies are held by Trust.
>
> Further, the terms of Trust require that the trustee distribute the proceeds of the policies to the estate of the first Partner to die on behalf of the surviving partner/shareholder, in payment for the stock the survivor is required to purchase, and the decedent's estate is required to sell. Any proceed in excess of the amount required under the shareholder's agreement to purchase the stock will be distributed to the surviving Partner. Thus, any proceeds received by the decedent's estate will be remitted on behalf of the survivor as payment for the purchase of decedent's stock in Corporation, and will not be received by the executor as the beneficiary, either directly or indirectly, of the insurance proceeds.
>
> In the present case, Partners will hold incidents of ownership over the insurance policies during the time in which the policies are held by Partners as individuals. However, the policies held by each Partner during this time will be the policies insuring the life of the other Partner. Accordingly, the policies would not be includible in the gross estate of the Partner holding the policies under section 2042 of the Code if that Partner had retained

> the policies until his death and, thus, the proceeds would not be includible in the gross estate of that Partner under section 2035 if the Partner dies within three years of the transferring the policies to Trust.

Letter Ruling 9511009 held:

> The policy proceeds will not be received by the executor of Partners' estate for purposes of section 2042(1) of the Code, nor will either Partner hold incidents of ownership to the irrevocable life insurance trust. Thus, the proceeds of the polices will not be includible under section 2042 in the gross estate of the insured Partner while the policies are held by Trust.

II.Q.4.i.ii.(c). Partnership Ownership of Policy

Neither Code § 2042 nor its Regulations specifically address the issues raised by insurance owned by a partnership in which the insured is a partner. However, case law and IRS rulings have analyzed these issues. The Tax Court has held that a general partner does not possess incidents of ownership in a policy that names a general partnership as the owner and beneficiary if the policy was purchased in the partnership's ordinary course of business and the insured partner owned less than a 50% interest in the general partnership.[4612] Rev. Rul. 83-147 held that a partner does possess incidents of ownership if the policy on the partner's life is owned by the partnership, designates a member of the partner's family as the beneficiary, and premiums were paid by the partnership in partial satisfaction of the partner's share of partnership income. The ruling stated that the result was different than the Tax Court case because the beneficiary was not the partnership.

In a number of Letter Rulings, the IRS has addressed Code § 2042 with respect to a partnership that owns and is designated as the beneficiary of an insurance policy on the life of one of its partners.

Letter Ruling 9623024 held that the insured general partner does not possess incidents of ownership in the policy if the partnership agreement states that the proceeds, once received by the partnership, can be distributed to the remaining partners in proportion to their interests to the extent that the proceeds from the policy were not needed to pay the partnership's obligations. The IRS reasoned that the value of the deceased partner's interest would include his pro rata portion of the proceeds and therefore inclusion under Code § 2042 would amount to unwarranted double counting of the proceeds.

Letter Rulings 9625022 and 9625023 ruled that life insurance proceeds would not be included in the estate of a member in a limited liability company (that was taxed as a partnership) who could not participate in decisions regarding a policy insuring the member's life held. Letter Rulings 9625013-9625019 had the same result and also involved using the proceeds to fund the purchase of a deceased owner's share of a related corporation and also of the limited liability company, which held real estate that it rented to the corporation.

[4612] *Estate of Knipp v. Commissioner*, 25 T.C. 153 (1955), *acq*. in result, 1959-1 C.B. 4, *aff'd* on another issue 244 F.2d 436 (4th Cir.), *cert. denied*, 355 U.S. 827 (1957).

Letter Rulings 9843024 and 200111038 held that the insured limited partner does not possess incidents of ownership in the policy if the partnership agreement precludes the limited partners from exercising any control over the partnership's management and investment activities.

Letter Ruling 200017051 ruled that the insured general partner does not possess incidents of ownership in the policy if the partnership agreement expressly states that an insured partner "had no right or power to exercise or to otherwise participate in the exercise of any of the incidents of ownership with respect to such policy or policies."[4613]

In Letter Ruling 200214028, the IRS ruled that the insured general partner did not possess incidents of ownership because the proceeds were payable to or for the benefit of the partnership. In that case, the partnership agreement required that the proceeds be used to redeem the insured partner's interest in the partnership.

TAM 200432015 dealt with Code section 2042 and the transfer of insurance policies to a limited liability company. The TAM deals with Code §§ 2035 and 2042 and involves an insured who transferred an insurance policy on his own life to a limited liability company. If none of the insureds own policies on their own lives that they transfer to a limited liability company, the TAM would not apply.

II.Q.4.i.iii. IRS' Response to Request that Resulted in Letter Ruling 200747002

In response to my ruling request, Letter Ruling 200747002 held that none of the insureds possessed incidents of ownership on the policies that the others contributed to the LLC.

However, the IRS requested some modifications to the LLC's operating agreement. The IRS limited the members' ability to make decisions regarding the LLC's holding of policies. Not mentioned in the ruling is that the operating agreement originally allowed the members voting rights customarily given in a manager-managed LLC, limiting them only to the extent that no member could vote regarding insurance on that member's life. The IRS was concerned that the members could collude in a manner akin to the reciprocal trust doctrine, so it required that the operating agreement preclude members from voting on anything relating to any life insurance policy. Similarly, the IRS required that the operating agreement not expressly authorize amendments by the members, preferring that applicable state law defaults control the situation.

The ruling did not address the effect of the members' assigning their interests in the LLC to others. Although the IRS was not troubled by the prospect of that occurring, it did not wish to consider situations that might arise by reason of such an assignment.

An issue with respect to with a ruling was not sought is the transfer-for-value rules, which make death benefits taxable if policies are transferred in various taxable transactions.[4614] Formation of the LLC should not implicate these rules, because formation is a nontaxable transfer.[4615] Similarly, a Member receiving an increased ownership percentage of a policy due to an increased contribution is also a nontaxable transfer.[4616] In our case, the Members also

[4613] It did not think to cite cases involving trust-owned insurance on a beneficiary's life, where no incidents of ownership were attributed to the beneficiary. Letter Rulings 9602010 and 9748020. Rev. Rul. 84-179 might also be helpful.
[4614] Code § 101(a)(2).
[4615] Code §§ 101(a)(2)(A), 721(a).
[4616] Code § 721(a).

participated in other LLCs that held rental real estate; because they were partners for income tax purposes, the transfer-for-value rules do not apply to transfers of policies between them.[4617]

II.Q.4.i.iv. Significance of Letter Ruling 200747002

The ruling has other implications. Using a corporate trustee to hold the policies as manager of the LLC provides security that the proceeds will be used as intended. As mentioned, one of the disadvantages of a cross-purchase is that a shareholder's creditors might be able to prevent application of the proceeds. Depending on applicable state law, the insurance being in an LLC might make a charging order the exclusive remedy. A charging order allows creditors to receive any distributions that belong to the debtor but does not allow the creditor to force the LLC to make distributions. The manager's duty to the other members would prevent the proceeds from being distributed without the consent of the deceased shareholder's beneficiaries.

The operating agreement's original restrictions on members' voting rights generally should be sufficient to avoid estate inclusion. The additional restrictions should be placed in the operating agreement only if seeking a Letter Ruling or advising a client who is willing to sacrifice flexibility to be as close as possible to the letter ruling's facts.

Letter Ruling 200747002 is not geared towards a policy with cash values. However, through a split-dollar arrangement, one might carve out the term portion for the LLC and make other arrangements with the cash value.[4618] Although the term portion eventually becomes uneconomic, one could use a variety of estate-planning techniques with the cash value portion before that happens so that, ultimately, the insurance arrangement becomes sustainable.

The ruling also held that Brother's Irrevocable Trust was a grantor trust, in which Brother was treated as owning Brother's Irrevocable Trust's assets for income tax purposes under Code § 678; Sister was similarly treated as the owner of Sister's Irrevocable Trust. This was critically important to allow Brother's Irrevocable Trust and Sister's Irrevocable Trust to own stock in the S corporation. Brother initially had a withdrawal right in Brother's Irrevocable Trust that had since lapsed; the same tool was used for Sister and Sister's Irrevocable Trust. Although such withdrawal rights are usually used to obtain the gift tax annual exclusion, in this case a significant purpose of granting withdrawal rights was to obtain grantor trust status treating the beneficiary as the owner.

The above issues are as far as the ruling was sought to cover. However, this structure has uses far beyond the issues discussed in the ruling.

First, Trusts 2A and 2B were originally funded with modest gifts that they invested in LLCs that used bank financing to buy real estate. These LLCs leased the real estate to the S corporation. The net cash flow from the rental operations would be used to pay the life insurance premiums through the insurance LLC. Thus, the income tax goal of holding real estate in partnerships was married with leveraging gifts to generation-skipping trusts.

Second, Trusts 2A and 2B were ideal for the tactic of selling stock to an irrevocable grantor trust.[4619] For example, Brother could sell S stock to Brother's Irrevocable Trust in exchange for a promissory note. No income tax would result during Brother's life, because Brother is treated

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[4617] Code § 101(a)(2)(B).
[4618] See footnote 4306 for a summary of how split-dollar arrangements work.
[4619] See part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.

for income tax purposes as owning Brother's Irrevocable Trust. If the IRS determined that the stock's value was too high and that therefore Brother made a gift, Brother would pay no gift tax because the gift is an incomplete gift due to Brother's power to appoint the trust's assets at death. If Brother's Irrevocable Trust were thinly funded, Brother and other trusts created by Grantor for Brother could guarantee the promissory note to provide additional economic reality to the sale.

If Brother dies during the term of the note, Sister and BA would use the insurance to buy Brother's Irrevocable Trust's stock, thus providing cash to retire the note to Brother.

If the sale of S stock to Brother's Irrevocable Trust generates cash flow in excess of the note payments, the excess cash could be used to pay premiums through the insurance LLC, allowing Brother's Irrevocable Trust to participate more in the buy-sell than it would have been able to do with just the net rental proceeds.

Note that Brother has access to the excess funds for Brother's support. The excess funds could also be used to help Brother's children when they are no longer legally dependents, without being limited by the annual gift tax exclusion or using Child 2A's applicable exclusion amount.

What if the parties had used a cash value policy subject to a split-dollar arrangement instead of term policies? After Brother's Irrevocable Trust fully repays the note on the sale of stock, it should have plenty of cash flow to repay the split-dollar obligations.

Sister would use the same strategy.

II.Q.4.i.v. Practical Logistics for Life Insurance LLC

First, keep in mind that any person who is at least a 5% owner of the LLC would be considered an employee whose notice and consent are required, as described in part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance. Whether the parties transfer the life insurance to the LLC or the LLC buys original issue insurance, the parties will probably use a notice and consent along the lines of part II.Q.4.g.iii Consent for Owner Who Is Not an Employee. However, the operating agreement might also include notice and consent as a safety valve.[4620]

Often, the operating business will pay the premiums on behalf of the owners – just to make sure it gets done so that the business' succession plan is funded as expected.

If the operating business is a C corporation, it would account for the premium payments as compensation (as an officer or director), because dividends are nondeductible to the company and taxable to the shareholders.

If the operating business is an S corporation, it would account for the premium payments as compensation or as a distribution. Compensation tends to be the more popular choice, in that it can be non-pro rata, but the parties' economic deal might make distributions more attractive, and any temporary timing differences of distributions should not cause problems with the S corporation single class of stock rules.[4621] However, in the Sixth Circuit the corporation might

[4620] See fn. fn. 4569, which is found in part II.Q.4.g.i Analysis of Code § 101(j); for an example, see part II.Q.4.g.ii Consent Integrated into Operating Agreement.
[4621] See part II.A.2.i.ii Temporary Timing Differences.

be compelled to treat the economic benefit from a split-dollar arrangement[4622] as a distribution.[4623]

When the operating company is taxed as a partnership, it might consider setting up a separate distribution account for premiums paid on behalf of each owner. That way, the distributions can be reconciled more easily against what the life insurance LLC is doing.

When the operating company pays a term premium, the life insurance LLC would credit the relevant owner's capital account with a contribution and debit premium expense, with the premium expense separately allocated to the relevant owner.

II.Q.4.i.vi. Letter Ruling 200947006

The IRS has also ruled that an insured who was a partner in a partnership had no incidents of ownership. In Letter Ruling 200947006, the insured had direct and indirect ownership of a partnership that held a policy on his life.[4624] That partnership and other partnerships (in which the insured had direct or indirect ownership) were beneficiaries. The arrangement was restructured so that the insured had no right to make decisions on behalf of a trust that owned the partnership, and the insured's other direct or indirect interest in the partnership was terminated. The IRS ruled that the insured not only had no incidents of ownership after the transaction but also (to avoid Code § 2035) had no incidents of ownership before the transaction.

II.Q.4.i.vii. Conclusion

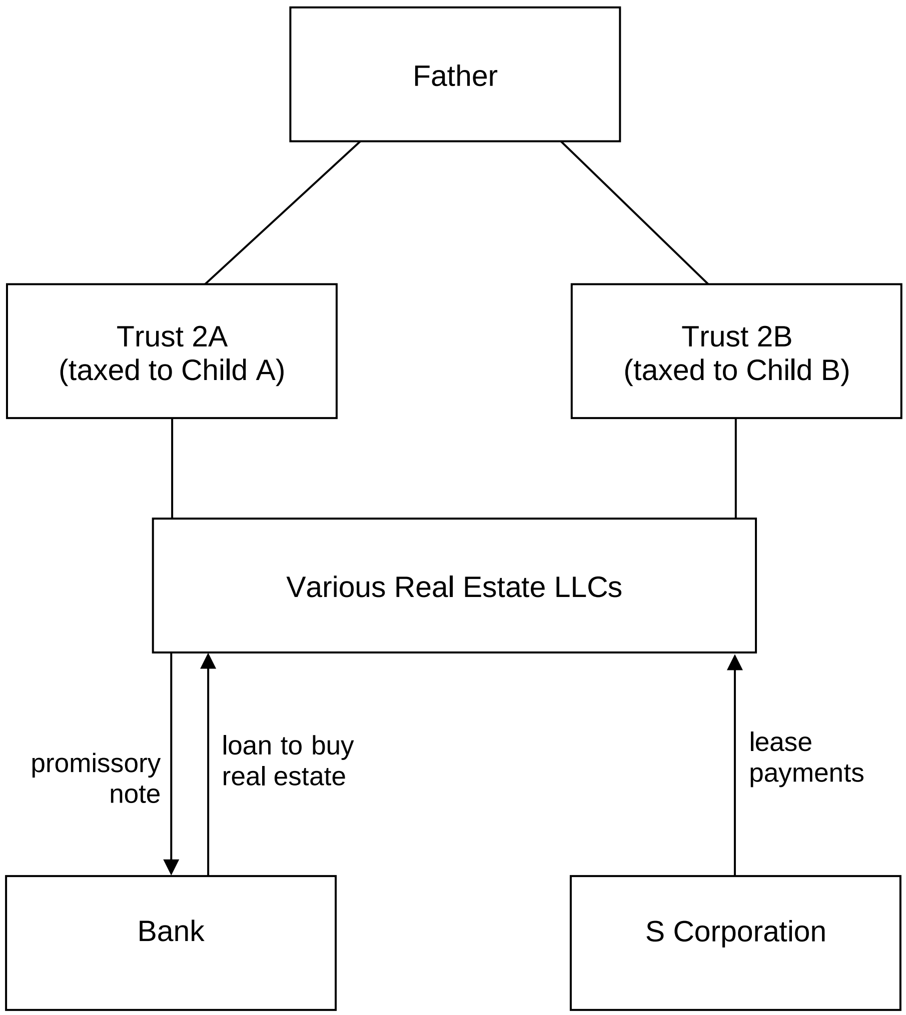
The Insurance LLC provides security for the owners, facilitates flexibility in making premium payments, and demonstrates a model for reducing the number of policies that must be used in a cross-purchase. Convincing the business owners' parents to set up generation-skipping perpetual trusts to buy real estate used in the business can help the business owners continue to enjoy the business' financial success while moving the business outside of the estate tax system.

For income tax issues generally, see parts II.Q.4.e Income Tax Issues When the Owner Who Is Not the Insured Dies. If a life insurance policy owned on a surviving owner receives a new basis when the beneficial owner predeceases the surviving owner,[4625] consider whether this new basis increases the "investment in the contract" and, if not, whether additional steps should be taken to effectuate that increase.[4626]

[4622] See generally part II.Q.4.f Split-Dollar Arrangements.
[4623] See text accompanying fns 4469-4473 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit **Arrangement under Reg. § 1.61-22**.
[4624] See also Letter Rulings 200948001 and 200949004, which appear to be companion rulings.
[4625] For basis changes when a partner dies, see part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations. For basis changes on the death of an owner other than the insured, see part II.Q.4.e.i Life Insurance Basis Adjustment on the Death of an Owner Who Is Not the Insured.
[4626] See part II.Q.4.e.ii Practical Issues In Implementing Any Basis Adjustment On the Death of an Owner Who Is Not the Insured.

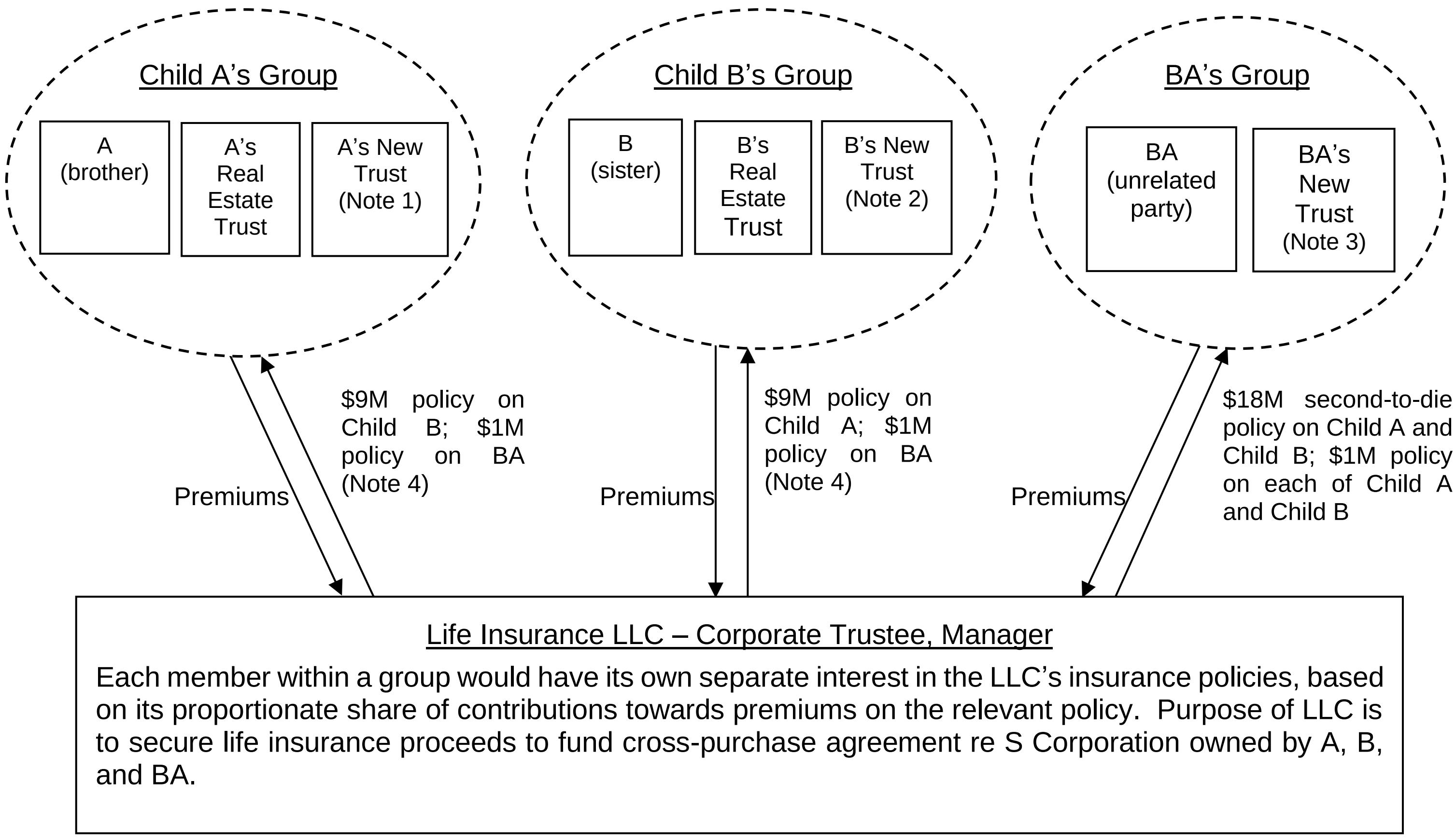
Appendix A

Prior Formation of Trusts



Appendix B

Insurance LLC Structure



Note 1: Child A would be the grantor and trustee of this irrevocable trust for his spouse's and their descendants' support, with appropriate prohibitions against discharging any support obligations.

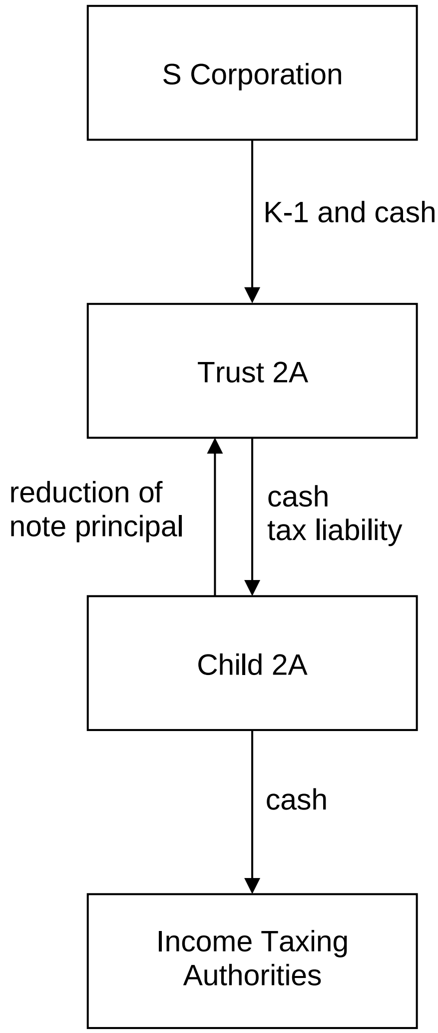
Note 2: Child B would be the grantor and trustee of this irrevocable trust for her descendants' support. (Her children are adults.) Her grandchild would be cut out, but her son could include him.

Note 3: BA would be the grantor and trustee of this irrevocable trust for his wife's and their descendants' support, with appropriate prohibitions against discharging any support obligations.

Note 4: If Child A dies first, Child B's group would become the premium payer with respect to Child A's group's policy on BA's life. If Child B dies first, Child A's group would become the premium payer with respect to Child B's group's policy on BA's life.

Appendix C

Later Sale of S corporation Stock to Irrevocable Grantor Trust



II.Q.4.j. Cross-Purchase Using Trusts

Letter Ruling 9328010 involved the following facts:[4627]

> Partners represent that together they own 100% of the stock of Corporation and also own 100% of the interest in Partnership. All Partners are shareholders of Corporation. Both Corporation and Partnership existed prior to the proposed transaction. Partners represent that Corporation owns life insurance policies on the lives of each Partner, with Corporation as the beneficiary of the policies. Currently, Partners and Corporation are party to a redemption agreement, under which upon the death of any shareholder (one of the Partners), Corporation must use the proceeds from the life insurance policy held by Corporation on the life of that deceased shareholder (Partner) to redeem the shares of Corporation owned by the deceased shareholder's (Partner's) estate.
>
> Partners represent that they intend to replace the current agreement with a new redemption agreement, entitled Stock and Partnership Unit Purchase Agreement [hereinafter new agreement], a copy of which is appended to the request for ruling. Under the new agreement, upon the death of a Partner (who is also a shareholder of Corporation), the surviving Partners will be obligated to purchase all shares in Corporation and interests in Partnership held by a deceased Partner's estate. The new agreement provides that Partners are to use the proceeds from a life insurance policy insuring the life of a deceased Partner to facilitate the discharge of the obligations of the surviving Partners to pay for the purchase of the Corporation shares and Partnership interests from the estate of a deceased Partner. In order to effectuate this redemption agreement, Partners have decided to transfer ownership of the life insurance policies as described below.
>
> Initially, Corporation will transfer the existing life insurance policies to Partnership in part payment of annual rent due Partnership from Corporation. Secondly, Partnership will transfer the policies to Partners such that after the transfers, the policies will be owned as follows:
>
> i. The policy on Partner A will be jointly owned by Partners B, C, D, and E, each owning an equal 25% interest in such policy.
>
> ii. The policy on Partner B will be jointly owned by Partners A, C, D, and E, each owning an equal 25% interest in such policy.
>
> iii. The policy on Partner C will be jointly owned by Partners A, B, D, and E, each owning an equal 25% interest in such policy.
>
> iv. The policy on Partner D will be jointly owned by Partners A, B, C, and E, each owning an equal 25% interest in such policy.
>
> v. The policy on Partner E will be jointly owned by Partners A, B, C, and D, each owning an equal 25% interest in such policy.

[4627] Letter Rulings 9328012, 9328017, 9328019 and 9328020 appear to be companion rulings.

After these transfers, neither Corporation nor Partnership will have any legal or beneficial interest in the life insurance policies.

Partners further represent that after the above transfer from the Partnership to the Partners, the policies will be transferred from Partners to Trust A, Trust B, Trust C, Trust D, and Trust E (hereinafter the Trusts). Copies of the trust agreements are appended to the request for ruling. Partners represent that each Trust is a grantor trust under sections 671−677 of the Code and that the only asset of each Trust will be a life insurance policy of the life of a partner, who is not a grantor in that trust.

The grantors of each Trust will be Partners that transferred the policy to the Trust; these same Partners will be the only beneficiaries of the Trust. The Trusts will be created as follows:

i. The grantors and beneficiaries of Trust A will be Partners B, C, D, and E; the only asset of Trust A will be the life insurance policy on the life of Partner A, currently owned by Partners B, C, D, and E.

ii. The grantors and beneficiaries of Trust B will be Partners A, C, D, and E; the only asset of Trust B will be the life insurance policy on the life of Partner B, currently owned by Partners A, C, D, and E.

iii. The grantors and beneficiaries of Trust C will be Partners A, B, D, and E; the only asset of Trust C will be the life insurance policy on the life of Partner C, currently owned by Partners A, B, D, and E.

iv. The grantors and beneficiaries of Trust D will be Partners A, B, C, and E; the only asset of Trust D will be the life insurance policy on the life of Partner D, currently owned by Partners A, B, C, and E.

v. The grantors and beneficiaries of Trust E will be Partners A, B, C, and D; the only asset of Trust E will be the life insurance policy on the life of Partner E, currently owned by Partners A, B, C, and D.

Partners represent that the transfers of the policies from Corporation to Partnership to Partners to Trusts will be completed within one month.

Partners further represent that upon the death of any Partner, the trust agreements of Trusts provides that the trustee of Trust will distribute the proceeds from the life insurance policy to the beneficiaries, grantors, who will then use the proceeds to pay the estate of the deceased Partner for the value of the Partner’s interest in Partnership and shares in Corporation. Additionally, upon the death of any Partner, the interest of the deceased Partner’s estate in the remaining Trusts will be transferred to the surviving Partners in return for a cash payment equal to the value of the estate’s interest in the unmatured policies which are owned by the remaining Trusts.

For example, upon the death of Partner A, the Trustee of Trust A will distribute the proceeds from the life insurance policy on the life of Partner A to the beneficiaries of Trust A, Partners B, C, D, and E; Partners B, C, D, and E will then use the proceeds to pay the estate of Partner A for the value of Partner A’s interest in Partnership and shares in Corporation. Additionally, all interests that Partner A has in Trusts B, C, D, and E will

> be transferred to Partners B, C, D, and E, pursuant to the terms of each Trust. In transferring the interest that Partner A had in the Trusts, the recipients of the interests will be the remaining beneficiaries of each Trust. Thus, as to Trust B, the grantors of Trust B are Partners A, C, D, and E. Partner A's interest in Trust B will be transferred in equal shares to the surviving grantors of Trust B, Partners C, D, and E; Partner B has no interest in Trust B and thus does not receive any of Partner A's interest therein. Similarly, as to Trust C, Partner A's interest will be transferred in equal shares to the surviving grantors, Partners B, D, and E. Similar transfers occur with respect to Partner A's interests in Trusts D and E. In exchange, the estate of Partner A will receive a cash payment equal to the value of those interests.

After citing then-Reg. § 1.101-1(b)(3)(ii) for the proposition that, "if the final transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer, the final transferee shall exclude the entire amount of the life insurance policy proceeds paid by reason of death of the insured from gross income under section 101(a)(1) of the Code," Letter Ruling 9328010 reasoned:

> Under the Taxpayers' facts, there are two separate transactions; the first is a series of contemporaneous transfers from Corporation to Partnership to certain Partners to certain Trusts and the second is a set of singular transfers that occur upon the death of a Partner when the interests in Trusts owning unmatured life insurance policies are transferred to other Partners.
>
> With respect to the first series of transfers, pursuant to section 1.101-1(b)(3)(ii) of the regulations, if the last transfer of the life insurance policies are to partners of the insureds, then the exclusion from income of the life insurance proceeds provided by section 101(a)(1) of the Code applies. The Taxpayers' representations indicate that the last transfers of the policies are to the Trusts. Under Rev. Rul. 74-76, when the grantors, Partners, contribute the life insurance policies to each Trust, there is no change in beneficial ownership of the policies; thus, the Partners who owned the policies prior to transfer to the Trusts continue to own them after the transfer. After the transfers, the Trusts are the legal owners of the policies and the grantors have beneficial ownership. In each Trust, the grantors are partners to the insureds. Thus, the final transfer in the first transaction is to partners of the insureds under section 101(a)(2)(B) of the Code.
>
> In the second transaction, upon the death of each Partner, the interest that the deceased Partner's estate has in the Trusts will be transferred to the surviving grantor Partners for each Trust. Since the trusts are grantor trusts and the only asset in each trust are unmatured life insurance policies, the estate of the deceased Partner is transferring interests in unmatured life insurance policies to persons who are partners of the insureds. When Partner A dies, any interest that Partner A had in Trust B is transferred to the other grantors of Trust B. The only asset of Trust B is a life insurance policy on the life of Partner B; at the death of Partner A, the surviving grantors of Trust B are Partners C, D, and E. Since Partners C, D, and E are partners in Partnership with Partner B, the insured under the life insurance policy in Trust B, the interest in Trust B is being transferred to partners of the insured. Thus, upon the death of a Partner, the interests which that deceased Partner's estate had in the life insurance policies on the remaining Partners, which are the sole assets of the Trusts, are transferred to partners of the insured under section 101(a)(2)(B) of the Code.

Letter Ruling 9328010 concluded:

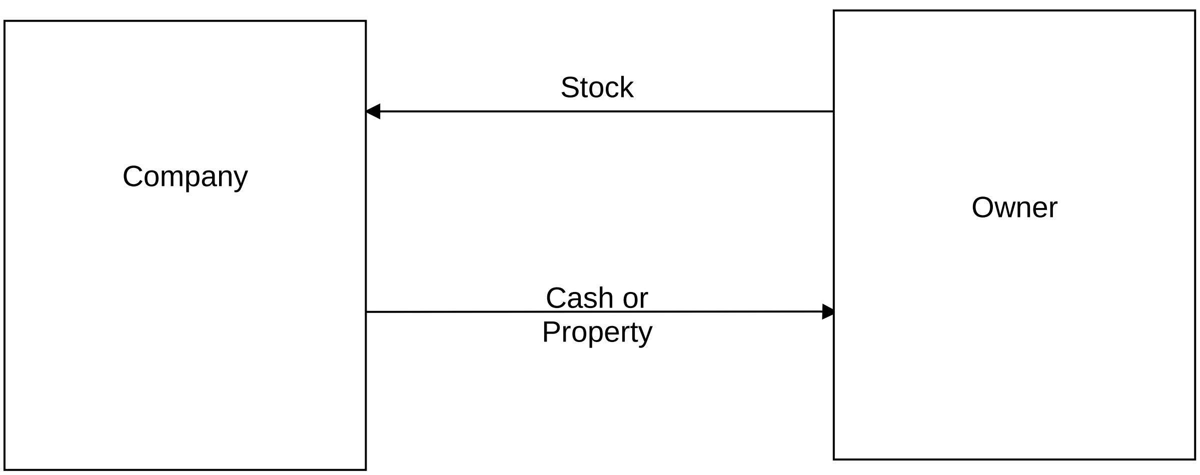
1. The transfer of the life insurance policies from Corporation to Partnership to Partners is a "transfer to a partner of the insured" within the meaning of section 101(a)(2)(B) of the Code and therefore not subject to the "transfer-for-value" limitation of section 101(a)(2).

2. The transfer of the life insurance policies from Partners to Trusts is not a "transfer for a valuable consideration" within the meaning of section 101(a)(2).

3. The transfer of a deceased Partner's beneficial interest in Trusts to the other surviving Partners is a "transfer to a partner of the insured" within the meaning of section 101(a)(2)(B) and therefore not subject to the "transfer-for-value" limitation of section 101(a)(2).

This strategy may work well if the ownership structure of A, B, C, D, and E remains unchanged perpetually. Unfortunately, that is not realistic, and a life insurance LLC provides a more nimble arrangement. If parties want to use irrevocable trusts, the trusts can own the life insurance LLC.

II.Q.5. Dividing a Business Using a Redemption - Corporation vs. Partnership



II.Q.5.a. Corporations Generally

Code § 302 provides a number of rules determining whether a redemption for state law purposes is treated as a sale or exchange of the stock or as a distribution for income tax purposes.

Sale or exchange treatment has the following benefits:

- Possible installment sale deferral.

- Capital gain treatment.

- Use of a pro rata share of basis.

Distributions are treated as the following (generally):

1. Reduction in basis (no gain) to the extent of S corporation accumulated adjustments account (AAA), if applicable. If and to the extent that state-law redemption of S corporation stock is reclassified as a distribution, the redemption uses basis dollar-for-dollar rather than prorating basis.

2. Taxable dividend (no offset for basis, no installment sale deferral) to the extent of C corporation earnings and profits (E&P), if a C corporation or if an S corporation that had been a C corporation.

3. Return of basis.

4. Gain from the sale or exchange of stock.

No deferral applies if the corporation's issuance of a note is treated as a distribution.[4628]

Corporate redemptions are discussed in more detail at part II.Q.7.a Corporate Redemption.

II.Q.5.b. Partnerships Generally

Partnerships do not have a rule equivalent to Code § 302.

Subject to certain exceptions, distributions to a partner are not taxable to the extent of basis in the partner's partnership interest.[4629] Basis includes the partner's allocable share of the partnership's debt, a rule that does not apply to C or S corporations.

Partnership distributions are described generally in part II.Q.8 Exiting From or Dividing a Partnership.

Partnership redemptions use basis to offset payments (except to the extent of certain "hot assets") dollar-for-dollar until exhausted, whereas corporate redemptions often pro-rate basis or sometimes don't use basis at all (to the extent taxed as a dividend). Furthermore, if the seller dies while installments are being made, the gain is already locked in if a sale of corporate (S or C) stock, whereas arguably a basis step-up applies to a partnership interest being redeemed. See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736, especially part II.Q.8.b.ii.(h) Interaction of Death with Code § 736 Payments.

II.Q.5.c. Distribution of Property

When a C corporation or an S corporation distributes property, it is deemed to have sold the property to its shareholders in a taxable transaction. In a C corporation, shareholders are taxed on dividend or partial or total liquidation. If a corporation contributes assets to charity, the contributed assets must not constitute substantially all of the corporation's assets, because a corporation recognizes gain if it conveys substantially all of its assets to a tax-exempt entity.[4630]

Generally, when a partnership distributes property, no tax consequences apply to anyone. Exceptions include:

[4628] See part II.Q.7.a.iii Redemption Taxed Either as Sale of Stock or Distribution; Which Is Better When, especially fn. 4816.
[4629] See part II.Q.8.b.i Distribution of Property by a Partnership.
[4630] Reg. § 1.337(d)-4(a)(1).

- Property contributed no more than 7 years before distribution that is distributed to a partner other than the partner who contributed may generate a deemed sale by the contributing partner, the recipient partner, or both (but no double taxation). Code §§ 704(c)(1)(B), 737.

- A distribution of marketable securities might be deemed a distribution of cash. Code § 731(c).

Partnership distributions of property are described in II.Q.8.b.i Distribution of Property by a Partnership.

II.Q.6. Contributing a Business Interest to Charity

After reading part II.Q.6.a General Concepts, see discussion of various issues, which are summarized below:

- Part II.Q.6.b Possible Deemed Sale or Reduced Deduction When Contributing Partnership Interest to Charity. Transferring a partnership interest in a way that reduces the donor's share of the partnership's liabilities constitutes a bargain sale that may trigger income tax. Also, the amount of any charitable contribution is reduced by the amount of gain which would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution).

- Part II.Q.6.c Possible Adverse Consequences When Contributing Partnership Interest to Charitable Remainder Trust. A charitable remainder trust pays a 100% tax on any unrelated business taxable income generated from any actual or deemed sale of a partnership interest and or from any K-1 it receives from holding a partnership. Additionally, that income is taxed to the beneficiary when the trust makes distributions.

- Part II.Q.6.d Unrelated Business Taxable Income (UBTI). Particular UBTI topics are described below.

    - Part II.Q.6.d.i UBTI Related to a Partnership or Sole Proprietorship. UBTI can arise from the partnership's business operations or from income generated by acquisition indebtedness. Partnership debt may make the entire gain on the sale of the partnership interest constitute unrelated business income (UBI) in ways that may surprise advisors. Discussion includes whether UBI includes non-debt-financed income from operations and gain on sale.

    - Part II.Q.6.d.ii UBTI Related to an S Corporation. UBTI automatically includes items on a K-1 issued by an S corporation and gain on the sale of S corporation stock, even if the S corporation invests only in items that otherwise would not constitute UBI.

    - Part II.Q.6.d.iii Charitable Deduction Against UBTI. An entity that receives UBI can deduct against it charitable distributions to the extent of 10% if the entity is a corporation or 50% if the entity is a trust, which percentages may increase on a temporary basis.[4631] To use this deduction, a donation for the benefit of an operating public charity should

[4631] See part II.G.4.g.i Charitable Deduction vs. Business Expense, including the increase of 50% to 100% for certain 2020 and 2021 contributions.

pass through a donor-advised fund taxed as a trust (or perhaps a supporting organization for the benefit of the charity).

- Part II.Q.6.e Assignment of Income on Property Being Sold. If property is subject to a legally binding obligation to sell before being donated, the donor will be taxed on the sale. However, careful drafting of the related letter of intent[4632] that typically is signed when negotiations open will avoid this issue.

- Part II.Q.6.f Incomplete Gift and Charitable Partial Interest Prohibitions:

  - Part II.Q.6.f.i Completed Gift Requirement. A gift to charity must be complete for gift tax purposes to qualify for an income tax deduction.

  - Part II.Q.6.f.iiForced Sale to Related Party for Note. When the donee was required to sell to a related party for a note, the IRS asserted that the donation was in substance the donation of a note, which is not deductible until paid.

  - Part II.Q.6.f.iii Charitable Partial Interest Prohibition. Most people are aware that split-interest gifts must be qualified charitable remainder or charitable lead trusts or qualify for other exceptions to be eligible for a charitable deduction. However, depending on the situation, slicing and dicing economic or control rights may also violate these rules.

II.Q.6.a. General Concepts in Contributing a Business Interest to Charity

Contributions to public charities can work well, although any income from an S corporation K-1 or from the sale of S corporation stock constitutes unrelated business income subject to tax (regardless of the nature of the corporation's assets).[4633] Contributions of closely-held business interests to private foundations can be deducted only to the extent of the contributed property's basis.[4634] Contributions of inventory to any charity are not deductible except to the extent of

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[4632] After a $2 billion recovery in a failed merger, *Texaco, Inc. v. Pennzoil Co.*, 729 S.W.2d 768 (Tex. App. Ct. 1987), business lawyers tightened up their letters of intent to preclude any legally binding agreement to buy or sell until the final sale documents are actually signed. For example, when two businesses explored forming a partnership and may have engaged in conduct suggesting a partnership, *Enterprise Products Partners, L.P. v. Energy Transfer Partners, L.P.*, 529 S.W.3d 531 (Tex. App. 2017), held that the following language in a letter of intent precluded a partnership from being formed absent proof of waiver of those conditions (emphasis added by court):

> Neither this letter nor the JV Term Sheet create any binding or enforceable obligations between the Parties and ... *no binding or enforceable obligations shall exist between the Parties with respect to the Transaction unless and until the Parties have received their respective board approvals and definitive agreements memorializing the terms and conditions of the Transaction have been negotiated, executed and delivered by both of the Parties.* Unless and until such definitive agreements are executed and delivered by both of the Parties, either [Enterprise] or ETP, for any reason, may depart from or terminate the negotiations with respect to the Transaction at any time without any liability or obligation to the other, whether arising in contract, tort, strict liability or otherwise.

The court reaffirmed:

> ETP also argues that the Letter Agreement did not contain a no-oral-modification clause, meaning that the parties permitted oral modifications to reflect changing circumstances. However, ETP does not cite, and we have not found, any evidence that the parties orally agreed to waive the conditions precedent.

[4633] See part II.Q.7.c S Corporation Owned by a Trust Benefitting Charity.

[4634] Code § 170(e)(1)(B)(ii).

basis.[4635] That's because Code § 170(e)(1)(A) disallows as a deduction "the amount of gain which would not have been long-term capital gain (determined without regard to section 1221(b)(3)) if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution)." Code § 1221, "Capital asset defined," provides in subsection (a), "In general":

> For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include -
>
> (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
>
> (2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167 , or real property used in his trade or business;
>
> (3) a patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by -
>
> (A) a taxpayer whose personal efforts created such property,
>
> (B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or
>
> (C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);
>
> (4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);
>
> (5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by -
>
> (A) a taxpayer who so received such publication, or
>
> (B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A);

[4635] Code § 170(e)(1); *Furrer v. Commissioner*, T.C. Memo. 2022-100 (no basis in contributed crops because all expenditures allocable to producing the crops had been deducted as expenses).

(6) any commodities derivative financial instrument held by a commodities derivatives dealer, unless -

(A) it is established to the satisfaction of the Secretary that such instrument has no connection to the activities of such dealer as a dealer, and

(B) such instrument is clearly identified in such dealer's records as being described in subparagraph (A) before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe);

(7) any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe); or

(8) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.

Real estate can constitute inventory; see part II.G.26.a Real Estate Dealer vs. Investor. Also, CCA 202309015 argued that LLC interests were inventory under Code § 1221; see part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest.

One might consider whether the entity should make the contribution instead of the owner making a contribution.[4636]

For substantiation requirements, see parts II.J.4.c.ii.(a) Contemporaneous Written Acknowledgement (CWA) and II.J.4.c.ii.(b) Appraisal and Form 8283 Requirements.

To increase the deduction for C corporation stock, consider contributing it to a charitable remainder unitrust (CRUT),[4637] in which the donor's retained interest is worth only the 10% minimum.[4638] After the CRUT sells the stock, it will have cash, and the donor can contribute his or her unitrust interest to the charity. Thus, 90% of the donation will be of an interest in cash, valued without discounts and without the basis limitation, but it should be done more than one year after the contribution was made to the CRUT to make the unitrust interest be a long-term capital asset; also, be sure to avoid a step transaction, which the IRS might use to assert that the partial interest disallowance applies.[4639] Also, if the sale turns out to generate fewer proceeds than expected, the donor might decide to keep part or all the unitrust interest.[4640]

[4636] See parts II.G.4.g.ii Basis Limitations on Deducting Charitable Contributions Made by an S corporation or a Partnership and II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction. For a comparison of S corporations donating business assets compared to donating S corporation stock when the donor owns all of the S corporation, see text accompanying fn. 4910.

[4637] A CRUT may begin life as an income-only unitrust and then switch to a trust that pays the unitrust without regard to income (a flip unitrust). Reg. § 1.664-3(a)(1)(i)(c). A flip CRUT is often used when the assets contributed do not generate enough income to pay the unitrust. For those clients who have sufficient liquidity, rather than doing a flip CRUT they might consider doing a straight CRUT and then contribute cash to the CRUT so that it has enough money to pay them, thereby obtaining an additional charitable deduction with respect this additional gift to the CRUT.

[4638] Code § 664(d)(1)(D) requires the actuarial value of the charitable remainder interest to be at least 10% of the value of the property contributed to the trust.

[4639] See part II.Q.6.f Incomplete Gift and Charitable Partial Interest Prohibition, especially fns. 4760-4761.

[4640] A donation may not be made too close to a sale, as described in part II.Q.6.e Assignment of Income (but this concern tends to be overstated).

Deductions for contributions of partnership interests or S corporation stock may be reduced by the business entity's hot assets.[4641]

Charitable remainder trusts cannot hold stock in an S corporation;[4642] however, an S corporation may donate property to a charitable remainder trust.[4643] Also, generally they should not hold an interest in an entity taxed as a partnership, if the partnership has business income[4644] or debt-financed income,[4645] because their unrelated business taxable income is taxed at 100%.[4646]

Contributions of business interests can cause self-dealing issues (although bequests might be less likely to cause self-dealing issues)[4647] and might be subject to rules limiting the period in which a charity may own a significant part of a closely-held business.[4648] On the IRS' website, "IRC Section 4943(c)(7), Extension of Period to Dispose of Certain Assets," explains:[4649]

IRC Section and Treas. Regulation

- IRC Section 4943(a) Initial tax
- IRC Section 4943(c)(1) Excess business holdings
- IRC Section 4943(c)(2) Permitted holdings in a corporation
- IRC Section 4943(c)(3) Permitted holdings in partnerships, etc.
- IRC Section 4943(c)(6) 5-year period to dispose of gifts, bequests, etc.
- IRC Section 4943(c)(7) 5-year extension of period to dispose of certain large gifts and bequests

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[4641] See part II.Q.6.b Possible Deemed Sale or Reduced Deduction When Contributing Partnership Interest to Charity, especially fns. 4655-4660 (fn. 4660 explaining that the rules limiting the charitable deduction for partnership interests apply to S corporation stock as well).
[4642] For what types of trusts can own stock in an S corporation, see part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation. An electing small business trust (ESBT) is the only type of trust described there into which a charitable remainder trust (CRT) might fit, but Code § 1361(e)(1)(B)(iii) prohibits a CRT from qualifying as an ESBT. However, an S corporation may donate property to a charitable remainder trust; see part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax.
[4643] See part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax.
[4644] Code § 512(a)(1), referring to Code § 513. However, note that Code § 512(b) excludes various items, such as interest and dividends, as well as real estate rental income. For more on UBTI, see part II.Q.6.c Possible Adverse Consequences When Contributing Partnership Interest to Charitable Remainder Trust, especially fn 4675 and the accompanying text, some of which goes beyond the context of a partnership interest.
[4645] Code § 512(b)(4), which is reproduced in fn. 4685 in part II.Q.6.d.i UBTI Related to a Partnership or Sole Proprietorship. Part II.Q.6.d.i discusses the scope of attributing debt to the sale of a partnership interest.
[4646] Code § 664(c)(2)(A).
[4647] See part II.Q.7.c.ii Private Foundations, Etc.
[4648] Code § 4943.
[4649] https://www.irs.gov/charities-non-profits/irc-section-4943c7-extension-of-period-to-dispose-of-certain-assets, Page Last Reviewed or Updated: 07-Sep-2022.

- IRC Section 4943(d) Definitions; special rules
- Treas. Regs. Section 53.4943-10 Business enterprise; definition

Resources (Court Cases, Chief Counsel Advice, Revenue Rulings, Internal Resources)

TRG 60.6 – Five-Year Extension of Initial Five-Year Disposition Period

IRC Section 4943 – Taxes on Excess Business Holdings

Reducing Private Foundation Excess Business Holdings: Additional Time to Dispose of Large Gifts or Bequests discusses the information required to be submitted with requests for extensions under Section 4943(c)(7). This information is also available in Section 4943(c)(7).

Analysis

How can a private foundation obtain an extension of time to reduce excess business holdings to permissible levels and avoid excise tax imposed under IRC Section 4943?

Section 4943(a) imposes an initial 10 percent tax on the value of any “excess business holdings” of a private foundation in a “business enterprise.” (For purposes of Section 4943, the term “private foundation” includes donor advised funds and certain Type II and III supporting organizations. See Section 4943(e)-(f)). Any excess business holdings remaining at the close of the taxable period are subject to the second-tier excise tax at a rate of 200 percent of the value of the excess business holdings under Section 4943(b).

“Business enterprise,” as defined in Treas. Reg. Section 53.4943-10(a)(1), means any activity which is regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated trade or business under Section 513. It does not include certain program-related activities (e.g., a functionally related business as defined in Section 4942(j)(4) or program-related investments as defined in Section 4944(c)) or a trade or business at least 95 percent of the gross income of which is derived from passive sources. See Section 4943(d)(3) and Treas. Reg. Section 53.4943-10 for more information.

The term “excess business holdings” is defined in Section 4943(c)(1) as the amount of stock or other interest in the enterprise a foundation would have to dispose of (to a person other than a disqualified person) for the remaining holdings of the foundation to be permitted holdings. Generally, under Section 4943(c)(2)(A) and 4943(c)(3)(A), a foundation is permitted to hold twenty percent of an interest in a business enterprise (such as voting stock in a corporation or profits interest in a partnership), reduced by the amount held by disqualified persons. Any excess holdings constitute excess business holdings for purposes of Section 4943. Excess business holdings acquired other than by purchase (e.g., by contribution) are treated as held by a disqualified person (rather than the foundation) for a five-year period beginning on the date such holdings were acquired by the foundation. See Section 4943(c)(6)(A). Section 4943(c)(6)(B) sets forth a similar rule for a change in holdings which causes an increase in excess business holdings. Note, however, that Section 4943(g) provides an exception for certain limited holdings to independently operated businesses which meet the requirements of Section 4943(g)(2), (3), and (4). See Section 4943(g) for more information on this exception. See Section 4943 for more information on permitted holdings, which are also discussed in detail in the IRC Section 4943 – Taxes on Excess Business Holdings Issue Snapshot.

When the excess business holdings provisions of Section 4943(a) apply, Section 4943(c)(7) provides that the Service may extend the five-year disposition period under Section 4943(c)(6) for an additional five years where there is an unusually large gift or bequest of diverse business holdings or holdings with complex corporate structures if:

a. the foundation establishes that -

   i. diligent efforts to dispose of the holdings have been made within the initial 5-year period and

   ii. disposition within the initial 5-year period has not been possible (except at a price substantially below fair market value) by reason of the size and complexity or diversity of the holdings.

b. before the close of the initial 5-year period-

   i. the foundation submits to the Service a plan for disposing of the excess business holdings involved in the extension, and

   ii. the foundation submits the plan to the appropriate state official (e.g., Attorney General) and forwards any response thereto to the Service; and

c. the Service determines the plan reasonably can be expected to be carried out before the close of the extension period.

Example: Foundation 2 was one of two successors in interest to the assets of Foundation 1, a dissolved entity that had received a distribution from Trust which included complex holdings. After receiving that distribution, Foundation 1 was restructured into Foundations 2 and 3, the latter of which then received interests in certain business enterprises that owned real estate that was being developed. Such distributions were treated as having been acquired other than by purchase. Due to the state of the real estate market and other factors, Foundation 2 was concerned about its ability to dispose of the interests, which were Section 4943 excess business holdings. The IRS granted an extension of the deadline for disposition thereof. Noting the criteria that had to be satisfied to extend the disposition deadline, the IRS held, inter alia, that Foundation 2 had made diligent efforts to dispose of the holdings but that such efforts had not been successful due at least in part to the size and complexity of the holdings. Foundation 2 thus was properly granted an additional five-year period within which to dispose of the interests. See PLR 201510056. Note: PLRs cannot be cited as precedent.

Example: Foundation received a bequest of 100 percent of stock in Corporation. Stock represented an excess business holding for foundation. At time of testator’s death, Corporation operated various retail stores and warehouses. Since testator’s death, substantial efforts were made to improve Corporation’s marketability. However, due to Corporation’s complex nature and the current economic conditions, it could not dispose of the excess business holdings except at a price substantially below fair market value.

> Corporation was being restructured and an investment management firm was employed to help market the stock and was in negotiations with a prospective buyer. IRS granted relief finding that the plan to dispose of the excess business holding within the additional five-year period can reasonably be expected to be carried out. See PLR 201329027.
>
> **Requesting approval of an extension**
>
> A request for extension of the period for disposition, as well as a copy of any response received from state officials, should be submitted as a private letter ruling request to the Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). To request the ruling, the foundation must follow the instructions in Revenue Procedure 2020-1 (updated annually) and pay the required user fee. The current user fee amount can be found in Appendix A (schedule of user fees) of Revenue Procedure 2020-1.
>
> **Issue Indicators or Audit Tips**
>
> - Review Part VII-B of Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Trust Treated as Private Foundation, for reporting of excess business holdings.
> - The five-year disposition period starts the date the business interest or stock is contributed.
> - Extensions should be substantiated by proof of IRS approval.
> - If a foundation fails to establish that an extension was approved, seek to impose the Section 4943 excise taxes.

Generally, the donor should contribute either all of the donor's interest in the business or an undivided interest in every right the donor has, including voting and other noneconomic rights.[4650] However, donating nonvoting stock and keeping voting stock would work.[4651] Similarly, one might create an LLC to control the sale of the donated partnership interest.[4652]

II.Q.6.b. Possible Deemed Sale or Reduced Deduction When Contributing Partnership Interest to Charity

When a partner transfers a partnership interest, any reduction in liabilities allocated to that partner is considered sale proceeds. Letter Ruling 9533014 commented:

> We also note certain other consequences of the proposed transaction. A proposes to transfer to Y by gift an interest in X. The transfer of a partnership interest subject to nonrecourse liabilities to a charitable remainder trust is treated as a sale or exchange for purposes of section 1011(b) of the Code. See section 1.1001-2(c), Example (4) of the regulations; Rev. Rul. 75-194, 1975-1 C.B. 80; *Guest v. Commissioner*, 77 T.C. 9 (1981), *acq.*, 1982-1 C.B. 1. Under sections 752(d) and 1011(b) of the Code, the

[4650] See part II.Q.6.f Incomplete Gift and Charitable Partial Interest Prohibition.
[4651] See fn. 4768 part II.Q.6.f Incomplete Gift and Charitable Partial Interest Prohibition. But donating voting stock and keeping the voting rights would not work. See fn. 4766.
[4652] See the paragraph of text accompanying fn. 4783 in part II.Q.6.f.iii Charitable Partial Interest Prohibition

> amount of A's share of partnership liabilities at the time of the transfer corresponding to the partnership interest transferred constitutes an amount realized by A. Consequently, in determining A's gain, A's basis must be apportioned as required by section 1011(b) of the Code and 1.1011-2(b) of the regulations. It is not known whether section 751 of the Code applies to the transfer to require that part of the gain be treated as ordinary income (e.g., through the application of the recapture rules of section 1250). If section 751 applies, the amount of the charitable contribution may be reduced under section 170(e)(5) (applying to contributions of ordinary income property). In determining whether a charitable contribution is allowable, section 170(e)(5) is to be applied without regard to section 1011(b) and the amount by which the contributed portion of the property must be reduced is the amount determined by taking into account the amount of gain which would have been ordinary income or long-term capital gain if the contributed portion of the property had been sold by the donor at its fair market value at the time of the sale or exchange. See section 1.1011-2(a)(1) of the regulations. Finally, we note that although the liability is nonrecourse, the charity must take the liability into account in determining the net fair market value of the trust assets for calculating the unitrust amount.

Similarly, if contributing a partnership interest results in the partner being relieved of liabilities[4653] previously allocated to that partner, the donor has made a bargain sale. Rev. Rul. 75-194 includes the following facts and conclusion:

> L became a limited partner in a partnership on its formation in 1971. In 1974, L contributed his entire limited partnership interest to a charitable organization described in section 170(c) of the Internal Revenue Code of 1954. On that date all of the partnership liabilities were liabilities on which neither L, the other partners, nor the partnership had assumed any personal liability. Also on that date, L's proportionate share of the value of the partnership assets was greater than his proportionate share of the partnership liabilities and because of partnership losses L's adjusted basis for his partnership interest was less than his proportionate share of the partnership liabilities. At the time of the contribution the partnership had no unrealized receivables or inventory items described in section 751.
>
> [Citations to Code §§ 170(a), 741, 752(c), 752(d), and 1011(b) and to Reg. §§ 1.170A-1(c), 1.752-1(e), 1.752-1(e), 1.170A-4(c)(2)(iii), 1.170A-4(c), and 1.1011-2 (including Reg. § 1.1011-2(a)(3)) follow.]
>
> Since the value of L's share of the partnership assets at the time he transferred his partnership interest exceeded his share of partnership liabilities at that time, a charitable contribution deduction is allowable under section 170 of the Code, subject to the reductions and limitations set forth therein. At the same time, pursuant to sections 752(d) and 1011(b), the amount of L's share of partnership liabilities at the time of the transfer constitutes an amount realized by L. Based on the foregoing, a bargain sale within the meaning of sections 170 and 1011(b) has occurred.
>
> Accordingly, in the instant case, L has a recognized gain on the transfer equal to the excess of the amount realized by L over that portion of the adjusted basis of L's partnership interest (at the time of the transfer) allocable to the sale under section 1011(b) of the Code. Since the partnership had no unrealized receivables or

[4653] See part II.C.3 Allocating Liabilities (Including Debt).

appreciated inventory items described in section 751, the gain is considered a gain from the sale of a capital asset under section 741.

This rule applies even if the liabilities are nonrecourse. Letter Ruling 9533014 commented:

> We also note certain other consequences of the proposed transaction. A proposes to transfer to Y by gift an interest in X. The transfer of a partnership interest subject to nonrecourse liabilities to a charitable remainder trust is treated as a sale or exchange for purposes of section 1011(b) of the Code. See section 1.1001-2(c), Example (4) of the regulations; Rev. Rul. 75-194, 1975-1 C.B. 80; *Guest v. Commissioner*, 77 T.C. 9 (1981), *acq.*, 1982-1 C.B. 1. Under sections 752(d) and 1011(b) of the Code, the amount of A's share of partnership liabilities at the time of the transfer corresponding to the partnership interest transferred constitutes an amount realized by A. Consequently, in determining A's gain, A's basis must be apportioned as required by section 1011(b) of the Code and 1.1011-2(b) of the regulations. It is not known whether section 751 of the Code applies to the transfer to require that part of the gain be treated as ordinary income (e.g., through the application of the recapture rules of section 1250). If section 751 applies, the amount of the charitable contribution may be reduced under section 170(e)(5) (applying to contributions of ordinary income property). In determining whether a charitable contribution is allowable, section 170(e)(5) is to be applied without regard to section 1011(b) and the amount by which the contributed portion of the property must be reduced is the amount determined by taking into account the amount of gain which would have been ordinary income or long-term capital gain if the contributed portion of the property had been sold by the donor at its fair market value at the time of the sale or exchange. See section 1.1011-2(a)(1) of the regulations. Finally, we note that although the liability is nonrecourse, the charity must take the liability into account in determining the net fair market value of the trust assets for calculating the unitrust amount.

Contributing various properties subject to debt, rather than a partnership interest, would result in the bargain sale rules applying to each property separately.[4654]

Also, the amount of any charitable contribution is reduced by the amount of gain which would not have been long-term capital gain[4655] if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution).[4656] Although the sale of a partnership interest generally is taxed as a capital gain[4657] (which might be long- or short-term), certain underlying assets might convert part or all of the gain to ordinary income.[4658] However, it appears that certain assets that otherwise might have severe limitations on

[4654] Letter Ruling 201709001.
[4655] Determined without regard to Code § 1221(b)(3).
[4656] Code § 170(e)(1)(A).
[4657] Code § 741; see part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest, especially fn. 5651 (look to partnership interest itself absent statutory authority to look through to the partnership's assets).
[4658] See parts II.Q.8.b.i.(g) Code § 751 – Hot Assets and II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), the latter including fn. 5087 the sale of partnership interests to a controlled corporation.

deductions[4659] may be held in a partnership without tainting the deduction for the partnership interest.[4660]

II.Q.6.c. Possible Adverse Consequences When Contributing Partnership Interest to Charitable Remainder Trust

Letter Ruling 9705013 approved a charitable remainder trust (CRT) investing in an in an investment partnership. However, contributing a partnership interest to a CRT is very complex and might not be worthwhile if the partnership operates a business or has significant debt-financed property. Below are some issues.

First is a possible gain on sale, as described in part II.Q.6.b Possible Deemed Sale or Reduced Deduction When Contributing Partnership Interest to Charity.

Second, a charitable remainder trust (CRT) pays a 100% tax on any unrelated business taxable income (UBTI).[4661] The beneficiary also pays tax on this income (along with the rest of the CRT's income) when distributed to the beneficiary.[4662] A gift of any partnership interest that has significant debt risks significant UBTI – a risk that is probably too high for a CRT, given this 100% tax.[4663] One might avoid the UBI issue if the donor keeps part of the partnership interest

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[4659] Code § 170(e)(1)(B) reduces the deduction regarding contributions:

- (i) of tangible personal property—
  - (I) if the use by the donee is unrelated to the purpose or function constituting the basis for its exemption under section 501 (or, in the case of a governmental unit, to any purpose or function described in subsection (c)), or
  - (II) which is applicable property (as defined in paragraph (7)(C), but without regard to clause (ii) thereof) which is sold, exchanged, or otherwise disposed of by the donee before the last day of the taxable year in which the contribution was made and with respect to which the donee has not made a certification in accordance with paragraph (7)(D),
- (ii) to or for the use of a private foundation (as defined in section 509(a)), other than a private foundation described in subsection (b)(1)(F),
- (iii) of any patent, copyright (other than a copyright described in section 1221(a)(3) or 1231(b)(1)(C)), trademark, trade name, trade secret, know-how, software (other than software described in section 197(e)(3)(A)(i)), or similar property, or applications or registrations of such property, or
- (iv) of any taxidermy property which is contributed by the person who prepared, stuffed, or mounted the property or by any person who paid or incurred the cost of such preparation, stuffing, or mounting

[4660] The flush language of Code § 170(e)(1), provides that, for purposes of applying Code § 170(e)(1) to the charitable contribution of stock in an S corporation, rules similar to those in fn. 4658 shall apply in determining whether gain on such stock would have been long-term capital gain if such stock were sold by the taxpayer. If the rules of Code § 170(e)(1)(B) looked through the partnership, presumably they would also look through an S corporation, which they do not.

[4661] Code § 664(c)(2)(A); Reg. § 1.664-1(c). The latter refers to UBTI as defined in section 512, determined as if part III, subchapter F, chapter 1, subtitle A of the Internal Revenue Code applied to such trust.

[4662] Code § 664(b); Reg. § 1.664-1(c). The latter provides, Such excise tax shall be allocated to corpus and, therefore, is not deductible in determining taxable income distributed to a beneficiary.

[4663] See part II.Q.6.d Unrelated Business Taxable Income, especially fns. 4697-4707. Letter Ruling 9015049 held:

> In the instant case, the Trust as proposed will make the payments on the mortgage liability for which the grantor remains personally liable. Therefore, pursuant to section 1.677(a)-1(d) of the

regulations, the grantor of the proposed Trust will be treated as the owner of the entire Trust. As long as the grantor is treated as the owner of the entire trust under section 677, the trust is not deemed to be created for purposes of section 664. Thus, the Trust as proposed is not a charitable remainder unitrust under section 664 of the Code.

Consider having the donor agree to pay all of debt and indemnify the CRT against having to pay any share of the debt. Often the donor will contribute a partial interest, and essentially pay the entire debt from his/her share of the sales proceeds. Here are some ideas suggested by others at a meeting I attended:

- Does the "hold harmless" approach resolve the grantor trust issue (if the donee is a CRT)? The answer appears to be "yes", because the CRT will not pay any debt of the donor – the donor in fact pays the entire debt personally.
- Does the "hold harmless" approach resolve the UBI issue? Maybe not – the property transferred is still "subject to a lien", which is the language used in Code § 514, regardless of the indemnification agreement. Further, *Tidler v. Commissioner*, T.C. Memo. 1987-268, noted in a similar situation that the property in question was subject to a debt, regardless of an indemnification, because the lender was not bound by the indemnification and could take the property from charity. The donor's obligation to pay or hold the donee harmless was seen as a promise to pay, deductible (if at all) only when paid.
- Does the "hold harmless" approach resolve the bargain sale issue? The donor is not really "discharged" from any debt, as he/she pays all of it. But *Tidler* isn't entirely helpful.
- Does the "hold harmless" approach resolve the self-dealing issue (if the donee is a private foundation or CRT)? It seems to me this should follow on the resolution of the bargain sale issue (the prohibited transaction is the sale aspect of the Bargain Sale). The CRT is not taking property and assuming a mortgage. Query, however, whether it is taking the property subject to a mortgage: one could argue "no" due to the donor's indemnification; on the other hand, the property is legally subject to a lien regardless of any contractual indemnification agreements made by the donor and the CRT (see discussion regarding UBI).

Tidler held:

> The fact of the matter is that the donated property remained subject to the mortgage and to foreclosure by the mortgagee in the event of nonpayment. Indeed, we believe that the mortgagee would at the very least be required first to pursue foreclosure before seeking any recovery from 197 Partnership. See notes 23 and 27, *supra*. In the foregoing context, we find it difficult to conclude that the value of the property should not be reduced by the amount of the mortgage obligation in order to determine the amount of the contribution by 197 Partnership to Intercity. To be sure, Intercity's exposure to loss may have been ultimately eliminated by the obligation of 197 Partnership under the special warranty, but it is clear that this obligation was one "in futuro" and, although it ran with the land, would not be considered breached until an adverse claim was made against the property. See *Marathon Builders, Inc. v. Polinger*, 263 Md. 410, 283 A.2d 617, 620 (1971); 6A Powell, *Law of Real Property*, par. 899 (1986). Furthermore, under Maryland law, the measure of damages for breach of a warranty [pg. 87-1305]Permalink to hereof title is limited to the consideration paid for the property plus interest and costs of enforcement of the warranty at the discretion of the finder of fact. *See Reamer v. Kessler*, 233 Md. 311, 196 A.2d 896, 899-900 (1964); *Wlodarek v. Thrift*, 178 Md. 453, 13 A.2d 774, 781 (1940). See also generally, 6A Powell, *Law of Real Property*, *supra*; 4 Tiffany, *Law of Real Property*, sec. 1017 (3d ed. 1975); 21 C.J.S., Covenants, sec. 148 (1940). In light of the foregoing, we conclude that the special warranty was, at best, a promise to make payments at some point or points of time in the future and that such a structure does not give rise to a charitable contribution until payment is actually made.[28] *Cf. Guren v. Commissioner*, 66 T.C. 118 (1976).
>
> [28] We express no opinion as to whether any such payments on the mortgage herein would in fact constitute as charitable contributions in view of the presence of the obligation under the special warranty deed, although as we have noted, that obligation may have been severely limited under Maryland law because of the absence of consideration. Moreover, we note that there is no evidence in the record herein that any payments were made in the mortgage by anyone after November 8, 1974. See also note 26, *supra.*

and contractually assumes the burden of the partnership's debt;[4664] whether that idea is practical or too complex depends on the situation.

[4664] The TAM's holding regarding the escrow fund to reallocate nonrecourse debt, which was described in fn. 4698, together with its reference to Code § 752 (see fn. 4697). See 735 T.M. *Private Equity Funds*, part VIII.H.1., suggesting:

> A fund that allows its tax-exempt investors to replace their share of any fund level debt with a capital contribution should allocate the debt to the other investors. *See* TAM 9651001 (applying § 752 to determine portion of partnership debt allocable to tax-exempt partner).

For the assumption of liabilities when transferring a partnership interest to which liabilities have been allocated, see fn. 6596, found in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System.

Hill & Mancino, *Taxation of Exempt Organizations*, ¶ 26.03[3] Nonassumed Debt, direct the reader to GCM 39486 (1986), in which the IRS internally had asked:

> If an organization exempt from tax under section 501(a) is a limited partner in a partnership that lends money under or acquires wrap-around mortgages, are the wrap-around mortgages debt-financed property of the exempt organization?

Relying on Rev. Rul. 75-99, the GCM concluded:

> A wrap-around mortgage acquired by the partnership as an investment solely by advancing its own funds is not debt-financed property merely because the wrap-around note is for an amount in excess of the funds advanced by the partnership.

Rev. Rul. 75-99 involved the following:

> An unincorporated trust, qualifying as a real estate investment trust under section 856 of the Internal Revenue Code of 1954, invested in a wrap-around loan. In the wrap-around loan in this case a party owning real estate encumbered by a senior mortgage executed a note to the trust for the total of the unpaid principal balance of the senior mortgage, plus cash advanced by the trust. The borrower also executed a mortgage to the trust encumbering the real estate described in the senior mortgage. The trust agreed to look solely to the mortgaged property for the payment of the indebtedness and agreed not to seek or obtain any deficiency or other money judgment in respect thereof. The borrower received from the trust that sum by which the principal amount of the wrap-around loan exceeded the unpaid principal balance of the senior mortgage.
>
> The trust is not liable to the senior mortgagee on the underlying note. However, the trust agreed with the mortgagor-owner to make the periodic payments of principal and interest due on the senior obligation, provided, however, that if the mortgagor defaults on its payments on the note to the trust, the trust is relieved of its obligation to make payments on the senior mortgage. For purposes of making payments on the senior mortgage and performing other obligations required under the mortgage, the borrower appointed the trust its attorney-in-fact.
>
> In the wrap-around loan in this case, the trust determined that certain property with a 300x dollar senior mortgage bearing interest at 7 percent per annum was of sufficient value to support a wrap-around loan to the owner in the amount of 400x dollars at 8 percent per annum. The borrower executed a note, and a mortgage securing the note, in the amount of 400x dollars at 8 percent per annum. The trust advanced 100x dollars to the borrower, the amount by which the wrap-around loan exceeded the principal of the senior mortgage. The borrower periodically pays to the trust an amount equal to interest at the rate of 8 percent on the 400x dollar note, together with principal thereon.

Rev. Rul. 75-99 held:

> Section 856(c)(2) and (3) of the Code provides that for a trust to qualify as a real estate investment trust, certain percentages of its gross income must be derived from specified sources, including interest and interest on obligations secured by mortgages on real property.
>
> For purposes of section 856(c)(2) and (3) of the Code, the indebtedness between the trust and the borrower giving rise to an obligation to pay interest is not the total amount of the wrap-around loan. See *Mindlin v. Davis*, 74 So.2d 789 (Fla. 1954). Although the borrower signs a note for 400x dollars, the trust actually loans the borrower 100x dollars. Payments made by the trust on

Consider whether, instead of contributing a partnership interest to a CRT, one might place the partnership interest in a corporation and contribute the corporation to the CRT. Such a corporation is commonly referred to as a blocker. Any partnership liabilities from which the donor is deemed to be relieved might trigger income on formation of the corporation.[4665] The CRT would not receive any UBTI; however, the corporation would pay tax on its share of the partnership's income and on any gain on sale of the partnership. If the partnership has little or no debt-financed property, then the corporation might save little tax and might even cost more tax; if it has much debt-financed property, then the corporation might produce a significant benefit. The benefit of forming the corporation would be taxing income at regular rates instead of 100% while getting the benefit of the deduction of the full value of the corporation (which presumably would be reduced by tax paid on the expected upcoming sale of the partnership interest). However, the corporation's sale of the partnership interest would be subject to income tax at corporate rates, whereas the CRT's sale of a partnership interest it owns directly would defer or avoid income tax on gain on the sale, if and to the extent that the sale would not generate UBTI. Furthermore, if the CRT sold its shares in the corporation, a purchaser would reduce the price to take into account the partnership's built-in gain, especially if the purchaser would have been able to benefit from depreciation or amortization deductions if it had bought the partnership interest directly.[4666] So, the blocker concept, although avoiding UBTI issues, might not save much money, and a donor concerned about UBTI might consider just selling the partnership interest and donating the proceeds.

Another way a CRT could avoid UBTI from a partnership is to contribute to a blocker any portion of the partnership interest that would generate UBTI. If the partnership interest is about to be sold and the sale itself would not generate UBTI, then the blocker can avoid UBTI on current income without subjecting the sale proceeds to the corporate tax regime. To avoid the prohibition described in part II.Q.6.f Incomplete Gift and Charitable Partial Interest Prohibition, the donor should contribute to the CRT a vertical slice of everything the donor owns in the partnership, and then the CRT contributes to the blocker the portion of the partnership interest that generates UBTI.

> the senior obligation are considered to be made on behalf of the borrower from payments received from the borrower on the 400x dollar note.
>
> Accordingly, it is held that only the interest on 100x dollars, the amount of the cash advanced by the trust, is includible in the trust's gross income.

Analogizing, GCM 39486 reasoned:

> Here, as in Rev. Rul. 75-99, there is no indication that the contract between the partnership and the borrower creates a debtor-creditor relationship between the partnership and the lender under the first mortgage. The partnership does not contract with the lender under the first mortgage for liability for repayment of the first mortgage. Thus, it cannot be said, on these facts, that the partnership has borrowed the amount of the first mortgage in order to advance the funds to the borrower. Accordingly, there is not any acquisition indebtedness.
>
> The same conclusion is reached by analyzing the property acquired. In this case, the partnership acquires a note secured by an interest in property subordinate to one or more other mortgages or similar interests in the property. The partnership does not acquire the borrower's property that is subject to these senior obligations. Thus, the property acquired is not, in our opinion, subject to any acquisition indebtedness, rather, the property acquired (the note) is an obligation to pay secured by the borrower's encumbered property. Thus, we think it is clear that a wrap-around note acquired by the partnership solely by advancing its own funds is not debt-financed property.

[4665] See part II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities.

[4666] See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

In either CRT scenario, the UBTI would be taxed at the corporate level and again when the CRT distributes the dividend to the recipient, rather than being taxed to the donor at the donor's ordinary income tax rates (which usually are higher than corporate rates but lower than corporate rates and capital gain rates combined), so the sale not taking place would increase the annual income tax burden. On the other hand, the charitable deduction might offset this tax disadvantage to a certain extent. Note also that distributions to the recipient, which are based on a percentage (5% or more) of the value of the CRT's assets, would likely be smaller than the annual distributions from the partnership.

Also note that the donor being compensated for services to the partnership or otherwise engaging in transactions with the partnership might be limited by self-dealing rules:[4667] Payment of compensation by a private foundation directly or indirectly to a disqualified person is self-dealing.[4668] One may be a disqualified person with respect to a CRT by being a "substantial contributor" to the CRT[4669] or a trustee of the CRT.[4670] The payment of compensation to a disqualified person by a partnership owned by the CRT is not direct self-dealing because the payment is not being made by the CRT to the recipient. Instead, one would look to rules governing indirect self-dealing[4671] between a disqualified person and an organization controlled[4672] by a private foundation.

Also, if the partnership is unmarketable,[4673] then any required valuation (at initial contribution and annually for a unitrust) must be performed exclusively by an independent trustee or determined by a current qualified appraisal from a qualified appraiser.[4674]

II.Q.6.d. Unrelated Business Taxable Income (UBTI)

II.Q.6.d.i. UBTI Related to a Partnership or Sole Proprietorship

UBTI can arise from business operations[4675] or from income generated by acquisition indebtedness. If a trade or business regularly carried on by a partnership of which an

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[4667] See Letter Ruling 9533014.
[4668] Code § 4941(d)(1)(D).
[4669] A substantial contributor is the creator of a charitable trust and any donor who gives more than $5,000 to the private foundation if the amount given is more than 2% of the total contributions in the taxable year. Code §§ 4946(a)(2) and 507(d)(2).
[4670] Code § 4946(a)(1).
[4671] Reg. § 53.4941(d)-1(b), which provides the indirect self-dealing rules and various exceptions.
[4672] Reg. § 53.4941(d)-1(b)(5).
[4673] Reg. § 1.664-1(a)(7)(ii) provides:

> *Unmarketable assets*. Unmarketable assets are assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely-held stock, and an unregistered security for which there is no available exemption permitting public sale.

[4674] Reg. § 1.664-1(a)(7)(i).
[4675] Code § 512(a)(1). Citing Code § 513(a), (c) and Reg. § 1.513-1(a), Letter Ruling 201626004 reasoned:

> Therefore, unless one of the specific exceptions of sections 512 or 513 is applicable, gross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if:
> (1) it is income from a trade or business;
> (2) such trade or business is regularly carried on by the organization; and

organization is a member is an unrelated trade or business with respect to the organization, the organization in computing its UBTI must, subject to the exceptions, additions, and limitations

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(3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

The Letter Ruling reviewed Reg. § 1.513-1(c)(1):

> Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be regularly carried on if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.

After reviewing Reg. § 1.513-1(d) (see fn. 4713 in part II.Q.6.d.i UBTI Related to a Partnership or Sole Proprietorship) for whether an activity is substantially related (other than through the production of funds) to the purposes for which exemption is granted, it reviewed case law:

> In *United States v. American Bar Endowment*, 477 U.S. 105 (1986), the Supreme Court held that a section 501(c)(3) organization's insurance program constituted both the sale of goods and the performance of services and, therefore, was a trade or business for purposes of the tax on unrelated business income. The organization was the group policyholder and administrator of insurance policies offering life, disability and medical coverage. Its activities included compiling a list of its members and soliciting their insurance business.
>
> In *Ohio Farm Bureau Federation, Inc., v, Commissioner*, 106 T.C. 222 (1996), the Tax Court concluded that a covenant not to compete did not constitute a trade or business. The Tax Court declined to treat the absence of activity as equivalent to the affirmative conduct of a trade or business in the context of unrelated business income.

The Letter Ruling addressed a donation of accounts receivable bequeathed to a foundation:

> At the time of Decedent's death, the Company's primary assets were receivables related to legal services provided by the Company in connection with certain lawsuits (the receivables). The receivables represent the Company's share of the remaining unpaid balance of the attorney's fees awarded upon settlement of the lawsuits. The fees due to the Company were determined under various settlement agreements and, under the terms of the settlement, payment of fees was deferred over time. Payments are expected to continue for approximately x additional years. The Company's ownership in its share of the attorney's fees payable wholly vested when the lawsuits finally settled, which was prior to Decedent's death. Currently, none of the Estate, the Foundation, or the Company provides any services in relation to the legal services generating the receivables. Furthermore, the Foundation represents that it will not perform any act (including administrative acts) with respect to the receivables other than receiving payments related to satisfaction of the receivables.
>
> The Foundation represents that the receivables:
>
> - Are comprised solely of income from services previously provided by the Company, including Decedent;
> - Are not debt-financed property within the meaning of section 514(b); and
> - Are not gains or losses from the sale or exchange or other disposition of any property or gains or losses from the lapse or termination of options to buy or sell securities.

The Letter Ruling concluded:

> However, the Company completed provision of the legal services prior to Decedent's death. The Foundation represents that none of the Estate, the Foundation, or the Company currently provides any services in relation to the receivables and, further, that the Foundation will not perform any act (including administrative acts) other than receiving payments related to satisfaction of the receivables. The Foundation is merely the distributee of the assets of the Estate and the recipient of the payments. The Foundation is performing no activity, similar to the organization in *Ohio Farm Bureau Federation, Inc.*, *supra*, other than receiving payments. The Foundation is neither selling goods nor performing any services in order to receive income from the receivables, unlike the organization in *United States v. American Bar Endowment*, *supra*, that was engaged in a trade or business. See section 513(c); Treas. Reg. Sec. 1.513-1(b). Therefore, the income resulting from the receivables is not unrelated business income within the meaning of section 512(a) and will not be subject to the tax on unrelated business income described in section 511(a).

contained in Code § 512(b), include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.[4676] For UBI purposes, generally a trust looks to "any trade or business regularly carried on by such trust or by a partnership of which it is a member."[4677] A partnership's activities are attributed to a nonprofit partner for purposes of determining both whether the nonprofit operates exclusively for Code § 501(c)(3) purposes[4678] and whether the nonprofit operates has engaged in an unrelated trade or business and therefore may be subject to the unrelated business income tax on its distributive share of the partnership's income.[4679]

When a foundation collects accounts receivable that the decedent had earned and bequeathed to it but the foundation did not conduct the business from which the accounts receivable arose, income from collecting the accounts was not UBI. Letter Ruling 201626004 reasoned:

> At the time of Decedent's death, the Company's primary assets were receivables related to legal services provided by the Company in connection with certain lawsuits (the receivables). The receivables represent the Company's share of the remaining unpaid balance of the attorney's fees awarded upon settlement of the lawsuits. The fees due to the Company were determined under various settlement agreements and, under the terms of the settlement, payment of fees was deferred over time. Payments are

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[4676] Code § 512(c)(1).

[4677] Code § 513(b) provides:

> The term "unrelated trade or business" means, in the case of—
>
> (1) a trust computing its unrelated business taxable income under section 512 for purposes of section 681 ; or
>
> (2) a trust described in section 401(a) , or section 501(c)(17) , which is exempt from tax under section 501(a);
>
> any trade or business regularly carried on by such trust or by a partnership of which it is a member.

Reg. 1.512(c)-1 provides:

> In the event an organization to which section 511 applies is a member of a partnership regularly engaged in a trade or business which is an unrelated trade or business with respect to such organization, the organization shall include in computing its unrelated business taxable income so much of its share (whether or not distributed) of the partnership gross income as is derived from that unrelated business and its share of the deductions attributable thereto. For this purpose, both the gross income and the deductions shall be computed with the necessary adjustments for the exceptions, additions, and limitations referred to in section 512(b) and in § 1.512(b)-1. For example, if an exempt educational institution is a partner in a partnership which operates a factory and if such partnership also holds stock in a corporation, the exempt organization shall include in computing its unrelated business taxable income its share of the gross income from the operation of the factory, but not its share of any dividends received by the partnership from the corporation. If the taxable year of the organization differs from that of the partnership, the amounts included or deducted in computing unrelated business taxable income shall be based upon the income and deductions of the partnership for each taxable year of the partnership ending within or with the taxable year of the organization.

[4678] Rev. Rul. 2004-51 concluded that the nonprofit's activities conducted through the partnership are not a substantial part of the nonprofit's activities within the meaning of Code § 501(c)(3) and Reg. § 1.501(c)(3)-1(c)(1). Therefore, based on all the facts and circumstances, the nonprofit's participation in the partnership, taken alone, will not affect the nonprofit's continued qualification for exemption as a Code § 501(c)(3) organization.

[4679] Rev. Rul. 2004-51 concluded that the nonprofit's activities conducted through the partnership constitute a trade or business that is substantially related to the exercise and performance of the nonprofit's exempt purposes and functions.

> expected to continue for approximately x additional years. The Company's ownership in its share of the attorney's fees payable wholly vested when the lawsuits finally settled, which was prior to Decedent's death. Currently, none of the Estate, the Foundation, or the Company provides any services in relation to the legal services generating the receivables. Furthermore, the Foundation represents that it will not perform any act (including administrative acts) with respect to the receivables other than receiving payments related to satisfaction of the receivables.
>
> The Foundation represents that the receivables:
>
> - Are comprised solely of income from services previously provided by the Company, including Decedent;
> - Are not debt-financed property within the meaning of section 514(b); and
> - Are not gains or losses from the sale or exchange or other disposition of any property or gains or losses from the lapse or termination of options to buy or sell securities.

Letter Ruling 201626004 concluded:

> However, the Company completed provision of the legal services prior to Decedent's death. The Foundation represents that none of the Estate, the Foundation, or the Company currently provides any services in relation to the receivables and, further, that the Foundation will not perform any act (including administrative acts) other than receiving payments related to satisfaction of the receivables. The Foundation is merely the distributee of the assets of the Estate and the recipient of the payments. The Foundation is performing no activity, similar to the organization in *Ohio Farm Bureau Federation, Inc.*, *supra*, other than receiving payments. The Foundation is neither selling goods nor performing any services in order to receive income from the receivables, unlike the organization in *United States v. American Bar Endowment*, *supra*, that was engaged in a trade or business. See section 513(c); Treas. Reg. Sec. 1.513-1(b). Therefore, the income resulting from the receivables is not unrelated business income within the meaning of section 512(a) and will not be subject to the tax on unrelated business income described in section 511(a).

On the other hand, when a partnership ran an active business, the taxpayer in Letter Ruling 9340043 cleansed the partnership's assets before contributing the partnership to a charitable remainder trust. Before the contribution, the partnership distributed cash, accounts receivable, and any substantially appreciated inventory pro rata to its owners. "Immediately after" the transfer of the partnership interest to the CRT, the partnership sold all its assets to the buyer. The ruling held that the sale "does not involve a sale of inventory or property held primarily for sale to customers in the ordinary course of the business of an investment management and advisory company;" therefore, under Code § 512(b)(5), the gain did not produce UBTI. Furthermore:

> Since the sale of the partnership assets occurred on October 21, 1992, the same day of the Trust's receipt of its interest in the partnership, the Trust was not the owner of a partnership interest in an unrelated trade or business, which would have produced unrelated business taxable income to the Trust. Therefore, the transaction will not result

> in the Trust's incurring any unrelated business income tax liability pursuant to section 512(c)(1) of the Code.
>
> The mere continued holding of its partnership interest after the partnership's assets other than office furnishings and equipment have been transferred to the subsidiary of F will not involve the Trust in any income producing activity which could be characterized as trade or business. Therefore, the Trust's mere holding of such partnership interest after the transfer of assets to F's subsidiary, as described previously, will not result in the Trust's incurring any unrelated business income tax liability pursuant to section 512(c)(1) of the Code.
>
> Accordingly, we have concluded that the Trust will not realize any income subject to unrelated business income tax as a result of the transactions described above.

Although dividends,[4680] interest,[4681] annuity payments,[4682] royalties,[4683] rent from real property or from personal property incidental to the real property rental,[4684] and capital gains (and gain from certain other property) generally do not constitute unrelated business income (UBI) if the donee does not engage in business activity, but if they arise from debt-financed property then they may constitute UBI.[4685] Below is a discussion of gain on sale without considering debt-financing, then debt-financing is addressed.

[4680] Code § 512(b)(1).

[4681] Code § 512(b)(1).

[4682] Code § 512(b)(1). Letter Ruling 200425027 held that bequests relating to the following were not UBI:

> In addition to receiving the residue of the Decedent's estate, Trust will be funded by a distribution from Decedent's Plan 1 and Decedent's Plan 2 (the "Plans"). In addition, Trust will be funded by a distribution from Decedent's Annuity. It is represented that (1) the Plans are qualified plans under section 401; (2) the Annuity is not a qualified plan under section 401 or an individual retirement account (IRA), but is a tax-sheltered annuity that was purchased by Decedent as an investment; and (3) the Decedent's basis in the Annuity was greater than the fair market value of the Annuity at the date of Decedent's death.

Similarly, Letter Ruling 200234019 held that bequests relating to the following, that an estate assigned to charity, were not UBI:

> Decedent's Estate included four contracts, represented as being annuities described in § 403(b), and three individual retirement accounts (IRAs), represented as being qualified IRAs described in § 408. Decedent was also the beneficiary of a custodial account held in the name of the Decedent's late spouse, represented as being an account described in § 403(b)(7).

[4683] Code § 512(b)(2).

[4684] Code § 512(b)(3). Short-term rentals involving significant services constitute UBI. Rev. Rul. 76-402 (ten-week summer tennis camp, in which a school provided tennis courts, furnished dormitory rooms, linens, maid service, meals, and dining facilities for use by the individual in conducting the camp), amplified Rev. Rul. 80-297; Rev. Rul. 80-298 (professional football team leases stadium from university for practice during several months of the year, with university providing heat, light, water, dressing room, linen, significant stadium security services, and maintenance of playing surface and all other ground.). The IRS' web page, at https://www.irs.gov/charities-non-profits/exclusion-of-rent-from-real-property-from-unrelated-business-taxable-income, provides an informal brief overview in "Exclusion of Rent from Real Property from Unrelated Business Taxable Income."
See also part II.L.2.a.ii Rental Exception to SE Tax, especially fns. 3429-3437, comparing the rental exception for self-employment tax to the rental exception for UBTI purposes (the latter being set forth in fn. 3434).

[4685] Superseding Code § 512(b)(5) and other exceptions, Code § 512(b)(4) provides:

The exclusion of gains, Code § 512(b)(5), provides:

> There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than-
>
> (A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or
>
> (B) property held primarily for sale to customers in the ordinary course of the trade or business.
>
> There shall also be excluded all gains or losses recognized, in connection with the organization's investment activities, from the lapse or termination of options to buy or sell securities (as defined in section 1236(c)) or real property and all gains or losses from the forfeiture of good-faith deposits (that are consistent with established business practice) for the purchase, sale, or lease of real property in connection with the organization's investment activities. This paragraph shall not apply with respect to the cutting of timber which is considered, on the application of section 631, as a sale or exchange of such timber.

This provision does not protect various depreciable or amortizable property from constituting UBI.[4686] When Code § 512(b)(5) refers to the sale, exchange, or other disposition of property, it encompasses "gains and losses from involuntary conversions, casualties, etc."[4687]

Special rules apply regarding options.[4688]

> Notwithstanding paragraph (1), (2), (3), or (5), in the case of debt-financed property (as defined in section 514) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514(a)(1), and there shall be allowed, as a deduction, the amount ascertained under section 514(a)(2).

[4686] Reg. § 1.1245-6(b) (see part II.G.6.b Code § 1245 Property) may override Code § 512(b)(5):
> *Nonrecognition sections overridden*. The nonrecognition provisions of subtitle A of the Code, which section 1245 overrides include, but are not limited to, sections 267(d), 311(a), 336, 337, 501(a), 512(b)(5) and 1039. See section 1245(b) for the extent to which section 1245(a)(1) overrides sections 332, 351, 361, 371(a), 374(a), 721, 731, 1031, 1033, 1071, and 1081 (b)(1) and (d)(1)(A). For limitation on amount of adjustments reflected in adjusted basis of property disposed of by an organization exempt from income taxes (within the meaning of section 501(a)), see paragraph (a)(8) of § 1.1245-2.

[4687] Reg. § 1.512(b)-1(d)(1).

[4688] Reg. § 1.512(b)-1(d)(2) provides:
> There shall be excluded from the computation of unrelated business taxable income any gain from the lapse or termination after December 31, 1975, of options to buy or sell securities (as that term is defined in section 1236(c)). An option is considered terminated when the organization's obligation under the option ceases by any means other than by reason of the exercise or lapse of such option. If the exclusion is otherwise available it will apply whether or not the organization owns the securities upon which the option is written, that is, whether or not the option is "covered." However, income from the lapse or termination of an option is excludable only if the option is written in connection with the organization's investment activities. Thus, for example, if the securities upon which the options are written are held by the organization as inventory or for sale to customers in the ordinary course of a trade or business, the income from the lapse or termination will not be excludable under the provisions of this paragraph. Similarly, if an organization is engaged in the trade or business of writing options (whether or not such options are covered) the exclusion will not be available.

Beyond that, let's focus on whether property, held by an exempt organization itself, is inventory or held for the sale to customers, which depend on the organization's activities. An exempt organization's specific business activities ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.[4689] "Where income producing activities are of a kind normally conducted by nonexempt commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business."[4690] Assets that normally

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[4689] Reg. § 1.513-1(c)(1) provides:

> *General principles*. In determining whether trade or business from which a particular amount of gross income derives is "regularly carried on," within the meaning of section 512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. This requirement must be applied in light of the purpose of the unrelated business income tax to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete. Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.

[4690] Reg. § 1.513-1(c)(2)(i), which continues:

> For example, the operation of a sandwich stand by a hospital auxiliary for only 2 weeks at a state fair would not be the regular conduct of trade or business. However, the conduct of year-round business activities for one day each week would constitute the regular carrying on of trade or business. Thus, the operation of a commercial parking lot on Saturday of each week would be the regular conduct of trade or business. Where income producing activities are of a kind normally undertaken by nonexempt commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business. For example, the operation of a track for horse racing for several weeks of a year would be considered the regular conduct of trade or business because it is usual to carry on such trade or business only during a particular season.

Reg. § 1.513-1(c)(2)(ii) provides:

> *Intermittent activities; in general*. In determining whether or not intermittently conducted activities are regularly carried on, the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by non-exempt organizations. In general, exempt organization business activities which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors. For example, the publication of advertising in programs for sports events or music or drama performances will not ordinarily be deemed to be the regular carrying on of business. Similarly, where an organization sells certain types of goods or services to a particular class of persons in pursuance of its exempt functions or "primarily for the convenience" of such persons within the meaning of section 513(a)(2) (as, for example, the sale of books by a college bookstore to students or the sale of pharmaceutical supplies by a hospital pharmacy to patients of the hospital), casual sales in the course of such activity which do not qualify as related to the exempt function involved or as described in section 513(a)(2) will not be treated as regular. On the other hand, where the nonqualifying sales are not merely casual, but are systematically and consistently promoted and carried on by the organization, they meet the section 512 requirement of regularity.

Reg. § 1.513-1(c)(2)(iii) provides:

> *Intermittent activities; special rule in certain cases of infrequent conduct*. Certain intermittent income producing activities occur so infrequently that neither their recurrence nor the manner of their conduct will cause them to be regarded as trade or business regularly carried on. For example, income producing or fund raising activities lasting only a short period of time will not

generate business income that the charity sells in an orderly disposition without undertaking further activity do not constitute UBI.[4691] Although crops contributed to a charitable remainder

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ordinarily be treated as regularly carried on if they recur only occasionally or sporadically. Furthermore, such activities will not be regarded as regularly carried on merely because they are conducted on an annually recurrent basis. Accordingly, income derived from the conduct of an annual dance or similar fund raising event for charity would not be income from trade or business regularly carried on.

[4691] Letter Ruling 9413020 provided:

> A is a sole proprietor engaged in the business of cattle ranching and farming. In these operations, he raises cattle to be sold for beef ("slaughter cattle") and crops. The crops and the slaughter cattle are sold to customers in the ordinary course of his business. As a first step in a plan to wind up and retire from his ranching and farming operation, A will fund the unitrust with separate irrevocable transfers of slaughter cattle and crops with a total value of approximately X. These two transfers will take place within a period of several weeks, and both transfers will occur in 1993.
>
> The trust agreement will permit A to make additional contributions to the unitrust at any time. A anticipates that he will transfer additional farming and ranching assets to the proposed unitrust in another series of transfers that will probably take place in about two years. That second series of transfers will occur as part of A's completion of his plan to wind up and retire from his ranching and farming operation. The items to be transferred at that time will include more slaughter cattle and crops, and also breeding cattle and farm machinery that A has used in his ranching and farming operations. (A is not in the business of selling either breeding cattle or farm machinery.) Although not all of these transfers will occur at one time, it is represented that they will all take place within a period of several months.
>
> A is a cash-basis taxpayer who has deducted all costs incurred in raising the slaughter cattle and crops for the years in which such costs were incurred. A will claim no income tax charitable contribution deduction for any transfer of slaughter cattle, crops, breeding stock or farm machinery (collectively "farm items") to the unitrust.
>
> C will have complete discretion as to whether and when to sell any farm items transferred to the proposed unitrust. It is likely that any quantity of farm items that is received by the unitrust in a particular transfer will be sold by the trustee in a single transaction, or at most two transactions, shortly after such farm items are transferred to the trust. However, at the time of a transfer to the unitrust, neither A nor C will be under any legally binding obligations to sell the transferred farm items.
>
> The proposed unitrust will not take over any operations of A's farm whose farm land and buildings will continue to be owned by the donor, who may retire and discontinue farming in a few years. If C decides to sell any slaughter cattle or crops that A has transferred to the unitrust, it will hire an agent that will try to find a buyer for the items in question at an attractive price. This is a method often used by farmers in selling the agricultural products they raise. It is also one of the fastest and most economical ways of liquidating such items. C will arrange for the slaughter cattle to be fed and cared for on a strictly maintenance basis (*i.e.*, it will not be engaging in efforts to "fatten them for market") from the time it receives them until a sale occurs. If C decides to sell breeding stock, it will sell them at a single auction after arranging for them to be fed and cared for from the time it receives them until the auction. It will use a similar procedure for disposing of any farm machinery it decides to sell. Thus, it is represented that the unitrust will not engage in regularly carried on sales of the farm items as a dealer and that the farm items to be sold are not held by the unitrust for sale to customers in the ordinary course of any unitrust business. It is also represented that the sales of donated farm items will not involve property that is debt-financed under section 514 of the Code….
>
> Section 1.513-1(c)(2)(iii) of the regulations indicates that business is not "regularly carried on" in the case of intermittent income-producing activities that occur so infrequently that neither their recurrence nor the manner of their conduct will cause them to be regarded as a business

trust (CRT) that sells the crops do not generate UBI when the CRT sells the crops, income from the sale remains ordinary (absent proof otherwise) and flows to the annuity or unitrust recipient as ordinary income.[4692]

For case law in a related area discussing when property is inventory from a regularly carried on business and when sales might be viewed as not from the conduct of a business, see part II.L.2.a.iii Whether Gain from Sale of Property is Subject to SE Tax.[4693] Real estate might or might not constitute inventory.[4694]

Rev. Rul. 60-352 asserts that the donation of an interest in a partnership holding installment obligations triggers income. For a discussion of installment obligations, see parts II.G.15 Limitations on the Use of Installment Sales and II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests (the latter including reference to a 2017 Tax Court case holding that specific statutory authority is required to view a partnership as an aggregate).[4695]

> regularly carried on. See also the discussion of a similar principle in *Robert L. Adam and Judith W. Adam v. Commissioner*, 60 T.C. 996 (September 27, 1973), *Acq.* 1974-1 C.B. 1….
>
> In this case, in regard to sections 511, 512, and 513 of the Code, occasional sales by the unitrust to dispose of the farm items described will not be "regularly carried on" within the meaning of section 512(a)(1) because such sales will be infrequent and intermittent. In addition, the farm items are the types of properties whose income from sales is excludible from unrelated business taxable income pursuant to section 512(b)(5), described above. Also, as to section 514, these transactions will not involve debt-financed property. Therefore, the unitrust's receipts of the proceeds from any sales of the farm items will not result in any unrelated business taxable income to the unitrust under sections 511 through 514.
>
> Accordingly, under sections 511, 512, 512(b)(5), 513, and 514 of the Code, the unitrust will not have any unrelated business taxable income on its sales, under the circumstances described, of the farm items which the donor may transfer to it.

[4692] *Furrer v. Commissioner*, T.C. Memo. 2022-100, in which the court applied the Code § 664 tiers and noted that the taxpayer did not contend that the crops became capital assets and noted that, even if the taxpayer had successfully argued that they were, the sale would have generated short-term capital gain. The taxpayer made various frivolous arguments that certain promoters of CRATs assert when selling their CRAT-creation services, but the IRS and court did not impose penalties for making these frivolous arguments.

[4693] Especially fn. 3439.

[4694] See part II.G.26.c Future Development of Real Estate. Referring to *Malat* cited in that fn., Letter Ruling 201630009 held:

> Foundation intends to hold the real estate properties as part of a diversified investment portfolio that will also contain cash and publicly traded securities and intends to continue to hold the properties, at least in the near term. Foundation anticipates that any sales of the real estate properties will be sporadic and occasional. The decision to retain or sell any of the real estate properties will be made by Foundation's Board of Directors based on the relevant facts and circumstances and in accordance with their fiduciary duty to prudently manage Foundation's investments. Any such decision will be made on a property-by-property basis, taking into consideration the overall investment portfolio, investment strategy, and capital appreciation. Foundation may decide to make capital improvements to the real estate properties as needed, but the real estate properties will not be held for the primary purpose of improving the properties for immediate resale. The real estate properties will be held as income producing properties and not as inventory used in a trade or business.

[4695] *Grecian Magnesite Mining v. Commissioner* is discussed more fully in part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest, especially fn. 5651.

Rev. Rul. 75-194 described how the bargain sale rules apply when contributing an interest in a partnership with debt. For how partnerships with debt work, see part II.C.3 Allocating Liabilities (Including Debt). The facts of Rev. Rul. 75-194 were:

> L became a limited partner in a partnership on its formation in 1971. In 1974, L contributed his entire limited partnership interest to a charitable organization described in section 170(c) of the Internal Revenue Code of 1954. On that date all of the partnership liabilities were liabilities on which neither L, the other partners, nor the partnership had assumed any personal liability . Also on that date, L's proportionate share of the value of the partnership assets was greater than his proportionate share of the partnership liabilities and because of partnership losses L's adjusted basis for his partnership interest was less than his proportionate share of the partnership liabilities. At the time of the contribution the partnership had no unrealized receivables or inventory items described in section 751.

Rev. Rul. 75-194 reasoned and held:

> Section 1.1011-2(a)(3) of the regulations provides that if property is transferred subject to an indebtedness, the amount of the indebtedness must be treated as an amount realized for purposes of determining whether there is a sale or exchange to which section 1011(b) of the Code and section 1.1011-2 apply, even though the transferee does not agree to assume or pay the indebtedness.
>
> Since the value of L's share of the partnership assets at the time he transferred his partnership interest exceeded his share of partnership liabilities at that time, a charitable contribution deduction is allowable under section 170 of the Code, subject to the reductions and limitations set forth therein. At the same time, pursuant to sections 752(d) and 1011(b), the amount of L's share of partnership liabilities at the time of the transfer constitutes an amount realized by L. Based on the foregoing, a bargain sale within the meaning of sections 170 and 1011(b) has occurred.
>
> Accordingly, in the instant case, L has a recognized gain on the transfer equal to the excess of the amount realized by L over that portion of the adjusted basis of L's partnership interest (at the time of the transfer) allocable to the sale under section 1011(b) of the Code. Since the partnership had no unrealized receivables or appreciated inventory items described in section 751, the gain is considered a gain from the sale of a capital asset under section 741.

For bargain sales, see part III.B.1.c.i Gifts with Consideration – Bargain Sales.

A partnership holding debt-financed assets can generate UBI not only on annual income but also on the sale of the partnership interest. Debt of a lower-tier partnership is attributed to an upper-tier partnership and then to the owner,[4696] so creating a patchwork of partnerships will not help.

[4696] Reg. 1.514(c)-1(a)(2), Example (4), which was cited in TAM 9651001 (which is reproduced in part in fns. 4697-4698 and analyzed in fns. 4700-4708), provides:

> In 1972 X, an exempt organization, forms a partnership with A and B. The partnership agreement provides that all three partners shall share equally in the profits of the partnership, shall each invest $3 million, and that X shall be a limited partner. X invests $1 million of its own funds in the

TAM 9651001 asserted that gain from the sale of a partnership generated UBI with respect to the partnership's debt that was allocated to the seller,[4697] except to the extent that the

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partnership and $2 million of borrowed funds. The partnership purchases as its sole asset an office building which is leased to the general public for purposes other than those described in section 514(b)(1)(A), (B), (C), or (D). The office building cost the partnership $24 million of which $15 million is borrowed from Y bank. This loan is secured by a mortgage on the entire office building. By agreement with Y bank, X s held not to be personally liable for payment of such mortgage. By reason of section 702(b) the character of any item realized by the partnership and included in the partner's distributive share shall be determined as if the partner realized such item directly from the source from which it was realized by the partnership and in the same manner. Therefore, a portion of X's income from the building is debt-financed income. Under these circumstances, since both the $2 million indebtedness incurred by X in acquiring its partnership interest and $5 million, the allocable portion of the partnership's indebtedness incurred with respect to acquiring the office building which is attributable to X in computing the debt/basis percentage (one-third of $15 million), were incurred in acquiring income-producing property, X has acquisition indebtedness of $7 million ($2 million plus $5 million). Similarly, the allocable portion of the partnership's adjusted basis in the office building which is attributable to X in computing the debt-basis percentage is $8 million (one-third of $24 million). Assuming no payment with respect to either indebtedness and no adjustments to basis in 1972, X's average acquisition indebtedness is $7 million and X's average adjusted basis is $8 million for such year. Therefore, X's debt/basis percentage with respect to its share of the partnership income for 1972 is 87.5 percent ($7 million/$8 million).

[4697] The TAM reasoned:

There is no disagreement concerning the fact that both Partnership and Z held debt-financed property. Sections 702(b) and 512(c)(1) of the Code make it clear that the income of a partnership retains its character in the hands of the partners. Thus, when Partnership and Z received income attributable to debt-financed property, X reported its share of this income as unrelated business income (UBI). The central area of disagreement is the treatment of income received from the sale of a partnership interest by an exempt organization when the interest of the exempt organization was not purchased with borrowed funds, but the property owned within the partnership was purchased by the partnership itself with (or partially with) borrowed funds. The facts indicate that X reported for each taxable year its distributive share of rental income from Partnership as unrelated debt-financed income. X did not report as unrelated debt-financed income X's gain on the sale of its interests in Partnership and Z, which held debt-financed real estate. Had Partnership and Z instead sold the debt-financed real estate, X's distributive share of gain from the sale would have been reportable as unrelated debt-financed income. X maintains that because X did not borrow directly to purchase its interests in Partnership and Z, gain from the sale of the partnership interests, rather than from the sale of the debt-financed real estate itself held by the partnerships, was not reportable as unrelated debt-financed income. However, whether X sells its interests in the partnerships or the partnerships sell the real estate, X is accomplishing economically the same result of realizing its share of any appreciation in the debt-financed real estate.

A partnership can be viewed in two ways under subchapter K: as a separate entity or as an aggregate of its partners. See *Casel v. Commissioner*, 79 T.C. 424, 432-33 (1982). The entity view of partnerships treats each partner as owning no direct interest in partnership assets or operations, but only an interest in the partnership entity itself. The aggregate view treats each partner as the owner of a direct and undivided interest in partnership assets and operations. Subchapter K is an attempt to balance the entity view with the aggregate view to avoid the use of a partnership as a means of obtaining improper tax advantages. The many situations not clearly covered by subchapter K can be resolved by both looking to whether the subchapter applies an entity or aggregate approach in analogous situations and considering the purpose of the particular provision of the Code to be applied.

partnership's non-recourse debt was effectively defeased by the establishment of the independently trusteed, fully funded escrow account which is contractually committed to paying

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The House Conference Committee report addressing the enactment of Subchapter K states that, even though Subchapter K takes an entity approach in transactions between a partner and a partnership, no inference is intended, however, that a partnership is to be considered as a separate entity for purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions. H.R. Rep. No. 2453, 83d Cong., 2d Sess. 59 (1954).

Example (4) of section 1.514(c)-1(a)(2) of the regulations shows that BOTH debt incurred to acquire a partnership interest AND debt incurred by the partnership to acquire property are included in calculating that portion of a partnership's interest that is subject to acquisition indebtedness. The debt/basis percentage thus calculated for the partnership interest is the same whether the partnership sells the property or the partner sells its partnership interest.

An interest in a partnership that holds debt-financed property is effectively an interest in the underlying assets and liabilities of the partnership. An anomalous result would occur if ownership of debt-financed property through a partnership would result in one tax treatment when direct ownership would result another. The aggregate view of the partnership interest, while not clearly delineated in section 514 of the Code, is suggested by Example (4) of section 1.514(c)-1(a)(2) of the regulations and is consistent with treatment of partnership interests elsewhere in the Internal Revenue Code (*e.g.*, section 751(a) and section 512(b)).

For purposes of the debt-financed property rule of section 514 of the Code, the aggregate approach should be applied with respect to sales of partnership interests consistently with the aggregate approach contemplated in section 512(b)(4) with respect to items of income from debt-financed property that flow through to the partners. Analogously, when a partner sells a partnership interest, section 751(a) requires a look through of its partnership interest to determine the character of assets sold and the classification of gain. It would make no economic or policy sense that X should defeat the existing aggregate approach to section 512(b)(4) simply by selling an intermediary rather than have the intermediary sell the debt-financed property. We believe that Congress could not have intended that section 512(b)(4) could be so easily avoided. Consequently, X's sales of its interests in Partnership and Z at a gain result in unrelated business income under section 514.

The debt on Partnership's revolving line of credit apparently existed, at least in part, when X acquired its interest in Partnership. Accordingly, X's share, if any, of this liability under section 752 and regulations thereunder constitutes acquisition indebtedness of X, because the indebtedness was effectively incurred by X in acquiring the partnership interest. See section 514(c)(1)(A) of the Code. In addition, X's share under the section 752 regulations of any increases in debt on the revolving line of credit after X acquires its interest in Partnership constitutes acquisition indebtedness to the extent the increases were incurred to acquire or improve property within the meaning of section 514(c)(1)(A), (B), or (C).

Because the debt with respect to X's interest in Z was incurred before July 18, 1984, the effective date for application of this exception to organizations such as X, the exception provided in section 514(c)(9)(A) of the Code is not applicable. See P.L. 98-369. In addition, X has not shown that it meets the specific requirements of section 514(c)(9)(B).

Reg. 1.514(c)-1(a)(2), Example (4), which was referred to in the quote above, is reproduced in fn. 4696.

interest and principal on the debt.[4698] The latter is consistent with Letter Rulings that held that loans from a partner to a partnership did not trigger debt-financed income.[4699]

The TAM was not clear how the UBI was computed. To me, the better view of the TAM's analysis is that one looks through the partnership to see the extent to which the debt constituted acquisition indebtedness with respect to the partnership's assets,[4700] which may extend to

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[4698] The TAM reasoned:

> Even though the properties of Z are collateral on the prior loan of Y's, the payment of the loan is not an obligation of Z, nor was it an obligation of Venture or a previous obligation of any of the other ventures. Y personally makes the payments and neither the loan nor the payments on it are considered in calculating partnership income. However, even though this is not a debt of Z, X could be at risk of loss of its share of the value of the property if the property should be foreclosed upon. Thus, X, in that case, though not contractually obligated, would in effect be paying on the loan. This risk is eliminated by the creation of the independently trusteed, fully funded, escrow account solely for the purpose of paying the loan should Y default. Therefore, the loan, although collateralized by Z property, is not an obligation or liability of Z or X, and the escrow account, which must at all times be maintained a level sufficient to pay off the loan, ensures that even if Y should default neither Z nor X would be at risk of any loss or be required to make any payments. Because neither Z nor X are obligated on the loan, and are not at risk to suffer any loss because of the loan, it is not a debt of either and can be excluded in calculating acquisition indebtedness.

[4699] Letter Ruling 8415105 included the following facts:

> In those instances in which the Partnership invests indirectly in a Project through a Joint Venture, the Partnership's investment may, in some transactions, consist of both a capital contribution and a loan to the particular Joint Venture. The monies invested by the Partnership in the Joint Venture will consist solely of the capital contributions received by the Partnership from Y {the corporate general partner] and the Limited Partners, including your capital contribution. Neither Y nor the Limited Partners will borrow any portion of their respective capital contributions. The Partnership's capital contribution and loan to the Joint Venture, together with the capital contribution, if any, of the developer, will be used by the Joint Venture to acquire the Project. Any funds used by the Joint Venture to acquire a Project will be obtained solely from the Partnership or the developer/co-venturer, and no part of the acquisition price will be financed by a third-party lender or the seller of a particular Project. The terms of the joint venture agreement to be entered into by the Partnership and a developer will provide that any such loan by the Partnership will be entitled to certain priorities established by the agreement or the laws of the jurisdiction under which the particular Joint Venture is formed, including for example, the repayment of the loan from any available liquidation proceeds prior to the return of either joint venturer's capital contribution.

Letter Ruling 8415105 concluded:

> The loans from the Partnership to any Joint Venture in which it is a co-venturer will be funded by each Limited Partner from each partner's capital, rather than by borrowing from third party sources. Accordingly, the properties acquired would not be considered to be debt-financed property within the meaning of section 514 of the Code. It follows that section 512(b)(4) would not apply in these situations.

Letter Ruling 8414066 appeared identical to Letter Ruling 8415105 in this respect.

[4700] Andersen Tax LLC, ¶ 20.02[2][c] Sources of UBTI and Exceptions From UBTI Characterization, *Tax Economics of Charitable Giving*, said in a footnote:

> To reach its conclusion, the IRS applied an aggregate (*i.e.*, not an entity) approach, so it looked through the partnership to determine if there was debt financing, and treated the situation the same as if the partnership itself sold the assets that had been debt financed.

591 T.M. *Real Estate Transactions by Tax-Exempt Entities*, part II.G.3.f., Sale of Partnership Interests, states:

treatment as UBI of a portion of other assets held by the partnership as well,[4701] but would also mean that debt incurred merely to fund operations after the CRT acquires the partnership

Applying an aggregate view of partnerships, the National Office advised that an interest in a partnership that holds debt-financed property is effectively an interest in the partnership's underlying assets and liabilities. Thus, the National Office deemed the charity to have received unrelated debt-financed income from the sale of its interest in the first partnership.

[4701] 723 T.M. *Publicly Traded Partnerships*, part III.D.2.c. Sale of a Partnership Interest, states:

Based on the rationale expressed in TAM 9651001,[849] the IRS may attempt to include in a tax-exempt organization's UBTI any gains recharacterized as ordinary income under § 751(a) to the extent those gains are attributable to excluded property. In TAM 9651001, the IRS relied in part on § 751(a) to justify its application of the aggregate view of partnerships.[850] The IRS also stated that the aggregate view of partnerships is consistent with the treatment of partnerships under § 512(b). This position also would be consistent with the IRS's apparent belief that the same result should occur regardless of whether the tax-exempt organization sold its interest in the partnership or the partnership sold its assets.[851]

[849] *Cf.* Rev. Rul. 89-108, 1989-2 C.B. 100 (gain from sale of partnership interest that is attributable to inventory is not eligible to be reported under installment sale rules because installment method would not be available if selling partner had sold its share of underlying inventory); CCA 200722027 (applying rationale of Rev. Rul. 89-108 to gain attributable to unrealized receivables). See also Rev. Rul. 91-32 (gain on sale of foreign partner's interest in partnership was ECI to extent attributable to U.S. trade or business property of partnership). [Gorin note: The Tax Court has repudiated Rev. Rul. 91-32. See fn. 4708.]

[850] It is not clear from the memorandum whether the IRS asserted that § 751(a) treats the transferor as selling an undivided interest in partnership assets rather than a partnership interest. Section 751(a) is merely an income recharacterization rule and should not constitute a basis for deeming a selling partner to have sold an interest in the underlying property of the partnership. The legislative history to the rules regarding transfers of partnership interests is consistent with this approach*. See, e.g.*, H.R. Rep. No. 83-1337, at 4096-7 (1954) (stating that § 751(a) was adopted to prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests, but that [t]he general rule that the sale of an interest in a partnership is to be treated as the sale of a capital asset is retained).

[851] *See* TAM 9651001 ([a]n anomalous result would occur if ownership of debt-financed property through a partnership would result in one tax treatment when direct ownership would result another). For example, if a partnership conducting an unrelated trade or business recognized income from the sale of inventory, § 512(b)(5) would not exclude from a tax-exempt organization's UBTI its distributive share of that income. § 512(b)(5)(A). If, instead, the tax-exempt organization sold its partnership interest, § 751(a) would recharacterize any gain or loss recognized by the organization from the sale that is attributable to the inventory as ordinary income, which then would be included in the tax-exempt organization's UBTI.

Carman, "'Contract Units' As A Work-Around For UBTI," *Journal of Real Estate Taxation* (4th Quarter 2011), stated:

If an exempt organization is a partner in a partnership that borrows money to make an investment, the unrelated debt-financed income rules are applied to the exempt organization as if the organization borrowed the money and owned the property directly.[9]

[9] Rev. Rul. 74-197, 1974-1 CB 143, TAM 9651001.

In Rev. Rul. 74-197, an exempt organization invested in a general partnership, which borrowed money to acquire investment property. The ruling held that the partnership's borrowing constituted acquisition indebtedness and, accordingly, the exempt trust's investment activity may result in UBTI.

Hill & Mancino, *Taxation of Exempt Organizations*, ¶ 26.06[4] Disposition of Partnership Interests, also approaches the issue on an aggregate basis [footnotes citing to TAM omitted]:

Importantly, the Service has also ruled that a partner of a partnership is treated as having unrelated debt-financed income on the disposition of a partnership interest that was not acquired with funds borrowed by the tax-exempt organization directly if the partnership itself had interest would not generate debt-financed income.[4702] One article suggests that the TAM may be wrong[4703] but would apply the TAM by referring to the partnership interest rather than looking

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> acquisition indebtedness with respect to partnership assets. The Service reasoned that a partnership is an aggregate of its partners and not a separate entity for this purpose and that a partnership interest is a direct and undivided interest in partnership assets and liabilities. The Service reasoned that [t]he 'aggregate' view of the partnership interest, while not clearly delineated in section 514 of the Code, is suggested by Example (4) of section 1.514(c)-1(a)(2) of the regulations and is consistent with treatment of partnership interests elsewhere in the Internal Revenue Code (*e.g.*, section 751(a) and section 512(b)). The Service also made the tax policy argument that [i]t would make no economic or policy sense that [the exempt partner] should defeat the existing aggregate approach to section 512(b)(4) simply by selling an intermediary rather than having the intermediary sell the debt-financed property. We believe that Congress could not have intended that section 512(b)(4) could be so easily avoided. The Service also ruled that this reasoning applied only to the extent that the partnership liabilities constituted acquisition indebtedness within the meaning of Section 514.

[4702] Hill & Mancino, *Taxation of Exempt Organizations*, ¶ 26.03[10] Indebtedness Incurred by Pass-Through Entities, commented on the TAM:

> In this technical advice memorandum, the Service also made an important distinction with regard to unsecured debt incurred by the partnership pursuant to a revolving line of credit: namely, that the partnership's unsecured debt under the revolving line of credit that was outstanding at the time the exempt organization became a partner was acquisition indebtedness of the partner with respect to its partnership interest, on the theory that a portion of the partnership's unsecured debt at the time of the exempt organization's admission became, in effect, a debt of the exempt partner. However, the Service also ruled that increases in debt on the revolving line of credit after the exempt organization acquires its partnership interest would constitute acquisition indebtedness only to the extent that the increases were incurred to acquire or improve property within the meaning of Section 514(c)(1)(A), Section 514(c)(1)(B) or Section 514(c)(1)(C). In other words, if the partnership drew down on its line of credit to fund operating expenses, rather than to fund acquisitions of property, increases in the debt incurred on the revolving line of credit after the exempt organization acquires its interest in the partnership would not constitute acquisition indebtedness.

[4703] Woodhull, Selling A Partnership Interest Means Complexity For Tax-Exempt Partners, *Taxation of Exempts* (WG&L) (Mar./Apr. 2012), stated that a number of practitioners have questioned whether the IRS position would be upheld if this issue were to be litigated and later argued:

> The IRS also noted that Example 4 of Reg. 1.514(c)-1(a)(2) provides further support for debt-financed UBTI characterization…. According to the IRS, the debt/basis percentage thus calculated for the partnership interest is the same whether the partnership sells the property or the partner sell its partnership interest.
>
> Notwithstanding the Service's statement in the TAM, Example 4 does not actually state that the debt/basis percentage is the same whether the partnership sells the property or the partner sells the partnership interest. Example 4 in fact provides that in 1972, X's average acquisition indebtedness is $7 million and X's average adjusted basis is $8 million for such year. Therefore, X's debt/basis percentage *with respect to its share of partnership income* [emphasis added] for 1972 is 87.5 percent. The conclusion that should be drawn from this example is that portfolio income (interest, rental income, and capital gains) that is reported to a tax-exempt partner on the partner's Schedule K-1 is debt-financed income to the extent of its entire debt/basis percentage. This conclusion in Example 4 is also consistent with Sections 512(c)(1) and 702(b). Both sections, as noted above, attribute the character of the income earned by the partnership to the partners. Furthermore, if the partnership sells its own debt-financed assets, it is clear under Sections 702(b), 512(c)(1), and 512(b)(4) that a portion of the realized gain will be characterized as debt-financed gain to the extent of the debt/basis percentage and that the debt portion of this percentage includes debt incurred to acquire the partnership interest as well as debt incurred by the partnership.

at the underlying assets,[4704] the latter seeming to be supported by a statement made by a treatise that in other places looks to the aggregate theory.[4705] It's difficult to reconcile the TAM's

> Again, in this situation, the debt-financed gain is reported on the Schedule K-1 issued to the tax-exempt partner. The distinction that appears to be missing from the IRS interpretation of Example 4 in TAM 9651001 is that the above Code sections all relate to income that is earned by the partnership and then allocated and reported on a Schedule K-1 as part of the partner's distributive share. The gain on the sale of a partnership interest is not earned by the partnership and is neither allocated nor reported on the partner's Schedule K-1. Thus, if one looks strictly at the Code and regulations, there is an argument that the gain from the sale of the partnership interest that was not acquired with debt should be excluded from characterization as debt-financed UBTI in that the partnership interest is not property subject to acquisition indebtedness. The fact that debt is used by the partnership to acquire underlying assets, and that this debt is used to determine the debt/basis percentage of the tax-exempt partner's distributive share of portfolio income allocated by the partnership, does not mean that the proceeds of the partner's sale of its ownership interest are subject to the debt-financed UBTI rules.
>
> The Service's conclusion in TAM 9651001 is that whether X sells its interests in the partnerships or the partnerships sell the real estate, X is accomplishing economically the same result of realizing its share of any appreciation in the debt-financed property. This may be true economically, but, as discussed above, the Code and regulations do not necessarily support that conclusion. Even when the IRS appears to acknowledge that the aggregate view is not clearly supported by Section 514, it still maintains that this approach is suggested by Example 4 and Sections 751 and 512(b), and notes that Congress could not have intended that Section 512(b)(4) could be so easily subverted.

[4704] Woodhull, Selling A Partnership Interest Means Complexity For Tax-Exempt Partners, *Taxation of Exempts* (WG&L) (Mar./Apr. 2012), stated:

> Assuming that [the TAM] is a correct interpretation, calculating debt-financed UBTI with respect to the tax-exempt partner's capital gain or loss on the sale of its interest in the partnership will require the partner to:
>
> (1.) Calculate the highest amount of the partnership's indebtedness during the 12-month period ending on the date of the sale, including the partnership's allocable share of any indebtedness in lower-tier partnerships.
>
> (2.) Calculate the tax-exempt partner's allocable share of that indebtedness. Assuming that the debt is nonrecourse debt secured only by the partnership assets, this may be determined by reference to the partner's overall interest in the partnership unless the partnership agreement provides otherwise. If the debt is recourse with respect to one or more partners, it would affect this determination.
>
> (3.) Divide the tax-exempt partner's share of the partnership's indebtedness by the partner's average adjusted basis in the partnership. The partner's average adjusted basis in the partnership is the average of the partner's adjusted basis as of the first day during the tax year of the partner during which it held the interest in the partnership and its adjusted basis as of the date of the sale.
>
> (4.) Multiply the tax-exempt partner's share of the partner's capital gain or loss on the sale of its interest in the partnership by the percentage calculated above. The resulting amount will be debt-financed UBTI to that partner.

It later concluded:

> To determine the portion of the partner's capital gain or loss that is debt-financed UBTI, the tax-exempt partner should multiply its capital gain realized from the sale of the partnership interest as calculated above by the debt/basis percentage, the numerator of which is the partner's share of the highest amount of the partnership's debt during the 12-month period preceding the sale, and the denominator of which is the partner's average adjusted basis in the partnership during the tax year in which the sale took place.

[4705] Compare from fn. 4702 & Mancino, *Taxation of Exempt Organizations*, ¶ 26.03[10] Indebtedness Incurred by Pass-Through Entities, stating that:

looking at the aggregate approach and then seeming to turn around and apply an entity approach.[4706] This uncertainty is not the only way in which the TAM's position creates serious tax issues for exempt organizations that acquire partnership interests for investment purposes.[4707]

On the other hand, the burden now appears to be on the IRS to point to a specific provision overriding the general rule that a partnership interest is taxed as a single asset, viewing the partnership as a single entity, rather than viewing the partnership interest as an aggregate of the underlying interests.[4708] In other words, even though Code § 702 preserves the character of income flowing through a partnership's K-1 and runs those items through a Code § 512 analysis, Code § 512(b)(5) does not look through the partnership interest in applying its exclusion from UBI to gain on sale of the interest (subject of course to the debt-financed override provided by Code § 512(b)(4)[4709]). Thus, although Code § 751 may recharacterize gain on sale of a partnership interest,[4710] Code § 751 does not purport to override

> the Service [took the position] that the partnership's unsecured debt under the revolving line of credit that was outstanding at the time the exempt organization became a partner was acquisition indebtedness of the partner with respect to its partnership interest, on the theory that a portion of the partnership's unsecured debt at the time of the exempt organization's admission became, in effect, a debt of the exempt partner.

with fn. 4701, Hill & Mancino, *Taxation of Exempt Organizations*, ¶ 26.06[4] Disposition of Partnership Interests:

> The Service reasoned that a partnership is an aggregate of its partners and not a separate entity for this purpose and that a partnership interest is a direct and undivided interest in partnership assets and liabilities. The Service reasoned that [t]he 'aggregate' view of the partnership interest, while not clearly delineated in section 514 of the Code, is suggested by Example (4) of section 1.514(c)-1(a)(2) of the regulations and is consistent with treatment of partnership interests elsewhere in the Internal Revenue Code (*e.g.*, section 751(a) and section 512(b)). The Service also made the tax policy argument that [i]t would make no economic or policy sense that [the exempt partner] should defeat the existing aggregate approach to section 512(b)(4) simply by selling an intermediary rather than having the intermediary sell the debt-financed property. We believe that Congress could not have intended that section 512(b)(4) could be so easily avoided. The Service also ruled that this reasoning applied only to the extent that the partnership liabilities constituted acquisition indebtedness within the meaning of Section 514.

[4706] The IRS might have been uncomfortable applying only an entity approach, in light of GCM 39486 (1986), described in detail in fn. 4664, in which debt from a wraparound mortgage was not deemed assumed by the tax-exempt partner.

[4707] Hill & Mancino, *Taxation of Exempt Organizations*, ¶ 29.05. Taxation of Pass-Through Income, made that observation, commenting:

> First, the sale of a partnership interest is not a sale of the underlying asset of the partnership, so the result is not necessarily economically the same. Second, the exempt organization may have no control over the timing of the incurrence or repayment of debt by the partnership. This position is problematic because Section 514 uses a twelve-month lookback rule.

[4708] *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (2017) (repudiating Rev. Rul. 91-32), discussed more fully in part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest, especially fn. 5651.

[4709] See fn. 4685.

[4710] See part II.Q.8.b.i.(g) Code § 751 – Hot Assets.

Code § 512(b)(5),[4711] so that ordinary income would not constitute UBI.[4712] Furthermore, merely holding a partnership interest that was donated and then selling it does not mean that the owner was engaged in a trade or business even though the partnership itself was, so selling the partnership interest does not constitute engaging in a business and therefore would not be captured by Code § 511, the latter being the underpinning of all UBI taxation. A similar argument would apply for tax-exempt investors that hold partnership interests as part of their investment strategy, so long as they are not dealers and the partnership interests themselves (without looking inside the partnerships) qualify under Code § 512(b)(5).

All of the above assumes that any business activity is unrelated to the exempt organization's exempt function. Gross income is UBI only if the trade or business producing the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted.[4713] Thus, one must examine the relationship between the business activities which generate the particular income in question—the activities, that is, of producing or distributing the goods or performing the services involved—and the accomplishment of the organization's exempt purposes.[4714] The collection of accounts receivable as part of the continuing day to day operation of exempt activities is not UBI.[4715] See also Advertising Unrelated Business Taxable Income and 3rd Party Contractor Issues | Internal Revenue Service (irs.gov).

II.Q.6.d.ii. UBTI Related to an S Corporation

Any K-1 income or gain from the sale of the S corporation stock constitutes unrelated business income if the shareholder is an IRA holding bank stock before October 22, 2004 or is a qualified retirement plan (other than an ESOP) or a Code § 501(c)(3) charity.[4716]

4711 Code § 751(a) and Reg. § 1.751-1(a)(1) provide that part of the gain "shall be considered as an amount realized from the sale or exchange of property other than a capital asset." Other than expressly not protecting certain noncapital assets such as inventory and property held for sale to customers, Code § 512(b)(5) does not require that property be a capital asset to qualify for its exclusion from UBI.
4712 However, Woodhull, Selling A Partnership Interest Means Complexity For Tax-Exempt Partners, *Taxation of Exempts* (WG&L) (Mar./Apr. 2012), expressed a view that is inconsistent with my conclusion (footnotes omitted):

> In general, the portion of a partner's gain or loss on the sale of a partnership interest that is attributable to Section 751 assets is treated as ordinary income or loss, and is subject to tax as UBTI to tax-exempt partners.

I called the author, and he said that he had not considered the point I raised above. In an informal conversation on November 10, 2017, he said that he agrees with my conclusion.
4713 Reg. 1.513-1(d)(1).
4714 Reg. 1.513-1(d)(1).
4715 Letter Ruling 9005068.
4716 Code § 512(e), which was added by P.L. 104-188 in 1996, effective for taxable years beginning after December 31, 1997.

A charitable remainder trust may not hold stock in an S corporation.[4717] Even if it could, the imposition of unrelated business income tax would be disastrous.[4718]

Suppose a trust's remainder passes to charity, and the trust holds S corporation stock. Every day the trust holds the stock after the primary beneficiary's death generates more and more UBTI. Consider converting the S corporation into an LLC taxed as an S corporation in a tax-free Code § 368(a)(1)(F) reorganization[4719] as early as one can (if converting is not more expensive than selling to an unrelated third party),[4720] then when the primary beneficiary dies the LLC has 75 days to convert to partnership or disregarded entity status retroactive to the date of death.[4721]

II.Q.6.d.iii. Charitable Deduction Against UBTI

If the charity is a trust, it may deduct up to 50%-60% of UBTI for gifts made to another charity.[4722] For 2020 and 2021, this is increased to 100% for certain cash contributions.[4723]

If the charity is a corporation, it may deduct up to 10% of UBTI for gifts made to another charity.[4724]

[4717] For what types of trusts can own stock in an S corporation, see part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation. An electing small business trust (ESBT) is the only type of trust described there into which a charitable remainder trust (CRT) might fit, but Code § 1361(e)(1)(B)(iii) prohibits a CRT from qualifying as an ESBT. However, an S corporation may donate property to a charitable remainder trust; see part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax.

[4718] See part II.Q.6.c Possible Adverse Consequences When Contributing Partnership Interest to Charitable Remainder Trust especially fns. 4661-4662.

[4719] See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

[4720] If the S corporation holds assets that are depreciable or amortizable in the hands of the buyer, conversion might trigger ordinary income on the entire gain from sale of those assets, whereas sale to a third party might generate ordinary income only to the extent of recapture of amortization or accelerated depreciation deductions. Compare part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill) to part II.G.6.b Code § 1245 Property.

[4721] See parts II.P.3 Conversions (timing of election to convert) and II.P.3.a From Corporations to Partnerships and Sole Proprietorships (effect of election to convert).

[4722] See part II.Q.7.c.i.(b) Business Income Limiting Trust Income Tax Deduction, especially fn 4931. Code § 170(b)(1)(G)(i) provides:

> *In general*. In the case of any contribution of cash to an organization described in subparagraph (A), the total amount of such contributions which may be taken into account under subsection (a) for any taxable year beginning after December 31, 2017, and before January 1, 2026, shall not exceed 60 percent of the taxpayer's contribution base for such year.

[4723] See part II.G.4.g.i Charitable Deduction vs. Business Expense, including the increase of 50% to 100% for certain 2020 and 2021 contributions.

[4724] Code § 512(b)(1) provides:

> In the case of any organization described in section 511(a), the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), but shall not exceed 10 percent of the unrelated business taxable income computed without the benefit of this paragraph.

Reg. § 1.512(b)-1(g)(3) provides:

> The contribution, whether made by a trust or other exempt organization, must be paid to another organization to be allowable. For example, a university described in section 501(c)(3) which is exempt from tax and which operates an unrelated business, shall be allowed a deduction… for

CCA 202027003 concluded:[4725]

> Section 265(a)(1) may not be applied to disallow a section 170 charitable contribution deduction allowed under section 512(b)(10) in calculating unrelated business taxable income under section 512(a)(1). This is because a charitable contribution is not

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gifts or contributions to another university described in section 501(c)(3) for educational work but shall not be allowed any deduction for amounts expended in administering its own educational program.

Code § 511(a) provides:

(1) *Imposition of tax*. There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a tax computed as provided in section 11. In making such computation for purposes of this section, the term "taxable income" as used in section 11 shall be read as "unrelated business taxable income".

(2) *Organizations subject to tax*.

(A) Organizations described in sections 401(a) and 501(c). The tax imposed by paragraph (1) shall apply in the case of any organization (other than a trust described in subsection (b) or an organization described in section 501(c)(1)) which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a).

(B) *State colleges and universities*. The tax imposed by paragraph (1) shall apply in the case of any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof, or by any agency or instrumentality of one or more governments or political subdivisions. Such tax shall also apply in the case of any corporation wholly owned by one or more such colleges or universities.

Code § 11 imposes tax on corporations.

[4725] CCA 202027003 reasoned:

> Other than UBTI, Organization's income generally is not subject to tax under section 501(a) and therefore falls within the classes of income considered tax-exempt income for purposes of section 265(a)(1). In order to determine if expenses are allocable to tax-exempt income for purposes of section 265(a)(1), courts have looked to whether the expenses were "intended to be covered" by tax-exempt income or whether the expenses would not exist "but for" the tax-exempt income. *See Induni v. Commissioner*, 990 F.2d 53 (1993); *Dalan v. Commissioner*, T.C. Memo. 1988-106. Similarly, Rev. Rul. 83-3 disallows expenses under section 265(a)(1) that were incurred for the purpose of earning or otherwise producing tax-exempt income and expenses that were incurred in carrying out the specific purpose to which the tax-exempt income is earmarked. 1983-1 C.B. 72, modified by Rev. Rul. 87-32, 1987-1 C.B. 131.
>
> In order to establish that a "contribution or gift" has been made under section 170, a taxpayer must show a voluntary and irrevocable transfer of ownership of money or property without the receipt of adequate consideration or a substantial return benefit. See *United States v. American Bar Endowment*, 477 U.S. 105, 116 (1986); see also *Transamerica Corp. v. United States*, 902 F.2d 1540 (Fed. Cir. 1990); *Singer Co. v. United States*, 449 F.2d 413 (Ct. Cl. 1971). In determining whether a taxpayer has made a contribution without the expectation of any return benefit or quid pro quo, the "external features of the transaction in question" are examined. *Hernandez v. Commissioner*, 490 U.S. 680, 690 (1989). In addition, the taxpayer is required to have charitable intent in making the contribution. See *American Bar Endowment*, 477 U.S. at 118.
>
> A charitable contribution is, by its nature, not allocable to any source of income, but instead arises from a donor's charitable intent to voluntarily transfer money or property without receiving any benefit in return. Consequently, section 265(a)(1) may not be applied to disallow Organization's charitable contribution deduction claimed in computing UBTI under section 512(a)(1).

allocable to tax-exempt income, but instead arises from a donor's charitable intent to voluntarily transfer money or property without receiving any benefit in return.

A charity that spends donations it receives on programs (as opposed to using donations for grants to other charities) should consider not receiving directly a gift that would generate UBTI, because the charity will be taxed on all of the UBTI:

- Instead, the gift should be made to a trust that is a Type I supporting organization or donor advised fund, so that the UBTI can be reduced by the trust's up to 50% deduction for distributions to the ultimate charity.

- The trust should consider forming a single member LLC that is disregarded for income tax purposes, to accept the donation; the LLC should have significant other assets. Contributions to the LLC will be deductible as if made directly to the trust.[4726] Forming the LLC may avoid a trap that applies when the flow-through entity does not distribute to the trust before yearend at least as much cash as the amount of the trust's expected charitable contribution deduction.[4727] The LLC would use cash from its other assets to distribute to the trust cash at least equal in amount to the gross income flowing through the LLC to the trust. That way, the trust's receipts from the LLC will equal or exceed the gross income passing through the LLC, allowing the trust to meet the rules requiring its contribution to charity to be from gross income that the trust actually received. However, that concern applies to charitable distributions not made from unrelated business income (UBI) and therefore deductible under Code § 642(c)[4728] and presumably does not apply to charitable distributions made from UBI and therefore deductible under Code § 681 applying the Code § 170 rules.[4729]

II.Q.6.e. Assignment of Income on Property Being Sold

The IRS has attacked the donation to charity of property that the charity then quickly sells as instead constituting a sale of that property by the donor.

More generally, Reg. § 1.671-1(c) discusses the assignment of income theory, distinguishing certain aspects from the grantor trust rules:[4730]

> Except as provided in such subpart E, income of a trust is not included in computing the taxable income and credits of a grantor or another person solely on the grounds of his dominion and control over the trust. However, the provisions of subpart E do not apply in situations involving an assignment of future income, whether or not the assignment is to a trust. Thus, for example, a person who assigns his right to future income under an employment contract may be taxed on that income even though the assignment is to a trust over which the assignor has retained none of the controls specified in sections 671 through 677. Similarly, a bondholder who assigns his right to interest may be taxed on interest payments even though the assignment is to an uncontrolled trust. Nor are the rules as to family partnerships affected by the provisions of subpart E, even though a partnership interest is held in trust. Likewise, these sections have no application in

[4726] See fn. 334, found in part II.B Limited Liability Company (LLC).
[4727] See part II.Q.7.c.i.(a) Contribution Must Be Made from Gross Income, describing the issue and a similar strategy in fns. 4921-4924.
[4728] See fn. 4727.
[4729] See part II.Q.7.c.i.(b) Business Income Limiting Trust Income Tax Deduction.
[4730] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

> determining the right of a grantor to deductions for payments to a trust under a transfer and lease-back arrangement. In addition, the limitation of the last sentence of section 671 does not prevent any person from being taxed on the income of a trust when it is used to discharge his legal obligation. See § 1.662(a)-4. He is then treated as a beneficiary under subparts A through D or treated as an owner under section 677 because the income is distributed for his benefit, and not because of his dominion or control over the trust.

The Humacid Company v. Commissioner, 42 T.C. 894, 912-913 (1964) (*Humacid*), held:[4731]

> The fact that at the time he delivered the notes to the exempt organizations on December 2, 1958, Huntsinger controlled petitioner and contemplated that petitioner would redeem the notes prior to the end of the year does not put him in constructive receipt of the redemption proceeds. Respondent has proffered no evidence that petitioner had credited or set aside any funds for the redemption of the notes prior to Huntsinger's contribution of the notes to the exempt organizations on December 2, 1958. *Cf.* sec. 1.451-2(a), Income Tax Regs. This Court has, upon numerous occasions, noted that the doctrine of constructive receipt is not to be lightly applied but is to be invoked only in situations where it is clearly justifiable. *Robert J. Dial*, 24 T.C. 117, 124 (1955); *Hal E. Roach*, 20 B.T.A. 919 (1930); *C.E. Gullett*, 31 B.T.A. 1067, 1069 (1935). The mere fact of Huntsinger's control of petitioner is not sufficient to constitute constructive receipt. *Hyland v. Commissioner*, 175 F.2d 422, 424 (C.A. 2, 1949), affirming a Memorandum Opinion of this Court; *Robert J. Dial*, *supra*; *Basil F. Basila*, 36 T.C. 111, 116-117 (1961). Since respondent has failed to prove that petitioner ever set aside any funds with which to redeem the notes donated by Huntsinger to the exempt organizations prior to such transfer, Huntsinger cannot be found to have been in constructive receipt of the redemption proceeds.
>
> We have found as a fact that Huntsinger made valid gifts of notes in the principal amount of $41,000 on December 2, 1958, giving up all right, title, and interest therein at that time. Respondent, moreover, has failed to establish that the notes so transferred by Huntsinger included any element of ordinary income thereon. Huntsinger's donation of those notes to the three organizations is not a case of anticipatory assignment of income (*cf. Helvering v. Horst*, 311 U.S. 112 (1940), and *S. M. Friedman*, 41 T.C. 428 (1963), on appeal (C.A. 6, May 5, 1964)), for Huntsinger was not transferring the right to receive earned income.
>
> The law with respect to gifts of appreciated property is well established. A gift of appreciated property does not result in income to the donor so long as he gives the property away absolutely and parts with title thereto before the property gives rise to income by way of a sale. *Stuart A. Rogers*, 38 T.C. 785, 788-789 (1962); *Elizabeth H. Potter*, 38 T.C. 951 (1962); *Campbell v. Prothro*, 209 F.2d 331 (C.A. 5, 1954); *Estate of W. G. Farrier*, 15 T.C. 277 (1950); *Elsie SoRelle*, 22 T.C. 459, 475-479 (1954); *South Lake Farms, Inc.*, 36 T.C. 1027 (1961), *affd.* 324 F.2d 837 (C.A. 9, 1963). On the basis of the facts before us, it is our opinion that Huntsinger did this. Therefore, he should not be regarded as having received income upon petitioner's redemption of the notes from the three charitable or educational organizations.

[4731] For more on constructive receipt, see fns 4205-4206 in part II.Q.1.e Trying to Avoid Possible Ordinary Income on the Sale of a Partnership or S Corporation.

Although the IRS does not attack the donation of marketable securities that a charity sells immediately after the contribution,[4732] it has attempted to treat, as a sale by the donor, the contribution of closely-held stock to a charity, followed by a redemption. After losing,[4733] the IRS ruled:[4734]

> In *Palmer*, the taxpayer had voting control of both a corporation and a tax-exempt private foundation. Pursuant to a single plan, the taxpayer donated shares of the corporation's stock to the foundation and then caused the corporation to redeem the stock from the foundation….The Service will treat the proceeds of a redemption of stock under facts similar to those in *Palmer* as income to the donor only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption.

An enforceable cause of action under the promissory estoppel theory counted as a legally binding commitment to sell stock.[4735] So did the tender of shares sufficient to bind the shareholders of a corporation being acquired by a taxable merger, even though the acquiring corporation had not legally bound itself to acquire the shares.[4736]

Until recently, taxpayers who fall within the no-binding-agreement safe harbor of Rev. Rul. 78-197 are protected from the IRS, even if the sale appears certain to occur. *Rauenhorst v.*

[4732] Rev. Rul. 74-53 (no assignment of income where no express or implied obligation imposed upon the trustee to sell or exchange). For the origin of the assignment of income rule, see *Lucas v. Earl*, cited in fn. 1896, found in part II.G.24 Taxing Entity or Individual Performing Services.

[4733] *Palmer v. Commissioner*, 62 T.C. 684 (1974), *aff'd* on another issue, 523 F.2d 1308 (8th Cir. 1975).

[4734] Rev. Rul. 78-197, followed by Letter Rulings 8623007, 9413020, 9452020, 9452026, 9611047, and 200230004.

[4735] *Blake v. Commissioner*, T.C. Memo 1981-579, *aff'd* 697 F.2d 473 (2nd Cir. 1982).

[4736] *Ferguson v. Commissioner*, 108 T.C. 244 (1997), *aff'd* 174 F.3d 997 (9th Cir. 1999), *followed Gail Vento, LLC v. U.S.*, 111 A.F.T.R.2d 2013-1505 (D.C. V.I. 2013). *Ferguson* included some contingencies that the court disregarded. In *Ferguson*, the gift was made September 9, 1988. Here is the timeline for the tender:

> On July 28, 1988, AHC, CDI Holdings, Inc. (CDI), and DC Acquisition entered into the merger agreement. According to the merger agreement, DC Acquisition would be merged into AHC, and AHC would thereupon become a wholly owned subsidiary of CDI as soon as practicable after DC Acquisition had purchased the stock of AHC pursuant to the tender offer. The merger agreement provided that each outstanding share of AHC stock, following the purchase of AHC stock pursuant to the tender offer, would be converted into the right to receive $22.50 a share in cash.
> On August 3, 1988, DC Acquisition made a tender offer for the stock of AHC at $22.50 a share.
> By the close of business on August 31, 1988, more than 50 percent of the outstanding shares of AHC stock had been tendered or guaranteed. At that time, despite the various contingencies to be discussed infra, we believe the reality and substance of the merger agreement and the tender offer indicate that the stock of AHC was converted from an interest in a viable corporation to a fixed right to receive cash.
> The tender or guarantee of more than 50 percent of the outstanding shares of AHC stock was the functional equivalent to a vote by the shareholders of AHC approving the merger. The terms of the tender offer provided that DC Acquisition, with the acquisition of a majority of AHC stock, could assure that the requisite number of affirmative votes in favor of the merger would be received even if no other shareholder voted in favor of the merger. Therefore, with the exception of the hypothetical possibility that a sufficient number of tendered or guaranteed shares of AHC stock could be withdrawn, DC Acquisition was positioned to proceed unilaterally with consummation of the merger by the close of business on August 31, 1988.

So the conditions to effectuate the merger had been satisfied before the gift, with the chance of the conditions being undone being viewed as remote.

Commissioner, 119 T.C. 157 (1993), focused exclusively on legally binding commitments.[4737] In that case, the court faulted the IRS' nonspecific allegations of an informal agreement or understanding between the donees and other parties, accepting on their face affidavits the taxpayer produced. The court also rejected the IRS' contentions that certain facts caused the assignment of income doctrine to apply:

> In support of respondent's position that the right to sale proceeds had ripened to a practical certainty at the time of the contributions, he cites: (1) The September 28, 1993, letter of intent from WCP expressing its intention to purchase all the issued and outstanding stock of NMG; (2) the October 22, 1993, resolution by WCP's board of directors, which authorized its officers to negotiate and enter into the agreement for the purchase of all the issued and outstanding capital stock of NMG; and (3) a valuation report prepared by Houlihan, Lokey, Howard, & Zukin (Houlihan Lokey), which was attached to petitioners' 1993 return and which opined that, as of November 12, 1993, there was little chance the transaction involving WCP would not close on or before December 31, 1993. Those items might be particularly relevant for determining whether the stock warrant purchase ripened to a practical certainty; however, none of those items alone, or in combination, show that the donees were legally bound, or could be compelled, to sell their stock warrants.

Given that the probability of sale affects valuation, a taxpayer might maximize the charitable deduction by waiting to make the donation until the date before the sale closes. However, the Tax Court looks at the facts, and *Chrem v. Commissioner*, T.C. Memo. 2018-164, which was a sale between related parties, included some unfortunate language when denying summary judgment for the taxpayer, misstating the conclusion of *Rauenhorst*.[4738] *Chrem* involved sloppy

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[4737] See fn 4632 regarding why letters of intent are tightly drafted to avoid any legally binding agreement before closing.

[4738] See the highlighted language in this except:

> Another relevant question is whether the charity is obligated, or can be compelled by one of the parties to the transaction, to surrender the donated shares to the acquirer. Rev. Rul. 78-197, 1978-1 C.B. 83 (1978); see *Rauenhorst v. Commissioner*, 119 T.C. 157, 166 (2002) (finding "the donee's control to be … an important factor"). The existence of an "understanding" among the parties, or the fact that transactions occur simultaneously or according to prearranged steps, may be relevant in answering that question. See, *e.g.*, *Blake v. Commissioner*, 697 F.2d 473, 480 (2d Cir. 1982) (stating that an "understanding" among the parties need not be "legally enforceable under state law"), *aff'g* T.C. Memo. 1981-579; *Ferguson v. Commissioner*, 108 T.C. 244 (1997) (finding assignment of income with respect to proceeds of merger that occurred contemporaneously with charitable contribution), *aff'd*, 174 F.3d 997 (9th Cir. 1999).
>
> We conclude that there exist genuine disputes of material fact that prevent us from resolving the assignment of income issue summarily. Comtrad and SDI were related by common management, the interests of both companies appear to have been aligned, and both companies seemingly desired that the stock acquisition be completed. If so, these facts may support the conclusion that the acquisition was virtually certain to occur. Respondent also points to emails and an alleged exchange of documents between JCF and petitioners on November 12, 2012. This evidence may support respondent's contention that JCF agreed in advance to tender its shares to SDI and that all steps of the transaction were prearranged.
>
> The parties also dispute the dates on which relevant events occurred. Petitioners assert that they transferred their shares to JCF on December 5 and there appears to be documentary evidence arguably supporting that assertion. Respondent contends that JCF did not acquire ownership of its 900 shares until (at the earliest) December 10, allegedly after JCF unconditionally agreed to sell the 900 shares to SDI. That contention derives arguable support from other documentary

taxpayers who did not obtain appraisals of the donated interests and had to argue substantial compliance in their effort to get a charitable deduction, so this may be a case of sloppiness being punished on many levels.

Dickinson v. Commissioner, T.C. Memo. 2020-128, demonstrates that *Chrem* was an outlier. *Dickinson* provides much comfort to taxpayers regarding donations of illiquid assets or concentrated positions when the charity has a policy of liquidating such donations. *Dickinson*'s facts were:

> Petitioner husband was the chief financial officer and a shareholder of Geosyntec Consultants, Inc. (GCI), a privately held company, during the years at issue. The GCI board of directors (Board) authorized shareholders to donate GCI shares to Fidelity Investments Charitable Gift Fund (Fidelity), an organization tax exempt under section 501(c)(3), through written consent actions in 2013 and 2014. In both consent actions the Board stated that Fidelity "has a donor advised fund program which incorporates procedures requiring … [Fidelity] to immediately liquidate the donated stock" and "seeks an imminent exit strategy and, therefore, promptly tenders the donated stock to the issuer for cash". The Board approved a third round of donations at a Board meeting by unanimous vote in 2015; the Board members signed the written minutes of the meeting. After each Board authorization, petitioner husband donated appreciated GCI shares to Fidelity. Petitioner husband remained a full-time GCI employee following each donation.
>
> GCI confirmed in letters to Fidelity that its books and records reflected Fidelity as the new owner of the shares. For each stock donation, petitioner husband signed a letter of understanding (LOU) to Fidelity, indicating that the transferred stock was "exclusively owned and controlled by Fidelity", and that Fidelity "maintains full discretion over all conditions of any subsequent sale" of the stock and "is not and will not be under any obligation to redeem, sell, or otherwise transfer" the stock. Petitioners received confirmation letters from Fidelity, which explained that Fidelity had "exclusive legal

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evidence, as well as from Empire's description of the proposed transaction, which recited that petitioners would transfer 900 shares to JCF "[s]imultaneously with SDI's acquisition of the 6,100 shares."

There are also genuine disputes of material fact concerning the extent to which JCF, having received the 900 shares, was obligated to tender them to SDI. Empire stated in its report that petitioners would use "all reasonable efforts to cause [JCF] to agree to sell the shares to SDI." At this juncture the record includes little if any evidence concerning petitioners' ability to sway JCF's actions or JCF's separate negotiations (if any) with SDI. Respondent contends that JCF had no meaningful discussions with SDI at all but was "simply informed by petitioners" that the 900 shares should be tendered at once. A trial will be necessary to determine whose version of the facts is correct.

One fact potentially relevant to this question concerns JCF's fiduciary duties as a custodian of charitable assets. If JCF tendered its Comtrad shares, it would immediately receive $4,050,000 in cash. If it refused to tender its shares and the entire transaction were scuttled, JCF would apparently be left holding a 13% minority interest in a closely held Hong Kong corporation, the market value of which might be questionable.

In sum, viewing the facts and the inferences that might be drawn from the facts in the light most favorable to respondent as the nonmoving party, we find that there exist genuine disputes of material fact that prevent summary adjudication of the assignment of income issue. To the extent petitioners seek summary judgment on this question, we will deny their motion.

> control over the contributed asset". Shortly after each donation, Fidelity redeemed the GCI shares for cash.

Dickinson reasoned and held:

> In the notice of deficiency, respondent determined that each donation of the GCI shares, followed by Fidelity's exchange of the shares for cash, should be treated in substance as a redemption of the shares for cash by petitioner husband, followed by petitioners' donation of the cash redemption proceeds to Fidelity. Per *Humacid Co. v. Commissioner*, 42 T.C. 894, 913 (1964), we respect the form of this kind of transaction if the donor (1) gives the property away absolutely and parts with title thereto (2) before the property gives rise to income by way of a sale. See also *Grove v. Commissioner*, 490 F.2d 241, 246 (2d Cir. 1973), *aff'g* T.C. Memo. 1972-98; *Carrington v. Commissioner*, 476 F.2d 704, 708 (5th Cir. 1973), *aff'g* T.C. Memo. 1971-222; *Behrend v. United States*, 31 A.F.T.R.2d (RIA) 73-406, 1972 WL 2627, at *3 (4th Cir. 1972); *Rauenhorst v. Commissioner*, 119 T.C. 157, 162-163 (2002).
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> The first *Humacid* prong requires us to determine whether the donor transferred all his rights in the donated property. See, *e.g.*, *Grove v. Commissioner*, 490 F.2d at 246; *Carrington v. Commissioner*, 476 F.2d at 708; *Behrend*, 1972 WL 2627, at *3. To defeat petitioners' motion on this point, respondent must set forth specific facts showing that there is a genuine dispute for trial as to whether petitioner husband made an absolutely perfected gift of the GCI stock before the redemption. See Rule 121(d); *Sundstrand Corp. v. Commissioner*, 98 T.C. at 520.
>
> GCI's letters to Fidelity confirming ownership transfer, Fidelity's letters to petitioners explaining that Fidelity had "exclusive legal control" over the donated stock, and the LOUs to the same effect all support petitioners' claim that petitioner husband transferred all his rights in the shares. Respondent makes much of the fact that Fidelity regularly redeemed the GCI shares shortly after each donation, according to what the Board understood to be Fidelity's internal procedures. Respondent argues that these facts suggest petitioner husband, GCI, and Fidelity could have arranged the redemptions in advance of the gifts, but a preexisting understanding among the parties that the donee would redeem donated stock does not convert a postdonation redemption into a predonation redemption. See *Behrend*, 1972 WL 2627, at *3. Furthermore, neither a pattern of stock donations followed by donee redemptions, a stock donation closely followed by a donee redemption, nor selection of a donee on the basis of the donee's internal policy of redeeming donated stock suggests that the donor failed to transfer all his rights in the donated stock. See, *e.g.*, *Grove v. Commissioner*, 490 F.2d at 242-245 (respecting form of transaction where donee needed to fundraise to support its operations, and over a decade consistently redeemed annual donations of stock for which donor remained entitled to dividends); *Carrington v. Commissioner*, 476 F.2d at 705-706 (respecting form of transaction where donee redeemed stock eight days after it was donated); *Palmer v. Commissioner*, 62 T.C. 684, 692-693 (1974), (respecting form of transaction where, pursuant to a single plan, the taxpayer donated stock to a foundation and then caused the corporation to redeem the stock from the foundation the day after the donation), *aff'd*, 523 F.2d 1308 (8th Cir. 1975). Petitioners' contemporaneous documentary evidence of an absolute gift, and respondent's failure to assert facts indicating any genuine controversy on this point, lead us to conclude that petitioner husband's donations satisfy the first *Humacid* requirement.

The second *Humacid* requirement, that the taxpayer make the donation before the stock gives rise to income by way of sale, implements the assignment of income doctrine: A taxpayer who has earned income cannot escape taxation by assigning his right to receive payment. See *Helvering v. Horst*, 311 U.S. 112, 116 (1940). *Humacid* prong two ensures that if stock is about to be acquired by the issuing corporation via redemption, the shareholder cannot avoid tax on the transaction by donating the stock before he receives the proceeds.

Where a donee redeems shares shortly after a donation, the assignment of income doctrine applies only if the redemption was practically certain to occur at the time of the gift, and would have occurred whether the shareholder made the gift or not. See *Palmer v. Commissioner*, 62 T.C. at 694-695; see also *Ferguson v. Commissioner*, 174 F.3d 997, 1003-1004 (9th Cir. 1999) (finding that the shareholder recognizes income from a stock sale where acquisition is "practically certain to occur", rather than the subject of "a mere anticipation or expectation", before the shareholder donates stock), *aff'g* 108 T.C. 244 (1997). In *Hudspeth v. United States*, 471 F.2d 275, 276 (8th Cir. 1972), for example, the court recast a stock donation as a taxable stock sale and donation of the sale proceeds where the taxpayer donated stock after the issuing corporation's directors and shareholders had adopted a plan of complete liquidation. See also *Jones v. United States*, 531 F.2d 1343, 1343-1344 (6th Cir. 1976); *Allen v. Commissioner*, 66 T.C. 340, 347 (1976).[2] By contrast, there was no assignment of income in *Palmer v. Commissioner*, 62 T.C. at 687-688, 695, even though all parties were related and anticipated the redemption before the donation, because "no vote for the redemption had yet been taken" when the shareholder donated the stock. As in *Palmer*, the redemption in this case was not a fait accompli at the time of the gift. As noted above, respondent argues that the parties may have prearranged for Fidelity to redeem the stock. Even if that was the case, it would not affect the analysis under the second *Humacid* requirement. Rather, we respect the form of the transaction because petitioner husband did not avoid receipt of redemption proceeds by donating the GCI shares.

[2] The Court of Appeals for the Ninth Circuit has gone a step further, asserting in dicta that stock sale proceeds are taxable to a shareholder who donates stock absent a binding obligation to sell if the facts and circumstances indicate that a tender offer and merger are "practically certain to proceed" in the immediate future. See *Ferguson v. Commissioner*, 174 F.3d 997, 1004 (9th Cir. 1999), *aff'g* 108 T.C. 244 (1997).

The parties point us to Rev. Rul. 78-197, 1978-1 C.B. 83, a "bright-line" rule the IRS applies in cases like *Palmer*, which focuses on the donee's control over the disposition of the appreciated property. See *Rauenhorst v. Commissioner*, 119 T.C. at 165.[3] This Court has not adopted Rev. Rul. 78-197, *supra*, as the test for resolving anticipatory assignment of income issues, see *Rauenhorst v. Commissioner*, 119 T.C. at 166, and does not do so today. The ultimate question, as noted in *Palmer*, is whether the redemption and the shareholder's corresponding right to income had already crystallized at the time of the gift. See *Palmer v. Commissioner*, 62 T.C. at 694-695. Regardless of whether the donee's obligation to redeem the stock may suggest the donor had a fixed right to redemption income at the time of the donation, see *Rauenhorst v. Commissioner*, 119 T.C. at 166-167, respondent does not allege that petitioner husband had any such right in this case. Accordingly, respondent's resort to Rev. Rul. 78-197, *supra*, is unavailing.

> [3] Rev. Rul. 78-197, 1978-1 C.B. 83, 83, announces that the IRS "will treat the proceeds as income to the donor under facts similar to those in the Palmer decision only if the donee is legally bound, or can be compelled by the [issuing] corporation, to surrender the shares for redemption."
>
> *Conclusion*
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> As required by *Humacid* and its progeny, petitioner husband made an absolute gift of the GCI shares in each taxable year before the stock gave rise to income by way of a sale. We will therefore grant petitioners' motion for summary judgment, and deny respondent's motion for partial summary judgment.

Based on all of the above, I believed that the "practical certainty" test is whether the legal requirement for the owner to sell the donated property was practically certain, not whether as a matter of the parties' actions the sale was practically certain and not whether the buyer was compelled to buy if the owner decided to sell. At least I did until *Estate of Hoensheid v. Commissioner*, T.C. Memo. 2023-34, decided to the contrary:

> While we consider a donee's legal obligation to sell as "significant to the assignment of income analysis," *Ferguson*, 108 T.C. at 259, it "is only one factor to be considered in ascertaining the 'realities and substance' of the transaction," *Allen*, 66 T.C. at 348 (quoting *Jones*, 531 F.2d at 1345). Instead, "the ultimate question is whether the transferor, considering the reality and substance of all the circumstances, had a fixed right to income in the property at the time of transfer." *Ferguson*, 108 T.C. at 259; see *Dickinson*, T.C. Memo. 2020-128, at *10. We thus look to several other factors that bear upon whether the sale of shares was virtually certain to occur at the time of petitioners' gift. In this case the relevant factors include (1) any legal obligation to sell by the donee, (2) the actions already taken by the parties to effect the transaction, see *Ferguson*, 106 T.C. at 264, (3) the remaining unresolved transactional contingencies, see *Robert L. Peterson Irrevocable Tr. #2 v. Commissioner*, T.C. Memo. 1986-267, 51 T.C.M. (CCH) 1300, 1316, *aff'd sub nom. Peterson v. Commissioner*, 822 F.2d 1093 (8th Cir. 1987), and (4) the status of the corporate formalities required to finalize the transaction, see *Estate of Applestein*, 80 T.C. at 345–46.
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> **A. Fidelity Charitable's Obligation to Sell**
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> We turn first to whether Fidelity Charitable did in fact have an obligation to sell the CSTC shares. We conclude that respondent has not established that Fidelity Charitable had any legal obligation to sell the shares.[23] As petitioners point out, the terms and conditions of Fidelity Charitable's Letter of Understanding expressly disclaimed any such obligation. In addition, respondent has not sufficiently established the existence of any informal, prearranged understanding between petitioners and Fidelity Charitable that might otherwise constitute an obligation. See *Greene v. United States*, 13 F.3d 577, 583 (2d Cir. 1994); see also *Chrem*, T.C. Memo. 2018-164, at *13. This factor weighs against an anticipatory assignment of income but is not dispositive. See *Ferguson*, 108 T.C. at 259.
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> [23] In *Chrem v. Commissioner*, T.C. Memo. 2018-164, we suggested that a donor-advised fund's sponsoring organization may be subject to fiduciary duties that might impose a legal obligation to sell contributed shares constituting a small minority interest in a closely held corporation. *Id*. at *15 ("If it refused to tender its shares and

the entire transaction were scuttled, [the sponsoring organization] would apparently be left holding a 13% minority interest in a closely held Hong Kong corporation, the market value of which might be questionable."); see also *Grove v. Commissioner*, 490 F.2d 241, 248 (2d Cir. 1973) (Oakes, J. dissenting) (looking to New York trust law and observing that offering donated shares for redemption was "the only practice which a university treasurer could correctly take and still meet his own statutory obligations as a fiduciary"), *aff'g* T.C. Memo. 1972-98. Respondent did not present arguments or testimony as to what, if any, fiduciary duties Fidelity Charitable might have owed that would compel it to sell the CSTC shares to HCI. Accordingly, lacking the benefit of meaningful briefing on the subject, we cannot find that Fidelity Charitable was in fact legally obligated to sell the contributed shares by way of fiduciary duty.

B. Bonuses & Shareholder Distributions

Next, we look to what acts CSTC and HCI took to effect the transaction before the July 13, 2015, gift. As of that date, a number of acts had already taken place that may suggest the transaction was a virtual certainty. One week before the gift, HCI had caused the incorporation of a new holding company subsidiary to acquire the CSTC shares. Three days before the gift, CSTC had amended its Articles of Incorporation to allow for written shareholder consent, an action requested by HCI. Most significantly, however, the "cash sweeping" actions taken by CSTC strongly suggest that the transaction with HCI was a virtual certainty before the gift on July 13.

On July 7, 2015 petitioner amended CSTC's Change in Control Bonus Plan in order to specify that CSTC "desire [sic] that the consummation of the Investment Transaction result in payments to eligible Grantees under the Plan." That same day, petitioner stated in an email that CSTC would "sweep the cash from the company prior to closing and distribute it to the brothers." As of July 7, CSTC and petitioner thus considered the transaction with HCI so certain to occur that they took action to trigger the bonus payouts, consistent with the plan to sweep CSTC's cash before closing. On July 10, 2015, CSTC then paid out approximately $6.1 million in employee bonuses and, a few days later on July 14, distributed approximately $4.7 million to petitioner and his two brothers as shareholders. While the July 14 distribution took place the day after the gift, petitioner's statement on July 7 evidences that the decision to make the distribution had already been made as of that date, if not well formally authorized by CSTC. See Mich. Comp. Laws § 450.1345(1) and (2). We thus find that, before July 13, CSTC and petitioner had distributed and/or determined to distribute over $10 million out of the corporation.

Moreover, we consider it highly improbable that petitioner and his two brothers would have emptied CSTC of its working capital if the transaction had even a small risk of not consummating. Absent its working capital, CSTC was no longer a going concern until the transaction was finalized. See *Cook*, 5 T.C. at 911 (finding assignment of income where donor of shares was "well aware that the corporate activities had all but ceased except for the actual distribution in liquidation"); see also *Apt v. Birmingham*, 89 F.Supp. 361, 393 (N.D. Iowa 1950) (stating that gain may be realized when "for all practical purposes corporate stock had no further purposes to fulfill" aside from underlying transaction). The bonus payouts and distributions do not appear from the record to have been in any way contingent on the final execution of the purchase agreement. Accordingly, we conclude that, once made, the bonus payouts and distributions could not be clawed back and had tax consequences upon receipt for the participating employees and shareholders, including petitioner himself.

In the reality of the transaction, the cash sweeps were thus highly significant conditions precedent to consummating the transaction with HCI. *Cf. Kinsey v. Commissioner*, 58 T.C. 259, 265–66 (1972) (finding right to income on shares from liquidation was fixed where "a substantial portion of [corporation's] assets were distributed prior to the date of the gift"), *aff'd*, 477 F.2d 1058 (2d Cir. 1973). As of July 13, 2015, the CSTC shares were essentially "hollow receptacles" for conveying proceeds of the transaction with HCI, "rather than an interest in a viable corporation." *Estate of Applestein*, 80 T.C. at 345-46; see *Hudspeth v. United States*, 471 F.2d 275, 279 (8th Cir. 1972) (describing donated shares as "merely empty vessels by which the taxpayer conveyed the liquidation proceeds"). The cash sweep strongly weighs in favor of a conclusion that the sale was a virtual certainty and thus petitioners' right to income from the shares was fixed as of July 13, 2015.

C. Unresolved Sale Contingencies

Next, we look to what unresolved sale contingencies remained between the parties as of the July 13, 2015, gift. See *Robert L. Peterson Irrevocable Tr. #2*, 51 T.C.M. (CCH) at 1316–19 (focusing on various contingencies that taxpayers argued precluded their right to sale proceeds from becoming fixed before a gift). Petitioners argue that the transaction with HCI was still being negotiated up until the closing on July 15. Petitioners rely on petitioner's trial testimony, where he identified several negotiated issues, including an environmental liability, employee compensation arrangements, and excess real estate. At trial petitioner testified that he and HCI "basically negotiated right up until the day before we closed" - i.e., July 14, 2015.

However, the record does not bear out the substance of petitioner's characterization. The identified employee compensation and excess real estate issues appear to have been resolved in drafts of the agreement prepared before July 13, 2015. At trial, a representative of HCI characterized the environmental liability issue as "the one probably biggest item of negotiation" resolved before closing. On July 10, 2015, HCI's counsel prepared a draft with a new seller indemnity provision addressing the environmental liability issue. By 4:38 a.m. on [*32] the morning of July 13, when HCI's counsel next ran a redline comparison of a new draft, the environmental liability provision had already been accepted into the draft agreement. Given that the written drafts memorialized the negotiations between the parties, we find that the parties had resolved the environmental liability issue before the contribution to Fidelity Charitable.

Moreover, the only substantive change made to the drafts after the contribution to Fidelity Charitable was a minor revision to the provision for ongoing compensation to Mark and Kurt to cover the cost of their health insurance. We thus find that none of the unresolved contingencies remaining on July 13, 2015, were substantial enough to have posed even a small risk of the overall transaction's failing to close. See *Robert L. Peterson Irrevocable Tr. #2*, 51 T.C.M. (CCH) at 1319 (concluding that remaining contingencies "at best...represent remote and hypothetical possibilities that the stock purchase would be abandoned"); *cf. Martin v. Machiz*, 251 F. Supp. 381, 389 (D. Md. 1966) (finding no assignment of income where, at time of gift of shares, parties had "substantial" disagreements about closing date and buyer's insistence on a surety bond as security for breach of warranty). We find that petitioner, consistent with his "99% sure" statement, waited until all material details had been agreed to with HCI before he transferred the shares to Fidelity Charitable. See *Malkan*, 54 T.C. at 1314 ("Even though [the taxpayer] had discussed creating the trusts for several months, he did not establish them until the parties had agreed upon the details of the sale."). The absence of significant unresolved contingencies also weighs in favor of the sale of shares to HCI being a virtual certainty.

D. Corporate Formalities

Finally, we look to the status of the corporate formalities necessary for effecting the transaction. See *Estate of Applestein*, 80 T.C. at 345-46 (finding that taxpayer's right to sale proceeds from shares had "virtually ripened" upon shareholders' approval of proposed merger agreement). Under Michigan law, a proposed plan to exchange shares must generally be approved by a majority of the corporation's shareholders. See Mich. Comp. Laws § 450.1703a(2)(d); *id*. § 450.1407(1). Formal shareholder approval of a transaction has often proven to be sufficient to demonstrate that a right to income from shares was fixed before a subsequent transfer. See *Ferguson*, 108 T.C. at 262; see also *Hudspeth*, 471 F.2d at 279. However, such approval is not necessary for a right to income to be fixed, when other actions taken establish that a transaction was virtually certain to occur. See *Ferguson*, 104 T.C. at 262-63 (rejecting taxpayer's "attempt to impose formalistic obstacle[]" of formal shareholder approval); see also *Hudspeth*, 471 F.2d at 280 (describing final resolution to dissolve corporation as a "mere formality" where shareholders and board had already approved plan of liquidation, despite "remote, hypothetically possible abandonment[]" of that plan); *Kinsey*, 58 T.C. at 265–66.

On June 11, 2015, petitioner and his two brothers (the sole shareholders of CSTC) unanimously approved pursuing a sale of all outstanding stock of CSTC to HCI. On July 15 they provided written consent to the final Contribution and Stock Purchase Agreement with HCI. However, viewed in the light of the reality of the transaction, the record shows that final written consent was a foregone conclusion. As a practical matter, finalizing the transaction with HCI presented petitioner and his two brothers with the opportunity to partially (or fully, as in Kurt's case) cash out of CSTC at a significant premium over their initial target price of $80 million. See *Ferguson v. Commissioner*, 174 F.3d at 1004–05 (considering formal shareholder approval to be unnecessary where shareholders were receiving substantial premium). From HCI's perspective, it also believed it was acquiring CSTC at a fair price and, as of July 13, had resolved the environmental liability issue, its final significant due diligence concern. See *id*. at 1005. All three Hoensheid brothers, and particularly petitioner, were involved in negotiating the transaction, making their approval all but assured as of July 13, 2015. *Cf. Perry v. Commissioner*, T.C. Memo. 1976-381, 35 T.C.M. (CCH) 1718, 1724 (concluding that shareholder approval of sale was not just a "rubber stamp" where corporation was not "a closely held corporation controlled by the same individuals who negotiated the [a]greement"). We conclude that formal shareholder approval was purely ministerial, as any decision by the brothers not to approve the sale was, as of July 13, "remote and hypothetical." *Jones*, 531 F.2d at 1346; see *Allen*, 66 T.C. at 347 (finding assignment of income despite parties not completing "purely ministerial act of executing quitclaim deed" before transfer). This factor is neutral as to whether petitioners' right to income was fixed.

E. Conclusion

> To avoid an anticipatory assignment of income on the contribution of appreciated shares of stock followed by a sale by the donee, a donor must bear at least some risk at the time of contribution that the sale will not close. On the record before us, viewed in the light of the realities and substance of the transaction, we are convinced that petitioners' delay in transferring the CSTC shares until two days before closing eliminated any such risk and made the sale a virtual certainty. Petitioners' right to income from the sale of CSTC shares was thus fixed as of the gift on July 13, 2015. We hold that petitioners recognized gain on the sale of the 1,380 appreciated shares of CSTC stock.
>
> We echo prior decisions in recognizing that our holding does not specify a bright line for donors to stop short of in structuring charitable contributions of appreciated stock before a sale. See *Allen*, 66 T.C. at 346 (rejecting proposed bright-line rule approach and noting that "drawing lines is part of the daily grist of judicial life"); see also *Harrison v. Schaffner*, 312 U.S. 579, 583–84 (1941). However, as petitioners' tax counsel seems to have recognized in her advice to petitioner, "any tax lawyer worth [her] fees would not have recommended that a donor make a gift of appreciated stock" so close to the closing of a sale. *Ferguson v. Commissioner*, 174 F.3d at 1006; see *Allen*, 66 T.C. at 346 (recognizing that realities and substance approach puts "a premium on consulting one's lawyer early enough in the game"). By July 13, 2015, the transaction with HCI had simply "proceeded too far down the road to enable petitioners to escape taxation on the gain attributable to the donated shares." *Allen*, 66 T.C. at 348.

I find this case difficult to reconcile with the *Rauenhorst* statement: "Those items might be particularly relevant for determining whether the stock warrant purchase ripened to a practical certainty; however, none of those items alone, or in combination, show that the donees were legally bound, or could be compelled, to sell their stock warrants."[4739] In *Rauenhorst*, the court faulted the IRS' nonspecific allegations of an informal agreement or understanding between the donees and other parties, accepting on their face affidavits the taxpayer produced. However, in *Hoensheid*, the IRS proved exactly how far along the sale was. To me, the court seems to be moving away from *Rauenhorst* and instead saying to taxpayers, "You can't get a deal totally worked out, take all of the economic steps consistent with being totally ready to close, pause for a day to figure out who you want to be taxed on the sale, rearrange ownership, then the next day close with new owners who will be taxable instead of you." For more about the gift's timing, see excerpt in part II.Q.6.f.i Completed Gift Requirement.

II.Q.6.f. Incomplete Gift and Charitable Partial Interest Prohibitions

II.Q.6.f.i. Completed Gift Requirement

The Tax Court has held that a Code § 170 deduction is allowed "only if the transfer at issue satisfies the six essential elements of a bona fide inter vivos gift:"[4740]

[4739] See fn 4737.

[4740] *Fakiris v. Commissioner*, T.C. Memo. 2017-126, fn. 12, citing:
Goldstein v. Commissioner, 89 T.C. 535, 541-542 (1987) (quoting *Weil v. Commissioner*, 31 B.T.A. 899, 906 (1934), *aff'd*, 82 F.2d 561 (5th Cir. 1936)); *Guest v. Commissioner*, 77 T.C. 9, 15-17 (1981); *Stjernholm v. Commissioner*, T.C. Memo. 1989-563.
Before that quote, the footnote stated:

(1) a donor competent to make the gift;

(2) a donee capable of taking the gift;

(3) a clear and unmistakable intention on the part of the donor to absolutely and irrevocably divest himself of the title, dominion, and control of the subject matter of the gift, in praesenti;

(4) the irrevocable transfer of the present legal title and of the dominion and control of the entire gift to the donee, so that the donor can exercise no further act of dominion or control over it;

(5) a delivery by the donor to the donee of the subject of the gift or the most effectual means of commanding the dominion of it; and

(6) acceptance of the gift by the donee.

Thus, a retained right to require the donee to transfer ownership to another nonprofit made the gift conditional and therefore nondeductible.[4741]

On the other hand, if the charity voluntarily sells donated stock to the issuer, the donor's control over the issuer does not prevent the gift from being complete.[4742]

> It is well settled that the term "charitable contribution" as it is used generally in sec. 170 and the regulations thereunder is synonymous with the term "gift". See *Collman v. Commissioner*, 511 F.2d 1263, 1267 (9th Cir. 1975), *aff'g in part, rev'g in part, and remanding* T.C. Memo. 1973-93; *Seed v. Commissioner*, 57 T.C. 265, 275 (1971); *Sutton v. Commissioner*, 57 T.C. 239, 242 (1971); *Wolfe v. Commissioner*, 54 T.C. 1707, 1713 (1970); *Murphy v. Commissioner*, 54 T.C. 249, 252 (1970); *McLaughlin v. Commissioner*, 51 T.C. 233, 234 (1968), *aff'd*, 23 A.F.T.R.2d (RIA) 69-1763 (1st Cir. 1969); *Perlmutter v. Commissioner*, 45 T.C. 311, 316-317 (1965); *DeJong v. Commissioner*, 36 T.C. 896, 899 (1961), *aff'd*, 309 F.2d 373, 376-379 (9th Cir. 1962); *Stjernholm v. Commissioner*, T.C. Memo. 1989-563, *aff'd*, 933 F.2d 1019 (10th Cir. 1991).

In light of *BC Ranch II, L.P. v. Commissioner*, 867 F.3d 547 (5th Cir. 2017), T.C. Memo. 2020-157 supplemented *Fakiris v. Commissioner*, T.C. Memo. 2017-126.

[4741] *Fakiris v. Commissioner*, T.C. Memo. 2017-126, mentioning Reg § 1.170A-1(e) (see fn. 4743) but also noting *Graev v. Commissioner*, 140 T.C. 377, 390 (2013), and *Briggs v. Commissioner*, 72 T.C. at 656-659. In light of *BC Ranch II, L.P. v. Commissioner*, 867 F.3d 547 (5th Cir. 2017), T.C. Memo. 2020-157 supplemented *Fakiris v. Commissioner*, T.C. Memo. 2017-126.

[4742] *DeWitt v. U.S.*, 204 Ct.Cl. 274 (1974), holding:

> Defendant does not affirmatively challenge DeWitt's donative intent, nor the actual delivery of the stock to the Academy; but it does contend that DeWitt did not relinquish dominion and control over the stock since it views the transfer of the stock as conditional based on an agreement between DeWitt and the Academy that the Academy would retain the stock until such time as DeWitt, through his controlled corporation, Mortgage Co., offered to repurchase the stock. Since DeWitt subsequently repurchased the stock through his controlled corporation, defendant sees in this fact substance for its view that a conditional agreement did exist when the stock was given to the Academy. This fact, however, is not particularly persuasive here, nor have similar facts had any determinative effect in analogous cases. See *Sheppard v. United States*, *supra*; *Carrington v. Commissioner*, *supra*; *Behrend v. United States*, decided December 14, 1972 (4th Cir.), 31 AFTR.2d 73-406; *Makoff v. Commissioner*, 26 Tax Ct. Mem. 83, 90 (1967); *Fox v. Commissioner*, 27 Tax Ct. Mem. 1001 (1968). Since the eight shares of stock were in a closely-

If a transfer for charitable purposes depends on the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible.[4743]

Estate of Hoensheid v. Commissioner, T.C. Memo. 2023-34, analyzed the timing of the transfer of stock in a closely-held corporation:

> "Ordinarily, a contribution is made at the time delivery is effected." Treas. Reg. § 1.170A-1(b). The regulations further provide that "[i]f a taxpayer unconditionally delivers or mails a properly endorsed stock certificate to a charitable donee or the donee's agent, the gift is completed on the date of delivery.[15] *Id*. However, the regulations do not define what constitutes delivery. See, *e.g., Dyer v. Commissioner*, T.C. Memo. 1990-51, 58 T.C.M. (CCH) 1321, 1323; *Brotzler v. Commissioner*, T.C. Memo. 1982-615, 44 T.C.M. (CCH) 1478, 1480; *Alioto v. Commissioner*, T.C. Memo. 1980-360, 40 T.C.M. (CCH) 1147, 1154, *aff'd*, 692 F.2d 762 (9th Cir. 1982). Accordingly, we must first look to state law for the threshold determination of whether petitioners divested themselves of their property rights via gift.[16] See *United States v. Nat'l Bank of Com.*, 472 U.S. 713, 722 (1985) (concluding that state law determines property rights and federal law classifies them for appropriate tax treatment); *Jones*, 129 T.C. at 150 ("In order to make a valid gift for Federal tax purposes, a transfer must at least effect a valid gift under the applicable State law."); *Greer v. Commissioner*, 70 T.C. 294, 304 (1978) (applying state gift law requirements to charitable contribution of property), aff'd on another issue, 634 F.2d

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held company, there was little, if any, market for them. Indeed, the only potential buyer was Mortgage Co., DeWitt's corporation. Thus, it is not surprising that the offer to purchase the stock came from the only likely source available.[6]

[6] Defendant attempts to make much of DeWitt's candid uncertainty that, if the policies of the Academy were such as to preclude any effort on his part to repurchase the stock, he doesn't know whether he would have made the gift of stock to the Academy. This pre-delivery speculation adds little to resolution of the matter at hand. DeWitt realized some risk existed, once he donated the stock to the Academy, that he might not be able to repurchase the stock from the Academy. He acknowledged that the risk was small since there was little, if any, market for the stock. However, even if the Academy sold the stock to another party, DeWitt would have sought to repurchase it from that party since the stock was worth more to him than anybody else. The important fact is that after delivery of the stock, DeWitt no longer had dominion and control over the stock. The presence of this risk factor supports the view that a bona fide gift of stock was given. See *Sheppard v. United States*, *supra*, 176 Ct.Cl. at 253-56, 361 F.2d at 977-78; *Apt v. Birmingham*, 89 F.Supp. 361, 392 (N.D. Iowa, 1950). The fact that DeWitt and the Academy may have expected and anticipated that the shares would be repurchased by Mortgage Co. does not invalidate the gift made. *Fox v. Commissioner*, *supra*, 27 Tax Ct. Mem. At 1013.

[4743] Reg § 1.170A-1(e), which provides:

Transfers subject to a condition or power. If as of the date of a gift a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an interest in property passes to, or is vested in, charity on the date of the gift and the interest would be defeated by the subsequent performance of some act or the happening of some event, the possibility of occurrence of which appears on the date of the gift to be so remote as to be negligible, the deduction is allowable. For example, A transfers land to a city government for as long as the land is used by the city for a public park. If on the date of the gift the city does plan to use the land for a park and the possibility that the city will not use the land for a public park is so remote as to be negligible. A is entitled to a deduction under section 170 for his charitable contribution.

1044 (6th Cir. 1980); *Kissling v. Commissioner*, T.C. Memo. 2020-153, at *22 ("Whether delivery is effected is a question of state law."). In doing so, we apply state law in the manner in which the highest court of the state has indicated that it would apply the law. See *Commissioner v. Estate of Bosch*, 387 U.S. 456, 465 (1967). Where the state's highest court is silent, we must discern and apply the state law, giving "proper regard" to the state's lower courts. See *Julia R. Swords Tr. v. Commissioner*, 142 T.C. 317, 342 (2014) (quoting *Commissioner v. Estate of Bosch*, 387 U.S. at 465).

[15] The regulations alternatively provide, in relevant part, that "[i]f the donor delivers the stock certificate to his bank or broker as the donor's agent, or to the issuing corporation or its agent, for transfer into the name of the donee, the gift is completed on the date the stock is transferred on the books of the corporation." Treas. Reg. § 1.170A-1(b).

[16] This Court has at times applied its own longstanding test for a valid inter vivos gift. See *Guest*, 77 T.C. at 16 (quoting *Weil v. Commissioner*, 31 B.T.A. 899, 906 (1934), *aff'd*, 82 F.2d 561 (5th Cir. 1936)). This test, while more extensive on its face than what is required under Michigan law, shares the same core elements: "donative intent, delivery by the donor and acceptance by the donee." *Goldstein v. Commissioner*, 89 T.C. 535, 542 (1987) (distilling the *Weil* test); see *Estate of Sommers v. Commissioner*, T.C. Memo. 2013-8, at *43 n.20 (analyzing validity of gift under principles consistent with both federal and state law); *Estate of Dubois v. Commissioner*, T.C. Memo. 1994-210, 1994 WL 184393, at *2 (reaching conclusion that no valid gift was made under both federal and state law).

As to the choice of state law, both parties focused their state law briefing on Michigan law, and we cannot discern a choice of law principle that would suggest the parties' understanding is incorrect. Accordingly, we apply the law of the state of petitioners' domicile, Michigan, with respect to whether and when petitioners made a valid gift of the CSTC shares. See *Macatawa Bank v. Wipperfurth*, 822 N.W.2d 237, 238 (Mich. Ct. App. 2011) ("The longstanding rule in Michigan is that 'the situs of intangible assets is the domicile of the owner unless fixed by some positive law.'" (quoting *Brown v. O'Donnell* (*In re Rapoport's Est.*), 26 N.W.2d 777, 781 (Mich. 1947))); see also *Malkan v. Commissioner*, 54 T.C. 1305, 1314 n.3 (1970) (applying law of the situs to determine validity of gift of shares of stock).

In determining the validity of a gift, Michigan law requires a showing of (1) donor intent to make a gift; (2) actual or constructive delivery of the subject matter of the gift; and (3) donee acceptance.[17] See *Davidson v. Bugbee*, 575 N.W.2d 574, 576 (Mich. Ct. App. 1997) (citing *Molenda v. Simonson*, 11 N.W.2d 835, 836 (Mich. 1943)); see also *United States v. Four Hundred Seventy Seven (477) Firearms*, 698 F. Supp. 2d 894, 902 (E.D. Mich. 2010) (applying Michigan law).

[17] Petitioners alternatively direct us to Article 8 of the Uniform Commercial Code (UCC), as adopted by Michigan, which on its face is applicable to gift transfers of certificated securities. *See* Mich. Comp. Laws § 440.1201(2)(cc) (2015) ("'Purchase' means taking by sale, lease, discount, negotiation, mortgage, pledge, lien, security interest, issue or reissue, gift, or any other voluntary transaction creating an interest in property." (Emphasis added.)); *id*. (dd); *id*. § 440.8301(1)(a) and (b) (delivery of certificated security occurs when purchaser or third party acting on their behalf "acquires possession of the security certificate"). While the Michigan Supreme Court

does not appear to have expressly addressed the issue, we do not read the UCC provisions as disturbing the longstanding Michigan common law test. See *id*. § 440.8302 cmt. 2 ("Article 8 does not determine whether a property interest in certificated or uncertificated security is acquired under other law, such as the law of gifts, trusts, or equitable remedies."); *id*. § 440.1103(2) (stating that "principles of law and equity" supplement UCC provisions); see also *Young v. Young*, 393 S.E.2d 398, 401 (Va. 1990) ("The common law requirements of delivery and acceptance are not removed by those provisions of the [UCC] pertaining to the transfer of securities.").

Petitioners and respondent each advance different dates for when petitioners made a gift to Fidelity Charitable of the CSTC shares. Petitioners argue that a gift was made on June 11, 2015, and they point to petitioner's testimony and Fidelity Charitable's corrected contribution confirmation letter, which both claim June 11 as the date of the gift. Respondent argues that a valid gift was not made until at least July 13, 2015, when Fidelity Charitable first received a stock certificate from petitioners' representatives.[18] We will examine each of three required elements for a valid gift in turn.

[18] Respondent raises a separate issue with regard to the dividend paid out by CSTC on July 14 to petitioner and the two brothers, but not paid to Fidelity Charitable, speculating that petitioners did not make a valid gift of the shares. Respondent's contention appears to be foreclosed by Michigan law, which provides that retention of a dividend does not preclude a valid gift of the underlying shares. See *Cook v. Fraser*, 299 N.W. 113, 114 (Mich. 1941) (citing *Ford v. Ford*, 259 N.W. 138 (Mich. 1935)); *In re Estate of Prinstein*, No. 252682, 2005 WL 1459575, at *1 (Mich. Ct. App. June 21, 2005) ("[T]he fact that a donor collects dividends on a security does not make an inter-vivos gift of that security invalid.").

A. Present Intent

The determination of a party's subjective intent at some historical point is necessarily a highly fact-bound issue. When deciding such an issue, we must determine "whether a witness's testimony is credible based on objective facts, the reasonableness of the testimony, the consistency of statements made by the witness, and the demeanor of the witness." *Ebert v. Commissioner*, T.C. Memo. 2015-5, at *5-6; see also *Estate of Kluener v. Commissioner*, 154 F.3d 630, 636 (6th Cir. 1998), *aff'g in relevant part* T.C. Memo. 1996-519. If contradicted by the objective facts in the record, we will not "accept the self-serving testimony of [the taxpayer]...as gospel." *Tokarski v. Commissioner*, 87 T.C. 74, 77 (1986); see *Davis v. Commissioner*, 88 T.C. 122, 143 (1987), *aff'd*, 866 F.2d 852 (6th Cir. 1989).

We start with petitioner's contemporaneous emails and the contemporaneous transactional documents, which we consider to be especially probative evidence with respect to his intent. On June 1, petitioner first expressed in an email that he wanted to wait to make the gift of the shares to Fidelity Charitable until the last possible moment, when he was "99% sure" that the sale to HCI would close. Petitioner's subsequent actions and communications were consistent with that intent. On June 11, petitioner and his two brothers executed the Consent to Assignment agreement, an act that demonstrated petitioner's generalized future intent to make a gift. However, the Consent to Assignment cannot establish that, as of June 11, such an intent was sufficiently present and specific. See *Czarski v. Bonk*, 124 F.3d 197, 1997 WL 535773, at *4 (6th Cir. 1997) (unpublished table decision) (applying Michigan law and finding no evidence establishing purported donor's "specific intent" with respect to the particular property). On its face, the Consent to Assignment agreement failed to specify a number of shares to be contributed, suggesting that petitioner had not yet decided that key detail. Similarly, the original stock certificate, which was prepared on or sometime after June 11, failed to specify an effective date, again suggesting that a date would be decided upon later.[19] On July 6, petitioner stated in an email that he was still "not totally sure of the shares being transferred to the charitable fund yet." That email confirms that, as of July 6, the details of the contribution were still in flux. Indeed, three days later, on July 9, Mr. Bear emailed Mr. Boland to inform him that "it looks like Scott has arrived at 1380 shares."

[19] We note that copies of the Consent to Assignment agreement and stock certificate that were produced to the Commissioner during the examination appear to have been modified and backdated to specify, respectively, a number of shares and an effective date that were not originally present at the time of the transaction. We find such inconsistencies to be significant in evaluating petitioners' claim that the gift was made on June 11. *Cf. Ferguson v. Commissioner*, 174 F.3d 997, 1000 (9th Cir. 1999) (questioning purported date of contribution where "the original handwritten date in a printed box entitled 'date of donation'...had been completely scratched out" and a new date written next to it), *aff'g* 108 T.C. 244 (1997).

At trial, petitioner testified that he believed the number of shares to be donated was set at 1,380 on June 11. That testimony is squarely contradicted by the Consent to Assignment agreement, petitioner's July 6 email, and Mr. Bear's July 9 email. See, e*.g.* , *Richardson v. Commissioner*, T.C. Memo. 1984-595, 49 T.C.M. (CCH) 67, 73-74 (concluding that taxpayer's characterization of date of contribution was not credible where in conflict with "documents written contemporaneously with the donation"). Petitioner also testified that his July 6 email was referring to a potential donation of a second tranche of shares, a theoretical event which apparently never took place. The record contains no evidence supporting the claim that petitioners attempted to make (or even contemplated) two separate gifts of CSTC shares. We find petitioner's self-serving testimony as to his intent to be incredible.

The record does not support a finding of present intent to make a gift until July 9 when petitioner settled on a number of 1,380 shares. From that point on, petitioner took a number of actions that confirmed his present intent to transfer. On July 9 or 10 petitioner delivered the physical stock certificate to Ms. Kanski's office. Similarly, on July 10 petitioner created an online giving account with Fidelity Charitable. Taken together, these actions provide sufficient credible evidence of petitioner's intent. We conclude that, as of July 9, petitioner had present intent to make a gift.

B. Delivery

At bottom, the delivery requirement generally contemplates an "open and visible change of possession" of the donated property. *Shepard v. Shepard*, 129 N.W. 201, 208 (Mich. 1910); *Davis v. Zimmerman*, 40 Mich. 24, 27 (1879). As the term itself suggests, manually providing tangible property to the donee is the classic form of delivery. *See, e.g.*, Restatement (Second) of Property § 31.1 cmt. b (Am. L. Inst. 1992) (describing the "simplest" form of delivery as the donor's "plac[ing] the subject matter of the gift in the hands of the intended donee"). Similarly, manually providing to the donee a stock certificate that represents intangible shares of stock is traditionally sufficient delivery. See Philip Mechem, Gifts of Corporation Shares, 20 Ill. L. Rev. 9, 15-16 (1925-1926) (collecting cases). However, the determination of what constitutes delivery is inherently context-specific and depends upon the “nature of the subject-matter of the gift” and the “situation and circumstances of the parties.” *Shepard*, 129 N.W. at 208 (“[N]o absolute rule can be laid down as to what will constitute a sufficient delivery....”).

Delivery need not necessarily be actual. Constructive delivery may be effected where property is delivered into the possession of another on behalf of the donee. *See, e.g. , In re Van Wormer’s Estate*, 238 N.W. 210, 212 (Mich. 1931) (finding constructive delivery where stock certificate was issued in the name of donee and deposited at bank). Whether constructive or actual, delivery “must be unconditional and must place the property within the dominion and control of the donee” and “beyond the power of recall by the donor.” *In re Casey Estate*, 856 N.W.2d 556, 563 (Mich. Ct. App. 2014) (citing *Osius v. Dingell*, 134 N.W.2d 657, 659 (Mich. 1965)); see *Geisel v. Burg*, 276 N.W. 904, 908 (Mich. 1937) (finding no valid gift where certificates of deposit were never placed beyond donor’s control). If constructive or actual delivery of the gift property occurs, its later retention by the donor is not sufficient to defeat the gift. See *Estate of Morris v. Morris*, No. 336304, 2018 WL 2024582, at *5 (Mich. Ct. App. May 1, 2018) (citing *Jackman v. Jackman*, 260 N.W. 769, 770 (Mich. 1935)); see also *Garrison v. Union Tr. Co.*, 129 N.W. 691, 692 (Mich. 1911).

With respect to delivery, neither Mr. Hoensheid nor Ms. Kanski was able to credibly identify a specific action taken on June 11 that placed the shares within Fidelity Charitable’s dominion and control.[20] See *Czarski*, 1997 WL 535773, at *4 (finding no evidence that donor took any action that would constitute delivery or place gift property in donee’s dominion and control); see also *Reed Smith Shaw & McClay v. Commissioner*, T.C. Memo. 1998-64, 1998 WL 62393, at *8 (declining to credit uncorroborated self-serving testimony regarding actions purportedly taken to effect transfer of shares to trust). Instead, petitioner’s and Ms. Kanski’s trial testimony suggested that the physical, partially completed stock certificate remained on petitioner’s desk until July 9 or 10, 2015, at which point it was dropped off at Ms. Kanski’s office. Consequently, delivery to Fidelity Charitable could not have taken place before July 9 or 10, because petitioner retained dominion and control of the shares while the physical certificate was sitting on his desk. *Cf. In re Casey Estate*, 856 N.W.2d at 563 (finding no delivery where donor retained property in his safe and could thus change the combination at any time to preclude access by purported donee).

[20] In his testimony, petitioner implied a belief that the execution of the Consent to Assignment agreement had effected a transfer. Execution of the Consent to Assignment agreement did not purport to transfer ownership of any portion of petitioner’s shares; instead, it merely allowed him the ability to transfer shares in the future.

The same principle is applicable to the three or four days when the physical certificate was in Ms. Kanski’s office, before the forwarding of the PDF share certificate to Fidelity Charitable. The Minority Stock Purchase Agreement’s seller representative clause, as executed, named Ms. Kanski’s firm, Clark Hill, as the seller’s representative of Fidelity Charitable. That designation raises the question of whether Ms. Kanski’s possession of the certificate constituted delivery to Fidelity Charitable. However, we cannot conclude that providing the certificate to Ms. Kanski removed the shares from petitioner’s power of recall. Petitioners have not provided any evidence to indicate that Ms. Kanski could have disregarded an instruction from petitioner - her client - to return or simply discard the stock certificate before July 13. See *Osius*, 134 N.W.2d at 656 (stating that a valid gift "must invest ownership in the donee beyond the power of recall by the donor"); *Snyder v. Snyder*, 92 N.W. 353, 354 (Mich. 1902) ("The retaining of any control in the hands of the donor over the subject of the gift renders it invalid."); see also *Londen v. Commissioner*, 45 T.C. 106, 109 (1965) (finding it "unlikely" that corporation's secretary "would have refused to honor a countermand of the transfer instructions issued by [the taxpayer]"); *Morrison v. Commissioner*, T.C. Memo. 1987-112, 53 T.C.M. (CCH) 251, 255 (finding no evidence that if taxpayer had "countermanded her instructions to transfer the stock, [her broker] would have refused to halt the transfer"). Thus, we conclude that the stock certificate, while in the possession of Ms. Kanski, was subject to recall by petitioner at any time and was not within the dominion and control of Fidelity Charitable, precluding delivery. See *Londen*, 45 T.C. at 109; *Zipp v. Commissioner*, 28 T.C. 314, 324-25 (1957) (finding retention of stock certificates by donor's attorney to preclude a valid gift), *aff'd*, 259 F.2d 119 (6th Cir. 1958); *Bucholz v. Commissioner*, 13 T.C. 201, 204 (1949) (finding no valid gift where taxpayer instructed custodian of corporate books to prepare stock certificates but remained undecided about ultimate gift).

In some jurisdictions, transfer of shares on the books of the corporation can, in certain circumstances, constitute delivery of an inter vivos gift of shares. See, e.g., *Wilmington Tr. Co. v. Gen. Motors Corp.*, 51 A.2d 584, 594 (Del. Ch. 1947); *Chi. Title & Tr. Co. v. Ward*, 163 N.E. 319, 322 (Ill. 1928); *Brewster v. Brewster*, 114 A.2d 53, 57 (Md. 1955). However, the Michigan Supreme Court does not appear to have addressed whether transfer on the books of a corporation alone can constitute delivery of a valid gift of certificated shares of stock. In several older tax cases, the U.S. Court of Appeals for the Sixth Circuit - to which an appeal in this case would lie, absent stipulation to the contrary - has stated that transfer on the books of a corporation constitutes delivery of shares of stock, apparently as a matter of federal common law. See *Lawton v. Commissioner*, 164 F.2d 380, 384 (6th Cir. 1947), *rev'g* 6 T.C. 1093 (1946); *Bardach v. Commissioner*, 90 F.2d 323, 326 (6th Cir. 1937), *rev'g* 32 B.T.A. 517 (1935); *Marshall v. Commissioner*, 57 F.2d 633, 634 (6th Cir. 1932), *aff'g in part, rev'g in part* 19 B.T.A. 1260 (1930). We have previously observed that, in this line of cases, the transfers on the books of the corporation were bolstered by other objective actions that evidenced a change in possession and thus a gift. See *Jolly's Motor Livery Co. v. Commissioner*, T.C. Memo. 1957-231, 16 T.C.M. (CCH) 1048, 1073 (distinguishing *Bardach* and *Marshall* and instead concluding that taxpayer failed to make a valid gift under Tennessee law); see also *Bucholz*, 13 T.C. at 204; *Campbell v. Commissioner*, T.C. Memo. 1979-411, 39 T.C.M. (CCH) 287, 289. We would thus be hesitant to conclude that transfer on the books of CSTC would be sufficient here as a matter of law, given the apparent split of authorities on the issue and lack of state law precedent. See Fletcher Cyclopedia of the Law of Corporations § 5684 (West 2022) ("Generally, a transfer of stock from the donor to the donee on the corporate books, standing alone, is not sufficient to constitute a valid gift, at least with regard to a close corporation where the donor is in control[.]"); Mark S. Rhodes, Transfer of Stock § 6:3 (7th ed. 2021) ("There is a division of authority as to whether a mere transfer on the books of the corporation without delivery of the certificate constitutes a valid gift of stock."); Mechem, Gifts of Corporation Shares, supra, at 25-26 (describing view that transfer on the books of the corporation effects only the relationship between new shareholder and corporation, while delivery of certificate separately transfers ownership of shares as property between persons).

However, even assuming arguendo that a transfer on the corporate books is sufficient to constitute delivery of certificated shares of stock in Michigan, we are still unable to find on the record before us that such a transfer occurred. The primary relevant evidence produced by petitioners is the printout of a purported stock ledger. The printout, which has a report date of July 13, shows an entry issuing 1,380 shares to Fidelity Charitable on July 10. At trial, however, petitioner testified that the printout was not from CSTC's official stock ledger but appeared to him instead to have been prepared by one of CSTC's attorneys. Indeed, petitioners themselves have at no point asserted that a gift occurred on July 10 and have not produced any evidence to corroborate such a transfer on the books of CSTC. We thus attribute little weight to the printout, given petitioners' failure to corroborate it with credible evidence. See *Sellers v. Commissioner*, T.C. Memo. 1977-70, 36 T.C.M. (CCH) 305, 312 (observing that self-serving corporate records are relevant evidence but "the weight to be accorded them is dependent upon their completeness and credibility"), *aff'd*, 592 F.2d 227 (4th Cir. 1979). Consequently, the record is insufficient to support a conclusion that delivery of the shares was made on July 10 via transfer on the books of CSTC.

Finally, we look to Mr. Bear's July 13 email of the PDF stock certificate to Fidelity Charitable. That email provides the strongest documentary evidence of the shares' leaving petitioner's dominion and control. Providing Fidelity Charitable with a copy of a stock certificate issued in its name was an objective act evidencing an "open and visible change of possession." *Shepard*, 129 N.W. at 208. Further, we find that this act placed the shares of CSTC in Fidelity Charitable's dominion and control, by providing Fidelity Charitable with an instrument that it could present to CSTC and exercise its rights as shareholder. Nor did any postdelivery retention by petitioner of a stock certificate render delivery ineffectual. See *id*. (stating that donor's postdelivery retention of stock certificates was "immaterial" to validity of gift). On the basis of the foregoing, we conclude that delivery of the shares of CSTC did not occur before July 13.

C. Acceptance

Donee acceptance of a gift is generally "presumed if the gift is beneficial to the donee." *Davidson*, 575 N.W.2d at 576; see *Osius*, 134 N.W.2d at 660; *Dunlap v. Dunlap*, 53 N.W. 788, 790 (Mich. 1892) ("The donation being for [the donees'] advantage, they will be deemed to have accepted it, unless the contrary appears."). Petitioners seek to reinforce that presumption by relying on the corrected contribution confirmation letter and yearend account statement from Fidelity Charitable, both of which stated that the shares were contributed (and thus presumably accepted by Fidelity Charitable) on June 11. Both Fidelity Charitable's guidelines and the year end account statement note that donors are able to request corrections of both contribution confirmation letters and account statements. Petitioners did not produce a copy of the original contribution confirmation letter, dated July 15, 2015, that they received from Fidelity Charitable. Such evidence could have confirmed whether Fidelity Charitable consistently understood the date of contribution to be June 11 and what errors were present in the original letter. Petitioners' failure to produce such evidence within their control gives rise to a presumption that it would be unfavorable to their case. See *Wichita Terminal Elevator Co. v. Commissioner*, 6 T.C. 1158, 1165 (1946), *aff'd*, 162 F.2d 513 (10th Cir. 1947). Given our conclusions above that neither the present intent nor the delivery requirement was met on June 11, we do not consider the corrected documentation from Fidelity Charitable to be reliable evidence with respect to the date of acceptance.

In contrast, Mr. Boland's July 13 email is the more convincing evidence and rebuts any presumption that acceptance took place on an earlier date. In that email Mr. Boland

> represented that he would need the stock certificate before he could take action with respect to the sale of shares to HCI. As Mr. Boland later testified, Fidelity Charitable typically required receipt of a stock certificate as a precondition to its acceptance of a gift when dealing with a contribution of closely held, certificated securities. Later on July 13, after receiving the stock certificate, Mr. Boland on behalf of Fidelity Charitable executed the Minority Stock Purchase Agreement under warranty of good title. That act is sufficient to establish acceptance by Fidelity Charitable. We conclude that acceptance occurred on July 13.
>
> **D. Conclusion**
>
> Petitioners have failed to establish that any of the elements of a valid gift was present on June 11, 2015. Instead, as a matter of state law, we find that petitioners made a valid gift of CSTC shares by effecting delivery on July 13. We thus conclude that petitioners divested themselves of title to the shares on July 13. See *Humacid Co.*, 42 T.C. at 913.

As is described in part II.Q.6.e Assignment of Income on Property Being Sold, the court in this case viewed the donor as holding and controlling the stock until all necessary steps to prepare for the sale had been completed, making signatures at closing a meaningless formality.

This uncertainty regarding gifts is less likely to occur when transferring an interest in a partnership or LLC than when transferring stock. Usually the partnership/operating agreement and applicable state law impose specific requirements regarding the transfer of the economic interest (which may require consent of other owners), admission as a partner/member (which may require consent of other owners), and the donee's acceptance of the terms of the partnership/operating agreement.

II.Q.6.f.ii. Forced Sale to Related Party for Note

CCA 201507018 disallowed a deduction of a partnership interest (referred to as Units) that the charitable organization immediately sold for a note to a related party for a note:

> In the present case, Partner has claimed a deduction under § 170 for a donation of Units to Organization. However, after Transaction, and within a day of Partner's assignment of Units to Organization, Organization does not hold any rights to Units. Organization holds Note. Further, Partner, through Partner's power to approve of Partnership distributions to Corp, controls when in fact interest payments will be made on Note. Had Partner or Corp contributed Note directly to Organization, a deduction under § 170 would not be allowed because payment of the donation would not have been made within the year and, under Rev. Rul. 68-174, Note would have been treated as a promise to make a donation, but not an actual donation….
>
> Under the terms of the Partnership Agreement, Organization is required to surrender its right as an assignee of Units to Partner on Partner's terms. Further, under the Partnership Agreement, Organization had to obtain the approval of Partner to transfer its interest in Units. Partner, in Partner's sole discretion, could approve or disapprove any transfer. Partner, in exercising this discretion, had no fiduciary duty at the time of Transaction to Organization. If Organization attempted to transfer its interest in Units to a third party, Partner had the power to nullify the transfer. Further, the Special Call Price would become active and the call price provision limits the call price to Organization's contributions which are zero. Accordingly, Partner had the power to nullify the donation

> to Organization if Organization attempted to transfer its interest in Units without Partner's approval. Further, Organization could not retain its interest in Units without violating its representations to the Service that it would not hold an interest in a Partnership with nonexempt taxpayers. Partnership could call Organization's interest in Units at any time. Based on the above elements of Transaction, Organization was essentially compelled to engage in Transaction.

A possibly required forced sale for a bargain price also violated the S corporation prohibition on a second class of stock.[4744]

However, when one donates property to charity and buys it back because the donor very much wanted the property and the charity very much needs cash, the sale is not considered

[4744] See text accompanying and preceding fn 288 in part II.A.2.i.ix Warrants Designed to Restore Original Shareholders' Equity Position.

forced.[4745] Even if the charity is required sign a right-of-first-refusal[4746] in connection with the donated stock that pays no dividends,[4747] the donor-controlled corporation's redemption of the donated stock is not concerned forced.[4748]

[4745] *DeWitt v. U.S.*, 204 Ct.Cl. 274 (1974), discussed in fn 4742, was along these lines, following *Sheppard v. United States*, 176 Ct.Cl. 244, 252, 361 F.2d 972, 976 (1965), which upheld a donation, involved the following:

> On June 16, 1959, plaintiff carried out his plan. He wrote letters to the Sisters and to the University offering to each, as a gift absolute, one-third of his right, title, and interest in Star's Pride, which he described as a one-sixth interest in the horse with a current market value of $50,000. He attached no conditions or obligations to these offers. However, on the same day, in the case of the University, and on the following day, in the case of the Sisters, he sent each donee a letter from The Farms, signed by him as president, by which The Farms offered to purchase the interest of each donee for the sum of $50,000. Each letter contained a paragraph advising that, if the offer was found acceptable, the proper officers of the respective donees should execute and return an enclosed form of bill of sale, upon receipt of which The Farms would make immediate payment…. On June 17 each donee accepted The Farms' offer, executed and delivered the bill of sale, and later received payment from The Farms in due course. As the recited facts demonstrate, the record is clear that neither donee acted under any legal obligation, express or implied, to accept The Farms' offer of purchase as a condition to accepting plaintiff's gift. However, neither donee "looked the gift horse in the mouth." They made no independent investigation of the value or earnings potential of Star's Pride, nor did they solicit offers from any other sources. Instead, they relied implicitly on plaintiff's integrity and international reputation for expertise in the field of standardbred horses.
>
> As for plaintiff, he had no real doubt that, despite the absence of any prior commitment by the charities, The Farms would be able to acquire the donated interests for cash. He was aware that, because of their construction programs, they wanted money, not an interest in a breeding stallion. He was also aware that, once the interest was beyond his effective control, there was a possibility that either donee (particularly the University) might shop around for a better offer from other persons interested in standardbred horses. He was willing to assume that risk, however, because he was ready to have The Farms outbid any possible competitor.
>
> On June 17, plaintiff also sold his own remaining one-sixth interest in Star's Pride to The Farms for $50,000 and reported the same on his 1959 income tax return as capital gain. On the same return he claimed a charitable contribution deduction of $50,000 for his gift to the Sisters and a like deduction for his gift to the University. The Commissioner of Internal Revenue disallowed both deductions in their entirety as not being valid gifts.

The court held:

> The proof is clear and convincing that there were no prearrangements or commitments entered into between taxpayer and the two charities, nor did he place any conditions upon, or tie any strings to, his gifts. Legally speaking, the charities were as free to deal with their donated interests as any other owner would be . As a matter of fact, the Mother Superior testified that the Academy would have sold to someone else had the bid price been higher, after Mr. Sheppard had been notified. She testified she relied on his judgment in the matter and felt she owed him, as the donor of the gift, this respect.
>
> Indeed, the defendant does not appear to controvert this, but it points vigorously to the taxpayer's candid testimony to the effect that, in his own mind, he felt confident The Farms' offer to purchase the interests from the charities would be accepted by them. That the reasoning which led him to this unilateral conviction was entirely sound is perhaps best demonstrated by the alacrity with which both charities accepted The Farms' offer.
>
> The fact remains, despite defendant's refusal to face it, that following the gifts there was a period of time, albeit short in duration, when plaintiff had lost control of two-thirds of his interest in Star's Pride. During that period he was exposed to the possibility, however remote he might have

considered it, that The Farms might not succeed in purchasing the donated interests short of increasing the amount of its offers….

The court is not unmindful of the tax benefits which flow from affording full recognition to the plaintiff's admittedly tax-motivated transactions in this case. Such motivation demands special analysis and scrutiny, but its presence is essentially immaterial except as an eye-opening mechanism or interpreter of equivocal conduct. [footnote omitted]

[4746] *Grove v. Commissioner*, 490 F.2d 241 (2nd Cir. 1973), described the right-of-first-refusal:

RPI agreed not to "sell, transfer, give, pledge or hypothecate, or in any way dispose of the whole or any part of the common stock of the Corporation now or hereafter owned ... until [RPI] shall have first offered the Corporation the opportunity to purchase said shares upon the terms and conditions hereinafter provided." The redemption price was established at book value of the shares as noted on the Corporation's most recent certified financial statement prior to the offer. Pursuant to the contract, the Corporation was "entitled (but not obligated) to purchase all or any part of the shares of stock so offered." If the Corporation did not exercise its option to purchase within sixty days, RPI could transfer the shares to any other party and the Corporation's right of first refusal would not subsequently attach to such transferred shares.[3]

[3] Other minority shareholders of the Corporation signed similar agreements, which, in effect put in writing the Corporation's practice of redeeming, when financial conditions permitted, any minority-owner shares offered to it, for example, by a departing employee or a deceased employee's widow.

[4747] *Grove v. Commissioner*, 490 F.2d 241 (2nd Cir. 1973), explained:

The Corporation's business is building airfields, highways, tunnels, canals, and other similar heavy construction projects in both the United States and foreign countries. These projects usually involve the investment of large sums of money over an extended period of time and involve a high degree of risk. Since, in this industry, contract payments normally are made only after specified levels of progress are achieved, a firm must always commit substantial amounts of its own funds, whether borrowed or internally generated, to a project. Moreover, a company can determine an acceptable contract price based only on its best estimate of the cost to complete the project. A bad "guess" or unforeseen contingency may require a firm to complete a project while incurring a loss. Not surprisingly, the mortality rate in this industry is high. To protect against such adverse developments, successful firms seek to maintain liquidity by holding ample cash or other assets easily converted to cash. One method of conserving cash, adopted by the Corporation, is to retain all earnings and refrain from paying dividends.

[4748] Affirming *Grove v. Commissioner*, T.C. Memo. 1972-98, in a 2-to-1 decision the Second Circuit, 490 F.2d 241 (1973), allowed a charitable deduction for a deduction for stock in exchange for a charitable gift annuity, citing *Behrend v. United States*, __ F.2d __ (4th Cir. 1972), holding:

Grove, of course, owned a substantial majority of the Corporation's shares. His vote alone was sufficient to insure redemption of any shares offered by RPI. But such considerations, without more, are insufficient to permit the Commissioner to ride roughshod over the actual understanding found by the Tax Court to exist between the donor and the donee….

Nothing in the December, 1954, minority shareholder agreement between the Corporation and RPI serves as a basis for disturbing the conclusion of the Tax Court. Although the Corporation desired a right of first refusal [on minority shares—understandably so, in order to reduce the possibility of unrelated, outside ownership interests—it assumed no obligation to redeem any shares so offered. In the absence of such an obligation, the Commissioner's contention that Grove's initial donation was only the first step in a prearranged series of transactions is little more than wishful thinking grounded in a shaky foundation. See *Carrington v. Commissioner of Internal Revenue*, *supra*, at __; *Behrend*, *supra*, at __, 73-1 USTC ¶9123 at 80,067; *Sheppard v. United States*, *supra*, at 978; *Robert L. Fox*, 27 TCM 1001, 1013 (1968).

We are not so naive as to believe that tax considerations played no role in Grove's planning. But foresight and planning do not transform a non-taxable event into one that is taxable. Were we to adopt the Commissioner's view, we would be required to recast two actual transactions—a gift by Grove to RPI and a redemption from RPI by the Corporation—into two completely fictional transactions—a redemption from Grove by the Corporation and a gift by Grove to RPI. Based upon the facts as found by the Tax Court, we can discover no basis for elevating the Commissioner's "form" over that employed by the taxpayer in good faith.

II.Q.6.f.iii. Charitable Partial Interest Prohibition

Generally, if a taxpayer contributes less than the taxpayer's entire interest in such property, for individual income tax purposes[4749] a charitable income[4750] tax deduction is allowed only to the extent that the value of the interest contributed would be allowable as a deduction if that interest had been transferred in trust:

- This rule does not apply if the donation is of "the taxpayer's entire interest in the property, such as an income interest or a remainder interest."[4751]

- However, if "the property in which such partial interest exists was divided in order to create such interest and thus avoid" the partial interest prohibition, the deduction is not allowed.[4752] Where the creation of the partial interest was 4 years before the charitable gift and was for reasons unrelated to a future charitable gift, the deduction is allowed.[4753]

[4749] This provision applies for purposes of Code § 170, which is contributions deducted on a personal income tax return (including contributions through an S corporation or a partnership). It does not apply for the fiduciary income tax deduction under Code § 642(c); see part II.J.4.c Charitable Distributions. However, if and to the extent that the trust has unrelated business taxable income, Code § 170 would apply to calculate the percentage limitations of the deduction; I have not formed an opinion on whether the UBTI rules makes the charitable partial interest prohibition not apply for income tax purposes. See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, fns. 4927-4933. See also part II.Q.6.d Unrelated Business Taxable Income.

[4750] Code § 170(f)(3)(A). However, Code § 170(f)(3)(B) excludes from this rule a contribution of a remainder interest in a personal residence or farm, a contribution of an undivided portion of the taxpayer's entire interest in property, and a qualified conservation contribution.

[4751] Reg. § 1.170A-7(a)(2)(i), which further provides:

> Thus, if securities are given to A for life, with the remainder over to B, and B makes a charitable contribution of his remainder interest to an organization described in section 170(c), a deduction is allowed under section 170 for the present value of B's remainder interest in the securities.

[4752] Reg. § 1.170A-7(a)(2)(i), which further provides:

> Thus, for example, assume that a taxpayer desires to contribute to a charitable organization an income interest in property held by him, which is not of a type described in paragraph (b)(2) of this section. If the taxpayer transfers the remainder interest in such property to his son and immediately thereafter contributes the income interest to a charitable organization, no deduction shall be allowed under section 170 for the contribution of the taxpayer's entire interest consisting of the retained income interest. In further illustration, assume that a taxpayer desires to contribute to a charitable organization the reversionary interest in certain stocks and bonds held by him, which is not of a type described in paragraph (b)(2) of this section. If the taxpayer grants a life estate in such property to his son and immediately thereafter contributes the reversionary interest to a charitable organization, no deduction will be allowed under section 170 for the contribution of the taxpayer's entire interest consisting of the reversionary interest.

[4753] In allowing a deduction for gifts made in 1975, Rev. Rul. 76-523 reasoned:

> In the instant case, the 1960 trusts were set up long before the revision of section 170 of the Code by the enactment of the Tax Reform Act of 1969. Thus, the taxpayers' purpose in setting up these trusts could not have been the avoidance of the provisions of section 170(f)(3)(A). Further, in view of all of the above circumstances, the taxpayer's purpose in setting up the 1971 trust was not the avoidance of the provisions of section 170(f)(3)(A), but to provide financial security to an old friend and valued former employee, while insuring their future financial security and protecting their interests in the family corporation from outside incursions. Only when these concerns were no longer relevant, because of the merger of the family corporation, did the taxpayers donate their remainder interests, which were their entire interests, to a charitable organization.

- On the other hand, the partial interest prohibition does not apply to a contribution of a partial interest in property if the contribution constitutes part of a charitable contribution not in trust in which all interests of the taxpayer in the property are given to a charitable organization.[4754]

- Nor does it apply "merely because the interest which passes to, or is vested in, the charity may be defeated by the performance of some act or the happening or some event, if on the date of the gift it appears that the possibility that such act or event will occur is so remote as to be negligible."[4755]

- Also, the prohibition does not apply to an undivided portion of a donor's entire interest in property, which "must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property and in other property into which such property is converted."[4756]

[4754] Reg. § 1.170A-7(a)(2)(ii), which continues:

> Thus, if on March 1, 1971, an income interest in property is given not in trust to a church and the remainder interest in the property is given not in trust to an educational organization described in section 170(b)(1)(A), a deduction is allowed for the value of such property.

[4755] Reg. § 1.170A-7(a)(3), referring to Reg § 1.170A-1(e), which is reproduced in fn. 4743, found in part II.Q.6.f.i Completed Gift Requirement.
[4756] Reg. § 1.170A-7(b)(1)(i).

Although the preceding bullet points describe income tax rules, similar rules apply for gift tax[4757] and estate tax[4758] purposes, except that, where the initial division results in an interest being transferred to a noncharitable person, any later contribution of the donor's entire remaining interest in the property "will not be considered the donor's entire interest in the property" for estate and gift tax purposes.[4759] Donating 20% of the taxpayer's unitrust interest in a charitable remainder trust six years after the trust's formation did not trigger the partial interest prohibition.[4760] Donating all of one's annuity interest in a charitable remainder annuity trust did not violate the prohibition,[4761] nor did donating all of one's unitrust in a charitable remainder unitrust trust.[4762]

Rev. Rul. 76-143 held that the partial interest prohibition denied charitable deductions when the taxpayer donated the cash surrender value and retained the right to the death benefit, even if all

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[4757] Code § 2522(c)(2), incorporating by reference the Code § 170(f)(3)(B) exclusion in fn. 4750; see Reg. § 25.2522(c)-3(c).

[4758] Code § 2055(e)(2), incorporating by reference the Code § 170(f)(3)(B) exclusion in fn. 4750; see Reg. § 20.2055-2(e)(2). Code § 2055(e)(3) may allow a post-mortem reformation.

[4759] Reg. §§ 25.2522(c)-3(c)(2)(i) and 20.2055-2(e)(2)(i). The former illustrates this rule:

> For example, if the donor gave a life estate in an office building to his wife for her life and retained a reversionary interest in the office building, the gift by the donor of one-half of that reversionary interest to charity while his wife is still alive will not be considered the transfer of a deductible interest; because an interest in the same property has already passed from the donor for private purposes, the reversionary interest will not be considered the donor's entire interest in the property. If, on the other hand, the donor had been given a life estate in Blackacre for the life of his wife and the donor had no other interest in Blackacre on or before the time of gift, the gift by the donor of one-half of that life estate to charity would be considered the transfer of a deductible interest; because the life estate would be considered the donor's entire interest in the property, the gift would be of an undivided portion of such entire interest.

[4760] Letter Ruling 9550026 involved a joint-and-survivor net-income charitable remainder unitrust. The transaction involved the following steps:

(a) Taxpayer A will execute a disclaimer that is substantially similar to the one submitted with your ruling request. This disclaimer provides that Taxpayer A disclaims his contingent right to receive Taxpayer B's unitrust interest after Taxpayer B's death. Taxpayer B will execute a disclaimer that is substantially similar to the one submitted with your ruling request. This disclaimer provides that Taxpayer B disclaims her contingent right to receive Taxpayer A's unitrust interest after Taxpayer A's death.

(b) Taxpayers will make a gift of a twenty percent undivided interest in the Unitrust Payment to University, by execution and delivery of an irrevocable assignment valid under State A law.

(c) The income interest in Trust which University receives in this gift will merge with its remainder interest in Trust, leaving University with a twenty percent undivided interest in the entire trust and an eighty percent undivided interest in the remainder of the trust.

(d) Taxpayers and University will consent to the partial termination of Trust in their respective capacities as grantors and beneficiaries so that all of the grantors and beneficiaries will have consented to termination of twenty percent of the trust.

(e) The trustee of Trust will distribute to University twenty percent of the trust assets. The distributed assets will be fairly representative of the relative bases of the various assets in the trust. The trustee will continue to hold the balance of the Trust assets in accordance with the terms of the trust.

The ruling concluded:

(1) Taxpayers will be entitled to an income tax deduction under section 170 of the Code for the value of the undivided interest in the Unitrust Payment transferred to University.

(2) Taxpayers will be entitled to a gift tax deduction under section 2522 of the Code for the value of the undivided interest in the Unitrust Payment transferred to University.

of the rights were fixed (including making the beneficiary designation irrevocable). The denial applied whether the cash value was fully paid[4763] or was for cash value build-up due to the current year's premium.[4764] Now, Code § 170(f)(10) also prohibits various split-dollar and similar arrangements from qualifying for the charitable deduction.

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(3) The value of Taxpayers' gift under sections 170 and 2522 of the Code will be the present value of the right to receive annual payments equal to nine percent of the value of twenty percent of the Trust assets determined annually for a term starting on the date of the transfer of the gift to University and ending on the date of death of the survivor of Taxpayers.

(4) The gift of the undivided part interest in Trust will not cause the trust to cease to be a trust described in 664(d)(2) of the Code.

(5) To the extent that in prior years, Trust had capital gain income, and that income was not realized or included in the income of Taxpayers, such capital gain shall not be included in the income of, or realized by, Taxpayers solely because of the transfer of the undivided interest in the Unitrust Payment to University.

[4761] Rev. Rul. 86-60 involved the following facts:

> *Situation 1*. In 1980, A created a charitable remainder annuity trust (hereinafter, CRAT) described in section 664(d)(1) of the Code. A retained the annuity interest in the trust for life. The remainder beneficiary was X, a charitable organization described in sections 170(c) and 2522(a). In 1984 A transferred the annuity interest in the trust to X.
>
> *Situation 2*. In 1980, A created a CRAT described in section 664(d)(1) of the Code. The trust instrument provides that the trustee shall pay the annuity amount annually to A for life and upon A's death to B, the successive life interest beneficiary, for such time as B survives. Upon the death of the survivor of A and B, the corpus is to be distributed to X, a charitable organization that meets the requirements of sections 170(c) and 2522(a). In 1984, A and B assigned their interests in the trust to the charitable remainder beneficiary.
>
> No property interests were created for the purpose of avoiding the rules of section 170(f)(2) and (f)(3)(A).

The ruling held:

> In *Situation 1*, the gift by A, the grantor, to the remainder beneficiary of A's retained life annuity interest in a charitable remainder annuity trust qualifies for an income tax charitable deduction under section 170 of the Code and a gift tax charitable deduction under section 2522.
>
> In *Situation 2*, where A has created a charitable remainder annuity trust with life annuity interest to A and survivor life annuity interest to B, the gifts by A and B of their life annuity interests in the trust to the charitable remainder beneficiary qualify for an income tax charitable deduction and a gift tax charitable deduction. A's gift of the life annuity, however, qualified for the gift tax charitable deduction only because the interest that was transferred was in one of the forms set out in section 25.2522(c)-3(c)(2) of the regulations.

[4762] Letter Ruling 9721014, citing Rev. Rul. 86-60. However, "X and Y represent that when Trust was created in 1986, there was no intention to divide the income and remainder interests in order to avoid the partial interest rules in section 170(f)." With a representation like that, I don't understand what the ruling accomplished.

[4763] The ruling reasoned:

> In *Situation 1*, the gift made by the taxpayer of the right to the cash surrender value of the policy was a gift of less than an entire interest in the property. Furthermore, a gift of this kind is not a gift of a fraction or percentage of each and every substantial interest owned by the donor in such property since the taxpayer retained the right to designate the beneficiary. Even if the taxpayer irrevocably designated the beneficiary prior to making the gift in order to create a remainder interest that would then constitute the taxpayer's entire interest in the property, such division would be regarded as having been made to avoid section 170(f)(3)(A) of the Code and the deduction would not be allowed.

[4764] The ruling reasoned:

Before we delve further into what violates the partial interest prohibition, let's consider the consequences other than denying the charitable deduction. *Keefer v. U.S.*, 130 A.F.T.R.2d 2022-5002 (N.D. TX 7/6/2022), reasoned:

> "The assignment of income doctrine holds that one who earns income cannot escape tax upon the income by assigning it to another." *Caruth Corp. v. United States*, 865 F.2d 644, 648 (5th Cir. 1989). Instead, "if one, entitled to receive [income] at a future date...makes a grant of it by anticipatory assignment, he realizes taxable income as if he had collected [it]...and then paid it over." *Id*. (quoting *Comm'r v. P.G. lake, Inc.*, 356 U.S. 260, 267 (1958)). "Ultimately, the question is whether the taxpayer himself ever earned income, or whether it was earned instead by the assignee," or, in the terms of Justice Holmes's famous metaphor for this doctrine (set out in *Lucas v. Earl*, 281 U.S. 111, 115 (1930)), "whether the fruit has been attributed to a different tree, or whether instead the entire tree has been transplanted." *Id*. at 649.
>
> Applied to a taxpayer's gift of "earnings derived from an income-producing asset, the crucial question is whether the asset itself, or merely the income from it, has been transferred." *Id*. at 648. "If the taxpayer gives away the entire asset, with accrued earnings, the assignment of income doctrine does not apply." *Id*. at 648-49 (first citing *Blair v. Comm'r*, 300 U.S. 5, 14 (1937); and then citing *United States v. Ga. R.R. & Banking Co.*, 348 F.2d 278, 285 (5th Cir. 1965)). But, it does apply "[i]f the taxpayer carves income or a partial interest out of the [granted] asset, and retains something for himself." *Id*. at 649 (quoting *P & G Lake*, 356 U.S. at 265 & n. 5).
>
> "Per *Humacid Co. v. Commissioner*, 42 T.C. 894, 913 (1964), [courts will] respect the form of [a donation of appreciated stock shares] if the donor (1) gives the property away absolutely and parts with title thereto (2) before the property gives rise to income by way of a sale." *Dickinson v. Comm'r*, 2020 WL 5249242, at *3 (T.C. Sept. 3, 2020) (first citing *Grove v. Comm'r*, 490 F.2d 241, 246 (2d Cir. 1973); then citing *Carrington v. Comm'r*, 476 F.2d 704, 708 (5th Cir. 1973); then citing *Behrend v. United States*, 1972 WL 2627, at *3 (4th Cir. 1972); and then citing *Rauenhorst v. Comm'r*, 119 T.C. 157, 162–163 (2002)).

Keefer v. U.S., 130 A.F.T.R.2d 2022-5002 (N.D. TX 7/6/2022),[4765] held:

> Based on this evidence, the Court finds that no genuine issue of material fact exists as to whether the Keefers carved out a portion of the 4% partnership interest before donating it to Pi. They did. After the assignment, Pi did not have the right that other partners had to share in a distribution of Available Cash Flow as described in the Partnership Agreement, but only had a right to share in the net proceeds of the Hotel sale. See *id*. at 35; Doc. 69-1, Appraisal, 209 (noting that "the Foundation would only share in the proceeds from Seller's Closing Statement; the Foundation would not receive its *pro rata* share in other net assets of the Partnership"). Or, in the unlikely event the Hotel sale had not been completed as planned, Pi would not have shared equally with the other limited partners in the duty to contribute funds for renovation, should additional

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> In *Situation 2*, the gift made by the taxpayer of the right to the cash surrender value of a nonpaid-up life insurance policy was also a gift of less than the taxpayer's entire interest in the property. Since the taxpayer retains the right to designate the beneficiary, and the right to surrender the policy and defeat the college's interest, the gift is not a gift of a fraction or percentage of each and every substantial interest in the property.

[4765] Motion for reconsideration denied, 130 A.F.T.R.2d 2022-5406 (N.D. TX 8/10/2022).

> funds be required to fulfill the partnership's obligations under the loan or franchise agreements. See Doc. 69-1, Keefer Dep., 34 (noting that the pre-assignment reserves were needed because "the Pi Foundation could not obviously contribute capital for the renovation"). Reflecting this carve out, the Appraisal calculated a lower value for the donated interest than for a full 4% interest in all of the partnership's assets. Doc. 69-9, Appraisal, 594 ("All assets not included in the $54 million [sale price] have been excluded."); *id*. at 595 (calculating 4% of net sale proceeds without reserves). Accordingly, the Keefers did not donate their full 4% partnership interest on June 18, 2015, but donated only a portion thereof. They did not transplant the *whole* tree.
>
> The anticipatory assignment of income doctrine therefore applies to this transaction.

If a donor transfers voting stock but retains the voting rights, Rev. Rul. 81-282 asserted that retaining the voting rights violated the partial interest prohibition.[4766] However, when a donor kept voting and donated nonvoting restricted[4767] stock, the donation did not constitute a partial interest;[4768] this reasoning also applied to an estate.[4769] Furthermore, when the donated voting

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[4766] The ruling reasoned:

> The right to vote stock is inherent in the ownership of common stock and, as such, is a property right. This right gives the holder a voice in the management of the corporation and is crucial in protecting the stockholder's financial interest. Therefore, the right to vote the stock of X is a substantial right in that stock. See *Brown v. McLanahan*, 148 F.2d 703 (4th Cir. 1945); and *DuVall v. Moore*, 276 F.Supp. 674 (N.D. Iowa 1967).
>
> While A's retention of the right to vote the stock will not defeat Y's right to dividends or the right to dispose of the stock, and, while the right retained by the donor will not defeat the donee's interest in the transferred property, nevertheless, A has not transferred all substantial rights in the stock to Y. Therefore, A has transferred a partial interest in property to Y within the meaning of section 170(f)(3) of the Code. See Rev. Rul. 76-143.

[4767] Comparing Class A voting to Class B nonvoting:

> The rights of the Class A shares are freely transferable. In contrast, the Class B shares are not transferable except: (1) to the Corporation; (2) in connection with an acquisition of the Corporation; (3) in the case of natural persons, upon death or pursuant to a valid and binding court order mandating transfer; or (4) with the consent of the Corporation's Board of Directors.

[4768] Letter Ruling 201129033, holding:

> In the present case, Donor and Donor's Spouse propose to transfer Class B common stock to Charity. The Class B common stock is a separate property interest apart from the other class of stock in Corporation. Under the facts as presented, the shares of one class of stock do not constitute an interest in the shares of any other class of stock. Therefore, we conclude that for gift tax purposes the plan described above will not result in interests in the same property passing for both charitable and noncharitable purposes within the meaning of § 2522(c)(2).

[4769] Letter Ruling 9022010 reasoned:

> In the present case, [four separate charities] will receive, in effect, under the terms of the will and the Trust, the residue of A's estate, which may include a portion of the Class A nonvoting shares of V. The outright distribution of the Class A nonvoting shares to [the charities] while the Class B voting shares are held in trust for the benefit of individuals will not be a distribution of property for both charitable and noncharitable purposes under section 2055(e)(2) of the Code.
>
> Each class of stock represents a separate property interest. Further, considering that the dividend rights and liquidation preferences of the respective classes are identical and considering the currently issued and outstanding shares in the various classes, each distributee of the respective classes of stock will receive all the property rights and economic benefits inherent in the equity interests represented by those shares. Under the facts as presented, the shares of one class of stock do not constitute an interest in the shares of any other class of stock.

stock was subject to a voting agreement created eight years previously for business purposes, the lack of voting rights did not make the gift a nondeductible partial interest.[4770] However, when the terms of the bequest required the executor to retain the stock and pay the dividends to an individual during the period of administration and to distribute the stock to the charity after administration is completed, Rev. Rul. 83-45 asserts that the dividend payment violates the partial interest rule. On the other hand, when a charity separated a debt obligation it issued into principal and income receipts that were legally separate rights, the partial interest prohibition did not apply when holders donated those rights.[4771]

Rev. Rul. 75-373 allowed a charitable contribution deduction in the manner and to the extent provided by Code § 170 for the value of the restricted easement granted in the following situation:

> An individual conveyed an easement in a tract of 50 acres of vacant, beachfront property to the county in which the property was located to be used solely as a public bathing beach and recreational area operated and maintained by the county. The land is located in a rapidly expanding urban area. The county is a political subdivision of state X.
>
> The deed from the taxpayer to the county granted the easement in gross in perpetuity but reserved to the taxpayer certain rights, including the right of access to and from the open water by boat from the remainder of the land owned by the grantor or his heirs, the right to have an open and usable channel connecting the open sea with the lands retained by the grantor, and the retention of all mineral rights in the land underlying the easement. Any prospective drilling and/or mining is to be done by slant from adjacent property so that the surface of the land will not be disturbed. The donor is responsible for all taxes, levies, and assessments of any kind to which the conveyed property is or

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> Therefore, we conclude that the estate plan described above will not result in interests in the same property passing for both charitable and noncharitable purposes, within the meaning of section 2055(e)(2) of the Code.

[4770] Letter Rulings 200108012, 200108013 and 200108014 included the following facts and holding:

> In 1992, Taxpayer and other Company shareholders entered into a voting agreement. The purpose of the voting agreement was to facilitate any future negotiations to sell Company. Pursuant to the voting agreement, Taxpayer transferred to Individual her voting rights with respect to corporate events affecting change of ownership or control of Company. The voting agreement required Taxpayer to agree to vote as directed by Individual. Recently, the voting agreement was amended to provide that the votes would be directed by a person who is not Individual and is not related to Taxpayer….
>
> When Taxpayer contributes her shares in Company stock to Foundation, she will not contribute all interests in the shares. Certain voting rights have already been transferred to a third party. The voting rights are substantial rights. See Rev. Rul. 81-282. However, because those rights had been transferred eight years ago for a business purpose, the interests were not divided in order to avoid section 170(f)(3)(A). Thus, section 1.170A-7(a)(2)(i) of the Regulations does not cause disallowance of the charitable contribution deduction in this case.

[4771] Letter Ruling 8939014 described the approved rights as follows:

> Each debenture receipt represents, in form, the right to receive specific future interest or principal payments on the debenture. Accordingly, the debenture receipts will be denominated as coupon receipts and principal receipts. Each coupon receipt will represent the right to receive a single payment at the date of a specific interest payment on the debenture. Each principal receipt will represent the right to receive a specific payment of principal on the debenture. No payments, however, will be made on any debenture receipt prior to the date on which the specific payment of interest or principal, respectively, is made on the debenture.

> shall be subject, but the assessment will be reduced to reflect the value of the easement conveyed....
>
> Under the law of state X, an easement in gross in perpetuity is a valuable property right or interest in favor of the party for whose benefit the easement is created and is enforceable by that party.
>
> In the instant case, the easement in gross in perpetuity is an open space easement within the meaning of section 1.170A-7(b)(1)(ii) of the regulations.

Rev. Rul. 76-253 disallowed a deduction for the contribution of land when the taxpayer retained timber-cutting rights. *Sells v. Commissioner*, T.C. Memo. 2021-12, also denied a deduction for donating timber:

> Although we find that the donation of Burning Bush's timber is at issue, we agree with the members that the Commissioner's analysis of it is quite confusing. He argues in his posttrial briefs that the timber donation violates section 170(h) - the subsection that addresses contributions of qualified conservation easements. He specifically argues that the timber donation doesn't have a conservation purpose since the clearcutting of land can't possibly be for a conservation purpose.
>
> As we search through the record, we find next to no other mention of the timber donation from either party. The only evidence that we have (besides the disallowance of the timber donations in the notices of deficiency) is the initial claiming of the deduction by the partners on their tax returns. Those returns each have two separate Forms 8283 attached - one for the donation of the conservation easement and one for the donation of "Timber". And attached to each form were separate appraisals - one of the value of the conservation easement and one of the value of the timber. The appraisal of the timber donation describes the value of eight timber products that were "growing on [the] property" but makes no mention of a conservation easement. When we look at the entire record, we find it more likely than not that the timber donation was not a donation of a conservation easement but rather just a separate noncash donation. Section 170(h) and its regulations that govern the donation of conservation easements just don't apply.
>
> But that doesn't mean the partners are out of the woods just yet. According to the appraisal, Burning Bush acquired the land on which it placed the easement on the very same date that it reported it had acquired the timber - August 6, 2002. And Burning Bush contributed both the easement and the timber to the same donee, COLT. Because of this, we find it more likely than not that the timber donated by Burning Bush is the same standing timber on which it had placed a conservation easement.
>
> That is a problem. The value that Burning Bush placed on the standing timber is its value as timber products. One can see this on the Form 8283 - which describes the donation of "Pulp, Chip N Saw, Saw Timber" - products that result from timber's harvest. And the attached appraisal - which described eight products - would require the timber's harvest.
>
> The problem here is that Alabama law[15] makes timber that hasn't been severed from the land the property of the land owner, and as a general rule not even a life tenant has the right to cut and sell it. See *White v. Watts*, 812 So.2d 328, 331 (Ala. 2001); *Wilder v. Scott*, 89 So.2d 682, 685 (Ala. 1956). There are exceptions to this general rule - if the property was a tree farm, *White*, 812 So.2d at 331; *Robinson v. Robinson*,

> 215 So.2d 585, 590-91 (Ala. 1967), or the timber cutting was an incident to clearing land for cultivation, *Westmoreland v. Birmingham Tr. & Sav. Bank*, 108 So. 536, 538 (Ala. 1926) - but none of these could conceivably apply here.
>
> > [15] State law defines property interests. See, *e.g.*, *Case v. United States*, 633 F.2d 1240, 1246 (6th Cir. 1980); *Oakbrook*, T.C. Memo. At *34.
>
> The cutting of timber and its conversion into lumber and other wood products is not a conservation purpose. See sec. 170(h)(4)(A); sec. 1.170A-14(e), Income Tax Regs. The deed forbids it.[16] That makes Burning Bush's donation of the timber either a nondeductible gift of a partial interest in real estate other than a conservation easement, or a future interest in tangible personal property. If it's the first, the Code says it's never deductible, see sec. 170(f)(3)(A); if it's the second, section 170(a)(3) says that it's not deductible until the timber is severed from the real property. Either way, the members of Burning Bush don't get deductions for donating standing timber to COLT for their 2003 tax year.
>
> > [16] That makes these cases different from *Butler Land Holdings, LLC v. Commissioner*, T.C. Memo. 2012-72, 2012 WL 913695, at *42-*43, because there the deed explicitly allowed the harvesting of timber as part of an approved plan.

Rev. Rul. 76-331 applied the partial interest rule to disallow the following contributions:

> *Situation 1*. A corporation transferred a tract of land to an organization described in section 170(c)(2) of the Code. However, it retained all mineral rights with respect to the property, including the sole right to exploit and sell any minerals obtained from the property.
>
> *Situation 2*. An individual, aged 50 and in good health, owned timberland that the individual leased to a corporation in 1975 for a term of 60 years. In 1976, the individual transferred this land to an organization described in section 170(c)(2) of the Code, subject to the individual's receiving, during the individual's lifetime, all the payments due under the lease. Upon the individual's death, all rights under the lease will pass to the charitable organization.

However, if the retained mineral interest cannot ever interfere with the charity's interest, the retained interest might be too insubstantial to invoke the partial interest disallowance.[4772] Donating land to the U.S. did not trigger the prohibition when the donor reserved the right to train a hunting dog and maintain paths for that purpose.[4773] Also, a donation of undivided

[4772] *Stark v. Commissioner*, 86 T.C. 243 (1986).

[4773] Rev. Rul. 75-66 involved the following facts and holding:

> An individual donated his entire interest in 800 acres of land to the United States and retained the right during his lifetime to train his personal hunting dog, and any other hunting dog he may subsequently own, on trails extending over the entire tract, including the right to maintain paths and lanes relating to the reserved use. The individual was informed by the United States Department of the Interior that the reservation would not interfere with the Government's use and enjoyment of the donated property. The trails for training the dog are used in accordance with the Department of the Interior's regulations on such use.
>
> the instant case, the retained right during the taxpayer's lifetime to train his personal hunting dog on the entire tract, in accordance with the regulations of the Department of the Interior on such use, is not substantial enough to affect the deductibility of the property contributed.

interests in real estate subject to leases was not subject to the partial interest disallowance when it conveyed all of the donor's rights and duties and substantial interests with respect to the leases and the undivided interests in the property.[4774] (Additional rulings regarding easements need to be reviewed.) But taxpayers who granted a fire department the right to conduct training exercises on their property and destroy a building thereon during the exercises were held not to donate any ownership interest in property to the fire department, and the partial interest rule prohibit deducting the value of the use of the property. *Patel v. Commissioner*, 138 T.C. 395 (2012), the official syllabus mentioning the following:

> At the end of May 2006, Ps purchased property in Vienna, Virginia (Vienna property), with the intention to demolish the house situated thereon (house) and construct a new one on the site. Their realtor told them about the Fairfax County Fire and Rescue Department (FCFRD) Acquired Structures Program, where a property owner allows FCFRD to conduct live fire training exercises on his or her property. As part of the exercises, FCFRD destroys, by burning, the designated building on the owner's property. Within a few weeks of purchasing the Vienna property, Ps contacted FCFRD and obtained information about the requirements for participating in the program. After Ps obtained a demolition permit and completed all of the other requirements, they executed documents granting FCFRD the right to conduct training exercises on the Vienna property and to destroy the house by burning during the exercises. During October 2006, FCFRD, along with six other fire departments, used the Vienna property to conduct live fire training exercises, during which the house was destroyed.

Mann v. U.S., 984 F.3d 317 (4th Cir. 2021), disallowed a deduction where the charity selected parts of a house it was given to demolish and the taxpayer later disposed of parts that the charity did not take. The appraisal valued everything that the charity could have taken, rather than what the charity actually did take. But the appraisal being flawed was only part of the story. The court reasoned:

> Thus, in the end, some components of the Manns' house were salvaged by Second Chance for resale; some components were destroyed as part of the deconstruction process; and the remaining components were left by Second Chance for demolition and removal by the Manns' contractor. In these circumstances, Linda's entire interest in the house was not donated to Second Chance, and the value of the house was therefore not deductible under 26 U.S.C. §§ 170(f)(3).
>
> While the Manns read the donation agreement more narrowly, focusing only on the conveyance language of all of her "right, title and interest" in the house, nonetheless when matters of taxation are involved, "substance rather than form prevails." *W. Va. N. R.R. Co. v. Comm'r*, 282 F.2d 63, 65 (4th Cir. 1960). Thus, "the taxability of a transaction is determined by its true nature rather than by the name which the parties may use in describing it." *Id*.; see also *Comm'r v. Ct. Holding Co.*, 324 U.S. 331, 334 (1945) ("To permit the true nature of the transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress"); *BB&T Corp. v. United States*, 523 F.3d 461, 471, 474 (4th Cir. 2008) (noting that "the doctrine of 'substance over form' recognizes that the substance of a transaction, rather than its form, governs for tax purposes" and that the doctrine thus "serves to prevent taxpayers from manipulating the tax code"). Moreover, "the transaction must be viewed as a whole." *Ct. Holding Co.*,

[4774] Letter Ruling 8639019.

> 324 U.S. at 334.; *cf*. *Volvo Cars of N. Am. v. United States*, 571 F.3d 373, 379 (4th Cir. 2009) (recognizing that "in applying federal law to determine the tax consequences of a transaction defined by state law, we look to the intention of the parties as evidenced by the written agreements read in light of the attendant facts and circumstances" (cleaned up)).
>
> Focusing on substance over form, Linda donated some components of the house for salvage, which were in fact removed from the house and taken by Second Chance for resale. And some of the house's components were destroyed onsite, either for work-force training or as necessary to remove salvageable components. But, Linda maintained the benefits and burdens of ownership of the remaining components which she ultimately paid her contractor to demolish. Thus, she did not donate, as personal property, her entire interest in the house to Second Chance, making the Manns' attempt to claim the value of the entire house as a charitable deduction improper.

If the owner of the working interest under an oil and gas lease[4775] gives an overriding royalty interest[4776] or a net profits interest[4777] to a charitable organization, Rev. Rul. 88-37 asserts that the partial interest rule bars the deduction. The ruling viewed the right to control or to participate

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[4775] The ruling describes a working interest:

> A working interest is the operating interest under an oil and gas lease. It is typically created by a transaction in which the owner of a tract of land, or the owner of the mineral rights to a tract of land, grants the right to exploit the oil and gas under the land, while at the same time retaining a royalty interest in production. Alternatively, the owner of a tract of land, or the owner of mineral rights to a tract of land, may, as in the instant case, retain the working interest and grant a royalty interest to another person. The owner of the working interest has the exclusive right to exploit the oil and gas resources. For federal tax purposes, a working interest is defined as an interest in oil and gas in place that is burdened with the cost of development and operation of the property. *Brooks v. Commissioner*, 424 F.2d 116 (5th Cir. 1970).

After defining an overriding royalty interest (see fn. 4776) and a net profits interest (see fn. 4777), the ruling comments:

> The right to exploit the oil and gas resources under the land is a right inherent in the ownership of a working interest. Even an owner of only a percentage of the working interest has the right to participate in decisions on the exploitation of the oil and gas resources. The owner of an overriding royalty interest or a net profits interest does not have this right.

[4776] The ruling describes an overriding royalty interest:

> An overriding royalty interest is an economic interest in oil and gas in place, created from the working interest. An overriding royalty entitles its owner to a specified fraction of gross production, free of operating and developing costs. The term of an overriding royalty interest is coextensive with the term of the working interest from which it was created. The transfer of an overriding royalty is an assignment of a property interest and is not an anticipatory assignment of income. See Rev. Rul. 67-118, 1967-1 C.B. 163.

[4777] The ruling describes a net profits interest:

> A net profits interest is, for federal tax purposes, an interest in oil and gas in place that is defined as a share of gross production measured by net profits from operation of the property. It is created out of the working interest and has the same duration. Unlike the income accruing to an overriding royalty, the income accruing to the net profits interest is reduced by specified operating and development costs, but the interest bears these expenses only to the extent of its share of the income. Unlike the working interest, the net profits interest is not required to pay out, advance, or become liable for such costs. *Burns v. Commissioner*, 78 T.C. 185, 209 (1982). Like a transfer of an overriding royalty, the transfer of such a net profits interest conveys, for federal tax purposes, a depletable property interest in oil and gas in place. See *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599 (1946), 1946-1 C.B. 69; *Burton-Sutton Oil Co., Inc. v. Commissioner*, 328 U.S. 25 (1946), 1946-1 C.B. 237.

in control, which a working interest has but which neither an overriding royalty interest nor a net profits interest has, as a substantial right, the retention of which prevents the donated interest from being considered an undivided interest in the donor's property rights.[4778]

On the other hand, separate bequests of preferred stock and common stock did not trigger the partial interest prohibition.[4779]

Rev. Rul. 2003-28 asserted that the partial interest prohibition applies to patents:

(1) A taxpayer's contribution to a qualified charity of a license to use a patent is not deductible under § 170(a) if the taxpayer retains any substantial right in the patent.[4780]

(2) A taxpayer's contribution to a qualified charity of a patent subject to a conditional reversion is not deductible under § 170(a), unless the likelihood of the reversion is so remote as to be negligible.

[4778] The IRS reasoned:

> … the donor did not contribute the donor's entire interest in the property but carved out and contributed only a portion of that interest. Further, the portion contributed was not an undivided portion of the donor's interest because it did not convey a fraction of each and every substantial interest or right owned by the donor in the property. By transferring an overriding royalty interest or a net profits interest, the donor has retained the right inherent in the ownership of a working interest to control, or, in the case of ownership of a part of the working interest, to participate in the control of, the development and operation of the lease. This right to control or to participate in control, similar to the retained voting rights in Rev. Rul. 81-282, is a substantial right, the retention of which prevents the donated interest from being considered an undivided portion.
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> After the transfer, … the contributed interest is a separate property interest for federal tax purposes. However, if the charitable interest is created by dividing a greater interest held by the donor, the application of section 170(f)(3) to deny the charitable contribution deduction is not precluded merely because the contributed interest is a separate property in the hands of the donee and the incidence of taxation on income from the contributed interest is shifted from the donor to the donee. Rev. Rul. 70-477, 1970-2 C.B. 62, for example, holds that for years after the effective date of section 170(f)(3), a contribution of rent-free use of property, even if recognized as a conveyance of property under local law, does not give rise to a deduction under section 170.
>
> In both Situation 1 and Situation 2, therefore, the contributed interest is less than the taxpayer's entire interest within the meaning of section 170(f)(3) of the Code, and is not an undivided portion of the taxpayer's entire interest. In each case, the partial interest was not transferred in trust and was not in a form that would have resulted in an allowable deduction under section 170(f)(2) had it been transferred in trust.

[4779] Letter Ruling 8950071.

[4780] The ruling reasoned:

> In *Situation 1*, X contributes a license to use a patent, but retains a substantial right, i.e., the right to license the patent to others. The license granted to University is similar to the rent-free lease described in § 1.170A-7(a)(1) and the partial interest in motion picture films described in § 1.170A-7(b)(1)(i), in that it constitutes neither X's entire interest in the patent, nor a fraction or percentage of each and every substantial interest or right that X owns in the patent. As a result, the contribution in Situation 1 constitutes a transfer of a partial interest, and no deduction under § 170(a) is allowable. The result would be the same if X had retained any other substantial right in the patent. For example, no deduction would be allowable if X had contributed the patent (or license to use the patent) solely for use in a particular geographic area while retaining the right to use the patent (or license) in other geographic areas.

(3) A taxpayer's contribution to a qualified charity of a patent subject to a license or transfer restriction is deductible under § 170(a), assuming all other applicable requirements of § 170 are satisfied, and subject to the percentage limitations of § 170, but the restriction reduces what would otherwise be the fair market value of the patent at the time of the contribution, and therefore reduces the amount of the charitable contribution for § 170 purposes.[4781]

Generally, all the rights to a partnership are considered a single property interest.[4782] It would not appear to be susceptible to being split up as separate assets the way that corporate stock would be. Thus, a donor should transfer a vertical slice of all of the donor's interest in the partnership. Suppose one wants to control a donated business interest or other property that requires special handling. One might target one's donation, divide it by 49%, and put that among into an LLC in which a majority vote of the members can direct the manager to sell the LLC's assets:

- For example, one owns a 20% partnership interest and wants to give away 5%. Transfer a 10.2% partnership interest (5% divided by 49%) into the LLC and then donate a 49% interest in the LLC to the charity. To encourage the charity – especially a donor-advised fund or supporting organization – to use any distributions from the LLC,[4783] one might also consider obligating the non-charitable member of the LLC to pay any expenses (such as from a seller's representations and warranties) either through its share of sale proceeds or by paying the expenses directly. Also, to minimize valuation discounts, require that all cash the LLC receives must be distributed, except for a very small amount required to pay expenses that are expected to occur in the near future; no reserve would be made for the expenses described in the preceding sentence, because the donor would be obligated to fund those as they arise. If the sale is imminent, the appraiser might very well apply a relatively small valuation discount.

- Suppose assets the donor wants to sell would be awkward to be held by a private foundation or would receive a reduced deduction if contributed to the private foundation, but the donor needs to control their sale. The donor could instead use the above LLC mechanism to donate to a donor-advised fund (DAF), and the private foundation could be the adviser if the DAF's procedures so permit. The DAF could not accept the asset to be sold with restrictions on control over the sale of the underlying asset, and the DAF might not

[4781] The ruling reasoned:

> In *Situation 3*, Z transfers to University all of Z's interests in the patent with the restriction that University cannot transfer or license the patent for a period of 3 years after the transfer. Unlike the conditional reversion in Situation 2, the restriction on transfer or license is not a condition that can defeat the transfer. Thus, Z's contribution is deductible under § 170(a), assuming all other applicable requirements of § 170 are satisfied, and subject to the percentage limitations of § 170. See Publication 526, Charitable Contributions (describing other requirements for, and limitations on, the deductibility of charitable contributions). Under § 1.170A-1(c), however, the restriction reduces what would otherwise be the fair market value of the patent, and therefore reduces the amount of Z's charitable contribution. If Z had received a benefit in exchange for the contribution, the value of the benefit would further reduce the amount of Z's charitable contribution. See § 1.170A-1(h); Rev. Rul. 67-246, 1967-2 C.B. 104. See also *Singer Co. v. United States*, 449 F.2d 413, 423-424 (Ct. Cl. 1971).

[4782] See part II.Q.8.e.ii.(a) Unitary Basis, citing Rev. Rul. 84-53.

[4783] See part II.Q.6.d.iii Charitable Deduction Against UBTI, pointing out that a donor-advised fund or supporting organization may generate a deduction against unrelated business income (UBI) by making distributions to a charity in the same calendar year that the entity receives the UBI.

> want the responsibility for deciding when to sell and what the sales terms should be.[4784] Meanwhile, the donor would get the full deduction, subject to any reduction due to the LLC's control mechanism.

Donating an assignee interest and retaining the voting rights might be comparable to Rev. Rul. 81-282[4785] and violate the split-interest prohibition. However, when taxpayers donated all of their interest, which was an interest as a limited partner, but the donees received only an interest as an assignee, the Tax Court[4786] and Fifth Circuit in *McCord* allowed a charitable gift tax deduction for an interest as an assignee.[4787] On the other hand, Judge Swift's concurring opinion in the Tax Court argued that the partial interest prohibition applied to assignee interests. Judge Swift pointed out that the donor transferred the economic rights but not the voting and other noneconomic rights[4788] to charity. The majority and Fifth Circuit did not address the issue, being content with the donor having transferred all of the donor's rights.[4789] Both arguments are correct, but neither pointed out what happened to the donor's voting rights. When a partner transfers all of the partner's interest in a partnership and the transferee is not admitted as a partner, the transferor's voting rights lapse. This lapse then gives others who have the right to vote on those matters a higher proportionate vote. Judge Swift, although pointing out that that the charity did not receive noneconomic rights, did not articulate that the donor's voting rights essentially shifted to the other limited partners. Neither the majority nor the Fifth Circuit addressed this shift; their written opinions did not indicate whether they understood that the shift occurred. Thus, one can point to *McCord* as support for the proposition that one does not need to transfer one's noneconomic rights to a charity to avoid the partial interest prohibition, if one does not retain any noneconomic rights, but the strength of this support is unclear, given the lack of analysis of what happened to the voting rights. To avoid any doubt, one might suggest transferring voting rights as well. On the other hand, in self-dealing letter rulings, the IRS did

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4784 See Fox, "Recent Court Decision in Donor Advised Fund Lawsuit Against Fidelity Investments Charitable Gift Fund Provides Lessons for Sponsors and Donors Alike," *Estate Planning Journal* (6/2021). This case involved a December 2017 donation to Fidelity's DAF, which the donors alleged had promised to give the donors input into the sale of stock that had blockage discount issues. The court held that the donors did not prove their case against Fidelity's DAF. My full sympathy is with Fidelity's DAF. In December 2016, at Fidelity's DAF's recommendation, I used the LLC mechanism described in the text above to help donors control the sale of their interests in a private company and received great service from Fidelity's DAF.

4785 See fn. 4766.

4786 *McCord v. Commissioner*, 120 T.C. 358 (2003) (reviewed opinion).

4787 *Succession of McCord, Jr. v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), allowing the deduction without even mentioning the partial interest rule.

4788 The majority described certain rights:

> Limited partners generally do not participate in the management of the partnership's affairs. However, limited partners do have veto power with respect to certain major decisions, most notably relating to voluntary bankruptcy filings. In addition, if any two of the children are not serving as managing partners, class B limited partners have voting rights with respect to certain large dollar managerial decisions. Limited partners also have access to certain partnership financial information.

4789 See fn. 4756, providing that transferring an undivided interest in all of the donor's rights is an exception to the partial interest rules. In *McCord*, the assigned interests also carried with them the right to sell their interests at fair market value for cash, which sale took place shortly after the transfer. Perhaps this quick liquidation made the court more sympathetic to allowing the charitable deduction?

not comment about the partial interest prohibition when approving the transfer of nonvoting interests in LLCs.[4790]

Finally, suppose neither an income nor an estate tax deduction is needed; rather, the donor is making a gift and does not want the partial interest prohibition to result in gift tax. In that case, consider instead donating to a Code § 501(c)(4) organization. See part II.Q.6.g Gift Tax Exclusion for Gifts to Certain Noncharitable Organizations.

II.Q.6.g. Gift Tax Exclusion for Gifts to Certain Noncharitable Organizations

Code § 2501(a)(6), "Transfers to certain exempt organizations," provides:[4791]

> Paragraph (1) shall not apply to the transfer of money or other property to an organization described in paragraph (4), (5), or (6) of section 501(c) and exempt from tax under section 501(a), for the use of such organization.

Code § 501(c)(4) describes:

> (A) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.
>
> (B) Subparagraph (A) shall not apply to an entity unless no part of the net earnings of such entity inures to the benefit of any private shareholder or individual.

Thus, a person who is charitably inclined who does not need the income tax deduction and would like to make a gift without complying with the charitable income tax deduction requirements may very well be able to achieve his or her goals through a donation to a Code § 501(c)(4) organization.

See Life Cycle of a Social Welfare Organization (irs.gov).

Code § 501(c)(5) refers to "labor, agricultural, or horticultural organizations."

Code § 501(c)(6) refers to:

> Business leagues, chambers of commerce, real-estate boards, boards of trade, or professional football leagues (whether or not administering a pension fund for football players), not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

[4790] See fn 4958 in part II.Q.7.c.ii Private Foundations, Etc. Some of the rulings cautioned that charitable deduction valuation issues may apply.

[4791] Code § 2501(a)(1), "General rule," provides:

> A tax, computed as provided in section 2502, is hereby imposed for each calendar year on the transfer of property by gift during such calendar year by any individual, resident or nonresident.

T.D. 9873 (7/23/2019), which promulgated Reg. § 1.506-1, explains:

> *1. Section 501(c)(4) Organizations*
>
> Section 501(a) of the Code generally provides that an organization described in section 501(c) is exempt from federal income tax. Section 501(c)(4) describes certain civic leagues or organizations operated exclusively for the promotion of social welfare and certain local associations of employees. An organization is described in section 501(c)(4) and exempt from tax under section 501(a) if it satisfies the requirements applicable to such status. Subject to certain exceptions, section 6033, in part, requires organizations exempt from taxation under section 501(a) to file annual information returns or notices, as applicable.
>
> Although an organization may apply to the IRS for recognition that the organization qualifies for tax-exempt status under section 501(c)(4), there is no requirement to do so (except as provided in section 6033(j)(2), which requires organizations that lose tax-exempt status for failure to file required annual information returns or notices and want to regain tax-exempt status to apply to obtain reinstatement of such status). Accordingly, a section 501(c)(4) organization that files annual information returns or notices (Form 990, "Return of Organization Exempt From Income Tax," or, if eligible, Form 990-EZ, "Short Form Return of Organization Exempt From Income Tax," or Form 990-N (e-Postcard)), as required under section 6033, need not seek an IRS determination of its qualification for tax-exempt status in order to be described in and operate as a section 501(c)(4) organization.
>
> *2. The PATH Act*
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> Section 405(a) of the PATH Act added section 506 to the Code, requiring an organization to notify the IRS of its intent to operate as a section 501(c)(4) organization. In addition, section 405(b) and (c) of the PATH Act amended sections 6033(f) and 6652(c), relating to information that section 501(c)(4) organizations may be required to include on their annual information returns and penalties for certain failures by tax-exempt organizations to comply with filing or disclosure requirements, respectively.
>
> Section 506(a) requires a section 501(c)(4) organization, no later than 60 days after the organization is established, to notify the Secretary of the Department of the Treasury (Secretary) that it is operating as a section 501(c)(4) organization (the notification). Section 506(b) provides that the notification must include: (1) The name, address, and taxpayer identification number of the organization; (2) the date on which, and the state under the laws of which, the organization was organized; and (3) a statement of the purpose of the organization. Section 506(c) requires the Secretary to send the organization an acknowledgment of the receipt of its notification within 60 days. Section 506(d) permits the Secretary to extend the 60-day notification period in section 506(a) for reasonable cause. Section 506(e) provides that the Secretary shall impose a reasonable user fee for submission of the notification. Section 506(f) provides that, upon request by an organization, the Secretary may issue a determination with respect to the organization's treatment as a section 501(c)(4) organization and that the organization's request will be treated as an application for exemption from taxation under section 501(a) subject to public inspection under section 6104.[1]

[1] The separate procedure by which an organization may request a determination of tax -exempt status is currently prescribed in Rev. Proc. 2019-5, 2019-1 IRB 230 and will be set forth in successor annual updates of that Revenue Procedure.

In addition, the PATH Act amended section 6033(f) to require a section 501(c)(4) organization submitting the notification to include with its first annual information return after submitting the notification any additional information prescribed by regulation that supports the organization's treatment as a section 501(c)(4) organization.

II.Q.6.h. Donation of Goodwill

Generally, goodwill must be sold at the same time the business is sold. See part II.Q.1.c Personal Goodwill and Covenants Not to Compete.

Suppose taxpayer wishes to donate an S corporation's goodwill to a charitable remainder trust: The CRT cannot hold the goodwill separately while S corporation runs the business; otherwise, prohibited self-dealing would occur. Consider the following:

1. Do a Code § 368(a)(1)(F) reorganization, in which an identical corporation is formed to serve as the parent of the existing corporation, and the existing corporation converts or merges into a single member, disregarded LLC. See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

2. Presumably one is selling only some of the S corporation's assets, because contributing substantially all of the S corporation's assets to the CRT would be a deemed taxable liquidation.[4792] Move the retained assets to a separate LLC or otherwise separate them from the LLC to be donated.

3. Cleanse the LLC to be donated, to avoid the 100% CRT tax on UBTI. Letter Ruling 9340043 is a sample roadmap described in part II.Q.6.d.i UBTI Related to a Partnership or Sole Proprietorship.

4. Donate the LLC to the CRT, keeping a 20-year fixed term interest. See part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax.

5. Complete the sale.

If you can use *Rauenhorst* to avoid step transaction,[4793] steps 3, 4 and 5 may be close together in time, but step 5 cannot be legally binding when you do step 3 or 4, so you may need a very understanding buyer.

II.Q.7. Exiting from or Dividing a Corporation

If selling less than all of a corporation's assets, see part II.Q.7.o Reorganizing to Sell a Business That Is Less Than All of a Corporation's Assets.

Double taxation applies to C corporations: taxation when the corporation earns profits and taxation when it distributes the profits. To encourage corporations to distribute profits (triggering

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[4792] See fn 4971 in part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax.
[4793] See fn 4737 in part II.Q.6.e Assignment of Income on Property Being Sold.

the second level of taxation), penalties are imposed for accumulating excessive profits. Before discussing these concepts, consider strategies to avoid future double taxation.

Although dividends are taxed at the same rates as capital gains, taxation of dividends might be less favorable, in that the recipient of a dividend generally cannot use his or her basis to reduce the gain on sale and would not be able to defer tax (with respect to the amount treated as a dividend) if a note is used in the redemption.[4794] A majority shareholder who waives a dividend that is paid to other shareholders does not recognize income if done for a bona fide business reason but does recognize income if the waiver is primarily to benefit family members.[4795] The IRS will consider a ruling request approving a waiver when the amounts benefitting family members are relatively incidental.[4796] When a subordinated note's value became an issue

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[4794] Code § 301(c)(1) states that the amount distributed as a dividend is ordinary income. Code § 316 generally provides that distributions are taxable as dividends to the extent of the corporation's current and accumulated earnings and profits. However, if and to the extent that a distribution is not a dividend, it is treated more favorably than a sale, in that such distributions first reduce the stock's basis, without any portion of the distribution considered to be a profit, until basis is exhausted. Code § 301(c)(2).

[4795] Rev. Rul. 56-431, holding:

> On the basis of facts in the instant case it is deemed that the benefits to be afforded the taxpayer's relatives by the waiver of his right to share in the dividend payments was the primary purpose for signing the waiver. The alleged business purpose to be served, namely, the payment of a larger dividend to minority stockholders who are key employees to maintain their good will, is merely incidental. No opinion is expressed whether such a purpose might be appropriate in other circumstances. Since the amounts distributed to the minority stockholders do not impair the capital by any greater amount than if distributed pro rata to all stockholders, the waiver is not considered necessary to protect the working capital of the corporation. Thus, the taxpayer's disposition of his power to receive his pro rata share of any dividends declared by the corporation, through effecting payment of such pro rata share to his relatives (including his minor children) as well as to his employees by the signing of a waiver must be considered the realization of income by him to the extent of dividend payments waived.
>
> For example, if the corporation in the instant case declared dividends of $1000 on January 31, 1955, and, in accordance with the waiver previously executed by the majority stockholder, it paid the total of such dividends, pro rata, to the minority stockholders, the taxpayer, or majority stockholder, will be considered to have realized income to the extent of 65 percent of the total dividends paid, or $650, since he owned 65 percent of the capital stock of the corporation. The minority stockholders will be considered to have received, as dividends, only $350.
>
> The above conclusion is not in conflict with Revenue Ruling 45, C. B. 1953-1, 178, which holds that the declaration of a dividend upon minority shares did not result in the receipt of income by the majority stockholder who had waived his right to share in the dividend. That ruling was based upon a factual situation in which no family or direct business relationship existed between the majority and minority stockholders and the arrangement was entered into only for bona fide business reasons, situations which do not exist in the instant case.

[4796] Section 3 of Rev. Proc. 67-14 provides that the IRS will consider a ruling request if all of the following conditions exist:

.01. A bona fide business reason must exist for the proposed waiver of dividends.

.02. The relatives of the stockholder proposing to waive his right to future dividends must not be in a position to receive more than 20 percent of the total dividends distributed to the nonwaiving shareholders. For this purpose the relatives of a waiving stockholder include his brother and sister (whether by the whole or half blood), spouse, ancestors, and lineal descendants, the spouses of his brothers and sisters (whether by the whole or half blood) and the spouses of his lineal descendants.

.03. A ruling issued on a proposed waiver of dividends transaction will clearly indicate that the ruling will no longer be applicable if any change in the stock ownership during the waiver relating to a merger with an unrelated third party, the IRS waived dividend treatment when the note was disposed of in a disproportionate manner.[4797]

Once commonly used strategy is to distribute the profits to owners through wages to owners (subject to immediate income and FICA taxation at individual rates) or through contributions to qualified retirement plans (subject to income taxation upon distribution from the plans).[4798] However, note that a corporation may not deduct unreasonably high compensation. This issue applies primarily when profits come from the sale of goods (rather than services) or from the efforts of non-owners. Generally, a professional should be able to justify compensation based on profits derived directly from the professional's work.

When a shareholder takes money out of a corporation without declaring compensation, the transfer constitutes a distribution unless the shareholder can prove that it was a bona fide loan to the shareholder[4799] or perhaps a repayment of a loan the shareholder made to the corporation.[4800] Payments by the majority shareholder of a corporation may also constitute income to the recipient, notwithstanding the recipient's practically unsupported allegations that the payments were loan repayments.[4801]

Any assets that could appreciate may be held by the owners directly and rented to the corporation. The owners should hold these assets in one or more LLCs.

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period enables nonwaiving relatives to receive more than 20 percent of a dividend, unless the change occurs because of death.

.04. A ruling issued on a proposed waiver of dividends transaction will not be effective for a period longer than three years from the date of the ruling.

.05. A request for a ruling on a proposed waiver of dividends transaction must be submitted to the National Office in accordance with Revenue Procedure 67-1, page 544, this Bulletin.

[4797] Letter Ruling 201636037.

[4798] See part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment.

[4799] *Zang v. Commissioner*, T.C. Memo. 2017-55, which held that the payments constituted income, without specifying the type of income. The court set forth the law:

> Objective factors are considered to determine the parties' intent and whether a bona fide loan occurred, and no single factor is dispositive. See *Welch v. Commissioner*, 204 F.3d 1228, 1230 (9th Cir. 2000), *aff'g* T.C. Memo. 1998-121; *Frierdich v. Commissioner*, 925 F.2d 180, 182 (7th Cir. 1991), *aff'g* T.C. Memo. 1989-393. We examine the following factors to determine whether the additional checks and cash withdrawals that petitioners received were loans:
> (1) the ability of the borrower to repay;
> (2) the existence or nonexistence of a debt instrument;
> (3) security, interest, a fixed repayment debt, and a repayment schedule;
> (4) how the parties' records and conduct reflect the transaction;
> (5) whether the borrower has made repayments;
> (6) whether the lender had demanded repayment;
> (7) the likelihood that the loans were disguised compensation for services; and
> (8) the testimony of the purported borrower and lender.
> *Welch v. Commissioner*, 204 F.3d at 1230; see also *Kaider v. Commissioner*, T.C. Memo. 2011-174.

[4800] See part II.G.20.b When Debt Is Recharacterized as Equity.

[4801] *Dufresne v. Commissioner*, T.C. Memo. 2019-93, citing the factors from *Welch v. Commissioner* in fn 4799. Ironically, the taxpayer and his mother (to whom he had purportedly loaned money) made their living doing psychic readings, must not have been able to see far enough in the future to know to keep better records to satisfy the IRS or to keep her out of bankruptcy.

II.Q.7.a. Corporate Redemption

II.Q.7.a.i. Redemption Compared to Cross-Purchase

The remaining parts of this part II.Q.7.a and part II.Q.7.b Redemptions or Distributions Involving S Corporations describe various issues involved in corporate redemptions.

How might one compare a redemption to a purchase by a new or existing shareholder (a cross-purchase)? One should consider the reliability (or lack thereof) of the corporation as a purchaser compared with a shareholder as a purchaser. A cross-purchase generally avoids the tax issues that involve redemptions. If C corporation stock is involved, one might consider preserving for the buyer the possibility that $10 million or more[4802] of future gain might be excluded from income;[4803] that benefit applies only to stock issued by the corporation, and a redemption that occurs to close to a stock issuance can disqualify the stock issuance.[4804] The special rule for ordinary loss treatment of up to $50,000 on the sale of stock also applies only to stock issued to the holder.[4805]

II.Q.7.a.ii. Hybrid Between Redemption and Cross-Purchase When Selling to New Shareholder or Other Shareholders

Instead of a shareholder selling all of his or her C corporation stock to a buyer, consider selling some of the stock and having the corporation redeem the rest. That way, instead of the buyer having to pay tax on dividends used to buy the stock, the buyer pays tax only on dividends the buyer uses to buy the seller's stock, and corporation completes the rest of the purchase, reducing the corporation's earnings and profits.[4806] This imposes double taxation (the corporation paying tax on its earnings used to buy the seller's stock, and the seller paying capital gain tax) instead of triple taxation (the corporation paying tax on its earnings used to pay

[4802] Or ten times the stock's basis, if greater. Code § 1202(b)(1)(B).
[4803] See part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation.
[4804] See text accompanying fns. 5220-5223 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[4805] See part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244.
[4806] In *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954):

> Prospective buyer did not want to assume the tax liabilities which it was believed were inherent in the accumulated earnings and profits of the corporation. To avoid said profits and earnings as a source of future taxable dividends, buyer purchased part of taxpayer's stock for cash. Three weeks later, after corporate reorganization and corporate action, the corporation redeemed the balance of taxpayer's stock, purchasing the same as treasury stock which absorbed substantially all of the accumulated earnings and surplus of the corporation.

The IRS and lower court did not like this tax-motivated structure. The Sixth Circuit said that taxpayers can use the structure that is most favorable, holding:

> Since the intent of the taxpayer was to bring about a complete liquidation of her holdings and to become separated from all interest in the corporation, the conclusion is inevitable that the distribution of the earnings and profits by the corporation in payment for said stock was not made at such time and in such manner as to make the distribution and cancellation or redemption thereof essentially equivalent to the distribution of a taxable dividend.

The IRS agreed to follow *Zenz* in Rev. Ruls. 54-458 (1939 Code) and 55-745 (1954 Code), which was followed (although in a different context) by Rev. Ruls. 75-447, 77-226, 79-273, 81-186, and 84-114.

a dividend to the buyer, then the buyer paying dividend tax, and the seller paying capital gain tax).[4807]

The redemption reduces the corporation's earnings and profits,[4808] thereby reducing potential dividend treatment and facilitating an S election.[4809] If the corporation does not make an S election, consider whether the buyer should first buy the stock directly from the corporation, which may make the stock eligible for a certain capital gain exclusion,[4810] followed by the seller being redeemed after a waiting period that is generally at least two years.[4811]

This method, however, does not provide the buyer with basis except to the extent that the buyer, rather than the corporation, buys the seller's stock.

II.Q.7.a.iii. Redemption Taxed Either as Sale of Stock or Distribution; Which Is Better When

In a redemption by an entity taxed as a corporation, the seller generally is taxed on the extent to which the redemption proceeds exceed the seller's tax basis.[4812] However, if the seller retains an interest in the corporation, or other family members also retain an interest, the redemption might be considered a distribution rather than a sale of the stock.[4813] In other words, what for state law purposes is a redemption is not necessarily treated as a redemption for income tax purposes.[4814]

A redemption for a promissory note that is recast as a dividend[4815] is immediately taxed; installment sale deferral does not apply – not even to the capital gain portion.[4816]

4807 For triple taxation, see parts II.Q.1.a.i.(b) C Corporation and II.Q.1.a.ii.(b) C Corporation Redemption (California).

4808 See fn. 4904, found in part II.Q.7.b.iv.(b) S Corporation Redemptions Using Life Insurance Proceeds.

4809 The main issue is avoiding possible termination of an S election described in part II.P.3.b.iii Excess Passive Investment Income, which is not difficult to avoid if one is attuned to the issue. See also parts II.P.3.b.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds and II.Q.7.b.iv.(a) S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations.

4810 See part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation.

4811 See the text accompanying fns. 5220–5232 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

4812 Code §§ 302(a), 1001.

4813 Code §§ 302(b)(2)(C) and 302(c) provide that family attribution can cause redemptions to be treated as distributions that might be taxed as dividends rather than as sales.

4814 However, since Code § 302(a) looks to the Code § 317(b) definition of redemption, generally a transaction must be a redemption for state law purposes before it might be considered a redemption for tax purposes.

4815 See fn. 4794 in part II.Q.7 Exiting from or Dividing a Corporation.

4816 Reg. §§ 1.301-1(b), 1.301-1(*l*); *Cox v. Commissioner*, 78 T.C. 1021 (1982); *Brams v. Commissioner*, 734 F.2d 290 (6th Cir. 1984), *aff'g* T.C. Memo. 1983-25. *Cox* held at 1028-1029:

> Section 453(b) requires a sale. Section 301(c)(3)(A) is intended to tax distributions which impair a corporation's capital as capital gains (*Cloutier v. Commissioner*, 24 T.C. 1006, 1013 (1955)). We can see no reason why a taxpayer should be allowed to account for section 301(c)(3)(A) gain differently from income under section 301(c)(1), especially since the applicability of section 301(c)(3)(A) depends, to a large extent, upon the combination of a fortuitous lack of

On the other hand, taxing as a distribution the redemption of S corporation stock might be more favorable than taxing it as the sale of the stock, because generally the former allows basis to apply first to all of the proceeds[4817] and the latter would use only the basis attributable to the block redeemed.

II.Q.7.a.iv. Dividends; Avoiding Dividend Treatment Using Redemptions under Code §§ 302 and 303

The rules are in part II.Q.7.a.iv.(a) Actual Payments.

For when transactions between corporations and shareholders constitute distributions, see part II.Q.7.a.iv.(b) Constructive Dividends.

II.Q.7.a.iv.(a). Actual Payments

The amount of cash (or fair market value of property)[4818] that a C corporation distributes to its shareholders:[4819]

(1) Is included in income to the extent that it is a dividend.

(2) Is applied against the adjusted basis of their stock, to the extent it is not a dividend and basis is available.

(3) Constitutes "gain from the sale or exchange of property" to the extent (1) and (2) do not apply.

"Dividend" means any distribution of property[4820] made by a corporation to its shareholders out of its earnings and profits accumulated after February 28, 1913, or out of its earnings and profits (E&P) of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), the latter without regard to the amount of the E&P at the time the distribution was made.[4821]

> corporate earnings and profits and a small stock basis. We find no intent in section 301(c)(3)(A) to afford shareholders access to a more desirable method of accounting. Section 301(c)(3)(A) merely characterizes the gain as gain from a sale or exchange, it does not provide the sale needed for section 453(b).

[4817] See part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally, especially the text accompanying fns. 4874-4875.

[4818] Code § 301(b)(1). Fair market value is determined as of the date of the distribution. Code § 301(b)(3).

[4819] Code § 301(c).

[4820] Reg. § 1.316-1(a)(1) refers to "any distribution of property as defined in section 317 in the ordinary course of business, even though extraordinary in amount." Code § 317(a) provides:

> For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

However, cases tax as a constructive dividend either the value or the out-of-pocket costs of goods or services a corporation provides to a shareholder in that person's capacity as such. See 764(3d) T.M. IV.F. (detailed discussion); *Federal Tax Coordinator* ¶J-2701 Distribution made for shareholder's benefit in his capacity as a shareholder; Bittker & Eustice, ¶8.06. Constructive Distributions, *Federal Income Taxation of Corporations & Shareholders* (WG&L).

[4821] Code § 316(a).

Although qualified dividends are taxed at the same rate as capital gains,[4822] redemptions have an advantage in that the shareholders may deduct tax basis against redemption proceeds. For stock passing from a decedent, the basis adjustment at death might eliminate any tax on redemption. Also, tax deferral using the installment method is not available if the state law redemption is treated for tax purposes as a dividend.[4823] Furthermore, to the extent that a redemption recharacterized as a distribution is treated as a return of capital (because it exceeds earnings and profits and the excess is not treated as a dividend), presumably the distribution would be a return of basis pro rata, which could create unexpected capital gain if some shares have high basis and others have low basis.[4824]

Code §§ 302 and 303 set forth two methods by which a stock redemption can be qualified to avoid dividend treatment.

Code § 303 provides a way for the estate of a deceased shareholder to obtain cash from a closely held corporation to pay estate taxes and expenses while obtaining the favored tax treatment of an exchange. To qualify for Code § 303, the estate's total stock holdings in the closely held corporation must exceed 35% of the total adjusted gross value of the estate, and the distribution must occur within 90 days after the expiration of the three-year limitations period for the assessment of estate tax set forth in Code § 6501(a) (subject to extension in Tax Court proceedings or if a Code § 6166 election is in place). The amount eligible for Code § 303 redemption cannot exceed the total administration expenses allowable under Code § 2053, including estate taxes and interest.

For amounts exceeding estate taxes and expenses, one of the following four exceptions must apply to qualify as an exchange under § 302:

(a) <u>The redemption is not essentially equivalent to a dividend</u>. This applies on a case-by-case basis, based on whether the redemption results in a "meaningful" reduction in ownership.[4825]

(b) <u>The redemption is substantially disproportionate</u>. A substantially disproportionate redemption is one that decreases the shareholder's voting stock interest below 80% and the shareholder's ownership of outstanding stock below 50% immediately following the redemption. Attribution make this exception difficult to satisfy.[4826]

(c) <u>The redemption is a complete termination of the shareholder's interest</u>. If the shareholder completely terminates his or her interest in the corporation, the redemption may qualify

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[4822] Code § 1(h)(11).
[4823] See Regs. §§ 1.301-1(d)(1)(ii), 1.301-1(h)(2)(i) and 1.301-1(l) and Code § 312(a)(2).
[4824] See part II.Q.7.h.ii Taxation of Shareholders When Corporation Distributes Cash or Other Property, especially the text accompanying fn. 5096.
[4825] *U.S. v. Davis*, 397 U.S. 301 (1970); Rev. Ruls. 75-502, 75-512, and 78-401; in ruling favorably for the taxpayer, Letter Ruling 201918009 also cited Rev. Ruls. 75-502, 76-385, and 77-726 but not 78-401. The transaction should also have a business purpose. See footnote 31 of *H.J. Heinz Company & Subs. v. U.S.*, 99 AFTR 2d 2007-2940, 76 Fed. Cl. 570 (2007).
[4826] Code §§ 302(c)(1), 318. See Harris & Kessler, Constructive Ownership under Section 318, *Business Entities* (WG&L), Mar/Apr 2016.

under Code § 302.[4827] A gift of stock to a family member, followed by a redemption of the donor's remaining stock, qualified as a complete termination.[4828]

(d) The redemption is a partial liquidation distribution. A distribution is a partial liquidation[4829] if:[4830]

(1) it is not essentially equivalent to a dividend (determined at the corporate level rather than the shareholder level);

(2) the distribution is pursuant to a plan and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year;

(3) the distribution is attributable to the distributing corporation's ceasing to conduct, or consists of the assets of, a qualified trade or business which the corporation has actively conducted for the five years immediately prior to the distribution; and

(4) the distributing corporation is actively engaged in the conduct of a qualified trade or business.

However, a buy-sell agreement might convert what appears to be a redemption above into a deemed dividend followed by a deemed cross-purchase. The IRS takes this position if a shareholder has the primary, unconditional obligation to enter into a cross-purchase and the corporation redeems the stock instead.[4831] However, the IRS does not take this position if a shareholder has a mere option to cross-purchase, if a shareholder's purchase obligation is contingent on the corporation not redeeming the stock, if a shareholder has the right to assign the purchase obligation to the corporation, or if the agreement is amended before a shareholder's purchase obligation became unconditional.[4832]

Also, certain Code § 302(d) redemptions and other transactions might be recharacterized if any of the company's stock "is structured so that dividends (as defined in section 316) paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder's investment (as opposed to only a return on the holder's investment)."[4833]

II.Q.7.a.iv.(b). Constructive Dividends

"A constructive dividend occurs when a corporation confers an economic benefit on a shareholder without the expectation of repayment." *Povolny Group, Inc. v. Commissioner*, T.C.

[4827] Reg. §§ 1.302-4, 1.302-4T. When a beneficiary grantor trust owns stock in a corporation, the beneficiary is the owner whose complete termination must be tested. Rev. Rul. 72-471, cited with approval in Rev. Rul. 85-13.
[4828] Letter Ruling 200939011.
[4829] Code § 302(b)(4) provides that redemption treatment applies if the distribution is:
(A) in redemption of stock held by a shareholder who is not a corporation, and
(B) in partial liquidation of the distributing corporation.
[4830] Code § 302(e).
[4831] Rev. Rul. 69-608, Situations 1, 2 and 3.
[4832] Rev. Rul. 69-608, Situations 4, 5, 6 and 7, respectively.
[4833] Reg. § 1.7701(l)-3(b)(2)(i), explaining stock to which Reg. § 1.7701(l)-3 might apply. See Reg. § 1.7701(l)-3(e), Example (3) for a Code § 302(d) redemption that would be recharacterized. Most planning for dividends and earnings & profits (E&P) under Code §§ 312 and 316 is beyond the scope of my materials.

Memo. 2018-37, in which payment to a related corporation was a dividend from the payor to the shareholder, followed by a contribution to capital from the shareholder to the recipient. The case was cited in fn 1161 in part II.G.4.a.ii Bad Debt Loss – Must be Bona Fide Debt and fn. 1839 in part II.G.20.b When Debt Is Recharacterized as Equity. The case reasoned:

> A *constructive* dividend occurs when "a corporation confers an economic benefit on a shareholder without the expectation of repayment." *Magnon v. Commissioner*, 73 T.C. 980, 993-94 (1980). A transfer between related corporations can be a constructive dividend to common shareholders even if those shareholders don't personally receive the funds. See, *e.g.*, *Benson v. Commissioner*, T.C. Memo. 2004-272, 2004 WL 2698858, at *18-*22 (payments for purported royalties and nonexistent services between related entities were constructive dividend), supplemented by T.C. Memo. 2006-55, *aff'd*, 560 F.3d 1133 (9th Cir. 2009); *Shedd*, 2000 WL 1337177, at *6-*7 (advance between shareholder's entities was constructive dividend). That type of transfer is a constructive dividend if the common shareholder has direct or indirect control over the transferred property and the transfer wasn't made for a legitimate business purpose but instead primarily benefited the shareholder. *Shedd*, 2000 WL 1337177, at *6-*7; see also *Stinnett's Pontiac Serv., Inc. v. Commissioner*, 730 F.2d 634, 641 (11th Cir. 1984), *aff'g* T.C. Memo. 1982-314. Povolny had complete control over the transferred funds - he was and is the sole shareholder of PG and Archetone International and he owns 49% of Archetone Limited. And there was no discernible business reason for PG to make the transfer - as we found above, there was no hope of repayment or contemplation of interest. The transfer was undeniably bad for PG, but it was good for Povolny because it reduced his other entities' liabilities. PG's payment of $70,000 of Archetone International's and Archetone Limited's expenses was therefore a constructive dividend to Povolny.

When a corporation performs services for a shareholder without the expectation of repayment, the corporation cannot deduct its costs of performing those services, and that cost constitutes a dividend. *Magnon v. Commissioner*, 73 T.C. 980, 993-94 (1980), holding:

> The provision of services by a corporation has been held to be "property" within the meaning of section 1.317-1, Income Tax Regs. *Loftin & Woodard, Inc. v. United States*, 577 F.2d 1206, 1214 (5th Cir. 1978); *Benes v. Commissioner*, 42 T.C. 358, 379 (1964), *affd*. 355 F.2d 929 (6th Cir. 1966).
>
> Where a corporation confers an economic benefit on a shareholder without the expectation of repayment, that benefit becomes a constructive dividend, taxable to the shareholder, even though neither the corporation nor the shareholder intended a dividend. However, "not every corporate expenditure which incidentally confers economic benefit on a shareholder is a constructive dividend." The crucial test of the existence of a constructive dividend is whether "the distribution was primarily for the benefit of the shareholder". *Loftin & Woodard, Inc. v. United States*, *supra* at 1214; *Crosby v. United States*, 496 F.2d 1384, 1388 (5th Cir. 1974); *Sammons v. Commissioner*, 472 F.2d 449 (5th Cir. 1972), *affg.*, *revg.*, and remanding a Memorandum Opinion of this Court.
>
> In the instant case, Magnon Service performed the electrical contracting services in issue primarily for Magnon's benefit as sole shareholder. All of the properties on which the corporation did work were owned by Magnon either in his own name or with partners. Moreover, there is no evidence in the record that Magnon ever intended that

> Magnon Service would acquire any interest in the properties on which it was working. See *Benes v. Commissioner*, *supra* at 379. Rather, the main purpose for the agreement between the corporation and Magnon, as recorded in the corporation's minutes for December 7, 1970, was to provide the sole shareholder with needed services at a low cost and with loose terms for repayment. Given that Magnon Service's agreements to perform jobs for unrelated customers usually provided for higher profit margins and more definite terms for repayment than did its agreement with Magnon, any business purpose for the corporation entering into the transaction with Magnon would be inadequate to disturb our conclusion that the corporation's services were performed primarily for the sole shareholder's benefit. *Sammons v. Commissioner*, *supra* at 453.
>
> Magnon Service also performed the services herein for Magnon without any expectation of being repaid for them. In *Benes v. Commissioner*, *supra*, we held (42 T.C. at 379) that where a taxpayer-shareholder has a corporation build property on his behalf, the costs incurred constitute a constructive dividend to the shareholder if: (1) He intends the property to be his from the very beginning, and (2) the shareholder has no intention of repaying the corporation either during or upon completion of the construction. Since Magnon apparently intended that the properties on which Magnon Service did work would remain his own from the start, he attempts to escape the result in *Benes* by arguing that he always intended to repay the corporation for its services. Based on the facts herein, however, we conclude that Magnon never intended to repay the corporation either during or upon the completion of its services and that Magnon's receipt of those services therefore constituted dividends to him during the years that the work was performed.

Elaborating on this test, *Palmarini, Inc. v. Commissioner*, T.C. Memo. 2022-119, explained:

> Thus, there is a two-part test to determine a constructive dividend: (1) the expense must be nondeductible to the corporation, and (2) it must represent some economic gain, benefit, or income to the shareholder. *See, e.g.*, *Dobbe v. Commissioner*, T.C. Memo. 2000-330, 80 T.C.M. (CCH) 577, 587, *aff'd*, 61 F. App'x 348 (9th Cir. 2003).

Palmarini, Inc. v. Commissioner, T.C. Memo. 2022-119, held:

> Mr. Palmarini argues that Palmarini Inc. uses his personal rental properties for the business purpose of storing its equipment, and that therefore its payments related to these properties are deductible business expenses of Palmarini Inc. in the nature of rent, rather than a constructive dividend to him. Although we accept that Palmarini Inc. may have made some use of these properties for business purposes, there is no documented rental agreement between Palmarini Inc. and Mr. Palmarini for the corporation's use of the properties, nor are there any recurring payments from which to infer that anything like a rental arrangement existed. Furthermore, these payments by Palmarini Inc. are to third parties, rather than to Mr. Palmarini, and the description lines simply state the address of the property and specify neither the work done nor its business purpose. Palmarini Inc.'s expenses for maintenance and improvements to Mr. Palmarini's personal rental properties represent a constructive dividend to him, see, *e.g.*, *Magnon*, 73 T.C. at 994; and, to the extent set out in the Commissioner's revised examination report and the parties' stipulation of settled issues, Mr. Palmarini may deduct the third parties' expenditures as rental expenses on Schedule E.

> Mr. Palmarini further asserts that Palmarini Inc.'s corporate bylaws provide for paying the cost of medical care and of a vacation for officers and their families. No copy of Palmarini Inc.'s corporate bylaws was produced in these cases; but even if we assume their existence, a corporation's bylaws do not overrule the federal income tax consequences of a corporation's distributions to its shareholders. Financial benefits to be paid to officers have their federal tax consequences even if bylaws authorize those benefits to be paid. Palmarini Inc.'s payment of personal expenses for Mr. Palmarini and his family must be included in his income as a constructive dividend. See, *e.g.*, *Dobbe*, 80 T.C.M. (CCH) at 587-88.

In *Starer v. Commissioner*, T.C. Memo. 2022-124, the shareholder played fast and loose with distributions in a few areas, including this one:

> Respondent determined that petitioners' rent-free use of the home owned by Bayview during the years in issue constituted a constructive dividend from Bayview to petitioners equal to the $24,000 per year fair rental value of the property. It is well settled that a shareholder's use of corporate property can result in a constructive dividend to him measured by the fair market rental value of the property. *Nicholls, North, Buse Co. v. Commissioner*, 56 T.C. 1225, 1240-42 (1971). Petitioners concede to residing in the home during that time without paying rent to Bayview and do not argue against the determination that their residence there constitutes a constructive dividend. Instead, they argue that an 87% reduction should be applied to the stipulated value of the constructive dividend on the basis of their self-serving testimony that they lived in only 13% of the home. We do not find this argument persuasive, and we have no obligation to accept uncorroborated self-serving testimony. *Tokarski v. Commissioner*, 87 T.C. 74, 77 (1986). In addition, petitioners have stipulated the amount of the constructive dividend and Rule 91(e) requires that we bind them to this stipulation absent clearly contrary evidence.[14] See *Jasionowski v. Commissioner*, 66 T.C. 312, 318 (1976) (holding that the Court has discretion not to be bound by the stipulation of facts where clearly contrary evidence is presented at trial). Consequently, we conclude petitioners' rent-free use of the home constitutes a constructive dividend from Bayview to petitioners in the amount stipulated by the parties.
>
> [14] The parties have also stipulated the resulting tax consequences if the Court determined petitioners' rent-free use of the home constitutes a constructive dividend.

A constructive dividend also applies when a corporation overpays shareholders. *Plentywood Drug, Inc. v. Commissioner*, T.C. Memo. 2021-45, analyzed rent a corporation paid to its shareholders. First, it discussed the principles:

> The rules we apply today are well settled. Section 162(a) allows a taxpayer to deduct the "ordinary and necessary" expenses he pays in carrying on a trade or business. The Code specifically lists the rent paid by a business as one of these deductible expenses. Sec. 162(a)(3). But for an expense like rent to be ordinary and necessary, it must also be reasonable in amount. *United States v. Haskel Eng'g & Supply Co.*, 380 F.2d 786, 788 (9th Cir. 1967). Any part of rent that is unreasonable is not ordinary and necessary and thus not deductible. *Velvet Horn, Inc. v. Commissioner*, 41 T.C.M. (CCH) 1445, 1449 (1981).

The Commissioner does not often question the reasonableness of a rent agreed to by parties at arm's length. But he does sometimes look closely to the fairness of rent charged when landlord and tenant might not have an incentive to drive a hard bargain:

> When there is a close relationship between lessor and lessee and in addition there is no arm's length dealing between them, an inquiry into what constitutes reasonable rental is necessary to determine whether the sum paid is in excess of what the lessee would have been required to pay had he dealt at arm's length with a stranger…

Place v. Commissioner, 17 T.C. 199, 203 (1951), *aff'd*, 199 F.2d 373 (6th Cir. 1952); see also *Safway Steel Scaffolds Co. of Ga. v. United States* 590 F.2d 1360, 1362 (5th Cir. 1979). The Commissioner sometimes suspects that a corporation might call a payment to its shareholders something like rent, which is deductible, when the economic reality is that it's a distribution of profits. If his suspicion turns out to be true, the seemingly deductible expense is actually a nondeductible dividend. Tax law calls such a dividend a "constructive" dividend because the corporation itself doesn't call it that on its books. See *Rosser v. Commissioner*, 99 T.C.M. (CCH) 1035, 1039 (2010); *Benson v. Commissioner*, 88 T.C.M. (CCH) 520, 534 (2004). Shareholders have to include constructive dividends in their taxable income under section 61(a)(7).[7] These kinds of cases are disputes about value, and as in any valuation dispute we may use testimony from experts, see *Harmon City, Inc. v. United States*, 733 F.2d 1381, 1383-84 (10th Cir. 1984), and may look at all the circumstances of the case and the entire history of transactions between the parties, *Safway Steel Scaffolds*, 590 F.2d at 1362.

[7] Plentywood Drug contends that the Commissioner may not recharacterize the rent that it pays as qualified dividends under section 482. But the Commissioner did not rely on section 482 to reclassify the rent. Section 482 caselaw is not relevant here. Plentywood Drug contends that the Commissioner may not recharacterize the rent that it pays as qualified dividends under section 482. But the Commissioner did not rely on section 482 to reclassify the rent. Section 482 caselaw is not relevant here.

Plentywood Drug, Inc. v. Commissioner, T.C. Memo. 2021-45, determined that the rent paid was excessive:

> A fair market rent is one at which "the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Sec. 1.170A-1(c)(2), Income Tax Regs. The parties in these cases quickly realized that finding comparable properties in a town of 1,700 people in frontier Montana and then using them to come up with a fair market rent would be difficult. One problem right out of the chute is that Montana is a nondisclosure state. This means that real-estate data such as sales prices that appraisers can typically find in other states is legally confidential and simply not available. This issue is magnified in a town the size of Plentywood, which already has a limited number of even potentially comparable buildings. We heard entirely credible testimony that Montanans - perhaps especially Montanans in small communities - don't commonly share details of their financial lives very readily with strangers. The Commissioner's expert was particularly credible in his statement that when he tried to find information in Plentywood he did not identify himself as an IRS agent.

The court evaluated the competing experts' views and determined that rent paid in two years exceeded fair rent by approximately 12% but declined to impose penalties, given the difficulty the valuation entailed.

II.Q.7.a.v. Redemptions and Alternative Minimum Tax

Before 2017 tax reform, life insurance proceeds received by a C corporation may have been taxed under the corporate alternative minimum tax (AMT) because insurance proceeds increase a corporation's book earnings, but are not included in the taxable income of the corporation.[4834] AMT did not apply to corporations whose average annual gross receipts did not exceed a threshold[4835] or to S corporations.[4836]

That version of corporate AMT has been repealed. However, a corporation with more than $1 billion of annual income is subject to corporate AMT. Notice 2023-64 imposes more unfavorable rules regarding book earnings than the old corporate AMT did, but of curse only to a selected few C corporations.

II.Q.7.a.vi. Redemptions and Accumulated Earnings Tax

Generally, a C corporation that accumulates funds could also be subject to the 20% accumulated earnings tax.[4837] The tax applies to every corporation "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed,"[4838] except:[4839]

(1) a personal holding company (as defined in section 542),

(2) a corporation exempt from tax under subchapter F (section 501 and following), or

(3) a passive foreign investment company (as defined in section 1297).

Thus, it complements the personal holding company tax, which is also designed to force C corporations to declare dividends. See part II.A.1.e Personal Holding Company Tax.

The tax is on "accumulated taxable income."[4840] "Accumulated taxable income" means the adjusted taxable income,[4841] minus the sum of the dividends paid deduction[4842] and the accumulated earnings credit.[4843]

[4834] Code § 56(g).
[4835] Code § 55(e)(1).
[4836] Code § 56(g)(6).
[4837] Code § 531.
[4838] Code § § 532(a).
[4839] Code § § 532(b).
[4840] Code § 531.
[4841] Code § 535(b) adjusts taxable income, including to deduct federal income and certain other taxes, deduct charitable contributions with modifications, disallow the dividends-received deductions, allow capital losses subject to modifications, and deduct U.S.-source capital gains.
[4842] Code § 561.
[4843] Code § 535(b).

The accumulated earnings credit works as follows:

- "If the corporation is a mere holding or investment company, the accumulated earnings credit is the amount (if any) by which $250,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year."[4844]

- Otherwise, the accumulated earnings credit is equal to such part of the earnings and profits for the taxable year as are retained for the business' reasonable needs, minus a certain deduction relating to U.S.-source capital gains.[4845] The dividends paid deduction[4846] reduces retained earnings and profits.[4847] The accumulated earnings credit for such a corporation is no less than the amount by which $250,000 exceeds the corporation's accumulated earnings and profits at the close of the preceding taxable year.[4848] The $250,000 amount is reduced to $150,000 for a corporation the principal function of which is the performance of services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.[4849]

Let's examine how the $250,000 credit would work for a mere holding or investment company. Suppose the accumulated earnings and profits at the close of the preceding taxable year were $250,000 or more. The credit would be zero, because $250,000 did not exceed the accumulated earnings and profits at the close of the preceding taxable year. Suppose the accumulated earnings and profits at the close of the preceding taxable year were $200,000. The credit would be $50,000, leaving $200,000 subject to the tax. the sweet spot would seem to be $125,000 accumulated earnings and profits at the close of the preceding taxable year, where a credit of $125,000 ($250,000 minus $125,000) would offset the $125,000 accumulated earnings and profits at the close of the preceding taxable year. Of course, that assumes that the corporation is not a personal holding company, which is exempt from the accumulated earnings tax.[4850]

Earnings and profits of a corporation accumulating beyond the business' reasonable needs is determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence proves otherwise.[4851] A corporation being a mere holding or investment company is prima facie evidence of the purpose to avoid income tax with respect to shareholders.[4852] If the corporation does not the liquidity to pay a cash distribution, it should consider declaring a Code § 565 consent dividend,[4853] being extra careful about the consent dividend if a trust that makes charitable contributions is a shareholder.[4854]

[4844] Code § 535(c)(3).
[4845] Code § 535(c)(1).
[4846] Code § 561.
[4847] Code § 535(c)(1).
[4848] Code § 535(c)(2)(A).
[4849] Code § 535(c)(2)(B).
[4850] See fn 4839 and part II.A.1.e Personal Holding Company Tax.
[4851] Code § 533(a).
[4852] Code § 533(a).
[4853] CCA 201653017 asserted accumulated earnings tax on a holding company and would not accept lack of liquidity as an excuse, pointing to the consent dividend procedure and relying on the discussion of that procedure's purpose in TAM 9124001.
[4854] See part II.Q.7.c.i.(b) Business Income Limiting Trust Income Tax Deduction, including the paragraph accompanying fn. 4917.

However, reasonable business needs include the business' reasonably anticipated needs, funding a redemption to pay estate tax or expenses of estate administration, or is being used to fund certain redemptions of charitable shareholders.[4855] Consider documenting the business purposes for accumulating earnings in annual meeting minutes. If the earnings get too high and cannot be reduced through high but reasonable compensation (especially qualified retirement plans) or rent, consider making an S election.[4856]

II.Q.7.a.vii. Corporate Liquidation

When a corporation liquidates completely:

- Generally, the liquidating corporation recognizes gain or loss on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value.[4857] Code § 337 (liquidation of an 80%-owned corporate subsidiary) and other provisions of Code § 336 provide exceptions. The entire gain (not just depreciation recapture) from the deemed sale of any depreciable or amortizable property may be taxed as ordinary income (which, in addition to having consequences to S corporation owners, can be an issue to C corporations that have capital losses that could otherwise be offset).[4858]

- The shareholder's proceeds are considered to be proceeds from selling the shareholder's stock.[4859] Such proceeds are reduced by any liabilities the shareholders assume.[4860] Subject to a particular exception, dividend taxation does not apply to the deemed sale proceeds.[4861]

Rather than applying installment sale rules to the gain on sale, basis is applied to each receipt until basis runs out, and then gain is recognized for proceeds in excess of basis.[4862]

"As a general rule, losses resulting from a complete liquidation will be recognized only after the corporation has made its final distribution."[4863] However, if at least 99% of the proceeds have been paid to the shareholders, they can recognize loss on the liquidation at that time.[4864] Furthermore, "certain exceptions to the general rule have been recognized by the courts where the stock is shown to have been worthless prior to complete liquidation, such as, for example, where the corporation's liabilities exceeded its assets,"[4865] or "where the losses are so

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4855 Code § 537(a)(1), (2).
4856 Although S corporations cannot have excessive income from investments, that prohibition is easy to avoid using a modest amount of oil and gas investments. See part II.P.3.b.iii Excess Passive Investment Income, especially fn. 3954.
4857 Code § 336(a).
4858 See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).
4859 Code § 331.
4860 Rev. Rul. 59-228.
4861 Code § 331(b).
4862 Rev. Rul. 85-48, amplifying Rev. Rul. 68-348. The proceeds are applied separately to each allocable block of stock. For allocating proceeds to more than one class of stock, see Rev. Rul. 79-10.
4863 *Schmidt v. Commissioner*, 55 T.C. 335, 340 (1970), citing *Dresser v. United States*, 55 F.2d 499, 511-512 (Ct. Cl. 1932), *certiorari denied* 287 U.S. 635 (1932); *Turner Construction Co. v. United States*, 364 F.2d 525 (2nd Cir. 1966); and Rev. Rul. 68-348.
4864 Rev. Rul. 69-334.
4865 *Schmidt v. Commissioner*, 55 T.C. 335, 340-341 (1970), citing *Dresser v. United States,* 55 F.2d 499, 512 (Ct. Cl. 1932), *certiorari denied* 287 U.S. 635 (1932)*; Industrial Rayon Corp. v. Commissioner*,

reasonably certain in fact and ascertainable in amount as to justify their deductions before they were absolutely realized."[4866]

Suppose a corporation transfers assets to a trust for the benefit of the shareholders to take of post-liquidation winding-up issues, such as contingent liabilities. In such a case, the shareholders are considered the "owners" of the trust under the grantor trust rules.[4867] If in a subsequent year, the shareholders or the trust discharge a contingent liability of the corporation, such discharge will give rise to a capital loss in the year of discharge.[4868]

One might decide that the above constitutes substantial authority for taking the following position:

1. When shareholders liquidate a corporate at a loss and some of the liquidating proceeds are escrowed to cover contingent liabilities, the loss is recognized at the time the proceeds are escrowed based on the amount of the escrow.

2. Any payments from the escrow for contingent liabilities are recognized as capital losses when paid. Any amounts escrowed for known liabilities would constitute liabilities assumed, reducing the net sale proceeds and causing or increasing the loss.

It has been suggested to me that the IRS might take a rigid position that losses are not allowed until all contingencies are finally resolved and that the above position is stronger when a liquidating trust is used rather than an escrow account. However, the language quoted in the analysis persuades me enough to take the deduction as described above.

II.Q.7.a.viii. Code § 318 Family Attribution under Subchapter C

Code § 318(a), "General rule," provides that, for purposes of those provisions of Subchapter C ("Corporate Distributions and Adjustments," which is Code §§ 301-386) to which the rules contained in Code § 318 are expressly made applicable:

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94 F.2d 383 (6th Cir. 1938); *Gowen v. Commissioner,* 65 F.2d 923 (6th Cir. 1933), *affirming* 24 B.T.A. 1028, *certiorari denied* 290 U.S. 687 (1933); *Weintraub v. United States,* 26 A.F.T.R. 1183 (E.D. Pa. 1939).

[4866] *Schmidt v. Commissioner*, 55 T.C. 335, 341 (1970), citing *Lucas v. American Code Co.*, 280 U.S. 445 (1930); *Commissioner v. Winthrop*, 98 F.2d 74 (2nd Cir. 1938), *affirming* 36 B.T.A. 314 (1937), *acq.* 1940-1 C.B. 5. Further discussing *Winthrop*, *Schmidt* stated:

> The *Winthrop* case was held to be controlling in *Palmer v. United States*, an unreported case (D. Conn. 1958, 1 A.F.T.R. 2d 863, 58-1 U.S.T.C. par. 9288). In that case, a corporation contracted to sell all of its assets, except cash, to another corporation and adopted a resolution to liquidate and dissolve. The purchase price was paid, 70 percent in cash and 30 percent in notes secured by a first mortgage on the property sold. The District Court held that the taxpayer sustained a loss in 1952, the year of the sale, since there was no uncertainty as to the amount of cash and the notes, secured by the mortgage, could reasonably be valued at par.

[4867] Rev. Rul. 72-137. Rev. Proc. 82-58 which specifies the conditions that must be present before the IRS will consider issuing advance rulings whether a liquidating trust is treated as such or as a business entity under Reg. § 301.7701-4, and Rev. Proc. 91-15 provides a checklist that must accompany all such requests. For rules governing liquidating trusts generally, see part II.D.4.b Liquidating Trusts. For grantor trusts generally, see part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

[4868] Rev. Rul. 72-137.

(1) *Members of family*.

(A) *In general*. An individual shall be considered as owning the stock owned, directly or indirectly, by or for—

(i) his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and

(ii) his children, grandchildren, and parents.

(B) *Effect of adoption*. For purposes of subparagraph (A)(ii), a legally adopted child of an individual shall be treated as a child of such individual by blood.

(2) *Attribution from partnerships, estates, trusts, and corporations*.

(A) *From partnerships and estates*. Stock owned, directly or indirectly, by or for a partnership or estate shall be considered as owned proportionately by its partners or beneficiaries.

(B) *From trusts*.

(i) Stock owned, directly or indirectly, by or for a trust (other than an employees' trust described in section 401(a) which is exempt from tax under section 501(a)) shall be considered as owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust.

(ii) Stock owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners) shall be considered as owned by such person.

(C) *From corporations*. If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation.

(3) *Attribution to partnerships, estates, trusts, and corporations*.

(A) *To partnerships and estates*. Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as owned by the partnership or estate.

(B) *To trusts*.

(i) Stock owned directly or indirectly, by or for a beneficiary of a trust (other than an employees' trust described in section 401(a) which is exempt from tax under section 501(a)) shall be considered as owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest. For purposes of this clause, a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is 5 percent or less of the value of the trust property.

(ii) Stock owned, directly or indirectly, by or for a person who is considered the owner of any portion of a trust under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners) shall be considered as owned by the trust.

(C) *To corporations*. If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person.

(4) *Options*. If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

(5) *Operating rules*.

(A) *In general*. Except as provided in subparagraphs (B)and (C), stock constructively owned by a person by reason of the application of paragraph (1), (2), (3), or (4), shall, for purposes of applying paragraphs (1), (2), (3), and (4), be considered as actually owned by such person.

(B) *Members of family*. Stock constructively owned by an individual by reason of the application of paragraph (1) shall not be considered as owned by him for purposes of again applying paragraph (1) in order to make another the constructive owner of such stock.

(C) *Partnerships, estates, trusts, and corporations*. Stock constructively owned by a partnership, estate, trust, or corporation by reason of the application of paragraph (3) shall not be considered as owned by it for purposes of applying paragraph (2) in order to make another the constructive owner of such stock.

(D) *Option rule in lieu of family rule*. For purposes of this paragraph, if stock may be considered as owned by an individual under paragraph (1) or (4), it shall be considered as owned by him under paragraph (4).

(E) *S Corporation treated as partnership*. For purposes of this subsection —

(i) an S corporation shall be treated as a partnership, and

(ii) any shareholder of the S corporation shall be treated as a partner of such partnership.

The preceding sentence shall not apply for purposes of determining whether stock in the S corporation is constructively owned by any person.

Code § 318(b) refers to provisions applying Code § 318.

See Harris & Kessler, "Constructive Ownership under Section 318," *Business Entities* (WG&L), Mar/Apr 2016.

Note that Code § 318(a)(2)(B)(ii) expressly recognizes the deemed owner of the trust under the grantor trust rules as an owner of the trust's stock.[4869] Letter Rulings have applied this provision for purposes of avoiding a deemed transfer that might have limited net operating losses under Code § 382,[4870] for purposes of determining whether a redemption constituted a dividend instead of a sale under Code § 302,[4871] or certain tests relating to a real estate investment trust (REIT) under Code § 856.[4872]

II.Q.7.b. Redemptions or Distributions Involving S Corporations

II.Q.7.b.i. Redemptions or Distributions Involving S corporations - Generally

An S corporation shareholder's taxation depends on whether the corporation has any accumulated earnings and profits ("E&P") from any part of its prior existence as a C corporation.[4873]

When reviewing this part II.Q.7.b.i, see parts:

- II.Q.7.b.i.(a) IRS View of Estimating Accumulated Earnings & Profits, and
- II.Q.7.b.i.(b) IRS View of Taxing Distributions When S Corporation Has Accumulated Earnings & Profits.

Code § 1368(a), "General rule," provides:

> A distribution of property made by an S corporation with respect to its stock to which (but for this subsection) section 301(c) would apply shall be treated in the manner provided in subsection (b) or (c), whichever applies.

Code § 1368(b), "S corporation having no earnings and profits, provides:

> In the case of a distribution described in subsection (a) by an S corporation which has no accumulated earnings and profits -
>
> (1) *Amount applied against basis*. The distribution shall not be included in gross income to the extent that it does not exceed the adjusted basis of the stock.

[4869] See part III.B.2.d.i.(a) General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation; fn 6529.
[4870] Letter Ruling 199918051.
[4871] Code § 302 is described in part II.Q.7.a.iii Redemption Taxed Either as Sale of Stock or Distribution; Which Is Better When. Code § 318 is applied in Letter Rulings 9035038, 9224036, 9810020, 201328025, and 201805011.
[4872] Letter Ruling 200132008.
[4873] For how E&P affects taxation of distributions from a C corporation, see fn 4821 in part II.Q.7.a.iv Dividends; Avoiding Dividend Treatment Using Redemptions under Code §§ 302 and 303.

(2) *Amount in excess of basis*. If the amount of the distribution exceeds the adjusted basis of the stock, such excess shall be treated as gain from the sale or exchange of property.

Code § 1368(c), "S corporation having earnings and profits, provides:

> In the case of a distribution described in subsection (a) by an S corporation which has accumulated earnings and profits -
>
> (1) *Accumulated adjustments account*. That portion of the distribution which does not exceed the accumulated adjustments account shall be treated in the manner provided by subsection (b).
>
> (2) *Dividend*. That portion of the distribution which remains after the application of paragraph (1) shall be treated as a dividend to the extent it does not exceed the accumulated earnings and profits of the S corporation.
>
> (3) *Treatment of remainder*. Any portion of the distribution remaining after the application of paragraph (2) of this subsection shall be treated in the manner provided by subsection (b).
>
> Except to the extent provided in regulations, if the distributions during the taxable year exceed the amount in the accumulated adjustments account at the close of the taxable year, for purposes of this subsection , the balance of such account shall be allocated among such distributions in proportion to their respective sizes.

Thus, if the corporation has an S election in place, then taxation as a distribution generally is favorable, in that distributions generally reduce basis,[4874] without any part of the distribution being treated as profit on the sale of stock.[4875] Redemptions might very well be taxed as distributions,[4876] so long as they are not partial liquidations.[4877] This can help when a corporation wants to make a distribution to a QSST without the QSST having to pay the beneficiary.[4878]

The accumulated adjustments account (AAA) is an account of the S corporation and is not apportioned among shareholders.[4879] AAA is increased for the taxable year of the corporation by the sum of the following items with respect to the corporation for the taxable year:[4880]

[4874] Note, however, that distributions from a Qualified Subchapter S Subsidiary to its parent are ignored. See Reg. § 1.1361-4(a)(1)(ii), the principles of which were adopted in Reg. § 1.1361-5(a)(4), Example (4).
[4875] See Rev. Rul. 95-14. However, life insurance and other nontaxable income will increase stock basis but will not increase the accumulated adjustments account (AAA). Code § 1368(e)(1). Similarly, premiums paid on life insurance owned by the S corporation do not reduce AAA. Rev. Rul. 2008-42. If the S corporation has prior C corporation earnings and profits, then a distribution in excess of AAA will constitute a taxable dividend rather than merely being applied against the basis acquired by that life insurance or other nontaxable income. Code §§ 1368(c)(2), 301(c).
[4876] See part II.Q.7.a.iv Dividends; Avoiding Dividend Treatment Using Redemptions under Code §§ 302 and 303.
[4877] See fns. 4829-4830 and accompanying text.
[4878] See part III.A.3.e.i.(a) QSSTs Generally.
[4879] Reg. § 1.1368-2(a)(1).
[4880] Reg. § 1.1368-2(a)(2).

(i) The items of income described in section 1366(a)(1)(A) other than income that is exempt from tax;

(ii) Any nonseparately computed income determined under section 1366(a)(1)(B); and

(iii) The excess of the deductions for depletion over the basis of property subject to depletion unless the property is an oil or gas property the basis of which has been allocated to shareholders under section 613A(c)(11).

AAA is decreased for the taxable year of the corporation by the sum of the following items with respect to the corporation for the taxable year:[4881]

(A) The items of loss or deduction described in section 1366(a)(1)(A);

(B) Any nonseparately computed loss determined under section 1366(a)(1)(B);

(C) Any expense of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account, other than -

(1) Federal taxes attributable to any taxable year in which the corporation was a C corporation; and

(2) Expenses related to income that is exempt from tax; and

(D) The sum of the shareholders' deductions for depletion for any oil or gas property held by the corporation described in section 1367(a)(2)(E).

The above reductions may decrease AAA below zero.[4882] Distributions under Code § 1368(b) or (c)(1) reduce AAA, but not below zero.[4883]

In corporations with accumulated C corporation earnings and profits, consider electing to treat the distribution first as a dividend coming from C corporation earnings and profits (E&P),[4884] if the taxation is comparable, to try to cleanse the S corporation of the E&P taint.[4885]

[4881] Reg. § 1.1368-2(a)(3)(i).

[4882] Reg. § 1.1368-2(a)(3)(ii), which further provides:

> The AAA is decreased by noncapital, nondeductible expenses under paragraph (a)(3)(i)(C) of this section even though a portion of the noncapital, nondeductible expenses is not taken into account by a shareholder under § 1.1367-1(g) (relating to the elective ordering rule). The AAA is also decreased by the entire amount of any loss or deduction even though a portion of the loss or deduction is not taken into account by a shareholder under section 1366(d)(1) or is otherwise not currently deductible under the Internal Revenue Code. However, in any subsequent taxable year in which the loss, deduction, or noncapital, nondeductible expense is treated as incurred by the corporation with respect to the shareholder under section 1366(d)(2) or § 1.1367-1(g) (or in which the loss or deduction is otherwise allowed to the shareholder), no further adjustment is made to the AAA.

[4883] Reg. § 1.1368-2(a)(3)(iii).

[4884] Code § 1368(e)(3). See part II.P.3.b Conversion from C Corporation to S Corporation, for special considerations involving S corporations that used to be C corporations.

[4885] In addition to E&P causing taxation of distributions, E&P can generate a tax or even terminate the S election if the corporation has too much "passive" income. See part II.P.3.b.iii Excess Passive Investment Income.

In *Sarvak v. Commissioner*, T.C. Memo. 2018-68, a taxpayer who received an excess distribution argued that applicable state law required him to return the distribution, converting the excess distribution into a debt he owed the corporation.[4886] The court rejected his argument. Certainly a properly advised taxpayer could borrow using a bona fide loan, and I consider this case a warning that taxpayers who skirt near the edge on distributions have appropriate documentation to support any borrowing they purport to have made.

See also part II.Q.7.a.vii Corporate Liquidation. Any activity for the year that affects basis is applied in determining the basis of the liquidated stock.[4887]

For the termination of the S election wiping out AAA, see part II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation.

For the effect of a transfer on the allocation of income reported on the involved shareholders' K-1s, see part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation, within part III.B.2.j Tax Allocations upon Change of Interest.

II.Q.7.b.i.(a). IRS View of Estimating Accumulated Earnings & Profits

This part II.Q.7.b.i.(a) describes the view set forth in the IRS' LB&I Concept Unit, "General Overview of Distributions and Accumulated Earnings & Profits," Document Control Number (DCN) SCO-C-009 (6/18/2020), which is referred to in this part as "the resource."

The resource explains generally how to estimate accumulated earnings & profits (AE&P):

> Neither the Code nor the Treasury regulations define earnings and profits (E&P) but for purposes of this practice unit, E&P and AE&P are synonymous.
>
> AE&P starts with taxable income. It is increased or decreased by the items described in IRC 312 and the regulations (money, principal amount of corporate debt, and the adjusted basis of other property distributed by the corporation). Generally, there is little difference between the AE&P of a C corporation and the accumulated retained earnings of that C corporation. As a result, a C corporation's retained earnings are sometimes used as an estimate of its AE&P….
>
> Before continuing the analysis, determine whether the tax return is reliable by reconciling the corporation's balance sheet and Schedule M-2. Complete both worksheets in the "Reconciliation" Excel workbook.
>
> The workbook should be prepared for the year under examination. But since the taxability of Adjustments Account, Shareholders' distributions is cumulative over the life of the S corporation, the examiner may want to prepare the worksheet for multiple years. If there is a difference between the balance sheet and Schedule M-2, ask the taxpayer to explain. Generally, there are three possible explanations:
>
> - The numbers on the balance sheet are incorrect and cannot be relied upon.

[4886] His argument was a bit more confused and convoluted than that, but that ultimately was the essence.
[4887] Letter Ruling 200106009.

- An entry was made directly to "Retained Earnings" thereby skipping the income statement and tax return. Examine all such entries to determine if taxable income is under-reported.

- The distribution sections of the Schedule K and Schedule M-2 are incomplete or incorrect.

- The above analysis of the reconciliation workbook should detect if Schedule K and Schedule M-2 are incorrect. If no entries were made directly to the retained earnings other than actual distributions, then this analysis yields the distribution amount. Always reconcile any differences.

The resource mentions IRM 4.10.3.9.4.23 as helpful in implementing the above. Then it explains how to discern AE&P from 2018 Form 1120S:

> There are several ways to determine if an S corporation has AE&P. An S corporation reports dividend distributions on Form 1120S, Schedule K, line 17c and non-dividend distributions on Form 1120S, Schedule K, line 16d. If the S corporation reports a dividend distribution on line 17c or on Schedule M-2, column (c), then it's reporting it has AE&P….
>
> Per the Instructions for Form 1120S, the taxpayer may estimate the AE&P amount based on retained earnings of the last year of the C corporation. If an amount is on Schedule M-2, line 1(c), ask how the amount was determined and request documentation to support the computation.
>
> **DECISION POINT**: If there is a dividend distribution reported on Form 1120S, Schedule K, line 17c, or AE&P amount reported on Form 1120S, Schedule M-2, then the S corporation has AE&P. Use this Practice Unit to calculate the AE&P. Next, use the Distributions with AE&P Practice Unit to calculate how much of the distribution is a dividend.
>
> **CAUTION**: If Form 1120S, Schedule M-2 is blank, don't automatically assume the S corporation does not have AE&P. S corporations sometimes fail to report AE&P on the return.
>
> If the return does not report a dividend distribution or AE&P on Schedule M-2, then gather additional facts to determine if AE&P exists. Since an S corporation does not accumulate AE&P once it becomes an S corporation, determine how such AE&P was acquired.
>
> An S corporation can accumulate or acquire AE&P in the following situations:
>
> 1. The S corporation has AE&P from years before the S election was made and it reported in those prior years as a C corporation.
>
> 2. The S corporation merges with a C corporation that has AE&P and the S corporation is the surviving corporation.

3. A wholly owned C corporation that has AE&P liquidates tax-free into the S corporation. The most common scenario is when an S corporation makes a QSub election for its wholly owned C corporation.

The resource then explains how to identify if one of these situations caused the S corporation to accumulate or acquire AE&P:

> <u>The S Corporation Has AE&P from Years When It Reported as a C Corporation</u>
>
> Look at page 1 of the Form 1120S. If the S corporation effective date (Box A) is later than the incorporation date (Box E), the S corporation may have AE&P from when it reported as a C corporation. However, the C corporation could have operated at a loss, resulting in no net AE&P.
>
> <u>The S Corporation Merges With a C corporation That Has AE&P and the S Corporation Is the Surviving Corporation</u>
>
> A tax-free merger of a C corporation into an S corporation results in the AE&P of the C corporation being carried over to the surviving S corporation. The balance sheet of the C corporation is added to the balance sheet of the S corporation ….
>
> The S Corporation Merges With a C corporation That Has AE&P and the S Corporation Is the Surviving Corporation In a tax-free merger, the S election date reported on Form 1120S, Page 1, Box A is the same as the date incorporated reported on Form 1120S, Page 1, Box E. Changes in commonly controlled entities on yK1 from year to year can also be used to identify merged entities. If there are indications that a merger took place, interview an officer or shareholder with knowledge of the company's history, capital structure, and operations to identify such merger transactions.
>
> <u>A wholly Owned C Corporation That Has AE&P Liquidates Tax-free into the S Corporation</u>
>
> A common scenario of a tax-free liquidation is when an S corporation makes a qualified subchapter S (QSub) election for its wholly owned C corporation. If a valid QSub election is filed for the C corporation, then the C corporation is deemed to liquidate into the S corporation and treated as its division at the close of the day before the QSub election is effective. The liquidation of a corporation into the parent is generally a tax-free liquidation where the S corporation takes a carryover basis in the QSub's assets.
>
> A significant difference between the retained earnings and the Accumulated Adjustment Account (AAA) is an indication of AE&P. Interview an officer or shareholder with knowledge of the company's history, capital structure, and operations to identify such liquidation transactions. Consider requesting IDRS information to identify QSub elections. yK1 can also be used to identify Qsubs. The S election and date incorporated may be the same.

The resource mentions IRM 4.10.3 as helpful for the above. Then it continues:

> **DECISION POINT**: Determine the amount of AE&P if at least one of the three events exists:

- The S corporation has AE&P from previous C corporation years,
- The S corporation merged with a C corporation with AE&P, or
- A C corporation with AE&P liquidates tax-free into the S corporation.

If not, then you should analyze distributions without AE&P. See the Taxability of Distributions Not From Accumulated Earnings & Profits Practice Unit for more information.

CAUTION: If there are no identifiable corporate events in which AE&P may have been accumulated or acquired, but there is a significant unexplained difference in beginning retained earnings and beginning AAA, request that the taxpayer reconcile the two amounts, as there may be another issue.

Determining the Amount of AE&P

There are simple ways to estimate an S corporation's amount of AE&P:

1. Use the amount reported on Form 1120S, Schedule B, line 9.
2. Obtain a copy of the entity's last C corporation return, just before it made its S election, and use the amount reported as retained earnings.
3. Using Form 1120S, take the difference between Beginning Retained Earnings (Schedule L, line 24b) less Beginning AAA (Schedule M-2, line 1a) less Beginning OAA (Schedule M2, line 1d) (RE>AAA+OAA)

Once the estimated amount of AE&P is determined, adjust as discussed below.

CAUTION: The return available closest in time to the AE&P acquisition event identified should be used for the most accurate estimate of AE&P.

CONSULTATION: If none of the above estimates are viable, then you should contact the Corporate Distributions & Adjustments Practice Network for guidance on the actual computation of AE&P.

Adjustments to AE&P – General Rule

When a C corporation elects S status, AE&P is frozen at the start of the first S corporation year and can only be reduced by the following:

- Distributions treated as dividends;
- Payment of tax by the S corporation for the recapture of investment tax credits claimed during a C corporation year (rare); or
- Certain redemptions, liquidations, reorganizations, and divisions.

If a C corporation is audited after it converts to an S corporation, and additional taxable income is determined, the additional taxable income will increase the corporation's

AE&P while the payment of the tax will decrease the AE&P. Any resulting tax paid during an S corporation year will not affect AAA.

The resource mentions Code §§ 1371 and 1379(c) as helpful for the above. Then it continues:

Adjustments to AE&P – Unreported Dividends

AE&P is reduced by reported dividend distributions but is not reduced by unreported dividend distributions. The S corporation has the burden to establish that the dividend amount was reported by the shareholders before AE&P is reduced. The duty of consistency precludes an S corporation from changing the character of distributions reported in closed statute years from non-dividend to dividend. Such a change would improperly reduce AE&P by reported non-dividend distributions.

The resource mentions Code § 1371(c)(1), *Welch v. Helvering*, 290 U.S. 111 (1933), and 15 *Mertens Law of Fed. Income Tax'n* Section 60:5. Quasi-Estoppel or Duty of Consistency, as helpful for the above. Then it continues:

Adjustments to AE&P – Percentage of Completion Method of Accounting

A C corporation's AE&P is frozen as of the date of the S election, even if the C corporation's AE&P was estimated under the percentage of completion method. Any adjustments made to this estimate after the S election is in place will apply to the AAA rather than the AE&P. The courts strictly interpreted IRC 1371(c)(1); that is, no adjustment shall be made to the AE&P of an S corporation, except for certain items noted in the Code.

The resource mentions Code §§ 1371(c)(1) and 312(h), (n)(7) as helpful for the above. Then it continues:

Adjustments to AE&P – Not Affected by Reversal of Timing Differences Subsequent to S Election

AE&P is not adjusted for the reversal of timing differences that occur between C corporation years and S corporation years.

Adjustments to AE&P - Corporate Transactions

AE&P is adjusted up or down based upon various corporate transactions such as certain redemptions, liquidations, reorganizations, divisions, etc. The rules of subchapter C are applied.

When a redemption is treated as a sale or exchange, the corporation's AAA and AE&P are reduced in proportion to the stock redeemed. However, when the redemption is treated as a distribution, the AAA and AE&P are computed in the same way as any other distribution from an S corporation and it does not reduce AE&P unless it is reported as a dividend distribution.

In a complete liquidation of the S corporation, the distribution of the property is not subject to dividend treatment. In addition, all of the AE&P is reduced to zero as a result of the liquidation. Note that a partial liquidation is treated in the same manner as a redemption.

A spin-off, split-off, or split-up transaction requires the allocation of the AE&P between the entities. See Treas. Reg. 1.312-10, Treas. Reg. 1.312-11, and the Corporate Distributions & Adjustments Practice Network resources in the Corporate/Business Issues & Credits Knowledge Base for additional information.

The resource mentions Code § 1371(c)(1) and *Broadaway v. Comm'r*, 111 F.3d 593 (8th Cir 1997), *aff'g Cameron v. Comm'r*, 105 T.C. 380 (1995), as helpful for the above. After discussing shareholders' requirement to track basis, it concludes with a series of examples:

<u>Determine AE&P Using the Final C Corporation Return</u>

Example 1: The retained earnings on the final C corporation return, just before making the S election, is $400,000. Thus, the estimated AE&P for the corporation is $400,000.

Example 2: The tax return for the final year of the C corporation is not available, but the tax return for the initial year S corporation is available and it reported beginning retained earnings of $400,000. This is the estimated AE&P for the corporation.

<u>How to Determine AE&P Using the Current S Corporation Return</u>

Example 3: An S corporation that previously reported as a C corporation is under examination. The balance sheet reflects beginning retained earnings of $450,000, beginning AAA of $35,000, and beginning OAA of $0. Estimated C corporation AE&P is $415,000 [which is beginning RE of $450,000 less $35,000 combined AAA and OA].

Example 4: Same facts as Example 3, except there are accumulated net timing differences of tax in excess of book deductions of $5,000 in depreciation and $7,000 in nondeductible travel and entertainment expenses. The estimated AE&P is reduced by the $5,000 of depreciation timing differences but the permanent difference in nondeductible travel and entertainment expenses does not reduce the estimated amount of AE&P. Therefore, there is $410,000 of estimated AE&P. The nondeductible travel and entertainment expenses already reduced retained earnings (as a deductible expense for book purposes) and AAA (as a nondeductible expense for tax purposes). Consequently, it is not an adjustment to arrive at AE&P.

<u>Common Transactions Resulting in an S Corporation Acquiring AE&P Through a Merger or Liquidation</u>

Example 5: Shareholder A wholly owns an S corporation and a C corporation. The S corporation and the C corporation are neither banks nor insolvent. There are no intercompany transactions.

The balance sheet of each entity reflects the following: [chart showing that the S corporation has $3.000 of AAA and $15,000 of retained earnings, the latter also representing estimated AE&P]

Shareholder A contributes the C corporation's stock into the S corporation in an IRC 368(a)(1)(A) tax-free merger transaction. The S corporation is the surviving entity.

The tax attributes of the C corporation, including any AE&P, carry over into the S corporation. Therefore, the estimated AE&P of the C corporation is $15,000 based upon the ending retained earnings immediately before the merger transaction. The balance sheet of the S corporation immediately after the merger transaction is reflected in the combined column. Using the combined balance sheet immediately after the merger transaction, AE&P is estimated as retained earnings less the AAA balance.

Example 6: Shareholder A wholly owns an S corporation and a C corporation. The S corporation and the C corporation are neither banks nor insolvent. There are no intercompany transactions.

The shareholder contributes the C corporation stock into the S corporation in a tax-free reorganization under IRC 368(a). The S corporation then makes a QSub election under IRC 1361(b)(3)(B) for the C corporation, resulting in a deemed liquidation of the C corporation into the S corporation (Treas. Reg. 1.1361-4(a)(2)). Using the same balance sheet as Example 5, the same results occur as the AE&P of the C corporation is carried over to the S corporation upon the deemed liquidation of the C corporation when the Qsub election is effective. The AE&P is still estimated as $15,000 and AAA is still $3,000.

The main difference between Example 5 and Example 6 is the C corporation no longer exists in Example 5 while the C corporation still exists in Example 6 but as a QSub of the S corporation. A QSub is disregarded for Federal income tax purposes but is not disregarded for other taxes like payroll and certain excise taxes, or for assessment of tax incurred in taxable years when it was a separate entity.

II.Q.7.b.i.(b). IRS View of Taxing Distributions When S Corporation Has Accumulated Earnings & Profits

This part II.Q.7.b.i.(a) describes the view set forth in the IRS' LB&I Transaction Unit, "Distributions with Accumulated Earnings & Profits," Document Control Number (DCN) SCO-T-008 (6/18/2020), which is referred to in this part as "the resource." The resource explains:

A C corporation has two levels of taxation, one at the corporate level and one at the shareholder level when the corporation distributes its earnings and profits to the shareholder(s) (i.e. a dividend). The S corporation income, loss and deduction items pass through to the shareholder(s) and are taxed or deducted at the shareholder level. One advantage of an S corporation is a single level of taxation, however there are situations where an S corporation distribution is taxable to the S corporation shareholder creating a second level of tax similar to a dividend distribution for a C corporation shareholder. Distributions from an S corporation can be either in cash or property; the tax effect of which to the shareholder can be non-taxable, long-term or short-term capital gain income, or ordinary or qualified dividend income.

<u>Sourcing the Distribution - General</u>

The taxability of S corporation distributions is covered primarily by IRC 1368. The distribution must be sourced by the S corporation to determine its taxability as a dividend or non-dividend distribution.

IRC 1368(c), 1379(c) and the Instructions for Form 1120S state that a distribution made by an S corporation with AE&P is made (or sourced) from the following items (in the order listed):

1. Accumulated Adjustments Account (AAA),

2. Previously Taxed Income (PTI) under IRC 1379(c),

3. Accumulated Earnings & Profits (AE&P) (i.e. a dividend distribution),

4. Tax Exempt Income in the Other Adjustments Account (OAA),

5. Non-taxable up to the shareholder's stock basis (i.e. a return of capital),

6. Any distributions in excess of the shareholder's stock basis will be taxed as a capital gain (i.e. a deemed sale of stock with no basis).

IRC 1368(c)(3) provides that any portion of a distribution remaining after the application of item 3 is treated consistently with IRC 1368(b), which states that all distributions made by an S corporation that do not have any AE&P will be:

1. Non-taxable up to the shareholder's stock basis (i.e. a return of capital), and

2. Any distributions in excess of the shareholder's stock basis will be taxed as a capital gain (i.e. a deemed sale of stock with no basis).

<u>Sourcing the Distribution - Elections to Change the Sourcing from AAA, PTI, AE&P, OAA</u>

An S corporation can make one or more of four possible elections, with the consent of all affected shareholders, to change the distribution source as described in Treas. Reg. 1.1368-1. The S corporation can elect to:

- Distribute AE&P before AAA,

- Forego sourcing distributions from PTI,

- Create a deemed dividend distribution to the extent of AE&P followed by a deemed capital contribution for the same amount,

- Report separate tax years for purpose of the first three elections if there is a qualifying disposition.

<u>Sourcing From AAA</u>

Thus, for S corporations with AE&P, verify its AAA, as any distribution in excess of AAA may be taxed as a dividend. AAA first came into existence for taxable years beginning after 1982. It represents the cumulative total of pass-through items generated by the S corporation, which have been taxed to the shareholders, and that remain undistributed by the S corporation. The AAA is a corporate account and does not belong to any particular shareholder. Thus, when an S corporation shareholder sells their stock, the AAA is unaffected. Unlike stock basis, the AAA can have a negative balance. The negative balance can be created by the pass through of loss and deduction items. Treas. Reg. 1.1368-2(a)(3)(ii). Distributions sourced from AAA are reported as non-dividend distributions by the S corporation to the shareholder. Keep in mind that non-dividend distributions can still be taxable to the shareholder as a capital gain to the extent the non-dividend distribution exceeds shareholder stock basis.

Sourcing from PTI

If the distribution is not sourced from AAA it can still be treated as a non-dividend distribution if the distribution is sourced from the PTI account. S corporation income, losses and deductions from before 1983 are recorded in PTI accounts. Any amount in these accounts apply to specific shareholders and can't be transferred to another shareholder. It is rare for an S corporation to have PTI since the election must have been made before 1983 and the current shareholder must have continuously owned S corporation stock from prior to 1983.

Sourcing from AE&P

If the distribution is not sourced from AAA or PTI, then the distribution is a dividend to the extent of AE&P. AE&P is generally the cumulative C corporation taxable income that is increased or decreased by the items described in IRC 312 and the Regulations. Generally, there is little difference between the AE&P of a C corporation and the accumulated retained earnings of that C corporation.

Sourcing from OAA

As discussed later in this Practice Unit, the AAA computation does not include tax-exempt income and the expenses related to the tax-exempt income. Tax-exempt items of income and expense are recorded in the OAA. All distributions after the AE&P is exhausted are non-dividend distributions. Therefore, the only purpose of the OAA account is to help the S corporation determine the source of the distribution that is not from S corporation taxable earnings (AAA or PTI), or C corporation taxable earnings (AE&P).

S Corporation Reporting

Once the S corporation has properly sourced the dividend distributions from AE&P and exhausted its AE&P, all other distributions are non-dividend distributions regardless of their source. Dividend and non-dividend distributions are reported separately. The S corporation reports all dividends on Form 1120S, Schedule K, line 17c and issues a Form 1099-DIV to the shareholders to report their individual dividends. Non-dividend distributions are reported on Form 1120S, Schedule K, line 16d, and on Schedule K-1, line 16d to the shareholders.

If the non-dividend distribution exceeds the shareholder's stock basis, the non-dividend distribution may still be taxable to the shareholders as a long-term or short-term capital gain. Please see the Taxability of Distributions Not From Accumulated Earnings and Profits Practice Unit for additional information on the taxability of non-dividend distributions.

CAUTION: If the distribution is part of a stock redemption transaction or a complete liquidation of the S corporation, the distribution might not be reportable as a dividend distribution even though it otherwise would be a dividend distribution according to the sourcing rules above. Please see the Taxability of Distributions Not From Accumulated Earnings and Profits Practice Unit for additional information on stock redemption transactions and complete liquidations of the S corporation.

AAA Ordering Rules – Regular Ordering

Since both losses and distributions are used in the computation of the AAA, it is important to understand the ordering rules of items that adjust the AAA. The ordering rules for the AAA are not the same as the ordering rules for stock basis. Distributions are applied to stock basis after current period income items but before non-deductibles and current period losses and deductions. This will result in more tax-free distributions, along with more deferred S corporation losses due to a lack of stock basis.

Per Treas. Reg. 1.1368-2(a)(5), the AAA ordering rules are:

1. Increased for income items and excess depletion;

2. Decreased for non-deductible, non-capital expenses and depletion;

3. Decreased for items of loss and deduction; and

4. Decreased for non-dividend distributions without making AAA negative.

Any distribution in excess of AAA is sourced from the next category of PTI, AE&P, then OAA as described in IRC 1368(c). The Sch. M2 row items follow the AAA ordering rules.

[picture of Form 1120S, Schedule M-2]

AAA Ordering Rules – Net Negative Adjustment Ordering

The AAA ordering rules are modified if the S corporation has a "net negative adjustment." IRC 1368(e)(1)(C). A "net negative adjustment" occurs when the S corporation's current year income items less the loss, deduction and non-deductible expenses (includable in the AAA computation) results in a negative number. The "net negative adjustment" rule allows distributions to be taken from beginning AAA, if the S corporation has a net loss for the year. Under the Small Business Job Protection Act of 1996, for tax years starting after December 31, 1996 when the S corporation has a net negative adjustment then per IRC 1368(e)(1)(C), the net negative adjustment AAA ordering rules are:

1. Decreased for non-dividend distributions to the extent of be

2. Increased for income items and excess depletion;

3. Decreased for non-deductible, non-capital expenses and depletion; and

4. Decreased for items of loss and deduction.

CAUTION: The distributions sourced from the beginning AAA will cause the AAA balance to become more negative. Any distributions in excess of the beginning AAA balance will not be sourced from AAA. The line items on Sch. M-2 do not follow the net negative adjustment AAA ordering rules; thus, the examiner needs to remember the above ordering rules when a net negative adjustment exists.

The resource then describes how to examine a distribution, setting forth the following facts:

- S corporation makes a distribution to the shareholder.
- S corporation has AE&P.
  - − Form 1120S, Schedule M-2, line 1(c)
- The S corporation should reflect the distribution on:
  - − Schedule K, line 16d (non-dividend) or 17c (dividend),
  - − Schedule K-1, Box 16, Code D (non-dividend),
  - − Schedule M-2, line 7 and
  - − Schedule L, Balance Sheet, as a reduction of Retained Earnings, line 24.
- If any amount of the distribution is a dividend, the S corporation should issue the shareholder a Form 1099-DIV for the dividend amount.

CAUTION: An S corporation may not properly report its amount of AE&P on Form 1120S, Schedule M-2, line 1(c). Even if reported, the amount of AE&P is allowed to be an estimate.

The resource then instructs, "Gather all the necessary facts to determine the correct amount of AE&P and AAA in order to properly compute the amount of dividend versus non-dividend distributions," describing the following fact elements:

- Use the Reconciliation Workbook to verify the reliability of the tax return information as discussed in the *General Overview of Distributions and Accumulated Earnings & Profits* Practice Unit.
- Determine the amount of AE&P at the beginning of the exam year. Use the *General Overview of Distributions and Accumulated Earnings & Profits Practice Unit* to determine the existence of AE&P and compute or estimate the amount of AE&P.
- For purpose of verifying or recomputing AAA, review the current and previous year form 1120S returns to determine the corrected items of income, loss, deduction, non-deductible expenses and distribution for the current and all prior S corporation years. Corrected items include any adjustments to income, loss, deduction or distribution items through an amended return or as adjusted through an examination.

The resource then sets forth, "**Issue 1** In general, computing the amount of taxable dividend distributions," providing the following explanations of the issue:

> S corporations must properly compute AAA, PTI, AE&P and OAA in order to accurately source and report dividend versus non-dividend distributions to shareholders. If the S corporation does not report the dividend, then in most cases the shareholder will not pick up the proper amount of income on their return. The issue is to ensure that the dividend distribution is taxed at the proper time during the corporation's life cycle.
>
> The first step is to allocate the items of income, loss and deduction between AAA and OAA. The PTI and AE&P accounts are not affected by current year income, loss or deduction items. Most income, loss or deduction items included in the computation are reported on Schedule K. Some, however, are only reported on Schedule K-1 or an attachment to Schedule K-1. These should also be included in the computation. For instance, the sale or other disposition of property for which a section 179 expense deduction was previously passed through to its shareholders is reported on Schedule K-1, Box 17, Code K and should be included in the AAA computation.
>
> This chart shows where the Schedule K items are reflected in the AAA, PTI, AE&P or OAA. Verify the AAA reported on the S corporation's Schedule M-2 is accurate. If it is not accurate, recompute AAA using the Schedules K beginning with the first S corporation year.

Schedule M-2 **Analysis of Accumulated Adjustments Account, Shareholders' Undistributed Taxable Income Previously Taxed, Accumulated Earnings and Profits, and Other Adjustments Account**
(see instructions)

	(a) Accumulated adjustments account	(b) Shareholders' undistributed taxable income previously taxed	(c) Accumulated earnings and profits	(d) Other adjustments account
1 Balance at beginning of tax year	$0 first year of S corp	Balance from pre-1983	C corp earnings	$0 first year of S corp
2 Ordinary income from page 1, line 21	Sch K line 1 (if income)			
3 Other additions	Sch K line 2-10			Sch K line 16a & 16b
4 Loss from page 1, line 21	(Sch K line 1 (if loss))			
5 Other reductions	(Sch K line 2-12d, 14l, 16c)			(related to tax exempt)
6 Combine lines 1 through 5	Subtotal	Subtotal	Subtotal	Subtotal
7 Distributions	Subtotal Sch K line 16d	Sch K line 16d	Sch K line 17c	Sch K line 16d
8 Balance at end of tax year. Subtract line 7 from 6	Total	Total	Total	Total

> Once the allocation is made to AAA and OAA, the distributions can be sourced. Distributions are sourced first from AAA to the extent of positive AAA after considering the income, loss and deduction items for the year unless the net negative adjustment rule applies or an election discussed in Issue 3 is elected.
>
> To the extent the distributions are not sourced from AAA, the distributions are next sourced from PTI unless the election discussed in Issue 3 is made. The distributions are sourced from PTI to the extent of positive PTI.
>
> To the extent not sourced from PTI, the distributions are next sourced from AE&P to the extent of positive AE&P and reported as dividend distributions to the shareholders. Any distributions not sourced from AE&P, regardless of their sourcing, are reported as nondividend distributions.

To determine the amount of distributions reportable as dividends versus non-dividends, use the Distributions with AE&P Worksheet to source them from AAA, PTI, AE&P or OAA.

Distributions from AAA to the extent of positive AAA after considering the income, loss and deduction items.
⬇
PTI
⬇
AE&P
⬇
OAA

- Review current and prior year returns for statements regarding reorganizations, liquidations and corporate division transactions that will impact the AE&P, AAA or PTI amounts. If an S corporation was previously a C corporation or received assets with a carryover basis from a C corporation, an amount should be included on Form 1120S, Schedule B lines 8 and 9. Also, review the balance sheet for any significant changes to owner's equity accounts to identify these transactions. Interview a corporate officer or review the board of director's minutes to verify your conclusions.

CAUTION: When a new S corporate entity is formed and a C corporation is merged into the S corporation in a tax-free transaction, the C corporation's AE&P carries over to the S corporation. However, the S corporation's date of incorporation and S election effective date remain the same. Review the newly formed S corporation's return for significant assets or sales. This may indicate a reorganization with a preexisting entity.

- Verify if any prior dividend distributions reported by the S corporation were actually reported as dividend distributions by the shareholder(s).

Correct the S corporation's AAA, OAA, AE&P, and PTI computation. Then reduce these accounts by the distribution (per ordering rules) to determine the correct amount of dividend versus non-dividend distribution required to be reported. The S corporation's AAA, OAA, AE&P, and PTI can be corrected for improper computations from prior years. Recompute AAA, OAA, AE&P and PTI if there were any errors identified in the computations in the current or prior years.

- Common errors in the computation of AAA include failure to:

  − Use the amended or exam adjusted items of income, loss, deduction and distribution in the computation.

  − Reconcile AAA current year increases and decreases to Schedule K. These reconciliation errors may be caused by:

  - Including book-tax differences in the AAA computation.

  - Neglecting to reduce AAA by loss and deduction items.

- Source distributions from AAA, OAA, AE&P, or PTI in prior years.

- Account at the S corporation-level for the impact of any redemption, merger, acquisition, split-up or split-off transactions on the account balances.

- Include tax-exempt income or expenses in AAA.

- Consider the Net Negative Adjustment rule.

- Reduce AAA for non-deductible expenses

- Exclude from AAA disallowed losses such as from related party sales and distributions of property when the Fair Market Value (FMV) is less than the adjusted tax basis.

The resource then sets forth, "**Issue 2** More than one distribution and part of the distribution exceeds the AAA," providing the following explanations of the issue:

> When an S corporation makes multiple distributions during the year that exceed the AAA balance at the close of the tax year, then the AAA balance is allocated among the distributions in proportion to the distributions' respective sizes. Therefore, each distribution made during the year could be partially a non-dividend distribution from AAA and partially a taxable dividend distribution from AE&P. However, AE&P is not prorated among the distributions, rather each distribution to which AAA (or PTI) is not allocated is from AE&P until AE&P is exhausted.
>
> Further, the allocation of AAA among various distributions can affect the shareholder's timing of income recognition and the amount of tax owed if the:
>
> - S corporation is on a different year end from the shareholders,
> - There are stock ownership changes during the year,
> - Shareholders receive disproportionate distributions during the year, or
> - The timing of distributions to each shareholder is different and AE&P will be exhausted.
>
> For example, calendar-year shareholders of a fiscal-year S corporation may not know until the next year whether any of the current year's distributions are taxable because they are taxed on dividends in the year received. In this situation, an extension or amended return is required for the shareholder's income tax return.

The resource mentions as helpful to the above Code §§ 444, 1368, 1378 and Reg. §§ 1.301-1(b) and 1.1368-2(b), then describes various fact elements:

- Determine if there is more than one distribution during the year and to whom the different distributions were made by reviewing the S corporation's General Ledger or through an interview of a corporate officer. The timing of each distribution to the different shareholders can make a tax difference even if the distributions are proportionate. Consider verifying the information by requesting the banking information for the timing of the distributions as appropriate.

- Review the Schedules K-1 for a year over year percentage change in stock ownership. If there are distributions before and after a change in ownership then the computation of dividend versus non-dividend distributions is more complicated. Depending on how ownership changed (i.e. stock sale, stock redemption, etc.), consider consulting with a specialist.

- Compare the shareholder's percentage of the total distributions for the year to the stock ownership percentages. If the percentages don't match, there is a distribution that is disproportionate to stock ownership. [Total distributions include the sum of dividend and non-dividend distributions reported on Schedule K.]

- Review tax returns to determine if the S corporation and shareholder file using different fiscal year ends.

The resource then explains potential adjustments:

> When an S corporation makes multiple distributions during the year that exceed the AAA balance at the close of the tax year, then the AAA balance is allocated among the distributions in proportion to the distributions' respective sizes. If you have determined the dividend versus non-dividend distributions will make a tax difference based upon one of the following circumstances:
>
> - The S corporation is on a different year end from the shareholders,
>
> - There are stock ownership changes during the year,
>
> - Shareholders receive disproportionate distributions during the year, or
>
> - AE&P will be exhausted and the timing of the distributions to the shareholders is different, then recompute the dividend versus non-dividend distribution allocation among the shareholders.
>
> Note that S Corporations are required to have a single class of stock by IRC 1361(b)(1)(D). Generally, this means that each share of S Corporation has equal rights to receive distributions. If an S corporation makes distributions that are disproportionate with respect its stock, it may mean that the S Corporation has violated the single class of stock rule. Contact your local counsel if you identify such a situation.

Before going further, I want to make sure the reader does not overstate the consequences of disproportionate distributions. Although the organizational documents must provide each share with equal rights to distributions,[4888] distributions that violate that provision do not bust the S election[4889] (although they should be corrected when discovered).

[4888] See part II.A.2.i Single Class of Stock Rule.
[4889] See parts II.A.2.i.ii Temporary Timing Differences; Other Varying Differences and II.A.2.i.iii Disproportionate Distributions.

The resource then provides examples:

Example 1 – Allocating AAA and AE&P to Multiple Distributions

S corporation is owned 50-50 by shareholders A and B. The S corporation has $3,000 of beginning AAA and earns $7,000 of income. The S corporation has $60,000 of AE&P and distributes $80,000 cash to Shareholder A on 3/31 and $20,000 cash to Shareholder B on 6/30.

	Date	Distribution	AAA	Dividend	Return of Capital
Shareholder A	3/31	80,000	8,000 (1)	60,000 (3)	12,000
Shareholder B	6/30	20,000	2,000 (2)	0	18,000
		100,000	10,000	60,000	30,000

(1) 80,000/100,000 x 10,000 = 8,000

(2) 20,000/100,000 x 10,000 = 2,000

(3) There is no rule that the AE&P be allocated proportionately to the distributions, so it is allocated to the distributions issued first until exhausted.

AAA before distributions is computed as 10,000 [10,000 = 3,000 + 7,000]. The distribution is sourced $10,000 as a non-dividend distribution and $60,000 is a dividend distribution with the remaining $30,000 being a return of capital. The AAA must be allocated to the shareholders in proportion to their distributions during the year. See the discussion on the previous slide with respect to the prohibition on multiple classes of stock.

Generally, S corporations and their shareholders will use a calendar year. Therefore, the year in which the dividend distribution is reported by the S corporation and the shareholder will be the same. However, an S corporation is allowed to have a different year end if it establishes a business purpose for the fiscal year to the satisfaction of the Secretary, or if the corporation elects a corporate year covered by IRC 444. The permitted year-ends for an IRC 444 election are September 30, October 31, or November 30.

Whenever an S corporation and any shareholder have different year ends, determine the timing of the distributions. The year in which the dividend distribution takes place for the shareholder will determine the year in which it is includable in the shareholder's taxable income. This is correct even if the S corporation is unable to determine if the distribution is taxable as a dividend until the end of the S corporation's year.

Adjust the shareholder's return for the proper year of dividend reporting. Note that the shareholder may have to file an amended return to report the dividend distribution.

CAUTION: This Practice Unit does not address the impact on the allocation of dividend versus non-dividend distributions if there is a stock sale or stock redemption transaction during the year. Please contact the S Corporations & Cooperatives Practice Network if there are dividend and non-dividend distributions in the same year as a stock redemption transaction.

Example 2 – Fiscal Year Distributions Exceeding AAA

S corporation's fiscal year ends October 31st. The shareholder is on a calendar year end of December 31st. For FY2 S corporation made the following distributions:

Date	Distribution
11-01-CY1	50,000
01-30-CY2	45,000
05-01-CY2	55,000
	$150,000

At the end of FY2, the corporation showed the following:

AAA at 10-31-FY2 Before Distributions	100,000
AE&P	20,000
Initial Stock Investment	250,000

Since the FY2 distributions exceeded the fiscal year-end AAA, AAA needs to be allocated based on the respective sizes of the distributions. The AAA is allocated as follows:

Date	Distribution	AAA		Dividend		Return of Capital
11-01-CY1	50,000	33,333	(1)	16,667	(3)	0
01-30-CY2	45,000	30,000	(2)	3,333		11,667
05-01-CY2	55,000	36,667		0		18,333
	150,000	100,000		20,000		30,000

(1) 50,000/150,000 x 100,000 = 33,333
(2) 45,000/150,000 x 100,000 = 30,000
(3) There is no rule that the AE&P be allocated proportionately to the distribution, so it is allocated to the distributions issued first until it is exhausted.

The shareholders would have to report $16,667 and $3,333 of dividend income in CY1 and CY2, respectively.

It should be noted that the shareholders will not know the amount of their CY1 dividend income until after FY2 closes when the S corporation's books are closed and the FY2 income tax return is completed. This would require the shareholders to estimate their FY1 dividend income when they file their CY1 return. They would then have to amend the CY1 return when the final figures are determined.

The resource then sets forth, "**Issue 3** Elections effecting distributions," providing the following explanations of the issue:

> The general sourcing rule is AAA, PTI, AE&P then OAA. However, an S corporation is allowed to make certain elections that will impact the general sourcing rule with the consent of all affected shareholders. The four elections are:
>
> - Election 1: Distribute AE&P Before AAA
> - Election 2: Forego PTI
> - Election 3: Deemed Dividend
> - Election 4: Separate Tax Years
>
> More than one election can be made in a given year. Each election is irrevocable once made and is effective only for the tax year of the election. There is no limit on the number of times an election can be made.

The resource cites in support of the above Reg. §§ 1.1368-1(f)(2), 1.1368-1(f)(4), 1.1368-1(f)(3), 1.1368-1(g), 1.1368-1(f)(5)(iv), and 1.1368-1(g)(2)(iii), then continues:

> <u>Election 1: Distribute AE&P Before AAA</u>
>
> An S corporation can elect to change the distribution sourcing rules to source distributions from AE&P before AAA. The election applies to all distributions for the year. The election does not provide that AE&P is distributed before PTI; therefore, the new sourcing of the distribution order is PTI, AE&P, AAA then OAA.

The resource cites in support of the above Code § 1368(e)(3) and Reg. § 1.1368-1(f)(2), then continues:

> <u>Election 2: Forego PTI</u>
>
> An S corporation can elect to forgo considering distributions from PTI. This is not the same as Election 1 where it is changing the ordering rules but rather the taxpayer does not consider PTI as a part of the computation. The election applies to all distributions for the year. This election by itself does not provide that AE&P is distributed before AAA; therefore, the ordering with the election is AAA, AE&P, OAA.

The resource cites in support of the above Reg. § 1.1368-1(f)(4), then continues:

> <u>Election 3: Deemed Dividend</u>
>
> An S corporation that lacks the assets to make a distribution can make an election to deem a dividend distribution followed by a corresponding deemed capital contribution. The deemed dividend distribution amount is limited to the amount of AE&P after considering any actual distributions from AE&P. The deemed dividend distribution is allocated pro-rata to the shareholders according to their stock ownership.

The resource cites in support of the above Reg. § 1.1368-1(f)(3), then continues:

> Election 4: Separate Tax Years
>
> The S corporation can elect to have two separate tax years for purposes of making Elections 1-3 if there is a qualifying disposition during the year. Qualifying dispositions include (i) certain dispositions of 20% or more of the stock by a shareholder, (ii) certain redemption transactions and (iii) certain new stock issuances. Qualifying dispositions do not include a complete termination of the shareholder's interest in which case an election under IRC 1377(a)(2) and Treas. Reg. 1.1377-1(b) must be made. The election requires separate taxable years for purposes of allocating items of income and loss, making adjustments to AAA, earnings and profits, and basis.

The resource cites in support of the above Code § 1377(a)(2) and Reg. §§ 1.1377-1(b) and 1.1368-1(g)(ii), then continues:

> Who Must Consent to Each Election
>
> An S corporation makes an election for a taxable year by attaching a statement to a timely filed (including extensions) original or amended return. The election must receive consent from each "affected shareholder." An affected shareholder is any shareholder to whom a distribution is made by the S corporation during the S corporation's taxable year. For purposes of Election 4, the affected shareholders are all shareholders during the year. Therefore, all shareholders must consent.
>
> Statements Required to Be Attached to the Return
>
> - The S corporation must attach a statement to an original filed return (including extensions) or an amended return. The statement must identify the election, state the shareholder(s) consent to the election and signed under penalty of perjury by a corporate officer (note that signing the return suffices the penalty of perjury signature requirement).
>
> - If Election 3, the deemed dividend election, is made, the statement must also include the amount of the deemed dividend allocated to each shareholder.
>
> - If Election 4, separate tax years, is made, the statement must provide facts regarding the qualifying disposition.

The resource cites in support of the above Code § 1368(e)(3) and Reg. § 1.1368-1(f)(5), (g)(iii) and (g)(5), then continues with the following fact elements:

- Review the S corporation tax return for any statements regarding elections.

- Request a copy of the S corporation's work papers allocating AAA, PTI, AE&P and OAA to its various distributions if the Schedule M-2 is not reconcilable. Normally, it's easy to reconcile the Schedule M-2 to the return; however, certain corporate transactions can occur that make it irreconcilable. For example, if there is a redemption, liquidation, split-up, split-off, merger or acquisition transaction, obtain additional information and workpapers.

- Request supporting documentation for the timing and amounts of any adjustments to AAA, PTI, AE&P, or OAA if the elections were part of a series of transactions that include a redemption, liquidation, split-up, split-off, merger or acquisition transaction.

The resource then continues with the following explanations of adjustments:

- Each of the elections can be made on an original filed return (including extensions) or an amended return. Therefore, the elections can be made during an examination.

- An S corporation can make Election 1, Distribute AE&P before AAA, and Election 2, Forego PTI, in the same year causing distributions to be sourced from AE&P, AAA then OAA. There are a variety of reasons an S corporation may make the elections including trying to avoid the Tax on Excessive Net Passive Investment Income, expiring shareholder net operating losses requiring income to offset the loss, or the distribution will be in excess of stock basis. Therefore, the shareholder may prefer to reduce AE&P instead, among other reasons.

- Election 1, Distribute AE&P before AAA, and Election 3, Deemed Dividend, are frequently requested on examinations when the issue involved is the tax on excessive net passive investment income, as the tax can result in a termination of the S election if there is excessive passive income and AE&P for 3 consecutive years. By making the election, the S corporation prevents the S election from terminating and reports a deemed dividend distribution in lieu of paying the additional tax on the passive investment income.

- An S corporation that does not have the cash to make the distributions may make Election 3 to: create basis to claim losses, to allow the shareholder to claim an expiring net operating losses, or because a new shareholder does not want AE&P and requires the old shareholder to recognize the dividend income.

Example 3 – Elections to Avoid Net Passive Investment Income Tax

At the end of CY3, S corporation has $1 million of AE&P and $5 million of AAA, and for years 1 through 4 the S corporation has passive income exceeding 25 percent of the corporation's gross receipts for each year as provided for under IRC 1375. The S corporation does not have PTI. The S corporation did not report the IRC 1375 tax in years 1 through 4 despite a legal requirement to do so.

If the statute of limitation for assessment on year 3 is open, the taxpayer can file elections 1 and 3 to have a deemed dividend distribution of $1 million effective on 12/31/CY3. The election eliminates the S corporation's AE&P and prevents the termination of the S corporation under IRC 1362(d)(3). The election has the effect of eliminating the IRC 1375 tax in years 3 and 4 and the S election won't terminate, but results in the shareholder reporting a $1 million dividend distribution in CY3.

Example 4 – Inadvertent Termination Relief and Elections

Same facts as Example 3 except, if the statute of limitations for assessment on years 1 through 3 are closed, the S election will terminate on the first day of CY4. The taxpayer can request inadvertent termination relief through a Private Letter Ruling (PLR) to prevent the S election from terminating. The PLR may require the S corporation to pay any IRC 1375 taxes.

The resource cites in support of the above Code § 1362(f) and 1375 and Reg. § 1.1368-1(f)(2), (3), then continues with a bibliography. Among the sources it cites are:

- *S Corporation Distributions* – ITM Course # 72814
- Audit Tool – S Corporation Distributions Issue Guide
- Audit Tool – S Corporation Corporate Issues & Advanced Topics Issue Guide
- Audit Tool – S Corporation Transactions with Shareholders Issue Guide
- Audit Tool – S Corporation Built-In Gains & Other Taxes Issue Guide
- *Practitioners Publishing Company (PPC) - 1120S Deskbook*
- *BNA Tax Management Portfolios U.S. Income Series Other Pass-through Entities* 731 S Corporations: Operations IV. Treatment of S corporation Distributions

II.Q.7.b.ii. Redemptions or Distributions Involving S Corporations Compared with Partnerships

Presumably any payment for stock treated as a distribution instead of a redemption would be applied pro rata to the owner's shares, which might cause premature taxation if some shares have much lower basis than other shares.[4890] However, if all shares have the same adjusted basis, this would not be a concern.

The owner of a partnership interest, however, treats all of the owner's interest in the partnership as a single holding,[4891] allowing the entirety of the owner's basis to be applied against any distribution before triggering gain.[4892] For more about partnership redemptions compared with installment sales of stock, see parts II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale and II.Q.8.b.ii.(e) Effect of Code § 736 Payments, Installment Sale Payments, or Deferred Compensation on Balance Sheet; be cautious, however, about property distributions,[4893] especially those within seven years of any contribution to a partnership in exchange for a partnership interest.[4894]

Partial liquidations would not receive this favorable distribution treatment for an S corporation,[4895] but classifying a pro rata distribution as a partial liquidation would not change

[4890] See part II.Q.7.h.ii Taxation of Shareholders When Corporation Distributes Cash or Other Property, especially fn. 5096.
[4891] See part II.Q.8.e.ii.(a) Unitary Basis.
[4892] See part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions.
[4893] See part II.Q.8.b.i Distribution of Property by a Partnership.
[4894] See part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, including a warning that a partner contributing cash in exchange for a partnership interest also causes these issues to arise, as described in the text accompanying fn. 5444.
[4895] See fns. 4829-4830 and accompanying text.

its treatment under Code § 736 as described above, so partnership treatment allows more rapid use of basis.

Also, suppose the corporation redeemed stock in exchange for a promissory note, and the redemption was treated as a distribution. Installment treatment is not permitted in a corporate setting for notes that are treated as distributions,[4896] thereby accelerating income, whereas a naked promise to pay a partner in redemption of a partnership interest does not count until cash is paid.[4897]

II.Q.7.b.iii. S Corporation Receipt of Life Insurance Proceeds

In Letter Ruling 200409010, upon the death of the key person, the S corporation (presumably using the accrual method of accounting) would immediately redeem the stock held by the key person at the time of death by issuing a promissory note to the key person's estate. After the redemption, the remaining shareholders would elect to cut off the taxable year.[4898] By terminating the taxable year after the redemption but before submitting a claim on the life insurance policy, the remaining shareholders sought to have all of the insurance proceeds allocated to their stock for purposes of increasing their tax basis. The IRS ruled that the life insurance death benefit will be required to be recognized as of the date of death. Notwithstanding needing to go through the claims submission and evaluation process, death would establish the corporation's rights to the proceeds as a beneficiary of the insurance policy.

Thus, the basis increase due to the receipt of the life insurance death benefit would not be allocated solely to the surviving shareholders. By using a redemption, they would have received a smaller basis increase than if they had received the life insurance proceeds directly and bought the decedent's stock. In fact, if and to the extent that an accounting cut-off can<u>not</u> be made, a portion of the basis increase would be allocated to the decedent's stock and perhaps subsumed (and, as a practical matter, lost) in the basis step-up of that stock upon death. If the accounting cut-off places date of death events into the decedent's hands, then perhaps the decedent's portion of basis from nontaxable income would be allocated to the decedent's stock and subsumed (and, as a practical matter, lost) in the basis step-up of that stock upon death.

Although cash basis taxpayers should be able to avoid these issues, be careful to see how the accounting cut-off would apply, because it can be quite tricky.

Of course, a C corporation's remaining shareholders receive no basis step-up as a result of a redemption (whether or not funded by life insurance).

To avoid these issues, I tend to prefer the planning in part II.Q.4.i Life Insurance LLC.

[4896] See fn. 4816.
[4897] See part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale.
[4898] Code § 1377(a)(2); for more details, see part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest.

II.Q.7.b.iv. S Corporation Distributions of, or Redemptions Using, Life Insurance Proceeds

II.Q.7.b.iv.(a). S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations

Below is a variation of the theme of part II.P.3.b.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds.

In Rev. Rul. 2008-42,[4899] an S corporation purchased an employer-owned life insurance contract on the life of one of its employees in order to cover expenses the company would incur as a result of the death of the employee (also known as a key-man policy). The employee was a highly compensated employee of the corporation. The corporation paid all of the premiums for the policy and was the beneficiary of the policy. At the end of the taxable year, the corporation had earnings and profits ("E&P"). The IRS reminded us that Code 101(j) imposes notice and reporting requirements regarding employer-owned life insurance to preserve the Code § 101 exclusion of life insurance proceeds from income taxation.[4900]

The IRS ruled that premiums paid did not reduce the S corporation's AAA. It also ruled that the death benefit received does not increase the S corporation's AAA. What the IRS does not point out is the general ordering rules of Code § 1368, which are that distributions from an S corporation are treated as the following:[4901]

1. A tax-free distribution to the extent of the lesser of stock basis or AAA, then

2. A taxable dividend to the extent of E&P, then

3. Return of principal to the extent of remaining basis, and finally

4. Capital gain.

Suppose, for example, that the shareholders contributed $10,000 to the corporation at its inception, and no stock has been transferred since inception. It operated as a C corporation and earned $1,000,000 of E&P. Then it elects S status and has $250,000 of AAA. A key employee dies, and the corporation receives $1,500,000 of life insurance proceeds from a term policy and then distributes $700,000 to the shareholders. The consequences are:

- Immediately before the employee died, the shareholders had tax basis in their stock of $260,000, which is the sum of the initial $10,000 contribution and the $250,000 of AAA. Immediately after the death, this tax basis is increased to $1,760,000 due to the receipt of death benefits.

- Of the $700,000 the shareholders receive, $250,000 is a tax-free return of AAA that they could have pulled out tax-free before the employee died; their stocks' tax basis is reduced to $1,510,000 by reason of the $250,000 tax-free distribution. The remaining $450,000 is a taxable dividend out of the $1,000,000 E&P, even though it can be traced to the tax-free life insurance proceeds and even though the shareholders have ample basis to receive

[4899] See New Ruling Provides Guidance on AAA of S corporations, *Business Entities* (WG&L) (Jan./Feb. 2009).
[4900] See part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.
[4901] See part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally.

distributions if the corporation had never been a C corporation. E&P is reduced to $550,000, since $450,000 out of the $1,000,000 E&P has been distributed.

Turning tax-free life insurance proceeds into taxable dividends – not a good deal!

Suppose instead that the shareholders had owned the policy, had been the beneficiaries, and had received distributions from the corporation to pay premiums:

- Each year, AAA would have been reduced to the extent of the distributions that were used to pay premiums.

- The shareholders receive the life insurance proceeds tax-free, assuming they complied with Code § 101(j) as in the Revenue Ruling.

- When the shareholders invest into the company the $800,000 that, under the above example was retained in the corporation, their stock basis increases by that $800,000 to $1,060,000 from the pre-death $260,000 used in the example.

- Thus, the shareholders have lower basis than in the first example, which is the price they pay for not having dividend income.

- If future distributions exceed AAA, they could have dividend income up to the full $1,000,000 of E&P.

Thus, this alternative defers dividend taxation but does not avoid it if future distributions significantly exceed AAA. However, if future distributions in excess of AAA are in the form of redemptions that are taxed as such, then this alternative might very well avoid dividend taxation.

A more tax-efficient way to structure this alternative would be for the shareholders to contribute their $800,000 investment of the life insurance proceeds to a new limited liability company taxed as a partnership. Then either:

- The new LLC loans the proceeds to the S corporation as needed, documenting the loan with interest at the applicable federal rate, or

- The S corporation then contributes all of its business assets to the LLC. Later, when the LLC does not need part or all of the $800,000 anymore, it can distribute that excess money to the shareholders as a tax-free return of their capital contribution. This might or might not be a practical alternative, depending on the non-tax issues caused by transferring the S corporation's assets, as well as the annual expense of filing two business income tax returns instead of one. This is more cumbersome than the loan alternative, but it might have the positive effect of shifting a significant portion of the business operations to a partnership income tax model, which is more tax-efficient when changing the composition of the business' equity ownership, as discussed at the beginning of part II.M Buying into a Business, as well at part II.M.4 Providing Equity to Key Employees and an Introduction to Code § 409A Nonqualified Deferred Compensation Rules, of these materials.

Finally, to protect the life insurance from various business exigencies inherent in the shareholders owning life insurance under the alternative, the shareholders should consider forming a limited liability company to hold the life insurance.

These issues could be avoided if the corporation had an S election in place from inception or to the extent it had distributed all of its E&P in the past. Owners of S corporations with E&P might consider cleansing the corporation's E&P while dividend rates are low. Code § 1368(e)(3) allows taxpayers to elect to reverse the normal distribution rules and have distributions come first from E&P and then from AAA to implement this strategy.[4902]

Finally, owners of limited liability companies or other entities taxed as partnerships would not need to even consider this issue.

II.Q.7.b.iv.(b). S Corporation Redemptions Using Life Insurance Proceeds

When an S corporation redeems stock under Code § 302(a) or 303(a):

- AAA is reduced by an amount equal to the AAA multiplied by the number of shares redeemed and divided by the number of shares of stock in the corporation immediately before the redemption.[4903]

- E&P is reduced by a ratable share of post-2/28/1913 E&P.[4904]

- These reductions in AAA and E&P are independent of each other.[4905]

If an S corporation is a former C corporation with significant E&P, then a disadvantage of a redemption relative to a cross-purchase is that AAA is reduced in a redemption, whereas in a cross-purchase AAA is not affected. (It could be an advantage if the goal is to cleanse the corporation of E&P to avoid worrying about the passive investment income rules, but those rules are easy to work around by investing in oil and gas partnerships; see part II.P.3.b.iii Excess Passive Investment Income.)

II.Q.7.b.v. Donation of Stock to Charity Followed by S Corporation Redemption

See part II.Q.6.d.ii UBTI Related to an S Corporation for the fact that gain on sale of S corporation stock and any S corporation K-1 items are per se UBTI.

If the donee is not an eligible shareholder (for example, a government),[4906] consider donating to a donor advised fund and then having the proceeds go to the charity. If the donor advised fund is organized as a trust, any UBTI can be offset by the charitable tax deduction that individuals generally receive.[4907]

[4902] See part II.P.3.b, for issues relating to S corporations that have E&P.
[4903] Code § 1368(e)(1)(B); Reg. § 1.1368-2(d)(1)(i).
[4904] Code § 312(n)(7), superseding the limitations of Reg. § 1.312-5. Rev. Rul. 79-376, which had governed, was obsoleted by Rev. Rul. 95-71, presumably in response to this change; see T.M. 767 Redemptions IV.A.2.c. The Senate Report to P.L. 98-369 that enacted the current statutory language provides:

> In the case of a distribution by a corporation in redemption of its own stock, earnings and profits are to be reduced in proportion to the amount of the corporation's outstanding stock that is redeemed. However, the Senate does not intend that earnings and profits be reduced by more than the amount of the redemption.

[4905] Reg. § 1.1368-2(d)(1)(iii).
[4906] See part II.A.2.f Shareholders Eligible to Hold S Corporation Stock, especially fn. 138.
[4907] See part II.Q.6.d.iii Charitable Deduction Against UBTI.

II.Q.7.c. S Corporation Owned by a Trust Benefitting Charity

S corporation stock is a challenging asset for a charity to hold. Not only the K-1 the charity receives from the S corporation but also gain on the sale of S corporation stock constitute unrelated business income; see part II.Q.6.d.ii UBTI Related to an S Corporation.

Note that a charitable remainder trust can own a partnership but not an S corporation;[4908] however, an S corporation may donate property to a charitable remainder trust.[4909]

Also see parts II.G.4.g.ii Basis Limitations on Deducting Charitable Contributions Made by an S corporation or a Partnership and II.Q.6 Contributing a Business Interest to Charity. For a discussion of S corporation contributions to charity, see C. Hoyt, "Charitable Gifts by Subchapter S corporations and by Shareholders of S corporation Stock," *ALI-ABA Estate Planning Course Materials Journal* (April 2006).[4910]

The S corporation's business activities are not attributable to the charity in determining the nature of the charity's activities, which means that a lot of S corporation business income does not destroy the charity's otherwise exempt status.[4911]

[4908] For what types of trusts can own stock in an S corporation, see part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation. An electing small business trust (ESBT) is the only type of trust described there into which a charitable remainder trust (CRT) might fit, but Code § 1361(e)(1)(B)(iii) prohibits a CRT from qualifying as an ESBT. However, an S corporation may donate property to a charitable remainder trust; see part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax.
[4909] See part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax.
[4910] http://files.ali-cle.org/thumbs/datastorage/lacidoirep/articles/EPCMJ_EPCMJ0604-HOYT_thumb.pdf.
[4911] Letter Ruling 201441018.

II.Q.7.c.i. Income Tax Trap - Reduction in Trust's Charitable Deduction

II.Q.7.c.i.(a). Contribution Must Be Made from Gross Income

Although trusts can deduct amounts of gross income[4912] paid to charity, the trust must actually receive the income in the current or a prior year[4913] and must be authorized to make the payment to charity.[4914] Gain recognized on the in-kind satisfaction of a pecuniary distribution to

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[4912] The amount must be payable out of gross income and not out of corpus. Rev. Rul. 2003-123 pointed out the requirement to trace gross income:

> Under section 642(c), a trust is generally allowed an unlimited charitable deduction for amounts that are paid from gross income for charitable purposes pursuant to the terms of the governing instrument. Because section 642(c) specifically requires that a charitable deduction is available only if the source of the contribution is gross income, tracing of the contribution is required in determining its source. *Van Buren v. Commissioner*, 89 T.C. 1101, 1109 (1987); *Riggs National Bank v. United States*, 352 F.2d 812 (Ct. Cl. 1965); *Mott v. United States*, 462 F.2d 512 (Ct. Cl. 1972), *cert. denied*, 409 U.S. 1108 (1973); see also *Crestar Bank v. Internal Revenue Service*, 47 F. Supp.2d 670 (E.D. Va. 1999).

However, various conventions apply to this tracing rule. Satisfaction of a formula pecuniary bequest that is not allocated income does not qualify for this charitable deduction. Rev. Rul. 68-667. On the other hand, if the trust instrument is silent, a charitable deduction is allowed when applicable state law provides that, where the trust instrument is silent, payments are required to be made first from income of the trust and, if the income is not sufficient, then from its principal. Rev. Rul. 71-285. Thus, the IRS is not looking to trace dollars mechanically but rather looks to whether the income was first earned and then allocated to the contribution.

[4913] *Green v. U.S.*, 880 F.3d 519 (10th Cir. 2018), upheld as reasonable the allowance in Reg. § 1.642(c)-1(a)(1) for a deduction:

> for an amount paid during the taxable year in respect of gross income received in a previous taxable year, but only if no deduction was allowed for any previous taxable year to the estate or trust, or in the case of a section 645 election, to a related estate, as defined under § 1.645-1(b), for the amount so paid.

[4914] Rev. Rul. 2004-5 stated:

> For a trust to claim a charitable deduction under § 642(c) for amounts of gross income that it contributes for charitable purposes, the governing instrument of the trust must give the trustee the authority to make charitable contributions. This requirement is an essential element to qualify the trust to claim a deduction for a charitable contribution made directly by the trust. In the case of a trust's investment in a partnership, the partnership may make a charitable contribution from the partnership's gross income, and that income is never available to the trust. For federal tax purposes, however, the trust must take into account its distributive share of the partnership's income, gain, loss, deductions (including charitable contributions), and credits. Under these circumstances, a trust's deduction for its distributive share of a charitable contribution made by a partnership will not be disallowed under § 642(c) merely because the trust's governing instrument does not authorize the trustee to make charitable contributions.

FSA 200140080 reached the same conclusion, pointing out that the UBTI concerns described below must also be addressed. CCA 200928029 (which appears to have been a quick email) asserted:

> Rev. Rul. 2004-5 does permit trusts to claim charitable contributions made by a partnership of which the trust is a partner, even if the trust instrument does not provide for charitable contributions. However, the Rev. Rul. does not eliminate a second requirement that this charitable contribution be made out of the trust's gross income. Therefore, the contribution of the easement does cannot be claimed as a charitable contribution.

Gross income distributed to charity under an inter vivos power of appointment to distribute to charity satisfies the requirement that the charitable distribution be authorized under the trust agreement. Letter Ruling 200906008.

charity meets this test;[4915] however, if gain is not recognized on an in-kind distribution, only the adjusted basis of the property may count.[4916] As to the latter, let's compare and contrast some scenarios:

- A trust's charitable contribution of appreciated marketable securities avoids capital gain tax on the sale of those securities but generates only a contribution deduction equal to basis.

- If the trust distributes the securities to its beneficiaries, the beneficiaries may deduct the full fair market value when contributing them to charity, but the beneficiaries' income and other itemized deductions (relative to the standard deduction) may or may not support that much of a deduction.

- If the trust has significant income taxed at ordinary rates, the trust might consider selling the securities for a long-term capital gain, then distributing the cash to charity. If the trust makes no distributions to noncharitable beneficiaries, then as a practical matter the contribution will reduce the trust's ordinary income subject to tax, because capital gains are always taxed first; thus, the sale and contribution may have the practical effect of converting ordinary income to capital gain, which may save substantial tax (at least that's how it works for individuals). On the other hand, if distributions are made to noncharitable beneficiaries, the charitable deduction may need to be allocated partly to capital gain on their K-1s; see fn 2822 in part II.J.8.f.i.(a) Allocating Deductions to Various Income Items.

Income included on an estate's K-1 from an S corporation does *not* support a Code § 642(c) deduction unless the S corporation distributes that income to the estate; this issue can also

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[4915] Rev. Rul. 83-75 (fn 2788), holding that the distribution by a trust of corpus consisting of appreciated securities in satisfaction of its obligation to pay a fixed annuity to a qualified charitable organization is a sale or exchange of the securities that results in taxable gain to the trust, but the trust is entitled to a charitable deduction equal to the amount of gain recognized upon the distribution of appreciated securities (after making adjustment for any deduction of capital gain provided under the tax law at that time). Letter Ruling 9044047 provided a similar result.

[4916] *Green v. U.S.*, 880 F.3d 519 (10th Cir. 2018), held:

> As an initial matter, the IRS asserts, and the Trust agrees, that the statutory phrase "any amount of the gross income" means that charitable donations must be made out of a trust's gross income, but that real property purchased with gross income can also be treated as the equivalent of gross income for purposes of the deduction outlined in § 642(c)(1). This, we conclude, is an entirely reasonable interpretation of the statutory language. More specifically, this interpretation is consistent with the statutory language, and also encourages charitable donations to a greater degree than an interpretation that fails to include a sourcing component, *i.e.*, an interpretation that limits the deduction to donations made exclusively from gross income.[4] See *Old Colony*, 301 U.S. at 384 ("Congress sought to encourage donations out of gross income ....").
>
> [4] In reaching this conclusion, we note that the Government has not cited to any section of the Code, any regulation, or even any treatise or basic accounting principle that directly supports its proposed interpretation.
>
> That still leaves open the question of the allowable amount of a deduction for donated real property that was purchased with a taxpayer's gross income. The IRS has consistently asserted, both in addressing the Trust's claim for a refund and in this litigation, that the deduction amount is limited to the taxpayer's adjusted basis in the donated real property, *i.e.*, the amount of gross income the taxpayer originally paid for the real property. Without granting any deference to the IRS's position, we conclude that it is the most reasonable interpretation of the statutory language, particularly when considered in light of the Code as a whole.

arise with consent dividends[4917] and partnership income.[4918] The latter problem does not apply if an electing small business trust election is made;[4919] so, instead of electing to be taxed as an estate,[4920] a qualified revocable trust might want to make an ESBT election. This policy is so strong that, in *Sid Richardson*, [4921] the Fifth Circuit held an estate was not permitted a charitable set-aside deduction with respect to undistributed S corporation income even though the estate was the sole owner of the S corporation and the charity ultimately received all of the estate's income, including the S corporation stock.[4922] The court reasoned:

> … to qualify for the charitable deduction, the amount here in question must have been (1) part of the Estate's gross income, and (2) pursuant to the terms of the governing instrument (here the Will) must have been (3) paid or permanently set aside or properly designated to be used exclusively for legitimate charitable purposes.
>
> In considering the Foundation's contentions it is important to understand in fact the undistributed income at issue never left the coffers of the Subchapter S corporation. Undaunted by this apparently insurmountable obstacle, the Foundation doggedly insists that the amounts in question have met the requirements of 642(c) and that the Estate is entitled to the claimed deduction. The Foundation explains that because Oils was a Subchapter S corporation, its undistributed income was a part of the Estate's gross income; and, under the terms of the Will, all of the income of the Estate was set aside for

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[4917] A consent dividend is a deemed (not actually distributed) dividend from a corporation to avoid accumulated earnings tax; see fn. 4853, found in part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax. *Estate of Esposito v. Commissioner*, 40 T.C. 459 (1963), denied a charitable set-aside deduction for consent dividends, even though the entire residue was set aside for charity.

[4918] In *Estate of Freund v. Commissioner*, 35 T.C. 629, *aff'd* 303 F.2d 30 (2nd Cor. 1962), the estate received a K-1 for all of the partnership's earnings, some of which decedent withdrew before death and some of which the estate withdrew after death. The charitable deduction was allowed only with respect to the amount the partnership to the estate distributed after death.

[4919] Under 2017 tax reform, Code § 642(c) does not apply to an ESBT; see fn 6055 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview and also note that fn 6054 allows an ESBT to deduct charitable contributions against its S corporation income only to the extent they are on the K-1 from the S corporation.

[4920] See part II.J.7 Code § 645 Election to Treat a Revocable Trust as an Estate.

[4921] *Sid W. Richardson Foundation v. U.S.*, 430 F.2d 710 (5th Cir. 1970), *reh. den.* 430 F.2d 710 [the decision and the denial of rehearing were published together], *cert. den.* 4/5/1971, *reh. den.*, 403 US 912 (1971). The tax years in question were 1960 and 1961 – before Code § 681 moved UBTI items from Code § 642(c) into Code § 170. Generally, Code § 512(e) treats as unrelated business income S corporation K-1 items and gain from the sale of S corporation stock, even if the S corporation never engaged in any business or debt-financed activities.

[4922] In this case involving 1960 and 1961 tax returns, the Fifth Circuit noted:

> Richardson's will (Will) provided that all of the income of the Estate which accrued during its administration would be included in the residue of his estate. The following residuary clause governed the final distribution of this income:
>
> > I give devise and bequeath ... all of the residue of my estate wherever situated which shall remain after the payment of debts and obligations, taxes and similar charges, the expenses of administering my estate and the satisfaction of the bequests and devises made in Article III hereof, to Sid W. Richardson Foundation....
>
> All of the specific bequests in the Will were satisfied in property except for $256,060.36 and a monthly provision for a sister payable out of corpus. None of the Estate's income was used to pay cash bequests. The residue of the Estate, including all outstanding capital stock of Oils and all income was transferred to the Foundation as of January 1, 1962.

> and "actually" did go to the Foundation, a charitable institution. Thus, it concludes that the requirements of § 642(c) have been met and the Estate is entitled to the deduction.
>
> We must reject this conjuration on two grounds. First, the undistributed income of Oils was never subject to the charitable provisions of the Will. Second, the amounts in question were not paid or permanently set aside or otherwise properly designated for charitable purposes.
>
> Although the undistributed income of Oils was considered in computing the gross income of the Estate, it was never a part of the Estate; it never came within the dominion and control of the executors as distinguished from the corporate entity; and it was never subject to the charitable provisions of decedent's Will. The Foundation's argument assumes that because the undistributed income of Oils was included in computing the Estate's gross income, it actually became a part of the Estate and was subject to the terms of the Will. We find no support for such an assumption.

After discussing other cases, Fifth Circuit concluded:

> The Foundation attempts to distinguish *Freund* and *Esposito* by arguing that in the instant case, the funds in question were "actually distributed by Oils to the Estate in the two years involved, all of which was under the complete control of the executors, who were required to see, and did see, that it went with the residue of the remainder to Foundation." This argument grossly misstates the facts. It could only be correct if the corporate existence of Oils were totally ignored. The Foundation supports its position by explaining that all of the stock of Oils was part of the corpus of the Estate and was duly transferred to the Foundation. In essence, the Foundation is arguing that ownership of the stock is ownership of the income and transfer of the stock is transfer of the income. The Foundation erroneously disregards the fact that Oils is a separate entity, and as such the undistributed profits could be used by Oils in any legitimate way it saw fit. The rule is well-settled that the fact that taxpayers exercised complete dominion and control over the corporation, were in charge of its administration and management, and fully directed its policies, does not justify disregarding the corporate entity for tax purposes.[6] The district court correctly rejected Foundation's claimed deduction for amounts equivalent to the undistributed income of Oils.[7]
>
> [6] *National Carbide v. Commissioner*, 336 U.S. 422 (1949); *Skarda v. Commissioner*, 250 F.2d 429 (10th Cir. 1957). One of the more perplexing aspects of this case is that the Foundation never argued that the corporate entity should be disregarded; such an argument would seem to be logically necessary to support its contention that the amount in question "actually" went to the Foundation. In any event, the above cited authorities seem conclusive on this point.
>
> [7] See the district court's opinion, 306 F.Supp. at 761. The court correctly and cogently concluded:
>
>> The capital stock of Richardson Oils came within the control of the provisions of the will, but the corporation's undistributed profits did not. Until a dividend was declared, the corporation had the right to use those profits in any legitimate way it saw fit, without regard to the provisions of the will which governed the Estate. Under those circumstances, Sec. 642(c) did not become applicable to such undistributed profits.

306 F. Supp at 762.

An S corporation was able to satisfy this requirement by distributing accounts receivable, which would first be used to satisfy remaining estate liabilities and then either be distributed to or set aside for the estate's sole beneficiary, a private foundation.[4923] If there is a disconnect between cash flow and K-1 items, it has been suggested that one consider creating an LLC that holds plenty of cash and also holds the partnership or S corporation. That way, the K-1 from the partnership or S corporation can be accompanied by cash. In other words, if the K-1 is $100,000, the LLC distributes $100,000 to the trust. If the pass-through entity is an S corporation, the estate must be the LLC's sole owner so that the LLC can be disregarded for income tax purposes; an LLC taxed as a partnership would not be an eligible S corporation shareholder.[4924] I am not confident that works, because the distribution is deemed to have come from the trust, not the S corporation, for income tax purposes.

The extent to which gross income the trust received during the year must be traced to a distribution from the trust to charity is unclear; the IRS appears to believe that, the distribution to charity can be deducted to the extent that the distributed property itself constituted gross income in the current or in any prior year, which means that only the basis of property distributed can be deducted.[4925]

[4923] Letter Ruling 201246003.

[4924] See part II.A.2.e.v Relief for Late S Corporation and Entity Classification Elections for the Same Entity, especially fns. 146-150, the latter which makes me very confident that a disregarded entity treated as owned by one qualified individual can hold stock in an S corporation so long as the entity continues to be disregarded in that manner.

[4925] CCA 201042023 (trust's charitable contribution deduction should be limited to the adjusted basis of the properties purchased from accumulated gross income). Contradicting the CCA and holding in the taxpayer's favor is *Green v. United States*, 116 A.F.T.R.2d 2015-6668 (W.D. Okla. 2015 (trust's charitable contribution deduction are *not* limited to the adjusted basis of the properties purchased from accumulated gross income), but the Tenth Circuit reversed, 880 F.3d 519 (1/12/2018), holding that only the basis of contributed property was deductible under Code § 642(c). *U.S. v. Benedict*, 338 U.S. 692 (1950) (capital gains which expressly is not to be taken into account in computing taxable net income as also excluded from statutory gross income) denied a deduction under for a contribution of certain capital gains because those gains were excludable from gross income under another provision. The CCA cited that case and *W.K. Frank Trust of 1931 v. Commissioner*, 145 F.2d 411 (3d Cir. 1944), both of which the *Green* judge rejected as controlling.

See also fn. 4912 (tracing requirement applies but uses accounting conventions rather than actual tracing); Fox, ¶12.04 Requirement That Source of Contribution Be From Gross Income, *Charitable Giving: Taxation, Planning, and Strategies* (WG&L); WTAS LLC, ¶31.09 Source of Payment: Gross Income Only, *Tax Economics of Charitable Giving* (WG&L), citing *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937) (charitable contributions by a trust need not be shown to have been paid out of income received in the year in which they were made if, by the terms of the trust, no limitation was prescribed on the source of payment), and its progeny.

Jonathan Blattmachr's 2015 Heckerling materials stated:

> It seems that if the partnership's gross income is used to acquire another asset, the contribution to charity of the asset, so acquired with the trust's gross income, should be treated as a contribution of gross income for purposes of Section 642(c).[23]
>
> [23] See, e.g., *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937), dealing with the predecessor to current Section 642(c) and in which the Court deferred to the fiduciary's accounting treatment to answer the question whether a certain payment was made from gross income or principal. See, also, Chief Counsel Advice (CCA) 201042023 (the Service ruled that a property bought with accumulated income of a trust was deductible under Section 642(c) when

II.Q.7.c.i.(b). Business Income Limiting Trust Income Tax Deduction

Although normally trusts may deduct all of their gross income that they pay to charity,[4926] this deduction is eliminated to the extent that the trust has unrelated business taxable income (UBTI).[4927] However, in computing the UBTI causing this disallowance, a charitable contribution deduction is allowed, using the percentages that apply to contributions by an individual.[4928] Thus, a partial charitable contribution is allowed to be made out of unrelated business income.[4929] The contribution must be made during the taxable year; the one-year delay permitted by Code § 642(c)(1) does not apply to this deduction.[4930] Furthermore, consider whether the trust also becomes subject to an individual's restrictions[4931] regarding substantiation[4932] and identity of donee.[4933]

Any K-1 income or gain from the sale of the S corporation stock constitutes unrelated business income if the shareholder is an IRA holding bank stock before October 22, 2004 or is a qualified

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distributed to charity because it was out of gross income. However, the charitable deduction was limited to the trust's adjusted basis in the property. (Not precedent.) Cf. *Crestar Bank v. Internal Revenue Service*, 47 F.Supp.2d 670 (E.D. Va. 1999); *Freund's Estate v. Commissioner*, 303 F.2d 30 (2nd Cir. 1962); *Sid W. Richardson Foundation v. U.S.,* 430 F.2d 710 (5th Cir. 1970); *Frank Trust of 1931 v. Commissioner*, 145 F.2d 411 (1944); *Estate of Joseph Esposito v. Commissioner*, 40 TC 459 (1963).

[4926] Code § 642(c).

[4927] Code §§ 642(c)(4) and 681. See part II.Q.6.d Unrelated Business Taxable Income.

[4928] Code § 512(b)(11); Reg. § 1.512(b)-1(g).

[4929] Reg. § 1.681(a)-2(b).

[4930] Reg. § 1.681(a)-2(a).

[4931] Reg. § 1.681(a)-2(a) provides:

> While the charitable contributions deduction under section 642(c) is entirely disallowed by section 681(a) for amounts allocable to unrelated business income, a partial deduction is nevertheless allowed for such amounts by the operation of section 512(b)(11), as illustrated in paragraphs (b) and (c) of this section.

Code § 512(b)(11) provides:

> In the case of any trust described in section 511(b), the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), and for such purpose a distribution made by the trust to a beneficiary described in section 170 shall be considered as a gift or contribution. The deduction allowed by this paragraph shall be allowed with the limitations prescribed in section 170(b)(1)(A) and (B) determined with reference to the unrelated business taxable income computed without the benefit of this paragraph (in lieu of with reference to adjusted gross income).

Tying in the final piece of statutory authority, Code § 511(b) provides:

> (1) *Imposition of tax*. There is hereby imposed for each taxable year on the unrelated business taxable income of every trust described in paragraph (2) a tax computed as provided in section 1(e). In making such computation for purposes of this section, the term taxable income as used in section 1 shall be read as unrelated business taxable income as defined in section 512.
>
> (2) *Charitable, etc., trusts subject to tax*. The tax imposed by paragraph (1) shall apply in the case of any trust which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a) and which, if it were not for such exemption, would be subject to subchapter J (sec. 641 and following, relating to estates, trusts, beneficiaries, and decedents).

[4932] See part II.J.4.c Charitable Distributions.

[4933] See part II.J.4.c Charitable Distributions, fn. 2575.

retirement plan (other than an ESOP) or a Code § 501(c)(3) charity;[4934] as mentioned in fn. 4931 above, Code § 681(a) takes away the Code § 642(c) deduction from trusts (and instead applies the individual percentage limitations) to the extent that they have unrelated business income, determined as if the trust were a Code § 501(c)(3) charity. This is yet another disadvantage of S corporations compared to partnerships, the income from which is unrelated business income only to the extent it fits within the usual unrelated business income (UBI) categories; see part II.Q.6.d Unrelated Business Taxable Income. If a trust that owns S corporation stock that is includible in the income beneficiary's estate and has a charitable remainderman, the S corporation might liquidate immediately after the beneficiary's death, to minimize UBTI; one easy way might be to convert the S corporation to an LLC taxed as an S corporation during the planning stage,[4935] then revoke the election to be taxed as a corporation as of the beneficiary's death. On the other hand, an ESBT might be in a better position to deduct charitable contributions flowing from an S corporation's K-1 than any other fiduciary entity holding an interest in a pass-through entity.[4936]

This partial deduction means that the trustee should not distribute all of the UBI to charity, because the trust will need to pay income tax on the UBI that cannot be fully offset by the charitable deduction.[4937] If the trust mandates that all of the income be paid to charity, the trustee may still allocate the taxes as an expenditure charged against income so that the trustee can pay the taxes.[4938]

Fortunately, these rules do not apply to estates.[4939] If a qualified revocable trust elects to be taxed as an estate, then it should escape this limitation.[4940] These rules also would not apply to

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[4934] Code § 512(e), some of which was added by P.L. 104-188, effective for taxable years beginning after December 31, 1997.
[4935] See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. Instead of doing a merger or former conversion, the S corporation might transfer all of its assets to the LLC and then liquidate, trying to use the statute of limitations for claims against liquidated companies to avoid claims by creditors from when the S corporation operated a business or otherwise subjected itself to tort liabilities; see part II.F.2 Asset Protection Benefits of Dissolving the Business Entity After Asset Sale.
[4936] See part II.Q.7.c.i.(a) Contribution Must Be Made from Gross Income, especially fn 4919 and the text preceding it.
[4937] For example, in Reg. § 1.681(a)-2(c), Ex. 3, the trust paid the charity all $31K of its UBI, but it still had $24K of taxable income (based on a 20% charitable deduction limitation). It reserved no cash to pay that tax, a fact not pointed out by the Example.
[4938] Section 506(a)(2) of the Uniform Principal and Income Act.
[4939] Code § 681 and the regulations thereunder apply to trusts; they does not mention estates. Letter Ruling 201246003 authorized a full Code § 642(c) deduction for income from an S corporation set aside for the estate's sole beneficiary, which was a private foundation.
[4940] See part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI)
Although the discussion below generally refers to trusts, generally it applies to estates as well. If a trustee has discretion to make an election regarding that trust, the election does not affect the choices available regarding other trusts the trustee manages.

I.A.1.o. Capital Gain Constitutes DNI Unless Excluded

Taxable income is DNI unless expressly excluded.

Code § 643(a)(3) provides:

> *Capital gains and losses*. Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c).

Thus, to be excluded from the income of a domestic trust, the gains must:

- Arise from the sale or exchange of capital assets,
- Be allocated to corpus, and
- Not be actually or deemed to be distributed.

The rest of this part II.J.8.a Capital Gain Constitutes DNI Unless Excluded focuses on the first two prongs.

I.A.1.o.i. Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset

Only gains from the sale of capital assets are ordinarily excluded from DNI.

For example, "property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business" is not a capital asset. Therefore, the sale of such property would constitute DNI, although it would not constitute trust accounting income. Whether other real estate is a capital asset depends on various facts.

However, "any recognized gain on the sale or exchange of property used in the trade or business" often receives capital gain treatment to the extent it does not constitute certain depreciation recapture. Goodwill that has not been amortized is a capital asset, but goodwill that is being amortized is not a capital asset. Thus, because such assets are not capital assets, such capital gains generally would be included in DNI.

I.A.1.o.ii. Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus

I am unaware of any authority defining "allocated to corpus" as used in Code § 643(a)(3). Presumably it means receipts by the trust that are allocated to principal.

Does the statute mean that capital gain are automatically included in DNI unless they are affirmatively allocated to principal and certain other conditions exist? Reg. § 1.643(a)-3(a) might overrule that requirement, providing (highlighting added):

> *In general*. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

This regulation essentially has three parts:

- Reg. § 1.643(a)-6 deals with foreign trusts.

- Reg. § 1.643(a)-3(b) explains when capital gains from the sale or exchange of an asset are included in DNI and does not include a requirement that the capital gain be allocated to principal. In fact, one of the prongs discusses the treatment when capital gains are allocated to income.

- Depending on the meaning one gives to "ordinarily," this regulation might dispense with the statutory requirement that capital gains be allocated to corpus. The regulation does not explain when it says "ordinarily" what the exceptions might be, other than Reg. §§ 1.643(a)-6 and 1.643(a)-3(b). There would appear to be substantial authority for saying that an affirmative allocation of capital gains to principal is or is not required.

This issue seems to be most important for the trust's gross income that does not take the form of receipts of cash or other property. For example, a trust might invest in a partnership, S corporation, or other flow-through entity that does not distribute all of its taxable income. How should one treat capital gain from a flow-through entity's sale of a capital asset, when the entity distributes less than all of its taxable income? Should the undistributed capital gain be included in DNI?

- With respect to the accumulated capital gain, the trust has no receipts and therefore is not allocated to corpus. Arguably, the capital gain is not excluded from DNI and therefore constitutes DNI.

- On the other hand, the accumulated capital gain benefits the trust's corpus. Should it be treated as if it had been allocated to corpus? In that case, should it be trapped inside the trust, given that it was accumulated inside the entity and not distributed to the beneficiary?

- Given this uncertainty, would the trustee have discretion to take a different position each year? In Reg. § 1.643(a)-3(b), the Treasury generally agreed that the trustee would not be required to take a consistent position year-by-year, except for capital gain allocated to corpus and treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary. Given that this gross income was not allocated corpus (because it was never physically received), perhaps the trustee has discretion to vary the treatment from year to year? Another approach might be to say that, because the undistributed capital gain was not allocated to principal, the regulations might presume that the undistributed capital gain is allocated to income and can be included in DNI inconsistently from year to year under Reg. § 1.643(a)-3(b)(1).

If all of a flow-through entity's K-1 items taxable to the trust are included in DNI, then part II.J.8.c Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal might cause ordinary income to be trapped at the trust level if the flow-through entity distributes cash in an amount less than all of these K-1 items; see part II.J.8.f Consequences of Allocating Capital Gain to DNI. In light of the consequences described there, the most taxpayer-favorable reading may be that capital gain is ordinarily excluded from DNI.

I leave it to the reader to decide which approach is “better” or perhaps to make that decision on a trust-by-trust basis.

For more on using flow-through entities, see part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

I.A.1.p. Should Capital Gain Be Allocated to DNI?

Often beneficiaries have income below the thresholds that cause the 3.8% tax and the additional 5% capital gain tax to be incurred, whereas trusts start paying those taxes at relatively modest income levels. Therefore, distributing capital gains to beneficiaries might be beneficial – at least from an income tax viewpoint.

Consider various factors described in part II.J.3 Strategic Fiduciary Income Tax Planning.

I.A.1.q. Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal

Generally, gains from the sale or exchange of capital assets, net of losses, are excluded from distributable net income (DNI). But that statement belies the flexibility we are about to see.

Reg. § 1.643(a)-3(b) provides:

> *Capital gains included in distributable net income*. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law) -
>
> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));
>
> (2) Allocated to corpus but treated consistently by the fiduciary on the trust’s books, records, and tax returns as part of a distribution to a beneficiary; or
>
> (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

Note the word “or” after paragraph (2) above. That indicates capital gains are included in DNI if and to the extent that any one or more of paragraph (1) (the “Income Rule”), paragraph (2) (the “Consistent Principal Rule”), or paragraph (3) (the “Discretionary Principal Rule”) applies. For more on the:

- Income Rule, see part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law

- Consistent Principal Rule, see part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary

- Discretionary Principal Rule, see part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary.

Before its amendment by T.D. 9102 (12/30/2003), Reg. § 1.643(a)-3 made it more difficult to include capital gain in DNI.

I.A.1.q.i. Income Rule: Capital Gain Allocated to Income Under State Law

Most states have adopted the Uniform Principal and Income Act, which will be referred to at UPIA for the rest of this part II.J.8.c.i, or its replacement, which is described in part II.J.5.b Uniform Fiduciary Income & Principal Act (UFIPA).

Generally, any capital gain included as the distributive share of income from a partnership or S corporation and distributed from the entity to the trust will constitute income under the Act, making the rest of this part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI) be moot.

Generally, the Act allocates capital gains to principal. The main exceptions are the power to adjust, unitrust distributions, and exceptions in the governing instrument; the power to adjust and power to convert to a unitrust followed adoption of the prudent investor rule. Following a discussion of each of these is a discussion of the respect fiduciary income tax law gives them.

I.A.1.q.i.(a). Power to Adjust

Capital gains may be reclassified as income if traditional trust accounting income principles cause insufficient receipts to be classified as income. See parts II.J.5.b.ii.(a) Power to Adjust.

I.A.1.q.i.(b). Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation

It is not uncommon for partnerships and S corporations to reinvest part of their annual income; indeed, to facilitate growth or simply a stronger capital structure (which lenders might require), many distribute only enough to pay their owners' income taxes (commonly referred to as a "tax distribution") plus a modest bonus (referred to below as a "bonus distribution").

Taxes on this reinvested income are charged against the income of a trust that owns such an entity. This is the only practical solution to the trust's obligation to pay its taxes, because the taxing authorities' claims against the trustee are much more pressing than the beneficiaries' claims. (Note that the income beneficiary of a Qualified Subchapter S Trust pays this tax – part III.A.3.e QSSTs and ESBTs – which has an effect similar to charging the trust's income.)

The Uniform Principal and Income Act includes a remedy for the income beneficiary that had to pay the tax on the entity's accumulated income that has been inherently baked into principal. Section 506(a)(3) authorizes a fiduciary to "make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from … the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary." This specific provision supplements any power to adjust that might generally apply.

Thus, when an interest in a partnership or an S corporation is sold, the trustee should consider whether to allocate some of the sale proceeds to income. However, it's not at all obvious that the trustee should make an adjustment; consider that:

- The entity made distributions specifically to pay this tax, so the trust or income beneficiary was not really "out of pocket" for this tax.

- If the entity had been a C corporation, the entity would have paid the tax itself. Its dividend would have equaled the bonus distribution, and this issue would never have arisen.

- The true issue is whether the bonus distribution was sufficient. Was the decision to accumulate income fair – a sound exercise of the business judgment of those who run the entity? Did those who control the entity promise a make-up distribution at some point because of a special project, or was the accumulation merely part of a solid plan to grow the business, which presumably would result in increased income and increased bonus distributions? Were those who control the entity running it just to benefit themselves (and, if owners, trying to extract more benefits as owners than the inactive owners received)? I have probably left out many other relevant considerations, but hopefully I have communicated why this decision is not easy.

See parts II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Trust Accounting Rules and II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets.

If the trustee is concerned that the income beneficiary might spend a perceived windfall unwisely, the trustee might consider using the power to adjust to spread distributions over an appropriate period of time. Such a spread over time might be more palatable if, instead of labelling the adjustment to sale proceeds as a tax reimbursement, the trustee labelled it as a make-up for insufficient bonus distributions, taking the position that future distributions to beneficiaries might be loosened because of a prior conservative distribution policy. The bonus distributions might have been sufficient from the viewpoint of what the entity should have distributed but might have been insufficient from the viewpoint of how much income the trustee should have tried to generate. As mentioned in part III.A.4.d.iv Advising Clients about the UPAIA § 505 Change and UFIPA § 506 (discussing conflicts with beneficiaries that might arise when an entity makes tax distributions but little or no bonus distributions), these issues have no easy answer.

See also part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Trust Accounting Rules.

I.A.1.q.i.(c). Unitrust

A unitrust is a trust that distributes fixed amounts, redetermined annually as a fixed percentage of the value of the trust's value, which value is redetermined annually but might be based on an average of values, such as the average value of the trust's assets for the past three years. See parts II.J.5.b.ii.(b) Unitrust and II.J.5.b.ii.(c) Comparing Power to Adjust to a Unitrust.

Reg. § 1.643(a)-3(e) provides the following examples regarding unitrusts:

> *Example (11)*. The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.
>
> *Example (12)*. The facts are the same as in Example 11, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire $80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.
>
> *Example (13)*. The facts are the same as in Example 11, except that neither state statutes nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

A right to income expressed initially solely as a unitrust interest may qualify for the QTIP marital deduction.

I.A.1.q.i.(d). Exceptions in the Governing Instrument

Although the Act provides general rules, it also allows trust agreements to override those rules:

> In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:
>
> (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
>
> (2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];
>
> (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and
>
> (4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

I.A.1.q.i.(e). Fiduciary Income Tax Recognition of the Trust Agreement and State Law

Code § 643(b) generally defers to the trust agreement and applicable state law. The Uniform Principal and Income Act ("UPIA") and the Uniform Fiduciary Principal & Income Act ("UFIPA") authorizes the trust agreement to override the Act.

However, Reg. § 1.643(b)-1 does not recognize trust agreements that depart too far from the usual rules:

> Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal.

Reg. § 1.643(b)-1 respects variations provided under applicable state law:

> However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year,

> including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods.

Circling back to the Act's authorizing trust agreements to depart from traditional principles, Reg. § 1.643(b)-1 concludes with:

> In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.

For the "reasonable and impartial exercise" requirement in the context of the power to adjust, see part II.J.5.b.ii.(a) Power to Adjust.

I often use a clause providing that the trustee has wide discretion but must reasonably and fairly balance the interests of the income and remainder beneficiaries. That language comes from the marital deduction regulations. Generally, the trustee's authority to allocate between income and principal does not trigger grantor trust status, does not constitute a power of appointment, and does not have generation-skipping transfer tax implications. The trustee might want to consider providing accountings or other notices to the beneficiaries that would start running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile this one on top of it, which procedure might help minimize any gift tax consequences to failing to make a claim.

How does one draw the line between what departs "fundamentally from traditional principles of income and principal" and what is "a reasonable and impartial exercise of a discretionary power granted to the fiduciary" under Reg. § 1.643(b)-1?

Presumably, the trustee should be on solid ground in allocating to income capital gains such that the total amount of all receipts allocated to income does not exceed 5%, given that the regulations expressly approve unitrusts in the 3%-5% range. The trusts should also be on solid ground in allocating to income capital gains generated by a partnership that the settlor intended to distribute to the income beneficiary.

Beyond that, it's a matter of facts and circumstances and judgment. However, Reg. § 1.643(a)-3(e), Example (4) respected a mandatory allocation of capital gain to income where a trust had $5,000 of dividends and $10,000 of capital gains, and the trustee distributed $17,000 to the beneficiary.

I.A.1.q.i.(f). Conclusion Regarding Allocating Capital Gain to Income

Reg. § 1.643(a)-3(b)(1) requires a consistent practice for unitrusts. Considering that the unitrust recipient is receiving cash and presumably would have the liquidity to pay tax on any capital gains distributed to the beneficiary, in many cases it would be fair to allocate capital gain to DNI to the extent that the unitrust amount exceeds the income that would apply under the Act's general rules. Given that one provides for a unitrust when tension between the income beneficiary and remaindermen might be high, the tension created by this tax issue would be high to the same degree. Consider providing a firm rule in the trust agreement regarding the allocation of capital gain to DNI. If one is concerned that shifting tax rates might create an unfair tax result, consider providing a clause reimbursing the unitrust beneficiary for taxes paid on the unitrust and on the reimbursement; this requires cooperation between the trustee's income tax preparer and the beneficiary's income tax preparer, but the calculation should be relatively mechanical.

For trusts that are not unitrusts, Reg. § 1.643(a)-3(b)(1) provides significant flexibility, allowing the trustee discretion whether to allocate capital gain to income for fiduciary accounting purposes (if the trust agreement and state law permit) and also whether to include in DNI the capital gain that was allocated to income.

Consider the nuances for a mandatory income trust. Distributions must be made no later than 65 days after yearend to include capital gain in DNI in every other situation. In a mandatory income trust, a power to adjust might be able to retroactively include capital gain in income – perhaps as late as when the tax return is prepared. For how mandatory income trusts work, see part II.J.5 Mandatory Income Trusts. For limits on retroactivity, see part II.J.5.a Issues Arising with Mandatory Income Trusts.

I.A.1.q.ii. Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary

Reg. § 1.643(a)-3(e) helps guide our application of Reg. § 1.643(a)-3(b)(2):

> *Example (1)*. Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the

discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.

Example (2). The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.

Example (3). The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments. This treatment of capital gains is a reasonable exercise of Trustee's discretion.

The all-or-nothing approach taken by Examples (1) and (2) is not very attractive, but we need to deal with it. Let's consider some fact patterns:

1. <u>The beneficiary needs regular annual distributions that cannot be made using a power to adjust</u>. Generally, distributions in excess of what can made using a power to adjust would not be sustainable. A power to adjust typically adjusts to a 3%-5% distribution, and most models suggest that distributions in excess of that will lead to a trust being depleted. Thus, a more likely scenario is that a power to adjust is not available, because state law prevents using the power to adjust in particular situations (unless the trust agreement overrides it). In such a case, the beneficiary's federal and state/local income tax bracket for capital gains needs to be compared to the trust's federal and state/local income tax bracket for capital gains. Note that a nonresident trust would have a zero state/local income tax bracket, to the extent that the trust does not have income from a business sourced to the state/local jurisdiction.

2. <u>The beneficiary's need for distributions in excess of income is sporadic</u>. It's difficult to predict how the beneficiary's federal and state/local income tax bracket for capital gains compares to the trust's federal and state/local income tax bracket for capital gains, given that rates will change and the trust's and its beneficiaries' circumstances might change over time. In such a case, consider whether the distribution might be phrased as "allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary." If that is likely to be the case, then consider not electing to carry out capital gain automatically under (b)(2) but rather deciding to rely on (b)(3), because (b)(3) is flexible whether to allocate capital gain to income, allowing the decision to made separately each year on a case-by-case basis.

Generally, trustees would not be likely to take advantage of the discretion that Example (3) provides to allocate to income only capital gain from the sale of certain specified assets or a particular class of investments, because such an election requires additional recordkeeping.

Some people point to the word “deem” in Example (1) and emphasize the need for such authority in the trust agreement or applicable state law. Uniform Trust Code § 816 generally authorizes trustees to make tax elections, so the authority to “deem” distributions to be capital gains is inherently authorized in UTC states, as well as any other state where a trustee generally has the authority to make tax elections.

I.A.1.q.iii. Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary

Reg. § 1.643(a)-3(b)(3) might seem confusing at first, but it actually has very practical use.

First, let’s look at some examples that Reg. § 1.643(a)-3(e) provides:

> Example (5). The facts are the same as in Example 1, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is $10,000, rather than $12,000. Because Trustee will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in Trust’s distributable net income for the taxable year.
>
> *Example (6)*. Trust’s assets consist of Blackacre and other property. Under the terms of Trust’s governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to A. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust’s distributable net income for the taxable year.

Although Reg. § 1.643(a)-3(b)(3) is viewed generally as discretionary, note that Example (6) is mandatory: if the trustee is required to distribute sale proceeds to a beneficiary, the capital gain from the sale is included in the DNI that the distribution carries out the beneficiary. Example (7) similarly requires all capital gain recognized in the trust’s final taxable year to be included in the DNI that the distribution carries out the beneficiary.

The practical application is based on the ability to count as prior year distributions those distributions made in the first 65 days of the current year. For example, any distribution made on or before March 5, 2020 can be treated as a 2019 or 2020 distribution. This election applies to the greater of accounting income under Reg. § 1.643(b)-1 or DNI under Reg. §§ 1.643(a)-1 through 1.643(a)-7. By completing the line on the trust’s income tax return, Form 1041, page 2, Part B, showing amounts (other than income required to be distributed currently) paid, credited, or otherwise required to be distributed and checking the Code § 663(b) box in “Other Information” at the bottom of Form 1041, page 2, the trustee decides how much of a current year distribution is allocated to the prior year; the balance would then be credited to the current year.

The practical application based on the 65-day rule would generally occur during February after the year ends and applies only if the trustee has discretion to distribute corpus. The regulations do not specify any particular trust records regarding the election, so do whatever seems best to evidence the intent. Perhaps the income tax return preparer emails the trustee recommending how much of a distribution be made to distribute income and capital gain under the 65-day rule (erring on the side of distributing too much), then the trustee makes the distribution, and the tax return carries through the intent. As long as the distribution is made timely, the tax return can treat none, part, or all of the distribution as a distribution of the taxable year's income. In a manner similar to Example (5), the trustee has referred to the capital gain itself in determining how much to distribute. Unlike Reg. § 1.643(a)-3(b)(2), Reg. § 1.643(a)-3(b)(3) allows one to carry out discretionary distributions of capital gain inconsistently from one year to another.

If the beneficiary does not require monthly or quarterly cash flow, the trustee can simply each February make a big distribution and apply it to the prior or current year for tax return preparation purposes. If the beneficiary does require monthly cash flow but is willing to accept informal constraints, the trustee makes the big distribution into an investment account that the beneficiary owns, and the account makes monthly transfers to the beneficiary's checking account. Obviously this would not work for a beneficiary who cannot exercise discipline, but there is a good segment of beneficiaries for whom it would work.

An alternative approach is to distribute an asset to a beneficiary before the asset is sold. Generally, the beneficiary will receive a carryover basis and then be taxed on the gain.

As with all tax planning, the strategies described in this part II.J.8.c.iii may be unavailable (based on the trust terms), inadvisable (based on sound financial planning), or stupid (giving money to a drug addict just to save taxes).

I.A.1.q.iv. Netting Capital Losses

Reg. § 1.643(a)-3(d), "Capital losses," provides:

> Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is distributed or required to be distributed to a particular beneficiary. See § 1.642(h)-1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

Thus, if and to the extent that Reg. § 1.643(a)-3(b)(3) includes capital gains in DNI (see part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary), capital losses are not netted against such gains. The recipient beneficiaries report all such capital gains, and the capital losses remain in the trust.

However, note that Reg. § 1.643(a)-3(b)(3) has two elements: "actually distributed to the beneficiary," which would tend to require tracing except in the case of trust termination, or "utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary," in which case the trustee would have needed to consciously decide to refer to the capital gain when making the distribution.

Unless the trustee traces or decides to refer to the gross capital gain (instead of the net capital gain) when making the distribution, the loss would be offset under Reg. § 1.643(a)-3(b)(3). Alternatively, the trustee might not trace and not refer to capital gain but rather exercise the power to adjust, which would invoke Reg. § 1.643(a)-3(b)(1) (see part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law) and include an automatic offset.

I.A.1.q.v. Conclusions Regarding the Basic Framework on Allocating Capital Gains to DNI

Often, one cannot predict whether the combination of federal, state, and local income tax rates will be higher inside or outside of the trust.

Quite frankly, I keep changing my mind regarding the best income tax elections as I encounter new situations. If the document is flexible as to distributions and distributions are appropriate, then I would lean toward:

- Flexible language allowing the trustee to allocate capital gains to income, so long as the trustee must reasonably and fairly balance the interests of the income and remainder beneficiaries.

- Using the 65-day-rule to distribute large capital gains to the beneficiary as DNI.

- Electing <u>not</u> to establish a practice of carrying out capital gain to beneficiaries under Reg. § 1.643(a)-3(b)(2) <u>unless</u> it appears that the above two approaches will not suffice to minimize overall income taxes. However, it is not uncommon for me to decide that the above. two approaches will not suffice to minimize overall income taxes. On the other hand, if the situation involves enough money, the trustee can covert capital gain that would otherwise be trapped inside the trust to trust accounting income, using the tool described in part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

Consider adding a withdrawal right of up to 5% of the trust's value. The beneficiary will be deemed to be the owner of the part that the beneficiary can withdraw and perhaps continue to be deemed the owner with respect to the lapsed portion. However, note that withdrawal rights can increase exposure to creditors to the extent of the withdrawal right and perhaps even after a lapse. For details on all of the ideas mentioned in this paragraph, see part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts. If one is concerned about the withdrawal right itself becoming a bad idea, consider using a provision along the following the lines:

> In addition to the distributions authorized by the preceding sentence, subject to the following sentence the trustee shall distribute to the beneficiary so much of the principal of the trust as the beneficiary, while at least __ years of age, may request once between February 23 and March 5 of every calendar year, on a noncumulative basis, up to five percent (5%) of the aggregate value, as of the time of such request by the beneficiary, of the principal of the trust. The trustee may, by instrument placed in the trust's records, provide that the preceding sentence shall not apply during any period (including the beneficiary's remaining life), which period shall begin no earlier than the January 1 following the date of the instrument.

This allows the trustee to turn off the withdrawal rights for any future year(s) without impeding the beneficiary's absolute right to withdraw during the current year.

I.A.1.q.vi. Fairness of Taxing Capital Gain to Beneficiaries; Need for Tax Distributions Here and Other Areas

Our income tax system taxes income to whoever receives it, subject to certain exceptions not relevant to this part II.J.8.c.vi. Therefore, it is fair to tax the beneficiaries.

However, when a distribution is made for a particular purpose and the money is spent, the beneficiary will get upset when handed a tax bill for which the beneficiary did not plan. Therefore, one might need to make a supplemental distribution to pay tax on the original distribution. The supplemental distribution would also need to be enough to pay tax on the supplemental distribution itself. This supplemental distribution is often referred to as "grossing up the distribution" to pay taxes.

This issue applies to more than just capital gains. Clients who leave residences in trust often wish to have the trust pay expenses that a life tenant would ordinarily pay. Distributions by the trust for those purposes run into the same problem – the money is spent for the intended purpose and not available to pay taxes. These distributions also need to be grossed up to pay taxes.

I.A.1.r. Distribution in Kind; Specific Bequests

I.A.1.r.i. Distribution in Kind - Generally

Except as provided below and except to the extent that it carries out DNI or constitutes a bequest of income, a distribution is a nontaxable gift (unless the recipient assumes liabilities, in which case it is taxed as a bargain sale).

When a trust distributes property to satisfy a pecuniary distribution (even if the amount is expressly authorized to be satisfied in cash or in kind), the trust recognizes gain on the deemed sale, even if the trust's residue is less than the pecuniary obligation. Such a pecuniary obligation includes an equalizing distribution (presumably unless expressed as a fractional share). This rule includes a pecuniary obligation in the form of an annuity payment to a beneficiary, and the gain recognized in paying the annuity is not included in the beneficiary's distributive net income (DNI) unless the rules for including capital gain in DNI are satisfied. If the trust's residue is less than the pecuniary obligation, the fact that all bequests are protected by Code § 663(a)(1) and therefore no residual beneficiary can pick up income under Code § 662 means that the trust will pay the tax, given that the beneficiaries of the protected bequests will not be picking up that income; note that the trustee will need to reserve for this tax before making distributions to beneficiaries and may have a mismatch for net investment income tax purposes as well. However, when a charity that was the annuity recipient was bequeathed the remainder, the resulting merger of interests and trust termination were not a taxable event. Also, if the bequest is satisfied using date-of-death values, presumably no gain or loss would be realized, but to qualify for the marital or charitable deduction the assets' value relative to date of death values must be "fairly representative of appreciation or depreciation in the value of all property thus available for distribution in satisfaction of such pecuniary bequest or transfer."

If a trust makes a non-pro rata distribution of residue without either the trust instrument or local law authorizing a non-pro rata distribution, each beneficiary may be treated as having received a pro rata distribution and exchanged it with the other beneficiaries. Otherwise, generally the trust does not recognize any gain or loss and the beneficiaries receive the same basis as the trust's; for further analysis of dividing trusts (including on termination), see part II.D.5 Severing Trusts with Multiple Grantors. However, the trust may elect to treat all property distributions during the taxable year as sales, but losses in transactions with beneficiaries and other related parties are disallowed except to the extent that they are from an estate (including a revocable trust electing to be taxed as an estate) satisfying a pecuniary bequest. The loss disallowance applies even if the distribution, taken as a whole, results in a net gain. Thus, gains are recognized and losses generally are not.

The amount deemed distributed is the lesser of the property's basis or fair market value, unless gain was recognized, in which case it is the property's value.

Distributing low basis assets will generate a new basis (often a step-up) when the beneficiary dies. However, distributed assets are subject to the beneficiary's creditors, changes in the beneficiary's estate tax posture (including not only changes in the tax law but also changes in financial situation through the beneficiary's own efforts or through marriage and change in residence to a state that imposes its own estate tax), and changes in the beneficiary's dispositive goals. To get a basis step-up, I would rather add (perhaps by decanting) a formula general power of appointment, as described in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.

Distributing an unmarketable partnership interest would carry out DNI without giving the beneficiary cash. However, valuation adjustments might depress the amount of the deemed distributions, and the beneficiary would be entitled to a proportionate share of future distributions from the partnership. However, if the trustee controls the partnership, the trustee can also control the distribution spigot.

I.A.1.r.ii. Specific Bequest

A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under Code § 661 and is not included in the gross income of a beneficiary under Code § 662, unless under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the recipient in more than three installments.

I.A.1.r.iii. Distributing a Note to the Obligor

Rev. Rul. 75-68 provides:

> The income of a testamentary trust consisting solely of interest from mortgages on the beneficiary's property was required to be distributed periodically. Although the mortgage notes held by the trust required the periodic payment of interest, it was agreed between

the beneficiary and the trustees, that the beneficiary would pay no interest on the mortgages and the trustees would distribute no income from the trust.

Held, notwithstanding the foregoing agreement, the interest income due on the mortgages held by the trust is includible in the gross income of the trust, and this same amount, as the distributable income of the trust, is includible in the gross income of the beneficiary. Further, the beneficiary is entitled to a deduction for this interest deemed paid on the mortgages.

Below is authority consistent with this conclusion:

Reg. § 1.643(c)-1(a) treats as a beneficiary "any person with respect to an amount used to discharge or satisfy that person's legal obligation as that term is used in § 1.662(a)-4." Reg. § 1.661(a)-2(d) provides:

The terms "income required to be distributed currently" and "any other amounts properly paid or credited or required to be distributed" also include any amount used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)-4.

Reg. § 1.662(a)-4, "Amounts used in discharge of a legal obligation," provides:

Any amount which, pursuant to the terms of a will or trust instrument, is used in full or partial discharge or satisfaction of a legal obligation of any person is included in the gross income of such person under section 662(a)(1) or (2), whichever is applicable, as though directly distributed to him as a beneficiary, except in cases to which section 71 (relating to alimony payments) or section 682 (relating to income of a trust in case of divorce, etc.) applies. The term "legal obligation" includes a legal obligation to support another person if, and only if, the obligation is not affected by the adequacy of the dependent's own resources. For example, a parent has a "legal obligation" within the meaning of the preceding sentence to support his minor child if under local law property or income from property owned by the child cannot be used for his support so long as his parent is able to support him. On the other hand, if under local law a mother may use the resources of a child for the child's support in lieu of supporting him herself, no obligation of support exists within the meaning of this paragraph, whether or not income is actually used for support. Similarly, since under local law a child ordinarily is obligated to support his parent only if the parent's earnings and resources are insufficient for the purpose, no obligation exists whether or not the parent's earnings and resources are sufficient. In any event, the amount of trust income which is included in the gross income of a person obligated to support a dependent is limited by the extent of his legal obligation under local law. In the case of a parent's obligation to support his child, to the extent that the parent's legal obligation of support, including education, is determined under local law by the family's station in life and by the means of the parent, it is to be determined without consideration of the trust income in question.

Reg. § 1.661(a)-2(d) provides:

> The terms "income required to be distributed currently" and "any other amounts properly paid or credited or required to be distributed" also include any amount used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)-4.

I.A.1.s. Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries

Generally, K-1 income from a passthrough business entity will carry out any income (including capital) distributed to the trust and then to the trust's beneficiaries. This section focuses on nongrantor trusts holding partnerships rather than S corporations, because generally a trust can hold S corporation stock that is not a grantor trust, QSST, or ESBT only during a relatively limited amount of time. (Although the principles in this part II.J.8.e would apply to a net income with make-up charitable remainder unitrust – a NIMCRUT – the IRS has concerns about that application and might shut it down at some point.)

Also, if one elected not to carry out capital gains under Reg. § 1.643(a)-3(b)(2) and later decides that all capital gain should be included in DNI going forward (or does not want to take a risk that the IRS will not respect deviations from general rules of the Uniform Principal and Income Act, consider forming an entity taxed as a partnership. Capital gains earned through a partnership generally constitute trust accounting income.

The Uniform Principal and Income Act provides that, generally, all cash distributions from an entity (including a partnership) are considered trust accounting income. Only the following distributions from an entity are not considered trust accounting income:

- property other than money;
- money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;
- money received in total or partial liquidation of the entity; and
- money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

Thus, a partnership's capital gains recognized in the ordinary course of managing and re-balancing a portfolio would constitute fiduciary accounting income to the extent distributed from the partnership in cash and therefore would be includible in DNI under (1) above.

To keep control of the partnership, consider having the trust be a 1% general partner and 98% limited partner, and the beneficiary or someone else might contribute 1% as a limited partner. Distributing a limited partnership interest to a beneficiary can carry out income and perhaps capital gain while at the same time not giving the beneficiary cash to spend (but be sure to distribute enough cash so that the beneficiary can pay tax on the distribution). Be careful to avoid the gain on formation that applies when a contributing partner diversifies the partner's holdings by forming the partnership. If the trust holds not only marketable securities but also investments in businesses, consider setting up one partnership for the business investments and another partnership for the marketable securities, which would help facilitate allocating trust assets on termination or any other trust division. Also consider whether a state with jurisdiction over the trust might subject the partnership itself to state income tax.

Complexity might arise if a partnership distributes less than all of its taxable income to a mandatory income trust. It is unclear whether all of the trust's distributive share of capital gain is DNI. Furthermore, interrelated calculations might be required for a mandatory income trust. Generally, we should look to see whether planning under part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law or II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is sufficient before recommending a partnership solely to address the issues described in part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.

I.A.1.t. Consequences of Allocating Capital Gain to DNI

I.A.1.t.i. General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income (and General Retention of the Character of DNI Distributed to Beneficiaries)

This part II.J.8.f.i first discusses netting deductions against income then discusses allocating that income.

I.A.1.t.i.(a). Allocating Deductions to Various Income Items

Rules for allocating deductions include:

- All deductible items directly attributable to one class of income are allocated to that class. To the extent that any items of deduction which are directly attributable to a class of income exceed that class of income, they may be allocated to any other class of income (including capital gains) included in distributable net income as described above except that any excess deductions attributable to tax-exempt income may not be offset against any other class of income.

- Deductions not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing DNI, but Code § 265 requires a portion of such indirect expenses to be allocated to non-taxable income. Such indirect expenses include trustee fees, the rental of safe deposit boxes, and state income and personal property taxes. Once one has allocated expenses to tax-exempt income, how does one choose to which items of taxable income to allocate deductions? One would consider allocating to those income items that are most highly taxed, considering federal and state income tax and the 3.8% tax on net investment income. For example, interest income is taxed at the highest rates, whereas qualified dividends are taxed at long-term capital gain rates. Within interest income, consider whether the interest is from U.S. obligations exempt from state income tax. Although distributions from qualified retirement plans and IRAs are taxed at the highest regular tax rate, they are exempt from the 3.8% tax on net investment income. See part II.I.6 Deductions Against NII (especially the text accompanying fns. 2307-2308).

- If a charitable deduction under Code § 642(c) is involved, any allocations of taxable income between the charitable deduction and the beneficiaries must have substantial economic effect.

- Special rules apply to depreciation deductions.

I.A.1.t.i.(b). Allocating Income Items Among Those Receiving It

In allocating income between the trust and the beneficiary (or beneficiaries), the amounts of DNI distributed to the beneficiaries:

> shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the estate or trust as the total of each class bears to the total distributable net income of the estate or trust in the absence of the allocation of different classes of income under the specific terms of the governing instrument.

However, this proportionate rule is subject to specific provisions in the governing instrument for the allocation of different classes of income or different allocations under local law, subject to tax-exempt income being allocated in a manner that does not allow it to be deducted.

Thus, except for tax-exempt income and allocations between the charitable and noncharitable shares (and any special rules regarding depreciation deductions), it appears that a trust agreement may create ordering provisions between which items of DNI the trust retains and which items of DNI the trust distributes to beneficiaries. However, such a provision might encounter significant resistance from the IRS.

Once one decides which items of DNI the trust distributes to beneficiaries, generally distributions to each beneficiary carry out a pro rata portion of ordinary income and capital gain items allocated to the beneficiaries, and any other characteristic of the income at the trust level retains its status in the beneficiary's hands (which, among other things, is important for net investment income tax purposes). Code § 652(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary.

Code § 662(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642(c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary. In the application of this subsection to the amount determined under paragraph (1) of subsection (a), distributable net income shall be computed without regard to any portion of the deduction under section 642(c) which is not attributable to income of the taxable year.

Reg. § 1.662(b)-1 provides:

> In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§ 1.662(a)-1 through 1.662(a)-4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For this purpose, the principles contained in § 1.652(b)-1 shall apply.

Reg. § 1.652(b)-1 provides:

> In determining the gross income of a beneficiary, the amounts includible under § 1.652(a)-1 have the same character in the hands of the beneficiary as in the hands of the trust. For example, to the extent that the amounts specified in § 1.652(a)-1 consist of income exempt from tax under section 103, such amounts are not included in the beneficiary's gross income. Similarly, dividends distributed to a beneficiary retain their original character in the beneficiary's hands for purposes of determining the availability to the beneficiary of the dividends received credit under section 34 (for dividends received on or before December 31, 1964) and the dividend exclusion under section 116…. Similarly, to the extent such amounts consist of an amount received as a part of a lump sum distribution from a qualified plan and to which the provisions of section 72(n) would apply in the hands of the trust, such amount shall be treated as subject to such section in the hands of the beneficiary except where such amount is deemed under section 666(a) to have been distributed in a preceding taxable year of the trust and the partial tax described in section 668(a)(2) is determined under section 668(b)(1)(B). The tax treatment of amounts determined under § 1.652(a)-1 depends upon the beneficiary's status with respect to them not upon the status of the trust. Thus, if a beneficiary is deemed to have received foreign income of a foreign trust,

the includibility of such income in his gross income depends upon his taxable status with respect to that income.

This proportionate requirement applies "unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation."

When allocating income among beneficiaries:

> The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation.

I.A.1.t.ii. How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary

If the amount of DNI is less than the amount distributed to the beneficiary, the issues described in this part II.J.8.f.ii How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary become important.

Some income might be inadvertently trapped in the trust if the allocation rules of part II.J.8.f.i General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income apply without being modified by any special ordering rule in the trust agreement and if all of a pass-through entity's capital gain constitutes DNI under an approach described in part II.J.8.a.ii Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus That's because looking exclusively at those two factors bypasses the analysis of part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal.

For example, trust has $10,000 of interest income. Trust's distributive share of partnership's income is $20,000 of dividend income and $70,000 of long-term capital gains. If the rules described in the preceding paragraph apply, then 10% of all distributions constitute interest income, 20% constitute dividend income, and 70% constitute long-term capital gains. Trust distributes $50,000 to the beneficiary. Therefore, each of the beneficiary and the trust has $5,000 of interest income, $10,000 of dividend income, and $35,000 of long-term capital gains.

Contrast that to an approach under which the trustee is able to control how much capital gain is included in DNI, under part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal. On a year-by-year basis, the trustee can selectively include capital gain in DNI to the extent that one or both of part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary or part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is available. By including in DNI just enough capital gain to cause the DNI to match the cash distributed to the beneficiary, the trustee can ensure that all of the ordinary income is distributed to the beneficiary.

QSSTs, because the beneficiary is treated as the owner of the S corporation stock for income tax purposes;[4941] of course, the beneficiary would have the overall charitable deduction contribution limitations, which limitations do not apply to trusts that do not have unrelated business income. An ESBT cannot deduct contributions it makes but can, subject to the rules of this part II.Q.7.c.i, deduct its distributive share of contributions the S corporation makes.[4942]

Once all of this analysis regarding unrelated business income is done at the trust level, presumably it will not be repeated at the charity's level, because the trust does not give the charity a K-1.[4943] When deciding whether to have a business run by a charity itself or by a trust that benefits charity, consider the following:

- If the activity definitely would generate UBTI, run it through the trust. Instead of all of the UBTI being taxed, the trust will be taxed on only the excess UBTI over the charitable deduction.

- If there is substantial authority for the activity not generating UBTI, for example because it is related to the charity's exempt purpose, then perhaps the charity should undertake the activity and report it as not being subject to UBTI.

I.A.1.u. Effectuating Allocation of Capital Gain to DNI

Form 1041 (Schedule D), Part III, column (1) allocates the beneficiaries' shares. Once one separates that, the rest should flow naturally.

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4941 See fn. 5992.

4942 See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fns. 6054.

4943 Consistent with Code § 663(a)(2), Reg. § 1.663(a)-2 provides:

> Any amount paid, permanently set aside, or to be used for the charitable, etc., purposes specified in section 642(c) and which is allowable as a deduction under that section is not allowed as a deduction to an estate or trust under section 661 or treated as an amount distributed for purposes of determining the amounts includible in gross income of beneficiaries under section 662. Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in section 642(c). For purposes of this section, the deduction provided in section 642(c) is computed without regard to the provisions of section 508(d), section 681, or section 4948(c)(4) (concerning unrelated business income private foundations).

See fn 2866 in part II.J.9.a.ii Separate Share Rule.

Notice 2004-35 provides:

> The Treasury Department and the Internal Revenue Service intend to propose regulations modifying Treas. Reg. § 53.4940-1(d)(2) to provide that a private foundation's net investment income for purposes of section 4940 does not include distributions from trusts and estates. Until further guidance is promulgated, income distributions from trusts and estates will not retain their character in the hands of a distributee private foundation for purposes of determining the foundation's net investment income under section 4940(c).

II.Q.7.c.ii. Private Foundations, Etc.

A private foundation may hold only limited amounts of an S corporation[4944] (or similar amounts for other entities, including C corporations and partnerships),[4945] and any excess amounts may be held for only five or so years.[4946] However, if the business entity does not operate a business and instead merely generates investment income, it will not be subject to this rule.[4947]

Code § 4941 imposes a modest penalty on each act of self-dealing between a disqualified person and a private foundation.[4948] The tax applies to each participating disqualified person[4949] and foundation manager,[4950] which becomes punitive if not corrected within the taxable period.[4951] "Self-dealing" means any direct or indirect:[4952]

(A) sale or exchange, or leasing, of property between a private foundation and a disqualified person;

(B) lending of money or other extension of credit between a private foundation and a disqualified person;

(C) furnishing of goods, services, or facilities between a private foundation and a disqualified person;

(D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;

(E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and

(F) agreement by a private foundation to make any payment of money or other property to a government official (as defined in section 4946(c)), other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90-day period.

[4944] See Potter, "Using S Corporation Stock to Fund an Individual Shareholder's Private Foundation," *Estates, Gifts & Trusts Journal* (BNA) 5/11/2017, saved as Thompson Coburn LLP document number 6561372.
[4945] Reg. § 53.4943-3(c) applies these rules to partnerships, sole proprietorships, trusts, etc. See Wilson, Better Late than Never: Incorporating LLCs into Section 4943 (3/31/2015), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2587781 or Thompson Coburn LLP document number 6174131; I am not expressing an opinion on the article's recommendations.
[4946] Code § 4943. The founder might be able to give all of his or her C corporation voting stock to one or more trusts and all of his or her nonvoting stock to charitable remainder trusts. See Letter Ruling 201303021.
[4947] Letter Ruling 201447043, citing Code § 4943(d)(3).
[4948] For an exemption when the self-dealer became a disqualified person as a result of the transaction, see text accompanying fn 2994 in part II.J.18.d Trust Commutations.
[4949] Code § 4941(a)(1).
[4950] Code § 4941(a)(2).
[4951] Code § 4941(b).
[4952] Code § 4941(d)(1).

In applying the above rules, Code § 4941(d)(2), "Special rules," provides:

(A) the transfer of real or personal property by a disqualified person to a private foundation shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the foundation assumes or if it is subject to a mortgage or similar lien which a disqualified person placed on the property within the 10-year period ending on the date of the transfer;

(B) the lending of money by a disqualified person to a private foundation shall not be an act of self-dealing if the loan is without interest or other charge (determined without regard to section 7872) and if the proceeds of the loan are used exclusively for purposes specified in section 501(c)(3);

(C) the furnishing of goods, services, or facilities by a disqualified person to a private foundation shall not be an act of self-dealing if the furnishing is without charge and if the goods, services, or facilities so furnished are used exclusively for purposes specified in section 501(c)(3);

(D) the furnishing of goods, services, or facilities by a private foundation to a disqualified person shall not be an act of self-dealing if such furnishing is made on a basis no more favorable than that on which such goods, services, or facilities are made available to the general public;

(E) except in the case of a government official (as defined in section 4946(c)), the payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation shall not be an act of self-dealing if the compensation (or payment or reimbursement) is not excessive;

(F) any transaction between a private foundation and a corporation which is a disqualified person (as defined in section 4946(a)), pursuant to any liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization, shall not be an act of self-dealing if all of the securities of the same class as that held by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value;

(G) in the case of a government official (as defined in section 4946(c)), paragraph (1) shall in addition not apply to -

(i) prizes and awards which are subject to the provisions of section 74(b) (without regard to paragraph (3) thereof), if the recipients of such prizes and awards are selected from the general public,

(ii) scholarships and fellowship grants which would be subject to the provisions of section 117(a) (as in effect on the day before the date of the enactment [10/22/86] of the Tax Reform Act of 1986) and are to be used for study at an educational organization described in section 170(b)(1)(A)(ii),

(iii) any annuity or other payment (forming part of a stock-bonus, pension, or profit-sharing plan) by a trust which is a qualified trust under section 401,

(iv) any annuity or other payment under a plan which meets the requirements of section 404(a)(2),

(v) any contribution or gift (other than a contribution or gift of money) to, or services or facilities made available to, any such individual, if the aggregate value of such contributions, gifts, services, and facilities to, or made available to, such individual during any calendar year does not exceed $25,

(vi) any payment made under chapter 41 of title 5, United States Code, or

(vii) any payment or reimbursement of traveling expenses for travel solely from one point in the United States to another point in the United States, but only if such payment or reimbursement does not exceed the actual cost of the transportation involved plus an amount for all other traveling expenses not in excess of 125 percent of the maximum amount payable under section 5702 of title 5, United States Code, for like travel by employees of the United States; and

(H) the leasing by a disqualified person to a private foundation of office space for use by the foundation in a building with other tenants who are not disqualified persons shall not be treated as an act of self-dealing if -

(i) such leasing of office space is pursuant to a binding lease which was in effect on October 9, 1969, or pursuant to renewals of such a lease;

(ii) the execution of such lease was not a prohibited transaction (within the meaning of section 503(b) or any corresponding provision of prior law) at the time of such execution; and

(iii) the terms of the lease (or any renewal) reflect an arm's-length transaction.

The IRS' web page provides an "an introduction to self-dealing, specifically IRC 4941(d)(1)(C), Furnishing of goods, services, or facilities between a private foundation and a disqualified person," which includes a basic summary and a link to IRS audit techniques.[4953]

Below is a brief review of some aspects of self-dealing issues; my materials are intended to provide only limited coverage.

Applying Code § 4941(d)(2)(E), Letter Ruling 201937003 reasoned:

> Treas. Reg. § 53.4941(d)-3(c)(1) provides, in part, that under § 4941(d)(2)(E), the payment of compensation by a private foundation to a disqualified person for personal services which are reasonable and necessary to carry out the exempt purpose of the private foundation shall not be an act of self-dealing if the compensation is not excessive. This rule applies without regard to whether the person who receives the compensation is an individual.

[4953] https://www.irs.gov/government-entities/private-foundations-self-dealing-irc-4941d1c.

Treas. Reg. § 53.4941(d)-3(c)(2) provides examples of “personal services” for purposes of Treas. Reg. § 53.4941(d)-3(c)(1). These include legal services, investment counseling services, and general banking services.

In *Madden v. Commissioner*, 74 T.C. Memo. 1997-395, the Tax Court ruled that maintenance, janitorial, and security services provided by a disqualified person to a private foundation are not “personal services” that are necessary to carrying out the exempt purposes of a private foundation for purposes of the exception to self-dealing. Citing the legislative history of § 4941, the Court noted that one of Congress’s stated goals in enacting § 4941 was to minimize the need for an arm’s-length standard by generally prohibiting self-dealing transactions between private foundations and disqualified persons and that any exceptions to the self-dealing transaction rules should be construed narrowly. The Court characterized the services described in the regulations under § 4941 as essentially professional and managerial in nature, and concluded that maintenance, janitorial, and custodial services do not meet the definition of “personal services” allowed under § 4941.

Founder is a substantial contributor, as defined in § 507(d)(2), and therefore, is a disqualified person with respect to Foundation as described in section 4946(a)(1)(A). Thus, any direct or indirect payment of compensation to Founder by Foundation will constitute an act of self-dealing unless an exception applies. Because A and B are disregarded as entities separate from their owners within the meaning of Treas. Reg. § 301.7701-3, any payments of compensation by Foundation to either of them are considered to be payments to Founder. [Redacted Text]. Founder, through A, which is a disregarded entity, employs individuals who provide a variety of services to Foundation. In order to carry out its exempt purposes, Foundation requires the services of individuals such as those employed by Founder through A, who provide the services described above to Foundation.

Payment of compensation by a private foundation to a disqualified person generally is an act of self-dealing under § 4941(d)(1)(D). However, § 4941(d)(2)(E) provides an exception to self-dealing for the payment of compensation by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purposes of the private foundation if the compensation is not excessive.

Treas. Reg. § 53.4941(d)-3(c)(2) provides examples of allowable personal services that consist of legal services, investment counseling services, and general banking services. Additionally, *Madden v. Commissioner*, *supra*, indicates that services that are professional and managerial in nature are types of personal services that are permitted under § 4941.

Foundation will enter into a services agreement to hire A to perform certain charitable program, grant-making and consulting services. Unlike the maintenance, janitorial, and custodial services described in *Madden v. Commissioner*, *supra*, the grant-making, consulting, investment, and management services that directly further charitable purposes are provided to Foundation by Founder through A (a disregarded entity) and are professional and managerial services. The programmatic, grant-making and consulting services are reasonable and necessary services that enable Foundation to carry out its charitable purposes. As such, they fall within the exception to the self-dealing rules for "personal services" described in § 4941(d)(2)(E) as long as the compensation is not excessive in relation to the services provided.

> The services agreement also will include a provision that permits A to hire B to provide investment services. This situation is similar to the example in Treas. Reg. § 53.4941(d)-3(c)(2), Example (2), in which a manager of a private foundation who owned an investment counseling business provided investment services directly to the private foundation and was paid compensation for those services. Consequently, payments by Foundation to A for B's investment services provided to Foundation will be payment for reasonable expenses necessary to carry out the exempt purposes of Foundation as long as the compensation is necessary and reasonable to carrying out Foundation's investment program and not excessive under § 4941(d)(2)(E).

> Accordingly, payment to A by Foundation of a reasonable fee for the described services will not constitute a prohibited act of self-dealing within the meaning of § 4941 as long as the amount of the payment is not excessive.

The sale or exchange of property between a private foundation and a disqualified person constitutes self-dealing, including the transfer of real or personal property by a disqualified person to a private foundation shall be treated as a sale or exchange if the foundation assumes a mortgage or similar lien which was placed on the property prior to the transfer, or takes subject to a mortgage or similar lien which a disqualified person placed on the property within the 10-year period ending on the date of transfer.[4954] The Code § 4941(d)(2)(F) exception for corporate transactions is quite important, in that it allows a corporation to redeem stock issued to a private foundation if everyone receives the same offer. Reg. § 53.4941(d)-3(d), "Certain transactions between a foundation and a corporation," provides:

> (1) In general. Under section 4941(d)(2)(F), any transaction between a private foundation and a corporation which is a disqualified person will not be an act of self-dealing if such transaction is engaged in pursuant to a liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization, so long as all the securities of the same class as that held (prior to such transaction) by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value. For purposes of this paragraph, all of the securities are not subject to the same terms unless, pursuant to such transaction, the corporation makes a bona fide offer on a uniform basis to the foundation and every other person who holds such securities. The fact that a private foundation receives property, such as debentures, while all other persons holding securities of the same class receive cash for their interests, will be evidence that such offer was not made on a uniform basis. This paragraph may apply even if no other person holds any securities of the class held by the foundation. In such event, however, the consideration received by holders of other classes of securities, or the interests retained by holders of such other classes, when considered in relation to the consideration received by the foundation, must indicate that the foundation received at least as favorable treatment in relation to its interests as the holders of any other class of securities. In addition, the foundation must receive no less than the fair market value of its interests.

[4954] Reg. § 53.4941(d)-2(a).

(2) *Examples*. The provisions of this paragraph may be illustrated by the following examples:

Example (1). Private foundation X owns 50 percent of the class A preferred stock of corporation M, which is a disqualified person with respect to X. The terms of such securities provide that the stock may be called for redemption at any time by M at 105 percent of the face amount of the stock. M exercises this right and calls all the class A preferred stock by paying 105 percent of the face amount in cash. At the time of the redemption of the class A preferred stock, it is determined that the fair market value of the preferred stock is equal to its face amount. In such case, the redemption by M of the preferred stock of X is not an act of self-dealing.

Example (2).[4955] Private foundation Y, which is on a calendar year basis, acquires 60 percent of the class A preferred stock of corporation N by will on January 10, 1970. N, which is also on a calendar year basis, is a disqualified person with respect to Y. In 1971, N offers to redeem all of the class A preferred stock for a consideration equal to 100 percent of the fact amount of such stock by the issuance of debentures. The offer expires January 2, 1972. Both Y and all other holders of the class A preferred stock accept the offer and enter into the transaction on January 2, 1972, at which time it is determined that the fair market value of the debentures is no less than the fair market value of the preferred stock. The transaction on January 2, 1972, shall not be treated as an act of self-dealing for 1972. However, because under § 53.4941(e)-1(e)(1)(i) an act of self-dealing occurs on the first day of each taxable year or portion of a taxable year that an extension of credit from a foundation to a disqualified person goes uncorrected, if such debentures are held by Y after December 31, 1972, except as provided in § 53.4941(d)-4(c)(4), such extension of credit shall not be excepted from the definition of an act of self-dealing by reason of the January 2, 1972, transaction. See § 53.4941(d)-4(c)(4) for rules indicating that under certain circumstances such debentures could be held by Y until December 31, 1979.

That applies only to corporations. As to partnerships, FSA 200015007 is reproduced in full:

ISSUES

1. Whether the self-dealing penalties of section 4941 would apply have if:

[4955] [My footnote:] Letter Ruling 9731034 held:

In your letter dated June 24, 1992, you were concerned with the tax consequences of a redemption of shares of common stock from B following the donation of such shares to B by C. Redemption was to be accomplished through extensions of credit by A, a disqualified person with respect to B. On August 31, 1993, we issued a favorable ruling to B (PLR #9347035) on this request. Subsequent to the issuance of the ruling it was discovered that the ruling was contrary to Example 2 of section 53.4941(d)-3(d)(2) of the Foundation and Similar Excise Taxes Regulations. When B was informed of our intent to revoke the ruling, B indicated that the transaction was never entered into and asked that the ruling request be withdrawn. On October 27, 1994, we acknowledged the withdrawal of B’s ruling request.

This letter formally revokes PLR #9347035.

a. all of the partners agreed to sell the partnership;

b. the foundation were to sell its interest to a third party, either separately or as part of a transaction involving the sale of all partnership interests;

c. if the other partners were to purchase the foundation's interest at fair market value to facilitate a sale of all interests to a third party?

2. Whether the exception found in section 4941(d)(2)(F) regarding liquidation of corporations would apply if all of the partners agreed to dissolve or liquidate the partnership.

3. What are the maximum penalties under section 4941 in any of the above situations.

4. Whether a private letter ruling could be obtained by the foundation covering any of the above situations.

CONCLUSIONS

1. Assuming that the foundation managers or other disqualified persons receive no benefit from the sale, the sale of the foundation's interest to a third party either separately or as part of a transaction involving the sale of all partnership interests, would not give rise to an act of self-dealing. Similarly, the sale of a disqualified person's interest in the partnership to anyone other than the foundation would not be an act of self-dealing. On the other hand, the sale by the foundation of its partnership interest at fair market value to a disqualified person would be an act of self- dealing.

2. If the procedure followed in dissolving or liquidating the partnership is in accord with Treas. Reg. section 53.4941 (d)-3(d), then the dissolution or liquidation of the private foundation's interest would not be self-dealing.

3. Section 4941 contains a two-tier series of sanctions. The first tier tax is a tax of 5% of the transaction amount which is imposed on the disqualified person regardless of intent, and a tax of 2 1/2% of the transaction amount imposed on a foundation manager who knowingly participates in the act of self-dealing. In the event that the self-dealing transaction is not corrected, a second tier tax of 200% of the transaction amount is imposed on the disqualified person and a tax of 50% of the transaction amount is imposed on a foundation manager who refuses to agree to the correction.

4. A ruling could be obtained on the sales transactions described above, or whether a liquidation or dissolution met the requirements of section 4941(d)(2)(F) of the Code.

FACTS

On date 1, decedent executed a revocable trust. The trust has two trustees, decedent's son, and employee, an unrelated individual who serves as the family's business advisor. The beneficiaries of the trust are son (50%) and decedent's grandsons, grandson 1 (25%) and grandson 2 (25%), the children of decedent's predeceased child.

On date 2, the trustees established a limited liability company. Son was designated as president and employee was designated as vice president and tax matters partner. The trust contributed $w in exchange for a 99% interest and son contributed $x for a 1% interest. On that same day, the trust and the company formed a limited partnership. The trust contributed $y in liquid assets and realty for a 99% limited partnership interest, while the company contributed its assets for a 1% general partnership interest. The trust then assigned .065% of its interest to the foundation, a tax- exempt private foundation.

Under the terms of the partnership agreement, the general partner has exclusive responsibility for the management, operations and control of the partnership's affairs. Unanimous consent of all partners is required to terminate the partnership prior to the expiration of its 50 year term or to amend the partnership agreement.

The foundation is a non-profit corporation founded by decedent's family more than thirty years earlier. Decedent was the president of foundation, and had made a substantial contribution to it. Son is now the president and employee is now the vice-president of foundation. The fair market value of all assets in foundation at the close of the taxable year which included decedent's date of death was $z.

Decedent died five days after the creation of the partnership. As of that date, the partnership interests were held as follows:

Partner	Partnership Interest
Company	1.000%
(General Partner)	
Revocable trust	98.935%
(Limited Partner)	
Foundation	0.065%
Limited Partner)	
Total	100.000%

In valuing decedent's 98.935% limited partnership interest, decedent's executor reduced the net asset value of the partnership to reflect the minority status and lack of marketability of the interests, The minority interest discount was based in part on the opinion of the estate's attorney that the presence of the foundation as a partner, which implicates the self-dealing provisions of IRC section 4941, would limit the ability of the hypothetical purchaser of decedent's 98.935% interest to maximize the return on that investment. Secondly, the estate argues that despite the existence of actual family control at all relevant times, section 4941 would effectively eliminate the family's ability to liquidate the partnership, thereby precluding the application of section 2704.

LAW AND ANALYSIS

OVERVIEW

Section 2031(a) of the Code provides that the value of the gross estate is to be determined for Federal estate tax purposes "by including … the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated." Value is determined at the moment of death. *Ahmanson Found. v. United States*, 674 F.2d 761, 767 (9th Cir. 1981). The standard for valuation is fair market value, defined as "'the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.'" *United States v. Cartwright*, 411 U.S. 546, 551 (1973) (quoting Treas. Reg. section 20.3031-1(b); *Collins v. Commissioner*, 3 F.3d 625, 633 (2d Cir. 1993). This objective test requires property to be valued from the viewpoint of a hypothetical buyer and seller, each of whom would seek to maximize his or her profit from any transaction involving the property. *Estate of Watts v. Commissioner*, 823 F.2d 483, 486 (11th Cir. 1987); *Estate of Bright v. United States*, 658 F.2d 999, 1005-1006 (5th Cir. 1981).

Section 2704 of the Code is part of a set of special valuation rules designed to mitigate the effect of Treas. Reg. section 20.3031-1(b) in certain intra-family contexts. Section 2704(b)(1) provides, in part, that in the case of a transfer of an interest in a partnership to a member of the transferor's family, it the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity, then an applicable restriction will be disregarded in valuing the transferred interest. An applicable restriction is one which limits the ability of the partnership to liquidate, but which the transferor or the family, either alone or collectively, has the right to remove after the transfer. Stated another way, in the case of a transfer subject to a liquidation restriction, if the family holds control both before and after the transfer, the transfer is valued without regard to the restriction. Section 2704 differs from section 2031 in that it looks to the actual parties to the transfer, and not to a hypothetical third party.

As noted above, the estate has argued that the presence of the foundation as a partner, which implicates the self-dealing provisions of IRC section 4941, would limit the ability of the hypothetical purchaser of decedent's partnership interest to maximize the return on that investment. Secondly, the estate argues that despite the existence of actual family control at all relevant times, section 4941 would effectively eliminate the family's ability to liquidate the partnership, thereby precluding the application of section 2704. For the reasons discussed below we believe that there are realistic sales transactions and liquidation transactions which would not subject the hypothetical purchaser, the foundation managers, the general partner or any disqualified persons to self- dealing taxes. Secondly, under certain circumstances, the foundation could join with the family in voting to liquidate the partnership without subjecting the foundation managers, the general partner or any disqualified persons to self-dealing taxes. Accordingly, we agree that the presence of the foundation in the transaction does not affect the application of either section 2031 or 2704. We will now answer the specific questions that you have posed.

Issue 1

Section 4941(a)(1) of the Code imposes a tax upon any act of self-dealing between a private foundation and any of its disqualified persons as defined in section 4946.

Section 4941(d)(1)(A) of the Code defines the term self- dealing to mean any direct or indirect sale or exchange, or leasing of property between a private foundation and a disqualified person. Section 4941(d)(1)(D) defines the term self-dealing to mean any direct or indirect payment of compensation (or payment or reimbursement of expenses) between a private foundation and a disqualified person. Section 4941(d)(1)(E) defines the term self- dealing to mean any direct or indirect transfer to, or use by or for the benefit of a disqualified person of the income or assets of a private foundation.

Section 4946(a)(1) of the Code provides, in pertinent part, that the term "disqualified person" means with respect to a private foundation, a person who is -

(A) a substantial contributor to the foundation;[1]

(B) a foundation manager(within the meaning of subsection (b)(1);[2]

(C) an owner of more than 20 percent of -- (i) the total combined voting power of a corporation, (ii) the profits interest of a partnership, or (iii) the beneficial interest of a trust or unincorporated enterprise, which is a substantial contributor to the foundation;

(D) a member of the family (including a spouse, children, and grandchildren) of any individual described in sub-paragraph (A), (B), or (C);

(E) a corporation in which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the total combined voting power;

(F) a partnership in which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the profits interest;

(G) a trust or estate in which persons described in subparagraph (A), (B), (C), or (D) hold more than 35 percent of the beneficial interest.

[1] Section 507(d)(2)(A) of the Code defines "substantial contributor" as any person who contributed or bequeathed an aggregated amount of more than $5,000 to a private foundation, if such amount is more than 2 percent of the total contributions and bequests received by the foundation before the close of the taxable year of the foundation in which the contribution or bequest is received by the foundation from such person. In the case of a trust, the term "substantial contributor" also means the creator of the trust. Section 507(d)(2)(B)(iv) provides that any person who is a substantial contributor on any date shall remain a substantial contributor for all subsequent periods.

[2] A "foundation manager" is an officer, director, or trustee of a foundation, as well as an employee having responsibility with respect to a specific act or failure to act. Section 4946(b).

Here, decedent's estate, the trust, the company, decedent's family, employee and the members of employee's family are "disqualified persons" for purposes of section 4941. An unrelated third party is not a disqualified person. For self-dealing to take place, there must be a disqualified person engaging in a transaction with a private foundation. Therefore, any transaction between the foregoing parties and the foundation could be an act of self-dealing. The sale by the foundation of its partnership interest at fair market value to another one of the pre-death partners would be an act of self-dealing. Furthermore, if the managers of the foundation sell the foundation's interest to a third party but receive some inappropriate benefit the sale would result in self-dealing by the managers. For example, Treas. Reg. section 53.4941(d)-2(f)(1) states that "the purchase or sale of stock or other securities by a private foundation shall be an act of self-dealing if such purchase or sale is made in attempt to manipulate the price of the stock or other securities to the advantage of a disqualified person." On the other hand, the sale by the foundation of its interest to a third party would not give rise to an act of self-dealing unless the managers or other disqualified persons received some benefit from the sale. Similarly the sale of a disqualified person's interest in the partnership to any one other than the foundation would not be an act of self- dealing. Thus, it is clear that sales can be hypothesized that do not constitute acts of self-dealing.

If all the partners including the foundation were to enter into an agreement to sell their interests as a unit to a third party, this agreement could result in an act of self-dealing. Depending upon the particular facts concerning such agreement the joint sale could be a prohibited use by the disqualified persons of the foundation's assets, within the meaning of section 4941(d)(1)(E). Similarly if the foundation managers were to sell the foundation's interest in conjunction with their own interests in order to get a personal benefit, questions could be raised about whether the foundation's assets were being used by the managers. On the other hand, and with regard to section 4941(d)(2)(F) of the Code, in *Deluxe Corp v. United States*, 885 F. 2d 848 (Fed. Cir. 1989), the circuit court held that a redemption offer was a bona fide offer within the meaning of treas. Reg. section 53.4941(d)-3(d)(1) despite the exclusion of officers and directors, who were shareholders, because to include them in the offer would create a potential conflict with the securities laws restrictions applying to them. Thus, assuming that a sale of the foundation's interest did not constitute a prohibited use of the foundation's assets by disqualified persons, it would not constitute an act of self-dealing.

Issue 2

Section 4941(d)(2)(F) of the Code provides that any transaction between a private foundation and a corporation which is a disqualified person pursuant to any liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization, shall not be an act of self-dealing if all the securities of the same class held by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value.

Treas. Reg. section 53.4941(d)-3(d)(1) provides, in part, that securities are not 'subject to the same terms' unless, pursuant to such transaction, the corporation makes a bona fide offer on a uniform basis to the foundation and every other person who holds such securities. Treas. Reg. section 53.4941(e)-1 (f) provides that for purposes of sections 53.4941(a)-1 through 53.4941(f)-1, fair market value shall be determined pursuant to the provisions of section 53.4942(a)-2(c)(4).

Section 4941(d)(2)(F) of the Code contains an exception to the general prohibition against transactions between private foundations and disqualified persons to permit certain essential transactions. The prohibitions against self-dealing were enacted in 1969 to protect private foundations from improper acts by those who control the foundation, and to curtail possible abuse of the foundation's tax-exempt status. H.R. Rep. No. 413, 91st Cong., 1st Sess. 20-21, reprinted in 1969 U.S. Code Cong. Admin. News 1645, 1665; S.Rep. No. 552, 91st Cong., 1st Sess. 28-29, reprinted in 1969 U.S. Code Cong. & Admin. News 2027, 2055. Nevertheless, as the Treasury explained when it endorsed the bill, see Hearings Before the Committee on Ways and Means, 91 Cong., 1st Sess. On the Subject of Tax Reform, pt 14 at 5059 (1969), an exception to the self-dealing rules "would be made to permit essential donor-foundation transactions." *Id* at 5322.

In enacting section 4941(d)(2)(F), Congress expressly rejected an absolute prohibition against transactions between private foundations and disqualified persons, but replaced the standard of the prior law, which had permitted arm's-length transactions with disqualified persons with one that requires that the foundation must be dealt with on the same terms as other parties to the transaction. The purpose of this requirement is to assure that a foundation's status is not abused, whether the transaction is a "liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization or reorganization", so that a foundation does not receive less advantageous terms than any other shareholder when dealing with a disqualified person. See S. Rep. No 552, supra at 28-29, 31 reprinted at 2055-58.

Section 4941(d)(2)(F) of the Code and Treas. Reg. section 53.4941(d)-3(d)(1) speak in terms of a corporation. We believe that in some situations these provisions provide guidance in the disposition of a private foundation's interest in a partnership. See, *e.g.*, PLR 9237032. Accordingly, if the procedure followed in dissolving or liquidating a partnership is in accord with Treas. Reg. section 53.4941(d)-3(d) then the dissolution or liquidation of the private foundation's interest would not be an act of self-dealing within the meaning of section 4941 of the Code. Cf. TAM 9205001, concluding on its facts that a stock redemption did not meet the criteria of section 4941(d)(2)(F).

Issue 3

Should a private foundation and a disqualified person engage in an act of self-dealing, a two-tier series of sanctions may be triggered. As to the first tier tax, a tax of 5% of the greater of the amount of money given or received or of the fair market value of the property given or received is automatically imposed on the disqualified person, regardless of the inadvertence of the transaction. Section 4941(a)(1). With regard to the sale of one of the current partners' partnership interest to the foundation the excise tax would be calculated on the higher of the fair market value of the partnership interest or the amount of money paid for it by the foundation. If the foundation's partnership interest were sold to the partnership or any one of the current partners the excise tax would be calculated on the higher of the fair market value of the partnership's interest or the amount of money paid for it. A liquidation or dissolution of the foundation's partnership interest would be equivalent to a sale to the partnership and the excise tax would be calculated in the same way unless the requirements of section 4941(d)(2)(F) were satisfied. If it were determined that the foundation managers or other disqualified persons improperly used the foundation's assets in arranging a sale of the entire partnership to a third party, the excise tax would be applied to the fair market value of that use. Treas. Reg. section 53.4941(e)-1(b)(2)(ii).

Not only is the 5% tax imposed for the taxable year of the transaction, but the 5% tax is applied again for each taxable year, or part of a year (within the taxable period as defined in section 4941(e)(1)), from the date on which the act of self-dealing occurs to the earlier of either the date of mailing of a deficiency notice regarding the tax imposed, the date on which the tax imposed by section 4941(a)(1) is assessed, or the date on which correction of the act of self-dealing is completed. To correct the transaction, the disqualified person must do one of two things, i.e. undo the transaction, to the extent possible, or, if rescission is not possible, then the disqualified person must place the foundation in at least the position in which it would have been had the disqualified person met the highest fiduciary standards of dealing in the original transaction. Section 4941(e)(3).

Under the first tier tax of sanctions, when the 5% tax is imposed on the disqualified person, a tax of 2 1/2% of the transaction amount may be imposed on the foundation manager. This may occur, however, only if the manager knowingly participates in the act of self-dealing. On the other hand, if the act of participation is not willful and arises from a reasonable cause, the sanction is inapplicable. Section 4941(a)(2). This tax on the manager has a limit of $10,000 for each act of self-dealing. Section 4941(c)(2).

Should the disqualified person fail to correct the self- dealing transaction within the correction period, a second tier tax is triggered and an additional tax of 200% of the transaction amount is imposed on the disqualified person. Section 4941(b)(1). An additional tax of 50% of the transaction amount is imposed on the foundation manager if the manager has refused to agree to part or all of the correction. Section 4941(b)(2). This tax on the manager has a limit of $10,000 for any one act of self-dealing. Section 4941(c)(2). The transaction amount under the second tier tax is the highest fair market value of the property during the taxable period. Section 4941(e)(2)(B).

Issue 4

A ruling could be obtained on the above sales transactions or on whether a liquidation or dissolution meets the requirements of section 4941(d)(2)(F) of the Code. The time it would take to obtain such a ruling would depend on the workload at the time.

Another self-dealing exception is Reg. § 53.4941(d)-1(b)(3), “Transactions during the administration of an estate or revocable trust,” which provides:

The term “indirect self-dealing” shall not include a transaction with respect to a private foundation’s interest or expectancy in property (whether or not encumbered) held by an estate (or revocable trust, including a trust which has become irrevocable on a grantor’s death), regardless of when title to the property vests under local law, if -

(i) The administrator or executor of an estate or trustee of a revocable trust either -

(a) Possesses a power of sale with respect to the property,

(b) Has the power to reallocate the property to another beneficiary, or

(c) Is required to sell the property under the terms of any option subject to which the property was acquired by the estate (or revocable trust);

(ii) Such transaction is approved by the probate court having jurisdiction over the estate (or by another court having jurisdiction over the estate (or trust) or over the private foundation);

(iii) Such transaction occurs before the estate is considered terminated for Federal income tax purposes pursuant to paragraph (a) of § 1.641(b)-3 of this chapter (or in the case of a revocable trust, before it is considered subject to sec. 4947);[4956]

(iv) The estate (or trust) receives an amount which equals or exceeds the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate (or trust); and

(v) With respect to transactions occurring after April 16, 1973, the transaction either -

(a) Results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up,

(b) Results in the foundation receiving an asset related to the active carrying out of its exempt purposes, or

(c) Is required under the terms of any option which is binding on the estate (or trust).

Also important is the Code § 4941(d)(2)(B) prohibition against any direct or indirect lending of money or other extension of credit between a private foundation and a disqualified person, with the Code § 4941(d)(2)(B) exception that a disqualified person may loan to a foundation if the foundation uses the loan for its exempt purposes. Reg. § 53.4941(d)-2(c), "Loans," provides:[4957]

(1) *In general*. Except as provided in subparagraphs (2), (3), and (4) of this paragraph, the lending of money or other extension of credit between a private foundation and a disqualified person shall constitute an act of self-dealing. Thus, for example, an act of self-dealing occurs where a third party purchases property and assumes a mortgage, the mortgagee of which is a private foundation, and subsequently the third party transfers the property to a disqualified person who either assumes liability under the mortgage or takes the property subject to the mortgage. Similarly, except in the case of the receipt and holding of a note pursuant to a transaction described in § 53.4941(d)-1(b)(3), an act of self-dealing occurs where a note, the obligor of which is a disqualified person, is transferred by a third party to a private foundation which becomes the creditor under the note.

(2) *Loans without interest*. Subparagraph (1) of this paragraph shall not apply to the lending of money or other extension of credit by a disqualified person to a private foundation if the loan or other extension of credit is without interest or other charge.

[4956] [My footnote:] The Reg. § 1.641(b)-3 trust termination rule is described in the text accompanying fn 2563 in part II.J.3.i Planning for Excess Losses, describing excess losses allowed to a beneficiary on termination of a trust. Reg. § 1.641(b)-3(a) is reproduced after fn 2732 in part II.J.8.
[4957] A hold-harmless provision does not seem to cure the problem. See fn 4663 in part II.Q.6.a

> (3) *Certain evidences of future gifts*. The making of a promise, pledge, or similar arrangement to a private foundation by a disqualified person, whether evidenced by an oral or written agreement, a promissory note, or other instrument of indebtedness, to the extent motivated by charitable intent and unsupported by consideration, is not an extension of credit (within the meaning of this paragraph) before the date of maturity.

Reg. § 53.4941(d)-2(c)(4) discusses the foundation's commercial banking relationships.

A bequest to a foundation of debt owed by a disqualified person constitutes self-dealing.[4958] One may avoid the foundation making decisions by bequeathing nonvoting interests in an LLC to it, such as occurred in Letter Ruling 201907004, which involved a charitable lead trust treated as a private foundation for these purposes. The facts were:

> Trustor transferred certain business interests to trusts established for the benefit of Trustor's descendants (Beneficiary Trusts) in exchange for promissory notes that pay interest only for a term of 30 years, with the total principal amount due at the end of the term. The sole beneficiary or all of the beneficiaries of each Beneficiary Trust are Trustor's descendants.
>
> Trustor assigned the promissory notes to LLC, a State limited liability company. The members of LLC are Trustor, who holds all of the nonvoting interests in LLC, and LLC 2, which holds all of the voting interests in LLC. The members of LLC 2 are Trustor's descendants and each holds interests as individuals.
>
> LLC will hold and administer the promissory notes and receive payments of interest and principal on the promissory notes. Aside from the cash initially contributed by LLC 2 for the voting interests in LLC (which will fund LLC expenses), LLC's sole assets and source of income will be the promissory notes.
>
> Power to manage the affairs of LLC is vested in the manager, who is selected and may be removed by a vote of the members holding at least a majority of the voting interests in LLC (currently LLC 2, which holds 100 percent of such voting interests). Daughter, who is also the trustee of Trust, is the initial manager of LLC. Daughter holds interests in LLC only in an individual capacity indirectly through her interests in LLC 2, not in her capacity as trustee of Trust.
>
> The members holding nonvoting interests (currently Trustor, who holds 100 percent of such nonvoting interests) possess no management rights or rights to vote on who will be the manager of LLC. LLC may be dissolved only with written approval of all members, whether holding voting or nonvoting interests.

Letter Ruling 201907004 reasoned and held:[4959]

> As a split-interest trust described in section 4947(a)(2), Trust is subject to the requirements of section 4941 as if it were a private foundation. Trustor is a disqualified

[4958] GCMs 37731 (10/26/1978) and 37037 (3/9/1977).

[4959] To similar effect, see Letter Rulings 201723006 (which also approved the LLC as not being a "business enterprise" subject to the excess business holdings prohibition), 201723005, 201446024 (approved post-mortem formation of LLC and approved the LLC as not being a "business enterprise" person under section 4946(a)(1)(A) with respect to Trust as a "substantial contributor" because Trustor is the creator of Trust. Daughter is a disqualified person under section 4946(a)(1)(B) with respect to Trust as a "foundation manager."

Beneficiary Trusts are disqualified persons under section 4946(a)(1)(G) with respect to Trust because they are trusts in which Trustor's descendants, who are disqualified persons under section 4946(a)(1)(D) with respect to Trust, hold more than a 35-percent beneficial interest. Beneficiary Trusts are the obligors of promissory notes given to Trustor in exchange for certain business interests. An act of self-dealing would occur if Trustor transferred the promissory notes to Trust, which would become creditor under the notes. See Treas. Reg. § 53.4941(d)-2(c)(1).

Instead, Trustor assigned the promissory notes to LLC and proposes to transfer nonvoting interests in LLC to Trust. Trust will acquire the nonvoting interests in LLC by gift rather than through a self-dealing transaction. However, if Trust would be considered to "control" LLC within the meaning of Treas. Reg. § 53.4941(d)-1(b)(5), then Trust would be considered to be the creditor, indirectly, under the note by reason of its ownership interest in LLC. See Treas. Reg. § 53.4941(d)-1(b)(8), Example (1).

As holder of the nonvoting interests, Trust will have no management rights or right to vote on the manager of LLC. LLC 2 will own all of the voting interests, giving LLC 2 the right to select and remove the manager LLC. As a holder of nonvoting interests, Trust will have a right to receive distributions only if LLC dissolves or chooses to make current distributions, but the timing and amount of such distributions will be uncertain and could not be compelled by Trust. Only LLC 2, as the holder of the voting interests, may elect or remove the manager of LLC, and such manager will have the sole power to manage the affairs of LLC and determine the timing and amount of distributions. Thus, Trust and Trust's trustees (acting only in such capacity) will not have sufficient votes or positions of authority to cause LLC to engage in a transaction.

Additionally, Trust will not have the power to compel dissolution of LLC since LLC may only be dissolved with written approval of all members, including LLC 2. The power associated with the nonvoting interests of LLC as a necessary party to vote on the liquidation of LLC is not considered equivalent to a "veto power" within the meaning of Treas. Reg. § 53.4941(d)-1(b)(5) because the power cannot be exercised over an action relevant to any potential act of self-dealing. Consequently, Trust will not "control" LLC within the meaning of Treas. Reg. § 53.4941(d)-1(b)(5).

Accordingly, Trust's receipt of nonvoting interests in LLC from Trustor will not constitute a loan or extension of credit between a "private foundation" and a "disqualified person" within the meaning of section 4941(d)(1)(B) and Treas. Reg. § 53.4941(d)-2(c) because Trust will not acquire an interest in the promissory note; instead, Trust will acquire nonvoting interests in LLC, with respect to which it will not have any management rights or control over distributions.

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subject to the excess business holdings prohibition; ruling obtained by Turney Berry's law firm), 201407023, and 201407021 (which also approved the LLC as not being a "business enterprise" subject to the excess business holdings prohibition).

> Thus, Trustor's proposed transfer of nonvoting interests in LLC to Trust will not constitute an act of self-dealing described in section 4941.

Note that nonvoting interests will be subject to valuation discounts, reducing the charitable deduction.[4960]

Letter Ruling 200635017 approved the following involving options and LLC holding notes:

> B had three children: C, married to D, E, married to F, and G. C, E, D, and G are now deceased. D, F and G are each referred to as a "Taxpayer" and collectively as the "Taxpayers."
>
> C, F and G entered into a business transaction with family members (including trusts or other entities controlled by, or created for the benefit of, family members). Pursuant to these transactions, C, F and G acquired a promissory note as consideration, each referred to as a "Note." Each Note provides for annual interest at the mid-term Applicable Federal Rate, with principal due at the end of the note term.
>
> Each Taxpayer created a single member limited liability company of which the Taxpayer is the sole member. Each of these entities is referred to as a "Company" and collectively as the "Companies." Each Taxpayer contributed his or her Note to his or her Company, in exchange for which the Taxpayer received all of the voting units ("Voting Units") and nonvoting units ("Nonvoting Units") of his or her respective Company. Pursuant to C's and D's estate plans, D's estate currently owns the Voting and Nonvoting Units in C's Company. In addition, F (through her revocable trust) currently owns the Voting and Nonvoting Units in F's Company, and G's estate currently owns the Voting and Nonvoting Units in G's Company. Each taxpayer entered into a limited liability company agreement ("Company Agreement") to govern his or her respective Company.
>
> Taxpayers state that each Company will be engaged solely in passive investment activities; will not engage in the operation of any business enterprise; and at least 95 percent of the gross income of each Company will be derived from passive investments that will include, for example, interest and dividends.
>
> Each Taxpayer created a charitable trust to be funded at his or her death. Each of these trusts is referred to as a "CT" and collectively as the "CTs." Each CT has a 20-year term commencing at the Taxpayer's death, during which term the CT will annually pay a guaranteed annuity to one or more charitable organizations.
>
> Each Taxpayer has also created a revocable trust, separate and distinct from the Taxpayer's CT. Taxpayers state that each Taxpayer has provided in his or her revocable trust that at the Taxpayer's death, the Nonvoting Units owned by the Taxpayer will be allocated to the CT created by that Taxpayer. As a Nonvoting Unit holder, the CT cannot be required by the Company or its members, under the Company Agreement, to make any capital contributions or take any other actions. Nor does the CT have a right to force any distributions from the Company. Rather, under the Company Agreement the CT only has a right to receive distributions (in proportion to its ownership interest) when the Company dissolves or otherwise chooses to make distributions. The Taxpayer's

[4960] See part II.O.3 Effect of Buy-Sell on Charitable Estate Tax Deduction.

Voting Units will be bequeathed to or in trust for the benefit of the Taxpayer's descendants.

Pursuant to an agreement (the "Option Agreement"), each Taxpayer (and his or her revocable trust) granted his or her children and a business entity controlled by the Taxpayers and their families (collectively, the "Option Holders") an option (the "Option") to purchase one or more specific assets (including the Note and any of the Nonvoting Units) (collectively, the "Option Assets") from the then current owner of the Option Assets, including the Company or the Taxpayer's estate or revocable trust. The Option Assets will not include any of the Voting Units. The Option Agreement provides that the Option Holders may purchase some or all of the Option Assets for a purchase price equal to the fair market value of such Option Assets as determined for federal estate tax purposes in the Taxpayer's estate at any time within nine months of the Taxpayer's death (the "Option Term"). The Option Holders will be required to pay the purchase price for the Option Assets in cash, marketable securities, or a combination of both.

With respect to any Option Assets to be purchased from the Taxpayer's estate or revocable trust, before the expiration of the Option Term, Taxpayers state that their estates or revocable trusts will petition a court of competent jurisdiction for approval of both the Option Holders' exercise of their options, as well as the tendering and receipt of consideration pursuant to each Option Agreement. Taxpayers state that the exercise of the Options by the Option Holders, the sale and purchase of Option Assets, and the tendering and receipt of consideration related thereto, will occur before the end of the period reasonably required by the executors or trustees to perform the ordinary duties of administration necessary for the settlement of the Taxpayers' estates and before the Taxpayers' revocable trusts are treated as trusts under section 4947 of the Code. Taxpayers state that the purchase of the Option Assets owned by the Taxpayers' estates or revocable trusts pursuant to each Option Agreement will be contingent upon receipt of approval from a court of competent jurisdiction.

Letter Ruling 200635017 concluded:

1. The exercise of the Option and the purchase of Option Assets from a Taxpayer's estate or revocable trust by the Option Holders, the tendering of consideration by the Option Holders to the Taxpayer's revocable trust or estate, the receipt of such consideration by the Taxpayer's revocable trust or estate, and a distribution of such consideration from the Taxpayer's revocable trust or estate to the CT, will satisfy the requirements for the exception to indirect self-dealing described in section 53.4941(d)-1(b)(3) of the regulations, and therefore will not constitute impermissible acts of self-dealing under section 4941 of the Code.

2. Neither (i) the exercise of an Option and related sale and purchase of the Option Assets between one or more disqualified persons as to a Taxpayer's CT and the Taxpayer's Company nor (ii) the retention by that Company of a Note following the Taxpayer's death, will constitute indirect acts of self-dealing pursuant to section 53.4941(d)-1 of the regulations, and will not violate section 4941 of the Code.

We are expressly not ruling as to whether any subsequent transactions between a CT and a Company would constitute an act of self-dealing under section 4941 of the Code.

3. A CT's ownership of Nonvoting Units will not constitute a violation of the prohibition against ownership of excess business holdings under section 4943 of the Code because the Company is not a "business enterprise" within the meaning of section 4943(d)(3).

Letter Ruling 9312024 applied Reg. § 53.4941(d)-1(b)(3) to approve a redemption and related note payments to M, a private foundation, ruling:[4961]

1. The sale by A's estate and the purchase by N and O or B of the shares pursuant to the terms of the Redemption Agreement for the consideration specified in the Redemption Agreement will not be an act of self-dealing with M under section 4941 of the Code by N, O, B, or A's estate.

2. The acceptance by A's estate and the delivery by N and O or B of the note of N and O or B in payment for the shares of N and O owned by A's estate will not be an act of self-dealing with M under section 4941 of the Code by N, O, B, or A's estate.

3. The distribution by A's estate to M of the note of N and O or of B will not be an act of self-dealing with M under section 4941 of the Code by N, O, B, or A's estate.

4. After distribution of the note by A's estate to M, payments on the note by N and O or B will not be acts of self-dealing under section 4941 of the Code by N and O or B as payor or M as payee.

5. The determination whether, for purposes of section 4941 of the Code and the regulations promulgated thereunder, A's estate will receive an amount which equals or exceeds the fair market value of M's interest or expectancy in the shares, will be determined after taking into account the terms of the Redemption Agreement to which the shares acquired by A's estate will be subject.

Letter Ruling 9112012 approved the following arrangement:

> You were established by A and B to carry on certain charitable endeavors. A and B are members of your seven member board of directors. In addition to other property interests, you have a remainder interest in certain nonresidential rental real estate. You have been recognized as exempt under section 501(c)(3) of the Code and are a private foundation within the meaning of section 509(a).
>
> A and B also established two revocable inter-vivos trusts which are controlled and operated by their two sons. The sons have never made contributions to you, nor have they been members of, nor served as your trustees. The trusts in turn have established a partnership. The partnership has the option to purchase the real estate you have the remainder interest in. A and B have also given quit claim deeds to the partnership transferring their current life estate in the property to the partnership. Your remainder

[4961] Consistent with this result (but not including all of the rulings) include Letter Rulings 200729043 (notes owed by disqualified persons to a corporation that liquidated into a revocable trust that distributed the notes to the foundation), 199924069, 9350038, 9108024, and 9042030 (the latter approving the foundation's "exercise of any rights granted it under the note and any deed of trust, security agreement or similar instrument that secures payment of the note").

interest has not vested because A and B are still living. Furthermore, as stated above the two inter-vivos trusts are revocable.

The option agreement provides that the partnership has an exclusive option to purchase the property, or any part thereof, for a period or five years from the date of death of the survivor of A and B. The option price shall be equal to the fair market value of the property as determined by a mutually agreed appraiser. The purchase price shall be amortized over thirty years and the rate or interest shall be the prevailing prime interest rate at a named bank. It also states that no brokerage fee shall be due as a result of this transaction.

Letter Ruling 9112012 reasoned:

Example (4) in Section 53.4941(d)-1(b)(8) of the regulations describes a situation where a substantial contributor to a private foundation bequeaths one-half of his estate to his spouse and one-half to the private foundation. The estate includes a one-third interest in a partnership, the remaining two-thirds of the partnership are owned by a disqualified person to the private foundation. The one-third interest was subject to an option agreement when it was acquired by the estate. The sale of the one-third interest in the partnership to the disqualified person did not constitute an act of self-dealing because the transaction satisfied the requirements set forth in section 53.4941(d)-1(b)(3).

The sons of A and B are disqualified parties and the partnership is controlled by them. You are the holder of the remainder interest in the property that the partnership has the option to buy. Therefore, unless otherwise excluded, any transaction between you and the partnership is an indirect act of self-dealing. The option agreement may be exercised within 5 years from the death of the grantors. The agreement provides that you will receive fair market value for your interest in the property. You have represented that a probate court with jurisdiction over this matter will approve the transaction and that the option agreement is legally binding upon the trust.

Accordingly, we have concluded that if the option is exercised under the conditions represented and if all of the requirements set forth in section 53.4941(d)-1(b)(3) of the regulations are satisfied, exercising the described option will not be an act of self-dealing.

Letter Ruling 201448023 applied Reg. § 53.4941(d)-1(b)(3) in its conclusion number 5 approving debt that otherwise would have constituted self-dealing, where "M" was a private foundation:

None of the following will constitute an act of direct or indirect self-dealing under § 4941:

a. The distribution from a decedent's Estate to a QTIP Trust, and the receipt by such Trust of a Note which was received by such Estate during the administration thereof in a transaction meeting all the requirements of § 53.4941(d)-1(b)(3), such Trust's holding of such Note during the lifetime of the surviving spouse, or the receipt by such Trust of any payments under such Note; or

b. The distribution from such QTIP Trust to M of any Note which was received by such Trust either from a decedent's Estate during the administration thereof or during the administration of the QTIP Trust after the surviving spouse's death in a transaction meeting all of the requirements of § 53.4941(d)-1(b)(3), and M's receipt of the same, its holding of any such Note, or its receipt of any payments under any such Note.

As to the interest rate for the debt, Franklin and Goode, "The Intermediary CLAT Alternative to the Residuary Estate Family Foundation Gift," 39 *ACTEC Law Journal* 355, 361, note 15 comments:

> Some planners believe that a promissory note issued under the estate administration exception to the self-dealing rules could simply carry an interest rate at the applicable Federal rate ("AFR"), and that would make the fair market value of the promissory note equal its face amount. In support for this position, I.R.C. § 7872 cites the AFR as the floor for a market rate loan. Moreover, in several existing PLRs, the IRS has blessed purchase transactions under the estate administration exception where the purchase price was provided through a promissory note bearing interest at the AFR. PLR 201206019 (Nov. 15, 2011); PLR 201129049 (Apr. 26, 2011); PLR 200124029 (Mar. 22, 2001). Attention should be paid, however, to the fact that in each PLR the taxpayer made a blanket representation that the promissory note in question had a fair market value equal to that of the property purchased without providing any further explanation. Additionally, the IRS made specific reference to such representation in reaching its conclusion despite having already established the note's rate of interest. Third-party loans, however, often carry much higher rates of interest. Given the near historically low AFRs, the government may view an AFR loan for purposes of the estate administration exception as being abusive. Pursuant to Treas. Reg. § 53.4941(d)-1(b)(3)(iv), the estate or trust must receive from the disqualified person property that "equals or exceeds the fair market value of the foundation's interest or expectancy ...." Therefore, consider whether the value of an AFR note is equal to its face value for purposes of the estate administration exception. Treas. Reg. §53.4941(e)-1(f) provides that "fair market value" under the estate administration exception should be determined pursuant to Treas. Reg. § 53.4942(a)-2(c)(4). This provision in turn makes reference to the principles stated in I.R.C. § 2031. Clearly, on the seller's side, the principles of § 2031 control how the property sold by the estate or trust would need to be valued. On the purchaser's side, it would seem odd if the promissory note being exchanged by the purchaser could be valued pursuant to different rules, such as § 7872, which might allow an AFR note to have a value equal to its face value. I.R.C. § 2031 provides for an all-inclusive view of a promissory note's value (*i.e.*, the note's value is not merely a factor of its principal amount and interest rate but also its terms of payment and enforceability, etc.). Treas. Reg. § 20.2031-4. The basic idea of the self-dealing rules is to prohibit a disqualified person from gaining an advantage at the foundation's expense. To construe the estate administration exception as allowing a disqualified person to garner a bargain rate of interest using the current low AFRs would seemingly violate the spirit of the self-dealing rules. For purposes of this paper, the assumption is that any promissory note issued under the estate administration exception must carry a market rate of interest, as well as other reasonable terms relating to enforceability, to enable the promissory note's value (*i.e.*, by appraisal) to equal its face value.

See Private Foundations: Amount Involved - Self-Dealing Lending of Money to Disqualified Persons IRC Section 4941(e)(2) | Internal Revenue Service (irs.gov).

II.Q.7.c.iii. Cleansing Earnings and Profits from a Prior C Corporation

As discussed above, dividend treatment applies to the extent that a distribution exceeds AAA and is made out of C corporation earnings and profits. This treatment would not apply on liquidation of the corporation.[4962] What happens when a trust that owns an interest in an S corporation has a charity as its beneficiary?

The charitable income tax deduction should offset dividend income received by the trusts from the corporation.[4963] Making an ESBT election should not affect the charitable income tax deduction, because the dividend is not considered part of the S portion.[4964] If the trust's basis in the S corporation stock was determined by reason of purchase, the dividend income reduces the basis of the S stock in determining the gain or loss on the sale that constitutes unrelated business taxable income.[4965]

If distributions exceed AAA and earnings & profits, that excess would be treated as a return of capital,[4966] reducing basis.[4967] Any amount that exceeds basis would be treated as a gain from the sale of stock,[4968] which would be treated as part of the S portion and, if an ESBT election is in effect, would not be offset by the charitable income tax deduction.

If an amount is intended to be accumulated in the trust, then using AAA is the easiest way.

If an amount is intended to be distributed to charity and it's possible that future distributions will need to be accumulated, then a Code § 1368(e)(3) election should be made to treat the distribution as a dividend from earnings and profits so that AAA is used only for future accumulated distributions.

II.Q.7.c.iv. Using a Charitable Remainder Trust to Avoid Built-in Gain Tax

If an S corporation contributes built-in gain property to a term-of-years (typically 20 years) charitable remainder trust ("CRT") for the benefit of the corporation[4969] and that property is sold for a capital gain, then the sale will not trigger immediate tax. Instead, the CRT's distributions

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[4962] See Letter Ruling 200402003 regarding an S corporation that merges into a nonprofit corporation.
[4963] Code § 642(c). Code § 512(e)(1) characterizes S corporation items as unrelated business income; however, those items are just items on the K-1 issued by the S corporation, together with any gain or loss on the disposition of the stock in the S corporation. Congress appeared to recognize that distributions of C corporation earnings and profits would escape this tax when it provided for basis reductions with respect to some of that dividend income, as described in the text accompanying fn. 4965; this basis reduction provision was enacted at the same time as the tax K-1 items and gain on the sale of stock. See Conference Report 104-737, reproduced in *RIA Checkpoint* at COMREP ¶13,611.001 S corporations permitted to have 75 shareholders. (Small Business Job Protection Act of 1996, PL 104-188, 8/20/96), P.L. 104-188, Sec. 1316(c), and P.L. 105-34, Sec. 1523(a).
[4964] Reg. §§ 1.641(c)-1(g)(2), 1.641(c)-1(l), Example (1)(iii).
[4965] Code § 512(e)(2). This rule would not apply if the trust acquired its stock by reason of death, since that provision (by way of Code § 1361(e)(1)(C)) refers to Code § 1012, not Code § 1014.
[4966] Code § 1368(c)(3).
[4967] Code § 1368(b)(1).
[4968] Code § 1368(b)(2).
[4969] The term interest must benefit the corporation; if it benefits the shareholders, then the gratuitous transfer will be treated as a constructive distribution to such partners or shareholders for tax purposes and the partners or the shareholders will be treated as the grantors of the trust. Letter Ruling 200203034, citing Reg. § 1.671-2(e)(4), and also holding that the trust would not qualify as a charitable remainder trust.

will come first from ordinary income and not from any built-in gain, and during the recognition period distributions will be subject to built-in gain tax only to the extent that capital gain constituting built-in gain is distributed to the S corporation.[4970] The contributed assets must not constitute substantially all of the corporation's assets, since a corporation recognizes gain if it conveys substantially all of its assets to a tax-exempt entity.[4971] See also part II.D.2 Business Entity as Grantor of Tru.

Also, if and to the extent that sale (or holding) of the asset constitutes unrelated business taxable income (UBTI), this strategy will not work. Any UBTI a CRT earns is subject to a 100% excise tax, in addition to being taxable when distributed to the beneficiary, resulting in an ultimate tax well in excess of 100%.[4972] For example, a so-called "negative basis asset"[4973] generally has significant debt-financed income, and debt-financed income/gain and ordinary business income are UBTI.[4974]

II.Q.7.d. Special Rules for Certain Sales of Stock in an S corporation

The sale of stock in an S corporation can be treated as a sale of the corporation's assets, followed by the corporation's liquidation. See part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.

II.Q.7.e. Bequest to a Corporation

A bequest to a corporation is treated as a bequest to the remaining shareholders, followed by a contribution of capital to the corporation.[4975] Thus, the remaining shareholders receive an increased basis in their stock in the corporation.

If the bequest is of stock in the corporation, a bequest to the remaining shareholders directly would be cleaner from an income tax perspective, in that the remaining shareholders may specifically identify lots of stock when they sell or otherwise transfer their stock. However, a bequest to the corporation might be simpler, in that ownership might vary over time, and a "transfer on death" designation to the corporation will accomplish the objective in a simple manner.

[4970] Letter Ruling 200644013 focused on whether a contribution of property that had built-in gain accumulated from prior C corporation years would trigger Code § 1374 built-in gain tax. In that ruling, the corporation contributed real estate to a 20-year CRT. Later, but before the end of the Code § 1374 recognition period, the CRT would sell the property and use the sale proceeds to invest in stocks, bonds, and other securities that pay interest and dividends. The IRS declined to rule on whether the corporation would have recognized built-in gain under Code § 1374 on unitrust amounts received by it after the recognition period. The donor corporation was required to represent that the donation did not constitute "substantially all" of the donor's assets; see fn 4971.

[4971] Reg. § 1.337(d)-4(a)(1). Note the last sentence in fn 4970.

[4972] See part II.Q.6.c Possible Adverse Consequences When Contributing Partnership Interest to Charitable Remainder Trust, especially fns. 4661-4662.

[4973] See fn. 6590 in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System.

[4974] Code §§ 512, 513, and 514. Consider whether Code § 514(c)(2)(B) might address that concern.

[4975] Rev. Rul. 74-329.

Naming a corporation as the beneficiary of a life insurance policy might generate some challenging disclosures on the estate tax return.[4976]

[4976] Reg. § 20.2031-2(f) provides:

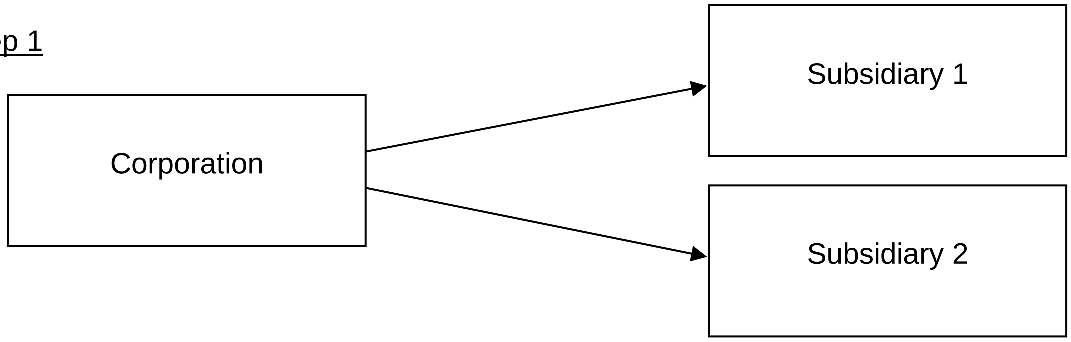
> In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity.

If the decedent gratuitously named the corporation as the beneficiary of a life insurance policy, arguably the death benefits' inclusion under Code § 2042 should be the only inclusion under the principle that it is really a bequest to the other shareholder and not to the corporation. Consideration of the death benefit should not equate to required inclusion in value in a situation such as that. However, the result is not nearly as clean as when the corporation itself owns the policy, which Reg. § 20.2042-1(c)(6) provides generally does not result in incidents of ownership even if the decedent controls the corporation. Reg. § 20.2042-1(c)(6), which is reproduced in part II.Q.4.i.ii.(b) Corporate Ownership of Policy. So a business owner who wants the business entity to hold insurance on the owner's life should consider instead having the entity own the policy. Consider Code § 2035 if transferring an existing policy. A tax-efficient way to move the policy might involve part II.Q.4.i Life Insurance LLC. When an entity owns a life insurance policy, consider part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

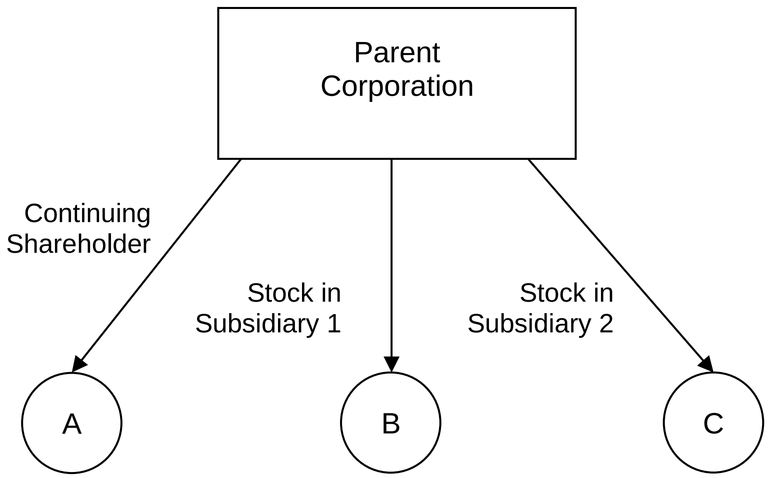
II.Q.7.f. Corporate Division into More Than One Corporation

II.Q.7.f.i. Overview

<u>Step 1</u>



<u>Step 2</u>



If a corporation owns another corporation, the parent corporation has no earnings and profits, and the subsidiary's value equals the parent's basis in its stock, then distributing the subsidiary might not have much tax effect. However, that is often not the case, and one wants to look for a way to do a tax-free corporate division, as described below.

In a spin-off, split up, etc., a corporation transfers one or more active businesses into one or more subsidiaries:

- "Active business" includes active real estate rental.
- It also includes an interest in an LLC that conducts an active business – 20% if the corporation performs management functions and 33-1/3% if not.

The active business needs to be at least 5 years old.

The transaction needs a business purpose that could not be accomplished in another nontaxable transaction.

- Estate planning is not a valid reason to split up a business.

- Differences in management objectives generally constitute a valid reason.

- Personal dislike is not enough; resolving disputes over business strategy generally is.

Letter Ruling 200842003 was a creative estate planning technique:[4977]

- Parent split corporation into 5 different entities.

- Parent sold an interest in each entity to a different irrevocable grantor trust for a different child.

- Although Code § 355 required the parent to continue to hold on to the new corporations, the parent was deemed not to have sold the corporations because the sale to the irrevocable grantor trust was disregarded for income tax purposes.

Also, a transaction in which (1) a parent corporation transfers all of the interests in its limited liability company that is taxable as a corporation to the first subsidiary in exchange for additional stock, (2) the first subsidiary transfers all of the interests in the limited liability company to the second subsidiary in exchange for additional stock, (3) the second subsidiary transfers all of the interests in the limited liability company to the third subsidiary in exchange for additional stock, and (4) the limited liability company elects to be disregarded as an entity separate from its owner for federal income tax purposes effective after it is owned by the third subsidiary, is properly treated for federal income tax purposes as two transfers of stock in Code § 351 exchanges followed by a Code § 368(a)(1)(D) reorganization.[4978]

Eustice, Kuntz & Bogdanski, *Federal Income Taxation of S Corporations* (WG&L), ¶ 3.03. Types of Shareholders,[4979] describes Letter Ruling 201949013 as:

> distributing corporation's "momentary ownership" of stock of controlled corporation distributed in split-off that was Type D reorganization did not cause controlled corporation to have ineligible shareholder for any portion of its first taxable year; thus, controlled corporation could be S corporation from its inception.

Bloomberg BNA's Tax Management Weekly Report (12/9/2019) described Letter Ruling 201949013:

> The IRS issued 15 rulings on an S corporation's ("Distributing") reorganization in which Distributing created Controlled as a subsidiary in order to facilitate a proposed transaction to resolve differences of opinion among its shareholders about how one of its lines of business, Business C, should be operated. Ruling (1) Upon the distribution, Controlled will no longer be a qualified subsidiary (QSub). Ruling (2) The contribution followed by the distribution will qualify as a reorganization under tax code Section 368(a)(1)(D), with Distributing and Controlled each "a party to a reorganization" within the meaning of Section 368(b). Rulings (3), (4), (7), (8) No gain or loss will be recognized by relevant entities in the contribution or the distribution. Rulings (5), (9) The basis of assets transferred in the Contribution and in the Distribution won't change upon

[4977] See part II.Q.7.f.iii.(g) Combining Split Up with Sale to Irrevocable Grantor Trust.
[4978] Rev. Rul. 2015-10.
[4979] As to Letter Ruling 201930011, the treatise says:
same as to multiple stocks distributed in split-up that was Type D reorganization.

the moment of transfer. Rulings (6), (10) The holding period for the recipient for a given asset will include that of the previous owner in the contribution and in the Distribution. Rulings (11),(12) Any earnings and profits will be allocated between Distributing and Controlled in accordance with Section 312(h) and regulations, and Distributing's accumulated adjustments account will be allocated between Distributing and Controlled in a similar manner. Ruling (13) Distributing's momentary ownership of Controlled stock won't cause Controlled to have an ineligible shareholder for any portion of its first taxable year under Section 1361(b)(1)(B); therefore Controlled will be permitted to elect to be an S corporation for its first taxable year provided it otherwise qualifies and makes such election effective immediately upon its QSub termination. Ruling (14), (15) Payments made by and between Distributing and Controlled will be treated as occurring immediately before the distribution.

Letter Ruling 201949013 involved the following facts and rulings:

Summary of Facts

Distributing was formed on Date 1 as a State A corporation. On Date 2, Distributing elected under § 1362(a) of the Code to be treated as a subchapter S corporation for Federal income tax purposes. Distributing is engaged in Business A, Business B, and Business C. Business A is operated by QSub 1, a State A corporation which has elected under § 1361(b)(3)(B) of the Code to be treated as a qualified subchapter S subsidiary for federal income tax purposes. Business B is operated by QSub 2, a State A limited liability corporation which has elected under § 1361(b)(3)(B) of the Code to be treated as a qualified subchapter S subsidiary for federal income tax purposes. Business C is operated by QSub 3, a State A limited liability corporation which has elected under § 1361(b)(3)(B) of the Code to be treated as a qualified subchapter S subsidiary for federal income tax purposes. Business C consists of assets including Asset A, Asset B, and Asset C. Distributing also owns a percent of LLC 1, a State A limited liability company which has elected to be disregarded for federal income tax purposes.

Distributing has both voting and non-voting shares of stock outstanding. Distributing's Series A stock represents a percent of the vote and b percent of the value. Distributing's Series B stock represents c percent of the vote and d percent of the value. Grantor Trust 1 owns e percent of the outstanding Series A stock. Grantor Trust 2 owns f percent of the outstanding Series A stock. Irrevocable Trust 1 owns g percent of the outstanding Series B stock. Irrevocable Trust 2 owns h percent of the outstanding Series B stock. Irrevocable Trust 3 owns i percent of the outstanding Series B stock. Distributing is managed and operated by the beneficiaries of Grantor Trust 1, Grantor Trust 2, Irrevocable Trust 1, Irrevocable Trust 2, and Irrevocable Trust 3.

On Date 3, Irrevocable Trust 1 elected to be treated as an electing small business trust under § 1361(e) of the Code. Irrevocable Trust 1 was created for the benefit of Beneficiary 1, Beneficiary 2, Beneficiary 3, and Beneficiary 4. Beneficiary 1, Beneficiary 2, Beneficiary 3, and Beneficiary 4 are siblings.

Beneficiary 1 is the beneficiary of Irrevocable Trust 4. Beneficiary 2 is the beneficiary of Irrevocable Trust 5. Beneficiary 3 is the beneficiary of Irrevocable Trust 6. Beneficiary 4 is the beneficiary of Irrevocable Trust 7.

Financial information has been submitted indicating that each of Business A and Business C have had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

To resolve differences of opinion among the shareholders as to how Business C should be operated, Distributing proposes the following transaction (the “Proposed Transaction”):

Proposed Transaction

To achieve the business purposes described above, the following series of steps are proposed:

1. The assets of Irrevocable Trust 1 will be divided into j equal shares and be contributed to Irrevocable Trust 4, Irrevocable Trust 5, Irrevocable Trust 6, and Irrevocable Trust 7. Irrevocable Trust 4 will receive k Series B shares of Distributing representing l percent of the outstanding Series B Shares. Irrevocable Trust 5, Irrevocable Trust 6, and Irrevocable Trust 7 will receive m Series B shares of Distributing representing n percent of the outstanding Series B Shares.

2. On Date 4, Controlled was formed as a subsidiary of Distributing. Distributing will file an election to treat Controlled as a qualified subchapter S subsidiary for federal income tax purposes under § 1361(b)(3)(B) of the Code. On Date 5, Controlled formed o State A single member limited liability companies (each a “Controlled SPE”).

3. Distributing will contribute Asset A, Asset B, and Asset C (the “Contribution” and collectively, the “Controlled Business”), Asset D, and p percent of LLC 1 to Controlled in exchange for Controlled common stock and the assumption of liabilities described in Step 4. Each asset of the Controlled Business and Asset D will be transferred to a separate Controlled SPE.

4. Distributing will cause Controlled to enter into a credit agreement with Bank, which will establish a line of credit with a maximum aggregate principal amount of $q prior to the Split-off and $r after the Split-off (the “Controlled Credit Line”). Prior to the Split-off, Controlled will draw down $q on the Controlled Credit Line, which will be evidenced by a promissory note (the “Controlled Loan”) and the outstanding principal of Distributing’s loan with Bank (the “Bank Loan”) will be reduced by a corresponding amount.

5. Any obligations (not otherwise settled or resolved in other steps) that would result in obligations between Distributing immediately following the Split-off (defined below) will be settled in cash, other than obligations under the Continuing Relationships (defined below).

6. Distributing will distribute all of the Controlled common stock to Irrevocable Trust 4 in exchange for all of the shares of Series B stock of Distributing owned by Irrevocable Trust 4 (the “Split-off” or the “Distribution”). Irrevocable Trust 4 may receive a cash distribution from Distributing equal to the Tax Cover Price, if that amount is positive, and Irrevocable Trust 4 will be required to pay the Negative Tax Cover to Distributing, if that amount is negative.

7. Contemporaneous with Step 6, Distributing will redeem for cash s shares of its Series A stock held by Grantor Trust 1 to reduce the percentage of Series A stock owned by Grantor Trust 1 to t percent of the outstanding Series A stock.

8. After the Split-off, Controlled will elect under § 1362(a) of the Code to be treated as an S corporation on the first available date, effective as of the date of the Split-off. Controlled's sole owner, Irrevocable Trust 4, will file a timely election to be treated as an electing small business trust under § 1361(e) of the Code.

9. Following the Proposed Transaction, Distributing will engage in certain continuing business relationships with Controlled, Irrevocable Trust, and Beneficiary 1 (collectively, the "Continuing Relationships"). All such relationships will be based on arm's length terms and conditions and will not be inconsistent with the overall separation of Business A and the Controlled Business.

Representations

With respect to the Distribution, except as set forth below, Distributing has made all of the representations in Section 3 of the Appendix to Rev. Proc. 2017-53, 2017-41 I.R.B. 283 in the form set forth therein.

Distributing has made the following alternative representations set forth in Section 3 of the Appendix to Rev. Proc. 2017-53:

Representations 3(a), 8(a), 11(a), 15(a), 22(a), 31(a), and 41(b).

Distributing has not made the following representations, which do not apply to the Proposed Transaction:

Representations 5, 6, 19, 20, 24, 25, 35, 36, 37, 38, 39, and 40.

In addition, except as set forth below, Distributing has made all of the representations in Section 3.04 of Rev. Proc. 2018-53, 2018-43 I.R.B. 667.

Distributing has made the following modified representation:

Representation 4: The Controlled Loan was obtained to substitute for an equivalent amount of Distributing Debt (the Bank Loan). Distributing incurred the Distributing Debt that will be satisfied with the Controlled Loan (a) before the request for any relevant ruling is submitted and (b) no later than 60 days before the earliest of the following dates: (i) the date of the first public announcement (as defined in § 1.355-7(h)(10)) of the Divisive Reorganization or a similar transaction, (ii) the date of the entry by Distributing into a binding agreement to engage in the Divisive Reorganization or a similar transaction, and (iii) the date of approval of the Divisive Reorganization or a similar transaction by the board of directors of Distributing.

Rulings

Based solely on the information submitted and representations made, we rule as follows:

1. The Split-off will cause a termination of Controlled's QSub election because Controlled will cease to be a wholly-owned subsidiary of an S corporation. For federal income tax purposes, Controlled will be treated as a new corporation acquiring all of its assets and assuming all of its liabilities from distributing immediately before the termination of Controlled's QSub election in exchange for the stock of Controlled (the Contribution), pursuant to Treas. Reg. § 1.1361-5(b)(1)(i) (§ 1361(b)(3)(B) and (C)).

2. The Contribution followed by the Split-off will qualify as a "reorganization" within the meaning of section 368(a)(1)(D). Distributing and Controlled will each be "a party to the reorganization" within the meaning of section 368(b).

3. Distributing will recognize no gain or loss on the Contribution. Sections 357 and 361(a).

4. Controlled will recognize no gain or loss on the Contribution. Section 1032(a).

5. Controlled's basis in each asset received in the Contribution will be the same as the basis of that asset in the hands of Distributing immediately prior to the Contribution. Section 362(b).

6. Controlled's holding period in each asset received in the Contribution will include the period during which Distributing held such asset. Section 1223(2).

7. Distributing will recognize no gain or loss on the Split-off. Section 361(c)(1).

8. Irrevocable Trust 4 will recognize no gain or loss (and no amount will be includable in its income) on the receipt of the stock of Controlled in the Split-off. Section 355(a).

9. The basis of the Controlled stock in the hands of Irrevocable Trust 4 immediately after the Split-off will be the same as the basis of the Distributing stock held by Irrevocable Trust 4 immediately before the Split-off. Section 358(a)(1).

10. Irrevocable Trust 4's holding period of the Controlled stock received in the Split-off will include the holding period of Irrevocable Trust 4's Distributing stock exchanged, provided that Irrevocable Trust 4 holds such Distributing stock as a capital asset on the date of the Split-off. Section 1223(1).

11. As provided in section 312(h), proper allocation of earnings and profits among Distributing and Controlled will be made in accordance with Treas. Reg. § 1.312-10(a).

12. Distributing's accumulated adjustments account immediately before the transaction will be allocated between Distributing and Controlled in a manner similar to the manner in which earnings and profits are allocated under § 312(h) in accordance with Treas. Reg. § 1.1368-2(d)(3) (§§ 1.312-10(a) and 1.1368-2(d)(3)).

13. Momentary ownership by Distributing of the stock of Controlled, as part of the reorganization, will not cause Controlled to have an ineligible shareholder for any portion of its first taxable year under section 1361(b)(1)(B). Controlled may, without requesting the Commissioner's consent, make a valid S corporation election before the expiration of the five-year period described in section 1361(b)(3)(D) and Treas. Reg. § 1.1361-5(c)(1), provided that (i) immediately following the distribution of the Controlled stock, Controlled is otherwise eligible to make an S corporation election, and (ii) the election is made effective on the date of the Split-off.

14. Payments made by and between Distributing and Controlled under the Continuing Relationships regarding liabilities, indemnities, or other obligations that (i) relate to periods ending on or before the Split-off, and (ii) do not become fixed and ascertainable until after the Split-off, will be treated as occurring immediately before the Split-off. See *Arrowsmith v. Commissione*r, 344 U.S. 6, 8 (1952); Rev. Rul. 83-73, 1983-1 C.B. 84.

15. Payments of Tax Cover Price made by Distributing to Irrevocable Trust 4 and payments of Negative Tax Cover Price made by Irrevocable Trust 4 to Distributing that do not become fixed and ascertainable until after the Split-off, will be treated as occurring immediately before the Split-off. See *Arrowsmith v. Commissioner*, 344 U.S. 6, 8 (1952); Rev. Rul. 83-73, 1983-1 C.B. 84.

Letter Ruling 202211009 approved a spin-off of Business A into a new corporation that was distributed to Family B in exchange for all of Family B's stock:

> Distributing is a State A corporation engaged in Business A which has a single class of voting common stock issued and outstanding (the "Distributing Stock"). Distributing Stock is owned equally by three families, Family A, Family B, and Family C. Distributing has outstanding debt, including the Related Party Note.
>
> Distributing has submitted financial information indicating that Business A has had the gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

If the corporation has a complex corporate structure implicating Code § 2701, one can prevent gift tax problems by making sure that the shareholders' rights in each corporation are identical to those they held in the parent corporation.[4980]

II.Q.7.f.ii. Code § 355 Requirements

Code § 355 provides seven requirements that must be met for a tax-free corporate division. The main corporation to be divided may be referred to as the distributing corporation. A corporation, stock in which is being distributed, may be referred to as the controlled corporation.

If a corporation cannot satisfy these rules, consider part II.Q.7.h.ix Value Freeze as Alternative to Code § 355 Division.

[4980] See Letter Ruling 9843010, discussed in fn. 7284.

The IRS will not issue private letter rulings merely to provide comfort. Instead, it will rule on only an issue of law the resolution of which is not essentially free from doubt and that is germane to determining the tax consequences of the transaction.[4981]

Furthermore, the IRS ordinarily will not issue letter rulings:[4982]

- If property owned by any distributing corporation or any controlled corporation becomes the property of a regulated investment company (RIC), within the meaning of Code § 851, or a real estate investment trust (REIT), within the meaning of Code § 856, in a certain type of transaction.[4983]

- If, immediately after any such distribution, the fair market value of the gross assets of the trade(s) or business(es) on which the distributing corporation or the controlled corporation relies to satisfy the active trade or business requirement of Code § 355(b) is less than 5% of the total fair market value of the gross assets of such corporation.[4984]

II.Q.7.f.ii.(a). Distribution to a Shareholder with Respect to the Shareholder's Stock

The first requirement Code § 355 sets out for a tax-free corporate division is that a distribution is made to a shareholder with respect to the shareholder's stock.[4985]

The distribution can be made in the following ways:

- First, the distribution could be a disproportionate distribution, where some of the shareholders receive a distribution and some do not. This type of division, a "split-off," is most often used when all of a company's stock is owned by the second generation of a family. One group of shareholders will receive a distribution of stock in the controlled corporation in exchange for their stock in the distributing corporation. The distribution could also be a pro-rata distribution.[4986] However, in family business succession planning, the pro-rata distribution scheme can be hard to use, since tax-free treatment might not be allowed if the distribution's stated purpose was to end shareholder dispute.

- Another option for distributions under Code § 355 would be a partially disproportionate distribution that involves a shareholder or group of shareholders leaving the distributing corporation completely, as in the disproportionate distribution, but one shareholder keeps his stock in the distribution corporation and receives some stock in the controlled corporation. This is another "split-off" scenario and is usually used when the corporate

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[4981] Rev. Proc. 2013-32.

[4982] Rev. Proc. 2015-43. Notice 2015-59 announced these changes because, depending on the situation:

> The Treasury Department and the Service believe that these transactions may present evidence of device for the distribution of earnings and profits, may lack an adequate business purpose or a Qualifying Business, or may violate other § 355 requirements. In addition, these transactions may circumvent the purposes of Code provisions intended to repeal the Supreme Court's decision in *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935) (General Utilities repeal). See, *e.g.*, §§ 311(b), 337(d), 367(a)(5), and 367(e); H.R. Rep. No. 100-391, at 1080-1084 (1987).

Section 3 of Notice 2015-59 was obsoleted by REG-134016-15 (7/15/2016).

[4983] Adding paragraph (57) to section 4.01 of Rev. Proc. 2015-3.

[4984] Adding paragraph (58) to section 4.01 of Rev. Proc. 2015-3.

[4985] Code § 355(a)(1)(A)(i). A distribution with respect to other securities is beyond the scope of these materials.

[4986] Code § 355(a)(2)(A).

separation occurs before the death of the business founder or family patriarch and that person holds the ownership interest in both corporations.

II.Q.7.f.ii.(b). Distribute Stock of a "Controlled Corporation" Which Distributing Corporation Controls Immediately Before the Distribution

The second requirement for a tax-free division under Code § 355 is that the distributing corporation must distribute stock of a "controlled corporation" which it controls immediately before the distribution.[4987]

Additionally, the distributing corporation must distribute all of the stock of the controlled corporation that it owns or at least must distribute enough of the stock to meet the Code § 368 control requirements.[4988] Under Code § 368, a corporation controls another if it owns at least 80% of the total combined voting power of the controlled corporation and at least 80% of the total number of shares of all other classes of stock of the controlled corporation. If the distributing corporation retains any of the controlled corporation's stock, it must establish that the retention was not in pursuance of a plan to avoid taxes.[4989]

Determining whether an acquisition of control has substance for federal tax purposes can be difficult and fact-intensive.[4990] The government became concerned that, in some cases, taxpayers may not be able to determine whether such an acquisition has substance with sufficient certainty to proceed with transactions that otherwise satisfy the requirements of Code § 355.[4991] Rev. Proc. 2016-40 provides a safe harbor[4992] for the following transactions that meet certain requirements:[4993]

(1) D owns C stock not constituting control of C;

(2) C issues shares of one or more classes of stock to D and/or to other shareholders of C (the issuance), as a result of which D owns C stock possessing at least 80 percent of the total combined voting power of all classes of C stock entitled to

[4987] Code § 355(a)(1)(A).
[4988] Code § 355(a)(1)(D); Reg. § 1.355-2(e)(1).
[4989] Reg. § 1.355-2(e)(2).
[4990] Rev. Proc. 2016-40, Section 2.10. In describing the background for this concern, various parts of Section 2 pointed to Rev. Rul. 56-117, Rev. Ruls. 63-260, 69-407, and 98-27 (limiting the application of *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), the limitation being based, in part, on § 1012(c) of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, 916-17, which added Code § 355(e)). Rev. Proc. 2016-40, Section 2.09 explained:

> Although the § 355(e) legislative history states, and Rev. Rul. 98-27 provides, that post-distribution events are not to be taken into account in determining whether a distributing corporation has control of the distributed corporation, this interpretation of § 355 applies only after it has been determined that, at the time of the distribution, the distributing corporation otherwise had control of the distributed corporation in substance. Thus, the § 355(e) legislative history and Rev. Rul. 98-27 do not prevent the step transaction doctrine from applying to determine if, taking into account all facts and circumstances (including post-distribution events), a pre-distribution acquisition of control has substance such that a distributing corporation has control of a corporation within the meaning of § 355(a)(1)(A) immediately prior to a distribution of the stock of that corporation.

[4991] Rev. Proc. 2016-40, Section 2.10.
[4992] Rev. Proc. 2016-40, Section 5 describes scope and effect of being within or not being within the safe harbors.
[4993] Rev. Proc. 2016-40, Section 3.

vote and at least 80 percent of the total number of shares of all other classes of stock of C;

(3) D distributes its C stock in a transaction that otherwise qualifies under § 355 (the distribution); and

(4) C subsequently engages in a transaction that, actually or in effect, substantially restores

(a) C's shareholders to the relative interests, direct or indirect, they would have held in C (or a successor to C) had the issuance not occurred; and/or

(b) the relative voting rights and value of the C classes of stock that were present prior to the issuance (an unwind).

The IRS will not assert that such a transaction lacks substance, and that therefore D lacked control of C immediately before the distribution, within the meaning of Code § 355(a)(1)(A), if the transaction is also described in one of the following safe harbors:[4994]

.01 No Action Taken Within 24 Months. No action is taken (including the adoption of any plan or policy), at any time prior to 24 months after the distribution, by C's board of directors, C's management, or any of C's controlling shareholders (as defined in § 1.355-7(h)(3)) that would (if implemented) actually or effectively result in an unwind.

.02 Unanticipated Third Party Transaction. C engages in a transaction with one or more persons (for example, a merger of C with another corporation) that results in an unwind, regardless of whether the transaction takes place more or less than 24 months after the distribution, provided that--

(1) There is no agreement, understanding, arrangement, or substantial negotiations (within the meaning of § 1.355-7(h)(1)) or discussions (within the meaning of § 1.355-7(h)(6)) concerning the transaction or a similar transaction (applying the principles of § 1.355-7(h)(12) and (13), relating to similar acquisitions), at any time during the 24-month period ending on the date of the distribution; and

(2) No more than 20 percent of the interest in the other party, in vote or value, is owned by the same persons that own more than 20 percent of the stock of C. For purposes of this section, ownership is determined by application of the constructive ownership rules of § 318(a) as modified by § 304(c)(3), except that for purposes of applying § 318(a)(3)(A) and (B), the principles of § 304(c)(3)(B)(ii) (without regard to § 304(c)(3)(B)(ii)(I)) apply.

For Code § 318(a), see part II.Q.7.a.viii Code § 318 Family Attribution under Subchapter C.

[4994] Rev. Proc. 2016-40, Section 4.

II.Q.7.f.ii.(c). Cannot Be Used Principally as a Device to Distribute the Earnings and Profits of either the Distributing or Controlled Corporations or Both

The third requirement is that the corporate division cannot be used principally as a device to distribute the earnings and profits of either the distributing or controlled corporations or both.[4995]

This rule prevents a corporation from helping its shareholders avoid dividend treatment by abusing Code § 355 and enabling shareholders to avoid immediate tax consequences, and to get capital gains treatment when one of the divided corporations is eventually sold. Although changes in the tax law since 2003 diminished the incentive to transform dividends into capital gains by lowering the tax rate on dividend income, sale treatment remains more beneficial than dividend treatment, because sale treatment allows the seller to use the seller's basis to offset gain and to defer tax using the installment method.[4996]

The determination that a division is being used as a device to avoid taxes is a facts and circumstances based test, but a number of "device factors" are strong evidence of tax avoidance. For example, when a distribution is pro-rata and no stock is surrendered back to the corporation, the IRS will take a close look at the transaction and make sure the distribution is not in fact a dividend.[4997] Another factor that may indicate abuse is when stockholders "cash-out" shortly after the division.[4998] The purpose of the Code § 355 tax-free provisions is to allow a corporation to continue its business is the form of two corporations instead of one, not to allow stockholders a quick tax-free way out of the company. The IRS will take into consideration significant changes in economic conditions that may have caused a stockholder to cash-out shortly after a distribution,[4999] but it is a situation the IRS will examine closely. The IRS will also examine the "nature, kind, amount, and use of the assets" of both the distributing and controlled corporations immediately after the transaction.[5000] This examination prevents a company from attempting to distribute assets unrelated to the corporation's business under a guise of splitting the corporation's active business. Another questionable situation arises when the controlled corporation and the distributing corporation have an exclusionary post-division relationship where one corporation is the secondary corporation that essentially serves the other.[5001] When such a relationship exists and the secondary corporation could be sold without adversely affecting the other corporation's business, the IRS considers this to be evidence of a tax-avoidance device.[5002] Proposed regulations would modify the nature and use of assets device factor.[5003]

In addition to listing numerous "device factors" in the Regulations, the IRS also provides a number of "nondevice factors" that are evidence of no tax avoidance purpose. Again, this determination is based on facts and circumstances, but the presence of one of these factors can help a corporation defend its division. These "nondevice factors" include having a strong business purpose of the transaction, having a distributing corporation that is publicly traded and

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4995 Code § 355(a)(1)(B).
4996 See part II.Q.7.a.iii Redemption Taxed Either as Sale of Stock or Distribution; Which Is Better When.
4997 Reg. § 1.355-2(d)(2)(ii).
4998 Reg. § 1.355-2(d)(2)(iii).
4999 PLR 9030037 (approving later trades when publicly traded stock was to be sold, but not by insiders), PLR 8932038 (approving post-division gift of 10% of corporation), PLR 9041078 (approving later trades when publicly traded stock was to be sold, but not by insiders).
5000 Reg. § 1.355-2(d)(2)(iv)(A).
5001 Reg. § 1.355-2(d)(2)(iv)(C).
5002 Reg. § 1.355-2(d)(2)(iv)(C).
5003 REG-134016-15 (7/15/2016).

widely held, and having a distribution to shareholders that are domestic corporations eligible for the dividends-received deduction.[5004] Proposed regulations would modify the corporate business purpose nondevice factor.[5005]

Proposed regulations would add a per se device test to the device determination.[5006]

The IRS has removed this test from its list of areas on which it will not issue a private letter ruling.[5007]

II.Q.7.f.ii.(d). Active Business

The fourth requirement of Code § 355 is the "active business" test. For what is an "active business," see part II.Q.7.f.iii Active Business Requirement for Code § 355.

Both the distributing corporation and the controlled corporation must be engaged in an active trade or business for five years before the distribution. Thus, it may not always be easy for a business owner to separate the business into two distinct corporations, and sometimes it may be more costly for the business owner to do so than it would be for him to maintain the business as a whole and use less tax-advantageous business separation techniques when such separation becomes necessary. For example, two divisions could be separated into two wholly owned limited liability companies.

Code § 355(b)(1) requires that either (A) immediately after the division the distributing and controlled corporations are engaged in the active conduct of a trade or business, or (B) immediately before the distribution, the distributing corporation has no assets other than stock or securities of the controlled corporation and the controlled corporation is engaged in an active business immediately after the distribution. Four specific requirements must be met in order for a corporation to be treated as engaged in an active business. First, the corporation must be engaged in the active conduct of a trade or business, or, immediately after the distribution, substantially all of its assets are stock and securities of a corporation controlled by it which is engaged is such a trade or business.[5008] "Active trade or business" for purposes of Code § 355 is defined as a specific group of activities of the corporation being carried on for purposes of earning income or profit and the activities included in such group include all operations that form any part of, or step in, the process of earning income or profit.[5009] Next,

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[5004] Reg. § 1.355-2(d)(3).
[5005] REG-134016-15 (7/15/2016).
[5006] REG-134016-15 (7/15/2016), providing:

> Under proposed § 1.355-2(d)(5), if designated percentages of Distributing's and/or Controlled's Total Assets are Nonbusiness Assets, the transaction would be considered a device, notwithstanding the presence of any other nondevice factors, for example, a corporate business purpose or stock being publicly traded and widely held. By their nature, these transactions present such clear evidence of device that the Treasury Department and the IRS have determined that the nondevice factors can never overcome the device potential. The only exceptions to this per se device rule would apply if the distribution is also described in § 1.355-2(d)(3)(iv) (distributions in which the corporate distributee would be entitled to a dividends received deduction under section 243(a) or 245(b)) or in redesignated § 1.355-2(d)(6) (§ 1.355-2(d)(5) of the current regulations, relating to transactions ordinarily not considered as a device).

[5007] Rev. Proc. 2016-45.
[5008] Code § 355(b)(2)(A).
[5009] Reg. § 1.355-3(b)(2)(ii). Specifically excluded from the definition of an active trade or business are activities such as holding of stock, securities, land or other property for investment purposes.

such trade or business is required to have been actively conducted throughout the five-year period ending on the date of the distribution.[5010] The trade or business also must not have been acquired within that five-year period in a transaction in which gain or loss was recognized either in whole or in part.[5011] Finally, the control of a corporation conducting an active trade or business must not have been acquired in a taxable transaction in the same five year period.[5012] Additional details are further below.

Rev. Rul. 2019-9 provides:

> This revenue ruling suspends Rev. Rul. 57-464, 1957-2 C.B. 244, and Rev. Rul. 57-492, 1957-2 C.B. 247, pending the completion of a study by the Department of the Treasury (Treasury Department) and the Internal Revenue Service (Service) regarding the active trade or business (ATB) requirement under sections 355(a)(1)(C) and (b) of the Internal Revenue Code.
>
> **Revenue Rulings**
>
> In Rev. Rul. 57-464, the Service considered the section 355 qualification of a corporation's separation of a manufacturing business from a group of real estate assets consisting of an old factory building used for storage and four other buildings: a duplex apartment building rented to employees of the corporation, a small office building rented to a single tenant, and two houses, one of which was occupied by a sister-in-law of the president of the corporation. The use of the old factory building for storage "was not in itself the active operation of a business as defined in the regulations." The rental activities "produced only a nominal rental" and "negligible" net income, and the properties "were acquired either as an investment or as a convenience to employees of the manufacturing business." The Service held that the separation did not satisfy the ATB requirement.
>
> In Rev. Rul. 57-492, a corporation engaged in refining, transporting, and marketing petroleum products began a separate operation to explore for and produce oil. The exploration and production operation incurred substantial expenditures but "did not include any income producing activity or any source of income" until less than five years preceding its separation from the primary refining, transportation, and marketing operation. The Service held that the exploration and production operation failed to

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Reg. § 1.355-3(b)(2)(iv). Additionally, owning or operating real or personal property used in a trade or business is not considered an active trade or business unless the owner also performs significant services with respect to the operation and management of the property. Reg. § 1.355-3(b)(2)(iv). Rev. Rul. 2007-42 approved a real estate rental activity that included certain services. The corporate parent of the LLC that engaged in those activities was deemed engaged in an active trade or business when the corporation owned 1/3 (but not 20%) of the LLC. Note also that proposed regulations have been issued that the author has not undertaken to study; see Cummings, The New Section 355(b) Active Trade or Business Proposed Regulations, *Journal of Taxation*, August 2007, page 74.

[5010] Code § 355(b)(2)(B). See Rev. Ruls. 2002-49 and 2007-42 regarding business conducted through an LLC.

[5011] Code § 355(b)(2)(C).

[5012] Code § 355(b)(2)(D). Letter Ruling 201551005 approved the target shareholders' receipt of cash boot and consequential recognition of gain when all of the target corporation's assets had a carryover basis. Letter Ruling 201551009 approved the recognition of income under Code §§ 481 (change of accounting method) and 751 (relating to differing interests in hot assets – see part II.Q.8.b.i.(g) Code § 751 – Hot Assets).

qualify as an ATB because, "[b]efore oil was discovered in commercial quantities ..., the venture ... did not include any income producing activity or any source of income."

Law

Section 355(a)(1) provides that, if certain requirements are met, a corporation may distribute stock and securities of a controlled corporation to its shareholders and security holders without recognition of gain or loss or income to the recipient shareholders or security holders. Among those requirements, both the distributing corporation and the controlled corporation must be engaged in an ATB immediately after the distribution. Sections 355(a)(1)(C) and (b), and § 1.355-3(a)(1)(i). Each trade or business must have been actively conducted throughout the five-year period ending on the date of the distribution. Section 355(b)(2)(B) and § 1.355-3(b)(3).

Section 1.355-3(b)(2)(ii) describes a "trade or business" as "a specific group of activities [that] are being carried on by the corporation for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit." In particular, "[s]uch group of activities ordinarily must include the collection of income and the payment of expenses." Section 1.355-3(b)(2)(ii).

Analysis

The Treasury Department and the Service are conducting a study to determine, for purposes of section 355, "whether a business can qualify as an ATB if entrepreneurial activities, as opposed to investment or other non-business activities, take place with the purpose of earning income in the future, but no income has yet been collected." See IRS statement regarding the active trade or business requirement for section 355 distributions, dated September 25, 2018, available at http://www.irs.gov/newsroom/statements-from-office-of-the-chief-counsel. The ATB analysis underlying the holdings in Rev. Rul. 57-464 and Rev. Rul. 57-492 focuses, in significant part, on the lack of income generated by the activities under consideration. Consequently, these rulings could be interpreted as requiring income generation for a business to qualify as an ATB.

Accordingly, Rev. Rul. 57-464 and Rev. Rul. 57-492 are suspended pending completion of the study. See IRM 32.2.2.8.1, para. 9 (Aug. 11, 2004) (providing that a revenue ruling can be suspended "only in rare situations to show that previously published guidance will not be applied pending some future action, such as ... the outcome of a Service study").

"Letter ruling addresses Section 355 ATOB requirement," *Journal of Taxation* (4/2020), reports:

Ltr. Rul. 201948001 (the PLR) focuses on whether a company satisfies the active trade or business (ATOB) requirement in a Section 355 transaction based on the business of a corporate subsidiary it indirectly owned through a foreign partnership. The IRS ruled that the acquisition of subsidiaries through a partnership termination did not preclude the businesses conducted by the subsidiaries from qualifying as an ATOB within the meaning of Section 355(b)….

Observations and implications. Although a PLR may not be relied on as precedent, this ruling indicates that in certain cases and when structured properly, a company may

> be able to rely on the ATOB of a corporate subsidiary of a partnership in order to satisfy the ATOB requirement in a Section 355 transaction. This ruling goes beyond previously issued PLRs as well as proposed regulations that the Treasury and the IRS issued in 2007 under Section 355(b) (the 2007 Proposed Regulations).
>
> The 2007 Proposed Regulations permit a distributing corporation to rely on an ATOB of a partnership in which the distributing corporation either holds a "substantial interest" or a "meaningful interest," as applicable, depending upon whether the distributing corporation performs active and substantial management functions for the partnership. The regulations do not specifically permit a distributing corporation to look through a partnership to the partnership's corporate subsidiary in order to rely on the corporate subsidiary's ATOB for purposes of satisfying the ATOB requirement under Section 355(b). However, the 2007 Proposed Regulations provide that a partnership may distribute the stock of a subsidiary to a distributing corporation and the distributing corporation may rely on the subsidiary's ATOB, notwithstanding that the distributing corporation acquired the stock of the subsidiary within five years of the Section 355 transaction date (See Prop. Reg. 1.355(b)(4)(ii)(B) and 1.355-3(d)(2), Example 35.)
>
> While the IRS also had previously issued at least one PLR that permitted a distributing corporation to rely on ATOB assets acquired from a partnership termination (Ltr. Rul. 201827008), Ltr. Rul. 201948001 appears to be the first PLR that permits a taxpayer to rely on a subsidiary's ATOB if that subsidiary was acquired from a partnership in a non-liquidating or a liquidating distribution within five years of the date of the Section 355 transaction. Although limited to its facts, the PLR illustrates that if an ATOB is held by a corporate subsidiary of a partnership, a taxpayer-partner intending to make a distribution in a Section 355 transaction may terminate the partnership prior to the Section 355 transaction and bring that subsidiary into its separate affiliated group and rely on the ATOB conducted by such subsidiary to satisfy the ATOB requirement under Section 355.

Letter Ruling 202033005, when a family business divided when a trust holding it terminated, is reproduced in part II.Q.7.f.ii.(f) Continuity of Interest.[5013]

Letter Ruling 202340015 approved a Code § 355 separation for the following (highlighting mine):

> Distributing is a publicly traded corporation engaged in non-pharmaceutical Business A and non-pharmaceutical Business B through its direct and indirect subsidiaries (the "Distributing Worldwide Group") which includes conducting research and development activities for the production of Product. Before Product can be marketed and sold to the public, it must go through a series of steps in order to receive approval from the Regulatory Agency. The operations associated with Business A and Business B are conducted in Country B and Country C, respectively.
>
> Distributing directly owns 100 percent of the stock of FSub 1 and FSub 2, which are each corporations organized under the laws of Country A. FSub1 and FSub 2, in turn, collectively own 100 percent of the stock of FSub 3, a corporation organized under the laws of Country B. FSub 3 owns the assets associated with Business A. Distributing

[5013] Beginning with the text accompanying fn 5028.

acquired 100 percent of the stock of FSub 1 on Date A in a transaction intended to qualify as a tax-free reorganization under § 368(a).

Distributing owns 100 percent of the stock of FSub 4, which is organized under the laws of Country A and classified as a corporation for federal income tax purposes. FSub 4 owns 100 percent of the stock of Sub 1, a corporation organized under the laws of Country C. Sub 1 directly owns 100 percent of the equity interests in LLC1, a limited liability company organized under the laws of Country C that is classified as an entity disregarded as separate from its owner for federal income tax purposes. Sub 1 and LLC1 collectively own the assets associated with Business B.

For more than five years, the Distributing Worldwide Group's employees have engaged in regular, continuing operational and managerial activities with respect to each of Business A and Business B. The Distributing Worldwide Group has not yet collected income associated with either Business A or Business B but submitted information in accordance with Rev. Proc. 2017-52 indicating that it had incurred substantial, continuing operating expenses representing the active conduct of a trade or business with respect to Business A and Business B for each of the past five years.

II.Q.7.f.ii.(e). Transaction Must Have At Least One Corporate Business Purpose

The fifth requirement is that the transaction must have at least one corporate business purpose.[5014]

The predecessor to this regulation provided that "a distribution by a corporation of stock of a controlled corporation will not qualify under section 355 of the Code where carried out for purposes not germane to the business of the corporations, and that the distribution must be incident to a readjustment of corporate structures required by business exigencies."[5015] Under that regulation, retaining a "franchise vital to the business of the distributing corporation" was a "valid business purpose."[5016]

[5014] Reg. § 1.355-2(b).

[5015] Rev. Rul. 75-337, summarizing then-Reg. § 1.355-2(c).

[5016] Rev. Rul. 75-337 involved the following facts:

> X corporation operated an automobile dealership. Its franchise for the sale and service of automobiles was in the name of individual A who managed X and owned 53 percent of its stock. A was 70 years old and this stock constituted the bulk of his estate. The balance of the stock was held by A's five daughters in equal proportions. Three of the daughters were also actively employed in the X business. The other two daughters were not actively employed by X.
>
> Y corporation, a wholly owned subsidiary of X, was engaged in the business of renting automobiles.
>
> The franchise policy of the automobile manufacturer did not favor granting or continuing a franchise where there were inactive shareholders unless the manager holding the franchise owned a majority of the stock. As an alternative, the manufacturer's policy permitted the granting or continuing of a franchise where there was no majority shareholder, provided the shareholders were few in number and all were active in the business. The manufacturer does not grant franchises to corporations, only to individuals or partnerships. The franchise was renewable periodically and was not transferable by inheritance or otherwise.
>
> As the first step in a plan to insure that X's shareholders would be able to renew the franchise upon the death or retirement of A, who was then 70 years old, X distributed three-fourths of the Y stock to the two inactive-daughter shareholders in exchange, value for value, for all of their X

This requirement ensures that nonrecognition treatment is given only to distributions that are part of readjustments of corporate structures caused by business exigencies and to readjustments of continuing interests in property under modified corporate form.[5017] The purpose must be a "real and substantial non Federal tax purpose."[5018] The distribution to shareholders does not satisfy a corporate business purpose if the corporate business purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation and is neither impractical nor unduly expensive.[5019]

> stock. The remaining one-fourth of the Y stock was distributed to A in exchange for shares of his X stock of equal value. A intended that upon his death the inactive-daughter shareholders would receive their inheritance in Y stock and assets other than stock of X.
>
> The distribution of the Y stock to A furthered the objective of enabling X's shareholders to retain the automobile franchise by increasing the percentage of ownership in X on the part of the active shareholders (other than A) and by providing A with Y stock which he could bequeath or gift to the inactive-daughter shareholders, leaving his remaining X stock available for bequests or gifts to the active shareholders.

Rev. Rul. 75-337 reasoned:

> Upon the death or retirement of A, the present stock ownership of X with proportionate bequests or gifts to A's daughters (because A's X stock represented the bulk of his estate) would preclude the existence of a majority active shareholder of X or all active shareholders in X for the purpose of renewing the X shareholders' franchise under the manufacturer's dealership policy. In order to insure qualification under the alternate conditions of the franchise policy, it was necessary to set the stage for X shareholders to retain the franchise at A's death or retirement, without chancing a potential interruption in the continuity of, or even the loss of, the franchise which might occur if nothing was done until after A's death or retirement. This was accomplished by first causing the Y stock to be distributed and then having A provide in his will or by gift for only the active shareholders to receive his shares of X stock.
>
> Thus, the distribution of Y stock is germane to the continuation of the X business in the reasonably foreseeable future. Execution of the plan will forstall an impending disruption to the X business by reason of the current active family group being unable to renew X's franchise upon A's death or retirement.
>
> In *Rafferty v. Commissioner*, 452 F.2d 767 (1st Cir. 1971), it was held, under a plan to avoid any remote possibility of interference in a business by future sons-in-law, that the spin-off had no immediate business reason, involved a personal motive and had as its primary purpose a desire to make bequests in accordance with an estate plan. The difficulties anticipated were so remote that they might never come to pass. The daughters might never marry - thus eliminating completely any cause to worry about business interference by future sons-in- law. There was, at best, "only an envisaged possibility of future debilitating nepotism," and the effect on the business was conjectural.
>
> In the instant case, the problem was immediate due to the advanced age of A and was directly related to the retention of a franchise vital to the business of the distributing corporation. Accordingly, the distribution by X of the Y stock to the inactive-daughter shareholders and to A in exchange for X stock is supported by a valid business purpose within the contemplation of section 1.355-2(c) of the regulations.

[5017] Reg. § 1.355-2(b).

[5018] Reg. § 1.355-2(b).

[5019] Reg. § 1.355-2(b)(3). Reg. § 1.355-2(b)(5), Example (3) provides:

> Corporation X is engaged in the manufacture and sale of toys and the manufacture and sale of candy. The shareholders of X wish to protect the candy business from the risks and vicissitudes of the toy business. Accordingly, X transfers the toy business to new corporation Y and distributes the stock of Y to X's shareholders. Under applicable law, the purpose of protecting the candy business from the risks and vicissitudes of the toy business is achieved as soon as X transfers the toy business to Y. Therefore, the distribution is not carried out for a corporate business purpose. See paragraph (b)(3) of this section.

The Regulations also note that a "shareholder purpose… is not a corporate business purpose."[5020] However, sometimes a shareholder's purpose is so coextensive with the corporate business purpose that no real distinction exists between the two, and in such cases, the transaction will be considered to have a corporate business purpose.[5021] Clearly, not all shareholder disputes will rise to the level of a corporate business purpose. For example, a dispute between shareholders who are not part of management would have little effect on the business itself, thus, such a dispute would not be co-extensive with a business purpose:

- The Regulations provide an example of a shareholder dispute that would be coextensive with a corporate business purpose.[5022] The example involves a corporation, owned by two shareholders, engaged in two businesses – manufacturing and selling furniture and selling jewelry. Shareholder A wants to continue the furniture business, and Shareholder B wants to continue the jewelry business. If A and B decide to split up the business and cut ties with one another, the transaction will be considered to have a corporate business purpose – the business will likely benefit from having the interested shareholder running the business – even though the separation was also driven by a shareholder purpose.

- Citing the above example, Rev. Rul. 2003-52 approved as having a business purpose the division of a farming corporation[5023] where the "distribution will eliminate this disagreement

[5020] Reg. § 1.355-2(b)(2).
[5021] Reg. § 1.355-2(b).
[5022] Reg. § 1.355-2(b)(5), Example (2).
[5023] The facts were:

Corporation X is a domestic corporation that has been engaged in the farming business for more than five years. The stock of X is owned 25 percent each by Father, age 68, Mother, age 67, Son, and Daughter. Although Father and Mother participate in some major management decisions, most of the management and all of the operational activities are performed by Son, Daughter, and several farmhands. The farm operation consists of breeding and raising livestock and growing grain.

Son and Daughter disagree over the appropriate future direction of X's farming business. Son wishes to expand the livestock business, but Daughter is opposed because this would require substantial borrowing by X. Daughter would prefer to sell the livestock business and concentrate on the grain business. Despite the disagreement, the two siblings have cooperated on the operation of the farm in its historical manner without disruption. Nevertheless, it has prevented each sibling from developing, as he or she sees fit, the business in which he or she is most interested.

Having transferred most of the responsibility for running the farm to the children, Father and Mother remain neutral on the disagreement between their children. However, because of the disagreement, Father and Mother would prefer to bequeath separate interests in the farm business to their children.

For reasons unrelated to X's farm business, Son and Daughter's husband dislike each other. Although this has not impaired the farms operation to date, Father and Mother believe that requiring Son and Daughter to run a single business together is likely to cause family discord over the long run.

To enable Son and Daughter each to devote his or her undivided attention to, and apply a consistent business strategy to, the farming business in which he or she is most interested, to further the estate planning goals of Father and Mother, and to promote family harmony, X transfers the livestock business to newly formed, wholly owned domestic corporation Y and distributes 50 percent of the Y stock to Son in exchange for all of his stock in X. X distributes the remaining Y stock equally to Father and Mother in exchange for half of their X stock. Going forward, Daughter will manage and operate X and have no stock interest in Y, and Son will manage and operate Y and have no stock interest in X. Father and Mother will also amend their

> and allow each sibling to devote his or her undivided attention to, and apply a consistent business strategy to, the farming business in which he or she is most interested, with the expectation that each business will benefit."[5024]

Real world businesses may not have such neatly separable businesses within one corporation, as in the example from the Regulations. But even in "single function" businesses, a shareholder purpose (shareholder dispute) can still rise to the level of a corporate business purpose. The IRS has approved a Code § 355 tax-free corporate division where the division was driven by friction that had developed between shareholders "regarding fundamental management policy and the expansion of the business" and the shareholders had been "unable to agree to a current fair market value of the stock."[5025]

Thus, for a shareholder dispute to rise to the level of a corporate business purpose, the dispute must be one that will negatively affect the corporation's business if it is not carried out. Disputes between purely passive shareholders will not reach that threshold. But disputes between active shareholders on whether to grow the company or other differences in business philosophies would likely reach the necessary corporate business purpose threshold. Essentially, as long as

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> wills to provide that Son and Daughter will inherit stock only in Y and X, respectively. After the distribution, Father and Mother will still each own 25 percent of the outstanding stock of X and Y and will continue to participate in some major management decisions related to the business of each corporation.
>
> Apart from the issue of whether the business purpose requirement of 1.355-2(b) is satisfied, the distribution meets all of the requirements of 368(a)(1)(D) and 355 of the Internal Revenue Code.

[5024] After reviewing the 1989 preamble to the regulations, T.D. 8238, the ruling cited the example then reasoned:

> The disagreement of Son and Daughter over the farms future direction has prevented each sibling from developing, as he or she sees fit, the business in which he or she is most interested. The distribution will eliminate this disagreement and allow each sibling to devote his or her undivided attention to, and apply a consistent business strategy to, the farming business in which he or she is most interested, with the expectation that each business will benefit. Therefore, although the distribution is intended, in part, to further the personal estate planning of Father and Mother and to promote family harmony, it is motivated in substantial part by a real and substantial non-Federal tax purpose that is germane to the business of X. Hence, the business purpose requirement of 1.355-2(b) is satisfied.

[5025] Letter Ruling 8943038. See also Letter Ruling 201411012, which, consistent with IRS ruling policy, declined to rule on business purpose:

> Sibling 1 is President of Distributing, operating and managing the businesses with active input from Sibling 2 and both siblings' adult children. In recent years, however, the Shareholders have disagreed significantly about the direction in which to take each of the businesses. Therefore, they propose the following transaction:
>
> (i) Distributing will form Controlled and transfer to it approximately c percent of Distributing's active trade or business assets, including some of the separable tracts of land, in exchange for all of Controlled's outstanding stock (the Contribution).
>
> (ii) Distributing will distribute to Sibling 2 all of the Controlled shares in exchange for all of Sibling 2's stock in Distributing (the Split-Off).
>
> After the Split-Off, Sibling 1 will hold all of the outstanding stock of Distributing, which will remain actively engaged in its historic businesses using the remaining d percent of its historic business assets. Sibling 2 will hold all of the outstanding stock of Controlled, which will be actively engaged in Business E using the c percent of Distributing's historic business assets received in the Contribution.

Presumably the taxpayers request the ruling to approve Code § 355's other requirements (although the IRS also declined to rule on the device test or whether the split-off was part of a plan proscribed by Reg. § 1.355-7).

the dispute is between active shareholders, as is usually the case in the standard family business model, it should be relatively easy to establish that the dispute would affect the corporation's operations, thus establishing that the shareholder purpose is co-extensive with a corporate business purpose.

The IRS has removed this test from its list of areas on which it will not issue a private letter ruling.[5026]

II.Q.7.f.ii.(f). Continuity of Interest

The sixth requirement is "continuity of interest." Reg. § 1.355-2(c)(1), "Requirement," provides:

> Section 355 applies to a separation that effects only a readjustment of continuing interests in the property of the distributing and controlled corporations. In this regard section 355 requires that one or more persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation. This continuity of interest requirement is independent of the other requirements under section 355.

Reg. § 1.355-2(c)(2), "Examples," provides:

> *Example (1)*. For more than five years, corporation X has been engaged directly in one business, and indirectly in a different business through its wholly owned subsidiary, S. The businesses are equal in value. At all times, the outstanding stock of X has been owned equally by unrelated individuals A and B. For valid business reasons, A and B cause X to distribute all of the stock of S to B in exchange for all of B's stock in X. After the transaction, A owns all the stock of X and B owns all the stock of S. The continuity of interest requirement is met because one or more persons who were the owners of X prior to the distribution (A and B) own, in the aggregate, an amount of stock establishing a continuity of interest in each of X and S after the distribution.
>
> *Example (2)*. Assume the same facts as in Example (1), except that pursuant to a plan to acquire a stock interest in X without acquiring, directly or indirectly, an interest in S, C purchased one-half of the X stock owned by A and immediately thereafter X distributed all of the S stock to B in exchange for all of B's stock in X. After the transactions, A owns 50 percent of X and B owns 100 percent of S. The distribution by X of all of the stock of S to B in exchange for all of B's stock in X will satisfy the continuity of interest requirement for section 355 because one or more persons who were the owners of X prior to the distribution (A and B) own, in the aggregate, an amount of stock establishing a continuity of interest in each of X and S after the distribution.
>
> *Example (3)*. Assume the same facts as in Examples (1) and (2), except that C purchased all of the X stock owned by A. After the transactions, neither A nor B own any of the stock of X, and B owns all the stock of S. The continuity of interest requirement is not met because the owners of X prior to the distribution (A and B) do not, in the aggregate, own an amount of stock establishing a continuity of interest in each of X and S after the distribution, i.e., although A and B collectively have

[5026] Rev. Proc. 2016-45.

retained 50 percent of their equity interest in the former combined enterprise, they have failed to continue to own the minimum stock interest in the distributing corporation, X, that would be required in order to meet the continuity of interest requirement.

Example (4). Assume the same facts as in Examples (1) and (2), except that C purchased 80 percent of the X stock owned by A. After the transactions, A owns 20 percent of the stock of X, B owns no X stock, and B owns 100 percent of the S stock. The continuity of interest requirement is not met because the owners of X prior to the distribution (A and B) do not, in the aggregate, have a continuity of interest in each of X and S after the distribution, *i.e.*, although A and B collectively have retained 60 percent of their equity interest in the former combined enterprise, the 20 percent interest of A in X is less than the minimum equity interest in the distributing corporation, X, that would be required in order to meet the continuity of interest requirement.

The division really must be a division and not essentially a sale. One or more direct or indirect owners of the distributing corporation before the distribution must own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation. Continuing ownership of 50% or more should be enough to establish a continuity of interest.[5027] In most family business divisions, meeting this test will not be a problem, since both the distributing and controlled corporations will be owned by original shareholders.

Letter Ruling 202033005 involved the following facts:[5028]

Summary of Facts

Distributing, formed under the laws of State A, is an accrual basis Subchapter S corporation, which is engaged primarily in Business A. It was formed on Date 1. One of Distributing's founders was Settlor. Distributing has outstanding A shares of stock, all of which are held by Trust as the sole shareholder. Sibling 1, Sibling 2, Sibling 3 and Sibling 4 (the "Siblings") are the remaindermen beneficiaries of Trust.

Distributing owns all of the outstanding stock of Q Sub 1 and all of the outstanding interests in Q Sub 2, both disregarded entities for federal income tax purposes. Each of Q Sub 1 and Q Sub 2 owns land that is unrelated to Distributing's Business A operations.

Controlled, formed under the laws of State A, is an accrual basis corporation formed to effectuate the proposed transaction. Controlled has outstanding B shares of stock, all of which are held by Distributing.

Distributing owns approximately C acres of land and leases another D acres of land. It is on this land that Distributing engages in Business A. Distributing has submitted financial and employment information indicating that it is actively engaged in Business A and

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[5027] See Reg. § 1.355-2(c)(2), Example (2) and Rev. Proc. 96-30, § 4.07.
[5028] To explain some of the terms used below, see parts II.A.2.g Qualified Subchapter S Subsidiary (QSub) and III.A.3.e.ii Electing Small Business Trusts (ESBTs.

represents that it has gross receipts and has documented operating expenses representing the active conduct of a trade or business for each of the past five years.

Settlor created Trust on Date 2 and funded it with all of the outstanding shares of Distributing. Trust elected to become an Electing Small Business Trust ("ESBT") on Date 3, the same day Distributing made its Subchapter S corporation election. Settlor and Trustee A served as co-trustees of Trust until Settlor's death, at which point Trust became irrevocable and Trustee A became the sole trustee.

Other than some cash in a bank account, Trust's sole asset is all the outstanding shares of Distributing. Under the terms of Trust, Trust shall terminate upon: (a) the last to die of Settlor, Trustee A, and X; and (b) either: (i) the youngest of Trustee A's children (Sibling 1, Sibling 2, Sibling 3 and Sibling 4, referred to in the aggregate as the Siblings) attains age 25; or (ii) the last survivor of Trustee A's children dies before attaining age 25. Upon termination, Trust's stock ownership in Distributing is to be transferred free of Trust in equal shares to each of the Siblings.

Trustee A died on Date 5. Settlor, Trustee A and X have passed away and the Siblings are all over age 25. Trust is terminating, and its ownership of Distributing's stock has vested in the Siblings equally. Because of considerable disagreement amongst the Siblings regarding the operation of Business A, the Siblings requested that Trustee B facilitate a settlement amongst them with respect to Distributing before terminating Trust and distributing to each of them his/her equal interest in the corpus of Trust. The settlement devised by Trustee B and approved by the Siblings is as follows (the "Proposed Transaction"):

Proposed Transaction (some of the steps have already been consummated):

1. On Date 4, Distributing organized Controlled.

2. Distributing shall timely elect to have Controlled treated as its qualified Subchapter S Subsidiary, effective as of Controlled's date of organization.

3. In exchange for all of Controlled's stock, Distributing will contribute to Controlled approximately one-half of the C acres of land now owned by Distributing, including any and all buildings and improvements situated thereon ("Contributed Land"), as well as certain assets and liabilities (in the aggregate, the "Contribution") pursuant to an Agreement and Plan of Reorganization ("Plan"), which will also provide -

    a. To the extent necessary, Controlled and Distributing will enter into an agreement or arrangement that would allow the Siblings access to their respective homes situated on the land to be distributed to Controlled. Alternatively, the homes may be moved.

    b. Any obligations for bank loans and mortgages affecting the land now divided between Distributing and Controlled shall be shared equally by Distributing and Controlled until refinanced by such corporations.

    c. Any existing mortgages or home equity lines of credit secured by the land now divided between Distributing and Controlled may be paid in full by Trust prior to the distribution or continue to be an obligation of the Siblings.

d. Distributing may retain the right to continue to lease the D acres of land it currently leases for its operations.

e. Distributing will have direct access to the water shed vital to the Business A operations of both corporations. Distributing and Controlled will enter into a water access and piping easement in connection with catching, storing and moving water from Distributing's land to Controlled's land via the existing water infrastructure. The cost to maintain the water infrastructure will be shared equitably.

f. After the Distribution, Controlled will have direct access to a water reservoir. Distributing and Controlled will enter into an agreement permitting Distributing's representatives reasonable travel across Controlled's land to access the reservoir.

g. Trustee B and the Siblings will outline an equitable percentage of Business A assets which will be retained by Distributing or transferred to Controlled.

h. Distributing will transfer approximately one-half of outstanding receivables or the proceeds from such receivables to Controlled.

i. Distributing will transfer to Controlled machinery and equipment, including office equipment, vehicles, furniture and fixtures, etc. not specifically identified with either Distributing or Controlled, as they agree, or if they are unable to agree, as Trustee B shall decide in Trustee B's sole discretion.

j. Distributing will transfer a one-half interest in the assets of or one-half of the stock ownership in Q Sub 1 to Controlled. If Q Sub 1's assets are sold before the closing occurs, the net proceeds shall be added to cash.

k. Distributing will transfer a one-half interest in the assets of or one-half of its membership interest in Q Sub 2 (after conversion to a multiple member LLC) to Controlled. If Q Sub 2's assets are sold before the closing occurs, the net proceeds shall be added to cash.

l. Distributing will distribute one-half of its interest in undeveloped coastal land to Controlled. If this property is sold before the closing occurs, the net proceeds shall be added to cash.

m. The balance from any outstanding accounts payable shall be paid equally by Distributing and Controlled.

n. Distributing's employees will either stay with Distributing or move to Controlled depending on how the Siblings and employees shall agree. The corporations shall not have or share common employees.

o. Distributing's Qualified Retirement Plan shall be divided between Distributing and Controlled, subject to the approval of the Internal Revenue Service, in proportion and according to the current employees covered by the Qualified Retirement Plan retained by each after the Closing Date. Account balances and liability for payment of benefits to former employees shall remain with Distributing.

p. Distributing will transfer cash and other assets not specifically identified above to Controlled to the extent necessary to equalize the net worth of Distributing and Controlled.

q. The ultimate values of Distributing and Controlled may be properly redetermined, necessitating adjustments to the above-mentioned distributions. In the event there are insufficient cash and other assets to equalize such values, Trustee B shall equalize such values, by reallocating assets, borrowing funds, creating a debt obligation between Distributing and Controlled, or such other means as the Trustee B determines, in the Trustee B's sole discretion, to be the most appropriate means to accomplish equalization. All transfers from Distributing to Controlled will be in furtherance of equalizing the net worth of the two corporations.

4. Trust will transfer to Distributing one-half of the outstanding shares of Distributing stock in exchange for all the outstanding shares of Controlled stock. Trust will either distribute: (A) all outstanding shares of Distributing's stock equally to Sibling 3 and Sibling 4 and all outstanding shares of Controlled's stock equally to Sibling 1 and Sibling 2; or (B) all outstanding shares of Distributing's stock equally to Sibling 1 and Sibling 2 and all outstanding shares of Controlled's stock equally to Sibling 3 and Sibling 4 (the "Distribution"). After the Distribution, Distributing will be wholly owned by Siblings 1 and 2 or Siblings 3 and 4, and Controlled will be wholly owned by the other Siblings.

5. After the Distribution, both Controlled and Distributing will be actively engaged in Business A, the historic business of Distributing and Controlled. Distributing and Controlled will each use in their Business A operations the historic business assets previously employed by Distributing in the operations of Business A.

6. Controlled will make a timely S-Corporation election.

Shareholders Before and After Distribution:

The income beneficiaries of Trust have passed away. Trust is terminating. The remaindermen of Trust are currently entitled to receive the Trust corpus, which consists of both principal and income, and the remaindermen are entitled to receive such Trust corpus in equal shares. Trust holds mere legal title to the Distributing shares; the remaindermen (*i.e.*, the Siblings) are the vested owners, not Trust. Trust continues pursuant to court order solely at the behest of the Siblings.

Representations:

Except as set forth below,

1. Trustee B makes all the representations in section 3 of the Appendix to Rev. Proc. 2017-52 in the form set forth therein.

2. Trustee B does not make the following representations, which do not apply to the Proposed Transaction: 5, 6, 20, 24, 25, 35, 36, 37, 38, 39, and 40.

3. Trustee B makes the following alternative representations set forth in section 3 of the Appendix to Rev. Proc. 2017-52: 3(a), 8(a), 11(a), 15(a), 22(a), 31(a) and 41(b).

Letter Ruling 202033005 called the following the "Significant Issue Ruling":

> Based solely on the information submitted and the representations made, we rule that Sibling 1, Sibling 2, Sibling 3 and Sibling 4 are the shareholders of Distributing for purposes of satisfying the shareholder control requirement of IRC § 368(a)(1)(D), and the continuity of interest requirement of Treas. Reg. § 1.355-2(c)(1).

Letter Ruling 202033005 called the following the "Transactional Ruling":

> Based solely on the information submitted and the representations made, we rule as follows with respect to the Proposed Transaction:

1. The Contribution, followed by the Distribution, will qualify as a reorganization under IRC § 368(a)(1)(D) and Distributing and Controlled will each be "a party to a reorganization" within the meaning of IRC § 368(b).

2. No gain or loss will be recognized by Distributing on the Contribution (IRC §§ 361(a) and 357(a)) to Controlled.

3. No gain or loss will be recognized by Controlled on the Contribution (IRC § 1032(a)).

4. Controlled's basis in each asset received from Distributing in the Contribution will be the same as the basis of such asset in the hands of Distributing immediately before the Contribution (IRC § 362(b)).

5. Controlled's holding period for each asset received from Distributing in the Contribution will include the period during which Distributing held that asset (IRC § 1223(2)).

6. No gain or loss will be recognized by Distributing on the Distribution (IRC § 361(c)(1)).

7. No gain or loss will be recognized by (and no amount will otherwise be included in the income of) any shareholder of Distributing upon receipt of Controlled stock in the Distribution (IRC § 355(a)).

8. The basis of the shares of Controlled in the hands of its shareholders immediately after the Distribution will be the same as the basis of the Distributing shares surrendered in exchange thereof (IRC § 358(a)(1)).

9. The holding period of the Controlled shares received by each shareholder in the Distribution will include the holding period of the Distributing shares surrendered in exchange therefor, provided that the Distributing shares were held as a capital asset in the Distributee's hands on the date of the Distribution (IRC § 1223(1)).

10. Earnings and Profits, if any, will be allocated between Distributing and Controlled in accordance with IRC § 312(h) and Treas. Reg. § 1.312-10(a).

11. Distributing's accumulated adjustment account immediately before the transaction will be allocated between Distributing and Controlled in a manner similar to the manner in which Distributing's earnings and profits will be allocated under IRC § 312(h) in accordance with Treas. Reg. § 1.1368-2(d)(3) (Treas. Reg. §§ 1.312-10(a) and 1.1368-2(d)(3)).

12. Pursuant to Treas. Reg. § 1.1361-5(b)(1)(i) (and (C)), the Distribution will cause a termination of Controlled's Q-Sub election because Controlled will cease to be a wholly owned subsidiary of Distributing, an S corporation.

13. For federal income tax purposes, Controlled will be treated as a new corporation acquiring all of its assets and assuming all of its liabilities from Distributing immediately before the termination of Controlled's Q-Sub election in exchange for the stock of Controlled.

14. The momentary ownership by Distributing of the stock of Controlled, as part of the reorganization under IRC § 368(a)(1)(D), will not cause Controlled to have an ineligible shareholder for any portion of its first taxable year under IRC § 1361(b)(1)(B), and will not, in itself, render Controlled ineligible to elect to be an S Corporation for its first taxable year.

15. If Controlled otherwise meets the requirements of a small business corporation under IRC § 1361, Controlled will be eligible to make a subchapter S election under IRC § 1362(a) for its first taxable year, provided that such election is made effective immediately following the termination of the original Q-Sub election.

Letter Ruling 202033005 limited its rulings' scope:

> This Office has made no determination regarding whether the Distribution (as defined below): (i) satisfies the business purpose requirement of Treas. Reg. § 1.355-2(b); (ii) is used principally as a device for the distribution of the earnings and profits of the Distributing corporation or the Controlled or both (see section 355(a)(1)(B) and Treas. Reg. § 1.355-2(d)); or (iii) is part of a plan (or series of related transactions) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50-percent or greater interest in Distributing or Controlled, or any predecessor or successor of Distributing or Controlled, within the meaning of Treas. Reg. § 1.355-8T (see section 355(e)(2)(A)(ii) and Treas. Reg. § 1.355-7).

Letter Ruling 202244008 approved the split-up of subsidiaries in an affiliated group:

> Parent directly owns all of the outstanding stock of Sub 1, a domestic corporation and a member of the Parent Group. Sub 1 engages in Business A1, Business A2, Business B, and Business C through its direct and indirect subsidiaries. Parent has submitted financial information in accordance with Rev. Proc. 2017-52 indicating that each of Business A1, Business A2, Business B, and Business C will have had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years at the time of the Proposed Transaction. The direct and indirect subsidiaries of Sub 1 relevant to the Proposed Transactions are described below….

For what are represented to be valid business reasons, Sub 1 proposes to separate Business A1, Business A2, and Business B from Business C in the following steps, which will occur sequentially unless otherwise specified...

II.Q.7.f.ii.(g). The Active Trade or Business That Existed Five Years Before the Separation Must Exist After the Separation

The final requirement is that the active trade or business that existed five years before the separation must exist after the separation.[5029]

This requirement will normally be easy to fulfill, as long as all other requirements are met, since corporations that meet the "active business" requirements will likely meet this requirement as well.

II.Q.7.f.iii. Active Business Requirement for Code § 355

The IRS and Treasury have provided significant guidance for what qualifies as an active business. Below is a history of some of the most important guidance.

II.Q.7.f.iii.(a). Farming

In Rev. Rul. 73-234, a corporation engaged in a farm operation as follows:

- The planting, raising, and harvesting of crops and the breeding and raising of livestock in the corporation's farm operation are done by tenant farmers, acting as independent contractors. The tenant farmers are compensated by a share of the proceeds from the sale of all crops and livestock resulting from the farm operation. The corporation employs a general handy-man to maintain the farm property and equipment.

- The corporation employs its sole shareholder and president to participate in the farm operation. He prefers to contract with tenant farmers who have experience with farm machinery and livestock. He supplies all equipment and arranges for all financing necessary for the corporation's operation. With regard to the farm equipment, he engages a local mechanic for the maintenance and repair thereof that is not performed by the general handy-man or the tenant farmers.

- The president devotes significant time and effort to the corporation's farm business. He studies Federal price support and acreage reserve programs, plans all rotation, planting, and harvesting of crops, and purchases and plans the breeding of livestock. He hires seasonal workers and purchases farming equipment, is responsible for handling sales of all crops and livestock, and is responsible for accounting to the tenant farmers for their shares of the proceeds of the sales.

The IRS ruled that the corporation's farm activities included its direct performance of substantial management and operational functions, apart from those activities performed by the tenant farmers acting as independent contractors. Therefore, the corporation satisfied the active business requirements.

[5029] Code § 355(b), Reg. § 1.355-2(h) and 1.355-3(b)(3). See also the last sentence of fn 5009 regarding proposed regulations under Reg. § 1.355-3.

Rev. Rul. 86-126 explains that not all tenant farming qualifies as an active business. In that case:

- The sole officers and shareholders are both farmers who are engaged in the business of farming their own individual tracts of farmland not owned by the corporation, which holds title to large tracts of farmland elsewhere in the same state. Each tract of land held by the corporation is leased for one year at a time to a tenant farmer who has agreed with the corporation to share one-half of all income and expenses of the farm. Each party to the lease is responsible for securing the financing necessary to pay that party's share of expenses. In the case of each tract leased, the planting, raising, and harvesting of corn and soybeans (the only crops grown on these farms) are done by the tenant farmer. The tenant farmer also supplies the farm equipment used in these activities. The tenant farmer repairs and maintains the equipment, and also maintains the irrigation system, fences, and other fixtures located on the property. After consulting with the corporation's officers, the tenant farmer purchases all herbicides, insecticides, and fertilizers used on the property. Also after consulting with them, the tenant farmer contracts to sell the crops at a future date, or sells them when harvested. Each tenant farmer is responsible for accounting to the corporation's officers for the corporation's share of the proceeds.

- The officers each devote to substantial part of their time to the operation of their own respective farms which are unconnected with the farmland owned by the corporation. After completing work on their own properties, the officers occasionally inspect the crops and improvements located on each leased tract. If any corrective steps must be taken, an officer points out the problem to the tenant farmer, who makes the necessary corrections in the way the tenant farmer sees fit. The officers also decide each year what portion of each tract will be leased, in the light of soil conservation needs, market conditions, and federal price support and acreage reserve programs. They review each tenant farmer's accounting of operations and sales.

The IRS contrasted this situation with Rev. Rul. 73-234. In that case, the corporation was engaged in hiring seasonal workers, purchasing and supplying equipment, maintaining equipment, arranging financing, planning all rotation and planting and harvesting of crops, purchasing livestock, planning livestock breeding, selling all crops and livestock, and accounting to the tenant farmers for their shares of the proceeds. That corporate activity, carried on through its own employees and constituting active and substantial managerial and operational activity, contrasts with the activity carried on by the employees of P in the present situation. Here, the IRS said, the corporation either did not engage in the above activities at all, or engaged in them only on a limited basis. At best, it said, the corporation could be considered to engage in some managerial and operational activity but not enough to "qualitatively distinguish its operations from mere investments."

Because of the absence of active and substantial operational and managerial activities, the corporation did not satisfy the active business requirement.

II.Q.7.f.iii.(b). Rev. Rul. 79-394 – Commercial Real Estate

In this ruling, the stock of corporation P is owned by four unrelated individuals. For over five years, P has owned all the stock of corporations X and Y. During that period, P has acted solely as a holding company, X has been engaged in the general contracting business, and Y has been engaged in renting its commercial and residential real estate to unrelated third parties. X's employees have performed all operational activities in connection with Y's rental business. X has paid its employees for these services and has been reimbursed by Y. Y's three officers, who are also officers of P and X, supervise, control and direct the employees of X performing work for Y. Y's officers receive no compensation from Y for the amount of their time devoted to the management and supervision of Y's affairs. These officers are paid only by P and X, and P and X have been reimbursed by Y for the services rendered by the officers to Y.

Y holds title to several commercial and residential rental buildings and associated realty. Y, through its officers and X's employees, continuously seeks additional property of a similar nature for expansion of its rental business. When property is located, Y negotiates its purchase and required financing. Y is primarily obligated on the mortgages relating to its property and pays the principal and interest due thereon. Newly acquired buildings are renovated or altered to reflect the design by Y of custom floor plans that make the property suitable for rental. Y periodically repaints and refurbishes its existing property.

Y endeavors to keep its property rented at all times. When new property is available or when existing property is vacated, Y immediately advertises to attract new tenants. Y verifies the information contained in a prospective tenant's application and negotiates the lease provisions.

Pursuant to the terms of its leases, Y provides and pays for gas, water, electricity, sewage, and insurance for the property and pays the taxes assessed thereon. Moreover, the lease agreements require Y to provide day-to-day maintenance and repair services. These services include insect control, janitorial service, trash collection, ground maintenance, and heating, air conditioning and plumbing maintenance. Y routinely inspects its properties.

Y maintains separate records and accounts to reflect income and expenses relating to each of Y's rental properties as well as Y's general expenses.

Y's above described activity in acquiring, renovating, refurbishing, maintaining, servicing and leasing its rental property is accomplished under the supervision and control of Y's officers using the employees of X.

For valid business reasons, P proposes to distribute all of the Y stock to one of its shareholders solely in exchange for all of that shareholder's P stock in a transaction intended to be tax-free under Code § 355(a). The fair market value of the Y stock to be distributed and the P stock to be surrendered in the exchange are equal.

After the proposed distribution, Y will continue its rental activities as discussed above, and will directly employ, on a full-time basis, most of those employees who have worked on its behalf before the distribution.

The IRS held that Y was engaged in the active conduct of a trade or business under Code § 355(b) for the five-year period preceding distribution of its stock, notwithstanding the fact that during that period it had no employees other than its officers. Moreover, Y will be engaged immediately after the distribution in the active conduct of a trade or business.

The IRS viewed the only factor tending to prove the lack of a pre-distribution active trade or business conducted by Y to be the absence of salaried employees of Y. The IRS reasoned that, given the nature of Y 's conduct of its pre-distribution rental operations and the existence of substantial objective factors that otherwise adequately demonstrate the active conduct of a trade or business, Y's failure to have salaried employees should not, without more, result in failure to meet the Code § 355(b) active trade or business requirement. However, the IRS further stated that the presence or absence of formal employment of employees other than officers, in the distributing corporation or the controlled corporation, will be one factor for consideration in making this determination under Code § 355(b).

II.Q.7.f.iii.(c). Rev. Rul. 80-181 – Reimbursement for Services

The IRS amplified Rev. Rul. 79-394, ruling that the Code § 355(b) active trade or business requirement is satisfied even if Y does not reimburse P and X for the use of their employees and officers in the conduct of Y's real estate activities.

The IRS pointed out, however, that, if Y did not reimburse X and P for the services that X's employees and X's and P's officers rendered to Y, then the IRS would apply Code § 482 to allocate income to X and P in an amount equal to an arm's length charge for the services rendered by the employees of X and the officers of X and P to Y. Y would then deduct the amounts deemed paid by Y to X and P for the services rendered.

II.Q.7.f.iii.(d). Rev. Rul. 92-17 – Participation by Partners in Rental LP

For more than 5 years, limited partnership LP has owned several commercial office buildings that are leased to unrelated third parties. Corporation D has owned a 20% interest in LP for more than 5 years, and throughout that period of time D has been a general partner of LP. The partnership agreement requires that D, as a general partner, provide the managerial services to LP necessary to operate LP's rental business. For more than 5 years, D has owned all the stock of C, a corporation which has been actively engaged for more than 5 years in the conduct of a trade or business that is unrelated to D's activities.

LP continuously seeks additional properties to expand its rental business. When a property is located, LP negotiates its purchase and financing and determines whether renovations or alterations are necessary to make the building suitable for rental. LP periodically repaints and refurbishes its existing properties.

LP's leases require LP to provide day-to-day upkeep and maintenance services for its office buildings. These services include trash collection, ground maintenance, electrical and plumbing repair, and insect control. Additionally, LP advertises for new tenants, verifies information contained in lease applications, negotiates leases, handles tenant complaints, prepares eviction notices and warnings for delinquent tenants, collects rent, and pays all expenses, including gas, water, sewage, electricity and insurance for the office buildings. LP also maintains financial and accounting records to reflect income and expenses relating to each of its rental properties as well as LP's general expenses.

LP has conducted these activities for more than five years. Officers of D form active and substantial management functions with respect to LP's activities, including making significant business decisions of the partnership (e.g., decisions with respect to significant renovations of partnership properties, the purchase and sale of properties, and significant financings and refinancings). In addition, D's officers regularly participate in the overall supervision, direction and control of LP's employees in their performance of LP's operational functions.

For a valid business purpose, D proposes to distribute all its C stock pro rata to D's shareholders in a transaction intended to satisfy Code § 355. After the distribution, officers of D will continue to provide LP with the services described above.

Except for the issue of whether the activities performed by D in connection with the operation of LP's rental business constitute an active trade or business, the transaction will otherwise meet all the requirements of Code § 355.

The IRS held that, if officers of a corporation that is a general partner in a limited partnership perform active and substantial management functions for the partnership, including making significant business decisions of the partnership and regular participation in the overall supervision, direction and control of the employees of the partnership in operating the partnership's rental business, the corporation is engaged in the active conduct of a trade or business under Code § 355(b) and the distribution of the stock of C by D to D's shareholders is tax-free to the D shareholders under section 355.

The IRS reasoned that the fact that a partnership engages in activities that would constitute the active conduct of a trade or business if conducted by a corporation does not mean that each partner in the partnership is considered to engage in the active conduct of a trade or business for purposes of Code § 355(b). It stated that whether a partner is considered to engage in the active conduct of a trade or business must be made with reference to the activities of the partner as well as the partnership.

It further reasoned that, D, like Y in Rev. Rul. 79-394, performs through its officers and the employees of LP significant services with respect to the operation and management of LP's rental business. The only factor tending to prove that D has not been engaged in the active conduct of a trade or business is D's lack of employees to perform the operational services necessary to operate LP's office buildings. However, this factor, standing alone, will not cause D to fail the Code § 355(b) active trade or business test.

II.Q.7.f.iii.(e). Rev. Rul. 2007-42 – Level of Participation in Rental LLC

The IRS contrasted two situations in which a corporation (D) owns a membership interest in an LLC taxed as a partnership, holding that in one case D was deemed engaged in the active conduct of a trade or business and the other case D was not deemed to be so engaged.

In Situation 1, D was deemed to be deemed engaged in the active conduct of a trade or business. For more than five years, LLC owned several commercial office buildings that are leased to unrelated third parties. LLC has one class of membership interests outstanding. For more than five years, D has owned a 33.3% membership interest in LLC and has owned all the stock of a subsidiary (C), a corporation that has been engaged for more than five years in the active conduct of a trade or business that is unrelated to D's activities.

LLC continuously seeks additional properties to expand its rental business. When a property is located, LLC negotiates its purchase and financing and determines whether renovations or alterations are necessary to make the building suitable for rental. LLC periodically repaints and refurbishes its existing properties.

Pursuant to the terms of its leases, LLC provides day-to-day upkeep and maintenance services for its office buildings. These services include trash collection, ground maintenance, electrical and plumbing repair, and insect control. Additionally, LLC advertises for new tenants, verifies information contained in lease applications, negotiates leases, handles tenant complaints, prepares eviction notices and warnings for delinquent tenants, collects rent, and pays all expenses, including gas, water, sewage, electricity and insurance for the office buildings. LLC also maintains financial and accounting records to reflect income and expenses relating to each of its rental properties as well as LLC's general expenses.

The above described activities of LLC have been conducted for more than five years. The employees of LLC perform all management and operational functions with respect to LLC's rental business. Neither D nor any other member of LLC performs services with respect to LLC's business.

The IRS ruled that D is engaged in the active conduct of LLC's rental business for purposes of Code§ 355(b) because D owns a significant interest in LLC and LLC performs the required activities that constitute an active trade or business under the regulations.

In Situation 2, the facts are the same as Situation 1 except that D owns a 20% membership interest in LLC. The IRS ruled that D was not engaged in the active conduct of LLC's rental business for purposes of Code§ 355(b) because a 20% interest was not sufficiently significant.

The IRS reasoned that the fact that a partnership engages in activities that would constitute the active conduct of a trade or business if conducted by a corporation does not necessarily mean that each partner in the partnership is considered to be engaged in the active conduct of a trade or business for purposes of Code § 355(b). In such a case, the determination of whether a partner is considered to be engaged in the active conduct of a trade or business must be based on the requirements of Code § 355 and the regulations thereunder taking into account the activities of the partner (if any), the partner's interest in the partnership, and the activities of the partnership.

Although Rev. Rul. 92-17 viewed a 20% interest in a partnership to be sufficient, in that case the corporate partner performed management functions. The IRS pointed out that D's officers performed active and substantial management functions with respect to LP, including the significant business decision-making of the partnership, and regularly participated in the overall supervision, direction, and control of LP's employees in operating LP's rental business. Rev. Rul. 2002-49 reached a similar conclusion where D and another corporation (X) each own a 20% interest in a member-managed LLC and D and X jointly managed the LLC's business.

The IRS looked to Reg. § 1.368-1(d)(4)(iii)(B) to validate its position that a one-third interest was sufficient to impute activity to a partner that does not perform active and substantial management functions for the business of the partnership. That regulation, regarding the continuity of business enterprise requirement applicable to corporate reorganizations, provides that the issuing corporation will be treated as conducting a business of a partnership if members of the qualified group, in the aggregate, own an interest in the partnership representing a significant interest in that partnership business.

II.Q.7.f.iii.(f). Proposed Regulations on Active Conduct of Business

Recent proposed regulations would provide that, for purposes of the active conduct of a business rule, a partner in a partnership will be attributed the trade or business assets and activities of that partnership during the period that such partner satisfies the requirements; however: the stock of a corporation owned by the partnership is not attributed to a partner; for purposes of determining the activities that are conducted by the partnership that may be attributed to the partner, the activities of independent contractors, and partners that are not affiliates of the partner, are not taken into account; and, generally, the activities of partners that are affiliates of the partner are only taken into account during the period that such partners are affiliates of the partner.[5030] The trade or business assets and activities of a partnership will be attributed to a partner if the partner owns a ***significant*** interest in the partnership. [5031] Generally, the trade or business assets and activities of a partnership will be attributed to a partner if the partner performs active and substantial management functions for the partnership with respect to the trade or business assets and activities (for example, makes decisions regarding significant business issues of the partnership and regularly participates in the overall supervision, direction, and control of the employees performing the operational functions for the partnership), and the partner owns a ***meaningful*** interest in the partnership. [5032]

Examples illustrate these concepts:[5033]

Example (8). <u>Jointly owned partnership</u>. For more than five years, D has owned all of the stock of C, and D and C each have owned a 17-percent interest in Partnership. Throughout this period, D and Partnership have engaged in the active conduct of ATB1 and ATB2, respectively. In year 6, D transfers its 17-percent interest in Partnership to C and distributes all of the C stock to the D shareholders. Because D owns Code § 1504(a)(2) stock of C, D and C are treated as one corporation for purposes of determining whether D and C are engaged in the active conduct of a trade or business.[5034] Accordingly, throughout the pre-distribution period, D and C are each treated as owning a 34-percent interest in Partnership, and both D and C are treated as engaged in the active conduct of both ATB1 and ATB2 throughout the pre-distribution period.[5035] The transfer of the Partnership interest is disregarded.[5036] After the distribution, C owns 34% of Partnership and is therefore engaged in the active conduct of ATB2. [5037] Therefore, both D and C satisfy Code § 355(b).

Example (22). <u>Partnership—meaningful but not significant</u>. For more than five years, unrelated X and Y have owned a 20% and one-third interests, respectively, in Partnership. The remaining interests in Partnership are owned by unrelated parties. For more than five years, Partnership has manufactured power equipment. But for the performance of all its management functions by employees of X, Partnership would satisfy all the requirements of Prop. Reg. § 1.355-3(b)(2)(i). X and/or Y will be attributed the trade or business assets and activities of Partnership only if the corporation satisfies the requirements of Prop. Reg. § 1.355-3(b)(2)(v)(B) or (C).[5038] While X does not satisfy the requirements of Prop. Reg. § 1.355-3(b)(2)(v)(B) because X's interest in Partnership is not significant, under Prop. Reg. § 1.355-3(b)(2)(v)(C), X owns a meaningful interest in Partnership and performs active and substantial management functions for the trade or business assets and activities of Partnership. Therefore, X is attributed the trade or business assets and activities of Partnership. Accordingly, X is engaged in the active conduct of the business of manufacturing power equipment.[5039] In determining whether Y is engaged in the business of manufacturing power equipment, the management functions performed by X for Partnership are not taken into account.[5040] Therefore, although Y is attributed Partnership's trade or business assets and activities under Prop. Reg. § 1.355-3(b)(2)(v)(B) because Y owns

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[5030] Prop. Reg. § 1.355-3(b)(2)(v)(A).
[5031] Prop. Reg. § 1.355-3(b)(2)(v)(B).
[5032] Prop. Reg. § 1.355-3(b)(2)(v)(C).
[5033] Prop. Reg. § 1.355-3(d)(2).
[5034] Prop. Reg. § 1.355-3(b)(1)(ii).
[5035] Prop. Reg. § 1.355-3(b)(2)(v)(A), (B).
[5036] Prop. Reg. § 1.355-3(b)(1)(ii).
[5037] Prop. Reg. § 1.355-3(b)(2)(v)(A), (B).
[5038] Prop. Reg. § 1.355-3(b)(2)(v)(A).
[5039] Prop. Reg. § 1.355-3(b)(2).
[5040] Prop. Reg. § 1.355-3(b)(2)(v)(A).

a significant interest in Partnership, Y is not engaged in the business of manufacturing power equipment because neither Y nor Partnership perform any management functions for the business.[5041]

Example (23). Partnership—significant but not meaningful. The facts are the same as Example 22 except that all the management functions related to the business of Partnership are performed by employees of Partnership. Because employees of Partnership perform all of the management functions related to the trade or business assets and activities of manufacturing power equipment, Partnership itself satisfies all the requirements of Prop. Reg. § 1.355-3(b)(2)(i). X neither owns a significant interest in Partnership nor performs active and substantial management functions with respect to the trade or business assets and activities of Partnership. Accordingly, X does not satisfy the requirements Prop. Reg. § 1.355-3(b)(2)(v)(B) or (C), X is not attributed the trade or business assets and activities of Partnership's business of manufacturing power equipment, and X is not engaged in the active conduct of the business of manufacturing power equipment. On the other hand, because Y owns a significant interest in Partnership, Y satisfies the requirements of Prop. Reg. § 1.355-3(b)(2)(v)(B). Therefore, Y is attributed the trade or business assets and activities of Partnership's business. Accordingly, Y satisfies the requirements of Prop. Reg. § 1.355-3(b)(2)(i) and is engaged in the active conduct of the business of manufacturing power equipment.

Example (24). Partnership—significant by many. The facts are the same as Example 23 except that X, Y, and Z each own a one-third interest in Partnership. Because X, Y, and Z each own a significant interest in Partnership, each of X, Y, and Z satisfies the requirements of Reg. § 1.355-3(b)(2)(v)(B). Accordingly, each of X, Y, and Z is attributed the trade or business assets and activities of Partnership, satisfies the requirements of Reg. § 1.355-3(b)(2)(i), and is engaged in the active conduct of the business of manufacturing power equipment.

II.Q.7.f.iii.(g). Combining Split Up with Sale to Irrevocable Grantor Trust

While we waited for those proposed regulations to be finalized, Letter Ruling 200842003 was issued, providing an excellent example of how a family business can be divided and then sold using a sale to a separate irrevocable grantor trust for each adult child. First, the parent split the corporation into five different entities. Then, the parent sold an interest in each entity to a different irrevocable grantor trust for a different child. Although Code § 355 required the parent to continue to hold on to the new corporations, the parent was deemed not to have sold the corporations because the sale to the irrevocable grantor trust was disregarded for income tax purposes. Below are details excerpted from the ruling.

Distributing is a C corporation. Less than 10 years ago, Distributing elected taxation as an S corporation. Distributing has two classes of common stock that differ only by the number of votes per share. All of the Distributing stock is owned by one family. Shareholder 5 is the parent of each of Shareholders 1 through 4. The parent and the children own the Series A stock. The children own the Series B stock. The parent is the majority shareholder of Distributing.

Distributing has directly had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

[5041] Prop. Reg. § 1.355-3(b)(2)(iii).

For what are represented to be valid business reasons, Distributing has proposed the following transactions (the "Proposed Transactions"):

(i) Distributing will create Controlled 1, Controlled 2, Controlled 3, and Controlled 4 (collectively, the "Controlled corporations").

(ii) Distributing will transfer all of its assets to the Controlled corporations in exchange for all of the stock of each of the Controlled corporations and the assumption by each of the Controlled corporations of the liabilities associated with the assets transferred (collectively, the "Contributions").

(iii) Distributing will distribute pro rata all of its stock in each of the Controlled corporations to Shareholders 1 through 5 in exchange for all of the stock of Distributing held by Shareholders 1 through 5 (collectively, the "Distributions"). Each of the Controlled corporations will make an S election on the first available date after the Distributions.

(iv) Distributing will liquidate.

Shareholder 5 will establish four irrevocable grantor trusts: Trust 1, Trust 2, Trust 3, and Trust 4 (collectively, the "Trusts"). Distributing represents that Shareholder 5 will be the grantor of each of the Trusts and will be treated as the owner of each Trust's assets under Code § 671. Shareholder 1 will be the sole beneficiary of Trust 1, Shareholder 2 will be the sole beneficiary of Trust 2, Shareholder 3 will be the sole beneficiary of Trust 3, and Shareholder 4 will be the sole beneficiary of Trust 4.

Shareholder 5 will transfer e% of her stock in Controlled 1 to Trust 1, e% of her stock in Controlled 2 to Trust 2, e% of her stock in Controlled 3 to Trust 3, and e% of her stock in Controlled 4 to Trust 4 (the "Gift Transactions"). Shareholder 5 will sell f% of her stock in Controlled 1 to Trust 1, f % of her stock in Controlled 2 to Trust 2, f% of her stock in Controlled 3 to Trust 3, and f% of her stock in Controlled 4 to Trust 4 in exchange for promissory notes from each Trust (the "Sale Transactions"). Distributing has represented that the Gift Transactions and the Sale Transactions are disregarded for federal income tax purposes.

Shareholder 5's estate plan provides that her ownership interests in each of the Controlled corporations will be separated, so that Shareholder 1 will only inherit the stock of Controlled 1, Shareholder 2 will only inherit the stock of Controlled 2, Shareholder 3 will only inherit the stock of Controlled 3, and Shareholder 4 will only inherit the stock of Controlled 4.

The taxpayer made the following representations regarding the Proposed Transactions:

(a) Neither the business nor control of any entity conducting this business was acquired during the five-year period ending on the date of the Distributions in a transaction in which gain or loss was recognized (or treated as recognized) in whole or in part.

(b) The fair market value of the stock of each of the Controlled corporations to be received by each shareholder of Distributing will be approximately equal to the fair market value of the Distributing stock surrendered by each shareholder in exchange therefor.

(c) No part of the consideration to be distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of the corporation.

(d) Following the Proposed Transactions, the Controlled corporations will each continue, independently and with its separate employees, the active conduct of its share of all the integrated activities of Business D conducted by Distributing prior to consummation of the Proposed Transactions.

(e) The distribution of the stock of each of the Controlled corporations is carried out for the following corporate business purposes: (1) to implement business succession planning; and (2) to avoid shareholder deadlock after implementation of the plan by allowing each shareholder in the post-transition structure to independently manage his or her portion of Distributing's business.

(f) The Proposed Transactions are not used principally as a device for the distribution of the earnings and profits of Distributing or the Controlled corporations.

(g) For purposes of Code § 355(d), immediately after the Distributions, no person (determined after applying Code § 355(d)(7)) will hold stock possessing 50% or more of the total combined voting power of all classes of Distributing stock entitled to vote or 50% or more of the total value of shares of all classes of Distributing stock, that was acquired by purchase (as defined in Code § 355(d)(5) and (8)) during the five-year period (determined after applying Code § 355(d)(6)) ending on the date of the Distributions.

(h) For purposes of Code § 355(d), immediately after the Distributions, no person (determined after applying Code § 355(d)(7)) will hold stock possessing 50% or more of the total combined voting power of all classes of any Controlled stock entitled to vote or 50% or more of the total value of the shares of all classes of any Controlled stock, that was either (i) acquired by purchase (as defined in Code § 355(d)(5) and (8)) during the five-year period (determined after applying Code § 355(d)(6)) ending on the date of the Distribution, or (ii) attributable to distributions on Distributing stock that was acquired by purchase (as defined in Code § 355(d)(5) and (8)) during the five-year period (determined after applying Code § 355(d)(6)) ending on the date of the Distributions.

(i) Any liabilities assumed (within the meaning of Code § 357(d)) by the Controlled corporations in the Proposed Transactions were incurred in the ordinary course of business and are associated with the assets being transferred.

(j) With respect to each Contribution to a Controlled corporation, the total adjusted bases and the total fair market value of the assets transferred to the Controlled corporation by Distributing in the Proposed Transactions will exceed the sum of the amount of any liabilities assumed (within the meaning of Code § 357(d)) by the Controlled corporation in the exchange.

(k) No intercorporate debt will exist between Distributing and any of the Controlled corporations at the time of, or subsequent to, the Distributions.

(l) Payments made in connection with all continuing transactions, if any, between any of the Controlled corporations will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.

(m) No parties to the Proposed Transactions are investment companies as defined in Code § 368(a)(2)(F)(iii) and (iv).

(n) The Distributions are not part of a plan or series of related transactions (within the meaning of Treas. Reg. § 1.355-7) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50% or greater interest (within the meaning of Code § 355(d)(4)) in either Distributing or any of the Controlled corporations (including any predecessor or successor of Distributing or any of the Controlled corporations).

(o) Immediately after the Distributions, either (i) no person will hold a 50% or greater interest (within the meaning of Code § 355(g)) in the stock of Distributing or any of the Controlled corporations who did not hold such an interest immediately before the distribution, or (ii) neither Distributing nor any of the Controlled corporations will be a disqualified investment corporation (within the meaning of Code § 355(g)(2)).

The IRS ruled as follows:

(1) Each Contribution, together with its respective Distribution, will be a reorganization within the meaning of Code § 368(a)(1)(D). With respect to each such reorganization, Distributing and the respective Controlled corporation will be "a party to a reorganization" within the meaning of Code § 368(b).

(2) No gain or loss will be recognized by Distributing on the Contributions (Code § 357(a) and 361(a)).

(3) No gain or loss will be recognized by any of the Controlled corporations on the Contributions (Code § 1032(a)).

(4) The basis of each asset received by each of the Controlled corporations in the Contributions will equal the basis of that asset in the hands of Distributing immediately before the Contributions (Code § 362(b)).

(5) The holding period of each asset received by each of the Controlled corporations in the Contributions will include the period during which Distributing held the asset (Code § 1223(2)).

(6) No gain or loss will be recognized by (and no amount will be included in the income of) Shareholder 1, Shareholder 2, Shareholder 3, Shareholder 4, or Shareholder 5 on their receipt solely of the stock of the Controlled corporations in the Distributions (Code § 355(a)).

(7) No gain or loss will be recognized by Distributing in connection with the Distributions (Code § 361(c)(1)).

(8) With respect to each of Shareholders 1 through 5, the aggregate basis of the stock of the Controlled corporations in their hands after the Distributions will equal the aggregate basis of the Distributing stock surrendered in exchange therefor, and this aggregate basis will be allocated between the stock of the Controlled corporations in proportion to the fair market value of each immediately following the Distributions in accordance with Treas. Reg. § 1.358-2(a) (Code § 358(a) and (b)(2)).

(9) The holding period of the stock in each of the Controlled corporations received by each of Shareholders 1 through 5 in the Distributions will include the holding period of the

Distributing stock surrendered in exchange therefor, provided the Distributing stock was held as a capital asset on the date of the Distributions (Code § 1223(1)).

(10) The earnings and profits of Distributing (if any) will be allocated to each of the Controlled corporations in accordance with Code § 312(h) and Treas. Reg. section 1.312-10(a).

(11) Each of the Controlled corporations will be subject to Code § 1374 with respect to any asset transferred from Distributing to the Controlled corporations to the same extent Distributing was subject to Code § 1374 with respect to such asset. For purposes of Code § 1374, the recognition period of each of the Controlled corporations will be reduced by the portion of Distributing's recognition period that expires prior to Distributing's transfer of the assets (Code § 1374(d)(8) and IRS Ann. 86-128).

The IRS specifically expressed no opinion regarding:

(i) Whether the Distributions satisfy the business purpose requirement of Treas. Reg. § 1.355-2(b);

(ii) Whether the Distributions are used principally as a device for the distribution of the earnings and profits of Distributing or the Controlled corporations;

(iii) Whether the Proposed Transactions are part of a plan (or series of related transactions) under Code § 355(e)(2)(A)(ii);

(iv) Whether Distributing's election to be taxed as a subchapter S corporation is valid; whether the Controlled corporations are otherwise eligible to be taxed as subchapter S corporations; and whether the Controlled corporations' elections to be taxed as subchapter S corporations will be valid under Code § 1362(a);

(v) The gift and estate tax treatment of the proposed transactions, including whether the Gift Transactions and the Sale Transactions constitute separate transactions for gift tax purposes and the extent to which the Gift Transactions and the Sale Transactions constitute transfers for adequate consideration in money or money's worth; and

(vi) Whether the Trusts are trusts grantor trusts.

II.Q.7.f.iii.(h). Other Estate Planning Applications of Split Ups

Other letter rulings involving Code§ 355 transactions in estate planning situations include:

- Letter Ruling 200850018 (Code § 303 redemption)
- Letter Ruling 200809017 (two families)
- Letter Ruling 200645010 (two locations)
- Letter Ruling 200645010 (three subsidiaries)

II.Q.7.f.iv. Tax Effects When Code § 355 Provisions Are Not Met

If a corporation might not be able to satisfy Code § 355, consider part II.Q.7.h.ix Value Freeze as Alternative to Code § 355 Division to avoid the consequences described in this part II.Q.7.f.iv.

II.Q.7.f.iv.(a). Distributing Corporation

In a number of situations, a distributing corporation may have to recognize gain on a distribution that would otherwise qualify as tax-free, Code § 355 distribution.[5042] The first of these exceptions to the non-recognition rule is the "disguised sale" rule of Code § 355(c)(2), as modified by Code § 355(d). Code § 355(c)(2) requires the distributing corporation to recognize gain when it distributes property, other than stock of the controlled corporation, if the fair market value of the property exceeds it adjusted basis.[5043] Code § 355(d) applies to certain distributions of the controlled corporation's stock, and requires that the distributing corporation recognize gain if any one person holds a 50% or greater interest in disqualified stock in either the distributing or controlled corporation after the distribution.[5044] In family business situations, often the majority shareholder (usually the founder) has owned the business for more than five years. Additionally, even if the founder has transferred equity in the business within the past five years through gifts or through a transfer at death, the disguised sale rule still will not apply, since they only apply to purchase transfers.[5045]

Code § 355(e) is similar to Code § 355(d), but applies when distributions are part of a plan in which one or more persons will acquire 50% or greater interest in either the distributing or controlled corporation.[5046] No five year requirement similar to Code § 355(d) applies, but if one or more persons acquires the 50% or greater interest in either corporation within two years before or after the distribution, then the transaction is considered to be "pursuant to a plan."[5047] Additionally, Code § 355(e) makes no distinction between transfers made for consideration and those made for no consideration. However, to prevent Code § 355(e) from making tax-free corporation division impossible, a number of exceptions limit what is considered an "acquisition" for Code § 355(e) purposes. For example, Code § 355(e)(3)(A)(i) states that the acquisition of stock in a controlled corporation by a distributing corporation will not be taken into account for Code § 355(e) purposes. Reg. § 1.355-8 fleshes out these rules some and describes the gain resulting from applying these rules.[5048] Additionally, in most family businesses, Code § 355(e) will not be an issue because of a related party provision similar to the one present in Code § 355(d), causing all stock owned by family members to be treated as owned by one person.[5049] The only time that Code § 355(e) is likely to come into play in family business

[5042] Code § 355(c)(2).
[5043] Code § 355(c)(2)(A)(ii). The distributing corporation is taxed as if it had sold the property to the distributee at fair market value. Code § 355(c)(2)(A) (flush language).
[5044] Code § 355(d)(2). Under Code § 355(d)(4), the 50% or greater interest means stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock. Disqualified stock is defined in Code § 355(d)(3) as any stock of the distributing corporation acquired by purchase during the five year period leading up to the distribution and as any stock in the controlled corporation that was acquired by purchase in the five years leading up to the distribution or by distribution on disqualified stock in the distributing corporation.
[5045] Reg. § 1.355-6(d)(1)(i)(A).
[5046] Code § 355(e)(2)(A); see Reg. § 1.355-7.
[5047] Code § 355(e)(2)(B).
[5048] T.D. 9888 (12/17/2019).
[5049] Code § 355(e)(4)(C)(i).

succession planning would be in cases where the founder plans to shift ownership to second generation family members who are not lineal descendants of the founder. In such cases, additional planning needs to be done to ensure the transfers and tax-free division will not be considered "pursuant to a plan."

All of the above assumes that the distribution satisfies the requirements of Code § 355 but for the conditions described above. If a transaction does not fit above, consider whether other tax-free provisions apply; otherwise, consider whether the distributing corporation might be taxed on the distribution, as provided in part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

II.Q.7.f.iv.(b). Controlled Corporation

Regardless of whether Code § 355 is met, the controlled corporation will not recognize gain or loss on a corporate division.[5050] Thus, the controlled corporation's basis in the property distributed to it by the distributing corporation before the distribution of the controlled corporation's stock will be equal to the property's basis in the hands of the distributing corporation, increased by any gain recognized by the distributing corporation on the transfer.[5051] When such property distributions are made to the controlled corporation, the distributing corporation must allocate part of its earnings and profits to the controlled corporation.[5052] This allocation will generally be made in proportion to the fair market value of the business and property interests retained by the distributing corporation and the business and property interests of the controlled corporation immediately after the distributions.[5053]

II.Q.7.f.iv.(c). Shareholders

Generally speaking, shareholders of the distributing and controlled corporations will not recognize any gain or loss on the receipt of the controlled corporation's stock in a Code § 355 division. However, if the shareholders of the controlled corporation receive "boot" in addition to stock, then they will have to recognize some gain. This situation will arise when a controlled corporation's shareholder receives other property or money, in addition to the controlled corporation's stock, so that the amount received is equal to the fair market value of the stock the shareholder gave up in the distributing corporation. When this occurs, the shareholder must recognize gain, but not more than the sum of the fair market value of other property and money received.[5054] This type of distribution could also lead to gift tax consequences if one of the shareholders receives more stock than he would have been entitled to, based on his original ownership in the distributing corporation. If the proper donative intent exists, the shareholder may be deemed to have received a gift from the other shareholders. Thus, it is important to make sure that when a shareholder receives more than he was entitled to (based on his ownership), the transfer is properly documented so that it is clear whether there was any intent to gift and the transfer can be properly taxed.

The total basis of all shareholders' stock in the distributing and controlled corporation after the division will be the same as the total basis of all shareholders' stock in the distributing

[5050] Code § 118(a).
[5051] Code § 362(b). However, Reg. § 1.362-3 reduces the basis of property acquired in loss importation transaction.
[5052] Reg. § 1.312-10(a). However, a distributing corporation's unused NOL carryover will not be allocated to the controlled corporation. Rev. Rul. 77-133.
[5053] Reg. § 1.312-10(a).
[5054] Code § 356(a)(1).

corporation before the division, increased by gain or other income each shareholder recognized and reduced by returns of capital each shareholder received or loss recognized.[5055] However, each individual shareholder's basis may be different before and after the division and must be recalculated after the division. The shareholder's basis is allocated among stock held after the distribution in based on each share's fair market value relative to the fair market value of all shares.[5056]

II.Q.7.g. Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill)

Generally, a sale or exchange of property, directly or indirectly,[5057] between related persons, will treat as ordinary income any gain recognized to the transferor if such property is depreciable or amortizable property in the hands of the transferee.[5058] Also beware similar issues relating to patents.[5059]

In this context, "related persons" means:[5060]

- a person and all entities which are controlled entities with respect to such person,
- a taxpayer and any trust in which such taxpayer (or his spouse) is a beneficiary, unless such beneficiary's interest in the trust is a remote contingent interest,[5061] and
- except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

As used above, "controlled entity" means, with respect to any person:[5062]

- a corporation more than 50% of the value of the outstanding stock of which is owned (directly or indirectly) by or for such person,[5063]
- a partnership more than 50% of the capital interest or profits interest in which is owned (directly or indirectly) by or for such person, and
- any entity which is a related person to such person under certain attribution rules.[5064]

[5055] Code § 358(a)(1).
[5056] Reg. § 1.358-2(a)(2).
[5057] Boot received in a Code § 351 transaction triggered Code § 1239 in *Fish v. Commissioner*, T.C. Memo. 2013-270 (QSSS status terminated when the subsidiary gained another shareholder, causing the parent to be deemed to have transferred the former QSSS' assets to the subsidiary in a Code § 351 transaction).
[5058] Code § 1239(a).
[5059] See part II.G.18.c Patents, especially fn. 1691.
[5060] Code § 1239(b).
[5061] Within the meaning of Code § 318(a)(3)(B)(i). For Code § 318(a), see part II.Q.7.a.viii Code § 318 Family Attribution under Subchapter C.
[5062] Code § 1239(c)(1).
[5063] A requirement to elect an independent director does not cause the shareholder's voting power to drop below this threshold. *Fish v. Commissioner*, T.C. Memo. 2013-270.
[5064] Code § 267(b)(3), (10), (11), or (12).

The Code § 267(c) constructive ownership rules apply in determining ownership,[5065] including to attribute ownership between individuals[5066] who are family members.[5067] In addition, stock owned by a trust is considered as being owned proportionately by its beneficiaries.[5068] However, nothing in Code § 267(c) attributes to a trust stock owned by its beneficiaries. Although stock owned by children would be attributed to each other,[5069] that ownership would flow to the trusts. Therefore, even though a corporation would be a controlled entity with respect to each of children, it would not be a controlled entity with respect to any trust owning no more than 50% of the value of its stock.

Therefore, if stock in an S corporation is distributed to separate taxpayer trusts for children after the surviving spouse's death so that no trust owns more than 50% of the value of its stock, the children's trusts can liquidate the corporation, and each trust can receive its own property (instead of a tenant-in-common interest in every corporate asset) so it can make its own investment decision separately after the liquidation. Depending on the situation,[5070] the trust may need to make an ESBT election.[5071]

Code § 1239 applies not only to depreciable property but also to "an amortizable section 197 intangible."[5072] A "section 197 intangible" includes goodwill,[5073] going concern value,[5074] workforce in place,[5075] any information base,[5076] know-how,[5077] customer-based intangibles,[5078]

[5065] Code § 1239(c)(2), applying Code § 267(c) (other than Code § 267(c)(3)) for purposes of Code § 1239. See part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses.
[5066] Code § 267(c)(2).
[5067] Code § 1239(c)(2), which applies Code § 267(c) without applying Code § 267(c)(3).
[5068] Code § 267(c)(1).
[5069] Code § 267(c)(2).
[5070] See part III.A.3.c.ii Flowchart of Testamentary Trusts (Trusts Created on Grantor's Death or Continued after QSST Beneficiary's Death).
[5071] See part III.A.3.e.ii Electing Small Business Trusts (ESBTs). If a child's trust is a QSST, generally K-1 income is taxable to the child as the deemed owner (which would raise concerns about child-to-child attribution), but K-1 income counts as trust income (instead of beneficiary deemed-owned income) if and to the extent it is from the actual or deemed sale of assets in connection with a sale or liquidation of the corporation; see fns 5995 and 5996 in part III.A.3.e.i.(a) QSSTs Generally.
[5072] Code § 197(f)(7); Reg. § 1.197-2(g)(8) (which is also consistent with the Joint Committee of Taxation report).
[5073] In this context, the value of a trade or business attributable to the expectancy of continued customer patronage, which expectancy may be due to the name or reputation of a trade or business or any other factor.
[5074] In this context, the additional value that attaches to property by reason of its existence as an integral part of an ongoing business activity, including the value attributable to the ability of a business to continue functioning or generating income without interruption notwithstanding a change in ownership, as well as the use of the revenues or net earnings that otherwise would not be received during any period if the acquired trade or business were not available or operational.
[5075] This includes the existence of a highly-skilled workforce, any existing employment contracts, or a relationship with employees or consultants.
[5076] This includes the intangible value of technical manuals, training manuals or programs, data files, and accounting or inventory control systems, customer lists, subscription lists, insurance expirations, patient or client files, or lists of advertisers.
[5077] This includes any patent, copyright, formula, process, design, pattern, know-how, format, package design, internally developed or modified computer software, or interest in a film, sound recording, video tape, book, or other similar property.
[5078] This includes the existence of a customer base, a circulation base, an undeveloped market or market growth, insurance in force, the existence of a qualification to supply goods or services to a particular

supplier-based intangibles,[5079] any license, permit, or other right granted by a governmental unit (even if the right is granted for an indefinite period or is reasonably expected to be renewed for an indefinite period), any covenant not to compete, any franchise, trademark, or trade name, and any right under a license, contract, or other arrangement providing for the use of property described above.[5080]

Does Code § 1239 apply to the sale of goodwill? This rule applies only if these assets are "amortizable." However, amortizable section 197 intangibles do not include any intangible created by the taxpayer (a self-created intangible).[5081] On the other hand, the exception for self-created intangibles does not apply to any intangible created in connection with the purchase of a business.[5082] Does the sale of a business transform self-created intangibles into amortizable section 197 intangibles at the time of the sale, so that Code § 1239 applies?[5083] The Tax Court has held that Code § 1239 applies to gain if the property is an amortizable section 197 intangible in the transferee's hands.[5084] (Also note that goodwill that is not being amortized and is held by a partnership would be eligible for a basis step if a Code § 754 election is in place.[5085])

However, Code § 1239 does not apply to depletable property that is not depreciable under Code § 167.[5086]

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customer, a mortgage servicing contract, an investment management contract, or other relationship with customers involving the future provision of goods or services.

[5079] This includes the existence of a favorable relationship with persons providing distribution services (such as favorable shelf or display space at a retail outlet), the existence of a favorable credit rating, or the existence of favorable supply contracts.

[5080] Reg. § 1.197-2(b).

[5081] Reg. § 1.197-2(d)(2)(i). See also fn. 4132 regarding amortization of purchased goodwill.

[5082] Reg. § 1.197-2(d)(2)(iii)(B).

[5083] One reading is that Reg. § 1.197-2(g)(8) would have omitted amortizable if this result had been intended. A contrary argument is that Code § 1239 looks to the property in the hands of the transferee, and the self-created goodwill becomes purchased goodwill in the transferee's hands and is therefore amortizable. The contrary argument is more consistent with the purpose of Code § 1239, but Congress might have had other thoughts when it later enacted Code § 197.

[5084] *Fish v. Commissioner*, T.C. Memo. 2013-270.

[5085] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, fn. 5684. For an example of the effect of a Code § 754 election on goodwill that is being amortized, see fn. 5795 in part II.Q.8.e.iv Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).

[5086] Letter Ruling 8139052, reasoning:

> Depletion is based upon the concept of the exhaustion of a natural resource, whereas depreciation is based upon the concept of exhaustion, wear and tear, and also obsolescence of property, not otherwise a natural resource, used in a trade or business or held for the production of income. Depletion and depreciation are made applicable to different types of assets and the method by which a depletion allowance is spread over the taxable years is different from that applied in the case of depreciation. 4 J. Mertens, *Law of Federal Income Taxation* 24.02 (1980 rev.).

Letter Ruling 200602018 held:

> Though Individual B and Taxpayer are related persons under section 1239(b)(1), section 1239(a) applies to the sale or exchange of the Reserves only if the Reserves are subject to the allowance for depreciation provided in section 167. By claiming deductions for depletion under section 611 and for intangible drilling costs under section 263(c), Taxpayer has represented that the Reserves

Furthermore, when a husband and wife who own all of a partnership sell the partnership to a corporation they control, Rev. Rul. 72-172 asserted that Code § 1239 applies to the sale followed by the distribution of the partnership's depreciable property from the dissolved partnership to the corporation.[5087] However, Letter Ruling 8052086 declined to apply Code § 1239 to the sale of a partnership interest, without mentioning Rev. Rul. 72-172;[5088] it has been suggested that Rev. Rul. 72-172 is confined to cases when the partnership terminates as a result of the transfer.[5089] Furthermore, outside of the context of Code § 1239, *Grecian*

> are mineral property and, therefore, not subject to the allowance for depreciation under section 167.
>
> … we conclude that section 1239(a) does not apply to the Reserves, which are subject to the allowance for depletion under section 611(a). However, section 1239(a) does apply to any improvements which are subject to the allowance for depreciation under sections 611(a) and 167.

[5087] The ruling stated:

> In the instant circumstances, the transaction had the effect of transferring to the corporation, the partnership assets attributable to the partners' interests in the partnership. See *United States v. R. T. and Gertrude Woolsey et al.*, 326 F.2d 287 (1963); *Edwin E. McCauslen v. Commissioner*, 45 T.C. 588 (1966); and Rev. Rul. 67-65, C.B. 1967-1, 168. Compare *Kimbell-Diamond Milling Company*, 14 T.C. 74 (1950), *affirmed per curiam* 187 F.2d 718 (1951) *certiorari denied*, 342 U.S. 827 (1951).

[5088] Letter Ruling 8052086, issue 7, reasoned:

> Section 1239(a) of the Code provides that in the case of a sale or exchange of property, directly or indirectly, between related persons, any gain recognized to the transferor shall be treated as ordinary income if such property is, in the hands of the transferee, of a character which is subject to the allowance for depreciation provided in Section 167.
>
> Section 1.167(a) of the regulations provides, in pertinent part, that an intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. Thus, since a partnership interest is an intangible asset of indefinite duration, a partnership interest is not property of a character which is subject to the allowance for depreciation provided in Section 167. Since the partnership interest being sold by Sub has a life of potentially indefinite duration, the partnership interest is not subject to the allowance for depreciation provided by Section 167 of the Code. Accordingly, Section 1239 of the Code will not operate to cause any portion of the gain recognized by Sub to be ordinary income.

[5089] McKee, Nelson & Whitmire, ¶ 16.03[1] Aggregate-Entity Theory, found within ¶ 16.03 Transfers of Partnership Interests: *Transfers of Partnership Assets Compared of Federal Taxation of Partnerships & Partners* (WG&L). Letter Ruling 8048051 commented (when Code § 1239 did not apply because the corporation was not a controlled corporation):

> Rev. Rul. 72-172, 1972-1 C.B. 265 holds that section 1239 of the Code applied upon the sale of all partnership interests, including depreciable property, totally owned by a man and wife to a corporation in which they owned all the capital stock. In this instance the transaction had the effect of transferring to the corporation, the partnership assets attributable to the partners' interest in the partnership.

Grace Kim, in "Redeeming a Partner with The Partnership's Note," *Tax Management Memorandum* (BNA) (3/21/2016) (saved as Thompson Coburn doc. 6817740), says:

> There is an argument that a partnership interest is not depreciable property and that therefore § 1239 does not apply to the sale or exchange of a partnership interest.[41]
>
> [41] See PLR 8052086 (explaining that since a partnership interest is an intangible asset of indefinite duration, a partnership interest is not property of a character which is subject to the allowance for depreciation provided in § 167, and thus § 1239 will not operate to cause any portion of the gain recognized by the seller of a partnership interest to be ordinary income). *Cf.* Rev. Rul. 72-172, 1972-1 C.B. 265, holding that § 1239 applies upon the sale of all partnership interests, including depreciable property, totally owned by a man and wife to a corporation in which they owned all the capital stock. Note that there have been legislative efforts to enact a provision that would subject partnership interests to § 1239. See, *e.g.*, H.R. 1935, Bill to Provide

Magnesite Mining v. Commissioner, 149 T.C. No. 3 (7/13/2017) explained that Code § 741, which governs the nature of gain on sale of a partnership interest, treats a partnership interest as an indivisible asset, unless a statute specifically overrides[5090] that treatment.[5091]

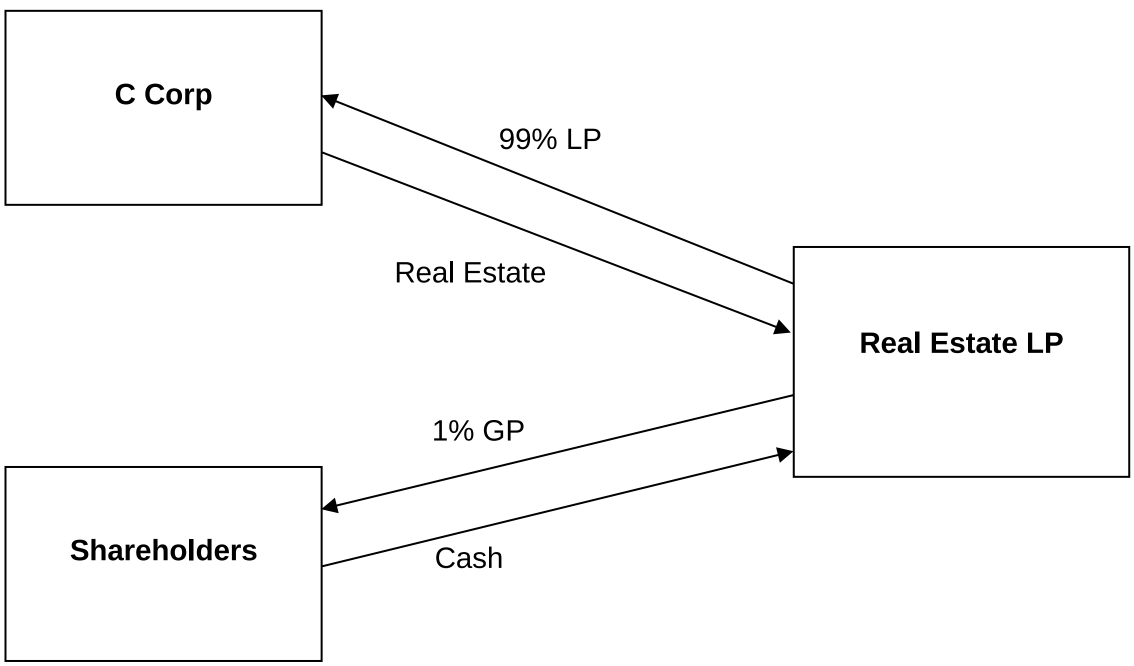
Although sales of partnership interests holding depreciable property trigger ordinary income taxation, that provision does so only to the extent of accumulated depreciation,[5092] whereas Code § 1239 applies with respect to the entire gain. Thus, placing depreciable property into a limited partnership,[5093] before liquidating the corporation or otherwise distributing the partnership interest, may avoid the full brunt of Code § 1239, subject to cautions about doing so too close to the liquidation.[5094]

The partnership provision most closely resembling Code § 1239 is part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

II.Q.7.h. Distributing Assets; Drop-Down into Partnership

II.Q.7.h.i. Structure

<u>Step 1</u>



for Tax Treatment of Partnership Interests Held by Partners Providing Services, Introduced by Rep. Sander Levin (D-Mich.), 111th Cong. 1st Sess. (2009). Arguably, such legislation would not have been needed if under current law partnership interests are subject to § 1239.

5090 See part II.Q.8.b.i.(g) Code § 751 – Hot Assets.

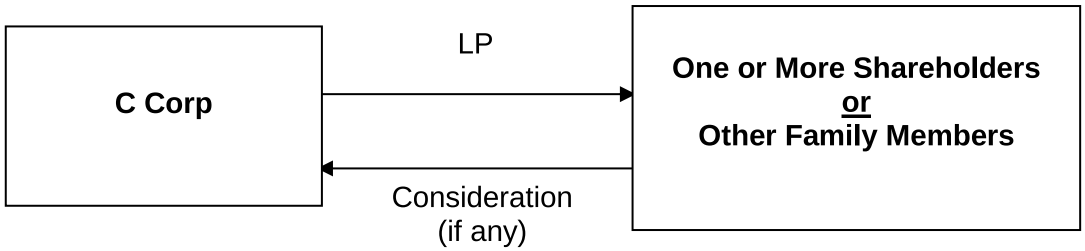
5091 See fn 5651 in part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest.

5092 See part II.Q.8.b.i.(g) Code § 751 – Hot Assets.

5093 See part II.Q.7.h Distributing Assets; Drop-Down into Partnership.

5094 See part II.Q.7.h.iii.(a) Taxable Gain to Corporation When It Distributes Property to Shareholders, especially fn. 5104.

Step 2



Step 1

General rule under Code § 721 is no gain or loss to contributing partner or receiving partnership when a partnership interest is issued in exchange for cash or other property.

Although real estate is illustrated here, this transaction could involve a line of business or marketable securities. However, if it involves marketable securities and the other partners contribute more than a de minimis amount, then one needs to consider additional issues to avoid gain recognition. Code § 721(b).

Step 2

The corporation recognizes gain as if it had sold the property that was distributed. Code § 311. Given that what is transferred is an interest as a limited partner, valuation discounts would reduce the transfer's value and therefore the gain that it triggers.

Shareholders recognize dividend income to the extent of the corporation's earnings and profits (E&P) if it is a distribution (or a state law redemption that does not qualify as an income tax redemption under Code § 302). The balance of the distribution simply reduces the stock's basis and is capital gain after that.

Step 2 could also be done as a taxable sale.

Step 2 might be done in stages to minimize step transaction attacks, including those mentioned in footnote 5104.

II.Q.7.h.ii. Taxation of Shareholders When Corporation Distributes Cash or Other Property

For taxation of distributions by S corporations, see part II.Q.7.b.iv.(a) S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations.

Distributions to shareholders of a C corporation are taxed as dividends to the extent of earnings and profits (E&P), then as return of basis, and then as gain on the sale of stock.[5095] The distributions are applied to each block of share proportionately; if a block of stock has basis lower than other blocks of stock and runs out of basis, then distributions attributable to that block trigger gain, even if the shareholder has plenty of basis available in other blocks of stock that would otherwise have been available to absorb the distribution tax-free.[5096]

[5095] Code § 301(c).
[5096] *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971), *rev'g* 303 F.Supp. 1 (E.D. Va. 1969).

Redemptions reduce E&P.[5097]

II.Q.7.h.iii. Taxation of Corporation When It Distributes Property to Shareholders

The rules below apply to S corporations as well as C corporations.[5098]

II.Q.7.h.iii.(a). Taxable Gain to Corporation When It Distributes Property to Shareholders Other Than in Liquidation of the Corporation

Code § 311(b)(1) taxes a corporation when it distributes appreciated assets to its shareholders in a distribution described in Code §§ 301-307 (note that corporate liquidations are described in Code §§ 331-346).[5099] The corporation is deemed to have sold the assets to the distributee.[5100] If the corporation is a C corporation, then the deemed sale is taxed at ordinary income rates, just like any other corporation gain or loss would be. If the corporation is an S corporation, then it is taxed to the shareholders on their K-1s,[5101] subject of course to any applicable built-in gain tax under Code § 1374.[5102] The entire gain (not just depreciation recapture) from the deemed sale of any depreciable or amortizable property may be taxed as ordinary income (which, in addition to having consequences to S corporation owners, can be an issue to C corporations that have capital losses that could otherwise be offset).[5103]

If the distribution is of all of the corporation's interest in the property, the IRS will attempt to disregard any valuation discounts that would not have applied if the corporation had distributed all of the corporation's interest in the property to one shareholder.[5104] Furthermore, if the IRS determines that a corporation's receipt of a partnership interest does not constitute adequate and full consideration for the property it transferred to the partnership, the IRS will argue that a dividend was made to the other partners and that the corporation recognized gain on the

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[5097] Code § 312(n)(7), superseding the limitations of Reg. § 1.312-5. Rev. Rul. 79-376, which had governed, was obsoleted by Rev. Rul. 95-71, presumably in response to this change; see T.M. 767 Redemptions IV.A.2.c. The Senate Report to P.L. 98-369 that enacted the current statutory language provides:

> In the case of a distribution by a corporation in redemption of its own stock, earnings and profits are to be reduced in proportion to the amount of the corporation's outstanding stock that is redeemed. However, the Senate does not intend that earnings and profits be reduced by more than the amount of the redemption.

[5098] Code § 1371(a).

[5099] For the latter, see part II.Q.7.a.vii Corporate Liquidation.

[5100] Although a bargain sale of property to a shareholder is a deemed sale for full fair market value with the bargain element constituting a divided, a corporation is not required to make a profit when it provides services to a shareholder – reimbursing the corporation for the costs it incurred is sufficient to avoid any sale or dividend treatment. *Welle v. Commissioner*, 140 T.C. 420 (2013) (services were incidental; business generally was conducted to make a profit in serving the general public).

[5101] Code § 1366.

[5102] See part II.P.3.b.ii Built-in Gain Tax.

[5103] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).

[5104] TAM 200443032; *Pope & Talbot, Inc. v. Commissioner*, 104 T.C. 574 (1995), *aff'd* 162 F.3d 1236 (9th Cir. 1999). See also *Robert E. Smith, III v. Commissioner*, T.C. Memo. 2017-218, in which an S corporation was formed and liquidated in the same year and claimed a loss on the deemed sale of the limited partnership interest it received when it also formed the partnership in the same year; the economic substance doctrine disallowed the loss and imposed penalties (see part II.G.17 Economic Substance Penalty and Doctrines, but the tax year was before Code § 7701(o) was enacted, so penalties applied even without that statute).

property deemed distributed to the other partners.[5105] However, in what might be the same case, the IRS lost that argument, when the taxpayer convinced the court of the taxpayer's business purpose, in *Cox Enterprises, Inc. & Subsidiaries v. Commissioner*.[5106]

II.Q.7.h.iii.(b). Nondeductible Loss to Corporation When It Distributes Property to Shareholders

Under Code § 311(a), a corporation cannot deduct a loss when distributing property, the value of which is less than its basis.

CCA 201421015 concluded:[5107]

> Disallowed § 311(a) losses will be treated as non-deductible, non-capital expenses pursuant to § 1367(a)(2)(D). Thus, a § 311(a) loss will reduce shareholders' bases in S corporation stock, and the S corporation must reduce its accumulated adjustments account.

II.Q.7.h.iv. Taxpayer Win in *Cox Enterprises* When IRS Asserted That Contributing Property to Partnership Constituted Distribution to Shareholders (2009); *Dynamo Holdings*' Limitation on Using *Cox Enterprises* (2018)

Before discussing *Cox Enterprises*, let's review an important concept when entities owned by related parties conduct business. *Dynamo Holdings Ltd. Partnership v. Commissioner*, T.C. Memo. 2018-61, enunciated the issue of "constructive distribution":

> It is well settled that a transfer of property from one entity to another for less than adequate consideration may constitute a constructive distribution to an individual who has ownership interests in both entities.[5108] A bargain sale, including a bargain sale based on competing property valuations, between related parties, however, does not automatically result in a constructive distribution.[5109]
>
> Courts have outlined a two-prong analysis to determine whether a transfer resulted in a constructive distribution. The first prong, the objective test, asks whether the transfer caused "funds or other property to leave the control of the transferor corporation and …[whether] it allow[ed] the stockholder to exercise control over such funds or property either directly or indirectly through some instrumentality other than the transferor

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[5105] TAM 200239001 (property deemed distributed is based on the value of the property contributed to the partnership rather than the value of the partnership interests received by the partner).

[5106] T.C. Memo. 2009-134.

[5107] This disallowed loss nevertheless reduces the S stock's basis. See fn. 1200. Code § 1367 is reproduced in part II.G.4.d.i Basis Limitation Generally.

[5108] Fn 76 of *Dynamo Holdings* cited here:

> *Stinnett's Pontiac Serv., Inc. v. Commissioner*, 730 F.2d at 640; *Cox Enters., Inc., & Subs. v. Commissioner*, T.C. Memo. 2009-134, 97 T.C.M. (CCH) 1767, 1774 (2009).

Fn 42 of *Dynamo Holdings* introduced the citation to *Stinnett's Pontiac Service, Inc. v. Commissioner*, 730 F.2d 634, 638 (11th Cir. 1984), *aff'g* T.C. Memo. 1982-314.

[5109] Fn 77 of *Dynamo Holdings* cited here:

> *Davis v. Commissioner*, T.C. Memo. 1995-283, 69 T.C.M. (CCH) 3004, 3007 (1995); *see also Joseph Lupowitz Sons, Inc. v. Commissioner*, 497 F.2d 862, 868 (3d Cir. 1974), *aff'g in part, rev'g in part* T.C. Memo. 1972-238; *Cox Enters., Inc., & Subs. v. Commissioner*, 97 T.C.M. (CCH) at 1775.

corporation."[5110] The second prong, the subjective test, a "crucial inquiry" in the constructive distribution determination, asks whether the transfer occurred primarily for the common shareholder's personal benefit rather than for a valid business purpose.[5111] Both prongs must be satisfied for a court to find a constructive distribution.[5112]

As to the objective prong, "Because the common shareholder does not directly receive funds or property in a transfer between entities, such a transfer is a distribution if: (1) the transferred funds leave the control of the transferring entity and (2) the owner controls the funds, directly or indirectly, through some means other than the transferor."[5113] As to the subjective prong, *Dynamo Holdings* enunciated:

> The subjective prong asks the Court to consider whether the transfer occurred primarily for the benefit of the common shareholder, rather than for a valid business purpose. In applying the subjective prong "the search for this underlying purpose usually involves the objective criterion of actual primary economic benefit to the shareholders as well".[5114] The Court of Appeals for the Eleventh Circuit states the point as follows: "In determining whether the primary purpose test has been met, we must determine not only whether a subjective intent to primarily benefit the shareholders exists, but also whether an actual primary economic benefit exists for the shareholders."[5115]
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> If the primary purpose is a valid business purpose, then the primary purpose is not for the shareholder benefit.[5116] The benefit to the shareholder must be "direct", a term broadly construed.[5117] For example, courts have found a benefit to the shareholder

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[5110] Fn 78 of *Dynamo Holdings* cited here:
See Stinnett's Pontiac Serv., Inc. v. Commissioner, 730 F.2d at 641 (quoting *Sammons v. Commissioner*, 472 F.2d 449, 451 (5th Cir. 1972), *aff'g in part, rev'g in part* T.C. Memo. 1971-145.

[5111] Fn 79 of *Dynamo Holdings* cited here:
Wilkof v. Commissioner, T.C. Memo. 1978-496, 37 T.C.M. (CCH) 1851-31, 1851-38 (1978), *aff'd*, 636 F.2d 1139 (6th Cir. 1981).

[5112] Fn 80 of *Dynamo Holdings* cited here:
Sammons v. Commissioner, 472 F.2d at 451; *Cox Enters., Inc., & Subs. v. Commissioner*, 97 T.C.M. (CCH) at 1774.

[5113] Fn 81 of *Dynamo Holdings* cited here:
Sammons v. Commissioner, 472 F.2d at 453; *Davis v. Commissioner*, 69 T.C.M. (CCH) at 3007.
Based on the *Dynamo Holdings* conclusion below, it's not surprising that the court concluded:
Considering the control Mrs. Moog exercised over Beekman and Dynamo through 2020072 Ontario, Ltd., we conclude the first prong of the two-prong analysis for a constructive distribution is satisfied. Mrs. Moog had the ability to divert the value of the property to her chosen recipient because of her control.

[5114] Fn 82 of *Dynamo Holdings* cited here:
Cox Enters., Inc., & Subs. v. Commissioner, 97 T.C.M. (CCH) at 1774 (quoting *Kuper v. Commissioner*, 533 F.2d 152, 160 (5th Cir. 1976)); *see also Stinnett's Pontiac Serv., Inc. v. Commissioner*, 730 F.2d at 641.

[5115] Fn 83 of *Dynamo Holdings* cited here:
Stinnett's Pontiac Serv., Inc. v. Commissioner, 730 F.2d at 641.

[5116] Fn 84 of *Dynamo Holdings* cited here:
Stinnett's Pontiac Serv., Inc. v. Commissioner, 730 F.2d at 641; *Sammons v. Commissioner*, 472 F.2d at 452; *Cox Enters., Inc., & Subs. v. Commissioner*, 97 T.C.M. (CCH) at 1774.

[5117] Fn 85 of *Dynamo Holdings* cited here:
Gilbert v. Commissioner, 74 T.C. 60, 64 (1980); *Wilkof v. Commissioner*, 37 T.C.M (CCH) at 1851-38; *see also Rushing v. Commissioner*, 52 T.C. 888, 894 (1969) ("[W]hatever personal benefit, if any, Rushing [the sole shareholder of the transferor and transferee corporations]

when the primary purpose of the transfer is to or for the benefit of a member of the shareholder's family.[5118]

The *Cox* court held that a corporation's contribution of a television station to a partnership did not constitute a dividend even though the partnership interest it received was originally worth $60.5 million less than the assets it contributed. The partners in the partnership were the remaindermen of certain trusts. These trusts, indirectly and collectively, owned 98% of the corporation's stock.

The corporation contributed assets worth $300 million, became the managing general partner, and received a majority partnership interest, which entitled it to 55% of partnership distributable profits and liquidation proceeds up to specified base amounts and 75% of distributable profits and liquidation proceeds in excess of those base amounts. The other partners contributed assets worth $62 million and received the balance of the rights to distributions. Thus, the corporation contributed nearly 83% ($300 million divided by $362 million) of the assets and received the right to profits of 55%-75%.

The IRS argued that the transfer to the partnership should be deemed an indirect distribution to the remaindermen of the trusts and therefore a distribution to the trusts. Judge Halpern rejected the IRS' contention. First, he held that the corporation's transfer to the partnership "was not intended to provide a gratuitous economic benefit to the other partners…." Second, he held that, even if the corporation had made such a gratuitous transfer, the transfer did not benefit the shareholder trusts.

In *Cox*, several factors demonstrated that the corporation's directors did not intend a gratuitous transfer:

1. The partnership's formation had nontax business reasons. As recommended by independent consultants, the corporation tried to sell these operating assets but was unable to do so. The partnership's formation allowed the corporation to retain, for use in other areas, the working capital it had previously needed for the television station.

2. The corporation's board's executive committee adopted a resolution that the other partners be required to make cash contributions to the partnership "in an amount corresponding to the fair market value of the partnership interests acquired by" those other partners. Furthermore, the other partners' acquisition of partnership interests was to "be on terms and conditions no less favorable to" the corporation "than the terms and conditions that would apply in a similar transaction with persons who are not affiliated with" the corporation.

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received was derivative in nature. Since no direct benefit was received, we cannot properly hold he received a constructive dividend."), *aff'd*, 441 F.2d 593 (5th Cir. 1971).

[5118] Fn 86 of *Dynamo Holdings* cited here:

Green v. United States, 460 F.2d 412, 419-421 (5th Cir. 1972); *Byers v. Commissioner*, 199 F.2d 273, 275 (8th Cir. 1952), *aff'g* a Memorandum Opinion of this Court, *Epstein v. Commissioner*, 53 T.C. 459, 474-475 (1969) (explaining that it is firmly established that when a corporation makes a transfer of property for no or insufficient consideration "to a member of the stockholder's family, whether it be directly or in trust, the stockholder has enjoyed the use of such property no less than if it had been distributed to him directly").

Based on the *Dynamo Holdings* conclusion below, it's not surprising that the court held that the test for constructive distributions was satisfied.

3. The corporation retained an outside accounting firm "to render an opinion of appropriate marketability and minority interest discounts applicable to a minority interest" in the partnership as of the date of formation. The partners made contributions based on the appraised amount. Three years later, the corporation's management discovered errors in computing the other partners' interests in the partnership and obtained a new appraisal. The other partners made additional contributions to bring their contributions up to the appraised value.

4. The court relied on *United States v. Byrum*[5119] to find that the controlling shareholders were subject to fiduciary duties to the minority shareholders. In the *Cox* case, two percent of the stock was owned by people who were not members of the controlling family; these minority shareholders were principally employees of the corporation. Judge Halpern pointed out that the minority shareholders did not own interests in the other partners and "would not be made financially whole for the likely shortfall in income and liquidation (or sale) proceeds" if the corporation's contribution to the partnership constituted a transfer to the other partners.

The court also found that any gratuitous transfer to the other partners would not have benefitted the shareholder trusts. The remaindermen of the trusts held significant interests in the partners, so a transfer to the other partners would have accelerated the remaindermen's interests in violation of the trust agreements. Because the trusts were the controlling shareholders (and the court assumed for the sake of argument that the trustees also controlled the actions of the other board members), the trustees would have violated their fiduciary duties by accelerating the interests of the remaindermen. Thus, a gratuitous transfer to the other partners would have been detrimental to the shareholder trusts as entities and would have violated the trustees' fiduciary duties.

The court concluded that any gratuitous transfer of an interest from the corporation to the other partners did not constitute a distribution to the shareholder trusts subject to Code § 311.[5120]

Other issues relating to these parties were still before the court when Judge Halpern wrote this opinion, some of which involved the trusts themselves. Subject to any light shed by those cases, one may draw some planning tips from this case:

1. As usual, documenting a transaction very well is always advisable, particularly documentation demonstrating an intent to deal at arms-length.

2. Although the Tax Court seems to place little weight on the *Byrum* case in family limited partnership cases under Code § 2036, having nonfamily member employees hold 2% of the stock might do the trick.

3. Practitioners often wonder whether parties must contribute assets with fair market value to obtain capital accounts proportionate to their interests in profits when all partners are making their initial contributions on formation of the partnership. In this case, the majority partner (the corporation) contributed assets with value significantly in excess of the value of its partnership interest. However, the minority partners contributed assets equal to the value of their interests in the partnership. Thus, the majority partners received capital accounts that were higher relative to their interests in profits compared with the minority partners'

[5119] 408 U.S. 135, 137-138 (1972).

[5120] For information on Code § 311, see part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

> capital accounts relative to their respective interests in profits. Judge Halpern did not seem to recognize this issue; if he did, he did not mention it in analyzing the dividend issue.[5121] It will be interesting to see whether the companion cases consider this issue to be of consequence.

However, *Dynamo Holdings Ltd. Partnership v. Commissioner*, T.C. Memo. 2018-61, which was a taxpayer win on other intra-family issues,[5122] contrasted its taxpayer's repeated bargain sales against *Cox Enterprises*' isolated transaction. *Dynamo Holdings* noted and reasoned (footnotes to *Cox Enterprises* omitted):

> Petitioners argue that Beekman's directors held fiduciary duties to the beneficiaries of the Canadian trusts not to deplete the value of Beekman and therefore Beekman could not have underpriced the property. Petitioners rely on *Cox Enters.*, where we held that there was not a constructive distribution. In *Cox Enters.*, one corporation contributed an asset to a partnership in exchange for a partnership interest the value of which was lower than the value of the contributed asset, effectively transferring value to the other partners. The other partners were two family partnerships. We found that the primary purpose was not to benefit the other partners, in part because the corporation's majority shareholder and directors would have had to breach their fiduciary duties. This would have resulted in a financial detriment to the minority shareholders who did not own any interest in the partnerships.
>
> Petitioners ask that we follow this line of reasoning because the beneficiaries of the Canadian trusts are not identical to the beneficiaries of the U.S. trusts. Petitioners argue that the directors, officers, and controlling shareholders did not breach any duties to the Canadian trusts by depleting value from Beekman. We disagree. *Cox Enters.* involved a single instance of undervaluing an interest. In these cases, we have found five bargain sales exceeding $200 million. Unlike *Cox Enters.*, we find that the directors, officers, and controlling shareholder acted for the benefit of the U.S. trusts and to the detriment of the Canadian trusts.
>
> We agree with the Commissioner that the primary intent and benefit was for Dynamo and by extension, the dynasty trusts. The bargain sale properties went to Dynamo, enhancing its value. The properties put more equity in Dynamo and freed up its liquid assets. This allowed Dynamo to develop its Florida business and increased Dynamo's borrowing capability. All of this directly benefited the dynasty trusts for the benefit of Christine and Mr. Julien and furthered Mrs. Moog's estate planning. Accordingly, Beekman made deemed distributions.

[5121] If this case is the same as TAM 200239001, then the IRS must have pressed this issue, because the TAM specifically addressed it. The judge did point out that the IRS argued, in the alternative, that the dividend was of the TV station or of a partnership interest. However, he still did not seem to notice the disproportionality on which the TAM focused.

[5122] See part III.B.1.a.i.(a) Loans Must be Bona Fide, text accompanying fns 6220-6236, excused defects in formalities of loans because, objectively, the parties treated the advances as loans, consistently reported them as such for tax purposes, and were intended to be - and actually were - repaid.

II.Q.7.h.v. Taxpayer Win in *Bross Trucking* When IRS Asserted Corporation Distribution of Goodwill to Shareholder Followed by Gift to Shareholder of New Corporation (2014)

In *Bross Trucking, Inc. v. Commissioner*,[5123] the IRS asserted that the existing corporation (Bross Trucking) distributed appreciated intangible assets to its sole shareholder, who then made a gift of the intangibles to his three sons, who organized their own[5124] corporation (LWK Trucking). The alleged value of the intangible assets would have required both filing a gift tax return and paying gift tax.

The court held:

> there are two regimes of goodwill: (1) personal goodwill developed and owned by shareholders; and (2) corporate goodwill developed and owned by the company. Bross Trucking's goodwill was primarily owned by Mr. Bross personally, and the company could not transfer any corporate goodwill to Mr. Bross in tax year 2004.

Although a lack of non-compete agreements generally facilitates the lack of corporate goodwill,[5125] in this case regulatory action jeopardized Bross Trucking's business and

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[5123] T.C. Memo. 2014-107.

[5124] The sons were not actually the owners – it was their Roth IRAs, as the court explained:

> LWK Trucking was organized on October 1, 2003. Its stock was divided into two classes when it was organized: class A voting stock and class B nonvoting stock. Class A stock represented a 98.2% interest in LWK Trucking and class B stock represented the remaining 1.8%. In December of 2003 each of the three Bross sons established a self-directed Roth IRA. Later that month, each of the Bross sons directed his respective Roth IRA to acquire 2,000 shares of class A shares in LWK Trucking. Together, the 6,000 shares acquired by the three Roth IRAs represented all of the class A shares in LWK Trucking, giving the three sons a combined 98.2% interest in LWK Trucking.[8] The remaining class B shares were acquired by an unrelated third party.

Footnote 8 commented:

> As stated infra note 19, a discussion on the merits of this structure is not relevant to the issues in these cases and the Court does not address the validity of this transaction.

Footnote 19 stated:

> Thus, Mr. Bross could not transfer Bross Trucking assets to his three sons, and it follows that the three Bross sons could not transfer Bross Trucking assets to each of their respective Roth IRAs. Accordingly, IRS Notice 2004-8, 2004-1, C.B. 333, is outside the scope of these cases because Bross Trucking and LWK Trucking never shared any assets. Further, a discussion on the structure of the Bross sons' ownership of LWK Trucking is outside the scope of this opinion.

My understanding is that the IRS initiated this audit to explore Roth IRA issues, then focused its attack on the corporate issues, trying to get more money from the taxpayers. For more on Roth IRAs owning businesses, see part II.G.22 IRA as Business Owner.

[5125] See part II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees? Focusing on the authority cited in fn. 4156, the *Bross Trucking* court held that any goodwill associated with Bross Trucking was personally owned by its shareholder:

> The remaining attributes assigned to Bross Trucking's goodwill all stem from Mr. Bross's personal relationships. Bross Trucking's established revenue stream, its developed customer base, and the transparency of the continuing operations were all spawned from Mr. Bross's work in the road construction industry.
>
> Any established revenue stream, developed customer base, or transparency of continuing operations was a direct result of Mr. Bross's personal efforts and relationships. Like the shareholder in Martin Ice Cream Co., Mr. Bross developed the crucial relationships with the

businesses' customers. Bross Trucking's customers chose to patronize the company solely because of the relationships that Mr. Bross personally forged. Mr. Bross had close, personal relationships with the owners of Bross Trucking's primary customers. For example, Mark Twain Redi-Mix, a substantial Bross Trucking customer, was owned by Mr. Bross's wife and two sons. As with the taxpayer in *Norwalk v. Commissioner*, T.C. Memo. 1998-279, it is safe to assume that Bross Trucking's customers sought Mr. Bross' personal ability and reputation when hiring Bross Trucking because he was a successful construction businessman who has been in the road construction industry since the 1960s.

Bross Trucking may have had a developed revenue stream, but only as a result of Mr. Bross' having personal relationships with the customers. It follows that Bross Trucking's developed customer base was also a product of Mr. Bross' relationships. Mr. Bross was the primary impetus behind the Bross Family construction businesses, and the transparency of the continuing operations among the entities was certainly his personal handiwork. [footnote omitted] His experience and relationships with other businesses were valuable assets, but assets that he owned personally.

A company does not have any corporate goodwill when all of the goodwill is attributable solely to the personal ability of an employee. See *MacDonald v. Commissioner*, 3 T.C. 720, 727 (1944); *Norwalk v. Commissioner*, T.C. Memo. 1998-279. Unlike the taxpayer's products in *Solomon v. Commissioner*, T.C. Memo. 2008-102, Bross Trucking's products did not contribute to developing the goodwill. This is demonstrated in part by the services performed by Bross Trucking. Bross Trucking's business model involved hiring independent contractors to haul equipment and supplies around the State. There were very few obstacles to obtaining authority and directly hiring the independent contractors who performed the actual work for Bross Trucking. The State of Missouri's deregulation of the trucking industry allows new entrants to easily begin trucking operations. In other words, it was not Bross Trucking's product which enticed customers to use its services because the services were not unique. *Cf. Schilbach v. Commissioner*, T.C. Memo. 1991-556 (holding that a single-shareholder-owned professional corporation possessed all of the goodwill because the corporation's services were unique and was not based on the ability of the shareholder). The expectation of continuing patronage must have been a result of the unique relationships between Mr. Bross and the customers.

….

Mr. Bross did not transfer any goodwill to Bross Trucking through an employment contract or a noncompete agreement. A key employee [footnote omitted] who develops relationships for his or her employer may transfer goodwill to the employer through employment contracts or noncompete agreements. See *Martin Ice Cream Co. v. Commissioner*, 110 T.C. at 207. The transfer is evidenced by the employee's covenant to not use his or her goodwill to compete against the employer. *O'Rear v. Commissioner*, 28 B.T.A. 698, 700 (1933) ([I]t is at least doubtful whether a professional man can sell or dispose of any good will which may attach to his practice except perhaps by contracting to refrain from practicing.), *aff'd*, 80 F.2d 473 (6th Cir. 1935). In other words, an employee transfers the benefit of his or her relationships to an employer when the employee cannot benefit from the relationships without the employer.

An employer has not received personal goodwill from an employee where an employer does not have a right, by contract or otherwise, to the future services of the employee. See *MacDonald v. Commissioner*, 3 T.C. at 727-728. Mr. Bross did not have an employment contract with Bross Trucking and was under no obligation to continue working for Bross Trucking. A contractual duty to continue to use his or her assets for the benefit of the company may show that an employee transferred personal goodwill to an employer for the length of the obligation. Mr. Bross, however, was under no such obligation: he was free to leave the company and take his personal assets with him. Similarly, the lack of an employment contract shows that there was not an initial obligation for Mr. Bross to transfer any of his personal assets to Bross Trucking. Bross Trucking did not take an ownership interest in Mr. Bross' goodwill from the beginning because Mr. Bross never agreed to transfer those rights. Thus, the lack of an employment contract between Mr. Bross and Bross Trucking shows that Bross Trucking did not expect to--and did not--receive necessitated forming a new company.[5126] Therefore, the court held that "the sole attribute of goodwill displayed by Bross Trucking was a workforce in place, and it is therefore the only

personal goodwill from Mr. Bross. Accordingly, Mr. Bross' personal goodwill remained a personal asset separate from Bross Trucking's assets.

An employee may transfer personal goodwill to an employer through a covenant not to compete. See *Martin Ice Cream Co. v. Commissioner*, 110 T.C. at 207-208; *H & M Inc. v. Commissioner*, T.C. Memo. 2012-290. In those cases the Court held an employee did not transfer personal goodwill to the employer because he or she did not sign a noncompete agreement. Similar to those taxpayers, Mr. Bross never transferred any personal goodwill to Bross Trucking by signing a noncompete agreement. Much in the same way that Bross Trucking did not have any contractual expectation of continued services from Mr. Bross while he was an employee, Bross Trucking could also not expect to benefit from Mr. Bross's personal goodwill after he left the business. Mr. Bross' freedom to use his personal goodwill in direct competition with Bross Trucking if he stopped working for the company shows that he did not transfer it to Bross Trucking.

[5126] The *Bross Trucking* court stated:

Bross Trucking might have had elements of corporate goodwill at some point but had lost most of it by the time of the alleged transfer. Specifically, through various regulatory infractions Bross Trucking lost any corporate goodwill because of an impending suspension and the negative attention brought by the Bross Trucking name. During the late 1990s and early 2000s Bross Trucking was investigated extensively by the DOT and the MCRS. As a result of the investigations, Bross Trucking faced a possible suspension of operations and several fines because the authorities gave Bross Trucking unsatisfactory safety ratings. Further, the various regulatory authorities were hounding Bross Trucking to the point that LWK Trucking wanted to immediately remove the Bross name from leased trucks to avoid their being spotted and stopped. The impending suspension would cause customers to reevaluate whether to trust Bross Trucking and continue to do business with it. Indeed, Mr. Bross expressed his concern to his attorney that Bross Trucking might not be able to perform necessary functions as a result of the suspension. Mr. Bross's solution was to find or create another business to take over the trucking needs for the Bross family businesses. This is the antithesis of goodwill: Bross Trucking could not expect continued patronage because its customers did not trust it and did not want to continue doing business with it.

Further, the lack of corporate goodwill is demonstrated by the necessity to separate LWK Trucking from Bross Trucking by hiding the Bross name on leased trucks. Trade names and trademarks are the embodiment of goodwill. *Canterbury v. Commissioner*, 99 T.C. 223, 252 (1992). LWK Trucking specifically chose to quickly remove the Bross Trucking name from any leased equipment to avoid confusion between the two companies. This shows that any transferred corporate goodwill was not valuable and may have actually been detrimental to LWK Trucking. In other words, LWK Trucking was trying to hide any relationship with Bross Trucking because association with the targeted company was seen in a negative light. A new company trying to use the transferred goodwill of another company would likely try to associate with the recognized company, not hide the company logo.

Mr. Bross credibly testified that Bross Trucking had relationships with several national suppliers for fuel and parts, but no evidence was submitted showing that LWK Trucking benefited from any transferred supplier relationships. Further, it is unclear whether Mr. Bross or Bross Trucking cultivated the supplier relationships.

….

Bross Trucking's customers had a choice of trucking options and chose to switch from Bross Trucking to LWK Trucking. Respondent's contention that Bross Trucking transferred a developed customer base and an established revenue stream is misleading because it suggests that the transfer was organized between Bross Trucking and LWK Trucking. It appears, however, that Bross Trucking's customers were interested in changing trucking providers because of the impending suspension, showing that the act was not a transfer of intangibles at the service attribute that the corporation could have distributed to Mr. Bross." The court rejected the IRS' assertion that Bross Trucking's intangible workforce assets were transferred to LWK Trucking[5127] or that any other transfers occurred.[5128]

provider level but a business choice made at the customer level. For example, forming LWK Trucking gave Mark Twain Redi-Mix, which shared ownership with LWK Trucking and one of Bross Trucking's primary customers, the option to use a trucking company with an untarnished reputation and clean service record. Thus, the facts support a finding that Bross Trucking did not transfer its customers but that the customers chose to use a new company because of Bross Trucking's troubled past.

[5127] The *Bross Trucking* court stated:

As discussed above, the only aspect of corporate goodwill that Bross Trucking displayed was a workforce in place, but Bross Trucking did not transfer an established workforce in place to Mr. Bross. Respondent repeatedly contends that most of the Bross Trucking employees became LWK Trucking employees. The evidence, however, shows that only about 50% of LWK Trucking's employees formerly worked at Bross Trucking. The Court is unconvinced that most of a workforce in place was transferred when only 50% of the current employees were previously employees by the alleged transferor. Instead it appears that LWK Trucking assembled a workforce independent of Bross Trucking. This is demonstrated by the new key employees and services offered by LWK Trucking. Mr. Bross's sons managed LWK Trucking and also engaged in services different from those performed at Bross Trucking. For instance, in 2004 LWK Trucking started One Star Midwest, which sold GPS services, and LWK Trucking later started performing truck maintenance for third parties. Bross Trucking did not perform these services and could not have provided employees to start the separate service lines . LWK Trucking may have hired former Bross Trucking employees, but there is no evidence that these employees were transferred to LWK Trucking rather than hired away on their own merit. It is also unclear whether any of the alleged transferred employees that moved to LWK Trucking were independent contract drivers. These drivers were not obligated to work solely for Bross Trucking and in fact were almost certainly expected to have contracts with companies outside of Bross Trucking. Independent contractors' choosing to accept work from a different business is not a transfer of workers.

[5128] The *Bross Trucking* court stated:

In addition, Bross Trucking did not distribute any cash assets and retained all the necessary licenses and insurance to continue business. Further, Mr. Bross remained associated with Bross Trucking and was not involved in operating or owning LWK Trucking. He was free to compete against LWK Trucking and use every cultivated relationship in order to do so. In other words, the fact that Bross Trucking could have resumed its hauling business supports the view that it retained any corporate intangibles. Accordingly, there was no transfer of intangible assets because Bross Trucking's customers chose to use a different company and Bross Trucking remained a going concern.

LWK Trucking did not benefit from any of Bross Trucking's assets or relationships. LWK Trucking was independently licensed and developed a wholly new trucking company. LWK Trucking did not take a transferred basis in any assets such as property or purchased authority. There is no indication that LWK Trucking used any relationship that Mr. Bross personally forged. The Bross sons were in a similarly close capacity to Bross Trucking's customers to develop relationships apart from Mr. Bross. Cultivating and profiting from independently created relationships are not, however, the same as receiving transferred goodwill. It is true that LWK Trucking's and Bross Trucking's customers were similar, but it does not mean that Bross Trucking transferred goodwill; instead the record shows that LWK Trucking's employees created their own goodwill.

II.Q.7.h.vi. IRS' Conservative Roadmap: Letter Ruling 200934013

This ruling approved a corporation's contribution of marketable securities to a partnership in exchange for a partnership interest.[5129] Unlike *Cox Enterprises*, no value was shifted, although future appreciation would be effectively shifted out. This ruling followed the IRS' position that one cannot create discounts by placing assets in a partnership and then distributing all of the corporation's partnership interests to the shareholders. A family-owned S corporation ("Corp") owned 100% of the membership interests in LLC, which was disregarded as an entity separate from Corp for federal tax purposes. LLC's operations consist solely of investing in a diversified portfolio of passive investment assets, including hedge funds, mutual funds, and private equity funds. LLC has no outstanding liabilities. Shareholder A and Corp reached an agreement pursuant to which Shareholder A was admitted as a new member of LLC. Specifically, Shareholder A contributed cash to LLC in exchange for a newly issued, non-voting, preferred interest in LLC. The terms and pricing of the preferred interest were based on an independent appraiser's determination of market rate terms for similar equity investments.

For what have been represented to be valid business purposes, the following steps were proposed: (i) Corp will distribute some of its membership interests in LLC pro-rata to its stockholders (the "Distributed LLC Interests") and (ii) LLC's operating agreement will be amended to provide Corp with a share of LLC's profits disproportionate to capital in exchange for Corp providing future management services to LLC with respect to LLC's ongoing activities. Corp made the following representations with respect to this ruling request:

(a) The principal purpose of the Shareholder A contribution to LLC in exchange for a preferred membership interest was to allow Shareholder A to invest his excess cash directly in a diversified portfolio of investment assets managed by a team of experienced professionals, in a manner that allows Shareholder A to enjoy a high rate of preferred return and a priority on distributions. The principal purposes of the Proposed Transaction are to: (1) increase flexibility with respect to the allocation of profits, losses, and cash distributions associated with the LLC asset pool through issuance of various classes of interests in LLC, (2) provide increased liability protection to the LLC asset pool from the ongoing business operations of Corp, (3) facilitate estate planning and charitable objectives of Corp shareholders with respect to their investment in LLC, and (4) facilitate continued co-investment amongst family members outside of Corp.

b) Shareholder A cannot independently cause Corp to distribute its interest in LLC. Additionally, Shareholder A's contribution to LLC was not dependent upon the consummation of the Proposed Transaction and the Corp stockholders had not ratified the Proposed Transaction as of the date of the ruling request.

(c) Following the Proposed Transaction, it is intended that LLC will continue to carry on the operations that were carried on by LLC before the Proposed Transaction.

(d) At the time of the Proposed Transaction, there will be no amounts payable or receivable between LLC and Corp or LLC and Shareholder A.

[5129] For more information on preferred partnerships, see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

(e) For purposes of measuring the Code § 311(b) gain to Corp on the Proposed Transaction, if any, the Distributed LLC interests will be valued as a percentage of the value of the assets held by LLC.[5130]

(f) To the best of Corp's knowledge and belief, there is no plan or intention for any transferor to transfer assets to LLC other than cash and/or a diversified portfolio of stocks and securities.[5131]

(g) The assets of LLC immediately prior to the admission of Shareholder A consisted of a diversified portfolio of stocks and securities.[5132]

(h) There is no intention following the Proposed Transaction to dispose of any material assets of LLC (other than dispositions in the ordinary course of business).

(i) To the best of Corp's knowledge and belief, the Corp stockholders have no plan or intention to dispose of any portion of the distributed LLC interests except for the potential transfer to irrevocable trusts which will be taxed as grantor trusts to the respective grantor.

(j) LLC has not, and will not, elect to be classified as a corporation.

(k) No property, other than cash, has ever been contributed by Corp to LLC, and LLC has never made a distribution of property to Corp.

The IRS ruled:[5133]

- The admission of Shareholder A to LLC caused LLC to convert to a partnership for U.S. federal income tax purposes. Corp, as the sole owner of LLC prior to the admission of Shareholder A, is deemed to contribute the existing assets of LLC to the newly-formed LLC partnership in exchange for a membership interest in LLC.[5134] This deemed transaction is treated as a nontaxable contribution of property to LLC by Corp.[5135] Additionally, because the assets of LLC are represented to be a diversified portfolio of assets, Code § 721(b) does not cause taxation with respect to Shareholder A's contribution of cash and to Corp's deemed contribution of property to LLC.

- Corp's adjusted basis in the Distributed LLC Interests is equal to the product of (A) the amount of Corp's adjusted tax basis in its entire membership interest in LLC and (B) a fraction, the numerator of which is the fair market value of the Distributed LLC Interests on

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[5130] Citing *Pope & Talbot, Inc. v. Commissioner*, 104 T.C. 574 (1995), aff'd 162 F.3d 1236 (9th Cir. 1999). See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.
[5131] For this representation, a portfolio of stocks and securities is diversified under Reg. § 1.351-1(c)(6)(i) if it satisfies the 25% and 50% tests of Code § 368(a)(2)(F)(ii), applying the relevant provisions of Code § 368(a)(2)(F)(ii), except that in applying Code § 368(a)(2)(F)(iv), government securities are included in determining total assets unless government securities are acquired to satisfy the requirements of Code § 368(a)(2)(F)(ii).
[5132] As defined under Reg. § 1.351-1(c)(6)(i).
[5133] The IRS also ruled regarding Code § 2701 – that a preferred payment right, the rate at which changes over time, was not a qualified payment right except to the extent that a qualified payment right election is made. Reg. § 25.2701-2(b)(6).
[5134] Rev. Rul. 99-5.
[5135] Code § 721(a).

the date of the distribution, and the denominator of which is the fair market value of Corp's entire membership interest in LLC as of that date.

- Corp will recognize gain, if any, on the pro-rata distribution of the Distributed LLC Interests to its stockholders to the extent the fair market value of the Distributed LLC Interests exceeds their adjusted tax basis in the hands of Corp on the date of the distribution.[5136]

II.Q.7.h.vii. What We Learned

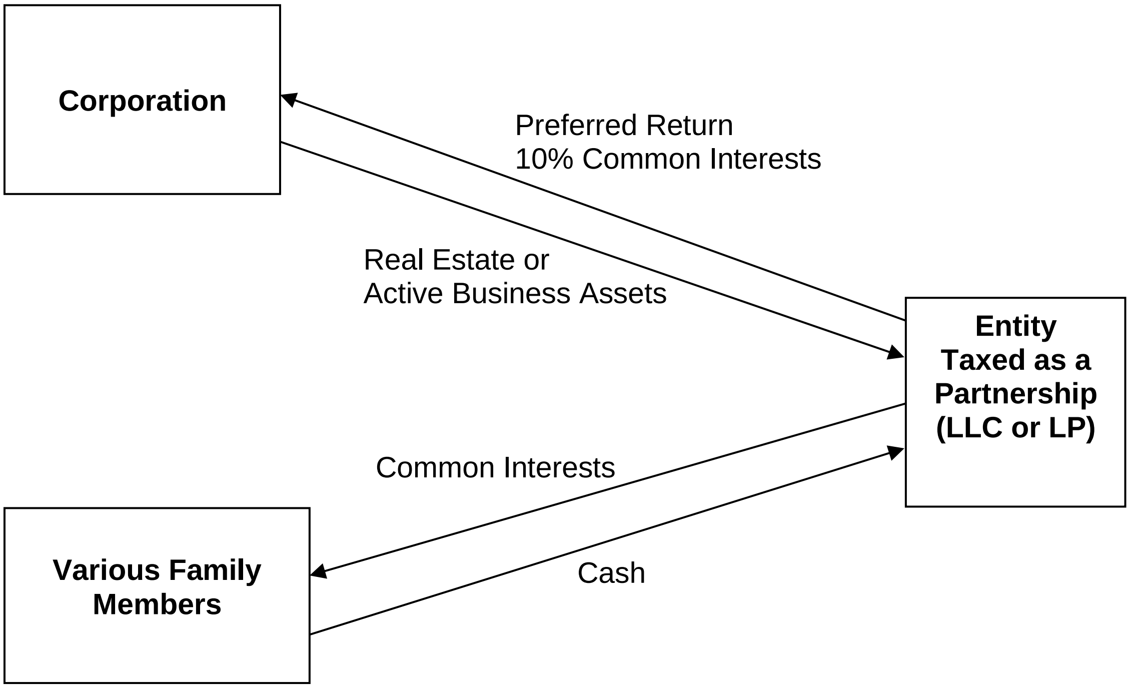
The *Cox* case represented a significant shift in value from the corporation to the shareholders' family members. The corporation's contribution was based on a full pro-rata share of its interest in the partnership, but the family members' contribution was based on the discounted value of its interest in the partnership. The IRS argued that the value shift was a disguised dividend to the shareholders, who wanted to benefit their family members, but the taxpayer convinced the court of the transaction's strong business purpose. The IRS would probably attack similar transactions, so tax advisors should go to extra lengths to document a strong business purpose and warn clients of the risks.

The Letter Ruling shows what the IRS is willing to approve. The IRS continues to want to treat a distribution of a recently formed partnership to its shareholders as if the corporation owned and was distributing the partnership's underlying property. Corporations might want to consider waiting for a while after forming the partnership, then they might consider selling the partnership interests to shareholders at various times in separate minority blocks of the partnership, but again they should be prepared for an IRS attack.

II.Q.7.h.viii. Value Freeze as Conservative Alternative

Consider the following structure:

[5136] Code § 311(b). See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.



The corporation contributes the real estate or other business assets to a partnership,[5137] taking in return a large preferred partnership interest and an interest in the residue of the profits (a "common interest") equal in value to at least 10% of the contributed equity, with the other partners receiving a common interest in the partnership for the balance. Thus, a large majority of the total return (appreciation plus cash flow) that exceeds the preferred interest will be outside of the corporation. Moving to this structure is discussed in part II.E.7.a Overview of How to Migrate into Desired Structure and diagrammed in part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure, culminating in the above structure, which is shown at part II.E.7.c.ii Moving New LLC into Preferred Structure.

The preferred return is to be satisfied out of the partnership's net cash flow and payable at the AFR or another appropriate fixed rate; we typically ask a qualified appraiser to tell us what the rate should be. The preferred return should be cumulative and payable on a periodic basis (at least annually) to constitute a qualified payment under Code § 2701.[5138] For more information on preferred partnerships, see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

If the corporation is receiving a return whose present value is equal to the value of the contributed goodwill (if any), it should not be treated as having distributed such goodwill to its shareholders. Using a preferred partnership adds safety, in that a corporation can easily escape the disguised sale rules. If the preferred profits distribution is payable at no more than

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[5137] If the owners perceive difficulty in transferring all of its assets, the owners can form an identical corporation, contribute all of the stock in the old corporation to the new corporation, then merge or convert the old corporation into an LLC owned solely by the new corporation. This first step should constitute a nontaxable F reorganization; see part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. The LLC can be the main organization in which the owners are separately admitted as members, but in most cases the corporation would just contribute its interest as the LLC's sole member to a limited partnership. See part II.E Recommended Structure for Entities.

[5138] Reg. § 25.2701-2(b)(6)(i)(B).

150% of the AFR or is limited to the extent of operating cash flow, each of two regulations[5139] separately creates a presumption that a sale has not occurred.[5140]

Investing at least 10% of equity in a common interest is our way of trying to provide the preferred partner with more economic risk than that undertaken by a lender, which is important under cases that held that complying with the disguised sale rules was not enough because the regulations create only a presumption.[5141] This 10%-of-equity-in-common approach is not a hard and fast rule but rather an exercise of judgment; much less than 10% may very well work.

[5139] Reg. §§ 1.707-4(a)(2) and 1.707-4(b), discussed further in part II.M.3.e Exception: Disguised Sale.

[5140] As discussed in part II.M.3.e Exception: Disguised Sale, it is unlikely that the partnership anti-abuse rules would come into play. The transaction is consistent with the intent of the partnership income tax rules:

- <u>The partnership must be bona fide, and each transaction must have a substantial business purpose.</u> The proposed transaction splits income for generally around 5 years, and it provides the old owner with a way to take control over the business more quickly if the transaction does not work out than in a traditional sale. The new owner benefits by minimizing his risk, in that he is not personally liable. These are substantial, practical business issues.
- <u>The form of each transaction must be respected under substance over form principles.</u> No games are being played here: the parties have every incentive to ensure that the new entity's cash flow is distributed as promised in the transaction.
- <u>Clear reflection of income.</u> All distributions the old owner receives are being taxed. The new owner is not being taxed on income the new owner does not receive.

For more information on possible attacks, see fn. 3585.

[5141] *Chemtech Royalty Associates, L.P. v. U.S.*, 114 A.F.T.R.2d 2014-5940 (5th Cir 2014) (1% partnership interest by provider of capital was not sufficient to make provider a partner where partner's preferred return was virtually certain to be paid and 99% partner indemnified provider for any losses; partnership lacked economic substance). Dow provided the partnership with a stable revenue stream and indemnified the banks that provided the capital against any liabilities the partnership incurred:

> First, the transactions were structured to ensure that Dow paid the foreign banks a fixed annual return on their investment regardless of the success of the [Chemtech] venture, just as in the transaction in *Castle Harbour II*….
> Second, Dow agreed to bear all of the non-insignificant risks arising out of the Chemtech transactions, which further shows that the parties did not intend to share any possible losses….
> Third, just as in *Castle Harbour II*, the foreign banks did not meaningfully share in any potential upside.

The court pointed out:

> As a practical matter, payment of less than the full priority return was highly unlikely because (i) the minimum royalty payments from Dow sufficiently funded the priority return, and (ii) Chemtech could not incur more than $1 million in annual expenses without the banks' approval.

Also, regarding penalties, the court held that:

> the district court erred in foreclosing the applicability of both the substantial-valuation and gross-valuation misstatement penalties. We remand for the court to determine whether to impose either or both of those penalties. We express no opinion on whether the court erred in imposing the negligence and substantial-understatement penalties. On remand, the court should consider the extent to which imposing those penalties remains consistent with this opinion.

Although the court held that the partnership lacked economic substance, no consideration appears to have been given to the penalty described in part II.G.17 Economic Substance.

Also note that the *Castle Harbour* trial court refused to uphold negligence penalties on the taxpayer's actions, *TIFD III-E, Inc. v. U.S.*, 113 A.F.T.R.2d 2014-1557 (D.C. Conn.), which is analyzed by Lipton, *Castle Harbour* V—The Government Loses (Again) in the District Court, *Journal of Taxation* (Oct. 2014).

Although one might be inclined to use an LLC, a limited partnership is better if the partnership engages in a trade or business, to help avoid self-employment tax.[5142] When using a limited partnership, consider using an entity taxed as an S corporation for the general partner and conducting business through various single-member LLCs that the limited partnership owns.[5143] For more description showing how to move in such a structure, see part II.E.7 Migrating into Partnership Structure, especially part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure.

Be careful about possible changes in accounting method. For example, if a cash method C corporation contributes its business to a partnership, the partnership might not be able to continue using the cash method;[5144] for example, if the corporation were a personal service corporation[5145] before the transaction and all of its personal service activities were moved to the partnership, the corporation might no longer qualify and therefore the partnership might not qualify as well. The corporation can avoid this limitation by making an S election[5146] but needs to plan around the built-in gain tax.[5147]

If the corporation has subsidiaries, the subsidiaries could convert to single-member disregarded LLCs, then do a tax-free liquidation;[5148] if the parent and subsidiaries file a consolidated return, be sure that the subsidiaries do not have any excess loss accounts[5149] or deferred intercompany transactions.[5150] Before the liquidation, the parent might consider contributing to the subsidiary any obligations of the subsidiary that the parent holds or cancelling them outright,[5151] particularly as needed to cause them to have a positive net worth on liquidation.[5152] If the corporation has affiliated corporations, they might combine in a tax-free reorganization[5153] before forming the new entity, so that only one corporation remains as the general partner; each corporation that does not survive the merger as a corporation could survive as an LLC (disregarded for tax purposes) wholly owned by the surviving corporation and then contributed to the limited partnership intact as an LLC that is then wholly owned by the partnership. Generally, among

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5142 See part II.L Self-Employment Tax (FICA).
5143 See part II.E Recommended Structure for Entities.
5144 Code § 448(a)(2).
5145 See part II.G.11 Personal Service Corporations.
5146 See generally part II.P.3.b Conversion from C Corporation to S Corporation.
5147 See part II.P.3.b.ii Built-in Gain Tax.
5148 Code §§ 332, 337. See 784 T.M. *Corporation Liquidations*; Bittker & Eustice, *Federal Income Taxation of Corporations & Shareholders* (WG&L), Chapter 10: Complete Liquidations and Other Taxable Dispositions of Corporate Stock and Assets in Bulk, part B. Subsidiary Liquidations.
5149 Reg. § 1.1502-19. See Hennessey, Yates, Banks & Pellervo, The Consolidated Tax Return (WG&L), ¶13.04. Excess-Loss Accounts.
5150 Reg. § 1.1502-13 (intercompany transactions). I am not an expert in Code § 332 and consolidated returns; one of my partners told me to watch for excess loss accounts or deferred intercompany transactions. The concept is that certain transactions not recognized in a consolidated environment are recognized when a corporation leaves the consolidated group – in this case, by liquidating a subsidiary.
5151 See Reg. § 1.332-7 if the parent does not do this. In a consolidated return environment, the parent can take a bad debt deduction based on the partial or complete worthlessness of the debt. Reg. § 1.1502-13(g)(7), Example 3(iii). For more details, see 784 T.M. *Corporate Liquidations*, part IV Tax Treatment of Intercorporate Debt in a Liquidation of a Subsidiary.
5152 See 784 T.M. Corporate Liquidations, III. Subsidiary Liquidations Not Qualifying Under §332, C. Insolvent Subsidiary. Reg. § 1.332-2(b) provides:

> Section 332 applies only to those cases in which the recipient corporation receives at least partial payment for the stock which it owns in the liquidating corporation. If section 332 is not applicable, see section 165(g) relative to allowance of losses on worthless securities.

5153 Code § 368.

other requirements, reorganizations require a continuity of business to be tax-free; this continuity can be satisfied when the acquired business is continued through the new partnership.[5154] Consider the effect of mergers on accounting methods, in that affiliated corporations using different accounting methods might need to change in some manner when combined into a single taxpayer.

If any owners are members of the same family or if any owner might split up his ownership in the corporate general partner from his interest as a limited partner when making transfers to family members, see parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.

Transferring the common interest in a preferred partnership is less tax-efficient than selling (to an irrevocable grantor trust)[5155] an interest in a partnership that just has one class of owners, because (appraisers tell us that) the return required on an equity interest in a partnership generally is significantly higher than the AFR. However, a traditional sale to an irrevocable grantor trust is not practical here, as the corporation would have to form the irrevocable grantor trust for its benefit,[5156] which would undermine the whole concept of getting the property out of corporate solution.

II.Q.7.h.ix. Value Freeze as Alternative to Code § 355 Division

Consider separately applying part II.Q.7.h.viii Value Freeze as Conservative Alternative to different lines of business or groups of assets to split up future growth in each line or group.

The common (non-preferred) interests might be owned by those who have the most interest in particular lines or groups.

Alternatively, each subsidiary depicted at the bottom of part II.E.6 Recommended Partnership Structure – Flowchart can remain wholly owned but might have a separate incentive plan, such as the partnership equivalent of a stock appreciation right.[5157]

None of these alternatives provides the clean break, disentangling shareholders from each other, provided by part II.Q.7.f Corporate Division into More Than One Corporation.

II.Q.7.i. Distribution or Sale to Shareholder to Defer Gain on the Sale of Corporate Assets and Perhaps Avoid Double Taxation on Part

Consider forming a partnership, using one of the techniques described in part II.Q.7.h Distributing Assets; Drop-Down into Partnership, more than two years before selling property.

[5154] Reg. § 1.368-1(d)(4)(iii)(A).
[5155] As described in part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.
[5156] If a corporation makes a gratuitous transfer to a trust that is not for a business purpose of the corporation but is for the personal purposes of one or more of the shareholders, the gratuitous transfer will be treated as a constructive distribution to such shareholders under federal tax principles and the shareholders will be treated as the grantors of the trust. Reg. § 1.671-2(e)(4). See part II.D.2 Business Entity as Grantor of Tru.
[5157] See part II.M.4.g Options to Acquire Equity, especially the text accompanying fn. 3768. See also part III.B.7.c Code § 2701 Interaction with Income Tax Planning.

The corporation then might sell the partnership interest using an installment note to defer tax.[5158] If the corporation is an S corporation, be sure not to convert capital gain into ordinary income by using depreciable or amortizable assets.[5159]

The partnership's tax return for the year of the sale of the partnership interest (or before) would elect to step-up the basis of its underlying assets.[5160]

If and to the extent that the corporation is a C corporation that can sell the partnership interest at a discount relative to the partnership's underlying assets, that discount reduces income subject to C corporation income tax.

Be careful if the corporation is an S corporation that was a C corporation within the past 5 years.[5161]

II.Q.7.j. Prohibition Against Using Partnership to Circumvent Tax on Gain in Property Used to Redeem Stock

Promulgated under Code § 732(f), Reg. § 1.337(d)-3(b) provides that a corporate partner is required to recognize gain when a transaction has the effect of the corporate partner acquiring or increasing an interest in its own stock in exchange for appreciated property when a partnership, either directly or indirectly, owns, acquires, or distributes stock of the corporate partner. Furthermore, Code § 732(f) provides that, if (1) a corporate partner receives a distribution from a partnership of stock in another corporation (distributed corporation); (2) the corporate partner has control of the distributed corporation immediately after the distribution or at any time thereafter; and (3) the partnership's basis in the stock immediately before the distribution exceeded the corporate partner's basis in the stock immediately after the distribution, then the basis of the distributed corporation's property must be reduced by this excess.[5162]

II.Q.7.k. Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation

Code § 1202 excludes part or all of the gain[5163] on the sale of stock in a qualified small business corporation originally issued to the seller (with some exceptions)[5164] and held for at least

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[5158] See parts II.Q.3 Installment Sales - Deferring Tax on Lump Sum Payout Expected More than Two Years in the Future and II.Q.8.e.ii Transfer of Partnership Interests: Effect on Transferring Partner.
[5159] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).
[5160] See part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).
[5161] See part II.P.3.b.ii Built-in Gain Tax.
[5162] T.D. 9833 (6/8/2018), promulgating Reg. § 1.732-3. T.D. 9833 further provides:

> The amount of this reduction is limited to the amount by which the sum of the aggregate adjusted basis of property and the amount of money of the distributed corporation exceeds the corporate partner's adjusted basis in the stock of the distributed corporation.

[5163] See text accompanying fns 5188-5193 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation. CCA 200609024 took the position that, in determining whether the statute of limitations was extended by omitting more than 25% of gross income, any capital gain excluded by Code § 1202 is not included in the gross income calculation.
[5164] See text accompanying fns 5208-5232 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

five years;[5165] be sure also to check for state income tax recognition of the exclusion.[5166] Many types of businesses are ineligible.[5167] Also, the corporation needs to have no more than $50 million at all times before and immediately after stock issuance[5168] and needs to have conducted sufficient business activities at all times.[5169] These business activities need to be either directly or through C corporation subsidiaries and require at least 80% of the assets being used for those activities (with additional restrictions on real estate ownership); they do not appear to be able to be done be through partnership subsidiaries.[5170] The corporation must have been a C corporation during substantially all of the taxpayer's holding period for such stock.[5171] Thus, stock in a former S corporation would not qualify, but an S corporation may form a C corporation subsidiary that would qualify;[5172] but beware of the mechanics.[5173]

The exclusion for most taxpayers is the greater of $10 million or 10 times the qualified small business stock's adjusted basis of the issued by the corporation and disposed of by the taxpayer during the taxable year.[5174] Adjusted basis used in the 10-times calculation includes the fair market value of property contributed to the corporation, but any built-in gain in contributed assets is not eligible for the exclusion, so running a business as a partnership and then converting to a C corporation has advantages and disadvantages for Code § 1202 purposes,[5175] as well as other tax considerations (beware of contributing too much debt; also consider forming a separate corporation for each business).[5176]

In contrast to the Code § 1202 exclusion, which requires a five-year holding period, under Code § 1045 a taxpayer may roll over the gain on the sale of qualified small business stock (QSBS) held for only six months by investing in other QSBS. See part II.Q.7.k.iv Code § 1045 Rollover of Gain from Qualified Small Business Stock (QSBS) to Another QSBS.

5165 See text accompanying fn 5196 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

5166 See Exhibit 3 of Jenson & Kohn, "Maximize Qualified Small Business Stock Exclusion," *Estate Planning Journal* (WG&L), October 2018.

5167 See text accompanying fns 5243-5248 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

5168 See text accompanying fns 5238-5242 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

5169 See part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.

5170 See fns 5255-5258 and 5268-5270 in part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.

5171 See fn 5233 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

5172 See text accompanying fns 5212-5218 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

5173 See text accompanying fns 5235-5237 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

5174 See text accompanying fns 5188-5193 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

5175 See text accompanying fns 5313-5314 in part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership?

5176 See text accompanying fns 5314-5315 in part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership?

Here are some ideas when comparing the Code § 1202 exclusion to other tools:

- Purchasers of businesses want to get a new basis in the business' assets rather than just buying stock.

  - If they buy stock instead of assets, they tend to require the sellers to make a special election to treat the stock sale as an asset sale followed by a liquidation; for example, see part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold in part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

  - When an S corporation's assets are deemed sold, the gain or other income on the shareholders' K-1s increases the basis in their stock.[5177] This benefit is much better than suffering through the limitations of Code § 1202 described in this part II.Q.7.k, because it applies regardless of the type of business, wipes out all of the gain (not just gain protected by Code § 1202), applies for state income tax purposes (not all states recognize Code § 1202), and protects more than just the original owner; further, an S corporation provides for tax-free distributions of earnings, which is not available for a C corporation.[5178] See part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.

- A seller-financed sale of a partnership may be able to avoid capital gain tax on the sale of goodwill, making it more tax-efficient than a tax-free sale of stock. For how the Code § 1202 exclusion compares to other sales of business, see part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis. You will notice that a redemption (purchase by the C corporation) is less taxing than a cross-purchase (purchase by other shareholders). In a cross-purchase, the purchased stock will not be eligible for the Code § 1202 exclusion when the buyer later sells it, because it was not originally issued to the buyer.[5179] Similarly, if stock is issued too close to a redemption (within two years), the transactions may be stepped together and the new stock treated as if it had been sold to the buyer instead of issued to the buyer.[5180]

Here is an example of Code § 1202, taken from an ABA Section of Taxation meeting:[5181]

- Tom Investor and Tammy Techy organize We Are Tech, LLC on 1/1/2016.

5177 Code § 1367, which is reproduced in part II.G.4.d.i Basis Limitation Generally.
5178 See part II.Q.7.h.ii Taxation of Shareholders When Corporation Distributes Cash or Other Property
5179 See text accompanying fns 5208-5211 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
5180 See text accompanying fns 5220-5232 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
5181 May 2018 meeting of the Sales, Exchanges and Basis Committee II.Q.7.k.ie of the American Bar Association's Section of Taxation, program name "The Tax Exemption for Small Business Stock is Big Business," slides named "Section 1202 Qualified Small Business Stock," presented by Kohn, Friedman, Rappaport, and Kristall (the latter probably did not author, because the IRS does not author presentation materials at such meetings).

- Each provides capital contributions of $2 million in exchange for 50% interest in the LLC, which is taxed as a partnership.

- During 2016, the LLC purchases a building for $2 million cash and no debt, creates IP assets worth $2 million, and sustains a $1 million loss.

- Thus, each member's capital account and outside basis is $1.5 million at the end of 2016.

- On January 1, 2017, the LLC incorporates as We Are Tech, Inc., a C corporation that would qualify as a qualified small business stock, in an assets-over transaction:

  - The LLC contributes all assets to the C corporation in exchange for stock, then distributes stock to each member in liquidation.

  - The transaction qualifies under Code § 351.[5182] See also Rev. Rul. 84-111.[5183]

  - The fair market value of the LLC's assets was $5 million at the time of transaction.

- Each shareholder receives a $1.5 million carry-over basis for general tax purposes[5184] and a $2.5 million basis (50% of fair market value) in applying Code § 1202.[5185]

- On January 1, 2018, Tom sells his stock in We Are Tech, Inc. for $10 million. Tom has realized an $8.5 million long-term capital gain ($10 million proceeds minus $1.5 million adjusted basis).

- Within 60 days, Tom reinvests in Tech Savvy, Inc., a qualified small business, for $8 million and elects rollover treatment under Code § 1045.[5186] Consequences:

  - Total recognition of $3 million long-term capital gain (LTCG), consisting of:

    - Immediate recognition of $1 million LTCG, which is the built-in gain deferred upon incorporation.[5187]

    - Immediate recognition of $2 million LTCG, which under Code § 1045(a) is the $10 million gross sales price minus the $8 million gross purchase price of replacement qualified small business stock

  - Adjusted basis under Code § 1045(b)(3) is $2.5 million.

[5182] See part II.M.2 Buying into or Forming a Corporation.
[5183] See part II.P.3.c.ii Transfer of Partnership Assets and Liabilities to a Newly Formed Corporation in Exchange for All of its Stock.
[5184] Code § 358(a).
[5185] See fns 5191-5198 (overall limitation on amount of gain excluded and determination of gain subject to exclusion) of part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[5186] See part II.Q.7.k.iv Code § 1045 Rollover of Gain from Qualified Small Business Stock (QSBS) to Another QSBS.
[5187] See fns 5191-5198 (overall limitation on amount of gain excluded and determination of gain subject to exclusion) of part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

- On January 2, 2022, Tom sells all of his stock in Tech Savvy, Inc. for $25 million without rolling over to another qualified small business:

  - Tom has realized an $22.5 million long-term capital gain ($25 million proceeds minus $2.5 million adjusted basis).

  - The Code § 1202 exclusion limit is $25 million, which is ten times the $2.5 million basis under Code § 1202.

  - The $22.5 million long-term capital gain is less than the Code § 1202 exclusion limit of $25 million, so all of the gain is excluded.

- Contrast with Tom selling all We Are Tech, Inc. stock to purchase Tech Savvy, Inc. in a non-Code § 1045 rollover:

  - $1 million total long-term capital gain recognition.

  - No need to recognize the other $2 million under Code § 1045(a).

  - However, Tom would need to wait until January 2, 2023 to sell in order to meet his holding period requirement.

Other ideas when selling C corporation stock are covered in parts:

- II.G.7 Deferral or Partial Exclusion of Capital Gains (Even from Investment Assets) Invested in Opportunity Zones

- II.G.8 Code § 165(a) Loss for Worthlessness; Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy

- II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244

- II.Q.7.m Deferring Gain on Sale of Marketable Securities by Investing in a Specialized Small Business Investment Company.

II.Q.7.k.i. Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation

This part II.Q.7.k applies to stock issued on or after August 11, 1993. The amount of gain that is subject to partial or complete exclusion from income cannot exceed the greater of:[5188]

(A) $10 million ($5 million for married filing separately)[5189] reduced by the aggregate amount of eligible gain taken into account under this rule for prior taxable years and attributable to dispositions of stock issued by such corporation, or

(B) 10 times the aggregate adjusted bases[5190] of qualified small business stock issued by the corporation and disposed of by the taxpayer during the taxable year. The greater of basis or

[5188] Code § 1202(b)(1).
[5189] Code § 1202(b)(3).
[5190] Only the basis on the date of issuance counts for purposes of this test. See the flush language at the end of Code § 1202(b)(1).

the fair market value of property contributed for Code § 1202 stock counts towards this basis limitation.[5191] The adjusted basis of any stock is determined without regard to any addition to basis after the date on which such stock was originally issued;[5192] therefore, to maximize the benefit of capital contributions, they should be made only in exchange for new stock when the company has assets with a basis (subject to unusual rules defining basis) of no more than $50 million.[5193]

The taxpayer must not be a corporation.[5194] However, an S corporation that holds qualified small business stock may be looked through to its owners who are taxed on the gain.[5195]

Gain is eligible only if from the sale or exchange of qualified small business stock held for more than 5 years.[5196] Also:[5197]

> If property (other than money or stock) is transferred to a corporation in exchange for its stock, the basis of the stock received is treated as not less than the fair market value of the property exchanged. Thus, only gains that accrue after the transfer are eligible for the exclusion.

Thus, contributing appreciated property in exchange for stock is a double-edged sword. On one hand, it provides an even greater amount of future gain that can be excluded. On the other hand, the built-in gain at the time of contribution is not eligible for the exclusion, whereas it would have been eligible if the property had been contributed earlier so that the appreciation occurred after contribution. Thus, if a partnership is considering converting to a C corporation, its owners should consider how long before they intend to sell (so that the 5-year holding period

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[5191] Code § 1202(i)(1) provides that, for purposes of Code § 1202:

Stock exchanged for property. In the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation -

(A) such stock shall be treated as having been acquired by the taxpayer on the date of such exchange, and

(B) the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged.

The legislative history quoted in the text accompanying fn 5197 makes me wonder whether this increase in the overall amount excluded was intended, but the statute's literal language appears to provide this result.

[5192] Code § 1202(b)(1) (flush language).

[5193] See fns 5238-5242.

[5194] Code § 1202(a)(1).

[5195] Code § 1202(g), discussed in the text accompanying fns 5212-5218 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[5196] Code § 1202(b)(2).

[5197] H. Rept. No. 103-111 (P.L. 103-66), p. 603. Code § 1202(i) provides that, for purposes of Code § 1202:

(1) *Stock exchanged for property*. In the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation-

  (A) such stock shall be treated as having been acquired by the taxpayer on the date of such exchange, and

  (B) the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged.

(2) *Treatment of contributions to capital.* If the adjusted basis of any qualified small business stock is adjusted by reason of any contribution to capital after the date on which such stock was originally issued, in determining the amount of the adjustment by reason of such contribution, the basis of the contributed property shall in no event be treated as less than its fair market value on the date of the contribution.

is satisfied) and whether appreciation while a partnership is good (to increase the 10-times-basis exclusion) or bad (pre-conversion appreciation ineligible for the exclusion).[5198]

A taxpayer who wishes to try to exceed these limitations might transfer stock to family members or others by gift before the stock appreciates, and presumably each donee would separately apply the limitation.[5199] If the taxpayer has insufficient lifetime gift tax exemption, consider transferring part of the stock to one or more incomplete gift nongrantor (ING) trusts;[5200] however, beware part II.J.9.c.i Multiple Trusts Created for Tax Avoidance. Another way to get more than $10 million limitation would be to have a separate C corporation for each qualified business.

For "qualified small business stock" issued after September 27, 2010 and held for more than five years, Code § 1202 excludes from income all of the gain from its sale or exchange, within the limits set forth above.[5201]

For "qualified small business stock" issued before September 28, 2010 and held for more than five years, Code § 1202 excludes from income a portion of the gain from its sale or exchange (within the limits set forth above)[5202]:

- If the above and other requirements are satisfied, then the portion excluded from income is 50% for stock (60% for gain attributable to an empowerment zone business) acquired before February 18, 2009 and 75% for stock acquired on or before September 27, 2010.[5203]

- Any gain that is not excluded is subject to 28% tax instead of the usual, lower capital gain rates.[5204]

- Note also that taxable gain from the sale of C corporation stock is subject to the 3.8% tax on net investment income,[5205] whereas gain on the sale of a partnership or S corporation stock engaged in a trade or business is largely excluded from that tax.[5206]

For stock acquired after September 27, 2010, alternative minimum taxable income no longer applies to the amount excluded from regular taxable income.[5207]

An example combining Code §§ 1202 and 1045 is in the text following fn 5181 in part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation.

"Qualified small business stock" means any stock in a C corporation which the taxpayer acquires on original issue by a qualified small business either in exchange for money or other

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[5198] See fn 5314 in part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership?
[5199] See Code § 1202(h), discussed at fns. 5274-5275.
[5200] See text accompanying fns 2514-2516 in part II.J.3.e.i Strategic State & Local Tax Issues re: Residence, briefly mentioning the idea of an incomplete gift nongrantor (ING) trust.
[5201] See text accompanying fn 5188.
[5202] See text accompanying fn 5188.
[5203] Code § 1202(a).
[5204] Compare Code § 1(h)(4) (tax on Code § 1202 gain) to Code § 1(h)(1) (tax on capital gains generally).
[5205] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[5206] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
[5207] Code § 1202(a)(4)(C), eliminating the application of Code § 57(a)(7).

property (not including stock)[5208] or as compensation for services provided to such corporation (other than services performed as an underwriter of such stock).[5209] An option to acquire stock does not count as stock until the stock is actually issued to the taxpayer.[5210] The House Report for the 1993 Revenue Reconciliation Act, P.L. 103-66, included:

> *Options, nonvested stock, and convertible instruments.*
>
> Stock acquired by the taxpayer through the exercise of options or warrants, or through the conversion of convertible debt, is treated as acquired at original issue. The determination whether the gross assets test is met is made at the time of exercise or conversion, and the holding period of such stock is treated as beginning at that time.

[5208] But, if a corporate reorganization is involved, see fn 5279 of part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.

[5209] Code § 1202(c)(1).

[5210] *Natkunanathan v. Commissioner*, T.C. Memo. 2010-15, *aff'd* 479 Fed. Appx. 775 (9th Cir. 2012), held that, where the taxpayer had been issued options to buy stock in his employer and did not exercise those options, except to acquire shares in a corporation (Intel) that acquired his employer, the taxpayer could not apply Code § 1202:

> Section 1202 itself does not define the term "stock" or otherwise specify what securities constitute stock for purposes of the qualified small business stock exclusion. By comparison, some provisions of the Code explicitly specify that the term "stock" includes options to acquire stock. See, *e.g.*, sec. 305(d)(1) ("For purposes of this section, the term `stock' includes rights to acquire such stock."); sec. 1091(a) (same). We are unaware of any authority that has interpreted the term "stock" for purposes of section 1202. However, we have previously declined to extend the term "stock" beyond its plain meaning in a statutory provision and construe it expansively to include options to acquire stock. See *Gantner v. Commissioner*, 91 T.C. 713 (1988) (options to purchase stock are not "shares" of "stock or securities" under the plain language of section 1091, which was subsequently amended to explicitly provide otherwise), *affd*. 905 F.2d 241 (8th Cir. 1990). Moreover, the legislative history of section 1202 suggests that Congress did not intend section 1202 to cover options to acquire stock.
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> Section 1202 was added to the Code by the Omnibus Budget Reconciliation Act of 1993, Pub.L. 103-66, sec. 13113(a), 107 Stat. 422. The accompanying conference report included the following statement: "Stock acquired by the taxpayer through the exercise of options * * * is treated as acquired at original issue. The determination whether the gross assets test is met is made *at the time of exercise* * * * and the holding period of such stock is treated as beginning at that time." H. Conf. Rept. 103-213, at 526 (1993), 1993-3 C.B. 393, 404 (emphasis added). The second sentence of the excerpt from the conference report quoted above, in the absence of any countervailing argument by petitioner, suggests to us that the original issuance contemplated by section 1202 in petitioner's case would be the issuance of Intel stock to petitioner upon exercise of his options. This conclusion seems appropriate since both the application of the gross assets test and the commencement of the holding period would occur at the time of such exercise.
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> Reading the term "stock" as used in section 1202 to exclude petitioner's options to acquire stock, we hold that petitioner could not possibly have satisfied the 5-year holding period requirement of section 1202(a)(1). Petitioner concedes that he sold the Intel stock received upon exercise of his options on the same day that he had exercised the options. Therefore, the period during which petitioner could have held qualified small business stock would, at most, have lasted 1 day. Moreover, for the stock underlying petitioner's options to constitute qualified small business stock under section 1202(d)(1), the aggregate gross assets of Intel on the date of exercise would have to have been less than or equal to $50 million. Petitioner makes no such claims with respect to Intel's aggregate gross assets.

In the case of convertible preferred stock, the gross assets determination is made at the time the convertible stock is issued, and the holding period of the convertible stock is added to that of the common stock acquired upon conversion.

Stock received in connection with the performance of services is treated as issued by the corporation and acquired by the taxpayer when included in the taxpayer's gross income in accordance with the rules of section 83.

Offsetting short positions.

A taxpayer cannot exclude gain from the sale of qualified small business stock if the taxpayer (or a related person) held an offsetting short position with respect to that stock any time before the 5-year holding period is satisfied. If the taxpayer (or a related person) acquires an offsetting short position with respect to qualified small business stock after the 5-year holding period is satisfied, the taxpayer must elect to treat the acquisition of the offsetting short position as a sale of the qualified small business stock in order to exclude any gain from that stock.

An offsetting short position is defined to be (1) a short sale of property substantially identical to the qualified small business stock (including writing a call option that the holder is more likely than not to exercise or selling the stock for future delivery) or (2) an option to sell substantially identical property at a fixed price.

If any stock in a corporation is acquired solely through the conversion of other stock in such corporation which is qualified small business stock in the hands of the taxpayer, the stock so acquired is treated as qualified small business stock in the hands of the taxpayer and is treated as having been held during the period during which the converted stock was held.[5211]

Special rules apply to C corporation stock owned by certain pass-through entities.[5212] A pass-through entity is any partnership, any S corporation,[5213] any regulated investment company (RIC),[5214] or any common trust fund.[5215] If any amount included in gross income by reason of holding an interest in a pass-through entity meets the requirements of the following sentence, the amount shall be treated as Code § 1202(a) gain and, for purposes of applying Code § 1202(b), that amount is treated as gain from a disposition of stock in the corporation issuing the stock disposed of by the pass-through entity and the taxpayer's proportionate share

[5211] Code § 1202(f).
[5212] Code § 1202(g).
[5213] Code § 1202(g)(4)(B).
[5214] Code § 1202(g)(4)(C). Notice 97-64, § 8, contemplates that temporary regulations will provide guidance on how RICs may designate dividends as "section 1202 gain distributions," which guidance is:

> expected to provide that: (1) section 1202 gain distributions will be designated separately for different issuers of qualified small business stock; (2) the exclusion from income permitted by section 1202 will be determined at the shareholder level not the RIC level; and (3) the maximum distributable section 1202 gain for each issuer will be calculated separately from limitations on all other classes of capital gain dividends but in the aggregate will not exceed the RIC's net capital gain.

Notice 2015-41, § 5, provides that Notice 97-64, § 8, continues to apply. Notice 2015-41, § 3, requires that RICs must account for "section 1202 gain" in distributions. Code § 1202(g) applies to such distributions.
[5215] Code § 1202(g)(4).

of the adjusted basis of the pass-through entity in such stock is taken into account.[5216] The amount must be attributable to gain on the sale or exchange by the pass-through entity of stock which is qualified small business stock in the hands of such entity (determined by treating such entity as an individual) and which was held by such entity for more than 5 years, and such amount must be includible in the gross income of the taxpayer by reason of the holding of an interest in such entity which was held by the taxpayer on the date on which such pass-through entity acquired such stock and at all times thereafter before the disposition of such stock by such pass-through entity.[5217] This gain exclusion does not apply to any amount to the extent such amount exceeds the amount to this rule would have applied if the amount were determined by reference to the interest the taxpayer held in the pass-through entity on the date the qualified small business stock was acquired.[5218]

The original issuance requirement means that stock bought from another shareholder would not qualify. May one avoid this prohibition by redeeming the seller and issuing stock to the buyer? Code § 1202(c)(3) imposes a waiting period related to redemption activity (including certain cross-purchases between related persons).[5219] Stock is disqualified if, at any time within 2 years before or after the issuance of such stock, the corporation issuing such stock purchased (directly or indirectly) any of its stock from the taxpayer or from a person related[5220] to the taxpayer.[5221] In applying the preceding sentence, one can ignore stock acquired from the taxpayer or a related person if the aggregate amount paid for the stock does not exceed $10,000 and no more than 2% of the stock held by the taxpayer and related persons is acquired.[5222] Also, stock is disqualified if, within the year before or after the issuance of such stock, the corporation made one or more purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5% of the aggregate value of all of its stock as

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[5216] Code § 1202(g)(1).
[5217] Code § 1202(g)(2).
[5218] Code § 1202(g)(3).
[5219] Code § 1202(c)(3)(C) refers to Code § 304(a), "Acquisition by related corporation (other than subsidiary)," which provides:

> For purposes of sections 302 and 303, if -
> (A) one or more persons are in control of each of two corporations, and
> (B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control,
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> then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. To the extent that such distribution is treated as a distribution to which section 301 applies, the transferor and the acquiring corporation shall be treated in the same manner as if the transferor had transferred the stock so acquired to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and then the acquiring corporation had redeemed the stock it was treated as issuing in such transaction.

[5220] Within the meaning of Code § 267(b) or 707(b). For a description of Code § 267(b), see part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses. For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.
[5221] Code § 1202(c)(3)(A).
[5222] Reg. § 1.1202-2(a)(2), which further provides:

> The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly) by the taxpayer and related persons immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

of the beginning of that 2-year period.[5223] The preceding sentence has a similar de minimis rule.[5224] These rules are strict and do not exclude redemptions that are not tied to issuances. For example, two founders don't get along, and the departing founder could sell his stock to either the corporation or to the remaining founder. If the departing founder were the buyer, the corporation may need to issue a dividend to that buyer, causing the buyer to pay a dividend tax.[5225] If the corporation were the buyer, this dividend tax could be avoided,[5226] but under the above anti-abuse rule the redemption may taint any issuance to a related party, whether the continuing founder or a new investor.

Although generally a shareholder who transfers stock to an employee or independent contractor (or to a beneficiary of an employee or independent contractor) is treated has transferring the stock to the corporation and the corporation then transferring the stock to the employee or independent contractor,[5227] any such deemed transfer to the corporation is not treated as such for purposes of the anti-redemption rules.[5228] The anti-redemption rules also are not triggered by any of the following:

- The stock was acquired by the seller in connection with the performance of services as an employee or director and the stock is purchased from the seller incident to the seller's retirement or other bona fide termination of such services.[5229]

- Before a decedent's death, the stock (or an option to acquire the stock) was held by the decedent or the decedent's spouse (or by both), by the decedent and joint tenant, or by a trust revocable by the decedent or the decedent's spouse (or by both), and the stock is purchased from the decedent's estate, beneficiary (whether by bequest or lifetime gift), heir, surviving joint tenant, or surviving spouse, or from a trust established by the decedent or decedent's spouse; and the stock is purchased within 3 years and 9 months from the date of the decedent's death.[5230]

- The stock is purchased incident to the disability or mental incompetency of the selling shareholder.[5231]

[5223] Code § 1202(c)(3)(B).

[5224] Reg. § 1.1202-2(b)(2) provides that, for purposes of this exception:

> … stock exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds $10,000 and more than 2 percent of all outstanding stock is purchased. The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of the stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock outstanding immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

[5225] See part II.Q.1.a.i.(c) C Corporation Double Taxation Under Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation, which is a variation of part II.Q.1.a.i.(a) C Corporation Triple Taxation.

[5226] Contrast part II.Q.1.a.i.(b) C Corporation Redemption with part II.Q.1.a.i.(a) C Corporation Triple Taxation.

[5227] Reg. § 1.83-6(d)(1).

[5228] Reg § 1.1202-2(c).

[5229] Reg. § 1.1202-2(d)(1)(i).

[5230] Reg. § 1.1202-2(d)(2).

[5231] Reg. § 1.1202-2(d)(3).

- The stock is purchased incident to the divorce (within the meaning of Code § 1041(c)) of the selling shareholder.[5232]

During substantially all of the taxpayer's holding period for such stock, the corporation must be a C corporation and use at least 80% (by value) of its assets in the active conduct of one or more qualified trades or businesses.[5233] See part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold. Therefore, the C corporation cannot have been an S corporation. However, an S corporation can contribute its assets to a C corporation, and the C corporation could then qualify for the exclusion.[5234] To simplify this process, the owners of the S corporation form a parent S corporation, which new parent assumes all of the original S corporation's tax attributes;[5235] this makes the original corporation a disregarded entity;[5236] then the original corporation elects C corporation treatment. Although technically this reorganization works, it appears that the subsidiary would have the same tax ID as the parent S corporation,[5237] making the C corporation appear on the IRS' records as a former S corporation, even though technically it is considered a new C corporation.

The corporation's aggregate gross assets cannot have a basis exceeding $50 million:[5238]

(A) the aggregate gross assets of such corporation (or any predecessor thereof) at all times on or after the date of the enactment of the Revenue Reconciliation Act of 1993, and before the issuance did not exceed $50,000,000,

(B) the aggregate gross assets of such corporation immediately after the issuance (determined by taking into account amounts received in the issuance) does not exceed $50,000,000, and

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5232 Reg. § 1.1202-2(d)(4).

5233 Code § 1202(c)(2)(A), (e). The taxpayer must affirmatively prove what the business assets are and that they met this 80% test. *Holmes v. Commissioner*, T.C. Memo. 2012-251, held:

> The record is again devoid of documentary evidence showing the amount of corporate assets owned during the years in which he held the stock and the amount of those assets used in its business of providing on demand physician practice management software. In fact, the only evidence in the record concerning LeonardoMD's business is a stipulated paragraph describing its business as providing on demand physician practice management software delivered over the Web, and petitioner's above-cited testimony. We cannot, on the basis of uncorroborated testimony and a stipulation that does not rule out inactive business assets and income, reasonably conclude that petitioner met his burden of proving that, during substantially all of his holding period for LeonardoMD stock, the corporation used at least 80% of its assets in the active conduct of one or more qualified trades or businesses.

5234 See fn 5213.

5235 See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization, especially fn 4078.

5236 See part II.A.2.g Qualified Subchapter S Subsidiary (QSub).

5237 See Reg. § 301.6109-1(i)(3) in the text accompanying fn 188 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).

5238 Code § 1202(d). This applies to gross assets at all times on or after the date of the enactment of the Revenue Reconciliation Act of 1993 and before the issuance, as well as immediately after the issuance (determined by taking into account amounts received in the issuance).

(C) such corporation agrees to submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes of this section.[5239]

Although regulations have not been issued regarding reporting requirements, taxpayers will lose the deduction if they do not have records to substantiate that the stock met this requirement.[5240]

As used above, "aggregate gross assets" means the amount of cash and the aggregate adjusted bases of other property held by the corporation.[5241] As used in (A) above:[5242]

> The adjusted basis of any property contributed to the corporation (or other property with a basis determined in whole or in part by reference to the adjusted basis of property so contributed) shall be determined as if the basis of the property contributed to the corporation (immediately after such contribution) were equal to its fair market value as of the time of such contribution.

[5239] [Footnote is mine and not in the statute:] Federal Tax Coordinator Analysis (RIA) ¶ S-4455 Reports With Respect to Exclusion of Gain From Qualified Small Business Stock (QSBS) reports:

> IRS has yet to issue either any reporting requirements described in Code Sec. 1202(d)(1)(C) … or any guidance as to the manner in which, as mandated by Code Sec. 1202(d)(1)(C), a corporation is to agree to meet these requirements. RIA understands that, until IRS provides guidance as to the manner in which a corporation is to agree, a corporation can issue QSBS without the necessity for the corporation to file any sort of agreement that it will comply with any reporting requirements, if and when issued. Presumably, if IRS ever does require reporting, it will prescribe procedures at that time for making the agreement called for in the Code.

[5240] *Natkunanathan v. Commissioner*, T.C. Memo. 2010-15, *aff'd* 479 Fed. Appx. 775 (9th Cir. 2012), held:

> There are no balance sheets or other financial statements of Cognet in the record that establish the amounts of total assets, total liabilities, or owner's equity of Cognet at any time, and petitioner made no attempt to introduce any such evidence at trial.[5] In the absence of any such evidence, we cannot determine the value of Cognet's gross assets at the time that it issued options to petitioner and, therefore, cannot conclude that Cognet constituted a qualified small business within the meaning of section 1202(d)(1) at that time.
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> [5] After the trial petitioner attached to his reply brief a document purporting to be a statement by the chief executive officer of Cognet at the time of its acquisition by and merger with Intel declaring that "*To the best of my recollection*, the company's assets, including physical assets and total value of outstanding shares did not exceed $50,000,000 before the acquisition." [Emphasis added.] Subsequently, after the record had closed upon the filing of reply briefs, petitioner filed a motion for leave to reopen the record in order to introduce a notarized version of this and other documents. A notarized written statement from Cognet's chief executive officer, even if it were introduced at trial, could have been subject to a hearsay objection and, absent concessions or stipulation by respondent, would probably not have been admitted into evidence. But here, where the purported statement constitutes an affidavit attached to a brief, Rule 143(b) explicitly bars us from considering it as evidence. We have previously issued an order denying petitioner's motion to reopen the record as inappropriate because petitioner has not shown good cause for his failure to introduce such evidence at trial.

Issuing stock options does not necessarily qualify as issuing stock; however, the taxpayer did not hold actual stock for the five-year holding period, so that's why the court looked at when the stock options were issued. See fn 5210 for more about these issues.

[5241] Code § 1202(d)(2)(A).

[5242] Code § 1202(d)(2)(B).

The following businesses are not eligible for this treatment:[5243]

- any trade or business involving the performance of services in the fields of health,[5244] law, engineering, architecture, accounting, actuarial science, performing arts,[5245] consulting,[5246] athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees,[5247]

- any banking, insurance, financing, leasing, investing, or similar business,

- any farming business (including the business of raising or harvesting trees),

- any business involving the production or extraction of products, such as oil, gas and mines, eligible for certain depletion deductions, or

- any business of operating a hotel, motel, restaurant, or similar business.

However, engaging in the above activities is not fatal, if it comprises a sufficiently small part of the business.[5248]

The corporation must be a domestic corporation other than a DISC or former DISC, corporation with respect to which an election under Code § 936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect, regulated investment company, real estate investment trust, REMIC, or cooperative.[5249]

Below are some rulings elaborating on the bullet point disqualified businesses:

CCA 202204007 asserted:

> We conclude that Corporation should be classified as a broker under the common meaning of the term and as it is defined under § 6045, rather than the more narrow definition that applies for purposes of § 199A.[9] While Corporation states that it does not

[5243] Code § 1202(e)(3). Code § 1202(e)(3)(A) is discussed in part II.E.1.c.iv Specified Service Trade or Business (SSTB) If Taxable Income Exceeds Certain Thresholds. However, that discussion is expressly limited to Code § 199A and cannot be relied upon in applying Code § 1202. CCA 202204007 is discussed after these bullet points.

[5244] Letter Ruling s201436001 and 201717010 are discussed after these bullet points. For additional context, when Congress enacted Code § 199A and referred to Code § 1202(e)(3), it also looked to Code § 448. See part II.E.1.c.iv.(b) Health. However, that discussion is expressly limited to Code § 199A and cannot be relied upon in applying Code § 1202.

[5245] For additional context regarding performing arts, when Congress enacted Code § 199A and referred to Code § 1202(e)(3), it also looked to Code § 448. See part II.E.1.c.iv.(f) Performing Arts. However, that discussion is expressly limited to Code § 199A and cannot be relied upon in applying Code § 1202.

[5246] For additional context regarding consulting, might when Congress enacted Code § 199A and referred to Code § 1202(e)(3), it also looked to Code § 448. See part II.E.1.c.iv.(g) Consulting. However, that discussion is expressly limited to Code § 199A and cannot be relied upon in applying Code § 1202. Letter Ruling 202342015 is discussed after these bullet points.

[5247] Letter Ruling 202319013 and *Owen v. Commissioner*, T.C. Memo. 2012-21, are discussed after these bullet points.

[5248] See part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold, especially fns 5251-5253.

[5249] Code § 1202(e)(4).

provide brokerage services but instead provides advertising services, it is our view that the actions and services provided by Corporation support our position that Corporation is a broker for purposes of § 1202(e)(3)(A).

> [9] It is important to emphasize that the §199A regulations' narrow interpretation of what constitutes brokerage services by its terms only applies for purposes of § 199A and no other Code section. Further, the examples in the section 448 regulations confirm the common meaning of the term brokerage services.

> A broker serves as an intermediary between a buyer and a seller, and Corporation does this. Corporation does not just passively publish advertisements on its website that are provided to it from potential lessors desiring to lease property. Unlike a search engine that provides content to users and also sends targeted advertisements to those users based on their search history, Corporation's website is solely devoted to effectuating agreements between potential lessors and potential lessees of certain property.

> Corporation charges a minimum flat fee to lessors irrespective of whether a potential lessor succeeds in entering into lease agreements as a result of the use of Corporation's website. However, Corporation is also compensated on a commission basis based on leasing transactions that are entered into as the result of the use of Corporation's website.

> Corporation does not have the authority to enter into leasing agreements on behalf of lessors that use its services. Corporation only provides a vehicle for potential lessees to transmit non-binding reservation requests to potential lessors. Only the potential lessor and lessee have the authority to enter into a binding lease agreement. However, brokerage activity can include simply bringing a potential buyer and seller together to work out the transaction. See *American West Hotel Brokers v. Wu*, 697 P.2d 34, 36 (Colo. 1985).

> The fact that Corporation's services are provided by software created by people rather than directly by people does not change the functional nature of the services. Because Corporation provides brokerage services within the meaning of § 1202(e)(3)(A), taxpayer is not entitled to exclude any of the gain from the sale of stock in Corporation under § 1202.

Letter Ruling 201436001 held that the health service and related exclusion did not apply to the taxpayer:

> Section 1202(e)(3) excludes various service industries and specified non-service industries from the term qualified trade or business. Thus, a qualified trade or business cannot be primarily within service industries, such as restaurants or hotels or the providing of legal or medical services. In addition, § 1202(e)(3) excludes businesses where the principal asset of the business is the reputation or skill of one or more of its employees. This works to exclude, for example, consulting firms, law firms, and financial asset management firms. Thus, the thrust of § 1202(e)(3) is that businesses are not qualified trades or businesses if they offer value to customers primarily in the form of services, whether those services are the providing of hotel rooms, for example, or in the form of individual expertise (law firm partners).

> Company is not in the business of offering service in the form of individual expertise. Instead, Company's activities involve the deployment of specific manufacturing assets and intellectual property assets to create value for customers. Essentially, Company is a pharmaceutical industry analogue of a parts manufacturer in the automobile industry. Thus, although Company works primarily in the pharmaceutical industry, which is certainly a component of the health industry, Company does not perform services in the health industry within the meaning of § 1202(e)(3). Neither are Company's business activities within any of the prohibited categories set forth in § 1202(e)(3).

Letter Ruling 201717010 held that the health service and related exclusion did not apply to a lab:

> Company provides laboratory reports to health care professionals. However, Company's laboratory reports do not discuss diagnosis or treatment. Company neither discusses with, nor is informed by, healthcare providers about the diagnosis or treatment of a healthcare provider's patients. Company's sole function is to provide healthcare providers with a copy of its laboratory report.
>
> Company neither takes orders from nor explains laboratory tests to patients. Company's direct contact with patients is billing patients whose insurer does not pay all of the costs of a laboratory test.
>
> In addition, you represent that the skills employees bring to Company are not useful in performing X tests and that skills they develop at Company are not useful to other employers.
>
> Further, none of Company's revenue is earned in connection with patients' medical care. Other than the laboratory director [who federal law required to have certain qualifications], Company's laboratory technicians are not subject to state licensing requirements or classified as healthcare professionals by any applicable state or federal law or regulatory authority.
>
> Although Company's laboratory reports provide valuable information to healthcare providers, Company does not provide health care professionals with diagnosis or treatment recommendations for treating a healthcare professional's patients nor is Company aware of the health care provider's diagnosis or treatment of the healthcare provider's patients. In addition, the skills that Company's employees have are unique to the work they perform for Company and are not useful to other employers.
>
> Thus, based on the facts and representations submitted, we conclude that for purposes of § 1202(e)(3), Company is not in a trade or business (i) involving the performance of services in the field of health or (ii) where the principal asset of the trade or business is the reputation or skill of one or more of its employees.

Letter Ruling 202342015 involved a C corporation that provided the following services:

> Company offers data migration and management services to businesses. It does not sell software or technical equipment as part of the services it provides. To understand its customers' needs, Company creates a transformation assessment plan. Its service delivery teams determine an optimized cloud and data transformation roadmap based on assessment outcomes. Company team members will integrate into the customer's team

> often on a full-time basis to orchestrate and troubleshoot the data migration and work to implement the data migration, as well as provide limited advice and counsel when working with a customer's team. Company also provides post-migration managed technical services, which include monitoring and resolving incidents.
>
> The invoices provided to Company's clients for the services it performs represent billing for implementation services and embedded advice. Company does not separately bill for advice and counsel. Taxpayer represents that more than 80% of Company's assets are used in its data migration and management business.

Letter Ruling 202342015 reasoned and ruled:

> Company's employees provide advice and counsel as part of the process of determining a client's data management needs but the advice and counsel is ancillary to and supports the sale of the implementation work Company's employees perform. Company does not separately bill for advice and counsel, but only for its final product of implementing data management solutions. Therefore, Company does not engage a trade or business involving the performance of services in the field of consulting….
>
> We conclude that for the purposes of section 1202(e)(3), Company is engaged in a qualified trade or business as defined in section 1202(e)(3) and is not engaged in a trade or business involving the performance of services in the field of consulting within the meaning of section 1202(e)(3)(A).

Letter Ruling 202342013 seems the same as Letter Ruling 202342015. However, it involved the following additional fact:

> On Date 1, Company elected to be classified as an S corporation but Company had more than one class of stock in violation of section 1.361-1(*l*)1 of the Regulations. Thus, Taxpayer represents that its S corporation election was immediately invalid.

See part II.A.2.h Important Protections for S Corporation Shareholder Agreements.

Letter Ruling 202342013 commented about that fact:

> Specifically, no opinion is expressed or implied concerning whether the Company made an invalid S corporation election on Date 1. However, this ruling is conditioned upon Taxpayer's representation that the S corporation election on Date 1 was invalid.

That's because a current or former S corporation cannot be qualified small business stock (although an S corporation can form a QSBS C corporation subsidiary).

Letter Ruling 202319013 had the following facts and conclusion:

> Company is an enterprise cloud application services software company, which provides solutions tailored to the operating functions and industry-specific challenges of their clients. The Company's employees possess technical skills and knowledge which allow for effective implementation and the quality of the Company's services. However, they are trained on one or more of the Company's proprietary service delivery processes and methodology packages that are unique to the Company and may not be utilized by the employees at any other employers that may provide the same or similar service. The

> Company can recruit and train new employees with the required technical skillset to perform substantially identical services using its methodology packages….
>
> The Company's employees possess technical skills and knowledge due to training received on one or more of the Company's proprietary service delivery processes and methodology packages. Such processes and packages are unique to Company and may not be utilized by the employees at other similar companies. The Company can recruit and train new employees with the required technical skillset to perform substantially identical services using its methodology packages. Therefore, the principal asset of the Company is not the reputation or skills of one or more employees, but the intellectual property held by the Company itself in its proprietary service delivery processes and methodology packages.

Also, a commission sales business was not disqualified under this provision. In *Owen v. Commissioner*, T.C. Memo. 2012-21, a company that sold prepaid legal service policies, including estate planning services, which were like insurance in that purchasers would get a reduced fee in legal cost by joining this prepaid legal membership, was a qualified small business. The court seemed to accept the taxpayer's testimony that, in the industry, independent contractors generally sold the products and services offered by the company. The taxpayer performed services as an executive and as a sales representative and his compensation was reported on Form W-2 (as an executive) and Form 1099-MISC (as an independent consultant who furnished services through his personal corporation that received commissions and in turn paid him using Form 1099-MISC. The court held:

> Although respondent argues that FFAEP is not qualified because one of the principal assets is the skill of Mr. Owen, the Court disagrees. While we have no doubt that the success of the Family First Companies is properly attributable to Mr. Owen and Mr. Michaels, the principal asset of the companies was the training and organizational structure; after all, it was the independent contractors, including Mr. Owen and Mr. Michaels in their commission sales hats, who sold the policies that earned the premiums, not Mr. Owen in his personal capacity.

However, ultimately this holding was moot (which did not stop the court from opining on it), because the taxpayer was trying to do a Code § 1045 rollover of gain on sale from one company to another. Although the new company qualified as described above, the company being sold did not (fn. 5261), resulting in the taxpayer losing the case. So, keep in mind the IRS' lack of incentive to appeal this holding when viewing it as instructive.

II.Q.7.k.ii. Limitation on Assets a Qualified Small Business May Hold

During substantially all of the taxpayer's holding period for the qualified small business stock,[5250] the corporation must use at least 80% (by value) of its assets in the active conduct of one or more qualified trades or businesses and be an eligible corporation.[5251] Assets used for certain start-up or research activities count as qualified.[5252] A specialized small business investment

[5250] Code § 1202(c)(2).
[5251] Code § 1202(e)(1).
[5252] Code § 1202(e)(2), "Special rule for certain activities," provides:

> For purposes of paragraph (1), if, in connection with any future qualified trade or business, a corporation is engaged in—
>
> (A) start-up activities described in section 195(c)(1)(A),

company automatically meets the active business requirement.[5253] Query whether the active business requirement of Code § 355[5254] may inform this discussion, even though it does not literally apply to Code § 1202.

In applying the requirement that the corporation hold active business assets, stock and debt in any subsidiary corporation are disregarded and the parent corporation is deemed to own its ratable share of the subsidiary's assets and to conduct its ratable share of the subsidiary's activities;[5255] no special rule applies to a subsidiary partnership.[5256] The parent owns more than 50% of the combined voting power of all classes of stock entitled to vote, or more than 50% in value of all outstanding stock, of a corporation for the parent to be able to treat the corporation as a subsidiary.[5257] If the holding falls below this threshold, then watch out – the parent fails the active business asset test for any period during which more than 10% of the value of its assets (in excess of liabilities) consists of stock or securities in other corporations which are not subsidiaries of such corporation (other than assets described under the "working capital" exception).[5258]

Under the "working capital" exception, active business assets include assets held as a part of the reasonably required working capital needs of a qualified trade or business of the corporation, or held for investment and are reasonably expected to be used within two years to finance research and experimentation in a qualified trade or business or increases in working capital needs of a qualified trade or business.[5259] However, for periods after the corporation has been in existence for at least two years, no more than 50% of the assets of the corporation may qualify as used in the active conduct of a qualified trade or business by reason of this rule.[5260] Be careful not to start the C corporation just accumulating cash for possible business operations, which will disqualify the corporation.[5261] To avoid this issue and for other reasons as

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(B) activities resulting in the payment or incurring of expenditures which may be treated as research and experimental expenditures under section 174, or

(C) activities with respect to in-house research expenses described in section 41(b)(4),

assets used in such activities shall be treated as used in the active conduct of a qualified trade or business. Any determination under this paragraph shall be made without regard to whether a corporation has any gross income from such activities at the time of the determination.

[5253] Code § 1202(c)(2)(B), referring to an eligible corporation licensed to operate under section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993). As to "specialized small business investment company," see part II.Q.7.m Deferring Gain on Sale of Marketable Securities by Investing in a Specialized Small Business Investment Company.

[5254] See part II.Q.7.f.iii Active Business Requirement for Code § 355.

[5255] Code § 1202(e)(5)(A). Code § 1202(d)(3)(A) provides that all corporations which are members of the same parent-subsidiary controlled group shall be treated as one corporation for purposes of the assets test. In determining what is a "parent-subsidiary controlled group," Code § 1202(d)(3)(B) refers to Code § 1563(a)(1), except that:

(i) "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a)(1), and

(ii) section 1563(a)(4) shall not apply.

[5256] See fns 5268-5270 in part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.

[5257] Code § 1202(e)(5)(C).

[5258] Code § 1202(e)(5)(B).

[5259] Code § 1202(e)(6).

[5260] Code § 1202(e)(6).

[5261] *Owen v. Commissioner*, T.C. Memo. 2012-21. The court addressed the qualifications of two companies, one of which did not qualify (this footnote) and one of which did qualify (fn. 5247). In discussing why the company was not a qualified small business under Code § 1202 and therefore not well, consider instead starting as an LLC taxable as a partnership then later converting to a corporation.[5262]

A corporation also fails the active business assets test for any period during which more than 10% of the total value of its assets consists of real property which is not used in the active conduct of a qualified trade or business.[5263] In applying the preceding sentence, the ownership of, dealing in, or renting of real property is not treated as the active conduct of a qualified trade or business;[5264] renting the property to the business may be better anyway.[5265]

In applying the active business asset test, rights to computer software which produces active business computer software royalties[5266] are treated as an asset used in the active conduct of a trade or business.[5267]

Although Code § 1202 authorizes qualified small business stock to be held by a partnership[5268] and corporate subsidiaries,[5269] it does not discuss the corporation conducting its business through one or more partnerships. Accordingly, from a planning perspective, I would not recommend having a corporation seeking qualified small business status invest its assets in a partnership. However, if one is asked to advice an owner of a corporation that is already invested in a partnership, I would look to the active business rules for corporate split-ups, which describe when an interest in a partnership constitutes an active business asset.[5270]

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eligible for a capital gain deferral under Code § 1045 (which rollover is not necessary for newer companies), the court imposed a 20% accuracy-related penalty:

> We also find that the Owens did not act with good faith with respect to the section 1045 transaction. Mr. Owen explained that it was his vision to build up J&L Gems as he had the Family First Companies; yet even as late as 2 years after the money had been deposited in the company, J&L Gems had only 16 pieces of jewelry. Mr. Owen should not in good faith have believed that deferring income tax under section 1045, by operating a business, merely involved depositing a large amount of cash in an account. Nor could he reasonably believe that using less than 8 percent of that cash to purchase inventory and selling only a part of what little inventory he did buy to his friends and coworkers was sufficient to defer the tax. Even under Mr. Owen's understanding of section 1045, that he had to operate the business in good faith and reasonably, he failed to meet that requirement.

[5262] See part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership? (especially the text accompanying fns. 5309-5317).
[5263] Code § 1202(e)(7).
[5264] Code § 1202(e)(7).
[5265] See parts II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation; Possible Way to Attain Basis Step-Up (which is even more of a concern for C corporations) and II.Q.1.b Leasing.
[5266] Within the meaning of Code § 543(d)(1).
[5267] Code § 1202(e)(7).
[5268] See part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation, especially fns. 5212-5218.
[5269] See fns. 5255-5258 in part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.
[5270] See part II.Q.7.f.iii Active Business Requirement for Code § 355.

In discussing Letter Ruling 202016013, which was a Code § 721(b) ruling, Banoff and Cohen comment:[5271]

> We observe that Section 1202 has (at least at first glance) a similar disconnect between subsidiary corporations and subsidiary partnerships. See Shop Talk, "Is LLC Business Attributed to Corporate Member for Section 1045 Purposes?," 93 *JTAX* 254 (October 2000). In that article, we hypothesized a taxpayer looking to roll over her sales proceeds from the sale of qualified small business stock (QSBS) within the meaning of Section 1045. (Coincidentally, Section 1045 (like the amendment to Section 351(e)) was enacted by The Taxpayer Relief Act of 1997.) Generally, under Section 1045(a), a noncorporate taxpayer may defer the recognition of otherwise taxable gain from the sale of QSBS that was held more than six months prior to the date of sale of the QSBS. In our 2000 Shop Talk article, we asked whether our hypothetical taxpayer could successfully invest those proceeds in a corporation that itself does not conduct a qualified small business but has an interest in a partnership or an LLC that engages in a business that otherwise would satisfy Section 1045 if the business were conducted by the corporation.
>
> Section 1045 defines QSBS by incorporating the definition of QSBS contained in Section 1202. Stock will be treated as QSBS under Section 1202 if, among other things, during substantially all of the period during which the taxpayer holds the stock, the issuing corporation must be engaged in an active trade or business.
>
> In order to satisfy the active business requirement, at least 80% of the issuer's assets (as measured by their FMV) must be used in the active conduct of one or more qualified businesses. A special look-through rule applies when a parent corporation owns stock in a subsidiary corporation that is engaged in a qualified business. Specifically, the parent corporation will be deemed to own a ratable share of the subsidiary's assets and to conduct its ratable share of the subsidiary's activities. Section 1202(e)(5)(A). To get this look-through treatment, the parent corporation must own more than 50% of the combined voting power of all classes of stock or more than 50% of the value of all the outstanding stock of the subsidiary corporation. Section 1202(e)(5)(C).
>
> Can the look-through rule that applies to parent and subsidiary corporations as described in Section 1202(e)(5) be extended to a corporation that owns an interest in a partnership or LLC, for purposes of Section 1202? Todd D. Golub, a Chicago CPA and attorney and author of a then-contemporaneous article on Section 1045 rollovers, provided Shop Talk in our 2000 article with these observations:
>
>> If the corporation is not the sole member and the LLC is taxable as a partnership, the look-through rule applicable to parent-subsidiary corporations on its face does not apply. Further, Section 1045 provides special rules for persons who invest in a flow-through entity that invests in QSBS to obtain the benefits of Section 1045. See also Rev. Proc. 98-48, 1998-2 CB 367, providing further guidance for persons who invest in flow-through entities to get the benefits of Section 1045. Thus, both Congress and the IRS considered the application of the aggregate theory of partnerships when

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[5271] Shop Talk column, "Section 721(b)-A Partnership Issue, a Corporate Issue, or Just a Jumble?" *Journal of Taxation* (7/2020). For a reproduction of most of Letter Ruling 202016013 and their detailed discussion of it, see text preceding and accompanying fns 3576-3577 in part II.M.3.b Exception: Diversification of Investment Risk.

> enacting Section 1045 but did not extend that theory to the determination of whether the qualified business requirement is met if a corporation invests in an LLC that engages in a qualified business. Thus, this omission may indicate that the look-through rule does not extend to a subsidiary LLC for purposes of Section 1045.
>
> The 1997 Blue Book states at page 58 that Congress enacted Section 1045 with the hope that the deferral benefit would encourage investors to reinvest funds in qualified small businesses, making more capital available to new, small businesses that are important to the long-term growth of the economy. There is no indication of why Congress limited the deferral benefit to investors that provide funds to small businesses that operate only in corporate form. So long as Congress intended to provide such a benefit, there is no apparent reason why it should not be extended to flow-through entities. In fact, by limiting this benefit to parent-subsidiary corporate relationships, Congress actually may have limited the funding that otherwise might be available to businesses that choose not to incorporate.
>
> Accordingly, it would seem that [for purposes of Sections 1045 and 1202] a look-through rule should apply to corporations that have an interest in LLCs or other entities taxed as partnerships that are engaged in a qualified business....
>
> Congress, however, did not go so far as to specifically provide for a look-through rule when a corporation invests directly in an LLC or partnership. So, if one looks solely to the statute [Section 1202], the business of the LLC arguably may not be attributable to the corporate member.

Golub's conclusion in our 2000 Shop Talk article is eerily and equally applicable to the corporate-partnership conundrum discussed in this article with respect to Section 721(b): "One can only hope that future guidance will clarify that the deferral benefit of Section 1045 should apply to the shareholders of corporations that invest directly in qualified businesses regardless of the form of entity that engages in the qualified business."

Golub's plea for guidance under Section 1045 (via Section 1202) published in Shop Talk 20 years ago apparently has gone unheard; there seems to have been no further guidance issued with respect to the attribution of a partnership's or an LLC's trade or business to a corporate member for purposes of Section 1045, notwithstanding strong policy reasons to support that result (just as there are under Sections 721(b) and 351(e)). Moreover, we are unaware of any letter rulings that provide relief to subsidiary partnerships and their corporate partners for purposes of Section 1045. On the other hand, Ltr. Rul. 202016013 (and the two predecessor letter rulings described above) have created a niche where certain qualifying (majority interest) contributors to partnerships would apparently be able to apply a corporate look-through rule to subsidiary partnerships. And these Section 721(b) rulings by analogy may give some (albeit indirect) comfort to taxpayers and practitioners for purposes of Section 1045 that the Service would similarly apply a corporate look-through/attribution rule to subsidiary partnerships for purposes of attributing their trades or businesses to corporate partners holding majority interests in their partnerships.

Special rules apply to certain tax-free transfers.[5272] If a transfer is by gift,[5273] at death, or from a partnership,[5274] the transferee is treated as having acquired such stock in the same manner as the transferor and having held such stock during any continuous period immediately preceding the transfer during which it was held (or treated as held under these rules) by the transferor:[5275]

- Presumably a taxpayer whose stock's value exceeds the cap of the exclusion of gain[5276] by giving the stock to family members, each of whom could sell the stock separately.

- If the transfer is from a partnership, it must be to a partner of stock with respect to which requirements similar to the pass-through rules described above are met at the time of the transfer (without regard to the 5-year holding period requirement).[5277]

If a trust transfers Code § 1202 stock to a beneficiary, does that count as a permitted transfer by gift? Probably so.[5278] However, I am unaware of any authority discussing Code § 1202(h)(2)(A) addressing this issue, so when in planning mode consider trying to avoid distributing the stock.

In a Code § 351 formation of a corporation or a Code § 368 reorganization, if qualified small business stock is exchanged for other stock which would not qualify as qualified small business stock but for this rule, that other stock shall be treated as qualified small business stock acquired on the date on which the exchanged stock was acquired.[5279] Unless the stock treated

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5272 Code § 1202(h).
5273 See text accompanying fn 5200 regarding gifts to trusts.
5274 Code § 1202(h)(2).
5275 Code § 1202(h)(1).
5276 See fn. 5188.
5277 Code § 1202(h)(2)(C).
5278 The paradigm created by Reg. §§ 1.102-1(b), (c) and 1.663(a)-1(b)(2)(i) is that distributions from trusts are treated as gifts unless they satisfy a requirement to distribute income. See text accompanying fn 2780 in part II.J.8.d.i Distribution in Kind - Generally
5279 Code § 1202(h)(4)(A). Letter Ruling 9810010 applied Code § 1202(h)(4) to a corporate split-up that was partly tax-free under Code §§ 355(a)(1) and 368(a)(1)(D). Letter Ruling 9810010 said that Code § 1202(h)(4)(A) necessarily means:

> Thus, stock received in a section 368 reorganization may be treated as QSBS despite the prohibition in section 1202(c)(1)(B)(i) against stock received in exchange for other stock.

Letter Ruling 9810010 continued:

> In the instant case, the taxpayers have represented that the portion of the Distributing stock given up by A through N in exchange for Controlled stock was qualified small business stock (QSBS) and that Controlled was a qualified small business at the time of the reorganization. As part of the section 368 reorganization, A through N received Controlled stock in exchange for a portion of their Distributing stock and thereafter sold their remaining Distributing stock to FX. Unless the specific shares of Distributing stock exchanged for Controlled stock can be adequately identified by each of the exchanging shareholders, it is assumed pursuant to section 1.1012-1(c)(1) that the Distributing stock exchanged will be charged against the earliest of such lots acquired in order to determine cost or other basis and holding period. This rule also applies in determining whether the Distributing QSBS held by each of the exchanging shareholders at the time of the exchange was among the Distributing stock exchanged for Controlled stock.
>
> Based on the assumption that the portion of the Distributing stock given up by A through N was QSBS in the hands of such shareholders as determined by applying the rules of section 1.1012-1, a portion of the Controlled stock received by such shareholders in exchange therefor will be treated as QSBS acquired on the date the exchanged Distributing QSBS was acquired (section 1202(h)(4)(A)). If the stock exchanged by a Distributing shareholder consists of both

as qualified small business stock by reason of the preceding sentence is issued by a corporation that (as of the time of that transfer) is a qualified small business, Code § 1202 applies to gain from the sale or exchange of stock treated as qualified small business stock by reason of the preceding sentence only to the extent of the gain which would have been recognized at the time of the transfer described in the preceding sentence if Code § 351 or 368 had not applied at that time.[5280]

To the extent provided in regulations, stock in a corporation, the basis of which (in the hands of a taxpayer) is determined in whole or in part by reference to the basis in his hands of stock in such corporation which meets certain requirements or which is received in a reorganization that is a mere change in form in exchange for stock which meets such requirements (and interests in an LLC that elected C corporation taxation qualify as stock),[5281] is treated as meeting such requirements.[5282] For more discussion, see "Section 351 Transactions and Section 368 Reorganizations" in RIA Checkpoint *Catalyst* ¶ 511:114 Original Issuance Requirement within ¶ 511:110 Qualified Small Business Stock: Definition.

If the taxpayer has an offsetting short position with respect to any qualified small business stock, Code § 1202(a) shall not apply to any gain from the sale or exchange of such stock unless the stock was held by the taxpayer for more than 5 years as of the first day on which there was such a short position, and the taxpayer elects to recognize gain as if such stock were sold on

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> QSBS and non-QSBS, then only a proportionate amount of the Controlled stock received in exchange will be treated as QSBS.

Ruling 12 of Letter Ruling 9810010 held:

> Based solely on the taxpayer's representations that a portion of the Distributing stock owned by A through N was classified as qualified small business stock under section 1202 (Distributing QSBS), a proportionate amount of Controlled stock received by each of A through N in exchange for such individual's Distributing QSBS will be treated as qualified small business stock (section 1202(h)(4)(A)). The holding period for the Controlled stock treated as qualified small business stock under section 1202(h)(4)(A) includes the holding period for which each of A through N held the Distributing QSBS. Further, based on the representation that Controlled was a qualified small business at the time of the reorganization, the limitation in section 1202(h)(4)(B) will not apply.
>
> Ruling (12) only applies to the Controlled stock that was received in exchange for Distributing stock that was QSBS in the hands of the individual shareholders at the time of the exchange. We have not been asked, and we do not address, whether any stock issued by Distributing was qualified small business stock at any time or whether Controlled is a qualified small business within the meaning of section 1202(d).

[5280] Code § 1202(h)(4)(B). Letter Ruling 9810010 noted:

> Section 1202(h)(4)(B) limits the amount of gain that can be excluded under section 1202(a) if the stock constitutes qualified small business stock by virtue of section 1202(h)(4)(A). However, the limitation does not apply if the stock is issued by a corporation that is itself a qualified small business as of the time of the reorganization.

Code § 1202(h)(4)(C) provides:

> *Successive application*. For purposes of this paragraph, stock treated as qualified small business stock under subparagraph (A) shall be so treated for subsequent transactions or reorganizations, except that the limitation of subparagraph (B) shall be applied as of the time of the first transfer to which such limitation applied (determined after the application of the second sentence of subparagraph (B)).

[5281] See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. Converting a corporation into an LLC taxed as a corporation was such a change. Letter Rulings 201603010-201603014.

[5282] Code § 1202(h)(3), incorporating by reference Code § 1244(d)(2).

such first day for its fair market value.[5283] For purposes of the preceding sentence, the taxpayer shall be treated as having an offsetting short position with respect to any qualified small business stock if the taxpayer has made a short sale of substantially identical property, the taxpayer has acquired an option to sell substantially identical property at a fixed price, or to the extent provided in regulations, the taxpayer has entered into any other transaction which substantially reduces the risk of loss from holding such qualified small business stock; in applying this rule, any reference to the taxpayer is treated as including a reference to any person who is related (within the meaning of Code § 267(b)[5284] or 707(b)[5285]) to the taxpayer.[5286]

II.Q.7.k.iii. Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership?

Does the exclusion for the sale of certain stock make being a C corporation more attractive than an S corporation or a partnership? First, we will explore when the sale of such stock has advantages, when the sale does not have advantages, and operational income tax issues.

If and to the extent that the gain on the sale of a business relates to the sale of self-created goodwill, the basis of the ownership interest does not reflect that basis, no matter what kind of entity owns the business. To that extent, the sale of such stock is more favorable than the sale of stock in an S corporation[5287] and the sale for cash of a partnership interest.[5288] However, the seller-financed sale of a partnership interest still produces better results than the sale of such stock.[5289]

In some situations, the exclusion for the sale of certain C corporation stock does not provide any particular advantage, if and to the extent that the owner of a pass-through interest would not have gain on sale. If and to the extent that the sale of the business interest arises from reinvested earnings, the basis of a partnership interest[5290] or stock in an S corporation is increased.[5291] Furthermore, if a pass-through entity redeems only part of one's ownership, the

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[5283] Code § 1202(j)(1).

[5284] Code § 267(b) is reproduced in part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses.

[5285] For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

[5286] Code § 1202(j)(2).

[5287] Compare part II.Q.1.a.i.(c) with part II.Q.1.a.i.(d) (moderate tax states) and part II.Q.1.a.ii.(c) with part II.Q.1.a.ii.(d) (California).

[5288] The sale of a partnership interest for cash generally would have similar dynamics regarding goodwill as the sale of S corporation stock. The sale of a partnership interest would have a slight advantage, in that the goodwill could obtain a basis step-up (part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations and fn. 5677, unless the anti-churning rules apply per part II.Q.1.c.iv Goodwill (and other intangible) Anti-Churning Rules, especially fn. 4175), but amortization would be over a 15-year period under Code § 197 (fn. 5561). Also, amortizing goodwill turns it into a hot asset, reducing opportunities for deferral on its sale; for more information on the sale of goodwill, including disadvantages of goodwill being amortized, see part II.Q.1.c.i Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation.

[5289] See parts II.Q.1.a.i.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill and II.Q.1.a.ii.(g) Partnership Use of Same Earnings as C Corporation – Redemption (California).

[5290] Code § 705. However, as described in part II.Q.8.e.ii.(a) Unitary Basis, a partner does not have the flexibility of a shareholder to pick and choose which shares to sell.

[5291] Code § 1367, which is reproduced in part II.G.4.d.i Basis Limitation Generally.

reinvested earnings might offset part or all of the gain on the sale – perhaps even that attributable to self-created goodwill.[5292]

Furthermore, the exclusion is available only for qualified stock that is issued, gifted, or bequeathed to the taxpayer,[5293] making it unavailable to subsequent purchasers of the stock. Some states, such as California,[5294] do not recognize the exclusion. Also, during substantially all of the taxpayer's holding period for the qualified small business stock, the corporation must use at least 80% (by value) of its assets in the active conduct of one or more qualified trades or businesses and be an eligible corporation.[5295] No rules explain how often one must evaluate the company's assets to see whether they satisfy that test; presumably testing whenever the qualified small business stock is issued[5296] and annually[5297] would suffice, to inject some reasonableness into the statute, but I am unaware of any authority addressing how frequently the corporation must evaluate its assets and their use to help its shareholders prove this element.

A stock sale tends to have a lower sale price than an asset sale, due to buyer's concerns about assuming undisclosed or unseen liabilities and perhaps not receiving a basis step-up in the corporation's assets. Because buyers want to depreciate or amortize business assets or may later sell them, buyers like to obtain a new basis in the entity's assets when they buy an interest in an entity. See Part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations. This is especially important when an entity sells only a business line,[5298] rather than the entire business. Therefore, many business sales are actual or deemed asset sales; for the latter, see part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold. When the entity sells all of its assets, it might as well liquidate to take full advantage of the exclusion on the gain on sale of the stock and let the shareholders move the sale proceeds outside of a potentially risky business environment.[5299]

[5292] For S corporations, see part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally, especially fns. 4874-4876. Of course, the basis resulting reduction basis reduces the ability to take distributions and increases future gains on the sale of the stock, the latter which might not be of concern if and to the extent the stock receives a new basis on the shareholder's death. See part II.H.9 Basis Step-Up In S Corporations That Had Been C Corporations.
For partnerships, see part II.Q.8.b Partnership Redemption or Other Distribution.
[5293] See various requirements described in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[5294] Cal. Rev. & Tax. Cd. § 18152.5(n).
[5295] See text accompanying fns 5250-5251 in part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.
[5296] An example of what purported evidence does not work is described in fn 5240 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[5297] A taxpayer who did not even come close to hitting the target of investing cash quickly enough is in fn 5261 in part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.
[5298] One cannot easily divide a business tax-free, sell a business line, and liquidate the corporation owning just that business lines. See part II.Q.7.f.ii Code § 355 Requirements.
[5299] See part II.F.2 Asset Protection Benefits of Dissolving the Business Entity After Asset Sale. Levun's article, cited at fn. 5320, comments:

> Note that the receipt of liquidation proceeds after a corporate asset sale also qualifies for the QSBC exclusion. However, because of the corporate-level tax exacerbated by the lack of a corporate capital gains rate, the scales would still tip in favor of flow-through taxation, notwithstanding no tax due on liquidation. In other words, assume all an entity owns is zero-basis

Until the 21% federal corporate income tax rate increases, a C corporation selling business assets tends to use a lower rate than does a pass-through entity. The latter generates income taxed at higher rates:

- Any equipment, amortizable (purchased) Code § 197 intangibles (including goodwill),[5300] certain intellectual property,[5301] and various other property[5302] is subject to taxation at high ordinary income tax rates. See part II.G.6.b Code § 1245 Property. Although ordinary income from the sale of business assets may be qualified business income eligible for the 20% deduction under Code § 199A, [5303] not all businesses qualify,[5304] and even those that do often won't be able to take advantage of large income from such sales because the deduction is limited to a formula based on wages paid, with possible adjustments for depreciable property held at the end of the year.[5305]

- Depreciable real estate may also trigger capital gain tax on depreciation recapture at higher rates.[5306] Also, if and to the extent that selling business assets generated a prior Code § 1231 ordinary loss, later gain from selling business assets is taxed as ordinary income instead of capital gain.[5307]

I am a big fan of partnerships, as described in part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and diagrammed in part II.E.6 Recommended Partnership Structure – Flowchart, after starting more simply as an LLC as described in part II.E.3 Recommended Structure for Start-Ups. Partnerships that are not capital-intensive are great candidates for avoiding any tax on the seller-financed sale of a partnership interest;[5308] that tool tends to apply to a sale to management or other owners, who care more about paying over time, in a manner than devotes less earnings to the buy-out, than they care about inside

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> self-created goodwill having a value of $1 million. In the case of an asset sale as an LLC, there would be federal tax due of $200,000 (assuming a 20-percent maximum capital gains rate). In the case of the same asset sale by a QSBC, while there would be no shareholder tax on the liquidation of the corporation, the corporate entity-level federal tax burden would be $340,000 (or tax at a 35-percent rate, to the extent the corporation has taxable income in excess of $10 million).

The reference to a 35% tax rate was before 2017 tax reform lowered the corporate tax rate.

[5300] Goodwill and other intangibles are not amortized and therefore not subject to this rule when they are self-created. When a business buys such assets, then they are amortizable. For how these rules work, see part II.G.18.d Amortization of Code § 197 Intangibles.

[5301] See parts II.G.18.b Sale or Exchange of Intellectual Property - Capital Gain vs. Ordinary Income and II.G.18.c Patents (the latter being subject to the former).

[5302] Various assets that are not capital assets, such as inventory (see Code § 1221(a), reproduced in fn 6914 in part III.B.2.j.iii.(e) Allocation of Specific Items), and assets triggering the assignment of income, such as cash basis accounts receivable, are among them. For certain assets held by a partnership, see part II.Q.8.b.i.(g) Code § 751 – Hot Assets.

[5303] See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.

[5304] See part II.E.1.c.iv Specified Service Trade or Business (SSTB) If Taxable Income Exceeds Certain Thresholds.

[5305] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

[5306] See fn 1495 in part II.G.6.a Code § 1231 Property. If and to the extent accelerated depreciation applied, beware of ordinary income treatment under part II.G.6.b Code § 1245 Property.

[5307] See text accompanying fn 1497 in part II.G.6.a Code § 1231 Property.

[5308] See parts II.Q.1.a.i.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill and II.Q.1.a.ii.(g) Partnership Use of Same Earnings as C Corporation – Redemption (California).

basis step-up. Furthermore, the death of a partner or sale or other qualified transfer of a partnership interest generates a new basis in the partnership's assets attributable to the relevant partnership interest; see part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

Furthermore, if one decides that a C corporation structure is ultimately desirable, one might consider instead starting as an LLC taxable as a partnership or sole proprietorship, which enables start-up losses to be deducted more easily anyway;[5309] then, if one determines that a C corporation is the ideal structure, convert[5310] to a qualified small business corporation[5311] the earlier of five years before a sale is anticipated or shortly before the $50 million gross asset limitation is exceeded.[5312] Factors when considering this strategy include:

- The delay in forming the corporation can help avoid being disqualified for not deploying start-up capital quickly enough.[5313]

- During this initial operating period, the owners could build value in the business, and the greater of value or basis of the partnership's assets when it converts to a C corporation is used in computing the exclusion of ten times the investment.[5314] This is a double-edged sword in that any value in excess of basis (in other words, built-in gain) at the time of the conversion is not eligible for the exclusion.[5315]

- The ability to deduct start-up losses may be good or bad, depending on whether the owner is in a high or low tax bracket. See part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good. If the taxpayer is in a high tax bracket, then consider taking bonus

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[5309] See part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner, especially part II.G.4.f Comparing C Corporation Loss Limitations to Those for Partnership and S Corporation Losses.

[5310] See part II.P.3.c Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations. One might simply file Form 8832 to elect corporate taxation, assign the LLC to a corporation, or convert or merge the LLC into a corporation. As to the former, Letter Ruling 201636003 held:

> While ownership of a corporation is normally tied to stock ownership, and under state law LLC owners hold a member interest and not formal stock, the term "stock" for federal tax purposes is not restricted to cases where formal stock certificates have been issued. Rather, it has been consistent Service position that for federal tax purposes stock ownership is a matter of economic substance, *i.e.*, the right to which the owner has in management, profits, and ultimate assets of a corporation. The presence or absence of pieces of paper called "stock" representing that ownership is immaterial. See Rev. Rul. 69-591, 1969-2 C.B. 172.
>
> Therefore, based on the facts and representations submitted, we rule that the Corporation stock meets the definition of qualified small business stock under §§§ 1202(c), 1202(f) and 1202(h).

[5311] See part II.P.3.c Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations.

[5312] See fn. 5238.

[5313] See part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold, especially the text accompanying fns. 5259-5261.

[5314] See part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation, especially fns. 5190-5198.

[5315] See paragraph of text accompanying fn. 5198 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

depreciation[5316] and generating a high-tax-rate deduction now, then paying tax at a lower rate when the assets are sold after conversion to C corporation taxation.

- If the entity accumulates debt in excess of basis, forming the corporation might be a taxable event.[5317]

- Before converting to ***a*** qualified small business corporation, consider whether the LLC might divide into separate entities, each of which conducts a separate business,[5318] and then each separate business would become its own qualified small business corporation with a separate limitation on the amount of gain that is excluded. That may also help stay under the $50 million gross asset limitation for each corporation.

For a case study on converting a partnership to a C corporation to accommodate a venture capital firm's desire for this exclusion, whether converting to a C corporation is a good idea, the Code § 1045 rollover, and issues facing recipients of profits interests on conversion,[5319] see Levun, "Using Partnerships to Leverage "Zero-Tax" Code Sec. 1202 Stock."[5320]

II.Q.7.k.iv. Code § 1045 Rollover of Gain from Qualified Small Business Stock (QSBS) to Another QSBS

Code § 1045 allows a taxpayer to roll over the gain into new qualified small business stock.[5321]

[5316] See part II.G.5 Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation, especially part II.G.5.b Bonus Depreciation.
[5317] See parts II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities and II.M.2.c Contribution of Partnership Interest to Corporation.
[5318] See part II.Q.8.d Partnership Division.
[5319] See part II.M.4.f Issuing a Profits Interest to a Service Provider. Levun, fn. 5320, points out:

> As a final observation, and somewhat of a frolic and detour, let's assume that the LLC being discussed in this column had a service provider that had been previously admitted as a partner (either by reason of (1) having received a fully vested LLC interest, (2) having received a profits interest subject to a substantial risk of forfeiture but for which the requirements of Rev. Proc. 2001-43, 2001-2 CB 191, had been satisfied or (3) having received a capital interest subject to a substantial risk of forfeiture for which a timely Code Sec. 83(b) election had been made. Also assume that, as part of the incorporation transaction contemplated above (to obtain QSBC stock), the service provider was required to agree to a substantial risk of forfeiture with respect to the C corporation stock he was now obtaining in the LLC to C corporation conversion transaction. Rev. Rul. 2007-49, 2007-2 CB 237, would require that a Code Sec. 83(b) election be made in order for the service partner to be treated as a shareholder in the corporation. This revenue ruling provides that the transfer of vested stock in exchange for nonvested stock in a tax-free corporate reorganization requires a Code Sec. 83(b) election in order for the service provider to be considered the tax owner of the shares received in the reorganization. While the revenue ruling addresses a tax-free reorganization under Code Sec. 368(a), there is no reason to believe that the result would be any different in a Code Sec. 351 transaction. Note that making a Code Sec. 83(b) election does not result in any tax to the service provider, as under the principles contained in Rev. Rul. 2007-49, the service provider would be considered to have paid an amount for the QSBC stock equal to its fair market value.

[5320] *Partnership Tax Watch Newsletter* (Current), No. 349, PARTNERSHIP TAX PLANNING and PRACTICE 11/22/2016, saved as Thompson Coburn LLP document no. 6486765.
[5321] Rev. Proc. 98-48 explains how to elect Code § 1045 deferral, the deadline for which may be extended using Reg. § 301.9100-3 relief (*see*, *e.g.*, Letter Ruling 201650010). Reg. § 1.1045-1 provides rules for partnerships and supersedes Rev. Proc. 98-48 to that extent (see T.D. 9353 8/14/2007). Letter

In the case of any sale of qualified small business stock held for more than 6 months[5322] by a taxpayer other than a corporation and with respect to which the taxpayer elects to apply Code § 1045, gain from the sale is recognized only to the extent that the amount realized on such sale exceeds the cost of any qualified small business stock (QSBS) purchased by the taxpayer during the 60-day period beginning on the date of such sale, reduced by any portion of that cost previously taken into account under Code § 1045.[5323]

Code § 1045 does not apply to any gain which the Code treats as ordinary income.[5324]

QSBS has the meaning given such term by Code § 1202(c). See various explanations under other subparts of this part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation. However, only the first 6 months of the taxpayer's holding period for the stock referred to in Code § 1045(a)(1) are taken into account for purposes of applying Code § 1202(c)(2).[5325]

A taxpayer is treated as having purchased any property if, but for Code § 1045(b)(3), the unadjusted basis of such property in the hands of the taxpayer would be its cost (within the

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Ruling 202244004 granted an extension of time until 60 days after the ruling to file an amended return to make a section 1045 election under Rev. Proc. 98-48, using the following reasoning:

> Taxpayer in this case has represented that it requested relief before the failure to make the regulatory election was discovered by the Service and that it failed to make the election because Taxpayer did not receive necessary K-1s to file his Year 1 return by the extended due date for Year 1. Thus, under sections 301.9100-3(b)(1)(i) and (ii), Taxpayer will be deemed to have acted reasonably and in good faith. Taxpayer has also represented that none of the circumstances listed in section 301.9100-3(b)(3) apply…
>
> … the interests of the government are not prejudiced in this case. Taxpayer has represented that granting relief would not result in a lower tax liability in the aggregate for all taxable years affected by the election than Taxpayer would have had if the election had been timely made (taking into account the time value of money). Furthermore, Taxpayer has represented that the taxable year in which the regulatory election should have been made and any taxable years that would have been affected had it been timely made, are not closed by the period of assessment.

[5322] Code § 1045(b)(4)(A) provides, "the taxpayer's holding period for such stock and the stock referred to in subsection (a)(1) shall be determined without regard to section 1223."

[5323] Code § 1045(a).

[5324] Code § 1045(a).

[5325] Code § 1045(b)(4)(B). Code § 1202(c)(2), "Active business requirement; etc.," provides:

> (A) *In general*. Stock in a corporation shall not be treated as qualified small business stock unless, during substantially all of the taxpayer's holding period for such stock, such corporation meets the active business requirements of subsection (e) and such corporation is a C corporation.
>
> (B) *Special rule for certain small business investment companies*.
>
> (i) *Waiver of active business requirement*. Notwithstanding any provision of subsection (e), a corporation shall be treated as meeting the active business requirements of such subsection for any period during which such corporation qualifies as a specialized small business investment company.
>
> (ii) *Specialized small business investment company*. For purposes of clause (i), the term "specialized small business investment company" means any eligible corporation (as defined in subsection (e)(4)) which is licensed to operate under section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993).

As to "specialized small business investment company," see part II.Q.7.m Deferring Gain on Sale of Marketable Securities by Investing in a Specialized Small Business Investment Company.

meaning of Code § 1012).[5326] Code § 1045(b)(3) uses the deferred gain to reduce the basis of any QSBS the taxpayer buys during the 60-day rollover period.

II.Q.7.l. Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244

An individual[5327] may deduct the first $50,000 of loss[5328] on the sale of "section 1244 stock" as an ordinary loss, rather than a capital loss.[5329]

"Section 1244 stock" is stock of a domestic corporation if:[5330]

- at the time such stock is issued, such corporation was a small business corporation,
- such stock was issued by such corporation for money or other property (other than stock and securities), and
- such corporation, during the period of its five most recent taxable years ending before the date the loss on such stock was sustained, derived more than 50% of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.

The corporation cannot be capitalized with more than $1 million adjusted basis of assets.[5331]

Although it applies to the sale of stock in an S corporation, it might not provide much of a benefit, as often such a loss arises from loss due to operations and therefore was already deducted as a loss on the K-1 issued to the shareholder each year. Similarly, this provision might not provide much of a benefit when choosing whether to be taxed as a corporation instead of a partnership, as often such a loss arises from loss due to operations and therefore was already deducted as a loss on the K-1 issued to the partners each year. Furthermore, S corporation shareholders and partners in a partnership would likely obtain a current deduction for such losses, rather than having to wait until their ownership is disposed of, and they would not be required to jump through any statutory hoops similar to Code § 1244 to obtain the ordinary loss deduction. For more information on the concepts described in this paragraph, see part II.G.4 Limitations on Losses.

[5326] Code § 1045(b)(2).
[5327] Trust, estates, and corporations are not eligible for this treatment. Code § 1244(d)(4); see Part II.J.11.b Code § 1244 Treatment Not Available for Trusts. Individuals may deduct losses flowing through partnerships if the partnerships were the original owners, and corporations may not claim this benefit. Reg. § 1.1244(a)-1(b)(2).
[5328] $100,000 if married filing jointly. Code § 1244(b).
[5329] Code § 1244(a).
[5330] Code § 1244(c).
[5331] Code § 1244(c)(3).

II.Q.7.m. Deferring Gain on Sale of Marketable Securities by Investing in a Specialized Small Business Investment Company

Generally, an individual may defer $50,000 or a corporation may defer $250,000 of gain on the sale of any publicly traded securities by reinvesting in a specialized small business investment company (SSBIC).[5332]

An SSBIC is any partnership or corporation licensed by the Small Business Administration under section 301(d) of the Small Business Investment Act of 1958 as in effect on May 13, 1993.[5333] That provision authorizes the licensing of small business investment companies organized to invest in small business concerns in such a way as to facilitate ownership by persons whose participation in the free enterprise system has been hampered by social or economic disadvantages.[5334]

II.Q.7.n. Selling Stock to an Employee Stock Ownership Plan (ESOP)

Code § 1042 defers the gain on the sale of stock to an ESOP. If the corporation is an S corporation, the deferral election may be made with respect to not more than 10% of the amount realized on such sale.[5335]

Under Code § 1042(e), qualified replacement property (QRP) is certain stock purchased with the proceeds of a sale of stock to an employee stock ownership plan (ESOP); this purchase allows the seller to defer gain on the sale, which deferred gain reduces the QRP's basis. Code § 1042(e) requires the deferred gain to be recognized if the seller later disposes of the QRP. Code § 1042(e)(3)(C) provides that a gift does not count as a Code § 1042(e) disposition. Divorce counts as such a gift; see part II.O.2.b Divorce – Income Tax Issues Relating to Buy-Sell Agreements.

II.Q.7.o. Reorganizing to Sell a Business That Is Less Than All of a Corporation's Assets

Suppose a business is being sold, and the corporation has nonoperating assets or other businesses that are not part of the sale.

Generally, the shareholders should form a new corporation with identical ownership, making the original corporation be a wholly owned subsidiary, with the original corporation contemporaneously being converted into an LLC that is treated as a disregarded entity for income tax purposes. This is a tax-free reorganization, with the LLC keeping its original tax ID and the new corporation getting its own tax ID but inheriting the old corporation's income tax attributes; see part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

Then the LLC can distribute to the parent whatever assets the corporation intends to keep. Generally, this presents less tax risk than keeping the old corporation's corporate status; see part II.P.3.a From Corporations to Partnerships and Sole Proprietorships.

[5332] Code § 1044.
[5333] Code § 1044(c)(3).
[5334] Federal Tax Coord. 2d ¶ I-3794.
[5335] Code § 1042(h).

If the parent is a C corporation, consider making an S election, converting to an LLC taxed as a partnership, or liquidating. See parts II.E.2 Comparing Exit Strategies from C Corporations and Pass-Through Entities and II.P.3.b Conversion from C Corporation to S Corporation.

I prefer not to keep liquidity from the sale in corporate format, because the owners may want different investment and distribution strategies, and separating a partnership is very likely to be much less painful than separating a corporation; compare part II.Q.7 Exiting from or Dividing a Corporation to part II.Q.8 Exiting From or Dividing a Partnership, being sure to read the FULL TABLE OF CONTENTS before diving into it. In most cases, I would prefer to move to partnership income taxation of nonbusiness assets as soon as we can, unless a significant owner has a relatively short life expectancy and the owners are willing until that person's death to liquidate; generally, one would convert to an S corporation and wait until at least 5 years after the S election to liquidate; especially consider parts II.P.3.b.ii Built-in Gain Tax on Former C Corporations under Code § 1374, II.P.3.b.iii Excess Passive Investment Income (may need to invest 3% of portfolio in oil & gas) and II.P.3.b.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds.

II.Q.8. Exiting From or Dividing a Partnership

See part II.Q.8.e.vi Required Documentation to Avoid Withholding on Sale or Redemption of Partnership Interest.

Below, a few themes emerge:

- Exiting a partnership in exchange for a portion of the partnership's assets can be a nontaxable event, in which the exiting partner's basis is reallocated among the distributed assets.[5336]

- Seller-financed redemptions for cash can save a level of capital gain tax, and the buyer and seller can come out ahead, if structured properly.

- If a partner contributes property with a basis not equal to its fair market value, and that partner or that property leaves the partnership within seven years of the contribution, beware of the tax effects!

Contrasting partnership and corporate tax-free divisions:

- A partnership division does not require a business purpose to be nontaxable, but a corporate division does. Generally, a partnership division is not taxable.[5337]

- Contrast a seven-year waiting period for partnership distributions (other than divisions) described further below with a five-year waiting period for corporate divisions. However, the waiting periods are for different reasons! In partnerships, it is to account for contributed property. In corporations, it is to make sure business activities are conducted continuously for at least five years.

[5336] See Abrams, Now You See It; Now You Don't: Exiting a Partnership and Making Gain Disappear, *TM Memorandum* (2/16/2009).

[5337] Reg. § 1.708-1(d).

Generally, the parties can designate whether a transaction constitutes a sale between partners or a redemption by the partnership.[5338]

See also part II.P.3.f Conversions from Partnership to Sole Proprietorships and Vice Versa.

Resources available to IRS examiners include those in part II.G.2.e IRS Practice Units.

II.Q.8.a. Partnership as a Master Entity

II.Q.8.a.i. Partnership Rules Allowing Basis Shifting

Partnerships provide the opportunity to shift basis from one asset to another, which can be helpful when it appears that a low basis asset will be sold; see part II.Q.8.b.i.(e) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property.[5339]

However, the partnership needs to be properly seasoned, which generally means at least 7 years from the time that property is contributed to the partnership until the time property is distributed.[5340] Changes in or issuances of partnership interests when the partnership has property with basis different from fair market value can also bring this 7-year waiting period into play.[5341]

If one has considerable marketable securities that one would like to be in a partnership, one should consider placing them in a partnership that has no business assets.[5342] Although the strategy described in this part II.Q.8.a is not geared toward marketable securities, if the estate is large enough then one might consider dividing the marketable securities into a few partnerships that move in different directions and using a series of rolling, asset-splitting GRATs to shift value to the next generation.[5343] This might be a good strategy for the cash generated from an equity-stripping transaction designed to obtain a basis step-up on real estate with minimal estate tax cost.[5344]

5338 Letter Ruling 9715008 (respecting the form of a sale between partners). The ruling relied on *Foxman v. Commissioner*, 41 T.C. 535, 551 (1964) (treating a transaction as a sale between partners), aff'd 352 F.2d 466 (3d Cir. 1965) and also cited *Cooney v. Commissioner*, 65 T.C. 101, 109 (1975) (treating a transaction as a redemption).

5339 Paul S. Lee of Northern Trust has been exploring this idea and has called this the mother ship partnership.

5340 See part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

5341 See text accompanying fn. 5444, which is part of the link from fn. 5340.

5342 Distributions of marketable securities from a partnership might be a taxable transaction. See parts II.Q.8.b.i.(a) Code § 731: General Rule for Distributions (distributions from a partnership generally do not generate income tax) and II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them) (special rules taxing such distributions). See particularly text accompanying fn. 5383 et. seq.

5343 See part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust, especially the text accompanying fn. 6504.

5344 See part II.H.10 Extracting Equity to Fund Large Gift. This strategy requires leveraging and maintaining a security interest in loan proceeds, and placing different baskets of marketable securities into separate LLCs (that start as single member LLCs but sooner or later become taxed as partnerships)

The basis shifting opportunity might work best when few assets are involved. Furthermore, generally it requires a Code § 754 election to be in effect, and such an election requires record-keeping that is often quite complex.[5345] Thus, one might consider dividing the partnership and making the Code § 754 election only with respect to the property involved in the basis shifting strategy.[5346]

Various basis stripping strategies involve plays on differences between outside basis and inside basis.[5347] A transfer of a partnership interest allocates basis according to the value of the transferred interest, rather than according to the proportion of rights to income, distributions, etc.[5348]

One might consider having any marketable securities be held in their own partnership that qualifies as an "investment partnership." See part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them).

Also, note that certain assets are not conducive to non-pro rata distributions of property. See part II.Q.8.b.i.(g) Code § 751 – Hot Assets. To the extent practicable, one might consider holding such assets in a separate partnership and leasing them to the businesses they serve.[5349] Consider the effect, if any, this isolation of leasing activity might have on the passive loss rules and the 3.8% net investment income tax.[5350]

Similarly, consider whether consolidating assets inside of a partnership affects the passive loss grouping rules,[5351] which impact not only the use of passive losses and credits but also the 3.8% tax on net investment income.[5352]

Check to see whether the applicable jurisdiction imposes fees or taxes on partnerships or LLCs.[5353]

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can facilitate maintaining this security interest. See part II.H.10.d Maintaining the Security Interest in the Loan Proceeds If Using a Donee Guarantee.

[5345] See generally part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

[5346] See part II.Q.8.d Partnership Division, especially fn. 5578 (division should result in identical percentage interests before and after the division for each partnership).

[5347] For an example, see part II.Q.8.e.iii.(a) Illustration of Inside Basis Issue. For a more generic description of inside basis and outside basis, see my blog article, "Tax basis: The key to reducing gain on sale or deducting asset purchases," at http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions/post/2017-01-10/tax-basis-the-key-to-reducing-gain-on-sale-or-deducting-asset-purchases.

[5348] See part II.Q.8.e.ii.(a) Unitary Basis.

[5349] Leasing tangible personal property generally constitutes self-employment income, whereas leasing real generally does not. See part II.L.2.a.ii Rental Exception to SE Tax.

[5350] See parts II.K Passive Loss Rules and II.I 3.8% Tax on Excess Net Investment Income (NII), especially II.K.1.e Rental Activities.

[5351] See part II.K.1.b Grouping Activities.

[5352] See part II.I.8 Application of 3.8% Tax to Business Income, especially part II.I.8.a.ii Passive Activity Grouping Rules.

[5353] For example, New York City imposes a 4% tax on unincorporated business organizations.

II.Q.8.a.ii. Caution When Using Master Entity If Liquidity Needed to Pay Estate Tax

Estate tax generated by business interests can be deferred. Obtaining a deferral for a year or two does not require any special structuring.[5354] Obtaining longer deferrals requires the right structure and involves more uncertainty with partnerships than with corporations.[5355]

If one places assets in a master partnership, consider whether those might affect the owner's estate's ability to make a Code § 6166 to defer estate tax if the owner has insufficient liquidity.[5356] If the partnership is merely a holding entity and does not itself engage in business activity, it might be considered a nonbusiness asset ineligible for such an election.[5357]

II.Q.8.a.iii. Examples of Using Partnership to Shift Basis

II.Q.8.a.iii.(a). Applying Outside Basis to Very Low Inside Basis

Each of A, B, and C invests $500 in a partnership that uses its $1,500 capital to buy land: Parcel X for $100 and Parcel Y for $1,400.

Parcel X grows in value to $900, and Parcel Y increases in value to $1,800. Thus, the partnership's assets are worth $2,700 ($900 plus $1,800). Thus, ignoring valuation adjustments, each partner's interest is worth $900 ($2,700 divided by 3).

The partnership distributes Parcel X to C in liquidation of C's partnership interest. C's $500 basis is applied to Parcel X, increasing its basis from $100 to $500.

If a Code § 754 election is not in place, then Parcel Y's basis does not change.

Although as a group the partners have managed to increase the real estate's tax basis, C did not get a great deal. If C sells Parcel X, C recognizes a $400 gain ($900 value minus its new $500 basis). If the partnership had sold Parcel X, the $800 gain ($900 value minus $100 basis before the distribution), then each partner (including C) would recognize a $267 gain ($800 divided by 3). Thus, C would pay tax on $133 more gain ($400 minus $267) than if the partnership had not distributed Parcel X. On the other hand, C is relieved of responsibility for $133 gain inherent in Parcel Y ($1,800 value minus $1,400 basis equals $400 gain; $400 gain divided by 3 partners equals $133).

II.Q.8.a.iii.(b). Basis Stripped from Distributed Property and Applied to Remaining Property

Each of D, E, and F contributes $200 to a partnership, which uses its $600 contributions to buy land: $200 for Parcel M and $400 for Parcel N. Parcel M increases in value to $400, and Parcel N decreases in value to $200. The partnership distributes Parcel N to F in redemption of F's partnership interest. Parcel N's basis is reduced to F's $200 basis, which is a $200 ($400 basis inside the partnership minus $200 in F's hands) basis reduction. If the

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[5354] See part III.B.5.e.i Overview of Discretionary Extensions Under Section 6161.
[5355] See part III.B.5.e.ii Code § 6166 Deferral.
[5356] See part III.B.5.e.ii Code § 6166 Deferral, especially part III.B.5.e.ii.(a) What is a Business?
[5357] Code § 6166(b)(9). Although Code § 6166(b)(8) provides special rules making corporate holding companies eligible, it does not apply to partnership holding companies. For more details, see fn. 7088.

partnership has a Code § 754 election in place, the $200 basis that is stripped from Parcel N is added to the basis of Parcel M, which is increased from $200 to $400.

II.Q.8.a.iii.(c). Basis Stripped from New Property and Applied to Existing Property

Each of G, H, and I contributes $100 to a partnership, which buys Parcel T (raw land) for $300. Parcel T's value increases to $900, and the partners take advantage of this value increase by causing the partnership to borrow $600 (which is $200 debt per partner) and distribute that $600 equally to G, H and I ($600 divided by 3 equals $200 distribution each), resulting in each having a capital account of -$100 ($100 initial contribution minus $200 distribution), which also happens to equate to $100 debt in excess of basis ($200 share of debt minus $100 original capital contribution). Note that each partner's share of Parcel T's unrealized appreciation is $200, which is $600 ($900 value minus $300 basis) divided by 3.

The partnership borrows $300 to buy Parcel U (raw land) for $300. Parcel U retains its value. Thus, the partnership's net value continues to be $300, which is the excess of the $1,200 values of Parcels T ($900) and U ($300) over the partnership's debt of $900 ($600 on Parcel T and $300 on Parcel U).

The partnership distributes Parcel U to G to redeem G's partnership interest. G assumes $200 of the debt on Parcel U, and the partnership shifts $100 of the debt on Parcel U to Parcel T. Thus, G receives $100 net value ($300 value of Parcel U minus $200 debt assumed). The basis of G's partnership interest before the distribution was $200, consisting of $100 original contribution plus $300 debt (1/3 of the partnership's $900 debt before distribution) minus $200 prior cash distribution. On the distribution, G assumed $200 of debt and was relieved of $300 of debt, for a net reduction in debt of $100. This $100 net debt reduction is treated as a $100 cash distribution. Thus, the basis of G's partnership interest after the distribution is $100 ($200 basis before distribution minus $100 deemed distribution), and G recognizes no gain or loss on the redemption on G's partnership interest. After the redemption:

- Parcel U's basis is reduced from its original $300 to the $100 basis of G's partnership interest. This $200 basis strip ($300 original basis minus $100 remaining basis) from Parcel U will be applied to increase the partnership's basis in Parcel T from its initial $300 to a new $500 if the partnership has a Code § 754 election in effect.

- G winds up with Parcel U with a $300 value, $100 basis, and a $200 debt. Thus, the net value of G's position is $100 ($300 value minus $200 debt). Before the redemption, G had net debt in excess of basis of $100; after the redemption, G continues to have $100 debt in excess of basis ($200 debt minus $100 basis in Parcel U).

- The partnership has Parcel T with $900 value, $500 basis, and $700 debt ($600 from the original borrowing and $100 from Parcel U). Thus, the partnership has property with $400 value in excess of basis ($900 value minus $500 basis), which is $200 value in excess of basis per partner ($400 divided by 2 partners), the same as before the redemption. Furthermore, the partnership has $200 debt in excess of basis ($700 debt minus $500 basis), which translates to each partner having $100 debt in excess of basis ($200 divided by 2 partners).

Has the partnership made a disguised sale of Parcel U to G? See Reg. § 1.707-6(b)(2).

II.Q.8.a.iii.(d). Basis Shift When Parent Owns Large Majority

Parent owns 98%, Son owns 1%, and Daughter owns 1% of a partnership. The partnership has land that the partnership previously bought that has $100 value and $100 debt, so the partnership has net equity of zero and each partner's interest is worthless. Based on prior distributions that zeroed out everyone's basis, Parent is allocated $98 debt in excess of basis, and each of Son and Daughter is allocated $1 debt in excess of basis ($2 total).

Partnership plans to sell the property would result in $98 gain to Parent, $1 gain to Son, and $1 gain to Daughter.

Instead, Parent contributes $25 to the partnership, which the partnership uses, together with $100 of additional borrowing to buy Parcel Q (land) for $125.

The partnership then redeems Parent, distributing Parcel Q and its associated $100 debt to Parent. Parent's basis in Parent's partnership interest before the redemption was $123, which comes from $98 original debt plus $98 new debt (98% of the $100 borrowed to buy Parcel Q) plus $25 contributed toward the purchase of Parcel Q minus $98 prior distributions. In the redemption, Parent assumed the $100 debt but was relieved of Parent's $196 ($98 original debt plus $98 new debt) share of liabilities before the redemption, the basis of Parent's partnership interest decreased by $96 ($196 liabilities relieved minus $100 liabilities assumed) to $27 ($123 minus $96). Thus, Parcel Q's basis deceases from its original $125 basis to $27 (the basis of Parent's partnership interest), a $98 reduction in basis. If the partnership has a Code § 754 election in place, this $98 basis strip from Parcel Q translates into a $98 increase in the basis of the original land.

After the redemption, each of Son and Daughter owns one half of the partnership. The partnership has the original land, with a value of $100, basis of $98, and liabilities of $100. When Parent was redeemed, Son and Daughter assumed the partnership's original debt, so their share of liabilities increases by $98 from $2 combined to $100 combined. Their basis increases correspondingly, so that, instead of having $2 debt in excess of basis, they have $98 debt in excess of basis ($100 liabilities allocated minus $2 prior distributions).

Thus, when the partnership sells the original property for $100, the partnership recognizes a $2 gain ($100 proceeds minus $98 basis), the same $2 gain that would have been allocated to Son and Daughter if Parcel Q had never come into the picture.

The difference is in Parent's treatment. Parent would have been allocated $98 gain before Parcel Q came into the picture. Now, Parent does not pay any tax on the sale of the original land. Instead, the basis of Parcel Q has been reduced by $98 because of the redemption. If Parent holds Parcel Q until death, Parcel Q's unrealized gain is wiped out by a basis step-up.

II.Q.8.b. Partnership Redemption or Other Distribution

II.Q.8.b.i. Distribution of Property by a Partnership

Distributions to a partner may be taxable under Code §§ 731, 704(c)(1)(B), and 737.[5358] After the parts describing Code § 731 are the discussions of the other two sections, followed by part II.Q.8.b.i.(d) Capital Accounting May Trigger Ordinary Income.

II.Q.8.b.i.(a). Code § 731: General Rule for Distributions

Partnership distributions of property are usually tax-free to both the partnership and the partner under Code § 731(a) and (b), whether current distributions or liquidating distributions.[5359]

A loan from a partnership to a partner who is obligated to repay the amount of the loaned money or property does not constitute a distribution subject to Code § 731 but is a loan governed by Code § 707(a). To the extent that such an obligation is canceled, the obligor partner will be considered to have received a distribution of money or property at the time of cancellation.[5360] The partnership has taxable income or loss in an amount equal to the difference between its basis in the distributed debt and the debt's fair market value at the time of the distribution, just as if the partnership had sold the debt for this amount and distributed the sale proceeds to the distributee-partner-debtor. The distributee-partner generally does not recognize any gain on the distribution unless the amount of the distribution exceeds the basis of his interest and, unless the special liquidating distribution rule in Code § 731(a)(2) applies, does not recognize a loss; however, the distributee-partner might recognize cancellation-of-indebtedness income on the deemed purchase of the debt.[5361]

The IRS treats differently partner indebtedness that the partnership bought from a third party. In that case, if the partnership distributes (in a liquidating or nonliquidating distribution) the indebtedness to the partner so that the debt is extinguished, the distribution of property rules will apply to determine the consequences for the partnership. Under Code § 61(a)(12) (and Reg. § 1.61-12(c)(2)), the partner is treated as having repurchased its indebtedness for an amount equal to the fair market value of the indebtedness and therefore will recognize capital gain or loss to the extent the fair market value of the indebtedness differs from the basis of the indebtedness determined under Code § 732.[5362]

CCA 201525010 stated, "The regulations under § 752 do not determine if a debt is recourse or nonrecourse to a partnership for purposes of determining whether, upon foreclosure of the property, the partnership has cancellation of debt income under § 61(a)(12) or gains from dealings in property under § 61(a)(3)." A panel at the May 2016 meeting of the ABA Section on Taxation seemed to disagree with the assumption of the parties in *Great Plains Gasification Associates v. Commissioner*, T.C. Memo. 2006-276, that certain debt was nonrecourse based

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[5358] Partnership distributions might also be subject to the anti-abuse rules (regulations issued under Code § 701), which was asserted in CCA 200650014 when a partnership acquired real estate to be distributed to a partner and that partner was allocated all of the economic risks of that real estate purchase.
[5359] Reg. § 1.731-1(a)(1)(i).
[5360] Reg. § 1.731-1(c)(2).
[5361] McKee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners* (WG&L), ¶ 19.02[5] Distributions of a Partner's Debt to the Debtor-Partner. Letter Ruling 201314004 confirmed the Code § 731 aspects of such a distribution but did not address any other issues.
[5362] Rev. Rul. 93-7.

on Code § 752. The author of CCA 201525010 indicated that the CCA was not just her view but rather was a consensus approach at the IRS.

A deficit capital account is not by itself sufficient to establish the creation of a loan. Similarly, the fact that on a final accounting the partners will take a deficit capital account into consideration is not sufficient to create an obligation to repay a loan. If there is no unconditional and legally enforceable obligation that requires a partner to repay any of the amounts withdrawn to the partnership on or before a determinable date, then withdrawals by that partner that created a deficit in his capital account are not loans governed by Code § 707(a) but are partnership distributions received by him in his capacity as a partner. Rev. Ruls. 73-301, 81-241.

Exceptions to the rule of tax-free distributions include:

- Part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

- Part II.Q.8.b.i.(g) Code § 751 – Hot Assets. Even if "hot assets" can be distributed tax-free under Code § 731(a), they may be tainted in terms of generating ordinary income when sold. For the latter, see part II.Q.8.b.i.(h) Characteristics of Distributed Property.

- Part II.M.3.e Exception: Disguised Sale.

Also, Code § 731(a)(1) requires a partner to recognize gain on a monetary distribution when the distribution exceeds the partner's adjusted basis in the partnership;[5363] for the taxation of any gain, see part II.Q.8.e.ii Transfer of Partnership Interests: Effect on Transferring Partner. A reduction in a partner's share of liabilities[5364] is considered a cash payment in the amount of the liabilities discharged.[5365] The amount of gain recognized is the excess of the distribution over

[5363]Code § 731(a)(2) explains potential loss recognition consequences of a partnership distribution.
[5364] See part II.C.3 Allocating Liabilities (Including Debt).
[5365] Rev. Rul. 74-40, Situations 2 and 3 are most relevant, but let's look at all three for the sake of completeness. Situation 1 involved the following facts and conclusions:

> L is a limited partner in partnership GL to which he contributed $10,000 in cash on its formation. His distributive share of partnership items of income and loss is 10 percent and he is not entitled to receive any guaranteed payments. The adjusted basis of his partnership interest at the end of the current year is $20,000. His proportionate share of partnership liabilities, on which neither he, the other partners nor the partnership have assumed any personal liability, is $15,000. The partnership has no other liabilities. L sells his interest in the partnership to M, an unrelated taxpayer, for $10,000 in cash. At the time of the transaction the partnership had no unrealized receivables or inventory items described in section 751 of the Internal Revenue Code of 1954 nor any goodwill and L had been paid his distributive share of partnership income.
> [Citations to Code §§ 752(c) and 741 and to Reg. §§ 1.752-1(e) and 1.751-1(d) follow.]
> Accordingly, in the instant situation, the amount realized by L from the sale of his partnership interest is $25,000, consisting of cash in the amount of $10,000 and release from his share of partnership liabilities in the amount of $15,000. Since the adjusted basis of L's interest in the partnership is $20,000, he realized a gain of $5,000 determined under the provisions of section 741 of the Code.

Situation 2 involved the following facts and conclusions:

the partner's adjusted basis;[5366] basis in a partnership interest includes any partnership debt allocated to it.[5367] If the partnership distributes cash and property to a partner in the same transaction, the partner applies the cash to basis and then allocates basis to the property distributed.[5368] However, if a liquidating distribution consists of only cash, unrealized receivables, or inventory with an adjusted basis to the recipient partner that is less than the partner's adjusted basis in the partnership, then the partner would recognize loss.[5369]

However, special rules apply to marketable securities, which might be treated as cash for purposes of Code § 731(a)(1) and therefore might trigger gain on distributions.[5370]

August, "The Debt Cancellation Culture of Section 108: Tax Hurdles for Partnerships Engaged in Debt Workouts," *Corporate Taxation* (WG&L), Sep/Oct 2023, explains "Partnership Transfer or Distribution of Encumbered Property on Disposition of Partnership Interest":

> Section 731(a) provides that a partner will realize gain from a distribution of money, including a deemed distribution resulting from a reduction in share of partnership liabilities under Section 752(b), in excess of his aggregate basis in the partnership. Where the partnership distributes property that is subject to an indebtedness, the partner

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> The facts are the same as in situation 1, except that L withdraws from the partnership and the partnership distributes $10,000 to him in cash in complete liquidation of his interest in the partnership.
>
> [Citations to Code §§ 752(b), 731(a), 731(c) and 736 and to Reg. § 1.736-1(b)(1) follow.]
>
> Accordingly, in the instant situation, distributions to L with respect to his partnership interest total $25,000 and consist of cash in the amount of $10,000 and a decrease in his share of the partnership liabilities in the amount of $15,000 that is considered under section 752(b) of the Code as a distribution of money to L by the partnership.
>
> Furthermore, since the money distributed ($25,000) exceeds the adjusted basis of L's interest in the partnership immediately before the distribution ($20,000), he realizes a gain of $5,000 determined under the provisions of section 731(a) of the Code.

Situation 3 involved the following facts and conclusions:

> Instead of selling his interest L withdraws from the partnership at a time when the adjusted basis of his interest in the partnership is zero and his proportionate share of partnership liabilities, all of which consist of liabilities on which neither he, the other partners nor the partnership have assumed any personal liability, is $15,000.
>
> Accordingly, L is considered to have received a distribution of money from the partnership of $15,000 and realizes a gain of $15,000 determined under the provisions of section 731(a) of the Code.

See also Rev. Rul. 77-402 (similar result when grantor trust status terminates with respect to a partnership interest), discussed in fn. 6591, found in part III.B.2.a Tax Basis Issues When Using Irrevocable Grantor Trusts, and Rev. Rul. 75-194 (deemed bargain sale of partnership interest contributed to charity), discussed in part II.Q.6.b Possible Deemed Sale or Reduced Deduction When Contributing Partnership Interest to Charity.

[5366] Code § 731(a)(1).

[5367] See part II.C.3 Allocating Liabilities (Including Debt), especially part II.C.3.a Basic Consequences of Changes in Liability Allocations.

[5368] Although Code § 731 and the regulations thereunder do not appear to address this issue, Reg. § 1.732-1(a) and (b) implicitly mandate this result when determining the basis of assets distributed to a partner.

[5369] Code § 731(a)(2).

[5370] See part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them).

will be taxable only to the extent that the amount of money distributed exceeds the basis of the distributee partner's interest in the partnership immediately before the distribution.

Where the partnership distributes encumbered property proportionately among the partners, then the distributee partners will not receive a deemed distribution of money under Section 752(b) because the amount of liability each partner assumes under Section 752(a) will generally equal the amount of liability that such partner is relieved of as a result of the distribution. It is now clear that increases and decreases in a distributee partner's liabilities occurring by reason of a liquidating or non-liquidating distribution are deemed to occur simultaneously for purposes of determining gain or loss under Section 731.[80]

[80] See Section 752(c).

If a partnership makes a disproportionate distribution of encumbered property, then any partner who receives less than his proportionate share of the encumbered property may be required to pick up gain under Section 751(b) . That's a fairly complex jigsaw puzzle that requires a thorough review. The result could also be an inside basis increase to the partnership. Again, "do the math!" As mentioned, a deemed distribution of money for liability reduction previously allocated to a partner may result in taxable gain under Section 731(a). Such gain is not eligible for exclusion under Section 108.

See parts II.C.3.c Allocations of Recourse and Nonrecourse Liabilities, II.G.31.b Debt Forgiveness (which includes more from August's article), and II.Q.8.b.i.(g) Code § 751 – Hot Assets.

II.Q.8.b.i.(b). Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them)

Although marketable securities are not normally considered cash for income tax purposes, they are treated as "money" for purposes of Code § 731(a)(1) gain calculation.[5371] Thus, distributions of marketable securities can result in gain under Code § 731(a)(1), if the total amount of money and securities distributed is higher than the adjusted basis of the partner's partnership interest. Beware that "marketable securities" means not only financial instruments[5372] and foreign currencies which are, as of the date of the distribution, actively traded,[5373] but also:[5374]

- any interest in a common trust fund or a regulated investment company, the latter which is offering for sale or has outstanding any redeemable security[5375] of which it is the issuer,

[5371] Code § 731(c)(1). Marketable securities are defined in Code § 731(c)(2)(A) as financial instruments and foreign currencies which are, as of the date of distribution, actively traded. Code § 731(c)(2)(B) includes mutual funds, derivatives and various other financial instruments. Code § 731(c)(2)(C) defines financial instruments to include stocks and other equity interests, evidences of indebtedness, options, forwards, futures, notional principal contracts and derivatives.
[5372] Financial instrument includes stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, and derivatives. Code § 731(c)(2)(C). Letter Ruling 200651023 held that Code § 731(c)(2)(C) does not apply to life insurance policies, which are "neither money nor marketable securities."
[5373] Code § 731(c)(2)(A).
[5374] Code § 731(c)(2)(B).
[5375] As defined in section 2(a)(32) of the Investment Company Act of 1940. Code § 731(c)(2)(B)(i)(II).

- any financial instrument which, pursuant to its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities,[5376]

- any financial instrument the value of which is determined substantially by reference to marketable securities,

- except to the extent provided in regulations, any interest in a precious metal which, as of the date of the distribution, is actively traded[5377] unless such metal was produced, used, or held in the active conduct of a trade or business by the partnership,

- except as otherwise provided in regulations, interests in any entity[5378] if substantially all of the assets[5379] of such entity consist (directly or indirectly) of marketable securities, money, or both, and

- to the extent provided in regulations,[5380] any interest in an entity[5381] not described in the preceding bullet point to the extent of the value of such interest which is attributable to marketable securities, money, or both.

However, two exceptions to the "marketable securities are money" rule of Code § 731(c) often apply. First, a marketable security is not treated as money if the security was contributed to the partnership by the partner receiving the distribution, except to the extent the security's value is attributable to other marketable securities or money contributed to the entity to which the distributed security relates.[5382] Second, Code § 731(c) does not apply to distributions of

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[5376] FSA 200219008 asserted that short-term (nine-month) debt instruments issued by a bank should be treated as financial instruments that were readily convertible into money. The IRS probably viewed them as the equivalent of certificates of deposit.
[5377] Within the meaning of Code § 1092(d)(1). Code § 731(c)(2)(B)(iv).
[5378] According to Letter Ruling 200223036, this includes a partnership division under part II.Q.8.d Partnership Division. More details on the Letter Ruling are at fn. 5608.
[5379] Reg. § 1.731-2(c)(3)(i) provides:

> *Substantially all*. For purposes of section 731(c)(2)(B)(v) and this section, substantially all of the assets of an entity consist (directly or indirectly) of marketable securities, money, or both only if 90 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

This rule also applies for purposes of the investment company rules that might trigger gain recognition when a partnership is formed. See part II.M.3.b Exception: Diversification of Investment Risk.
[5380] Reg. § 1.731-2(c)(3)(ii) provides:

> *Less than substantially all*. For purposes of section 731(c)(2)(B)(vi) and this section, an interest in an entity is a marketable security to the extent that the value of the interest is attributable (directly or indirectly) to marketable securities, money, or both, if less than 90 percent but 20 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

This rule also applies for purposes of the investment company rules that might trigger gain recognition when a partnership is formed. See part II.M.3.b Exception: Diversification of Investment Risk.
[5381] Letter Ruling 200223036 provides helpful analysis of the consequences of a situation similar to this arising from a partnership division. See fn. 5608.
[5382] Code § 731(c)(3)(A)(i); Reg. § 1.731-2(d)(1)(i). Letter Rulings 201537002 and 201537003 applied that rule to replacement stock certificates (referring to Reg. § 1.1012-1(c)(2)) for purposes of this rule and Code §§ 704(c)(1)(B) and 737; the rulings appear to be merely comfort rulings, because nothing jumped out at me as in doubt.

marketable securities by investment partnerships to eligible partners.[5383] An investment partnership is defined in Code § 731(c)(3)(C)(i) as a partnership that never has been engaged in any trade or business[5384] and whose assets have always substantially consisted of money, stock, notes and bonds, interest rate or currency contracts, foreign currencies, interests in or derivate financial instruments, and other specifically prescribed assets; and an eligible partner is a partner who has contributed only the aforementioned types of assets to the partnership.[5385] With regard to investment partnership status, remember that, if the partnership owns an interest in an entity that is a disregarded entity or partnership for federal income tax purposes, that entity's activity will be treated as a trade or business activity of the holding partnership. Thus, it could be beneficial to set up two partnerships and have one hold the assets that will prevent investment partnership status and another that would be an investment partnership. Furthermore, certain investment partnerships formed with almost all contributions being in the form of cash might be eligible for avoiding the mandatory inside basis step-down that applies when certain transfers of partnership interests or assets occur when a partnership has significant loss assets.[5386]

Two more exceptions might not apply frequently but are still important to note. First, if the security was acquired in a nonrecognition transaction and the value of the securities and money exchanged in that nonrecognition transaction is less than 20% of the value of all the assets exchanged in the nonrecognition transaction, the securities will not be considered money.[5387] Additionally, the security is not treated as money if it was not a marketable security on the date the partnership acquired it and the issuing entity did not have any outstanding marketable securities at that time, the partnership held the security for at least six months before it became

[5383] Reg. § 1.731-2(e)(1). An eligible partner includes a remainderman of a trust that was an eligible partner. Letter Rulings 200824005 and 200824009. This includes the remaindermen when the LLC starts as a disregarded entity and becomes a partnership when distributed to the remaindermen. Letter Ruling 201421001 (described more fully in fn. 372). However, it does not include the transferor or transferee in a nonrecognition transaction involving a transfer of any portion of an interest in a partnership with respect to which the transferor was <u>not</u> an eligible partner. Code § 731(c)(3)(C)(iii)(II). The committee reports to P.L. 103-465 (12/8/94) explained:

> A partner who is not an eligible partner may not remove the taint from his partnership interest by transferring any portion of his interest to another person in a transaction in which gain or loss is not recognized in whole or in part.

This may suggest a more limited scope to Code § 731(c)(3)(C)(iii)(II), but the regulations did not adopt any such limitation, so I would not rely on this suggestion of limited scope for planning purposes. The implicit corollary to the above is that, if the transferor is an eligible partner with respect to the transferor's entire partnership interest, a transferee partner in a nonrecognition transaction is also an eligible partner.

[5384] Reg. § 1.731-2(e)(4) provides:

> *Partnership tiers*. For purposes of section 731(c)(3)(C)(iv) and this section, a partnership (upper-tier partnership) is not treated as engaged in a trade or business engaged in by, or as holding (instead of a partnership interest) a proportionate share of the assets of, a partnership (lower-tier partnership) in which the partnership holds a partnership interest if—
>
> (i) The upper-tier partnership does not actively and substantially participate in the management of the lower-tier partnership; and
>
> (ii) The interest held by the upper-tier partnership is less than 20 percent of the total profits and capital interests in the lower-tier partnership.

[5385] Code § 731(c)(3)(C)(iii). Investment partnerships, as defined in 86 Ill. Admin. Code § 100.9730, are also exempted from the Illinois replacement tax that generally would otherwise apply to an Illinois partnership. 35 ILCS 5/205(b).

[5386] See text accompanying footnote 5712.

[5387] Reg. § 1.731-2(d)(1)(ii).

marketable, and the partnership distributed the security within five years of when it became marketable.[5388]

In addition to these four general exceptions to Code § 731(c), Code § 731(c)(3)(B) limits the amount of marketable securities treated as money, thereby limiting the amount of gain a recipient partner has to recognize. The limitation is calculated by first determining the partner's share of the partnership's built-in gain in all of its marketable securities, before the distribution is made.[5389] From this amount you subtract the partner's distributive share of the built-in gain that is attributable to marketable securities held by the partnership immediately after the transaction.[5390] The end result is the amount of marketable securities that are treated as "property other than money." Thus, to the extent a distribution of marketable securities does not decrease the recipient's share of built-in gain, the recipient will not be taxed under Code § 731(c). In other words:

- Try to make sure that each person retains a proportionate amount of unrealized appreciation.

- If the parties miss the mark a little, then they are taxed on shifted unrealized appreciation only to the extent that they missed the mark.

- Consider that any tax imposed will increase basis. Given that marketable securities tend to turn over anyway, part or all of the tax due to missing the mark a little might very well be saved when the marketable securities are later sold.

II.Q.8.b.i.(c). Disguised Sale from Partnership to Partner

A distribution of property from a partnership to a partner may be recharacterized as sale of that property in exchange for the partner's contribution of cash or property.[5391] Generally, one would apply rules similar to those described in part II.M.3.e Exception: Disguised Sale.[5392]

Thus, when a partnership distributes property and within two years after the distribution the recipient contributes cash, the partnership is deemed to have sold the property if the rules described in part II.M.3.e Exception: Disguised Sale would have recharacterized the opposite transaction.[5393]

[5388] Reg. § 1.731-2(d)(1)(iii).
[5389] Code § 731(c)(3)(B); Reg. § 1.731-2(b)(2).
[5390] *Id*.
[5391] Reg. § 1.707-6(a) provides:

> Rules similar to those provided in § 1.707-3 apply in determining whether a transfer of property by a partnership to a partner and one or more transfers of money or other consideration by that partner to the partnership are treated as a sale of property, in whole or in part, to the partner.

[5392] See fn. 5391, in which Reg. § 1.707-6(a) refers to Reg. § 1.707-3.
[5393] Reg. § 1.707-6(d), Example (1), "Sale of property by partnership to partner," provides:

> (i) A is a member of a partnership. The partnership transfers property X to A. At the time of the transfer, property X has a fair market value of $1,000,000. One year after the transfer, A transfers $1,100,000 to the partnership. Assume that under the rules of section 1274 the imputed principal amount of an obligation to transfer $1,100,000 one year after the transfer of property X is $1,000,000 on the date of the transfer.

Disclosure rules similar to those described in part II.M.3.e Exception: Disguised Sale would apply.[5394]

II.Q.8.b.i.(d). Capital Accounting May Trigger Ordinary Income

If a distribution (including client-based intangibles – taking clients with you) has a fair market value that exceeds the distributee's capital account, then the usual "qualified income offset" provision may trigger ordinary income to the distributee if the partnership agreement does not have "substantial economic effect" and values the distribution in a manner that drives the distributee's capital account negative.[5395] When the client-based intangibles, which had a book value of zero, were distributed with a significant book value, the increase in book value was allocated to the remaining partners rather than to the distributees. If enough of the increase in book value had been allocated to the distributees, the distributees' capital account could have been zero rather than negative as a result of the distribution. Using target allocations and adjusting book values to match the distributions may have prevented that result.

Therefore, when a partner receives a distribution, consider analyzing the effect and including in the withdrawal agreement provisions to address that possible result. Possible approaches include:

- No gain or loss on distribution.
- The partnership recognizes capital gain on the sale of the asset and allocates it to the distributee.[5396]
- The allocation of ordinary income described above. However, further analysis would be required to determine how confident one can be in advising clients that they can attain this ordinary income result.

(ii) Since the transfer of $1,100,000 to the partnership by A is made within two years of the transfer of property X to A, under rules similar to those provided in § 1.707-3(c), the transfers are presumed to be a sale unless the facts and circumstances clearly establish otherwise. If no facts exist that would rebut this presumption, on the date that the partnership transfers property X to A, the partnership is treated as having sold property X to A in exchange for A's obligation to transfer $1,100,000 to the partnership one year later.

[5394] Reg. § 1.707-6(c) provides:
Disclosure rules. Similar to the rules provided in §§ 1.707-3(c)(2) and 1.707-5(a)(7)(ii), a partnership is to disclose to the Internal Revenue Service, in accordance with § 1.707-8, the facts in the following circumstances:
(1) When a partnership transfers property to a partner and the partner transfers money or other consideration to the partnership within a two-year period (without regard to the order of the transfers) and the partnership treats the transfers as other than a sale for tax purposes; and
(2) When a partner assumes or takes subject to a liability of a partnership in connection with a transfer of property by the partnership to the partner, and the partnership incurred the liability within the two-year period prior to the earlier of the date the partnership agrees in writing to the transfer of property or the date the partnership transfers the property, and the partnership treats the liability as a qualified liability under rules similar to § 1.707-5(a)(6)(i)(B).

[5395] For more details, see the text accompanying and preceding fn 510 in part II.C.7 Maintaining Capital Accounts.

[5396] See part II.Q.1.c Personal Goodwill and Covenants Not to Compete, especially subpart II.Q.1.c.i Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation.

II.Q.8.b.i.(e). Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property

When the distribution is a liquidating distribution, the partner's adjusted basis in the distributed property is equal to the adjusted basis of the partner's interest in the partnership, less any money distributed.[5397] Therefore, if a high basis partnership interest is redeemed in exchange for low basis property, the property receives a new basis equal to the basis of the redeemed partnership interest;[5398] this basis increase has no consequences to the partnership if a Code § 754 election is not in place (and certain mandatory basis adjustments are not in effect)[5399] and no consequences to the redeemed partner or other partners so long as none of the exceptions to the nonrecognition apply.[5400] The consequence would be a basis reduction.[5401] However, this basis reduction would apply only to the extent of any unrealized losses in the partnership's assets; it would not reduce the basis of any assets with unrealized gains.[5402]

In non-liquidating distributions, the partner's adjusted basis in the property distributed is simply the partnership's adjusted basis in the property before the distribution.[5403] However, the partner's adjusted basis in the distributed property cannot exceed his adjusted basis in his partnership interest less any money distributed at the same time.[5404]

The substituted basis portion continues the contributing partner's depreciation schedule.[5405]

If a transferee partner receives a distribution of property from the partnership within two years after acquiring an interest or part thereof in the partnership by a transfer with respect to which a Code § 754 election was not in effect, the partner may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have as if a Code § 754 election were in effect; see part II.Q.8.e.iii.(e) Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election. This applies whether or not the distribution liquidates the partnership interest.

However, when a partnership distributes unrealized receivables (Code § 751(c)) or substantially appreciated inventory items (Code § 751(d)) in exchange for any part of a partner's interest in

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[5397] Code § 732(b).
[5398] Code § 732(b).
[5399] Part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, fn. 3184 briefly describes the effect on basis when a Code § 754 election is in place or in connection with certain substantial built-in loss transactions.
[5400] For possible exceptions to nonrecognition, see parts II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them), II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, and II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.
[5401] See part II.Q.8.e.iii.(e) Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election.
[5402] See fn. 4241, found in part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.
[5403] Code § 732(a)(1).
[5404] Code § 732(a)(2).
[5405] Code § 168(i)(7).

other partnership property (including money), or, conversely, partnership property (including money) other than unrealized receivables or substantially appreciated inventory items in exchange for any part of a partner's interest in the partnership's unrealized receivables or substantially appreciated inventory items, the distribution will be treated as a sale or exchange of property under the provisions of Code § 751(b).[5406] In such case, Code § 732 determines the partner's basis of the property which the partner is treated as having sold to or exchanged with the partnership (as constituted after the distribution); the partner is considered as having received such property in a current distribution and, immediately thereafter, as having sold or exchanged it.[5407] However, Code § 732 does not apply in determining the basis of that part of property actually distributed to a partner which is treated as received by the partner in a sale or exchange under Code § 751(b), so the basis of such property shall be its cost to the partner.[5408]

The rule that assets received in a liquidating distribution get a basis equal to the liquidated partnership interest's basis can result in the liquidated asset receiving a basis step-up:[5409]

> Partner B, with a partnership interest having an adjusted basis to him of $12,000, retires from the partnership and receives cash of $2,000, and real property with an adjusted basis to the partnership of $6,000 and a fair market value of $14,000. The basis of the real property to B is $10,000 (B's basis for his partnership interest, $12,000, reduced by $2,000, the cash distributed).

However, this can turn around to bite the taxpayer, when the basis of the distributed assets exceeds the basis of the recipient's partnership interest (even if not in liquidation):[5410]

> Partner R has an adjusted basis of $10,000 for his partnership interest. He receives a current distribution of $4,000 cash and property with an adjusted basis to the partnership of $8,000. The basis of the distributed property to partner R is limited to $6,000 ($10,000, the adjusted basis of his interest, reduced by $4,000, the cash distributed).

Thus, the distributed property's basis decreased by $2,000, the excess of the $8,000 basis before the distribution over the $6,000 basis after the distribution.

However, Code § 734(b)(1), which applies if a Code § 754 election is in effect,[5411] causes the partnership to allocate this basis to other assets.

Special opportunities are available if the partnership has low basis property and a partner has a low basis partnership interest. (The partner might need to receive a large cash distribution to turn a high basis partnership interest into a low basis partnership interest.)[5412] The partnership

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[5406] Reg. § 1.732-1(e).
[5407] Reg. § 1.732-1(e), referring to Code § 751(b) and Reg. § 1.751-1(b).
[5408] Reg. § 1.732-1(e).
[5409] Reg. § 1.732-1(b).
[5410] Reg. § 1.732-1(a), Example (2).
[5411] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.
[5412] If the partnership borrows to finance this distribution, consider the interest tracing rules to make sure that the partnership can deduct the interest. Because the debt the partnership incurred generally would give everyone's partnership interest a higher basis, note the suggestions further below in this part II.Q.8.b.i.(e) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property for keeping the basis of the distributee partner's partnership interest low.

borrows to buy property. The partnership then distributes the new property to the partner with the low basis. If a Code § 754 election is in place or if the distribution falls within the special rules of Code § 732(d), the distribution strips basis from the new property and results in the partnership allocating that stripped basis to the old, low basis property.

This basis stripping technique requires more work than is described above. The debt the partnership incurred generally would give everyone's partnership interest a higher basis.[5413] Increasing the basis of the distributee partner's partnership interest would reduce the basis stripping. Keeping the basis of the distributee partner's partnership interest low requires one of the following to occur:

- Make the distribution terminate the partner's interest in the partnership. Because the distributee will no longer be a partner, he will no longer be allocated any liabilities in the partnership. This reallocation of liabilities will be treated as a cash distribution,[5414] reducing the basis of his partnership interest available to allocate to the distributed property.[5415]

    - If the partner whose interest is being redeemed contributed to the partnership within seven years assets that the partnership retains or was allocated some built-in gain in the property when other partners were later admitted to the partnership, the partner would recognize gain when leaving the partnership,[5416] undercutting part or all of the short-term tax saving from the basis stripping transaction. To plan in advance for the possibility of using this strategy, on might consider forming a partnership many years before the opportunity arises.[5417]

    - If the partner wishes to stay in the partnership, consider dividing the partnership before this series of transactions,[5418] so that only the low basis asset remains in the partnership that eventually would buy this new property. Note, however, that a partnership division that distributes a partnership holding marketable securities might trigger Code § 731(c) gain.[5419]

- Take some special action to make sure that the partners other than the distributee partner are allocated the debt used to buy the new property. These actions relate to the nature of the debt, loan guarantees, and other documentation shifting risk of loss regarding the debt.[5420]

[5413] Code §§ 752(a) (a partnership's incurring debt is treated as a cash contribution to the partnership), 722 (contribution of cash increases the basis of the contributor's partnership interest).
[5414] Code § 752(b).
[5415] Reg. § 1.732-1(b).
[5416] See part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.
[5417] See part II.Q.8.a Partnership as a Master Entity.
[5418] See part II.Q.8.d Partnership Division. The division should keep the partners' percentage ownership the same in each partnership before and after the division to prevent the 7-year anti-mixing bowl rules (see fn. 5416) from applying to either partnership; see fn. 5578.
[5419] See fns. 5378 and 5608.
[5420] See part II.C.3 Allocating Liabilities (Including Debt). Code § 752 analysis can interact with the Code § 465 at-risk rules; see part II.G.4.j At Risk Rules, especially CCA 201606027, including key excerpts in fns. 1282-1285.

- If the distributed property is encumbered by debt to reduce the equity distributed to the redeemed partner, make sure that the debt is old and cold.[5421]

[5421] See Reg. § 1.707-6(b)(2) (dealing with liabilities incurred in connected with disguised sales). Reg § 1.707-6(d) includes the following example:

Example (2). *Assumption of liability by partner*.

(i) B is a member of an existing partnership. The partnership transfers property Y to B. On the date of the transfer, property Y has a fair market value of $1,000,000 and is encumbered by a nonrecourse liability of $600,000. B takes the property subject to the liability. The partnership incurred the nonrecourse liability six months prior to the transfer of property Y to B and used the proceeds to purchase an unrelated asset. Assume that, under the rule of § 1.707-5(a)(2)(ii) (which determines a partner's share of a nonrecourse liability), B's share of the nonrecourse liability immediately before the transfer of property Y was $100,000.

(ii) The liability is not allocable under the rules of § 1.163-8T to capital expenditures with respect to the property transferred to B and was not incurred in the ordinary course of the trade or business in which the property transferred to the partner was used or held. Since the partnership incurred the nonrecourse liability within two years of the transfer to B, under rules similar to those provided in § 1.707-5(a)(5), the liability is presumed to be incurred in anticipation of the transfer unless the facts and circumstances clearly establish the contrary. Assuming no facts exist to rebut this presumption, the liability taken subject to by B is not a qualified liability. The partnership is treated as having received, on the date of the transfer of property Y to B, $500,000 ($600,000 liability assumed by B less B's share of the $100,000 liability immediately prior to the transfer) as consideration for the sale of one-half ($500,000/$1,000,000) of property Y to B. The partnership is also treated as having distributed to B, in B's capacity as a partner, the other one-half of property Y.

Also, be careful not to trip the anti-abuse regulations, which set forth basic ideas generally respecting[5422] or criticizing[5423] partnership transactions, including a facts and circumstances

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[5422] Reg. § 1.701-2(a) provides:

> *Intent of subchapter K*. Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements—
>
> (1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.
>
> (2) The form of each partnership transaction must be respected under substance over form principles.
>
> (3) Except as otherwise provided in this paragraph (a)(3), the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, proper reflection of income). However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the proper reflection of income requirement of this paragraph (a)(3) is treated as satisfied with respect to a transaction that satisfies paragraphs (a)(1) and (2) of this section to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision. See, for example, paragraph (d) Example 6 of this section (relating to the value-equals-basis rule in § 1.704-1(b)(2)(iii)(c)), paragraph (d) Example 9 of this section (relating to the election under section 754 to adjust basis in partnership property), and paragraph (d) Examples 10 and 11 of this section (relating to the basis in property distributed by a partnership under section 732). See also, for example, §§ 1.704-3(e)(1) and 1.752-2(e)(4) (providing certain de minimis exceptions).

For regulations under Code § 752 that were changed in October 2016, see part II.C.3 Allocating Liabilities (Including Debt).

[5423] Reg. § 1.701-2(b) provides:

> *Application of subchapter K rules.* The provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K as set forth in paragraph (a) of this section (intent of subchapter K). Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K—
>
> (1) The purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners;
>
> (2) One or more of the purported partners of the partnership should not be treated as a partner;
>
> (3) The methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income;
>
> (4) The partnership's items of income, gain, loss, deduction, or credit should be reallocated; or
>
> (5) The claimed tax treatment should otherwise be adjusted or modified.

test.[5424] These regulations accept some basis shifting, which is inherent in Code § 732 itself, such as apportioning among tangible assets with equal value[5425] or among a group of

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[5424] Reg. § 1.701-2(c) provides:

Facts and circumstances analysis; factors. Whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. The factors set forth below may be indicative, but do not necessarily establish, that a partnership was used in such a manner. These factors are illustrative only, and therefore may not be the only factors taken into account in making the determination under this section. Moreover, the weight given to any factor (whether specified in this paragraph or otherwise) depends on all the facts and circumstances. The presence or absence of any factor described in this paragraph does not create a presumption that a partnership was (or was not) used in such a manner. Factors include:

(1) The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly;

(2) The present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. For example, this analysis may indicate that it was contemplated that a partner who was necessary to achieve the intended tax results and whose interest in the partnership was liquidated or disposed of (in whole or in part) would be a partner only temporarily in order to provide the claimed tax benefits to the remaining partners;

(3) One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities (through distribution preferences, indemnity or loss guaranty agreements, or other arrangements), or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

(4) Substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;

(5) Partnership items are allocated in compliance with the literal language of §§ 1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of section 704(b) and those regulations. In this regard, particular scrutiny will be paid to partnerships in which income or gain is specially allocated to one or more partners that may be legally or effectively exempt from federal taxation (for example, a foreign person, an exempt organization, an insolvent taxpayer, or a taxpayer with unused federal tax attributes such as net operating losses, capital losses, or foreign tax credits);

(6) The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party); or

(7) The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or a related party).

[5425] Reg. § 1.701-2(d) provides:

Example (10). Basis adjustments under section 732; use of partnership consistent with the intent of subchapter K.

(i) A, B, and C are partners in partnership PRS, which has for several years been engaged in substantial bona fide business activities. For valid business reasons, the partners agree that A's interest in PRS, which has a value and basis of $100x, will be liquidated with the following assets of PRS: a nondepreciable asset with a value of $60x and a basis to PRS of $40x, and related equipment with two years of cost recovery remaining nonmarketable securities[5426] the basis of a partnership interest that is being liquidated. On the other hand, the regulations view as abusive duplication of losses a partner contributing property

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and a value and basis to PRS of $40x. Neither asset is described in section 751 and the transaction is not described in section 732(d). Under section 732(b) and (c), A's $100x basis in A's partnership interest will be allocated between the nondepreciable asset and the equipment received in the liquidating distribution in proportion to PRS's bases in those assets, or $50x to the nondepreciable asset and $50x to the equipment. Thus, A will have a $10x built-in gain in the nondepreciable asset ($60x value less $50x basis) and a $10x built-in loss in the equipment ($50x basis less $40x value), which it expects to recover rapidly through cost recovery deductions. In selecting the assets to be distributed to A, the partners had a principal purpose to take advantage of the fact that A's basis in the assets will be determined by reference to A's basis in A's partnership interest, thus, in effect, shifting a portion of A's basis from the nondepreciable asset to the equipment, which in turn would allow A to recover that portion of its basis more rapidly. This shift provides a federal tax timing advantage to A, with no offsetting detriment to B or C.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1) and (2) of this section have been satisfied. The validity of the tax treatment of this transaction is therefore dependent upon whether the transaction satisfies (or is treated as satisfying) the proper reflection of income standard under paragraph (a)(3) of this section. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, paragraph (a)(3) of this section provides that if the application of a provision of subchapter K produces tax results that do not properly reflect income, but the application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision (and the transaction satisfies the requirements of paragraphs (a)(1) and (2) of this section), then the application of that provision to the transaction will be treated as satisfying the proper reflection of income standard.

(iii) A's basis in the assets distributed to it was determined under section 732(b) and (c). The transaction does not properly reflect A's income due to the basis distortions caused by the distribution and the shifting of basis from a nondepreciable to a depreciable asset. However, the basis rules under section 732, which in some situations can produce tax results that are inconsistent with the proper reflection of income standard (see paragraph (a)(3) of this section), are intended to provide simplifying administrative rules for bona fide partnerships that are engaged in transactions with a substantial business purpose. Taking into account all the facts and circumstances of the transaction, the application of the basis rules under section 732 to the distribution from PRS to A, and the ultimate tax consequences of the application of that provision of subchapter K, are clearly contemplated. Thus, the application of section 732 to this transaction will be treated as satisfying the proper reflection of income standard under paragraph (a)(3) of this section. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

[5426] Reg. § 1.701-2(d) provides:

Example (9). Absence of section 754 election; use of partnership consistent with the intent of subchapter K.

(i) PRS is a bona fide partnership formed to engage in investment activities with contributions of cash from each partner. Several years after joining PRS, A, a partner with a capital account balance and basis in its partnership interest of $100x, wishes to withdraw from PRS. The partnership agreement entitles A to receive the balance of A's capital account in cash or securities owned by PRS at the time of withdrawal, as mutually with a built-in loss and later receiving other assets with low value in liquidation of his partnership interest (to get a high basis allocated to the distributed assets), then selling the distributed

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agreed to by A and the managing general partner, P. P and A agree to distribute to A $100x worth of non-marketable securities (see section 731(c)) in which PRS has an aggregate basis of $20x. Upon distribution, A's aggregate basis in the securities is $100x under section 732(b). P RS does not make an election to adjust the basis in its remaining assets under section 754. Thus, PRS's basis in its remaining assets is unaffected by the distribution. In contrast, if a section 754 election had been in effect for the year of the distribution, under these facts section 734(b) would have required PRS to adjust the basis in its remaining assets downward by the amount of the untaxed appreciation in the distributed property, thus reflecting that gain in PRS's retained assets. In selecting the assets to be distributed, A and P had a principal purpose to take advantage of the facts that A's basis in the securities will be determined by reference to A's basis in its partnership interest under section 732(b), and because PRS will not make an election under section 754, the remaining partners of PRS will likely enjoy a federal tax timing advantage (i.e., from the $80x of additional basis in its assets that would have been eliminated if the section 754 election had been made) that is inconsistent with proper reflection of income under paragraph (a)(3) of this section.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1) and (2) of this section have been satisfied. The validity of the tax treatment of this transaction is therefore dependent upon whether the transaction satisfies (or is treated as satisfying) the proper reflection of income standard under paragraph (a)(3) of this section. A's basis in the distributed securities is properly determined under section 732(b). The benefit to the remaining partners is a result of PRS not having made an election under section 754. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, paragraph (a)(3) of this section provides that if the application of a provision of subchapter K produces tax results that do not properly reflect income, but application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision (and the transaction satisfies the requirements of paragraphs (a)(1) and (2) of this section), then the application of that provision to the transaction will be treated as satisfying the proper reflection of income standard.

(iii) In general, the adjustments that would be made if an election under section 754 were in effect are necessary to minimize distortions between the partners' bases in their partnership interests and the partnership's basis in its assets following, for example, a distribution to a partner. The electivity of section 754 is intended to provide administrative convenience for bona fide partnerships that are engaged in transactions for a substantial business purpose, by providing those partnerships the option of not adjusting their bases in their remaining assets following a distribution to a partner. Congress clearly recognized that if the section 754 elections were not made, basis distortions may result. Taking into account all the facts and circumstances of the transaction, the electivity of section 754 in the context of the distribution from PRS to A, and the ultimate tax consequences that follow from the failure to make the election with respect to the transaction, are clearly contemplated by section 754. Thus, the tax consequences of this transaction will be treated as satisfying the proper reflection of income standard under paragraph (a)(3) of this section. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

assets at a loss,[5427] a result largely deterred by changes in the law since then.[5428] They also view as abusive distributing an insubstantial asset, allocating substantial basis to it, and then

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[5427] Reg. § 1.701-2(d) provides the following example in which the lack of a Code § 754 election was viewed as abusive:

> *Example (8).* Plan to duplicate losses through absence of section 754 election; use of partnership not consistent with the intent of subchapter K.
>
> (i) A owns land with a basis of $100x and a fair market value of $60x. A would like to sell the land to B. A and B devise a plan a principal purpose of which is to permit the duplication, for a substantial period of time, of the tax benefit of A's built-in loss in the land. To effect this plan, A, C (A's brother), and W (C's wife) form partnership PRS, to which A contributes the land, and C and W each contribute $30x. All partnership items are shared in proportion to the partners' respective contributions to PRS. PRS invests the cash in an investment asset (that is not a marketable security within the meaning of section 731(c)). PRS also leases the land to B under a three-year lease pursuant to which B has the option to purchase the land from PRS upon the expiration of the lease for an amount equal to its fair market value at that time. All lease proceeds received are immediately distributed to the partners. In year 3, at a time when the values of the partnership's assets have not materially changed, PRS agrees with A to liquidate A's interest in exchange for the investment asset held by PRS. Under section 732(b), A's basis in the asset distributed equals $100x, A's basis in A's partnership interest immediately before the distribution. Shortly thereafter, A sells the investment asset to X, an unrelated party, recognizing a $40x loss.
>
> (ii) PRS does not make an election under section 754. Accordingly, PRS's basis in the land contributed by A remains $100x. At the end of year 3, pursuant to the lease option, PRS sells the land to B for $60x (its fair market value). Thus, PRS recognizes a $40x loss on the sale, which is allocated equally between C and W. C's and W's bases in their partnership interests are reduced to $10x each pursuant to section 705. Their respective interests are worth $30x each. Thus, upon liquidation of PRS (or their interests therein), each of C and W will recognize $20x of gain. However, PRS's continued existence defers recognition of that gain indefinitely. Thus, if this arrangement is respected, C and W duplicate for their benefit A's built-in loss in the land prior to its contribution to PRS.
>
> (iii) On these facts, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for federal tax purposes (see paragraph (c) of this section). Accordingly, the transaction lacks a substantial business purpose (see paragraph (a)(1) of this section). In addition, factors (1), (2), and (4) of paragraph (c) of this section indicate that PRS was used with a principal purpose to reduce substantially the partners' tax liability in a manner inconsistent with the intent of subchapter K. On these facts, PRS is not bona fide (see paragraph (a)(1) of this section), and the transaction is not respected under applicable substance over form principles (see paragraph (a)(2) of this section). Further, the tax consequences to the partners do not properly reflect the partners' income; and Congress did not contemplate application of section 754 to partnerships such as PRS, which was formed for a principal purpose of producing a double tax benefit from a single economic loss (see paragraph (a)(3) of this section). Thus, PRS has been formed and availed of with a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or other statutory authorities, such as the substance over form doctrine or the disguised sale rules under section 707 (see paragraph (h) of this section)), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

[5428] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

selling it at a substantial loss.[5429] Depending on the situation, not making a Code § 754 election might be considered abusive[5430] or not abusive.[5431] Also, the IRS reserves the right to assert and to rely upon applicable nonstatutory principles and other statutory and regulatory authorities

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[5429] Reg. § 1.701-2(d) provides:

> *Example (11).* Basis adjustments under section 732; plan or arrangement to distort basis allocations artificially; use of partnership not consistent with the intent of subchapter K.
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> (i) Partnership PRS has for several years been engaged in the development and management of commercial real estate projects. X, an unrelated party, desires to acquire undeveloped land owned by PRS, which has a value of $95x and a basis of $5x. X expects to hold the land indefinitely after its acquisition. Pursuant to a plan a principal purpose of which is to permit X to acquire and hold the land but nevertheless to recover for tax purposes a substantial portion of the purchase price for the land, X contributes $100x to PRS for an interest therein. Subsequently (at a time when the value of the partnership's assets have not materially changed), PRS distributes to X in liquidation of its interest in PRS the land and another asset with a value and basis to PRS of $5x. The second asset is an insignificant part of the economic transaction but is important to achieve the desired tax results. Under section 732(b) and (c), X's $100x basis in its partnership interest is allocated between the assets distributed to it in proportion to their bases to PRS, or $50x each. Thereafter, X plans to sell the second asset for its value of $5x, recognizing a loss of $45x. In this manner, X will, in effect, recover a substantial portion of the purchase price of the land almost immediately. In selecting the assets to be distributed to X, the partners had a principal purpose to take advantage of the fact that X's basis in the assets will be determined under section 732(b) and (c), thus, in effect, shifting a portion of X's basis economically allocable to the land that X intends to retain to an inconsequential asset that X intends to dispose of quickly. This shift provides a federal tax timing advantage to X, with no offsetting detriment to any of PRS's other partners.
>
> (ii) Although section 732 recognizes that basis distortions can occur in certain situations, which may produce tax results that do not satisfy the proper reflection of income standard of paragraph (a)(3) of this section, the provision is intended only to provide ancillary, simplifying tax results for bona fide partnership transactions that are engaged in for substantial business purposes. Section 732 is not intended to serve as the basis for plans or arrangements in which inconsequential or immaterial assets are included in the distribution with a principal purpose of obtaining substantially favorable tax results by virtue of the statute's simplifying rules. The transaction does not properly reflect X's income due to the basis distortions caused by the distribution that result in shifting a significant portion of X's basis to this inconsequential asset. Moreover, the proper reflection of income standard contained in paragraph (a)(3) of this section is not treated as satisfied, because, taking into account all the facts and circumstances, the application of section 732 to this arrangement, and the ultimate tax consequences that would thereby result, were not clearly contemplated by that provision of subchapter K. In addition, by using a partnership (if respected), the partners' aggregate federal tax liability would be substantially less than had they owned the partnership's assets directly (see paragraph (c)(1) of this section). On these facts, PRS has been formed and availed of with a principal purpose to reduce the taxpayers' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under applicable judicial principles and statutory authorities, such as the disguised sale rules under section 707, see paragraph (h) of this section), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

[5430] Reg. § 1.701-2(d), Example (8), reproduced in fn 5427.

[5431] Reg. § 1.701-2(d), Example (9), reproduced in fn 5426.

to challenge transactions,[5432] which might subject taxpayers to penalties,[5433] so be careful not to get too cute.

Other partnership transactions might also be helpful.[5434]

Note that partners can shift basis without going through this process, but the transactions also require seasoning. Suppose A has for many years held low basis real estate worth $1 million. Last year, B bought real estate for $1 million, intending to hold it for investment. A and B swap real estate in a tax-free Code § 1031 exchange.[5435] The old property now has a high basis in B's hands, and the new property has a low basis in A's hands. Code § 1031 generally requires A and B to have intended to hold the property for investment when they bought them and to intend to hold the swapped property for investment after the Code § 1031 exchange.

In reviewing anything in this part II.Q.8.b.i.(e), consider whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.

II.Q.8.b.i.(f). Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value

The Code § 731(a) rule that there are no tax consequences to a partner when the partner receives a partnership distribution is subject to two exceptions if the distribution is made within seven years after the partner contributed property to the partnership:

- First, earlier it was discussed that Code § 704(c)(1)(B) triggers gain when the partnership distributes contributed property to a partner other than the contributing partner[5436] within seven years after the contribution; it also applies if the partnership agreement is amended within seven years to shift to the other partner the burdens and benefits and the property is distributed to that other partner more than seven years after contribution.[5437]

- Second, Code § 737 will trigger gain to a distributee partner if the partner contributes property to the partnership and then receives a distribution of some other property[5438] within seven years of the partner's original contribution. When such a distribution is made, the partner must recognize gain equal to the lesser of (1) the excess of the fair market value of the distributed property over the partner's partnership interest's adjusted basis (less any money received in the distribution) or (2) the partner's net pre-contribution gain.[5439] Net pre-contribution gain, as defined in Code § 737(b), is the gain that would have been recognized by the distributee partner under Code § 704(c)(1)(B) if all property the partner had contributed to the partnership within seven years of the distribution that was still held by the

[5432] Reg. § 1.701-2(i).
[5433] See part II.G.17 Economic Substance Penalty.
[5434] See Abrams, Now You See It; Now You Don't: Exiting a Partnership and Making Gain Disappear, *TM Memorandum* (2/16/2009).
[5435] See part II.G.16 Like-Kind Exchanges.
[5436] When a partnership distributes to a partner property that the partnership contributed, none of Code § 704(c)(1)(B), 731(c) or 737 applied. See fn. 5382.
[5437] Reg. § 1.704-4(f)(2), Example (1).
[5438] When a partnership distributes to a partner property that the partnership contributed, none of Code § 704(c)(1)(B), 731(c) or 737 applied. See fn. 5382.
[5439] Code § 737(a)(1) and (2).

partnership immediately before the distribution was distributed by the partnership to some other partner.

These rules relate to Code § 704(c) responsibility – the allocation to a partner of built-in gain or loss when the partnership contributes to a partnership property the basis of which differs from its fair market value – which integrates with part II.P.1.a.i Allocations of Income in Partnerships.

“The transferee of all or a portion of a contributing partner’s partnership interest succeeds to the transferor’s net precontribution gain, if any, in an amount proportionate to the interest transferred.”[5440] Because debt associated with contributed property is allocated to a partner to the extent of Code § 704(c) gain,[5441] anti-abuse rules prevent the acceleration or duplication of loss through the assumption of potentially suspect obligations.[5442] Obligations that are not

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[5440] Reg. § 1.737-1(c)(2)(iii), which further provides:

> See § 1.704-3(a)(7) and § 1.704-4(d)(2) for similar provisions in the context of section 704(c)(1)(A) and section 704(c)(1)(B).

Reg. § 1.704-3(a)(7) provides:

> *Transfer of a partnership interest*. If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner. This rule does not apply to any person who acquired a partnership interest from a § 1.752-7 liability partner in a transaction to which paragraph (e)(1) of § 1.752-7 applies. See § 1.752-7(c)(1).

Reg. § 1.704-4(d)(2) provides:

> *Transfers of a partnership interest*. The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) and this section to the extent of the share of built-in gain or loss allocated to the transferee partner. See § 1.704-3(a)(7).

[5441] See paragraph (2) of the text accompanying fn 439 in part II.C.3.c.iii Allocating Nonrecourse (Remaining) Liabilities.

[5442] Reg. § 1.752-7(a) provides:

> *Purpose and structure*. The purpose of this section is to prevent the acceleration or duplication of loss through the assumption of obligations not described in § 1.752-1(a)(4)(i) in transactions involving partnerships. Under paragraph (c) of this section, any such obligation that is assumed by a partnership from a partner in a transaction governed by section 721(a) is treated as section 704(c) property. Paragraphs (e), (f), and (g) of this section provide rules for situations where a partnership assumes such an obligation from a partner and, subsequently, that partner transfers all or part of the partnership interest, that partner receives a distribution in liquidation of the partnership interest, or another partner assumes part or all of that obligation from the partnership. These rules prevent the duplication of loss by prohibiting the partnership and any person other than the partner from whom the obligation was assumed from claiming a deduction, loss, or capital expense to the extent of the built-in loss associated with the obligation. These rules also prevent the acceleration of loss by deferring the partner’s deduction or loss attributable to the obligation (if any) until the satisfaction of the § 1.752-7 liability (within the meaning of paragraph (b)(8) of this section). Paragraph (d) of this section provides a number of exceptions to paragraphs (e), (f), and (g) of this section, including a de minimis exception. Paragraph (i) provides a special rule for situations in which an amount paid to satisfy a § 1.752-7 liability is capitalized into other partnership property. Paragraph (j) of this section provides special rules for tiered partnership transactions.

Reg. § 1.752-7(c)(1)(i) provides:

> *Section 704(c)*. Except as otherwise provided in this section, sections 704(c)(1)(A) and (B), section 737, and the regulations thereunder, apply to § 1.752-7 liabilities. See § 1.704-3(a)(12).

potentially suspect include those that generate basis (such as buying or improving an asset), result in an immediate deduction, or give rise to a nondeductible expense.[5443]

If a new partner joins a partnership (or an existing partner makes a non-pro rata contribution) when the partnership holds property the basis of which differs from its fair market value:

- The existing partners' capital accounts obtain Code § 704(c) responsibility;[5444] this is called a "reverse-Code § 704(c))" allocation. Thus, any unrealized gain that occurred between the time the partnership acquired the property and the time a new partner joined (or an existing partner makes a non-pro rata contribution) constitutes Code § 704(c) responsibility that is allocated to all of the existing partners.[5445] This responsibility can be reflected by either a

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> However, §1.704-3(a)(7) does not apply to any person who acquired a partnership interest from a § 1.752-7 liability partner in a transaction to which paragraph (e)(1) of this section applies.

Reg. § 1.752-7(e)(1) limits deduction, loss, or capital expense is allowed to the partnership on the satisfaction of a Reg. § 1.752-7 liability.

[5443] Reg. § 1.752-1(a)(4)(i). For details, see fn 396 in part II.C.3.b What Is a "Liability" and also fn 6279 in part III.B.1.a.ii.(d) Income Tax Consequences Involving Loan Guarantees.

[5444] See Reg. § 1.704-3(a)(6). See also Reg. § 1.704-1(b)(2)(iv)(s)(2).

[5445] Reg. §§ 1.704-1(b)(5), Example (14)(i), provides:

> MC and RW form a general partnership to which each contributes $10,000. The $20,000 is invested in securities of Ventureco (which are not readily tradable on an established securities market)…. Assume that the Ventureco securities subsequently appreciate in value to $50,000. At that time SK makes a $25,000 cash contribution to the partnership (thereby acquiring a one-third interest in the partnership), and the $25,000 is placed in a bank account. Upon SK's admission to the partnership, the capital accounts of MC and RW (which were $10,000 each prior to SK's admission) are, in accordance with paragraph (b)(2)(iv)(f) of this section, adjusted upward (to $25,000 each) to reflect their shares of the unrealized appreciation in the Ventureco securities that occurred before SK was admitted to the partnership. Immediately after SK's admission to the partnership, the securities are sold for their $50,000 fair market value, resulting in taxable gain of $30,000 ($50,000 less $20,000 adjusted tax basis) and no book gain or loss. An allocation of the $30,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(f) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the $30,000 taxable gain will, in accordance with section 704(c) principles, be shared $15,000 to MC and $15,000 to RW, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

Reg. §§ 1.704-1(b)(5), Example (14)(ii), provides:

> Assume the same facts as (i), except that after SK's admission to the partnership, the Ventureco securities appreciate in value to $74,000 and are sold, resulting in taxable gain of $54,000 ($74,000 less $20,000 adjusted tax basis) and book gain of $24,000 ($74,000 less $50,000 book value). Under the partnership agreement the $24,000 book gain (the appreciation in value occurring after SK became a partner) is allocated equally among MC, RW, and SK, and such allocations have substantial economic effect. An allocation of the $54,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(f) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the taxable gain will, in accordance with section 704(c) principles, be shared $23,000 to MC $23,000 to RW, and $8,000 to SK, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

Reg. §§ 1.704-1(b)(5), Example (14)(iii), provides:

> Assume the same facts as (i) except that after SK's admission to the partnership, the Ventureco securities depreciate in value to $44,000 and are sold, resulting in taxable gain of $24,000

special allocation of gain in the partnership agreement or by revaluing capital accounts on the books,[5446] but the partnership must take one of these steps for the partnership agreement to be respected.[5447] An unexpected part of this issue is that one can become saddled with Code § 704(c) responsibility for assets one did not contribute; consider whether this might reset the seven-year period with respect to that newly acquired Code § 704(c) responsibility (I have not researched the latter). Also, beware that a book-up

($44,000 less $20,000 adjusted tax basis) and a book loss of $6,000 ($50,000 book value less $44,000). Under the partnership agreement the $6,000 book loss is allocated equally among MC, RW, and SK, and such allocations have substantial economic effect. An allocation of the $24,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(f) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the $24,000 taxable gain will, in accordance with section 704(c) principles, be shared equally between MC and RW, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

[5446] For how to revalue, see Reg. § 1.704-1(b)(2)(iv)(f), which is reproduced in fn. 507 in part II.C.7 Maintaining Capital Accounts. See also Reg. § 1.704-1(b)(5), Example (33). Although generally this responsibility is determined separately for each asset, see an alternative approach is in part II.P.1.a.i.(b) Special Rules for Allocations of Income in Securities Partnerships.

[5447] See Reg. § 1.704-1(b)(5), Example (14)(iv), referencing Reg. § 1.704-1(b)(1)(iii), (iv).
Reg. § 1.704-1(b)(1)(iii) provides:

> *Effect of other sections*. The determination of a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) under section 704(b) and this paragraph is not conclusive as to the tax treatment of a partner with respect to such distributive share. For example, an allocation of loss or deduction to a partner that is respected under section 704(b) and this paragraph may not be deductible by such partner if the partner lacks the requisite motive for economic gain (see, *e.g.*, *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966)), or may be disallowed for that taxable year (and held in suspense) if the limitations of section 465 or section 704(d) are applicable. Similarly, an allocation that is respected under section 704(b) and this paragraph nevertheless may be reallocated under other provisions, such as section 482, section 704(e)(2), section 706(d) (and related assignment of income principles), and paragraph (b)(2)(ii) of § 1.751-1. If a partnership has a section 754 election in effect, a partner's distributive share of partnership income, gain, loss, or deduction may be affected as provided in § 1.743-1 (see paragraph (b)(2)(iv)(m)(2) of this section). A deduction that appears to be a nonrecourse deduction deemed to be in accordance with the partners' interests in the partnership may not be such because purported nonrecourse liabilities of the partnership in fact constitute equity rather than debt. The examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address the effect of other sections or limitations on such allocations.

Reg. § 1.704-1(b)(1)(iv) provides:

> *Other possible tax consequences*. Allocations that are respected under section 704(b) and this paragraph may give rise to other tax consequences, such as those resulting from the application of section 61, section 83, section 751, section 2501, paragraph (f) of § 1.46-3, § 1.47-6, paragraph (b)(1) of § 1.721-1 (and related principles), and paragraph (e) of § 1.752-1. The examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address other tax consequences that may result from such allocations.

Implicit in clause (iv) is that failure to maintain proper capital accounts can have gift tax consequences under Code § 2501.
Also see Reg. § 1.704-1(b)(2)(iv)(b), which is reproduced in the text accompanying fn. 500 in part II.C.7 Maintaining Capital Accounts.

resulting from a revaluation may shift nonrecourse liabilities,[5448] which can generate income tax.[5449]

- If the partnership included a nominal partner merely to get the seven-year period running and the previously contributed property is promptly distributed to a partner who is admitted just after the seven-year had run, the nominal partner's existence is ignored in determining the seven-year period, so Code § 704(c)(1)(B) taxes the contributing partner.[5450]

Note that Code § 737 is applied after Code § 731(c), which means that any marketable securities that are treated as money for Code § 731(c) purposes are ignored when applying Code § 737.[5451] This can lead to a favorable result for a distributee partner in two ways. First, since the property piece of the distribution is reduced by treating marketable securities as money, the Code § 737 gain potential is reduced. Second, the total amount of cash and marketable securities treated as money could be less than the basis of the distributee partner's partnership interest, resulting in no gain recognition under Code § 731.

As in the Code § 704(c) analysis, the prevailing view among commentators seems to be that a transferee of a partnership interest will "step into" the transferor's shoes in Code § 737 situations. This view is supported by the fact that regulations supporting Code § 704(c)(1)(B) and Code § 737 were written by the same people, at the same time, in the same project, and are likely to have been designed to work in coordination with one another. A partner should not be able to avoid the rules of Code § 737 by transferring the partnership interest to a third party. Thus, the transferee partner should be treated as the contributing partner under Code § 737.[5452]

When contributed property is distributed to any non-contributing partner within seven years of its contribution, the contributing partner is treated as if the property were sold to the recipient partner at its fair market value and must recognize the proper gain or loss under Code § 704(c)(1)(A); however, an exception applies for certain deemed like-kind exchanges.[5453]

[5448] See text preceding and accompanying fn 398 in part II.C.3.c Allocations of Recourse and Nonrecourse Liabilities.

[5449] See part II.C.3.a Basic Consequences of Changes in Liability Allocations.

[5450] Reg. § 1.704-4(f)(2), Example (2).

[5451] Reg. § 1.731-2(g).

[5452] I am very comfortable with the statement in the text, although it is not totally free from doubt. See Robinson, Don't Nothing Last Forever – Unwinding the FLP to the Haunting Melodies of Subchapter K, *ACTEC Journal*, Spring 2003, p. 302; Blum and Harrison, Another View: A Response to Richard Robinson's Don't Nothing Last Forever – Unwinding the FLP to the Haunting Melodies of Subchapter K, *ACTEC Journal*, Spring 2003, p. 313; and Robinson's Comments on Blum and Harrison's Another View, *ACTEC Journal*, Spring 2003, p. 318.

[5453] Code § 704(c)(2). See Borden and Longhofer, The Effect of Like-Kind Property on the Section 704(c) Anti-Mixing Bowl Rules, *TM Real Estate Journal* (3/2/2011). Reg. § 1.704-4(d)(3) provides:

> *Distributions of like-kind property*. If section 704(c) property is distributed to a partner other than the contributing partner and like-kind property (within the meaning of section 1031) is distributed to the contributing partner no later than the earlier of (i) 180 days following the date of the distribution to the non-contributing partner, or (ii) the due date (determined with regard to extensions) of the contributing partner's income tax return for the taxable year of the distribution to the noncontributing partner, the amount of gain or loss, if any, that the contributing partner would otherwise have recognized under section 704(c)(1)(B) and this section is reduced by the amount of built-in gain or loss in the distributed like-kind property in the hands of the contributing partner immediately after the distribution. The contributing partner's basis in the distributed like-kind property is determined as if the like-kind property were distributed in an unrelated distribution

This like-kind exception applies not only to Code § 704(c) but also to Code § 737.[5454] Thus, partners in a real estate mixing bowl partnership might completely avoid gain recognition under Code §§ 704(c)(1)(B) and 737 if the partnership is liquidated before the seven year waiting period and the different partners each receive part or complete ownership of various properties owned by the partnership.[5455]

For issues relating to built-in losses, see the American Bar Association Section of Taxation's "Comments on Proposed Regulations on Certain Partnership Provisions of the American Jobs Creation Act of 2004," *Tax Lawyer*, vol. 69, No. 1, p. 5 (Fall 2015).

II.Q.8.b.i.(g). Code § 751 – Hot Assets

Code § 751(a) and Reg. § 1.751-1(a)(1) provide that part of the gain attributable to hot assets (substantially appreciated inventory or unrealized receivables) "shall be considered as an amount realized from the sale or exchange of property other than a capital asset." Because capital gain treatment does not apply, this gain tends to be viewed colloquially as ordinary income, even though it is actually gain from the sale of property. This noncapital gain is "qualified business income" that may receive a deduction of up to 20% under Code § 199A.[5456]

When read together, Reg. § 1.751-1(b)(1)(i), -1(b)(2)(i), -1(b)(3)(i), and the -1(g) examples provide that one looks to differences in Code § 751 allocation before and after the distribution. If a partner is distributed exactly its share of each item of Code § 751 property, so that nobody's share of Code § 751 property decreases, then Code § 751 does not apply.

A partner might be deemed to have entered into a transaction regarding hot assets if:[5457]

- The partner receives hot assets in exchange for all or a part of the partner's interest in other partnership property (including money), or

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> prior to the distribution of any other property distributed as part of the same distribution and is determined without regard to the increase in the contributing partner's adjusted tax basis in the partnership interest under section 704(c)(1)(B) and this section. See § 1.707-3 for provisions treating the distribution of the like-kind property to the contributing partner as a disguised sale in certain situations.

Reg. § 1.704-4(d)(4) provides an example.

[5454] In determining the precontribution gain subject to possible taxation under Code § 737, Reg. § 1.737-1(c)(2)(iv) provides:

> *Section 704(c)(1)(B) gain recognized in related distribution*. A distributee partner's net precontribution gain is determined after taking into account any gain or loss recognized by the partner under section 704(c)(1)(B) and § 1.704-4 (or that would have been recognized by the partner except for the like-kind exception in section 704(c)(2) and § 1.704-4(d)(3)) on an actual distribution to another partner of section 704(c) property contributed by the distributee partner that is part of the same distribution as the distribution to the distributee partner.

However, Reg. § 1.737-1(c)(2)(v) requires an actual distribution:

> *Section 704(c)(2) disregarded*. A distributee partner's net precontribution gain is determined without regard to the provisions of section 704(c)(2) and § 1.704-4(d)(3) in situations in which the property contributed by the distributee partner is not actually distributed to another partner in a distribution related to the section 737 distribution.

[5455] Breitstone and Wilensky, Dividing a Real Estate Empire: The Mixing Bowl Alternative, *TM Memorandum* (BNA) (3/9/2015).

[5456] See Reg. § 1.199A-3(b)(1)(i), reproduced in part II.E.1.c.ii.(a) Generally; List of Items Included in QBI.

[5457] Code § 751(b)(1).

- The partner receives partnership property (including money) in exchange for all or a part of the partner's interest in hot assets.

This rule does not apply to not apply to a distribution of property that the distributee contributed to the partnership or Code § 736(a) payments to a retiring partner or successor in interest of a deceased partner.[5458] Also, if applies only if and to the extent that a partner receives more or less than that partner's share of hot assets.[5459]

Proposed regulations "prescribe how a partner should measure its interest in a partnership's unrealized receivables and inventory items … and … provide guidance regarding the tax consequences of a distribution that causes a reduction in that interest."[5460]

A partnership's inventory items are "substantially appreciated" if their fair market value exceeds 120% of the partnership's adjusted basis in such property, unless a principal purpose for acquiring such property was to avoid these rules regarding inventory items.[5461] "Inventory items" include:[5462]

- the partnership's Code § 1221(a)(1) property,[5463]

- any other partnership property that, if the partnership sold or exchanged them, would be considered property other than a capital asset and other than Code § 1231 property,[5464] and

[5458] Code § 751(b)(2).
[5459] See Reg. §§ 1.751-1(b)(1)(i), 1.751-1(b)(2)(i), and 1.751-1(b)(3)(i), and the Reg. § 1.751-1(g) examples.
[5460] REG-151416-06, Certain Distributions Treated as Sales or Exchanges [FR Doc. 2014-25487 Filed 10/31/2014 at 8:45 am; Publication Date: 11/03/2014]. The proposed regulations would obsolete Rev. Rul. 84-102. For the effective date:

> The regulations, as proposed, apply to distributions occurring in any taxable period ending on or after the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register. The rules contained in § 1.751-1(a)(2) would apply to transfers of partnership interests that occur on or after [11/03/2014]. However, the rules contained in § 1.751-1(a)(2) are a clarification of existing rules, and no inference is intended from the change to § 1.751-1(a)(2) with respect to sales or exchanges of partnership interests prior to the effective date for § 1.751-1(a)(2). The rules contained in § 1.751-1(a)(3) continue to apply to transfers of partnership interests that occur on or after December 15, 1999. A partnership and its partners would be able to rely on § 1.751-1(b)(2) of these proposed regulations for purposes of determining a partner's interest in the partnership's section 751 property on or after [11/03/2014] provided the partnership and its partners apply each of § 1.751-1(a)(2), § 1.751-1(b)(2), and § 1.751-1(b)(4) of these proposed regulations consistently for all partnership distributions and sales or exchanges, including for any distributions and sales or exchanges the partnership makes after a termination of the partnership under section 708(b)(1)(B).

See Longhofer and Rimmke, Proposed Section 751(b) Regulations: An Exchange for the Better? *Journal of Taxation* (Aug. 2015).
[5461] Code § 751(b)(3).
[5462] Code § 751(d).
[5463] Real estate might or might not constitute inventory. See part II.G.26.c Future Development of Real Estate.
[5464] Code § 1231 is discussed in part II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business. Code § 1245 depreciation recapture overrides Code § 1231; see fn. 1494.

- any other property the partnership held that, if held by the selling or distributee partner, would be considered property of the type described above.

"Unrealized receivables" include, to the extent not previously includible in income under the partnership's tax accounting method, any rights (contractual or otherwise) to payment for:[5465]

- goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or

- services rendered, or to be rendered.

For purposes of Code §§ 731, 732, 741, and 751, but not for purposes of Code § 736,[5466] "unrealized receivables" includes the following as if the partnership had been sold it at its fair market value, to the extent that their sale would trigger certain unfavorable tax treatment:[5467]

- mining property,[5468]

- stock in a DISC,[5469]

- Code § 1245 property (as defined in Code § 1245(a)(3) (generally, depreciable personal property and amortizable intangible property),[5470]

- stock in certain foreign corporations,[5471]

- Code § 1250 property (generally, real estate depreciated faster than straight-line depreciation),[5472]

[5465] Code § 751(c).
[5466] P.L. 103-66 (8/10/1993), § 13262(b), deleted the reference to Code § 736. As to Code § 736, see part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.
[5467] Code § 751(c).
[5468] As defined in Code § 617(f)(2), to the extent that Code § 617(d)(1) would apply.
[5469] As described in Code § 992(a), to the extent that Code § 995(c) would apply.
[5470] See part II.G.6.b Code § 1245 Property and, with respect to amortizable Code § 197 intangibles, fn 1526 reproducing Code § 1245(b)(8), treating such intangibles as one Code § 1245 property, and fn 1704 in part II.G.18.d Amortization of Code § 197 Intangibles, reproducing Code § 197(f)(7), treating all amortizable Code § 197 intangibles as subject to Code § 167.
[5471] As described in Code § 1248, to the extent that Code § 1248(a) would apply. For purposes of applying Code § 731, 741, and 751, in the case of an individual, the tax attributable to such amount shall be limited in the manner provided by Code § 1248(b) (relating to gain from certain sales or exchanges of stock in certain foreign corporation). Code § 751(e).
[5472] As defined in Code § 1250(c), to the extent that Code § 1250(a) would apply. Code § 1250(a)(1)(A)(i) applies Code § 1250(a) to additional depreciation, referring to subsections (b)(1) and (b)(4). Subsection (b)(1) applies to depreciation faster than straight line. Subsection (b)(4) applies to certain rehabilitation expenditures. Reg. § 1.1(h)-1(b)(3), "Section 1250 capital gain," provides:

(i) *Definition*. For purposes of this section, section 1250 capital gain means the capital gain (not otherwise treated as ordinary income) that would be treated as ordinary income if section 1250(b)(1) included all depreciation and the applicable percentage under section 1250(a) were 100 percent.

(ii) *Share of section 1250 capital gain allocable to interest in partnership*. When an interest in a partnership held for more than one year is sold or exchanged in a transaction in which all

- farm land,[5473]
- franchises, trademarks, or trade names,[5474] or
- an oil, gas, or geothermal property.[5475]

For purposes of Code §§ 731, 732, 741, and 751, but not for purposes of Code § 736, "unrealized receivables" also includes any market discount bond[5476] and any short-term obligation[5477] but only to the extent of the amount which would be treated as ordinary income if the partnership had sold such property.

More drastic consequences may apply when selling to a controlled corporation interests in a partnership holding depreciable property (including depreciable real estate that would not have depreciation recapture under Code § 1250), taxing the entire gain as ordinary income, not just the part that might have constituted depreciation recapture.[5478]

See also part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

Reg. § 1.6050K-1(a)(1), "In general," provides:

> Except as otherwise provided in this paragraph (a), a partnership shall make a separate return on Form 8308 with respect to each section 751(a) exchange (as defined in paragraph (a)(4)(i) of this section) of an interest in such partnership which occurs after December 31, 1984. A partnership that is in doubt as to whether partnership property constitutes section 751 property to any extent or as to whether a transfer of a partnership interest constitutes a section 751(a) exchange may file Form 8308 in order

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realized gain is recognized, there shall be taken into account under section 1(h)(7)(A)(i) in determining the partner's unrecaptured section 1250 gain the amount of section 1250 capital gain that would be allocated (taking into account any remedial allocation under §1.704-3(d)) to that partner (to the extent attributable to the portion of the partnership interest transferred that was held for more than one year) if the partnership transferred all of its section 1250 property in a fully taxable transaction for cash equal to the fair market value of the assets immediately before the transfer of the interest in the partnership. If less than all of the realized gain is recognized upon the sale or exchange of an interest in a partnership, the same methodology shall apply to determine the section 1250 capital gain recognized by the transferor, except that the partnership shall be treated as transferring only a proportionate amount of each section 1250 property determined as a fraction that is the amount of gain recognized in the sale or exchange over the amount of gain realized in the sale or exchange. This paragraph (b)(3) does not apply to a transaction that is treated, for Federal income tax purposes, as a redemption of a partnership interest.

(iii) *Limitation with respect to net section 1231 gain*. In determining a transferor partner's net section 1231 gain (as defined in section 1231(c)(3)) for purposes of section 1(h)(7)(B), the transferor partner's allocable share of section 1250 capital gain in partnership property shall not be treated as section 1231 gain, regardless of whether the partnership property is used in the trade or business (as defined in section 1231(b)).

[5473] As defined in Code § 1252(a), to the extent that Code § 1252(a) would apply.
[5474] Referred to in Code § 1253(a), to the extent that Code § 1253(a) would apply.
[5475] As defined in Code § 1254, to the extent that Code § 1254(a) would apply.
[5476] As defined in Code § 1278.
[5477] As defined in Code § 1283.
[5478] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), especially the text accompanying fns. 5087-5092.

to avoid the risk of incurring a penalty under section 6721. The penalty under section 6721 will generally apply, however, to partnerships that do not file Form 8308 where in fact a section 751(a) exchange occurred, except as provided in paragraphs (a)(2) and (e) of this section.

Reg. § 1.6050K-1(a)(4), "Definitions," provides that, for purposes of Code § 6050K and Reg. § 1.6050K-1:

(i) *Section 751(a) exchange*. The term "section 751(a) exchange" means any sale or exchange of a partnership interest (or portion thereof) in which any portion of any money or other property received by a transferor partner in exchange for all or a part of his or her interest in the partnership is attributable to section 751 property. The term does not include a distribution which is treated as a sale or exchange between the distributee and the partnership under section 751(b) of the Code.

(ii) *Section 751 property*. The term "section 751 property" means unrealized receivables, as defined in section 751(c) of the Code, and inventory items which have appreciated substantially in value ("substantially appreciated inventory items"), as defined in section 751(d) of the Code.

(iii) *Transferor and transferee*. The term "transferor" means the beneficial owner of a partnership interest immediately before the transfer of that interest. The term "transferee" means the beneficial owner of a partnership interest immediately after the transfer of that interest. However, if a partnership does not know the identity of the beneficial owner of an interest in the partnership, the record holder of such interest shall be treated as the transferor or transferee (as the case may be) for purposes of paragraphs (b) and (c) of this section.

See About Form 8308, Report of a Sale or Exchange of Certain Partnership Interests.

Notice 2024-19 explains in part II, "Background":

> Generally, § 6050K and § 1.6050K-1 require a partnership with § 751 property to provide information to each transferor and transferee that are parties to a sale or exchange of an interest in the partnership (or portion thereof) in which any money or other property received by a transferor from a transferee in exchange for all or part of the transferor's interest in the partnership is attributable to § 751 property (§ 751(a) exchange). Section 1.6050K-1(a)(2) provides that partnerships are required to report each § 751(a) exchange on Form 8308. Generally, § 1.6050K-1(f)(1) provides that a partnership is required to file Form 8308 as an attachment to its Form 1065, U.S. Return of Partnership Income, for the taxable year of the partnership that includes the last day of the calendar year in which the § 751(a) exchange took place. Form 8308 is due at the time for filing the partnership return, including extensions….
>
> On November 30, 2020, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) published T.D. 9926, 85 FR 76910, which amended § 1.6050K-1(c)(2) to require a partnership to furnish to a transferor partner the information necessary for the transferor to make the transferor partner's required statement in § 1.751-1(a)(3). Among other items, § 1.751-1(a)(3) requires a transferor partner in a § 751(a) exchange to submit with the transferor partner's income tax return a statement setting forth the amount of gain or loss attributable to § 751 property. In

> October 2023, the IRS released a revised version of Form 8308. Consistent with the requirements in § 1.6050K-1(c)(2), new Part IV of the 2023 Form 8308 requires a partnership to report, among other items, the partnership's and the transferor partner's share of § 751 gain and loss, collectibles gain under § 1(h)(5), and unrecaptured § 1250 gain under § 1(h)(6).

Notice 2024-19, part III, "Grant of Relief," provides:

> With respect to § 751(a) exchanges during calendar year 2023, the IRS will not impose penalties under § 6722 solely for failure to furnish Form 8308 with a completed Part IV by the due date specified in § 1.6050K-1(c)(1) for a partnership that (1) timely and correctly furnishes to the transferor and transferee a copy of Parts I, II, and III of Form 8308, or a statement that includes the same information, by the later of (a) January 31, 2024, or (b) 30 days after the partnership is notified of the § 751(a) exchange, and (2) furnishes to the transferor and transferee a copy of the complete Form 8308, including Part IV, or a statement that includes the same information and any additional information required under § 1.6050K-1(c), by the later of (a) the due date of the partnership's Form 1065 (including extensions), or (b) 30 days after the partnership is notified of the § 751(a) exchange.
>
> The relief provided in this notice applies only with respect to furnishing Form 8308 to the transferor and transferee. This notice does not provide relief with respect to filing Form 8308 as an attachment to a partnership's Form 1065; as such, this notice does not provide relief from penalties under § 6721 for failure to file correct information returns.

II.Q.8.b.i.(h). Characteristics of Distributed Property

Often, asset distributions precede, follow, or are substitutes for the transfer of partnership interests. Therefore, the concepts of distributions and transfers of partnership interests should be considered together. For the latter, see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

A distributed property's basis depends on whether the distribution liquidated the partner's partnership interest:

- Generally, the basis of property (other than money) distributed by a partnership to a partner, other than in liquidation of the partner's interest, is its adjusted basis to the partnership immediately before such distribution.[5479] However, this basis cannot exceed the adjusted basis of the partner's interest in the partnership, reduced by any money distributed in the same transaction.[5480]

- The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest is the partnership interest's adjusted basis, reduced by any money distributed in the same transaction.[5481]

[5479] Code § 732(a)(1).
[5480] Code § 732(a)(2). If that cap causes a loss of basis, the partnership can reallocate that lost basis to the partnership's other assets under Code § 734 if a Code § 754 election is in place. See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.
[5481] Code § 732(b).

However, neither of these rules applies to the extent that a distribution is treated as a sale or exchange of property under Code § 751(b) (relating to unrealized receivables and inventory items).[5482]

Also, special rules apply to a partner who acquired all or a part of his interest by a transfer with respect to which a Code § 754 election is not in effect, and to whom a distribution of property (other than money) is made with respect to the transferred interest within two years after such transfer.[5483] The partner may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided in Code § 743(b) were in effect.[5484] Depending on the situation, this basis adjustment requires elections or is mandatory.[5485]

A partner's holding period for property received in a distribution from a partnership generally includes the partnership's holding period.[5486]

When a partner who receives "hot assets" later disposes of them, the partner will recognize ordinary income:

- The disposition of Code § 751(c) unrealized receivables received from a partnership is ordinary gain or loss.[5487]

- The disposition of Code § 751(d) inventory received from a partnership, within 5 years from the date of the distribution,[5488] is ordinary gain or loss.[5489]

[5482] Code § 732(e). For details regarding these assets, see part II.Q.8.b.i.(g) Code § 751 – Hot Assets.
[5483] Code § 732(d). For a discussion of these rules, including any opportunity to shift basis from non-depreciable to depreciable assets, see McKee, Nelson & Whitmire, ¶26.01 Transferees' Special Basis Adjustments in Connection With Subsequent Distributions, *Federal Taxation of Partnerships & Par*tners (WG&L).
[5484] Reg. § 1.732-1(d)(1)(iii). The amount of this adjustment is not diminished by any depletion or depreciation of that portion of the basis of partnership property arising from this special basis adjustment, since depletion or depreciation on such portion before distribution is allowed or allowable only if the optional adjustment under Code § 743(b) is in effect. Reg. § 1.732-1(d)(1)(iv). If this property is not the same property which would have had a special basis adjustment, then such special basis adjustment applies to any like property received in the distribution, if the transferee, in exchange for the property distributed, has relinquished the transferee's interest in the property with respect to which the transferee would have had a special basis adjustment. Reg. § 1.732-1(d)(1)(v).
[5485] Reg. § 1.731-1(d)(2), (3), (4).
[5486] Code § 735(b). See Goold & Schneider, Finding the Gold Nuggets in Partnership Holding Periods, *Passthrough Entities* 31 (Nov./Dec. 2002). See also Borden, Navigating State Law and Tax Issues Raised by Partnership and LLC Reorganizations, *Business Entities* (Jul./Aug. 2014), suggesting that the holding period of distributed property might be the longer of the partnership's holding period or the partnership interest's holding period.
[5487] Code § 735(a)(1).
[5488] For purposes of this rule, the partnership's holding period does not tack, and Code § 751(d) (defining inventory item) shall be applied without regard to any holding period in Code § 1231(b). Code § 735(b), (c)(1).
[5489] Code § 735(a)(2).

If any of these hot assets is disposed of in a nonrecognition transaction or a series of nonrecognition transactions, the above tax treatment shall also apply to any substituted basis property resulting from such transaction(s).[5490]

II.Q.8.b.ii. Partnership Redemption – Complete Withdrawal Using Code § 736

When reading this part II.Q.8.b.ii, beware of part II.Q.8.b.i.(d) Capital Accounting May Trigger Ordinary Income.

II.Q.8.b.ii.(a). Introduction to Code § 736

When a partnership redeems[5491] a partner's interest in full,[5492] Code § 736(a) provides that payments may be deductible to the partnership and ordinary income to the selling partner;[5493] if and to the extent that these payments are based on partnership income rather than being fixed, they constitute a shifting of a distributive share of partnership income to the retiring partner, rather than a deduction to the partnership and income to the retiring partner.[5494] Or, one may

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[5490] Code § 735(c)(2)(A). This rule does not apply to any stock in a C corporation received in a Code § 351 exchange. Code § 735(c)(2)(B).

[5491] Code § 736 applies only to payments made by the partnership and not to transactions between partners. Reg. § 1.736-1(a)(1)(i). If the responsibility for making payments in a transaction between partners is assigned to the partnership, the assignment does not transform the sale into a Code § 736 redemption. *Coven v. Commissioner*, 66 T.C. 295 (1976), *acq.* 1976-2 C.B. 1, reasoning:

> We therefore conclude that petitioner sold his partnership interest to Suttenberg individually. The resulting tax consequences accordingly cannot be determined by section 736, since that section applies "only to payments made by the partnership and not to transactions between the partners." Sec. 1.736-1(a)(1)(i), Income Tax Regs. See also *Karan v. Commissioner*, 319 F.2d 303, 307 (7th Cir. 1963), *affg.* a Memorandum Opinion of this Court; *Smith v. Commissioner*, 313 F.2d 16, 19 (10th Cir. 1962), *affg.* 37 T.C. 1033 (1962); *Charles F. Phillips*, 40 T.C. 157, 161 (1963); 1 Willis, Partnership Taxation, sec. 46.01, p. 606 (2d ed. 1976).[10]
>
> [10] Although the agreement made a specific allocation for goodwill, capital gains treatment under sec. 736(b)(2)(B) would still not be possible, even if that agreement were not later superseded, because sec. 736 is inapplicable to this sale between partners. Furthermore, even if sec. 736 were applicable, the Consultant Contract, which was adopted, does not make any reference to goodwill, and the partnership did not operate under a written agreement: no operative written partnership agreement specifying payments for goodwill thus existed. Sec. 736(b)(2)(B) would therefore still be inapplicable. See *V. Zay Smith*, 37 T.C. 1033, 1037 (1962), *affd.* 313 F.2d 16 (10th Cir. 1962).

[5492] Code § 736 applies only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership. Code § 736 does not apply if the estate or other successor in interest of a deceased partner continues as a partner in its own right under local law. Reg. § 1.736-1(a)(1)(i). A partner retires when that person ceases to be a partner under local law. However, for partnership income tax purposes, a retired partner or a deceased partner's successor will be treated as a partner until such partner's interest in the partnership has been completely liquidated. Reg. § 1.736-1(a)(1)(ii). Thus, if one of the members of a two-person partnership retires or dies and the retiring member or deceased member's estate is to receive Code § 736 payments, the partnership will not be considered terminated, nor will the partnership year close with respect to either partner, until the retiring partner's or deceased member's estate's entire interest is liquidated, since the retiring partner or deceased member's estate continues to hold a partnership interest in the partnership until that time. Reg. § 1.736-1(a)(6).

[5493] For whether such payments are subject to self-employment tax, see part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.

[5494] Reg. § 1.736-1(a)(4). The retiring partner might like (if credits are passed through) or dislike (if nondeductible expenses increase taxable income) this result.

choose to apply Code § 736(b) so that they are nondeductible to the partnership (although possibly depreciated or amortized) and gain to the partner.[5495]

In analyzing the discussion below, note that one must be careful in relying on the regulations, which were last amended before P.L. 103-66 was enacted in 1993. The legislative history to 1993 changes to Code § 736 provides:

> *In general*.
>
> The bill generally repeals the special treatment of liquidation payments made for goodwill and unrealized receivables. Thus, such payments would be treated as made in exchange for the partner's interest in partnership property, and not as a distributive share or guaranteed payment that could give rise to a deduction or its equivalent. The bill does not change present law with respect to payments made to a general partner in a partnership in which capital is not a material income-producing factor. The determination of whether capital is a material income-producing factor would be made under principles of present and prior law [e.g., sections 401(c)(2) and 911(d) of the Code and old section 1348(b)(1)(A) of the Code]. For purposes of this provision, capital is not a material income-producing factor where substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by an individual. The practice of his or her profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which such individual conducts his or her practice so long as such capital investment is merely incidental to such professional practice. In addition, the bill does not affect the deductibility of compensation paid to a retiring partner for past services.
>
> *Unrealized receivables*.
>
> The bill also repeals the special treatment of payments made for unrealized receivables (other than unbilled amounts and accounts receivable) for all partners. Such amounts would be treated as made in exchange for the partner's interest in partnership property. Thus, for example, a payment for depreciation recapture would be treated as made in exchange for an interest in partnership property, and not as a distributive share or guaranteed payment that could give rise to a deduction or its equivalent.

The comment about unrealized receivables – particularly recapture of depreciation for not only Code § 1245 property but also Code § 1250 property – is quite important. Generally, when selling a partnership interest, sale proceeds are reclassified as ordinary income to the extent attributable to that property and many other types of property. See part II.Q.8.b.i.(g) Code § 751

[5495] Except to the extent Code § 751(b) applies (see part II.Q.8.b.i.(g) Code § 751 – Hot Assets), the amount of any gain or loss with respect to such payments is determined under Code § 731. Reg. § 1.736-1(b)(6). However, where the total of such payments is a fixed sum, the seller may elect (in the seller's tax return for the first taxable year for which the seller receives such payments), to report and to measure the amount of any gain or loss by the difference between the amount treated as a distribution under Code § 736(b) in that year, and the portion of the partner's adjusted basis that bears the same proportion to the partner's total adjusted basis for the partner's partnership interest as the amount distributed under Code § 736(b) in that year bears to the total amount to be distributed under Code § 736(b). *Id*.

– Hot Assets. However, the scope of items subject to that ordinary income recharacterization is dramatically reduced in a Code § 736 redemption.[5496]

Regarding payments for past services, see part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner, regarding when such payments are not subject to self-employment tax.

Code § 736 prevails over the rules of Code § 1001 that normally govern sales.[5497] For further discussion, see part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale.

We will see below that generally a Code § 736(b) payment is taxed under Code § 731(a), so one might wonder how important it might be to be within the scope of Code § 736. Part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale, especially the text accompanying fns. 5525-5528, explains why Code § 736 treatment can be extremely important.

Further below, a brief discussion illustrates why a partner whose interest is being redeemed would generally prefer Code § 736(a) treatment, even though at first glance it would seem that the retiring partner would prefer Code § 736(b) treatment, because capital gains rates are lower than ordinary income rates.

II.Q.8.b.ii.(b). Flexibility in Choosing between Code § 736(a) and (b) Payments

Before explaining this counter-intuitive rule, let's discuss the flexibility allowed. Within certain limits, the redemption agreement can provide that as much or as little of the redemption payments receive treatment under Code § 736(a) or (b).[5498] However, Code § 736(b) payments

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[5496] See text accompanying fns 5467-5477 in part II.Q.8.b.i.(g) Code § 751 – Hot Assets.

[5497] The first sentence of Reg. § 1.1001-1(a) says, "**Except as otherwise provided in subtitle A of the Code**, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained." (emphasis added)

[5498] Reg. § 1.736-1(b)(5)(iii). For what constitutes an agreement designating payments, see *Commissioner v. Jackson Investment Company*, 346 F.2d 187 (9th Cir. 1965), *rev'g* 41 T.C. 675 (reviewed decision 1964 holding that a withdrawal agreement was not given effect under Code § 736 as it did not constitute a partnership agreement); the Tax Court seems to have abandoned its decision in *Jackson Investment Company* in other Circuits as well – see *Spector v. Commissioner*, T.C. Memo. 1982-433, characterizing *Jackson Investment Company* as involving an ambiguous provision. If an agreement between all the remaining partners and the withdrawing partner or his successor in interest does not designate payments, then, subject to the limits described further below, Reg. § 1.736-1(b)(5)(i), (ii) provide the following:

> If a fixed amount (whether or not supplemented by any additional amounts) is to be received over a fixed number of years, the portion of each payment to be treated as a distribution under section 736(b) for the taxable year shall bear the same ratio to the total fixed agreed payments for such year (as distinguished from the amount actually received) as the total fixed agreed payments under section 736(b) bear to the total fixed agreed payments under section 736(a) and (b). The balance, if any, of such amount received in the same taxable year shall be treated as a distributive share or a guaranteed payment under section 736(a)(1) or (2). However, if the total amount received in any one year is less than the amount considered as a distribution under section 736(b) for that year, then any unapplied portion shall be added to the portion of the payments for the following year or years which are to be treated as a distribution under section 736(b). For example, retiring partner W who is entitled to an annual payment of $6,000 for 10 years for his interest in partnership property, receives only $3,500 in 1955. In 1956, he receives $10,000. Of this amount $8,500 ($6,000 plus $2,500 from 1955) is treated as a distribution under section 736(b) for 1956; $1,500, as a payment under section 736(a).

cannot exceed the fair market value of the withdrawing partner's share of the partnership property;[5499] therefore, Code § 736(a) must apply to such excess.

Except as discussed below, Code § 736(b) payments cannot be for (and therefore Code § 736(a) must apply to) the partnership's:

- Unrealized receivables;[5500]

- Goodwill, except to the extent that the partnership agreement provides for a payment with respect to goodwill.

The above limitation on what constitutes Code § 736(b) payments means that such payments must be classified as Code § 736(a) payments. It does not mean that such payments are the only types of payments that can be classified as Code § 736(a) payments instead of Code § 736(b) payments.[5501]

However, starting in 1993, payments for unrealized receivables and goodwill are eligible for Code § 736(a) treatment only if capital is not a material income-producing factor for the partnership and the retiring or deceased partner was a general partner in the partnership.[5502] The regulations have not been updated to take into account this rule. In applying this rule, capital is not a material income-producing factor where substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by an individual.[5503] The professional practice of a doctor, dentist, lawyer, architect, or accountant is not treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which such individual conducts that practice if the capital investment is merely incidental to such professional practice.[5504]

Code § 736(a) payments are available for payments in the form of mutual insurance not determined by reference to any partnership asset,[5505] payments of compensation to a retired

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> If the retiring partner or deceased partner's successor in interest receives payments which are not fixed in amount, such payments shall first be treated as payments in exchange for his interest in partnership property under section 736(b) to the extent of the value of that interest and, thereafter, as payments under section 736(a).

Whether a Code § 754 election is in effect or is deemed to be in effect might affect whether undesignated payments are 736(a) or 736(b) payments. McBride, Alice's Estate in the Wonderland of Subchapter K, *Tax Notes* 2/23/2009, pages 971-980.

[5499] Reg. § 1.736-1(b)(5)(iii).

[5500] Code § 736(b)(2)(A). Unrealized receivables include the right to payments for (1) goods delivered, or to be delivered, to the extent the proceeds would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered, or to be rendered. Code § 751(c), which is further described in part II.Q.8.b.i.(g) Code § 751 – Hot Assets. However, for purposes of Code § 736, they do not include other items that Code § 751 would normally treat as unrealized receivables. See text accompanying fns. 5466-5477.

[5501] Reg. § 1.736-1(b)(3) provides a ceiling on payments for goodwill, not a floor under which they may not be lowered. *Tolmach v. Commissioner*, T.C. Memo. 1991-538.

[5502] Code § 736(b)(3).

[5503] See part II.Q.8.b.ii.(a) Introduction to Code § 736.

[5504] See part II.Q.8.b.ii.(a) Introduction to Code § 736.

[5505] Reg. § 1.736-1(a)(2).

partner for past services,[5506] and perhaps a portion[5507] of payments where capital is a material income-producing factor.[5508]

If and to the extent that goodwill would not be eligible for Code § 736(a) treatment, consider how one would measure goodwill. For example, if the retiring partner was undercompensated for prior services before the company reached its full potential or for any other reason, payments could be allocated to past services.

If none of the above works around the inability to apply Code § 736(a) to goodwill, consider doing a partial redemption instead of a complete termination. Code § 736 applies only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership.[5509] Instead, provide a preferred interest in the partnership's profits up to a certain limit. Generally, reallocating profits between partners is not a taxable event.[5510]

II.Q.8.b.ii.(c). Comparing Code § 736(a) with (b) Strategically

See the example in part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis. The "Capital Gains to Seller" scenario corresponds to part II.Q.1.a.i.(d) S Corporation Double Taxation, which corresponds to Code § 736(b) payments, and the "Ordinary Income to Seller" scenario corresponds to part II.Q.1.a.i.(e) Partnership Single Taxation of Goodwill, which corresponds to Code § 736(a) payments. The contrast between these scenarios is illustrated in part II.Q.1.a.i.(f) Partnership Use of Same Earnings as S Corporation in Sale of Goodwill.

<u>Main Points</u>

1. Using a capital gain Code § 736(b) scenario, taxes consume much more to the parties as a whole than would the ordinary income Code § 736(a) scenario in meeting the targeted payments of "principal." Thus, the ordinary income scenario provides more money available to buy out the seller and ease the stress of the buy-out.

2. To compensate the seller for a higher ordinary income tax rate, the seller must receive more to generate the same after-tax flow. Thus, the stated sales price would appear to be higher and more burdensome, although really the buyer is better off because deducting the payments saves more than the additional purchase price cost.

3. In the § 736(a) scenario, increases in ordinary income tax rates harm the seller disproportionately, although it might be possible for the buyer to agree to pay seller more because the buyer saves more tax by making those additional payments. On the other hand, in a capital gain scenario, an increase in capital gain rates without a corresponding increase in ordinary income rates would not help the buyer save as much tax by paying the seller more.

[5506] See part II.Q.8.b.ii.(a) Introduction to Code § 736.
[5507] If the partners have agreed that the value of the Code § 736(b) payments is not to exceed a certain amount that is below fair market value, the remainder would be Code § 736(a) payments.
[5508] Banoff, More on Section 736(a) Payments After RRA '93 Changes, 83 *Journal of Taxation* 191 (Sept. 1995).
[5509] See fn. 5492.
[5510] See part II.C.6 Shifting Rights to Future Profits.

4. Code § 736(a) requires a complete liquidation in the redeemed partner's interest.[5511] However, the complete redemption may be made over time, and Code § 736 does not terminate the partnership, even if only one owner is left (but Code § 736 does not prevent termination if the partnership ceases activity).[5512] If the partnership assumes the partner's share of liabilities, it cannot deduct the payment of those liabilities under Code § 736 later than the year in which the partner's relationship with the partnership terminated;[5513] the liabilities are treated as relieved (and therefore cash is deemed paid) when the withdrawing partner is no longer a partner (ignoring the Code § 736 deemed continuation).[5514]

5. The above treatment does not apply to the extent that the LLC is repaying the seller's capital account, to the extent that the seller's capital account would be the LLC's earnings that are

[5511] Reg. § 1.736-1(a)(1)(i).

[5512] Rev. Rul. 75-154 involved the following facts:

> ABC partnership was formed in 1968 to conduct a management consulting business. Under the terms of the partnership agreement, upon retirement, the retiring partner was entitled to receive, in addition to amounts paid for his interest in partnership property, a specified amount payable in monthly installments over a three-year period following his retirement. There was no provision in the partnership agreement with respect to the payment to a retiring partner for goodwill.
>
> Partner C retired on January 2, 1972, and received 12 monthly payments from the partnership during 1972. On January 2, 1973, all of the business and financial activities of the partnership ended and A and B withdrew from the business. The former partners, A and B, assumed their share of the remaining liability to C and made the required payments for the years 1973 and 1974.

The ruling analyzed and held:

> Section 1.736-1(a)(6) of the Income Tax Regulations provides, in part, that a retiring partner or a deceased partner's successor in interest receiving payments under section 736 of the Code is regarded as a partner until the entire interest of the retiring or deceased partner is liquidated. Therefore, if one of the members of a 2-man partnership retires under a plan whereby he is to receive payments under section 736, the partnership will not be considered terminated, nor will the partnership year close with respect to either partner, until the retiring partner's entire interest is liquidated, since the retiring partner continues to hold a partnership interest in the partnership until that time.
>
> Section 1.736-1(a)(6) of the regulations prevents the termination of a partnership under section 708 of the Code, only in those situations in which the partnership would otherwise be terminated because of the withdrawal of a retiring or a deceased partner who is entitled to receive payments under section 736(a)(2). However, in the instant case, section 1.736-1(a)(6) of the regulations does not prevent the termination of the partnership under section 708, even though C was receiving liquidating payments under section 736(a)(2). It was the withdrawal of A and B that caused the partnership to terminate, not C's prior retirement.
>
> Accordingly, the partnership did not continue to exist under section 736 of the Code, but terminated under section 708 when partners A and B discontinued the financial operation of the partnership and withdrew from the business.
>
> It has been previously held that payments that would have been deductible by a partnership had it continued in existence were deductible by the former partners after termination of the partnership. See *Flood v. United States*, 133 F.2d 173 (1st Cir. 1943).
>
> Thus, in the instant case, after the partnership terminated, payments made by former partners A and B, in satisfaction of the liability to retired partner C, are deductible by them as trade or business expenses under section 162(a) of the Code in the year paid, since the payments would have been deductible by the partnership if it had not terminated. Furthermore, the payments to C are includible in C's gross income under section 61(a) in the year received.

[5513] *Whitman & Ransom v. Commissioner*, T.C. Memo. 2005-172.

[5514] See Reg. § 1.736-1(b)(7), Example (1), implementing Reg. § 1.736-1(a)(2) (treating assumption of liabilities treated as a distribution of money under Code § 752 in applying Code § 736).

allocated to the seller but not distributed. The seller would not be taxed on such distributions, because they were taxed when originally earned.

6. Combined with a Code § 754 election, a Code § 736(b) payment would generate a separate basis for each asset whose basis is adjusted, and each year a new set of assets would be created.[5515] Rather than try to recover that tax benefit, a Code § 736(a) is an easier way for the remaining partners to avoid tax on earnings used to buy the redeemed partner.

7. A partnership might be structured with profits interests that shift over time, which might achieve results similar to that of Code § 736 without the partner completely retiring. For example, suppose an older partner brought in a lot of business, but the agreement would be that the younger partners would take over the business after a number of years. The partnership might be structured to give the older partner a larger profits interest in early years and a smaller profits interest in later years. Generally, merely shifting interests in future profits is not a taxable event.[5516] The objective would be to structure it not as a sale, but rather as an allocation of profits related to the business each partner generates and the services each partner performs.

8. A technique similar to Code § 736 ordinary income payments used to be available to corporations in some situations. If the corporation could make a case that the departing shareholder was under-compensated for prior services, the corporation would pay compensation to him or her, with economic results similar to that of Code § 736 ordinary income payments. Code § 409A has made that strategy more difficult to use, imposing a 20% penalty on deferred compensation to the extent substantially vesting occurs after December 31, 2004, unless the statute's strict requirements are satisfied. To use deferred compensation payments based on prior services, the parties would need to prove that it is fair to compensate the selling owner-employee for prior services even though the employer was previously not legally obligated to do so. The sooner one plans for this future compensation, the easier it will be to prove reasonableness, since the owner-employee will be earning the compensation over time in a manner that is specifically referred to as an incentive for continued efforts. A challenge is that an appropriate level of compensation may be difficult to determine many years in advance of a sale.

<u>Additional Code § 736 Issues</u>

As discussed above, to the extent permitted by law, generally:

- Returns of basis should be structured as Code § 736(b) payments, because the seller is not taxed on them, and

- Profit on the sale of a partnership should be structured as Code § 736(a) payments, and the sale price should be increased at least enough to compensate the seller for paying taxes at ordinary income and self-employment and similar tax rates instead of any applicable capital gain rates.

[5515] See the paragraph of text accompanying fn. 5546 in part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale.
[5516] See part II.C.6 Shifting Rights to Future Profits.

II.Q.8.b.ii.(d). Comparing Code § 736(b) to an Installment Sale

Suppose one partner is exiting and being bought out over time, and one or more remaining partners will have higher interests in profits and losses. Should it be structured as a sale from one partner to another, or should the partnership redeem the exiting partner? If the latter, should the partnership issue a note to the partner?

In many cases, the partnership should redeem the exiting partner, documented by the partnership agreement without a separate promissory note. Code § 736 redemptions of a retiring partner are often better than an installment sale; and issuing a note might move the transaction into an unclear tax posture, whereas relying solely on the partnership agreement avoids certain questions. Merely shifting the right to future profits would not generate an income tax consequence;[5517] however, shifting a partner's capital account and any gain or loss inherent in that partner's share of the partnership's existing value would have income tax consequences. We have already seen how Code § 736(a) payments tend to work better for the partnership's value relating to goodwill;[5518] the rest of this part II.Q.8.b.ii.(d) discusses all components of value in a general sense.

Code § 736 taxes the retired partner on Code § 736 payments as if the retired partner were still a partner;[5519] complete liquidation of a partner's interest does not occur until no more payments may be made to the withdrawn partner.[5520] Code § 736(a) payments are taxed in the year for which they are made, rather than in the year of receipt.[5521] Furthermore, except to the extent Code § 751(b) applies, the amount of any gain or loss with respect to payments under Code § 736(b) for a retiring or deceased partner's interest in property for each year of payment is determined under Code § 731.[5522]

Code § 736 redemptions do not appear to contemplate the installment sale rules applying. If Code § 736 applies instead of the installment sale rules applying, then, rather than pro rating basis among the scheduled installment payments the way an installment sale would work, basis is applied fully to the earliest payments until it is used up. Thus, Code § 736 payments defer recognition of gain on sale relative to installment sales, a benefit that is not present in the sale of stock in a C or an S corporation; it also allows distributions to be applied to the partner's entire basis in the partnership,[5523] whereas distributions to shareholders are applied pro rata to their

[5517] See part II.C.6 Shifting Rights to Future Profits.
[5518] See part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis, especially parts II.Q.1.a.i.(f) Partnership Use of Same Earnings as S Corporation in Sale of Goodwill and II.Q.1.a.i.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill.
[5519] Reg. § 1.736-1(a)(6). Although a partner retires when he ceases to be a partner under local law, a retired partner or a deceased partner's successor will be treated as a partner for partnership income tax purposes (subchapter K, chapter 1 of the Code) until the partner's interest in the partnership has been completely liquidated. Reg. § 1.736-1(a)(1)(ii). Does this continuation of treatment as a partner apply for purposes of the income in respect of a decedent rules of Code § 1014(c), which is found in subchapter O of chapter 1 of the Code? See part II.I.8.d.iv Treatment of Code § 736 Redemption Payments under Code § 1411.
[5520] *Brennan v. Commissioner*, T.C. Memo, 2012-209 (citing Reg. § 1.761-1(d) and imposing a negligence penalty for failure to report the partner's distributive share of income earned before the partner received the final payment) , *aff'd* 116 A.F.T.R.2d 2015-6569 (9th Cir. 2015).
[5521] Reg. § 1.736-1(a)(5).
[5522] Reg. § 1.736-1(b)(6).
[5523] See part II.Q.8.e.ii.(a) Unitary Basis.

shares and are taxed according to the basis in each block of shares,[5524] perhaps heightening the impact of deferred basis recovery for those sales that are redemptions recharacterized as distributions.

The installment sale of a partnership interest can be particularly disastrous if the partnership has significant "hot assets," which can include not only inventory and accounts receivable but also depreciable property,[5525] because income from those items is taxable immediately – even if it exceeds the amount that the seller received up front.[5526] However, depreciable property and certain other property[5527] are not "hot assets" when applying Code § 736.[5528] Also, when a partnership redeems a partnership interest and the redeemed partner is allocated ordinary income from hot assets, the remaining partners receive basis in those hot assets.[5529] This contrasts with S corporations, where the remaining shareholders report ordinary income on corresponding items.[5530]

Not all redemptions qualify for Code § 736 treatment – they need to be "in liquidation of the interest of a retiring partner or a deceased partner."[5531] If a Code § 736 payment obligation is evidenced as a promissory note rather than contract right, do the installment sale provisions apply when the partner receives the note?[5532] The amounts paid for his interest in assets are treated in the same manner as a distribution in complete liquidation under Code §§ 731, 732, and, where applicable, 751.[5533]

[5524] See part II.Q.7.h.ii Taxation of Shareholders When Corporation Distributes Cash or Other Property, especially fn. 5096.

[5525] See part II.Q.8.b.i.(g) Code § 751 – Hot Assets.

[5526] See part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests, especially fn. 5655.

[5527] See part II.Q.8.b.i.(g) Code § 751 – Hot Assets, especially fns. 5468-5475.

[5528] See part II.Q.8.b.i.(g) Code § 751 – Hot Assets, especially fn. 5466.

[5529] Reg. § 1.751-1(g), Example (2), paragraph (e)(1).

[5530] See part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[5531] Code § 736(a), (b)(1). Reg. § 1.736-1(a)(1)(i) elaborates:

> Section 736 and this section apply only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership. See section 761(d). Section 736 and this section do not apply if the estate or other successor in interest of a deceased partner continues as a partner in its own right under local law. Section 736 and this section apply only to payments made by the partnership and not to transactions between the partners. Thus, a sale by partner A to partner B of his entire one-fourth interest in partnership ABCD would not come within the scope of section 736.

[5532] See Kim and Saunders, Redeeming a Partner with The Partnership's Note, *TM Memorandum* (BNA) (3/21/2016) (saved as Thompson Coburn doc. 6817740).

[5533] Reg. § 1.736-1(a)(2), which also refers to Reg. § 1.751-1(b)(4)(ii). Reg. § 1.751-1(b)(4)(ii) provides:

> Section 751(b) does not apply to payments made to a retiring partner or to a deceased partner's successor in interest to the extent that, under section 736(a), such payments constitute a distributive share of partnership income or guaranteed payments. Payments to a retiring partner or to a deceased partner's successor in interest for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, constitute payments under section 736(a) and, therefore, are not subject to section 751(b). However, payments under section 736(b) which are considered as made in exchange for an interest in partnership property are subject to section 751(b) to the extent that they involve an exchange of substantially appreciated inventory items for other property. Thus, payments to a retiring partner or to a deceased partner's successor in interest under section 736 must first be divided between payments under section 736(a) and

Neither Code § 731 nor Code § 732 nor the regulations under either statute address the effect of distributing a note in which the partnership is the maker. For purposes of maintaining capital accounts, generally distributions of notes do not count as distributions except to the extent that the partner disposes of or the partnership repays the note, but a distribution of a note will count as a distribution if the note is readily tradable on an established securities market,[5534] is negotiable,[5535] or perhaps if it is payable upon demand.[5536] However, a leading treatise strongly opposes counting a note in which the partnership is the maker, whether or not negotiable, as a distribution;[5537] the treatise does, suggest, however, reducing the basis available to allocate to

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> section 736(b). The section 736(b) payments must then be divided, if there is an exchange of substantially appreciated inventory items for other property, between the payments treated as a sale or exchange under section 751(b) and payments treated as a distribution under sections 731 through 736. See subparagraph (1)(iii) of this paragraph, and section 736 and § 1.736-1.

However, the scope of unrealized receivables is narrower under Code § 736 than on other transactions involving hot assets; see part II.Q.8.b.i.(g) Code § 751 – Hot Assets, especially the text accompanying fn. 5466.

[5534] In addition to Reg. § 1.704-1(b)(2)(iv)(e)(2) that is reproduced in fn. 5535, consider that Code §§ 731(c)(2)(B)(ii) (any financial instrument which, pursuant to its terms or any other arrangement, is readily … exchangeable for, money or marketable securities) and 731(c)(2)(C) (The term 'financial instrument' includes … evidences of indebtedness ….) treat a distribution of publicly traded debt as a cash distribution.

[5535] Reg. § 1.704-1(b)(2)(iv)(e)(2) provides:

> *Distribution of promissory notes*. Notwithstanding the general rule of paragraph (b)(2)(iv)(b)(5), except as provided in this paragraph (b)(2)(iv)(e)(2), if a promissory note is distributed to a partner by a partnership that is the maker of such note, such partner's capital account will be decreased with respect to such note only when there is a taxable disposition of such note by the partner or when the partnership makes principal payments on the note. The previous sentence shall not apply if a note distributed to a partner by a partnership who is the maker of such note is readily tradable on an established securities market. Furthermore, the capital account of a partner whose interest in a partnership is liquidated will be reduced to the extent of (i) the fair market value, at the time of distribution, of any negotiable promissory note (of which such partnership is the maker) that such partnership distributes to the partner on or after the date such partner's interest is liquidated and within the time specified in paragraph (b)(2)(ii)(b)(2) of this section, and (ii) the fair market value, at the time of liquidation, of the unsatisfied portion of any negotiable promissory note (of which such partnership is the maker) that such partnership previously distributed to the partner. For purposes of the preceding sentence, the fair market value of a note will be no less than the outstanding principal balance of such note, provided that such note bears interest at a rate no less than the applicable federal rate at time of valuation.

[5536] Consider that Code §§ 731(c)(2)(B)(ii) (any financial instrument which, pursuant to its terms … is readily convertible into, or exchangeable for, money) and 731(c)(2)(C) (The term 'financial instrument' includes … evidences of indebtedness ….) treat a distribution of a demand note as a cash distribution.

[5537] McKee, Nelson & Whitmire, ¶19.05. Distributions in Complete Liquidation of a Partnership Interest, *Federal Taxation of Partnerships & Partners* (WG&L), reasons (footnotes omitted):

> Treating even a secured negotiable promissory note of the partnership as cash or a cash equivalent, the distribution of which triggers gain under § 731(a), would be inconsistent with the statutory scheme of Subchapter K because a § 754 election by the partnership would permit the partnership to increase the basis of its assets as the result of the distribution of zero-basis property. Similarly, treating a partnership's promissory note as property for purposes of applying §§ 731 and 732 also would produce results totally inconsistent with the Subchapter K scheme. Property characterization in connection with a current distribution would give the note a zero basis in the distributee-partner's hands under § 732(a)(1) because it would have a zero basis in the partnership's hands immediately prior to the distribution. Subsequent payments on the note would have to be treated as payments rather than distributions; the expenditure of partnership assets with no corresponding overall impact on the bases of the partners' interests would destroy

other distributed assets by the amount of payments expected to be made.[5538] Issuing a formal note creates much complexity and uncertainty,[5539] so one might consider keeping the payment right a contract right not reduced to a note. On the other hand, using a note and installment sale treatment would enable a cleaner break between the redeemed partner and the partnership and simplify inside basis step up issues (fn. 5546). The clean break from the partnership allows the retiring partner not to be treated as a partner any more for income tax purposes[5540] but also locks in the installment sale gain as income in respect of a decedent, the latter making the installment obligation ineligible for a basis step-up at death, whereas mere Code § 736(b) installments appear eligible for a basis step-up at death.[5541]

> the symmetry between the partnership's basis in its assets and the partners' bases in their interests, which Subchapter K strives to preserve. Similarly, if a partnership note were treated as property distributed as the sole consideration for the liquidation of a partner's entire interest in the partnership, it would take on a basis equal to the distributee-partner's basis in his interest. If a § 754 election were in effect, the partnership would be required to reduce the basis of its retained assets under § 734(b)(2)(B) by the amount of the distributee-partner's post-distribution basis in the note. By contrast, a cash distribution in the amount of the note would produce an increase in the basis of partnership assets if the cash distributed exceeded the distributee-partner's predistribution basis in his interest. A partnership note should thus not be treated as property under §§ 731 and 732, either. Payments on the note should be treated as distributions of cash, subject to all the rules applicable to such distributions.

[5538] McKee, Nelson & Whitmire, ¶19.05. Distributions in Complete Liquidation of a Partnership Interest, *Federal Taxation of Partnerships & Partners* (WG&L), reasons in a footnote:

> See Reg. § 1.732-1(b) (Where a partnership distributes property (other than money) in liquidation of a partner's entire interest in the partnership, the basis of such property to the partner shall be an amount equal to the adjusted basis of his interest in the partnership reduced by the amount of any money distributed to him *in the same transaction*. (emphasis added)). The reference to the same transaction should be interpreted to refer to the entire series of liquidating distributions in order to be consistent with the Regulations § 1.761-1(d) definition of liquidation. Further, any other interpretation of Regulations § 1.732-1(b) would make the timing of liquidating distributions a key ingredient in determining the basis of distributed property, and would allow taxpayers to artificially inflate the basis of property distributed in liquidation by agreeing to defer cash distributions. For example, assume a partner, whose basis of his interest is $10,000, is to receive $4,000 cash and a capital asset in liquidation of his interest. Under the interpretation suggested in the text, the distributed capital asset will have a basis of $6,000 to the partner regardless of the order in which the distributions are made. If subsequent cash distributions are not taken into account in computing the basis of the distributed capital asset, the capital asset will take a basis of $10,000 if it is distributed first and the $4,000 cash distribution will be taxable when received, a combination that would allow the distributee to accelerate losses (by selling the distributed capital asset) in exchange for a deferred gain on the eventual receipt of the cash.

[5539] See Cuff, Distributions of Promissory Notes In Liquidation of a Partner's Interest, *Journal of Real Estate Taxation* (now simply *Real Estate Taxation*) (WG&L), (1st Qtr. 2006) (capital accounting for promissory note distributions to a partner, allocations with respect to contributed property, allocations after a book-up of partnership assets, the minimum gain chargeback, the qualified income offset, unrecaptured Code § 1250 gain, allocation of partnership liabilities, and collapsible partnerships); Cuff, Promissory Notes In Liquidation of a Partner's Interest Still Hold Questions, *Journal of Real Estate Taxation* (now simply *Real Estate Taxation*) (WG&L), (2nd Qtr. 2006) (considering the interplay of the rules described in the 1st Qtr. Article, and the rules on disguised sales and collapsible partnerships).

[5540] See fns. 5519-5520.

[5541] See fns. 5544 and 5545 and part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

One might also be cautious when admitting a partner and redeeming a partner close in time to each, lest the IRS argue a disguised sale between the retiring partner and the new partner.[5542]

Letter Ruling 8304059 assumed that using a promissory note to redeem a partner does not necessarily take the transaction out of Code § 736 and ruled that any interest paid constitutes a Code § 707(c) guaranteed payment and that Reg. §§ 1.267(b)-1(b) and 1.707-1(c) prevent Code § 267 from limiting the timing of the interest deduction. Although a Code § 736 payment may bear interest, it need not.[5543] For details on Code § 707(c), see part II.C.8.a Code § 707 -

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[5542] See Kim and Saunders, Redeeming a Partner with The Partnership's Note, *TM Memorandum* (BNA) (3/21/2016) (saved as Thompson Coburn doc. 6817740). Announcement 2009-4 stated:

> Until new guidance is issued, any determination of whether transfers between a partner or partners and a partnership is a transfer of a partnership interest will be based on the statutory language, guidance provided in legislative history, and case law.

Announcement 2009-4 looks askance at a couple of cases in this area, which cases are discussed in the Kim and Saunders article but which might control, notwithstanding the IRS' view. Announcement 2009-4 stated:

> Section 707(a)(2)(B) provides that, under regulations prescribed by the Secretary, if transfers of property between a partner or partners and a partnership, when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated as either transactions between the partnership and one who is not a partner or between two or more partners acting other than in their capacity as partners. The legislative history of section 707(a)(2)(B) indicates the provision was adopted as a result of Congressional concern that taxpayers were deferring or avoiding tax on sales of partnership property, including sales of partnership interests, by characterizing sales as contributions of property, including money, followed or preceded by related partnership distributions. See H.R. Rep. No. 861, 98th Cong. 2nd Sess. 861 (1984), 1984-3 (Vol. 2) CB 115. Specifically, Congress was concerned about court decisions that allowed tax-free treatment in cases that were economically indistinguishable from sales of property to a partnership or another partner, and believed that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance. See H.R. Rep. No. 432, 98th Cong. 2nd Sess. 1218 (1984) (H.R. Rep.), and S. Prt. No. 169 (Vol. I), 98th Cong. 2nd Sess. 225 (1984) (S. Prt.) (discussing *Communications Satellite Corp. v. United States*, 625 F.2d 997 (Ct. Cl. 1980), and *Jupiter Corp. v. United States*, 2 Cl. Ct. 58 (1983), both of which involved disguised sales of a partnership interest).

[5543] Garlock, ¶1308 Debt Contributed To And Distributed From Partnerships, *Federal Income Taxation of Debt Instruments* (CCH), asserts in ¶1308.02 Distributions of Debt Instruments from Partnerships, [B] Debt of the Partnership:

> …The real issue, then, is whether interest will be imputed on partnership notes to partners that do not bear adequate stated interest. As noted above, the better view is that interest should not be imputed.
>
> If a partnership's note distributed to a partner is respected for all tax purposes, and if the partner's interest in the partnership is not reduced as a result of the distribution (as would be the case in a situation involving a pro rata distribution of notes to all partners), the determination of its issue price is unclear. The note is not issued for cash or property because the partner is not giving anything to the partnership in exchange for the note. There is no partnership analogue to section 1275(a)(4), which deems a corporation's note distributed to a shareholder as being issued in exchange for property. Hence, section 1273(b) does not provide any rule for determining the note's issue price.[258] Reg. § 1.1273-2(d)(1), which is broader than the corresponding statutory rule, effectively treats any debt instrument not issued for money or publicly traded property or subject to section 1274 as having an issue price equal to its stated redemption price.
>
> If the debt distributed provides for qualified stated interest (QSI), then its stated redemption price at maturity equals its stated principal amount and little is at stake here. The stated interest is respected as interest, and the stated principal amount is respected as principal. Even if the interest is at a rate below the AFR (or is zero), no interest is imputed under section 1274 because

Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.

It appears that a basis adjustment would apply at the retiring partner's death, which might eliminate a considerable part of the gain to be recognized on future installments (to the extent that gain is not attributable to the deceased partner's share of items constituting income in respect of a decedent)[5544] and might also lead to depreciation and goodwill amortization deductions.[5545] Thus, installment sales lock in gain as income in respect of a decedent, whereas Code § 736 payments appear eligible for a basis step-up. A partnership agreement might even convert Code § 736(a) payments to Code § 736(b) payments upon death, perhaps reducing the installments to take into account the smaller tax burden imposed on the seller.

Suppose that the partnership agreement provided for a Code § 736(b) payment with respect to goodwill. Each Code § 736(b) installment would give rise to a new goodwill asset that could be amortized over 180 months.[5546] Thus, the parties could get some tax arbitrage by the buyer getting ordinary deductions over 15 years when the seller gets capital gain, but query what the time value of money would be like in a business deal, which generally requires a faster payback. If assets have a faster depreciation period but the number of assets to track is high, consider abandoning the use of Code § 736(b) payments and simply using Code § 736(a); see part II.Q.8.b.ii.(c) Comparing Code § 736(a) with (b) Strategically.

> the debt was not issued in exchange for property and no interest is imputed under section 7872 because a loan from a partnership to a partner is not one of the categories of loans subject to that section, absent regulations treating the loan as a significant tax effect loan.[259] The only real problem arises if the debt provides for stated interest that is not QSI. Because all payments other than QSI are included in a debt's stated redemption price at maturity,[260] the effect of treating the debt's issue price as being equal to its stated redemption price at maturity would be to recharacterize all stated interest on the debt as principal. It is doubtful that this result was intended. The more sensible rule is to treat the debt instrument as issued for its stated principal amount in this situation.
> [258] See ¶ 203. Section 1273(b)(1) and (2) apply to debt instruments not issued for property, but the rules in those paragraphs depend on the price at which the instruments were offered for sale or actually sold, and this does not apply in the present case. Section 1273(b)(4) is generally the rule that applies if no other rule applies (and it deems the issue price to be equal to the stated redemption price at maturity), but it only applies to debt issued for property.
> [259] See ¶ 402.02.
> [260] See ¶ 202.01.

[5544] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, fn. 5682.
[5545] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, especially fn. 5684.
[5546] Reg. § 1.734-1(e)(1), referred to by McKee, Nelson & Whitmire, ¶25.02. Allocations of Section 734(b) Adjustments to Partnership Assets: Section 755, *Federal Taxation of Partnerships & Partners* (WG&L), interpreting the consequence of Rev. Rul. 93-13, which provides:

> If a partnership that has in effect an election to adjust basis under section 754 of the Internal Revenue Code completely liquidates the interest of a partner by agreeing to make a series of cash payments that are treated as distributions under section 736(b)(1), the section 734(b) basis adjustments to partnership property respond in timing and amount with the recognition of gain or loss by the retiring partner with respect to those payments.

If the Code § 736(b) payments were contingent, perhaps Reg. § 1.197-2(f)(2) would apply to amortize the new payments over the remaining months of the 180-month period.

Presumably, this lack of installment sale treatment would allow partnership redemptions to avoid the interest on deferred tax liabilities that Code § 453A imposes on installment sales. A prominent treatise states:[5547]

> A selling partner who receives deferred payments and reports gain under § 453 may be subject to acceleration of deferred gain under the pledge rule in § 453A(d) and may be required to pay interest on his deferred tax liability under § 453A(c). There are no analogous provisions applicable to deferred distributions to partners whose partnership interests are liquidated under § 736.

The treatise later states:[5548]

> In general, amounts that are computed like interest and paid to a partner for the use of partnership capital constitute guaranteed payments under § 707(c). Because a retired partner who receives post-retirement liquidation distributions is treated as a continuing partner (and not as a partnership creditor) for Subchapter K purposes until his interest is completely liquidated, it seems that any "interest" paid with respect to deferred § 736(b) distributions should be treated as guaranteed payments to the retired partner for the use of his unreturned capital. This notion is buttressed by the fact that § 736(a)(2) treats all payments "made in liquidation of the interest of a retiring partner" as § 707 guaranteed payments if they are determined without regard to partnership income and are not paid for the retiring partner's interest in partnership property under § 736(b).
>
> If deferred liquidation payments cannot bear tax-recognized interest, it follows that the imputed interest rules of §§ 483, 1272, and 7872 do not apply to deferred liquidation distributions under § 736. [In other words, deferred payments under Code § 736 should not be recharacterized as part principal and part interest.] From a policy perspective, inapplicability of these rules may not be as offensive as might first appear, since the timing of any tax benefits and burdens of deferred liquidation payments under § 736 are matched. Thus, because deferred liquidation payments are not treated as liabilities, the continuing partners cannot increase the bases of their partnership interests by the amount of deferred payments under § 752(a). In addition, the partnership is entitled to adjust the basis of its assets under § 734(b) only when the deferred payments are actually made and the retired partner actually recognizes gain or loss. Finally, if amounts payable to a retired partner include interest-like payments, such payments constitute § 736(a)(2) payments that will be included in the income of the retired partner at the same time that they are deducted by the partnership under the matched timing rules of § 707(c).

I am not aware of any primary authority addressing the above issue.

[5547] McKee, Nelson & Whitmire, ¶16.02. Transfers of Partnership Interests by Sale or Exchange: Tax Consequences of Liquidations Compared, *Federal Taxation of Partnerships & Partners*.

[5548] McKee, Nelson & Whitmire, ¶22.02[4][c] Interest on Deferred Section 736(b) Payments, *Federal Taxation of Partnerships & Partners*. For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.

II.Q.8.b.ii.(e). Effect of Code § 736 Payments, Installment Sale Payments, or Deferred Compensation on Balance Sheet

Generally, Code § 736(a)(1) payments that are structured as preferred distributions of profits are considered equity and do not affect the entity's net worth.

On the other hand, Code § 736(a)(2) guaranteed payments and Code § 736(b) installment sale payments would be liabilities on the entity's balance sheet. Similarly, in a cross-purchase, the buyers would have liability on their balance sheets (which can also impede the use of guaranties). Finally, deferred compensation agreements, which are the corporate attempt to replicate Code § 736(a)(2) guaranteed payments, would also constitute a liability on the entity's balance sheets.

Liabilities on balance sheets can impede access to credit before and during the buy-out period. That a business is transitioning from the successful founder to new management doesn't help that situation.

Thus, Code § 736(a)(1) payments that are structured as preferred distributions of profits might very help the business' operations relative to the other ways of structuring buyouts.

II.Q.8.b.ii.(f). Planning for the 3.8% Tax on Net Investment Income and Passive Loss Rules When Using Code § 736 Payments

For purposes of the 3.8% tax on net investment income,[5549] see part II.I.8.d.iv Treatment of Code § 736 Redemption Payments under Code § 1411.

See also part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736.

II.Q.8.b.ii.(g). Code § 736 Payments as Retirement Income – Possible FICA and State Income Tax Benefits

Compensatory payments to be made for the rest of a partner's life, which generally would be Code § 736(a) payments, might be excluded from FICA but would be subject to Code § 409A. See part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.

No state may impose income tax on any retirement income of an individual who is not a resident or domiciliary of that state (as determined under that state's laws).[5550] "Retirement income" includes income from a written plan, program, or arrangement that is in effect immediately

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[5549] See part II.I 3.8% Tax on Excess Net Investment Income.

[5550] 4 U.S.C. § 114(a). Missouri Private Letter Ruling No. LR 3570 (1/2/2007) held that this statute protected the following payments from state income tax:

> Applicant is a participant of a Retirement Plan (RP) and is also a participant of an Insurance Plan (collectively, the Plans). The purpose of the Plans is to supplement retirement benefits from the Pension Plan (Pension Plan) and the Retirement Plan for eligible corporate officers in recognition of service to their employer. The administrator of the RP is the Corporation and the administrator of the insurance plan is a committee within the Pension Plan.
>
> ….
>
> In this case the Plans are plans or arrangements as described in IRC section 3121(v)(2)(C) and the monthly payments meet the requirements of section 114(b)(1)(I)(i) of Title 4 of the United States Code. Therefore, for purposes of state income tax, the monthly payments from the Plans received by Applicant will be treated as retirement income as defined in section 114(b) of Title 4 of the United States Code.

before retirement begins and provides retirement payments in recognition of prior service to be made to a retired partner,[5551] if the income is from an excess benefit plan[5552] or if the income is part of a series of substantially equal periodic payments payable at least annually for either the life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and a designated beneficiary of the recipient) or a period of not less than 10 years.[5553]

II.Q.8.b.ii.(h). Interaction of Death with Code § 736 Payments

Generally, the retiring partner's payments would consist of:

- Code § 736(a) payments (taxable as ordinary income), grossed up for income taxes as illustrated in the different purchase prices used in parts II.Q.1.a.i.(f) Partnership Use of Same Earnings as S Corporation in Sale of Goodwill and II.Q.1.a.i.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill, would be paid during the retiring partner's life, and

- Code § 736(b) payments, not grossed up but generally tax-free because the deceased partner's successor in interest has received a basis step-up, would be made after the retiring partner's death.[5554]

Perhaps the partnership has life insurance to pay a retired partner. The life insurance is received tax-free (so long as the partnership complies with the rules on employer-owned life insurance, which apply to any 5% partner, whether or not the partner actually works in the business).[5555] Thus, the partnership does not need to deduct payments it makes to the retired partner's beneficiaries. Furthermore, the basis step-up mentioned above, if my assumption is correct, means that there is no capital gain tax for the retired partner's beneficiaries to avoid. Code § 753 denies a basis step-up to Code § 736(a) payments but does not address Code § 736(b) payments, which implies that Code § 736(b) payments receive a basis step-up. Therefore, consider converting Code § 736(a) payments to Code § 736(b) payments when a partner dies, perhaps reducing the payments to take into account that the seller does not need to be grossed up to pay the seller's taxes on the distribution.

[5551] 4 U.S.C. § 114(b)(4) provides:

> For purposes of this section, the term retired partner is an individual who is described as a partner in section 7701(a)(2) of the Internal Revenue Code of 1986 and who is retired under such individual's partnership agreement.

[5552] 4 U.S.C. § 114(b)(1)(I)(ii) refers to:

> a payment received after termination of employment and under a plan, program, or arrangement (to which such employment relates) maintained solely for the purpose of providing retirement benefits for employees in excess of the limitations imposed by 1 or more of sections 401(a)(17), 401(k) , 401(m) , 402(g), 403(b), 408(k), or 415 of such Code or any other limitation on contributions or benefits in such Code on plans to which any of such sections apply.

I have assumed, without verification, that withdrawal from a partnership counts as termination of employment, consistent with the treatment of partners as employees eligible to participate in a qualified retirement plan. Please let me know what you discover when you research this issue.

[5553] 4 U.S.C. § 114(b)(1)(I)(i).

[5554] For the basis step-up, see fns. 5544 and 5545 in part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale.

[5555] See part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

II.Q.8.b.iii. Partnership Alternative to Seller-Financed Sale of Goodwill

Is goodwill an asset that belongs to the individual owner or to the entity? Where a non-compete agreement is not in place and business is largely attributable to the close personal relationships that the owner has developed and maintained for decades, goodwill belongs to the owner personally.[5556] Where a contract allocates large amounts to the entity's goodwill and the owner enters into a noncompete agreement to preserve the entity's goodwill, the owner's receipt of noncompetition payments is ordinary income rather than the sale of personal goodwill.[5557] Given that the buyer's deductions relating to goodwill are the same as for a noncompetition agreement,[5558] the seller should consider maximizing the extent to which payments directly to the seller are for personal goodwill rather than a covenant not to compete.[5559]

As a practical matter, often the buyer will be able to pay the promissory note for goodwill only if the business is sufficiently profitable. If the business is not profitable, the seller would need to sue the buyer to enforce the note, and all that lawsuit would accomplish would be a judgment against someone who cannot pay it. The seller's most effective recourse might be to take over the business, which the judgment on the promissory note is unlikely to accomplish without further legal action.

[5556] See part II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees?

[5557] *Muskat v. U.S.*, 554 F.3d 183 (1st Cir. 2009), *aff'g* 101 AFTR 2d 2008-1606 (D.N.H. 2008). When Muskat sold his business to Jac Pac and agreed not to compete, nothing in the contract mentioned that Muskat was selling personal goodwill. The trial court described the negotiations for the sale:

> During the negotiation process, the parties were well-aware of Jac Pac's business goodwill, to which more than $15,000,000 of the purchase price was allocated. Warren testified that he was not aware of any goodwill in the transaction other than Jac Pac's goodwill. The noncompetition agreement defines Goodwill as an asset of Jac Pac including its goodwill and business as a going concern. The purpose of the noncompetition agreement was to protect Jac Pac's Goodwill in the transaction. Muskat acknowledged in the agreement that the noncompetition provisions were necessary to preserve and protect the proprietary rights and the goodwill of [MAC] (including [Jac Pac's goodwill]) and the Related Entities as going concerns. The consideration paid under the agreement was expressly for the covenants not to compete, with no mention of personal goodwill.

The District Court applied First Circuit precedent requiring the taxpayer to produce strong proof before applying tax treatment that varied from the transaction's legal documentation. The First Circuit agreed with the District Court and also clarified what strong proof means: To constitute "strong proof" a taxpayer's evidence must have persuasive power closely resembling the "clear and convincing" evidence required to reform a written contract on the ground of mutual mistake. For a discussion of whether a taxpayer may use substance over form, see also cases cited in fn 5699 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

In *Duffy v. U.S.*, 120 Fed. Cl. 55 (Ct. Fed. Cl. 2015), *aff'd* 117 A.F.T.R.2d 2016-397 (Fed. Cir. 2016), the recipient of proceeds in a settlement in a case for retaliatory firing asserted that the settlement was for personal injury or as compensation for impaired personal goodwill, the latter because he could not find a job because his former employer would not give him a reference. However, the settlement agreement provided that the payment was for the exclusive purpose of avoiding the expense and inconvenience of further litigation. The Court of Claims used that language to throw out the taxpayer's personal injury and goodwill assertions and held for the IRS. The Federal Circuit cited the quoted language and also noted, Mr. Duffy simply extinguished his claims, and any goodwill in his business remained with him.

[5558] Compare Code § 197(d)(1)(A) (goodwill) with Code § 197(d)(1)(E) (covenant not to compete).

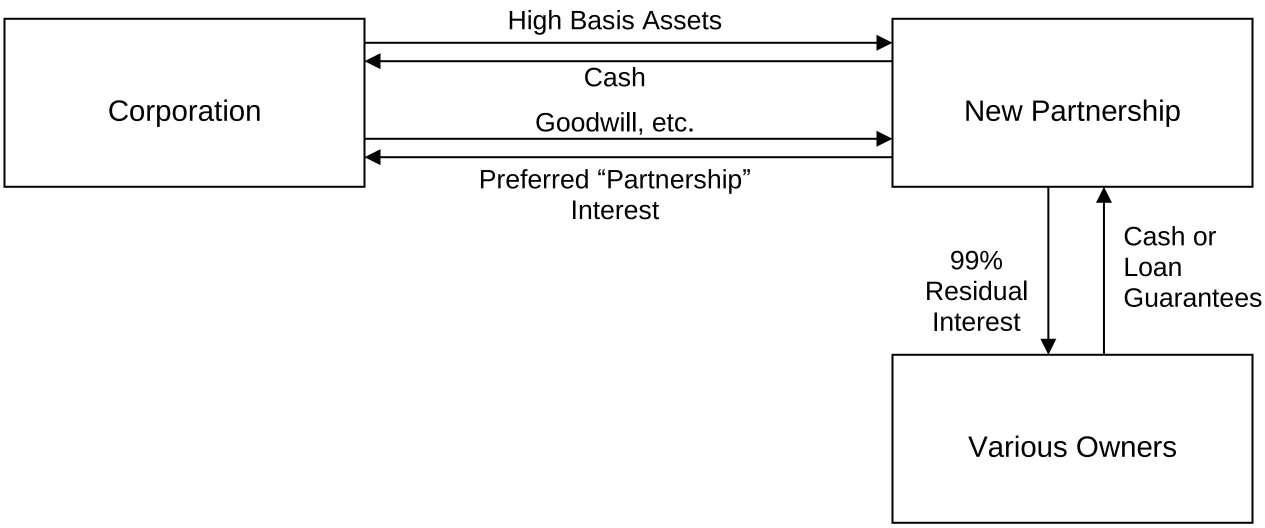
[5559] One might also consider whether applicable state law allows the buyer more latitude in imposing restrictions relating to sale of goodwill than for a noncompetition agreement and whether the seller is trading off state law rights for favorable tax treatment.

The seller might prefer a mechanism in which:

- The seller has a quicker route to gaining control over the business if the buyer does not attain the results necessary to pay the seller.

- The deal is more tax-efficient than the traditional sale of goodwill.

This mechanism recognizes that, although the transfer of goodwill is technically a debt-financed deal, it really carries risks similar to an equity interest. Below is a diagram showing the transaction, in which the seller contributes the goodwill to a new entity in exchange for what for tax purposes is considered a preferred partnership interest.[5560]



This new arrangement needs to involve a real sharing of profits. Therefore, ideally the existing corporation would continue to own a residual interest. The amount and duration of the retained residual interest depend on the facts and circumstances.

The sale of high basis assets is optional. The high basis assets can instead be included in the contribution to capital. Because preferred partnership rates are higher than interest rates, the new partnership – essentially the various owners who own a 99% residual interest in the new partnership in the agreement – would be incurring a higher cost of capital than if the partnership bought the assets for a note. On the other hand, transferring all assets in the business in one fell swoop is appealing and might be the most practical; for how to transfer assets by operation of law to avoid issues that might arise from piecemeal or inadvertently incomplete transfers, see part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

Usually this structure is not for new owners but rather so that the existing owners can own the business in a more tax-efficient structure. The shareholders, as individual owners of the new entity, sign a covenant not to compete (together with other provisions protecting the new entity's intellectual property, etc.) in consideration for their interest in the new entity, as well as contributing some reasonable amount of cash. When an individual retires, that person's capital

[5560] For more information on preferred partnerships, see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

account is returned over time, and the perpetual residual profits interest is converted to a preferred profits interest until a target amount is reached. This new preferred profits interest would consist of Code § 736(a) payments (taxable as ordinary income), grossed up for income taxes, and Code § 736(b) payments, not grossed up; see part II.Q.8.b.ii.(h) Interaction of Death with Code § 736 Payments.

For the new entity's structure, see part II.E Recommended Structure for Entities, except that this arrangement involves the corporate partner owning not only the 1% of profits commonly shared but also a preferred partnership interest.

Let's look at the non-tax financial issues, then discuss the tax issues in addition to the advantages discussed in parts II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis and II.Q.7.h Distributing Assets; Drop-Down into Partnership.

II.Q.8.b.iii.(a). Non-Tax Financial Issues When Using a Preferred Partnership to Acquire Goodwill and Other Assets

The seller receives preferred payments equal to the lesser of the entity's net operating cash flow or a target amount before any amounts are distributed to the buyer. Because the payments are targets and not mandatory, they do not constitute debt or a fixed obligation; rather, they are a return of investment to the owners. Stock purchases for a note and deferred compensation constitute liabilities on financial statement that can impair financing– enough that such arrangements might be considered highly unattractive. This liability might very well be required to be disclosed in financial statements even if the event triggering the notes or deferred compensation have not occurred and are unlikely to occur soon. Clients and advisors tend not to consider this issue when planning, so be sure to raise it early and have the CPA directly address this issue.

If the target is not attained, then:

- The deficiency is added to the following year's target amount.
- The seller might be given control over certain aspects of running the business. This could be as modest as limiting the buyer's compensation for services rendered or as far-reaching as taking over control of part or all of the business' operations. The partial or total shift on control would be a focal point of negotiations.

These provisions would be built directly into the partnership agreement. So that they know that authority has not been transferred to the seller, third-party lenders would require assurances that the buyer is complying with the agreement with the seller, thus providing an independent check on the buyer's compliance with the deal.

After the seller has received all that has been bargained-for, the seller would no longer be an owner of the entity.

II.Q.8.b.iii.(b). Tax Issues When Transferring Assets to New Entity

Suppose the seller is an S corporation. If all of an S corporation's assets were sold to a new entity, the corporation would recognize income taxable to its shareholder. The sale of goodwill would be taxable, but the new entity's deduction for that payment would be spread over 180 months (15 years).[5561] Furthermore, if the IRS were to find that goodwill was transferred to the new entity at a substantial value, without the S corporation retaining a sufficient interest in the new entity, then:

- 1. The S corporation would have income equal to the goodwill.
- 2. The shareholders would have immediate dividend income equal to the goodwill, which they then contributed to the new entity without receiving an immediate deduction (the deduction would be spread over 180 months).

If the entity transfers its assets to a new LLC, retaining a preferred interest at no more than 150% of the AFR[5562] that distributes only to the extent of operating cash flow, a sale is presumed not to have occurred.[5563] If the S corporation is receiving a return whose present value (using the AFR) is equal to the value of the contributed goodwill (if any), the S corporation should not be treated as having distributed such goodwill to its shareholders. It might be advisable to give the corporation a small but significant profits interest in the LLC.

This concept of transferring to a new LLC also works better when the transferring entity is a partnership. Suppose the transferring entity sells all of its assets in exchange for a promissory note, and the buyer is unable to make all of the payments. Any basis remaining in the note would need to be written off as a bad debt.[5564] Contrast that to a partnership redemption, in which distributions or payments generally are applied to basis first and generate a gain only after recovering basis,[5565] subject to possible application of the disguised sale rules for payments made in the first two years.[5566]

II.Q.8.c. Related Party Sales of Non-Capital Assets by or to Partnerships

Gain on the sale of property is ordinary income if it is not a capital asset in the hands of the transferee and the sale is between:[5567]

- a partnership and a person owning, directly or indirectly, more than 50% of the capital interest, or profits interest, in such partnership, or
- two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital interest or profits interests.

In applying this rule, "the ownership of a capital or profits interest in a partnership shall be determined in accordance with the rules for constructive ownership of stock provided in

[5561] Code § 197 provides for 15 years, and Reg. § 1.197-2(f)(1)(i) applies this starting with a particular month.
[5562] AFR meaning the applicable federal rate provided under the tax laws as an arms-length interest rate.
[5563] See part II.M.3.e.i.(b) Distributions Presumed Not to Be Disguised Sales.
[5564] CCA 201328031.
[5565] See parts II.Q.8.b.i Distribution of Property by a Partnership and II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.
[5566] See part II.M.3.e Exception: Disguised Sale, explaining the rules and simple steps to avoid their application.
[5567] Code § 707(b)(2). Code § 707(b)(1) lists the same parties.

section 267(c) other than paragraph (3) of such section."[5568] For Code § 267(c), see part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses.[5569]

For an explanation of regulations proposed November 27, 2023, see text accompanying and following fn 1417 in part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses. Note that the Tax Reform Act of 1986 modified Code § 707(b), so keep in mind that some of the prior authority mentioned in the rest of this part II.Q.8.c may reflect prior law.

An irrevocable trust paying mandatory income to the grantor's surviving spouse, remainder to the grantor's children is not related under Code § 267(b) or 707(b)(1) with respect to grantor trusts deemed owned by the grantor's two siblings, respectively.[5570]

In applying the first bullet point above, grantor trusts are disregarded from their deemed owners. See CCA 201343021.[5571]

Property subject to this rule includes trade accounts receivable, inventory, stock in trade, and depreciable or real property used in the trade of business.[5572] If a business is being sold and a related partnership needs to transfer assets as part of the sale, that asset transfer may implicate Code § 707(b)(2) if it is to the business on or before the sale. The related partnership may need to sell either to the buyer separately or to the business after the buyer owns the business.

Rev. Rul. 67-105 provides:

> Advice has been requested whether a partnership, owned entirely by A and B, may sell a portion of its real property, held for more than 6 months, to another partnership owned entirely by the adult children of A and B, and treat the gain on such sale as long-term capital gain.
>
> A and B are the only partners in X, a valid partnership for Federal income tax purposes, which owns and operates various citrus groves. X proposes to sell one of its groves to Y, a valid partnership for Federal income tax purposes, for use in Y's fruit-growing business. The sale to Y will be at fair market value and in an arms-length transaction. All of the partners in Y are children of A and B and operate this partnership independently of their parents. Neither A nor B is a member of the Y partnership.
>
> Section 707(b)(2)(B) of the Internal Revenue Code of 1954 provides that in the case of a sale or exchange, directly or indirectly, of property which in the hands of the transferee is property other than a capital asset (as defined in section 1221 of the Code), any recognized gain shall be considered as gain from the sale or exchange of property other than a capital asset, if the sale or exchange is between partnerships in which the same persons own, directly or indirectly, more than 80 percent of the capital or profits interests in each partnership. See also section 1.707-1(b)(2) of the Income Tax Regulations.
>
> In determining ownership for the purposes of section 707(b)(2)(B) of the Code, the rules for the constructive ownership of stock provided in section 267(c)(1), (2), (4), and (5) of

[5568] Code § 707(b)(3).
[5569] Code § 267(c) and Reg. § 1.267(c)-1 are reproduced in the text following fn 1423 in that part.
[5570] Letter Ruling 200920032.
[5571] See fn 6523 in part III.B.2.d.i.(a) General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation.
[5572] Reg. § 1.707-1(b)(2).

> the Code are applied pursuant to section 707(b)(3) of the Code. Under the rule provided by section 267(c)(2) of the Code, an individual shall, for the purpose of section 707(b)(2)(B) of the Code, be considered as owning the interests in a partnership owned, directly or indirectly, by or for his family. The family of an individual is defined in section 267(c)(4) of the Code, as including brothers, and sisters, spouse, ancestors, and lineal descendants.
>
> Accordingly, A and B must be regarded as the owners of the interests in the Y partnership owned by their children. See *Max A. Burde v. Commissioner*, 43 T.C. 252 (1964), *affirmed* 352 F. 2d 995 (1965), *certiorari denied*, 383 U.S. 966 (1966). Thus, the gain realized by the X partnership upon the sale of its citrus grove to Y partnership for use in Y's business will be treated as gain from the sale of property other than a capital asset.

Dyess v. Commissioner, T.C. Memo. 1993-219, reasoned and held:

> The parties in this case agree that the sale of Foxfire Village involved property described in section 707(b)(2), that is, property, which, in the hands of the transferee, is property other than a capital asset as defined in section 1221. Thus, the issue is whether petitioner and Nace owned 80 percent or less of the Foxfire partnership on the date of the sale, thereby saving the transaction from the application of section 707(b)(2)(B). This depends upon petitioner's argument that the Court should disregard the form of the Foxfire limited partnership agreement executed on October 4, 1982, and rely upon what petitioner views as the substance of the transaction.
>
> Respondent argues that section 707(b)(2)(B) is a concisely and clearly drafted provision that must be applied as it is written. Respondent points out that section 707(b)(2)(B) provides a bright-line test and gives plain notice to taxpayers concerning when its restrictions apply. Since, on October 4, 1982, petitioner and Nace owned and controlled 100 percent of Equity and 92.5 percent of Foxfire, respondent concludes that petitioner improperly classified the income he received from the sale of Foxfire Village as capital gain rather than as ordinary income as mandated by section 707(b)(2)(B).
>
> Petitioner admits that, at the time of the sale of property, he and Nace technically owned and controlled more than 80 percent of the partnership interests in Equity and in Foxfire. However, petitioner asserts that the substance of the transaction, rather than its form, dictates that the transaction be viewed not as one between related entities (controlled partnerships) but as one between Equity and a partnership of petitioner, Nace, and a sufficient number of unrelated investors (so as not to constitute controlled partnerships).
>
> Petitioner argues that the substance is readily apparent from the events leading to and occurring after the transaction and is quite different from the mechanical form of the transaction. Petitioner states that he had a commitment and prearranged plan to bring in local, unrelated investors as limited partners. The transfer of the property to Foxfire would have been futile, he says, without the completion of a series of transactions that transferred the limited interests to the outside investors. Without that series, he argues, there would have been no need to create a limited partnership, in light of the fact that the whole purpose of the venture was to provide capital and liquidity to a failing real estate holding.

Petitioner contends that at the time of the transaction he was holding, in an escrow-like arrangement, the limited partnership interests in conjunction with Nace merely for convenience and to avoid unnecessary expenses prior to transferring the interests to the limited partners once they had paid their capital contributions. Petitioner asserts that the holding of the limited partnership interests by himself and Nace was merely an accommodation to avoid having expensive Articles of Limited Partnership with escrow agreements.9 Petitioner asserts that the time between the acquisition of the property and the entry of all of the limited partners was merely 30 to 45 days after October 4, 1982.10 He contends that neither he nor Nace received any tax benefits from the holding of the limited partnership interests during this interim period.11 Therefore, petitioner concludes that, when the substance rather than the form of the transaction is considered, Equity's sale of Foxfire Village to Foxfire does not violate section 707(b)(2)(B).

Respondent does not dispute that petitioner is entitled to have the substance of the transaction examined, as it is an established principle of tax law that the substance of a transaction will govern over its form. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Gregory v. Helvering*, 293 U.S. 465 (1935); *Kuper v. Commissioner*, 533 F.2d 152, 155 (5th Cir. 1976), *affg. in part and revg. in part* 61 T.C. 624 (1974). Nevertheless, respondent asserts that the substance of the transaction in this case is fully consistent with its form, and that, as a result, section 707(b)(2)(B) is applicable.

Respondent suggests that substance over form, specifically the step transaction doctrine invoked by petitioner, may not be applicable in cases involving provisions such as section 707(b)(2)(B) that mandate restrictive tax treatment for transactions between related parties.[12] Even if the step transaction doctrine is applicable, respondent asserts that petitioner has offered no evidence proving that the form of the partnership agreement does not comport with the substance of the transaction at issue.

[12] In support of this suggestion respondent cites *King Enterprises, Inc. v. United States*, 189 Ct. Cl. 466, 477, 418 F.2d 511, 516 (1969): "aphorisms about 'closely related steps' and 'integrated transactions' may have different meanings in different contexts, and … there may be not one rule, but several, depending on the substantive provision of the Code to which they are being applied" (quoting Mintz & Plumb, Step Transactions, pp. 247, 252-253 (1954)).

As another rule of substance over form, the step transaction doctrine "treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result". *Penrod v. Commissioner*, 88 T.C. 1415, 1428 (1987).[13] As described in *Smith v. Commissioner*, 78 T.C. 350, 389 (1982):

> The step transaction doctrine generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary stops is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts are not bound by the twisted path taken by the taxpayer, and the intervening stops may be disregarded or rearranged. [Citation omitted.]

[13] See also *Barter v. Commissioner*, T.C. Memo. 1990-142.

Courts have applied three tests in deciding whether to employ the step transaction doctrine in a particular situation: (1) the binding commitment test, (2) the end result test, and (3) the interdependence test. Under the binding commitment test, a series of transactions are collapsed if, at the time the first step is taken, there is a binding commitment to undertake the later steps. *Commissioner v. Gordon*, 391 U.S. 83, 96 (1968). Under the end result test, the step transaction doctrine is applicable if it appears that a series of formally separate steps are really prearranged parts of a single transaction intended from the outset to reach an ultimate result. *King Enterprises, Inc. v. United States*, 189 Ct. Cl. 466, 475, 418 F.2d 511, 516 (1969). The interdependence test focuses on "whether on a reasonable interpretation of objective facts the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." *Redding v. Commissioner*, 630 F.2d 1169, 1177 (7th Cir. 1980), *revg. and remanding* 71 T.C. 597 (1979) (quoting Paul, Selected Studies in Federal Taxation 200, 254 (2d series 1938)).

The final limited partnership agreement for Foxfire (the Agreement) is clear and unambiguous in its language, but petitioner seeks to vary its meaning. In doing so, petitioner invokes this Court's "strong proof" rule. The strong proof rule requires that a taxpayer, who seeks to establish a position at variance with the language of the written agreement to which he or she was a party, must present more than a preponderance of the evidence that the terms of the written instrument do not reflect business reality and the actual intentions of the contracting parties. *Elrod v. Commissioner*, 87 T.C. 1046, 1066 (1986); *G C Services Corp. v. Commissioner*, 73 T.C. 406, 412 (1979). Alternatively, respondent asserts that we should require petitioner to meet the *Danielson* standard, a parol evidence rule of substantive law that proposes that "a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.". *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967), *vacating and remanding* 44 T.C. 549 (1965), *cert. denied* 389 U.S. 858 (1967). The Court of Appeals for the Fifth Circuit, to which an appeal in this case would lie, has declined to follow the strong proof rule in certain situations, applying instead the Danielson approach. *Spector v. Commissioner*, 641 F.2d 376 (5th Cir. 1981), *revg. and remanding* 71 T.C. 1017 (1979), *cert. denied* 454 U.S. 868 (1981). In the instant case, we would reach the same result under either the strong proof rule or the *Danielson* rule.

The uncontroverted facts of the case at issue are that, on October 4, 1982, petitioner and Nace held a combined 92.5-percent ownership in Foxfire, which on the day of its formation bought real property from another partnership (Equity) of which they owned a combined 100 percent. Petitioner and Nace gave notes to the Foxfire partnership in the total amount of $185,000 and executed a formal, binding partnership agreement. They were directly involved in the drafting of that agreement. The Agreement in no way suggests that there were undisclosed limited partners in Foxfire as of October 4, 1982.

Petitioner argues that the Letter, which was drafted and executed to waive the requirement of the Agreement that an interest could not be sold without the prior offer to and rejection by the other partners, indicated that there were other limited partners in Foxfire. We do not agree. The prospective investors who signed that Letter were, on October 4, 1982, under no legally binding commitments to become limited partners, and they actually signed the Letter sometime after October 4, 1982. The Letter, seeking to waive restrictions on the sale of a partnership interest, merely provides that additional limited partners can be brought into the partnership in the future. Neither the Agreement nor the Letter provides for the entry of limited partners on the date of the formation of the Foxfire partnership as petitioner contends. That Letter does not change the fact that, at the time of the sale of the Foxfire Village property, petitioner and Nace were the owners of 92.5 percent of Foxfire. Although the people contacted about the investment opportunity orally expressed strong interest in purchasing interests in Foxfire, they would not commit to investing until after the formation of Foxfire and its acquisition of the Foxfire Village property. These prospective investors, other than Laube, would not commit to investing before seeing the documentation of the transaction and having it reviewed by their personal attorneys or accountants. Just as the potential investors were not bound to make investments, petitioner and Nace were not bound to sell to the previously contacted potential investors. They intended to sell to whoever first offered the money to purchase a limited interest.

The substance or economic reality of the transaction, *i.e.*, the infusion of capital by bringing in limited partners, was in fact accomplished by the form or structure of the limited partnership agreement that was actually used. That economic result could also have been accomplished by other forms or structures. What petitioner complains of is not the failure to achieve the substance or economic reality of the transaction, but the personal tax consequences to him of the form or structure that was used for that purpose.

Petitioner had, or should have had, knowledge of the tax consequences associated with the different forms available for the structure of the limited partnership agreement. The record shows that petitioner consulted Jackson about possible forms of a limited partnership. He also consulted him about tax considerations, but the record is silent as to the nature of any tax advice he received. The initial version of the partnership agreement drafted by Jackson contemplated first selling the 10 limited partnership interests for $150,000 and then having the partnership purchase an undivided 75-percent interest in the Foxfire Village property from Equity, with petitioner and Nace to contribute their remaining 25 percent of that property as their capital contribution. Had that structure been used, the limited partners would have held a 75-percent interest in the partnership at the time of the purchase of the property from Equity. In that event, the restriction of section 707(b)(2)(B) regarding sales of property between “controlled partnerships” would not appear to come into play.

The record does not contain any satisfactory explanation as to why that draft version was not used. See supra note 3. In any event, a different version was executed, with three partners and with petitioner and Nace holding 92.5 percent of the partnership interests on October 4, 1982, the date the partnership was formed and the date of the sale of the property. Although Jackson was under the misimpression that the limited partnership interests had already been sold or virtually sold, he knew the partnership would be changed as the limited partners came in. He drafted a First Amendment to Certificate of Limited Partnership with blank lines so the names of the limited partners could be added later. In fact, three more such amendments were drafted, executed, and recorded in the county court by the time the last of the limited partners had purchased their interests in March of 1983.

Petitioner cannot now disavow the route he in fact followed for a different route he might have but did not take. Furthermore, one cannot find, from the face of the Agreement or from the facts as they developed, that outside limited partners were actually present and part of the partnership on the date of its formation as petitioner contends. The facts show there were no outside limited partners (other than Laube) at that time. Petitioner has met neither the strong proof test nor the *Danielson* test and cannot now successfully invoke the substance over form doctrine to disavow the manner in which the Foxfire partnership was structured and the limited partnership interests sold.

The transaction at issue, thus, was in substance and in form a sale between related partnerships, falling under the provisions of section 707(b)(2)(B). In this case, petitioner is not asking us merely to "skip, collapse, or rearrange the steps he employed[,] … [h]e is instead asking that we accept … new … steps or events that did not take place. The step transaction doctrine cannot be stretched so far". *Glacier State Electric Supply Co. v. Commissioner*, 80 T.C. 1047, 1057-1058 (1983). We must rely upon the established principle that "a taxpayer is bound by what he did and he cannot prevail upon the basis of what he could have done but did not do." *Island Gas, Inc. v. Commissioner*, 30 T.C. 787, 795 (1958). See also *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974), where the Supreme Court stated:

> This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not … and may not enjoy the benefit of some other route he might have chosen to follow but did not.

On brief, petitioner raises a new argument that, under the "interim closing of the books" method, he was never in violation of section 707(b)(2)(B) as he was always deemed to have less than the prohibited percentage of ownership in Foxfire. Petitioner asserts that, when the interim closing of the books method is applied to the partnership, the outside investors, who entered the partnership on October 14, 1982, are deemed to have owned their limited partnership interests as of October 4, 1982. There is no evidence in the record to suggest that Foxfire ever used or contemplated using the interim closing of the books method.[14]

[14] There is no indication that Foxfire closed its books when limited partners were taken in in October or again in November of 1982. There is a strong suggestion that that did not occur, since the loss for 1982 was allocated according to the percentages of interest as of December 31, 1982.

In any event, petitioner has misconstrued the purpose of the interim closing of the books accounting method. When a partner sells or exchanges a portion of or all of his partnership interest, his distributive share of partnership items for the portion of the taxable year he held that interest must be determined. Sec. 706(c) and (d). Prior to the Tax Reform Act of 1976, partners who entered partnerships late in the tax year were nevertheless taking into account partnership items incurred prior to their entries (*e.g.*, "retroactive allocations" of partnership losses). The Tax Reform Act of 1976 provided that, when partners' interests change during the taxable year, each partner's share of various items of partnership income, gain, loss, deduction, and credit is to be determined by taking into account each partner's varying interest in the partnership during the taxable year. H. Rept. 98-861 (1984), 1984-3 C.B. (Vol.2) 1, 109. Section 72(a) of Public Law 98-369, 98 Stat. 494, 589, again addressed the retroactive allocation issue, adding a new subsection (d) to section 706 (relating to taxable years of partner and partnership). Section 706(d)(1) generally provides, with exceptions for certain cash basis items, that

> if during any taxable year of the partnership there is a change in any partner's interest in the partnership, each partner's distributive share of any item of income, gain, loss deduction, or credit of the partnership for such taxable year shall be determined by the use of any method prescribed by the Secretary by regulations which takes into account the varying interests of the partners in the partnership during such taxable year.

We have recognized that the determination of the varying interests of the partners may be made by using the interim closing of the books method, the proration method, or any other reasonable method. *Richardson v. Commissioner*, 76 T.C. 512 (1981), *affd*. 693 F.2d 1189 (5th Cir. 1982); sec. 1.706-1(c)(2)(ii), Income Tax Regs. We described the interim closing of the books accounting method in *Cottle v. Commissioner*, 89 T.C. 467, 495 (1987) as follows:

> The interim closing of the books method requires a closing of the partnership books as of the date of entry of the new partner and the computation of the various items of partnership income, gain, loss, deduction, and credit as of that date.

The interim closing of the books method would not help petitioner if the books were closed "as of the date of entry" of the new partners. Petitioner essentially relies on an accounting convention to avoid the clear terms of Foxfire's limited partnership agreement and the proscription of section 707(b)(2)(B). When Congress enacted section 706(d) in 1984, it considered but did not pass a monthly convention.

The legislative history of 706(d) indicates that the Senate amendment contained an explicit provision for a monthly convention: "when there is a disposition of less than an entire interest in a partnership by a partner (including entry of a new partner), the partnership may elect (on an annual basis) to determine the varying interests of the partners by using a monthly convention that treats any changes in any partner's interest as occurring on the first day of the month." H. Rept. 98-861, supra 1984-3 C.B. (Vol. 2) at 110. The conference agreement eliminated the monthly convention and determined that the statutory provision of a monthly convention as adopted by the Senate was unnecessary since the Secretary intended to provide for a monthly convention by regulation. *Id*. at 112. The legislative history also indicates that the Secretary may provide for other conventions and "may deny the use of any convention when the occurrence of significant, discrete events (e.g., a large, unusual gain or loss) would mean that use of a convention could result in significant tax avoidance". *Id*.

The Commissioner issued an information release that permitted partnerships using the interim closing of the books method to use a mid-month convention, to be effective until issuance of regulations.[15] I.R.S. News Release IR-84-129 (Dec. 13, 1984). The information release was issued in 1984, after the taxable year at issue in this case and provided as follows:

> The Internal Revenue Service today announced that partnerships using the "interim-closing-of-the-books" method to take into account the varying interests of partners during a taxable year will be permitted to use a semi-monthly convention….

Under a semi-monthly convention, this [each partner's distributive share] is determined by treating partners entering during the first 15 days of the month as entering on the first day of the month and partners entering after the 15th day of the month (but before the end of the month) as entering on the 16th day of the month, except to the extent section 706(c)(2)(A) of the Code applies. Partnerships that use the proration method will not be permitted to use a semi-monthly convention, but rather will be required to use a daily convention.

[15] No such regulations have yet been issued. [my comment: for updates to this issue, see part III.B.2.j.iii Allocations upon Change of Interest in a Partnership.

The release does not indicate that the mid-month convention may be used by taxpayers for tax years before 1984.

The interim closing of the books method and the mid-month convention are accounting methods designed to make the computation of varying partnership interests easier when a partnership interest has been sold or exchanged during the taxable year. However, there remains the obligation to use them in a manner that ensures that the tax treatment of various partnership items reflects economic reality. The determination to be made for section 707(b)(2)(B), however, is not a matter of accounting methods or conventions. Section 707(b)(2)(B) requires that a partner's percentage ownership of the capital interest or the profits interest be determined on a particular date, at the time the property is sold or exchanged, to establish the presence or absence of controlled partnerships (i.e., partnerships in which the same persons own more than 80 percent).[16] Nothing in the legislative history of section 706(d) suggests that the convention is to be extended beyond distributive share determinations to impute ownership interests for purposes of section 707(b)(2)(B). Section 707(b)(3) explicitly states that the constructive ownership rules of section 267(c) are to be used to determine percentage ownership of a capital or profits interest.

[16] The current version of sec. 707(b)(2)(B) has reduced the percentage to more than 50 percent.

In any event, as noted earlier, the record does not indicate that Foxfire used the interim closing of the books method in 1982, and therefore would not be entitled to use the mid-month convention. The parties have stipulated that, on its 1982 partnership return, Foxfire reported a loss, which was allocated among the partners in accordance with ownership interests as of December 31, 1982. Thus, Equity and Foxfire constitute two controlled partnerships, and section 707(b)(2)(B) applies to the sale of Foxfire Village by Equity to Foxfire.

The corporate provision most closely related to this one is part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), including possible ordinary income taxation when selling to a controlled corporation interests in a partnership holding depreciable property.[5573]

[5573] See text accompanying fns. 5087-5092.

II.Q.8.d. Partnership Division

For an overview with helpful charts and diagrams, see Borden, "Navigating State Law and Tax Issues Raised by Partnership and LLC Reorganizations," *Business Entities* (Jul./Aug. 2014).[5574]

II.Q.8.d.i. Partnership Division - Generally

In the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50% or less in the capital and profits of the prior partnership) are a continuation of the prior partnership.[5575] Thus, generally a partnership can be divided without immediate income tax recognition.[5576]

However, some divisions might be taxable.[5577] Also, tax elections might be revoked and re-started for the new partnership. Furthermore, a division could re-start the seven-year waiting period for measuring Code § 704(c) responsibility; however, if each partner's overall interest in

[5574] RIA Checkpoint *Catalyst*, ¶ 218:123 Tax Characterization of Division Transaction, discussed a ruling: In IRS Letter Ruling 201619001, the IRS respected the form of a transaction when a partnership division was one step of a larger transaction. In the ruling, an existing partnership (X) divided into two partnerships, X and M, in a transaction in which the partners of X before the division owned identical interests in both X and M after the division. Following the division, M transferred all of its assets to a third partnership (OP) in exchange for partnership interests in OP and other property (stock of the principal partner of OP, a real estate investment trust (REIT stock)). M then liquidated, distributing the partnership interests to some of its partners and the REIT stock to other partners. The partners receiving the REIT stock agreed to treat the transaction as if they sold their partnership interests in M to OP (see ¶ 218:114). The IRS ruled that the transaction would be treated in accordance with its form—i.e., as a division followed by a merger—and that the partners receiving the REIT stock would be treated as having sold their interests to the resulting merged partnership. IRS Letter Ruling 201619001

> Comment: The IRS could have disregarded the division and recharacterized the transaction in IRS Letter Ruling 201619001 as a transfer of property by X directly to OP in exchange for partnership interests and other property (the REIT stock). In that case, the transaction would have been treated as a part-sale, part-contribution under IRC § 707(a)(2)(B). See Topic #206, Transactions Between Partner and Partnership, at ¶ 206:150. Presumably, the form of the transaction was intended to permit the gain attributable to the receipt of the REIT stock to be taken into account solely by the partners of X that received the stock.

[5575] Code § 708(b)(2)(B). Even an apparently taxable division might have less adverse tax effects than one might have thought. When a court ordered a partnership's assets sold and three of five partners bought all of the assets and continued operation of the business, the transaction was not treated as a sale of partnership assets to the three remaining partners but rather was considered as a sale or a liquidation of the partnership interests of the two withdrawing partners. Rev. Rul. 66-264.

[5576] Reg. § 1.708-1(d).

[5577] If a foreign person is directly or indirectly involved, see the discussion of when Code § 721(a) does not apply to any deemed contribution to a partnership in part II.M.3.g Exception: Foreign Partner (among various other exceptions to Code § 721(a).

each partnership property does not change, then Code § 704(c) responsibility would not be affected.[5578] Below are the rules governing whether the above events occur.[5579]

II.Q.8.d.ii. Which Partnership Keeps Original Partnership's Tax Identity?

When a partnership divides into two or more partnerships, any resulting partnership(s)[5580] shall be considered a continuation of the prior partnership[5581] if the members of the resulting partnership(s) had an interest of more than 50% in the capital and profits of the prior partnership.[5582]

[5578] The preamble to T.D. 8925 provides:

> To the extent that a partnership division merely affects a restructuring of the form in which the partners hold property (that is, each partner's overall interest in each partnership property does not change), the IRS and Treasury agree that a partnership division should not create new section 704(c) property or section 737 net precontribution gain. However, it is not clear that this result is necessarily appropriate where a division is non-pro rata as to the partners, where some property is extracted from or added to the partnerships in connection with the division, or where new partners are added to the ownership group in connection with the division. The IRS and Treasury intend to study this issue and request comments in this regard.

McKee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners* (WG&L), ¶ 13.06 Partnership Terminations and Continuations Resulting From Mergers and Divisions, opines:

> The authors believe that, unless there are extenuating circumstances, a division should never be the occasion for the creation of new § 704(c) property or § 737 net precontribution gain. The justification for this conclusion flows from the very nature of a division; it is a restructuring of the form in which partners hold property through partnerships. There are no additions or deletions of property to or from the partnership pool. There is no change in the composition of the partners as a group. Instead of owning all the property through a single partnership, the partners now own it through several partnerships. Why should a transaction that involves so little change be the occasion for the imposition of such draconian rules?
>
> The authors' view is consistent with the rules applicable to § 708(b)(1)(B) terminations which, unlike divisions, involve substantial changes in the composition of the partner group. Both the § 704(c)(1)(B) Regulations and the § 737 Regulations provide that these provisions do not apply to the deemed distribution of interests in the new partnership that is caused by the termination. Subsequent distributions by the new partnership may trigger § 704(c)(1)(B) or § 737 with respect to partners in the new partnership who were partners in the terminated partnership, but only to the same extent they would have been triggered without the termination. [citing Reg. §§ 1.704-3(c)(3), 1.737-2(a).] A similar rule should apply to divisions. While further developments are anticipated, they are not expected any time soon.

[5579] See McKee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners* (WG&L), ¶ 13.06 Partnership Terminations and Continuations Resulting From Mergers and Divisions. Also note that Reg. § 1.708-1(d)(6) provides:

> If any transactions described in paragraph (d)(3) of this section are part of a larger series of transactions, and the substance of the larger series of transactions is inconsistent with following the form prescribed in such paragraph, the Commissioner may disregard such form, and may recast the larger series of transactions in accordance with their substance.

[5580] As defined in Reg. § 1.708-1(d)(4)(iv), which provides that a resulting partnership is a partnership resulting from the division that exists under applicable jurisdictional law after the division and that has at least two partners who were partners in the prior partnership. For example, where a prior partnership divides into two partnerships, both partnerships existing after the division are resulting partnerships.

[5581] As defined in Reg. § 1.708-1(d)(4)(ii), which provides that the prior partnership is the partnership subject to division that exists under applicable jurisdictional law before the division.

[5582] Reg. § 1.708-1(d)(1).

Any other resulting partnership will not be considered a continuation of the prior partnership but will be considered a new partnership.[5583]

If the members of none of the resulting partnerships owned an interest of more than 50% in the capital and profits of the prior partnership, none of the resulting partnerships will be considered a continuation of the prior partnership, and the prior partnership will be considered to have terminated.[5584]

Where members of a partnership which has been divided into two or more partnerships do not become members of a resulting partnership which is considered a continuation of the prior partnership, such members' interests shall be considered liquidated as of the date of the division.[5585]

The resulting partnership that is treated as the divided partnership[5586] shall file a return for the taxable year of the partnership that has been divided and shall include the name, address, and employer identification number (EIN) of the prior partnership. [5587]

All other resulting partnerships that are regarded as continuing and new partnerships shall file separate returns for the taxable year beginning on the day after the date of the division with new EINs for each partnership.[5588]

All resulting partnerships that are regarded as continuations of a prior partnership are subject to preexisting elections that were made by that prior partnership.[5589] A subsequent election that is made by a resulting partnership does not affect the other resulting partnerships.[5590]

[5583] Reg. § 1.708-1(d)(1).
[5584] Reg. § 1.708-1(d)(1).
[5585] Reg. § 1.708-1(d)(1).
[5586] As defined in Reg. § 1.708-1(d)(4)(i), which provides as follows:

> The divided partnership is the continuing partnership which is treated, for Federal income tax purposes, as transferring the assets and liabilities to the recipient partnership or partnerships, either directly (under the assets-over form) or indirectly (under the assets-up form). If the resulting partnership that, in form, transferred the assets and liabilities in connection with the division is a continuation of the prior partnership, then such resulting partnership will be treated as the divided partnership. If a partnership divides into two or more partnerships and only one of the resulting partnerships is a continuation of the prior partnership, then the resulting partnership that is a continuation of the prior partnership will be treated as the divided partnership. If a partnership divides into two or more partnerships without undertaking a form for the division that is recognized under Reg. § 1.708-1(d)(3), or if the resulting partnership that had, in form, transferred assets and liabilities is not considered a continuation of the prior partnership, and more than one resulting partnership is considered a continuation of the prior partnership, the continuing resulting partnership with the assets having the greatest fair market value (net of liabilities) will be treated as the divided partnership.

[5587] Reg. § 1.708-1(d)(2)(i). The return must include the names, addresses, and EINs of all resulting partnerships that are regarded as continuing. The return must also state that the partnership is a continuation of the prior partnership and shall set forth separately the respective distributive shares of the partners for the periods before and including the date of the division and after the date of division.
[5588] Reg. § 1.708-1(d)(2)(i).
[5589] Reg. § 1.708-1(d)(2)(ii).
[5590] Reg. § 1.708-1(d)(2)(ii).

II.Q.8.d.iii. Assets-Over vs. Assets-Up Division

II.Q.8.d.iii.(a). Assets-Over Divisions

Generally, in an "assets-over" division, an existing partnership transfers some portion of its assets and liabilities (directly or by distributing an interest in an entity the partnership owns) to a new partnership, and immediately thereafter distributes interests in the new partnership to some or all of its partners.

When in doubt, the division is an "assets-over" division.[5591]

In an assets-over division, the following transactions are deemed to have occurred:

- Where at least one resulting partnership is a continuation of the prior partnership:
    - The divided partnership[5592] contributes certain assets and liabilities to a recipient partnership(s)[5593] in exchange for interests in such recipient partnership(s).
    - Immediately thereafter, the divided partnership distributes the interests in such recipient partnership(s) to some or all of its partners in partial or complete liquidation of the partners' interests in the divided partnership.[5594]
- Where none of the resulting partnerships is a continuation of the prior partnership:
    - The prior partnership will be treated as contributing all of its assets and liabilities to new resulting partnerships in exchange for interests in the resulting partnerships.

[5591] Reg. § 1.708-1(d)(3)(i). The preamble, T.D. 8925, provides:

> …it is appropriate to require consistency in applying either the Assets-Over Form or the Assets-Up Form to characterize a transfer of assets to a resulting partnership. However, where a single partnership is divided in a transaction that involves a transfer of assets (either actual or deemed) to multiple partnerships, the transfer to each resulting partnership should be viewed separately. As with mergers involving more than two partnerships, it is consistent with the purposes of these regulations, in the context of divisions, to allow the transfer to one resulting partnership to be characterized under the Assets-Over Form while characterizing the transfer to another resulting partnership under the Assets-Up Form. The proposed regulations provided an example that illustrates when such a division accomplished under both the Assets-Over Form and the Assets-Up Form will be respected. The final regulations do not change the example. See § 1.708-1(d)(5) Example 7 of the final regulations. The final regulations also add an example to illustrate when a division accomplished under both the Assets-Over Form and the Assets-Up Form will not be respected.

[5592] See fn. 5586.

[5593] As defined in Reg. § 1.708-1(d)(4)(iii), which provides that a recipient partnership is a partnership that is treated as receiving, for Federal income tax purposes, assets and liabilities from a divided partnership, either directly (under the assets-over form) or indirectly (under the assets-up form).

[5594] Reg. § 1.708-1(d)(3)(i)(A).

- Immediately thereafter, the prior partnership will be treated as liquidating by distributing the interests in the new resulting partnerships to the prior partnership's partners.[5595] Distributions of partnership interests trigger Code § 743 adjustments.[5596]

Code § 737 and Reg. § 1.737-2 do not apply to a transfer by a partnership (transferor partnership) of all of the Code § 704(c) property contributed by a partner to a second partnership (transferee partnership) in a Code § 721 exchange, followed by a distribution as part of the same plan or arrangement of an interest in the transferee partnership (and no other property) in complete liquidation of the interest of the partner that originally contributed the Code § 704(c) property to the transferor partnership.[5597] A later distribution of property by the transferee partnership to a partner of the transferee partnership that was formerly a partner of the transferor partnership is subject to Code § 737 to the same extent that a distribution from the transferor partnership would have been subject to Code § 737.[5598]

II.Q.8.d.iii.(b). Assets-Up Divisions

Generally, in an "assets-up" division, an existing partnership distributes assets and liabilities to some or all of its partners, who then contribute them to a new partnership.

If the divided partnership[5599] distributes certain assets (such that state law causes the partners to be treated as the owners of such assets)[5600] to some or all of its partners in partial or complete liquidation of the partners' interests in the divided partnership and immediately thereafter such partners contribute the distributed assets to one or more partnerships in exchange for interests in such recipient partnership(s), the transaction is respected as an "assets-up" division.[5601]

5595 Reg. § 1.708-1(d)(3)(i)(B).

5596 See parts II.Q.8.e.i Distribution of Partnership Interests and II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

5597 Reg. § 1.737-2(b)(2).

5598 Reg. § 1.737-2(b)(3).

5599 Which Reg. § 1.708-1(d)(4)(i) requires to be a continuing partnership.

5600 The preamble in T.D. 8925 says:

> While the IRS and Treasury believe that it should be necessary for a partnership to actually convey ownership of the partnership's assets to its partners in order to follow the Assets-Up Form, it should not be necessary for the partners to actually assume the liabilities of the partnership in order to follow such form. Pursuant to section 752 and the regulations thereunder, a partner essentially is deemed to have directly incurred a share of the partnership's liabilities. Requiring the partners to actually assume debt that they already are deemed to have incurred is unnecessary. Such a requirement also could create a trap for the unwary. If a partner momentarily assumes an amount of the partnership's debt that is less than the partner's share of such debt under section 752 (and other partners momentarily assume an amount of debt in excess of their shares), the partner could inappropriately recognize gain as a result of the deemed distribution.

5601 Reg. § 1.708-1(d)(3)(ii)(A). That form is respected for transfers to a particular recipient partnership only if all assets held by the prior partnership that are transferred to the recipient partnership are distributed to, and then contributed by, the partners of the recipient partnership.

If none of the resulting partnerships is a continuation of the prior partnership, then despite the partners' transitory ownership of some or all of the prior partnership's assets, the form of a partnership division will be respected for Federal income tax purposes if:[5602]

- The prior partnership distributes certain assets (such that state law causes the partners to be treated as the owners of such assets) to some or all of its partners in partial or complete liquidation of the partners' interests in the prior partnership, and

- Immediately thereafter, such partners contribute the distributed assets to a resulting partnership(s) in exchange for interests in such resulting partnership(s).

However, if the prior partnership does not liquidate for state law purposes, then, with respect to the assets and liabilities that, in form, are not transferred to a new resulting partnership, the prior partnership will be treated as transferring these assets and liabilities to a new resulting partnership in an assets-over division.[5603]

II.Q.8.d.iii.(c). Effect of Basis Issues on Type of Division

If the basis of the partnership's assets ("inside basis") exceeds the basis of the partnership interests ("outside basis") involved, then one would tend to want to preserve the inside basis, and an assets-over division would tend to be attractive.

If the outside basis exceeds the inside basis, then one might seek to have the outside basis applied to the partnership's assets in an assets-up division, which involves a liquidating distribution.

See part II.Q.8.b.i.(h) Characteristics of Distributed Property.

II.Q.8.d.iii.(d). Checklist of Issues in Choosing Assets-Over vs. Assets-Up

If any division described above is part of a larger series of transactions, and the substance of the larger series of transactions is inconsistent with following the form prescribed above, the IRS may disregard such form, and may recast the larger series of transactions in accordance with their substance.[5604]

The following are among issues to consider in planning partnership divisions:[5605]

- Any mixing bowl gain in current transaction?[5606]
    - Assets up: Are contributed assets distributed to another partner, or other assets contributed to a Code § 704(c) partner within 7 years?

[5602] Reg. § 1.708-1(d)(3)(ii)(B). That form is respected for transfers to a particular recipient partnership only if all assets held by the prior partnership that are transferred to the recipient partnership are distributed to, and then contributed by, the partners of the recipient partnership.
[5603] Reg. § 1.708-1(d)(3)(ii)(B).
[5604] Reg. § 1.708-1(d)(6).
[5605] A selected list from Borden, O'Conner, and Schneider, Partnership and LLC Reorganizations, 2013 *LLC Institute* (10/18/2013).
[5606] See part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737.

- Assets over: If one looks through distributed partnership interest, would underlying asset distribution trigger Code § 704(c)(1)(B) or Code § 737 gain?

- These issues apply only if the partners do not have identical percentage interests in each partnership.[5607]

- Is there any potential gain under Code § 731(c), relating to a distribution of marketable securities? An assets-over division that distributes a partnership the value of which is at least 20% marketable securities might be an indirect distribution of marketable securities.[5608]

- Consider future mixing bowl ramifications from creation of new 7-year mixing bowl clock.[5609]

  - Can form be changed to minimize costs?

  - What are future distribution plans?

- Consider effect of debt shifts under Code § 752, because deemed distributions from relief of debt might trigger income.

- Any Code § 708(b)(1)(B) terminations of lower-tier partnerships?

[5607] See fn. 5578.

[5608] See part II.Q.8.b.i.(a) Code § 731, including fns. 5379 and 5380. Letter Ruling 200223036 included the following facts and holding:

> To effect an assets-over form of division, LLC proposes contributing certain assets, including marketable securities, and liabilities to LLC 2 in exchange for 100 percent of the membership interests in LLC 2. Immediately thereafter, LLC will distribute the interests in LLC 2 to Son, Son's Trusts, and Mother's Trust (Distributee Partners) in partial or complete liquidation of their interests in LLC. Consequently, LLC's partnership division will yield two resulting partnerships, LLC and LLC 2. The respective members of LLC and LLC 2 immediately after the division will have had an interest in capital and profits of the prior partnership (LLC before the division) of more than 50 percent. Therefore, we assume that each of the two resulting partnerships will be considered a continuation of the prior partnership. In addition, as the partnership that will transfer the assets and liabilities in the division, LLC should constitute the divided partnership. As the partnership that will be treated as receiving the assets and liabilities, LLC 2 should constitute the recipient partnership.
>
> Because the term money includes marketable securities, LLC's distribution of the interests in LLC 2 to the Distributee Partners will have potential gain consequences under § 731(a). LLC's shares of stock in three public companies meet the definition of marketable securities under § 731(c). In addition, more than 90 percent of the value of LLC 2 will be attributable to the marketable securities, stock shares, it will receive in the division. Therefore, the membership interests in LLC 2 themselves should constitute marketable securities (in an amount equal to their fair market value on the distribution date), the distribution of which should constitute a distribution of money.
>
> A limitation applies to the amount of the distribution of marketable securities (membership interests) that is treated as a distribution of money. The amount of such a distribution is reduced under § 731(c)(3)(B) by a distributee partner's share of the built- in gain in the securities held by the partnership. LLC is concerned that the partnership referred to in § 731(c)(3)(B) in determining the reduction amount may include both continuing partnerships, LLC and LLC 2, thereby eliminating most of the anticipated limitation on any § 731(a) gain resulting from the proposed division.

[5609] See part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737.

- Compare state or local taxes based on form - particularly transfer taxes.

- Consider potential application of new Code § 704(c)(1)(C) if one or more assets are depreciated, even if overall net appreciation. Code § 704(c)(1)(C) locks in built-in loss to contributing partner and could create differences depending on form chosen.[5610]

- Consider Code § 704(c) generally.

  - If assets up, individual partners are Code § 704(c) contributing partners on specific assets.

  - If assets over, consider Code § 704(c) step in the shoes rules.

  - In either case, if the division is pro rata, no new Code § 704(c) responsibility should be created.[5611]

- If assets up transaction, consider disguised sale rules: were appreciated assets contributed within prior two years?[5612]

- Will assets up transaction result in a shift, at least transitorily, of hot asset sharing or trigger any Code § 751(b) gain?[5613]

II.Q.8.e. Transfers of Partnership Interests

II.Q.8.e.i. Distribution of Partnership Interests

Except as otherwise provided in regulations, for purposes of Code § 708 (termination of partnership, which generally no longer applies),[5614] Code § 743 (adjustment to inside basis of partnership property when the outside basis of the partnership interest changes), and any partnership income tax matters specified in regulations, any distribution of an interest in a partnership (not otherwise treated as an exchange) is treated as a Code § 761(e) exchange.[5615] CCA 201517006 held that shifting rights to future profits not is treated as a Code § 761(e) exchange; see part II.C.6 Shifting Rights to Future Profits.

[5610] See fn. 5707.
[5611] See fn. 5578.
[5612] See part II.M.3.e Exception: Disguised Sale.
[5613] See part II.Q.8.e.ii Transfer of Partnership Interests: Effect on Transferring Partner and part II.Q.8.b.i.(g) Code § 751 – Hot Assets.
[5614] See part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).
[5615] Code § 761(e) provides:

> *Distributions of partnership interests treated as exchanges*. Except as otherwise provided in regulations, for purposes of—
> (1) section 708 (relating to continuation of partnership),
> (2) section 743 (relating to optional adjustment to basis of partnership property), and
> (3) any other provision of this subchapter specified in regulations prescribed by the Secretary,
>
> any distribution of an interest in a partnership (not otherwise treated as an exchange) shall be treated as an exchange.

The Conference Report adopting this rule focused on a distribution of a partnership interest by a partnership or corporation.[5616] The relevant regulation focuses on distributions by partnerships;[5617] corporate distributions are already taxable as sales or exchanges through corporate income tax provisions.[5618] However, the statute's literal language is not so limited (and CCA 201726012 took a broad approach),[5619] so this rule also appears to apply to any distribution (other than a specific bequest) of a partnership interest by an estate or trust.[5620] Therefore, under prior law, when a trust or estate distributes at a 50% or more partnership interest, the partnership would have terminated, resetting all partnership elections and stretching the period over which depreciation is deducted.[5621] The distribution would have been added to all other transfers constituting a sale or exchange under Code §708 within a period of 12 consecutive months to determine whether such a termination occurs under pre-2018 law;[5622] to avoid such a consequence, one might have spread distributions over a period exceeding 12 months.

Furthermore, TAM 201929019 took the position that a deemed distribution of a partnership interest in an assets-over merger of two partnerships under Reg. § 1.708-1(c)(3)(i)[5623] is treated as an "exchange" pursuant to Code § 761(e). TAM 201929019 reasoned:

[5616] Tax Reform Act of 1984, P.L. 98-369, 7/18/1984.

[5617] Reg. § 1.761-1(e) provides:

> *Distribution of partnership interest*. For purposes of section 708(b)(1)(B) and § 1.708-1(b)(1)(iv), the deemed distribution of an interest in a new partnership by a partnership that terminates under section 708(b)(1)(B) is not a sale or exchange of an interest in the new partnership. However, the deemed distribution of an interest in a new partnership by a partnership that terminates under section 708(b)(1)(B) is treated as an exchange of the interest in the new partnership for purposes of section 743.

A new partnership formed as the result of the termination of a partnership under Code § 708(b)(1)(B) is not required to use the same method as the terminated partnership with respect to Code § 704(c) property deemed contributed to the new partnership by the terminated partnership under Reg. § 1.708-1(b)(1)(iv); see fn. 3836 in part II.P.1.a.i Allocations of Income in Partnerships.

See part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).

[5618] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders. Note that Code § 761(e) was enacted in 1984, before tax-free corporate liquidations were abolished in 1986, so the reference to corporate distributions did make sense when Code § 761(e) was enacted.

[5619] CCA 201726012 (under the signature of David R. Haglund), in addressing, "Issue 1: Whether the transfer of a partnership interest in a complete liquidation to which § 332(a) applies or a reorganization to which § 368(a)(1)(A) and/or (D) applies is a transfer by sale or exchange for purposes of § 743(b)," held:

> The regulations under § 761 do not limit the definition of exchange to taxable exchanges for purposes of § 743. In particular, no provisions limit the definition of an exchange between related parties or members of a consolidated group. The transactions at issue here involved the distribution of a partnership interest as part of the complete liquidation of a corporate partner, and the transfer of a partnership interest as part of the reorganization of a corporate partner. Consequently, these transactions constitute an exchange for purposes of § 743 under the provisions of § 761(e).

[5620] For further analysis, see McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, ¶23.05. Special Problems Relating to the Income Taxation of Partnership Interests Held by Estates and Trusts. For how distributions affect allocating tax items under Code § 706, see part III.B.2.j.iii Allocations upon Change of Interest in a Partnership.

[5621] Reg. § 1.708-1(b)(1); see part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).

[5622] Reg. § 1.708-1(b)(1).

[5623] See part II.Q.8.e.v Partnership Mergers, especially the text accompanying fns 5819-5820.

Under § 1.708-1(c)(3)(i), X is deemed to contribute all of its assets and liabilities to Y in exchange for an interest in Y (Step 1), and immediately thereafter, X is deemed to distribute interests in Y to A and Q in liquidation of X (Step 2). Except as otherwise provided in regulations, any distribution of an interest in a partnership is treated as an exchange under § 761(e) for purposes of §§ 708 and 743. Neither the Code nor the regulations suggest that § 761(e) was only intended to apply to actual distributions and, therefore, not intended to apply to constructive distributions such as the one described in § 1.708-1(c)(3)(i). Under Subchapter K of the Code, partnership distributions that are "deemed" to occur as a result of the application of certain rules in the Code or regulations to specific facts (such as "deemed" distributions of cash or money under § 731(a) resulting from the forgiveness or shifting of liabilities among partners under § 752(b)) generally will have the same or similar tax effects as actual partnership distributions of money or other property. Accordingly, under the plain language of § 761(e), we conclude that X's deemed distribution of interests in Y to A and Q in liquidation of X resulting from an assets-over merger under § 1.708-1(c)(3)(i) is treated as an exchange for purposes of § 743(b).

A argues that Congress did not intend § 761(e)(2) to apply to constructive distributions of partnership interests because when Congress amended § 743(b) to require mandatory basis adjustments for a partnership with a substantial built-in loss, it did not also amend the parenthetical language in § 761(e)(2) to reference a "substantial built-in loss." Because the parenthetical language in § 761(e)(2) only references an "optional adjustment to basis of partnership property" when a § 754 election is in effect, A argues that § 761(e) was not meant to apply to constructive distributions of partnership interests when a partnership has a substantial built-in loss. A disconnect in A's argument exists because if A's argument is correct, then § 761(e) would not apply to actual distributions of partnership interests when a partnership has a substantial built-in loss. Clearly, this was not what Congress intended when it amended § 743(b).

We disagree that the failure to amend the parenthetical language in § 761(e)(2) was meant to limit the application of § 743(b) to only actual distributions of partnership interests when a § 754 election is in effect for the partnership. The "relating to" parenthetical language is best read as a descriptive short-hand reference to § 743 and not as limiting language. We find support for our interpretation of § 761(e) in the fact that Congress also did not amend the parenthetical language in § 755(a) when it enacted the substantial built-in loss mandatory basis adjustment rule. Both parentheticals in § 755(a) only refer to optional basis adjustments to partnership property and not the mandatory basis adjustments that would apply when the partnership has a substantial built-in loss. Interpreting § 755(a) as only applying to optional basis adjustments would be erroneous given that § 755 and related regulations provide the exclusive rules for allocation of basis among specific partnership properties when §§ 734(b) and 743(b) adjustments apply. No other rules or methods outside of § 755 provide for allocation of basis among specific partnership properties for mandatory basis adjustments. Because it would be erroneous to limit the application of § 755 to optional basis adjustments based solely on the failure to amend the parenthetical language in § 755(a), it would be equally erroneous to interpret the failure to amend the parenthetical language in § 761(e)(2) as limiting § 761(e) to apply only to optional basis adjustments under § 743(b) and not to mandatory basis adjustments under § 743(b) as well. A's argument regarding the parenthetical language in § 761(e) is unpersuasive and, thus, § 761(e) applies to actual and constructive distributions of partnership interests when either a § 754 election is in effect for the partnership or the partnership has a substantial built-in loss.

Alternatively, A argues that Y, the resulting partnership in this case, should be treated as a continuation of both X and Y under the literal language of § 708(b)(2)(A) and, as a result, § 761(e) should not apply to any constructive distributions that would result by treating X as a terminated partnership under the "tiebreaker rule" in § 1.708-1(c)(1). In A's view, because the merger of two partnerships owned by the same majority partner in the same proportion represents a "mere change in form," the deemed steps that occur under § 1.708-1(c)(3)(i) by treating X as a terminated partnership under § 1.708-1(c)(1) should have no substantive tax effects or consequences, including any potential § 743(b) adjustments. A cites language from the preamble to proposed regulations under § 704(c) to support A's argument that because the majority ownership of X and Y was essentially unchanged after the merger, the transaction should result in no substantive tax consequences to the partners.[6]

[6] See Preamble to Proposed § 1.704-4(c)(4) and § 1.737-2(b), 72 Fed. Reg. 46932, 46933 (Aug. 22, 2007).

We disagree with A's argument that no substantive tax effects or consequences should result when X and Y merge. When a resulting partnership could be considered the continuation of more than one of the merging or consolidating partnerships under § 708(b)(2)(A) (for example, because the same majority partner owns both partnerships), the "tiebreaker rule" in § 1.708-1(c)(1) mandates that only one of the merging or consolidating partnerships continues (based on fair market value of assets contributed) while any other merging or consolidating partnership terminates. This rule and the rule in § 1.708-1(c)(3)(i) describing the steps that are treated as occurring to effectuate the deemed termination of any merged or consolidated partnership as a result of the merger cannot be ignored. For tracking basis and capital accounts, determining partnership elections, and other administrative concerns, only one merging partnership can be treated as continuing. Additionally, A's reliance on the preamble to the regulations under § 704(c) is misplaced. The "substantive tax consequences" described in that preamble concern the recognition of immediate gain and not the conformity of partnership basis under § 743(b). Finally, A's assertion that the merger in this case represents a "mere change in form" ignores the fact that Federal tax law recognizes the existence of separate entities and the resulting tax consequences from transactions between those separate entities. The fact that two separate entities are owned by the same majority partner does not mean they are the same partnership or should be treated as one partnership for Federal income tax purposes. A chose the form of the transaction (in this case, a merger of X into Y) for A's own reasons. This indicates that the form of the transaction had real substantive legal effects, and therefore, the transaction was not a mere change in form. Accordingly, the transaction as carried out had substantive effects and consequences that are respected for Federal income tax purposes, and the transaction is of a type that falls within and is subject to § 1.708-1(c)(3)(i). The deemed steps that occur as a result of an assets-over merger under § 1.708-1(c)(3)(i) include the treatment of the constructive distribution by X of the partnership interest in Y as an exchange under § 761(e) for purposes of § 743(b).

A also argues that because Rev. Rul. 90-17, 1990-1 C.B. 119, holds that a deemed distribution resulting from an assets-over merger is not an exchange under § 761(e) for § 708(b)(1)(B) purposes, it should not be treated as an exchange for purposes of

§ 743(b). Even though A concedes that Rev. Rul. 90-17 does not address whether a deemed distribution resulting from an assets-over merger is an exchange for purposes of § 743, A argues that the conclusion that the deemed distribution in an asset-over merger is not an exchange for § 743 purposes necessarily follows from this ruling because § 761(e) applies to both §§ 708 and 743. Accordingly, not applying § 708 for purposes of § 761(e) means that § 743 cannot be applied for § 761(e) purposes either. We disagree. As discussed in Rev. Rul. 90-17, the § 708(b)(2)(A) merger rules take precedence over the § 708(b)(1)(B) termination rule in cases where both could theoretically apply. Therefore, even though deemed distributions resulting from assets-over mergers may not be properly treated as exchanges for purposes of applying § 708(b)(1)(B) to the resulting partnership, neither the Code nor the regulations prevent a deemed distribution resulting from an assets-over merger from being treated as an exchange of the distributed interests in the resulting partnership under § 708(b)(2)(A), for purposes of applying § 743(b) to those distributed interests. The holding in Rev. Rul. 90-17 supports this position and does not alter our conclusion that a deemed distribution of a partnership interest in an assets-over merger is treated as an exchange under § 761(e) for purposes of § 743(b).

Finally, A asserts that the netting rule of § 1.752-1(f) reflects and implements a "single transaction/unitary basis" approach and that the application of § 743(b) to the assets-over merger under § 1.708-1(c)(3)(i) assumes a two-step transaction in which the interest acquired in Step 2 is disaggregated from all other interests previously held by the transferee partner in the resulting partnership. Accordingly, A argues that a single transaction approach cannot be reconciled with the separate interest/bifurcated approach that applies for § 743(b) purposes and, therefore, § 743(b) should not apply to an assets-over merger under § 1.708-1(c)(3)(i).

We disagree. The application of the netting rule in § 1.752-1(f) to an assets-over merger under § 1.708-1(c)(3)(i) also does not alter our conclusion. Even though the netting rule in § 1.752-1(f) treats an assets-over merger under § 1.708-1(c)(3)(i) as a single transaction for purposes of determining any net liability shifts under § 752, § 1.752-1(g) Example 2 (illustrating the application of the netting rule when two partnerships merge) demonstrates that an assets-over merger is a single transaction involving two steps, as described in § 1.708-1(c)(3)(i). Therefore, by respecting the deemed steps that occur in an assets-over merger, the single transaction approach can be reconciled with the separate/bifurcated approach that applies for § 743(b) purposes.[7]

[7] See footnote 14, infra, for additional detail.

[14.] For example, when applying the separate/bifurcated approach of § 743(b) to the facts from Example 2 of § 1.752-1(g) assuming a § 754 election is in effect and accounting for B's net decrease in liabilities under § 752, B has no adjustment under § 743. This is correct because before the merger, the inside and outside bases of B in partnership T and partnership S are equal. For simplicity, B's share of partnership liabilities in partnership T and partnership S is determined under § 1.752-3(a)(3). When partnership T merges into partnership S and transfers its assets ($600 of adjusted basis and value of $1,000) and liabilities ($900) to partnership T, B's share of partnership T's liabilities decreases by $630. B's share of partnership S's liabilities, as a momentary indirect partner in partnership S, is $70 (7% of $1,000). Under the netting rule in § 1.752-1(f), B does not recognize any gain under § 731. Absent the netting rule, B would recognize $140 of gain under § 731. For purposes of determining

B's § 743(b) adjustment, B's outside basis in partnership S (transferred partnership interest) is $0 ($420 (B's outside basis in partnership T before the merger) less $630.

If a partnership does not make a Code § 754 election when a partner dies, consider asking the partnership to make the election when the decedent's estate or (former) revocable trust funds bequests by distributing the partnership interest, which also might be an event triggering a basis adjustment. The basis adjustment is not tied to any change in basis but rather generally catches up the "inside basis" to the "outside basis,"[5624] so every estate or (former) revocable trust has a chance to make up for the partnership's failure to make a Code § 754 election. Note also that, if a Code § 754 election is in place as of date of death, technically the basis adjustments need to be done not only as of date of death but also as of date of distribution. However, if the adjustments are made as of date of death and the distribution is a carryover basis event, then the fact that outside basis equals inside basis means that no further Code § 743(b) is required.[5625]

However, a disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, or the liquidation of a partnership interest, was not a sale or exchange for purposes of Code § 708.[5626] Willis & Postlewaite, ¶ 16.01[7] Termination by Gift, Transfer on Death, or Distribution from Estate or Trust, *Partnership Taxation* (WG&L), states:

> The transfer of a partnership interest by bequest or inheritance also is specifically excluded from sale or exchange treatment.[69] The treatment of a distribution of a partnership interest from a trust or estate, however, is less clear. There is no explicit language in the Regulations excluding such distributions from sale or exchange treatment.[70] Thus, while a transfer of a partnership interest to a trust or estate (if in the form of a gift or bequest) is not an exchange, a distribution of such an interest from the trust or estate arguably constitutes such a transfer.[71] The statutory language provides that, subject to Regulations, any distribution will constitute a § 708 exchange.[72] While the Conference Committee Report[73] focuses only on distributions of partnership interests made by partnerships and corporations, the language clearly is not so limited.
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> [69] Reg. § 1.708-1(b)(2).

[5624] See part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss), particularly the paragraph in which lies the text accompanying fn. 5678.
[5625] See fn. 5679 and accompanying text.
[5626] Reg. § 1.708-1(b)(2), which was last amended after Code § 761(e) was enacted. Does a distribution from a trust qualify for this exception? The Conference Report adopting Code § 761 in 1984 does not expressly address trusts, saying that Code § 761 provides:

> that for purposes of section 708, section 743, or any other provision of subchapter K specified in regulations (not just section 743 as in the House bill and Senate amendment) a distribution of a partnership interest by a partnership or corporation will be treated as a sale or exchange of the interest.

Reg. § 1.708-1(b)(2) was Reg. § 1.708-1(b)(1)(ii) before it was re-designated by T.D. 8925 (1/4/2001). It had the same provision since its adoption in 1956. The 2001 redesignation related to comprehensive rules on partnership mergers and divisions and did not mention Code § 761. When T.D. 8717 (5/8/1997) amended other provisions of Reg. § 1.708-1, it also amended Reg. § 1.761-1, without touching this language. So my best guess is that Treasury did not view Code § 761 as having an impact on that particular sentence.
Distributions from trusts tend to be viewed as gifts. See part II.J.8.d Distribution in Kind.

[70] Regulation § 1.708-1(b)(2) in permitting an assignment of a partnership interest to "a successor in interest" without risk of termination might be thought to include transfers of an interest from a trust. The assignment language, however, appears to modify only the word "gift".

[71] But see Private Letter Ruling 8605047, involving a terminated trust and the distribution of its assets which included a 50 percent interest in a partnership. The Ruling contained no reference to the termination issue under § 708, possibly because its focal point was whether the partnership, which later divided into two partnerships, could retain its use of a fiscal year.

[72] IRC § 761(e), discussed at ¶ 16.01[8].

[73] HR Rep. No. 861, 98th Cong., 2d Sess. 864 (1984).

Tax policy, authority in related sections of Subchapter K, and subsequent legislative history, however, dictate that distributions from estates and trusts should be exempted from coverage.[74] However, the Regulation does not contain such an exemption.[75]

[74] IRC § 761(e). See Regulation § 1.706-1(c)(3)(vi) example (3) (distribution of a partnership interest by an estate is not a sale or exchange of the interest; the partnership taxable year does not close with respect to the estate as partner). Compare Revenue Ruling 72-352, 1972-2 CB 395 (distribution of a partnership interest to a trust beneficiary upon termination of the trust closes the partnership taxable year with respect to the trust as partner). See discussion at ¶ 9.06.

[75] Reg. § 1.761-1(e). The Senate Finance Committee Report (S. Rep. No. 313, 99th Cong., 2d Sess. 924 (1986)) suggested that the Regulations under § 761(e) exclude such dispositions from sale or exchange treatment. The Report provided that it "is intended that exceptions might include a distribution of a partnership interest by an estate or testamentary trust by reason of the death of a partner will not be treated as a sale or exchange for purposes of § 708(b)."

However, the concept of a partnership terminating by reason of a transfer no longer exists. See part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).

Code § 761(e)(2) provides, "Except as otherwise provided in regulations, for purposes of … section 743 (relating to optional adjustment to basis of partnership property) …, any distribution of an interest in a partnership (not otherwise treated as an exchange) shall be treated as an exchange." Regulations do not modify the application of Code § 761(e)(2).

II.Q.8.e.ii. Transfer of Partnership Interests: Effect on Transferring Partner

II.Q.8.e.ii.(a). Unitary Basis

A partner has a single basis in a partnership interest (determined under Code § 705), even if such partner is both a general partner and a limited partner of the same partnership.[5627] (A partner also has a single capital account that reflects all of the partner's interests, "regardless of

[5627] Rev. Rul. 84-53, citing Rev. Rul. 84-52.

the class of interests owned by such partner (*e.g.*, general or limited) and regardless of the time or manner in which such interests were acquired.")[5628]

A partner does not have a divided holding period in an interest in a partnership unless the partner acquired portions of an interest at different times or acquired portions of the partnership interest in exchange for property transferred at the same time but resulting in different holding periods.[5629] The portion of a partnership interest to which a holding period relates is determined by reference to a fraction, the numerator of which is the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates, and the denominator of which is the fair market value of the entire partnership interest (determined

[5628] Reg. § 1.704-1(b)(2)(iv)(b), which is reproduced in the text accompanying fn. 500 in part II.C.7 Maintaining Capital Accounts.
[5629] Reg. § 1.1223-3(a). See McKee, Nelson & Whitmire, ¶ 4.01[2][a] Contributing Partner's Holding Period for His Partnership Interest, *Federal Taxation of Partnerships & Partners* (WG&L). For other aspects of split holding periods, including options to buy, see Bittker & Lokken, ¶ 49.5 Split Holding Periods, *Federal Taxation of Income, Estates, and Gifts* (WG&L), Rev. Ruls. 62-140 and 75-524, and *Commissioner v. Williams*, 256 F.2d 152 (1958), *aff'd on rehearing*, 285 F.2d 582 (5th Cir. 1961).

immediately after the transaction).[5630] Special rules apply to the sale or exchange of all or a portion of an interest in a partnership[5631] and distributions.[5632]

When one transfers a partnership interest, the basis allocated to the transferred interest is based on the relationship between the value of the transferor's partnership interest and the value of the transferred interest.[5633] Thus, when one transfers partnership interests that are

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[5630] Reg. § 1.1223-3(b)(1). The rest of Reg. § 1.1223-3(b) provides:

> (2) *Special rule*. For purposes of applying paragraph (b)(1) of this section to determine the holding period of a partnership interest (or portion thereof) that is sold or exchanged (or with respect to which gain or loss is recognized upon a distribution under section 731), if a partner makes one or more contributions of cash to the partnership and receives one or more distributions of cash from the partnership during the one-year period ending on the date of the sale or exchange (or distribution with respect to which gain or loss is recognized under section 731), the partner may reduce the cash contributions made during the year by cash distributions received on a last-in-first-out basis, treating all cash distributions as if they were received immediately before the sale or exchange (or at the time of the distribution with respect to which gain or loss is recognized under section 731).
>
> (3) *Deemed contributions and distributions*. For purposes of paragraphs (b)(1) and (2) of this section, deemed contributions of cash under section 752(a) and deemed distributions of cash under section 752(b) shall be disregarded to the same extent that such amounts are disregarded under § 1.704-1(b)(2)(iv)(c).
>
> (4) *Adjustment with respect to contributed section 751 assets*. For purposes of applying paragraph (b)(1) of this section to determine the holding period of a partnership interest (or portion thereof) that is sold or exchanged, if a partner receives a portion of the partnership interest in exchange for property described in section 751(c) or (d) (section 751 assets) within the one-year period ending on the date of the sale or exchange of all or a portion of the partner's interest in the partnership, and the partner recognizes ordinary income or loss on account of such a section 751 asset in a fully taxable transaction (either as a result of the sale of all or part of the partner's interest in the partnership or the sale by the partnership of the section 751 asset), the contribution of the section 751 asset during the one-year period shall be disregarded. However, if, in the absence of this paragraph, a partner would not be treated as having held any portion of the interest for more than one year (e.g., because the partner's only contributions to the partnership are contributions of section 751 assets or section 751 assets and cash within the prior one-year period), this adjustment is not available.
>
> (5) *Exception*. The Commissioner may prescribe by guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) a rule disregarding certain cash contributions (including contributions of a de minimis amount of cash) in applying paragraph (b)(1) of this section to determine the holding period of a partnership interest (or portion thereof) that is sold or exchanged.

For Code § 751, see part II.Q.8.b.i.(g) Code § 751 – Hot Assets. Reg. § 1.1223-3(e), "Section 751(c) assets," provides:

> For purposes of this section, properties and potential gain treated as unrealized receivables under section 751(c) shall be treated as separate assets that are not capital assets as defined in section 1221 or property described in section 1231.

See part II.G.6.a Code § 1231 Property.

[5631] Reg. § 1.1223-3(c).

[5632] Reg. § 1.1223-3(d).

[5633] Rev. Rul. 84-53 allocates this basis as follows:

> Under section 1.61-6(a) of the regulations, when a partner makes a taxable disposition of a portion of an interest in a partnership, the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market

discounted relative to one's holding, one also transfers a proportionately smaller portion of basis to the transferee. Note also that, if a transfer is made to a grantor trust, the consequences of the transfer apply only when the trust ceases to be taxed to the grantor.[5634]

Presumably the basis could be divided if the buyer uses an S corporation for a subsequent investment into the partnership. Other consequences of that structure are in part II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker, especially part II.L.5.a S Corporation Blocker Generally.

Also, dividing a partnership would isolate the basis with respect to groups of assets in that the groups of assets are in separate partnerships; any such division should result in percentage interests that are the same in each partnership before or after the division.[5635]

II.Q.8.e.ii.(b). Character of Gain on Sale of Partnership Interest

Although the sale of stock in a corporation (whether or not an S election is in place)[5636] is pure capital gain or loss, the sale of a partnership interest often has an ordinary income component. The gain is ordinary to the extent attributable to the selling partner's indirect interest in the partnership's unrealized receivables, certain depreciable assets, and inventory items;[5637] the rest generally receives capital gain treatment.[5638] If any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer (or any other related person) in a disfavored trade or business, the holding period for long-term capital gain treatment may be extended to over three

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> value of the entire interest. However, if such partnership has liabilities, special adjustments must be made to take into account the effect of those liabilities on the basis of the partner's interest. In cases where the partner's share of all partnership liabilities does not exceed the adjusted basis of such partner's entire interest (including basis attributable to liabilities), the transferor partner shall first exclude from the adjusted basis of such partner's entire interest an amount equal to such partner's share of all partnership liabilities, as determined under section 1.752-1(e) of the regulations. A part of the remaining adjusted basis (if any) shall be allocated to the transferred portion of the interest according to the ratio of the fair market value of the transferred portion of the interest to the fair market value of the entire interest. The sum of the amount so allocated plus the amount of the partner's share of liabilities that is considered discharged on the disposition of the transferred portion of the interest (under section 752(d) of the Code and section 1.1001-2 of the regulations) equals the adjusted basis of the transferred portion of the interest.
>
> On the other hand, if the partner's share of all partnership liabilities exceeds the adjusted basis of such partner's entire interest (including basis attributable to liabilities), the adjusted basis of the transferred portion of the interest equals an amount that bears the same relation to the partner's adjusted basis in the entire interest as the partner's share of liabilities that is considered discharged on the disposition of the transferred portion of the interest bears to the partner's share of all partnership liabilities, as determined under section 1.752-1(e).

For Reg. § 1.752-1 after October 2016 changes, see part II.C.3 Allocating Liabilities (Including Debt). I have not yet reviewed their interaction with Rev. Rul. 84-53.

[5634] See part III.B.2.d.i Federal Income Tax and Irrevocable Grantor Trust Treatment, especially fn. 6531.

[5635] See part II.Q.8.d Partnership Division, especially fn. 5578.

[5636] Code § 341, before its repeal, provided exceptions for collapsible corporations.

[5637] Code § 751(a); for details on the assets subject to these rules, see part II.Q.8.b.i.(g) Code § 751 – Hot Assets. See also fn. 5366.

[5638] Code § 741.

years (instead of over one year); see part II.M.4.f.ii.(b) Code § 1061 - Certain Sales of Compensatory Partnership Interests Recharacterized from Long-Term to Short-Term Gains.

"Unrealized receivables" includes previously untaxed rights to payment from the sale of:[5639]

1. Inventory or other ordinary income items, or

2. Services rendered, or to be rendered.

Depreciable assets to which this provision applies are primarily those the sale of which would trigger depreciation recapture, such as depreciation on tangible personal property or accelerated depreciation on the sale of real property; see part II.Q.8.b.i.(g) Code § 751 – Hot Assets.[5640] However, sometimes depreciable real property without accelerated depreciation might be subject to more onerous provisions.[5641]

"Inventory items" includes not only inventory[5642] but certain other ordinary income items,[5643] whether those assets would receive that treatment in the hands of the partnership or the selling partner.[5644] Under prior law, this provision applies only if those assets are substantially appreciated,[5645] meaning that their fair market value exceeds 120% of the adjusted basis to the partnership of such property.[5646] However, now inventory items do not have to be substantially appreciated to impute ordinary income on the portion of the sale of the partnership interest attributable to such items;[5647] thus, the sale of a partnership interest is treated less favorably than a redemption,[5648] since a redemption triggers ordinary income attributable to inventory items only if the inventory items are substantially appreciated.[5649]

[5639] Code § 751(c). Untaxed means to the extent that income arising from such rights to payment was not previously includible in income under the method of accounting employed by the partnership. Reg. § 1.751-1(c)(1). Reg. § 1.751-1(c) describes various aspects of various kinds of unrealized receivables.
[5640] The flush language of Code § 751(c) refers to mining property, stock in a DISC, section 1245 property, stock in certain foreign corporations, section 1250 property, farm land, franchises, trademarks, or trade names, and an oil, gas, or geothermal property, but only to the extent of the amount which would be treated as gain to which certain recapture provisions would apply if, at the time of the sale of the partnership interest, such property had been sold by the partnership at its fair market value. Similar treatment applies any market discount bond and any short-term obligation to the extent of the amount would have been treated as ordinary income; however, this sentence does not apply with respect to the redemption of a partnership interest under Code § 736.
[5641] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), particularly fn. 5087 the sale of partnership interests to a controlled corporation, which is which is further reaching than Code § 751.
[5642] Code § 751(d)(1).
[5643] Code § 751(d)(2).
[5644] Code § 751(d)(3).
[5645] Reg. § 1.751-1(a)(1).
[5646] Reg. § 1.751-1(d)(1).
[5647] Before P.L. 105-34 was amended in 1997, Code § 751(a)(2) applied to impute ordinary income on the sale of a partnership interest with respect to inventory items of the partnership which have appreciated substantially in value. P.L. 105-34 struck which have appreciated substantially in value from Code § 751(a)(2).
[5648] Milo, The Tax Cost of Hot Assets upon the Disposition of a Partnership Interest, *The Tax Advisor* (August 2010).
[5649] Code § 751(b)(3).

When a partner transfers part or all of the partner's interest via gift, part of that transfer will be treated as a sale if the partner's share of partnership liabilities exceeds the adjusted basis of the partner's partnership interest. The transfer is treated as such because liability is shifting from the donor to the donee, and the donor is treated as having received cash to the extent that the donor's share of liabilities is reduced. The shift can be analyzed in two potential ways. One way would be to argue the shift is governed by Code § 752(b), which treats a reduction in a partner's share of partnership liabilities as a deemed cash distribution. In this case, the donor would recognize gain to the extent the distribution exceeded his partnership interest adjusted basis. However, another view is that only a portion of the basis of the partner's partnership interest should be allocated to the sale portion of the transfer, and gain is recognized to the extent the shift in liabilities exceeds the allocated portion of the adjusted basis.[5650]

For the effect of a transfer on the allocation of income reported on the involved partners' K-1s, see part III.B.2.j.iii Allocations upon Change of Interest in a Partnership, found within part III.B.2.j Tax Allocations upon Change of Interest.

Rev. Rul. 91-32 held that gain or loss of a foreign partner that disposes of its interest in a partnership that is engaged in a trade or business through a fixed place of business in the United States will be United States source effectively connected income (ECI) gain or will be ECI loss that is allocable to United States source ECI gain, to the extent that the partner's distributive share of unrealized gain or loss of the partnership would be attributable to ECI (United States source) property of the partnership. However, *Grecian Magnesite Mining v.*

[5650] Code § 752(d).

Commissioner, 149 T.C. 63 (2017),[5651] repudiated Rev. Rul. 91-32.[5652] Before getting to that analysis, it explained that Code § 741 works solely at the entity level (which is the focus of this part Character of Gain on Sale of Partnership InterestII.Q.8.e.ii.(b) and why that case is mentioned here), treating the partnership interest as a single unitary asset, without looking through to the underlying assets, absent any overriding provision:

> In sum, section 736(b)(1) provides that payments such as those giving rise to the disputed gain "*shall* … be considered as a distribution by the partnership"; section 731(a) provides that such gain "shall be considered as gain … from the sale or exchange of the

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[5651] Aff'd 926 F3d 819 (D.C. Cir. 2019). The ECI portion of the case was repealed, as described in the text following fn 940 in part II.E.1.c.viii Income or Gain from or Sale of Property Used in the Business or Business Interest Itself. The Official Tax Court Syllabus described the case as follows:

> In 2001 P, a foreign corporation, purchased an interest in PS, a U.S. limited liability company that was treated as a partnership for U.S. income tax purposes. From 2001 to 2008 income was allocated to P from PS, and P paid income tax in the United States. In 2008 P's interest was redeemed by PS, and P received two liquidating payments, one in July 2008 and the second in January 2009 but deemed to have been made on December 31, 2008. P realized gain totaling over $6.2 million, of which $2.2 million was deemed attributable to U.S. real property interests (and which P now concedes is taxable income). P contends that the remainder—"disputed gain" of $4 million—is not taxable for U.S. purposes. P timely filed a Form 1120-F, "U.S. Income Tax Return of a Foreign Corporation", for 2008, wherein it reported its distributive share of PS's income, gain, loss, deductions, and credits, but did not report any income it received from the redemption of its partnership interest (i.e., neither the now-conceded real estate gain nor the disputed gain). P did not file a return or pay any income tax in the United States for 2009. Ps reporting position was recommended to it by an experienced certified public accountant ("C.P.A.") who was recommended to P by its U.S. lawyer.
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> R prepared a substitute for return pursuant to sec. 6020(b) for P's 2009 year, and issued a notice of deficiency for 2008 and 2009, determining, inter alia, that P must recognize its gain on the redemption of its partnership interest for U.S. tax purposes as U.S.-source income that was effectively connected with a U.S. trade or business, consistent with Rev. Rul. 91-32. P timely filed a petition with this Court.
>
> *Held*: P's disputed gain was capital gain that was not U.S.-source income and that was not effectively connected with a U.S. trade or business. This Court will not follow Rev. Rul. 91-32. P is therefore not liable for U.S. income tax on the disputed gain.
>
> Held, further, as to the now-conceded tax liability for gain on the real estate, P is not liable for the sec. 6662(a) penalty for 2008 or the additions to tax under sec. 6651(a)(1) and (2) for 2009, because P reasonably relied on the erroneous advice of the C.P.A.

[5652] The court summarized:

> Our level of deference to agency interpretations of law varies. Where the interpretation construes an agency's own ambiguous regulation, that interpretation is accorded deference, *Rand v. Commissioner*, 141 T.C. 376, 380-381 (2013) (citing *Auer v. Robbins*, 519 U.S. 452, 461 (1997)). On the other hand, where a revenue ruling improperly interprets the text of relevant statutes and has inadequate reasoning, we afford it no deference at all. *PSB Holdings, Inc. v. Commissioner*, 129 T.C. 131, 145 (2007). Between these poles, we follow revenue rulings to the extent that they have the "power to persuade". See *id.* at 144.
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> Rev. Rul. 91-32 is not simply an interpretation of the IRS's own ambiguous regulations, and we find that it lacks the power to persuade. Its treatment of the partnership provisions discussed above in part II.B is cursory in the extreme, not even citing section 731 (which, as we set out, yields a conclusion of "gain or loss from the sale or *exchange of the partnership interest*" (emphasis added)). The ruling's subchapter K analysis essentially begins and ends with the observation that "subchapter K of the Code is a blend of aggregate and entity treatment for partners and partnerships." We criticize the ruling's treatment of the subchapter N issues in notes 22 and 24 below. We decline to defer to the ruling. We will instead follow the Code and the regulations to determine whether the disputed gain is effectively connected income.

partnership interest of the distributee partner"; and section 741 provides that such gain "*shall* be considered as gain … from the sale or exchange of a capital asset". (Emphasis added.) Accordingly, GMM's gain from the redemption of its partnership interest is gain from the sale or exchange of an indivisible capital asset - *i.e.*, GMM's interest in the partnership.

The court reasoned:

The Commissioner posits that the only way to reconcile the two provisions is to interpret section 741 as applicable only to the character of the gain recognized - *i.e.*, as capital rather than ordinary. That is, the Commissioner maintains that while section 741 expressly requires that the gain "shall be considered as gain or loss from the sale or exchange of a capital asset", the statute does not preclude treating the (capital) gain as arising not from the sale of the partnership interest per se (which the entity theory would yield) but from the partnership's underlying assets that give value to the partnership interest (which the aggregation theory would yield).

It is true that, in providing that the gain "shall be considered as gain * * * from the sale or exchange of a capital asset", section 741 does not specify which asset. However, there are four flaws in the Commissioner's approach that cause us to reject it. First, he exaggerates the conflict between an "entity theory" construction of section 741 and the existence of an exception in section 897(g). In its own terms, section 741 acknowledges one exception ("except as otherwise provided in section 751"),[16] so section 741 is only a general rule, not a rule of absolute and universal application. Congress is always free, having enacted a general rule, to enact exceptions.

[16] Section 751 is a specific exception to section 741 that causes unrealized receivables and inventory items to be addressed separately from the remainder of the partnership interest when that interest is sold or liquidated. In the context of liquidating distributions, the partnership is deemed to have bought the liquidated partner's share of those assets from that partner, so that that partner has gain of a character and amount consistent with such a hypothetical sale. The IRS did not assert application of section 751(b) in the SNOD, and the Commissioner has not asserted it as an alternative position in this case. Consequently, we do not consider section 751 further. We note that by the express terms of section 741, section 751 is (like section 897(g); see supra note 11) an exception, and it mandates an "aggregation" approach for characterizing only gain "attributable to" unrealized receivables or inventory items". This statute thus presumes the existence of a general rule to which this aggregation approach is an exception. Section 751 does not provide (and the Commissioner does not contend that it provides) a general rule that all gain from a partner's sale of its partnership interest shall be considered an amount received from the sale of the partnership's properties of whatever types.

Second, the Commissioner's reading of section 741 gives insufficient effect to one word in the statute. Section 741 provides that income realized on the sale of a partnership interest "shall be considered as gain * * * from the sale or exchange of a capital *asset*". (Emphasis added.) Congress used the singular "asset", rather than the plural "assets". This singular wording is more consistent with the treatment of the sale of a partnership interest according to the entity theory, under which the selling partner is deemed to have sold only one asset (its partnership interest) rather than being deemed to have sold its interest in the multiple underlying assets of the partnership. See also *P.B.D. Sports, Ltd.*

v. Commissioner, 109 T.C. 423, 438 (1997) ("Generally, subchapter K employs the entity approach in treating transfers of partnership interests. The sale of a partnership interest is treated as the sale of a single capital asset rather than as a transfer of the individual assets of the partnership. See secs. 741 and 742."); *Unger v. Commissioner*, T.C. Memo. 1990-15 (listing section 741 as an example of the entity theory in the Internal Revenue Code), *aff'd*, 936 F.2d 1316 (D.C. Cir. 1991). And absent some overriding mandate, section 731 directs that gain or loss on a distribution (such as the one at issue) "shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner" (that is, as directed by section 741).

Third, Congress has explicitly carved out a few exceptions to section 741 that, when they apply, do require that we look through the partnership to the underlying assets and deem such a sale as the sale of separate interests in each asset owned by the partnership. If Congress had intended section 741 to be interpreted as a look-through provision, these exceptions in sections 751 and 897(g) would be superfluous. See *TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001).

Accordingly, the enactment of section 897(g) actually reinforces our conclusion that the entity theory is the general rule for the sale or exchange of an interest in a partnership. Without such a general rule, there would be no need to carve out an exception to prevent U.S. real property interests from being swept into the indivisible capital asset treatment that section 741 otherwise prescribes.

Fourth, section 731(a)—brought into this analysis by the express wording of section 736(b)(1)—makes explicit that the "entity theory" generally applies to a partner's gain from a distribution:

> Any gain or loss recognized under this subsection shall be considered as gain or loss *from the sale or exchange of the partnership interest* of the distributee partner.

Sec. 731(a) (emphasis added). This wording could hardly be clearer. The partnership provisions in subchapter K of the Code provide a general rule that the "entity theory" applies to sales and liquidating distributions of partnership interests—i.e., that such sales are treated not as sales of underlying assets but as sales of the partnership interest. Of course, Congress may enact exceptions or different rules, such as for foreign partners, and we consider that possibility below; but we begin our analysis with this generality from subchapter K.

The Commissioner's interpretation of the Code acknowledges the same sequence we have followed—i.e., that section 736(b)(1) leads to section 731, which in turn leads to section 741, but he evidently thinks such an analysis stops short. The Commissioner apparently maintains that, after applying those sections in that order, one must still return to section 736(b)(1)—so that, while section 741 mandates the capital character of the income, in the end the distribution is still characterized as "payments * * * made in exchange for the interest of such partner in partnership property". Sec. 736(b)(1) (emphasis added). The emphasized phrase certainly does appear in section 736(b)(1), and the analysis in this case begins there precisely because GMM did indeed receive payments that, given the nature of a partnership, can be said to have been made ultimately in exchange for GMM's interest in the partnership's various items of property. However, sections 736(b)(1), 731(a), and 741 tell us what to do with such payments for tax purposes; and as we have shown, they direct us to a conclusion: "gain or loss from the sale or exchange of the partnership interest", sec. 731(a), which is "a [singular] capital asset", sec. 741. We see no reason to abandon that conclusion, return to section 736(b)(1), and halt at the phrase that most nearly coincides with the Commissioner's position.[17]

[17] Indeed, when we read section 736(a) and (b) together, it becomes clear that the role of the words "partnership property" in section 736(b) is to distinguish distributions made for such property from those made out of a partner's "distributive share" of entity-level partnership income (as in section 736(a)(1)) or as a "guaranteed payment" (as in section 736(a)(2)). A partner's "distributive share", sec. 736(a)(1), is governed by sections 704(b) and 701; the tax treatment of a "guaranteed payment", sec. 736(a)(2), is provided in section 707(a); and payments for partnership property, sec. 736(b), are "considered as a distribution by the partnership"—i.e., are treated as provided in section 731. In none of these instances is the ultimate tax treatment of the transfer of money or property from a partnership to a partner prescribed solely by reference to section 736.

The Commissioner also argues that section 741 should not be applied to characterize the income at issue because applying it in that manner would contradict "Congress' intent in enacting section 865", the sourcing rule we discuss below in part IV.B. The Commissioner argues that, when addressing a partnership question under subchapter K of the Code (which deals primarily with partners and partnerships) and applying a Code section (such as section 865) that is outside of subchapter K, one must look to "the nature of the partnership interest involved, together with the intent and purpose of the non-subchapter K section being applied." Using this rule, the Commissioner explains that not section 741 but rather section 736(b)(1) more appropriately characterizes the type of income here—i.e., as a payment for GMM's interest in the "partnership property". We see no basis for the Commissioner's selection of this particular phrase from section 736(b)(1) as the guiding star for navigating the intersection of partnership taxation and the taxation of international transactions, and we have already explained why this phrase is at the beginning and not the end of the analysis. More important, the Commissioner cites no authority for his posited rule, which seems (at least as he uses it here) to shortcut or distort the subchapter K analysis by invoking a purpose (not explicitly enacted) that he discerns in subchapter N. The Commissioner has not convinced us to reconsider the argument that we rejected 38 years ago when it was advanced by the taxpayer in Pollack. Addressing ourselves to the statutory text, we conclude that subchapter K mandates treating the disputed gain as capital gain from the disposition of a single asset, and in part IV.B below we apply the provisions of section 865 accordingly.

CCA 202309015 asserted that LLC interests were inventory and that sales were taxed as ordinary income (and presumably subject to self-employment tax). The CCA characterized the facts:

Between Year 1 and Year 4, Taxpayer directly, and indirectly through entities owned and managed by Taxpayer (Managed LLCs),[1] engaged in the promotion and sale of interests in LLCs. The only asset held by the LLCs was land. Each of the LLCs engaged in transactions involving the donation of an easement with respect to the land, in exchange for a charitable contribution deduction, as described in Notice 2017-10,[2] and/or the donation of a fee simple interest in the land in exchange for a charitable contribution deduction. Hereinafter, because the analysis is the same and for ease of discussion, we refer to these transactions, collectively, as the SCE transactions and to the LLCs that donated the easements and/or land as the SCE LLCs. The character of the gain Taxpayer recognized on the sales of the SCE LLCs is the subject of this advice.

[1] Taxpayer held, through disregarded entities, interests in the Managed LLCs with A and B through which Taxpayer engaged in the transactions described herein. Taxpayer reported the activities of the Managed LLCs as partnerships for federal tax purposes.

[2] 2017-4 I.R.B. 544.

According to information provided by Taxpayer, Taxpayer has been engaged in a variety of business activities including real estate management, acquisition, and investment activities.[3] In at least Year 2, Taxpayer represented that Taxpayer and the Managed LLCs did not sell real property and were not engaged in a trade or business of selling real property.[4] Promotional materials for the sale of the SCE transactions described certain principals of Managed LLCs as "only providing additional information regarding the potential acquisition of membership interests to prospective members and are not acting as a real estate broker nor are they acting as a broker or dealer in securities."[5] During the audit of Taxpayer, LB&I Examination found that Taxpayer's activities are primarily operated through X, located in State, and that X conducts its activities through various Managed LLCs.

[3] 30-day Letter Protest Taxpayer Resp. 2 for Year 2 Form 1040, p. 2.

[4] 30-day Letter Protest Taxpayer Resp. 2 for Year 2 Form 1040, p. 4.

[5] X, Year 3 Information Package for: Y, p. 4.

Transaction Steps[6]

[6] In general, the transaction steps were the same when the SCE LLC donated easements and/or the land.

Taxpayer, or Taxpayer through a Managed LLC, managed, marketed, and negotiated all transaction steps. From Year 1 through Year 4, Taxpayer generally undertook the following steps to promote and sell the SCE LLC interests. Taxpayer:

1. Identified a third-party owner of an undeveloped piece of land who held the land for more than one year (Landowner). Landowner formed an LLC (Land LLC) and contributed the undeveloped land to Land LLC.

2. Formed a Managed LLC that purchased a% of the interests in Land LLC from Landowner in exchange for cash.

3. Directed Land LLC to subdivide the undeveloped land into parcels, contribute one parcel each to several newly formed LLCs (SCE LLC),[7] and distribute the SCE LLC interests b% to Landowner and a% to Managed LLC, the same ownership percentages each held in Land LLC. Land LLC continued to hold one of the parcels.

   [7] Taxpayer reported the activities of the SCE LLCs as partnerships for federal tax purposes.

4. Directed Managed LLC to either continue to hold a% interest in each SCE LLC, or distribute the interest to its partners, Taxpayer, A, and B.

5. Managed LLC, or Taxpayer, A, and B, then sold c% of the SCE LLC interests to a newly formed LLC (Investor LLC) of which Managed LLC or Taxpayer was the managing member. Taxpayer used a different newly formed Managed LLC to sell the SCE LLC interests every year. Individual investors contributed tens of thousands of dollars into the Investor LLC to purchase the SCE LLC interests. Managed LLC, or Taxpayer, A, and B , continued to hold d% interest in and act as the managing member of SCE LLC.

Typically, within one to four months from the date of Land LLC's formation, the SCE LLC donated the easement and/or the land to a § 501(c)(3) organization.[8] The SCE LLC reported the donation as a charitable contribution on its federal tax returns. Taxpayer and the investors, through Investor LLC, claimed a deduction for their distributive shares of the charitable contribution deduction.

[8] X, Year 3 Information Package for: Y, pp. 7, 14, 21.

Taxpayer, through Investor LLC, made oral and written promises to the investors that they would receive a charitable contribution deduction with respect to the donation of the easement and/or the land many times the amount the investors contributed to Investor LLC.[9] Although the promotional materials for the Investor LLCs offered the investors several investment options, Taxpayer, acting as managing member of the SCE LLCs caused all the SCE LLCs to donate easements and/or the land to § 501(c)(3) organizations. Taxpayer, through Investor LLC, received a promotional fee or other consideration in connection with the sales of the SCE LLC interests to the investors.[10]

[9] X, Year 3 Information Package for: Y, pp. 14-15.

[10] X, Year 3 Information Package for: Y, p. 7.

From Year 1 through Year 4, Taxpayer and the Managed LLCs, collectively, reported about $e of gain on the sales of their interests in f SCE LLCs to the Investor LLCs. Other than in Year 4, Taxpayer reported the gain from the sales of the SCE LLC interests as long-term capital gain.[11] In Year 4, Taxpayer sold SCE LLC interests directly and reported the gain from these sales as long-term capital gain. During Year 4, Taxpayer also formed an entity that elected to be treated as an S corporation for federal tax purposes. Taxpayer contributed SCE LLC interests to the S corporation that then sold the SCE LLC interests. Taxpayer reported gain on the sales of the SCE LLC interests sold by the S corporation as Schedule E ordinary income. On Taxpayer's personal tax return, Taxpayer reported no other source of income other than the income generated by Taxpayer from the promotion and sale of the SCE transactions.

[11] Each Managed LLC reported the sales of the SCE LLC interests as long-term capital gain, its share of the charitable deduction from the SCE LLC, and other expenses associated with the SCE transactions. Each Managed LLC also reported distributions of the SCE LLC sale proceeds.

CCA 202309015 argued that the LLC interests were inventory under Code § 1221:

> In *Malat*, the Supreme Court stated, "[a]s used in § 1221(1), 'primarily' means 'of first importance' or 'principally.'"[12] The court also explained that the purpose of § 1221 "is to differentiate between the 'profits and losses arising from the everyday operation of a business' on the one hand and 'the realization of appreciation in value accrued over a substantial period of time' on the other."[13]
>
> [12] *Malat v. Riddell*, 383 U.S. 569, 572 (1966).
>
> [13] *Id. (quoting Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 52 (1955); Commissioner v. Gillette Motor Transport, Inc.*, 364 U.S. 130, 134 (1960)).
>
> The following factors indicate whether property is held primarily for sale to customers in the ordinary course of a trade or business: "(1) the frequency and regularity of sales; (2) the substantiality of sales;" (3) duration of ownership; (4) whether the property held for sale and property held for investment were separately identified; (5) purpose for acquiring the property; (6) sales and advertising efforts; (7) the time and effort devoted to the sales activity; and "(8) how the sales proceeds were used."[14] "The frequency and regularity of sales are among the most important factors in determining whether an asset is held for investment or as inventory."[15] Applying these factors, Taxpayer held directly, or through Managed LLCs, the SCE LLC interests primarily for sale to customers (investors).
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> [14] *Williford v. Commissioner*, T.C. Memo. 1992-450 (citing *United States v. Winthrop*, 417 F.2d 905, 910 (5th Cir.1969); *Byram v. United States*, 705 F.2d 1418, 1424 (5th Cir. 1983); *Ross v. Commissioner*, 227 F.2d 265 (5th Cir. 1955)).
>
> [15] *David Taylor Enterprises, Inc. v. Commissioner*, T.C. Memo. 2005-127 (citing *Suburban Realty Co. v. United States*, 615 F.2d 171, 176 (5th Cir. 1980)).
>
> (1) From Year 1 through Year 4, Taxpayer sold interests in f SCE LLCs to the Investor LLCs, the sales took place every year, and there were multiple investors in each Investor LLC.
>
> (2) From Year 1 through Year 4, Taxpayer recognized gain of about $e from selling the SCE LLC interests to the Investor LLCs.
>
> (3) The length of time from the acquisition of the Land LLC interests to the sale of Taxpayer's interests in the SCE LLCs was usually less than a year.
>
> (4) Taxpayer did not separately identify property held for sale versus property held for investment with respect to the SCE LLC interests.
>
> (5) Taxpayer directed Managed LLC to acquire an interest in the Land LLC from Landowners to create the SCE LLCs and sell interests in these SCE LLCs quickly, usually within a year.
>
> (6) Each year from Year 1 through Year 4, Taxpayer vigorously advertised the SCE transactions, through promotional and other written materials and verbal communications, to attract investors who would contribute a minimum of tens of

thousands of dollars to an Investor LLC. Taxpayer also engaged in significant sales activities, resulting in sales of interests in f SCE LLCs with multiple investors buying interests in Investor LLCs every year.

(7) Taxpayer devoted a substantial amount of time to the SCE transactions. Taxpayer found Landowner with whom Taxpayer negotiated a land purchase price, convinced the Landowner to structure the land sale as a sale of a% interest in Land LLC with Landowner keeping b% in Land LLC.[16] Taxpayer determined the scope and nature of the SCE transactions and arranged financing. Taxpayer directed the subdivision of land in Land LLC, the creation of SCE LLCs and placement of the subdivided land parcels into them, hired appraisers and other professionals, directed the creation of Investor LLC and the promotion and sale of interests therein to investors. As managing member of Investor LLC and in other ways, Taxpayer caused the SCE LLCs to donate the easement and/or the land. Taxpayer repeated these steps every year from Year 1 through Year 4.

[16] X, Year 3 Information Package for: Y, p. 2.

(8) "Use of sales proceeds to replenish inventory indicates property is held for sale."[17] Taxpayer clearly intended to replace the SCE LLC interests being sold. From Year 1 through Year 4, Taxpayer created new SCE LLCs and sold Taxpayer's interests in them. The frequency and size of these transactions support that Taxpayer used the proceeds from the sales of the SCE LLC interests to purchase replacement properties for subsequent similar transactions.

[17] *Williford*, T.C. Memo. 1992-450.

In selling the SCE LLC interests, Taxpayer met each factor relevant to whether property is held primarily for sale to customers in the ordinary course of a trade or business. This confirms that, under § 1221(a)(1), Taxpayer held the SCE LLC interests as inventory "or property held... primarily for sale to customers in the ordinary course of Taxpayer's trade or business," not as capital assets. In addition, Taxpayer sold the SCE LLC interests quickly, generally within a year, and did not hold them on a long-term basis. Thus, under *Malat*, Taxpayer realized income "from the everyday operation of a business" and not "the realization of appreciation in value accrued over a substantial period of time." Therefore, Taxpayer's gain on the sales of the SCE LLC interests is ordinary income.

In *Corn Products Refining Co.*, a corn products manufacturer's profits and losses from trading in corn futures were held to be ordinary income, not capital gains under the predecessor to § 1221.[18] The court determined that trading in corn futures was not "separate and apart from [the company's] manufacturing operations," but "a form of insurance against increases in the price of raw corn," which was "closely geared to [the] company's manufacturing enterprise [and very] important to its successful operation."[19]

[18] *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955).

[19] *Id*. at 49-50.

The SCE LLC interests sold by Taxpayer are also excepted from the capital asset definition under Corn Products, as the SCE LLC interests are not "separate and apart from” Taxpayer’s operations but are rather “closely geared to” Taxpayer’s business, promoting SCE LLC interests, and are critically “important to its successful operation.”20

[20] *Id*.

Section 1221 applies despite § 741

Section 741 provides that in the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in § 751 (relating to unrealized receivables and inventory items).

While the general rule under § 741 treats the sale of partnership interests as a sale of a capital asset, here § 1221 applies, despite § 741, because the legislative history indicates that § 741 contemplates only the sale of partnership assets that are in fact capital assets.

The legislative history of § 741 shows that Congress intended to codify a line of court decisions that held that the sale of a partnership interest is generally considered to be a sale of a capital asset.[21] In enacting § 741, Congress stated that “[u]nder present decisions the sale of a partnership interest is *generally* considered to be a sale of a capital asset, and any gain or loss realized is treated as a capital gain or loss.”[22] Further, Congress intended that “[t]he House and your committee’s bill retain the *general rule* of present law that the sale of an interest in a partnership is to be treated as the sale of a capital asset.”[23]

[21] See *Pollack v. Commissioner*, 69 T.C. 142, 148 (1977) (Tannenwald, J., dissenting).

[22] H. Rept. No. 1337, 83d Cong., 2d Sess. (1954) (emphasis added).

[23] S. Rept. 1622, 83d Cong., 2d Sess. (1954) (emphasis added).

In the cases prior to the enactment of § 741, the government took the position that the aggregate theory of partnership determined the result such that the sale of a partnership interest was a sale of the selling partner’s undivided interest in each specific partnership asset.[24] The courts rejected the government’s position and found that the sale of a partnership interest was the sale of a capital asset under § 117 (the predecessor to § 1221).[25] The courts that addressed the question of the treatment of the sale of partnership interests determined, in part, whether the entity or aggregate theory would prevail in the sale of a partnership interest.[26] In these cases, the courts reasoned that because partners did not have a separate or exclusive right to the partnership assets, but rather a common interest in all the assets, a partner’s sale of their partnership interest should be treated as the sale of a capital asset as opposed to the sale of their interest in the partnership assets.[27]

[24] GCM 26379, 1950-1 C.B. 58.

[25] See, *e.g.*, *Kessler v. United States*, 124 F.2d 152, 153 (3rd Cir. 1941); *Commissioner v. Shapir*o, 125 F.2d 532, 533 (6th Cir. 1942); *Long v. Commissioner*, 173 F.2d 471, 471-72 (5th Cir. 1949) (finding that a partner’s sale of a partnership

interest is a sale of a capital asset, rather than his share of each asset owned in the partnership).

[26] See, *e.g.*, *Kessler*, *supra*; *Commissioner v. Lehman*, 165 F.2d 383, 384 (2nd Cir. 1948).

[27] See, *e.g.*, *Shapiro*, *supra*; *Commissioner v. Smith*, 173 F.2d 470, 470 (5th Cir. 1949); *Thornley v. Commissioner*, 147 F.2d 416, 422; *Lehman*, 165 F.2d at 385-386.

Notably, the courts that addressed the treatment of the sale of a partnership interest in the pre-1954 cases did not deal with facts that showed the sale of a partnership interest was something other than the sale of a capital asset.[28] In other words, the courts were not given the opportunity to consider whether capital gain or ordinary income treatment would apply when a taxpayer was engaged in the business of holding partnership interests for sale to customers. Given the facts of the pre-1954 cases and Congress's intent to codify a line of cases that held that the entity approach should determine the consequences of the sale of a partnership interest, Congress intended to give capital asset treatment only to the sale of partnership interests that are in fact held as capital assets.

[28] See, *e.g.*, *Kessler*, *supra* (advertising agency partnership); *Shapiro*, *supra* (partnership engaged in the business of manufacturing and selling cosmetics and medicines); *Thornley*, 147 F.2d at 416-17 (3rd Cir. 1944) (advertising agency partnership); *Stilgenbaur v. United States*, 115 F.2d 283, 285 (9th Cir. 1940) (general produce partnership); *Lehman*, *supra* (brokerage business partnership); *Smith*, *supra* (oil - field retailer partnership); *Long*, *supra* (drilling partnership).

Further, Congress's statement that § 741 retained merely the general rule of present law that the sale of a partnership interest is treated as the sale of a capital asset leaves open the possibility for ordinary treatment on the sale of a partnership interest when the facts and circumstances are appropriate.

Here, because the substance of the sales of the SCE LLC interests by the Taxpayer (and the Managed LLCs) were necessary steps in the SCE transactions (facilitated using LLC interests) in the ordinary course of Taxpayer's trade or business of selling SCE LLC interests, § 1221(a)(1) applies to determine the character of the gain on such sales. We are not challenging the entity approach of partnership taken by § 741 (*i.e.*, that the sale of a partnership interest is treated as the sale of a single asset, like corporate stock). The application of § 1221 under the present set of facts harmonizes §§ 1221 and 741 such that capital gain treatment does not apply when a taxpayer's gain or loss arises from the everyday operation of a trade or business. Thus, § 741 does not foreclose treating the gain on the sale of the SCE LLC interests as ordinary income in situations when, as here, the SCE LLC interests were pre-arranged products frequently created and sold to customers (investors).

CCA 202309015 reviewed whether real estate was a Code § 751 asset:

Here, the facts presented do not support that the land was included in the inventory[30] of the SCE LLCs or held by the SCE LLCs primarily for sale to customers. Additionally, there are no facts to support that the SCE LLCs were engaged in the trade or business of selling land. Each SCE LLC donated the easement, and/or the land, to a § 501(c)(3) organization on behalf of the investors. Therefore, § 751(a)(2) and (d)(1) collectively would not apply to characterize the gain recognized by Taxpayer (or the Managed LLCs) as ordinary income.

[30] Here and elsewhere in this document, potential characterization of real property as inventory is included in the analysis for the sake of consistency with the statutory language in § 751. However, note that the Tax Court has held that real property does not constitute merchandise within the meaning of § 471. See *W.C. & A.N. Miller Development Company v. Commissioner*, 81 T. C. 619 (1983). Accordingly, ordinary income treatment would depend on a determination that the underlying real property constitutes property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

Section 751(a)(2) and (d)(1) would apply, however, to characterize the gain recognized by Taxpayer (or the Managed LLCs) as ordinary income if additional facts are presented to support their application. That is, the facts must support that the SCE LLCs were engaged in the trade or business of selling land and that the land held by the SCE LLCs was either inventory or held primarily for sale to customers by the SCE LLCs.

Sections 751(a)(2) and (d)(3)

Collectively, § 751(a)(2) and (d)(3) apply to characterize as ordinary the gain recognized from the sale of a partnership interest attributable to partnership property, which, if held by the selling partner, would be considered: (1) property of the kind described in § 1221(a)(1) and (2) any other property considered to be other than a capital asset and other than property described in § 1231. In other words, ordinary treatment would be appropriate when a partnership asset, if held by the selling partner is, property other than a capital asset to the selling partner; inventory to the selling partner; or held by the selling partner primarily for sale to customers in the ordinary course of the selling partner's trade or business.

Here, the facts presented do not support that Taxpayer (or the Managed LLCs) was in the trade or business of selling land. Promotional materials for the SCE transactions described Taxpayer as not acting as a real estate broker with respect to the SCE transactions. Additionally, in at least one year Taxpayer stated that neither Taxpayer, nor the Managed LLCs, sold land and was not engaged in the business of selling land. Accordingly, the land in the SCE LLCs, if held by Taxpayer (or the Managed LLCs), would have been a capital asset to Taxpayer (or the Managed LLCs) because there is no indication that the land was inventory to the Taxpayer (or the Managed LLCs) or held by Taxpayer (or the Managed LLCs) primarily for sale to customers in the ordinary course of the Taxpayer's (or the Managed LLCs') trade or business. Therefore, § 751(a)(2) and (d)(3) collectively would not apply to characterize the gain recognized by Taxpayer (or the Managed LLCs) as ordinary income.

Section 751(a)(2) and (d)(3) would apply, however, to characterize the gain recognized by Taxpayer (or the Managed LLCs) on the sales of the SCE LLCs as ordinary income if additional facts are presented to support their application. That is, the facts must support that the Taxpayer (or the Managed LLCs) was engaged in the business of selling land. In addition, the facts must support that the land held by the SCE LLCs was (i) inventory to the Taxpayer (or the Managed LLCs); (ii) property other than a capital asset to the

> Taxpayer (or the Managed LLCs); or (iii) property held by the Taxpayer (or the Managed LLCs) primarily for sale to customers.

CCA 202309015 concluded:

> 1. Yes. Despite § 741, § 1221 applies to treat Taxpayer's gain on the sales of LLC interests as ordinary income because Taxpayer held the LLC interests primarily for sale to customers in the ordinary course of a trade or business during Year 3 through Year 4.
>
> 2. No. Sections 741 and 751(d)(1) and (d)(3) do not collectively apply to treat Taxpayer's gain on the sales of LLC interests as ordinary income because Taxpayer was not engaged in a trade or business of selling land during Year 3 through Year 4.

Presumably "SCE" is an abbreviation for syndicated conservation easement, which the IRS has labeled abusive, describing them as follows in IR-2022-214 (12/6/2022):

> In these transactions, investors typically acquire an interest in a partnership that owns land and then claim an inflated charitable contribution deduction based on a grossly overvalued appraisal when the partnership donates a conservation easement on the land.

The promoters in CCA 202309015 were churning out multiple alleged tax schemes. The LLCs were not investment vehicles (any activity involving the land was purely incidental to the primary purpose) but rather arrangements to sell tax benefits. This is very different than a low-income housing tax credit project, new market tax credit project, or qualified opportunity fund that promotes tax benefits expressly intended to promote rental or business activity within the project. I view CCA 202309015 as a narrow approach to impose heavy taxes on those who promote allegedly abusive tax schemes. I am not concerned about spillover into serial entrepreneurs or those with numerous real estate investment portfolios; the latter are already constrained by part II.G.26.a Real Estate Dealer vs. Investor. This paragraph is just a judgment call that may or may not be correct.

II.Q.8.e.ii.(c). Availability of Installment Sale Deferral for Sales of Partnership Interests

Generally, sales of partnership interests are eligible for installment sale deferral under Code § 453 (subject to the limitations of Code §§ 453A and 453B).[5653]

However, the income from the sale of a partnership interest may not be reported under the installment method to the extent it represents income attributable to some of the partnership's "hot assets" under Code § 751[5654] that would not be eligible for the installment sale treatment if sold directly.[5655]

[5653] Rev. Rul. 76-483. For more discussion on these limitations and recommended strategies, see part II.G.15 Limitations on the Use of Installment Sales.

[5654] See part II.Q.8.b.i.(g) Code § 751 – Hot Assets.

[5655] Rev. Rul. 89-108 held that the income from the sale of a partnership interest may not be reported under the installment method to the extent it represents income attributable to the partnership's substantially appreciated inventory under Code § 751(d) that would not be eligible for the installment sale treatment if sold directly. It explained:

The IRS has asserted that installment sale treatment is not available for partnership interests to the extent that the cash-basis partnership's underlying assets constitute unrealized receivables for payment for services rendered;[5656] consider whether that is a valid argument in light of *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (2017) (repudiating Rev. Rul. 91-32).[5657]

Under section 741 of the Code, the sale of a partnership interest generally is treated as the sale of a single capital asset without regard to the nature of the underlying partnership property. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 70 (1954). In this respect, the tax treatment of the sale of a partnership interest differs from that accorded the sale of a sole proprietorship. See, *e.g.*, *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945), which held that the sale of an entire business as a going concern was the sale of the individual assets of the business. See also Rev. Rul. 68-13, 1968-1 C.B. 195, which holds that the installment sale of a sole proprietorship is generally considered to be a sale of individual assets of the proprietorship for purposes of applying section 453.

Section 751 of the Code was enacted to prevent the conversion of certain potential ordinary income into capital gain upon the sale or exchange of a partnership interest. This section, in effect, severs certain income items from the partnership interest. H.R. Rep. No. 1337, *supra*, at 70, 71, and S. Rep. No. 1622, 83d Cong., 2d Sess. 99 (1954). Thus, to the extent a partnership interest represents substantially appreciated inventory or unrealized receivables described in section 751, the tax consequences to the transferor partner are the same tax consequences which would be accorded an individual entrepreneur. H.R. Rep. No. 1337 at 71, and S. Rep. 1622, *supra*, at 99. In effect, the transferor partner is treated as disposing of the property described in section 751 independently of the rest of his partnership interest. S. Rep. No. 1622 at 98, 99. *George Edward Quick Trust v. Commissioner*, 54 T.C. 1336 (1970), *acq.* 1970-2 C.B. xxi, *aff'd per curiam*, 444 F.2d 90 (8th Cir. 1971); *Woodhall v. Commissioner*, T.C. Memo. 1969-279, *aff'd*, 454 F.2d 226 (9th Cir. 1972).

Gain recognized under section 741 of the Code on the sale of a partnership interest is reportable under the installment method. See Rev. Rul. 76-483, 1976-2 C.B. 131. However, because section 751 effectively treats a partner as if the partner had sold an interest in the section 751 property of the partnership, the portion of the gain that is attributable to section 751 property is reportable under the installment method only to the extent that income realized on a direct sale of the section 751 property would be reportable under such method. Because the installment method of reporting income would not be available on a sole proprietor's sale of the inventory, the installment method is not available for reporting income realized on the sale of a partnership interest to the extent attributable to the substantially appreciated inventory which constitutes inventory within the meaning of section 453(b)(2)(B).

Accordingly, P's income from the sale of the partnership interest may not be reported under the installment method to the extent it represents income attributable to the partnership's substantially appreciated inventory which would not be eligible for installment sale treatment if sold directly. The balance of the income realized by P from the sale of the partnership interest is reportable under the installment method.

[5656] In CCAs 200722027 and 200728001, the IRS asserted that installment sale treatment is not available for partnership interests to the extent that the cash-basis partnership's underlying assets constitute unrealized receivables for payment for services rendered, based on its interpretation of some cases as holding that compensation for services could not be reported under the installment method. See *Sorensen v. Commissioner*, 22 T.C. 321 (1954) (a reviewed decision), *followed Mingo v. Commissioner*, T.C. Memo. 2013-149, *aff'd* 773 F.3d 629 (5th Cir. 2014) (the latter also holding that the disallowance of the installment method is a change of accounting method triggering adjustments under Code § 481, to which the statute of limitations does not apply).

[5657] The case is discussed more fully in part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest, especially fn. 5651.

Although publicly traded stock is not eligible for installment sale treatment,[5658] the sale of an interest in a partnership owning publicly traded stock might not preclude deferral.[5659] For partnerships that have a lot of hot assets – especially those with significant depreciable property, a Code § 736 redemption[5660] often would generate a much better result.[5661]

II.Q.8.e.iii. Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations

II.Q.8.e.iii.(a). Illustration of Inside Basis Issue

For a more generic description of inside basis and outside basis, see my blog article, "Tax basis: The key to reducing gain on sale or deducting asset purchases."[5662]

Here is an example:

An S corporation has assets with zero basis and $1,000,000 value.

Sam Sucker buys 50% of stock for $500,000.

Assets are sold, and S corporation gives Sam a K-1 for his $500,000 share of the gain. Sam is the proud owner of a $1,000,000 basis in his stock ($500,000 purchase price plus $500,000 K-1) that is worth $500,000.

Smart Sally finds a partnership with the same characteristics - assets with zero basis and $1,000,000 value.

Sally buys a 50% partnership interest for $500,000. The partnership makes a Code § 754 election, giving Sally a $500,000 in her half of its assets; see part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest. See also part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754

[5658] Code § 453(k)(2).

[5659] The legislative history to the Tax Reform Act of 1986, P.L. 99-514, suggests that the sale of a partnership interest would be eligible for installment treatment as follows:

> The committee intends that any Treasury regulations would not deny use of the installment method if the seller could not have sold, or caused the sale of, the publicly traded stock or securities directly. For example, a retiring partner in a large investment partnership makes an installment sale of his partnership interest, a substantial portion of the value of which is attributable to stocks and securities held by the partnership. Provided that the retiring partner, could not have sold or caused the sale of the partnership's assets directly, the gain on the sale of the partnership interest may be reported on the installment method.

The letter ruling described in fn. 4082 held that the installment method applied to the sale of stock in an S corporation that appears to have held only marketable securities, suggesting that Code § 453(k)(2) would not apply absent regulations being promulgated.

[5660] See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

[5661] See part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale, especially fn. 5526.

[5662] http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions/post/2017-01-10/tax-basis-the-key-to-reducing-gain-on-sale-or-deducting-asset-purchases.

Election or Required Adjustment for Built-in Loss). For a single member LLC, any change to outside basis would automatically apply to the inside basis.[5663]

When the partnership sells its assets, Sally has no gain on that sale and is content with her $500,000 basis. If assets are not sold, Sally is happy with any depreciation on her share of assets

Going back to Sam, he does have a way to avoid this terrible result. If the S corporation is liquidated in the same year in which the assets are sold, he can apply his $1 million basis to his $500,000 liquidation proceeds to net a $500,000 loss, which he may be able use to offset gain on the sale of the corporation's assets. See part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation, especially part II.H.8.a.i Solution That Works for Federal Income Tax Purposes (To an Extent). However, if Sam lives in a different state than wherever the assets sale is sourced, then the Sam's loss on the sale of the stock will not offset the gain on the sale of the assets; see part II.H.8.a.ii State Income Tax Disconnect. Also, to the extent that the S corporation's assets generated ordinary income on sale, such as recapture of depreciation of personal property, Sam's capital loss from liquidation will not offset Sam's ordinary income from the asset sale; see part II.H.8.b Depreciable Personal Property in an S Corporation. Finally, if a substantial part of the S corporation's assets is sold, but an even larger part is not sold, the other owners are unlikely to be willing to liquidate.

However, Code § 338(h)(10) provides a special opportunity when all of the stock in an S corporation is sold and the S corporation is liquidated. The election allows the parties to treat all of the S corporation's assets as having been sold to the person that bought the S corporation stock, enabling the buyer to get a new tax basis on the assets. Meanwhile, the deemed gain on sale of the S corporation's assets increases the basis of the stock in the S corporation, so that often the shareholders are not taxed on the stock's sale and might even have a loss on the sale.[5664] The main downside[5665] to the selling shareholders is that the deemed asset sale might trigger ordinary income taxation (including without limitation depreciation recapture of Code § 1245 property, which is generally depreciable tangible personal property) or higher capital gain taxation (including without limitation the sale of Code § 1250 property, which generally is depreciable real estate), whereas they generally would have paid lower regular long-term capital gain rates on the sale of their S corporation stock had they not made the Code § 338(h)(10) election.

[5663] See fn. 2097 in part II.H.2.h Basis Step-Up for Property Held Outside an Entity; Moving Liabilities Outside of an Entity to Maximize Deductions for Estate Tax Purposes, the latter which points out that results may be better not holding assets in an entity.

[5664] Reg. § 1.338(h)(10)-1(d)(5)(i) provides:

> *In general*. If T is an S corporation target, S corporation shareholders (whether or not they sell their stock) take their pro rata share of the deemed sale tax consequences into account under section 1366 and increase or decrease their basis in T stock under section 1367. Members of the selling consolidated group, the selling affiliate, or S corporation shareholders are treated as if, after the deemed asset sale in paragraph (d)(3) of this section and before the close of the acquisition date, they received the assets transferred by old T in the transaction described in paragraph (d)(4)(i) of this section. In most cases, the transfer will be treated as a distribution in complete liquidation to which section 331 or 332 applies.

See part II.Q.7.a.vii Corporate Liquidation for the tax consequences of the deemed liquidation.

[5665] For former C corporations that have made their S election too recently, beware of part II.P.3.b.ii Built-in Gain Tax.

Code § 338(h)(10) is also available for C corporations, but it does not provide the same benefits to the sellers, in that the corporation's recognition of gain on its deemed sale of assets does not increase its shareholders' stock basis.

II.Q.8.e.iii.(b). Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss)

Upon a partner's death (including the death of the grantor of a revocable trust,[5666] of the beneficiary of a QTIP trust,[5667] or presumably of the holder of a general power of appointment[5668]) or on the sale or exchange of a partnership interest, the partnership's property's basis is adjusted under Code § 743 if the partnership has in effect a Code § 754 election[5669] and makes a Code § 754 election on the return that covers the taxable period that includes the date of death, which election might be filed[5670] up to 12 months after the due

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[5666] Rev. Rul. 79-84, which reasoned as follows in arriving at that conclusion:

> Before A's death, A had powers over T of the types described in sections 676 and 677 of the Code, and T was therefore a grantor trust. Additionally, T held a partnership interest. Under the principles of Rev. Rul. 77-402, A is considered to have been the partner during this period for federal income tax purposes. Further, at the time of A's death T ceased to be a grantor trust. The partnership interest is thus considered to have been transferred from A to T at that time. As a result, a transfer of a partnership interest occurred upon the death of a partner.

See also Reg. § 1.1001-2(c), Example (5) is reproduced in fn 6591 in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System. Query whether an irrevocable trust for the benefit of A's spouse, which would have been a grantor trust under Code § 677 but excluded from A's estate, would qualify for this treatment.

[5667] The IRS seems to believe that a Code § 743(a) adjustment would apply when a QTIP trust holds a partnership interest and the surviving spouse dies, even though the individual who died is not actually a partner. See Letter Ruling 200019029 (approving a late Code § 754 election without addressing the literal language of Code § 743(a)). Note that Code § 1014(b)(10), which provides a basis adjustment for QTIP assets when the surviving spouse dies, was enacted after Code § 743(a). Thus, considering the surviving spouse to be a partner for purposes of Code § 743(a) is consistent with the philosophy of Code § 1014(b)(10) and should, as a matter of tax policy, be the correct result, even though it seems inconsistent with the literal language of Code § 743(a). See also part II.Q.8.e.i Distribution of Partnership Interests regarding the effect of a distribution on Code § 743.

[5668] Inclusion in the surviving spouse's estate under fn 5667 is not as direct an estate inclusion as inclusion by reason of a general power of appointment. See text accompanying fn 3792 in part II.O.2.e Marital Deduction Trusts - Discount Planning.

[5669] Code § 743(a) does not address whether an adjustment of basis in partnership property may occur by reason of other transfers without a Code § 754 election. For example, the statute does not address whether an adjustment would be made with respect to a transfer by gift (*i.e.*, not a transfer by sale or exchange or the death of a partner which are referenced in Code § 743) even if a Code § 754 election is in place. Code § 1015(d), allowing a basis adjustment for gift tax paid, was not in existence when Code § 743 was enacted. That might be why Code § 743 does not discuss the gift situation. The legislative history when Code § 1015(d) was adopted makes no mention at all of this partnership issue. The issue would seem to be: would an inside adjustment of partnership property be made in the absence of a statute (since no statute is applicable) under general tax principles? That is further complicated by the fact that tax principles sometimes use an aggregate theory and sometimes an entity theory with respect to partnerships. Although perhaps a position might be taken that the payment of gift tax should trigger an inside basis adjustment, if I were to take that position I would disclose it on Form 8725. A safer approach might be to follow the payment of gift tax by a transfer, which part II.Q.8.e.i Distribution of Partnership Interests discusses generally would give rise to an inside basis adjustment.

[5670] T.D. 9963 (2022) removed the signature requirement from Reg. § 1.754-1(b); REG-116256-17 (10/12/2017) issued proposed regulations to that effect, on which taxpayers could then rely.

date.[5671] However, whether or not the election provided in Code § 754 is in effect, the basis of partnership property is not adjusted as the result of a contribution of property, including money, to the partnership.[5672] The Code § 754 election may not be filed in a year before death occurs, unless some other Code § 743 or 734 event occurs in the year covered by the filing.[5673] When a partnership interest is community property and receives an outside basis adjustment of both halves, both halves are eligible for a corresponding inside basis adjustment by reason of that death.[5674]

See also part II.Q.8.e.i Distribution of Partnership Interests regarding the effect of a distribution on Code § 743, including not only a variety of actual or deemed nontaxable exchanges that are treated as distribution but also a suggestion that a trust's or estate's distribution of a partnership interest (other than distributing specifically bequeathed property), triggers application of a Code § 743 adjustment. Thus, even though ideally one should make a Code § 754 as of the year if death (if one decides to make the election), if the suggestion described in the preceding sentence is correct then one may also make a Code § 754 election as of the year in which the

[5671] Reg. § 301.9100-2(a)(2)(vi) grants an automatic 12-month extension from the due date of the partnership's return, including extensions (Reg. § 301.9100-2(a)(1)), with the election made on an amended return (Reg. § 301.9100-2(c)).

In addition to making the election, the partnership must attach a statement to its tax return that reports the name and taxpayer identification number of the transferee partner, the basis adjustment computation, and the allocation of the basis adjustment to the partnership's properties. Reg. § 1.743-1(k)(1). The transferee partner has an obligation to provide written notice to the partnership of the information needed to compute the basis adjustment, as listed in Reg. § 1.743-1(k)(2). Once that notice is given, the partnership can rely on that information in preparing the adjustment, as long as no partner who is responsible for federal income tax reporting has any knowledge that the information is clearly erroneous. Reg. § 1.743-1(k)(3). Failure to attach this statement would not appear to invalidate the Code § 754 election; this result is inferred by the fact that Reg. § 1.743-1(k)(2) provides procedures for when errors or omissions are made in complying with obligations under Reg. § 1.743-1(k).

Does the long term holding period under Code § 1233(9), that applies when assets are included in a decedent's estate, also apply to the portion of the basis of a partnership's assets that constitutes a basis adjustment under Code § 743? Rev. Rul. 68-79 says that, generally, the change in the holding period of a partnership interest does not change the partnership's holding period in its assets. However, it does not address the impact, if any, on a Code § 754 election. With one exception, regulations under Code §§ 743, 755 and 1233 do not address this issue. Reg. § 1.743-1(j)(4)(i)(B)(1) restarts the holding period for depreciable property when there is a positive adjustment but does not change it when there is a negative adjustment, Reg. § 1.743-1(j)(4)(ii)(B).

[5672] Reg. § 1.743-1(a). Instead, see part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.

[5673] Reg. § 1.754-1(b), which is modified in certain ways as described in fn 5671, provides:

> An election under section 754 and this section to adjust the basis of partnership property under sections 734(b) and 743(b), with respect to a distribution of property to a partner or a transfer of an interest in a partnership, shall be made in a written statement filed with the partnership return for the taxable year during which the distribution or transfer occurs. For the election to be valid, the return must be filed not later than the time prescribed by paragraph (e) of § 1.6031-1 (including extensions thereof) for filing the return for such taxable year (or before August 23, 1956, whichever is later). Notwithstanding the preceding two sentences, if a valid election has been made under section 754 and this section for a preceding taxable year and not revoked pursuant to paragraph (c) of this section, a new election is not required to be made….

[5674] Rev. Rul. 79-124.

revocable trust or estate distributes property (other than a specific bequest). A corporate liquidation would also be a triggering event – even if it is a nontaxable event.[5675]

Tiered partnerships may carry the effect of Code § 754 elections throughout the partnership system, if each layer has an election in place. Two revenue rulings describe these rules. First, the facts and holdings of Rev. Rul. 78-2 were:

> X, an investment partnership, was formed for the purpose of holding interests in operating real estate partnerships. X is a partner of partnership Y, an operating real estate partnership ….
>
> For purposes of sections 743 and 754 of the Code, a sale or exchange of an interest in X or the death of a partner of X is considered to result in an adjustment to the basis of the property of Y as though the transferee partner were a partner of Y.
>
> Accordingly, upon the transfer of an interest in X by sale or exchange or on the death of a partner of X during a taxable year with respect to which elections under section 754 of the Code are in effect for X and Y, the adjustment to the basis of partnership property under section 743(b) will include, (a) an adjustment to X's partnership interest in Y and (b) an equivalent basis adjustment to Y's property with respect to X and the transferee partner of X only. Compare Rev. Rul. 77-309, 1977-2 C.B. 216, concerning the allowance of a distributive share of partnership loss to a limited partner in a limited partnership that is itself a limited partner of another limited partnership.

The facts of Rev. Rul. 87-115 were:

> UTP is a partnership in which A, B, C, and D are equal partners. UTP is a partnership in which A, B, C, and D each contributed 30x dollar of cash to UTP upon its formation, and they each have a 30x interest in partnership capital and surplus. A's share of the adjusted basis of partnership property is 30x dollars, the sum of A's interest as a partner in partnership capital and surplus, plus A 's share of partnership liabilities (neither UTP nor LTP have any liabilities). UTP is an equal partner in LTP, along with X and Y. LTP was formed by X, Y, and Z, who each contributed 110x dollars of cash to LTP upon its formation. UTP purchased its interest in LTP from Z for 80x dollars in a taxable year for

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[5675] CCA 201726012 (under the signature of David R. Haglund), in addressing, "Issue 1: Whether the transfer of a partnership interest in a complete liquidation to which § 332(a) applies or a reorganization to which § 368(a)(1)(A) and/or (D) applies is a transfer by sale or exchange for purposes of § 743(b)," reasoned:

> Sale or exchange is not defined in § 743, the regulations thereunder, or the legislative history of the provision. Section 743 was enacted to ameliorate the tax consequences to a transferee partner by giving a partnership the option to eliminate discrepancies between a transferee partner's inside and outside basis when the partnership's inside basis in its property is not equal to the fair market value of the property. Jt. Comm. On Taxation, *Summary of the New Provisions of the Internal Revenue Code of 1954*, at 92 (1955).
> General Counsel Memorandum 35921 (July 29, 1974) held that for purposes of § 743(b), a transfer of a partnership in a liquidation under former § 333 was not a transfer of an interest by sale or exchange. As demonstrated by the GCM, whether the distribution of a partnership interest by a liquidating corporation was a sale or exchange was considered an open question prior to the Deficit Reduction Act of 1984 (1984 Act). See, *e.g.*, John S. Pennell and Terence F. Cuff, "Tax Results of Liquidation of Corporate Partner Still Unclear Despite DRA 1984," *Journal of Taxation*, Vol. 62, No. 2 (February 1985).

> which LTP did not have an election under section 754 in effect. UTP, X, and Y each have a 110x dollar interest in partnership capital and surplus.
>
> UTP has an adjusted basis of 120x dollars in its property as follows: an adjusted basis of 80 dollars in its partnership interest in LTP and an adjusted basis of 40x dollars in inventory. UTP's partnership interest in LTP has a fair market value of 120x dollars, and UTP's inventory has a fair market value of 80x dollars. LTP has only one asset, a capital asset that is not a section 751 asset. LTP's asset has an adjusted basis of 330 x dollars and a fair market value of 360x dollars.
>
> In 1985, A sold A's entire interest in UTP to E for 50x dollars.
>
> **Situation 1**
>
> Both UTP and LTP have valid section 754 elections in effect.
>
> **Situation 2**
>
> UTP has a section 754 election in effect, but LTP does not.
>
> **Situation 3**
>
> UTP does not have a section 754 election in effect, but LTP does.

Rev. Rul. 87-115 reviewed Rev. Rul. 78-2, then reasoned:

> In essence, if an election under section 754 is not in effect, the partnership is treated as an independent entity, separate from its partners. Thus, absent a section 754 election, even though the transferee receives a cost basis for the acquired partnership interest, the partnership does not adjust the transferee's share of the adjusted basis of partnership property. If, however, an election under section 754 is in effect, the partnership is treated more like an aggregate of its partners, and the transferee's overall basis in the assets of the partnership is generally the same as it would have been had the transferee acquired a direct interest in its share of those assets. Nevertheless, the transferee's adjusted basis for specific partnership assets will not necessarily equal the basis the assets would have had if the transferee had acquired a direct interest in the assets. The difference is due to the fact that the transferee's basis in specific partnership assets is controlled by section 755, which does not adopt a pure aggregate approach. See section 1.755-1(c) of the regulations.
>
> **Situation 1**
>
> E purchased A's interest for 50x dollars. Thus, under section 742, E's basis in E's partnership interest is 50x dollars. Because UTP made a valid section 754 election, under section 743(b) UTP must increase the adjusted basis of its property by 20x dollars, the excess of the transferee partner's basis in the partnership interest (50x dollars) over that partner's share of the adjusted basis of such property. Under section 1.743-1(b)(1), E's share of the adjusted basis of partnership property is 30x dollars, because E succeeds to A's interest in partnership capital and surplus. See, *e.g.*, section 1.743-1(b)(1) Example (2). The 20x dollar special basis adjustment raises UTP's adjusted basis in its partnership property to 140x dollars, but the additional 20x dollars

must be segregated and allocated solely to E. Under section 755, the 20x dollars must be allocated between capital assets (UTP's interest in LTP) and other assets (UTP's inventory).

Under section 1.755-1(b)(2) of the regulations, to the extent that an amount paid by a purchaser of a partnership interest (here, 50x dollars) is attributable to the value of capital assets (here, 120x dollars, the value of UTP's interest in LTP), any difference between the amount so attributable and the transferee partner's share of the partnership basis of such property constitutes a special basis adjustment with respect to such capital assets. In the instant case, 30x dollars (60 percent of 50 x dollars) of E's purchase price is attributable to the value of UTP's interest in LTP, because 120 x dollars, the value of UTP's interest in LTP, is 60 percent of 200x dollars, the total value of UTP's property. Thus, 10x dollars, the difference between the 30 x dollars attributable to the value of UTP's interest in LTP and 20x dollars, E's proportionate share of UTP's basis in LTP, is a special basis adjustment to UTP's interest in LTP. This adjustment gives E an adjusted basis of 30x dollars in UTP's interest in LTP. The remaining 10 x dollars of the 20x dollar special basis adjustment is allocated to the adjusted basis of UTP's inventory. This gives E a 20x dollar adjusted basis in UTP's inventory.

Because UTP made a section 754 election manifesting an intent to be treated as an aggregate for purposes of sections 754 and 743, it is appropriate, for purposes of section 743 and 754, to treat the sale of A's partnership interest in UTP as a deemed sale of an interest in LTP. The selling price of E 's share of UTP's interest in LTP is deemed to equal E's share of UTP's adjusted basis in LTP, 30x dollars (¼ of 80x dollars plus 10x dollars, E 's special basis adjustment). Further, this deemed sale of an interest in LTP triggers the application of section 743(b) to LTP. Because LTP made a valid section 754 election, under section 743(b) LTP must increase the adjusted basis of its partnership property by 2.5x dollars, the excess of E's share of UTP's adjusted basis in LTP (30x dollars) over E's share of the adjusted basis of LTP's property (¼ of 110x dollars, or 27.5x dollars). Section 755 applies to LTP to allocate this basis adjustment, but because LTP has only one asset, no allocation is necessary. The 2.5 x dollar adjustment must be segregated and allocated solely to UTP and E, the transferee partner of UTP.

Situation 2

UTP has made a valid section 754 election. Thus, as in Situation 1, E gets an adjusted basis of 30x dollars in UTP's interest in LTP and an adjusted basis of 20x dollars in UTP's inventory. Also, as in Situation 1, because UTP made a section 754 election, it is appropriate, for purposes of sections 754 and 743, to treat the sale of A's interest in UTP as the sale of an interest in LTP. However, in this situation, LTP does not have a section 754 election in effect. That is, under section 743(a), LTP chose not to have the basis of its property adjusted as the result of the transfer of an interest in it. Thus, E's purchase of a partnership interest in UTP has no effect on LTP's adjusted basis in its property.

Situation 3

LTP has made a valid election under section 754, but UTP does not make a section 754 election. On the sale by A of an interest in UTP, E succeeds to A's 20x dollar adjusted basis in UTP's interest in LTP and to A's 10 x dollar adjusted basis in UTP's inventory. E succeeds to these bases because, by not making a section 754 election, UTP chose not to have the basis of its property adjusted as the result of the transfer of an interest in UTP.

In addition, by not making a section 754 election, UTP manifested an intent to be treated as an entity for purposes of sections 754 and 743. Thus, it is inappropriate, for purposes of sections 754 and 743, to treat A's sale of an interest in UTP as the sale of an interest in LTP. Consequently, UTP cannot increase E 's share of the basis of LTP's property. Nevertheless, LTP's section 754 election is not meaningless. If UTP were to sell its partnership interest in LTP, the purchaser's share of the adjusted basis of LTP's assets would be adjusted.

Rev. Rul. 87-115 held:

Situation 1

Upon the sale of A's partnership interest in UTP, the transferee's (E's) share of UTP's adjusted basis in its assets is adjusted by the amount by which the basis in E's partnership interest differs from E's share of UTP's adjusted basis in its assets. In addition, E's share of LTP's adjusted basis in its assets is adjusted by the amount by which E's share of UTP's adjusted basis in LTP differs from E's share of the adjusted basis of LTP's property.

Situation 2

Upon the sale of A's partnership interest in UTP, E's share of UTP's adjusted basis in its assets is adjusted by the amount by which the basis in E's partnership interest differs from E's share of UTP's adjusted basis in its assets. However, because LTP did not make a section 754 election, the transfer does not affect LTP's adjusted basis in its property.

Situation 3

The sale of A's partnership interest in UTP does not affect either UTP's adjusted basis in its property or LTP's adjusted basis in its property.

Letter Ruling 201906002 reasoned:

As stated in Rev. Rul. 87-115, when an upper-tier partnership has a § 754 election in effect, any § 743(b) adjustment resulting from the deemed transfer is segregated and allocated solely to the transferee of the upper-tier partnership interest.

Further, with respect to any increase in the basis of partnership property under § 743, a partnership is treated as an aggregate of its owners under the anti-churning rules. Section 197(f)(9)(E).

See part II.Q.1.c.iv Goodwill (and other intangible) Anti-Churning Rules.[5676]

[5676] Especially text accompanying fns 4180-4181 in part II.Q.1.c.iv Goodwill (and other intangible) Anti-Churning Rules.

If the basis of the transferee partner's partnership interest is greater than the former partner's share of the basis of the partnership's assets, then the election will give the new partner a stepped-up basis in the partnership assets.[5677] This basis adjustment is not necessarily tied to the change in basis between the old and new partner; rather, it is based on the relationship between the basis in the partnership interest (the "outside basis") and basis of the partnership's assets allocable to that partner (the "inside basis"). Of course, a change in basis of the partnership interest affects this relationship. However, prior changes in basis of the partnership also count. In fact, a substituted basis transaction, in which the basis in the partnership interest might or might not change, triggers the basis adjustment;[5678] however, no adjustment is made in a substituted basis transaction if the outside basis equals the inside basis.[5679] If a partnership does not make a Code § 754 election when a partner dies, consider asking the partnership to make the election when the decedent's estate or (former) revocable trust funds bequests by distributing the partnership interest, which also might be an event triggering a basis adjustment;[5680] as described above, that basis adjustment is not tied to any change in basis but rather generally catches up the "inside basis" to the "outside basis."

In a sale or exchange situation, the transferee partner's basis step-up in partnership assets is based on the extent to which the partner's basis in the partnership interest exceeds the basis of the partner's share of the partnership's assets; any contingent payments cause a basis increase to the extent they constitute gain to the seller and potentially deductible interest to the extent they constitute interest income to the seller.[5681] If the transfer is caused because of a partner's death, the basis step-up is based on the fair market value of the deceased partner's partnership interest as of the date of death, plus the transferee partner's share of partnership liabilities, minus any allocable income in respect of a decedent items;[5682] although liabilities are included in the basis of a partnership interest, they do not generate a basis increase in the partnership's assets.

[5677] Code § 743(b). Note that previously non-amortizable self-created goodwill becomes purchased amortizable goodwill. Letter Ruling 9715008 (but only if the remaining partners and the selling partner are not related under Code § 197(f)(9)(C)). See also.

[5678] Reg. § 1.755-1(b)(5). Reg. § 1.755-1(b)(5)(iv), Example (2) provides a basis adjustment as the result of a wholly nontaxable contribution to a partnership under Code § 721.

[5679] Reg. § 1.755-1(b)(5)(ii) provides, If the total amount of the basis adjustment under section 743(b) is zero, then no adjustment to the basis of partnership property will be made under this paragraph (b)(5).

[5680] See part II.Q.8.e.i Distribution of Partnership Interests.

[5681] Letter Ruling 9715008, which also held that contingent payments made more than 6 months after the date of the sale would be divided into additional principal and unstated interest under Reg. § 1.1275-4(c).

[5682] Code § 743; Reg. § 1.742-1. Code § 691 income in respect of a decedent includes the portion of the distributive share of partnership income of the decedent partner's successor in interest that is attributable to the decedent for the period ending with the date of the decedent's death. Letter Ruling 9715008. See also Rev. Rul. 66-325 (no basis step-up for accounts receivable under Code § 743 because Code § 736(a) applied); *Long v. Commissioner*, 71 T.C. 1 (1978), *aff'd* 660 F.2d 416 (10th Cir. 1981) (estate increased its basis in partnership interest to extent it paid liabilities); *Hesse v. Commissioner*, 74 T.C. 1307 (1980) and Letter Ruling 9102018 (no basis step-up for distributive share of income that is attributable to decedent for the period ending with the date of his death – obsoleted by later changes to Code § 706 because the income is reported on the decedent's final return and therefore not an unrecognized item at death). Regarding basis step-up attributable to liabilities, see fn 2091 in part II.H.2.g Partnership Basis Adjustments.

A partner's share of income in respect of a decedent under Code § 691 (including unrealized receivables) does not receive a basis step-up.[5683] Unrealized receivables are not eligible for a basis step-up, but goodwill that is not being amortized is eligible for a basis step-up.[5684]

When a person's partnership interest is liquidated, the basis of the partnership interest is allocated to the assets that person receives:[5685]

- This has led to the observation that, if one is going to liquidate the partnership anyway, a Code § 754 election might not be necessary. However, if the partnership sells its assets and then liquidates, then this strategy might not work as well for state income tax purposes as it does for federal income tax purposes;[5686] a Code § 754 election might be particularly important if the owner of the partnership interest resides in a state other than the state in which the partnership does business.

- These rules can generate opportunities to enhance the basis of an asset to be sold (but might be attacked if used to accelerate or duplicate recognition of loss):[5687]

    - A partner who receives low basis assets can use the basis in his partnership interest to increase the basis in those assets. If a Code § 754 election is not in effect, then this basis increase is not matched by a corresponding decrease in the distributed asset. Absence of a Code § 754 election might[5688] or might not[5689] be considered abusive in such a case.

    - If a partnership interest with a low basis is liquidated in exchange for high basis assets, a Code § 754 election will take into account the basis reduction in the distributed asset and increase the basis in its remaining assets by a corresponding amount.

Once a Code § 754 election is made, it cannot be revoked without IRS consent. This is extremely important to remember, since the election can lead to a step-down in the basis of partnership assets if the basis of the transferee's interest is less than the transferor's partnership property adjusted basis.

[5683] Reg. § 1.755-1(b)(4)(i).
[5684] Example provided in Reg. § 1.755-1(b)(4)(ii).
[5685] Code § 732(b).
[5686] By analogy, when an S corporation sells its assets to a third party and liquidates, it can replicate in many ways the partnership result for federal income purposes but not necessarily for state income tax purposes. Compare part II.H.8.a.i Solution That Works for Federal Income Tax Purposes with part II.H.8.a.ii State Income Tax Disconnect.
[5687] See part II.Q.8.b.i.(e) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property.
[5688] See example in fn. 5427 (absence of Code § 754 election considered a duplication of loss). However, Congress has since attacked this abuse (see part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000), so the concerns expressed in the example might be less likely to be applied now.
[5689] See fn. 5426.

Because a Code § 754 election is irrevocable, consider dividing a partnership before making the election; divisions generally are income tax-free.[5690] Reasons to avoid Code § 754 elections except to the extent necessary include:

- Avoiding record-keeping requirements regarding events where basis changes are not worth the complexity.

- Reducing the possibility of events causing an inside basis step-down. However, sometimes basis reductions must be made as if a Code § 754 election were in effect.[5691] To avoid possible unwanted inside basis reductions, one should consider monitoring a partnership's unrealized losses and realizing losses to the next necessary to keep net unrealized losses comfortably below $250K.

The partnership and the transferee partner, including a decedent's estate, should consider extending their income tax returns so that any IRS adjustments to basis, including the value of assets in the decedent's gross estate, can be reflected in the transferee partner's income tax returns; ignoring the interplay of these statutes of limitations can cause the taxpayer to lose the benefit of the basis step-up.[5692] For example, suppose decedent died December 1, 2004, and the partnership sold assets December 31, 2004. The estate tax return is due August 1, 2005 (nine months after death) and may be audited as late as August 1, 2008. The estate's income tax return for calendar year 2004 is due April 15, 2005, and may be amended only as late as April 15, 2008. Thus, audit adjustments on the estate tax return might be made between April 15, 2008 and August 1, 2008, but the estate could not amend its income tax return to reflect any increase in basis due to the audit. The partnership should extend the due date of its return.[5693] Additionally, the estate could file an extension for its initial income tax return, so that the return is filed timely between August 1, 2005 and October 15, 2005 (six months being the latest date for an extension). An alternative to extending the estate's income tax return might be for the estate to choose a fiscal year ending on or after April 30, 2005; note that a Code § 645 election would be required if the decedent's partnership interest were held in a revocable trust. Additional measures may be required to preserve the basis step-up.[5694]

If the partnership's assets are included in the decedent's gross estate under Code § 2036, the partnership's assets will receive a basis adjustment, without regard to whether a Code § 754

[5690] See part II.Q.8.d Partnership Division.

[5691] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

[5692] In *Malm v. U.S.*, 420 F.Supp. 1040 (D.C. N.D. 2005), the court stated:

> Harry Malm died on August 5, 1998. His estate included shares of Medtronic stock. The IRS disputed the estate's valuation of that stock. The dispute wound up in court, and on July 23, 2003, this Court ruled that the IRS' stock valuation was correct….As a result of this ruling, the Medtronic stock had a higher fair market value than reported by the estate on its federal estate tax return. Therefore, the estate's federal income tax return overstated the amount of the gain on the sale of this stock….The estate filed its income tax return on November 14, 1999. Since the estate did not file a claim for a refund on that return until February 12, 2004, its claim is barred by the statute of limitations.

[5693] The partnership will need to make any Code § 754 election no later than the extended due date of the return. If the election does not look worthwhile but upon audit it starts looking worthwhile, the IRS will not grant Code § 9100 relief. Letter Ruling 200626003.

[5694] See text accompanying and following fn 1421 in part II.G.4.m.i Code § 1341 Claim of Right Deduction.

election was made;[5695] any gift of a partnership interest brought back under Code § 2036 qualifies for the new basis, even though the donee and not the donor's estate owned the partnership interest,[5696] and the partnership (and possibly the partners) needs to take appropriate steps to preserve the use of this basis step-up for sales that occur after death and before any estate tax audit concludes.[5697] Consider whether an estate that is well below the threshold for paying estate tax would argue that any partnership interest it holds should be disregarded under Code § 2036 and the underlying assets included in the estate, so that the

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[5695] Letter Ruling 200626003. See *Hurford*, discussed in fn 1574 in part II.G.8 Code § 165(a) Loss for Worthlessness; Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy.

[5696] *Estate of Jorgensen v. Commissioner*, T.C. Memo. 2009-66, an equitable recoupment case described more fully in the text accompanying and preceding fn 1425 in part II.G.4.m.ii Equitable Recoupment, which held:

> Respondent argues that if we determine the estate is entitled to equitable recoupment, we should limit the recoupment to the income taxes paid by Jerry Lou and Gerald, who, pursuant to Ms. Jorgensen's will and revocable trust, are ultimately responsible for the estate tax liability. The grandchildren are not liable for the estate tax deficiency. In *Estate of Branson*, the residuary beneficiary, like Gerald and Jerry Lou, was responsible for the estate tax liability and was the one who overpaid income tax, thus entitling the estate to equitable recoupment. However, the relevant caselaw does not indicate that the taxpayer who overpaid tax must be the one responsible for the related deficiency for equitable recoupment to apply.
>
> We have found that there was an implied agreement that Ms. Jorgensen would retain control of the assets she contributed to the partnerships even though she purported to give partnership interests to her children and grandchildren. The partnerships paid her expenses including her Federal and California estate tax liabilities (as calculated on the estate tax returns). The assets were included in her gross estate as if they had not been transferred to the partnerships. The goal of Ms. Jorgensen's gift program was to reduce the value of her estate; i.e., a testamentary goal. Because of the program, the objects of her bounty, her children and grandchildren, paid income taxes on assets that were later determined to be properly included in valuing her gross estate, thus subjecting those assets to improper double taxation. Under these circumstances, we find that there is sufficient identity of interest between Ms. Jorgensen's estate and her children and grandchildren.
>
> It would be inequitable for the assets to be included in the value of Ms. Jorgensen's gross estate under section 2036 on the one hand, and on the other hand for the estate not to recoup the income taxes her children and grandchildren overpaid on their sale of those very same assets but are unable to recover in a refund suit. Accordingly, the estate is entitled to equitable recoupment of the 2003 income taxes overpaid by Ms. Jorgensen's children and grandchildren as a result of our determination that the values of the assets Ms. Jorgensen transferred to the partnerships are included in the value of her gross estate under section 2036.

The recoupment referred to above arose from the estate tax case being settled after the statute of limitations had passed for amending the donees' income tax returns that reported gain from sale of some of the included assets. See part II.G.4.m.ii Equitable Recoupment, which is part of part II.G.4.m Fixing Unfair Income Tax Results.

See also Rev. Rul. 79-124, cited in fn 5674, holding a Code § 743(b) adjustment applies to a Code § 1014(b)(6) basis adjustment for community property.

[5697] See text accompanying and following fn 1421 in part II.G.4.m.i Code § 1341 Claim of Right Deduction; see also text accompanying fn 1426 in part II.G.4.m.ii Equitable Recoupment.

assets could get a higher basis step-up.[5698] Query the level of proof required to invoke Code § 2036 in such a situation.[5699] The logistics of this inside basis step-up are unclear:

[5698] See fns 91-92 in part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders (which part highlighted an S corporation's ability to avoid Code § 2036).

[5699] For an estate tax TAM, see fn 230 in part II.A.2.i.i.(b) Why Nonvoting Shares Are Needed for Estate Planning. The TAM cited *Estate of Robinson v. Commissioner*, 101 T.C. 499, 513-514 (1993), which case, involving annual exclusion gifts, stated:

> The ability of a taxpayer to avoid the form of a transaction requires strong proof in this Court, and is even more restricted by the Court of Appeals for the Eleventh Circuit, the court to which an appeal in the instant case would be taken. *Bradley v. United States*, 730 F.2d 718, 720 (11th Cir. 1984). The rule, first announced in *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967), vacating and remanding 44 T.C. 549 (1965), is as follows:
>
> > A party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.…
>
> Although *Danielson* involved the allocation of payments to a covenant not to compete, it is clear that the rule applies beyond the confines of such an allocation. *Sullivan v. United States*, 618 F.2d 1001 (3d Cir. 1980); *Coleman v. Commissioner*, 87 T.C. 178, 202 (1986), *affd.* in an unpublished order 833 F.2d 303 (3d Cir. 1987). The Court of Appeals for the Eleventh Circuit has also adopted a similar rule to the rule in *Danielson*. *Bradley v. United States*, *supra*. We are bound to follow *Bradley* under the rule of *Golsen v. Commissioner*, 54 T.C. 742 (1970), *affd.* 445 F.2d 985 (10th Cir. 1971).
>
> The rule in *Danielson* prevents a taxpayer from arguing against the form of a transaction adopted by the taxpayer and the other parties to the transaction unless mistake, undue influence, fraud, duress, or other defenses to the formation of a contract could be shown by the taxpayer in action against the other parties to the transaction. The rule in *Danielson* is not applicable when the form of the transaction adopted by the parties is ambiguous. *Smith v. Commissioner*, 82 T.C. 705, 713-714 (1984).
>
> In the instant case, neither the form of the transaction nor the deeds used to facilitate the transaction can be reasonably construed as ambiguous. The deeds do not refer to any interests that petitioner contends decedent's great-grandchildren had in the transferred properties. Therefore, under the rule in *Danielson*, petitioner is prevented from arguing that implied trusts were created under Georgia law for the benefit of decedent's great-grandchildren.

Along the lines of a case cited above that the taxpayer could not report as goodwill – taxed as capital gain - payments under a covenant not to compete, which was ordinary income, *Muskat v. U.S.*, 554 F.3d 183 (1st Cir. 2009), *aff'g* 101 AFTR 2d 2008-1606 (D.N.H. 2008), which is further described in fn 5557 in part II.Q.8.b.iii Partnership Alternative to Seller-Financed Sale of Goodwill, stated:

> In our view, to constitute "strong proof" a taxpayer's evidence must have persuasive power closely resembling the "clear and convincing" evidence required to reform a written contract on the ground of mutual mistake.

In rejecting a taxpayer's argument that an S corporation of which he owned 49% had a second class of stock, *Mowry v. Commissioner*, T.C. Memo. 2018-105, which is also discussed in fns 259-260 in part II.A.2.i.iii Disproportionate Distributions, held:

> Generally taxpayers are bound by the form of the transaction that they choose unless they can provide "strong proof" that the parties intended a different transaction in substance. *Schulz v. Commissioner*, 294 F.2d 52, 55 (9th Cir. 1961), *aff'g* 34 T.C. 235 (1960); see also *Vandenbosch v. Commissioner*, T.C. Memo. 2016-29, at *19-*20. There is no proof that either petitioner or G. Mowry intended an arrangement different from that which they agreed to and reported consistently on their tax filings.

Zaritsky & Law, "Finding Basis - It's Not Always Where You Thought It Was" (5/18/2020), asserted.

- If the partnership's assets are somehow treated as passing by reason of the decedent's death, is there somehow a new contribution to the partnership that generates outside basis?

- If not, then outside basis may be much lower than inside basis. In that case, a Code § 754 election may have cause inside basis to decrease to match outside basis when the relevant partnership interest is transferred. Another result would be inside basis being stripped when assets are distributed without outside basis to match.

- Because these issues have not been definitively explored, it may be wise not to distribute the relevant partnership interest or distribute the stepped up assets from the partnership until after one is confident that there will be no IRS Code § 2036 inquiry.

- Although not directly on point, the policy of *Estate of Jorgensen v. Commissioner*, T.C. Memo. 2009-66, described in part II.G.4.m.ii Equitable Recoupment, suggests that the Tax Court would accept giving the taxpayer the full income tax benefit of Code § 2036 inclusion. The only way to do that is to treat the assets as passing from the decedent to the partnership immediately after death, to avoid the trap described above. I am very comfortable taking a reporting position consistent with this theory in such a case, while at the same being aware that the lack of authority directly addressing this issues makes this analysis less than ironclad.

In reviewing anything in this part II.Q.8.e.iii.(b), consider whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.

II.Q.8.e.iii.(c). When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000

Generally, Code § 754 election adjusts the basis of a partnership's assets when certain events occur; those events are described in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets, which also refers back to part II.Q.8.e.i Distribution of Partnership Interests. The idea is that the value of the partnership's assets should reflect the basis in the partnership interest when a triggering event occurs that may or may not change of basis in the partnership interest. If outside basis changes at some point and the inside basis is not reconciled then, other events may trigger an inside basis adjustment.[5700] Estate planners tend

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The courts and the IRS, however, have held that the taxpayer cannot argue substance over form, because the taxpayer selects the form of the transaction and cannot thereafter challenge it. *City of New York v. Comm'r*, 103 T.C. 481 (1994), *aff'd*, 70 F.3d 142 (D.C. Cir. 1995) ("To freely allow tax-payers to argue for alternative tax treatment of a transaction upon the examination of the returns would be tantamount to administering the tax laws based on a policy that tax consequences flow from the 'transaction taxpayers have chosen or from any other form [of transaction] they might have chosen, whichever is … [more favorable]'"); *Estate of Durkin v. Comm'r*, 99 T.C. 561, 571-573 (1992); *Comm'r v. Danielson*, 378 F.2d 771 (3d Cir. 1967), *rev'g* 44 T.C. 549 (1965); *Coleman v. Comm'r*, 87 T.C. 178 (1986), *aff'd without op.* 833 F.2d 303 (3d Cir. 1987); *Howell v. Comm'r*, T.C. Memo. 2012-303. See also, CCA 201121020; FSAs 199921002, 199909018, 200004011, and 200242004; and TAMs 9515003, 200334001, and 200418008.

For a more recent case reciting the doctrine's history, see part II.G.33 Taxpayer Disavowing Form. That case held that "the taxpayer must establish that the form of the transaction was not chosen for the purpose of obtaining tax benefits … that are inconsistent with those the taxpayer seeks through disregarding that form.""

[5700] See part II.Q.8.e.iii.(a) Illustration of Inside Basis Issue.

to view death as the main triggering event, but the scope of events that trigger these changes is quite broad.

In one limited case involving straddles, the IRS ruled that failure to make a Code § 754 election constituted an abuse.[5701]

IRS provided to its personnel "Guidance on the Revocation of Internal Revenue Code Section 754 Election Procedures," outlining on August 26, 2021 procedures for use by LB&I and SB/SE employees when determining whether to approve or deny a request filed by a partnership to revoke its election to adjust the basis of partnership property under IRC section 754, available at https://www.irs.gov/pub/foia/ig/lmsb/lbi-04-0621-0004.pdf. Taxpayers use Form 15254, Request for Section 754 Revocation, available at https://www.irs.gov/forms-pubs/about-form-15254.

When a Code § 754 election is in place, any Code § 743 adjustments that apply to the transfers of partnership interests require the partnership to essentially create a separate set of books for each partner[5702] (until the relevant partnership interest is liquidated),[5703] whereas any Code § 734 adjustments (increasing or decreasing inside basis as a result of a change in the basis of distributed property) apply to the partnership as a whole.[5704] For more details on the implementation of a Code § 743(b) basis step-up, see part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

[5701] Notice 2002-50; see also Reg. § 1.701-2(e)(1) and the discussion of the anti-abuse regulations described in part II.Q.8.b.i.(e) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property.

[5702] Reg. § 1.743-1(j).

[5703] If the Code § 743(b) basis adjustment remains when the partnership interest is liquidated, instead of being wasted it may cause an inside basis adjustment and perhaps even a capital account adjustment. See fns 515-519 in part II.C.7 Maintaining Capital Accounts.

[5704] Code § 734(b) provides:

> *Method of adjustment*. In the case of a distribution of property to a partner by a partnership with respect to which the election provided in section 754 is in effect or with respect to which there is a substantial basis reduction, the partnership shall—
>
> (1) increase the adjusted basis of partnership property by—
>
> (A) the amount of any gain recognized to the distributee partner with respect to such distribution under section 731(a)(1), and
>
> (B) in the case of distributed property to which section 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by section 732(d)) over the basis of the distributed property to the distributee, as determined under section 732, or
>
> (2) decrease the adjusted basis of partnership property by—
>
> (A) the amount of any loss recognized to the distributee partner with respect to such distribution under section 731(a)(2) , and
>
> (B) in the case of distributed property to which section 732(b) applies, the excess of the basis of the distributed property to the distributee, as determined under section 732, over the adjusted basis of the distributed property to the partnership immediately before such distribution (as adjusted by section 732(d)).
>
> Paragraph (1)(B) shall not apply to any distributed property which is an interest in another partnership with respect to which the election provided in section 754 is not in effect.

CCA 201521012 explained the interaction of Code § 734(b) with Code § 481 adjustments for change in accounting method.[5705] Also, in reviewing anything in this part II.Q.8.e.iii.(c), consider whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.

The taxpayer can take advantage of a basis step-up, without the partnership making a Code § 754 election, by receiving a distribution of appreciated assets within two years after death or sale or exchange of the partnership interest; see part II.Q.8.e.iii.(e) Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election. Such a distribution would tend to undermine valuation discounts, which might be good (higher basis step-up) or bad (potentially higher estate tax).

If a partnership holds assets with built-in losses greater than $250,000, one must consider harvesting those losses before engaging in any disposition or acquisition of any interest in the partnership, including the death of a partner. The rest of this section explains why.

The American Jobs Creation Act added three new mandatory basis adjustment rules that can cause serious problems if a partnership does not have a Code § 754 election in effect.[5706] The

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[5705] When the IRS determined that a partnership had improperly deferred gain:

> When there is a change in accounting method to which IRC § 481(a) is applied, income for taxable years preceding the year of change must be determined under the accounting method that was then used, and income for the year of change and the following taxable years must be determined under the new accounting method as if the new method had always been used. Accordingly, Taxpayer's IRC § 734(b) adjustments for years preceding the year of change must be computed using the accounting method that was then used. Taxpayer's IRC § 734(b) adjustments for the year of change and subsequent years must be redetermined consistent with the new accounting method.
>
> In computing the net § 481(a) adjustment, a taxpayer must take into account all relevant accounts. See Rev. Proc. 2002-18, section 2.04(1), Rev. Proc. 97-27, 1997-1 C.B. 680, section 2.05(1). Here, the IRC § 481(a) adjustment represents the difference in gain or loss for all of the underlying securities that would have been recognized under the new method, less the gain or loss that was recognized under the prior method as of the beginning of the year of change. Taxpayer's IRC § 734(b) adjustments for taxable years prior to the year of change, as calculated under the prior method, are fully taken into account in calculating the basis in the securities. In addition, beginning in the year of change, Taxpayer's basis in its securities will be modified to reflect the gain or loss recognized in connection with the change in accounting method.
>
> The determination of whether a partnership has a change in accounting method does not depend on whether the partnership made an election under IRC § 754, whose only purpose and effect is to eliminate distortions caused by partnership distributions and sales of partnership interests. The partners of a partnership using a given accounting method ultimately recognize the same amount of cumulative taxable income over the life of the partnership whether or not the partnership makes an election under IRC § 754. A change in accounting method under IRC § 446 occurs when Taxpayer/partnership no longer treats certain securities transactions as options and thus, stops deferring the gains, losses, income, or deductions associated with those transactions.

[5706] For more details, see IRS Notice 2005-32; see also Rosenberg, AJCA Imposes New Burdens for Partnership Basis Adjustments Under Sections 734 and 743, *Journal of Taxation*, vol. 101, No. 6, 12/2004 at 334, which was followed by Lipton and Golub, Dealing With the Service's Interim Guidance on Downward Basis Adjustments Under 734 and 743, *Journal of Taxation*, vol. 103, No. 1, 7/2005 at 33; Schneider, New Basis Rules Aim at Transfer and Duplication of Built-in Losses, *Taxes – The Tax Magazine*, May 2005 at 39. Also note that Reg. § 1.701-2(d), Ex. 8 also considers failure to make a first rule applies to limit the transfer of built-in losses on property contributed to a partnership after October 22, 2004.[5707] The second rule applies when a partnership distributes cash or property after October 22, 2004 that results in the transferee either recognizing a loss or receiving a stepped-up basis in the property greater than $250,000.[5708] The third rule applies when a partner dies or transfers an interest in a partnership after October 22, 2004 and the partnership has built-in losses greater than $250,000.[5709] Furthermore, starting in 2018, this adjustment applies when the transferee partner would be allocated a loss of more than $250,000 if the partnership assets were sold for cash equal to their fair market value immediately after such transfer.[5710]

Limited exceptions apply to certain electing investment partnerships and securitization partnerships.[5711] One of these provisions encourages taxpayers to structure marketable securities partnerships as follows: all contributions are cash in exchange for partnership interests issued within 24 months of formation; the partnerships buys investment assets but does not engage in a trade or business; no partner can readily redeem that partner's partnership interest; and the partnership has a term of no more than 15 years;[5712] this structure has other advantages as well.[5713]

These adjustments can be particularly disturbing when a partnership interest is sold to a related party. Let's start with an example from IRS Notice 2005-32 that tracks the legislative history:

Section 754 election to be an abuse, but Ex. 9 does not consider failure to make a Section 754 election to be an abuse. Similarly, if a tax-indifferent party attempts to shift built-in losses to a U.S. taxpayer who has not incurred an economic loss so that the U.S. taxpayer may claim a deduction of the built-in losses from the distressed assets, the transaction might be a listed transaction under Notice 2008-34.

[5707] Code § 704(c)(1)(C). For a discussion of proposed regulations, see Kim and Carrasco, Proposed Regulations on Contributions of Built-in Loss Property: Paving a Framework for Super C, *TM Memorandum* (BNA), 10/20/2014, Vol. 55, No. 21. See also the American Bar Association Section of Taxation's Comments on Proposed Regulations on Certain Partnership Provisions of the American Jobs Creation Act of 2004, *Tax Lawyer*, vol. 69, No. 1, p. 5 (Fall 2015).

[5708] Code § 734(b).

[5709] Code § 743(a) and (b), as amended.

[5710] Code § 743(d)(1)(B). The Senate Report said:

> For example, a partnership of three taxable partners (partners A, B, and C) has not made an election pursuant to section 754. The partnership has two assets, one of which, Asset X, has a built-in gain of $1 million, while the other asset, Asset Y, has a built-in loss of $900,000. Pursuant to the partnership agreement, any gain on sale or exchange of Asset X is specially allocated to partner A. The three partners share equally in all other partnership items, including in the built-in loss in Asset Y. In this case, each of partner B and partner C has a net built-in loss of $300,000 (one third of the loss attributable to asset Y) allocable to his partnership interest. Nevertheless, the partnership does not have an overall built-in loss, but a net built-in gain of $100,000 ($1 million minus $900,000). Partner C sells his partnership interest to another person, D, for $33,333. Under the provision, the test for a substantial built-in loss applies both at the partnership level and at the transferee partner level. If the partnership were to sell all its assets for cash at their fair market value immediately after the transfer to D, D would be allocated a loss of $300,000 (one third of the built-in loss of $900,000 in Asset Y). A substantial built-in loss exists under the partner-level test added by the provision, and the partnership adjusts the basis of its assets accordingly with respect to D.

[5711] Code §§ 734(e) and 743(e), (f).

[5712] Code § 743(e).

[5713] Distributions of marketable securities might be considered nontaxable distributions of property rather than potentially taxable distributions of cash. See text accompanying footnotes 5383-5385.

> PRS is a partnership which does not have an election under § 754 in effect. PRS has no liabilities. The fair market value of PRS's assets is $4 million and the adjusted basis of PRS's assets is $4.3 million. Under § 743(d), PRS has a substantial built-in loss because the adjusted basis of the partnership property exceeds the fair market value of the partnership property by more than $250,000. A, a partner of PRS, sells a 25 percent partnership interest in PRS to B for its fair market value of $1 million. Under § 743(b), an adjustment is required to the adjusted basis of PRS's assets with respect to B....

Presumably that adjustment would be to reduce the basis of the partnership's assets by $75,000, which is the excess of A's $1,075,000 pro rata share of the basis of the partnership's assets (25% of $4,300,000) over the sale price ($1,000,000).

This provision was intended to prevent double deductions as follows, assuming that the basis of A's partnership interest is 25% of the basis of the partnership's assets:

- A has a $75,000 loss, since A's basis of $1,075,000 (25% of $4.3 million) exceeds A's $1,000,000 proceeds.

- B reports a $75,000 loss when PRS sells its assets.

What if, however, B were a related party, and Code § 267 prevented A from deducting the loss? Generally, the perceived double deduction would not apply, since A cannot deduct A's $75,000 loss. Therefore, as a matter of policy, the $75,000 mandatory basis adjustment should not apply. However, the statute does not appear to have any exceptions that take into account a Code § 267 loss disallowance, so it appears that B would be stuck with the negative basis adjustment. Thus, neither A nor B recognizes this loss.[5714]

The situation is worsened when one applies valuation adjustments, since (unlike the example in Notice 2005-32) A's partnership interest is worth less than a pro-rata-share of the underlying assets. For example, suppose A sold A's partnership interest to B for $750,000? Then a special allocation of basis adjustment would reduce B's share of the basis from A's original $1,075,000 to only $750,000. So, at first glance, the basis reduction is $325,000 ($1,075,000 minus $750,000), which exceeds the $300,000 ($4.3 million minus $4 million) substantial built-in loss that triggered the whole situation. However, the basis reduction cannot decrease an asset's basis below its fair market value,[5715] so this provision is not as onerous as it might have seemed.

One might sell the partnership's loss assets so that the partners recognize the loss, then buy other assets that have similar investment attributes but do not constitute "substantially identical stock or securities" under the wash sale rules of Code § 1091. That should avoid the mandatory basis reductions and give A the losses that would otherwise have been disallowed.

[5714] B would be able to take advantage of this disallowed loss if and to the extent that B later sells B's partnership interest for a gain. Code § 267(d).

[5715] See fn. 4241 in part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

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

For when a transfer triggers a Code § 743 inside basis adjustment, see part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000. This part II.Q.8.e.iii.(d) assumes that one has determined that a Code § 743(b) adjustment applies. In reviewing anything in this part II.Q.8.e.iii.(d), consider whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.

Before getting into how the allocations work, consider various reporting issues:

- Make a Code § 754 election on the partnership return covering the year of transfer, if not yet in effect.

- A transferee that acquires, by sale or exchange, an interest in a partnership with a Code § 754 election in effect for the taxable year of the transfer, must notify the partnership, in writing, within 30 days of the sale or exchange.[5716] A transferee that acquires, on the death of a partner, an interest in a partnership with a Code § 754 election in effect for the taxable year of the transfer, must notify the partnership, in writing, within one year of the death of the deceased partner.[5717] In making the adjustments under Code § 743(b) and any statement or return relating to such adjustments under this section, a partnership may rely on the written notice described above to determine the transferee's basis in a partnership interest, unless any partner who has responsibility for the partnership's federal income tax reporting has knowledge of facts indicating that the statement is clearly erroneous.[5718] A partnership is not required to make Code § 743(b) adjustments (or any statement or return relating to those adjustments) with respect to any transfer until it has been notified of the transfer.[5719] If the transferee fails to provide the partnership with the written notice described

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[5716] Reg. § 1.743-1(k)(2)(i) (also referred to by Reg. § 1.755-1(d)), which further provides:

> The written notice to the partnership must be signed under penalties of perjury and must include the names and addresses of the transferee and (if ascertainable) of the transferor, the taxpayer identification numbers of the transferee and (if ascertainable) of the transferor, the relationship (if any) between the transferee and the transferor, the date of the transfer, the amount of any liabilities assumed or taken subject to by the transferee, and the amount of any money, the fair market value of any other property delivered or to be delivered for the transferred interest in the partnership, and any other information necessary for the partnership to compute the transferee's basis.

[5717] Reg. § 1.743-1(k)(2)(ii), which further provides:

> The written notice to the partnership must be signed under penalties of perjury and must include the names and addresses of the deceased partner and the transferee, the taxpayer identification numbers of the deceased partner and the transferee, the relationship (if any) between the transferee and the transferor, the deceased partner's date of death, the date on which the transferee became the owner of the partnership interest, the fair market value of the partnership interest on the applicable date of valuation set forth in section 1014, and the manner in which the fair market value of the partnership interest was determined.

[5718] Reg. § 1.743-1(k)(3).

[5719] Reg. § 1.743-1(k)(4), which provides that a partnership is notified of a transfer when either:

> (i) The partnership receives the written notice from the transferee required under paragraph (k)(2) of this section; or
>
> (ii) Any partner who has responsibility for federal income tax reporting by the partnership has knowledge that there has been a transfer of a partnership interest.

above, the partnership must attach a statement to its return in the year that the partnership is otherwise notified of the transfer.[5720]

- A partnership that must adjust the bases of partnership properties under Code § 743(b)) must attach a statement to the partnership return for the year of the transfer setting forth the name and taxpayer identification number of the transferee as well as the computation of the adjustment and the partnership properties to which the adjustment has been allocated.[5721]

What happens when a partner who has received a Code § 743(b) basis adjustment later transfers the partnership interest? Reg. § 1.743-1(f), "Subsequent transfers," provides:

> Where there has been more than one transfer of a partnership interest, a transferee's basis adjustment is determined without regard to any prior transferee's basis adjustment. In the case of a gift of an interest in a partnership, the donor is treated as transferring, and the donee as receiving, that portion of the basis adjustment attributable to the gifted partnership interest. The provisions of this paragraph (f) are illustrated by the following example:
>
> *Example.*
>
> (i) A, B, and C form partnership PRS. A and B each contribute $1,000 cash, and C contributes land with a basis and fair market value of $1,000. When the land has appreciated in value to $1,300, A sells its interest to T1 for $1,100 (one-third of $3,300, the fair market value of the partnership property). An election under section 754 is in effect; therefore, T1 has a basis adjustment under section 743(b) of $100.
>
> (ii) After the land has further appreciated in value to $1,600, T1 sells its interest to T2 for $1,200 (one-third of $3,600, the fair market value of the partnership property). T2 has a basis adjustment under section 743(b) of $200. This amount is determined without regard to any basis adjustment under section 743(b) that T1 may have had in the partnership assets.
>
> (iii) During the following year, T2 makes a gift to T3 of fifty percent of T2's interest in PRS. At the time of the transfer, T2 has a $200 basis adjustment under section 743(b). T2 is treated as transferring $100 of the basis adjustment to T3 with the gift of the partnership interest.

The 1954 legislative history says:

> If property with respect to which the transferee has a special basis under section 743(b) is distributed to a partner other than the transferee, then the transferee partner's special basis allocable to such property is shifted to other property remaining in the partnership (or distributed to the transferee in the same transaction) in the same manner as is

[5720] Reg. § 1.743-1(k)(5), which describes the attachment, as well as what to do when the transferee supplies the information.

[5721] Reg. § 1.743-1(k)(1)(i); in addition to referring to this requirement, Reg. § 1.755-1(d) indicates that this statement should include the partnership properties to which the adjustment is allocated under section 755, which is what this part II.Q.8.e.iii.(d) is all about. See Reg. § 1.743-1(k)(1)(ii) for special rules for oil and gas properties that are depleted at the partner level under Code § 613A(c)(7)(D).

described on page 400 of the report of the Committee on Finance with respect to the Senate amendments (S. Rept. 1622, 83d Cong., 2d sess.).

Reg. § 1.743-1(g), "Distributions," provides:

(1) *Distribution of adjusted property to the transferee*.

(i) *Coordination with section 732*. If a partnership distributes property to a transferee and the transferee has a basis adjustment for the property, the basis adjustment is taken into account under section 732. See § 1.732-2(b).

(ii) *Coordination with section 734*. For certain adjustments to the common basis of remaining partnership property after the distribution of adjusted property to a transferee, see § 1.734-2(b).

(2) *Distribution of adjusted property to another partner*.

(i) *Coordination with section 732*. If a partner receives a distribution of property with respect to which another partner has a basis adjustment, the distributee does not take the basis adjustment into account under section 732.

(ii) *Reallocation of basis*. A transferee with a basis adjustment in property that is distributed to another partner reallocates the basis adjustment among the remaining items of partnership property under § 1.755-1(c).

(3) *Distributions in complete liquidation of a partner's interest*. If a transferee receives a distribution of property (whether or not the transferee has a basis adjustment in such property) in liquidation of its interest in the partnership, the adjusted basis to the partnership of the distributed property immediately before the distribution includes the transferee's basis adjustment for the property in which the transferee relinquished an interest (either because it remained in the partnership or was distributed to another partner). Any basis adjustment for property in which the transferee is deemed to relinquish its interest is reallocated among the properties distributed to the transferee under § 1.755-1(c).

(4) *Coordination with other provisions*. The rules of sections 704(c)(1)(B), 731, 737, and 751 apply before the rules of this paragraph (g).

(5) *Example*. The provisions of this paragraph (g) are illustrated by the following example:

Example.

(i) A, B, and C are equal partners in partnership PRS. Each partner originally contributed $10,000 in cash, and PRS used the contributions to purchase five nondepreciable capital assets. PRS has no liabilities. After five years, PRS's balance sheet appears as follows:

Assets

	Adjusted basis	Fair Market value
Asset 1	$10,000	$10,000
Asset 2	4,000	6,000
Asset 3	6,000	6,000
Asset 4	7,000	4,000
Asset 5	3,000	13,000
Total	30,000	39,000

Capital

	Adjusted per books	Fair Market value
Partner A	$10,000	$13,000
Partner B	10,000	13,000
Partner C	10,000	13,000
Total	30,000	39,000

(ii) A sells its interest to T for $13,000 when PRS has an election in effect under section 754. T receives a basis adjustment under section 743(b) in the partnership property that is equal to $3,000 (the excess of T's basis in the partnership interest, $13,000, over T's share of the adjusted basis to the partnership of partnership property, $10,000). The basis adjustment is allocated under section 755, and the partnership's balance sheet appears as follows:

Assets

	Adjusted basis	Fair Market value	Basis adjustment
Asset 1	$10,000	$10,000	0.00
Asset 2	4,000	6,000	666.67
Asset 3	6,000	6,000	0.00
Asset 4	7,000	4,000	(1,000.00)
Asset 5	3,000	13,000	3,333.33
Total	30,000	39,000	3,000.00

	Capital Adjusted per books	Fair Market value	Special basis
Partner T	$10,000	$13,000	$3,000
Partner B	10,000	13,000	0
Partner C	10,000	13,000	0
Total	30,000	39,000	3,000

(iii) Assume that PRS distributes Asset 2 to T in partial liquidation of T's interest in the partnership. T has a basis adjustment under section 743(b) of $666.67 in Asset 2. Under paragraph (g)(1)(i) of this section, T takes the basis adjustment into account under section 732. Therefore, T will have a basis in Asset 2 of $4,666.67 following the distribution.

(iv) Assume instead that PRS distributes Asset 5 to C in complete liquidation of C's interest in PRS. T has a basis adjustment under section 743(b) of $3,333.33 in Asset 5. Under paragraph (g)(2)(i) of this section, C does not take T's basis adjustment into account under section 732. Therefore, the partnership's basis for purposes of sections 732 and 734 is $3,000. Under paragraph (g)(2)(ii) of this section, T's $3,333.33 basis adjustment is reallocated among the remaining partnership assets under § 1.755-1(c).

(v) Assume instead that PRS distributes Asset 5 to T in complete liquidation of its interest in PRS. Under paragraph (g)(3) of this section, immediately prior to the distribution of Asset 5 to T, PRS must adjust the basis of Asset 5. Therefore, immediately prior to the distribution, PRS's basis in Asset 5 is equal to $6,000, which is the sum of (A) $3,000, PRS's common basis in Asset 5, plus (B) $3,333.33, T's basis adjustment to Asset 5, plus (C) ($333.33), the sum of T's basis adjustments in Assets 2 and 4. For purposes of sections 732 and 734, therefore, PRS will be treated as having a basis in Asset 5 equal to $6,000.

For more details on distributions generally when a Code § 754 election is in effect, see part II.Q.8.e.iii.(e) Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election.

As noted in part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, special rules apply when built-in losses are involved. For a discussion of proposed regulations implementing Code § 743(b) adjustments in such cases, see the American Bar Association Section of Taxation's "Comments on Proposed Regulations on Certain Partnership Provisions of the American Jobs Creation Act of 2004," *Tax Lawyer*, vol. 69, No. 1, p. 5 (Fall 2015).

For effectuating these basis adjustments, see part II.Q.1.g Partnership Basis Adjustments.

II.Q.8.e.iii.(e). Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election

The basis of partnership property is adjusted as the result of a distribution of property to a partner if a Code § 754 election is in effect with respect to such partnership or if there is a substantial basis reduction with respect to such distribution:[5722]

(1) To the extent that the adjustment is an increase, the partnership increases the basis of its property by:[5723]

- (A) the amount of any gain recognized to the distributee partner with respect to such distribution under Code § 731(a)(1), and

- (B) in the case of distributed property to which Code § 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by Code § 732(d) – see further below) over the basis of the distributed property to the distributee, as determined under Code § 732.[5724]

(2) To the extent that the adjustment is a decrease, the partnership increases the basis of its property by:[5725]

- (A) the amount of any loss recognized to the distributee partner with respect to such distribution under Code § 731(a)(2), and

- (B) in the case of distributed property to which Code § 732(b) applies, the excess of the basis of the distributed property to the distributee, as determined under Code § 732, over the adjusted basis of the distributed property to the partnership immediately before such distribution (as adjusted by Code § 732(d)).

This adjustment to the basis of the partnership's property may also cause partners' capital accounts to be adjusted.[5726]

Reg. § 1.734-1(e), "Recovery of adjustments to basis of partnership property," includes:

(1) *Increases in basis*. For purposes of section 168, if the basis of a partnership's recovery property is increased as a result of the distribution of property to a partner, then the increased portion of the basis must be taken into account as if it were newly-purchased recovery property placed in service when the distribution occurs. Consequently, any applicable recovery period and method may be used to determine the recovery allowance with respect to the increased portion of the basis. However, no change is made for purposes of determining the recovery allowance under section 168 for the portion of the basis for which there is no increase.

5722 Code § 734(a), see part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.
5723 Code § 734(b)(1).
5724 The rule in (B) does not apply to any distributed property which is an interest in another partnership with respect to which a Code § 754 election is not in effect.
5725 Code § 734(b)(2).
5726 See fn 514 in part II.C.7 Maintaining Capital Accounts.

(2) *Decreases in basis*. For purposes of section 168, if the basis of a partnership's recovery property is decreased as a result of the distribution of property to a partner, then the decrease in basis must be accounted for over the remaining recovery period of the property beginning with the recovery period in which the basis is decreased.

However, basis adjustments under Code § 732 or 734(b) do not qualify for bonus depreciation.[5727]

Code § 755 allocates the basis adjustment described above.[5728] Generally, any Code § 743(b) change in the adjusted basis of partnership property will be allocated in a manner which has the effect of reducing the difference between the fair market value in any other manner permitted by regulations;[5729] this concept prevents any increase in the basis of assets that are distributed from reducing the basis of the partnership's assets with unrealized gain. In applying Code § 755 allocations to Code § 734(b) basis adjustments:

(1) Where a distribution of partnership property results in an adjustment to the basis of undistributed partnership property under Code § 734(b)(1)(B) or (b)(2)(B), the adjustment must be allocated to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose.[5730] Where a distribution results in an adjustment under Code § 734(b)(1)(A) or (b)(2)(A) to the basis of undistributed partnership property, the adjustment is allocated only to capital gain property.[5731]

(2) If a basis increase is allocated within a class, the increase is allocated first to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation before such increase (but only to the extent of each property's unrealized appreciation), and any remaining increase must be allocated among the properties within the class in proportion to their fair market values.[5732] If a basis decrease is allocated within a class, the decrease is allocated first to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation before such decrease (but only to the extent of each property's unrealized depreciation), and any remaining decrease must be allocated among the properties within the class in proportion to their adjusted bases (as adjusted under the preceding sentence).[5733]

[5727] See text accompanying fns 1472 and 1473 in part II.G.5.b Bonus Depreciation.

[5728] Code § 732(c).

[5729] See fn. 4241, found in part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

[5730] Reg. § 1.755-1(c)(1)(i), which continues:

> Thus, when the partnership's adjusted basis of distributed capital gain property immediately prior to distribution exceeds the basis of the property to the distributee partner (as determined under section 732), the basis of the undistributed capital gain property remaining in the partnership is increased by an amount equal to the excess. Conversely, when the basis to the distributee partner (as determined under section 732) of distributed capital gain property exceeds the partnership's adjusted basis of such property immediately prior to the distribution, the basis of the undistributed capital gain property remaining in the partnership is decreased by an amount equal to such excess. Similarly, where there is a distribution of ordinary income property, and the basis of the property to the distributee partner (as determined under section 732) is not the same as the partnership's adjusted basis of the property immediately prior to distribution, the adjustment is made only to undistributed property of the same class remaining in the partnership.

[5731] Reg. § 1.755-1(c)(1)(ii).

[5732] Reg. § 1.755-1(c)(2)(i).

[5733] Reg. § 1.755-1(c)(2)(ii).

(3) Where Code § 734(b)(2) requires a decrease in the basis of partnership assets and the amount of the decrease exceeds the adjusted basis to the partnership of property of the required character, the basis of that property is reduced to zero (but not below zero).[5734]

(4) Where an increase or a decrease in the basis of undistributed property cannot be made because the partnership owns no property of the character required to be adjusted, or because the basis of all the property of a like character has been reduced to zero, the adjustment is made when the partnership later acquires property of a like character to which an adjustment can be made.[5735]

If a transferee partner receives a distribution of property (other than money) from the partnership within two years after the partner acquired the partner's interest or part thereof in the partnership by a transfer with respect to which a Code § 754 election was not in effect, the partner may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the Code § 754 election were in effect.[5736] For these purposes, a "transfer of a partnership interest occurs upon a sale or exchange of an interest or upon the death of a partner."[5737] Also, if a Code § 754 election is not in place, a partner is required to apply this rule to a distribution to him, whether or not made within two years after the transfer, if at the time of his acquisition of the transferred interest:[5738]

[5734] Reg. § 1.755-1(c)(3).

[5735] Reg. § 1.755-1(c)(4).

[5736] Reg. § 1.732-1(d)(1)(iii). Reg. § 1.732-1(d)(1)(iv) provides:

> If an election under section 732(d) is made upon a distribution of property to a transferee partner, the amount of the adjustment with respect to the transferee partner is not diminished by any depletion or depreciation of that portion of the basis of partnership property which arises from the special basis adjustment under section 732(d), since depletion or depreciation on such portion for the period prior to distribution is allowed or allowable only if the optional adjustment under section 743(b) is in effect.

The final regulations did not change the proposed regulations much. The preamble to the proposed regulations, REG 209682-94, provides:

> Section 732(d) provides a special rule that applies to determine the basis of property distributed to a transferee partner who acquired any part of its partnership interest in a transfer when an election under section 754 was not in effect. When the special rule applies, the basis of distributed property is adjusted immediately before the distribution to reflect the basis that the property would have had if the partnership had a section 754 election in effect at the time the transferee acquired the partnership interest. As a result, the basis of the distributed property in the hands of the partnership immediately before the distribution more closely approximates its fair market value. Consequently, the transferee's basis in the distributed property will also more closely approximate its fair market value.

[5737] Reg. § 1.732-1(d)(1)(i).

[5738] Reg. § 1.732-1(d)(4). The preamble to the proposed regulations, REG 209682-94, provided:

> The purpose of § 1.732-1(d)(4) was to prevent distortions caused by section 732(c) that might inflate the basis of depreciable, depletable, or amortizable property above its fair market value. At the time that the regulations were adopted, such distortions might occur because section 732(c) allocated basis among distributed properties based on their relative bases. The changes made to section 732(c) by the Taxpayer Relief Act of 1997, Public Law 105-34, section 1061, 111 Stat. 788, 945-46 (1997), make the distortions targeted by the regulations less likely to occur. As a result, the Service and Treasury request comments on the proper scope of section 732(d), and specifically, under what circumstances, if any, the Secretary should exercise its authority to mandate the application of section 732(d) to a transferee.

T.D. 8847 described and responded to the requested comments:

- The fair market value of all partnership property (other than money) exceeded 110% of its adjusted basis to the partnership,

- An allocation of basis under Code § 732(c) upon a liquidation of his interest immediately after the transfer of the interest would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such an allowance, and

- A Code § 743(b) basis adjustment would change the basis to the transferee partner of the property actually distributed.

If property is distributed to a transferee partner who makes a Code § 732(d) election, and if that property is not the same property that would have had a special basis adjustment, then the special basis adjustment applies to any like property received in the distribution, if the transferee, in exchange for the property distributed, has relinquished the transferee's interest in the property with respect to which the transferee would have had a special basis adjustment.[5739] This rule applies whether the property in which the transferee has relinquished the transferee's interest is retained or disposed of by the partnership.[5740]

Special rules apply to unrealized receivables and substantially appreciated inventory items.[5741] Also, in reviewing anything in this part II.Q.8.e.iii.(e), consider whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.

II.Q.8.e.iii.(f). Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold

When an asset sale is desirable for tax purposes but a stock sale is necessary for nontax purposes, Code § 338(g) permits a corporation that buys another corporation from the target's parent in a qualified purchase to elect to treat the stock purchase as an asset purchase. This may help if the gain on sale can be offset by net operating losses[5742] – especially the target's[5743] – or perhaps if the corporation expects to be taxed at a lower rate now and a higher rate later.

Several commentators suggested that the mandatory application of section 732(d) no longer should be required, because the changes made to section 732(c) by the Taxpayer Relief Act of 1997, Public Law 105- 34, 111 Stat. 788, 945-46 (1997), make the distortions targeted by the regulations less likely to occur. However, other commentators noted that distortions caused by section 732(c) still may occur. Accordingly, the rule contained in § 1.732-1(d)(4), which requires the mandatory application of section 732(d) in certain cases, remains in effect.

[5739] Reg. § 1.732-1(d)(1)(v).

[5740] Reg. § 1.732-1(d)(1)(v). For a shift of transferee's basis adjustment under Code § 743(b) to like property, see Reg. § 1.743-1(g).

[5741] See fns. 5406-5408, found in part II.Q.8.b.i.(e) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property.

[5742] See part II.G.4.l.ii Net Operating Loss Deduction.

[5743] Code § 382 limits the amount of the taxable income of any new loss corporation for any post-change year which may be offset by pre-change losses. However, Code § 382(h)(1)(C) provides that this limitation does not apply to any gains recognized by reason of an election under Code § 338.

Similarly, the owners of an S corporation should consider making a Code § 338(h)(10) election when selling their S corporation stock to a corporation.[5744] The stock that is sold must be at least 80% of the voting power and at least 80% of the total value of the corporation's stock.[5745]

The election causes the stock sale to be treated as if the S corporation sold all its assets while owned by the sellers and while still an S corporation. Gain is therefore recognized by the S corporation and taxed to the selling shareholders, which creates additional basis in their S corporation stock. The actual sale of the stock is ignored for tax purposes and the shareholders are treated as receiving the sale proceeds in liquidation of the S corporation.

Thus, the selling shareholders will be taxed on a deemed asset sale and liquidation, rather than on a stock sale:

- Unless they bought a portion of their stock at a premium over the value of the corporation's assets, a Code § 338(h)(10) election will generally not significantly affect the amount of gain on which they would be taxed. However, it may cause a portion of their gain to be ordinary income, rather than capital gain, to the extent that a sale of the S corporation's assets would generate ordinary income, and state income tax surprises might occur; for a discussion of the some of the issues mentioned in the sentence, see similar issues raised in part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation. But, the whole point was to replicate an asset sale for tax purposes, so the Code § 338(h)(10) election merely allows a different form to be used for the deemed asset sale. Note, however, that ordinary income tax to the seller may be more expensive than the deduction allowed the buyer, if the buyer is a C corporation taxed at a lower rate, so in an environment of very low C corporation rates relative to individual rates may tend to drive the parties further apart with respect to the value of a Code § 338(h)(10) election. These concerns about ordinary income tend to be moot, because buyers usually agree to allocate proceeds in a manner that generates only capital gain on the deemed sale of assets; see part II.Q.1.f Code § 1060 Allocation Rule When Selling Business.

- Thus, gain on sale of the assets will be capital gain and add to basis of the stock that is deemed sold on liquidation. Unless pre-sale outside basis was lower than pre-sale inside basis, this addition to basis will result in a new outside basis greater than or equal to liquidation proceeds. This has some concepts in common with part II.H.8.a Depreciable Real Estate in an S Corporation – Possible Way to Replicate Effect of Basis Step-Up If the Stars Align Correctly.

- This mechanism automatically avoids gain on sale of stock, with no limit. Compare that with the limitations on the exclusion for the gain on the sale of certain C corporation stock under part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation.

These income tax consequences may affect selling shareholders differently. Variations in purchase price among shareholders do not violate the S corporation single-class-of-stock rule if

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[5744] Reg. § 1.338(h)(10)-1(c)(1) authorizes a Code § 338(h)(10) election when a corporation buys stock of the target corporation meeting the requirements of Code § 1504(a)(2) from a selling consolidated group, a selling affiliate, or the S corporation shareholders in a qualified stock purchase. See Code §§ 338(d)(3) and 338(h)(3)(A).
[5745] Code § 1504(a)(2).

determined in arm's length negotiations with the purchaser. See part II.A.2.i.vii Adjustments in Code § 338(h)(10) Sales in part II.A.2.i Single Class of Stock Rule.

If the purchaser is not a corporation, a Code § 336(e) election might allow the buyer to replicate the results of a Code § 338(h)(10) election.[5746] The selling corporation or S corporation shareholder(s) must dispose of stock of another corporation (target) in a qualified stock disposition.[5747] "Qualified stock disposition" means any transaction or series of transactions in which stock meeting the requirements of Code § 1504(a)(2) of a domestic corporation is either sold, exchanged, or distributed, or any combination thereof, by another domestic corporation or by the S corporation shareholders in a disposition,[5748] during the 12-month disposition period.[5749] "Disposition" means any sale, exchange, or distribution of stock, but only if:[5750]

(A) The basis of the stock in the hands of the purchaser is not determined in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom the stock is acquired or under Code § 1014(a) (property acquired from a decedent);

(B) Subject to an exception for certain Code § 355(d)(2) and (e)(2) transactions,[5751] the stock is not sold, exchanged, or distributed in a transaction to which Code § 351, 354, 355, or 356 applies and is not sold, exchanged, or distributed in any transaction described in regulations in which the transferor does not recognize the entire amount of the gain or loss realized in the transaction; and

(C) The stock is not sold, exchanged, or distributed to a related person.

Both the rules governing Code § 338(h)(10) elections and Code § 336(e) elections[5752] provide that stock acquired by a purchasing corporation from a related corporation is generally not considered acquired by purchase.[5753] The seller cannot be a person the ownership of whose stock would, under Code § 318(a) (other than Code § 318(a)(4)), be attributed to the buyer.[5754] (Also, in reviewing anything in this part II.Q.8.b.i.(e), consider whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.)

A Code § 336(e) election for an S corporation target is made by completing the following requirements:[5755]

[5746] Reg. § 1.336-1(a) provides that the effects of Code § 338(h)(10) and the regulations thereunder generally apply to Code § 336(e) elections.
[5747] Reg. § 1.336-2(a), referring to Reg. § 1.336-1(b)(6) in defining a qualified stock disposition.
[5748] Within the meaning of Reg. § 1.336-1(b)(5).
[5749] Reg. § 1.336-1(b)(6).
[5750] Reg. § 1.336-1(b)(5).
[5751] Reg. § 1.336-1(b)(5)(ii) provides that:

> a distribution of stock to a person who is not a related person in a transaction in which the full amount of stock gain would be recognized pursuant to section 355(d)(2) or (e)(2) shall be considered a disposition.

[5752] Reg. § 1.336-1(b)(5)(iii) provides:

> *Transactions with related persons*. In determining whether stock is sold, exchanged, or distributed to a related person, the principles of section 338(h)(3)(C) and § 1.338-3(b)(3) shall apply.

[5753] Reg. § 1.338-3(b)(3).
[5754] Code § 338(h)(3)(A)(iii). For Code § 318(a), see part II.Q.7.a.viii Code § 318 Family Attribution under Subchapter C.
[5755] Reg. § 1.336-2(h)(3).

- All of the S corporation shareholders, including those who do not dispose of any stock in the qualified stock disposition, and the S corporation target must enter into a written, binding agreement, on or before the due date (including extensions) of the Federal income tax return of the S corporation target for the taxable year that includes the disposition date, to make a Code § 336(e) election;

- The S corporation target must retain a copy of the written agreement; and

- The S corporation target must attach the Code § 336(e) election statement, to its timely filed (including extensions) Federal income tax return for the taxable year that includes the disposition date. A Reg. § 301.9100-3 extension of time to file the election may be available.[5756]

Instead of the seller(s) being treated as selling stock, the target is treated as selling its assets to an unrelated person in a single transaction at the close of the disposition date (but before the deemed liquidation described below)[5757] in exchange for the aggregate deemed asset disposition price.[5758] The target realizes the deemed disposition tax consequences from the deemed asset disposition before the close of the disposition date while the target is owned by seller or the S corporation shareholders.[5759] If the target is an S corporation, its S election continues in effect through the close of the disposition date (including the time of the deemed asset disposition and the deemed liquidation) notwithstanding the usual rules for S corporation terminations.[5760] Also, if the target is an S corporation (but not a qualified subchapter S subsidiary (QSub) [5761]), any direct or indirect subsidiaries of the target that the target has elected to treat as QSubs remain qualified QSubs through the close of the disposition date.[5762] If the target is an S corporation, its shareholders (whether or not they sell or exchange their stock)

5756 Letter Rulings 201652014 and 201711007, the latter holding:

WITHIN 45 DAYS OF THE DATE ON THIS LETTER, S Corporation Target and the S Corporation Shareholder must enter into a written, binding agreement to make a section 336(e) election and S Corporation Target must file the section 336(e) election statement in accordance with § 1.336-2(h). The section 336(e) election statement must be attached to S Corporation Target's tax return for B Year. In addition, a copy of this letter must be attached to S Corporation Target's return. Alternatively, if S Corporation Target files its return electronically, it may satisfy the requirement of attaching a copy of this letter to the return by attaching a statement to its return that provides the date and control number (PLR-131803-16) of this letter ruling.

WITHIN 120 DAYS OF THE DATE ON THIS LETTER, all relevant parties must file or amend, as applicable, all returns and amended returns (if any) necessary to report the transaction consistently with the making of a section 336(e) election for the taxable year in which the transaction was consummated (and for any other affected taxable year).

The above extension of time is conditioned on the taxpayers' (*i.e.*, Purchaser's, S Corporation Target's, and S Corporation Shareholder's) tax liability (if any) being not lower, in the aggregate, for all years to which the section 336(e) election applies than it would have been if the Election had been timely filed (taking into account the time value of money). No opinion is expressed as to the taxpayers' tax liability for the years involved. A determination thereof will be made by the applicable Director's office upon audit of the federal income tax returns involved.

5757 Reg. § 1.336-2(b)(1)(iii).

5758 Reg. § 1.336-2(b)(1)(i)(A).

5759 Reg. § 1.336-2(b)(1)(i)(A).

5760 Reg. § 1.336-2(b)(1)(i)(A).

5761 See part II.A.2.g Qualified Subchapter S Subsidiary (QSub).

5762 Reg. § 1.336-2(b)(1)(i)(A).

take their pro rata share of the deemed disposition tax consequences into account under Code § 1366 and increase or decrease their basis in target stock under Code § 1367.[5763]

Immediately after the deemed asset disposition described above, the target is treated as acquiring all of its assets from an unrelated person in a single, separate transaction at the close of the disposition date in exchange for an amount equal to the adjusted grossed-up basis.[5764] The target remains liable for the tax liabilities it had before this deemed sale and purchase (including the tax liability for the deemed disposition tax consequences).[5765]

The target and seller (or S corporation shareholders) are treated as if, before the close of the disposition date, after the deemed asset disposition described above, and while target is owned by seller or S corporation shareholders, the target transferred all of the consideration deemed received in the deemed asset disposition to seller or S corporation shareholders, any S corporation election for the original target terminated, and the original target ceased to exist.[5766] This transfer to the seller or S corporation shareholders is characterized for Federal income tax purposes in the same manner as if the parties had actually engaged in the transactions deemed to occur above and taking into account other transactions that actually occurred or are deemed to occur.[5767]

Thus, the following transactions are deemed to have occurred:

1. The target sells its assets to a hypothetical buyer.

2. The target is treated as having bought its assets from a hypothetical seller.

3. The target liquidates, while the old shareholders are deemed to continue owning the stock.

The time for taking into account liabilities in the hypothetical asset transaction and the amount of the liabilities taken into account is determined as if the consideration included the discharge of the liabilities by the unrelated person.[5768] For example, if no amount of a liability is properly taken into account in amount realized as of the beginning of the day after the disposition date, the liability is not initially taken into account in determining the purchase price, but it may be taken into account at some later date.[5769] At the January 2017 American Bar Association Section of Taxation meeting, a discussion of Code § 336(e) gave this example:[5770]

[5763] Reg. § 1.336-2(b)(1)(iii)(A). Code § 1367 is reproduced in part II.G.4.d.i Basis Limitation Generally.
[5764] Reg. § 1.336-2(b)(1)(ii).
[5765] Reg. § 1.336-2(b)(1)(ii).
[5766] Reg. § 1.336-2(b)(1)(iii)(A).
[5767] Reg. § 1.336-2(b)(1)(iii)(A), which continues:

> For example, the transfer may be treated as a distribution in pursuance of a plan of reorganization, a distribution in complete cancellation or redemption of all of its stock, one of a series of distributions in complete cancellation or redemption of all of its stock in accordance with a plan of liquidation, or part of a circular flow of cash. In most cases, the transfer will be treated as a distribution in complete liquidation to which sections 331 or 332 and sections 336 or 337 apply.

[5768] Reg. § 1.336-3(d)(2).
[5769] Reg. § 1.336-3(d)(2).
[5770] Slides discussed by Bakal, Bakke, Mottahedeh, and Weiss are saved as Thompson Coburn LLP document no. 6563470.

- Deemed asset purchase price equals cash paid plus "liabilities" assumed.

- Liabilities do not include amounts which are not currently deductible or amounts not borrowed from a third party.

- Assume that the assets are worth 100 and are associated with 20 of liabilities, and that the purchaser pays 80 for the target's stock.

- On the target's deemed liquidation after filing a conversion election, assets distributed are worth 100, but basis is limited to 80, which potentially triggers 20 of gain.

The meeting gave the following examples of liabilities that may trigger this gain:

- Environmental and other contingent liabilities

- Deferred compensation (Code § 404(a)(5))[5771]

- Obligations to perform future services (*Pierce*)

- Economic performance (Code § 461(h))

However, it was suggested that such a mismatch may occur in a straight asset sale as well.

A minority shareholder who retains its target stock does not recognize gain or loss with respect to its shares of target stock; thus, the minority shareholder's basis (except as noted below) and holding period for that target stock are not affected by Code § 336(e) election.[5772] Notwithstanding this treatment of the minority shareholder, if a Code § 336(e) election is made, target will still be treated as disposing of all of its assets in the deemed asset disposition.[5773] If the target is an S corporation, any K-1 items the minority shareholder reports by reason of the deemed sale will affect the shareholder's basis.[5774]

[5771] *Hoops, LP v. Commissioner*, T.C. Memo. 2022-9, held:

> Section 404(a)(11)(B) provides that, for purposes of determining when deferred compensation is paid, no amount shall be treated as received by the employee, or paid, until it is actually received by the employee. This result is consistent with Congress' intent for nonqualified plans under section 404, as discussed in the previous section, to deviate from the clear reflection of income principle and require matching of income inclusion and deduction between the employee and employer. Accordingly, Hoops must include the deferred compensation liability in its amount realized on the 2012 sale and is not entitled to offset or reduce its amount realized by the amount of the deferred compensation liability.

For an introduction to deferred compensation, see parts II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules and II.Q.1.d Nonqualified Deferred Compensation, the latter focusing on using it to complement a stock sale that is not treated as an asset sale.

[5772] Reg. § 1.336-3(d)(3).

[5773] Reg. § 1.336-3(d)(3).

[5774] Note the parenthetical in this quote from Reg. § 1.336-2(b)(1)(iii)(A):

> If old target is an S corporation, S corporation shareholders (whether or not they sell or exchange their stock) take their pro rata share of the deemed disposition tax consequences into account under section 1366 and increase or decrease their basis in target stock under section 1367.

A handy list comparing Code § 338(h)(10) elections and Code § 336(e) elections is found at Harper & Andersen, "Section 336(e)-Another Tool in the Toolbox," *BNA Daily Tax Report* (5/28/2014).[5775]

At the May 2017 American Bar Association Section of Taxation meeting, a discussion of Code §§ 336(e), 338(h)(10), 453(h), and 453B(h), included:[5776]

- Helpful flowcharts showing the transactions deemed to occur in Code § 336(e) or 338(h)(10) elections.
- Potential surprises, how to avoid them using a one-day note for 100% of the transaction, and disadvantages of doing so.[5777]
- State approaches.

One way to avoid the complexity of these elections and disparate state law treatment may be to create a new parent corporation, convey or merge the old corporation into a new single-member, tax-disregarded LLC, and then sell the LLC to the buyers. The first two steps constitute a tax-free Code § 368(a)(1)(F) transaction.[5778] Selling the LLC to the buyers means that the buyer is not concerned with the old corporation's status as an S corporation.[5779] If the LLC becomes a partnership that is then sold, the allocation of purchase price among assets might become more complex; see part II.Q.1.f Code § 1060 Allocation Rule When Selling Business and II.Q.8.b.i.(g) Code § 751 – Hot Assets.

II.Q.8.e.iii.(g). Certain Changes in Inside Basis May Reduce Foreign Tax Credits

A "covered asset acquisition" may disqualify a portion of the foreign tax credit.[5780]

For purposes of this rule, "covered asset acquisition" means:[5781]

(A) a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies,

(B) any transaction which-

[5775] A copy of which is saved as Thompson Coburn LLP document no. 6344607.
[5776] "Converting Stock Sales to Assets Sales (and Back Again)," slides discussed by Dolan, Harper, and Waters, is saved as Thompson Coburn LLP document no. 6617969.
[5777] If the buyer was willing to pay cash and the seller wanted the one-day note, the buyer's willingness to pay cash does not prevent the seller from using the installment method – only the actual deal counts. Rev. Rul. 73-396. See Reg. § 1.453-11, "Installment obligations received from a liquidating corporation." See also *The Tax Adviser*, "S Corporation Sale of Assets Followed by a Liquidation" (10/1/2008).
[5778] See parts II.E.7.c.i.(b) Use F Reorganization to Form LLC and II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. If the entity is an S corporations, this tool also involves part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[5779] For example, the S corporation may have had an ineligible shareholder. See parts II.A.2.f Shareholders Eligible to Hold S Corporation Stock and III.A.3.a.ii How a Trust Can Fall Short of Being Wholly Owned by One Person, the latter explaining how one might think that a trust is a wholly-owned grantor trust but may be incorrect.
[5780] Code § 901(m)(1).
[5781] Code § 901(m)(2).

(i) is treated as an acquisition of assets for purposes of this chapter, and

(ii) is treated as the acquisition of stock of a corporation (or is disregarded) for purposes of the foreign income taxes of the relevant jurisdiction,

(C) any acquisition of an interest in a partnership which has an election in effect under section 754, and

(D) to the extent provided by the Secretary, any other similar transaction.

Prop. Reg. § 1.901(m)-2(b) would add:[5782]

(4) Any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as an acquisition of assets for purposes of U.S. income tax and as the acquisition of an interest in a fiscally transparent entity for purposes of a foreign income tax;

(5) Any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as a partnership distribution of one or more assets the U.S. basis of which is determined by section 732(b) or 732(d) or which causes the U.S. basis of the partnership's remaining assets to be adjusted under section 734(b), provided the transaction results in an increase in the U.S. basis of one or more of the assets distributed by the partnership or retained by the partnership without a corresponding increase in the foreign basis of such assets; and

(6) Any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as an acquisition of assets for purposes of both U.S. income tax and a foreign income tax, provided the transaction results in an increase in the U.S. basis without a corresponding increase in the foreign basis of one or more assets.

Generally, international structures and most of subchapter C are beyond the scope of this paper. This part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits is merely one consideration when an international structure is affected by the tools described in parts II.Q.8.b.i.(e) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property, II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss) and II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10),

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[5782] These supplement Reg. § 1.901(m)-2T(b) (which is not repeated in the text because it does not seem to add to the statute):

Covered asset acquisitions. Except as provided in paragraph (d) of this section, the transactions set forth in this paragraph (b) are CAAs.

(1) A qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies (section 338 CAA);

(2) Any transaction that is treated as an acquisition of assets for U.S. income tax purposes and as an acquisition of stock of a corporation (or the transaction is disregarded) for foreign income tax purposes;

(3) Any acquisition of an interest in a partnership that has an election in effect under section 754 (section 743(b) CAA);

(4)-(6) [Reserved].

and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.

II.Q.8.e.iv. Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform)

Caution – This part II.Q.8.e.iv was repealed by 2017 tax reform.

If a sale or exchange of 50% or more of the total interest in partnership capital ***and***[5783] profits occurs (in the aggregate) within a 12-month period, the partnership is deemed to have terminated.[5784] However, a disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, the liquidation of a partnership interest, and the contribution of property to a partnership do not constitute such a sale or exchange is not a sale or exchange for purposes of this test.[5785]

If a partnership is terminated by a sale or exchange of an interest, the partnership is deemed to contribute all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership is deemed to distribute interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up:[5786]

- Subject to the points made below in this part II.Q.8.e.iv, see parts II.Q.8.b.i Distribution of Property by a Partnership and II.M.3 Buying into or Forming a Partnership for the deemed distribution from the old partnership and contribution to the new partnership, respectively (which tend to be tax-free transactions).

- Book values and capital accounts from the old partnership carry over to the new partnership.[5787] Therefore, no Code § 704(c) accounting for newly contributed property applies; instead, the terminating entity's Code § 704(c) accounting carries over.[5788]

- These deemed transactions do not trigger Code § 704(c)(1)(B)[5789] or Code § 737[5790] taxation on the distribution of property within seven years after contribution, which makes sense given the continuation of Code § 704(c) accountability.

- The partner who acquired the partnership interest in the sale or exchange that triggered the deemed termination would obtain a basis adjustment in the partnership's assets that this partner is deemed to acquire if a Code § 754 election is in place.[5791] A partner with a Code § 743 basis adjustment in the partnership's property will continue to have the same

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5783 For example, the sale of a 30% interest in partnership capital and a 60% interest in partnership profits is not the sale or exchange of 50% or more of the total interest in partnership capital and profits. Reg. § 1.708-1(b)(2).
5784 Code § 708(b)(1)(B).
5785 Reg. § 1.708-1(b)(2).
5786 Reg. § 1.708-1(b)(4).
5787 Reg. § 1.704-1(b)(2)(iv)(l).
5788 Reg. § 1.704-3(a)(3)(i). See part (iii) of the example in Reg. § 1.708-1(b)(4).
5789 Reg. § 1.704-4(c)(3).
5790 Reg. § 1.737-2(a).
5791 Reg. § 1.708-1(b)(5).

basis adjustment with respect to property deemed contributed by the terminated partnership to the new partnership,[5792] regardless of whether the new partnership makes a Code § 754 election.[5793] See part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest, which describes inside basis adjustments.[5794]

- Any start-up expenditures being amortized under Code § 195(b) or organizational expenses being amortized under Code § 709(b)(1) continue to use the same schedule.[5795] However, depreciation of tangible property starts over,[5796] as does the method for accounting for book-

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[5792] Referring to Reg. § 1.708-1(b)(1)(iv).
[5793] Reg. § 1.743-1(h)(1).
[5794] See part II.Q.8.e.iii.(a) Illustration of Inside Basis Issue.
[5795] Reg. § 1.708-1(b)(6). See also Reg. §§ 1.197-2(g)(2) and 1.197-2(k), Example (16), the latter providing:

(i) A and B are partners with equal shares in the capital and profits of general partnership P. P's only asset is an amortizable section 197 intangible, which P had acquired on January 1, 1995. On January 1, 2000, the asset had a fair market value of $100 and a basis to P of $50. On that date, A sells his entire partnership interest in P to C, who is unrelated to A, for $50. At the time of the sale, the basis of each of A and B in their respective partnership interests is $25.

(ii) The sale causes a termination of P under section 708(b)(1)(B). Under section 708, the transaction is treated as if P transfers its sole asset to a new partnership in exchange for the assumption of its liabilities and the receipt of all of the interests in the new partnership. Immediately thereafter, P is treated as if it is liquidated, with B and C each receiving their proportionate share of the interests in the new partnership. The contribution by P of its asset to the new partnership is governed by section 721, and the liquidating distributions by P of the interests in the new partnership are governed by section 731. C does not realize a basis adjustment under section 743 with respect to the amortizable section 197 intangible unless P had a section 754 election in effect for its taxable year in which the transfer of the partnership interest to C occurred or the taxable year in which the deemed liquidation of P occurred.

(iii) Under section 197, if P had a section 754 election in effect, C is treated as if the new partnership had acquired two assets from P immediately preceding its termination. Even though the adjusted basis of the new partnership in the two assets is determined solely under section 723, because the transfer of assets is a transaction described in section 721, the application of sections 743(b) and 754 to P immediately before its termination causes P to be treated as if it held two assets for purposes of section 197. See paragraph (g)(3) of this section. B's and C's proportionate share of the new partnership's adjusted basis is $25 each in one asset, which continues to be amortized over the 10 years remaining in the original 15-year amortization period. For the other asset, C's proportionate share of the new partnership's adjusted basis is $25 (the amount of the basis increase resulting from the application of section 743 to the sale or exchange by A of the interest in P), which is amortized over a new 15-year period beginning in January 2000.

(iv) If P did not have a section 754 election in effect for its taxable year in which the sale of the partnership interest by A to C occurred or the taxable year in which the deemed liquidation of P occurred, the adjusted basis of the new partnership in the amortizable section 197 intangible is determined solely under section 723, because the transfer is a transaction described in section 721, and P does not have a basis increase in the intangible. Under section 197(f)(2) and paragraph (g)(2)(ii) of this section, the new partnership continues to amortize the intangible over the 10 years remaining in the original 15-year amortization period. No additional amortization is allowable with respect to this asset.

[5796] In proposing regulations that T.D. 8717 (5/8/1997) finalized, [PS-5-96], Termination of a Partnership under Section 708(b)(1)(B), stated:

tax differences when depreciating assets.[5797] The terminating partnership cannot depreciate any assets it places in service during the termination year;[5798] rather the new partnership depreciates them, including receiving bonus depreciation[5799] for any assets placed in service during the termination year.[5800]

- For purposes of certain procedures regarding changing accounting methods, a technical termination constitutes cessation of a trade or business.[5801]

- The new partnership retains the old partnership's tax ID.[5802] Each of the old and new partnership files a short period return, with the new partnership filing a return for its taxable year beginning after the date of termination of the terminated partnership.[5803]

Contrast this with a corporation (whether or not an S election is in place). It is not deemed to terminate when its shareholders change, although a change in shareholders could impair the use of net operating losses, etc.[5804]

> In addition, the proposed regulations will not change the effect of a termination on the depreciation of partnership property by the new partnership. Property deemed contributed to the new partnership will continue to be subject to the anti-churning provisions of section 168(f)(5), which generally require the new partnership to depreciate the property as if it were newly-acquired property under the same depreciation system used by the terminated partnership. This result is required by statute and is not affected by the specific mechanics of a termination under section 708(b)(1)(B). See Code sections 168(f)(5); 168(i)(7); 168(e)(4) and (f)(10)(repealed 1986).

Code § 168(i)(7) provides that the transferee steps into the shoes of the transferor when depreciating an asset to which Code § 332, 351, 361, 721, or 731 applies. However, Code § 168(i)(7)(B) provides that this rule does not apply in the case of a partnership's termination under Code § 708(b)(1)(B). By negative implication, such a termination restarts the depreciation period. See McKee, Nelson & Whitmire, ¶ 13.05[2][k] Effect on Depreciation of Partnership Property, *Federal Taxation of Partnerships & Partners* (WG&L).

[5797] Reg. § 1.704-3(a)(2).

[5798] Reg. § 1.168(d)-1(b)(3)(ii) includes:

> No depreciation deduction is allowed for property placed in service and disposed of during the same taxable year.

[5799] See part II.G.5.b Bonus Depreciation.

[5800] Reg. § 1.168(k)-1(b)(5)(iii).

[5801] See Section 3.04(2)(f) of Rev. Proc. 2015-13, the other provisions of which Rev. Proc. 2015-33 clarified. Lovett, "Technical Termination of LLCs and Partnerships: Overview, Mechanics and Opportunities," *TM Real Estate Journal* (BNA) (2/1/2017), suggests that the termination's closing the tax year will require that two separate installments of a prior Code § 481(a) adjustment be taken into account in one calendar year.

[5802] Reg. § 301.6109-1(d)(2)(iii); see also the Example in Reg. § 1.708-1(b)(4).

[5803] Notice 2001-5.

[5804] Code § 382.

II.Q.8.e.v. Partnership Mergers

For partnership mergers, see Notice 2005-15,[5805] Notice 2009-70[5806] and any related proposed regulations.[5807] For an overview of mergers, with helpful charts and diagrams, see Borden,

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[5805] Notice 2005-15 announced the principles of proposed regulations, which Notice 2009-70, § 2 described:

> On August 22, 2007, the IRS and the Treasury Department published in the Federal Register (2007-41 I.R.B. 790 [72 FR 46932]) a notice of proposed rulemaking (REG-143397-05) (the Proposed Merger Regulations), consistent with Notice 2005-15 (2005-1 C.B. 527), providing that (1) section 704(c)(1)(B) applies to newly created section 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over merger, but does not apply to newly created reverse section 704(c) gain or loss resulting from a revaluation of property in the continuing partnership, and (2) for purposes of section 737(b), net precontribution gain includes newly created section 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over merger, but does not include newly created reverse section 704(c) gain or loss resulting from a revaluation of property in the continuing partnership. On November 6, 2007, corrections to the proposed regulations were published in the Federal Register (72 FR 62608).
>
> The proposed regulations include several examples. Example (3) of the proposed regulations (see Treas. Proposed Reg. § 1.704-4(c)(4)(ii)(F), Example (3)) involves a situation where built-in gain property contributed to the transferor partnership has both a revaluation loss in the transferor partnership and additional gain upon merger with the transferee partnership. The example concludes that the section 704(c) layers are collapsed in the merger and that upon contribution to the transferee partnership the property had only built-in gain and no built-in loss.

After describing Example (3), Notice 2009-70 states:

> A number of rules in existing regulations may be relevant to mergers, divisions and tiered partnerships. In particular Treas. Reg. § 1.704-3(a)(7)-(9) may apply.

[5806] Notice 2009-70, § 3, "Discussion," provides:

> While no requests for a hearing were received in response to the proposed regulations issued on August 22, 2007, the IRS and the Treasury Department did receive comments relating to the proposed regulations and took notice of a number of articles published in response to the proposed regulations.
>
> Most of the comments and articles address Example (3) which provides that property either has a built-in gain or built-in loss upon merger, not both, and that original section 704(c) gain is reduced by subsequent revaluation losses. Several comments discussed not only the specifics of Example (3), but also the broader implications of the example. In particular, the commentators questioned whether the example implies that a subsequent revaluation loss would reduce prior section 704(c) gains rather than create a new section 704(c) loss layer where there has been no partnership merger. Another comment suggested that the section 704(c) allocations in the example could be different if, for example, the transferor partnership used the remedial method instead of the traditional method. Other commentators expressed concerns that the application of the proposed regulations would result in tax allocations after the merger that are not consistent with the economic arrangement of the partners of the transferor partnership. For example, if layers of reverse section 704(c) built-in gain or built-in loss are collapsed in the merger, then a partner who prior to the merger was allocated a net loss for book purposes with respect to the property would not recognize a corresponding tax loss until liquidation of its interest. They contend that if the transferor partnership had continued in existence instead of liquidating, the section 704(c) layers would have been preserved under the tiered partnership rules of Treas. Reg. § 1.704-3(a)(9). Some practitioners believe the results should be the same in a merger.
>
> The IRS and the Treasury Department have also become aware that there are conflicting views among practitioners about how section 704(c) layers should be maintained with respect to tiered partnerships. One view is that an aggregate approach should apply or be permitted such that a tiered partnership arrangement can be "looked through" and section 704(c) applied as if the

"Navigating State Law and Tax Issues Raised by Partnership and LLC Reorganizations," *Business Entities* (Jul./Aug. 2014), suggesting using an "assets-over" form to preserve basis or holding period and an "assets-up" type to change basis or holding period.[5808] For example, TAM 201929019[5809] asserted that a deemed distribution of a partnership interest in an assets-over merger (described below) is treated as an exchange that triggered an automatic basis step-down (or would have triggered a basis step-up if a Code § 754 election had been place and the assets had increased in value) under part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000. Hamill, "Tax Reporting Issues Following a Merger of Partnerships," *Journal of Taxation* (6/2023),[5810] discussed:

> This article will address the tax filing requirements and reporting issues for the terminated and continuing partnerships. This will include basic information such as due dates for tax returns, use of tax identification numbers, identification and survival of tax attributes, any information required to be attached to the returns, reporting of shares of liabilities in the continuing partnership and the effects of any shifts in such shares, determinations of MACRS deductions in the terminated and continuing partnerships, and the holding periods of partnership properties and partnership interests. The intent is to assist the tax return preparers of the combining partnerships with both basic and advanced reporting issues. Exhibits are provided to identify the continuing partnership,

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> partners of the upper-tier partnership directly own a portion of the assets of the lower-tier partnership (the Aggregate Approach). Another view is the entity approach under which the upper-tier partnership is treated as owning an interest in the lower-tier partnership but is not treated as owning any interest in the section 704(c) property of the lower-tier partnership (the Entity Approach). Each approach raises different issues and has unique consequences.
> After extensive consideration of the concerns raised, the IRS and the Treasury Department believe that comments would be helpful to the development of guidance concerning section 704(c) layers in tiered partnerships and in mergers and divisions. The IRS and Treasury Department believe that it is appropriate to consider the issues regarding section 704(c) layers in general before finalizing the Proposed Merger Regulations.

Notice 2009-70 requested comments on a number of issues, without requesting comments on the principles described in Notice 2005-15.

[5807] See also CCA 201315026. RIA Checkpoint *Catalyst*, ¶ 218:111 Merger or Consolidation of Partnerships, described a ruling:

> In IRS Letter Ruling 201619001, a real estate investment trust (REIT) formed a partnership (OP), then transferred cash and its own stock to the partnership in exchange for a partnership interest. A second partnership (M) then transferred all of its assets to OP in exchange for OP partnership interests and the REIT stock. M then liquidated, distributing the REIT stock to some of its partners and the OP partnership interests to the remaining partners. The IRS ruled that the transaction was a merger of OP and M under Reg. § 1.708-1(c). IRS Letter Ruling 201619001.
>
> > Comment: In IRS Letter Ruling 201619001, M was formed immediately before the merger as the result of the division of a third partnership (X) into two separate partnerships. The IRS respected the form of the transaction as a division followed by a merger. The apparent purpose of this form was to permit the partners of X receiving REIT stock (who were also partners of M after the division) as having sold their partnership interests in M to OP under Reg. § 1.708-1(c)(4) (see ¶ 218:114) For further discussion, see Substance Over Form Exception in ¶ 218:113.

[5808] For a description of the two types of transactions, see part II.Q.8 Exiting From or Dividing a Partnership, especially part II.Q.8.d.iii Assets-Over vs. Assets-Up Division.

[5809] See fn 5623 of part II.Q.8.e.i Distribution of Partnership Interests.

[5810] Saved as Thompson Coburn LLP doc. no. 30167834.

distinguish the two forms of combinations, and identify the statutory provisions supporting the tax consequences of a merger or consolidation.

More detailed issues that may confound reporting will also be discussed. These include: (1) The treatment of old and new layers of Section 704(c) gain or loss, including partner-level reporting for items M and N on a partner's schedule K-1; (2) The treatment of the 7-year rule for recognition of Section 704(c) gains as a result of a distribution that triggers either Section 704(c)(1)(B) or Section 737; (3) The recording of tax basis and Section 704(b) "book" basis capital accounts for the continuing partnership; (4) The ability of the continuing partnership to complete a Section 1031 exchange started by any of the partnerships involved in the merger or consolidation; (5) The effect of the merger or consolidation on an partnership election to defer gain by investing in a qualified opportunity fund or a merger of partnerships with interests qualifying as qualified opportunity zone property; (6) Tax allocations in the continuing partnership in the year of merger based on the varying interests rule; (7) The effect of the merger or consolidation on prior Section 465 aggregation or Section 469 grouping decisions of the combining partnerships; (8) The effect of the merger or consolidation on the ability of the continuing partnership to change or to make new aggregation decisions for purposes of Section 199A ; and, (9) The applicability of the Section 743(d) mandatory basis adjustment rule.

Below are some details of partnership mergers.

If two or more partnerships merge or consolidate into one partnership, the resulting partnership is considered a continuation of the merging or consolidating partnership the members of which own an interest of more than 50% in the capital and profits of the resulting partnership.[5811] Generally, if this resulting partnership can be considered a continuation of more than one of the merging or consolidating partnerships, it is considered the continuation solely of that partnership which is credited with the contribution of assets having the greatest fair market value (net of liabilities) to the resulting partnership, and any other merging or consolidating partnerships shall be considered as terminated.[5812] However, if the members of none of the merging or consolidating partnerships have an interest of more than 50% in the capital and profits of the resulting partnership, all of the merged or consolidated partnerships are terminated, and a new partnership results.[5813]

The taxable years of any merging or consolidating partnerships which are considered terminated shall be closed in under Code § 706(c) the regulations thereunder, and those partnerships shall file their returns for a taxable year ending upon the date of merger or consolidation.[5814] Any resulting partnership shall file a return for the taxable year of the merging or consolidating partnership that is considered as continuing.[5815]

A merger is an "assets-over" merger unless it as an "assets-up" merger.[5816] In an "assets-up" merger, the merged or consolidated partnership that is considered terminated as described above distributes all of its assets to its partners (in a manner that causes the partners to be

[5811] Code § 708(b)(2)(A); Reg. § 1.708-1(c)(1).
[5812] Reg. § 1.708-1(c)(1).
[5813] Reg. § 1.708-1(c)(1).
[5814] Reg. § 1.708-1(c)(2).
[5815] Reg. § 1.708-1(c)(2), which also provides that the resulting partnership shall keep its original taxpayer identification number and include certain tax disclosures.
[5816] Reg. § 1.708-1(c)(3)(i).

treated, under the laws of the applicable jurisdiction, as the owners of such assets) in liquidation of the partners' interests in the terminated partnership, and immediately thereafter, the partners in the terminated partnership contribute the distributed assets to the resulting partnership in exchange for interests in the resulting partnership.[5817] The form of such a partnership merger or consolidation will be respected for federal income tax purposes despite the partners' transitory ownership of the terminated partnership's assets.[5818]

When two or more partnerships merge or consolidate into one partnership under the applicable jurisdictional law, without undertaking a form for the merger or consolidation, or undertake a form for the merger or consolidation that is not an assets-up merger, any merged or consolidated partnership that is considered terminated is treated as undertaking the assets-over form for Federal income tax purposes.[5819] Under the assets-over form, the merged or consolidated partnership that is considered terminated contributes (or is treated as contributing) all of its assets and liabilities to the resulting partnership in exchange for an interest in the resulting partnership, and immediately thereafter, the terminated partnership distributes interests in the resulting partnership to its partners in liquidation of the terminated partnership.[5820] For whether an assets-over merger constitutes a Code § 761(e) transfer, see TAM 201929019, described in the text following fn 5623 in part II.Q.8.e.i Distribution of Partnership Interests.

Code §§ 704(c)(1)(B) and 737 and Reg. §§ 1.704-4 and 1.737-2 do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in Code § 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement.[5821] A later distribution of Code § 704(c) property by the transferee partnership to a partner of the transferee partnership is subject to Code § 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to Code § 704(c)(1)(B).[5822] Similarly, a later distribution of property by the transferee partnership to a partner of the transferee partnership that was formerly a partner of the transferor partnership is subject to Code § 737 to the same extent that a distribution from the transferor partnership would have been subject to Code § 737.[5823]

In an assets-over merger, a sale of all or part of a partner's interest in the terminated partnership to the resulting partnership that occurs as part of a merger or consolidation will be respected as a sale of a partnership interest if the merger agreement (or another document) specifies that the resulting partnership is purchasing interests from a particular partner in the merging or consolidating partnership and the consideration that is transferred for each interest sold, and if the selling partner in the terminated partnership, either before or at the same time as the transaction, consents to treat the transaction as a sale of the partnership interest.[5824]

[5817] Reg. § 1.708-1(c)(3)(ii).
[5818] Reg. § 1.708-1(c)(3)(ii).
[5819] Reg. § 1.708-1(c)(3)(i).
[5820] Reg. § 1.708-1(c)(3)(i).
[5821] Reg. §§ 1.704-4(c)(4), 1.737-2(b)(1).
[5822] Reg. § 1.704-4(c)(4).
[5823] Reg. § 1.737-2(b)(3).
[5824] Reg. § 1.708-1(c)(4), referring to Code § 741 and Reg. § 1.741-1 for determining the selling partner's gain or loss on the sale or exchange of the partnership interest; see part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest. Letter Ruling 201619001 (described in fn. 5807) respected a sale under

When merging, consider whether any relief of debt or other actual or deemed distributions within two years might constitute a disguised sale. See part II.M.3.e Exception: Disguised Sale. However, some divisions might be taxable to the extent that they rely on Code § 721(a) nonrecognition.[5825]

The IRS expects to issue regulations, effective for distributions from partnerships made after January 19, 2005, providing the following regarding Code § 704(c) gain and reverse-Code § 704(c) gain:[5826]

> The regulations will apply the principles of Rev. Rul. 2004-43 to distributions of property following assets-over partnership mergers. The regulations will apply to distributions of property with newly created § 704(c) gain or loss whether or not that gain or loss is treated as reverse § 704(c) gain or loss as the result of a revaluation by the transferor partnership. The regulations also will apply to distributions of property with original § 704(c) gain or loss that existed upon contribution to the transferor partnership. However, the regulations will provide that if the transferor partnership in an assets-over merger holds contributed property with original § 704(c) gain or loss, the seven year periods in §§ 704(c)(1)(B) and 737 do not restart with respect to that gain or loss as a result of the merger.
>
> The regulations will provide that § 704(c)(1)(B) does not apply to newly created § 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger involving partnerships owned by the same owners in the same proportions. In addition, the regulations will provide that for purposes of § 737, net precontribution gain does not include newly created § 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger involving partnerships owned by the same owners in the same proportions. In order for merging partnerships to qualify for the exceptions described in this paragraph, each partner's percentage interest in the transferor partnership's capital, profits, losses, distributions, liabilities, and all other items must be the same as the partner's percentage interest in those items of the continuing partnership.

The survivor of merged partnerships may want to see whether it qualifies for special Code § 704(c) accounting for securities partnerships.[5827]

Reg. § 1.708-1(c)(4), when the contribution agreement relating to a merger will specify (i) that the partnership is purchasing its interest in another partnership from each particular partner in the purchasing partnership and (ii) the consideration that is transferred for each interest purchased.

[5825] If a foreign person is directly or indirectly involved, see the discussion of when Code § 721(a) does not apply to any deemed contribution to a partnership in part II.M.3.g Exception: Foreign Partner (among various other exceptions to Code § 721(a).

[5826] Notice 2005-15. Query whether the regulations would be retroactive, given all of the time that has passed. For a description of reverse-Code § 704(c) allocations, see part II.Q.8.b.i.(f) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, especially fns. 5444-5447.

[5827] See fn. 3878 (especially Letter Ruling 201710008), found in part II.P.1.a.i Allocations of Income in Partnerships.

A book-up resulting from a revaluation (which results from a merger or consolidation) may shift nonrecourse liabilities,[5828] which can generate income tax.[5829] When two or more partnerships merge or consolidate in an assets-over merger, increases and decreases in partnership liabilities associated with the merger or consolidation are netted by the partners in the terminating partnership and the resulting partnership to determine the effect of the merger under the Code § 752 rules allocating liabilities to partners and determining whether a change in liabilities constitutes a distribution or contribution.[5830] For more information, see part II.C.3 Allocating Liabilities (Including Debt).

If any merger described above is part of a larger series of transactions and the substance of the larger series of transactions is inconsistent with following the form prescribed above, the IRS may disregard the form and recast the larger series of transactions according to their substance.[5831]

Langdon and Byrd, "Missing Partnership Merger Definition Raises Questions," *The Tax Advisor* (7/2016), discussed "determining the federal income tax consequences when a taxpayer collapses two partnerships - one an upper-tier partnership, or UTP, and the other a lower-tier partnership, or LTP - into a single entity." The article says:

> The lack of a merger definition means that the tax characterization can vary dramatically depending on how the transaction is viewed. To illustrate possible different treatments, consider this scenario.
>
> **Example**: X, Y, and a UTP own 10%, 10%, and 80% interests, respectively, in an LTP. Neither X nor Y holds an interest in the UTP. The parties agree to consolidate the two entities by having X and Y contribute their LTP interests to the UTP in exchange for interests in the UTP. For state law purposes, both legal entities still exist after the transaction, although for federal income tax purposes only one partnership remains. The remaining partnership is owned 10% by X, 10% by Y, and 80% by the UTP's former partners.

[5828] See text preceding and accompanying fn 398 in part II.C.3.c Allocations of Recourse and Nonrecourse Liabilities.

[5829] See part II.C.3.a Basic Consequences of Changes in Liability Allocations.

[5830] Reg. § 1.752-1(f).

[5831] Reg. § 1.708-1(c)(6)(i), providing the following example in Reg. § 1.708-1(c)(6)(ii):

> A, B, and C are equal partners in partnership ABC. ABC holds no section 704(c) property. D and E are equal partners in partnership DE. B and C want to exchange their interests in ABC for all of the interests in DE. However, rather than exchanging partnership interests, DE merges with ABC by undertaking the assets-up form described in paragraph (c)(3)(ii) of this section, with D and E receiving title to the DE assets and then contributing the assets to ABC in exchange for interests in ABC. As part of a prearranged transaction, the assets acquired from DE are contributed to a new partnership, and the interests in the new partnership are distributed to B and C in complete liquidation of their interests in ABC. The merger and division in this example represent a series of transactions that in substance are an exchange of interests in ABC for interests in DE. Even though paragraph (c)(3)(ii) of this section provides that the form of a merger will be respected for Federal income tax purposes if the steps prescribed under the assets-up form are followed, and paragraph (d)(3)(i) of this section provides a form that will be followed for Federal income tax purposes in the case of partnership divisions, these forms will not be respected for Federal income tax purposes under these facts, and the transactions will be recast in accordance with their substance as a taxable exchange of interests in ABC for interests in DE.

Because of the lack of guidance on partnership mergers, there appear to be at least three potential characterizations of this transaction for federal income tax purposes.

Alternative 1: LTP Merges Into UTP

It is generally thought a merger exists in any case in which (1) at least two tax partnerships exist immediately before a transaction, (2) immediately after the transaction only one tax partnership exists, and (3) the equity holders of each of the preexisting tax partnerships become equity holders in the single remaining tax partnership as part of the transaction. From this perspective, the transaction could be viewed as a merger because two partnerships existed at the beginning of the day and only one partnership remains at the end.

Sec. 708(b)(2)(A) provides:

> In the case of a merger or consolidation of two or more partnerships, the resulting partnership shall, for purposes of this section, be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership [(the ownership test)].

Here, determining which of the LTP or the UTP should be considered the continuing partnership depends on whether an aggregate or entity approach to partnerships is taken.

Under an entity approach, of the historic partners of the LTP (X, Y, and the UTP), only X and Y hold interests in the resulting partnership (20%). The historic partners of the UTP hold the remaining 80% interest in the resulting partnership. Accordingly, the resulting partnership would appear to be considered a continuation of the UTP. This result depends on treating the UTP as an entity for purposes of applying the ownership test.

If the UTP were treated as an aggregate, then arguably both partnerships would be treated as continuations, but under Regs. Sec. 1.708-1(c)(1), the resulting partnership would be treated as a continuation of the LTP because the net value of the LTP's assets exceeded the net value of the UTP's assets. The aggregate approach appears to be inconsistent with the entity-level focus of Sec. 708, but if it were applied, the application of the merger rules would be largely consistent with the liquidation of the UTP and continuation of the LTP characterization discussed below. Under Regs. Sec. 1.708-1(c)(3)(i), the form of a merger then would be characterized as the LTP contributing all its assets and liabilities to the UTP for a "hook" interest, with the LTP then making a liquidating distribution of the new UTP interests to its partners (UTP, X, and Y).

The merger characterization may not be an exact fit for this transaction because a common expectation of a merger is that the resulting entity will go forward with a combination of assets and operations obtained from the merged entities. In this transaction, there has been no combination of assets and operations. The historic holding company activity of the UTP has disappeared, and the historic operating activity of the LTP has survived without any change other than the identity of the majority of its direct owners. Furthermore, application of the ownership test appears inconsistent with the realities of the transaction because the UTP would be viewed as the continuing partnership despite contributing no real assets in the transaction, while the LTP is deemed to terminate despite being the source of all the assets.

Alternative 2: UTP Liquidates and LTP Continues

If the results of the merger characterization do not quite fit the economic realities of the transaction, Sec. 708 suggests an alternative characterization. Sec. 708(a) provides that an existing partnership shall be considered as continuing if it is not terminated, and Sec. 708(b)(1)(A) provides that a partnership will be considered terminated if no part of its business, financial operation, or venture is carried on by any of its partners in a partnership form. Under this rule, the LTP would be treated as continuing because the LTP's historic business would still be operated in partnership form, while the UTP would be treated as terminating because its historic business—holding an investment in the LTP—would no longer exist.

If the LTP is considered to continue, then the substance of the transaction appears to be a liquidation of the UTP. Under a liquidation scenario, the UTP is deemed to make liquidating distributions of the LTP interests to its partners, and, pursuant to Sec. 732(b), the partners would take a substituted basis in the LTP interest received.

The UTP's liquidation view gives effect to the requirements of Secs. 708(a) and 708(b)(1)(A) and avoids creating a new layer of Sec. 704(c) gain, but it seems out of line with the form of the transaction. The partners that actually engage in a transaction (X and Y) are treated as doing nothing, while the partners of the UTP (which do not engage in a state law transaction) are treated as exchanging their interests in the UTP for interests in the LTP.

Alternative 3: X and Y Contribute LTP Interests in a Sec. 721 Transaction

As a third alternative, it may be appropriate to give effect to the form of the transaction (a Sec. 721 contribution of interests in the LTP by X and Y to the UTP). Following the contribution, the UTP would hold all the partnership interests in the LTP, and the LTP would terminate under Sec. 708(b)(1)(A).

This perspective is similar to what is described in Rev. Rul. 99-6, Situation 1, in which Partner B purchases, in a taxable transaction, the partnership interests held by Partner A. Under the ruling, Partner A is treated as selling its interest to Partner B, but Partner B must treat the transaction as if (1) the partnership made a liquidating distribution of a proportionate interest in the partnership assets to Partner A; (2) Partner A sold its proportionate interest in assets to Partner B; and (3) Partner B received a liquidating distribution of its proportionate interest in assets from the partnership.

As with the merger characterization, this viewpoint appears to create a layer of Sec. 704(c) gain for X and Y. In addition, it is not clear that Rev. Rul. 99-6 was intended to apply to a nonrecognition transaction. If it was intended to apply to this transaction, it is not clear that the Sec. 721 contribution viewpoint can be reconciled with the terms of Sec. 708(b)(1)(A). If the model of Rev. Rul. 99-6 is followed, the LTP would terminate under Sec. 708(b)(1)(A), but this characterization is inconsistent with the terms of the statute because X and Y continue to be partners with regard to the historic operations of LTP. Under existing case law (*Byrum*, 440 F.2d 949 (6th Cir. 1971), *aff'd*, 408 U.S. 125 (1972)), a revenue ruling may be disregarded if it conflicts with the statute it purports to interpret.

Conclusion

None of these three characterizations appears to meet all of the existing guidance and policies of the transaction. The absence of a definition of "merger" for purposes of Sec. 708 makes it difficult for taxpayers to know how to appropriately apply the U.S. federal income tax rules when faced with choosing among at least these three possible characterizations and possibly more when a holding partnership structure is collapsed.

II.Q.8.e.vi. Required Documentation to Avoid Withholding on Sale or Redemption of Partnership Interest

Generally, if any portion of the gain (if any) on any disposition of an interest in a partnership would be treated under Code § 864(c)(8) as effectively connected with the conduct of a trade or business within the United States, the transferee shall be required to deduct and withhold a tax equal to 10% of the amount realized on the disposition.[5832]

However, this requirement does not apply if the transferor furnishes to the transferee an affidavit by the transferor stating, under penalty of perjury, the transferor's United States taxpayer identification number and that the transferor is not a foreign person.[5833]

A sample affidavit is in Thompson Coburn LLP doc. no. 6729373.

Also see Notice 2018-29, "Guidance Regarding the Implementation of New Section 1446(f) for Partnership Interests That Are Not Publicly Traded."

II.Q.9. Trust Selling a Business

See parts:

- II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets,
- II.J.15 QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items, and
- II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.

[5832] Code § 1446(f)(1).

[5833] Code § 1446(f)(2)(A). Subparagraphs (B) and (C) provide:

(B) *False affidavit*. Subparagraph (A) shall not apply to any disposition if -

(i) the transferee has actual knowledge that the affidavit is false, or the transferee receives a notice (as described in section 1445(d)) from a transferor's agent or transferee's agent that such affidavit or statement is false, or

(ii) the Secretary by regulations requires the transferee to furnish a copy of such affidavit or statement to the Secretary and the transferee fails to furnish a copy of such affidavit or statement to the Secretary at such time and in such manner as required by such regulations.

(C) *Rules for agents*. The rules of section 1445(d) shall apply to a transferor's agent or transferee's agent with respect to any affidavit described in subparagraph (A) in the same manner as such rules apply with respect to the disposition of a United States real property interest under such section.

See also parts:

- II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation,
- II.I.8.d.iv Treatment of Code § 736 Redemption Payments under Code § 1411, and
- II.I.8.g Structuring Businesses in Response to 3.8% Tax.

II.R. Choice of Entity Hypothetical

Alice, Ben and Connie want to form a business manufacturing and selling widgets. They have been friends for many years. Even though they consider themselves family, technically they are not related to each other.

Alice is a natural at sales. She has many contacts and could sell any product that she believes is beneficial to the customer. Alice is terrific at selling not only to potential customers but also potential investors.

Ben is great at putting together and running organizations. He always knows what is going on in the business, tracking current progress, making short-term and long-term financial projections, and keeping everyone focused on the company's goals. Ben is talented at securing financing and making investors feel comfortable that they are receiving accurate information.

Connie is a creative genius. She has scientific knowledge, engineering skills, and a keen mind for how to make machines and manufacturing and packaging processes work. Connie will enable the company to be a low-cost producer for generic products and to efficiently tailor manufacturing processes to fit special customer needs.

Initial Formation - Year 1

Connie came up with a revolutionary widget that every household should have, and Alice has informally discussed with various retailers how they might help market the product. Ben has arranged a $1,000,000 bank loan, but the bank is going to make Alice, Ben and Connie personally guarantee loan repayment. Alice, Ben and Connie have agreed to take no compensation the first year, $50,000 each the second year, and then see where the business is headed. The business requires a $500,000 machine, as well as five employees to run it, initially under Connie's supervision. The business leases its space.

How should they set up their deal in Year 1?

Types of entities: sole proprietorships, partnerships, C corporations and S corporations. Business ownership and management structure. Tax on formation. Allocating gain when entity later sells contributed property. Ability to deduct losses: basis and at-risk limitations; net operating losses at entity vs. shareholder level; Code § 1244 stock. Allocating gain and loss from ongoing operations; tax distribution clauses. Self-employment/FICA tax: partnership vs. limited partnership vs. S corporation vs. C corporation.

Outside Investors - Year 2

Due to additional capital needs to take the business to the next level, Alice has been working on securing two investors who would put up capital of $250,000 each. They seek an annual preferred return of 20%, as well as one-fifth each of the business' residual value.

How should they bring in the investors? What governance/approval mechanisms would the investors want to protect themselves?

Tax on later contribution to entity. Allocation of income from operations, including preferred returns and, if taxed as a partnership, disguised sale issues. Restrictions on shareholders (S corporations).

Buying Out Outside Investors - Year 5

In Year 5, the business is earning $600,000 per year net profit, after paying $100,000 annual compensation to each of Alice, Ben and Connie. Alice, Ben and Connie are not getting along with the outside investors and want to buy them out. They believe the business will continue to expand and do not wish to share this growth with the investors when the company is later sold, and they are tired of paying a 20% return to the investors.

How should Alice, Ben and Connie go about buying out the investors? How would the form of organization affect this?

Structurally, it would require an agreement on the part of the investors to be bought out. The founders could have an option built into the original financing arrangements allowing them to buy back at certain formula, or upon certain triggers. Discuss dispute resolution mechanisms as well as buy-out options. Contrast S corporation or C corporation buy-out with after-tax dollars with LLC buy-out with pre-tax dollars under Code § 736, which can eliminate capital gain tax on part or all of the complete liquidation of an LLC member's interest.

Bigger Workforce; Family Business Succession Planning - Year 10

In Year 10, the business is earning $2,000,000 net profit, after paying $250,000 annual compensation to each of Alice, Ben and Connie. It has full sales and manufacturing forces and excellent office support, for a total of 50-100 employees. Everyone loves these new widgets; Connie keeps finding ways to improve the product; and Alice keeps finding new customers. Ben, however, is tired of trying to keep up with their unbridled energy. Ben's son, George, just received an MBA from a leading business school. Ben thinks that George should take over Ben's job and would like to transfer some of his equity to him. Alice and Connie agree to let George work his way into the business, getting experience in various office functions and eventually moving up to Ben's job in five years if George works out well.

How should they handle George's new role and Ben's phasing out of his own role? What if George turns out to be a slacker?

Estate planning issues: tax rates and exemption levels, ability to make gifts, transferring business opportunities or leveraged businesses, asset protection planning using trusts, passing to spouse and children, fair vs. equal, dividing into voting and nonvoting ownership interests, need for single class of equity interest (consider nonvested stock), and estate tax issues with related party buy-sell agreements. Alice, Ben and Connie want to institute some kind of nonqualified deferred compensation plan for themselves. Develop simple performance bonus for George, payable within 2½ months after close of year with no option for deferral. Important to set goals based on where Alice, Ben and Connie want George to be in five years. If George turns out to be a slacker, he gets no bonus. When Ben wants to transfer some of his shares to George, consider the issues of restrictions on transfer, rights of first refusal, etc.

Purchase of Retiring Founder's Interest; Business Succession Planning to Current Key Employee - Year 15

In Year 15, Alice gets bored. She wants to sell her share of the business to Ben, George and Connie and retire to a tropical island, along with the main characters in John Grisham's first two books. Sally, an employee who has been a top salesman for years, wants to take Alice's job. However, Sally has no money to invest to buy out Alice. Furthermore, Sally wants some financial incentives based on the company's sales and profitability.

Should the company, the other owners, or Sally buy out Alice? What kind of incentives should Sally be given?

Availability of capital gain rates when entity sells assets. Tax on splitting up or dissolving. Code § 736 payments. Consider phantom shares or restricted stock for Sally. George needs to be ahead of Sally because he is the son of the founder and, in his mind, the heir apparent. Include George in same plan developed for Sally. Also see issues from Year 10.

Purchase of Deceased Founder's Interest, Including Possible Sale of Business - Year 20

In Year 20, Connie dies. The stresses of keeping up with changing technology and foreign competition left her exhausted.

How should the remaining owners handle buying out Connie's ownership interest, which under her estate plan would pass to her husband, Herman?

Instead, should they sell the business? To the employees or to outside investors? Possible merger?

What if the remaining owners prefer to retire, turning the business over to the employees?

Estate tax deferral. Restricted stock (or phantom stock) immediately vested. Also see issues from Year 15.

III. Estate Planning Implications

The first section of this portion deals with drafting and administering trusts and estates, including income taxation and fiduciary responsibility. The second section deals with transfer tax issues, including transfers during life, estate tax issues, and special valuation issues (including the effect of buy-sell agreements). The third section discusses fairness within families, including allocating assets when businesses are involved and potential conflicts of interest involved in those allocation decisions.

The American College of Trust and Estate Counsel provides free estate planning resources for those who do not specialize in the field.

The AICPA has Trust, Estate and Gift Tax Resources.[5834]

III.A. Drafting and Administering Trusts and Estates

Drafting trusts to hold business interests involves melding the grantor's wishes with the related income tax consequences, especially when holding stock in S corporations. Trustees need to consider diversifying, but when a special purpose of the trust is to hold a business interest, the trustees will want to make sure that the businesses are professionally run in a manner that is both economically sound for the beneficiaries but also minimizes the trustees' liability.

III.A.1. General Benefits of Trusts

Increasingly, people are becoming aware of the need to protect their assets from claims by creditors or spouses. Clients can do a big favor for their surviving spouses or children by leaving assets in trust instead of outright. The trust agreement can provide them with virtually complete control over the trust. Or, if clients wish, the trust agreement could be very restrictive. It all depends on what they want.

For example, a wife leaves her entire estate outright to her husband upon her death. They orally agree that he will leave her remaining assets to their children at his death. Unfortunately, that's a moral, not a legal, agreement. Suppose the husband remarries after the wife's death. Under Missouri law, upon his death, his new spouse would have the right to about 1/3 of his estate. This would be contrary to the clients' originally agreed goal of having all of their assets pass to their children at her death.

What about estate taxes? A credit shelter trust can protect future appreciation from estate tax, for those concerned about it. Lawyers can include various options to attain basis step-up through selective estate inclusion, to the extent it later turns out to be beneficial.

Clients can avoid these problems and reduce or avoid estate tax by leaving their property in trust for the surviving spouse. If they wish, the surviving spouse can be the sole trustee, take distributions for support as the surviving spouse determines, and change how the trust's assets pass at the surviving spouse's death to take into account changes in their children's family circumstances. Because the assets are in a trust the first spouse created, if the second spouse remarries, the new spouse would not have a claim on them upon the second spouse's death. Because the first spouse used his or her estate tax exclusion amount to create the trust, it will be excluded from the surviving spouse's estate at the surviving spouse's death, and the surviving spouse can use his or her exclusion amount to cover the assets that the surviving spouse owned outside of that trust.

What about leaving assets to children? Even adult children may need protection from creditors and spouses. Suppose a child starts a new business. The child's creditors will demand personal guarantees. If the client leaves assets to the child outright, they would be at risk. Likewise, if the child marries, the child's spouse might persuade the child to put the money in a joint account. If the child later divorces, the child will need to split this account with the soon-to-be ex-spouse.

[5834] See http://www.aicpa.org/INTERESTAREAS/TAX/RESOURCES/TRUSTESTATEANDGIFT/Pages/default.aspx.

When I asked a client whether he liked the idea of trusts for his children, he told me about his neighbor. The neighbor bought a house for his daughter and her husband. The house was titled jointly in their names. When the daughter divorced, the neighbor bought his ex-son-in-law's half so that the daughter could own the house outright. In other words, the neighbor paid for his daughter's house one and a half times!

Clients can avoid these, and other (special needs trusts), problems by leaving your property in a separate trust for each child. If the client wishes, his or her child can be the sole trustee of the child's trust, take distributions to support the child as the child determines, and change how the trust's assets pass at the child's death. The child might even be able to pass the trust's assets free from estate tax, even if the child's separate assets use up the estate tax exclusion amount.

I often authorize an independent person to make unlimited distributions to the beneficiary, to facilitate tax planning or decanting.[5835]

Many states now allow trusts to last forever. However, flexible drafting can let each generation change the rules for the next.

By using trusts, we can help clients protect their families from predators. We can also build in flexibility to allow them to react to changes that nobody can foresee, so that we can help clients give their families a legacy that they might enjoy forever.

III.A.2. Liability Issues

In most states, trusts may hold interests in general partnerships or sole proprietorships only if the governing instrument or a state statute grants the trustee authority to do so, because of the liability risks involved. Even investments in limited liability entities may be considered too risky unless they have a proven track record. The propriety of an authorized investment in a closely-held business is determined by applying the same standard of care as for other assets.[5836]

Under the Uniform Prudent Investor Act (UPIA), [5837] a trustee "shall invest and manage trust assets as a prudent investor would by considering the purposes, terms, distribution requirements, and other circumstances of the trust;" and in making such decisions, the trustee "shall exercise reasonable care, skill and caution."[5838] Additionally, a trustee's investment and management decisions regarding individual assets are to be evaluated with respect to the trust portfolio as a whole and "as part of an overall investment strategy having risk and return objectives reasonably suited to the trust."[5839] While making investment decisions and managing trust assets, the trustee should consider factors such as general economic conditions, tax consequences, the role of the asset in the overall trust portfolio, and the expected return from the asset.[5840] Perhaps the most important factor to be considered is the asset's special relationship or value to the purposes of the trust or to one or more of the beneficiaries, when the special purpose of the trust is to hold a business interest.[5841] This factor ties in with the UPIA's

[5835] See part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.
[5836] See generally, Bogert, *The Law of Trusts and Trustees*, § 679 (Rev. 2d. Ed. 1982).
[5837] Citations to the Uniform Prudent Investor Act (UPIA) are to the version adopted in 1994, published April 18, 1995, by the National Conference of Commissioners on Uniform State Laws.
[5838] UPIA §2(a).
[5839] UPIA §2(b).
[5840] UPIA §2(c) .
[5841] UPIA §2(c)(8).

other requirement that the trustee diversify the trust investments unless special circumstances indicate the trust's purposes would be better served without diversification.[5842] Thus, when the trust's specific purpose is to hold a business interest, a lack of diversity in the assets of the trust will not run afoul of the UPIA's requirements. Finally, the UPIA imposes a "duty of impartiality" when the trust has more than one beneficiary. The trustee is to act impartially in performing his or her duties and in doing so should take into account any differences in the beneficiaries' interests. For example, the trustee has to consider any potential conflicts between the interests of beneficiaries interested in trust income versus those interested in trust principal.[5843] This duty of impartiality will affect the trustee's investment and management conduct with regard to principal and income allocations – especially with regard to tax burden allocations.

The Uniform Trust Code (UTC)[5844] provides default rules governing the trustee's duties and powers but allows for many of those rules to be modified by terms of the trust.[5845] Among those duties are the duty of loyalty and the duty of impartiality among beneficiaries, a duty identical to the UPIA's duty of impartiality.[5846] With regard to the duty of loyalty, the trustee must act in furtherance of the best interests of the beneficiaries. Specifically, when the trust holds a business interest, the trustee has a duty to vote shares and use proper care to promote beneficiary interests; and when the trust is the sole owner of an entity, the trustee should elect or appoint a director or manager to manage the entity in the best interests of the beneficiaries.[5847] In a corporate context, the trustee must vote for corporate directors who will follow policy consistent with the trustee's duty of impartiality. The UTC also emphasizes that when a trustee has special skills or expertise in an area, he or she should use those skills in managing the trust.[5848] In recognition of the trustee's ability to hold business interests, the UTC gives the trustee the power to continue business and take actions that would be taken by shareholders, members, or property owners and allows the trustee to exercise rights of an absolute owner with respect to stocks or other securities.[5849] One might consider including a provision addressing the compensation a person earns as trustee, as a director, and as an officer or other employee of the company – who makes the payments and how do the payments relate to each other. These duties might conflict with the corporate directors' duties to *all* the shareholders.

With regard to partnership interests specifically, National Banks may find it difficult to hold a partnership interest. The Office of the Comptroller of the Currency (OCC) regulates these banks and has stated that, as a general partner, a bank's liability is not limited to the principal of a particular account, but that it would object to a bank investing in general partnerships unless local law limited the bank's liability.[5850] As a limited partner, a bank usually would not have a say in the management of the assets. When a bank does hold a limited partnership interest, the OCC will not object if such investment is authorized by the governing instrument, local law or by written consent of account beneficiaries. Additionally, the bank would still be subject to the

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[5842] UPIA §3.
[5843] UPIA § 6.
[5844] Citations to the Uniform Trust Code are to the version adopted in 2004, as amended or revised in 2005, published March 7, 2005, by the National Conference of Commissioners on Uniform State Laws.
[5845] UTC §105.
[5846] UTC §802, §803.
[5847] UTC §802(g).
[5848] UTC §806.
[5849] UTC §816(6), (7).
[5850] Note that a partnership may register as a limited liability partnership (LLP) to limit the general partner's liability. When a limited partnership registers as an LLP, it might be called a limited liability limited partnership (LLLP).

prudent investment standard, and the investment would have to meet the objective of the entity to match the outsider's offer.[5851] Distributions are mandatory, but the person controlling the entity may establish reasonable reserves.

Some people give the donee the right to sell the interest to the donee for cash equal to the appraised value, which right lasts 15-45 days – whatever the practitioner feels is similar to what would be a reasonable period within which to exercise *Crummey* rights.[5852]

III.A.3. Trusts Holding Stock in S Corporations

Estates, including not only decedents' estates but also bankruptcy estates, are qualified shareholders during a reasonable period of administration.[5853]

The holder of a usufruct interest is similar to a life tenant and is not considered to be a trustee of a trust. Rather, the holder is treated as the sole owner for K-1 purposes.[5854]

The rest of this part III.A.3 deals with trusts.

Rev. Rul. 93-79 held:

> A state court order, which retroactively reforms a trust to meet the requirements of a qualified subchapter S trust, does not have retroactive effect for purposes of determining the trust's eligibility to be a shareholder of an S corporation.

However, Rev. Rul. 93-79 also held:

> The trust reformation, however, will be recognized prospectively. Therefore, because X has never been an S corporation, it may file a new S corporation election for a subsequent taxable year without waiting the 5-year period specified in section 1362(g) of the Code for new S corporation elections by corporations whose previous elections have terminated.

Rev. Rul. 93-79 reasoned:

> In the present situation, the original terms of the Trust did not satisfy the requirements of section 1361(d)(3)(A)(ii) of the Code regarding distributions of corpus. Consequently, the Trust was not a QSST and was ineligible to be an S corporation shareholder. Thus, the S corporation election filed by X on March 15, 1992, was ineffective because the Trust held shares of X at the time the election was filed. In an effort to cure the ineffective

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[5851] If a right of first refusal contains a fixed price instead of just the right to match the offering price, and that fixed price is less than the offering price, failure to exercise that right generally would constitute a gift. Letter Ruling 9117035.

[5852] *Crummey v. Commissioner*, 397 F.2d 82, (9th Cir. 1968); see *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991) (reviewed decision approving annual exclusion for gifts to grandchildren who had *Crummey* rights exercisable for 15 days and otherwise had only contingent remainder interests); *Mikel v. Commissioner*, T.C. Memo. 2015-64 (sustaining annual exclusion for withdrawal rights provided to 60 beneficiaries; alternative dispute resolution process did not prevent beneficiaries from having enforceable rights).

[5853] Code §§ 1361(b)(1)(B), 1361(c)(3); Reg. §§ 1.1361-1(b)(1)(ii), 1.1361-1(b)(2).

[5854] Rev. Rul. 64-249 (ruling under former Code § 1371); Letter Ruling 9018048 (ruling under Code § 1361).

election, the Trust's beneficiaries obtained a court-approved retroactive reformation of the governing trust instrument.

Retroactive changes of the legal effects of a transaction through judicial nullification of a transfer or judicial reformation of a document do not have retroactive effect for federal tax purposes. *American Nurseryman Publishing Company v. Commissioner*, 75 T.C. 271, 276-277 (1980), *aff'd without published opinion*, 673 F.2d 1333 (7th Cir. 1982); *Estate of Hill v. Commissioner*, 64 T.C. 867 (1975), *aff'd without published opinion*, 568 F.2d 1365 (5th Cir. 1978); *Emerson Institute v. United States*, 356 F.2d 824 (D.C. Cir. 1966), *cert. denied*, 385 U.S. 822 (1966); *Piel v. Commissioner*, 340 F.2d 887 (2d Cir. 1965); *M.T. Straight Trust v. Commissioner*, 245 F.2d 327 (8th Cir. 1957); *Eisenberg v. Commissioner*, 161 F.2d 506 (3d Cir. 1947), *cert. denied*, 332 U.S. 767 (1947); *Sinopoulo v. Jones*, 154 F.2d 648 (10th Cir. 1946).

American Nurseryman considered whether an S corporation election was terminated when stock in the corporation was transferred to a trust. A state court found that the stock transfer was a mistake and held it to be void. The Tax Court disregarded the effect of the state court action for purposes of determining the federal tax status of the corporation and found that the S election was terminated. The court followed the consistently expressed judicial opinion that judicial reformation cannot operate to change the federal tax consequences of a completed transaction.

Quoting its opinion in *M.T. Straight Trust v. Commissioner*, 24 T.C. 69 (1955), *aff'd*. 245 F.2d 327 (8th Cir. 1957), the court in *American Nurseryman* said that it recognized that "[t]here are numerous cases in which the construction or interpretation of an instrument by a decision of a State court involving the taxpayer and rendered subsequent to the taxable period involved has been relied upon to determine the tax consequences of the document, but the court stated that "In the instant case, however, the reformation decree is not a determination of the legal effect of the original trust instrument under local law, nor does it purport to be such a determination. On the contrary, it alters and modifies the instrument." 75 T.C. 275. The court went on to observe that "as a general rule a reformation of an instrument has retroactive effect as between the parties to the instrument, but not as to third parties who previously acquired rights under the instrument." 75 T.C. 276.

In *Flitcroft v. Commissioner*, 328 F.2d 449 (9th Cir. 1964), *rev'g*. 39 T.C. 52 (1962), the taxpayers established trusts that were not by their terms irrevocable. State law mandated that a trust was not irrevocable unless expressly stated in the trust instrument. A state court reformed the trusts, based on the asserted original intent of the grantors, and decreed that the trusts were irrevocable from their execution. The Ninth Circuit held that the trusts were irrevocable for federal tax purposes. The Service does not follow the Ninth Circuit's decision in *Flitcroft* to the extent it requires the Service to give effect to a retroactive reformation.

Accordingly, the reformation of the Trust will not be recognized retroactively to cure the defective S corporation election filed by X. Because an ineligible trust held shares of X stock at the time X's S corporation election was filed, X was not a small business corporation on that date (as required by section 1362(a) of the Code) and on each day of 1992 before that date (as required by section 1362(b)(2)(B)(i)). Therefore, X never became an S corporation because the S corporation election filed by X on March 15, 1992, was ineffective. Furthermore, the provision of section 1362(b)(2) permitting

> certain otherwise ineffective elections to be effective for the following taxable year does not permit the election filed by X to be valid for the following taxable year, 1993, because X was not a small business corporation when the election was filed.

However, see parts II.A.2.e.iii Relief for Late S corporation Elections Within 3+ Years, II.A.2.e.v Relief for Late S Corporation and Entity Classification Elections for the Same Entity, and III.A.3.c.iii.(b) Flowchart Showing Relief for Late QSST & ESBT Elections.

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

A wholly owned grantor trust is among the types of trusts that can hold stock in an S corporation. For a description of the types of trusts that qualify, see part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation.

Below are discussions of what types of trusts can qualify as wholly owned grantor trusts, what it means to be "wholly" owned, how a trust can fall short, and what step an S corporation should take to avoid a trust falling short if it is at risk for doing so.

III.A.3.a.i. Qualifying as a Wholly Owned Grantor Trust

This part III.A.3.a Wholly Owned Grantor Trusts – How to Qualify, Risks, and Protective Measures discusses a trust that qualifies as a shareholder solely because all of the trust is treated under the grantor trust rules as owned by an individual who is a citizen or resident of the United States.[5855] If a trust has more than one deemed owner but they have substantially separate and independent shares, the trusts are treated as separate trusts[5856] and may separately qualify as wholly owned grantor trusts.[5857]

[5855] Implementing Code § 1361(c)(2)(A)(i), Reg. § 1.1361-1(h)(1)(i) provides:

> *Qualified subpart E trust*. A trust all of which is treated (under subpart E, part I, subchapter J, chapter 1) as owned by an individual (whether or not the grantor) who is a citizen or resident of the United States (a qualified subpart E trust). This requirement applies only during the period that the trust holds S corporation stock.

[5856] Implementing the flush language at the end of Code § 1361(d)(3), Reg. § 1.1361-1(j)(3) includes:

> For purposes of sections 1361(c) and (d), a substantially separate and independent share of a trust, within the meaning of section 663(c) and the regulations thereunder, is treated as a separate trust.

[5857] In approving a community property trust as an eligible shareholder before and after divorce, Letter Ruling 9729025 held:

> Under the trust agreement, H and W retain the power to revoke TR and revest the trust's property in themselves. Therefore, H and W are treated, under section 676, as the owners of TR until their divorce. Because TR is treated as owned entirely by H and W between d2 and d3, TR is a trust described in section 1361(c)(2)(A)(i).
>
> Under section 663(c) and section 1.663(c)-1(a) of the Income Tax Regulations, shares of a single trust are treated as separate trusts if the trust has more than one beneficiary and the different beneficiaries have substantially separate and independent shares. Section 1.663(c)-3 provides that the applicability of the separate share rule generally depends upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. Thus, if an instrument directs a trustee to divide the trust estate into separate shares for each beneficiary and the trustee is given discretion, with respect to each share, to distribute or

If not a foreign trust,[5858] such a grantor trust automatically qualifies as an S corporation shareholder,[5859] and the trust's deemed owner is treated as the shareholder for all tax purposes,[5860] including the 100-shareholder limitation.[5861]

A revocable trust would qualify as a grantor trust taxed to its grantor.[5862] An irrevocable trust might qualify as a grantor trust taxed to the grantor under the normal rules of Code §§ 671-677, to the beneficiary under Code § 678, or to the beneficiary through a QSST election made by the beneficiary.

A trust might be taxable to a beneficiary under Code § 678 if the beneficiary has a withdrawal right with respect to all gifts to the trust (a *Crummey* trust);[5863] whether such withdrawal rights impair spendthrift protection requires additional analysis.[5864] Examples of Code § 678 trusts include:

- Grantor creates a "vested" trust for a grandchild, as follows: The grandchild can withdraw the entire gift and all earnings on the gift. This withdrawal right lapses in full after a

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> accumulate income or to distribute principal or accumulated income or to do both, separate shares will exist under section 663(c).
>
> Upon the dissolution of H's and W's marriage, the community property held by TR (including the X stock) was divided equally on the trustee's books and each half was treated as the separate property of H and W. As a result, H was entitled to all of the income from his separate share of the trust property and so much of the principal as he directed. Likewise, W was entitled to all of the income from her separate share of the trust property and so much of the income as she directed. Therefore, H's and W's shares of TR are substantially separate and independent shares within the meaning of section 663(c).

I am not sure that I agree with the logic of why the trust qualified while they were married, although ultimately the result was probably correct. The ruling points out that Code § 1361(c)(1) treats spouses as one shareholder for purposes of Code § 1361(b)(1)(A). However, the ruling determined eligibility under Code § 1361(c)(2)(A)(i), so presumably applying the spousal unity rule for purposes of Code § 1361(b)(1)(A) would not have been relevant to the ruling. Therefore, because the ruling's spousal unity reasoning appears incorrect, make sure that any community property trusts are held as separate and independent shares during life.
For further analysis, see fns 6618-6619 and accompanying text in part III.B.2.h.i Who Is the Grantor

[5858] Consistent with the last sentence of Code § 1361(c)(2)(A), Reg. § 1.1361-1(h)(2) precludes a foreign trust, as defined in Code § 7701(a)(31), from holding stock, even it otherwise would qualify as a shareholder.

[5859] Code § 1361(c)(2)(A)(i).

[5860] Code § 671. Grantor trusts may use their deemed owners' social security numbers as their taxpayer identification numbers. Reg. § 1.671-4(b)(2)(A). However, a QSST must file Form 1041 and attach a statement of the items treated as having been received directly by its beneficiary. Reg. § 1.671-4(b)(6). One might consider filing Form 1041 for other grantor trusts as well to get the statute of limitations running on grantor trust treatment.

[5861] Code § 1361(c)(2)(B)(i).

[5862] Code § 676.

[5863] See discussion of IRS Letter Rulings in 730-2nd T.M., S corporation*s: Formation and Termination*, II.E.1.b(3), and in *Federal Income Taxation of S corporations* ¶ 3.03[10] (4th ed., Warren, Gorham & Lamont). A trustee-beneficiary's power to make distributions to himself under an ascertainable standard might make the trustee-beneficiary a Code § 678 owner to the extent of that distributions would be authorized under that standard. Letter Rulings 8211057 and 200747002 (Code § 678(a)(2) lapse followed by the beneficiary-trustee being able to make distributions to himself under an ascertainable standard was sufficient to allow the trust to hold stock in an S corporation). For more details, see part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.

[5864] See parts III.B.2.i.ix Creditor and Gift/Estate Tax Issues Regarding Withdrawal Rights.

reasonable interval. The grandchild is the sole beneficiary during his or her life and has a general power of appointment upon death. For income tax purposes, one may treat the trust as deemed owned 100% by the beneficiary.[5865] The gift qualifies for the annual exclusion.[5866] For estate tax purposes, the trust is includible in the beneficiary's estate.[5867] If and to the extent that the gift qualifies for the annual exclusion, the gift is also exempt for generation-skipping transfer (GST) purposes, without using any GST exemption.[5868] If and to the extent that the lapse exceeds the greater of $5,000 or 5% of the trust's assets (subject to coordination with other lapses by that beneficiary),[5869] the beneficiary has made an incomplete gift[5870] and for GST purposes becomes the transferor;[5871] however, because the trust is included in the beneficiary's estate for estate tax purposes, the beneficiary's GST exemption needs to be allocated upon death anyway.

- Grantor makes a gift of less than $5,000 to the trust[5872] and later sells stock in an S corporation to the trust.[5873]

- Decedent bequeaths to a trust over which the beneficiary holds an unlimited withdrawal right, making the trust taxable to the beneficiary under Code § 678(a)(1), building in features that would trigger Code § 678(a)(2) after the withdrawal rights lapse.[5874]

Note that the settlor's grantor trust powers trump any beneficiary's grantor trust powers.[5875]

A beneficiary may also be treated as the owner by making a "QSST" election[5876] to have the grantor trust rules apply. See part III.A.3.e.i QSSTs.

III.A.3.a.ii. How a Trust Can Fall Short of Being Wholly Owned by One Person

If a person is treated as the owner of a portion of a trust, that portion may or may not include both ordinary income and other income allocable to corpus.[5877] However, for a trust to meet the

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[5865] See parts III.B.2.i.vii Portion Owned When a Gift Over $5,000 is Made.
[5866] For qualification of withdrawal rights for the annual exclusion and whether an interest in a business entity qualifies for the annual exclusion, see part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts, especially the paragraph accompanying fn. 6345.
[5867] Code § 2041(a)(2).
[5868] Code § 2642(c).
[5869] Code § 2514(e). For more details on calculating the 5% lapse, see fn 6125 in part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts (Whether or Not a Sale Is Made).
[5870] Reg. 25.2511-2(b).
[5871] See Reg. § 26.2652-1(a)(5), Example (5), reproduced in fn 673 in part II.D.3 Trust as Grantor or Deemed Owner of Another Trust.
[5872] See part III.B.2.i.vi Funding the Trust with Small Gifts.
[5873] See part III.B.2.i.v Sale to a Beneficiary Deemed-Owned Trust – When a Traditional Sale to an Irrevocable Grantor Trust Does Not Meet the Client's Objectives.
[5874] See part III.B.2.i.viii Funding the Trust with a Large Initial Gift or Bequest.
[5875] Code § 678(b).
[5876] Code § 1361(d)(1). If the beneficiary dies and the trust continues, with another beneficiary stepping into his or her place, the QSST election remains in place, Reg. § 1.1361-1(j)(9); but, if the trust terminates by reason of the beneficiary's death, then a new QSST election must be filed. Reg. § 1.1361-1(j)(9)(ii), Example (2). One might consider including a clause that, during trust administration, after the beneficiary's death and before separate trusts can be funded, the trust will not terminate but rather will continue as a single trust with separate shares pursuant to Reg. § 1.1361-1(j)(9)(ii), Example (1).
[5877] Reg. § 1.671-3(b).

wholly owned grantor trust rules, one person must be the deemed owner of both income and principal.[5878]

If the grantor's spouse is a beneficiary, the trust is not necessarily deemed wholly owned,[5879] so an additional grantor trust power might be advisable.[5880] The trust might very well cease qualifying as a wholly-owned grantor trust upon separation or divorce,[5881] so that an ESBT election might be necessary after divorce or separation.[5882]

If a trust qualifies as being deemed wholly owned by the beneficiary, consider what might happen if the provision upon which the beneficiary's deemed ownership is based includes some ambiguity.[5883] Also, if the beneficiary does not have a withdrawal right over every gift to the trust and over the income and gains generated by each such gift or if the beneficiary has a withdrawal right that lapses in an incorrect manner, the trust might not be deemed wholly owned by the beneficiary.[5884]

III.A.3.a.iii. Steps an S Corporation Might Take to Avoid a Trust Falling Short of Being a Wholly-Owned Grantor Trust

An S corporation might insist that certain protective measures be taken in case a trust falls short of being deemed wholly owned by one person.

If the trust is intended to be deemed owned wholly by the beneficiary, the beneficiary might file a QSST election, just in case the trust is not deemed wholly owned by the beneficiary. A beneficiary cannot elect QSST treatment if the grantor is taxed as the owner; however, a beneficiary may elect QSST treatment if the beneficiary is taxed as the owner.[5885] However, the beneficiary might not want to make the QSST election during any time when the trust is buying stock from the beneficiary, because a QSST election complicates the purchase and might make the process of getting the value of the stock out of the beneficiary's estate take twice as long.[5886]

For a trust deemed owned by its settlor (or a trust deemed owned by its beneficiary where QSST status is undesirable to impractical), the trust might file an ESBT election, just in case the

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[5878] Code § 1361(c)(2)(A)(i). Letter Ruling 200226006 held that a trust that was partly a nongrantor trust and partly a grantor trust did not satisfy this rule, even though the grantor trust portion was created by contributing S corporation stock and the nongrantor portion was created by contributing other assets. (Generally I would recommend separating grantor and nongrantor trusts anyway; the facts in that letter ruling were particularly problematic in that the trust appears to be partially a GST-exempt trust and partially a Code § 2036 trust.) This ruling is consistent with Reg. § 1.1361-1(k)(1), Example (10), paragraph (iii) (reproduced in fn. 5973, which is found in part III.A.3.e.i.(a) QSSTs Generally). Letter Ruling 200942020 approved an irrevocable grantor trust as an S corporation shareholder when it had multiple *Crummey* power holders, holding that Code § 678(b) caused the grantor's deemed owner status to trump the beneficiaries' deemed owner status.

[5879] Letter Ruling 201208013.

[5880] See part III.B.2.h How to Make a Trust a Grantor Trust.

[5881] See fn. 5973, discussing how Reg. § 1.1361-1(k)(1), Example (10), applies Code § 682 to a trust owning stock in an S corporation.

[5882] See parts III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation (especially part III.A.3.b.v An Electing Small Business Trust) and III.A.3.e.ii.(a) Qualification as an ESBT.

[5883] See part III.B.2.i.xii Dealing with Code § 678(a)(2) Uncertainty.

[5884] See part III.B.2.i.vii Portion Owned When a Gift Over $5,000 is Made.

[5885] Reg. § 1.1361-1(j)(6)(iv).

[5886] See part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (Including Possible Pitfalls).

trust is not a wholly-owned grantor trust taxable to only one person. Although estate planners commonly rely on swap powers, they are not foolproof.[5887] A grantor trust may make an ESBT election.[5888] However, grantor trust treatment trumps ESBT taxation.[5889] That doesn't mean that the ESBT election is not technically in effect[5890] - it just means that the election has no current income tax consequences.

These protective measures are not necessarily beneficial to anyone other than the S corporation:

- A grantor trust can use regular income taxation for the first two years after the grantor's death and get more favorable income tax treatment as a regular trust.[5891] Post-mortem ESBT treatment may be good or bad, depending on whether the income distribution deduction would generate higher or lower federal and state (consider the trust's and beneficiaries' respective residences) income taxes; see part II.J.3 Strategic Fiduciary Income Tax Planning (and other cross-references in the footnote at the end of this sentence).[5892] The ESBT portion of the trust should get a $10,000 state income tax deduction that is separate from the non-S portion, so if the trust has other income then having an additional state income tax deduction can help; see part II.J.3.d Who Benefits Most from Deductions.

- Some grantor trusts might qualify as a QSST or an ESBT upon termination of grantor trust status. The regulations limit how often one can switch back and forth between QSST and ESBT status. Initially making the ESBT election means that, after switching to a QSST once, the trust must wait 36 months before switching back to a QSST or later back to an ESBT again. Absent the initial ESBT election, the beneficiary could make a QSST election upon termination of grantor trust status and later switch to ESBT status with waiting 36 months. Part III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock

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[5887] Whether a swap power is effective depends on the facts and circumstances, as described in Reg. § 1.675-1(b)(4)(iii). Part III.B.2.h.iii Swap Power quotes this regulation and describes why estate planners do not mind relying on it as the sole grantor trust feature. Letter Ruling 9548013 held (highlighting added):

> Based upon the facts and representations you submitted, we conclude that A will be treated as the owner of TR1 and B will be treated as the owner of TR2 provided that the District Director determines that the circumstances indicate that A and B hold the power of administration over the entire corpus of their respective trusts in a nonfiduciary capacity. Therefore, A and B will be considered the owners of their respective trusts until their deaths, the termination of the trusts, or they release their administrative power, whichever comes first.

To protect an S election against an adverse finding by the District Director, one might want the additional protection that an ESBT election provides.

[5888] Reg. §§ 1.1361-1(m)(2)(v) (general approval for grantor trust to make an ESBT election), 1.1361-1(m)(8)(iii), Example 3 (Code § 678 trust may make an ESBT election).

[5889] Reg. § 1.641(c)-1(c). A partial grantor trust is illustrated in Reg. §1.641(c)-1(*l*), Example (1).

[5890] A trust may not make a protective ESBT election. Reg. § 1.1361-1(m)(2)(v), which concludes with:

> In addition, a trust that qualifies as an ESBT may make an ESBT election notwithstanding that the trust is a wholly-owned grantor trust.

[5891] Code § 1361(c)(2)(A)(ii). See Code § 641(c) for ESBTs' unfavorable income tax treatment.

[5892] With that part or outside that part, see especially parts II.J.4.h.i Trapping Income in Trust Notwithstanding Distributions – ESBT, as well as parts II.E.1.f Trusts/Estates and the Code § 199A Deduction (especially part II.E.1.f.ii Electing Small Business Trusts (ESBTs)), II.J.3.a Who Is Best Taxed on Gross Income, II.J.3.c Who Is Benefits the Most from Losses, II.J.3.d Who Benefits Most from Deductions, III.A.3.e.ii.(b) ESBT Income Taxation - Overview, and III.A.3.e.ii.(c) When ESBT Income Taxation Might Help.

describes this, as well as the Reg. § 1.1361-1(m)(6) requirement to obtain a private letter ruling to revoke an ESBT election when not converting to a QSST.

If the sole risk to being wholly owned is the separation or divorce of a beneficiary from the grantor, an irrevocable grantor trust that includes the grantor's spouse as a beneficiary might provide that separation or divorce terminates the spouse's interest. That provision might avoid the need for an ESBT election upon which the S corporation otherwise might have required.

III.A.3.a.iv. Why to Be Extraordinarily Sensitive to Protecting the S Election

Some people point to the generous relief the IRS provides for inadvertent terminations and decide that going to great lengths to protect the S election is not necessary.[5893]

However, a buyer might be very sensitive to the S election's validity, particularly in a stock sale that is treated as an asset purchase.[5894] Fixing any problems that the buyer's tax counsel perceives to exist (whether or not the problem actually exists) can delay a transaction, during which time other issues might arise that might cause the seller to lose a sale to a strategic buyer at a premium price. I became much more aware of this issue when a transaction worth hundreds of millions of dollars faced a possible delay due to an issue caused by prior counsel and I was asked to obtain a private letter ruling to fix it; I was able to get a private letter ruling in only six weeks from the date of submission, but until I did the client was very nervous about the six-month delay projected by those who insisted on the PLR. If I had not been able to get the PLR that quickly (which I have no assurance of being able to replicate) and that deal had cratered, I wonder what the repercussions would have been to prior counsel and then realized that any of us could be in that situation someday if there is even the slightest concern.

A solution that may satisfy the buyer (but does not cure the seller's S corporation problem) involves moving all of the corporation's assets into a single member LLC, which can be done using state law conversion/merger statutes and then selling that LLC.[5895] That solution may address other issues as well.[5896]

[5893] See part III.A.3.c.iii.(b) Flowchart Showing Relief for Late QSST & ESBT Elections and the related discussion preceding that.
[5894] See part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.
[5895] See fns. 5778-5779 in part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.
[5896] See part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold, especially fns. 5770-5776.

III.A.3.b. Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation

To qualify as S corporation shareholders for any length of time,[5897] generally[5898] an irrevocable trust must either be a grantor trust or an electing small business trust (ESBT). Planning to avoid the 3.8% tax on net investment income[5899] requires additional planning regarding participation in the business; it may be advisable to have the trustee materially participate even if the trust is a grantor trust.[5900]

If not a foreign trust,[5901] any of the trusts described below may be a shareholder. See also part III.B.2.j.ii.(e) Change in Qualification of Trust to Hold S corporation Stock During Taxable Year, which is part of part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

III.A.3.b.i. A Trust All of Which Is Treated Under the Grantor Trust Rules as Owned by An Individual Who Is a Citizen or Resident of the United States

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

III.A.3.b.ii. A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death

Code § 1361(c)(2)(A)(ii). This includes a former QSST.[5902]

[5897] Trusts can qualify as S shareholders by electing to be taxed as an estate under Code § 645 (which election has a limited duration under Code § 645(b)(2)), by being a continuation of a grantor trust under Code § 1361(c)(2)(A)(ii), or a testamentary trust under Code § 1361(c)(2)(A)(iii) – for the latter, see part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, especially part III.A.3.b.iii A Trust with Respect to Stock Transferred to It Pursuant to The Terms of a Will (or a Qualified Revocable Trust When a Code § 645 Election Terminates), But Only for the 2-Year Period Beginning on The Day on Which Such Stock Is Transferred to It.

[5898] A voting trust does not have time limits on how long it is an eligible shareholder under Code § 1361(c)(2)(A)(iv).

[5899] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

[5900] See part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.

[5901] Consistent with the last sentence of Code § 1361(c)(2)(A), Reg. § 1.1361-1(h)(2) precludes a foreign trust, as defined in Code § 7701(a)(31), from holding stock, even it otherwise would qualify as a shareholder.

[5902] Reg § 1.1361-1(j)(7)(ii) provides:

> If, upon the death of an income beneficiary, the trust continues in existence, continues to hold S corporation stock but no longer satisfies the QSST requirements, is not a qualified subpart E trust, and does not qualify as an ESBT, then, solely for purposes of section 1361(b)(1), as of the date of the income beneficiary's death, the estate of that income beneficiary is treated as the shareholder of the S corporation with respect to which the income beneficiary made the QSST election. The estate ordinarily will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day of the income beneficiary's death. During the period that the estate is treated as the shareholder for purposes of section 1361(b)(1), the trust is

Generally, such a trust is an eligible shareholder only for the 2-year period beginning on the day of the deemed owner's death.[5903] It does not include a trust that did not own the stock during the deemed owner's life and received the stock pursuant to the terms of a will,[5904] which is subject instead to the time period described in part III.A.3.b.iii A Trust with Respect to Stock Transferred to It Pursuant to The Terms of a Will (or a Qualified Revocable Trust When a Code § 645 Election Terminates), But Only for the 2-Year Period Beginning on The Day on Which Such Stock Is Transferred to It. However, if the trust is subject to an election under Code § 645,[5905] then the trust is taxed as an estate and can hold the stock during the entire period during which the trust is taxable as an estate.[5906] Whether the trust qualifies as a former grantor trust or as an estate, the grantor's estate is treated as the owner for purposes of the 100-shareholder limitation.[5907]

> treated as the shareholder for purposes of sections 1366, 1367, and 1368. If, after the 2-year period, the trust continues to hold S corporation stock and does not otherwise qualify as a permitted shareholder, the corporation's S election terminates. If the termination is inadvertent, the corporation may request relief under section 1362(f).

[5903] Reg. § 1.1361-1(h)(1)(ii), "Subpart E trust ceasing to be a qualified subpart E trust after the death of deemed owner," provides:

> A trust that was a qualified subpart E trust immediately before the death of the deemed owner and that continues in existence after the death of the deemed owner, but only for the 2-year period beginning on the day of the deemed owner's death. A trust is considered to continue in existence if the trust continues to hold the stock pursuant to the terms of the will or the trust agreement, or if the trust continues to hold the stock during a period reasonably necessary to wind up the affairs of the trust. See § 1.641(b)-3 for rules concerning the termination of trusts for federal income tax purposes.

The Reg. § 1.641(b)-3 trust termination rule is described in the text accompanying fn 2563 in part II.J.3.i Planning for Excess Losses, describing excess losses allowed to a beneficiary on termination of a trust. Reg. § 1.641(b)-3(a) is reproduced in fn 2732 in part II.J.8.

[5904] Regs. § 1.1361-1(k)(1), Example 3, paragraph (i), provides:

> *2-year rule under section 1361(c)(2)(A)(ii) and (iii)*. F owns stock of Corporation P, an S corporation. In addition, F is the deemed owner of a qualified subpart E trust that holds stock in Corporation O, an S corporation. F dies on July 1, 2003. The trust continues in existence after F's death but is no longer a qualified subpart E trust. On August 1, 2003, F's shares of stock in Corporation P are transferred to the trust pursuant to the terms of F's will. Because the stock of Corporation P was not held by the trust when F died, section 1361(c)(2)(A)(ii) does not apply with respect to that stock. Under section 1361(c)(2)(A)(iii), the last day on which the trust could be treated as a permitted shareholder of Corporation P is July 31, 2005 (that is, the last day of the 2-year period that begins on the date of the transfer from the estate to the trust). With respect to the shares of stock in Corporation O held by the trust at the time of F's death, section 1361(c)(2)(A)(ii) applies and the last day on which the trust could be treated as a permitted shareholder of Corporation O is June 30, 2005 (that is, the last day of the 2-year period that begins on the date of F's death).

[5905] See part II.J.7 Code § 645 Election to Treat a Revocable Trust as an Estate.

[5906] Regs. §§ 1.1361-1(k)(1), Example 3, paragraph (ii) and 1.645-1(e)(2)(i); Letter Ruling 200529006.

[5907] Code § 1361(c)(2)(B)(ii). Reg. § 1.1361-1(h)(3)(i)(B) provides:

> If stock is held by a trust defined in paragraph (h)(1)(ii) of this section, the estate of the deemed owner is generally treated as the shareholder as of the day of the deemed owner's death. However, if stock is held by such a trust in a community property state, the decedent's estate is the shareholder only of the portion of the trust included in the decedent's gross estate (and the surviving spouse continues to be the shareholder of the portion of the trust owned by that spouse under the applicable state's community property law). The estate ordinarily will cease to be treated as the shareholder upon the earlier of the transfer of the stock by the trust or the expiration of the 2-year period beginning on the day of the deemed owner's death. If the trust

Reg. § 1.1361-1(k)(1), Example (1) illustrates how these rules might apply to a joint revocable trust when the grantor dies and then again later when the survivor's revocable trust and downstream irrevocable trusts are funded:

(i) *Terms of the trust*. In 1996, A and A's spouse, B, created an inter vivos trust and each funded the trust with separately owned stock of an S corporation. Under the terms of the trust, A and B designated themselves as the income beneficiaries and each, individually, retained the power to amend or revoke the trust with respect to the trust assets attributable to their respective trust contributions. Upon A's death, the trust is to be divided into two separate parts; one part attributable to the assets A contributed to the trust and one part attributable to B's contributions. Before the trust is divided, and during the administration of A's estate, all trust income is payable to B. The part of the trust attributable to B's contributions is to continue in trust under the terms of which B is designated as the sole income beneficiary and retains the power to amend or revoke the trust. The part attributable to A's contributions is to be divided into two separate trusts both of which have B as the sole income beneficiary for life. One trust, the Credit Shelter Trust, is to be funded with an amount that can pass free of estate tax by reason of A's available estate tax unified credit. The terms of the Credit Shelter Trust meet the requirements of section 1361(d)(3) as a QSST. The balance of the property passes to a Marital Trust, the terms of which satisfy the requirements of section 1361(d)(3) as a QSST and section 2056(b)(7) as QTIP. The appropriate fiduciary under § 20.2056(b)-7(b)(3) is directed to make an election under section 2056(b)(7).

(ii) *Results after deemed owner's death*. On February 3, 1997, A dies and the portion of the trust assets attributable to A's contributions including the S stock contributed by A, is includible in A's gross estate under sections 2036 and 2038. During the administration of A's estate, the trust holds the S corporation stock. Under section 1361(c)(2)(B)(ii), A's estate is treated as the shareholder of the S corporation stock that was included in A's gross estate for purposes of section 1361(b)(1); however, for purposes of sections 1366, 1367, and 1368, the trust is treated as the shareholder. B's part of the trust continues to be a qualified subpart E trust of which B is the owner under sections 676 and 677. B, therefore, continues to be treated as the shareholder of the S corporation stock in that portion of the trust. On May 13, 1997, during the continuing administration of A's estate, the trust is divided into separate trusts in accordance with the terms of the trust instrument. The S corporation stock that was included in A's gross estate is distributed to the Marital Trust and to the Credit Shelter Trust. A's estate will cease to be treated as the shareholder of the S corporation under section 1361(c)(2)(B)(ii) on May 13, 1997 (the date on which the S corporation stock was transferred to the trusts). B, as the income beneficiary of the Marital Trust and the Credit Shelter Trust, must make the QSST election for each trust by July 28, 1997 (the end of the 16-day-and-2-month period beginning on the date the estate ceases to be treated as a shareholder) to have the trusts become permitted shareholders of the S corporation.

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qualifies and becomes an electing QSST, the beneficiary and not the estate is treated as the shareholder as of the effective date of the QSST election, and the rules provided in paragraph (j)(7) of this section apply. If the trust qualifies and becomes an ESBT, the shareholders are determined under paragraphs (h)(3)(i)(F) and (h)(3)(ii) of this section as of the effective date of the ESBT election, and the rules provided in paragraph (m) of this section apply.

Reg. § 1.1361-1(k)(1), Example (2) illustrates how these rules might apply to a revocable trust that stays intact when the grantor dies and includes a variation where a beneficiary has an unlimited withdrawal right after the grantor's death[5908] (common in joint revocable trusts for small estates):

(i) *Qualified subpart E trust as shareholder*. In 1997, A, an individual established a trust and transferred to the trust A's shares of stock of Corporation M, an S corporation. A has the power to revoke the entire trust. The terms of the trust require that all income be paid to B and otherwise meet the requirements of a QSST under section 1361(d)(3). The trust will continue in existence after A's death. The trust is a qualified subpart E trust described in section 1361(c)(2)(A)(i) during A's life, and A (not the trust) is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *Trust ceasing to be a qualified subpart E trust on deemed owner's death*. Assume the same facts as paragraph (i) of this Example 2, except that A dies without having exercised A's power to revoke. Upon A's death, the trust ceases to be a qualified subpart E trust described in section 1361(c)(2)(A)(i). A's estate (and not the trust) is treated as the shareholder for purposes of section 1361(b)(1). A's estate will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of the Corporation M stock by the trust (other than to A's estate), the expiration of the 2-year period beginning on the day of A's death, or the effective date of a QSST or ESBT election if the trust qualifies as a QSST or ESBT. However, until that time, because the trust continues in existence after A's death and will receive any distributions with respect to the stock it holds, the trust is treated as the shareholder for purposes of sections 1366, 1367, and 1368. If no QSST or ESBT election is made effective upon the expiration of the 2-year period, the corporation ceases to be an S corporation, but the trust continues as the shareholder of a C corporation.

(iii) *Trust continuing to be a qualified subpart E trust on deemed owner's death*. Assume the same facts as paragraph (ii) of this Example 2, except that the terms of the trust also provide that if A does not exercise the power to revoke before A's death, B will have the sole power to withdraw all trust property at any time after A's death. The trust continues to qualify as a qualified subpart E trust after A's death because, upon A's death, B is deemed to be the owner of the entire trust under section 678. Because the trust does not cease to be a qualified subpart E trust upon A's death, B (and not A's estate) is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368. Since the trust qualifies as a QSST, B may make a protective QSST election under paragraph (j)(6)(iv) of this section.

Note that, if the grantor's gross estate (for federal estate tax purposes) might be subject to estate tax, it is common for the trustee to hold the S stock for more than two years after the grantor's death. This is done to avoid the trustee incurring personal liability under the tax laws, because a final determination of estate tax might not be made until after the two-year period has expired. Therefore, the trustee should consider making a Code § 645 election, as described in the preceding paragraph.

[5908] Part (iii) of the regulation allows a protective QSST election, which is helpful as described in fn 5966 in part III.A.3.e.i.(a) QSSTs Generally.

Suppose S corporation stock a trust held at its deemed owner's death was transferred upon that death to two trusts created by the agreement that created the original trust. Would those trusts be treated as continuations of the original grantor trust under Code § 1361(c)(2)(A)(ii)? Letter Ruling 201709016[5909] assumed, without explanation, that the answer is "yes." Given that trust law treats the new trusts as separate trusts and legal title was transferred from the original trust, the former grantor trust does not appear to have continued its existence as to the transferred shares, so I would not rely on that assumption when planning.

Even when keeping the S corporation stock in such a trust or estate is permitted, doing so might come at an income tax cost. If the S corporation does not distribute all of its income, part or all its income might be taxed at the highest rate.[5910] One might save significant annual income taxes by distributing the S corporation stock to one or more QSSTs, each of which is taxed at its beneficiary's income tax rate (without regard to how much cash the S corporation distributes),[5911] which might be significantly lower. However, if estate tax is or might be due, consider the risks that the executor takes in distributing property before estate tax is paid in full.[5912]

For additional cash flow issues relating to a trust that was a grantor trust before the deemed owner's death, see also part III.A.3.d Special Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.

III.A.3.b.iii. A Trust with Respect to Stock Transferred to It Pursuant to The Terms of a Will (or a Qualified Revocable Trust When a Code § 645 Election Terminates), But Only for the 2-Year Period Beginning on The Day on Which Such Stock Is Transferred to It

Code § 1361(c)(2)(A)(iii). In such a case, the testator's estate is treated as an owner for purposes of the 100-shareholder limitation.[5913]

Reg. § 1.1361-1(h)(1)(iv), "Testamentary trusts, provides:

> A trust (other than a qualified subpart E trust, an electing QSST, or an electing small business trust) to which S corporation stock is-
>
> (A) Transferred pursuant to the terms of a will, but only for the 2-year period beginning on the day the stock is transferred to the trust except as otherwise provided in paragraph (h)(3)(i)(D) of this section; or
>
> (B) Transferred pursuant to the terms of an electing trust as defined in § 1.645-1(b)(2) during the election period as defined in § 1.645-1(b)(6), or deemed to be distributed at the close of the last day of the election period pursuant to § 1.645-1(h)(1), but in each case only for the 2-year period beginning on the day the stock is transferred or

[5909] In Letter Ruling 201709016, the two successor trusts qualified as QSSTs, but no QSST election was made within two years after the original deemed owner's death. The ruling allowed late QSST elections to be made, retroactive to two years after the original deemed owner's death.
[5910] See parts III.A.4 Trust Accounting Income Regarding Business Interests and III.F.2 Trust Accounting and Taxation.
[5911] See part III.A.3.e.i.(a) QSSTs Generally.
[5912] See generally III.B.3.c.iv Federal Estate Tax Liens.
[5913] Code § 1361(c)(2)(B)(iii).

> deemed distributed to the trust except as otherwise provided in paragraph (h)(3)(i)(D) of this section.

Thus, because a revocable trust that has made a Code § 645 election is treated as an estate, any transfer from that estate by reason of termination of the election or by bequest under that revocable trust is treated as transferred pursuant to the terms of a will. See part II.J.7 Code § 645 Election to Treat a Revocable Trust as an Estate.

Inadvertent termination relief has been granted for failure to make QSST elections for downstream trusts after the grace period expires.[5914] A special rule applies if a Code § 645 election terminates before the stock is distributed to the transferee trust. On the close of the last day of the election period, the combined electing trust and related estate, if there is an executor, or the electing trust, if there is no executor, is deemed to distribute the share (or shares, as determined under Code§ 663(c)) comprising the electing trust to a new trust in a distribution to which Code §§ 661 and 662 apply.[5915] The qualified revocable trust is an eligible shareholder for the 2-year period beginning on the day the stock is deemed distributed to the trust.[5916] Special rules apply for determining who is treated as the owner for purposes of the 100-shareholder limitation.[5917]

Reg. § 1.1361-1(k)(1), Example (3) provides:

> (i) *2-year rule under section 1361(c)(2)(A)(ii) and (iii)*. F owns stock of Corporation P, an S corporation. In addition, F is the deemed owner of a qualified subpart E trust that holds stock in Corporation O, an S corporation. F dies on July 1, 2003. The trust continues in existence after F's death but is no longer a qualified subpart E trust. On August 1, 2003, F's shares of stock in Corporation P are transferred to the trust pursuant to the terms of F's will. Because the stock of Corporation P was not held by the trust when F died, section 1361(c)(2)(A)(ii) does not apply with respect to that stock. Under section 1361(c)(2)(A)(iii), the last day on which the trust could be treated as a permitted shareholder of Corporation P is July 31, 2005 (that is, the last day of the 2-year period that begins on the date of the transfer from the estate to the trust). With respect to the shares of stock in Corporation O held by the trust at the time of F's death, section 1361(c)(2)(A)(ii) applies and the last day on which the trust could be treated as a permitted shareholder of Corporation O is June 30, 2005 (that is, the last day of the 2-year period that begins on the date of F's death).

[5914] Letter Rulings 202004002, 202004003, and 202004004.

[5915] Reg. § 1.645-1(h)(1).

[5916] Reg. § 1.1361-1(h)(1)(iv)(B).

[5917] Reg. § 1.1361-1(h)(3)(i)(D) provides:

> If stock is transferred or deemed distributed to a testamentary trust described in paragraph (h)(1)(iv) of this section (other than a qualified subpart E trust, an electing QSST, or an ESBT), the estate of the testator is treated as the shareholder until the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day that the stock is transferred or deemed distributed to the trust. If the trust qualifies and becomes an electing QSST, the beneficiary and not the estate is treated as the shareholder as of the effective date of the QSST election, and the rules provided in paragraph (j)(7) of this section apply. If the trust qualifies and becomes an ESBT, the shareholders are determined under paragraphs (h)(3)(i)(F) and (h)(3)(ii) of this section as of the effective date of the ESBT election, and the rules provided in paragraph (m) of this section apply.

(ii) *Section 645 electing trust and successor trust*. Assume the same facts as in paragraph (i) of this Example 3, except that F's trust is a qualified revocable trust for which a valid section 645 election is made on October 1, 2003 (electing trust). Because under section 645 the electing trust is treated and taxed for purposes of subtitle A of the Code as part of F's estate, the trust may continue to hold the O stock pursuant to § 1361(b)(1)(B), without causing the termination of Corporation O's S election, for the duration of the section 645 election period. However, on January 1, 2004, during the election period, the shares of stock in Corporation O are transferred pursuant to the terms of the electing trust to a successor trust. Because the successor trust satisfies the definition of a testamentary trust under paragraph (h)(1)(iv) of this section, the successor trust is a permitted shareholder until the earlier of the expiration of the 2-year period beginning on January 1, 2004, or the effective date of a QSST or ESBT election for the successor trust.

III.A.3.b.iv. A Trust Created Primarily to Exercise the Voting Power of Stock Transferred to It

Code § 1361(c)(2)(A)(iv). In such a case, each beneficiary of the voting trust is treated as the owner for purposes of the 100-shareholder limitation.[5918]

To qualify as a voting trust, the beneficial owners must be treated as the owners of their respective portions of the trust under the grantor trust rules, and the trust must have been created pursuant to a written trust agreement entered into by the shareholders, that:[5919]

(A) Delegates to one or more trustees the right to vote;

(B) Requires all distributions with respect to the stock of the corporation held by the trust to be paid to, or on behalf of, the beneficial owners of that stock;

(C) Requires title and possession of that stock to be delivered to those beneficial owners upon termination of the trust; and

(D) Terminates, under its terms or by state law, on or before a specific date or event.[5920]

Let's explore the requirement that the beneficial owners be treated as the owners of their respective portions of the trust under the grantor trust rules.[5921] This is automatic for the settlors of the trust,[5922] but not automatic when the settlors transfer their beneficial interests (voting trust certificates) to others. One treatise suggests making the beneficiaries entitled to distributions, but that might not satisfy the requirement that the trust agreement require payment of distributions to the beneficiaries; therefore, one might consider giving the beneficiaries the right

[5918] Code § 1361(c)(2)(B)(iv).
[5919] Reg. § 1.1361-1(h)(1)(v).
[5920] I am not aware of any authoritative interpretation of on or before a specific date or event. Presumably the trust might provide that the trust terminates when it holds no voting stock or perhaps when each individual in a named list of people has died.
[5921] Reg. § 1.1361-1(h)(1)(v)(C). If the beneficiary originally transferred the stock to the trust, then it is a grantor trust under Code § 677. Otherwise, the trust needs to qualify as an investment trust; see part II.D.4.a Investment Trusts, which also describes the income tax consequences when a voting trust that is an investment trust sells stock. This regulation was adopted by TD 8600 (7/20/1995). For the IRS' interpretation before then, see Letter Ruling 9344020.
[5922] Code § 677(a) combined with Reg. § 1.1361-1(h)(1)(v)(B).

to withdraw any distributions the trust receives from the S corporation, followed by a requirement that the trustee pay to the beneficiaries any such distributions.[5923] It has also been suggested that the voting trust might qualify as an investment trust, in which case a transferee would be treated as a grantor and therefore the trust would automatically qualify.[5924]

III.A.3.b.v. An Electing Small Business Trust (ESBT)

Code § 1361(c)(2)(A)(v). In such a case, each potential current beneficiary of the trust is treated as the owner for purposes of the 100-shareholder limitation.[5925] The 100-shareholder limitation is made less severe by a family attribution rule, treating a person, his or her spouse, and his or her descendants as one shareholder.[5926] A charitable remainder trust cannot own stock in an S corporation, so an electing small business trust (ESBT) election would not help it; instead, consider donating the stock to a charity in exchange for a charitable gift annuity, after

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[5923] When the beneficiary has the right to withdraw such distributions, Code § 678(a)(1) would treat the beneficiary as the owner. After that withdrawal right has lapsed, the IRS' Letter Ruling position would support a position that Code §§ 678(a)(2) and 677(a) would treat the beneficiary as the owner.

[5924] See part II.D.4.a Investment Trust. Letter Ruling 201226019 approved this approach, holding:

1. During the lives of A and B and after their deaths, Voting Trust will be classified as an investment trust under § 301.7701-4(c) for U.S. federal income tax purposes.
2. During the lives of A and B (assuming they are the only holders of the Certificates during their lives), Voting Trust will be considered a qualified voting trust under § 1361(c)(2)(A)(iv) and § 1.1361-1(h)(1)(v). Accordingly, Voting Trust will be a permitted S corporation shareholder. If, during their lives, A or B transfer all or a portion of their Certificates to a transferee that is a permitted S corporation shareholder, the transferee will be treated as a successor grantor of the Voting Trust. Therefore,
    - (i) Voting Trust will continue to be a voting trust described in § 1361(c)(2)(A)(iv) and a permitted S corporation shareholder, and
    - (ii) the Certificate holders will include in their gross income and report their proportionate share of the S corporation income that is allocated to the Company shares held by the Voting Trust.
3. After the death of A or B, when the executor of their respective Wills (the Executor) holds the Certificates held by A or B, as applicable, prior to their deaths, A's and B's respective estates (if the period during which such estates hold the Certificates does not exceed the period actually required to fully administer the estates as described in § 1.641(b)-3(a)) will be treated as successor grantors of the Voting Trust. After the Executor distributes the Certificates held by A or B in accordance with the terms and provisions of their estate planning documents, as applicable, such transferees of the Certificates will be treated as successor grantors of their portions of the Voting Trust. Therefore,
    - (i) Trust will continue to be a voting trust described in § 1361(c)(2)(A)(iv) and a permitted S corporation shareholder, and
    - (ii) the Certificate holders will include in their gross income and report their proportionate share of the S corporation income that is allocated to the Company shares held by the Voting Trust.

The Reg. § 1.641(b)-3 trust termination rule is described in the text accompanying fn 2563 in part II.J.3.i Planning for Excess Losses, describing excess losses allowed to a beneficiary on termination of a trust. Reg. § 1.641(b)-3(a) is reproduced after fn 2732 in part II.J.8.

[5925] Code § 1361(c)(2)(B)(v) applied in Reg. § 1.1361-1(m)(4)(vii). The 2017 tax reform act amended Code § 1361(c)(2)(B)(v) to make it not apply for purposes of Code § 1361(b)(1)(C), the latter which does not allow an S corporation to "have a nonresident alien as a shareholder." Thus, an ESBT may have a nonresident alien as a beneficiary, which makes sense because the trust is paying tax at the highest possible rate, notwithstanding having such a beneficiary. See part II.A.2.f Shareholders Eligible to Hold S Corporation Stock, especially fns 140-136.

[5926] Family attribution rules ameliorate the 100-shareholder limitation. See fn 160 in part II.A.2.f Shareholders Eligible to Hold S Corporation Stock.

considering unrelated business taxable income issues.[5927] For details about ESBTs, see part III.A.3.e.ii Electing Small Business Trusts (ESBTs, which is found in part III.A.3.e QSSTs and ESBTs.

III.A.3.b.vi. Retirement Plans

Retirement plans are trusts, so let's discuss those for a moment. First, IRAs are qualified under Code § 408, not § 401(a). Therefore, IRAs are not eligible shareholders, as they are not trusts that qualify under these rules.[5928] Second, qualified retirement plans are eligible shareholders[5929] but are taxed on unrelated business taxable income,[5930] including ***all*** income from S corporations, whether or not it normally constitutes unrelated business income.[5931] However, employee stock ownership plans (ESOPs) are not subject to this tax.[5932] Furthermore, transitory ownership by an IRA of S corporation stock rolled over from an IRA will not terminate the S election.[5933]

III.A.3.b.vii. Charitable Trusts

Charities are permitted shareholders.[5934] The S corporation's business activities are not attributable to the charity in determining the nature of the charity's activities, which means that a lot of S corporation business income does not destroy the charity's otherwise exempt status.[5935]

5927 See part II.Q.7.c S Corporation Owned by a Trust Benefitting Charity.
5928 Reg. § 1.1361-1(h)(1)(vii), which became final on August 13, 2008, provides that individual retirement accounts (including Roth IRAs) are not eligible S corporation shareholders, unless they satisfy the exception created in Code § 1361(c)(2)(A)(vi) for bank stock that was held by the IRA as of October 22, 2004. That regulation is extremely unlikely to be challenged as, for various reasons, a reviewed opinion of the Tax Court concluded that IRAs, including Roth IRAs, were not eligible shareholders before that regulation was promulgated. *Taproot Administrative Services, Inc. v. Commissioner*, 133 T.C. 202.
5929 Code § 1361(c)(6)(A), referring to organizations described in Code § 401(a).
5930 Code § 511(a)(1), 501(a).
5931 Code § 512(e)(1).
5932 Code § 512(e)(3).
5933 Rev. Proc. 20014, Section 4 provides:

> The Service will accept the position that an S corporation's election is not affected as a result of an ESOP's distribution of S corporation stock where the participant directs that such stock be distributed to an IRA in a direct rollover, provided that:
>
> .01. The terms of the ESOP require that the S corporation repurchase the stock immediately upon the ESOP's distribution of the stock to an IRA;
>
> .02. Either, pursuant to the terms of the ESOP, the S corporation actually repurchases the S corporation stock contemporaneously with, and effective on the same day as, the distribution, or, pursuant to the terms of the ESOP, the ESOP is permitted to assume the rights and obligations of the S corporation to repurchase the S corporation stock immediately upon the ESOP's distribution of the stock to an IRA and the ESOP actually repurchases the S corporation stock contemporaneously with, and effective on the same day as, the distribution; and
>
> .03. No income (including tax-exempt income), loss, deduction, or credit attributable to the distributed S corporation stock under § 1366 is allocated to the participant's IRA.

5934 Code § 1361(c)(6) provides that an organization, which not only is described in Code § 401(a) or 501(c)(3) but also is exempt from taxation under Code § 501(a), may be a shareholder in an S corporation.
5935 Letter Ruling 201441018.

However, a charitable remainder trust is not a permitted shareholder. See part II.Q.7.c S Corporation Owned by a Trust Benefitting Charity for that[5936] and other nuances.

III.A.3.b.viii. Observations About Trusts as S Corporation Shareholders

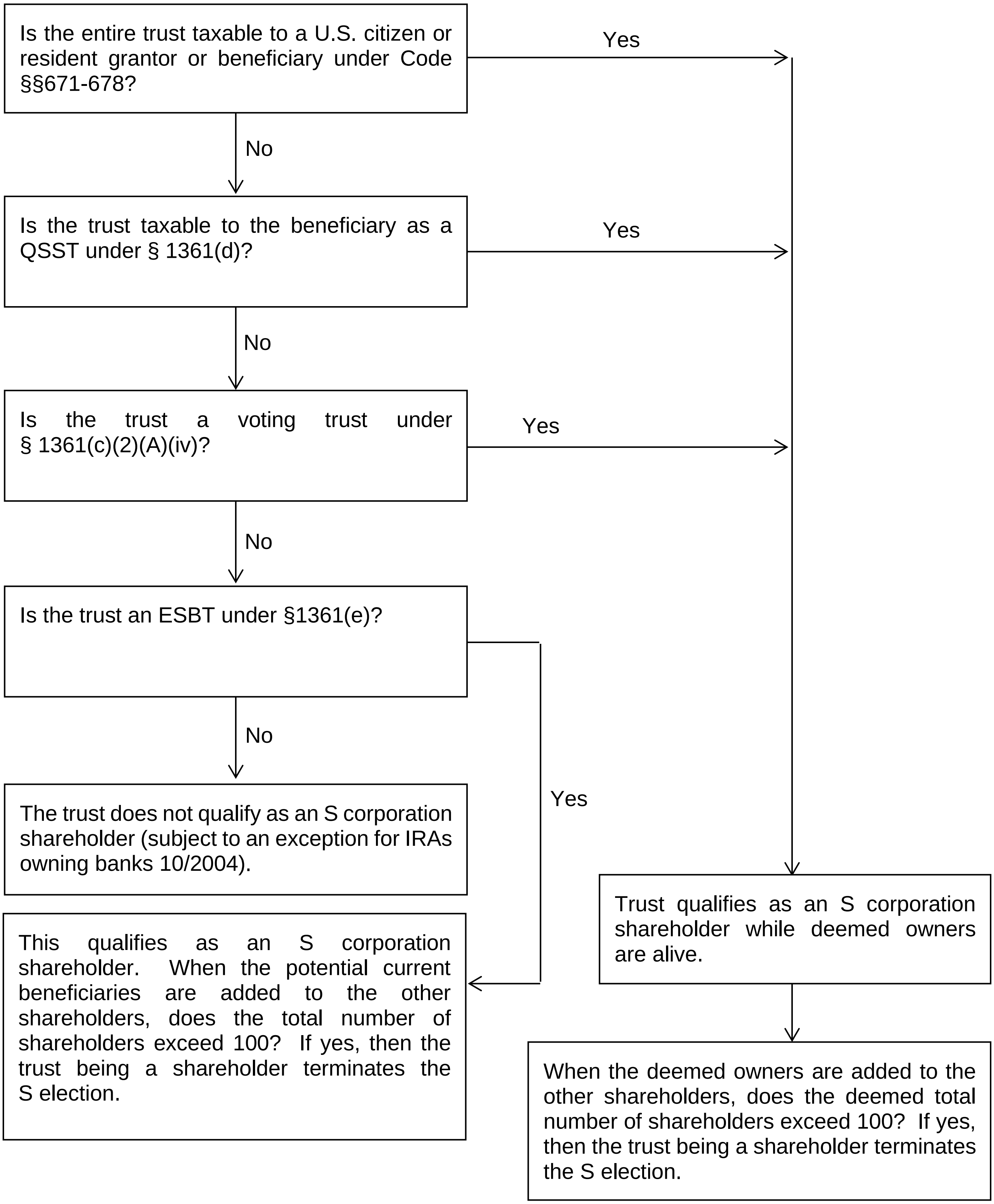
The shareholder agreement does not need to specify these trusts, as the reference to causing the corporation not to be a "small business corporation" as defined in Code § 1361(b)(1) should be sufficient to limit which kinds of trusts may be owners without going into all the detail described above. However, when preparing shareholders' estate plans, make sure the beneficiaries of the estate plans qualify.

III.A.3.c. Deadlines for Trust Qualifying as S Corporation Shareholder

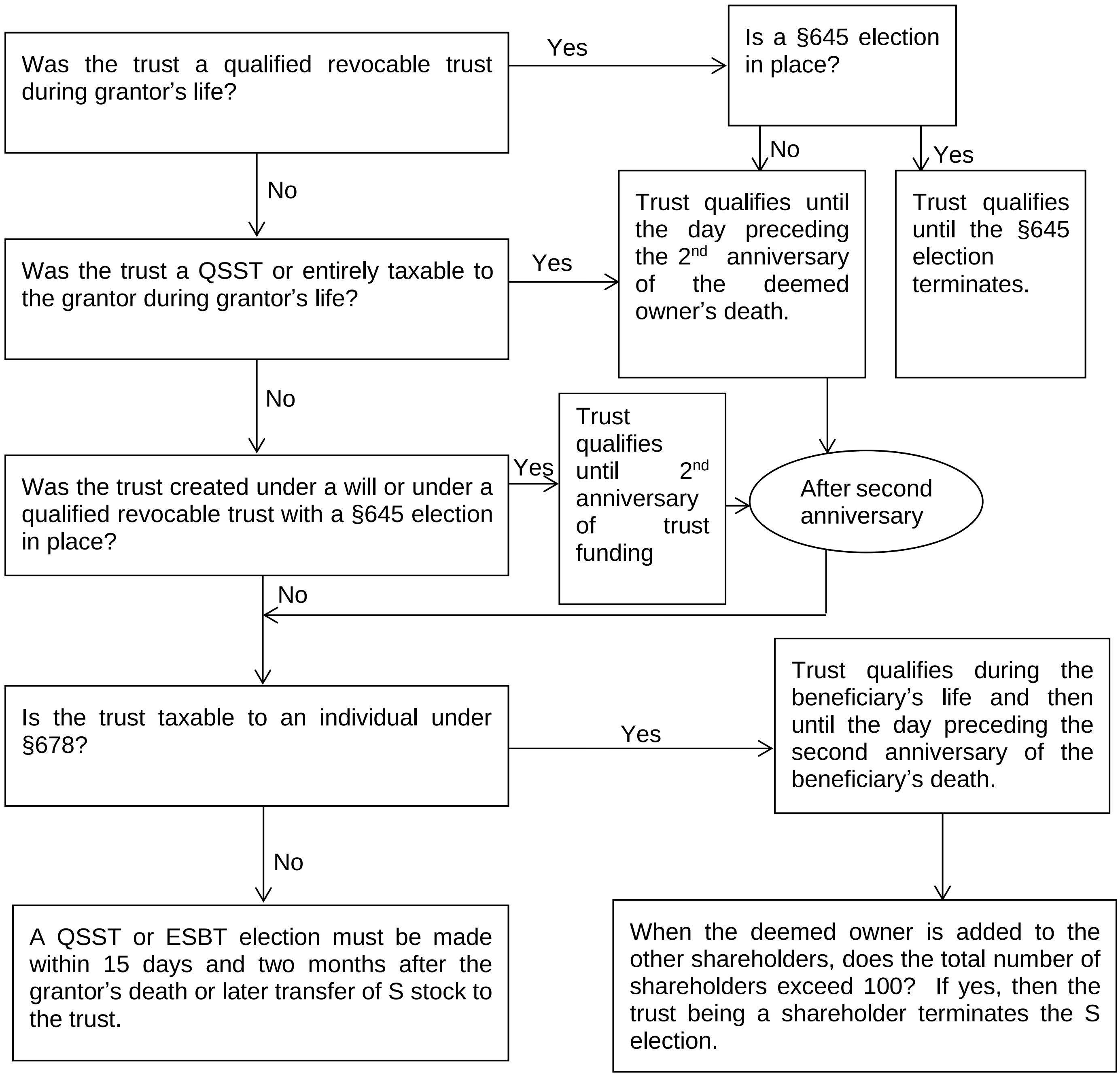
Below are some flowcharts illustrating trust qualification as a shareholder of an S corporation. The flowcharts do not consider trusts that are tax-exempt.

[5936] See fn 4908.

III.A.3.c.i. Flowchart of Inter Vivos Trusts (Trusts Created while Grantor is Alive)



III.A.3.c.ii. Flowchart of Testamentary Trusts (Trusts Created on Grantor's Death or Continued after QSST Beneficiary's Death)



III.A.3.c.iii. Deadlines for QSST and ESBT Elections

III.A.3.c.iii.(a). General Description of Deadlines for QSST and ESBT Elections

A separate QSST election must be made with respect to each S corporation in which the trust owns stock.[5937] Although initially an ESBT election needs to be filed at every IRS Service Center that receives the returns of the S corporations the trust owns, no future ESBT elections are required when the trust acquires stock in another S corporation.[5938]

The beneficiary must make a QSST election no later than fifteen days and two months after the trust received the stock.[5939] The trustee of an ESBT must file the ESBT election within the same time framework.[5940] If the trust is a wholly owned grantor trust or meets some other exception allowing it to be an eligible shareholder,[5941] the deadline would be based on whenever the election's effective date is required[5942] or desired. If the trust is already an eligible shareholder and the QSST or ESBT election is made with an effective date that is later than when the trust first acquired the stock, when drafting the QSST or ESBT election I generally include the fact of that qualification when I say when the trust first acquired the stock, so that any IRS reviewer of the election will see that there does not appear to be any time gap in the trust's eligibility as a shareholder.

If an ESBT or QSST election is made late or is in some manner defective, the S corporation status can be retroactively reinstated if the termination or invalidity was inadvertent, within a reasonable period of time after discovery of the terminating event or invalid election steps were taken to rectify the situation, and the corporation and shareholders agree to adjustments that the IRS may require for the period.[5943] If a trust fails to make an ESBT election and fails to file tax returns consistent with the ESBT election, the corporation and each of its shareholders must

[5937] Reg. § 1.1361-1(j)(6)(i).
[5938] Reg § 1.1361-1(m)(2)(i).
[5939] Reg. § 1.1361-1(j)(6)(ii)(C). A QSST election by a person who is under a legal disability by reason of age may be made on that person's behalf by that person's guardian or other legal representative, or if there be none, by that person's natural or adoptive parent. Reg. § 1.1361-1(j)(6)(i).
[5940] Reg. § 1.1361-1(m)(3)(i) provides that trust is an ESBT on the effective date of the ESBT election.
[5941] See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation.
[5942] For example, Reg. § 1.1361-1(j)(6)(iii)(C) provides:

> If a trust ceases to be a qualified subpart E trust, satisfies the requirements of a QSST, and intends to become a QSST, the QSST election must be filed within the 16-day-and-2-month period beginning on the date on which the trust ceases to be a qualified subpart E trust. If the estate of the deemed owner of the trust is treated as the shareholder under paragraph (h)(3)(i) of this section, the QSST election may be filed at any time, but no later than the end of the 16-day-and-2-month period beginning on the date on which the estate of the deemed owner ceases to be treated as a shareholder.

As a further example, Reg. § 1.1361-1(j)(6)(iii)(D) provides:

> If a testamentary trust is a permitted shareholder under paragraph (h)(1)(iv) of this section, satisfies the requirements of a QSST, and intends to become a QSST, the QSST election may be filed at any time, but no later than the end of the 16-day-and-2-month period beginning on the day after the end of the 2-year period.

For Reg. § 1.1361-1(h)(1)(iv), see part III.A.3.b.iii A Trust with Respect to Stock Transferred to It Pursuant to The Terms of a Will (or a Qualified Revocable Trust When a Code § 645 Election Terminates), But Only for the 2-Year Period Beginning on The Day on Which Such Stock Is Transferred to It.
[5943] Reg. § 1.1362-4(a). Among the many private letter rulings providing relief for a late ESBT election is Letter Ruling 202234003, involving multiple failures.

file any original and amended returns for all open taxable years consistent with the inadvertent termination relief.[5944]

The corporation and all persons who were shareholders of the corporation at any time during the period must consent to make to any adjustments that the IRS may require.[5945] Each consent should be in the form of a statement agreeing to make the adjustments:[5946]

- The statement must be signed by the shareholder and corporation.
- A shareholder's consent statement should include the name, address, and taxpayer identification numbers of the corporation and shareholder, the number of shares of stock owned by the shareholder, and the dates on which the shareholder owned any stock.
- The corporate consent statement should include the name, address, and taxpayer identification numbers of the corporation and each shareholder.

A late ESBT or QSST election may be made within 3 years and 75 days after the effective date of the election, without the $30,000 fee generally required for letter rulings under Code § 9100, illustrated by the following chart provided by the IRS:[5947]

Retroactive reinstatement is required to prevent the accumulated adjustments account (AAA) from being wiped out.[5948]

For the statute authorizing relief and the importance of provisions in a shareholders' agreement ensuring that this relief would be available, see part II.A.2.h Important Protections for S Corporation Shareholder Agreements.

[5944] Letter Ruling 201943018.

[5945] Reg. § 1.1362-4(e). However, if relief under Rev. Proc. 2013-30 applies, Section 6.01(4) of that procedure requires:

> Statements from all shareholders during the period between the date the S corporation election was to have become effective or was terminated and the date the completed Election Form is filed that they have reported their income on all affected returns consistent with the S corporation election for the year the election should have been made and for all subsequent years.

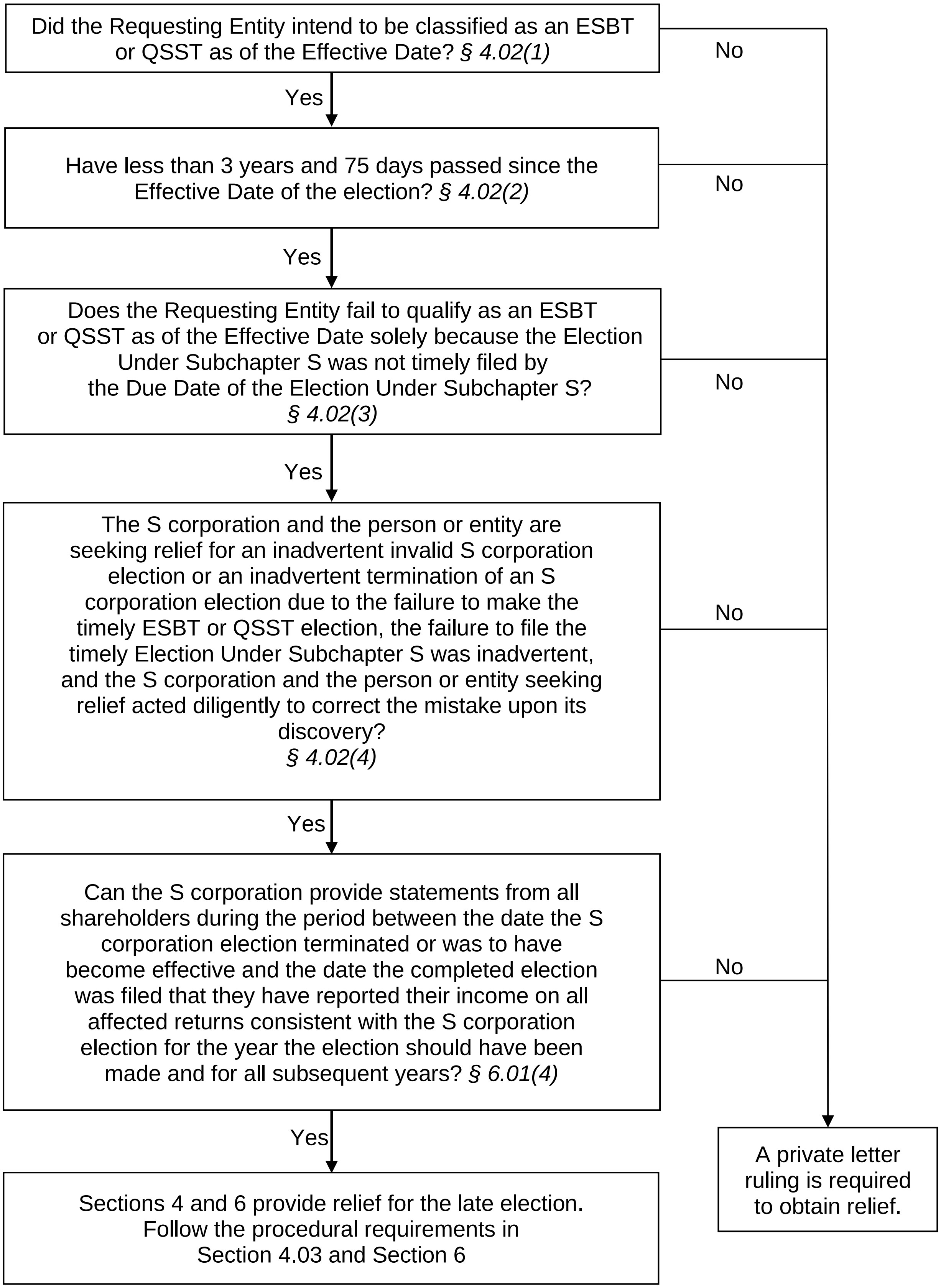
Presumably, these statements are in lieu of consenting to adjustments. One might consider supplementing the statements by agreeing to make adjustments as required by Reg. § 1.1362-4(e), but supplementing the statements does not appear to be required. The relevant IRS web page is https://www.irs.gov/businesses/small-businesses-self-employed/late-election-relief.

[5946] Reg. § 1.1362-4(e).

[5947] Rev. Proc. 2013-30, modifying and superseding Rev. Procs. 2003-43, 2004-48, and 2007-62. One might consider checking the most recent annual Revenue Procedure for issuing letter rulings, the successor to Rev. Proc. 2020-1, for any updates to user fees and to verify the status of Rev. Proc. 2013-30. Also, some taxpayers might qualify for reduced user fees. The relevant IRS web page is https://www.irs.gov/businesses/small-businesses-self-employed/late-election-relief.

[5948] For AAA's importance, see part II.Q.7.b Redemptions or Distributions Involving S Corporations. For the idea that termination of the S election wipes out AAA, see part II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation.

III.A.3.c.iii.(b). Flowchart Showing Relief for Late QSST & ESBT Elections



III.A.3.d. Special Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests

III.A.3.d.i. Various Fiduciary Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests

Regarding basis step-up issues regarding S corporation stock, see fn 2082 in part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

If one bequeaths S corporation stock, consider expressly providing that any distributions with respect to that stock are to be passed on to the beneficiary receiving that stock. Not only does such a provision ensure fairness if the trust/estate administration lasts any significant amount of time, but it also prevents a potentially unfair tax result from occurring, as described below.

A bequest of a partnership interest or S corporation stock that is "ascertainable under the terms of a testator's will as of the date of his death, or under the terms of an inter vivos trust instrument as of the date of the inception of the trust" is a specific bequest that does not count as a distribution that carries with it distributable net income;[5949] the "date of the inception" rule means that the exercise of an inter vivos limited power of appointment does not fall within this exception. On the other hand, income allocated to a beneficiary *does* count a distribution that carries with it distributable net income.[5950] The bequest of the partnership interest or S corporation stock does not constitute a separate share, but distributions bequeathed to the recipient of that business interest *do* constitute a separate share.[5951] See part II.J.9.a.ii Separate Share Rule.

See parts III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation (especially part III.B.2.j.ii.(e) Change in Qualification of Trust to Hold S corporation Stock During Taxable Year) and III.B.2.j.iii Allocations upon Change of Interest in a Partnership.

The distributive share of partnership or S corporation income that does not constitute trust accounting income:[5952]

> is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount of such gross income allocated to each share is based on the relative value of each share that could potentially be funded with such amounts.

[5949] Reg. § 1.663(a)-1(b)(1), delineating items that qualify for the exclusion under Reg. § 1.663(a)-1(a). See Reg. § 1.663(a)-1(b)(3), Example (1).

[5950] Reg. § 1.663(a)-1(b)(2)(i), defining items that do not qualify for the exclusion under Reg. § 1.663(a)-1(a).

[5951] Reg. § 1.663(c)-5, Example (8). Reg. § 1.663(c)-4(a) provides:

> Separate shares include… the income on bequeathed property if the recipient of the specific bequest is entitled to such income …. Conversely, a gift or bequest … of property as defined in section 663(a)(1) is not a separate share.

[5952] Reg. § 1.663(c)-2(b)(4), which applies to:

> the allocation of the portion of gross income includible in distributable net income that is not attributable to cash received by the estate or trust (for example, original issue discount, a distributive share of partnership tax items, and the pro rata share of an S corporation's tax items).

Tying together the separate share rules[5953] with the above rules regarding distributive shares of partnership or S corporation income, one can distill the following rules:[5954]

- DNI equal to undistributed income is allocated among the separate shares according to the amount of income to which each share is entitled.

- DNI equal to distributions from an S corporation or partnership constituting trust accounting income is allocated among the separate shares according to the amount of income to which each share is entitled.[5955] DNI equal to distributions from an S corporation or partnership not

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[5953] See generally part II.J.9.a.ii Separate Share Rule.

[5954] Reg. § 1.663(c)-5, Examples (4) and (5) provide:

Example 4. (i) *Facts*. Testator, who dies in 2000, is survived by a spouse and one child. Testator's will provides for a pecuniary formula bequest to be paid in not more than three installments to a trust for the benefit of the child of the largest amount that can pass free of Federal estate tax and a bequest of the residuary to the surviving spouse. The will provides that the bequest to the child's trust is not entitled to any of the estate's income and does not participate in appreciation or depreciation in estate assets. During the 2000 taxable year, the estate receives dividend income of $200,000 and pays expenses of $15,000 that are deductible on the estate's federal income tax return. The executor partially funds the child's trust by distributing to it securities that have an adjusted basis to the estate of $350,000 and a fair market value of $380,000 on the date of distribution. As a result of this distribution, the estate realizes long-term capital gain of $30,000.

(ii) *Conclusion*. The estate has two separate shares consisting of a formula pecuniary bequest to the child's trust and a residuary bequest to the surviving spouse. Because, under the terms of the will, no estate income is allocated to the bequest to the child's trust, the distributable net income for that trust's share is zero. Therefore, with respect to the $380,000 distribution to the child's trust, the estate is allowed no deduction under section 661, and no amount is included in the trust's gross income under section 662. Because no distributions were made to the spouse, there is no need to compute the distributable net income allocable to the marital share. The taxable income of the estate for the 2000 taxable year is $214,400 ($200,000 (dividend income) plus $30,000 (capital gain) minus $15,000 (expenses) and minus $600 (personal exemption)).

Example 5. The facts are the same as in Example 4, except that during 2000 the estate reports on its federal income tax return a pro rata share of an S corporation's tax items and a distributive share of a partnership's tax items allocated on Form K-1s to the estate by the S corporation and by the partnership, respectively. Because, under the terms of the will, no estate income from the S corporation or the partnership would be allocated to the pecuniary bequest to child's trust, none of the tax items attributable to the S corporation stock or the partnership interest is allocated to the trust's separate share. Therefore, with respect to the $380,000 distribution to the trust, the estate is allowed no deduction under section 661, and no amount is included in the trust's gross income under section 662.

Example 6. The facts are the same as in Example 4, except that during 2000 the estate receives a distribution of $900,000 from the decedent's individual retirement account that is included in the estate's gross income as income in respect of a decedent under section 691(a). The entire $900,000 is allocated to corpus under applicable local law. Both the separate share for the child's trust and the separate share for the surviving spouse may potentially be funded with the proceeds from the individual retirement account. Therefore, a portion of the $900,000 gross income must be allocated to the trust's separate share. The amount allocated to the trust's share must be based upon the relative values of the two separate shares using a reasonable and equitable method. The estate is entitled to a deduction under section 661 for the portion of the $900,000 properly allocated to the trust's separate share, and the trust must include this amount in income under section 662.

[5955] Reg. § 1.663(c)-2(b)(2) provides that:

constituting trust accounting income would be allocated to each share according to "its portion of gross income that is includible in distributable net income and its portion of any applicable deductions or losses."[5956] Note that distributions from an S corporation or partnership that do not constitute trust accounting income but constitute gross income would constitute DNI only if they are (a) not from the sale of a capital asset,[5957] or (b) from the sale of a capital asset but satisfy the rules for including capital gain in DNI.[5958]

- Note that the amounts deducted by the trust or estate and included in the beneficiary's income are the lesser of the beneficiary's allocable share of DNI and the amount actually distributed.[5959] If and to the extent that the trust or estate does not make distributions (or is not required to make) to the beneficiary attributable to DNI, the distributive shares of partnership or S corporation income are trapped inside the trust or estate to the extent not distributed (or required to be made). Thus, the estate or trust is taxed on that income, even though the recipient of the specific bequest ultimately benefits from the undistributed income.

However, practical logistics might suggest not allocating distributions to the recipient of the specific bequest. It is not unusual for tax distributions to be made after yearend. For example, A dies January 31, 2016. The partnership or S corporation makes distributions April 1, 2016 to the owners to pay taxes incurred with respect to 2015 income. A's estate or revocable trust will need that cash to pay its 2015 tax that is due April 15, 2016. Therefore, if A's estate plan bequeathed the partnership or S corporation to B, B should be allocated all of the distributions with respect to the partnership or S corporation, other than distributions relating to 2015 tax and other than distributions relating to tax on income earned between January 1, 2016 and January 31, 2016. Furthermore, these distributions might also draw an allocation of DNI. Thus, consider a clause along these lines (after further thought if the specific bequest is to a QTIP trust):[5960]

> If any partnership interest or stock in any S corporation is specifically allocated to one or more persons, the person(s) entitled to the allocation shall also be entitled to any distributions from the date of the allocation until the date the partnership interest or stock is distributed; however, any distributions that were intended for the payment of tax imposed on taxable items with respect to periods before the event that caused that allocation shall be paid to the person reporting those items.

Also note that state corporate law might not permit distributions to use record dates (determining who is the shareholder of record) more than a certain number of days before the distribution. For example, Missouri law does not allow a corporation to make a distribution with

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> gross income includible in distributable net income that is income within the meaning of section 643(b) … is allocated among the separate shares in accordance with the amount of income that each share is entitled to under the terms of the governing instrument or applicable local law.

For income under Code § 643(b), see part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law; although focused on capital gain, it discusses Code § 643(b) generally as well.

[5956] Reg. § 1.663(c)-2(b)(1).

[5957] See part II.J.8.a Capital Gain Constitutes DNI Unless Excluded.

[5958] See part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.

[5959] See part II.J.9.a.ii Separate Share Rule, especially the text accompanying fns. 2863-2865.

[5960] If the specific bequest is to a QTIP trust and income otherwise payable to the QTIP trust is diverted, query whether that violates the requirement that QTIP exclusively benefit the surviving spouse.

a record date more than 70 days before the date of distribution.[5961] If these statutes apply, one might consider declaring a distribution in the form of a promissory note, the principal of which is any taxes, interest, and penalties imposed on the shareholders by reason of any examination of any prior year returns. This method might also be needed for taxes during the current year, depending on whether the tax laws allow the corporation to close its books as of the date of death. One might also consider converting the corporation into an LLC taxed as an S corporation using a tax-free reorganization,[5962] because LLC laws might not impose such a requirement.

III.A.3.d.ii. Bequeathing S Corporation Stock to or from QSSTs – Special Fiduciary Income Tax Issues

If the terminating trust is a QSST,[5963] coordinate these concerns with those found in part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies, which also includes a reference to marital deduction issues relating to the payment of income.[5964]

If the trust terminates in favor of one or more QSSTs, consider whether, during post-mortem administration, part or all of the income might be trapped inside the trust at high income tax rates if the S corporation does not distribute all of the income shown on the K-1 that the corporation issues the trust.[5965] A similar issue arises for partnerships, which may be placed into one or more S corporations using a QSST strategy. Quickly funding the QSST(s) may tax the income at the beneficiary's rate instead of the trust's rate; see part III.A.4.a General Strategies Regarding Fiduciary Income Taxation of Business Interests.

III.A.3.e. QSSTs and ESBTs

III.A.3.e.i. QSSTs

After reviewing a variety of QSST issues that apply during the beneficiary's life, see part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies, for a discussion of various issues one should consider when a beneficiary makes a QSST election.

III.A.3.e.i.(a). QSSTs Generally

After determining a trust's eligibility for its beneficiary to make a "qualified subchapter S trust" (QSST) election, see part III.A.3.c.iii Deadlines for QSST and ESBT Elections. A beneficiary may make a protective QSST election.[5966]

5961 R.S.Mo. § 351.250.
5962 See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.
5963 See part III.A.3.e.i QSSTs.
5964 See fn. 6006.
5965 See part III.A.4 Trust Accounting Income Regarding Business Interests, as well as parts II.J.11 Trust Business Income Tax Nuances and III.A.3.e QSSTs and ESBTs.
5966 See Reg. § 1.1361-1(k)(1), Example (2), part (iii), reproduced in the text accompanying fn 5908 in part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death.

A QSST may have only one beneficiary (who also must be a U.S. citizen or resident) who may receive income or corpus during the beneficiary's lifetime, and all of its income must be distributed currently to that beneficiary[5967] while the trust[5968] holds S stock.[5969]

The only-one-beneficiary rule is in Code § 1361(d)(3)(A) and Reg. § 1.1361-1(j)(1)(ii), (iii). A trust cannot qualify as a QSST if it provides that, if the trust does not hold shares of an S corporation, the trust may terminate during the life of the current income beneficiary and distribute its corpus to persons other than the current income beneficiary. Rev. Rul. 89-55. Consistent with this limitation, Reg. § 1.1361-1(j)(2)(iii) restricts powers of appointment:

> If, under the terms of the trust, a person (including the income beneficiary) has a special power to appoint, during the life of the income beneficiary, trust income or corpus to any person other than the current income beneficiary, the trust will not qualify as a QSST. However, if the power of appointment results in the grantor being treated as the owner of the entire trust under the rules of subpart E, the trust may be a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section.

Note, however, that failure to make a trust a spendthrift trust (and therefore allowing the beneficiary's interest to be assignable) will not disqualify the trust as a QSST unless it gets assigned (and then it might or might not disqualify the trust).[5970] On the other hand, Letter

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[5967] Code § 1361(d)(3). Letter Ruling 9014008 ruled that a distribution to a grantor trust created by the beneficiary would not qualify, but Letter Rulings 9442036, 9444022, 9444024, and 9444059 permitted distributions to a disability trust because the beneficiary did not have legal capacity, and Letter Rulings 8831020, 9001010, and 9140055 approved distributions to custodial accounts under the Uniform Transfers to Minors Act (the latter also approved distributions to "a court-appointed guardian or conservator of the beneficiary"). This requirement does not preclude secured sales in which all income is used to buy the stock (part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (Including Possible Pitfalls)), nor does it prevent the trust from agreeing to make payments to a third party if stock the trust bought is resold within a certain number of years after the trust's purchase (Letter Ruling 200140040).

[5968] In Letter Ruling 200404037, the IRS accepted the representation that applicable state law deemed a life estate, with the power to sell, to be a trust relationship between the life tenant and the remaindermen and that the deemed trust satisfies the requirements for treatment as a QSST. Letter Ruling 200247030 elaborated on the basis for this deemed trust treatment:

> It is represented that under State law, a life tenant, with the power to sell or dispose of property devised to him or her for life with remainder to designated persons, is a trustee or quasi trustee and occupies a fiduciary relationship to the remaindermen. In the exercise of that power, the life tenant owes to the remaindermen the highest duty to act honorably and in good faith. A life tenant is a trustee in the sense that he cannot injure or dispose of property to the injury of the rights of the remaindermen, but differs from a pure trustee in that he may use property for his exclusive benefit and take all income and profits.

[5969] Rev. Rul. 92-20 held that a provision in a trust agreement authorizing the trustee to accumulate trust income if the trust does not hold any shares of an S corporation does not, by itself, preclude the trust's qualification as a QSST.

[5970] Reg. § 1.1361-1(j)(2)(iv). Reg. § 1.1361-1(k), Example (5), "QSST when current income beneficiary assigns the income interest to a person not named in the trust," provides:

> On January 1, 1996, stock of Corporation R, a calendar year S corporation, is transferred to a trust that satisfies all of the requirements to be a QSST. Neither the terms of the trust nor local law preclude the current income beneficiary, K, from assigning K's income interest in the trust. K files a timely QSST election that is effective January 1, 1996. On July 1, 1996, K assigns the income interest in the trust to N. Under applicable state law, the trustee is bound as a result of the assignment to distribute the trust income to N. Thus, the QSST will cease to qualify as a QSST under section 1361(d)(3)(A)(iii) because N's interest will terminate on K's death (rather than on

Ruling 9437021 viewed the possibility of distribution from the QSST to another trust for that same beneficiary as an error, but ruled that it was harmless error in that case because the recipient trust never existed and therefore could never receive a distribution (see also fn. 5967 regarding the distribution of income other than directly to the beneficiary); however, one might not want to assume that the IRS' national office will repeat this kind and gentle approach. Thus, one may need to avoid authorizing the merger or decanting of any trust that has a QSST election in place. For decanting, see fn. 2646, found in part II.J.4.i Modifying Trust to Make More Income Tax Efficient. However, the Uniform Trust Decanting Act allows decanting to be done by trust amendment rather than actual transfer of assets, in which case a QSST need not prevent decanting; for details on decanting by mere amendment, see fn. 2960, found in part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.

Also, the grantor trust treating a person other than the current income beneficiary as the owner of a part or all of that portion of a trust which does not consist of the S corporation stock does not disqualify the trust from making a QSST election. Reg. § 1.1361-1(j)(2)(vi). Does that, by negative implication, suggest that the settlor (who is not the beneficiary) being treated as deemed owner of the portion of a trust that includes the S corporation stock precludes a QSST election? Reg. § 1.1361-1(j)(4) suggests that prohibition exists; Reg. § 1.1361-1(k)(1), Example (10), paragraph (iii) (reproduced in fn. 5973) confirms that result.

As to the requirement to distribute income: All of the trust's income, not just the income from the S stock, must be distributed or distributable currently. Letter Ruling 9603007. This refers to trust accounting income, not taxable income. Reg. § 1.1361-1(j)(1)(i). Letter Ruling 200446007 held that the amount of a deemed dividend under Code § 1361(d)(3)(B) was not required to be distributed. Also, consistent with ideas discussed in part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally (with fn 4878 referring the reader here), Letter Ruling 200451021 clarifies that, when Code § 302(d) taxes a partial liquidation as a distribution rather than as a redemption, the trust itself is not taxed on any income on the distribution if the trust has sufficient AAA to absorb the basis reduction (Ruling Request 1) and the proceeds from the sale of stock in partial liquidation are principal that the QSST does not need to distribute (Ruling Request 2). Similarly, in Letter Ruling 9349009:

> Company wishes to make a substantial distribution to its shareholders, but for estate planning purposes, its shareholders prefer that the distribution be treated as principal of the Trusts rather than income distributable to the Beneficiaries. Company proposes making a cash distribution to its shareholders ("Distribution") in a stock redemption under section 302(d) of the Code.

Letter Ruling 9349009 held:

> As indicated above, each of the Trusts gives the trustee broad discretionary power to allocate trust receipts between income and principal. Moreover, it is represented that under State law the Distribution should be allocated to principal. Accordingly, the Distribution proceeds received by the Trusts will not constitute fiduciary accounting "income" within the meaning of section 643(b) of the Code.
>
> Assuming the Distribution will qualify as a redemption under section 302(d) of the Code, we conclude that the provisions of sections 1368(b) and 1368(c) will apply for purposes

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N's death). Accordingly, as of the date of the assignment, the trust ceases to be a QSST and Corporation R ceases to be an S corporation.

> of determining whether the Distribution to Company's shareholders will be includable in their gross income. In addition, the treatment of the proposed Distribution by the Trusts as principal rather than income will not cause the Trusts to fail to satisfy the current distribution requirement of section 1361(d)(3). Therefore, assuming the Trusts otherwise qualify as qualified subchapter S trusts, the Distribution will not adversely affect Company's election to be an S corporation.

In Letter Ruling 200234062, an S corporation distributed a partnership interest to its shareholders; the partnership held only cash. Because a distribution of property did not constitute fiduciary accounting income, the partnership interests were not required to be distributed to the income beneficiary. The facts were:

> Company elected in 1999 to be treated as an S corporation for federal income tax purposes. Company has accumulated earnings and profits from periods prior to 1999. Company has 32 shareholders. Fifty three percent of the stock in Company is owned by Trusts #1 through #26, which were established between and by Grantor, Grantor's son (Son), the spouse of Son (Spouse), and the granddaughters of Grantor (Granddaughter 1 and Granddaughter 2) for the benefit of various descendants of Grantor. Granddaughters 1 and 2 are also shareholders of Company. The remaining 4 shareholders are other trusts (not at issue in this ruling request) established by one of the granddaughters. All of the individual trustees of Trusts #1 through #26 are descendants of Grantor. In addition, an independent corporate trustee is a co-trustee of Trusts #1 through #8, and Trusts #18 and #19. A major asset of each of the trusts is stock in Company.
>
> It is represented that: Trusts #1 through #8 and Trusts #18 and #19 qualify as shareholders of Company as electing small business trusts (ESBTs); Trusts #9 through #17 qualify as shareholders of Company as qualified subchapter S trusts (QSST Trusts); and Trusts #20 through #26 are grantor trusts, within the meaning of Subpart E, Part I, Subchapter J, Chapter 1, Subtitle A of the Internal Revenue Code of 1986.
>
> **Trusts #1 - #19:**
>
> Trusts #1 through #4 are either inter vivos or testamentary trusts that were created by Grantor primarily for the benefit of Granddaughters 1 and 2 and their issue. Trusts #5 through #8 are either inter vivos or testamentary trusts that were created by Son also primarily for the benefit of Granddaughters 1 and 2 and their issue. Likewise, Trusts #9 through #19 are either inter vivos or testamentary trusts that were created by Spouse primarily for the benefit of Granddaughters 1 and 2 and their issue. Trusts #1 through #19 do not contain any provision directing the allocation of receipts between income and principal. Trusts #1 through #19 are governed by Maryland law and were irrevocable prior to September 25, 1985. It is represented that no additions have been made to any of Trust #1 through Trust #19 after September 25, 1985.
>
> **Trusts #20 - #23:**
>
> Trusts #20 through #23 are irrevocable trusts that were established on Date 1, after September 25, 1985, by Granddaughter 1, primarily for the benefit of her issue and their descendants. You represent that Granddaughter 1 allocated sufficient GST exemption so that Trusts #20 through #23 each has an inclusion ratio of zero for generation-

skipping transfer tax purposes. These trusts are also governed by Maryland law. Art. III(G)13 of each trust states that:

> Fiduciary Powers. In addition to the powers granted by law, I grant my Trustee the powers set forth in the Estates and Trusts Article of the Maryland Code, as well as the powers set forth in the following paragraphs, which is subject, however, to the restrictions set forth in the following Paragraphs H, I, and J of this Article. My Trustee (hereinafter sometimes referred to as "fiduciary") is empowered, in its discretion as a fiduciary and without the order or ratification of any court: ...
>
> 13. To determine whether items should be charged or credited to income or principal or allocated between income and principal, in such manner as the Trustee deems equitable and fair under all the circumstances, without regard to how such items are treated for federal estate or income tax purposes, . . .

Further, the Maryland Uniform Principal and Income Act (Md. Code Ann., Est. & Trusts, § 15-508 (2001)) provides, in part:

> (c) Receipts allocated to principal. - Except as provided in subsection (f) of this section, a trustee shall allocate the following receipts from an entity to principal:
>
> (1) Property other than money;
>
> (2) Money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity; . . .

Trusts #24 - #26:

Trusts #24 through #26, are irrevocable trusts established on Date 2, after September 25, 1985, by Granddaughter 2 primarily for the benefit of her issue and their descendants. You also represent that Granddaughter 2 allocated sufficient GST exemption so that Trusts #20 through #23 each has an inclusion ratio of zero for generation-skipping transfer tax purposes. Trusts #24 through #26 are governed by New Jersey law. Art. III(G)(13) of each trust states that:

> Fiduciary Powers. In addition to the powers granted by law, I grant my Trustee the powers set forth in the New Jersey Statutes, as well as the powers set forth in the following paragraphs, which shall be subject, however, to the restrictions set forth in the following Paragraphs H, I, and J of this Article. My Trustee (hereinafter sometimes referred to as "fiduciary") is empowered, in its discretion as a fiduciary and without the order or ratification of any court: . . .
>
> 13. To determine whether items should be charged or credited to income or principal or allocated between income and principal, in such manner as the Trustee deems equitable and fair under all the circumstances, without regard to how such items are treated for federal estate or income tax purposes, ...

Further, New Jersey law provides that, where the trust instrument makes provision for the ascertainment of principal and income or grants discretion to the fiduciary or other person to do so, the provision or the grant of discretion shall control, notwithstanding any provision in the New Jersey statute. N.J. Stat. Ann. § 3B:19A-5(a) (West 2001).

> The shareholders of Company created LLC1, a limited liability company, in 2000. The shareholders' membership interests in LLC1 are in the same proportion as their respective shares in Company. It is represented that, to date, no capital contributions have been made to LLC1 by its members.
>
> **Proposed Transaction**
>
> Company proposes to create a second limited liability company (LLC2) in which Company will initially be the sole member. Upon the creation of LLC2, Company will contribute property and cash to LLC2 in an amount not in excess of its accumulated adjustments account, as defined in § 1368(e)(1) of the Internal Revenue Code. Company will then distribute its interest in LLC2 to its shareholders in proportion to each of the shareholders' stock holdings in Company. The trustee of each of the Trusts will allocate the LLC2 interests received to principal. LLC2 will then merge into LLC1 with LLC1 as the surviving entity. All of these transactions will occur in quick succession.

After ruling that the changes will not undo GST grandfathering or change the GST inclusion ratio, Letter Ruling 200234062 held:

> The distribution of the LLC2 interests to the QSST Trusts is a distribution of property allocable to principal under Maryland law. Therefore, the receipt of the LLC2 interests by the QSST Trusts will not be considered a receipt of income to the trusts for § 1361(d)(3)(B) purposes. As the receipt of the LLC2 interests is not income to the QSST Trusts, the proposed transaction will not cause the QSST Trusts to fail to qualify as QSSTs if they do not distribute the LLC2 interests to the beneficiaries of those trusts.
>
> During the time Company is the sole member of LLC2, LLC2 will be treated as a disregarded entity for federal tax purposes. Therefore, the transfer of assets to LLC2 has no federal tax consequences. Company's distribution of the LLC2 interests to its shareholders will be considered a distribution of the property and cash held by LLC2 followed by a contribution of the property and cash to LLC2 by the shareholders. The distribution of the LLC2 interests by Company (treated as a distribution of LLC2 's property and cash) will be subject to §§ 1368 and 311(b). Furthermore, the shareholders of Company will be treated as contributing the property and cash to LLC2 under § 721.

Although LLC1 was an empty shell, even if it had assets the merger of LLC2 into it would have been nontaxable. See part II.Q.8.e.v Partnership Mergers.

This result is consistent with section 401(d)(1) of the Uniform Fiduciary Income and Principal Act (2018) and section 401(c)(1) of the (last revised in 2008) Uniform Principal & Income Act (UPIA). Comments trace this rule back to the 1962 UPIA. Further thoughts:

- With this precedent, the taxpayers might feel emboldened to repeat this transaction every year – the corporation might put cash into a new single member LLC, distribute to the shareholder, then merge into LLC1. That would frustrate the intent behind the QSST distribute-all-income requirement, so I would not try it without a private letter ruling.

- Query whether a QSST's trustee has a duty to object to annual receipts of operating income in the form of property other than cash. In doing the planning suggested by the ruling, consider who is making the decision. I tend to make voting stock 5% of the entity's stock and pass that differently than nonvoting stock, so consider making the voting shareholders be different from these QSSTs and not having a paper trail of doing this at the request of the QSSTs' trustees.

- Consider whether the trustee of a QSST should consider exercising the power to adjust when this occurs.

- Consider whether a beneficiary may object to a trustee's decision not to pursue these avenues. However, the beneficiary must prove an abuse of discretion.

If the income may be used to discharge the beneficiary's parent's support obligation, actual (not mere potential) use for that purpose may ruin the trust's qualification. Reg. 1.1361-1(j)(2)(ii)(B), "Legal obligation to support," provides:

> If under local law a distribution to the income beneficiary is in satisfaction of the grantor's legal obligation of support to that income beneficiary, the trust will not qualify as a QSST as of the date of distribution because, under section 677(b), if income is distributed, the grantor will be treated as the owner of the ordinary income portion of the trust or, if trust corpus is distributed, the grantor will be treated as a beneficiary under section 662. See § 1.677(b)-1 for rules on the treatment of trusts for support and § 1.662(a)-4 for rules concerning amounts used in discharge of a legal obligation.

Reg. § 1.1361-1(j)(2)(ii)(C) provides an example illustrating Reg. 1.1361-1(j)(2)(ii)(B):

> *Example*. F creates a trust for the benefit of F's minor child, G. Under the terms of the trust, all income is payable to G until the trust terminates on the earlier of G's attaining age 35 or G's death. Upon the termination of the trust, all corpus must be distributed to G or G's estate. The trust includes all of the provisions prescribed by section 1361(d)(3)(A) and paragraph (j)(1)(ii) of this section, but does not preclude the trustee from making income distributions to G that will be in satisfaction of F's legal obligation to support G. Under the applicable local law, distributions of trust income to G will satisfy F's legal obligation to support G. If the trustee distributes income to G in satisfaction of F's legal obligation to support G, the trust will not qualify as a QSST because F will be treated as the owner of the ordinary income portion of the trust. Further, the trust will not be a qualified subpart E trust because the trust will be subject to tax on the income allocable to corpus.

However, if the distribution is caught within the first 2½ months of the year, consider converting the trust to an ESBT. See parts III.A.3.c.iii Deadlines for QSST and ESBT Elections and III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.

The income distribution rule is that all income either actually is distributed each year or is required to be distributed each year;[5971] inadvertent termination relief may be available if the

[5971] Code § 1361(d)(3)(B); Reg. § 1.1361-1(j)(1)(i), the latter which expressly recognizes that income distributed in the first 65 days of the year may be treated under Code § 663(b) as being distributed in the immediately preceding year. Letter Rulings 8508048, 8836057, and 199927011 approved trusts in which the income must be distributed currently, but the beneficiary may elect in any year to have the trustee retain all or any portion of the income of the trust (it is not clear whether the trusts expressly permitted their beneficiaries to elect that retention or whether that was simply a practice that was contemplated); for related issues not discussed in the rulings, see part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts, especially part III.B.2.i.ix Creditor and Gift/Estate Tax Issues Regarding Withdrawal Rights, Whether Currently Exercisable or Lapsed.

income is not distributed and catch-up distributions are made.[5972] Special rules apply to an inter vivos QTIP or another trust for a spouse.[5973] If a QSST ceases to meet any of the requirements of Reg. § 1.1361-1(j)(1)(ii), the QSST rules will cease to apply as of the first day on which that requirement ceases to be met.[5974] If such a trust ceases to meet the income distribution

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[5972] Letter Ruling 201710001.

[5973] Reg. § 1.1361-1(j)(4) approves testamentary QTIP trusts but, for inter vivos ones, prohibits a QSST election during marriage and requires one to ensure that the grantor is treated as wholly owning the trust:

> However, if property is transferred to a QTIP trust under section 2523(f), the income beneficiary may not make a QSST election even if the trust meets the requirements set forth in paragraph (j)(1)(ii) of this section because the grantor would be treated as the owner of the income portion of the trust under section 677. In addition, if property is transferred to a QTIP trust under section 2523(f), the trust does not qualify as a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section (a qualified subpart E trust), unless under the terms of the QTIP trust, the grantor is treated as the owner of the entire trust under sections 671 to 677.

Reg. § 1.1361-1(k)(1), Example (10), provides:

> (i) *Transfers to QTIP trust*. On June 1, 1996, A transferred S corporation stock to a trust for the benefit of A’s spouse B, the terms of which satisfy the requirements of section 2523(f)(2) as qualified terminable interest property. Under the terms of the trust, B is the sole income beneficiary for life. In addition, corpus may be distributed to B, at the trustee’s discretion, during B’s lifetime. However, under section 677(a), A is treated as the owner of the trust. Accordingly, the trust is a permitted shareholder of the S corporation under section 1361(c)(2)(A)(i), and A is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.
>
> (ii) *Transfers to QTIP trust where husband and wife divorce*. Assume the same facts as in paragraph (i) of this Example 10, except that A and B divorce on May 2, 1997. Under section 682, A ceases to be treated as the owner of the trust under section 677(a) because A and B are no longer husband and wife. Under section 682, after the divorce, B is the income beneficiary of the trust and corpus of the trust may only be distributed to B. Accordingly, assuming the trust otherwise meets the requirements of section 1361(d)(3), B must make the QSST election within 2 months and 15 days after the date of the divorce.
>
> (iii) *Transfers to QTIP trust where no corpus distribution is permitted*. Assume the same facts as in paragraph (i) of this Example 10, except that the terms of the trust do not permit corpus to be distributed to B and require its retention by the trust for distribution to A and B’s surviving children after the death of B. Under section 677, A is treated as the owner of the ordinary income portion of the trust, but the trust will be subject to tax on gross income allocable to corpus. Accordingly, the trust does not qualify as an eligible shareholder of the S corporation because it is neither a qualified subpart E trust nor a QSST.

Paragraph (iii) illustrates two points. First, to qualify as a wholly owned grantor trust (see part III.A.3.a.i Qualifying as a Wholly Owned Grantor Trust), the trust must have not only its income but also its principal deemed owned wholly by the same individual (see part III.A.3.a.ii How a Trust Can Fall Short of Being Wholly Owned by One Person, especially fn. 5878); therefore, when drafting a trust for a spouse that holds stock in an S corporation for which an ESBT election is not in effect, one should consider including a grantor trust power beyond merely Code § 677, to make sure that the entire trust is taxed to the grantor (see part III.B.2.h How to Make a Trust a Grantor Trust). Second, no part of a QSST may be deemed owned by a person other than the beneficiary.

Paragraph (ii) offers insight into the application of Code § 677(a) after divorce. See part III.B.2.h.ix Code § 682 Limitations on Grantor Trust Treatment, the result of which is that, if distributions are made after separation, the trust no longer qualifies as a wholly owned grantor trust and a QSST election is unavailable; therefore, an ESBT election must be made (but note that Code § 682 is being repealed by 2017 tax reform). For the interaction of divorce with Chapter 14, see parts III.B.7.b.iv Divorce Planning to Avoid Code § 2701 and III.B.7.d Code § 2702 Overview, especially the text accompanying fns. 7393-7398.

[5974] Reg. § 1.1361-1(j)(5).

requirement of Reg. § 1.1361-1(j)(1)(i), but continues to meet all of the requirements Reg. § 1.1361-1(j)(1)(ii), the QSST rules will cease to apply as of the first day of the first taxable year beginning after the first taxable year for which the trust ceased to meet that income distribution requirement. See parts III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation[5975] and III.A.3.e.i.(b) QSST Issues When Beneficiary Dies.

Reg. § 1.1361-1(k)(1), Example (4) illustrates the income distribution rule (before the number of shareholder limitation was increased from 75 to 100):

(i) *QSST when terms do not require current distribution of income*. Corporation Q, a calendar year corporation, makes an election to be an S corporation effective for calendar year 1996. On July 1, 1996, G, a shareholder of Corporation Q, transfers G's shares of Corporation Q stock to a trust with H as its current income beneficiary. The terms of the trust otherwise satisfy the QSST requirements, but authorize the trustee in its discretion to accumulate or distribute the trust income. However, the trust, which uses the calendar year as its taxable year, initially satisfies the income distribution requirement because the trustee is currently distributing all of the income. On August 1, 1996, H makes a QSST election with respect to Corporation Q that is effective as of July 1, 1996. Accordingly, as of July 1, 1996, the trust is a QSST and H is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *QSST when trust income is not distributed currently*. Assume the same facts as in paragraph (i) of this Example 4, except that, for the taxable year ending on December 31, 1997, the trustee accumulates some trust income. The trust ceases to be a QSST on January 1, 1998, because the trust failed to distribute all of its income for the taxable year ending December 31, 1997. Thus, Corporation Q ceases to be an S corporation as of January 1, 1998, because the trust is not a permitted shareholder.

(iii) *QSST when a person other than the current income beneficiary may receive trust corpus*. Assume the same facts as in paragraph (i) of this Example 4, except that the events occur in 2003 and H dies on November 1, 2003, and the trust does not qualify as an ESBT. Under the terms of the trust, after H's death, L is the income beneficiary of the trust and the trustee is authorized to distribute trust corpus to L as well as to J. The trust ceases to be a QSST as of November 1, 2003, because corpus distributions may be made to someone other than L, the current (successive) income beneficiary. Under section 1361(c)(2)(B)(ii), H's estate (and not the trust) is considered to be the shareholder for purposes of section 1361(b)(1) for the 2-year period beginning on November 1, 2003. However, because the trust continues in existence after H's death and will receive any distributions from the corporation, the trust (and not H's estate) is treated as the shareholder for purposes of sections 1366, 1367, and 1368, during that 2-year period. After the 2-year period, the S election terminates and the trust continues as a shareholder of a C corporation. If the termination is inadvertent, Corporation Q may request relief under section 1362(f). However, the S election would not terminate if the trustee distributed all Corporation Q shares to L, J, or both on or before October 31, 2005, (the last day of

[5975] Especially fn 6853 in part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest.

the 2-year period) assuming that neither L nor J becomes the 76th shareholder of Corporation Q as a result of the distribution.

Suppose a QSST owns the S corporation stock through a single-member LLC that is disregarded for income tax purposes. Only distributions from the LLC to the trust – rather than distributions from the S corporation – must be distributed to satisfy the QSST rules. I would tend to stay away from the idea of reducing what must be distributed to the beneficiary:

- I am concerned about gift tax issues for failure to require the trustee to pull out the LLC's assets.[5976] Is the trustee making sure the statute of limitations runs annually so that the income beneficiary's claim at death is not huge,[5977] and is the annually retained income less than 5% of the distributions?[5978] Does the lapse generate Code § 678 issues regarding the LLC's non-S corporation income[5979] or Code § 2036 issues regarding the excess lapse?[5980]

- I am also concerned about – upon termination - the trustee distributing the LLC to more than one beneficiary, thereby creating a partnership that is not eligible to hold S stock and terminating the S election.[5981]

Reg. § 1.1361-1(k)(1), Example (7) illustrates the effect of a remote possibility[5982] that principal may be distributed to someone other than the current income beneficiary and curing that defect:

> QSST when settlor of trust retains a reversion in the trust. On January 10, 1996, M transfers to a trust shares of stock in corporation X, an S corporation. D, who is 13 years old and not a lineal descendant of M, is the sole income beneficiary of the trust. On termination of the trust, the principal (including the X shares) is to revert to M. The trust instrument provides that the trust will terminate upon the earlier of D's death or D's 21st birthday. The terms of the trust satisfy all of the requirements to be a QSST except those of section 1361(d)(3)(A)(ii) (that corpus may be distributed during the current income beneficiary's life only to that beneficiary) and (iv) (that, upon termination of the trust during the life of the current income beneficiary, the corpus, must be distributed to that beneficiary). On February 10, 1996, M makes a gift of M's reversionary interest to D. Until M assigns M's reversion in the trust to D, M is deemed to own the entire trust under section 673(a) and the trust is a qualified subpart E trust. For purposes of section 1361(b)(1), 1366, 1367, and 1368, M is the shareholder of X. The trust ceases

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5976 See discussion of Rev. Rul. 84-105 in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts.

5977 See part II.J.4.j.i Need to Provide Notices.

5978 See text following fn 2621 in part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary, discussing Rev. Rul. 66-87 and *Fish v. U.S*.

5979 See part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.

5980 Part III.C Code § 2036.

5981 See text accompanying fns 146-157 in part .

5982 Using the latest mortality tables that had issued, on July 5, 2019 a 13-year-old had a 99.5% chance of reaching age 21. I don't know why Code § 673(a) was chosen, because the facts below do not appear to satisfy Code § 673(a), which provides that, subject to subsection (b) when the beneficiary is a minor descendant, "The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion."
See fn 5987, which reproduces the holding of Rev. Rul. 93-31 regarding a remote possibility that the corpus of the trust will be distributed during the lifetime of the current income beneficiary to someone other than that beneficiary

> to be a qualified subpart E trust on February 10, 1996. Assuming that, by virtue of the assignment to D of M's reversionary interest, D (upon his 21st birthday) or D's estate (in the case of D's death before reaching age 21) is entitled under local law to receive the trust principal, the trust will be deemed as of February 10, 1996, to have satisfied the conditions of section 1361(d)(3)(A)(ii) and (iv) even though the terms of the trust do not explicitly so provide. D must make a QSST election by no later than April 25, 1996 (the end of the 16-day-and-2-month period that begins on February 10, 1996, the date on which the X stock is deemed transferred to the trust by M). See example (5) of § 1.1001-2(c) of the regulations.

Some annual expenses are ordinarily allocated one-half to income and one-half to principal. Generally, these include (1) the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee, and (2) expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests.[5983] If S corporation distributions are the trust's only source of cash, this rule is impractical, because the trust would be unable to pay the portion of the expense allocated to principal. Accordingly, I often suggest that the trustee make an adjustment, allocating the entire expense to income, which might be authorized under either state law[5984] or the governing instrument.[5985] If the business or the stock is sold later, the proceeds are taxable to the trust, rather than the beneficiary; at that time, some of the proceeds might be allocated to income to make up for these prior allocations of administrative expenses, which would help move taxable items from the trust's high rates to the beneficiary's potentially lower rates.[5986]

A trust that has substantially separate and independent shares, each of which is for the sole benefit of one beneficiary, may qualify as a QSST with respect to each separate share.[5987] For

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[5983] Section 501 of the Uniform Principal and Income Act, which can be found at http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008).

[5984] See part II.J.8.c.i.(a) Power to Adjust.

[5985] See parts II.J.8.c.i.(d) Exceptions in the Governing Instrument and II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law, especially fns. 2765-2770 (language that might be included in one's forms authorizing such an adjustment, as well as the consequences of using such language).

[5986] See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax) and II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets. See also part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the . For form language that might facilitate this allocation, see fn. 2765, found in part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

[5987] Code § 1361(d)(3); see Letter Ruling 201119005, discussed in fn 6001 in part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies. Although the statute cites to the separate share rules under Code § 663(c) (see part II.J.9.a.ii Separate Share Rule), the test is more stringent than that. Code § 663(c) provides for that distributions to other beneficiaries be ignored in determining separate share treatment if the possibility of distribution is remote. Rev. Rul. 93-31 holds:

> A substantially separate and independent share of a trust, within the meaning of section 663(c) of the Code, is not a QSST if there is a remote possibility that the corpus of the trust will be distributed during the lifetime of the current income beneficiary to someone other than that beneficiary.

For example, if an inter vivos QSST includes a clause requiring the payment of estate tax if the grantor dies during the beneficiary's life, and that payment clause might benefit the grantor's estate beyond whatever applicable law would provide but for that clause, the IRS' view is that mere possibility of such a example, a grantor sets up an irrevocable trust for the benefit of his four children, who are the only children he will ever have. Each child receives one-fourth of the income and corpus distributions. Each child would be considered the owner of one-fourth of the stock owned by the trust.[5988] This could also work well for a vested trust for a grandchild, which qualifies for the GST annual exclusion;[5989] see part III.A.3.a.i Qualifying as a Wholly Owned Grantor Trust for an example of a vested trust.

To avoid the requirement that all of the trust income – not just its S corporation income – be distributed to the beneficiary, it is not uncommon for a trust agreement to divide the trust so that the QSST is a separate trust. For inter vivos QSSTs, this approach might have additional state income tax benefits; see part II.J.15.b QSSTs and State Income Tax Issues. On a separate but related note, suppose a QSST holds investments (such as partnerships) that generate taxable income without necessarily generating trust accounting income. Can the nongrantor trust portion of the QSST take an income distribution deduction with respect to the distributions to the beneficiary of trust accounting income derived from S corporation? The QSST regulations[5990] do not address it, but the grantor trust regulations provide some support for my preliminary view that the nongrantor trust portion cannot get credit for those distributions.[5991]

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diversion might disqualify the QSST from inception. Letter Ruling 201451001 (which I obtained to obtain inadvertent termination relief at the insistence of the CPAs for the company that was acquiring my client). However, paying transfer tax on the beneficiary's death should not cause any QSST problem. Letter Ruling 9014008 (GST tax).
See the text accompanying fn 5982 for an example in the regulations about what happens when the remote possibility is cured.

[5988] However, it would not work if trust provided that the birth of another child after the trust is created would cause the trust to be divided five ways, essentially diverting one-fourth of each existing trust. Rev. Rul. 89-45.

[5989] Code § 2642(c)(2) provides that the GST annual exclusion applies to a trust that uses *Crummey* withdrawal rights only if the grandchild (or other skip person) is the sole beneficiary of the trust, and the trust's assets must be includible in the beneficiary's gross estate upon her death. Code § 2654(b) provides that substantially separate and independent shares of different beneficiaries shall be treated as separate trusts under the GST rules. Suppose a grantor sets up an irrevocable trust for the benefit of his four grandchildren. Each grandchild receives one-fourth of the income and corpus distributions; the trust distributes all of its income each year; and each of the four living grandchild would be considered the owner of one-fourth of the stock owned by the trust. If a grandchild who dies before or after trust termination holds a general power of appointment over one-fourth of the trust's assets, the trust will qualify for the GST annual exclusion and as a QSST.

[5990] Reg. § 1.1361-1(j).

[5991] Reg. § 1.671-3(a)(2) provides:

> If the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion. Items directly related to trust property not included in the portion treated as owned by the grantor or other person are governed by the provisions of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code.

"Items" refers to "items of income, deduction, and credit against tax attributable to or included in that portion," so I can't say with absolute certainty what the answer is. However, I think that the "better" answer is that distributions from the trust of S corporation trust accounting income would be attributable to the grantor trust portion. This is consistent with the IRS' general approach in CCA 201327009, discussed in the text accompanying fns 6113-6115 in part III.A.3.e.vi.(a) Grantor Trust Issues Involved in a Sale of S Stock to a QSST.

The beneficiary of a QSST is taxed on all of the QSST's K-1 income and losses from the S corporation[5992] (although the trust still needs to get its own tax ID and use a grantor information statement to report K-1 items to the beneficiary).[5993] However, when the QSST sells the stock, the trust itself is taxable on any gain on the sale,[5994] including any gain the corporation incurs after adopting a plan of complete liquidation[5995] or from the deemed asset sale resulting from a Code § 338(h)(10) election.[5996] If the corporation actually sells its assets without adopting a plan of liquidation, I am unsure of the result. For additional planning issues, see parts II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business, II.J.8.a.i Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset (discussing whether the gain is included in DNI), and II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax). From the above, one can glean that depreciation recapture on the actual or deemed sale of personal property is ordinary income that is principal but might be best taxed to the beneficiary, who might either be in a lower tax bracket or might have losses from operations during the year of sale passing through the grantor trust portion to offset; thus, consider including in one's trust the flexibility to distribute principal or to reallocate principal to income.[5997]

The beneficiary must make a separate QSST election with respect to each corporation whose stock the trust holds.[5998]

See part II.A.2.d Estate Planning Strategies Available Only for S Corporation Shareholders for a brief introduction to a QSST's unique benefits. To explore a QSST's unique attributes as a grantor trust deemed owned by its beneficiary, see part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs.

Also note that a QSST election might enhance (or perhaps reduce) the trust's ability to deduct charitable contributions made by the S corporation.[5999]

[5992] Code § 1361(d)(1)(B). Reg. § 1.1361-1(j)(7)(i) provides:

> The income beneficiary who makes the QSST election and is treated (for purposes of section 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

Reg. § 1.1361-1(j)(8) further provides:

> If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made.

[5993] Reg. § 1.671-4(b)(6)(iii).

[5994] Reg. § 1.1361-1(j)(8). However, for purposes of recognizing any losses suspended due to the at-risk rules of Code § 465 or the passive activity rules of Code § 469, the regulation treats the beneficiary as having sold the stock so that the suspended losses can be triggered. For more details on such sales, see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets.

[5995] Letter Rulings 9721020 and 199905011. This includes gain from the actual sale of assets as well as gain on the Code § 336 deemed sale of assets distributed to shareholders. Of course, Code § 331 gain on the deemed sale of stock on dissolution is also taxed to the trust.

[5996] Letter Rulings 9828006, 199920007, and 201232003.

[5997] See part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law, which includes parts discussing allocating to income what otherwise would be principal receipts.

[5998] Reg. § 1.1361-1(j)(6)(i). Inadvertent termination relief is available when the trust acquires stock in another S corporation if a timely QSST election is not made with respect to that other S corporation. Letter Ruling 201618003.

[5999] See part II.Q.7.c S Corporation Owned by a Trust Benefitting Charity, especially the text accompanying fn. 4941.

III.A.3.e.i.(b). QSST Issues When Beneficiary Dies

QSSTs have excellent post-mortem planning flexibility:

- A QSST may hold stock for two years after the beneficiary's death without making any election at all.[6000]

- If a QSST continues as separate QSST-eligible shares for each beneficiary after termination but before the new QSST trusts are actually funded, no new election is required until actual funding of the new trusts; in other words, the QSST election stays in effect, with the individual remaindermen taxed as the QSST beneficiaries until actual post-mortem trust funding occurs.[6001]

The latter is a very important tool. Consider what happens after the beneficiary dies and before the stock is retitled in the remaindermen's names. If the S corporation does not distribute all of its taxable income, the trust might not be able to obtain an income distribution deduction to carry out all of the income to the remaindermen, thereby trapping the income[6002] at the trust's presumably higher income tax rates.[6003] Keeping the QSST election intact post-mortem before stock retitling to make sure that individual beneficiaries are taxed directly on the S corporation's K-1 income might save income tax during that period.

However, challenges arise when the remaindermen are not the residual beneficiaries of the beneficiary's estate plan. The S corporation might make distributions to pay the shareholders' income taxes after the beneficiary dies, and then how will the beneficiary's estate pay tax on the

[6000] See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, especially part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death.

[6001] See Reg. § 1.1361-1(j)(9)(ii), contrasting Example (1) with Example (2). Code § 1361(d)(2)(B)(ii) provides:

> Elections with respect to successive income beneficiaries. If there is an election under this paragraph with respect to any beneficiary, an election under this paragraph shall be treated as made by each successive beneficiary unless such beneficiary affirmatively refuses to consent to such election.

Letter Ruling 201119005 held that, when the QSST beneficiary died, separate shares were created that qualified as QSSTs, without any QSST election needing to be affirmatively made with respect to the remaindermen, in the following scenario:

> Upon B's death, Trust's assets were divided into two shares. The income from one share is required to be paid to C and the income from the other share is required to be paid to D. During the life of each of C and D (the income beneficiaries), the income and principal from one beneficiary's share can only be paid to that income beneficiary. Neither income beneficiary has a claim against the income and principal of the other beneficiary's share. Since Date 4, the income from each share of Trust has been distributed to the income beneficiary of that share. Neither beneficiary has affirmatively refused to consent to the QSST election made for Trust on Date 3.

For separate share treatment for QSSTs, see fn 5987 in part III.A.3.e.i.(a) QSSTs Generally.

[6002] See parts III.A.4 Trust Accounting Income Regarding Business Interests and III.F.2 Trust Accounting and Taxation.

[6003] Note, however, that trapping income inside trusts might be beneficial. See parts II.J.3 Strategic Fiduciary Income Tax Planning and III.A.3.e.ii.(c) When ESBT Income Taxation Might Help, the latter not directly on point but having some helpful ideas.

beneficiary's allocable share[6004] of the S corporation's income? What happens when a QSST's beneficiary dies, the beneficiary's estate is taxed on pre-mortem income, and the remaindermen are different than the beneficiaries of the beneficiary's estate? This might occur, for example, in a second marriage situation. Although the Uniform Principal and Income Act discusses issues along these lines to a certain extent,[6005] drafting to address this issue would be advisable:

- If the beneficiary does not control disposition of the trust's assets, the beneficiary might consider negotiating income tax reimbursement provisions with the trustee as a condition of making the QSST election.

- If the beneficiary does control disposition, the beneficiary might consider exerting that control to require that the remaindermen reimburse the beneficiary's estate for income tax on the pre-mortem income. On the other hand, if the QSST's remaindermen are the same as under the beneficiary's estate plan generally, the opportunity to create a debt (taxes on the earned but undistributed income) on the beneficiary's estate tax return might prove beneficial. In the latter case, the beneficiary might exercise any power of appointment he or she might have to provide for the QSST election to remain in place after the beneficiary's death during trust administration before the trust is divided.

One might consider a provision along the following lines:

(1) If the individuals to whom the S corporation stock is allocated do not share in the residue of the deceased beneficiary's estate (in this Agreement, Article 5 determines the sharing of the residue of my estate, because my will bequeaths my estate to the Revocable Trust and Article 5 bequeaths the residuary trust assets), then any distributions the S corporation makes to pay its shareholders' taxes with respect to their distributive shares of taxable income before the date of death shall be treated as income earned before the beneficiary's death and paid to the beneficiary's estate.

(2) If and to the extent that paragraph (1) does not apply, during trust administration, after the beneficiary's death and before separate trusts can be funded, the trust will not terminate but rather will continue as a single trust with separate shares pursuant to U.S. Treas. Reg. section 1.1361-1(j)(9)(ii), Example (1), and the trusts for the beneficiaries will be amended under [the QSST provisions].

Such a provision would not cause any marital deduction problems for the trust that is terminating.[6006] However, if the trust is included in the beneficiary's estate and the beneficiary is bequeathing the stock to a QTIP trust and income otherwise payable to the QTIP trust is

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[6004] See part III.B.2.j Tax Allocations upon Change of Interest, especially part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

[6005] Section 201 of the Uniform Principal and Income Act (last amended or revised in 2008; see http://www.uniformlaws.org/shared/docs/principal%20and%20income/upia_final_08_clean.pdf) addresses actions when a trust terminates.

[6006] Rev. Rul. 92-64 generally allows income earned during the surviving spouse's life but paid after the surviving spouse's death to be paid to either the surviving spouse's estate (if allowed under state law) or the successor beneficiary. State corporate law often limits the gap between record date (the date on the shareholder actually owned the stock) and payment date; generally, an LLC taxed as an S corporation would not face this problem. Of course, in a trust situation, with either type of entity the trust would receive the distribution and then direct it according to the beneficiaries' respective interests, if the ownership interest was not transferred between death and date of the distribution from the corporation.

diverted, query whether that violates the requirement that QTIP exclusively benefit the surviving spouse.

A successive income beneficiary may disaffirm this QSST continuation, retroactively by as much as 2 months and 15 days (but may not disaffirm after that period).[6007]

The amount of income allocated before and after death is also potentially subject to considerable uncertainty, unless an election to close the corporation's books is made, as described in part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation, especially part III.B.2.j.ii.(d) Death of a Shareholder.

If the stock is bequeathed to a person other than the persons receiving the trust's residue, consider the issues in part III.A.3.d Special Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests, which addresses timing issues relating to distributions to pay taxes on the trust's distributive share of the entity's income.

Letter Ruling 201420005 addressed the following facts:

> The information submitted states that X was incorporated under the laws of State on Date 1, and elected to be an S corporation effective Date 2. Trust 1, Trust 2 and Trust 3, each of which was a qualified subchapter S trust (QSST) under § 1361(d)(1) for which A was the sole income beneficiary, were shareholders of X.
>
> On Date 3, A died. Trust 1, Trust 2 and Trust 3 each continued to qualify as a permissible S corporation shareholder under § 1.1361-1(j)(7)(ii) of the Income Tax Regulations for the 2-year period beginning on the day of the deemed owner's death and ending on Date 4.
>
> On Date 4, Trust 1, Trust 2 and Trust 3 each became an ineligible shareholder of X and X's election to be an S corporation terminated. On Date 5, the trustees of each of Trust 1, Trust 2 and Trust 3 distributed each Trust's stock in X to Trust 4, which X represents is a QSST. X represents that the circumstances resulting in the termination of X's S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning.

[6007] Reg. § 1.1361-1(j)(10), "Affirmative refusal to consent," provides:

- (i) *Required statement*. A successive income beneficiary of a QSST must make an affirmative refusal to consent by signing and filing with the service center where the corporation files its income tax return a statement that -
  - (A) Contains the name, address, and taxpayer identification number of the successive income beneficiary, the trust, and the corporation for which the election was made;
  - (B) Identifies the refusal as an affirmative refusal to consent under section 1361(d)(2); and
  - (C) Sets forth the date on which the successive income beneficiary became the income beneficiary.
- (ii) *Filing date and effectiveness*. The affirmative refusal to consent must be filed within 15 days and 2 months after the date on which the successive income beneficiary becomes the income beneficiary. The affirmative refusal to consent will be effective as of the date on which the successive income beneficiary becomes the current income beneficiary.

Without mentioning any of the rules stated above, Letter Ruling 201420005 concluded:

> Based solely on the information submitted and the representations made, we conclude that X's S corporation election terminated on Date 4, when Trust 1, Trust 2 and Trust 3 became ineligible shareholders. We further conclude that the termination of X's S corporation election was an inadvertent termination within the meaning of § 1362(f). Accordingly, pursuant to the provisions of § 1362(f), X will be treated as an S corporation from Date 4 and thereafter, provided that X's S corporation election was otherwise valid and has not otherwise terminated under § 1362(d).

The ruling did not address how Trust 1, Trust 2 and Trust 3 were administered after A's death. Did they accumulate income, as trusts do between date of termination and date of funding the downstream trusts? Or, did they distribute all of the income to the sole beneficiary of Trust 4, who presumably under state law should have received any fiduciary accounting income not necessary to wind up Trust 1, Trust 2 or Trust 3? These questions make me want to be very specific in referring to Reg. § 1.1361-1(j)(9)(ii), Example (1), as does the sample clause listed above. If one does not have similar language, consider documenting in writing that this continuation is in fact occurring between date of termination and date of funding the downstream trusts if for some reason it is impractical to fund the downstream trusts before the two-year post-mortem grace period expires. That documentation might also save income taxes; see fns 6002-6003 and the accompanying text.

III.A.3.e.ii. Electing Small Business Trusts (ESBTs)

III.A.3.e.ii.(a). Qualification as an ESBT

After determining eligibility to make an electing small business trust (ESBT) election, see part III.A.3.c.iii Deadlines for QSST and ESBT Elections. Make sure the election correctly refers to the date shares were transferred to the trust that is selected as the effective date.[6008]

To qualify to make an ESBT election,[6009] the trust cannot have as a beneficiary any person other than an individual, an estate, a charity within certain definitions;[6010] if a potential current

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[6008] Letter Ruling 201941006 granted inadvertent termination relief as of Date 3 in the following situation:

> On Date 2, Trust 1 acquired shares in A. Trust 1 qualified under § 1362(c)(2)(A)(v) as an eligible S corporation shareholder and timely filed an ESBT election effective Date 2. A represents that on Date 3, under the laws of State Trust 1 merged with and into Trust 2, with Trust 2 surviving. As a result of the merger, the shares of A owned by Trust 1 were transferred to Trust 2 as of Date 3.
>
> On Date 4, the trustee of Trust 2 filed an election under § 1362(c)(2)(A)(v) to be treated as an ESBT effective Date 5. The ESBT election incorrectly stated that the shares of A owned by Trust 1 prior to the merger were transferred to Trust 2 on Date 5, when the shares were actually transferred on Date 3. A represents that Trust 2 intended the ESBT election to be effective as of Date 3. As a result, A's S corporation election terminated on Date 3 because Trust 2 was an ineligible shareholder.

See parts II.J.18.b Trust Mergers and II.J.18.c Decanting, the latter being relevant because a decanting may be a trust merger treated as a mere continuation of the original trust.

[6009] Code § 1361(e)(1)(A)(iii) authorizes the election.

[6010] Code § 1361(e)(1)(A)(i). Permitted charities include an organization described in Code § 170(c)(2), (3), (4), or (5) or, if it has a contingent interest in the trust and is not a potential current beneficiary, a Code § 170(c)(1) organization. As described in part II.A.2.f Shareholders Eligible to Hold S Corporation Stock, 2017 tax reform allowed a nonresident alien (NRA) to be a beneficiary. In exchange, any part of the trust that the NRA is deemed to own is taxed as a nongrantor S portion; see fns 142-143.

beneficiary of an ESBT is not an eligible shareholder of an S corporation, the S election terminates.[6011] "Beneficiary" includes a person who has a present, remainder, or reversionary interest in the trust.[6012] A distributee trust is the beneficiary of the ESBT only if the distributee trust is a Code § 170(c)(2) or (3) organization.[6013] In all other situations, any person who has a beneficial interest in a "distributee trust" is a beneficiary of the ESBT, rather than the trust itself being considered to be a beneficiary.[6014] A "distributee trust" is a trust that receives or may receive a distribution from the ESBT, whether the rights to receive the distribution are fixed or contingent, or immediate or deferred.[6015]

If an impermissible shareholder might become a potential current beneficiary, one might consider taking steps to exclude that person from being a potential current beneficiary ("PCB") of the ESBT portion.[6016] Generally, a PCB is any person who at any time during the taxable year is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust;[6017] the deemed owner of a grantor trust is also a PCB.[6018] A potential trap

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[6011] Reg. § 1.1361-1(m)(5)(iii), which provides further:

> For example, the S corporation election will terminate if a charitable remainder trust becomes a potential current beneficiary of an ESBT. Such a potential current beneficiary is treated as an ineligible shareholder beginning on the day such person becomes a potential current beneficiary, and the S corporation election terminates on that date. However, see the special rule of paragraph (m)(4)(iii) of this section. If the S corporation election terminates, relief may be available under section 1362(f).

[6012] Reg. § 1.1361-1(m)(1)(ii)(A).

[6013] Reg. § 1.1361-1(m)(1)(ii)(B).

[6014] Reg. § 1.1361-1(m)(1)(ii)(B).

[6015] Reg. § 1.1361-1(m)(1)(ii)(B).

[6016] Letter Ruling 200913002 held that such a modification did not affect GST grandfathering.

[6017] Code § 1361(e)(2). Reg. § 1.1361-1(m)(4)(i) provides:

> *Generally*. For purposes of determining whether a corporation is a small business corporation within the meaning of section 1361(b)(1), each potential current beneficiary of an ESBT generally is treated as a shareholder of the corporation. Subject to the provisions of this paragraph (m)(4), a potential current beneficiary generally is, with respect to any period, any person who at any time during such period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust. A person is treated as a shareholder of the S corporation at any moment in time when that person is entitled to, or in the discretion of any person may, receive a distribution of principal or income of the trust. No person is treated as a potential current beneficiary solely because that person holds any future interest in the trust. An NRA potential current beneficiary of an ESBT is treated as a shareholder for purposes of the 100-shareholder limit under section 1361(b)(1)(A). However, an NRA potential current beneficiary of an ESBT is not treated as a shareholder in determining whether a corporation is a small business corporation for purposes of the NRA-shareholder prohibition under section 1361(b)(1)(C).

Reg. § 1.1361-1(m)(4)(iii) further provides:

> *Special rule for dispositions of stock*. Notwithstanding the provisions of paragraph (m)(4)(i) of this section, if a trust disposes of all of the stock which it holds in an S corporation, then, with respect to that corporation, any person who first met the definition of a potential current beneficiary during the 1-year period ending on the date of such disposition is not a potential current beneficiary and thus is not a shareholder of that corporation.

Reg. § 1.1361-1(m)(4)(v) also provides:

> *Contingent distributions*. A person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (such as the death of the holder of a power of appointment) is not a potential current beneficiary until such time or the occurrence of such event.

For the effect of a power of appointment, see fn 6032.

[6018] Reg. § 1.1361-1(m)(4)(ii) provides:

applies when an ESBT terminates in favor of trusts (the "downstream trusts"). After the event terminating the ESBT (such as the primary beneficiary's death) and before the trust distributes its assets to the downstream trusts, the downstream trusts might become PCBs, applying the following rules:

(1) Generally, a trust that exists is a distributee trust if it becomes entitled to, or at the discretion of any person, may receive a distribution from principal or income of an ESBT.[6019] A trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit.[6020] A trust that is not yet funded not currently a distributee trust.[6021]

(2) If the distributee trust qualifies a trust described in part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, then the persons who would be its PCBs if the distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT.[6022] However, if the distributee trust is a former grantor trust[6023] or is a testamentary trust,[6024] in either case during the special initial 2-year period, then the relevant estate is treated as the ESBT's PCB during that period.[6025]

(3) If the distributee trust is not a trust described in part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, then the distributee trust is the potential current beneficiary of the ESBT and the corporation's S corporation election terminates.[6026] However, if the distributee trust would be a valid QSST or ESBT if the relevant election were made and the election is not made because the trust does not hold S stock, then the distributee trust does not count as a PCB,[6027] and the distributee trust's

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> *Grantor trusts*. If all or a portion of an ESBT is treated as owned by a person under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code, such owner is a potential current beneficiary in addition to persons described in paragraph (m)(4)(i) of this section.

[6019] Reg. § 1.1361-1(m)(4)(iv)(A).
[6020] Reg. § 1.1361-1(m)(4)(iv)(A).
[6021] Reg. § 1.1361-1(m)(4)(iv)(A). Letter Rulings 200816012 and 200913002 approved as an ESBT a trust prohibiting distributions to a nonresident alien for so long as (1) the trust has an ESBT election in effect, and (2) a non-resident alien is not permitted to be a PCB of an ESBT under the Code and Regs. (I do not know why the rulings cited Reg. § 1.1361-1(m)(4)(iv) instead of Reg. § 1.1361-1(m)(4)(v). I wonder whether that is a typo.) However, starting in 2018, a nonresident alien may be a beneficiary of an ESBT. See part II.A.2.f Shareholders Eligible to Hold S Corporation Stock, especially fns 140-136.
[6022] Reg. § 1.1361-1(m)(4)(iv)(C).
[6023] See part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death.
[6024] See part III.A.3.b.iii A Trust with Respect to Stock Transferred to It Pursuant to The Terms of a Will (or a Qualified Revocable Trust When a Code § 645 Election Terminates), But Only for the 2-Year Period Beginning on The Day on Which Such Stock Is Transferred to It.
[6025] Reg. § 1.1361-1(m)(4)(iv)(C).
[6026] Reg. § 1.1361-1(m)(4)(iv)(B).
[6027] Reg. § 1.1361-1(m)(4)(iv)(D) provides:

> For the purposes of paragraph (m)(4)(iv)(C) of this section, a trust will be deemed to be described in section 1361(c)(2)(A) if such trust would qualify for a QSST election under section 1361(d) or an ESBT election under section 1361(e) if it owned S corporation stock.

Letter Ruling 200912005 approved a distributee trust that would have been eligible to make an ESBT election even though its sole remainderman was a charity (it did not, as drafted, qualify as a charitable remainder trust).

Reg. § 1.1361-1(m)(8)(vi), Example 6, provides:

> (A) *Distributee trust that would itself qualify as an ESBT*. Trust-1 holds stock in X, an S corporation, and has a valid ESBT election in effect. Under the terms of Trust-1, the

PCBs would count as PCBs of the trust that does hold the S stock.[6028] Another option is for the main trust to partially fund the distributee trust and have the distributee trust then qualify as a shareholder.[6029]

Each potential current beneficiary is treated as a shareholder for the purposes of the 100-shareholder limitation.[6030]

Regulations had provided that an open-ended inter vivos power of appointment violates the 100-shareholder limitation; however, Congress modified that provision for years beginning after December 31, 2004 to provide that powers of appointment are considered during a period only

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trustee has discretion to make distributions to A, B, and Trust-2, a trust for the benefit of C, D, and E. Trust-2 would qualify to be an ESBT, but it owns no S corporation stock and has made no ESBT election. Under paragraph (m)(4)(iv) of this section, Trust-2's potential current beneficiaries are treated as the potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Thus, A, B, C, D, and E are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Trust-2 itself will not be counted as a shareholder of Trust-1 for purposes of section 1361(b)(1).

(B) *Distributee trust that would not qualify as an ESBT or a QSST*. Assume the same facts as Example 6 in paragraph (m)(8)(vi)(A) of this section except that D is a charitable remainder trust. Trust-2 would not be eligible to make an ESBT or QSST election if it owned S corporation stock and therefore Trust-2 is a potential current beneficiary of Trust-1. Since Trust-2 is not an eligible shareholder, X's S corporation election terminates.

(C) *Distributee trust that is a section 1361(c)(2)(A)(ii) trust*. Assume the same facts as in Example 6 in paragraph (m)(8)(vi)(A) of this section except that Trust-2 is a trust treated as owned by A under section 676 because A has the power to revoke Trust-2 at any time prior to A's death. On January 1, 2003, A dies. Because Trust-2 is a trust described in section 1361(c)(2)(A)(ii) during the 2-year period beginning on the day of A's death, under paragraph (m)(4)(iv)(C) of this section, Trust-2's only potential current beneficiary is the person listed in section 1361(c)(2)(B)(ii), A's estate. Thus, B and A's estate are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1).

[6028] Reg. § 1.1361-1(m)(4)(iv)(B) provides:

If the distributee trust is a trust described in section 1361(c)(2)(A), the persons who would be its potential current beneficiaries (as defined in paragraphs (m)(4)(i) and (ii) of this section) if the distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT. Notwithstanding the preceding sentence, however, if the distributee trust is a trust described in section 1361(c)(2)(A)(ii) or (iii), the estate described in section 1361(c)(2)(B)(ii) or (iii) is treated as the potential current beneficiary of the ESBT for the 2-year period during which such trust would be permitted as a shareholder.

See Reg. § 1.1361-1(m)(8)(vi), Example 6, reproduced in fn. 6027.

[6029] Reg. § 1.1361-1(m)(8)(v), Example 5, provides:

Potential current beneficiaries and distributee trust holding S corporation stock. Trust-1 has a valid ESBT election in effect. The trustee of Trust-1 has the power to make distributions to A directly or to any trust created for the benefit of A. On January 1, 2003, M creates Trust-2 for the benefit of A. Also on January 1, 2003, the trustee of Trust-1 distributes some S corporation stock to Trust-2. A, as the current income beneficiary of Trust-2, makes a timely and effective election to treat Trust-2 as a QSST. Because Trust-2 is a valid S corporation shareholder, the distribution to Trust-2 does not terminate the ESBT election of Trust-1. Trust-2 itself will not be counted toward the shareholder limit of section 1361(b)(1)(A). Additionally, because A is already counted as an S corporation shareholder because of A's status as a potential current income beneficiary of Trust-1, A is not counted again by reason of A's status as the deemed owner of Trust-2.

[6030] Code § 1361(c)(2)(B)(v).

to the extent exercised during that period,[6031] and the regulations now reflect this change.[6032] If a distribution can be made to an existing trust, that trust must be qualify under the general rules for trusts as S corporation shareholders;[6033] similar to the power of appointment rule, that rule does not apply until the distributee trust has been created.[6034]

[6031] Code § 1361(e)(2).

[6032] Reg. § 1.1361-1(m)(4)(vi)(A) provides:

> (A) *Powers of appointment*. A person to whom a distribution may be made during any period pursuant to a power of appointment (as described for transfer tax purposes in section 2041 and § 20.2041-1(b) of this chapter and section 2514 and § 25.2514-1(b) of this chapter) is not a potential current beneficiary unless the power is exercised in favor of that person during the period. It is immaterial for purposes of this paragraph (m)(4)(vi)(A) whether such power of appointment is a ``general power of appointment'' for transfer tax purposes as described in §§ 20.2041-1(c) and 25.2514-1(c) of this chapter. The mere existence of one or more powers of appointment during the lifetime of a power holder that would permit current distributions from the trust to be made to more than the number of persons described in section 1361(b)(1)(A) or to a person described in section 1361(b)(1)(B) or (C) will not cause the S corporation election to terminate unless one or more of such powers are exercised, collectively, in favor of an excessive number of persons or in favor of a person who is ineligible to be an S corporation shareholder. For purposes of this paragraph (m)(4)(vi)(A), a ``power of appointment'' includes a power, regardless of by whom held, to add a beneficiary or class of beneficiaries to the class of potential current beneficiaries, but generally does not include a power held by a fiduciary who is not also a beneficiary of the trust to spray or sprinkle trust distributions among beneficiaries. Nothing in this paragraph (m)(4)(vi)(A) alters the definition of "power of appointment" for purposes of any provision of the Internal Revenue Code or the regulations.
>
> (B) *Powers to distribute to certain organizations not pursuant to powers of appointment*. If a trustee or other fiduciary has a power (that does not constitute a power of appointment for transfer tax purposes as described in §§ 20.2041-1(b) and 25.2514-1(b) of this chapter) to make distributions from the trust to one or more members of a class of organizations described in section 1361(c)(6), such organizations will be counted collectively as only one potential current beneficiary for purposes of this paragraph (m), except that each organization receiving a distribution also will be counted as a potential current beneficiary. This paragraph (m)(4)(vi)(B) shall not apply to a power to currently distribute to one or more particular charitable organizations described in section 1361(c)(6). Each of such organizations is a potential current beneficiary of the trust.

[6033] Reg. § 1.1361-1(m)(4)(iv)(B).

[6034] Reg. § 1.1361-1(m)(4)(iv)(A), which further provides:

> For this purpose, a trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit. Thus, if a trust instrument provides for a trust to be funded at some future time, the future trust is not currently a distributee trust.

An ESBT cannot have a beneficiary whose interest was acquired by purchase.[6035] This prohibition does not have anything to do with whether the trust has purchased or might later purchase S stock.[6036]

[6035] Code § 1361(e)(1)(A)(ii). For whether a change in a beneficiary's interest in a trust might cause an interest in the trust to be obtained by purchase in violation of this rule, see Potter, Trust Decanting of S corporation Shareholders: Avoiding Inadvertent Termination of the Company's S Election, *TM Memorandum* (BNA) (12/29/2014) or *TM Estates, Gifts and Trusts Journal* (BNA) (3/12/2015). Letter Ruling 201834007 ruled:

> A is causing A's grantor trust to transfer the shares of X stock to the Trust pursuant to the divorce Decree, and the amount of the liabilities assumed plus the liabilities that the property transferred is subject to does not exceed the adjusted basis of the property transferred.
>
> Accordingly, based on the facts submitted and representations made, provided that the transfer of the shares of X stock to the Trust occurs within six years of the entry of final judgment and the terms of the Trust as executed by A and B remain materially identical to those submitted, we conclude that § 1041(a) applies and A and B will not recognize any gain or loss on the transfer of the shares of X stock from A's grantor trust to the Trust.
>
> Further, § 1041(b) applies such that the transfer is treated as a gift under § 1041(b). As such, B's acquisition of B's lifetime distribution rights in the Trust for consideration is not a purchase within § 1361(e) because the sale is not governed by § 1012(a). Accordingly, B's acquisition of B's distribution rights will not disqualify Trust from being an ESBT.

Letter Rulings 201436006 and 201436007 ruled that the following transactions did not constitute a prohibited purchase of an interest in a trust:

> X created Trust 1 on D1. Trust 1 is a grantor trust wholly owned by X. X proposes to create Trust 2 which will be a grantor trust wholly owned by X. X proposes to contribute S corporation stock to Trust 2 and sell the Trust 2 remainder interest to Trust 1. Trust 2 will elect to be an electing small business trust (ESBT) under 1361(e) upon creation.
>
> ….
>
> [W]e conclude that the sale of the Trust 2 remainder interest to Trust 1 will not disqualify Trust 2 from being an ESBT under § 1361(e) during the period when Trust 1 is a grantor trust as to X because the sale of the remainder interest is not a purchase within the meaning of § 1361(e). The sale of the remainder interest is not a purchase within the meaning of 1361(e) because the sale is not governed by § 1012(a). However, to the extent that the sale is treated as a gift, the sale will be covered by § 1015(a). In addition, we conclude that Trust 2 will not cease to be or fail to qualify as an ESBT after the termination of Trust 1's grantor trust status because Trust 1's acquisition of the remainder is not a purchase within the meaning of § 1361(e).

[6036] Reg. § 1.1361-1(m)(1)(iii) provides:

> *Interests acquired by purchase*. A trust does not qualify as an ESBT if any interest in the trust has been acquired by purchase. Generally, if a person acquires an interest in the trust and thereby becomes a beneficiary of the trust as defined in paragraph (m)(1)(ii)(A), and any portion of the basis in the acquired interest in the trust is determined under section 1012, such interest has been acquired by purchase. This includes a net gift of a beneficial interest in the trust, in which the person acquiring the beneficial interest pays the gift tax. The trust itself may acquire S corporation stock or other property by purchase or in a part-gift, part-sale transaction.

T.D. 8994 (5/13/2002) stated:

> Two commentators requested clarification on whether a trust is eligible to be an ESBT if it acquires property in a part-gift, part-sale transaction, such as a gift of encumbered property or a net gift, in which the donor transfers property to a trust provided the trust pays the resulting gift tax. Section 1361(e)(1)(A)(ii) provides that a trust is eligible to be an ESBT only if "no interest in the trust was acquired by purchase." Section 1361(e)(1)(C) defines <u>purchase</u> as "any acquisition if the basis of the property acquired is determined under section 1012." The proposed regulations provide that if any portion of a beneficiary's basis in the beneficiary's interest is determined under section 1012, the beneficiary's interest was acquired by purchase. The final regulations clarify

If an ESBT transfers stock to a qualified voting trust,[6037] the ESBT continues to be treated as the owner for purposes of reporting income and the current beneficiaries of the ESBT continue to be treated as the shareholders for purposes of determining whether the corporation remains eligible to be taxed as an S corporation.[6038]

If an ESBT is decanted, be sure to file a new ESBT election.[6039]

A trust ceases to be an ESBT on the first day the trust fails to meet the definition of an ESBT, and the last day the trust is treated as an ESBT is the day before the date on which the trust fails to meet the definition of an ESBT.[6040] A trust ceases to be an ESBT on the first day following the day the trust disposes of all S corporation stock; but, if the trust is using the installment method to report income from the sale or disposition of its stock in an S corporation, the trust ceases to be an ESBT on the day following the earlier of the day the last installment payment is received by the trust or the day the trust disposes of the installment obligation.[6041]

III.A.3.e.ii.(b). ESBT Income Taxation - Overview

ESBT income taxation is complicated. An ESBT is treated as two separate trusts for purposes of chapter 1 of subtitle A of the Code.[6042] The portion that consists of stock in one or more S corporations is treated as one trust, and the portion that consists of all the other assets in the trust is treated as a separate trust.[6043] The grantor trust rules trump this treatment;[6044] but, to the extent a nonresident alien is a deemed owner, that portion is reallocated to the nongrantor S portion.[6045] However, the ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return.[6046]

The income from the Schedule K-1 that the S corporation files for the trust is separately taxed to the trust at the highest individual income tax rate for that type of income.[6047] Very few deductions are allowed against this income, and the income distribution deduction is not

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> that the prohibition on purchases applies to purchases of a beneficiary's interest in the trust, not to purchases of property by the trust. A net gift of a beneficial interest in a trust, where the donee pays the gift tax, would be treated as a purchase of a beneficial interest under these rules, while a net gift to the trust itself, where the trustee of the trust pays the gift tax, would not.

The Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-96), December 18, 1996 (Blue Book), stated:

> No interest in the trust may be acquired by purchase. For this purpose, "purchase" means any acquisition of property with a cost basis (determined under sec. 1012). Thus, interests in the trust must be acquired by reason of gift, bequest, etc. The trust itself may acquire property (including stock of an S corporation) by purchase.

[6037] See part III.A.3.b.iv A Trust Created Primarily to Exercise the Voting Power of Stock Transferred to It.
[6038] Letter Ruling 201837012.
[6039] Letter Ruling 201442047, essential parts of which are reproduced in the text accompanying fn 2970 in part II.J.18.c.ii Tax Consequences of Decanting, viewed decanting as requiring a new ESNT election. The ruling seems to indicate that beneficial interests did not change in the trust merger and that the decanting was solely to change trustee provisions.
[6040] Reg. § 1.1361-1(m)(5)(i).
[6041] Reg. § 1.1361-1(m)(5)(ii).
[6042] Code § 641(c); Reg. § 1.641(c)-1(a).
[6043] Reg. § 1.641(c)-1(a).
[6044] Reg. § 1.641(c)-1(a).
[6045] See fns 142-143 in part II.A.2.f.
[6046] Reg. § 1.641(c)-1(a).
[6047] Code § 641(c)(1); Reg. § 1.641(c)-1(e).

available;[6048] capital loss carryforwards appear to be allowable.[6049] Two CCAs discussed how ESBTs treat NOLs:

CCA 200734019 involved the following facts:

> Trust was created pursuant to the last will and testament of A, who died on Date 1 . Trust, a residuary testamentary trust, was funded on Date 2 with various assets including the stock of X, an S corporation. Prior to A's death, A held the X stock directly. During the administration of A's estate, the estate did not have sufficient income to absorb losses attributable to the X stock which gave rise to a NOL as defined under § 172.
>
> The NOL carryover remained unused upon the termination of A's estate on Date 2 , the same date that Trust was funded. As a residuary testamentary beneficiary of A's estate, Trust succeeded to the NOL carryover that was unused by A's estate at the time of its termination under § 642(h)(1).
>
> Trust qualified as a permissible S corporation shareholder under § 1361(c)(2)(A)(iii) during the 2-year period beginning on Date 2, the date the X stock was transferred to it pursuant to A's will. In order to remain an eligible trust following the 2-year period, the trustee made an election for Trust to be an ESBT under § 1361(c)(3), effective Date 3.

CCA 200734019 asserted:

> We conclude that § 641(c)(2)(C) provides a complete list of the items of income, loss, deduction, or credit that the S portion of an ESBT may take into account. Section 642(c)(2)(C), flush language, provides that "no deduction or credit shall be allowed for any amount not described in this paragraph." The NOLs that Trust succeeded to under § 642(h)(1) are not described in § 641(c)(2)(C); therefore, the S portion of Trust is precluded from taking deductions attributable to those NOLs. However, the NOLs should be available as a deduction to the non-S portion Trust following Trust's ESBT election.

CCA 202335014 posited the following facts:

> In its X taxable year, an S corporation incurred an NOL that it passed through to its sole shareholder, an ESBT. The ESBT had sufficient basis in its stock to fully claim the loss. However, it did not have sufficient income in its S portion to cover the loss, thus creating an NOL at the trust level. The ESBT carried the NOL to its Y taxable year to use against the income of the S portion.

CCA 202335014 explained:

> S corporation shareholders generally take into account in their current taxable year the items their pro rata share of the S corporation's income, loss, deduction, or credit allocated to them under § 1366(a)(1). But the ability to use the losses flowing through in

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[6048] Code § 641(c)(2).

[6049] Reg. § 1.641(c)-1(d)(3)(i) disallows deductions for losses capital losses that exceed gains by more than $3,000 under Code § 1211(b) but does not refer to capital loss carryforwards under Code § 1212. Nothing directly addresses whether capital losses incurred before making an ESBT election but relating to S corporation items can be deducted against capital gain incurred while an ESBT.

the current year may be limited for various reasons, including when the shareholder's current year income is less than the amount of the losses, the basis limitation of § 1366(d)(1) applies, or other provisions of law such as the "at-risk" rules under § 465 or the passive loss rules under § 469, and such suspended losses will be deductible in other taxable years only as specifically authorized by the relevant provision.

In the case of an individual S corporation shareholder who is allocated a loss from the corporation, if the amount of the loss exceeds the shareholder's gross income for the taxable year, the shareholder may sustain an NOL, which the shareholder may carry to another taxable year pursuant to § 172(b) and claim an NOL deduction under § 172(a). However, if such a loss is allocated to the S portion of an ESBT shareholder and creates a trust-level NOL, the special rules of § 641(c)(2)(C) are implicated, complicating the question of whether such NOL may be carried over to another taxable year of the trust and taken into account by the S portion in that year.

Uncertainty in this area has been created in part by commentators' speculation as to the meaning of CCA 200734019 (issued 8/24/07). In the CCA, Trust was a residuary testamentary trust created pursuant to the will of A, who died on Date 1. On Date 2, Trust was funded with assets including stock of X, an S corporation, which A had held directly during life. During the administration of A's estate (between Dates 1 and 2), A's estate did not have sufficient income to absorb losses attributable to the X stock, giving rise to an NOL. The NOL carryover remained unused at the termination of the estate and funding of Trust on Date 2, and Trust succeeded to it under § 642(h)(1). Pursuant to § 1361(c)(2)(A)(iii), Trust qualified as an S corporation shareholder for the 2-year period beginning on Date 2. To remain as an eligible shareholder following that period, Trust elected to be an ESBT effective Date 3.

The CCA concludes that § 641(c)(2)(C) provides a complete list of the items of income, loss, deduction, or credit that the S portion of an ESBT may take into account, the flush language specifically denying a deduction or credit for any amount not included in the statutory list. Because the NOLs that Trust succeeded to under § 642(h)(1) are not listed, the S portion was precluded from taking deductions attributable to them. However, the NOLs would be available as a deduction to the non-S portion. The CCA notes that the taxpayer had argued that the NOL should be allocated to the S portion of Trust because it is attributable to losses sustained by the S corporation whose stock is held in that portion. The CCA rejects this taxpayer argument based on the "plain language" of § 641(c)(2)(C).

A standard treatise, S Corporations Federal Taxation (May 2020 updated version), Blau, Richard D., Lemons, Bruce N., and Rohman, Thomas P., (hereinafter, "Blau") suggests at § 19:35 a possible government interpretation of the CCA that would forbid the S portion of an ESBT from using NOL carryovers in any situation:

> As an additional example, consider that while losses that pass through the S corporation to the ESBT under § 1366 are specifically required to be taken into account in the S portion of the trust, the S portion of the trust may have insufficient income to absorb these losses in a particular year. In that case, the S portion of the trust would carry such loses back forward [sic], presumably, under § 172 to a prior or future year. But, when the losses are carried forward to the future year, the losses arise, not under § 1366, but, rather, under § 172. The Service might argue that since losses under § 172 are not 'items required to be taken into account under § 1366' as

provided in § 641(c)(2)(C), these types of carry forward losses can only be taken into account with respect to the non-S portion of the trust, perhaps resulting in the inability to use the losses against future income of the S corporation passed through to the S portion of the trust. One can argue that such an approach would not be appropriate.

The footnotes to the quoted text cite to the CCA and suggest that its holding could have been reached on other grounds: “One way of dealing with this issue would have been for the Service to simply have noted that since the losses had arisen before the trust was an ESBT, the losses were necessarily part of the non-S portion of the trust.” They then suggest multiple reasons in opposition to a reading of the CCA as disallowing any NOL carryovers to the S portion of an ESBT, which we paraphrase as follows:

1. There is no policy ground for disallowing losses carried forward or back under a section other than § 1366. The statute and regulation only require that they “originate” under § 1366. Section 1.641(c)-1(d)(2)(i) states that rules otherwise applicable to trusts apply in determining the extent to which a loss or deduction may be taken into account by the S portion; under those rules, a trust would normally be able to carry over a § 1366 loss under § 172.

2. Disallowing losses that flowed through under § 1366 in a prior or subsequent year leads to an unreasonable result. If an ESBT owned stock in two S corporations, it would clearly be able to offset flow-through gain from one with a flow-through loss from the other, yet a narrow reading of the CCA would disallow the use of losses from one corporation against gain from that same corporation if they occurred in different years, which the treatise describes as “simply mak[ing] no sense.”

3. As previously noted, the CCA conclusion could have been reached on the alternative ground that the losses were part of the non-S portion because they arose before the trust was an ESBT that had an S portion.[2]

4. Losses suspended under § 1366(d) because of insufficient current year basis would be treated more favorably than other losses for no apparent reason. The statute explicitly allows these losses to carry forward, whereas losses based on insufficient current year income would be permanently lost.

5. Section 1.641(c)-1(j) does not imply any limit on the use of NOL carryovers by the S portion of an ESBT during its existence, but merely addresses the use of unused NOLs upon the termination of the S portion.

[2] This point is not convincing. We would have reached the same answer in the CCA, as in this document, if the testamentary trust and the ESBT had existed concurrently.

We agree with the commentators that the holding of the CCA does not require the disallowance of all NOL carryovers by the S portion of an ESBT. The ESBT described in the CCA received the NOL carryovers from another taxpayer, the estate, under the special rule of § 642(h)(1) allowing these items to be carried over to a successor rather than lost at the estate’s termination. The ESBT never had a § 1366 item related to these losses. We believe that if a loss flowing through to the S portion of an ESBT under § 1366 cannot be used in the current taxable year because of the lack of offsetting income, it is nonetheless an item “taken into account” by reason of § 1366 in the prior or

> subsequent year in which it is deductible under § 172. To hold otherwise is to defeat the language of both § 1.641(c)-1(d)(2)(i) that the rules "otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account," and of § 1.642(d)-1 providing that the § 172 NOL deduction should be "generally" available other than for listed exceptions. We do not feel compelled to interpret § 641(c)(2)(C) in a manner that anomalously disadvantages certain § 1366 flow-through losses relative to others or ESBTs relative to other S corporation shareholders.

State and local income taxes and administrative expenses directly related to the S portion and those allocated to that portion are taken into account by the S portion.[6050] These items may be allocated in any manner that is reasonable in light of all the circumstances, including the terms of the governing instrument, applicable local law, and the trustee's practice with respect to the trust if it is reasonable and consistent.[6051] Note that the $10,000 limit on state income tax deductions[6052] would apply separately to the S portion and the non-S portion,[6053] allowing the trust to deduct up to $20,000 in state income tax.

Complications arise if the ESBT is a grantor trust in whole or in part or if the trust is a charitable lead trust or other trust eligible for a charitable income tax deduction. The charitable deduction applies only the charitable contributions passing through a K-1 from the S corporation to the trust and not to contributions made by the trust.[6054] Effective for tax years beginning after December 31, 2017, an ESBT's contribution deduction does not apply Code § 642(c) but rather uses the Code § 170 limits based on the rules that apply to individuals,[6055] which means that the

[6050] Reg. § 1.641(c)-1(d)(4)(i), which is specifically authorized by Code § 641(c)(2)(C)(iii).
[6051] Reg. § 1.641(c)-1(h). For an example, see Reg. § 1.641(c)-1(*l*)(1)(iv).
[6052] For the $10,000 limit, see the text accompanying fn 2509 in part II.J.3.d Who Benefits Most from Deductions. Because Reg. § 1.641(c)-1(d)(4)(i).says that these taxes are "taken into account," rather than "deducted," the regulation does not appear to provide an independent basis for a deduction.
[6053] See fns 6042-6043 in this part III.A.3.e.ii.(b).
[6054] The charitable deduction is not allowed against ESBT income if made directly by the trust. See Code § 641(c)(2)(C) and Reg. § 1.641(c)-1(d)(1), disallowing all deductions except those expressly listed (but the deduction should be allowed against the non-S portion of the trust). However, Reg. § 1.641(c)-1(d)(2)(ii) describes charitable deductions passing through a K-1 the ESBT receives from an S corporation:

> *Special rule for charitable contributions*. If a deduction described in paragraph (d)(2)(i) of this section [referring to K-1 items] is attributable to an amount of the S corporation's gross income that is paid by the S corporation for a charitable purpose specified in section 170(c) (without regard to section 170(c)(2)(A)), the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1) [the unlimited charitable deduction for trusts]. The limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion.

Code § 512(e)(1)(B)(i) provides all S corporation K-1 income is per se unrelated business income, so Code § 681 and Reg. § 1.681(a)-2(a) would apply the individual contribution limits, rather than the unlimited Code § 642(c), to such deductions. For more information about Code § 681, mentioned in the last sentence of this regulation, see part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction.
[6055] Code § 641(c)(2)(E) provides:

> (i) Section 642(c) shall not apply.
> (ii) For purposes of section 170(b)(1)(G), adjusted gross income shall be computed in the same manner as in the case of an individual, except that the deductions for costs which are paid or

charitable deduction generally is based on the fair market of property donated, in contrast to the Code § 642(c) deduction being limited to the property's adjusted basis;[6056] furthermore, Code § 170 but not Code § 642(c) deductions may be passed through to beneficiaries as excess deductions on termination.[6057] For other differences between Code §§ 170 and 642(c), see part II.J.4.c Charitable Distributions.

For application of the passive loss rules to ESBTs, see part II.K.2.b.v Electing Small Business Trusts (ESBTs) and the Passive Loss Rules.

Regarding the Code § 199A deduction, which generally is 20% of qualified business income, see part II.E.1.f Trusts/Estates and the Code § 199A Deduction, especially part II.E.1.f.ii Electing Small Business Trusts (ESBTs).

If the nongrantor trust portion of an ESBT is included in a person's estate, the ESBT election might prevent a basis step-up of depreciable property.[6058]

For a corporate split-up involving ESBTs, see Letter Ruling 202033005, when a family business divided when a trust holding it terminated. It is reproduced in part II.Q.7.f.ii.(f) Continuity of Interest.[6059]

III.A.3.e.ii.(c). When ESBT Income Taxation Might Help

ESBT income taxation can be favorable in the right circumstances. For example:

- The trust's income might be taxed at lower state income rates (or not at all) inside the trust than in the beneficiary's hands, or
- The beneficiary might be in the top income tax bracket, and reporting additional income would cause the beneficiary to lose some itemized deductions, AMT exemption, or personal exemptions.

In either case, the ESBT can make distributions to the beneficiary without passing S corporation income to the beneficiary. To maximize this flexibility, the trustee might consider dividing the ESBT into two separate trusts – one that holds S stock and one that holds any distributions that the trustee intends to reinvest, based on the following analysis:

> incurred in connection with the administration of the trust and which would not have been incurred if the property were not held in such trust shall be treated as allowable in arriving at adjusted gross income.

The Senate report adopting this rule said:

> The Senate amendment provides that the charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather by the rules applicable to individuals. Thus, the percentage limitations and carryforward provisions applicable to individuals apply to charitable contributions made by the portion of an ESBT holding S corporation stock.

[6056] See fn 4925 in part II.Q.7.c.i.(a) Contribution Must Be Made from Gross Income.
[6057] See text accompanying fn 2561 in part II.J.3.i Planning for Excess Losses.
[6058] See part II.J.11.a.ii.(c) Trust vs. Separately Recognized Business Entity Holding Depreciable Property, particularly fns. 2895-2896.
[6059] Beginning with the text accompanying fn 5028.

1. Distributions from a trust that generates investment income (other than S corporation K-1 income) will carry out income to the beneficiary.

2. If the investments are held in a separate trust, that trust can accumulate income and trap the investment income.

3. Therefore, when the trustee of the trust that holds S stock receives a distribution, the trustee would retain enough to pay income tax and administrative expenses, distribute to the beneficiary as appropriate, and then transfer the balance of the cash to the trust that generates investment income.

This three-part analysis applies when the S corporation distributes all of its income. It would not apply if the corporation distributes only enough for its shareholders to pay tax and uses the rest to grow the business (or its marketable securities portfolio). For trusts that are somewhere in between, it might or might not be helpful.

III.A.3.e.iii. Comparing QSSTs to ESBTs

A QSST tends to be used when:

- The trust is a marital trust or other trust whose income is required to be distributed currently to one beneficiary with no other current beneficiary. Under the marital trust rules,[6060] all income must be distributed annually, which means that, under normal trust rules, the income that the spouse is required to receive is taxable to her, just like any other mandatory income beneficiary.[6061]

- The beneficiary's income tax rate is lower than the trust's income tax rate. Because trust income above a modest threshold is taxed at the highest possible rates that apply to individuals,[6062] a beneficiary in a lower bracket should save taxes.

A QSST is not the best for trusts intended to accumulate their income, including trusts with multiple current beneficiaries. In most such cases, such trusts should be ESBTs.

ESBTs might avoid the 3.8% NII tax[6063] by appointing a trustee who is active in the business if the beneficiary is not active in the business.[6064] A QSST's income is not subject to the 3.8% NII tax if the beneficiary is active in the business[6065] or has income below the threshold;[6066] however, because the trustee's participation is what counts when the QSST sells the stock, consider making the trustee active well in advance of a potential sale.[6067] Also note that, if the

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[6060] Code §§ 2056(b)(1) and 2523(b).
[6061] Code § 651.
[6062] Code § 1(e)(2).
[6063] For the 3.8% tax on net investment income (NII), see II.I 3.8% Tax on Excess Net Investment Income. For calculating the tax on an ESBT, see fn 2912 (which also refers to an example in the proposed regulations) and the accompanying text.
[6064] See parts II.K.2.b.i Participation by a Nongrantor Trust: Authority and II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.
[6065] A QSST is a grantor trust deemed owned by the beneficiary. The 3.8% tax looks to the character of the income in the hands of the deemed owner; see fn. 2318.
[6066] See part II.I.3 Tax Based on NII in Excess of Thresholds.
[6067] See part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.

trust directly or indirectly owns real estate that is rented to the S corporation, a QSST election might complicate a trust's qualification for the self-rental exception, which exception would enable the taxable rental income avoid the 3.8% NII tax, so the trustee might consider retaining some stock in an ESBT, rather than moving all of the stock into a QSST.[6068] See also part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good.

See part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies, for a discussion of various issues one should consider when a beneficiary makes a QSST election.

Other than possible complexity regarding taxes on the earned but undistributed income, a QSST generally has more flexibility than an ESBT. A QSST offers options for deferring S corporation trust tax elections.[6069] If the trustee of an irrevocable grantor trust makes an ESBT election as a protective measure,[6070] the trust's ESBT taxation continues after death,[6071] in effect springing into place without any of the savings that other former irrevocable grantor trusts (including QSSTs) have.[6072]

On the other hand, ESBTs might provide more flexibility that QSSTs in avoiding adverse taxation of certain related party sales of depreciable or amortizable property or in replicating an inside basis step-up if the stock receives a basis step-up. For related party sales, see part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill). For inside basis step-up opportunities,[6073] see part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation, explaining how to replicate an inside basis step-up for property to the extent that Code § 1239 is not triggered, as

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[6068] See part II.I.8.g Structuring Businesses in Response to 3.8% Tax, particularly the text accompanying fns. 2460-2461.

[6069] See text accompanying fns. 6000-6001.

[6070] A trustee cannot make a conditional ESBT election. Reg. § 1.1361-1(m)(2)(v). If the trustee of a grantor trust makes an unconditional current ESBT election, the election is in effect but does not control the trust's taxation to the extent trumped by the grantor trust rules. Reg. § 1.641(c)-1(c). T.D. 8994 (5/13/2002) includes the government's response to the idea that a protective ESBT election should be available:

> One commentator suggested that grantor trusts should be permitted to make protective ESBT elections in light of the uncertain status of some trusts that may be grantor trusts under section 674. The IRS and the Treasury Department continue to believe that a conditional ESBT election that only becomes effective in the event the trust is not a wholly-owned grantor trust should not be available. A conditional ESBT election should not be allowed because the ESBT election must have a fixed effective date. If, in the absence of a conditional ESBT election, the trust is an ineligible shareholder, relief under section 1362(f) may be available for an S corporation. In addition, a trust that qualifies as an ESBT may make an ESBT election notwithstanding that the trust is a wholly-owned grantor trust.

[6071] Reg. § 1.1361-1(m)(8)(iv), Example 4.

[6072] part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, especially part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death regarding a grantor trust's continuing eligibility to hold S stock for two years after the deemed owner's death. Normal trust income tax rules, which generally are more favorable than ESBT income tax rules, apply during that time. See text accompanying fns. 6047-6049 for ESBT taxation.

[6073] Part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations explains such issues.

well as state income tax issues that can complicate matters when the taxpayer is not a resident of the state in which the property is located.[6074]

A QSST complicates purchases made out of earnings, as described in part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST. In ESBTs, interest on the promissory note is deductible only for tax years beginning after December 31, 2006.[6075] A better solution is a trust taxable to its beneficiary under Code § 678.[6076] Also, it might be possible for the income beneficiary to sell S corporation stock to the QSST and not recognize gain or loss on the sale.[6077]

III.A.3.e.iv. Flexible Trust Design When Holding S Corporation Stock

Consider a GST-exempt trust with only one beneficiary, with discretionary distributions of income and principal under an ascertainable standard. An independent person is authorized to direct that, for a period of no less than 36 months, all of the income is required to be distributed, based on the following:

- The minimum period of time between ESBT and QSST conversions is 36 months. This minimum period applies between conversions but does not apply to the first conversion. In other words, once the first ESBT or QSST election is made, a conversion to the alternate form (QSST or ESBT) can be made at any time. However, once one converted from a QSST to an ESBT or vice versa, the 36-month period applies in reversing the conversion.[6078] But for this process, Reg. § 1.1361-1(m)(6) provides:

  > An ESBT election may be revoked only with the consent of the Commissioner. The application for consent to revoke the election must be submitted to the Internal Revenue Service in the form of a letter ruling request under the appropriate revenue procedure.

- Mandatory distributions ensure no missteps in distributing income to maintain QSST status, because mandatory income trusts are not required to prove actual distributions of all of the income. However, a trust that actually distributes all of its income qualifies even without a mandatory distribution clause.[6079]

- Before converting, split the trust if it has assets other than S corporation stock, so that the other assets are not subjected to the QSST distribution scheme.

- The independent person would also be authorized to turn off the mandatory income direction for any trust taxable year that begins after the date the mandatory income direction is turned off. (Otherwise, the IRS might argue that the mandatory income provision is illusory because it could get turned off at any time during the year.)

[6074] See part II.H.8.a.ii State Income Tax Disconnect.
[6075] Reg. § 1.641(c)-1(d)(4)(ii) provides, (ii) *Special rule for certain interest*. Interest paid by the trust on money borrowed by the trust to purchase stock in an S corporation is allocated to the S portion but is not a deductible administrative expense for purposes of determining the taxable income of the S portion. This was repealed for tax years beginning after December 31, 2006 by Code § 641(c)(2)(C)(iv).
[6076] See fn 5863.
[6077] See part III.B.2.i.xiv QSST as an Alternative Form of Beneficiary Deemed-Owned trust.
[6078] Reg. §§ 1.1361-1(j)(12)(iii), 1.1361-1(m)(7)(iii).
[6079] See fn. 5971.

This would open up the opportunity to toggle between QSST and ESBT taxation, while allowing any ESBT income to accumulate inside an environment protected from estate taxes and creditors. After a trust has been an ESBT for 36 months, it may be divided into a separate trust for each beneficiary, and each new trust can separately either continue as an ESBT or become subject to a QSST election.[6080] Thus, every three years the trustee can consider how much of the trust should be a QSST and how much an ESBT and then ask the independent person to adjust the mandatory income direction as appropriate. This toggling decision would take into account the expected annual S corporation income, the beneficiary's adjusted gross income, and the beneficiary's participation in the business (see below).

In making these elections, consider part III.A.3.c.iii Deadlines for QSST and ESBT Elections.

Note that toggling only affects whether income distributions to that beneficiary may or must be mandatory or discretionary; the beneficiary must remain the trust's sole beneficiary of income[6081] and principal[6082] during the beneficiary's life.[6083] Thus, if the beneficiary has an inter vivos limited power of appointment, the beneficiary can hold the power of appointment during an initial ESBT period,[6084] but once the trust converts to a QSST the beneficiary must permanently renounce the power of appointment.

S corporation business income is free from the 3.8% tax on net investment income (NII) if the recipient significantly participates in the S corporation's business activity.[6085] For a QSST, one would look to the beneficiary's participation, whereas for an ESBT the IRS would look to the participation of a trustee;[6086] however, for a QSST, the IRS would look to trustee participation when the trust sells S corporation stock or the S corporation sells substantially all of its business assets.[6087]   If the beneficiary materially participates in the business, then either QSST or ESBT taxation could avoid the tax, the latter if the beneficiary is appointed as a trustee for purposes of holding the S corporation stock and satisfies the rules for trustee participation.[6088] If the beneficiary does not materially participate in the business, the S corporation income would constitute NII; however, the beneficiary might be in a sufficiently low tax bracket that the 3.8% tax on NII might not apply to the beneficiary at all.

Additionally, if the beneficiary already owns stock in the S corporation, the trust might buy the stock from the beneficiary, perhaps without any capital gain tax on the sale.[6089]

[6080] Letter Ruling 201122003.
[6081] Code § 1361(d)(3)(A)(i).
[6082] Code § 1361(d)(3)(A)(ii).
[6083] Rev. Rul. 93-31 provides that even a remote possibility of these conditions not being met would disqualify the trust from being a QSST. See fn 5987 in part III.A.3.e.i.(a) QSSTs Generally.
[6084] See text accompanying fns. 6031-6032.
[6085] See part II.I.8 Application of 3.8% Tax to Business Income (application of the 3.8% tax on net investment income), especially part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.
[6086] See parts II.J Fiduciary Income Taxation (application of the 3.8% tax on net investment income) (particularly fn. 2318 and later sections of part II.J dealing with the sale of QSST or ESBT stock) and II.K.2 Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business (determining when a trust materially participates).
[6087] See part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax).
[6088] See parts II.K.2.b.i Participation by a Nongrantor Trust: Authority and II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.
[6089] See part III.B.2.i.xiv QSST as an Alternative Form of Beneficiary Deemed-Owned trust.

Finally, QSSTs provide more post-mortem tax options than ESBTs, so pre-mortem toggling to QSST status can provide this enhanced flexibility.[6090]

III.A.3.e.v. Converting a Multiple Beneficiary ESBT into One or More QSSTs

III.A.3.e.v.(a). Strategic Issues

Every dollar of ESBT income is taxed at 37% federal income tax and 3.8% tax on net investment income ("NII").[6091] The beneficiaries' federal income tax brackets might be significantly lower,[6092] and the NII tax would not apply except to the extent that their modified adjusted gross income exceeds $200,000 for a single individual or $250,000 for a married person filing jointly.

However, any trustee and tax preparation fees might be deductible by the beneficiaries as miscellaneous itemized deductions (and disallowed for AMT purposes) rather than being deducted directly against the S corporation income.[6093]

This might increase the state income tax on the business income. As an ESBT, only the trust's state income tax posture is considered. Depending on the ESBT's state of residence, the ESBT might not be responsible for tax on the trust's income (particularly investment income) that is not sourced to a particular state. If the trust is converted to QSSTs, each beneficiary would need to file an income tax return for each state in which the S corporation does business, reporting his or her share of each state's income, thereby complicating each beneficiary's income tax return preparation. Additionally, each beneficiary who lives in a state with income tax would need to pay state income tax on his or her share of income, ameliorated in whole or in part by a credit for income taxes paid to other states.

The ESBT might have been accumulating income or perhaps distributing income to separate GST-exempt trusts for beneficiaries, the latter so that each beneficiary decides on a case-by-case basis whether to accumulate income in a protected trust. This accumulation might be important for estate tax reasons, as well as perhaps for nontax reasons. Now, however:

- With the $5+ million estate tax exemption, this accumulation strategy has less estate tax benefit, if the beneficiaries do not have estates near the exemption.

- Trusts that accumulate income face the same increase in federal income tax and NII tax as described above if they are ESBTs or have more than $12,000[6094] in taxable income, so the accumulation strategy would have additional income tax costs.

[6090] See text accompanying fn. 6069.
[6091] See part II.I 3.8% Tax on Excess Net Investment Income. It's possible that some ESBT income might be below the adjusted gross income threshold. See part II.J.14 Application of 3.8% NII Tax to ESBTs.
[6092] Consider the effect of phase-outs based on adjusted gross when evaluating the beneficiaries' income tax rates.
[6093] Reg. § 1.67-2T(b)(1).
[6094] $12,750 in 2019 per Rev. Proc. 2018-57, § 3.01, Table 5; presumably higher in future years.

III.A.3.e.v.(b). Implementation

The trustee might consider the following:

- Evaluate the trustee's authority to divide trusts and to convert separate trusts into QSSTs. If the trust has beneficiaries of more than one generation (*e.g.*, children and grandchildren), the trustee needs to consider any fiduciary duties to the lower generations (*e.g.*, grandchildren) in dividing the trust into separate trusts for the upper generation (*e.g.*, children). The trustee might obtain ratification from all adult beneficiaries to protect the trustee. The parent (who is not a beneficiary) of any minor or unborn descendant would sign on behalf of that descendant; this can be problematic if the child who is a beneficiary is divorced or otherwise having marital troubles. A consent by a beneficiary might raise Code § 2702 issues; this is less of a concern if the beneficiary had not been receiving distributions and never expected to receive distributions before that beneficiary's parent's death.

- If centralized management is a concern:

    - Determine whether the trustee is authorized to commingle the QSSTs, treating them as separate shares.[6095] The trustee might maintain a single new bank account for new deposits, which would then either distribute anything it receives or reimburse the existing account for administrative expenses the trust incurs. The division of shares would be done simply by recording the shares on a spreadsheet.

    - See whether the beneficiaries have the right to change the trustees of their separate trusts, which rights they might not have had in the main trust.

- Determine whether paying 100% of annual trustee fees and administrative expenses regarding the QSST portion out of income reasonably and fairly balances the interests of the income and remainder beneficiaries, as the trust might not have another source to pay those fees; the trustee would want to reserve the right to allocate them to principal in the year of sale.[6096] Normally such fees and expenses are allocated one-half to income and one-half to one-half to principal.[6097] Perhaps the corporation would pay the fees, but

[6095] This is permitted under the last sentence of Code § 1361(d)(3) and Reg. § 1.1361-1(j)(3).
[6096] Gain on sale of stock, including any gain reported on a K-1 form the S corporation issues reporting gain by reason of a Code § 338(h)(10) election to treat a stock sale as an asset sale, is taxable to the trust, rather than the being taxable as the grantor trust portion. See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax) and III.A.3.e.i QSSTs, particularly the text accompanying fns. 5994-5996, dealing with sales of not only S corporation stock but also of an S corporation's business in an asset sale. For additional planning issues, see parts II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business and II.J.8.a.i Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset (discussing whether the gain is included in DNI). Of course, the trust might obtain a distribution deduction by distributing the sale proceeds; see part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI), especially part II.J.8.a.ii Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus.
[6097] Section 501 of the Uniform Principal & Income Act.

note that the payment might need to be a separately stated K-1 item, if the character of the fees would change on a beneficiary's income tax return.[6098]

III.A.3.e.v.(c). Timing Tax Deductions in Year of Conversion

Consider which expenses would be better deductions against ESBT or QSST income and pay them in the appropriate time period.

K-1 items need to be pro-rated.[6099]

Presumably, administrative expenses relating to S corporation income would be allocated to the time before and after the conversion and any expenses allocable to the QSST portion would be deductible by the beneficiary.

III.A.3.e.vi. QSST as a Grantor Trust; Sales to QSSTs

Because the beneficiary pays tax on not only the S corporation's distributed income but also its undistributed income, a QSST can be a way to:

- Avoid high trust income tax rates and take advantage of a full run through the beneficiary's graduated tax rates.

- Allow the beneficiary to deduct a loss before the trust's termination, if the stock has sufficient basis.

- Have the beneficiary pay tax on any reinvested earnings used to grow the S corporation, increasing the trust's value and reducing the beneficiary's gross estate.

- Prevent the grantor of a trust for a spouse from being taxed on any reinvested taxable income after divorce.[6100] If the beneficiary/former spouse may also receive principal distributions, the beneficiary may elect to treat the trust as a QSST, thereby ensuring that the taxable items of the trust's assets inside an S corporation owned by the trust are taxable to the beneficiary, whether or not actually distributed to the beneficiary.[6101]

- Allow the beneficiary to sell S corporation stock (and, indirectly, other assets) to the trust on what appears to be a tax-free basis.[6102] A sale to an irrevocable grantor trust is a powerful estate planning technique.[6103] Clients sometimes balk at selling assets to a trust where they are not beneficiaries, because they might need the assets for their living expenses. For a client who refuses to part with all of the enjoyment of sufficient assets, consider suggesting

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[6098] See text accompanying fn. 6093 and Code § 1366(a)(1)(A).
[6099] See part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.
[6100] Code § 677 treats the grantor as owners of any items that can be distributed to or held for eventual distribution to the grantor or the grantor's spouse. Code § 672(e)(1)(A) treats as the spouse any individual who was the spouse of the grantor at the time of the creation of such power or interest. Thus, divorce does not terminate grantor trust treatment. However, Reg. § 1.682(a)-1(a)(1) provides that the grantor is not taxed as the owner to the extent that income is paid, credited, or required to be distributed and therefore taxed to the former spouse.
[6101] See fn. 5973, noting the contrast between paragraphs (ii) and (iii) within Example (10).
[6102] See part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (Including Possible Pitfalls).
[6103] See part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

that he or she sell assets to a trust in which he or she is a beneficiary and is the deemed owner - a beneficiary deemed-owned trust.[6104]

The grantor trust aspects can be powerful planning techniques but are also subject to some significant disadvantages.[6105]

Beneficiary deemed-owned trusts involve complex tax issues, including the risk that the Internal Revenue Service, which generally has stopped issuing private letter rulings regarding such trusts,[6106] might at some point take a position inconsistent with its many past favorable private letter rulings. The complexity involved often includes a sale being highly leveraged (sometimes using a trust funded with no more than $5,000), which might invite IRS scrutiny.

QSSTs do not face the funding issues that apply to many other beneficiary deemed-owned trusts. They can be funded very substantially and still be entitled to grantor trust treatment.

III.A.3.e.vi.(a). Grantor Trust Issues Involved in a Sale of S Stock to a QSST

If a QSST buys the beneficiary's stock from the beneficiary after making a QSST election for its then-existing S stock (issued by the same corporation), that would be a disregarded transaction for income tax purposes, following the general principle under Rev. Rul. 85-13 that a transaction between a trust and its deemed owner (for income tax purposes) is disregarded (for income tax purposes).[6107]

The regulation that treats the beneficiary as the Code § 678(a) provides that the trust's <u>selling</u> or <u>distributing</u> the stock is attributable to the trust, not the beneficiary,[6108] but does not discuss the consequences of the trust <u>buying</u> S corporation stock. This regulation overrode Rev. Rul. 92-84, which applied grantor trust treatment to a QSST's sale of S corporation stock; however, the logic of Rev. Rul. 92-84 might continue to apply (as a matter of good analysis, not as a matter of precedent) to the extent that the regulation is silent. The preamble to the regulation[6109] overrode Rev. Rul. 92-84 for practical reasons: if the trust no longer holds S stock during the deferred consummation of an installment sale, how could QSST treatment apply? That should not be a concern when the trust is <u>buying</u> stock. Although the IRS might have concerns about the asymmetry involved (the trust buying stock from the beneficiary having a different result than

[6104] See part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.
[6105] See part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts.
[6106] Rev. Proc. 2015-3, Section 4.01(39), provides that ordinarily the IRS will not rule on:

> Whether a person will be treated as the owner of any portion of a trust over which that person has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner of the trust under § 671 if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of § 2041, if the trust purchases the property from that person with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.

[6107] Code § 1361(d)(1)(B) provides, for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the [QSST] election … is made.
[6108] For gain on sale of stock or assets and for related planning opportunities, see text accompanying fns. 5994-5996.
[6109] T.D. 8600.

the trust selling stock to the beneficiary), those concerns would not appear to be supported by the IRS' official pronouncements.[6110]

If an income beneficiary who sells S corporation stock to an existing QSST that already owns stock in the same S corporation, the above analysis might be more comfortable. Three companion private letter rulings, in approving the merger of one QSST into another, used analysis that supports this concept:[6111]

> Under 1.1361-1(j)(7), the X shares which make up the corpus of Exempt QSST A and Exempt QSST B are treated as directly owned by Y. Any transfer of the X shares, pursuant to a merger under Article 5.6, would effectively be a transfer of the shares from Y to Y.

What is the tax treatment of interest payments on a promissory note a QSST uses to buy stock in an S corporation?[6112] The IRS has taken the position that, when the QSST buys stock from a

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[6110] This asymmetry already exists under Rev. Rul. 85-13. In that ruling, initially the trust was not a grantor trust. The grantor bought stock from the trust in exchange for an unsecured promissory note. The note's existence is what made the trust a grantor trust deemed owned by its grantor and caused the transaction to be disregarded. On the other hand, if the trust had bought stock from its grantor, its grantor would have recognized gain on the sale, because a promissory note owed by the trust to the grantor would not have triggered grantor trust status. This asymmetry did not prevent that ruling from becoming the IRS' formal position.

Notice 97-24 points out that Rev. Rul. 85-13 avoids assets receiving a basis step-up. In the case of a beneficiary selling to a QSST, if the beneficiary did not pay capital gain tax on the sale to the trust, then the stock the trust acquires, which will be outside of the estate tax system, will not receive a new basis and therefore will be taxed more highly to the trust if sold after beneficiary's death (or after any other event terminating grantor trust status).

Based on a long line of law, Rev. Rul. 85-13 held that the deemed owner was the deemed owner of the trust's property. See fn. 6525.

The bottom line is that the beneficiary would be deemed to own the stock that the beneficiary sells to the trust both before and after the proposed transaction. One cannot have a recognition event when one sells closely-held business stock, which Rev. Rul. 90-7 expressly held is deemed owned by a trust's deemed owner, to oneself. Rev. Rul. 85-13 recognized this longstanding principle when it reasoned:

> A transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction. See *Dobson v. Commissioner*, 1 B.T.A. 1082 (1925).

The *Dobson* case itself involved closely-held business stock. Rev. Rul. 2007-13, reproduced in fn 4338 in part II.Q.4.b.i Transfer for Value Rule Generally, reaffirmed this concept, and it should be applied to the sale to a QSST as well.

[6111] Letter Rulings 200441013, 200441014, and 200441015.

[6112] In all fairness, the beneficiary should get the deduction, especially in light of the separate share rules under Code § 663. However, an argument can be made that only S corporation K-1 items are treated as part of the Code § 678 share allocated to the beneficiary. Code § 1361(d)(1)(B) provides, "for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under paragraph (2) is made...." On the other hand, Code §§ 1361(d)(1)(B) and 641(c)(1)(A) use very similar language. Therefore, when an issue is not expressly addressed by authority, the ESBT and QSST rules should be read consistently. The principle behind the ESBT regulation quoted in fn 6075 tends to support the beneficiary's deduction of interest under Code § 1361(d)(1)(B) (or a disregard of the interest income and deduction under Code § 678 if the seller is the beneficiary), because the Regulation's allocation of the interest to the S portion remains intact.

third party using a promissory note, the note is part of the S corporation portion that is deemed owned by the QSST's beneficiary and therefore the interest is deductible by the beneficiary.[6113] Informal conversations indicated that this position was the result of discussions at the highest levels of IRS policy-makers. Interest expense is deductible on Schedule E, Part II of the beneficiary's individual income tax return.[6114]

This position - that the promissory note is part of the S corporation portion that the beneficiary is deemed to own - gives me confidence that a beneficiary's sale to a QSST would be disregarded under Rev. Rul. 85-13 because the beneficiary would be considered to be selling to himself or herself.[6115]

Furthermore, often a trust that holds stock in an S corporation is split off as a separate QSST, which never accumulates any income, because all of the income is distributed to the beneficiary. Allocating income to a nonexistent non-S portion would not make sense in those situations. That contrasts with ESBTs, where generally there is no reason for the S stock to be held in a separate trust.
Allocating the interest deduction to the non-S corporation portion of the trust would result in a mismatch, in that the interest the trust pays is allocated to income that the beneficiary, not the trust, is treated as owning for income tax purposes. It would appear to run counter to the spirit of the debt-tracing rules of Reg. § 1.163-8T, which would characterize the interest as related to the S corporation. If the interest is allocated to the non-S corporation portion of the trust, its deductibility should relate to the nature of the income passing through on the K-1 the trust receives from the company. To the extent the K-1 income is income from a trade or business, presumably the interest would be expense from trade or business that would generate a net operating loss carryover if the trust did not have sufficient other income.
Reg. § 1.163-8T(a)(4)(i). Notice 89-35 supports this approach:

> In the case of debt proceeds allocated under section 1.163-8T to the purchase of an interest in a passthrough entity (other than by way of a contribution to the capital of the entity), the debt proceeds and the associated interest expense shall be allocated among all the assets of the entity using any reasonable method. Reasonable methods of allocating debt among the assets of a passthrough entity ordinarily include a pro-rata allocation based on the fair market value, book value, or adjusted basis of the assets, reduced by any debt of the passthrough entity or the owner allocated to such assets.

If the trust generates a net operating loss (NOL) carryforward due to the interest expense, be sure not to make an ESBT election, as Chief Counsel Advice 200734019 takes the position that the NOL carryforward is not deductible against ESBT income.

[6113] CCA 201327009 allows the beneficiary to deduct the interest when the QSST buys from a third party using a promissory note. The IRS declined to rule on the loan's effect under the at-risk rules out of concern that taxpayers would set up a Code § 465(c)(4) device to limit liability. Because the trust had no other assets, debt tracing was not a concern, and all of the interest was allocated to the S corporation activity. The IRS also declined to address the passive loss rules.

[6114] The 2013 instructions to Form 1040, Schedule E, Part II say:

> Interest expense relating to the acquisition of shares in an S corporation may be fully deductible on Schedule E. For details, see Pub. 535.

Publication 535, for use in preparing 2013 returns, says to report interest expenses from S corporation business borrowing on Schedule E (Form 1040), line 28, entering interest expense and the name of the S corporation in column (a) and the amount in column (h). Presumably this would also apply to loans to a QSST to acquire stock in an S corporation.

[6115] This background on CCA 201327009 results from informal discussions with an attorney, who has since left the IRS, when I asked whether the IRS would consider approving a sale to a QSST. The IRS informally indicated that it would decline to issue such a ruling if I sought it, because it was not totally certain of the result and does not wish to encourage sales to Code § 678 trusts. It was suggested that the IRS never would have approved a sale to an irrevocable grantor trust if it had realized that the technique would become so popular.

III.A.3.e.vi.(b). Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts (Whether or Not a Sale Is Made)

Using QSSTs involves challenges that do not apply to other Code § 678 trusts. Consider the disadvantages of an S corporation as an investment vehicle that is shared among family members:

- Take Care to Make Formation of Corporation Nontaxable. See part II.M.2 Buying into or Forming a Corporation.

- Inability to Divide S Corporation. An S corporation that does not engage in a trade or business would not be able to be divided income-tax free under Code § 355.[6116] This would trap all family members in a single investment entity, unable to manage investments suitable for each person's goals.

- Tax Cost of Distributing Investments. A distribution of investments would be taxed as a sale.[6117] Thus, distributing marketable securities to family members so that they go their separate ways would subject them to capital gain tax on the deemed sale of the investments. Distributing depreciable property might subject them to tax on ordinary income.[6118]

  However, pre-mortem planning might help. Suppose the trust is a credit shelter trust or a GST-exempt trust and the beneficiary's estate is subject to estate tax. If the QSST sells its investments that have unrealized gain, the income (capital gain) tax liability will be a debt deductible on the beneficiary's estate tax return. Harvesting gain would prevent the distribution of securities from being a taxable event at the shareholder level. However, the distribution of securities in a corporation would generate income tax to the extent that the fair market value of the distribution exceeds the basis (and might generate dividend income if and to the extent the corporation had been a C corporation and the distribution constituted a distribution of earnings and profits); on the other hand, the recognition of gain on the sale of securities would increase the stock's basis.[6119] Just be sure that the pre-mortem gain harvesting is not pursuant to a plan of liquidation[6120] or a sale of stock combined with a Code § 338(h)(10) election;[6121] either event would subject to sale of assets to stock at the trust's level, rather than the beneficiary's level.[6122]

[6116] See part II.Q.7.f Corporate Division, including part II.Q.7.f.iii Active Business Requirement for Code § 355.
[6117] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.
[6118] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property.
[6119] See part II.Q.7.b Redemptions or Distributions Involving S Corporations.
[6120] See fn. 5995, found within part III.A.3.e.i.(a) QSSTs Generally. This is important because an S corporation that used be a C corporation can avoid dividend taxation by engaging in a liquidation; see fn. 4861, found within part II.Q.7.a.vii Corporate Liquidation.
[6121] See fn. 5996, found within part III.A.3.e.i.(a) QSSTs Generally.
[6122] In addition to the citations within fns. 6120 and 6121, see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax).

- Inability to Swap. Although a beneficiary does not recognize gain or loss when selling S corporation stock to a QSST, the trust would recognize income on selling S corporation stock back to the beneficiary.[6123]

- All Income Must Be Distributed. A QSST must distribute to its beneficiary all of its trust accounting income. This can be controlled by the S corporation not making distributions to the trust. The IRS might argue that the beneficiary's failure to compel the trustee to compel a distribution from the S corporation constitutes a gift. Note, however, that the IRS considers 3%-5% to be a reasonable range for income distributions, so the IRS should view any distributions within than range as sufficient.[6124] If distributions were below this range, the IRS would argue that the lapsing withdrawal right 5-and-5 safe harbor of Code § 2514(e) that appears to protect such a small lapse is calculated in a way that does not provide much protection.[6125]

- Personal Use Assets. Placing personal use assets inside an S corporation would require the charging of rent. The S corporation would recognize rental income, and those paying rent would not be able to deduct that rent. If the beneficiary uses a trust asset for personal purposes, he does not need to pay rent, since the point of the trust is to benefit him.

These limitations are not imposed on Code § 678(a)(2) trusts. When their assets are divided among family members, the division is done on a tax-free basis and they can each go their separate ways quite easily.

Consider who pays income tax for the year in which the beneficiary dies.[6126] These considerations also apply when the beneficiary of a Code § 678(a)(2) trust dies, although the beneficiary of the latter has a broader power of appointment than the former.

Income tax difficulties in splitting an S corporation after the beneficiary's death might be addressed as follows:

- Form a Partnership. By forming an entity taxed as a partnership with the beneficiary, other family members, or other trusts, a QSST might be able to access investment opportunities not otherwise available to it or might be able to facilitate their access to investment opportunities not available to them. Although such a partnership could preserve the expected annual cash flow, the commitment to retaining funds in the partnership would reduce the fair market value of the S corporation's partnership interest. This value reduction would also reduce the tax if the corporation distributes some or all of assets when the QSST divides upon the beneficiary's death. Such a partnership should be formed well in advance of the beneficiary's death.[6127] When the beneficiary dies, perhaps the S corporation would distribute some of its partnership interests right away so that the trust could immediately fund part of the bequests; then, later, after the trustee is satisfied that all tax and other fiduciary liabilities have been resolved, the S corporation could distribute the remaining partnership interests.[6128] Furthermore, the partnership could later divide in a variety of ways

[6123] Reg. § 1.1361-1(j)(8); see fns. 5994-5996.
[6124] See part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law, especially the text accompanying fn. 2764.
[6125] See part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary.
[6126] See part III.A.3.d Special Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.
[6127] See part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially fn 5104.
[6128] Distributing in stages would tend to alleviate the concerns described in fn 5104.

on a tax-free basis,[6129] so that each family member can implement his or her own investment strategy over time; however, if the family members do not have strategies that either are consistent with each other's or complement each other's, pursuing different investment strategies would rend to require asset sales that might generate capital gain tax.[6130]

- Create Separate Corporations. Suppose a trustee decides to contribute its assets to an S corporation with the expectation that the beneficiary will make a QSST election. Instead, consider forming a separate S corporation for the future benefit of each of the beneficiary's children. When the beneficiary dies, each of the beneficiary's children will be allocated a separate S corporation, thereby eliminating the need to divide the corporation or distribute its assets. This solution merely postpones the issue, because these issues would need to be addressed when a child of the beneficiary dies (or if a child predeceases the beneficiary, but that postponement might be sufficiently beneficial to address concerns for a while).

- Marital Trust QSST Doesn't Have This Problem. If a marital deduction trust that holds 100% of an S corporation and the beneficiary makes a QSST election, then the S corporation stock gets a basis step-up, which essentially passes through in a nontaxable (because of the basis step-up) liquidation, subject to certain qualifications; see part II.H.8.a Depreciable Real Estate in an S Corporation – Possible Way to Replicate Effect of Basis Step-Up If the Stars Align Correctly, subject to the caveats in part II.H.8.a.i.(b) Challenging Issues When S Corporation Liquidates Holding Depreciable Property or Other Ordinary Income Property. This is one of the few times when I like to have an LLC elect S corporation status, because the S corporation status can be revoked, resulting in a constructive liquidation, retroactively within 75 days after the beneficiary spouse's death.

See also parts II.A.2.d.ii Estate Planning and Income Tax Disadvantages of S Corporations, II.A.2.d.iii Which Type of Entity for Which Situation? and III.A.3.d Special Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.

III.A.3.e.vi.(c). Required Structure for a Sale to a QSST (Including Possible Pitfalls)

In QSSTs, all income must be distributed to the beneficiary.[6131] Therefore, at first glance, it would appear impossible for a QSST to use its S corporation distributions to buy stock.

However, if a QSST buys stock in a secured sale in which it pledges all of its S corporation distributions, the trust never receives the distributions, so the trust has no income receipts to

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[6129] See part II.Q.8 Exiting From or Dividing a Partnership.

[6130] If the strategies are consistent with each other's, then the partnership could simply divide pro rata. If the strategies complement each other's, then each person could take the assets that interest him or her. Anything else would require post-division adjustments, most likely accomplished through sales.

[6131] Reg. § 1.1361-1(j)(1)(i) provides

> All of the income (within the meaning of § 1.643(b)-1) of the trust is distributed (or is required to be distributed) currently to one individual who is a citizen or resident of the United States. For purposes of the preceding sentence, unless otherwise provided under local law (including pertinent provisions of the governing instrument that are effective under local law), income of the trust includes distributions to the trust from the S corporation for the taxable year in question, but does not include the trust's pro rata share of the S corporation's items of income, loss, deduction, or credit determined under section 1366….

pay to the beneficiary.[6132] Private letter rulings have readily accepted this theory for mandatory income trusts;[6133] this theory should apply to a discretionary income trust.[6134]

A significant disadvantage is that this method might take twice as long as a normal sale to a grantor trust. In most states, the trustee must transfer from principal to income an amount equal to the income paid to reduce the principal balance of the note (as used in this part III.A.3.e.vi.(c), the "adjustment amount").[6135] Thus, although note payments complete the sale (the obligation to the beneficiary in the beneficiary's capacity as a creditor), they create an obligation that the trust owes to the beneficiary as a beneficiary:

- Worst Case Scenario – Simplistic view. In other words, first the trust repays the note, then the trust repays the beneficiary the income that was diverted from the beneficiary (as a beneficiary) to pay the note. Thus, the original note principal is not removed from the estate tax system until both the note and the adjustment amount to the beneficiary are fully paid. However, if the adjustment amount is not expected to be paid made for a while, consider that the possible inclusion of the adjustment amount in the beneficiary's estate might very well be the present value of that principal distribution, which might be significantly less than the amount of the principal that is owed.

- Actual Law – Not So Bad? The trust's obligation is to transfer to income principal equal to the adjustment amount. This means that, when the trust receives cash generally classified as principal, it must reclassify that cash as income, to the extent of the adjustment amount.

[6132] The trust would need to pay any future cash receipts of principal to the beneficiary to make up for this diversion of amounts that would otherwise constitute trust accounting income. Adopting Section 502(b) of the Uniform Principal and Income Act (last amended or revised in 2008; see http://www.uniformlawcommission.com/Act.aspx?title=Principal and Income Amendments (2008)), RSMo section 469.453.2 provides:

> If a principal asset is encumbered with an obligation that requires income from that asset to be paid directly to the creditor, the trustee shall transfer from principal to income an amount equal to the income paid to the creditor in reduction of the principal balance of the obligation.

[6133] This accounting treatment is consistent with Letter Rulings 200140040 (which not only diverted dividends to repay the seller but also required that the trust pay additional purchase price if it resold the stock within a certain period of time after buying the stock), 200140043, and 200140046 (trust's purchases from another shareholder), as well as 9140055 (distributions used to pay bank loan used to buy stock), which rulings essentially treated the repayment of principal on the notes as income disbursements rather than principal disbursements. See also Letter Ruling 9639013, permitting the use of income to repay notes on a seller-financed sale to QSSTs. CCA 201327009 did not expressly consider this issue; however, based on the facts and conclusion, it implicitly assumed that the use of S corporation distributions to repay the note was permitted.

Other rulings dealing with principal and income issues include Letter Rulings 9140055 (beneficiary repayment of trust distribution to pay interest QSST owed bank), 200446007 (deemed dividend is not fiduciary accounting income and therefore not required to be distributed), and 200451021 (redemption treated as distribution for income tax purposes, but proceeds were principal not required to be distributed).

[6134] What if the trust would be relying on the payment of actual income to satisfy Code § 1361(d)(3)(B) and Reg. § 1.1361-1(j)(1)(i)? One might be concerned that the trust would be receiving no income and therefore would be making no distributions of income. On the other hand, all of the company's distributions that are payable to the trust would in fact wind up in the hands of the trust's sole beneficiary; it will simply get there as a note repayment, rather than as a distribution. Thus, relying on the payment of actual income would not appear to violate the spirit of Code § 1361(d)(3)(B) and Reg. § 1.1361-1(j)(1)(i).

[6135] See fn. 6132.

That principal receipt might never happen during the beneficiary's life, and the trust might never be required to pay the beneficiary.

Consider the following ways to repay this additional obligation, if it exists:

1. Suppose the trust is a discretionary income trust. Perhaps an independent trustee would be able to toggle on and off the mandatory income feature (which, of course, is not possible in a one-lung QTIP plan[6136] but might be possible using a *Clayton*-QTIP plan).[6137] After the note is repaid, the independent trustee might turn off the mandatory income obligation. If the beneficiary never needs the income under the standards provided by the trust, the trust might accumulate funds thereafter and never pay cash equal to the full adjustment amount. However, the IRS might argue that such a modification undermines the point of recharacterizing the principal as income,[6138] so consider a compromise: Instead of the trustee accumulating income under the discretionary standards and perhaps never paying the adjustment amount, the trustee and beneficiary come to the following agreement: The trustee agrees to pay future income to the beneficiary to the extent of the adjustment amount, notwithstanding the fact that the trustee has determined that the beneficiary would not receive income under the trust's new distribution standards. That income is payable until the earlier of the beneficiary's death or amounts equal to the adjustment amount have been paid. The trustee might sign a revocable letter directing the company to pay the beneficiary directly any distributions of income (up to the adjustment amount) that normally would have gone to the trust.

2. If the trust is a mandatory income trust, see whether the corporation will make a distribution to all shareholders in partial liquidation of the entity or merely redeem the trust's stock, depending whether it is important to keep proportionate stock ownership. Such a distribution or redemption might very well constitute a nontaxable return of AAA (reinvested S corporation taxable income).[6139] For example, a partial liquidation would be a principal distribution for trust accounting purposes (even if it is a distribution of AAA for income tax purposes) that could then be used to repay the principal obligation.

3. If the trust has other assets, then gain from the sale of other assets would be used to repay this principal obligation. Being transferred to income[6140] or being used to determine a distribution[6141] should cause the capital gain to be taxed to the beneficiary.

When drafting a trust that might engage in such a transaction, keep in mind the above issue. Perhaps the trustee might have some flexibility in allocating receipts and disbursements

[6136] For an explanation of a one-lung plan, including some of its advantages and disadvantages, see part II.H.2.a Free Basis Step-Up When First Spouse Dies.
[6137] For a description of a *Clayton*-QTIP plan, see the paragraph accompanying fn. 6153.
[6138] Reg. § 1.643(b)-1 provides, "Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized." See part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law, especially the text accompanying fn. 2763.
[6139] See part II.Q.7.b Redemptions or Distributions Involving S Corporations.
[6140] See part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law.
[6141] See part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary.

between principal and income?[6142] Perhaps the trust might have a provision requiring the trustee to give the beneficiary notice of a right to principal and provide that the right to that principal adjustment lapses as provided in Code § 2514(e)?

Consider whether the IRS might attack the sale as follows:

- The IRS might argue that stock's value exceeded the sale price; therefore, the IRS might argue, the seller made a gift to a trust that benefits the seller, triggering Code § 2036 inclusion.

- One might consider using a defined value clause,[6143] instructing the trustee to distribute any excess value to a separate share of the trust, of which 10% would be structured as a completed gift (no power of appointment over the remainder) and 90% would be structured as an incomplete gift (power of appointment over the remainder - perhaps even a presently exercisable withdrawal right) or a sale. With adequate disclosure, the gift tax statute of limitations would run regarding how much comprises the completed gift and incomplete gift portions.[6144] For a fully completed gift, see part III.B.2.i.xviii Sample Beneficiary Deemed-Owned Trust.

- The separate share of the trust would be treated as a separate trust for QSST purposes; however, the separate share's treatment as a grantor trust as to the seller[6145] would make a QSST election unnecessary during the seller's life.

- Might the fact that the separate share is created only in the event of an audit cause that share to be disrespected? It did for a charitable gift (see part III.B.3.h *Moore*), but charitable gifts have stricter standards than noncharitable gifts.

Such a possible Code § 2036 attack may deter using this technique. If one is trying to move miscellaneous assets by contributing them to an S corporation and selling the S corporation stock to a trust, consider instead using a preferred partnership.[6146] However, if one has an operating business in an S corporation, a preferred partnership is not available[6147] unless the transferor is the sole owner or all of the owners have the same estate planning goal.[6148]

III.A.3.e.vi.(d). Using a QSST to Buy Stock When Using a "One-Lung" Marital Deduction Plan

One of my favorite estate planning tools for married couples is to bequeath the entire residue into a trust that can qualify to the QTIP marital deduction. The executor may elect a marital deduction with respect to none, part, or all of the trust. For an explanation of some of the

[6142] For flexibility in allocating between income and principal, see part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law, which includes a sample general clause (not geared toward the QSST sale issue) as well as the regulations governing such allocations.
[6143] See part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.
[6144] See part III.B.4 Adequate Disclosure on Gift Tax Returns.
[6145] Code § 677.
[6146] See part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.
[6147] A partnership is not an eligible owner of a S stock. Code § 1361(b)(1)(B); see part II.A.2.e.v Relief for Late S Corporation and Entity Classification Elections for the Same Entity.
[6148] If the transferor is the sole owner or all owners have the same estate planning goals, the S corporation itself could contribute its assets to a preferred partnership. See part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

advantages and disadvantages of such a plan, see part II.H.2.a Free Basis Step-Up When First Spouse Dies.

More recently, I have been including in the trust the authority for an independent trustee to make distributions for the surviving spouse's welfare. If the surviving spouse is the trustee, he or she may appoint as a co-trustee a person who is not a related or subordinate party,[6149] who could make a distribution for welfare and then resign.

Suppose the decedent's estate tax exemption is insufficient to cover all of the decedent's S corporation stock. Some S corporation stock is allocated to a trust excluded from the estate tax system (a "nonmarital trust"), and the rest is allocated to a marital deduction trust (a "marital trust"). The surviving spouse elects QSST treatment for each trust.[6150] The marital trust distributes its S corporation stock to the surviving spouse, who then sells it to the nonmarital trust in exchange for a promissory note.

If the client has an independent trustee who is quite comfortable with the surviving spouse and the remainderman, one might consider using *Clayton*-QTIP planning.[6151] *Clayton*-QTIP planning is where the portion that is not elected QTIP goes to a trust that has different dispositive provisions than the portion that is elected QTIP.[6152] In the nonmarital trust, an independent trustee would be able to distribute income for the surviving spouse's welfare (in addition to any other desirable discretionary distributions for the surviving spouse). This would help address a particular drawback to sales to QSSTs.[6153]

III.A.3.e.vi.(e). Converting Existing Trust to a QSST to Obtain Beneficiary Deemed-Owned Trust Status

Suppose the client is the beneficiary of an existing GST-exempt trust with discretionary distributions. Consider converting the trust into a QSST, by whatever legal means are available to do so. Consider the ideas discussed in parts III.A.3.e.iv Flexible Trust Design and III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSSTs.

Then the client can sell the client's S corporation stock to the QSST.

If the client does not have an S corporation, the client could contribute assets to an S corporation and then sell the S corporation stock to the trust. Alternatively, an existing GST-exempt trust with only one beneficiary might simply form an S corporation and the beneficiary make a QSST election, effectively converting the trust to a beneficiary deemed-owned trust.[6154] However, in either case, be sure to consider exit strategies upon the client's death, as described

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[6149] As fn. 6713 explains, the spouse's power to appoint a trustee who can distribute for the spouse's welfare will not cause the spouse to hold a general power of appointment if the trustee is not a related or subordinate party, as defined in Code § 672(c) (see fn. 2541).
[6150] Using this strategy, a QSST election is required for the nonmarital trust but not for the marital trust. However, making such an election for the marital trust tends to simplify income tax issues.
[6151] Authorizing an independent trustee to be the executor with authority to make the QTIP election should avoid any attack the IRS might make whether a spouse who is the executor had made a gift to the extent that failure to make a QTIP election causes the surviving spouse to lose his or her mandatory income rights.
[6152] Reg. § 20.2056(b)-7(d)(3) authorizes this in response to case law.
[6153] See fn. 6137.
[6154] This would be ideal if the trust is already a mandatory income trust. If the trust is not a mandatory income trust, then complying with the requirement to distribute all income might be tricky.

in part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts.

III.A.3.e.vi.(f). QSST to Convert Terminating Trust to GST-Exempt Life Trust

Suppose the client created a trust for children that terminates at various ages. The client could create a QSST for each adult child.

See part III.A.3.e.vi.(e) Converting Existing Trust to a QSST for considerations involved in using this strategy.

III.A.4. Trust Accounting Income Regarding Business Interests

When a trust holds a business entity interest, complicated accounting and tax issues can arise. One of the main reasons for these complexities is the difference between accounting income and taxable income. Accounting income helps determine the amount of distributions a trust is required to make, under the governing instrument or state law, which in turn may determine how much taxable income is carried out to the beneficiaries of the trust. The Code defines "income required to be distributed currently" as the fiduciary accounting income that must be distributed currently pursuant to the governing instrument or state law. Because fiduciary accounting income is determined by state law or the governing instrument, differences between taxable income and accounting income generally arise. An example of such a difference would be capital gains. Capital gains are usually principal for fiduciary accounting purposes, but taxable income for income tax purposes.

III.A.4.a. General Strategies Regarding Fiduciary Income Taxation of Business Interests

Trusts and estates reach the top income tax brackets and are subjected to the 3.8% tax on net investment income[6155] far more rapidly than beneficiaries. See part II.J Fiduciary Income Taxation.

Part III.F Hypothetical illustrates the issues described in this part III.A.4 Trust Accounting Income Regarding Business Interests. That income tax dynamic may subject income to a higher tax bracket than if all of the income were taxed in a QSST, in which the beneficiary is the deemed owner of all of the K-1 income.[6156] Thus:

- If the trust holds S corporation stock, consider facilitating a QSST election.

- If the trust holds a partnership interest, consider placing the partnership interest in an S corporation (or in a slightly more elaborate structure)[6157] and facilitating a QSST election.

III.A.4.b. Example for Trust Accounting Income Regarding Business Interests

A similar problem can arise when a trust holds a partnership interest. Often a partnership may report significant earnings on its K-1s, but may distribute a much smaller amount in cash to its

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[6155] See part II.I 3.8% Tax on Excess Net Investment Income.
[6156] See part III.A.3.e.i QSSTs.
[6157] The trustee might place the partnership interest into an LLC, owned by one S corporation for each expected remainderman. See part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts (Whether or Not a Sale Is Made).

partners. For example, a trust could receive a partnership K-1 with $100,000 of taxable income but may only receive $60,000 of cash as a distribution. The $60,000 is all the accounting income, because the amount distributed does not exceed the amount of income attributable to the trust.[6158] When this happens, the trust will have distributable income equal to $60,000, but will be unable to distribute the additional $40,000 of "phantom income" from the K-1, meaning the trust will be taxed on the $40,000. This can lead to cash flow problems when the trust has no other income, since once the trust distributes the $60,000 to the beneficiary it will have no available cash to pay the taxes. The Uniform Principal and Income Act[6159] provides a solution to this problem. Under old section 505(c)(1), a tax that is required to be paid by a trustee on the trust's share of an entity's taxable income is proportionally divided between principal and income based on the receipts allocated to each.[6160] Thus, the trustee will be able to keep some of the cash to pay the taxes on the trust's undistributed income. See below for the 2008 clarification to section 505 that makes sure that the trustee has enough money to pay the tax.

Another example, with a flowchart, is at part III.F.2 Trust Accounting and Taxation.

III.A.4.c. Distributions from Entities as Trust Accounting Income or Principal

Generally, cash distributions from a business entity are trust accounting income unless they are in partial or complete liquidation. Below are how the Uniform Principal & Income Act ("UPIA") and Uniform Fiduciary Income & Principal Act ("UFIPA") treat a trust's receipt of distributions. UFIPA is the Uniform Law Commission's 2018 overhaul of UPIA; check applicable state law to see which of them applies. I was ABA Advisor to the 2008 amendments to UPIA, which did not change the rules below (except for part III.A.4.d Distributions from Pass-Through Entities Used to Pay Income Tax) and an ACTEC observer and an active participant in drafting UFIPA.

Before reviewing these rules, note that their application is just a first step. Consider also parts:

- III.A.4.d Distributions from Pass-Through Entities Used to Pay Income Tax (when the trustee may use trust accounting income to pay tax attributable to the business entity's reinvested income, even if the trust requires trust accounting income to be distributed),

- II.J.8.c.i.(a) Power to Adjust (reclassifying principal as income and vice versa), and

- II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Trust Accounting Rules (when the business entity is sold, reimbursing an income beneficiary burdened by part III.A.4.d - see first bullet point above).

UPIA § 401, Character of Receipts," provides:

> (a) In this section, "entity" means a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or any other organization in which a trustee has an interest other than a trust or estate

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[6158] Uniform Principal and Income Act § 401(b). See footnote 6159.
[6159] Citations to the Uniform Principal and Income Act are to the version adopted in 1997, as amended or revised in 2000, published August 21, 2003, by the National Conference of Commissioners on Uniform State Laws.
[6160] See also R.S.Mo. § 469.459.3(1).

to which Section 402 applies, a business or activity to which Section 403 applies, or an asset-backed security to which Section 415 applies.

(b) Except as otherwise provided in this section, a trustee shall allocate to income money received from an entity.

(c) A trustee shall allocate the following receipts from an entity to principal:

(1) property other than money;

(2) money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;

(3) money received in total or partial liquidation of the entity; and

(4) money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

(d) Money is received in partial liquidation:

(1) to the extent that the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation; or

(2) if the total amount of money and property received in a distribution or series of related distributions is greater than 20 percent of the entity's gross assets, as shown by the entity's year-end financial statements immediately preceding the initial receipt.

(e) Money is not received in partial liquidation, nor may it be taken into account under subsection (d)(2), to the extent that it does not exceed the amount of income tax that a trustee or beneficiary must pay on taxable income of the entity that distributes the money.

(f) A trustee may rely upon a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity's board of directors or other person or group of persons authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors.

The official Comment to UPIA § 401 explains:

Entities to which Section 401 applies. The reference to partnerships in Section 401(a) is intended to include all forms of partnerships, including limited partnerships, limited liability partnerships, and variants that have slightly different names and characteristics from State to State. The section does not apply, however, to receipts from an interest in property that a trust owns as a tenant in common with one or more co-owners, nor would it apply to an interest in a joint venture if, under applicable law, the trust's interest is regarded as that of a tenant in common.

Capital gain dividends. Under the Internal Revenue Code and the Income Tax

Regulations, a "capital gain dividend" from a mutual fund or real estate investment trust is the excess of the fund's or trust's net long-term capital gain over its net short-term capital loss. As a result, a capital gain dividend does not include any net short-term capital gain, and cash received by a trust because of a net short-term capital gain is income under this Act.

Reinvested dividends. If a trustee elects (or continues an election made by its predecessor) to reinvest dividends in shares of stock of a distributing corporation or fund, whether evidenced by new certificates or entries on the books of the distributing entity, the new shares would be principal. Making or continuing such an election would be equivalent to deciding under Section 104 to transfer income to principal in order to comply with Section 103(b). However, if the trustee makes or continues the election for a reason other than to comply with Section 103(b), e.g., to make an investment without incurring brokerage commissions, the trustee should transfer cash from principal to income in an amount equal to the reinvested dividends.

Distribution of property. The 1962 Act describes a number of types of property that would be principal if distributed by a corporation. This becomes unwieldy in a section that applies to both corporations and all other entities. By stating that principal includes the distribution of any property other than money, Section 401 embraces all of the items enumerated in Section 6 of the 1962 Act as well as any other form of nonmonetary distribution not specifically mentioned in that Act.

Partial liquidations. Under subsection (d)(1), any distribution designated by the entity as a partial liquidating distribution is principal regardless of the percentage of total assets that it represents. If a distribution exceeds 20% of the entity's gross assets, the entire distribution is a partial liquidation under subsection (d)(2) whether or not the entity describes it as a partial liquidation. In determining whether a distribution is greater than 20% of the gross assets, the portion of the distribution that does not exceed the amount of income tax that the trustee or a beneficiary must pay on the entity's taxable income is ignored.

Other large distributions. A cash distribution may be quite large (for example, more than 10% but not more than 20% of the entity's gross assets) and have characteristics that suggest it should be treated as principal rather than income. For example, an entity may have received cash from a source other than the conduct of its normal business operations because it sold an investment asset; or because it sold a business asset other than one held for sale to customers in the normal course of its business and did not replace it; or it borrowed a large sum of money and secured the repayment of the loan with a substantial asset; or a principal source of its cash was from assets such as mineral interests, 90% of which would have been allocated to principal if the trust had owned the assets directly. In such a case the trustee, after considering the total return from the portfolio as a whole and the income component of that return, may decide to exercise the power under Section 104(a) to make an adjustment between income and principal, subject to the limitations in Section 104(c).

UFIPA § 401, "Character of Receipts from Entity," provides more details about factual inquiries or assumptions the trustee may make and adds clarity to various terms. It says:

(a) In this section:

(1) “Capital distribution” means an entity distribution of money which is a:

(A) return of capital; or

(B) distribution in total or partial liquidation of the entity.

(2) “Entity”:

(A) means a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or any other organization or arrangement in which a fiduciary owns or holds an interest, whether or not the entity is a taxpayer for federal income tax purposes; and

(B) does not include:

(i) a trust or estate to which Section 402 applies;

(ii) a business or other activity to which Section 403 applies which is not conducted by an entity described in subparagraph (A);

(iii) an asset-backed security; or

(iv) an instrument or arrangement to which Section 416 applies.

(3) “Entity distribution” means a payment or transfer by an entity made to a person in the person’s capacity as an owner or holder of an interest in the entity.

(b) In this section, an attribute or action of an entity includes an attribute or action of any other entity in which the entity owns or holds an interest, including an interest owned or held indirectly through another entity.

(c) Except as otherwise provided in subsection (d)(2) through (4), a fiduciary shall allocate to income:

(1) money received in an entity distribution; and

(2) tangible personal property of nominal value received from the entity.

(d) A fiduciary shall allocate to principal:

(1) property received in an entity distribution which is not:

(A) money; or

(B) tangible personal property of nominal value;

(2) money received in an entity distribution in an exchange for part or all of the fiduciary’s interest in the entity, to the extent the entity distribution reduces the fiduciary’s interest in the entity relative to the interests of other persons that own or hold interests in the entity;

(3) money received in an entity distribution that the fiduciary determines or estimates is a capital distribution; and

(4) money received in an entity distribution from an entity that is:

(A) a regulated investment company or real estate investment trust if the money received is a capital gain dividend for federal income tax purposes; or

(B) treated for federal income tax purposes comparably to the treatment described in subparagraph (A).

(e) A fiduciary may determine or estimate that money received in an entity distribution is a capital distribution:

(1) by relying without inquiry or investigation on a characterization of the entity distribution provided by or on behalf of the entity, unless the fiduciary:

(A) determines, on the basis of information known to the fiduciary, that the characterization is or may be incorrect; or

(B) owns or holds more than 50 percent of the voting interest in the entity;

(2) by determining or estimating, on the basis of information known to the fiduciary or provided to the fiduciary by or on behalf of the entity, that the total amount of money and property received by the fiduciary in the entity distribution or a series of related entity distributions is or will be greater than 20 percent of the fair market value of the fiduciary's interest in the entity; or

(3) if neither paragraph (1) nor (2) applies, by considering the factors in subsection (f) and the information known to the fiduciary or provided to the fiduciary by or on behalf of the entity.

(f) In making a determination or estimate under subsection (e)(3), a fiduciary may consider:

(1) a characterization of an entity distribution provided by or on behalf of the entity;

(2) the amount of money or property received in:

(A) the entity distribution; or

(B) what the fiduciary determines is or will be a series of related entity distributions;

(3) the amount described in paragraph (2) compared to the amount the fiduciary determines or estimates is, during the current or preceding accounting periods:

(A) the entity's operating income;

(B) the proceeds of the entity's sale or other disposition of:

(i) all or part of the business or other activity conducted by the entity;

(ii) one or more business assets that are not sold to customers in the ordinary course of the business or other activity conducted by the entity; or

(iii) one or more assets other than business assets, unless the entity's primary activity is to invest in assets to realize gain on the disposition of all or some of the assets;

(C) if the entity's primary activity is to invest in assets to realize gain on the disposition of all or some of the assets, the gain realized on the disposition;

(D) the entity's regular, periodic entity distributions;

(E) the amount of money the entity has accumulated;

(F) the amount of money the entity has borrowed;

(G) the amount of money the entity has received from the sources described in Sections 407, 410, 411, and 412; and

(H) the amount of money the entity has received from a source not otherwise described in this paragraph; and

(4) any other factor the fiduciary determines is relevant.

(g) If, after applying subsections (c) through (f), a fiduciary determines that a part of an entity distribution is a capital distribution but is in doubt about the amount of the entity distribution which is a capital distribution, the fiduciary shall allocate to principal the amount of the entity distribution which is in doubt.

(h) If a fiduciary receives additional information about the application of this section to an entity distribution before the fiduciary has paid part of the entity distribution to a beneficiary, the fiduciary may consider the additional information before making the payment to the beneficiary and may change a decision to make the payment to the beneficiary.

(i) If a fiduciary receives additional information about the application of this section to an entity distribution after the fiduciary has paid part of the entity distribution to a beneficiary, the fiduciary is not required to change or recover the payment to the beneficiary but may consider that information in determining whether to exercise the power to adjust under Section 203.

The official Comment to UFIPA § 401 explains:

> **Entities to which Section 401 applies**. Section 401 covers distributions from all types of entities. For example, the reference to partnerships in Section 401(a)(2)(A) includes all forms of partnerships, including limited partnerships, limited liability partnerships, and variants that have slightly different names and characteristics from state to state. And subsection (b) provides that the same is true of a chain or chains of entities, whether the entities are the same or different and no matter how many tiers the entities represent. This section does not apply, however, to receipts from an interest in property that a

fiduciary owns as a tenant-in-common with one or more coowners, nor would it apply to an interest in a joint venture if, under applicable law, the interest is regarded as that of a tenant-in-common.

Section 401(a)(2)(A) of the 2018 Act clarifies that Section 401 applies to an entity that meets these tests whether or not the entity is respected for federal income tax purposes. In Section 401(a)(2)(B) the 2018 Act retains the exceptions from the application of Section 401 in Section 401(a) of the 1997 Act, except that it clarifies that it does not exclude a business that might appear to be described in Section 403 if it is conducted in an entity that is subject to Section 401 under Section 401(a)(2)(A). This clarification and a similar clarification to Section 403(a)(2) prevent what might otherwise seem to be a circularity between Sections 401 and 403, with each of those sections excluding an entity described in the other section.

Terms. The 2018 Act introduces the term “entity distribution” to refer to distributions from entities to which Section 401 applies and the term “capital distribution” to refer to distributions of money, rather than other property, which nevertheless are treated as principal. “Capital distribution” replaces the former term “total or partial liquidation” and includes a “return of capital.”

Reinvested dividends. If a fiduciary elects (or continues an election made by a predecessor) to reinvest dividends in shares of stock of a distributing corporation or fund, whether evidenced by new certificates or entries on the books of the distributing entity, the new shares would be principal. Making or continuing such an election would be equivalent to making an adjustment from income to principal under Section 203. If the fiduciary makes or continues the election for a reason other than to comply with the standards of Section 203, such as making an investment without incurring brokerage commissions, the fiduciary has the option of considering a corresponding transfer of cash from principal to income.

Distribution of property. The 1962 Act described a number of types of property that would be principal if distributed by a corporation. This became unwieldy in a section (former Section 401) that applied to both corporations and all other entities. By stating that the distribution of any property other than money is generally allocated to principal, subsection (d)(1) embraces all of the items enumerated in Section 6 of the 1962 Act as well as any other form of nonmonetary distribution not specifically mentioned in that act. The new exception in subsections (c)(2) and (d)(1)(B) for “tangible personal property of nominal value” would cover, for example, an item of food sent to owners (and perhaps others such as customers, suppliers, and employees) at a holiday time. It is not necessarily given in proportion to ownership interests, and as a practical matter it often needs to be allocated to income, in effect, so it can be conveniently distributed and enjoyed.

With respect to large distributions of cash, the 2018 Act is sensitive to the fact that the fiduciary might not have enough information to properly categorize the distribution. Subsection (d)(2) addresses the relatively easy case of a likely non-pro-rata distribution that reduces the fiduciary’s proportionate interest in the entity – in effect, a redemption. Subsection (d)(4) retains the special rule for capital gain dividends from a regulated investment company (RIC) or real estate investment trust (REIT) that was added in 1997, and adds a reference to other distributions that federal income tax law treats comparably.

Subsection (d)(2) retains the rule that a distribution in exchange for part of all of the fiduciary's interest in the entity is principal, but clarifies that this rule applies only to the extent the transaction reduces the fiduciary's proportional interest in the entity relative to other owners. It does not necessarily apply, for example, to a corporate reorganization in which shareholders exchange their stock for other stock. If all owners receive proportionate distributions, the distribution to the fiduciary is tested as described in the next paragraph.

With regard to receipts of money that could be what the act refers to as a "capital distribution" – a return of capital or a distribution in partial liquidation of the entity – subsections (d)(3), (e), and (f) provide some help with what the act acknowledges might be only an "estimate" by the fiduciary. For this purpose, subsection (e) provides that the fiduciary may first rely on how the entity describes the distribution, unless the fiduciary possesses information that casts doubt on that description or the fiduciary is a majority voting owner, in which case the fiduciary may have a duty to inquire or investigate further. Next, the fiduciary may be satisfied with treating the distribution as a capital distribution if information the entity provides, together with other information the fiduciary knows, indicates that the distribution exceeds 20 percent of the fair market value of the fiduciary's interest. This 20 percent test is retained from the 1997 Act, except that (i) it is a permissive safe harbor and not a presumption and (ii) the 1997 Act applied the 20 percent test to "the entity's gross assets" and the 2018 Act applies it to "the fair market value of the fiduciary's interest in the entity," thus focusing the inquiry on the distribution to that fiduciary rather than all distributions made by the entity. For this purpose, what the available information indicates is or will be a series of distributions is aggregated. Finally, under subsection (e)(3), the fiduciary may make a determination or estimate based on factors in subsection (f), including but not limited to the entity's characterization of the distribution, that may help point the fiduciary to a distribution that is extraordinary enough under the circumstances to be treated as a capital distribution. But it is not possible to describe a "capital distribution" with reference to objective characteristics alone, and fiduciaries will have to exercise some judgment in making the necessary determinations and estimates.

Because estimates may be necessary and are expressly contemplated by the act, subsections (h) and (i) help the fiduciary know how to make distributions on the basis of incomplete information and, as a last resort, cite the power to adjust between income and principal in Section 203.

III.A.4.d. Distributions from Pass-Through Entities Used to Pay Income Tax

In the summer of 2008, the Uniform Law Commission amended Section 505 of the Uniform Principal & Income Act (the "UPAIA"); see part III.A.4.d.vi Appendix to 505 Discussion. The amendment responds to litigation over the income tax burden when a mandatory income trust holds an interest in a partnership or other pass-through entity. This article addresses the concerns underlying the changes, explains the changes, and discusses the planning implications of this change and related issues.

When a mandatory income trust holds an interest in a partnership or other flow-through entity, coordinating the UPAIA with fiduciary income tax rules can get tricky. The changes to UPAIA section 505 provide needed clarity regarding the treatment of taxes paid regarding a trust's distributive share of an entity's income; however, they do not address the other issues described in part II.J.5 Mandatory Income Trusts.

The Uniform Law Commission approved an overhaul of UPAIA in 2018. The Uniform Fiduciary Income and Principal Act ("UFIPA") retained UPAIA § 505 but renumbered it as UFIPA § 506. I was an ACTEC observer and was actively involved with the drafting committee.

III.A.4.d.i. Concerns Underlying the UPAIA Section 505 Changes

Before discussing the technical reasons for change, one must understand some of the basic income tax rules governing business entities, the rules governing the income taxation of trusts, and how they interact.

Income Tax Rules Governing Business Entities

Three different paradigms apply to business entities. A traditional corporation (also known as a "C corporation") pays income taxes on its own income. When it distributes its current or accumulated earnings, the distribution is taxed to its shareholders as a dividend. It might also make one or more distributions in partial or total liquidation, which is taxed to its shareholders as a sale of part or all of the stock rather than a dividend if certain tax law requirements are satisfied.

The Tax Reform Act of 1986 prevented C corporations from liquidating without both the shareholders and corporation being taxed. These new rules encouraged those who owned C corporations to convert them to S corporations. S corporation owners are taxed on the corporation's income rather than the corporation being taxed on the income. An example will help explain this difference:

- <u>C Corporation</u>. Suppose the corporation has one shareholder, A. A invests $1,000x. In Year 1, the corporation earns $100,000x and pays $40,000x in income tax, leaving $60,000x of after-tax earnings and a total of $61,000x of cash. The corporation liquidates, distributing $61,000x to A. A pays income tax of $12,000x on the excess of the $61,000x proceeds over the $1,000x that A invested. After paying taxes, A has $49,000x ($61,000x liquidation proceeds minus $12,000x taxes that A paid).

- <u>S corporation</u>. Same situation, only an S election is in place. In Year 1, the corporation pays no income tax on its earnings; instead, A receives Schedule K-1 from the corporation reporting $100,000x of gross income and pays $40,000x income tax on the corporation's earnings. Code § 1366(c). The corporation distributes $40,000x to A to pay the income taxes, so A has really not used any of A's own money to pay the income tax. Code § 1368(b)(1) provides that this distribution is not taxed because it does not exceed the shareholder's tax basis. However, A's investment in the corporation has increased for income tax purposes. A's basis is now $61,000x, which is the $1,000x that A invested, plus the $100,000x income on which A was taxed, minus the $40,000x that the corporation distributed to A to pay A's income tax. Code § 1367. The corporation then liquidates, distributing $61,000x to A ($1,000x that A invested, plus $100,000x earnings, minus $40,000x distributed to A to pay A's income taxes). A keeps the entire $61,000x without paying any income tax on the distribution, because A received the same amount as A is deemed to have invested.

In the example, the sole shareholder has received more using an S corporation than using a C corporation. The $40,000x that the S corporation distributed to A really was not intended as a benefit to A; instead, it was reimbursing A for the taxes that A paid on the corporation's income. The $40,000x is referred to below as a "tax distribution."

C and S corporations are the first two of the three paradigms. Partnerships (including limited liability companies taxed as partnerships) have similar effects on the taxation of owners for purposes of UPAIA section 505. Therefore, this article refers to S corporations and partnerships as "flow-through" entities and uses "K-1 income" to describe the income from the flow-through entity that an owner needs to report. For reasons beyond the scope of this article, partnerships have much more flexible income tax rules regarding distributions from the entity to owners.

In the example above, let's compare distributions from C corporations with distributions from flow-through entities.

- The owner of a C corporation receives no distribution.

- The owner of a pass-through entity receives a tax distribution, so that the owner retains no cash after paying income taxes.

Suppose that, in the example above, the owner is a mandatory income trust:

- A trust that owns stock in a C corporation has no trust accounting income because it has no receipts.

- How much trust accounting income does a trust that owns a pass-through entity have that must be distributed to the beneficiary? To achieve parity with the C corporation scenario, the income taxes paid using the tax distribution would be charged against income, so that again the beneficiary receives nothing. However, that result was not clear under UPAIA section 505 before the amendment.

One must understand trust income taxation to fully understand how UPAIA section 505 works.

Income Tax Rules Governing Trusts

Suppose a trust receives Schedule K-1 reporting $100,000x income. Ignoring the trust's small exemption amount and very modest use of lower tax brackets, the trust would be required to pay $40,000x of income tax, assuming a 40% federal and state income tax rate. However, if the trust distributes $100,000x to its beneficiary, it receives a $100,000x income distribution deduction and pays no income tax;[6161] instead, the trust gives the beneficiary a Schedule K-1 reporting $100,000x income, and the beneficiary pays income tax on the $100,000x Schedule K-1 income (to the extent not offset by the beneficiary's deductions, exemptions, etc.).[6162]

Carrying this example further, suppose the trust receives only a $40,000x tax distribution and does not have other funds to distribute to the beneficiary. If the trust distributes the $40,000x to the beneficiary, then the trust receives a $40,000x income distribution deduction and must pay $24,000x income tax ($60,000x multiplied by 40%) on its remaining $60,000x ($100,000x Schedule K-1 income minus $40,000x income distribution deduction) taxable income. However, the trustee has no funds with which to pay the $24,000x income tax. In fact, the only way to

[6161] Code §§ 651, 661.
[6162] Code §§ 652, 662.

prevent the trustee from not being able to pay income tax with respect to the Schedule K-1 income would be for the trustee to retain the entire tax distribution.

What are the principles that apply to determining the income distribution deduction described above? First, compute the amount of trust's distributable net income (taxable income, with certain adjustments). Next, determine the amount required to be distributed and any additional amounts actually distributed to the beneficiary. The income distribution deduction, which is always taxable to the beneficiary through the Schedule K-1 the trustee gives to the beneficiary, is the lesser of the distributable net income or the distributions described above. The rules become more complicated when one considers capital gains, tax-exempt income, or other similar issues, but the framework is similar.

Now let's apply this to a mandatory income trust. The trust accounting income, determined under the UPAIA, is an amount required to be distributed using the above principles. Some people assume that the Schedule K-1 income is the amount deemed distributed. That assumption is false. For income tax purposes, the amount of income required to be distributed is based on state law fiduciary accounting income.[6163] UPAIA Section 102(4) provides that "'income' means money or property that a fiduciary receives as a current return…." Thus, income would not exceed "money or property that a fiduciary receives" even if the Schedule K-1 income is higher.

In a trust that receives a $40,000x tax distribution, the trust has $40,000x of income receipts.[6164] How much income tax should the trustee deduct from the $40,000x receipt to determine the income that must be distributed? UPAIA section 505 answers that question. However, the answer was unclear and bred litigation, because beneficiaries receiving no cash from a mandatory income trust were understandably upset. Below, this article explains the UPAIA change and how attorneys drafting estate plans or representing disappointed beneficiaries might advise their clients in light of these changes and existing law.

III.A.4.d.ii. Explanation of the UPAIA Section 505 Changes

Before this amendment, the language of UPAIA section 505 was ambiguous regarding accounting for tax distributions. The amendment clarifies the overriding principle that the trustee of a mandatory income trust uses tax distributions to the extent necessary to pay income taxes and distributes any remaining income to the beneficiary. The official comments contain an algebraic formula that might be used when an interrelated calculation is required, which is whenever distributions from a pass-through are less than its Schedule K-1 income and the trustee has no other funds to distribute to the beneficiary or pay income tax on its Schedule K-1 income.

The policy behind this change is that the UPAIA should not place trustees in a position where they cannot pay the trust's income tax. Generally, it is not practical or prudent for a trustee to borrow to pay income tax when the trustee has no idea when, if ever, a distribution in excess of a tax distribution will be made. Furthermore, if the trust owned C corporation stock rather than an interest in a flow-through entity, the trust would never have received a distribution from the business entity anyway.

[6163] Reg. §§ UPAIA Section 401(b).
[6164] UPAIA Section 401(b).

In the example above, suppose the business entity annually accumulated the $40,000x excess of Schedule K-1 income over the tax distribution. Suppose these accumulated amounts were later distributed to the trust. UPAIA section 506(a)(3) would authorize additional distributions to the beneficiary because the beneficiary essentially paid the tax on these accumulated amounts when the trustee used the tax distributions to pay income tax instead of distributing part or all of them to the beneficiary.

Before turning to advising clients about these changes, let's discuss particular rules affect how these rules apply to various trusts that own stock in S corporations:

- An electing small business trust ("ESBT") does not receive an income distribution deduction with respect to its Schedule K-1 income that is distributed to its beneficiary.[6165]

- A qualified subchapter S trust ("QSST") under Code Section 1361(d), or other trust treated as wholly owned by one grantor or one beneficiary, does not pay taxes on any of its Schedule K-1 income from an S corporation. Instead, the individual beneficiary or grantor treated for income tax purposes as receiving Schedule K-1 income pays all the income taxes attributable to the Schedule K-1 income.[6166] Therefore, the trustee would distribute to the beneficiary all of the tax distribution.

- Only in very limited situations may a trust not described above be qualified to hold stock in an S corporation. The main situations involve trusts that were grantor trusts during the grantor's or beneficiary's life (but only for the two years following the deemed owner's death), estates (including a revocable trust taxed as an estate if a Code Section 645 election is made), and trusts that are funded upon termination of an estate (but only for the two years following funding).[6167]

III.A.4.d.iii. UFIPA § 506

UFIPA § 506, "Income Taxes," provides:

(a) A tax required to be paid by a fiduciary which is based on receipts allocated to income must be paid from income.

(b) A tax required to be paid by a fiduciary which is based on receipts allocated to principal must be paid from principal, even if the tax is called an income tax by the taxing authority.

(c) Subject to subsection (d) and Sections 504, 505, and 507, a tax required to be paid by a fiduciary on a share of an entity's taxable income in an accounting period must be paid from:

(1) income and principal proportionately to the allocation between income and principal of receipts from the entity in the period;

(2) principal to the extent the tax exceeds the receipts from the entity in the period.

[6165] Code § 1361(e); Reg. § 1.641(c)-1(i).
[6166] Code § 1361(d)(1)(B).
[6167] Code § 1361(c)(2). See part III.A.3 Trusts Holding Stock in S Corporations.

(d) After applying subsections (a) through (c), the fiduciary shall adjust income or principal receipts, to the extent the taxes the fiduciary pays are reduced because of a deduction for payments made to a beneficiary.

UFIPA § 506 retained the Comment to UPAIA (see part III.A.4.d.vi Appendix to 505 Discussion) and added a Comment clarifying that it has no effect on the marital deduction.[6168]

III.A.4.d.iv. Advising Clients about the UPAIA § 505 Change and UFIPA § 506

The common yet extreme scenario posited – where a mandatory income trust owns only an interest in a flow-through entity that limits distributions to tax distributions – presents difficult challenges for settlors, trustees, and beneficiaries. The changes to UPAIA section 505 and UFIPA § 506 allow the trustee to pay the trust's taxes notwithstanding these significant other challenges. One must consider why this difficult situation arises, what the trustee must do to alter the trust's investments if the trust agreement does not address the issue, and how to minimize disputes about what the trustee should do.

III.A.4.d.iv.(a). Why This Difficult Situation Arises

The first question is why the settlor would provide for a mandatory income interest, while expecting that no income will be available to distribute to the beneficiary? Scenarios include:

- *Marital Deduction Mandatory Income Requirement*. The trust is for a surviving spouse who does not need distributions but must provide for mandatory income to qualify for the marital deduction. The trust has the usual clause allowing the spouse to require the trustee to make the property productive. In some cases, using a separate trust to hold a flow-through entity without holding any other assets might be necessary to minimize the estate tax risk of buy-sell agreements.[6169] The Internal Revenue Service has taken the position that a fixed-price buy-sell agreement, in which the sale price of a decedent's equity is less than the Internal Revenue Service-determined fair market value, effectively passes property to a person other than the surviving spouse and therefore disqualifies the marital trust from being eligible for a marital deduction.[6170] If the client uses a fixed-price buy-sell agreement, the client might protect the marital deduction with respect to other assets by placing the other assets into a marital deduction trust that is separate from the trust that holds the client's equity. In such a case, the settlor should make sure that the spouse understands the trust's purposes and does not expect any distributions from the

[6168] The added Comment says:

Marital deduction issues. Any payment of income tax from income could raise issues of the estate or gift tax marital deduction, especially if the income on which that income tax is paid is not fully distributed, as in the case of income retained in an entity owned in whole or in part by the trust. These issues are similar to the issues raised by Revenue Ruling 2006-26 in the context of defined contribution qualified retirement plans and individual retirement accounts (IRAs). See Section 409 and the Comment thereto. The 2018 Act makes no change to Section 506 because the power in the spouse to cause the trust assets to be made reasonably productive of income addresses any marital deduction issue. See Section 413.

[6169] In addition to the estate tax reason mentioned below, a QSST that holds only S stock (and no other assets) is not required to take any particular action to continue to qualify as an S corporation shareholder within two years after the beneficiary dies. Code §§ 1361(c)(2)(A)(ii), 1361(d)(1)(B).

[6170] See part II.O.2.c Effect of Buy-Sell Agreement on Marital Deduction, especially fn 3780.

trust. If, however, the surviving spouse is adverse to the remaindermen, then the grantor settlor should consider a prenuptial agreement or other ways of documenting a particular expectation of cash flow to the surviving spouse.

- *Future Income Expected*. The settlor does not expect income to be generated initially but expects the business entity eventually to generate income and does not expect the beneficiary to need the income until later. In this case, the settlor might consider describing the settlor's expectation regarding income so that the trustee has more guidance on what the settlor expects and can respond to concerns that the income beneficiary might raise.

- *Post-Mortem Business Sale Expected*. The settlor wanted to mandate income distributions, knowing full well that the business would need to be sold. The settlor might not have been able to find a buyer while alive, might have wanted to have a place to work for as long as the settlor lived, or might have wanted to wait until death to save income (including capital gain) tax on the sale.

III.A.4.d.iv.(b).What the Trustee Must Do to Alter the Trust's Investments If the Trust Agreement Does Not Address the Issue

The Uniform Prudent Investor Act (the "Investor Act") imposes various requirements:

- The trustee must consider "the purposes, terms, distribution requirements, and other circumstances of the trust."[6171]

- The trustee must further consider not only total return from income and appreciation of capital but also needs for liquidity and regularity of income.[6172]

- "A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."[6173]

- "Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this [Act]."[6174]

- "If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries."[6175]

Thus, absent an expression of intent to the contrary, the trustee has a duty to sell enough of the business interest to generate income sufficient to fairly balance the income beneficiary's interests against the other beneficiaries' interests; note that a sale might not be required if the

[6171] Section 2(a) of the Investor Act.
[6172] Section 2(c)(5) and (7) of the Investor Act.
[6173] Section 3 of the Investor Act.
[6174] Section 4 of the Investor Act.
[6175] Section 6 of the Investor Act.

business already generates sufficient income to create that fair balance. The trustee also must sell enough of the business interest to create a diversified portfolio. Therefore, for all practical purposes, the trustee must dispose of substantially all of the business interest, if that comprises too much of the trust.

The trust agreement can expressly modify this duty to sell. It might include some or all of the following provisions:

- Expressly authorize the trustee to hold the property (for a particular period of time or indefinitely), notwithstanding its failure to produce income and notwithstanding any requirement to diversify that might otherwise apply. However, this authorization might be insufficient when the stock is performing poorly.[6176] Although the lower court's decision was reversed, it indicates what some judges might do. Also, such a provision cannot be used for marital deduction trusts if it would deprive the surviving spouse of the right to income.[6177] The author routinely includes language authorizing the spouse to require that the trustee either make the trust's property productive or convert it to income-producing property within a reasonable time.[6178]

- Subject to the marital trust concerns described above, require the trustee to hold the property (for a particular period of time or indefinitely). The authorization to hold might be viewed as requiring the trustee to consider the merits of selling even if it places less pressure to sell, whereas the requirement to hold should remove any requirement to consider selling.

- Give family members interested in the business the power to direct the trustee to hold the business interest. Some states completely relieve the trustee of liability for following directions that the trust agreement authorizes; others might implicitly impose a duty to resist instructions if the instructions appear inconsistent with the trustee's duties to various beneficiaries.

- If the trust is not a marital trust, add as beneficiaries those family members working in the business by stating that a purpose of retaining the business interest is to provide jobs for those family members. Even if the trust agreement does not provide for distributions to them, some steps should be taken to recognize their interests; otherwise, the trustee has no duty to protect their interests.[6179]

Note, however, that these ideas do not resolve marital deduction issues if the surviving spouse wants more income. Consistent with the regulations cited in fn 6178, UFIPA § 413 provides:

> *Marital Deduction Property Not Productive of Income*. If a trust received property for which a gift or estate tax marital deduction was allowed and the settlor's spouse holds a

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[6176] *Testamentary Trust UW Dumont* , 791 N.Y.S.2d 868 (Surr. Ct. 2004), reversed *In re Chase Manhattan Bank*, 809 N.Y.S.2d 360 (N.Y.A.D. 2006).
[6177] Regs. §§ 20.2056(b)-5(f)(5) (general power of appointment marital trusts), 20.2056(b)-7(d)(2) (same rules apply to QTIP trusts).
[6178] Reg. § 20.2056(b)-5(f)(4) suggests such a provision if the trust's assets consist substantially of unproductive property. However, Reg. § 20.2056(b)-5(f)(5) looks to the trust's overall return and approves of distributing principal to make up for lack of income from any nonproductive assets, so such a provision can relate to the trust's overall level of distributions, rather than requiring that each asset be productive.
[6179] Section 5 of the Investor Act.

> mandatory income interest in the trust, the spouse may require the trustee to make property productive of income, convert property to property productive of income within a reasonable time, or exercise the power to adjust under Section 203, to the extent the trust assets otherwise do not provide the spouse with sufficient income from or use of the trust assets to qualify for the deduction. The trustee may decide which action or combination of actions to take.

UFIPA § 413 did not make any substantive changes to UPAIA.[6180]

III.A.4.d.iv.(c). How to Minimize Disputes About What the Trustee Should Do

The most effective way to minimize disputes is to have legally binding, unambiguous language in the trust. However, being too detailed might unduly tie the trustee's hands when the settlor really wanted to rely on the trustee's judgment. It is impossible to predict the future, and giving the trustee flexibility is often the best call.

The settlor should consider discussing with family members the settlor's intent in placing an essentially unproductive asset into a mandatory income trust. An income beneficiary who has lowered expectations might be less demanding, especially if the trustee and the other beneficiaries are all in the room when the settlor expresses this intent.

The settlor might also consider writing a precatory letter to the trustee (and beneficiaries, if appropriate) expressing this intent. Although the trustee cannot rely on this letter to change the trustee's legal obligations, a trustee usually finds comfort to the extent the letter supports the trustee's discretionary actions under the trust agreement.

For example, to maximize flexibility in a trustee who is to make the ultimate decision, the settlor would:

- include in the trust agreement express authority (but not a mandate) for the trustee to retain assets originally contributed (or sold by the settlor) to the trust, including without limitation (name of the company, its affiliates, etc.), without any requirement to diversify under the Investor Act, and

- write a precatory letter to the trustee.

Extreme caution is recommended in using such provisions with a marital deduction trust or other trust that the tax laws require to have a mandatory income provision. Being too explicit might trigger an attack on the provision as undermining the mandatory income characterization; however, including a right to make productive should suffice.[6181]

[6180] The Comment to UPAIA § 413 says

> In Section 413 the 2018 Act makes little substantive change from the 1997 Act. It omits Section 413(b) of the 1997 Act, which had provided:
>
> > In a case not governed by subsection (a), proceeds from the sale or other disposition of an asset are principal without regard to the amount of income the asset produces during any accounting period.
>
> Section 404(2) of the 2018 Act provides that proceeds from a sale or exchange of a principal asset remain principal, which renders former Section 413(b) duplicative.

[6181] See fn. 6178.

III.A.4.d.iv.(d).Fairness When the Trust Sells Its Interest in the Entity

See parts II.J.8.c.i.(b) Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation and II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Trust Accounting Rules.

III.A.4.d.v. Conclusion

The amendment to UPAIA section 505 should prove helpful. It should avoid disputes over whether the trustee will be able to pay the trust's income taxes and place the focus where it belongs – whether a mandatory income trust should hold assets that, in the aggregate, produce no after-tax income. Trusts to hold most or all of their assets in the form of flow-through entities such as partnerships that sometimes make no more than tax distributions might be drafted with a discretionary instead of a mandatory income distribution and in any event should be drafted with careful consideration to the Uniform Prudent Investor Act.

III.A.4.d.vi. Appendix to 505 Discussion

Below are the amendments to Uniform Principal and Income Act, which are incorporated into the UPAIA at http://www.law.upenn.edu/bll/archives/ulc/upaia/2008_final.htm:

Section 505 is amended to read:

SECTION 505. INCOME TAXES

(a) A tax required to be paid by a trustee based on receipts allocated to income must be paid from income.

(b) A tax required to be paid by a trustee based on receipts allocated to principal must be paid from principal, even if the tax is called an income tax by the taxing authority.

(c) A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid ~~proportionately~~:

(1) from income to the extent that receipts from the entity are allocated <u>only</u> to income; ~~and~~

(2) from principal to the extent that~~:~~

~~(A)~~ receipts ~~from~~ the entity are allocated <u>only</u> to principal; ~~and~~

~~(B) the trust's share of the entity's taxable income exceeds the total receipts described in paragraphs (1) and (2)(A).~~

<u>(3) proportionately from principal and income to the extent that receipts from the entity are allocated to both income and principal; and</u>

<u>(4) from principal to the extent that the tax exceeds the total receipts from the entity.</u>

(d) ~~For~~ purposes ~~of this section, receipts allocated to principal or income~~

~~must be reduced by the amount distributed to a beneficiary from principal or income for which the trust receives a deduction in calculating the tax.~~ After applying subsections (a) through (c), the trustee shall adjust income or principal receipts to the extent that the trust's taxes are reduced because the trust receives a deduction for payments made to a beneficiary.

Comment

~~**Electing Small Business Trusts.** An Electing Small Business Trust (ESBT) is a creature created by Congress in the Small Business Job Protection Act of 1996 (P.L. 104-188). For years beginning after 1996, an ESBT may qualify as an S corporation stockholder even if the trustee does not distribute all of the trust's income annually to its beneficiaries. The portion of an ESBT that consists of the S corporation stock is treated as a separate trust for tax purposes (but not for trust accounting purposes), and the S corporation income is taxed directly to that portion of the trust even if some or all of that income is distributed to the beneficiaries.~~

~~A trust normally receives a deduction for distributions it makes to its beneficiaries. Subsection (d) takes into account the possibility that an ESBT may not receive a deduction for trust accounting income that is distributed to the beneficiaries. Only limited guidance has been issued by the Internal Revenue Service, and it is too early to anticipate all of the technical questions that may arise, but the powers granted to a trustee in Sections 506 and 104 to make adjustments are probably sufficient to enable a trustee to correct inequities that may arise because of technical problems.~~

Taxes on Undistributed Entity Taxable Income. When a trust[6182] owns an interest in a pass-through entity, such as a partnership or S corporation, it must report its share of the entity's taxable income regardless of how much the entity distributes to the trust. Whether the entity distributes more or less than the trust's tax on its share of the entity's taxable income, the trust must pay the taxes and allocate them between income and principal.

Subsection (c) requires the trust to pay the taxes on its share of an entity's taxable income from income or principal receipts to the extent that receipts from the entity are allocable to each. This assures the trust a source of cash to pay some or all of the taxes on its share of the entity's taxable income. Subsection 505(d) recognizes that, except in the case of an Electing Small Business Trust (ESBT), a trust normally receives a deduction for amounts distributed to a beneficiary. Accordingly, subsection 505(d) requires the trust to increase receipts payable to a beneficiary as determined under subsection (c) to the extent the trust's taxes are reduced by distributing those receipts to the beneficiary.

Because the trust's taxes and amounts distributed to a beneficiary are interrelated, the trust may be required to apply a formula to determine the correct amount payable to a beneficiary. This formula should take into account that each time a distribution is made to a beneficiary, the trust taxes are reduced and amounts distributable to a beneficiary are increased. The formula assures that after deducting distributions to a beneficiary, the trust has enough to satisfy its taxes on its share of the entity's taxable income as reduced by distributions to

[6182] [This is my footnote.] UFIPA added "nongrantor" before "trust" beneficiaries.

Example (1) – Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $100,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35% tax bracket.
Trust T's tax on $1 million of taxable income is $350,000. Under Subsection (c) T's tax must be paid from income receipts because receipts from the entity are allocated only to income. Therefore, T must apply the entire $100,000 of income receipts to pay its tax. In this case, Beneficiary B receives nothing.

Example (2) - Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $500,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35% tax bracket.
Trust T's tax on $1 million of taxable income is $350,000. Under Subsection (c), T's tax must be paid from income receipts because receipts from P are allocated only to income. Therefore, T uses $350,000 of the $500,000 to pay its taxes and distributes the remaining $150,000 to B. The $150,000 payment to B reduces T's taxes by $52,500, which it must pay to B. But the $52,500 further reduces T's taxes by $18,375, which it also must pay to B. In fact, each time T makes a distribution to B, its taxes are further reduced, causing another payment to be due B.

Alternatively, T can apply the following algebraic formula to determine the amount payable to B:

$$D = (C-R*K)/(1-R)$$

D = Distribution to income beneficiary
C = Cash paid by the entity to the trust
R = tax rate on income
K = entity's K-1 taxable income

Applying the formula to Example (2) above, Trust T must pay $230,769 to B so that after deducting the payment, T has exactly enough to pay its tax on the remaining taxable income from P.

Taxable Income per K-1	1,000,000
Payment to beneficiary	230,769[6183]
Trust Taxable Income	$ 769,231
35% tax	269,231

Partnership Distribution	$ 500,000
Fiduciary's Tax Liability	(269,231)
Payable to the Beneficiary	$ 230,769

[6183] D = (C-R*K)/(1-R) = (500,000 – 350,000)/(1 - .35) = $230,769. (D is the amount payable to the income beneficiary, K is the entity's K-1 taxable income, R is the trust ordinary tax rate, and C is the cash distributed by the entity).

In addition, B will report $230,769 on his or her own personal income tax return, paying taxes of $80,769. Because Trust T withheld $269,231 to pay its taxes and B paid $80,769 taxes of its own, B bore the entire $350,000 tax burden on the $1 million of entity taxable income, including the $500,000 that the entity retained that presumably increased the value of the trust's investment entity.

If a trustee determines that it is appropriate to so, it should consider exercising the discretion granted in UPIA section 506 to adjust between income and principal. Alternatively, the trustee may exercise the power to adjust under UPIA section 104 to the extent it is available and appropriate under the circumstances, including whether a future distribution from the entity that would be allocated to principal should be reallocated to income because the income beneficiary already bore the burden of taxes on the reinvested income. In exercising the power, the trust should consider the impact that future distributions will have on any current adjustments.

III.A.5. Fiduciary Duties Regarding Business Interests Held in Trust

Issues regarding the duty to diversify are discussed in part III.A.4.d.iv, Advising Clients about the UPAIA § 505 Change and UFIPA § 506.

This author has heard of bank regulators requiring corporate trustees to revalue closely-held business interests annually, citing 12 CFR 9.6, which provides:

Sec. 9.6 Review of fiduciary accounts.

(a) *Pre-acceptance review*. Before accepting a fiduciary account, a national bank shall review the prospective account to determine whether it can properly administer the account.

(b) *Initial post-acceptance review*. Upon the acceptance of a fiduciary account for which a national bank has investment discretion, the bank shall conduct a prompt review of all assets of the account to evaluate whether they are appropriate for the account.

(c) *Annual review*. At least once during every calendar year, a bank shall conduct a review of all assets of each fiduciary account for which the bank has investment discretion to evaluate whether they are appropriate, individually and collectively, for the account.

III.A.6. Post-Mortem Trust and Estate Administration

Although the decedent's final income tax year ends with the date of death, the filing of a return and payment of tax may be made as though the decedent had lived throughout the last taxable year.[6184] For details on activity on the date of death and when the decedent's final income tax year closes and the estate's fiduciary income tax year begins, see part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[6184] Reg. § 1.443-1(a)(2).

If a joint return is filed, the surviving spouse may sign the first return on behalf of both of them if no court-appointed executor is serving and certain other conditions are satisfied;[6185] otherwise, the court-appointed executor signs, and if no executor is court-appointed then another person "charged with" the decedent's property may sign.[6186] A person "charged with" the decedent's property includes an heir,[6187] the trustee of the decedent's revocable trust,[6188] or perhaps an

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[6185] Reg. § 1.6013-1(d).

[6186] Reg. § 1.6012-3(b). If multiple executors are named, any one of them may sign the return. Rev. Rul. 83-41, citing Reg. § 1.6012-3(b)(1). Rev. Rul. 83-41 also allows any one fiduciary to sign a fiduciary income tax return or extend the time to assess tax, citing Reg. § 1.6012-3(a)(1). Rev. Rul. 84-165 clarifies:

> While a consent signed by any one executor or administrator is valid for federal tax purposes, more than one executor or administrator may sign the consent.

Rev. Rul. 83-41 also discusses rules for signing consents for an active or a dissolved corporation regarding tax generally or for a partnership liable for employment or excise taxes.

[6187] CCA 201334040 (an informal letter – not a National Office pronouncement) advised:

> Q. Decedent is a non-filer who died intestate with one asset: a bank account held by the decedent, her daughter, and her daughter's husband. Field counsel considers the daughter a distributee and proposed having the daughter to sign a Form 56, Notice Concerning Fiduciary Relationship, and then sign the decedent's unfiled tax returns and Form 870 or 872.
>
> A. The daughter may sign the decedent's unfiled returns, because section 6012(b)(1) provides that "Tax returns of decedents are to be made by the decedent's executor, administrator, or other person charged with the property of the decedent." The daughter has the decedent's property. If the daughter submits balance due returns, those are acceptable without proof of authority; but if she claims credit elects or refunds, the Service may demand Form 1310 and/or documentary authority before refunding or crediting any claimed overpayment. See IRM 3.11.3.10.2(3). The Service may communicate with the daughter and her representatives about returns the daughter signs for her mother.
>
> Section 6501(c)(4)(A) provides for extending the ASED and section 6213(d) provides for waiving restrictions on assessment, but who may sign ASED extension consents and waivers for decedents is not specified in the statutes or regulations. Although Revenue Ruling 83-41, 1983-1 C.B. 349, clarified, amplified by Rev. Rul. 84-165, 1984-2 C.B. 305, held that "the Service will generally apply the rules applicable to execution of the original returns to consents to the extension of time to make an assessment", it ruled that in the absence of a court-appointed administrator for an intestate decedent, nobody may sign an ASED extension for the intestate decedent. Under the revenue rulings, the daughter may sign ASED extensions for her liability as a transferee, because it's her own liability, but she may not sign Form 870 or 872 for her mother's estate without being appointed as the personal representative (administrator) for her mother's estate by a court of competent jurisdiction. The same rules should apply to Form 870, as well. The Service should require letters of administration or equivalent proof of such appointment before accepting an 870 or 872 from the daughter.
>
> The daughter should also submit a Form 56 to document her fiduciary relationship as the personal representative of her mother's estate. The regulations require the fiduciary to retain proof of authority to act for the principal, sec. 301.6903-1(b)(2), and the same authority that would provide a foundation for Form 56 would likely suffice for Forms 870 and 872 (that is, letters of administration from a state probate court).

[6188] CCA 201334040 (an informal letter – not a National Office pronouncement) advised:

> Q: Decedent established a revocable trust into which he transferred all his assets before he died. He died testate, naming B his executor. B is also one of three trustees of the trust. The will has not been probated, and nothing passed under the will. Field counsel proposes treating the trustees as "testamentary trustees" and having them sign Form 56 and Form 870 or 872. The trust documents require the trustees to act unanimously, and the trustees have voted to appoint B the person to handle IRS matters.

agent under a durable power of attorney who does not yet know of the death.[6189] However, only a court-appointed executor may sign an amended return[6190] or consent to extend the time to assess tax.[6191]

See part III.A.3.d Special Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests. Consider whether to do a very quick funding of any QSSTs created upon death or to place a partnership interest in an S corporation owned by a QSST; see part III.A.4.a General Strategies Regarding Fiduciary Income Taxation of Business Interests. A huge downside to quick funding is the executor's personal liability if an federal debts are unpaid before the distribution[6192] or due to an estate tax lien imposed on the executor's own assets.[6193] An executor can obtain some assurance by filing Forms 4810 to get the statute of limitations on income tax matters shortened, writing a letter to the IRS (certified mail, return receipt requested)

A: B may execute any unfiled returns for the decedent, because section 6012(b)(1) provides that "Tax returns of decedents are to be made by the decedent's executor, administrator, or other person charged with the property of the decedent." The Service will accept returns signed by B as trustee in possession of the decedent's property, but the Service may require a Form 1310 and/or documentation of B's appointment by a court if the returns claim an overpayment.
As for filing a Form 870 or 872, the Service should require proof of authority, confirmed by a court (that is, letters testamentary), before accepting either an ASED extension or a waiver of restrictions on assessment.

[6189] CCA 201334040 (an informal letter – not a National Office pronouncement) advised:
Q: The day after decedent died (in New Jersey) and before his attorney-in-fact learned the decedent (principal) had died, the POA (acting in Florida) executed a Form 872 extending the ASED. No probate has been opened, and no representative has been appointed.
A: The ASED extension signed by the attorney-in-fact the day after the taxpayer's death and at a time when neither the attorney-in-fact nor the IRS knew that the taxpayer had died is valid, because under both Florida law (where the attorney-in-fact acted) and New Jersey law (where the taxpayer died and may have been domiciled) acts by an attorney-in-fact done in good faith and without knowledge that the principal is dead are valid and binding. Fla. Stat. § 709.2109(4); N.J. Stat. § 46:2B-8.5(a).
Now that the attorney-in-fact is aware of the principal's death, the POA is terminated, and he is not authorized to act for the decedent. If the estate wishes to submit a Form 870 or 872, the Service should require proof of authority to bind the estate. If the decedent died intestate, then court appointment of an administrator (and letters of administration) will be required. If the decedent died testate and named an administrator, then court approval (and letters testamentary) will be required.
Conclusion: In all cases, if the purported personal representative won't provide proof of authority (letters of administration or letters testamentary from an appropriate court), then no 870 or 872 should be accepted, and notices of deficiency should issue to ensure that the assessments are valid (copies to the taxpayer's last known address and to the address of any fiduciaries, whether confirmed or not).

[6190] CCA 201107020, citing *Estate of Weisel v. Commissioner*, T.C. Memo. 1990-351, and Rev. Rul. 83-41. The CCA was an informal letter – not a National Office pronouncement.

[6191] Rev. Rul. 83-41; CCA 201107020 (see fn. 6190); CCA 201334040 (see fns. 6187-6189). However, Rev. Rul. 83-41 held that heirs liable under Code § 6901 as transferees may sign consents for their own liabilities.

[6192] 31 U.S.C. § 3713(b), as described in fn. 7167 in part III.B.5.e.iv.(e) Which Estates Are Affected by the Estate Tax Lien?.

[6193] See part III.B.5.e.iv Federal Estate Tax Liens.

to the IRS to obtain a discharge under Code §§ 2204(a), (b) and 6905,[6194] and obtaining an agreement by the beneficiaries to pay back any distributions if the executor did not reserve enough (a "refunding agreement");[6195] however, a refunding agreement is only as good as the executor's ability to seize assets from the beneficiaries.

[6194] Instead of a letter, one might file IRS Form 5495. However, the form has various requirements, and neither provision requires using the form. Referring to the format for a Code § 2204 discharge request, *U.S. v. Paulson*, 125 A.F.T.R.2d 2020-1429 (DC CA 03/23/2020) held:

> Currently, there is no authority that requires specific format, form or wording to make an application for discharge. See *United States v. Johnson*, 224 F.Supp.3d 1220, 1237 (D. Utah 2016) ("*Johnson II*"), reversed on other grounds *United States v. Johnson*, 920 F.3d 639 (10th Cir. 2019). However, Plaintiff argues that Michael Paulson signed various documents in different capacities and sometimes would sign the same document multiple times in his differing capacities. (Doc. No. 191-1 at 19–21.) There is no such requirement, however, how to sign the letter nor is there a requirement that Michael Paulson was supposed to provide two letters to the IRS….
>
> Further, the IRS never contacted Michael Paulson regarding any confusion over the letter. In fact, the IRS never responded to the letter. The IRS is "to notify the fiduciary (1) of the amount of such tax for which it has been determined the fiduciary is liable, or (2) that it has been determined that the fiduciary is not liable for any such tax." 26 U.S.C. § 2204. If there was any confusion, Plaintiff argues that the IRS should have alerted the fiduciary that he remained liable for the full amount of "any estate tax for which the fiduciary may be personally liable." The Court agrees. Plaintiff should not have waited twelve years to raise this issue in litigation.

In fn 1, *U.S. v. Paulson*, 131 A.F.T.R.2d 2023-1743 (9th Cir. 5/17/2023), noted that the U.S. did not appeal this conclusion.

Johnson (fn 7171) awarded the taxpayer attorney fees when the IRS persisted with arguments that the taxpayer did not qualify for a Code § 2204 discharge.

[6195] Letter Ruling 201745001 held that entering into a refunding agreement with a private foundation would not be a prohibited act of self-dealing under Code § 4941, and any repayments the foundation may make would not constitute taxable expenditures under Code § 4945. The IRS described the refunding agreement:

> You represent that Trust and Foundation are seeking to fulfill Grantor's intent that the Trust distribute the maximum value of Trust to the Foundation at the earliest opportunity. You further represent that the administration of Trust has not been completed and is ongoing. Pursuant to the provisions of Trust instrument, assets remaining to be distributed to the Foundation may be or become subject to expenses, losses or liabilities sustained in the administration of Trust. You state that under State law, Trustee 1 and Trustee 2 may be personally liable for expenses, losses and liabilities sustained in the administration of the Trust. Given the potential exposure to future claims and liabilities against Trust, Trustee 1 and Trustee 2 believe it would be prudent to retain until the completion of trust administration a sufficient reserve to satisfy any such claims. You represent that there is a risk that liabilities will likely extend well beyond the termination of Trust. The transfer of the remaining assets of Trust to the Foundation is within the powers of Trustee 1 and Trustee 2. Foundation has requested that Trustee 1 and Trustee 2 accelerate distributions of the assets of the Trust to Foundation before Trustee 1 and Trustee 2 know the full extent of potential claims and liabilities. In order to induce Trustee 1 and Trustee 2 to make substantial distributions to Foundation sooner than they otherwise would make them, Foundation has proposed to execute and deliver to Trustee 1 and Trustee 2 the Agreement.
>
> Under the Agreement, Foundation acknowledges that Trustee 1 and Trustee 2 would normally defer a substantial portion of the distributions to Foundation until a final resolution of all liabilities and claims. Trustee 1 and Trustee 2 would only make a final distribution of the remaining assets of the Trust when they are satisfied that all liabilities of the Trust have been determined and discharged. Trustee 1 and Trustee 2 are willing to consider accelerating the distribution of assets to the Foundation, provided that the Foundation obligates itself to indemnify Trustee 1 and Trustee 2. Further, under the Agreement, Foundation agrees to return any distribution required to

See part III.B.2.j Tax Allocations upon Change of Interest in a Business, especially parts III.B.2.j.ii.(d) Death of a Shareholder and III.B.2.j.iii.(c) Death of a Partner — Treated Like a Transfer of a Partner's Entire Interest. Consider planning opportunities for allocations in the year of death or when funding bequests, such as measuring pre- and post-mortem income based on an accounting cut-off or pro-rata, per-share, per-day.

Planning for partnership interests also includes:

- Obtaining an inside basis step-up on death. See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations. (Pre-mortem planning includes part II.H.2.i Avoiding a Basis Step-Down.) If the decedent owned all (perhaps most) of the stock of an S corporation than held only marketable securities or other nondepreciable property, consider whether liquidating the corporation (for example, converting it to an LLC taxed as a sole proprietorship or partnership) might facilitate an inside basis at little cost; see part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation; Possible Way to Attain Basis Step-Up.

- Distributing a partnership interest when funding bequests provides an opportunity to obtain an inside basis step-up (especially if the partnership did not make the requisite election on or before the partnership's taxable year that included date of death) and make new partnership elections, but it also might cause depreciation periods to start again (which could significantly defer depreciation for real estate). See parts II.Q.8.e.i Distribution of Partnership Interests and II.Q.8.e.iv Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).

See also part III.B.2.e.ii Tax ID Issues When the Deemed Owner of a Grantor Trust Dies; Related Effect on Quarterly Payments of Estimated Income Tax.

Also, Code § 451(b)(3)(A)(iii) accelerates certain income of an accrual taxpayer who has an applicable financial statement (AFS) - "a financial statement which is certified as being prepared in accordance with generally accepted accounting principles and which is … an audited financial statement of the taxpayer which is used for (I) credit purposes, (II) reporting to shareholders, partners, or other proprietors, or to beneficiaries, or (III) any other substantial nontax purpose." [6196] Reg § 1.451-3(c)(6)(i) provides:[6197]

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be refunded under the Agreement to either Trustee 1 or Trustee 2 should claims and liabilities arise. Under the Agreement, the distribution of assets to the Foundation will include cash or in kind assets whether investment securities, real property or other assets. Pursuant to the Agreement, Trustee 1 and Trustee 2 can be assured that the Foundation will pay such amounts or return such portion of distributions that Trustee 1 and Trustee 2 determine in their sole and absolute discretion are needed or desirable to pay all such liabilities.
In addition, under the Agreement, Foundation agrees to indemnify and hold harmless Trustee 1 and Trustee 2 from any and all liabilities and expenses sustained in the administration of the Trust. Further, nothing in the Agreement requires Trustee 1 or Trustee 2 to make any distributions to Foundation at any particular time and Trustee 1 and Trustee 2 shall determine the amounts of and whether to make distributions in their sole and absolute discretion.

[6196] An excerpt from the preamble to the regulations is in fn 4430 in part II.Q.4.e.i Life Insurance Basis Adjustment on the Death of an Owner Who Is Not the Insured.

[6197] T.D. 9941 (1/6/2021) provides background for this inclusion:

However, the Treasury Department and the IRS agree with comments suggesting that taxpayers should be afforded the flexibility of applying an offset for costs incurred against AFS income inclusions from the future sale of inventory, the “AFS cost offset method.” Accordingly, a taxpayer that uses the AFS cost offset method determines the amount of gross income includible for a year prior to the year in which ownership of inventory transfers to the customer by reducing the amount of revenue it would otherwise be required to include under the AFS Income Inclusion Rule for the taxable year (AFS inventory inclusion amount) by the cost of goods related to the item of inventory for the taxable year, the “cost of goods in progress offset.” The net result is the amount that is required to be included in gross income for that year under the AFS Income Inclusion Rule. The deferred revenue, that is, the revenue that was reduced by the cost of goods in progress offset for a taxable year prior to the taxable year that ownership of the item of inventory is transferred to the customer, is generally taken into account in the taxable year in which ownership of the item of inventory is transferred to the customer.

The final regulations provide that the cost of goods in progress offset for each item of inventory for the taxable year is calculated as (1) the cost of goods incurred through the last day of the taxable year, (2) reduced by the cumulative cost of goods in progress offset amounts attributable to the items of inventory that were taken into account in prior taxable years, if any. However, the cost of goods in progress offset cannot reduce the AFS inventory inclusion amount for the item of inventory below zero. Further, the cost of goods in progress offset attributable to one item of inventory cannot reduce the AFS inventory inclusion amount attributable to a separate item of inventory. Any cost of goods that were not used to offset AFS inventory inclusion amounts because they were subject to limitation are considered when the taxpayer determines the cost of goods in progress offset for that item of inventory in a subsequent taxable year.

The cost of goods in progress offset is determined by reference to the costs and expenditures related to each item of inventory produced or acquired for resale, which costs have been incurred under section 461 and have been capitalized and included in inventory under sections 471 and 263A or any other applicable provision of the Code at the end of the year. However, the cost of goods in progress offset does not reduce the costs that are capitalized to the item of inventory produced or acquired for resale by the taxpayer under the contract. That is, while the cost of goods in progress offset reduces the AFS inventory inclusion amount, it does not affect how and when costs are capitalized to inventory under sections 471 and 263A or any other applicable provision of the Code or when those capitalized costs will be recovered. Instead, the cost of goods in progress offset serves only to reduce or “offset” any AFS income inclusion amounts for the item of inventory and defer such amounts to the taxable year in which ownership of the item of inventory is transferred to the customer.

The costs of goods comprising the cost of goods in progress offset must be determined by applying the inventory accounting methods used by the taxpayer for Federal income tax purposes. A taxpayer must calculate its cost of goods in progress offset by reference to all costs that the taxpayer has permissibly capitalized and allocated to items of inventory under its inventory method, but may not consider costs that are not properly capitalized under such method.

In the taxable year in which ownership of the item of inventory is transferred to the customer, any revenue deferred by way of a prior year cost offset is included in gross income in the year of the transfer along with any additional revenue that is otherwise required to be included in gross income under the AFS Income Inclusion Rule for such year. Although no cost offset is permitted in such year, the taxpayer would recover costs capitalized and allocated to the item of inventory transferred as cost of goods sold in such year in accordance with sections 471 and 263A or any other applicable provision of the Code. However, if in a taxable year prior to the taxable year in which ownership of the item of inventory is transferred to the customer, either (A) the taxpayer dies or ceases to exist in a transaction other than a transaction to which section 381(a) applies, or (B) the taxpayer’s obligation to the customer with respect to the item of inventory ends other than in a transaction to which 381(a) applies or certain section 351(a) transactions between members of the same consolidated group, then all payments received for the item of inventory that were not previously included in gross income as a result of the application of the cost offset rules are required to be included in gross income in such year.

> A taxpayer that uses the AFS cost offset method or the advance payment cost offset method must include in gross income for a taxable year prior to the taxable year in which an item of inventory is transferred to the customer, all payments received for the item of inventory that were not previously included in gross income … if, in that taxable year, the taxpayer … dies ….

III.B. Transfer Tax Issues

Transfer tax issues include transfers during life, estate tax issues, and special valuation issues.

III.B.1. Transfers During Life

Transfers during life include many ways of transferring equity to one's loved ones. The simplest way is shifting a business opportunity. Gifts without consideration can appear straightforward, but then valuation issues complicate matters, and designing trusts to hold stock in S corporations can be tricky. More advanced tactics include transfers to grantor retained annuity trusts and various sale techniques, including self-canceling installment notes and private annuities.

III.B.1.a. Business Opportunities

A business owner who plans to add new locations or new products or services may be able to use some basic techniques to let family members participate in the business' growth. These techniques involve shifting these business opportunities to the family members.

New businesses often have speculative value. Even a successful business may have difficulty expanding into new locations or adding products or services. When starting a new business, consider giving most of the ownership to family members through nonvoting ownership interests. For example, the client owns 1% of the company and all of the voting rights, and the client's children own 99% of the company without any voting rights. The 99% that the client gives his or her children has little value if the new business has an uncertain future. Because the client controls the business, the client can use the business techniques that the client has mastered to make sure it is managed correctly. However, the children own 99% of the profits that the client creates. Examples of this might include investing in the following that might be leased or otherwise profitably provided to the existing business:

- New location.
- New line of business.
- New customer target group.
- New equipment.
- New business method.
- New patent.

Examples are further described in part III.B.1.a.v Sending Business or Performing Services.

Whatever form the gift may take, as it stands, the Code does not mention the term "gift of opportunity." This, naturally, has not stopped the IRS from pursuing these "gifts" as taxable transfers. The gift tax was initially devised as a backstop to the federal estate tax; however, this purpose was seemingly broadened by the decision in *Dickman v. Commissioner*.[6198] In *Dickman*, the Supreme Court established that the gratuitous gift of the use of property constituted a taxable gift.[6199] In holding such, the court stated that, "Congress intended the gift tax statute to reach all gratuitous transfers of any valuable interest in property."[6200] The court goes further by adding, "the gift tax was designed to encompass all transfers of property and property rights having significant value."[6201] Several past cases highlight the extensive grasp of the gift tax provisions. "Gift," as Congress intended the word, means all of the "protean arrangements which the wit of man can devise that are not business transactions within the meaning of ordinary speech."[6202] The gift tax is "broad enough to include property, however conceptual or contingent,"[6203] and may "reach every kind and type of transfer by gift."[6204] Suffice it to say, the Supreme Court has supported a broad interpretation of what may fall under the purview of the gift tax statutes.

That being said, the IRS has encountered limited success in its efforts at reaching gifts of opportunity. The following discussion outlines some of these successes, and, likewise, some of its failures.

Be sure to properly document any legal rights that the prospective owners should have. The IRS may argue that certain opportunities later ripened into rights belonging to the person who provided the business opportunities.[6205]

Loaning money to a child or other family member, under the holding in *Crown v. Commissioner*[6206] did not produce gift tax liability should the lending parent fail to charge or collect interest on the loans. The court stated that interest-free demand loans were not transfers of property within the meaning of the gift tax statutes, as the borrowing child had no legally protected right against the lending parent.[6207] Furthermore, the child's use of the money was not an interest with an exchangeable value.[6208]

In certain respects, *Dickman* changed this. The Supreme Court, as previously mentioned, held that the right to use the loaned money represented a valuable, taxable gift because it represents a transfer of property by gift.[6209] The Court softened this blow by recapping the merits of the gift tax exclusions available to individuals and families, such as the annual exclusion, gift splitting, exemptions, and the unified credit.[6210] However, *Crown* might apply in particular circumstances. For instance, a parent who allows his or her adult child to use the family vacation home rent-free

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[6198] 465 U.S. 330 (1984).
[6199] *Id*. at 333.
[6200] *Id*. at 334.
[6201] *Id*.
[6202] *Commissioner v. Wemyss*, 324 U.S. 303, 306 (1945).
[6203] *Smith v. Shaughnessy*, 318 U.S. 176, 180 (1943).
[6204] *Robinette v. Helvering*, 318 U.S. 184, 187 (1943).
[6205] See *Cavallaro*, discussed in fn 6333 in part III.B.1.a.vi Asset Transfers to Children or Their Businesses.
[6206] 585 F.2d 234 (7th Cir. 1978).
[6207] Id. at 239.
[6208] Id.
[6209] *Dickman*, 465 U.S. at 333.
[6210] *Id.* at 341-42.

might not make a gift tax liability if the child does not have a legally enforceable right, against the parent, to stay in the home.[6211] *Dickman* involved loans and other arrangement where the borrower had a legally protected interest to use loaned funds. It also reasoned:

> What was transferred here was the use of a substantial amount of cash for an indefinite period of time. An analogous interest in real property, the use under a tenancy at will, has long been recognized as a property right. E*. g., Restatement (Second) of Property* § 1.6 (1977); G. Thompson, *Commentaries on the Modern Law of Real Property* § 1020 (J. Grimes ed. 1980). For example, a parent who grants to a child the rent-free, indefinite use of commercial property having a reasonable rental value of $8000 a month has clearly transferred a valuable property right.

Making long-term loans to a client's children at low interest rates is an easy way to help them acquire investments, whether a privately-owned business, real estate, or marketable securities. See parts III.B.1.a.i Loans and III.B.1.a.ii Loan Guarantees.

Thus, although a short-term use of property might be free from gift tax, indefinite use of property is more problematic.[6212]

III.B.1.a.i. Loans

Interest-free or below-market loans are governed by Code § 7872, which generally requires imputation of interest of such loans.[6213] Each month, the IRS publishes a revenue ruling that prescribes interest rates to be used for federal tax purposes. These Applicable Federal Rates (AFRs) provide short-, mid-, and long-term government rates of interest.

Fundamental to using the AFR is that there is a reasonable expectation of repayment.[6214] See part III.B.1.a.i.(a) Loans Must be Bona Fide.

These loans break down into two categories: term loans and demand loans. A term loan, as the name implies, is a loan for a specific term, i.e. it has a defined start date and end date. A demand loan is a loan that is immediately callable at any time.

See also part II.G.4.a.i Loans to Businesses – Whether AFR Is Required, discussing whether Code § 7872 applies. If Code § 7872 does not apply, then one might consider whether to charge interest anyway to avoid a gift under common law principles;[6215] characterization of a transfer to a family controlled entity as a contribution to capital rather a loan can result in the IRS seeking to apply the draconian Code § 2701.[6216]

[6211] The *Dickman* Court expressly reserved for future cases adult children's use of cars or vacation cottages. *Id.* at 336.
[6212] See Letter Ruling 8104207.
[6213] *Dickman* has been superseded and codified as Code § 7872, which provides for short-term (under three years), mid-term (three to nine years), and long-term (over nine years) AFRs.
[6214] See part III.B.1.a.ii.(a) Gift Tax Issues. In the income tax arena, debt might be recharacterized as equity. See part II.G.20.b When Debt Is Recharacterized as Equity.
[6215] Gift tax applies to not only direct but also indirect gifts. Code § 2511(a); Reg. § 25.2511-1(h)(1), which governs indirect gifts through business entities and is reproduced in part III.B.1.h Transfers in the Ordinary Course of Business.
[6216] Code § 2701(e)(5). See III.B.7.b Code § 2701 Overview, and III.B.7.c Code § 2701 Interaction with Income Tax Planning.

Code § 7872 provides certain exceptions to the general rule of imputing interest. For instance, gift loans between individuals may qualify for a de minimis exception. If the outstanding aggregate amount of loans between individuals is less than $10,000, then the general rules of Code § 7872 will not apply.[6217] The same rule holds true for compensation-related and corporate shareholder loans.[6218] Also, Code § 7872 provides for an income tax (but not gift tax) exclusion of accrued interest where aggregate loans do not exceed $100,000.[6219]

For loans between spouses, see fns 7254-7260 and the accompanying text in part III.B.6.d Divorce as an Opportunity to Transfer.

For notes arising from a taxable sale, also see part II.G.15 Limitations on the Use of Installment Sales.

III.B.1.a.i.(a). Loans Must be Bona Fide

Dynamo Holdings Ltd. Partnership v. Commissioner, T.C. Memo. 2018-61, held that advances between family-owned entities were not gifts. The court summarized relevant principles:

> The question of whether a taxpayer has entered into a bona fide creditor-debtor relationship pervades Federal tax litigation.[6220] The parties must have actually intended to establish a debtor-creditor relationship for a transaction to be a bona fide loan.[6221] To find a bona fide creditor-debtor relationship, we must determine that at the time the advances were made there was "an unconditional obligation on the part of the transferee to repay the money, and an unconditional intention on the part of the transferor to secure repayment."[6222]
>
> We apply special scrutiny to intrafamily transfers and transactions between entities in the same corporate family or with shared ownership.[6223] Transfers between family members are presumed to be gifts.[6224] This presumption can be rebutted by "an affirmative showing that there existed a real expectation of repayment and intent to enforce the collection of the indebtedness."[6225] When analyzing transfers between related parties, it is useful to compare the transactions at issue to arm's-length transactions and normal

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[6217] Code § 7872(c)(2)(A).
[6218] Code § 7872(c)(3)(A).
[6219] Code § 7872(d)(1).
[6220] Fn 18 of *Dynamo Holdings* cited here:
See, e.g., Ellinger v. United States, 470 F.3d 1325, 1333-1334 (11th Cir. 2006); *Calloway v. Commissioner*, 135 T.C. 26, 36-37 (2010), *aff'd*, 691 F.3d 1315 (11th Cir. 2012).
[6221] Fn 19 of *Dynamo Holdings* cited here:
Calloway v. Commissioner, 135 T.C. at 37; see also *Ellinger*, 470 F.3d. at 1333.
[6222] Fn 20 of *Dynamo Holdings* cited here:
Haag v. Commissioner, 88 T.C. 604, 616 (1987), *aff'd without published opinion*, 855 F.2d 855 (8th Cir. 1988).
[6223] Fn 21 of *Dynamo Holdings* cited here:
Kean v. Commissioner, 91 T.C. 575 (1988); *Malone & Hyde, Inc. v. Commissioner*, 49 T.C. 575, 578 (1968); *Vinikoor v. Commissioner*, T.C. Memo. 1998-152, 75 T.C.M. (CCH) 2185 (1998).
[6224] Fn 22 of *Dynamo Holdings* cited here:
Perry v. Commissioner, 92 T.C. 470, 481 (1989), *aff'd without published opinion*, 912 F.2d 1466 (5th Cir. 1990); *Barr v. Commissioner*, T.C. Memo. 1999-40, 77 T.C.M. (CCH) 1370, 1372 (1999); *Vinikoor v. Commissioner*, 75 T.C.M. (CCH) at 2187.
[6225] Fn 23 of *Dynamo Holdings* cited here:
Vinikoor v. Commissioner, 75 T.C.M. at 2187.

business practices.[6226] However, we must also be mindful of the business realities of related parties.[6227] For example, we have held that security and other creditor protections are less important in a related-party context.[6228]

Dynamo Holdings viewed debt-vs.-equity cases as helpful but not directly on point.[6229] Instead, the court to looked to a case that the Eleventh Circuit affirmed without a published opinion:

> In *Jones v. Commissioner*, we used a long-standing nine-factor facts and circumstances test to determine whether two parties entered into a valid debtor-creditor relationship.[6230] We evaluated all the pertinent facts and circumstances of the case, including whether:
>
>> (1) There was a promissory note or other evidence of indebtedness, (2) interest was charged, (3) there was security or collateral, (4) there was a fixed maturity date, (5) a demand for repayment was made, (6) any actual repayment was made, (7) the transferee had the ability to repay, (8) any records maintained by the transferor and/or the transferee reflected the transaction as a loan, and (9) the manner in which the transaction was reported for Federal tax is consistent with a loan.

Describing its approach that was different than what the parties urged,[6231] the court stated:[6232]

> We apply a special scrutiny to transactions between companies with shared ownership and intrafamily transfers, and we presume that transfers between family members are

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[6226] Fn 24 of *Dynamo Holdings* cited here:
Estate of Mixon v. United States, 464 F.2d 394, 403 (5th Cir. 1972); *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 494 (1980).

[6227] Fn 25 of *Dynamo Holdings* cited here:
Litton Bus. Sys., Inc. v. Commissioner, 61 T.C. 367, 377-378 (1973); *NA Gen. P'ship & Subs. v. Commissioner*, T.C. Memo. 2012-172, 103 T.C.M. (CCH) 1916, 1920 (2012); *see also Malone & Hyde, Inc. v. Commissioner*, 49 T.C. at 578.

[6228] Fn 26 of *Dynamo Holdings* cited here:
NA Gen. P'ship & Subs. v. Commissioner, 103 T.C.M. (CCH) at 1920-1921.

[6229] The court noted that the case would be appealed to the Eleventh Circuit and listed that Circuit's "13-factor debt-versus-equity test," which "asks the Court to look to the totality of all the facts and circumstances and specifically directs the Court to consider" various factors, citing *Ellinger v. United States*, 470 F.3d 1325], 1333-1334 (11th Cir. 2006). The Tax Court then noted:

> But this is not a debt-versus-equity case. The Commissioner argues that the transfers were gifts, not equity. As a result, our inquiry is not focused on weighing debt versus equity, but rather on considering whether there is a bona fide debt. While the debt-versus-equity test adopted by the Court of Appeals offers some guidance, it is not directly on point.

[6230] Fn 29 of *Dynamo Holdings* cited here:
Jones v. Commissioner, T.C. Memo. 1997-400, 74 T.C.M. (CCH) 473, 482 (1997), *aff'd without published opinion*, 177 F.3d 983 (11th Cir. 1999).

[6231] The court noted:

> Petitioners allege that Dynamo and Beekman had the intent to repay and be repaid as demonstrated by their subjective declarations of their intent. Conversely, the Commissioner argues that we should draw an adverse inference from Mrs. Moog's failure to testify at trial and infer that Dynamo and Beekman did not intend to repay and be repaid. We disagree with both parties.

[6232] The court explained:

> Beekman and Dynamo had shared ownership and control. Both Dynamo and Beekman were owned in part by trusts for which Christine, Mr. Julien and their families were beneficiaries. Transfers between the two structures were transfers between companies with shared ownership.

gifts.[6233] Here, transfers between Beekman and Dynamo were transfers between companies with both shared ownership and intrafamily transfers.

Reviewing issues relating to formal indicia of debt, the court noted:

> Dynamo and Beekman satisfied some but not all of the formal indicia of debt. We agree with the Commissioner that at the time the advances were made there was no contemporaneous promissory note identifying all the terms of the agreement, there was no collateral set aside to ensure repayment, there was no invoice or demand made by Beekman, and there was no fixed maturity date or intent to force Dynamo into bankruptcy if required to ensure repayment. However, there are many meaningful indicia of debt. Dynamo and Beekman maintained records that reflected advances as debt in their general ledgers, and they executed promissory notes.

Regarding issues relating to formal indicia of debt, the court concluded:

> We are not troubled by any shortcomings in Dynamo's and Beekman's formal indicia of debt. They must be taken into account in the context of the business realities of the transaction. We would be surprised if Mr. Julien wrote himself an invoice, demanded repayment, or required a credit check or audited financial statements before making an advance. The management of these companies was the same, and they had full knowledge of and access to all financial information. Moreover, we have consistently held that these formal indicia of debt are little more than declarations of intent without accompanying objective economic indicia of debt.[6234]

Dynamo Holdings then reviewed the "economic indicia of debt":

> In ascertaining the economic realities of the transaction, it is helpful to measure the transfer against the economic realities of the marketplace to determine whether a third party lender would have extended the loan.[6235] Dynamo and Beekman satisfy all the objective economic indicia of debt. Beekman charged and Dynamo accrued interest on

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Transfers between Beekman and Dynamo were ultimately intrafamily transfers. When Beekman made transfers to Dynamo, value was being transferred from one family of companies, the majority of which were held by trusts for which Delia Moog is a beneficiary, Delia Moog Family Trust and Delia Moog Family Trust #2, to another family of companies, the majority of which were held by trusts for which her daughter and nephew and their families were beneficiaries. While Christine and Mr. Julien were also beneficiaries of some of the trusts which owned Beekman, the transfers from Beekman to Dynamo reduced Delia Moog's beneficial interest in the underlying properties in favor of her daughter, her nephew, and their families.
Given the nature of these transfers, we treat them with special scrutiny and determine whether the advances are gifts or loans for Federal tax purposes on the basis of the totality of the circumstances.[33] On that basis we find that the advances were loans.
[33] *See Estate of Mixon*, 464 F.2d at 402.

[6233] Fn 32 of *Dynamo Holdings* cited here:
Perry v. Commissioner, 92 T.C. at 481; *Kean v. Commissioner*, 91 T.C. at 595; *Vinikoor v. Commissioner*, 75 T.C.M. (CCH) at 2187.

[6234] Fn 45 of *Dynamo Holdings* cited here:
Alterman Foods, Inc. v. United States, 505 F.2d 873, 879 (5th Cir. 1974); *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968); *Sensenig v. Commissioner*, T.C. Memo. 2017-1, at *24-*26, *aff'd*, __ F. App'x __, 2018 WL 508567 (3d Cir. Jan. 23, 2018).

[6235] Fn 46 of *Dynamo Holdings* cited here:
Sensenig v. Commissioner, at *26-*27.

> the advances in 2006 and 2007. Beekman reported and paid tax on that interest income. Dynamo reported and deducted that interest expense. Dynamo repaid some of the advances before any examination began. At all times, Dynamo had the ability to repay the loans. Importantly, Dynamo could have received loans on substantially similar terms. And Dynamo did receive sizable loans from third parties.

Dynamo Holdings concluded on this issue:

> After analyzing the facts, we hold that Dynamo and Beekman entered into a bona fide creditor-debtor relationship. At the time the advances were made, Dynamo had an unconditional obligation to repay the loans, and Beekman had an unconditional intent to be repaid. A bona fide loan precludes a constructive distribution.[6236] Because we found that the advances were bona fide debt, the advances are not constructive distributions. Likewise, Dynamo is entitled to deduct the interest expenses.

Although the *Dynamo Holdings* taxpayers prevailed, they had to overcome their documentation weaknesses. One might consider documenting the expectation of repayment and the loan itself using the principles of Reg. § 1.385-2; I am not at all suggesting that such documentation is necessary but merely that a tax planner who is extraordinarily cautious might find some comfort there.[6237] This is part of part II.G.20 Debt vs. Equity; Potential Denial of Deduction for Business Interest Expense; see also parts II.G.4.a.ii Bad Debt Loss – Must be Bona Fide Debt, II.G.4.d.ii Using Debt to Deduct S Corporation Losses (discussing deducting S corporation losses against loans from shareholders to the corporation and the consequences of doing so), and II.Q.7 Exiting from or Dividing a Corporation, text accompanying fns 4799-4801 (payments to employee-shareholder characterized as distributions or compensation instead of loans). For a case describing a family's heroic efforts to shore up a family business, first investing money, then buying subordinated debt that faced foreclosure and later converting the debt into senior preferred equity, which were still not enough to save the company, generating a loss of the initial investment, see *MCM Investment Management, LLC v. Commissioner*, T.C. Memo. 2019-158, which is described in detail in part II.G.8 Code § 165(a) Loss for Worthlessness; Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy.[6238]

Estate of Moore v. Commissioner, T.C. Memo. 2020-40, discussed whether transfers were loans or gifts:

> "A purported loan between family members is always subject to close scrutiny…. The presumption, for tax purposes at least, is that a transfer between family members is a gift." *Perry v. Commissioner*, 92 T.C. 470, 481 (1989), *aff'd* without published opinion, 912 F.2d 1466 (5th Cir. 1990). The presumption may be rebutted upon a showing that the transferor had a real expectation of repayment and an intention to enforce the debt. *Estate of Van Anda v. Commissioner*, 12 T.C. 1158, 1162 (1949), *aff'd*, 192 F.2d 391 (2d Cir. 1951). A promise to pay money in the future coupled with an implied

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[6236] Fn 58 of *Dynamo Holdings* cited here:

Schnallinger v. Commissioner, T.C. Memo. 1987-9 (1987).

[6237] As part II.G.20 Debt vs. Equity; Potential Denial of Deduction for Business Interest Expense discusses, generally Reg. § 1.385-2 targets C corporations engaged in international financial transactions and would not apply to intra-family loans for estate planning. However, if one can satisfy Reg. § 1.385-2, which was geared toward perceived abuses, presumably one would go a long way toward showing a loan's bona fides.

[6238] Text between that accompanying fns 1556-1561.

understanding that the promise will not be enforced does not create a true debtor-creditor relationship. As we held in *Estate of Maxwell v. Commissioner*, 98 T.C. 594, 605 (1992), *aff'd*, 3 F.3d 591 (2d Cir. 1993), "a stated obligation to pay a fixed sum of money may be disregarded as having no value where the facts show that the parties did not contemplate that the obligation would be met."

Whether there's a true loan is a question of fact, and we have several factors to help determine whether a transfer creates a bona fide debt:

- the name given to the instrument underlying the transfer of funds;
- the presence or absence of a fixed maturity date and a schedule of payments;
- the presence or absence of a fixed interest rate and actual interest payments;
- the source of repayment;
- the adequacy or inadequacy of capitalization;
- the identity of interest between creditors and equity holders;
- the security for repayments;
- the transferee's ability to obtain financing from outside lending institutions;
- the extent to which repayment was subordinated to the claims of outside creditors;
- the extent to which transferred funds were used to acquire capital assets; and
- the presence or absence of a sinking fund to provide repayment.

Estate of Rosen, 91 T.C.M. (CCH) at 1236; see also *Zimmerman v. United States*, 318 F.2d 611, 613 (9th Cir. 1963); *Hubert Enters., Inc. v. Commissioner*, 125 T.C. 72, 92 (2005), *aff'd in part, rev'd in part* on other grounds and remanded, 230 F.App'x 526 (6th Cir. 2007).

We do find it more likely than not that these were gifts:

- Each of Moore's children signed a note promising to pay back to the FLP $500,000 on or before February 2010. Interest on the purported loans was set at 3.56% per annum. This factor weighs in favor of a finding that the transfer of the FLP funds created a bona fide debt. But ...
- The promissory notes have no fixed payment schedule. This factor weighs against a finding of bona fide debt. See *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625, 631 (6th Cir. 1986), *aff'g* T.C. Memo. 1985-58; *Estate of Rosen v. Commissioner*, 91 T.C.M. (CCH) at 1237.
- Moore's children have never paid any interest on the loans despite the notes' requirement to do so. The estate asserts that Moore's children simply did not understand the terms of the loans, but during trial they testified that Hahn had

advised them that they did not need to make payments. The FLP has never demanded repayment. These facts persuade us that Moore's children did not intend to make interest payments and the facts weigh strongly against a finding of bona fide debt. See *Roth Steel Tube Co.*, 800 F.2d at 631; *Estate of Rosen*, 91 T.C.M. (CCH) at 1237.

- Lynda testified that she intended to pay back the loan to the FLP with FLP assets - assets currently unavailable as a result of the estate's litigation with the Commissioner. Repayment that depends solely on earnings does not support a finding of bona fide debt. *Roth Steel Tube Co.*, 800 F.2d at 632; *Estate of Rosen*, 91 T.C.M. (CCH) at 1237.

- The record does not provide any evidence that Moore's children had the resources to repay the loans. Thin or inadequate capitalization to fund a transferee's obligations weighs against a finding of bona fide debt. *Estate of Rosen*, 91 T.C.M. (CCH) at 1237-38.

- There is a disproportionate ratio between Moore's children's ownership interests in the FLP and the debt they owe to it - this tends to weigh in favor of a bona fide debt. See *id*. at 1238.

- The promissory notes signed by Moore's children were not secured - this weighs strongly against a finding of bona fide debt. See *Roth Steel Tube Co.*, 800 F.2d at 632; *Estate of Rosen*, 91 T.C.M. (CCH) at 1238.

- Given that Moore's children did not have any security for the purported loans, and the absence of any evidence that they had the resources to repay the loans, we do not believe that they would have been able to obtain comparable funding from another lender. This weighs against a finding of bona fide debt. See *Roth Steel Tube Co.*, 800 F.2d at 631; *Estate of Rosen*, 91 T.C.M. (CCH) at 1238.

- Because the funds from the FLP were unsecured, they would have been subordinate to other claims. But without any known creditors of Moore's children this factor is either inapplicable or weighs slightly against the finding of bona fide debt. See *Estate of Rosen*, 91 T.C.M. (CCH) at 1238.

- There is very little on the record regarding the children's use of the funds though the estate contends that the children made very poor investments. We will give this factor little weight.

- Nothing on the record suggests that Moore's children set aside funds - aside from their plan to use FLP assets to repay their debts to the FLP - to repay their notes. This weighs against a finding of bona fide debt. See *Roth Steel Tube Co.*, 800 F.2d at 632; *Estate of Rosen*, 91 T.C.M. (CCH) at 1238.

We pick a path through the prongs to what we think is the most important fact of all - Moore listed a desire for each of his children to receive $500,000 as one of his estate planning goals. Hahn even testified that the payments needed to be loans for tax purposes—that "having [them] as a gift wouldn't be the best use of the tax laws." We find Hahn credible on this point to the very limited extent that we agree that it would benefit the estate to make the transfers look like loans. But we also find that Moore's intent to make gifts and the children's course of conduct that treated the transfers as gifts mean that those transfers were not in fact loans.

Based on our review of the record, we find that the $500,000 transfers of FLP funds to Moore's children were not loans but gifts subject to section 2501 to the extent that they exceed the exclusion under section 2503(b). Additionally, because the gifts to his children were made within the three-year period preceding Moore's death, the gross estate is increased by the value of tax paid on these gifts.[21] See sec. 2035(b).

> [21] Section 2035(b) states that the "amount of the gross estate … shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse during the 3-year period ending on the date of the decedent's death."

Regarding another loan, *Estate of Moore v. Commissioner*, T.C. Memo. 2020-40, held:

A taxpayer must prove that when the funds were disbursed there was an "unconditional obligation and intent on the part of the transferee to repay the money and an unconditional intent on the part of the transferor to secure repayment." *Estate of Rosen*, 91 T.C.M. (CCH) at 1236; see also *Busch v. Commissioner*, 728 F.2d 945, 948 (7th Cir. 1984), *aff'g* T.C. Memo. 1983-98; *Haag v. Commissioner*, 88 T.C. 604, 615-16 (1987), *aff'd*, 855 F.2d 855 (8th Cir. 1988).

There is very little on the record that indicates that the $2 million transfer from the FLP to the Living Trust was a loan: Lynda testified during trial that she "believed" the FLP had lent Moore money but was unaware of any details, even though the estate tax return reflects the payment as a loan. Other than that, there is nothing. There is no evidence in the record that there was ever a promissory note, that the FLP ever charged interest or the Living Trust ever paid it, or that there was any collateral for the loan. It also appears that there was no maturity date on the loan and that no payments were made. As of the date of trial there has never been a demand for repayment. The estate simply did not meet its burden. We, therefore, find that the estate is not entitled to deduct the $2 million payment as a loan. On the other hand, we do find that Moore spent this money before he died, mostly on income tax that he owed on the sale of the farm. It should not be included in his taxable estate under section 2033.[22]

> [22] As the Commissioner notes, the Moore children themselves kicked in $400 at the FLP's inception. See *supra* p. 14. The parties should make a small adjustment in their Rule 155 computations so this is not taxed.

Estate of Mary P. Bolles v. Commissioner, T.C. Memo. 2020-71, discussed whether advances were loans or gifts:

Both parties rely on the analysis of *Miller v. Commissioner*, T.C. Memo. 1996-3, *aff'd*, 113 F.3d 1241 (9th Cir. 1997), for the traditional factors used to decide whether an advance is a loan or a gift. Those factors are explained as follows: (1) there was a promissory note or other evidence of indebtedness, (2) interest was charged, (3) there was security or collateral, (4) there was a fixed maturity date, (5) a demand for repayment was made, (6) actual repayment was made, (7) the transferee had the ability to repay, (8) records maintained by the transferor and/or the transferee reflect the

> transaction as a loan, and (9) the manner in which the transaction was reported for Federal tax purposes is consistent with a loan.
>
> These factors are not exclusive. See, *e.g.*, *Estate of Maxwell v. Commissioner*, 98 T.C. 594 (1992), *aff'd*, 3 F.3d 591 (2d Cir. 1993). In the case of a family loan, it is a longstanding principle that an actual expectation of repayment and an intent to enforce the debt are critical to sustaining the tax characterization of the transaction as a loan. *Estate of Van Anda v. Commissioner*, 12 T.C. 1158, 1162 (1949), *aff'd per curiam*, 192 F.2d 391 (2d Cir. 1951).
>
> While Mary recorded the advances to Peter as loans and kept track of interest, there were no loan agreements or attempts to force repayment. Respondent focuses on the lack of security for the loans to Peter. We agree that the reasonable possibility of repayment is an objective measure of Mary's intent. The estate maintains that during her life Mary always considered these advances as loans. We cannot reconcile this argument with the deterioration of Peter's financial situation and the ultimate failure of his practice in San Francisco and later in Las Vegas.
>
> Peter's creativity as an architect and his ability to attract clients likely impressed Mary. We find she expected him to make a success of the practice as his father had, and she was slow to lose that expectation. However, it is clear she realized he was very unlikely to repay her loans by October 27, 1989, when her trust provided for a specific block of Peter's receipt of assets at the time of her death. Accordingly, in 1990 the "loans" lost that characterization for tax purposes and became advances on Peter's inheritance from Mary. In conclusion, we find the advances to Peter were loans through 1989 but after that were gifts. We have considered whether she forgave any of the prior loans in 1989, but we find that she did not forgive the loans but rather accepted they could not be repaid on the basis of Peter's financial distress.

For loans of shares, see part II.A.1.d Lending Securities.

III.B.1.a.i.(b). Term Loans

Term loans with an interest rate below the AFR immediately result in a completed gift of the difference between the amount of proceeds and the value of the repayments using the AFR. For instance, the July 2005 mid-term monthly AFR was 3.79%. On a five-year loan of $100,000, the monthly payment would be $1,832. An interest-free loan, however, would generate a monthly payment of only $1,667. The monthly difference between the two payments is $165. The present value of five years' worth of $165 monthly payments is $9,006 (at the AFR), a figure which also represents the completed gift.

If an interest-free or below-market term loan is made, the lender is treated as having transferred an amount equal to the money loaned, less the present value of all payments due under the loan.[6239] The present value is calculated using a discount rate equal to the AFR for the term of the loan.[6240] If principal payments are fixed in total amount but uncertain as to time, for the term use the latest possible date on which a principal payment can be made.[6241] Although some

[6239] Code §§ 7872(b)(1), 7872(d)(2).
[6240] Code § 7872(f)(1).
[6241] Reg. § 1.1274-4(c)(4), which also provides that, "in the case of an installment obligation, [refer] to the longest weighted average maturity under any possible payment schedule."

have suggested that, for sales, one could use the AFR for the month of the sale or for either of the two preceding months, in an intra-family transaction I would always use the AFR for the month of sale.[6242]

The loan will be considered to have original issue discount ("OID") in an amount equal to the excess of the money loaned over the present value of the payments due on the loan.[6243] The lender will accrue interest income in each year of the loan. The borrower's tax treatment on the loan depends on whether he or she can deduct the interest. If deductible, it must be deducted in each year of the loan.

III.B.1.a.i.(c). Demand Loans

Demand loans (those immediately callable at any time), are valued annually for gift tax purposes. The short-term AFR is used, assuming that on the last day of the year, the amount of interest was paid to the lender, who in turn made a gift back to the borrower.[6244]

A demand loan could call for annual interest payments.

Every July, the IRS releases a blended annual rate.[6245]

Suppose the client wants to extend a line of credit to a business or family member. Below are terms one might use:

> For value received, the undersigned, _________ ("Borrower"), acting by and through its fiduciaries in their fiduciary capacity only, promises to pay to the order of ____________ ("Lender"), the principal sum of ________ Dollars ($_______), increased by any additional amounts Lender disburses to Borrower, all as documented or may be documented from time to time on Schedule A, such amount (as may be increased) on demand (the "Maturity Date"), together with all accrued interest thereon, as provided in this Promissory Note (the "Note").
>
> This Note may be funded in multiple advances (each an "Advance" and collectively referred to herein as "Advances") upon the request of Borrower at any time after the date hereof until the Maturity Date.
>
> Borrower further promises to pay to the order of Lender interest from time to time on the outstanding principal balance of this Note from the date of this Note to the Maturity Date at the rate of _____ Percent (___%) per annum. Absent prior demand, all accrued and unpaid interest on this Note shall be due and payable annually on each December 31 during the term of this Note, commencing on December 31, ____, and on the Maturity Date. All payments received by Lender under this Note shall be allocated first to accrued and unpaid interest and then to principal. Lender shall adjust the interest rate

[6242] See Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1447. I have additional commentary saved as document # 5278071, which even more strongly reinforces my view as applied to sales to irrevocable grantor trusts.
[6243] Code § 7872(b)(2)(A). Added to this OID amount is any OID that the loan would carry before considering the gift element. Code § 7872(b)(2)(B).
[6244] Code § 7872(a)(1); See generally Kathryn Henkel ¶ 28.02, Section 7872: Imputed Interest on Below-Market Loans, Estate Planning and Wealth Preservation (June 2005).
[6245] Prop. Reg. § 1.7872-13(a). For example, see Rev. Rul. 2019-16, Table 6, one in a series that began with Rev. Rul. 86-17.

hereof at the time of each Advance to the Applicable Federal Rate under Section 1274 of the Internal Revenue Code of 1986, as amended (the "AFR") if the AFR is higher than the then-current interest rate on this Note. Lender shall also adjust the interest rate hereof each January 1 if the rate for the year that contains that January 1 as determined under Revenue Ruling 86-17 (or any administrative or regulatory pronouncement that replaces it) (the "Blended Rate") is greater than the interest rate that would apply but for this sentence. If the AFR or Blended Rate, as the case may be, is higher than the then-current interest rate on this Note, then such higher rate shall apply to the entire outstanding principal balance of this Note, with the interest accruing at that higher rate as of the adjustment date. The amount of interest accruing under this Note shall be compounded on a daily basis.

Thus:

- Each time an advance is made, I look at the short-term rate and use the higher of the loan's current rate or the short-term rate at the time of the loan.

- Every summer, when the blended annual rate for demand loans is issued, I adjust the interest rate retroactively to January 1 if the blended rate exceeds the interest rate that otherwise applies that January 1.

- Each December I calculate the interest due and inform the client. At that time, and each time the client communicates any other advances and payments to me, I ask whether we should lock in the term and interest rate. I normally don't have more than one or two of the loans outstanding at any particular time, and nobody got caught by the 2022 surge in interest rates.

The software I use is TValue 6 - TimeValue Software, which makes these calculations very easy to do. It lets one input various loans and payments and change interest rates as often as one wants very quickly and easily.

In the interest of simplicity, my methodology concedes more than is necessary. If the interest rate decreases, my methodology does not give the taxpayer the benefit. Furthermore, theoretically, each advance is a separate loan, so the interest rate would start at the short-term AFR and then move to the blended annual rate and change every year, without regard to any higher interest rates that apply to subsequent loans. Furthermore, the order in which payments are to be applied to each loan is unclear in such a situation. Ultimately, the question is how material the difference in methods would be, in terms of the cost of the time to calculate vs. the tax saved.

III.B.1.a.i.(d). Refinancing or Cancelling Loans

Regulations provide some flexibility in loan work-outs[6246] or other loan modifications;[6247] for the latter, see part II.G.31.a Debt Modifications. For a general discussion of the relevant issues, see *Hunt v. Commissioner*, T.C. Memo. 1989-335. Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment

[6246] Prop. Reg. § 1.7872-11(a)(2), providing no income taxation in some situations when accrued interest is forgiven.
[6247] Reg. § 1.1001-3(c), discussing exceptions to the general rule that a significant modification of debt instrument is a taxable exchange.

would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for purposes of the Code § 166 bad debt deduction.[6248]

For income and transfer tax consequences of cancellation by reason of gift or bequest and issues raised by discounting the value of a note on death, see part III.B.5.b Promissory Notes.

See also part II.G.31.b Debt Forgiveness.

When refinancing, canceling or otherwise transferring notes arising from a taxable sale, also see part II.G.15 Limitations on the Use of Installment Sales.

III.B.1.a.i.(e). Payment in Kind

Plans to pay in kind concern me. Part II.A.1.d.i Code § 1058 Loan of Securities generally requires that a loan of securities must be repaid with an equity return. Of course, those are income tax rules, not estate tax rules, but without any estate tax rules addressing these issues a court might analogize.

Thus, if securities are sold to a trust for a note that is expected to be repaid with those securities and the IRS successfully asserts that the sale was essentially a loan of the securities, could the IRS assert that any payment less than an equity return constituted a gift? Consider whether to create cash flow projections showing realistically how the note will be repaid. I would keep those in a privileged file until IRS audits and then consider producing it. That's because, if one attached those projections to a gift tax return and payments vary from the schedule, the IRS might assert that the taxpayer is not following the plan and that the note should be disrespected.

III.B.1.a.ii. Loan Guarantees

Generally, a guarantee (guaranty) is a promise to pay another person's debt, and the borrower is required to repay the guarantor any funds the grantor pays on the borrower's behalf:[6249]

[6248] Reg. § 1.166-2(b).

[6249] *Standard Oil Company of New Jersey v. Commissioner*, 7 T.C. 1310, 1321 (1946) (a reviewed decision supplemented 11 T.C. 843 (1948), *acq.* 1949-2 C.B. 3), held:

> Guaranty is defined in 38 C.J.S. 1129 as follows:
>
> > A guaranty or guarantee may be generally defined as a collateral promise or undertaking by one person to answer for the payment of some debt or the performance of some contract or duty in case of the default of another person, who in the first instance is liable for such payment or performance; a collateral promise or undertaking to pay a debt owing by a third person in case the latter does not pay.
>
> A guaranty may be one of various kinds, such as an absolute or conditional guaranty, a guaranty of payment or of collection, a general, special, continuing, or unlimited guaranty, or a letter of credit. 38 C.J.S. 1139. In the instant proceeding, as noted above, the agreement of November 6, 1929 states that the guaranty thereby given shall be deemed a continuing guaranty. In 38 C.J.S. 1142 A continuing guaranty is one which is not limited to a single transaction, but which contemplates a future course of dealing, covering a series of transactions, generally for an indefinite time or until revoked.
>
> In 38 C.J. S. 1130, it is stated:

- The lender loans to the borrower.

- The guarantor promises that the loan will be repaid. The guarantee may be for part or all of the loan.

- At some point, the lender may collect from the guarantor.

- The guarantor steps into the lender's shoes with respect to the amount the lender collects (subrogation right). Using this subrogation right, the guarantor can attempt to collect from the borrower.

- The guarantor is out-of-pocket only for amounts not collected from the borrower (including collection expenses, which loans usually impose on the borrower).

Generally, a lender enforces the guarantee when the borrower defaults. The guarantee agreement may require the lender to take various actions against the borrower before collecting from the guarantor. Or, it may allow the lender to collect from the guarantor once the event of default concerns, essentially placing the full burden of collection efforts on the guarantor. To make it even easier for the lender to collect from the guarantor, the lender may require that the loan documentation show the guarantor not as such but rather as a nominal co-borrower. The true borrower receives the loan proceeds and makes payments, and the guarantor/nominal co-borrower steps in only if the true borrower is unable to pay. If co-borrowers own the collateral securing the loan, one co-borrower might transfer the collateral to the other and the other assumes the loan, so that the transferee becomes the only true borrower and the transferor becomes a mere guarantor.[6250]

Case law and related authority look to whether, when the guarantee was made, the guarantor intended to enforce the guarantor's subrogation right. This intent must be proven objectively by analyzing whether one could reasonably expect the borrower to repay the loan. If so, making the guarantee does not constitute a gift (see part III.B.1.a.ii.(a) Gift Tax Issues Involving Loan Guarantees), and any payment under a loan guarantee (net of any collection form the borrower under the subrogation right) is deductible for estate tax purposes as a claim against the estate (see part III.B.1.a.ii.(b) Code § 2053 Estate Tax Deduction re Loan Guarantees). For income tax consequences of a guarantor's payments, see part III.B.1.a.ii.(d) Income Tax Consequences Involving Loan Guarantees.

> A guaranty in its technical and legal sense has relation to some other contract or obligation with reference to which it is a collateral undertaking; it is a secondary and not a primary obligation.

Numerous authorities are cited in the footnote for the above proposition, including *Howell v. Commissioner*, 69 Fed. (2d) 447. In that case the Circuit Court of Appeals, Eighth Circuit, among other things said:

> That in the case of suretyship or guaranty there is an implied agreement on the part of the principal debtor to reimburse his surety or guarantor is unquestioned. See *Melletee Farmers' Elevator Co. v. H. Poehler Co.* (D.C.) 18 Fed. (2d) 430; *In re Dailey et al.* (D.C.) 19 Fed. (2d) 95; *United States Fidelity & Guaranty Co. v. Centropolis Bank of Kansas City, Mo.* (C.C.A. 8) 17 Fed. (2d) 913, 917, 53 A.L.R. 295; *National Surety Co. v. Salt Lake County* (C.C.A. 8) 5 Fed. (2d) 34; (compare *Jenkins v. National Surety Co.*, 277 U.S. 258, 48 S.Ct. 445, 72 L.Ed. 874); 28 C.J. 1037.

[6250] An example of this is *Estate of Hendrickson v. Commissioner*, T.C. Memo. 1999-357, discussed in part III.B.1.a.ii.(b) Code § 2053 Estate Tax Deduction re Loan Guarantees.

Most of the cases described in parts III.B.1.a.ii.(a) and III.B.1.a.ii.(b) were decided before *Dickman v. Commissioner*, 465 U.S. 330 (1984),[6251] held that a loan may have gift tax consequences. This aspect of *Dickman* was codified by Code § 7872, which provides that lending money at no less than the applicable federal rate does not constitute a transfer.[6252] Let's unpack the implications of this codification:

- Code § 7872(e)(1) and (f)(2) refer to the applicable federal rate (AFR) under Code § 1274(d).

- Code § 1274(d)(1)(C) determines the AFR "based on the average market yield … on outstanding marketable obligations of the United States…."

- In the appraisal profession, such obligations are the benchmark for risk-free rates of return. Appraisers then add various risk factors to determine an appropriate discount rate or required rate of return.

- Therefore, under Code § 7872, loans are deemed to charge adequate interest if they charge interest based on a risk-free loan.

In other words, given that Code § 7872 applies to borrowers who are not the U.S. government and places no qualifications whatsoever on who may use it, Congress has decreed that credit risk is not taken into account in determining adequacy of interest! It's not quite that simple, however, in that Code §§ 1271-1275 are read together as one coherent set of rules. In determining whether to give effect to a schedule of stated payments, Reg. § 1.1273-1(c)(1)(ii) ignores "the possibility of nonpayment due to default, insolvency, or similar circumstances" unless "the lending transaction does not reflect arm's length dealing and the holder does not intend to enforce the remedies or other terms and conditions." Thus, if one structures a loan with terms (other than interest rate) that reflect arm's length dealing, the only remaining issue is whether the holder intends to enforce the remedies and other terms and conditions. Fortunately, we have a body of law that determines this intent – the pre- and post-*Dickman* authority described in parts III.B.1.a.ii.(a) and III.B.1.a.ii.(b) referred to above.

Compare a loan guarantee to a back-to-back loan. In the latter, instead of guaranteeing a loan, the person whose credit capacity (the "credit intermediary") is to be used borrows from a commercial lender, then loans the proceeds to the ultimate borrower. The borrower grants a security interest to the credit intermediary, which the credit intermediary then assigns (together with whatever collateral the credit intermediary provides) to the lender. This back-to-back mechanism is not just an estate planning tool – rather, it is required for a shareholder in an S corporation to obtain basis against which to deduct the corporation's debt-financed losses.[6253]

Consider the terms of the back-to-back loan. Nothing in Code § 7872 looks to the source of a lender's funds – how much interest the credit intermediary pays on the loan from the commercial lender that the credit facilitator uses to loan to the ultimate borrower. Thus, the credit intermediary can obtain a loan at market interest rates, which take into account the risk a commercial lender takes in lending to the credit intermediary, then turn around and loan that money to the ultimate borrower at the AFR – a risk-free interest rate. Code § 7872 prevents the arbitrage – the excess of interest paid to the commercial lender over the AFR – from constituting

[6251] Discussed further in text accompanying fns 6209-6210 in part III.B.1.a Business Opportunities.
[6252] See part III.B.1.a.i Loans.
[6253] See part II.G.4.d.ii Using Debt to Deduct S Corporation Losses.

a gift. Furthermore, the credit intermediary must pay the commercial lender whether or not the ultimate borrower is performing on the loan.

Because the interest arbitrage and financial risk the credit intermediary incurs exceed the cost and risk assumed by a guarantor and such an arrangement does not constitute a gift, I believe that Code § 7872 inherently means that a loan guarantee does not constitute a gift – but if and only if objectively there was a reasonable expectation that the borrower would pay the loan and the guarantee was merely to bridge the gap between a reduced-risk loan and the risks inherent in loaning to that particular borrower. If the client wants to reduce whatever tax risk a loan guarantee presents, the client can engage in a back-to-back loan, but consider that the client:

- Still needs to be able to prove a reasonable expectation that the borrower would pay the loan, and

- Must deal directly with the lender and borrower on a regular (sometimes monthly) basis, whereas with a loan guarantee the guarantor has no role regarding loan payment until the borrower defaults.

The latter bullet point is a key reason why a client may want to be a guarantor instead of the credit intermediary in a back-to-back loan. Enforcing loans to family members can disrupt family relationships. My personal view is that making the borrower deal with a bank injects formality into the process and increases the likelihood of payment. Whenever a client asks me about possibly loaning to a friend, I first ask whether not getting repaid would ruin the friendship (and the client's financial position) and also recommend offering to guarantee a bank loan to that friend instead; those questions usually put the kibosh on the friend's request. Considering these dynamics, relative to a back-to-back loan a loan guarantee seems to me to have a strong nontax business reason.

Tribune Media Company v. Commissioner, T.C. Memo. 2021-122, respected a guaranty that was unlikely ever to be called; for an excerpt from with a complete discussion, see part II.C.3.c.ii.(a) Permanent Rules Allocating Economic Risk of Loss to Recourse Liabilities.

One CPA expressed concern to me that an S corporation guaranteeing a loan made to a shareholder might generate a second class of stock if "a principal purpose of the agreement is to circumvent" the single class of stock requirement.[6254] To address such a concern, consider providing that:

- Any payment on the guaranteed loan must be accompanied by a similar proportionate loan to each other shareholder, with the payment on the guaranteed loan and the similar proportionate loan payable with interest at a rate no less than the AFR.

- If there is no reasonable expectation of repayment at the time that the payment on the guaranteed loan is made, the payment on the guaranteed loan is instead a distribution and the other shareholders will receive similar distributions.

[6254] See Reg. § 1.1361-1(*l*)(2)(i), reproduced in part II.A.2.i.ii Temporary Timing Differences; Other Varying Differences, especially fn 1211 (lender was related party)

- If the borrower transfers the stock while the guaranteed loan continues in effect, any payments on behalf of the borrower will be treated as payments to the transferee, with the transferee's sole recourse being against the borrower.

This part III.B.1.a.ii includes:

III.B.1.a.ii.(a). Gift Tax Issues Involving Loan Guarantees

Ultimately, if objectively there is a reasonable expectation that the loan will be repaid, I believe that a guarantee does not constitute a gift. The overall logic is in part III.B.1.a.ii Loan Guarantees; supporting detail is below in this part III.B.1.a.ii.(a).

Shiman v. Commissioner, 60 F.2d 65 (2nd Cir. 1932), held that, although a payment under a guarantee may occur when the borrower is insolvent and appear to be a gift, the test for a gift is the borrower's apparent ability to repay the loan when the guarantee is made:

> …. Indeed, if the putative lender knows that the borrower is without resources and likely never to have any, it may be reasonable with nothing further, to assume that he merely means to give the money. The conduct of neither party would in that case have its usual implication, and no contract would result. In the case at bar there was no reason to suppose, when Shiman guaranteed the accounts that Oppenheim would be unable to make him whole. Oppenheim was then solvent, and his promise, implied from the facts, was as authentic as any other. Nobody disputes that this is the common understanding, or that a contract results from it. Oppenheim's obligation was indeed conditional upon Shiman's to the brokers. Only in case Shiman was called upon to perform, was Oppenheim to repay him; no debt arose between the two till Shiman paid, though as soon as he did, Oppenheim owed him the amount at once. But it made no difference that when Shiman did in fact pay, the situation had become such that, had he then voluntarily done so, the advance would have been a gift. He was forced to pay by his earlier undertaking, which from 1920 forward bound his freedom of choice. It has indeed been at times debated whether a conditional obligation is an obligation at all until the condition is fulfilled, but the dispute is scholastic. Except so far as the doctrine of anticipatory breach may require, a promise to perform in the future, whether absolute or conditional, does not circumscribe the conduct of the promisor meanwhile; it limits his freedom only when the time arrives, or if the event occurs. Nevertheless, that limitation has all along been fixed by the promise, and requires no further consent by the promisor to hold him. He has subjected himself to events beyond his control. So it is absurd to treat the performance as it would have been had it been freely made at the time. That cannot be a gift which the putative giver was powerless to withhold.
>
> Next the Commissioner says that in any event there can be no deduction because Shiman suffered no loss; the debt was worthless at the moment it arose, for Oppenheim was then insolvent and known to be. If the deduction had been for the loss of purchased

> property, this would be clearly untrue. The statute, section 204 (a) and (b) of the Act of 1924, 26 USCA § 935 (a, b) and note, fixes the "cost" of property acquired after March 1, 1913, as the basis for losses which may be deducted under section 214 (a) (4, 5), 26 USCA § 955 (a) (4, 5). A man who buys property at more than its value, does not forfeit his deduction by his bad judgment. It is immaterial to prove that he could have got it for less; he is taxed upon his actual net income, not on what another, more sagacious, might have secured. But this was not a deduction for a loss under section 214 (a) (4) or (5), to be calculated under section 204 (a) and (b); it was for a debt "ascertained to be worthless and charged off within the taxable year." Section 214 (a) (7), 26 USCA § 955(a)(7). Though there was no debt until Shiman paid the brokers, it then became such at once and was known to be worthless as soon as it arose; verbally at any rate there is no difficulty. Nor is there any reason to impute a purpose to except such cases; the loss is as real and unavoidable as though the debt had had some value for a season….

Estate of Davidson v. Commissioner, 26 BTA 754 (1932), was not really a guarantee case but rather was whether a securities loan was really a gift. The court held that the transfer was a gift, because the taxpayer did not prove that the borrower would be indebted to the taxpayer if the taxpayer was unable return the securities:

> Whether the transaction detailed in the findings of fact created an indebtedness to the taxpayer on the part of his son depends upon the intention of the taxpayer in the transfer of the securities. *Jacob Grossman*, 9 B.T.A. 643. If taxpayer's intention was that his son be permitted to use the securities as a pledge and return them when no longer needed and also to pay him their value in case of sale by the pledgee, the transaction would leave the son indebted as claimed by petitioners. However, if the intent was that the son return the securities when no longer needed by him, but that in the case of their sale by the pledgee, his son would not be indebted to him for their value, no indebtedness would arise. *Hattie Wolff*, 26 B.T.A. 622.
>
> The evidence from which we must draw our conclusion is meager. It is well settled that a transfer of money or other property by a father to a son is presumed to be a gift or advance rather than a loan. *Storey v. Storey*, 214 Fed. 973. However, such presumption is not conclusive, but may be rebutted by a sufficient showing of intent to the contrary. *William M. Fleitmann, Jr., et al., Executors*, 22 B.T.A. 1291; *Redfield v. Eaton*, 53 Fed. (2d) 693; *Elizabeth N. C. Hetherington*, 20 B. T. A. 806.
>
> The record shows that the transfer of these securities was made by the taxpayer upon a request by his son to establish a credit upon which he might draw to protect his equity in a stock-trading account. We think the evidence of his discussion of the matter with another son before making the transfer and his final agreement thereto after that son expressed the belief that the need for the securities was only temporary, is sufficient to show that it was the taxpayer's intention that these securities be returned to him if not sold to satisfy the indebtedness of the pool account. However, in the face of the contrary presumption and without additional evidence, may we conclude that it was the taxpayer's intention that his son pay him or remain indebted to him for the value of these securities in case they were sold by the broker? There was no specific agreement between petitioner and his son and we have no evidence indicating that after the securities were sold by the brokers petitioner considered an indebtedness as existing. The taxpayer died in 1930 and it does not appear that the son and daughter, who are the executors of his estate and who, it is assumed, realize what his intention was in respect

> to this matter, have listed any indebtedness of R. J. Davidson, Jr., as an asset of the estate or charged against him in the settlement of the estate any indebtedness owing to the decedent.
>
> We do not think that the transfer of property by a father to a son with the understanding that it be returned if not lost by him is sufficient basis for a presumption of intention that the value of the property be paid by the son in case of its loss. It appears that such is the situation here. However, even in the event that petitioners' contention with respect to the intent of the taxpayer in the transfer of these securities could be sustained and an indebtedness held to have been created on the part of the son, such indebtedness would not be subject to a charge-off by the taxpayer as a worthless debt. It is shown that the transfer of these securities by the taxpayer was with the knowledge that the use to which they were to be put was a most hazardous one and that their sale by the pledgee would only be under conditions leaving his son utterly unable to pay an indebtedness of this amount. It appears, further, that the securities were in no sense sold by the taxpayer to his son, but that he permitted their use merely as security. It is clear that they remained the property of the taxpayer, subject to the right of the pledge to sell them if necessary. Any increase in their value while held by the pledgee was to the benefit of the taxpayer, and if the transaction did give rise to an indebtedness on the part of the son, such indebtedness arose only upon the contingency of the sale of the securities by the pledgee. *Osterloh v. Lucas*, 37 Fed. (2d) 277. The happening of such contingency would necessarily leave the son bankrupt, the debt would be wholly worthless and uncollectible when it came into existence, and there would consequently be no value represented by it to be charged off by the taxpayer. *Eckert v. Burnet*, 283 U. S. 140.
>
> We have noted carefully the recent opinion of the Circuit Court of Appeals for the Second Circuit in *Shiman v. Commissioner*, 60 Fed. (2d) 65, reversing a decision of the Board which denied a bad debt deduction growing out of a guarantee by the taxpayer of certain brokerage accounts of his brother-in-law. In that case a substantially different situation was presented. Here, we have a case of a transfer by a father to his son with knowledge of the critical condition of the latter's affairs, in which the father had no interest other than that arising from his paternal interest in his son's welfare. In the Shiman case there was a guarantee of brokerage accounts of a brother-in-law at a time when the latter was known to be solvent and in certain of these accounts the taxpayer himself owned a part interest.
>
> Our conclusion is that as a result of the transaction in question the taxpayer had no indebtedness due him, on account of these securities transferred to his son, for which he was entitled to take credit as a debt ascertained to be worthless and charged off in the taxable year.

In *Pierce v. Commissioner*, 41 B.T.A. 1261 (1940), the taxpayer guaranteed loans made to his son's corporation. When the lender called the loan, some was paid, but the taxpayer had to pay part. The court framed the issues:

> We are called on to decide here whether the petitioner's payment of $24,506.46 on his guarantee of the indebtedness of his son is (1) a contribution to the capital cost of stock held by the petitioner which he sought to protect by his guarantee, (2) a gift to his son made when the business affairs of the son did not warrant a prudent loan, or (3) a loan made to his son, ascertained by the petitioner to be worthless in 1933 and charged off at that time.

After dismissing the capital contribution theory, because the taxpayer paid the bank and did not receive any equity in the corporation for his payment, turned to the remaining issues:

> The respondent must fail also in his alternative contention, that the funds paid out by the petitioner may not be regarded as loans, but were gifts made to his son. Respondent's argument is based on his allegation that the financial position of the petitioner's son during the period of the first guarantee and the subsequent increases was so insecure as to render any advances imprudent from a business standpoint and more in the nature of gifts. He assigns the close relation between the petitioner and his son as the reason for the advances and a further basis for branding the outlays as gifts. The evidence, however, is clear that the petitioner's son was solvent by a safe margin at the time of the original guarantee and the increase on September 29, and that petitioner felt assured during the entire period from September 4, 1930, through December 28, 1931, that the position of his son if protected at those times by petitioner's guarantees would ultimately be saved by the later increased value of the collateral. The petitioner, as an officer of the corporations the stock of which was held as collateral, was in a favorable position to pass judgment as to the fair value of the stock so held and its future prospects, and he has stated his opinion that it was worth at least double its market value in September 1930. While we do not accept this testimony as conclusive of the value of the stock, we think it sheds light on the petitioner's intentions and objects in making the guarantees. See *Daniel Gimbel*, 36 B. T. A. 539. The petitioner regarded these dealings as sound from a business standpoint and this regardless of the personal relationship which obtained between him and the debtor, his son. The guarantee which petitioner made in October 1930 of the indebtedness of one J. C. Howard, a legal stranger, we think strengthens this impression.
>
> The petitioner was prompted to make the guarantees for an additional reason which we think furnishes valid basis for holding that these advances were not gifts. The primary objective, as we have noted, of the guarantees was to protect the market value of securities held by the petitioner. Advances made for such purposes are closely related to business expenses and when intended to be in the form of a loan are clearly deductible when the resultant debt becomes worthless.
>
> Here, the evidence points conclusively to the fact that the petitioner intended to hold his son as a debtor in whatever amount he was required to pay on the guarantees. This intent is made plainer by the execution of the note in the amount of $20,000. We do not take this latter fact, however, as an indication that the additional $4,506.46 was meant as a gift. The entire amount must be reckoned as a single transaction. It seems clear, further, that D. W. Pierce, Jr., was hopelessly insolvent at the time the petitioner made his payments and that the debt became worthless as soon as it came into being. Whether the $4,506.46 difference between the debt and the note is properly explained, as the petitioner alleges, by the fact that when the note was signed the exact amount of the guarantee payment had not been ascertained or by some other fact, the entire debt was ascertained to be worthless immediately after the payments in June 1933, and it is thus a proper deduction in that year. *Shiman v. Commissioner*, 60 Fed. (2d) 65; *H. Rodney Sharp*, 38 B.T.A. 166; *Daniel Gimbel*, *supra*.

In *Ortiz v. Commissioner*, 42 B.T.A. 173 (1940), the Official Tax Court Syllabus summarized the guarantee issue at hand:

> Petitioner guaranteed certain brokerage accounts of her husband, who was trading in securities. During 1934 she was forced to respond under her guaranty and make good a deficit in his accounts. The husband had no earning capacity and such property as he had was taken by the wife in reduction of the amount paid under her contract of guaranty. *Held*, under the facts petitioner is entitled to deduct the difference between the amount paid under the guaranty and the value of the property taken from her husband, as a debt ascertained to be worthless and charged off.

Ortiz refuted the IRS' argument that, because the taxpayer's guarantee was in the nature of a gift, no deduction was allowed:

> We understand respondent's argument to be that the satisfaction of the deficit in Julien Ortiz's accounts under the contract of guaranty did not create a debt. He denies the existence of a debt because, he says, under the evidence a gift was intended. On the contrary, we think the evidence establishes the lack of any donative intent. Prior to the market crash Julien Ortiz's stock market transactions had been profitable, and his wife believed that profitable operations in his accounts would be resumed. Before executing the contract of guaranty she consulted with her financial adviser and her husband, who assured her that she would suffer no loss under the guaranty. Each of them believed that the market would go up and there would be no occasion to respond under the contract of guaranty. If the wife had been motivated by a donative intent, there would have been no hesitancy. She would have been ready and willing to give her husband any necessary funds. That no such donative intent existed is demonstrated by her act in taking over the security remaining in his accounts and requiring him to convey to her the real property in his name. These acts are inconsistent with donative intent. *Cf. Elizabeth N. C. Hetherington*, 20 B. T. A. 806; *Edward H. Moore*, 22 B. T. A. 366; appeal dismissed, 59 Fed. (2d) 1069; *William M. Fleitmann, Jr., et al., Executors*, 22 B.T.A. 1291; *Roy Nichols*, 17 B. T. A. 580.
>
> Furthermore, respondent's argument ignores the legal consequences that flow from the contract of guaranty. Where a guarantor is forced to answer for the debt or default of another the law implies a promise on the part of the principal debtor to reimburse his guarantor. *Howell v. Commissioner*, 69 Fed. (2d) 447, and cases cited; *certiorari denied*, 292 U. S. 654. When Alice duPont Ortiz was forced to respond under her guaranty, the law implied a promise by Julien Ortiz to reimburse her. The guarantor's payment did not extinguish the debt; it merely substituted the guarantor for the creditor, and thereafter she was entitled to assert any rights that the creditor may have had against the principal debtor or against any security held for the debt, 24 American Jurisprudence 955; 60 Corpus Juris 740, and the facts show that she exercised the rights so acquired against the principal debtor and against the security held for the debt. As a matter of law, therefore, a debtor-creditor relationship existed between husband and wife immediately upon her payment of the deficit in his accounts pursuant to her contract of guaranty.
>
> The facts and circumstances under which this debt was created are so similar to the facts and circumstances existing in *Shiman v. Commissioner*, 60 Fed. (2d) 65, and the arguments advanced in the two cases are so alike, that a detailed analysis of the Circuit Court's decision will be helpful in disposing of the present issue. In July 1920 Shiman guaranteed a brokerage account of his brother-in-law, Oppenheim, who was speculating in stocks. At the time Shiman guaranteed the account Oppenheim was solvent, but thereafter he fell into financial straits and became insolvent. In October 1924 the brokers forced Shiman to pay $10,000 into the account under his guaranty in order to keep the

account open for the balance of the year. In 1925 the account was closed out and Shiman had to pay an additional sum of more than $26,000 under his guaranty. In his 1924 return Shiman claimed the $10,000 payment as a loss, or a worthless debt, but the Commissioner and this Board denied the deduction. The Circuit Court, however, reversed. The Commissioner's argument, that the payment created no debt because it was a gift, was rejected, as was the argument that in any event Shiman was entitled to no deduction because the debt was worthless the moment it arose, as Oppenheim was then insolvent and known to be. The court likewise rejected the argument that until the account was closed out the debt was not ascertained to be worthless, and the argument that the charge-off was insufficient.

However, guaranteeing a loan that had no reasonable expectation of repayment constituted a gift and therefore did not support a bad debt deduction in *Ellisberg v. Commissioner*, 9 T.C. 463 (1947), which reasoned:

> In the instant case the principal obligor was the endorser's son. He wished to go into a business requiring credit and capital, neither of which he had. The father loaned or gave to the son both capital and credit. The new business did not prosper. Because the father desired to see the son continue in business, he endorsed the son's notes executed for the purposes of obtaining additional capital. At that time the father made no investigation into the son's business or financial prospects. All he knew was that the business was not prospering and that the son always needed more money. After the father paid the notes thus endorsed, he made no effort to collect against his son the amount of his payment and he filed no claim on account thereof in the bankruptcy proceedings in which his son was later involved, nor did the son ever list such a debt as one of his liabilities or take any step indicating that he acknowledged the existence of this indebtedness.
>
> Under the circumstances disclosed by the record in this case, we are of the opinion that the transaction in question is equivalent to one in which a father borrowed money from a bank and, in effect, made a gift of the proceeds to his son. It will not, in our opinion, justify a bad debt deduction, since, on the facts shown, it is impossible for us to conclude that the petitioner and his son intended a debt to arise from petitioner's payments of his son's notes. See *Charles J. Matthews*, 8 T. C. 1313.
>
> In *D. W. Pierce*, 41 B.T.A. 1261, we permitted the deduction as a bad debt of amounts paid by a father on account of a guarantee of a son's obligation. In that case, however, we pointed out (p. 1265) "that the petitioner's son was solvent by a safe margin at the time of the … guarantee," that the petitioner regarded the transaction "as sound from a business standpoint, and this regardless of the personal relationship" between him and his son, and that the evidence in that case pointed "conclusively to the fact that the petitioner intended to hold his son as a debtor in whatever amount he was required to pay on the guarantees." In the instant case the record before us requires a holding on all these points contrary to that reached in the *Pierce* case.

Fox v. Commissioner, 14 T.C. 1160 (1950), held that a securities loan and a loan guaranty did not constitute gifts and that losses under those arrangements constituted deductible nonbusiness bad debts:[6255]

[6255] The Second Circuit, 192 F.2d 101 (1951), held that the loss was a business loss, because settling the guaranty with the lender was necessary to allow the taxpayer to free her account to invest for profit.

> Any claim that the securities were furnished by petitioner to her husband without intent that he should return them to her is, we think, without merit. Neither do we think that she intended that any amounts she might have to pay under the guaranty should be regarded as gifts. Petitioner was not making a gift to her husband, but rather was making him a loan of some of her securities and through the guaranty of his account a loan of her credit. There was a definite agreement for the return of the securities and, whether expressed in words or not, there was a legally implied obligation to reimburse her for any sums she might be required to pay under her guaranty. That the law implies a promise on the part of a principal debtor to reimburse his guarantor where the guarantor is forced to pay his debt or make good his default does not in our opinion require elaboration. For a full discussion of that legal principle see *Howell v. Commissioner*, 69 Fed. (2d) 447. See also *Thomas Watson*, 8 T.C. 569; *Alice du Pont Ortiz*, 42 B.T.A. 173; *D. W. Pierce*, 41 B.T.A. 1261; and *Daniel Gimbel*, 36 B.T.A. 539.

The Tax Court found no taxable gift when the taxpayer helped refinance her husband's note (at a time before the unlimited marital deduction). For legitimate business reasons, the husband (J.C.) asked the taxpayer to become the primary named borrower, although the taxpayer clearly was not, in substance, the borrower. *Bradford v. Commissioner*, 34 T.C. 1059, 1064-65 (1960), *acq.* 1961-2 C.B. 4., held:

> The facts and circumstances surrounding the transaction here involved do not convince us that petitioner intended to divest herself of any property or interest therein owned by her in 1938, or that any of the parties involved anticipated that any of her property would ever be used to satisfy the obligation to the bank. In the first place she did not own property in 1938 that would have come anywhere near satisfying the obligation to the bank, and she had no prospects of acquiring any except through her husband. Secondly, the entire transaction was arranged by J.C., his collateral was retained as security for petitioner's note, and he testified that it was understood that the bank would look first to his collateral for liquidation of the obligation, and he hoped and expected that the collateral would increase sufficiently in value to cover the entire obligation. J.C. paid the interest on the loan and it is reasonable to assume that all parties involved looked to J.C.'s assets and his earning power to liquidate the loan.
>
> This does not mean that petitioner was not obligated on the indebtedness evidenced by her note. We assume the bank could have taken judgment against her on the note had it not been paid, and levied on her property to help satisfy the judgment, and that it probably would have done so had that course of action become necessary. But unless and until such action was taken we do not believe petitioner parted with, or intended to part with, dominion and control of any property owned by her which would give rise to a gift tax.
>
> Granted that section 501 is comprehensive enough to "include property, however conceptual or contingent," *Smith v. Shaughnessy*, 318 U.S. 176, and to reach any passage of control over the economic benefits of property, *Estate of Sanford v. Commissioner*, 308 U.S. 39; nevertheless, no matter how intangible, the donor must own a property right or interest which is capable of being, and is, transferred. *Commissioner v. Mills*.[6256] Petitioner transferred no property or interest in property in 1938 but only made a promise to pay in the future if called upon to do so. *John D. Archbold*,

[6256] 183 F.2d 32 (C.A. 9, 1950), affirming 12 T.C. 468.

> 42 B.T.A. 453. The fact that J.C. may have derived some economic benefit in 1938 as a result of this promise is not controlling. Regs. 79, art. 1.

In *Cogan v. Commissioner*, T.C. Memo. 1971-251, advances the taxpayer made to her son did not constitute bona fide debt and therefore could not support a bad debt deduction:

> Petitioner did not require her son to execute a note for these amounts; there was no agreement to pay interest; and, no time was fixed for repayment. The alleged debt was not scheduled in the bankruptcy proceedings; nor was it claimed as a bad debt deduction in petitioner's tax return. We are not convinced by petitioner's explanation of the reason the deduction was not claimed on her tax return for the taxable year 1967. We cannot believe that, considering the surrounding facts and circumstances in which the payments and advances were made, petitioner intended to enforce collection of them against her son who was the sole support of his wife and three young children. Lacking this intent there is no clear showing that a debtor-creditor status was created; the advances and payments are presumed to be gifts. *William Francis Mercil*, 24 T.C. 1150 (1955); *Estate of Carr V. Van Anda*, 12 T.C. 1158 (1949) *aff'd. per curiam* 192 F.2d 391; *C. B. Hayes*, 17 B.T.A. 86 (1929). See *Evans Clark*, 18 T.C. 780 (1952).

However, payments on a loan guarantee did support a bad debt deduction. *Cogan* held:

> We think payment to the United California Bank stands on a different footing. For many years prior to the taxable year, petitioner had guaranteed loans by the bank to her son. While her concealment from him of the fact of her guaranty raises some question as to whether her ultimate payments under the guaranty represents gifts, we are satisfied that, more probably, she was motivated by a desire to instill confidence in her son in the ultimate success of his business enterprise. We think that, at the time of the transaction, there existed a real expectation of repayment and an intent to enforce collection. *Giffen Andrew*, 54 T.C. 239 (1970). Accordingly, we have found that petitioner did not intend to make a gift to her son at the time she made the guaranties in question*. Cf. Kate Baker Sherman*, 18 T.C. 746 (1952).

Letter Ruling 9113009 held that loan guarantees conferred "valuable economic benefits" to the grantee that constituted a gift. If the grantee, without the guarantees, would pay a higher interest rate on the loan, or otherwise be unable to obtain the loan altogether, then the grantee has received a valuable property interest. The grantor had assumed a legally enforceable obligation for less than full consideration. Thus, when a loan guarantee became binding, the grantor had made a completed gift.

At least one commentator, at the time, noted the "foolishness" with which loan guarantees were taxed.[6257] The folly came by way of comparison of the effects of a parent loaning a child funds (possibly using a "back-to-back" loan) versus a parent guaranteeing a child's loan. Code § 7872, which superseded *Dickman*, controls below-market demand loans. Thus, at the October 2010 short-term AFR,[6258] a parent could lend his or her child funds at 1.73% for almost nine years without incurring gift tax liability. If the parent has wonderful credit, he or she may be able to borrow funds for himself or herself at the prime lending rate, which, as of October 1, 2010, was 3.25%. Thus, using a back-to-back loan, a parent who could borrow at the prime lending rate can essentially gift 1.52% per year tax-free. However, if the parent

[6257] See Randall J. Gingiss, The Gift of Opportunity, 41 *DePaul L. Rev.* 395, 409 (1991-1992).
[6258] Rev. Rul. 2010-24.

simply chose to guarantee the child's loan, under Letter Ruling 9113009, this would incur gift tax liability.

Letter Ruling 9409018 withdrew Letter Ruling 9113009 as to that issue. Letter Ruling 9409018 reasoned:

> Under section 2056(b)(4), if property passing to the surviving spouse is encumbered in any manner, the encumbrance is taken into account in the same manner as if the amount of a gift to the spouse were being determined. Under the terms of the taxpayer's will, assets will pass to the Estate Trust for the benefit of the surviving spouse only if there are any loan guarantees outstanding at the taxpayer's death. The marital deduction for the bequest of such assets would not be reduced by the entire unpaid balance of the guaranteed loans unless at the time of the taxpayer's death it appears that a default after the Estate Trust is funded is likely, that assets of the Estate Trust will be used to pay the entire unpaid balance of such loans, and that the subrogation rights appear to be worthless.
>
> It is well settled that, notwithstanding the restrictions of section 2056(b), an asset in the form of a promissory note that passes from a decedent to or for the benefit of the surviving spouse is ordinarily eligible for the marital deduction, whether the note passes outright to the spouse or to an estate trust described in section 20.2056(e)-2(b) or to a marital trust described in section 2056(b)(5) or (b)(7). After a decedent's death, the spouse (or the trustee of the trust for the benefit of the spouse) holds the note as a creditor of the borrower and is subject to a risk of loss if the borrower were to default and be incapable of repaying the note. It follows that the mere presence of a promissory note among assets passing to a trust for the benefit of the surviving spouse would not ordinarily cause the disallowance of the marital deduction.
>
> If one or more assets (not necessarily promissory notes) pass from a decedent to or for the benefit of the spouse subject to a loan guarantee encumbrance, the spouse (or the trustee of the trust for the benefit of the spouse) is subject to a risk of loss if the borrower were to default and be incapable of repaying the guaranteed loan. In the event of default, the spouse (or the trustee) would pay the lender pursuant to the guarantee, as a result of which the spouse (or the trustee) would be immediately subrogated to the lender and would consequently become a creditor of the borrower for the amount paid pursuant to the guarantee.
>
> Thus, for purposes of section 2056(b), the position of a spouse (or trustee) as a note holder is indistinguishable from the position of a spouse (or trustee) as holder of assets subject to a loan guarantee. In the case of the note asset and in the case of the guarantee-encumbered asset, the risk of the borrower's default presents the same issue for purposes of determining whether a surviving spouse's interest in the asset is considered a nondeductible terminable interest. In either case, neither the borrower nor the lender possesses an "interest in" or a "power to appoint" property, as those terms are used in section 2056(b).
>
> Accordingly, in the present case, the mere presence of a loan guarantee as an encumbrance on assets passing from the taxpayer at death would not ordinarily cause the complete disallowance of the marital deduction that would otherwise be allowable for the bequest to the Estate Trust or the Marital Trust. This would be so whether the

guaranteed loan had been made to an entity owned by the taxpayer or had been made to some other borrower.

Letter Ruling 9409018's theory of loan guarantees is enshrined in regulations in a different context.[6259]

Thus, a parent should be able to make his or her credit standing available to his or her children without creating an income or gift tax event.[6260] What is essentially a loan of creditworthiness, though it may enable a child to obtain a loan at a more favorable interest rate or a loan that would have otherwise been unavailable to him or her, should not factor into gift of opportunity analysis. Thus, one of the more troublesome aspects of *Carriage Square* has been superseded. Furthermore, in Letter Ruling 200534014,[6261] the IRS did not appear to be troubled by a parent providing his creditworthiness to his child, pointing to some cases that seem to have been decided under state law where parents loaned collateral to their children. The Tax Court has referred to loan guarantees as "unmatured, potential claims."[6262]

One can glean from all of the above that, if the intent to repay is not genuine, then the arrangement is vulnerable to IRS attack;[6263] however, an adequately secured legal obligation to repay may be respected, even if the lender intends to forgive.[6264] The converse is that, if the

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[6259] Part II.G.4.d.ii.(a) Limitations on Using Debt to Deduct S Corporation Losses, explains that a shareholder gets no basis for guarantees but does get basis for loans made from the shareholder to the corporation, then in fn 1214 cites Reg. § 1.1366-2(a)(2)(iii), Example (4), "Guarantee," which provides:

> A is a shareholder of S, an S corporation. In 2014, S received a loan from Bank. Bank required A's guarantee as a condition of making the loan to S. Beginning in 2015, S could no longer make payments on the loan and A made payments directly to Bank from A's personal funds until the loan obligation was satisfied. For each payment A made on the note, A obtains basis of indebtedness under paragraph (a)(2)(ii) of this section. Thus, A's basis of indebtedness is increased during 2015 under paragraph (a)(2)(ii) of this section to the extent of A's payments to Bank pursuant to the guarantee agreement.

[6260] Streng, *Estate Planning*, 800-2d T.M. VII.D.2. See also Hatcher and Manigault, Using Beneficiary Guarantees in Defective Grantor Trusts, *Journal of Taxation* (March 2000) (beneficiary guarantees of loans to trusts). Some have suggested that the Tax Court's position is that a beneficiary does not make a gift by guaranteeing a loan to a trust from which (s)he benefits. Blattmachr and Zaritsky, "Is the BDIT Ready for Primetime?" *Probate Practice Reporter* (University of South Carolina School of Law, ISBN 1044-7423), Sept. 2012.

[6261] In addition to the fact that letter rulings are not precedent, this particular ruling dealt with the effect of a child conveying to the parent stock in the company that borrowed the money. Thus, the loan of credit-worthiness was not the true issue; rather, the parent was deemed to have held the stock in trust for the child. The author does not recommend intentionally creating the facts present in that ruling.

[6262] *Estate of Theis v. Commissioner*, 81 T.C. 741, 748 (reviewed decision 1983) (rejecting estate tax deduction for claim due to guarantees that were legally valid, but the underlying loan was not in default), *aff'd* 770 F.2d 981 (11th Cir. 1985); followed *Estate Of Charles P. Cafaro v. Commissioner*, T.C. Memo. 1989-348.

[6263] Rev. Rul. 77-299 (IRS did not respect notes intended to be forgiven in the amount of the annual exclusion each year). If one wants to transfer property over time and use the annual exclusion, then, the IRS argues, one should simply give a small portion of the property each year. Rev. Rul. 83-180. The latter strategy would take longer if the property appreciates, but that might be the cost of obtaining the annual exclusion. In the income tax arena, debt might be recharacterized as equity. See part II.G.20 Debt vs. Equity; Potential Denial of Deduction for Business Interest Expense.

[6264] *Haygood v. Commissioner*, 42 T.C. 936 (1964), *acq. in result*, 1965-1 C.B. 4, *nonacq.*, 1977-2 C.B. 2, held:

intent to repay is genuine, then no transfer occurs until the person who bears the credit risk not only makes a payment but also, on a gratuitous basis, forgoes commercially reasonable remedies against the debtor to recover the right to be reimbursed for that payment.[6265] If a later forgiveness is gratuitous, then the forgiveness of principal should be treated as a gift rather than cancellation of indebtedness income.[6266] The forgiveness of interest will not constitute a deemed receipt of interest by the lender and a deemed payment by the borrower if the forgiveness includes in substantial part the loan principal.[6267]

> In the instant case if donative intent were the criterion our question would be easily solved for the record is amply clear that petitioner intended to donate only $3,000 per year of the property here involved to each of her sons until such time as the full value had been given to them. However, since this not the criterion, it is necessary to look to the property that passed to petitioner in return for the real property transferred to see if the amount of petitioner's gifts to her sons in 1961 of the city property exceeded the $6,000 she reported. See *Estate of Sarah A. Bergan*, 1 T.C. 543 (1943). In *Estate of Koert Bartman*, 10 T.C. 1073 (1948), we recognized that the consideration for the transfer of property by a taxpayer to each of his three children was less than the value of the property transferred. In that case we held that the transfers were for inadequate consideration, and therefore to the extent the value of the property transferred exceeded the value of the consideration given by the children, the taxpayer had made a gift within the meaning of the statute. We did, however, recognize that the agreements to pay annuities and notes were given by the children to the parent in consideration for the property. In the *Bartman* case the taxpayer had contended that none of the gifts was sufficiently complete to occasion the incidence of gift tax because by means of the annuity obligations, the taxpayer retained a right of invasion of the gift. We did not sustain that contention. Likewise, in the instant case we agree with respondent that the gift of the land, insofar as its value exceeded the consideration received by petitioner therefor, was completed in the year 1961. The existence of the vendor's lien notes and deeds of trust would not cause the transfer to be so incomplete as not to be a consummated gift at the time of the transfer to the extent the value of the property exceeded the value of the consideration received therefor. *Cf. Mable G. Adams*, 44 B.T.A. 1091, 1093 (1940), and cases there cited.
>
> We hold that the value of the property transferred by petitioner did not exceed the value of the vendor's lien notes and deeds of trust received in return therefor by more than the $3,000 in the case of each son, which amounts petitioner has reported as gifts in the year 1961.

[6265] An income tax analogy is Prop. Reg. § 1.465-6(d), providing that, in applying the at-risk rules:

> If a taxpayer guarantees repayment of an amount borrowed by another person (primary obligor) for use in an activity, the guarantee shall not increase the taxpayer's amount at risk. If the taxpayer repays to the creditor the amount borrowed by the primary obligor, the taxpayer's amount at risk shall be increased at such time as the taxpayer has no remaining legal rights against the primary obligor.

[6266] If the parent's will cancels the loan, the loan is included in the parent's gross estate, but the Code § 102 exclusion of bequests from income trumps Code § 61(a)(12). Letter Ruling 9240003. Although it addressed a different situation, in analyzing the consequences of an employee's loan modification, Rev. Rul. 2004-37 stated:

> Not every indebtedness that is cancelled results in the debtor realizing gross income by reason of discharge of indebtedness within the meaning of §§ 61(a)(12) and 108(a). Debt discharge that is only a medium for some other form of payment, such as a gift or salary, is treated as that form of payment, rather than under the debt discharge rules. S. Rep. No. 1035, 96th Cong., 2d Sess. 8 n.6 (1980), 1980-2 C.B. 620, 624 n.6.

Code § 108(e)(6) confirms no cancellation of indebtedness income when a shareholder cancels a debt owed by the corporation to the shareholder.

[6267] Prop. Reg. § 1.7872-11(a)(2).

If one is concerned that a loan guarantee is a gift, one should structure the loan as a back-to-back loan, meaning the parent borrows from the proposed lender and loans money to the child.[6268] If that is impractical, consider paying the parent a reasonable guarantee fee.

Notwithstanding the lack of gift tax consequences, consider additional documentation when a trust guarantees the obligations of another trust. The IRS might argue that, by entering into a transaction for the benefit of someone other than the beneficiaries, the fruits of that transaction belong to the guarantor trust.[6269] Steps to try to avoid such an argument might include:

- a provision in the trust agreement allowing extending credit to other trusts for the benefit of the trust's beneficiaries,
- charging a fair market value guarantee fee would give a guarantee a business purpose, or
- obtaining the beneficiaries' consent.

On the other hand, suppose the beneficial interests in the trusts are substantially the same. Although trusts are often treated as entities outside of trust law, under trust law a trust is not an entity at all. Under trust law, a trust is the relationship between the trustee(s) (the holder(s) of legal title) and the beneficiaries (those who receive distributions for their own use) pursuant to the wishes of whoever gave property to the trust (the settlor(s)). Trustees have a duty to promote the beneficiaries' interests pursuant to this relationship. Whether the trustees further this relationship by holding property in separate accounts or pursuant to different trust instruments with substantially the same terms is of no consequence – in either case, all of the funds are to be used to promote this relationship. All trust experts with whom I have spoken agree that a trustee of identical trusts has a fiduciary duty to use one trust to promote the activities of the other trust. Thus, one trust guaranteeing a loan to a substantially identical trust would have a solid business purpose.

III.B.1.a.ii.(b). Code § 2053 Estate Tax Deduction re Loan Guarantees

Ultimately, if objectively there is a reasonable expectation that the loan will be repaid, I believe that any payment on a loan guarantee imposed on assets included in a decedent's gross estate would constitute a claim deductible for estate tax purposes. The overall logic behind considering such a loan guarantee as having adequate and full consideration in money or

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[6268] Back-to-back loans are not unusual in the S corporation area, to give the shareholder basis against which to deduct losses. See part II.G.4.d.ii.(a) Limitations on Using Debt to Deduct S Corporation Losses, especially fn 1211 (lender was related party).

[6269] *Harris Trust and Sav. Bank v. Salomon Smith Barney, Inc.*, 530 U.S. 238, 250 (2000), an ERISA case that looked to general trust law principles, noted:

> As petitioners and amicus curiae the United States observe, it has long been settled that when a trustee in breach of his fiduciary duty to the beneficiaries transfers trust property to a third person, the third person takes the property subject to the trust, unless he has purchased the property for value and without notice of the fiduciary's breach of duty. The trustee or beneficiaries may then maintain an action for restitution of the property (if not already disposed of) or disgorgement of proceeds (if already disposed of), and disgorgement of the third person's profits derived therefrom. *See, e.g., Restatement (Second) of Trusts* §§ 284, 291, 294, 295, 297 (1957); 4 A. Scott & W. Fratcher, *Law of Trusts* § 284, § 291.1, pp. 77–78, § 294.2, p. 101, § 297 (4th ed. 1989) (hereinafter *Law of Trusts*); 5 *id.*, § 470, at 363; 1 D. Dobbs, Law of Remedies § 4.7(1), pp. 660–661 (2d ed. 1993); G. Bogert, *Law of Trusts and Trustees* § 866, pp. 95–96 (rev. 2d ed. 1995).

money's worth is in part III.B.1.a.ii Loan Guarantees; supporting detail is below in this part III.B.1.a.ii.(b), but please note that Prop. Reg. § 20.2053-4 may change this analysis.

When a guarantor dies and the guarantee has not been collected upon, the guarantee is merely a contingent claim. Only if the lender collects from the guarantor's gross estate and the guarantor's gross estate is not restored (see last bullet point above) will the guarantor's gross estate actually be out-of-pocket. Thus, in analyzing Code § 2053, consider:

- Rules for deducting contingent claims
- How much the guarantor's gross estate actually pays (or has paid) the lender
- How much the guarantor's gross estate actually has collected or is expected to collect from the borrower

Let's review some cases.

Carney v. Benz, 90 F.2d 747 (1st Cir. 1937) is short, so here is the full opinion:

> This case involves the same statutory provisions which we lately had occasion to consider in *Commissioner v. Lyne Administrator*, 90 F.(2d) 745.*
>
> > * Revenue Act of 1926, chap. 27, 44 Stat. 9.
> >
> > Sec. 303. "For the purpose of the tax the value of the net estate shall be determined -
> >
> > ("(a)) In the case of a resident, by deducting from the value of the gross estate -
> >
> > "(1) Such amounts for … claims against the estate, …to the extent that such claims… were incurred or contracted bona fide and for an adequate and full consideration in money or money's worth." U.S.C. title 26, § 412, 26 U.S.C.A. § 412 note.
> >
> > Revenue Act of 1932, c. 209, § 805, 47 Stat. 169, 280. Section 303 (a) (1) of the Revenue Act of 1926, as amended, is amended to read as follows:
> >
> > ("(b)) Such amounts - …
> >
> > "(3) for claims against the estate … as are allowed by the laws of the jurisdiction, … under which the estate is being administered….
> >
> > The deduction herein allowed in the case of claims against the estate, … or any indebtedness shall, when founded upon a promise or agreement, be limited to the extent that they were contracted bona fide and for an adequate and full consideration in money or money's worth." U.S.C. title 26. § 412, 26 U.S.C.A. § 412.
>
> The present question is whether the claim sought to be deducted from the gross estate was founded upon sufficient consideration. The Commissioner denied the deduction and imposed an additional tax. The executors paid under protest and, claim for refund having been denied, brought suit to recover in the District Court, where they obtained a judgment in their favor. The Collector has appealed.

There is no dispute about the facts. Jacob C. Benz, a citizen and resident of Massachusetts, died in November, 1932, leaving a substantial estate. Paine Webber & Co., stockbrokers, presented a claim against his estate in the amount of $52,811, which was duly paid by the executors and was claimed by them as a deduction in computing the net value of the estate for the federal estate tax. It is the item here in controversy. The claim arose on a written guaranty to Paine Webber & Co. which Benz had made, guaranteeing the account of the Doris Realty & Investment Company. No question is made but what the amount claimed by Paine Webber & Co. was due under guaranty.

The guaranty was given under the following circumstances: The Doris Realty & Investment Company was a Massachusetts corporation organized in 1926. It was owned and operated by the decedent's wife and daughter. In 1929 the company desired to open a stock-trading account with Paine Webber & Co. The brokers required that the account should be guaranteed by Benz, and he gave the guaranty in question. At the end of 1929 the account showed a substantial profit, but in May, 1933, when it was closed out, there was a deficiency amounting to the sum claimed.

The Commissioner disallowed the deduction on the ground that Benz did not receive for the contract of guaranty adequate and full consideration in money or money's worth, as required by the statute. He insists that claims are not deductible unless the consideration for the contract on which they are founded was received by the decedent. There is a dictum to this effect in *Latty v. Commissioner*, 62 F.(2d) 952, 954 (C.C.A.6), but the facts in that case were fundamentally different from those here, and the contract on which the claimed deduction rested was uncommercial in character. In Glaser v. Commissioner, 69 F.(2d) 254, 257 (C.C.A.8), which is also relied on by the Commissioner, it was said that a contract on which a deduction could be based must be "a business transaction on the part of the decedent or a contract intended to augment his estate," etc. In *Porter v. Commissioner*, 60 F.(2d) 673, 675 (C.C.A.2), it was said that the section was not limited "to cases where the consideration passes to the testator; for example, a promise to pay for goods delivered to another might fall within it, if the testator has recourse over." In *United States v. Mitchell* (C.C.A.) 74 F.(2d) 571, in which the facts were very similar to those in the present case it was held that the claim was deductible; and in the very recent case *Commissioner v. Bryn Mawr Trust Co.* (C.C.A.) 87 F.(2d) 607, it was held that the statute did not require that the consideration for the contract on which the claim was based should be received by the decedent, disapproving the Commissioner's regulation that it must be so in order to make the claim deductible.

The statute is to be construed according to the natural and reasonable meaning of the words used, having in mind the purpose which it was designed to accomplish. The purpose of this section in the light of its legislative history [see *United States v. Mitchell* (C.C.A.) 74 F.(2d) 571] was to prevent deductions, under the guise of claims, of what were in reality gifts or testamentary distributions. There was no intention so far as appears of discriminating between bona fide claims against an estate, making some of them deductible and others not. We think the statute means that bona fide business contracts entered into upon adequate legal consideration give rise, if resulting in loss, to allowable deductions. The things which the statute was intended to disallow were colorable family contracts and similar undertakings made as a cloak to cover gifts. There are many kinds of business agreements in which the consideration does not move to the promissor, *e. g.*, contracts of guaranty and of surety, endorsements of commercial paper, etc. There is no reason why claims of this character should be discriminated against, and nothing in the statute which requires that the consideration on which the

> claim rests should have been received by the decedent. As suggested in *United States v. Mitchell*, *supra*, if Congress had intended so to restrict the statute, there is every reason to believe it would have said so.
>
> In the present case the guaranty which the decedent gave to Paine Webber & Co. was a purely commercial undertaking. The District Judge in effect so found. He also found: "The instant case presents no suggestion of an attempted testamentary disposition of property." It does not appear that Benz expected to lose by giving the guaranty; as has been said, the Doris Company was at first successful. Benz had a right of recourse against the corporation but it is not suggested that there were assets of the corporation available in reduction of the amount paid under the guaranty. It is argued for the Commissioner that the decedent's wife and daughter who received his estate were owners of the Doris Company, and that therefore his guaranty amounted to a gift to them. But the Doris Company was an independent entity. It does not appear that the beneficiaries under the decedent's will were obligated on its contracts, still less that in making the guaranty Benz intended to make or in fact made any gift to them.
>
> The judgment of the District Court is affirmed, with costs.

Commissioner v. Porter, 92 F.2d 426 (2nd Cir. 1937) explained "full consideration in money or money's worth":

> The purpose of the phrase under discussion was, in our opinion, to prevent a man from diminishing his taxable estate by creating obligations not meant correspondingly to increase it but intended as gifts or a means of distributing it after his death. See *Latty v. Commissioner*, 62 F.(2d) 952 (C.C.A.6). Thus, if a guarantor reserve no recourse over against the principal in the transaction, the guaranty would be in substance a gift; as we pointed out in the *Porter* Case, *supra*. But the present record does not disclose a transaction of that character. There is no evidence that the decedent surrendered his right of subrogation to the pledged collateral or his right to seek reimbursement from other property of his son-in-law should the guaranty be called. It is true that in October, 1931, when the guaranty was increased by $30,000, the collateral was $50,000 short of the loans, and that, as stipulated, the right of subrogation at the guarantor's death and at all times since was valueless. But the stipulation does not say that, when the guaranty was given, the son-in-law was insolvent or that the guarantor had no reasonable expectation of reimbursement if he should be called upon to pay. So far as appears, it was an ordinary business transaction by which an accommodation guarantor, if required to pay, would acquire rights equal in value to the obligations he had assumed. The Board rightly held the claim deductible.

Mccoy v. Rasquin, 102 F.2d 434 (2nd Cir. 1939), allowed a deduction with respect to amounts paid with respect to a loan guarantee in which the debtor paid only part of the obligation, even though the guaranty benefitted a family member:

> It is argued that the case at bar differs from that of *Commissioner v. Porter*, *supra*, because the guaranty there was an accommodation to the decedent's son-in-law who was not a beneficiary of the decedent's estate, whereas in this case there was a provision in the decedent's will that any loss occasioned to her estate by meeting the guaranty was to be deducted from the share of her son William D. McCoy and should not come out of the portion bequeathed to her daughter Ann McCoy Winters. We cannot see that the provision in the will of Mrs. McCoy that the loss by reason of the guaranty

> should come out of the son's share matters at all. The primary debtor was not the son, but a corporation in which he and the decedent were both interested. While he was the president and the largest stockholder of the company, there is no reason to go behind the corporate entity or to find that the object of the compromise was tax evasion.

Dodge v. Gagne, 23 F.Supp. 729 (D. N.H. 1938), in allowing a deduction for payments of decedent's guarantee of his sister-in-law's notes, commented:

> It is contended by the defendant that the transactions constituted a gift, but the argument appears to be labored. I see nothing to indicate that the transaction was anything out of the ordinary. It is common for a person to sign notes for the purpose of helping another, having confidence that he will never be called upon to pay and it is human nature to postpone payment so long as there is any hope that the maker will discharge his obligation….
>
> It cannot be seriously questioned that Dodge's endorsement of his sister-in-law's note was a valid claim against his estate under the laws of the State of New Hampshire. That obligation had existed for some years. The fact that Dodge paid the interest on the notes subsequent to the date when his sister-in-law became unable to do so, indicates only that he was trying to postpone the day of payment. It may have been because he had other use for his money or that the same was tied upon in investments and unavailable. Payment was eventually made after his death from his estate.
>
> The statute was enacted to prevent deductions under the guise of claims which were in reality gifts or testamentary distributions. The transactions in the case at bar do not fall within either of the above provisions.

Commissioner v. Wragg, 141 F.2d 638 (1st Cir. 1944), held:

> Thus when it has appeared that the decedent's right over against the primary obligor was worth its face value, no deduction has been allowed for a secondary liability (*Estate of Lay*, 40 B.T.A. 522; *Hartford Nat. Bank & Trust Co. v. Smith*, D.C. Conn., 54 F.Supp. 579; see also *Parrott v. Commissioner*, 9 Cir., 30 F.2d 792, certiorari denied 279 U.S. 870, 49 S.Ct. 512, 73 L.Ed. 1007; *Buck v. Helvering*, 9 Cir., 73 F.2d 760); but when it has appeared that the right over was valueless a deduction for it has been allowed. *United States v. Mitchell*, 7 Cir., 74 F.2d 571; *Commissioner v. Porter*, 92 F.2d 426; *Carney v. Benz*, 1 Cir., 90 F.2d 747, 113 A.L.R. 365; *Dodge v. Gagne*, D.C., 23 F.Supp. 729. And, when it has appeared that the right was worth something but not its face value a deduction has been allowed to the extent of the amount which actually had to be paid and could not be recovered from the primary obligor by the estate. *McCoy v. Rasquin*, 2 Cir., 102 F.2d 434; *Eckhart v. Commissioner*, 33 B.T.A. 426, 440; *Estate of Borland*, 38 B.T.A. 598. In view of these cases, particularly the two last cited, it does not seem to us that the Tax Court in the case at bar would have allowed the deduction unless it had come to the conclusion that the right of the estate over against the primary obligor, the decedent's son, was valueless. To be sure it made no such finding categorically, but nevertheless we feel that such a finding is implicit in the factual background of the case and that it must have been assumed by the Tax Court that the estate would ultimately have to bear the loss or else it would not have reached the result which it did. The facts upon which we base our conclusion are that at various times the creditors had threatened to sell the collateral pledged to secure the notes; that upon some occasions actions were instituted by creditors against the

> decedent's estate on the notes, and that the execution on the judgment obtained by the conservator against the son was never levied upon or satisfied although the conservator as a fiduciary was under a legal duty to collect on his judgment, regardless of the family relationship involved, if he could. It seems to us that the creditors would not have taken the steps which they did if the son had been solvent, and that the conservator, if possible, would have collected on his judgment against the son. In the absence of evidence we cannot assume that he neglected to do so in breach of his fiduciary duties. Thus we think that the Tax Court must have concluded, but merely failed to state, that the right of the estate over against the son was valueless, and, this being so, we see no point in remanding the case for a definite finding to that effect.

Estate of Hofford v. Commissioner, 4 T.C. 542 (1945), allowed a deduction relating to a loan guarantee in this situation:[6270]

> In his deficiency notice the respondent disallowed the item, "in the absence of proof that it was contracted for adequate and full consideration in money or money's worth." It is not necessary that the consideration referred to in the statute be received by the decedent. *Porter v. Commissioner*, 60 Fed. (2d) 673; *Dodge v. Gagn*e, 23 Fed. Supp. 729; *Old Colony Trust Co., Executor*, 39 B. T. A. 871, 879. In the instant proceeding the decedent endorsed a note for the Lehighton Legion Home Association. The money received by the latter was used to buy uniforms for its members. The association was clearly debtor for borrowed money on the note which it executed. The testimony is that the association paid some interest on the note to the bank, but never paid anything on the principal. There is no evidence that the decedent intended any gift to the association by his accommodation endorsement and there is no reason to suppose that he intended any gift. After the decedent's executors paid the note, they made a demand on the association for repayment, but it was without funds and the note was then uncollectible.

In *Estate of Duval v. Commissioner*, 4 T.C. 722 (1945), the Official Tax Court Syllabus summarized:

> Where a bank, owner of a claim against decedent as guarantor of notes, consented to distribution of the estate without payment of its claim, reserving, however, a claim against a co-guarantor, and where the estate will never be required to pay the claim, *held*, such claim is not deductible from the gross estate of decedent, although formally allowed by a court having jurisdiction of the settlement of the estate.

In *Duval*, the decedent guaranteed a loan made to a corporation of which she was a shareholder. The court disallowed a deduction for the guarantee:

> In view of this peculiar and unusual liability, a liability that in the case of a solvent and going corporation is not at all likely ever to be enforced where in practical effect the stockholders' liability is rather that of surety than that of a primary debtor, although as a matter of law the liability of the stockholder is primary, we hold that the payment by the corporation of its indebtedness should be considered as satisfying the claim against the estate as of the date of the death of the deceased. If the debt of the corporation is paid by the corporation before it is paid by the stockholder, the liability of the stockholder is

[6270] The case was appealed on other issues, which a reviewed opinion of the Tax Court addressed without disturbing this holding.

> extinguished. For purposes of appraisement of the estate for the fixing of the Federal estate tax, the stockholders' liability should be considered as a potential claim rather than an actual claim, until it is paid by the estate or it is reasonably certain that it must be paid.
>
> In the present case the liability does not attain the dignity of a potential claim. In point of fact, there is no claim at all. The position of petitioners is much weaker than that present in *Charles H. Lay*, 40 B. T. A. 522, where we said:
>
>> Of course, if when decedent died, there had been indebtedness to [the creditor] for money borrowed by the decedent, the claim would have been deductible in full. Doubtless, the Commissioner would not contend otherwise, but where an estate is liable only as a surety or endorser, it cannot take any deduction because of such liability where the principal has ample assets to pay the indebtedness. *Cf. Buck v. Helvering*, *supra*; *Parrott v. Commissioner*, 30 Fed. (2d) 792.

In affirming this holding, the Ninth Circuit, 152 F.2d 103 (1945), elaborated that the subrogation right was key:

> … Whether the rights over be called a right of subrogation or a right to a right of subrogation or contribution, decedent at her death had property rights of value, and the right upon payment to acquire the right of subrogation is the property right which must be included in the gross estate.
>
> No difficulty is encountered in fixing the value of the rights over. It is conceded that the company and the co-guarantor were, at the time of decedent's death, solvent and able to pay the claims and so continued up to the time of the hearing in the tax court. The Tax Court so found and its finding is not challenged. In fact, it may be said the question admits of no dispute, the petitioners having so stipulated. At the hearing before the tax court the petitioners endeavored to show by expert testimony the value of the rights over at the time of decedent's death. This testimony was rejected by the tax court and we think correctly so. When, as here, the concession is made that the company was fully able to pay and discharge the debt, there is no reason to encumber the record by the introduction of opinion evidence as to the value. Such evidence would have been of no assistance to the tax court.

Rev. Rul. 60-247 provides:

> Advice has been requested concerning the deduction, for Federal estate tax purposes, of claims against the estate which have not been paid or which will not be paid because the creditor waives payment, fails to file his claim within the time limit and under the conditions prescribed by applicable local law, or otherwise fails to enforce payment.
>
> The question here arises from a United States District Court decision in the case of *Bertha Jacobi Winer v. United States*, 153 Fed. Supp. 941, which involved a suit by the executrix to recover estate tax paid by the estate of her deceased mother on the grounds that the Commissioner of Internal Revenue erred in disallowing a deduction for a claim of the daughter-executrix against the estate. The claim had become void and uncollectible by virtue of noncompliance with the applicable state statute. The daughter had loaned money to her mother and had received notes in exchange. The court found that there was no question of the legitimacy of the debt. Under the applicable state

statute, however, a claim not filed in the office of the proper authority within a stated period of time becomes void and can no longer be the basis of a cause of action. The court found further that noncompliance with the statute was inadvertent and that the daughter could not profit by the deduction as she was taking nothing under the mother's will.

The United States District Court for the Southern District of New York held for the plaintiff on the ground that the daughter had, on date of death, an "enforceable claim" and that no more is needed to warrant deduction. It attached no importance to the fact that the debt could not be collected….

Section 2053(a) of the Internal Revenue Code of 1954 provides, in part, that the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts for claims against the estate as are allowable by the laws of the jurisdiction under which the estate is being administered.

Section 20.2053-4 of the Estate Tax Regulations states, in part, that only claims enforceable against the decedent's estate may be deducted.

In *Jacob A. Jacobs, et al., Executors of the Last Will of Morris Eisenstadt, Deceased, v. Commissioner*, 34 Fed. (2d) 233, Ct. D. 128, C.B. VIII-2, 403 (1929), *certiorari denied*, 280 U.S. 603, the opinion of the court was that Congress intended to provide a deduction for those claims which were presented and allowed or otherwise determined as valid against the estate and actually paid or were to be paid. In that case a widow elected to accept the provision of the will of her deceased husband in her favor in lieu of the amount provided by an antenuptial contract. The antenuptial contract provided for payment of an amount to her upon his death out of his estate in lieu of dower and other marital rights. Under the state law such contract was valid and enforceable against the estate of the deceased husband at the time of his death. The court held, however, that the amount stipulated in the antenuptial contract was not deductible from the gross estate of the decedent for the reasons stated above.

The principles stated in the Jacobs case were cited with approval in *John Jacobs, et al., Executors of the Will of Carrie Jacobs Brown v. Commissioner*, 34 B.T.A. 594. There, personal property taxes were assessed by a county auditor upon property owned by the decedent. Subsequently, the state taxing authorities issued a certificate of immunity which, by state statute, constituted a defense in any action for recovery of the assessment. The taxes assessed had not been paid and no demand had been made by the taxing authorities. The court held that the assessment was not a claim against the estate and, therefore, the amount was not deductible for Federal Estate tax purposes.

Both the *Jacobs* and the *John Jacobs* cases were cited with approval in *Estate of William P. Metcalf, et al., v. Commissioner*, 7 T.C. 153. In that case, real estate taxes and penalties had accrued and constituted a lien on certain property of the decedent prior to his death. A suit to enforce the lien had been instituted, and the suit was compromised by the estate for a lesser amount than the amount of the taxes claimed. The court held that only the lesser amount was deductible from the gross estate of the decedent.

In *Estate of Ethel M. DuVal, et al., v. Commissioner*, 4 T.C. 722, *affirmed*, 152 Fed. (2d) 103, certiorari denied 328 U.S. 838, a bank, owner of a claim against decedent as guarantor of notes, consented to distribution of the estate without payment of its claim. It reserved, however, a claim against a co-guarantor. The estate would never be required to pay the claim. The court held that such claim was not deductible from the gross estate of the decedent. The opinion of the Tax Court of the United States stated, "A claim is an assertion of a right. If there be no assertion of a right or if the right to assert has been relinquished or abandoned, there is no claim."

Accordingly, it is the position of the Internal Revenue Service that no deduction will be allowed for claims against the estate which have not been paid or will not be paid because the creditor waives payment, fails to file his claim within the time limit and under the conditions prescribed by applicable local law, or otherwise fails to enforce payment.

Consistent with (but not citing) Rev. Rul. 60-247, *Estate of Conard v. Commissioner*, T.C. Memo. 1975-249, held:

The deduction for claims against the estate provided by section 2053(a)(3)[1] is limited to those claims which are allowable under the laws of the jurisdiction in which the estate is administered and which represent personal obligations of the decedent at the time of his death. Whether or not the claim has matured does not affect deductibility.[2]

[1] [footnote restated the statute]

[2] Estate Tax Regs. 20.2053-4.

It is settled, however, that Congress was concerned with actual claims, not theoretical ones that the estate will never be required to pay. *Jacobs v. Commissioner*, 34 F.2d 233, 235 (8th Cir. 1929), *cert. denied* 280 U.S. 603 (1929). Thus, although a valid, enforceable claim exists at the time of death, if subsequent events relieve the estate of liability for the claim, no deduction will be allowed.[3] *Estate of Quintard Peters Courtney*, 62 T.C. 317 (1974); *Estate of Frank G. Hagmann*, 60 T.C. 465 (1973), *affd. per curiam* 492 F.2d 796 (5th Cir. 1974); *Estate of Ethel M. DuVal*, 4 T.C. 722 (1945), *affd*. 152 F.2d 103 (9th Cir. 1945), *cert. denied* 328 U.S. 838 (1946); *John Jacobs, Executors*, 34 B.T.A. 594 (1936).[4]

[3] A claim against the decedent as a secondary obligor is deductible if rights against the primary obligor are worthless. *Commissioner v. Wragg*, 141 F.2d 638 (1st Cir. 1944). See also *John Parrott, Jr., Executors*, 7 B.T.A. 134 (1927), *affd*. 30 F.2d 792 (9th Cir. 1929), *cert. denied* 379 U.S. 870 (1929). Richard testified that the primary obligor (Salt City Business College, Inc.) was unable to pay the notes, was insolvent, and continued to lose money after his sister's death. Respondent did not challenge Richard's characterization on cross-examination, nor present any contradictory evidence. Additionally, the estate tax return valued the stock in the corporation at zero and respondent did not challenge this valuation. While by no means free from doubt, we believe the state of the record requires a conclusion that at the time of the decedent's death the primary obligor was unable to honor the notes in question or reimburse the guarantors. Thus, in denying relief to petitioner, we do not do so on the grounds that the primary obligor was able to pay or that the petitioner would be subrogated to rights against the primary obligor equal to the claim against the estate. See Du *Val's Estate v. Commissioner*, 152 F.2d 103 (9th Cir. 1945), *affg*. 4 T.C. 722 (1945), *cert. denied* 328 U.S. 838 (1946).

> [4] For a different view, see *Russell v. United States*, 260 F.Supp. 493 (N.D. Ill. 1966); *Winer v. United States*, 153 F.Supp. 941 (S.D. N.Y. 1957). See also Stephens, Maxfield, & Lind, Federal Estate and Gift Taxation, 5-17, 5-18 (3d Ed.).
>
> The conclusion we reach is dictated by our decision in *Estate of Frank G. Hagmann*, *supra*. There bona fide obligations on which the decedent was primarily liable were deducted from the gross estate. The relevant state statute provided that claims not properly filed would be void and unenforceable. No claims in respect of the debts were filed within the statutory period. We held that since the estate assets would not be used to pay the debts, the respondent's disallowance must be sustained.
>
> Similarly, the deduction must be denied in the instant case. Kansas law[5] requires that any demand against a decedent's estate, including those arising from liability as a surety, guarantor or indemnitor, be exhibited within 9 months of publication of the first notice to creditors. Moreover, Kansas law requires that liens upon the property of a decedent not existing at death must be exhibited in the same manner as other claims against the estate.[6] Failure to exhibit the claim precludes its later enforcement.
>
> [fn 5, 6 citations to Kansas law omitted]
>
> In this case, notice of the appointment of an executor and notice to the creditors to present their claims was first given on April 15, 1970. The bar date for filing claims was January 15, 1971, and the Bank failed to present any claim by this date. The petitioner was thus relieved of liability on the notes endorsed by the decedent as co-guarantor. The petitioner has not and will not be required to honor the notes as co-guarantor. Consequently, the deduction must be denied.

Estate of Scofield v. Commissioner, T.C. Memo. 1980-470, had the following Official Tax Court Syllabus:

> Decedent executed a will leaving substantially all his estate to his son and naming his son as executor. Subsequently, he guaranteed bank loans made to his son and pledged securities as collateral for the loans. The bank filed no claims against the estate during its probate, but the securities were distributed to the son subject to the security interest of the bank.
>
> Held: (1) Under California law, the bank's claim on the guaranty was not extinguished by failure to file a claim against the estate since the claim was secured; (2) under sec. 2053, I.R.C. 1954, the estate is entitled to a deduction for the bank's lien, but the amount of the deduction must be reduced by the value of the right of subrogation against the son; and (3) the value of such right determined.

Scofield introduced its analysis:

> We deal next with the Commissioner's contention that the decedent's guaranty and pledge were "in the nature of gifts or testamentary dispositions" to the extent they secured loans used by Mr. Scofield for personal living expenses. The argument derives from the cases construing section 2053(c), which provides in part:
>
> > The deduction allowed by this section in the case of claims against the estate, unpaid mortgages, or any indebtedness shall, when founded on a promise or

agreement, be limited to the extent that they were contracted bona fide and for an adequate and full consideration in money or money's worth …

In construing this provision,[4] this and other courts have consistently held that the consideration in money or money's worth need not pass to the decedent. *Commissioner v. Porter*, 92 F.2d 426 (2d Cir. 1937), *affg.* 34 B.T.A. 798 (1936); *Carney v. Benz*, 90 F.2d 747 (1st Cir. 1937); *Commissioner v. Bryn Mawr Trust Co.*, 87 F.2d 607 (3d Cir. 1936), *affg.* a Memorandum Opinion of this Court; *Commissioner v. Kelly's Estate*, 84 F.2d 958 (7th Cir. 1936), *affg.* 31 B.T.A. 941 (1934), *cert. denied* 299 U.S. 603 (1936); *Estate of Borland v. Commissioner*, 38 B.T.A. 598 (1938); *Estate of Wade v. Commissioner*, 21 B.T.A. 339 (1930). A guarantor's obligation has been held to have been contracted for adequate and full consideration in money or money's worth when there has been a loan of money to a third party as a result of the guaranty and the guaranty thereby became binding. *Estate of Hofford v. Commissioner*, 4 T.C. 542 (1945), *supp. opinion* 4 T.C. 790 (1945); *Commissioner v. Porter*, *supra*; *Carney v. Benz*, *supra*; *Estate of Borland v. Commissioner*, *supra*.[5]

[4] The requirement of an "adequate and full consideration in money or money's worth" came into law in 1926 as sec. 303(a)(1) of the Rev. Act of 1926, ch. 27, 44 Stat. 72.

[5] In *Latty v. Commissioner*, 62 F.2d 952, 954 (1933), dismissing petn. to rev. 23 B.T.A. 1250 (1931), the Sixth Circuit, in dicta, expressed some doubt about such holdings by saying: "we think that ordinarily these words [the consideration requirement of sec. 2053(c)] must be construed to evidence an intent upon the part of Congress to permit the deduction of claims only to the extent that such claims were contracted for a consideration which at the time either augmented the estate of the decedent, granted him some right or privilege he did not possess before, or operated to discharge a then existing claim, as for breach of contract or personal injury." However, our research has revealed no recent decisions on the issue, and the Commissioner has not asked us to reconsider such holdings. Under the circumstances, we decline to do so on our own initiative.

In view of such decisions, it is clear that the estate is not to be denied the deduction merely because the decedent received no consideration in money or money's worth for the guaranty. However, the Commissioner relies on dicta in some of such cases and argues that, in part, the deduction should be disallowed because the guaranty arrangement was used by the decedent as a means of making testamentary gifts to Mr. Scofield. The petitioner responds that by this argument, the Commissioner is seeking, indirectly, to challenge the holding that the deduction is not to be disallowed merely because the decedent received no consideration in money or money's worth for the guaranty.

The *Scofield* standards regarding loan guarantees appear more favorable to estates than other claims against an estate. For example, before the unlimited marital deduction for qualified terminable interest property, any payments to a spouse upon death pursuant to a prenuptial agreement had to be supported by the decedent having received some property. In *Sutton v. Commissioner*, T.C. Memo 1973-211:

The requirement that an allowable claim against the estate must be contracted "for an adequate and full consideration in money or money's worth" dates back in its present form to the Revenue Act of 1926. It was carried over without change in section 2053 of

> the Revenue Act of 1954.[3] The courts have long held that it is not sufficient that the claim be enforceable as a matter of state law. In order to meet the test prescribed in the statute, there must be a commensurate benefit flowing from the claimant to the decedent. See *Latty v. Commissioner*, 62 F.2d 952 (C.A. 6, 1933). Furthermore, the consideration flowing to the decedent and the claim against the decedent must be of comparable value in terms of dollars and cents. *Estate of Herbert C. Tiffany*, 47 T.C. 491 (1967); *Estate of Ella J. Davis*, 57 T.C. 833 (1972). The consideration for Helen's life annuity of $400 per month predicated on the prenuptial agreement fails to meet that test. Decedent received nothing of comparable value. See *Estate of Frances R. Pollard*, 52 T.C. 741 (1969).
>
> [3] H. Rept. No. 1337, 83d Cong., 2d Sess. (1954), p. A317.

However, that strictness might be explained by Code § 2053(b), which has always viewed marital rights as insufficient consideration – except in the context of divorce, etc.

Scofield reasoned and held regarding the guaranty being a bona fide claim:

> In support of his position, the Commissioner relies on the facts that the decedent made a gift to Mr. Scofield in 1968, that in that year, the decedent also executed his will in which he bequeathed substantially all of his estate to Mr. Scofield, that Mr. Scofield admitted that his income was negligible in the years 1968 through 1973, that Mr. Scofield used some of the funds borrowed from the bank to cover his personal expenses, and that Mr. Scofield sustained substantial losses in his stock transactions during those years. In addition, the Commissioner asserts that the decedent knew that Mr. Scofield needed some of the borrowed funds for his personal expenses and that the decedent reasonably knew that he would be called upon to pay off the loans to Mr. Scofield. However, the record contains not one iota of evidence indicating that the decedent was aware of the facts that Mr. Scofield needed to use some of the borrowed funds for his personal expenses and that Mr. Scofield was sustaining losses on his stock transactions. Although Mr. Scofield testified in this case, he was never asked any questions concerning whether he revealed his need for funds and his financial condition to the decedent.
>
> In this case, as in the *Hofford*, *Carney*, and *Porter* cases, the arrangements between the decedent and the lender took the form of a commercial transaction. In *Hofford*, *Carney*, and *Porter*, the courts recognized that they were dealing with what appeared to be a business transaction, and in their dicta, they made clear that they would look behind the form of the transaction only when there was evidence indicating that the arrangement was being used for the purpose of making gifts. Since the Commissioner has the burden of proof on this issue in this case, he has the burden of proving that in entering into the guaranty arrangement, the decedent intended to make gifts to Mr. Scofield, and the evidence is clearly insufficient to carry that burden. For all that we know, the decedent may have been wholly unaware of the fact that Mr. Scofield was using some of the borrowed funds for personal expenses or that Mr. Scofield was sustaining substantial losses; Mr. Scofield may have, deliberately or otherwise, withheld such information from the decedent. Moreover, even if the decedent was aware of such circumstances, both he and Mr. Scofield may have been eternally optimistic, hoping that Mr. Scofield's investments would, in time, prove far more successful. Without evidence showing that the decedent was aware of Mr. Scofield's need for money, we cannot infer that the decedent intended to make gifts by his continuing to guarantee the loans to Mr. Scofield.

> Inasmuch as the Commissioner has failed to prove that gifts were intended, he has failed to bring his case within the dicta of *Hofford*, *Carney*, and *Porter*.[6] Consequently, we need not, and do not, decide whether to adopt such dicta in this case.
>
> > [6] It should be recognized that in the *Jermyn* case, the petitioner had the burden of proving that the decedent did not intend to make gifts. Whether we would reach the same result on the record in this case if the burden was on the petitioner is a matter not to be considered.

Scofield analyzed subrogation:

> In *Eckhart v. Commissioner*, 33 B.T.A. 426 (1935), the decedent had endorsed two promissory notes which were payable on demand. At the date of his death, a balance of approximately $148,000 was due on the notes, and they were secured by collateral of the maker having a value of $65,000. After the decedent's death, the holder of the notes made an unsuccessful demand on the maker for payment, filed a claim against the decedent's estate which was allowed, and sold the collateral for approximately $19,000. The proceeds of the collateral were applied to the notes, and the estate paid the difference and claimed a deduction therefor. This Court rejected the Commissioner's position that the deduction should be limited to the difference between the debt and the value of the collateral at the date of death and allowed the entire deduction. 33 B.T.A. at 440-441. We recognized the general rule for valuing the estate, but we pointed out that the amount of certain claims and losses depends upon events occurring subsequent to the valuation date. The estate was actually required to pay the entire difference between the amount of the debt and the proceeds from the sale of the collateral, and the Court held that such amount should be deductible.
>
> The right of subrogation in this case is like the collateral in *Eckhart*: such right is not an asset of the estate which should be valued on the valuation date; rather, it represents an amount to be applied in reduction of the bank's lien in determining the amount of the allowable deduction. As in *Eckhart*, we believe that the amount of the deduction to be allowed in this case should not be based simply on the circumstances existing at the valuation date but should take into consideration all the events occurring during the administration of the estate. The Commissioner recognized that the amount of the lien is to be reduced by the payments made during the administration of the estate. Similarly, the reduction resulting from the existence of the right of subrogation should not be computed until the administration of the estate was completed and the collateral was distributed to Mr. Scofield, subject to the lien. Accordingly, we hold that the value of the right of subrogation should be determined as of the date of the distribution of the assets of the estate. For such purpose, the net value of Mr. Scofield's distribution is determined as of that date, and his net worth is determined as of that date.

Propstra v. U.S., 680 F.2d 1248 (9th Cir. 1982), did not allow consideration of post-mortem events in determining the deductibility of "claims that are certain and enforceable at the time of death":

> As a preliminary matter we must determine the nature of the lien claims against the estate. The law is clear that post-death events are relevant when computing the deduction to be taken for disputed or contingent claims. See Treas. Reg. §20.2053-

1(b)(3)("No deduction may be taken on the basis of a vague or uncertain estimate."). See also *Estate of DuVal v. Commissioner*, 4 T.C. 722 (1945), *aff'd*, 152 F.2d 103 (9th Cir.), *cert. denied*, 328 U.S. 838, 66 S.Ct. 1013, 90 L.Ed. 1613 (1946). Less certain is the relevance of post-death events with regard to claims that are certain and enforceable at the time of death.

We first must determine whether the claim was disputed or contested. The Government argues that the estate contested the lien claims, citing the notation "contested in part" on the estate tax return in support of its argument. The estate contends that the notation was irrelevant; because the Association lacked the power to compromise its lien claim against decedent's estate at the time of his death, the claims were certain (that is for a liquidated sum), enforceable, and owing.

The executrix for the estate had hoped to find a defense against the Association's lien claims against the estate. This hope was reflected in the notation "contested in part" written next to the deductions taken for these claims on the estate tax form that she filed. The executrix' hopes, however, have no bearing on whether the Association's claims were certain or enforceable. The Government concedes that at the time of decedent's death the Association lacked the authority to settle its claims for less than their full amount. Moreover, the executrix had no legal or factual arguments that would support a challenge to the claims. The estate lacked even a colorable defense against the Association's claims. Consequently, the Association's lien claims were certain and enforceable.

This conclusion necessitates an examination of whether post-death events are relevant when computing the permissible deduction for certain and enforceable claims.[9] We rule that, as a matter of law, when claims are for sums certain and are legally enforceable as of the date of death, post-death events are not relevant in computing the permissible deduction.

[9] The commentators have differing opinions regarding this issue. See, e.g., Palmquist, The Estate Tax Deductibility of Unenforced Claims Against a Decedent's Estate, 11 Gonzaga L.Rev. 707 (1976) (post-death events irrelevant); Comment, Estate and Income Tax: Claims Against the Estate and Events Subsequent to Date of Death, 22 UCLA L.Rev. 654 (1975) (post-death events irrelevant); Comment, Effect of Events Subsequent to the Decedent's Death on the Valuation of Claims Against His Estate Under Section 2053 of the Federal Estate Tax, 1972 Ill.L. Forum 770 (post-death events relevant).

Neither section 2053(a) nor the tax regulations state on their face whether post-death events are relevant when computing the permissible deduction for certain and enforceable claims against the estate. Nevertheless, we think that various indicia show that Congress intended that post-death events be disregarded when valuing the claims against an estate.[10]

[10] In examining cases that have previously considered this issue, we have found an irreconcilable split in authority. Compare *Commissioner v. Strauss*, 77 F.2d 401, 405 (7th Cir. 1935); *Russell v. United States*, 260 F.Supp. 493, 499 (N.D. Ill. 1966); *Winer v. United States*, 153 F.Supp. 941 (S.D.N.Y. 1957); *Estate of Lester v. Commissioner*, 57 T.C. 503 (1972) with *Gowetz v. Commissioner*, 320 F.2d 874 (1st Cir. 1963); *Commissioner v. Estate of Shively*, 276 F.2d 372, 374 (2nd Cir. 1960); *Estate of*

Courtney, 62 T.C. 317 (1974); *Estate of Hagmann v. Commissioner*, 60 T.C. 465 (1973), *aff'd*, 492 F.2d 796 (5th Cir. 1974). Faced with these conflicting views, we have examined the arguments underlying each and conclude that *Strauss*, *Winer* and their progeny are more persuasive.

First, we find significance in a change in wording made by Congress when it enacted the Internal Revenue Code of 1954. Predecessors to section 2053 had authorized deductions of the value of only such claims "as are allowed by the laws of the jurisdiction ... under which the estate is being administered." See, e.g., Int. Rev. Code of 1939, ch. 3, §812(b)(3), 53 Stat. 123 (emphasis added). Some courts interpreted this language as meaning that the deduction was only for such claims as were actually paid. See *Commissioner v. Estate of Shively*, 276 F.2d 372, 374 (2nd Cir. 1960); *Estate of Metcalf v. Commissioner*, 7 T.C. 153, 160 (1946), *aff'd in unpublished opinion*, 47-2 U.S. Tax Cas. (CCH) ¶10,556 (6th Cir. 1947). Consequently, they concluded that post-death events were relevant to the valuation of claims against the estate and that the compromised portion of the claim against the estate "no longer represented an enforceable claim." *Estate of Metcalf*, 7 T.C. at 160. Other courts, however, noted that deductibility was conditioned on a claim's enforceability under local law, and that enforceability was to be determined as of the time of death. See *Smyth v. Erikson*, 221 F.2d 1, 3 (9th Cir. 1955); *Winer v. United States*, 153 F.Supp. 941, 943 (S.D.N.Y. 1957). They reasoned that the use of the term "allowed" "[was] not to be construed as meaning that unless a claim against the estate has been allowed by the state court no deduction therefor will be permitted." *Smyth*, 221 F.2d at 3. These courts reasoned that Congress intended that the phrase be used as a substantive guide delineating those claims (and other estate disbursements) that would be deductible. Specifically, Congress intended the phrase to mean that only claims based on legally recognized and enforceable rights were deductible; claims that were unenforceable because they lacked legal foundation were not deductible, even if actually paid. See *Wolfsen v. Smyth*, 223 F.2d 111 (9th Cir. 1955); *Jones v. United States*, 424 F.Supp. 236 (E.D. Ill. 1974). Congress lent support to this latter construction when, in enacting the Internal Revenue Code of 1954, it replaced "allowed" with "allowable." Accord, *Russell v. United States*, 260 F.Supp. 493, 499 (N.D. Ill. 1966); Comment, supra, 22 UCLA L.Rev. at 670.

Treasury Regulation 20.2053-4 also supports the construction that certain and enforceable claims against the estate should be valued without regard to post-death events. In pertinent part, it provides:

"The amounts that may be deducted as claims against a decedent's estate are such only as represent personal obligations of the decedent *existing at the time of his death*, whether or not then matured, and interest thereon which had accrued at the time of death .... Only claims *enforceable* against the decedent's estate may be deducted."

(emphasis added). Significantly, the regulation designates "the time of death" as the critical reference point. In addition, it speaks of "enforceable" rather than "enforced" claims. These factors further suggest that post-death events are irrelevant to the computation of certain and enforceable claims against the estate. Accord, *Winer*, 153 F.Supp. at 943. See *also Jacobs v. Commissioner*, 34 F.2d 233, 236-37 (8th Cir.) (McDermott, J., dissenting), *cert. denied*, 280 U.S. 603, 50 S.Ct 85, 74 L.Ed. 647 (1929).

Finally, our construction is consistent with the teaching of *Ithaca Trust Co. v. United States*, 279 U.S. 151 49 S.Ct 291, 73 L.Ed. 647 (1929). In *Ithaca Trust* the Supreme

Court considered whether post-death facts should be considered in measuring the value of a charitable gift for the purpose of deducting that value from the gross estate when computing the taxable estate. In holding that post-death events should be ignored, the Court reasoned:

> The first impression is that it is absurd to resort to statistical probabilities when you know the fact. But this is due to inaccurate thinking. The estate so far as may be is settled as of the date of the testator's death. The tax is on the act of the testator not on the receipt of property by the legatees. Therefore the value of the thing to be taxed must be estimated as of the time when the act is done .... Tempting as it is to correct uncertain probabilities by the now certain fact, we are of [the] opinion that it cannot be done ....

279 U.S. at 155, 49 S.Ct. at 291 (citations omitted).[11] In Ithaca Trust, the bequest was not for a liquidated sum; its value depended on the valuation of the use of property for the life of the testator's widow. The fact that she died within six months of the date of the testator's death was held not to be a proper consideration, and her life estate was determined according to mortality tables as of the date of the testator's death. In contrast, in the present case the amount of the assessment was fixed as of the date of death. Therefore there is even less reason to look to post-death events.

[11] *Ithaca Trust* is arguably distinguishable from the instant case on the grounds that it dealt with charitable bequests, which are deductible from the gross estate pursuant to a statutory section different from that authorizing deductions for claims against the estate. See *Jacobs v. Commissioner*, 34 F.2d 233 (8th Cir.), *cert. denied*, 280 U.S. 603, 50 S.Ct. 85, 74 L.Ed. 647 (1929). This technical distinction, although accurate, fails to explain why deductions for claims against the estate should be computed differently from charitable bequests. The Eighth Circuit, relying on this distinction in Jacobs, provided no indication of why Congress would have intended such an anomolous result.

The Government denies the force of these arguments, and cites to *Jacobs v. Commissioner*, in which the Eighth Circuit construed a predecessor to section 2053(a) as requiring the consideration of post-death events when computing the value of claims against the estate.[12] *Jacobs*, however, is without persuasive force for several reasons. First, *Jacobs* is distinguishable from the instant case. In Jacobs, the decedent's will gave his widow a power to elect between two alternatives. Her claim, therefore, was not certain and enforceable; it was contingent. Second, we find the *Jacobs* court's analysis of Congressional intent unconvincing. The Eighth Circuit placed heavy reliance on the fact that "claims against the estate" appeared in the same paragraph as funeral and estate administration expenses.[13] The court reasoned that, because funeral and administration expenses necessarily require consideration of post-death events, Congress must also have intended that post-death events be considered when computing claims against the estate. 34 F.2d at 236. We do not find this convincing evidence of Congressional intent. The same statutory section provides for the deduction of unpaid mortgages (or other indebtedness) on property when the value of the decedent's interest in that property has been included in the value of the gross estate. See note 8 supra. This amount can be ascertained as of the date of death. See *Commissioner v. Kelly's Estate*, 84 F.2d 958, 963-64 (7th Cir.), cert. denied, 299 U.S. 603, 57 S.Ct. 230, 81 L.Ed. 445 (1936). Thus, the contents of section 2053 do not give rise to any inference regarding whether post-death events should be considered when valuing claims against an estate. Moreover, except with regard to matters like funeral and administrative expenses, which by their very nature require valuation after a decedent's death, Congress has been explicit in providing for consideration of post-death events. See I.R.C. §§2013, 2032, and 2054. Third, Jacobs was decided before the change in the Code discussed above, which indicates Congress' most recently expressed intent. Finally, we find the Jacobs court's distinction of Ithaca Trust, which was decided approximately six months before Jacobs, inadequate for reasons already stated. See note 11 supra. For these reasons, Jacobs is of dubious precedential value to our determination of whether post-death events are relevant when computing the value of certain and enforceable claims against the estate.

[12] *Jacobs* has spawned a line of authority supporting the proposition that post-death events must be taken into account when computing the value of certain and enforceable claims against the estate. See, *e.g.*, *Gowetz v. Commissioner*, 320 F.2d at 876; *Estate of Shively*, 276 F.2d at 375; *Estate of Hagmann*, 60 T.C. at 467-69; *Estate of Metcalf*, 7 T.C. at 161; *John Jacobs v. Commissioner*, 34 B.T.A. 594, 596-97 (1936), remanded on stipulation, 95 F.2d 1006 (6th Cir. 1938).

[13] The statute involved in Jacobs, section 403(a)(1) of the Revenue Act of 1921, 42 Stat. 279, c. 136, closely resembled the one now before us, I.R.C. §2053.

The Government also relies on Revenue Ruling 60-247.[14] Although revenue rulings are occasionally entitled to weight in the interpretive process, they are not conclusive statements of the law. See *McMartin Industries, Inc. v. Vinal*, 441 F.2d 1274 (8th Cir. 1971); *Macey's Jewelry Corp. v. United States*, 387 F.2d 70, 72 (5th Cir. 1967). A revenue ruling that conflicts with the revenue statutes must be ignored. *Idaho Power Co. v. Commissioner*, 477 F.2d 688, 696 n.10 (9th Cir. 1973), rev'd on other grounds, 418 U.S. 1, 94 S.Ct. 2757, 41 L.Ed.2d 535 (1974); *United States v. Eddy Brothers, Inc.*, 291 F.2d 529, 531 (8th Cir. 1961). In issuing Revenue Ruling 60-247, the Commissioner relied extensively on *Jacobs*, *John Jacobs*, and *Estate of Metcalf*, all of which are unconvincing in their assessment of Congressional intent regarding the relevance of post-death events when computing the value of certain and enforceable claims against an estate. We are not persuaded by a revenue ruling that relies on cases that we find unpersuasive. Moreover, we note that Revenue Ruling 60-247 was disregarded in *Russell v. United States*, 260 F.Supp. 493, 499-500 (N.D.Ill.1966).

[14] A deduction, for Federal estate tax purposes, will not be allowed for claims against the estate which have not been paid or will not be paid because the creditor waives payment, fails to file his claim within the time limit and under the conditions prescribed by applicable local law, or otherwise fails to enforce payment. An exception is made in cases where the claim may be deemed to have been paid through the payment of a legacy in an amount at least equal to that of the claim. Rev. Rul. 60-247, 1960-2 C.B. 272.

Having concluded that section 2053 precludes the consideration of post-death events in computing the value of certain and enforceable claims against an estate, we reverse the summary judgment granted in the Government's favor and remand for further proceedings consistent with this holding.

Estate of Theis v. Commissioner, 81 T.C. 741 (1983), a reviewed case with a well-reasoned dissent, the Official Tax Court Syllabus summarized:

Decedents gave one separate tract of land to each of their two children, but retained life estates in both parcels. Both children mortgaged the properties. Decedents joined in executing the mortgages. Decedent-husband also signed the note on one of the properties as an accommodation party, making him secondarily liable for its payment. Both properties were included at their date-of-death fair market value in the decedents' gross estates under sec. 2036(a), I.R.C. 1954. Decedents deducted the principal balances due on the mortgages from their gross estates. No claims had been made against the estates for payment. The children, who were primarily liable on the mortgages, appear solvent and have continued to make payments thereon. *Held*:

1. Neither estate is entitled to a deduction for a claim against the estate under sec. 2053(a)(3). *Estate of Courtney v. Commissioner*, 62 T.C. 317 (1974), followed.

2. Under the described circumstances of this case, no deduction is allowed for a mortgage debt under sec. 2053(a)(4).

3. The deduction or exclusion provided by sec. 20.2053-7, Estate Tax Regs., is not applicable.

The majority concluded that no deduction or exclusion was allowed, because that would have generated an end-run around Code § 2036:

A literal reading of section 20.2053-7, Estate Tax Regs., would require us to agree with petitioners. But we do not find that regulation applicable here. Section 20.2053-7, Estate Tax Regs., like section 2053(a)(4), was intended to cover situations involving the liability for mortgages on a decedent's own property. *Estate of Johnstone v. Commissioner*, 19 T.C. 44 (1952).[12] In the instant cases, the property was mortgaged after the decedents transferred remainder interests. To adopt a literal reading of section 20.2053-7, Estate Tax Regs., would be to go against the purpose and intent of section 2036(a) and section 2053(a)(4). For example, suppose an individual gifts a remainder interest in property to his children and retains a life estate, the children could then mortgage the property (without having their father cosign the mortgage) or could sell the property to a third party who mortgages it. If we agreed with petitioners' contention, the father would have to include only the net equity of redemption value (i.e., subtract the mortgages) in his gross estate. This is wholly contradictory to the express language of section 2036(a). We cannot agree with petitioners because we do not think that Congress intended to allow deductions to estates for debts that the decedents would not be required to pay.[13]

[12] We note that the ultimate conclusion in Johnstone was contrary to this result because the decedent retained an interest in the property, as a tenant in common, at death. However, despite its contrary conclusion, this Court's reasoning in Johnstone supports our result in this case.

[13] Petitioners' reliance on our opinion in Estate of Scofield v. Commissioner, T.C. Memo. 1980-470, for the proposition that the bank's liens were not extinguishable and therefore and deductible under section 2053 is misplaced.

Petitioners misstate the result of that case. In *Scofield*, a father executed a will in which he bequeathed stock to his son. The son borrowed money from a bank with the father acting as guarantor and pledging his stock as security. When the father died, the estate attempted to deduct the principal amount of the lien from the value of the gross estate.

The lien was not deductible in full, as petitioners in the present cases assert, but rather was offset by the value of the estate's right of subrogation against the son. Also, the case is distinguishable in that the Commissioner, unlike the present cases, conceded that the liens were deductible under sec. 20.2053-7, Estate Tax Regs., and the taxpayer conceded that the amount of the deduction was to be offset by the value of the estate's right of subrogation against the son. Indeed, when viewed in light of its differing facts and concessions, we read Scofield as supportive of our conclusions herein. See note 14 *infra*.

The record here does not indicate that the decedents have made, or will have to make, payments on the mortgage notes. The decedents' children appear to be solvent. In addition, no claims have ever been presented against the estates for payment. As noted previously, there are no claims against the decedents' estates for payment and no deductions are allowed under section 2053(a)(3). *Estate of Courtney v. Commissioner*, 62 T.C. 317 (1974).

We think the same result should follow in the instant cases where the decedents were not primarily liable on the mortgages and will not have to bear the burden of repayment. Section 20.2053-7, Estate Tax Regs., is not applicable to reduce petitioners' inclusion in their gross estates. Hence, we hold that the proper amount to be included in each decedent's estate is $45,000, which represents his or her share of the entire value of the properties (which has been stipulated to be $90,000.[14]

[14] Moreover, even if sec. 20.2053-7, Estate Tax Regs., were applicable here, it would not aid petitioners. We have held that the decedents were not primarily liable on the mortgages. Accordingly, if we applied the regulation to the instant cases, it would require that the only value that need be returned in the decedents' gross estates is the equity of redemption value. However, this amount would then be offset by the decedents' right of contribution against their children. In other words, the decedents' recovery from their children would reduce the estates' exclusions. *Estate of Shedd v. Commissioner*, 37 T.C. 394 (1961), *affd*. 320 F.2d 638 (9th Cir. 1963); *Du Val's Estate v. Commissioner*, 152 F.2d 103 (9th Cir. 1945), *affg*. 4 T.C. 722 (1945). See also R. Stephens, G. Maxfield & S. Lind, Federal Estate and Gift Taxation, 5.03 [6.] (1978). Here, the decedents as accommodation parties on the mortgages would have a right of recourse against their children for primary payment of the indebtedness. See Fla. Stat. Ann. sec. 673.3-415(5) (1966); *Beardmore v. Abbott*, 218 So. 2d 807 (Fla. Dist. Ct. App. 1969); *Central Trust Co. v. Manly*, 100 F.2d 992 (5th Cir. 1939). Accordingly, as in Estate of Shedd, and Du Val's Estate, the decedents' right of contribution would be used to offset any deduction (or exclusion) that the decedents would be entitled to. In the present cases the value of the property greatly exceeds the principal value of the mortgages. Also, the children appear solvent. Hence, applying sec. 20.2053-7, Estate Tax Regs., would require us to hold that the fair market value of the offset (or right of contribution) is equal to the value of the mortgages. Since the exclusion would be offset by this right of contribution, the value of the property includable in the decedents' gross estates would be each decedent's share of the entire value of the property, or $45,000 (per agreement by the parties).

Rev. Rul. 84-42 involved the following facts:

> In 1976, *D*, a resident of State X, gratuitously conveyed a remainder interest in real estate to *A*, retaining a life estate.
>
> In 1976, a bank in State X loaned *A* 100x dollars and as security received a mortgage on the property signed by both *A* and *D*. Under the law of State X, *D*, was a guarantor and, as such, had a right of reimbursement against *A*, the primary obligor, in the event *D* was required to pay the loan directly or if *D*'s life estate was sold in foreclosure. *A* was solvent at the time of the loan transaction, and *D* had a reasonable expectation of reimbursement from *A* in the event *D* was required to pay the loan for *A*. At and after *D*'s death, *A* remained solvent and was expected to continue paying the loan.
>
> *D* died in 1981. Because *D* retained a life estate in the transferred property, the value of property was subject to inclusion in *D*'s gross estate under section 2036 of the Code. The executor of *D*'s estate sought to deduct the mortgage balance alternatively under section 2053(a)(3) or (a)(4) of the Code.

Rev. Rul. 84-42 reasoned and held:

> In Rev. Rul. 76-235, 1976-1 C.B. 277, the decedent gratuitously transferred property in contemplation of death. Subsequent to the transfer and one month prior to the decedent's death, the transferee obtained a loan mortgaging the property to secure the loan. The decedent received no proceeds from the loan, and neither the decedent nor the decedent's estate was liable for the loan.
>
> The ruling holds that the full value of the transferred property is includible in the decedent's gross estate under section 2035 of the Code as in effect prior to amendment by the Tax Reform Act of 1976, and the amount of the mortgage is not deductible from the decedent's gross estate under section 2053 of the Code.
>
> In the present case, the decedent made a transfer described in section 2036 of the full value of the unencumbered remainder interest. The property was encumbered after the transfer, and D received no proceeds from the loan. Furthermore, the encumbrance of the property had no immediate effect on D's continued retention of the lifetime enjoyment of the property. Other than as a guarantor, neither D nor his estate was liable for the loan. Therefore, in accordance with Rev. Rul. 76-235, the entire value of the property is includible in D's gross estate under section 2036 of the Code, and no deduction is allowed for the mortgage under section 2053(a)(4).
>
> Unlike the situation in Rev. Rul. 76-235, in the present case D participated in the loan transaction as guarantor. However, where the decedent is a guarantor, and there is a right of reimbursement, the amount deductible under section 2053(a)(3) cannot exceed the amount the estate actually pays on the debt and is further limited by any expectation of reimbursement. See *Commissioner v. Wragg*, 141 F.2d 638, 640 (1st Cir. 1944); and *Estate of Duval v. Commissioner*, 4 T.C. 722, 726 (1945), aff'd, 152 F.2d 103 (9th Cir. 1945), *cert. denied* 328 U.S. 838 (1945).
>
> If the executor of D's estate is not called upon to pay the indebtedness, the amount of the indebtedness is not deductible as a claim against the estate for purposes of section 2053(a)(3) of the Code. See Rev. Rul. 60-247, 1960-2 C.B. 272. If the executor

is called upon and pays the indebtedness, the amount of the indebtedness is not deductible for purposes of section 2053 because A was solvent at that time and D’s estate has a right of reimbursement. If, in the situation described above, A became insolvent subsequent to the loan transaction and was delinquent in making the loan payments, D’s estate could deduct, under section 2053, the amount paid on the indebtedness reduced by the reasonable value of the right of reimbursement. See Rev. Rul. 60-247 and *Commissioner v. Wragg*, cited above, at page 640.

HOLDING

If D is guarantor of a loan to A, with a right of reimbursement, and the loan is secured by a mortgage on property D had previously transferred to A subject to a retained life estate, the entire value of the property, unreduced by the mortgage, is includible in D’s gross estate under section 2036 of the Code. If D’s estate is not called upon to pay the indebtedness, no amount of the indebtedness is deductible under section 2053.

First Interstate Bk. of Ariz., N.A. v. U.S., 57 AFTR 2d 86-1561 (D. AZ 1986), addressed first a guarantee that the debtor paid in part after the guarantor’s death:

At the time of death, decedent was guarantor, with his wife, of the $400,000 United Bank loan to the primary obligor T.G.K. Construction Company. Approximately four months after decedent’s death, the primary obligor-T.G.K. paid off $50,000 of the principal on the United Bank loan, leaving $350,000 on the loan.

Plaintiff argues that T.G.K.’s subsequent payment of the $50,000 is irrelevant to the amount of deduction arising from the United Bank loan. Plaintiff argues that the estate is entitled to a deduction equal to the decedent’s one-half community share of the liability represented by the United Bank’s claim, or $200,000. Defendant argues that the deduction should only be in the amount of $175,000 based upon the contingent liability of the decedent-guarantor after payment of the $25,000 of the primary obligor-T.M.C. Determination of the correct amount of deduction allowable to plaintiff turns on whether the post-death event of the payment by the primary obligor is to be taken into account.

“[A]s a matter of law, when claims are for sums certain, and are legally enforceable as of the date of death, post-death events are not relevant in computing the permissible deduction.” *Propstra v. United States*, 680 F.2d 1248, 1254 (9th Cir. 1982). Post-death events are relevant when the claims are disputed or contingent. *Propstra*, 680 F.2d at 1253. The real issue is whether, at the time of decedent’s death, the claim by United Bank against the decedent as guarantor was for a sum certain and legally enforceable or contingent and uncertain.

The ultimate liability of the decedent-guarantor was wholly contingent upon the ability of the primary obligor-T.G.K. to pay the amount due on the note. While in serious financial difficulty at the time of decedent’s death, Stipulation of Facts at 3, T.G.K. was not in default. The ultimate liability, therefore, was uncertain. Post-death events, such as T.G.K.’s payment of $50,000 on the outstanding principal, should be taken into account in determining the deduction.

Consequently, the correct amount of deduction that the estate may claim is $175,000, and the taxable estate was properly calculated by the Internal Revenue Service using the lesser amount.

First Interstate Bk. then considered the deductibility of a claim that, if unsecured, would have been invalid because the lender failed to make a claim against the estate. However, the guarantee was secured by the estate's property, so the estate paid is (using other assets). The court upheld the deduction for the claim, reasoning:

> … Decedent's ultimate liability was contingent upon the ability of T.G.K. to continue construction without needing the construction bonds insured by Fireman's Fund. While T.G.K. was in serious financial shape at the time of decedent's death, Stipulated Facts at 3, it was still operating and continued to operate for almost six months after the decedent's death. Since the claim was uncertain and contingent, post-death events should be considered and failure to comply with Ariz. Rev. Stat. Ann. § 14-3801 would appear to bar the deduction under 26 U.S.C. §2053.
>
> However, Ariz. Rev. Stat. Ann. § 14-3814 provides, in pertinent part:
>
>> If any assets of the estate are encumbered by mortgage, pledge, lien or other security interest, the personal representative may pay the encumbrance or any part thereof ... whether or not the holder of the encumbrance has presented a claim, if it appears to be for the best interest of the estate.
>
> In the instant case, Fireman's Fund had a security interest in all of T.G.K. and the Knochenhauers rights under contracts, subcontracts, machinery and equipment and contract payments. See Plaintiff's Response to Motion for Summary Judgment and Motion for Summary Judgment at 7. Defendant argues that Fireman's Fund did not have a secured obligation. Defendant's Reply Memorandum at 10. A "security interest" is no more than the right of a creditor to attach and perfect an interest in the property superior to the interest of any other creditor. *First Nat'l Bank of Arizona v. Carbajal*, 132 Ariz. 263, 645 P.2d 778, 783 (1982) (in banc). Fireman's Fund had that right under the security-indemnity agreement. As such, the payment of the encumbrance was allowable under Ariz. Rev. Stat. Ann. § 14-3814 as being in the best interest of the estate.

Estate of Cafaro v. Commissioner, T.C. Memo. 1989-348, allowed a deduction for a claim in part to the extent the estate actually paid. Next, the court determined that the decedent was only a guarantor and not a borrower under certain loans:

> When the claims against the estate are based on the fact that the decedent acted as a guarantor or an accommodation party for the debts of another who has not defaulted, such claims are considered unmatured, potential claims, a secondary rather than a primary liability. *Estate of Theis v. Commissioner*, *supra*, 81 TC at 747-748. Thus, when the decedent is a guarantor for the debts of another, events that occurred after the decedent's death and that affected that secondary liability are considered by the courts. *Estate of Hagmann v. Commissioner*, *supra*, 60 TC at 468; *Estate of DuVal v. Commissioner*, *supra*, 4 TC at 726; *Schiffman v. United States*, 51 F. Supp. 728, 732 (Ct. Cl. 1943). In Illinois, a guaranty contract is extinguished when the primary obligor is released from the liability, since there is no longer any obligation to guarantee. *Rock Island Bank & Trust Co. v. Stauduhar*, 59 Ill. App. 3d 892, 375 N.E.2d 1383, 1389-1390 (1978). Events after the death of the decedent may be considered to determine whether an obligation exists and how much of it can be deducted from the guarantor's estate. *Estate of Du Val v. Commissioner*, *supra*, 4 TC at 726. The reasoning behind this is that if two guarantors to the same note died at the same time and outside events were not considered to determine whether the estate was actually required to pay the claim, both

> guarantors would be able to deduct this same debt from their taxable estates, neither of whom might actually ever pay the claim. *Estate of Du Val v. Commissioner*, *supra*.
>
> With regard to the loans as to which the decedent signed his name along with either Associates Partnership, Ltd. or Executive Centers of America, Inc., petitioner claims that the decedent was the co-maker on the loans rather than the guarantor and so the estate may deduct the full amount of the claim. A guarantor or an accommodation maker is a party who signs an instrument in any capacity for the purpose of lending his name to it. Ill. Rev. Stat. ch. 26, par. 3-415(1) (1965); *Marcus v. Wilson*, 16 Ill. App. 3d 724, 306 N.E.2d 554, 559 (1973). The intent of the parties is the significant factor in determining whether the party is an accommodation party, and if no intent is expressed, the purpose or use of the instrument is a significant element. *Aurora Firefighter's Credit Union v. Harvey*, 163 Ill. App. 3d 915, 516 N.E.2d 1028, 1032 (1987); *Holcomb State Bank v. Adamson*, 107 Ill. App. 3d 908, 438 N.E.2d 635, 638 (1982). When a party receives no direct benefit from the execution of a note, including the fact that the party is not the one to whom the proceeds are given, that party will likely be considered an accommodation party. *Aurora Firefighter's Credit Union v. Harvey*, *supra*; *Godfrey State Bank v. Mundy*, 90 Ill. App. 3d 142, 412 N.E.2d 1131, 1136 (1980). The fact that the party may sign the note where makers normally sign does not mean that the party is not an accommodation party. *Holcomb State Bank v. Adamson*, *supra*.

Then, the court denied a deduction with respect to all loan guarantees that had not been called:

> Since the decedent acted as a guarantor with regard to the three bank loans with respect to which the parties primarily liable had not defaulted, these claims are unmatured, potential claims. We conclude that events after the decedent's death may be considered to determine the validity and enforceability of the claims and how much, if any, may be deducted as a claim against the estate. Although the claims on the above three notes were timely filed in the Probate Court, there is no evidence that any of the primary obligors ever defaulted on the debts and all three notes were paid by someone other than petitioner….

Letter Ruling 9321004 involved the following facts:

> The decedent was the founder, sole shareholder, and president of an incorporated architectural firm specializing in interior design. The decedent's 100 percent stock ownership interest was included in his gross estate for federal estate tax purposes at its date of death value.
>
> On December 31, 1988, the decedent executed a written guaranty, personally guaranteeing payment by the corporation of its obligations under an office lease. The obligations included payments for monthly rent as well as specified taxes and expenses. The landlord was not related to the decedent or his corporation. The guaranty covered four calendar years beginning with 1989. The decedent's liability was not to exceed $150,000 for each of the first two years and $75,000 for each of the second two years. Under the guaranty, the landlord could enforce against the decedent any claim it could enforce against the corporation without first enforcing the claim against the corporation.
>
> On October 1, 1990, the decedent died. At his death, the corporation was solvent and not in default on the lease. However, after the decedent's death, the corporation's

business contracted, and the corporation ceased operations about one year after his death.

Approximately five months after the decedent's death, based on the guaranty, the landlord timely filed a contingent creditor's claim in the local probate court against the decedent's estate. The claim was approved by the estate and allowed by the court. In September 1991, about 11 months after the date of death, the corporation defaulted on the lease. On October 15, 1991, soon after the corporation ceased doing business, the landlord terminated the lease, and subsequently demanded $75,000 from the estate under the guaranty. In December 1991, approximately 14 months after the decedent's death, the estate paid the $75,000.

Letter Ruling 9321004 reasoned and ruled:

> Although there is some divergence among the courts concerning the relevance of post-death events in determining the deductibility of claims against an estate under section 2053(a)(3) of the Code,[1] there seems to be general agreement that post-death events would be taken into account if the claim is "contingent" as of the date of death. *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982); *Estate of Cafaro v. Commissioner*, T.C. Memo 1989-348. In *Estate of Cafaro v. Commissioner*, the Tax Court considered the deductibility of claims for debts guaranteed by the decedent for primary obligors who had not defaulted as of the decedent's death. The Tax Court enunciated the following rules concerning decedent-guarantors:
>
>> When the claims against the estate are based on the fact that the decedent acted as a guarantor or as an accommodation party for the debts of another who has not defaulted, such claims are considered unmatured, potential claims, a secondary rather than a primary liability. *Estate of Theis v. Commissioner*, 81 T.C. at 747-748. Thus, when the decedent is a guarantor for the debts of another, events that occurred after the decedent's death and that affected that secondary liability are considered by the courts. *Estate of Hagmann v. Commissioner*, 60 T.C. at 468; *Estate of Du Val v. Commissioner*, 4 T.C. at 726; *Schiffman v. United States*, 51 F.Supp. 728, 732 (Ct. Cl. 1943).
>
> [1] See, generally, *Estate of Van Horne v. Commissioner*, 78 T.C. 728, 736-737 (1982), *aff'd*., 720 F.2d 1114 (9th Cir. 1983), and the cases discussed therein. *Van Horne* held that post-death events are generally not considered in determining the deductibility of an annuity. The Eighth Circuit has found section 2053(a)(3) to require the consideration of post-death events in determining the deductibility of claims against an estate. In *Estate of Sachs v. Commissioner*, 856 F.2d 1158 (8th Cir. 1988), the estate claimed a deduction under section 2053(a)(3) of the Code for an income tax liability owed by the decedent at death which subsequently ceased to exist due to the post-death enactment of retroactive statutory relief. The court held that "an estate loses its [section] 2053(a)(3) deduction for any claim against the estate which ceases to exist legally, regardless of whether the nullification of the claim could have been foreseen." *Id*. at 1161.
>
> The court stated that "the date-of-death principle of valuation does not apply to claims against the estate deducted under [section] 2053(a)(3)." Borrowing from its opinion in *Jacobs v. Commissioner*, 34 F.2d 233 (8th Cir. 1929), *cert. denied*, 280 U.S. 603, the court found that Congress intended the deduction of "actual claims, not theoretical

> ones." Stated the court, "It was, in our opinion, claims presented and allowed or otherwise determined as valid against the estate and actually paid or to be paid that Congress had in mind." *Id*. at 1160.

The court found that because post-death events are to be taken into account and because the estate never paid any amounts pursuant to the guarantee, the estate could not deduct any of the claims based on the guarantee.

In the present case, the decedent died during the second year of the lease, at a time when the corporation was solvent. At his death, under the guaranty, the decedent had a potential liability of $150,000 for calendar year 1990, $75,000 for calendar year 1991, and $75,000 for calendar year 1992. At the time of death, the decedent's estate was subject to a contingent obligation incurred pursuant to a bona fide arm's length contractual arrangement entered into by the decedent prior to his death. Under the guaranty, the decedent's liability was enforceable directly against him if the corporation failed to meet its obligations under the lease. Thus, the estate's post-death payment of its liability under the guaranty was made pursuant to a personal obligation of the decedent existing at the time of his death. As the court explained in *Estate of Cafaro*, post- death events (*i.e.* the default by the primary obligor and payment by the estate) would be taken into account under these circumstances for purposes of section 2053(a)(3) of the Code.

Accordingly, in the present case, the estate may deduct, under section 2053(a)(3) of the Code, the $75,000 it paid as guarantor of the corporation's obligations under the lease reduced by the reasonable value of any right of reimbursement. See Rev. Rul. 84-42, 1984-1 C.B. 194, holding that, if the primary obligor is insolvent and in default when the guarantor's estate pays a claim, the estate can deduct the amount paid reduced by the reasonable value of the right of reimbursement.

Conclusion

The decedent's estate may claim a deduction under section 2053(a)(3) of the Code for the post-death payment of the obligation under the guarantee agreement, even though at the time of the decedent's death the primary obligor had not yet defaulted.

In *Estate of Hendrickson v. Commissioner*, T.C. Memo. 1999-357, the lender never called the guarantee (arising from a loan that morphed from actual to nominal co-borrower), so no deduction was allowed:

As a result of these assumptions by the children (and their spouses), decedent effectively became a guarantor, rather than a co-obligor, with respect to most of the Land Bank loan. Because a guarantor's rights to contribution (or subrogation) are greater than a co-obligor's, it would be inappropriate to determine the value of decedent's contribution rights by reference to the number of obligors on the Land Bank loan. See Estate of *Theis v. Commissioner*, 770 F.2d 981 (11th Cir. 1985) (section 2053 deduction denied in its entirety where decedent was only secondarily liable, because decedent had 100-percent right of contribution from primary debtor), *affg*. 81 T.C. 741 (1983) ….

In *Estate of Theis v. Commissioner*, *supra*, we were required to consider the availability of a deduction for joint and several debt, where the security for the loan was included in

> the decedent's estate. We held that no unpaid mortgage deduction was allowable, because the decedent was in fact a guarantor or accommodation party, rather than a true co-obligor. See *id*. at 748-751.
>
> As noted above, in this case: (1) The children and their spouses expressly assumed most of decedent's share of the Land Bank loan; (2) decedent had rights of contribution (or subrogation) against her co-obligors on the Land Bank loan, but we are unable to determine the value of those rights; (3) petitioner admits that most of the proceeds of the Land Bank loan did not benefit decedent, and there is little evidence that more than a de minimis portion of the proceeds benefited decedent; (4) payments have continued to be made on the Land Bank loan since decedent's death; (5) neither Garry's estate nor decedent deducted the interest on the Land Bank loan; (6) no claims were filed against decedent's estate with respect to the Land Bank loan; and (7) only a small portion of the security for the Land Bank loan was included in decedent's estate.
>
> On the basis of all these facts and circumstances, we hold that petitioner is not entitled to any deduction for the Land Bank loan under section 2053(a)(4), even though a small portion of the security for the loan was included in decedent's estate. See *Estate of Theis v. Commissioner*, supra; *Estate of Courtney v. Commissioner*, *supra*; *cf. Estate of Fawcett v. Commissioner*, 64 T.C. 889 (1975) (Commissioner's determination that one-half of joint and several debt was deductible as an unpaid mortgage was not disturbed); *Estate of Scofield v. Commissioner*, T.C. Memo. 1980-470 (estate's unpaid mortgage deduction, reduced by value of decedent's right of subrogation, held proper where decedent guaranteed secured debt; property securing debt was distributed to decedent's son (the primary debtor) by the estate, subject to the mortgage; and the giving of the guaranty was not a gift).

III.B.1.a.ii.(c). Loan Guarantees Forbidden for IRAs

"Prohibited transaction" includes any direct or indirect "lending of money or other extension of credit" between a plan and a disqualified person.[6271]

If, during any taxable year of an IRA owner, that individual or his beneficiary engages in any prohibited transaction with respect to such account, such account ceases to be an IRA as of the first day of such taxable year.[6272]

III.B.1.a.ii.(d). Income Tax Consequences Involving Loan Guarantees

Generally, a guarantee is not considered to be a payment for income tax purposes. Instead, when the lender forces the guarantor to make a payment, the actual payment is a loan from the guarantor to the borrower.

Guarantees can play a role in certain C corporation debt-equity disputes: C corporation shareholders often prefer to treat advances to the corporation as debt, so that they can extract the money without the extraction constituting a dividend.[6273] This has prompted disputes over whether advances are debt or equity.[6274] Along these lines, a shareholder's guarantee of a corporation's loans may be characterized as a loan to the shareholder followed by the

[6271] Code § 4975(c)(1)(B).
[6272] Code § 408(e)(2)(A). See part II.G.22 IRA as Business Owner, especially fn. 1872.
[6273] See part II.Q.7.h.ii Taxation of Shareholders When Corporation Distributes Cash or Other Property.
[6274] See part II.G.20 Debt vs. Equity; Potential Denial of Deduction for Business Interest Expense.

shareholder's contribution to capital if the corporation is thinly capitalized and the lender looks to the guarantor as the primary source for payment, in which case the corporation's repayment constitutes a distribution to the shareholder that might be taxable as a dividend.[6275] If a corporation is thinly capitalized, the shareholder's payment of the corporation's bank loan pursuant to a guarantee is not deductible as a debt when the loan (really the shareholder's subrogation rights against an insolvent corporation) is more properly characterized as a contribution to capital.[6276]

[6275] *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972) (*cert. den.* 409 U.S. 1076 (1972)), *aff'g* T.C. Memo. 1970-182. See Bittker & Eustice, *Federal Income Taxation of Corporations & Shareholders* (WG&L), ¶ 4.03[3][f][iii] Borrower identity: guarantees and back-to-back loans, stating in a footnote:

> The leading case on this issue is *Plantation Patterns, Inc. v. Comm'r*, 462 F2d 712 (5th Cir.), *cert. denied*, 409 US 1076 (1972); see also *Casco Bank & Trust Co. v. United States*, 544 F2d 528 (1st Cir. 1976), *cert. denied*, 430 US 907 (1977), and cases cited therein; *In re Lane*, 742 F2d 1311, 1320 (11th Cir. 1984) (guaranties used as substitutes for infusion of more capital). But, for cases treating the corporation as the true debtor, see *J. Paul Smyers*, 57 TC 189 (1971) (fact that bank loan would not have been made without guarantee of shareholder does not, per se, make bank loan equity when corporation is not otherwise thin); *Murphy Logging Co. v. United States*, 378 F2d 222 (9th Cir. 1967) (corporation was not thin in either case); *Falkoff v. Comm'r*, 604 F2d 1045 (7th Cir. 1979) (corporation held to be true borrower); *Intergraph Corp.*, 106 TC 312 (1996), *aff'd*, *121 F3d 723* (11th Cir. 1997) (form of loan was to subsidiary; substance followed form; not a guarantor parent). Compare *Joseph Creel*, 72 TC 1173 (1979), aff'd sub nom. *Martin v. Comm'r*, 649 F2d 1133 (5th Cir. 1981) (on facts at issue, where corporation borrowed funds and loaned proceeds to guarantor shareholders, transactions recast as loan by third party to shareholders). The same issue arises in connection with S corporations, as discussed at ¶ 6.06[4][b]; see, *e.g.*, *Bergman v. United States*, 174 F3d 928 (8th Cir. 1999) .

[6276] *Titmas v. Commissioner*, T.C. Memo. 1995-267; *Peterson v. Commissioner*, T.C. Memo. 1997-377. Bittker & Eustice, ¶ 4.03[3][f][iii] Borrower identity: guarantees and back-to-back loans, Federal Income Taxation of Corporations & Shareholders, explains (footnotes omitted, except for one):

> Use of shareholder-guaranteed corporate loans is sometimes suggested as a method of avoiding the thin capitalization problem. The theory is that if the corporation is organized with a minimum of equity capital and then borrows whatever funds it may need from a bank or other outside lender on notes endorsed by its shareholders, the interest paid by the debtor corporation to the lender should be deductible under § 163 and the repayment of the borrowed funds at maturity should not constitute a dividend to its shareholders. This recommendation of guaranteed loans as a solution to the problems of the thin corporation, however, underestimates the perspicacity of the courts. Just as a bond may not necessarily be a bond, a guarantor may not necessarily be a guarantor, and, for that matter, a lender may not necessarily be a lender. In form, the bank may have lent money to the corporation upon the shareholders' guarantee, but the substance of the transaction may be that the bank made the loan to the shareholders, who in turn passed the funds on to the corporation as—perish the thought—a capital contribution.[172]
>
> If a transaction is recast in this fashion, any payments by the corporation to the bank (whether labeled interest or repayment of loan) serve to discharge obligations of the shareholders to the bank and thus are disguised dividends. If the corporation becomes insolvent, however, the shareholders would suffer capital losses (long-term or short-term, as the case may be) under § 165(g), rather than short-term capital losses under § 166(d) as interpreted by the *Putnam* case. Similarly, where a loan is made by one party to an intermediary party who relends to a borrower that is related to the first lender (a so-called back-to-back loan), regulations may recast such transactions, under appropriate circumstances, in accordance with their true substance, namely, as a direct loan from the first lender to the related borrower.

Footnote 172:

However, that loan treatment does not extend to the S corporation arena for the purpose of creating basis to absorb loss; for that specific purpose, an actual loan and not a mere guarantee is required.[6277] Only when the guarantor pays on the loan is the guarantor considered to have made a loan.[6278]

In the partnership arena, a guarantee does not constitute a liability,[6279] but it can affect how debt is allocated among the partners, because generally debt is allocated according to who bears the economic risk of loss.[6280] For more information, see part II.C.3 Allocating Liabilities (Including Debt), including when a guarantee may be disregarded in allocating liabilities; *Tribune Media Company v. Commissioner*, T.C. Memo. 2021-122, respected a guaranty, concluding:[6281]

> We will not invalidate a collection guaranty simply because the lenders must seek payment from other potential sources before turning to the guarantor. Similarly, we will not invalidate a guaranty because the borrowing entity structured its debt to mitigate the risk of default. An entity may (and is perhaps encouraged to) create a debt structure that maximizes its ability to satisfy the terms of its debt agreements.

When a taxpayer makes a payment to discharge part or all the taxpayer's agreement to act as a guarantor where the agreement provides for a right of subrogation or other similar right against the issuer, treatment as a worthless debt is not allowed until the taxable year in which the right of subrogation or other similar right becomes totally worthless (or partially worthless in the case of an agreement which arose in the course of the taxpayer's trade or business).[6282] Normally, a

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The leading case on this issue is *Plantation Patterns, Inc. v. Comm'r*, 462 F2d 712 (5th Cir.), *cert. denied*, 409 US 1076 (1972); see also *Casco Bank & Trust Co. v. United States*, 544 F2d 528 (1st Cir. 1976), *cert. denied*, 430 US 907 (1977), and cases cited therein; *In re Lane*, 742 F2d 1311, 1320 (11th Cir. 1984) (guaranties used as substitutes for infusion of more capital). But, for cases treating the corporation as the true debtor, see *J. Paul Smyers*, 57 TC 189 (1971) (fact that bank loan would not have been made without guarantee of shareholder does not, per se, make bank loan equity when corporation is not otherwise thin); *Murphy Logging Co. v. United States*, 378 F2d 222 (9th Cir. 1967) (corporation was not thin in either case); *Falkoff v. Comm'r*, 604 F2d 1045 (7th Cir. 1979) (corporation held to be true borrower); *Intergraph Corp.*, 106 TC 312 (1996), *aff'd*, 121 F3d 723 (11th Cir. 1997) (form of loan was to subsidiary; substance followed form; not a guarantor parent). Compare *Joseph Creel*, 72 TC 1173 (1979), *aff'd sub nom. Martin v. Comm'r*, 649 F2d 1133 (5th Cir. 1981) (on facts at issue, where corporation borrowed funds and loaned proceeds to guarantor shareholders, transactions recast as loan by third party to shareholders). The same issue arises in connection with S corporations, as discussed at ¶ 6.06[4][b]; see, *e.g.*, *Bergman v. United States*, 174 F3d 928 (8th Cir. 1999).

[6277] See part II.G.4.d.ii.(a) Limitations on Using Debt to Deduct S Corporation Losses, fns. 1203-1204.

[6278] Reg. § 1.1366-2(a)(2)(ii), reproduced in fn. 1203. Reg. § 1.1366-2(a)(2)(iii), Example (4) provides: *Guarantee*. A is a shareholder of S, an S corporation. In 2014, S received a loan from Bank. Bank required A's guarantee as a condition of making the loan to S. Beginning in 2015, S could no longer make payments on the loan and A made payments directly to Bank from A's personal funds until the loan obligation was satisfied. For each payment A made on the note, A obtains basis of indebtedness under paragraph (a)(2)(ii) of this section. Thus, A's basis of indebtedness is increased during 2015 under paragraph (a)(2)(ii) of this section to the extent of A's payments to Bank pursuant to the guarantee agreement.

[6279] Reg. § 1.752-1(a)(4)(i), quoted in part II.C.3.b What Is a "Liability" in fn 396.

[6280] See also Reg. § 1.175-4(b)(2)(iv)(A).

[6281] For an excerpt from the case with a complete discussion, see part II.C.3.c.ii.(a) Permanent Rules Allocating Economic Risk of Loss to Recourse Liabilities.

[6282] Reg. § 1.166-9(e)(2). *Intergraph Corp. v. Commissioner*, 106 T.C. 312, 324 (1996), held:

guarantor's payment on a debt will be deductible,[6283] either as a business bad debt[6284] or non-business bad debt. Bad debt deductions apply only where the taxpayer received reasonable consideration for making the guarantee and provides that consideration received from a spouse or other defined family member must be direct consideration in the form of cash or property.[6285]

When a guarantor becomes primarily liable on a debt and that debt is later forgiven, the forgiveness does not constitute cancellation of indebtedness income.[6286] That's because merely providing the guarantee does not increase the guarantor's assets.[6287] If a taxpayer who

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> Section 1.166-9(a), (d), and (e)(2), Income Tax Regs., properly read, stands for the proposition that where a guarantor does have rights of subrogation and reimbursement from the original debtor (regardless of whether or not these rights are expressly stated in the guaranty agreement), the provisions of section 1.166-9(e)(2), Income Tax Regs., apply, and the guarantor is not entitled to a bad debt deduction until the rights of subrogation and reimbursement are shown to be worthless. See *Howell v. Commissioner*, 69 F.2d 447, 451 (8th Cir. 1934), *affg.* 22 B.T.A. 140 (1931); *Martin v. Commissioner*, 52 T.C. 140, 143 (1969); *Rietzke v. Commissioner*, 40 T.C. 443, 451 (1963), *affd.* 424 F.2d 1368 (9th Cir. 1970); *Bradford v. Commissioner*, 22 T.C. 1057, 1069 (1954), *revd.* on other issues 233 F.2d 935 (6th Cir. 1956); *Standard Oil Co. v. Commissioner*, 7 T.C. 1310, 1323 (1946), *supplemented by* 11 T.C. 843 (1948).

[6283] See Blattmachr and Zaritsky, Is the BDIT Ready for Primetime? *Probate Practice Reporter* (University of South Carolina School of Law, ISBN 1044-7423), Sept. 2012.

[6284] For a debt to be a business bad debt, it needs to be incurred in connection with the taxpayer's trade or business; furthermore, to be engaged in a trade or business, an individual must be involved in an activity with continuity and regularity, and the primary purpose for engaging in the activity must be for income or profit. *Alpert v. Commissioner*, T.C. Memo. 2014-70 (sustaining accuracy-related penalties when taxpayer could not produce credible evidence of the above).

[6285] Reg. § 1.166-9(e); *Lair v. Commissioner*, 95 T.C. 35 (1990) (imposing penalties for deducting loss on guarantee of family member's obligation in light of that regulation).

[6286] *Mylander v. Commissioner*, T.C. Memo. 2014-191, reasoning:

> Under the guaranty petitioners were secondary obligors as to the Murray debt because they were obligated to pay the debt only if the Ledbetters—the primary obligors—defaulted. See *Restatement 3d*, Suretyship & Guaranty, sec. 1 (1996). When the Ledbetters defaulted, a cause of action against petitioners accrued to Mr. Murray which led to the State court judgment against petitioners and the subsequent covenant not to execute. Under the State court judgment, as well as the covenant not to execute, petitioners' secondary obligation became a primary obligation. See *Chevron Chem. Co. v. Mecham*, 536 F.Supp. 1036, 1043 (D. Utah 1982) (Default on the primary contract by the debtor ripens an unconditional guaranty into an actionable liability of the guarantor separate and apart from that of the principal debtor. The guarantor's obligation becomes absolute and is no longer secondary[.]).
>
> Petitioners argue that even if they had become primary obligors on the Murray debt, they did not realize any COD income when the remaining debt was forgiven because they did not receive the benefit of the non-taxable proceeds from the loan obligation. We agree with petitioners.

[6287] *Mylander v. Commissioner*, T.C. Memo. 2014-191, reasoning:

> Even though petitioners had become primary obligors under the guaranty, their situation remained similar to those of the taxpayers in *Hunt* and *Landreth*. We observed in *Landreth v. Commissioner*, 50 T.C. at 813, that where the guarantor is relieved of his contingent liability *** because of a release given him by the creditor, no previously untaxed accretion in assets thereby results in an increase in net worth. See also *Hunt v. Commissioner*, T.C. Memo. 1990-248, 59 T.C.M. (CCH) at 649-650 (quoting *Landreth v. Commissioner*, 50 T.C. at 813).
>
> We do not see any material difference between the situation in *Landreth* and one in which a guarantor's contingent liability has ripened into a primary liability. Unlike a debtor who borrows funds, a guarantor who assumes a contingent liability does not receive an untaxed accretion of assets which is accompanied by an offsetting obligation to pay. This remains the case even after the guarantor becomes a primary obligor because of the debtor's default. Regardless of whether

intended to be a guarantor mistakenly signs loan documentation as the primary obligor and the taxpayer never received the loan proceeds, never made payments, and never was looked to for payments, the taxpayer is recognized as a mere guarantor and does not realize income when the loan is forgiven.[6288] A cash basis guarantor who issues a note to the lender does not thereby make a deductible payment.[6289]

> the guarantor is a secondary obligor or has become a primary obligor, when the debt is discharged the guarantor's net worth is not increased over what it would have been if the original transaction had never occurred. *Landreth v. Commissioner*, 50 T.C. at 813.
>
> Petitioners did not receive any untaxed accretion of assets when they gave the guaranty. Nor did they receive any untaxed accretion of assets with respect to the guaranty when they later became primarily liable on the Murray debt as a result of the State court judgment. Therefore, when the remaining debt was forgiven petitioners did not realize an untaxed increase in wealth any more than had they remained secondary obligors.[14]
>
> [14] Respondent argues that, pursuant to our decision in *Hahn v. Commissioner*, T.C. Memo. 2007-75, petitioners received an accession to wealth upon the discharge of the remaining debt. We find that *Hahn* is distinguishable because in that case the taxpayer was a debtor, not a guarantor, and received untaxed loan proceeds. *Id.*, slip op. at 2.

The court concluded:

> Petitioners were initially secondary obligors on the Murray debt, under the terms of the guaranty. They did not receive any valuable consideration in exchange for the guaranty. Upon the Ledbetters' default, and the subsequent State court judgment and covenant not to execute, petitioners became primarily liable on the Murray debt. However, at no point did they receive an untaxed accretion of assets with respect to the guaranty. Accordingly, we find that, when the remaining debt was forgiven by Mr. Murray in 2010, petitioners did not have an accession to wealth and did not realize any COD income.

[6288] *Bullock v. Commissioner*, T.C. Memo. 2017-219, relying on the testimony of the taxpayer of her daughter-in-law (one of the intended borrowers), reasoned:

> When petitioner went to the car dealership, she did not intend to be the primary obligor on the loan. In fact, she did not realize until trial that she had signed paperwork stating otherwise. She did not intend to personally repay the loan, and she made no payments on the loan. See *Monon R.R. v. Commissioner*, 55 T.C. 345, 357 (1970) ("The intent of the parties, in turn, may be reflected by their subsequent acts[.]"). The credit union also understood that petitioner intended only to be a cosigner; it was aware that petitioner's son and daughter-in-law were responsible for the loan payments, and it never looked to petitioner for repayment. See *id* . Without an intention for petitioner to repay the debt, there was no bona fide primary obligation between petitioner and the credit union. See *PepsiCo P.R., Inc. v. Commissioner*, T.C. Memo. 2012-269, at *55, *88-*91 (emphasizing the lack of intent to create a repayable obligation as a factor in holding that no debt existed).
>
> Instead, petitioner, with the knowledge of the credit union, essentially operated as a guarantor for her son and daughter-in-law. Petitioner was merely promising to be responsible for her son and daughter-in-law in the event they failed to make the loan payments; she made no payments on the loan, and she never used the truck.
>
> Because petitioner was merely the secondary obligor, her net worth was not "increased over what it would have been if the original transaction had never occurred." See *Mylander v. Commissioner*, at *18, *22 (holding that the taxpayers did not receive COD income for a debt that they had become primary obligors on via a guaranty (citing *Landreth v. Commissioner*, 50 T.C. at 813)). When the truck loan was forgiven, petitioner did not realize an untaxed increase in wealth. See *id*. at *23. Therefore, petitioner did not receive $8,164 in cancellation of debt income...

PepsiCo P.R., Inc. v. Commissioner is quoted extensively in the text accompanying fn. 1839 in part II.G.20 Debt vs. Equity; Potential Denial of Deduction for Business Interest Expense.

[6289] *Helvering v. Price*, 309 U.S. 409 (1940), following *Eckert v. Burnet*, 283 U.S. 140 (1931), which held:

Factors determining whether a corporation may deduct guarantee fees paid to shareholders include: the fees must be reasonable,[6290] businesses of the same type and size as the payor corporation must customarily pay guarantor fees to their shareholders, shareholders must demand compensation in exchange for signing on as guarantors, the payment of guarantor fees suggests a constructive dividend if the corporation's profitability enabled it to pay a dividend and yet no dividends were paid out during the relevant tax year, and the courts give consideration to the proportional relationship between the amount of the payments and the shareholders' stock ownership.[6291] In deciding the deductibility of guaranty fees paid to a shareholder employee, courts consider:[6292]

> The facts of the transaction concerned were that the petitioner and his partner were joint endorsers of notes issued by a corporation that they had formed. There remained due upon these notes $44800, that the corporation was unable to pay. In 1925 the petitioner and his partner in settlement of their liability made a joint note for that sum to the bank that held the corporation's paper, received the old notes, marked paid, and destroyed them. The petitioner claims the right to deduct half that sum as a debt "ascertained to be worthless and charged off within the taxable year" under the Revenue Act of 1926, c. 27, § 214(a)(7), 44 Stat. 9, 27 (26 USCA § 955(a)(7).
>
> It seems to us that the Circuit Court of Appeals sufficiently answered this contention by remarking that the debt was worthless when acquired. There was nothing to charge off. The petitioner treats the case as one of an investment that later turns out to be bad. But in fact it was the satisfaction of an existing obligation of the petitioners, having, it may be, the consequence of a momentary transfer of the old notes to the petitioner in order that they might be destroyed. It is very plain we think that the words of the statute cannot be taken to include a case of that kind. We do not perceive that the case is bettered by the fact that some of the original notes years before were given for property turned over to the corporation by the partnership that formed it. For the purpose of a return upon a cash basis there was no loss in 1925 . As happily stated by the Board of Tax Appeals the petitioner "merely exchanged his note under which he was primarily liable for the corporation's notes under which he was secondarily liable, without any outlay of cash or property having a cash value." A deduction may be permissible in the taxable year in which the petitioner pays cash. The petitioners says that it was definitely ascertained in 1925 that the petitioner would sustain the losses in question . So it was, if the petitioner ultimately pays his note. So was the tax considered in *United States v. Mitchell*, 271 U.S. 9, 12, 46 S.Ct. 418, 70 L.Ed. 799, but it could not be deducted until it was paid.

[6290] Bittker & Lokken, ¶ 79.4. Loans or Advances, *Federal Taxation of Income, Estates, and Gifts* (WG&L), when discussing Code § 482 implications of interest paid between related companies,

> A related issue, which has not been directly litigated in the United States, is arm's length pricing of fees for guaranteeing a related person's debt. See *General Elec. Capital Canada Inc. v. Queen*, 2009 TCC 563 (Tax Court of Canada 2009); Breen, Evaluating the Arm's-Length Price of Financial Guarantees; A Review of the OECD Framework, 59 Tax Notes Int'l 869 (Sept. 13, 2010); Hales, Robinson, Axelsen & Ielceanu, Determining Arm's-Length Guarantee Fees, 39 Tax Mgmt. Int'l J. 445 (2010); Stewart, Officials Engage Practitioners on Pricing of Guarantee Fees, 127 Tax Notes 770 (May 17, 2010). See also Horst, How to Determine Tax-Deductible, Debt-Related Costs For a Subsidiary, 62 Tax Notes Int'l 589 (May 16, 2011); Miller, Federal Income Tax Consequences of Guarantees: A Comprehensive Framework for Analysis, 48 Tax Law. 103 (1994).

[6291] *Seminole Thriftway, Inc. v. U.S.*, 42 Fed. Cl. 584 (1999), after discussing *Tulia Feedlot, Inc. v. U.S.*, 513 F.2d 800, 804 (5th Cir. 1975); *Olton Feed Yard, Inc. v. U.S.*, 592 F.2d 272 (5th Cir. 1979); *Tulia Feedlot, Inc. v. U.S.*, 3 Cl. Ct. 364 (1983); and *Fong v. Commissioner*, T.C. Memo. 1984-402. *A.A. and E.B. Jones Co. v. Commissioner*, T.C. Memo. 1960-284, approved fees for guaranteeing surety bonds that were required to do business when the taxpayers proved that the payments were usual and were comparable to others in somewhat similar circumstances.

[6292] *E.J. Harrison and Sons, Inc. v. Commissioner*, T.C. Memo. 2003-239, citing:

(1) Whether, given the financial risks, the fees are reasonable in amount;

(2) whether businesses of the same type and size as the payor must customarily pay guarantor fees to shareholders;

(3) whether the shareholder demanded compensation for the guaranty;

(4) whether the payor had sufficient profits to pay a dividend, but failed to do so; and

(5) whether the purported guaranty fees were proportional to stock ownership.

Clary Hood, Inc. v. Commissioner, T.C. Memo. 2022-15, reasoned and held:

> Petitioner's justification for Mr. Hood's higher compensation for the years at issue includes Mr. Hood's debt guaranties and surety bond guaranties during the review period. Guaranty fees may qualify as a deductible business expense under section 162(a). See *R.J. Nicoll Co. v. Commissioner*, 59 T.C. at 51-52; *A.A. & E.B. Jones Co. v. Commissioner*, T.C. Memo. 1960-284. This Court has taken into account some of the following considerations when deciding the deductibility of such fees paid to a shareholder-employee: (1) whether the fees were reasonable in amount given the financial risks; (2) whether businesses of the same type and size as the payor customarily pay such fees to shareholders; (3) whether the shareholder-employee demanded compensation for the guaranty; (4) whether the payor had sufficient profits to pay a dividend but failed to do so; and (5) whether the purported guaranty fees were proportional to stock ownership. *E.J. Harrison & Sons, Inc. v. Commissioner*, 2003 WL 21921049, at *14; *Fong v. Commissioner*, T.C. Memo. 1984-402, *aff'd without published opinion*, 816 F.2d 684 (9th Cir. 1987).
>
> The record shows that it is customary for the owners of construction companies to guarantee debts and bonds, and that compensation for these guaranties is appropriate.

See *Olton Feed Yard, Inc. v. United States*, 592 F.2d 272, 275-276 (5th Cir. 1979); *Tulia Feedlot, Inc. v. United States*, 513 F.2d 800, 803-806 (5th Cir. 1975); *Fong v. Commissioner*, T.C. Memo. 1984-402, *affd*. without published opinion 816 F.2d 684 (9th Cir. 1987); *Seminole Thriftway, Inc. v. United States*, 42 Fed. Cl. 584, 589-590 (1998) (the guaranty fee cases).

The court held:

> Mrs. Harrison's loan guaranties represented one of her principal contributions to petitioner. They did not, as in the no-fee cases, merely supplement her performance of substantial managerial activities on petitioner's behalf. Therefore, we find those cases to be inapposite. Rather, we find that the factors utilized in the guaranty fee cases are properly suited to the task of determining what amount, if any, may be considered reasonable compensation for Mrs. Harrison's personal guaranties. Because (1) Mrs. Harrison was willing to issue the guaranties without compensation, (2) there is no evidence that businesses of the same type and size as petitioner customarily paid guarantor fees to shareholders, (3) petitioner had sufficient profits to pay dividends, but failed to do so, and (4) the evidence does not establish what amount, if any, would constitute reasonable compensation for her guaranties, we find that Mrs. Harrison's guaranties do not support the characterization of any amount she received from petitioner as reasonable compensation. Instead, we view the shareholder guaranties in this case as a means of protecting the shareholders' ownership interests in petitioner, not as a function of their employment by petitioner. See *Olton Feed Yard, Inc. v. United States*, 592 F.2d at 275-276 (stating that employee-shareholders' willingness to guaranty, without charge, the corporate employer's debt is evidence that such individuals "signed the guaranties in order to protect and enhance their investment in the corporation").

> Further, respondent's expert witness, Mr. Fuller, found that the compensation petitioner paid to Mr. Hood in the years at issue for his surety bond guaranties was reasonable.[28] We recognize that Mr. Hood historically did not seek compensation for the guaranties and petitioner had sufficient profits to pay a dividend during the years at issue; however, we place more weight on the customary nature and reasonableness of the fees.
>
> > [28] Mr. Fuller distinguishes the surety bond guaranties from the debt guaranties. He concluded that no compensation should have been issued with respect to the debt guaranties because petitioner also lent money and extended credit to Mr. Hood and his other businesses during the years at issue.

(Above we are focusing on compensating a shareholder for financial risk. For compensating a shareholder for services performed, see part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment.)

When a savings and loan association engaged in the financing of residential mortgages, established a "pool" of mortgages, all of which are insured by the Federal Housing Administration, the Farmers Home Administration, or are insured or guaranteed by the Veterans Administration, those who bought an interest in the mortgages[6293] may deduct the servicing, custodian, and guarantee fees under Code § 162 or 212.[6294]

Code § 102 (no income on a gift) trumps Code § 61(a)(2) (discharge of indebtedness is income income).[6295]

III.B.1.a.iii. Gift of Services

The gift tax applies to gifts of property, not services. Before *Dickman*, the courts generally concluded that the gift tax only applied to transfers of title or interest in property. This is clearly no longer true, considering how the court chose to define "property": "[It] is more than just the physical thing – the land, the bricks, the mortar – it is also the sum of all the rights and powers incident to ownership of the physical thing. Property is composed of constituent elements and of these elements the right to *use* the physical thing to the exclusion of others is the most essential and beneficial."[6296]

[6293] Rev. Rul. 84-10 treated the pools as multiple owner grantor trusts, presumably having in mind the rules discussed in part II.D.4.a Investment Trusts, which is part of part II.D.4 Disregarding Multiple Owner Trust for Income Tax Purposes. Rev. Rul. 84-10 noted:

> The Service has discussed the federal income tax consequences of similar pooling arrangements in Rev. Rul. 71-399, 1971-2 C.B. 433, amplified by Rev. Rul. 81-203, 1981-2 C.B. 137, Rev. Rul. 80-96, 1980-1 C.B. 317, Rev. Rul. 74-300, 1974-1 C.B. 169, Rev. Rul. 74-221, 1974-1 C.B. 365, and Rev. Rul. 72-376, 1972-2 C.B. 647 (concerning mortgage pools established by the Federal Home Loan Mortgage Corporation); Rev. Rul. 70-544, 1970-2 C.B. 6, and Rev. Rul. 70-545, 1970-2 C.B. 7, both modified by Rev. Rul. 74-169, 1974-1 C.B. 147 (concerning mortgage pools guaranteed by the Government National Mortgage Association); and Rev. Rul. 77-349, 1977-2 C.B. 20 (concerning a mortgage pool created by a commercial bank).

[6294] Rev. Rul. 70-544.

[6295] *Helvering v. American Dental*, 318 U.S. 322 (1943) (interpreting predecessors to these statutes); *Bosse v. Commissioner*, T.C. Memo. 1970-355 (not citing *Helvering v. American Dental* but rather determining the gratuitous nature of the forgiveness).

[6296] *Dickman*, 465 U.S. at 336, quoting *Passailaigue v. U.S.*, 224 F.Supp 682, 686 (M.D. Ga. 1963).

A pre-*Dickman* case held that donating one's own services does not create gift tax liability relating to the value or profits derived from those services.[6297] "The taxpayer is not under any duty to cultivate the fruits of his capital (or labor) and will not be taxed as if he had when he hasn't."[6298] Also, *Dickman* states that the gift tax is an excise tax on transfers of property.[6299] *Dickman* did not address gifts of services.

The IRS ruled that a timely waiver of fees for serving as executor was neither income to, nor a gift by, the executor, reasoning:[6300]

> The crucial test of whether the executor of an estate or any other fiduciary in a similar situation may waive his right to receive statutory commissions without thereby incurring any income or gift tax liability is whether the waiver involved will at least primarily constitute evidence of an intent to render a gratuitous service. If the timing, purpose, and effect of the waiver make it serve any other important objective, it may then be proper to conclude that the fiduciary has thereby enjoyed a realization of income by means of controlling the disposition thereof, and at the same time, has also effected a taxable gift by means of any resulting transfer to a third party of his contingent beneficial interest in a part of the assets under his fiduciary control. See [Revenue Rulings 56-472 and 225] and the authorities therein cited, as well as section 25.2511-1(c) of the Gift Tax Regulations.
>
> The requisite intention to serve on a gratuitous basis will ordinarily be deemed to have been adequately manifested if the executor or administrator of an estate supplies one or more of the decedent's principal legatees or devisees, or of those principally entitled to distribution of decedent's intestate estate, within six months after his initial appointment as such fiduciary, with a formal waiver of any right to compensation for his services. Such an intention to serve on a gratuitous basis may also be adequately manifested through an implied waiver, if the fiduciary fails to claim fees or commissions at the time of filing the usual accountings and if all the other attendant facts and circumstances are consistent with a fixed and continuing intention to serve gratuitously. If the executor or administrator of an estate claims his statutory fees or commissions as a deduction on one or more of the estate, inheritance, or income tax returns which are filed on behalf of the estate, such action will ordinarily be considered inconsistent with any fixed or definite intention to serve on a gratuitous basis. No such claim was made in the instant case.

Commentators generally agree that, if the service provider clearly establishes intent not to charge for services before the service provider earned compensation income, then gratuitously rendering services will not constitute a gift, because no property has been transferred.

For services generating property interests benefitting donees, see part III.B.1.a.v Sending Business or Performing Services.

[6297] *Hogle v. Commissioner*, 7 T.C. 986 (1946 reviewed decision), *aff'd* 165 F.2d 352 (10th Cir. 1947).
[6298] *Crown*, 585 F.2d at 236
[6299] *Dickman*, 465 U.S. at 340.
[6300] Rev. Rul. 66-167, followed *Breidert v. Commissioner*, 50 T.C. 844 (1968) (executor's commission was claimed on estate tax return but was still deemed not income when executor refused to pay himself), Rev. Rul. 70-237, and Letter Ruling 7846049. *Breidert v. Commissioner* was distinguished in *O'Connell v. Commissioner*, T.C. Memo. 1980-432.

III.B.1.a.iv. Family Partnerships

III.B.1.a.iv.(a). Gift/Estate Tax Uses and Issues Regarding Family Partnerships

Generally, my materials do not cover valuation disputes, annual exclusion issues, or Code § 2036 cases. Code § 2036 causes estate inclusion when a decedent retained the right to income from or certain other rights to property that the decedent transferred except in a bona fide sale for adequate and full consideration in money or money's worth.[6301] The Tax Court seems to employ a smell test when evaluating partnerships or other arrangements that generate significant discounts from the net asset (fair market) value of the entity's underlying assets.[6302]

[6301] For a very brief summary of this issue and how using an S corporation instead of a partnership can avoid the issue, see fns. 91-92 in part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders.
[6302] For example, see *Cahill* and related cases regarding intergenerational split dollar arrangements, described in part II.Q.4.f.v Estate Tax Consequences of Split-Dollar Agreements.

However, a decedent's rights over distributions from a Massachusetts business trust[6303] did not implicate Code § 2036(a)(2)[6304] or 2038.[6305]

[6303] The official Tax Court syllabus of *Estate of Cohen v. Commissioner*, 79 T.C. 1015 (1982), described:

Over a period of about 28 months ending some 4 years prior to his death, the decedent transferred all of his common shares and 7,350 of his 7,500 preferred shares in a Massachusetts real estate trust to his children, grandchildren, and great-grandchildren. The primary function of the trust was to lease a store facility to the corporate retail business operated by the decedent and his three sons. The decedent and his sons were the trustees of the trust when the transfers were made and at all times thereafter until the death of the decedent. *Held*: The discretion accorded the trustees in the trust agreement in respect of the declaration and payment of annual dividends on the common and preferred shares was not unlimited under State law; it was conditioned at least upon a good-faith exercise of bona fide business judgment. Accordingly, in view of the substantial similarity between this real estate trust and a corporation, the trustees' dividend power did not constitute a "right" to designate possession or enjoyment of the income of the shares. *United States v. Byrum*, 408 U.S. 125 (1972), followed.

[6304] The court held:

In view of the perceived limitations on the dividend power in the trust agreement in question, and the apparent willingness of the Massachusetts courts to hold business trustees to a fair standard of conduct,[3] we conclude that the decedent and his sons did not have the power to withhold dividends arbitrarily. Thus, they did not have an "ascertainable and legally enforceable" right to shift income between the classes of shareholders, and the dividend power does not require inclusion of either the common or preferred shares in the decedent's estate under section 2036(a)(2). We think *Byrum* is controlling.[4]

[3] Moreover, we think that the Massachusetts courts would be even more alert to look into the existence of business judgment of the trustees where the exercise of the trustees' discretion might operate to the disadvantage of one group of beneficiaries in favor of another group.

[4] The facts in this case make it a much weaker one for the Government than *Estate of Gilman v. Commissioner*, 65 T.C. 296 (1975), *affd*. 547 F.2d 32 (2d Cir. 1976). By reason of the unusual facts there presented, a sharp division arose within this Court. The dissenters were of the view that the decedent had retained the actual enjoyment of the transferred shares which made section 2036(a)(1) applicable. However, there was no disagreement between the majority and the dissenters as to the applicability of *Byrum* under sec. 2036(a)(2), and in view of the reliance by the majority upon *Byrum* in respect of both subsections (a)(1) and (a)(2), the controlling effect of *Byrum* in the present case follows *a fortiori* from *Gilman*. Here, there is no contention whatever that the decedent retained actual enjoyment of the transferred shares. Indeed, the record shows that he had long ceased to exercise any meaningful control over the enterprise, and that it had, in fact, reached the point where it had largely surpassed his comprehension. His role was primarily of a ceremonial nature without any real exercise of business control or even any significant participation in the business, which was, in fact, being run by his three sons.

The Government also contends that the power of the trustees to redeem the preferred shares at par value is a right to designate enjoyment under section 2036(a)(2). It is stipulated, however, that fair market value of these shares was equal to their par value at the decedent's death, and we fail to see how enjoyment of the shares would be diminished by the payment of fair market value in exchange therefor. This would simply give the beneficiary more freedom of action in respect of the transferred property, while section 2036 is designed to draw into the estate property of which the decedent has in some way kept control. The Government's contention must be rejected.

[6305] The court held:

The 1970 amendment which created the two classes of shares in no way purported to change the alteration provision or the termination provision, and in the absence of any persuasive indications to the contrary, we think that the amendment must be construed to leave intact such critical rights. A fair construction of the amended agreement is that the absence of a vote for the

In *Estate of Clyde W. Turner, Sr. v. Commissioner*, 151 T.C. No. 10 (2018), the Code § 2207B right of recovery regarding estate tax on Code § 2036 assets prevented that estate tax from reducing the marital deduction.[6306]

preferred shareholders is meant to exclude them from participation in the regular business affairs of the trust, but that their consent must nevertheless be obtained in respect of such fundamental matters as alteration of the agreement and termination of the trust. And this construction is consistent with the language of the amendment, which states that "The beneficial interests of the cestuis que trustent shall be represented by transferable shares which shall consist of two classes." Thus, the two classes of shares *together* represent the "cestuis que trustent," and these are the same "cestuis que trustent" whose consent is required. Therefore, even after 1790, the agreement could be altered or the trust terminated only with the consent of "all parties having an interest." Because these provisions appear to add nothing to the rights of the parties under Massachusetts law (see *Ryan v. McManus*, 323 Mass. 221, 80 N.E.2d 737, 742 (1948); *Commissioner of Corporations, Etc. v. Second Nat. Bank*, 308 Mass. 1, 30 N.E.2d 889, 895 (1941)),[5] section 2038 is rendered inapplicable here by section 20.2038-1(a)(2), Estate Tax Regs., quoted supra.[6]

[5] These Massachusetts decisions were concerned with regular trusts rather than realty trusts. Nevertheless, they seem particularly relevant here, because the Mezuries shares were transferable and in each of these cases the Supreme Judicial Court stressed the connection between the assignability of beneficial interests and the power of the beneficiaries to alter or terminate the trust. For example, in *Commissioner of Corporations, Etc. v. Second Nat. Bank*, the court stated (30 N.E.2d at 895):

> "The power conferred by law upon the beneficiaries acting together to terminate or modify the trust is closely analogous with respect to each beneficiary, to the power of such beneficiary to assign his interest in the trust estate."
>
> See also *Ryan v. McManus*, 80 N.E.2d at 742.

[6] Even if the Government were correct in its interpretation of the amended trust agreement, so that the consent of only the holders of the common shares was required in order to alter the agreement or terminate the trust, the common shares transferred by the decedent in 1970 would in any event be excluded from his gross estate by reason of sec. 20.2038-1(a)(2), Estate Tax Regs.

[6306] The court held:

Under section 2036 the gross estate includes the values of the section 2036 assets that Clyde Sr. transferred during his lifetime. The fact that property that might otherwise go to the surviving spouse would be used to pay the estate tax liabilities attributable to the section 2036 assets does not compel a conclusion that the marital deduction must be reduced. The estate is entitled to recover from the recipients of section 2036 assets during Clyde Sr.'s lifetime an amount equal to the liability attributable to the section 2036 inclusion that the estate pays. That recovery will enable the estate to distribute to the surviving spouse property value undiminished by the tax payments. Section 20.2056(b)-4(c), Estate Tax Regs., does not require a different result when the Federal estate and State death taxes have no effect upon the net value distributable to the surviving spouse. See, *e.g.*, *Estate of Gill v. Commissioner*, T.C. Memo. 2012-7 (marital deduction not reduced where marital deduction property does not bear the economic burden of the tax). Accordingly, we hold that the estate need not reduce the marital deduction by the amount of Federal estate and State death taxes it must pay because the tax liabilities are attributable to the section 2036 assets, the estate has the right to recover the amount paid under section 2207B, and the estate must exercise that right to recover to give effect to Clyde Sr.'s intention that Jewell receive her share of the estate undiminished by the estate's tax obligations. Respondent makes an additional argument that focuses on the interest owed on the Federal estate tax liability. Respondent contends that under section 20.2056(b)-4, Estate Tax Regs., the estate tax interest expense is a transmission expense,[11] and therefore it reduces the residue and correspondingly reduces the marital deduction. However, under section 2207B(c), "[i]n the case

When a partner receives a capital account (or increases an existing capital account) by the fair market value of contributed assets (as is required by the regulations under Code § 704(b)),[6307] the contribution to the partnership is not a gift.[6308] However, if the partnership's income and loss are not proportionate to capital accounts, see parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.

Any part of the discussion below that relates to preferred partnership is subject to part III.B.7.b Code § 2701 Overview when considering how to structure a preferred return so that the preferred return is given effect for gift tax purposes (including whether a sale is for adequate and full consideration). Note, however, that using a preferred partnership may help avoid Code § 2036.[6309]

One problem with sales to irrevocable grantor trusts[6310] is that neither the growth nor the value of the asset at the time of the sale receives a basis step-up at death; the same issue applies to gifts. Considerable growth is required for the estate tax savings to make up for the income tax benefits lost due to the lack of a basis step up.[6311] See part II.H Income Tax vs. Estate and Gift Tax (Particularly for Depreciable Property). One way to obtain a basis step-up on the value of the gift or sold asset at the time of the transfer is to retain a preferred partnership interest and transfer the common interest.[6312]

III.B.1.a.iv.(b). Income Tax Aspects of Family Partnerships

Numerous provisions in part II Income Tax Flexibility discuss partnership income taxation generally. For an operating business, a robust structure is described in part II.E Recommended Structure for Entities. See also part II.Q.8.a Partnership as a Master Entity.

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of penalties and interest attributable to the additional taxes described in subsection (a), rules similar to the rules of subsections (a) and (b) [of section 2207B] shall apply." Accordingly, the amount that the estate is entitled to recover from the section 2036 asset recipients includes applicable interest.

[11] Sec. 20.2056(b)-4(d)(1)(ii), Estate Tax Regs., defines estate transmission expenses as "expenses that would not have been incurred but for the decedent's death and the consequent necessity of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it."

[6307] See part II.C.7 Maintaining Capital Accounts, especially fn. 500.

[6308] *Estate of Jones v. Commissioner*, 116 T.C. 121, 128 (2001), holding:

> The contributions of property in the case at hand are similar to the contributions in *Estate of Strangi* and are distinguishable from the gifts in *Shepherd*. Decedent contributed property to the partnerships and received continuing limited partnership interests in return. All of the contributions of property were properly reflected in the capital accounts of decedent, and the value of the other partners' interests was not enhanced by the contributions of decedent. Therefore, the contributions do not reflect taxable gifts.

[6309] For the scope of this possible protection, see fns 2209-2211 in part II.H.11.a Basics of Preferred Partnerships.

[6310] See part III.B.2.a Tax Basis Issues within part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

[6311] See Stacy Eastland's materials at the 2015 Heckerling Institute on Estate Planning.

[6312] See part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

Code § 704(e) was amended in 2015;[6313] now:

- If a partnership interest is created by gift, the donee's distributive share is includible in the donee's gross income, except to the extent that the share is determined without allowance of reasonable compensation for services that the donor rendered to the partnership, and except to the extent that the portion of that share attributable to donated capital is proportionately greater than the donor's share attributable to the donor's capital.[6314] In applying this rule, "an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital."[6315]

- Regarding a capital interest in a partnership in which capital is a material income-producing factor, whether a person is a partner with respect to that interest is determined without regard to whether such interest was derived by gift from any other person.[6316]

Before these amendments, the following analysis applied:

Suppose a parent real estate entrepreneur makes a capital contribution to become the general and managing partner of a family partnership. The children all make capital contributions, as limited partners, in amounts greater than or equal to the parent's. The lion's share of the capital necessary to finance the project is borrowed from banks, presumably on the basis of the parent's good credit and standing in the financial community. If the transaction succeeds, the banks are paid back and the children are rewarded in proportion to their capital contributions. If the transaction fails, however, the banks and the parent, as general partner, are left holding the bag. This scenario is similar in some respects to *Carriage Square, Inc. v. Commissioner*.[6317]

In *Carriage Square*, the father, through his corporation, Carriage Square, Inc., contributed funds to a partnership (10% of total funds), while five trusts, for the benefit of his wife and children, each contributed the remainder (90%). The father became the general partner, while the trusts became limited partners. The father would then purchase land with borrowed money and sell the land to the partnership, with the partnership borrowing the necessary capital from the same bank on a guarantee by the father. The partnership would also take out a construction loan,

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[6313] RIA's history provides [some punctuation added]:

> In 2015, P.L. 114-74, Sec. 1102(b)(1), deleted para. (e)(1), and redes. paras. (e)(2) and (e)(3) as paras. (e)(1) and (e)(2), respectively. P.L. 114-74, Sec. 1102(b)(2), substituted this subsection for this section in para. (e)(2) (as redes. by Sec. 1102(b)(1)). P.L. 114-74, Sec. 1102(b)(3), substituted Partnership Interests Created by Gift for Family Partnerships the heading of subsec. (e), effective for partnership tax. yrs. begin. after 12/31/2015.
>
> Prior to deletion, para. (e)(1) read as follows:
>
> (1) *Recognition of interest created by purchase or gift*. A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

[6314] Code § 704(e)(1), which further provides, The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service.

[6315] Code § 704(e)(2), which further provides:

> The family of any individual shall include only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons.

[6316] Code § 761(b).

[6317] 69 T.C. 119 (1977).

again guaranteed by the father. Once the real estate development became successful, the five trusts received 90% of the profits.

The *Carriage Square* majority held that the borrowed capital was not a material income-producing factor.[6318] Code § 704(e)(1), a non-exclusive safe harbor, stated that a person shall be recognized as a partner for income tax purposes if he or she owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person. However, whether capital is a material income-producing factor in a partnership is for the fact finder to determine on a case-by-case basis. Essentially, the court believed the bank would not have loaned the money to capitalize the venture without the secured guarantees by the father.

The court held that the partnership was a sham designed to transfer tax-free income streams to the children. Because capital was not a material income producing factor, Code § 704(e)(1) did not apply. Also, the court held, the partners did not have a valid business purpose for forming the partnership, considering the 90% share of profits the trusts earned in light of their limited capital contributions and consequential limited risk (since they did not guarantee the loans). Because the partnership could borrow whatever amounts it needed based on the guarantees by the father, their capital contributions were not material. Further, because the father, through the general partner corporation, performed all the services necessary to operate the business, assumed all the risk of business failure, and used his contacts and community goodwill to secure the loans, the court held that the trusts were not partners.[6319] Judge Tannenwald, in his dissent, instead of discounting the partnership interests of the trusts, raised the specter of the trusts' partnership interests having been acquired by gift under Code § 704(e)(2).[6320]

A family partnership in which capital is not a material income-producing factor may still be recognized as a valid entity and the persons within it as valid partners under the *Culbertson* standard.[6321] Partners must show they had a good faith business motive for entering into the partnership. However, for income tax purposes, failure to satisfy Code § 704(e)(1) would preclude the partnership from passing the *Culbertson* hurdle.[6322]

Commentators have long questioned the *Carriage Square* holding.[6323] The case, as the Tax Court admitted, was an egregious example of tax avoidance.[6324]

For income tax purposes, Reg. § 1.704-1(e)(3)(i)(a) appears to respect allocating a preferred return to the donor but not allocating a preferred return to a donee:

[6318] The court believed that Reg. § 1.704-1(e)(1)(i) prohibited the borrowed capital from being considered as an income producing factor because it was not contributed by a partner. *Id*. at 127. The production of income by a partnership is attributable to the capital or services, or both, contributed by the partners. Reg. § 1.704-1(e)(1). Here, the capital was guaranteed by a non-partner, the father.
[6319] *Carriage Square, Inc. v. Commissioner*, 69 T.C. 119, 128.
[6320] *Carriage Square, Inc. v. Commissioner*, 69 T.C. 119, 140-41.
[6321] *Commissioner v. Culbertson*, 337 U.S. 733 (1949).
[6322] Howard Zaritsky, ¶ 10.09 The Family Partnership Rules, *Tax Planning for Family Wealth Transfers: Analysis With Forms*.
[6323] W. McKee, W. Nelson, R. Whitmire*, Federal Taxation of Partnerships and Partners*, ¶ 14.02 (3rd ed. 1997) (stating that establishing a recognizable capital interest is less onerous under Code § 704(e)(1) and Reg. § 1.704-1(e)(1)(iv) than *Carriage Square* believes).
[6324] *Carriage Square, Inc. v. Commissioner*, 69 T.C. 119, 131.

> Where a capital interest in a partnership in which capital is a material income-producing factor is created by gift, the donee's distributive share shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such distributive share attributable to donated capital is proportionately greater than the distributive share attributable to the donor's capital. For the purpose of section 704, a capital interest in a partnership purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual, for the purpose of the preceding sentence, shall include only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons.

Letter Ruling 9808010 included (highlighting added):

> We conclude that the family limited partnership's allocations will satisfy the requirements of section 704(e)(2) if the donors' distributive shares of partnership income represent an equal or greater proportion of the total partnership income (computed without reduction for guaranteed payments) than the donors' capital represents of the total partnership capital. For this purpose, the donors' distributive shares of partnership income include guaranteed payments (as defined in section 707(c) and section 1.707-1(c)) that the donors are required to include in income for the taxable year and the donors' allocable shares (under section 704(b), but not section 704(c)) of the partnership's net income for the taxable year.

III.B.1.a.v. Sending Business or Performing Services

Code § 2501 taxes "the transfer of property by gift." Reg. § 25.2501-1(a)(1) also taxes only "transfers by gift of property." When a donor provides services – whether working full-time or merely sharing business connections – does that work constitute earning income and transferring the property earned from those services or is merely allowing the donee the opportunity to earn income herself/himself from her/his own exploitation of the opportunity or wise investment of her/his own assets? Merely rendering services is discussed in part III.B.1.a.iii Gift of Services. Part of the discussion below views certain employment benefits as merely incidental to working, along the lines of part III.B.1.i Transfers with Contingencies Based on Acts of Independent Significance; you will find below that this area involves a continuum, and where a situation falls sometimes is a judgment call on which experts may differ reasonably.

The first two subparts below describe cases in chronological order, and the final subpart evaluates the principles:

- III.B.1.a.v.(a) Purely Shifting Business Opportunities
- III.B.1.a.v.(b) Property Transfer Clearly Tied to Services
- III.B.1.a.v.(c) Evaluating the Continuum

III.B.1.a.v.(a). Purely Shifting Business Opportunities

In *Crowley v. Commissioner*, 34 T.C. 333, 345-47, *acq.* 1961-2 C.B. 4, a father owned a savings and loan. In addition to the traditional sources of income, the business generated income by means of appraisal fees, insurance fees, and title commissions. He created a partnership for his four children to handle these ancillary income streams for the S&L. One son was trained as an appraiser and insurance agent, handling the S&L's appraisal and insurance needs. The profits from this work were shared between the S&L and the partnership. The Tax Court held that the income was all taxable to the partnership and not to the father. Having determined that no income was attributable to the father, the court held that there were no gift tax issues.

The son could not have obtained the amount of appraisal work he did without the aid of his father. This was a business opportunity that the son (and his siblings) had not earned on the basis of individual ability. One author suggested that such nepotism would be extraordinarily difficult to tax and the IRS does not regularly pursue it.[6325]

With a slight nod to *Crowley*, the income tax case *Alabama-Georgia Syrup Co. v. Commissioner*, 36 T.C. 747, 767 (1961), *acq.* 1962-2 C.B. 3 held:

> It is a fair inference that Louis directed business to suppliers for whom Katherine was broker, but this fact does not require a conclusion that the income from the brokerage commissions was in substance that of [Louis' corporation].

Bross Trucking, Inc. v. Commissioner, T.C. Memo. 2014-107, held that:

- Lack of non-compete precluded corporate goodwill regarding owner-officer's relationships.
- Owner's sons developed relationships with owner's customers when owner shut down owner's business due to regulatory hassles and sons started new corporation.
- Workforce intangible not deemed transferred when only 50% of the employees of the old corporation worked for the new corporation.

For a detailed analysis of *Bross Trucking*, see part II.Q.7.h.v Taxpayer Win in *Bross Trucking* When IRS Asserted Corporation Distribution of Goodwill to Shareholder Followed by Gift to Shareholder of New Corporation (2014).

Also see *Estate of Adell v. Commissioner*, T.C. Memo. 2014-155 (lack of non-compete precluded corporate goodwill regarding owner-officer's relationships; customers did business with owner's son because they trusted the son personally; son was qualified to run the business), part of a line of cases discussed in part II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees?

However, paying a commission for doing nothing is a gift. Rev. Rul. 81-54 analyzed the gift implications of a DISC, which is a sham corporation expressly authorized for income tax purposes to reduce the tax rate on exports. Rev. Rul. 81-54 involved the following facts:

[6325] Gingiss, The Gift of Opportunity, 41 *DePaul L. Rev* 395, 410 (1991-1992).

> Corporation M, a domestic manufacturing business, was organized in 1972. All of M's stock has been continuously owned in equal shares by individuals A, B, and C. M sells one-half of its products outside the United States.
>
> In January 1978, the three shareholders of M formed a DISC in order to maximize the profitability of export sales transactions by M. A, B, and C each transferred $1,000 in cash to the DISC in exchange for equal shares of the stock of the DISC. Immediately thereafter, A, B, and C made gifts of all of their DISC stock to three irrevocable trusts created for the benefit of their respective minor children. Each of the spouses of A, B, and C was designated as sole trustee of the trust for their respective children. The trustees of the three trusts were given full power to deal with the trust assets as if they owned those assets outright.
>
> After the DISC stock was transferred to the trust, M and the DISC agreed in writing that the DISC would be the exclusive agent of M with respect to all export sales of M products. Under the terms of the agreement, the DISC is to be paid a commission for each export sales transaction. The amount of the commission on each sale is stated in the agreement to be the "maximum amount permitted under the intercompany pricing rules of section 994 of the Internal Revenue Code."
>
> The agreement requires that all commissions on sales of M products during a taxable year of the DISC be paid to the DISC within 30 days after the end of that taxable year. The agreement provides that it shall terminate immediately at the will of either party. Upon termination, a final payment of all outstanding obligations between M and the DISC is to be made.
>
> The taxable year of the DISC ends on December 31. The DISC performed no significant services.

Rev. Rul. 81-54 reasoned:

> In the present case, the three shareholders of M made gifts of the shares of the DISC stock when they transferred the shares to the trusts for their respective children. The value of the transferred DISC stock was equal to the value of the underlying assets of the DISC on the date of the stock transfers.
>
> Transactions completed pursuant to the written agreement resulted in a continuing transfer of a portion of M's income to the trust beneficiaries via the DISC commission arrangement. This transfer of income is not in the ordinary course of business under section 25.2512-8 of the regulations. The creation of the DISC by A, B, and C was founded on a valid business purpose in view of the income tax advantages generally associated with the formation of DISCs. However, under these facts, the transfer of M's income to the DISC, and thus, indirectly to the trust beneficiaries, as a result of the trust's ownership of the DISC stock, was not required in the course of M's business and had no valid business purpose in regard to M.
>
> M's retained right to unilaterally terminate the agreement with the DISC makes any transfer of commission that the DISC may receive from future transactions incomplete until the transactions take place. Upon completion of each transaction, the owners of M no longer retain any dominion and control over the payment of commissions to the DISC, because under the agreement, the DISC is entitled to a commission on each sale.

> Therefore, under section 25.2511-2 of the regulations, discussed above, the donor's gifts occur as each transaction through the DISC is completed. The measure of the gift is the amount transferred to the DISC on each sale.

Rev. Rul. 81-54 held:

> (1) A, B, and C each made taxable gifts of shares in the DISC to the trusts created for their children upon the transfer of those shares. The value of each donor's gift is the aliquot portion of the DISC's asset value at the date of transfer.
>
> (2) A, B, and C have made and will continue to make gifts of profits that would otherwise flow to M in the absence of the agreement with the DISC. These gifts occur each time M sells its products by way of the DISC. See section 25.2511-1(h)(1) of the Gift Tax Regulations. The gifts continue as long as the agreement is in effect. The total value of the gifts by each donor is one-third of the amount transferred to the DISC on each sale.
>
> Holdings (1) and (2) above would be the same if the contract between the DISC and M had been entered into prior to the transfer of the DISC stock to the trust.

To avoid gift tax consequences, a DISC should have the same owners as the exporter. Also, a DISC should not be owned by an IRA.[6326]

Although a DISC is a statutory sham, generally income tax principles require one who earns profits to pay the tax on those profits.[6327] Is presenting a person with an opportunity to earn money the same thing as assigning those earnings? *Hospital Corp. of America*, 81 T.C. 520, 588-590 (1983) (Code § 367 income tax case):

> Respondent's argument is that since petitioner could have executed the contract itself or designated any of its domestic subsidiaries to execute the contract, its choice of having LTD negotiate, execute, and perform the contract is in substance the transfer of property by petitioner to LTD which required an advance ruling. Respondent specifically argues that HSP, Inc., a domestic subsidiary that performed other management contracts, could have been selected by petitioner to perform this contract.
>
> Respondent then asserts that petitioner's "indisputable control" over the execution of the contract requires the conclusion that execution of the contract in the name of LTD was the transfer of the contract to LTD. We have answered respondent's argument in *Crowley v. Commissioner*, 34 T.C. 333, 345 (1960), where we stated: "There is a difference between being in a position to control who shall perform the activities which produce the income and being in a position to control … who shall receive income after it is produced, and we think that distinction is basic in this case." Petitioner's control in organizing and designating LTD to negotiate, execute, and perform the KFSH management contract is not the same as control over who shall receive the income after it is earned.

[6326] See text accompanying fns 1874-1882 in part II.G.22 IRA as Business Owner.
[6327] See generally part II.Q.6.e Assignment of Income on Property Being Sold.

> We are satisfied that LTD negotiated and executed the contract and later performed the contract, but with substantial assistance from petitioner….
>
> Petitioner, in presenting LTD with an opportunity to enter into a contract, did not transfer any legally enforceable contractual or other right to LTD. Instead, in discovering this business opportunity and making it available to LTD, petitioner simply performed a service for which it is entitled to reasonable compensation. [footnote omitted] We therefore hold that petitioner did not transfer any property to LTD…

III.B.1.a.v.(b). Property Transfer Clearly Tied to Services

Rev. Rul. 68-334 addressed "whether the value of the amount received under a group term life insurance policy is includible in an employee's gross estate for Federal estate tax purposes under each of the situations discussed herein." It reasoned and held:

> In determining whether the decedent possessed an incident of ownership in the policy, consideration must be given to the effect of State or other applicable law. See section 20.2042-1(c)(5) of the regulations. The decedent's rights in the policy are generally determined by local insurance or property laws.
>
> The insurance laws of most States require that an employee have the right to convert his group insurance into individual insurance within a specified time after termination of his employment. The conversion privilege is a safeguard for the insured and cannot be deleted from the policy. Moreover, as a provision required by statute it cannot be waived by mutual consent of the parties to the contract, unsupported by consideration. See *Thomas Satery v. Great American Reserve Insurance Co.*, 278 S.W. 2d 377 (1955).
>
> The application of section 2042 of the Code to amounts received under group term life insurance policies is illustrated by three factual situations, as follows:
>
> *Situation 1*. The decedent at the time of his death was insured for 50x dollars under a group term life insurance policy wholly paid for by his employer. Neither the group term policy nor State law gives the employee the right to convert his group insurance into individual insurance upon termination of his employment. The policy provides that each employee's coverage ceases upon termination of his employment. The employee makes an irrevocable assignment of his insurance under the group policy.
>
> The value of the proceeds of the policy is includible in the gross estate of the insured employee since he had the power to cancel the insurance by terminating his employment, and any power to effect such a cancellation is an incident of ownership with respect to the policy. See section 20.2042-1(c)(2) of the regulations. It is also evident that the assignee of the policy had no means of preventing a termination of the decedent's employment from causing a loss of such assignee's interest in the policy and thus effectively controlling its ultimate disposition.
>
> *Situation 2*. The decedent at the time of his death was insured for 50x dollars under a group term life insurance policy wholly paid for by his employer. As required by State law, the employee is granted under the terms of the policy the right to convert his group insurance into individual insurance upon termination of his employment. Both the policy and State law permit absolute assignment of the group insurance including the conversion privilege. The policy provides that coverage under the group policy shall

cease upon termination of employment. The employee makes an irrevocable assignment of his insurance under the group policy, but retains the conversion privilege.

The value of the proceeds of the group term life insurance is includible in the gross estate of the insured. The decedent has effectively retained the power to control the disposition of the insurance through an exercise of the conversion privilege upon any termination of his employment and has thus retained an incident of ownership with respect to the policy. If either the group policy or local law prohibits an assignment of the conversion privilege, the same result follows notwithstanding any purported assignment of the conversion privilege.

Situation 3. The facts are similar to those in *Situation 2*, in that both the group policy and the State law permit the employee to make an absolute assignment of all of his incidents of ownership in the policy. The policy provides that coverage thereunder shall cease upon termination of employment. Upon such termination of the insured's employment, the assignee acting alone could convert to a 50x dollar individual policy. The employee made an irrevocable assignment of all of his incidents of ownership in the policy, including the conversion privilege. The insured could not have effected cancellation of the insurance coverage by terminating his employment. Consequently, the insured decedent did not die possessed of any incidents of ownership in the policy.

No part of the value of the proceeds of the group insurance is includible in the insured's gross estate under section 2042 of the Code. Under the circumstances, the assignee's right to the amount of the group term coverage could not have been defeated by any action within the control of the assignor.

Rev. Rul. 72-307 held:

Revenue Ruling 69-54 holds that the decedent's power to cancel the insurance coverage solely by terminating his employment is an incident of ownership in the policy that requires inclusion of the value of the proceeds in his gross estate under section 2042 of the Code.

An insured's power to cancel his insurance coverage by terminating his employment is a collateral consequence of the power that every employee has to terminate his employment. The examples in section 20.2042-1(c) of the regulations, on the other hand, concern powers that directly affect the insurance policy or the payment of its proceeds without potentially costly related consequences. Where the power to cancel an insurance policy is exercisable only by terminating employment, it is not deemed to be an incident of ownership in the policy.

Accordingly, it is held that under the circumstances of Situation 1 of Revenue Ruling 69-54, the value of the proceeds of the group insurance is not includible in the insured's gross estate under section 2042 of the Code.

Revenue Ruling 69-54 is hereby modified.

Estate of Smead v. Commissioner, 78 T.C. 43 (1982), reasoned and held:

In determining whether the decedent possessed incidents of ownership with respect to the policy, the relevant question is whether decedent had the capacity to do something to affect the disposition of the proceeds if he had so wanted. *United States v. Rhode Island Hospital Trust Co.*, 355 F.2d 7, 11 (1st Cir. 1966). As that case points out, however, we must look primarily to the “policy facts” (the rights given in the insurance contract) rather than the “intent facts” (the insured’s subjective intentions) in making that determination.[8] And we must also keep in mind that “The very phrase ‘incidents of ownership’ connotes something partial, minor, or even fractional in its scope. It speaks more of possibility than of probability.” 355 F.2d at 10. It is the existence of even a “fractional” power, not the probability of its exercise, that controls. *Schwager v. Commissioner*, 64 T.C. 781, 791 (1975). Some of the “fractional” powers not listed in the pertinent estate tax regulations that have been held to constitute an “incident of ownership” include the power to prevent a change of beneficiary by withholding his written consent (*Schwager v. Commissioner*, *supra*) and the power to select an optional mode of settlement and thereby vary the time and manner in which the insurance proceeds will be paid (*Estate of Lumpkin v. Commissioner*, 474 F.2d 1092 (5th Cir. 1973), *revg.* 56 T.C. 815 (1971); *but compare Estate of Connelly v. United States*, 551 F.2d 545 (3d Cir. 1977)).

[8] Of course, a strict application of the so-called policy facts doctrine may be inappropriate in a case where the terms of the insurance policy have been impacted by the terms of a property settlement agreement and a State court order in such a fashion that the policy rights are effectively removed from the insured. See *Estate of Beauregard v. Commissioner*, 74 T.C. 603 (1980).

However, if the “fractional” power possessed by the insured is contingent upon an event over which the insured has no control, it does not constitute an incident of ownership in the policy. *Estate of Smith v. Commissioner*, 73 T.C. 307 (1979). In Smith, the insured was given the right, in the event the employer stopped paying the premiums, to prevent cancellation of a policy on his life by purchasing the policy from his employer for the policy’s cash surrender value. We held that decedent did not possess any incidents of ownership with respect to the insurance policy, because any rights he may have had were contingent upon an event over which he had no control. Similarly, in Estate of *Beauregard v. Commissioner*, 74 T.C. 603 (1980), any power the insured might have possessed under the terms of the policy to change beneficiaries had been effectively removed under local law by the property settlement agreement and local court order directing the insured to name his minor children as his beneficiaries. We held that the insured possessed no incident of ownership in the policy at the time of his death. We so held even though there was a possibility, once the children reached their majority or upon the occurrence of other specified events, that the insured might regain the right to name beneficiaries under the policy. That contingency of course had not occurred at the time of the insured’s death. In both Smith and Beauregard, the insured’s purported rights in the policy were entirely too contingent or remote to constitute incidents of ownership possessed by the decedent at the time of his death. It is in this context that we must consider the right of decedent here to convert his group policy into an individual policy upon termination of his employment.

We start from the premise that there is no incident of ownership where the insured has only the right to be covered by insurance, with the proceeds payable to a beneficiary selected by the employer. *Estate of Beauregard v. Commissioner*, 74 T.C. at 608. The only right decedent had was the right, given by the policy and by local State law, to convert his group policy to an individual insurance policy.[9] That right was thus contingent upon the termination of his employment. Termination could occur either at the complete discretion of his employer or by decedent's voluntary action. Decedent had no control over the former, but he did control the voluntary termination of his employment. Petitioner argues, however, that decedent did not possess at his death any incident of ownership because he did not possess an immediately exercisable right to convert and that all decedent possessed at death was a "contingent option to purchase insurance." Petitioner further argues that the contingency decedent did control, voluntary termination of his employment, is an act so detrimental to the insured because of the potential adverse economic consequences that it is not the type of right that warrants inclusion of insurance proceeds in decedent's gross estate. We agree.

[9] Although the group policy was silent as to decedent's right to assign any rights under the group policy, including the conversion privilege, the Michigan State law gave him the right to assign:

Mich. Comp. Laws sec. 500.4439 (Mich. Stat. Ann. 24.14439 (Callaghan 1972)). [Group Life Policy; assignment of rights; validity; effect; intent of section.] SEC. 4439. A person whose life is insured under a group insurance policy may, subject and pursuant to the terms of the policy, or pursuant to an arrangement between the insured, the employer and the company, assign (other than to the employer) all or any part of his incidents of ownership, rights, title and interests, both present and future, under such policy including specifically, but not by way of limitation, the right to designate and redesignate a beneficiary or beneficiaries thereunder, the right to make any requisite contributions to maintain the insurance in force, and the right to have an individual policy issued to him in case of termination of employment. Such an assignment by the insured, made either before or after the effective date hereof, is valid for the purpose of vesting in the assignee, in accordance with any provisions included therein as to the time at which it is to be effective, all of such incidents of ownership, rights, title and interests so assigned, but without prejudice to the company on account of any payment it may make or individual policy it may issue prior to receipt of notice of the assignment. This section is not intended to alter the law of this state but is intended only to confirm in express statutory form the law as it exists presently.

Respondent no doubt agrees that decedent had the right to assign, and would agree that if decedent had made an irrevocable assignment of all his incidents of ownership in the group policy, including the conversion privilege, the insurance proceeds would not be includable in his gross estate. See situation 2 of Rev. Rul. 69-54, 1969-1 C.B. 221. Decedent did not make any assignment in this case.

While the right to assign is an incident of ownership (sec. 20.2042-1(c)(2), Estate Tax Regs.), that feature alone is not sufficient for inclusion in decedent's gross estate in this case. The right to assign rights under a policy constitutes a substantive incident of ownership only if one or more of the rights which may be assigned constitute incidents of ownership. Thus, if the conversion privilege was not an incident of ownership, the right to assign it would not be an incident of ownership either. See *Estate of Lumpkin v. Commissioner*, 56 T.C. 815, 828 (1971), *revd. on other grounds*, 474 F.2d 1092 (5th Cir. 1973).

This same argument has been made before in a similar context involving the right to surrender or cancel an insurance policy. The right to surrender or cancel an insurance policy is, in both the legislative history of the predecessor of section 2042(2) and in the pertinent estate tax regulations, plainly stated to be an incident of ownership. However, where the only way the insured can surrender or cancel a policy is by quitting his job, that is not considered to be an incident of ownership. While respondent at one time argued that the right to quit one's job and thereby effect cancellation of a group life insurance policy was an incident of ownership possessed by the insured,[10] the courts did not agree and respondent has since changed his position in that regard. *Estate of Beauregard v. Commissioner*, *supra* at 608; *Estate of Lumpkin v. Commissioner*, *supra* at 825, *revd. on other grounds* 474 F.2d 1092 (5th Cir. 1973); *Landorf v. United States*, 187 Ct. Cl 99, 408 F.2d 461 (1969); Rev. Rul. 72-307, 1972-1 C.B. 307, modifying situation 1 in Rev. Rul. 69-54, 1969-1 C.B. 222.

[10] See *Commissioner v. Treganowan*, 183 F.2d 288, 293 (2d Cir. 1950), *revg.* 13 T.C. 159 (1949), and situation 1 in Rev. Rul. 69-54, 1969-1 C.B. 221.

In *Landorf v. United States*, *supra*, the Court of Claims held that a decedent's right to cancel an insurance policy by terminating his employment was not an incident of ownership within the meaning of section 2042(2). The court stated "we do not believe that Congress intended to include the power to terminate employment, a right which everyone can exercise at any time, to be an 'incident of ownership' in property simply because the property involved is somehow related to the employment." 187 Ct. Cl. At 112, 408 F.2d at 469.

Respondent has also recognized that an insured's "power to cancel his insurance coverage by terminating his employment is a collateral consequence of the power that every employee has to terminate his employment" and has ruled that possession of that power does not require inclusion of life insurance proceeds in the insured's gross estate. Rev. Rul. 72-307, 1972-1 C.B. 307, 308. The ruling contrasts termination of employment with the examples of incidents of ownership in section 20.2042-1(c)(2) of the Estate Tax Regulations that concern powers that "directly affect the insurance policy or the payment of its proceeds *without potentially costly related consequences*." (Emphasis added.) Termination of employment carries with it potentially adverse economic consequences. Respondent now agrees that where the power to cancel an insurance policy is exercisable only by terminating employment, it is not deemed to be an incident of ownership in the policy. Yet respondent argues here that the power to exercise a conversion privilege, which is exercisable only by terminating employment, should be treated as an incident of ownership in the policy. We disagree.

Respondent would have us distinguish Rev. Rul. 72-307, because it deals strictly with the power to cancel insurance by terminating employment. We are not willing to draw that distinction. With respect to cancellation of insurance, respondent has conceded that a power that would otherwise unquestionably be considered a taxable incident of ownership (the power to cancel insurance) does not so qualify where the power can only be exercised by quitting one's job. If quitting one's job is too high a price to pay for the right to cancel an insurance policy, it is likewise too high a price to pay for the right to convert to another policy.

Assuming that the conversion privilege can ever be a power that directly affects the group insurance policy or the payment of its proceeds, i.e., the type of power that respondent considers to be an incident of ownership in the group policy, the conversion privilege can only be exercised by termination of one's employment. We think that such voluntary termination of employment, the only power within the control of the decedent in this case, cannot be said to be "without potentially costly related consequences." We

> conclude that the conversion privilege that decedent could exercise or control only by quitting his job was entirely too contingent and too remote to be considered an incident of ownership possessed by the decedent at the time of his death. *Estate of Smith v. Commissioner*, *supra*; *Estate of Beauregard v. Commissioner*, *supra*. Therefore, the proceeds of the group life insurance policy are not properly includable in decedent's gross estate under section 2042(2).

Rev. Rul. 84-130 modified Situation 2 of Rev. Rul. 69-54, addressing, "If a decedent transferred all the incidents of ownership in a noncontributory group-term life insurance policy on decedent's life, but retained the right to convert the policy to an individual policy should the decedent cease employment, are the proceeds includible in the decedent's gross estate under section 2042(2) of the Internal Revenue Code?" based on the following facts:

> D died in March 1982. At the time of death, D was employed by Y Corporation which made all the payments on a group term life insurance policy on D's life. Under the terms of the policy, D owned all the incidents of ownership. In 1977, D transferred all the ownership rights to A. However, D retained the right to convert the policy to an individual policy in the event D's employment with Y was terminated.

Rev. Rul. 84-130 reasoned and held:

> Section 2042(2) of the Code provides that the value of the gross estate includes the value of proceeds from insurance policies on the life of the decedent receivable by beneficiaries other than the executor where the decedent possessed incidents of ownership in the policy exercisable either alone or in conjunction with any other person.
>
> Section 20.2042-1(c)(2) of the Estate Tax Regulations provides that the term "incidents of ownership," in general, means the right of the insured or the insured's estate to the economic benefits of the policy. Examples of incidents of ownership include the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, and to obtain from the insurer a loan against the surrender value of the policy.
>
> These examples contained in section 20.2042-1(c)(2) of the regulations concern powers that directly affect the insurance policy rather than powers that are collateral consequences of potentially costly related actions of the decedent. An example of a power exercisable only as a result of potentially costly related action, and thus not an incident of ownership for purposes of section 2042(2) of the Code, is the power to cancel a group-term policy by termination of employment. That power of cancellation is considered a collateral consequence of the power that every employee has to terminate employment. See, Rev. Rul. 72-307, 1972-1 C.B. 307; see also, Rev. Rul. 82-5, 1982-1 C.B. 131. Similarly, a power to convert a group-term policy that is exercisable only by the voluntary termination of employment is a collateral consequence of a potentially costly action. That is, as is the case in Rev. Rul. 72-307, the power to convert is a collateral consequence of the power that every employee has to terminate employment.
>
> Although termination of employment may occur either at the complete discretion of the employer or by the decedent's voluntary action, for purposes of section 2042(2) of the Code, the Service will not distinguish between conversion rights exercisable upon voluntary termination of employment and such rights exercisable upon involuntary termination.

Accordingly, the insurance proceeds payable to A under the group insurance policy are not includible in D's gross estate because D's retained conversion privilege is not an incident of ownership for purposes of section 2042(2) of the Code. The Service acquiesces in the result in the decision in *Estate of Smead v. Commissioner*, 78 T.C. 43 (1982), which held that a retained conversion privilege exercisable only on termination of employment was not an incident of ownership. See page 2, this Bulletin.

HOLDING

If a decedent transferred all the incidents of ownership in a noncontributary group-term life insurance policy on the decedent's life, but retained the right to convert the policy to an individual policy should the decedent's employment be terminated, the proceeds are not includible in the decedent's gross estate under section 2042(2) of the Code.

EFFECT ON OTHER REVENUE RULINGS

The holding of Situation 2 of Rev. Rul. 69-54, 1969-1 C.B. 221, is modified to hold that a conversion privilege exercisable only in the event of the termination of employment is not an incident of ownership for purposes of section 2042(2) of the Code.

Agreeing to perform services in exchange for the recipient transferring property to the service provider's child constituted a gift from the service provider to the child. *Dodge v. United States*, 443 F.Supp. 535 (D. Or. 1977). Similarly, Reg. § 1.61-22(c)(2)(ii) provides that split-dollar life insurance[6328] benefits received by an irrevocable trust created by an employee constitute compensation to the employee and a gift from the employee to the trust.

DiMarco v. Commissioner, 87 T.C. 653, 656-663 (1986), explained:

The only issue for decision in this case is whether the present value of the survivors income benefit that is payable by IBM to Joan M. DiMarco is an adjusted taxable gift within the meaning of section 2001... Thus, the survivors income benefit that is payable by IBM to Joan M. DiMarco is an adjusted taxable gift within the meaning of section 2001 only if it is also a taxable gift within the meaning of section 2503 that was made by decedent after December 31, 1976.

We begin our analysis by noting that it is unclear precisely what respondent argues in this case. On brief, he proposes that we adopt as an ultimate finding of fact that "Decedent made a completed gift of the Survivor's Benefit to unnamed beneficiaries upon the commencement of his employment on January 9, 1950." Two pages later in the same brief he argues that "the transfer should be treated as a completed gift in 1979." In the statutory notice of deficiency and the stipulation of facts, respondent appears to take the position that decedent actually made a completed gift of the survivors income benefit at the time of his death in 1979. Respondent finally attempts to clarify his position by stating in his reply brief that it is his "position that the gift of the Survivor's Benefit occurred in 1950 and the inability to value said gift requires … [respondent] to treat the gift as complete on the date of death when the gift finally became subject to valuation."

After reviewing carefully respondent's briefs, the statutory notice of deficiency, and the stipulation of facts, it appears to us that respondent is making two arguments in this

[6328] Part II.Q.4.f Split-Dollar Arrangements.

case. First, it appears that respondent argues that decedent made a completed transfer of a property interest in the survivors income benefit for gift tax purposes on January 9, 1950, but that because the interest could not be valued at that time, it was necessary to treat the transfer as an open transaction and to value the transferred property and impose the gift tax on the date of decedent's death, when the property interest finally became subject to valuation. In the alternative, respondent appears to argue that decedent made an incomplete transfer of a property interest in the survivors income benefit for gift tax purposes on January 9, 1950, because the property interest could not be valued at that time, but that the transfer became complete on November 16, 1979, when decedent died, because the transferred property could then and for the first time be valued.

Petitioner argues, for a variety of reasons, that decedent never made a taxable gift of the survivors income benefit. Petitioner argues that decedent never owned a property interest in the survivors income benefit that he was capable of transferring. Petitioner further contends that, even if decedent owned such an interest, he never transferred it, and if he did transfer it, he never did so voluntarily. Petitioner also asserts that transfers of property cannot become complete for gift tax purposes upon the death of the donor, and that decedent never made a completed transfer of any property interest he may have owned in the survivors income benefit before his death because he always had the power to revoke the transfer, if any was made, simply by resigning his employment with IBM. Petitioner finally argues that, if the decedent made a taxable gift of the survivors income benefit, he did so before December 31, 1976, and that such a gift does not qualify as an adjusted taxable gift within the meaning of section 2001. For the reasons set forth below, we find for petitioner.

Section 2501(a)(1) imposes a tax on the "transfer of property by gift." Section 2511(a) provides that the tax "shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible." However, a transfer of property qualifies as a taxable gift only if the transfer is complete, and a transfer is complete for gift tax purposes only when the transferor relinquishes dominion and control over the transferred property. Sec. 25.2511-2(b), Gift Tax Regs.; *Estate of Sanford v. Commissioner*, 308 U.S. 39, 42-43 (1939). At the time the transfer is complete, the transferred property must be valued. Sec. 2512(a). This value is then used in determining the gift tax that is due. Sec. 2502.

Respondent argues that decedent transferred a property interest in the survivors income benefit for gift tax purposes on January 9, 1950. This transfer was either complete or incomplete for gift tax purposes. If the transfer was complete, we have little difficulty in disposing of this case because a completed transfer would have been a taxable gift that was made by decedent before December 31, 1976, and section 2001 expressly defines an adjusted taxable gift as a taxable gift that was made after December 31, 1976. On the other hand, if the transfer was incomplete for gift tax purposes, we do not believe that it became complete or that we can deem that it became complete at the time of decedent's death.[7]

[7] Respondent does not assert that the transfer became complete for gift tax purposes at any time other than Jan. 9, 1950, or Nov. 16, 1979.

Section 25.2511-2(f), Gift Tax Regs., provides that -

> The relinquishment or termination of a power to change the beneficiaries of transferred property, *occurring otherwise than by the death of the donor (the statute being confined to transfers by living donors)*, is regarded as the event that completes the gift and causes the tax to apply…. [Emphasis added.]

We believe that this regulation precludes our finding in this case that the alleged transfer of property by decedent on January 9, 1950, became complete for gift tax purposes by reason of decedent's death.

We recognize, of course, that respondent does not assert in this case that the alleged transfer on January 9, 1950, became complete and subject to the gift tax because decedent's death terminated a power to change the beneficiaries of the transferred property. Even so, in view of the fact that a transfer of property that becomes complete because the donor's death terminates a power to change the beneficiaries of the transferred property is not subject to the gift tax, we decline to hold that a transfer of property that becomes complete because the donor's death makes it possible for the first time to value the transferred property is subject to the gift tax. We perceive nothing in the gift tax statute or the regulations that would justify such a result.

In addition, we believe that respondent has confused the issues of completion and valuation in this case. Respondent appears to argue that, because the value of the survivors income benefit could not be determined on January 9, 1950, when the alleged transfer occurred, the transfer should be treated as incomplete for gift tax purposes until the survivors income benefit became susceptible of valuation, when decedent died, at which time the transfer became complete and subject to the gift tax. For the reasons stated above, we have already held that transfers of property do not become complete for gift tax purposes by reason of the death of the donor. We also question, however, whether the fact that the value of transferred property cannot be readily determined at the time of transfer is relevant in determining whether the transfer is complete for gift tax purposes. We have noted above that transfers of property are complete and subject to the gift tax at the time the donor relinquishes dominion and control over the transferred property. Nothing in the statute or the regulations suggests that, even if a donor relinquishes dominion and control over transferred property, the transfer is or can be considered to be incomplete for gift tax purposes if the value of the property is uncertain. To the contrary, in *Smith v. Shaughnessy*, 318 U.S. 176, 180 (1943), the Supreme Court appears to have considered and expressly rejected this argument in the following language:

> The government argues that for gift tax purposes the taxpayer has abandoned control of the remainder and that it is therefore taxable, while the taxpayer contends that no realistic value can be placed on the contingent remainder and that it therefore should not be classed as a gift.
>
> We cannot accept any suggestion that the complexity of a property interest … can serve to defeat a tax…. Even though these concepts of property and value may be slippery and elusive they can not escape taxation so long as they are used in the world of business. The language of the gift tax statute, "property … real or personal, tangible or intangible," is broad enough to include property, however conceptual or contingent….

Accordingly, we reject any suggestion by respondent either that transfers of property are incomplete for gift tax purposes simply because "no realistic value can be placed" on the property at the time the transfer occurs, or that transfers of property become complete for gift tax purposes only when the value of the transferred property can be easily ascertained.

Respondent also argues that completed transfers of property for gift tax purposes can and should be treated as open transactions in those cases where the transferred property is difficult to value, and that valuation of the transferred property and the imposition of the gift tax should be postponed until the value of the property can be readily determined. We reject this contention. The clear language of the statute and the regulations requires that transferred property be valued for gift tax purposes at the time the transfer becomes complete. Section 2512(a) provides that, in the case of a gift, "the value thereof at the *date of the gift* shall be considered the amount of the gift." (Emphasis added.) In addition, section 25.2511-2(a), Gift Tax Regs., states as follows:

> The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer…. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his *act of making the transfer*, [and] *is measured by the value of the property passing from the donor*…. [Emphasis added.]

As a result, property must be valued and the gift tax imposed at the time a completed transfer of the property occurs.[8]

> [8] Respondent relies heavily on Rev. Rul. 81-31, 1981-1 C.B. 475, and argues here that we should adopt its reasoning and holding. To the extent that this ruling can be read as holding either that a transfer of property can become complete for gift tax purposes by reason of the death of the donor, or that it is permissible to treat a completed transfer of property as an open transaction and to value the transferred property and impose the gift tax at some time other than when the completed transfer occurs, we regard the ruling as being inconsistent with the gift tax statute and the regulations.[6329]

We also agree with petitioner that decedent never made a taxable gift of any property interest in the survivors income benefit because we find no act by decedent that qualifies as an act of "transfer" of an interest in property. His participation in the plan was involuntary, he had no power to select or change the beneficiaries of the survivors income benefit, no power to alter the amount or timing of the payment of the benefit, and no power to substitute other benefits for those prescribed by the plan. These facts are substantially similar to the facts of *Estate of Miller v. Commissioner*, 14 T.C. 657 (1950), an estate tax case wherein we also concluded that the decedent had performed no qualifying act of transfer. In *Estate of Miller*, respondent argued, relying on cases where the decedent had purchased for a lump sum joint and survivor annuity contracts and at the time of purchase irrevocably designated the surviving annuitants, that the decedent had, for purposes of section 811(c) of the 1939 Code, transferred property during his life that was intended to take effect at his death. We rejected this contention and concluded that the decedent could not have transferred any property interest for any purpose

[6329] [my footnote:] Rev. Rul. 98-21 reasserts the IRS' argument that the Tax Court rejected here, but Rev. Rul. 98-21 conveniently omitted this rejection.

because he had not performed any act that possibly could be construed as an act of transfer. We stated as follows:

> we find no act on the part of the decedent which we think can properly be characterized as a “transfer” of an interest in property. Unlike the purchase of the annuity contracts in the *Wilder*, *Clise*, and *Mearkle* cases, the decedent’s participation in the pension plan inaugurated by his employer was not voluntary. The plan itself nominated the surviving beneficiaries, limiting them to the wife or the minor children of the officer or employee. Decedent, other than by continuing in his employment at the bank, which incidentally he had enjoyed for 13 years prior to the establishment of the plan, had no part in the selection of his wife as a surviving pensioner. Nor did he personally possess any means of defeating her pension rights other than by resigning his position at the bank… [14 T.C. at 664-665.]

While we recognize that in *Estate of Miller* respondent argued that there had been a transfer of property that was subject to the estate tax, and in this case respondent argues that there has been a transfer of property that is subject to the gift tax, we do not believe that this difference is significant. To the contrary, this Court and others have long held that the estate and gift taxes are to be read in pari materia and construed together. *Merrill v. Fahs*, 324 U.S. 308, 311-313 (1945); *Estate of Sanford v. Commissioner*, 308 U.S. 39, 42, 44 (1939); *Carson v. Commissioner*, 71 T.C. 252, 260 (1978), *affd.* 641 F.2d 864 (10th Cir. 1981).

Respondent argues, however, that decedent’s simple act of going to work for IBM on January 9, 1950, constituted an act of transfer by decedent for gift tax purposes. We disagree. None of the cases cited by respondent hold that, without more, the simple act of going to work for an employer that has an automatic, nonelective, company-wide survivors income benefit plan similar to the one at issue in this case constitutes a transfer of an interest in the benefit for either estate or gift tax purposes. Moreover, we doubt that it can be maintained seriously that decedent began his employment with IBM on January 9, 1950 (when he was 24, unmarried, and without dependents), for the purpose or with any intention of transferring property rights in the survivors income benefit. While we agree with respondent that a taxable event may occur without a volitional act by the donor, as in a case where an incomplete transfer of property becomes complete because of the occurrence of an event outside the donor’s control, we do not believe that a taxable event can occur for gift tax purposes unless there is first and in fact an act of transfer by the donor; and there can be no act of transfer unless the act is voluntary and the transferor has some awareness that he is in fact making a transfer of property, that is, he must intend to do so. See *Harris v. Commissioner*, 340 U.S. 106, 109 (1950); *Welch v. Henry*, 305 U.S. 134, 147 (1938); *Estate of Hite v. Commissioner*, 49 T.C. 580, 594 (1968); *Seligmann v. Commissioner*, 9 T.C. 191, 195 (1947).[9] It is apparent to us that decedent never intended and never voluntarily acted to transfer any interest that he may have owned in the survivors income benefit. There being no act of transfer by decedent, there can be no transfer of property by gift.

[9] The fact that there can be no taxable gift unless there is a voluntary act of transfer does not mean that the donor also must have donative intent when he makes the transfer. Sec. 25.2511-1(g)(1), Gift Tax Regs.; *Commissioner v. Wemyss*, 324 U.S. 303, 306 (1945). Any completed transfer of a beneficial interest in property for less than an adequate and full consideration in money or money’s worth, unless

made in the ordinary course of business, will be subject to the gift tax. Sec. 25.2512-8, Gift Tax Regs.

Moreover, we question whether decedent ever owned a property interest in the survivors income benefit that he was capable of transferring during his lifetime.[10]

[10] The parties stipulated that "Petitioner does not dispute Respondent's contention that Decedent's eligible survivors had a right to receive payment under the plan as long as the conditions set forth in the plan were satisfied." While we are uncertain what the parties intended by this stipulation, we note that to the extent it may be read as a stipulation of law, we are not bound by it. *Rollert Residuary Trust v. Commissioner*, 80 T.C. 619, 630 (1983), *affd.* 752 F.2d 1128 (6th Cir. 1985).

He had no voice in selecting the beneficiaries of the survivors income benefit and no ability to affect or determine the benefits payable to them. The categories of beneficiaries, the determination whether a claimant is an eligible beneficiary, and the amounts payable to the beneficiaries all were controlled directly by the provisions of the plan and indirectly by IBM, and payments were made directly to the beneficiaries by IBM. Furthermore, the benefits were payable out of the general assets of IBM, not out of any fund in which decedent had a vested interest, and the benefits did not accrue until decedent's death. Most importantly, IBM had the power and the right to modify the plan and the survivors income benefit at any time and in its sole discretion. Under these circumstances, we have little difficulty in concluding that decedent never acquired fixed and enforceable property rights in the survivors income benefit that he was capable of transferring during his lifetime. In *Estate of Miller v. Commissioner*, *supra*, we reached the same conclusion, on similar facts, in the following language:

> The trustees were empowered at any time to change the rules and regulations or to substitute entirely new rule... The pension trust could be terminated at any time by the bank and, although rule 29 provided that upon termination provision should be made for the continuance of all pensions then being paid to pensioners, there was no assurance that decedent's pension rights could have been enforced to their fullest extent against the pension trust unless there existed sufficient funds in the trust upon its cessation to discharge all of its obligations.
>
> Nor did the pension rights granted the wife … stand in any stronger position than those of her husband, for it is clear that whatever rights she possessed were subject to the same contingencies as those of the decedent…. Any pension granted to the wife would cease upon remarriage…. it is our considered opinion that decedent's pension rights and those of his wife under the pension trust never acquired the character of fixed and enforceable property rights which were susceptible to transfer by him….
>
> [14 T.C. at 664.]

Respondent argues, however, that in *Estate of Wolf v. Commissioner*, 29 T.C. 441 (1957), *revd. on other grounds* 264 F.2d 82 (3d Cir. 1959), we held in circumstances similar to those in this case, that decedent owned enforceable property rights in three trusts. The facts of *Estate of Wolf* are easily distinguishable from the facts of this case, however, for the same reason that in *Estate of Wolf* we distinguished *Estate of Miller v. Commissioner*, *supra*: in *Estate of Wolf* the employer had no unfettered right to modify or

> terminate the trusts, whereas here, as in *Estate of Miller*, the employer had the right to modify the plan at any time and in its sole discretion. *Estate of Wolf v. Commissioner*, 29 T.C. at 447.
>
> Respondent also attempts to distinguish *Estate of Miller* from this case by arguing that payment of the survivors income benefit in this case was much more likely to occur than was payment of the pension benefit in *Estate of Miller*, because IBM's financial resources were much greater than the resources of the employer in *Estate of Miller*. In addition, respondent argues that the employer in *Estate of Miller* had the unfettered right to change the rules and regulations of the pension plan and even to terminate it, while in this case, IBM only had the right, in its discretion, to modify the plan. In our view, neither of these differences are significant.[11]
>
> > [11] Respondent also argues, citing *Estate of Schelberg v. Commissioner*, 612 F.2d 25 (2d Cir. 1979), *revg.* 70 T.C. 690 (1978), that the survivors income benefit must be a taxable gift within the meaning of sec. 2503 because it is not taxable under sec. 2039. We of course express no view in this case as to whether the survivors income benefit is taxable under sec. 2039. However, even if the survivors income benefit is not taxable under sec. 2039, we fail to see how that could justify our reaching an improper result in this case.
>
> In our opinion, decedent never made a taxable gift of any interest in the survivors income benefit to his wife. It follows that the present value of the survivors income benefit is not an adjusted taxable gift within the meaning of section 2001.

Rev. Rul. 92-68 held:

> The Internal Revenue Service has reconsidered Rev. Rul. 81-31, 1991-1 C.B. 475, in view of the Tax Court's opinion in *Estate of DiMarco v. Commissioner*, 87 T.C. 653 (1986), *acq. in result*, 1990-2 C.B. 1. Rev. Rul. 81-31 held that a decedent made a gift of the value of a death benefit passing to the decedent's surviving spouse and that the gift became complete in the calendar quarter in which the decedent died, at which time the amount of the gift first became susceptible of valuation. The ruling is inconsistent with the result in *DiMarco*. Rev. Rul. 81-31 is hereby revoked.

The final taxable year involved in *Estate of DiMarco* was 1979. After that case and before Rev. Rul. 92-68 was enacted, in 1984 Code § 61(a) was amended to include fringe benefits in income (emphasis added):[6330]

> *General Definition*. Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
>
> (1) Compensation for services, including fees, commissions, *fringe benefits*, and similar items…

[6330] For a discussion of "fringe benefits" under Code § 1372, applying partnership rules to those owning at least 2% of an S corporation, see text accompanying fn 4472 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit **Arrangement under Reg. § 1.61-22**, describing a unanimous Tax Court reviewed opinion.

Reg. § 1.61-2(a) summarizes the general rules:

(1) Wages, salaries, commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses (including Christmas bonuses), termination or severance pay, rewards, jury fees, marriage fees and other contributions received by a clergyman for services, pay of persons in the military or naval forces of the United States, retired pay of employees, pensions, and retirement allowances are income to the recipients unless excluded by law. Several special rules apply to members of the Armed Forces, National Oceanic and Atmospheric Administration, and Public Health Service of the United States; see paragraph (b) of this section.

(2) The Code provides special rules including the following items in gross income:

(i) Distributions from employees' trusts, see sections 72, 402, and 403, and the regulations thereunder;

(ii) Compensation for child's services (in child's gross income), see section 73 and the regulations thereunder;

(iii) Prizes and awards, see section 74 and the regulations thereunder.

(3) Similarly, the Code provides special rules excluding the following items from gross income in whole or in part:

(i) Gifts, see section 102 and the regulations thereunder;

(ii) Compensation for injuries or sickness, see section 104 and the regulations thereunder;

(iii) Amounts received under accident and health plans, see section 105 and the regulations thereunder;

(iv) Scholarship and fellowship grants, see section 117 and the regulations thereunder;

(v) Miscellaneous items, see section 122.

These items do not necessarily coordinate with the transfer of property to the service provider's donees. For example, gifts to employees are not necessarily compensation income; see part II.M.4.c Gifts to Employees. On the other hand, Reg. § 1.61-2(d), "Compensation paid other than in cash," seems to classify certain noncash compensation as constituting or being equivalent to a transfer of property:

(1) *In general*. Except as otherwise provided in paragraph (d)(6)(i) of this section (relating to certain property transferred after June 30, 1969), if services are paid for in property, the fair market value of the property taken in payment must be included in income as compensation. If services are paid for in exchange for other services, the fair market value of such other services taken in payment must be included in income as compensation. If the services are rendered at a stipulated price, such price will be presumed to be the fair market value of the compensation received in

the absence of evidence to the contrary. For special rules relating to certain options received as compensation, see §§ 1.61-15, 1.83-7, and section 421 and the regulations thereunder. For special rules relating to premiums paid by an employer for an annuity contract which is not subject to section 403(a), see section 403(c) and the regulations thereunder and § 1.83-8(a). For special rules relating to contributions made to an employees' trust which is not exempt under section 501, see section 402(b) and the regulations thereunder and § 1.83-8(a).

(2) *Property transferred to employee or independent contractor*.

(i) Except as otherwise provided in section 421 and the regulations thereunder and § 1.61-15 (relating to stock options), and paragraph (d)(6)(i) of this section, if property is transferred by an employer to an employee or if property is transferred to an independent contractor, as compensation for services, for an amount less than its fair market value, then regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value at the time of the transfer is compensation and shall be included in the gross income of the employee or independent contractor. In computing the gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of such difference included in gross income.

(ii)

(A) *Cost of life insurance on the life of the employee*. Generally, life insurance premiums paid by an employer on the life of his employee where the proceeds of such insurance are payable to the beneficiary of such employee are part of the gross income of the employee. For example, if an employee or independent contractor is the owner (as defined in § 1.61-22(c)(1)) of a life insurance contract and the payments with regard to such contract are not split-dollar loans under § 1.7872-15(b)(1), the employee or independent contractor must include in income the amount of any such payments by the employer or service recipient with respect to such contract during any year to the extent that the employee's or independent contractor's rights to the life insurance contract are substantially vested (within the meaning of § 1.83-3(b)). This result is the same regardless of whether the employee or independent contractor has at all times been the owner of the life insurance contract or the contract previously has been owned by the employer or service recipient as part of a split-dollar life insurance arrangement (as defined in § 1.61-22(b)(1) or (2)) and was transferred by the employer or service recipient to the employee or independent contractor under § 1.61-22(g). However, the amount includible in the employee's gross income is determined with regard to the provisions of section 403 and the regulations thereunder in the case of an individual contract issued after December 31, 1962, or a group contract, which provides incidental life insurance protection and which satisfies the requirements of section 401(g) and § 1.401-9, relating to the nontransferability of annuity contracts. For the special rules relating to the includibility in an employee's gross income of an amount equal to the cost of certain group-term life insurance on the employee's life which is carried directly or indirectly by his employer, see section 79 and the regulations thereunder. For special rules relating to the exclusion of contributions by an employer to accident and health plans for the employee, see section 106 and the regulations thereunder.

(B) *Cost of group-term life insurance on the life of an individual other than an employee*. The cost (determined under paragraph (d)(2) of § 1.79-3) of group-term life insurance on the life of an individual other than an employee (such as the spouse or dependent of the employee) provided in connection with the performance of services by the employee is includible in the gross income of the employee.

(3) *Meals and living quarters*. The value of living quarters or meals which an employee receives in addition to his salary constitutes gross income unless they are furnished for the convenience of the employer and meet the conditions specified in section 119 and the regulations thereunder. For the treatment of rental value of parsonages or rental allowance paid to ministers, see section 107 and the regulations thereunder; for the treatment of statutory subsistence allowances received by police, see section 120 and the regulations thereunder.

(4) *Stock and notes transferred to employee or independent contractor*. Except as otherwise provided by section 421 and the regulations thereunder and § 1.61-15 (relating to stock options), and paragraph (d)(6)(i) of this section, if a corporation transfers its own stock to an employee or independent contractor as compensation for services, the fair market value of the stock at the time of transfer shall be included in the gross income of the employee or independent contractor. Notes or other evidences of indebtedness received in payment for services constitute income in the amount of their fair market value at the time of the transfer. A taxpayer receiving as compensation a note regarded as good for its face value at maturity, but not bearing interest, shall treat as income as of the time of receipt its fair discounted value computed at the prevailing rate. As payments are received on such a note, there shall be included in income that portion of each payment which represents the proportionate part of the discount originally taken on the entire note.

(5) *Property transferred on or before June 30, 1969, subject to restrictions*. Notwithstanding paragraph (d) (1), (2), or (4) of this section, if any property is transferred after September 24, 1959, by an employer to an employee or independent contractor as compensation for services, and such property is subject to a restriction which has a significant effect on its value at the time of transfer, the rules of § 1.421-6(d)(2) shall apply in determining the time and the amount of compensation to be included in the gross income of the employee or independent contractor. This (5) is also applicable to transfers subject to a restriction which has a significant effect on its value at the time of transfer and to which § 1.83-8(b) (relating to transitional rules with respect to transfers of restricted property) applies. For special rules relating to options to purchase stock or other property which are issued as compensation for services, see § 1.61-15 and section 421 and the regulations thereunder.

(6) *Certain property transferred, premiums paid, and contributions made in connection with the performance of services after June 30, 1969*.

(i) *Exception*. Paragraph (d)(1), (2), (4), and (5) of this section and § 1.61-15 do not apply to the transfer of property (as defined in § 1.83-3(e)) after June 30, 1969, unless § 1.83-8 (relating to the applicability of section 83 and transitional rules) applies. If section 83 applies to a transfer of property, and the property is not subject to a restriction that has a significant effect on the fair market value of such property, then the rules contained in paragraph (d)(1), (2), and (4) of this section and § 1.61-15 shall also apply to such transfer to the extent such rules are not inconsistent with section 83.

(ii) *Cross references*. For rules relating to premiums paid by an employer for an annuity contract which is not subject to section 403(a), see section 403(c) and the regulations thereunder. For rules relating to contributions made to an employees' trust which is not exempt under section 501(a), see section 402(b) and the regulations thereunder.

Generally, Code § 83 provides income tax consequences compensatory transfers of property. For that provision and related issues, see part II.M.4 Providing Equity to Key Employees and an Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

Rev. Rul. 98-21 asked, "When is the transfer of a nonstatutory stock option (*i.e.*, a compensatory stock option that is not subject to the provisions of section 421 of the Internal Revenue Code) by the optionee to a family member, for no consideration, a completed gift under section 2511?" and provided the following facts:

> A is employed by Company. Company has one class of stock. Company has a stock option plan under which employees can be awarded nonstatutory stock options to purchase shares of Company's stock. These stock options are not traded on an established market. The shares acquired on the exercise of an option are freely transferable, subject only to generally applicable securities laws, and subject to no other restrictions or limitations. Company grants to A, in consideration for services to be performed by A, a nonstatutory stock option to purchase shares of Company common stock. Company's stock option plan provides that the stock option is exercisable by A only after A performs additional services.
>
> All options granted under Company's stock option plan expire 10 years from the grant date. The exercise price per share of A's option is the fair market value of one share of Company's common stock on the grant date. Company's stock option plan permits the transfer of nonstatutory stock options to a member of an optionee's immediate family or to a trust for the benefit of those individuals. The effect of such a transfer is that the transferee (after the required service is completed and before the option's expiration date) will determine whether and when to exercise the stock option and will also be obligated to pay the exercise price.
>
> Before A performs the additional services necessary to allow A's option to be exercised, A transfers A's option to B, one of A's children, for no consideration.

Rev. Rul. 98-21 reasoned and held:

> Section 2501 imposes a tax on the transfer of property by gift by any individual. The gift tax is not imposed upon the receipt of the property by the donee, is not necessarily determined by the measure of enrichment resulting to the donee from the transfer, and is not conditioned upon the ability to identify the donee at the time of the transfer. The tax is a primary and personal liability of the donor, is an excise upon the donor's act of

making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable. Section 25.2511-2(a) of the Gift Tax Regulations.

The gift tax applies to a transfer of property by way of gift, whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible. Section 25.2511-1(a). For this purpose, the term property is used in its broadest and most comprehensive sense and reaches "every species of right or interest protected by law and having an exchangeable value." H.R. Rep. No. 708, 72d Cong., 1st Sess. 27 (1932); S. Rep. No. 665, 72d Cong., 1st Sess. 39, (1932); both reprinted in 1939-1 (Part 2) C.B. 476, 524. Some rights, however, are not property. See *e.g.*, *Estate of Howell v. Commissioner*, 15 T.C. 224 (1950) (nonvested pension rights were not property rights includible in gross estate under section 811(c) of the 1939 Code); *Estate of Barr v. Commissioner*, 40 T.C. 227 (1963) *acq.*, 1964-1 C.B. 4 (death benefits payable at discretion of board of directors who usually but not always, agreed to payment, were in the nature of hope or expectancy and not property rights includible in gross estate for estate tax purposes).

Generally, a gift is complete when the donor has so parted with dominion and control over the property as to leave the donor no power to change its disposition, whether for the donor's own benefit or for the benefit of another. Section 25.2511-2(b).

In *Estate of Copley v. Commissioner*, 15 T.C. 17 (1950), *aff'd*, 194 F.2d 364 (7th Cir. 1952), *acq.*, 1965-2 C.B. 4, the petitioner entered into an antenuptial agreement in which the petitioner promised to give the future spouse a sum of money in consideration of the marriage and in lieu of all the spouse's marital rights in the petitioner's property. The agreement became legally enforceable under state law on the date of the marriage in 1931. The petitioner transferred part of the sum of money in 1936 and the rest in 1944. The court concluded that a gift tax would have been due in 1931 if there had been a gift tax law in effect at that time.

In Rev. Rul. 79-384, 1979-2 C.B. 344, a parent promised to pay a child $10,000 if the child graduated from college. Rev. Rul. 79-384 holds that the parent made a gift on the day the child graduated from college, the date when the parent's promise became enforceable and determinable in value.

In Rev. Rul. 80-186, 1980-2 C.B. 280, a parent transferred to a child, for nominal consideration, an option to purchase real property for a specified period of time at a price below fair value. Rev. Rul. 80-186 holds that the transfer is a completed gift at the time the option is transferred provided the option is binding and enforceable under state law on the date of the transfer.

In the present case, Company grants to A nonstatutory stock option conditioned on the performance of additional services by A. If A fails to perform the services, the option cannot be exercised. Therefore, before A performs the services, the rights that A possesses in the stock option have not acquired the character of enforceable property rights susceptible of transfer for federal gift tax purposes. A can make a gift of the stock option to B for federal gift tax purposes only after A has completed the additional required services because only upon completion of the services does the right to exercise the option become binding and enforceable. In the event the option were to become exercisable in stages, each portion of the option that becomes exercisable at a different time is treated as a separate option for the purpose of applying this analysis. In the event that B is a skip person (within the meaning of section 2613(a)), the generation-skipping transfer tax would apply at the same time as the gift tax. See Rev. Proc. 98-34, 1998-18, which sets forth a methodology to value certain compensatory stock options for gift, estate, and generation-skipping transfer tax purposes.

Holding

On the facts stated above, the transfer to a family member, for no consideration, of a nonstatutory stock option, is a completed gift under section 2511 on the later of (i) the transfer or (ii) the time when the donee's right to exercise the option is no longer conditioned on the performance of services by the transferor.

In Letter Ruling 199952012, the taxpayer sought a ruling only regarding options that were vested and exercisable, in light of the position of Rev. Rul. 98-21.

Rev. Rul. 98-21 is wrong. The stock options were transferred in an a legally enforceable transaction in which the donor totally relinquished control. Rev. Ruls. 79-384 and 80-186 held that gifts were complete when the donor's relinquishment of rights became enforceable, and in Rev. Rul. 98-21 the donor relinquished his rights when he transferred the option, not when he performed the services. The IRS' concern that the option may have had no value when it was transferred because it was not exercisable at the time of the transfer is an argument that footnote 8 of *Di Marco* rejected.[6331]

How does Rev. Rul. 98-21 compare with the split-dollar regulations issued in 2003? In Reg. § 1.61-22(c)(2)(ii), the employee's rights in the insurance policy belong to an irrevocable life insurance trust, so the employee has no control over the benefits the employer is providing. However, each year the employer is making a new transfer by paying the premiums, and that transfer is in the nature of compensation for services rendered; thus, the employer's annual transfer is compensation to the employee and a gift by the employee to the trust. In Rev. Rul. 98-21, the employer is not making any further transfers of property after issuing the stock option.

III.B.1.a.v.(c). Evaluating the Continuum

Congress and the IRS have attacked certain compensatory awards – generally in the partnership area:

- Profits interests generally receive capital gain treatment on sale; see part II.M.4.f Issuing a Profits Interest to a Service Provider. However, some profits interests require a 3-year holding period to receive long-term capital gain rates; see part II.M.4.f.ii.(b) Code § 1061 - Certain Sales of Compensatory Partnership Interests Recharacterized from Long-Term to Short-Term Gains. Although profits interests can carry through capital gain, distributions of profits can be recharacterized as compensation income (and the payment may or may not be deductible) if the payment stream is not sufficiently subject to entrepreneurial risk; see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed. Also, distributions to partners who contribute property to a partnership may be disguised sales if

[6331] See text accompanying and preceding fn 6329.

they are not sufficiently subject to entrepreneurial risk; see part II.M.3.e Exception: Disguised Sale Rules.[6332]

- Code § 2701 can artificially inflate gift tax values when using a profits interest; see part III.B.7.c Code § 2701 Interaction with Income Tax Planning, especially parts III.B.7.c.i Profits Interest in a Partnership that Was a Straight-Up Partnership before the Transfer, III.B.7.c.ii Profits Interest in a Partnership in Which Transferor and Applicable Family Members Initially Hold Only a Profits Interest, III.B.7.c.iii Same Class Exception - Possible Application to Profits Interests and Other Situations and III.B.7.c.iv Transfers When Owner Holds Profits Interest/Carried Interest and Other Interests.

The more complex the structure, the more difficulty one may have separating potential gifts. Code § 2501 does not subject to gift tax services one family member performs for another, but it does tax transfers of property that third parties make to one family member in exchange for services provided by another family member.

Here are some example of strategies that I think work:

- If the business gives the children a long-term lease that secures 100% bank financing, and the business and lease are so solid that, using rental payments to pay down the mortgage, the children are pretty much guaranteed to get a fully paid-for building. The children did nothing (triple net lease) and got a building. Yes, it took decades to grow that equity instead of a year or two, but it was the parents' efforts at making the business solid that got that equity to the children. And the business could have bought the real estate itself with a mortgage but chose to instead finance it with a lease, but really the lease obligations were as real a business obligation as the mortgage would have been.

- Another example – client developed an equipment leasing business – multi-million dollar pieces of equipment. He knew businesses that would rent the equipment on a long-term lease, he knew bankers that will loan to finance the equipment, and he set up the financing deals and leases. It's all through his personal efforts. He had an S corporation (100% owned by him) that he used for deals, but he had no contractual obligation to the corporation to do deals for it. He set up deals for his children, too. 100% of the deal value was generated through his upfront efforts – it's all triple net leases.

- See also part III.B.1.a.vii Business Expansion into New Location.

What if client decides to work on a deal with unrelated parties; and the client, irrevocable trusts for the client's family, or some combination of the above could invest and participate in a new undertaking? The investment is necessary to start the business but is relatively small compared to the business' value if the client and his/her cohorts put together profitable deals for the business. All investors lose if the deals are not put together, but those putting together the deals have a great track record of success. Is granting the opportunity to invest a gift? Not according to *Crowley* and *Alabama-Georgia Syrup Co*. How about when third party investors pour in funds, increasing the value of all of the original investors' investments?

[6332] Conversely, if a partnership has a capital call (requires the partners to contribute funds) and distributes property to the partners too closely together, the partnership might have inadvertently sold the distributed assets. See part II.Q.8.b.i.(c) Disguised Sale from Partnership to Partner.

- The relative ownership of the client and the trusts does not change due to the third party investors, so this is all growth in business value. Rev. Rul. 98-21 may take issue with this, in that the client's ongoing services are part of what caused this value increase, but failure to perform those services would not have caused any business interest to be forfeited, so even Rev. Rul. 98-21's attack on lack of vesting would not apply.

- On the other hand, *Dodge* and the split dollar regulations involve transfers by third parties that constitute compensation to the service provider and gifts from the service provider to the person(s) benefitting from the transfer, and we have a third party influx of cash here. Some estate planners are uncomfortable with this rapid influx of value into the trusts, believing that the nature of the deal is different than the real estate and equipment deals described above. I do not share their discomfort but pass it along to you so that you can find your own comfort zone.

III.B.1.a.vi. Asset Transfers to Children or Their Businesses

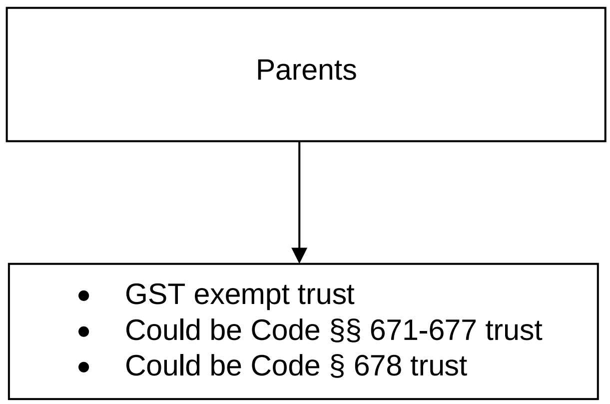
When transferring an asset with low current value from which the children could reap significant profits, be extra careful to make sure that the transfers are properly documented to ensure locking in the current value. Otherwise, the IRS might argue that the transferor still owns the asset or transferred it at a later time.[6333]

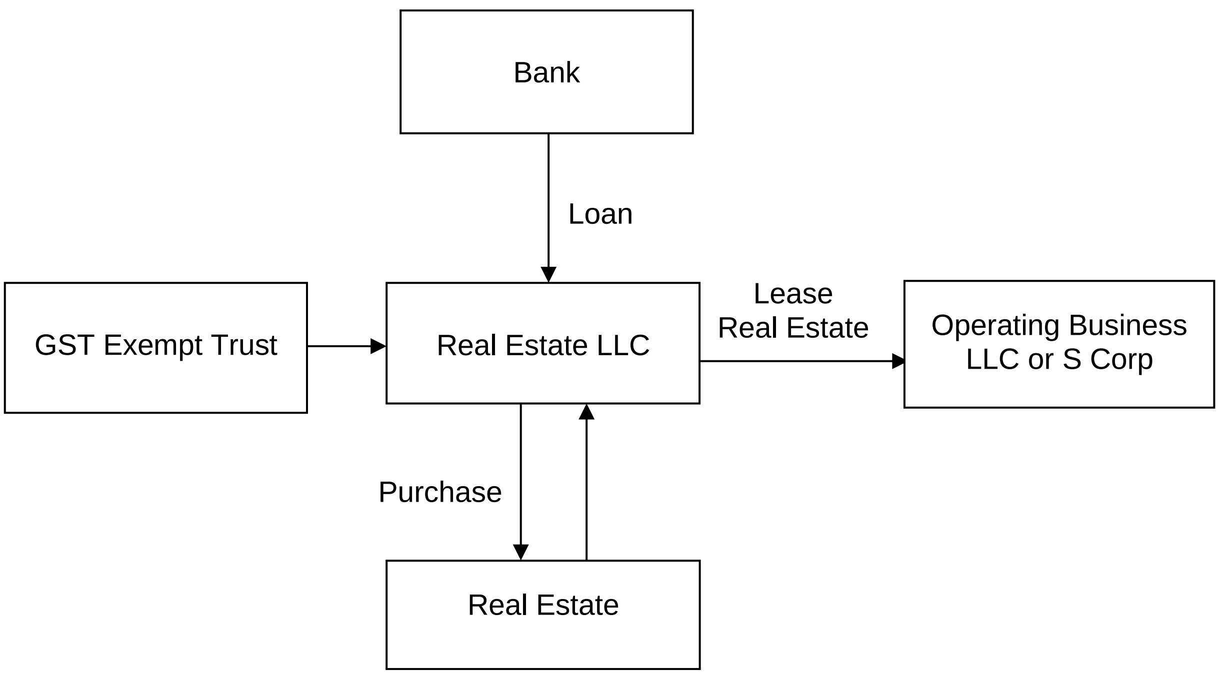
Be careful to document values and the business purpose. See parts II.Q.7.h.iv Taxpayer Win in *Cox Enterprises* When IRS Asserted That Contributing Property to Partnership Constituted Distribution to Shareholders (2009); *Dynamo Holdings'* Limitation on Using *Cox Enterprises* (2018), II.Q.7.h.v Taxpayer Win in *Bross Trucking* When IRS Asserted Corporation Distribution of Goodwill to Shareholder Followed by Gift to Shareholder of New Corporation (2014) and II.Q.7.h.vi IRS' Conservative Roadmap: Letter Ruling 200934013.

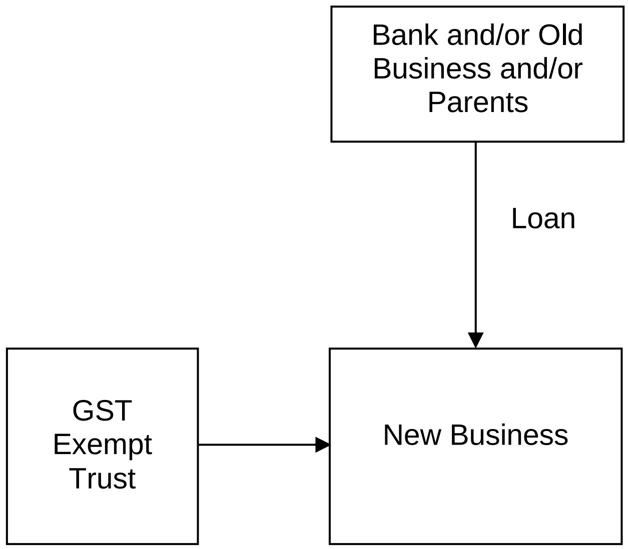
[6333] *Cavallaro v. Commissioner*, T.C. Memo. 2014-189 (supposed transfer was documented many years later; gift occurred at time of proper documentation), *rev'd* on other grounds 118 A.F.T.R.2d ¶2016-5517 (1st Cir. 11/18/2016).

III.B.1.a.vii. Business Expansion into New Location

Consider the following:







III.B.1.a.vii.(a). Estate Planning

A new business or real estate venture often has either minimal value or net asset value. This structure moves future growth outside of the estate tax system.

However, one might consider some mechanism to get the property back into the estate tax system, to get a basis step-up when a beneficiary dies; this concern applies particularly when a beneficiary's gross estate is below the beneficiary's available estate tax exemption, but planning strategies can provide a basis step-up with minimal estate tax even if the beneficiary has a taxable estate.[6334]

When used for real estate, growth in value, although desirable, is not necessary for this to be beneficial for estate tax planning. The property will gain equity simply by the real estate LLC using the rent to pay down the mortgage.

When used for real estate, this can facilitate equalizing bequests to family members not involved in the business. The outsiders get real estate rental income, and the insiders get business income.

When used for an operating business, this also facilitates siblings pursuing different lines of business or different locations so that they are not entangled with each other as long.

To explore any gift tax issues relating to the ideas above, see part III.B.1.a.v Sending Business or Performing Services.

III.B.1.a.vii.(b). FICA Planning

Partnership income from a trade or business is generally subject to self-employment tax, unless the partner is a limited partner.

[6334] See part II.H Income Tax vs. Estate and Gift Tax (Particularly for Depreciable Property).

In recent income tax cases, the Service has tried to characterize a member of a limited liability company as a limited partner to disallow losses for income tax purposes under the Code § 469 passive loss rules. Courts have rejected this attempt.

Real estate rental income is not subject to self-employment tax. Holding the real estate in a separate LLC would allow the business LLC to deduct rent payments for income and self-employment tax purposes and the real estate LLC owners to be subject to income but not self-employment tax. This self-employment tax savings is often small in initial years, because if the property were held in the business LLC then the business would deduct interest, depreciation, etc. However, as the mortgage gets paid down (thereby decreasing interest deductions) and rent increases, this savings can be significant.

See II.L.3 Self-Employment Tax: General Partner or Sole Proprietor, for a detailed discussion.

III.B.1.b. Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts

Interpreting the Revenue Act of 1932, *Smith v. Shaughnessy*, 318 U.S. 176 (1943), held:

> The government argues that for gift tax purposes the taxpayer has abandoned control of the remainder and that it is therefore taxable, while the taxpayer contends that no realistic value can be placed on the contingent remainder and that it therefore should not be classed as a gift.
>
> We cannot accept any suggestion that the complexity of a property interest created by a trust can serve to defeat a tax. For many years Congress has sought vigorously to close tax loopholes against ingenious trust instruments.[3] Even though these concepts of property and value may be slippery and elusive they can not escape taxation so long as they are used in the world of business. The language of the gift tax statute, "property … real or personal, tangible or intangible", is broad enough to include property, however conceptual or contingent. And lest there be any doubt as to the amplitude of their purpose, the Senate and House Committees, reporting the bill, spelled out their meaning as follows:
>
>> "The terms 'property,' 'transfer,' 'gift', and 'indirectly' [in § 501] are used in the broadest sense; the term 'property' reaching every species of right or interest protected by the laws and having an exchangeable value."[4]
>
> [3] 2 Paul, *Federal Estate & Gift Taxation*, Chap. 17; Schuyler, "Powers of Appointment and Especially Special Powers: The Estate Taxpayer's Last Stand," 33 Ill.L.Rev. 771; Leaphart, "The Use of the Trust to Escape the Imposition of Federal Income & Estate Taxes," 15 Corn.L.Q. 587.
>
> [4] Senate Report No. 665, 72d Cong., 1st Sess., p. 39; House Report No. 708, supra, p. 29.
>
> The Treasury regulations, which we think carry out the Act's purpose, made specific provisions for application of the tax to, and determination of the value of, "a remainder… subject to an outstanding life estate."[5]

[5] Treas. Regulations 79 (1936 Ed.) Arts. 2, 3, 17, 19. Cf. *Commissioner of Internal Revenue v. Marshall*, 2 Cir., 125 F.2d 943, 945, 141 A.L.R. 445.

> The essence of a gift by trust is the abandonment of control over the property put in trust. The separable interests transferred are no gifts to the extent that power remains to revoke the trust or recapture the property represented by any of them, Burnet v. Guggenheim, supra, or to modify the terms of the arrangement so as to make other disposition of the property, Sanford v. Commissioner, supra. In the Sanford case the grantor could, by modification of the trust, extinguish the donee's interest at any instant he chose. In cases such as this, where the grantor has neither the form nor substance of control and never will have unless he outlives his wife, we must conclude that he has lost all "economic control" and that the gift is complete except for the value of his reversionary interest.[6]

[6] The conclusion reached here is in accord with that of the several Circuit Courts of Appeal which have considered the problem: *Commissioner v. Marshall*, 2 Cir., 125 F.2d 943, 141 A.L.R. 445; *Commissioner v. Beck's Estate*, 2 Cir., 129 F.2d 243; *Commissioner v. McLean*, 5 Cir., 127 F.2d 942; *Helvering v. Robinette*, 3 Cir., 129 F.2d 832, affirmed by this Court today; *Hughes v. Commissioner*, 9 Cir., 104 F.2d 144; and see the cases cited in Note (2), supra.

On the same day, *Robinette v. Helvering*, 318 U.S. 184 (1943), held:

> The instruments created by these grantors purported on their face wholly to divest the grantors of all dominion over the property; it could not be returned to them except because of contingencies beyond their control. Gifts of future interests are taxable under the Act, § 504 (b), 26 U.S.C.A. Int.Rev.Acts, page 586, and they do not lose this quality merely because of the indefiniteness of the eventual recipient. The petitioners purported to give the property to someone whose identity could be later ascertained and this was enough.

Reg. § 25.2511-2(a) provides:

> The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable. For gift tax rules related to an ABLE account established under section 529A, see § 1.529A-4 of this chapter.

DiMarco v. Commissioner, 87 T.C. 653, 656-663 (1986), discussed in part III.B.1.a.v.(b) Property Transfer Clearly Tied to Services, held that a property transfer that the purported donor did not instigate did not constitute a gift. Therefore, it was not an "act of making [a] transfer."

Reg. § 25.2512-8, "Transfers for insufficient consideration," provides:[6335]

> Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth. A consideration not reducible to a value in money or money's worth, as love and affection, promise of marriage, etc., is to be wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift. Similarly, a relinquishment or promised relinquishment of dower or curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the spouse's property or estate, shall not be considered to any extent a consideration "in money or money's worth." See, however, section 2516 and the regulations thereunder with respect to certain transfers incident to a divorce. See also sections 2701, 2702, 2703 and 2704 and the regulations at § 25.2701-0 through 25.2704-3 for special rules for valuing transfers of business interests, transfers in trust, and transfers pursuant to options and purchase agreements.

See part II.D.2 Business Entity as Grantor of Trust or Donor to Charity or Other Donee, which focuses on gifts made by the business entity that are attributed to owners, whereas this part III.B.1.b focuses on transfers of business interests by the owners.

See part III.B.1.e.ii Valuing a Beneficial Interest in a Trust, which essentially caps the value of any gift a beneficiary makes in this part III.B.1.b.

Zeydel, "Developing Law On Changing Irrevocable Trusts: Staying Out Of The Danger Zone," 47 *Real Property, Trust and Estate Law Journal* 1, 54-61 (Spring 2012), suggests that the safe harbors under Reg. § 26.2601-1(b)(4)(i), which are described in part III.B.1.d.i Effect of "Additions" on Grandfathering from GST Rules, provide clues as to transactions that the IRS does not view as gifts.

Rev. Rul. 75-71 involved the following facts:

> In 1968 three of X's sisters, the only then surviving of the original six brothers and sisters, entered into an agreement whereby each contracted, in the event she survived X, to transfer to the children of any contracting party who failed to survive X, that portion of X's estate to which the deceased contracting party would have been entitled if all three contracting parties had survived X. X died in 1973, leaving the taxpayer as the sole surviving beneficiary. Thereafter, upon receipt of her inheritance, the taxpayer made distributions to her nieces and nephews pursuant to the terms of the agreement with their parents.
>
> Under the applicable local law, the agreement between the expectant legatees for the benefit of the third party beneficiaries created a mutually binding contractual obligation at the time of its execution. However, because of the aleatory nature of the contract, it did not become enforceable until X died. That is, performance under the contract was

[6335] As to the second sentence, see part III.B.1.h Transfers in the Ordinary Course of Business.

> dependent upon the uncertainty that any party would actually receive an inheritance under X's will since she could have revoked or amended the will or disposed of all her property before she died. Such uncertainty was removed only by her death.

Rev. Rul. 75-71 held:

> Although the local law treats the transfers in this case as performance of contractual obligations based on mutual promises of the contracting parties, the transfers are not deprived of their essential characteristics as gifts if the donor does not receive "adequate and full consideration in money or money's worth" in return for the transferred property. In this case the taxpayer received nothing more than the assurance that, if she should die before X and one or both of the other two expectant legatees should survive X, her children would receive one-third of the total inheritance from X. Such an assurance is not "adequate and full consideration in money or money's worth" since it does not offset the decrease in the value of the taxpayer's estate that was caused by the transfer of two-thirds of her inheritance. *Commissioner v. Wemyss*, 324 U.S. 303 (1945); *Estate of John M. Goetchuis*, 17 T.C. 495 (1951); *Commissioner v. Bristol*, 121 F. 2d 129 (1st Cir. 1941).
>
> At the date of death of X the uncertainty that there would ever be a transfer of property pursuant to the contract between the prospective legatees was removed. It was at this time that the rights of the third party beneficiaries (the nieces and nephews) became enforceable against the taxpayer, thus allowing the value of the gift to be determined.
>
> Accordingly, the payments that the taxpayer became obligated to make pursuant to the terms of the contract with the other prospective legatees were taxable as gifts at the date of X's death.

Much of this part III.B.1.b deals with the consequences of trust modification. For trust modification generally, see part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting. If and to the extent a beneficiary's consent is not required for an action to take place, such as in part II.J.18.c Decanting, the beneficiary has a better case for the modification not constituting a gift. If and to the extent that the person(s) modifying the trust has discretion to do so and a beneficiary has no rights to stop the modification, such as described in part II.J.18.f Commutation vs Mere Division, that beneficiary has a better case for the modification not constituting a gift. These arguments are important, because the consequences of a beneficiary making a gift in trust are disproportionately big; see part III.B.7.d Code § 2702 Overview.[6336]

For smaller companies, consider gifts either outright or in trust. Gifts provide more favorable valuation rules than transfers by bequest. Suppose, for example, that a decedent bequeathed 100% of the stock of her business to her children. The bequest is of a single 100% block of stock, so valuation adjustments for lack of control would not apply. However, if while alive she gave a 20% block of stock to each of five children, so that she gave away 100% of all of stock all at once. Each 20% block is valued separately, with valuation adjustments for lack of control.[6337] Similarly, when a taxpayer owning 100% of real property gave a 48% interest each

[6336] Especially text accompanying fns 7381-7390.
[6337] Rev. Rul. 93-12.

son and retained a 4% interest for himself, each son's interest was properly valued as a stand-alone 48% interest.[6338]

When a donor delivers a properly indorsed stock certificate, when the gift is complete depends on to whom the donor delivers the certificate:[6339]

- If delivered to the donee or the donee's agent, the gift is complete for gift tax purposes on the date of delivery.

- If delivered to the donor's bank or broker as the donor's agent, or to the issuing corporation or its transfer agent, for transfer into the name of the donee, the gift is complete on the date the stock is transferred on the corporation's books.

A gift to a minor should probably be done using the Uniform Transfers to Minors Law unless the gift is in trust. Gifts to minors of partnership interests that are not done in that manner can be problematic, and a conservatorship would be advisable.[6340]

For corporations, the author frequently recommends that clients create nonvoting stock, doing a 19-for-1 nonvoting-for-voting stock dividend.[6341] The parent keeps the voting stock, which represents all of the voting rights, but only 5% of the distribution rights, the parent then transfers part or all of the nonvoting stock.[6342] This restructuring may also be a prelude to the more advanced techniques.

For an S corporation, a simple way to protect the principal from the donee's creditors (including the IRS through estate taxes) would be to use a qualified subchapter S trust (QSST).[6343] A QSST has only one beneficiary, and all of its income must be distributed to that individual. A QSST's income is taxed to its beneficiary,[6344] which means that the trust's fiduciary income tax returns simply report the trust's income on a statement, which the beneficiary then uses to prepare his or her own individual income tax returns. For the merits of QSSTs compared to

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[6338] *Buck v. U.S.*, 128 A.F.T.R.2d 2021-6043 (D. Conn. 09/24/2021).

[6339] Reg. § 25.2511-2(h). When in doubt as to whether the gift was complete, look at the parties' conduct and local law. *Estate of Davenport*, T.C. Memo. 1997-390, *aff'd* 184 F.3d 1176 (10th Cir. 1999) (completed gift when donor signed stock power).

[6340] Reg. § 1.704-1(e)(2)(viii) provides that, except where a minor child is shown to be competent to manage his own property and participate in the partnership activities in accordance with his or her interest in the property, a minor child generally will not be recognized as a member of a partnership unless control of the property is exercised by another person as fiduciary for the sole benefit of the child, and unless there is such judicial supervision of the conduct of the fiduciary as is required by law. Of course, that is an income tax regulation and does not on its face apply for gift/estate/GST tax purposes. An income tax regulation cannot override the state law property rights that apply for gift/estate/GST tax purposes, and the *Pierre* case certainly drove home that point when it held that the check-the-box regulations did not apply to determine the gift tax effect of the transfer of an interest in a single-member LLC; *Pierre* is described in part III.B.1.e Valuation Issues. On the other hand, gift/estate/GST tax rules governing partnerships are not well-defined, and courts and the IRS often look to income tax rules when figuring out matters involving partnerships, so a conservatorship would be recommended to avoid an argument, as well as to prove acceptance of the gift.

[6341] See fn 234 for reporting requirements relating to this stock dividend.

[6342] A transfer of nonvoting stock poses much less estate tax risk than a transfer of minority voting stock. See fns 230-232.

[6343] Code § 1361(d)(3).

[6344] Code § 1361(d)(1)(B).

other alternatives, see part III.A.3 Trusts Holding Stock in S Corporations, especially part III.A.3.e.iii Comparing QSSTs to ESBTs.

Whether a transfer qualifies for the gift tax annual exclusion depends on whether the property is transferable or income-producing and whether it is outright or in trust.[6345] If the interest transferred is not income-producing, consider giving the donee the right to sell it to the donor for its fair market value within 30 days after the transfer. If, however, the donor received the funds from an unauthorized distribution from a trust, the gift may be undone.[6346]

For the first year a gift is made to a trust that has generation-skipping transfer (GST) potential, I strongly recommend filing timely (including extensions) a gift tax return stating whether the donor elects to automatically allocate[6347] or not allocate[6348] GST exemption to the donor's current and future gifts to the trust, which election may be revoked or otherwise modified on future timely-filed gift tax returns. "Vested" trusts for grandchildren (or other skip persons) may qualify for the GST annual exclusion, but trusts that do not so qualify are much more common. A trust whose beneficiaries are only skip persons is itself considered a skip person, and gifts to such a trust automatically are allocated GST exemption. Also, a trust that reserves enough benefits for skip persons is a "GST trust" (unless opted out under the first sentence of this paragraph),[6349] gifts to which are "indirect skips" that automatically attract GST exemption.

[6345] For qualification of withdrawal rights for the annual exclusion, see *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), and its progeny. For whether an interest in a business entity qualifies for the annual exclusion, see part III.B.1.h Transfers in the Ordinary Course of Business. For the amount of the annual exclusion, see Code § 2503(b).

[6346] The official Tax Court syllabus to *Estate of Lillian L. Halpern v. Commissioner*, T.C. Memo. 1995-352:

> A trust established for D's benefit under the will of her husband, H, provided for payment to her of income for life (and principal according to an ascertained standard) and gave her a testamentary general power of appointment. Distributions of trust principal were made to members of D's family, both before and after D, having suffered a stroke, was adjudged incompetent. Those distributions were not authorized by H's will or by court order. All living members of the family, including D, agreed, either personally or through custodians, to the distributions before D's incompetency; D did not agree, even through her guardians, to the distributions after her incompetency, but all the other members of the family did agree.
>
> *Held*, sec. 2038, I.R.C., does not apply to include any of the distributions in D's gross estate. *United States v.* Field, 255 U.S. 257 (1921), followed.
>
> Held further, a Pennsylvania court would not have returned to the marital trust the assets *distributed* to family members prior to D's incompetency, and those assets are therefore not included in D's gross estate under sec. 2041, I.R.C. *Estate of Council v. Commissioner*, 65 T.C. 594 (1975), followed.
>
> *Held* further, a Pennsylvania court would have returned to the marital trust the assets distributed following D's incompetency, and they therefore are included in D's gross estate under sec. 2041, I.R.C.
>
> *Held* further, assets transferred through the 1986 distributions, which occurred within 3 years of D's death, are not included in her gross estate under sec. 2035, 2038, or 2041, I.R.C., by virtue of that timing.

[6347] Code § 2632(b)(5)(A)(ii).

[6348] Code § 2632(b)(5)(A)(i).

[6349] Code § 2632(c)(3)(B) describes what a "GST trust" is. Letter Ruling 200243026 involved a GST trust. Letter Ruling 201714008 seems to indicate that one ignores unexercised powers of appointment when determining whether a trust is a "GST trust." Letter Ruling 201714008 involved the following facts:

> On Date, a date occurring after 2001, Donor created Trust for the benefit of Brother, Brother's spouse, and Brother's descendants. On the same date, Donor transferred $a to Trust.

Restructuring trusts might or might not have tax consequences. The discussion in the rest of this part III.B.1.b is subject to the idea that any person, who is a remainderman in default of the exercise of a power of appointment and is not a current permissible distributee, appears not to have an interest in any modification that affects only current trust administration and therefore would not make a gift upon any such modification.[6350] However, CCA 202118008 argued that the interests of remaindermen in default of a testamentary power of appointment, who were children when the class of potential appointees was descendants, were readily valued.[6351]

Suppose a trust includes a power that would cause estate inclusion and a court modifies the trust (not a retroactive clarification, but rather a prospective modification). Letter Ruling 201652002 approved reforming a GRAT to include required language.[6352] Florida Trust

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> Under the trust instrument, Brother has a lifetime and testamentary limited power to appoint trust assets to Brother's spouse or lineal descendants, subject to an ascertainable standard, and the power to appoint trust assets to any charitable organization, but has no power to appoint assets in favor of himself, his estate, his creditors, the creditors of his estate, or to discharge any of his legal obligations.
>
> Under the trust instrument, Brother has a withdrawal power in an amount equal to any contribution to Trust and upon his death, the withdrawal power passes to Brother's spouse. The withdrawal power may not exceed the least of (i) the total amount of contributions to Trust during that year, (ii) the amount allowable at the time of the first contribution as an exclusion from gift tax under § 2503(b)(3) (or twice this amount if the donor is married on the date of the last of all contributions made during that year), and (iii) the greater of $5,000 or 5 percent of the value of Trust. Trust provides that any unexercised right of withdrawal shall lapse at the end of each year or, if earlier, thirty days after the contribution to which it relates.

Counsel advised the donor that the trust was a "GST trust." Later, counsel was not quite sure. Thus, rather than formally electing to treat the trust as a "GST trust" on a gift tax return reporting the first gift to the trust, a pretty painless procedure, the donor instead needed to get an expensive letter ruling. Fortunately, Letter Ruling 201714008 held:

> In this case, Trust is a trust that could have a GST with respect to the transferor. Under the terms of Trust, no provision is made for mandatory distributions to beneficiaries who are non-skip persons. Although Brother is granted a power of appointment over Trust corpus, the power is limited to a certain class of beneficiaries and Brother has no power to appoint assets in favor of himself, his estate, his creditors, the creditors of his estate, or to discharge any of his legal obligations. Although Trust provides withdrawal powers to beneficiaries who are non-skip persons, since the amount of the annual withdrawal rights in Trust do not exceed the amount referred to in § 2503(b), the amount subject to the withdrawal right shall not be considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal pursuant to § 2632(c)(3)(B). Furthermore, the withdrawal rights lapse each year in their entirety. Accordingly, based on the facts submitted and the representations made, we conclude that none of the exceptions to the definition of a "GST trust" in § 2632(c)(3)(B) apply. Therefore, on the date of Donor's Transfer to Trust, Trust was considered a "GST trust" under § 2632(c)(3)(B) and, accordingly, we conclude that Donor's available GST exemption was automatically allocated to the transfer to Trust on Date pursuant to § 2632(c)(1).

[6350] See fn 2136 in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.

[6351] CCA 202118008 is described in detail in the text preceding the text accompanying fn 2996 in part II.J.18.d Trust Commutations.

[6352] For comments from the ACTEC Fellow who obtained the ruling, see Thompson Coburn LLP document number 6488460. Letter Ruling 201941023 gave retroactive effect (and therefore no tax consequences) to a reformation:

> In this case, an examination of the relevant trust instruments, affidavits, and representations of the parties indicate that the original terms of Paragraph 7.02, resulting from a scrivener's error, were contrary to the intent of Settlor. The purpose of the reformation is to correct the scrivener's error, not to alter or modify the trust instrument.

Code § 736.0416, which corresponds to Uniform Trust Code § 416, authorized the action. The GRAT's savings clause probably helped a lot in terms of making the court action a retroactive reformation clarify the original intent rather than a prospective modification:

> In this case, each trust instrument provides that Grantor's retained interest is intended to constitute a qualified interest within the meaning of § 2702(b)(1). However, the attorney retained to draft each trust instrument failed to include in each instrument the prohibition required by § 25.2702-3(d)(6) thus causing the interest Grantor retained in each Trust to fail to constitute a qualified interest within the meaning of § 2702(b)(1). The trust instruments and State Statute permit the amendment of each Trust.
>
> Accordingly, based on the facts submitted and the representations made, we conclude that as a result of the judicial reformation of Trusts to correct scrivener's error, Grantor's interest in each Trust is a qualified interest under §§ 25.2702-2 and 25.2702-3, effective as of the date each Trust was created.

Although the modification itself might have transfer tax consequences, if the modification is legally binding then the IRS will respect its subsequent effect – even if inconsistent with what the highest court in the state would have done. Rev. Rul. 73-142 held:

> In this case the lower court had jurisdiction over the parties and over the subject matter of the proceeding. Thus, the time for appeal having elapsed, its judgment is final and conclusive as to those parties, regardless of how erroneous the court's application of the state law may have been. Consequently, after the time for appeal had expired, the grantor-decedent did not have the power to appoint himself as successor trustee. The aforesaid rights and powers which would otherwise have brought the value of the trust corpus within the provisions of sections 2036 and 2038 of the Code were thus effectively cut off before his death.
>
> Unlike the situation in *Bosch*, the decree in this case was handed down before the time of the event giving rise to the tax (that is, the date of the grantor's death). Thus, while the decree would not be binding on the Government as to questions relating to the grantor's power to appoint himself as trustee prior to the date of the decree, it is controlling after such date since the decree, in and of itself, effectively extinguished the power. In other words, while there may have been a question whether the grantor had such power prior to the decree, there is no question that he did not have the power thereafter.
>
> Accordingly, it is held that the value of the property transferred to the inter vivos trust is not includible in the grantor-decedent's gross estate under section 2036 or section 2038 of the Code.

However, the IRS sometimes conflates the two concepts, as it did in CCA 201747005.[6353]

Failing to enforce one's legal rights might constitute a gift. Rev. Rul. 84-105 held that the surviving spouse made a gift by failing to object to underfunding of a general power of

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[6353] See part II.J.4.c.i Estate or Nongrantor Trust Contribution Deduction Requirements, looking at the requirement that the governing instrument must authorize a distribution to charity for the trust to take the Code § 642(c) charitable deduction.

appointment marital deduction trust for her benefit over which she appeared to have an unlimited withdrawal right:

> In the present case, S could have recovered the [shortfall] by routinely asserting in the local probate court the right as beneficiary under D's will to have the bequest adequately satisfied. The fact that some of the land would have had to be either sold or severed to satisfy fully the bequest to S would not have impaired S's claim for full satisfaction. The failure of S to raise an objection to the underfunding of the testamentary trust at some time before the expiration of S's right to appeal the final order of the local probate court in effect constituted an irrevocable transfer to C by S of the 40x dollar amount.
>
> S's acquiescence in the underfunding of the trust is not an assignment or surrender of a property interest in settlement of a controversy described in section 20.2056(e)-2(d)(1) of the regulations. Further, S's acquiescence is not a qualified disclaimer because S made no disclaimer of the 40x dollar amount within 9 months of D's death.
>
> For purposes of the estate and gift tax provisions of the Code, the amount of property that passed from D to S under D's will was [the full amount of the bequest shown on the estate tax return], notwithstanding the underfunding of S's trust. The [shortfall] that was diverted by D's executor from S to C is a gift by S to C on [the expiration date of S's right to appeal the probate court's approval of the estate settlement].

Rev. Rul. 81-264 held that D made a gift to A by failing to enforce A's note payable to D:

> Here, as in all such familial transactions, there is a presumption that the transfer of wealth from D to A without consideration is not entirely free of donative intent. *Estate of Lang v. Commissioner*, 64 T.C. 404 (1975), *aff'd*, 613 F.2d 770 (9th Cir. 1980). A had the resources to pay the debt, and, as D's child, was the natural object of D's bounty. On these facts, D's failing to enforce the debt obligation and permitting it to be barred by the statute has not been shown to be free of donative intent, and thus is not a transaction in the ordinary course of business within the meaning of section 25.2512-8 of the regulations.
>
> It does not matter that the running of the statute of limitations does not extinguish the debt but merely creates an affirmative defense in a collection suit. Control of the debt passes to the debtor when the statute of limitations runs. Thereafter, it is the debtor rather than the creditor who decides whether and under what terms loaned funds will be repaid. The essence of a gift is such relinquishment of control by the donor over the property. *Estate of Lang v. Commissioner*.

Providing background to Rev. Rul. 81-264, GCM 38584 reasoned:

> We generally agree with the conclusion of the proposed revenue ruling that D makes a gift to A upon the expiration of the statute of limitations. *Estate of Lang v. Commissioner*, 64 T.C. 404 (1975), *aff'd*, 613 F.2d 770 (9th Cir. 1980). In *Lang*, the Service asserted a gift tax deficiency based upon the lapse of the statute of limitations on the collection of certain loans made by Mrs. Lang to her son. The Tax Court, finding that the petitioner had not overcome the presumption of correctness of the respondent's determination that taxable gifts were made upon the expiration of the statute, sustained the Commissioner. The court noted that donative intent on the part of Mrs. Lang was irrelevant to the

determination that a gift had been made[1] and that Mrs. Lang was presumed to know that the statute had run.

[1] *See Commissioner v. Wemyss*, 324 U.S. 303, 306 (1945), Treas. Reg. § 25.2511-1(g)(1).

The Ninth Circuit, in affirming the Tax Court decision, analyzed the transfer of property necessary to an imposition of a gift tax in the following manner.

> The running of the statute of limitations, however, accomplishes much more than the taxpayer suggests. It serves to transfer control of a debt to the debtor at the end of the statutory period. Thereafter, it is the debtor rather than the creditor who decides whether and under what terms loaned funds will be repaid. *Cf. Smith v. Shaughnessy*, 318 U.S. 176, 181 (1943) ("The essence of a [taxable] gift by trust is the abandonment of control over the property put in trust ") That control is transferred by a statutory mechanism rather than an overt donative gesture is not significant. "Indirect" gifts are as subject to the gift tax as are "direct" gifts. I.R.C. § 2511(a); Treas. Reg. § 25.2511-1(c) (1958). *Estate of Lang*, 613 F.2d at 773.

The Ninth Circuit also noted several factors that supported the presumption of a gift. Mrs. Lang's son had borrowed money from Mrs. Lang on five separate occasions, never repaying any portion of it. Further, Mrs. Lang had expressly forgiven portions of two of the loans, and in her will she forgave the remaining debts of her son, including the loans at issue. Finally, the court noted that the loans were not typical business loans since they bore no interest. Based upon these facts, the court held that the Tax Court did not err in finding that Mrs. Lang had allowed the statute of limitations to run and had thereby implicitly forgiven the debts. Moreover, the court noted that this finding of donative intent was not essential to a finding that a taxable gift had occurred.

Therefore, we generally agree that under the facts in the proposed revenue ruling D will make a gift to A upon the expiration of the statute of limitations on the collection of the loan. We wish to point out, however, that there may be occasions where a taxpayer can successfully argue that the transfer occasioned by the lapse of the statute of limitations was made "in the ordinary course of business' within the meaning of Treas. Reg. § 25.2512-8 so as to prevent such transfer from being classified a gift. Treas. Reg. § 25.2512-8 provides in relevant part as follows:

> § 25.2512-8 *Transfers for insufficient consideration*. Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth….

Although not articulated with any precision by either the Tax Court or the Ninth Circuit, this concern that certain transfers occasioned by the lapse of the statute of limitations might not be gifts is evident in both opinions. The Tax Court flatly stated:

> We do not thereby imply that in all circumstances the mere running of the statute of limitations on a loan constitutes a gift for gift tax purposes. We merely hold that under the circumstances of this case, we cannot rule that petitioner has carried its burden of proof to the contrary. *Estate of Lang*, 64 T.C. at 413.

The Ninth Circuit specifically noted that the loans by Mrs. Lang to her son "were not typical business loans, for they bore no interest," 613 F.2d at 773. Interestingly, in answering the petitioner's assertion that, because Mrs. Lang had died, it had no way of proving she did not intend to allow the statute to run, the Ninth Circuit stated in a footnote that petitioner might have had other parties testify whether Mrs. Lang ever made informal attempts to collect the debts. Since the court, as discussed above, also noted that donative intent was irrelevant, its discussion of methods for proving intent in the footnote can be construed as relating to the limited exception for transfers made "in the ordinary course of business."

Intrafamily transactions are of course subject to great scrutiny and will create the presumption of a gift. *Heringer v. Commissioner*, 235 F.2d 149, 151 (9th Cir. 1956). Both the courts and the Service have recognized, however, that bona fide, arm's length transfers between family members or related persons may be for an adequate consideration in money or money's worth in certain circumstances and therefore not be taxable gifts. *See, e.g.*, *Beveridge v. Commissioner*, 10 T.C. 915 (1948), *acq.*, 1949-1 C.B. 1; *Estate of Friedman v. Commissioner*, 40 T.C. 714 (1963), *acq.*, 1964-1 (Part 1) C.B. 4; *Estate of Messing v. Commissioner*, 48 T.C. 502 (1967), *acq.*, 1968-1 C.B. 2; G.C.M. 33351, … I-2255 (Oct. 13, 1966). O.M. 19249, … I-95-80 (May 9, 1980).

Under the facts in the proposed revenue ruling, D's loan to A , unlike the situation in Lang, was evidenced by a legally enforceable promissory note with interest payable at the market rate. Although D and A initially intended the note to be enforceable, A failed to repay it upon maturity even though A had "some financial resources" Based upon these facts, the ruling concludes that D made a gift to A upon the expiration of the statute of limitations. We believe that D might under certain circumstances be able to convince a court that the transfer occasioned by the lapse of the statute of limitations was made "in the ordinary course of business." For example, suppose that the loan to A had been for use in A's sole proprietorship. Although A had some business and personal assets, D's collection of the loan would have bankrupted the business, leaving D with a net recovery after court costs of far less than the money loaned. D decided not to sue for collection because he believed that the prospects of eventual full recovery on the note were good. D fully intended to eventually recover all the money loaned. Under such circumstances, D may be able to convince a court that the transfer occasioned by the lapse of the statute was made "in the ordinary course of business."

We emphasize that we are not suggesting the Service should necessarily accept a taxpayer's contentions in this regard, for the evidence produced may well be self-serving. As discussed above, intrafamily transactions create the presumption of a gift. We only wish to note that where a transferor like D is able to show that the statute of limitations lapsed under circumstances similar to those outlined above, we believe a court might find that no taxable gift has occurred.[2]

[2] We express no opinion on whether D would be allowed a bad debt deduction if the debt became worthless under such circumstances. Courts have often treated advances by parents to their children as gifts rather than true debts for income tax

purposes. *See*, *e.g.*, *Grossman v. Commissioner*, 9 B.T.A. 643 (1927); *Davidson v. Commissioner*, 37 T.C.M. 725 (1978). When courts have found a true indebtedness to exist, however, they have sometimes allowed bad debt deductions. See, *e.g.*, *Estate of Ames v. Commissioner*, 5 T.C.M. 73 (1946); *Walsh v. Commissioner*, 313 F.2d 389 (4th Cir. 1963). Of course, the debt must generally be worthless for a deduction to be allowed, and courts have sometimes found taxpayer's proof of worthlessness insufficient when no efforts to collect on loans to family members have been made. *See*, *e.g.*, *Griffiths v. Commissioner*, 70 F.2d 946 (7th Cir. 1934); *Acheson v. Commissioner*, 155 F.2d 369 (5th Cir. 1946). We likewise express no opinion on whether a deduction for non-business bad debts would be allowed in view of the limitations on deductibility under section 267 of the Code.

We recognize that the proposed revenue ruling should not be a roadmap for taxpayer avoidance. We therefore feel that it is unnecessary to highlight the "ordinary course of business' exception through an extended discussion of its potential application to the facts in the proposed ruling. We believe that the reference to Treas. Reg. § 25.2512-8 in the analysis section of the proposed ruling is sufficient to acknowledge the existence of an exception to the general rule.[3]

[3] Our concern that certain transfers occasioned by the lapse of the statute of limitations might be "in the ordinary course of business' in no way affects the rationale or conclusion in Rev. Rul. 77-299, 1977-2 C.B. 343, considered by this office in G.C.M. 36356 …, I-216-75 (Aug. 4, 1975). As the proposed revenue ruling notes, Rev. Rul. 77-299 held that the intent to forgive promissory notes at the inception of a "loan" rendered such notes illusory consideration; hence, the transfer was not made for an adequate consideration in money or money's worth, and a gift was made of the loan proceeds. Under the proposed revenue ruling, the note given by A to D was intended to be enforceable. Consequently, there was consideration at the loan's inception.

Finally, we have revised the facts of the proposed revenue ruling to indicate that the statute of limitations on the collection of the interest expired at the same time as the statute of limitations on the collection of the principal. While the general rule with respect to installment payments of interest due before the maturity of the principal debt is that the statute of limitations does not begin to run until the principal debt is due and payable,[4] in certain jurisdictions the statute begins to run against each installment when it becomes payable.[5] To avoid unnecessary confusion and to provide simplicity of result, we have therefore made the above-mentioned factual revision. Consequently, the amount of the gift will equal the unpaid balance of the principal plus accrued interest.

[4] See Annot., 36 A.L.R. 1085 (1925).

[5] Annot., 36 A.L.R. 1085 (1925), *supra* n.4; *See*, *e.g.*, *Fuller v. White*, 33 Cal.2d 236, 201 P.2d 16 (1949) (interpreting Cal. Code Civ. Proc. § 337).

A revised proposed ruling incorporating this suggested change is attached for your consideration.

Thus, the trustee might want to consider providing accountings or other notices to the beneficiaries that would start running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile them together, which procedure might help minimize any gift tax consequences to failing to make a claim.[6354]

If a beneficiary exercises his inter vivos limited power of appointment in a manner that moves all of the trust's assets elsewhere, the beneficiary has made a gift of the beneficiary's interest in the trust, even though Code § 2514 itself does not capture the exercise as a gift. Reg. § 25.2514-1(b)(2) provides:

> The power of the owner of a property interest already possessed by him to dispose of his interest, and nothing more, is not a power of appointment, and the interest is includible in the amount of his gifts to the extent it would be includible under section 2511 or other provisions of the Internal Revenue Code. For example, if a trust created by S provides for payment of the income to A for life with power in A to appoint the entire trust property by deed during her lifetime to a class consisting of her children, and a further power to dispose of the entire corpus by will to anyone, including her estate, and A exercises the inter vivos power in favor of her children, she has necessarily made a transfer of her income interest which constitutes a taxable gift under section 2511(a), without regard to section 2514.

Letter Ruling 9451049 held that the exercise of an inter vivos limited power of appointment constituted a gift:

> The inter vivos powers held by A and B to direct distributions to the descendants of the decedent cannot be exercised to benefit the possessor of the power, her estate or the creditors of either. Consequently, these powers are not general powers of appointment as described under section 2514. Further, the exercise of these powers will not result in the release of any general power possessed by either A or B over trust corpus, as described in section 25.2514-1(b)(2)….
>
> However, A and B have, during their respective lives, the right to periodic distributions of income and principal to provide for health, support and maintenance in the standard of living to which each is accustomed. The proposed exercise by A and B of their respective special powers would constitute a transfer of their interests under section 25.2514-1(b)(2) and section 2511(a). The value of their interests is readily ascertainable. See Rev. Rul. 75-550, 1975-2 C.B. 357. Consequently, A and B's exercise of their respective powers to appoint their respective trust estates to each other constitutes a transfer of their respective beneficial interests in each trust. See section 25.2514-1(b)(2). Each transfer would constitute a taxable gift under section 2511(a).

Rev. Ruls. 70-292 and 75-550 are not directly on point but do explain how to value a beneficial interest for purposes of the Code § 2013 credit for tax on prior transfers. They are reproduced in part III.B.1.e.ii Valuing a Beneficial Interest in a Trust.

Reg. § 25.2514-3(e), Example (1), provides:

> The income is payable to L for life. L has the power to cause the income to be paid to R. The exercise of the right constitutes the making of a transfer of property under

[6354] See part II.J.4.j Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure.

> section 2511. L's power does not constitute a power of appointment since it is only a power to dispose of his income interest, a right otherwise possessed by him.

Reg. § 25.2514-3(e), Example (2), provides:

> The income is to be accumulated during L's life. L has the power to have the income distributed to himself. If L's power is limited by an ascertainable standard (relating to health etc.) as defined in paragraph (c)(2) of § 25.2514-1, the lapse of such power will not constitute a transfer of property for gift tax purposes. If L's power is not so limited, its lapse or release during L's lifetime may constitute a transfer of property for gift tax purposes. See especially paragraph (c)(4) of § 25.2514-3.

Reg. § 25.2514-3(e), Example (3), provides:

> The income is to be paid to L for life. L has a power, exercisable at any time, to cause the corpus to be distributed to himself. L has a general power of appointment over the remainder interest, the release of which constitutes a transfer for gift tax purposes of the remainder interest. If in this example L had a power to cause the corpus to be distributed only to X, L would have a power of appointment which is not a general power of appointment, the exercise or release of which would not constitute a transfer of property for purposes of the gift tax. Although the exercise or release of the nongeneral power is not taxable under this section, see § 25.2514-1(b)(2) for the gift tax consequences of the transfer of the life income interest.

Rev. Rul. 79-327 reasons:[6355]

> An income interest and a special power to appoint the underlying property to other persons are separate rights that may be possessed by an individual. If the individual possesses both the special power and the income interest, the exercise of the special power during life results in a gift, for purposes of section 2511, since the individual, by exercising the power, also relinquishes the income interest. See section 25.2514-1(b)(2) of the regulations. But see *Self v. United States*, 142 F.Supp. 939 (Ct. Cl. 1956), where the court reached a contrary conclusion. The Service will not follow *Self* to the extent that it is contrary to the regulations.
>
> Example 3 of section 25.2514-3(e), discussed above, considers only the gift tax consequences of the exercise or release of a special power of appointment and is limited to the application of section 2514 with respect to a transfer of corpus subject to the power. Therefore, Example 3 does not address the section 2511 gift tax consequences of the relinquishment of an income interest. Thus, a release of the special power, permitting the remainder to pass in default of appointment, results in no gift. However, the exercise of the special power terminates the life interest resulting in a gift of that interest under section 2511. See E.T. 23, 1950-1 C.B. 133, declared obsolete in Rev. Rul. 67-97, 1967-1 C.B. 380, setting forth the same position with regard to statutory provisions and regulations under the 1939 Internal Revenue Code substantially similar to those in issue in this case.

[6355] In Reg. § 26.2601-1(b)(4)(i)(E), Example (7), two siblings relinquished their income interests in favor of another sibling beneficiary. The Example concludes that the relinquishment constituted a taxable gift but did not change the trust's GST-grandfathered status.

Letter Ruling 200243026 asserted that this rule applies even though any distributions to the beneficiary were in the "sole discretion" of a disinterested trustee. Letter Ruling 200243026 reasoned:

> Pursuant to Trust, Spouse also has interests in the income and principal of Trust. Trust provides that the Disinterested Trustee, in his sole discretion, may distribute to Spouse income and/or principal as the Disinterested Trustee deems necessary or appropriate for the care, support, maintenance, education, advancement of life and comfortable living of Spouse. As a result of Spouse's exercise of his inter vivos special power appointing the Trust corpus to the Child 3 Trust, Grandchild 1 Trust, and Grandchild 2 Trust, Spouse will relinquish his income and corpus interests in Trust. Although Spouse's rights to receive income and principal distributions from Trust are subject to the sole discretion of the Disinterested Trustee, the relinquishment of these interests will be a taxable gift under § 2511(a). See *Estate of Regester*, *supra* and Rev. Rul. 79-327, *supra*. The value of the gift is a question of fact and the Service does not rule on such factual determinations. See Rev. Proc. 2002-1, 2002-1 I.R.B. 1, 20, and Rev. Rul. 75-550, 1975-2 C.B. 357 (illustrating the correct method of computing the value of a decedent's interest in a residuary trust subject to the discretionary power of the trustee to invade corpus for the benefit of others).

Further above, the ruling had mentioned:

> *Estate of Regester v. Commissioner*, 83 T.C. 1 (1984) (holding that a decedent made a taxable gift of her life interest in the income of a trust when she transferred the corpus of the trust through the exercise of a special power of appointment).

TAM 9419007 asserted that an inter vivos limited power was tantamount to a general power because the taxpayer had the current right to income and the right to receive all of the principal at age 30. The facts were:

> THE CREATION OF THE TRUSTS:
>
> Under the facts as presented, in 1959, the Grantor purportedly created eleven separate trusts for the benefit of the members of the family of M. Each trust had an initial term of 20 years. During the first 15 years of the trust term, income was accumulated. During the next 5 years of the trust term, income was paid for the support of a designated older generation family member.
>
> At the end of the 20-year term, each trust was to be held for the benefit of a designated grandchild of N. The principal and accumulated income of each separate trust was distributable to a designated grandchild when he or she reached age 30. If a grandchild died before reaching age 30, the trust property otherwise distributable to him or her was to be distributed instead to his or her issue, or if none, to (or for the benefit of) the other younger generation family members. Between the end of the 20-year trust term and the date that a respective grandchild reached age 30, the income of the separate trust held for that grandchild was payable to him or her. The provision creating this interest states:
>
>> As to any persons designated to receive distributions . . . who shall be under 30 years of age at the end of the 60 month period, instead of making distribution to such person, TRUSTEE SHALL DISTRIBUTE TO SUCH PERSON THE NET INCOME FROM HIS TRUST UNTIL HE ATTAINS THE AGE OF 30, at which time

> Trustee shall distribute to him all the accumulated income fund, current income and any principal then remaining in his trust. [Emphasis added.]

> Under the provisions of each separate trust, each grandchild had a power of appointment, labeled a "Limited Power of Appointment." The power was exercisable at any time during the grandchild's lifetime by written instrument or at death by testamentary instrument. Under the "Limited Power of Appointment," each grandchild could appoint "his interest in the trust estate" to, or in trust for, certain family members. The trust instrument states:

>> No power of appointment . . . shall be exercised to any extent in favor of the Donee of such power, his estate or for the benefit of his creditor or the creditors of his estate....

> THE DONOR'S EXERCISE OF THE POWER OF APPOINTMENT BEFORE REACHING AGE 30:

> The Donor is a grandchild of N and was the designated beneficiary of one of the trusts. Her siblings and cousins were the designated beneficiaries of the other trusts.

> The initial 20-year trust term ended in 1979 at which time the grandchildren, including the Donor, became the prime beneficiaries of the trusts. In early 1980, before any of the grandchildren had reached age 30, but after they had all attained their majority, the Donor and the other grandchildren each exercised his or her power to appoint his or her trust interests. Pursuant to a document captioned "Exercise of Limited Power of Appointment" dated February 1980, the Donor directed that her trust interests be distributed to newly created trusts (herein referred to as the Family Trusts) for the benefit of certain other family members. The other grandchildren made similar dispositions.

> At the time that the powers of appointment were exercised, the Donor (and each grandchild) possessed: 1) a contingent remainder interest in a trust (which would ripen into absolute ownership of the property upon that grandchild's reaching age 30); and 2) the right to receive current trust income until reaching age 30. The issue presented is whether the Donor made a taxable gift when she exercised the "Limited Power of Appointment," thus relinquishing these interests in favor of the other family members.

If and to the extent that the transfer is a gift, person exercising the power of appointment becomes the transferor with respect to the gifted portion and may allocate GST exemption to that portion.[6356] Letter Ruling 200243026 reasoned:

> Further, because Spouse will have made a taxable gift of his income and principal interests to the three trusts, Spouse will be considered the transferor of the value of the taxable gift for purposes of chapter 13. The beneficiaries of the Grandchild 1 Trust and Grandchild 2 Trust include Spouse's grandchildren, descendants of the grandchildren or charitable organizations. Therefore, the trust is a skip person. Accordingly, the transfer is a direct skip for purposes of chapter 13. Spouse's GST exemption will be deemed allocated to the property transferred by him to the two trusts, unless Spouse elects not to have § 2632(b) apply. The beneficiaries of the Child 3 Trust include Spouse's child, Child 3, Child 3's spouse, Child 3's issue, spouses of Child 3's issue, and descendants

[6356] See part III.B.1.d.iii Who Is the Transferor.

> of Child 3. The trust could have a generation-skipping transfer with respect to the transferor, Spouse, and the trust does not come within any exceptions contained in § 2632(c)(3)(B)(i). Therefore, the Child 3 Trust is a GST trust. Accordingly, the transfer is an indirect skip for purposes of chapter 13. Spouse's GST exemption is deemed allocated to the property transferred by Spouse to the Child 3 Trust, unless Spouse elects not to have § 2632(c) apply. Each portion of the three trusts of which Spouse is the transferor will comprise the chapter 13 portion of each trust. The non-chapter 13 portions and the chapter 13 portions of each trust are treated as separate trusts for purposes of chapter 13. Section 26.2654-1(a)(2)(i).
>
> Accordingly, based upon the facts submitted and representations made, we rule as follows: The proposed exercise of the power of appointment by Spouse and the resulting transfer of the appointed assets of Trust to the two GSETs and the Child 3 Trust will not constitute constructive additions to the Trust under § 26.2601-1(b)(1)(v). The proposed exercise of the power of appointment by Spouse will result in a taxable gift of Spouse's income and principal interests under § 2511. For purposes of chapter 13, Spouse will be the transferor of the gifted property transferred by Spouse to the Child 3 Trust and the two GSETs. The gifted property in each trust will comprise the chapter 13 portion of the trusts. The balance of the corpus of each trust will constitute the non-chapter 13 portion of each trust. Spouse's GST exemption will be deemed allocated to the chapter 13 portions of each trust, unless Spouse elects not to have § 2632(b) and (c) apply. The chapter 13 portion of each trust will have an inclusion ratio determined under § 2642. The non-chapter 13 portions of each trust will be exempt from GST tax under § 26.2601-1(b)(i).

For more about when gifts change the transferor, see part III.B.1.d.iii Who Is the Transferor. Reg. § 26.2654-1(a)(2), "Multiple transferors with respect to single trust," is reproduced in part III.B.1.d.iii Who Is the Transferor.

Of course, a nonqualified disclaimer of a life estate constitutes a gift of the value of the life estate.[6357]

Another gift might be early termination of a trust. When a beneficiary may receive distributions under an ascertainable standard and has an annual right to withdraw from the trust, the beneficiary made a gift by renouncing distributions to her while living,[6358] caused her to become

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[6357] Letter Ruling 201928003, which the taxpayer requested under Reg. § 25.2512-5(d)(4), held:

> In the present case, Taxpayer disclaimed her life estate interests in three trusts on Date 2. The disclaimer constituted completed gifts to the owners of the remainder interests in the trusts. At the time the gifts were made, Taxpayer had been diagnosed as being terminally ill with at least a fifty percent probability that she would die within one year of Date 2. Taxpayer died on Date 3. Because Taxpayer was terminally ill within the meaning of § 25.7520-3(b)(3) at the time of the Date 2 gifts, the mortality component prescribed under § 7520 for ordinary life estate interests may not be used to determine the present value of the life estate interests disclaimed by Taxpayer on Date 2. Thus, an actuarial factor of .00043 must be used in valuing the gifts.

[6358] Letter Ruling 200745015, reasoning:

> The value of the gift is a question of fact and the Service does not rule on such factual determinations. See Rev. Proc. 2007-1, 2007-1 I.R.B. 1, 14. However, since the gift is not an absolute right to distributions of income or principal, it cannot be valued by use of the tables contained in § 2512. See *Deal v. Commissioner*, 29 T.C. 730 (1958). Rather, the value of the gift should be determined in accordance with the general valuation principles contained in § 25.2512-

the transferor for GST purposes to the extent of the property she renounced,[6359] but did not blow GST grandfathering for the remaining property.[6360] Renouncing a testamentary nongeneral power of appointment did not have gift tax consequences or blow GST grandfathering.[6361]

On the other hand, if Mom creates a trust for the benefit of Daughter and Daughter's children, but Daughter doesn't need all of that money and would like her children to benefit currently and cooperates in the trustee's obtaining a court order directing early partial termination of the trust. That action:[6362]

- Is not subject to income tax,[6363]

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1. Further, such an interest has more than a nominal value. See Rev. Rul. 67-370, 1967-1 C.B. 324.

[6359] Letter Ruling 200745015, further explaining (with "exemption" referring to grandfathering from GST tax):

> As stated above, under § 2652, for purposes of chapter 13, Daughter is the transferor of X shares that will be transferred to the three subtrusts. Accordingly, the three subtrusts are not exempt from chapter 13 by virtue of Trust's exemption. Daughter may allocate her GST exemption to the three subtrusts at the time of the transfer or GST exemption may be automatically allocated under § 2632(c)(1) depending on whether the subtrusts are GST Trusts as defined in that Code section. Based upon the facts provided and the representations made, we conclude that Daughter is the transferor of the X shares that will be transferred to the three subtrusts for purposes of chapter 13 and, accordingly, distributions and terminating distributions from the subtrusts to skip persons are subject to GST tax.

[6360] Letter Ruling 200745015, reasoning:

> Trust was executed prior to September 25, 1985, and it is represented that there have been no additions (actual or constructive) to Trust since that date. Accordingly, Trust is not subject to chapter 13. Daughter's renunciation of her entire beneficial interest in X shares is a taxable transfer for gift tax purposes. X shares will be transferred into three subtrusts in which Daughter will have no interest. The property remaining in Trust continues to be subject to the original Trust provisions, with no modifications to those provisions. Based upon the facts provided and the representations made, we conclude that Daughter's renunciation of her entire beneficial interest in X shares will not cause Trust to become subject to chapter 13.

[6361] Letter Ruling 200745015, reasoning:

> As discussed above, Daughter holds a testamentary nongeneral power of appointment over Trust. Daughter will release this power over X shares that are transferred to the three subtrusts. The power of appointment was created in Trust, an irrevocable Trust, that is not subject to chapter 13. Therefore, the release of the power of appointment over X shares will not be treated as a constructive addition to Trust. Accordingly, based upon the facts provided and the representations made, we conclude that the release of Daughter's testamentary nongeneral power of appointment over X shares will not cause Trust to become subject to chapter 13.

[6362] Per Letter Ruling 201122007, parts of which are quoted in the footnotes below.

[6363] Letter Ruling 201122007, which did not appear to involve any debt, concluded Ruling 1 by reasoning:

> In general, a gift or other transfer without reciprocal consideration is not treated as a sale or exchange or as a distribution of property that results in a realization of income by the donor. *See, e.g.*, § 1.1001-1(e) (illustrating that the gift portion of a transfer is not treated as gain realized). The same would be true of a transfer from a trust as provided in the terms of the trust agreement or by court order modifying the trust agreement. Such a transaction is not a realization event in which property differing in kind or extent is being exchanged. In addition, gross income does not include the value of property acquired by gift, bequest, devise or inheritance. See § 102.
>
> Based on the information submitted, Taxpayer, the remainder beneficiaries, and Trust will not recognize gain as a result of the early distribution of a portion of the trust principal to the remainder beneficiaries because the distribution will not constitute a sale, exchange, or other

- Will not blow the trust's grandfathering from generation-skipping transfer tax,[6364] and
- Will constitute a gift by Daughter, albeit perhaps a nominal gift.[6365]

Rev. Rul. 67-370 is somewhat disturbing, in that one needs to impose survivorship as a condition precedent to prevent inclusion in an outright remainderman's gross estate.[6366] It starts:

> Advice has been requested whether a certain remainder interest in trust which may be terminated at the will of another is an interest in property within the meaning of section 2033 of the Internal Revenue Code of 1954.
>
> Under the terms of an inter vivos trust, controlled by New York law, the decedent or his estate was to receive the principal upon the death of the settlor. The settlor had reserved the right to modify, alter, or revoke the trust during her lifetime. Subsequent to the

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realization event. Also, there is no accession of wealth to Taxpayer or Trust. In addition, to the extent that any portion of the early distribution of the trust principal and accumulated income (previously taxed to the trust) constitutes a gift, bequest, devise or inheritance to the remainder beneficiaries, it will not constitute includable income to the remainder beneficiaries for federal income tax purposes because of the exclusion provided under § 102.

[6364] Letter Ruling 201122007 concluded Ruling 2 by reasoning:

> State Statue provides that a noncharitable irrevocable trust may be modified on consent of all the beneficiaries if the court concludes that modification is not inconsistent with a material purpose of the trust.
>
> Based on the facts presented and representations made, we conclude that if State court issues an order approving the early distribution of a portion of the trust principal to the remainder beneficiaries, as discussed above, this distribution will not shift any beneficial interest in Trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification. In addition, the early distribution of a portion of the trust principal to the remainder beneficiaries will not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original trust. Accordingly, based on the facts submitted and the representations made, we conclude that if, under a State court order, the trustees of Trust make an early distribution of the trust principal to the remainder beneficiaries, such a distribution will not cause Trust to be subject to the generation-skipping transfer tax imposed by chapter 13.

[6365] Letter Ruling 201122007 concluded Ruling 3 by reasoning:

> Taxpayer attests that Taxpayer has never received a distribution from Trust and that her income and resources are sufficient to maintain her current standard of living for the remainder of her lifetime. However, that does not negate the fact that under Section 6(a) of Trust, Taxpayer has an income interest entitling her to distributions of income in the case of emergency and at the discretion of the trustee. The interest may be nominal, however, the value of the gifted interest is a factual determination, not a determination of whether or not Taxpayer has made a gift of the interest.
>
> Based upon the facts submitted and representations made, we conclude that Taxpayer will make a gift of her interest in the portion of the early distribution of the trust principal to the remainder beneficiaries. The value of this gift is a question of fact and the Service does not rule on such factual determinations. See Rev. Proc. 2011-1, 2011-1 I.R.B. 1, 13.

Note that the IRS might argue that the value of Taxpayer's gift in Letter Ruling 201122007 is the value of Taxpayer's entire interest in the trust. See part Code § 2702 Overview, especially the text accompanying fns. 7381-7388.

[6366] Rev. Rul. 67-370 is cited by the text accompanying fn 2062 in part II.H.2.c QTIP Trusts - Code § 2519 Trap.

> decedent's death, the settlor modified the trust and extinguished the estate's defeasible remainder interest.

After reciting Code § 2033 and Reg. § 20.2033-1(a), the IRS reasoned:

> Where a decedent's right to receive benefits under a trust is so conditioned as to terminate at his death, such interest does not constitute an includible interest in property for the purpose of section 2033 of the Code. Revenue Ruling 55-438, C.B. 1955-2, 601. A contrary result will naturally obtain, however, in case the decedent owns any beneficial interest in a trust which survives his death, whether or not such interest is subject to being lawfully curtailed or cut off at any time thereafter. The decedent's interest in the trust involved in the subject case is thus an includible interest. It was clearly "descendible, devisable, and alienable" as a matter of New York law, for example, and would undoubtedly have resulted in the receipt of substantial assets by decedent's estate if the settlor had not proceeded to revoke the same. *In re: Horn-blower's Estate*, 180 N.Y. Misc. 517, 40 N.Y.S.2d 712 (1943).
>
> In providing that the value of the gross estate shall include the value of "all" property to the extent of the interest therein of the decedent at the time of his death, section 2033 is not affected by formal legal distinctions of nomenclature under state law. Therefore, it is not relevant to the application of section 2033 that a particular interest in property which survives the decedent's death may be either defeasible or indefeasible.
>
> Any determination of what would be the fair market value of a particular remainder interest like that under consideration herein would be affected by its possible curtailment or complete divestment at some point after decedent's death, in accordance with the general rules for the valuation of property which are set forth in section 20.2031-1(b) of the Estate Tax Regulations. See *Estate of Waldo G. Bryant v. Commissioner*, 36 B.T.A. 669 (1937), *affirmed* 104 F.2d 1011 (1939), *affirmed sub nom. Helvering v. Hallock*, 309 U.S. 106 (1940), Ct. D. 1440, C.B. 1940-1, 223. See also *Smith v. Shaughnessy*, 318 U.S. 176, 180 (1943), Ct. D. 1575, C.B. 1943, 1144. The mere presence of these possibilities does not warrant the assignment of a merely nominal value to such a defeasible interest in any case where there is still a reasonable probability that the estate will actually acquire possession of at least some substantial portion of the property in question. See *In re: Hornblower's Estate*, above.
>
> It is accordingly held that if a defeasible interest in property survives the decedent's death, its fair market value is includible in the decedent's gross estate.

To avoid this result, consider always requiring survivorship as a condition preceding to the remainderman taking outright. Leaving the remainder in trust may also help. We tend to suggest that a remainderman's interest being subject to the primary beneficiary's power of appointment may make any diminishment of the remainderman's interest not constitute more than a nominal gift, but the precautions stated above in this paragraph may be important to implement to support that suggestion. CCA 202118008 asserted that children, who were outright remaindermen of property that the current beneficiary could have been appointed to children or their descendants, made a gift of the entire remainder when they consented to distributing the entire trust to the current beneficiary.[6367]

[6367] See text preceding fn 2995 in part II.J.18.d Trust Commutations.

Other authority related to valuing a gift diminishing a discretionary interest includes:[6368]

> Rev. Rul. 67-370. *Cf. Snyder v. Comm'r*, T.C. Memo. 1989-529. (holding that the value of a gift of common stock prior to the enactment of chapter 14 of the Code could be discounted in order to reflect the rights of preferred shareholders' put rights). *See* Rev. Rul. 75-550 (valuing an income interest at a discount to reflect all possible invasions of principal). *See*, *e.g.*, PLR 8535020 (May 30, 1985) ("The fact that the trustee has discretion regarding distributions of income and principal to you is a factor that must be taken into account in determining the fair market value of your beneficial interest"). *See also* PLR 8824025 (June 17, 1988) (the value of discretionary interest in principal appears "negligible" where no distributions had been made); PLR 8905035 (Nov. 4, 1988) (the value of a discretionary interest is to be valued under general valuation principles); PLR 9451049 (Sept. 22, 1994) (the value of the right to distributions for support "is readily ascertainable"); PLR 9714030 (Jan. 7, 1997) (the value of discretionary interest is to be valued under general valuation principles); PLR 9802031 (Oct. 14, 1997) (the value of discretionary support interest "is determined based on all relevant factors, such as the projected needs of [the beneficiary] for health, education, support, and maintenance for the remainder of his life"); PLR 9811044 (Dec. 11, 1997) (the value of discretionary interest is to be valued under general valuation principles); PLR 199908060 (Dec. 2, 1998) (discretionary interests "have some value, however minimal"); PLR 200243026 (July 24, 2002) (the value of interest subject to discretion of trustee is a question of fact); PLR 200339021 (June 19, 2003) (the value of a contingent support interest is a question of fact); PLR 200745015 (June 6, 2007) (a discretionary interest has "more than a nominal value"); PLR 200745016 (June 8, 2007) (a discretionary interest has "more than a nominal value"); PLR 201122007 (Feb. 24, 2011) (a discretionary interest where no distributions received may be "merely nominal"); PLR 201342001 (July 22, 2013) (expressing no opinion on the value of discretionary interests).

Generally, a conversion to a unitrust has not gift tax or GST consequences.[6369]

In Letter Ruling 201920001:

> Several years after Grantor's death, the trustees became aware that Article III(b)(2) lacked the language necessary to prevent an appointment of trust property to non-family members and that the broad language could be construed as granting a general power of appointment to the Beneficiaries. This would result in inclusion of trust property in each Beneficiary's gross estate. It is represented that such a result was contrary to Grantor's intent. On Date 3, Son 1, in his capacity as the trustee of Trust A and Trust C, and as representative by joinder of Trust B, petitioned Court to reform Trusts A, B, and C to include the necessary limiting language to qualify each Beneficiary's power of appointment as a limited power of appointment, expressly prohibiting the appointment of trust assets to a Beneficiary, such Beneficiary's estate, the creditors of such Beneficiary, and the creditors of such Beneficiary's estate.

[6368] Bramwell & Weissbart, "The Dueling Transferors Problem in Generation-Skipping Transfer Taxation," ACTEC Law Journal, Vol. 1, No. 1 (Spring 2015), 95, 109 (fns 37-39), saved as Thompson Coburn LLP doc. no. 7289312.

[6369] This result is strongly supported by Reg. § 26.2601-1(b)(4)(i)(E), Example (11). See text accompanying fn 6395 in part III.B.1.d.i Effect of "Additions" on .

> The petition was supported by three affidavits, one each from Grantor's Accountant, Law Firm, and Son 1, in his capacity as the trustee of Trusts A and C and as representative by joinder of Trust B. Accountant swore that Grantor intended the trusts to be GST exempt. Law Firm swore that Grantor did not recognize that including the power of appointment language would result in including the trust assets in each Beneficiary's gross estate.
>
> On Date 4, Court issued an order, effective Date 1, that limited the power of appointment language in Article III(b)(2) to exclude the Beneficiary, the Beneficiary's estate, the creditors of the Beneficiary, and the creditors of the Beneficiary estate. On Date 5, Court issued an amended order clarifying that the trusts terminate at the death of the named grandchild and that per stirpes distributions are to be outright and in fee. The amended order clarifies that each separate trust held for a Beneficiary shall terminate upon the death of such Beneficiary. This is consistent with the provisions of each trust, as originally executed. Further, the amended order clarifies that each trust shall provide that upon such termination, the remaining principal and any undistributed income of such separate trust shall be distributed as such deceased Beneficiary may appoint to or for the benefit of one or more of the lineal descendants of the child of the Grantor (Son 1, Son 2, or Daughter, depending upon the trust) who is a lineal ascendant of such beneficiary, but excluding such Beneficiary, such Beneficiary's estate, the creditors of such Beneficiary, and the creditors of such Beneficiary's estate. The default provisions of each trust remain unchanged. Both orders were issued contingent upon a ruling from the Internal Revenue Service.
>
> On Date 7, Court issued a second amended order that reforms Article III(c) to limit the Beneficiary's withdrawal right to the lesser of (1) that amount equal to the greater of that amount which under § 2514(e) will not be considered a release of a power of appointment as the result of a lapse of the power (currently the greater of $5,000 or five percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed power could be satisfied), or that amount that, under § 2503(b) may be excluded in computing the total amount of gifts made during such calendar year, or (2) the fair market value of any property, determined as of the date of the gift, added to this trust by gift during such calendar year. This order is also contingent upon a ruling from the Internal Revenue Service.

Regarding possible estate inclusion under Code § 2036(a) or 2038(a)(1), Letter Ruling 201920001 reasoned and ruled:

> In the present case, Trusts A, B, and C are irrevocable trusts. During Year 1 through Year 7 and Year 9 through Year 11, Spouse and Grantor consented to treat their gifts as having been made one-half by each donor. Accordingly, Spouse and Grantor are each treated as the transferor of one-half of the total transfers to the trusts during those years. During Years 12 through 19, Spouse made gifts to each trust. Accordingly, Spouse is the transferor of those gifts to the trusts during those years. However, Spouse did not retain any right or interest in the trusts. Spouse did not retain a beneficial interest in the trusts and did not retain the right to alter, amend, revoke, or terminate any of the trusts. Further, Spouse did not retain the right to designate who would possess or enjoy the property or income derived from the trusts. The reformation and modification of Trusts A, B, and C were made pursuant to Court orders and not as a result of rights retained by Spouse. Accordingly, based upon the facts submitted and representations made, we conclude that the judicial reformation and modification of Trusts A, B, and C will not

> cause the corpus of Trust A, B, and C to be included in the gross estate of Spouse for federal estate tax purposes.

As to gift tax issues and whether a beneficiary had a general power of appointment, Letter Ruling 201920001 reasoned and ruled:

> State Statute provides that upon application of a settlor or any interested person, the court may reform the terms of a trust, even if unambiguous, to conform the terms to the settlor's intent if it is proved by clear and convincing evidence that both the accomplishment of the settlor's intent and the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement. In determining the settlor's original intent, the court may consider evidence relevant to the settlor's intent even though the evidence contradicts an apparent plain meaning of the trust instrument.
>
> In *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), the Court considered whether a state trial court's characterization of property rights conclusively binds a federal court or agency in a federal estate tax controversy. The Court concluded that the decision of a state trial court as to an underlying issue of state law should not be controlling when applied to a federal statute. Rather, the highest court of the state is the best authority on the underlying substantive rule of state law to be applied in the federal matter. If there is no decision by that court, then the federal authority must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. In this respect, the federal agency may be said, in effect, to be sitting as a state court.
>
> In the present case, an examination of the relevant trust instruments, affidavits, and representations of the parties strongly indicates that Grantor and Spouse did not intend for the Beneficiaries of Trusts A, B, and C to have inter vivos or testamentary general powers of appointment. In reforming the trusts, Court found that there was clear and convincing evidence that the language in Article III(b)(2) and Article III(c) were scrivener's errors and that the reformation and modification of the trusts was necessary and appropriate to achieve Grantor's and Spouse's objectives, and that the reformation was not contrary to Grantor's and Spouse's intentions.
>
> Consequently, based on the facts submitted and representations made, we conclude that the Court's Orders of Date 4, Date 5, and Date 7, reforming and modifying the trust instruments based on scrivener's errors, are consistent with applicable State law that would be applied by the highest court of that state. Trusts A, B, and C, as reformed and modified pursuant to the Court's Orders, do not provide the Beneficiaries with either inter vivos or testamentary general powers of appointment over the assets of each respective Beneficiary's trust under §§ 2041(b) and 2514(c). Accordingly, based on the facts submitted and the representations made, we conclude that the judicial reformation and modification of Trusts A, B, and C do not constitute the exercise or release of a general power of appointment by a Beneficiary resulting in a gift under § 2514 and that the assets of the deceased Beneficiary's trust will not be includible in such Beneficiary's gross estate under § 2041.

As to GST issues, Letter Ruling 201920001 reasoned and ruled:

> In the present case, Grantor and Spouse made gifts to Trusts A, B, and C. The primary beneficiaries of Trusts A, B, and C are the grandchildren of Grantor and Spouse.

> Pursuant to the reformation of Trusts A, B, and C, the Beneficiaries possess testamentary limited powers of appointment to appoint to one or more of the lineal descendants of Son 1, Son 2, or Daughter, depending upon which trust. In default of the exercise, the trust property passes to lineal descendants of that Grandchild, or if there are none, to the living descendants of Son 1, Son 2, or Daughter, depending upon which trust. The Beneficiaries, lineal descendants of the Beneficiaries of Son 1, Son 2, and Daughter are persons assigned to a generation which is two or more generations below the generation assignment of the Grantor and, accordingly, the Beneficiaries are skip persons as defined under § 2613(a)(1). Accordingly, we conclude Trust A, B, and C are "skip persons" as defined under § 2613(a)(2) and the gifts to Trusts A, B, and C are direct skips as defined in § 2612(c)(1).
>
> Because Grantor and Spouse consented to split gifts under § 2513 for Year 1 through Year 7 and Year 9 through Year 11, Grantor and Spouse are treated as the transferor of one-half of the Year 1 through 7 and Year 9 through Year 11 gifts to the trusts under § 2652(a)(2). Therefore, based on the facts submitted and representations made, we conclude that, the deemed allocation rules under § 2632(b) apply to allocate Grantor's and Spouse's unused GST exemption to one-half each of the Year 1 through Year 7 and Year 9 through Year 11 gifts to the trusts and to allocate Grantor's unused GST exemption to the bequests to the trusts in Year 11, and to allocate Spouse's unused GST exemption to the Year 12 through Year 19 gifts to Trusts A, B, and C.

Letter Ruling 202206008 tacitly approved the idea that a trustee who can distribute for a beneficiary's welfare may use that authority to grant the beneficiary a general power of appointment.[6370]

Letter Ruling 201647001 held that the children did not make a gift when a trust was modified to add a clause authorizing an independent trustee to reimburse the grantor's income tax, because the reimbursement clause was "administrative in nature" and did not "result in a change in beneficial interests" in the trust. Neither that change nor any other change done at the same time had any income, gift, estate, or GST tax consequences. However, Letter Ruling 201647001 was disavowed by CCA 202352018, which concluded that authorizing reimbursement of the income tax owed by A, the grantor, was a taxable gift:[6371]

> Under the governing instrument of Trust, Child and Child's issue each have an interest in the trust property. As a result of the Year 2 modification of Trust, A acquires a beneficial interest in the trust property in that A becomes entitled to discretionary distributions of income or principal from Trust in an amount sufficient to reimburse A for any taxes A pays as a result of inclusion of Trust's income in A's gross taxable income. In substance, the modification constitutes a transfer by Child and Child's issue for the benefit of A. This is distinguishable from the situations in Rev. Rul. 2004-64 where the original governing instrument provided for a mandatory or discretionary right to reimbursement for the

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[6370] Letter Ruling 202206008 is discussed in more detail in the text accompanying and preceding fn 2129 in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.

[6371] For a complete excerpt, see text accompanying fn 6978 in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner. Note that a gratuitous payment of another person's obligation constitutes a (possibly excludible) gift by the payor, followed by a (possibly deductible) payment by the obligor. *Lang v. Commissioner*, T.C. Memo. 2010-286 (donor's gifts were not taxable; obligor could deduct medical and tax payments).

grantor's payment of the income tax. Thus, as a result of the Year 2 modification, Child and Child's issue each have made a gift of a portion of their respective interest in income and/or principal.[1] *See* § 25.2511-1(e) and § 25.2511-2(b). *See also Robinette v. Helvering*, 318 U.S. 184 (1943). The result would be the same if the modification was pursuant to a state statute that provides beneficiaries with a right to notice and a right to object to the modification and a beneficiary fails to exercise their right to object.

As alluded to above, many of the gifts raised in this part III.B.1.b involve complex gift tax issues, which may spill over into the GST arena. See part III.B.1.d Generation-Skipping Transfer (GST) Issues.

In the employment arena, some employee benefits to family members may not be considered gifts,[6372] whereas others may be.[6373]

III.B.1.c. When a Gift Triggers Income Tax

A gift can trigger gift tax when it is a part sale. See part III.B.1.c.i Gifts with Consideration – Bargain Sales.

So might a gift of an item that includes or is deemed to include deferred income. See part III.B.1.c.ii Gift of Deferred Income Item May Trigger Income Tax.

Turning off grantor trust status may trigger a deemed gift for income tax purposes that may trigger the consequences described above. For grantor trust status, see part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

III.B.1.c.i. Gifts with Consideration – Bargain Sales

III.B.1.c.i.(a). Bargain Sales to Individuals, Including Net Gifts

Where a transfer of property is in part a sale and in part a gift (a "bargain sale"), the donor has gain to the extent that the amount realized by the donor exceeds the donor's adjusted basis in the property.[6374] However, a donor may not deduct a loss in a bargain sale.[6375]

A bargain sale includes transferring property subject to a debt.[6376] For treatment of interest expense when a partnership interest that carries with it an allocation of partnership debt, see part II.C.3.d Deducting Interest Expense.[6377]

Examples of computing gain or gift when property is transferred in bargain sale:[6378]

> *Example (1)*. A transfers property to his son for $60,000. Such property in the hands of A has an adjusted basis of $30,000 (and a fair market value of $90,000). A's gain is $30,000, the excess of $*60*,000, the amount realized, over the adjusted

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[6372] See fn 3771 in part II.M.4.g Options to Acquire Equity (Stock Options, etc.).
[6373] See part II.Q.4.f Split-Dollar Arrangements.
[6374] Reg. § 1.1001-1(e)(1).
[6375] Reg. § 1.1001-1(e)(1).
[6376] See fn. 6591, found in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System.
[6377] Especially the text accompanying fns 457-459.
[6378] Reg. § 1.1001-1(e)(2).

basis, $30,000. He has made a gift of $30,000, the excess of $90,000, the fair market value, over the amount realized, $60,000.

Example (2). A transfers property to his son for $30,000. Such property in the hands of A has an adjusted basis of $60,000 (and a fair market value of $90,000). A has no gain or loss, and has made a gift of $60,000, the excess of $90,000, the fair market value, over the amount realized, $30,000.

Example (3). A transfers property to his son for $30,000. Such property in A's hands has an adjusted basis of $30,000 (and a fair market value of $60,000). A has no gain and has made a gift of $30,000, the excess of $60,000, the fair market value, over the amount realized, $30,000.

Example (4). A transfers property to his son for $30,000. Such property in A's hands has an adjusted basis of $90,000 (and a fair market value of $60,000). A has sustained no loss, and has made a gift of $30,000, the excess of $60,000, the fair market value, over the amount realized, $30,000.

Examples of computing basis in property transferred in bargain sale include:[6379]

Example (1). If A transfers property to his son for $30,000, and such property at the time of the transfer has an adjusted basis of $30,000 in A's hands (and a fair market value of $60,000), the unadjusted basis of the property in the hands of the son is $30,000.

Example (2). If A transfers property to his son for $60,000, and such property at the time of transfer has an adjusted basis of $30,000 in A's hands (and a fair market value of $90,000), the unadjusted basis of such property in the hands of the son is $60,000.

Example (3). If A transfers property to his son for $30,000, and such property at the time of transfer has an adjusted basis in A's hands of $60,000 (and a fair market value of $90,000), the unadjusted basis of such property in the hands of the son is $60,000.

Example (4). If A transfers property to his son for $30,000 and such property at the time of transfer has an adjusted basis of $90,000 in A's hands (and a fair market value of $60,000), the unadjusted basis of the property in the hands of the son is $90,000. However, since the adjusted basis of the property in A's hands at the time of the transfer was greater than the fair market value at that time, for the purpose of determining any loss on a later sale or other disposition of the property by the son its unadjusted basis in his hands is $60,000.

Letter Ruling 7752001 involved a net gift:

The taxpayer, a trust, received x shares of common stock on December 17, 1973, and received y shares of common stock on February 14, 1974. All the shares of common stock were transferred to the taxpayer subject to the condition that the taxpayer pay all gift taxes arising as a result of the transfers. In satisfaction of this condition, the taxpayer paid all gift taxes imposed as a result of this transaction.

[6379] Reg. § 1.1015-4(b).

> On April 17, 1974, the taxpayer sold all the shares of common stock received from the transferor-donor. The net proceeds from the sale was z. For purposes of determining gain {or loss} on the sale, the taxpayer computed its basis in the shares of common stock by assuming the donor's basis in the common stock as provided in section 1.1015-1 of the regulations increased by the amount of Federal gift tax paid with respect to the gift of the common stock as provided in section 1.1015-15 of the regulations. Under this basis computation method, the taxpayer's basis in the common stock was determined in whole or in part by reference to the donor's basis. For the purpose of determining its holding period in the common stock as provided in section 1223 of the Code, the method of calculating basis employed by the taxpayer would permit the taxpayer to tack on to the period it held the common shares, the period the common shares were held by the donor. Since the combined period that the stock was held by the taxpayer and the donor was greater than six months at the time of the sale, the taxpayer reported the gain from the sale as long-term capital gain.
>
> Alternatively, had the taxpayer calculated its basis in the stock pursuant to section 1.1015-4 of the regulations, as a transfer in part a gift and in part a sale, the resulting basis under this calculation method would have been determined without reference to the donor's adjusted basis in the stock. Since, under this basis computation method, the taxpayer would not have held the property for longer than six months at the time of the sale, the gain from the sale would not qualify for long-term capital gain treatment.
>
> In brief, the basis computation method employed by the taxpayer resulted in the taxpayer acquiring a basis in the stock that was less than the basis that would have resulted had the basis computation method provided in section 1.1015-4 of the regulations been followed. However, contrary to the result produced by the method provided in section 1.1015-4 of the regulations, the basis computation method employed by the taxpayer permitted the taxpayer's sale of the stock to qualify for long-term capital gain treatment.

Letter Ruling 7752001 involved a net gift:

> The question that arises is whether the taxpayer's method of computing its basis in the shares of common stock is in accordance with section 1015 of the Code and the regulations promulgated thereunder.
>
> To prevent possible confusion, a distinction between the term "net gift" and the term "part sale and part gift" will be made at the outset. For gift tax purposes, a gift conditioned on the payment by the donee of the gift tax is termed a "net gift." The net gift is determined by reducing the gross value of the gift by the amount of the gift, and the gift tax is computed on that amount. The net gift theory is premised on the theory that the property transferred is encumbered with the gift tax, a burden assumed by the donee for the benefit of the donor. The Service does not challenge the net gift concept for gift tax purposes. See Rev. Rul. 71-232, 1971-1 C.B. 275, as superseded by Rev. Rul. 75-72, 1975-1 C.B. 310, see also Rev. Rul. 76-57, 1976-1 C.B. 297 and Rev. Rul. 76-104, 1976-1 C.B. 301. The net gift concept is applied only for gift tax purposes and has no application for income tax purposes.
>
> The term "part sale and part gift" has no inherent genetic meaning except to illustrate situations in which the transferor has transferred property for consideration below the

property's fair market value, with the intent to make a gift to the transferee of the value of the property exceeding the consideration. The donor in a part sale and part gift situation has a dual intention to confer a gift on the donee and also to receive some benefit, for example, the payment of the donor's gift tax liability. The term "part sale and part gift" is generally used to describe the income tax consequences of a taxpayer's transaction.

The part sale and part gift concept originated in the context of encumbered gift. *MAGNOLIA DEVELOPMENT CORPORATION V. COMMISSIONER*, T.C. Memo. 1960-177, is a case in point. In MAGNOLIA, the court held that a corporate taxpayer realized gain when the taxpayer encumbered its stock with a fair market value of $42,500 for a loan in the amount of $42,000 on the eve and in anticipation of the transfer of the encumbered securities to a university. Immediately thereafter, the university sold the stock to a waiting buyer, repaid the loan, and retained the remaining $500. The court viewed the transaction as a sham and held the transaction to be in substance "a sale of the stock for a price $500 less than its fair market value of $42,500, which made the selling price $42,000, with a gift of the balance ….."

In *TURNER V. COMMISSIONER*, 47 T.C. 356 (1968), *AFF'D PER CURIAM*, 410 F.2d 752 (6th Cir. 1969), *NONACQ*., 1971-2 C.B. 4, a taxpayer made gifts of highly appreciated stock to several donees subject the donees' agreement to pay the resulting gift taxes. The Service asserted that since the donor in this transaction received a taxable benefit in the amount of the payment of his gift tax liability, the transaction was a partial sale in which the donor realize a taxable gain. The court, however, was not persuaded by the Service's position, and held the donor "intended" to make net gifts, a transaction that resulted in no taxable gain to the donor.

In 1973, the Tax Court decided *JOHNSON V. COMMISSIONER*, 59 T.C. 791 (1973), *AFF'D*, 495 F.2d 1079 (6th Cir. 1974), *CERT. DENIED*, 419 U.S. 1040 (1974). In *JOHNSON*, the taxpayer owned stock having a basis of $10,000 but with a fair market value of over $500,000. Using the stock as collateral, he borrowed $200,000 from a bank on a nonrecourse note. The taxpayer then transferred the pledged stock to an irrevocable trust for the benefit of his children. Shortly thereafter the trustees canceled the taxpayer's note and replaced it with their own note, secured by the same stock. The taxpayer subsequently used $150,000 of his loan proceeds to pay the gift taxes. The Service, alleging the transaction was in substance a part sale and part gift, determined the taxpayer realized long-term capital gain on the excess loan proceeds over the adjusted basis of the transferred stock. The Tax Court, relying primarily on *CRANE V. COMMISSIONER*, 331 U.S. 1 (1947), in which the Supreme Court held that the amount realized on the sale of property included the amount of a nonrecourse mortgage, agreed with the Service and held when property is given to another subject to a loan in excess of the donor's adjusted basis in the property, and the transferee pays or assumes payment of the loan, the transaction is in part a sale and in part a gift. The court further stated that unlike *TURNER*, the transfers in *JOHNSON* were not conditioned on the payment of the gift tax liability by the recipients, and the loans at issue were not to be equated with the gift tax liabilities in *TURNER*.

On appeal, the taxpayer conceded that the *CRANE* doctrine applied to the extent of the $50,000 he received in excess of the gift tax liability, but he argued the result of the transaction was identical to *TURNER* as far as the gift tax liability of $150,000 was concerned. In a decision that may be interpreted as having effectively overruled *TURNER*, the Sixth Circuit Court of Appeals affirmed the Tax Court and held the taxpayer realized income to the extent the loan proceeds exceeded the basis of the transferred stock. The court further concluded that the donee's payment of the donor's gift tax liability was income to the donor, but whether the transaction were described as a "part sale and part gift" or a "net gift" was not important. That the taxpayer received something of value upon transferring his encumbered stock into a trust was the significant factor. 495 F.2d at 1083. The court also stated that the transaction at issue fell within the parameters of *CRANE*, and that the same result would be reached if the court described the $150,000 used to pay the gift taxes as equivalent to what happened in *TURNER*. In addition, the court reasoned that in substance the donor was obtaining cash necessary to pay his gift taxes. If the donor acquired cash upon transfer of the donated property, then he realized income under Code section 1001(b) to the extent the amount received exceeded his property basis. This was true, the court added, whether the event triggering the realization of income was a sale, or discharge of indebtedness, or something else. 495 F.2d at 1084. Finally, the court did not expressly overrule the Tax Court's decision in *TURNER*, but did limit the precedential value of *TURNER* to its peculiar fact situation, namely, transfers to individual donees.

Despite the holding of *JOHNSON*, judicial acceptance of the part sale and part gift concept in the area of transfers to individual donees is unsettled. In *HIRST V. COMMISSIONER*, 63 T.C. 307 (1974), *APPEAL DOCKETED*, Docket No. 75-1543, (4th Cir., filed June 3, 1975), the Tax Court followed the precedent of TURNER and held that a donor's conveyance of several parcels of land to her son and grandchildren conditioned on the son's payment of the resulting gift taxes was not a partial sale. Although the Tax Court acknowledged that the Sixth Circuit's decision in *JOHNSON* was critical of *TURNER* and admitted the persuasiveness of the Service's more "realistic" approach, the court noted, at page 314, that the Sixth Circuit had affirmed *TURNER* and had failed to expressly overrule it in *JOHNSON*.

Despite the Tax Court's opinion in *HIRST*, it is the Service's position that donors who transfer appreciated property to trusts or to individuals conditioned upon the transferees' payment of resulting gift taxes realize taxable income to the extent the benefits received exceed the donors' adjusted bases in the transferred property. The transferees receive the transferred property in a single transaction that is in part a sale and in part a gift.

In the instant case, it is the taxpayer's position that it received the stock from the donor in a net gift transaction governed by the *TURNER* case. Since, if there is no sale element in the transfer of stock to the taxpayer, the taxpayer's basis is the same as the donor's basis in the stock, it follows that section 1223(2) of the Code entitles the taxpayer in computing its holding period to include the period during which the donor held the stock. It is the position of the Service that TURNER was incorrectly decided and that the tax consequences of the transaction in the instant case is governed by the part sale and part gift concept employed in the JOHNSON case and that the taxpayer's basis in the transferred stock must be computed in accordance with the provisions of section 1.1015-4 of the regulations.

Although the taxpayer contends that it received the stock in a net gift transaction, it asserts, in the alternative, that even if the transaction is viewed as a partial sale, and even if section 1.1015-4 of the regulations applies to the transaction, nevertheless, the provisions of section 1.1015-4 cannot be construed to deny the taxpayer from tacking on to its holding period, the period in which the stock was held by the donor.

The taxpayer cites in support of this alternative assertion the decision in *CITIZEN'S NATIONAL BANK OF WACO V. UNITED STATES*, 417 F.2d 675 (5th Cir. 1969). In *WACO*, the settlors of several trusts transferred stock to the trusts in a part sale and part gift transaction whereby the trusts assumed an indebtedness of the settlors. The amount of the indebtedness assumed by the trusts was $500,000 and the settlors' basis in the stock was $498,468. Thus the trusts' cost basis in the stock exceeded the basis in the hands of the settlors. Within six months after the transfer, the company that issued the transferred stock was liquidated, and its assets were distributed to the trusts. On its tax return, each trust reported its share of the fair market of the assets received in exchange for the stock, deducted its basis, and reported the gain as long-term capital gain.

The issue presented in *WACO* was whether, for the purpose of determining the trusts' holding period for the stock, the trusts were entitled to tack the settlors' holding period to their own holding period under section 1223(2) of the Code.

Section 1223(2) of the Code provides that a taxpayer may include, for purposes of determining the taxpayer's holding period, the period for which the property was held by another person, if the property has the same basis in whole or in part in hands of the taxpayer as it would have in the hands of such other person.

Section 1015(a) of the Code provides, in part, that a transferee's basis for property acquired by gift shall be the same as it would be in the hands of the transferor. Section 1015(b) provides that the basis of property acquired by a transfer in trust (other than by a transfer in trust by a gift, bequest or devise) shall be the same as it would be in the hands of the grantor, increased by the amount of gain or decreased by the amount of loss recognized to the grantor on the transfer.

Section 1.1015-4(a)(1) of the regulations provides that where a transfer of property is in part a sale and in part a gift, the unadjusted basis of the property in the hands of the transferee is the greater of the amount paid by the transferee for the property, or the transferor's adjusted basis for the property at the time of the transfer. Section 1.1015-4(a)(2) of the regulations allows an increase of the transferee's basis in donated property, as determined by the provisions of section 1.1015-4(a)(1) by the amount of Federal gift taxes paid.

In *WACO*, the amount paid by the trusts was greater than the transferors' adjusted basis for the property at the time of the transfers. Since the amount paid by the trusts had no reference to the transferors' basis as required under section 1223 of the Code for tacking, the Service contended that the trusts were not allowed to tack the transferors' holding period to their own.

The court in *WACO* agreed that the Service's application of section 1.1015-4 of the regulations would be correct if this regulation were a valid interpretation of the provisions of section 1015 of the Code. The court noted that section 1015(a) provides that the transferee's basis "shall be the same as it would be in the hands of the donor." Also, section 1015(b) dealing with sales to trusts provides that the transferee's basis "shall be the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer." The court concluded at page 680 that:

> Since both the gift and the sale subsections of section 1015 employ words which would permit tacking, and since neither subsection makes any distinction in this regard between a transferee who pays more than his grantor's basis and one who does not, we think that such a distinction in the regulation pertaining to a part gift part sale transaction is unreasonable and inconsistent with the statute. We therefore hold that the trustee in the instant case is entitled to tack the settlors' holding periods to the trusts and to the extent Treas. Reg. section 1.1015-4 would prevent such it is invalid.

It is the Service's position that the court in WACO erred in its decision and that section 1.1015-4 of the regulations is a valid interpretation of the provisions of section 1015. There are several reasons for the Service's continued acceptance of the validity of the basis determination method prescribed by section 1.1015-4.

Fundamental to the court's decision in WACO, is the court's assumption that both the gift and sale subsection of section 1015 of the Code permit tacking where the transferees are trusts. This assumption rests upon the court's determination that section 1015(b) a provision that relates to sales to trusts, permits tacking since it defines the trusts' basis by reference to the basis of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor. As the court itself noted on page 679, "the two concepts, price paid and grantor's basis increased or decreased by the amount of gain or loss recognized to the grantor, produce identical results as far as the actual amount of the transferee's basis is concerned." Despite this implicit recognition by the court that the transferee under section 1015(b) acquired a cost basis, the court, nevertheless, permitted the trusts to tack on the settlors' holding period since it viewed the trusts as acquiring, under the wording of section 1015(b) the same basis in whole or in part as the basis would have been in the hands of the transferors.

In effect, the court in WACO recognizes that where property is received in a sale, the purchaser's basis in the purchased property is the amount of consideration furnished the seller whether the purchaser be an individual or a trust. However, if the purchaser were an individual, the individual's holding period in the property would not include the seller's holding period, whereas if the purchaser were a trust, the trust's holding period would include the seller's holding period. This curious result is contrary to logic and contrary to Congressional intent.

Although Congress phrased section 1015(b) of the Code in terms of the transferor's basis plus gain or loss recognized by the transferor on the sale, the conceptual and the practical effect would be the same if the trust's basis were determined under section 1012 that defines basis as the transferee's cost. Congress in enacting the tacking provisions of section 1223(3) intended tacking to apply under circumstances where a transferee steps into the shoes of the transferor through a transaction that conceptually does not carry with it any substantive tax consequences flowing from the change in ownership, such as a tax-free exchange of stock pursuant to a reorganization. See H. REP. NO. 1, 69th Cong., 1st Sess., p. 6 (1939-1 C.B. (Part 2) 315, 319); S. REP. NO. 52, 69th Cong., 1st Sess., p. 18 (1939-1 C.B. (Part 2) 332, 346). Congress noted that the question frequently arises in a reorganization situation whether the period the taxpayer held the stock that he exchanged for new stock should be added to the period for which he held his new stock." The same question arises in the case of property received by gift after December 31, 1920." There is no reference to the concept of tacking applying to transfers to trust after December 31, 1920.

Unlike the situation where property is exchanged in a reorganization or where property is gratuitously conveyed to a donee, there are substantive tax consequences flowing from a sale of property to a trust. A sale gives rise to realization and recognition of gain and results in the transferee acquiring a basis in the purchased property that is not the same as the seller's basis in the property. As the Tax Court in *MCCAUSLEN V. COMMISSIONER*, 45 T.C. 588, 592 (1966) stated in an issue involving an analogous problem:

The provision for taking on the partnership's holding period is entirely consistent with the general statutory scheme of postponing recognition of gain or loss … . But where … a partner acquires another partner's share by purchase and, as a consequence of the termination of the partnership resulting from such purchase, acquires the partnership assets relating to such purchased interest, the statute has no application. *THE STATUTE CANNOT BE CONSTRUED AS PERMITTING THE PURCHASER TO TACK ON THE PARTNERSHIP'S HOLDING PERIOD OF SUCH ASSETS*. (Emphasis added.)

Although the court in *WACO* limited the applicability of section 1.1015-4 of the regulations so that a trust transferee will always be permitted to tack on the transferor's holding period, there is nothing in the judicial and administrative history of this regulation to lead to a conclusion that the regulation applies differently to a situation where the transferee is a trust from a situation where the transferee is a taxpayer other than a trust.

During the period from 1933 to 1939, the Service in its litigation posture asserted a "split transaction principle" in part sale and part gift transactions. See I.T. 2681, XII-1 C.B. 93 (1933). Under the split transaction principle, the transferor's basis would be allocated into a sale element and a gift element. The sale element of the transferor's basis was determined in accordance with a ratio in which the numerator was the purchase price and the denominator was the property's fair market value. For example, a father has stock which he purchased for $6 and with a fair market value of $15. The father transfers the stock to his son for $10. Under the split transaction principle, to determine the gain to the father on the transaction, the father's sale element basis would be $4 (10/15 x $6). The son's basis would consist of the cost of the purchased element, $10, plus the father's gift element basis, $2, namely $12.

However, in 1939 the Board of Tax Appeals in *FINCKE V. COMMISSIONER*, 39 B.T.A. 510 (1939), held that splitting was erroneous as a matter of law and that such a transaction could not be fragmented. In 1939, the Service acquiesced in *FINCKE*, revoked I.T. 2681, and stated with respect to such transaction that (a) the transferor's gain would be equal to the amount paid by the transferee less the transferor's basis for all of the property and (b) the transferee's basis would be equal to the amount so paid. I.T. 3335, 1939-2 C.B. 193. That position has been followed since 1939 and is reiterated in the regulations promulgated under the 1954 Code. (See regulations section 1.1015-4(a) and (b) (Example (2)) (transferee's basis): section 1.1001-1(e)(1) and (2) (Example (1)) (transferor's gain).

Thus, section 1.1015-4 of the regulations is a response to the *FINCKE* case. It is significant to note that the part sale and part gift transactions in *FINCKE* arose from both transfers to individuals and transfers in trust.

Administratively, although section 1.1015-4 of the regulations was first promulgated in 1957 (T.D. 6265, 1957 C.B. 463, filed November 6, 1957, the position set forth in the regulation has been followed by the Service and publicly known since 1939 (I.T. 3335). In addition, Congress amended section 1015 in 1958 by the addition of subsection (d) to provide that the basis of property in the hands of a transferee should be increased by the gift tax paid with respect to the transfer (Technical Amendments Act of 1958, Pub. L. No. 85-866, section 43(a) 72 Stat. 1606), without questioning the method of computing basis that is prescribed by the regulation. S. REP. NO. 1983, 85th Cong., 2d Sess., pp. 70, 198 (1958-3 C.B. 922, 991, 1119). Under such circumstances, the principle set forth in *HELVERING V. WINMILL*, 305 U.S. 79, 83, would be particularly applicable here:

> Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially re-enacted statutes, are deemed to have received Congressional approval and have the effect of law.

In summary, despite the *WACO* decision, it is the Service's position that the provisions of section 1.1015-4 of the regulations apply with equal validity to both individual transferees and trust transferees.

In the instant case, the taxpayer asserts as a final argument the provisions of section 1.1015-4 of the regulations should only apply to those number of shares of common stock the aggregate fair market value of which total the taxes paid by the taxpayer on the gifts (the "sale element"). The taxpayer further asserts that its basis in the remaining shares (the "gift element") should be determined by sections 1.1015-1 and 1.1015-5 of the regulations, so that the taxpayer's basis in the gift element shares would be the donor's basis increased by the amount of gift tax paid.

The fallacy with this assertion is twofold. Section 1.1015-4 does not apply to sales, but rather to transactions that are in part sales and in part gifts. Secondly, the taxpayer's assertion is analogous to the split transaction principle argued unsuccessfully by the Service in FINCKE in 1939. As has been noted, since 1939 it has been the position of the Service that a part sale and part gift transaction is a single transaction, the tax consequences of which may not be determined as if the transaction were a pure sale to extent of the consideration furnished and to the amount in excess of the consideration, a pure gift.

Conclusion

Based upon the information submitted and the applicable law discussed herein, it is determined that:

1) Section 1.1015-4 of the regulations provides the proper method for determining the taxpayer's basis in the transferred shares of common stock.

2) The taxpayer may not in determining its holding period in the transferred stock tack on the period in which the donor held the stock.

3) The taxpayer has not purchased some shares at full fair market value and received the remainder by gift, but rather has paid an amount, namely, the gift tax, for all the transferred stock in a part sale and part gift transaction.

For gift tax purposes, Code § 7872 applies when valuing notes the buyer issues in a bargain sale.[6380]

When an irrevocable grantor trust holds an interest in an entity taxed as a partnership is allocated liabilities in excess of basis, turning off grantor trust status is a deemed bargain sale.[6381]

III.B.1.c.i.(b). Bargain Sales to Charities

Code § 1011(b), “Bargain Sale to a Charitable Organization,” provides:

> If a deduction is allowable under section 170 (relating to charitable contributions) by reason of a sale, then the adjusted basis for determining the gain from such sale shall be that portion of the adjusted basis which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property.

Reg. § 1.1011-2(a), “In general,” provides

> (1) If for the taxable year a charitable contributions deduction is allowable under section 170 by reason of a sale or exchange of property, the taxpayer’s adjusted basis of such property for purposes of determining gain from such sale or exchange must be computed as provided in section 1011(b) and paragraph (b) of this section. If after applying the provisions of section 170 for the taxable year, including the percentage limitations of section 170(b), no deduction is allowable under that section by reason of the sale or exchange of the property, section 1011(b) does not apply and the adjusted basis of the property is not required to be apportioned pursuant to paragraph (b) of this section. In such case the entire adjusted basis of the property is to be taken into account in determining gain from the sale or exchange, as provided in § 1.1011-1(e). In ascertaining whether or not a charitable contributions deduction is allowable under section 170 for the taxable year for such purposes, that section is to be applied without regard to this section and the amount by which the contributed portion of the property must be reduced under section 170(e)(1) is the amount determined by taking into account the amount of gain which would have been ordinary income or long-term capital gain if the contributed portion of the property had been sold by the donor at its fair market value at the time of the sale or exchange.
>
> (2) If in the taxable year there is a sale or exchange of property which gives rise to a charitable contribution which is carried over under section 170(b)(1)(D)(ii) or section 170(d) to a subsequent taxable year or is postponed under section 170(a)(3) to a subsequent taxable year, section 1011(b) and paragraph (b) of this section must be applied for purposes of apportioning the adjusted basis of the property for the year of the sale or exchange, whether or not such contribution is allowable as a deduction under section 170 in such subsequent year.

[6380] See fn. 7067 in part III.B.5.b Promissory Notes.

[6381] See text accompanying fn 6554 in part III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation. Much debate has occurred over whether a bargain sale would occur on the grantor’s death; see fn. 6591 in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System.

(3) If property is transferred subject to an indebtedness, the amount of the indebtedness must be treated as an amount realized for purposes of determining whether there is a sale or exchange to which section 1011(b) and this section apply, even though the transferee does not agree to assume or pay the indebtedness.

(4)

(i) Section 1011(b) and this section apply where property is sold or exchanged in return for an obligation to pay an annuity and a charitable contributions deduction is allowable under section 170 by reason of such sale or exchange.

(ii) If in such case the annuity received in exchange for the property is nonassignable, or is assignable but only to the charitable organization to which the property is sold or exchanged, and if the transferor is the only annuitant or the transferor and a designated survivor annuitant or annuitants are the only annuitants, any gain on such exchange is to be reported as provided in example (8) in paragraph (c) of this section. In determining the period over which gain may be reported as provided in such example, the life expectancy of the survivor annuitant may not be taken into account. The fact that the transferor may retain the right to revoke the survivor's annuity or relinquish his own right to the annuity will not be considered, for purposes of this subdivision, to make the annuity assignable to someone other than the charitable organization. Gain on an exchange of the type described in this subdivision pursuant to an agreement which is entered into after December 19, 1969, and before May 3, 1971, may be reported as provided in example (8) in paragraph (c) of this section, even though the annuity is assignable.

(iii) In the case of an annuity to which subdivision (ii) of this subparagraph applies, the gain unreported by the transferor with respect to annuity payments not yet due when the following events occur is not required to be included in gross income of any person where -

(a) The transferor dies before the entire amount of gain has been reported and there is no surviving annuitant, or

(b) The transferor relinquishes the annuity to the charitable organization. If the transferor dies before the entire amount of gain on a two-life annuity has been reported, the unreported gain is required to be reported by the surviving annuitant or annuitants with respect to the annuity payments received by them.

Reg. § 1.1011-2(b), "Apportionment of adjusted basis," provides

For purposes of determining gain on a sale or exchange to which this paragraph applies, the adjusted basis of the property which is sold or exchanged shall be that portion of the adjusted basis of the entire property which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the entire property. The amount of such gain which shall be treated as ordinary income (or long-term capital gain) shall be that amount which bears the same ratio to the ordinary income (or long-term capital gain) which would have been recognized if the entire property had been sold by the donor at its fair market value at the time of the sale or exchange as the amount realized

> on the sale or exchange bears to the fair market value of the entire property at such time. The terms "ordinary income" and "long-term capital gain", as used in this section, have the same meaning as they have in paragraph (a) of § 1.170A-4. For determining the portion of the adjusted basis, ordinary income, and long-term capital gain allocated to the contributed portion of the property for purposes of applying section 170(e)(1) and paragraph (a) of § 1.170A-4 to the contributed portion of the property, and for determining the donee's basis in such contributed portion, see paragraph (c)(2) and (4) of § 1.170A-4. For determining the holding period of such contributed portion, see section 1223(2) and the regulations thereunder.

Reg. § 1.1011-2(c) provides examples and cross-references examples in Reg. § 1.170A-4(d).

Also see part II.Q.6.b Possible Deemed Sale or Reduced Deduction When Contributing Partnership Interest to Charity.

III.B.1.c.ii. Gift of Deferred Income Item May Trigger Income Tax

Deferred income is triggered by a gift of an note used to defer tax on an installment sale. See part II.G.15 Limitations on the Use of Installment Sales.

Other than a gift to an irrevocable grantor trust, the following may trigger income tax:

- A gift of an interest in an opportunity zone (such as a qualified opportunity fund) accelerates the donor's deferred income.[6382]

- A direct or indirect gift of a carried interest. A carried interest may exist in a partnership interest where distributions are not proportionate to capital accounts. Proposed regulations attribute through tiers of entities the indirect holding of a carried interest.[6383]

Be sure to do due diligence on whether either condition exists before facilitating a gift other than to a grantor trust and before turning off grantor trust powers.

III.B.1.c.iii. Incomplete Gift

Reg. § 25.2511-2, "Cessation of donor's dominion and control," governs when a gift is complete. Subsection (b):

> As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined. For example, if a donor transfers property to another in trust to pay the income to the donor or accumulate it in the discretion of the

[6382] See part II.G.7.b Transfers of a Qualified Opportunity Fund (QOF).
[6383] See Code § 1061(d), reproduced in fn 3754 and the related discussion in part II.M.4.f.ii.(b) Code § 1061 - Certain Sales of Compensatory Partnership Interests Recharacterized from Long-Term to Short-Term Gains, including that proposed regulations assert that "transfer" includes gifts.

> trustee, and the donor retains a testamentary power to appoint the remainder among his descendants, no portion of the transfer is a completed gift. On the other hand, if the donor had not retained the testamentary power of appointment, but instead provided that the remainder should go to X or his heirs, the entire transfer would be a completed gift. However, if the exercise of the trustee's power in favor of the grantor is limited by a fixed or ascertainable standard (see paragraph (g)(2) of §25.2511-1), enforceable by or on behalf of the grantor, then the gift is incomplete to the extent of the ascertainable value of any rights thus retained by the grantor.

Reg. § 25.2511-2(c) discusses the donor reserving other powers:

> A gift is incomplete in every instance in which a donor reserves the power to revest the beneficial title to the property in himself. A gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard. Thus, if an estate for life is transferred but, by an exercise of a power, the estate may be terminated or cut down by the donor to one of less value, and without restriction upon the extent to which the estate may be so cut down, the transfer constitutes an incomplete gift. If in this example the power was confined to the right to cut down the estate for life to one for a term of five years, the certainty of an estate for not less than that term results in a gift to that extent complete.

Estate of Demuth, Jr. v. Commissioner, 132 A.F.T.R.2d 2023-5122 (3rd Cir. 7/12/2023), reasoned and held:

> A gift is "incomplete in every instance in which a donor reserves the power to revest the beneficial title to the property in himself." 26 C.F.R. § 25.2511-2 (c). We apply state law to determine when a gift in the form of a check is completed. See, *e.g.*, *Burnet v. Harmel*, 287 U.S. 103, 110 (1932) ("[S]tate law creates legal interests but the federal statute determines when and how they shall be taxed."); *Metzger v. Comm'r*, 38 F.3d 118, 121 (4th Cir. 1994) ("We refer to state law to determine whether a donor has relinquished dominion and control over a gift in the form of a check[.]" (citing *Estate of Dillingham v. Comm'r*, 903 F.2d 760, 763 (10th Cir. 1990))); Rev. Rul. 96-56, 1996-2 C.B. 161 (noting local law applies to determine whether a check from a donor is a complete gift).
>
> Under Pennsylvania law,[5] an inter vivos gift is a gift given with the intention of being completed when the donor is living. *Titusville Tr. Co. v. Johnson*, 100 A.2d 93, 96 (Pa. 1953). To find an inter vivos gift has been completed, there must be (1) an intention to make the gift and (2) an "actual or constructive delivery at the same time, of a nature sufficient to divest the giver of all dominion." *Id*. at 96-97. In the case of a check, delivery of the check alone does not complete the gift because the donor may revoke the gift up until the time it is deposited or cashed.[6] *In re Eshenbaugh's Estate*, 174 A. 809, 811 (Pa. Super. Ct. 1934) (citations omitted); see also In re Kern's Estate, 33 A. 129, 129 (Pa. 1895) ("[T]he delivery of a...check is not an executed gift of the money, but remains revocable, and will be revoked by the death of the promisor before actual payment."). This is consistent with Pennsylvania's Commercial Code, which allows for a drawer of a check to stop payment on the check until the earliest of the drawer's bank accepting, certifying, or making final payment of the check. See 13 Pa. Cons. Stat. §§ 3409, 4403(a), 4303(a).

[5] The parties agree that because the Decedent was domiciled in Pennsylvania at the time of his death, Pennsylvania state law controls.

[6] If, however, "the check is drawn for the whole and exact amount in the bank," it is deemed "an equitable assignment of the fund," and thus it is viewed as a completed gift. *In re Eshenbaugh's Estate*, 174 A. 809, 811 (Pa. Super. Ct. 1934) (citations omitted).

Here, the seven checks at issue were all deposited and paid after the death of the Decedent. Because there had not been "actual or constructive delivery...of a nature sufficient to divest the giver of all dominion," *Titusville*, 100 A.2d at 96-97, the checks were still revocable at the time the Decedent died. The Decedent therefore still "reserve[d] the power to revest the beneficial title to the property in himself," 26 C.F.R. § 25.2511-2 (c), and thus the inter vivos gifts here were not completed and remained part of the Estate. See *Estate of Gagliardi v. Comm'r*, 89 T.C. 1207, 1213 (1987) (applying Pennsylvania law and holding that checks delivered to the payees before, but paid after, the decedent's death are part of the gross estate for federal estate tax purposes).[7]

[7] Courts of Appeals interpreting similar laws in other states have also held that checks delivered before a decedent's death but paid after were revocable at the time of his death and therefore are incomplete gifts that must be included in the estate. See, *e.g.*, *Metzger v. Comm'r*, 38 F.3d 118, 121 (4th Cir. 1994) (observing that under Maryland law, a gift in the form of a check is an incomplete gift and includible in the gross estate because "the delivery of a personal check is only conditional payment, and the gift remains incomplete until the donee presents the check for payment and the check is accepted by the drawee bank" (quoting *Malloy v. Smith*, 290 A.2d 486, 487-88 (Md. 1972))); *Estate of Dillingham v. Comm'r*, 903 F.2d 760, 763 (10th Cir. 1990) (same, where Oklahoma law allows a decedent to "retain[] the power to stop payment and thereby defeat the claims of the donees from the time the checks were delivered...until they were cashed"); *Rosano v. United States*, 245 F.3d 212, 213 (2d Cir. 2001) (same, applying New York law which gives the decedent "the ability, at any time until the checks [are] paid, to order that payment on the checks be stopped").

The Estate argues that the seven checks at issue were properly excluded because they were given in contemplation of Decedent's death, and therefore were completed gifts in causa mortis. Under Pennsylvania law, gifts "causa mortis" are gifts "prompted by the [donor's] belief...that his death is impending, and [are] made as a provision for the donee if death ensues." *Titusville*, 100 A.2d at 96. Pennsylvania courts have found that where the circumstances support a finding of a gift causa mortis, checks delivered before, but paid after, the decedent's death are completed gifts. See, *e.g.*, *In re Estate of Smith*, 694 A.2d 1099, 1102 (Pa. Super. Ct. 1997); *In re Fleigle Estate*, 13 Fiduc. 2d 141, 145-47 (Pa. C.C.P. 1993), *aff'd on other grounds*, *In re Estate of Fleigle*, 664 A.2d 612 (Pa. Super. Ct. 1995).

A gift causa mortis differs from an inter vivos gift in that "it is made when the donor believes he is about to die, and is revocable should he survive." *Estate of Smith*, 694 A.2d at 1102 n.2. To determine whether a gift was given in causa mortis, one must show that "at the time of the alleged gift, the decedent intended to make a gift, the decedent apprehended death, the res of the intended gift was either actually or constructively delivered, and death actually occurred." *Id*. at 1101. Whether a gift was given in causa mortis thus "depends primarily upon the state of the donor's mind." *Titusville*, 100 A.2d at 97. To determine this, "the attendant circumstances should be considered, including the nature and extent of his sickness, illness or injuries, his physical condition, his conduct, and anything that was said to and by him." *Id*.

The Estate has not shown that the Decedent wrote the checks as gifts in causa mortis. The only evidence arguably supporting this point is that the Decedent was diagnosed with an end-stage medical condition in early September 2015, and that the yearly gifts given to family members were generally given in December rather than September. There is no evidence, however, that indicates the Decedent directed Donald to distribute the September 2015 checks in contemplation of his death.[8] In fact, the record reflects that the only directions the Decedent gave to Donald as his agent was that Donald was authorized to "give gifts to Decedent's issue in an amount not to exceed the annual exclusion from the federal gift tax," and to "give gifts to any permitted donee for tuition." App. 18-19. As such, the Estate's argument that the checks were properly completed gifts causa mortis fails because there is nothing to show that the Decedent contemplated death when the checks were written on his behalf. Thus, the value of the seven remaining checks was improperly excluded from the gross estate.

[8] The Estate seems to make an argument that Donald expressed sufficient donative intent to support a gift given in causa mortis because "he knew of his father's end-stage medical condition." Appellant Br. at 6. The only relevant state of mind, however, was the Decedent's, see, *e.g.*, *Titusville*, 100 A.2d at 96 (noting that a gift causa mortis is made "when the donor believes he is about to die"), and so Donald's state of mind is irrelevant to the question of whether the gifts were given in causa mortis.

Please read the rest of Reg. § 25.2511-2.

III.B.1.d. Generation-Skipping Transfer (GST) Issues

These materials do not attempt to cover GST issues generally but rather cover selected matters that I feel like documenting.

For allocations of GST exemption on a gift tax return filed after the original due date and before the extended due date, see part II.G.19.e Superseding Returns.

III.B.1.d.i. Effect of "Additions" on Grandfathering from GST Rules

An addition to a grandfathered trust causes the trust to lose its exclusion from the GST system to the extent of the addition; if an individual other than the transferor made the addition, the addition is treated as a separate trust for GST purposes.[6384] A probate court modification that

[6384] Reg. § 26.2601-1(b)(1)(iv) provides:

In general. If an addition is made after September 25, 1985, to an irrevocable trust which is excluded from chapter 13 by reason of paragraph (b)(1) of this section, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13. If an addition is made, the trust is thereafter deemed to consist of two portions, a portion not subject to chapter 13 (the non-chapter 13 portion) and a portion subject to chapter 13 (the chapter 13 portion), each with a separate inclusion ratio (as defined in section 2642(a)). The non-chapter 13 portion represents the value of the assets of the trust as it existed on September 25, 1985. The applicable fraction (as defined in section 2642(a)(2)) for the increases distributions to skip persons beyond what was originally intended caused the entire trust to lose its grandfathering, with the original transferor remaining the transferor.[6385]

Important scholarship on who is the transferor, particularly when one beneficiary is deemed to have made a gift to other beneficiaries of all or part of the deemed donor-beneficiary's interest in a trust, is cited in fn 6368 in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts. Part III.B.1.b includes some rulings relating to GST issues.

A constructive addition is treated as an addition to a grandfathered trust.[6386] Constructive additions include certain powers of appointment[6387] (if and to the extent the regulation is valid) to

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> non-chapter 13 portion is deemed to be 1 and the inclusion ratio for such portion is 0. The chapter 13 portion of the trust represents the value of all additions made to the trust after September 25, 1985. The inclusion ratio for the chapter 13 portion is determined under section 2642. This paragraph (b)(1)(iv)(A) requires separate portions of one trust only for purposes of determining inclusion ratios. For purposes of chapter 13, a constructive addition under paragraph (b)(1)(v) of this section is treated as an addition. See paragraph (b)(4) of this section for exceptions to the additions rule of this paragraph (b)(1)(iv). See § 26.2654-1(a)(2) for rules treating additions to a trust by an individual other than the initial transferor as a separate trust for purposes of chapter 13.

Reg. § 26.2654-1(a)(2), "Multiple transferors with respect to single trust," is reproduced in part III.B.1.d.iii Who Is the Transferor.

[6385] Letter Ruling 9448024, as modified by Letter Ruling 9522032.

[6386] See the highlighted portion of Reg. § 26.2601-1(b)(1)(iv) in fn. 6384.

[6387] Reg. § 26.2601-1(b)(1)(v)(A) provides:

> *Powers of appointment*. Except as provided in paragraph (b)(1)(v)(B) of this section, where any portion of a trust remains in the trust after the post-September 25, 1985, release, exercise, or lapse of a power of appointment over that portion of the trust, and the release, exercise, or lapse is treated to any extent as a taxable transfer under chapter 11 or chapter 12, the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed is treated as if that portion had been withdrawn and immediately retransferred to the trust at the time of the release, exercise, or lapse. The creator of the power will be considered the transferor of the addition except to the extent that the release, exercise, or lapse of the power is treated as a taxable transfer under chapter 11 or chapter 12. See section 26.2652-1 for rules for determining the identity of the transferor of property for purposes of chapter 13.

the extent not excluded[6388] and the relief of certain liabilities.[6389] Except to the extent that the above rules allocate subsequent appreciation and accumulated income between the original trust and additions, appreciation in the trust's value and accumulated income are not considered an addition to the principal of a trust.[6390] Reg. § 26.2601-1(b)(1)(iv)(C)(1) provides:

> *In general*. The allocation fraction allocates appreciation and accumulated income between the chapter 13 and non-chapter 13 portions of a trust. The numerator of the allocation fraction is the amount of the addition (valued as of the date the addition is made), determined without regard to whether any part of the transfer is subject to tax under chapter 11 or chapter 12, but reduced by the amount of any Federal or state estate or gift tax imposed and subsequently paid by the recipient trust with respect to the addition. The denominator of the allocation fraction is the total value of the entire trust immediately after the addition. For purposes of this paragraph (b)(1)(iv)(C), the total value of the entire trust is the fair market value of the property held in trust (determined under the rules of section 2031), reduced by any amount attributable to or paid by the trust and attributable to the transfer to the trust that is similar to an amount that would be allowable as a deduction under section 2053 if the addition had occurred at the death of the transferor, and further reduced by the same amount that the numerator was reduced to reflect Federal or state estate or gift tax incurred by and subsequently paid by the recipient trust with respect to the addition.

The regulation continues by describing the consequences of multiple additions, then Reg. § 26.2601-1(b)(1)(iv)(C)(2) provides examples. I am unclear how one can value an addition, when its amount is "determined without regard to whether any part of the transfer is subject to tax under chapter 11 or chapter 12…." How does one measure the amount of the

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[6388] Reg. § 26.2601-1(b)(1)(v)(B) provides:

> *Special rule for certain powers of appointment*. The release, exercise, or lapse of a power of appointment (other than a general power of appointment as defined in section 2041(b)) is not treated as an addition to a trust if -
>
> (1) Such power of appointment was created in an irrevocable trust that is not subject to chapter 13 under paragraph (b)(1) of this section; and
>
> (2) In the case of an exercise, the power of appointment is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of the trust, extending beyond any life in being at the date of creation of the trust plus a period of 21 years plus, if necessary, a reasonable period of gestation (the perpetuities period). For purposes of this paragraph (b)(1)(v)(B)(2), the exercise of a power of appointment that validly postpones or suspends the vesting, absolute ownership or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date of creation of the trust) will not be considered an exercise that postpones or suspends vesting, absolute ownership or the power of alienation beyond the perpetuities period. If a power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

[6389] Reg. § 26.2601-1(b)(1)(v)(C) provides:

> *Constructive addition if liability is not paid out of trust principal*. Where a trust described in paragraph (b)(1) of this section is relieved of any liability properly payable out of the assets of such trust, the person or entity who actually satisfies the liability is considered to have made a constructive addition to the trust in an amount equal to the liability. The constructive addition occurs when the trust is relieved of liability (*e.g.*, when the right of recovery is no longer enforceable). But see section 26.2652-1(a)(3) for rules involving the application of section 2207A in the case of an election under section 2652(a)(3).

[6390] Reg. § 26.2601-1(b)(1)(vi).

transfer that is a "constructive addition"? Reg. § 26.2601-1(b)(1)(v)(D), Example (3), "Entire portion of trust subject to lapsed power is treated as an addition," provides:

> On September 25, 1985, B possessed a general power of appointment over the assets of an irrevocable trust that had been created by T in 1980. Under the terms of the trust, B's power lapsed on July 20, 1987. For Federal gift tax purposes, B is treated as making a gift of ninety-five percent (100% − 5%) of the value of the principal (see section 2514). However, because the entire trust was subject to the power of appointment, 100 percent (that portion of the trust subject to the power) of the assets of the trust are treated as a constructive addition. Thus, the entire amount of all generation-skipping transfers occurring pursuant to the trust instrument after July 20, 1987, are subject to chapter 13.

Reg. § 26.2601-1(b)(4) sets forth safe harbors for when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust will not cause the trust to lose its grandfathered status. These safe harbors apply to certain discretionary powers,[6391]

[6391] Reg. § 26.2601-1(b)(4)(i)(A) provides:

> The distribution of trust principal from an exempt trust to a new trust or retention of trust principal in a continuing trust will not cause the new or continuing trust to be subject to the provisions of chapter 13, if -
>
> (1) Either -
>
> (i) The terms of the governing instrument of the exempt trust authorize distributions to the new trust or the retention of trust principal in a continuing trust, without the consent or approval of any beneficiary or court; or
>
> (ii) at the time the exempt trust became irrevocable, state law authorized distributions to the new trust or retention of principal in the continuing trust, without the consent or approval of any beneficiary or court; and
>
> (2) The terms of the governing instrument of the new or continuing trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date the original trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus a period of 21 years, plus if necessary, a reasonable period of gestation. For purposes of this paragraph (b)(4)(i)(A), the exercise of a trustee's distributive power that validly postpones or suspends the vesting, absolute ownership, or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date the original trust became irrevocable) will not be considered an exercise that postpones or suspends vesting, absolute ownership, or the power of alienation beyond the perpetuities period. If a distributive power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

settlements,[6392] judicial constructions,[6393] or certain modifications.[6394] Reg. § 26.2601-1(b)(4)(i)(E) provides examples of these safe harbors.

[6392] Reg. § 26.2601-1(b)(4)(i)(B) provides:

> A court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause the new or continuing trust to be subject to the provisions of chapter 13, if -
>
> (1) The settlement is the product of arm's length negotiations; and
>
> (2) The settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

[6393] Reg. § 26.2601-1(b)(4)(i)(C) provides:

> judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause the new or continuing trust to be subject to the provisions of chapter 13, if -
>
> (1) The judicial action involves a bona fide issue; and
>
> (2) The construction is consistent with applicable state law that would be applied by the highest court of the state.

[6394] Reg. § 26.2601-1(b)(4)(i)(D) provides:

> (1) A modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.
>
> (2) For purposes of this section, a modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust. In addition, administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1 of this chapter.

Among the safe harbors is Reg. § 26.2601-1(b)(4)(i)(E), Example (11), "Conversion of income interest to unitrust interest under state statute":[6395]

> In 1980, Grantor, a resident of State X, established an irrevocable trust for the benefit of Grantor's child, A, and A's issue. The trust provides that trust income is payable to A for life and upon A's death the remainder is to pass to A's issue, per stirpes. In 2002, State X amends its income and principal statute to define income as a unitrust amount of 4% of the fair market value of the trust assets valued annually. For a trust established prior to 2002, the statute provides that the new definition of income will apply only if all the beneficiaries who have an interest in the trust consent to the change within two years after the effective date of the statute. The statute provides specific procedures to establish the consent of the beneficiaries. A and A's issue consent to the change in the definition of income within the time period, and in accordance with the procedures, prescribed by the state statute. The administration of the trust, in accordance with the state statute defining income to be a 4% unitrust amount, will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. Further, under these facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes. Similarly, the conclusions in this example would be the same if the beneficiaries' consent was not required, or, if the change in administration of the trust occurred because the situs of the trust was changed to State X from a state whose statute does not define income as a unitrust amount or if the situs was changed to such a state from State X.

The Reg. § 26.2601-1(b)(4)(i)(D)(1) safe harbor for a modification that does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation is satisfied when an outright distribution to a lower generation is deferred but the trust is subject to a testamentary general power of appoint. Letter Ruling 202011001 held:[6396]

> In this case, Trust A was irrevocable prior to September 25, 1985. The amended trust agreement provides for outright distribution to the beneficiaries upon the termination of Trust A and the Trust A Successor Trusts, 21 years after the death of Son. Under the proposed modification of the trust agreement, any share upon the termination of Trust A and the Trust A Successor Trusts distributable to a beneficiary who is under the age of b, will be held in a continuing trust for that continuing beneficiary. Each continuing beneficiary will have a testamentary general power of appointment with respect to the property. Under § 2041(a)(2), the continuing beneficiary's trust property will be includible in his or her estate at his or her death. Further, each continuing beneficiary will be treated as the transferor of the trust corpus for GST tax purposes under § 2652(a)(1). The proposed modification will not result in a shift of any beneficial interest in any beneficiary who occupies a generation lower than the persons holding the beneficial interests. Further, the proposed modification in further trust will not extend the

[6395] Letter Ruling 200810019 applied this Example. See text accompanying fn 3014 in part II.J.18.f Commutation vs Mere Division. Query the result when converting an income interest subject to a floor and a ceiling, which was found an income taxable event in Letter Ruling 200231011, described in fn 2989 and the accompanying text in part II.J.18.d Trust Commutations.

[6396] I have not reviewed Letter Rulings 202011002, 202011003, 202011004, and 202011005, which are said to be companion rulings. Letter Ruling 202013001 had the same reasoning with substantially the same facts; I have not reviewed Letter Rulings 202013002, 202013003, 202013004, and 202013005, which are said to be companion rulings.

> time for vesting of any beneficial interest in any trust. Accordingly, based on the facts presented and the representations made, we rule that the proposed modification will not cause Trust A or the Trust A Successor Trusts to lose their exemption from the GST tax of chapter 13.

Similarly, Letter Ruling 201947001 held that converting a trust to age 21 to a lifetime trust with a testamentary general power of appointment would not blow the trust's grandfathered GST status:[6397]

> Under the proposed modification of Article II, § 2.2(e) of Trust, the Trust property is divided upon Son's death into the same trust shares as under the original governing instrument of Trust. Each share will be held in a separate trust for the lifetime benefit of the beneficiary for whom it is created and any remaining trust property including undistributed income will be subject to that beneficiary's general power of appointment at his or her death. Therefore, the value of such property will be included in the beneficiary's gross estate under § 2041(a)(2) and the beneficiary will be treated as the transferor of such property for GST tax purposes under § 2652(a)(1). Under these circumstances, we conclude that the modification of Article II of § 2.2(e) of Trust will not shift a beneficial interest in Trust to any beneficiary occupying a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification will not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original governing instrument of Trust.

In Letter Ruling 201938004, in the initial trust modification, the parties seemed to forget to grant the necessary testamentary general power of appointment when extending the term and then later remembered to do it:[6398]

> Decedent died testate on Date 1, a date prior to September 25, 1985. Under the terms of Decedent's last will and testament, a trust (Trust) was created for the primary benefit of Decedent's grandson, Beneficiary. Under the terms of Trust, all the trust income was to be distributed to Beneficiary for life, and upon Beneficiary's death to Beneficiary's living issue, per stirpes. Distributions of principal were not permitted. Trust terminates upon the earlier of two dates: (1) the date that is 21 years after Beneficiary's death, or (2) the date that the youngest of Beneficiary's issue reach the age of 21. Upon Trust's termination, the trustee is to distribute the trust corpus to Beneficiary's then-living issue, *per stirpes*.
>
> In Year 1, Beneficiary and the trustee of Trust petitioned Court to modify Trust. At that time, Beneficiary had one son (Son) and two grandchildren (Grandson and Granddaughter), all of whom were over the age of 21. Accordingly, under the terms of Trust as of Year 1, Trust was to terminate upon Beneficiary's death and the assets of Trust were to be distributed outright to Son if living.
>
> Pursuant to a Court order dated Date 2, Trust was modified and any outright distribution to Son upon termination was instead to be held in further trust for Son's lifetime benefit.

[6397] I am told that Letter Rulings 201947002, 201947003, 201947004, 201947005, 201947006, 201947007, 201947008, and 201947009 are companion rulings.
[6398] Letter Rulings 201938005 and 201938006 appear to be companion rulings.

Under the new terms of Trust, the trustee had absolute discretion to pay income or corpus to or for the benefit of Son, and at the death of Son, distribute one half of the trust to Grandson, if living, in a separate trust, otherwise to his estate; and one half to Granddaughter, if living, in a separate trust, otherwise to her estate. Trust as modified also directed the trustee to consider, before making a distribution, whether a beneficiary was a substance abuser and if the trustee so suspects, to request that the beneficiary submit to testing and treatment. Any treatment costs are to be charged first against income and then principal.

Beneficiary died on Date 3, survived by Son. Son died on Date 4, survived by Grandson and Granddaughter.

In Year 2, the trustee petitioned Court to further construe Trust to clarify that Son has a general power of appointment over the assets in Trust. Such clarification ensures that the assets of Trust will be taxed as part of Son's gross estate and that there will be no extension of the time for vesting under the original terms of Trust. Pursuant to a Court order dated Date 5, Trust was clarified to state that Son has a general power of appointment over the assets of Trust. The order further provides that Trust is not required to file annual accounts or final accounts with the Court insofar as such accountings are no longer necessary.

Letter Ruling 201938004 held:

In *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), the Court considered whether a state trial court's characterization of property rights conclusively binds a federal court or agency in a federal estate tax controversy. The Court concluded that the decision of a state trial court as to an underlying issue of state law should not be controlling when applied to a federal statute. Rather, the highest court of the state is the best authority on the underlying substantive rule of state law to be applied in the federal matter. If there is no decision by that court, then the federal authority must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. In this respect, the federal agency may be said, in effect, to be sitting as a state court.

In this case, an examination of the documents together with state law confirms that Decedent intended to give Son a power of appointment and the Date 5 order clarified such right. Further, the court order providing that no annual accounts or final accounts were required is administrative in nature under § 26.2601-1(b)(4)(i)(D)(2), and will not be considered to shift a beneficial interest to a lower generation in the trust. *See* § 26.2601-1(b)(4)(i)(E), *Example 10*. Because the assets are to be included in Son's gross estate, Son is now treated as the owner for GST purposes. Accordingly, after the judicial construction and modifications to the administrative and dispositive provisions of Trust, Trust remains exempt from the application of the GST tax and no distributions during the term of Trust or upon final termination will be subject to GST tax.

Letter Ruling 202217005 repeated the above *Bosch* analysis and held:

The terms of New Trust provide that Granddaughter has a testamentary power to appoint the principal of New Trust for any one or more persons out of a class composed of (i) the descendants of Granddaughter and (ii) the descendants of Settlor (other than (A) a child of Settlor and (B) a grandchild of Settlor if such grandchild does not have at

> least one then living descendant). The references to the "descendants of Settlor" and a "grandchild of Settlor" are properly viewed as not including Granddaughter's estate or the creditors of Granddaughter's estate. Consistent with this analysis, the Date 5 Order construed the terms of New Trust to provide that Son granted Granddaughter a power to appoint the remainder of New Trust on her death only to Settlor's then-living descendants, or trusts for their benefit, other than to a child of Settlor and a grandchild of Settlor if such grandchild does not have at least one then living descendant.
>
> Granddaughter's power to appoint is not exercisable in favor of Granddaughter, Granddaughter's creditors, Granddaughter's estate, or the creditors of Granddaughter's estate, and accordingly, is not a general power of appointment. Based on an analysis of facts submitted and the representations made, we conclude that the Date 5 State Court Order is consistent with applicable State law as it would be applied by the highest court of State.
>
> Accordingly, based on the facts submitted and the representations made, we conclude that: (1) Granddaughter does not possess a general power of appointment under § 2041 over New Trust, which therefore remains GST tax exempt pursuant to its grandfathered status; (2) no part of New Trust will be included in Granddaughter's gross estate for federal estate tax purposes under § 2041; and (3) Granddaughter does not have a general power of appointment over New Trust, and therefore Granddaughter has neither released a general power of appointment over New Trust for federal gift tax purposes under § 2514, nor made a constructive addition to New Trust under § 26.2601-1(b)(1)(v)(A).

Letter Ruling 202239003[6399] involved a GST-grandfathered trust that modified a trust for a disabled grandchild:

> Article 3.B.1. provides, in relevant part, that with respect to each share, until termination of the trust, the trustees may from time to time or at any time pay to the grandchild such amounts, if any, from the net income and/or principal of said share as they may determine, adding to principal from time to time any income not so expended. In addition, if and when the grandchild has attained the age of 25, the trustees are to distribute to him or her such amount of the principal of said share as he or she may from time to time or at any time demand in writing, provided that the total subject to withdrawal does not exceed one-half of the value of said share when the grandchild attains the age of 25.
>
> Article 3.B.2. provides, in relevant part, that the trust of said share is to terminate when the grandchild attains the age of 35 or sooner dies. Upon such termination, the trust property of said share, if any remains, is to be paid over to the grandchild, if then living. If the grandchild is not living, the trust property of said share is to be paid over according to the grandchild's power to appoint by will executed after he or she attained the age of 18, to one or more of the grandchild's spouse, Grandmother's issue other than the grandchild, or spouses of such issue. In default of appointment, the remaining property of said share is to be paid to the issue of grandchild, per stirpes; or, if grandchild has no issue then living, to the then living issue of grandchild's parent, who is Grandmother's child, per stirpes; or, if there is no such issue then living, to said parent; otherwise per

[6399] Letter Ruling 202239004 has pretty much the same facts and ruling.

stirpes to Grandmother's then living issue; or, if there is no issue of Grandmother then living, to Charity.

Beneficiary is a grandchild of Grandmother. Beneficiary was born with cognitive deficits and other disabilities. On Date 2, Beneficiary's parents were appointed as her permanent conservators.

State Statute provides that the court may modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust. To the extent practicable, the modification shall be made in accordance with the settlor's probable intent. The court may modify the administrative terms of a trust if continuation of the trust on its existing terms would be impracticable or wasteful or impair the trust's administration.

On Date 3, the trustees of Trust petitioned Trial Court to modify the terms of Trust as they apply to the shares created for the benefit of Beneficiary. As modified, Article 3.B.1. of Trust will provide that with respect to each share, until termination of the trust, the trustees may from time to time or at any time pay to Beneficiary such amounts, if any, from the net income and/or principal of said share as they may determine, adding to principal from time to time any income not so expended. Further, as modified, Article 3.B.2. of Trust will provide that the trust of said share is to terminate upon the death of Beneficiary. If Beneficiary is less than 25 years of age at the time of her death, the remaining trust property of said share is to be paid over to her issue, per stirpes; or, if she has no issue then living, to the then living issue of her parent, who is Grandmother's child, per stirpes; or, if there is no such issue then living, to said parent; otherwise per stirpes to Grandmother's then living issue; or, if there is no issue of Grandmother then living, to Charity. If Beneficiary is at least 25 years of age but less than 35 years of age at the time of her death, one-half of the remaining property of said share is to be paid over to the personal representatives of her estate to be disposed of as part of her estate. The balance of the property is to be paid over to her issue, per stirpes; or, if she has no issue then living, to the then living issue of her parent, who is Grandmother's child, per stirpes; or, if there is no such issue then living, to said parent; otherwise per stirpes to Grandmother's then living issue; or, if there is no issue of Grandmother then living, to Charity. If Beneficiary is at least 35 years of age at the time of her death, the remaining property of said share is to be paid over to the personal representatives of her estate to be disposed of as part of her estate.

It is represented that Beneficiary's legal incompetency is a circumstance that was not anticipated by Grandmother and that the modification to keep Beneficiary's inheritance in trust for her lifetime furthers the essential purpose of Trust to provide financially for Grandmother's grandchildren. On Date 4, Trial Court ordered that Trust be modified, contingent upon a favorable ruling from the Internal Revenue Service.

Letter Ruling 202239003 cited Reg. § 26.2601-1(b)(4)(i)(D)(1) and reasoned and held:

In the present case, the proposed modification of Trust, under State Statute, provides that Beneficiary's interest in Trust will continue to be held in trust for the exclusive benefit of Beneficiary during her lifetime. If Beneficiary dies before the age of 25, the property in Trust will pass under the terms of the modified trust in the same manner as it would have passed in default of the power of appointment under the terms of the original trust. If

> Beneficiary dies after the age of 25 and before the age of 35, one-half of the then remaining property of Trust is includible in Beneficiary's gross estate for federal estate tax purposes and the other one-half portion will pass as it would have passed under the terms of the original trust. If Beneficiary dies after the age of 35, upon Beneficiary's death, Trust will terminate and all of the trust property will be includible in Beneficiary's gross estate for federal estate tax purposes.
>
> Furthermore, the proposed modification of Trust will not result in a shift of any beneficial interest in the trust to any beneficiary who occupies a generation lower than the persons holding the beneficial interests. In addition, the proposed modification of Trust will not extend the time for vesting of any beneficial interest in the modified trust beyond the period provided for in the original trust. Accordingly, based on the facts presented and the representations made, we find that after the proposed modification of Trust, Trust will remain exempt from the application of the GST tax and that no distribution from or termination of any interest in Trust will be subject to the GST tax.

Consistent with other rulings,[6400] the IRS viewed including assets in the beneficiary's estate (in this case the estate actually receiving the assets) as an acceptable substitute for the eliminated inter vivos general power of appointment (right to withdraw assets). Along that line, after discussing decanting Letter Ruling ruled:

> In the instant case, Trust A does not expressly authorize the trustee to distribute principal from Trust A to Trust B. While State 2 Statute authorizes the trustee to make such a distribution, to satisfy the requirement in § 26.2601-1(b)(4)(i)(A), the state law must be in effect at the time the exempt trust became irrevocable. In this case, State 2 Statute was enacted and become applicable to Trust A subsequent to the execution of Trust A. Accordingly, the effect of the proposed distribution of Trust A principal to Trust B on the exempt status of the trusts will be evaluated under the rules in § 26.2601-1(b)(4)(i)(D).
>
> Article 3.1 of Trust B sets forth income and principal distribution terms and conditions identical to those in Section 2 of Trust A. Article 3.4 of Trust B provides for termination of Trust B at the same time Trust A would have terminated under Section 3, taking into account that Grantor and Grantor's Spouse are now deceased and the youngest issue of Grantor living on Date 1 has already attained the age of x. Article 3.5 of Trust B identifies the same class of remainder beneficiaries as in Section 3 of Trust A. Trust B differs from Trust A, however, by providing in Article 4 for the creation of separate trusts for each Article 3.5 beneficiary after the termination of Trust B.
>
> Under Article 4.1 and 4.2 of Trust B, the beneficiary of each Article 4 Trust is the sole lifetime beneficiary of the trust and is granted a testamentary general power of appointment over the principal of such trust. The grant of a testamentary general power of appointment to the sole lifetime beneficiary of a trust is viewed as functionally equivalent to granting outright ownership. *See* Restatement (Second) of Property § 19.4 (1986). For transfer tax purposes, the grant of the power will cause the value of each beneficiary's Article 4 Trust to be includible in the gross estate of the beneficiary at his or her death under § 2041(a)(2) and the beneficiary to be treated as the transferor of the Article 4 Trust for GST tax purposes under § 2652(a)(1). Therefore, with respect to these provisions of Trust B, the distribution of principal from Trust A to Trust B will not cause a

[6400] See Letter Rulings 202011001, 201947001, and 201938004.

shift of a beneficial interest to a lower generation beneficiary nor extend the time for vesting of any beneficial interest beyond the period provided for in the original trust.

Not satisfying the safe harbors means only that one must test for actual or constructive additions. When a court or trustee takes action (or a trustee fails to act), that action might affect beneficial interests. One may be concerned that failure to act vigorously in court or to make a claim against the trustee may constitute an actual or constructive addition. The beneficiaries who failed to act may need to allocate GST exemption to provide a zero inclusion ratio to the extent that they are transferors. These issues become much more complex when a beneficiary has a retained interest in the trust, because the ETIP rule may prevent allocating GST exemption in a manner that sets the inclusion ratio until the beneficiary's interest terminates. Thus, satisfying the safe harbors avoids addressing these issues to the extent that one is concerned about GST issues; however, the safe harbors do not address gift or estate tax issues that might apply to such a failure to act. Regarding the latter, see part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts.

What about changes to trusts that are not grandfathered and have a zero inclusion ratio? Absent a transfer subject to gift tax or estate tax, distributions or other actions would not trigger a change in the inclusion ratio. But what if distributions or other actions constitute a gift? Examples of such gifts are in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts. Generally, anything that would not cause a trust to lose grandfathering also would not change the trust's inclusion ratio. A typical statement to that effect is in Letter Ruling 201134017:[6401]

> No guidance has been issued concerning changes that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a change that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust.

III.B.1.d.ii. Estate Tax Inclusion Period (ETIP)

Code § 2642(f), "Special rules for certain inter vivos transfers," provides that, except as provided in regulations:

> (1) *In general*. For purposes of determining the inclusion ratio, if -
>
> (A) an individual makes an inter vivos transfer of property, and
>
> (B) the value of such property would be includible in the gross estate of such individual under chapter 11 if such individual died immediately after making such transfer (other than by reason of section 2035),
>
> any allocation of GST exemption to such property shall not be made before the close of the estate tax inclusion period (and the value of such property shall be determined under paragraph (2)). If such transfer is a direct skip, such skip shall be treated as occurring as of the close of the estate tax inclusion period.

[6401] Letter Ruling 200839025 had a similar statement.

(2) *Valuation*. In the case of any property to which paragraph (1) applies, the value of such property shall be -

(A) if such property is includible in the gross estate of the transferor (other than by reason of section 2035), its value for purposes of chapter 11, or

(B) if subparagraph (A) does not apply, its value as of the close of the estate tax inclusion period (or, if any allocation of GST exemption to such property is not made on a timely filed gift tax return for the calendar year in which such period ends, its value as of the time such allocation is filed with the Secretary).

(3) *Estate tax inclusion period*. For purposes of this subsection, the term "estate tax inclusion period" means any period after the transfer described in paragraph (1) during which the value of the property involved in such transfer would be includible in the gross estate of the transferor under chapter 11 if he died. Such period shall in no event extend beyond the earlier of -

(A) the date on which there is a generation-skipping transfer with respect to such property, or

(B) the date of the death of the transferor.

(4) *Treatment of spouse*. Except as provided in regulations, any reference in this subsection to an individual or transferor shall be treated as including a reference to the spouse of such individual or transferor.

(5) *Coordination with subsection (d)*. Under regulations, appropriate adjustments shall be made in the application of subsection (d) to take into account the provisions of this subsection.

When Code § 2642(f)(1) says, "any allocation of GST exemption to such property shall not be made before the close of the estate tax inclusion period," it seems to void any attempted allocation. However, regulations do not prevent an allocation but rather postpone computation of the inclusion ratio, as demonstrated by Reg. § 26.2632-1(c)(1)(ii), "Other allocations":

> An affirmative allocation of GST exemption cannot be revoked, but becomes effective as of (and no earlier than) the date of the close of the ETIP with respect to the trust. If an allocation has not been made prior to the close of the ETIP, an allocation of exemption is effective as of the close of the ETIP during the transferor's lifetime if made by the due date for filing the Form 709 for the calendar year in which the close of the ETIP occurs (timely ETIP return). An allocation of exemption is effective in the case of the close of the ETIP by reason of the death of the transferor as provided in paragraph (d) of this section.

The first two examples in Reg. § 26.2632-1(c)(5) confirm this concept of immediate allocation, followed by later determination of inclusion ratio:

> The following examples illustrate the rules of this section as they apply to the termination of an ETIP during the lifetime of the transferor. In each example assume that T transfers $100,000 to an irrevocable trust:

Example (1). *Allocation of GST exemption during ETIP*. The trust instrument provides that trust income is to be paid to T for 9 years or until T's prior death. The trust principal is to be paid to T's grandchild on the termination of T's income interest. If T dies within the 9-year period, the value of the trust principal is includible in T's gross estate under section 2036(a). Thus, the trust is subject to an ETIP. T files a timely Form 709 reporting the transfer and allocating $100,000 of GST exemption to the trust. The allocation of GST exemption to the trust is not effective until the termination of the ETIP.

Example (2). *Effect of prior allocation on termination of ETIP*. The facts are the same as in Example 1, except the trustee has the power to invade trust principal on behalf of T's grandchild, GC, during the term of T's income interest. In year 4, when the value of the trust is $200,000, the trustee distributes $15,000 to GC. The distribution is a taxable distribution. The ETIP with respect to the property distributed to GC terminates at the time of the taxable distribution. See paragraph (c)(3)(iii) of this section. Solely for purposes of determining the trust's inclusion ratio with respect to the taxable distribution, the prior $100,000 allocation of GST exemption (as well as any additional allocation made on a timely ETIP return) is effective immediately prior to the taxable distribution. See § 26.2642-1(b)(2). The trust's inclusion ratio with respect to the taxable distribution is therefore .50 (1−(100,000/200,000)).

Generally, I would recommend waiting until the ETIP terminates, but if GST exemption is going to decrease and would otherwise be wasted then consider allocating it to the ETIP trust.

A GRAT's Code § 2036 exposure may closes when the final annuity payment is payable, rather when it is actually paid. That is because an overdue annuity payment is includible under Code § 2033 (an asset actually owned by an estate) rather than Code § 2036 (a retained right to income or another stream of payments). In support of the former, Reg. § 20.2036-1(c)(1)(i) provides:

> Payments that become payable to the decedent prior to the decedent's date of death, but are not paid until after the decedent's date of death, are includible in the decedent's gross estate under section 2033.

In support of the latter, Reg. § 20.2036-1(c)(2)(i) contains (emphasis added):

> If a decedent transferred property into such a trust and retained or reserved the right to use such property, or the right to an annuity, unitrust, or other interest in such trust with respect to the property decedent so transferred for decedent's life, any period not ascertainable without reference to the decedent's death, or **for a period that does not in fact end before the decedent's death**, then the decedent's right to use the property or the retained annuity, unitrust, or other interest (whether payable from income and/or principal) constitutes the retention of the possession or enjoyment of, or the right to the income from, the property for purposes of section 2036.

The idea is that amounts payable during life are generated by the trust's property and constitute an interest in the trust, but an overdue payment is not so much a reflection of the trust's property's earning capacity. The preamble to T.D. 9555 (11/8/2011) says the following about a grantor retained trust ("GRT"):

One commentator requested that the regulations clarify the interaction of sections 2033 and 2036 in a situation where the decedent establishes a GRT under the terms of which the retained interest is paid to the decedent for a specified term of years and, if the decedent dies prior to the expiration of that term, the retained annuity or other payment is to be paid to the decedent's estate for the balance of the term. See for example § 25.2702-3(e), Example 5.

The commentator noted that, because all or a portion of the trust corpus is includible in the decedent's gross estate under section 2036, the annuity or other payments that become payable after the decedent's death and are required to be paid to the estate for the remainder of the trust term are reflected in the amount includible under section 2036, and therefore should not also be includible under section 2033.

The IRS and the Treasury Department agree. To the extent that all or a portion of the trust corpus is includible in the gross estate under section 2036 as a result of the decedent's retained annuity or other interest, double inclusion of the same asset would result if any payment that becomes payable after the decedent's date of death to the estate also is included in the decedent's gross estate under section 2033 as a separate item. Accordingly, § 20.2036-1(c)(1)(i) of the regulations has been revised to provide specifically that payments that become payable to the decedent's estate after the decedent's death (as opposed to payments that are payable to the decedent prior to the decedent's death but are not paid until after the decedent's death) are not subject to inclusion under section 2033, if section 2036 is applied to include all or a portion of the trust corpus in the gross estate. This rule is also reflected in § 20.2036-1(c)(2)(iv), Example 2 paragraph (ii) and Example 7.

The payments described in the preceding paragraph are to be distinguished, however, from annuity or other payments payable to the decedent prior to the decedent's date of death, but that are not paid until after death. Such payments are includible in the decedent's gross estate under section 2033 as a separate receivable. Thus, such an amount payable by the trust reduces the fair market value of the trust as of the date of death, but is included in the decedent's gross estate under section 2033 as a receivable amount.

Reg. § 26.2632-1(c)(3), "Termination of an ETIP," provides:

An ETIP terminates on the first to occur of -

(i) The death of the transferor;

(ii) The time at which no portion of the property is includible in the transferor's gross estate (other than by reason of section 2035) or, in the case of an individual who is a transferor solely by reason of an election under section 2513, the time at which no portion would be includible in the gross estate of the individual's spouse (other than by reason of section 2035);

(iii) The time of a GST, but only with respect to the property involved in the GST; or

(iv) In the case of an ETIP arising by reason of an interest or power held by the transferor's spouse under subsection (c)(2)(i)(B) of this section, at the first to occur of -

(A) The death of the spouse; or

(B) The time at which no portion of the property would be includible in the spouse's gross estate (other than by reason of section 2035).

When Code § 2036 inclusion ends when the annuity was payable, the unpaid annuity becomes a Code § 2033 asset, so under Reg. §§ 26.2632-1(c)(3)(ii) and 26.2632-1(c)(1)(iii) the ETIP does not close until the annuity is actually paid.

Whenever the ETIP closes, a potential indirect skip occurs. Reg. § 26.2632-1(c)(5), Example (5) provides (emphasis added):

> Election out of automatic allocation of GST exemption for trust subject to an ETIP. On December 1, 2003, T transfers $100,000 to Trust A, an irrevocable GST trust described in section 2632(c)(3) that is subject to an estate tax inclusion period (ETIP). T made no other gifts in 2003. The ETIP terminates on December 31, 2008. T timely files a gift tax return (Form 709) reporting the gift on April 15, 2004. On May 15, 2006, T files a Form 709 on which T properly elects out of the automatic allocation rules contained in section 2632(c)(1) with respect to the December 1, 2003, transfer to Trust A in accordance with paragraph (b)(2)(iii) of this section. Because the indirect skip is not deemed to occur until December 31, 2008, T's election out of automatic GST allocation filed on May 15, 2006, is timely, and will be effective as of December 31, 2008 (unless revoked on a Form 709 filed on or before the due date of a Form 709 for calendar year 2008).

This seems to indicate that the indirect skip occurs the moment the ETIP closes and that, absent an election not to allocate GST exemption, GST exemption would be allocated.

One might considering delaying termination of a trust subject to an ETIP so that it may divide in a manner consistent with Reg. § 26.2642-6(j), Example (8), which is reproduced in the text accompanying fn 6406 in part III.B.1.d.iv Qualified Severances. A practical use is described in the text accompanying fn 6518 in part III.B.2.c.v GRIT's Estate Tax Consequences.

III.B.1.d.iii. Who Is the Transferor

Reg. § 26.2654-1(a)(2), "Multiple transferors with respect to single trust," provides:

> (i) *In general*. If there is more than one transferor with respect to a trust, the portions of the trust attributable to the different transferors are treated as separate trusts for purposes of chapter 13. Treatment of a single trust as separate trusts under this paragraph (a)(2) does not permit treatment of those portions as separate trusts for purposes of filing returns and payment of tax or for purposes of computing any other tax imposed under the Internal Revenue Code. Also, additions to, and distributions from, such trusts are allocated pro rata among the separate trusts unless otherwise expressly provided in the governing instrument.
>
> (ii) *Addition by a transferor*. If an individual makes an addition to a trust of which the individual is not the sole transferor, the portion of the single trust attributable to each separate trust is determined by multiplying the fair market value of the single trust immediately after the contribution by a fraction. The numerator of the fraction is the value of the separate trust immediately after the contribution. The denominator of the fraction is the fair market value of all the property in the single trust immediately after the transfer.

Although referring to "transferor" before defining that term may seem premature, I want you to realize that what for a variety of purposes may constitute one trust may be treated for GST purposes as multiple trusts. When one determines "transferor" below, one may be determining who is the transferor for only a portion of what you might otherwise view as a single trust.

Before defining "transferor," consider that who is a skip person depends on who is the transferor. Also, each transferor may have different capacity to allocate GST exemption. Controlling which distributions are allocated to coming from a transferor's separate trust tends to be better than the pro rata rule described above.[6402] Consider dividing a trust into one or more separate trusts for each transferor. Reg. § 26.2654-1(a)(3) authorizes such a division "at any time."[6403]

Reg. § 26.2652-1(a), "Transferor defined," provides:

> (1) *In general*. Except as otherwise provided in paragraph (a)(3) of this section, the individual with respect to whom property was most recently subject to Federal estate or gift tax is the transferor of that property for purposes of chapter 13. An individual is treated as transferring any property with respect to which the individual is the transferor. Thus, an individual may be a transferor even though there is no transfer of property under local law at the time the Federal estate or gift tax applies. For purposes of this paragraph, a surviving spouse is the transferor of a qualified domestic trust created by the deceased spouse that is included in the surviving spouse's gross estate, provided the trust is not subject to the election described in § 26.2652-2 (reverse QTIP election). A surviving spouse is also the transferor of a qualified domestic trust created by the surviving spouse pursuant to section 2056(d)(2)(B). For generation-skipping transfer tax rules related to an ABLE account established under section 529A, see § 1.529A-4.
>
> (2) *Transfers subject to federal estate or gift tax*. For purposes of this chapter, a transfer is subject to Federal gift tax if a gift tax is imposed under section 2501(a) (without regard to exemptions, exclusions, deductions, and credits). A transfer is subject to Federal estate tax if the value of the property is includible in the decedent's gross estate as determined under section 2031 or section 2103.

Reg. § 26.2652-1(a)(5) illustrates the above principles:

> *Example (1)*. *Identity of transferor*. T transfers $100,000 to a trust for the sole benefit of T's grandchild. The transfer is subject to Federal gift tax because a gift tax is imposed under section 2501(a) (without regard to exemptions, exclusions, deductions, and credits). Thus, for purposes of chapter 13, T is the transferor of the $100,000. It is immaterial that a portion of the transfer is excluded from the total amount of T's taxable gift by reason of section 2503(b).
>
> *Example (2)*. *Gift splitting and identity of transferor*. The facts are the same as in Example 1, except T's spouse, S, consents under section 2513 to split the gift with T.

[6402] Because the trusts have different grantors (see part III.B.2.h.i Who Is the Grantor), such a division would not be subject to part II.J.9.c.i Multiple Trusts Created for Tax Avoidance.
[6403] Reg. § 26.2654-1(a)(3) is reproduced in fn 705 in part II.D.5 Severing Trusts with Multiple Grantors.

For purposes of chapter 13, S and T are each treated as a transferor of $50,000 to the trust.

Example (3). *Change of transferor on subsequent transfer tax event*. T transfers $100,000 to a trust providing that all the net trust income is to be paid to T's spouse, S, for S's lifetime. T elects under section 2523(f) to treat the transfer as a transfer of qualified terminable interest property, and T does not make the reverse QTIP election under section 2652(a)(3). On S's death, the trust property is included in S's gross estate under section 2044. Thus, S becomes the transferor at the time of S's death.

Example (4). *Effect of transfer of an interest in trust on identity of the transferor*. T transfers $100,000 to a trust providing that all of the net income is to be paid to T's child, C, for C's lifetime. At C's death, the trust property is to be paid to T's grandchild. C transfers the income interest to X, an unrelated party, in a transfer that is a completed transfer for Federal gift tax purposes. Because C's transfer is a transfer of a term interest in the trust that does not affect the rights of other parties with respect to the trust property, T remains the transferor with respect to the trust.

Example (5). *Effect of lapse of withdrawal right on identity of transferor*. T transfers $10,000 to a new trust providing that the trust income is to be paid to T's child, C, for C's life and, on the death of C, the trust principal is to be paid to T's grandchild, GC. The trustee has discretion to distribute principal for GC's benefit during C's lifetime. C has a right to withdraw $10,000 from the trust for a 60-day period following the transfer. Thereafter, the power lapses. C does not exercise the withdrawal right. The transfer by T is subject to Federal gift tax because a gift tax is imposed under section 2501(a) (without regard to exemptions, exclusions, deductions, and credits) and, thus, T is treated as having transferred the entire $10,000 to the trust. On the lapse of the withdrawal right, C becomes a transferor to the extent C is treated as having made a completed transfer for purposes of chapter 12. Therefore, except to the extent that the amount with respect to which the power of withdrawal lapses exceeds the greater of $5,000 or 5% of the value of the trust property, T remains the transferor of the trust property for purposes of chapter 13.

Note in Example (4) that C made a taxable gift, but T remained the transferor because the relationship of the beneficial interests to each other did not change.

Note in Example (5) that a lapse of a general power of appointment changes the transferor to the extent that the lapse constitutes a taxable transfer.

If and to the extent that the transfer is a gift, person exercising the power of appointment becomes the transferor with respect to the gifted portion and may allocate GST exemption to that portion.[6404]

[6404] Letter Ruling 200243026, described in the text accompanying fn 6356 in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts. The follow Letter Rulings are said to support the idea that, when a beneficiary who makes a taxable release of his/her interest in a trust, the beneficiary should be treated as withdrawing the actuarial value of his/her interest (whatever it may be) and recontributing that amount to the trust, thereby creating two transferors of the trust for GST tax purposes, namely, the original transferor and the beneficiary: 9707026, 9714030, 200001012, 200210018, 200745015, 200901013, 201342001, 9811044, 200745015, and 9811044.

Reg. § 26.2652-1(a)(3), "Special rule for certain QTIP trusts," provides:[6405]

> Solely for purposes of chapter 13, if a transferor of qualified terminable interest property (QTIP) elects under §26.2652-2(a) to treat the property as if the QTIP election had not been made (reverse QTIP election), the identity of the transferor of the property is determined without regard to the application of sections 2044, 2207A, and 2519.

Reg. § 26.2652-1(a)(5) illustrates the above principles:

> *Example (6)*. *Effect of reverse QTIP election on identity of the transferor*. T establishes a testamentary trust having a principal of $500,000. Under the terms of the trust, all trust income is payable to T's surviving spouse, S, during S's lifetime. T's executor makes an election to treat the trust property as qualified terminable interest property and also makes the reverse QTIP election. For purposes of chapter 13, T is the transferor with respect to the trust. On S's death, the then full fair market value of the trust is includible in S's gross estate under section 2044. However, because of the reverse QTIP election, S does not become the transferor with respect to the trust; T continues to be the transferor.
>
> *Example (7)*. *Effect of reverse QTIP election on constructive additions*. The facts are the same as in Example 6, except the inclusion of the QTIP trust in S's gross estate increased the Federal estate tax liability of S's estate by $200,000. The estate does not exercise the right of recovery from the trust granted under section 2207A. Under local law, the beneficiaries of S's residuary estate (which bears all estate taxes under the will) could compel the executor to exercise the right of recovery but do not do so. Solely for purposes of chapter 13, the beneficiaries of the residuary estate are not treated as having made an addition to the trust by reason of their failure to exercise their right of recovery. Because of the reverse QTIP election, for GST purposes, the trust property is not treated as includible in S's gross estate and, under those circumstances, no right of recovery exists.
>
> *Example (8)*. *Effect of reverse QTIP election on constructive additions*. S, the surviving spouse of T, dies testate. At the time of S's death, S was the beneficiary of a trust with respect to which T's executor made a QTIP election under section 2056(b)(7). Thus, the trust is includible in S's gross estate under section 2044. T's executor also made the reverse QTIP election with respect to the trust. S's will provides that all death taxes payable with respect to the trust are payable from S's residuary estate. Since the transferor of the property is determined without regard to section 2044 and section 2207A, S is not treated as making a constructive addition to the trust by reason of the tax apportionment clause in S's will.

Reg. § 26.2652-1(a)(4), "Split-gift transfers," provides:

> In the case of a transfer with respect to which the donor's spouse makes an election under section 2513 to treat the gift as made one-half by the spouse, the electing spouse is treated as the transferor of one-half of the entire value of the property transferred by

[6405] For Code § 2519, see part II.H.2.c QTIP Trusts - Code § 2519 Trap. Reg. § 26.2652-1(a)(1) includes, "For purposes of this paragraph, a surviving spouse is the transferor of a qualified domestic trust created by the deceased spouse that is included in the surviving spouse's gross estate, provided the trust is not subject to the election described in § 26.2652-2 (reverse QTIP election)."

> the donor, regardless of the interest the electing spouse is actually deemed to have transferred under section 2513. The donor is treated as the transferor of one-half of the value of the entire property. See § 26.2632-1(c)(5) Example 3, regarding allocation of GST exemption with respect to split-gift transfers subject to an ETIP.

As to the latter, see part III.B.1.d.ii Estate Tax Inclusion Period (ETIP).

Reg. § 26.2652-1(a)(5), Example (9), "Split-gift transfers," explains:

> T transfers $100,000 to an inter vivos trust that provides T with an annuity payable for ten years or until T's prior death. The annuity satisfies the definition of a qualified interest under section 2702(b). When the trust terminates, the corpus is to be paid to T's grandchild, GC. T's spouse, S, consents under section 2513 to have the gift treated as made one-half by S. Under section 2513, only the actuarial value of the gift to GC is eligible to be treated as made one-half by S. However, because S is treated as the donor of one-half of the gift to GC, S becomes the transferor of one-half of the entire trust ($50,000) for purposes of Chapter 13.

III.B.1.d.iv. Qualified Severances

Code § 2642(a)(3), "Severing of trusts," provides:

(A) *In general*. If a trust is severed in a qualified severance, the trusts resulting from such severance shall be treated as separate trusts thereafter for purposes of this chapter.

(B) *Qualified severance*. For purposes of subparagraph (A) -

(i) *In general*. The term "qualified severance" means the division of a single trust and the creation (by any means available under the governing instrument or under local law) of two or more trusts if -

(I) the single trust was divided on a fractional basis, and

(II) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

(ii) *Trusts with inclusion ratio greater than zero*. If a trust has an inclusion ratio of greater than zero and less than 1, a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In such case, the trust receiving such fractional share shall have an inclusion ratio of zero and the other trust shall have an inclusion ratio of 1.

(iii) *Regulations*. The term "qualified severance" includes any other severance permitted under regulations prescribed by the Secretary.

(C) *Timing and manner of severances*. A severance pursuant to this paragraph may be made at any time. The Secretary shall prescribe by forms or regulations the manner in which the qualified severance shall be reported to the Secretary.

Reg. § 26.2642-6, "Qualified severance," begins with subsection (a), "In general":

> If a trust is divided in a qualified severance into two or more trusts, the separate trusts resulting from the severance will be treated as separate trusts for generation-skipping transfer (GST) tax purposes and the inclusion ratio of each new resulting trust may differ from the inclusion ratio of the original trust. Because the post-severance resulting trusts are treated as separate trusts for GST tax purposes, certain actions with respect to one resulting trust will generally have no GST tax impact with respect to the other resulting trust(s). For example, GST exemption allocated to one resulting trust will not impact on the inclusion ratio of the other resulting trust(s); a GST tax election made with respect to one resulting trust will not apply to the other resulting trust(s); the occurrence of a taxable distribution or termination with regard to a particular resulting trust will not have any GST tax impact on any other trust resulting from that severance. In general, the rules in this section are applicable only for purposes of the GST tax and are not applicable in determining, for example, whether the resulting trusts may file separate income tax returns or whether the severance may result in a gift subject to gift tax, may cause any trust to be included in the gross estate of a beneficiary, or may result in a realization of gain for purposes of section 1001. See § 1.1001-1(h) of this chapter for rules relating to whether a qualified severance will constitute an exchange of property for other property differing materially either in kind or in extent.

As to Reg. § 1.1001-1(h), see part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.

Reg. § 26.2642-6(b), "Qualified severance defined," provides:

> A qualified severance is a division of a trust (other than a division described in § 26.2654-1(b)) into two or more separate trusts that meets each of the requirements in paragraph (d) of this section.

Reg. § 26.2642-6(c), "Effective date of qualified severance," provides:

> A qualified severance is applicable as of the date of the severance, as defined in § 26.2642-6(d)(3), and the resulting trusts are treated as separate trusts for GST tax purposes as of that date.

Reg. § 26.2642-6(d), "Requirements for a qualified severance," provides, "For purposes of this section, a qualified severance must satisfy each of the following requirements:"

> (1) The single trust is severed pursuant to the terms of the governing instrument, or pursuant to applicable local law.
>
> (2) The severance is effective under local law.
>
> (3) The date of severance is either the date selected by the trustee as of which the trust assets are to be valued in order to determine the funding of the resulting trusts, or the court-imposed date of funding in the case of an order of the local court with jurisdiction over the trust ordering the trustee to fund the resulting trusts on or as of a specific date. For a date to satisfy the definition in the preceding sentence, however, the funding must be commenced immediately upon, and funding must occur within a

reasonable time (but in no event more than 90 days) after, the selected valuation date.

(4) The single trust (original trust) is severed on a fractional basis, such that each new trust (resulting trust) is funded with a fraction or percentage of the original trust, and the sum of those fractions or percentages is one or one hundred percent, respectively. For this purpose, the fraction or percentage may be determined by means of a formula (for example, that fraction of the trust the numerator of which is equal to the transferor's unused GST tax exemption, and the denominator of which is the fair market value of the original trust's assets on the date of severance). The severance of a trust based on a pecuniary amount does not satisfy this requirement. For example, the severance of a trust is not a qualified severance if the trust is divided into two trusts, with one trust to be funded with $1,500,000 and the other trust to be funded with the balance of the original trust's assets. With respect to the particular assets to be distributed to each separate trust resulting from the severance, each such trust may be funded with the appropriate fraction or percentage (pro rata portion) of each asset held by the original trust. Alternatively, the assets may be divided among the resulting trusts on a non-pro rata basis, based on the fair market value of the assets on the date of severance. However, if a resulting trust is funded on a non-pro rata basis, each asset received by a resulting trust must be valued, solely for funding purposes, by multiplying the fair market value of the asset held in the original trust as of the date of severance by the fraction or percentage of that asset received by that resulting trust. Thus, the assets must be valued without taking into account any discount or premium arising from the severance, for example, any valuation discounts that might arise because the resulting trust receives less than the entire interest held by the original trust. See paragraph (j), Example 6 of this section.

(5) The terms of the resulting trusts must provide, in the aggregate, for the same succession of interests of beneficiaries as are provided in the original trust. This requirement is satisfied if the beneficiaries of the separate resulting trusts and the interests of the beneficiaries with respect to the separate trusts, when the separate trusts are viewed collectively, are the same as the beneficiaries and their respective beneficial interests with respect to the original trust before severance. With respect to trusts from which discretionary distributions may be made to any one or more beneficiaries on a non-pro rata basis, this requirement is satisfied if -

(i) The terms of each of the resulting trusts are the same as the terms of the original trust (even though each permissible distributee of the original trust is not a beneficiary of all of the resulting trusts);

(ii) Each beneficiary's interest in the resulting trusts (collectively) equals the beneficiary's interest in the original trust, determined by the terms of the trust instrument or, if none, on a per-capita basis. For example, in the case of the severance of a discretionary trust established for the benefit of A, B, and C and their descendants with the remainder to be divided equally among those three families, this requirement is satisfied if the trust is divided into three separate trusts of equal value with one trust established for the benefit of A and A's descendants, one trust for the benefit of B and B's descendants, and one trust for the benefit of C and C's descendants;

(iii) The severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation (as determined under section 2651) than the person or persons who held the beneficial interest in the original trust; and

(iv) The severance does not extend the time for the vesting of any beneficial interest in the trust beyond the period provided for in (or applicable to) the original trust.

(6) In the case of a qualified severance of a trust with an inclusion ratio as defined in § 26.2642-1 of either one or zero, each trust resulting from the severance will have an inclusion ratio equal to the inclusion ratio of the original trust.

(7)

(i) In the case of a qualified severance occurring after GST tax exemption has been allocated to the trust (whether by an affirmative allocation, a deemed allocation, or an automatic allocation pursuant to the rules contained in section 2632), if the trust has an inclusion ratio as defined in § 26.2642-1 that is greater than zero and less than one, then either paragraph (d)(7)(ii) or (iii) of this section must be satisfied.

(ii) The trust is severed initially into only two resulting trusts. One resulting trust must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the applicable fraction, as defined in § 26.2642-1(b) and (c), used to determine the inclusion ratio of the original trust immediately before the severance. The other resulting trust must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the excess of one over the fractional share described in the preceding sentence. The trust receiving the fractional share equal to the applicable fraction shall have an inclusion ratio of zero, and the other trust shall have an inclusion ratio of one. If the applicable fraction with respect to the original trust is .50, then, with respect to the two equal trusts resulting from the severance, the trustee may designate which of the resulting trusts will have an inclusion ratio of zero and which will have an inclusion ratio of one. Each separate trust resulting from the severance then may be further divided in accordance with the rules of this section. See paragraph (j), Example 7, of this section.

(iii) The trust is severed initially into more than two resulting trusts. One or more of the resulting trusts in the aggregate must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the applicable fraction used to determine the inclusion ratio of the original trust immediately before the severance. The trust or trusts receiving such fractional share shall have an inclusion ratio of zero, and each of the other resulting trust or trusts shall have an inclusion ratio of one. (If, however, two or more of the resulting trusts each receives the fractional share of the total value of the original trust equal to the applicable fraction, the trustee may designate which of those resulting trusts will have an inclusion ratio of zero and which will have an inclusion ratio of one.) The resulting trust or trusts with an inclusion ratio of one must receive in the aggregate that fractional share of the total value of the original trust as of the date of severance that is equal to the excess of one over the fractional share described in the second sentence of this paragraph. See paragraph (j), Example 9, of this section.

Reg. § 26.2642-6(e), “Reporting a qualified severance,” provides:

(1) *In general*. A qualified severance is reported by filing Form 706-GS(T), ‘‘Generation-Skipping Transfer Tax Return for Terminations,’’ (or such other form as may be provided from time to time by the Internal Revenue Service (IRS) for the purpose of reporting a qualified severance). Unless otherwise provided in the applicable form or instructions, the IRS requests that the filer write ‘‘Qualified Severance’’ at the top of the form and attach a Notice of Qualified Severance (Notice). The return and attached Notice should be filed by April 15th of the year immediately following the year during which the severance occurred or by the last day of the period covered by an extension of time, if an extension of time is granted, to file such form.

(2) *Information concerning the original trust*. The Notice should provide, with respect to the original trust that was severed -

(i) The name of the transferor;

(ii) The name and date of creation of the original trust;

(iii) The tax identification number of the original trust; and

(iv) The inclusion ratio before the severance.

(3) *Information concerning each new trust*. The Notice should provide, with respect to each of the resulting trusts created by the severance -

(i) The name and tax identification number of the trust;

(ii) The date of severance (within the meaning of paragraph (c) of this section);

(iii) The fraction of the total assets of the original trust received by the resulting trust;

(iv) Other details explaining the basis for the funding of the resulting trust (a fraction of the total fair market value of the assets on the date of severance, or a fraction of each asset); and

(v) The inclusion ratio.

Reg. § 26.2642-6(f), “Time for making a qualified severance,” provides:

(1) A qualified severance of a trust may occur at any time prior to the termination of the trust. Thus, provided that the separate resulting trusts continue in existence after the severance, a qualified severance may occur either before or after -

(i) GST tax exemption has been allocated to the trust;

(ii) A taxable event has occurred with respect to the trust; or

(iii) An addition has been made to the trust.

(2) Because a qualified severance is effective as of the date of severance, a qualified severance has no effect on a taxable termination as defined in section 2612(a) or a

taxable distribution as defined in section 2612(b) that occurred prior to the date of severance. A qualified severance shall be deemed to occur before a taxable termination or a taxable distribution that occurs by reason of the qualified severance. See paragraph (j) Example 8 of this section.

Reg. § 26.2642-6(g), “Trusts that were irrevocable on September 25, 1985,” provides:

(1) *In general*. See § 26.2601-1(b)(4) for rules regarding severances and other actions with respect to trusts that were irrevocable on September 25, 1985.

(2) *Trusts in receipt of a post-September 25, 1985, addition*. A trust described in § 26.2601-1(b)(1)(iv)(A) that is deemed for GST tax purposes to consist of one separate share not subject to GST tax (the non-chapter 13 portion) with an inclusion ratio of zero, and one separate share subject to GST tax (the chapter 13 portion) with an inclusion ratio determined under section 2642, may be severed into two trusts in accordance with § 26.2654-1(a)(3). One resulting trust will hold the non-chapter 13 portion of the original trust (the non-chapter 13 trust) and will not be subject to GST tax, and the other resulting trust will hold the chapter 13 portion of the original trust (the chapter 13 trust) and will have the same inclusion ratio as the chapter 13 portion immediately prior to the severance. The chapter 13 trust may be further divided in a qualified severance in accordance with the rules of this section. The non-chapter 13 trust may be further divided in accordance with the rules of § 26.2601-1(b)(4).

Reg. § 26.2642-6(h), “Treatment of trusts resulting from a severance that is not a qualified severance,” provides:

Trusts resulting from a severance (other than a severance recognized for GST tax purposes under § 26.2654-1) that does not meet the requirements of a qualified severance under paragraph (b) of this section will be treated, after the date of severance, as separate trusts for purposes of the GST tax, provided that the trusts resulting from such severance are recognized as separate trusts under applicable state law. The post-severance treatment of the resulting trusts as separate trusts for GST tax purposes generally permits the allocation of GST tax exemption, the making of various elections permitted for GST tax purposes, and the occurrence of a taxable distribution or termination with regard to a particular resulting trust, with no GST tax impact on any other trust resulting from that severance. Each trust resulting from a severance described in this paragraph (h), however, will have the same inclusion ratio immediately after the severance as that of the original trust immediately before the severance. (See § 26.2654-1 for the inclusion ratio of each trust resulting from a severance described in that section.) Further, any trust resulting from a nonqualified severance may be severed subsequently, pursuant to a qualified severance described in this § 26.2642-6.

Reg. § 26.2642-6(j), “Examples,” provides, “The rules of this section are illustrated by the following examples:”

Example (1). *Succession of interests*. T dies in 2006. T’s will establishes a testamentary trust (Trust) providing that income is to be paid to T’s sister, S, for her life. On S’s death, one-half of the corpus is to be paid to T’s child, C (or to C’s estate if C fails to survive S), and one-half of the corpus is to be paid to T’s grandchild, GC (or to GC’s estate if GC fails to survive S). On the Form 706, ‘‘United States Estate (and Generation-Skipping Transfer) Tax Return,’’ filed for T’s estate, T’s executor allocates all of T’s available GST tax exemption to other transfers and trusts, such that Trust’s inclusion ratio is 1. Subsequent to filing the Form 706 in 2007 and in accordance with applicable state law, the trustee divides Trust into two separate trusts, Trust 1 and Trust 2, with each trust receiving 50 percent of the value of the assets of the original trust as of the date of severance. Trust 1 provides that trust income is to be paid to S for life with remainder to C or C’s estate, and Trust 2 provides that trust income is to be paid to S for life with remainder to GC or GC’s estate. Because Trust 1 and Trust 2 provide for the same succession of interests in the aggregate as provided in the original trust, the severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied.

Example (2). *Succession of interests in discretionary trust*. In 2006, T establishes Trust, an irrevocable trust providing that income may be paid from time to time in such amounts as the trustee deems advisable to any one or more members of the group consisting of T’s children (A and B) and their respective descendants. In addition, the trustee may distribute corpus to any trust beneficiary in such amounts as the trustee deems advisable. On the death of the last to die of A and B, the trust is to terminate and the corpus is to be distributed in two equal shares, one share to the then-living descendants of each child, per stirpes. T elects, under section 2632(c)(5), to not have the automatic allocation rules contained in section 2632(c) apply with respect to T’s transfers to Trust, and T does not otherwise allocate GST tax exemption with respect to Trust. As a result, Trust has an inclusion ratio of one. In 2008, the trustee of Trust, pursuant to applicable state law, divides Trust into two equal but separate trusts, Trust 1 and Trust 2, each of which has terms identical to the terms of Trust except for the identity of the beneficiaries. Trust 1 and Trust 2 each has an inclusion ratio of one. Trust 1 provides that income is to be paid in such amounts as the trustee deems advisable to A and A’s descendants. In addition, the trustee may distribute corpus to any trust beneficiary in such amounts as the trustee deems advisable. On the death of A, Trust 1 is to terminate and the corpus is to be distributed to the then-living descendants of A, per stirpes, but, if A dies with no living descendants, the principal will be added to Trust 2. Trust 2 contains identical provisions, except that B and B’s descendants are the trust beneficiaries and, if B dies with no living descendants, the principal will be added to Trust 1. Trust 1 and Trust 2 in the aggregate provide for the same beneficiaries and the same succession of interests as provided in Trust, and the severance does not shift any beneficial interest to a beneficiary who occupies a lower generation than the person or persons who held the beneficial interest in Trust. Accordingly, the severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied.

Example (3). *Severance based on actuarial value of beneficial interests*. In 2004, T establishes Trust, an irrevocable trust providing that income is to be paid to T’s child C during C’s lifetime. Upon C’s death, Trust is to terminate and the assets of Trust are to be paid to GC, C’s child, if living, or, if GC is not then living, to GC’s estate. T properly elects, under section 2632(c)(5), not to have the automatic allocation rules contained in section 2632(c) apply with respect to T’s transfers to Trust, and T does not otherwise allocate GST tax exemption with respect to Trust. Thus, Trust has an inclusion ratio of one. In 2009, the trustee of Trust, pursuant to applicable state law, divides Trust into two separate trusts, Trust 1 for the benefit of C (and on C’s death to C’s estate), and Trust 2 for the benefit of GC (and on GC’s death to GC’s estate).

The document severing Trust directs that Trust 1 is to be funded with an amount equal to the actuarial value of C's interest in Trust prior to the severance, determined under section 7520 of the Internal Revenue Code. Similarly, Trust 2 is to be funded with an amount equal to the actuarial value of GC's interest in Trust prior to the severance, determined under section 7520. Trust 1 and Trust 2 do not provide for the same succession of interests as provided under the terms of the original trust. Therefore, the severance is not a qualified severance. Furthermore, because the severance results in no non-skip person having an interest in Trust 2, Trust 2 constitutes a skip person under section 2613 and, therefore, the severance results in a taxable termination subject to GST tax.

Example (4). *Severance of a trust with a 50% inclusion ratio*. On September 1, 2006, T transfers $100,000 to a trust for the benefit of T's grandchild, GC. On a timely filed Form 709, ''United States Gift (and Generation-Skipping Transfer) Tax Return,'' reporting the transfer, T allocates all of T's remaining GST tax exemption ($50,000) to the trust. As a result of the allocation, the applicable fraction with respect to the trust is .50 [$50,000 (the amount of GST tax exemption allocated to the trust) divided by $100,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to the trust is .50 [1-.50]. In 2007, pursuant to authority granted under applicable state law, the trustee severs the trust into two trusts, Trust 1 and Trust 2, each of which is identical to the original trust and each of which receives a 50 percent fractional share of the total value of the original trust, valued as of the date of severance. Because the applicable fraction with respect to the original trust is .50 and the trust is severed into two equal trusts, the trustee may designate which resulting trust has an inclusion ratio of one, and which resulting trust has an inclusion ratio of zero. Accordingly, in the Notice of Qualified Severance reporting the severance, the trustee designates Trust 1 as having an inclusion ratio of zero, and Trust 2 as having an inclusion ratio of one. The severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied.

Example (5). *Funding of severed trusts on a non-pro rata basis*. T's will establishes a testamentary trust (Trust) for the benefit of T's descendants, to be funded with T's stock in Corporation A and Corporation B, both publicly traded stocks. T dies on May 1, 2004, at which time the Corporation A stock included in T's gross estate has a fair market value of $100,000 and the stock of Corporation B included in T's gross estate has a fair market value of $200,000. On a timely filed Form 706, T's executor allocates all of T's remaining GST tax exemption ($270,000) to Trust. As a result of the allocation, the applicable fraction with respect to Trust is .90 [$270,000 (the amount of GST tax exemption allocated to the trust) divided by $300,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to Trust is .10 [1-.90]. On August 1, 2008, in accordance with applicable local law, the trustee executes a document severing Trust into two trusts, Trust 1 and Trust 2, each of which is identical to Trust. The instrument designates August 3, 2008, as the date of severance (within the meaning of paragraph (d)(3) of this section). The terms of the instrument severing Trust provide that Trust 1 is to be funded on a non-pro rata basis with assets having a fair market value on the date of severance equal to 90% of the value of Trust's assets on that date, and Trust 2 is to be funded with assets having a fair market value on the date of severance equal to 10% of the value of Trust's assets on that date. On August 3, 2008, the value of the Trust assets totals $500,000, consisting of Corporation A stock worth $450,000 and Corporation B stock worth $50,000. On August 4, 2008, the trustee takes all action necessary to transfer all of the Corporation A stock to Trust 1 and to transfer all of the Corporation B stock to Trust 2. On August 6, 2008, the stock transfers are completed and the stock is received by the appropriate resulting trust. Accordingly, Trust 1 is funded with assets having a value equal to 90% of the value of Trust as of the date of severance, August 3, 2008, and Trust 2 is funded with assets having a value equal to 10% of the value of Trust as of the date of severance. Therefore, the severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied. Trust 1 will have an inclusion ratio of zero and Trust 2 will have an inclusion ratio of one.

Example (6). *Funding of severed trusts on a non-pro rata basis*.

(i) T's will establishes an irrevocable trust (Trust) for the benefit of T's descendants. As a result of the allocation of GST tax exemption, the applicable fraction with respect to Trust is .60 and Trust's inclusion ratio is .40 [1-.60]. Pursuant to authority granted under applicable state law, on August 1, 2008, the trustee executes a document severing Trust into two trusts, Trust 1 and Trust 2, each of which is identical to Trust. The instrument of severance provides that the severance is intended to qualify as a qualified severance within the meaning of section 2642(a)(3) and designates August 3, 2008, as the date of severance (within the meaning of paragraph (d)(3) of this section). The instrument further provides that Trust 1 and Trust 2 are to be funded on a non-pro rata basis with Trust 1 funded with assets having a fair market value on the date of severance equal to 40% of the value of Trust's assets on that date and Trust 2 funded with assets having a fair market value equal to 60% of the value of Trust's assets on that date. The fair market value of the assets used to fund each trust is to be determined in compliance with the requirements of paragraph (d)(4) of this section.

(ii) On August 3, 2008, the fair market value of the Trust assets totals $4,000,000, consisting of 52% of the outstanding common stock in Company, a closely-held corporation, valued at $3,000,000 and $1,000,000 in cash and marketable securities. Trustee proposes to divide the Company stock equally between Trust 1 and Trust 2, and thus transfer 26% of the Company stock to Trust 1 and 26% of the stock to Trust 2. In addition, the appropriate amount of cash and marketable securities will be distributed to each trust. In accordance with paragraph (d)(4) of this section, for funding purposes, the interest in the Company stock distributed to each trust is valued as a pro rata portion of the value of the 52% interest in Company held by Trust before severance, without taking into account, for example, any valuation discount that might otherwise apply in valuing the noncontrolling interest distributed to each resulting trust.

(iii) Accordingly, for funding purposes, each 26% interest in Company stock distributed to Trust 1 and Trust 2 is valued at $1,500,000 (.5 x $3,000,000). Therefore, Trust 1, which is to be funded with $1,600,000 (.40 x $4,000,000), receives $100,000 in cash and marketable securities valued as of August 3, 2008, in addition to the Company stock, and Trust 2, which is to be funded with $2,400,000 (.60 x $4,000,000), receives $900,000 in cash and marketable securities in addition to the Company stock. Therefore, the severance is a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied.

Example (7). *Statutory qualified severance*. T dies on October 1, 2004. T's will establishes a testamentary trust (Trust) to be funded with $1,000,000. Trust income is to be paid to T's child, S, for S's life. The trustee may also distribute trust corpus from time to time, in equal or unequal shares, for the benefit of any one or more members of the group consisting of S and T's three grandchildren (GC1, GC2, and GC3). On S's death, Trust is to terminate and the assets are to be divided equally among GC1, GC2, and GC3 (or their respective then-living descendants, per stirpes). On a timely filed Form 706, T's executor allocates all of T's remaining GST tax exemption ($300,000) to Trust. As a result of the allocation, the applicable fraction with respect to the trust is .30 [$300,000 (the amount of GST tax exemption allocated to the trust) divided by $1,000,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to the trust is .70 [1-.30]. On June 1, 2007, the trustee determines that it is in the best interest of the beneficiaries to sever Trust to provide a separate trust for each of T's three grandchildren and their respective families. The trustee severs Trust into two trusts, Trust 1 and Trust 2, each with terms and beneficiaries identical to Trust and thus each providing that trust income is to be paid to S for life, trust principal may be distributed for the benefit of any or all members of the group consisting of S and T's grandchildren, and, on S's death, the trust is to terminate and the assets are to be divided equally among GC1, GC2, and GC3 (or their respective then-living descendants, per stirpes). The instrument severing Trust provides that Trust 1 is to receive 30% of Trust's assets and Trust 2 is to receive 70% of Trust's assets. Further, each such trust is to be funded with a pro rata portion of each asset held in Trust. The trustee then severs Trust 1 into three equal trusts, Trust GC1, Trust GC2, and Trust GC3. Each trust is named for a grandchild of T and provides that trust income is to be paid to S for life, trust principal may be distributed for the benefit of S and T's grandchild for whom the trust is named, and, on S's death, the trust is to terminate and the trust proceeds distributed to the respective grandchild for whom the trust is named. If that grandchild has predeceased the termination date, the trust proceeds are to be distributed to that grandchild's then-living descendants, per stirpes, or, if none, then equally to the other two trusts resulting from the severance of Trust 1. Each such resulting trust is to be funded with a pro rata portion of each Trust 1 asset. The trustee also severs Trust 2 in a similar manner, into Trust GC1(2), Trust GC2(2), and Trust GC3(2). The severance of Trust into Trust 1 and Trust 2, the severance of Trust 1 into Trust GC1, Trust GC2, Trust GC3, and the severance of Trust 2 into Trust GC1(2), Trust GC2(2) and Trust GC3(2), constitute qualified severances, provided that all other requirements of section 2642(a)(3) and this section are satisfied with respect to each severance. Trust GC1, Trust GC2, Trust GC3 will each have an inclusion ratio of zero and Trust GC1(2), Trust GC2(2), and Trust GC3(2) will each have an inclusion ratio of one.

Example (8). *Qualified severance deemed to precede a taxable termination*.[6406] In 2004, T establishes an inter vivos irrevocable trust (Trust) for a term of 10 years providing that Trust income is to be paid annually in equal shares to T's child C and T's

[6406] [my footnote:] One might considering delaying termination of a trust subject to part III.B.1.d.ii Estate Tax Inclusion Period (ETIP) so that it may divide in a manner consistent with this Example. A practical use is described in the text accompanying fn 6518 in part III.B.2.c.v GRIT's Estate Tax Consequences.

grandchild GC (the child of another then-living child of T). If either C or GC dies prior to the expiration of the 10-year term, the deceased beneficiary's share of Trust's income is to be paid to that beneficiary's then-living descendants, per stirpes, for the balance of the trust term. At the expiration of the 10-year trust term, the corpus is to be distributed equally to C and GC; if either C or GC is not then living, then such decedent's share is to be distributed instead to such decedent's then-living descendants, per stirpes. T allocates T's GST tax exemption to Trust such that Trust's applicable fraction is .50 and Trust's inclusion ratio is .50 [1-.50]. In 2006, pursuant to applicable state law, the trustee severs the trust into two equal trusts, Trust 1 and Trust 2. The instrument severing Trust provides that Trust 1 is to receive 50% of the Trust assets, and Trust 2 is to receive 50% of Trust's assets. Both resulting trusts are identical to Trust, except that each has different beneficiaries: C and C's descendants are designated as the beneficiaries of Trust 1, and GC and GC's descendants are designated as the beneficiaries of Trust 2. The severance constitutes a qualified severance, provided all other requirements of section 2642(a)(3) and this section are satisfied. Because the applicable fraction with respect to Trust is .50 and Trust was severed into two equal trusts, the trustee may designate which resulting trust has an inclusion ratio of one, and which has an inclusion ratio of zero. Accordingly, in the Notice of Qualified Severance reporting the severance, the trustee designates Trust 1 as having an inclusion ratio of one, and Trust 2 as having an inclusion ratio of zero. Because Trust 2 is a skip person under section 2613, the severance of Trust resulting in the distribution of 50% of Trust's corpus to Trust 2 would constitute a taxable termination or distribution (as described in section 2612(a)) of that 50% of Trust for GST tax purposes, but for the rule that a qualified severance is deemed to precede a taxable termination that is caused by the qualified severance. Thus, no GST tax will be due with regard to the creation and funding of Trust 2 because the inclusion ratio of Trust 2 is zero.

Example (9). *Regulatory qualified severance*.

(i) In 2004, T establishes an inter vivos irrevocable trust (Trust) providing that trust income is to be paid annually in equal shares to T's children, A and B, for 10 years. Trust provides that the trustee has discretion to make additional distributions of principal to A and B during the 10-year term without adjustments to their shares of income or the trust remainder. If either (or both) dies prior to the expiration of the 10-year term, the deceased child's share of trust income is to be paid to the child's then living descendants, per stirpes, for the balance of the trust term. At the expiration of the 10-year term, the corpus is to be distributed equally to A and B; if A and B (or either of them) is not then living, then such decedent's share is to be distributed instead to such decedent's then living descendants, per stirpes. T allocates GST tax exemption to Trust such that Trust's applicable fraction is .25 and its inclusion ratio is .75.

(ii) In 2006, pursuant to applicable state law, the trustee severs the trust into three trusts: Trust 1, Trust 2, and Trust 3. The instrument severing Trust provides that Trust 1 is to receive 50% of Trust's assets, Trust 2 is to receive 25% of Trust's assets, and Trust 3 is to receive 25% of Trust's assets. All three resulting trusts are identical to Trust, except that each has different beneficiaries: A and A's issue are designated as the beneficiaries of Trust 1, and B and B's issue are designated as the beneficiaries of Trust 2 and Trust 3. The severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied. Trust 1 will have an inclusion ratio of 1. Because both Trust 2 and Trust 3 have each received the fractional share of Trust's assets equal to Trust's applicable fraction of .25, trustee designates that Trust 2 will have an inclusion ratio of one and that Trust 3 will have an inclusion ratio of zero.

Example (10). *Beneficiary's interest dependent on inclusion ratio*. On August 8, 2006, T transfers $1,000,000 to Trust and timely allocates $400,000 of T's remaining GST tax exemption to Trust. As a result of the allocation, the applicable fraction with respect to Trust is .40 [$400,000 divided by $1,000,000] and Trust's inclusion ratio is .60 [1-.40]. Trust provides that all income of Trust will be paid annually to C, T's child, for life. On C's death, the corpus is to pass in accordance with C's exercise of a testamentary limited power to appoint the corpus of Trust to C's lineal descendants. However, Trust provides that if, at the time of C's death, Trust's inclusion ratio is greater than zero, then C may also appoint that fraction of the trust corpus equal to the inclusion ratio to the creditors of C's estate. On May 3, 2008, pursuant to authority granted under applicable state law, the trustee severs Trust into two trusts. Trust 1 is funded with 40% of Trust's assets, and Trust 2 is funded with 60% of Trust's assets in accordance with the requirements of this section. Both Trust 1 and Trust 2 provide that all income of Trust will be paid annually to C during C's life. On C's death, Trust 1 corpus is to pass in accordance with C's exercise of a testamentary limited power to appoint the corpus to C's lineal descendants. Trust 2 is to pass in accordance with C's exercise of a testamentary power to appoint the corpus of Trust to C's lineal descendants and to the creditors of C's estate. The severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied. No additional contribution or allocation of GST tax exemption is made to either Trust 1 or Trust 2 prior to C's death. Accordingly, the inclusion ratio with respect to Trust 1 is zero. The inclusion ratio with respect to Trust 2 is one until C's death, at which time C will become the transferor of Trust 2 for GST tax purposes. (Some or all of C's GST tax exemption may be allocated to Trust 2 upon C's death.)

Example (11). *Date of severance*. Trust is an irrevocable trust that has both skip person and non-skip person beneficiaries. Trust holds two parcels of real estate, Property A and Property B, stock in Company X, a publicly traded company, and cash. On June 16, 2008, the local court with jurisdiction over Trust issues an order, pursuant to the trustee's petition authorized under state law, severing Trust into two resulting trusts of equal value, Trust 1 and Trust 2. The court order directs that Property A will be distributed to Trust 1 and Property B will be distributed to Trust 2, and that an appropriate amount of stock and cash will be distributed to each trust such that the total value of property distributed to each trust as of the date of severance will be equal. The court order does not mandate a particular date of funding. Trustee receives notice of the court order on June 24, and selects July 16, 2008, as the date of severance. On June 26, 2008, Trustee commences the process of transferring title to Property A and Property B to the appropriate resulting trust(s), which process is completed on July 8, 2008. Also on June 26, the Trustee hires a professional appraiser to value Property A and Property B as of the date of severance and receives the appraisal report on Friday, October 3, 2008. On Monday, October 6, 2008, Trustee commences the process of transferring to Trust 1 and Trust 2 the appropriate amount of Company X stock valued as of July 16, 2008, and that transfer (as well as the transfer of Trust's cash) is completed by October 9, 2008. Under the facts presented, the funding of Trust 1 and Trust 2 occurred within 90 days of the date of severance selected by the trustee, and within a reasonable time after the date of severance taking into account the nature of the assets involved and the need to obtain an appraisal. Accordingly, the date of severance for purposes of this section is July 16, 2008, the resulting trusts are to be funded based on the value of the original trust assets as of that date, and the severance is a qualified severance assuming that all other requirements of section 2642(a)(3) and this section are met. (However, if Trust had contained only marketable securities and cash, then in order to satisfy the reasonable time requirement, the stock transfer would have to have been commenced, and generally completed, immediately after the date of severance, and the cash distribution would have to have been made at the same time.)

Example (12). *Other severance that does not meet the requirements of a qualified severance*.

(i) In 2004, T establishes an irrevocable inter vivos trust (Trust) providing that Trust income is to be paid to T's children, A and B, in equal shares for their joint lives. Upon the death of the first to die of A and B, all Trust income will be paid to the survivor of A and B. At the death of the survivor, the corpus is to be distributed in equal shares to T's grandchildren, W and X (with any then-deceased grandchild's share being paid in accordance with that grandchild's testamentary general power of appointment). W is A's child and X is B's child. T elects under section 2632(c)(5) not to have the automatic allocation rules contained in section 2632(c) apply with respect to T's transfers to Trust, but T allocates GST tax exemption to Trust resulting in Trust having an inclusion ratio of .30.

(ii) In 2009, the trustee of Trust, as permitted by applicable state law, divides Trust into two separate trusts, Trust 1 and Trust 2. Trust 1 provides that trust income is to be paid to A for life and, on A's death, the remainder is to be distributed to W (or pursuant to W's testamentary general power of appointment). Trust 2 provides that trust income is to be paid to B for life and, on B's death, the remainder is to be distributed to X (or pursuant to X's testamentary general power of appointment). Because Trust 1 and Trust 2 do not provide A and B with the contingent survivor income interests that were provided to A and B under the terms of Trust, Trust 1 and Trust 2 do not provide for the same succession of interests in the aggregate as provided by Trust. Therefore, the severance does not satisfy the requirements of this section and is not a qualified severance. Provided that Trust 1 and Trust 2 are recognized as separate trusts under applicable state law, Trust 1 and Trust 2 will be recognized as separate trusts for GST tax purposes pursuant to paragraph (h) of this section, prospectively from the date of the severance. However, Trust 1 and Trust 2 each have an inclusion ratio of .30 immediately after the severance, the same as the inclusion ratio of Trust prior to severance.

Example (13). *Qualified severance following a non-qualified severance*. Assume the same facts as in Example 12, except that, as of November 4, 2010, the trustee of Trust 1 severs Trust 1 into two trusts, Trust 3 and Trust 4, in accordance with applicable local law. The instrument severing Trust 1 provides that both resulting trusts have provisions identical to Trust 1. The terms of the instrument severing Trust 1 further provide that Trust 3 is to be funded on a pro rata basis with assets having a fair market value as of the date of severance equal to 70% of the value of Trust 1's

> assets on that date, and Trust 4 is to be funded with assets having a fair market value as of the date of severance equal to 30% of the value of Trust 1's assets on that date. The severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied. Trust 3 will have an inclusion ratio of zero and Trust 4 will have an inclusion ratio of one.

If the trust instrument requires automatic severance of a trust into separate trusts with zero and one inclusion ratios, then no special severance procedure is needed. T.D. 9421 (7/31/2008) explains:

> The commentators noted that the proposed regulations under § 26.2654-1(a)(1)(iii) address the treatment of severances resulting in separate trusts that are required under the terms of a trust instrument (mandatory severances) but that are neither severances otherwise recognized under section 2654 nor qualified severances under section 2642. The proposed regulations conclude that the separate shares or trusts resulting from such a severance, if recognized as separate trusts under state law, will be recognized as separate for GST tax purposes. The commentators questioned why the proposed changes to the regulations under section 2654 must address those severances that result in separate trusts when this issue is already addressed in § 26.2642-6(h) of the proposed regulations dealing with nonqualified severances. Section 26.2654-1(a)(1)(iii) was intended to address only mandatory severances that, as with the other types of severances covered by § 26.2654-1(a), are dictated by the terms of the trust. On the other hand, § 26.2642-6(h) addresses discretionary severances, that is, severances that are elective and within the discretion of the trustee. The severances described in § 26.2654-1 are governed by that section. Therefore, the proposed addition to this section has not been removed.
>
> The proposed regulations under section 2654 state a general rule that separate shares or trusts resulting from a mandatory severance, that are recognized as separate trusts for GST tax purposes, will not be treated as separate trusts for purposes of filing income tax returns or calculating any other taxes. The comments noted that this statement should not apply to shares or trusts that are recognized as separate trusts under local law. Rather, this statement should apply only to separate shares created within a single trust that are not recognized under local law as separate trusts. The final regulations reflect this change.

Commenting on the above, Harrington, Plaine & Zaritsky, *Generation-Skipping Transfer Tax*, ¶ 9.03. Segregating Exempt and Nonexempt Assets, explains:

> The regulations also state that trusts resulting from a non-qualified severance will still be treated prospectively as separate trusts for GST tax purposes if the resulting trusts are recognized as separate trusts under applicable state law. After the severance, in general, GST exemption may be allocated, elections may be made, and a taxable distribution or termination may occur with respect to one resulting trust without a GST tax impact on the other trust or share resulting from the severance. Unless the governing instrument provides otherwise, additions to, and distributions from, such trusts are allocated pro rata among the separate trusts. Moreover, the inclusion ratios of the resulting trusts are the same as the original trust immediately before the severance.

A footnote to this paragraph elaborates:

> Treas. Regs. §§ 26.2642-6(h), 26.2654-1(a)(1)(i), 26.2654-1(a)(1)(iii), 26.2654-1(a)(5), Ex. 8. In response to these regulations as proposed, commentators questioned why the proposed changes to the regulations under Section 2654 must address those severances that result in separate trusts when this issue is already addressed in Treasury Regulations Section 26.2642-6(h) of the proposed regulations dealing with nonqualified severances. Treasury Regulations Section 26.2654-1(a)(1)(iii) was intended to address only mandatory severances that, as with the other types of severances covered by Treasury Regulations Section 26.2654-1(a), are dictated by the terms of the trust. On the other hand, Treasury Regulations Section 26.2642-6(h) addresses discretionary severances, that is, severances that are elective and within the discretion of the trustee. The severances described in Treasury Regulations Section 26.2654-1 are governed by that section. Therefore, the proposed addition to this section was not removed in the final regulations. See 73 Fed. Reg. at 44,650 (July 31, 2008).

III.B.1.d.v. Automatic Allocation of GST Exemption

Letter Ruling 202210010 recited some of the basics of the GST system during life:

> Section 2601 imposes a tax on every GST. A GST is defined under § 2611(a) as: (1) a taxable distribution; (2) a taxable termination; and (3) a direct skip.
>
> Section 2602 provides that the amount of the tax is the taxable amount multiplied by the applicable rate. Section 2641(a) defines "applicable rate" as the product of the maximum federal estate tax rate and the inclusion ratio with respect to the transfer.
>
> Section 2642(a) provides the method for determining the inclusion ratio.
>
> Section 2631(a) provides that for purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption amount which may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor. Section 2631(b) provides that any allocation under § 2631(a), once made, shall be irrevocable.
>
> Section 2632(a) provides that any allocation by an individual of his GST exemption under § 2631(a) may be made at any time on or before the date prescribed for filing the estate tax return for such individual's estate (determined with regard to extensions), regardless of whether such a return is required to be filed.
>
> Section 2632(c)(1) provides that if any individual makes an indirect skip during such individual's lifetime, any unused portion of such individual's GST exemption shall be allocated to the property transferred to the extent necessary to make the inclusion ratio for such property zero. If the amount of the indirect skip exceeds such unused portion, the entire unused portion shall be allocated to the property transferred.
>
> Section 2632(c)(3)(A) provides that the term "indirect skip" means any transfer of property (other than a direct skip) subject to the tax imposed by chapter 12 made to a GST trust. Section 2632(c)(3)(B) provides, in relevant part, that the term "GST trust" means a trust that could have a generation-skipping transfer with respect to the transferor unless the trust falls within any of six enumerated exceptions.

Section 2632(c)(3)(B)(ii) provides that a trust is not a GST trust if the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals.

Section 2632(c)(3)(B)(iii) provides that a trust is not a GST trust if the trust instrument provides that, if one or more individuals who are non-skip persons die on or before a date or event described in clause (i) or (ii), more than 25 percent of the trust corpus either must be distributed to the estate or estates of one or more of such individuals or is subject to a general power of appointment exercisable by one or more of such individuals.

Section 26.2632-1(b)(2)(iii)(A) of the Generation-Skipping Transfer Tax Regulations provides that a transferor may prevent the automatic allocation of GST exemption (elect out) with respect to any transfer or transfers constituting an indirect skip made to a trust or to one or more separate shares that are treated as separate trusts under § 26.2654-1(a)(1).

Section 26.2632-1(b)(2)(iii)(B) provides that an election out of automatic allocation of GST exemption is made by attaching an election out statement to a timely filed Form 709.

Letter Ruling 202210010 involved the following situation:

On Date 1, in Year (a date after December 31, 2000), Donor established an irrevocable trust, Trust, for the benefit of her descendants. During Donor's lifetime, the trustee may distribute the income and principal of Trust to Donor's descendants in the trustee's sole discretion to provide for health, education, maintenance and support. Upon Donor's death, Trust divides into separate shares each benefitting one of Donor's children and his or her descendants. During each child's life, the trustee may distribute principal and income in his sole discretion to such child and his or her descendants to provide for health, education, maintenance and support.

Each child may at his or her death appoint the remainder of his or her separate trust to any person or entity other than the child's estate, the child's creditors or the creditors of the child's estate. Additionally, each child may also appoint to the creditors of his or her estate an amount of the trust having a value equal to the greatest dollar amount which produces the lowest sum of (i) wealth transfer taxes payable with respect to such child's estate, and (ii) generation-skipping transfer tax payable with respect to Trust. Any unappointed assets of a child's separate trust will continue in trust for the benefit of his or her descendants.

On Date 2, in Year, Donor transferred x non-voting partnership units in LP, a limited partnership, to Trust. Donor reported the Date 2 transfers to Trust on her Year Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return. However, the Date 2 transfer to Trust was incorrectly reported on Form 709, Schedule A, Part 1-Gifts Subject Only to Gift Tax instead of on Schedule A, Part 3-Indirect Skips. Furthermore, the automatic allocation of the GST exemption was not reported on Schedule D, Computation of Generation-Skipping Transfer Tax.

Letter Ruling 202210010 reasoned and concluded:

> In this case, more than 25 percent of the principal of Trust would be subject to a general power of appointment held by the children and exercisable by them upon their deaths if GST exemption is not allocated to more than 25 percent of Trust. Nevertheless, the general power of appointment contingent upon the inclusion ratio of the trust does not in this case prevent the trust from being a GST trust under § 2632(c)(3)(B). Accordingly, the terms of Trust satisfy the definition of a GST trust under § 2632(c)(3)(B) at the time of the Date 2 transfer to Trust.
>
> Additionally, Donor’s failure to correctly report the Date 2 transfers on her Year Form 709 did not constitute an election out of the automatic allocation rules under § 26.2632-1(b)(2)(iii), because no election out statement was attached to Donor’s Year Form 709. Therefore, Donor’s Date 2 transfer to Trust satisfies the definition of an indirect skip under § 2632(c)(1). Accordingly, based upon the facts submitted and the representations made, we conclude that Donor’s available GST exemption was automatically allocated to the Date 2 transfer to Trust.

Letter Ruling 202244003 discussed some of the basics of the GST system upon death:

> On Date 4, Decedent’s executor timely filed Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return for the estate. On Date 5, Decedent’s executor filed a supplemental Form 706. Schedule R was not included on either return, and thus none of Decedent’s generation-skipping transfer tax (GST) exemption was affirmatively allocated to Trust. You represent that prior to Decedent’s death, Decedent had not allocated any GST exemption during Decedent’s lifetime with respect to any transfer, and Decedent’s entire GST exemption was available for allocation at the time of her death.

Letter Ruling 202313008 discussed some of the basics of automatically allocating GST exemption during life:

> Section 2632(c)(5)(A)(ii) provides that any individual may elect to treat any trust as a GST trust for purposes of this subsection with respect to any or all transfers made by such individual to such trust.
>
> Section 2642(a)(1) provides that the inclusion ratio with respect to any property transferred in a generation-skipping transfer is the excess (if any) of one over the “applicable fraction.” Under 2642(a)(1), the applicable fraction is defined as a fraction the numerator of which is the amount of the GST exemption allocated to the trust (or to property transferred in a direct skip), and the denominator of which is the value of the property transferred to the trust (or involved in the direct skip), reduced by the sum of any federal estate tax or state death tax actually recovered from the trust attributable to such property and any charitable deduction allowed under § 2055 or 2522 with respect to such property.
>
> Section 2642(b)(2) provides that if property is transferred as a result of the death of the transferor, the value of such property shall be its value as finally determined for purposes of chapter 11. Any allocation to property transferred as a result of the death of the transferor shall be effective on and after the date of the death of the transferor.

Section 2642(g)(1)(A) provides that the Secretary shall by regulation prescribe such circumstances and procedures under which extensions of time will be granted to make an election to treat a trust as a GST trust under § 2632(c)(5)(A)(ii).

Section 2642(g)(1)(B) provides that in determining whether to grant relief under this paragraph, the Secretary shall take into account all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant. For purposes of determining whether to grant relief under this paragraph, the time for making the allocation (or election) shall be treated as if not expressly prescribed by statute.

Notice 2001-50, 2001-2 C.B. 189, provides, in part, that, under § 2642(g)(1)(B), the time for allocating the GST exemption to lifetime transfers is to be treated as if not expressly prescribed by statute and taxpayers may seek an extension of time to make an allocation described in § 2642(b)(1) or (b)(2) under the provisions of § 301.9100-3.

Section 301.9100-1(c) provides that the Commissioner has discretion to grant a reasonable extension of time under the rules set forth in §§ 301.9100-2 and 301.9100-3 to make a regulatory election, or a statutory election (but no more than six months except in the case of a taxpayer who is abroad), under all subtitles of the Code except subtitles E, G, H, and I.

Section 301.9100-3(a) provides that, in general, requests for extensions of time for regulatory elections that do not meet the requirements of § 301.9100-2 must be made under the rules of § 301.9100-3.

Section 301.9100-3 provides the standards used to determine whether to grant an extension of time to make an election whose due date is prescribed by a regulation (and not expressly provided by statute). In accordance with § 2642(g)(1)(B) and Notice 2001-50, taxpayers may seek an extension of time to make an allocation described in § 2642(b)(2) under the provisions of § 301.9100-3.

Requests for relief under § 301.9100-3 will be granted when the taxpayer provides the evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the government.

Section 301.9100-3(b)(1)(v) provides that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election.

Based on the facts submitted and representations made, we conclude that the requirements of § 301.9100-3 have been satisfied. Accordingly, Donor is granted an extension of time of 120 days from the date of this letter to make an election under § 2632(c)(5)(A)(ii) to treat Trust as a GST trust with respect to all transfers made by Donor to Trust.

The election should be made on an amended Form 709 and filed with the Kentucky Service Center at the following address: Department of the Treasury, Internal Revenue

Service, Stop 824G, 7940 Kentucky Drive, Florence, KY 41042-2915. A copy of this letter should be attached to the Form 709.

That conclusion was based on the following facts:

On Date 1 in Year 1, a date after December 31, 2000, Donor established Trust for the benefit of his descendants. On Dates 2, 3, and 4, all in Year 1, Donor transferred cash and securities to Trust. On Dates 5, 6, and 7, all in Year 2, Donor transferred additional cash and securities to Trust.

Donor relied on Attorney to prepare Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return reporting Donor's Year 1 transfers to Trust. Donor instructed Attorney to make an election under § 2632(c)(5)(A)(ii) to treat Trust as a GST trust. Although Attorney intended to make such election, Attorney inadvertently failed to properly make the election on the Year 1 Form 709.

Letter Ruling 202244003 explained:

Section 2612(a) provides that the term taxable termination means a termination (by death, lapse of time, release of a power, or otherwise) of an interest in property held in trust where the property passes to a skip person with respect to the transferor of the property. Section 2612(b) provides that the term taxable distribution means any distribution from a trust to a skip person other than a taxable termination or a direct skip. Under §2612(c)(1), a direct skip is a transfer subject to federal estate or gift tax made by a transferor to a skip person. A skip person is defined in § 2613(a) as (1) a natural person assigned to a generation which is two or more generations below the generation assignment of the transferor, or (2) a trust if either all the interests in such trust are held by skip persons, or there is no person holding an interest in the trust, and at no time after such transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person.

Section 2631(a), as in effect on Date 2, provided that for purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption of $1,000,000 which may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor. Section 2631(b) provides that any allocation under § 2631(a), once made, shall be irrevocable.

Section 2632(a) provides that any allocation by an individual of his GST exemption under § 2631(a) may be made at any time on or before the date prescribed for filing the estate tax return for such individual's estate (determined with regard to extensions), regardless of whether such a return is required to be filed.

Section 2632(b)(1) provides that if any individual makes a direct skip during his lifetime, any unused portion of such individual's GST exemption shall be allocated to the property transferred to the extent necessary to make the inclusion ratio for such property zero. Section 2632(b)(2) provides that the unused portion of an individual's GST exemption is that portion of such exemption that had not previously been allocated or treated as allocated by the individual.

Section 2632(c)(1), as in effect on Date 2, provided that any portion of an individual's GST exemption which has not been allocated within the time prescribed by § 2632(a) shall be deemed to be allocated as follows: (A) first, to property which is the subject of a direct skip occurring at such individual's death; and (B) second, to trusts with respect to which such individual is the transferor and from which a taxable distribution or a taxable termination might occur at or after such individual's death.

Section 26.2632-1(d)(1) of the Generation-Skipping Transfer Tax Regulations provides that an allocation of a decedent's unused GST exemption by the executor of the decedent's estate is made on the appropriate United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706 or Form 706NA) filed on or before the date prescribed for filing the return by § 6075(a) (including any extensions actually granted (the due date)). An allocation of GST exemption to a trust is void if the allocation is made with respect to a trust that has no GST potential with respect to the transferor for whom the allocation is being made, as of the date of the transferor's death. For this purpose, a trust has GST potential even if the possibility of a GST is so remote to be negligible.

Section 26.2632-1(d)(2) provides that a decedent's unused GST exemption is automatically allocated on the due date for filing Form 706 to the extent not otherwise allocated by the decedent's executor on or before that date. The automatic allocation occurs whether or not a return is actually required to be filed. Unused GST exemption is allocated pro rata (subject to the rules of § 26.2642-2(b)), on the basis of the value of the property as finally determined for purposes of chapter 11 (chapter 11 value), first to direct skips treated as occurring at the transferor's death. The balance, if any, of unused GST exemption is allocated pro rata (subject to the rules of § 26.2642-2(b)) on the basis of the chapter 11 value of the nonexempt portion of the trust property (or in the case of trusts that are not included in the gross estate, on the basis of the date of death value of the trust) to trusts with respect to which a taxable termination may occur or from which a taxable distribution may be made. The automatic allocation of GST exemption is irrevocable, and an allocation made by the executor after the automatic allocation is made is ineffective. No automatic allocation of GST exemption is made to a trust that will have a new transferor with respect to the entire trust prior to the occurrence of any GST with respect to the trust.

As discussed above, it is represented that prior to her death, Decedent did not allocate any GST exemption to any inter vivos transfers and that, at the time of Decedent's death, her entire GST exemption of $1,000,000 was available. Pursuant to the automatic allocation rules contained in § 2632(c)(1), as in effect on Date 2, GST exemption was automatically allocated first to the direct skip transfers occurring at death, which were the two $a transfers to Decedent's granddaughters and the interest in stocks and securities that you represent had a value of $b that Daughter 1 disclaimed in a qualified disclaimer. The remaining GST exemption, if any, would be deemed to be allocated to Trust. Accordingly, based upon the facts submitted and the representations made, we conclude that the automatic allocation rules of § 2632(c), as in effect on Date 2, operated to cause the unused portion of Decedent's available GST exemption to be automatically allocated to Trust.

Letter Ruling 202326012 involved the following facts:

On Date 1 of Year 1, a date after December 31, 2000, Taxpayer established and funded Trust 1, an irrevocable grantor retained annuity trust (GRAT). Taxpayer's retained interest in Trust 1 terminated on Date 1 of Year 3. The remaining principal of Trust 1 passed in equal shares to Children's Trusts, each a separate trust for the primary benefit of each of Taxpayer's children. Children's Trusts have GST potential. For GST tax purposes, the estate tax inclusion period (ETIP) with respect to Taxpayer's transfer to Trust 1 closed on Date 1 of Year 3.

On Date 2 of Year 2, Taxpayer established and funded Trust 2, another GRAT. Taxpayer's retained interest in Trust 2 terminated on Date 2 of Year 4. The remaining principal in Trust 2 passed in equal shares to Children's Trusts. For GST tax purposes, the ETIP with respect to Taxpayer's transfer to Trust 2 closed on Date 2 of Year 4.

On Date 3 of Year 4, Taxpayer established and funded Trust 3, another GRAT. Taxpayer's retained interest in Trust 3 terminated on Date 3 of Year 6. The remaining principal in Trust 3 passed in equal shares to Children's Trusts. For GST tax purposes, the ETIP with respect to Taxpayer's transfer to Trust 3 closed on Date 3 of Year 6.

Also in Year 4, Taxpayer made an additional direct transfer of $x to each of the Children's Trusts.

On Date 4 of Year 5, Taxpayer established and funded Trust 4, another GRAT. Taxpayer's retained interest in Trust 4 terminated on Date 4 of Year 7. The remaining principal in Trust 4 passed in equal shares to Children's Trusts. For GST tax purposes, the ETIP with respect to Taxpayer's transfer to Trust 4 closed on Date 4 of Year 7.

On Date 5 of Year 6, Taxpayer established and funded Trust 5, another GRAT. Taxpayer's retained interest in Trust 5 terminated on Date 5 of Year 8. The remaining principal in Trust 5 passed in equal shares to Children's Trusts. For GST tax purposes, the ETIP with respect to Taxpayer's transfer to Trust 5 closed on Date 5 of Year 8.

Taxpayer retained Firm to prepare Taxpayer's Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return for Years 1 through 8. Taxpayer did not intend for any portion of her GST exemption to be applied to the transfers she made to Trusts 1 through 5 (as described above) or to the direct transfer she made to each of Children's Trusts in Year 4. Firm, however, did not advise Taxpayer that under the rules of § 2632(c), a portion of Taxpayer's GST exemption would be automatically allocated to these transfers. In addition, Firm did not advise Taxpayer of the ability to elect out of the automatic allocation of GST exemption by making an election under § 2632(c)(5) on Form 709. As a result, Taxpayer failed to make an election on Taxpayer's Forms 709 for Years 3, 4, 6, 7, and 8 to opt out of the automatic allocation of GST exemption to the transfers Taxpayer made to Trusts 1 through 5. In addition, Taxpayer failed to make an election on Taxpayer's Form 709 for Year 4 to opt out of the automatic allocation of GST exemption for any and all transfers made to Children's Trusts. In Year 9, Attorney discovered the failure to opt out.

It has been represented that, to date, no taxable distributions, taxable terminations, or any other events have occurred with respect to Trusts 1 through 5 or Children's Trusts that would give rise to a GST tax liability. In addition, no other transfers other than those described above have been made to Children's Trusts.

Letter Ruling 202326012 reasoned and ruled:

Section 26.2632-1(b)(2)(iii)(A) provides, in relevant part, that a transferor may prevent the automatic allocation of GST exemption (elect out) with respect to any transfer or transfers constituting an indirect skip made to a trust or to one or more separate shares that are treated as separate trusts under § 26.2654-1(a)(1). A transferor may elect out with respect to - (1) one or more prior-year transfers subject to § 2642(f) (regarding ETIPs) made by the transferor to a specified trust or trusts; (2) one or more (or all) current year transfers made by the transferor to a specified trust or trusts; (3) one or more (or all future transfers made by the transferor to a specified trust or trusts; (4) all future transfers made by the transferor to all trusts (whether or not in existence at the time of the election out); or (5) any combination of (1) through (4).

Section 26.2632-1(b)(2)(iii)(B) provides that to elect out, the transferor must attach an election out statement to a Form 709 filed within the time period provided in § 26.2632-1(b)(2)(iii)(C). In general, the election out statement must identify the trust, and specifically must provide that the transferor is electing out of the automatic allocation of GST exemption with respect to the described transfer or transfers. Under § 26.2632-1(b)(2)(iii)(C), to elect out, the Form 709 with the attached election out statement must be filed on or before the due date for timely filing the Form 709 for the calendar year in which the ETIP closes.

Section 26.2632-1(c)(1)(i) provides that a direct skip or an indirect skip that is subject to an ETIP is deemed to have been made only at the close of the ETIP. The transferor may prevent the automatic allocation of GST exemption to a direct skip or an indirect skip by electing out of the automatic allocation rules at any time prior to the due date of the Form 709 for the calendar year in which the close of the ETIP occurs (whether or not any transfer was made in the calendar year for which the Form 709 was filed, and whether or not a Form 709 otherwise would be required to be filed for that year).

Section 2642(b)(1)(A) provides that, except as provided in § 2642(f), if the allocation of the GST exemption to any transfers of property is made on a gift tax return filed on or before the date prescribed by § 6075(b) for such transfer or is deemed to be made under § 2632(b)(1) or (c)(1), the value of such property for purposes of § 2642(a) shall be its value as finally determined for purposes of chapter 12 (within the meaning of § 2001(f)(2)), or, in the case of an allocation deemed to have been made at the close of an ETIP, its value at the time of the close of the ETIP.

Section 2642(f)(1) provides that for purposes of determining the inclusion ratio, if an individual makes an inter vivos transfer of property, and the value of such property would be includible in the gross estate of such individual under chapter 11 if such individual died immediately after making such transfer (other than by reason of § 2035), any allocation of GST exemption to such property shall not be made before the close of the ETIP (and the value of such property shall be determined under § 2642(f)(2)).

Section 2642(f)(3) provides that for purposes of § 2642(f), the term “estate tax inclusion period” means any period after the transfer described in paragraph (1) during which the value of the property involved in such transfer would be includible in the gross estate of the transferor under chapter 11 if the transferor died.

Section 2642(g)(1)(A) provides, generally, that the Secretary shall by regulation prescribe such circumstances and procedures under which extensions of time will be granted to make an election under § 2632(c)(5).

> Section 2642(g)(1)(B) provides that in determining whether to grant relief under § 2642(g)(1), the Secretary shall take into account all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant. For purposes of determining whether to grant relief, the time for making the allocation (or election) shall be treated as if not expressly prescribed by statute.
>
> Notice 2001-50, 2001-2 C.B. 189, provides that, under § 2642(g)(1)(B), the time for allocating the GST exemption to lifetime transfers and transfers at death, the time for electing out of the automatic allocation rules, and the time for electing to treat any trust as a GST trust are to be treated as if not expressly prescribed by statute. The Notice further provides that taxpayers may seek an extension of time to make an allocation described in § 2642(b)(1) or (2) or an election described in § 2632(b)(3) or (c)(5) under the provisions of § 301.9100-3.
>
> Sections 301.9100-1 through 301.9100-3 provide the standards the Commissioner will use to determine whether to grant an extension of time to make an election. Section 301.9100-2 provides an automatic extension of time for making certain elections. Section 301.9100-3 provides the standards used to determine whether to grant an extension of time to make an election whose date is prescribed by a regulation (and not expressly provided by statute). In accordance with § 2642(g)(1)(B) and Notice 2001-50, a taxpayer may seek an extension of time to make an allocation described in § 2642(b)(1) or (b)(2) or an election described in § 2632(b)(3) or (c)(5) under the provisions of § 301.9100-3.
>
> Section 301.9100-3(a) provides, in part, that requests for relief subject to § 301.9100-3 will be granted when the taxpayer provides the evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government.
>
> Under § 301.9100-3(b)(1)(v), a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election.
>
> Based on the facts submitted and representations made, we conclude that the requirements of § 301.9100-3 have been satisfied. Accordingly, Taxpayer is granted an extension of time of 120 days from the date of this letter to make an election under § 2632(c)(5)(A)(i)(I) that the automatic allocation rules not apply to the transfers Taxpayer made in Year 1 to Trust 1, in Year 2 to Trust 2, in Year 4 to Trust 3, in Year 5, to Trust 4, and in Year 6 to Trust 5. In addition, Taxpayer is granted an extension of time of 120 days from the date of this letter to make an election under § 2632(c)(5)(A)(i)(II) to have automatic allocation of GST exemption not apply to any and all transfers to Children's Trusts. The election for each of Trust 1 through 5 should be made on an amended Form 709 for the year in which the ETIP closed for that trust. The election for the Children's Trusts should be made on an amended Form 709 for Year 4….

Letter Ruling 202337006 involved the following facts and ruling:

> Donors relied on Accounting Firm for tax advice. Donors failed to inform Accounting Firm of the gifts made to Trust in 2010. As a result, Accounting Firm failed to prepare a 2010

> Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return for either of the Donors in 2010 to opt out of the automatic allocation of GST exemption to the transfers to Trust. Accordingly, Donors failed to elect out of automatic allocation for their 2010 transfers to Trust, and GST exemption was automatically allocated to these transfers….
>
> Based on the facts submitted and representations made, we conclude that Donors acted reasonably and in good faith under § 301.9100-3(b). In addition, we conclude that granting relief will not prejudice the interests of the government. Accordingly, Donors are granted an extension of time of 120 days from the date of this letter to make an election under § 2632(b)(3) that the automatic allocation rules not apply to Donors' 2010 transfers to Trust.

III.B.1.e. Valuation Issues

III.B.1.e.i. Valuing Business Interests

Business that are not publicly traded are inherently difficult to value.

Corporations that engage in a Code § 162 trade or business are likely to be valued based on their projected net cash flow, with earlier years' results being used to determine whether projected earnings are reasonable.

Pierre v. Commissioner, 133 T.C. 24 (2009), a reviewed decision (12-6 majority), held that state law property rights and not the check-the-box regulations determine gift tax valuation:

> We begin with a brief summary of the longstanding statutes, regulations, and caselaw that constitute the Federal gift tax valuation regime. Section 2501(a) imposes a tax on the transfer of property by gift. The amount of a gift of property is the value of the property at the date of the gift. Sec. 2512(a). It is the value of the property passing from the donor that determines the amount of the gift. Sec. 25.2511-2(a), Gift Tax Regs. "The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of the relevant facts." Sec. 25.2512-1, Gift Tax Regs. Where property is transferred for less than adequate and full consideration in money or money's worth, the amount of the gift is the amount by which the value of the property transferred exceeds the value of the consideration received. Sec. 2512(b).
>
> In addition to the statutes and regulations, there is significant Supreme Court precedent interpreting them and guiding the implementation of the Federal gift and estate tax.[9] The Supreme Court, in *Bromley v. McCaughn*, 280 U.S. 124 (1929), held that the imposition of a gift tax is within the constitutional authority of Congress. The holding in *Bromley* turned on a finding that the gift tax is an excise tax rather than a direct tax. As the Supreme Court stated in *Bromley v. McCaughn*, *supra* at 135-136:
>
>> The general power to "lay and collect taxes, duties, imposts, and excises" conferred by Article I, § 8 of the Constitution, and required by that section to be uniform throughout the United States, is limited by § 2 of the same article, which requires "direct" taxes to be apportioned, and section 9, which provides that "no capitation or other direct tax shall be laid unless in proportion to the census" directed by the Constitution to be taken…

> … a tax imposed upon a particular use of property or the exercise of a single power over property incidental to ownership, is an excise which need not be apportioned…
>
> … [The gift tax] is a tax laid only upon the exercise of a single one of those powers incident to ownership, the power to give the property owned to another….

[9] The Federal estate tax is interpreted in pari materia with the Federal gift tax. See *Estate of Sanford v. Commissioner*, 308 U.S. 39, 44 (1939) (citing *Burnet v. Guggenheim*, 288 U.S. 280, 286 (1933)).

The Supreme Court has also provided guidance as to the appropriate roles of Federal and State law in the valuation of transfers. A fundamental premise of transfer taxation is that State law creates property rights and interests, and Federal tax law then defines the tax treatment of those property rights. See *Morgan v. Commissioner*, 309 U.S. 78 (1940). It is well established that the Internal Revenue Code creates “no property rights but merely attaches consequences, federally defined, to rights created under state law.” *United States v. Nat. Bank of Commerce*, 472 U.S. 713, 722 (1985) (quoting *United States v. Bess*, 357 U.S. 51, 55 (1958)). In *Morgan v. Commissioner*, *supra* at 80-81, the Supreme Court stated:

> State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed. Our duty is to ascertain the meaning of the words used to specify the thing taxed. If it is found in a given case that an interest or right created by local law was the object intended to be taxed, the federal law must prevail no matter what name is given to the interest or right by state law.

In *Morgan*, the Court disregarded the State law classification of a power of appointment as “special” where the rights associated with that power of appointment under State law (*i.e.*, the power to appoint to anyone, including the holder’s estate and creditors) were properly classified under Federal law as a general power of appointment. As is standard in Federal estate and gift tax cases, the interest was created by State law, respected by the Court, and taxed pursuant to the Federal estate and gift tax provisions. In short, the Court ignored the label, not the interest created, and determined whether the interest fell within the Federal statute. This Court, in *Knight v. Commissioner*, 115 T.C. 506 (2000), followed the Supreme Court precedent discussed above. As we said in *Knight v. Commissioner*, *supra* at 513 (citing *United States v. Nat. Bank of Commerce*, *supra* at 722, *United States v. Rodgers*, 461 U.S. 677, 683 (1983), and *Aquilino v. United States*, 363 U.S. 509, 513 (1960)): “State law determines the nature of property rights, and Federal law determines the appropriate tax treatment of those rights.”

Pursuant to New York law petitioner did not have a property interest in the underlying assets of Pierre LLC, which is recognized under New York law as an entity separate and apart from its members. N.Y. Ltd. Liab. Co. Law sec. 601. Accordingly, there was no State law “legal interest or right” in those assets for Federal law to designate as taxable, and Federal law could not create a property right in those assets. Consequently, pursuant to the historical Federal gift tax valuation regime, petitioner’s gift tax liability is determined by the value of the transferred interests in Pierre LLC, not by a hypothetical transfer of the underlying assets of Pierre LLC.

The court then applied this background to its view of the check-the-box regulations:

> While we accept that the check-the-box regulations govern how a single-member LLC will be taxed for Federal tax purposes, i.e., as an association taxed as a corporation or as a disregarded entity, we do not agree that the check-the-box regulations apply to disregard the LLC in determining how a donor must be taxed under the Federal gift tax provisions on a transfer of an ownership interest in the LLC. If the check-the-box regulations are interpreted and applied as respondent contends, they go far beyond classifying the LLC for tax purposes. The regulations would require that Federal law, not State law, apply to define the property rights and interests transferred by a donor for valuation purposes under the Federal gift tax regime. We do not accept that the check-the-box regulations apply to define the property interest that is transferred for such purposes. The question before us (*i.e.*, how a transfer of an ownership interest in a validly formed LLC should be valued under the Federal gift tax provisions) is not the question addressed by the check-the-box regulations (i.e., whether an LLC should be taxed as a separate entity or disregarded so that the tax on its operations is borne by its owner). To conclude that because an entity elected the classification rules set forth in the check-the-box regulations, the long-established Federal gift tax valuation regime is overturned as to single-member LLCs would be "manifestly incompatible" with the Federal estate and gift tax statutes as interpreted by the Supreme Court. See sec. 7701.
>
> We note that Congress has enacted provisions of the Internal Revenue Code, see secs. 2701, 2703, that disregard valid State law restrictions in valuing transfers. Where Congress has determined that the "willing buyer, willing seller" and other valuation rules are inadequate, it expressly has provided exceptions to address valuation abuses. See chapter 14 of the Internal Revenue Code, sections 2701 through 2704, which specifically are designed to override the standard "willing buyer, willing seller" assumptions in certain transactions involving family members.
>
> By contrast, Congress has not acted to eliminate entity-related discounts in the case of LLCs or other entities generally or in the case of a single-member LLC specifically. In the absence of such explicit congressional action and in the light of the prohibition in section 7701, the Commissioner cannot by regulation overrule the historical Federal gift tax valuation regime contained in the Internal Revenue Code and substantial and well-established precedent in the Supreme Court, the Courts of Appeals, and this Court, and we reject respondent's position in the instant case advocating an interpretation that would do so. Accordingly, we hold that petitioner's transfers to the trusts should be valued for Federal gift tax purposes as transfers of interests in Pierre LLC and not as transfers of a proportionate share of the underlying assets of Pierre LLC.

See part III.E Fairness Within Families; Valuation, for a further discussion of valuation.

Among IRS resources is http://www.irs.gov/Businesses/Valuation-of-Assets, which includes separate papers on discounts for lack of marketability and S corporations.

III.B.1.e.ii. Valuing a Beneficial Interest in a Trust

Rev. Rul. 61-88 ruled:

> Under the terms of an irrevocable trust, the decedent or his estate was entitled to receive certain property on the death of the life tenant G, provided G died without issue.

The decedent was survived by G, a married woman aged 44 living with her husband H. At the time of decedent's death, G had never borne a child, but G and H were believed to be still capable of having issue.

Section 2031 of the Internal Revenue Code of 1954 provides that the gross estate of a decedent shall be determined by including to the extent provided by law the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated, except real property situated outside of the United States. General rules for the valuation of property for purposes of section 2031 are set forth in section 20.2031-1 of the Estate Tax Regulations.

In the absence of facts tending to show that birth of issue to G is impossible, valuation of the remainder interest of the present decedent's estate by the mere mechanical application of actuarial formulas is not supportable. See *Estate of Louis Sternberger, et al. v. United States*, 348 U.S. 187, Ct.D. 1777, C.B. 1955-1, 450. However, merely because an interest in property cannot be evaluated with sufficient accuracy to support a deduction, it does not necessarily follow that the interest is without value. Section 20.2037-1(c)(3) of the Estate Tax Regulations, dealing with the valuation of a decedent's reversionary interest for the purposes of section 2037 of the Code (transfers taking effect at death) makes this clear in the following excerpt:

> The value is ascertained in accordance with recognized valuation principles for determining the value for estate tax purposes of future or conditional interests in property. (See sections 20.2031-1, 20.2031-7, and 20.2031-9.) For example, if the decedent's reversionary interest was subject to an outstanding life estate in his wife, his interest is valued according to the actuarial rules set forth in section 20.2031-7. On the other hand, if the decedent's reversionary interest was contingent on the death of his wife without issue surviving and if it cannot be shown that his wife is incapable of having issue (so that his interest is not subject to valuation according to the actuarial rules in section 20.2031-7), his interest is valued according to the general rules set forth in section 20.2031-1.

In general, a remainder interest which becomes operative upon the death without issue of a woman aged 44 may be of considerable value. In making the valuation, however, consideration should be given to all known circumstances relative to the particular life tenant, rather than to women aged 44 in general.

Accordingly, it is held that, in the instant case, the remainder interest, since it is not susceptible of valuation under actuarial rules, should be evaluated in accordance with the general rules for the valuation of property set forth in section 20.2031-1 of the regulations.

Rev. Rul. 67-53 involved the following facts:

A grantor created a trust during his lifetime under the terms of which he reserved the right to net income for his life. The trust instrument provided that at his death net income was payable to the grantor's wife for life, subject to the power of the trustee, in his absolute and uncontrolled discretion, to withhold any or all of such income and to add all or any part of it to the principal of the trust. The instrument also provided that at the grantor's death or at the death of his wife, whichever occurred last, the principal and any accumulated income of the trust were to be paid to the grantor's then living children. At

> the grantor's death the principal of the trust was includible in his gross estate for Federal estate tax purposes. Thereafter, the trustee annually paid out the entire amount of net income of the trust to the wife of the grantor until her death.

Rev. Rul. 67-53 cited rules valuing the credit for tax on prior transfers, Code § 2013(a)[6407] and Reg. § 20.2013-4(a):

> Where a trustee possesses the power, in his absolute and uncontrolled discretion, to pay out net income to the income beneficiary of a trust or to accumulate such income, the beneficiary's interest cannot be valued according to recognized valuation principles as of the date of the transferor's death. Therefore, notwithstanding the fact that such income was actually paid to the decedent-transferee, the credit for tax on prior transfers under section 2013 of the Code is not allowable with respect to such an interest.

[6407] In describing Code § 2013(a), Rev. Rul. 67-53 referred to Rev. Rul. 59-9, which is reproduced here:

> Advice has been requested whether the estate of a decedent who had been the beneficiary of a life estate in a testamentary trust may be credited with all or any part of the amount of the Federal estate tax paid with respect to the transfer of such property in the estate of a prior decedent.
>
> In the instant case the decedent and her sister were the lifetime income beneficiaries of a residual trust created under the will of their father. Under the terms of the will the decedent and her sister were to receive the income from the trust in equal shares during their lifetimes and, at the death of either, the income was to be paid to the survivor. At the death of the last to survive, the income was to be paid to their children. The decedent died in the year 1955 which was within ten years after the death of her father. The value of the property included in the residual trust was included in the father's gross estate and a Federal estate tax was paid thereon. Since the interest which the decedent possessed in the residual trust terminated at her death, the life estate which she had in the trust was not included in her gross estate for Federal estate tax purposes. The specific question presented is whether the life estate qualifies for the credit for tax on prior transfers authorized by section 2013 of the Internal Revenue Code of 1954 even though it is not included in the gross estate of the transferee decedent.
>
> Section 2013 of the Code provides that the estate of a deceased who had received property from another decedent shall be credited with all or a part of the amount of the Federal estate tax paid with respect to such property in the transferor decedent's estate, provided that the decedents died within the statutory period.
>
> In determining whether the credit authorized by section 2013 of the Code is allowable, it is not necessary that the property transferred be identified in or traced through the transferee's estate. If the property was included in the gross estate of the transferor and a Federal estate tax paid thereon, the credit for tax on prior transfers may be applied to the interest received by the transferee, notwithstanding the fact that such interest is not included in the transferee decedent's estate for Federal estate tax purposes. Furthermore, the right of survivorship which the decedent possessed in the life tenancy also constitutes an interest in property which passed to her from her father and, as such, qualifies for the credit authorized by section 2013 of the Code.
>
> The amount to be used in computing the amount of credit which may be allowed is the value of the life estate plus the value of the secondary life estate determined as of the date of the transferor-decedent's death on the basis of recognized actuarial principles and without regard to the amount of income actually received by the life tenant.
>
> In view of the foregoing, it is held that the value of a life estate, without more, qualifies for the credit for tax on prior transfers authorized by section 2013 of the Code, notwithstanding the fact that it is not included in the gross estate of the transferee decedent.

Rev. Rul. 66-271 applied Rev. Rul. 59-9 to a Louisiana usufruct, which Rev. Rul. 66-271 described as:

> Generally, a usufruct is the right of enjoying a thing, the property of which is vested in another, and to draw from the same all the profit, utility, and advantages which it may produce. (Article 533 of the Civil Code of Louisiana.) A usufruct may be established in many ways; by a deed of sale, by a marriage contract, by donation, compromise, exchange, last will, and even by operation of law. (Article 540 of the Civil Code of Louisiana.)

Rev. Rul. 70-292 allowed such a credit:

> An ascertainable standard has been inferred where the language of the instrument relates to the beneficiary's accustomed manner of living. *Ithaca Trust Company v. United States*, 279 U.S. 151 (1929), Ct. D. 61, C.B. VIII-1, 313 (1929). If the instrument does not specifically limit the power of invasion to the accustomed standard of living of the beneficiary, such a restriction will be implied where the power is limited by such words as "comfort and support" or "hospital or medical expenses." Such an interpretation will be made if it is consistent with applicable local law and other language of the instrument does not require a different construction. Rev. Rul. 54-285, C.B. 1954-2, 302.
>
> In this case, the trustee's discretionary power to divert income of the residuary trust for the benefit of the surviving spouse can occur only if such diversion is necessary for her comfort, support, hospital or medical expenses. Thus, the power of diversion is impliedly limited by a definite standard. In addition (under the circumstances of this case), as of the date of the transferor's death, the likelihood of any diversion is so remote as to be negligible.
>
> In view of the foregoing, it is concluded that the transferee's income interest in the trust property is capable of valuation. Therefore, it is held that the credit for tax on prior transfers authorized by section 2013 of the Code is allowable with respect to such interest. For the situation where the bequest is not susceptible of valuation, see Rev. Rul. 67-53, C.B. 1967-1, 265.

Rev. Rul. 75-550 provides:

> Under the terms of the residuary trust, the trustee was granted the discretionary power to invade the trust corpus in such amount as the trustee deemed necessary "for the comfort, support, hospital or medical expenses" of either *B* or the children, or any or all of them. The trustee was empowered to invade the corpus without taking into account the independent sources of income to *B* or the children. However, no withdrawals for the benefit of *B* could be made until and unless the corpus of the marital deduction trust was exhausted….
>
> In this case, the trustee's discretionary power to invade corpus of the residuary trust for the benefit of *B* and the children can occur only if such diversion is necessary for their "comfort, support, hospital or medical expenses." Thus, the power of invasion is impliedly limited by a definite standard. Rev. Rul. 70-292, cited above. In addition, as of the date of transferor A's death, the likelihood of any invasion of the trust corpus on behalf of the children was not so remote as to be negligible.
>
> Accordingly, *B's* life estate in the residuary trust ($1,344,127) was capable of valuation at *A's* death by taking into account the estimated amount of all possible invasions from the corpus on a year-to-year basis….

Rev. Rul. 76-472 involved the following facts:

> Advice has been requested as to the proper method of valuing a decedent's remainder interest in property that is subject to diminution due to the possibility of a future increase in the prescribed remainder class.

> The decedent's grandparent, G a resident of State Y, died in 1960. G bequeathed a life estate in real property to daughter M, with the remainder to the issue of M. At the time of G's death, M had three children, A (the decedent), B and C. A died in 1974 survived by B, C and M. M was aged 53 years at the date of decedent's death.
>
> Under the laws of State Y, the word "issue" as used in G's will includes all the lawful lineal descendants of M, both adopted and natural. Also under the laws of State Y, A at the date of death had a vested right to a share of the remainder interest in G's real property upon the death of M. However, if M should have an additional child or children through birth or adoption, such child or children would also share in the remainder interest at M's death, along with A's estate and B and C. The value of the individual shares of the existing remaindermen would decrease accordingly.

Rev. Rul. 76-472 reasoned and held:

> Section 2031 of the Internal Revenue Code of 1954 provides that the value of the gross estate of the decedent shall be determined by including, to the extent provided by law, the value at the time of death of all property, real or personal, tangible or intangible, wherever situated.
>
> Section 20.2031-1(b) of the Estate Tax Regulations provides in part:
>
>> (b) *Valuation of property in general*. The value of every item of property includible in a decedent's gross estate under sections 2031 through 2044 is its fair market value …. All relevant facts and elements of value as of the applicable valuation date shall be considered in every case….
>
> Section 20.2031-10(d) of the regulations provides in part:
>
>> (d) *Remainders or reversionary interests*. If a decedent had, at the time of his death, a remainder or a reversionary interest in property to take effect after an estate for the life of another, the present value of his interest is obtained by multiplying the value of the property by the [appropriate factor from the actuarial tables in section 20.2031-10(f)]….
>
> In general, future interests in property that a decedent owns at death are taxed just as possessory interests. Thus, the value of a vested remainder interest is includible in the value of a remainderman's gross estate under section 2033 of the Code even though the remainderman dies before obtaining possession of the property. See *John G. Frazer*, 6 T.C. 1255 (1946), *aff'd*, 162 F. 2d 167 (3d Cir. 1947); *Utley v. United States*, 290 F.2d 188 (9th Cir. 1961). If the decedent's vested remainder interest is to take effect upon the termination of the life estate of another, the present value of the decedent's interest is ordinarily ascertainable by use of the actuarial formula set forth in section 20.2031-10(d) of the regulations. However, if the amount of decedent's interest is subject to possible future diminution by reason of the occurrence or nonoccurrence of a contingency, the valuation of such interest does not always lend itself to mere mechanical application of actuarial formulas. See Rev. Rul. 61-88, 1961-1 C.B. 417.
>
> In the instant case, the decedent's remainder interest is subject to being diminished by either the birth or adoption of children by M. To properly reflect either one of these possible contingencies, the remainder interest should be valued in accordance with the

> general rules for the valuation of property set forth in section 20.2031-1(b) of the regulations. See Rev. Rul. 67-370, 1967-2 C.B. 324; Rev. Rul. 61-88, 1961-1 C.B. 417.
>
> In making the valuation, the actuarial value of the decedent's remainder interest, ascertained by the formula set forth in section 20.2031-10(d) of the regulations, should be the starting point. Consideration should then be given to all known facts and circumstances that might tend to decrease such value, with due regard for (1) the certainty that a woman who has reached the age of 53 years will not bear children is far greater than that which attends most other human affairs and (2) the unlikelihood that a woman of that age will adopt a child.

Estate of Lloyd v. United States, 650 F.2d 1196, (Ct.Cl. 1981) involved these facts:

> It is the Family Trust with which we are directly concerned. The income from that trust which was initially valued at over $440,000 was to be paid, with minor exceptions, to Mrs. Lloyd during her lifetime. After her death, the income was to be paid to the Lloyds' two daughters and, upon the death of each daughter, one-half of the principal was to pass to the issue of that daughter. The will gave the corporate trustee the authority to pay sums from the principal of the Family Trust to Mrs. Lloyd or any of Mr. Lloyd's issue whenever the trustee, in "its sole and uncontrolled discretion may deem necessary or advisable …." The same paragraph went on to list a number of illustrative purposes for which invasion would be appropriate. It also declared that the principal of the Family Trust was not to be invaded on Mrs. Lloyd's behalf until the Marital Trust principal was exhausted. The will allowed the trustee, when exercising its discretionary power to invade, to consider other resources of the persons for whom the trust principal could be invaded, to the extent it deemed it "wise and proper" to do so.
>
> In addition to her interest in the Family Trust, Mrs. Lloyd was also the beneficiary of the Marital Trust. Under the terms of that trust, which was initially valued at over $600,000, she was to receive all of the trust income for life, and was also granted a general testamentary power of appointment over the trust corpus. The corporate trustee was given the authority, "for any reason, [to] pay to [Mrs. Lloyd], out of the principal of the trust estate of the Marital Trust, such sum or sums as the corporate trustee, in its uncontrolled discretion, may deem necessary or advisable."
>
> At the time of Mr. Lloyd's death, he left his wife, two daughters, and seven grand children. It is undisputed on these motions that his wife was, at that time and until her death five years later in 1975, a person of substantial means. She owned her own home, and in addition to the income she received under the Family and Marital Trusts, she also became the settlor of a revocable trust with a value at her death of over $570,000. Both of the Lloyd's daughters also had substantial family incomes from other trusts and from their spouses' incomes.

Estate of Lloyd v. United States, 650 F.2d 1196, (Ct.Cl. 1981) reasoned and held:

> Defendant takes the position that this statutory and regulatory scheme requires section 2013 valuation to be based solely on the facts and circumstances known or reasonably predictable at the time of the transferor's death. Plaintiff would have us rather adopt a "hindsight" or "wait-and-see" approach, incorporating reliance on certain factors which became known only after Mr. Lloyd's (the section 2013 transferor) death, such as whether the corpus of the Family Trust was actually invaded during Mrs. Lloyd's lifetime.

We agree that the Government's "look forward" method is the only acceptable one. The value of property for section 2013 is to be the value used in determining the federal estate tax liability of the transferor (as reduced by certain other factors not relevant here). 26 U.S.C. §2013(d). See also, 26 C.F.R. §20.2013-4(a). That value is determined at the time of that decedent's death. 26 U.S.C. §2031(a). Treasury Regulation 20.2013-4(a) provides that the value of life estates and other limited interests are to be determined "*as of the date of the transferor's death* …." (emphasis added). The legislative history of section 2013 is in harmony with this time of valuation, see S. Rep. No. 1622, 83d Cong. 2d Sess. 463 reprinted in [1954] U.S. Code Cong. & Ad. News 4621, 4755-56, which has consistently been followed by the IRS. See, Rev. Rul. 70-292, 1970-1 C.B. 187, 188; Rev.Rul. 67-53, 1967-1 C.B. 265, 266. This has been the way life estates have been valued for over fifty years for federal estate tax purposes, at least whenever Congress has indicated, as here, that their value is to be set as of the decedent's death. *Ithaca Trust Co. v. United States*, 279 U.S. 151, 154-55 (1929).

In the face of this strong support for "looking forward," plaintiff relies on *Estate of Chesterton v. United States*, 213 Ct.Cl. 345, 551 F.2d 278 *cert.* denied, 434 U.S. 835 (1977), for a "wait-and-see" approach. That case, which allowed a deduction from the estate tax of only those post-death support payments actually made under what is now section 2053 of the Code, is quite different. Section 2053 includes no requirement for a date-of-death valuation while section 2013 and its regulations clearly do impose such a mandate. Moreover, the Chesterton court pointed out that Congress probably treated post-death support payments as in the same category as funeral and administrative expenses which normally arise after death. That of course is not true of section 2013 which looks squarely to valuation at the time of the transferor's death. Also, we cannot avoid a comment on plaintiff's inconsistency. The Estate would have us look at some facts as of the time of Mrs. Lloyd's death (e.g. that the principal was not in fact invaded), but to ignore other circumstances then known (e.g., that she lived only 5 years after Mr. Lloyd rather than her 17 year estimated life expectancy under 26 C.F.R. §20.2031-7). If the "wait-and-see" method were to be fully followed, we very much doubt that plaintiff would indorse it.

III Regulation 20.2013-4 requires that value be determined "on the basis of recognized valuation principles," but it does not define those principles, other than to refer to regulations containing actuarial tables for determining life estate values. Section 2013 itself is no more specific. It is implicit, however, in the statute and the regulations that a life estate or other property for which credit is sought under section 2013 must be rationally capable of valuation at the transferor's death. This is a principle of valuation long followed in comparable estate tax situations, *Humes v. United States*, 276 U.S. 487 (1928); *Ithaca Trust Co.*, *supra*, 279 U.S. at 154; *Merchants Bank v. Commissioner*, 320 U.S. 256, 261 (1943), and we think that it clearly applies to section 2013 as well. See *Holbrook v. United States*, 575 F.2d 1288, 1292 (9th Cir. 1978); *American Nat'l Bank and Trust Co. of Chattanooga v. United States*, 31 A.F.T.R. 2d 1363 (E.D. Tenn. 1972); Rev. Rul 67-53 1967-1 C.B. 265, 266.

The next step for this case is to refine that standard for life estates as to which the corpus can be invaded. On that problem, defendant urges that we refer to the decisions under a former version of 26 U.S.C. §2055 (estate tax deductions for a charitable remainder after a life estate).[3] Before its amendment in 1969 (which obviated the need for these rules), section 2055 (and its regulation) authorized an estate tax deduction for the value of a charitable remainder, but the deduction was limited by interpretation to the extent the remainder's value was "presently ascertainable." In a leading case in this area, the Supreme Court described the standard under section 2055 for the allowance of a deduction of the value of a charitable remainder:

[3] This mode has been followed by the Ninth Circuit and by IRS in revenue rulings. Holbrook, supra, 575 F.2d at 1291, Rev.Rul. 70-292, 1970-1 C.B. 187, 188.

> Only where the conditions on which the extent of invasion of the corpus depends are fixed by reference to some *readily ascertainable and reliably predictable facts* do the amount which will be diverted from the charity and the present value of the bequest become adequately measurable. And, in these cases, the taxpayer has the burden of establishing that the amounts will either be spent by the private beneficiary or reach the charity are thus *accurately calculable*. [*Merchants Bank*, *supra*, 320 U.S. at 261. (emphasis added).]

The Court went on (as it had earlier) to require that the invasion of the corpus for the life beneficiary be circumscribed so that the value of the life estate, and reciprocally that of the charitable remainder, could be properly calculated under the "ascertainable" standard. *See also Ithaca Trust Co.*, *supra*, 279 U.S. at 154 (extent of invasion of corpus for life beneficiary held to be "fixed in fact and capable of being stated in definite terms of money"); *Henslee v. Union Planters Bank*, 335 U.S. 595, 598-600 (1949) (extent of possible invasion of corpus not ascertainable and therefore charitable deduction not allowable).[4]

[4] Under this controlling criterion, the extrinsic facts at the testator's death which would show the likelihood or remoteness of corpus invasion were irrelevant to whether the charitable interest was "presently ascertainable." *Salisbury v. United States*, 377 F.2d 700, 703 n.5 (2d Cir. 1967). That was simply decided from the terms and intent of the will. See note 12, infra.

The Supreme Court's lead under the then section 2055 was followed by a large number of lower court decisions (for a general survey, see *Salisbury v. United States*, 377 F.2d 700, 703-06 (2d Cir. 1967)) which made very fine distinctions depending on the particular phrasing of the purposes for which the will allowed invasion of the corpus for the life beneficiary's purposes. Some judges and commentators decried these subtle distinctions as hair-splitting and unrealistic, see *Blodget v. Delaney*, 201 F.2d 589, 594-95 (1st Cir. 1953) (Magruder, C. J., concurring); *Seubert v. Shaughnessy*, 233 F.2d 134, 138 (2d Cir. 1956) (Clark, C. J.); see also, *Salisbury*, supra, 377 F.2d at 706 n.10, and as we have said the 1969 Congress ended the need for this process under section 2055 by changing the provisions for charitable deductions.

A good deal could be said for wholly abandoning with respect to section 2013 the "presently ascertainable" formula previously used under section 2055, and for relying instead solely on the realistic probabilities of actual invasion of the corpus at the time of the testator's death. See, e.g., *Blodget*, supra, 201 F.2d at 595 (Magruder, C. J., concurring); *Seubert*, supra, 233 F.2d at 138. But we are reluctant to do so in this case because the IRS and a Court of Appeals have decided to follow the decisions under section 2055 (see note 3, supra)[5] and because we think that, assuming that the tests are basically equivalent for the two sections, the terms of Mr. Lloyd's will, as interpreted in the light of Rhode Island law (the domiciliary state), combine to create a standard under which Mrs. Lloyd's life interest was both susceptible of determination "on the basis of recognized valuation principles" under section 2013 and its regulations, and sufficiently ascertainable and calculable to meet, at the minimum, the requirements applicable to the old section 2055 cases. See Part IV, infra.

[5] When section 2013 was first adopted in 1954, the "ascertainable" rule under section 2055 was in full force.

Nevertheless, in applying the former 2055 decision to section 2013 it is to be remembered that for the present class of case there is a difference. Under section 2055, in order to value the charitable remainder, the court looked to see whether a trustee could invade the corpus for a previous life beneficiary without an ascertainable standard limiting that invasion. What had to be found before a charitable deduction was allowed was a ceiling beyond which the corpus could not be invaded for the benefit of the life beneficiary - i.e., the maximum amount of invasion for the life interest. In section 2013, on the other hand, the interest to be valued is the life estate itself, and to show measurability the "ascertainable standard" need necessarily go no further than to establish the minimum amount of trust principal which is safe from invasion for others (and the concommitant life income created by that amount of principal). In this case, for instance, we need consider at this point only whether Mr. Lloyd intended that the trust principal not be invaded for others beyond a certain point, so that there would always be money available for his wife's benefit from the Family Trust, and her life interest would indisputably have some value.[6]

[6] See note 12, infra.

IV. Under section 2055, a tax benefit was generally allowed where "the trustee's powers are so circumscribed either by the trust instrument or state law that the value of the interest in question is 'accurately calculable.' " *Holbrook*, supra, 575 F.2d at 1291. (emphasis added.) State law is highly persuasive in will construction because of the state's power over the trustee's invasion of corpus. *Salisbury*, supra, 377 F.2d at 707.

Rhode Island law governs the interpretation of Mr. Lloyd's will since it was his domicile. The settled law of that state is that

> the intent of the testator must be ascertained if possible from the language of the will … as a whole. In discovering that intent, the words used are to be given their primary, ordinary and common meaning, unless it plainly appears that they are used in another sense….
>
> That intent, when ascertained, is to be given effect unless contrary to law. [*Lees v. Howarth*, 131 A.2d 229, 230-31 (R.I. 1957).]

Accord, *Industrial Nat'l Bank of R.I. v. Rhode Island Hospital*, 207 A.2d 286, 291 (R.I. 1965).

Under that standard, the dispositive provisions of Mr. Lloyd's will clearly evidence to us that his primary concern was for the welfare of his surviving widow. He provided that, in addition to receiving all of his tangible personal property, Will, ¶4, she would receive the entire net income of both the Family and Marital Trusts during her lifetime. Since these two trusts comprised almost the whole of his estate, the fact that she was the sole beneficiary of their income is proof of his great desire to see to her well-being. Moreover, principal of the Marital Trust could be paid to Mrs. Lloyd "for any reason," and in "such sum or sums as the corporate trustee, in its uncontrolled discretion, may deem necessary or advisable." Will, ¶10(a). Over and above these sources of funds, Mr. Lloyd provided that, if the principal of the Marital Trust were ever exhausted, his wife could receive payments out of Family Trust principal.

We infer from the combination of these provisions that Mr. Lloyd's foremost concern in his will was insuring that after his death his wife would be able to maintain a standard of living appropriate to her station in life.[7] We are convinced that this purpose was implicit in his estate plan as a whole, and served as a curb on the Trustee's power to invade the corpus of the Family Trust, set forth in paragraph 10(b) of the will.

> [7] That standard encompasses more than simply the provision of money sufficient to maintain Mrs. Lloyd in her prior mode of life. Rather, it includes such sums of money as would be necessary to allow her to live as others in the same financial bracket as she and her husband would normally live. Thus even though Mrs. Lloyd may have lived very modestly, and below the standard accepted as average for her "class", before Mr. Lloyd's death, there is no indication in the terms of his will that he expected or desired that her lifestyle would be so restricted when he was no longer alive. For instance, if Mrs. Lloyd had not travelled in the past (although travel was common among her financial equals) and she decided she would like to do so after her husband's death, such expenses would appropriately comprise part of those to be considered in maintaining her in a way appropriate to her station in life.

Paragraph 10(b) provided that

> (b) The Trustees may at any time and from time to time pay to my said wife and my issue, or any one or more of them exclusive of the other or others, *out of the principal of the Family Trust, such sum or sums as the corporate Trustee in its sole and uncontrolled discretion may deem necessary or advisable*.... Without restricting the discretion of the corporate trustee as to paying principal of the trust estate of the Family Trust, and only by way of illustration, principal may be paid for the care, maintenance, support, education or advancement, or to meet any emergency in the health of or the expense of the last illness and funeral, or otherwise for the benefit, comfort, convenience or welfare, of any person then or prospectively entitled to receive income from said trust, or any of the issue of, or any member of the immediate family of any such person or issue, or to make up any deficiency in income or in purchasing power caused by currency or credit inflation or by changes in the cost of living. [(emphasis added).]

The Government contends that this creates a power of invasion, especially for others, so broad and all-inclusive that it renders the life interest in the Family Trust incapable of valuation and not calculable under the "ascertainable" standard. We must disagree.

Although a literal reading of parts of paragraph 10(b), taken out of context and without consideration of the limitations placed on the trustee's discretionary powers by Rhode Island law and by the will as a whole, might support the defendant's position, we cannot look at the Trustee's invasion authority in that isolated way. Instead, the testator's intent as to the extent of the invasion power must be determined by looking at the will as a whole, *Metcalf v. Gladding*, 87 A. 195, 197 (R.I. 1913), and "the key words of an instrument must be interpreted in light of their context." *Salisbury*, supra, 377 F.2d at 706.

The invasion power is limited in the will to situations where it is deemed by the trustee to be "necessary or advisable." By way of example, the will lists a number of situations which the testator believed might warrant exercise of this power. Defendant would focus on the power's potential breadth and literal all-inclusiveness, as well as on the will's directive that it is exercisable by the corporate Trustee whenever it, "*in its sole and uncontrolled discretion* may deem necessary or advisable." (emphasis added). But, as we have emphasized, to look at this language alone would be to ignore the testator's basic intent shown by other aspects of the will and the entirety of the instrument. To interpret the words absolutely, and thus find the power limitless "would destroy the purpose of the trust and frustrate the settlor's plan of disposition…. [I]n such circumstances [courts] have confined [the power's] exercise by fixed standards." *Industrial Bank*, supra, 207 A.2d at 290. In other words, a major purpose of the trust would be destroyed, and Mr. Lloyd's estate plan frustrated, if the corpus of the Family Trust were invaded for others to such an extent that it - taken together with other sources of income (see Will, ¶10(c)) - was not sufficient to support Mrs. Lloyd appropriately to her life station.

Even where a power is termed "uncontrolled" or "absolute," these words are not necessarily interpreted literally by the Rhode Island courts. Rather,

> "[i]n such a case the mere fact that the trustee has acted beyond the bounds of a reasonable judgment is not a sufficient ground for interposition by the court, so long as the trustee acts in a state of mind in which it was contemplated by the settlor that he would act. But *the court will interfere if the trustee acts in a state of mind not contemplated by the settlor. Thus the trustee will not be permitted to act dishonestly, or from some motive other than the accomplishment of the purposes of the trust, or ordinarily to act arbitrarily without an exercise of his judgment.*" [*Industrial Bank, supra*, 207 A.2d at 290, (citing from Restatement (Second) Of Trusts §187, subsec. 13j (1959)) (emphasis added).]

See also, *Viall v. Rhode Island Hospital Trust Co.*, 123 A. 570, 572 (R.I. 1924); *Angell v. Angell*, 68 A. 583, 586 (R.I. 1908). That principle of Rhode Island law would govern here to compel the Trustee to preserve at least so much of the trust corpus as was necessary to provide fully for Mrs. Lloyd during her life - that being Mr. Lloyd's primary intent.

The same is true as to the will's declaration that the Trustee could invade corpus in such measure as it considered "necessary or advisable." Those words, as we have suggested, take on meaning from the testator's dominant purpose[8] and indicate that there should be no invasion which would so deplete the corpus that the income would be insufficient for proper maintenance of Mrs. Lloyd.

[8] In *Industrial Bank, supra*, the Rhode Island Supreme Court found that where exercise of the trustees' power was limited to what was "right and proper," it was "clear that the decedent did not intend that in all events their discretion should be unlimited." 207 A.2d at 291.

Similarly for the will's prescription that the

> corporate trustee may take into consideration all other available resources of any of [those for whom the trust corpus could be invaded] to such extent, and only to such extent, as it may deem wise and proper. [Will, ¶10(c).]

This language is phrased in precatory fashion and relies on the Trustee's view of "wise and proper" action, but the Trustee's discretion must always be exercised in accord with Rhode Island fiduciary law and with the will's overriding purpose. In this instance, the beneficiaries apparently all had substantial income from other sources, and the Trustee's power to invade the Family Trust would have to take into account those outside founts of income. Cf., *Peckham v. Newton*, 4 A. 758, 760 (R.I. 1886).[9]

[9] With respect to invasions of the Family Trust for the benefit of the wife, it is clearly "wise and proper" that the trustee would consider whether, if the principal were invaded currently, there would remain sufficient principal to produce income necessary to provide for Mrs. Lloyd's needs in the future (considering her other sources of income).

Defendant would discard the Rhode Island decisions because they did not involve a power to invade corpus, but we think the general principles they announce were meant to control trustees generally, not merely in the direct circumstances of that specific case. In particular, *Industrial Bank, supra*, is very close. Those parties asked the court to determine whether, under Rhode Island law, a trustee's power to allocate receipts and disbursements, expenses, and loss to either income or principal, made the value of the charitable remainder nonascertainable under section 2055. The decision how to allocate was left to the trustees "according to their judgment of what is right and proper under the circumstances, (without being bound by any court decision as to any other trust instrument) …." 207 A.2d at 289. While this power does not go to the invasion of principal, its effect is quite analogous since it allows the trustees to control, under very broad discretion, the flow of money in and out of principal and income. The state court looked at the overall testamentary scheme to discern the testator's intent, and found, as we do here, that the language if literally interpreted woul4d frustrate the testator's intent, and that therefore the trustees' powers should be limited by fixed standards. 207 A.2d at 290. Although the standards applied in Industrial Bank are, of course, not fully applicable to this case (different powers being involved), that case is important in that it gives guidance as to how the Rhode Island courts will view the grants of very broad powers in this general area.[10]

[10] A section 2055 problem was directly involved in *Industrial Bank*, and the state court found an ascertainable standard. Defendant urges that the 2055 standards should be used for section 2013 and on that view *Industrial Bank* is obviously significant for the present case.

Defendant also contends that Rhode Island law will uphold the grant of an absolute power. See *Lees, supra*, 131 A.2d at 231; *Metcalf, supra*, 87 A. at 197. In both of those cases, however, the court said that absolute or arbitrary powers were not favored, and only where it was clear from the will that the testator really intended to confer such a power, would it be recognized as such.[11] That, as we have stressed, is not true here.

[11] In *Metcalf*, the court found that, looking at the will as a whole, the testator had clearly intended to give his wife an absolute power to make advancements to their children. 87 A. at 198. In Lees, the parties agreed that an absolute power to invade the corpus had been granted, and the court found that that was in fact the testator's intent, subject to the requirement that the trustees act in good faith. 131 A.2d at 230-231.

The only relevant court decision under section 2013 is *Holbrook v. United States*, 575 F.2d 1288 (9th Cir. 1978). That case concerned the valuation for section 2013 of a life income interest created by a trust which authorized the trustees to invest in unproductive assets, to retain investments for speculative appreciation purposes, and to convert the estate to cash or securities producing little or no income, for as long as they deemed advisable. *Id*. at 1289-90. The Government contended, and the Ninth Circuit agreed, that such powers rendered the decedent's life income interest under the trust incapable of valuation as of the transferor's death, and hence ineligible for a tax credit under section 2013. *Id*. at 1290. Those plaintiffs conceded that the trust instrument did not provide a standard for valuation, and instead relied on Arizona law to place limits on the trustees' powers. *Id*. at 1291. The Holbrook court, applying the testator's intent as called for by Arizona law, held:

> To imply from this provision [making the decedent a life beneficiary of the trust income] that the trustees were under an absolute duty to produce income for the life income beneficiaries is to ignore the general plan of the instrument, which … [was] intended to vest the trustees with broad discretion so that they could flexibly manage the trust fund in order to produce a great deal of, or very little, income. … [I]t cannot be said that a decision by the trustees to invest in assets producing little or no income would constitute a remediable abuse of discretion under Arizona law. [*Id*. at 1291-91.]

Holbrook is plainly very different from this case. That instrument expressly contemplated that the trustees could act so as to obtain and pay no income at all for the life estate, and the court found that this was the testator's intent. To the same general effect, see Rev. Rul. 67-53, 1967-1 C.B. 265, 266.

V The end-result for this case is that Mrs. Lloyd's life interest in the Family Trust was sufficiently ascertainable at the time of Mr. Lloyd's death to avoid being held not to be calculable under section 2013. The Trial Division will have to determine the value of her interest (taking the standard we have prescribed as the minimum available to her) and also the amount of tax credit allowable to the estate.[12]

[12] In the section 2055 cases, once an ascertainable standard was found the courts looked to "the remoteness of invasion, or the extent of possible invasion, in terms of the standard, to determine the likelihood that the charity will take and the value of [its interest]." See *Newton Trust Co. v. Comm'r*, 160 F.2d 175, 178-79 (1st Cir. 1947); *Salisbury, supra*, 377 F.2d at 708. It was also held that the extrinsic facts (e.g. financial circumstances) at the testator's death are relevant to the remoteness of invasion (though irrelevant to the existence of an "ascertainable standard"). *Salisbury, supra*, 377 F.2d at 703 n.5 (see note 4, supra). See also Rev. Rul. 70-292, 1970-1 C.B. 187, 188 (similar position for section 2013).

Letter Ruling 8608002 included the following facts:

> Under the will of decedent's predeceased spouse, the residue of the estate passed to an INTER VIVOS trust created by the spouse. Upon the death of decedent's spouse, the corpus of the trust was divided between a "Marital Trust" and "Family Trust" created thereunder.
>
> The Marital Trust provided the decedent with a life estate coupled with a testamentary general power of appointment. In addition, the trustee of the Marital Trust was authorized to invade the trust corpus for the benefit of decedent if the income therefrom was insufficient for decedent's support, maintenance and comfort, or if such payments were otherwise necessary to maintain for decedent the standard of living to which she had become accustomed during married life.
>
> Article Third of the trust instrument contains the provisions specifically pertaining to the Family Trust. Paragraph (b) thereof provides, as follows:
>
>> (b) The net income from the Family Trust shall be paid to or used or expended for the Settlor's wife, ... {decedent named} ..., the Settlor's daughter, ... {daughter named} ..., and any grandchildren of the Settlor living at the time of any such payment, in such shares and amounts (if any such payment shall be made to more than one of the foregoing persons) as the Trustee in its absolute and sole discretion shall determine. In Paragraph (c) of Article Third, decedent's spouse expressed his intention with respect to the payment of income from the Family Trust, as follows:
>>
>> (c) It is the Settlor's intention that the income from the Family Trust shall be expended primarily for the benefit of the Settlor's wife, ... {wife named} ..., unless in the sole judgment and opinion of the Trustee, the Settlor's said daughter, ... {daughter named} ..., or Settlor's grandchildren have real need for any portion of said income. Paragraph (d) of Article Third of the trust instrument provides for the invasion of trust corpus, as follows:
>>
>> (d) If, in the opinion of the Trustee, the income herein provided, together with receipts from other sources, shall not be sufficient to generously support and maintain the Settlor's said wife and suitably to provide for the Settlor's said daughter, or the Settlor's grandchildren, then the Trustee is authorized to use and expend such part of the principal of the Family Trust as it may deem necessary for such purposes.

Letter Ruling 8608002 cited Code § 2013, Reg. §§ 20.2013-1(a), 20.2013-4(a), and 20.2013-5(a) and Rev. Ruls. 67-53, 70-292, and 75-550, then continued:

> In *Estate of Pollock v. Comm.*, 77 T.C. 1296 (1981), the Tax Court held that the discretionary life interest of a transferor's wife in a trust was not susceptible of valuation so as to qualify for the credit under section 2013 of the Code. The transferor's wife was one of three potential income distributees. The other distributees were the transferor's two children. In *Pollock*, a controlling fact was that the discretionary life interest was subject to the trustee's broad power to invade trust principal to enable the transferor's children to engage in a business venture. In addition, the court in Pollock found nothing in the governing instrument which pointed to any intention on the part of the transferor to favor his wife over his children with respect to the payment of trust income. Based primarily upon this finding and upon the trustee's broad power to invade trust principal

for the children, the court concluded that the transferor's wife did not have a fixed right to a determinable portion of the trust income for life and that, therefore, the wife's interest did not qualify for the credit under section 2013 of the Code.

In the instant case, unlike that in *Pollock*, the dispositive provisions of the trust instrument clearly evidence an intention on the part of the transferor to favor his wife over his daughter and grandchildren with respect to the payment of trust income. For example, paragraph (c) of Article Third of the trust instrument specifically provides that the income from the Family Trust be expended primarily for the benefit of the present decedent. The instant case is also wholly unlike *Pollock*, as well as Rev. Rul. 67-53, in that the trustee here has only a limited power to invade trust principal for others. By looking at paragraph (d) of Article Third of the trust instrument in conjunction with paragraph (c) thereof, it is sufficiently clear that the transferor intended to limit the trustee's power to invade trust principal for others to amounts necessary to "suitably provide" for the "real need" of these beneficiaries. Under applicable local law, the trustee was bound by this limitation imposed by the transferor. *In Re Estate of Mendelson*, 391 Mich. 706, 220 N.W. 2d 33 (1974). Further, this limitation constitutes an ascertainable standard which renders the present decedent's life interest susceptible of valuation. *Estate of McCoy v. U.S.*, 511 F. 2d 1090 (6th Cir. 1975).

Estate of Weinstein v. U.S., 820 F.2d 201 (6^{th} Cir. 1987), involved the following facts:

The decedent's husband, Mr. Simon Weinstein, set up an inter vivos trust in May of 1976, twelve days before he died of a heart attack. Under the trust's terms a portion of the trust property equal in value to 50% of Mr. Weinstein's adjusted gross estate was to go into a marital deduction trust on Mr. Weinstein's death. (The value of the trust property ultimately assigned to the marital deduction trust proved to be approximately $194,000.) The widow, who was given a testamentary power of appointment over the principal, was to receive the entire income of the marital deduction trust during her lifetime, and the trustee was authorized to invade the principal, if necessary, in order to maintain her in the standard of living to which she was accustomed. The balance of the assets in the inter vivos trust - a balance that proved to be worth approximately $155,000 - was to be held during the widow's life in a non-marital deduction trust for the benefit of the widow and the couple's two children. After the widow's death the assets in the non-marital deduction trust would go ultimately to the couple's issue. What we are concerned with here is the valuation, at the time of the husband's death, of the widow's interest in the non-marital deduction trust.

The trust instrument declared that it was the settlor's intent that his widow "be adequately provided for," to which end it was provided that the trustee's powers "shall be liberally construed insofar as allowing the said Trustee to distribute any and all amounts of the income or principal of [the non-marital deduction trust] for [the widow's] benefit so as to allow Settlor's said spouse to continue to maintain herself in the manner to which she has been accustomed throughout their married life ...."

The instrument further declared that:

"It is the Settlor's express stated intent that the Settlor is creating [the non-marital deduction trust] primarily for the benefit of the Settlor's spouse, and the needs and wishes of the Settlor's children ... shall be deemed secondary to the needs and wishes of the Settlor's spouse. In determining whether or not to make distributions

> and the amount to be distributed, the Trustee shall consider only the net income payable hereunder with such other income as the spouse may have from all other sources ... but it shall not take into consideration any property owned by the spouse except to the extent of the spouse's need of income or principal to maintain the same. It is the further general intent of Settlor that the principal of the [non-marital deduction trust] herein created not be depleted in favor of Settlor's spouse until the principal from the marital trust is exhausted. Furthermore, the Trustee does have the power to accumulate the income hereunder, but it is the general intent but not absolute direction of Settlor that in the event the spouse of Settlor does not reasonably need the income so produced, then the income shall be distributed to Settlor's named issue ... so as to avoid an accumulation of income in said [non-marital deduction trust]."

The Trustee was given broad powers to invest, reinvest, manage and administer the assets of the trust, all of which powers, according to the terms of the trust instrument, "shall be exercised in a fiduciary capacity." The trustee was also empowered to make such distributions of income and principal from the non-marital deduction trust to the beneficiaries thereof (the widow and children) "as the Trustee, in the exercise of the Trustee's sole and uncontrolled discretion, may determine." This language is followed immediately by that first quoted above, to the effect that "[i]t is the intent of the Settlor that Settlor's spouse be adequately provided for ...."

The record indicates that at the time of the settlor's death his wife, who was not employed outside the home, had no sources of income other than social security, the marital deduction trust, and the non-marital deduction trust.

The government took the position that the value of the widow's interest in the non-marital deduction trust could not be determined because the trustee had the power to invest the assets of that trust in non-productive assets, to invade principal for the benefit of the children, to accumulate any income that might be realized, and to distribute any such income to the children rather than to the widow.

The widow's estate took the position that the husband's intent had been to enable his wife to enjoy her customary standard of living during the remainder of her life. The estate retained Mr. Thomas Custis, a Fellow of the Society of Actuaries, to "make a definitive determination" of the fair market value of the widow's interest in the non-marital deduction trust, assuming that the husband's intent had been as described. A copy of the actuary's report was attached to the complaint with which the widow's estate commenced this lawsuit; on the basis of the valuation set forth in the report, the estate is seeking an estate tax refund of slightly over $16,000.

The actuary - presumably after making inquiry into the widow's customary standard of living - concluded that "it is highly unlikely that [the widow's] income from the Marital Trust and Social Security would be adequate to meet her needs." He further concluded that "it is appropriate to assume a 90% probability that the income from the Non-marital Trust would be paid to Mrs. Beatrice Weinstein during her lifetime." The actuary thought it unlikely that the principal of the non-marital deduction trust would be invaded, given the provision prohibiting depletion of the principal of that trust before exhaustion of the principal of the marital deduction trust, and he assumed that the non-marital deduction trust (and, presumably, the other trust as well) would earn a return of six percent per annum. Using these and other assumptions that he considered reasonable in light of all

> the facts available at the time of the husband's death, and taking into account the age of the widow at that time, the actuary stated that in his professional opinion Mrs. Weinstein's interest in the non-marital deduction trust had a fair value, as of the date of the husband's death, of $81,906.33. The government does not deny that the estate would be entitled to a $16,000 refund if the actuary is correct.

Estate of Weinstein v. U.S., 820 F.2d 201 (6th Cir. 1987), reasoned and held that the Code § 2013 credit was allowable because "it was not impossible to arrive at a rational valuation of the widow's interest":

> The government conceded that the regulations adopted under §2013 of the Internal Revenue Code provide, under certain circumstances, for the granting of an estate tax credit in respect of "the prior ... transfer of a life estate to the decedent, even though such a life interest is not included in the present decedent's estate and ... therefore, is not subject to federal estate taxes." As the government pointed out, however, the regulations governing the value of such a life interest provide that "the value of the interest is determined as of the date of the transferor's death *on the basis of recognized valuation principles* ...." 26 C.F.R. § 20.2013-4(a). (Emphasis supplied). If the interest is subject to contingencies that make it incapable of valuation in accordance with "recognized valuation principles," the government argued, it is well established that there can be no credit; see, among other authorities, Rev. Rul. 67-53, 1967-1 C.B. 265. Citing *Detroit Bank & Trust Co. v. United States*, 338 F.Supp. 971 (E.D. Mich. 1971), *affd.*, 72-2 U.S.T.C. ¶12,886 (6th Cir. 1972), the government noted that "the courts have examined both the trust instrument and applicable state law to determine whether or not there existed a standard which so controls the trustee's discretion that the value of the interest in question is susceptible of valuation as of the transferor's death."
>
> The government's analytical approach is, we believe, correct. If, under the terms of the trust instrument and applicable state law, there is an ascertainable standard by which the trustee's discretion is controlled, and if it is possible, in the light of that standard, to make a reasonable estimate of the value of the transferee-decedent's interest as of the time of the transferor's death, the decedent's estate is entitled to the benefit of the §2013 credit. If the trustee's discretion is so unrestrained that there is no reasonable way of placing a value on the decedent's interest, the §2013 credit is not available. Accordingly, we must determine what the trust instrument actually says and what discretion the trustee actually has under the governing state law. The trust instrument was executed in Michigan, and it says that its provisions are to be construed in accordance with the laws of that state, so it is to the law of Michigan that we must turn.
>
> In Michigan, as elsewhere, "the court's sole objective is to ascertain and give effect to the intent of the testator or settlor." *In re Nowels Estate*, 339 N.W.2d 861, 863 (Mich.App. 1983). In determining that intent, the court must look to the trust document and "construe the instrument so that each word contained therein has meaning, if it is possible to do so." *Detroit Bank & Trust Co. v. Grout*, 289 N.W.2d 898, 905 (Mich. App. 1980).
>
> These principles are clearly dispositive of the government's argument that the breadth of the trustee's investment powers makes it impossible to determine the value of the widow's interest because of the possibility that the trust assets might be invested in non-income-producing property. The powers vested in the trustee are no broader than those customarily granted in trusts of this kind, and the trust instrument expressly provides that

all of the trustee's powers "shall be exercised in a fiduciary capacity." In executing the trust, Mr. Weinstein said in so many words that he intended that his wife "be adequately provided for," and he said in so many words that he was creating the non-marital deduction trust "primarily for the benefit of [his] spouse" and only "secondarily" for the benefit of his children and their issue. We must accept as true, at this juncture, the representations that the widow had no extra-trust income other than social security, and that social security alone would not meet her needs. For the trustee to leave the widow in want and to try to further the interests of the children at her expense by investing the trust estate in non-productive assets would be a clear breach of the trustee's fiduciary duty. See *Matter of Estate of Butterfield*, 341 N.W.2d 453, 459 (Mich. 1983).

The government makes a somewhat more plausible argument that the widow's interest in the non-marital deduction trust cannot be valued rationally because the trustee is authorized to pay over to "any" beneficiary of that trust, including the children, "such amount of the income and/or principal ... as the Trustee, in the exercise of the Trustee's sole and uncontrolled discretion, may determine." The Michigan Supreme Court has held, however, that notwithstanding an express grant of "uncontrolled discretion" to the trustee in determining how much of the income of a trust shall be paid out, the trustee must still exercise his discretion in accordance with any standards set forth in the trust instrument or reasonably inferable from its terms. *In re Estate of Mendelson*, 220 N.W.2d 33 (Mich. 1974). The Michigan Supreme Court squarely held in that case that a provision for the "proper maintenance [of a beneficiary], according to her standard of living" established such a standard. *Id.* at 35.

So it is in the case at bar. The trust instrument that is before us may not be a model to be emulated as far as its draftsmanship is concerned, but taken as a whole it clearly manifests an intent to provide, first and foremost, for the maintenance of the settlor's widow in the manner to which she had been accustomed throughout her married life. Using that standard, it ought to be possible to arrive at a reasonable estimate of the widow's needs. We know that if all of the trust assets were invested at six percent, and if the widow received 100% of the income from the marital deduction trust and 90% of the income from the non-marital deduction trust, her total income from both trusts would be approximately $20,000 per year. The record does not disclose how much additional income she received from social security, and all of these matters can be explored more fully by the trial court on remand, but it is probably unlikely that a closer examination of the facts will disclose any great disproportion between the widow's total income and her actual needs as measured by the standard set forth in the trust.

The situation presented in the case at bar is strikingly similar to that in *Estate of Lloyd v. United States*, 650 F.2d 1196 (Ct.Cl. 1981). There, as here, the decedent's estate claimed a § 2013 tax credit in respect of trust property in which the decedent had been given an equitable life interest by her late husband. There, as here, the government contended that the widow's interest could not be valued because the trustee was empowered to pay out of the principal of the trust, to any member of a class that included the widow but was not limited to her, such sums as the trustee "in its sole and uncontrolled discretion" might deem necessary or advisable. 650 F.2d at 1201. There, as here, the dispositive provisions of the instrument creating the trust showed that the husband's "primary concern was for the welfare of his surviving widow," for whom the husband wished to insure "a standard of living appropriate to her station in life." Id. The Court of Claims recognized, as we do, that "[i]t is implicit ... in the statute and the regulations that a life estate or other property for which credit is sought under section

> 2013 must be rationally capable of valuation at the transferor's death," id. at 1199, but the court rejected the government's contention that the power to invade trust principal for the benefit of persons other than the widow rendered her interest in the trust incapable of valuation under the "ascertainable" standard. Id. at 1202. We reach the same conclusion here, and we see nothing to the contrary in *Holbrook v. United States*, 575 F.2d 1288 (9th Cir. 1978), *Estate of Pollock v. Commissioner*, 77 T.C. 1296 (1981), or the other cases on which the government relies. Because the power to accumulate income and the other powers cited by the government must also be exercised in the light of the primary intent of the settlor to provide for the maintenance of his widow in accordance with her past style of living, the existence of those powers does not alter our conclusion.
>
> The conclusion that the widow's interest in the non-marital deduction trust can be valued "on the basis of recognized valuation principles" finds confirmation, we believe, in Rev. Rul. 70-292, 1970-1 C.B. 187. There it was held that a §2013 credit was allowable notwithstanding that the trustee was empowered to divert to a third party such trust income as the trustee "deems necessary" for "comfort, support, hospital or medical expenses." The ruling states that the "accustomed manner of living" of the third party, although not expressly referred to in the trust instrument, provided an "ascertainable standard" that would govern the exercise of the trustee's discretion. Accord, Rev.Rul. 75-550, 1975-2 C.B. 357.

Letter Ruling 9644053 included the following facts:

> 2. THE ANNUITY AGREEMENT. The agreement provides that, upon the effective date of the agreement, B will make an initial payment to an irrevocable trust, described below, created for the benefit of A. Also, B will make annual payments to the same trust during A's life. The amount of the annual payments will vary depending on a formula that will take into account the value of certain of A's assets held by, on behalf of, or in trust for A at a specified time prior to each payment date. The agreement also provides for additional payments upon the happening of certain contingencies and provides for penalties and remedies upon default. The annuity agreement is secured by the guarantee of payment described below, which, in turn, is secured by the Deed of Trust, also described below. The payments will terminate at A's death. If B predeceases A, the agreement provides that B's estate will be liable for all future payments.

Letter Ruling 9644053 addressed whether, if B predeceases A, the total of the outstanding payments that B's estate is obligated to pay to A under the Annuity Agreement constitutes a claim against B's estate that will qualify for a deduction under section 2053:

> Section 20.2053-1(b)(3) of the Estate Tax Regulations provides that an item may be entered on a return for deduction though its exact amount is not then known, provided it is ascertainable with reasonable certainty, and will be paid. No deduction may be taken upon the basis of a vague or uncertain estimate. If the amount of the liability was not ascertainable at the time of final audit of the return by the district director and, as a consequence, it was not allowed as a deduction in the audit, and subsequently the amount of the liability is ascertained, relief may be sought by a petition to the Tax Court or a claim for refund as provided by sections 6213(a) and 6511, respectively.
>
> Section 20.2053-4 provides that the amounts that may be deducted as claims against the decedent's estate are such only as represent personal obligations of the decedent

existing at the time of death, whether or not matured, and interest thereon which had accrued at the time of death.

If B predeceases A, under the terms of the Annuity Agreement, A will have a claim against B's estate for the annual payments to A for the remainder of A's life. B's obligation to pay the annual amount is a full recourse obligation that will not terminate until A's death and, thus, a personal obligation of B. The claim will be an integral part of the Marital Settlement Agreement that will be filed in and approved by the appropriate local court having jurisdiction over administration of the estate. Thus, the obligation will be an enforceable obligation under the law of the appropriate jurisdiction.

In addition, in order to be deductible under section 2053, the claim must have been founded upon a bona fide agreement entered into for adequate and full consideration. Under section 2043(b)(2), property transferred in settlement of marital rights will be deemed to have been transferred for adequate and full consideration for purposes of section 2053 if the provisions of section 2516 are satisfied. In Issue #2, above, we concluded that the transfer, pursuant to the Marital Settlement Agreement, from B to A of the right to payments under the Annuity Agreement will not constitute a transfer subject to the gift tax under section 2516 if the divorce occurs within the applicable 3-year period. Thus, since the payments under the Annuity Agreement are deemed to be made for adequate and full consideration, a claim for those payments will qualify as a deductible claim under section 2053 provided the divorce occurs within the applicable time period and provided the amount of the claim is ascertainable.

In this case, a specified amount will be paid upon the effective date of the Annuity Agreement followed by annual payments during B's life. The actual amount of the successive annuity payments under the agreement are determined under a formula that bases the amount to be paid each year on the excess of a specified amount, which changes periodically, over A's "excess ready reserves," as determined at the time for payment. The term "excess ready reserves" generally means the excess of A's liquid assets (less the amount attributable to the sale of any residence of A) over a specified amount. Additional payments may be made if certain contingencies are satisfied.

The value of the decedent's estate is generally determined as of the decedent's date of death. *Ithaca Trust Co. v. United States*, 279 U.S. 151 [(1929). If the decedent, as of the date of death, had a right to receive payments for a term of years or for the life of another person, the present value of that stream of payments would be determined under sections 2031 and 7520 and would be includible in the decedent's gross estate. Conversely, if the decedent was legally obligated to pay a sum certain for a term certain or the life of another individual, the present value of the stream of payments, determined under sections 2031 and 7520 as of the date of the decedent's death, would generally qualify as a deductible claim against the decedent's estate under section 2053, assuming the other requirements of section 2053 are satisfied.

Under section 2053, a claim may be deducted on the return even if the exact amount of the claim is not then known if the amount is ascertainable with reasonable certainty and will be paid. No deduction may be taken upon a vague or uncertain estimate. Where the value of a claim can be determined and the claim is legally enforceable at the time of death, a deduction is allowable for the present value of that claim at the date of death. In *Propstra v. United States*, 680 F.2d 1248, 1254-1257 (9th Cir. 1982), the court applied the date-of-death valuation principle enunciated in *Ithaca Trust Co. v. United States*, *supra*, to lien claims that were for a sum certain and legally enforceable at the date of death. Even though the claims were later settled for less than the amount deducted, the court allowed the estate to deduct the full amount of the subsequently compromised lien claims. However, the court stated at page 1253 that “post-death events are relevant when computing the deduction to be taken for disputed or contingent claims.” In *Estate of Van Horne v. Commissioner*, 720 F.2d 1114 (9th Cir. 1983), the court held that where the claims are legally enforceable, the actuarial value at the date of death is deductible even though subsequent events establish that a lesser amount was actually paid.

In situations where claims against an estate are only potential, unmatured, contingent, or contested at the date of death, courts have concluded that post-death events can be the best evidence of the date-of-death value of the claim. See *Estate of Van Horne*, *supra*, at 734-739; *Estate of Kyle v. Commissioner*, 94 T.C. 829, 849 (1990); and *Estate of Cafaro v. Commissioner*, T.C. Memo. 1989-348.

Post-death events are also taken into account when a claim becomes unenforceable after the date of death. In *Estate of Sachs v. Commissioner*, 856 F.2d 1158 (8th Cir. 1988), the court held that no deduction was allowed for a claim that, after the decedent’s death, ceased to exist legally because Congress amended the law even though the change in the law was not foreseeable at the time of the decedent’s death. See also *Jacobs v. Commissioner*, 34 F.2d 233 (8th Cir. 1929). The Tax Court has also adopted this line of reasoning. See *Estate of Theis v. Commissioner*, 81 T.C. 741 (1983), *aff’d*, 770 F.2d 981 (11th Cir. 1985); *Estate of Hagmann v. Commissioner*, 60 T.C. 465, *aff’d*, 492 F.2d 796 (5th Cir. 1974); and *Estate of Cafaro*, *supra*. In *Estate of Chesterton v. United States*, 551 F.2d 278 (Ct. Cl. 1977), the Court of Claims used the post-death approach in determining the value of alimony payments payable until remarriage because the spouse remarried after receiving only 9 payments.

Consequently, where a claim is uncontested and legally enforceable, but the amount that will finally be paid under the claim may vary depending on factors that cannot be foreseen, for purposes of section 2053, the claim will be valued based on its actuarially determined present value at the date of death, which will include consideration of post-death events as evidence of that present value.

Even though an interest may include a contingency that precludes the determination of its present value by the mere application of actuarial formulas, that interest may still be valued under general valuation rules. In determining the value in such a case, consideration must be given to all known circumstances relative to the particular interest being valued. See Rev. Rul. 61-88, 1961-1 C.B. 417. In Rev. Rul. 75-550, 1975-2 C.B. 357, for purposes of section 2013, an income interest for the life of the beneficiary was valued by taking into account all possible invasions from corpus on a year-to-year basis. In that case, the history of financial need and current expenditures of the beneficiary were taken into consideration in determining whether and to what extent the corpus may be invaded to meet the future needs of the beneficiary. Thus, the present value of the beneficiary’s life estate at its creation was determined by consideration of past needs and spending habits.

In the instant case, determination of the present value of the annuity payments is particularly difficult due to the formula that bases the annual amount on the excess of a specified amount over A’s “ready reserves.” As described above, the amount of A’s “ready reserves” will vary each year based on A’s expenditures during the preceding year. If B predeceases A, at the time of B's death, A will have a history of expenditures and payments computed under the Annuity Agreement. At that time, this history of payments will be relevant in computing A's future needs and, consequently, payments under the agreement. Thus, because the claim will be uncontested and legally enforceable with the amount of the annual payments subject to speculation, the present value of those payments may be determined at B's death.

In addition, the value of the annuity payments that will qualify as a deductible claim may also be influenced by post-death events, such as the number and amount of payments actually made. After considering post-death events, if the amount of the payments actually made is less than the date-of-death value described above, the claim will be allowed to the extent of the payments actually made.

Accordingly, a claim for the present value of the payments determined at B's death will qualify as a claim against B's estate for which a deduction under section 2053 will be allowable, assuming the other requirements of section 2053 are satisfied, not to exceed the payments actually made under the Annuity Agreement.

Conclusion:

If B predeceases A, a deduction under section 2053(a)(3) will be allowable as a claim against B's estate for the present value, as of the date of B's death, of the future payments to A by B's estate under the Annuity Agreement. However, any allowable deduction will be limited to the amount of the payments actually paid, not to exceed the present value of the payments computed as of B's date of death.

III.B.1.f. Self-Canceling Installment Notes

A self-canceling installment note (SCIN) involves a sale of property to a buyer in exchange for an installment note that expires upon a certain cancellation event.[6408] Typically, an older family member sells to a younger family member and the cancellation event is the seller's death.[6409] When the obligation to make payments on the SCIN ceases upon the seller's death, nothing of value exists to be included in the seller's gross estate. Thus, the unpaid purchase price and future appreciation in the property are excluded from the gross estate.[6410]

Other advantages of a properly structured SCIN include: the avoidance of gift tax, possible increased liquidity for the seller, the ability to completely secure the property, the ability to use capital losses and possibly give the buyers an increased basis in the transferred property (compared with a gift), and the seller's ability to spread income out over time.

[6408] For a comprehensive discussion, see Akers, SCINs and Private Annuities: Disappearing Value or Disappearing Strategies? *Heckerling Institute on Estate Planning* 2015. That would be a more helpful starting point than my materials.
[6409] The cancellation event could also be the buyer's death, the first to die of the buyer and seller, or the death of a third party.
[6410] However, any delinquent payments will be included in the gross estate.

Disadvantages of using a SCIN include: questions regarding stepped-up basis at death, a finite term of payments, restrictions on alienability of the sold property for two years,[6411] and potential income from discharge of indebtedness.

For the arrangement to be characterized as a SCIN, buyers and sellers have to maintain the form and substance of a SCIN. Since SCINs are transactions between family members, strict scrutiny applies and the transactions are presumed to be gifts. To rebut this presumption, taxpayers must show a genuine intent and expectation that payment be made.[6412] To avoid inclusion of the value of the property in the gross estate under Code § 2036, the seller cannot retain an interest in the property.[6413] Also, the loan's terms must cancel the note at death; a bequest of a note is not a SCIN.[6414] Although the SCIN term need not be the seller's life, the chosen term cannot exceed the seller's life expectancy; if it does, the SCIN might be re-characterized as a private annuity.[6415]

Most importantly, the buyer has to pay a premium to the seller as compensation for the chance that the seller may die before full payment is received.[6416] If this risk premium is too low, the IRS might re-characterize the transaction as a bargain sale or part gift.[6417] Traditionally, estate planners use Code § 7520 interest and mortality rates to set this premium; however, CCA 201330033 asserted:[6418]

> We do not believe that the § 7520 tables apply to value the notes in this situation. By its terms, § 7520 applies only to value an annuity, any interest for life or term of years, or any remainder. In the case at hand, the items that must be valued are the notes that decedent received in exchange for the stock that he sold to the grantor trusts. These notes should be valued based on a method that takes into account the willing-buyer willing-seller standard in § 25.2512-8. In this regard, the decedent's life expectancy,

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[6411] Code §453(e) (accelerates income if the buyer sells the property within two years after an installment sale).

[6412] *Estate of Costanza v. Commissioner*, 320 F.3d 595, 597 (6th Cir. 2003).

[6413] See *Cain v. Commissioner*, 37 T.C. 185, 187-188 (1961) (stock not included in gross estate where the seller divested herself of all title to and control over the stock), *acq*. 1962-2 C.B. 4.

[6414] *Estate of Buckwalter v. Commissioner*, 46 T.C. 805, 816-817 (1966).

[6415] GCM 39503 (1986).

[6416] See *Estate of Moss v. Commissioner*, 74 T.C. 1239, 1246-47 (1980) (full consideration for SCIN includes consideration for the cancellation provision; court held no inclusion in estate but did not discuss how to value the cancellation provision), *acq. in result*, 1981-2 C.B. 2 (acquiesce that notes were excluded from gross estate without necessarily agreeing with the court's reasoning). Although the IRS has not provided guidance on how to calculate this premium, it is usually calculated using the actuarial likelihood that the seller will die during the term of the trust using IRS life expectancy tables as indicated in Reg. § 20.2031-7.

[6417] See *Estate of Berkman v. Commissioner*, 38 T.C. Memo 1979-46 ([T]he difference between the amount of each transfer and the fair market value of each promissory note given in exchange constitutes a taxable gift.).

[6418] CCA 201330033 involved Brad Poston, indicating that the IRS had its top people involved in this ruling. My understanding is that this case involved a $2.6 billion deficiency and was docketed in the Tax Court: *Estate of William M. Davidson v. Commissioner*, Docket No. 013748-13, https://www.ustaxcourt.gov/UstcDockInq/DocketDisplay.aspx?DocketNo=13013748, that each of the taxpayer and IRS retained two medical experts, and that all four experts concluded that, at the time of the transactions, the transferor had a greater than 50% chance of living for more than 12 months. On July 6, 2015, the court entered a stipulated judgment, increasing the transfer tax assessed from the $168.5 million shown on the return to $320.5 million – a substantial increase but the $152 million stipulated deficiency was only a small fraction of the asserted deficiency.

> taking into consideration decedent's medical history on the date of the gift, should be taken into account. I.R.S. Gen. Couns. Mem. 39503 (May 7, 1986).

GCM 39503 had commented on SCINs:

> …unlike the private annuity, there is no requirement that the actuarial tables are to be used in determining the gift taxation of installment sale. Thus, the taxpayer's particular health status may be considered, and there is more room to establish that the terms of the sale are reasonable. See S. Banoff and M. Hartz, "Sales of Property: Will Self-Cancelling Installment Notes Make Private Annuities Obsolete?," 59 *Taxes* 499 (1981); E. Schnee, "Cancelling a Debt Correctly Can Give Rise to Estate and Gift Tax Advantages," 8 *Est. Plan.* 276 (1981).

At least one noted commentator has vigorously asserted that the CCA is wrong. He points out that it is inconsistent with the position that the IRS has taken in valuing lottery winnings. Note that Code § 7520 was enacted after GCM 39503 was issued, so the GCM and its related Revenue Ruling did not address Code § 7520. Nevertheless, if one is concerned about the CCA's and GCM's position, one might consider using a private annuity, which is discussed in part III.B.1.g Private Annuities.

A properly structured SCIN will pre-empt inclusion of the property in the seller's gross estate. Gift tax will also be averted if the SCIN's value - including the premium for self-cancellation - equals the value of the property transferred.[6419] Also, Chapter 14 should not apply to a properly structured SCIN.[6420]

For the buyer's income tax purposes, since a SCIN is an installment sale, the buyer should be able to deduct whatever part of each payment represents deductible interest, if the property purchased is an investment or a trade or business. The buyer's basis should be the property's full stated price.[6421] A more complicated issue is whether buyers recognize gain based on cancellation of indebtedness[6422] when the seller dies. Although it seems unfair to tax both the buyer and seller (as discussed below) on this gain, to date there has been no decision on this issue; however, the better view is that the buyer does not recognize income. In addressing the issue of the buyer's basis, courts and the IRS assumed that the buyer's basis would increase without a corresponding income recognition unless the seller or seller's estate recognizes income.

[6419] See *Wilson v. Commissioner*, T.C. Memo. 1992-480 (1992). The premium for the cancellation feature is based on § 7520 rules and IRS actuarial tables if the seller is not terminally ill. See note 6438.

[6420] See Letter Ruling 9436006 (1994) (neither §2701 nor § 2702 applied to a note because debt is not a retained interest in a trust).

[6421] GCM 39503 (1986). See *Frane v. Commissioner*, cited at fn. 6424, at 570-71. It has been suggested that regulations on contingent payments indicate that basis in a SCIN builds as payments come due because one cannot rely on the scheduled payments (Regs. §§ 1.483-4(b), 1.1275-4(c)(5)(iii)). However, under Reg. § 1.1272-1(c)(2), an alternative payment schedule applies only if, based on all the facts and circumstances as of the issue date the alternative payment schedule is significantly more likely than not to occur. Because a properly structured SCIN has a term that is less than life expectancy, it would be practically impossible for an alternate payment schedule to be significantly more likely than not to occur.

[6422] Code § 61(a)(12).

The seller of property for a SCIN pays income tax on the receipt of payments according to the installment method (unless the seller opts out of it).[6423] In *Estate of Frane v. Commissioner:*[6424]

- The Tax Court in a reviewed case held that cancellation upon death caused the decedent's final return to report income with respect to the installment obligation that was cancelled, and the Eighth Circuit affirmed regarding recognition but reversed in that the Eighth Circuit held that the estate reported the income rather than being reported on the decedent's final return.[6425] The dissent in the Tax Court claimed that income should not be realized because no payments are due after death that can be cancelled.[6426] The dissent further suggested a way around the holding by phrasing the exchange as a contingent sale,[6427] but that technique has not been tested in court.[6428]

- When a note is cancelled in a manner that triggers gain, that confirms that the note is not a contingent payment obligation. Because the note is not a contingent payment obligation, the basis of the purchased asset is not affected by cancellation.[6429]

[6423] Code § 453. Interest on deferred tax may apply to transactions aggregating over $5 million. Code § 453A(c). The seller's gain is accelerated if the buyer is a related party and re-sells the property within two years. Code § 453(e). For more special rules, see part II.G.15 Limitations on the Use of Installment Sales.

[6424] 998 F.2d 567 (8th Cir. 1993).

[6425] The Eighth Circuit cited Code § §691(a)(2) and Rev. Rul. 86-72. See part II.G.15 Limitations on the Use of Installment Sales, especially the legislative history cited in fn 1603.

[6426] *Estate of Frane v. Commissioner*, 98 T.C. 341 (1992) (reviewed decision), *aff'd* in part and *rev'd* in part, 998 F.2d 567 (8th Cir. 1993).

[6427] THE PARTIES INTEND THIS TO BE A CONTINGENT PAYMENT SALE. The purchase price of the stock is variable, and will be somewhere between $0 and $141,050, depending upon how long seller lives. A condition precedent to each contingent payment is that seller be alive on the scheduled potential payment date. Consequently, if seller dies before any scheduled potential payment, the obligation to such payment does not come into existence.

[6428] Another possible route to avoid *Frane* is to use an irrevocable grantor trust as the transferee and argue that death cannot be a cancellation event since no realization event occurs during life. See fn 6591 in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System.

[6429] In *Frane*, the Eighth Circuit noted:

> In addressing "Death Terminating Installment Sales," the IRS General Counsel[5] acknowledges that generally a taxpayer may not increase its basis in property "to reflect obligations it assumed in acquiring the property which are contingent or indefinite." Gen. Couns. Mem. 39,503 (May 7, 1986). This reasoning would lead to the conclusion that the Frane children's' basis in the property is the principal they actually paid. However, the memorandum concludes that the obligor of a self-cancelling installment note has a basis in property purchased with the note equal to the note's face value. Interestingly, the General Counsel's reasoning is that since section 453B will tax the obligee on the amount of appreciation, the obligor should get the benefit of an increased basis. This argument is, of course, circular in our case, for the Franes have tried to establish that section 453B cannot tax the obligee because the obligor will not receive the benefit of an increased basis. The General Counsel's reasoning is nevertheless instructive, because the injustice the Franes complain of only occurs if the treatments accorded the obligor and obligee are inconsistent. The General Counsel's memorandum shows that the plain language of sections 453B and 691(a)(5) can be applied to make the obligee recognize gain, a consistent treatment can be afforded the obligor, and no injustice results.
>
> [5] Although the Internal Revenue Service has yet to issue regulations on determining an obligor's basis in property purchased with a death-terminating installment note, most commentators agree that the obligor's basis is the face amount of the note, whether the note is self-cancelling or is

Because increasing the principal adds to the potential income tax issues at death described above, charging a higher interest rate seems preferable. Although intra-family loans tend to pay interest annually, note that, in a SCIN, the seller might die before receiving an interest payment. Consider making the interest payments monthly, as was done in *Costanza*, so that the seller actually receives the benefit of the interest payment.[6430]

A SCIN is a good planning technique when the seller wants security, the buyer has means to make payments, the buyer wants an interest deduction, the buyer plans to hold the property for at least two years, the seller's income tax bracket is relatively low, and estate tax bracket is relatively high. Although having the means to repay a promissory note is always important, consider that the mortality premium increases the cash flow paid to seller and that the IRS would argue for testing the cash flow assuming that the seller lived to the life expectancy used in determining the mortality premium;[6431] therefore, consider making sure that the buyer has outside funds to be able to pay the mortality premium.

III.B.1.g. Private Annuities

III.B.1.g.i. Private Annuities: Estate Planning Implications

Generally, a private annuity is a transfer of property for the transferee's unsecured promise to make specific, periodic payments to the transferor for the rest of the transferor's life.[6432] In distinguishing private annuities from installment sales (and therefore also SCINs), IRS has stated:[6433]

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canceled gratuitously by the obligee. See 2 New York University Institute on Federal Taxation section 48.03[5] (1985); John A. Warnick & Brian C. Ellis, Private Annuities, 195-3rd Tax Management 23 (1984); Roszak, *supra* note 1, at 24; Banoff & Hartz, *supra* note 1, at 506; Pinzur & Beskin, *supra* note 1, at 408; Sheldon I. Banoff & Michael O. Hartz, Self-Cancelling Installment Notes: New IRS Rulings Expand Opportunities, 65 J.Tax'n 146, 151 (1986). But see Oetgen, *supra* note 2, at 605 (arguing that tax policies would be better served by giving obligor "basis only for his out-of-pocket costs," at least up to the time when the note is canceled); Robert J. Onda, Self-Cancelling Installment Sales: An Income Tax and Estate Planning Evaluation, 36 U. Fla. L. Rev. 1021, 1044 (1984) (upon cancellation, obligor's basis should be adjusted downward).

[6430] CCA 201330033.

[6431] CCA 201330033.

[6432] For a comprehensive discussion, see Akers, SCINs and Private Annuities: Disappearing Value or Disappearing Strategies? *Heckerling Institute on Estate Planning* 2015. That would be a more helpful starting point than my materials.

[6433] GCM 39503 (1986), the basis for Rev. Rul. 86-72. Additional language from the GCM follows:

ISSUES

(1) Where property is conveyed in return for a contractual obligation to make payments until a specified principal sum has been paid, or until the conveyor's death, whichever occurs first, is the obligation to make the payments treated as an annuity under section 72 of the Code, or as an installment obligation under section 453?

…..

CONCLUSION

(1) (A) We believe that when property is transferred in exchange for a transferee's promise to make periodic payments to the transferor until his death, the transaction should be considered a private annuity.

(B) When property is transferred in exchange for a transferee's promise to make periodic payments until a stated monetary amount is reached, or until the transferor's death, whichever occurs first, the transaction should be considered a private annuity, except as stated below.

….
ANALYSIS
….
ISSUE (1) Clearly, a private annuity can fit literally within this definition of an installment sale. The Committee Reports, however, state that the Act 'does not deal directly' with private annuities. S. Rep. No. 96-1000, 1980-2 CB at 500, n. 12; H.R. Rep. No. 96-1042, 96th Cong., 2d Sess. 10, n. 12 (1980). In our view, this language does not mean that private annuities are not installment sales; rather, it was meant to leave room for the Service to determine what constitutes an installment sale and what constitutes a private annuity. In other words, the Committee meant that the Act does not deal with private annuities as such, but does effectively deal with them to the extent that they are determined to be installment sales.

This brings us to the question of whether the installment sales rules of section 453 of the Code or the annuity rules of section 72 govern the treatment of periodic payments received by a taxpayer who has conveyed property in return for a contractual right to receive payments for a period not longer than the remainder of his life. We start with the premise that the substance of the transaction rather than the parties' characterization of it should control the question. We believe that where the conveyor of property receives a right to periodic payments for the remainder of his life, with no monetary limit provided, as in situation 1, the payments represent an annuity and should be governed by section 72. A stream of payments for life is squarely within the accepted concept of an annuity in our opinion, so the annuity rules in the Code, at section 72, are logically applicable. The Service already appears to have so recognized in Rev. Rul. 69-74, 1969-1 CB 43, which applies section 72 where appreciated property is exchanged for a right to periodic payments for life.

We do not think the 1980 amendment to the installment sales rules requires a different conclusion. While the amendment makes installment sale reporting available where a sale price is contingent, we infer that at least the primary intent of the legislation was to cover cases where the contingency relates to the profitability of the property to the purchaser. [fn: Neither the legislative history nor Temp. Treas. Reg. section 15A.453-1(c) provide specific guidance as to the type of contingencies that are contemplated.] As we have already explained, we believe the statement in the committee reports referring specifically to private annuities confirms our belief that the legislation was not intended to subject private annuity transactions to the installment reporting rules.

Where the stream of payments to which a conveyor of property is entitled will cease upon reaching a monetary limit, or upon his earlier death, as in situations 2 and 3, the question of whether the transaction is an annuity or an installment sale is somewhat closer in our view. While the life-limiting feature of the contractual right to receive payments still militates for annuity treatment, the monetary limit tends to dilute the annuity nature of the transaction and to make it more like the typical installment sale for a fixed consideration. Further, if we treat as annuities all situations in which the payments terminate at the death of the recipient, we would be transforming what are in substance installment sales into annuities in some instances.

Suppose for example that property is transferred in return for the transferee's promise to pay the transferor $1,000x annually, until $10,000x has been paid or until the transferor's death, whichever occurs first. Assume further that the transferor's life expectancy at the time of the sales agreement, determined by reference to Table I.-Ordinary Life Annuities-One Life Expected Return Multiples, Treas. Reg. section 1.72-9, is 30.4 years. Under these facts it is relatively unlikely that an amount less than the agreed maximum price will be paid. Therefore, if we treated this as an annuity, we would be allowing taxpayers to determine the characterization of their transaction by a provision that may have been added only to produce annuity treatment, with small chance of the provision ever coming into play.

In order to avert this problem, we believe that the following approach should be used in determining whether annuity treatment or installment sale treatment is appropriate where there is a monetary limit upon the total amount that will be paid. When the terms of a property transaction are structured so that there is a stated maximum payout that will be achieved in a period less than the life expectancy of the transferor (as determined at the time of the transaction in

> A private annuity is generally an arrangement whereby an individual transfers property, usually real estate, to a transferee who promises to make periodic payments to the transferor for the remaining life of the transferor. A private annuity may also include a transaction whereby the transferee agrees to make periodic payments until a specific monetary amount is reached or until the transferor's death, whichever occurs first. Private annuity arrangements are often used for intra-family transfers whereby an older family member transfers appreciated property to a younger family member in order to gain tax advantages, e.g., removal of the property from the transferor's gross estate….
>
> When the terms of a property transaction are structured so that there is a stated maximum payout that will be achieved in a period less than the life expectancy of the transferor (as determined at the time of the transaction in accordance with Table I, Treas. Reg. section 1.72-9), then the transaction will be characterized as an installment sale with a contingent sales price, and will be treated in accordance with the installment sale rules.

Private annuities offer many of the same advantages as SCINs. The property and its future appreciation are excluded from the gross estate,[6434] probate is avoided, gift tax is avoided, the transferor acquires increased liquidity, wealth is kept in the family, and capital losses can be utilized. Unlike SCINs, the transferor is paid for life, though the payments will be lower since no risk premium is included.

Private annuities also have disadvantages. Private annuities do not allow a step-up in basis at death. Unlike SCINs, the transferee cannot deduct interest payments, and private annuities also have a default risk since they are unsecured. Moreover, private annuities bear the risk that the transferor could outlive actuarial life expectancy, though it may be drafted to cap payments so that they do not extend for more than a short time after life expectancy. Regulations provide:[6435]

> In the case of an annuity payable from a trust or other limited fund, the annuity is not considered payable for the entire defined period if, considering the applicable section 7520 interest rate at the valuation date of the transfer, the annuity is expected to exhaust the fund before the last possible annuity payment is made in full. For this purpose, it must be assumed that it is possible for each measuring life to survive until age 110.

If a trust is the obligor, consider structuring the payment stream so that it is for the lesser of the annuitant's life or a term of years (to avoid using age 110 for the exhaustion test), with the term of years being at least the annuitant's life expectancy, with the life expectancy measure using the longer of the Code § 72 tables and the Code § 7520 tables (to qualify the payment stream as an annuity rather than a SCIN).

> accordance with Table I, Treas. Reg. section 1.72-9), then the transaction will be characterized as an installment sale with a contingent sales price, and will be treated in accordance with the installment sale rules. Hence, in situation 3, supra at page 2, where the seller's life expectancy at the time of the sales agreement is 11 years, and the maximum stated sales price will be reached in 10 years, the transaction will be termed an installment sale rather than an annuity.

[6434] *Hirsh v. United States*, 35 F.2d 982 (Ct. Cl. 1929), excluded from the decedent's estate private annuities payable by his children to him as part of a bargain sale, where the sold property did not secure the annuity.

[6435] Reg. §§ 25.7520-3(b)(2)(i), 1.7520-3(b)(2)(i) and 20.7520-3(b)(2)(i).

Like a SCIN, certain rules have to be followed to have an exchange properly characterized as a private annuity. Because the exchange is between family members, strict scrutiny applies. In order to have the transfer characterized as a private annuity and not as a gift or part gift, the annuity's actuarial value should equal the fair market value of the property.[6436] The annuity's actuarial value is based on the Code § 7520 rate of interest and the transferor's life expectancy.[6437] To determine life expectancy, the actuarial tables should be used unless the transferor is terminally ill. An individual known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50% probability that the individual will die within 1 year; however, if the individual survives for 18 months or longer after the date of the decedent's death, that individual shall be presumed to have not been terminally ill at the date of death unless the contrary is established by clear and convincing evidence.[6438]

To avoid re-characterization of the private annuity as a transfer with a retained life interest, which would be included in the transferor's gross estate under Code § 2036(a), the transferor cannot retain an interest in the property.[6439] When a trust buys from its grantor in an exchange for a private annuity, the Tax Court held that it will look at several factors to determinate whether the transaction might be characterized for income tax purposes as a gift to a trust instead of a sale, including: (1) the relationship between the creation of the trust and the transfer of property to the trust; (2) the relationship between the income generated by the transferred property and the amount of the annuity payments; (3) the degree of control over the transferred properties exercisable by the transferor; (4) the nature and extent of the transferor's continuing interest in the transferred properties; (5) the source of the annuity payment; and (6) the arm's-length nature of the annuity/sale arrangement.[6440] A treatise suggested the following have caused Code § 2036 inclusion:[6441] the transferor retained an interest in the transferred property, the

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[6436] *Estate of Cullison v. Commissioner*, T.C. Memo. 1998-216 (1998), *aff'd* 221 F.3d 1347 (9th Cir. 2000) (unpublished decision). See also *212 Corp. v. Commissioner*, 70 T.C. 788, 798 (1978) (reviewed decision).

[6437] *Cullison*, fn. 6436 (holding that the transitional rules of Reg. § 25.7520-4 required the use of §7520 actuarial rules). Section 7520 regulations require the use of Code § 72 tables for annuities.

[6438] Regs. §§1.7520-3(b)(3), 20.7520-3(b)(3), 25.7520-3(b)(3).

[6439] See *Greene v. U.S.*, 237 F.2d 848, 852-853 (7th Cir. 1956) (transferred securities included in gross estate where transferor retained the right to all income generated by the securities); *Estate of Holland v. Commissioner*, 47 B.T.A. 807 (1942) (transferred stock included in life estate where transferors retained voting rights, transferees could not divest the stock, and the annuity payments were tied to stock value), *acq*. 1942-2 C.B. 9. Rev. Rul. 68-183 (an income tax ruling regarding Code § 677) held that, when annuity payments equaled the current income yield of the entire property held in trust, in substance the sale constituted a contribution of the sold property to the trust with a reservation by the grantor of annual payments of a fixed amount for life. Rev. Rul. 79-94 applied Code § 2036 to a more complicated set of facts with a similar theme.

[6440] *Weigl v. Commissioner*, 84 T.C. 1192, 1225-26 (1985) (reviewed decision) (income tax case holding that a transfer to trust does not create an annuity where the transferor effectively controls the trust). An attempt to dispose of a family limited partnership interest using a private annuity was ignored when the children who promised to pay the annuity were not expected to use their own funds to make the payments. *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278; the resulting estate tax inclusion provided a basis step to the partnership that held the partnership at death (without using a Code § 754 election – see part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000) – as described in fn. 1574, found in part II.G.8 Code § 165(a) Loss for Worthlessness; Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy. Sloppy documentation using foreign trusts lost the day for the taxpayer in *Melnik v. Commissioner*, T.C. Memo. 2006-25, responding to a taxpayer's attempt to rely on *Fabric* and *Stern*, cited in fn. 6442.

[6441] 805 *T.M.* V.A.3.c.

transferee is not personally liable for the annuity payments, the annuity payments have been secured, the transferee has no independent financial means from which to make annuity payments, the transferee's annuity payments are identical or substantially similar to the income generated from the transferred assets, and the possibility that the transferee would ever be called upon to make annuity payments from the transferee's own funds is remote. The 2008 regulation change determining estate inclusion for GRATs, T.D. 9414, included the following explanation in the preamble:

> With regard to the position of certain taxpayers that the full and adequate consideration exception under section 2036 is satisfied when the present value of the remainder interest is zero, the IRS and Treasury Department believe that this exception to section 2036 does not apply. There is a significant difference between the bona fide sale of property to a third party in exchange for an annuity, and the retention of an annuity interest in property transferred to a third party. In the bona fide sale, there is a negotiation and agreement between two parties, each of whom is the owner of a property interest before the sale; each uses his or her own property to provide consideration to the other in exchange for the property interest to be received from the other in the sale. When the transferor retains an annuity or similar interest in the transferred property (as in the case of a GRAT or GRUT), the transferor is not selling the transferred property to a third party in exchange for an annuity because there is no other owner of property negotiating or engaging in a sale transaction with the transferor. The transferor, instead, is transferring the property subject to a retained possession and enjoyment of, or right to, the income from the property. If the grantor retains the interest for life, for any period not ascertainable without reference to the grantor's death, or for a period that does not in fact end before the grantor's death, the property is subject to inclusion in the grantor's gross estate under section 2036.

Courts (primarily the Ninth Circuit and cases appealable to it, as well as the Seventh Circuit) have upheld properly structured annuity sales to trusts.[6442] A trust should have significant seed money before buying from its grantor in exchange for a private annuity.[6443] The IRS has

[6442] *Estate of Fabric v. Commissioner*, 83 T.C. 932 (1984); *Stern v. Commissioner*, 747 F.2d 555 (9th Cir. 1984), *rev'g* 77 T.C. 614 (1981). In *Fabric*, the corporate trustee personally guaranteed payment of the annuity, worth $1,215,000, by a trust with $750 of initial funding; because the case was appealable to the Ninth Circuit, which had reversed the Tax Court in *Stern* and *LaFargue* (income tax case in fn. 6729), the Tax Court held that the guarantee and other issues sufficed to require it to respect the annuity agreement, despite sloppiness in execution of the plan. In an income tax case (also appealable to the Ninth Circuit) that had followed *LaFargue*, *Benson v. Commissioner*, 80 T.C. 789 (1983) respected an annuity with a present value of over $177,500 when the trust was funded with only $5. Careful documentation can convince the court that the obligors had the ability to pay and that the seller wanted to receive the payments. *Kite v. Commissioner*, T.C. Memo. 2013-43.

[6443] Gans and Blattmachr, Private Annuities and Installment Sales: *Trombetta* and Section 2036, 120 *Journal of Taxation* 227 (May 2014), focusing on *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958), and trying to distinguish *Trombetta* (fn. 6446) from *Ray v. U.S.*, 762 F.2d 1361 (9th Cir. 1985).

Fidelity-Philadelphia is often cited for the proposition that providing another source for paying an annuity, such as a personal guarantee, causes the annuity to be respected as not constituting a retained interest in the trust. Here are the facts (footnotes omitted):

> The question before the Court is whether the proceeds of certain insurance policies on the life of the decedent, payable to named beneficiaries and irrevocably assigned by the insured, should be included in the estate of the decedent for the purposes of the federal estate tax. The facts are not in dispute. In 1934 decedent, then aged 76, purchased a series of annuity-life insurance policy

combinations. Three single-premium life insurance policies, at face value of $200,000, $100,000, and $50,000, respectively, were obtained without the requirement of a medical examination. As a condition to selling decedent each life insurance policy, the companies involved required decedent also to purchase a separate, single-premium, nonrefundable life annuity policy. The premiums for each life insurance policy and for each annuity policy were fixed at regular rates. The size of each annuity, however, was calculated so that in the event the annuitant-insured died prematurely the annuity premium, less the amount allocated to annuity payments already made, would combine with the companion life insurance premium, plus interest, to equal the amount of insurance proceeds to be paid. Each annuity policy could have been purchased without the insurance policy for the same premium charged for it under the annuity-life insurance combination.

> The decedent's children were primary beneficiaries of the insurance policies; the Fidelity-Philadelphia Trust Company, as trustee of a trust established by decedent, was named beneficiary of the interests of any of decedent's children who predeceased her. In the year of purchase, decedent assigned all rights and benefits under two of the life insurance policies to her children and under the other to the Fidelity-Philadelphia Trust Company as trustee. These rights and benefits included the rights to receive dividends, to change the beneficiaries, to surrender the policies, and to assign them. Dividends were received, but, as far as the record discloses, none of the other rights was exercised. A gift tax on these transfers was paid by the decedent in 1935.
>
> In 1938 decedent amended the above-mentioned trust so that it became irrevocable. As the Government concedes, the decedent retained no beneficial or reversionary interest in the trust.
>
> The insured died in 1946. The proceeds of the three insurance policies were not included in her estate in the estate tax return.

Here's the Court's analysis; evaluate for yourself what the case stands for (footnotes and citations omitted, except for one pivotal footnote):

> Prior to death, the decedent had divested herself of all interests in the insurance policies, including the possibility that the funds would return to her or her estate if the beneficiaries predeceased her. The assignees became the owners of the policies before her death; they had received the right to the immediate and unlimited use of the policies to the full extent of their worth. The immediate value of the policies was always substantial. In the year of assignment their total cash surrender value was over $289,000; in the year of death it was over $326,000. Under the assignment, the decedent had not become a life tenant who postpones the possession and enjoyment of the property by the remaindermen until her death…. On the contrary, the assignees held the bundle of rights, the incidents of ownership, over property from which the decedent had totally divorced herself….
>
> …. Instead of the provision taxing transfers intending to take effect in possession or enjoyment at or after the transferor's death, the provision… the Government relies on the provision taxing transfers in which the transferor has retained until death the right to income from the transferred property. However, the Government's position that the annuities were income from property which the insured transferred to her children under the life insurance policies is not well taken. To establish its contention, the Government must aggregate the premiums of the annuity policies with those of the life insurance policies and establish that the annuity payments were derived as income from the entire investment. This proposition cannot be established. Admittedly, when the policies were purchased, each life insurance-annuity combination was the product of a single, integrated transaction. However, the parties neither intended that, nor acted as if, any of the transactions would have a quality of indivisibility. Regardless of the considerations prompting the insurance companies to hedge their life insurance contracts with annuities, each time an annuity-life insurance combination was written, two items of property, an annuity policy and an insurance policy, were transferred to the purchaser. The annuity policy could have been acquired separately, and the life insurance policy could have been, and was, conveyed separately. The annuities arose from personal obligations of the insurance companies which were in no way conditioned on the continued existence of the life insurance contracts. These periodic payments would have continued unimpaired and without diminution in size throughout the life of the insured even if the life insurance policies had been extinguished.[8] Quite clearly the annuity payments

attacked a sale where all of the trust's income was required to pay interest on promissory notes issued to the decedent.[6444]

> arose solely from the annuity policies. The use and enjoyment of the annuity policies were entirely independent of the life insurance policies. Because of this independence, the Commissioner may not, by aggregating the two types of policies into one investment, conclude that by receiving the annuities, the decedent had retained income from the life insurance contracts.
>
> [8] Where a decedent, not in contemplation of death, has transferred property to another in return for a promise to make periodic payments to the transferor for his lifetime, it has been held that these payments are not income from the transferred property so as to include the property in the estate of the decedent. *E.g.*, *Estate of Sarah A. Bergan*, 1 T.C. 543, *acq.*, 1943 Cum Bull. 2; *Security Trust & Savings Bank, Trustee*, 11 B.T.A. 833; *Seymour Johnson*, 10 B.T.A. 411; *Hirsh v. United States*, 35 F.2d 982 (Ct. Cl. 1929); *cf*. *Welch v. Hall*, 134 F.2d 366. In these cases the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made.

In *Bergan*, a 1943 case, one sister transferred assets to another in exchange for the latter's promise to support the former for the rest of her life; the Tax Court held that the sister who transferred made a gift to the extent that the value of the transferred assets exceeded the value of the support obligation, and none of the transferred assets were included in the transferor's estate.

Footnote 8 was pivotal when the Seventh Circuit reversed the Tax Court in *Estate of Becklenberg v. Commissioner*, 273 F2d 297 (7th Cir. 1959).

> We agree that decedent (under the interpretation made by the Superior Court of Cook County) retained a right to receive $10,000 annually, by way of annuity or by distribution from the Trust. Although this sum was, in fact, paid to decedent out of the income of the Trust for most years, it does not appear that the payments were restricted to income. In 1942, in settling decedent's claim for deficiencies in payments previously made to her, a portion of the corpus was distributed to decedent with approval of the Superior Court. Under the 1938 Trust, payments might be made from principal. Under the construction of the Superior Court, decedent would have had to be paid $10,000 annually, even though the Trust produced an income of less than $10,000, and it had been necessary to invade corpus. Unlike the Tax Court, we believe that the Trust had an obligation to pay decedent $10,000 annually, and that her right to receive it was not limited to the property transferred by her or the income therefrom.
>
> The Tax Court has computed the amount of the Trust assets to be includible in decedent's gross estate as though the Trust here required decedent to be paid $10,000 out of taxable income, whereas decedent could have been paid out of principal. She retained the right to receive $10,000 annually for life; she did receive $10,000 annually for life. Thus at her death, there was nothing left to be included in her gross estate.

The court then said that the case was more like *Fidelity-Philadelphia* than any case in which the decedent had retained income, citing footnote 8 from that case, concluding:

> Because of the basis on which this case has been determined, we do not reach various other questions respecting such matters as, for example, valuation of assets which decedent transferred to the Trust, or computation of the amount of corpus which would have been needed to produce an income of $10,000 annually, had decedent retained the right to receive payments of $10,000 annually, limited to income of the Trust.

[6444] TAM 9251004 involved the following facts:

> In 1980, the Donor became the income beneficiary (with general power of appointment) of a marital trust created by her spouse (the marital trust).
>
> On December 29, 1989, the Donor directed the trustee of the marital trust to distribute 480,000 shares of closely-held stock to a new trust for the benefit of her grandchildren (the trust) in exchange for 15-year interest-only notes having a face value of approximately $1.5 million. The notes were to pay 11 percent interest per year with principal payable on December 15, 2004.

Furthermore, the seller should not retain too much control over the trust. In *Bixby v. Commissioner*, 58 T.C. 757 (1972), the named settlor gave $1,000 to each trust, and the parent of the named beneficiaries sold $129,000 of closely-held stock to the trust in exchange for a private annuity with a present value equal to the value of the sold stock. The court held that

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> Based on a returned value of $12 per share, the entire block of stock represented a transfer of $5,760,000. The value of the stock was based on the assumption that the stock would yield approximately 6.25 percent, the current dividend being paid at the time of the gift. Donor's representative characterized the Donor's action as a direction to make a sale/gift.
>
> Pursuant to the terms of the trust and the Donor's instructions, the trustee immediately allocated the stock and assigned the debt to separate trust shares for each of the Donor's 12 grandchildren as follows:
>
> (1) Approximately 23 percent of the stock (and approximately 32 percent of the debt) equally to two shares for the benefit of the two children of the Donor's Child A;
>
> (2) approximately 33 percent of the stock (and approximately 33 percent of the debt) equally to four shares for the benefit of the four children of the Donor's Child B; and
>
> (3) approximately 44 percent of the stock (and approximately 35 percent of the debt) equally to six shares for the benefit of the six children of Donor's Child C.
>
> Prior to the sale/gift, if the corporation were to continue paying a dividend of $0.75 per share with respect to the 480,000 shares of stock, the Donor would receive $360,000 in dividend income. Immediately after the sale/gift, the Donor, by reason of her income interest, became entitled to receive annual payments of $165,000.
>
> ….
>
> The entire trust corpus consists of shares of stock of Corporation. Immediately after the gift/sale, Child A held (individually or as a trustee of this and other trusts) 63.3 percent of the voting power of Corporation. Thus, Child A not only has the ability to control the dividend stream flowing to the various trust shares but is also directed to vote the stock, enter into agreements, etc., in a manner that is consistent with his own best interests (as an individual family owner) and with the best interest of the beneficiaries of the other trusts (representing family ownership of Corporation).
>
> On January 4, 1990, six days after the stock transfer, the notes were transferred to the Donor's three children in the same proportion that the debt was allocated among their children; *i.e.*, 32 percent of the notes were transferred to Child A, 33 percent of the notes were transferred to Child B, and 35 percent of the notes were transferred to Child C. Thus, each child became entitled to receive approximately one-third of the $165,000 previously payable to the surviving spouse (by way of the marital trust).

Donor died in 1992, less than three years after the notes were transferred to Donor's children. The IRS invoked Code § 2035 inclusion, claiming that the decedent transferred her alleged Code § 2036 retained interest within 3 years of death, conveniently omitting any reference to the *Becklenberg* case and other authority cited in fn. 6443:

> For purposes of section 2036 it is immaterial that a retained right is stated in terms of a contractual right or limited to a specific dollar amount so long as the retained right is a preferential right to a significant portion of the income. *Estate of C. B. Swartz*, 9 T.C. 229 (1947); *Estate of Fry*, 9 T.C. 503 (1947).
>
> As noted above, under the circumstances of this case the Donor's transfer of the closely-held stock into the trust with a retention of a priority right to a major share (if not all) of the trust income in the form of note interest payments must be considered a retention of the right to receive trust income. Because section 2036 of the Code includes the value of all property to the extent the Donor has retained an income interest therein, and because the Donor retained, at the time of the sale/gift, the right to receive the first $165,000 of trust income the value of the transferred stock would have been includible in the Donor's gross estate under section 2036 of the Code.

each seller retained so much control that they really just made a transfer in trust, with annuity payments recast as trust distributions, and was taxed under Code § 677 as the grantor:[6445]

[6445] The court relied heavily on *Samuel v. Commissioner*, 306 F.2d 682, 687 (1st Cir. 1962) (a grantor trust income tax case). Before reciting the control in the text quoted above, *Bixby* reasoned:

> The test of control that can be drawn from *Samuel* is an eminently practical one. Did the purported annuitant transfer so many incidents of ownership that it can be said that he or she no longer has effective control over the property? We believe that this test should be applied in a strict fashion in order to curb abuses in the area of private annuities. The outcome in each case will depend upon the attendant facts as viewed, we hope, in the light of reality. The fact that annuity agreements were executed is, of course, not controlling. *Harold W. Smith*, 56 T.C. 263 (1971); *Estate of Cornelia B. Schwartz*, 9 T.C. 229 (1947). Also, it should be noted that the *Samuel* test need not coincide with similar-sounding tests in other areas of the tax law where other considerations may be at work, for example, the test carefully constructed by Congress in sections 671 through 678, the test appearing under the family partnership provisions (see *Adolph K. Krause*, 57 T.C. 890 (1972), and the legislative history, regulations, and cases cited therein), and the specific tests of section 2036 (see *United States v. Byrum*, 408 U.S. 125 (1972), petition for rehearing pending; *Estate of Pamelia D. Holland*, 47 B.T.A. 807 (1942), and Supplemental Opinion, 1 T.C. 564 (1943); *Estate of William F. Hofford*, 4 T.C. 542 (1945), and Supplemental Opinion, 4 T.C. 790 (1945)).

After the text quoted in the main body of this paper, the court concluded:

> Some analogous cases in the section 2036 area are instructive. In *Estate of Pamelia D. Holland*, *supra*, the decedent and her husband sold to their children all the stock of a corporation for a nominal amount of money. At the same time it was agreed that the father was to be paid a salary of $25,000 per year for as long as he lived and if he predeceased his wife, she was to be paid the same salary for as long as she lived. The father did predecease the mother, and upon her death the Commissioner determined that the value of the stock should be included in her estate. We agreed with the Commissioner's determination. Although the payments were labeled as salary payments, were not specified as company profits or dividends on stock, and were paid pursuant to a valid contract, in essence they represented a retained income interest. In the recent case of *United States v. Byrum*, *supra*, the Supreme Court discussed *Holland* and concluded that The settlor in Holland retained a considerably greater interest than Byrum retained, including an income interest. *Holland* was also discussed, at length, in *Estate of William F. Hofford*, *supra* , a case involving very similar facts. In *Hofford* we found that the salary payments were in fact just that—salary payments. We noted, among other things, that when the recipient of the payments attempted to exercise control over the transferred property by attempting to oust his cotrustees, he failed. Suffice it to say that if the present case were a section 2036 case, we would treat it as having more in common with *Holland* than with *Byrum* or *Hofford*. Not only have petitioners retained a greater interest than did the petitioner in *Byrum*, but in contrast to the petitioner in *Hofford*, the petitioners in this case have succeeded on at least one occasion in directing the trusts.
>
> In view of our conclusion that the annual payments were not annuity payments, we find that the individual petitioners were the settlors of the Bermuda trusts. They furnished the consideration for the creation of the trusts. The named settlor was settlor in form only. *Cf. Harold W. Smith*, *supra*; *Estate of Cornelia B. Schwartz*, *supra*; *George H. Whiteley, Jr.*, 42 B.T.A. 402, *affd.* 120 F.2d 782 (C.A. 3, 1941), certiorari denied 314 U.S. 657 (1941); *Buhl v. Kavanagh*, 118 F.2d 315 (C.A. 6, 1941). Furthermore, we hold that the annual payments represent amounts distributable without the consent or approval of an adverse party under section 677(a)(1).[36] The purported annuity agreements amounted to little more than prearranged distributions. The petitioners are therefore taxable on the income of the trusts during 1961 as owners of those trusts under section 671.
>
> [36] the rule is well established that a deficiency may be approved on the basis of reasons other than those relied upon by the Commissioner or even where his reason may be incorrect. [citations omitted]

> In this case it is plain that the petitioner-"annuitants" deliberately avoided relinquishing control over the stock and its proceeds. Through the advisory committees they could continue to deal with the property as before—with a free hand. They could direct its investment; they could borrow it without payment of interest or providing security; they could use it to purchase life insurance; they could have themselves appointed as "Voting Trustees" and vote stock. It cannot be said that the advisory committees were not susceptible to the petitioners' directions because we find that they were, based on the closeness of family relations, the tendency of the trusts to act in tandem, and the solidarity of the trusts as demonstrated during the Tyer purchase transaction. Nor can petitioners rely on the fact that title to the property was technically in the name of the trustee. *Corliss v. Bowers*, 281 U.S. 376 (1930). And any suggestion that the committees and the Bermuda trustee must act perforce to benefit the named beneficiaries is undercut by the fact that the trustee is absolved of any liability and the trust income, while subject in some instances to a limited right of withdrawal, is not distributable until after the death of the petitioner for whom the trust was named. *Cf. Estate of Willard V. King*, 37 T.C. 973 (1962), an estate tax case.

A properly structured private annuity should not implicate chapter 14, with the exception of annuities paid by a trust, which may involve Code § 2702 issues.[6446] Code § 2702 applies to gifts in trust where the transferor or an applicable family member retains a qualified interest.[6447] Thus, Code § 2702 can be avoided where no gift exists (the fair market value of the property equals the actuarial value of the annuity)[6448] or where neither the transferor retains an interest in the trust after the transfer nor the transferee had an interest before the transfer.[6449]

III.B.1.g.ii. Private Annuities: Income Tax Implications

For income tax purposes, ***on or before October 18, 2006***, if the annuity is unsecured,[6450] then the transferor is treated as though the property were sold in a deferred recognition event for a term equal to the transferor's life expectancy.[6451] Each annuity payment consists of a capital component (including return of basis and capital gain) and an annuity component. An exclusion ratio determines how much of each payment is excluded from income as recovery of capital. The exclusion ratio is the transferor's investment in the contract (adjusted basis in the property) divided by the expected return from the annuity (life expectancy multiplied by annuity payments).[6452] The capital gain portion is the difference between the seller's basis in the property and the seller's expected return. The remaining amount is the annuity portion, which is

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[6446] *Estate of Trombetta v. Commissioner*, T.C. Memo. 2013-234.
[6447] Code § 2702(a), (b).
[6448] For a sale to work as a practical matter, the trust needs to have significant other assets. Otherwise, the sale might be subject to Code § 2036 attack, because of failing the exhaustion test (fn. 6435 and accompanying text) or using all of the trust's income to pay the annuity (fn. 6439 and accompanying text).
[6449] See Letter Ruling 9253031 (1992) (Code § 2702 applied to an annuity where the taxpayer sold marketable securities to a preexisting trust in exchange for an unsecured private annuity).
[6450] If the annuity is fully secured, gain is recognized immediately (although the interest portion is deferred). GCM 39503 (1986); *Bell v. Commissioner*, 60 T.C. 472 (1973) (reviewed decision, *aff'd* per curiam 668 F.2d 448 (8th Cir. 1982)), followed by *212 Corp. v. Commissioner*, 70 T.C. 788, 802 (1978) (reviewed decision).
[6451] An installment sale has limitations on deferral, which limitations do not apply to annuities. See fn. 6423 and part III.B.1.g.ii Private Annuities: Income Tax Implications for how that appears to be changing.
[6452] Code § 72(b); Rev. Rul. 69-74.

taxed as ordinary income.[6453] Regulations govern how an annuity contract can avoid the original issue discount rules that impute interest on uneven payments; careful attention must be paid if the annuity is not a flat payment for life.[6454]

The transferee in a private annuity transaction is treated like the purchaser of an annuity, with the distinction that amounts paid in excess of the purchase price are non-deductible annuity payments, not deductible interest.[6455] The transferee's basis varies for different circumstances.[6456] For depreciation purposes during the transferor's life, the unadjusted basis is the present value of the annuity promise on the date of the agreement. For calculating tax on a disposition of the annuity property for a gain during the transferor's life, the transferee's unadjusted basis is the sum of annuity payments made plus the prospective payments owed at the date of disposition. If the sale is for a loss during the transferor's life, the transferee's unadjusted basis is the sum of the annuity payments made to the date of disposition. If the transferor outlives life expectancy—causing the transferee to pay more than the original present value of the annuity—the transferee's unadjusted basis increases accordingly. Upon the transferor's death, the transferee's unadjusted basis – for future disposition and depreciation purposes – becomes the sum of annuity payments made.

For income tax purposes, ***<u>after October 18, 2006</u>***, proposed regulations[6457] provide that the gain from the sale of property in exchange for a private annuity cannot be deferred, except as described below. First, the effective date is delayed six months if all three of the following conditions are satisfied:

(i) the issuer of the annuity contract is an individual;

(ii) the obligations under the annuity contract are not secured, either directly or indirectly; and

(iii) the property transferred in the exchange is not subsequently sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange.

Second, the IRS has requested suggestions on the following topics:

(i) the clarity of the proposed regulations and how they can be made easier to understand;

(ii) what guidance, if any, is needed in addition to Rev. Rul. 55–119, 1955–1 CB 352, see § 601.601(d)(2), on the treatment of the issuer of an annuity contract that is not taxed under the provisions of subchapter L of the Code;

[6453] Rev. Rul. 69-74.
[6454] Reg. § 1.1275-1(j). Reg. § 1.1275-1(j)(2) generally excludes an annuity from OID treatment if the contract provides for periodic distributions made not less frequently than annually for the life (or joint lives) of an individual (or a reasonable number of individuals) and does not contain any terms or provisions that can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants).
[6455] Rev. Rul. 55-119.
[6456] Rev. Rul. 55-119.
[6457] REG-141901-05, Exchanges of Property for an Annuity, Fed. Reg. Vol. 71, No. 201, p. 61441, proposing changes to Reg. §§ 1.72-6(e), 1.1001-1(j).

(iii) whether any changes to § 1.1011-2 (concerning a bargain sale to a charitable organization in exchange for an annuity contract), conforming those regulations to the proposed regulations, would be appropriate;

(iv) circumstances (and corresponding changes to the regulations under section 453, if any) in which it might be appropriate to treat an exchange of property for an annuity contract as an installment sale;

(v) circumstances, if any, in which the fair market value of an annuity contract for purposes of § 1.1001-1(j) should be determined other than by tables promulgated under the authority of section 7520; and

(vi) additional transactions, if any, for which the six month delayed effective date would be appropriate.

Note that the IRS still has not finalized the proposed regulations. Arguably, a taxpayer can rely on Rev. Rul. 69-74, which has not been revoked, for tax deferral. However, doing so risks retroactive application of the proposed regulations if they are ever finalized.

In a pre-2006 transaction, one taxpayer made a private annuity sale to a nongrantor trust to trigger gain, then later made the trust a grantor trust to try to avoid gain on the remaining annuity payments; the IRS said this transaction was abusive but rejected certain attacks its examiner made and asked the examiner to try to find other attacks.[6458]

III.B.1.g.iii. Private Annuities: Planning Observations

A private annuity is a good planning technique when the transferor has a shorter actual than actuarial life expectancy (yet will live beyond 18 months), the borrower has means to make payments, and the lender wants a source of retirement income. If one is concerned that the lender will live too long, the lender might contribute the SCIN to a GRAT, so that excess value goes to the lender's beneficiaries. One might consider waiting for a while before gift the SCIN to a GRAT, because such a gift might undermine the argument that the SCIN was done for investment purposes.

The trade-off is that the basis of the purchased property will be relatively small. If one is using high basis property and would like to avoid a basis step–down, then one might consider placing the asset in an entity so that the asset's basis is preserved and only the basis in the entity itself is decreased.

See parts III.B.1.g Private Annuities and III.B.1.f Self-Canceling Installment Notes.

III.B.1.h. Transfers in the Ordinary Course of Business or to Business Entities

Weller v. Commissioner, 38 T.C. 790, 805-807 (1962), held:

> Section 2512(b) of the Code provides that where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property transferred exceeds the consideration shall be deemed a gift. Respondent's regulations have long modified this rather ironclad approach of the Code.

[6458] CCA 200923024. An excerpt from CCA 200923024 is in fn. 6533 in part III.B.2.d.i.(a) General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation.

While providing in section 25.2512-8 of the regulations that sales of property may constitute gifts for gift tax purposes to the extent the value of the property exceeds the consideration received, it is stated immediately thereafter: “However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm’s length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money’s worth.” The courts have given approval to respondent’s regulations. See *Commissioner v. Wemyss*, 324 U.S. 303 (1945); *Estate of Monroe D. Anderson*, 8 T.C. 706 (1947). The parties are in accord that the question is whether this sale was a bona fide, arm’s-length sale, at a freely negotiated price, without donative intent, in the ordinary course of business.

Very briefly, the evidence indicates that after Miller sold his interest in the partnership for approximately 1½ times book value, Carl made an effort to dispose of a 25-percent interest on about the same basis for the purpose of diversifying his investments and to obtain cash for personal use. He was unsuccessful in this effort. One of the persons he offered to sell to or through was Beyer. Beyer was not in a position to buy that large an interest but did evidence an interest in acquiring a much smaller interest. Beyer offered to pay book value for the 2-percent interest and, while Carl was not happy with this price, he did agree to sell Beyer a 2-percent interest in all the Weller companies for book value in order to get cash he wanted for personal use. There is no evidence, except the discrepancy between price and stipulated value, that either party felt he was giving or receiving any more than was necessary to consummate the transaction. Both Carl and Beyer testified it was an arm’s-length transaction. Nor is there any evidence of any reason Carl would have for making a gift to Beyer. Beyer was not a natural object of Carl’s bounty. While donative intent is not a requisite for a gift for tax purposes, *Commissioner v. Wemyss*, *supra*, the absence of donative intent is specifically made relevant under the regulations to the question whether the transfer was made in the ordinary course of business, and donative intent may be considered in determining generally whether a taxable gift has been made. *Eleanor A. Bradford*, 34 T.C. 1059 (1960).

Respondent contends that Carl’s motive in selling the partnership interest to Beyer at less than its actual value was to establish a value for his and Emily’s gifts of a 34-percent interest in the partnership transferred to the trusts on the same day; and that the price was therefore not fixed in an arm’s-length business transaction. While it would appear somewhat anomalous that two knowledgeable and experienced businessmen, dealing at arm’s length, would reach a price far below fair market value for the 2-percent interest, it must be remembered that the $22,000-fair-market-value figure was stipulated long after the transaction took place, it is higher than the relative price for which Miller had recently sold his interest in the partnership, Carl had been unable to sell any part of his interest for even the Miller price in previous efforts, and the price was actually the book value of a 2-percent interest. It would also be somewhat unrealistic to believe that Carl would deliberately sell a 2-percent interest in his business to an outsider at half price in the hopes that it would fix the value of the much larger interest he was transferring to the trusts for gift tax purposes, particularly when the Miller sale of a more comparable interest had recently been consummated at a higher price and the sale price to Beyer was not specifically broken down between the various interests sold. We will not indulge in such speculation to override the affirmative evidence presented.

There is no evidence that Beyer or anyone else would have given Carl more at that time for the 2-percent interest sold. Perhaps Carl was too anxious to sell, or simply made a

> bad bargain, but if he did, such a result - if it proceeds from a genuine business transaction - does not lead to a taxable gift. See *William H. Gross*, 7 T.C. 837 (1946). More likely we merely see demonstrated herein how hypothetical may be the figure for, and how theoretical may be the concept of, "fair market value," in particular circumstances.
>
> Petitioners have demonstrated error in respondent's determination that Carl made a taxable gift to Beyer, and we hold for petitioners on this issue.

In *Estate of Edward S. Redstone v. Commissioner*, 145 T.C. 259 (2015), in which the IRS claimed that a son's transfer of stock to his children to settle a dispute with his father, the court explained:

> A transfer of property will be regarded as occurring "in the ordinary course of business" and thus will be considered to have been made "for an adequate and full consideration in money or money's worth" only if it satisfies the three elements specified in section 25.2512-8, Gift Tax Regs. To meet this standard, the transfer must have been bona fide, transacted at arm's length, and free of donative intent. In applying this regulation to settlements of family disputes, we have identified certain subsidiary factors that may also be relevant. We have considered, for example: whether a genuine controversy existed between the parties; whether the parties were represented by and acted upon the advice of counsel; whether the parties engaged in adversarial negotiations; whether the value of the property involved was substantial; whether the settlement was motivated by the parties' desire to avoid the uncertainty and expense of litigation; and whether the settlement was finalized under judicial supervision and incorporated in a judicial decree. See, *e.g.*, *Estate of Natkanski*, 64 T.C.M. (CCH) at 59; *Estate of Noland*, 47 T.C.M. (CCH) at 1644-1645.

Reg. § 25.2512-8 is reproduced in the text accompany fn 6335 in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts.

In determining whether a dispute is bona fide, the court said:

> The requirement that the transfer be "bona fide" considers whether the parties were settling a genuine dispute as opposed to engaging in a collusive attempt to make the transaction appear to be something it was not. See *Black's Law Dictionary* 199 (9th ed. 2009) (defining "bona fide" as "made in good faith; without fraud or deceit").

For the next prong, the court held:

> The requirement that the transfer be "arm's length" is satisfied so long as the taxpayer acts "as one would act in the settlement of differences with a stranger."

Regarding being free from donative intent, the court said:

> The evidence clearly established that Edward transferred stock to his children, not because he wished to do it, but because Mickey demanded that he do it…. The transfer of stock in trust for Michael and Ruth Ann was prompted by Mickey's twin desires to ensure his grandchildren's financial security and to keep the Redstone family business within the Redstone family. At the time of the settlement, Edward had no desire to transfer stock to his children. He was forced to accept this transfer in order to placate

> Mickey, settle the family dispute, and obtain a $5 million payment for the remaining 66 2/3 shares ….
>
> We find that Edward acquiesced in the notion of an “oral trust” because he had no other alternative; this was a “deal breaker” for Mickey. There is no evidence that Edward, in making this transfer, was motivated by love and affection or other feelings that normally prompt the making of a gift.

The IRS argued that the fact that neither the donee trust nor the beneficiaries provided any consideration for the transfer meant that a gift was made to them. The court rejected that argument:

> Respondent’s argument derives no support from the text of the governing regulations. Section 25.2511-1(g)(1), Gift Tax Regs., provides unequivocally that “[t]he gift tax is not applicable to a transfer for a full and adequate consideration in money or money’s worth.” section 25.2512-8, Gift Tax Regs., provides that a “transfer of property made in the ordinary course of business *** will be considered as made for an adequate and full consideration in money or money’s worth.” section 25.2512-8, Gift Tax Regs., specifies three elements that an ordinary business transaction must meet, and we have found that Edward’s transfer met all three elements. The consequence of that determination is that “[t]he gift tax is not applicable to *** [the] transfer.” Sec. 25.2511-1(g)(1), Gift Tax Regs.

That taxpayer’s brother established similar trusts pursuant to the same general goal, only he established these trusts voluntarily, rather than being compelled to do so by litigation. In finding for the IRS, *Sumner Redstone v. Commissioner*, T.C. Memo. 2015-237 held:

> Petitioner’s transfer of stock to his children was undoubtedly prompted by the Settlement Agreement, both as to its timing and its terms, and this transfer surely pleased Mickey [the taxpayer’s father] by ensuring the financial security of his four grandchildren on equal terms. But this is not enough to make it a transaction “in the ordinary course of business.” Pleasing parents, like pleasing children, is presumptively a family motivation, and we discern no evidence tending to rebut that presumption here. There was no claim against Sumner; there were no arm’s-length negotiations; and he received no consideration from anyone in exchange for his transfer.
>
> In transferring stock to the Brent and Shari Trusts, Sumner was essentially motivated by the kinship that he had with his father and his children. Sumner was the sole trustee of both his children’s Trusts; there is no evidence that he was reluctant to effect this transfer or that it disadvantaged him from a business perspective.[6] The transfer thus bears all the indicia of donative intent toward the natural objects of his affection.
>
> [6] By contrast, Edward was clearly reluctant to transfer stock to his own children’s Trusts; for one thing, Sumner, rather than he, was the sole trustee of those Trusts. Both economic and family reasons motivated Edward to insist on securing outright ownership of (or payment for) all 100 shares that were originally registered in his name. See *Estate of Redstone*, 145 T.C. at __ (slip op. at 25 & n.5).

Intra-family sales are scrutinized, and the IRS argues that the ordinary course of business exception does not apply. This can include indirect transfers involving entities, in that an entity’s owners are considered the transferors or transferees, as the case may be. Reg § 25.2511-1(h)(1) provides:

> A transfer of property by a corporation to B is a gift to B from the stockholders of the corporation. If B himself is a stockholder, the transfer is a gift to him from the other stockholders but only to the extent it exceeds B's own interest in such amount as a shareholder. A transfer of property by B to a corporation generally represents gifts by B to the other individual shareholders of the corporation to the extent of their proportionate interests in the corporation. However, there may be an exception to this rule, such as a transfer made by an individual to a charitable, public, political or similar organization which may constitute a gift to the organization as a single entity, depending upon the facts and circumstances in the particular case.

As applied to partnerships, *see*, *e.g.*, *Shepherd v. Commissioner*, 115 T.C. 376 (reviewed decision 2000), *aff'd* 283 F.3d 1258 (11th Cir. 2002); *Senda v. Commissioner*, T.C. Memo 2004-160, *aff'd* 433 F.3d 1044 (8th Cir. 2006). *Estate of Maggos v. Commissioner*, T.C. Memo. 2000-129, held that a corporate redemption in excess of the fair market value (including valuation adjustments relating to control and marketability) was a gift. *Estate of Trenchard v. Commissioner*, T.C. Memo. 1995-121, involved corporate formation, and a merger was at issue in *Cavallaro v. Commissioner*, T.C Memo. 2019-144, on remand from 842 F.3d 16 (1st Cir. 2016), *aff'g in part and rev'g in part* T.C. Memo. 2014-189. *Tilton v. Commissioner*, 88 T.C. 590 (1987), held that a gift to a corporation was a gift to its shareholders but that, as ***indirect*** donees, the shareholders had no transferee liability under Code § 6324(b) under those particular facts; as to the latter, the Tax Court reasoned:

> We have been unable to locate, and respondent has not cited, any case in which a shareholder of a corporation was charged with donee-transferee liability for gift taxes payable on a nonshareholder's transfer to the corporation.[7] Even assuming, without deciding, that an indirect donee-shareholder under section 2511(a) may be charged with transferee liability as a result of a gratuitous transfer to a corporation by a nonshareholder, however, we hold for petitioners on this issue.
>
> [7] In the trust area, the courts have addressed the transferee liability of trust beneficiaries as indirect donees where gratuitous transfers were made to the trusts by nonbeneficiaries. Transferee gift tax liability has been upheld in one case where the trust estate was found to be the transferee, as such, even though the beneficiaries were indirect donees under the predecessor of sec. 2511(a). *Fidelity Trust Co. v. Commissioner*, 141 F.2d 54, 57 (3d Cir. 1944), *affg*. an order of this Court. In another case, the beneficiary was found to be the transferee but the beneficiary's obligation was found to have been assumed by the trustee under the predecessor of sec. 6903. *Fletcher Trust Co. v. Commissioner*, 141 F.2d 36, 40-41 (7th Cir. 1944), *affg*. 1 T.C. 798 (1943). See also *Want v. Commissioner*, 280 F.2d 777, 782 (2d Cir. 1960), *revg. on other grounds* 29 T.C. 1223 (1958). A gift to a trust differs from a nonshareholder's gift to a corporation in that the trustee, not the beneficiary, controls the trust estate whereas the donee-shareholders may (and in this case did) control the corporation, and no statute comparable to sec. 6903 applies with respect to corporations.
>
> Where transferee liability is determined against an indirect donee, the second sentence of section 6324(b) must be applied with caution. That sentence does not flatly make the donee-transferee liable for the tax. Rather, it carefully limits such liability to the extent of the value of the gift, and this means "the liability is limited to the value of the gift to the particular donee sought to be charged." *Want v. Commissioner*, 280 F.2d 777, 781 (2d Cir. 1960), *revg. on other grounds* 29 T.C. 1223 (1957); *La Fortune v.*

Commissioner, 263 F.2d 186, 194 (10th Cir. 1958), *affg*. 29 T.C. 479 (1958); Baur v. Commissioner, 145 F.2d 338, 339 (3d Cir. 1944), *affg*. 2 T.C. 1016 (1943).[8] In the case of a gift to a small solvent family corporation, as in the *Kincaid* and *Heringer* cases, the increased value of the corporation's assets attributable to the transfer would usually cause a proportionate increase in the value of the corporation's stock. That may not be true, however, in the case of an insolvent or nearly insolvent corporation.

[8] This limitation under sec. 6324(b) is consistent with the general rule limiting transferee liability to the value of the property received by the transferee. *Phillips v. Commissioner*, 283 U.S. 589 (1931); *United States v. Fernon*, 640 F.2d 609, 611 (5th Cir. 1981); *Nader v. Commissioner*, 323 F.2d 139, 140 (7th Cir. 1963), *affg*. a Memorandum Opinion of this Court.

The burden of proving transferee liability, including the value of the gift to the donee-transferee, rests with respondent. Sec. 6902(a); see also, *e.g.*, *Ashton v. Commissioner*, 28 B.T.A. 582, 584-585 (1933); *Vogelstein v. Commissioner*, 16 B.T.A. 947, 949 (1929). Because section 6324(b) limits donee-transferee liability to the value of the gift to the particular donee, respondent has the burden of proving the amount of the increase, if any, in the value of the Circle Bar stock owned by Daniel and David attributable to the transfer and he has not carried that burden.

The trial record before us contains no complete or precise information on the assets or liabilities of Circle Bar or opinion evidence on the valuation of the stock before or after the April 4, 1978, transfer. If Circle Bar's stock had a zero value both before and after the transfer, there was no enhancement in the value of the stock in the hands of Daniel and David that would support the imposition of donee-transferee liability for the gift tax on them under section 6324(b). The evidence bearing on the subject indicates that Circle Bar was on the edge of bankruptcy before the transfer and that it probably remained insolvent after the transfer.

Rev. Rul. 71-443 reasoned and held:

Although a gift to a corporation is a gift to the stockholders, the corporation acquires title to the transferred property. Shareholders of the corporation do not have any present or immediate right to use, possess, or enjoy the donated property or the income from the property. This they can do only upon liquidation of the corporation or declaration of dividends the first of which usually requires approval by the owners of a majority of the stock and both of which usually require approval by a majority of the corporation's directors. *Ballantine on Corporations* (Rev. 1946), sec. 239, at 562; secs. 301-302, at 709-711.

Accordingly, since in this case each stockholder-donee's use, possession, or enjoyment of the gift property or its proceeds are dependent upon contingencies beyond his individual control, the gifts are gifts of future interests. See *Irwin S. Chanin v. United States*, 393 F.2d 972, at 976 (1968). Therefore, it is held that the gifts do not qualify for the $3,000 per-donee annual exclusion provided by section 2503(b) of the Code.

With respect to the question involving the marital deduction, the transfer of property to the corporation represents a gift to the donor's wife to the extent of her proportionate interest in the corporation, or 46 percent. See section 25.2511-1(h)(1) of the regulations. Since no part of the share of the property transferred to her would pass to any other person for less than full and adequate consideration in money or money's worth, it would not be a terminable interest as defined in section 25.2523(b)-1 of the regulations.

Accordingly, it is held that the portion of the transfer to the corporation that is equal to the wife's proportionate interest in the corporation represents a gift to the wife that qualifies for the marital deduction under section 2523(a) of the Code.

For whether an interest in any other business entity qualifies for the annual exclusion, see *Hackl v. Commissioner*, 118 T.C. 279 (2002), *aff'd* 335 F.3d 664 (7th Cir. 2003), and its progeny, including *Price v. Commissioner*, T.C. Memo. 2010-2; *Fisher v. U.S.*, 105 A.F.T.R.2d 2010-1347 (D. Ind 2010); *Estate of Wimmer v. Commissioner*, T.C. Memo. 2012-157; *Estate of Purdue v. Commissioner*, T.C. Memo. 2015-249 (annual exclusion upheld because LLC's assets produced income).

III.B.1.i. Transfers with Contingencies Based on Acts of Independent Significance

Sometimes an action has important nontax consequences that are considered to dwarf their tax consequences to such an extent that the action's effect on property rights do not have transfer tax consequences. This may help avoid inclusion described in part III.D Code § 2038.

Such an act of independent significance includes:

- Adoption. A trust provision automatically including the settlor's after-born and after-adopted children as beneficiaries is not equivalent to the settlor's retention of a power to designate or change beneficial interests within the meaning of Code § § 2036(a) and 2038.[6459]

- Divorce. "The act of divorcing one's spouse is an act of independent significance, the incidental and collateral consequences of which is to terminate the spouse's interest in the trust. Thus, we do not believe the decedent possessed an "incident of ownership" in the insurance policy as a result of the trust provision which would terminate the interest of the decedent's spouse in the event of a divorce."[6460] If B has a power to terminate a trust and receive all of the trust assets if A and B divorce or are legally separated and they never do, B's termination power will not constitute a general power of appointment in the existence of decedent's death that would cause the value of the Spousal Trust to be included in B's gross estate.[6461]

- Termination of Employment. "An insured's power to cancel his insurance coverage by terminating his employment is a collateral consequence of the power that every employee has to terminate his employment" that does not constitute an incident of ownership under Code § 2042.[6462] "If a decedent transferred all the incidents of ownership in a noncontributory group-term life insurance policy on the decedent's life, but retained the right to convert the policy to an individual policy should the decedent's employment be terminated, the proceeds are not includible in the decedent's gross estate" under

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[6459] Rev. Rul. 80-255.
[6460] Letter Ruling 8819001.
[6461] Letter Ruling 9141027, viewing the contingency of divorce or separation as an act of independent significance and citing *Estate of Tully v. United States*, 528 F.2d 1401 (Ct. Cl. 1976) (see fn. 4310 in part II.Q.4.a Funding the Buy-Sell), and Rev. Rul. 80-255, the latter cited in fn. 6459.
[6462] Rev. Rul. 72-307.

Code § 2042(2).[6463] See part III.B.1.a.v Sending Business or Performing Services. Various buy-sell provisions may also constitute acts of independent significance.[6464]

- Death Benefits Decedent Did Not Control. Survivors' loss benefits, payable under a no-fault automobile insurance policy, are not includible in the decedent's gross estate.[6465]

- Terminate Enrollment in College. The contingency that a person terminate enrollment in college is an act of independent significance for certain gift tax purposes.[6466]

[6463] Rev. Rul. 84-130, stating:

> The Service acquiesces in the result in the decision in *Estate of Smead v. Commissioner*, 78 T.C. 43 (1982), which held that a retained conversion privilege exercisable only on termination of employment was not an incident of ownership. See page 2, this Bulletin.

TAM 9349002 purported to limit the scope of Rev. Rul. 84-130; see part II.Q.4.i.ii Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity.

[6464] See fn. 4310 in part II.Q.4.a Funding the Buy-Sell.

[6465] Rev. Rul. 82-5, reasoning:

> The decedent was required to obtain the coverage by the state's no-fault automobile insurance statute and had no choice as to the persons entitled to receive survivors' loss benefits or the amount of the benefits. The right to survivors' loss benefits was created by statute for the benefit of a decedent's dependents and is designed to compensate for amounts that they would have received from the decedent had the decedent lived. Since the loss for which the benefits are designed to compensate for did not accrue until after the decedent died, the right of the decedent's spouse to the benefits also did not arise until after the decedent died. Thus, the decedent had no interest in the survivors' loss benefits at the date of death and the benefits are not includible under section 2033 of the Code. See Rev. Rul. 56-637, 1956-2 C.B. 600, which holds that workmen's compensation benefits payable to the dependents of a deceased employee are not includible in the deceased's gross estate for federal estate tax purposes; Rev. Rul. 67-277, 1967-2 C.B. 322, which holds that the lump sum payable under section 402(i) of title 42 of the United States Code (the Social Security Act) to the widow or widower of the deceased is not includible in the decedent's gross estate for federal estate tax purposes; and Rev. Rul. 54-19, 1954-1 C.B. 179, which holds that amounts receivable in settlement of claims under the New Jersey "Death of Wrongful Act" statute are not includible in the decedent's gross estate. Furthermore, the Service does not consider the survivor's loss benefits to be includible in the decedent's gross estate under section 2042 of the Code. While the Service takes no position on whether the survivor's loss benefits are classifiable as life insurance proceeds, nonetheless, the proceeds would not be includible in the decedent's gross estate because the decedent did not possess any incidents of ownership. Neither the power to cancel the policy and relinquish the motor vehicle registration nor the power to substitute a policy with identical survivor's benefits constitutes an incident of ownership within the meaning of section 2042. See Rev. Rul. 72-307, 1972-1 C.B. 307; *Jordahl v. Commissioner*, 65 T.C. 92 (1975), *acq.* 1977-1 C.B. 1.

[6466] Rev. Rul. 75-415 reasoned:

> The only way C can immediately obtain the use, possession, or enjoyment of a proportionate share of the income interest is to terminate enrollment as a full-time student in an institution of higher learning. Although C's action will result in the enjoyment of the income interest, such action is merely a collateral consequence of a power that every student has to drop out of school. C's termination of enrollment does not directly affect the trust and, therefore, is a barrier to the present enjoyment of the income interest.
>
> Accordingly, the gift tax exclusion authorized by section 2503(b) of the Code for gifts of present interests is not allowable with respect to a donee's right to receive one-third of the income from property for a term of years if enjoyment is to commence at the earlier of the expiration of three years from the date of gift or termination of enrollment as a full-time student in an institution of higher learning.

The “event or contingency must not be illusory and must have some significant non-tax consequence independent of the decedent’s ability to exercise the power.”[6467]

[6467] Holding that the ministerial requirement that one actually withdrawal right in a particular sequence was not enough to prevent it from constituting a general power of appointment under Code § 2041, *Kurz v. Commissioner*, 101 T.C. 44, 59-61 (1993), *aff’d* 68 F3d 1027 (7th Cir. 1995), made the statement quoted in the text above and further reasoned:

> The legislative history, however, clearly indicates that all property of which the decedent on the date of his death had practical, if not technical, ownership is to be included in his estate. We think any illusory or sham restriction placed on a power of appointment should be ignored. An event or condition that has no significant non-tax consequence independent of a decedent’s power to appoint the property for his own benefit is illusory. For example, for purposes of section 2038, a power is disregarded if it becomes operational as a mere by-product of an event, the non-tax consequences of which greatly overshadow its significance for tax purposes. See Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts*, par. 126.5.4, at 126-64 (2d ed. 1984). If the power involves acts of “independent significance”, whose effect on the trust is “incidental and collateral”, such acts are also deemed to be beyond the decedent’s control. See Rev. Rul. 80-255, 1980-2 C.B. 272 (power to bear or adopt children involves act of “independent significance”, whose effect on a trust that included after-born and after-adopted children was “incidental and collateral”); see also *Estate of Tully v. United States*, 208 Ct. Cl. 596, 528 F.2d 1401, 1406 (1976) (“In reality, a man might divorce his wife, but to assume that he would fight through an entire divorce process merely to alter employee death benefits approaches the absurd.”). Thus, if a power is contingent upon an event of substantial independent consequence that the decedent could, but did not, bring about, the event is deemed to be beyond the decedent’s control for purposes of section 2038.
>
> We do not think that, where the general power of appointment is the right to withdraw principal from a trust, Congress intended that application of section 2041(a)(2) could be avoided by stacking or ordering the withdrawal powers; *i.e.*, exercising the power to withdraw a certain number of dollars before the power to withdraw the next portion comes into operation. A condition that has no significant non-tax consequence independent of a decedent’s power to appoint the property for her own benefit does not prevent practical ownership; it is illusory and should be ignored. We conclude that for purposes of section 2041, although the condition does not have to be beyond the decedent’s control, it must have some significant non-tax consequence independent of the decedent’s power to appoint the property. Petitioner has not demonstrated that withdrawing principal from the Marital Trust Fund has any significant non-tax consequence independent of decedent’s power to withdraw principal from the Family Trust Fund. Such condition is illusory and, thus, is not an event or a contingency contemplated by the section 20.2041-3(b), Estate Tax Regs.
>
> We hold that, if by its terms a general power of appointment is exercisable only upon the occurrence during the decedent’s lifetime of an event or contingency that has no significant non-tax consequence independent of the decedent’s ability to exercise the power, the power exists on the date of decedent’s death, regardless of whether the event or contingency did in fact occur during such time. Because petitioner has failed to demonstrate any significant non-tax consequence independent of decedent’s right to withdraw principal from the Family Trust Fund, we hold that, on the date of her death, decedent had a general power of appointment over 5 percent of the Family Trust Fund that causes that portion to be includable in her estate under section 2041.
>
> Decedent’s power of appointment over 5 percent of the Family Trust Fund was in existence on the date of her death regardless of the fact that the principal of the Marital Trust Fund had not been completely exhausted by that date. Hence, 5 percent of the Family Trust Fund was includable in her gross estate.

III.B.1.j. Transfer of Stock

Reg. § 25.2511-2(h) provides:

> If a donor delivers a properly indorsed stock certificate to the donee or the donee's agent, the gift is completed for gift tax purposes on the date of delivery. If the donor delivers the certificate to his bank or broker as his agent, or to the issuing corporation or its transfer agent, for transfer into the name of the donee, the gift is completed on the date the stock is transferred on the books of the corporation.

III.B.2. Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust

The grantor establishes an irrevocable trust that is excluded from the grantor's estate for estate tax purposes but treated as owned by the grantor for income tax purposes. See part III.B.2.h How to Make a Trust a Grantor Trust Taxed to a U.S. Citizen or Resident, especially part III.B.2.h.iii Swap Power.

Being treated as the owner means that (among other things):

- The grantor reports all of the trust's taxable items on the grantor's income tax return. In other words, the trust grows free from income (including capital gain) tax, and the grantor's taxable estate decreases because the grantor is paying taxes on the trust's income.

- The grantor may enter into transactions with the trust that are ignored for income tax purposes. When the grantor sells an interest in an entity taxed as a partnership or as an S corporation in exchange for a note:

  - The entity makes distributions to its owners to pay their income tax on their distributive share of the entity's income ("tax distributions");

  - Because the trust does not pay income tax, it uses its tax distributions to repay the note; and

  - The grantor uses the note payments to pay income taxes; thus, rather than restoring the grantor's estate for the value of the sold business interest, the note payments go straight to the taxing authorities, making the note essentially be a disappearing asset.

To drill deeper into this sale idea, see part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust.

For more details on the effect of grantor trust treatment, see part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

III.B.2.a. Tax Basis Issues When Using Irrevocable Grantor Trusts

Whenever using irrevocable grantor trusts, consider that, as discussed below, the assets the trust holds will not get a basis step-up at death. Consider recommending that clients or their income tax preparers monitor the relationship between value and basis. If value becomes significantly larger than basis for one or more assets, consider having the trust sell those to the grantor in exchange for cash or another high basis asset.

See part II.H Income Tax vs. Estate and Gift Tax (Particularly for Depreciable Property), especially part II.H.5 Irrevocable Trust Planning and Basis Issues. These issues are especially pronounced for buildings, which, in addition to any increase in value, experiencing an ongoing loss of basis through annual depreciation deductions; any basis step-up can generate future depreciation deductions as well, making part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion be particularly attractive.

If grantor trust status terminates, generally the grantor is deemed to have sold to the trust the assets the grantor had been deemed to own immediately before the sale in exchange for whatever the principal balance is of any notes payable to the grantor and any liabilities of which the grantor has been deemed relieved.[6468]

The trust's basis in the assets is the sum of:[6469]

(1) Whichever of the following is the greater:

(i) The amount paid by the transferee for the property, or

(ii) The transferor's adjusted basis for the property at the time of the transfer, and

(2) The amount of increase, if any, in basis authorized by section 1015(d) for gift tax paid (see § 1.1015-5).

Rev. Rul. 2023-2 posits the issue, "Is there a basis adjustment under § 1014 of the Internal Revenue Code (Code) to the assets of a trust on the death of the individual who is the owner of the trust under chapter 1 of the Code (chapter 1) if the trust assets are not includible in the owner's gross estate pursuant to chapter 11 of the Code (chapter 11)?" Rev. Rul. 2023-2 analyzed and concluded:

> **Analysis**
>
> For property to receive a basis adjustment under § 1014(a), the property must be acquired or passed from a decedent. For property to be acquired or passed from a decedent for purposes of § 1014(a), it must fall within one of the seven types of property listed in § 1014(b). Asset does not fall within any of the seven types of property listed in § 1014(b).
>
> First, upon A's death, Asset was not "bequeathed," "devised," or "inherited" within the meaning of § 1014(b)(1). A "bequest" is the act of giving property (usually personal property or money) by will. Black's Law Dictionary (11th ed. 2019). The Supreme Court defined "bequest" as a "gift of personal property by will" for purposes of the predecessor provision of § 102 that, as today, excluded gifts, bequests, devises, or inheritance from gross income for income tax purposes. *United States v. Merriam*, 263 U.S. 179, 184 (1923).
>
> A "devise" is the act of giving property, especially real property, by will. Black's Law Dictionary (11th ed. 2019). Volume 97 of the Corpus Juris Secundum notes that although "bequest" and "bequeath" strictly refer to a gift by will of personal property, the

[6468] See fn. 6591.

[6469] Reg. § 1.1015-4(a), which applies to noncharitable bargain sales.

words may be given a broader meaning to include real property which, under the narrower definition, would be a devise. See 97 C.J.S. Wills § 1861 (2022).

An “inheritance” is property received from an ancestor under the laws of intestacy or property that a person receives by bequest or devise. Black’s Law Dictionary (11th ed. 2019).

In *Bacciocco v. United States*, 286 F.2d 551, 554-55 (6th Cir. 1961), the court found that property transferred in trust prior to the decedent’s death is not bequeathed or inherited because it did not pass either by will or intestacy. The court stated, “[w]e construe those terms [bequest and inheritance] according to their usual and normal meaning” and noted that the decedent’s death did not transfer the assets to the trust. Id. at 554-56. This does not imply that property in a trust could never fall within the meaning of § 1014 (such as property included in the decedent’s gross estate or property specifically described by §§ 1014(b)(2), (3), or (4)); however, in the facts outlined above, the trust property does not fall within the meaning of those terms.

The Congressional committee report explaining the basis of property acquired from a decedent for purposes of § 1014(b) (then designated § 113(a)(5) of the 1939 Code) stated that the provision “applies basically to property in the decedent’s probate estate and includible in his gross estate under § 811(a) [the predecessor provision of § 2031(a)]. In addition, it applies to property acquired by certain specifically described methods of disposition which are treated as though the acquisition was by bequest, devise, or inheritance.” H.R. Rep. No 83-1337 at 4407-08 (March 9, 1954). Citing that report, the court in *Collins v. United States*, 318 F. Supp. 382, 386 (C.D. Cal. 1970) stated, “[i]t seems clear that property cannot be said to come from a decedent by ‘bequest, devise, or inheritance’ unless it is part of the decedent’s probate estate under the laws of the state of his domicile.” The court determined that payments made to a widow by her deceased husband’s employers, under contracts negotiated by her husband, did not pass from the decedent under § 1014 and so would not acquire a basis determined by the contract’s FMV at the decedent’s death but instead were income with respect to a decedent that would not receive a basis adjusted to date of death value.

Second, Asset does not fall within any of the remaining types of property listed in § 1014(b). Asset is not described in § § 1014(b)(2), (3), or (4) because A did not retain a power to revoke or amend T or hold a power to appoint Asset. Asset also is not described by § 1014(b)(6) because it is not community property. Finally, Asset is not described by § § 1014(b)(9) or (10) because it is not included in A’s gross estate under the provisions of chapter 11. Because at A’s death Asset does not fall within any of the seven types of property listed in § 1014(b), Asset does not receive a basis adjustment under § 1014(a) at A’s death.

Holding

A creates T, an irrevocable trust, retaining a power which causes A to be the owner of the entire trust for income tax purposes under chapter 1 but does not cause the trust assets to be included in A’s gross estate for purposes of chapter 11. If A funds T with Asset in a transaction that is a completed gift for gift tax purposes, the basis of Asset is not adjusted to its fair market value on the date of A’s death under § 1014 because Asset was not acquired or passed from a decedent as defined in § 1014(b). Accordingly, under this revenue ruling's facts, the basis of Asset immediately after A's death is the same as the basis of Asset immediately prior to A's death.

III.B.2.b. General Description of GRAT vs. Sale to Irrevocable Grantor Trust

For a company whose value is so high that its stock cannot be transferred merely by annual exclusion gifting, we often transfer S stock to irrevocable grantor trusts – trusts whose assets are, or will be later, excluded from the grantor's estate, but whose income is currently taxable to the grantor. Two types of transfers most commonly used are:

- Gift to Grantor Retained Annuity Trust (GRAT).[6470] The grantor gives property (nonvoting stock)[6471] to the trust and receives an annuity for a fixed term of years in exchange for the transfer of property. Usually, the annuity is expressed as a specific percentage of the initial value of the trust's assets.[6472] This initial value is the value determined for federal tax purposes,[6473] and adjustments to payments are required if the initial value is incorrectly determined.[6474] The amount of the gift is the excess of the gifted property's value over the present value of the retained annuity, determined using Code § 7520 interest rates.[6475] If the IRS increases the initial value, the annuity also increases, allowing the grantor to report a gift that is either zero or close to zero. GRATs have become more popular since a 2000 court decision on valuing retained annuities.[6476]

- Sale to Irrevocable Grantor Trust. The grantor makes a gift[6477] to an irrevocable grantor trust equal to at least one-ninth of the value of the property the grantor is going to sell.[6478] The grantor sells property (nonvoting stock) to the trust and receives a promissory note.[6479] While the trust is a grantor trust, income tax does not apply to the sale.[6480]

[6470] 9This is just a summary of certain features of a GRAT that help determine its financial success. The technical requirements are beyond this article's scope. If a GRAT fails to meet the terms required by the statute or regulations, consider a reformation, as occurred in fn. 6352.
[6471] See part II.A.2.i.i.(b) Why Nonvoting Shares Are Needed for Estate Planning.
[6472] Code § 2702(b)(2).
[6473] Reg. § 25.2702-3(b)(1)(ii)(B).
[6474] Reg. § 25.2702-3(b)(2).
[6475] Code § 2702(a)(2)(B).
[6476] Reg. § 25.2702-2(a)(5), giving credit for an annuity payable to an estate, amended in response to *Walton v. Commissioner*, 115 T.C. 589 (2000), *acq*. IRS Notice 2003-72.
[6477] Arguably the trust should not grant withdrawal rights (*Crummey* rights) to the beneficiaries. The argument is that Code § 678(b) provides that a grantor's rights to income supersede a beneficiary's right to income for grantor trust purposes, but do a grantor's rights to income supersede a beneficiary's right to principal for grantor trust purposes? Letter Rulings 200603040 and 200606006 and numerous rulings before and after those rulings have read Code § 678(b) in the context of taxable income, rather than fiduciary accounting income, so including *Crummey* rights should be OK.
[6478] *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, approved a gift of LLC interests followed by a sale for promissory notes three days later using this structure.
[6479]If somehow the IRS successfully recharacterizes the note described below as equity, then the Code § 2701 rules come into play. Code § 2701 assigns at least a 10% minimum value to the junior equity, which would be represented by the initial gift to the trust. For example, if the property to be sold is worth $9M, then the gift would be $1M, so that the junior equity would be worth 10% ($1M divided by the $10M total in the trust). This 1/9 funding also provides more substance to the trust. Finally, the trust should make all interest payments on time, and the 1/9 funding provides funding in case corporate cash flow to the shareholders is insufficient (due to a temporary downturn in business, for example).
[6480] Rev. Rul. 85-13.

The gift to a GRAT is safer than a sale to an irrevocable grantor trust, in that the grantor can ensure that the gift is close to zero, even if the IRS tries to adjust the property's value; I often use formula sales to mitigate the risk of a sale to an irrevocable grantor trust, but formula sales remain a point of contention.[6481] A sale to an irrevocable grantor trust triggers income tax if the grantor trust powers are turned off;[6482] to the extent that the note's principal exceeds the basis of the trust's assets, a bargain sale is likely to have occurred.[6483] It also does not require an up-front gift, which can cause complexity when the grantor tries to sell stock to an irrevocable grantor trust and does not have enough gift tax exemption available to provide sufficient funding.[6484] Finally, GRATs have a 105-day grace period in the event of a late payment.[6485]

As to deviations from the payment schedule, Reg. § 25.2702-3(d)(5), "Commutation," provides:

> The governing instrument must prohibit commutation (prepayment) of the interest of the holder.

The preamble in T.D. 8395 (2/4/1992) explains:

> Commentators suggested that commutation of qualified interests be permitted. This change is not made. Commutation (*i.e.*, the prepayment of the term holder's interest) shifts the risk of a decline in interest rates from the remainder beneficiaries to the term holder. Therefore, a commuted term interest may not ultimately yield the same value to the term holder as the annuity or unitrust interest originally retained by the transferor. Congress intended in enacting section 2702, that a term interest would be valued at an amount greater than zero, only if the form of the term interest insures that the holder actually receives the value attributed to the interest. Allowing commutation would be inconsistent with this intent.

A word about zero gifts: don't do them. To avoid income tax on the annuity payment (GRAT) or on the sale and note payments (sale to irrevocable trust), the taxpayer needs to establish that the trust is a grantor trust. See part III.B.2.h.i Who Is the Grantor. Having even a small gift should satisfy that requirement. In the grand scheme of things, having a $100 or $1,000 taxable gift isn't going to make a material difference in the taxpayer's estate/gift tax exclusion amount.

[6481] Formula sales are described in part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.

[6482] The sale might qualify for installment sale treatment; see Code §§ 453, 453A. Note that the transfer of an installment obligation upon termination of a trust accelerates remaining gain. See part II.G.15 Limitations on the Use of Installment Sales.
Letter Ruling 200722027 asserted that:

- A partnership interest does not qualify for installment sale treatment to the extent that it represents income attributable to Code § 751(c)(2) unrealized receivables for payment for services rendered.
- The seller may report the balance of the income realized from the sale of the partnership interest using the installment method of reporting.

[6483] See fn. 6591, found in part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

[6484] Loan guarantees are commonly used to shore up trusts that are thinly funded; see fn. 6489 regarding thinly funded trusts. For tax consequences of loan guarantees, see part III.B.1.a.ii Loan Guarantees. Although I believe that paying a reasonable guarantee fee is not required to avoid a gift (with which not everyone agrees), it may be helpful to provide a nontax reason why the guarantor provided the guarantee. See part III.B.2.i.vi Funding the Trust with Small Gifts. The guarantee fee would be income to the guarantor but not deductible, the latter result because the sale does not exist for income tax purposes. As a practical matter, the appraiser valuing the business should also be able to recommend a guarantee fee.

[6485] Reg. § 25.2702-3(b)(4).

For a sale to an irrevocable grantor trust, if the taxpayer has not opened a bank account before the sale, see whether the trust might have provided for nominal consideration and whether the trustee might have that cash in hand without having opened a bank account. I prefer, however, that, for a sale to an irrevocable grantor trust, the funding be more substantial than that, if possible, as mentioned above. However, if no initial gift actually occurred, the desired income tax effect is still attainable: Part III.B.2.h.i Who Is the Grantor explains that, absent a an actual gratuitous transfer, the nominal settlor is treated as the grantor under the grantor trust rules.

CCA 202152018 took a hard line against a taxpayer who obtained an appraisal that intentionally omitted material facts:

> …. Under the fair market value standard as articulated in § 25.2512-1, the hypothetical willing buyer and willing seller, as of Date 2, would be reasonably informed during the course of negotiations over the purchase and sale of the shares and would have knowledge of all relevant facts, including the pending merger. Indeed, to ignore the facts and circumstances of the pending merger undermines the basic tenets of fair market value and yields a baseless valuation, and thereby casts more than just doubt upon the bona fides of the transfer to the GRAT.
>
> In addition, although the governing instrument of Trust appears to meet the requirements in § 2702 and the corresponding regulations, intentionally basing the fixed amount required by § 2702(b)(1) and § 25.2702-3(b)(1)(i) on an undervalued appraisal causes the retained interest to fail to function exclusively as a qualified interest from the creation of the trust. The trustee's failure to satisfy the "fixed amount" requirement under § 2702 and § 25.2702-3(b)(1)(ii)(B) is an operational failure because the trustee paid an amount that had no relation to the initial fair market value of the property transferred to the trust; instead, the amount was based on an outdated and misleading appraisal of Company, at a time when Company had received offers in the multi-billion dollar range. When asked about the use of the outdated appraisal, the company that conducted the appraisal stated only that business operations had not materially changed during the 6-month period. In contrast, in valuing the transfer to the charitable trust, the company that conducted the appraisal focused only on the tender offer, and accordingly gave little weight to the business operations for valuation purposes.
>
> The operational effect of deliberately using an undervalued appraisal is to artificially depress the required annual annuity. Thus, in the present case, the artificial annuity to be paid was less than 34 cents on the dollar instead of the required amount, allowing the trustee to hold back tens of millions of dollars. The cascading effect produced a windfall to the remaindermen. Accordingly, because of this operational failure, Donor did not retain a qualified annuity interest under § 2702. See *Atkinson*.

The CCA reinforces the strategy I have always used: When a client faces an impending sale to a strategic buyer, the client can still engage in estate planning transactions before the sale, so long as the client informs the appraiser of the impending sale. Modern letters of intent routinely provide that the expected sale is not legally binding until the sale documents are actually signed.[6486] After a letter of intent has been signed, the risk of not closing remains substantial, and an informed appraiser will tend to provide only perhaps a 50% chance of not closing as due diligence proceeds, and even on the eve of the sale often a 20% chance of not closing. The

[6486] See fn 4632 in part II.Q.6 Contributing a Business Interest to Charity.

taxpayer gambles that the sale does not close and the sale price is too high, but the strategies described in this part III.B.2.b[6487] may allow the taxpayer to recover from such a failed gamble.

CCA 201939002 characterized its facts:

> Donor is a co-founder and Chairman of the Board of Corporation A, a publicly-traded corporation. On Date 1, Donor transferred Shares to Trust, a newly-formed grantor retained annuity trust with a [Redacted Text] term, with a remainder to his children. [Redacted Text] later on Date 2, after the market closed, Corporation A announced a merger with Corporation B. The merger was the culmination of [Redacted Text] negotiations with multiple parties, and then, [Redacted Text] before the Date 1 transfer, exclusive negotiations with Corporation B.
>
> On the [Redacted Text] day of trading after the merger was announced, the value of the Corporation A stock increased substantially, though less than the agreed merger price. The merger was consummated more than [Redacted Text] after Date 1.
>
> The Internal Revenue Service has reviewed the underlying transaction documents from the year preceding the merger. Such documents include the Corporation A and Corporation B exclusivity agreement, correspondence between Corporation A and Corporation B, and Board meeting minutes. The record as compiled to date supports the position that, as of Date 1, the hypothetical willing buyer of the stock could have reasonably foreseen the merger and anticipated that the price of Corporation A stock would trade at a premium.

CCA 201939002 asserted:

> The value of property for Federal transfer tax purposes is a factual inquiry wherein the trier of fact must weigh all relevant evidence and draw appropriate inferences to arrive at the property's fair market value. *Bank One Corp. v. Commissioner*, 120 T.C. 174 (2003), *rev'd on other grounds*, 458 F3d 564 (7th Cir. 2006) (citing *Commissioner v. Scottish Am. Inv. Co.*, 323 U.S. 119 (1944)). For this purpose, fair market value is the price that a hypothetical willing buyer would pay a hypothetical willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. Treas. Reg. § 25.2512-1; Rev. Rul. 59-60, 1959-1 C.B. 237. The valuation of property is a question of fact. See *Redstone v. Commissioner*, T.C. Memo. 2015-237.
>
> The willing buyer and willing seller are hypothetical persons, rather than specific individuals or entities, and their characteristics are not necessarily the same as those of the donor and the donee. See *Estate of McCord v. Commissioner*, 120 T.C. 358 (2003), *rev'd on other grounds*, 461 F3d 614 (5th Cir. 2006); *Estate of Newhouse v. Commissioner*, 94 T.C. 193 (1990). The hypothetical willing buyer and willing seller are presumed to be dedicated to achieving the maximum economic advantage. *Newhouse*, 94 T.C. at 218.
>
> The principle that the hypothetical willing buyer and seller are presumed to have "reasonable knowledge of relevant facts" affecting the value of property at issue applies even if the relevant facts at issue were unknown to the actual owner of the property.

[6487] If one uses a sale to an irrevocable grantor trust instead of a GRAT, consider the strategies described in part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.

Estate of Kollsman v. Commissioner, T.C. Memo. 2017-40, appeal docketed, No. 18-70565 (9th Cir. Feb. 27, 2018). Moreover, both parties are presumed to have made a reasonable investigation of the relevant facts. *Id*. Thus, in addition to facts that are publicly available, reasonable knowledge includes those facts that a reasonable buyer or seller would uncover during the course of negotiations over the purchase price of the property. *Id*. Moreover, a hypothetical willing buyer is presumed to be "reasonably informed" and "prudent" and to have asked the hypothetical willing seller for information that is not publicly available. *Estate of Kollsman*, *supra*.

Generally, a valuation of property for Federal transfer tax purposes is made as of the valuation date without regard to events happening after that date. *Ithaca Trust Co. v. United States*, 279 U.S. 151 (1929). Subsequent events may be considered, however, if they are relevant to the question of value. *Estate of Noble v. Commissioner*, T.C. Memo. 2005-2, n.3. Federal law favors the admission of probative evidence, and the test of relevancy under the Federal Rules of Evidence is designed to achieve that end. Id. Thus, a post-valuation date event may be considered if the event was reasonably foreseeable as of the valuation date. *Trust Services of America, Inc. v. U.S.*, 885 F.2d 561, 569 (9th Cir. 1989); *Bank One Corp.*, 120 T.C. 174, 306. Furthermore, a post-valuation date event, even if unforeseeable as of the valuation date, also may be probative of the earlier valuation to the extent that it is relevant to establishing the amount that a hypothetical willing buyer would have paid a hypothetical willing seller for the subject property as of the valuation date. *See Estate of Gilford v. Commissioner*, 88 T.C. 38, 52-55 (1987).

In *Silverman v. Commissioner*, T.C. Memo. 1974-285, *aff'd*, 538 F.2d 927 (2d Cir. 1976), *cert. denied*, 431 U.S. 938 (1977), the petitioners gifted shares of preferred stock while in the process of reorganizing with the intent to go public. The Tax Court rejected the expert testimony presented by the petitioners because the expert failed to take into account the circumstances of the future public sale.

In *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999), *aff'g* 108 T.C. 244 (1997), the appellate court considered the issue of whether the Tax Court correctly held that taxpayers were liable for gain in appreciated stock under the anticipatory assignment of income doctrine. In Ferguson, taxpayers owned 18 percent of AHC and served as officers and on the board of directors. In late 1987 and early 1988, the AHC board of directors contacted and eventually authorized Goldman, Sachs & Co. to find a purchaser of AHC and to assist in the negotiations. By July 1988, Goldman, Sachs had found four prospective purchasers. Shortly thereafter, AHC entered into a merger agreement with DCI Holdings, Inc. With the taxpayers abstaining from the vote, the AHC board unanimously approved the merger agreement. On August 3, 1988, the tender offer was started. On August 15, taxpayers with the help of their broker executed a donation-in-kind record with respect to their intention to donate stock to a charity and two foundations. On September 9, 1988, the charity and the foundations tendered their stock. On September 12, 1988, the final shares were tendered and on October 14, 1988, the merger was completed. The court concluded that the transfers to charity and the foundations occurred after the shares in AHC had ripened from an interest in a viable corporation into a fixed right to receive cash and the merger was "practically certain" to go through. In particular, the court noted that "[t]he Tax Court really only needed to ascertain that as of [the valuation] date, the surrounding circumstances were sufficient to indicate that the tender offer and the merger were practically certain to proceed by the time of their actual deadlines - several days in the future." *Ferguson*, 174 F.3d at 1004.

> Consequently, the assignment of income doctrine applied and the taxpayers realized gain when the shares were disposed of by charity and the foundations.
>
> The current case shares many factual similarities with Ferguson, including the targeted search by the Board of Directors of Corporation A to find merger candidates, the exclusive negotiations with Corporation B immediately before the final agreement, the generous terms of the merger, and an agreement that was "practically certain" to go through. While the *Ferguson* opinion deals exclusively with the assignment of income doctrine, it also relies upon the proposition that the facts and circumstances surrounding a transaction are relevant to the determination that a merger is likely to go through. *See Bank One* and *Kollsman*, *supra*. The current case presents an analogous issue, that is, whether the fair market value of the stock should take into consideration the likelihood of the merger as of the Date 1 transfer of Shares to Trust. The *Ferguson* and *Silverman* opinions, as considered by the Tax Court and the Second and Ninth Circuit Courts of Appeal, support the conclusion that the value of stock in Corporation A must take into consideration the pending merger. Accordingly, a value determined on the basis of the selling price as provided under § 25.2512-2(b) does not represent the fair market value of Shares as of the valuation date; pursuant to § 25.2512-2(e), other relevant facts and elements of value must be considered in determining fair market value. Under the fair market value standard as articulated in § 25.2512-1, the hypothetical willing buyer and willing seller, as of Date 1, would be reasonably informed during the course of negotiations over the purchase and sale of Shares and would have knowledge of all relevant facts, including the pending merger. Indeed, to ignore the facts and circumstances of the pending merger would undermine the basic tenets of fair market value and yield a baseless valuation.

"Estate Planning Current Developments and Hot Topics," by Steve R. Akers, Ronald D. Aucutt, and Kerri G. Nipp of Bessemer Trust, Dallas, Texas, for ALI's Estate Planning for the Family Business Owner 2023 (10/6/2023), included item 18.b, which described the disposition of the CCA:

> The IRS eventually conceded. *Baty v. Commissioner*, Tax Court Docket No. 12216-21 (Petition filed June 23, 2021, Stipulated Decision Entered June 17, 2022).

A sale to an irrevocable grantor trust has several advantages over GRATs, if one is willing to take gift tax audit risks:

- Payments back to the grantor are lower and more flexible than in a GRAT.[6488]

[6488] A sale uses the applicable federal rate (§ 1274), and a GRAT uses the § 7520 rate, which is 120% of the annual mid-term rate (rounded to the nearest 0.2%). A sale can have interest-only payments with a balloon payment upon maturity, with optional principal prepayments. A GRAT must have relatively even payments, with any year's payment no greater than 120% of the prior year's payment. Reg. § 25.2702-3(b)(1)(ii). Thus, a GRAT requires higher payments up-front, which leaves less in the trust to grow.

- If the grantor dies during the term, the assets in the trust should not be brought back into the grantor's estate[6489] (unlike a GRAT).[6490] On the other hand, if one is using low basis assets and the grantor dies before significant estate tax savings are realized, the tax benefit of the basis step-up from the GRAT's includability might very well exceed the tax detriment of estate tax on the growth.

- Having a business interest included in one's estate (the result of dying during the GRAT's annuity term) may generate estate tax deferral under Code § 6166, whereas a promissory note is not eligible for that deferral.[6491] If losing Code § 6166 deferral is a concern, consider having the trust buy insurance in the grantor's life:

  - If the grantor dies while the note is outstanding, the trust can use the death benefit to pay down the note, providing liquidity for the grantor's estate. Also, if the trust may have relied on tax distributions from the purchased business interest to make note payments, the trust will need those tax distributions to pay its own tax after the grantor's death, so the trust may need the death benefit to replace the trust's inability to use tax distributions to pay the note. Term life insurance, with a death benefit that decreases over time, may be an appropriate tool.

[6489] If the promissory note is considered an interest in the trust and is worth less than the stock sold, the IRS might argue that the sale was not for adequate and full consideration and attempt to include the trust in the grantor's estate under Code § 2036(a)(1). The IRS' argument would be that the only source of payment was the transferred property and that the grantor retained an interest in the trust. This has been a point of contention in sales for private annuities, as described in fn. 6443, found in part III.B.1.g.i Private Annuities: Estate Planning Implications. This issue generally does not arise when selling to an individual, as shown by Rev. Rul. 77-193 (but in a more complex set of facts):

> In addition, since B's promise to pay for the timber rights is a personal obligation of B as transferee, the obligation is not chargeable to the transferred property, and the payments are wholly independent of whether or not the transferred property produces income for the transferee. Thus, no part of the transferred property is includible in the transferor's gross estate under section 2036(a)(1) of the Code. See the following footnote in *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U. S. 274, 280 (1958), 1958-1 C.B. 557, 559:
>
> > Where a decedent, not in contemplation of death, has transferred property to another in return for a promise to make periodic payments to the transferor for his life-time, it has been held that these payments are not income from the transferred property so as to include the property in the estate of the decedent. *E.g.*, *Estate of Sarah A. Bergan*, 1 T.C. 543, *Acq.*, 1943 Cum. Bull. 2; *Security Trust & Savings Bank, Trustee*, 11 B.T.A. 833; *Seymour Johnson*, 10 B.T.A. 411; *Hirsh v. United States*, 1929, 35 F.2d 982, 68 Ct. Cl. 508; *cf. Welch v. Hall*, 1 Cir. 134 F.2d 366. In these cases the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made.
>
> Accordingly, it is held that section 2036 of the Code does not apply to the transaction under which A conveyed timber rights to B for a term of years in exchange for a cash payment and promissory notes, not all of which had reached maturity at the time of A's death, and A subsequently conveyed all of his interest and estate in the land to C.

[6490] If the grantor dies while receiving payments from a GRAT, then all or part of the GRAT will be included in the grantor's estate under Code 2036(a)(1). In FSA 200036012, the IRS took the position that all of a GRAT is included under Code § 2039, but the better view is that Code § 2039 should not apply, the latter which is now confirmed by Regs. §§ 20.2036-1(c)(2), 20.2039-1(e). *Badgley v. U.S.*, 125 A.F.T.R.2d 2020-685 (9th Cir. 2020), upheld estate inclusion of a GRAT while declining to address the validity of Reg. § 20.2036-1(c)(2).

[6491] See part III.B.5.e.ii Code § 6166 Deferral.

- The grantor cannot turn off grantor trust status to the extent of the amount used to pay these premiums. See part III.B.2.h.v Life Insurance.

- The grantor can apply GST exemption up front on a highly leveraged basis (in other words, using a small amount of GST exemption relative to the property transferred to the trust); whereas, to make a GRAT exempt the grantor would apply GST exemption at the end of its term, based on the trust's asset's values at that time:[6492] But then we have uncertainty as to how much the assets were worth when GST exemption is allocated, and the GST statute of limitations runs at a much later date.[6493] And evaluating how to run the gift tax statute of limitations (if even possible) on a sale from a GST-nonexempt trust to a GST-exempt trust can be dicey.[6494]

    - If the grantor and spouse split gifts, then each may allocate GST exemption at the back end.[6495] Generally, gifts that may be included in the donor's estate should not be split, because the consenting spouse's gift tax exemption is not restored if the asset is included in the donor's estate. However, splitting GRATs that are nearly zeroed out would make any loss of gift tax exemption be nominal.

    - One might consider the remaindermen selling their interest in the GRAT to a GST-exempt trust when the GRAT is created, so that the GRAT remainder becomes GST-exempt, an approach implicitly rejected by Letter Ruling 200107015 (charitable lead annuity trust, not a GRAT). Commentators have questioned Letter Ruling 200107015,

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[6492] Code § 2642(f); see part III.B.1.d.ii Estate Tax Inclusion Period. One should opt out of automatic allocation of GST exemption to a GRAT upon inception. Although Reg. § 26.2632-1(c)(1)(i) provides, A direct skip or an indirect skip that is subject to an estate tax inclusion period (ETIP) is deemed to have been made only at the close of the ETIP, Reg. § 26.2632-1(c)(2)(ii)(A) provides that the value of transferred property is not considered as being subject to inclusion in the gross estate of the transferor or the spouse of the transferor if the possibility that the property will be included is so remote as to be negligible. A possibility is so remote as to be negligible if it can be ascertained by actuarial standards that there is less than a 5 percent probability that the property will be included in the gross estate. A counter-argument to this is that the proceeds from annuity payments will be part of the grantor's gross estate no matter when the grantor dies; given that Reg. § 26.2632-1(c)(1)(iii) provides that an ETIP applies to the entire trust if any part of it is subject to an ETIP suggests that the less than 5% so remote as to be negligible exception will not apply to a GRAT until all of the annuity payments have been paid. Rather than choosing which argument is right, I take the easy route and opt out. Letter Ruling 201705002 allowed a donor to opt out late when she instructed the gift tax return preparer to opt out and the preparer inadvertently failed to elect out of the automatic allocation of GST exemption.

[6493] See text accompanying fn 7005 in part 0 See Sheppard, "No Notice, No Examination, No Problem: IRS Further Deprives Appraisers of Procedural Protections," *Taxation of Exempts* (WG&L) (1/2022).
Sale from One Trust to Another.

[6494] See part 0 See Sheppard, "No Notice, No Examination, No Problem: IRS Further Deprives Appraisers of Procedural Protections," *Taxation of Exempts* (WG&L) (1/2022).
Sale from One Trust to Another.

[6495] Code § 2652(a)(2); Reg. § 26.2652-1(a)(4), the latter which provides:

> *Split-gift transfers*. In the case of a transfer with respect to which the donor's spouse makes an election under section 2513 to treat the gift as made one-half by the spouse, the electing spouse is treated as the transferor of one-half of the entire value of the property transferred by the donor, regardless of the interest the electing spouse is actually deemed to have transferred under section 2513. The donor is treated as the transferor of one-half of the value of the entire property. See § 26.2632-1(c)(5) Example 3, regarding allocation of GST exemption with respect to split-gift transfers subject to an ETIP.

See also Reg. § 26.2632-1(c)(2), applying ETIP regarding the life of a spouse even if no gift splitting occurred.

some rejecting and some accepting its result as applied to GRATs;[6496] note that the trustee can make a distribution to a skip person, file the appropriate forms to run the statute of limitations (SOL) on the inclusion ratio, and resolve the issue of inclusion ratio when the SOL runs.[6497] However, also consider whether such a sale might result in the IRS arguing that the purchaser trust is included in the seller's estate if the seller is a beneficiary.[6498]

- To avoid these dicey back-end issues, some advocating terminating the GRAT outright to those children who survive and provide make-up lifetime transfers or bequests to the children of any child who predeceases the GRAT's termination. Then each generation is blessed with going through this ordeal until the wealth gets sufficiently diluted. Contrast that to perpetual GST-exempt trusts, where the children get full benefit from the wealth without having to part with any during their lives.

S corporation stock can work very well for a GRAT or sale to an irrevocable grantor trust over a 5-10 year period. Frequently, S corporation stock is valued at 4-5 times earnings, so it is easy to pay for the sale. For example, suppose an S corporation generates $200,000 of net cash flow per-year and distributes $90,000 each year to the shareholders so that they can pay their taxes. The corporation is worth $1 million (5 times earnings). In the first year, the promissory note payments from the trust to the grantor are $90,000, which the grantor uses to pay taxes as usual. The $90,000 payments are $60,000 interest (using a 6% AFR) and $30,000 principal. If the corporation distributes all of its earnings to get estate tax matters taken care of, then it distributes $200,000 in the first year, which the trust could use to pay $60,000 interest and

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6496 See Harrington, Plaine & Zaritsky, ¶ 9.12[5] Assignments of Remainder Interests—Uncharted Waters (found within ¶9.12. Examples of Deferring or Minimizing the Application of the Generation-Skipping Transfer Tax), *Generation-Skipping Transfer Tax* (WG&L). But see Bramwell and Weissbart, The Dueling Transferors Problem in Generation-Skipping Transfer Taxation, *ACTEC Law Journal*, Vol. 41, No. 1 (Spring 2015) (concluding that the sale strategy does not work because the sale does not change the transferor).

6497 See part 0 See Sheppard, "No Notice, No Examination, No Problem: IRS Further Deprives Appraisers of Procedural Protections," *Taxation of Exempts* (WG&L) (1/2022).
Sale from One Trust to Another, especially the text accompanying fn. 7005.

6498 See *Estate of Magnin v. Commissioner*, 184 F.3d 1074 (9th Cir. 1999) (not included in seller's estate), *rev'g* T.C. Memo. 1996-25; *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997) (not included in seller's estate), *rev'g* 77 A.F.T.R.2d 96-1411 (W.D. Tex. 1996); *Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309 (3rd Cir. 1996) (not included in seller's estate), *rev'g* 105 TC 252 (1995), *cert. denied* 1997 WL 134397 (5/19/1997). *D'Ambrosio* distinguished *Gradow v. United States*, 11 Cl. Ct. 808 (1987), *aff'd* 897 F.2d 516 (Fed. Cir. 1990), and *Pittman v. United States*, 878 F.Supp. 833 (E.D. N.C. 1994), with the Fifth Circuit stating:

> In support of its equilibrium rule, the *Gradow* court cited precedent in the adequate and full consideration area, most notably *United States v. Allen*, 293 F.2d 916 (10th Cir.), *cert. denied*, 82 S.Ct. 378 (1961).
>
> ….
>
> The problem with the *Gradow* dicta is that, in its effort to escape the hypothetical posed by the taxpayer, it lost sight of the very principle the court was trying to apply; namely, the notion that adequate and full consideration under the exception to section 2036(a) requires only that the sale not deplete the gross estate. *Gradow* was correct in observing that it is not unreasonable to require that, at a minimum, the sale accomplish an equilibrium for estate tax purposes. *Gradow*, 11 Cl. Ct. at 813-14. Indeed, *United States v. Allen*, 293 F.2d 916, when properly construed, stands simply for that proposition.

CCM 201745012 listed other reasons why it believes that that a deathbed purchase by the grantor of a GRAT of the remainder interest for its actuarial value did not work.

$140,000 principal. In the second year, the trust could use the $200,000 distribution to pay $51,600 interest and $148,400 principal. The note could easily be paid off in 5-10 years, even if the corporation's earnings do not increase.

Thus, a sale of an interest in an entity taxed as a partnership or S corporation to an irrevocable grantor trust works especially well because the entity makes distributions to its owners to pay taxes and the trust itself does not pay taxes and can use that distribution to pay the note. Contrast that to a C corporation, where the corporation pays its own taxes and avoids paying dividends to avoid double taxation on earnings.[6499]

For hard-to-value assets, a GRAT that does not have a lot of cash flow might require payments be made in kind. The IRS might argue that the payments back to the grantor were overvalued, so that the grantor really did not receive a large enough annuity payment. To reduce this possibility, consider using do an increasing annuity with enough liquid assets to be sure to pay the first three years of payments, the GRAT borrowing from a bank to make the distributions, or using a formula distribution equal to the annuity payment.

For a sale to an irrevocable grantor trust involving an asset that does not generate much cash flow, consider how the note will be repaid; if one cannot develop a solid plan for repaying the note consider alternative strategies. Consider instead using a GRAT or sale to an irrevocable grantor trust to generate cash flow, which then might be used to buy that non-cash-flowing asset. GRATs and sales to irrevocable grantor trusts can also be used to roll out of a split-dollar arrangement, which generally require an exit strategy.[6500]

For marketable securities, consider using a rolling, asset-splitting GRAT strategy, which is as follows:[6501] The grantor divides the grantor's marketable securities portfolio into baskets that move in different directions. For the sake of developing an example, consider using four different baskets and starting with four separate two-year GRATs.[6502] Each GRAT distributes roughly half of the initial value of its assets on its first anniversary and a slightly larger one on the second anniversary on its second anniversary. If anything is left at the GRAT's termination, it might continue in an irrevocable grantor trust for the grantor's children or might be distributed to them.[6503] If a GRAT does well, the children get the excess growth; if it does not do well, the grantor absorbs the loss. If an asset hits a peak during the GRAT's term, the grantor might swap it out for a stable asset to lock in the gain. Each year, when the grantor receives roughly one-half of the initial value of the assets, the grantor places them in another GRAT. Thus, the grantor starts with four GRATs, but after the first year creates another set of four two-year GRATs. Thus, generally the grantor would have eight GRATs. Because each GRAT's funding should occur on a single day, consider using an LLC to hold a basket, so that asset transfers can be done using assignments of LLC interests instead of moving assets. Each LLC will be disregarded for income tax purposes so long as all of the owners are GRATs or other revocable or irrevocable grantor trusts owned by the same person.[6504]

[6499] For other issues comparing C corporations to pass-through entities, see part II.E.2.a Transferring the Business.
[6500] See part II.Q.4.f Split-Dollar Arrangements.
[6501] I first heard of this strategy listening to Carlyn McCaffrey lecture at Heckerling in 2001.
[6502] Ideally, one would have separate GRAT for each asset. However, the strategy needs to be practical to work. Whether one should have more or fewer baskets depends on the client's situation.
[6503] Generally my preference would be an irrevocable grantor trust, but consider GST complexity in doing this. Many permutations of back-end strategies might constitute reasonable approaches.
[6504] See fn. 330.

With either technique, if the grantor's spouse is also the parent of the grantor's descendants who are beneficiaries of the trust, the grantor might consider including the spouse as a beneficiary (sometimes known as a SLAT – spousal limited access trust). A disadvantage of this approach would be the inability to turn off the grantor trust status, in whole or in part; authorizing an independent trustee to make distributions for the spouse's welfare might ease the pain of unrelenting grantor trust status.

Finally, if the asset being transferred is an interest in a closely-held business, consider liquidity to pay estate tax. If the grantor dies during the initial GRAT term, any business interest that is included in the grantor's estate is potentially eligible for long-term estate tax deferral.[6505] If the grantor dies holding a note from a sale to an irrevocable grantor trust, the note is a passive asset for which estate tax deferral is not available. The grantor might consider term life insurance to fund any estate tax incurred on the note. The parties might also prepare in advance documents to effectuate a sale of the business asset from the irrevocable grantor trust back to the grantor in exchange for the remaining balance on the note, so that the sale back to the grantor could be effectuated on short notice if the grantor is about to die.[6506] The sale back to the grantor might not only provide a chance of estate tax deferral but also might generate a basis step-up in the reacquired assets.[6507]

III.B.2.c. Grantor Retained Income Trust (GRIT)

In a grantor retained income trust (GRIT), the grantor retains the right to income for a period of time or for life.

For income tax purposes, the grantor is the deemed owner of the trust's income. See parts III.B.2.h.viii Code § 677(a) and GRATs and III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

A GRIT needs to be established in a state that grants spendthrift protection to a trust for the settlor's benefit, because subjecting the trust's assets to the donor's creditors may cause the gift to be wholly incomplete.

III.B.2.c.i. Completed Gift to Self-Settled Trust

If a court in a creditor-friendly state cannot obtain jurisdiction over the trustee or over the trust's assets, then the rules of the protective state would tend to prevail.[6508]

Uhl v. United States, 241 F.2d 867 (7th Cir. 1957), held no estate inclusion beyond that attributable to what the grantor had absolute right to receive at the time of death. Although the trustee had uncontrolled discretion to distribute more, creditors could not reach anything beyond the fixed sums to which the grantor was entitled.

[6505] See part III.B.5.e.ii Code § 6166 Deferral.

[6506] The sale might be a formula sale, buying back the portion of business assets having a value equal to the remaining value of the note, as finally determined for federal gift tax purposes. See part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.

[6507] For the latter, consider whether Code § 1014(e) might apply and whether the assets should therefore be bequeathed to persons other than the irrevocable grantor trust.

[6508] *Hanson v. Denckla*, 357 U.S. 235 (1958).

Rev. Rul. 76-103 had the following facts:

> The grantor created an irrevocable inter vivos trust on September 2, 1975. During the lifetime of the grantor, trust income may, in the absolute discretion of the trustee, be paid to the grantor or accumulated and added to principal. Any amount of trust principal may be distributed to the grantor at any time, in the absolute discretion of the trustee. Upon the death of the grantor, any remaining principal is payable to the issue of the grantor. The surrounding facts indicated that the trust had not been created primarily for the benefit of the grantor.
>
> The trust was created in State X and has been administered under the laws of that State from the date of the transfer. The terms of the trust include, however, a provision allowing the trustee, in its absolute discretion, to move the situs of the trust to any other State.
>
> Under the law of State X, the trust is a "discretionary trust" and the entire property of the trust may be subjected to the claims of the grantor's creditors, whenever such claims may arise.
>
> The question presented is whether the transfer in trust is an incomplete gift for Federal gift tax purposes because the assets of the trust are subject to the claims of creditors of the grantor.

Rev. Rul. 76-103 quoted Reg. § 25.2511-2(b), (c) then reasoned:

> In *Alice Spaulding Paolozzi*, 23 T.C. 182 (1954), *acq*. 1962-1 C.B. 4, a grantor empowered the trustees to determine how much of trust income should be distributed, in their absolute discretion, in the best interest of the grantor. Any unpaid income was to be added to principal. The Tax Court agreed with the petitioner's interpretation of Massachusetts law as allowing both prior and subsequent creditors of the grantor to reach the maximum amount of income that the trustees could in their discretion pay out to the grantor. The grantor could thus effectively enjoy all the trust income by relegating the creditors to the trust for settlement of their claims. Therefore, the court held that no taxable gift of trust income had been made.
>
> In the present case, the law of State X is similar to that of Massachusetts when the *Paolozzi* case, above, was decided. As long as the trustee continues to administer the trust under the law of State X, the grantor retains dominion and control over the trust property.
>
> Accordingly, in the instant case, the grantor's transfer of property to the trust does not constitute a completed gift for Federal gift tax purposes.
>
> If and when the grantor's dominion and control of the trust assets ceases, such as by the trustee's decision to move the situs of the trust to a State where the grantor's creditors cannot reach the trust assets, then the gift is complete for Federal gift tax purposes under the rules set forth in section 25.2511-2 of the regulations (quoted above).
>
> Furthermore, if the grantor dies before the gift becomes complete, the date of death value of the trust corpus will be includible in the grantor's gross estate, for Federal estate tax purposes, under section 2038 of the Code because of the grantor's retained power

to, in effect, terminate the trust by relegating the grantor's creditors to the entire property of the trust.

Rev. Rul. 77-378 had the following facts:

> On January 16, 1975, approximately one half of the grantor's income- producing property was conveyed to an irrevocable inter vivos trust created on that day. The terms of the trust require the trustee (a corporation) to accumulate income and add it to principal during the lifetime of the grantor. Upon the death of the grantor, the trust will terminate and its assets will be paid to the grantor's spouse and children.
>
> Pursuant to the trust agreement the trustee was empowered to pay to the grantor such amounts of the trust's income and principal as it determines in its absolute and uncontrolled discretion. However, under the applicable state law the trustee's decision whether to distribute trust assets to the grantor is entirely voluntary. The grantor cannot require that any of the trust's assets be distributed to the grantor nor can the creditors of the grantor reach any of the trust's assets.

Rev. Rul. 77-378 quoted Reg. § 25.2511-2(b) then reasoned:

> Even though a trustee may have an unrestricted power to return all of the trust's assets to the grantor, if the grantor's interest in the trust is not enforceable either by the grantor or on the grantor's behalf, then the grantor has parted with dominion and control over the property transferred into trust. See section 25.2511-2(b) of the regulations. Furthermore, if the grantor retains such a mere expectancy that the trustee will distribute trust assets to the grantor rather than an enforceable interest in the trust, the expectancy does not prevent the completion or reduce the value of the gift. *Herzog v. Commissioner*, 41 B.T.A. 509 (1940), *aff'd*, 116 F. 2d 591 (2nd Cir. 1941).
>
> In *Herzog*, the grantor transferred assets in trust with instructions to the trustee to pay the income to the grantor or the grantor's wife at such times and in such amounts as the trustee should deem proper with a remainder over to certain named beneficiaries. On the same day the trust was created the trustee directed that all of the trust income be paid to the grantor. The grantor argued that for gift tax purposes the value of property transferred in trust should be reduced by an amount representing the value of the income for life receivable by the grantor if the trustee in the trustee's uncontrolled discretion should so direct. The Board of Tax Appeals stated:
>
>> There would be no doubt of his nonliability for gift tax upon the value of the income if he had reserved to himself the absolute right to the income for his life. But he made no such reservation. He transferred the entire property. Whether he would enjoy any of its income depended entirely on the trustee, who, in his uncontrolled discretion, could deprive him of it completely. It was only by virtue of the trustee's direction, which on this record must be regarded as entirely voluntary. that the donor received any of the income; and this direction might be terminated whenever the trustee deemed it proper that the wife should receive the income. Such a hope or passive expectancy is not a right. It is not enough to lessen the value of the property transferred. [41 B.T.A. at 510] (citations omitted).
>
> Accordingly, the Board held that since the transfer by the grantor was complete the gift tax was, by its own terms, applicable to the value of the entire property transferred.

> In the instant case, the grantor has parted with dominion and control over the property that the grantor transferred into trust. Although the trustee has an unrestricted power to pay trust assets to the grantor, the grantor cannot require that any of the trust's assets be distributed to the grantor nor can the grantor utilize the assets by going into debt and relegating the grantor's creditors to the trust. See *Paolozzi v. Commissioner*, 23 T.C. 182 (1954), *acq.*, 1962-2 C.B. 5. Whether the grantor would enjoy any of the trust's assets is dependent entirely on the uncontrolled discretion of the trustee. Such a hope or passive expectancy does not lessen the value of the property transferred. Accordingly, the Federal gift tax is applicable to the entire value of the property transferred to the trust by the grantor.
>
> In Rev. Rul. 62-13, 1962-1 C.B. 181, the Service announced that it would follow the decisions in *Commissioner v. Vander Weele*, 254 F. 2d 895 (6th Cir. 1958) and *Gramm v. Commissioner*, 17 T.C. 1063 (1951), *acq*., 1962-1 C.B. 4. In the *Vander Weele* and *Gramm* cases the courts held that the grantors of irrevocable inter vivos trusts had not completely parted with dominion and control over the trust assets since they retained enforceable rights to some or all of the trusts' assets. For example, in *Vander Weele*, the court noted that under state law the settlor could in actuality retain the economic benefit and enjoyment of the entire trust income and corpus by borrowing money or by selling, assigning, or transferring the grantor's interest in the trust fund and relegating the grantor's creditors to the trust fund for payment. 254 F.2d at 898. Thus, in view of the settlor's retained rights there was no assurance that anything of value would pass to the remaindermen and the gift was entirely incomplete. See *Holtz v. Commissioner*, 38 T.C. 37 (1962), *acq*., 1962-2 C.B. 4. Also, the court in *Gramm* made it clear that where the grantor reserves no interest, the gift is complete. It did this by distinguishing Herzog on the ground that there "the grantor did not reserve the income to himself, and whether he received it or not was in the uncontrolled discretion of the trustee." However, Rev. Rul. 62-13 may be read to imply that broad powers given to a trustee to invade trust income and corpus for the benefit of the grantor may be sufficient to render the gift incomplete even though the grantor's interest in the trust assets is unenforceable. Therefore, Rev. Rul. 62-13 is hereby clarified to remove any implication that an entirely voluntary power held by a trustee to distribute all of the trust's assets to the grantor is sufficient to render a gift incomplete either in whole or in part.
>
> Accordingly, in the present case, the Federal gift tax is applicable to the entire value of the property transferred to the trust by the grantor.

Some might read that as holding that the IRS will look only to the law of the state in which the trust has situs. However, Rev. Rul. 2004-64, Situation 3, refers to whether applicable local law subjects the trust's assets to the grantor's creditors; Rev. Rul. 2004-64, which is discussed further in fns. 6961-6980, is found in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner.

Outwin v. Commissioner, 76 T.C. 153 (1981), provided an Official Tax Court Syllabus:

> Edson S. Outwin created four irrevocable trusts under which he was to be the sole potential beneficiary during his lifetime. The trustees were authorized to distribute income or corpus to him in their absolute and uncontrolled discretion. His wife, Mary M. Outwin, was named a beneficiary in the event she survived her husband. The trust agreements further provided that all discretionary distributions to Edson S. Outwin required the prior written consent of his wife. Parallel provisions were incorporated in an

irrevocable trust created by Mary M. Outwin. Under her trust agreement any discretionary distributions she received required the prior written consent of her husband. None of the trusts have made any discretionary distributions; consequently, neither spouse has been asked to give his or her consent to such distributions. Held: Under Massachusetts law the creditors of the grantor of each trust could reach the trust assets for satisfaction of claims, notwithstanding the veto power over discretionary distributions vested in the grantor's spouse. Thus, the grantors failed to relinquish dominion and control over the property and the transfers were incomplete for gift tax purposes. *Paolozzi v. Commissioner*, 23 T.C. 182 (1954), followed.

The entire opinion finding for the taxpayers is below:

We must decide whether the transfers by the petitioners to their respective discretionary trusts in 1969 constituted completed gifts subject to tax under section 2501. The gift tax provisions of the Internal Revenue Code do not define the term "completed gift"[2] but it is well settled that a conveyance in trust will not be subject to gift tax where the donor retains dominion and control over the property transferred. *Estate of Sanford v. Commissioner*, 308 U.S. 39 (1939); *Burnet v. Guggenheim*, 288 U.S. 280 (1933); *Estate of Mandels v. Commissioner*, 64 T.C. 61 (1975); *Hambleton v. Commissioner*, 60 T.C. 558 (1973); *Estate of Holtz v. Commissioner*, 38 T.C. 37 (1962); sec. 25.2511-2(b), Gift Tax Regs. In the present cases, the discretionary trusts are irrevocable under the terms of the written trust agreements. In each instance the grantor may receive lifetime distributions of trust income or corpus only in the "absolute and uncontrolled discretion" of the trustees. The trustees are empowered to distribute the entire corpus to the grantor even though such distribution results in the termination of the trust. Additionally, the trust agreements require the grantor's spouse to give his or her prior written consent in an individual capacity to any such distributions. Upon the death of the grantor, the surviving spouse acquires the right to mandatory distributions of trust income on at least an annual basis, plus distributions of principal in the unfettered discretion of the trustees. The grantor's spouse is also given a special testamentary power of appointment over the trust corpus. Under these circumstances, we must decide whether petitioners have sufficiently parted with dominion and control over their property so as to qualify the transfers as completed gifts.

[2] Sec. 2511(a) provides that "section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible."

Petitioners contend that no completed gifts resulted because the trustees of the discretionary trusts had orally agreed prior to the execution of the written agreements to (1) distribute the trust income or corpus whenever the grantors requested such funds, and (2) terminate the trusts upon their request by making liquidating distributions of all the remaining corpus. Consequently, petitioners maintain that they never relinquished dominion and control over the property transferred. In the alternative, they argue that under Massachusetts law the creditors of a grantor-beneficiary of a discretionary trust can reach the assets of the trust for satisfaction of their claims, notwithstanding the veto power over discretionary distributions vested in the grantor's spouse. Accordingly, they contend that the gifts are incomplete under the principle established in *Paolozzi v. Commissioner*, 23 T.C. 182 (1954).

Respondent contends that the evidence is insufficient to prove the existence of the oral agreements alleged by the petitioners, and that, even if such agreements did exist between the grantors and the trustees, there was no agreement between the grantors (petitioners) which would restrict the right of either grantor to veto distributions from the other's discretionary trust(s). Respondent further argues that the transfers in trust were completed gifts under sections 25.2511-2(b) and 25.2511-1(g)(2), Gift Tax Regs.,[3] since there are no fixed or ascertainable standards enforceable by or on behalf of the grantor which limit the trustees' discretion to make distributions. Finally, respondent contends that under Massachusetts law the assets of a discretionary trust cannot be subjected to the claims of the grantor's creditors where (1) distributions are subject to the approval of the grantor's spouse, who is also a secondary beneficiary, and (2) there are no enforceable standards to limit the trustees' discretion in making such distributions. Thus, respondent maintains that the rule of law in Paolozzi is inapplicable. We hold for petitioners.

[3] [this footnote reproduced Regs. §§ 25.2511-2(b) and 25.2511-1(g)(2).]

Where the trust agreement specifies, as here, that distributions to the settlor are to be made in the absolute discretion of the trustees, with no enforceable standard provided, the transfer is generally held to be complete for gift tax purposes. *Herzog v. Commissioner*, 116 F.2d 591 (2d Cir. 1941); *Rheinstrom v. Commissioner*, 105 F.2d 642 (8th Cir. 1939); *Estate of Holtz v. Commissioner*, 38 T.C. 37, 42 (1962); sec. 25.2511-(b), Gift Tax Regs. *Cf*. *Commissioner v. Irving Trust Co.*, 147 F.2d 946 (2d Cir. 1945); *Estate of Toeller v. Commissioner*, 6 T.C. 832 (1946), *affd*. 165 F.2d 665 (7th Cir. 1948). A different result obtains, however, where state law permits creditors of the settlor-beneficiary to pierce the trusts for satisfaction of claims.

In *Paolozzi v. Commissioner*, 23 T.C. 182 (1954), the taxpayer created a trust under the terms of which the trustees were authorized to pay her so much of the trust income as they in their absolute discretion determined to be in her best interest. Upon her death the trust assets were to be distributed to her issue. She reported a taxable gift when the trust was established in an amount equal to the value of the assets transferred reduced by the value of a life estate for an individual her age. Respondent determined that the amount of the gift should be undiminished by the value of the life estate since here interest in the trust income was at best an expectancy, and not susceptible of valuation by actuarial methods. This Court rejected respondent's determination on the ground that, under Massachusetts law, the creditors of a settlor-beneficiary of a discretionary trust could reach for satisfaction of claims the maximum amount which the trustee could pay to the settlor or apply for her benefit. Thus, we concluded that the taxpayer could at any time obtain the economic benefit of the trust income simply by borrowing and then forcing her creditors to look to her interest in the trust income for a source of repayment. On this basis, we held that the gift was incomplete to the extent of the value of her life estate. Accord, *Vander Weele v. Commissioner*, 27 T.C. 340, 343-344 (1956), *affd*. 254 F.2d 895 (6th Cir. 1958) (involving Michigan law). See also *Estate of Holtz v. Commissioner*, 38 T.C. 37, 42 n. 3 (1962); *Herzog v. Commissioner*, 116 F.2d 591 (2d Cir. 1941) (reaching a contrary result under New York law); Rev. Rul. 76-103, 1976-1 C.B. 293. Cf. *Hambleton v. Commissioner*, 60 T.C. 558, 565-566 (1973).

Under the rule of Paolozzi, then, we must determine whether the assets of the Edson S. Outwin and Mary M. Outwin discretionary trusts could be subjected to the claims of the grantor's creditors under Massachusetts law, which governs the interpretation and administration of the trusts.

The general rule in this country regarding the rights of creditors of a settlor-beneficiary of a discretionary trust is expressed in 1 Restatement, Trusts 2d, sec. 156(2) (1959):"Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit." An example of the application of this rule is set forth in Griswold, Spendthrift Trusts, sec. 481 (2d ed. 1947):

> §481. Discretionary trusts. The settlor may attempt to retain a beneficial interest free from the claims of his creditors, by giving his property to a trustee and investing the trustee with complete discretion to decide whether the income shall be paid to him and, if so, how much of it. Thus, A may convey property to T on trust to pay A during A's life so much of the income as in T's uncontrolled discretion he deems wise, with a provision that on A's death the principal and any accumulated income shall be conveyed to B. The remainder, so far as the principal is concerned, being a present vested remainder in B and not subject to A's control, is beyond the reach of A's creditors, unless the transfer is a fraudulent conveyance. Does the fact that the trustee is given discretion over the disposition of the income exempt the income, likewise, from the claims of creditors? The courts have very properly held that in such a case creditors of the settlor may reach the entire income from the trust property during his life. A person can not settle his own property so that it will be free from the claims of creditors and yet retain the right to receive the income, if it is paid to any one, during his lifetime. [Fn. ref. omitted.]

See also 2 A. Scott, Trusts, sec. 156.2 (3d ed. 1967); G. Bogert, Trusts & Trustees, sec. 228 (2d ed. 1965).

The Supreme Judicial Court of Massachusetts formally adopted this general rule in *Ware v. Gulda*, 331 Mass. 68, 117 N.E.2d 137 (1954). In that case the settlor established a trust which provided for payments of income or principal for her support and maintenance in the sole discretion of the trustee. During her lifetime, she was the sole potential beneficiary; upon her death, the property was to go to her two daughters and her son, who was also the named trustee. An attorney brought suit against the settlor for the purpose of collecting past-due legal fees and won a court order directing the Second National Bank of Boston, which became a successor trustee following the death of the settlor's son, to pay the claim out of the trust assets. Following an appeal by the bank the Supreme Judicial Court upheld the order and offered the following explanation (117 N.E. 2d at 138):

> The substance of what happened is this. Louise with her own property created a trust of which she was, for her lifetime, to be the sole beneficiary, if there was to be one at all. The decision as to making or withholding payments, as to both principal and income, was to be entirely in the discretion of the trustee. She was to be incapable of making an assignment of any interest in the trust property, which was intended to be beyond the reach of creditors. At the moment there is no amount which the trustee has exercised its discretion to pay to Louise, although in the past it has made payments to her both of principal and of income.

> Merely because the trustee has not exercised the discretionary power conferred upon it by Louise seems to us to be an insufficient ground to distinguish this case in principle from the rule of years' standing we recently restated in *Merchants National Bank v. Morrissey*, 329 Mass. 601, 605, 109 N.E.2d 821, 823: "*The established policy of this Commonwealth long has been that a settlor cannot place property in trust for his own benefit and keep it beyond the reach of creditors*. *Pacific National Bank v. Windram*, 133 Mass. 175; *Jackson v. Von Zedlitz*, 136 Mass. 342; *Taylor v. Buttrick*, 165 Mass. 547, 551, 43 N.E. 507; *Forbes v. Snow*, 245 Mass. 85, 89, 140 N.E. 418."
>
> The rule we apply is found in Restatement: Trusts, § 156(2): "Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit." It has substantial support in authority. *Greenwich Trust Co. v. Tyson*, 129 Conn. 211, 224, 27 A.2d 166; Warner v. Rice, 66 Md. 436, 8 A. 84; *Hay v. Price*, 15 Pa.Dist.R. 144; *Menken Co. v. Brinkley*, 94 Tenn. 721, 728-729, 31 S.W. 92; *Petty v. Moores Brook Sanitarium*, 110 Va. 815, 817, 67 S.E. 355, 27 L.R.A., N.S., 800; Scott, Trusts, § 156.2; Griswold, Spendthrift Trusts (2d ed.) § 481. See Am. Law of Property, § 23.18. Although every exercise of the power might take property away from the remaindermen, that is no objection where the trustee could pay the entire principal to the creator of the trust.

[Emphasis added.]

Thus, the Massachusetts Court held that creditors of the settlor-beneficiary could reach the trust assets despite the fact that under the terms of the trust instrument, distributions by [pg. 165]the trustee to or on behalf of, the settlor were completely within its discretion, and even though the interests of the remaindermen beneficiaries would be adversely affected by such action. See also *State Street Bank & Trust Co. v. Reiser*, 7 Mass. App. Ct. 633, 389 N.E.2d 768 (1979). The *Gulda* decision provided the basis for our holding in Paolozzi v. Commissioner, supra, to the effect that a settlor-beneficiary of a discretionary income interest in a Massachusetts trust had failed to relinquish dominion and control over such interest for gift tax purposes.

Respondent does not dispute the correctness of Gulda or its continued viability as a part of Massachusetts trust law. Nor does he challenge the propriety of our decision in *Paolozzi*. Rather, he seeks to distinguish those cases on the ground that discretionary distributions from the trusts herein require the prior individual consent of the grantor's spouse, who is also a remainderman beneficiary thereof. The presence of such a veto power in an interested party, respondent contends, imposes a significant limitation on the trustees' discretion and thereby removes these cases from the general rule of *Gulda*. We disagree.

After a rather extensive search of the law of Massachusetts as well as other jurisdictions, we have found no authorities, nor have the parties cited any, which have addressed this precise issue. The decision of the Mississippi Supreme Court in *Deposit Guaranty National Bank v. Walter E. Heller & Co.*, 204 So. 2d 856 (Miss. 1967), relied on by petitioner, is clearly distinguishable. There, the settlor created a trust and retained the right to request distributions, of principal of up to 25 percent of the trust assets in any given year. Before the trustee could make such distributions it was required to obtain the approval of a third party designated as "Advisor to the Trustee." The court allowed a creditor to attach the trust assets despite the incorporation of a spendthrift clause in the trust agreement and notwithstanding the approval power vested in the adviser (204 So. 2d at 861):

Of course, the withdrawals mentioned had to be with the approval of the advisor. This does not save the situation; for if there were no advisor it would have to be with the approval of the Trustee. In either event, if a man were setting up a trust of his own property and were naming the trustee and the advisor as in this case, it would be easy for him to select some person who would approve any demand for withdrawal that he made.

However, in contrast to the present cases, the individual vested with the approval right did not have an interest in the trust which could influence the manner in which he exercised that right.

Nevertheless, it is our opinion that the veto power bestowed upon the grantor’s spouse in connection with the trusts herein is insufficient to render the *Gulda* rule inapplicable. The Gulda opinion and the cases cited therein evidence a strong public policy in Massachusetts against persons placing property in trust for their own benefit while at the same time insulating such property from the claims of creditors. That policy would be easily frustrated if creditors were prevented from reaching the trust assets merely because the settlor’s spouse is given an interest in the trust and the right to veto discretionary distributions which might deplete that interest. It is not unreasonable to assume that, because of the marital relationship, the settlor could anticipate the complete acquiescence of his spouse in any discretionary distributions which he might receive, regardless of their effect on her interest as a remainderman. Thus, in the absence of unforeseen circumstances, such as divorce, the possibility of a spousal veto in such situation may be at best a remote possibility. This is particularly true in the present cases, where the fact that each spouse has the right to veto distributions from the other’s discretionary trust(s) could discourage the exercise of that authority through fear of reprisal. For these reasons, we think that the veto powers held by the petitioners do not, by themselves, place the trusts outside the scope of the Gulda decision.

Respondent, however, argues that the interest of the grantor’s spouse as a remainderman beneficiary makes him or her truly adverse in spite of the marital relationship. He draws an analogy between this case and certain gift tax authorities which hold that a power in the grantor to revoke or alter a trust does not render a gift incomplete if the power is exercisable only in conjunction with a person having “a substantial adverse interest” in the trust. Sec. 25.2511-2(c) and (e), Gift Tax Regs.; see *Latta v. Commissioner*, 212 F.2d 164 (3d Cir. 1954), *cert. denied* 348 U.S. 825 (1954); *Camp v. Commissioner*, 195 F.2d 999 (1st Cir. 1952); *Commissioner v. Prouty*, 115 F.2d 331 (1st Cir. 1940). Both Camp and Prouty indicate that the grantor’s spouse may qualify as an adverse party if he or she possesses a direct legal or equitable interest in the trust property. Yet, while this may be true for gift tax purposes, it does not necessarily follow that the concept is relevant in determining the rights of creditors under State law respecting assets placed in a discretionary trust for the settlor’s own benefit. In the latter case, the principal concern is not whether a completed gift has occurred, but rather whether a transfer in trust will be permitted to shield the grantor’s assets from the claims of present or future creditors. In that context we think the veto power held by the grantor’s spouse would be ineffective to shelter the discretionary trust assets from such claims, even though the spouse qualifies as an adverse party under general gift tax principles.[4]

[4] Although in *Prouty* the First Circuit stated that the donor's spouse could qualify as an adverse party, the Court did express some doubts on the matter and we share in its perceptions as they pertain to the issue before us (*Commissioner v. Prouty*, 115 F.2d 331, 335 (1940)):

> "Examining these intimate family trusts, one must recognize an element of unreality in the inquiry whether a beneficiary's interest is substantially adverse to the grantor. The supposition is that, given a sufficient stake in the trust, the beneficiary is not likely to yield to a wish of the grantor to revoke the trust. In many cases the grantor may have full confidence in the compliant disposition of the member of the family he selects to share his power of revocation, even though such member is named as beneficiary of a handsome interest in the trust. The very fact that the grantor reserved a power to revoke indicates a mental reservation on his part as to the finality of the gift; and if the grantor wishes to hold on to a power of recapture, it stands to reason he will vest the veto power in someone whose acquiescence he can count on. *** However, we cannot read into the gift tax, any more than into Sections 166 and 167, the proposition that a member of the grantor's immediate family can never be deemed to have "a substantial adverse interest." So far as the gift tax is concerned, it is fair enough to take the grantor at his word. *** [Citation omitted.]"

Respondent further contends that *Gulda* does not apply because there are no enforceable standards under State law to limit the trustees' discretion in making distributions to the grantors. In *Gulda* the discretionary distributions were to be made for the "support and maintenance" of the settlor. Respondent contends that (1) such language creates an enforceable standard under Massachusetts law whereby the settlor could legally compel the trustees to distribute sufficient funds to satisfy that standard, and (2) to the extent the settlor had such a right, she had an interest which could be reached by creditors. Since there are no ascertainable standards to govern the trustees' discretion in the present cases, respondent maintains that the grantors had no enforceable right to discretionary distributions and therefore *Gulda* does not control.

Again we must disagree. Regardless of whatever judicial restrictions Massachusetts courts might place on the exercise of the trustees' discretion, we see no basis for assuming that the *Gulda* decision was predicated on the existence of an enforceable right in the settlor to discretionary distributions. The rule adopted by the Massachusetts Supreme Court and set forth in 1 Restatement, Trusts 2d, sec. 156(2) (1959), refers only to amounts which the trustee could pay to the settlor; it makes no mention of amounts which the trustee could be required to pay in the event the settlor seeks judicial review of the trustee's actions. None of the authorities we have consulted cite the existence of an enforceable right to discretionary distributions as the rationale for the Restatement rule. See generally 2 A. Scott, Trusts, sec. 156.2 (3d ed. 1967), and the cases cited therein. Moreover, we note that this Court applied the *Gulda* rule in *Paolozzi* where the trust agreement required only that discretionary distributions of income be made in the settlor's "best interest," a standard generally considered to be less explicit than the support and maintenance provision found in *Gulda*. See 3 A. Scott, Trusts, sec. 187.2 (3d ed. 1967). Yet, this Court found it unnecessary to consider whether and to what extent the standard was judicially enforceable under Massachusetts law. Similarly, we applied the *Paolozzi* rule in *Vander Weele v. Commissioner*, 27 T.C. 340 (1956), *affd*. 254 F.2d 895 (6th Cir. 1958), without regard to the enforceability of the standard provided ("comfortable well-being and enjoyment") under Michigan law.

We hold, therefore, that creditors of the petitioners could reach the assets of their respective discretionary trusts for reimbursement under Massachusetts law, and under the holding of *Paolozzi* the petitioners have failed to surrender dominion and control over the trust assets.[5]

[5] Although the transfers in trust in these cases are not subject to gift tax, the settlor's ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the settlor's gross estate under secs. 2036(a)(1) or 2038(a)(1). See *Estate of Uhl v. Commissioner*, 25 T.C. 22 (1955), *revd*. 241 F.2d 867 (7th Cir. 1957) (Seventh Circuit disagreed with this Court's finding that creditors of the settlor had the right to reach the trust assets under Indiana law, but did not directly dispute the conclusion that such a right, had one existed, would cause inclusion in the settlor's gross estate under the predecessor to sec. 2036(a)); Rev. Rul. 76-103, 1976-1 C.B. 293 (inclusion required under section 2038(a)); see also C. Lowndes, "Some Doubts About the Use of Trusts to Avoid the Estate Tax," 47 Minn. L. Rev. 31, 36-37 (1962).

In reaching our decision in this case we expressly disavow any reliance on the oral understandings between the petitioners and the trustees to the effect that the trustees would be totally responsive to any requests from the petitioners for discretionary distributions. On occasion, this Court has considered extrinsic evidence, such as the settlor's financial condition, his purpose in establishing the trust, and oral assurances by the trustees that the funds would be made available upon request, to help determine whether a right to discretionary distributions rendered a transfer in trust incomplete for gift tax purposes. See Estate of Holtz v. Commissioner, 38 T.C. 37, 43-44 (1962); Vander Weele v. Commissioner, 27 T.C. 340, 345-346 (1956), affd. 254 F.2d 895 (6th Cir. 1958); *Gramm v. Commissioner*, 17 T.C. 1063, 1066 (1951). In each of these cases, however, a standard limiting the trustee's discretion was provided in the trust instrument and the extrinsic evidence served primarily to indicate the probability that the trust funds would be used to satisfy that standard. There are no ascertainable standards in the trust agreements before us. In fact, other than the requirement that the trustees act in good faith, there are absolutely no limitations placed on the trustees' discretionary authority. They are specifically directed to exercise their discretion without regard to the independent financial resources of any beneficiary, and without regard to whether any anticipated distributions would lead to the termination of the trust. Yet, these provisions vesting absolute discretion in the trustees are flatly contradicted by the oral understandings to which the petitioners and the trustees testified. We are inclined to give such testimony little weight for several reasons: (1) The petitioners' testimony is self-serving; (2) the trustees are close personal friends of the petitioners; and (3) the petitioners have yet to receive any distributions from their respective discretionary trusts.[6] Furthermore, we note that, while the testimony indicates that the petitioners received the specified assurances from trustees Henry B. Thielbar and Morris H. Bergreen, there is insufficient evidence to prove that either of the petitioners agreed in advance to consent to any proposed distributions from the other's trust(s). Accordingly, we rest our decision in this case solely on the creditor's rights theory set forth in *Paolozzi*.

> [6] Petitioner Edson S. Outwin and trustees Henry B. Thielbar and Morris H. Bergreen testified that distributions from the discretionary trusts would eventually be necessary to pay off loans made by the Outwin Investment Co. to the Edson S. Outwin Revocable Trust, which loans currently exceed the revocable trust's capital account balance in the partnership. The fact remains, however, that the only distributions petitioner has received thus far have come from the revocable trust, and we see no reason to speculate on whether and to what extent distributions from the discretionary trusts might be forthcoming in the future.

Estate of German v. Commissioner, 7 Cl. Ct. 641 (1985), described the issue at hand:

> The question presented is whether the decedent divested herself of her interest in property in 1969 when she transferred such property to a trust with a proviso that the trustees might, in their absolute discretion, pay any or all of the income or principal to decedent at any time during her lifetime, if they received the written consent of the person who was entitled to receive the principal and accumulated income of the trust after her death, or, whether she continued to enjoy the right to the income or principal of the trust up to the date of her death, because under Maryland law if she chose to incur any debts her creditors could still attach or levy upon the trust assets to collect them.

This was a refund case, so the IRS was the defendants. The court reasoned and held:

> The government's theory is based upon the rationale of *Outwin v. Commissioner*, 76 T.C. 153 (1981) (*acq*., 1981-2 C.B. 2), a gift tax case. There the taxpayer had created four irrevocable trusts, which were to accumulate the income during his lifetime. After his death, if his wife survived him she was entitled to mandatory distributions of the trust income annually, and to distribution of the corpus to her only in the absolute and uncontrolled discretion of the trustee. In addition, she was given a special testamentary power of appointment over the corpus. Notwithstanding the foregoing, the trustees were given the power at any time during the life of the grantor, to pay to, or apply for the benefit of, the grantor, such part or parts of the income and principal as the trustees should determine in their absolute and uncontrolled [pg. 85-1579]discretion, for any reason whatsoever, notwithstanding that such payments might result in the termination of the trust; but such distributions by the trustees required the prior written consent of the grantor's spouse.
>
> The Commissioner determined that in transferring property to such trusts Mr. Outwin had made a completed taxable gift, while the taxpayer contended to the contrary. The Tax Court overruled the Commissioner on the ground that the gift was not completed because the donor retained dominion and control over the property transferred. The court stated that "[w]here the trust agreement specifies … that distributions to the settlor are to be made in the absolute discretion of the trustees, with no enforceable standard provided, the transfer is generally held to be complete for tax purposes." *Id*. at 162. However, "[a] different result obtains … where state law permits creditors of the settlor-beneficiary to pierce the trusts for satisfaction of claims." *Id*. This result follows, the court said, from the fact that if under state law the creditors of a settlor-beneficiary of a discretionary trust may reach for satisfaction of claims the maximum amount which the trustee may pay to the settlor or apply for her benefit, the taxpayer may at any time "obtain the economic benefit of the trust income simply by borrowing and then forcing [his] creditors to look to [his] interest in the trust income for a source of repayment." *Id*. Because it found that the settlor-beneficiary's creditors did have such a right under

Massachusetts law, which was applicable to the Outwin trust, the court held that the gift was incomplete to the extent of the value of the settlor-beneficiary's life estate. Accord *Commissioner v. Vander Weele*, 254 F.2d 895 (6th Cir. 1958) (applying Michigan law); *Paolozzi v. Commissioner*, 23 T.C. 182 (1954) (also applying Massachusetts law); and Rev. Rul. 76-103, 1976-1 C.B. 293. But see *Herzog v. Commissioner*, 116 F.2d 591 (2d Cir. 1941), and *In Re Uhl's Estate*, 241 F.2d 867 (7th Cir. 1957), reaching contrary results under New York and Indiana law, respectively.

Defendant claims that under Maryland law, which is applicable to the trusts herein, decedent's creditors could have reached the principal and interest of such trusts until the time of her death, and, accordingly, she had not disposed of her right to possession and enjoyment of the property and the transfer took effect upon her death. On the other hand, plaintiff maintains that Maryland law did not give decedent's creditors such right, and, accordingly, her gifts were completed at the time she transferred the assets in trust and they were no longer subject to estate tax. Thus, the narrow issue to be decided herein is as to the extent of decedent's creditors' rights with respect to the trust income and assets under Maryland law.

The authority upon which defendant relies primarily for Maryland law is the decision in *Warner v. Rice*, 66 Md. 436, 8 A. 84 (1887). That case presented the question as to whether or not the income of a debtor, from certain property embraced in a deed of trust made by himself and his wife prior to incurring the debts, was liable to attachment or execution in a suit for his debts. The deed was made "[i]n trust for the use and benefit of said George Warner and his immediate family, free from liability for any of his debts, contracts, or engagement; and when, if so by said trustees found requisite, by him being proper, to apply to uses, rents, income, and profits to the support and maintenance of said George and his said family during his, said George's, life, and, after his decease, the same to go as he by last will may have directed, or, in case of his decease intestate, the same to go according to law under the existing statutory provisions of the law of Maryland." *Id*. 8 A. at 85. The court held that Mr. Warner's creditors could reach the income of this trust because "a beneficial legal estate, in fee or for life, cannot be conveyed or devised to a person with a provision that it shall not be alienated, or that it shall not be subject to the debts of the legal owner" (id.); that "equitable estates cannot be effectually created with a proviso against alienation, or that they shall not be liable to the debts of the *cestui que trust* …and, generally, whenever property is subject to alienation by the owner it is subject to his debts" (*id*. at 85-86); and because, in this case -

> The object of the deed of trust was not to destroy or divest himself of his right of property, but simply to place a legal estate therein in a trustee, as, perhaps, a guard against improvident management. But the equitable estate remains in George Warner during his life, with full power of disposition by will, and, in default of will, the property devolves on his heirs and representatives at his death, when the trust will terminate. It is only during his life that the rents, profits, and income from the property are directed to be applied to the support of himself and his family, when and as the trustee may deem proper. Full and complete control is retained in the cestuis que trust over the investments, and change of investments; and they declare, moreover, that they are entitled and reserve the right to collect, receive, and have, each for her or himself, the rents, issues, and profits of his or her share, conformably with the trust declared. As we have seen, there is no limitation over or cesser of George

> Warner’s equitable life-estate, or his interest in the rents and profits of the property, upon seizure of the same by his creditors. (*Id*. at 86.)

In response to the argument by Warner that the trustee had discretion as to whether or not he would pay over the rents and profits to Warner, the court noted that if the trustee did not pay them over, he had no authority to accumulate them for any other purpose; they would still belong to the estate of George Warner and the trustee would have to account to his executor or administrator for such arrearage. Id. Accordingly, “[t]he discretion given the trustee, if the terms of the direction can be construed into a power to exercise a discretion at all, can only apply to the manner of the application, and not to any power to withhold or divert the rents and profits, and apply them to any other purpose.” *Id*.

The instant case is distinguishable from *Warner* in several respects: First, if the trustee here, in the exercise of his discretion, did not distribute the income or principal to Mrs. German, it would go to the specified remaindermen; whereas in Warner the undistributed trust income would be accumulated for the settlor’s benefit and the corpus distributed pursuant to his will. Second, unlike *Warner*, before the settlor here could receive any distribution from the trustees, the consent of a beneficiary having an adverse interest had to be obtained. Third, the trusts here, but not in Warner, made dispositions of the property upon the death of the settlor and were not intended solely to shield her assets from her creditors.

In *Mercantile Trust Co. v. Bergdorf Goodman & Co*. 167 Md. 158, 173 A. 31 (1934), the Maryland Court of Appeals confirmed that where there is no proof of fraud the rights of attaching creditors to property in a trust created by a debtor depend upon whether the property which is not distributed to the settlor-beneficiary or according to his direction goes back to the settlor or to a third-party at his death. There the settlor had created an inter vivos trust, retaining a life estate in the trust assets and a power of appointment by will, which, if not exercised, would result in the property going to her then living issue or next of kin. The Maryland court held that although the creditors could attach the settlor’s income from the life estate, in the absence of a fraudulent conveyance they could not reach the corpus of the trust, because, “there was an immediate vesting of the remainder in the next of kin of the settlor”, and “[w]ith the ownership of the corpus in the remaindermen, even though the possession may be delayed or defeated by the will of the donor, … the corpus cannot be attached to satisfy the creditors of the settlor.” (*Id*. at 165-66, 173 A. at 34-35.) Accord, *United States v. Baldwin*, 283 Md. 586, 391 A. 2d 844 (1978). If the unexercised right of the settlor in Mercantile Trust Co. and Baldwin to dispose of the corpus by will was not sufficient to render the trust property subject to execution by creditors because of the interests of the remaindermen in such property in default of appointment, for the same reason it would appear that the unexercised discretion of the trustees of Mrs. German’s trust with respect to both principal and income would not render either vulnerable to Mrs. German’s creditors under Maryland law.

Apart from *Warner v. Rice*, defendant has not cited any Maryland decision in which creditors were able to reach income or corpus which could be distributed to the settlor of a trust, not as a matter of right, but in the uncontrolled discretion of the trustee.

Equally important, defendant has cited no decision, either in the Maryland courts or elsewhere, where the creditor was held entitled to attach trust property where the

> trustee's discretion could only be exercised with the prior consent of those who would receive the property in default of such exercise. In *Outwin*, the Tax Court likewise confessed that it had been unable to find any authorities in any state which addressed the precise issue. *Outwin*, 76 T.C. at 165. However, it resolved that problem by reasoning that in view of the strong public policy of the Massachusetts courts against persons placing property in trust for their own benefit while at the same time insulating such property from the claims of creditors the veto power of a spouse would not be a barrier to such creditors under Massachusetts law, because it assumed (1) that (in the absence of divorce) the possibility that the spouse would veto a disbursement by the trustee to her husband was remote, and (2) the fact that the husband might reciprocate by veto of disbursements to the wife under her similar trust would tend to further discourage her veto. *Id*. at 166-67. This court finds no such strong public policy in the Maryland courts where there is a remainder interest. It finds no assumption by the Maryland courts that the wife may be deemed merely the husband's alter ego for purposes of insulating property from a settlor's creditors in a nonfraudulent conveyance transaction. Indeed, *Watterson v. Edgerly*, 40 Md. App. 230, 388 A.2d 934 (1978), appears to be to the contrary. And the instant case does not involve reciprocal husband and wife trusts.
>
> Thus, defendant has not established that under Maryland law creditors of the settlor could have reached the trust income or principal of her discretionary trusts up to the time of her death.
>
> The most satisfactory resolution of this question of state law would have been by certification to the Maryland Court of Appeals. See *United States v. Baldwin*, 283 Md. 586, 391 A.2d 844 (1978). Unfortunately, while the Uniform Certification of Questions of Law Act, Md. [Courts and Judicial Proceedings] Code Ann. §§ 12-601-12-609 (1984), grants jurisdiction to the Maryland Court of Appeals to answer questions of law certified to it by a United States District Court or United States Court of Appeals, it does not allow certification from this court. Accordingly, it is the duty of this court to approximate the law of the state from decisions of its highest court as best it can. See *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967).

The Official Tax Court Syllabus of *Estate of Paxton v. Commissioner*, 86 T.C. 785 (1986), states:

> During his lifetime, decedent created two trusts to which he and his spouse transferred, in exchange for certificates of beneficial interest in the trusts, their residence, stock in several corporations, patents, and virtually all other property they owned except a patent royalty agreement with one of their corporations. They later transferred some of their [pg. 786] certificates to other family members. Decedent's son, his accountant, his attorney, and other close associates served as trustees. Under the terms of the trust instruments, the trustees were given full discretionary power to distribute the income and corpus of the trusts to the holders of certificates of interest, and the distributions were not required to be proportionate among the holders of such certificates. Held, on consideration of all the facts, decedent retained "enjoyment of, or the right to the income from" the transferred property within the meaning of sec. 2036(a)(1), I.R.C. 1954, because (1) there was an understanding, express or implied, that decedent would receive distributions of corpus or income from the trusts if, as, and when he requested them; and (2) decedent could incur indebtedness and relegate his creditors to the trusts for repayment. Held, further, even though decedent's estate did not file an estate tax return,

it is not liable for an addition to tax under sec. 6651(a), I.R.C. 1954, because, in failing to file such a return, the executor of the estate relied upon the advice of tax counsel. *United States v. Boyle*. 469 U.S. 241, 105 S.Ct. 687 (1985), followed.

In the portion of the Tax Court's opinion titled, "Retention of Interest Creditors Could Reach," the court said:

> As settlor-beneficiary, decedent retained the economic benefit and enjoyment of the entire trust income and corpus because he could borrow money or otherwise incur indebtedness and relegate his creditors to the trust for payment. Retention of the right to use the trust as a form of security for his indebtedness in this manner left Mr. Paxton with a significant interest in the property. See *United States v. Estate of Grace*, 395 U.S. 316, 320 (1969). In our opinion, that is sufficient to require his transfers to the trusts to be included in his gross estate under section 2036(a)(1).
>
> The widely accepted legal principle controlling the rights of the creditors of a settlor-beneficiary of a trust in which the trustees are given discretion, not controlled by an ascertainable legal standard, to make distributions to the settlor, is stated in 1 *Restatement, Trusts 2d*, sec. 156(2) (1959), as follows:
>
>> Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit.[26]
>>
>> [26] See also 2 A. Scott, Trusts, sec. 156.2 (3d ed. 1967). G. Bogert, *Trusts and Trustees*, sec. 223, at 438-439 (2d rev. ed. 1979), states:
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>>> "If a settlor creates a trust for his own benefit and inserts a spendthrift clause, it is void as far as then existing or future creditors are concerned, and they can reach his interest under the trust. Numerous cases uphold this doctrine, and many statutes assert it. [Fn. refs. omitted.]"
>>
>> The omitted footnotes list the decisions of 16 State courts and the statutes of 18 States. Comment e, accompanying 1 *Restatement, Trusts 2d*, sec. 156 (1959), deals with discretionary trusts of the type created by Mr. Paxton as follows:
>>
>>> e. Discretionary trust for the settlor. Where by the terms of the trust a trustee is to pay the settlor or apply for his benefit as much of the income or principal as the trustee may in his discretion determine, his transferee or creditors can reach the maximum amount which the trustee could pay to him or apply for his benefit.
>>
>> See also E. Griswold, *Spendthrift Trusts*, sec. 481 (2d ed. 1947).
>
> To permit the owner in creating a trust to retain for his own benefit an interest in the entrusted property which cannot be reached by creditors is against public policy. *Nelson v. California Trust Co.*, 33 Cal. 2d 501, 202 P.2d 1021 (1949); *In re Mogridge's Estate*, 342 Pa. 308, 20 A.2d 307, 309 (1941).
>
> This principle has been applied in both estate and gift tax cases.[27] Where the decedent at any time during his life could have obtained the economic benefit of the trust income

or corpus by borrowing and then forcing creditors to look to his interest in the trust income for a source of repayment, this interest has been held sufficient to require the inclusion of the transferred property in decedent's gross estate under section 2036(a)(1). *Estate of Uhl v. Commissioner*, 25 T.C. 22 (1955), *revd. and remanded* 241 F.2d 867 (7th Cir. 1957); see also *Estate of Boardman v. Commissioner*, 20 T.C. 871 (1953). In reversing the *Uhl* decision, the Court of Appeals did not directly dispute the Tax Court's view that the settlor of a trust is regarded for tax purposes as retaining any interest in the trust which his creditors can reach but concluded that under Indiana law the settlor's creditors could not have reached the trust property.[28]

[27] See note 18 *supra*.

[28] See Lowndes, "Some Doubts About the Use of Trusts to Avoid the Estate Tax," 47 Minn. Law Rev. 31, 36 (1962); Covey, "Power to Distribute to Grantor," 98 Trusts and Estates, 322, 325 (1959); *Estate of German v. United States*, 7 Cl.Ct. 641, 643 (1985).

Similarly, in the related gift tax area, transfers to a discretionary trust have been held to be incomplete and not subject to the gift tax where, under the applicable State law, the creditors of the settlor-beneficiary could reach the income or corpus of a discretionary trust. *Paolozzi v. Commissioner*, 23 T.C. 182, 186-187 (1954) (Massachusetts law); *Vander Weele v. Commissioner*, 27 T.C. 340, 343-344 (1956), *affd*. 254 F.2d 895 (6th Cir. 1958) (Michigan law); *Outwin v. Commissioner*, 76 T.C. 153, 162-165 (1981) (Massachusetts law). The principle was explained in *Vander Weele v. Commissioner*, 254 F.2d at 898, holding that no gift tax was incurred by a settlor-beneficiary of a trust, as follows:

> The trustees were granted almost unrestricted power to invade the corpus of the trust for the benefit of the trustor, with the possibility of the repayment of the entire trust fund to her. The trust conveyance in effect created no completed taxable gift to the remaindermen - the husband and children of the trustor. There was no assurance that anything of value would pass to the remaindermen. The settlor could in actuality retain the economic benefit and enjoyment of the entire trust income and corpus of the trust estate by borrowing money or by selling, assigning, or transferring her interest in the trust fund and relegating her creditors to the trust fund for payment.

On the other hand, a gift tax has been held applicable where under State law, as interpreted by the court, the settlor-beneficiary's creditors could not reach the trust corpus or income. *Herzog v. Commissioner*, 116 F.2d 591 (2d Cir. 1941), *affg*. 41 B.T.A. 509 (1940) (New York law);[29] see also *Rheinstrom v. Commissioner*, 105 F.2d 642 (8th Cir. 1939), *affg. on this issue* 37 B.T.A. 308 (1938).

[29] Since *Herzog v. Commissioner*, 116 F.2d 591 (2d Cir. 1941), *affg*. 41 B.T.A. 509 (1940), was decided, the New York courts have come to accept the Restatement rule as the law in that State. See *Vanderbilt Credit Corp. v. Chase Manhattan Bank*, 100 A.D.2d 544, 473 N.Y. Supp. 2d 242, 245-246 (1984), where the court stated:

> "when a person creates for his own benefit a discretionary trust, his creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit, even though the trustee in the exercise of his discretion wishes to pay nothing to the beneficiary or to his creditors, and even

> though the beneficiary could not compel the trustee to pay him anything (see *Ware v. Gulda*, 331 Mass. 68, 117 N.E.2d 137; *State Street Bank & Trust Co. v. Reiser*, 7 Mass. App. 633, 389 N.E.2d 768; *Greenwich Trust Co. v. Tyson*, 129 Conn. 211, 27 A.2d 166; *Restatement, Trusts 2d*, sec. 156, subd. [2]; 2 *Scott, Trusts* [3d ed.], sec. 156.2; contra *Herzog v. Commissioner of Internal Revenue*, 116 F.2d 591 (2nd Cir))."

In the instant case, according to the Yakima County Superior Court, the trustees of the PFO trust could make distributions of income or corpus to the holders of certificates of interest and the distributions need not be made pro rata in proportion to the number of units of beneficial interest held by the distributees. Within their discretion, therefore, the trustees could have made distributions to Mr. Paxton, up to and including the entire trust corpus. Under Washington law, we are convinced, his creditors could have reached such amounts. Accordingly, his inter vivos transfers to the trusts are includable in his gross estate under section 2036(a)(1).

Two Washington statutes address this issue. Wash. Rev. Code Ann. sec. 6.32.250 (1977), one of the provisions dealing with exemptions from seizure, states:

> Property exempt from Seizure. This chapter does not authorize the seizure of, or other interference with, … property held in trust for a judgment debtor where the trust has been created by, or the fund so held in trust has proceeded from, a person other than the judgment debtor….[30]

[30] Wash. Rev. Code Ann. sec. 6.32.250 (1977) is subject to two statutory limitations: Wash. Rev. Code Ann. sec. 30.30.120 (1977), which expressly exempts from Wash. Rev. Code Ann. sec. 6.32.250 (1977) claims for furnishing "the necessities of life," claims of "support for the children under the age of eighteen of any beneficiary," and a vested remainder in the trust upon its expiration; and Wash. Rev. Code Ann. sec. 19.36.020 (1977), which states the rule that a person cannot create a spendthrift trust for himself. Wicker, "Spendthrift Trusts," 10 Gonzaga L. Rev. 1, 9 (1974); Comment, "Spendthrift Trusts in Washington—The Statutory Restraint Upon Involuntary Alienation," 58 Wash. L. Rev. 831, 836-837 (1983).

The Washington supreme court has stated that the "practical effect of [this] statute has been to clothe every active trust with statutory spendthrift provisions,"[31] *Seattle First Nat. Bank v. Crosby*, 42 Wash. 2d 234, 254 P.2d 732, 738 (1953), but the "other than the judgment debtor" language limits the statute to trusts created by one who is not also a beneficiary.[32] This limitation appears to be an implicit recognition of the principle of 1 *Restatement, Trusts 2d*, sec. 156(2) (1959), quoted above. Bogert, *Trusts & Trustees*, sec. 223, at 440, n. 99 (2d rev. ed. 1979). In other words, this provision does not prevent the seizure of property held for a judgment debtor in a trust created by the judgment debtor.

[31] A spendthrift provision provides that the interest of the beneficiary is inalienable and that creditors cannot reach the interest in satisfaction of their claims. Griswold, *Spendthrift Trusts*, sec. 1 (2d ed. 1947).

[32] See E. Griswold, sec. 473, at 541.

Wash. Rev. Code Ann. sec. 19.36.020 (1977) further provides:

> Deeds, etc., in trust for grantor void as to creditors. That all deeds of gift, all conveyances, and all transfers or assignments, verbal or written, of goods, chattels or things in action, made in trust for the use of the person making the same, shall be void as against the existing or subsequent creditors of such *person*.

This section is in substance a statutory enactment of the Restatement rule. 2 A. Scott, *Trusts*, sec. 156.2 (3d ed. 1967). We think the statute means exactly what it says. Petitioners argue, however, that the section is applicable only where the property was transferred to the trust with a specific intent to defraud creditors. Petitioners argue that the section does not apply here because Mr. Paxton had no intention of defrauding his current or subsequent creditors.

Most of the cases in which Wash. Rev. Code Ann. sec. 19.36.020 (1977) has been applied were cases in which there was evidence of actual fraud. *Allard v. La Plain*, 152 Wash. 211, 277 P. 843 (1929); *Van Stewart v. Townsend*, 176 Wash. 311, 28 P.2d 999 (1934); *Carroll v. Carroll*, 18 Wash.2d 171, 138 P.2d 653 (1943); *Jones v. Jones*, 56 Wash.2d 328, 353 P.2d 441 (1960). However, we have found no Washington case in which the court held that fraud must be proved to invoke Wash. Rev. Code Ann. sec. 19.36.020 (1977).[33]

[33] Comment a. on 1 *Restatement, Trusts 2d*, sec. 156(2) (1959), makes clear that intent to defraud is not a factor in applying the rule, as follows:

> a. Intention to defraud creditors not required. The rules stated in this Section are applicable although the transfer is not a fraudulent conveyance. The interest of the settlor-beneficiary can be reached by subsequent creditors as well as by those who were creditors at the time of the creation of the trust, and it is immaterial that the settlor-beneficiary had no intention to defraud his creditors.

See also E. Griswold, sec. 473, at 540.

Nevertheless, if petitioner is correct that Wash. Rev. Code Ann. sec. 19.36.020 (1977) is limited to transfers with actual intent to defraud, and Wash. Rev. Code Ann. sec. 6.32.250 (1977), referred to above, also does not apply here because the trusts created by Mr. Paxton fall within the exception, we are then left with the common law on the rights of creditors to reach trust income and corpus where the trust was created by the debtor and the trustees have discretion to distribute income and corpus to him. We have found no cases (and petitioners have cited none) suggesting that the courts of Washington would not follow the almost universally accepted rule of 1 *Restatement, Trusts 2d*, sec. 156(2).[34] Accordingly, we find that because decedent's [pg. 819]creditors could reach the maximum amount which, under the terms of the trust declarations, could be distributed to him, decedent's transfers to the trusts are includable in his gross estate under section 2036(a)(1).[35]

[34] The Court of Appeals for the Ninth Circuit in applying the Restatement rule has recognized that a "spendthrift trust" provision in Massachusetts, California, and generally, is invalid as to the creditors of the trustor. *Hughes v. Commissioner*, 104 F.2d 144, 148 (9th Cir. 1939). See also, *e.g.*, *Matter of Goff*, 706 F.2d 574, 587 (5th Cir. 1983) (law of Texas) ("the general rule is well established"); *Liberty Nat. Bank*

v. Hicks, 173 F.2d 631, 634 (D.C. Cir. 1948) ("the universal rule"); *Byrnes v. Commissioner*, 110 F.2d 294, 295 nn. 1&2 (3d Cir. 1940), *revg*. 39 B.T.A. 594 (1939) (law of Pennsylvania); *Vanderbilt Credit Corp. v. Chase Manhattan Bank*, 100 A.D. 544, 473 N.Y. Supp. 2d 242, 245-246 (1984); *Elec. Workers v. IBEW-NECA Holiday Trust*, 583 S.W.2d 154, 162 (Mo. 1979); *Proctor v. Woodhouse*, 127 Vt. 148, 241 A.2d 785, 790 (1968) ("prevailing authority"); *Merchants Nat. Bank of New Bedford v. Morrissey*, 329 Mass. 601, 109 N.E.2d 821, 823 (1953) ("weight of authority"); *Nelson v. California Trust Co.*, 33 Cal.2d 501, 202 P.2d 1021, 1022 (1949); *McArthur v. Faw*, 183 Tenn. 504, 193 S.W.2d 763, 768 (1946) ("well settled limitation"); *Greenwich Trust Co. v. Tyson*, 129 Conn. 211, 27 A.2d 166, 171 (1942) ("overwhelming weight of authority"); *Harrison v. City National Bank of Clinton, Iowa*, 210 F. Supp. 362 (S.D. Iowa 1962).

[35] We think our conclusion is consistent with the Washington State courts' treatment of the Washington statutory scheme regarding spendthrift trusts and creditors' rights. Historically, the courts have sought to limit the broad scope of these statutes, and consequently, have often found the statutes inapplicable to the given situation and have applied instead the common law rule, *Erickson v. Bank of California, N.A.*, 97 Wash.2d 246, 643 P.2d 670, 673 (1982) (Wash. Rev. Code Ann. sec. 30.30.120 (1977), not applicable to trusts with express spendthrift provisions); *Knettle v. Knettle*, 197 Wash. 225, 84 P.2d 996, 998 (1938) (Wash. Rev. Code Ann. sec. 6.32.250 (1977) not applicable to "passive" trusts); see also Comment, "Spendthrift Trusts in Washington - The Statutory Restraint Upon Involuntary Alienation," 58 Wash. L. Rev. 831, 846-849 (1983).

Furthermore, the court in *Erickson* concluded that Wash. Rev. Code Ann. sec. 30.30.120 (1977) was not meant to restrict the common law as it applies to spendthrift trusts, and finding that section inapplicable to express spendthrift trusts, applied 1 *Restatement, Trusts 2d*, sec. 157(b). We likewise have found no indication that Wash. Rev. Code Ann. secs. 6.32.250 and 19.36.020 (1977) were intended to restrict the common law of Washington.

Letter Ruling 8037116 failed to address the issue of creditor attack, concluding that the ability of this decedent to receive income and principal under the terms of the trust he created is not sufficient to require inclusion of the property under Code § 2036(a)(1).

Letter Ruling 9837007 involved the following facts:

> According to the facts submitted, Donor, a resident of State, proposes to create an irrevocable trust (Trust) for the benefit of herself and her descendants. Trustee will be appointed as the only trustee. Trustee is to pay, during the Donor's lifetime, any part or all of the income and/or principal in such amounts and at such times, as the Trustee, in its sole and absolute discretion determines, among one or more of the class consisting of the Donor and the Donor's living descendants. Any income that is not distributed is to be added to the corpus of the trust. Upon the Donor's death, the corpus is to be divided into separate trusts for each then living child of Donor, and a separate trust for each child who died leaving issue. The Trustee is to distribute the income and principal, in its discretion, among the beneficiaries. If no descendant of Donor is living at the time of Donor's death, the income and principal of the Trust is to be distributed to one or more organizations described in sections 170(c), 2055(a), and 2522(a) of the Internal Revenue Code, as the trustee may determine.

Under Articles SIXTH and NINTH of the Trust, Donor, her descendants, or any person related or subordinate to these persons (within the meaning of section 672(c) of the Code) are precluded from serving as trustee. Donor will not have the power to remove or replace the trustee or to appoint a successor trustee. It is represented that Donor is not a shareholder, director, officer, or employee of Trustee. If Trustee should cease to serve as trustee, Donor's authorized representative will name a successor trustee.

It is represented that there is no agreement, express or implied, between the Donor and the Trustee as to how Trustee will exercise its sole and absolute discretion to pay income and principal among the beneficiaries.

Donor proposes to fund Trust with cash, securities and/or undeveloped land located in State valued at approximately $x. It is represented that Donor has no known or anticipated debts other than a home mortgage loan and that Donor is not under any obligation or order of child support.

Article TENTH provides that the interest of a beneficiary (including the grantor) of the trust may not be either voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee.

Under Article EIGHTH, section 8.1, the validity, construction and effect of Trust is to be governed by the law of State. Further, section 8.2 provides that the situs of the Trust shall be State.

State Statute provides that a person who in writing transfers property in trust may provide that the interest of a beneficiary of the trust may not be either voluntarily or involuntarily transferred before the payment or delivery of the interest to the beneficiary by the trustee. If a trust contains this transfer restriction, the restriction prevents a creditor existing when the trust is created, a person who subsequently becomes a creditor, or any other person from satisfying a claim out of the beneficiary's interest in the trust unless:

1. the transfer was intended in whole or in part to hinder, delay, or defraud creditors or other persons;

2. the trust provides that the settlor may revoke or terminate all or part of the trust without the consent of a person who has a substantial beneficial interest in the trust and the interest would be adversely affected by the exercise of the power held by the settlor to revoke or terminate all or part of the trust;

3. the trust requires that all or a part of the trust's income or principal, or both, must be distributed to the settlor; or

4. at the time of the transfer, the settlor is in default by 30 or more days of making a payment due under a child support order.

Letter Ruling 9837007 cited Reg. § 25.2511-2(b) and Rev. Rul. 77-378 and reasoned and held:

In the present case, Donor proposes to create Trust, to be administered under the laws of State, for the benefit of herself and her living descendants. The trustee will have sole and absolute discretion to pay, during the Donor's lifetime, part or all of the income

> and/or principal of Trust to Donor and the Donor's living descendants. It is represented that there is no agreement, express or implied, between the Donor and the Trustee as to how Trustee will exercise its sole and absolute discretion to pay income and principal among the beneficiaries.
>
> In addition, under State Statute, because the trust contains certain language specified in the statute, a creditor of the grantor will be precluded from satisfying claims out of the grantor's interest in the trust.
>
> Based on the representation that there is no express or implied agreement between the Donor and the Trustee as to how Trustee will exercise its sole and absolute discretion to pay income and principal among the beneficiaries, we conclude that the proposed transfer by Donor of property to Trustee to be held under the Trust agreement will be a completed gift for federal gift tax purposes.
>
> We are expressly not ruling on whether the assets held under the Trust agreement at the time of Donor's death will be includible in Donor's gross estate for federal estate tax purposes.

Letter Ruling 200944002 ruled that transfers to a self-settled spendthrift trust was a completed gift and that the trust's assets would not be included in the grantor's estate, but We are specifically not ruling on whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036. For more discussion, see Rothschild, D. Blattmachr, Gans, and J. Blattmachr, IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate, *Estate Planning Journal* (WG&L) (1/2010).

Argentina set up a trust under its own law, but its assets were held by a New York person, allowing a New York creditor to reach the assets. *EM Ltd. v. Republic of Argentina*, 2009 WL 2568433 (S.D.N.Y. 2009), *aff'd* 389 Fed. Appx. 38 (2nd Cir. 2010), *cert. den. Republic of Argentina v. EM Ltd.*, 131 S.Ct. 1474, 179 L.Ed.2d 301 (U.S. 2011).

In *Weitz v. Weitz*, 2012 N.Y. Slip. Op. 30767(U), N.Y. Sup. Ct. No. 016811-08 (3/22/2012), a New York trial court held that, when assets that were subject to a divorce judgment were transferred to a Cook Islands trustee, the receipt of a fraudulent conveyance subjected the trustee to New York's jurisdiction, even though the trustee:

> 1) does not own, lease or have any other interest in any real property located in New York; 2) does not have an office in New York; 3) does not have a bank account in New York; 4) does not have any officers or employees in New York; 5) does not have a telephone number in New York; 6) has never filed a lawsuit in New York; 7) has no investments in any business located in New York; 8) is not licensed to do business in New York; 9) has never warehoused or stored inventory or supplies in New York; and 10) does not advertise in New York.

An Illinois resident set up a Cook Islands trust with all of the contacts needed to be governed by Cook Islands law, but the Illinois Supreme Court held that the trust was void as against the creditors of the settlor/beneficiary. *Rush University Medical Center v. Sessions*, 980 N.E.2d 45 (Ill. 2012), Illinois Supreme Court upheld the trial court and reversed the appellate court:

This rule has a 500–year lineage (see Erwin N. Griswold, *Spendthrift Trusts Created in Whole or in Part for the Benefit of the Settlor*, 44 Harv. L. Rev. 203, 204 (1930) (citing 3 Hen. VII, c. 4)), has been consistently applied as the law in Illinois for over 140 years (see, *e.g.*, *Guffin v. First National Bank of Morrison*, 74 Ill. 259 (1874); *Crane*, 238 Ill. App. 257 (1925); *In re Morris*, 151 B.R. 900 (C.D. Ill. 1993); *In re Marriage of Chapman*, 297 Ill.App.3d 611, 231 Ill. Dec. 811, 697 N.E.2d 365 (1998); *Dexia Credit Local v. Rogan*, 624 F.Supp.2d 970, 976 (N.D. Ill. 2009)), at least until the instant appellate court's decision, and remains the law in the vast majority of states throughout the nation (see Helene S. Shapo et al., *Bogaert's Trusts and Trustees* § 223 (3d ed. 2007); *Restatement (Third) of Trusts* § 58 cmt. e (2003)).

The court's broad statement, "void as to existing and future creditors," sounds like the whole trust is void. However, the following excerpt (downloaded 3/3/2017) from the above citation to *Bogert's* clarifies that the scope as limited to the settlor's interest:

> The entire spendthrift clause, both as to voluntary and involuntary alienation, is void. The creditors can reach the settlor-beneficiary's interest,[11] and the settlor-beneficiary can transfer her interest.[12] The trust itself is not void, however, and the settlor cannot have it set aside on the ground of attempted fraud on creditors.[13] If the settlor is the sole beneficiary, she will be able to revoke the trust or ask for its termination.[14] If she is not the sole beneficiary she may not revoke in the absence of statutory authority.[15]
>
> [11] A spendthrift trust provision is invalid as to a contingent interest provided for the settlor in a trust. *Hughes v. Commissioner of Internal Revenue*, 104 F.2d 144, 39-2 U.S. Tax Cas. (CCH) ¶9538, 23 A.F.T.R. (P-H) ¶24 (C.C.A. 9th Cir. 1939), citing text, § 224.
>
> Where a settlor is the sole beneficiary of a spendthrift trust, his creditors can reach principal and income for the satisfaction of their claims on the ground that "it is against public policy to permit a man to tie up his property in such a way that he can enjoy it but prevent his creditors from reaching it." *Nelson v. California Trust Co.*, 33 Cal. 2d 501, 202 P.2d 1021 (1949).
>
> *Abrahams v. New York State Tax Com'n*, 131 Misc.2d 594, 500 N.Y.S.2d 965 (Sup 1986).
>
> A spendthrift clause in a trust for the settlor is void as to his interests. *Pilkington v. West*, 246 N.C. 575, 99 S.E.2d 798 (1957), citing text.
>
> [12] [various citations omitted]
>
> Where a settlor creates a spendthrift trust for himself, he may nevertheless assign the income of it…
>
> A settlor who made herself a life beneficiary of a spendthrift trust and accepted the interest can later destroy the trust as to herself by an instrument renouncing her interest and conveying it to the remaindermen beneficiaries, whose interests are then accelerated…. The spendthrift clause is not effective as to the settlor.
>
> Where a statute validates spendthrift trusts and declares that attempted assignments of the interests of beneficiaries thereunder are void, there is an implied exception of the

case where the settlor is the beneficiary and an assignment by such beneficiary is valid. ….

A spendthrift clause is not binding on a settlor-beneficiary and he may transfer his interest….

The spendthrift clause did not prevent a settlor-life beneficiary from assigning his right to receive income from the trust, but a right to receive principal on demand, which was vested in him personally, was not transferable....

The settlor created a trust to give his wife an annuity of $5,000 a year, and provided that any excess income should be paid to him, and that the principal should go to him at the death of the life tenant, or if he died before his wife that the principal should be disposed of as he appointed or to his heirs and next of kin if no appointment was made. Spendthrift provisions were inserted in the trust instrument as to both beneficiaries. The court held the clause as to the settlor was invalid; he could assign his interest under the trust to creditors and give them security, there being no proof that he was insolvent at the time he made the assignments. The power of appointment was destroyed by the assignments. On the death of both husband and wife the assignees of the husband are entitled to the capital of the trust….

Notwithstanding a spendthrift clause, a settlor-beneficiary can transfer his interest….

Where a settlor creates a spendthrift trust for herself for life, and later consents to taking less than the amount provided by the trust instrument, she is in effect giving a part of her interest to the remainder beneficiaries, which she may do, since the spendthrift provisions for the settlor are invalid….

[13] A spendthrift trust provision as to a settlor's life interest is invalid, but this does not invalidate the trust or make the trust subject to attack by the settlor. It merely results in the striking of the spendthrift clause. *Liberty Nat. Bank v. Hicks*, 173 F.2d 631, 9 A.L.R.2d 1355 (D.C. Cir. 1948). Noted in 37 Geo. L.J. 648 (1949); 17 U. Chi. L. Rev. 516 (1950).

[14] See § 1004, post.

[15] *Reidy v. Small*, 154 Pa. 505, 26 A. 602 (1893); *Rynd v. Baker*, 193 Pa. 486, 44 A. 551 (1899); *Willard v. Integrity Trust Co.*, 273 Pa. 24, 116 A. 513 (1922). But see *Stephens v. Moore*, 298 Mo. 215, 249 S.W. 601 (1923).

For cases where the settlor-beneficiary sought to revoke with the collusion of a creditor, see *First Nat. Bank v. Parker*, 87 N.J. Eq. 595, 101 A. 276 (Ct. Err. & App. 1917); *Kutz v. Nolan*, 224 Pa. 262, 73 A. 555 (1909).

The settlor-beneficiary of an irrevocable trust containing spendthrift provisions could not terminate the trust. The trust provided that the trustees in their discretion could pay principal to one or more of the settlor's descendants during the settlor's lifetime. The spendthrift provisions could not apply to settlor's interest but were severable, and the trust could not be terminated on the grounds that its purposes had been accomplished since the support and education of settlor's descendants remained a continuing purpose.

Fewell v. Republic Nat. Bank of Dallas, 513 S.W.2d 596 (Tex. Civ. App. Eastland 1974), *writ refused n.r.e.*, (Feb. 12, 1975), citing text, § 223.

Dexia Credit Local v. Rogan, 624 F.Supp.2d 970, 976 (N.D. Ill. 2009), applied the law to all of the settlor's possible discretionary distributions and refused to apply the law of the jurisdiction in which the trust was created:

> Under Illinois law, spendthrift trusts are valid except when they have been created or funded by a judgment debtor. See 735 ILCS 5/2–1403. A self-settled spendthrift trust is "void as to existing or future creditors, and they can reach his or her interest under the trust." *In re Marriage of Chapman*, 297 Ill.App.3d 611, 620, 231 Ill. Dec. 811, 697 N.E.2d 365, 371 (1998); see also *Barash v. Morris (In re Morris)*, 151 B.R. 900, 906–07 (C.D. Ill. 1993). This rule reflects the law in most U.S. jurisdictions. *E.g.*, *Restatement (Third) of Trusts* § 58(2); *Restatement (Second) of Trusts* § 156(2). Bahamian law to the contrary would violate Illinois' public policy. Accordingly, this Court will not apply Bahamian law to the construction and operation of the PGR trust. See, *e.g.*, *Scentura Creations, Inc. v. Long*, 325 Ill.App.3d 62, 69, 258 Ill. Dec. 469, 756 N.E.2d 451, 457 (2001) ("a party cannot rely on the protections of foreign law to enforce a contract that is illegal in the forum of the local government.").[2]
>
> [2] Dexia has also cited persuasive authority that under Illinois law it is not bound by the PGR trust's choice of law provision as a third party and that application of the "most significant relationship test" would result in the application of Illinois rather than Bahamian law. See generally Dexia Mot. for Summ. J. at 18–22.
>
> Illinois law permits Dexia to reach Peter Rogan's interest in the PGR trust. Under the terms of that trust, the trustees can provide Peter Rogan with the entire corpus of the trust, as well as all of the trust's income. Indeed, Dexia has submitted evidence, uncontested by the Rogan children, that Peter Rogan has received millions of dollars of distributions from the PGR trust. Because the PGR trust is self-settled and its settlor, Peter Rogan, can receive all of the trust's income as well as its entire corpus, Dexia, as his creditor, is entitled to execute on the assets of the Trust. Accordingly, the Court grants Dexia's motion for summary judgment with respect to its request for turnover of the Rogan children's interests in the PGR trust.[3]
>
> [3] Under the authority cited above, there is no requirement that a creditor prove a trustee never refused to honor a request for a distribution by a settlor in order to execute on the assets of a self-settled spendthrift trust. Thus Dexia was not required to submit any evidence that the PGR trust's trustees had never refused a request by Peter Rogan.

III.B.2.c.ii. GRIT When Code § 2702 Applies

See part III.B.7.d Code § 2702 Overview. If Code § 2702 disregards the value of the grantor's retained interest, the grantor will have made a gift equal to 100% of what the grantor gave to the trust.

If triggering the 100% gift rule of Code § 2702 is desirable, the trust cannot be a wholly incomplete gift. One way to do this is not to give the grantor a power of appointment over where the trust passes at the grantor's death. Instead of precluding such a power entirely, one might preclude it over only a portion of the trust and giving the grantor a power of appointment over the rest. ACTEC Fellow R. Eric Viehman developed this idea in "Using an Enhanced Grantor

Retained Income Trust (E-GRIT) to Preserve the Basic Exclusion Amount," which he presented at an ACTEC meeting and in other venues.[6509] The power of appointment aspect concerns me, as described in part III.B.2.c.iii GRIT When Code § 2702 Does Not Apply. Eric responded:[6510]

> I think the sentence Steve cites from Treas. Reg. 25.2511-2(b) must be interpreted in light of the of the three preceding sentences in that very same regulation. These preceding sentences clearly stand for the following propositions:
>
> 1. A gift is incomplete as to any "part thereof" as to "which the donor has so parted with dominion and control as to leave him no power to change its disposition."
>
> 2. A gift can be "partially complete and partially incomplete."
>
> 3. The determination of whether a gift is partially incomplete depends on all of the facts and circumstances, requiring an examination of the "scope" of any reserved power.
>
> In light of those propositions, the fourth sentence you cite is properly interpreted as applying when the donor's testamentary power of appointment applies to the trust's entire "remainder" and not just a portion thereof. If the cited sentence means that a trust contribution is wholly incomplete even when the donor's testamentary power applies to less than 100% of the trust's remainder, it would directly contradict one or more of the propositions enumerated above. Since the cited sentence is delineated as an example applying those very propositions, it should not (and I would argue cannot) be read to man that a contribution to a trust (such as an E-GRIT) is a wholly incomplete gift when the donor has completely surrendered dominion and control over part of the trust's remainder.

CCA 201208026 discussed the interaction of completed gift concepts and Code § 2702. It is reproduced in part in the completed gift discussion of part III.B.2.c.iii GRIT When Code § 2702 Applies.

III.B.2.c.iii. GRIT When Code § 2702 Does Not Apply

If Code § 2702 does not apply, how can one made a completed gift of principal – or perhaps principal and income – while generating estate inclusion?

Reg. § 25.2511-2(b) provides (highlighting added):

> As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined. For example, if a donor transfers property to another in trust to pay the income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among his

[6509] The 3/4/2019 version is saved as Thompson Coburn LLP document number 9953565.

[6510] 12/28/2020 email. The reader may not rely on Eric's statements, which I have included merely to rebut from the concerns expressed in fn 6511 part III.B.2.c.iii GRIT When Code § 2702 Does Not Apply.

> descendants, no portion of the transfer is a completed gift. On the other hand, if the donor had not retained the testamentary power of appointment, but instead provided that the remainder should go to X or his heirs, the entire transfer would be a completed gift. However, if the exercise of the trustee's power in favor of the grantor is limited by a fixed or ascertainable standard (see paragraph (g)(2) of § 25.2511-1), enforceable by or on behalf of the grantor, then the gift is incomplete to the extent of the ascertainable value of any rights thus retained by the grantor.

The highlighted sentence makes retaining a power of appointment potentially problematic.[6511] Reg. § 25.2511-2(e) elaborates on when a donor is treated as retaining a power of appointment:

> A donor is considered as himself having a power if it is exercisable by him in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom. A trustee, as such, is not a person having an adverse interest in the disposition of the trust property or its income.

The corollary is that, if a donor can exercise a power only with the consent of a person not having a substantial adverse interest in the disposition of the transferred property, the donor has made a completed gift. However, such a power does cause estate inclusion, under Reg. § 20.2036-1(b)(3), which provides (highlighting added):

> The phrase "right... to designate the person or persons who shall possess or enjoy the transferred property or the income therefrom" includes a reserved power to designate the person or persons to receive the income from the transferred property, or to possess or enjoy nonincome-producing property, during the decedent's life or during any other period described in paragraph (a) of this section. With respect to such a power, it is immaterial (i) whether the power was exercisable alone or only in conjunction with another person or persons, whether or not having an adverse interest; (ii) in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent; and (iii) whether the exercise of the power was subject to a contingency beyond the decedent's control which did not occur before his death (*e.g.*, the death of another person during the decedent's lifetime). The phrase, however, does not include a power over the transferred property itself which does not affect the enjoyment of the income received or earned during the decedent's life. (See, however, section 2038 for the inclusion of property in the gross estate on account of such a power.) Nor does the phrase apply to a power held solely by a person other than the decedent. But, for example, if the decedent reserved the unrestricted power to remove or discharge a trustee at any time and appoint himself as trustee, the decedent is considered as having the powers of the trustee.

[6511] The text preceding fn 6510 in part III.B.2.c.ii GRIT When Code § 2702 Applies refers to an article that takes the position that (1) setting aside a pecuniary amount in trust that cannot be distributed in trust to the donor and that the donor cannot appoint (the "undistributable amount"), and (2) giving the donor the power to appoint the rest of the trust, combines to make the gift to the trust partially complete. However, Reg. § 25.2511-2(b) begins with a reference to "any property, or part thereof or interest therein…." Does the regulation require bifurcating the gift, as if it were two gifts made to separate trusts, or does "part thereof or interest therein" refer to a fractional share, and the undistributable amount is not a fractional share, making regulation not apply? I invite the reader to consider these issues in light of Eric's response in the text following fn 6510.

Thus, retaining a power of appointment exercisable only in conjunction with the takers of the takers in default of the exercise would constitute a completed gift but would also cause federal estate tax inclusion.

CCA 201208026 analyzed whether a gift was complete in the following circumstances:

> The Trust states that it is irrevocable, and that the Donors renounce any power to determine or control the beneficial enjoyment of Trust income or principal. However, the Trust provides the Donors with testamentary limited powers of appointment. If the Donors do not exercise their testamentary powers, the property remaining in the Trust at termination will be distributed to Child A and Child B.
>
> The trustee, Child A, has absolute and unreviewable discretion in administering the Trust for the benefit of the Donors' children, other lineal descendants, and their spouses (beneficial term interests). Income and principal may be distributed at any time for a beneficiary's health, education, maintenance, support, wedding costs, purchase of a primary residence or business, or for any other purpose. Income and principal may also be distributed to a charitable organization.

CCA 201208026 cited Reg. § 25.2511-2 and reasoned:

> In *Chanler v. Kelsey*, 205 U.S. 466 (1907), the Supreme Court considered, in part, the legal interest that is subject to a testamentary power of appointment. In that case, a grantor created a trust providing a lifetime income interest for his daughter. The trust also provided the daughter with a testamentary limited power to appoint the trust property. If she failed to exercise the power when she died, the trust property was to be distributed to designated persons. The Court held that, for New York inheritance tax purposes, the daughter's execution of her testamentary power was considered "the source of title" to the remainder. As the holder of a testamentary power of appointment, she controlled the remainder passing at her death. See 205 U.S. at 474.
>
> Though it predates the enactment of the gift tax, the *Chanler* opinion supports the proposition that a testamentary power of appointment relates to the remainder of a trust, not the preceding beneficial term interests. The testamentary power does not (and cannot) affect the trust beneficiaries' rights and interests in the property during the trust term. Rather, a trustee with complete discretion to distribute income and principal to the term beneficiaries may, in exercising his discretion, distribute some or all of the trust property during the trust term. The holder of a testamentary power has no authority to control or alter these distributions because his power relates only to the remainder, i.e., the property that will still be in the trust when the beneficial term interests are terminated. *See* Bowe-Parker, *Page on the Law of Wills* § 45.12 (1962). See also Bittker and Lokken, *Federal Taxation of Income, Estate and Gifts* ¶ 226.6.7 (2011); Howard M. Zaritsky, *Tax Planning for Family Wealth Transfers* (4th ed. 2011 Cum. Supp. No. 2) ¶ 3.03[1].
>
> From the time the gift tax was enacted, taxpayers have contested the issue of when a donor parts with dominion and control so as to make a completed gift. For example, in *Sanford's Estate v. Commissioner*, 308 U.S. 39 (1939), the grantor, in 1913, transferred property to a trust for others. He reserved (i) a revocation power exercisable at any time during his life to retrieve the property and thereby terminate every beneficial interest; and (ii) a modification power exercisable at any time during his life to terminate or change

every beneficial interest. In 1919, the grantor relinquished his revocation power, but he retained his modification power. In 1924, he relinquished his modification power. The Court held that notwithstanding the grantor's creation of the trust and relinquishment of his revocation power, he retained dominion and control over the disposition of the trust property until he renounced his power to modify the trust. Consequently, the grantor made a taxable gift in 1924 when he relinquished his modification power. *See Burnett v. Guggenheim*, 288 U.S. 280 (1933).

Following *Sanford's Estate*, the Supreme Court considered various situations in which a trust instrument purported to divest the respective grantor of all dominion and control over property to the extent that the property could not be returned to the grantor except by reason of contingencies beyond his control. In these cases, the Court noted that the respective grantor lost all economic control upon making the transfer, which he would not regain unless certain contingencies occurred. The Court concluded that the respective gifts were complete except for the value of the retained rights. *Smith v. Shaughnessy*, 318 U.S. 176 (1943); *Robinette v. Helvering*, 318 U.S. 184 (1943); *Estate of Kolb v. Commissioner*, 5 T.C. 588 (1945). See § 25.2511-2(c).

Consistent with *Chanler v. Kelsey*, the Service has maintained in litigation that a power holder's testamentary limited power of appointment relates only to the remainder of the respective trust. See *Poinier v. Commissioner*, 858 F.2d 917 (3d Cir. 1988) (testamentary power holder's renunciation of her power relates to the remainder), *aff'g* 86 T.C. 478 (1986). See also *Robinson v. Commissioner*, 675 F.2d 774 (5th Cir. 1982) (grantor's power to change the beneficiaries who would receive trust property when her lifetime income interest terminated constituted a gift of the remainder), *aff'g* 75 T.C. 346 (1980). See *Smith v. Shaughnessy*, *supra* (right to receive income during the trust term and testamentary power to appoint the remainder are separate and severable interests).

In the case at hand, when each Donor transferred property to the Trust on Date, he or she retained a testamentary limited power to appoint so much of it as would still be in the Trust at his or her death.[1] The Trust emphasizes that the Donors do not retain any powers or rights to affect the beneficial term interests of their children, other issue, and their spouses (and charities) during the Trust term. With respect to those interests, the Donors fully divested themselves of dominion and control of the property when they transferred the property to the Trust on Date. Indeed, during the period extending from the creation of the Trust until the Donors' deaths, the trustee, Child A, has sole and unquestionable discretion to distribute income and principal to the beneficial term interests. He may even terminate the Trust by distributing all of the property.

[1] We note that the Trust has conflicting provisions. In one provision, the Donors emphatically renounce any power to determine or control the beneficial enjoyment of the Trust, but other provisions state that the Donors have testamentary limited powers of appointment. Under State law, generally, if two provisions conflict and cannot be reconciled, the latter provision is considered to indicate the grantor's subsequent intention, and that provision prevails. That is the rule unless the general scope of the trust leads to a contrary conclusion. *Cite 1*. We believe that the highest court of State would conclude that the Donors intended to retain the testamentary limited powers and, thus, did so.

Accordingly, for gift tax purposes, the Donors' transfers to the Trust constituted a completed gift of the beneficial term interests. The Donors' testamentary limited powers

> of appointment relate only to the Trust remainder. Their relinquishment of their testamentary powers during the Trust term would affect only the ultimate disposition of the remainder and, as such, would constitute a transfer of the remainder. Bittker and Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 126.6.7 (2011).

CCA 201208026 included the following under "Case Development, Hazards and Other Considerations":

> It is our belief that § 2702 applies in valuing the gifts in this case. Section 2702 provides special valuation rules with respect to transfers of interests in trusts. Generally, under § 2702(a)(2), the value of any retained interest which is not a qualified interest shall be treated as being zero. Section 25.2702-2(a)(4) provides that an interest in trust includes a power with respect to a trust if the existence of the power would cause any portion of a transfer to be treated as an incomplete gift. Accordingly, under § 25.2702-2(a)(4), the Donors' retained testamentary powers are interests, and the value of their retained interests is zero. Therefore, the value of the Donors' gift is the full value of the transferred property.

For an in-depth analysis of the CCA's implications, see Zeydel, "When is a Gift to a Trust Complete - Did CCA 201208026 Get it Right? *Journal of Taxation* (9/2012).

III.B.2.c.iv. GRIT Instead of GRAT for Divorced or Otherwise Unrelated Parties

Reg. § 25.2702-1(c)(7) excludes from Code § 2702:

> *Certain property settlements*. A transfer in trust if the transfer of an interest to a spouse is deemed to be for full and adequate consideration by reason of section 2516 (relating to certain property settlements) and the remaining interests in the trust are retained by the other spouse.

Reg. § 25.2702-4(d) explains:

> *Example (5)*. H and W enter into a written agreement relative to their marital and property rights that requires W to transfer property to an irrevocable trust, the terms of which provide that the income of the trust will be paid to H for 10 years. On the expiration of the 10-year term, the trust is to terminate and the trust corpus is to be paid to W. H and W divorce within two years after the agreement is entered into. Pursuant to section 2516, the transfer to H would otherwise be deemed to be for full and adequate consideration. Section 2702 does not apply to the acquisition of the term interest by H because no member of H's family acquired an interest in the property in the same transaction or series of transactions. The result would not be the same if, on the termination of H's interest in the trust, the trust corpus were distributable to the children of H and W rather than W.

The last sentence of the above example points out an important issue: When a divorce decree benefits children beyond the support owed to them, then either the obligor has made a gift to the children or the spouse who gave up rights to create the obligation to the children is making a gift.[6512] Letter Ruling 9235032 would treat the whole transfer in the above Example as a gift if

[6512] Rev. Ruls. 68-379, 79-363.

the children are included as beneficiaries and the spouse did not have a qualified retained interest.

However, suppose spouse A creates a trust to pay income to spouse B for life, remainder to spouse A. If the two divorce within two years after entering a separation agreement that requires the creation of this trust, this transaction will not be subject to Code § 2702; and, if spouse A predeceases spouse B, then the trust will be included in spouse A's estate, minus the value of spouse B's income interest.[6513] If, after the divorce, A gives the remainder interest in the trust to A's and B's children, Code § 2702 will not apply, because B will no longer be married to A.[6514]

Note also that, when former spouses re-arranging their obligations of alimony and child support settled with a lump sum payment, that change was not subject to gift tax.[6515]

III.B.2.c.v. GRIT's Estate Tax Consequences

If the grantor dies while holding the right to income, the trust is included in the grantor's estate for estate tax purposes. See part III.C Code § 2036. Code § 2642(f), the estate tax inclusion period (ETIP) rule, prevents any GST exemption from fixing the trust's inclusion ratio until the grantor dies. See part III.B.1.d.ii Estate Tax Inclusion Period.

The taxable gift will essentially reduce or eliminate the impact of including the GRIT in the grantor's estate for estate tax purposes. For example, if the GRIT is worth $1 million at inception and $1.5 million at the grantor's death, generally the effect would be $1 million of lifetime gift/estate tax exemption used for the gift and another $500,000 ($1.5 million minus $1.0 million) included in the taxable estate, for a total use of $1.5 million gift/estate tax exemption. However, certain anti-abuse regulations may be promulgated to limit the estate tax credit given for this lifetime use of the exemption. For all the ideas described in this paragraph, see part II.H.12.a Taxable Gifts of Property Included in the Donor's Estate.

Suppose Mom wants to create a GRIT where she receives income for life and discretionary principal, followed by trusts for her children (and their descendants). If the anti-abuse rule is not in effect, the GRIT may be a great way to make her comfortable locking in the use of her gift/estate tax exemption without jeopardizing her retirement.

In that example, I would recommend appointing as a trustee (perhaps the sole trustee or a special co-trustee) a nonadverse party who can make distributions to or for the benefit of one or more of Mom and her descendants:

- If that nonadverse trustee decides that Mom no longer needs all of the trust, that trustee could split one or more trusts for one or more of the descendants. Reasons to split off these trusts may include:
    - The trust's value has grown much larger than Mom needs.

6513 Letter Ruling 201707007.
6514 Except for the part about estate inclusion, the example and analysis were by C. McCaffrey & J. McCaffrey, "*Obergefell* and the Authority of the IRS to Challenge Valid Marriages and Divorces," *Steve Leimberg's Estate Planning Email Newsletter*, No. 2345 (9/21/2015).
6515 Letter Ruling 201206005.

- Mom's income needs have decreased.
- Mom's life expectancy has decreased, so how money Mom needs for the rest of her life has become greatly reduced.

- If the anti-abuse rule is in effect and applies to GRITs, perhaps the trustee will terminate Mom's life interest altogether to avoid estate inclusion. If Mom needs a flow of income, the children – not a trust for the children – might pay Mom a life annuity.[6516] If Mom initially retained a mandatory income interest or rights to discretionary distributions that are susceptible to valuation, then beware possible income tax on the full value of whatever Mom receives (in other words, perhaps with no reduction for basis).[6517]

- If Mom releases her income interest, then Code § 2035 will pull back the released power if she dies within three years after the release. However, if the trustee terminates her income interest by distributing the trust to or for the benefit of Mom's descendants, Code § 2035 would not apply.

- Mom may allocate GST exemption before the GST exemption decreases. As described in part III.B.1.d.ii Estate Tax Inclusion Period (ETIP), because of Code § 2036 the initial allocation would not fix the trust's inclusion ratio; however, the trust could later be divided and the inclusion ratio determined with respect to any part no longer subject to an ETIP.

- A GRIT can be paired with a trust that is not included in the grantor's estate (a "Gift Trust"). When the GRIT terminates, its assets pass to the Gift Trust. Because the ETIP rule complicates GST issues, consider having the Gift Trust terminate a couple of years after the grantor's death, so that GST issues can be addressed and appropriate severances done.[6518]

- If the GRIT's assets increase in value above the amount of the original taxable gift, consider moving the excess assets to the Gift Trust. Consider borrowing from a financial institution to fund the transfer, so that the Gift Trust receives cash to invest and low basis assets remain in the GRIT to receive a basis step-up on the grantor's death. One can maximize the GRIT's borrowing potential by securing the loan with not only the GRIT's assets but also secondarily with the reinvested loan proceeds. See part II.H.10 Extracting Equity to Fund Large Gift.

- If promulgated, the anti-abuse regulations may target only the bonus exclusion amount – the amount by which the lifetime gift/estate tax exemption scheduled to expire at the end of 2025 exceeds the permanent amount. If so, consider also moving the bonus exclusion amount used to make the original taxable gift over to the Gift Trust.

So, a GRIT may be a viable strategy even if anti-abuse regulations are issued, but the parties need to be aware of and monitor the threat and be prepared to act if the anti-abuse regulations would apply to the GRIT.

TAM 199935003 argued that a trustee commuting a GRIT, as expressly authorized by the trust agreement, should not be respected because the grantor was terminally ill at the time of the

[6516] See part III.B.1.g Private Annuities.
[6517] See parts II.J.18.d Trust Commutations and II.J.18.f Commutation vs Mere Division.
[6518] See Reg. § 26.2642-6(j), Example (8), which is reproduced in the text accompanying fn 6406 in part III.B.1.d.iv Qualified Severances.

commutation; allegedly they always planned commutation. The IRS argued a Code § 2035 disposition or a gift of the entire amount that would have been included in the grantor's estate. I would strongly resist such an argument, in that the grantor is not releasing the power but rather the trustee is exercising discretion. Furthermore, the Code § 7520 tables overvalued the terminally ill grantor's life estate, so the grantor could not have been making a gift. The IRS viewed the trust agreement contemplating commutation to be a smoking gun. If a trustee has absolute discretion – no ascertainable standards - to distribute to or for the benefit of the grantor and other beneficiaries, the IRS' case would seem much more difficult to make.

III.B.2.c.vi. SPAT – Not a GRIT

Suppose a client wants to make a completed gift without retaining an interest - to assure use of the lifetime gift/estate tax exemption and fix the GST inclusion ratio - but wants the flexibility of being added back as a beneficiary?

This idea may be especially attractive for those living in a state that does not respect self-settled spendthrift trusts.

A special power of appointment trust ("SPAT") was the subject explored by Blattmachr, Gans, and O'Connor, "SPATs: A Flexible Asset Protection Alternative to DAPTs," *Estate Planning Journal* (2/2019):

> This article proposes the use of an irrevocable trust created for beneficiaries other than the grantor, in which one or more individuals (who are not the grantor and are not necessarily a beneficiary) have a lifetime special power of appointment, held in a nonfiduciary capacity, that may be used to direct assets back to or for the benefit of the grantor. The grantor would have no entitlement to benefits or even eligibility to receive benefits in the discretion of the trustee or another fiduciary; but only by the exercise of a special power of appointment held by someone in a nonfiduciary capacity-essentially a non-self-settled trust from which the grantor may benefit. In other words, the grantor would have no more right to benefit from the assets than if they were owned by someone else individually. To be sure, the concept of allowing the grantor to benefit from the trust assets through the exercise of a special power of appointment is not new. But questions about the structure of such an arrangement and its effectiveness need to be considered.

The article compares a SPAT to an ING [footnotes omitted from quote]:

> **An analogy to ING trusts**. For years, practitioners have assisted clients in the creation of incomplete nongrantor trusts, created in asset jurisdictions such as Alaska, Delaware, and Nevada. The purpose of these "ING" trusts generally is to attempt to avoid state income tax on assets held in trust, which otherwise would be taxed to the grantor who lives in a locale with state income tax. There are several analogies that exist between ING trusts and SPATs.
>
> One of the key ingredients to ING trusts is the existence of a "distribution committee," or "power of appointment committee," which is a group consisting of at least two individuals other than the grantor to whom the committee may direct the trustee to make distributions. In these trusts, the trustee has no discretion to distribute income or principal during the grantor's lifetime. Instead, distributions by the trustee are made only at the unanimous direction of the distribution committee or with the grantor and one

other member of the distribution committee. The distribution committee can direct distributions to its own members. The members of the distribution committee act in a nonfiduciary capacity.

Although there is no "special power" or language that the distribution committee cannot appoint to themselves, the predominant theory is that the members of the distribution committee do not possess a general power of appointment, and that the decision to direct the trustee to make distributions was not a gift for federal gift tax purposes by any of them. If a person has a power of appointment that is exercisable only in conjunction with the creator of the power, then that power is not a general power of appointment. Because there is no general power of appointment, there is no gift by a member of the distribution committee incurred by exercising the power of a committee member.

The role of the distribution committee in ING trusts is similar to the role of the special powerholder SPATs. The special powerholder holds the power in a nonfiduciary capacity. The difference is that the distribution committee members can cause distributions to themselves. In contrast, the SPAT powerholder cannot exercise the power in favor of himself or herself.

The ING trust generally is structured as an incomplete gift for federal gift tax purposes. There are two powers of an ING trust that, when combined, give comfort that the gift to the trust is incomplete:

(1) The grantor retains a testamentary special power of appointment.

(2) The lifetime distribution power that is held by the grantor together with a member of the distribution committee.

As discussed above, like an ING trust, the grantor of a SPAT can render the transfer to the trust an incomplete gift by retaining a special testamentary power of appointment. Unlike an ING, in which the grantor, by joining with a member of the distribution committee, can direct distributions, the grantor does not have any ability to affect the special power.

Each of the private letter rulings "approving" ING trusts involved trusts established in DAPT jurisdictions. The reason is that a trust is a grantor trust if the trust assets are subject to the claims of the grantor's creditors. Although, as expressed earlier, a SPAT should not be subject to the claims of the grantor's creditors as it is not a self-settled trust (as no trustee holds the discretionary to make distributions to or for the grantor), it makes sense to consider creating any SPAT in a DAPT jurisdiction.

As to the final point above, if a special power of appointment is exercised in favor of the grantor, generally the grantor is still considered the settlor, so the trust would be consider self-settled. Possible scenarios include:

1. The state in which the trust was created changes its law to respect self-settled spendthrift trusts.

2. The exercise of the power of appointment moves the trust to a state that respects self-settled spendthrift trusts.

3. The grantor has run out of money, and estate inclusion may provide a free basis step-up.

To what extent is this an issue? If the IRS can argue step transaction, Code § 2036 would apply to such a trust, regardless of state law; if the holder of the power of appointment waited until the trust was old-and-cold, presumably the IRS would have difficulty arguing step transaction unless the client or lawyer left a paper trail. Otherwise, generally only the assets that can be distributed to the grantor would be subject to the grantor's creditors, and the power of appointment can create two trusts: (1) a unitrust, where only the unpaid unitrust amount for that year as of date of death is includible; and (2) a discretionary trust, to meet emergency needs, which would be fully includible.

The grantor's possible addition as a beneficiary may complicate analysis under the grantor trust rules, which rules generally are described in part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust, especially part III.B.2.h How to Make a Trust a Grantor Trust Taxed to a U.S. Citizen or Resident.

The grantor is not yet a beneficiary, so Code § 677 does not apply. See part III.B.2.h.viii.(a) Code § 677(a) Generally.

The power to add the grantor as a beneficiary means that you need to rely on not violating Code § 674(a), because Reg. § 1.674(d)-2(b) prevents Code § 674(b)(5), (6), and (7), (c), and (d) from helping. See part III.B.2.h.vii.(a) Distribution Provisions Resulting from Control Causing Grantor Trust Treatment. If all of the trustees are beneficiaries, then Code § 674(a) grantor trust status may be avoided, if and to the extent that the trustees are therefore adverse parties.

The other question is what if the power to add the grantor is not currently exercisable, but rather the person holding that power is not in place yet. Then arguably Reg. § 1.674(d)-2(b) does not apply. But we must see whether we must ignore that the person holding that power is not in place yet. The legislative history to Code § 672(d) seems to suggest that we cannot ignore that the person holding that power is not in place yet, but I'm not quite sure. See the language at the end of the introductory portion of part III.B.2.h How to Make a Trust a Grantor Trust Taxed to a U.S. Citizen or Resident.

So I'm not sure the extent to which a SPAT may or must be a grantor trust.

III.B.2.d. Income Tax Effect of Irrevocable Grantor Trust Treatment

III.B.2.d.i. Federal Income Tax and Irrevocable Grantor Trust Treatment

III.B.2.d.i.(a). General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation

Both a GRAT and a sale to an irrevocable grantor trust rely on grantor trust treatment.[6519] If a GRAT were not a grantor trust, using property other than cash to satisfy the annuity would constitute a taxable sale.[6520]

If the grantor or another person is treated as the owner of any portion of a trust under the grantor trust rules, that person's taxable income and credits includes those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust.[6521] Such an item of income, deduction, or credit is treated as if it had been received or paid directly by the deemed owner.[6522]

Grantor trusts have less favorable treatment for state taxes and miscellaneous itemized deductions than do nongrantor trusts. See part II.J.3.d Who Benefits Most from Deductions.

Furthermore, in estates and nongrantor trusts, generally deductions are netted against income rather than being passed through separately on the K-1s given to beneficiaries. See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items and Reg. §§ 1.67-2T(b)(1) and 1.67-4.

CCA 201343021, issued by policy maker Bradford R. Poston, Senior Counsel, Branch 2, Passthroughs & Special Industries, commented:[6523]

> We believe that Rev. Rul. 85-13 should be read broadly, requiring that a grantor trust not be recognized as a separate taxable entity for federal income tax purposes if someone has such dominion and control over it as to create a single identity of interest between the trust and the owner. As Rev. Rul. 85-13 states, it would be anomalous for the existence of a grantor trust would be ignored for purposes of attribution of income, deduction, and credit, and yet retain its identity as a separate entity capable of entering into a sales transaction with the owner. When a grantor or other person exercises dominion and control over a trust, either by retaining a power over or an interest in the trust by dealing with the trust property for the owner's benefit, the owner has treated the trust property as though it were the owner's property. The Service position of treating the owner of an entire trust as the owner of the trust's assets is consistent with and supported by the rationale for attributing items of income, deduction, and credit to the

[6519] Key rulings include Rev. Ruls. 81-6, 85-13, 2004-64, 2007-13, 2008-22, and 2011-28, as well as Rev. Procs. 2008-45 and 2008-46. Other pronouncements touching upon these rules include Notice 90-1 and Rev. Ruls. 88-103, 90-7 and 2004-86. For more on Rev. Rul. 2004-64, see fns. 6961-6980, found in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner.
[6520] Reg. § 1.661(a)-2(f).
[6521] Code § 671.
[6522] Reg. § 1.671-2(c)
[6523] The CCA's comment associated this footnote refers to Code §§ 267 and 707(b)(1)(A). Code § 267 is reproduced in part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses; within that part, fn 1416 refers back to this footnote. For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships; fn 5571 refers back to this footnote.

> owner. Accordingly, we conclude that a trust that is treated as a grantor trust is ignored as a separate entity apart from the owner for all federal income tax purposes, including §§ 267 and 707(b)(1)(A).

The CCA continued:

> [I]t should be noted that there have been a very limited set of circumstances after the publication of Rev. Rul. 85-13 where the Service or the courts have treated a grantor trust and its owner as separate entities for a federal income tax purpose:
>
> (1) *Rothstein* itself has never been overturned, and theoretically is still good law in the Second Circuit. We have found only one case which, in dicta, follows the reasoning in *Rothstein*. In *Zand v. Comm'r*, T.C. Memo 1996-19, the Tax Court found that a grantor was not the owner of a trust under § 675(3), relating to grantor borrowings from the trust, because the loan met the exceptions provided in § 675(3) for borrowings with adequate interest and security made by an independent trustee. The Court continued, however, that even had the grantor been properly treated as the owner, he still would have been able to deduct interest paid to the trust because the grantor trust provisions only relate to income attribution.
>
> (2) Rev. Rul. 85-13 never explicitly revoked or modified Rev. Rul. 74-243, 1974-1 C.B. 106. Rev. Rul. 85-13 cites numerous cases and rulings for its conclusion, but also mentions Rev. Rul. 74-243 as one counter-example. In Rev. Rul. 74-243, a corporate executive accepted a government appointment and transferred property, including a qualified stock option, to a "blind trust" which would have been a grantor trust under §677, although the ruling does not explicitly describe it as a grantor trust. The ruling concludes that the transfer of the option to the trust was a taxable disposition under § 425. Rev. Rul. 74-243 has not been applied or cited approvingly by the Service or a court after 1985, although it arguably still technically reflects the Service's position under the narrow facts of the ruling. Moreover, at least two PLRs (9124019, 9309027) (both issued by CC:TEGE apparently without coordinating with CC:PSI) have allowed similar transfers to grantor trusts without triggering a taxable disposition.
>
> (3) *Textron v. Comm'r*, 117 T.C. 67 (2001) was arguably inconsistent with Rev. Rul. 85-13. In *Textron*, a domestic corporation owned substantially all the stock of a foreign corporation, which it was ordered (initially by the Federal Trade Commission, and later confirmed by a federal district court injunction) to transfer to a voting trust with a court-appointed trustee. It was uncontested that the voting trust was a grantor trust to Textron under § 677. The issue before the Tax Court was whether Textron was taxable on the foreign corporation's subpart F income during the existence of the voting trust; the Court found that the trust, not Textron, was the shareholder for purposes of §§ 951(a) and 958(a), but then ruled in favor of the government on the alternative ground that the trust was taxable as the subsidiary's U.S. shareholder, with the subpart F income then flowing through to Textron. The decision was criticized for its inconsistency with Rev. Rul. 85-13 and other grantor trust authority in Stevens, Matthew A., "A Grantor Trust Visits Subpart F: Ruminations on *Textron v. Commissioner* and other Anomalies", 21 *Va. Tax Rev. 507* (2002).
>
> (4) PLRs 201117042 and 201129045 appear to conflict with Rev. Rul. 85-13. PLRs 201117042 and 201129045 were issued by IRS Employee Plans, and state

> that an individual retirement account (IRA) cannot be transferred to a grantor trust of the IRA owner.[6524] The conflict between these rulings and Rev. Rul. 85-13 was noted in Beers, Deborah M., "IRS Issues Two Seemingly Contradictory Rulings on Effects of Transfer of IRA to Special Needs Grantor Trust," 36 *Tax Mgmt. Est. & Tr. J* 230 (2011) and Jones, Michael J., "The Economy and other Retirement Mysteries," *Trusts & Estates*, January 2012, at 35. Both articles mention prior PLRs issued by the same office appearing to accept that the owner of a grantor trust is the owner of its assets, which may include an IRA. See PLRs 200620025, 200826008, and 201116005.

The deemed owner of a portion of the trust is also deemed to directly own that portion of the trust's property.[6525] Thus, when a person who is deemed to own all of a trust sells assets to that trust, no transaction is deemed to have occurred.[6526] Furthermore, when the grantor trust status is turned off, the sale does not spring into existence merely because a sale had occurred.[6527] When the deemed owner of a trust sells its interest in the trust, the seller is deemed to sell the trust's assets to the buyer, and the buyer becomes the trust's deemed owner.[6528]

[6524] [This is my footnote and not from the CCA:] Reg. § 1.408-4(a)(2) prohibits an individual from assigning the IRA. How does this interact with the fact that grantor trusts generally are disregarded? Choate, ¶ 6.1.06, *Life and Death Planning for Retirement Benefits* (Digital Edition, viewed 6/28/2016), suggests that a transfer to a grantor trust that permitted distributions to anyone other than the individual IRA owner during that individual's life would be a transfer triggering Reg. § 1.408-4(a)(2). Given that Letter Rulings 200620025, 200826008, and 201116005 approved transfers of inherited IRAs to special needs trusts for the benefit of the beneficiary, that suggestion appears consistent with the IRS' approach.

[6525] Notice 90-1 stated, "If the grantor is treated as the owner of all the trust under sections 671 through 677, the grantor is considered to be the owner of the trust assets for federal income tax purposes". Rev. Rul. 2004-86 followed that idea. Rev. Rul. 87-61 points that, under Rev. Rul. 85-13, a grantor who is treated as the owner of a portion of a trust represented by specific trust property is considered to be the owner of that property, and Rev. Rul. 88-103 makes a similar statement. Rev. Rul. 90-7 applied that concept to an exchange of closely-held business stock. This principle was reaffirmed by Rev. Rul. 2007-13, reproduced in fn 4338 in part II.Q.4.b.i Transfer for Value Rule Generally.

[6526] Rev. Rul. 85-13, reasoning, "A transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction. See *Dobson v. Commissioner*, 1 B.T.A. 1082 (1925)."

[6527] See Letter Rulings 201436006 and 201436007 in fn. 6035.

[6528] A specialized application of this idea involving multiple grantors is in part II.D.4.a Investment Trusts. For the proposition cited in the text, TAM 200814026 reasoned:

> The transaction is properly characterized as follows: (1) prior to Date 8, X, the seller and grantor, was treated as the owner of Trust 1 under § 677; (2) if a grantor is treated as the owner of the entire trust, the grant or is treated as the owner of the trust's assets for federal income tax purposes, and X's sale of the beneficial ownership interest in Trust 1 to Taxpayer is treated as a sale of X's assets; (3) Taxpayer therefore is treated as purchasing the assets of Trust 1; (4) Taxpayer is treated as forming a new trust; and (5) Taxpayer is treated as contributing the Trust 1 assets to the new trust. Taxpayer thus is treated as a grantor with respect to Trust 1 pursuant to § 1.671-2(e)(1), which provides that the term "grantor" includes a person who makes a non-gratuitous transfer of property to a trust, and as an owner under § 677. As a result, Taxpayer may not properly claim a bad debt deduction to discharge its obligation on the Notes through the redemptions on Dates 11 through 17 because transactions between Taxpayer and Trust 1 are disregarded for federal income tax purposes.

The deemed owner is also treated as an owner of stock under the Code § 318 attribution rules.[6529]

Rev. Rul. 85-13 ignored the existence of a note that its deemed owner owed a trust. This seems analogous to disregarding a debt that one division of a corporation owes another division.[6530]

A gift to a trust occurs for income tax purposes not when the gift is made but rather when the grantor trust powers are turned off.[6531]

Code § 1015(d) provides a basis increase when gift tax is paid on a gift. However, because a transfer to a grantor trust does not exist for income tax purposes, is it a gift under Code § 1015(d), or does Code § 1015(d) merely look to whether a gift was made for gift tax purposes? The latter appears to be the rule.[6532] However, to avoid doubt on the consequence of any gift tax paid when a transfer is made to a trust, consider having the grantor trust status with respect to such a gift arise, through an automatic trigger, at some point after the tax-triggering gift is made.

Generally, converting from a nongrantor trust to a grantor trust is not a realization event,[6533] and the IRS has taken the position that the conversion is not even considered to be a distribution to

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[6529] See text accompanying fns 4869-4872 in part II.Q.7.a.viii Code § 318 Family Attribution under Subchapter C.

[6530] Rev. Rul. 80-228 involved the following facts:

> X corporation operated its business in two entirely separate divisions ("Division 1" and "Division 2"), keeping a separate bank account and a separate set of books for each division. Each division also maintained an intracompany account in their respective books of account and transactions between the two divisions were recorded therein. For valid business reasons X organized a new corporation, Y. All the assets of Division 2 were transferred by X to Y at net book value in exchange for all of the stock of Y. At the time of the transfer, the intracompany account payable due to Division 1 from Division 2 was 100x dollars. On its opening balance sheet Y listed an account payable to X of 100x dollars and X, conversely, listed an account receivable from Y of 100x dollars. Within one year after the transfer the account payable of Y was paid in full to X.

Disagreeing with the Code § 351(b) analysis of *Wham Construction Company, Inc. v. United States*, Civil No. 72-689 (D.S.C., Feb. 16, 1976), *aff'd* Civil No. 76-2047 (4th Cir. 1979), Rev. Rul. 80-228 held:

> In the instant case the account receivable to X from Y was a note or other evidence of indebtedness received by X in a section 351 transaction and it constituted "other property" for purposes of section 351(b) of the Code. This is due to the fact that the preincorporation intracompany accounts could not have given rise to a debtor-creditor relationship between X and Y because X could not, prior to incorporation of Y, have been liable for a debt to itself. The intracompany accounts were mere bookkeeping entries by X, a single corporation, to show the activities of separate divisions for internal accounting purposes.

For Code § 351(b), see part II.M.2.a Initial Incorporation – Generally.

[6531] Reg. § 1.671-2(e)(2)(i) provides, "A transfer of property to a trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes."

[6532] Without mentioning why this might be a concern, Letter Ruling 9109027 ruled that gift tax paid on a GRIT that was a wholly owned grantor trust caused a basis increase. For some factual background on the ruling, see fn. 3672 in part II.M.4.c.i When a Gift to a Service Provider Is Compensation and Not a Gift.

[6533] CCA 200923024 made a strong statement to this effect:

> Assuming the transaction in the present case is abusive, asserting that the conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor would have an impact

the grantor.[6534] However, one might exercise caution where the nongrantor trust has debt in excess of basis, in case a rule similar to the converse situation arises: when a trust converts from a grantor trust to a nongrantor trust during the grantor's life, the grantor being relieved of debt in excess of the basis of the trust's assets causes income to be recognized.[6535] See also part III.B.2.j Tax Allocations upon Change of Interest, given that a change in grantor trust status is a change in ownership for income tax purposes.

Starting with a discussion of Letter Ruling 201730017, Ed Morrow comments on converting a nongrantor trust to a grantor trust:[6536]

> While the IRS got the ultimate rulings correct in this PLR, some of their reasoning and interim conclusions to get there are incorrect, overbroad or misleading. This PLR concerned a non-grantor CLT converting to a grantor-CLT and the taxpayer was attempting to get a charitable income tax deduction at the time of conversion similar to

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> on non-abusive situations. A nongrantor trust may become a grantor trust in several situations: examples include the appointment of a related or subordinate trustee to replace an independent trustee as in the present case (§ 674); a borrowing of the trust corpus under § 675(3) (discussed below in ISSUE 2 with regard to the application of Rev. Rul. 85-13); or the payment of the grantor's legal support obligations under § 677(b). No prior guidance dealing with these events has indicated that they result in taxable income to the deemed transferee (the owner of the grantor trust). Rev. Rul. 85-13 concluded that the grantor became the owner of the trust corpus which he had indirectly borrowed and thus was taxable on the trust's income and, as the deemed owner of the trust assets, could not engage in a transaction with the trust that would be respected for income tax purposes. It did not conclude that the grantor realized the amount of the indirect borrowing or any portion of that amount as income under § 61 or any other section. Therefore, while we agree that this appears to be an abusive transaction, the Service should not take the position that the mere conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor.

The CCA suggesting attacking a transaction that potentially abused the grantor trust rules instead by considering applying the step transaction, the economic substance doctrine or other judicial doctrines. I have been told that Brad Poston wrote the CCA.

[6534] Letter Rulings 201730012, 201730017 and 201730018, all under Brad Poston's name, held:

> Rev. Rul. 77-402 concludes that the lapse of grantor trust status during the grantor-owner's life may have income tax consequences, but does not impose such consequences on a non-grantor trust that becomes a grantor trust. Rev. Rul. 85-13 describes the income tax effects of a non-grantor trust becoming a grantor trust, which effects did not include the realization or recognition of any income by the grantor-owner by reason of the conversion. Given the lack of authority imposing such consequences, we conclude that the conversion of Trust from a non-grantor trust to a grantor trust will not be a transfer of property to Grantor from Trust under any income tax provision.

The grantor had created a nongrantor charitable lead trust and wanted a ruling that the conversion to a grantor charitable lead trust would constitute a distribution to the grantor, followed by a deductible charitable contribution; see Code § 170(f)(2)(B). The IRS may have simply been trying to prevent toggling on grantor trust status from generating a deduction.

[6535] See parts III.B.2.j.i Changing Grantor Trust Status and III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System, fn. 6591.

[6536] Part ii(k), "Potential Advantage? – Changing Status from Non-Grantor to Grantor Trust: Is Conversion a Termination of Non-Grantor Trust as Taxpayer per IRC §642(h)?" in Morrow, Edwin P., IRC Section 678 and the Beneficiary Deemed Owner Trust (BDOT) (April 19, 2018). Available at SSRN: https://ssrn.com/abstract=3165592 or http://dx.doi.org/10.2139/ssrn.3165592 (last revised 10/6/2022). That ruling and Letter Rulings 20173012 and 201730018 were discussed in Zaritsky, Lane & Danforth, § 7:8. Conversions of Trust Status, *Federal Income Taxation of Estates and Trusts* (WG&L), which as of 9/30/2023 appears to have been updated since Ed wrote his piece.

someone funding a grantor CLAT ab initio. The PLR is correct to cite Rev. Rul. 85-13 and conclude that the conversion was not a sale or exchange or taxable event, but it goes too far when it says that there "will not be a transfer of property to Grantor from Trust under any income tax provision" or that it is "not a transfer of property held by Trust to Grantor as settlor of Trust for income tax purposes." Of course they are transfers, and who else would they be to if not to the grantor? What the IRS should have concluded instead is that conversion is indeed a transfer, just not a sale or disposition under IRC § 1001 that would be a taxable transfer. The reason the settlor should have been denied a new charitable income tax deduction is that the transfer to a grantor CLT has to come from an individual (or trust deemed owned by an individual) to receive the tax deduction under § 170, and this transfer to the grantor CLT came from a non-grantor trust. A non-grantor trust can only receive a charitable deduction under § 642(c), and cannot receive one under § 170 (with exception for S corp/ESBTs after TCJA).[159] The settlor/taxpayer was a transferee upon conversion, not a transferor as the IRS mistakenly refuted. The IRS implies that if conversion were deemed a transfer from the non-grantor trust the settlor/taxpayer would receive a deduction under § 170, but this is incorrect.

[159] IRC §642(c)(1).

Despite all the very favorable authority and guidance on conversions, there are still unanswered questions about how certain tax characteristics would flow through to the newly deemed owner on conversion. The threshold questions, whether a non-grantor trust converts to a standard grantor trust or a BDOT, are whether there is 1) a distribution to the deemed owner for income tax purposes and, trickier, 2) whether the non-grantor trust is considered "terminated" under Subchapter J.[160] In most cases, but not all, it would be advantageous to be considered terminated. A mere distribution will carry out current year DNI, but it would take a termination of the trust to carry out capital gains if they are not otherwise made part of DNI, or to carry out net operating losses (NOLs), capital loss carryforwards and excess deductions under IRC §642(h). Passive loss carryforwards should add to basis on termination.[161]

[160] [Ed quotes Code § 642(h), which is discussed in part II.J.3.i Planning for Excess Losses.]

[161] [Ed quotes Code § 469(j)(12), which is discussed in part II.K.2.d Effect of Death of an Individual or Termination of Trust on Suspended Passive Losses.]

Some tax items, however, such as losses suspended due to at risk rules[162] and certain tax credits or other tax carryovers,[163] may not pass out on termination.[164] If there were substantial amounts in these categories, taxpayers may prefer that a conversion to grantor trust status not be considered a termination of the trust as a separate taxpayer, so that it may convert back to non-grantor trust status at some point to later soak up such tax preferences.

[162] [Ed cite Code § 465, which is discussed in part II.G.4.j At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities).]

[163] See, e.g., IRC §27 (foreign tax credit), IRC §53 (alternative tax credit), IRC §611 (depletion carryover), IRC § 163(d) (investment interest carryover). Many business

credits turn into deductions in final year when a taxpayer "dies or ceases to exist", IRC § 196. Does a trust cease to exist on becoming a grantor trust?

[164] Losses in pass through entities that are suspended may also be trapped and not pass out to beneficiaries on termination, see Treas. Reg. § 1.1366-2(a)(6) for S corporations and *Sennett v. Commissioner*, 80 T.C. 825, 831 (1983), *aff'd* 752 F2d 428 (9th Cir. 1985) for partnerships, which may be cause for delaying any outright distribution (or, potentially delaying full conversion to BDOT status). [See parts II.G.4.c Basis Limitations for Deducting Partnership and S Corporation Losses, II.G.4.d Basis Limitation for Shareholders in an S Corporation, II.G.4.e Basis Limitations for Partners in a Partnership, and II.G.4.k Be Sure to Use Suspended Losses as Soon as They Become Available.]

One influential treatise concludes that:

> "a [non-grantor] trust that becomes a grantor trust should be deemed to terminate and to distribute its assets to the grantor, as its beneficiary. Thus, the grantor should be treated as a beneficiary succeeding to the property of the trust, for purposes of Section 642(h), which would allow the grantor to succeed to the unused capital loss carryovers. A capital loss carryover resulting from an asset sale by a grantor trust should be a personal loss of the taxpayer, under Section 671. The grantor should logically continue to be able to deduct the loss carryover even if the trust ceases to be a grantor trust."[165]

[165] Zaritsky, Lane & Danforth, *Federal Income Taxation of Estates and Trusts* (WG&L), ¶ 7.03[5] Capital Loss Carryovers and Change of Grantor Trust Status.

PLR 9220012, discussed previously herein, which permitted beneficiaries to use capital loss carryforwards on conversion from non-grantor trust to BDOT status, is perfectly consistent with this conclusion.[6537] However, PLRs are not citable authority.

Some distinguished experts, however, question whether the conversion from a non-grantor trust to a grantor trust is a termination, and question whether carryovers such as passive losses, capital losses, disallowed investment interest and net operating losses would merely be suspended (and perhaps even expire in the case of NOLs) after changing from non-grantor to grantor trust status.[166] It's certainly an open question.

[166] Carol Cantrell, The Fiduciary's Handbook of Sneaky Post-Mortem Income Tax Issues, page 9-10, 47th Annual Philip E. Heckerling Institute on Estate Planning, January 14-18, 2013. See also *Mysteries of the Blinking Trust*, by Laura Peebles, Trusts and Estates, Sept. 2008.

The IRS and courts may ultimately adopt a middle ground between the above two interpretations. Is the trust terminated as an entity for income tax purposes when it no longer has any income, deductions, credits reported to it as a separate taxpayer? Arguably, yes, the property is now considered the grantor's (or beneficiary deemed owner's) for income tax purposes. But it is not clear, and the regulations are extremely awkward to interpret in the context of grantor trusts. The most recent IRS

[6537] Letter Ruling 9220012 is reproduced in part III.B.2.i.vii.(b) Determining Portion Owned When Trust Is Only a Partial Grantor Trust.

pronouncement did not address this issue.[167] It may not be a simple yes or no answer. The answer should not turn on whether the trust terminates for state law – after all, many trusts, older GPOA marital trusts and §2503(c) trusts in particular, simply grant a beneficiary a right to withdraw the entire corpus at some point (becoming a IRC § 678 trust with income taxed to powerholder) and no one has ever argued that this is not a de facto termination of the trust for IRC §642(h) purposes.[168]

[167] CCA 200923024.

[168] This is in contrast to a non-grantor trust that is winding up, which will still be considered a separate taxpayer during a reasonable wind up period, *e.g. Dominion Trust Co. of Tenn. v. U.S.*, 786 F Supp. 1321 (M.D. Tenn. 1991), but not if termination were unreasonably postponed, at which point it would be taxed to the beneficiary as equitable owner. Treas. Reg. § 1.641(b)-3(d).

The closest analogy might be what happens when an ESBT ceases to be a separate trust. In such case, the carryovers and excess deductions are not suspended until the trust becomes an ESBT again - they pass out to the rest of the trust.[169]

[169] IRC § 641(c)(4).

The regulation discussing trust "termination" is not under the §642(h) regulations as we might expect, but under §641(b) regulations, and does not speak to situations in which the tax status changes.[170] If, as hinted at by this regulation, vesting in the beneficiary is important, converting to a BDOT arguably fits into this definition better than converting to a garden variety IGT, since most grantors have no property interest in an IGT whatsoever and it's hard to argue that property has been distributed to them (unless, of course, we ignore the trust as a taxpayer and consider the distribution to be to the deemed owner). By contrast, a BDOT beneficiary has extensive property rights over the assets. Treas. Reg. § 1.641(b)-3(b) does not fit a conversion scenario well at all though. Once the grantor trust rules apply to a trust, they apply. There is no "wind up" period as described in the regulation.

[170] [quoting Reg. § 1.641(b)-3(b), which is reproduced in the text accompanying fn 2563 in part II.J.3.i Planning for Excess Losses.]

In some conversion scenarios, might we have a "suspension" (this is my term, not a term used in any code or regulations) rather than a "termination"? It's not hard to imagine the IRS arguing that anytime there is a meaningful possibility within the unilateral control of the parties to revert back to non-grantor trust status that there is no termination, merely a temporary suspension of tax status, and therefore IRC §642(h) should not apply, and the losses and other deductions would be suspended until either the grantor dies, the deemed owner dies, or unless and until there is no unilateral ability of the deemed owner (or trustee) to revoke the IRC § 673-678 triggering power.

Referring to losses passing out on a trust's termination (part II.J.3.i Planning for Excess Losses), 819-2d T.M. part XII.F. Toggling Grantor Trust Powers suggests:

The loss of the trust's separate taxable status may not constitute termination for this purpose, though, once again, there is no clear authority, and the conversion to a grantor trust could be treated as the equivalent of a final distribution of the trust assets. In such a case, the grantor trust would appear to be the person succeeding to the property of the nongrantor trust, and thus the grantor would be able to take advantage of those losses.

However, the above did not discuss and argue against Letter Rulings 201730012, 201730017 and 201730018 and CCA 200923024, so it is not a weighty statement. On the other hand, those positions that the IRS has taken are not precedent, and converting from nongrantor trust status to grantor trust status changes the deemed ownership from that of the trust to that of the deemed owner, so what else could be but termination of the trust holding assets and the deemed owner holding the assets; see fn 6525 for the deemed owner holding the assets. Those IRS positions do not squarely address this question and appear to be result-oriented, so they also have questionable weight. For example, Reg. § 1.671-3(a)(1) says that the grantor or other deemed owner "takes into account in computing his income tax liability all items of income, deduction, and credit (including capital gains and losses) to which he would have been entitled had the trust not been in existence during the period he is treated as owner." That sounds like a wholly-owned grantor trust no longer exists and therefore has terminated. Note that this rule does not apply to changes during life in determining whether an S corporation accounting cut-off applies under part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest; on the other hand, the stock ownership is treated as having changed under part III.B.2.j.ii.(e) Change in Qualification of Trust to Hold S corporation Stock During Taxable Year, and the only limitation in the tax treatment of changes of ownership appears to be being barred for relief under the accounting cut-off.

An irrevocable grantor trust's assets that are not included in the grantor's estate generally would not receive a new basis at the grantor's death. Rev. Rul. 2023-2 provides that grantor trust status alone does not generate a Code § 1014 basis step-up.[6538] See also part II.H.5 Irrevocable Trust Planning and Basis Issues.

Reg. § 1.108-9, dealing with excluding cancellation of indebtedness income under the insolvency and bankruptcy provisions of Code § 108, would not disregard a grantor trust in all cases.

III.B.2.d.i.(b). Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation

A person may be the deemed owner of none, part, or all of a trust. The deemed owner includes "those items of income, deduction, and credit against tax attributable to or included in that portion."[6539] For example:

(1) A person who is treated as the owner of an entire trust (corpus as well as ordinary income) takes into account all items of income, deduction, and credit (including capital gains and losses) to which that person would have been entitled had the trust not been in existence during the period that person is treated as owner.[6540]

(2) If the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion, items directly related to trust property not included in the portion treated as owned by the person are taxed under the

[6538] Rev. Rul. 2023-2 is quoted extensively in part III.B.2.a Tax Basis Issues When Using Irrevocable Grantor Trusts.
[6539] Reg. § 1.671-3(a).
[6540] Reg. § 1.671-3(a)(1).

nongrantor trust rules, and items that relate to both portions "must be apportioned in a manner that is reasonable in the light of all the circumstances of each case, including the terms of the governing instrument, local law, and the practice of the trustee if it is reasonable and consistent."[6541]

(3) If the portion of a trust treated as owned by a person consists of an undivided fractional interest in the trust, or of an interest represented by a dollar amount, a pro rata share of each item is normally allocated to the portion.[6542] If a slice of the entire trust is involved, see part III.B.2.i.vii Portion Owned When a Gift Over $5,000 is Made, especially part III.B.2.i.vii.(a) Determining Portion Owned When a Withdrawal Right Does Not Lapse in Full Before Any Income Is Earned. Regarding rights to corpus or income, regulations provide:[6543]

> … where the portion owned consists of an interest in or a right to an amount of corpus only, a fraction of each item (including items allocated to corpus, such as capital gains) is attributed to the portion.

Furthermore:[6544]

> If the grantor or other person is treated as an owner because of his power over or right to a dollar amount of ordinary income, he will first take into account a portion of those items of income and expense entering into the computation of ordinary income under the trust instrument or local law sufficient to produce income of the dollar amount required. There will then be attributable to him a pro rata portion of other items entering into the computation of distributable net income under subparts A through D, such as expenses allocable to corpus, and a pro rata portion of credits of the trust.

If a person is treated as the owner of a portion of a trust, that portion may or may not include both ordinary income and other income allocable to corpus.[6545] For example:

(1) Only ordinary income is included by reason of an interest in or a power over ordinary income alone.[6546]

[6541] Reg. § 1.671-3(a)(2).

[6542] Reg. § 1.671-3(a)(3), which provides:

> If the portion of a trust treated as owned by a grantor or another person consists of an undivided fractional interest in the trust, or of an interest represented by a dollar amount, a pro rata share of each item of income, deduction, and credit is normally allocated to the portion. Thus, where the portion owned consists of an interest in or a right to an amount of corpus only, a fraction of each item (including items allocated to corpus, such as capital gains) is attributed to the portion. The numerator of this fraction is the amount which is subject to the control of the grantor or other person and the denominator is normally the fair market value of the trust corpus at the beginning of the taxable year in question. The share not treated as owned by the grantor or other person is [taxed ignoring the grantor trust rules].

Nuances regarding taxing a beneficiary as an owner are explored in part III.B.2.i.vii.(a) Determining Portion Owned When a Withdrawal Right Does Not Lapse in Full Before Any Income Is Earned.

[6543] Reg. § 1.671-3(a)(3).

[6544] Reg. § 1.671-3(c), incorporated by reference into Reg. § 1.671-3(a)(3).

[6545] Reg. § 1.671-3(b).

[6546] Reg. § 1.671-3(b)(1), which further provides:

(2) Only income allocable to corpus is included by reason of an interest in or a power over corpus alone, if satisfaction of the interest or an exercise of the power will not result in an interest in or the exercise of a power over ordinary income which would itself cause that income to be included.[6547]

(3) Both ordinary income and other income allocable to corpus are included by reason of an interest in or a power over both ordinary income and corpus, or an interest in or a power over corpus alone which does not come within the provisions of subparagraph (2) of this paragraph.[6548]

If only income allocable to corpus is included in computing a deemed owner's tax liability, the deemed owner will take into account in that computation only those items that would not be included under the nongrantor trust rules when computing the current income beneficiaries' tax liability if all distributable net income had actually been distributed to those beneficiaries.[6549]

On the other hand, if a person is treated as an owner solely because of the person's interest in or power over ordinary income alone, the person will take into account in computing the person's tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to corpus which enter into the computation of distributable net income.[6550]

See Reg. § 1.677(a)-1(g) for examples when a grantor has a current or reversionary right to income, illustrating the effect of Reg. § 1.677(a)-1(f), "Accumulation of income," which provides:

Thus, if a grantor is treated under section 673 as an owner by reason of a reversionary interest in ordinary income only, items of income allocable to corpus will not be included in the portion he is treated as owning. Similarly, if a grantor or another person is treated under sections 674-678 as an owner of a portion by reason of a power over ordinary income only, items of income allocable to corpus are not included in that portion. (See paragraph (c) of this section to determine the treatment of deductions and credits when only ordinary income is included in the portion.)

[6547] Reg. § 1.671-3(b)(2), which further provides:

For example, if a grantor has a reversionary interest in a trust which is not such as to require that he be treated as an owner under section 673, he may nevertheless be treated as an owner under section 677(a)(2) since any income allocable to corpus is accumulated for future distribution to him, but items of income included in determining ordinary income are not included in the portion he is treated as owning. Similarly, he may have a power over corpus which is such that he is treated as an owner under section 674 or 676(a), but ordinary income will not be included in the portion he owns, if his power can only affect income received after a period of time such that he would not be treated as an owner of the income if the power were a reversionary interest. (See paragraph (c) of this section to determine the treatment of deductions and credits when only income allocated to corpus is included in the portion.)

[6548] Reg. § 1.671-3(b)(3), which further provides:

For example, if a grantor is treated under section 673 as the owner of a portion of a trust by reason of a reversionary interest in corpus, both ordinary income and other income allocable to corpus are included in the portion. Further, a grantor includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated under section 674 or 676 as an owner because of a power over corpus which can affect income received within a period such that he would be treated as an owner under section 673 if the power were a reversionary interest. Similarly, a grantor or another person includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated as an owner under section 675 or 678 because of a power over corpus.

[6549] Reg. § 1.671-3(c).

[6550] Reg. § 1.671-3(c).

> If income is accumulated in any taxable year for future distribution to the grantor (or his spouse in the case of property transferred in trust by the grantor after Oct. 9, 1969), section 677(a)(2) treats the grantor as an owner for that taxable year. The exception set forth in the last sentence of section 677(a) does not apply merely because the grantor (or his spouse in the case of property transferred in trust by the grantor after Oct. 9, 1969) must await the expiration of a period of time before he or she can receive or exercise discretion over previously accumulated income of the trust, even though the period is such that the grantor would not be treated as an owner under section 673 if a reversionary interest were involved. Thus, if income (including capital gains) of a trust is to be accumulated for 10 years and then will be, or at the discretion of the grantor, or his spouse in the case of property transferred in trust after October 9, 1969, or a nonadverse party, may be, distributed to the grantor (or his spouse in the case of property transferred in trust after Oct. 9, 1969), the grantor is treated as the owner of the trust from its inception. If income attributable to transfers after October 9, 1969 is accumulated in any taxable year during the grantor's lifetime for future distribution to his spouse, section 677(a)(2) treats the grantor as an owner for that taxable year even though his spouse may not receive or exercise discretion over such income prior to the grantor's death.

In addition to determining the types of items attributed deemed ownership, one needs to know for what part of the year the grantor is deemed to own those items. Under Code § 675(3),[6551] a grantor-trustee who has both borrowed the entire trust corpus and repaid the borrowed funds plus interest in the same year is treated for federal income tax purposes as the owner of the entire trust for that year, notwithstanding full payment.[6552]

For borrowing all of the income, *Benson v. Commissioner*, 76 T.C. 1040, 1044-1049 (1981), held:

> Section 675 is one of a series of Internal Revenue Code sections collectively known as the grantor trust rules. See secs. 671 through 679. Sections 673 through 677 enumerate the instances in which a trust grantor is treated as owning all or part of a trust. For tax purposes, a grantor is credited with the trust income, deductions, and credits allocable to the trust "portion" he is treated as owning. Sec. 671. The purpose of those grantor trust rules is to tax a trust grantor on trust items over which he has retained substantial

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[6551] See part III.B.2.h.iv Borrow Power, especially fns. 6644-6646.

[6552] Rev. Rul. 86-82, reasoning:

> In *Mau v. United States*, 355 F.Supp. 909 (D. Hawaii 1973), the taxpayer established five separate trusts, with the taxpayer designated trustee of each. In 1965, the taxpayer borrowed money from each of the trusts. These amounts were not repaid until 1969. The taxpayer argued that section 675(3) of the Code did not cause the taxpayer-grantor to be liable for federal income tax on the trusts' 1965 income because the loans were not outstanding at the beginning of the year. The court rejected this interpretation of the statute, reasoning that section 675(3) was enacted to prevent the shifting of taxable income in situations where a grantor retained control and use of trust properties through borrowing. Therefore, the court held that the borrowing of trust corpus or income by a grantor at any time during a taxable year would result in the grantor being taxed on trust income for that entire year under section 675(3). The court concluded that the taxpayer was taxable on income of the trusts in 1965, the year the borrowing occurred, even though the loans were made after the beginning of the year. If section 675(3) otherwise applies for a given year, its effect is not avoided by making repayment before the year closes. *Mau* therefore stands for the principle that section 675(3) applies for any year during any part of which a loan by a trust to the grantor-trustee is outstanding.

dominion and control, see section 1.671-2(b), Income Tax Regs., and it is with that purpose in mind that we interpret section 675(3) and “portion.”

At the outset, we note that while “portion” is used throughout the Code sections comprising the grantor trust rules, its meaning varies from section to section and from case to case. Sec. 1.671-3, Income Tax Regs.[12] “Portion’s” flexible meaning is necessary to fulfill the purpose of the grantor trust rules—taxation of a grantor only on trust items over which he has retained substantial dominion and control. See sec. 1.671-2(b), Income Tax Regs. Given a myriad of dispositive variables, “portion” must have an adaptable meaning. For example, under section 676, a trust grantor is treated as owning any trust “portion” which he can revoke. If the grantor can revoke the entire trust, then “portion” means the entire trust. However, if the grantor can revoke only the remainder interest and has no power to alter the income interest, “portion” means only the remainder interest, since the grantor has no power over the income interest and should not be taxed on it. See sec. 1.671-3(b)(2), Income Tax Regs.

[12] The regulations recognize six possible meanings of “portion”: the entire trust; the trust accounting income; the trust corpus; a fraction or dollar amount of trust accounting income; a fraction or dollar amount of corpus; or specific trust property. See sec. 1.671-3(a) to (c), Income Tax Regs. See also, Schmolka, “Selected Aspects of the Grantor Trust Rules,” U. Miami 9th Inst. on Estate Planning par. 1400 (1975).

In determining what “portion” of a trust should be treated as being owned by its grantor, most of the grantor trust rules focus on powers set forth in the trust instrument which evidence a grantor’s dominion and control over trust property without regard to whether or not those powers are ever exercised.[13] In most cases, it is fairly simple to tell over what part of a trust a power extends; therefore, the meaning of “portion” is easily decided. For example, if a grantor has the power to distribute the entire trust to his spouse, the entire trust is treated as his even if only part of the trust is actually so distributed. See sec. 677(a)(1). On the other hand, if a grantor has the power to distribute only current income to his spouse, he is treated as owning only the current income interest in the trust. In the latter case, “portion” means only the current income interest, because that is the only trust segment over which the grantor has any power.

[13] See, e.g., secs. 674; 675(1), (2), and (4); 676; 677(a).

Section 675(3) differs from the other provisions which provide rules for determining grantor ownership of a trust, because it requires an affirmative act, borrowing, rather than a mere power, before it applies.[14] Nevertheless, the same theme underlies section 675(3) as underlies the other Code sections which treat a grantor as owning the trust. In both cases, the justification for taxation of the grantor is evidence of substantial grantor dominion and control. Thus, our proper inquiry is not what the grantor has borrowed but what the grantor’s borrowing represents in terms of the grantor’s dominion and control over the trust.

[14] See also sec. 677(b), which applies when trust income is actually used, pursuant to a discretionary power, to support or maintain a beneficiary, other than the grantor’s spouse, whom the grantor is legally obligated to support or maintain. That section clearly limits taxation of the grantor to income actually so applied.

In order fully to understand the implications of grantor borrowing, section 675(3) must be read in conjunction with section 675(2). Section 675(2) treats a grantor as the owner of the trust anytime the grantor, a nonadverse party, or both have the power to loan income or corpus to the grantor without adequate security or without adequate interest, unless a nongrantor trustee may make such loans to any and all persons. Thus, the mere power to loan trust property to the grantor on favorable terms, vested in the grantor or a nonadverse party, evidences enough grantor dominion and control over the trust to justify taxing all the trust income to the grantor.[15] However, if a nongrantor trustee can make unsecured or no-interest loans to anyone, the grantor is seemingly on equal footing with the rest of the world, and the evidence of grantor dominion and control is less.

[15] Of course, if the tainted lending power extends only to a "portion" of the trust, that is, if the grantor could only lend himself corpus, then only that "portion" should be attributed to the grantor. *Cf.* sec. 1.671-3(b)(2), Income Tax Regs.

Section 675(2) can be avoided easily. A trust grantor can install a "friendly" trustee[16] and give that trustee a general power to make unsecured or no-interest loans to anyone. In all probability, the "friendly" trustee would not make such loans to anyone except the grantor; but, nevertheless, section 675(2) would not apply. However, a grantor cannot rely on such an escape from section 675(2) if he contemplates actually borrowing from the trust. When actual borrowing occurs, section 675(3) must be considered.

[16] By referring to a friendly trustee, we mean one who is a related or subordinate party subservient to the grantor. See secs. 675(3) and 672(c).

As previously noted, section 675(3) treats a trust grantor as owning any "portion of a trust in respect of which" he borrows, if the loans are either unsecured or bear no interest or are made by a "friendly" trustee, unless the grantor repays the loans before the beginning of the taxable year. It might seem that section 675(3) serves to tax the grantor only on the part of the trust he actually borrows. But, such an interpretation would read 675(3) as treating the grantor as owning the "portion" he borrowed rather than owning the "portion of [the] trust in respect of which" he borrowed, which is what the statute mandates.[17] Moreover, such a reading would produce an unacceptable result. The power to make unsecured or no-interest loans to a trust grantor causes the grantor to be treated as owner of the entire trust under section 675(2). It would be incongruous if unsecured or no-interest loans actually made to the grantor caused only the part of the trust actually borrowed to be treated as the grantor's under section 675(3). That result would make avoidance of section 675(2) not only easy, but relatively harmless from the grantor's viewpoint—he could still obtain trust property in the form of favorable loans but without having to worry about being treated as owning any substantial part of the trust. Therefore, we refuse to read "portion of [the] trust in respect of which" to mean merely "portion."

[17] In *Holdeen v. Commissioner*, T.C. Memo. 1975-29, the grantor-taxpayer established a complicated series of long-term trusts benefiting his family and various charities. His daughter served as trustee of one of the trusts and expended $80,000 from that trust for mortgage participation certificates on property the grantor-taxpayer owned which was subject to preexisting mortgages. We held that the grantor-taxpayer indirectly borrowed $80,000 from the trust which he repaid when he transferred the mortgaged property to the trust. We held further that the grantor-taxpayer was to be treated under

sec. 675(3) as owner of an $80,000 "portion" of the trust during the years between the loan and the repayment.

It might seem that *Holdeen* stands for the proposition that "portion" means the amount actually borrowed. However, such does not follow from a careful reading of that case. The $80,000 borrowed in *Holdeen* was corpus and we, in effect held that $80,000 of the corpus was the "portion of [the] trust in respect of which" the grantor-taxpayer borrowed. Furthermore, it is unclear whether any more could have been borrowed. See note 19 infra. In summary, Holdeen involved a cash loan from corpus and is thus distinguishable from most cases which involve a noncash corpus, cash loans, direct borrowing, and clearly defined borrowing perimeters. We do not find *Holdeen* necessarily inconsistent with our holding in this case.

Likewise, we reject petitioners' contention that "portion" refers to the amount borrowed in comparison to the entire trust. Petitioner would have us calculate a fraction arrived at by dividing the amount borrowed by the trust corpus, and treat that fraction as the trust "portion" owned by the grantor. If such were the case, a trust grantor could borrow the entire trust income derived from the entire trust corpus but only be treated as owning a fraction of the trust, even though his borrowing evidences dominion and control over the entire trust. We find such a result patently unreasonable and unsupported by the statutory language or any other authority.[18]

[18] Petitioners mistakenly rely on *Holdeen v. Commissioner*, T.C. Memo. 1975-29, as supporting their interpretation of sec. 675(3). See note 17 *supra*.

On the other hand, we need not address respondent's contention that "portion" means the entire trust whenever a grantor has the power to borrow all corpus or income and any trust property is borrowed. See *Mau v. United States*, 355 F.Supp. 909 (D. Hawaii 1973). In this case, petitioner-husband borrowed all the trust income and that income was derived from the entire trust corpus. Thus, it is clear that petitioner-husband should be treated as owner of the entire trust. It does not matter in this case whether we reach that result via respondent's automatic entire trust rule or via calling petitioner-husband owner of the entire trust simply because he actually borrowed "in respect of" the entire trust. The same result is reached either way. It is best to wait for a case clearly presenting the problem to analyze fully respondent's "entire trust" contention.[19]

[19] Such a case would arise if, for example, a trust grantor transferred two separate income-producing stocks to a trust, but only borrowed the income derived from one of those stocks. Respondent would argue that the grantor's borrowing represents not only the grantor's control of the property he has in hand but is indicative of his ability to control all the trust property on similar terms. Just as the mere existence of a power to revoke evidences substantial dominion and control, see sec. 676, so does the mere existence of unsecured or no-interest borrowing or borrowing from a "friendly" trustee. It appears from respondent's brief in this case that, if the grantor-taxpayer could demonstrate that his borrowing does not evidence his ability to borrow the entire trust on sec. 675(3) terms, respondent would not argue that the entire trust should be treated as being owned by that grantor-taxpayer. For example, if the trust terms forbid grantor borrowing of current income, and a grantor only borrowed corpus, then he should be treated as owning only corpus, since his borrowing from corpus evidences no dominion and control over income. In other words, respondent's position would be

that the grantor-taxpayer must show that all the trust could not be borrowed on the same terms that part was borrowed.

Petitioners in this case have made no showing that less than all the trust should be treated as being owned by petitioner-husband. [footnote re burden of proof omitted] As previously noted, he borrowed all the trust income which was in respect of all the trust corpus. His borrowings undoubtedly indicate significant dominion and control over the entire trust. Accordingly, we conclude that petitioner-husband is treated as owning the entire trust during 1974 and 1975.

For borrowing less than all of the income, *Bennett v. Commissioner*, 79 T.C. 470, 484-485 (a reviewed opinion) (1982), held:[6553]

In the instant case, the grantors have borrowed some, but not all of the trust income in previous years[24] and have made no borrowings in the current taxable year. Under these circumstances, we conclude that petitioners should be taxed on that portion of the current year's trust income which the total unpaid loans at the beginning of the taxable year bear to the total trust income of prior years plus the trust income for the taxable year at issue.[25] Such an allocation is consistent with the flexible approach articulated in *Benson v. Commissioner*, *supra* (see note 22 supra).[26]

[24] Both parties have premised their arguments on the basis that all borrowings were from trust income and there is not convincing evidence of record that cash corpus was

[6553] The court reasoned at 483-484:

The 1954 Code introduced the concept of a "portion" of the trust. For example, whatever the result under the Clifford regulations, under the 1954 Code, if the grantor has the power to borrow only ordinary income without adequate interest and security (see sec. 1.671-1(b), Income Tax Regs.), he is taxed only on ordinary income and not on income attributable to corpus. See sec. 675(2); sec. 1.671-3(b)(1), Income Tax Regs. Thus, when the grantor is taxed because of a power, the language of the trust instrument will generally determine over what portion of the trust the power may be exercised and, therefore, the portion of the trust in respect of which the grantor is treated as the owner. However, unlike the other provisions of section 675 which tax the grantor on powers which he has over the trust or portions thereof, section 675(3) taxes the grantor because of events(i.e., borrowings). Therefore, in interpreting the words "portion in respect of which" for purposes of section 675(3), we believe our inquiry should take into account what the grantor actually borrowed.[22] *Cf.* section 1.671-3(c), Income Tax Regs., which recognizes that the grantor is taxed only a part of the trust income if he has a "power over or right to a dollar amount of ordinary income." We reject respondent's contention that the grantor is taxable on all the trust income whenever he borrows any of such income; such an interpretation would give insufficient weight to the word "portion" in section 675(3). Nor should the grantors be taxable on the entire income for 1973 and 1974 merely because their loans outstanding at the beginning of the taxable years ($426,000) were in excess of those years' income ($167,434.43 and $206,494.69). We do not believe that the fact that the grantors have borrowed a portion of prior years' income necessarily means that they have borrowed "in respect of" the entire income of the current year.[23]

[22] *Benson v. Commissioner*, 76 T.C. 1040 (1981), holds that the amount borrowed does not per se determine the portion of the trust on which the grantor is taxable but does not stand for the proposition that the amount borrowed is irrelevant in making such a determination. Indeed, we inferred that, in another case, the amount borrowed might be relevant. See 76 T.C. at 1048.

[23] We emphasize that all of the trust income involved herein constituted "ordinary income," *i.e.*, income not allocable to corpus. We leave to another day the question of the extent to which the latter type of income would enter into the calculation of the "portion in respect of which" the grantor of a trust would be taxable under section 675(3). As a consequence of the foregoing, all references to trust income herein are to "ordinary income" before distributions to beneficiaries.

available. See *Benson v. Commissioner*, 76 T.C. at 1046 n. 17. See also note 23, *supra*.

[25] Such an allocation gives effect, albeit indirectly, to the distributions made to the beneficiaries; such amounts were obviously not borrowed and, therefore, do not enter into the numerator and they also do not reduce the denominator (see note 23 supra). We further note that sec. 675(3) treats unpaid interest as borrowing; in the instant case, interest was in fact fully paid each year.

[26] In *Benson*, we held that, when 100 percent of the current year's income attributable to the entire trust corpus was borrowed, the grantor was taxable on 100 percent of that income. Consistent with that approach, if, in the present case, there had been borrowings in 1973 or 1974, it would appear that the grantors would have been taxed on the portion which the current year's borrowings bear to the current year's income or on the portion which total borrowings bear to total income through the end of the taxable year, whichever is greater. On the other side of the coin, the allocation formula we adopt could produce taxability to grantors of an amount of trust income in excess of the amount remaining after distributions to beneficiaries. But this consequence occurs in respect of other provisions dealing with grantor trusts and seems to be mandated by sec. 675(3), which clearly specifies some taxability where there are unpaid borrowings at the beginning of the taxable year. We also note that, at least under the circumstances of this case where all the income constituted "ordinary income," it would appear to make no difference in the computation of the fractional formula we have adopted whether "trust income" is "gross income" or "taxable income" before distributions to the beneficiaries, since each of the petitioners would be entitled to their pro rata share of the deductions properly charged to the trust income. See sec. 671.

Except for an actual borrowing under Code § 675(3), turning off the grantor trust features generally is effective for the rest of the year.[6554] Reg. § 1.1001-2(c), Example (5)[6555] would deem this transfer to occur on the day the grantor trust powers are turned off; this was followed by *Madorin v. Commissioner*, 84 T.C. 667 (1985). TAM 200010010 cited Reg. § 1.1001-2(c), Example (5), and held:

> Similarly, in the present case, X has created a grantor trust and is treated as the owner of the entire trust and the owner of all the trust property. Thus, although X has nominally transferred a shares of Company stock to Trust 2, X remains the owner of the trust property for federal income tax purposes. Therefore, when Trust 2 terminates and transfers a shares of Company stock to the remainder trusts for C and D, X is considered to have disposed of the Company stock to the remainder trusts, along with the associated liability assumed by the remainder trusts, and X's amount realized includes the amount of liabilities from which X is discharged as a result of the disposition.
>
> X argues that this case is distinguishable from Example 5 in section 1.1001-2(c) because, in that example, T purchased an interest in P and C deducted the distributive share of partnership losses attributable to the partnership interest held by T, while, in the

[6554] See Zaritsky, *Tax Planning for Family Wealth Transfers During Life: Analysis With Forms*, ¶ 3.02[3][j][iii] Turning off grantor trust status, for a complete analysis of this topic.
[6555] Reg. § 1.1001-2(c), Example (5) is reproduced in fn 6591 in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System.

> present case X did not deduct losses attributable to debt incurred by Trust 2. Therefore, X argues that X should not be considered the owner of all the trust property for federal income tax purposes, and X should not be considered to have transferred ownership of the stock, subject to the liability, to the remainder trusts. X argues that instead, Trust 2 should be treated as the owner of the stock, and Trust 2 should be treated as the transferor of the stock, subject to the liability, to the remainder trusts. In addition, X argues that the debt is incurred by reason of Trust 2's acquisition of the stock, and since under Rev. Rul. 85-13, the amount of the debt did not increase Trust 2's basis in the stock, the liability should not be included in Trust 2's amount realized under section 1.1001-2(a)(3).
>
> However, although X did not deduct losses attributable to debt incurred by Trust 2, X received an annuity payment from Trust 2 that was not includible in X's income, and thus, X benefitted from the debt incurred by Trust 2. Therefore, we conclude that the present case is not distinguishable from Example 5 of section 1.1001-2(c). Because X was considered the owner of the stock for federal income tax purposes, the exception in section 1.1001-2(a)(3) does not apply to the present case. X, not Trust 2, is the transferor of the stock on termination of Trust 2 and X did not incur the indebtedness in order to acquire the stock within the meaning of section 1.1001-2(a)(3).
>
> In addition, X argues that the language of section 1.1001-2(a)(3) does not require that the debt be incurred by reason of the transferor's acquisition of the property, but merely be incurred by reason of any acquisition of the property. Therefore, X states that regardless of whether X or Trust 2 is treated as the transferor of the stock to the remainder trusts, the amount of the liability should not be included in X's amount realized because the debt was incurred by reason of Trust 2's acquisition of Company stock. Section 1.1001- 2(a)(3) states that "In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property." We believe this language can only be reasonably read to refer to the transferor's acquisition of the property. We believe this case is substantially identical to Example 5 in section 1.1001-2(c).

For the income tax consequences of a gift where the donee assumes liabilities, see part III.B.1.c.i Gifts with Consideration – Bargain Sales**.** For the consequences on the nature of interest expense after a sale of a partnership interest, see *Lipnick v. Commissioner*, 153 T.C. No. 1 (2019), discussed in the text accompanying fns 457-459 in part II.C.3.d Deducting Interest Expense on Debt Incurred by a Partnership.

See also part III.B.2.j.i Changing Grantor Trust Status, which is part of part III.B.2.j Tax Allocations upon Change of Interest in a Business, which explores how such changes affect allocations of K-1 income from partnerships and S corporations. Within the latter discussion, fn. 6853 supports the following surprising result:

> Irrevocable trust holds stock in S corporation. Grantor turns off grantor trust status, effective the end of December 30. The S corporation sells its assets December 31 (or is deemed to do so when the trust sells its stock and elects to treat the stock sale as an asset

sale).[6556] Because the grantor owned the stock for almost all of the year, the grantor is taxed on almost all of the gain, notwithstanding the fact that the trust was not a grantor trust when the stock was sold. If the stock were not sold until the following January 1, the grantor would not be taxed at all.

III.B.2.d.i.(c). Federal Fiduciary Income Tax Reporting of Irrevocable Grantor Trust Treatment

Generally, items of income, deduction, and credit attributable to any portion of a trust that the grantor trust rules treat as owned by the grantor or another person, are not reported by the trust on Form 1041, "U.S. Income Tax Return for Estates and Trusts," but are shown on a separate statement to be attached to that form.[6557] Exceptions apply to certain trusts deemed owned all by one person, widely held fixed investment trusts, and environmental remediation trusts.[6558]

Eligible trusts may report differently. Ineligible trusts include a common trust fund under Code § 584(a), a trust that has its situs or any of its assets located outside the United States, a QSST,[6559] a trust all of which is treated as owned by one grantor or one other person whose taxable year is a fiscal year, a trust all of which is treated as owned by one grantor or one other person who is not a United States person, and a trust all of which is treated as owned by two or more grantors or other persons, one of whom is not a United States person.[6560] Ineligible trusts also include a trust the deemed owner of which is an exempt recipient for information reporting purposes and a trust treated as owned by two or more persons, the latter trust if one or more deemed owners are exempt recipients for information reporting purposes unless not only at least one deemed owner of the trust is a person who is not an exempt recipient for information reporting purposes but also the trustee reports without regard to whether any of the grantors or other persons treated as owners of the trust are exempt recipients for information reporting purposes.[6561]

An eligible trust, all of which is treated as owned by one person, may furnish the deemed owner's name and taxpayer identification number (TIN) and the trust's address to all payors during the taxable year, and comply with certain additional requirements,[6562] and the trustee is not required to file any type of return with the IRS.[6563] The deemed owner must provide to the trustee a complete Form W-9 or acceptable substitute Form W-9 signed under penalties of perjury.[6564] Unless the deemed owner is the trustee or a co-trustee of the trust, the trustee must furnish the deemed owner of the trust with a statement that:[6565]

(1) Shows all items of income, deduction, and credit of the trust for the taxable year;

6556 The election is described in part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.
6557 Reg. § 1.671-4(a).
6558 Reg. § 1.671-4(a).
6559 See part III.A.3.e.i QSSTs, found in part III.A.3.e QSSTs and ESBTs.
6560 Reg. § 1.671-4(b)(6).
6561 Reg. § 1.671-4(b)(7).
6562 Reg. § 1.671-4(b)(2)(i)(A).
6563 Reg. § 1.671-4(b)(2)(ii)(B).
6564 Reg. § 1.671-4(b)(7).
6565 Reg. § 1.671-4(b)(2)(ii)(A).

(2) Identifies the payor of each item of income;

(3) Provides the grantor or other person treated as the owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(4) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

Another alternative method an eligible trust may use is to furnish the trust's name, TIN, and address to all payors during the taxable year.[6566] In that case, the trustee must file with the IRS the appropriate Forms 1099, reporting the income or gross proceeds paid to the trust during the taxable year, and showing the trust as the payor and the deemed owner of the trust as the payee.[6567]

Unless the deemed owner of the trust is the trustee or a co-trustee of the trust, the trustee must also furnish to the deemed owner of the trust a statement that:[6568]

(i) Shows all items of income, deduction, and credit of the trust for the taxable year;

(ii) Provides the grantor or other person treated as the owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(iii) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

For purposes of all of the above rules in this part III.B.2.d.i.(c), a trust all of which is treated as owned by a married couple filing jointly under Code § 6013 is considered to be owned by one grantor.[6569]

A grantor trust owned by a business in a large multinational enterprise might be required to file Form 8975.[6570]

[6566] Reg. § 1.671-4(b)(2)(i)(B).

[6567] Reg. § 1.671-4(b)(2)(iii)(A), which also provides:

> The trustee has the same obligations for filing the appropriate Forms 1099 as would a payor making reportable payments, except that the trustee must report each type of income in the aggregate, and each item of gross proceeds separately. See paragraph (b)(5) of this section regarding the amounts required to be included on any Forms 1099 filed by the trustee.

[6568] Reg. § 1.671-4(b)(2)(iii)(B)(1). This statement satisfies the trustee's obligation to furnish statements to recipients with respect to the Forms 1099 filed by the trustee. Reg. § 1.671-4(b)(2)(iii)(B)(2).

[6569] Reg. § 1.671-4(b)(1).

[6570] See text accompanying fn. 665 in part II.D.2 Business Entity as Grantor of Tru.

III.B.2.d.i.(d). S corporation Issues Regarding Irrevocable Grantor Trust Treatment

See parts III.A.3.a Wholly Owned Grantor Trusts – How to Qualify, Risks, and Protective Measures, III.A.3.b.i A Trust All of Which Is Treated Under the Grantor Trust Rules as Owned by An Individual Who Is a Citizen or Resident of the United States, and III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death. See also part III.B.2.j Tax Allocations upon Change of Interest in a Business, especially parts III.B.2.j.i Changing Grantor Trust Status and III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

If S corporation stock is reported under the first alternative method (using the deemed owner's TIN) and the deemed owner actually owns or is deemed to own (using the deemed owner's TIN) stock in the same S corporation, may the S corporation issue one K-1 to the deemed owner instead of a separate K-1 to each actual owner? If the S corporation takes that position, the K-1 should break out each actual owner's portion of the items, not only to respect each trust's separateness but also to facilitate any additional reporting required if the grantor is not the trustee or a co-trustee.[6571] Second, the S corporation must furnish to each person who is a shareholder at any time during such taxable year a copy of such information shown on such return as may be required by regulations.[6572] Reg. § 1.6037-1(a) requires Form 1120S to set forth:

(1) The names and addresses of all persons owning stock in the corporation at any time during the taxable year;

(2) The number of shares of stock owned by each shareholder at all times during the taxable year;

(3) The amount of money and other property distributed by the corporation during the taxable year to each shareholder;

(4) The date of each distribution of money and other property; and

(5) Such other information as is required by the form or by the instructions issued with respect to such form.

Pages 21-22 were the only place in the Instructions for Form 1120S (2016) that I noticed a reference to shareholder identifying information. Although they do not discuss grantor trusts, they refer to a situation that might be analogous:

> If a single-member limited liability company (LLC) owns stock in the corporation, and the LLC is treated as a disregarded entity for federal income tax purposes, enter the owner's identifying number in item D and the owner's name and address in item E.

See also part II.A.2.e.ii Procedure for Making the S Election; Relief for Certain Defects in Making the Election, especially fn. 124.

[6571] Reg. § 1.671-4(b)(2)(iii)(B)(1). This statement satisfies the trustee's obligation to furnish statements to recipients with respect to the Forms 1099 filed by the trustee. Reg. § 1.671-4(b)(2)(iii)(B)(2).
[6572] Code § 6037(b).

III.B.2.d.ii. State Income Tax Effect of Irrevocable Grantor Trust Treatment

Not all states recognize grantor trust status.[6573]

Thus, a transaction that might be ignored for federal income tax purposes might be subjected to state income tax.

III.B.2.d.iii. Effect of State Tax on Logistics Involving S corporations and Partnerships Held in Grantor Trusts

Often states require withholding or similar payments regarding an owner's share of state tax liabilities.

When an irrevocable grantor trust owns an interest in an S corporation or partnership, the business entity might be required to make payments on behalf of the deemed owner. This can be awkward, in that the deemed owner is not the actual owner, and the business entity might not have a legal relationship with the deemed owner.

Consider how the business entity, trust, and deemed owner might contract regarding this flow of cash, so that the deemed owner is not treated as receiving a distribution from the business entity or the trust. When the deemed owner has sold assets to the trust and holds a note from the trust, these arrangements might be made in the form of deemed distributions from the entity to the trust, followed by note payments. When the note is fully repaid or the ownership structure is more complex, one might need to spend more time carefully planning any necessary arrangements and documenting them as burdens on the business entity under by state tax law and not something that is voluntarily arranged for the deemed owner's benefit.

III.B.2.e. Grantor Trust Tax Identification Number During Life and Upon Death

III.B.2.e.i. Grantor Trust Treatment During the Grantor's Life

Subject to certain exceptions,[6574] a grantor trust may use the taxpayer identification number (TIN) of the deemed owner rather than obtaining its own TIN.[6575] Reg. § 301.6109-1(a)(2), "A trust that is treated as owned by one or more persons pursuant to sections 671 through 678," provides:[6576]

> (i) *Obtaining a taxpayer identification number*.
>
> > (A) *General rule*. Unless the exception in paragraph (a)(2)(i)(B) of this Section applies, a trust that is treated as owned by one or more persons under sections 671 through 678 must obtain a taxpayer identification number as provided in paragraph (d)(2) of this section.

[6573] See part II.J.3.e.iii Whether a State Recognizes Grantor Trust Status; Effect of Grantor Trust Status on a Trust's Residence, especially fn. 2533.

[6574] Reg. § 1.671-4(b)(6) lists various exceptions, including requiring that a qualified subchapter S trust not use its beneficiary's social security number.

[6575] Reg. § 1.671-4(b)(2)(i)(A).

[6576] Reg. § 301.6109-1(a)(5), "Persons treated as payors," provides:

> For purposes of paragraphs (a)(2), (3), and (4) of this section, a payor is a person described in § 1.671-4(b)(4) of this chapter.

(B) *Exception for a trust all of which is treated as owned by one grantor or one other person and that reports under § 1.671-4(b)(2)(i)(A) of this chapter*. A trust that is treated as owned by one grantor or one other person under sections 671 through 678 need not obtain a taxpayer identification number, provided the trust reports pursuant to § 1.671-4(b)(2)(i)(A) of this chapter. The trustee must obtain a taxpayer identification number as provided in paragraph (d)(2) of this section for the first taxable year that the trust is no longer owned by one grantor or one other person or for the first taxable year that the trust does not report pursuant to § 1.671-4(b)(2)(i)(A) of this chapter.

(ii) *Obligations of persons who make payments to certain trusts*. Any payor that is required to file an information return with respect to payments of income or proceeds to a trust must show the name and taxpayer identification number that the trustee has furnished to the payor on the return. Regardless of whether the trustee furnishes to the payor the name and taxpayer identification number of the grantor or other person treated as an owner of the trust, or the name and taxpayer identification number of the trust, the payor must furnish a statement to recipients to the trustee of the trust, rather than to the grantor or other person treated as the owner of the trust. Under these circumstances, the payor satisfies the obligation to show the name and taxpayer identification number of the payee on the information return and to furnish a statement to recipients to the person whose taxpayer identification number is required to be shown on the form.

The deemed owner is required to give the trustee a Form W-9 reporting the deemed owner's TIN.[6577] Unless the deemed owner is the trustee or a co-trustee of the trust, the trustee must furnish the deemed owner of the trust with a statement that:[6578]

(1) Shows all items of income, deduction, and credit of the trust for the taxable year;

(2) Identifies the payor of each item of income;

(3) Provides the deemed owner with the information necessary to take the items into account in computing the deemed owner's taxable income; and

(4) Informs the deemed owner that the items of income, deduction and credit and other information shown on the statement must be included in computing the deemed owner's taxable income and credits on the deemed owner's income tax return.

Reg. § 1.671-4(b)(4), "Persons treated as payors," provides:

(i) *In general*. For purposes of this section, the term payor means any person who is required by any provision of the Internal Revenue Code and the regulations thereunder to make any type of information return (including Form 1099 or Schedule K-1) with respect to the trust for the taxable year, including persons who make payments to the trust or who collect (or otherwise act as middlemen with respect to) payments on behalf of the trust.

[6577] Reg. § 1.671-4(b)(1).
[6578] Reg. § 1.671-4(b)(2)(ii)(A).

(ii) *Application to brokers and customers*. For purposes of this section, a broker, within the meaning of section 6045, is considered a payor. A customer, within the meaning of section 6045, is considered a payee.

As a practical matter, usually the trustee simply forwards to the deemed owner all information reporting forms the trustee receives.

If the trust does not use this reporting, then the trustee files fiduciary income tax returns (IRS Form 1041) and attaches a grantor information statement reporting the trust's income, etc. to be included on the deemed owner's return.[6579]

The trustee might want to consider the latter if:

- The grantor trust treatment is uncertain, so that the statute of limitations on the issue of grantor trust status can start running.

- The deemed owner has creditor issues. Although grantor trust status does not change a trust's asset protection features, a financial institution might use the deemed owner's TIN to determine which accounts to turn over to a creditor garnishing accounts held at the financial institution. The deemed owner then expends time and money to correct the financial institution's mistake. I have seen this happen.

If a trust has more than one owner, then generally the trust must report on Form 1041 using the latter procedure.[6580] However, if all of the trust is treated as owned by spouses who file a joint return, the spouses are treated as one owner.[6581] Whose social security number should be used presumably is a moot point for federal income tax purposes; if contributions are unequal, one might use the number of the spouse who contributed more than the other. However, in Missouri (and perhaps some other states), spouses have separate run-ups through the brackets, so one should consider what might be least likely to cause the state income tax return preparer to incorrectly allocate income.

III.B.2.e.ii. Tax ID Issues When the Deemed Owner of a Grantor Trust Dies; Related Effect on Quarterly Payments of Estimated Income Tax

The trust (or portion of a trust) that ceases to be a grantor trust by reason of the deemed owner's death may no longer report under the grantor trust rules.[6582] If all of the trust was treated as owned by the decedent, the trust must obtain a new TIN upon deemed owner's death, if the trust will continue after the deemed owner's death.[6583] Reg. § 301.6109-1(a)(3),

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[6579] See Reg. § 1.671-4(b)(2)(B).
[6580] Reg. § 1.671-4(b)(3).
[6581] Reg. § 1.671-4(b)(8).
[6582] Reg. § 1.671-4(h)(2). Reg. § 1.671-4(h)(3) explains how to report the trust's income for that year.
[6583] Reg. § 1.671-4(h)(2), which also cross-references Reg. § 301.6109-1(a)(3)(i) for rules regarding obtaining a TIN upon the deemed owner's death. Rev. Rul. 57-51 held that, upon the death of the grantor of a revocable trust that had been filing grantor information returns (and therefore had its own tax ID), "the trust became a separate entity for Federal income tax purposes for the first time and hence a *new* taxpayer…. For tax purposes, the existence of the trust in this case, prior to the time it became irrevocable, is ignored."

"Obtaining a taxpayer identification number for a trust, or portion of a trust, following the death of the individual treated as the owner," provides:[6584]

(i) *In general*.

(A) *A trust all of which was treated as owned by a decedent*. In general, a trust all of which is treated as owned by a decedent under subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code as of the date of the decedent's death must obtain a new taxpayer identification number following the death of the decedent if the trust will continue after the death of the decedent.

(B) *Taxpayer identification number of trust with multiple owners*. With respect to a portion of a trust treated as owned under subpart E (section 671 and following), part I, subchapter J, chapter 1 (subpart E) of the Internal Revenue Code by a decedent as of the date of the decedent's death, if, following the death of the decedent, the portion treated as owned by the decedent remains part of the original trust and the other portion (or portions) of the trust continues to be treated as owned under subpart E by a grantor(s) or other person(s), the trust reports under the taxpayer identification number assigned to the trust prior to the decedent's death and the portion of the trust treated as owned by the decedent prior to the decedent's death (assuming the decedent's portion of the trust is not treated as terminating upon the decedent's death) continues to report under the taxpayer identification number used for reporting by the other portion (or portions) of the trust. For example, if a trust, reporting under § 1.671-4(a) of this chapter, is treated as owned by three persons and one of them dies, the trust, including the portion of the trust no longer treated as owned by a grantor or other person, continues to report under the tax identification number assigned to the trust prior to the death of that person. See § 1.671-4(a) of this chapter regarding rules for filing the Form 1041, "U.S. Income Tax Return for Estates and Trusts," where only a portion of the trust is treated as owned by one or more persons under subpart E.

(ii) *Furnishing correct taxpayer identification number to payors following the death of the decedent*. If the trust continues after the death of the decedent and is required to obtain a new taxpayer identification number under paragraph (a)(3)(i)(A) of this section, the trustee must furnish payors with a new Form W-9, "Request for Taxpayer Identification Number and Certification," or an acceptable substitute Form W-9, containing the new taxpayer identification number required under paragraph (a)(3)(i)(A) of this section, the name of the trust, and the address of the trustee.

See the IRS links provided at part II.G.1 How and When to Obtain or Change an Employer Identification Number (EIN).

[6584] Reg. § 301.6109-1(a)(5), "Persons treated as payors," provides:

For purposes of paragraphs (a)(2), (3), and (4) of this section, a payor is a person described in § 1.671-4(b)(4) of this chapter.

Reg. § 1.671-4(b)(4) is found in part III.B.2.e.i Grantor Trust Treatment During the Grantor's Life.

Because the trust income tax return from after the date of death until December 31 will not be a taxable year of 12 months, the trust cannot use the prior year exception for calculating payments of estimated income tax.[6585]

However, payments of estimated income tax are not required, with respect to "any taxable year ending before the date 2 years after the date of the decedent's death," if the taxpayer is either the decedent's estate or a grantor trust wholly owned by the decedent before death, which trust is one "to which the residue of the decedent's estate will pass under his will (or, if no will is admitted to probate, which is the trust primarily responsible for paying debts, taxes, and expenses of administration)."[6586] Although the decedent's (previously) revocable trust generally would qualify, if one has any doubts then one might consider electing to treat the trust as part of the decedent's estate.[6587]

[6585] The last sentence of Code § 6654(d)(1)(B) provides that the prior year exception "shall not apply if the preceding taxable year was not a taxable year of 12 months or if the individual did not file a return for such preceding taxable year."
[6586] Code § 6654(*l*)(2).
[6587] See part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI)

Although the discussion below generally refers to trusts, generally it applies to estates as well. If a trustee has discretion to make an election regarding that trust, the election does not affect the choices available regarding other trusts the trustee manages.

I.A.1.v. Capital Gain Constitutes DNI Unless Excluded

Taxable income is DNI unless expressly excluded.

Code § 643(a)(3) provides:

> *Capital gains and losses*. Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c).

Thus, to be excluded from the income of a domestic trust, the gains must:

- Arise from the sale or exchange of capital assets,
- Be allocated to corpus, and
- Not be actually or deemed to be distributed.

The rest of this part II.J.8.a Capital Gain Constitutes DNI Unless Excluded focuses on the first two prongs.

I.A.1.v.i. Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset

Only gains from the sale of capital assets are ordinarily excluded from DNI.

For example, "property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business" is not a capital asset. Therefore, the sale of such property would constitute DNI, although it would not constitute trust accounting income. Whether other real estate is a capital asset depends on various facts.

However, "any recognized gain on the sale or exchange of property used in the trade or business" often receives capital gain treatment to the extent it does not constitute certain depreciation recapture. Goodwill that has not been amortized is a capital asset, but goodwill that is being amortized is not a capital asset. Thus, because such assets are not capital assets, such capital gains generally would be included in DNI.

I.A.1.v.ii. Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus

I am unaware of any authority defining "allocated to corpus" as used in Code § 643(a)(3). Presumably it means receipts by the trust that are allocated to principal.

Does the statute mean that capital gain are automatically included in DNI unless they are affirmatively allocated to principal and certain other conditions exist? Reg. § 1.643(a)-3(a) might overrule that requirement, providing (highlighting added):

> *In general*. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

This regulation essentially has three parts:

- Reg. § 1.643(a)-6 deals with foreign trusts.

- Reg. § 1.643(a)-3(b) explains when capital gains from the sale or exchange of an asset are included in DNI and does not include a requirement that the capital gain be allocated to principal. In fact, one of the prongs discusses the treatment when capital gains are allocated to income.

- Depending on the meaning one gives to "ordinarily," this regulation might dispense with the statutory requirement that capital gains be allocated to corpus. The regulation does not explain when it says "ordinarily" what the exceptions might be, other than Reg. §§ 1.643(a)-6 and 1.643(a)-3(b). There would appear to be substantial authority for saying that an affirmative allocation of capital gains to principal is or is not required.

This issue seems to be most important for the trust's gross income that does not take the form of receipts of cash or other property. For example, a trust might invest in a partnership, S corporation, or other flow-through entity that does not distribute all of its taxable income. How should one treat capital gain from a flow-through entity's sale of a capital asset, when the entity distributes less than all of its taxable income? Should the undistributed capital gain be included in DNI?

- With respect to the accumulated capital gain, the trust has no receipts and therefore is not allocated to corpus. Arguably, the capital gain is not excluded from DNI and therefore constitutes DNI.

- On the other hand, the accumulated capital gain benefits the trust's corpus. Should it be treated as if it had been allocated to corpus? In that case, should it be trapped inside the trust, given that it was accumulated inside the entity and not distributed to the beneficiary?

- Given this uncertainty, would the trustee have discretion to take a different position each year? In Reg. § 1.643(a)-3(b), the Treasury generally agreed that the trustee would not be required to take a consistent position year-by-year, except for capital gain allocated to corpus and treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary. Given that this gross income was not allocated corpus (because it was never physically received), perhaps the trustee has discretion to vary the treatment from year to year? Another approach might be to say that, because the undistributed capital gain was not allocated to principal, the regulations might presume that the undistributed capital gain is allocated to income and can be included in DNI inconsistently from year to year under Reg. § 1.643(a)-3(b)(1).

If all of a flow-through entity's K-1 items taxable to the trust are included in DNI, then part II.J.8.c Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal might cause ordinary income to be trapped at the trust level if the flow-through entity distributes cash in an amount less than all of these K-1 items; see part II.J.8.f Consequences of Allocating Capital Gain to DNI. In light of the consequences described there, the most taxpayer-favorable reading may be that capital gain is ordinarily excluded from DNI.

I leave it to the reader to decide which approach is "better" or perhaps to make that decision on a trust-by-trust basis.

For more on using flow-through entities, see part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

I.A.1.w. Should Capital Gain Be Allocated to DNI?

Often beneficiaries have income below the thresholds that cause the 3.8% tax and the additional 5% capital gain tax to be incurred, whereas trusts start paying those taxes at relatively modest income levels. Therefore, distributing capital gains to beneficiaries might be beneficial – at least from an income tax viewpoint.

Consider various factors described in part II.J.3 Strategic Fiduciary Income Tax Planning.

I.A.1.x. Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal

Generally, gains from the sale or exchange of capital assets, net of losses, are excluded from distributable net income (DNI). But that statement belies the flexibility we are about to see.

Reg. § 1.643(a)-3(b) provides:

> *Capital gains included in distributable net income*. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law) -
>
> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));
>
> (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or
>
> (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

Note the word "or" after paragraph (2) above. That indicates capital gains are included in DNI if and to the extent that any one or more of paragraph (1) (the "Income Rule"), paragraph (2) (the "Consistent Principal Rule"), or paragraph (3) (the "Discretionary Principal Rule") applies. For more on the:

- Income Rule, see part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law
- Consistent Principal Rule, see part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary
- Discretionary Principal Rule, see part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary.

Before its amendment by T.D. 9102 (12/30/2003), Reg. § 1.643(a)-3 made it more difficult to include capital gain in DNI.

I.A.1.x.i. Income Rule: Capital Gain Allocated to Income Under State Law

Most states have adopted the Uniform Principal and Income Act, which will be referred to at UPIA for the rest of this part II.J.8.c.i, or its replacement, which is described in part II.J.5.b Uniform Fiduciary Income & Principal Act (UFIPA).

Generally, any capital gain included as the distributive share of income from a partnership or S corporation and distributed from the entity to the trust will constitute income under the Act, making the rest of this part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI) be moot.

Generally, the Act allocates capital gains to principal. The main exceptions are the power to adjust, unitrust distributions, and exceptions in the governing instrument; the power to adjust and power to convert to a unitrust followed adoption of the prudent investor rule. Following a discussion of each of these is a discussion of the respect fiduciary income tax law gives them.

I.A.1.x.i.(a). Power to Adjust

Capital gains may be reclassified as income if traditional trust accounting income principles cause insufficient receipts to be classified as income. See parts II.J.5.b.ii.(a) Power to Adjust.

I.A.1.x.i.(b). Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation

It is not uncommon for partnerships and S corporations to reinvest part of their annual income; indeed, to facilitate growth or simply a stronger capital structure (which lenders might require), many distribute only enough to pay their owners' income taxes (commonly referred to as a "tax distribution") plus a modest bonus (referred to below as a "bonus distribution").

Taxes on this reinvested income are charged against the income of a trust that owns such an entity. This is the only practical solution to the trust's obligation to pay its taxes, because the taxing authorities' claims against the trustee are much more pressing than the beneficiaries' claims. (Note that the income beneficiary of a Qualified Subchapter S Trust pays this tax – part III.A.3.e QSSTs and ESBTs – which has an effect similar to charging the trust's income.)

The Uniform Principal and Income Act includes a remedy for the income beneficiary that had to pay the tax on the entity's accumulated income that has been inherently baked into principal. Section 506(a)(3) authorizes a fiduciary to "make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from … the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary." This specific provision supplements any power to adjust that might generally apply.

Thus, when an interest in a partnership or an S corporation is sold, the trustee should consider whether to allocate some of the sale proceeds to income. However, it's not at all obvious that the trustee should make an adjustment; consider that:

- The entity made distributions specifically to pay this tax, so the trust or income beneficiary was not really "out of pocket" for this tax.

- If the entity had been a C corporation, the entity would have paid the tax itself. Its dividend would have equaled the bonus distribution, and this issue would never have arisen.

- The true issue is whether the bonus distribution was sufficient. Was the decision to accumulate income fair – a sound exercise of the business judgment of those who run the entity? Did those who control the entity promise a make-up distribution at some point

> because of a special project, or was the accumulation merely part of a solid plan to grow the business, which presumably would result in increased income and increased bonus distributions? Were those who control the entity running it just to benefit themselves (and, if owners, trying to extract more benefits as owners than the inactive owners received)? I have probably left out many other relevant considerations, but hopefully I have communicated why this decision is not easy.

See parts II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Trust Accounting Rules and II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets.

If the trustee is concerned that the income beneficiary might spend a perceived windfall unwisely, the trustee might consider using the power to adjust to spread distributions over an appropriate period of time. Such a spread over time might be more palatable if, instead of labelling the adjustment to sale proceeds as a tax reimbursement, the trustee labelled it as a make-up for insufficient bonus distributions, taking the position that future distributions to beneficiaries might be loosened because of a prior conservative distribution policy. The bonus distributions might have been sufficient from the viewpoint of what the entity should have distributed but might have been insufficient from the viewpoint of how much income the trustee should have tried to generate. As mentioned in part III.A.4.d.iv Advising Clients about the UPAIA § 505 Change and UFIPA § 506 (discussing conflicts with beneficiaries that might arise when an entity makes tax distributions but little or no bonus distributions), these issues have no easy answer.

See also part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Trust Accounting Rules.

I.A.1.x.i.(c). Unitrust

A unitrust is a trust that distributes fixed amounts, redetermined annually as a fixed percentage of the value of the trust's value, which value is redetermined annually but might be based on an average of values, such as the average value of the trust's assets for the past three years. See parts II.J.5.b.ii.(b) Unitrust and II.J.5.b.ii.(c) Comparing Power to Adjust to a Unitrust.

Reg. § 1.643(a)-3(e) provides the following examples regarding unitrusts:

> *Example (11)*. The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is

allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.

Example (12). The facts are the same as in Example 11, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire $80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.

Example (13). The facts are the same as in Example 11, except that neither state statutes nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

A right to income expressed initially solely as a unitrust interest may qualify for the QTIP marital deduction.

I.A.1.x.i.(d). Exceptions in the Governing Instrument

Although the Act provides general rules, it also allows trust agreements to override those rules:

In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:

(1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];

(2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];

(3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and

(4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

I.A.1.x.i.(e). Fiduciary Income Tax Recognition of the Trust Agreement and State Law

Code § 643(b) generally defers to the trust agreement and applicable state law. The Uniform Principal and Income Act ("UPIA") and the Uniform Fiduciary Principal & Income Act ("UFIPA") authorizes the trust agreement to override the Act.

However, Reg. § 1.643(b)-1 does not recognize trust agreements that depart too far from the usual rules:

> Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal.

Reg. § 1.643(b)-1 respects variations provided under applicable state law:

> However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods.

Circling back to the Act's authorizing trust agreements to depart from traditional principles, Reg. § 1.643(b)-1 concludes with:

> In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.

For the "reasonable and impartial exercise" requirement in the context of the power to adjust, see part II.J.5.b.ii.(a) Power to Adjust.

I often use a clause providing that the trustee has wide discretion but must reasonably and fairly balance the interests of the income and remainder beneficiaries. That language comes from the marital deduction regulations. Generally, the trustee's authority to allocate between income and principal does not trigger grantor trust status, does not constitute a power of appointment, and does not have generation-skipping transfer tax implications. The trustee might want to consider providing accountings or other notices to the beneficiaries that would start running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile this one on top of it, which procedure might help minimize any gift tax consequences to failing to make a claim.

How does one draw the line between what departs "fundamentally from traditional principles of income and principal" and what is "a reasonable and impartial exercise of a discretionary power granted to the fiduciary" under Reg. § 1.643(b)-1?

Presumably, the trustee should be on solid ground in allocating to income capital gains such that the total amount of all receipts allocated to income does not exceed 5%, given that the regulations expressly approve unitrusts in the 3%-5% range. The trusts should also be on solid ground in allocating to income capital gains generated by a partnership that the settlor intended to distribute to the income beneficiary.

Beyond that, it's a matter of facts and circumstances and judgment. However, Reg. § 1.643(a)-3(e), Example (4) respected a mandatory allocation of capital gain to income where a trust had $5,000 of dividends and $10,000 of capital gains, and the trustee distributed $17,000 to the beneficiary.

I.A.1.x.i.(f). Conclusion Regarding Allocating Capital Gain to Income

Reg. § 1.643(a)-3(b)(1) requires a consistent practice for unitrusts. Considering that the unitrust recipient is receiving cash and presumably would have the liquidity to pay tax on any capital gains distributed to the beneficiary, in many cases it would be fair to allocate capital gain to DNI to the extent that the unitrust amount exceeds the income that would apply under the Act's general rules. Given that one provides for a unitrust when tension between the income beneficiary and remaindermen might be high, the tension created by this tax issue would be high to the same degree. Consider providing a firm rule in the trust agreement regarding the allocation of capital gain to DNI. If one is concerned that shifting tax rates might create an unfair tax result, consider providing a clause reimbursing the unitrust beneficiary for taxes paid on the unitrust and on the reimbursement; this requires cooperation between the trustee's income tax preparer and the beneficiary's income tax preparer, but the calculation should be relatively mechanical.

For trusts that are not unitrusts, Reg. § 1.643(a)-3(b)(1) provides significant flexibility, allowing the trustee discretion whether to allocate capital gain to income for fiduciary accounting purposes (if the trust agreement and state law permit) and also whether to include in DNI the capital gain that was allocated to income.

Consider the nuances for a mandatory income trust. Distributions must be made no later than 65 days after yearend to include capital gain in DNI in every other situation. In a mandatory income trust, a power to adjust might be able to retroactively include capital gain in income – perhaps as late as when the tax return is prepared. For how mandatory income trusts work, see part II.J.5 Mandatory Income Trusts. For limits on retroactivity, see part II.J.5.a Issues Arising with Mandatory Income Trusts.

I.A.1.x.ii. Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary

Reg. § 1.643(a)-3(e) helps guide our application of Reg. § 1.643(a)-3(b)(2):

> *Example (1)*. Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.
>
> *Example (2)*. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.
>
> *Example (3)*. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments. This treatment of capital gains is a reasonable exercise of Trustee's discretion.

The all-or-nothing approach taken by Examples (1) and (2) is not very attractive, but we need to deal with it. Let's consider some fact patterns:

1. The beneficiary needs regular annual distributions that cannot be made using a power to adjust. Generally, distributions in excess of what can made using a power to adjust would not be sustainable. A power to adjust typically adjusts to a 3%-5% distribution, and most models suggest that distributions in excess of that will lead to a trust being depleted. Thus, a more likely scenario is that a power to adjust is not available, because state law prevents using the power to adjust in particular situations (unless the trust agreement overrides it). In such a case, the beneficiary's federal and state/local income tax bracket for capital gains needs to be compared to the trust's federal and state/local income tax bracket for capital gains. Note that a nonresident trust would have a zero state/local income tax bracket, to the extent that the trust does not have income from a business sourced to the state/local jurisdiction.

2. The beneficiary's need for distributions in excess of income is sporadic. It's difficult to predict how the beneficiary's federal and state/local income tax bracket for capital gains compares to the trust's federal and state/local income tax bracket for capital gains, given that rates will change and the trust's and its beneficiaries' circumstances might change over time. In such a case, consider whether the distribution might be phrased as "allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary." If that is likely to be the case, then consider not electing to carry out capital gain automatically under (b)(2) but rather deciding to rely on (b)(3), because (b)(3) is flexible whether to allocate capital gain to income, allowing the decision to made separately each year on a case-by-case basis.

Generally, trustees would not be likely to take advantage of the discretion that Example (3) provides to allocate to income only capital gain from the sale of certain specified assets or a particular class of investments, because such an election requires additional recordkeeping.

Some people point to the word "deem" in Example (1) and emphasize the need for such authority in the trust agreement or applicable state law. Uniform Trust Code § 816 generally authorizes trustees to make tax elections, so the authority to "deem" distributions to be capital gains is inherently authorized in UTC states, as well as any other state where a trustee generally has the authority to make tax elections.

I.A.1.x.iii. Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary

Reg. § 1.643(a)-3(b)(3) might seem confusing at first, but it actually has very practical use.

First, let's look at some examples that Reg. § 1.643(a)-3(e) provides:

> Example (5). The facts are the same as in Example 1, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is $10,000, rather than $12,000. Because Trustee will use the amount of any realized capital gain to determine

the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.

Example (6). Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to A. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

Although Reg. § 1.643(a)-3(b)(3) is viewed generally as discretionary, note that Example (6) is mandatory: if the trustee is required to distribute sale proceeds to a beneficiary, the capital gain from the sale is included in the DNI that the distribution carries out the beneficiary. Example (7) similarly requires all capital gain recognized in the trust's final taxable year to be included in the DNI that the distribution carries out the beneficiary.

The practical application is based on the ability to count as prior year distributions those distributions made in the first 65 days of the current year. For example, any distribution made on or before March 5, 2020 can be treated as a 2019 or 2020 distribution. This election applies to the greater of accounting income under Reg. § 1.643(b)-1 or DNI under Reg. §§ 1.643(a)-1 through 1.643(a)-7. By completing the line on the trust's income tax return, Form 1041, page 2, Part B, showing amounts (other than income required to be distributed currently) paid, credited, or otherwise required to be distributed and checking the Code § 663(b) box in "Other Information" at the bottom of Form 1041, page 2, the trustee decides how much of a current year distribution is allocated to the prior year; the balance would then be credited to the current year.

The practical application based on the 65-day rule would generally occur during February after the year ends and applies only if the trustee has discretion to distribute corpus. The regulations do not specify any particular trust records regarding the election, so do whatever seems best to evidence the intent. Perhaps the income tax return preparer emails the trustee recommending how much of a distribution be made to distribute income and capital gain under the 65-day rule (erring on the side of distributing too much), then the trustee makes the distribution, and the tax return carries through the intent. As long as the distribution is made timely, the tax return can treat none, part, or all of the distribution as a distribution of the taxable year's income. In a manner similar to Example (5), the trustee has referred to the capital gain itself in determining how much to distribute. Unlike Reg. § 1.643(a)-3(b)(2), Reg. § 1.643(a)-3(b)(3) allows one to carry out discretionary distributions of capital gain inconsistently from one year to another.

If the beneficiary does not require monthly or quarterly cash flow, the trustee can simply each February make a big distribution and apply it to the prior or current year for tax return preparation purposes. If the beneficiary does require monthly cash flow but is willing to accept informal constraints, the trustee makes the big distribution into an investment account that the beneficiary owns, and the account makes monthly transfers to the beneficiary's checking account. Obviously this would not work for a beneficiary who cannot exercise discipline, but there is a good segment of beneficiaries for whom it would work.

An alternative approach is to distribute an asset to a beneficiary before the asset is sold. Generally, the beneficiary will receive a carryover basis and then be taxed on the gain.

As with all tax planning, the strategies described in this part II.J.8.c.iii may be unavailable (based on the trust terms), inadvisable (based on sound financial planning), or stupid (giving money to a drug addict just to save taxes).

I.A.1.x.iv. Netting Capital Losses

Reg. § 1.643(a)-3(d), "Capital losses," provides:

> Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is distributed or required to be distributed to a particular beneficiary. See § 1.642(h)-1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

Thus, if and to the extent that Reg. § 1.643(a)-3(b)(3) includes capital gains in DNI (see part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary), capital losses are not netted against such gains. The recipient beneficiaries report all such capital gains, and the capital losses remain in the trust.

However, note that Reg. § 1.643(a)-3(b)(3) has two elements: "actually distributed to the beneficiary," which would tend to require tracing except in the case of trust termination, or "utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary," in which case the trustee would have needed to consciously decide to refer to the capital gain when making the distribution.

Unless the trustee traces or decides to refer to the gross capital gain (instead of the net capital gain) when making the distribution, the loss would be offset under Reg. § 1.643(a)-3(b)(3). Alternatively, the trustee might not trace and not refer to capital gain but rather exercise the power to adjust, which would invoke Reg. § 1.643(a)-3(b)(1) (see part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law) and include an automatic offset.

I.A.1.x.v. Conclusions Regarding the Basic Framework on Allocating Capital Gains to DNI

Often, one cannot predict whether the combination of federal, state, and local income tax rates will be higher inside or outside of the trust.

Quite frankly, I keep changing my mind regarding the best income tax elections as I encounter new situations. If the document is flexible as to distributions and distributions are appropriate, then I would lean toward:

- Flexible language allowing the trustee to allocate capital gains to income, so long as the trustee must reasonably and fairly balance the interests of the income and remainder beneficiaries.

* Using the 65-day-rule to distribute large capital gains to the beneficiary as DNI.

* Electing not to establish a practice of carrying out capital gain to beneficiaries under Reg. § 1.643(a)-3(b)(2) unless it appears that the above two approaches will not suffice to minimize overall income taxes. However, it is not uncommon for me to decide that the above. two approaches will not suffice to minimize overall income taxes. On the other hand, if the situation involves enough money, the trustee can covert capital gain that would otherwise be trapped inside the trust to trust accounting income, using the tool described in part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

Consider adding a withdrawal right of up to 5% of the trust's value. The beneficiary will be deemed to be the owner of the part that the beneficiary can withdraw and perhaps continue to be deemed the owner with respect to the lapsed portion. However, note that withdrawal rights can increase exposure to creditors to the extent of the withdrawal right and perhaps even after a lapse. For details on all of the ideas mentioned in this paragraph, see part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts. If one is concerned about the withdrawal right itself becoming a bad idea, consider using a provision along the following the lines:

> In addition to the distributions authorized by the preceding sentence, subject to the following sentence the trustee shall distribute to the beneficiary so much of the principal of the trust as the beneficiary, while at least __ years of age, may request once between February 23 and March 5 of every calendar year, on a noncumulative basis, up to five percent (5%) of the aggregate value, as of the time of such request by the beneficiary, of the principal of the trust. The trustee may, by instrument placed in the trust's records, provide that the preceding sentence shall not apply during any period (including the beneficiary's remaining life), which period shall begin no earlier than the January 1 following the date of the instrument.

This allows the trustee to turn off the withdrawal rights for any future year(s) without impeding the beneficiary's absolute right to withdraw during the current year.

I.A.1.x.vi. Fairness of Taxing Capital Gain to Beneficiaries; Need for Tax Distributions Here and Other Areas

Our income tax system taxes income to whoever receives it, subject to certain exceptions not relevant to this part II.J.8.c.vi. Therefore, it is fair to tax the beneficiaries.

However, when a distribution is made for a particular purpose and the money is spent, the beneficiary will get upset when handed a tax bill for which the beneficiary did not plan. Therefore, one might need to make a supplemental distribution to pay tax on the original distribution. The supplemental distribution would also need to be enough to pay tax on the supplemental distribution itself. This supplemental distribution is often referred to as "grossing up the distribution" to pay taxes.

This issue applies to more than just capital gains. Clients who leave residences in trust often wish to have the trust pay expenses that a life tenant would ordinarily pay. Distributions by the trust for those purposes run into the same problem – the money is spent for the intended purpose and not available to pay taxes. These distributions also need to be grossed up to pay taxes.

I.A.1.y. Distribution in Kind; Specific Bequests

I.A.1.y.i. Distribution in Kind - Generally

Except as provided below and except to the extent that it carries out DNI or constitutes a bequest of income, a distribution is a nontaxable gift (unless the recipient assumes liabilities, in which case it is taxed as a bargain sale).

When a trust distributes property to satisfy a pecuniary distribution (even if the amount is expressly authorized to be satisfied in cash or in kind), the trust recognizes gain on the deemed sale, even if the trust's residue is less than the pecuniary obligation. Such a pecuniary obligation includes an equalizing distribution (presumably unless expressed as a fractional share). This rule includes a pecuniary obligation in the form of an annuity payment to a beneficiary, and the gain recognized in paying the annuity is not included in the beneficiary's distributive net income (DNI) unless the rules for including capital gain in DNI are satisfied. If the trust's residue is less than the pecuniary obligation, the fact that all bequests are protected by Code § 663(a)(1) and therefore no residual beneficiary can pick up income under Code § 662 means that the trust will pay the tax, given that the beneficiaries of the protected bequests will not be picking up that income; note that the trustee will need to reserve for this tax before making distributions to beneficiaries and may have a mismatch for net investment income tax purposes as well. However, when a charity that was the annuity recipient was bequeathed the remainder, the resulting merger of interests and trust termination were not a taxable event. Also, if the bequest is satisfied using date-of-death values, presumably no gain or loss would be realized, but to qualify for the marital or charitable deduction the assets' value relative to date of death values must be "fairly representative of appreciation or depreciation in the value of all property thus available for distribution in satisfaction of such pecuniary bequest or transfer."

If a trust makes a non-pro rata distribution of residue without either the trust instrument or local law authorizing a non-pro rata distribution, each beneficiary may be treated as having received a pro rata distribution and exchanged it with the other beneficiaries. Otherwise, generally the trust does not recognize any gain or loss and the beneficiaries receive the same basis as the trust's; for further analysis of dividing trusts (including on termination), see part II.D.5 Severing Trusts with Multiple Grantors. However, the trust may elect to treat all property distributions during the taxable year as sales, but losses in transactions with beneficiaries and other related parties are disallowed except to the extent that they are from an estate (including a revocable trust electing to be taxed as an estate) satisfying a pecuniary bequest. The loss disallowance applies even if the distribution, taken as a whole, results in a net gain. Thus, gains are recognized and losses generally are not.

The amount deemed distributed is the lesser of the property's basis or fair market value, unless gain was recognized, in which case it is the property's value.

Distributing low basis assets will generate a new basis (often a step-up) when the beneficiary dies. However, distributed assets are subject to the beneficiary's creditors, changes in the beneficiary's estate tax posture (including not only changes in the tax law but also changes in financial situation through the beneficiary's own efforts or through marriage and change in residence to a state that imposes its own estate tax), and changes in the beneficiary's dispositive goals. To get a basis step-up, I would rather add (perhaps by decanting) a formula general power of appointment, as described in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.

Distributing an unmarketable partnership interest would carry out DNI without giving the beneficiary cash. However, valuation adjustments might depress the amount of the deemed distributions, and the beneficiary would be entitled to a proportionate share of future distributions from the partnership. However, if the trustee controls the partnership, the trustee can also control the distribution spigot.

I.A.1.y.ii. Specific Bequest

A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under Code § 661 and is not included in the gross income of a beneficiary under Code § 662, unless under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the recipient in more than three installments.

I.A.1.y.iii. Distributing a Note to the Obligor

Rev. Rul. 75-68 provides:

> The income of a testamentary trust consisting solely of interest from mortgages on the beneficiary's property was required to be distributed periodically. Although the mortgage notes held by the trust required the periodic payment of interest, it was agreed between the beneficiary and the trustees, that the beneficiary would pay no interest on the mortgages and the trustees would distribute no income from the trust.
>
> *Held*, notwithstanding the foregoing agreement, the interest income due on the mortgages held by the trust is includible in the gross income of the trust, and this same amount, as the distributable income of the trust, is includible in the gross income of the beneficiary. Further, the beneficiary is entitled to a deduction for this interest deemed paid on the mortgages.

Below is authority consistent with this conclusion:

Reg. § 1.643(c)-1(a) treats as a beneficiary "any person with respect to an amount used to discharge or satisfy that person's legal obligation as that term is used in § 1.662(a)-4."
Reg. § 1.661(a)-2(d) provides:

> The terms "income required to be distributed currently" and "any other amounts properly paid or credited or required to be distributed" also include any amount used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)-4.

Reg. § 1.662(a)-4, "Amounts used in discharge of a legal obligation," provides:

> Any amount which, pursuant to the terms of a will or trust instrument, is used in full or partial discharge or satisfaction of a legal obligation of any person is included in the gross income of such person under section 662(a)(1) or (2), whichever is applicable, as though directly distributed to him as a beneficiary, except in cases to which section 71 (relating to alimony payments) or section 682 (relating to income of a trust in case of divorce, etc.) applies. The term "legal obligation" includes a legal obligation to support another person if, and only if, the obligation is not affected by the adequacy of the dependent's own resources. For example, a parent has a "legal obligation" within the meaning of the preceding sentence to support his minor child if under local law property or income from property owned by the child cannot be used for his support so long as his parent is able to support him. On the other hand, if under local law a mother may use the resources of a child for the child's support in lieu of supporting him herself, no obligation of support exists within the meaning of this paragraph, whether or not income is actually used for support. Similarly, since under local law a child ordinarily is obligated to support his parent only if the parent's earnings and resources are insufficient for the purpose, no obligation exists whether or not the parent's earnings and resources are sufficient. In any event, the amount of trust income which is included in the gross income of a person obligated to support a dependent is limited by the extent of his legal obligation under local law. In the case of a parent's obligation to support his child, to the extent that the parent's legal obligation of support, including education, is determined under local law by the family's station in life and by the means of the parent, it is to be determined without consideration of the trust income in question.

Reg. § 1.661(a)-2(d) provides:

> The terms "income required to be distributed currently" and "any other amounts properly paid or credited or required to be distributed" also include any amount used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)-4.

I.A.1.z. Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries

Generally, K-1 income from a passthrough business entity will carry out any income (including capital) distributed to the trust and then to the trust's beneficiaries. This section focuses on nongrantor trusts holding partnerships rather than S corporations, because generally a trust can hold S corporation stock that is not a grantor trust, QSST, or ESBT only during a relatively limited amount of time. (Although the principles in this part II.J.8.e would apply to a net income with make-up charitable remainder unitrust – a NIMCRUT – the IRS has concerns about that application and might shut it down at some point.)

Also, if one elected not to carry out capital gains under Reg. § 1.643(a)-3(b)(2) and later decides that all capital gain should be included in DNI going forward (or does not want to take a risk that the IRS will not respect deviations from general rules of the Uniform Principal and Income Act, consider forming an entity taxed as a partnership. Capital gains earned through a partnership generally constitute trust accounting income.

The Uniform Principal and Income Act provides that, generally, all cash distributions from an entity (including a partnership) are considered trust accounting income. Only the following distributions from an entity are not considered trust accounting income:

- property other than money;
- money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;
- money received in total or partial liquidation of the entity; and
- money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

Thus, a partnership's capital gains recognized in the ordinary course of managing and re-balancing a portfolio would constitute fiduciary accounting income to the extent distributed from the partnership in cash and therefore would be includible in DNI under (1) above.

To keep control of the partnership, consider having the trust be a 1% general partner and 98% limited partner, and the beneficiary or someone else might contribute 1% as a limited partner. Distributing a limited partnership interest to a beneficiary can carry out income and perhaps capital gain while at the same time not giving the beneficiary cash to spend (but be sure to distribute enough cash so that the beneficiary can pay tax on the distribution). Be careful to avoid the gain on formation that applies when a contributing partner diversifies the partner's holdings by forming the partnership. If the trust holds not only marketable securities but also investments in businesses, consider setting up one partnership for the business investments and another partnership for the marketable securities, which would help facilitate allocating trust assets on termination or any other trust division. Also consider whether a state with jurisdiction over the trust might subject the partnership itself to state income tax.

Complexity might arise if a partnership distributes less than all of its taxable income to a mandatory income trust. It is unclear whether all of the trust's distributive share of capital gain is DNI. Furthermore, interrelated calculations might be required for a mandatory income trust. Generally, we should look to see whether planning under part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law or II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is sufficient before recommending a partnership solely to address the issues described in part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.

I.A.1.aa. Consequences of Allocating Capital Gain to DNI

I.A.1.aa.i. General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income (and General Retention of the Character of DNI Distributed to Beneficiaries)

This part II.J.8.f.i first discusses netting deductions against income then discusses allocating that income.

I.A.1.aa.i.(a). Allocating Deductions to Various Income Items

Rules for allocating deductions include:

- All deductible items directly attributable to one class of income are allocated to that class. To the extent that any items of deduction which are directly attributable to a class of income exceed that class of income, they may be allocated to any other class of income (including capital gains) included in distributable net income as described above except that any excess deductions attributable to tax-exempt income may not be offset against any other class of income.

- Deductions not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing DNI, but Code § 265 requires a portion of such indirect expenses to be allocated to non-taxable income. Such indirect expenses include trustee fees, the rental of safe deposit boxes, and state income and personal property taxes. Once one has allocated expenses to tax-exempt income, how does one choose to which items of taxable income to allocate deductions? One would consider allocating to those income items that are most highly taxed, considering federal and state income tax and the 3.8% tax on net investment income. For example, interest income is taxed at the highest rates, whereas qualified dividends are taxed at long-term capital gain rates. Within interest income, consider whether the interest is from U.S. obligations exempt from state income tax. Although distributions from qualified retirement plans and IRAs are taxed at the highest regular tax rate, they are exempt from the 3.8% tax on net investment income. See part II.I.6 Deductions Against NII (especially the text accompanying fns. 2307-2308).

- If a charitable deduction under Code § 642(c) is involved, any allocations of taxable income between the charitable deduction and the beneficiaries must have substantial economic effect.

- Special rules apply to depreciation deductions.

I.A.1.aa.i.(b). Allocating Income Items Among Those Receiving It

In allocating income between the trust and the beneficiary (or beneficiaries), the amounts of DNI distributed to the beneficiaries:

> shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the estate or trust as the total of each class bears to the total distributable net income of the estate or trust in the absence of

the allocation of different classes of income under the specific terms of the governing instrument.

However, this proportionate rule is subject to specific provisions in the governing instrument for the allocation of different classes of income or different allocations under local law, subject to tax-exempt income being allocated in a manner that does not allow it to be deducted.

Thus, except for tax-exempt income and allocations between the charitable and noncharitable shares (and any special rules regarding depreciation deductions), it appears that a trust agreement may create ordering provisions between which items of DNI the trust retains and which items of DNI the trust distributes to beneficiaries. However, such a provision might encounter significant resistance from the IRS.

Once one decides which items of DNI the trust distributes to beneficiaries, generally distributions to each beneficiary carry out a pro rata portion of ordinary income and capital gain items allocated to the beneficiaries, and any other characteristic of the income at the trust level retains its status in the beneficiary's hands (which, among other things, is important for net investment income tax purposes). Code § 652(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary.

Code § 662(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642(c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary. In the application of this subsection to the amount determined under paragraph (1) of subsection (a), distributable net income shall be computed without regard to any portion of the deduction under section 642(c) which is not attributable to income of the taxable year.

Reg. § 1.662(b)-1 provides:

> In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§ 1.662(a)-1 through 1.662(a)-4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For this purpose, the principles contained in § 1.652(b)-1 shall apply.

Reg. § 1.652(b)-1 provides:

> In determining the gross income of a beneficiary, the amounts includible under § 1.652(a)-1 have the same character in the hands of the beneficiary as in the hands of the trust. For example, to the extent that the amounts specified in § 1.652(a)-1 consist of income exempt from tax under section 103, such amounts are not included in the beneficiary's gross income. Similarly, dividends distributed to a beneficiary retain their original character in the beneficiary's hands for purposes of determining the availability to the beneficiary of the dividends received credit under section 34 (for dividends received on or before December 31, 1964) and the dividend exclusion under section 116…. Similarly, to the extent such amounts consist of an amount received as a part of a lump sum distribution from a qualified plan and to which the provisions of section 72(n) would apply in the hands of the trust, such amount shall be treated as subject to such section in the hands of the beneficiary except where such amount is deemed under section 666(a) to have been distributed in a preceding taxable year of the trust and the partial tax described in section 668(a)(2) is determined under section 668(b)(1)(B). The tax treatment of amounts determined under § 1.652(a)-1 depends upon the beneficiary's status with respect to them not upon the status of the trust. Thus, if a beneficiary is deemed to have received foreign income of a foreign trust, the includibility of such income in his gross income depends upon his taxable status with respect to that income.

This proportionate requirement applies "unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation."

When allocating income among beneficiaries:

> The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation.

III.B.2.f. Triggering the Statute of Limitations for Grantor Trusts

The tax return for the deemed owner is what determines the statute of limitations for any grantor trust items.[6588] However, that does not expressly address the issue about whether the trustee should have filed a tax return and whether the trust should have been taxable on those items.

I.A.1.aa.ii. How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary

If the amount of DNI is less than the amount distributed to the beneficiary, the issues described in this part II.J.8.f.ii How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary become important.

Some income might be inadvertently trapped in the trust if the allocation rules of part II.J.8.f.i General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income apply without being modified by any special ordering rule in the trust agreement and if all of a pass-through entity's capital gain constitutes DNI under an approach described in part II.J.8.a.ii Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus That's because looking exclusively at those two factors bypasses the analysis of part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal.

For example, trust has $10,000 of interest income. Trust's distributive share of partnership's income is $20,000 of dividend income and $70,000 of long-term capital gains. If the rules described in the preceding paragraph apply, then 10% of all distributions constitute interest income, 20% constitute dividend income, and 70% constitute long-term capital gains. Trust distributes $50,000 to the beneficiary. Therefore, each of the beneficiary and the trust has $5,000 of interest income, $10,000 of dividend income, and $35,000 of long-term capital gains.

Contrast that to an approach under which the trustee is able to control how much capital gain is included in DNI, under part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal. On a year-by-year basis, the trustee can selectively include capital gain in DNI to the extent that one or both of part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary or part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is available. By including in DNI just enough capital gain to cause the DNI to match the cash distributed to the beneficiary, the trustee can ensure that all of the ordinary income is distributed to the beneficiary.

I.A.1.bb. Effectuating Allocation of Capital Gain to DNI

Form 1041 (Schedule D), Part III, column (1) allocates the beneficiaries' shares. Once one separates that, the rest should flow naturally.

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[6588] *Lardas v. Commissioner*, 99 T.C. 490 (1992) (reviewed decision, with only one judge dissenting). For a quote from *Lardas*, see fn. 1705, found in part II.G.19 IRS Audits.

When the trust turns into a nongrantor trust, the trust's return is the proper one to audit, even if it distributes income to the beneficiary.[6589]

Regarding amended returns generally, *Broadhead v. Commissioner*, TC Memo 1955-328, reasoned and held:

> Faced with proof that petitioner was not aware of the accounting error giving rise to the understatement of lumber sales until after the return was filed, respondent now says that petitioner "willfully and deliberately attempted to evade and defeat his income taxes when he refused to file the amended return after being advised to do so by his accountant."
>
> The respondent had the burden of proof under the issue. He established no more than the cause of the understatement; lack of knowledge by petitioner of the bookkeeping error until after the return was filed; the preparation of an amended return by the accountant of petitioner, and that petitioner never filed the amended return, even though advised to do so by his accountant. Petitioner was not required by statute to file an amended return, and if one had been tendered for filing, respondent could have declined to accept it. *Ira Goldring*, 20 T.C. 79, 83. If the return was false and fraudulent with intent to evade tax, as respondent alleged in his answer raising the issue, the filing of an amended return would not have cured the fraud. *George M. Still, Inc.*, 19 T.C. 1072, *affd.* 218 F.2d 639.

Badaracco v. Commissioner, 464 U.S. 386 (1984), discussed fraudulent returns, but its comments on amended returns may be more important:

> Petitioners Badaracco concede that they filed initial returns that were "false or fraudulent with the intent to evade tax." Petitioner Deleet, for present purposes, upon this review of its motion for summary judgment, is deemed to have filed false or fraudulent returns with the intent to evade tax. Section 6501(c)(1), with its unqualified language, then allows the tax to be assessed "at any time." Nothing is present in the statute that can be construed to suspend its operation in the light of a fraudulent filer's subsequent repentant conduct.[7] Neither is there anything in the wording of § 6501(a) that itself enables a taxpayer to reinstate the section's general three-year limitations period by filing an amended return. Indeed, as this Court recently has noted, *Hillsboro National Bank v. Commissioner*, __ U.S. __, __, n. 10 (1983) (slip op. 8), the Internal Revenue Code does not explicitly provide either for a taxpayer's filing, or for the Commissioner's acceptance, of an amended return; instead, an amended return is a creature of administrative origin and grace. Thus, when Congress provided for assessment at any time in the case of a false or fraudulent "return," it plainly included by this language a false or fraudulent original return. In this connection, we note that until the decision of the Tenth Circuit in *Dowell v. Commissioner*, 614 F.2d 1263 (1980), cert. pending, No. 82-1873, courts consistently had held that the operation of § 6501 and its predecessors turned on the nature of the taxpayer's original, and not his amended return.[8]
>
> > [7] Under every general income tax statute since 1918, the filing of a false or fraudulent return has indefinitely extended the period of limitations for assessment of tax. See Revenue Act of 1918, §250(d), 40 Stat. 1083; Revenue Act of 1921, §250(d), 42 Stat. 265; Revenue Act of 1924, §278(a), 43 Stat. 299; Revenue Act of 1926, §278(a), 44

[6589] *Fendell v. Commissioner*, 906 F.2d 362 (8th Cir. 1990), *rev'g* 92 T.C. 708 (1989).

Stat., pt. 2, p. 59; Revenue Act of 1928, §276(a), 4 Stat 857; Revenue Act of 1932, §276(a), 47 Stat. 238; Revenue Act of 1934, §276(a), 48 Stat. 745; Revenue Act of 1936, §276(a), 49 Stat. 1726; Revenue Act of 1938, §276(a), 52 Stat. 540 Internal Revenue Code of 1939, §276(a).

[8] The significance of the original, and not the amended, return has been stressed in other, but related, contexts. It thus has been held consistently that the filing of an amended return in a nonfraudulent situation does not serve to extend the period within which the Commissioner may assess a deficiency. See *e.g. Zeilerbach Paper Co. v. Helvering*, 293 U.S. 172 (1934); *National Paper Products Co. v. Helvering*, 293 U.S. 183 (1934); *National Refining Co. v. Commissioner*, 1 B.T.A. 236 (1924). It also has been held that the filing of an amended return does not serve to reduce the period within which the Commissioner may assess taxes where the original return omitted enough income to trigger the operation of the extended limitations period provided by § 6501(e) or its predecessors. See. *e.g., Houston v. Commissioner*, 38 T.C. 486 (1962); *Goldring v. Commissioner*, 20 T.C. 79 (1953). And the period of limitations for filing a refund claim under the predecessor of § 6511(a) begins to run on the filing of the original, not the amended, return. *Kaltreider Construction, Inc. v. United States*, 303 F.2d 366, 368 (CA3), *cert. denied*, 371 U.S. 877 (1962).

III.B.2.g. Income Tax Concerns When Removing Property from the Estate Tax System

Note that gifts of properties subject to liabilities in excess of basis (sometimes referred to as "negative basis" assets,[6590] which is a technically incorrect description that gets the point across) will trigger gain recognition. Even if one uses an irrevocable grantor trust as the donee, one must consider any income tax consequences when grantor trust status terminates,

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[6590] There is no such thing as a negative basis. Negative basis asset is just a shorthand description for a certain situation:

1. The basis of the partnership interest is zero, before considering liabilities.
2. The partner's basis in liabilities allocated to the partner is less than the face amount of those liabilities.

Under Code § 752, the allocation of liabilities is considered a contribution that creates basis and a reduction in liabilities is considered a distribution that, under Code § 731, reduces basis or creates gain. A so-called negative basis asset occurs when a partner has used not only the basis in item 1 but also has taken losses against his item 2 share of liabilities. The partner's basis in liabilities is zero or a positive number; it's just that the deemed distribution when liabilities are relieved exceeds the partner's basis in the liabilities that are relieved.

For example, ignoring all other partners: a partner contributes $100 to a partnership that borrows $50 and buys equipment for $150. The partnership writes off the full value of the equipment through depreciation deductions over time. The partner's capital account is negative $50 ($100 contribution minus $150 depreciation deductions). The partner's basis is zero: $100 actual contribution, plus $50 liabilities that constitute a deemed contribution, minus $150 in losses. If the partner were suddenly relieved of the $100 of liabilities, he would have no basis to absorb the $50 deemed distribution and would have to recognize income. The transfer of the partnership interest would cause that deemed distribution to occur. Having gain without receiving any cash is phantom income by reason of disposing of a negative basis asset, that really has a zero basis; this result is fair, because the partner already deducted $50 more than the cash he contributed ($150 deductions minus $100 cash contribution).

For the basis of the property that the trust is deemed to have received, see part III.B.2.a Tax Basis Issues, including fn. 6469.

For reporting of "negative basis," see text accompanying and preceding fn 502 in part II.C.7 Maintaining Capital Accounts.

including the controversy as to whether the grantor's death is a deemed bargain sale. If a grantor trust terminates during life in a manner that results in the grantor being relieved of liabilities, gain is recognized under Rev. Rul. 77-402 (reduction in allocation of liabilities with respect to a partnership interest); Reg. § 1.1001-2(c), Example (5);[6591] *Madorin v. Commissioner*, 84 T.C. 667 (1985); see also fn. 6482 for installment sale issues. Regarding dispositions of partnership interests to which liabilities had been allocated, see Rev. Rul. 74-40, quoted in full in fn. 5365, found in part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions, and Rev. Rul. 75-194 (deemed bargain sale of partnership interest contributed to charity), discussed in part II.Q.6.b Possible Deemed Sale or Reduced Deduction When Contributing Partnership Interest to Charity. For the consequences on the nature of interest expense after such a transaction, see *Lipnick v. Commissioner*, 153 T.C. No. 1 (2019), discussed in the text accompanying fns 457-459 in part II.C.3.d Deducting Interest Expense on Debt Incurred by a Partnership.

For grantor trust status generally and the effect of turning on grantor trust status, see part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment, especially part III.B.2.d.i Federal Income Tax and Irrevocable Grantor Trust Treatment, especially fn. 6533. See also part III.B.1.c.i Gifts with Consideration – Bargain Sales.

Blattmachr, Gans & Jacobson, Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death, 96 *J. of Taxation* 149 (Sept. 2002), asserts that gain is not recognized at death. CCA 200923024 appears to have accepted their arguments; relying on Rev. Rul. 85-13, the IRS lawyer said that turning on grantor trust status was not a taxable event. An excerpt from CCA 200923024 is in fn. 6533 in part III.B.2.d.i.(a) General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation, but here is another excerpt:[6592]

> The authorities cited only discuss the application of § 1001 to the party who is considered to have transferred ownership (the "transferor") of trust assets. Regulation 1.1001-2(c), Example 5, *Madorin*, and Rev. Rul. 77-402 are silent regarding the income tax

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[6591] Example (5) provides:

> In 1975 C, an individual, creates T, an irrevocable trust. Due to certain powers expressly retained by C, T is a "grantor trust" for purposes of subpart E of part 1 of subchapter J of the Code and therefore C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as owner of T, deducts the distributive share of partnership losses attributable to the partnership interest held by T. In 1978, when the adjusted basis of the partnership interest held by T is $1,200, C renounces the powers previously and expressly retained that initially resulted in T being classified as a grantor trust. Consequently, T ceases to be a grantor trust and C is no longer considered to be the owner of the trust. At the time of the renunciation all of P's liabilities are liabilities on which none of the partners have assumed any personal liability and the proportionate share of which of the interest held by T is $11,000. Since prior to the renunciation C was the owner of the entire trust, C was considered the owner of all the trust property for Federal income tax purposes, including the partnership interest. Since C was considered to be the owner of the partnership interest, C not T, was considered to be the partner in P during the time T was a "grantor trust". However, at the time C renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust with the result that C was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor C. On the transfer, C's share of partnership liabilities ($11,000) is treated as money received. Accordingly, C's amount realized is $11,000 and C's gain realized is $9,800 ($11,000 − $1,200).

[6592] Reg. § 1.1001-2(c), Example (5) is reproduced in fn 6591 in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System.

> consequences to the party who receives trust assets (the "transferee"), which in these examples was the nongrantor trust. We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event.

Estate of Steve K. Backemeyer v. Commissioner, 147 T.C. 526 (2016), informs the discussion a little. The Official Tax Court Syllabus describes the case:

> Ps were husband and wife. H was a sole proprietor farmer. H purchased certain farm inputs in 2010 intending to use them to cultivate crops the following year. H, a cash-method taxpayer, deducted his expenditures on the inputs under I.R.C. sec. 162 for that same tax year. H died in March 2011 not having used any of the purchased farm inputs. They were subsequently transferred to W, who began her own farming business as sole proprietor upon H's death. W used all the farm inputs in 2011 to grow crops that were then sold in 2011 and 2012. W deducted for tax year 2011 an amount equal to the value of the farm inputs inherited from H.
>
> *Held*: The tax benefit rule does not require the recapture upon H's death in 2011 of deductions he claimed for 2010 for his expenditures on the farm inputs.
>
> *Held*, further, the I.R.C. sec. 6662 accuracy-related penalty for a substantial understatement of income tax does not apply, since Ps' deductions of the inputs under I.R.C. sec. 162 were appropriate, and the sole denied deduction conceded by Ps was not large enough to merit imposition of the penalty.

In evaluating the tax benefit rule (see part II.G.4.m.iii Tax Benefit Rule), the court considered the four-part test applying the tax benefit rule developed in *Frederick v. Commissioner*, 101 T.C. 35, 41 (1993). Applying that test, the court stated (highlighting added):

> Having established the inapplicability of the third *Frederick* criterion in this case, we now turn to the fourth criterion, which mandates that a nonrecognition provision of the Code not prevent the inclusion of the tax benefit in gross income. This requirement is not met here, since nonrecognition on death is among the strongest principles inherent in the income tax. See, *e.g.*, *Willging v. United States*, 474 F.2d 12, 13 (9th Cir. 1973) (stating that a cash basis farmer owning appreciated assets is not taxable on the unrealized appreciation, nor is his spouse, because of the section 1014 basis step-up). When an individual dies, his assets are not taxed under the income tax but rather under the estate tax. Upon the assets' distribution to the decedent's heirs, section 102(a) explicitly provides that the heirs' "[g]ross income does not include the value of property acquired by gift, bequest, devise, or inheritance."[4] And, as discussed above, section 1014 operates to provide a step-up in basis of the inherited property in the hands of the decedent's heirs; if an heir subsequently disposes of the property, gain is realized only to the extent the proceeds exceed the stepped-up basis. Sec. 1001(a).

> [4] Secs. 102(b) and 691, which govern the includability of income from a decedent's property and income in respect of decedents, do not apply in this case, since the farm inputs are property and not income from property.[6593]
>
> In approaching the fourth Frederick criterion, we also accept the Supreme Court's observation on the effect of sections 1245(b)(2) and 1250(d)(2), which exempt transfers at death from the application of the general depreciation rules, and from which the transfer in *Bliss Dairy*, 460 U.S. at 386 n.20, was not exempted. Section 1245(a) provides that in the case of a disposition of certain depreciable property, the lesser of the allowed depreciation deductions or realized gain should be taxed as ordinary income. Section 1250(a) establishes depreciation recapture rules for depreciable real property otherwise excluded from the operation of section 1245. Sections 1245 and 1250, along with section 111, codify the tax benefit rule as applied in certain situations. See, *e.g.*, *Estate of Munter v. Commissioner*, 63 T.C. 663, 671 (1975) ("While the rule is judicial in origin, it is applied to specific situations by certain Code provisions. See, for example, secs. 111, 1245, and 1250. Where not codified, the judicial rule continues.").
>
> It is telling that the depreciation recapture rules, which, we are reminded, are "a partial codification of the tax benefit rule," *Bliss Dairy*, 460 U.S. at 386 n.20, do not extend to transfers at death. The regulations bespeak this by omitting from the list of nonrecognition Code sections overridden by the depreciation recapture provisions of sections 1245 and 1250 those sections governing the treatment of a decedent's property. See secs. 1.1245-6(b), 1.1250-1(c)(2), Income Tax Regs. In *Bliss Dairy*, 460 U.S. at 398, the Supreme Court observed that depreciation recapture under sections 1245 and 1250 was an important exception to the nonrecognition statute at issue there. This is not the case with transfers at death, to which the depreciation recapture rules do not apply. Since sections 1245 and 1250 codify the tax benefit rule as it relates to depreciated property and expressly exclude transfers at death from the rule's scope, see *id.* at 386 n.20 ("[Sections] 1245(b)(1), (2), and 1250(d)(1), (2)
>
>> … are a partial codification of the tax benefit rule … [and] exempt dispositions by gift and transfers at death from the operation of the general depreciation recapture rules."), it follows that the uncodified remainder of the common law tax benefit rule, with which we are concerned in this case, operates in a similar fashion, *cf. Segel v. Commissioner*, 89 T.C. 816, 841 (1987) ("Even though the [tax benefit] rule originated in the Courts, it has the implicit approval of Congress[.]").

The language highlighted at the beginning of the above long quote seems to indicate that a Code § 1014 basis step-up may preclude recognition at death. However, Rev. Rul. 2023-2 provides that grantor trust status alone does not generate a Code § 1014 basis step-up,[6594] so the issue of possible recognition at death is not yet totally settled. Furthermore, the highlighted quote overstates its own strength, citing dictum from *Willging*, which is not quite so supportive; *Willging* is reproduced in part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[6593] [my footnote:] For Code § 691 income in respect of a decedent issues in a similar situation, see text accompanying fns 4434-4437in part II.Q.4.e.i Life Insurance Basis Adjustment on the Death of an Owner Who Is Not the Insured.

[6594] Rev. Rul. 2023-2 is quoted extensively in part III.B.2.a Tax Basis Issues When Using Irrevocable Grantor Trusts.

Because no case has addressed this issue squarely, notwithstanding emphatic comments made by one of the co-authors of the cited article, the reader might consider advising clients that this tax treatment is a risk. I believe that this risk might also be a benefit – if gain is recognized, then the trust has a higher basis; since the trust is typically a GST-exempt entity and the income tax on the sale will likely be paid with assets that are not GST-exempt (as well as the income tax perhaps being a debt of the estate that reduces the amount subject to estate tax), paying the tax might be beneficial in the long run. Furthermore, if and to the extent that one is able to secure capital gain treatment on the sale and then depreciate the stepped-up basis, one might find this tax risk to be quite beneficial. See part II.H Income Tax vs. Estate and Gift Tax (Particularly for Depreciable Property). Some take the position that, even without this sale treatment, the assets receive a basis adjustment when the grantor dies, because the assets were deemed owned by the grantor immediately before death; CCA 200937028 (which should have little weight because it was a rather cursory discussion of the issue and was not approved using IRS National Office procedures) disputes that position.

To avoid a deemed gift on death, consider a sale to a spousal grantor trust.[6595] One might consider the grantor retaining an interest in the partnership and assuming liabilities in a side agreement,[6596] so that the grantor's estate and not the irrevocable grantor trust is allocated the liabilities in excess of basis, which would then be cleansed.[6597] This shifting should have no income tax consequences during life, since the client and the irrevocable grantor trust are deemed to be the same person. This shifting might or might be available, depending on the nature of the loan and the partners' respective legal liabilities, in which case other shifting opportunities might be available at the partnership level; one should coordinate carefully with the partnership's income tax return preparer.

Rev. Rul. 72-406 provides that the basis for the property deemed sold is based on the grantor's original basis.

For why one might not want to move low basis assets outside of the estate tax system and how to cleanse a "negative basis" situation, see part II.H Income Tax vs. Estate and Gift Tax (Particularly for Depreciable Property), especially part II.H.5 Irrevocable Trust Planning and Basis Issues.

If one does recognize gain on the termination of a grantor trust,[6598] generally the gain would be the extent that the amount realized by the grantor exceeds the grantor's adjusted basis in the property as described in part III.B.1.c.i Gifts with Consideration – Bargain Sales:

- Beware of any nonrecourse debt, because the basis against which the nonrecourse debt is allocated would be limited to the property securing the nonrecourse debt. One might consider placing that that property in a partnership that has more assets against which the debt can be allocated.[6599]

[6595] See part III.B.2.i.xv Sale to Trust Created by Spouse: An Alternative Way to Have a Trust Benefitting Client.

[6596] For opportunities and limitations on this idea, see part II.C.3 Allocating Liabilities (Including Debt). Code § 752 analysis can interact with the Code § 465 at-risk rules; see part II.G.4.j At Risk Rules, especially CCA 201606027, including key excerpts in fns. 1282-1285.

[6597] See part II.H.2 Basis Step-Up Issues.

[6598] See fn. 6591.

[6599] ACTEC Fellow George P. Mair noticed this issue and planning opportunity. See fn. 6596 regarding the grantor expressly assuming the liability when contributing the property to the partnership.

- However, no loss is sustained on such a transfer if the amount realized is less than the adjusted basis.[6600] For the basis of the property that the trust is deemed to have received, see part III.B.2.a Tax Basis Issues, including fn. 6469.

For example, suppose one sold property with a fair market value of $1 million to an irrevocable grantor trust in exchange for a $1 million note, and the grantor trust powers are turned off when the note has a $500,000 face amount:

- Assuming the note had interest of at least the AFR, the note's remaining principal of $500,000 is the sale price when the grantor trust power is turned off. The $500,000 needs to be compared to the basis of the trust's assets.

- If the trust's assets have an aggregate basis of at least $500,000, then the basis does not change,[6601] and there is no gain or loss on sale under the bargain sale rules.

- If and to the extent that $500,000 exceeds the aggregate basis of the trust's assets, that excess is gain, to be recognized under the installment method unless the grantor reports the whole gain. As a result of the gain, the trust's assets have a new basis of $500,000.[6602]

The Code § 453 installment sale rules apply to any gain recognized.[6603]

The above discussion focuses on domestic trusts. Reg. § 1.684-2(e), "Deemed transfers when foreign trust no longer treated as owned by a U.S. person," provides:

(1) *In general*. If any portion of a foreign trust is treated as owned by a U.S. person under subpart E of part I of subchapter J, chapter 1 of the Internal Revenue Code, and such portion ceases to be treated as owned by that person under such subpart (other than by reason of an actual transfer of property from the trust to which § 1.684-2(d) applies), the U.S. person shall be treated as having transferred, immediately before (but on the same date that) the trust is no longer treated as owned by that U.S. person, the assets of such portion to a foreign trust.

(2) *Examples*. The following examples illustrate the rules of this paragraph (e). In all examples, A is a U.S. citizen and FT is a foreign trust. The examples are as follows:

Example (1). *Loss of U.S. beneficiary*.

(i) On January 1, 2001, A transfers property, which has a fair market value of 1000X and an adjusted basis of 400X, to FT. At the time of the transfer, FT has a U.S. beneficiary within the meaning of § 1.679-2, and A is treated as owning FT under section 679. Under § 1.684-3(a), § 1.684-1 does not cause A to recognize gain at the time of the transfer.

(ii) On July 1, 2003, FT ceases to have a U.S. beneficiary as defined in § 1.679-2(c) and as of that date neither A nor any other person is treated as owning any portion of FT. Pursuant to § 1.679-2(c)(2), if FT ceases to be treated as having a U.S. beneficiary,

[6600] Reg. §§ 1.1001-1(e)(1), 1.1011-2.
[6601] See Reg. § 1.1015-4(b), Example (1).
[6602] See Reg. § 1.1015-4(b), Example (2).
[6603] Reg. § 1.1001-1(d); Code § 453(a). See part II.G.15 Limitations on the Use of Installment Sales.

A will cease to be treated as owner of FT beginning on the first day of the first taxable year following the last taxable year in which there was a U.S. beneficiary. Thus, on January 1, 2004, A ceases to be treated as owner of FT. On that date, the fair market value of the property is 1200X and the adjusted basis is 350X. Under paragraph (e)(1) of this section, A is treated as having transferred the property to FT on January 1, 2004, and must recognize 850X of gain at that time under § 1.684-1.

Example (2). *Death of grantor*.

(i) The initial facts are the same as in paragraph (i) of Example 1.

(ii) On July 1, 2003, A dies, and as of that date no other person is treated as the owner of FT. On that date, the fair market value of the property is 1200X, and its adjusted basis equals 350X. Under paragraph (e)(1) of this section, A is treated as having transferred the property to FT immediately before his death, and generally is required to recognize 850X of gain at that time under § 1.684-1. However, an exception may apply under § 1.684-3(c).

Example (3). *Release of a power*.

(i) On January 1, 2001, A transfers property that has a fair market value of 500X and an adjusted basis of 200X to FT. At the time of the transfer, FT does not have a U.S. beneficiary within the meaning of § 1.679-2. However, A retains the power to revoke the trust. A is treated as the owner of the trust under section 676 and, therefore, under § 1.684-3(a), A is not required to recognize gain under § 1.684-1 at the time of the transfer.

(ii) On January 1, 2007, A releases the power to revoke the trust and, as of that date, neither A nor any other person is treated as owning any portion of FT. On that date, the fair market value of the property is 900X, and its adjusted basis is 200X. Under paragraph (e)(1) of this section, A is treated as having transferred the property to FT on January 1, 2007, and must recognize 700X of gain at that time.

III.B.2.h. How to Make a Trust a Grantor Trust Taxed to a U.S. Citizen or Resident

For policy concerns, see ACTEC submits a Report on Grantor Trusts (June 24, 2021).

Generally, the rules in this part III.B.2.h apply “only to the extent such application results in an amount (if any) being currently taken into account (directly or through 1 or more entities) under this chapter in computing the income of a citizen or resident of the United States or a domestic corporation.”[6604] The most common application is a revocable trust – a mere probate avoidance tool – which Code § 676 treats as owned by the grantor with the power to revoke. However, this part III.B.2 focuses on irrevocable trusts.

To protect one’s clients from depleting their estates to the point of jeopardizing their standard of living, the ideal power is one that the grantor can turn off completely. Powers may treat the grantor as deemed owner of only a portion of the trust; for details, see part III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation.

[6604] Code § 672(f)(1).

Rev. Proc. 2020-3, § 3.01(92), "Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners," provides that the IRS will not rule on:[6605]

> Whether the grantor will be considered the owner of any portion of a trust when (i) substantially all of the trust corpus consists or will consist of insurance policies on the life of the grantor or the grantor's spouse, (ii) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (iii) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, and (iv) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under §§ 673 to 677.

When considering the powers described in various portions of this part III.B.2.h, consider Reg. § 1.675-1(c):

> *Authority of trustee*. The mere fact that a power exercisable by a trustee is described in broad language does not indicate that the trustee is authorized to purchase, exchange, or otherwise deal with or dispose of the trust property or income for less than an adequate and full consideration in money or money's worth, or is authorized to lend the trust property or income to the grantor without adequate interest. On the other hand, such authority may be indicated by the actual administration of the trust.

If a power is not exercisable currently but is subject to other actions that must occur first, can one disregard that power until those conditions are satisfied? Code § 672(d), "Rule where power is subject to condition precedent," provides:

> A person shall be considered to have a power described in this subpart even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power.

Reg. § 1.672(d)-1, "Power subject to condition precedent," elaborates, but keep in mind that it was promulgated in 1956 and does not reflect changes since then:

> Section 672(d) provides that a person is considered to have a power described in subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, even though the exercise of the power is subject to a precedent giving of notice or takes effect only after the expiration of a certain period of time. However, although a person may be considered to have such a power, the grantor will nevertheless not be treated as an owner by reason of the power if its exercise can only affect beneficial enjoyment of income received after the expiration of a period of time such that, if the power were a reversionary interest, he would not be treated as an owner under section 673. See sections 674(b)(2), 676(b), and the last sentence of section 677(a). Thus, for example, if a grantor creates a trust for the benefit of his son and retains a power to revoke which takes effect only after the expiration of 2 years from the date of exercise, he is treated as an owner from the inception of the trust. However, if the grantor retains a power to revoke, exercisable at any time, which can only affect the beneficial enjoyment of the

[6605] Rev. Proc. 2020-3, § 3.01(93), relating to distribution committees used in creating an incomplete gift nongrantor trust ("ING"), is reproduced in fn 2517 in part II.J.3.e.i Strategic State & Local Tax Issues re: Residence.

> ordinary income of a trust received after the expiration of 10 years commencing with the date of the transfer in trust, or after the death of the income beneficiary, the power does not cause him to be treated as an owner with respect to ordinary income during the first 10 years of the trust or during the income beneficiary's life, as the case may be. See section 676(b).

The regulations focus on the passage of time and only briefly refer to a "precedent giving of notice." Does this phrase refer to a ministerial notice or a substantive action? Let's look at the legislative history to Code § 672(d). HR Rep. 1337, 83d Cong., 2d Sess. A213 (1954) explains:

> Subsection (d) contains the rule that a person shall be considered to have a power even though the exercise is subject to the precedent giving of notice or takes effect only on the expiration of a certain period of time after the exercise of the power. This provision, which is designed to prevent avoidance through the use of contingent powers, corresponds to the similar provision in section 39.22(a)-21(d) of the regulations. The fact that a power is held in the capacity of trustee is not material except where expressly or impliedly stated, as in sections 674(d) and 675(4).

In a similar vein, S. Rep. 1662, 83d Cong., 2d Sess. 366 (1954) provides:

> Subsection (d) contains the rule that a person shall be considered to have a power even though the exercise is subject to the precedent giving of notice or takes effect only on the expiration of a certain period of time after the exercise of the power. This provision, which is designed to prevent avoidance through the use of contingent powers, corresponds to the similar provision in section 39.22(a)-21(d) of the regulations. The fact that a power is held in the capacity of trustee is not material except where expressly or impliedly stated, as in sections 674(d) and 675(4).

III.B.2.h.i. Who Is the Grantor

A grantor includes any person to the extent such person directly or indirectly[6606] makes a gratuitous transfer of property to a trust; although a person may be the nominal grantor of a trust, that person cannot be the deemed owner unless that person actually makes a gratuitous

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[6606] Reg. § 1.671-2(e)(6), Example (3), provides:

> A, an attorney, creates a foreign trust, FT, on behalf of A's client, B, and transfers $100 to FT out of A's funds. A is reimbursed by B for the $100 transferred to FT. The trust instrument states that the trustee has discretion to distribute the income or corpus of FT to B and B's children. Both A and B are treated as grantors of FT under paragraph (e)(1) of this section. In addition, B is treated as the owner of the entire trust under section 677. Because A is reimbursed for the $100 transferred to FT on behalf of B, A is not treated as transferring any property to FT. Therefore, A is not an owner of any portion of FT under sections 671 through 677 regardless of whether A retained any power over or interest in FT described in sections 673 through 677. Furthermore, A is not treated as an owner of any portion of FT under section 679. Both A and B are responsible parties for purposes of the requirements in section 6048.

transfer to the trust.[6607] If more than one person makes a gratuitous transfer, each is a grantor.[6608]

A gratuitous transfer is any transfer other than a transfer for fair market value, without regard to whether the transfer is treated as a gift for gift tax purposes.[6609] For that purpose, a transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust;[6610] thus, buying property from a

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[6607] Reg. § 1.671-2(e)(1) provides:

> For purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(2) of this section) of property to a trust. For purposes of this section, the term property includes cash. If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust. (See section 6048 for reporting requirements that apply to grantors of foreign trusts.) However, a person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust under sections 671 through 677 or 679. Also, a person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and who makes no other transfers to the trust that constitute gratuitous transfers is not treated as an owner of any portion of the trust under sections 671 through 677 or 679. See also § 1.672(f)-5(a).

[6608] Reg. § 1.671-2(e)(1); Reg. § 1.671-2(e)(6), Example (1).

[6609] Reg. § 1.671-2(e)(2)(i).

[6610] Reg. § 1.671-2(e)(2)(ii), which further provides:

> For example, rents, royalties, interest, and compensation paid to a trust are transfers for fair market value only to the extent that the payments reflect an arm's length price for the use of the property of, or for the services rendered by, the trust. For purposes of this determination, an interest in the trust is not property received from the trust. In addition, a person will not be treated as making a transfer for fair market value merely because the transferor recognizes gain on the transaction. See, for example, section 684 regarding the recognition of gain on certain transfers to foreign trusts.

As to the payment of interest on a loan, Reg. § 1.671-2(e)(6), Example (6) provides:

> A borrows cash from T, a trust. A has not made any gratuitous transfers to T. Arm's length interest payments by A to T will not be treated as gratuitous transfers under paragraph (e)(2)(ii) of this section. Therefore, under paragraph (e)(1) of this section, A is not a grantor of T with respect to the interest payments.

Reg. § 1.671-2(e)(2)(iii) provides:

> For purposes of this paragraph (e), a gratuitous transfer does not include a distribution to a trust with respect to an interest held by such trust in either a trust described in paragraph (e)(3) of this section or an entity other than a trust. For example, a distribution to a trust by a corporation with respect to its stock described in section 301 is not a gratuitous transfer.

Regarding the latter, see parts II.D.2 Business Entity as Grantor of Tru and II.Q.7.a.iv Dividends; Avoiding Dividend Treatment Using Redemptions under Code §§ 302 and 303 (discussing Code § 301).

Reg. § 1.671-2(e)(3) provides:

> A grantor includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in certain investment trusts described in § 301.7701-4(c) of this chapter, liquidating trusts described in § 301.7701-4(d) of this chapter, or environmental remediation trusts described in § 301.7701-4(e) of this chapter.

See part II.D.4 Disregarding Multiple Owner Trust for Income Tax Purposes, which discusses each of these trusts.

trust for more than its value is a gratuitous transfer to the trust.[6611] Receiving an interest in the trust is not considered receiving fair market value under this test.[6612]

Reg. § 1.671-2(e)(6), Example (1), provides:

> A creates and funds a trust, T, for the benefit of her children. B subsequently makes a gratuitous transfer to T. Under paragraph (e)(1) of this section, both A and B are grantors of T.

Reg. § 1.671-2(e)(6), Example (7), illustrates how to treat a trust that has more than one grantor:[6613]

> A, B's brother, creates a trust, T, for B's benefit and transfers $50,000 to T. The trustee invests the $50,000 in stock of Company X. C, B's uncle, purportedly sells property with a fair market value of $1,000,000 to T in exchange for the stock when it has appreciated to a fair market value of $100,000. Under paragraph (e)(2)(ii) of this section, the $900,000 excess value is a gratuitous transfer by C. Therefore, under paragraph (e)(1) of this section, A is a grantor with respect to the portion of the trust valued at $100,000, and C is a grantor of T with respect to the portion of the trust valued at $900,000. In addition, A or C or both will be treated as the owners of the respective portions of the trust of which each person is a grantor if A or C or both retain powers over or interests in such portions under sections 673 through 677.

Reg. § 1.671-2(e)(6), Example (8), addresses who is the grantor after a grantor dies:

> G creates and funds a trust, T1, for the benefit of G's children and grandchildren. After G's death, under authority granted to the trustees in the trust instrument, the trustees of

[6611] Reg. § 1.671-2(e)(6), Example (7) provides:

> A, B's brother, creates a trust, T, for B's benefit and transfers $50,000 to T. The trustee invests the $50,000 in stock of Company X. C, B's uncle, purportedly sells property with a fair market value of $1,000,000 to T in exchange for the stock when it has appreciated to a fair market value of $100,000. Under paragraph (e)(2)(ii) of this section, the $900,000 excess value is a gratuitous transfer by C. Therefore, under paragraph (e)(1) of this section, A is a grantor with respect to the portion of the trust valued at $100,000, and C is a grantor of T with respect to the portion of the trust valued at $900,000. In addition, A or C or both will be treated as the owners of the respective portions of the trust of which each person is a grantor if A or C or both retain powers over or interests in such portions under sections 673 through 677.

[6612] Reg. § 1.671-2(e)(6), Example (5) provides:

> A transfers cash to a trust, T, through a broker, in exchange for units in T. The units in T are not property for purposes of determining whether A has received fair market value under paragraph (e)(2)(ii) of this section. Therefore, A has made a gratuitous transfer to T, and, under paragraph (e)(1) of this section, A is a grantor of T.

[6613] The Example cites Reg. § 1.671-2(e)(2)(ii), which provides:

> For purposes of this paragraph (e), a transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust. For example, rents, royalties, interest, and compensation paid to a trust are transfers for fair market value only to the extent that the payments reflect an arm's length price for the use of the property of, or for the services rendered by, the trust. For purposes of this determination, an interest in the trust is not property received from the trust. In addition, a person will not be treated as making a transfer for fair market value merely because the transferor recognizes gain on the transaction. See, for example, section 684 regarding the recognition of gain on certain transfers to foreign trusts.

T1 transfer a portion of the assets of T1 to another trust, T2, and retain a power to revoke T2 and revest the assets of T2 in T1. Under paragraphs (e)(1) and (5) of this section, G is the grantor of T1 and T2. In addition, because the trustees of T1 have retained a power to revest the assets of T2 in T1, T1 is treated as the owner of T2 under section 678(a).

The next-to-the-last sentence of Example (8) confirms that G's status as a grantor does not terminate upon G's death. G's estate does not succeed to G's status as a grantor.[6614]

Although, as described above, Reg. § 1.671-2(e) is very clear that one is the grantor of only the portion the person gave to the trust, curiously Reg. § 1.671-2(e)(1) provides that person is the grantor if that person creates or funds the trust.[6615] To explain that, let's look at the preamble to the final regulations. T.D. 8831 (7/23/1999) explains:

> Under the original proposed regulations, a grantor was defined to include any person to the extent such person either (i) creates a trust or (ii) directly or indirectly makes a gratuitous transfer to a trust. Commenters questioned why a nominal creator who has made no transfer to a trust should be treated as a grantor and asked for an explanation of the tax significance of such treatment.
>
> Treating a nominal creator as a grantor ensures that someone will be responsible for reporting the creation of a foreign trust by a U.S. person even if the trust is not immediately funded. See section 6048(a)(3)(A)(i) and (a)(4)(A). At the same time, Treasury and the IRS believe that an accommodation grantor, such as an attorney who creates a trust on behalf of a client, (although a grantor) should not be treated as an owner of the trust. Accordingly, the temporary regulations provide that a person who either creates a trust, or funds a trust with an amount that is directly repaid to such person within a reasonable period of time, but who makes no other transfers to the trust that constitute gratuitous transfers, will not be treated as an owner of any portion of the trust under sections 671 through 677 or 679.

[6614] When an estate succeeded to its decedent's reversionary interest, Rev. Rul. 75-267 held:

> … the grantor, during his lifetime, was the owner of the trust corpus under section 677 of the Code because of his reversionary interest in such corpus including any accumulated capital gain. Therefore, in accordance with section 671, the grantor was required to include in computing his taxable income, for each of his taxable years during which he was alive, any capital gain or loss realized by the trust as if the trust had not been in existence.
>
> Furthermore, the estate's acquisition of the reversionary interest in the trust after the grantor's death did not cause it to be treated as the owner of the trust. Thus, since the estate is a taxable person separate from the grantor, it is not treated as a grantor described in sections 673 through 677 of the Code, and since the executor of the estate has no power to vest the corpus or income of the trust in the estate, it is not a person having a power under section 678. Therefore, in the instant case any capital gain or loss realized by the trust after the grantor's death is not taxable to the estate but is includible in computing the trust's taxable income subject to the rules contained in subparts A, B, C, and D, part I, subchapter J, chapter 1 of the Internal Revenue Code of 1954 (sections 641 to 669 inclusive).

[6615] See fn 6607, which includes:

> … a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer …. If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust….

Thus, referring to the "creator" is intended merely to ensure that certain reporting is done; it is not intended to change the idea that a person who in substance funds a trust is treated as the grantor.

The preamble to the proposed regulations, [REG-252487-96], RIN 1545-AU90, also focuses on the substance of the funding:

> If a person creates … any portion of a trust primarily as an accommodation for another person, the other person will be treated as a grantor with respect to such portion of the trust. See, *e.g.*, *Stern v. Commissioner*, 77 T.C. 614 (1981), *rev'd on other grounds*, 747 F.2d 555 (9th Cir. 1984).

Let's take a step back to confirm the use of "gratuitous." Reg. § 1.671-2(e)(2)(i) provides:

> A gratuitous transfer is any transfer other than a transfer for fair value. A transfer of property to a trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes.

Thus, any transfer that is not a "transfer for fair market value" is a "gratuitous transfer" – even a transfer passing by reason of the transferor's death. Treating more than one person as grantors is consistent with Reg. § 1.671-2(e)(6), Example (1), which provides:

> A creates and funds a trust, T, for the benefit of her children. B subsequently makes a gratuitous transfer to T. Under paragraph (e)(1) of this section, both A and B are grantors of T.

Reg. § 1.671-2(e)(6), Example (7), illustrates how to treat a trust that has more than one grantor:[6616]

> A, B's brother, creates a trust, T, for B's benefit and transfers $50,000 to T. The trustee invests the $50,000 in stock of Company X. C, B's uncle, purportedly sells property with a fair [child]et value of $1,000,000 to T in exchange for the stock when it has appreciated to a fair [child]et value of $100,000. Under paragraph (e)(2)(ii) of this section, the $900,000 excess value is a gratuitous transfer by C. Therefore, under paragraph (e)(1) of this section, A is a grantor with respect to the portion of the trust valued at $100,000, and C is a grantor of T with respect to the portion of the trust valued at $900,000. In addition, A or C or both will be treated as the owners of the respective portions of the trust of which each person is a grantor if A or C or both retain powers over or interests in such portions under sections 673 through 677.

[6616] The Example cites Reg. § 1.671-2(e)(2)(ii), which provides:

> For purposes of this paragraph (e), a transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust. For example, rents, royalties, interest, and compensation paid to a trust are transfers for fair market value only to the extent that the payments reflect an arm's length price for the use of the property of, or for the services rendered by, the trust. For purposes of this determination, an interest in the trust is not property received from the trust. In addition, a person will not be treated as making a transfer for fair market value merely because the transferor recognizes gain on the transaction. See, for example, section 684 regarding the recognition of gain on certain transfers to foreign trusts.

With more than one grantor, each person is grantor with respect to the portions that person funded, and all tax items relating to those portions are allocated to each portion.[6617]

Reg. § 1.671-2(e)(6), Example (8), addresses who is the grantor after a grantor dies:

> G creates and funds a trust, T1, for the benefit of G's children and grandchildren. After G's death, under authority granted to the trustees in the trust instrument, the trustees of T1 transfer a portion of the assets of T1 to another trust, T2, and retain a power to revoke T2 and revest the assets of T2 in T1. Under paragraphs (e)(1) and (5) of this section, G is the grantor of T1 and T2. In addition, because the trustees of T1 have retained a power to revest the assets of T2 in T1, T1 is treated as the owner of T2 under section 678(a).

The next-to-the-last sentence of Example (8) confirms that G's status as a grantor does not terminate upon G's death.

Letter Ruling 9304017 glossed over this distinction for a married couple (C and D) that together were grantors of a separate trust for each child, holding:

> In addition, because C and D are treated as the owners of all of the income and corpus of the Trusts, we conclude that Trust A and Trust B may be shareholders of an S corporation under section 1361(C)(2)(A)(i) of the Code. Accordingly, X's S corporation status will not terminate as a result of the transfer of X stock to Trust A and Trust B.
>
> After the deaths of C and D, Trust A, Trust B, and any separate share trust created thereunder will be considered a qualified subchapter S trust under section 1361(d)(3) of the Code, provided that each beneficiary is a citizen or resident of the United States and that a valid election is made by or on the behalf of the respective beneficiary under section 1361(d)(2).

What would happen if only one of C or D died? Letter Ruling 9304017 did not expressly address that time period and failed to mention Reg. § 1.671-2(e)(5). However, the ruling seems intended to approve the trust during all time periods before and after the deaths of C and D, so the taxpayer in that ruling is likely protected. On the other hand, the ruling's failure to address Reg. § 1.671-2(e)(5) makes it unwise for taxpayers to rely on Letter Ruling 9304017, and any suggestion that a trust deemed owned by more than one grantor is treated as owned 100% by the surviving grantor when one of the grantor's dies[6618] is wrong because it contradicts Example (8), which continues a person's status as the grantor after that person dies.

[6617] Reg. § 1.671-3(a)(2). For how much each person is treated as owning, see part III.B.2.i.vii.(b) Determining Portion Owned When Trust Is Only a Partial Grantor Trust.

[6618] Montgomery and Montgomery, "The Joint and Survivor Grantor Trust and the S Election," *Tax Notes Federal*, Vol. 174 (3/28/2022), starting at 1818, makes this error. In a letter dated April 15, 2022 Blattmachr, Boyle, and Zaritsky called out this error in a Letter to the Editor, *Tax Notes Federal*, Vol. 175 (4/25/2022), starting at 1818, but the authors rejected that letter's conclusion in a Response, *Tax Notes Federal*, Vol. 175 (5/2/2022), starting at 751. Of course, Blattmachr, Boyle, and Zaritsky were correct, but they might have been more persuasive had they mentioned how Examples (7) and (8) work together. Readers rely on the article at their peril. That being said, in a joint revocable trust where the surviving spouse has the unequivocal right to withdraw the entire the trust, Code § 678(a)(1) treats the surviving spouse as the deemed owner of the deceased spouse's portion of the trust, making the surviving spouse the deemed owner of all of the trust (half under Code §676 and half under Code § 678), so joint trusts with that feature will qualify while either or both spouses are living.

Letter Ruling 9729025 held that a community property revocable trust qualified during marriage and upon divorce, because each spouse owned a substantially separate and independent share.[6619]

"If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust."[6620]

Exercising - not merely holding[6621] - a general power of appointment makes the person exercising the power the grantor to the extent of the exercise,[6622] even if the trust was a grantor trust deemed owned by the settlor before the exercise.[6623] For more on general powers of appointment, see parts II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap and II.H.5.d Using Grantor's Parent's Exemption for Basis Step-Up.

III.B.2.h.ii. Code § 672(e) Spousal Attribution

Code § 672(e), "Grantor treated as holding any power or interest of grantor's spouse," provides:

> (1) *In general*. For purposes of this subpart, a grantor shall be treated as holding any power or interest held by -
>
> > (A) any individual who was the spouse of the grantor at the time of the creation of such power or interest, or

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[6619] See fn 5857 in part III.A.3.a.i Qualifying as a Wholly Owned Grantor Trust.

[6620] Reg. § 1.671-2(e)(5), which provides:

> If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code.

As to the first sentence of the regulation, see part II.D.3 Trust as Grantor or Deemed Owner of Another Trust.

[6621] Reg. § 1.671-2(e)(6), Example (4) provides:

> A creates and funds a trust, T. A does not retain any power or interest in T that would cause A to be treated as an owner of any portion of the trust under sections 671 through 677. B holds an unrestricted power, exercisable solely by B, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in B. B is treated as an owner of the portion of T that is subject to the withdrawal power under section 678(a)(1). However, B is not a grantor of T under paragraph (e)(1) of this section because B neither created T nor made a gratuitous transfer to T.

See generally part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.

[6622] Reg. § 1.671-2(e)(6), Example (9) provides:

> G creates and funds a trust, T1, for the benefit of B. G retains a power to revest the assets of T1 in G within the meaning of section 676. Under the trust agreement, B is given a general power of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B's child. Under paragraph (e)(1) of this section, G is the grantor of T1, and under paragraphs (e)(1) and (5) of this section, B is the grantor of T2.

See generally part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.

[6623] Reg. § 1.671-2(e)(5), which is reproduced in fn 6620 in part III.B.2.h.i Who Is the Grantor.

(B) any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to periods after such individual became the spouse of the grantor.

(2) *Marital status*. For purposes of paragraph (1)(A), an individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

The Senate Report (PL 100-647, 11/10/88) explains:

> **Present Law.**
>
> The grantor of a trust is treated as the owner of the trust's assets if he retains certain powers or interests over all or a portion of the trust (sec. 671-678). In that situation, the income and deductions of the portion are taxed directly to the grantor. The grantor is not, however, treated as the owner by virtue of certain powers exercisable by trustees, none of whom is the grantor and not more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor. The grantor also is treated as the owner of a trust if the trust makes certain loans to him.
>
> The grantor is treated as holding all powers and interests of the grantor's spouse if the grantor's spouse is living with the grantor when such interests and powers are created.
>
> **Explanation of Provisions.**
>
> The bill provides that the grantor will be treated as holding any power or interest that was held by an individual either (1) who was the grantor's spouse at the time that the power or interest was created or (2) who became the grantor's spouse subsequent to the creation of that power or interest. For this purpose, individuals are not considered married if they are legally separated under a decree of divorce or of separate maintenance.
>
> In addition, the grantor is treated as owner of a trust by virtue of certain powers exercisable by trustees if the grantor's spouse is a trustee or more than half of the trustees are related or subordinate parties subservient to the wishes of the spouse. The grantor also is treated as the owner where the trust makes certain loans to the grantor's spouse.

Absent Code § 672(e), spousal attribution does not exist. *Laganas v. Commissioner*, 281 F.2d 731, 735 (1st Cir. 1960), held:

> Is the commissioner to investigate the existing rapport, or lack of it, between a particular taxpayer and his wife before determining the incidence of the tax? We believe that a single rule must be adopted, and that the preferable one is to assume that each wife stands on her own feet. C*ommissioner v. Katz*, 7 Cir., 1943, 139 F.2d 107, 110; *Phipps v. Commissioner*, 2 Cir., 1943, 137 F.2d 141, 144.

Code § 672(e)(1) looks to whether a person "was the grantor's spouse at the time that the power or interest was created," which status does not appear to be terminated by divorce.

Before 2018, its effect was somewhat mitigated by part III.B.2.h.ix Code § 682 Limitations on Grantor Trust Treatment (Repealed for Post-2018 Divorces). Code § 672(e) does not seem to coordinate with Code § 682. However, Reg. § 1.1361-1(k) was promulgated after Code § 672(e) was enacted, so Reg. § 1.1361-1(k)(1), Example (10),[6624] may clarify somewhat the scope of Code § 672(e), in that it requires a QSST election when the grantor of an inter vivos QTIP trust divorces the spousal beneficiary.

When Congress repealed Code § 682, it gave no clue as to its views on how the repeal affected Code § 672(e). ACTEC requested guidance:

- ACTEC Comments to Joint Committee on Taxation, House Ways and Means, and Senate Finance Committee re Repeal of I.R.C. Section 682 (July 5, 2018) (asking to limit the repeal's effect to trusts that were created after repeal).

- ACTEC Comments on guidance in connection with the Repeal of Section 682 (Notice 2018-37) (July 2, 2018) (asking the Treasury and IRS for guidance on how the repeal affected Code § 672(e)).

The latter explores various nuances how Code § 672(e) works. Rather than reproduce it, I recommend clicking on the link.

III.B.2.h.iii. Swap Power

Code § 675(4), a provision commonly relied upon in drafting irrevocable grantor trusts, treats a grantor of a trust as the owner if:

> A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term "power of administration" means any one or more of the following powers… (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

The trust agreement should specify that the grantor does not hold this power in a fiduciary capacity and preferably that, if the grantor is a trustee, some other trustee (preferably one who is not a related or subordinate party as described in Code § 672(c))[6625] has the fiduciary power to review the grantor's exercise. These principles come from two sources:

1. The income tax statute quoted above requires the power to be exercisable in a nonfiduciary capacity.[6626] Reg. § 1.675-1(b)(4)(iii) provides:

   > If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. This presumption may be rebutted only by clear and convincing proof that the power is not

[6624] Reproduced in fn 5973 in part III.A.3.e.i.(a) QSSTs Generally.
[6625] Rev. Rul. 95-58 and related private letter rulings in fn 6713 in part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.
[6626] Letter Ruling 9037011 included the following caveat with the trust agreement expressly stated that the trustee's exercise of the power would be in a nonfiduciary capacity: "Provided that the circumstances surrounding the administration of the power held by [the nongrantor trustee] to substitute property of equal value for the trust corpus do not indicate that the power is held in a fiduciary capacity…." In that Letter Ruling, a co-trustee was available to review the exercise.

exercisable primarily in the interests of the beneficiaries. If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.

2. From an estate tax perspective Rev. Rul. 2008-22 provides:

> [T]he trustee [must have] a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

Rev. Rul. 2008-22 held that, if it complies with the estate tax standard above,[6627] "a grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under § 2036 or 2038." Rev. Rul. 2011-28 extends Rev. Rul. 2008-22 to Code § 2042, so that this swap power can apply to life insurance as well.

Some view uncertainty as to whether Rev. Rul. 2008-22 protects voting stock in a closely-held corporation from Code § 2036 inclusion. I believe it does protect voting stock, because Rev. Rul. 2008-22 applies to Code § 2036, not just Code § 2036(a). However, the ruling's analysis focuses on Code § 2036(a), and the lack of any reference in the ruling to Code § 2036(b) makes others nervous. However, I tend not to recommend gifts of voting stock in trust anyway; see part II.A.2.i.i.(b) Why Nonvoting Shares Are Needed for Estate Planning.

Relying on Rev. Rul. 85-13, Letter Rulings 200846001 and 200842007 ruled that exercise of a swap power over grantor trusts were not taxable; however, they did not rely on the swap powers themselves to make the trusts grantor trusts.

A clause I tend to use (which may be used only by a qualified lawyer using his or her independent judgment) is:

> POWER TO EXCHANGE ASSETS. I, acting alone in my individual capacity and not in any fiduciary capacity, shall have the power, with respect to any trust created under this Agreement, to reacquire the trust corpus by substituting other property of an equivalent value.[6628] The power described in this Section may be exercised by me or by an agent of mine appointed under a durable power of attorney or through any other means, whose actions shall be conclusive and binding.[6629] Neither the consent of the trustee nor the

[6627] Most practitioners do not believe that prior documents need to be fixed.
[6628] This language is intended to track the statute. The grantor is not required to hold this power; the grantor is listed to provide flexibility as described below in the annotation to this clause.
[6629] To leave no doubt that the grantor's incapacity does not extinguish the power.

> consent of any other person shall be required. Upon exercise of this power, the person exercising it (the "Exchanger") shall notify the trustee; if the Exchanger is the trustee, the Exchanger shall notify the person designated in [the provision designating trustees] to succeed the Exchanger as trustee, ignoring any exercise by the Exchanger of powers under [the provision for changing the designation of trustees], and such designated successor shall serve as special trustee for purposes of this Section; and, if there is a total vacancy, then the Exchanger shall appoint a special trustee.[6630] The trustee or this special trustee, as the case may be, shall comply with Rev. Rul. 2008-22 or Rev. Rul. 2011-28, as applicable, including satisfying himself, herself, or itself that the properties acquired and substituted pursuant to this Section are in fact of equivalent value and that the proposed substitution will not have the effect of shifting beneficial interests among trust beneficiaries.[6631] The power described in this Section may be released by a written statement executed by me or by an agent appointed under a durable power of attorney or through any other means (whose actions shall be conclusive and binding), and delivered to the trustee.[6632]

Although the trustee cannot resist the swap if the swap is for equivalent value, at least one court has held that the trustee can refuse the swap if the trustee determines that the value the grantor offers to pay is insufficient.[6633] Hood, "Snap, Crackle, Swap: The Substitution Power Under the Microscope," *Estate Planning Journal* (4/2020), describes this and other litigation when grantors have exercised swap powers and trustees resisted. The cases he described uses clauses similar to what I described above, and the courts differed as to whether the trustee had the right to stop the swap by arguing lack of equivalent value. Because these cases demonstrate uncertainty, the author asserts that the failure to be more specific about the process of exercising the swap power constitutes negligence by the drafter, because not being specific has led to litigation. Although I share his concern about what my clause means in terms of how to execute the swap power, this uncertainty leads to the opposite conclusion regarding drafting:

- If we are more specific in our drafting and the IRS asserts that our specific procedures do not accomplish what the statute and regulations say, then we would have unnecessarily subjected the trust to income tax litigation. Generally, we use this clause to give the grantor

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[6630] The swap power cannot be subjected to fiduciary constraints, so the person holding the power should not be acting as a fiduciary with respect to the swap power. See Reg. § 1.675-1(b)(4)(iii) above.

[6631] This tracks standards within Rev. Rul. 2008-22. I include this language to be very clear about tracking the ruling; however, a trustee's fiduciary duties generally would include these standards, so that trusts that do not have such a clause tend to be likely to comply with the ruling anyway.

[6632] I tend to rely on swap powers to give the grantor control over grantor trust status. This sentence is intended to clearly authorize turning off that status.

[6633] *In re Dino Rigoni Intentional Grantor Trust for Benefit of Rajzer*, 2015 WL 4255417 (Court of Appeals of Michigan 7/14/2015), held:

> Once Rigoni has tendered property of equivalent value, the trustee lacks the discretion to deny the substitution. The trustee, however, still possessed the power and duty to determine whether the attempted substitution complied with the requirements of the substitution clause. See 3 *Restatement Trusts, 3d* (2007), p. 55, comment d (The primary duty of the trustee in regard to such a power is to ascertain whether an attempted exercise is within the terms of the power and to refuse to comply if it is not.). The trial court did not err in giving effect to every word of the substitution clause. *Kostin*, 278 Mich. App at 53. In fact, Rigoni's argument would substantially rewrite the substitution clause by essentially causing it to read, I may substitute any property for trust assets; if the trustee determines that the value of the property substituted was not equivalent, it may seek additional value afterwards. We decline to rewrite the unambiguous language of the substitution clause in such a fashion. See *Ourlian v. Major*, 333 Mich. 491, 496; 53 NW2d 346 (1952).

control over whether the trust is a grantor trust, not to give the grantor the power to shove a transaction down the trustee's throat. Therefore, I will stick with my clause and live with the uncertainty as to how to administer it so that the trust can have avoid the uncertain tax results that including such details may generate.

- If a lawyer decides to use the more specific clause because the lawyer prefers a specific procedure notwithstanding the income tax risk it generates, consider taking extra tax precautions. First, instead of using the grantor's social security number, consider using a separate tax ID and filing annual fiduciary income tax returns with grantor information statements to run the statute of limitations on the trustee's tax filing obligations.[6634] Also, generally I recommend that an irrevocable grantor trust that holds stock in an S corporation file an ESBT election to protect the S election in case the IRS determines that the trust is not a 100% grantor trust;[6635] that recommendation becomes even more important if one takes more risks whether the swap power achieves grantor trust treatment.

I also tend to fund irrevocable grantor trusts with *nonvoting* stock when closely-held businesses are involved. The "Law and Analysis" portion of Rev. Rul. 2008-22 that discussed Code § 2036 cited Code § 2036(a), and the provision regarding closely-held businesses is in Code § 2036(b). Because the literal holding of Rev. Rul. 2008-22 addressed all of Code § 2036, a swap power itself probably will not trigger Code § 2036 inclusion of closely-held business stock. However, if the grantor is capable of providing input to the trustee on how to vote stock, concerns other than the swap power also strongly suggest not initially funding the trust with voting stock.[6636] It's possible that other concerns[6637] might suggest later exchanging the nonvoting stock for voting stock[6638] after the trust is no longer a grantor trust, but to avoid a step-transaction argument I do not discuss this idea with clients until the grantor trust status is about to be turned off.

Guidance on the use of this power can also be found in the charitable area. Rev. Proc. 2008-45[6639] contains annotated sample declarations of trust and alternate provisions that meet the requirements for an inter vivos charitable lead unitrust (CLUT) providing for unitrust payments payable to one or more charitable beneficiaries for the unitrust period followed by the distribution of trust assets to one or more noncharitable remaindermen. Of particular interest is Section 8.09:[6640]

[6634] See parts III.B.2.e Grantor Trust Tax Identification Number During Life and Upon Death and III.B.2.f Triggering the Statute of Limitations for Grantor Trusts.
[6635] See part III.A.3.a Wholly Owned Grantor Trusts – How to Qualify, Risks, and Protective Measures. If this issue does not raise serious concerns with you, within part III.A.3.a you might start with part III.A.3.a.iv Why to Be Extraordinarily Sensitive to Protecting the S Election.
[6636] See II.A.2.i.i.(b) Why Nonvoting Shares Are Needed for Estate Planning through II.A.2.i.i.(d) Reallocations between Voting and Nonvoting Stock.
[6637] See part II.K.2.b Participation by an Estate or Nongrantor Trust.
[6638] Such a swap would not be an income taxable event. Code § 1036. One might want to use a formula swap, such as the number of nonvoting shares of value equal to the traded voting shares, to try to protect the swap from being considered a gift. See part II.A.2.i.i.(e) Example of Recapitalizing Voting and Nonvoting.
[6639] Its companion pronouncement, Rev. Proc. 2008-46, issued forms for testamentary CLUTs.
[6640] Note that the statute does not say who must hold the swap power to make it a grantor trust. Is it a big leap to treat the trust as a grantor trust when a person **other than** the grantor holds the swap power, as Section 8.09 does? No, since Reg. § 1.675-1(b)(4) (emphasis added) provides, The existence of certain powers of administration exercisable in a nonfiduciary capacity by **any nonadverse party** without the approval or consent of any person in a fiduciary capacity will cause the grantor to be treated as the owner. For more details on Code § 675(4)(C), see 819 T.M. XII.C.

(1) *Power to substitute trust assets*. The donor to a CLUT may claim an income tax charitable deduction under § 170(a) if the donor is treated as the owner of the entire CLUT under the provisions of subpart E, part I, subchapter J, chapter 1, subtitle A of the Code. Paragraph 11, Retained Powers and Interests, of the sample trust in section 7 creates a grantor CLUT through the use of a power to substitute trust assets under § 675(4) that is held by a person other than the donor, the trustee, or a disqualified person as defined in § 4946(a)(1), and is exercisable only in a nonfiduciary capacity. The circumstances surrounding the administration of a CLUT will determine whether a § 675(4) substitution power is exercised in a fiduciary or nonfiduciary capacity. This is a question of fact. Note, that the exercise of a § 675(4) power may result in an act of self-dealing under § 4941.

(2) *Other powers or provisions to create a grantor trust*. As noted above, the sample trust in section 7 includes a § 675(4) power that is held by someone other than donor, the trustee, or a disqualified person as defined in § 4946(a)(1), and that may be exercised only in a nonfiduciary capacity. The CLUT instrument may instead incorporate a power or provision, other than the one provided in the sample trust in section 7, that will cause the donor to be treated as the owner of the entire CLUT under the provisions of subpart E, part I, subchapter J, chapter 1, subtitle A of the Code. See § 671 et seq. However, practitioners should exercise caution when choosing a particular power or provision because certain methods of creating a grantor trust may have unforeseen tax consequences.

Letter Ruling 200944002 ruled that a transfer to a self-settled spendthrift trust was a completed gift. It also ruled that the trust's assets would not be included in the grantor's estate, but "we are specifically not ruling on whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036." Letter Ruling 200944002 provides a good roadmap for obtaining a private letter ruling when creating such a trust in light of Rev. Rul. 2008-22, which requires certain procedural safeguards when a grantor exercises a swap power (the right to substitute assets of equivalent value).[6641]

If a grantor turns off this power but would like to reactivate it, consider forming an identical trust with a swap power and then the trustee of the nongrantor trust merges the nongrantor trust into the grantor trust.

III.B.2.h.iv. Borrow Power

Another way to make a trust a grantor trust is:[6642]

A power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without

[6641] Conversations with the IRS seem to indicate that the IRS will tend to avoid issuing private letter rulings on sales to irrevocable grantor trusts, so be sure to have an informal pre-submission conference before putting together a formal ruling request.
[6642] Code § 675(2).

> adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

Because the IRS would probably attack the use of inadequate interest as beneficial enjoyment, when using this power I tend to require that the loan must be one that will not make the loan be characterized as a "below-market loan" under Code § 7872(e)(1) and that, instead, the loan may have inadequate security. The framework of Code § 7872 and related regulations governing the use of the AFR to determine the interest rate do not take creditworthiness into account so long as the loan is reasonably expected to be repaid; see part III.B.1.a.ii.(a) Gift Tax Issues Involving Loan Guarantees.

Although I am not concerned whether such a power has Code § 2036 implications, to be extra careful one might give a nonadverse party the authority to give the right to borrow, rather than simply giving the grantor the right to borrow.[6643]

An actual borrowing by the grantor or the grantor's spouse also makes the grantor taxable on the trust's income in part or in whole of the loan is not adequately secured or the trustee is not independent,[6644] and borrowing for any part of the year makes the grantor taxable for the whole year.[6645] If the trust loans to a business entity owned by the grantor, does that count as a loan to the grantor? Yes, if it's a partnership; no if it's a C corporation.[6646]

Zand v. Commissioner, T.C. Memo. 1996-19, held:[6647]

> Section 675(3) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which the grantor has directly or indirectly borrowed the corpus or

[6643] From Interactive Legal Solutions, which Jonathan Blattmachr kindly shared with me:

> During the Grantor's lifetime, the Loan Director shall have the power, exercisable at any time and from time to time in a non-fiduciary capacity (within the meaning of Code Sec. 675) without the approval or consent of any person in a fiduciary capacity within the meaning of that section, to compel the Trustee to loan some or all of the trust property to the Grantor without adequate security within the meaning of Code Sec. 675(2) although with adequate interest within the meaning of that section.

[6644] Code § 675(3); Reg. § 1.675-1(a)(3); Rev. Rul. 85-13 (grantor borrowed all assets so 100% grantor trust). For more details, see Zaritsky, Lane & Danforth, *Federal Income Taxation of Estates and Trusts* (WG&L), ¶11.04. Actual Borrowing from the Trust. Code § 675(3) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which:

> The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor. For periods during which an individual is the spouse of the grantor (within the meaning of section 672(e)(2)), any reference in this paragraph to the grantor shall be treated as including a reference to such individual.

[6645] See part III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation, fn. 6552.

[6646] *Bennett v. Commissioner*, 79 T.C. 470 (1982).

[6647] The court continued:

> Respondent relies on *Benson v. Commissioner*, 76 T.C. 1040 (1981); *Bixby v. Commissioner*, 58 T.C. 757 (1972); and *Bennett v. Commissioner*, 79 T.C. 470 (1982). Such reliance is misplaced. Those cases are distinguishable. In *Benson* the loan was unsecured, and the grantor's spouse was the sole trustee. In *Bixby* the settlors were held not to be the true grantors

income and has not completely repaid the loan, including the interest, before the beginning of the taxable year. However, the section also provides that this requirement does not apply to a loan which provides for adequate interest and security and if the loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor. Here these three conditions are met: (1) The loans bore adequate interest; (2) the loans were adequately secured; and (3) the majority of the trustees (the two attorneys) were not related, subordinate, or subservient to the grantor. Lawyers are not proscribed by section 672(c) and thus may qualify as independent. See Bittker & Lokken, Federal Taxation of Income, Estates and Gifts, par. 80.1.4, at 18-19 (2d ed. 1991); 452-2nd T.M. Grantor Trusts: Sections 671-679, A-14. See also *Estate of Goodwyn v. Commissioner*, T.C. Memo. 1976-238. Moreover, even if section 675(3) did apply, its effect by its terms is to tax all or a portion of the trust income to petitioner. It does not provide for the disallowance of the interest expenses claimed by him. Indeed, the net result to the grantor may be no increase in tax because the trusts' interest income taxed to the grantor may be offset by a deduction for interest on the loans. See Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts*, par. 80.7 at 64.

III.B.2.h.v. Life Insurance

Subject to certain exceptions, Code § 677(a)(3) taxes to the grantor income that is or may be applied to the payment of premiums on policies insuring the grantor's or grantor's spouse's life.

The "better" view is that the grantor is taxed only to the extent that the trust actually pays premiums, but the answer is uncertain.[6648]

The transfer of life insurance might trigger immediate income tax, might make the death benefit partly or wholly taxable, or both.[6649] To avoid those consequences and the uncertainty of Code § 677(a)(3), I generally use a swap power in my trusts holding life insurance.[6650] A swap power over a trust holding life insurance does not trigger Code § 2042 incidents of ownership in the grantor-insured.[6651]

Suppose one has a nongrantor trust that wishes to hold insurance on the grantor's life. If the grantor wishes to limit taxation on the trust's income and is not comfortable with the uncertainty of the "better" view, consider dividing the trust so that only what is needed to pay premiums is in the portion that hold life insurance. That portion might invest in tax-exempt bonds, annuities

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for purposes of the grantor trust rules. Rather, the subsequent transferors were the actual grantors. There was no discussion of section 675(3) in the *Bixby* case. In *Bennett* the grantors were the trustees, and the loan was unsecured.

[6648] Zaritsky & Aucutt, ¶ 12.02[5][c][v] Power to pay life insurance premiums, *Structuring Estate Freezes: Analysis With Forms* (WG&L). Internal doc. no. 6207986 is a thorough analysis of the issue espousing the better view, but the author asked me not to share it with anyone, so I would need to spend several hours going through the materials to provide a fully researched analysis or would merely refer the person asking to contact the author. See also *Corning v. Commissioner*, 104 F.2d 329 (6th Cir. 1939), and *Weil v. Commissioner*, 3 T.C. 579 (1944), acq. 1944 C.B. 29.

[6649] See part II.Q.4.a Funding the Buy-Sell, especially fns. 4330-4342.

[6650] See part III.B.2.h.i Who Is the Grantor.

[6651] Rev. Rul. 2011-28.

(which would generate income tax on distributions from the annuities to pay premiums),[6652] or cash-value-rich life insurance. If the trustee of one trust pays premiums on life insurance on the grantor's life owned by another trust, then the grantor is the Code § 677(a) deemed owner "of the amount of the trust income which is used to pay the premiums on these policies of insurance on her life."[6653]

III.B.2.h.vi. Protecting the Grantor

The grantor's payment of income tax under the grantor trust rules is not a gift.[6654]

When using one or both of the swap or borrow powers to establish grantor trust powers, I generally provide that the powers may be exercised or released by the grantor's agent.

One might protect the grantor simply by encouraging the grantor not to transfer all of the grantor's interest in the entity being transferred. For example, if the grantor transfers half and keeps half, then the grantor might be able to use the half the grantor retained to pay tax on the taxable income generated by both halves. For the reasons described in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner, I hesitate to use income tax reimbursement clauses, but I tend to include in GRATs the option or requirement to make a distribution to the grantor to the extent that income tax on the GRAT's income exceeds the annuity payment.[6655]

The end of part III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation discusses whether the release of grantor trust powers changes deemed ownership for the taxable year prospectively - or perhaps not at all! For an example of how bad timing could be disastrous when an S corporation is involved, see the indented text accompanying fn. 6556 in that part III.B.2.d.i.(b).

One might be concerned whether a power of appointment, a power to decant, a power to merge, or some other power might cause the grantor to be taxed as the owner after the grantor turns off those powers. If one is concerned about this, consider including a savings clause that says that, under no event may the trustee's actions or any such power cause the trust to be a grantor trust, determined as if the swap or borrow power (that is being used to make the trust a grantor trust) does not exist. If the grantor's spouse is a beneficiary, one would generally need to make this savings clause apply only after the spouse's death[6656] or divorce.[6657]

[6652] Although Code § 72(u) states that a taxpayer that is not a natural person cannot defer tax on annuities, various private letters ruling, citing favorable legislative history, do not apply this prohibition to most trusts.
[6653] Rev. Rul. 66-313.
[6654] Rev. Rul. 2004-64, which is discussed further in fns. 6961-6980, found in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner.
[6655] See part III.B.2.h.viii.(b) GRATs as Grantor Trusts.
[6656] See Code §§ 677, 672(e).
[6657] See fn. 5973.

III.B.2.h.vii. Distribution Provisions Might Prevent Turning Off Grantor Trust Status

III.B.2.h.vii.(a). Distribution Provisions Resulting from Control Causing Grantor Trust Treatment

If the grantor (or current to former spouse)[6658] or a nonadverse party, or both, can make distributions without the approval or consent of any adverse party, the trust might be a grantor trust under Code § 674(a). "Adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by making or not making the distribution.[6659] Because a beneficiary's interest might not be totally adverse to distributions being made,[6660] I hesitate to rely on a person being an adverse party.

Below are some situations in which Code § 674(a) does not apply to the power to make distributions, so long as no person, other than a person substituting other beneficiaries to succeed to his or her interest in the trust, has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries (other than providing for after-born or after-adopted children) to whom distributions may be made:[6661]

- A power over income is solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or a current or former spouse of the grantor,[6662] and is limited by an ascertainable standard.[6663]

- A power over income, principal, or both, is solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or a current or former spouse of the grantor,[6664] and no more than half of whom are related or

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[6658] Code § 672(e)(1) provides that a grantor shall be treated as holding any power or interest held by any individual who either was the spouse of the grantor at the time of the creation of such power or interest or became the spouse of the grantor after the creation of such power or interest; the latter applies only with respect to periods after such individual became the spouse of the grantor.
[6659] Code § 672(a). For a distribution committee qualifying as an "adverse party," see text accompanying fns 2514-2516 in part II.J.3.e.i Strategic State & Local Tax Issues re: Residence, briefly mentioning the idea of an incomplete gift nongrantor (ING) trust.
[6660] Reg. § 1.672(a)-1 provides various limitations. However, Letter Ruling 201310002 viewed as adverse to the grantor a distribution committee consisting of the grantor and four sons, when all of the grantor's descendants were eligible to receive discretionary distributions.
[6661] Reg. § 1.674(d)-2(b), discussed further below.
[6662] Code § 674(d) says, spouse living with the grantor. However, see fn. 6658 regarding spousal attribution under Code § 672(e), which, when Congress enacted it, Congress did not appear to try to reconcile with the living with the grantor condition of Code § 674(d). To avoid any argument, one might exclude any current or former spouse from being a trustee if one wants to rely on this exception.
[6663] Code § 674(d).
[6664] For the reference to current or former spouse, see fn. 6658.

subordinate parties[6665] who are subservient to the wishes of the grantor.[6666] Note that an ascertainable standard is not required to qualify for this exclusion. Note also that the power must be exercisable by a trustee or trustees, so the exception would not apply to the holder of a power of appointment.

- A power to distribute principal under an ascertainable standard.[6667]

- A power to distribute income to any current income beneficiary (or accumulate that income), if any accumulated income must ultimately be payable to the beneficiary, the beneficiary's estate, or the beneficiary's appointees under the broadest possible nongeneral power of appointment.[6668] Note that an ascertainable standard is not required to qualify for this exclusion and also does not help qualify for this exclusion; the only time an ascertainable standard helps is above where neither the grantor nor the grantor's spouse is a trustee.[6669] Consider the following language to qualify for the first sentence of this bullet point:

  > The trustee is authorized to distribute to any one or more of the primary beneficiary and the primary beneficiary's spouse and descendants as shall be living from time to time during the term of the trust, to provide for their support, any part or all of the income, principal or both of the trust; however, during my life, any distributions of income may be made only to the primary beneficiary, and any income that the trustee could have distributed that is added to principal may be distributed only to the primary beneficiary (as used in this Section, such undistributed income is the "Designated Principal"), and (1) any distributions of principal to the beneficiary under this Section shall be allocated first to the Designated Principal, and (2) any exercise of the beneficiary's powers under subsection (b) shall reduce the Designated Principal. After my death and subject to the above limitations regarding the Designated Principal, the trustee also is authorized to distribute to one or more of the beneficiary's spouse and descendants as shall be living from time to time during the term of the trust to provide for their reasonable support and comfort, any part or all of the income, principal or both. Any distributions under this subsection need not be equal, and the trustee shall have the right, within the limits of such standards, to pay all of such income, principal or both to any one or more of such persons to the complete exclusion of any other. Any such distribution shall be charged against the trust as a whole and not against the ultimate distributive share of any person.

[6665] Code § 672(c) provides that:

> the term related or subordinate party means any nonadverse party who is-
> (1) the grantor's spouse if living with the grantor;
> (2) any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.
>
> For purposes of [Code § 674], a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence.

[6666] Code § 674(c).

[6667] Code § 674(b)(5)(A).

[6668] Code § 674(b)(6)(A); see fn. 6679 for the relevant regulation and the paragraph accompanying it for related issues.

[6669] See text accompanying fns 6662-6663.

That language targets income earned while the grantor is living and restricts its use during the primary beneficiary's life; tracking the accumulated income as Designated Principal is intended to prevent it from being lumped together with other principal under the typical language of any undistributed income being added to principal. Upon death, the primary beneficiary would still need the broad power of appointment described in the first sentence; if the primary beneficiary does not have such a power (for example, when the grantor wants to limit the power of appointment to include only the grantor's descendants), then the primary beneficiary needs to have that broad power over the Designated Principal remaining at the primary beneficiary's death.

These exceptions are not intended to be exhaustive; they are simply the ones to which I most frequently look.

Reg. § 1.674(b)-1(b)(5), "Powers to distribute corpus," explains the Code § 674(b)(5) exception for powers to distribute corpus:[6670]

(i) If the power is limited by a reasonably definite standard which is set forth in the trust instrument, it may extend to corpus distributions to any beneficiary or beneficiaries or class of beneficiaries (whether income beneficiaries or remaindermen) without causing the grantor to be treated as an owner under section 674. See section 674(b)(5)(A). It is not required that the standard consist of the needs and circumstances of the beneficiary. A clearly measurable standard under which the holder of a power is legally accountable is deemed a reasonably definite standard for this purpose. For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; or to enable him to maintain his accustomed standard of living; or to meet an emergency, would be limited by a reasonably definite standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not limited by a reasonably definite standard. The entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard. For example, if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power, the power is not limited by a reasonably definite standard. However, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no reasonably definite standard exists.

(ii) If the power is not limited by a reasonably definite standard set forth in the trust instrument, the exception applies only if distributions of corpus may be made solely in favor of current income beneficiaries, and any corpus distribution to the current income beneficiary must be chargeable against the proportionate part of corpus held in trust for payment of income to that beneficiary as if it constituted a separate trust (whether or not physically segregated). See section 674(b)(5)(B).

(iii) This subparagraph may be illustrated by the following examples:

Example (1). A trust instrument provides for payment of the income to the grantor's two brothers for life, and for payment of the corpus to the grantor's nephews in equal shares. The grantor reserves the power to distribute corpus to pay medical

[6670] For an ascertainable standard for gift tax purposes, see the text accompanying fn 2485 in part II.J.2.b Trust Provisions Authorizing Distributions.

expenses that may be incurred by his brothers or nephews. The grantor is not treated as an owner by reason of this power because section 674(b)(5)(A) excepts a power, exercisable by any person, to invade corpus for any beneficiary, including a remainderman, if the power is limited by a reasonably definite standard which is set forth in the trust instrument. However, if the power were also exercisable in favor of a person (for example, a sister) who was not otherwise a beneficiary of the trust, section 674(b)(5)(A) would not be applicable.

Example (2). The facts are the same as in example (1) except that the grantor reserves the power to distribute any part of the corpus to his brothers or to his nephews for their happiness. The grantor is treated as the owner of the trust. Paragraph (5)(A) of section 674(b) is inapplicable because the power is not limited by a reasonably definite standard. Paragraph (5)(B) is inapplicable because the power to distribute corpus permits a distribution of corpus to persons other than current income beneficiaries.

Example (3). A trust instrument provides for payment of the income to the grantor's two adult sons in equal shares for 10 years, after which the corpus is to be distributed to his grandchildren in equal shares. The grantor reserves the power to pay over to each son up to one-half of the corpus during the 10-year period, but any such payment shall proportionately reduce subsequent income and corpus payments made to the son receiving the corpus. Thus, if one-half of the corpus is paid to one son, all the income from the remaining half is thereafter payable to the other son. The grantor is not treated as an owner under section 674(a) by reason of this power because it qualifies under the exception of section 674(b)(5)(B).

The grantor being the trustee (or dominating the trustee)[6671] prevents one from looking to Code § 674(c) or (d) for relief and might risk estate inclusion. Using (and abiding by)[6672] ascertainable standards should avoid estate inclusion[6673] and would suffice for avoiding grantor trust status as to principal,[6674] but further steps would be required as to income.[6675]

Reg. § 1.674(d)-2(b) provides:

Power to add beneficiaries. The exceptions described in section 674(b)(5), (6), and (7), (c), and (d) are not applicable if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where the action is to provide for after-born or after-adopted children. This limitation does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed to his interest in the trust (so that he would be an adverse party as to the exercise or nonexercise of that power). For example, the limitation does not apply to a power in a beneficiary of a nonspendthrift trust to assign his interest. Nor does the

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[6671] See *Wyly*, described in fn 6713 in part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts. For additional precedent in the Code § 678 area, see fn. 6672.

[6672] For Code § 678 income tax cases where an ascertainable standard was ignored by the parties and therefore also ignored by the court, see fns 6746-6747 and the accompanying text in part III.B.2.i.iii Can a Trust Without a Withdrawal Right Be a Code § 678 Trust?.

[6673] See Rev. Rul. 73-143 re Code § 2038 and Reg. § 20.2036-1(b)(3) re: looking to Code § 2038 when applying Code § 2036.

[6674] See fn. 6667.

[6675] See text accompanying fn. 6668.

> limitation apply to a power held by any person which would qualify as an exception under section 674(b)(3) (relating to testamentary powers).

Neither the regulation nor the relevant statutes provide whether "after-born or after-adopted children" refer to children of the grantor or of anyone. For some context, see fn. 6459 in part III.B.1.i Transfers with Contingencies Based on Acts of Independent Significance.

Letter Ruling 9710006 held that the following power to add charities prevented an exception to Code § 674 from applying:[6676]

> Under the terms of TR, during A's lifetime, TT may pay to and among A's descendants and their spouses, A's father, and 4, a charitable organization, such amounts of the income and principal as the TT, in its sole discretion, determines from time to time. In addition, TT may add additional charitable or educational organizations to the class of named beneficiaries to which TR may currently make distributions of income and principal.

Letter Ruling 9304017 held that the following trustee's power to add descendants prevented an exception to Code § 674 from applying:[6677]

> X is a corporation that has elected to be treated as a small business corporation under subchapter S of the Code. A is the beneficiary of Trust A and B is the beneficiary of Trust B. C and D are the parents of A and B. A, B, C, and D are all citizens of the United States. C owns a majority interest in X. C and D are the Grantors of Trust A and Trust B (the Trusts). E is the Trustee of the Trusts. It is represented that E has no direct or indirect interest in the Trusts. It is further represented that the Trusts' principal will consist mainly of X stock.
>
> Section 3.1 of the Trusts' trust agreements (the "Trust Agreements") provides that at any time prior to the death of the last surviving Grantor, the Trustee in his sole discretion may add as a beneficiary any one or more of the Grantors' living descendants. At any time prior to the death of the last surviving Grantor, the Trustee in his sole discretion may remove any beneficiary previously added. Any beneficiary so removed shall have no further interest in the trust estate unless subsequently added as a beneficiary as provided above. The Trustee may at any time irrevocably renounce in writing the power to add or remove beneficiaries, which renunciation will be binding on all successor Trustees.

Suppose the grantor is not a beneficiary of a trust, but someone holding a testamentary power of appointment can make the grantor a beneficiary. Does that trigger Code § 677, if the power holder does not have a beneficial interest adverse to its exercise? Yes, if the power may be exercised only to benefit the grantor.[6678] No, for the broadest possible nongeneral power of

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[6676] Letter Ruling 9709001 appears to be a companion ruling.

[6677] For more analysis of Letter Ruling 9304017, see fn 6618 in part III.B.2.h.i Who Is the Grantor.

[6678] Reg. § 1.672(a)-1(c) provides:

> The interest of an ordinary income beneficiary of a trust may or may not be adverse with respect to the exercise of a power over corpus. Thus, if the income of a trust is payable to A for life, with a power (which is not a general power of appointment) in A to appoint the corpus to the grantor either during his life or by will, A's interest is adverse to the return of the corpus to the grantor during A's life, but is not adverse to a return of the corpus after A's death. In other words, A's

appointment where the power holder is the sole beneficiary to whom distributions may be made currently.[6679] Consider whether the latter should be narrowly construed, in light of Code § 676[6680] or one case decided before the regulations cited in fn. 6679 were promulgated.[6681] In any event, consider whether allowing a power of appointment to be

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> interest is adverse as to ordinary income but is not adverse as to income allocable to corpus. Therefore, assuming no other relevant facts exist, the grantor would not be taxable on the ordinary income of the trust under section 674, 676, or 677, but would be taxable under section 677 on income allocable to corpus (such as capital gains), since it may in the discretion of a nonadverse party be accumulated for future distribution to the grantor. Similarly, the interest of a contingent income beneficiary is adverse to a return of corpus to the grantor before the termination of his interest but not to a return of corpus after the termination of his interest.

[6679] Reg. § 1.674(b)-1(b)(6)(i). First, some context, elaborating on fn. 6668: Reg. § 1.674(b)-1(b)(6)(i) provides:

> Section 674(b)(6) excepts a power which, in general, enables the holder merely to effect a postponement in the time when the ordinary income is enjoyed by a current income beneficiary. Specifically, there is excepted a power to distribute or apply ordinary income to or for a current income beneficiary or to accumulate the income, if the accumulated income must ultimately be payable either:
>
> (a) To the beneficiary from whom it was withheld, his estate, or his appointees (or persons designated by name, as a class, or otherwise as alternate takers in default of appointment) under a power of appointment held by the beneficiary which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate (section 674(b)(6)(A))…

Reg. § 1.674(b)-1(b)(6)(i)(c) includes the following in parentheses:

> [I]f a trust otherwise qualifies for the exception in (a) of this subdivision the trust income will not be considered to be taxable to the grantor under section 677 by reason of the existence of the power of appointment referred to in (a) of this subdivision.

Thus, even though the beneficiary might appoint to the grantor under Reg. § 1.674(b)-1(b)(6)(i)(a), Code § 677(a) does not apply. Note that the parenthetical applies to when the trust has only one income beneficiary. Was the parenthetical merely an aside, or did it intend to create an exception to applying Code § 677? I view it as the former but leave it up to the reader to decide for himself or herself.

[6680] Code § 676(a) treats the grantor as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both. However, Code § 676(b) provides:

> Subsection (a) shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest. But the grantor may be treated as the owner after the occurrence of such event unless the power is relinquished.

Generally, I do not believe that Code § 676 is intended to apply to the broadest possible testamentary power of appointment that might be exercised in favor of the grantor, given that the Code § 674(b)(6)(A) safe harbor for grantor trust treatment, which is described more fully in fns. 6668 and 6679 and was enacted at the same time as Code §676, would be rendered meaningless by that reading.

Note also that Code § 676 was not listed among the grounds for treating the grantor as owner of corpus under Reg. § 1.672(a)-1(c) – see fn. 6678. However, it was among the provisions listed as not causing grantor trust treatment regarding income in that regulation.

[6681] A very prolific and knowledgeable lawyer said that, when grantor trust status is being prevented, he has always prohibited any power of appointment from being exercised in favor of the grantor, the grantor's spouse, any creditor of either, or the estate or the creditor of the estate of either. That lawyer cited broad language *Kaplan v. Commissioner*, 66 F.2d 401 (1st Cir. 1933):

exercised in a way that might benefit the grantor is important enough to risk not being able to turn off grantor trust status. For some trusts, the point might be moot; for example, a trust for the benefit of the grantor's spouse might always be a grantor trust so long as they are married, although one would then need to consider what if they are no longer married.

Relying on a beneficiary being adverse is not as easy as it might appear:

- A beneficiary is adverse to the extent that the beneficiary has "a substantial beneficial interest in a trust which would be adversely affected by the exercise or nonexercise of a power which he possesses respecting the trust."[6682] Merely being a trustee does not constitute a beneficial interest, but holding a general power of appointment does.[6683] A beneficial interest is substantial "if its value in relation to the total value of the property subject to the power is not insignificant."[6684]

- Even if a beneficiary is an adverse party, the beneficiary may be an adverse party only as to part of the income or principal, depending on the beneficial interest.[6685] Thus, if A, B, C, and

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> We think the statute means that if under any circumstances or contingencies any part of the accumulated income might inure to the benefit of the grantor such portion of the income is taxable to him.

However, *Kaplan* involved a reversion, not merely a possibility that a beneficiary might exercise a power of appointment to the grantor:

> Kaplan made a written declaration of trust and transferred to himself as trustee under it certain personal property. By the terms of the instrument, the income of the trust property was to be paid to Kaplan's wife for her life, with a reversion of the beneficial interest to him if he outlived her, and if he did not, then on her death to his children. The declaration also permitted the trustee to accumulate a reasonable portion of the income, the accumulation to be payable at the discretion of the trustee to the person or persons who at the time of payment were entitled to the income of the trust.

The broad language should be read in context of the whole paragraph, under which he served as trustee in this pre-1954 Code case:

> The first point made for the petitioner is that the Kaplan trust is not within the terms of the statute. This depends on whether the expression in the statute may, in the discretion of the grantor of the trust *** be held or accumulated for future distribution to him refers to the accumulation of income which, under certain contingencies, may in the future be paid to the grantor, or to the accumulation of income which must in the future come to the grantor. This provision was intended, as its legislative history clearly shows, as a protection to the government against evasion of income taxes, especially surtaxes, by means of trusts whereby the grantor, although parting with the legal control of the trust property, reserved a practical control over the income of it which could, in point of fact, be exercised for his own benefit. As Kaplan named himself trustee, the large discretion given in the trust instrument to the trustee as to the accumulation and payment of income is attributable to him personally. By the terms of the trust that discretion can be exercised for his own possible benefit, within wide limits. We see no occasion for refinement of construction against the government. We think the statute means that if under any circumstances or contingencies any part of the accumulated income might inure to the benefit of the grantor such portion of the income is taxable to him.

When reading the broad language in the context of the whole paragraph, I do not see that holding as extending to the possibility that a beneficiary might one day make the grantor a beneficiary. Rather, that case involved a grantor who was a remainderman. Ultimately, however, you the reader need to decide yourself whether the broad language troubles you.

[6682] Reg. § 1.672(a)-1(a).
[6683] Reg. § 1.672(a)-1(a).
[6684] Reg. § 1.672(a)-1(a).
[6685] Reg. § 1.672(a)-1(b).

D are equal income beneficiaries of a trust and the grantor can revoke with A's consent, the grantor is treated as the owner of three-fourths of the trust.[6686] Similarly, a beneficiary with only a mandatory income interest is not adverse as to principal passing at his or her death.[6687] Furthermore, a remainderman's interest is adverse to the exercise of any power over the trust's corpus, but not to the exercise of a power over any income interest preceding the remainder.[6688]

- A remote contingent remainder interest is not a substantial adverse interest.[6689]

[6686] Reg. § 1.672(a)-1(b).

[6687] See fn. 6678.

[6688] Reg. § 1.672(a)-1(d). The last sentence of the regulation should be read in light of a 5% interest in Code § 673 replacing the 10-year period referenced in that sentence.

[6689] In *Barker v. Commissioner*, 25 T.C. 1230, 1234 (1956), the taxpayer's parents took only if he died before age 35 leaving no wife or descendants:

> The facts show that the actuarial probability that the trust would be terminated by death of petitioner is negligible - the probability of a male aged 21 attaining the age of 35 being a minimum of 96.85 per cent and a maximum of 97.3968 per cent. Further, petitioner's parents could take down no accumulated income unless petitioner died before reaching the age of 35 and left neither wife nor issue to survive him. He has both a wife and a child. On the facts we hold that petitioner's father and mother had no substantial adverse interest in the trust income.

Similarly, *Chase National Bank v. Commissioner*, 225 F.2d 621 (8th Cir. 1955) said:

> Concerning the contingent interest, it must be borne in mind that during the first taxable year Lenore was over 54 years old, Delos was 29 and Nedra 18. Both children were married. Delos had a child and Nedra had a child the following year. Thus the possibility of either of the beneficiaries and his issue dying before reaching age 35, when the corpus was to be distributed, was somewhat remote. Where the possibility that contingent remaindermen will ever get anything is as remote as it is here, it cannot be considered a benefit amounting to a substantial adverse interest. See *Cushman v. Commissioner*, 2 Cir., 1946, 153 F.2d 510, 513-514; *Joseloff v. Commissioner*, 1947, 8 T.C. 213.

The court continued further below:

> The estate contends that the ruling in the case of *Commissioner of Internal Revenue v. Katz*, 7 Cir., 1943, 139 F.2d 107 necessitates a holding adverse to the respondent. In that case, Meyer Katz created three trusts to provide independent wealth for his children. The trusts could be terminated only by writing of the grantor and his wife, or the child beneficiary after he reached 21 years of age. In the event of the death of a child prior to the termination of the trust, the income was to be distributed to the issue of such child; but in case such child died without issue, the income was to be distributed in equal shares to the grantor's wife and children surviving. Under these facts, it was determined that Mrs. Katz had a substantial adverse interest. In our opinion, the *Katz* case is as close to the nebulous line of demarcation between adverse interests which are substantial and those which are insubstantial as is the case at bar; but on the opposite side of the line. For Lenore to recover a portion of the trust res, either Delos or Nedra, plus his or her child, must have predeceased her; and do it within 6 years or 17 years respectively. Mrs. Katz needed only to survive any one of her children, none of them having issue during the taxable year. Lenore's possibility of benefitting from the trust was far more remote than that of Mrs. Katz. See also *Joseloff v. Commissioner*, *supra*. The *Katz* case is distinguished on the facts.

Of course, all of the above were under the Internal Revenue of 1939. *Holt v. U.S.*, 669 F.Supp. 751 (D. Va. 1987), the grantor of a trust, who had four children, argued that her parents were:

> "adverse parties" within the meaning of the Code because of the provision in Article IX of the trust agreement that the corpus be distributed to them should none of her grandchildren or great-grandchildren survive the termination of the trust at the death of her last child. The question in this case, though, is only whether the income from the trust is taxable to Plaintiffs. The only possible incentive of the Trustees to withhold disbursements of income would be to enhance the

- Does all of this mean that one must measure the likelihood of a person receiving a distribution from the trust (even if eligible), or just the likelihood that a person will become eligible for current distributions (whether or not that eligibility will ever result in a distribution)? If the former, consider that beneficiaries who exercise inter vivos powers of appointment or fail to contest actions changing beneficial interests or diverting trust assets (certain decantings)[6690] often take the position that they never received distributions and that the value of their beneficial interests was zero or approached zero.[6691] The latter might very well be the case, based on fns 2514-2516 in part II.J.3.e.i Strategic State & Local Tax Issues re: Residence, briefly mentioning the idea of an incomplete gift nongrantor (ING) trust; however, I remain uncomfortable relying on that approach absent a private letter ruling issued to the taxpayer taking that position.

Thus, generally one is adverse only if and to the extent that a distribution to another beneficiary would reduce future distributions to that adverse party. The IRS would assert that an adverse party would be making a gift if and to the extent of the present value of those forgone distributions, except to the extent that the distributions to the spouse are pursuant to an ascertainable standard.[6692]

III.B.2.h.vii.(b). Distribution Provisions Benefitting Grantor Causing Grantor Trust Treatment

Generally, the grantor is treated as the owner of any portion of a trust, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse, held or accumulated for future distribution to the grantor or the grantor's spouse, or applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (with certain exceptions regarding charitable life insurance).[6693]

Income is not be considered taxable to the grantor merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed.[6694] That rule applies even though it might have been applied or distributed for other purposes.[6695]

If amounts so applied or distributed toward support obligations are paid out of corpus or out of other than income for the taxable year, such amounts are considered to be distributions to the grantor in the same way as distributions to any other beneficiary.[6696]

---

size of the corpus in which they have an extremely remote contingent interest. This purported interest in the trust income is, in my view, highly questionable and certainly does not constitute a "substantial interest" that would be adversely affected by exercise of the Trustees' power to distribute the income to the beneficiaries, particularly where family members are involved.

[6690] See part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.

[6691] See part III.B.1.c.i Gifts with Consideration – Bargain Sales, text accompanying fns 6365-6368.

[6692] See Reg. § 25.2511-1(g) in the text accompanying fn 2485 in part II.J.2.b **Trust** Provisions Authorizing Distributions.

[6693] Code § 677(a). See part III.B.2.h.viii.(a) Code § 677(a) Generally.

[6694] Code § 677(b).

[6695] Reg. § 1.677(b)-1(a).

[6696] Code § 677(b).

For a custodial account that may be used to discharge the grantor's legal obligation of support, the amount of such income includible in the gross income of a person obligated to support or maintain a minor is limited by the extent of his legal obligations under local law.[6697] To the extent that the account's income is not so includible in the gross income of the person obligated to support or maintain the minor (donee), that income is taxable to the minor.[6698]

III.B.2.h.viii. Code § 677(a) and GRATs

III.B.2.h.viii.(a). Code § 677(a) Generally

Code § 677(a) provides:

> The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be -
>
> (1) distributed to the grantor or the grantor's spouse;
>
> (2) held or accumulated for future distribution to the grantor or the grantor's spouse; or
>
> (3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)).
>
> This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

Reg. § 1.677(a)-1(b)(2) modifies "without the approval or consent of any adverse party" by instead saying "without the approval or consent of any adverse party other than the grantor's spouse." Therefore, a spouse is not an "adverse party."[6699]

[6697] Rev. Rul. 56-484. For possible estate tax issues, see *Exchange Bank & Trust Co. of Fla. v. United States*, 694 F2d 1261 (Fed. Cir. 1982) (which I've been told applied the reciprocal trust doctrine).

[6698] Rev. Rul. 56-484.

[6699] Referring to the 1969 addition of the spouse to Code § 677, *Amabile v. Commissioner*, T.C. Memo. 1986-180 held:

> By that amendment, Congress effectively ruled out the possibility of a spouse being treated as an adverse party when a provision in the trust allows for the income to be used for that spouse's benefit. *Vercio v. Commissioner*, 73 T.C. 1246, 1258 (1980). Section 1.677(a)-1(b)(2), Income Tax Regs., supports this conclusion.

Other than a special rule related to child support,[6700] Code § 677(a) applies if and to the extent that the trust may discharge the grantor's legal obligation.[6701]

For more on Code § 677(a)(3), see part III.B.2.h.v Life Insurance.

The interaction of former Code § 682 (when a spouse becomes separated or divorced), with Code § 677 was somewhat complex.[6702] Reg. § 1.677(a)-1(b)(2) concludes with:

> With respect to the treatment of a grantor as the owner of a portion of a trust solely because its income is, or may be, distributed or held or accumulated for future distributions to a beneficiary who is his spouse or applied to the payment of premiums for insurance on the spouse's life, section 677(a) applies to the income of a trust solely during the period of the marriage of the grantor to a beneficiary. In the case of divorce or separation, see sections 71 and 682 and the regulations thereunder.

Reg. § 1.682(a)-1(a)(1)(i) is quite clear that Code § 682 shifted only so much of the income as is paid, credited, or required to be distributed to the ex-spouse beneficiary. Therefore, the cross-reference to Code § 682 might lead one to believe that Code § 677(a) would apply to the extent that distributions are not made to the ex-spouse, consistent with certain legislation history to the Tax Reform Act of 1969:

> Both versions of the bill provide that in the case of a trust created by a taxpayer for the benefit of his spouse, the trust income which may be used for the benefit of the spouse is to be taxed to the creator of the trust as it is earned. However, this provision is not to apply where another provision of the Code requires the wife to include in her gross income the income from a trust.

However, Reg. § 1.1361-1(k)(1), Example (10), paragraph (ii),[6703] indicates that the more expansive reading of the next-to-the last-sentence of Reg. § 1.677(a)-1(b)(2) applies, so that Code § 677(a) will never tax the grantor on distributions that are accumulated for possible future distribution to the ex-spouse. Note, however, that the next-to-the last-sentence of Reg. § 1.677(a)-1(b)(2) does not apply to a spouse who is separated, so the more limited rules of Reg. § 1.682(a)-1(a)(1)(i) would have applied.

[6700] Code § 677(b), "Obligations of support," provides:

> Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the grantor under section 662.

[6701] Rev. Rul. § 54-516 (before 1954 Code); *Wiles v. Commissioner*, 59 T.C. 289 (1972) (invoking Code § 677), *acq.* 1973-2 C.B. 4, *aff'd* 491 F2d 1406 (5th Cir. 1974) (per curiam).

[6702] See part III.B.2.h.ix Code § 682 Limitations on Grantor Trust Treatment (Repealed for Post-2018 Divorces).

[6703] Reproduced in fn 5973 in part III.A.3.e.i.(a) QSSTs Generally.

III.B.2.h.viii.(b). GRATs as Grantor Trusts

GRATs are described in parts III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust and III.B.7.d Code § 2702 Overview.

The very significant annuity payments the grantor receives makes a GRAT a grantor trust under Code § 677(a)(1) in whole or in part, depending on how the payments relate to the GRAT's taxable income. To try to nail down grantor trust treatment, I tend to use the powers described in one or both of parts III.B.2.h.iii Swap Power or III.B.2.h.iv Borrow Power. Nailing down grantor trust treatment also eliminates any uncertainty as to whether satisfying the annuity in kind, during the grace period after the date for final payment, is a taxable event. It also helps protect the GRAT's eligibility to hold stock in an S corporation, although I prefer also making an ESBT election, all as described in part III.A.3.a Wholly Owned Grantor Trusts – How to Qualify, Risks, and Protective Measures.

Because the grantor cannot turn off grantor trust treatment during the annuity term, consider whether the grantor should be a mandatory or discretionary distributee of income in excess of the annuity amount.[6704]

Letter Ruling 9449013[6705] recognized as a grantor trust seven GRATs without any back-up grantor trust clauses. The only clause upon which it relied provided that "the payment of the annuity installment shall be made from the income and, to the extent that income is not sufficient, the principal of the trust" and directed the trustee to "accumulate any net income not so paid and add it to the principal of the trust." (Contrary to the latter, I prefer to direct the trustee not to accumulated any unpaid income and not to add it to principal until after the final annuity payment has been satisfied.) It concluded:

> The grantor is the owner of the trust under section 677(a) because article I(B) provides that the annuity installment is to be paid from income and, to the extent income is not sufficient, from principal. Therefore, the grantor will be considered the owner of the entire trust for purposes of section 671 until the earlier of the grantor's death or the termination of the trust….
>
> In accordance with the principle set forth in Rev. Rul. 85-13, we conclude that neither the grantors nor the trusts will recognize any gain or loss as a result of the grantor's transfer of shares of Company stock to fund the trusts, or as the result of the transfer from a trust to a grantor in payment of an annuity, or as the result of the substitution by the grantor of cash or other property for shares of stock.

Letter Ruling 9504021 also recognized as a grantor trust a GRAT without any back-up grantor trust clauses.

Letter Ruling 9451056 treated a GRAT as a grantor trust under Code § 677 "because the income of each trust may be distributed to the respective trust grantor during the annuity period." However, in addition to annuity payments:[6706]

[6704] See part III.B.2.h.vi Protecting the Grantor, especially fn. 6655.

[6705] Letter Rulings 9449012 and 9448018 contained similar terms, the latter also ruling that the trust qualified as an S corporation shareholder as a wholly-owned grantor trust.

[6706] The trust also included a swap power, but the ruling did not mention that when concluding that the trust was a grantor trust.

> For any year in which the grantor is considered the owner of the trust for federal income tax purposes, the trustees shall distribute to the grantor, in addition to the annuity amount, an amount equal to the excess of the grantor's personal income tax liability (as owner of the trust) over the grantor's personal income tax liability computed as if the grantor were not treated as the owner of the trust.

Letter Rulings 200001013 and 200001015 treated the following GRAT as grantor trusts:

> Under the terms of the Trust, Taxpayer will receive an annuity payable first from income, and to the extent accumulated income is insufficient, from principal. In addition, during the Trust term, the trustee (a nonadverse party) will have the sole discretion to pay the Taxpayer all of the Trust's net income (if there is any remaining after payment of the annuity). Therefore, under section 677, Taxpayer will be treated as the owner of the income portion of the Trust during the Trust term. Additionally, capital gains are accumulated and added to corpus and Taxpayer has a general testamentary power exercisable only by will to appoint the accumulated amounts. Therefore, under section 674(a), Taxpayer will be treated as the owner of the corpus portion of the Trust during the Trust term. Accordingly, Taxpayer will be treated as the owner of the Trust for purposes of section 671 during the Trust term.

III.B.2.h.ix. Code § 682 Limitations on Grantor Trust Treatment (Repealed for Post-2018 Divorces)

Code § 682 overrides grantor trust treatment to the extent that distributions are made or are required to be made to a divorced or legally separated spouse and treats that recipient as a beneficiary. Except to the extent that distributions constitute Code § 71 alimony, distributions are taxed under the usual rules governing distributions to beneficiaries under part II.J.1 Trust's Income Less Deductions and Exemptions Is Split Between Trust and Beneficiaries.[6707]

Code § 682 has been repealed effective for divorces after December 31, 2018. See Notice 2018-37.

[6707] Reg. § 1.682(a)-1(a)(2) provides:

> If section 71 applies, it requires inclusion in the wife's income of the full amount of periodic payments received attributable to property in trust (whether or not out of trust income), while, if section 71 does not apply, section 682(a) requires amounts paid, credited, or required to be distributed to her to be included only to the extent they are includible in the taxable income of a trust beneficiary under subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code.

Letter Ruling 9235032 applies these rules to determining whether the recipient is taxed on capital gains, pointing to the rules described in part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI):

> In this case, the trustee is required under the governing instrument to allocate net capital gains to income when paying the annual annuity amount to A. That allocation is permitted under local law….
>
> The taxable income of the trust and of A will be determined in accordance with subchapter J of the Code, including, in particular, sections 682 and 662 of the Code, relating to amounts includible in the gross income of A and of the trust, and section 661, relating to the trust's deduction of amounts distributed to A as an annuity interest, limited by the trust's distributable net income. For purposes of section 661, the trust's distributable net income, determined under section 643, will include net capital gains to the extent required to be distributed to satisfy the annuity amount.

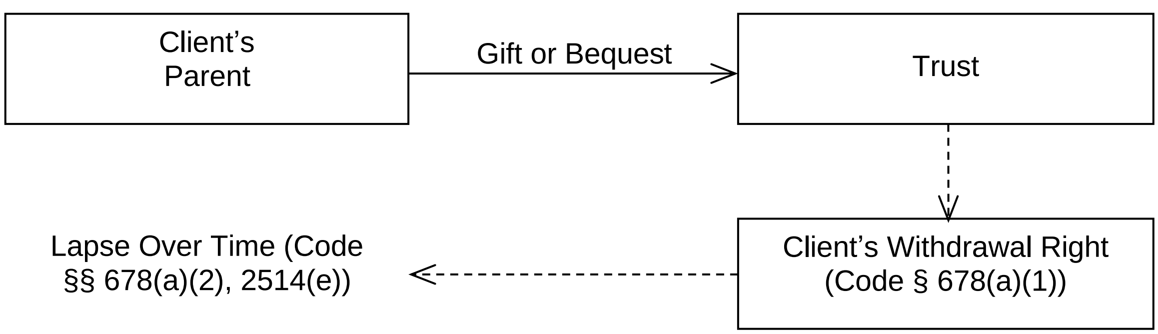
Note, however, that grantor trust provisions other than Code § 677 may trigger grantor trust treatment; see Letter Ruling 200408015 (swap power caused grantor trust treatment regarding capital gains that were not distributed to the ex-spouse).[6708]

III.B.2.i. Code § 678 Beneficiary Deemed-Owned Trusts

For a one-hour oral presentation of various issues in this part III.B.2.i, go to my CPA Academy instructor page and find the most recent version of "Beneficiary Deemed-Owned Trusts." For related applications of the planning described in this part III.B.2.i, see Morrow, "IRC Section 678 and the Beneficiary Deemed Owner Trust (BDOT)" (5/6/2018, last revised 4/22/2021), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3165592.

Under certain circumstances, Code § 678 treats a beneficiary as the owner of part or all of a trust for income tax purposes to the extent that the grantor is not treated as the deemed owner. As to the latter, see part III.B.2.h.i Who Is the Grantor. Treating the beneficiary as the owner of all of a trust for income tax purposes not only allows the beneficiary to bypass high fiduciary income tax rates but also to sell assets to the trust. For more details about fiduciary income tax rates and the effect of the trust being deemed owned by a beneficiary, see parts II.J.3 Strategic Fiduciary Income Tax Planning and III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment, the latter which includes the fact that not all states recognize federal grantor trust rules.

In most cases, the beneficiary needs to have a withdrawal right. See part III.B.2.i.iii Can a Trust Without a Withdrawal Right Be a Code § 678 Trust? If the goal is to have part or all of the trust excluded from the beneficiary's estate for estate tax purposes, the trust is often structured as set forth below:



While the beneficiary holds a withdrawal right, Code § 678(a)(1) treats the beneficiary as the owner of whatever the beneficiary can withdraw.

Code § 678(a)(2) is somewhat more challenging. It treats the beneficiary as the owner if "such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof." Whether the lapse of a withdrawal right constitutes a partial release or other modification is unclear; however, numerous private letter rulings have said it does. One way to fit within its literal language is in part III.B.2.i.x Letter Ruling 200949012. Because the IRS generally has stopped issuing private

[6708] Letter Ruling 200408015 is discussed further in fn. 7398, found in part III.B.7.d Code § 2702 Overview.

letter rulings on Code § 678(a)(2), I recommend that the trust obtain its own taxpayer ID and file annual fiduciary income tax returns with grantor information statements. See part III.B.2.i.xii Dealing with Code § 678(a)(2) Uncertainty.

If the beneficiary allows a withdrawal right to lapse, the beneficiary has made a gift to the extent of the greater of $5,000 or 5% of the value of the assets out of which the withdrawal right could have been satisfied; see part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary. The most straightforward way to create a trust deemed 100% owned by a beneficiary where the withdrawal right's lapse keeps the whole trust out of the beneficiary's estate is for the grantor give up to $5,000, which the trusts places in a non-interest-bearing account for perhaps 30 days, then the withdrawal right lapses in full; see part III.B.2.i.i Designing Trust Wholly Owned by Beneficiary from Inception. As described in part III.B.2.i.vi Funding the Trust with Small Gifts: Ideally, the trust would invest in a business that does not require much capital or borrow at the AFR (most likely from a related party) to invest in that business. If the grantor is the beneficiary's parent, that parent might bequeath to an identical larger (even if not huge) trust for the beneficiary that could then guarantee loans made to the small trust, because the trustee has a fiduciary duty to promote transactions that build assets in an identical fiduciary arrangement.

Once the original trust grows or has a companion trust guarantor, the beneficiary might sell the beneficiary's S corporation or partnership (LLC) to the original trust in exchange for a note. See parts III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust and III.B.2.i.v Sale to a Beneficiary Deemed-Owned Trust – When a Traditional Sale to an Irrevocable Grantor Trust Does Not Meet the Client's Objectives. The most vocal proponent of a sale calls it a Beneficiary Defective Inheritor's Trust (BDIT), but he tends to use thinly-funded trusts and relies on guarantees motivated by guarantee fees, which I sometimes do, but only when I am not given enough time to plan it the way described above. Nevertheless, our trust designs are very similar, and here is mine: the beneficiary is the trustee, can distribute to himself using ascertainable standards, and has the broadest possible nongeneral inter vivos and testamentary powers of appointment; and an independent person may make distributions for the beneficiary's welfare. The latter is important not only for flexibility but also to pay the beneficiary's income tax because, after the grantor dies, the beneficiary cannot turn off the beneficiary's deemed ownership of the trust for income tax purposes. See part III.B.2.i.i Designing Trust Wholly Owned by Beneficiary from Inception.

Although BDOT would be the most logical name for a beneficiary deemed-owned trust, most people use BDOT to describe when the beneficiary has the right to withdraw the taxable income. Part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary:

- Describes how a trustee can use distribution authority to "credit" a distribution to a beneficiary, which is treated as making a distribution for that year and setting up BDOT status for future years to the extent that the beneficiary does not withdraw the credited amount.

- Includes language creating a BDOT, which may either be included when drafting the trust or integrated through a trustee's distribution authority or by a trust modification.

If a trust can withdraw from another trust, see part II.D.3 Trust as Grantor or Deemed Owner of Another Trust.

When the beneficiary has the right to withdraw the entire trust funding, which is no more than $5,000, and that withdrawal right lapses before the trust funding is able to grow (generally around 30 days, plus or minus), the trust is often referred to as a BDIT, a term coined by its most ardent proponent[6709] (although not one I would have chosen personally).[6710]

If the beneficiary has the right to withdraw all of a significantly larger initial gift, consider part III.B.2.i.viii Funding the Trust with a Large Initial Gift or Bequest.

If one wants to make the beneficiary the deemed owner of the entire trust at all times and the trust is not a BDIT, please study part III.B.2.i.vii Portion Owned When a Gift Over $5,000 is Made, especially part III.B.2.i.vii.(a) Determining Portion Owned When a Withdrawal Right Does Not Lapse in Full Before Any Income Is Earned.

One may easily make a trust be entirely owned by a beneficiary without using withdrawal rights, but planning up front for distribution to more than one remainderman upon termination may require more complexity than at first imagined; see part III.B.2.i.xiv QSST as an Alternative Form of Beneficiary Deemed-Owned trust.

III.B.2.i.i. Designing Trust Wholly Owned by Beneficiary from Inception

Structure described in this part:

Beneficiary's powers:

- Trustee – may distribute for own support and support of descendants; may invest in any manner that does not trigger estate tax issues (insurance on the trustee's life being an example); may totally re-write who serves as trustee. However, if the beneficiary lives in (or might move to) a creditor-friendly state, then the beneficiary should not serve as trustee or have the right to remove and replace the trustee.[6711]

[6709] "The Beneficiary Defective Inheritor's Trust (BDIT): Finessing the Pipe Dream," www.oshins.com/images/BDIT_article.pdf. See Blattmachr and Zaritsky, "Is the BDIT Ready for Primetime?" *Probate Practice Reporter* (University of South Carolina School of Law, ISBN 1044-7423), Sept. 2012.

[6710] In using this term, I am acceding to popular use. Generally I would avoid naming an estate planning tool after a Michael Jackson song: https://www.youtube.com/watch?v=kOn-HdEg6AQ.

[6711] Part III.B.2.i.ix Creditor and Gift/Estate Tax Issues Regarding Withdrawal Rights, Whether Currently Exercisable or Lapsed, points out that not all states clearly protect from creditors a beneficiary who allowed a withdrawal right to lapse. Conflict of laws issues might arise if the trust is established in a state that provides such protection and the trustee or trust's assets are in a state that does not. If a court in a creditor-friendly state cannot obtain jurisdiction over the trustee or over the trust's assets, then the rules of the protective state would tend to prevail. *Hanson v. Denckla*, 357 U.S. 235 (1958); see part III.B.2.i.xLetter Ruling 200949012 in part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts. Suppose, however, that a court in a creditor-friendly state obtains jurisdiction over the trustee or trust's assets and wants to apply that state's laws. New York has done so in a conflict-of-laws situation and allowed the creditor to reach the assets.

- Power to restructure who serves as independent trustee should a vacancy in that position occur;[6712] may not name a person who is a related or subordinate party with respect to the beneficiary.[6713]

[6712] Consider the possibility that a court might order a beneficiary to remove the independent trustee and replace it with one that would be likely to distribute assets or that is subject to the court's jurisdiction. The latter might threaten the trust's spendthrift status. See note 6711. Limiting the beneficiary's power to one of replacement rather than removal-and-replacement might avoid that problem. Another feature might be to grant the power to remove the independent trustee to a person who lives (and will always live) in a protective state who can remove the independent trustee, triggering the beneficiary's right to replace the independent trustee; if a court in a creditor-friendly state never obtains jurisdiction over this person, this power should not be problematic.

[6713] Reg. § 20.2041-1(b)(1) provides:

> A power in a donee to remove or discharge a trustee and appoint himself may be a power of appointment. For example, if under the terms of a trust instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and the decedent has the unrestricted power to remove or discharge the trustee at any time and appoint any other person including himself, the decedent is considered as having a power of appointment. However, the decedent is not considered to have a power of appointment if he only had the power to appoint a successor, including himself, under limited conditions which did not exist at the time of his death, without an accompanying unrestricted power of removal.

Do the restrictions of Rev. Rul. 95-58 suffice to prevent the power to appoint a trustee from being a general power of appointment under the above regulation? The following Letter Rulings applied Rev. Rul. 95-58 and held that certain rights did not cause inclusion as a general power of appointment under Code § 2041: 9607008 (right to remove a corporate trustee and replace it with a corporate trustee that was not a related or subordinate party), 200229013 (beneficiaries were not imputed powers of family trust company where beneficiaries renounced their right, directly or indirectly, to participate as a trustee, or in any other capacity, in any decisions regarding discretionary distribution and members of distributions committee could not include any related or subordinate party), 200533008 (right to remove a corporate trustee and replace it with a corporate trustee that was not a related or subordinate party), 200734010 (right to replace a resigned corporate trustee with a corporate trustee that was not a related or subordinate party), 201207001 (power to remove distribution trustee and replace with a party that is not a related or subordinate party), 201209003 (power to fill vacancy with beneficiary's spouse's business partners who were not related or subordinate to beneficiary), 201345004 (power to remove distribution trustee and replace with a person that is not a related or subordinate party did not implicate Code § 2041 or 2514), the apparently related 201345026, 201345027, 201345028, 201432005, and 201433006 (same), 201434004 (same), 201434005, 201436003 (same), 201634016, 201634017, 201641020 (power to fill vacancy with a person that is not a related or subordinate party is not the equivalent of the power referred to in the examples in Reg. §§ 20.2041-1(b)(1) and 25.2514-1(b)(1) where an individual may remove a trustee and appoint himself), 201647001 (power to remove and replace the trustee with person that is not a related or subordinate party did not implicate Code § 2036, 2038, 2041 or 2514), 201702016, 201702017 and 201702018 (power to remove and replace the trustee with person that is not a related or subordinate party did not implicate Code § 2041 or 2514 or have any GST implications), and 202152006 (inserting protective language to avoid a general power of appointment and make a reverse QTIP election; see fn 2007 in part II.H.2.a Free Basis Step-Up When First Spouse Dies). I have been told (but have not verified) that Letter Rulings 9735023, 9746007, 200031008, and 200533010 had a similar result. However, an asset protection case, *SEC v. Wyly*, 2014 WL 4792229 (S.D.N.Y. 9/25/2014), held that the grantors' control over the independent trustees was so powerful that they essentially held the distribution powers themselves, undermining Code § 674(c) (and perhaps the estate tax premise of these Letter Rulings). Also, for Code § 678 income tax cases where an ascertainable standard was ignored by the parties and therefore also ignored by the court, see fns 6746-6747 and the accompanying text in part III.B.2.i.iii Can a Trust Without a Withdrawal Right Be a Code § 678 Trust?.

- Broad inter vivos limited power of appointment.
- Broad testamentary limited power of appointment.
- However, generally I do not grant the beneficiary a power of appointment over 10%-100% to avoid a sale being an incomplete gift, and one might consider a gift to that nonappointive portion that applies regardless of audit. See part III.B.4 Adequate Disclosure on Gift Tax Returns, especially text accompanying fns 7061-7061.

Independent Trustee:

- May distribute for welfare.[6714]
- Holds any other tax-sensitive powers.

If and to the extent anyone other the primary beneficiary may receive distributions during the grantor's life, be careful to avoid inadvertently making the grantor the deemed owner under Code § 674,[6715] because the grantor as deemed owner supersedes the beneficiary as the deemed owner.[6716]

The independent trustee holds any insurance on the beneficiary's life if life insurance is purchased and has sole authority over any tax-sensitive powers. Furthermore, the beneficiary has the power to remove the independent trustee and appoint an individual or corporate successor trustee that is not related or subordinate to the beneficiary (within the meaning of section Code § 672(c)). I do not necessarily grant the power to remove the independent trustee, because the authority upon which this is based does not expressly extend to general powers of appointment and holding life insurance; however, one might very well be able to obtain a private letter ruling that extends to general powers of appointment and holding life insurance or decide that one is sufficiently comfortable with prior letter rulings as nonprecedential technical authority.[6717]

In *First National Bank of Denver v. United States*, 648 F.2d 1286 (10th Cir. 1981), the parties assumed that the beneficiary's right to remove and replace a corporate trustee, that could make distributions beyond an ascertainable standard, with another corporate trustee did not constitute a general power of appointment. The only argument was whether the beneficiary was required to appoint another corporate trustee, which the taxpayer proved to be the case. *Estate of Wilson v. Commissioner*, T.C. Memo. 1992-479, citing the above case favorably, found that a surviving spouse had a general power of appointment when she was authorized to appoint herself as sole trustee and terminate the trust, thereby qualifying the trust as a general power of appointment marital deduction trust.

[6714] Because the beneficiary will always be the deemed owner with no possibility of turning off that deemed ownership, authorizing distributions to reimburse taxes (or using a broader standard) is quite important. See Rev. Rul. 2004-64, which is discussed further in fns. 6961-6980, found in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner. The first sentence in this footnote exaggerates a little – if the grantor is living, the trust could be turned into being deemed owned by the grantor, terminating beneficiary deemed ownership, and then later the grantor trust powers might be toggled off.

[6715] See part III.B.2.h.vii Distribution Provisions Might Prevent Turning Off Grantor Trust Status.

[6716] Code § 678(b).

[6717] The right to remove and replace a trustee with such a trustee was discussed in Rev. Rul. 95-58. See part III.C.3 Safe Harbor re Right to Change Trustee - Rev. Rul. 95-58.

III.B.2.i.ii. Building Up Trust Wholly Owned by Beneficiary from Inception

An irrevocable trust treated as owned by the beneficiary for income tax purposes but not for estate tax purposes – can be a very useful tool. For example, your client owns a business that is expanding. Her mother creates a beneficiary deemed-owned trust, making a $5,000 gift. The trust forms a limited liability company (LLC). The LLC makes a deal with the business – the LLC builds the building, and the business will rent the building from the LLC. The LLC takes the lease to a lender and obtains financing for the purchase of land and construction of the building. Over time, the LLC uses the rental income to pay down the mortgage, acquiring equity in the building. When the mortgage is retired, the trust continues receiving rental income and gaining equity. The annual income taxes the beneficiary pays reduces the beneficiary's estate. Eventually the beneficiary might get to the point where her other assets are depleted, so that her estate is reduced to the estate tax applicable exclusion amount. She can then live off the trust comfortably, without having a conflict between having plenty of retirement income and avoiding estate tax, because her primary source of income – the trust – is outside of the estate tax system.

Generally, beneficiary deemed-owned trusts are formed as follows: the grantor establishes an irrevocable trust for the benefit of one of the grantor's children ("the beneficiary"). The grantor is the client's parent or another person who is not in a business relationship with the beneficiary[6718] sets up a beneficiary deemed-owned trust. The beneficiary has a withdrawal right over gifts to the trust, which withdrawal right lapses to the greatest extent allowable without the lapse constituting a gift.[6719] The trust is irrevocable and is structured so that the only assets included in the beneficiary's estate are unlapsed withdrawal rights. The grantor allocates GST exemption to the trust. The trust can then pass from generation to generation outside of the estate tax system.

I strongly recommend not depositing the gift into an interest-bearing account and not entering into any transactions with the trust between the date of funding and the date of the lapse. For my reasons, see part III.B.2.i.vii.(a) Determining Portion Owned When a Withdrawal Right Does Not Lapse in Full Before Any Income Is Earned.

The beneficiary is taxed as the owner[6720] of the portion that beneficiary can withdraw.[6721] As described further below, the trust is drafted so that the grantor is not taxed as the owner for

[6718] If a business associate of the beneficiary sets up the trust, the transfer to trust might be deemed a payment to the beneficiary, followed by a gift from the beneficiary to the trust. See, *e.g.*, Reg. §§ 1.61-22(c)(2)(ii), 1.83-6(d)(1).

[6719] Code § 2514(e) provides that the lapse of a withdrawal right does not constitute a gift to the extent that the lapse does not exceed the greater of $5,000 or 5% of the trust's assets. Because the $5,000 limit applies to all lapses during the year with respect to the holder of the withdrawal right, and coordination between irrevocable trusts often is cumbersome or impractical, when drafting it's usually best when describing the lapse to refer either to Code § 2514 or a lapse of 5% without mentioning the $5,000 amount. For more details on calculating the 5% lapse, see part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary.

[6720] However, Beneficiary is not treated as the grantor for income tax purposes. Reg. § 1.671-2(e)(6), Example (4). This rule is necessary for Code § 678(b) work.

[6721] Code § 678(a)(1) provides, "A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself." This includes an unlimited withdrawal rights, Rev. Rul. 85-45 (Code § 121 exclusion for gain on sale of residence applied to beneficiary), and applies even to a income tax purposes[6722] and so that, if the beneficiary had been the settlor, the beneficiary would have been taxed as the owner for income tax purposes.[6723] Thus, the beneficiary is treated as the owner of the trust for income tax purposes - many private letter rulings have held that Code § 678(a)(2) taxes the beneficiary after a withdrawal right lapses, even though the statute requires that the beneficiary "partially released or otherwise modified" the withdrawal right.[6724] The deemed owner is treated as the owner of the income for tax purposes, whether that income is allocated to trust accounting income or principal (such as capital gain).[6725]

This withdrawal right must apply to all property transferred to the trust. Otherwise, only the portion subject to the initial withdrawal right will be taxed to the beneficiary.[6726] Partial withdrawal rights generate partial deemed ownership,[6727] so that any future sale to the trust will

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beneficiary who lacks legal capacity to exercise the power, Rev. Rul. 81-6. In *Campbell v. Commissioner*, T.C. Memo. 1979-495, the right to withdraw capital gains taxed the beneficiary on the trust's capital gains, even though the beneficiary did not exercise the withdrawal right.

[6722] See text following fn 6733.

[6723] Code § 678(a)(2) provides, A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which… person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

[6724] In The Year in Review: An Estate Planner's Perspective on Recent Tax Developments, *TM Estates, Gifts and Trusts Journal* (BNA) (1/13/2011), Howard Zaritsky commented [dates of PLRs excised below]:

> The IRS never explains this, but always treats the lapse of the withdrawal right as a modification or partial release. See PLRs 201039010; 200747002; 200147044; 200104005; 200022035; 200011058, 200011054–200011056; 199942037; 199935046–199935047; 9812006; 9810006–9810008; 9810004; 9809005–9809008; 9745010; 9739026; 9625031; 9535047; 9504024; 9450014; 9448018; 9320018; 9311021; 9226037; 9140047; 9034004; 9009010; 8936031; 8827023; 8805032; 8701007; 8613054; 8521060; 8342088. See also Blattmachr, Gans & Lo, A Beneficiary as Trust Owner: Decoding § 678, 35 *ACTEC J.* 106, 114–117 (Fall 2009).

[6725] Reg. § 1.671-3(b)(3).

[6726] Reg. § 1.671-3(a)(3). For more on Reg. § 1.671-3(a)(3), see part III.B.2.i.vii.(a) Determining Portion Owned When a Withdrawal Right Does Not Lapse in Full Before Any Income Is Earned.

[6727] Letter Ruling 9034004 involved a trust in which the beneficiary, A, received mandatory income distributions and had the noncumulative annual right to withdraw the greater of $5,000 or 5% of the trust's principal at the end of the year. For 11 years, A never exercised her withdrawal right, but the trustee did exercise his discretionary power to the trust corpus. The trustee made substantial discretionary distributions of corpus to A over the years, depleting the trust to the point that only a single piece of real estate remained. That asset was sold at a gain, and the trustee requested a ruling concerning the portion of any gain that A must report as a result of a series of lapses of her withdrawal right. Based on Reg. § 1.671-3(a)(3) and Rev. Rul. 67-241, the IRS ruled that, when A failed to exercise her withdrawal right, she would be treated as if she partially released a power to withdraw a portion of the trust corpus under Code § 678(a)(2). Because the income of that portion will be paid to A, she would be treated as the owner of that portion of the trust under Code §§ 677 and 678. During each succeeding year in which A failed to exercise her power, A was treated as the owner of an increasing portion of corpus of T. Each year, she was treated as owning an additional portion of corpus, multiplying the amount which she could withdraw by a fraction, the numerator of which is the portion of trust corpus which she is not already treated as owning, and the denominator of which is the total of trust corpus from which the withdrawal could be made. Discretionary distributions made by the trustee from corpus would be treated as coming from both the portion of corpus which A is treated as owning and from the portion which she is not treated as owning, in the same ratio as the fraction mentioned above.

For more on Reg. § 1.671-3(a)(3), see part III.B.2.i.vii.(a) Determining Portion Owned When a Withdrawal Right Does Not Lapse in Full Before Any Income Is Earned.

Letter Rulings 200022035 and 200104005 had similar facts and the same result.

be recognized to the extent of the part that is not deemed to be owned by the beneficiary. At least one commentator is concerned that, under the literal language of certain regulations, a lapse of the entire withdrawal right might not suffice and that those who do not obtain a private letter ruling on this issue do so at their own risk.[6728]

As mentioned above, the trust is drafted so that, if the beneficiary had been the settlor, the beneficiary would have been taxed as the owner for income tax purposes. The primary approach I use relies on Code § 678(a)(2) with Code § 677(a); combined, these sections

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Letter Rulings 8035067, 8308033 and 8326074 mentioned Reg. § 1.671-3(a)(3) and Rev. Rul. 67-241 in connection with withdrawal rights but not say how to apply them.
Letter Ruling 8142061 involved a trust in which the beneficiary, N, had the right to withdraw the first $6,000 of gifts made to a trust each year. N would eventually receive all of the trust's assets by the time he attained age 35. Using language similar to (but mote explicit than) Letter Ruling 7852042, the IRS said (emphasis added), Therefore, until his power is exercised, released or allowed to lapse, N will be treated as the owner of **each item of income**, deduction and credit (including ordinary income items and items allocable to corpus, such as capital gains) **which is attributable to any new property which is transferred by gift to the trust** (subject to the $6,000 limitation contained in the trust agreement). Furthermore, the IRS pointed out that, if N fails to his withdrawal right over a gift to the trust, it will become a permanent part of the corpus of the trust. Because the income of that portion may be distributed to N or accumulated for future distribution to N, N will be treated as the owner of that portion of the trust (subject to the $6,000 limitation contained in the trust agreement), citing Code § 677.
LaFargue, notes 6729-6730, applied Reg. § 1.671-3(a)(3) to tax a grantor (who the trust did not designate as a beneficiary) on the trust's income to the extent that the grantor received annuity payments, so that case does not shed any light.
In *Scheft v. Commissioner*, 59 T.C. 428 (1972), the grantor was deemed to own all of the trust but tried to use a fiscal year vs. calendar year argument to say that Reg. § 1.671-3(a)(3) caused some ambiguity in calculations, but the court held that this argument did not change the fact that all of the trust's income and principal could be accumulated for the grantor's benefit. *Garvey v. Commissioner*, T.C. Memo. 1986-200, rejected the need for Reg. § 1.671-3(a)(3) for similar reasons and taxed the whole trust to the grantor.
Letter Ruling 201038004 is one of the most recent rulings about trusts deemed partially owned by beneficiaries. Thus, it does not help in the area of sales to irrevocable grantor trusts, although it helps focus on some issues. The IRS ruled that a beneficiary with the right to withdraw income would be taxable on the income under Code § 678. Any undistributed income, which was not yet added to principal, would be includible in the beneficiary's estate as a general power of appointment. Any income that had been added to principal and constituted a lapse in excess of the greater of $5,000 or 5% of the trust's assets would be includible in the beneficiary's estate under Code § 2036, since the beneficiary was deemed to have transferred that part of the accumulated income and also retained the right to the income in that transferred property. The ruling did not address whether any capital gains later realized on the principal that constituted accumulated income would be taxable to the beneficiary under Code § 678(a)(2). The ruling did not address the gift tax consequences of the lapse, which presumably would be an incomplete gift because of the beneficiary's retained general power of appointment.
Consider instead giving the beneficiary a hanging power so that the power can lapse in a way that does not make any of the lapsed income includible in the beneficiary's estate. That might help not only for estate tax purposes but also for protection from future creditors. This structure has the advantage of allowing the trust's income to be accumulated income tax-free (to the trust, since the beneficiary is taxable personally on the income), with only the excess income, if any, being included in the beneficiary's estate. Given that income yields tend to be significantly lower than 5%, perhaps none of the accumulated income will ever be included in the beneficiary's estate. On the other hand, significant income tax benefits might be lost to the family as a whole. Trustee fees would be fully deductible if this were a nongrantor trust. Trustee fees attributable to the grantor trust portion would be deductible, if at all, as miscellaneous itemized deductions subject to the 2% floor and also disallowed for purposes of the alternative minimum tax.
[6728] See Zaritsky, ¶ 4.08[3][l][i] Beneficiary ownership of the trust, *Tax Planning for Family Wealth Transfers: Analysis With Forms (*WG&L).

provide that the beneficiary shall be treated as the owner of any portion of a trust, whose income without the approval or consent of any adverse party is, or, in the discretion of the beneficiary or a nonadverse party, or both, may be distributed to the beneficiary or held or accumulated for future distribution to the beneficiary. It has been suggested that a line of cases limits the application of Code § 677.[6729] I disagree with this suggestion[6730] but recommend that those who plan sales to beneficiary deemed-owned trusts consider these cases not only for that issue but also to get a flavor for how courts might respond to such sales. Also consider granting the beneficiary the power to borrow from the trust at the AFR but without adequate security, which will make the beneficiary and not the grantor the owner under a combination of Code § 678(a)(2) and 675(2).

The beneficiary can be the only beneficiary of the trust, which provides more financial security (but perhaps more risk if a creditor with a claim sympathetic to a judge brings a case against the trust), but it also precludes using the trust to help the beneficiary's descendants, so whether to authorize distributions to the beneficiary's descendants depends on the circumstances. Making the beneficiary the sole person to whom distributions can be made simplifies testing under the grantor trust rules, particularly when the beneficiary has an inter vivos power of appointment.[6731]

Many letter rulings requested that the beneficiary be treated as the sole owner of the trust under the grantor trust rules so that the trust could qualify as a shareholder in an S corporation.[6732]

To create instantly a large trust to buy a married beneficiary's business, see part III.B.2.i.xv Sale to Trust Created by Spouse: An Alternative Way to Have a Trust Benefitting Client.

[6729] *Lazarus v. Commissioner*, 58 T.C. 854 (1972), *acq*. 1973-2 C.B. 1, *aff'd*, 513 F.2d 824 (9th Cir. 1975); *LaFargue v. Commissioner*, 73 T.C. 40 (1979), *aff'd in part, rev'd and rem'd in part*, 689 F.2d 845 (9th Cir. 1982), *on remand*, T.C. Memo. 1985-90, *aff'd*, 800 F.2d 936 (9th Cir. 1986); and *Stern v. Commissioner*, 77 T.C. 614 (1981), *rev'd and rem'd*, 747 F.2d 555 (9th Cir. 1984).

[6730] In *Lazarus* and *LaFargue*, fn. 6729, the grantor was not a named beneficiary of the trust. The Tax Court taxed the grantor on the income of retained annuities because it treated the grantor as the settlor and the annuity payments were all that the grantor could receive. The court expected that the grantor would be fully taxed on all of the income as the grantor received it from the trust; presumably the court thought it was fairer to tax the grantor each year when the grantor received the annuity to better match cash received with income reported. I don't view those cases as limiting the application of Code § 677. In *Stern*, however, the person who sold property to the trust in exchange for an annuity was a beneficiary of the trust. The Tax Court held that he was the settlor (because the sale for the annuity was really a transfer with a retained interest) and that the income was fully taxable to him under Code § 677. The Ninth Circuit reversed, respecting the sale for the annuity. The settlor of each trust involved was either a business associate (who received no benefit other than the prospect of future business) or a family member; the seller was not the settlor (except allegedly with respect to the annuity sale, which the Ninth Circuit rejected). Implicitly, Code § 677 could not apply because the seller, who was also the beneficiary, was not the grantor.

[6731] A power to add beneficiaries can cause Code § 674 to apply – by preventing the exceptions to Code § 674(a) from applying. However, when the sole beneficiary can add beneficiaries, that power does not prevent the exceptions to Code § 674(a) from applying. Reg. § 1.674(d)-2(b).

[6732] Code § 1361(c)(2)(A)(i) authorizes as a shareholder of an S corporation a trust all of which is treated under the grantor trust rules as owned by an individual who is a United States citizen or resident. Code § 1361(c)(2)(A)(ii) authorizes such a trust to continue to hold S corporation stock for the 2-year period beginning on the day of the deemed owner's death. For a discussion of rulings treating trusts as grantor trusts so that they can hold S corporation stock, see Christian & Grant, ¶ 8.02[2] Grantor Trusts, *Subchapter S Taxation* (WG&L).

The trust must be drafted so that the grantor is not taxed as the owner for income tax purposes.[6733] If the grantor is taxed as the owner under other provisions of the grantor trust rules, then the beneficiary is not taxed as the owner to the extent provided in Code § 678(b). Even if the beneficiary is the deemed owner of the trust under Code § 678, the settlor continues to be the grantor for income tax purposes until the beneficiary exercises the beneficiary's withdrawal right.[6734] Among possible grantor trust rules that might apply, one would consider at least avoiding the grantor being treated as owner under part III.B.2.h.vii Distribution Provisions Might Prevent Turning Off Grantor Trust Status.

Although Code § 678(b) appears limited in scope, most commentators believe, and numerous recent Letter Rulings hold, that any conflict in whether the grantor or a beneficiary of the trust is treated as the owner for income purposes is resolved in favor of the grantor being treated as such an owner. Thus, for example, a swap power under Code § 675(4)(C) (see part III.B.2.h.iii Swap Power) might not work, if both Grantor and Beneficiary would be deemed owners, and Code § 678(b) would make Grantor the trust's deemed owner. However, when the beneficiary was the holder of the swap power, Letter Rulings 9311021 and 201216034 held that the trust was deemed owned by only the beneficiary, not by the grantor; the law behind this is questioned by several top lawyers I know, so I remain very reluctant to include a swap power during the settlor's life. The rulings might be focused on the fact that the beneficiary is an adverse party as to the grantor; see Reg. § 1.675-1(b)(4), which is discussed in fn. 6640, found in part III.B.2.h.i Who Is the Grantor.

Furthermore, suppose a trust would be a beneficiary grantor trust, but for Code § 678(b) causing the settlor's grantor trust powers to trump the beneficiary's. Suppose further that the settlor dies or otherwise turns off his or her grantor trust powers. Does the beneficiary become the deemed owner, since the Code § 678(b) suppression of the beneficiary's grantor trust powers no longer applies? No, said the IRS in Letter Ruling 9321050, inexplicably reversing its position in Letter Ruling 9026036. The beneficiary would need a new withdrawal right over all of the trust's assets once the settlor's powers are turned off, and then have those new withdrawal rights lapse over time. Blattmachr, Gans and Lo, A Beneficiary as Trust Owner: Decoding Section 678, *ACTEC Journal* (Fall 2009), found this change in position puzzling (as do I). Given that the IRS did not explain why it changed its position, either position would appear to have

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[6733] Code § 678(b), "Exception where grantor is taxable," provides:

> Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

Reg. § 1.678(b)-1 does not add any nuances.

Zaritsky, ¶ 4.08. Crummey Trusts, *Tax Planning for Family Wealth Transfers During Life: Analysis With Forms* (WG&L), states (footnotes omitted):

> The IRS has repeatedly ruled (and continues to rule) privately that a Crummey power does not render the power holder the deemed owner of any portion of a trust that is also a grantor trust, under Sections 671 through 679. In most of these rulings, the IRS restates the rule of Section 678(b), and then flatly concludes that, if the grantor owns the trust under Section 671, the grantor is deemed to own the entire trust, notwithstanding the Crummey powers held by the beneficiaries. A few of the rulings expressly rely on the application of Regulations Section 1.671-2(b), which states that the word "income" refers to taxable income, and does not distinguish between capital gains and ordinary income of the trust. It does not refer to trust accounting income, which is the key to the IRS analysis. The IRS also has stated that a right over corpus can affect income, so that a right over either corpus or income is covered by Section 678(b).

[6734] See Reg. §§ 1.672-1(e)(5) and 1.672-1(e)(6), Ex. (4).

substantial authority; however, when planning, one would consider that presumably on audit the IRS would assert its most recent position.

III.B.2.i.iii. Can a Trust Without a Withdrawal Right Be a Code § 678 Trust?

In making a trust without a withdrawal right taxable to its beneficiary as the deemed owner, a direct, clear approach that can be very effective but has significant limitations on practicality in the long run is in part III.B.2.i.xiv QSST as an Alternative Form of Beneficiary Deemed-Owned trust.

A trust without a withdrawal right might be converted to a partial beneficiary deemed-owned trust over time if the trustee credits distributions to the beneficiary and then the beneficiary lets his or her right to take those distributions lapse.[6735]

A more fundamental question is what is the threshold for beneficiary control over a trust to activate Code § 678(a)(1), which requires that the beneficiary have "a power exercisable solely by himself to vest the corpus or the income therefrom in himself."[6736] Certainly a withdrawal

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[6735] See fn. 2610 in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles.

[6736] *Trust No. 3 v. Commissioner*, 33 T.C. 734 (1960) held as follows when a trust tried to invoke Code § 678 to avoid taxation:

> An examination of the legislative history of section 678 discloses that it was the intention of Congress to incorporate the rule of *Edward Mallinckrodt, Jr.*, 2 T.C. 1128, *affd*. (C.A. 8) 146 F. 2d 1, *certiorari denied* 324 U.S. 871, which had been set forth in section 39.22(a)-22 of Regulations 118. See H. Rept. No. 1337, 83d Cong., 2d Sess., p. 63, and S. Rept. No. 1622, 83d Cong., 2d Sess., p. 87. In the latter committee report it is stated that a person other than a grantor may be treated as the substantial owner of the trust if he has an unrestricted power to take the trust principal or income. The *Mallinckrodt* case involved an adult beneficiary who had the right to terminate the trust. It was held that currently and without any restriction whatever the taxpayer could take as his own the income of the trust. In the *Mallinckrodt* case, we relied in part upon *Corliss v. Bowers*, 281 U.S. 376, in which the Supreme Court stated, But taxation is not so much concerned with the refinement of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid. *** The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.
>
> Read in the light of the legislative history of the section, we think section 678 should not be held to apply in the situation here presented. It cannot be said that these beneficiaries were currently entitled to the income of the trust or that their command over the corpus or income was unfettered. Indeed, the trust provisions in question would seem to have been intended by the grantors of the trust to restrict, in accordance with the law of Illinois, the command hereof the minor beneficiaries over the property and income of the trust, particularly since the grantors did not proceed to have guardians appointed. Otherwise, the grantors would have made provision for themselves or others to exercise the power for the beneficiaries or would have proceeded to have guardians appointed for the beneficiaries. We conclude that the income in question was that of the petitioner under section 641.

The Seventh Circuit reversed, 285 F.2d 102 (1960), holding that a guardian need not be appointed to give effect to a withdrawal right, which result the IRS reached in fn. 6737. This case is mentioned above simply because of the Tax Court's view of the legislative history, which the appellate court did not controvert when it held that a minor's withdrawal right is not really encumbered by the need to appoint a guardian:

> We believe that, for several reasons, the Commissioner's argument lacks substance. It is not denied by him that the beneficiaries were given a right to terminate the trust and to take possession of the trust property, but he considers that their minority bars them because (he says)

right will do the trick.[6737] On the other hand, subjecting the withdrawal right to an ascertainable standard does not work.[6738] However, when a trust authorized "the trustees to invade corpus, at their sole discretion, to provide for [the beneficiary's] support, welfare and maintenance, so long as the total net income and corpus paid to [the beneficiary] do not exceed $100,000 in any accounting year," the first $100,000 of annual income was taxable to the beneficiary while serving as sole trustee;[6739] on the other hand, "support, maintenance, comfort and enjoyment" was sufficiently ascertainable to avoid taxation in a pre-1954 case,[6740] as was "needs,

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> they could not assert that right except through a guardian duly appointed. This distinction is unconvincing in view of the fact that the appointment of a guardian for a minor under a state law is a matter of routine in which the federal government has no concern. To effectuate a termination of the trust as to any child and a delivery of its share of the accumulated income or corpus to the child, customarily there would be delivered to the trustees a properly authenticated copy of letters of guardianship and a receipt for the assets and monies delivered. However, we think the necessity of such routine steps would have no bearing upon the fundamental question of the legal right of the beneficiaries to terminate the trust. We should not deny an undisputed right because the conventional methods of exercising it have not been described in the instrument creating the right.

[6737] Rev. Rul. 67-241 (power to require distribution on request caused Code § 678(a)(1) to apply); *Trust No. 3 v. Commissioner*, 285 F.2d 102 (7th Cir. 1960), and Rev. Rul. 81-6, which applied even though the beneficiary was a minor and could not actually exercise the withdrawal right until a court appointed a representative.

[6738] *Funk v. Commissioner*, 185 F.2d 127 (3rd Cir. 1950), decided under pre-Code § 678 case law, involved a beneficiary who as trustee was authorized in her discretion to pay all or a part of the net income annually … to herself, in accordance with [her] needs, of which she shall be the sole judge. In distinguishing it from other cases:

> Here, the trustee had no a fortiori right to the income, nor did the absence of any needs on the part of either her co-beneficiary or herself confer such right upon her. What was not needed was directed by the settlor to be accumulated and added to principal, and the trustee's discretionary power to distribute conclusively terminated. She did not even have the authority to invade the principal in the event the income proved inadequate.

Letter Ruling 9227037 (trustee shall also pay … for the proper health, support and maintenance of Spouse, after considering any income or resources of Spouse outside the trust and reasonably available for such purposes).

[6739] Letter Ruling 8211057. Compare that to *Townsend v. Commissioner*, 5 T.C. 1380 (1945), in which a state court had ruled that the beneficiary was entitled to $30,000 per year for maintenance and support unless the parties returned to court to determine a different amount; the Tax Court held that the beneficiary was taxable on the $30,000 each year whether or not she withdrew it. Blattmachr, Gans and Lo, A Beneficiary as Trust Owner: Decoding Section 678, *ACTEC Journal* (Fall 2009), argues that *Townsend* should not be relied upon and that the Letter Ruling used welfare and therefore was not an ascertainable standard.

[6740] *Smither v. U.S.*, 108 F.Supp 772 (S.D. Tex. 1952), *aff'd* 205 F.2d 518 (5th Cir. 1953) (adopting by reference the trial court's opinion). See also *Stavroudis v. Commissioner*, 27 T.C. 583 (1956), in which the beneficiary was not trustee and the court rejected the suggestion that she could control distributions:

> Respondent appears to contend that since under paragraph Fifth of the trust instrument, the trustees are given power, in their sole discretion, to invade the corpus of the trust in the event of financial need, they, in effect, have unlimited discretion to distribute trust corpus to petitioner in accordance with her desires. Petitioner, however, is not a trustee of the trust in question and possessed no power, under the terms of the trust instrument, arbitrarily to direct the trustees to make disbursements to her from either principal or income, beyond the amounts specified as her guaranteed annual income.... The trust instrument therefore creates a standard limiting the power of the trustees to invade the corpus of the trust on behalf of petitioner, thus restricting the rights of petitioner in the trust principal to the extent that she cannot be held to be the substantial owner thereof. *Eva V. Townsend*, 5 T.C. 1380; *Lewis Hunt Mills*, 39 B.T.A. 798; *Funk v. Commissioner*, *supra*.

maintenance and comfort" in a Code § 678 case[6741] or "support and maintenance" in Letter Ruling 8939012. Granting a beneficiary "the right to use so much thereof, either of the corpus or the income or both, as may be required by her for her personal support and maintenance, the reasonableness thereof to be determined by her" was enough to make her the deemed owner when it was a bequest in addition to her life estate;[6742] this case affirmed the trial court's finding that the beneficiary was taxable, but for context note that the trial court had gone further and stated that a trust was never intended to be created at all and that instead the beneficiary was the true owner, so one needs to place this case in the context of a very broad interpretation of the language that was used.[6743]

[6741] *U.S. v. De Bonchamps*, 278 F.2d 127 (9th Cir. 1960). Similarly, support, comfort, health and service were sufficiently ascertainable to avoid taxation of capital gain to the life tenant in the pre-Code § 678 case of *Security-First Nat. Bank v. U.S.*, 181 F.Supp 911 (S.D. Ca. 1960).

[6742] *Koffman v. U.S.*, 300 F.2d 176 (6th Cir. 1962).

[6743] *Koffman v. U.S.*, 193 F.Supp 946 (E.D. Mich. 1961), held:

> Construing the language of the above quoted paragraph SECOND, plaintiff, Fannie Koffman, simply received a life estate in all her deceased husband's estate together with the right to do as she saw fit with the corpus or income or both. Therefore, any income accruing to this life interest belonged to plaintiff and was taxable to her.
>
> I am convinced that a trust was *not* intended, *nor* one created in fact. The instrument did not provide for separation of any legal or equitable titles to the property. The executor here did not hold the legal title to the property. There was no trustee. The executor was merely given limited managerial rights for a specific period (which period in truth, had expired under the partnership arrangement apparently.) But even liberally viewing the over-all language of the instrument's provisions as trust provisions, the plaintiff would still have sufficient power over the property as a beneficiary to be considered the owner of all the distributable income for tax purposes.
>
> Section 678, 1954 Internal Revenue Code, deals with such situations. It provides in pertinent part:
>
>> (a) General Rule.—A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which: (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself ***
>
> In the instant case, plaintiff was solely able to determine what would actually be distributed to her from the available income, but fact remains that all such property was distributable to her. The amount that she would consider reasonable was her business and hers alone. There was no one with the available right to check her discretion in this matter.
>
> See *Emery v. Commissioner of Internal Revenue*, 156 F.2d 728 - quoting from *Corliss v. Bowers*, 281 U.S. 376, at 378 -
>
>> The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.
>
> The *Emery* case likened the principles and logic of the Corliss case where it was the settlor of the trust who had broad powers to a situation where a beneficiary receives and retains such powers (as could be said here about plaintiff beneficiary's powers.) The fact that plaintiff beneficiary did not exercise these powers in her own favor during taxable years does not make the income any less taxable to her. It is not necessary to collect income which is attributable to person for purposes of income taxation. *Helvering v. Stuart*, 317 U.S. 154. A beneficiary is not taxed on what he receives, but his share of the distributable net income. See Sections 652(a) and 662(a), Internal Revenue Code of 1954. Plaintiff in this case was entitled to the whole share.
>
> While we were impressed by plaintiff's theory that the widow beneficiary would be bound by reasonableness in the amount she needed for expenses and costs of living, nevertheless the words the reasonableness thereof to be determined by her made an impression upon this court and we sought to learn how those words or words of similar import had been interpreted by the Federal Court and the Supreme Court of the State of Michigan. In this connection we found that when the contract provides that something be done to the satisfaction of the purchasing party the courts have held time and time again that while the product or work might be satisfactory to

In light of this uncertainty, if the settlor wants to make a trust a grantor trust as to the beneficiary while placing restrictions on the beneficiary's withdrawal rights then the settlor might consider providing only a temporary unrestricted withdrawal right and then lapsing it or subjecting it to restrictions after the lapse. Note that, to avoid a gift, the lapsed power to withdraw, to the extent that the lapse exceeds the 5-and-5 amount provided in Code § 2514(e), could be retained and subjected to the consent of a nonadverse party, allowing the withdrawal right to retain its status as a general power of appointment[6744] while providing some assurance of a check on its exercise; alternatively, if the power of appointment is no longer a general power of appointment, holding a present beneficial interest and a testamentary power of appointment should cause the gift to be incomplete.[6745]

However, *Goldsby v. Commissioner*, T.C. Memo. 2006-274, held:

> We look to State law to examine the nature of rights and interests in a trust. *Estate of Nicholson v. Commissioner*, 94 T.C. 666, 672-673 (1990). Arkansas courts consider the four corners of the governing instrument to ascertain the intention of the settlor regarding the nature of interests in a trust. *Estate of Whiting v. Commissioner*, T.C. Memo. 2004-68 (citing *Aycock Pontiac, Inc. v. Aycock*, 983 S.W.2d 915, 919-920 (Ark. 1998)); *Gregory v. Moose*, 590 S.W.2d 665, 667-668 (Ark. Ct. App. 1979).
>
> We look to the provisions of the trust agreement to determine whether petitioner is treated as the owner of any portion of the trust under section 678. We find that petitioner is treated as the owner of the income portion of the trust under section 678. Petitioner has significant powers with respect to the trust income on account of his dual role as trustee and sole income beneficiary. He was able to, was required to, and did vest the income of the trust in himself. Petitioner as trustee was required to cause the trust periodically to pay him (as income beneficiary) the entire net income of the trust. Petitioner, as trustee, owed fiduciary duties with respect to the income only to himself, the sole income beneficiary.
>
> Accordingly, we conclude that petitioner has the sole power to vest the trust's in come in himself and is treated as the owner of the income portion of the trust.[4]
>
> [4] The unique circumstances require a finding that petitioner should be treated as the owner of the trust's income portion. We note, and petitioners acknowledge on brief, that this finding does not apply in every situation involving a simple trust.

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everybody else, and the refusal of the purchasing party to accept the work or the product might even be very frivolous, yet if not done to his satisfaction he or she was not obliged to accept or pay for it. *Silsby Manuf'g Co. v. Town of Chico*, 24 F. 893, 894; *Patterson v. Alabama Vermiculite Corp.*, 149 F.Supp. 548. Michigan takes a very serious view of this provision. *Wood Machine Co. v. Smith*, 50 Mich. 565; *Schmand v. Jandorf*, 175 Mich. 88, 140 N.W. 996; *Graham v. City of Grand Rapids*, 141 Mich. 612, 104 N.W. 983; *Plano Manuf'g Co. v. Ellis*, 68 Mich. 101, 35 N.W. 841; *Gibson v. Cranage*, 39 Mich. 49, 50.

In the case at bar the last word was given to the widow to decide how much she wanted. Some of her expenses might be frivolous; might be considered absolute waste by some but it was up to her to decide and because of that power placed in her we believe puts an entirely different aspect upon the taxing power of the United States.

[6744] Code § 2514(c)(3)(B).

[6745] Letter Ruling 201525002 describes various nuances to making an incomplete gift, including dealing with the beneficiary's incapacity.

The context is that the taxpayer was claiming a deduction for a trust's donation of a conservation easement, asserting that the trust was a grantor trust. After finding above that the taxpayer was the deemed owner of the income, the court held that the donation was made out of corpus, over which the taxpayer was not the deemed owner. In some ways, however, the Code § 678(a) holding might be considered dictum, in that the court ultimately held that Code § 678 did not apply to the contribution and the taxpayer lost the case.

In an ERISA case using income tax ownership for attributing control, beneficiaries who had a withdrawal right as individuals that was limited by ascertainable standards were Code § 678 owners because they routinely made withdrawals ignoring those standards.[6746] A reviewed case, *Flato. v. Commissioner*, 14 T.C. 1241 (1950),[6747] under the 1939 Code, held:

[6746] *United Food and Commercial Workers Unions and Participating Employers Pension Fund v. Magruder Holdings, Inc.*, 2019 WL 1409725 (D. Md. 2019) (slip opinion), holding:

> Defendants counter that the HEMS limitation on the distribution of principal or income necessarily precludes the application of the Grantor Trust Rule, as it prevents the siblings from having a power exercisable solely by themselves to vest the corpus or the income therefrom in themselves. But Defendants introduce no evidence that the HEMS limitation was dutifully followed. To the contrary, Mr. Flinchum explained that HEMS was not taken into consideration when payments were distributed to the Siblings. ECF No. 49-7 at 40. He also stated that none of the siblings had ever discussed with him whether a payment complied with HEMS requirements. ECF No. 53-3 at 6-7. The Siblings either could not recall having ever consulted with anyone regarding HEMS requirements, ECF Nos. 53-4 at 9, 53-5 at 6-7, or admitted that they had never declined a payment because of the HEMS requirements, ECF No. 53-6 at 5-6. Regardless of whether, as Defendants suggest, a dutifully followed HEMS provision nullifies the application of the Grantor Trust Rule as a matter of law, a HEMS provision that exists only on paper cannot be said to restrict the power exercisable by the Siblings as to the Family Trust. Therefore, the Grantor Trust Rule applies, and the Family Trust's 49% ownership of F&S will be attributed evenly to the Siblings.[4]
>
> [4] Because the Court resolves the question of ownership using the Grantor Trust Rule, it need not determine how to calculate the Siblings' actuarial interest in F&S.

[6747] *Aff'd* 195 F.2d 580 (5th Cir. 1952), which reasoned:

> It is well established, of course, that where income is subject to one's unfettered command and he is free to enjoy it at his own option, he may be taxed on such income whether he elects to enjoy it or not. *Corliss v. Bowers*, 281 U.S. 376, 50 S.Ct. 336, 74 L.Ed. 916. This principle is not limited to the grantor of a trust, but is equally applicable to the beneficiary of a trust. *Bunting v. Commissioner of Internal Revenue*, 6 Cir., 164 F.2d 443; *Grant v. Commissioner of Internal Revenue*, 5 Cir., 174 F.2d 891. The incidence of taxation may not be avoided by mere "legal paraphernalia which inventive genius may construct", *Helvering v. Clifford*, 309 U.S. 331, 60 S.Ct. 554, 556, 84 L.Ed. 788, but the Court must look to the "whole nexus of relations between the settlor, the trustee and the beneficiary", *Helvering v. Elias*, 2 Cir., 122 F.2d 171, 172, and if it concludes that in spite of the form resorted to in effecting a transaction, the results thereof give the beneficiary command over the distribution of the income of a trust, such income is taxable to the beneficiary.
>
> Petitioners rely on *Plimpton v. Commissioner of Internal Revenue*, 1 Cir., 135 F.2d 482, to support their contention that the form and not the substance of a trust is determinative of the incidence of taxation and that no judicial inquiry into the conduct of the parties or the actual operation of the trust should be made. Respondent seeks to distinguish that ruling. We do not think it should be applied to the facts of this case. The rule expressed in *Commissioner of Internal Revenue v. Tower*, 327 U.S. 280, 291, 66 S.Ct. 532, 538, 90 L.Ed. 670, "By the simple expedient of drawing up papers, single tax earnings cannot be divided into two tax units and surtaxes cannot be thus avoided", evidences an intention that the results achieved is the criteria for determining the incidence of taxation rather than the "legal paraphernalia" employed to attain

> We believe that it is fair to infer from the facts of this case that although the distributions of trust income were to be made at the "discretion" of the trustees, the intention of the grantors was that the beneficiaries could have what they wanted of the trust income and that the discretionary provision was more in the nature of a safeguard to be withheld unless family considerations dictated its enforcement. Albeit there is no evidence of any collusion by the trustee-beneficiaries, on the other hand, there is no evidence of any substantial discretion exercised. The evidence indicates that the beneficiaries requested and got such amounts of trust income as they desired. The fair inference is that they got what they wanted. In our opinion the evidence is sufficient to cause this trust income to be taxed to the beneficiaries. *Edward Mallinckrodt, Jr.*, 2 T. C. 1128; *affd.*, 146 Fed.(2d) 1. *Edgar R. Stix*, 4 T.C. 1140; *affd.*, 152 Fed.(2d) 562.

I tend to prefer that otherwise nongrantor mandatory income trusts be treated as nongrantor trusts, to get better deductions. See part III.B.2.d.i.(a) General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation.

III.B.2.i.iv. Benefits of Beneficiary Deemed-Owned Trusts Other Than Leveraged Transactions or Estate Reduction

Some grantor trusts are created with the thought of the income tax liability reducing the grantor's estate or engaging in leveraged transactions.

However, beneficiary deemed-owned trusts can be very important in planning for the family without a taxable estate, which comprises 99.9% of the population when the estate tax exemption is over $5 million. Trusts are taxed at the highest income tax rates after reaching a relatively low taxable income threshold.[6748] Once informed of this issue, families who wish to use trusts to meet nontax objectives would like to avoid those high rates.

This part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts describes how to make a trust a beneficiary deemed-owned trust and discusses various issues in doing so.

In addition to those tools, one might build in some simple ideas into trusts that one commonly uses, which might make the trust a beneficiary deemed-owned trust with respect to a part. For example, one might grant the beneficiary an annually exercisable 5% withdrawal right. If one is concerned about the beneficiary's creditors using this withdrawal right to obtain funds, one might appoint an independent trustee who could temporarily grant or suspend this withdrawal right. If a trust does not include a withdrawal right, consider the trustee determining that a particular amount (up to 5% if the trust) is appropriate to distribute and, instead of distributing it, makes it available to the beneficiary to draw upon.[6749]

> such results. The Tax Court was justified in considering the results achieved rather than limiting its consideration to the language of the trust agreements. In support of its conclusion, the Tax Court could properly consider the family relationship of all the parties; the parents' desire to divest themselves of their interest in the partnerships; the manner of creation and number of the trusts; that the father admittedly wanted his three sons to carry on the business; that the two elder sons did manage it; even if not tacitly admitted, the inference, at least, that the gifts of cash to each son were applied to the purchase of the partnership interest which was transferred to the trusts created for each son's benefit; and that notes given for the balance were paid from partnership profits; in short, the entire background of the transactions and business which earned the income.

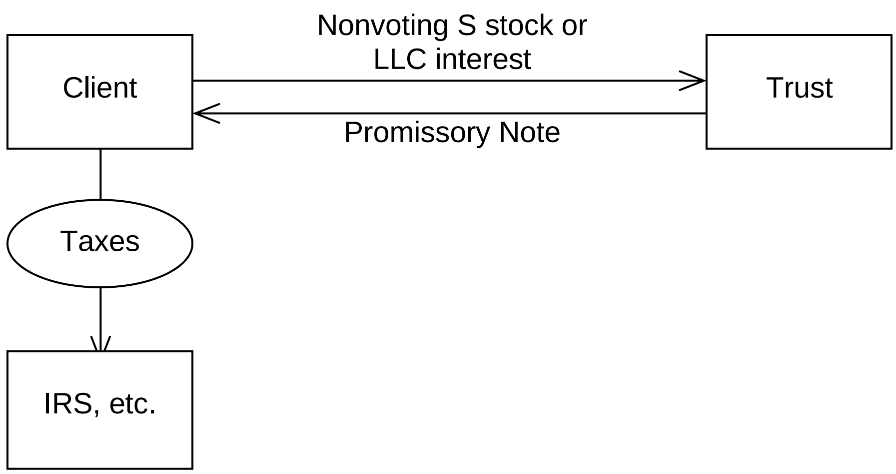
[6748] For a general discussion of trust income tax issues, see part II.J Fiduciary Income Taxation.

[6749] See part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary.

For more information, see parts II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles and III.B.2.i.vii Portion Owned When a Gift Over $5,000 is Made.

III.B.2.i.v. Sale to a Beneficiary Deemed-Owned Trust – When a Traditional Sale to an Irrevocable Grantor Trust Does Not Meet the Client's Objectives

A sale to a beneficiary deemed-owned trust can be a useful alternative to a traditional sale to an irrevocable grantor trust. In a typical sale to an irrevocable grantor trust, the senior family member sells an interest in a partnership or S corporation to a trust for the benefit of descendants or other family members. The sale is structured to be effective for transfer tax purposes but ignored for income tax purposes.



The sale is not subject to income tax, because for income tax purposes all the beneficiary has done is sold assets to himself or herself.[6750] Now, the business interest is outside of the estate tax system, yet the beneficiary has access to the trust's assets, so the beneficiary is more comfortable with the transfer than with selling to a traditional irrevocable grantor trust.

Furthermore, if the beneficiary has a power of appointment[6751] and the IRS asserts that the sale price was inadequate, any resulting gift is an incomplete gift[6752] and therefore is not subject to gift tax.[6753] This might be less susceptible to IRS attempts to impose gift tax than a defined value clause. For gift tax disclosure issues, see fns 7059-7061 in part III.B.4 Adequate Disclosure on Gift Tax Returns, which suggest that one might consider providing an upfront

[6750] See Rev. Rul. 85-13. See also part III.B.2.i.viii.(d) Large Gift with Subsequent Large Power to Withdraw.
[6751] That is not a general power of appointment under Code § 2041(b)(1), since the goal is avoiding inclusion in Beneficiary's estate.
[6752] Reg. § 25.2511-2(b).
[6753] In Letter Ruling 200949012, the Distribution Trustee could distribute the entire trust to Beneficiary. Thus, after an IRS audit, the incomplete gift portion could be transferred back to Beneficiary to engage in future sales to the trust.

completed gift to a portion of the trust over which the beneficiary does not have a power of appointment;[6754] for example:[6755]

> The Sale Price shall be the sum of (a) the “Estimated Fair Market Value” (defined below) of the Transferred Units, plus (b) Ninety Percent (90%) of the “Excess Value” (defined below), if any. The Excess Value shall equal the excess, if any, of the “Final Fair Market Value” (defined below) of the Transferred Units over the Estimated Fair Market Value of the Transferred Units. If the Final Fair Market Value of the Transferred Units is equal to or less than the Estimated Fair Market Value, the Excess Value shall be zero (0). The Transferred Units with a value equal to Ten Percent (10%) of the Excess Value, if any (the “Gift Units”), shall be held in a new trust that Buyer hereby creates called the _____ Gift Trust, which shall be governed by the same terms and conditions of the Trust Agreement Establishing the ____ Legacy Trust dated ____ (the “Trust Agreement”) which govern Buyer, except that [Beneficiary] shall not hold a power of appointment under Section ___ or Section ___ of the Trust Agreement. The number of the Gift Units described in the preceding sentence shall be based on the fair market value of the Gift Units as finally determined for federal gift tax purposes as of the date first written above, in accordance with the valuation principles set forth in Regulation section 25.2512-1 as promulgated by the United States Treasury under section 2512 of the Internal Revenue Code of 1986, as amended The trustee agrees that the _____ Gift Trust is a new trust that the trustee holds as nominee pursuant to Section ____ [commingling clause] of the Trust Agreement, which authorizes the trustee to make joint investments for any separate trust thereunder of which the trustee is trustee or co-trustee and to hold such joint investments as a common fund for purposes of administration, dividing the net income therefrom in the same proportions as the respective interests of such trusts herein.

Why might the client not want to do a traditional sale to an irrevocable grantor trust?

- The client is concerned about preserving income for retirement or emergencies. The client might not feel comfortable reducing his or her estate to the amount of estate tax exemption.

- The client might not want to give that amount of wealth to his or her children too soon, as doing so might destroy work ethic.

- The client might want to control where the assets pass on the client’s death.

- As an entrepreneur, the client likes to feel that he or she has a stake in the business’ success. If the assets belong to a trust for the children, the client might feel as if he or she lost this emotional investment in the business.

A sale to a beneficiary deemed-owned trust might be a palatable alternative that the client would do, rather than doing nothing.

[6754] If a bargain element is finally determined for gift tax purposes and the provisions for remaindermen become unacceptable, the independent trustee could decant the trust using that trustee’s authority for make distributions to or for the benefit of the beneficiary. To avoid estate inclusion, the independent trustee might decant the entire bargain element.

[6755] This clause may also help in a sale to an irrevocable trust the beneficiary’s spouse created for the beneficiary. See part III.B.2.i.xv Sale to Trust Created by Spouse: An Alternative Way to Have a Trust Benefitting Client.

III.B.2.i.vi. Funding the Trust with Small Gifts

III.B.2.i.vi.(a). General Concept of Funding with Small Gifts

In the BDIT structure, the trust is funded with a gift of up to $5,000, which the beneficiary has the right to withdraw. When a withdrawal right lapses, the beneficiary is deemed to have made a gift to the trust only if and to the extent the lapse exceeds the greater of $5,000 or 5% of the trust's assets (a "5&5 power").[6756] If and to the extent that a lapse exceeds a 5&5 power, and the beneficiary holds some power over the lapsed property, then a portion of the trust will be included in the beneficiary's estate, either because of strings under Code § 2036 or 2038 or because the lapse constitutes an incomplete gift. To avoid these issues, a BDIT is funded with an amount that does not exceed $5,000. The beneficiary should not hold withdrawal rights over any other trust that lapse before the lapse of the withdrawal right over the beneficiary deemed-owned trust; otherwise, the lapse might exceed the limits of a 5&5 power.

However, $5,000 is rather thin capitalization to support the trust's purchase of the beneficiary's partnership (LLC) interest or S corporation stock. Therefore, the trustee will find someone other than the beneficiary to guarantee a portion of the sale. The trustee will compensate that person for the risk by paying a guarantee fee.[6757] The guarantee fee will constitute income to the recipient but might not be deductible by the trust.[6758] If the guarantee fee is more money than the trust currently has, finding another motivation other than the guarantee fee might be advisable. For example, a trust with similar beneficiaries might guarantee a loan to a trust that benefits those beneficiaries, because the trustee would have a duty to try to get more assets to any fiduciary arrangement with the same or very similar terms. The grantor of the small trust – often the beneficiary's parent – might bequeath funds to an identical trust for the same beneficiary, which then might guarantee loans to the small trust. Or, instead of borrowing from the beneficiary to fund the sale, the trust might borrow from another trust – perhaps an irrevocable trust created by the beneficiary.

[6756] Code § 2514(e). This statement oversimplifies the rule, in that these provisions might need to be coordinated with other lapses with respect to other trusts. For more details on calculating the 5% lapse, see fn 6125 in part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts (Whether or Not a Sale Is Made).

[6757] The guarantee fee is not a tax law requirement, but it might be advisable – see part III.B.1.a.ii Loan Guarantees, especially part III.B.1.a.ii.(a) Gift Tax Issues and fn. 6269. Because the sale is a transaction between related parties, it receives a higher level of scrutiny. Thus, it is advisable to show the IRS and the courts the business motivation of each party to the transaction, including the guarantor, which a guarantee fee might do. One might consider using a formula to determine the fee –a market rate that is the greater of the rate needed to avoid a gift for gift tax purposes or the rate needed to avoid treatment as grantor under Reg. §1.671-2(e).

[6758] See, *e.g., A. A. and E. B. Jones Co. v. Commissioner*, T.C. Memo 1960-284 (approving deduction for fees for personal guarantees charged to obtain surety bonds); *Olton Feed Yard, Inc. v. U.S.*, 592 F.2d 272 (5th Cir. 1979) (guarantee fees were a nondeductible disguised dividend); *Tulia Feedlot, Inc. v U.S.*, 52 A.F.T.R.2d 83-5702, 3 Cl. Ct. 364 (1983) (approving a corporation's deduction of 3% guarantee fees paid to shareholders); *Fong v. Commissioner*, T.C. Memo 1984-402 (guarantee fees were not an ordinary and necessary business expense); *Seminole Thriftway Inc. v. U.S.*, 82 A.F.T.R.2d 98-7497, 42 Fed. Cl. 584 (1999) (guarantee fees were a nondeductible disguised dividend); *Container Corporation v. Commissioner*, 134 T.C. 122 (2010) (addressing withholding rules in international transactions; did not address deductibility). It's difficult to glean much from these cases, because generally the argument was really about disguised dividends to avoid C corporation double taxation.

Consider setting up to take advantage of business opportunities,[6759] without its only future significant activity being a sale to the beneficiary deemed-owned trust. For example, the client asks his or her parent to fund a beneficiary deemed-owned trust for one of the following situations:

- The client's business is expanding and needs another facility in which to operate. The trust forms an LLC to hold the real estate. The operating company agrees to a long-term lease with LLC. The lender might allow the LLC to be relatively thinly capitalized if it views the lease obligation to be solid. The use of beneficiary deemed-owned trusts to hold real estate and later participate in an S corporation buy-sell agreement was the subject matter of the trusts used in my Life Insurance LLC private letter ruling;[6760] Be careful to make sure that the rent paid to the LLC is not excessive, lest the IRS argue that the owners of the tenant made a gift to the owners of the LLC; and a gift to the trust that owns the LLC might change the trust's income tax posture. Alternatively, consider the beneficiary setting up the highly leveraged LLC with the lease in place and then selling it to the trust, which would avoid issues with the initial lease; although this issue might pop up when it's time to renew the lease, the trust might be very well capitalized by then (due to success during the intervening period), minimizing the risk associated with this idea.

- The client is establishing a new line of business that does not require much in the way of start-up costs. This is especially an issue if the existing business is inside of a corporation, which is not as flexible or income tax-advantageous when the business is later sold,[6761] splits up,[6762] or passes to beneficiaries.[6763]

One does not need to use a thinly funded trust to make this structure work. Here are some examples of other ways to do it:

- Instead of setting up one trust for all descendants to receive annual exclusion gifts, do one trust for each child. Don't do it with the idea of doing a sale soon – do it with the idea of building a war chest over time that eventually can be used to invest in business assets. As with any *Crummey* trust, withdrawal rights tend to accumulate in the early years and lapse as the trust's investments grow. There are drawbacks to this idea. First, a *Crummey* trust for all descendants has a larger corpus from which a 5% withdrawal right can be satisfied, so the separate trust for each child has the disadvantage of much, much slower lapses. Second, a *Crummey* trust for all descendants is a simpler vehicle for the grantor to use for planning, such as holding a policy on the grantor's life or buying assets for the grantor. Finally, the beneficiary deemed-owned trust is not a grantor trust as to the grantor, so it loses the tremendous power of depleting the grantor's estate.[6764] One might recommend

[6759] See generally part III.B.1.a Business Opportunities.
[6760] See text after footnote 4619, including the chart shown as Appendix C to that portion of these materials. I had not informed the clients of the sale to beneficiary grantor trust concept when we established the trusts – I simply told them that it would be nice for the real estate trusts to be able to hold S corporation stock for future flexibility since the operating business is an S corporation.
[6761] See part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis.
[6762] See part II.Q.7.f Corporate Division.
[6763] See part II.H.2 Basis Step-Up Issues.
[6764] See n. 6722 for why a beneficiary grantor trust should not be structured as deemed owned by the settlor at any time. Presumably, this problem could be cured if, after the settlor's grantor trust powers are turned off, the beneficiary is given the right to withdraw the entire trust, but I am unaware of any rulings on point.

that a client use some of each strategy. For example, the parent contributes $5,000 per year to a separate trust for each child and uses the balance of his or her annual exclusion for children and grandchildren for a gift to a trust for all descendants. The $5,000 gift should be done as early as possible in the year, so that other lapses during the year do not eat into the $5,000 amount.

- Perhaps the client with the business interests has parents who don't feel that they can afford to give the client money because they need it for their own retirement. They can create a BDIT now and then bequeath the child's share to an otherwise identical trust (a companion trust) that would later guarantee loans to the BDIT. Also, if the client is using up all of the client's lifetime gift/estate tax and GST exemptions, consider that the client might later want to create a trust that has different terms but would lack the exemptions; if the client's parent establishes a BDIT for the client, the client can enter into transactions with the BDIT with the support of the companion trust or perhaps with loans from one or more irrevocable trusts created by the client.

- If the client has children who already have substantial estates of their own, consider setting up a BDIT for each child and a companion trust with the same idea as the preceding bullet point.

III.B.2.i.vi.(b). Contingency Plan for Trust Funded with Small Gifts

What if a transaction that the trust directly or indirectly enters into winds up being recharacterized as a bargain sale or similar transaction? Especially given the trust's initial small trust funding, this indirect gift might be very significant and might change the trust's income tax characteristics.

Consider providing that, after the initial funding, any future direct or indirect gift will be accounted for as a separate share, which share the beneficiary may withdraw at any time. For this share, one might then use the planning described in part III.B.2.i.viii Funding the Trust with a Large Initial Gift or Bequest. For example, the portion of the withdrawal right of the separate share that annually lapsed might be added back to the main trust, using the principles of Letter Ruling 9009010.[6765]

III.B.2.i.vii. Portion Owned When a Gift Over $5,000 is Made

III.B.2.i.vii.(a). Determining Portion Owned When a Withdrawal Right Does Not Lapse in Full Before Any Income Is Earned

Before delving into the details below, see part III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation. As a withdrawal right over the trust's gross income, see the sample clause in the text accompanying fn 2628 in part II.J.4.f Making Trust a

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[6765] Letter Ruling 9009010 is described in depth in part III.B.2.i.viii.(b) Large Gift for Multiple Beneficiaries. The strategy proposed here is different from the Letter Ruling's facts, but the principle is similar. A disadvantage of the idea of moving the lapsed portion from the separate share to the main trust is that the amount out of which the withdrawal right could be satisfied might be considered smaller, resulting in smaller annual lapses.

Partial Grantor Trust as to a Beneficiary, but the clause that is drafted actually makes the trust a grantor trust over all of the withdrawable gross income.

Reg. § 1.671-3(a)(3) provides:[6766]

> If the portion of a trust treated as owned by a grantor or another person consists of an undivided fractional interest in the trust, or of an interest represented by a dollar amount, a pro rata share of each item of income, deduction, and credit is normally allocated to the portion. Thus, where the portion owned consists of an interest in or a right to an amount of corpus only, a fraction of each item (including items allocated to corpus, such as capital gains) is attributed to the portion. The numerator of this fraction is the amount which is subject to the control of the grantor or other person and the denominator is normally the fair market value of the trust corpus at the beginning of the taxable year in question. The share not treated as owned by the grantor or other person is [taxed ignoring the grantor trust rules].

Concern has been expressed about calculating this fraction in the example above. If this regulation were interpreted narrowly in cases when the withdrawal right extends over a particular dollar amount rather than a fractional share determined with reference to the gift creating the withdrawal right, then when calculating the fraction above one would mechanically calculate a lower portion owned by the beneficiary each year.

Let's apply this concern to the example in part III.B.2.i.viii.(a) Large Gift for One Beneficiary. After seven years, withdrawal rights are only $650K, with a trust value of $1.4M, so that only 46% ($650K divided by $1.4M) is deemed owned by the beneficiary. Thus, the second sale to the trust could generate substantial income tax.

This approach does not give the beneficiary credit for the fruits of the portion deemed owned by the beneficiary. Logically, when the trust is created, the beneficiary owns 100%. All income earned in the first year would be taxable to the beneficiary. However, those who would narrowly construe this Regulation would compute the fraction the next year ignoring the fact that, by allowing the income to be reinvested, the beneficiary has, in effect, contributed this deemed income to the trust. With that view, they certainly would not view any unrealized gains or other gain in equity as contributed by the beneficiary, either.

The IRS has issued numerous letter rulings without expressing this view.[6767] Thus, I would feel confident in submitting a ruling request (if available). Nevertheless, if one does not obtain his or

[6766] Letter Ruling 5809125370A elaborated on this:

> Where the portion of a trust owned by a grantor consists of an interest in or a right to an amount of corpus only, a fraction of each item of income is attributed to the portion. The numerator of this fraction is the amount which is subject to the control of the grantor and the denominator is normally the value of the trust corpus at the beginning of the taxable year in question. See section 1.671-3(a)(3) of the regulations. Accordingly, you would be taxed also on the fraction of each item of ordinary income of the trust attributable to the portion of trust corpus which ... you would be treated as owning.

[6767] The following Letter Rulings held that a trust was eligible to hold stock in an S corporation because the beneficiary who had withdrawal rights was deemed to own all of the trust when the withdrawal rights applied to all gifts to the trust and the power lapsed in full, rather than hanging and lapsing over time: Letter Rulings 200147044, 200011058, 200011054, 200011055, 200011056, 199942037, 199935046, 199935047, 9812006, 9810006, 9810007, 9810008, 9810004, 9810006, 9809005, 9809006, 9809007, her own private letter ruling, one risks the IRS changing its approach, so one might consider an alternative approach.

If one is concerned about the IRS suddenly taking a narrow view of Reg. § 1.671-3(a)(3), one might design a trust with respect to which the beneficiary can withdraw all of the trust's assets - not just an amount equal to the initial gift. The withdrawal right lapses each year to the extent of 5&5.

What does one do with the lapsed portion? Perhaps one might require the trustee to transfer it to a separate trust, somewhat along the lines of the single trust in Letter Ruling 9009010, described in part III.B.2.i.viii.(b) Large Gift for Multiple Beneficiaries. That separate trust invests in any new business opportunity or buys business interests from the beneficiary. That way, none of these leveraged uses of the lapsed amounts are included in the beneficiary's estate.

9809008, 9745010, 9739026, 9625031, 9535047, 9504024, 9448018, 9320018, 9226037, 9140047 (included passing reference to, but no analysis of, Reg. § 1.671-3), 9009010, 8936031, 8827023 (included passing reference to, but no analysis of, Reg. § 1.671-3), 8805032 (included passing reference to, but no analysis of, Reg. § 1.671-3), 8701007 (included passing reference to, but no analysis of, Reg. § 1.671-3), 8809043 (included passing reference to, but no analysis of, Reg. § 1.671-3), 8613054 (included passing reference to, but no analysis of, Reg. § 1.671-3), 8521060, and 8342088 (included passing reference to, but no analysis of, Reg. § 1.671-3). A typical ruling in the late 1990s or later held:

> Because contributions to Trust will be subject to D's withdrawal power, D will be treated as having a power to vest each corpus contribution in D within the meaning of section 678(a)(1). For purposes of sections 678(a)(2) and 677(a), if D fails to exercise the withdrawal power, D will be treated as having released the power while retaining a right to have all trust income distributed to D or accumulated for later distribution. Therefore D will be treated as the owner of Trust under section 678(a).

However, Letter Ruling 9311021 included hanging powers. Without citing Reg § 1.671-3(a)(3) or mentioning any issues along those lines, the IRS ruled:

> The primary beneficiary is treated as the owner of that portion of the trust in which his withdraw right has not yet lapsed under section 678(a)(1) of the Code, because of his ability to withdraw any additions to the trust. in addition, upon the lapse of the withdrawal power the primary beneficiary still has a section 675(4)(C) power over the trust property because he may, at his option, exercisable in a non-fiduciary capacity, acquire all or any part of the property of the trust by exchanging for it property of equal value. Thus, under section 678(a)(2), the primary beneficiary is also treated as the owner of the trust property for which his withdrawal power has lapsed.

See part III.B.2.h.iii Swap Power.

Similarly, Letter Ruling 201216034 ignored this issue with the following:

> Under the Trust instrument of Trust, Grantor may contribute, at any time and from time to time, to the principal of the Trust corpus. Primary Beneficiary has the power, following any such contribution to Trust by Grantor during Grantor's life, to withdraw the entire value of the contribution. Primary Beneficiary's power of withdrawal is cumulative. On D2 of each year, the total amount Primary Beneficiary may withdraw with respect to all preceding calendar years is reduced by the amount of $5,000.00, or 5 percent of the value of the Trust principal on D2 of that year, whichever is the greater amount and to that extent Primary Beneficiary's power of withdrawal shall lapse.

Perhaps contrary to the above rulings are Letter Rulings 7943152 and 7943153. The surviving spouse had an unlimited withdrawal right in a marital trust. Her release prevented her from being taxed on the trust's corpus - because she no longer had any interest in the trust's principal, her release was a **complete** release, not **a partial release or modification**. This can be distinguished from the rulings above in that those rulings still included a power to distribute principal for the beneficiary after the lapse. For other Letter Rulings, see fn 6727 in part III.B.2.i.ii Building Up Trust.

Suppose only a single small gift funds the trust, and that gift lapses shortly after the gift. To be safe, make sure that the amount that the beneficiary can withdraw is the full amount of the gift, including any increases in the trust's value between date of gift and date of lapse. For example:

1. Don't deposit the gift into an interest-bearing account.

2. Don't enter into any transactions with the trust between the date of funding and the date of the lapse. (Usually one wants to wait anyway to reduce the chance of a step-transaction argument.)

I have similar concerns over a so-called BDOT, which is an abbreviation for beneficiary deemed-owned grantor trusts. That abbreviation would appropriately apply to all trusts in this part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts, but instead it's use colloquially to apply to a trust (the "BDOT"), all of the taxable items of income of which may be withdrawn by another trust. The first paragraph in this part III.B.2.i.vii.(a) describes how to draft such a withdrawal right. Code § 678(a)(1) would apply to make the beneficiary trust the deemed owner of the BDOT regarding those items that could have been withdrawn. Consider, however how Code § 678(a)(2) might apply under the portion rules described above regarding any income earning after the withdrawal right lapses (if the withdrawal right is not renewed). Also consider any gift, estate, and GST consequences of the lapse of the beneficiary trust's right to withdraw from the BDOT.

III.B.2.i.vii.(b). Determining Portion Owned When Trust Is Only a Partial Grantor Trust

For each year a beneficiary fails to exercise a withdrawal right, the beneficiary will be treated as the owner of an increasing portion of the corpus of the trust. The annual increase of the portion of the corpus of the trust that the beneficiary will be treated as the owner is the product of the amount which the beneficiary could withdraw multiplied by a fraction, the numerator of which is the portion of the trust corpus that he is not already treated as owning, and the denominator of which is the total trust corpus from which the withdrawal could be made.[6768]

Letter Ruling 9220012 involved the following facts:

> The taxpayers have represented that on x, M and F, as trustors, executed the documents creating the Trusts (Trusts A, B, C, D, and E) which are the subject of this ruling. Each instrument created an irrevocable Trust for the benefit of one of the children of M and F. One of the children, A, was to serve as trustee of each Trust. The Trusts were created and are administered under the law of State S. State S has adopted the Uniform Principal and Income Act. The Trusts were substantially similar in their dispositive provisions.
>
> Each Trust called for current distributions (not less frequently than quarterly) of the net income of each Trust to its beneficiary. Upon the death of the current income beneficiary, the remaining corpus was to be divided into separate trusts for each of the beneficiary's living lawful descendants. If the beneficiary died without issue or the last of his descendants died, then any remaining portion of trust property was to be divided into equal shares among the surviving children of the grantors and held in separate trusts for each. Should none of the grantors' children be living at that time, then the property was

[6768] Letter Rulings 9034004, 200022035, 200104005.

to be distributed in accordance with a general power of appointment exercisable by the last surviving child or the last surviving lawful descendant of the named beneficiary.

The named beneficiary of each respective Trust had the right to withdraw any or all corpus from each Trust after they reached the age of forty (40). There was a restriction on the right of the beneficiary to withdraw corpus which consisted of property related to X (the "X property"). The Trusts also provided that the trustee could make discretionary distributions of corpus to the beneficiaries if the trustee deemed the net income to be insufficient for the property support, maintenance, education, health and recreation of the beneficiary entitled to receive income from that particular Trust.

A resigned as trustee during y. The grantors and beneficiaries agreed to name Y as trustee, and Y accepted the appointment. y is an independent trustee, unrelated to the grantors. Soon thereafter the Trusts sold certain securities at a loss resulting in short term capital losses which the Trusts carried forward. When A and B turned 40, they claimed the losses on their personal returns.

In Z, each named beneficiary of a child's Trust executed a Petition for Instructions to Trustee asking the appropriate court to instruct the trustee to enter into an agreement to modify the Trusts to eliminate the beneficiaries' powers to invade the corpus. A and B had reached the age of forty by the time of the petitions but had not withdrawn any assets from their respective Trusts. C, D, and E had not yet reached the age of 40. On XX, the court granted the petition. On yy, the grantors and the trustee entered into an agreement modifying each Trust.

Letter Ruling 9220012 reasoned and ruled:

(1) The modification of the Trusts will not affect the manner in which the income, gain, loss, deduction, and credits of the Trusts whose beneficiaries had not yet turned forty at the time of the modification (Trusts C, D, and E) are to be reported by those Trusts and their beneficiaries. Those beneficiaries who had not yet reached the age of 40 at the time of the modification of the Trusts to remove the power of withdrawal (C, D, and E) never held such a power and therefore cannot be treated as owners of any part of their respective Trusts under section 678 of the Code.

(2) The beneficiaries (A and B) who had turned forty prior to the modification of the Trusts (Trusts A and B) have partially released a power to vest corpus in themselves within the meaning of section 678(a) while retaining a right to the income of their Trusts. Thus, under sections 678(a) and 677 those beneficiaries are to be treated as owners of both the corpus portion and the income portion of their Trusts during the period they possessed their power to withdraw corpus and right to income and as owners of only the ordinary income portion after the release of the power over corpus. Capital gains and losses allocable to corpus under the Uniform Principal and Income Act are to be reported by beneficiaries during the period when they held the power over corpus. After the release of the power over corpus, capital gains and losses allocable to corpus under the Uniform Principal and Income Act are to be reported by the Trust unless paid, credited, or required to be distributed to the beneficiaries as defined under section 643 of the Code and the regulations thereunder. We express no opinion concerning whether or not A and B ever had a section 678(a)(1) withdrawal power with respect to the X property.

(3) Subsequent to the modifications of the Trusts, the capital gains and losses of Trusts C, D, and E will continue to be reported by the Trust in accordance with sections 641 and 643 and the law of State S.

To the extent they remain available, the short-term capital losses of Trusts A and B, which became items of deduction under section 671 reportable on the beneficiaries' returns when they turned forty, may be used by A and B to offset their capital gains, including capital gains actually distributed by Trusts A and B.

III.B.2.i.vii.(c). Reporting Portion Owned When Only a Partial Grantor Trust

The partial owner is treated as owning those items of income, deduction, and credit against tax attributable to or included in that portion. These items are shown on a separate statement to be attached to IRS Form 1041. The portions of trust corpus considered so owned are not subject to the provisions of Code §§ 661(a)(2) and 662(a)(2) when distributed to the deemed owner.[6769]

III.B.2.i.viii. Funding the Trust with a Large Initial Gift or Bequest

Below are two examples of way to make large gifts. In either case, consider having any lapsed withdrawal right transferred to a separate trust deemed owned 100% by the beneficiary before it acquires any S corporation stock.

An alternative to these methods is part III.B.2.i.xiv QSST as an Alternative Form of Beneficiary Deemed-Owned trust.

III.B.2.i.viii.(a). Large Gift for One Beneficiary

Suppose the settlor gives or bequeaths $1M to a beneficiary deemed-owned trust, allocates GST exemption to the gift or bequest, and provides that the beneficiary can withdraw the entire amount of the initial gift. Each year, 5% of the withdrawal rights lapse, subject to coordination with other trusts with respect to which the beneficiary has withdrawal rights.[6770]

With $1M funding, many more investment opportunities are available than with $5K initial funding, and the trust would be useful and significant, even if no sale ever occurred.

Let's ignore investment return for a moment and suppose two years pass. Each year, $50K (5% of $1M) has lapsed, so that a total of $100K of withdrawal rights have lapsed ($50K times two). The trust's assets consist of $900K, over which the beneficiary has withdrawal rights, and $100K, over which the beneficiary does not have a withdrawal right.

[6769] Rev. Rul. 67-241; for the grantor trust effect, see parts III.B.2.i.ii Building Up Trust, especially fn. 6727, and III.B.2.i.iii Can a Trust Without a Withdrawal Right Be a Code § 678 Trust?, especially fn. 6737

[6770] For example, The total amount that may be withdrawn by the Primary Beneficiary under this Section after December 31 of a calendar year with respect to Transfers that occurred at any time (including in a prior year) before December of such calendar year shall be reduced by the maximum amount that the Primary Beneficiary could fail to withdraw on such date without such failure constituting a release of a general power of appointment under Code section 2514. This provides a lapse of 31 days and makes sure that other lapses that occur during the year are taken into account, without ruining what the other trusts were trying to accomplish.

The beneficiary then sells $400K of nonvoting S corporation stock to the trust, in exchange for a promissory note of $400K. My target would be 20% equity in the deal, calculated by dividing $100K unlapsed withdrawal rights by $500K assets ($100K unlapsed withdrawal rights plus $400K nonvoting S corporation stock) subject to the deal. I did not count the assets subject to withdrawal rights as part of the deal, because they are reserved for any future exercise of the beneficiary's withdrawal rights. The trust uses the S corporation's earnings and earnings on the trust's other investments to repay the note over the next five years.[6771]

So, after seven years, the withdrawal right has lapsed at least $50K per year, for a total lapse in excess of $350K.[6772] The trust now consists of $650K of the original gift over which the beneficiary has withdrawal rights, $350K of the original gift in which the beneficiary no longer has withdrawal rights, and $400K of nonvoting S corporation stock.[6773]

With $750K of equity ($350K original gift in which the beneficiary no longer has withdrawal rights plus $400K of nonvoting S corporation stock), the beneficiary sells another $3M of nonvoting S corporation stock, using the same ideas as the first sale.

Let's further suppose that the second note is repaid in another five years:

- Lapses have occurred at a rate of $70K per year,[6774] for a total lapse of $350K during this five-year period. Add that to $350K of prior lapses, and total lapses equal $700K.

- The trust is now worth $4.4M, which consists of $300K ($1M minus $700K of lapses) of the original gift over which the beneficiary has withdrawal rights, $700K of the original gift in which the beneficiary no longer has withdrawal rights, and $3.4M of nonvoting S corporation stock.

- Note that future lapses will be at the rate of $220K per year.[6775] Thus, in two more years, the $300K remaining withdrawal rights will be gone.

Thus, after 14 years, all of the withdrawal rights have lapsed, and the trust has a net worth of $4.4M.

Future leveraged sales can be done, each time increasing the trust's equity significantly, just like traditional sales to irrevocable grantor trusts, but the beneficiary has access to the assets he or she sold to the trust.

[6771] I would tend to use a note with annual payments of only interest required, with principal payable in just under nine years to allow use of the mid-term applicable federal rate. The trust would prepay the note as investment earnings become available. Five years is just a realistic assumption; the actual time might vary significant. However, based on traditional valuation principles, it should easily be repaid within nine years.

[6772] For simplicity sake, this example ignores lapses to the extent of 5% of the increasing equity in the stock (through growth and principal repayments of the note) and any investment earnings.

[6773] Assuming no change in the stock's value.

[6774] $1M initial gift plus $400K nonvoting stock equals $1.4M. 5% of $1.4M is $70K. Again, this example ignores lapses to the extent of 5% of the increasing equity in the stock (through growth and principal repayments of the note) and any investment earnings.

[6775] $1M original gift plus $3.4M nonvoting stock equals $4.4M. 5% of $4.4M is $220K. Again, this example ignores lapses to the extent of 5% of the increasing equity in the stock (through growth and principal repayments of the note) and any investment earnings.

This approach is slower than the traditional sale to a BDIT, but it has more substance and does not rely on finding a third party guarantor to whom to pay possibly nondeductible guarantee fees.

III.B.2.i.viii.(b). Large Gift for Multiple Beneficiaries

Letter Ruling 9009010 is an example of using one large trust to fund gifts to many beneficiaries:

- The grantor established seven trusts (trusts A-H), each for the primary benefit of a different child), each of which was funded by two annual gifts of less than $5K with respect to which the primary beneficiary had a withdrawal right that lapsed on December 31 of the year in which the gift was made. The IRS ruled that the primary beneficiary was deemed the owner of the entire trust.[6776]

- Later, the grantor established a single trust (Trust Q), with a gift of under $20K per beneficiary, with each beneficiary having a pro-rata withdrawal right. When the withdrawal rights lapsed in 20 days, the trustee was required to distribute the shares attributable to a beneficiary's separate trust (one of trusts A-H). The IRS ruled that each of the original trusts retained its character as being deemed owned solely by its primary beneficiary. Transferring the lapsed portion to the separate trust should help avoid confusion over which part of the trust the beneficiary owns.[6777]

- These gifts were of S corporation stock. In ruling that the beneficiaries were deemed to own all trust Q's assets,[6778] the IRS did not mention the fact that each grantor trust holding S corporation stock must have a sole owner.[6779] I would not risk transferring S corporation stock to such a trust, absent a ruling that each beneficiary had a separate share,[6780] unless an electing small business trust election were in place.[6781]

III.B.2.i.viii.(c). Comparison

Having a combined trust that then divides as in Letter Ruling 9009010 can provide a bigger pot that will create greater lapses. On the other hand, if only one beneficiary is to receive a trust in this arrangement, then this splitting-off of the withdrawal right can be detrimental. Any lapses in the trust that received the initial gift will be limited to what remains in that trust; the lapse would not consider the assets of the recipient trust. In the example above with one large trust in which only one beneficiary had withdrawal rights, I posited that the last two years of lapses would be $220K each because the trust had $4.4M equity; if we had split-off the withdrawal portion and sold the nonvoting stock to a recipient trust, none of the recipient trust's assets would be considered in calculating the lapse, and the lapse would have been $50K or less (5% of $1M, increased by investment earnings but depleted by assets transferred to the recipient trust).

[6776] Citing Code § 678 and Reg. § 1.671-3 (without any analysis of the latter).
[6777] *Goldsby, Jr. v. Commissioner*, T.C. Memo. 2006-274, held that the taxpayer was not the deemed owner of certain property because he was owner of a different portion.
[6778] Citing Rev. Rul. 85-13.
[6779] Code § 1361(c)(2)(A)(i).
[6780] See fns. 5856-5857 in part III.A.3.a.i Qualifying as a Wholly Owned Grantor Trust.
[6781] See part III.A.3.a.iii Steps an S Corporation Might Take to Avoid a Trust Falling Short of Being a Wholly-Owned Grantor Trust.

III.B.2.i.viii.(d). Large Gift with Subsequent Large Power to Withdraw

In Letter Ruling 202022002,[6782] the beneficiary had the right to withdraw all assets but did not have the right to withdraw a certain LLC that the trust owned.[6783] However, the beneficiary had the right to withdraw proceeds from the sale of the LLC.

After citing Rev. Rul. 85-13, the IRS ruled that the trust's sale of the LLC to the beneficiary would not be recognized for federal income tax purposes.[6784]

III.B.2.i.ix. Creditor and Gift/Estate Tax Issues Regarding Withdrawal Rights, Whether Currently Exercisable or Lapsed

When a beneficiary holds a withdrawal right, in many states the beneficiary's creditors can force that beneficiary to exercise the withdrawal right.[6785] If all of the withdrawal rights lapse within a

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[6782] Obtained by ACTEC Fellow Jonathan Rikoon.

[6783] The facts were:

> According to the representations submitted, Grantors created Trust 1, an irrevocable trust for the benefit of Grantors' children and grandchildren. Grantors transferred Shares to Trust 1. Pursuant to the Trust 1 indenture dated Date 1, Trust 1 was divided into separate trusts for each of Grantors' children and grandchildren.
>
> The Trust 1 indenture prohibits a distribution of the Shares, but allows for distribution of the proceeds from the sale of the Shares. On Date 2, Trust 1 contributed all of its Shares to LLC, a newly formed entity classified as a partnership for federal tax purposes, in exchange for membership interests in LLC. Trust 1 represents that the same restriction placed on the distribution of Shares also restricts the distribution of the LLC interests. Effective Date 3, Trust 1 transferred a portion of its LLC interests to Subtrust LLC's assets include cash and the Shares. A is the sole beneficiary of Subtrust.
>
> Trust 1 represents that A has the authority to withdraw all of Subtrust's assets when A reaches age 40 except the LLC interests. Pursuant to her withdrawal right, on Date 4, A withdrew all of Subtrust's assets except the LLC interests.
>
> On Date 5, the trustees of Subtrust agreed to sell a portion of the LLC interests held in Subtrust to Trust 2 in exchange for \$a cash and a \$b promissory note. Trust 1 represents that Trust 2 is a grantor trust with respect to A under subpart E of part I of subchapter J of the Code. Trust 1 further represents that A has the authority to withdraw the cash and promissory note from Subtrust after the proposed sale.

[6784] The IRS concluded:

> Based solely on the facts submitted and representations made, we conclude that because A has a power exercisable by herself to vest the proceeds from the sale of Subtrust's LLC interests in herself and that those proceeds are Subtrust's only asset, A will be treated as the owner of Subtrust under § 678. Consequently, the transfer of the LLC interests to Trust 2 is not recognized as a sale for federal income tax purposes because Trust 2 and Subtrust are both wholly owned by A.
>
> Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the transaction described above under any other provision of the Code. Specifically, this ruling is conditioned upon Trust 2 being a grantor trust as to A and A having the authority to withdraw the promissory note from Subtrust. If these facts are not as represented by Trust 1, then this ruling is null and void.

[6785] See, *e.g.*, Uniform Trust Code § 505(b)(1) and Uniform Powers of Appointment Act § 502(a)(1), which are RSMo §§ 456.505.6(1) and 456.985.2(6). However, some states do not subject the beneficiary's withdrawal right to creditors. See, *e.g.*, 12 Del. C. § 3536(d)(2) (Delaware); NRS § 163.417.1(a) (Nevada) (in addition, it has been suggested that NRS §§ 163.4157 and 21.090(1)(cc)(3) exempt withdrawal rights from execution, because withdrawal rights are powers of appointment), North Carolina General Statutes § 36c-5-505(b)(1).

short amount of time after they are created, this should not be a significant problem, since the duration of exposure is small. So, a gift that is solely within the 5-and-5 power is not very concerning. If, however, a trust is funded with a large gift or bequest that lapses only gradually over time, then more is put at risk to the beneficiary's creditors and estate tax inclusion. Also, an allocation of the grantor's GST exemption might turn out to be wasted to a certain extent.

From an estate tax viewpoint, a withdrawal right is itself a general power of appointment that is includible in the beneficiary's estate, whether or not it is subject to the beneficiary's creditors.[6786] This is not troublesome while the withdrawal right is exercisable, because we expect that result. However, as described below, the beneficiary's creditors might be able to reach part or all of the trust's assets after a lapse, in which case the beneficiary's interest in that portion of the trust's assets are included in the beneficiary's estate, making the beneficiary deemed-owned trust strategy not work.

If the trust has a typical spendthrift clause in it, one might think that the beneficiary's creditors cannot reach the trust's assets. However, the spendthrift clause will not be valid if and to the extent the beneficiary is considered to be the settlor of the trust and either applicable state law does not respect self-settled spendthrift trusts or the trust does not comply with any limitations applicable state law places upon self-settled spendthrift trusts. Would state creditor law consider a beneficiary whose withdrawal rights lapsed to have, in substance, made a gift to the trust, so that it becomes a self-settled trust for creditor protection purposes?

The drafters of the Uniform Trust Code ("UTC")[6787] recognized and fixed this issue by providing that that, "upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in Section 2041(b)(2) or 2514(e) of the Internal Revenue Code of 1986, or Section 2503(b) of the Internal Revenue Code of 1986…."[6788] Section 503(b) of the Uniform Powers of Appointment Act follows the UTC's lead.[6789]

Thus, any state that has adopted UTC § 505(b)(2) or a similar statute or has case law along those lines should be a safe jurisdiction (regarding protecting the beneficiary's interest from creditors) for a beneficiary deemed-owned trust. These states include Alabama, Alaska, Arizona, Arkansas, Colorado, Delaware, D.C., Florida, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, 6790, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, North Carolina, Ohio, Oregon, Pennsylvania, Tennessee, Texas, Utah, Vermont, Virginia, Washington and Wisconsin.[6790] This is just a partial listing received from a list-serve

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[6786] Code § 2041(b)(1).

[6787] http://www.uniformlaws.org/Act.aspx?title=Trust Code.

[6788] Uniform Trust Code § 505(b)(1). The Comments to that section expressly recognize that issue and decided to follow the lead of Arizona and Texas in fixing it.

[6789] http://www.uniformlaws.org/Act.aspx?title=Powers of Appointment.

[6790] See, e.g., **Alabama** Code § 19-3B-505(c)(2) (follows UTC); ARS § 14-10505(B)(2) (**Arizona** - protection applies to lapsed withdrawal rights, without any limitations whatsoever); [ULA cites **Arkansas** as having no variation in this language]; **D.C.** Code § 19-1305.05(b)(2) (protection applies to lapses to the extent of the greater of annual exclusion or 5&5); **Florida** Statutes section 736.0505(2) (protection applies to the greater of 5&5 or the annual exclusion (double if the donor is married)); 12 Del. C. § 3536(c)(1) (**Delaware** - protection applies to lapsed annual exclusion gift, even if above 5&5); **Idaho** Statutes § 15-7-502(5)(b) (protection applies to the greater of 5&5 or the annual exclusion and in certain other situations); 760 ILCS 5/16.2 (**Illinois** - protection applies to lapsed annual exclusion gift, even if above 5&5); KSA § 58a-505(b)(2) (**Kansas** - protection applies to lapsed annual exclusion gift, even if above 5&5);

KRS § 386B.5-040(2)(b) (**Kentucky** protection applies without regard to the lapse's size); **Louisiana** Revised Statutes Title 9, Section 2004(2) (protecting any lapsed withdrawal right, without limit); **Maryland** Trust Code §§ 14.5-103(p) (defining power of withdrawal to be the greater of 5&5 or the annual exclusion – the latter doubled if the donor is married), 14.502 (a)(2), (e)(2), and 14.5-508(b); MCL § 700.7506 (**Michigan** – protection provided without limit); RSMo § 456.5-505.6 (**Missouri** - protection applies to lapses to the extent of the greater of annual exclusion or 5&5); [ULA reproduces **Nebraska** language referring to the greater of amounts in Code § 2041(b)(2), 2514(e) or 2503(b)]; NRS § 163.5559 (**Nevada** - protection applies to lapsed annual exclusion gift, even if above 5&5); [ULA cites **New Hampshire** as having no variation in this language]; NJS.3B:31-39.b(2) (effective 180 days after 1/19/2016) (**New Jersey** - protection applies to lapses to the extent of the greater of annual exclusion or 5&5); **North Carolina General Statutes** § 36c-5-505(b)(2) (protection provided even in excess of 5&5); **Ohio** Trust Code § 5805.06(B)(2) (protection applies to lapsed annual exclusion gift, even if above 5&5); [ULA reproduces **Oregon** language referring to the greater of amounts in Code § 2041(b)(2), 2514(e) or 2503(b)]; 20 **Pa.** C.S.A. §§ 7703 (defining withdraw power of withdrawal as excess over the greater of amounts in Code § 2041(b)(2), 2503(b) or 2514(e); presumably may in definition is same as shall), 7748 (power of withdrawal reachable by creditor whether or not lapsed; potentially problematic for hanging withdrawal rights above the annual exclusion that lapse within 5&5); **Tenn.** Code § 35-15-505(b) (protection applies to lapsed annual exclusion gift, even if above 5&5); **Texas** Property Code section 112.035(e); [ULA seems to cite **Utah** and **Vermont** as having no variation in this language]; **Va.** Code § 64.2-747(B) (protection applies to the greater of 5&5 or the annual exclusion (double if the donor is married)); RCW § 11.95.160 (**Washington** lapse protected without limits); **Wisconsin** statutes section 701.06(6)(b) (protection applies to lapsed annual exclusion gift, even if above 5&5). Some states apply double the annual exclusion amount if the donor is married at the time of the gift.

One Alaska lawyer stated to me that **Alaska** law infers that the lapse does not deem the beneficiary to be a settlor. The lawyer pointed to AS 34.40.115, which allows a beneficiary to hold an inter vivos (or testamentary) general power of appointment exercisable to the beneficiary, without the creditor being able to execute on an unexercised power.

University National Bank v. Rhoadarmer, 827 P.2d 561 (**Colo.** App. 1991), *cert. den.* (3/3/1992), prevented a creditor from requiring the current exercise of an annual 5&5 withdrawal right and from attaching trust property with respect to which the withdrawal power had lapsed.

Irwin Union Bank & Trust Co. v. Long, 312 N.E.2d 908 (**Ind.** App. 1st Dist. 1974) protected a lapsed gift, but its holding did not provide protection when the beneficiary had an ongoing withdrawal right over the entire trust, *Lincoln Nat. Bank and Trust Co. v. Figel*, 427 N.E.2d 5 (Ind. App. 4th Dist. 1981).

In New York, EPTL sections 10-7.1 and 10-7.2 provide that creditors can reach a general but not a limited inter vivos power of appointment; see *EM Ltd. v. Republic of Argentina*, regarding self-spendthrift trusts (citing *Vanderbilt Credit Corp. v. Chase Manhattan Bank, NA*, 100 A.D.2d 544, 546 (2d Dep't 1984); *Vanderbilt* has been suggested to me as commentators' favored reading of New York law).

Section 5205(c)(1) of the New York Civil Practice Law and Rules authorizes spendthrift protection for beneficiaries if the trust was not created by and has not proceeded from the beneficiary. Whether a lapse of a general power of appointment makes the trust created by or proceeded from the beneficiary is an issue that does not appear to have been addressed.

The California Probate Code subjects an unlimited withdrawal right to the claims of the holder's creditors. Probate Code §§ 611(a)(generally referring to a withdrawal right as a general power of appointment), 682(a). If and to the extent that the withdrawal right lapses upon the holder's death, it is subject to the creditors of the holder's estate. Probate Code § 682(b). California's statutes do not appear to address the effect of a lapse during life. If and to the extent that the lapse made the beneficiary treated as the settlor, the beneficiary's creditors of the settlor may reach the maximum amount that the trustee could pay to or for the benefit of the beneficiary, not exceeding the amount of the beneficiary's deemed proportionate contribution to the trust. Probate Code § 15304.

In his blog, professor Charles E. Rounds, Jr. made the following comment about **Massachusetts**:

> Section §505(b)(2) (or a provision comparable) is lacking in the version of the UTC that was enacted in Massachusetts. The commentary that accompanies the MUTC, specifically that accompanies Mass. Gen, Laws ch. 190B, § 505(a), confirms that the omission was intentional, but does little else: The Committee deleted subsection (b), which would have changed current

inquiry and additional citations I have come across; I have not reviewed Uniform Trust Code states not listed above and have not researched the law of any other state.[6791]

Suppose the goal is to tax the beneficiary as the owner for income tax purposes, protect the property from the beneficiary's creditors, but not worry about protecting the entire trust from being includible in the beneficiary's estate? It may be possible to use a hanging withdrawal right that is protected from the beneficiary's creditors. This is one scenario addressed in part III.B.2.i.xvi Includible Beneficiary Deemed-Owned Trusts.[6792]

If the trust's governing law and the law of the state in which the beneficiary resides do not both affirmatively protect the beneficiary's interest in the trust from the beneficiary's creditors, then one must consider whether the trust might be includible in the beneficiary's estate and determine whether other techniques might be more appropriate.

III.B.2.i.x. Letter Ruling 200949012

The ruling describes the subject trust, where the beneficiary was deemed the owner under the grantor trust rules, as follows:[6793]

> …Grantor proposes to create a trust ("Trust") for the benefit of Beneficiary. Under the terms of Trust, Beneficiary will serve as the Investment Trustee of Trust, A will serve as the Distribution Trustee of Trust and Company will serve as the Administrative Trustee of Trust (collectively, "Trustees"). A will have no beneficial interest in Trust. The Distribution Trustee will be authorized, but not required, to distribute income or corpus of Trust to Beneficiary. Beneficiary will have the power, during his lifetime, to direct the net income and/or principal of the Trust to be paid over or applied for Beneficiary's benefit, but only to the extent necessary for Beneficiary's health, education, maintenance or support. This power will not lapse.
>
> Additionally, Beneficiary will have the power to withdraw any property assigned, transferred or delivered, to the extent constituting a direct or indirect transfer for federal gift tax purposes, by Grantor to the Trustees. This power will lapse each calendar year in an amount equal to the greater of $z or y% of the value of the corpus of the Trust.
>
> Upon Beneficiary's death, all of the income and principal of Trust will be distributed either outright or in trust to such person or persons (other than Beneficiary, Grantor, their estates, their creditors and the creditors or their estates) and/or qualified charitable organizations as Beneficiary may appoint by Beneficiary's will. If Beneficiary does not

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Massachusetts law relating to creditor rights against property subject to powers of withdrawal and with respect to lapsing [sic], released or waived powers of withdrawal. No explanation of what that current law might be and how that law might have been changed by the enactment of UTC § 505(b) is supplied.

[6791] For a complete list, see Morrow, Edwin P., "IRC Section 678 and the Beneficiary Deemed Owner Trust (BDOT)" (April 19, 2018), available at SSRN: https://ssrn.com/abstract=3165592 or http://dx.doi.org/10.2139/ssrn.3165592, particularly Ed's appendix titled, "Creditor Protection for Assets Subject to Presently Exercisable General Powers of Appointment (Including Crummey, "Five and Five" or Other Withdrawal Powers) Pre and Post Lapse in Trust."

[6792] See text accompanying fns 6820-6823.

[6793] Even though a BDIT has many of the same features that were included in this letter ruling, the lawyer who obtained the ruling stated that it was not a BDIT.

exercise this power, the Distribution Trustee shall select one or more qualified charitable organizations for the distribution of the income and principal of Trust.

Grantor is not a beneficiary under the Trust, and has no interest under the Trust. Trust provides that no income or principal of Trust may be paid or appointed for the benefit of Grantor or Grantor's spouse, or to pay premiums on insurance policies on the life of Grantor and/or Grantor's spouse. Trust further provides that neither Grantor nor Grantor's spouse may act as a Trustee of Trust and that no more than one-half of Trustees of Trust may be related or subordinate parties to Grantor, within the meaning of § 672(c).

Trust further provides that Grantor does not intend to be treated under subpart E of Part I of subchapter J as the owner of Trust. Trust further provides that neither *Grantor* nor any other "nonadverse party" as that term is defined in § 672(b) shall have the power to (1) purchase, exchange or otherwise deal with or dispose of Trust's principal or income for less than adequate consideration or (2) borrow any of Trust's principal or income without adequate interest or security.

Trust further provides that no person, other than a United States person, shall have the authority to control any substantial decision (within the meaning of § 7701(a)(30)(E) of any trust created and held under Trust. No court, other than a court *within* the United States, shall exercise primary supervision over the administration of any trust created and held under Trust. Grantor and Beneficiary represent that Trust will be a domestic trust within the meaning of § 301.7701-7 of the Procedure and Administration Regulations.

The IRS ruled that Beneficiary, not Grantor, would be treated as owning the trust for income tax purposes.

Some of the trust's key features are noteworthy:

1. Beneficiary had the right to withdraw whatever Beneficiary decided (s)he needed for living expenses. Beneficiary's right to withdraw the entire initial gift to the trust had partially lapsed into a right to withdraw for living expenses.[6794]

2. The Distribution Trustee could distribute part or all of the trust to Beneficiary. This might also facilitate decanting (distributing to a new trust created by the trustee) if administrative provisions need to be changed in the future.[6795]

3. The references at the end to various foreign trust provisions are to avoid the grantor trust treatment that would have been imposed on Grantor if the trust had been a foreign trust.[6796]

The state's spendthrift statute:

prevents a creditor existing when the trust is created or a person who subsequently becomes a creditor, from satisfying a claim out of the beneficiary's interest in the trust unless, (1) the trust provides that the settlor may revoke or terminate all or part of the trust without the consent of a person who has a substantial beneficial interest in the trust

[6794] This feature is more fully discussed in III.B.2.i.xii Dealing with Code § 678(a)(2) Uncertainty.
[6795] See part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.
[6796] Code § 679.

> and the interest would be adversely affected by the exercise of the power held by the settlor to revoke or terminate all or part of the trust; (2) the settlor intends to defraud a creditor by transferring the assets to the trust; (3) the settlor is currently in default of a child support obligation by more than 30 days; or (4) the trust requires that all or a part of the trust's income or principal, or both, must be distributed to the settlor.

The IRS ruled that the gift was a completed gift and that the trust would not be included in the settlor's estate for estate tax purposes. However, the IRS declined to rule "whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036." This caveat is not surprising, given the parameters of Rev. Rul. 2004-64.[6797] Generally, the trustee should avoid making distributions to the settlor to the extent possible to minimize the possibility that the IRS would raise Code § 2036 on audit. Taxpayers probably will not be able to replicate this ruling.[6798]

Readers might want to consider integrating into their planning beneficiary deemed-owned trusts with some or all of the features set forth in Letter Ruling 200949012. However, I personally would not grant the beneficiary the continuing right to withdraw under ascertainable standards unless we could be sure that such a right to withdraw could not be reached by the beneficiary's creditors. Most states do not provide protection over the portion that a beneficiary could withdraw at the time the creditor attacks the trust and therefore would not be suitable for the structure of Letter Ruling 200949012; the trust in that ruling was formed under Alaska law, which does provide such protection. Several states protect a beneficiary's limited power of appointment from creditors, but the very logic that underlies Letter Ruling 200949012 might also be fodder for creditors: if the ongoing limited power of appointment is merely a partial continuation of the absolute withdrawal right, then might creditors also say that the statutes that protect limited powers do so only when they are not a mere partial continuation of a general power?[6799]

III.B.2.i.xi. My Suggestion for Distribution Trustee – A Variation of Letter Ruling 201039010

The structure provided in Letter Ruling 200949012 is very sound from a Code § 678(a)(2) perspective, but it presents some challenges. For example, suppose someone established an Alaska trust that had those provisions, but the beneficiary lived in a state that did not provide the same level of protection as Alaska at the time the creditor makes the attack. Would that state be required under the Full Faith and Credit clause of the U.S. Constitution to defer to Alaska law, or would that state's public policy be so compelling as to override that deference? If the assets are subject to the jurisdiction of a state that does not provide that level of protection, they might very well be subject to creditors. However, if a court in a creditor-friendly state cannot obtain jurisdiction over the trustee or over the trust's assets, then the rules of the protective state would tend to prevail. See part III.B.2.c.i Completed Gift to Self-Settled Trust.

[6797] See fns. 6961-6980, found in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the .

[6798] See Rev. Proc. 2013-3 § 4.01(48), (52), (55), and (63).

[6799] For example, New York protects limited powers, but only if the trust was not created by and has not proceeded from the beneficiary. See fn 6790.

I suggest a middle ground. For example, in Letter Ruling 200747002 (which I obtained), the grantor set up an irrevocable trust for Child. Child was trustee and could make distributions under an ascertainable standard to Child and Child's descendants. Child also had the power to appoint at Brother's death to anyone except to Child, Child's creditors, Child's estate or the creditors of Child's estate. The IRS ruled that the trust was taxable to Child (and will qualify to hold stock in an S corporation).

Alternatively, in Letter Ruling 201039010, the beneficiary had the power to withdraw each gift, but the amount that can be withdrawn by the primary beneficiary in any one calendar year is limited to the maximum amount as to which the power of withdrawal can lapse without the lapse constituting the release of a general power of appointment under Code §§ 2041(b)(2) and 2514(e). The independent trustee had absolute discretion to distribute part or all of the net income as the trustee deems appropriate to any one or more then living of the beneficiaries, in amounts and proportions as the trustee determines. The IRS ruled that the trust will be taxable to the beneficiary (and will qualify to hold stock in an S corporation) if all gifts will be subject to this withdrawal power.

After analyzing Letter Ruling 201039010, I have very significant concern in having a pattern of the independent trustee making distributions each year, once the note is repaid and the beneficiary can no longer afford to pay the trust's taxes.[6800] Therefore, my future structure in light of this ruling will be to name the beneficiary as trustee to make distributions under an ascertainable standard and to name an independent trustee authorized to make distributions in excess of that. I would rather see the beneficiary take distributions for support, if necessary, since that does not cause estate tax inclusion problems; it still might get to the point that the independent trustee makes distributions to pay taxes, but that is less likely under my suggested structure. However, if the trust's governing law and the law of the state in which the beneficiary resides do not both affirmatively protect the beneficiary's interest in the trust from the beneficiary's creditors when the beneficiary serves as trustee, my preferred structure might have risk; fortunately, the Uniform Trust Code protects beneficiaries who serve as trustees.[6801]

[6800] Rev. Rul. 2004-64 held that, if the trust's governing instrument or applicable local law granted the trustee the discretion to reimburse the grantor of a grantor trust for the grantor's income tax liability with respect to trust income, the existence of that discretion, by itself (whether or not exercised) will not cause the value of the trust's assets to be includible in the grantor's gross estate; see fns. 6961-6980, found in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the .. However, Situation 3 of the ruling included some important caveats. The ruling assumed no understanding, express or implied, between the grantor and the trustee regarding the trustee's exercise of discretion. It also said that inclusion might apply if the discretion to make distributions is combined with other facts, including without limitation an understanding or pre-existing arrangement between the grantor and the trustee regarding the trustee's exercise of this discretion, a power retained by the grantor to remove the trustee and name the grantor as successor trustee, or applicable local law subjecting the trust assets to the claims of the grantor's creditors.

[6801] Uniform Trust Code § 504(e) provides, If the trustee's or cotrustee's discretion to make distributions for the trustee's or cotrustee's own benefit is limited by an ascertainable standard, a creditor may not reach or compel distribution of the beneficial interest except to the extent the interest would be subject to the creditor's claim were the beneficiary not acting as trustee or cotrustee. North Carolina General Statutes § 36C-5-504(f). The Comments to Uniform Trust Code § 504 provide a helpful discussion of this issue. For a review of Uniform Trust code states, see Kingma, A Beneficiary Serving as Trustee May Affect Asset Protection, *Estate Planning Journal* (4/2011). Some states provide this level of protection even if an ascertainable standard is not used. Indiana (IC 30-4-2.1-14 through 30-4-2.1-17), Missouri (RSMo § 456.5-504.1), Nevada (NRS §§ 163.41731(d) and 163.4177.10), and Alaska (AS 34.40.110(g), providing that a beneficiary who is not the settlor does not lose spendthrift protection by serving as

If applicable state law is favorable in this area and the concern is over where the beneficiary might later move, I would still strongly consider my preferred structure, because a pattern of distributions by an independent trustee concerns me greatly;[6802] to address the concern over where the beneficiary might later move, perhaps the independent trustee could be given the power to eliminate the beneficiary's right to serve as trustee for distributions.

III.B.2.i.xii. Dealing with Code § 678(a)(2) Uncertainty

The person who obtained Letter Ruling 200949012 has suggested that the right to withdraw should not completely lapse, because Code § 678(a)(2) requires that the beneficiary "has previously partially released or otherwise modified" the withdrawal right, and a complete lapse would inconsistent with a "partial release." I asked whether the IRS agreed with his reading of Code § 678(a)(2), and he said, "The IRS did not express any such concern when I obtained Letter Ruling 200949012." The subsequent issuance of Letter Rulings 201038004 and 201216034 implicitly confirms that the IRS does not agree with his reading of Code § 678(a)(2).

Although private letter rulings tend to indicate the IRS' position at the time the ruling was issued, they do not bind the IRS with respect to other taxpayers. Furthermore, the IRS will not rule whether a person will be treated as the owner of any portion of a trust over which that person has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner of the trust under Code § 671 if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of Code § 2041, if the trust purchases the property from that person with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.[6803] Thus, obtaining a private letter ruling to avoid this uncertainty might not be possible.

Absent a ruling, consider whether the following extra caution might be desirable: Instead of using the beneficiary's social security number as the trust's tax ID, obtain a separate tax ID for the trust. The trust files annual Form 1041, reporting its status as a grantor trust. This will get the statute of limitations running with respect to this issue. Although private letter rulings are not

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trustee) might be the only states where a beneficiary can be a trustee, have sole and absolute discretion as trustee to distribute the entire trust to himself or herself, and still have the trust's assets protected from his or her own creditors. I have been told that Hasseler, Trustee-Beneficiaries, Creditors, and New York's EPTL: The Surprises That Result and How the UTC Solves Them, 69 Albany Law Review 1169 (2006), is a good summary of New York law in this area; Hessler posits that New York law provides that a beneficiary who is a trustee is protected from creditors even if the trustee/beneficiary may distribute all of the trust's assets without any standards (assuming the beneficiary is not also a settlor).

[6802] What if the beneficiary has the right to remove and replace the trustee and applicable state law imputes the trustee's powers to the beneficiary? Presumably, a pattern of distributions following the beneficiary's desires would increase the risk of such an imputation. Note that Uniform Trust Code § 504(e) requires the beneficiary's discretion as trustee to be pursuant to a standard. If the beneficiary is imputed the trustee's power, and the trustee's power exceeds what is protected under Uniform Trust Code § 504(e) or other comparable applicable state law, then perhaps the beneficiary's creditors could reach the trust's assets. This line of reasoning makes me want to allow the beneficiary to serve as a trustee who can make distributions for his or own support and therefore rarely requests that the independent trustee make discretionary distributions; this mechanism would tend to avoid a pattern of distributions by the independent trustee. Indiana has done a great job of anticipating and refuting the creditor attacks about which this footnote expresses concerns; see IC 30-4-2.1-15.

[6803] Rev. Proc. 2013-5, Section 4.01(39).

precedent, they constitute authority on which one can rely to avoid penalties,[6804] and the large number of letter rulings – all reaching the same conclusion – should constitute substantial authority.[6805]

III.B.2.i.xiii. Protecting Against Excessive Income Tax Estate Burn-Off

Consider that the beneficiary's income tax liability continuing forever might deplete the beneficiary's estate to uncomfortably low levels (estate burn-off). The beneficiary can sell assets to obtain funds to pay taxes, but eventually the beneficiary might run out of assets.

Arguably, recurring income tax payments are an ordinary part of a person's living expenses. Perhaps distributions to pay the beneficiary's taxes might be considered part of the beneficiary's support? If not, consider the mechanisms below.

Giving the beneficiary the power to borrow at the AFR without adequate security certainly gives the beneficiary a safety valve. However, a loan that the beneficiary will not be able to repay might be considered a distribution, if there is no intent to repay, and giving the beneficiary what might be tantamount to an unlimited withdrawal right could create exposure to creditors and estate tax. So, the safety valve of borrowing might be considered a temporary solution.

The BDIT and other models might give an independent trustee the right to distribute as much as the independent trustee deems advisable, without any limit. As mentioned above, a pattern of making distributions whenever the beneficiary asks for money might be troublesome. Consider, however, having two separate independent trustees for such distributions.

1. Tax Distributions. One independent trustee (the "tax distribution trustee"), who the beneficiary can remove and replace, makes distributions to pay income taxes, but the distributions might start many years down the road, when the estate burn-off threatens to become excessive. The trustee might just pay the taxes directly, preventing the creditors from attaching the money when it gets in the beneficiary's hands. Even if a creditor might somehow be able to attach these distributions, the creditor would have to fight the taxing authorities.

2. Other Distributions. The other independent trustee would be more difficult to remove and generally would not decide to make distributions. An exception might be if a gift tax audit finds that the beneficiary did not receive adequate and full consideration. The lack of adequate and full consideration might cause the beneficiary to be deemed the grantor of that portion of the trust. That portion of the trust would be an incomplete gift, as described further above, and therefore would be includible in the beneficiary's estate. The independent trustee might then distribute this portion to the beneficiary to try to cleanse the trust. This event would happen in the first several years of the trust, so estate burn-off would eventually cleanse the beneficiary's estate of these assets as well.

How much of the trust's income and gains are truly needed to support the beneficiary? Suppose a trust had $1 billion of assets and the beneficiary spent only $1 million per year?

[6804] Reg. § 1.6662-4(d)(3)(iii).
[6805] Rulings more than ten years old are generally accorded little weight. Reg. § 1.6662-4(d)(3)(ii). However, combined with recent rulings, they do demonstrate a consistent position.

Some part of the trust would not be needed for the beneficiary's support. Consider the following approaches:

1. Release Power. The independent trustees release their power to make distributions beyond certain limits. The assets beyond those limits are not available for distribution, other than for the beneficiary's support. Therefore, not all of the assets are available for distribution to the beneficiary. This limits the amount of income and gains accumulated for the beneficiary's future use. The excess income would not be taxable to the beneficiary.[6806] One might consider special drafting to authorize the trustee to impose these limits without violating a duty to the beneficiary.

2. Split Trust. The beneficiary could exercise the beneficiary's power of appointment by appointing to a new trust such portion as is not needed to provide for the beneficiary's support. The beneficiary would not be a beneficiary of the new trust; or, alternatively, an adverse party would be appointed trustee to make Code § 677 not apply. Although this might constitute a taxable gift, the value of the taxable gift might be zero, if this splitting of the trust does not cause the beneficiary's distributions to decrease. The splitting of the new trust might be done in conjunction with a net gift agreement, in case any gift taxes are imposed.

III.B.2.i.xiv. QSST as an Alternative Form of Beneficiary Deemed-Owned trust

If the income beneficiary elects to have a trust holding S corporation stock as a "qualified subchapter S trust" (QSST),[6807] the beneficiary is treated as the Code § 678(a) owner of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made.[6808]

How does a QSST compare to other beneficiary deemed-owned trusts? Other beneficiary deemed-owned trusts will always be taxed to the beneficiary. With those other trusts, generally the beneficiary needs to rely on an independent trustee to distribute enough to pay tax, once the tax burn-off has reduced the beneficiary's estate to the beneficiary's target level. With a QSST, all of the trust's income must be distributed to the beneficiary, so an agreement that the S corporation make tax distributions would suffice to get income to the beneficiary to pay taxes. On the other hand, distributing the income to the beneficiary means that tax burn-off is not occurring, and generally distributions from the S corporation are being distributed to the beneficiary rather than being accumulated in the trust. Thus:

- If tax burn-off to deplete the beneficiary's other assets is a key goal, then either use a beneficiary deemed-owned trust other than a QSST or use a QSST with an S corporation that does not distribute enough to pay its owner's taxes (the latter being unusual).

- If the goal is simply to facilitate a sale to trust to get the asset's appreciation outside of the estate tax system and the ability to toggle off grantor trust status is important, use a QSST. See part III.A.3.e.iv Flexible Trust Design.

[6806] See *Townsend v. Commissioner*, 5 T.C. 1380 (1945).
[6807] See part III.A.3.e.i QSSTs for QSSTs generally and part III.A.3.e QSSTs and ESBTs generally for a comparison of the two types of trusts most commonly used when the grantor is no longer living or does not want to pay the trust's taxes.
[6808] Reg. § 1.1361-1(j)(8).

For a description of the advantages and disadvantages of using a QSST in this manner, see part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs, especially part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts and III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (which also discusses how the asset's base value is not moved outside of the estate tax system).

III.B.2.i.xv. Sale to Trust Created by Spouse: An Alternative Way to Have a Trust Benefitting Client

Consider having the client's spouse establish an irrevocable trust for the client. The trust would be a grantor trust, taxable to the spouse under Code § 677 (with perhaps a swap power included). The client might then sell assets to the trust. Consider limiting the beneficiary's power of appointment over any bargain sale element.[6809]

Whereas beneficiary deemed-owned trusts tend to be thinly funded, with no more than $5,000 initially,[6810] a spousal irrevocable grantor trust can be well-funded. However, when making gifts to the trust (to seed it or otherwise), the donor spouse should avoid using property that the beneficiary spouse gifted to the donor.[6811]

Just as a sale to a beneficiary deemed-owned trust, the beneficiary could be a trustee authorized to make distributions for his or her support. A trustee not appointed by the beneficiary or an independent trustee appointed by the trustee should be able to make distributions for the beneficiary's welfare, which the beneficiary might use to pay the grantor-spouse's income taxes. These concerns parallel those described in part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts. However, in this case, the beneficiary's spouse, not the beneficiary, is subject to income tax. And, with the repeal of Code § 682, the spousal grantor has no way to turn off the Code § 677 power that may apply via Code § 672(e) spousal attribution, even after divorce; see part III.B.2.h.ix Code § 682 Limitations on Grantor Trust Treatment (Repealed for Post-2018 Divorces). Thus, a grantor tax-reimbursement provision may be much more important to consider; see parts III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner and III.B.2.h.vi Protecting the Grantor.

It is much less likely that a sale to an irrevocable grantor trust taxable to seller that the deemed owner's death is a taxable event.[6812] However, a disadvantage is that I tend to recommend that the beneficiary not have a power of appointment in 10% of the remainder, to get the gift tax statute of limitations running.[6813] Also, the interest deduction might not fully offset the interest income.[6814]

[6809] See text accompanying fn 6755 in part III.B.2.i.v Sale to a Beneficiary Deemed-Owned Trust – When a Traditional Sale to an Irrevocable Grantor Trust Does Not Meet the Client's Objectives.
[6810] Compare part III.B.2.i.vi Funding the Trust with Small Gifts with parts III.B.2.i.vii Portion Owned When a Gift Over $5,000 is Made and III.B.2.i.viii Funding the Trust with a Large Initial Gift or Bequest.
[6811] See fn 7481 in part III.D Code § 2038.
[6812] See fn 6591 in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System, which describes uncertainty in that area. I very much agree that the note has full basis in the sale to spousal grantor trust, as described below in this part III.B.2.i.xv.
[6813] See part III.B.4 Adequate Disclosure on Gift Tax Returns.
[6814] See text accompanying fn 6818.

The most comprehensive article on the subject is Culp, Hattenhauer, and Mellen, "The Tax and Practical Aspects of the Installment Sale to a Spousal Grantor Trust," 44 *ACTEC Law Journal* No. 1 (Mar. 2019), pages 63-127.[6815] The authors conclude:

> In conclusion, the authors believe the following tax consequences flow from a sale of property to a spousal grantor trust. In each case it is assumed that there has been a bona fide sale of property by the selling spouse to the spousal grantor trust and a valid and enforceable note was received in exchange for the property sold.
>
> 1. The selling spouse should not recognize gain on the sale of property to a spousal grantor trust under Section 1041, even if the grantor spouse dies while the note is outstanding.
>
> 2. If the selling spouse sells property to the spousal grantor trust for full and adequate consideration, the selling spouse should not be treated as making a taxable gift to the spousal grantor trust and the assets of the spousal grantor trust should not be included in the selling spouse's estate for estate tax purposes.
>
> 3. Prior to the selling spouse's death, payments received by the selling spouse should be received income-tax-free, although interest payments will be taxable to the selling spouse and may be deductible by the grantor spouse.
>
> 4. If the grantor spouse dies while the note is outstanding the selling spouse should continue to receive installment payments on the note tax free.
>
> In addition, the authors recommend that the sale to a spousal grantor trust structure should include the following:
>
> 1. The parties should obtain an appraisal of the property sold.
>
> 2. Practitioners should consider using a formula clause for gift and estate tax purposes.
>
> 3. Practitioners should consider designing the spousal grantor trust to give the selling spouse an interest or powers that would cause any potential taxable gift on the sale to the trust to be incomplete for gift tax purposes.
>
> 4. For gift tax purposes, a gift tax return adequately disclosing a completed non-gift transaction should be considered to begin the running of the gift tax statute of limitations and provide a discreet period of time to determine the extent, if any, that the transfer is treated as a gift (whether complete or incomplete) by the selling spouse.
>
> 5. The terms of the trust should allow or authorize an independent trustee or trust protector to decant trust assets to a new trust or otherwise terminate any retained interests or powers of the selling spouse that may cause inclusion in the selling spouse's gross estate for estate tax purposes.

[6815] Saved as Thompson Coburn LLP doc. no. 7430010; see 67th-131st pages of PDF. Briani Mellen is now Briani Bennett, with the same law firm at https://www.ceclaw.com/attorneys/briani-bennett-mellen.

6. The terms of the trust should set forth the intent and purpose for the trust to be wholly grantor to the grantor spouse during his or her lifetime.

As to recommendation 2, see part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers. As to recommendations 3 and 4, see part III.B.4 Adequate Disclosure on Gift Tax Returns. As to recommendation 6, see parts III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment, III.B.2.e Grantor Trust Tax Identification Number During Life and Upon Death, III.B.2.f Triggering the Statute of Limitations for Grantor Trusts (expressing concern that the statute of limitations might not run on a sale to an incomplete gift trust and recommending that the beneficiary not have a power of appointment over 10% of the remainder), III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System, III.B.2.h How to Make a Trust a Grantor Trust Taxed to a U.S. Citizen or Resident, III.B.2.i.xiii Protecting Against Excessive Income Tax Estate Burn-Off, and III.B.2.j.i Changing Grantor Trust Status (the latter within part III.B.2.j Tax Allocations upon Change of Interest in a Business).

When the client sells assets to the trust, the client would be deemed to have sold the assets to the client's spouse, and Code § 1041 would cause nonrecognition of the gain on sale.[6816] The interest income and expense would be recognized for income tax purposes as if Code § 1041 did not exist.[6817] Although presumably the interest expense would be deductible by the spouse against the spouse's S corporation income, note that various phase-outs of deductions and exemptions work from adjusted gross income, so the inclusion of income would have a slightly adverse income tax effect.[6818] Also, an adverse tax consequence could occur if wife did not receive adequate and full consideration for the stock she transferred to the trust. Although the Code § 7872 below-market interest loan rules do not apply to transactions between spouses, I would charge interest to avoid a gift.[6819] In "Beyond the Binary: Choosing Between Grantor and Non-Grantor Status," 2020 Heckerling Institute on Estate Planning, part I.D.3.c.(2), "Issue a term loan providing payments with a present value equal to the amount of the loan," McCaffrey and Bramwell describe how to avoid charging stated interest and a gift; I would like to see the idea further developed to discuss how to treat prepayment and any risk of the IRS disrespecting a note when annual payments are not scheduled to be made. In that same presentation, part I.D.3.d, "Basis in the Note Issued by the Spousal Grantor Trust," discusses:

(1) Why basis could matter. When the spousal grantor trust issues a note for the purchase price, so long as the spouse is alive, the payments made by the spousal grantor trust to the taxpayer will be protected from tax by Section 1041 regardless of the basis of the notes in the hands of the taxpayer.[36]

> [36] PLR 9235026 (May 29, 1992); PLR 9123053 (March 13, 1991).

Basis does matter under the following circumstances:

(a) Possible deemed modification on death of grantor spouse. The significant modification of a debt instrument is treated as an exchange of the original debt instrument for the modified instrument.[37] A change in the identity of the obligor

[6816] If the sale is for a loss, see fn. 7254 in part III.B.6.d Divorce as an Opportunity to Transfer.
[6817] See fns. 7256 and 7257 in part III.B.6.d Divorce as an Opportunity to Transfer.
[6818] See part II.C.3.d Deducting Interest Expense on Debt Incurred by a Partnership, which includes a more general discussion of interest deductions.
[6819] See fns. 7254 and 7260 in part III.B.6.d Divorce as an Opportunity to Transfer.

on a recourse debt instrument is treated under the regulations as a significant modification unless certain requirements are met.[38] If a modification causes an exchange to occur, the holder of the note recognizes gain equal to the excess of the fair market value of the note after the modification over the taxpayer's basis in the note.

[37] *Cottage Savings Assoc. v. Comm'r*, 499 U.S. 554 (1991); Treas. Reg. Section 1.1001-3.

[38] Treas. Reg. § 1.1001-3(e)(4).

When the spouse who created a spousal grantor trust dies, the trust will become a new taxpayer, a non-grantor trust.[39] The IRS could take the position that the change in the tax identity of the obligor is a modification for purposes of the regulation. If the taxpayer's basis in the note is less than face, this treatment would cause the taxpayer to recognize gain.

[39] The issue raised in this paragraph could occur if grantor trust status ended for any other reason.

[My comment – see part II.G.31.a Debt Modifications.]

(b) Note issued by spousal grantor trust should be treated as nonrecourse. A change in the identity of the obligor is a significant modification only if the debt is a recourse debt instrument. Although the regulations do not provide definitions of recourse and nonrecourse debts, it is generally understood that a recourse debt is a debt that holds the borrower personally liable. All other debts are considered nonrecourse. The creditor under a nonrecourse debt instrument is limited to the collateral provided by the borrower to secure the loan.[40] Using this definition while the spouse is alive, the debt of the spousal grantor trust seems clearly to be nonrecourse debt as to the spouse. The spouse has no personal liability for the debt. The taxpayer can look only to the assets of the spousal grantor trust for the payment of the note issued by the trust.

[40] IRS Publication 5182, Cancellation of Debt, p. 6 (2014).

Although the spousal trust shares a tax identity with the spouse during the spouse's life, the shared identity has no significance outside of the world of the income tax. It has, for example, no bearing on the legal rights of the taxpayer under the note and no impact on the collectability of the note. As a result, the technical change of the identity of the obligor for income tax purposes should not be treated as a modification of the note for purposes of Treas. Reg. § 1.1001-3(b).

(c) Payments made on the note after death of grantor spouse. As discussed above, when the spouse dies, the spousal grantor trust will no longer share a tax identity with the taxpayer's spouse. As a result, the IRS could take the position that payments made on the note after the spouse's death are not protected by Section 1041. If the basis of the note in the hands of the taxpayer is less than face, the satisfaction of the note by the non-grantor trust might be a tax recognition event. If so, the taxpayer would recognize gain equal to the principal amount of the note.

(d) **Terms of note actually modified**. The taxpayer and the trustee of the spousal grantor trust could agree to modify the terms of the note. If the modification occurs while the spouse is alive, the deemed exchange caused by the application of Treas. Reg. § 1.1001-3 should be protected from tax by Section 1041 regardless of the basis of the note in the hands of the taxpayer. If the modification occurs after the spouse's death, the IRS could take the position that the modification causes gain recognition to the extent of the fair market value of the note after the modification over the taxpayer's basis in the note.

(e) **Sale of note to third party**. If the transferor spouse sells the note to a third party, the taxpayer will recognize gain equal to the excess of the price received over the sales price of the note.

(2) **What is the taxpayer's basis in note issued by a spousal grantor trust in exchange for a transfer of property?** If the taxpayer's basis in the note issued by the spousal grantor trust is equal to the face value of the note, the issues listed above largely disappear. So long as the value of the note and the taxpayer's basis in the note are equal at the time of an actual or deemed debt modification, the modification would not cause recognition of gain. Similarly, there would be no gain recognition when the taxpayer sold the note to a third party or when the trust, after the spouse's death, satisfies the note.

There is uncertainty as to a taxpayer's basis in a note issued by the trustees of a spousal grantor trust in a Section 1041 exchange. Because the taxpayer received the note in an exchange treated as a gift for income tax purposes, if the issuance of the note is treated as a transfer of property, the taxpayer's basis in the note could be deemed to be the same as the trustees' basis in the note, which should be the same as the spouse's basis in the note.

(a) **Self-made notes**. There is no direct authority that explains how a taxpayer's basis in his or her own obligation (a "selfmade note") should be determined. There is some guidance in the partnership and corporate tax context that suggests that a taxpayer's basis in a self-made note contributed to a partnership or corporation is zero and does not increase his or her basis in either type of entity.[41] Other cases, however, have rejected this conclusion.[42]

[41] *E.g., Seggerman Farms, Inc. v. Comm'r*, 308 F.3d 803 (7th Cir. 2002); *Gemini Twin Fund III*, TCM 1991-315, *aff'd without pub. opn.* 8 F.3d 26 (9th Cir. 1993); *Alderman v. Comm'r*, 55 TC 662 (1971); Rev. Rul. 68-629 1968-2 C.B. 154.

[42] *Lessinger v. Comm'r*, 872 F.2d 519 (2d Cir. 1989) *rev'g* 85 TC 824 (1985); *Peracchi v. Comm'r*, 143 F.3d 487 (9th Cir. 1998) *rev'g* TCM 1996-191. For one tax advisor's discussion as to why the IRS position in the zero basis cases is flawed, see Kenneth P. Brewer, "The Zero Basis Hoax," Tax Notes April 28, 1994.

Perhaps more important, the focus of these cases was on the taxpayer, not on the entity to which the self-made note had been contributed. The cases finding against the taxpayers held that the taxpayer had a zero basis in the self-made notes because he or she incurred no cost in making the note.[43] There was no discussion of the tax consequences to the entity, when the debt was paid or if it sold the self-made note to a third party. In a 1995 Field Service Advice, Assistant Chief Counsel (Field Service) Daniel J. Wiles advised that treating the basis of the self-made note in the hands of the entity as zero would result in the entity recognizing income when the taxpayer paid the debt, and that the litigating hazards of advancing such position would be overwhelming.[44]

[43] *Alderman v. Comm'r*, 55 TC 662, 665 (1971).

[44] 1995 FSA LEXIS 160.

In the case of the note issued to a taxpayer by a spousal grantor trust, the concern is with the taxpayer's basis in the note, not with his or her basis in the trust. We should not be concerned with the basis of the grantor spouse or the spousal grantor trust in the note. In fact, it is misleading to even suggest that the question of the trust's or the spouse's basis in note is a meaningful one. Assets have basis; obligations in the hands of the obligor, do not.

(b) Note should have basis. The question of the taxpayer's basis in the note should be answered with reference to the policy behind Section 1041. Congress intended that property transfers between spouses be free of income tax including those transfers that are to be paid for over time. There is no good policy reason for placing a selling taxpayer in a worse position because the spouse cannot afford to make immediate payment for the transferred property.

There are at least two ways of achieving this result.

(i) Note has basis when issued. First, the note issued by the spousal grantor trust could be treated as having a basis equal to the face amount when issued. This treatment seems most consistent with the objectives of Section 1041. It would result in equal treatment between those taxpayers whose spouses are able to make current payment for transferred property and those who are not. The taxpayer who receives a note would be able to sell it to a third party and would be able to receive payments on the note after the death of the spouse without adverse tax consequences. This approach was suggested by the America Institute of Certified Public Accountants in the 1998 testimony of its representative before the House Committee on Ways and Means.[45]

[45] Available on Tax Notes web site.

(ii) Extension of section 1041 treatment. The second approach is to conclude that the taxpayer's basis in the note is irrelevant and to treat payments, whenever made, as an integral part of the same transaction that caused the issuance of the note. Under the principal set forth by the Supreme Court in *Arrowsmith v. Comm'r*, 344 U.S. 6 (1952), this treatment should extend the tax-free treatment of the issuance of the note to payments under the note.

> The issuance of the note was treated as a gift for income tax payments; payments under the note should be treated as gifts as well.

I agree with their conclusion that the holder should have basis in a note issued by a trust deemed owned by the holder's spouse. For more details, see Dana, "Till Death Do Us Part: The Riddle of Note Basis in a Sale to a Spouse's Grantor Trust," 114 Journal of Taxation 340 (6/2011).

A disadvantage of this technique relative to a sale to a beneficiary deemed-owned trust is that the grantor spouse could not be a beneficiary upon the client's death unless the trust is created in a jurisdiction that recognizes self-settled spendthrift trusts and the spouse is able to rebut any Code § 2036 or 2038 arguments.

III.B.2.i.xvi. Includible Beneficiary Deemed-Owned Trusts

The preceding discussion within this part III.B.2.i tends to focus on how to create a trust that is not includible in the beneficiary's estate for estate tax purposes.

Suppose, however, that the beneficiary's estate tax posture is not a concern, but rather the donor wants the beneficiary be treated as owning the property for income tax purposes but is concerned about protecting the property and finds unattractive the planning described in part III.B.2.i.xiv QSST as an Alternative Form of Beneficiary Deemed-Owned trust. Consider using a large gift with a withdrawal right that lapses each year only to the extent of 5% of the property that can be withdrawn, but after 30 days (or some other relatively short period) the consent of a nonadverse party is required.

For estate and gift tax purposes, requiring the consent of a nonadverse party (who may be a trustee) does not prevent the withdrawal right from being a general power of appointment,[6820] so the general power of appointment will not be treating as lapsing. For example, Reg. § 25.2514-3(b)(2) provides:

> Such power is not considered as a general power of appointment if it is not exercisable by the possessor except with the consent or joinder of a person having a substantial interest in the property subject to the power which is adverse to the exercise of the power in favor of the possessor, his estate, his creditors, or the creditors of his estate. An interest adverse to the exercise of a power is considered as substantial if its value in relation to the total value of the property subject to the power is not insignificant. For this purpose, the interest is to be valued in accordance with the actuarial principles set forth in § 25.2512-5 or, if it is not susceptible to valuation under those provisions, in accordance with the general principles set forth in § 25.2512-1. A taker in default of appointment under a power has an interest which is adverse to an exercise of the power. A coholder of the power has no adverse interest merely because of his joint possession of the power nor merely because he is a permissible appointee under a power. However, a coholder of a power is considered as having an adverse interest where he may possess the power after the possessor's death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate. Thus, for example, if X, Y, and Z held a power jointly to appoint among a group of persons which

[6820] Code §§ 2041(b)(1)(C)(ii), 2514(c)(3)(B); Reg. §§ 20.2041-3(c), 25.2514-3(b)(2). For a detailed discussion, including a reproduction of Reg. § 20.2041-3(c), see part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.

> includes themselves and if on the death of X the power will pass to Y and Z jointly, then Y and Z are considered to have interests adverse to the exercise of the power in favor of X. Similarly, if on Y's death the power will pass to Z. Z is considered to have an interest adverse to the exercise of the power in favor of Y. The application of this subparagraph may be further illustrated by the following examples in each of which it is assumed that the value of the interest in question is substantial:
>
> *Example (1)*. The taxpayer and R are trustees of a trust under which the income is to be paid to the taxpayer for life and then to M for life, and R is remainderman. The trustees have power to distribute corpus to the taxpayer. Since R's interest is substantially adverse to an exercise of the power in favor of the taxpayer, the latter does not have a general power of appointment. If M and the taxpayer were trustees, M's interest would likewise be adverse.
>
> *Example (2)*. The taxpayer and L are trustees of a trust under which the income is to be paid to L for life and then to M for life, and the taxpayer is remainderman. The trustees have power to distribute corpus to the taxpayer during L's life. Since L's interest is adverse to an exercise of the power in favor of the taxpayer, the taxpayer does not have a general power of appointment. If the taxpayer and M were trustees, M's interest would likewise be adverse.
>
> *Example (3)*. The taxpayer and L are trustees of a trust under which the income is to be paid to L for life. The trustees can designate whether corpus is to be distributed to the taxpayer or to A after L's death. L's interest is not adverse to an exercise of the power in favor of the taxpayer, and the taxpayer therefore has a general power of appointment.

Reg. §§ 20.2041-3(c), 25.2514-3(b)(2) treat a co-holder of a power of appointment as an adverse party only if the co-holder would be a taker in default of the exercise or has some other interest as a beneficiary.

For a detailed discussion about why a trustee's concerns about fiduciary duties do not make the trustee "adverse" when the trustee has no beneficial interest in the trust, see part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.

For state law purposes, requiring the consent of a nonadverse trustee or other party may cause the power not to be treated as a withdrawal right.[6821]

[6821] For example, referring to a 5&5 power and the gift tax annual exclusion, Uniform Trust Code § 505(b)(2) provides:

> upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in Section 2041(b)(2) or 2514(e) of the Internal Revenue Code of 1986, or Section 2503(b) of the Internal Revenue Code of 1986 ….

R.S.Mo. § 456.5-505.6(2) provides that, for purposes of creditors attacking a beneficial interest:

> Upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in Sections 2041(b)(2), 2514(e) or 2503(b) of the Internal Revenue Code.

However, the lapse of a withdrawal right for state law purposes may subject the lapsed portion to the beneficiary's creditors.[6822] However, some states provide that lapses do not subject the lapsed portion to the beneficiary's creditors, even if the beneficiary could have withdrawn the entire trust. See part III.B.2.i.ix Creditor and Gift/Estate Tax Issues Regarding Withdrawal Rights, Whether Currently Exercisable or Lapsed.[6823]

A release of a general power of appointment is a gift,[6824] even if it is done by not suing a trustee for reducing the property subject to a testamentary general power.[6825]

Suppose the grantor cares only about making the beneficiary the owner for income tax purposes[6826] and creates the trust for control (to avoid outright ownership that might harm the beneficiary) and did not mind the property being included in the beneficiary's estate for estate tax purposes (which may even be desirable to attain a basis step-up)[6827] or even perhaps subjecting the property to the beneficiary's creditors (if one cannot use a favorable state in light of fn 6823). Consider using a trust along the lines of one that qualifies for the Code § 2642(c)(2) GST annual exclusion.[6828] The beneficiary would have the right to withdraw the gift (and any income on it)[6829] for only a limited period of time (such as 30 days), after which the withdrawal right would lapse in full (or, if one wants to go for creditor protection, the withdrawal right would continue but could be exercised only with the consent of a nonadverse party; see the text accompanying fn 6823).

[6822] For example, Uniform Trust Code § 103(11) provides:

> "Power of withdrawal" means a presently exercisable general power of appointment other than a power: (A) exercisable by a trustee and limited by an ascertainable standard; or (B) exercisable by another person only upon consent of the trustee or a person holding an adverse interest.

R.S.Mo. § 456.1-103(17) provides:

> "Power of withdrawal", a presently exercisable power of a beneficiary to withdraw assets from the trust without the consent of the trustee or any other person….

[6823] Especially the text accompanying fns 6790-6791.

[6824] Reg. § 25.2514-3(c)(4), reproduced in part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary.

[6825] Rev. Rul. 86-39, reproduced in part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary.

[6826] But note part III.B.2.i.xii Dealing with Code § 678(a)(2) Uncertainty.

[6827] See part II.H Income Tax vs. Estate and Gift Tax (Particularly for Depreciable Property).

[6828] Code § 2642(c), "Treatment of certain direct skips which are nontaxable gifts," provides:

> (1) *In general*. In the case of a direct skip which is a nontaxable gift, the inclusion ratio shall be zero.
>
> (2) *Exception for certain transfers in trust*. Paragraph (1) shall not apply to any transfer to a trust for the benefit of an individual unless—
>
> (A) during the life of such individual, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such individual, and
>
> (B) if the trust does not terminate before the individual dies, the assets of such trust will be includible in the gross estate of such individual.
>
> Rules similar to the rules of section 2652(c)(3) shall apply for purposes of subparagraph (A).

Code § 2652(c)(3), "Certain support obligations disregarded," provides:

> The fact that income or corpus of the trust may be used to satisfy an obligation of support arising under State law shall be disregarded in determining whether a person has an interest in the trust, if—
>
> (A) such use is discretionary, or
>
> (B) such use is pursuant to the provisions of any State law substantially equivalent to the Uniform Gifts to Minors Act.

[6829] See part III.B.2.i.vii.(a) Determining Portion Owned When a Withdrawal Right Does Not Lapse in Full Before Any Income Is Earned.

III.B.2.i.xvii. Conclusion

A beneficiary deemed-owned trust can be a useful tool. It allows a beneficiary to reduce his or her estate by the taxes paid on its income. It might invest in a new business opportunity or buy the beneficiary's interest in a business entity, allowing the beneficiary to keep using the business interest, even though it is outside the estate tax system.

The best candidate for such a trust is a beneficiary who lives in a state that clearly provides that the lapse of the beneficiary's withdrawal right does not make the beneficiary deemed to be the settlor for asset protection purposes. If the beneficiary does not live in such a state, then creditors can press a conflict of laws issue. Such a case might very well occur, given that thinly-capitalized trusts, where the beneficiary can remove and replace the independent trustee at will, have been promoted as safe. A creditor victory might then open the door to IRS attack, making the conflict-of-laws issue more important to avoid.

The beneficiary's taxation on the trust's income seems well-settled as far as private letter rulings are concerned, but what if the IRS changes its approach? Extra attention might be given to lapses of hanging powers when a trust is funded with a large gift or bequest, since concern has been raised about the scope of Reg. § 1.671-3(a)(3). Fitting a lapse of a withdrawal right under Code § 678(a)(2) might cause doubt, unless one uses the structure of Letter Ruling 200949012 (but then one must consider conflict of laws issues, as the author of that ruling told me that Alaska and Delaware are the only states that would provide the beneficiary with protection from creditors).

The allocation of authority between the beneficiary as a trustee and an independent person as trustee needs to be carefully crafted. Once a beneficiary's assets are reduced to a particular level, the beneficiary will want consistent distributions. The beneficiary should be authorized as trustee to make distributions to himself or herself under an ascertainable standard than rely on distributions by an independent trustee. Not only will this make the beneficiary more comfortable with the situation, it will also prevent a potentially dangerous pattern of distributions by the independent trustee. However, if the beneficiary lives in or might move to a state that does not protect the beneficiary's interest in the trust from creditors and is relying on the law of another state, then a different approach should be considered.

Special care should be taken to protect against excessive estate burn off due to taxes imposed on the beneficiary.

In conclusion, a beneficiary deemed-owned trust can be useful in many situations, but it requires careful structuring and consideration of obtaining a private letter ruling (if available). A sale to a trust created by the client's spouse might be a palatable alternative if a private letter ruling is available.

III.B.2.i.xviii. Sample Beneficiary Deemed-Owned Trust

Please use your independent judgment in deciding to use none, part or all of the provisions below:[6830]

> SECTION 3.1 DESIGNATION. Assets to be held as the Beneficiary Deemed-Owned Trust ("BDOT") for the primary benefit of [Beneficiary] pursuant to the provisions

[6830] From Thompson Coburn LLP document number 28003681.

of this Article shall be held as a separate trust estate with income and principal distributed as provided in this Article and shall be designated in substantially the following form: "[Beneficiary] BDOT dated ________ ___, ____." If and to the extent that [Beneficiary] makes a gift to the trust, the trustee shall hold that gift as a separate share (the "Nonappointive Share").

SECTION 3.2 WITHDRAWAL POWER. [Beneficiary] shall have a withdrawal right over the initial transfer to the trust. Such withdrawal right shall lapse thirty (30) days after the initial transfer. Until the withdrawal right lapses, the trust's assets must remain in a non-interest-bearing account. The withdrawal right shall be exercised only in an instrument demanding distribution of part or all of the trust's assets, executed by [Beneficiary] and served on the trustee of the BDOT. Upon receipt of such instrument, the trustee shall immediately satisfy such demand out of trust assets.

SECTION 3.3 DISTRIBUTION OF INCOME AND PRINCIPAL. The trustee may distribute so much or all of the income and principal of the trust as the trustee deems necessary for [Beneficiary]'s support and shall distribute so much or all of the income and principal of the trust as the Special Trustee deems advisable for [Beneficiary]'s welfare.

SECTION 3.4 TERMINATION AND DISTRIBUTION. The trust shall terminate upon [Beneficiary]'s death, and the trustee shall distribute the remaining assets (other than the Nonappointive Share) as [Beneficiary] Appoints among any one or more of a class consisting of all persons, specifically excluding, however, [Beneficiary], [Beneficiary]'s estate, [Beneficiary]'s creditors, and the creditors of [Beneficiary]'s estate. To the extent [Beneficiary] fails to Appoint or has no power to Appoint, the trustee shall allocate the unappointed assets to ….

Features above include:

- To explain the distribution provisions, see part II.J.2.b Trust Provisions Authorizing Distributions.

- The Nonappointive Share is intended to make the gift portion of any alleged bargain sale to the trust be a completed gift. See part III.B.4 Adequate Disclosure on Gift Tax Returns.[6831]

III.B.2.j. Tax Allocations upon Change of Interest in a Business

Both S corporations and partnerships are flow-through entities. The grantor trust rules treat a grantor as owner of the trust for federal income tax purposes. As such, the income generated by the grantor's business, through the trust, is imputed back to the grantor. This income, naturally, generates tax liability.

In the case of either a GRAT or sale to an irrevocable grantor trust, generally the grantor is taxed on all of the trust's income, and payments back to the grantor have no income tax consequences.[6832] A GRAT can be disastrous to the grantor if the company is very successful and the grantor has to pay income tax in excess of the grantor's payments (an "exploding GRAT"), so GRATs should allow the grantor to be reimbursed for income taxes on part or all of

[6831] Especially fn 7061.
[6832] For the lack of income tax on payments using appreciated property, see Rev. Rul. 85-13.

the GRAT's income. This generally is not necessary for an irrevocable grantor trust, which is usually drafted so that the grantor trust taxation can be turned off. The trust agreement may authorize an independent trustee to reimburse the grantor's income tax so long as the decision to reimburse is made in the trustee's absolute discretion and cannot be legally compelled by the grantor.[6833]

This issue is only magnified by the sale of the business. Now, instead of just the imputed income generated by the business, the grantor must pay taxes on any gain from the sale. Ideally, the grantor would like to "turn off" the grantor trust features, essentially making the trust the owner for income tax purposes.[6834] Turning off the grantor trust features generally would be deemed, for income tax purposes, as a transfer from the grantor to the trust at that time.[6835] If a person is treated as the owner of an entire trust (corpus as well as ordinary income), that person takes into account in computing that person's income tax liability all items of income, deduction, and credit (including capital gains and losses) to which that person would have been entitled had the trust not been in existence during the period that person is treated as owner.[6836] See also part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

The next part discusses the income tax effect of turning off grantor trust status, followed by tax allocations upon a change of interest in S corporations and partnerships. See also part III.A.3.c Deadlines for Trust Qualifying as S Corporation Shareholder.

[6833] Rev. Rul. 2004-64, Situation 2; see fns. 6961-6980, found in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner.

[6834] Be sure not to get too cute in deciding which trusts are grantor trusts and when to turn powers on or off. See Notice 2007-73.

[6835] See fns. III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation, especially timing issues described in fns. 6552-6554. See also part III.B.1.c.i Gifts with Consideration – Bargain Sales.

[6836] See part III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation. Although various rulings discuss how this affects the accounting period the trust generally uses to report income, rulings discussing the exact timing are scarce. Rev Rul. 85-13 held:

(1) A's receipt of the entire corpus of the trust in exchange for A's unsecured promissory note constituted an indirect borrowing of the trust corpus which caused A to be the owner of the entire trust under section 675(3) of the Code.

(2) At the time A became the owner of the trust, A became the owner of the trust property. As a result, the transfer of trust assets to A was not a sale for federal income tax purposes and A did not acquire a cost basis in those assets. Accordingly, when A sold the shares of Corporation Z stock on January 20, 1984, A recognized gain of $30x (amount realized of $50x less adjusted basis of $20x). Further, this holding would apply even if the trust held other assets in addition to A's promissory note if A, under any of the grantor trust provisions, was treated as the owner of the portion of the trust represented by the promissory note because A would be treated as the owner of the purported consideration (the promissory note) both before and after the transaction. See section 1.671-3(a)(2) of the regulations.

III.B.2.j.i. Changing Grantor Trust Status

An article from a prolific tax planner discusses the effect of changing grantor trust status during the grantor's life:[6837]

- Pass through entities
- Payments of estimated taxes
- Suspended losses
- Basis
- Carryovers (including excess deductions on termination under Code § 642(h).[6838]

Note that a change in grantor trust status would not be eligible[6839] for an S corporation accounting cut-off in which S corporation activity is taxed to those who owned the stock on a particular date rather than pro-rata, per-share, per-day,[6840] whereas such a cut-off may very well be available for a partnership interest.[6841] Thus, when a grantor trust owns S corporation stock, the grantor should consider turning off grantor trust status before January 1 of the year of sale if the grantor wants to avoid paying tax when the business is sold. The pro-rata per-share per-day that a change in grantor trust treatment requires applies to K-1 items but not to gain or loss on deemed liquidation of S corp.

III.B.2.j.ii. Tax Allocations on the Transfer of Stock in an S Corporation

III.B.2.j.ii.(a). General Rules for Tax Allocations on the Transfer of Stock in an S Corporation

Although basis adjustments apply to partnership assets when a partnership interest is transferred in a taxable event or at a partner's death,[6842] similar adjustments do not apply to the corporation's assets when stock in an S corporation is transferred in a taxable event or at a shareholder's death. The basis adjustment might be replicated by liquidating the corporation, in which case the corporation is deemed to sell its assets,[6843] increasing the assets' basis. The shareholders are taxed on the sale of the assets. Then the shareholders will have a loss on liquidation to the extent that their basis, increased by death (or purchase, etc.) and increased by

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[6837] Peebles, Mysteries of the Blinking Trust, *Trusts and Estates*, pp. 16-20 of Sept. 2008 issue, which is saved as Thompson Coburn LLP doc. no. 5654628. For changing grantor status by reason of the deemed owner's death, see fn 6591 in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System.

[6838] See part II.J.3.i Planning for Excess Losses.

[6839] If the grantor trust does not hold all of the stock that the grantor owns or is deemed to own, an accounting cut-off is not available at all; see part III.B.2.j.ii.(b) Transfer of Less Than Shareholder's Entire Interest. Even if does own all of that stock, an accounting cut-off still is not available; see fn. 6853, found in part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest.

[6840] See generally part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

[6841] See part III.B.2.j.iii Allocations upon Change of Interest in a Partnership, especially part III.B.2.j.iii.(e) Allocation of Specific Items, the latter which may require an accounting cut-off for various items.

[6842] See text accompanying footnotes 5669-5693 and 6895-5711.

[6843] Code § 336.

their K-1 income from the deemed sale of the corporation's assets, exceeds the fair market value of the assets distributed. In a perfect world, if the sole shareholder dies, the K-1 income will be offset by the shareholder's loss on liquidation. However, the nature of the K-1 income might not be a pure long-term capital gain, as depreciation recapture and the related party rules relating depreciable or amortizable property might apply.[6844] Furthermore, if the shareholder is a QSST, the gain on the deemed asset sale passes through to the beneficiary, whereas the loss is trapped in the trust;[6845] thus, where possible, liquidate the S corporation before funding a QSST after a basis-changing event.

Below is a discussion of pro-rating income from the transfer of stock.[6846]

Big increases in income (such as from the sale of significant capital asset) toward the end of a taxable year can cause problems for a shareholder whose stock is transferred before the sale. The deadline for declaring a dividend is often 1-2 months after the record date, so that the transferring shareholder might not be eligible for the related tax distribution, even if the other shareholders would otherwise have agreed to use an earlier record date. One might consider requiring in the shareholders' agreement a requirement that an accounting cut-off be done so that the gain is allocated to the recipient shareholder and not the transferring shareholder.[6847] If the stock is held in trust before and after the transfer, the Uniform Principal and Income Act might remedy this mismatch.[6848]

III.B.2.j.ii.(b). Transfer of Less Than Shareholder's Entire Interest

A grantor who transfers only a portion of his or her interest in the S corporation has no choice of tax allocation method. The deemed transferor and transferee will be allocated a pro rata portion of S corporation items based upon a two-step process:[6849]

[6844] Code § 1239. Pay careful attention to the Code § 267 attribution rules and exceptions to those rules. Code § 267(c)(1) has more limited attribution when trusts are involved, so Code § 1239 is easier to avoid when the decedent passes assets in trust rather than outright. II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property.

[6845] Reg. § 1.1361-(j)(8) provides:

> Coordination with grantor trust rules. If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made. However, solely for purposes of applying the preceding sentence to a QSST, an income beneficiary who is a deemed section 678 owner only by reason of section 1361(d)(1) will not be treated as the owner of the S corporation stock in determining and attributing the federal income tax consequences of a disposition of the stock by the QSST. For example, if the disposition is a sale, the QSST election terminates as to the stock sold and any gain or loss recognized on the sale will be that of the trust, not the income beneficiary. Similarly, if a QSST distributes its S corporation stock to the income beneficiary, the QSST election terminates as to the distributed stock and the consequences of the distribution are determined by reference to the status of the trust apart from the income beneficiary's terminating ownership status under sections 678 and 1361(d)(1). The portions of the trust other than the portion consisting of S corporation stock are subject to subparts A through D of subchapter J of chapter 1, except as otherwise required by subpart E of the Internal Revenue Code.

[6846] See footnote 226 for a distribution method to take into account varying interests.

[6847] See text accompanying footnotes 6851-6861.

[6848] Section 506 of the Uniform Principal and Income Act. The Comments mention that QSSTs were considered when drafting Section 506(a)(3).

[6849] Code § 1377(a)(1).

(1) each corporate item is assigned, in equal portion, to each day of the taxable year.

(2) that portion is divided pro rata among the shares outstanding on that day.

The grantor is treated as a shareholder for the day of disposition, including the day of his or her death.[6850]

III.B.2.j.ii.(c). Transfer of Shareholder's Entire Interest

When a grantor transfers the entire S corporation interest, he or she uses the daily proration rule of Code § 1377(a)(1) unless an election is made to apply the special rule of Code § 1377(a)(2), described below.

A grantor who terminates his or her entire interest, in conjunction with the remaining shareholders, may elect to terminate the corporation's tax year.[6851] Reg. § 1.1377-1(b)(4) provides that this election is available:[6852]

> on the occurrence of any event through which a shareholder's entire stock ownership in the S corporation ceases, including a sale, exchange, or other disposition of all of the stock held by the shareholder; a gift under section 102(a) of all the shareholder's stock; a spousal transfer under section 1041(a) of all the shareholder's stock; a redemption, as defined in section 317(b), of all the shareholder's stock, regardless of the tax treatment of the redemption under section 302; and the death of the shareholder.

Reg. § 1.1377-1(a)(2)(iii), "Shareholder trust conversions," provides:[6853]

> If, during the taxable year of an S corporation, a trust that is an eligible shareholder of the S corporation converts from a trust described in section 1361(c)(2)(A)(i), (ii), (iii), or (v) for the first part of the year to a trust described in a different subpart of section 1361(c)(2)(A)(i), (ii), or (v) for the remainder of the year, the trust's share of the S corporation items is allocated between the two types of trusts. The first day that a qualified subchapter S trust (QSST) or an electing small business trust (ESBT) is treated

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6850 Reg. § 1.1377-1(a)(2)(ii).
6851 Code § 1377(a)(2).
6852 Reg. § 1.1377-1(b)(4) also provides that, in determining whether a shareholder's entire interest in an S corporation has been terminated, any interest held by the shareholder as a creditor, employee, director, or in any other non-shareholder capacity is disregarded.
6853 T.D. 8994 explains:

> A commentator suggested that a trust's conversion to an ESBT should result in a complete termination of the trust's interest in the S corporation for purposes of section 1377(a)(2) because the incidence of taxation with respect to S corporation items will change as a result of the ESBT election….The final regulations do not adopt the suggestion that all conversions of a trust to an ESBT should be treated as a complete termination of the trust's interest in the S corporation for purposes of section 1377(a)(2)….When a trust changes from a wholly-owned grantor trust or QSST to an ESBT or from an ESBT to a QSST, the individuals who are shareholders of the S corporation under section 1361(c)(2)(B) remain the same. The election to terminate the taxable year provided in section 1377(a)(2) applies to the termination of a <u>shareholder's</u> interest in the S corporation. Accordingly, it is appropriate to treat the conversion of a trust described in section 1361(c)(2)(A)(ii) or (iii) to an ESBT or QSST as a termination of the prior trust's interest in the S corporation, but not to treat other conversions to an ESBT or QSST as terminations. The election under § 1.1368-1(g) is also not available because the conversion of the trust is not a qualifying disposition.

as an S corporation shareholder is the effective date of the QSST or ESBT election. Upon the conversion, the trust is not treated as terminating its entire interest in the S corporation for purposes of paragraph (b) of this section, unless the trust was a trust described in section 1361(c)(2)(A)(ii) or (iii) before the conversion.

Reg. § 1.1377-1(a)(2)(iii) is illustrated in Reg. § 1.1377-1(c), Example (3), "Effect of conversion of a qualified subchapter S trust (QSST) to an electing small business trust (ESBT):"

(i) On January 1, 2003, Trust receives stock of S corporation. Trust's current income beneficiary makes a timely QSST election under section 1361(d)(2), effective January 1, 2003. Subsequently, the trustee and current income beneficiary of Trust elect, pursuant to § 1.1361-1(j)(12), to terminate the QSST election and convert to an ESBT, effective July 1 2004. The taxable year of S corporation is the calendar year. In 2004, Trust's pro rata share of S corporation's nonseparately computed income is $100,000.

(ii) For purposes of computing the income allocable to the QSST and to the ESBT, Trust is treated as a QSST through June 30, 2004, and Trust is treated as an ESBT beginning July 1, 2004. Pursuant to section 1377(a)(1), the pro rata share of S corporation income allocated to the QSST is $49,727 ($100,000 x 182 days/366 days), and the pro rata share of S corporation income allocated to the ESBT is $50,273 ($100,000 x 184 days/366 days).

For an example of how this could be disastrous, see the indented text accompanying fn. 6556 in part III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation.

Query whether a cut-off applies when the deemed owner of a grantor trust dies:[6854]

- It is a conversion of a trust described in Code § 1361(c)(2)(A)(i) (a wholly owned grantor trust)[6855] to a trust described in Code § 1361(c)(2)(A)(ii) (a trust that was a wholly owned grantor trust immediately before the death of the deemed owner and which continues in existence after such death),[6856] so Reg. § 1.1377-1(a)(2)(iii) would seem to prohibit a cut-off. On the other hand, Reg. § 1.1377-1(b)(4) permits a cut-off when a shareholder dies. Generally, conflicting provisions are interpreted by giving effect to the one most tailored to the situation. Because the death of the deemed sole owner of a trust is just one of many ways to convert a grantor trust to a nongrantor trust, Reg. § 1.1377-1(b)(4) should control when conflicting with Reg. § 1.1377-1(a)(2)(iii). On the other hand, Reg. § 1.1377-1(a)(2)(iii) expressly contemplates a conversion to a trust described in Code § 1361(c)(2)(A)(ii), which can occur only when the deemed owner dies.

- Instinctively, most tax advisors would view applying Reg. § 1.1377-1(a)(2)(iii) to a revocable trust would be preposterous – they would argue that of course Reg. § 1.1377-1(b)(4) would control. But I'm not sure how they would get around the fact that Reg. § 1.1377-1(a)(2)(iii) expressly contemplates a conversion to a trust described in Code § 1361(c)(2)(A)(ii). To

[6854] See part III.B.2.j.ii.(d) Death of a Shareholder.
[6855] See part III.A.3.b.i A Trust All of Which Is Treated Under the Grantor Trust Rules as Owned by An Individual Who Is a Citizen or Resident of the United States.
[6856] See part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death.

avoid this argument, have the (formerly) revocable trust elect income taxation as an estate,[6857] so that it is not taxed as a trust at all.[6858] Another option would be for the

[6857] See part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI)
Although the discussion below generally refers to trusts, generally it applies to estates as well. If a trustee has discretion to make an election regarding that trust, the election does not affect the choices available regarding other trusts the trustee manages.

I.A.1.cc. Capital Gain Constitutes DNI Unless Excluded

Taxable income is DNI unless expressly excluded.

Code § 643(a)(3) provides:

> *Capital gains and losses*. Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c).

Thus, to be excluded from the income of a domestic trust, the gains must:

- Arise from the sale or exchange of capital assets,
- Be allocated to corpus, and
- Not be actually or deemed to be distributed.

The rest of this part II.J.8.a Capital Gain Constitutes DNI Unless Excluded focuses on the first two prongs.

I.A.1.cc.i. Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset

Only gains from the sale of capital assets are ordinarily excluded from DNI.

For example, "property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business" is not a capital asset. Therefore, the sale of such property would constitute DNI, although it would not constitute trust accounting income. Whether other real estate is a capital asset depends on various facts.

However, "any recognized gain on the sale or exchange of property used in the trade or business" often receives capital gain treatment to the extent it does not constitute certain depreciation recapture. Goodwill that has not been amortized is a capital asset, but goodwill that is being amortized is not a capital asset. Thus, because such assets are not capital assets, such capital gains generally would be included in DNI.

I.A.1.cc.ii. Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus

I am unaware of any authority defining "allocated to corpus" as used in Code § 643(a)(3). Presumably it means receipts by the trust that are allocated to principal.

Does the statute mean that capital gain are automatically included in DNI unless they are affirmatively allocated to principal and certain other conditions exist? Reg. § 1.643(a)-3(a) might overrule that requirement, providing (highlighting added):

> *In general*. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

This regulation essentially has three parts:

- Reg. § 1.643(a)-6 deals with foreign trusts.

- Reg. § 1.643(a)-3(b) explains when capital gains from the sale or exchange of an asset are included in DNI and does not include a requirement that the capital gain be allocated to principal. In fact, one of the prongs discusses the treatment when capital gains are allocated to income.

- Depending on the meaning one gives to "ordinarily," this regulation might dispense with the statutory requirement that capital gains be allocated to corpus. The regulation does not explain when it says "ordinarily" what the exceptions might be, other than Reg. §§ 1.643(a)-6 and 1.643(a)-3(b). There would appear to be substantial authority for saying that an affirmative allocation of capital gains to principal is or is not required.

This issue seems to be most important for the trust's gross income that does not take the form of receipts of cash or other property. For example, a trust might invest in a partnership, S corporation, or other flow-through entity that does not distribute all of its taxable income. How should one treat capital gain from a flow-through entity's sale of a capital asset, when the entity distributes less than all of its taxable income? Should the undistributed capital gain be included in DNI?

- With respect to the accumulated capital gain, the trust has no receipts and therefore is not allocated to corpus. Arguably, the capital gain is not excluded from DNI and therefore constitutes DNI.

- On the other hand, the accumulated capital gain benefits the trust's corpus. Should it be treated as if it had been allocated to corpus? In that case, should it be trapped inside the trust, given that it was accumulated inside the entity and not distributed to the beneficiary?

- Given this uncertainty, would the trustee have discretion to take a different position each year? In Reg. § 1.643(a)-3(b), the Treasury generally agreed that the trustee would not be required to take a consistent position year-by-year, except for capital gain allocated to corpus and treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary. Given that this gross income was not allocated corpus (because it was never physically received), perhaps the trustee has discretion to vary the treatment from year to year? Another approach might be to say that, because the undistributed capital gain was not allocated to principal, the regulations might presume that the undistributed capital gain is allocated to income and can be included in DNI inconsistently from year to year under Reg. § 1.643(a)-3(b)(1).

If all of a flow-through entity's K-1 items taxable to the trust are included in DNI, then part II.J.8.c Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal might cause ordinary income to be trapped at the trust level if the flow-through entity distributes cash in an amount less than all of these K-1 items; see part II.J.8.f Consequences of Allocating Capital Gain to DNI. In light of the consequences described there, the most taxpayer-favorable reading may be that capital gain is ordinarily excluded from DNI.

I leave it to the reader to decide which approach is "better" or perhaps to make that decision on a trust-by-trust basis.

For more on using flow-through entities, see part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

I.A.1.dd. Should Capital Gain Be Allocated to DNI?

Often beneficiaries have income below the thresholds that cause the 3.8% tax and the additional 5% capital gain tax to be incurred, whereas trusts start paying those taxes at relatively modest income levels. Therefore, distributing capital gains to beneficiaries might be beneficial – at least from an income tax viewpoint.

Consider various factors described in part II.J.3 Strategic Fiduciary Income Tax Planning.

I.A.1.ee. Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal

Generally, gains from the sale or exchange of capital assets, net of losses, are excluded from distributable net income (DNI). But that statement belies the flexibility we are about to see.

Reg. § 1.643(a)-3(b) provides:

> *Capital gains included in distributable net income*. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law) -
>
> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be

greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

Note the word "or" after paragraph (2) above. That indicates capital gains are included in DNI if and to the extent that any one or more of paragraph (1) (the "Income Rule"), paragraph (2) (the "Consistent Principal Rule"), or paragraph (3) (the "Discretionary Principal Rule") applies. For more on the:

- Income Rule, see part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law
- Consistent Principal Rule, see part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary
- Discretionary Principal Rule, see part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary.

Before its amendment by T.D. 9102 (12/30/2003), Reg. § 1.643(a)-3 made it more difficult to include capital gain in DNI.

I.A.1.ee.i. Income Rule: Capital Gain Allocated to Income Under State Law

Most states have adopted the Uniform Principal and Income Act, which will be referred to at UPIA for the rest of this part II.J.8.c.i, or its replacement, which is described in part II.J.5.b Uniform Fiduciary Income & Principal Act (UFIPA).

Generally, any capital gain included as the distributive share of income from a partnership or S corporation and distributed from the entity to the trust will constitute income under the Act, making the rest of this part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI) be moot.

Generally, the Act allocates capital gains to principal. The main exceptions are the power to adjust, unitrust distributions, and exceptions in the governing instrument; the power to adjust and power to convert to a unitrust followed adoption of the prudent investor rule. Following a discussion of each of these is a discussion of the respect fiduciary income tax law gives them.

I.A.1.ee.i.(a). Power to Adjust

Capital gains may be reclassified as income if traditional trust accounting income principles cause insufficient receipts to be classified as income. See parts II.J.5.b.ii.(a) Power to Adjust.

I.A.1.ee.i.(b). Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation

It is not uncommon for partnerships and S corporations to reinvest part of their annual income; indeed, to facilitate growth or simply a stronger capital structure (which lenders might require), many distribute only enough to pay their owners' income taxes (commonly referred to as a "tax distribution") plus a modest bonus (referred to below as a "bonus distribution").

Taxes on this reinvested income are charged against the income of a trust that owns such an entity. This is the only practical solution to the trust's obligation to pay its taxes, because the taxing authorities' claims against the trustee are much more pressing than the beneficiaries' claims. (Note that the income beneficiary of a Qualified Subchapter S Trust pays this tax – part III.A.3.e QSSTs and ESBTs – which has an effect similar to charging the trust's income.)

The Uniform Principal and Income Act includes a remedy for the income beneficiary that had to pay the tax on the entity's accumulated income that has been inherently baked into principal. Section 506(a)(3) authorizes a fiduciary to "make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from … the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary." This specific provision supplements any power to adjust that might generally apply.

Thus, when an interest in a partnership or an S corporation is sold, the trustee should consider whether to allocate some of the sale proceeds to income. However, it's not at all obvious that the trustee should make an adjustment; consider that:

- The entity made distributions specifically to pay this tax, so the trust or income beneficiary was not really "out of pocket" for this tax.

- If the entity had been a C corporation, the entity would have paid the tax itself. Its dividend would have equaled the bonus distribution, and this issue would never have arisen.

- The true issue is whether the bonus distribution was sufficient. Was the decision to accumulate income fair – a sound exercise of the business judgment of those who run the entity? Did those who control the entity promise a make-up distribution at some point because of a special project, or was the accumulation merely part of a solid plan to grow the business, which presumably would result in increased income and increased bonus distributions? Were those who control the entity running it just to benefit themselves (and, if owners, trying to extract more benefits as owners than the inactive owners received)? I have probably left out many other relevant considerations, but hopefully I have communicated why this decision is not easy.

See parts II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Trust Accounting Rules
and II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets.

If the trustee is concerned that the income beneficiary might spend a perceived windfall unwisely, the trustee might consider using the power to adjust to spread distributions over an appropriate period of time. Such a spread over time might be more palatable if, instead of labelling the adjustment to sale proceeds as a tax reimbursement, the trustee labelled it as a make-up for insufficient bonus distributions, taking the position that future distributions to beneficiaries might be loosened because of a prior conservative distribution policy. The bonus distributions might have been sufficient from the viewpoint of what the entity should have distributed but might have been insufficient from the viewpoint of how much income the trustee should have tried to generate. As mentioned in part III.A.4.d.iv Advising Clients about the UPAIA § 505 Change and UFIPA § 506 (discussing conflicts with beneficiaries that might arise when an entity makes tax distributions but little or no bonus distributions), these issues have no easy answer.

See also part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Trust Accounting Rules.

I.A.1.ee.i.(c). Unitrust

A unitrust is a trust that distributes fixed amounts, redetermined annually as a fixed percentage of the value of the trust's value, which value is redetermined annually but might be based on an average of values, such as the average value of the trust's assets for the past three years. See parts II.J.5.b.ii.(b) Unitrust and II.J.5.b.ii.(c) Comparing Power to Adjust to a Unitrust.

Reg. § 1.643(a)-3(e) provides the following examples regarding unitrusts:

> *Example (11)*. The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.
>
> *Example (12)*. The facts are the same as in Example 11, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire $80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise

of Trustee's discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.

Example (13). The facts are the same as in Example 11, except that neither state statutes nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

A right to income expressed initially solely as a unitrust interest may qualify for the QTIP marital deduction.

I.A.1.ee.i.(d). Exceptions in the Governing Instrument

Although the Act provides general rules, it also allows trust agreements to override those rules:

> In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:
>
> (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
>
> (2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];
>
> (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and
>
> (4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

I.A.1.ee.i.(e). Fiduciary Income Tax Recognition of the Trust Agreement and State Law

Code § 643(b) generally defers to the trust agreement and applicable state law. The Uniform Principal and Income Act ("UPIA") and the Uniform Fiduciary Principal & Income Act ("UFIPA") authorizes the trust agreement to override the Act.

However, Reg. § 1.643(b)-1 does not recognize trust agreements that depart too far from the usual rules:

> Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal.

Reg. § 1.643(b)-1 respects variations provided under applicable state law:

> However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods.

Circling back to the Act's authorizing trust agreements to depart from traditional principles, Reg. § 1.643(b)-1 concludes with:

> In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.

For the "reasonable and impartial exercise" requirement in the context of the power to adjust, see part II.J.5.b.ii.(a) Power to Adjust.

I often use a clause providing that the trustee has wide discretion but must reasonably and fairly balance the interests of the income and remainder beneficiaries. That language comes from the marital deduction regulations. Generally, the trustee's authority to allocate between income and principal does not trigger grantor trust status, does not constitute a power of appointment, and does not have generation-skipping transfer tax implications. The trustee might want to consider providing accountings or other notices to the beneficiaries that would start running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile this one on top of it, which procedure might help minimize any gift tax consequences to failing to make a claim.

How does one draw the line between what departs "fundamentally from traditional principles of income and principal" and what is "a reasonable and impartial exercise of a discretionary power granted to the fiduciary" under Reg. § 1.643(b)-1?

Presumably, the trustee should be on solid ground in allocating to income capital gains such that the total amount of all receipts allocated to income does not exceed 5%, given that the regulations expressly approve unitrusts in the 3%-5% range. The trusts should also be on solid ground in allocating to income capital gains generated by a partnership that the settlor intended to distribute to the income beneficiary.

Beyond that, it's a matter of facts and circumstances and judgment. However, Reg. § 1.643(a)-3(e), Example (4) respected a mandatory allocation of capital gain to income where a trust had $5,000 of dividends and $10,000 of capital gains, and the trustee distributed $17,000 to the beneficiary.

I.A.1.ee.i.(f). Conclusion Regarding Allocating Capital Gain to Income

Reg. § 1.643(a)-3(b)(1) requires a consistent practice for unitrusts. Considering that the unitrust recipient is receiving cash and presumably would have the liquidity to pay tax on any capital gains distributed to the beneficiary, in many cases it would be fair to allocate capital gain to DNI to the extent that the unitrust amount exceeds the income that would apply under the Act's general rules. Given that one provides for a unitrust when tension between the income beneficiary and remaindermen might be high, the tension created by this tax issue would be high to the same degree. Consider providing a firm rule in the trust agreement regarding the allocation of capital gain to DNI. If one is concerned that shifting tax rates might create an unfair tax result, consider providing a clause reimbursing the unitrust beneficiary for taxes paid on the unitrust and on the reimbursement; this requires cooperation between the trustee's income tax preparer and the beneficiary's income tax preparer, but the calculation should be relatively mechanical.

For trusts that are not unitrusts, Reg. § 1.643(a)-3(b)(1) provides significant flexibility, allowing the trustee discretion whether to allocate capital gain to income for fiduciary accounting purposes (if the trust agreement and state law permit) and also whether to include in DNI the capital gain that was allocated to income.

Consider the nuances for a mandatory income trust. Distributions must be made no later than 65 days after yearend to include capital gain in DNI in every other situation. In a mandatory income trust, a power to adjust might be able to retroactively include capital gain in income – perhaps as late as when the tax return is prepared. For how mandatory income trusts work, see part II.J.5 Mandatory Income Trusts. For limits on retroactivity, see part II.J.5.a Issues Arising with Mandatory Income Trusts.

I.A.1.ee.ii. Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary

Reg. § 1.643(a)-3(e) helps guide our application of Reg. § 1.643(a)-3(b)(2):

> *Example (1)*. Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.
>
> *Example (2)*. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.
>
> *Example (3)*. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments. This treatment of capital gains is a reasonable exercise of Trustee's discretion.

The all-or-nothing approach taken by Examples (1) and (2) is not very attractive, but we need to deal with it. Let's consider some fact patterns:

1. <u>The beneficiary needs regular annual distributions that cannot be made using a power to adjust</u>. Generally, distributions in excess of what can made using a power to adjust would not be sustainable. A power to adjust typically adjusts to a 3%-5% distribution, and most models suggest that distributions in excess of that will lead to a trust being depleted. Thus, a more likely scenario is that a power to adjust is not available, because state law prevents using the power to adjust in particular situations (unless the trust agreement overrides it). In such a case, the beneficiary's federal and state/local income tax bracket for capital gains needs to be compared to the trust's federal and state/local income tax bracket for capital gains. Note that a nonresident trust would have a zero state/local income tax bracket, to the

extent that the trust does not have income from a business sourced to the state/local jurisdiction.

2. The beneficiary's need for distributions in excess of income is sporadic. It's difficult to predict how the beneficiary's federal and state/local income tax bracket for capital gains compares to the trust's federal and state/local income tax bracket for capital gains, given that rates will change and the trust's and its beneficiaries' circumstances might change over time. In such a case, consider whether the distribution might be phrased as "allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary." If that is likely to be the case, then consider not electing to carry out capital gain automatically under (b)(2) but rather deciding to rely on (b)(3), because (b)(3) is flexible whether to allocate capital gain to income, allowing the decision to made separately each year on a case-by-case basis.

Generally, trustees would not be likely to take advantage of the discretion that Example (3) provides to allocate to income only capital gain from the sale of certain specified assets or a particular class of investments, because such an election requires additional recordkeeping.

Some people point to the word "deem" in Example (1) and emphasize the need for such authority in the trust agreement or applicable state law. Uniform Trust Code § 816 generally authorizes trustees to make tax elections, so the authority to "deem" distributions to be capital gains is inherently authorized in UTC states, as well as any other state where a trustee generally has the authority to make tax elections.

I.A.1.ee.iii. Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary

Reg. § 1.643(a)-3(b)(3) might seem confusing at first, but it actually has very practical use.

First, let's look at some examples that Reg. § 1.643(a)-3(e) provides:

> Example (5). The facts are the same as in Example 1, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is $10,000, rather than $12,000. Because Trustee will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.
>
> *Example (6)*. Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to A. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

Although Reg. § 1.643(a)-3(b)(3) is viewed generally as discretionary, note that Example (6) is mandatory: if the trustee is required to distribute sale proceeds to a beneficiary, the capital gain from the sale is included in the DNI that the distribution carries out the beneficiary. Example (7) similarly requires all capital gain recognized in the trust's final taxable year to be included in the DNI that the distribution carries out the beneficiary.

The practical application is based on the ability to count as prior year distributions those distributions made in the first 65 days of the current year. For example, any distribution made on or before March 5, 2020 can be treated as a 2019 or 2020 distribution. This election applies to the greater of accounting income under Reg. § 1.643(b)-1 or DNI under Reg. §§ 1.643(a)-1 through 1.643(a)-7. By completing the line on the trust's income tax return, Form 1041, page 2, Part B, showing amounts (other than income required to be distributed currently) paid, credited, or otherwise required to be distributed and checking the Code § 663(b) box in "Other Information" at the bottom of Form 1041, page 2, the trustee decides how much of a current year distribution is allocated to the prior year; the balance would then be credited to the current year.

The practical application based on the 65-day rule would generally occur during February after the year ends and applies only if the trustee has discretion to distribute corpus. The regulations do not specify any particular trust records regarding the election, so do whatever seems best to evidence the intent. Perhaps the income tax return preparer emails the trustee recommending how much of a distribution be made to distribute income and capital gain under the 65-day rule (erring on the side of distributing too much), then the trustee makes the distribution, and the tax return carries through the intent. As long as the distribution is made timely, the tax return can treat none, part, or all of the distribution as a distribution of the taxable year's income. In a manner similar to Example (5), the trustee has referred to the capital gain itself in determining how much to distribute. Unlike Reg. § 1.643(a)-3(b)(2), Reg. § 1.643(a)-3(b)(3) allows one to carry out discretionary distributions of capital gain inconsistently from one year to another.

If the beneficiary does not require monthly or quarterly cash flow, the trustee can simply each February make a big distribution and apply it to the prior or current year for tax return preparation purposes. If the beneficiary does require monthly cash flow but is willing to accept informal constraints, the trustee makes the big distribution into an investment account that the beneficiary owns, and the account makes monthly transfers to the beneficiary's checking account. Obviously this would not work for a beneficiary who cannot exercise discipline, but there is a good segment of beneficiaries for whom it would work.

An alternative approach is to distribute an asset to a beneficiary before the asset is sold. Generally, the beneficiary will receive a carryover basis and then be taxed on the gain.

As with all tax planning, the strategies described in this part II.J.8.c.iii may be unavailable (based on the trust terms), inadvisable (based on sound financial planning), or stupid (giving money to a drug addict just to save taxes).

I.A.1.ee.iv. Netting Capital Losses

Reg. § 1.643(a)-3(d), "Capital losses," provides:

> Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is

distributed or required to be distributed to a particular beneficiary. See § 1.642(h)-1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

Thus, if and to the extent that Reg. § 1.643(a)-3(b)(3) includes capital gains in DNI (see part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary), capital losses are not netted against such gains. The recipient beneficiaries report all such capital gains, and the capital losses remain in the trust.

However, note that Reg. § 1.643(a)-3(b)(3) has two elements: "actually distributed to the beneficiary," which would tend to require tracing except in the case of trust termination, or "utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary," in which case the trustee would have needed to consciously decide to refer to the capital gain when making the distribution.

Unless the trustee traces or decides to refer to the gross capital gain (instead of the net capital gain) when making the distribution, the loss would be offset under Reg. § 1.643(a)-3(b)(3). Alternatively, the trustee might not trace and not refer to capital gain but rather exercise the power to adjust, which would invoke Reg. § 1.643(a)-3(b)(1) (see part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law) and include an automatic offset.

I.A.1.ee.v. Conclusions Regarding the Basic Framework on Allocating Capital Gains to DNI

Often, one cannot predict whether the combination of federal, state, and local income tax rates will be higher inside or outside of the trust.

Quite frankly, I keep changing my mind regarding the best income tax elections as I encounter new situations. If the document is flexible as to distributions and distributions are appropriate, then I would lean toward:

- Flexible language allowing the trustee to allocate capital gains to income, so long as the trustee must reasonably and fairly balance the interests of the income and remainder beneficiaries.

- Using the 65-day-rule to distribute large capital gains to the beneficiary as DNI.

- Electing not to establish a practice of carrying out capital gain to beneficiaries under Reg. § 1.643(a)-3(b)(2) unless it appears that the above two approaches will not suffice to minimize overall income taxes. However, it is not uncommon for me to decide that the above. two approaches will not suffice to minimize overall income taxes. On the other hand, if the situation involves enough money, the trustee can covert capital gain that would otherwise be trapped inside the trust to trust accounting income, using the tool described in part II.J.8.e Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries.

Consider adding a withdrawal right of up to 5% of the trust's value. The beneficiary will be deemed to be the owner of the part that the beneficiary can withdraw and perhaps continue to be deemed the owner with respect to the lapsed portion. However, note that withdrawal rights can increase exposure to creditors to the extent of the withdrawal right and perhaps even after a lapse. For details on all of the ideas mentioned in this paragraph, see part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts. If one is concerned about the withdrawal right itself becoming a bad idea, consider using a provision along the following the lines:

> In addition to the distributions authorized by the preceding sentence, subject to the following sentence the trustee shall distribute to the beneficiary so much of the principal of the trust as the beneficiary, while at least __ years of age, may request once between February 23 and March 5 of every calendar year, on a noncumulative basis, up to five percent (5%) of the aggregate value, as of the time of such request by the beneficiary, of the principal of the trust. The trustee may, by instrument placed in the trust's records, provide that the preceding sentence shall not apply during any period (including the beneficiary's remaining life), which period shall begin no earlier than the January 1 following the date of the instrument.

This allows the trustee to turn off the withdrawal rights for any future year(s) without impeding the beneficiary's absolute right to withdraw during the current year.

I.A.1.ee.vi. Fairness of Taxing Capital Gain to Beneficiaries; Need for Tax Distributions Here and Other Areas

Our income tax system taxes income to whoever receives it, subject to certain exceptions not relevant to this part II.J.8.c.vi. Therefore, it is fair to tax the beneficiaries.

However, when a distribution is made for a particular purpose and the money is spent, the beneficiary will get upset when handed a tax bill for which the beneficiary did not plan. Therefore, one might need to make a supplemental distribution to pay tax on the original distribution. The supplemental distribution would also need to be enough to pay tax on the supplemental distribution itself. This supplemental distribution is often referred to as "grossing up the distribution" to pay taxes.

This issue applies to more than just capital gains. Clients who leave residences in trust often wish to have the trust pay expenses that a life tenant would ordinarily pay. Distributions by the trust for those purposes run into the same problem – the money is spent for the intended purpose and not available to pay taxes. These distributions also need to be grossed up to pay taxes.

I.A.1.ff. Distribution in Kind; Specific Bequests

I.A.1.ff.i. Distribution in Kind - Generally

Except as provided below and except to the extent that it carries out DNI or constitutes a bequest of income, a distribution is a nontaxable gift (unless the recipient assumes liabilities, in which case it is taxed as a bargain sale).

When a trust distributes property to satisfy a pecuniary distribution (even if the amount is expressly authorized to be satisfied in cash or in kind), the trust recognizes gain on the deemed sale, even if the trust's residue is less than the pecuniary obligation. Such a pecuniary obligation includes an equalizing distribution (presumably unless expressed as a fractional share). This rule includes a pecuniary obligation in the form of an annuity payment to a beneficiary, and the gain recognized in paying the annuity is not included in the beneficiary's distributive net income (DNI) unless the rules for including capital gain in DNI are satisfied. If the trust's residue is less than the pecuniary obligation, the fact that all bequests are protected by Code § 663(a)(1) and therefore no residual beneficiary can pick up income under Code § 662 means that the trust will pay the tax, given that the beneficiaries of the protected bequests will not be picking up that income; note that the trustee will need to reserve for this tax before making distributions to beneficiaries and may have a mismatch for net investment income tax purposes as well. However, when a charity that was the annuity recipient was bequeathed the remainder, the resulting merger of interests and trust termination were not a taxable event. Also, if the bequest is satisfied using date-of-death values, presumably no gain or loss would be realized, but to qualify for the marital or charitable deduction the assets' value relative to date of death values must be "fairly representative of appreciation or depreciation in the value of all property thus available for distribution in satisfaction of such pecuniary bequest or transfer."

If a trust makes a non-pro rata distribution of residue without either the trust instrument or local law authorizing a non-pro rata distribution, each beneficiary may be treated as having received a pro rata distribution and exchanged it with the other beneficiaries. Otherwise, generally the trust does not recognize any gain or loss and the beneficiaries receive the same basis as the trust's; for further analysis of dividing trusts (including on termination), see part II.D.5 Severing Trusts with Multiple Grantors. However, the trust may elect to treat all property distributions during the taxable year as sales, but losses in transactions with beneficiaries and other related parties are disallowed except to the extent that they are from an estate (including a revocable trust electing to be taxed as an estate) satisfying a pecuniary bequest. The loss disallowance applies even if the distribution, taken as a whole, results in a net gain. Thus, gains are recognized and losses generally are not.

The amount deemed distributed is the lesser of the property's basis or fair market value, unless gain was recognized, in which case it is the property's value.

Distributing low basis assets will generate a new basis (often a step-up) when the beneficiary dies. However, distributed assets are subject to the beneficiary's creditors, changes in the beneficiary's estate tax posture (including not only changes in the tax law but also changes in financial situation through the beneficiary's own efforts or through marriage and change in residence to a state that imposes its own estate tax), and changes in the beneficiary's dispositive goals. To get a basis step-up, I would rather add (perhaps by decanting) a formula general power of appointment, as described in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.

Distributing an unmarketable partnership interest would carry out DNI without giving the beneficiary cash. However, valuation adjustments might depress the amount of the deemed distributions, and the beneficiary would be entitled to a proportionate share of future distributions from the partnership. However, if the trustee controls the partnership, the trustee can also control the distribution spigot.

I.A.1.ff.ii. Specific Bequest

A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under Code § 661 and is not included in the gross income of a beneficiary under Code § 662, unless under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the recipient in more than three installments.

I.A.1.ff.iii. Distributing a Note to the Obligor

Rev. Rul. 75-68 provides:

> The income of a testamentary trust consisting solely of interest from mortgages on the beneficiary's property was required to be distributed periodically. Although the mortgage notes held by the trust required the periodic payment of interest, it was agreed between the beneficiary and the trustees, that the beneficiary would pay no interest on the mortgages and the trustees would distribute no income from the trust.
>
> *Held*, notwithstanding the foregoing agreement, the interest income due on the mortgages held by the trust is includible in the gross income of the trust, and this same amount, as the distributable income of the trust, is includible in the gross income of the beneficiary. Further, the beneficiary is entitled to a deduction for this interest deemed paid on the mortgages.

Below is authority consistent with this conclusion:

Reg. § 1.643(c)-1(a) treats as a beneficiary "any person with respect to an amount used to discharge or satisfy that person's legal obligation as that term is used in § 1.662(a)-4." Reg. § 1.661(a)-2(d) provides:

> The terms "income required to be distributed currently" and "any other amounts properly paid or credited or required to be distributed" also include any amount used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)-4.

Reg. § 1.662(a)-4, "Amounts used in discharge of a legal obligation," provides:

> Any amount which, pursuant to the terms of a will or trust instrument, is used in full or partial discharge or satisfaction of a legal obligation of any person is included in the gross income of such person under section 662(a)(1) or (2), whichever is applicable, as though directly distributed to him as a beneficiary, except in cases to which section 71 (relating to alimony payments) or section 682 (relating to income of a trust in case of divorce, etc.) applies. The term "legal obligation" includes a legal obligation to support another person if, and only if, the obligation is not affected by the adequacy of the dependent's own resources. For example, a parent has a "legal obligation" within the meaning of the preceding sentence to support his minor child if under local law property or income from property owned by the child cannot be used for his support so long as his parent is able to support him. On the other hand, if under local law a mother may use the resources of a child for the child's support in lieu of supporting him herself, no

> obligation of support exists within the meaning of this paragraph, whether or not income is actually used for support. Similarly, since under local law a child ordinarily is obligated to support his parent only if the parent's earnings and resources are insufficient for the purpose, no obligation exists whether or not the parent's earnings and resources are sufficient. In any event, the amount of trust income which is included in the gross income of a person obligated to support a dependent is limited by the extent of his legal obligation under local law. In the case of a parent's obligation to support his child, to the extent that the parent's legal obligation of support, including education, is determined under local law by the family's station in life and by the means of the parent, it is to be determined without consideration of the trust income in question.

Reg. § 1.661(a)-2(d) provides:

> The terms "income required to be distributed currently" and "any other amounts properly paid or credited or required to be distributed" also include any amount used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)-4.

I.A.1.gg. Partnerships and S corporations Carry Out Income and Capital Gain to Beneficiaries

Generally, K-1 income from a passthrough business entity will carry out any income (including capital) distributed to the trust and then to the trust's beneficiaries. This section focuses on nongrantor trusts holding partnerships rather than S corporations, because generally a trust can hold S corporation stock that is not a grantor trust, QSST, or ESBT only during a relatively limited amount of time. (Although the principles in this part II.J.8.e would apply to a net income with make-up charitable remainder unitrust – a NIMCRUT – the IRS has concerns about that application and might shut it down at some point.)

Also, if one elected not to carry out capital gains under Reg. § 1.643(a)-3(b)(2) and later decides that all capital gain should be included in DNI going forward (or does not want to take a risk that the IRS will not respect deviations from general rules of the Uniform Principal and Income Act, consider forming an entity taxed as a partnership. Capital gains earned through a partnership generally constitute trust accounting income.

The Uniform Principal and Income Act provides that, generally, all cash distributions from an entity (including a partnership) are considered trust accounting income. Only the following distributions from an entity are not considered trust accounting income:

- property other than money;
- money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;
- money received in total or partial liquidation of the entity; and
- money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

Thus, a partnership's capital gains recognized in the ordinary course of managing and re-balancing a portfolio would constitute fiduciary accounting income to the extent distributed from the partnership in cash and therefore would be includible in DNI under (1) above.

To keep control of the partnership, consider having the trust be a 1% general partner and 98% limited partner, and the beneficiary or someone else might contribute 1% as a limited partner. Distributing a limited partnership interest to a beneficiary can carry out income and perhaps capital gain while at the same time not giving the beneficiary cash to spend (but be sure to distribute enough cash so that the beneficiary can pay tax on the distribution). Be careful to avoid the gain on formation that applies when a contributing partner diversifies the partner's holdings by forming the partnership. If the trust holds not only marketable securities but also investments in businesses, consider setting up one partnership for the business investments and another partnership for the marketable securities, which would help facilitate allocating trust assets on termination or any other trust division. Also consider whether a state with jurisdiction over the trust might subject the partnership itself to state income tax.

Complexity might arise if a partnership distributes less than all of its taxable income to a mandatory income trust. It is unclear whether all of the trust's distributive share of capital gain is DNI. Furthermore, interrelated calculations might be required for a mandatory income trust. Generally, we should look to see whether planning under part II.J.8.c.i Income Rule: Capital Gain Allocated to Income Under State Law or II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is sufficient before recommending a partnership solely to address the issues described in part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.

I.A.1.hh. Consequences of Allocating Capital Gain to DNI

I.A.1.hh.i. General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income (and General Retention of the Character of DNI Distributed to Beneficiaries)

This part II.J.8.f.i first discusses netting deductions against income then discusses allocating that income.

I.A.1.hh.i.(a). Allocating Deductions to Various Income Items

Rules for allocating deductions include:

- All deductible items directly attributable to one class of income are allocated to that class. To the extent that any items of deduction which are directly attributable to a class of income exceed that class of income, they may be allocated to any other class of income (including capital gains) included in distributable net income as described above except that any excess deductions attributable to tax-exempt income may not be offset against any other class of income.

- Deductions not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing DNI, but Code § 265 requires a portion of such indirect expenses to be allocated to non-taxable income. Such indirect expenses include trustee fees, the rental of safe deposit boxes, and state income and personal property taxes. Once one has allocated expenses to tax-exempt income, how does one choose to which items of taxable income to allocate deductions? One would consider allocating to those income items that are most highly taxed, considering federal and state income tax and the 3.8% tax on net investment income. For example, interest income is taxed at the highest rates, whereas qualified dividends are taxed at long-term capital gain rates. Within interest income, consider whether the interest is from U.S. obligations exempt from state income tax. Although distributions from qualified retirement plans and IRAs are taxed at the highest regular tax rate, they are exempt from the 3.8% tax on net investment income. See part II.I.6 Deductions Against NII (especially the text accompanying fns. 2307-2308).

- If a charitable deduction under Code § 642(c) is involved, any allocations of taxable income between the charitable deduction and the beneficiaries must have substantial economic effect.

- Special rules apply to depreciation deductions.

I.A.1.hh.i.(b). Allocating Income Items Among Those Receiving It

In allocating income between the trust and the beneficiary (or beneficiaries), the amounts of DNI distributed to the beneficiaries:

> shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the estate or trust as the total of each class bears to the total distributable net income of the estate or trust in the absence of the allocation of different classes of income under the specific terms of the governing instrument.

However, this proportionate rule is subject to specific provisions in the governing instrument for the allocation of different classes of income or different allocations under local law, subject to tax-exempt income being allocated in a manner that does not allow it to be deducted.

Thus, except for tax-exempt income and allocations between the charitable and noncharitable shares (and any special rules regarding depreciation deductions), it appears that a trust agreement may create ordering provisions between which items of DNI the trust retains and which items of DNI the trust distributes to beneficiaries. However, such a provision might encounter significant resistance from the IRS.

Once one decides which items of DNI the trust distributes to beneficiaries, generally distributions to each beneficiary carry out a pro rata portion of ordinary income and capital gain items allocated to the beneficiaries, and any other characteristic of the income at the trust level retains its status in the beneficiary's hands (which, among other things, is important for net investment income tax purposes). Code § 652(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion

> of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary.

Code § 662(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642(c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary. In the application of this subsection to the amount determined under paragraph (1) of subsection (a), distributable net income shall be computed without regard to any portion of the deduction under section 642(c) which is not attributable to income of the taxable year.

Reg. § 1.662(b)-1 provides:

> In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§ 1.662(a)-1 through 1.662(a)-4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For this purpose, the principles contained in § 1.652(b)-1 shall apply.

Reg. § 1.652(b)-1 provides:

> In determining the gross income of a beneficiary, the amounts includible under § 1.652(a)-1 have the same character in the hands of the beneficiary as in the hands of the trust. For example, to the extent that the amounts specified in § 1.652(a)-1 consist of income exempt from tax under section 103, such amounts are not included in the beneficiary's gross income. Similarly, dividends distributed to a beneficiary retain their original character in the beneficiary's hands for purposes of determining the availability to the beneficiary of the dividends received credit under section 34 (for dividends received on or before December 31, 1964) and the dividend exclusion under section 116…. Similarly, to the extent such amounts consist of an amount received as a part of a lump sum distribution from a qualified plan and to which the provisions of

> section 72(n) would apply in the hands of the trust, such amount shall be treated as subject to such section in the hands of the beneficiary except where such amount is deemed under section 666(a) to have been distributed in a preceding taxable year of the trust and the partial tax described in section 668(a)(2) is determined under section 668(b)(1)(B). The tax treatment of amounts determined under § 1.652(a)-1 depends upon the beneficiary's status with respect to them not upon the status of the trust. Thus, if a beneficiary is deemed to have received foreign income of a foreign trust, the includibility of such income in his gross income depends upon his taxable status with respect to that income.

This proportionate requirement applies "unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation."

When allocating income among beneficiaries:

> The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation.

I.A.1.hh.ii. How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary

If the amount of DNI is less than the amount distributed to the beneficiary, the issues described in this part II.J.8.f.ii How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary become important.

Some income might be inadvertently trapped in the trust if the allocation rules of part II.J.8.f.i General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income apply without being modified by any special ordering rule in the trust agreement and if all of a pass-through entity's capital gain constitutes DNI under an approach described in part II.J.8.a.ii Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus That's because looking exclusively at those two factors bypasses the analysis of part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal.

For example, trust has $10,000 of interest income. Trust's distributive share of partnership's income is $20,000 of dividend income and $70,000 of long-term capital gains. If the rules described in the preceding paragraph apply, then 10% of all distributions constitute interest income, 20% constitute dividend income, and 70% constitute long-term capital gains. Trust distributes $50,000 to the beneficiary. Therefore, each of the beneficiary and the trust has $5,000 of interest income, $10,000 of dividend income, and $35,000 of long-term capital gains.

Contrast that to an approach under which the trustee is able to control how much capital gain is included in DNI, under part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal. On a year-by-year basis, the trustee can selectively include capital gain in DNI to the extent that one or both of part II.J.8.c.ii Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a individual to hold the stock in his or her own name and do a nonprobate transfer via either the applicable state's nonprobate transfer statute or by ensuring that the stock is a "security" that can be transferred using the Uniform TOD Security Registration Act.[6859]

To effect this interim closing of the corporation's books, each of the affected shareholders and the corporation must consent to the election. An affected shareholder is defined as:[6860]

(1) the shareholder whose interest is terminated; and

(2) all shareholders to whom such shareholder has transferred shares during the taxable year (if such shareholder has transferred shares to the corporation, the affected shareholders include all persons who are shareholders during the taxable year).

Subsequently, the books will be treated as if the taxable year consisted of two taxable years, the first of which ends on the close of the day in which the grantor's entire interest in the S corporation is terminated.[6861]

However, the grantor probably will not be able or willing to divest himself or herself of his or her entire interest in the S corporation to effect this result. More likely, the grantor has structured the transfer so that he or she retains the voting shares of the company, while transferring the vast majority of corporate stock to the trust as non-voting shares. A conventional structure might have the grantor retaining 5% of the company shares as its only voting stock, while transferring 95% of the remaining non-voting stock to the trust. By terminating grantor trust status in such a situation, the grantor will not be able cut off his or her entire interest in the S corporation. Instead, the grantor should consider turning off the grantor trust powers before the tax year of sale to avoid this concern.

Beneficiary or part II.J.8.c.iii Discretionary Principal Rule: Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is available. By including in DNI just enough capital gain to cause the DNI to match the cash distributed to the beneficiary, the trustee can ensure that all of the ordinary income is distributed to the beneficiary.

I.A.1.ii. Effectuating Allocation of Capital Gain to DNI

Form 1041 (Schedule D), Part III, column (1) allocates the beneficiaries' shares. Once one separates that, the rest should flow naturally.

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[6858] See fn 5906 in part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death.
[6859] For the latter, search https://www.uniformlaws.org/home. If the S corporation is an LLC, the operating agreement might provide for such a transfer on death, if allowed by state law (which generally would be the case).
[6860] Code § 1377(a)(2)(B).
[6861] Reg. § 1.1377-1(b)(1).

See part II.A.2.k Terminating an S Election regarding allocation of income between taxable periods when an S election terminates, which provides more liberal opportunities to do accounting cut-offs (but generally at a high tax cost).

III.B.2.j.ii.(d). Death of a Shareholder

The death of a shareholder (grantor) is treated as if the grantor had sold his or her entire interest in the S corporation. As such, the applicable tax allocation rules upon the death of the grantor are similar to those of a transfer of the entire interest, as enunciated above. If the shareholder dies (or if the shareholder is an estate or trust and the estate or trust terminates) before the end of the taxable year of the corporation, the shareholder's pro rata share of these items is taken into account on the shareholder's final return,[6862] with the date of death being reported on the decedent shareholder's final individual income tax return.[6863] Items from the portion of the corporation's taxable year after the shareholder's death will be taken into account by the estate or other person acquiring the stock.[6864]

If the stock is held in a revocable trust or an irrevocable grantor trust, see text accompanying fns 6855-6859 in part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest.

***General Rule (Default Rule)* — Daily Proration**

As above, the default rule of daily proration applies absent the corporation and shareholder's joint election for an interim closing of the books.

***Special Rule (By Agreement)* — Interim Closing of the Books**

The executor or administrator of the deceased grantor's estate may consent to the termination election on behalf of the deceased grantor and his estate.[6865] As before, all affected shareholders must consent to the election.

III.B.2.j.ii.(e). Change in Qualification of Trust to Hold S corporation Stock During Taxable Year

If, during an S corporation's taxable year, a trust that is an eligible shareholder of the S corporation converts from a trust described in Code § 1361(c)(2)(A)(i), (ii), (iii), or (v)[6866] for the first part of the year to a trust described in a different subpart of Code § 1361(c)(2)(A)(i), (ii), or (v) for the remainder of the year, the trust's share of the S corporation items is allocated

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[6862] Reg. § 1.1366-1(a)(1).
[6863] Reg. § 1.1377-1(a)(2)(ii) provides:

> *Determining shareholder for day of stock disposition*. A shareholder who disposes of stock in an S corporation is treated as the shareholder for the day of the disposition. A shareholder who dies is treated as the shareholder for the day of the shareholder's death.

[6864] Senate Report, 1982 Subchapter S Revision Act, PL 97-354.
[6865] Reg. § 1.1377-1(b)(5)(ii).
[6866] See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation.

between the two types of trusts.[6867] This includes a trust that is an ESBT[6868] for part of the year and an eligible shareholder under Code § 1361(c)(2)(A)(i)-(iv) for the rest of the year.[6869]

The first day that a QSST[6870] or an ESBT is treated as an S corporation shareholder is the effective date of the QSST or ESBT election.[6871] Upon the conversion, the trust is not treated as terminating its entire interest in the S corporation for purposes of part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest, unless the trust was a trust described in part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death or III.A.3.b.iii A Trust with Respect to Stock Transferred to It Pursuant to The Terms of a Will (or a Qualified Revocable Trust When a Code § 645 Election Terminates), But Only for the 2-Year Period Beginning on The Day on Which Such Stock Is Transferred to It before the conversion.[6872]

III.B.2.j.ii.(f). Distribution after Transfer

Consider whether the donor or other transferor will need to receive distributions after the transfer and whether state law permits such transfers. For example, a shareholder might need a distribution to pay taxes but might not know how much until after the corporate income tax return for the year is filed.

State corporate law might impose time limits preventing distributions to shareholders more than a particular number of days after the record date.[6873] Using an LLC or other unincorporated entity for state law purposes might allow one to dispense with this limitation. Of course, the transferee could always agree to pay more to the transferor, but that imposes risk on the transferor with respect to the transferee's ability or willingness to perform.

One taxpayer argued that distributions the calendar year after her gave 95% of his stock should be applied against the basis of the donated stock, suggesting that the gift was not complete because that following calendar year he received distributions with respect to the donated stock, but the court didn't agree with his arguments.[6874]

III.B.2.j.ii.(g). Mismatch When Grantor Trust Status Changes in Year of Sale

Note that changes in grantor trust status do not generate an accounting cut-off for K-1 items, including gain from the deemed sale of assets; see part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest. When an S corporation undergoes a deemed asset sale, the K-1 income tends to increase basis to equal or exceed the stock's liquidation value; see part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.

However, when turning on grantor trust status, gain or loss on the sale of the stock is reportable solely by the deemed owner on the day of sale. See part III.B.2.d.i.(b) Portions of Irrevocable

[6867] Reg. § 1.1377-1(a)(2)(iii).
[6868] See part III.A.3.e.ii Electing Small Business Trusts (ESBTs.
[6869] Reg. § 1.1361-1(m)(3)(iv). Reg. § 1.641(c)-1(d)(2)(i) refers to Reg. § 1.1361-1(m)(3)(iv), which in turn refers to Reg. § 1.1377-1(a)(2)(iii).
[6870] See part III.A.3.e.i QSSTs.
[6871] Reg. § 1.1377-1(a)(2)(iii).
[6872] Reg. § 1.1377-1(a)(2)(iii).
[6873] See, *e.g.*, R.S.Mo. § 351.250.
[6874] *Miller v. Commissioner*, T.C. Memo. 2011-189.

Grantor Trust Deemed Owned for Federal Income Taxation. Given that the sale of stock tends to be a loss, as described above, ideally it would offset the K-1 gain described above; however, it might not, to the extent that K-1 gain is allocated to the nongrantor trust.

And the converse situation arises when grantor trust status is turned off.

III.B.2.j.iii. Allocations upon Change of Interest in a Partnership

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

For implementation of the rules set forth in this part III.B.2.j.iii Allocations upon Change of Interest in a Partnership, see part III.B.2.j.iii.(e) Allocation of Specific Items, which also applies in other situations.

Rev. Rul. 72-352 held that a trust's distribution of its partnership interest to the remainderman on the termination of the trust did not terminate the taxable year of the partnership but the taxable year of the partnership did close with respect to the trust in its capacity as partner, so that the trustees must include in the gross income of the trust its distributive share of the partnership items and any guaranteed payments as though the partnership year had ended on the trust's termination date. Consider that ruling in the context of the rest of part III.B.2.j.iii, which describes regulations adopted after that ruling but do not expressly refer to that ruling.

III.B.2.j.iii.(a). Transfer of Less Than a Partner's Entire Interest

Generally, the partnership's taxable year does not close with respect to a partner who sells or exchanges less than his entire interest or whose interest is reduced (whether by entry of a new partner, partial liquidation of a partner's interest, gift, or otherwise);[6875] even a transfer of a partner's entire interest by gift does not close the taxable year.[6876] Under prior law, the sale or exchange of at least 50% of a partnership terminated the partnership, closing the books,[6877]but for those purposes a "sale or exchange" did not include the disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, or the liquidation of a partnership interest;[6878] see part II.Q.8.e.iv Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).

Subject to certain exceptions, if during any taxable year of the partnership there is a change in any partner's interest in the partnership, each partner's distributive share of any item of income, gain, loss, deduction, or credit of the partnership for such taxable year are determined by the use of any method prescribed by regulations which takes into account the varying interests of the partners in the partnership during such taxable year.[6879] The exceptions are:

[6875] Code § 706(c)(2)(B); Reg. § 1.706-1(c)(3).
[6876] Reg. § 1.706-1(c)(5), which further provides that the income up to the date of gift attributable to the donor's interest shall be allocated to the donor under Code § 704(e)(2).
[6877] Reg. § 1.708-1(b)(3).
[6878] Reg. § 1.708-1(b)(2).
[6879] Code § 706(d)(1).

- If during any taxable year of the partnership any partner's interest changes, then (except to the extent provided in regulations) each partner's distributive share of any allocable cash basis item[6880] shall be determined:[6881]
    - by assigning the appropriate portion of such item to each day in the period to which it is attributable,[6882] and
    - by allocating the portion assigned to any such day among the partners in proportion to their interests in the partnership at the close of such day.[6883]
- If during any taxable year of the partnership there is a change in any partner's interest in the partnership (the "upper tier partnership"), and such partnership is a partner in another partnership (the "lower tier partnership"), then (except to the extent provided in regulations) each partner's distributive share of any item of the upper tier partnership attributable to the lower tier partnership shall be determined by assigning the appropriate portion (determined by applying principles similar to the principles described in fn. 6882) of each such item to the appropriate days during which the upper tier partnership is a partner in the lower tier partnership and by allocating the portion assigned to any such day among the partners in proportion to their interests in the upper tier partnership at the close of such day.[6884]

III.B.2.j.iii.(b). Transfer of Partner's Entire Interest

The taxable year of a partnership closes "with respect to a partner whose entire interest terminates (whether by reason of death, liquidation or otherwise.)"[6885]

[6880] Code § 706(d)(2)(B) provides:

> For purposes of this paragraph, the term allocable cash basis item means any of the following items with respect to which the partnership uses the cash receipts and disbursements method of accounting:
> (i) Interest.
> (ii) Taxes.
> (iii) Payments for services or for the use of property.
> (iv) Any other item of a kind specified in regulations prescribed by the Secretary as being an item with respect to which the application of this paragraph is appropriate to avoid significant misstatements of the income of the partners.

[6881] Code § 706(d)(2)(A).

[6882] Code § 706(d)(2)(A)(i). Code § 706(d)(2)(C)(i) provides that, if any portion of any allocable cash basis item is attributable to any period before the beginning of the taxable year, such portion shall be assigned under this rule to the first day of the taxable year. Code § 706(d)(2)(D) provides that, if any portion of a deductible cash basis item is assigned under this rule to the first day of any taxable year, then such portion shall be allocated among persons who are partners in the partnership during the period to which such portion is attributable in accordance with their varying interests in the partnership during such period, and any amount allocated under this rule to a person who is not a partner in the partnership on such first day shall be capitalized by the partnership and treated in the manner provided for in Code § 755.

Code § 706(d)(2)(C)(ii) provides that, if any portion of any allocable cash basis item is attributable to any period after the close of the taxable year, such portion shall be assigned under this rule to the last day of the taxable year.

[6883] Code § 706(d)(2)(A)(ii).

[6884] Code § 706(d)(3).

[6885] Code § 706(c)(2)(A). See also part II.Q.8.e.i Distribution of Partnership Interests.

A partnership taxable year closes with respect to a partner:[6886]

- who sells or exchanges his entire interest in the partnership,[6887]
- whose entire interest in the partnership is liquidated, or
- who dies.

In such a case, the partner includes in the partner's taxable income for the partner's taxable year within or with which the partner's interest in the partnership ends the partner's distributive share of items described in Code § 702(a) and any guaranteed payments under Code § 707(c) for the partnership taxable year ending with the date of such termination.[6888]

The partnership's taxable year, with respect to the remaining partners, does not close, unless the partnership is otherwise terminated, such as under Code § 708(b), which used to provide that the sale or exchange of a partnership interest which, by itself or aggregated with sales or exchanges in the preceding 12 months, transfers an interest of 50% or more of the total partnership capital or profits will effectively terminate the partnership.[6889]

III.B.2.j.iii.(c). Death of a Partner — Treated Like a Transfer of a Partner's Entire Interest

The death of a partner is treated as if the partner had transferred his or her entire interest in the partnership. Previously, the deceased partner's estate received all of the deceased partner's income for the partnership taxable year in which the death occurred. This is no longer true, and the taxable year closes with respect to a partner whose entire interest in the partnership has terminated.[6890] Thus, the death of a partner is treated as a transfer of the deceased partner's entire partnership interest to his or her estate.

If the decedent partner's estate or other successor sells or exchanges its entire interest in the partnership, or if its entire interest is liquidated, the partnership taxable year with respect to the estate or other successor in interest closes on the date of such sale or exchange, or the date of the completion of the liquidation.[6891]

[6886] Reg. § 1.706-1(c)(2)(i).

[6887] Note also that Reg. § 1.706-1(c)(2)(iii) provides:

> *Deemed dispositions*. A deemed disposition of the partner's interest pursuant to § 1.1502-76(b)(2)(vi) (relating to corporate partners that become or cease to be members of a consolidated group within the meaning of §§ 1.1502-1(h)), 1.1362-3(c)(1) (relating to the termination of the subchapter S election of an S corporation partner), or 1.1377-1(b)(3)(iv) (regarding an election to terminate the taxable year of an S corporation partner), shall be treated as a disposition of the partner's entire interest in the partnership solely for purposes of section 706.

[6888] Reg. § 1.706-1(c)(2)(i). For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.

[6889] Reg. § 1.708-1(b)(3). See parts II.Q.8.e.i Distribution of Partnership Interests (when a distribution as a sale or exchange) and II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).

[6890] Code § 706(c)(2)(A).

[6891] Reg. § 1.706-1(c)(2)(i). The sale or exchange of a partnership interest does not, for the purpose of this rule, include any transfer of a partnership interest which occurs at death as a result of inheritance or any testamentary disposition. *Id.*

Reg. § 1.706-1(c)(2)(ii) provides an example:

> H is a partner of a partnership having a taxable year ending December 31. Both H and his wife W are on a calendar year and file joint returns. H dies on March 31, 2016. Administration of the estate is completed and the estate, including the partnership interest, is distributed to W as legatee on November 30, 2016. Such distribution by the estate is not a sale or exchange of H's partnership interest. The taxable year of the partnership will close with respect to H on March 31, 2016, and H will include in his final return for his final taxable year (January 1, 2016, through March 31, 2016) his distributive share of partnership items for that period under the rules of sections 706(d)(2), 706(d)(3), and § 1.706-4. W will include in her return for the taxable year ending December 31, 2016, her distributive share of partnership items for the period of April 1, 2016, through December 31, 2016, under the rules of sections 706(d)(2), 706(d)(3), and § 1.706-4.

Note that a partner's death can trigger a basis increase – or reduction – in that partner's share of the partnership's assets.[6892] Even absent a Code § 754 election, the possibility of reduction requires monitoring to make sure that the partnership's assets do not have a substantial built-in loss.[6893]

III.B.2.j.iii.(d). Other Occasions Calling for an Interim Closing of the Books

Because determination of the adjusted basis and fair market value is necessary to comply with Code § 755 allocations, a Code § 754 election[6894] by the partnership to adjust the basis of partnership assets for the benefit of a transferee partner[6895] or in the case of a liquidation[6896] will require an interim closing of the books.

Applying Code § 732(d) basis adjustments on distributions[6897] and Code § 708(b) partnership terminations[6898] might also require interim closings.

III.B.2.j.iii.(e). Allocation of Specific Items

The rules of this part III.B.2.j.iii.(e) apply for determining the partners' distributive shares of partnership items when a partner's interest in a partnership varies during the taxable year as a result of the disposition of a partial or entire interest in a partnership[6899] or if a partner sells or exchanges a part of his interest in a partnership or if the interest of a partner is reduced[6900]

[6892] See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.
[6893] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.
[6894] For more on Code § 754 elections (and similar rules that apply without an election when the partnership has a substantial built-in loss), see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.
[6895] Code § 743(b).
[6896] Code § 734(b).
[6897] See part II.Q.8.e.iii.(e) Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election.
[6898] See part II.Q.8.e.iv Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).
[6899] As described in Reg. § 1.706-1(c)(2) and (3).
[6900] As described in Reg. § 1.706-1(c)(3), including by the entry of a new partner.

(collectively, a "variation").[6901] However, they do not override certain other provisions.[6902] In all cases, all partnership items for each taxable year must be allocated among the partners, and no partnership items may be duplicated, regardless of the particular provisions that apply and regardless of the method or convention adopted by the partnership.[6903]

In allocating items, a partnership must take the following steps in the order indicated:[6904]

1. Determine whether certain additional exceptions apply:[6905]

    - This general rule will not preclude changes in the allocations among contemporaneous partners for the entire partnership taxable year (or among contemporaneous partners for a segment if the item is entirely attributable to a segment), if any variation in a partner's interest is not attributable to a contribution of money or property by a partner to the partnership or a distribution of money or property by the partnership to a partner; and the allocations resulting from the modification satisfy the provisions of Code § 704(b) and the regulations promulgated thereunder.[6906]

    - With respect to any taxable year in which there is a change in any partner's interest in a partnership for which capital is not a material income-producing factor, the partnership and such partner may choose to determine the partner's distributive share of partnership income, gain, loss, deduction, and credit using any reasonable method to account for the varying interests of the partners in the partnership during the taxable year provided that the allocations satisfy the provisions of Code § 704(b).[6907]

[6901] Reg. § 1.706-4(a)(1).

[6902] Reg. § 1.706-4(a)(2) provides:

> Items subject to allocation under other rules, including sections 108(e)(8) and 108(i) (which provide special allocation rules for certain items from the discharge or retirement of indebtedness section), section 704(c) (relating to allocations with respect to certain contributed property), § 1.704-3(a)(6) (relating to allocations with respect to revalued property), section 706(d)(2) (relating to the determination of partners' distributive shares of allocable cash basis items), and section 706(d)(3) (relating the determination of partners' distributive share of any item of an upper tier partnership attributable to a lower tier partnership), are not subject to the rules of this section. In addition, the rules of this section do not apply in making allocation of book items pursuant to § 1.704-1(b)(2)(iv)(e), (f), or (s).

[6903] Reg. § 1.706-4(a)(2).

[6904] Reg. § 1.706-4(a)(3).

[6905] Reg. § 1.706-4(a)(3)(i), referring to Reg. § 1.706-4(b).

[6906] Reg. § 1.706-4(b)(1).

[6907] Reg. § 1.706-4(b)(2). Whether capital is a material income-producing factor might have changed since the regulation was promulgated by T.D. 9728 on July 31, 2015. See part III.B.1.a.iv.(b) Income Tax Aspects of Family Partnerships.

2. Determine which of its items are subject to allocation under certain special rules for extraordinary items, and allocate those items accordingly.[6908] Subject to a small item exception,[6909] extraordinary items that may not be prorated[6910] include: [6911]

    - Any item from the disposition or abandonment (other than in the ordinary course of business) of a capital asset;[6912]

    - Any item from the disposition or abandonment (other than in the ordinary course of business) of property used in a trade or business;[6913]

    - Any item from the disposition or abandonment of certain assets excluded from the definition of capital asset[6914] if substantially all the assets in the same category from the

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[6908] Reg. § 1.706-4(a)(3)(ii), referring to Reg. § 1.706-4(e).

[6909] Reg. § 1.706-4(e)(3) provides:

> *Small item exception*. A partnership may treat an item described in paragraph (e)(2) of this section as other than an extraordinary item for purposes of this paragraph (e) if, for the partnership's taxable year the total of all items in the particular class of extraordinary items (as enumerated in paragraphs (e)(2)(i) through (xi) of this section, for example, all tort or similar liabilities, but in no event counting an extraordinary item more than once) is less than five percent of the partnership's gross income, including tax-exempt income described in section 705(a)(1)(B), in the case of income or gain items, or gross expenses and losses, including section 705(a)(2)(B) expenditures, in the case of losses and expense items; and the total amount of the extraordinary items from all classes of extraordinary items amounting to less than five percent of the partnership's gross income, including tax-exempt income described in section 705(a)(1)(B), in the case of income or gain items, or gross expenses and losses, including section 705(a)(2)(B) expenditures, in the case of losses and expense items, does not exceed $10 million in the taxable year, determined by treating all such extraordinary items as positive amounts.

[6910] Reg. § 1.706-4(e)(1), which provides:

> The partnership must allocate extraordinary items among the partners in proportion to their interests in the partnership item at the time of day on which the extraordinary item occurred, regardless of the method (interim closing or proration method) and convention (daily, semi-monthly, or monthly) otherwise used by the partnership. These rules require the allocation of extraordinary items as an exception to the proration method, which would otherwise ratably allocate the extraordinary items across the segment, and the conventions, which could otherwise inappropriately shift extraordinary items between a transferor and transferee. However, publicly traded partnerships (as defined in section 7704(b)) that are treated as partnerships may, but are not required to, apply their selected convention in determining who held publicly traded units (as described in § 1.7704-1(b) or (c)(1)) at the time of the occurrence of an extraordinary item. Extraordinary items continue to be subject to any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year (for example, the limitation for section 179 expenses).

[6911] Reg. § 1.706-4(e)(2).

[6912] As defined in Code § 1221 (determined without the application of any other rules of law). Reg. § 1.706-4(e)(2). Real estate might or might not constitute inventory. See part II.G.26.c Future Development of Real Estate.

[6913] As defined in Code § 1231(b) (determined without the application of any holding period requirement). Reg. § 1.706-4(e)(2)(ii).

[6914] Referring to the following provisions in Code § 1221(a):

> (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
>
> (2) [excluded from this list]

same trade or business are disposed of or abandoned in one transaction (or series of related transactions);[6915]

- Any item from assets disposed of in an applicable asset acquisition;[6916]

- Any item resulting from any change in accounting method initiated by the filing of the appropriate form after a variation occurs;[6917]

- Any item from the discharge or retirement of indebtedness (except items subject to special allocation rules provided in Code § 108(e)(8) and (i));[6918]

- Any item from the settlement of a tort or similar third-party liability or payment of a judgment;[6919]

- Any credit, to the extent it arises from activities or items that are not ratably allocated;[6920]

- For all partnerships, any additional item if, the partners agree[6921] to consistently treat such item as an extraordinary item for that taxable year; however, this rule does not apply if treating that additional item as an extraordinary item would result in a substantial distortion of income in any partner's return; any additional extraordinary items continue to be subject to any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year (for example, the limitation for Code § 179 expenses);[6922]

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(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by-
  (A) a taxpayer whose personal efforts created such property,
  (B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or
  (C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);
(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);
(5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by-
  (A) a taxpayer who so received such publication, or
  (B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A);
[remaining provisions of Code § 1221(a) are excluded from this list.]

[6915] Reg. § 1.706-4(e)(2)(iii).
[6916] Reg. § 1.706-4(e)(2)(iv), referring to Code § 1060(c).
[6917] Reg. § 1.706-4(e)(2)(v).
[6918] Reg. § 1.706-4(e)(2)(vi).
[6919] Reg. § 1.706-4(e)(2)(vii).
[6920] Reg. § 1.706-4(e)(2)(viii), giving as an example the Code § 47 rehabilitation credit, which is based on placement in service.
[6921] Within the meaning of Reg. § 1.706-4(f) ; see fns. 6949-6952.
[6922] Reg. § 1.706-4(e)(2)(ix).

- Any item which, in the IRS' opinion, would, if ratably allocated, result in a substantial distortion of income in any return in which the item is included;[6923]

- Any item identified as an additional class of extraordinary item in guidance published in the Internal Revenue Bulletin.[6924]

3. Determine with respect to each variation whether it will apply the interim closing method or the proration method.[6925] Absent an agreement of the partners[6926] to use the proration method, the partnership must use the interim closing method.[6927] The partnership may use different methods (interim closing or proration) for different variations within each partnership taxable year; however, the IRS may place restrictions on the ability of partnerships to use different methods during the same taxable year in guidance published in the Internal Revenue Bulletin.[6928]

4. Determine when each variation is deemed to have occurred under the partnership's selected convention (generally, daily, semi-monthly, or monthly).[6929]

5. Determine whether there is an agreement of the partners[6930] to perform regular monthly or semi-monthly interim closings.[6931] If so, then the partnership will perform an interim closing of its books at the end of each month (in the case of an agreement to perform monthly closings) or at the end and middle of each month (in the case of an agreement to perform

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6923 Reg. § 1.706-4(e)(2)(x).
6924 Reg. § 1.706-4(e)(2)(xi).
6925 Reg. § 1.706-4(a)(3)(iii).
6926 Within the meaning of Reg. § 1.706-4(f); see fns. 6949-6952.
6927 Reg. § 1.706-4(a)(3)(iii).
6928 Reg. § 1.706-4(a)(3)(iii).
6929 Reg. § 1.706-4(a)(3)(iv), referring to the selected convention under Reg. § 1.706-4(c). However, all variations within a taxable year shall be deemed to occur no earlier than the first day of the partnership's taxable year, and no later than the close of the final day of the partnership's taxable year. Thus, for a calendar year partnership applying either the semi-monthly or monthly convention to a variation occurring on January 1st through January 15th, the variation will be deemed to occur at the beginning of the day on January 1st. Reg. § 1.706-4(c)(2)(i). Also, if a person becomes a partner during the partnership's taxable year as a result of a variation, and ceases to be a partner as a result of another variation, if both such variations would be deemed to occur at the same time under the rules of Reg. § 1.706-4(c)(1), then the variations with respect to that partner's interest will instead be treated as occurring on the dates each variation actually occurred. Reg. § 1.706-4(c)(2)(ii). Thus, the partnership must treat such a person as a partner for the entire portion of its taxable year during which the partner actually owned an interest; see Reg. § 1.706-4(c)(4), Example (2). However, Reg. § 1.706-4(c)(2)(ii) (by its own terms) does not apply to publicly traded partnerships (as defined in Code § 7704(b)) that are treated as partnerships with respect to holders of publicly traded units (as described in Reg. § 1.7704-1(b) or 1.7704-1(c)(1)).
6930 Within the meaning of Reg. § 1.706-4(f); see fns. 6949-6952.
6931 Reg. § 1.706-4(a)(3)(v), referring to closings under Reg. § 1.706-4(d). Reg. § 1.706-4(d)(1) provides:

> *Optional regular monthly or semi-monthly interim closings*. Under the rules of this section, a partnership is not required to perform an interim closing of its books except at the time of any variation for which the partnership uses the interim closing method (taking into account the applicable convention). However, a partnership may, by agreement of the partners (within the meaning of paragraph (f) of this section) perform regular monthly or semi-monthly interim closings of its books, regardless of whether any variation occurs. Regardless of whether the partners agree to perform these regular interim closings, the partnership must continue to apply the interim closing or proration method to its variations according to the rules of this section.

For a discussion of Reg. § 1.706-4(f) referred to above, see fns. 6949-6952.
Reg. § 1.706-4(d)(2) provides an example of the principles of Reg. § 1.706-4(d)(1).

semi-monthly closings), regardless of whether any variation occurs.[6932] Absent an agreement of the partners to perform regular monthly or semi-monthly interim closings, the only interim closings during the partnership's taxable year will be at the deemed time of the occurrence of variations for which the partnership uses the interim closing method.[6933]

6. Determine the partnership's segments, which are specific periods of the partnership's taxable year created by interim closings of the partnership's books.[6934] The first segment starts with the beginning of the taxable year of the partnership and ends at the time of the first interim closing.[6935] Any additional segment begins immediately after the closing of the prior segment and ends at the time of the next interim closing.[6936] However, the last segment of the partnership's taxable year must end no later than the close of the last day of the partnership's taxable year.[6937] If no interim closings occur, the partnership has one segment, which corresponds to its entire taxable year.[6938]

7. Apportion the partnership's items for the year among its segments.[6939] The partnership determines the items of income, gain, loss, deduction, and credit of the partnership for each segment.[6940] Generally, a partnership treats each segment as though the segment were a separate distributive share period.[6941] For purposes of determining allocations to segments, any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year will apply based upon the partnership's satisfaction of the limitation or requirement as of the end of the partnership's taxable year.[6942]

8. Determine the partnership's proration periods, which are specific portions of a segment created by a variation for which the partnership chooses to apply the proration method.[6943] The first proration period in each segment begins at the beginning of the segment and ends at the first time of the first variation within the segment for which the partnership selects the proration method.[6944] The next proration period begins immediately after the close of the prior proration period and ends at the time of the next variation for which the partnership selects the proration method.[6945] However, each proration period ends no later than the close of the segment.[6946]

[6932] Reg. § 1.706-4(a)(3)(v).
[6933] Reg. § 1.706-4(a)(3)(v).
[6934] Reg. § 1.706-4(a)(3)(vi).
[6935] Reg. § 1.706-4(a)(3)(vi).
[6936] Reg. § 1.706-4(a)(3)(vi).
[6937] Reg. § 1.706-4(a)(3)(vi).
[6938] Reg. § 1.706-4(a)(3)(vi).
[6939] Reg. § 1.706-4(a)(3)(vii).
[6940] Reg. § 1.706-4(a)(3)(vii).
[6941] Reg. § 1.706-4(a)(3)(vii). For example, a partnership may compute a capital loss for a segment of a taxable year even though the partnership has a net capital gain for the entire taxable year. Reg. § 1.706-4(a)(3)(vii).
[6942] Reg. § 1.706-4(a)(3)(vii). For example, the expenses related to the election to expense a Code § 179 asset must first be calculated (and limited if applicable) based on the partnership's full taxable year, and then the effect of any limitation must be apportioned among the segments in accordance with the interim closing method or the proration method using any reasonable method. Reg. § 1.706-4(a)(3)(vii).
[6943] Reg. § 1.706-4(a)(3)(viii).
[6944] Reg. § 1.706-4(a)(3)(viii).
[6945] Reg. § 1.706-4(a)(3)(viii).
[6946] Reg. § 1.706-4(a)(3)(viii).

9. Prorate the items of income, gain, loss, deduction, and credit in each segment among the proration periods within the segment.[6947]

10. Determine the partners' distributive shares of partnership items by taking into account the partners' interests in such items during each segment and proration period.[6948]

Various provisions above refer to agreements by the partners.[6949] "Agreement of the partners" refers to:

- An agreement of all the partners to select the method, convention, or extraordinary item in a dated, written statement maintained with the partnership's books and records,[6950] or

- A selection of the method, convention, or extraordinary item made by a person authorized to make that selection,[6951] if that person's selection is in a dated, written statement maintained with the partnership's books and records.[6952]

In either case, the dated written agreement must be maintained with the partnership's books and records by the due date, including extension, of the partnership's tax return.

As mentioned in fn. 6902, a special rule for determining a partner's share of the partnership's allocable cash-basis items also applies.[6953] Each partner's distributive share of any allocable cash basis items shall be determined:[6954]

(1) by assigning the appropriate portion of such items to each day in the period to which it is attributable; and

(2) by allocating the portion assigned to any such day among the partners in proportion to their partnership interests at the close of such day.

Also, the modified accrual method must be applied with respect to the following allocable cash basis items, as paid or received by the partnership:[6955]

(1) interest; or

(2) taxes; or

(3) payments for services or for the use of property (for example, rent); or

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[6947] Reg. § 1.706-4(a)(3)(ix).
[6948] Reg. § 1.706-4(a)(3)(x).
[6949] Reg. § 1.706-4(f) refers to Reg. § 1.706-4(a)(3)(iii) (relating to selection of the proration method), Reg. § 1.706-4(c)(3) (relating to selection of the semi-monthly or monthly convention), Reg. § 1.706-4(d) (relating to performance of regular monthly or semi-monthly interim closings), and Reg. § 1.706-4(e)(2)(ix) (relating to selection of additional extraordinary items).
[6950]One example is a selection that is included in the partnership agreement.
[6951] This might be under a grant of general authority provided for by state law or in the partnership agreement.
[6952] Reg. § 1.706-4(f).
[6953] Code § 706(d)(2).
[6954] Code § 706(d).
[6955] Code § 706(d)(2)(B)(i-iv).

(4) any other item specified by regulations.

III.B.2.j.iv. Income Tax Reimbursement Clause

III.B.2.j.iv.(a). Grantor Trust Reimbursing for Tax Paid by the Deemed Owner

I usually include a clause providing that the trust cannot reimburse the grantor, to avoid a possible argument that the grantor has an equitable right to be reimbursed that may be included in the grantor's estate for estate tax purposes. The Uniform Trust Decanting Act[6956] suggests that decanting[6957] may allow a trust to be switched from grantor trust to nongrantor trust or vice versa.[6958]

If the grantor cannot achieve accounting cut off or cannot terminate his grantor trust powers to escape the dire tax consequences of an exploding GRAT or irrevocable grantor trust, an income tax reimbursement clause may be a valuable tool to remedy this problem. In its simplest form, the income tax reimbursement clause authorizes the trustee with a discretionary power to reimburse the grantor for income taxes incurred in excess of the annuity or note payments.

An income tax reimbursement provision will cause inclusion of the trust assets in the grantor's gross estate if it constitutes a transfer with a retained life estate interest in the trust assets.[6959] Any retention of a right to apply the trust property towards the discharge of a legal obligation

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[6956] As adopted July 2015. See http://www.uniformlaws.org/Act.aspx?title=Trust Decanting.

[6957] See part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.

[6958] Section 19(b)(9) provides:

> Subject to paragraph (4):
>
> (A) except as otherwise provided in paragraph (7), the second trust may be a nongrantor trust, even if the first trust is a grantor trust; and
>
> (B) except as otherwise provided in paragraph (10), the second trust may be a grantor trust, even if the first trust is a nongrantor trust.

Section 19(b)(4) prohibits decanting that would mess up an S election. For example, I do not believe that a QSST's S corporation stock can be transferred into another trust by decanting, but the Act authorizes decanting to take the form of a trust amendment without actually transferring the stock, which may be permissible by a QSST, depending on the amendment. See part III.A.3.e.i.(a) QSSTs Generally.
Section 19(b)(7) protects grantor trust status under Code § 672(f)(2)(A), which describes the conditions under which the grantor trust rules treat a nonresident alien as a deemed owner.
Section 19(b)(10) provides:

> An authorized fiduciary may not exercise the decanting power if a settlor objects in a signed record delivered to the fiduciary within the notice period and:
>
> (A) the first trust and a second trust are both grantor trusts, in whole or in part, the first trust grants the settlor or another person the power to cause the first trust to cease to be a grantor trust, and the second trust does not grant an equivalent power to the settlor or other person; or
>
> (B) the first trust is a nongrantor trust and a second trust is a grantor trust, in whole or in part, with respect to the settlor, unless:
>
> (i) the settlor has the power at all times to cause the second trust to cease to be a grantor trust; or
>
> (ii) the first-trust instrument contains a provision granting the settlor or another person a power that would cause the first trust to cease to be a grantor trust and the second-trust instrument contains the same provision.

[6959] Code § 2036(a). The right to be reimbursed for tax liability over the annuity or note amount, presumably, could be deemed as the possession or enjoyment of, or the right to the income from, the property or the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

causes inclusion under Code § 2036[6960] and, if the right is absolute, Code § 2041. GRATs should include income tax reimbursement clauses, which potentially makes them includible in the grantor's gross estate. Often, this is not a concern, because GRATs are often fully included in the grantor's estate if the grantor dies during the annuity term. However, in the case of a sale to the irrevocable grantor trust, only the note is included under Code § 2036; therefore, avoiding estate inclusion due to tax reimbursement clauses is particularly important.

Rev. Rul. 2004-64 provides specific guidance on this point.[6961] When trust language provides an unrelated trustee[6962] discretionary power to reimburse the grantor for excess income taxes, the reimbursement clause will not necessarily cause estate inclusion, if there is no understanding that the trustee will reimburse the grantor.[6963] Subsequent rulings discussing tax reimbursement clauses include:

- In Letter Ruling 200822008, the trust was to be modified authorizing the trustee "to pay to the Grantor or the Grantor's legal representative those amounts sufficient to satisfy the Grantor's federal, state, or local income tax liability actually incurred by the Grantor attributable to the 'pass through' of the Trust's taxable income." Such distributions would be subject to the consent of an independent "Reimbursement Committee"[6964] and an adult child who qualifies as a Code § 672(c) adverse party; including the child seems unnecessary[6965]

6960 Reg. § 20.2036-1(b)(2). The grantor is legally obligated to pay his or her income taxes, thus any right to reimbursement for this legal obligation may be included in the grantor's gross estate.

6961 See also Forsberg & Worthington, Income Tax Reimbursement Clauses in Irrevocable Grantor Trusts – When to Use Them and When Not to Use Them, *Probate & Property*, Vol. 19, No. 3, May/June 2005.

6962 Rev. Rul. 2004-64 includes in its facts, "The governing instrument of Trust requires that the trustee be a person not related or subordinate to [the grantor] within the meaning of § 672(c) of the Internal Revenue Code.

6963 Rev. Rul. 2004-64, Situation 3. See Letter Ruling 201647001, described in fn. 6976.

6964 The ruling included the following details:

> The initial member of the Reimbursement Committee will be A. It is represented that A is neither an employee of Grantor, nor an employee of a corporation whose stock is owned by the Grantor (or Trust, Exempt Trust or Non-Exempt Trust) or whose executives include Grantor, nor a relative of the Grantor listed in section 672(c). Spouse, if she is then living, otherwise Grantor's living children by majority vote, or if there are no then living children of Grantor, then Grantor's living issue (by majority vote) may remove any persons then serving on the Reimbursement Committee, and or appoint additional persons at any time with or without cause. However, no one related or subordinate to the Grantor within the meaning of § 672(c), can be appointed to the Reimbursement Committee.

The ruling elaborated on A's relationship:

> In addition, because A's only relationship to the Grantor presumably is that of the Grantor's independent attorney, A also does not meet the definition of a related or subordinate party under § 672(c). Accordingly, the Reimbursement Committee consisting of A will not be considered a related or subordinate party within the meaning of § 672(c).

6965 The ruling noted:

> Under the terms of the provision, a consenting child beneficiary must be an adverse party; therefore, such a child beneficiary does not meet the definition of a related or subordinate party under § 672(c). Accordingly, a consenting child beneficiary will not be considered a related or subordinate party within the meaning of § 672(c). We note that this conclusion does not require us to address whether the beneficiary children of the Grantor are in fact adverse parties (and if they are, to what extent, *i.e.*, part or all of the Trust), because the Reimbursement Provision requires a child beneficiary be an adverse party.

and potentially harmful, given that a child who is an adverse party may make a taxable gift by consenting.[6966]

- In Letter Ruling 200944002, instead of providing an income tax reimbursement right,[6967] the trust authorized distributions to the grantor, among other beneficiaries, in the trustee's sole and absolute discretion.[6968] The trustee was independent.[6969] State law respected spendthrift provisions regarding the settlor.[6970] The ruling held no Code § 2036 inclusion so long as no pre-arrangement regarding distributions to the settlor.[6971]

[6966] To be an adverse party, the child must have "a substantial beneficial interest in a trust which would be adversely affected by the exercise or nonexercise of a power which he possesses respecting the trust." See part III.B.2.h.vii Distribution Provisions Might Prevent Turning Off Grantor Trust Status, especially the text accompanying fns. 6682-6688. By negative implication, Reg. § 25.2511-1(g)(1) suggests the possibility that a trustee's decision to make distributions may be a gift if the trustee is a beneficiary: "A transfer by a trustee of trust property in which he has no beneficial interest does not constitute a gift by the trustee…." Reg. § 25.2511-1(g)(2) elaborates - see text accompanying fn 2485 in part II.J.2.b **Trust** Provisions Authorizing Distributions. See also Reg. § 20.2041-1(c)(2) (exception to estate tax general power of appointment – see text accompanying fn 2124 in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap).
Without suggesting whether or not the tax reimbursement clause fits this exception, I would prefer to avoid the issue.

[6967] The trust agreement "provides that trustee shall not pay Grantor or Grantor's executors any income or principal of Trust in discharge of Grantor's income tax liability." See text accompanying fn. 6979.

[6968] The trust provided that:

> trustee will pay over the income and principal of Trust in such amounts and proportions as trustee in its sole and absolute discretion may determine for the benefit of one or more members of the class consisting of Grantor, Grantor's spouse and Grantor's descendants.

[6969] The trust provided that:

> the following persons may not be a trustee of Trust or any other trust created under trust: (1) Grantor; (2) the spouse or a former spouse of Grantor; (3) any individual who is a beneficiary of Trust or a trust created under Trust; (4) the spouse or a former spouse of a beneficiary of any trust hereunder; (5) anyone who is related or subordinate to Grantor within the meaning of § 672(c).

[6970] The ruling described applicable state law:

> State Statute provides that a person who in writing transfers property in trust may provide that the interest of a beneficiary of the trust, including a beneficiary who is the settlor of the trust, may not be either voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee. Under State Statute, if the trust instrument contains this transfer restriction, it prevents a creditor existing when the trust is created or a person who subsequently becomes a creditor, from satisfying a claim out of the beneficiary's interest in the trust unless, (1) the trust provides that the settlor may revoke or terminate all or part of the trust without the consent of a person who has a substantial beneficial interest in the trust and the interest would be adversely affected by the exercise of the power held by the settlor to revoke or terminate all or part of the trust; (2) the settlor intends to defraud a creditor by transferring the assets to the trust;(3) the settlor is currently in default of a child support obligation by more than 30 days; or (4) the trust requires that all or a part of the trust's income or principal, or both, must be distributed to the settlor.

[6971] After citing the non-reimbursement clause in fn. 6967, the ruling reasoned and held:

> Although Rev. Rul. 2004-64 does not consider this situation, it is clear from the analysis, that because the trustee is prohibited from reimbursing Grantor for taxes Grantor paid, that Grantor has not retained a reimbursement right that would cause Trust corpus to be includible in Grantor's gross estate under § 2036. See Rev. Rul. 2004-64. In addition, the trustee's discretionary

- Letter Ruling 201647001, ***which the IRS has since disavowed***, approved modifying a trust to authorize independent trustees[6972] to reimburse income tax[6973] when, due to "unforeseen and unanticipated circumstances," the grantors' payment of income tax had become "unduly burdensome." Letter Ruling 201647001 held that the children did not make a gift when the trust was modified, because the reimbursement clause was "administrative in nature" and did not "result in a change in beneficial interests" in the trust, meaning the changes did not constitute a gift[6974] and did not cause it to lose its zero inclusion ratio for GST purposes.[6975]

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authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under § 2036.

We are specifically not ruling on whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036.

[6972] The ruling analyzed the trustee provisions:

Trust prohibits Grantors from serving as trustees of Trust and any trusts created thereunder. However, pursuant to the modifications to Article 8 of Trust, Grantors will retain the power to remove and replace the Trustees, including the Independent Trustee. However, any successor Independent Trustee appointed by Grantors cannot be related or subordinate within the meaning of § 672(c) to the Grantors. Accordingly, under Rev. Rul. 95-58, Grantor's retained removal and replacement powers are not considered the reservation of the Independent Trustee's powers for purposes of § 2038. Further, the Family Trustees do not possess any powers to distribute income or corpus to the Trust beneficiaries. Therefore, Grantors' powers to remove and replace the Family Trustees will not cause the Trust corpus to be included in the gross estate of either Grantor under § 2038. Accordingly, we conclude that the modifications to Article 8 which grants Grantors the power to remove and replace the Trustees will not cause the Trust corpus to be included in the gross estate of either Grantor under § 2038.

[6973] The modification included:

Section 13.3(b) is modified to include a tax reimbursement clause requiring compliance with Situation 3 of Rev. Rul. 2004-64, 2004-2 C.B. 7. Specifically, Section 13.3(b), as modified, provides that Grantors shall not be entitled to any right of reimbursement under any applicable law for their tax liability (whether federal, state or otherwise), if any, attributable to a trust being treated as a "grantor trust" as to either Grantor under §§ 671 through 679. If in any calendar year, a trust created hereunder is treated as a "grantor trust" as to either Grantor under §§ 671 through 679, an Independent Trustee may from time to time, distribute to a Grantor so much of the income or principal of the trust as may be sufficient to satisfy all or part of such Grantor's personal income tax liability attributable to the inclusion of all or part of the trust's income in such Grantor's taxable income in excess of the amount of such taxes that would have been imposed if the trust's income, gains, losses and deductions had not been included in the determination of such Grantor's income tax liability.

[6974] "The proposed modifications to Articles 5, 6, 9, 12, and 13 are administrative in nature and do not result in a change in beneficial interests in Trust. We conclude that these modifications do not result in a deemed transfer by any of the children for purposes of § 2501."

[6975] The ruling reasoned and held:

In the instant case, Trust became irrevocable after September 25, 1985. It is represented that sufficient GST exemption was allocated to Trust so that Trust has an inclusion ratio of zero under § 2642. No guidance has been issued concerning changes that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a change that would not affect the GST status of a trust that was irrevocable on September 25, 1985, should similarly not affect the exempt status of such a trust.

Article 5.1 is modified only to the extent to provide that the modification to Trust may not extend the term of any trust created under Trust. Under Rulings 2 and 4, we concluded that the

Subject to qualifications regarding any prearrangement, the ruling held no inclusion in the grantors' estates.[6976] (Note that, if the trustee mistakenly taxes the sale to a beneficiary, reimbursing the beneficiary should not generate any transfer tax consequences.[6977])

In contrast, CCA 202352018, which had the opposite result, involved the following facts:

> In Year 1, A establishes and funds Trust, an irrevocable inter vivos trust, for the benefit of A's Child and Child's descendants. Trustee is the current trustee of Trust and satisfies the governing instrument requirement that a trustee of Trust must be a person not related or subordinate to A within the meaning of § 672(c) of the Code. Under the governing instrument of Trust, a trustee of Trust may distribute income and principal to or for the benefit of Child in the trustee's absolute discretion. Upon Child's death, Trust's remainder is to be distributed to Child's issue, per stirpes.
>
> Under the governing instrument of Trust, A retains a power that causes A to be the deemed owner of Trust under § 671 of the Code, and, accordingly, all items of income, deductions, and credits attributable to Trust are included in A's taxable income.

> proposed modifications to do not constitute the release, exercise, or lapse of powers of appointment for purposes of §§ 2041 and 2514. Accordingly, the proposed modifications do not constitute constructive additions to Trust. The modifications were effected in accordance with state law and pertain to the administration of Trust.
>
> Accordingly, the proposed modifications to Articles 5, 6, 8, 9, 12, and 13 of Trust are administrative in nature and under § 26.2601-1(b)(4)(i)(D)(2), will not be considered to shift a beneficial interest to a lower generation in the trust or extend the time for vesting of any beneficial interest in the trust beyond the period provided for in Trust. See Example 10 of § 26.2601-1(b)(4)(i)(E).
>
> Therefore, based upon the facts submitted and representations made, we conclude that the proposed modifications of Trust will not cause Trust, as modified, to lose its zero inclusion ratio for GST tax purposes under chapter 13.

[6976] The ruling reasoned and held:

> In this case, under the terms of Section 13.3(b), as proposed, the Independent Trustee will have the discretion to reimburse either Grantor with respect to the income tax liability actually incurred by the Grantor attributable to Trust items, for periods after the Trust instrument is modified. Only a Trustee who is not related or subordinate to either Grantor, within the meaning of § 672(c) may exercise the powers to reimburse either Grantor. Accordingly, assuming there is no understanding, express or implied, between either Grantor and the Independent Trustee regarding the Independent Trustee's exercise of discretion, the Independent Trustee's discretion to satisfy either of the Grantor's obligation would not alone cause the inclusion of the trust in either of the Grantor's gross estate for federal estate tax purposes. However, as noted in Rev. Rul. 2004-64, such discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between either of the Grantor and the Independent Trustee regarding the Independent Trustee's exercise of this discretion; a power retained by either Grantor to remove the trustee and name the grantor as successor trustee; or applicable local law subjecting the trust assets to the claims of either of the Grantor's creditors) may cause inclusion of Trust's assets in either of the Grantor's gross estate for federal estate tax purposes.
>
> Based upon the facts submitted and representations made, we conclude that the proposed modifications of Trust will not cause the property of Trust to be included in the gross estate of either Grantor for federal estate tax purposes.

[6977] See part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the , especially fn. 2909.

Neither State law nor the governing instrument of Trust requires or provides authority to a trustee of Trust to distribute to A amounts sufficient to satisfy A's income tax liability attributable to the inclusion of Trust's income in A's taxable income.

In Year 2, when Child has no living grandchildren or more remote descendants, Trustee petitions State Court to modify the terms of Trust. Pursuant to State Statute, Child and Child's issue consent to the modification. Later that year, State Court grants the petition and issues an Order modifying Trust to provide a trustee of Trust the discretionary power to reimburse A for any income taxes A pays as a result of the inclusion of Trust's income in A's taxable income.

CCA 202352018 cited the following authority:

Under § 671 of the Code, if the grantor of a trust is treated as the owner of any portion of the trust under subpart E, those items of income, deductions, and credits against tax of the trust that are attributable to that portion of the trust must be included in computing taxable income or credits of the grantor.

Section 2501(a)(1) imposes a tax for each calendar year on the transfer of property by gift during the calendar year by any individual. Section 2511(a) provides that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 25.2511-1(c)(1) of the Gift Tax Regulations provides that the gift tax applies to gifts indirectly made. Further, any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Section 25.2511-1(e) provides that if a donor transfers by gift less than their entire interest in property, the gift tax is applicable to the interest transferred. Further, if the donor's retained interest is not susceptible of measurement on the basis of generally accepted valuation principles, the gift tax is applicable to the entire value of the property subject to the gift.

Section 25.2511-1(g)(1) provides in relevant part that donative intent on the part of the transferor is not an essential element in the application of the gift tax to the transfer. The application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor.

Section 25.2511-2(a) provides that the gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer. Rather, it is a tax upon the donor's act of making the transfer. The measure of the gift is the value of the interest passing from the donor with respect to which they have relinquished their rights without full and adequate consideration in money or money's worth.

Section 25.2511-2(b) provides that as to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for their own benefit or for the benefit of another, the gift is complete. If a donor transfers property to another in trust to pay the income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among the donor's descendants, no portion of the transfer is a completed gift. On the other hand, if the donor had not retained the testamentary power of appointment, but instead provided that the remainder should go to X or X's heirs, the entire transfer would be a completed gift.

> Rev. Rul. 67-370, 1967-1 C.B. 324,[6978] concludes that a defeasible remainder interest in trust which is subject to termination at the will of another is an interest in property within the meaning of § 2033 of the Code. The ruling notes that the fair market value of the interest would be affected by its possible divestment under general transfer tax rules for the valuation of property, but the value of that interest would not necessarily be nominal.

> In Rev. Rul. 2004-64, 2004-2 C.B. 7, a grantor created an irrevocable inter vivos trust for the benefit of the grantor's descendants and retained sufficient powers with respect to the trust so that the grantor is treated as the owner of the trust under subpart E of the Code. In relevant part, the ruling considers two situations in which the trustee reimburses the grantor for taxes paid by the grantor that are attributable to the inclusion of all or part of the trust's income in the grantor's income. In Situation 2 of Rev. Rul. 2004-64, the distribution reimbursing the grantor is mandated under the terms of the governing instrument. In Situation 3 of Rev. Rul. 2004-64, the governing instrument provides the trustee with the discretionary authority to make a reimbursing distribution. In both of these situations, when the trustee of the trust reimburses the grantor for the income tax paid by the grantor, the ruling concludes that the payment does not constitute a gift by the trust beneficiaries because the distribution was either mandated by the terms of the governing instrument or made pursuant to the exercise of the trustee's discretionary authority granted under the terms of the governing instrument.

CCA 202352018 reasoned and concluded:

> Under the governing instrument of Trust, Child and Child's issue each have an interest in the trust property. As a result of the Year 2 modification of Trust, A acquires a beneficial interest in the trust property in that A becomes entitled to discretionary distributions of income or principal from Trust in an amount sufficient to reimburse A for any taxes A pays as a result of inclusion of Trust's income in A's gross taxable income. In substance, the modification constitutes a transfer by Child and Child's issue for the benefit of A. This is distinguishable from the situations in Rev. Rul. 2004-64 where the original governing instrument provided for a mandatory or discretionary right to reimbursement for the grantor's payment of the income tax. Thus, as a result of the Year 2 modification, Child and Child's issue each have made a gift of a portion of their respective interest in income and/or principal.[1] *See* § 25.2511-1(e) and § 25.2511-2(b). *See also Robinette v. Helvering*, 318 U.S. 184 (1943). The result would be the same if the modification was pursuant to a state statute that provides beneficiaries with a right to notice and a right to object to the modification and a beneficiary fails to exercise their right to object.

> [1] PLR 201647001 concludes that the modification of a trust to add a discretionary trustee power to reimburse the grantor for the income tax paid attributable to the trust

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[6978] [my footnote] Rev. Rul. 67-370 is excerpted in the text accompanying fn 6366 in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts.

income is administrative in nature and does not result in a change of beneficial interests in the trust. These conclusions no longer reflect the position of this office.

The gift from Child and Child's issue of a portion of their interests in trust should be valued in accordance with the general rule for valuing interests in property for gift tax purposes in accordance with the regulations under § 2512 and any other relevant valuation principles under subtitle B of the Code.[2]

[2] Although the determination of the values of the gifts requires complex calculations, Child and Child's issue cannot escape gift tax on the basis that the value of the gift is difficult to calculate. *See Smith v. Shaughnessy*, 318 U.S. 176, 180 (1943) ("The language of the gift tax statute, 'property ... real or personal, tangible or intangible,' is broad enough to include property, however conceptual or contingent.")

For more on consequences of trust modifications, see parts III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts and III.B.1.e.ii Valuing a Beneficial Interest in a Trust. A trust modification adding a reimbursement right when no reimbursement is contemplated may be at most a nominal gift, whereas such a modification anticipating a concrete need for reimbursement might not be quite so innocuous. Consider the grantor selling illiquid assets to the trust to raise the cash to pay tax instead of adding a reimbursement right.

However, if the grantor has an enforceable right to reimbursement, the reimbursement right will cause estate inclusion.[6979] Furthermore, applicable local law subjecting the trust assets to the claims of the grantor's creditors may cause inclusion of the trust in the grantor's gross estate.[6980] This raises the issue of whether or not the availability of self-settled trusts (spendthrift trusts in which the grantor is the beneficiary) to the grantor's creditors subjects the trust to inclusion under Code § 2036.

The general rule is that the grantor's creditors can require distribution of self-settled trust assets to the extent which the trustee had discretion to make distributions.[6981] To the extent creditors can reach a self-settled trust, they are generally includible under Code § 2036 or an incomplete gift due to the grantor's retained power to terminate the trust by consigning his or her creditors to the trust assets.[6982] However, some states permit self-settled trusts to be protected from the grantor's creditors generally[6983] and some states only with respect to reimbursing taxes.[6984]

The Bankruptcy Abuse and Prevention Act of 2005, however, causes some concern about how well domestic asset protection trusts ("DAPTs") prevent creditors from gaining access to trust assets. Of particular concern is the 10-year lookback provision, which states that transfers to self-settled trusts by the debtor in which the debtor is a beneficiary of the trust within ten years before filing for bankruptcy.[6985] However, the language of the Act included a scienter requirement indicating that the grantor, by means of the transfer, intended to hinder, delay, or

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[6979] Rev. Rul. 2004-64, Situation 2.
[6980] Rev. Rul. 2004-64, Situation 3.
[6981] Rev. Rul. 76-103; Forsberg & Worthington, "Income Tax Reimbursement Clauses in Irrevocable Grantor Trusts – When to Use Them and When Not to Use Them," *Probate & Property*, Vol. 19, No. 3, May/June 2005, note 27 at 7 (citing 2A Austin W. Scott, *Trusts* § 156).
[6982] Rev. Rul. 76-103; Code § 2038(a)(1).
[6983] See "Comparison of the Domestic Asset Protection Statutes," edited by David G. Shaftel and available to ACTEC Fellows on the State Surveys page at http://www.actec.org/resources/state-surveys.
[6984] See, *e.g.*, Texas Trust Code § 112.035(d)(1) (see Thompson Coburn LLP doc. no. 6599538).
[6985] 11 U.S.C. § 548(e)(1)(A-C).

defraud any party to which the debtor was indebted.[6986] In other words, the burden would lay on the bankruptcy trustee to show that the filer had the necessary fraudulent intent. Thus, DAPTs formed for legitimate purposes, such as transfer tax minimization, will retain their usefulness as estate planning tools.[6987] However, at least one commentator has noted that it would be difficult for a filer to argue that the transfer of assets to a DAPT was not intended to delay or hinder a creditor.[6988] As such, some uncertainty remains as to whether a grantor will be required to wait the full ten years before the hole in the DAPT is plugged so that creditors will be unable to reach the trust assets. With this lingering uncertainty about the 2005 Act, it will be difficult for practitioners to definitively say that these self-settled trusts are free from creditor claims, and subsequently, not includible in the grantor's gross estate. Keep that in mind when considering using a tax reimbursement clause.

If the grantor is concerned about being able to pay the income tax and cannot structure the trust to allow the grantor to turn off grantor trust status, the grantor should consider retaining a sizable portion of the asset being transferred. That retention may frustrate the grantor's goal of minimizing estate tax, but the grantor needs to be able to sleep at night.

III.B.2.j.iv.(b). Tax Distributions from Partnerships and S Corporations after Termination of Interest

Partnerships and S corporations typically make distributions to pay their owners' taxes. Usually these consist of just enough to their quarterly estimated tax payments, followed by a distribution the following March or April so that their owners can pay any balance due on undistributed income, to the extent not covered by the distributions to make the required quarterly estimated tax payments.

This practice causes certain issues to arise when an interest terminates before distributions are made to pay all of the tax incurred on income earned before termination. Language to address this issue is included in part III.A.3.d Special Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.

III.B.3. Defined Value Clauses in Sale or Gift Agreements or in Disclaimers

III.B.3.a. Overview

Usually property sold to an irrevocable grantor trust is a difficult-to-value asset. The IRS might assert that the property that was sold was worth more than what the seller received and that therefore the seller made a large gift. A defined value clause often provides that any such excess goes to an entity, gifts to which do not trigger gift tax. The excess might go to a charity, marital deduction trust, or a GRAT (the latter being most likely to be attacked by the IRS). However, *Wandry* (described in part III.B.3.j) approved a gift of LLC interests defined by a fixed dollar amount, without any excess going to a charity or other entity, so we have a path for making such gifts; on the other hand:

[6986] 11 U.S.C. § 548(e)(1)(D).
[6987] Shaftel & Bundy, D.A.P.T. 2005: The Report of My Death Was an Exaggeration, *Steve Leimberg's Asset Protection Planning Newsletter* #68 (May 23, 2005), available at http://www.leimbergservices.com.
[6988] Jay Adkisson & Chris Reiser, Bankruptcy Act Impact on Life Insurance and Domestic Asset Protection Trusts, *Steve Leimberg's Asset Protection Planning Newsletter* #66 (May 3, 2005), available at http://www.leimbergservices.com.

- The IRS officially said that it disagreed with the case.[6989] It has been suggested that the IRS feared appealing the case because of the 10th Circuit's taxpayer-favorable holding described in *King*, which is found in part III.B.3.e. My understanding is that IRS examiners have been stubbornly resisting respecting *Wandry* clauses, with more reasonable positions taken on appeal.

- It has been suggested that:[6990]

  - "The finality rules apply to the value of a prior gift but not necessarily to the extent of the property transferred."[6991]

[6989] In nonacquiescing, AOD 2012-004 (11/13/2012) argued:

> In 2004, each taxpayer executed a document transferring to each donee that number of membership interests in an LLC equal to a specified dollar value. Relying on an appraisal, each taxpayer then transferred a fixed percentage interest to each donee equal to the specified dollar value, *i.e.*, a 2.39 percent interest. Each transfer was subject to a reallocation between the taxpayer and the donee based upon the fair market value of the interest as finally determined for federal gift tax purposes. Until such time, each donee will enjoy the beneficial ownership of a 2.39 percent interest. In the Tax Court, the parties resolved the valuation issue by agreeing to a value that was higher than that stated in the taxpayers' appraisal. Interpreting the instrument of transfer in light of *Estate of Petter v. Commissioner*, 653 F.3d 1012 (9th Cir. 2009), the Tax Court held that the gifts were of a specified dollar value of LLC interests, to be construed in light of the agreed value, *i.e.*, a 1.98 percent interest. Further, the court held that the instrument of transfer did not allow the taxpayers to "take property back" but rather, simply corrected the allocation of the interests between the taxpayers and the donees. The application of the gift tax is based on the objective facts and circumstances of the transfer, and not upon the donative intent of the donor. Treas. Reg. § 25.2511-1(g). A gift is complete for federal tax purposes when the donor parts with dominion and control, leaving him no power to change its disposition. Treas. Reg. § 25.2511-2(b). The donor's retention of an interest that is dependent upon the occurrence of an event beyond the donor's control will not cause the transfer to be incomplete. *Smith v. Shaughnessy*, 318 U.S. 176, 181 (1943); *Robinette v. Helvering*, 318 U.S. 184, 187 (1943); *Estate of Kolb v. Commissioner*, 5 T.C. 588, 593 (1945); *Mack v. Commissioner*, 39 B.T.A. 220, 229 (1939). In determining the scope of the transfer, the Tax Court dismissed the entries on the LLC's books and records, the entries on the taxpayers' gift tax returns, and the entries on the LLC's subsequent income tax returns, finding that the instrument of transfer best described the gifts. Based on the LLC's books and records, the gift tax returns, and the LLC's income tax returns, however, it is undisputed that on the date of the gift, each taxpayer transferred a 2.39 percent interest to each donee, subject to a return of a portion of that interest in the event of a final determination of a greater value. The final determination of value for federal gift tax purposes is an occurrence beyond the taxpayers' control. Thus, on the date of the gift the taxpayers relinquished all dominion and control over the fixed percentage interests. The fact that the contingency occurred, and that the taxpayers are now entitled to a return of a portion of the interests, does not change this fact. See Treas. Reg. § 25.2511-2(b). *Estate of Petter v. Commissioner*, *supra*, is not to the contrary. In *Petter*, there was no possibility that the transferred property would return to the donor, and thus, the court had no need to consider the extent to which the gift was complete. Accordingly, the Tax Court erred in determining that the property transferred for federal gift tax purposes was anything other than the fixed percentage membership interest, *i.e.*, a 2.39 percent interest, transferred on the date of the gift to each donee.

[6990] Bramwell and Dillion, "Not Another *Wandry* Article: Real Issue With *Wandry* Formulas," *Estate Planning Journal* (5/2014).

[6991] The authors of the article in fn 6990 point out that Code §§ 2504(c) and 2001(f) provide that the statute of limitations runs regarding the valuation of gifts but do not refer to other issues. However, the authors also point out that, using language similar to that of Reg. § 25.2504-2(b), Reg. § 20.2001-1(b) provides:

- "There may not be a mechanism in the first place for achieving a final determination of the extent of the property transferred."[6992]

- Finality rules are strictly construed in favor of the government,[6993] so the uncertainty described in the above bullet points may be interpreted against the taxpayer.

In his 2019 Heckerling materials, John Porter argued that, "Given the numerous types of formula clauses routinely sanctioned by the Treasury, the IRS's position seems disingenuous."[6994] The formula clauses he cited include:

> *Adjusted taxable gifts and section 2701(d) taxable events occurring after August 5, 1997*. For purposes of determining the amount of adjusted taxable gifts as defined in section 2001(b), if, under section 6501, the time has expired within which a gift tax may be assessed under chapter 12 of the Internal Revenue Code (or under corresponding provisions of prior laws) with respect to a gift made after August 5, 1997…, then the amount of the taxable gift will be the amount as finally determined for gift tax purposes under chapter 12 of the Internal Revenue Code and the amount of the taxable gift may not thereafter be adjusted. The rule of this paragraph (b) applies to adjustments involving all issues relating to the gift, including valuation issues and legal issues involving the interpretation of the gift tax law.

[6992] The authors suggest:

> Section 2001(f)(2), however, only defines the "final determination" of a gift's "value." It does not explain how a "final determination" of any other issue can be achieved. Based on the text of Section 2001(f)(2), therefore, it is unclear whether there is a mechanism for resolving whether the taxpayer has correctly determined how much property he or she previously transferred by dollar formula.
>
> Moreover, it does not appear that a court would have jurisdiction even to decide what portion was transferred by a *Wandry* formula.[23] The Tax Court does not generally issue declaratory judgments….
>
> [23] Strictly speaking, the nature of the property transferred by dollar formula is a question of state law, not federal law. However, federal courts must understand what rights are created under state law in order to decide the federal tax questions. See, *e.g.*, *Pierre*, 133 TC 24 (2009) ("A fundamental premise of transfer taxation is that State law creates property rights and interests, and Federal tax law then defines the tax treatment of those property rights.").
>
> Without such a declaration, however, or without at least the possibility of such a declaration,[28] a taxpayer cannot achieve a final determination of the extent of the property transferred by a Wandry formula. Even after the statute of limitations for assessment of gift tax has lapsed, therefore, the IRS might still contend, upon a later transfer, that more of the property previously transferred by dollar formula remained in the hands of the taxpayer than the taxpayer supposed. A Wandry-style gift does not so much reduce or eliminate gift tax risk as postpone it until a later time.
>
> [28] The concept of a "final determination" implies that a court could have made a determination, even if the parties ultimately agree or one party concedes. After all, if the extent of property transferred by Wandry-style formula is contested but no court has jurisdiction to resolve the dispute, it is unclear whose position—the taxpayer's or the IRS's—should prevail.

Pierre is described in part III.B.1.e Valuation Issues.

[6993] The authors suggest:

> The United States Supreme Court has held that "statutes of limitation ... must receive a strict construction in favor of the government."[29] The finality rules, meanwhile, are "essentially ... statute of limitations provision[s]."[30] Consequently, the finality rules must be construed against the taxpayer.
>
> [29] *Badaracco*, 53 AFTR 2d 84-446, 464 US 386, 78 L Ed 2d 549, 84-1 USTC ¶ 9150, 1984-1 CB 254 (1984).
>
> [30] Estate of Smith, *supra* note 13. [Note 13 cited *Estate of Smith v. Commissioner*, 94 T.C. 872 (1990).]

[6994] Saved as Thompson Coburn LLP document number 7336669.

- Formula marital deduction clauses (Rev. Proc. 64-19, 1964-1 C.B. 682)
- Formula GST transfers (Treas. Regs. §§ 26.2632-1(b)(2)(11), 26.2632-1(d)(1))
- Split-interest charitable trusts (Treas. Reg. § 1.644-2(a)(1)(iii); Rev. Rul. 72-395, 1972-2 C.B. 340; Treas. Reg. § 20.2055-2(e)(2)(vi)(a))
- Formula transfers to a GRAT (Treas. Reg. § 25.2702-3(b)(1)(ii)(B))

To avoid arguments over *Wandry*, consider using an inter vivos QTIP trust. The donor can make a formula QTIP election (beware that the election must be made timely – no relief is available for a late gift tax QTIP election).[6995] A special trustee could be authorized to distribute the marital deduction trust,[6996] so this part of the trust could be terminated once the gift tax statute of limitations expires, then the donee spouse could engage in estate planning with the distributed assets. A disadvantage of such a plan is that the nonmarital portion is mandatory income, which is inconsistent with the goal of accumulating assets in that trust. Furthermore, a later sale to the mandatory income trust has some disadvantages,[6997] so a later sale to a separate accumulation trust guaranteed by the mandatory income trust[6998] would be more helpful (but clients tend to dislike the complexity of administering multiple trusts).

Another alternative is to make a gift to trust, with any excess over the desired gift passing as described in part III.B.3.e Disclaimers.

It has been suggested that fixing the excess value to a charity provides an independent third party that has the attorney general and the IRS (through Code § 4958 intermediate sanctions) looking over its shoulder. In *Petter* (described in part III.B.3.m) and *McCord* (described in part III.B.3.n), representatives from the charity described their due diligence. That was absent in *Christiansen* (described in part III.B.3.l), involving a formula disclaimer in favor of charity, but the executor was able to describe her fiduciary duties. The tension between taxable and deductible is already present when we do formula marital bequests. However, having different interests in the buyer and recipient of the gift suggests a tension between the parties involved that would lead to the defined value clause being enforced independent of IRS attack, providing the defined value clause with more credibility. *Petter* and *Christiansen* are great for families who don't mind getting more money to charities, because they involved increased gifts to charity. *McCord* is better for those who want to agree up front, because it involved a formula clause that the charity and donee settled without the donor's involvement. Regardless of the approach, see part III.B.3.d Charity Due Diligence.

An alternative is to have a defined value purchase clause:

- Suppose the buyer has liquidity to pay the entire purchase price up front.[6999] The grantor sells to the trust an interest in an operating business in exchange for an interest in an LLC that holds marketable securities. The LLC is designed to try to avoid valuation discounts; for

[6995] Regarding lack of relief for a late inter vivos QTIP election, see fn 2004 in part II.H.2.a Free Basis Step-Up When First Spouse Dies.
[6996] I include the special trustee for the marital and nonmarital portions, so that the donor's gift tax election does not change beneficial interests in the trust.
[6997] See part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (Including Possible Pitfalls).
[6998] See part III.B.1.a.ii Loan Guarantees.
[6999] Carlyn McCaffrey suggested this idea at the 2011 Heckerling Institute.

example, any member can withdraw at will and receive cash or marketable securities. The consideration is so much of the buyer's interest in the LLC as has a value equal to the interest in the operating business.

- For a leveraged deal, use a promissory note, the principal of which is the fair market value, as finally determined, of the transferred asset, relying on part III.B.3.f Defined Consideration Clause.

- In either event, clauses providing for a gift over leave some unfinished business, particularly if the gift over goes to a trust that continues to be inside the estate tax system. Furthermore, retroactively adjusting cash flows from the transferred asset might be awkward. It might very well be easier simply to adjust the principal on a note, recharacterizing past payments and extending the payment term a little. Whether the consideration itself has a defined value or simply is a note with principal equal to a formula amount, transferring the entire difficult-to-value asset provides certainty that growth in the asset is outside the estate tax system; if one instead transferred a portion of that asset determined by formula, then an IRS audit might bring part of that asset (and its growth) back into the transferor's estate.

Defining the transfer or consideration received based on finally determined values, rather than making a transfer and causing a subsequent transfer to avoid gift tax, remains an important distinction. In December 2014, the Fourth Circuit reaffirmed in a different context [7000] its commitment to *Procter* (described in part III.B.3.o *Procter* and Other Cases) and refused to recognize a transfer made after a determination; the Tax Court continues to strongly reject conditions subsequent.[7001]

Formula transfers based on values as finally determined for gift tax purposes require running the gift tax statute of limitations. See part III.B.4 Adequate Disclosure on Gift Tax Returns.

III.B.3.b. Due Diligence Regarding Values

Caveat for all strategies described in this part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers: These strategies are intended to help taxpayers deal with the fact that the IRS may in good faith disagree with the appraisals the taxpayers obtain in good faith, simply because appraisal involves a lot of judgment and is not a precise science. Please, please, please – I beg you - do not use these tools to game the system with an appraisal that the taxpayer knows is low. Such a bad faith effort will meet stiff IRS opposition, as described in the text accompanying and preceding fn 6487 in part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust. I am concerned that the IRS will successfully litigate such a bad faith effort and make these strategies less effective in protecting taxpayers who are using them merely to deal with the uncertainty inherent in the appraisal process. Instead, in a sale to an irrevocable grantor trust, one might ask the appraiser whether any additional factors would generate a higher value that the draft appraisal, because the consequences of a higher value estimated by the appraiser – taking a little longer to repay the note than otherwise might have been the case – are small relative to the risk that the IRS successfully argues that the transaction does not work at all because the taxpayer was trying to game the system.

[7000] *Belk v. Commissioner*, 774 F.3d 221, *aff'g* 140 T.C. 1 (2013) (savings clause did not fix provision expressly prohibited by conservation easement regulations).
[7001] See fn. 7030 in part III.B.3.l *Christiansen*.

Also note that the IRS has greatly cut back appraisers' procedural protections. See generally 20.1.12 Penalties Applicable to Incorrect Appraisals | Internal Revenue Service (irs.gov). IRM part 20.1.12.3, "Asserting the IRC 6695A Penalty" (10-06-2021), provides:

(1) An IRC 6695A appraiser penalty case will be conducted as a separate and distinct case from the related tax examination.

(2) During the related tax examination, examiners and attorneys will, as warranted, develop facts and circumstances to determine whether or not an IRC 6695A appraiser penalty case should be opened. This determination will be documented in the examination workpapers.

(3) All discussions related to appraiser penalties with either the taxpayer, return preparer, or designated power of attorney, will be limited to the development of facts to determine the applicability of a penalty. Penalties under IRC 6695A will not be proposed in the presence of the taxpayer.

(4) Generally, an IRC 6695A penalty against an appraiser will not be proposed until the related tax examination is completed at the group level. The appraiser penalty case can proceed when the related tax examination case is closed agreed, closed no response after default, is in Appeals or is in Tax Court.

    Caution: If the statute of limitation on the IRC 6695A penalty will expire within 180 days, then the penalty case file should be worked, or a statute extension should be obtained so a protective assessment can be made if needed. See IRM 20.1.12.4, Statute of Limitations.

(5) The penalty does not apply if the appraiser can establish the appraisal value "more likely than not" was correct. Pending further guidance, consult Counsel regarding "more likely than not" determinations.

(6) The amount of the IRC 6695A penalty is the lesser of:

    a. The greater of:

        10% of the amount of the underpayment (defined by IRC 6664(a) attributable to the misstatement)

        or

        $1,000, or

    b. 125% of the gross income received from the preparation of the appraisal.

(7) If the claimed value of the property on the return or claim for refund, which is based on an appraisal, results in a substantial valuation misstatement, substantial estate or gift tax valuation understatement, or gross valuation misstatement, with respect to such property, the examiner or attorney should open an IRC 6695A penalty case.

    a. **Substantial Valuation Misstatement**. A substantial valuation misstatement under Chapter 1 (Normal Taxes and Surtaxes) occurs when the claimed value of the property is 150% or more of the correct amount of such valuation, IRC 6662(e).

b. **Substantial Estate or Gift Tax Valuation Understatement**. A substantial estate or gift tax valuation understatement occurs if the value of the property claimed is 65% or less of the amount determined to be the correct amount of such valuation, IRC 6662(g).

c. **Gross Valuation Misstatement**. A gross valuation misstatement under Chapter 1 (Normal Taxes and Surtaxes) occurs when the claimed value of the property is 200% or more of the correct amount of such valuation, IRC 6662(h).

d. **Gross Estate or Gift Tax Valuation Understatement**. A gross estate or gift tax valuation understatement occurs if the value of the property claimed is 40% or less of the amount determined to be the correct amount of such valuation, IRC 6662(h).

See Sheppard, "No Notice, No Examination, No Problem: IRS Further Deprives Appraisers of Procedural Protections," *Taxation of Exempts* (WG&L) (1/2022).

III.B.3.c. Sale from One Trust to Another

Suppose a trust sells a difficult-to-value asset to another trust. The grantor trust rules (part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust) can prevent tax on the sale in some circumstances:

- Transfers between trusts deemed owned by the same grantor, if sale is completed sufficiently before grantor trust status terminates. "Completed sufficiently" means that the remaining balance on the note is no more than the basis of the transferee trust's assets; see part III.B.1.c.i.(a) Bargain Sales to Individuals.

- The transferee trust ("buyer") might be deemed owned by transferor trust ("seller"). The buyer's grantor gives up to $5,000 to the buyer in a non-interest-bearing account and gives the seller a right to withdraw the gift, far enough in advance that the gift is not stepped together with the sale. An independent person is authorized to make unlimited distributions from the buyer to the seller, and the buyer has no features that would make its grantor the deemed owner of any part of the buyer. The seller would be the deemed owner of the buyer. For more analysis, see part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.

Before describing the sale, let's explore more the idea of the buyer being deemed owned by the seller. For example, suppose a decedent did not have enough GST exemption to fully protect bequests to a beneficiary, and the trustee of the trust that is protected from GST tax (the "exempt trust") would like to use a grantor trust strategy to acquire the assets of the trust that is not protected from GST tax (the "nonexempt trust"):

- The exempt trust transfers up to $5,000 to a new trust in a non-interest-bearing account and gives the seller a right to withdraw the gift, far enough in advance that the gift is not stepped together with the sale.

- An independent person is authorized to make unlimited distributions from the new trust to the nonexempt trust, and the new trust has no features that would make the exempt trust the deemed owner of any part of the new trust. This is important not only to trigger Code § 678(a)(2) but also to give the trustee of the nonexempt trust a source of assets to pay tax for the year of its termination.

- The exempt trust, the terms of which are identical to the new trust except for the features described above, would guarantee the new trust's purchase of the nonexempt trust's assets.

- While the note effectuating the sale is outstanding, the nonexempt trust would use note payments to pay taxes on the new trust's taxable items and to make distributions to the nonexempt trust's beneficiaries.

Ideally, all of the living beneficiaries of the trust have identical interests before and after, so that all one really is doing in the event of a gift is changing the terms of their limited powers of appointment (relating on how far into the future they can appoint the property). Whether or not one is in that situation, let's discuss the type of formula valuation clause to use - define what is transferred or define the purchase price?

- If the transaction is adjusted in the former, then the refunded business interest will need to be transferred, leaving one with the valuation issue again.

- If the transaction is adjusted in the latter, then it's just an additional purchase price that needs to be paid.

How would one run the statute of limitations? Would each beneficiary file a gift tax return? If not, then one never has finality for gift tax purposes, and formula valuation clauses that depend on gift tax return finality would not apply. If you are able to get all beneficiaries to file gift tax returns, I would try to make sure that some significant part of any gift made would constitute a completed gift.[7002] If a beneficiary who consents or fails to object to the sale has an interest in the transferee trust, Code § 2702 may treat the beneficiary as having made a gift of the beneficiary's entire interest in the transferring trust, without subtracting the beneficiary's retained interest.[7003]

The main concern might be any effect on protection from generation-skipping transfer (GST) tax; see part III.B.1.d Generation-Skipping Transfer (GST) Issues. If the sale is challenged, it might be a constructive or actual addition that affects the trust's exclusion from the GST system (in the case of a grandfathered trust)[7004] or a gift that changes the inclusion ratio (for other trusts). Advise the trustee of the recipient trust to make a small taxable distribution after the sale and do appropriate reporting relating to Form 706-GS(D-1), so that the statute of limitations runs on the issue of inclusion ratio:

- Each time a distribution from a trust that is not grandfathered from the GST system is made to a skip person, the trustee must file Form 706-GS(D-1), Notification of Distribution from a Generation-Skipping Trust, with the IRS and gives to the beneficiary. This form is required even if the trust has a zero inclusion ratio.

- The first time a distribution is made after the sale, the beneficiary files Form 706-GS(D), Generation-Skipping Transfer Tax Return for Distributions, in which the beneficiary reports

[7002] See text accompanying fn 7061 in part III.B.4 Adequate Disclosure on Gift Tax Returns.
[7003] See text accompanying fns 7381-7390 in part III.B.7.d Code § 2702 Overview.
[7004] See part III.B.1.d.i Effect of "Additions" on Grandfathering from GST Rules.

zero GST tax due. Presumably no matter how small or large the distribution is, this filing runs one prong of the statute of limitations (SOL) for the inclusion ratio; the SOL runs on the later of that or when the SOL runs for the transferor's estate tax return.[7005] Because the form's instructions say that a beneficiary is not required to file if the trust has a zero inclusion ratio, the beneficiary would not file any more Forms 706-GS(D) after the SOL on the inclusion ratio has run until some event occurs that might change the trust's inclusion ratio.

Note further that, if and to the extent that a beneficiary makes a gift to a trust, that beneficiary becomes the transferor with respect to that portion of the trust.[7006] Therefore:

- Many individuals who are skip persons with respect to the transferor are not skip persons with respect to the beneficiary who became a transferor. Presumably Form 706-GS(D) would run the SOL with respect to only the portion of the trust from which the distribution to the filing recipient of the distribution constituted a generation-skipping transfer.

- The beneficiary should allocate GST exemption to provide a zero inclusion ratio to protect the portion of the trust with respect to which the beneficiary is the transferor. However, if that beneficiary is also a beneficiary of the transferee trust, the gift may be incomplete or the retained beneficial interest or power of appointment may also trigger Code § 2036 or 2038.[7007] If and to the extent the beneficiary is the transferor of a portion that is includible in the beneficiary's estate, consider part III.B.1.d.ii Estate Tax Inclusion Period (ETIP).

Note that Reg. § 301.6501(c)-1 requires "adequate disclosure" for only Chapters 12 (gift tax) and 14 (special valuation rules applying to lifetime transfers), not for Chapter 13 (GST tax). The instructions to Form 706-GS-(D) and Form 706-GS(D-1) do not require evidence of inclusion ratio. Therefore, it looks like we don't need to provide any particular information that would help the IRS decide whether to audit GST transfers from a trust not included in the beneficiary's estate, other than letting it know of the bare existence of the distribution.

[7005] Reg. § 26.2642-5(b) provides:

> (b) *Other GSTs*. With respect to taxable distributions and taxable terminations, the inclusion ratio for a trust becomes final, on the later of—
>
> (1) The expiration of the period for assessment with respect to the first GST tax return filed using that inclusion ratio (unless the trust is subject to an election under section 2032A in which case the applicable date under this subsection is the expiration of the period of assessment of any additional GST tax due as a result of a cessation, etc. of qualified use under section 2032A); or
>
> (2) The expiration of the period for assessment of Federal estate tax with respect to the estate of the transferor. For purposes of this paragraph (b)(2), if an estate tax return is not required to be filed, the period for assessment is determined as if a return were required to be filed and as if the return were timely filed within the period prescribed by section 6075(a).

For gifts to a trust, an additional GST rule informs us about finality. The inclusion ratio is 1 minus the applicable fraction. Code § 2642(a)(1). The applicable fraction is based on allocations of GST exemption to the trust, Code § 2642(a)(2)(A), and the growth of property to which GST exemption has already been allocated, Code 2642(d). Reg. § 26.2642-2(a)(1) helps some – particularly with initial transfers to a trust that are reported timely.

> In the case of a timely allocation under § 26.2632-1(b)(2)(ii), the denominator of the applicable fraction is the fair market value of the property as finally determined for purposes of chapter 12.

[7006] See part III.B.1.d.iii Who Is the Transferor.

[7007] See parts III.C Code § 2036 and III.D Code § 2038.

The question then is whether to:

- Take one's chances on a sale between trusts, or

- Distribute to the beneficiaries, who can then decide separately whether to engage in estate planning transactions that would provide better finality.

As to the latter:

- If the beneficiaries have quantifiable rights, consider any income tax consequences described in part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting, especially part II.J.18.f Commutation vs Mere Division. For an oral discussion, see Sale of Interest in Trust; Negative Capital Accounts; Final Regs on Transfer for Value.

- Be careful to avoid a step transaction. For example, suppose a trust not protected from GST tax distributes to a child of the transferor, then that child sets up a trust for that child's children. That child's children would be skip persons with respect to the original transferor. If and to the extent that the distribution and creation of the new trust are treated as a continuation of the original trust, the transferor may be treated as the transferor of none, part, or all of the new trust, even if the child made a taxable gift. See part III.B.1.d.iii Who Is the Transferor.

III.B.3.d. Charity Due Diligence

At a meeting I attended, one charity stated that it vets gifts very seriously because it has large reputational exposure with the IRS. Due diligence includes:

- Reviewing the governing documents of the business entity, the interest of which is being transferred. This includes closely-held business entities, real estate, restricted stock, and cash value life insurance.

- Having an exit strategy within a reasonable amount of time to sell to someone who is not the donor and is not a family member but can include the company (if the other shareholders have similar price when they retire, die, etc.). Transfer restrictions cannot burden the sale too much. However, they are careful to avoid assignment of income.

- Leaving some money in escrow if any contingent liabilities, capital calls, or unrelated business income tax are involved.

- Donor needs to get appraisal and file Form 8283. The charity will file Form 8282 reporting a sale within two years of donation.

Examples of what that charity has done:

- Donor wanted to make serial gifts of $10K per year. The charity asked whether governing documents permit the transfer, what its transfer rights were, how the redeemed stock would be valued, and what was the redemption plan (including company's financial capability to redeem). The company eventually put together a standing charitable plan.

- Donor wanted to give S corporation stock. The fund escrowed 20% to pay unrelated business income tax and for accounting fees. The fund keeps an escrow until the three-year statute of limitations runs.

The lawyer who has beaten the IRS in these cases cautions us not to refer to the gift over as a contingent or conditional gift. This is a fixed gift, and he likes to see not just a lid but a real gift to the charity that occurs at the time of the transaction; his caution to that effect is borne out by part III.B.3.h *Moore*. This gives the charity incentive to audit the gift. The charity's due diligence is strong evidence of substance/bona fides.

One advisor views donor advised funds as the best charitable donees. Minimum distribution, excess business holding,[7008] self-dealing, and jeopardizing investment rules burden planning for a private foundation, particularly when an uncertain interest is being donated.

For cases involving formula charitable gifts, see parts:

- III.B.3.h *Moore* – Charitable deduction denied because charity gets nothing unless IRS audits

- III.B.3.i Graev - Charitable deduction denied because chance that charity would have to return the gift was not "so remote as to be negligible"

- III.B.3.l *Christiansen* – approved formula disclaimer that resulted in charitable gift

- III.B.3.m Petter – approved a transfer to charity in a sale/gift transfer, based on values as "finally determined for federal gift tax purposes"

- III.B.3.n *McCord* (2003, 2006) – courts respected agreement under which fixed dollar amounts worth of business interests determined what portion went to the family and what portion went to charity; after the transfer, the family and charity obtained appraisals that they used to agree among themselves who got what portion of business interests

III.B.3.e. Disclaimers

A formula disclaimer can be quite effective and, unlike the other tools described in this part III.B.3, is not susceptible to IRS audit if one complies with all of the rules of Code § 2518 and the regulations thereunder.

First, we will describe the Code and selected regulations. Then, we will describe practical issues.

[7008] Code § 4943(e) applies this tax to donor advised funds in certain situations.

III.B.3.e.i. Disclaimers – Code and Regulations

Code § 2518(a), "General rule," provides:[7009]

> For purposes of this subtitle, if a person makes a qualified disclaimer with respect to any interest in property, this subtitle shall apply with respect to such interest as if the interest had never been transferred to such person.

"This subtitle" means estate, gift, GST, and similar transfer taxes. Thus, Code § 2518 allows a certain amount retroactive transfer tax planning. Generally, qualified disclaimers are recognized for income tax purposes, even though Code § 2518 does not expressly apply for that purpose.

Code § 2518(b), "Qualified disclaimer defined," provides:

> For purposes of subsection (a), the term "qualified disclaimer" means an irrevocable and unqualified refusal by a person to accept an interest in property but only if –
>
> (1) such refusal is in writing,
>
> (2) such writing is received by the transferor of the interest, his legal representative, or the holder of the legal title to the property to which the interest relates not later than the date which is 9 months after the later of -
>
> (A) the day on which the transfer creating the interest in such person is made, or
>
> (B) the day on which such person attains age 21,
>
> (3) such person has not accepted the interest or any of its benefits, and
>
> (4) as a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either -
>
> (A) to the spouse of the decedent, or
>
> (B) to a person other than the person making the disclaimer.

Generally, Code § 2518 applies to transfers creating an interest in the person disclaiming made after December 31, 1976, so the time for making a disclaimer under a pre-1977 trust may be

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[7009] Reg. § 25.2518-1(b), "Effect of a qualified disclaimer," provides:

> If a person makes a qualified disclaimer as described in section 2518(b) and § 25.2518-2, for purposes of the Federal estate, gift, and generation-skipping transfer tax provisions, the disclaimed interest in property is treated as if it had never been transferred to the person making the qualified disclaimer. Instead, it is considered as passing directly from the transferor of the property to the person entitled to receive the property as a result of the disclaimer. Accordingly, a person making a qualified disclaimer is not treated as making a gift. Similarly, the value of a decedent's gross estate for purposes of the Federal estate tax does not include the value of property with respect to which the decedent, or the decedent's executor or administrator on behalf of the decedent, has made a qualified disclaimer. If the disclaimer is not a qualified disclaimer, for the purposes of the Federal estate, gift, and generation-skipping transfer tax provisions, the disclaimer is disregarded and the disclaimant is treated as having received the interest.

later than that required by Code § 2518(b)(2). Specifically, Reg. § 25.2518-1(a), "Applicability," provides:

> (1) *In general*. The rules described in this section, § 25.2518-2, and § 25.2518-3 apply to the qualified disclaimer of an interest in property which is created in the person disclaiming by a transfer made after December 31, 1976. In general, a qualified disclaimer is an irrevocable and unqualified refusal to accept the ownership of an interest in property. For rules relating to the determination of when a transfer creating an interest occurs, see § 25.2518-2(c)(3) and (4).
>
> (2) *Example*. The provisions of paragraph (a)(1) of this section may be illustrated by the following example:
>
> *Example*. W creates an irrevocable trust on December 10, 1968, and retains the right to receive the income for life. Upon the death of W, which occurs after December 31, 1976, the trust property is distributable to W's surviving issue, per stirpes. The transfer creating the remainder interest in the trust occurred in 1968. See § 25.2511-1(c)(2). Therefore, section 2518 does not apply to the disclaimer of the remainder interest because the transfer creating the interest was made prior to January 1, 1977. If, however, W had caused the gift to be incomplete by also retaining the power to designate the person or persons to receive the trust principal at death, and, as a result, no transfer (within the meaning of § 25.2511-1(c)(2)) of the remainder interest was made at the time of the creation of the trust, section 2518 would apply to any disclaimer made after W's death with respect to an interest in the trust property.
>
> (3) Paragraph (a)(1) of this section is applicable for transfers creating the interest to be disclaimed made on or after December 31, 1997.

Reg. § 25.2518-1, "Cross-reference," provides:

> For rules relating to the effect of qualified disclaimers on the estate tax charitable and marital deductions, see §§ 20.2055-2(c) and 20.2056(d)-1 respectively. For rules relating to the effect of a qualified disclaimer of a general power of appointment, see § 20.2041-3(d).

Reg. § 20.2055-2(c)(1), "Decedents dying after December 31, 1976," authorizes disclaimers in favor of charity as late as the extended due date for the estate tax return:

> In the case of a bequest, devise, or transfer made by a decedent dying after December 31, 1976, the amount of a bequest, devise or transfer for which a deduction is allowable under section 2055 includes an interest which falls into the bequest, devise or transfer as the result of either -
>
> (i) A qualified disclaimer (see section 2518 and the corresponding regulations for rules relating to a qualified disclaimer), or
>
> (ii) The complete termination of a power to consume, invade, or appropriate property for the benefit of an individual by reason of the death of such individual or for any other reason, if the termination occurs within the period of time (including extensions) for

filing the decedent's Federal estate tax return and before such power has been exercised.

Reg. § 20.2056(d)-1 cross-references Reg. §§ 20.2056A-1 through 20.2056A-13, which include rules for fixing a trust to allow it to qualify for the marital deduction for a trust for the beneficiary of a noncitizen spouse.

Reg. § 20.2041-3(d)(6) discusses a disclaimer of a general power of appointment:

(i) A disclaimer or renunciation of a general power of appointment created in a transfer made after December 31, 1976, is not considered to be the release of the power if the disclaimer or renunciation is a qualified disclaimer as described in section 2518 and the corresponding regulations. For rules relating to when the transfer creating the power occurs, see § 25.2518-2(c)(3) of this chapter. If the disclaimer or renunciation is not a qualified disclaimer, it is considered a release of the power by the disclaimant.

(ii) The disclaimer or renunciation of a general power of appointment created in a taxable transfer before January 1, 1977, in the person disclaiming is not considered to be a release of the power. The disclaimer or renunciation must be unequivocal and effective under local law. A disclaimer is a complete and unqualified refusal to accept the rights to which one is entitled. There can be no disclaimer or renunciation of a power after its acceptance. In the absence of facts to the contrary, the failure to renounce or disclaim within a reasonable time after learning of its existence will be presumed to constitute an acceptance of the power. In any case where a power is purported to be disclaimed or renounced as to only a portion of the property subject to the power, the determination as to whether or not there has been a complete and unqualified refusal to accept the rights to which one is entitled will depend on all the facts and circumstances of the particular case, taking into account the recognition and effectiveness of such a disclaimer under local law. Such rights refer to the incidents of the power and not to other interests of the decedent in the property. If effective under local law, the power may be disclaimed or renounced without disclaiming or renouncing such other interests.

(iii) The first and second sentences of paragraph (d)(6)(i) of this section are applicable for transfers creating the power to be disclaimed made on or after December 31, 1997.

Reg. § 25.2518-2(a) parrots the requirements of Code § 2518(b). Reg. § 25.2518-2(b) provides details on the disclaimer being written.[7010]

[7010] Reg. § 25.2518-2(b), "Writing," provides:

(1) *Requirements*. A disclaimer is a qualified disclaimer only if it is in writing. The writing must identify the interest in property disclaimed and be signed either by the disclaimant or by the disclaimant's legal representative.

(2) *Delivery*. The writing described in paragraph (b)(1) of this section must be delivered to the transferor of the interest, the transferor's legal representative, the holder of the legal title to the property to which the interest relates, or the person in possession of such property.

Reg. § 25.2518-2(c), "Time limit," provides:

(1) *In general*. A disclaimer is a qualified disclaimer only if the writing described in paragraph (b)(1) of this section is delivered to the persons described in paragraph (b)(2) of this section no later than the date which is 9 months after the later of -

(i) The date on which the transfer creating the interest in the disclaimant is made, or

(ii) The day on which the disclaimant attains age 21.

(2) *A timely mailing of a disclaimer treated as a timely delivery*. Although section 7502 and the regulations under that section apply only to documents to be filed with the Service, a timely mailing of a disclaimer to the person described in paragraph (b)(2) of this section is treated as a timely delivery if the mailing requirements under paragraphs (c)(1), (c)(2) and (d) of § 301.7502-1 are met. Further, if the last day of the period specified in paragraph (c)(1) of this section falls on Saturday, Sunday or a legal holiday (as defined in paragraph (b) of § 301.7503-1), then the delivery of the writing described in paragraph (b)(1) of this section shall be considered timely if delivery is made on the first succeeding day which is not Saturday, Sunday or a legal holiday. See paragraph (d)(3) of this section for rules applicable to the exception for individuals under 21 years of age.

(3) *Transfer*.

(i) For purposes of the time limitation described in paragraph (c)(1)(i) of this section, the 9-month period for making a disclaimer generally is to be determined with reference to the transfer creating the interest in the disclaimant. With respect to inter vivos transfers, a transfer creating an interest occurs when there is a completed gift for Federal gift tax purposes regardless of whether a gift tax is imposed on the completed gift. Thus, gifts qualifying for the gift tax annual exclusion under section 2503(b) are regarded as transfers creating an interest for this purpose. With respect to transfers made by a decedent at death or transfers that become irrevocable at death, the transfer creating the interest occurs on the date of the decedent's death, even if an estate tax is not imposed on the transfer. For example, a bequest of foreign-situs property by a nonresident alien decedent is regarded as a transfer creating an interest in property even if the transfer would not be subject to estate tax. If there is a transfer creating an interest in property during the transferor's lifetime and such interest is later included in the transferor's gross estate for estate tax purposes (or would have been included if such interest were subject to estate tax), the 9-month period for making the qualified disclaimer is determined with reference to the earlier transfer creating the interest. In the case of a general power of appointment, the holder of the power has a 9-month period after the transfer creating the power in which to disclaim. If a person to whom any interest in property passes by reason of the exercise, release, or lapse of a general power desires to make a qualified disclaimer, the disclaimer must be made within a 9-month period after the exercise, release, or lapse regardless of whether the exercise, release, or lapse is subject to estate or gift tax. In the case of a nongeneral power of appointment, the holder of the power, permissible appointees, or takers in default of appointment must disclaim within a 9-month period after the original transfer that created or authorized the creation of the power. If the transfer is for the life of an income beneficiary with succeeding interests to other persons, both the life tenant and the other remaindermen, whether their interests are vested or contingent, must disclaim no later than 9 months after the original transfer creating an interest. In the case of a remainder interest in property which an executor elects to treat as qualified terminable interest property under section 2056(b)(7), the remainderman must disclaim within 9 months of the transfer creating the interest, rather than 9 months from the date such interest is subject to tax under section 2044 or 2519. A person who receives an interest in property as the result of a qualified disclaimer of the interest must disclaim the previously disclaimed interest no later than 9 months after the date of the transfer creating the interest in the preceding disclaimant. Thus, if A were to make a qualified disclaimer of a specific bequest and as a result of the qualified disclaimer the property passed as part of the residue, the beneficiary of the residue could make a qualified disclaimer no later than 9 months after the date of the testator’s death. See paragraph (d)(3) of this section for the time limitation rule with reference to recipients who are under 21 years of age.

(ii) Sentences 1 through 10 and 12 of paragraph (c)(3)(i) of this section are applicable for transfers creating the interest to be disclaimed made on or after December 31, 1997.

(4) Joint property.

(i) Interests in joint tenancy with right of survivorship or tenancies by the entirety. Except as provided in paragraph (c)(4)(iii) of this section (with respect to joint bank, brokerage, and other investment accounts), in the case of an interest in a joint tenancy with right of survivorship or a tenancy by the entirety, a qualified disclaimer of the interest to which the disclaimant succeeds upon creation of the tenancy must be made no later than 9 months after the creation of the tenancy regardless of whether such interest can be unilaterally severed under local law. A qualified disclaimer of the survivorship interest to which the survivor succeeds by operation of law upon the death of the first joint tenant to die must be made no later than 9 months after the death of the first joint tenant to die regardless of whether such interest can be unilaterally severed under local law and, except as provided in paragraph (c)(4)(ii) of this section (with respect to certain tenancies created on or after July 14, 1988), such interest is deemed to be a one-half interest in the property. (See, however, section 2518(b)(2)(B) for a special rule in the case of disclaimers by persons under age 21.) This is the case regardless of the portion of the property attributable to consideration furnished by the disclaimant and regardless of the portion of the property that is included in the decedent’s gross estate under section 2040 and regardless of whether the interest can be unilaterally severed under local law. See paragraph (c)(5), Examples (7) and (8), of this section.

(ii) Certain tenancies in real property between spouses created on or after July 14, 1988. In the case of a joint tenancy between spouses or a tenancy by the entirety in real property created on or after July 14, 1988, to which section 2523(i)(3) applies (relating to the creation of a tenancy where the spouse of the donor is not a United States citizen), the surviving spouse may disclaim any portion of the joint interest that is includible in the decedent's gross estate under section 2040. See paragraph (c)(5), Example (9), of this section.

(iii) Special rule for joint bank, brokerage, and other investment accounts (*e.g.*, accounts held at mutual funds) established between spouses or between persons other than husband and wife. In the case of a transfer to a joint bank, brokerage, or other investment account (e.g., an account held at a mutual fund), if a transferor may unilaterally regain the transferor's own contributions to the account without the consent of the other cotenant, such that the transfer is not a completed gift under §25.2511-1(h)(4), the transfer creating the survivor's interest in the decedent's share of the account occurs on the death of the deceased cotenant. Accordingly, if a surviving joint tenant desires to make a qualified disclaimer with respect to funds contributed by a deceased cotenant, the disclaimer must be made within 9 months of the cotenant's death. The surviving joint tenant may not disclaim any portion of the joint account attributable to consideration furnished by that surviving joint tenant. See paragraph (c)(5), Examples (12), (13), and (14), of this section, regarding the treatment of disclaimed interests under sections 2518, 2033 and 2040.

(iv) Effective date. This paragraph (c)(4) is applicable for disclaimers made on or after December 31, 1997.

(5) Examples. The provisions of paragraphs (c)(1) through (c)(4) of this section may be illustrated by the following examples. For purposes of the following examples, assume that all beneficiaries are over 21 years of age.

Example (1). On May 13, 1978, in a transfer which constitutes a completed gift for Federal gift tax purposes, A creates a trust in which B is given a lifetime interest in the income from the trust. B is also given a nongeneral testamentary power of appointment over the corpus of the trust. The power of appointment may be exercised in favor of any of the issue of A and B. If there are no surviving issue at B's death or if the power is not exercised, the corpus is to pass to E. On May 13, 1978, A and B have two surviving children, C and D. If A, B, C or D wishes to make a qualified disclaimer, the disclaimer must be made no later than 9 months after May 13, 1978.

Example (2). Assume the same facts as in example (1) except that B is given a general power of appointment over the corpus of the trust. B exercises the general power of appointment in favor of C upon B's death on June 17, 1989. C may make a qualified disclaimer no later than 9 months after June 17, 1989. If B had died without exercising the general power of appointment, E could have made a qualified disclaimer no later than 9 months after June 17, 1989.

Example (3). F creates a trust on April 1, 1978, in which F's child G is to receive the income from the trust for life. Upon G's death, the corpus of the trust is to pass to G's child H. If either G or H wishes to make a qualified disclaimer, it must be made no later than 9 months after April 1, 1978.

Example (4). A creates a trust on February 15, 1978, in which B is named the income beneficiary for life. The trust further provides that upon B's death the proceeds of the trust are to pass to C, if then living. If C predeceases D, the proceeds shall pass to D or D's estate. To have timely disclaimers for purposes of section 2518, B, C, and D must disclaim their respective interests no later than 9 months after February 15, 1978.

Example (5). A, a resident of State Q, dies on January 10, 1979, devising certain real property to B. The disclaimer laws of State Q require that a disclaimer be made within a reasonable time after a transfer. B disclaims the entire interest in real property on November 10, 1979. Although B's disclaimer may be effective under State Q law, it is not a qualified disclaimer under section 2518 because the disclaimer was made later than 9 months after the taxable transfer to B.

Example (6). A creates a revocable trust on June 1, 1980, in which B and C are given the income interest for life. Upon the death of the last income beneficiary, the remainder interest is to pass to D. The creation of the trust is not a completed gift for Federal gift tax purposes, but each distribution of trust income to B and C is a completed gift at the date of distribution. B and C disclaim each income distribution no later than 9 months after the date of the particular distribution. In order to disclaim an income distribution in the form of a check, the recipient must return the check to the trustee uncashed along with a written disclaimer. A dies on September 1, 1982, causing the trust to become irrevocable, and the trust corpus is includible in A's gross estate for Federal estate tax purposes under section 2038. If B or C wishes to make a qualified disclaimer of his income interest, he must do so no later than 9 months after September 1, 1982. If D wishes to make a qualified disclaimer of his remainder interest, he must do so no later than 9 months after September 1, 1982.

Example (7). On February 1, 1990, A purchased real property with A's funds. Title to the property was conveyed to "A and B, as joint tenants with right of survivorship." Under applicable state law, the joint interest is unilaterally severable by either tenant. B dies on May 1, 1998, and is survived by A. On January 1, 1999, A disclaims the one-half survivorship interest in the property to which A succeeds as a result of B's death. Assuming that the other requirements of section 2518(b) are satisfied, A has made a qualified disclaimer of the one-half survivorship interest (but not the interest retained by A upon the creation of the tenancy, which may not be disclaimed by A). The result is the same whether or not A and B are married and regardless of the proportion of consideration furnished by A and B in purchasing the property.

Example (8). Assume the same facts as in Example (7) except that A and B are married and title to the property was conveyed to "A and B, as tenants by the entirety." Under applicable state law, the tenancy cannot be unilaterally severed by either tenant. Assuming that the other requirements of section 2518(b) are satisfied, A has made a qualified disclaimer of the one-half survivorship interest (but not the interest retained by A upon the creation of the tenancy, which may not be disclaimed by A). The result is the same regardless of the proportion of consideration furnished by A and B in purchasing the property.

Example (9). On March 1, 1989, H and W purchase a tract of vacant land which is conveyed to them as tenants by the entirety. The entire consideration is paid by H. W is not a United States citizen. H dies on June 1, 1998. W can disclaim the entire joint interest because this is the interest includible in H's gross estate under section 2040(a). Assuming that W's disclaimer is received by the executor of H's estate no later than 9 months after June 1, 1998, and the other requirements of section 2518(b) are satisfied, W's disclaimer of the property would be a qualified disclaimer. The result would be the same if the property was held in joint tenancy with right of survivorship that was unilaterally severable under local law.

Example (10). In 1986, spouses A and B purchased a personal residence taking title as tenants by the entirety. B dies on July 10, 1998. A wishes to disclaim the one-half undivided interest to which A would succeed by right of survivorship. If A makes the disclaimer, the property interest would pass under B's will to their child C. C, an adult, and A resided in the residence at B's death and will continue to reside there in the future. A continues to own a one-half undivided interest in the property. Assuming that the other requirements of section 2518(b) are satisfied, A may make a qualified disclaimer with respect to the one-half undivided survivorship interest in the residence if A delivers the written disclaimer to the personal representative of B's estate by April 10, 1999, since A is not deemed to have accepted the interest or any of its benefits prior to that time and A's occupancy of the residence after B's death is consistent with A's retained undivided ownership interest. The result would be the same if the property was held in joint tenancy with right of survivorship that was unilaterally severable under local law.

Example (11). H and W, husband and wife, reside in state X, a community property state. On April 1, 1978, H and W purchase real property with community funds. The property is not held by H and W as jointly owned property with rights of survivorship. H and W hold the property until January 3, 1985, when H dies. H devises his portion of the property to W. On March 15, 1985, W disclaims the portion of the property devised to her by H. Assuming all the other requirements of section 2518(b) have been met, W has made a qualified disclaimer of the interest devised to her by H. However, W could not disclaim the interest in the property that she acquired on April 1, 1978.

Example (12). On July 1, 1990, A opens a bank account that is held jointly with B, A's spouse, and transfers $50,000 of A's money to the account. A and B are United States citizens. A can regain the entire account without B's consent, such that the transfer is not a completed gift under §25.2511-1(h)(4). A dies on August 15, 1998, and B disclaims the entire amount in the bank account on October 15, 1998. Assuming that the remaining requirements of section 2518(b) are satisfied, B made a qualified disclaimer under section 2518(a) because the disclaimer was made within 9 months after A's death at which time B had succeeded to full dominion and control over the account. Under state law, B is treated as predeceasing A with respect to the disclaimed interest. The disclaimed account balance passes through A's probate estate and is no longer joint property includible in A's gross estate under section 2040. The entire account is, instead, includible in A's gross estate under section 2033. The result would be the same if A and B were not married.

Example (13). The facts are the same as Example (12), except that B, rather than A, dies on August 15, 1998. A may not make a qualified disclaimer with respect to any of the funds in the bank account, because A furnished the funds for the entire account and A did not relinquish dominion and control over the funds.

Example (14). The facts are the same as Example (12), except that B disclaims 40 percent of the funds in the account. Since, under state law, B is treated as predeceasing A with respect to the disclaimed interest, the 40 percent portion of the account balance that was disclaimed passes as part of A's probate estate, and is no longer characterized as joint property. This 40 percent portion of the account balance is, therefore, includible in A's gross estate under section 2033. The remaining 60 percent of the account balance that was not disclaimed retains its character as joint property and, therefore, is includible in A's gross estate as provided in section 2040(b). Therefore, 30 percent (½ × 60 percent) of the account balance is includible in A's gross estate under section 2040(b), and a total of 70 percent of the aggregate account balance is includible in A's gross estate. If A and B were not married, then the 40 percent portion of the account subject to the disclaimer would be includible in A's gross estate as provided in section 2033 and the 60 percent portion of the account not subject to the disclaimer would be includible in A's gross estate as provided in section 2040(a), because A furnished all of the funds with respect to the account.

Example (1) above illustrates a harsh rule. The remaindermen need to disclaim based not on the primary beneficiary's death but on the first irrevocable transfer that caused them to have any kind of interest whatsoever. They need to make that decision up front, even if they have no idea whether the primary beneficiary might appoint to them, put restrictions on them, or cut them out entirely. Even harsher is if the trust is a QTIP trust that may give rise to transferee liability with respect to estate tax on assets passing at the surviving spouse's death.[7011] However, as Example (2) illustrates, if a remainderman takes subject to a preceding general power of appointment, that remainderman can wait to disclaim until after the general power of appointment lapses or is exercised.

Reg. § 25.2511-1(h)(4) is extended to savings bonds by Rev. Rul. 68-269, Situation 5, and to brokerage accounts by Rev. Rul. 69-148.

Reg. § 25.2518-2(d), "No acceptance of benefits," provides:

(1) *Acceptance*. A qualified disclaimer cannot be made with respect to an interest in property if the disclaimant has accepted the interest or any of its benefits, expressly or impliedly, prior to making the disclaimer. Acceptance is manifested by an affirmative act which is consistent with ownership of the interest in property. Acts indicative of acceptance include using the property or the interest in property; accepting dividends, interest, or rents from the property; and directing others to act with respect to the property or interest in property. However, merely taking delivery of an instrument of title, without more, does not constitute acceptance. Moreover, a disclaimant is not considered to have accepted property merely because under applicable local law title to the property vests immediately in the disclaimant upon the death of a decedent. The acceptance of one interest in property will not, by itself, constitute an acceptance of any other separate interests created by the transferor and held by the disclaimant in the same property. In the case of residential property, held in joint tenancy by some or all of the residents, a joint tenant will not be

[7011] See part III.B.5.e.v Transferee Liability, especially the text accompanying fn 7208.

considered to have accepted the joint interest merely because the tenant resided on the property prior to disclaiming his interest in the property. The exercise of a power of appointment to any extent by the donee of the power is an acceptance of its benefits. In addition, the acceptance of any consideration in return for making the disclaimer is an acceptance of the benefits of the entire interest disclaimed.

(2) *Fiduciaries*. If a beneficiary who disclaims an interest in property is also a fiduciary, actions taken by such person in the exercise of fiduciary powers to preserve or maintain the disclaimed property shall not be treated as an acceptance of such property or any of its benefits. Under this rule, for example, an executor who is also a beneficiary may direct the harvesting of a crop or the general maintenance of a home. A fiduciary, however, cannot retain a wholly discretionary power to direct the enjoyment of the disclaimed interest. For example, a fiduciary's disclaimer of a beneficial interest does not meet the requirements of a qualified disclaimer if the fiduciary exercised or retains a discretionary power to allocate enjoyment of that interest among members of a designated class. See paragraph (e) of this section for rules relating to the effect of directing the redistribution of disclaimed property.

(3) *Under 21 years of age*. A beneficiary who is under 21 years of age has until 9 months after his twenty-first birthday in which to make a qualified disclaimer of his interest in property. Any actions taken with regard to an interest in property by a beneficiary or a custodian prior to the beneficiary's twenty-first birthday will not be an acceptance by the beneficiary of the interest.

(4) *Examples*. The provisions of paragraphs (d)(1), (2) and (3) of this section may be illustrated by the following examples:

Example (1). On April 9, 1977, A established a trust for the benefit of B, then age 22. Under the terms of the trust, the current income of the trust is to be paid quarterly to B. Additionally, one half the principal is to be distributed to B when B attains the age of 30 years. The balance of the principal is to be distributed to B when B attains the age of 40 years. Pursuant to the terms of the trust, B received a distribution of income on June 30, 1977. On August 1, 1977, B disclaimed B's right to receive both the income from the trust and the principal of the trust, B's disclaimer of the income interest is not a qualified disclaimer for purposes of section 2518(a) because B accepted income prior to making the disclaimer. B's disclaimer of the principal, however, does satisfy section 2518(b)(3). See also §25.2518-3 for rules relating to the disclaimer of less than an entire interest in property.

Example (2). B is the recipient of certain property devised to B under the will of A. The will stated that any disclaimed property was to pass to C. B and C entered into negotiations in which it was decided that B would disclaim all interest in the real property that was devised to B. In exchange, C promised to let B live in the family home for life. B's disclaimer is not a qualified disclaimer for purposes of section 2518(a) because B accepted consideration for making the disclaimer.

Example (3). A received a gift of Blackacre on December 25, 1978. A never resided on Blackacre but when property taxes on Blackacre became due on July 1, 1979, A paid them out personal funds. On August 15, 1979, A disclaimed the gift of Blackacre. Assuming all the requirements of section 2518(b) have been met, A has made a qualified disclaimer of Blackacre. Merely paying the property taxes does not constitute an acceptance of Blackacre even though A's personal funds were used to pay the taxes.

Example (4). A died on February 15, 1978. Pursuant to A's will, B received a farm in State Z. B requested the executor to sell the farm and to give the proceeds to B. The executor then sold the farm pursuant to B's request. B then disclaimed $50,000 of the proceeds from the sale of the farm. B's disclaimer is not a qualified disclaimer. By requesting the executor to sell the farm B accepted the farm even though the executor may not have been legally obligated to comply with B's request. See also §25.2518-3 for rules relating to the disclaimer of less than an entire interest in property.

Example (5). Assume the same facts as in example (4) except that instead of requesting the executor to sell the farm, B pledged the farm as security for a short-term loan which was paid off prior to distribution of the estate. B then disclaimed his interest in the farm. B's disclaimer is not a qualified disclaimer. By pledging the farm as security for the loan, B accepted the farm.

Example (6). A delivered 1,000 shares of stock in Corporation X to B as a gift on February 1, 1980. A had the shares registered in B's name on that date. On April 1, 1980, B disclaimed the interest in the 1,000 shares. Prior to making the disclaimer, B did not pledge the shares, accept any dividends or otherwise commit any acts indicative of acceptance. Assuming the remaining requirements of section 2518 are satisfied, B's disclaimer is a qualified disclaimer.

Example (7). On January 1, 1980, A created an irrevocable trust in which B was given a testamentary general power of appointment over the trust's corpus. B executed a will on June 1, 1980, in which B provided for the exercise of the power of appointment. On September 1, 1980, B disclaimed the testamentary power of appointment. Assuming the remaining requirements of section 2518(b) are satisfied, B's disclaimer of the testamentary power of appointment is a qualified disclaimer.

Example (8). H and W reside in X, a community property state. On January 1, 1981, H and W purchase a residence with community funds. They continue to reside in the house until H dies testate on February 1, 1990. Although H could devise his portion of the residence to any person, H devised his portion of the residence to W. On September 1, 1990, W disclaims the portion of the residence devised to her pursuant to H's will but continues to live in the residence. Assuming the remaining requirements of section 2518(b) are satisfied, W's disclaimer is a qualified disclaimer under section 2518(a). W's continued occupancy of the house prior to making the disclaimer will not by itself be treated as an acceptance of the benefits of the portion of the residence devised to her by H.

Example (9). In 1979, D established a trust for the benefit of D's minor children E and F. Under the terms of the trust, the trustee is given the power to make discretionary distributions of current income and corpus to both children. The corpus of the trust is to be distributed equally between E and F when E becomes 35 years of age. Prior to attaining the age of 21 years on April 8, 1982, E receives several distributions of income from the trust. E receives no distributions of income between April 8, 1982 and August 15, 1982, which is the date on which E disclaims all interest in the income from the trust. As a result of the disclaimer the income will be distributed to F. If the remaining requirements of section 2518 are met, E's disclaimer is a qualified disclaimer under section 2518(a). To have a qualified disclaimer of the interest in corpus, E must disclaim the interest no later than 9 months after April 8, 1982, E's 21st birthday.

Example (10). Assume the same facts as in example (9) except that E accepted a distribution of income on May 13, 1982. E's disclaimer is not a qualified disclaimer under section 2518 because by accepting an income distribution after attaining the age of 21, E accepted benefits from the income interest.

Example (11). F made a gift of 10 shares of stock to G as custodian for H under the State X Uniform Gifts to Minors Act. At the time of the gift, H was 15 years old. At age 18, the local age of majority, the 10 shares were delivered to and registered in the name of H. Between the receipt of the shares and H's 21st birthday, H received dividends from the shares. Within 9 months of attaining age 21, H disclaimed the 10 shares. Assuming H did not accept any dividends from the shares after attaining age 21, the disclaimer by H is a qualified disclaimer under section 2518.

Reg. § 25.2518-2(e), "Passage without direction by the disclaimant of beneficial enjoyment of disclaimed interest," provides:

(1) *In general*. A disclaimer is not a qualified disclaimer unless the disclaimed interest passes without any direction on the part of the disclaimant to a person other than the disclaimant (except as provided in paragraph (e)(2) of this section). If there is an express or implied agreement that the disclaimed interest in property is to be given or bequeathed to a person specified by the disclaimant, the disclaimant shall be treated as directing the transfer of the property interest. The requirements of a qualified disclaimer under section 2518 are not satisfied if -

(i) The disclaimant, either alone or in conjunction with another, directs the redistribution or transfer of the property or interest in property to another person (or has the power to direct the redistribution or transfer of the property or interest in property to another person unless such power is limited by an ascertainable standard); or

(ii) The disclaimed property or interest in property passes to or for the benefit of the disclaimant as a result of the disclaimer (except as provided in paragraph (e)(2) of this section).

If a power of appointment is disclaimed, the requirements of this paragraph (e)(1) are satisfied so long as there is no direction on the part of the disclaimant with respect to the transfer of the interest subject to the power or with respect to the transfer of the power to another person. A person may make a qualified disclaimer of a beneficial interest in property even if after such disclaimer the disclaimant has a fiduciary power to distribute to designated beneficiaries, but only if the power is subject to an ascertainable standard. See examples (11) and (12) of paragraph (e)(5) of this section.

(2) *Disclaimer by surviving spouse*. In the case of a disclaimer made by a decedent's surviving spouse with respect to property transferred by the decedent, the disclaimer satisfies the requirements of this paragraph (e) if the interest passes as a result of the disclaimer without direction on the part of the surviving spouse either to the surviving spouse or to another person. If the surviving spouse, however, retains the right to direct the beneficial enjoyment of the disclaimed property in a transfer that is not subject to Federal estate and gift tax (whether as trustee or otherwise), such spouse will be treated as directing the beneficial enjoyment of the disclaimed property, unless such power is limited by an ascertainable standard. See examples (4), (5), and (6) in paragraph (e)(5) of this section.

(3) *Partial failure of disclaimer*. If a disclaimer made by a person other than the surviving spouse is not effective to pass completely an interest in property to a person other than the disclaimant because -

(i) The disclaimant also has a right to receive such property as an heir at law, residuary beneficiary, or by any other means; and

(ii) The disclaimant does not effectively disclaim these rights, the disclaimer is not a qualified disclaimer with respect to the portion of the disclaimed property which the disclaimant has a right to receive. If the portion of the disclaimed interest in property which the disclaimant has a right to receive is not severable property or an undivided portion of the property, then the disclaimer is not a qualified disclaimer with respect to any portion of the property. Thus, for example, if a disclaimant who is not a surviving spouse receives a specific bequest of a fee simple interest in property and as a result of the disclaimer of the entire interest, the property passes to a trust in which the disclaimant has a remainder interest, then the disclaimer will not be a qualified disclaimer unless the remainder interest in the property is also disclaimed. See §25.2518-3(a)(1)(ii) for the definition of severable property.

(4) *Effect of precatory language*. Precatory language in a disclaimer naming takers of disclaimed property will not be considered as directing the redistribution or transfer of the property or interest in property to such persons if the applicable State law gives the language no legal effect.

(5) *Examples*. The provisions of this paragraph (e) may be illustrated by the following examples:

Example (1). A, a resident of State X, died on July 30, 1978. Pursuant to A's will, B, A's son and heir at law, received the family home. In addition, B and C each received 50 percent of A's residuary estate. B disclaimed the home. A's will made no provision for the distribution of property in the case of a beneficiary's disclaimer. Therefore, pursuant to the disclaimer laws of State X, the disclaimed property became part of the residuary estate. Because B's 50 percent share of the residuary estate will be increased by 50 percent of the value of the family home, the disclaimed property will not pass solely to another person. Consequently, B's disclaimer of the family home is a qualified disclaimer only with respect to the 50 percent portion that passes solely to C. Had B also disclaimed B's 50 percent interest in the residuary estate, the disclaimer would have been a qualified disclaimer under section 2518 of the entire interest in the home (assuming the remaining requirements of a qualified disclaimer were satisfied). Similarly, if under the laws of State X, the disclaimer has the effect of divesting B of all interest in the home, both as devisee and as a beneficiary of the residuary estate, including any property resulting from its sale, the disclaimer would be a qualified disclaimer of B's entire interest in the home.

Example (2). D, a resident of State Y, died testate on June 30, 1978. E, an heir at law of D, received specific bequests of certain severable personal property from D. E disclaimed the property transferred by D under the will. The will made no provision for the distribution of property in the case of a beneficiary's disclaimer. The disclaimer laws of State Y provide that such property shall pass to the decedent's heirs at law in the same manner as if the disclaiming beneficiary had died immediately before the testator's death. Because State Y's law treats E as predeceasing D, the property disclaimed by E does not pass to E as an heir at law or otherwise. Consequently, if the remaining requirements of section 2518(b) are satisfied, E's disclaimer is a qualified disclaimer under section 2518(a).

Example (3). Assume the same facts as in example (2) except that State Y has no provision treating the disclaimant as predeceasing the testator. E's disclaimer satisfies section 2518(b)(4) only to the extent that E does not have a right to receive the property as an heir at law. Had E disclaimed both the share E received under D's will and E's intestate share, the requirement of section 2518(b)(4) would have been satisfied.

Example (4). B died testate on February 13, 1980. B's will established both a marital trust and a nonmarital trust. The decedent's surviving spouse, A, is an income beneficiary of the marital trust and has a testamentary general power of appointment over its assets. A is also an income beneficiary of the nonmarital trust, but has no power to appoint or invade the corpus. The provisions of the will specify that any portion of the marital trust disclaimed is to be added to the nonmarital trust. A disclaimed 30 percent of the marital trust. (See §25.2518-3(b) for rules relating to the disclaimer of an undivided portion of an interest in property.) Pursuant to the will, this portion of the marital trust property was transferred to the nonmarital trust without any direction on the part of A. This disclaimer by A satisfies section 2518(b)(4).

Example (5). Assume the same facts as in example (4) except that A, the surviving spouse, has both an income interest in the nonmarital trust and a testamentary nongeneral power to appoint among designated beneficiaries. This power is not limited by an ascertainable standard. The requirements of section 2518(b)(4) are not satisfied unless A also disclaims the nongeneral power to appoint the portion of the trust corpus that is attributable to the property that passed to the nonmarital trust as a result of A's disclaimer. Assuming that the fair market value of the disclaimed property on the date of the disclaimer is $250,000 and that the fair market value of the nonmarital trust (including the disclaimed property) immediately after the disclaimer is $750,000, A must disclaim the power to appoint one-third of the nonmarital trust's corpus. The result is the same regardless of whether the nongeneral power is testamentary or inter vivos.

Example (6). Assume the same facts as in example (4) except that A has both an income interest in the nonmarital trust and a power to invade corpus if needed for A's health or maintenance. In addition, an independent trustee has power to distribute to A any portion of the corpus which the trustee determines to be desirable for A's happiness. Assuming the other requirements of section 2518 are satisfied. A may make a qualified disclaimer of interests in the marital trust without disclaiming any of A's interests in the nonmarital trust.

Example (7). B died testate on June 1, 1980. B's will created both a marital trust and a nonmarital trust. The decedent's surviving spouse, C, is an income beneficiary of the marital trust and has a testamentary general power of appointment over its assets. C is an income beneficiary of the nonmarital trust, and additionally has the noncumulative right to withdraw yearly the greater of $5,000 or 5 percent of the aggregate value of the principal. The provisions of the will specify that any portion of the marital trust disclaimed is to be added to the nonmarital trust. C disclaims 50 percent of the marital trust corpus. Pursuant to the will, this amount is transferred to the nonmarital trust. Assuming the remaining requirements of section 2518(b) are satisfied, C's disclaimer is a qualified disclaimer.

Example (8). A, a resident of State X, died on July 19, 1979. A was survived by a spouse B, and three children, C, D, and E. Pursuant to A's will, B received one-half of A's estate and the children received equal shares of the remaining one-half of the estate. B disclaimed the entire interest B had received. The will made no provisions for the distribution of property in the case of a beneficiary's disclaimer. The disclaimer laws of State X provide that under these circumstances disclaimed property passes to the decedent's heirs at law in the same manner as if the disclaiming beneficiary had died immediately before the testator's death. As a result, C, D, and E are A's only remaining heirs at law, and will divide the disclaimed property equally among themselves. B's disclaimer includes language stating that "it is my intention that C, D, and E will share equally in the division of this property as a result of my disclaimer." State X considers these to be precatory words and gives them no legal effect. B's disclaimer meets all other requirements imposed by State X on disclaimers, and is considered an effective disclaimer under which the property will vest solely in C, D, and E in equal shares without any further action required by B. Therefore, B is not treated as directing the redistribution or transfer of the property. If the remaining requirements of section 2518 are met, B's disclaimer is a qualified disclaimer.

Example (9). C died testate on January 1, 1979. According to C's will, D was to receive ⅓ of the residuary estate with any disclaimed property going to E. D was also to receive a second ⅓ of the residuary estate with any disclaimed property going to F. Finally, D was to receive a final ⅓ of the residuary estate with any disclaimed property going to G. D specifically states that he is disclaiming the interest in which the disclaimed property is designated to pass to E. D has effectively directed that the disclaimed property will pass to E and therefore D's disclaimer is not a qualified disclaimer under section 2518(a).

Example (10). Assume the same facts as in example (9) except that C's will also states that D was to receive Blackacre and Whiteacre. C's will further provides that if D disclaimed Blackacre then such property was to pass to E and that if D disclaimed Whiteacre then Whiteacre was to pass to F. D specifically disclaims Blackacre with the intention that it pass to E. Assuming the other requirements of section 2518 are met, D has made a qualified disclaimer of Blackacre. Alternatively, D could disclaim an undivided portion of both Blackacre and Whiteacre. Assuming the other requirements of section 2518 are met, this would also be a qualified disclaimer.

Example (11). G creates an irrevocable trust on February 16, 1983, naming H, I and J as the income beneficiaries for life and F as the remainderman. F is also named the trustee and as trustee has the discretionary power to invade the corpus and make discretionary distributions to H, I or J during their lives. F disclaims the remainder interest on August 8, 1983, but retains his discretionary power to invade the corpus. F has not made a qualified disclaimer because F retains the power to direct enjoyment of the corpus and the retained fiduciary power is not limited by an ascertainable standard.

Example (12). Assume the same facts as in example (11) except that F may only invade the corpus to make distributions for the health, maintenance or support of H, I or J during their lives. If the other requirements of section 2518(b) are met, F has made a qualified disclaimer of the remainder interest because the retained fiduciary power is limited by an ascertainable standard.

Reg. § 25.2518-3(a), "Disclaimer of a partial interest," explains how various interests in trusts can be parsed and separately disclaimer or accepted:

(1) *In general*.

(i) *Interest*. If the requirements of this section are met, the disclaimer of all or an undivided portion of any separate interest in property may be a qualified disclaimer even if the disclaimant has another interest in the same property. In general, each interest in property that is separately created by the transferor is treated as a separate interest. For example, if an income interest in securities is bequeathed to A for life, then to B for life, with the remainder interest in such securities bequeathed to A's estate, and if the remaining requirements of section 2518(b) are met, A could make a qualified disclaimer of either the income interest or the remainder, or an undivided portion of either interest. A could not, however, make a qualified disclaimer of the income interest for a certain number of years. Further, where local law merges interests separately created by the transferor, a qualified disclaimer will be allowed only if there is a disclaimer of the entire merged interest or an undivided portion of such merged interest. See example (12) in paragraph (d) of this section. See § 25.2518-3(b) for rules relating to the disclaimer of an undivided portion. Where the merger of separate interests would occur but for the creation by the transferor of a nominal interest (as defined in paragraph (a)(1)(iv) of this section), a qualified disclaimer will be allowed only if there is a disclaimer of all the separate interests, or an undivided portion of all such interests, which would have merged but for the nominal interest.

(ii) *Severable property*. A disclaimant shall be treated as making a qualified disclaimer of a separate interest in property if the disclaimer relates to severable property and the disclaimant makes a disclaimer which would be a qualified disclaimer if such property were the only property in which the disclaimant had an interest. If applicable local law does not recognize a purported disclaimer of severable property, the disclaimant must comply with the requirements of paragraph (c)(1) of § 25.2518-1 in order to make a qualified disclaimer of the severable property. Severable property is property which can be divided into separate parts each of which, after severance, maintains a complete and independent existence. For example, a legatee of shares of corporate stock may accept some shares of the stock and make a qualified disclaimer of the remaining shares.

(iii) *Powers of appointment*. A power of appointment with respect to property is treated as a separate interest in such property and such power of appointment with respect to all or an undivided portion of such property may be disclaimed independently from any other interests separately created by the transferor in the property if the requirements of section 2518(b) are met. See example (21) of paragraph (d) of this section. Further, a disclaimer of a power of appointment with respect to property is a qualified disclaimer only if any right to direct the beneficial enjoyment of the property which is retained by the disclaimant is limited by an ascertainable standard. See example (9) of paragraph (d) of this section.

(iv) *Nominal interest*. A nominal interest is an interest in property created by the transferor that -

(A) Has an actuarial value (as determined under § 20.2031-7) of less than 5 percent of the total value of the property at the time of the taxable transfer creating the interest,

(B) Prevents the merger under local law or two or more other interests created by the transferor, and

(C) Can be clearly shown from all the facts and circumstances to have been created primarily for the purpose of preventing the merger of such other interests.

Factors to be considered in determining whether an interest is created primarily for the purpose of preventing merger include (but are not limited to) the following: the relationship between the transferor and the interest holder; the age difference between the interest holder and the beneficiary whose interests would have merged; the interest holder's state of health at the time of the taxable transfer; and, in the case of a contingent remainder, any other factors which indicate that the possibility of the interest vesting as a fee simple is so remote as to be negligible.

(2) *In trust*. A disclaimer is not a qualified disclaimer under section 2518 if the beneficiary disclaims income derived from specific property transferred in trust while continuing to accept income derived from the remaining properties in the same trust unless the disclaimer results in such property being removed from the trust and passing, without any direction on the part of the disclaimant, to persons other than the disclaimant or to the spouse of the decedent. Moreover, a disclaimer of both an income interest and a remainder interest in specific trust assets is not a qualified disclaimer if the beneficiary retains interests in other trust property unless, as a result of the disclaimer, such assets are removed from the trust and pass, without any direction on the part of the disclaimant, to persons other than the disclaimant or to the spouse of the decedent. The disclaimer of an undivided portion of an interest in a trust may be a qualified disclaimer. See also paragraph (b) of this section for rules relating to the disclaimer of an undivided portion of an interest in property.

Reg. § 25.2518-3(b), "Disclaimer of undivided portion," allows an undivided fractional interest to be disclaimed, so long as the character of the interest is not changed:

> A disclaimer of an undivided portion of a separate interest in property which meets the other requirements of a qualified disclaimer under section 2518(b) and the corresponding regulations is a qualified disclaimer. An undivided portion of a disclaimant's separate interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the disclaimant in such property and must extend over the entire term of the disclaimant's interest in such property and in other property into which such property is converted. A disclaimer of some specific rights while retaining other rights with respect to an interest in the property is not a qualified disclaimer of an undivided portion of the disclaimant's interest in property. Thus, for example, a disclaimer made by the devisee of a fee simple interest in Blackacre is not a qualified disclaimer if the disclaimant disclaims a remainder interest in Blackacre but retains a life estate.

Reg. § 25.2518-3(c) allows a pecuniary amount to be disclaimed, so long as a proportionate amount of the income is also disclaimed.

Reg. § 25.2518-3(d) provides examples.

III.B.3.e.ii. Disclaimer Strategy

Take-aways from part III.B.3.e.i Disclaimers – Code and Regulations include:

- A disclaimer may be made within 9 months after a transfer. A remainderman needs to consider disclaiming when the trust creating his/her interest is created.[7012]

- The disclaimant cannot receive any income or other benefits from the portion of the property that was disclaimed.

- A disclaimer may be made using a formula.

In the context of this part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers, we typically do sales to irrevocable grantor trusts.[7013] In a year in which gift/estate tax exemption is decreasing or other uncertainties exist, a free look for 9 months - the period within which a disclaimer generally must be made – is helpful.

Suppose a donor wants to make a gift using his exemption before it decreases but would like a free look. The donor might make a gift, and then the recipient might disclaim if it looks like the exemption won't decrease, after all. For example, wife makes a gift to a trust for her husband. The instrument of gift provides that, if the gift is disclaimed, it reverts back to wife. Now the question is who can disclaim. Because trustees have a fiduciary duty to promote the beneficiaries' interests in the trust, a trustee would be very reluctant to disclaim, unless the trust agreement expressly authorizes the trustee to disclaim and releases the trustee from liability for doing so. If the husband disclaims, then the trust would pass to those who would succeed to his

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[7012] See text accompanying and immediately preceding fn 7011 in part III.B.3.e.i Disclaimers – Code and Regulations.

[7013] See part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

interest, unless the trust agreement provides that the husband's disclaimer binds all beneficiaries. So, whenever a disclaimer is contemplated regarding a gift to a trust, consider special drafting of the trust. Also consider that the disclaimant cannot hold a power of appointment in any trust that receives the disclaimed assets.

Because the disclaimant cannot control where the gift passes, consider the including in the instrument of gift where the remainder might go.

Part III.B.3.l *Christiansen* described how the Tax Court approved a formula disclaimer that resulted in charitable gift.

Consider a gift to a trust for descendants with a formula disclaimer that goes outright to the donor's spouse.

III.B.3.f. Defined Consideration Clause

Although a gift to an alternative taker, particularly but not necessarily a charity, has worked well in recent cases, consider instead defining the consideration to be paid. Below is an example; readers are cautioned not to rely on this example but rather to analyze the law themselves in determining what might be appropriate language.

A clause in the sale agreement might provide:

> In consideration of a sum equal to the "Fair Market Value" (defined below) of the Transferred Property (the "Sale Price"), concurrently with its execution of this Agreement on the Effective Date, Seller is irrevocably granting, selling, transferring and conveying the Transferred Property to Buyer on the terms set forth herein.
>
> The "Fair Market Value" of the Transferred Property shall be such value as finally determined for federal gift tax purposes on the transfer of the Transferred Property by Seller as of the Effective Date, in accordance with the valuation principles set forth in United States Treasury Regulation section 25.2512-1. Seller agrees to file a gift tax return reporting this transaction so as to cause the gift tax statute of limitations to run.[7014]

See part III.B.4 Adequate Disclosure on Gift Tax Returns, with some additional features suggested when then the seller is also a beneficiary of the buyer trust.

A promissory note might refer to the Sale Price in the sale agreement and then provide:

> Promptly after the initial determination of the Sale Price and again upon the final determination for federal gift tax purposes of the Sale Price under the Sale Agreement, Holder shall be entitled to attach to this Note a statement fixing the amount of principal due under this Note in a manner appropriate to make this Note a "negotiable instrument" within the meaning of Section 3-104 of the Uniform Commercial Code as in effect in the State of ____.

[7014] If the seller is the client's revocable trust, the client would – as an additional party - sign the sale agreement as an individual, personally making the promise to file the gift tax return.

An Allonge might then estimate the purchase price once the appraisal is finalized:

> Effective as of the date of such Promissory Note, the initial principal amount of the Promissory Note is estimated to be $__________________.

In the examples above, the purchase price is the finally determined gift tax value. Any amount in the promissory note is expressly referred to as an estimate.

If the seller is a beneficiary of the buyer trust, see text accompanying fns 6753- 6755 in part III.B.2.i.v Sale to a Beneficiary Deemed-Owned Trust – When a Traditional Sale to an Irrevocable Grantor Trust Does Not Meet the Client's Objectives.

Although *King* below approved a defined consideration clause, it did not follow procedures as strong as that suggested above. Following *King* are some cases that set initial prices and required subsequent action to adjust the price to the gift tax value, rather than referring to the gift tax value as the sale price the way the example above does. These other cases might be viewed as falling into Rev. Rul. 86-41, Situation 2, quoted further below.[7015] As of the Fall 2016, the IRS was attacking a formula purchase price that does not quite follow my example,[7016] but my understanding is that the case settled favorably.

King v. United States[7017] approved the following clause:

> ... However, if the fair market value of The Colorado Corporation stock as of the date of this letter is ever determined by the Internal Revenue Service to be greater or less than the fair market value determined in the same manner described above, the purchase price shall be adjusted to the fair market value determined by the Internal Revenue Service.

The Tenth Circuit held:

> The district court distinguished the facts in the case at bar from those in *Procter*, *supra*, finding that the parties intended that the trusts pay a full and adequate consideration for the stock and that the clause was a proper means of overcoming the uncertainty in ascertaining the fair market value of the stock. The court concluded that there was an intention to cause the trusts to pay full and fair consideration for the stock and to make an actual adjustment of the price paid upon the event of a determination by the IRS. We agree. It is important to observe that the IRS does not dispute the contention that it was difficult, if not impossible, to accurately value the stock at the time of its transfer in 1969 and that the parties inserted the specific valuation paragraph in the agreement because the transaction was intended as a sale and not as a gift. The trial court's determination was one of fact. That finding is not clearly erroneous.

[7015] The text accompanying fn. 7041, found in part III.B.3.o *Procter* and Other Cases, reproduces Rev. Rul. 86-41.

[7016] Steve Akers' November 2016 report on *True v. Commissioner*, Tax Court Docket Nos. 21896-16 and 21897-16 (petitions filed October 11, 2016), states:

> According to the petition, the transfer agreement for the sales to his children provided that if it is determined for federal gift tax purposes that the interests sold were undervalued by FMV Opinions, the purchase price would be increased to reflect the finally-determined fair market values.

The description above seems to lie somewhere between *King* and *McLendon*, both described below.

[7017] 545 F.2d 700 (10th Cir. 1976).

We believe that the IRS reliance on *Procter*, *supra*, is misplaced. Here, there was at no time or in any way an attempt to alter or negate the plain terms of the valuation clause and no attempt by the trustees was made to reconvey the stock to King or to cancel the notes in anticipation of an unfavorable valuation ruling.

Authorities relied upon by the Government dealing with contingencies which, upon fruition, alter, change or destroy the *nature* of the transaction do not apply here. The proviso for adjustment of the purchase price of the stock to equal its fair market value did not affect the *nature* of the transaction. But, argues the IRS, even though the parties may have intended to pay full consideration for the stock, still this fact is immaterial for gift tax purposes because the test is solely objective, i.e., whether the transfer was made for full and adequate consideration. In a nutshell, IRS contends that if King's intent to make a sale would not be sufficient to prevent the gift tax were the price adjustment clause absent, "that intent obviously cannot be used to legitimate the presence of the clause so as to avoid the tax". [Br. of Appellant, p. 16]. Treasury regulations, references and citations are relied upon. The IRS presents persuasive arguments, based upon its rules that (a) for accounting purposes, absent specific statutory language to the contrary, tax consequences attach at the end of fixed and regular accounting periods, regardless how subsequent events might affect the economic or tax results of the transaction, (b) taxpayers cannot amend a transaction retroactively to avoid the federal tax consequences of prior taxable periods and (c) the difficulty of valuing the property transferred does not make the gift tax inapplicable. IRS further contends that the record does not show an attempt by the parties at the time of suit to make an actual price adjustment and the gift tax would be virtually emasculated if the parties' intention to effect a transfer for a full consideration were enough to satisfy the requirements of 26 U.S.C.A. § 2512(b) of the Internal Revenue Code of 1954.

The trial court's finding that there was no donative intent and that the transaction was made in the ordinary course of business at arm's length is not clearly erroneous. Further, it does not work an abuse upon the operative intent of § 2512, *supra*, *i.e.*, to reach donative transfers and to exclude transfers whose consideration is not reducible to money or money's worth. The transfers involved here can be ultimately reduced to money's worth and are, accordingly, excluded from the gift tax consequences. No diminution of King's estate can result from the trial court's finding.

The statutory framework underlying the federal gift tax scheme is clear on its face. § 2501 imposes a tax on the transfer of property by gift. § 2512(a) provides that if the gift made is in property, the value thereof at the date of the gift shall be considered the amount of the gift. In the case of a holding company such as The Colorado Corporation, gifts of its shares of stock are governed by Treas. Reg. § 25.2512-2 (26 C.F.R.) which provides general guidance for valuing the shares of stock based on bid and asked prices, where selling prices and bid and asked prices are not available for dates both before and after date of gifts, where selling prices or bid and asked prices do not represent fair market value and where selling prices or bid and asked prices are unavailable. Treas. Reg. § 25.2512(1)(1968) is the general valuation rule. It provides that "the value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts".

We are cognizant of the rule that in reviewing a challenged regulation, the regulation must be sustained if found to be reasonable and consistent with the statute.

> *Commissioner of Internal Revenue v. South Texas Lumber Co.*, 333 U.S. 496 (1948). We are also aware of the rule that where there is a possibility that several methods of valuation are permissible, any one chosen by the IRS may not be set aside. *DuPont's Estate v. Commissioner of Internal Revenue*, 233 F.2d 210 (3rd Cir. 1956), *cert. denied* 352 U.S. 878 (1956).
>
> The IRS contention that the price adjustment clause violates public policy in that it deters administrative enforcement of the gift tax provisions is valid *only* if the transaction be construed as an inter vivos transfer undertaken to reduce King's estate. The IRS argument would be applicable if we were to hold that the trial court's finding that King intended that the trust pay full and adequate consideration predicated upon the price-adjustment proviso is clearly erroneous. It is not. Under the facts found, King is not subject to the gift tax under Treas. Reg. § 25.2512-8 because the transaction was made in the ordinary course of business at arm's length, free from any donative intent. We hold that the trial court did not err in holding that the aforesaid stock transfers are not subject to a gift tax.
>
> To be sure, it has been held that the absence of a donative intent will not alone prevent a transfer from being subject to gift taxation, but this is not the controlling factor when the transfer has been found to have been made "at arm's length in the ordinary course of business". *Commissioner of Internal Revenue v. Wemyss*, 324 U.S. 303, 307 (1945). See also 156 A.L.R. 1022. Interpretive of the Code requirements of "an adequate and full consideration in money or money's worth" the Supreme Court has held that the return must be an adequate and full equivalent and that the requisite consideration cannot be equated with mutual promises satisfying common law consideration sufficient to support an agreement. *Taft v. Commissioner*, 304 U.S. 351 (1938); 116 A.L.R. 346.
>
> Significantly, we believe, is the fact that perhaps the main purpose of the gift tax was to prevent or compensate for the avoidance of death taxes by taxing the gifts of property inter vivos which, but for the gifts, would be subject in its original or converted form to the tax laid upon transfers at death. *Sanford's Estate v. Commissioner*, 308 U.S. 39 (1939). No such risk is involved in the instant case.
>
> We hold that the trial court did not err in finding that the stock sold to Trusts No. 1 under the "price adjustment" proviso is not subject to the gift tax provisions.

Estate of McLendon v. Commissioner[7018] rejected a clause that did not define the purchase price as the gift tax value but rather set a price that would later be adjusted:

> The parties here to recognize that the valuation of many of the assets set out on attached Exhibit A are, by their nature, as determined by the best judgement of the parties and independent consultants engaged to assist in the valuation process and may be subject to differing opinions. Therefore, the parties agree that, to the extent any of the values on the attached Exhibit A are changed through a settlement process with the Internal Revenue Service, or a final decision of the United States Tax Court, the purchase price hereunder shall be adjusted accordingly, with interest on said adjustment at the rate of ten percent (10%) from the date hereof until said final determination of

[7018] T.C. Memo. 1993-459.

> value, and the annuity payments due and payable hereunder shall likewise be adjusted to reflect any such change in valuation.

In *Harwood v. Commissioner*,[7019] the Tax Court reviewed the following provision, which did not define the purchase price as the gift tax value but rather set a price that would later be adjusted:

> Article First. Property subject to this instrument listed in Schedule "A" is referred to as the "trust estate" and shall be held, administered, and distributed in accordance with this instrument. In the event that the value of the partnership interest listed in Schedule "A" shall be *finally determined* to exceed $400,000 for purposes of computing the California or United States Gift Tax, and in the opinion of the Attorney for the trustee a lower value *is not reasonably defendable*, the trustee shall immediately execute a promissory note to the trustors in the usual form at 6 percent interest in a principal amount equal to the difference between the value of such gift and $400,000. The note shall carry interest and be effective as of the day of the gift. [Emphasis supplied.]

The court held:

> In the instant case, we have found that the interests in HIC held by the Harwood Family Trusts were worth substantially in excess of $400,000.
>
> The trustees were aware (we assume) of the Kleiner report and the IRS's gift tax determination, but they evidently believed that a value lower than the appraised value and the value determined by IRS was defensible, and did not issue promissory notes to the trust grantors. There, we believe, the matter ends, since we do not believe the savings clause in issue requires (or entitles) the trustees to issue promissory notes to the trust grantors in the event of a court judgment finding a value above $400,000 for the limited partnership interests given to the trusts.[28]
>
> We hold that the savings clause in the Morris J. Harwood 1976 Family Trust and the Arthur H. Harwood 1976 Family Trust has no effect on the amount of the gifts we have otherwise determined were made to the trusts by petitioners herein.[29]
>
> [28] It might be thought that *King v. United States,* 545 F.2d 700 (10th Cir. 1976), should control because no diminution of petitioners' estates will occur if we find that neither trust received a gift in excess of $400,000, since arguably they will be compensated by the trusts for any amount that the value of the interests in HIC donated to the trusts exceeded $400,000. Since we have no guarantee that the trusts will ever issue notes to petitioners, and, indeed, since on our reading of the trust instruments the time for issuing notes is past, we are unable to accept this position.
>
> [29] We express no opinion as to what result we would have reached had the trustees issued notes to the grantors, or had HIC been bankrupt at the time of trial, or had the savings clause required the issuance of notes if a final judgment by a court found that the interests in HIC donated to each trust had values in excess of $400,000.

In 1975, Tax Court in *Dickinson*[7020] approved an agreement that provided for the estate to sell stock for its value, as finally determined for federal estate tax purposes.

[7019] 82 T.C. 239 (1984).

[7020] *Dickinson* is excerpted in fn 7044 in part III.B.3.o *Procter* and Other Cases.

III.B.3.g. Value Determined by Appraiser

If a formula transfers a business interest equal in value to that determined by an appraiser, rather than using a value "finally determined for federal gift tax purposes," the business interest is whatever the appraiser determined, rather than that finally determined for federal gift tax purposes.

This matter of common sense was unsuccessfully disputed by the taxpayer in *Nelson v. Commissioner*, T.C. Memo. 2020-81, which reasoned and held:

> We look to the transfer documents rather than subsequent events to decide the amount of property given away by a taxpayer in a completed gift. See *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, 2009 WL 4598137, at *12 (citing *Succession of McCord v. Commissioner*, 461 F.3d 614, 627 (5th Cir. 2006), *rev'g and remanding* 120 T.C. 358 (2003)), *aff'd*, 653 F.3d 1012 (9th Cir. 2011); see also *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944) (disregarding the subsequent reallocation of property to the donor via a saving clause as contrary to public policy), *rev'g and remanding* a Memorandum Opinion of this Court. Petitioners argue that the transfer instruments show that Mrs. Nelson transferred specific dollar amounts, not fixed percentages, citing a series of cases that have respected formula clauses as transferring fixed dollar amounts of ownership interests. In each of those cases we respected the terms of the formula, even though the percentage amount was not known until fair market value was subsequently determined, because the dollar amount was known. *Wandry v. Commissioner*, T.C. Memo. 2012-88, 2012 WL 998483, at *4; *Hendrix v. Commissioner*, T.C. Memo. 2011-133, 2011 WL 2457401, at *5-*9; *Estate of Petter v. Commissioner*, 2009 WL 4598137, at *11-*16.
>
> Saving clauses have been treated differently. As we explained in *Estate of Petter* and *Wandry*, courts have rejected saving clauses because they relied on conditions subsequent to adjust the gifts or transfers so the size of the transfer (as measured either in dollar amount or percentage) could not be known. Thus, for example, in *Commissioner v. Procter*, 142 F.2d at 827, the Court of Appeals for the Fourth Circuit rejected a clause adjusting part of a gift to "automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of … [the taxpayer]" because the adjustment would be triggered only by a "final judgment or order of a competent federal court of last resort that any part of the transfer … is subject to gift tax."
>
> In *Succession of McCord v. Commissioner*, 461 F.3d at 618, the Court of Appeals for the Fifth Circuit upheld a gift of an interest in a partnership expressed as "a dollar amount of fair market value in interest" reduced by a transfer tax obligation rather than a percentage interest that was determined in agreements subsequent to the gift. It held that "a gift is valued as of the date that it is complete; the flip side of that maxim is that subsequent occurrences are off limits." *Id*. at 626. The formula clause in the initial transfer document did not include qualifying language that fair market value was to be "as finally determined for [Federal gift] tax purposes," but the court did not find that omission fatal because the value of the gift was ascertainable as of the date it was complete. *Id*. at 627.
>
> Petitioners argue that we should construe the transfer clauses here as more akin to the formula clauses that were upheld in *Succession of McCord*, *Estate of Petter*, and

Wandry, that is, read them as transferring dollar amounts rather than percentages. However, as part of their argument, they cite evidence of their intent, which includes their settlement discussions with IRS Appeals and subsequent adjustments to reflect changes in valuation to reflect those discussions. Of course, as in *Succession of McCord*, we look to the terms of the transfer instruments and not to the parties' later actions except to the extent that we conclude the terms are ambiguous and their actions reveal their understanding of those terms. *Id*. at 627-628.

Therefore, to decide whether the transfers were of fixed dollar amounts or fixed percentages, we start with the clauses themselves, rather than the parties' subsequent actions. The gift is expressed in the memorandum of gift as a "limited partner interest having a fair market value of TWO MILLION NINETY-SIX THOUSAND AND NO/100THS DOLLARS ($2,096,000.00) as of December 31, 2008 …, as determined by a qualified appraiser within ninety (90) days of the effective date of this Assignment." Similarly, the sale is expressed in the memorandum of sale as a "limited partner interest having a fair market value of TWENTY MILLION AND NO/100THS DOLLARS ($20,000,000.00) as of January 2, 2009 …, as determined by a qualified appraiser within one hundred eighty (180) days of the effective date of this Assignment."

The transferred interests thus are expressed in the transfer instruments as an interest having a fair market value of a specified amount as determined by an appraiser within a fixed period. The clauses hang on the determination by an appraiser within a fixed period; value is not qualified further, for example, as that determined for Federal estate tax purposes. See, *e.g.*, *Estate of Christiansen v. Commissioner*, 130 T.C. 1, 14-18 (2008) (upholding gift clause providing fair market value "as such value is finally determined for federal estate tax purposes"), *aff'd*, 586 F.3d 1061 (8th Cir. 2009); *Estate of Petter v. Commissioner*, 2009 WL 4598137, at *11-*16 (upholding gift clause transferring the number of units of a limited liability company "that equals one-half the minimum … dollar amount that can pass free of federal gift tax by reason of Transferor's applicable exclusion amount" along with a clause providing for an adjustment to the number of units if the value "is finally determined for federal gift tax purposes to exceed the amount described" in the first clause).

Unlike the clause in *Succession of McCord*, "fair market value" here already is expressly qualified. By urging us to interpret the operative terms in the transfer instruments as transferring dollar values of the limited partner interests on the bases of fair market value as later determined for Federal gift and estate tax purposes, petitioners ask us, in effect, to ignore "qualified appraiser … [here, Mr. Shrode] within … [a fixed period]" and replace it with "for federal gift and estate tax purposes." While they may have intended this, they did not write this.

They are bound by what they wrote at the time. As the texts of the clauses required the determination of an appraiser within a fixed period to ascertain the interests being transferred, we conclude that Mrs. Nelson transferred 6.14% and 58.35% of limited partner interests in Longspar to the Trust as was determined by Mr. Shrode within a fixed period.

III.B.3.h. *Moore*

Moore v. Commissioner, T.C. Memo. 2020-40, disallowed a charitable deduction that was contingent on a Code § 2036 disrespecting of a family limited partnership (FLP):

The Commissioner argues that the estate is not entitled to an increase in charitable deductions as a result of any increase in the value of Moore's estate. The estate, however, points to article 5, section 2 of the Irrevocable Trust. That section directs the Irrevocable Trust's trustees to distribute funds to the Living Trust to allow the Living Trust to move money to the Charitable Trust to enable the estate to take additional charitable deductions thereby minimizing its estate tax.

There are two problems for the estate here. The first is a very specific problem in the actual language of the Irrevocable Trust, which doesn't speak of increased value, but instead speaks of "an amount equal to the value of any asset of *this trust* which is includible in my gross estate for federal estate tax purposes" (emphasis added). The asset's value that we find is includible in Moore's gross estate is his farm, and his farm is not an asset of the Irrevocable Trust - it's an asset of the Mellons now and was in part an asset of the FLP. All the Irrevocable Trust owns is a large chunk of that FLP, not that partnership's assets.

There is also a second, much more general problem here. Charitable deductions are allowed only for the value of property in a decedent's gross estate if transferred to a charitable donee "by the decedent during his lifetime or by will." Sec. 20.2055-1(a), Estate Tax Regs. We have repeatedly denied charitable deductions where the donation turned upon the actions of the decedent's beneficiary or an estate's executor or administrator. See, *e.g.*, *Estate of Engelman v. Commissioner*, 121 T.C. 54, 70-71 (2003); *Estate of Marine v. Commissioner*, 97 T.C. 368, 378-79 (1991), *aff'd*, 990 F.2d 136 (4th Cir. 1993).

Charitable deductions must be ascertainable at a decedent's date of death. *Ithaca Tr. Co. v. United States*, 279 U.S. 151, 154 (1929) (transfers to a charity must be "fixed in fact and capable of being stated in definite terms of money"); *Estate of Marine*, 97 T.C. at 375. Section 20.2055-2(b)(1), Estate Tax Regs., states:

> If, as of the date of a decedent's death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible.

Whether the Living Trust would get additional funds from the Irrevocable Trust to transfer to the Charitable Trust was not ascertainable at Moore's death but only after an audit by the Commissioner, followed by a determination that additional property should be included in Moore's estate, followed by either the successful defense of that position or the estate's acquiescence to his determinations. For the exception to apply, it would have to have been almost certain that the Commissioner would not only challenge, but also successfully challenge the value of the estate. We do not think that's a reasonable conclusion.

The estate likens its facts to those of *Estate of Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009), *aff'g* 130 T.C. 1 (2008), and *Estate of Petter v. Commissioner*, 653 F.3d 1012 (9th Cir. 2011), *aff'g* T.C. Memo. 2009-280. In *Estate of Christiansen v. Commissioner*, 586 F.3d at 1062-63, even though the amount of the property to be transferred was subject to change based on a formula clause, we allowed a charitable deduction because the transfer itself was not contingent on the happening of some event.

In *Estate of Petter*, a FLP was to distribute LLC units to the trusts that Ms. Petter had set up for each of her children. The trusts were to receive a specific number of units up to a set dollar amount, with any units over that set value going to charity. *Estate of Petter*, 653 F.3d at 1020. Since the value of these units was unknown (because it was based on the FMV of stock held by the FLP), *id*., if a subsequent audit by the Commissioner led to a revaluation of the units then some of those units that had already been transferred to trusts had to be retransferred to the charitable donee in accordance with the trust provisions, *id*. at 1019. As in *Estate of Christiansen*, value was at issue, but not whether there would be a transfer to the donee at all. *Estate of Petter*, 653 F.3d at 1018.

Article 5, section 2 of Moore's Irrevocable Trust does not say that the Living Trust will receive a transfer of assets of unknown value. It says that whether the Living Trust will even receive a transfer of assets is unknown - contingent on an examination by the Commissioner. This is unlike *Estate of Christiansen*, where we knew the charity would get a transfer of assets, just not the value, or *Estate of Petter*, where we knew the charity would get some transfer of value, just not how much. Here, we don't know if the charity would get any additional assets at all.

We, therefore, deny any charitable deduction for funds that might be transferred to the Charitable Trust under article 5, section 2 of the Irrevocable Trust.[23]

[23] As an alternate argument, the Commissioner contends that even if the article 5, section 2 clause is valid, the Irrevocable Trust lacks the assets to donate a sum large enough to eliminate the estate tax. We need not address that issue here.

III.B.3.i. Graev

Graev v. Commissioner[7021] involved a side letter in which the charity agreed to return the donation if the charitable deduction for a conservation easement was disallowed. The court held that the chance of disallowance was not so remote as to be negligible, so the existence of that reversionary interest disallowed the deduction, citing Reg. § 1.170A-1(e) for the principle that:

> no deduction for a charitable contribution that is subject to a condition (regardless of what the condition might be) is allowable, unless on the date of the contribution the possibility that a charity's interest in the contribution "would be defeated" is "negligible".

The Tax Court explained this standard:

> In prior cases, we have defined "so remote as to be negligible" as "a chance which persons generally would disregard as so highly improbable that it might be ignored with reasonable safety in undertaking a serious business transaction." *885 Inv. Co. v. Commissioner*, 95 T.C. 156, 161 (1990) (quoting *United States v. Dean*, 224 F.2d 26, 29 (1st Cir. 1955)). Stated differently, it is "a chance which every dictate of reason would justify an intelligent person in disregarding as so highly improbable and remote as to be lacking in reason and substance." *Briggs v. Commissioner*, 72 T.C. at 657. What is

[7021] 140 T.C. 377 (2013).

> determinative under the section 170 “remote” regulations is the possibility, after considering all the facts and circumstances, that NAT’s reception and retention of the easement and cash would be defeated.

The side later proved fatal to this:

> Informed by his accountants’ warning, Mr. Graev initially asked NAT about the possibility of a side letter from NAT that promised the return of contributions if deductions were disallowed. NAT eventually gave Mr. Graev such a letter on September 24, 2004. The mere fact that he required the side letter is strong evidence that, at the time of Mr. Graev’s contribution, the risk that his corresponding deductions might be disallowed could not be (and was not) “ignored with reasonable safety in undertaking a serious business transaction.” *885 Inv. Co. v. Commissioner*, 95 T.C. at 161.
>
> Mr. Graev was not alone in his assessment of the risk of disallowance. NAT considered it “standard Trust policy” to return a cash contribution to the extent a deduction therefor was disallowed by the IRS. In numerous instances NAT issued “comfort letters” assuring donors of this policy. The very essence of a comfort letter implies a non-negligible risk; and the author uses the letter to induce the recipient to enter into a transaction. In this case the risk was either partial or complete disallowance of Mr. Graev’s claimed charitable contribution deductions. NAT’s course of dealing confirms that the possibility that the IRS might disallow Mr. Graev’s deductions was not “so remote as to be negligible”. See 26 C.F.R. secs. 1.170A-1(e), 1.170A-7(a)(3), 1.170A-14(g)(3).

Among many other unsuccessful arguments, the taxpayers argued that the side letter “is a nullity and should be disregarded for tax purposes because it provides for the donor’s potential recovery of the contributions in the event of unwanted tax consequences,” relying on *Commissioner v. Procter*, 142 F.2d 824, 827-828 (4th Cir. 1944). After describing the Fourth Circuit’s opinion (see part III.B.3.o *Procter* and Other Cases), the Tax Court explained why *Procter* did not apply:

> The Court of Appeals for the Fourth Circuit held that the clause in Procter was “clearly a condition subsequent and void because contrary to public policy”, *id*., for three reasons:
>
> (1) Such a clause “has a tendency to discourage the collection of the tax by the public officials charged with its collection”, thereby discouraging efforts to collect the tax. *Id.*
>
> (2) “[T]he effect of the condition would be to obstruct the administration of justice by requiring the courts to pass upon a moot case”. *Id.*
>
> (3) “[T]he condition is to the effect that the final judgment of a court is to be held for naught because of the provision of an indenture necessarily before the court when the judgment is rendered.” *Id*. That is, a final judgment would cause the condition to be operative, but the condition should not be allowed to operate to undo the judgment, since the instrument containing the condition was before the court, and all matters pertaining thereto merged in the judgment. *Id*. at 827-828.
>
> None of these three reasons would apply to nullify NAT’s side letter:
>
> First, the conditions in NAT’s side letter would not discourage the collection of tax. This Opinion decides that the Graevs are not entitled to charitable contribution deductions

(and that there are therefore deficiencies in their income tax), and the return of the contributions to the Graevs would not at all undo or contradict that holding but would instead be consistent with that holding. In order for the condition in the side letter to be triggered, the deductions must be disallowed, and income tax will thereafter be owing whether or not the contribution is returned.

Second, the possibility of the subsequent return of the contributions does not render this case moot. The Graevs claimed deductions; the IRS disallowed them and determined deficiencies of tax; the Graevs challenged that determination, and we must decide the matter. If we had upheld the deductions, the condition in the side letter would never have been met, the gift would be complete, the contribution would be deductible (assuming other qualifications are met), and we would enter decision in favor of the Graevs to overturn the IRS's deficiency determination. Because instead we disallow the deductions and enter decision in the IRS's favor, upholding the deficiency determination, the condition in the side letter is triggered and the gift presumably reverts to the donor. However, in this case, unlike *Procter*, the reversion to the donor would not be inconsistent with the court's holding—i.e., the tax collector in our case, unlike *Procter*, would collect the tax consistent with the judgment even if the condition become operative and the gift were returned to the donor.

Third, although the final judgment in the IRS's favor would cause the side letter to be operative, the return of the contribution pursuant to the side letter would not operate to undo the judgment, as was the case in *Procter*. The return would have no effect on the Graevs' tax liabilities.

Other cases have similarly distinguished *Procter* and have held that certain tax contingency provisions are not void as against public policy. See *Estate of Christiansen v. Commissioner*, 130 T.C. 1, 8 n.7, 17-18 (2008) (a clause that "increases the amount donated to charity should the value of the estate be increased", "would not make us opine on a moot issue [i.e., the value of the estate], and wouldn't in any way upset the finality of our decision in this case"), *aff'd*, 586 F.3d 1061 (8th Cir. 2009); *Estate of Dickinson v. Commissioner*, 63 T.C. 771, 777 (1975) (stating that the "agreement makes no attempt to nullify … [the Court's] determination" (citing *Surface Combustion Corp. v. Commissioner*, 9 T.C. 631, and *O'Brien v. Commissioner*, 46 T.C. 583)); *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280 ("a judgment adjusting the value of each unit will actually trigger a reallocation of the number of units between the trusts and the foundation under the formula clause. So we are not issuing a merely declaratory judgment"), *aff'd*, 653 F.3d 1012 (9th Cir. 2011).

III.B.3.j. Wandry

Wandry v. Commissioner[7022] approved a defined value gift of LLC interests, rejecting the IRS' usual arguments:

> I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows:

[7022] T.C. Memo. 2012-88.

Name	Gift Amount
Kenneth D. Wandry	$261,000
Cynthia A. Wandry	261,000
Jason K. Wandry	261,000
Jared S. Wandry	261,000
Grandchild A	11,000
Grandchild B	11,000
Grandchild C	11,000
Grandchild D	11,000
Grandchild E	11,000
	1,099,000

> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.

After filing a notice of appeal and then dropping its appeal, the IRS nonacquiesced in *Wandry*, viewing the adjustment as a reversion that occurred after the date of the gift.[7023] The nonacquiescence might be viewed as an implicit acquiescence in *Petter*.[7024]

[7023] AOD 2012-004 asserted that the initially estimated amount of the gift was a completed gift of that amount, reasoning:

> In determining the scope of the transfer, the Tax Court dismissed the entries on the LLC's books and records, the entries on the taxpayers' gift tax returns, and the entries on the LLC's subsequent income tax returns, finding that the instrument of transfer best described the gifts. Based on the LLC's books and records, the gift tax returns, and the LLC's income tax returns, however, it is undisputed that on the date of the gift, each taxpayer transferred a 2.39 percent interest to each donee, subject to a return of a portion of that interest in the event of a final determination of a greater value . The final determination of value for federal gift tax purposes is an occurrence beyond the taxpayers' control. Thus, on the date of the gift the taxpayers relinquished all dominion and control over the fixed percentage interests. The fact that the contingency occurred, and that the taxpayers are now entitled to a return of a portion of the interests, does not change this fact. See Treas. Reg. § 25.2511-2(b)…. Accordingly, the Tax Court erred in determining that the property transferred for federal gift tax purposes was anything other than the fixed percentage membership interest, *i.e.*, a 2.39 percent interest, transferred on the date of the gift to each donee.

[7024] See part III.B.3.m. AOD 2012-004 reasoned:

> *Estate of Petter v. Commissioner*, *supra*, is not to the contrary. In *Petter*, there was no possibility that the transferred property would return to the donor, and thus, the court had no need to consider the extent to which the gift was complete.

III.B.3.k. *Hendrix*

Hendrix v. Commissioner,[7025] was similar to *McCord*[7026] with respect to having a formula division between charitable and noncharitable donees, and the Tax Court followed the Fifth Circuit's holding.

III.B.3.l. *Christiansen*

Estate of Helen Christiansen v. Commissioner,[7027] affirming a unanimous decision of the Tax Court, approved a formula disclaimer based on fixed dollar values, with the residue passing to other beneficiaries based on values as finally determined for estate tax purposes. See part III.B.3.e Disclaimers.

The reasoning would also apply to defined value clauses. The case is strongest when those who benefit from an increase in value have interests adverse to those who benefit from a decrease in value. The presence of a charity was helpful in this case, but that didn't necessarily decide the outcome - it simply rebuffed one of the IRS' complaints about the effect of the holding.

The Tax Court, in a unanimous reviewed opinion,[7028] had held that a partial disclaimer was valid at least as to an amount that subsequently passed to a foundation that Helen Christiansen ("Christiansen") named as a contingent beneficiary in her will. The Tax Court also held that Christiansen's estate was entitled to a charitable deduction for this amount.

Christiansen's only child, who was also the executor of Christiansen's estate, disclaimed her interest in the estate "as finally determined for federal estate tax purposes" as to all amounts over $6.35 million. The disclaimer read:[7029]

> A. Partial Disclaimer of the Gift: Intending to disclaim a fractional portion of the Gift, Christine Christiansen Hamilton hereby disclaims that portion of the Gift determined by reference to a fraction, the numerator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, less Six Million Three Hundred Fifty Thousand and No/100 Dollars ($6,350,000.00) and the denominator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001 ("the Disclaimed Portion"). For purposes of this paragraph, the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, shall be the price at which the Gift (before payment of debts, expenses and taxes) would have changed hands on April 17, 2001, between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts for purposes of Chapter 11 of the [Internal Revenue] Code, as such value is finally determined for federal estate tax purposes.

[7025] T.C. Memo. 2011-133.
[7026] See part III.B.3.n McCord (2003, 2006).
[7027] 586 F.3d 1061 (8th Cir. 2009).
[7028] 130 T.C. 1 (2008).
[7029] 130 T.C. at 5.

Christiansen's will provided that 25% of any disclaimed amounts were to go to a charitable foundation. The IRS challenged both the validity of the disclaimer and the amount reported as the estate's overall value.

The parties eventually settled regarding a substantially increased valuation for the estate based largely on adjustments to marketability discounts the estate had claimed for limited partnership interests in a family ranching enterprise. This resulted in a corresponding increase in the valuation of the contribution to the charitable foundation. However, the IRS denied the estate an increased charitable deduction. The IRS argued that the act of challenging the estate's return and the resulting adjustment to the estate's value served as post-death, post-disclaimer contingencies that disqualified the disclaimer under Code § 2518 and Reg. § 20.2055-2(b)(1). The estate appealed to the Tax Court, and the Tax Court rejected the IRS' arguments.

On appeal to the Eighth Circuit, the IRS argued two points:

1. Because the overall value of the estate was not finally determined at the time of death, but only after the Commissioner's partially successful challenge, the transfer to the foundation was, ultimately, "dependent upon the performance of some act or the happening of a precedent event," violating Reg. § 20.2055-2(b)(1). The IRS claimed that the challenge mounted against the estate's initial return and the ultimate process of settling the estate's value constituted the purported "precedent event" or contingency.

2. The IRS asserted policy concerns related to the incentives and disincentives that exist regarding the decision to conduct audits in any given case. In particular, the IRS argued that the Eighth Circuit should disallow fractional disclaimers that have a practical effect of disclaiming all amounts above a fixed-dollar amount. The IRS maintained that such disclaimers fail to preserve a financial incentive for it to audit an estate's return. With such a disclaimer, any post-challenge adjustment to the value of an estate could consist entirely of an increased charitable donation. Because this scenario would provide no possibility of enhanced tax receipts as an incentive for the IRS to audit the return and ensure accurate valuation of the estate, the IRS argued such disclaimers should be categorically disqualified as against public policy.

Regarding the first argument, the court rejected the IRS' interpretation of Reg. § 20.2055-2(b)(1). The court held that the regulation is clear and unambiguous and it does not speak in terms of the existence or finality of an accounting valuation at the date of death or disclaimer; rather, it speaks in terms of the existence of a transfer at the date of death. The court quoted Reg. § 20.2055-2(b)(1): "If, as of the date of a decedent's death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible." It also pointed out that Code § 2518(a) provides that a qualifying disclaimer relates back to the time of death by allowing disclaimed amounts to pass as though the initial transfer had never occurred, which was consistent with applicable state law. The court held that all that remained uncertain following the disclaimer was the valuation of the estate, and therefore, the value of the charitable donation; the foundation's right to receive 25% of those amounts in excess of $6.35 million was certain.

The court criticized the IRS for failing to distinguish between events that occur post-death that change the actual value of an asset or estate and events that occur post-death that are merely part of the legal or accounting process of determining value at the time of death. The IRS cited several cases in which courts disallowed deductions because future contingent events might have defeated a transfer or a charitable contribution, but the court pointed out that, in each cited case, the actual contingencies under scrutiny were outside the legal or accounting process of determining a date-of-death value for the estate or an asset. The court pointed out that none of the cited cases stands for the proposition that deductions are to be disallowed if valuations involve lengthy or disputed appraisal efforts or if the IRS actions in challenging a return result in determination of an adjusted value. The court agreed with the Tax Court's statement:

> That the estate and the IRS bickered about the value of the property being transferred doesn't mean the transfer itself was contingent in the sense of dependent for its existence on a future event. Resolution of a dispute about the fair market value of assets on the date Christiansen died depends only on a settlement or final adjudication of a dispute about the past, not the happening of some event in the future.

The court pointed out that, in a different subsection of the regulation, Treasury recognizes that references to values "as finally determined for Federal estate tax purposes" are sufficiently certain to be considered "determinable" for purposes of qualifying as a guaranteed annuity interest. Reg. § 20.2055-2(e)(2)(vi)(a). In doing so, Treasury expressly uses the above-quoted language to distinguish fixed determinable amounts from fluctuating formulas that depend upon future conditions for their determination. The regulation provides:

> An amount is determinable if the exact amount which must be paid under the conditions specified in the instrument of transfer can be ascertained as of the appropriate valuation date. For example, the amount to be paid may be a stated sum for a term of years, or for the life of the decedent's spouse, at the expiration of which it may be changed by a specified amount, but *it may not be redetermined by reference to a fluctuating index such as the cost of living index*. In further illustration, the amount to be paid may be expressed in terms *of a fraction or a percentage of the net fair market value, as finally determined for Federal estate tax purposes*, of the residue of the estate on the appropriate valuation date, or it may be expressed in terms of a fraction or percentage of the cost of living index on the appropriate valuation date.

Id. (Emphasis added by the court). The court held that references to value "as finally determined for estate tax purposes" are not references that are dependent upon post-death contingencies that might disqualify a disclaimer. Because the only uncertainty in this case was the calculation of value to be placed on a right to receive 25% of the estate in excess of $6.35 million, and because no post-death events outside the context of the valuation process are alleged as post-death contingencies, the court held that the disclaimer was a "qualified disclaimer" under Code § 2518(a). The court strongly rejected the IRS' assertion that its challenge to the estate's return and the ultimate valuation process and settlement are the type of post-death events that may disqualify a partial disclaimer.

The court then addressed the IRS' second argument. It agreed with the IRS that the Tax Court's ruling in this case may marginally detract from the incentive to audit estate returns. The court accepted the possibility that in some hypothetical case involving a fixed-dollar-amount partial disclaimer, a post-challenge correction to an estate's value could result in a charitable deduction equal to the increase in the estate, resulting in no increased estate tax (which was not the case here, but the court said that it would not have changed the result). The IRS argued that a policy supporting audits as a means to enforce accurate reporting requirements mandates that the court disallow fixed-dollar-amount partial disclaimers because of the potential moral hazard or untoward incentive they create for executors to undervalue estates.

For several reasons, the court rejected the IRS' demand that it interpret the statute and regulations in an effort to maximize the incentive to audit:

a. The court noted that the IRS' role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws, citing Code §§ 7801(a)(1), 7803(a)(2).

b. The court found no evidence of a clear Congressional intent suggesting a policy to maximize incentives for the Commissioner to challenge or audit returns. The court found Congress' relevant policy to be to encourage charitable donations by allowing deductions for such donations and held that allowing fixed-dollar-amount partial disclaimers supports this broad policy.

c. The court placed weight on the fact that, even if it were to find a general congressional intent regarding a need to maximize the incentive-to-audit, no corresponding rule of construction would be necessary in the present context to promote accurate reporting of estate values. The IRS' policy argument assumed that executors and administrators will purposefully undervalue assets in order to take advantage of his marginally decreased incentive to audit. In this case, executors must accurately report estate values, not only because of general state law fiduciary duties but also because and state and federal laws impose financial liability or, in some circumstances criminal sanctions, upon false statements, fraud, and knowing misrepresentations.

d. Finally, the court pointed out, with a fixed-dollar-amount partial disclaimer, the contingent beneficiaries taking the disclaimed property have an interest in ensuring that the executor does not under-report the estate's value. Thus, the contingent beneficiaries have an interest in serving a watchdog function, which is aligned with the IRS' interest in ensuring accurate reporting of estate values. Furthermore, the daughter was not only the primary beneficiary who made the contested partial disclaimer, she was also the executor of the estate and a board member for the charity that benefitted from the disclaimer. Because she owed a fiduciary obligation to both the estate and the foundation, any self-dealing in this instance would clearly violate her general state law fiduciary obligation to put the charity's interests above her own and possibly also violate state and federal statutory prohibitions on certain forms of self-dealing. The court held that, in general and on the specific facts of the present case, sufficient mechanisms were in place to promote and police the accurate reporting of estate values beyond just the threat of IRS audit, thereby undercutting the IRS' policy-based argument.

Although the Eighth Circuit had more sympathy for the taxpayer because charity was involved, the court emphasized that it rejected the IRS' policy for broader policy reasons. This was a big taxpayer win as to the foundation.

However, the Tax Court did not respect a disclaimer of the primary beneficiary's interest in a trust, because the beneficiary did not disclaim her contingent remainder interest. Over a lone dissent, the court rejected the disclaimer's savings clause, in which the beneficiary "hereby takes such actions to the extent necessary to make the disclaimer set forth above a qualified disclaimer." The court held:[7030]

> Such contingent clauses—contingent because they depend for their effectiveness on a condition subsequent—are as ineffective as disclaimers as they are for revocable spousal interests, see *Estate of Focardi v. Commissioner*, T.C. Memo. 2006-56, and gift adjustment agreements, see *Ward v. Commissioner*, 87 T.C. 78, 110-11 (1986).

For more about *Ward*, see the text following fn. 7042 in part III.B.3.o *Procter* and Other Cases.

III.B.3.m. *Petter*

In *Estate of Petter v. Commissioner*,[7031] the donor (Anne) inherited a large amount of valuable stock and set up an LLC to hold it. She divided ownership of the company among herself, trusts for her children's benefit, and charities, using the following formula gift:

> 1.1 Transferor …
>
> 1.1.1 assigns to the Trust as a gift the number of Units described in Recital C above that equals one-half the minimum[7032] dollar amount that can pass free of federal gift tax by reason of Transferor's applicable exclusion amount allowed by Code Section 2010(c). Transferor currently understands her unused applicable exclusion amount to be $907,820, so that the amount of this gift should be $453,910; and
>
> 1.1.2 assigns to The Seattle Foundation as a gift to the A.Y. Petter Family Advised Fund of The Seattle Foundation the difference between the total number of Units described in Recital C above and the number of Units assigned to the Trust in Section 1.1.1.
>
> 1.2
>
> The Trust agrees that, if the value of the Units it initially receives is finally determined for federal gift tax purposes to exceed the amount described in Section 1.1.1, Trustee will,

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[7030] 130 T.C. at 13-14. In denying the use of a savings clause to qualify a conservation easement for a charitable deduction, *Palmolive Building Investors v. Commissioner*, 149 T.C. No. 18 (10/10/2017) (a unanimous reviewed decision) reaffirmed its rejection of conditions subsequent, holding:

> We have previously held that the requirements of section 170 must be satisfied at the time of the gift. See *Kaufman II*, 136 T.C. at 309; *Mitchell v. Commissioner*, at *13-*14. Additionally, this Court and others have held that "[w]hen a savings clause provides that a future event alters the tax consequences of a conveyance, the savings clause imposes a condition subsequent and will not be enforced." *Belk v. Commissioner*, 774 F.3d 221, 229 (4th Cir. 2014), *aff'g* T.C. Memo. 2013-154; see also *Commissioner v. Procter*, 142 F.2d 824, 827 (4th Cir. 1944); *Estate of Christiansen v. Commissioner*, 130 T.C. 1, 13, (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009). The saving clause cannot retroactively modify the Deed to comply with section 170 and its regulations.

See part III.B.3.o *Procter* and Other Cases.

[7031] T.C. Memo. 2009-280 (Judge Holmes).

[7032] The court noted here:

> This is a typo. The intention of all the parties involved was to refer to the maximum amount that could pass free of gift tax. The Commissioner did not raise any problems that this language might cause, and we find it to have been a mere scrivener's error.

> on behalf of the Trust and as a condition of the gift to it, transfer the excess Units to The Seattle Foundation as soon as practicable.
>
> The Foundations similarly agree to return excess units to the trust if the value of the units is "finally determined for federal gift tax purposes" to be less than the amount described in section 1.1.1. Donna's documents are similar but substitute the Kitsap Community Foundation for the Seattle Foundation.

The formula sale included the following:

> 1.1 Transferor …
>
> 1.1.1 assigns and sells to the Trust the number of Units described in Recital C above that equals a value of $4,085,190 as finally determined for federal gift tax purposes; and
>
> 1.1.2 assigns to The Seattle Foundation as a gift to the A.Y. Petter Family Advised Fund of The Seattle Foundation the difference between the total number of Units described in Recital C above and the number of Units assigned and sold to the Trust in Section 1.1.1.
>
> 1.2
>
> The Trust agrees that, if the value of the Units it receives is finally determined to exceed $4,085,190, Trustee will, on behalf of the Trust and as a condition of the sale to it, transfer the excess Units to The Seattle Foundation as soon as practicable. Likewise, the Seattle Foundation agrees to transfer shares to the trust if the value is found to be lower than $4,085,190.

The court stated, "We have no doubt that behind these complex transactions lay Anne's simple intent to pass on as much as she could to her children and grandchildren without having to pay gift tax, and to give the rest to charities in her community."

In summarizing *Christiansen* and *McCord* (the latter discussed further below), the court said:

> A shorthand for this distinction is that savings clauses are void, but formula clauses are fine. But figuring out what kind of clause is involved in this case depends on understanding just what it was that Anne was giving away. She claims that she gave stock to her children equal in value to her unified credit and gave all the rest to charity. The Commissioner claims that she actually gave a particular number of shares to her children and should be taxed on the basis of their now-agreed value.

After giving various reasons for its decision, the court held:

> Again, we fail to see how Anne's gift to the trusts was not an "assignment of a … fraction of a certain value." Anne's initial gift to her children could have been expressed as a gift of the number of units equal to the lesser of 940 or the fraction with the numerator of $453,910 and the denominator of the value of a unit as finally determined for Federal tax purposes. Her gift to the foundations would then be expressed as 940 less the fraction where the numerator is $453,910 and the denominator is the value of a unit as finally determined for Federal tax purposes, or:
>
> 940 - 453,910 /(Value of a unit for tax purposes) = charitable gift

> The sales could be expressed in a similar mathematical formula. In fact, only the charities could take a gift of an "open ended amount;" the children's gifts and sales were capped at the dollar amounts set in the transfer documents. We are again unpersuaded. We refuse to hold against Anne simply because she chose to express her intended allocation of the gift in plain English, rather than the kind of mathematical formula outlined in regulations for other types of transfers.
>
> In summary, Anne's transfers, when evaluated at the time she made them, amounted to gifts of an aggregate and set number of units, to be divided at a later date based on appraised values. The formulas used to effect these transfers were not void as contrary to public policy, as there was no "severe and immediate" frustration of public policy as a result, and indeed no overarching public policy against these types of arrangements in the first place.

Thus, in addition to the Tax Court approving formula disclaimers in *Christiansen*, we now have a Tax Court case approving a formula sale. The approved formula sale included a condition subsequent - if the value of the property the buyer receives were finally determined to exceed the sale price, the trustee, on behalf of the trust and as a condition of the sale to it, would be required to transfer the excess property to the charity as soon as practicable.

III.B.3.n. *McCord* (2003, 2006)

In *McCord v. Commissioner* taxpayers prevailed in the Fifth Circuit[7033] after losing in the Tax Court in a reviewed opinion.[7034] *McCord* involved an assignment of limited partnership interests, which the Fifth Circuit described as:

> a sequentially structured "defined value clause":
>
> 1. First, to the Generation Skipping Tax Trusts ("GST trusts"), "a dollar amount of fair market value in interest of MIL equal to the dollar amount of Taxpayers' net remaining generation skipping tax exemption, reduced by the dollar value of any transfer tax obligation owed by these trusts by virtue of their assumption thereof.
>
> 2. Second, to the Sons $6,910,932.52 worth of fair market value in interest of MIL, reduced by the dollar value of (1) the interests in MIL given to the GST trusts, and (2) any transfer tax obligation owed by the Sons by virtue of their assumption thereof.
>
> 3. Third, to the Symphony, $134,000.00 worth of such in interest of MIL.
>
> 4. Last, to CFT,[7035] the dollar amount of the interests of the Taxpayers in MIL, if any, that remained after satisfying the gifts to the GST trusts, the Sons, and the Symphony.
>
> All gifts were complete on execution of the Assignment Agreement on January 12, 1996. No other agreements - written or oral, express or implied - were found to have existed between the Taxpayers and (1) the Sons, (2) the GST trusts, (3) the Symphony, or (4) CFT, as to what putative percentage interest in MIL belonged to, or might eventually be received by, any of the donees under the dollar-value formula clause. Rather,

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[7033] 461 F.3d 614 (2006).
[7034] 120 T.C. 358 (2003).
[7035] The court's abbreviation for the Community Foundation of Texas, Inc.

> because the interests donated by the Taxpayers to the GST trusts, the Sons, and the Symphony were expressed in dollars, "fair market value" is defined in the Assignment Agreement in terms of the applicable "willing-buyer/willing-seller" test specified in the applicable Treasury Regulation.[7036]

About one and one-half months after signing the assignment, an independent appraisal valued the interests, and then the parties entered into an agreement defining their rights based on that appraisal. The IRS attacked the transaction, and a majority of the Tax Court, rejecting the trial judge's view, found for the IRS. The Fifth Circuit upheld the plain language of the assignment.

Part of the formula language that the Tax Court had disallowed but to which the Fifth Circuit gave effect was the net gift treatment (reducing the value of a gift by any liabilities assumed by the donee) of the transferees' agreement to pay any estate tax on gift tax brought back into the donor's estate with respect to gifts made within three years before death.[7037] In a 2013 reviewed decision, the Tax Court reversed its position on this net gift treatment, so that the net gift should work in all jurisdictions.[7038] Although unpaid gift taxes on gifts made by a decedent are deductible,[7039] the donee's agreement to pay the gift tax makes the gift tax nondeductible for estate tax purposes.[7040]

III.B.3.o. ***Procter* and Other Cases**

The IRS has been trying to use its victory in *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), *cert. denied,* 323 U.S. 756 (144), reversing a Tax Court Memorandum Opinion dated July 6, 1943 (1943 WL 9169). The Fourth Circuit was disturbed by:

> the following provision of the trust indenture making the gift, viz.:
>
> > Eleventh: The settlor is advised by counsel and satisfied that the present transfer is not subject to Federal gift tax. However, in the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property hereby transferred which is decreed by such court to be subject to gift tax, shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from the trust hereby created.
>
> We do not think that the gift tax can be avoided by any such device as this. Taxpayer has made a present gift of a future interest in property. He attempts to provide that, if a federal court of last resort shall hold the gift subject to gift tax, it shall be void as to such part of the property given as is subject to the tax. This is clearly a condition subsequent and void because contrary to public policy. A contrary holding would mean that upon a decision that the gift was subject to tax, the court making such decision must hold it not a gift and therefore not subject to tax. Such holding, however, being made in a tax suit to which the donees of the property are not parties, would not be binding upon them and they might later enforce the gift notwithstanding the decision of the Tax Court. It is

[7036] Citing Reg. § 25.2512-1.
[7037] Code § 2035(b).
[7038] *Steinberg v. Commissioner*, 141 T.C. 258.
[7039] Reg. § 20.2053-6(d).
[7040] *Estate of Sommers v. Commissioner*, 149 T.C. No. 8 (2017).

manifest that a condition which involves this sort of trifling with the judicial process cannot be sustained.

The condition is contrary to public policy for three reasons: In the first place, it has a tendency to discourage the collection of the tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax would be to defeat the gift. In the second place, the effect of the condition would be to obstruct the administration of justice by requiring the courts to pass upon a moot case. If the condition were valid and the gift were held subject to tax, the only effect of the holding would be to defeat the gift so that it would not be subject to tax. The donor would thus secure the opinion of the court as to the taxability of the gift, when there would be before the court no controversy whatever with the taxing authorities which the court could decide, the only possible controversy being as to the validity of the gift and being between the donor and persons not before the court. *Cf. Lord v. Veazie*, 8 How. 251, 12 L.Ed. 1067; *Van Horn v. Kittitas County, C.C*., 112 F. 1. As was well said by Chief Justice Taney *in Lord v. Veazie*, *supra* [8 How. 255, 12 L.Ed. 1067]:

> It is the office of courts of justice to decide the rights of persons and of property, when the persons interested cannot adjust them by agreement between themselves,—and to do this upon the full hearing of both parties. And any attempt, by a mere colorable dispute, to obtain the opinion of the court upon a question of law which a party desires to know for his own interest or his own purposes, when there is no real and substantial controversy between those who appear as adverse parties to the suit, is an abuse which courts of justice have always reprehended, and treated as a punishable contempt of court.

In the third place the condition is to the effect that the final judgment of a court is to be held for naught because of the provision of an indenture necessarily before the court when the judgment is rendered. It should be remembered that it is not possible to obtain a declaratory judgment from a federal court as to whether the gift in question is subject to the gift tax. 28 U.S.C.A. § 400; *Wilson v. Wilson*, 4 Cir., 141 F.2d 599. The only way, therefore, in which it could be determined by "final judgment" of a federal court of last resort that any part of a transfer was subject to a gift tax would be for a tax to be assessed by the Commissioner and upheld by such court in the course of legal proceedings instituted for its enforcement or for its recovery after payment. This final judgment would fix the liability of the donor for the tax; and only then could the condition become operative. The condition, [pg. 754] however, could not be given the effect of invalidating a judgment which had been rendered when the instrument containing the condition was before the court, since all matters are merged in the judgment. To state the matter differently, the condition is not to become operative until there has been a judgment; but after the judgment has been rendered it cannot become operative because the matter involved is concluded by the judgment.

The IRS' view of *Procter* is enshrined in Rev. Rul. 86-41:[7041]

Situation 1.

In 1982, A transferred an interest in a tract of income producing real property to B. Under the deed of transfer, B received a one-half undivided interest in the tract. However, the

[7041] Situation 2 is referred in fn. 7015, which is found in part III.B.3.e Disclaimers.

deed further provided that if the one-half interest received by B were ever determined by the Internal Revenue Service to have a value for federal gift tax purposes in excess of $10,000, then B's fractional interest would be reduced so that its value equaled $10,000. Under local law the adjustment clause operated as a condition subsequent. Thus, if the Service determined that a gift was made in excess of $10,000, the adjustment clause would effectively reconvey to A a fractional share of the tract of real property sufficient to reduce the value of B's interest to $10,000 as of the date of the gift.

On A's federal gift tax return, A reported that the fair market value of the one-half interest transferred by gift to B was $10,000 (one-half the value of the entire tract), and applied the annual exclusion against the gift. On examination of A's 1982 federal gift tax return, it was determined that the fair market value of a one-half interest in the tract subject to the transfer to B was $15,000 rather than $10,000.

Situation 2.

The facts are the same as in Situation 1, except that B was not required to reconvey any property to A. Rather, the transfer contained the condition that if the Internal Revenue Service determined that B received a gift in excess of $10,000, B would transfer to A consideration equal to the amount of the excess.

The IRS held:

In *Situations 1 and 2*, the facts demonstrate that A intended to make a gift to B of a present one-half interest in the property. In both cases, the purpose of the adjustment clause was not to preserve or implement the original, bona fide intent of the parties, as in the case of a clause requiring a purchase price adjustment based on an appraisal by an independent third party retained for that purpose. Rather, the purpose of the clause was to recharacterize the nature of the transaction in the event of a future adjustment to A's gift tax return by the Service. As in Rev. Rul. 65-144, the terms of the deed of transfer to B providing for the reduction of the portion transferred would tend to discourage the examination of returns and the collections of tax and therefore are ineffective for federal gift tax purposes. Because the reduction provision is ineffective for federal gift tax purposes, A has made a gift of a present one-half interest in the property, the first $10,000 of which qualifies for the annual exclusion under section 2503 of the Code. The value of the gift is $15,000, the fair market value of a one-half interest in the tract as determined on examination. The fact that, in *Situation 2*, the adjustment of the gift was to be made by recharacterizing the transfer as a part-gift/part-sale is irrelevant…..

In both *Situations 1* and *2,* if the donor transfers a specified portion of real property under terms that provide for a recharacterization of the transaction depending on the Service's valuation of the property for federal gift tax purposes, the adjustment clause will be disregarded for federal tax purposes. Consequently, in both cases the value of the gift will be determined without regard to the adjustment clause and the first $10,000 in the value of the gift, as so determined, will qualify for the annual exclusion from gift tax.

In *Ward v. Commissioner,*[7042] the Tax Court rejected the following clause as void as against public policy:

> 2. Future Adjustment. Each party hereto agrees that if it should be finally determined for Federal gift tax purposes that the fair market value of each share of capital stock of the Corporation exceeds or is less [pg. 88] than $2,000.00 an adjustment will be made in the number of shares constituting each gift so that each Donor will give to each Donee the maximum number of full shares of capital stock of the Corporation, the total value of which will be $50,000.00 from each Donor to each Donee and a total of $150,000 from each Donor to all Donees. Any adjustment so made which results in an increase or decrease in the number of shares held by a stockholder of the Corporation will be made effective as of the same date as this Agreement, and any dividends paid thereafter shall be recomputed and reimbursed as necessary to give effect to the intent of this Agreement.

The court held:[7043]

> [T]he agreement here purports to retroactively alter the amount of an otherwise completed gift. Furthermore, since there is no assurance that the petitioners will either recover the excess shares or, at the time of their deaths, possess the power to recover such shares, and since the shares are not worthless, the petitioners' estates may be reduced by the transfer of the shares. See *Harwood v. Commissioner*, 82 T.C. at 275 n. 28.
>
> Accordingly, we conclude that the gift adjustment clause involved here is void as contrary to public policy and has no effect on the gift taxes otherwise due on the gifts of stock to the petitioners' sons.

For the continued viability of *Ward*, see part III.B.3.l *Christiansen*, text accompanying fn. 7030.

Estate of Dickinson, Jr. v. Commissioner[7044] involved the following corporate agreement entered into in 1961:

> 1. (a) Dickinson for himself, his heirs, executors and administrators agrees that his estate shall sell to the Company and the Company agrees that it will purchase from said estate a number of shares of the Company's stock which shall be the lesser of the following two numbers of shares: either (i) 8795 shares of the Company's stock owned by Dickinson at the date of this agreement, or (ii) the number of shares whose total price computed in accordance with paragraph 3 below shall have a total equal to the sum of the estate, inheritance and succession taxes (including any interest collected as part of such taxes) imposed because of the death of Dickinson. ***
>
> 2. Dickinson agrees that during his lifetime he will not, by sale or other disposition, reduce the number of shares of the Company's stock held by him below 8795 shares.

[7042] 87 T.C. 78 (1986).
[7043] For the clause that *Harwood* (cited in the quote below) struck down, see the text accompanying fn. 7019 in part III.B.3.e Disclaimers.
[7044] 63 T.C. 771 (1975).

> 3. The price per share to be paid by the Company for the shares which it is obligated to purchase from Dickinson's estate shall be the sum of the following items taken from the Company's balance sheet—(a) Reserve for Replacement and Advertising, (b) Employees' Pension and Contingency Reserve, (c) Common Stock, (d) Capital Surplus, (e) Earned Surplus—divided by the number of shares of stock of the Company outstanding at the date of said balance sheet. The balance sheet to be used in computing the price per share, in accordance with this paragraph 3, shall be that set forth in the Company's Federal Corporation Income Tax Return (Treasury Form 1120, Schedule L or such equivalent schedule as may hereafter be required by law) for the end of the taxable period ending next prior to the death of Dickinson.

In the course of estate administration, the parties entered into the following agreement:

> Whereas, *** [Mr. Dickinson] is irrevocably bound by an Agreement between him and *** [the company] dated June 29th, 1961, so that his executors will be required to sell to the Company a number of shares of stock in the Company as provided in paragraph 1(a) of *** [the 1961] Agreement at a specified price as provided in paragraph 3 of *** [the 1961] Agreement, and *** [Mr. Dickinson] is precluded by *** [the 1961] Agreement from selling such shares to others during his lifetime; and ***
>
> Whereas, *** [Mrs. Dickinson, E. E. Dickinson III, and Alan Page Dickinson] hold all of the common stock in the Company not held by *** [Mr. Dickinson] and desire that *** [the 1961] Agreement remain in full force and effect;
>
> Now Therefore:
>
> In consideration of the foregoing and of the sum of One (1) Dollar and other good and valuable considerations, the parties hereto do hereby agree as follows:
>
> 1. (a) In the event that the Internal Revenue Service should take an action which would disregard for estate tax valuation purposes the price for said shares as provided in paragraph 3 of *** [the 1961] Agreement or take an action which would in effect deny the benefits of Section 303[7045] and thereby be contradictory to the intentions of Congress in enacting this section governing the redemption of stock to pay death taxes, the personal representatives of *** [Mr. Dickinson] may, if they in their sole discretion deem such action by the Internal Revenue Service to threaten a damaging result either to the estate, heirs, devisees and legatees of *** [Mr. Dickinson], or to the remaining stockholders of the Company, request to be relieved of the estate's obligation to sell said stock pursuant to *** [the 1961] agreement, and *** [Mrs. Dickinson, E. E. Dickinson III, and Alan Page Dickinson] agree for themselves, their heirs, executors, administrators and assigns, that upon receipt of such request they will whether acting as stockholders and/or directors of the Company cause the Company to release the estate of *** [Mr. Dickinson] from such obligations as it may have under *** [the 1961] Agreement.

The court held:

> There is no doubt about what Mr. Dickinson wished to happen and about what has in fact taken place. After having made the 1961 agreement, apparently he became

[7045] [my footnote:] Code § 303 is explained in part II.Q.7.a.iv.(a) Actual Payments, which is within part II.Q.7.a.iv Dividends; Avoiding Dividend Treatment Using Redemptions under Code §§ 302 and 303.

concerned about its tax consequences and sought the advice of his counsel. The counsel advised him that the “buy-sell” agreement might not be effective for purposes of determining the value of the stock subjected to taxation. He was also advised that if the 1961 agreement were not modified, the estate might encounter the very situation which now exists—namely, the Commissioner would take the position that the fair market value of the stock should be used for valuation purposes, but that the agreement should be applied for purposes of administering the estate. To avoid such paradoxical results, Mr. Dickinson and his family made the 1962 agreement, which was designed to enable his family to set aside the 1961 agreement for all purposes, if the Commissioner sought to set it aside for valuation purposes. Since the Commissioner has adopted the anticipated position as to the valuation of the stock, the family has carried out Mr. Dickinson’s wishes and set the 1961 agreement aside for all purposes. Thus, we have a situation in which the “buy-sell” agreement has been duly set aside, and it should have no effect in administering the estate, unless we hold that it is to be given effect notwithstanding the efforts to terminate it.

In our judgment, there are no reasons for refusing to give effect to the 1962 agreement and the actions taken pursuant thereto. See *Estate of Arthur H. Hull,* 38 T.C. 512 (1962), reversed on another issue 325 F.2d 367 (C.A. 3, 1963); *Estate of Mary Redding Shedd,* 37 T.C. 394 (1961), *aff’d* 320 F.2d 638 (C.A. 9, 1963); cf. *Welch v. Hall,* 134 F.2d 366 (C.A. 1, 1943); compare *William H. Board,* 14 T.C. 322 (1950). The Commissioner relies upon *Commissioner v. Procter,* 142 F.2d 824 (C.A. 4, 1944), reversing and remanding a Memorandum Opinion of this Court, certiorari denied 323 U.S. 756 (1944), in which the grantor of a trust provided that if one of the gifts was held by a court to be subject to the gift tax, the gift was to be revoked. The court held that such a clause was void because it would tend to discourage administrative action and would cause a judicial decision to become a mere nullity. However, the rationale of *Procter* is not applicable to the facts of the case before us. In this case, the Commissioner has taken the position that the 1961 agreement should be disregarded for purposes of fixing the value of the stock subjected to taxation, and the estate has accepted that position. The 1962 agreement makes no attempt to nullify that determination; its only objective is to establish consistency in the administration of the estate. Mr. Dickinson recognized that if the stock was to be taxed on the basis of its fair market value, his estate plan would be distorted if the formula price was used for other purposes, and the only purpose of the 1962 agreement was to avoid such a distortion of his plan. That agreement was a reasonable and appropriate means of anticipating possible future adverse action by the Commissioner and avoiding its consequences. Such agreement is similar to those provisions which we have recognized in *Surface Combustion Corp.,* 9 T.C. 631 (1947), *aff’d* 181 F.2d 444 (C.A. 6, 1950), and *William D. O’Brien,* 46 T.C. 583 (1966).

Nor are we convinced by the Commissioner’s other objection to the 1962 agreement. Both parties agree that the 1961 and 1962 agreements have no effect on the value of the stock to be included in the estate. Once the 1962 agreement was made, there was no serious uncertainty about what would ultimately take place. One could be assured that the Commissioner would not accept the formula price for purposes of valuing the stock (section 20.2031-2(h), Estate Tax Regs.), and once he takes that action, it would set in motion proceedings under the 1962 agreement to set aside the 1961 agreement for all purposes. Thus, there was no genuine difficulty in determining the value of the interests that would pass under the will. Cf. *Estate of Inez G. Coleman,* 52 T.C. 921 (1969). Accordingly, we hold that the parties to the 1962 agreement have effectively terminated any obligations under the 1961 agreement and that the formula price has no effect in determining the amount of the estate which passes under the will and the value of the interests passing thereunder.

Readers are encouraged to reconcile the clauses described in the above cases and the reasoning set forth by the courts and the IRS.

III.B.3.p. Beneficiary Deemed-Owned Trust as an Alternative to Formula Sale

The beneficiary deemed-owned trusts discussed in part III.B.2.i, Code § 678 Beneficiary Deemed-Owned Trusts, generally include a broad non-general power of appointment exercisable at the beneficiary's death.

If a beneficiary makes a sale to such a trust, any resulting gift is likely to be an incomplete gift and therefore protected from gift tax. However, that portion would be subject to estate tax.

If one wants to a do a formula sale to a beneficiary deemed-owned trust, consider making part of the transfer a completed gift to another transferee.[7046] Consider whether the formula clause might refer to value as finally determined for "transfer tax" purposes, instead of "gift tax" purposes, so that estate tax finality would work if the gift tax statute of limitations does not run.

III.B.3.q. Settlement of *Sorensen* (*Wandry* Clause) (2022)

"Estate Planning Current Developments and Hot Topics," by Steve R. Akers, Ronald D. Aucutt, and Kerri G. Nipp of Bessemer Trust, Dallas, Texas, for ALI's Estate Planning for the Family Business Owner 2023 (10/6/2023), included item 13:

> ***Wandry* Clause Gift Tax Case Settled, *Sorensen v. Commissioner*, T.C. Docket 24797-18, 24798-18, 20284-19, 20285-19 (Decision Entered Aug. 22, 2022)**
>
> a. **Basic Facts**. Chris and Robin Sorensen grew up in a firefighter family. Their father was a firefighter. They loved joining in communal meals at the firehouse, and Robin decided at a young age that one day he would open a restaurant. Eventually, the brothers scrounged $28,000 in loans from family members and in 1994 started a sandwich shop (because it required the least capital investment compared to other restaurants). They had only one employee and the family (parents, sisters, spouses, even children) volunteered to provide other labor for the restaurant. Their single sandwich shop eventually turned into a number of Firehouse Subs franchises across the country. Their motto: "Big picture, we love to cook, we love to serve people, we love the hospitality industry. We make sandwiches for a living."
>
> The company succeeded and grew substantially. By 2014, the company owned 27 restaurants, had 823 franchisees, and had over $550 million of sales system wide. In late 2014 they decided to make gifts to use their $5.34 million gift exclusion amounts for fear that the gift exclusion might be reduced in the future. On December 31, 2014, each brother created a grantor trust and made a gift to the trust of nonvoting shares of Firehouse stock having a value of $5,000,000 as finally determined for federal gift tax purposes. [Observation: This approach had been approved two years earlier in *Wandry*

[7046] See text accompanying fn. 7061, found in part III.B.4 Adequate Disclosure on Gift Tax Returns.

v. Commissioner, T.C. Memo. 2012-88.] They signed Irrevocable Stock Powers transferring

> [a] specific number of nonvoting shares in FIREHOUSE RESTAURANT GROUP, INC., a Florida corporation (the "Company"), that have a fair market value as finally determined for federal gift tax purposes equal to exactly $5,000,000. The precise number of shares transferred in accordance with the preceding sentence shall be determined based on all relevant information as of the date of transfer in accordance with a valuation report that will be prepared by the Dixon Hughes Goodman, LLP ("DHG"), Jacksonville, Florida, an independent third-party professional organization that is experienced in such matters and appropriately qualified to make such a determination. However, the determination of fair market value is subject to challenge by the Internal Revenue Service ("IRS"). While the parties intend to initially rely upon and be bound by the valuation report prepared by DHG, if the IRS challenges the valuation and a final determination of a different fair market value is made by the IRS or a court of law, the number shares [sic] transferred from the transferor to the transferee shall be adjusted accordingly so that the transferred shares have a value exactly equal to $5,000,000, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or court of law.

An appraisal valued the nonvoting shares at $532.79 per share as of December 31, 2014, and $5.0 million worth of shares was 9,384.56 shares. The attorney recommended transferring that amount exactly, but the parties rounded the number of initially transferred shares to 9,385, which represented about 30% of each brother's nonvoting shares. They later decided to transfer a total of up to about 50% of their shares, and on March 31, 2015, each brother sold to his respective trust 5,365 nonvoting shares in exchange for a $2,858,418 secured promissory note (using the $532.79 per share value in the appraisal as of December 31, 2014). (The sales were not *Wandry* defined value transfers.)

The 2014 gift tax returns reported the defined value formula transfers, described the number of shares determined to have a value of $5.0 million based on an appraisal (attached on one brother's gift tax return but not on the other brother's return), and further explained:

> Therefore based on the formula set forth above and the value as determined by the Valuation Report, the donor transferred 9,385 non-voting shares in Firehouses stock … with a value equal to $5,000,000, and the precise number of shares transferred cannot be finally determined until the value of such shares are finally determined for federal gift tax purposes.

The 2015 gift tax returns did not report the sale of shares in 2015 as a non-gift transaction.

In a gift tax audit, the IRS's expert appraised the shares at $1,923.56/share, later adjusted to $2,076.86/share. The Notices of Deficiency were confusing because of confusion by the IRS as to how many shares had been transferred in 2014 and 2015, but the amount of gift tax ultimately in dispute for each brother (according to their pretrial memorandum) was about $8.95 million for 2014 and $4.62 million for 2015, totaling about $13.57 million. In addition, penalties in dispute for each brother were about $3.58 million for 2014 and $1.85 million for 2015, or a total of $5.43 million.

Jumping ahead seven years, the entire company was sold on November 15, 2021, for $1 billion cash, which was allocated among the shareholders. Each of the trusts received about $153 million.

b. **Issues**. Three issues were in contention. (1) Are the defined value formula gifts respected? At issue is whether the defined value approach approved in Wandry v. Commissioner, T.C. Memo. 2012-88 would be respected. (2) What is the appropriate fair market value of the shares on the dates of the 2014 gift and the 2015 sale? (3) Are penalties appropriate or should they be waived for reasonable cause?

c. **IRS Arguments for Refusing to Respect the Defined Value Transfers.**

(1) **The Donors Relinquished Dominion and Control of 9,385 Shares on 12/31/14.**

(a) **Facts Supporting.**

i. **Company Reporting**. The company reported that each trust owned 9,385 shares on its stock ledgers and on income tax returns. [***Planning Observation***: Include an "asterisked" explanation on the stock ledger and tax returns. Using "uncertificated shares" may facilitate this reporting.]

ii. **Distributions**. The trusts received pro rata distributions based on owning 9,385 shares. [***Planning Observation***: Document in company records that distributions are based on the initially determined amount of shares, which could be adjusted based on finally determined gift tax values, and that the brothers and their trusts will make appropriate adjustments between themselves if the shares are changed.]

[my comment: I build that into stock powers.]

iii. **No Agreement with Trusts**. The trusts never agreed to transfer shares based on the defined value formula and did not countersign the stock powers, which described the transfers as defined value formula transfers. [**Planning Observation**: Have the trusts countersign the stock powers to specifically acknowledge the conditions under which they are receiving the stock transfers.]

[my comment: I build that into stock powers.]

iv. **Third-Party Buyer**. The trusts transferred 9,385 shares each to the third-party purchaser, who paid the trusts for those shares. [Planning Observation: Have the buyer acknowledge that the ownership of shares is based on the defined value formula transfers, but that the trusts and donors agree that collectively they own the 9,385 shares and transfer them to the buyer; if adjustments are made in the ownership of the shares, the donors and trusts will adjust the sales proceeds appropriately but acknowledge that the buyer can pay the purchase price attributable to the 9,385 shares to the respective trusts.]

(b) **Cow Analogy**. The IRS's Pretrial Memorandum includes this analogy to a defined value gift of cows.

> Consider that if a farmer agrees to transfer his son [sic] several cows worth $1,000 as finally determined for federal gift tax purposes, and the farmer's appraiser determines that five cows equal that value, then the transfer is for five cows. The son is now the owner of five cows. Years pass. The son breeds the cows and opens a barbeque stand. If a later gift tax examination finds that each cow was actually worth more, and that two extra cows had been included in the transfer, **nothing in the agreement would allow the farmer to take the two cows back. They were sold as barbeque.** The parties might be held to their agreement - a transfer of the number of cows as finally determined to equal $1,000 coupled with the possibility of the farmer getting something (barbeque?) in the event of a redetermination of value. But whatever it is, it won't be the cows transferred. And it might be nothing; the farmer may not pursue his claim, and if he does, he is now just a general creditor who must stand in line with all the other unsecured creditors of the barbecue operation.
>
> The farmer's use of a transfer clause that contemplates subsequent events does not change the fact that the transfer of the five cows was complete on the execution of the documents. This is the case even though the number of cows was indefinite until the initial appraisal was completed. [Citations omitted.] The transfer was of five cows, regardless of whether the transfer is structured as a gift or a sale.
>
> Under the farmer's transfer document, however, a redetermination of the value of a cow might give rise to a right of recovery against the son. But a right that is dependent upon the occurrence of an event beyond the donor's control, such as a later redetermination of value by federal authorities or the courts, does not alter the fact that the transfer is complete for gift tax purposes upon the execution of the documents. [Citations omitted.] The possibility that the farmer might get something back does not change the fact that he transferred five cows upon the execution of the documents, regardless of whether the transfer is structured as a gift or a sale. (Emphasis added.)

[***Observation***: The IRS reportedly often uses this folksy analogy in audits involving *Wandry* transfers. The Fifth Circuit in *Nelson v. Commissioner*, 128 AFTR 2d 2021-6532, Cause No. 20-61068 (5th Cir. November 3, 2021), *aff'g*, T.C. Memo. 2020-81, referred to this analogy presented by the IRS in that case. The emphasis on not being able to adjust the transfer of cows because they have been turned into barbeque ignores that we are in a society with a monetary system and can make appropriate adjustments to determine that the proper value is transferred.]

(c) ***Procter* Argument**. The language in the stock power attempting to "adjust" the number of shares transferred is a condition subsequent and violates public policy, based on *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). That language precludes the IRS from enforcing the gift or making efforts to collect gift tax and precludes enforcing valuation misstatement penalties.

[my comment: see part III.B.3.o *Procter* and Other Cases]

The taxpayers reside in Florida so the case would be appealable to the Eleventh Circuit Court of Appeals. The IRS cited an Eleventh Circuit case that referred to Procter. *TOT Property Holdings, LLC v. Commissioner*, 1 F.4th 1354 (11th Cir. 2021) (language in a conservation easement deed purporting to bring the easement in compliance with regulations held to be an unenforceable savings clause; clause presented "the same sort of catch-22 situation that leads to the trifling with the judicial process").

The IRS distinguished formula allocation clauses in which the transferor clearly transferred all of a specific block of shares or interests, and the formula clause allocates the block between two recipients (and the transfer to one of those recipients would not result in a taxable gift). Those types of clauses have been approved in various cases (*Petter*, *Christiansen*, *McCord*, *Hendrix*). [***Planning Observation***: This argument by the IRS clearly suggests that those types of defined value clauses are more likely to be respected by the IRS.]

[my comment: see parts III.B.3.m *Petter*, III.B.3.l *Christiansen*, III.B.3.n *McCord* (2003, 2006), and III.B.3.k *Hendrix*.]

(2) ***Wandry* Was Wrongly Decided**. *Wandry* reasoned (referring to *Estate of Petter v. Commissioner*) that a savings clause is void because it creates a donor that tries to "take property back," but the transfer document in question reflected the intent to transfer "a predefined … percentage interest expressed through a formula" to each donee, and the transfer document does not allow taxpayers to "take property back," but only to correct the allocations. The IRS suggested several reasons why that analysis is faulty.

- The formula transfer created a condition subsequent that could not change the fact the gift was complete as of the date the donors gave up control of LLC units.

- The adjustment to capital accounts to reflect the values as finally determined for gift tax purposes was not merely an internal accounting adjustment as discussed in Wandry but affected each member's economics in the LLC.

- *Wandry* referred to competing interests, but unlike a situation involving a transfer to a third party, there are no real competing interests where the donor is gifting property to a spouse and/or children and both the donor and donee want to maximize the number of units transferred.

- The *Wandry* approach subverts Congressional intent regarding valuation misstatement penalties in gift tax matters. The court would not be deciding the amount of gift tax on property transferred but would just be determining the property that should be returned to the donor. In that scenario, there could never be a valuation misstatement penalty.

- The IRS's Pretrial Memorandum summarized its criticism of *Wandry*:

> The Wandry opinion improperly focused on the donors' intent rather than the donors' relinquishment of dominion and control over gifted property, as required by the statutes and regulations thereunder. Therefore, to the extent necessary to resolve this issue, this Court should find Wandry was wrongly decided, and petitioners owe additional gift tax to the extent that the value of 9,385 nonvoting shares of FRG exceeds petitioner's annual exclusions and lifetime exemption equivalents.

(3) **Facts Are Distinguishable from Wandry**. In Wandry, the court noted that the number of LLC units initially transferred was unclear from the record before the court. In

this case, specific shares were gifted and the benefits attributable to those shares were shifted.

Furthermore, unlike the donors in *Wandry*, the Sorensen donors failed to follow their own transfer clauses. Based on the appraised value, $5.0 million worth of shares would have been 9,384.56 shares, but (contrary to their attorney's advice) the donors for administrative simplicity rounded that to 9,385 shares, which resulted in transferring shares worth $5,000,234.15. Thus, the facts align more with *Knight v. Commissioner*, 115 T.C. 515-16 (2000) (in which the donors did not report the transfer as a formula transfer on the gift tax return) than with Wandry. [***Observation***: The IRS made this argument over $234.15 in a transfer of $5.0 million worth of hard-to-value assets. Really??]

A transfer of shares in an S corporation (by the Sorensens) is different than the transfer of units in an LLC in Wandry (where there is broader flexibility to determine the economic rights of members).

(4) **Other Arguments**. The IRS also argued that the shares transferred could not be adjusted because of the sale of all shares to a third party and because the taxpayers had stipulated that each brother had gifted 9,385 shares.

d. **Valuation**. The parties obviously had substantial differences in their valuations of the nonvoting shares. The experts used similar valuation approaches but applied significantly different risk adjustments and comparables. Also, the IRS disputed the use of "tax affecting" for valuing S corporation shares. [***Observation***: the IRS Pretrial Memorandum cited several cases that rejected tax affecting but did not cite the more recent *Estate of Jones v. Commissioner* case (T.C. Memo. 2019-101) that accepted a tax affecting analysis under the facts of that case.]

e. **Penalties**. The taxpayers argued that penalties should not apply because a three-prong test (described in *Neonatology Associates v. Commissioner*, 115 T.C. 43, 99 (2000), *aff'd*, (3rd Cir. 2002)) for the reasonable cause exception was satisfied: (1) the adviser was a professional with expertise to justify reliance, (2) the taxpayer provided accurate and necessary information to the adviser, and (3) the taxpayer actually relied on the adviser's judgment in good faith.

The IRS maintained that the valuation understatements were attributable to negligence and disregard of rules and regulations.

As to the 2014 gifts, the brothers knew they gifted 9,385 shares as shown by their reporting on 2015-2020 income tax returns, stock ledgers, and their gift tax returns, as well as the receipt by each of the trusts of about $153 million from the sale of the company. Also, they knew the 9,385 shares were worth far more than $5.0 million because of the company's "prior five years of distributions, revenue, and operating income growth, and store expansion."

As to the 2015 sales, the brothers "failed to report a transaction in which they transferred stock … for far less than its value." Also, they relied on an appraisal with a December 31, 2014, valuation date to determine the value of shares transferred in 2015.

f. **Settlement**. A Stipulation of Settled Issues reached the following conclusions:

- A defined value formula clause does not apply to or control the donor's transfer of nonvoting shares on December 31, 2014.

- Each brother gave 9,385 shares on December 31, 2014.

- Each gifted nonvoting share was valued at $1,640, for a total gift from each brother of $15,391,400 (a difference of $10,391,400 from the reported value of $5,000,000, which had resulted in a gift tax of zero).

- No penalties applied as a result of the 2014 gifts.

- Each brother sold 5,365 shares on March 31, 2015.

- Each sold nonvoting share was valued at $1,722, for a total transferred value of $9,238,530, less the $2,858,418 consideration received, resulting in a gift by each brother of $6,380,112.

- The 10% accuracy related penalty under § 6662(a) applies to the 2015 transfer.

A Decision for the 2015 transaction reported a gift tax deficiency of $2,516,045 and a penalty under §6662(a) of $251,605.

The Stipulation regarding the 2014 gift of $15,391,400 would have resulted in a gift tax of a little over $4.0 million (assuming few taxable gifts had been made previously).

Therefore, the total gift tax deficiency for each brother for 2014 and 2015 was $4,000,000+ plus $2,516,045, or a total of $6,516,045+. The total penalty was $251,605.

Observations:

(1) Because of the huge appreciation resulting from the sale in 2021, the brothers were probably highly motivated to be treated as having transferred 9,385 shares in 2014, and not have some of those shares treated as having been owned by the donors. Applying the defined value formula, based on the stipulated value of $1,640 per share, would have resulted in each trust receiving only about $87 million from the sale in 2021 rather than about $153 million.

[Each brother was treated as giving 9,385 shares and selling 5,365 shares to his grantor trust. That is a total of 14,750 shares (9,385 + 5,365). In the 2021 sale, each trust received $153 million. That is about $10,372.88 per share (153,000,000 ÷ 14,750).

Under the settlement, the gift tax value was stipulated to be $1,640 per share. If the defined value clause were given effect, that would reduce the number of shares given to about 3,049 (5,000,000 ÷ 1,640). The total shares held by each grantor trust would then be about 8,414 (3,049 + 5,365). Then upon sale in 2021, each trust would have received about $87,277,412 (8,414 × 10,372.88).]

(2) The values resulting from the settlement ($1,640 per share for the gift and $1,722 per share for the sale) were much closer to the IRS's position that the shares were worth about $2,000 per share than the donors' appraised value of about $500 per share.

Query how much of that added value was attributable to not allowing tax affecting of the S corporation shares?

(3) The 10% negligence penalty under § 6662(a) was applied to the 2015 transaction but not the 2014 transaction. Was this because the 2015 transfer was not reported on a gift tax return? Or perhaps it was because the sale price was based on an appraisal as of three months earlier if significant financial changes occurred during those three months (the stipulated per share value was increased by five percent from December 31, 2014, to March 31, 2015, representing a 20% annualized increase if that growth was extrapolated over a full year).

(4) By any measure, the transfer transactions were wildly successful from a transfer planning standpoint (unless the parents were concerned they had transferred too much!). For a gift tax of about $6.5 million, as of seven years later each brother had transferred $153 million minus the $2.9 million (approximately) note from the 2015 sale, or $150.1 million – reflecting an effective tax rate of less than 5%.

(5) Do not use the *Wandry* formula in the stock power in Sorensen as a template for drafting *Wandry* assignments. The assignment began with assigning that number of shares equal to a particular value as finally determined for federal gift tax purposes, but then continued on with language that arguably could be closer to a Procter transfer. Stick closer to the assignment language used in *Wandry*.

(6) As discussed in Item 13.c(1)(a) above, planning tips can be gleaned from the IRS arguments in *Sorensen* for structuring and documenting the transfer of shares in satisfaction of the formula assignment before the time that a final determination of gift tax value is made, including documentation regarding the stock ledger, distributions, and the sale to the third party as well as having the donee specifically acknowledge the formula transfer on the stock power.

(7) The treatment of *Wandry* transfers varies among IRS estate and gift tax attorneys, but the national office of the IRS does not like Wandry clauses.

(8) Be wary of using *Wandry* transfers if the transferred assets could explode in value. A change in the finally determined gift tax value could result in many of the transferred assets remaining with the donor – and all the appreciation attributable those assets remaining in the donor's gross estate.

(9) An alternative to assure that all of a particular block of assets is transferred is to use a combined *Wandry*/*King* approach as discussed in Item 12.c(6) above.

Item 12.c(6), "Combined Wandry/King Approach," comments:

In addition, a combined *Wandry*/consideration adjustment approach could be used (sometimes referred to as a two-tiered *Wandry* transfer). The client would make a traditional *Wandry* transfer of that number of units that is anticipated to be worth the desired transfer amount (which could either be a gift or a sale), but with a provision that if those units are finally determined for federal gift tax purposes to be worth a higher value, the shares that were not transferred because of the *Wandry* provision would be sold for a note as of the same date as the *Wandry* gift, with the price being determined by the finally determined gift tax value. See Joy Matak, Steven Gorin & Martin

Shenkman, *2020 Planning Means a Busy 2021 Gift Tax Return Season*, LEIMBERG ESTATE PLANNING NEWSLETTER #2858 (February 2, 2021) (includes excellent suggested detailed disclosures for reporting a two-tiered *Wandry* transfer on a gift tax return and income tax return, including Schedule K-1 disclosures).

That approach was used in *True v. Commissioner* (Tax Court Docket Nos. 21896-16 & No. 21897-16), which cases were settled on a basis that, as reported in Tax Court filings, appears favorable for the taxpayer. The father made transfers of assets worth well over $160 million under these clauses (any gifts were deemed to be made equally by the spouses under the split gift election). The IRS determined that the transfers resulted in additional gifts by the parents collectively of $94,808,104 resulting in additional combined gift taxes of 35% of that amount, or $33,182,836. The taxpayers avoided that horror show and ended up paying only an additional $4,008,642 (combined) of gift tax under stipulated decisions filed in both cases in July 2018. The taxpayers no doubt viewed an additional current outlay of about $4 million rather than $33 million as a huge victory (even if the audit may have resulted in additional value being included in the parents' estates under revised face amounts of notes). For a discussion of *True v. Commissioner*, see Item 8.c(17) of Aucutt, Grantor Retained Annuity Trusts (GRATs) and Installment Sales to Grantor Trusts (July 2022) found here[7047] and available at www.bessemertrust.com/for-professionalpartners/advisor-insights.

III.B.4. Adequate Disclosure on Gift Tax Returns

If any gift of property the value of which is required to be shown on a gift tax return and is not shown on such return, any gift tax on such gift may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.[7048] However, any understatement of use of lifetime gift tax exemption that causes for future returns does not prevent the statute of limitations for the future returns from running, unless the understatement resulted from a false or fraudulent return with intent to evade tax or willful attempt to defeat or evade tax.[7049] CCA 201614036, which reasoned:

> Under the regs, only the failure to disclose a gift on the return for the year of that gift keeps the ASED open, not a failure to accurately report the sum of prior year gifts on a return for a later year.

[7047] The link I supplied is to the September 2023 version, but the item number is the same.

[7048] Code § 6501(c)(9), which also provides:

> The preceding sentence shall not apply to any item which is disclosed in such return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item.

Reg. § 301.6501(c)-1(f)(1), "In general," provides:

> If a transfer of property, other than a transfer described in paragraph (e) of this section, is not adequately disclosed on a gift tax return (Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return"), or in a statement attached to the return, filed for the calendar period in which the transfer occurs, then any gift tax imposed by chapter 12 of subtitle B of the Internal Revenue Code on the transfer may be assessed, or a proceeding in court for the collection of the appropriate tax may be begun without assessment, at any time.

[7049] See also CCA 201643020, which held:

> In this case, the $a gift was reported on the tax year Y31 gift tax return. Thus, step one is met and the matter is concluded. Therefore, despite X's failure to report prior years' gifts on the Y31 return, the special limitation period in section 6501(c)(9) does not apply to the $a gift.

As a result, if the only problem with the subsequent year gift tax returns is understatement of the amounts of prior year gifts, then the understatement of gift tax due for those subsequent years may be assessed only within the normal § 6501(a) 3-year period. The returns for [Redacted Text] should be carefully evaluated, because the ASEDs for those returns should still be open.

The six-year ASED for substantial omission in § 6501(e)(2) will not extend the ASED for gift tax returns whose only defect is underreported prior year gifts, because the language "if the taxpayer omits from... the total amount of the gifts made during the period for which the return was filed" also refers to the current-year gifts; gift tax returns are annual returns, even if the taxpayer is required to report prior year gifts and to properly use those when calculating the tax on the current year gifts.

It would take a legislative fix to § 6501(c)(9) and (e)(2) to close this gap.

Of course, if some other exception, like § 6501(c)(1) (false or fraudulent return with intent to evade tax) or § 6501(c)(2) (willful attempt to defeat or evade tax), applies, there would be an independent ground for an unlimited ASED. But there would have to be sufficient facts to support one of those exceptions.

Once the statute of limitations runs for assessing gift tax, it also runs for determining adjusted taxable gifts for estate tax purposes.[7050]

Of course, the gift tax return needs to be properly signed. Unfortunately, only a court-appointed personal representative may sign a decedent's gift tax return.[7051]

[7050] Code § 2001(f), "Valuation of gifts," provides:

(1) *In general*. If the time has expired under section 6501 within which a tax may be assessed under chapter 12 (or under corresponding provisions of prior laws) on -

(A) the transfer of property by gift made during a preceding calendar period (as defined in section 2502(b)); or

(B) an increase in taxable gifts required under section 2701(d),

the value thereof shall, for purposes of computing the tax under this chapter, be the value as finally determined for purposes of chapter 12.

(2) *Final determination*. For purposes of paragraph (1), a value shall be treated as finally determined for purposes of chapter 12 if -

(A) the value is shown on a return under such chapter and such value is not contested by the Secretary before the expiration of the time referred to in paragraph (1) with respect to such return;

(B) in a case not described in subparagraph (A), the value is specified by the Secretary and such value is not timely contested by the taxpayer; or

(C) the value is determined by a court or pursuant to a settlement agreement with the Secretary.

For purposes of subparagraph (A) , the value of an item shall be treated as shown on a return if the item is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item.

[7051] Reg. § 25.6019-1(g) requires the "executor or administrator" of the decedent's estate to file and makes no reference to anyone else having the authority or obligation to file. CCA 201405016 reasoned:

What we may not have said clearly enough is that § 2203 is only operative in the estate tax context. In relevant part, the statute provides:

When an election to split gifts was improperly applied to split a gift to trust in which a spouse had an interest that was not susceptible of determination, the running of the statute of limitations precluded adjusting the split gift reporting to correct the error.[7052]

If the taxpayer omits from the total amount of the gifts made during the period for which the return was filed such total gifts as exceed in amount 25% of the total amount of gifts stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed.[7053] However, any item that is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the IRS of the nature and amount of such item, is not considered to have been omitted.[7054] Also, any increases in the valuation of assets disclosed on the return are not taken into account in computing the 25% omission from the total gifts stated in the gift tax return.[7055]

> > The term "executor" whenever it is used in this title **in connection with the estate tax imposed by this chapter** means...
>
> The plain language of the statute limits the statutory executor to the estate tax regime (Chapter 11). Section 2203 does not provide any authority in the income tax regime (Chapter 1) or in the gift tax regime (Chapter 12) or in the GSTT regime (Chapter 13).

For how an executor might obtain protection against gift tax liability, see text accompanying fn 7186 in part III.B.5.e.iv.(g) How to Avoid the Pitfalls of the Estate Tax Lien.

[7052] Letter Ruling 201523003 reasoned:

> In Rev. Rul. 56-439, 1956-2 C.B. 605, a gift is made in trust pursuant to which the trustee is to distribute any part or all of the income or principal of the trust to or among the spouse of the donor and other descendants of the donor at such times and in such proportions and amounts as the trustee determines in its sole discretion. The ruling concludes that, under the facts presented, the value of the right to receive the income or principal to be distributed to the spouse is not susceptible of determination. Therefore, the gift to the spouse is not severable from the gifts to the other beneficiaries, and the gift may not to any extent be considered as made one-half by the donor and one-half by his spouse within the meaning of § 2513.
>
> In this case, in Year 1, Husband transferred property to Family Trust, Trust 1, and Trust 2. On their Year 1 Forms 709, Husband and Wife each elected gift split treatment for those gifts. The property of Trust 1 and Trust 2 was transferred to Family Trust at the end of the annuity terms of those trusts. Wife is an income and principal beneficiary of Family Trust. Family Trust provides that the independent trustee may pay to or use for the benefit of any one or more of Wife, Husband's descendants, and his descendant's spouses so much or all of the income and principal of the trust in such proportions as the independent trustee, in the trustee's discretion, determines to be desirable for their respective welfare and best interests. Wife's interests in the income and principal of Family Trust are not susceptible of determination and, therefore, Wife's interests are not severable from the interests that the other beneficiaries have in Family Trust. See Rev. Rul. 56-439. However, under § 2504(c), the time for determining whether gift split treatment is effective with respect to the Year 1 through Year 3 transfers of property to Family Trust has expired. Therefore, the gift split treatment is irrevocable for purposes of the Year 1 transfer to Family Trust and the Years 2 and 3 transfers of property from Trust 1 and Trust 2 to Family Trust.
>
> In Year 3, on their Forms 709, Husband and Wife each elected gift split treatment for the transfers to Trusts 3 and 4. Under § 25.2513-1(b)(4), the election to split gifts is not effective. The period of limitations has not expired for Year 3. Accordingly, Husband is not precluded under § 2504(c) from filing a supplemental Year 3 Form 709 to report the Year 3 transfers to Trust 3 and Trust 4 as being made solely by him.

[7053] Code § 6501(e)(2).

[7054] Code § 6501(e)(2).

[7055] Reg. § 301.6501(e)-1(b)(2).

Reg. § 301.6501(c)-1(f)(2), “Adequate disclosure of transfers of property reported as gifts,” provides:

> A transfer will be adequately disclosed on the return only if it is reported in a manner adequate to apprise the Internal Revenue Service of the nature of the gift and the basis for the value so reported. Transfers reported on the gift tax return as transfers of property by gift will be considered adequately disclosed under this paragraph (f)(2) if the return (or a statement attached to the return) provides the following information -
>
> (i) A description of the transferred property and any consideration received by the transferor;
>
> (ii) The identity of, and relationship between, the transferor and each transferee;
>
> (iii) If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument;
>
> (iv) Except as provided in § 301.6501-1(f)(3), a detailed description of the method used to determine the fair market value of property transferred, including any financial data (for example, balance sheets, etc. with explanations of any adjustments) that were utilized in determining the value of the interest, any restrictions on the transferred property that were considered in determining the fair market value of the property, and a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property. In the case of a transfer of an interest that is actively traded on an established exchange, such as the New York Stock Exchange, the American Stock Exchange, the NASDAQ National Market, or a regional exchange in which quotations are published on a daily basis, including recognized foreign exchanges, recitation of the exchange where the interest is listed, the CUSIP number of the security, and the mean between the highest and lowest quoted selling prices on the applicable valuation date will satisfy all of the requirements of this paragraph (f)(2)(iv). In the case of the transfer of an interest in an entity (for example, a corporation or partnership) that is not actively traded, a description must be provided of any discount claimed in valuing the interests in the entity or any assets owned by such entity. In addition, if the value of the entity or of the interests in the entity is properly determined based on the net value of the assets held by the entity, a statement must be provided regarding the fair market value of 100 percent of the entity (determined without regard to any discounts in valuing the entity or any assets owned by the entity), the pro rata portion of the entity subject to the transfer, and the fair market value of the transferred interest as reported on the return. If 100 percent of the value of the entity is not disclosed, the taxpayer bears the burden of demonstrating that the fair market value of the entity is properly determined by a method other than a method based on the net value of the assets held by the entity. If the entity that is the subject of the transfer owns an interest in another non-actively traded entity (either directly or through ownership of an entity), the information required in this paragraph (f)(2)(iv) must be provided for each entity if the information is relevant and material in determining the value of the interest; and

(v) A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer (see § 601.601(d)(2) of this chapter).

An informal IRS memo discussed adequate disclosure a little and asserted that failure to report a complete and accurate EIN for the business entity that was the subject of the gift caused the statute of limitations not to run when a qualified appraisal was not attached.[7056] A qualified appraisal must, in addition to stating the appraiser's qualifications, contain:[7057]

(A) The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal.

(B) A description of the property.

(C) A description of the appraisal process employed.

(D) A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions.

(E) The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value.

(F) The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions.

(G) The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred.

(H) The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

LAFA 20172801F asserted that the statute of limitations had not run when:

> Donor filed a Form 709 to report the Year 7 gifts, but failed to adequately report any of the Year 7 gifts because Donor did not describe the transferred property, nor did Donor provide a description of the method used to determine the value of the transferred property.

[7056] LAFA 20152201F commented:

> Our research identified only two opinions involving adequate disclosure under I.R.C.§ 6501(c)(9): *Lewis v. Commissioner* (*In re Estate of Brown*), T.C. Memo. 2013-50 and *Estate of Sanders v. Commissioner*, T.C. Memo. 2014-100. Both opinions deny motions for summary judgment without analyzing whether the respective taxpayers had adequately disclosed their gifts under the applicable regulations.

[7057] Reg. § 301.6501(c)-1(f)(3)(ii).

CCA 200221010 involved the following facts:

> ABC LLC was formed in 1997 as a limited liability company under Delaware law and treated as a partnership for federal tax purposes. At the time of formation, Taxpayer was a member in ABC LLC and held a 1% interest. Through a series of transactions not relevant to the determination of the issues in this case, Taxpayer acquired an additional 19% interest in ABC LLC. Taxpayer's entire 20% interest was composed of Class B units.
>
> On April 7, 1997, Taxpayer gifted the 19% interest in ABC LLC to a generation-skipping trust. On that same day, Taxpayer gifted the remaining 1% interest in ABC LLC to a family trust. Taxpayer and Taxpayer's Wife split the value of both gifts in accordance with section 2513 of the Internal Revenue Code. Taxpayer filed his gift tax return (Form 709) on October 9, 1998 and attached the following description of the gifts: "Class B units in ABC LLC. Units acquired on 4/6/97 for $200,000 cash." In addition, Taxpayer indicated that the gifts were made on 4/7/97 with a value on that date of $200,000 and an adjusted basis of $200,000. Taxpayer's Form 709 was due on April 15, 1998 and therefore was not timely filed.
>
> The Service maintains that the fair market value of Taxpayer's transfers to the two trusts at the time of the transfers was $14 million. The Service proposes to issue a notice of deficiency to Taxpayer for the 1997 tax year for the deficiency in gift tax. The Service has raised the question of whether it may rely on the exception for gifts not adequately shown on a return as a defense to the argument that the period of limitations for assessing deficiencies has expired with respect to Taxpayer's 1997 gift tax liability. In the alternative, the Service has raised the question of whether it may rely on the exception for a substantial omission of gifts as a defense to the argument that the period of limitations for assessing deficiencies has expired with respect to Taxpayer's 1997 gift tax liability.

CCA 200221010 reasoned and asserted:

> Neither the Code nor the Treasury regulations provide guidance on what constitutes "a manner adequate to apprise the Service of the nature and amount of such item." Moreover, we have found no gift tax cases interpreting the adequate disclosure standards of sections 6501(c)(9) or 6501(e)(2). However, we note that section 6501(e)(1) provides a similar exception to the period of limitations for a substantial omission of items in the income tax context and section 6501(e)(1)(A)(ii) contains identical language regarding adequate disclosure. The Tax Court has recognized that "an examination of section 6501(e)(1) and (2) shows that the two are in pari materia in dealing with the same subject - the application of the statute of limitations - and, accordingly, we may give due consideration to income tax cases in deciding estate tax cases on this same subject." *Estate of Williamson v. Commissioner*, T.C. Memo. 1996-426. While this decision was in the context of the period of limitations exception for the substantial omission of items from the gross estate, we see no reason why the same standard should not apply in the gift tax context. Moreover, the legislative history for section 6501(e)(2) indicates that section 6501(e)(2) "applies to estate and gift taxes a rule, corresponding to the income-tax rule." S. Rep. No. 83-1622, at 584 (1954); H.R. Rep. No. 83-1337, at 414 (1954). In addition, because section 6501(c)(9) also utilizes the "manner adequate to apprise the Secretary" language, we believe the same adequate disclosure standard should apply. Thus, income tax cases construing the

adequate disclosure standard in the context of a substantial omission of items can be used as guidance for determining whether there has been adequate disclosure for purposes of sections 6501(c)(9) and 6501(e)(2).

The disclosure required to trigger section 6501(e)(1) and avoid application of the POSTF-160250-01 extended period of limitations has been held to require production of a "clue" with respect to the omission of income. *University Country Club, Inc. v. Commissioner*, 64 T.C. 460, 470 (1975). "[T]his does not mean simply a 'clue' which would be sufficient to intrigue a Sherlock Holmes. But neither does it mean a detailed revelation of each and every underlying fact." *George Edward Quick Trust v. Commissioner*, 54 T.C. 1336 (1970), *aff'd per curiam*, 444 F.2d 90 (8th Cir. 1971). The disclosure must be sufficiently detailed that a decision whether to select the return for audit may be a reasonably informed one. *Estate of Fry v. Commissioner*, 88 T.C. 1020, 1023 (1987) (citation omitted). Moreover, the 6-year period of limitations applies where there is either a complete omission of an item of the requisite amount or misstating of the nature of an item. *Phinney v. Chambers*, 392 F.2d 680, 685 (5th Cir. 1968). In either situation, the Service is at a disadvantage in detecting errors and consequently needs more time to uncover those errors. *Id*.

Turning now to the question of whether there was sufficient information on Taxpayer's gift tax return to apprise the Service of the nature of the interests in ABC LLC, we note that the regulations that correspond with section 6501(c)(9) contain detailed guidance on what constitutes adequate disclosure of transfers of property reported as gifts. In this regard, Treas. Reg. § 301.6501(c)-1(e) sets detailed guidelines for a transfer of property subject to the special valuation rules of section 2701 or section 2701, while Treas. Reg. § 301.6501(c)-1(f) sets detailed guidelines for gifts made after December 31, 1996 not adequately disclosed on a return filed after December 3, 1999. Based on the facts submitted, we cannot determine whether Taxpayer's transfers of interests in ABC LLC were subject to the special valuation rules of sections 2701 or 2702. Thus, we cannot determine whether the adequate disclosure standard of Treas. Reg. § 301.6501(c)-1(e) is applicable in this case. Moreover, we note that Taxpayer and Taxpayer's Wife filed gift tax returns for the 1997 calendar year prior to December 3, 1999, (the effective date of the regulations) making Treas. Reg. § 301.6501(c)-1(f) also inapplicable. See Treas. Reg. § 301.6501(c)-1(f)(8). Nonetheless, both regulations illustrate the type of information that should be on the return (or a statement attached thereto) for the return to commence the running of the period of limitations on assessment. In particular, a gift tax return (or statement attached thereto) should contain, at a minimum, a description of the transferred property, the identity of the transferor and each transferee, the relationship between those parties, and a description of the method used to determine the value of the gift. In addition, for a transfer of property in trust, the gift tax return should contain a description of the terms of the trust. Moreover, the Service has indicated that where a donor files a gift tax return but fails to adequately disclose a gift because the information required under Treas. Reg. § 301.6501(c)-1(f)(2) for the gift was not submitted with the return, the period of limitations on assessment with respect to that return does not begin to run. Rev. Proc. 2000-34, 2000-2 C.B. 186.

While the effective date of the regulations under section 6501(c)(9) and the publication date of the revenue procedure make them inapplicable in this case, the principles upon which they are based are implicit in section 6501(c)(9) itself. The statute requires that information about the nature and amount of the gift must be included on the return (or statement attached thereto). The regulations under section 6019 illustrate the type of information a gift tax return should contain. First, the gift tax return must contain "the fair market value of all gifts not made in money." Treas. Reg. § 25.6019-3(a). In addition, "[t]he instructions printed on the return should be carefully followed." *Id*. Further, the gifts made during the calendar year "must be listed on the return and described in a manner that they may be readily identified." Treas. Reg. § 25.6019-4. See also Instructions to Form 709, p. 5 (" Describe each gift in enough detail so that the property can be easily identified.") While there are no examples in the Treasury regulations or the Instructions to Form 709 pertaining to ownership interests in a limited liability company, we believe information similar to that required for a gift of stock should be contained on the gift tax return. In this regard, the gift tax regulations provide the following:

> Description of stocks shall include number of shares, whether common or preferred, and, if preferred, what issue thereof, par value, quotation at which returned, exact name of corporation, and, if the stock is unlisted, the location of the principal business office, the State in which incorporated and the date of incorporation, or if the stock is listed, the principal exchange upon which sold.

Treas. Reg. § 25.6019-4.

Analogizing the requirements for a gift of stock to a gift of an interest in a limited liability company, we conclude that the description of a gift of an interest in an LLC should include the number of units in the limited liability company, the class type, and the percentage of ownership interest that the gift represents.

In the present situation, we conclude that the Taxpayer did not include an adequate description of the gifts to the two trusts. In particular, Taxpayer did not identify the number of units in ABC LLC being transferred, the percentage of ownership interest that those units represented, or the nature of Class B interests. Taxpayer only identified the name of the limited liability company, the purported value and the fact that the units were Class B units. This information did not allow the Commissioner to make a reasonably informed decision whether to select the return for audit. Nor do we believe that Taxpayer may legitimately argue that the absence of detailed information on the return should itself have given the Commissioner a "clue" to look for the missing information. We believe that in enacting section 6501(c)(9), Congress intended that taxpayers should fully disclose the nature of their gifts on the return or attachments thereto-not simply leave a trail of questions for the Commissioner to pursue. Therefore, we conclude that Taxpayer did not adequately disclose the nature of the gifts. Consequently, the period of limitations on POSTF-160250-01 assessment with respect to Taxpayer's gift tax return remains open.

Turning now to whether section 6501(e)(2) applies in this case, we note that the total amount of gifts stated on Taxpayer's return was $200,000. In order to apply the 6-year period of limitations on assessment to Taxpayer's return, the Service must prove that items properly includible in total gifts for that calendar year in excess of $50,000 were omitted. Taxpayer's gift tax return discloses Class B units in a limited liability company. The fair market value of the Class B units at the time the gifts were made was $14 million. In accordance with section 2503, those gifts were subject to gift tax. Because the fair market value of the Class B units is in excess of 25% of the total gifts stated on Taxpayer's return, we conclude that there has been a substantial omission of items within the meaning of section 6501(e)(2). As discussed above, Taxpayer did not

> adequately disclose the nature and amount of the omitted items. Therefore, the tax due on the transfers can be assessed at any time on or before October 9, 2004.

Reg. § 25.6019-4, "Description of property listed on return," which is not promulgated under the adequate disclosure rules but rather the rules for filing gift tax returns (before the adequate disclosure rule was enacted), provides:

> The properties comprising the gifts made during the calendar year (or calendar quarter with respect to gifts made after December 31, 1970, and before January 1, 1982) must be listed on the return and described in a manner that they may be readily identified. Thus, there should be given for each parcel of real estate a legal description, its area, a short statement of the character of any improvements, and, if located in a city, the name of the street and number. Description of bonds shall include the number transferred, principal amount, name of obligor, date of maturity, rate of interest, date or dates on which interest is payable, series number where there is more than one issue, and the principal exchange upon which listed, or the principal business office of the obligor, if unlisted. Description of stocks shall include number of shares, whether common or preferred, and, if preferred, what issue thereof, par value, quotation at which returned, exact name of corporation, and, if the stock is unlisted, the location of the principal business office, the state in which incorporated and the date of incorporation, or if the stock is listed, the principal exchange upon which sold. Description of notes shall include name of maker, date on which given, date of maturity, amount of principal, amount of principal unpaid, rate of interest and whether simple or compound, and date to which interest has been paid. If the gift of property includes accrued income thereon to the date of the gift, the amount of such accrued income shall be separately set forth. Description of the seller's interest in land contracts transferred shall include name of buyer, date of contract, description of property, sale price, initial payment, amounts of installment payments, unpaid balance of principal, interest rate and date prior to gift to which interest has been paid. Description of life insurance policies shall show the name of the insurer and the number of the policy. In describing an annuity, the name and address of the issuing company shall be given, or, if payable out of a trust or other fund, such a description as will fully identify the trust or fund. If the annuity is payable for a term of years, the duration of the term and the date on which it began shall be given, and if payable for the life of any person, the date of birth of that person shall be stated. Judgments shall be described by giving the title of the cause and the name of the court in which rendered, date of judgment, name and address of judgment debtor, amount of judgment, rate of interest to which subject, and by stating whether any payments have been made thereon, and, if so, when and in what amounts.

Estate of Robinson, 101 T.C. 499 (1993), which was before the adequate disclosure statute was enacted, discussed omitted gifts:

> Assuming, without deciding, for the purpose of the instant case, that claiming more annual exclusions than allowable under section 2503(b) would lead to our holding that an omission from the total amount of gifts occurred for purposes of section 6501(e)(2), the gift tax returns filed by decedent made no such omission. As stated above, section 6501(e)(2) provides that items which are adequately disclosed are not taken into account in determining the amount omitted from total gifts. The Federal gift tax returns filed by decedent stated the number of annual exclusions being claimed and, therefore, adequately apprised the Commissioner of the specific number of annual exclusions claimed by decedent. Indeed, respondent does not argue that decedent did not

> adequately disclose the annual exclusions being claimed. Consequently, the exclusions are not to be taken into account for purposes of determining the amount omitted from total gifts for purposes of section 6501(e)(2), and the 6-year period of limitations found in section 6501(e)(2) is not applicable to the 1983 gift tax year.

Daniels v. Commissioner, T.C. Memo. 1994-591, which also was before the adequate disclosure statute was enacted, involved the following facts and holding:

> On March 9, 1983, petitioners each timely filed for 1982 a Federal gift tax return that reflected the gifts of 285 shares of Penn-Daniels common stock to their children in the total amount of $110,110. Respondent, however, contends that the alleged gift of “value” (namely, the alleged increase in the value of the children’s common stock as a result of the alleged $1,751,680 difference between the fair market value of the common stock petitioner exchanged for the preferred stock petitioner received) constitutes a separate and distinct gift (*i.e.*, separate from the gift of the common stock itself) that was not disclosed on petitioners’ 1982 Federal gift tax returns and that respondent’s adjustment with regard to this gift of “value” does not constitute a mere increase in the value of the gift of the common stock. Respondent then contends that the amount of this omitted gift constitutes more than 25 percent of the total gifts that were reported on petitioners’ gift tax returns, and therefore that the 6-year period of limitation on assessment is applicable, and petitioners’ consents extending the statute of limitations are applicable as to both the alleged $1,751,680 gift of “value” and also as to the $717,288 alleged increase in the value of the gift of the common stock.
>
> Petitioners respond that, in fact and substance, respondent’s alleged gift of “value” simply constitutes a determination by respondent that petitioner’s gift of Penn-Daniels common stock should be increased in value, and that there was no second, separate, and distinct gift apart from the gift of the 285 shares of Penn-Daniels common stock. Petitioners, therefore, argue that regardless of the merit or lack of merit in respondent’s revaluation of the gift, because a mere increase by respondent in the value of a reported gift does not constitute an “omitted item” under section 6501(e)(2), respondent’s proposed adjustments for 1982 are barred by the 3-year period of limitation. The reported fair market value of the gifts was based on the liquidation value of the 285 shares of Penn-Daniels common stock that was transferred by petitioner to the children as reflected in the Robinson-Humphrey valuation report. The gifts of the 285 shares of Penn-Daniels common stock were described on petitioners’ gift tax returns as being part of the reorganization of Penn-Daniels….
>
> Regardless of which theory is used under the step-transaction doctrine, the facts before us lead to the same conclusion. The transaction that respondent seeks to treat as giving rise to two separate gifts constituted only one gift to each of petitioners’ children. There was a single plan of corporate reorganization and recapitalization intended to create, simultaneously, a single specific outcome regardless of the sequence of the steps. Accomplishing only one of the steps in the reorganization would not have effected the change in control sought by the various participants to the reorganization.
>
> The undisputed record shows that only petitioner was to exchange Penn-Daniels common stock for preferred stock and that exchange, effectively, was to occur simultaneously with petitioner’s gift of the remaining 285 shares of Penn-Daniels common stock to his children. The evidence is clear that no one step would have been taken except in contemplation of the other steps. We agree with petitioners that the

relevant steps before us constitute one gift by petitioner to his children of Penn-Daniels common stock. We would be exalting form over substance if we were to conclude that petitioner made one direct gift of the common stock and another gift of the alleged increase in "value" of that common stock as a result of some difference in the value of the common stock petitioner exchanged for the preferred stock he received. If respondent is correct in her valuation of the common and preferred stock of Penn-Daniels, that increase simply would cause an increase in the valuation of the 285 shares of common stock that petitioner gave to his children.

It appears that respondent is making this second gift of "value" argument because respondent failed to increase the value of petitioner's gift of common stock to petitioners' children within the 3-year limitation period on the assessment of tax under section 6501(a). Respondent's argument that there was a second distinct gift undisclosed on petitioners' gift tax returns, therefore triggering the 6-year statute of limitations, in fact is nothing more than a belated effort to revalue petitioner's gift of the common stock to petitioners' children.

Schlapfer v. Commissioner, T.C. Memo. 2023-65, explained (yellow highlighting is mine):

IV Adequate Disclosure

"A disclosure is 'adequate' if it is 'sufficiently detailed to alert the Commissioner and his agents as to the nature of the transaction so that the decision as to whether to select the return for audit may be a reasonably informed one.'" *Thiessen v. Commissioner*, 146 T.C. 100, 114 (2016) (quoting *Estate of Fry v. Commissioner*, 88 T.C. 1020, 1023 (1987)). The Commissioner directs us to the reporting requirements for strict compliance. *See, e.g.*, Treas. Reg. § 25.6019-4. But Treasury Regulation § 301.6501(c)-1(f)(2) provides that transfers reported on a gift tax return will be considered adequately disclosed if the return (or a statement attached to the return) provides the following information:

(i) A description of the transferred property and any consideration received by the transferor;

(ii) The identity of, and relationship between, the transferor and each transferee;

(iii) If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument;

(iv) Except as provided in § 301.6501(c)-1(f)(3), a detailed description of the method used to determine the fair market value of property transferred, including any financial data (for example, balance sheets, etc. with explanations of any adjustments) that were utilized in determining the value of the interest, any restrictions on the transferred property that were considered in determining the fair market value of the property, and a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property....; and

(v) A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer....

These requirements can be satisfied by filing Form 709 with the required information, or if needed, an amended Form 709 with the required information. Rev. Proc. 2000-34, §§ 3 and 4, 2000-2 C.B. 186, 186. However, if an amended return is the one that satisfies adequate disclosure, then the period of limitations commences with the filing of the amended return, not the original return. *Id.* Whether a statement attached to a gift tax return adequately discloses a gift is a question of fact. *Estate of Hicks Sanders v. Commissioner*, T.C. Memo. 2014-100, at *7. Mr. Schlapfer argues that the period to assess gift tax has expired because he adequately disclosed the gift on his 2006 gift tax return. He points to four documents to support this claim: (1) the gift tax return; (2) a protective filing attachment; (3) Schedule F of Form 5471 for his 2006 tax return; and (4) the Offshore Entity Statement. The Commissioner argues that the period to assess gift tax did not expire because Mr. Schlapfer did not adequately disclose the gift. Specifically, he asserts that (1) the Offshore Entity Statement is not part of the 2006 gift tax return and it should not be considered to determine whether Mr. Schlapfer made an adequate disclosure of the gift; and (2) even if the Offshore Entity Statement is considered, Mr. Schlapfer still failed to adequately disclose the gift because he failed to satisfy all applicable requirements of Treasury Regulation § 301.6501(c)-1(f)(2).

A. Disclosure Contents We Can Consider

The Commissioner argues that the Offshore Entity Statement is not among the documents we should consider in determining whether the gift was adequately disclosed. We disagree.

We have addressed the question of what documents to consider for adequate disclosure in cases interpreting section 6501(e)(1) (regarding substantial income omissions), and we find that the rationale used in those cases applies with equal force here. Under section 6501(c)(9), the Commissioner may assess a gift tax at any time if a gift is not shown on a return unless the gift is "*disclosed in such return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item*." (Emphasis added.) Section 6501(e)(1)(B)(iii) has similar wording, providing that the period of limitations for the Commissioner to determine the amount omitted from gross income will extend to six years unless "*such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item*." (Emphasis added.) "Where the same word or phrase appears multiple times within a statutory text, it is generally presumed to have the same meaning each place it appears." *Whistleblower 22716-13W v. Commissioner*, 146 T.C. 84, 92-93 (2016) (citing *Atl. Cleaners & Dyers, Inc. v. United States*, 286 U.S. 427, 433 (1932) ("Undoubtedly, there is a natural presumption that identical words used in different parts of the same act are intended to have the same meaning.")). A review of applicable IRS guidance and a plain reading of the statute do not warrant a conclusion that Congress intended the similar phrases in section 6501(c)(9) and (e)(1) to be interpreted differently. Therefore, we look to adequate disclosure caselaw decided under section 6501(e)(1) for guidance in determining what documents can be used to prove adequate disclosure under section 6501(c)(9).

This Court has frequently looked beyond a taxpayer's return for purposes of determining adequate disclosure, especially where the return references a separate document. *See Reuter v. Commissioner*, T.C. Memo. 1985-607, 51 T.C.M. (CCH) 99, 102 (discussing *Benderoff v. United States*, 398 F.2d 132 (8th Cir. 1968), *Walker v. Commissioner*, 46 T.C. 630 (1966), *Roschuni v. Commissioner*, 44 T.C. 80 (1965), and *Rose v. Commissioner*, 24 T.C. 755 (1955)). For example, when the taxpayer's individual return references an information return (such as a partnership or S corporation return), we may look to those information returns to determine whether items were adequately disclosed. See Reuter, 51 T.C.M. (CCH) at 102. When deciding whether an item has been adequately disclosed, we may consider not only a return, but also documents attached to the return plus informational documents referenced in the return.

The Offshore Entity Statement provided with the gift tax return must be considered in determining adequate disclosure. It was submitted to the OVDP in a disclosure packet that included the gift tax return. Furthermore, the protective filing attached to the gift tax return referenced controlled foreign company (CFC) stock, which alerted the IRS to look to the Offshore Entity Statement for information on the gift referred to in the gift tax return. We will consider the return and all documents accompanying the return. Therefore, the documents we will consider in determining whether Mr. Schlapfer adequately disclosed the gift are the gift tax return, the protective filing, all relevant Forms 5471, and the Offshore Entity Statement.

B. Strict vs. Substantial Compliance

The Commissioner argues that Mr. Schlapfer did not adequately disclose the gift because he failed to strictly satisfy all applicable requirements of Treasury Regulation § 301.6501(c)-1(f)(2). Mr. Schlapfer disagrees, arguing that he strictly, or at least substantially, complied with all applicable requirements of the Treasury regulation.

The Commissioner may insist that taxpayers strictly comply with regulatory requirements, but in certain circumstances we have held that regulatory requirements can be satisfied by substantial compliance. *See, e.g.*, *Am. Air Filter Co. v. Commissioner*, 81 T.C. 709, 719 (1983). The question the Court must ask in determining whether to apply substantial or strict compliance to regulatory requirements is whether the requirements relate "to the substance or essence of the statute." *Bond v. Commissioner*, 100 T.C. 32, 41 (1993) (quoting *Taylor v. Commissioner*, 67 T.C. 1071, 1077 (1977)). If the requirement is essential, then strict adherence to all regulatory requirements is a precondition to satisfying the statute. *Id*. However, if the requirement is "procedural or directory in that [it is] not of the essence of the thing to be done...[it] may be fulfilled by substantial...compliance." *Id*. (quoting *Taylor*, 67 T.C. at 1077-78). This test requires us to examine section 6501(c)(9) to determine whether the adequate disclosure requirements of Treasury Regulation § 301.6501(c)-1(f)(2) go to the essence of the statute or are merely procedural or directory.

Section 6501(c)(9) provides that the Commissioner may assess a gift tax at any time if a taxpayer fails to report a gift on a gift tax return, unless the gift is otherwise adequately disclosed on the return or a statement attached to it. Its essence is to provide the Commissioner with a viable way to identify gift tax returns that should be examined with minimum expenditure of resources. T.D. 8845, 1999-2 C.B. 683, 684. The purpose of the adequate disclosure requirements in the regulation is to provide taxpayers with guidance on what constitutes adequate disclosure for purposes of section 6501(c)(9).

The Department of the Treasury has acknowledged that substantial compliance can satisfy the adequate disclosure requirements. In Treasury Decision 8845, which promulgated Treasury Regulation § 301.6501(c)-1(f), Treasury specifically addressed substantial compliance. It rejected a recommendation that the regulation should expressly allow substantial compliance because of "the difficulty in defining and illustrating what would constitute substantial compliance." T.D. 8845, 1999-2 C.B at 685. It went on to note, however, that its rejection of the suggestion did not mean "that the absence of any particular item or items would necessarily preclude satisfaction of the regulatory requirements, depending on the nature of the item omitted and the overall adequacy of the information provided." *Id*. That statement describes, and accepts, the very essence of substantial compliance. Therefore, we conclude that the adequate disclosure requirements can be satisfied by substantial compliance.[7]

[7] Generally, "[s]tatutes of limitation sought to be applied to bar rights of the Government, must receive a strict construction in favor of the Government." *Badaracco v. Commissioner*, 464 U.S. 386, 391 (1984) (quoting *E.I. Dupont de Nemours & Co. v. Davis*, 264 U.S. 456, 462 (1924)). However, we have applied the substantial compliance doctrine to situations where we are tasked in determining whether a return was sufficient to commence the running of the statute of limitations. *See*, *e.g.*, *Gen. Mfg. Corp. v. Commissioner*, 44 T.C. 513, 523-24 (1965).

C. Whether Mr. Schlapfer Strictly or Substantially Complied With the Adequate Disclosure Requirements

Under Treasury Regulation § 301.6501(c)-1(f)(2), a transfer will be considered adequately disclosed if the taxpayer provides the following information on a gift tax return or statement attached to it: (i) a description of the gift and consideration received for the gift; (ii) the identities of and relationship between the transferor and transferee; (iii) if the gift is transferred in trust, the trust tax identification number and a description of the terms of the trust; (iv) a detailed description of the method used to determine the fair market value of the gift; and (v) a statement describing any position taken that is contrary to Treasury regulations or revenue rulings published at the time of the transfer. Here, we need to decide only whether Mr. Schlapfer strictly or substantially satisfied requirements (i), (ii), and (iv). A taxpayer will be deemed to have substantially complied with a requirement if it is procedural and the taxpayer fulfilled all other essential purposes of the requirement. *See Am. Air Filter Co.*, 81 T.C. at 719. Therefore, if Mr. Schlapfer fails to strictly comply with a requirement, we will find that he substantially complied with it if he has fulfilled all essential purposes of the requirement. We will look to the gift tax return, the protective filing, all relevant Forms 5471, and the Offshore Entity Statement to determine compliance.

1. Description of the Property and Consideration Received

Assuming the gift is the EMG stock, Mr. Schlapfer has strictly satisfied this requirement. Treasury Regulation §§ 301.6501(c)-1(f)(2)(i) requires that Mr. Schlapfer's gift tax return, or a statement attached to it, provide a description of the transferred property and any consideration he received.[8] The 2006 Instructions for Form 709 instructed taxpayers to "[d]escribe each gift in enough detail so that the property can be easily identified." 2006 Instructions for Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, at 8. For stock, the instructions specify that the taxpayer should disclose the number of shares and identify whether they are common or preferred. *Id*. Mr. Schlapfer provided the required information via three attachments: the protective filing, the Offshore Entity Statement, and the 2006 Form 5471. On the protective filing attached to the return, Mr. Schlapfer stated that he made a gift of CFC stock valued at $6,056,686. On the Offshore Entity Statement, he stated that "EMG was established by the Taxpayer in 2003, and was beneficially owned by the Taxpayer until July 6, 2006, at which time the Taxpayer gifted his entire interest in EMG to his mother." Lastly, on the 2006 Form 5471, he disclosed the number of and type of EMG shares. Together, these statements provided the IRS with a description of the property.

[8] Mr. Schlapfer transferred his shares of EMG stock for no consideration.

However, if the gift is the UVL Policy, Mr. Schlapfer did not strictly satisfy this requirement. He did not provide any information on his gift tax return, or on documents attached to it, that directly referenced or described a transfer of a life insurance policy. But this failure does not preclude him from satisfying adequate disclosure. As previously mentioned, disclosure is adequate if it is sufficiently detailed to alert the Commissioner to the nature of the transaction so that the decision to select a return for audit is reasonably informed. *Thiessen*, 146 T.C. at 114. And when finalizing the adequate disclosure regulations, Treasury provided "that the absence of any particular item or items would [not] necessarily preclude satisfaction of the regulatory requirements, depending on the nature of the item omitted and the overall adequacy of the information provided." T.D. 8845, 1999-2 C.B at 685. Thus, these "regulatory requirements" are not actually required. A requirement does not have to be satisfied depending on the importance of the requirement and what information is provided by the taxpayer. Furthermore, the Treasury Regulations provide that "[a] transfer *will* be adequately disclosed...only if it is reported in a manner adequate to apprise the [IRS] of the nature of the gift....Transfers reported on the gift tax return as transfers of property by gift will be considered adequately disclosed...if the return...provides the following information." Treas. Reg. § 301.6501(c)-1(f)(2) (emphasis added). The difference between the wording used in these two sentences informs us that the requirements are not mandatory, but act as guidance to taxpayers to inform them on a way to satisfy adequate disclosure. Thus, we must determine whether Mr. Schlapfer's description of the property transferred was sufficient to alert the Commissioner to the nature of the gift.

Mr. Schlapfer provided enough information to satisfy this requirement through substantial compliance. While he may have failed to describe the gift in the correct way (assuming the gift is the UVL Policy), he did provide information to describe the underlying property that was transferred. Mr. Schlapfer asserts that he chose to disclose the assets held in the insurance policy instead of the actual policy because the OVDP required him to disregard entities holding foreign assets. The UVL Policy's value comes primarily from EMG stock, so Mr. Schlapfer's describing the transferred property as EMG stock goes to the nature of the gift. Because this description was sufficient to alert the Commissioner to the nature of the gift, Mr. Schlapfer substantially complied with this requirement.

2. Identity of the Parties[9]

Mr. Schlapfer did not strictly satisfy this requirement. Treasury Regulation § 301.6501(c)-1(f)(2)(ii) requires that Mr. Schlapfer provide the identity of, and his relationship to, each transferee. Mr. Schlapfer has stated various times that he transferred property by gift to his mother, aunt, and uncle. However, the Offshore Entity

Statement states that he “gifted his entire interest in EMG to his mother;” there was no mention of his aunt or uncle. Because his return and documents attached thereto failed to identify his aunt and uncle as transferees, he did not strictly comply with this requirement.

[9] For this requirement, it is immaterial whether the gift is the stock or the life insurance policy; therefore we do not analyze it separately for each gift.

But Mr. Schlapfer substantially complied with this requirement. This requirement was procedural, and a failure to list the identity and relationship of each transferee was not essential to the overall purpose of the requirement, which was to provide the IRS with enough information to understand the nature of the transfer. Mr. Schlapfer’s statement on the Offshore Entity Statement listing his mother as the transferee provided the IRS with enough to understand the relationship between Mr. Schlapfer and the transferee, a member of his family. His failure to provide the names of his aunt and uncle does not make a meaningful difference in understanding the nature of the transfer. Therefore, we find that he substantially complied with the requirement when he identified his mother as the transferee.

3. Description of Method Used to Determine FMV of Gift

Mr. Schlapfer did not strictly satisfy this requirement. Treasury Regulation § 301.6501(c)-1(f)(2)(iv) requires that Mr. Schlapfer provide a detailed description of the method used to determine the fair market value of property transferred, including any financial data (balance sheets, etc. with explanations of any adjustments). Mr. Schlapfer did not provide any statement describing how he determined the fair market value of the gift, regardless of whether it is the EMG stock or the UVL Policy. Therefore, he failed to strictly satisfy this requirement.

However, Mr. Schlapfer substantially complied with this requirement. Assuming the gift is the EMG stock, Mr. Schlapfer provided enough financial information to apprise the Commissioner of the method used to determine its fair market value. The 2006 instructions for Form 709 explained that the purpose of this requirement is to provide the IRS with information on how the taxpayer determined the gift’s fair market value. See 2006 Instructions for Form 709, at 8. The instructions also identified documents that could be submitted to satisfy this requirement. *Id*. (“For stock of close corporations or inactive stock, attach balance sheets, particularly the one nearest the date of the gift, and statements of net earnings or operating results and dividends paid for each of the 5 preceding years.”)

Mr. Schlapfer provided all the documents identified in the instructions. His Forms 5471 for 2004, 2005, and 2006 enclosed balance sheets, statements of net earnings, dividends paid, and operating results. Furthermore, his Offshore Entity Statement stated that “[t]axpayer is taking into account all of the income earned by the accounts underlying EMG in the enclosed Amended U.S. Individual Tax Returns during the years he controlled and beneficially owned EMG.” Although Mr. Schlapfer did not provide all the financial documentation listed in the regulation, he provided the information identified in the 2006 Form 709 instructions, which was enough to show the IRS how he determined the fair market value of the EMG stock. Therefore, he substantially complied with this requirement.

> Furthermore, Mr. Schlapfer substantially complied even if the gift is the UVL Policy. The UVL Policy's principal asset is the EMG stock, and the documents we considered above were enough to apprise the Commissioner of the method used to determine the fair market value of the EMG stock. Because the UVL Policy's value stems primarily from the EMG stock, those same documents can be used to illustrate the method used to determine the fair market value of the UVL Policy. Accordingly, we find that Mr. Schlapfer substantially complied with this requirement.
>
> **V. Conclusion**
>
> Mr. Schlapfer strictly or substantially complied with Treasury Regulation § 301.6501(c)-1(f)(2)(i), (ii), and (iv) by way of his gift tax return, protective filing, Offshore Entity Statement, and Forms 5471. As a result, he adequately disclosed the gift on his 2006 gift tax return, causing the three-year assessment period to commence on November 20, 2013, when he submitted his disclosure package to the OVDP, and end on November 30, 2017 (three years after that date including extensions). Therefore, we conclude that the period of limitations to assess the gift tax expired before the Commissioner issued the notice of deficiency. Accordingly, we will deny the Commissioner's Motion for Summary Judgment and grant Mr. Schlapfer's Cross-Motion for Summary Judgment.

Steve Akers and Ron Aucutt comment on the case at https://www.bessemertrust.com/insights/schlapfer-v-commissioner-tc-memo-2023-65. Their analysis is very helpful (as always).

Note that disclosures made in connection with the OVDP were not necessarily attached to the gift tax return, but the court considered them anyway, given that the gift tax returns were reviewed as part of the examination. In *Bishop v. U.S.*, 338 F.Supp 1336 (N.D. Miss. 1970), *aff'd per curiam* 468 F.2d 950 (5th Cir. 1972), *cert. den.* 10/10/1972, "the Agent charged with the responsibility of examining decedent's Estate Tax Return was fully informed in respect to" the transaction that was later determined to be a gift instead of a qualified disclaimer, but that did not run the statute of limitations for the decedent's gift tax returns; so, be sure to file gift tax returns separately instead of relying on attaching them to the estate tax return.

Consider disclosing a transfer on a gift tax return as a sale that is not taxed as a gift but is disclosed for the sake of completeness, including running the statute of limitations on whether a transaction is an incomplete gift. Reg. § 301.6501(c)-1(f)(4), "Adequate disclosure of non-gift completed transfers or transactions," provides:

> Completed transfers to members of the transferor's family, as defined in section 2032A(e)(2), that are made in the ordinary course of operating a business are deemed to be adequately disclosed under paragraph (f)(2) of this section, even if the transfer is not reported on a gift tax return, provided the transfer is properly reported by all parties for income tax purposes. For example, in the case of salary paid to a family member employed in a family owned business, the transfer will be treated as adequately disclosed for gift tax purposes if the item is properly reported by the business and the family member on their income tax returns. For purposes of this paragraph (f)(4), any other completed transfer that is reported, in its entirety, as not constituting a transfer by gift will be considered adequately disclosed under paragraph (f)(2) of this section only if the following information is provided on, or attached to, the return -

(i) The information required for adequate disclosure under paragraphs (f)(2)(i), (ii), (iii) and (v) of this section; and

(ii) An explanation as to why the transfer is not a transfer by gift under chapter 12 of the Internal Revenue Code.

The description might be along these lines:

> Information relating to this transaction, including an appraisal that considers discounts for lack of marketability and lack of a right to vote, is attached to this gift tax return as Exhibit A and is disclosed under United States Treasury Regulation § 301.6501(c)-1(f)(4). This transfer is not a gift under Chapter 12 of the Internal Revenue Code because it is a bona fide sale for an adequate and full consideration in money or money's worth.

For a formula sale described in part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers, which uses language such as "value as finally determined for federal gift tax purposes," adequate disclosure is required to effectuate that clause. I have the potential donor sign the transfer agreement personally agreeing to file a gift tax return adequately disclosing the transfer.

If the sale is from a beneficiary of a trust to that trust (or vice versa), which may include a beneficiary deemed-owned trust or a spousal limited access trust (SLAT),[7058] additional considerations arise. Any gift to the trust would be an incomplete gift if beneficiary has certain interests in the trust life and upon death.[7059] It has been suggested that the gift tax statute of limitations would not run;[7060] my main concern is whether any such gift being an incomplete gift would make the sale not constitute a "completed transfer" under Reg. § 301.6501(c)-1(f)(4). Whether that argument is correct is up to the reader to decide. If one is concerned about that argument, one might consider including a gift of all or a portion of the transferred asset to a

[7058] For a SLAT, see part III.B.2.i.xv Sale to Trust Created by Spouse: An Alternative Way to Have a Trust Benefitting Client.

[7059] Reg. § 301.6501(c)-1(f)(5) discusses disclosing incomplete gifts. For what is an incomplete gift, see Reg. § 25.2511-2.

[7060] Mulligan, "Searching for Transfer Tax Finality With Sales to BIDITs," *Journal of Taxation* (Nov. 2013), criticized reporting sale treatment as causing finality. He asserts that reporting the sale as a completed gift misleads the IRS because any gift would, in fact, be incomplete. I disagree with the criticism, which perhaps was directed against statements that the gift is complete. The reporting I do does not mention whether the gift is complete or incomplete; it merely states that a sale was made that the IRS can audit and is accompanied by copies of the trust and transactional documents. I believe that disclosing the sale puts the IRS on notice that a transfer was made that can be audited and does not discourage the IRS from auditing the way that a disclosure under Reg. § 301.6501(c)-1(f)(5) would. Furthermore, that author suggested that the trust include language providing that any beneficial interest and any inter vivos or testamentary power of appointment conferred on the beneficiary does not apply to any assets that are ultimately determined for federal gift tax purposes to have been transferred by the beneficiary to the trust for less than adequate and full consideration. Such a provision would eliminate any interest or power in assets that the transfers to the trust that would cause the transfer to be an incomplete gift, which would also undermine the purpose of a sale to that trust.
More on point is Reg. § 301.6501(c)-1(f)(4), which applies only to a "completed transfer," without defining or otherwise describing what a "completed transfer" is. Is a sale to a trust a "completed transfer" whenever the sale completely transfers the property? The article implicitly assumes that completed transfer requires that, if the fair market value of the property transferred exceeds the sales price, the excess must be a completed gift.

donee as to whom a gift would be completed, generally by limiting the beneficiary's power to appoint at death.[7061] If the trust is well-funded (more likely to be the case for a SLAT), instead of using a formula sale consider the trust paying the beneficiary more than the estimated fair market value, with the idea that the sale price will be adequate even with significant audit adjustments and any excess of the sale price over the value constituting a distribution. The latter may be estate-tax-inefficient in that more assets are now in the beneficiary's estate, but presumably the beneficiary's or grantor's estate eventually may be depleted by the grantor trust income tax liability.

Special rules apply to disclosing transfers under Chapter 14.[7062]

If one fails to adequately disclose, one can file a supplemental gift tax return with adequate disclosure to get the statute of limitations running.[7063] In Letter Ruling 201638017, a gift in trust was reported as an outright gift to the primary beneficiary, and the donor was allowed to file a supplemental gift tax return retroactively allocating GST exemption to the trust.

It is not unusual to see a draft appraisal omitting the date of transfer and including what might be an incomplete description of the property (value per share rather than valuing the block of stock actually transferred). If one uses a defined value clause determining the price of sold property or the quantity of ownership interest transferred,[7064] one can readily have the appraisal finalized after the transfer to include the date of transfer and provide a full description of the property transferred. Also, it is not unusual for financial information to be available only through the end of the month or quarter preceding the sale, in which case management would represent no material changes in operations between the end of that month or quarter and the date of the transfer, and the appraisal is provided as of the date of the transfer (as stated in Reg. § 301.6501(c)-1(f)(3)(ii)(A) above) rather than as of month-end or quarter-end. In light of *Schlapfer*, an appraisal valuing one share that is attached in support of a reporting a fully disclosed bloc of shares that is described on the return may suffice, but I would rather use the process described in this paragraph than argue substantial compliance.

Which statute of limitations (SOL) runs due to adequate disclosure? An exception to the general 3-year rule is Code § 6501(e)(2), "Estate and gift taxes," provides:

> In the case of a return of estate tax under chapter 11 or a return of gift tax under chapter 12, if the taxpayer omits from the gross estate or from the total amount of the gifts made during the period for which the return was filed items includible in such gross estate or such total gifts, as the case may be, as exceed in amount 25 percent of the gross estate stated in the return or the total amount of gifts stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. In determining the items omitted from the gross estate or the total gifts, there shall not be taken into account any item which is omitted from the gross estate or from the total gifts stated in

[7061] See part III.B.2.i.xviii Sample Beneficiary Deemed-Owned Trust (fully completed gift) and text accompanying fn. 6144, found in part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (Including Possible Pitfalls).
[7062] See text accompanying fn. 7271, found in part III.B.7 Chapter 14.
[7063] Rev. Proc. 2000-34.
[7064] See the other provisions of this part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.

> the return if such item is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.

Reg. § 301.6501(e)-1(b)(2) elaborates:

> Further, there shall not be taken into account in computing the 25 percent omission from the gross estate stated in the estate tax return or from the total gifts stated in the gift tax return, any increases in the valuation of assets disclosed on the return.

Estate of Dillingham v. Commissioner, 903 F.2d 760 (10th Cir. 1990) gives the IRS the burden to establish that the 6-year limitation period applies:

> Appellant first argues that, because the respondent issued the notice of deficiency in the estate tax case after the expiration of the three-year limitation period, respondent has the burden to establish that the alternate six-year limitation period applies.[3] We agree. To obtain the extended limitation period of § 6501(e)(2), respondent must show that omitted amounts were properly includible in the gross estate and that an amount in excess of twenty-five percent of the gross estate was omitted. See, *Weikel v. Commissioner*, 51 T.C.M. (CCH) 432 (1986); *Reis v. Commissioner*, 1 T.C. 9 (1942), *aff'd*, 142 F.2d 900 (6th Cir. 1944). Accordingly, respondent in this case must show that the six checks delivered by the decedent on December 24, 1980, were properly includible in decedent's gross estate. However, as we discuss below, we conclude that respondent's burden was satisfied as a matter of law through the facts as stipulated.
>
> [3] Appellant made this same argument before the tax court in its first motion for reconsideration. The tax court agreed with appellant, but found that respondent had met the burden. Memorandum Sur Order at 2-3.

Do omitted charitable gifts count toward the 15% test? 2022 Form 709 Instructions provide:

> If you are required to file a return to report noncharitable gifts and you made gifts to charities, you must include all of your gifts to charities on the return.

One might consider the cost-benefit in reporting small outright charitable gifts if they are not material to the 25% calculation.

Note that running the gift tax SOL does not run the SOL on the trust's being exempt from GST tax. To do the latter, the trustee makes a distribution to a skip person and files the appropriate forms to run the statute of limitations on the GST inclusion ratio.[7065]

III.B.5. Estate Tax Issues

Estate tax issues include general valuation problems, deferral under Code § 6166, and marital deduction considerations and related planning.

[7065] See part 0 See Sheppard, "No Notice, No Examination, No Problem: IRS Further Deprives Appraisers of Procedural Protections," *Taxation of Exempts* (WG&L) (1/2022).
Sale from One Trust to Another, especially the text accompanying fns. 7005.

III.B.5.a. Alternate Valuation Date

Code § 2032, "Alternate Valuation," may reduce estate tax if values decrease within 6 months after death. Code § 2032(a), "General," provides:

> The value of the gross estate may be determined, if the executor so elects, by valuing all the property included in the gross estate as follows:
>
> (1) In the case of property distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date of distribution, sale, exchange, or other disposition.
>
> (2) In the case of property not distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death such property shall be valued as of the date 6 months after the decedent's death.
>
> (3) Any interest or estate which is affected by mere lapse of time shall be included at its value as of the time of death (instead of the later date) with adjustment for any difference in its value as of the later date not due to mere lapse of time.

Code § 2632(b), "Special rules," coordinates deductions with the alternate valuation.

Code § 2032(c), "Election must decrease gross estate and estate tax," provides:

> No election may be made under this section with respect to an estate unless such election will decrease –
>
> (1) the value of the gross estate, and
>
> (2) the sum of the tax imposed by this chapter and the tax imposed by chapter 13 with respect to property includible in the decedent's gross estate (reduced by credits allowable against such taxes).

Code § 2032(d), "Election," provides:

> (1) *In general*. The election provided for in this section shall be made by the executor on the return of the tax imposed by this chapter. Such election, once made, shall be irrevocable.
>
> (2) *Exception*. No election may be made under this section if such return is filed more than 1 year after the time prescribed by law (including extensions) for filing such return.

Consistent with Code § 2032(d)(2), Letter Ruling 202019015 granted an extension of time to elect alternative valuation when:

> Attorney advised the personal representative of the potential benefits of making an alternate valuation election and the personal representative intended to make such election on Form 706. However, the alternate valuation date appraisals were not completed by the extended due date of the Form 706. On Date 2, Decedent's estate timely filed Form 706 without making the election for alternate valuation under § 2032.

> On Date 3, Decedent's estate filed a supplemental Form 706, attached all appraisals required, paid the reported tax due, and elected alternate valuation under § 2032.

Letter Ruling 202329001 granted an extension of time to elect alternate valuation:

> Decedent's estate timely filed Form 706 on Date 2. Tax Professional did not advise Decedent's estate of its option to elect alternate valuation under § 2032 on the Form 706, and, consequently, Decedent's estate did not elect alternate valuation under § 2032 on the Form 706.
>
> On or about Date 3, which was within one year after the due date of the Form 706, Decedent's estate filed a supplemental Form 706 making the alternate valuation election under § 2032. Subsequently, Decedent's estate submitted this request for an extension of time under § 301.9100-3 to make the election.

III.B.5.b. Promissory Notes

Notes or other claims held by the decedent are likewise included even though they are cancelled by the decedent's will.[7066]

[7066] Reg. § 20.2033-1(b).

Although for gift tax purposes a note's value generally is equal to its face amount under Code § 7872 principles,[7067] for estate tax purposes valuation discounts might apply.[7068] Reg. § 20.2031-4 (issued 6/23/1958) provides:

[7067] *Frazee v. Commissioner*, 98 T.C. 554 (1992), held that Code § 7872, not Code § 483(e) or 1274, applies in valuing a promissory note in a transaction that was part gift and part sale. See part III.B.1.c.i Gifts with Consideration – Bargain Sales.

Estate of True v. Commissioner, T.C. Memo. 2001-167, held:

> The deferred payment arrangement allowed 3 months to pass between the dates Jean True's sales were completed for tax purposes and the payment date. For this reason, respondent asserts that the deferred payment arrangement should be considered to be a loan (from Jean True to her sons) of the $13,298,978 sales price for that 3-month period. Because Jean True did not charge or receive any interest on this amount, respondent further asserts that the deferred payment arrangement was a below-market gift loan to which section 7872 applies.
>
> Petitioners argue that even if Jean True's sales were completed on the notice dates (as we have decided), section 7872 cannot apply to the deferred payment arrangement. The buy-sell agreements required Jean True's sales to be consummated within 6 months after the notice dates. As a result, if the deferred payment arrangement were a "contract for the sale or exchange of any property" to which section 483 ordinarily could apply, no portion of the sales price would be recharacterized as interest under that section. See sec. 483(a), (c)(1) (although sec. 483 generally applies to payments made under any contract for the sale or exchange of any property, it does not apply unless some contract payments are due more than 1 year after the sale or exchange). Similarly, if the deferred payment arrangement were a "debt instrument given in consideration for the sale or exchange of property" to which section 1274 ordinarily could apply, no portion of the sales price would be recharacterized as original issue discount (OID) under that section. See sec. 1274(c)(1) (although sec. 1274 generally applies to any debt instrument given in consideration for the sale or exchange of property, it does not apply unless some payments under the debt instrument are due more than 6 months after the date of the sale or exchange).
>
> Petitioners assert that because no portion of the $13,298,978 aggregate sales price would be recharacterized as interest or OID under section 483 or 1274, the deferred payment arrangement cannot be treated as a below-market loan subject to section 7872. We disagree. In *Frazee v. Commissioner*, 98 T.C. 554 (1992), we considered the relationship of sections 483, 1274, and 7872 for gift tax purposes and rejected arguments quite similar to those made by petitioners in the case at hand.
>
> The taxpayers in Frazee sold property to family members in exchange for a note. The interest rate on the note, although less than a market rate, was sufficient to avoid the recharacterization of any part of the stated principal of the note as interest under section 483. The Frazee taxpayers argued that as a result, the note could not be a "below-market loan" subject to section 7872. We disagreed. In our view, sections 483 and 1274 were enacted to ensure the proper characterization of payments as principal or interest for income tax purposes. By contrast, the key issue for gift tax purposes is the valuation of all payments (both principal and interest). See *Krabbenhoft v. Commissioner*, 94 T.C. 887, 890 (1990), *affd.* 939 F.2d 529 (8th Cir. 1991). We held in *Frazee* that sections 483 and 1274 simply were not relevant for that gift tax purpose.
>
> The Commissioner's primary position in Frazee was that the value of the intrafamily note for gift tax purposes should be its "present value" under section 7872 (i.e., a value determined by reference to the applicable Federal rate), rather than its fair market value under general tax principles (i.e., a value determined by reference to market interest rates). Although we found this position to be "anomalous" because it was contrary to the traditional fair market value approach, *Frazee v. Commissioner*, *supra* at 590, we nevertheless accepted the Commissioner's treatment of the intrafamily note as a below-market gift loan subject to section 7872. See *id.*; *cf. Blackburn v. Commissioner*, 20 T.C. 204 (1953).
>
> Petitioners correctly observe that section 7872(f)(8) provides that section 7872 does not apply to any loan to which section 483 or 1274 applies. This prohibition is not applicable to the case at

The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. However, items of interest shall be separately stated on the estate tax return. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.

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hand. Technically, neither section 483 nor section 1274 applies to the deferred payment arrangement, because the buy-sell agreements required payment to be made within 6 months after the notice dates. See sec. 483(c)(1) (sec. 483 does not apply where no payment is due more than 1 year after the sale or exchange); sec. 1274(c)(1) (sec. 1274 only applies where at least one payment is due more than 6 months after the sale or exchange).

Petitioners also observe that certain proposed section 7872 regulations state that section 7872 does not apply to any loan given in consideration for the sale or exchange of property, within the meaning of sections 483(c)(1) and 1274(c)(1), even if the rules of those sections do not technically apply by reason of safe harbors or other exceptions. See sec. 1.7872-2, Proposed Income Tax Regs., 50 Fed. Reg. 33553, 33557 (Aug. 20, 1985). We note, however, that although proposed regulations constitute a body of informed judgment on which courts may draw for guidance, see *Frazee v. Commissioner*, *supra* at 582, we accord them no more weight than a litigating position, see *KTA-Tator, Inc. v. Commissioner*, 108 T.C. 100, 102-103 (1997); *F.W. Woolworth Co. v. Commissioner*, 54 T.C. 1233, 1265-1266 (1970).

The Commissioner proposed section 1.7872-2, Proposed Income Tax Regs., *supra*, in 1985, and has never adopted it in final form. The Commissioner has since asserted that section 7872 can apply to loans given in consideration for the sale or exchange of property, in both *Frazee v. Commissioner*, *supra*, and the case at hand. Moreover, our acceptance in *Frazee* of the Commissioner's position that section 7872 applied to the intrafamily note necessarily rejected the position taken in the proposed regulation.

For all these reasons, consistent with our decision in *Frazee*, we hold that the deferred payment arrangement may be a below-market loan subject to section 7872, even though no part of the sales price would be treated as interest or OID under sections 483 and 1274.[90]

[90] The Court of Appeals for the Seventh Circuit held, in *Ballard v. Commissioner*, 854 F.2d 185 (7th Cir. 1988), *revg.* T.C. Memo. 1987-128, that a note should have no gift tax consequences where it stated interest at the "safe harbor" rate referred to by sec. 483 and no portion of the note's stated principal amount would be recharacterized as interest for that reason. In *Krabbenhoft v. Commissioner*, 94 T.C. 887 (1990), *affd.* 939 F.2d 529 (8th Cir. 1991), we reconsidered our position on the relevance of sec. 483 for gift tax purposes in light of the reversal of our Ballard decision, and decided not to follow that reversal except where required by the *Golsen* rule (see *Golsen v. Commissioner*, 54 T.C. 742 (1970), *affd.* 445 F.2d 985 (10th Cir. 1971)). Moreover, the Court of Appeals for the Tenth Circuit, to which an appeal of this case would lie, has agreed with our view, as affirmed by the Court of Appeals for the Eighth Circuit in *Krabbenhoft*, that sec. 483 is not relevant for gift tax valuation purposes. See *Schusterman v. United States*, 63 F.3d 986 (10th Cir. 1995).

See also Letter Rulings 9408018 (quoted in fn 3730 regarding a note for a corporate redemption under part II.M.4.e.iii Succession Planning Using Redemptions When Parent is Living) and 9535026 (quoted in fn 7304 in part III.B.7.b.i Code § 2701 Definitions).

[7068] Blattmachr et al, "How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note," *Journal of Taxation*, Vol. 109, No. 01 (7/2008). Informal views of another excellent commentator are in my document number 5780917. See also Letter Ruling 9240003 (valuing notes based on the borrower's ability to repay them), based on *Estate of Harper v. Commissioner*, 11 T.C. 717 (1948), *acq.* 1949-1 C.B. 2.

Citing Reg. § 20.2031-4, Rev. Rul. 67-276 provides:

> Mortgages and mortgage participation certificates come within the scope of the above regulation. The presumption that their face value is their true value governs unless the representative of the estate submits convincing evidence to the contrary.
>
> If it is contended that the actual value of mortgages or mortgage participation certificates is less than their face value, pertinent factors to be taken into consideration in fixing the correct value include the valuation of real estate and any collateral covered by the mortgages, arrears in taxes and interest, gross and net rentals, foreclosure proceedings, assignment of rents, prior liens or encumbrances, present interest yield, over-the-counter sales, bid and asked quotations, and etc. The existence of an over-the-counter market for such securities and the quotations and opinions of value furnished by brokers and real estate appraisers cannot be accepted as conclusive evidence of the value of such securities. Such sales and bid and asked quotations are merely items to be considered with other evidence in fixing values.
>
> In valuing unit mortgages consideration will be given first to the value of the property securing the mortgages, applying the same factors as are used in fixing the valuation of real estate owned in fee. Where the mortgage is amply secured, the value will be determined to be its face value plus accrued interest to the date of death. Where the security is insufficient, the mortgage will be valued upon the basis of the fair market value of the property less back taxes, estimated foreclosure expenses, and, where justified, the expense of rehabilitation. If the mortgage is not affected by moratorium laws, the mortgagee's recourse against the mortgagor personally will be taken into consideration. The valuation of such assets is a question of fact and the burden of proof is upon the estate to overcome the presumption that the face value is the true value where a lower value is sought to be established.

Citing Reg. § 20.2031-4 and Rev. Rul. 67-276, TAM 8229001 provides:

> Here the decedent had no right to the payment of principal or interest until each yearly installment became due. Similarly, the estate does not have the right to demand payment of the full face value but has only the right to the yearly installments.
>
> The effect of section 20.2031-4 is to recognize (1) that any principal amount payable in the future normally carries an interest accrual with it and (2) that when the stated interest rate on the obligation is 'fair' (equal to the current market rate of interest for such type of obligation), the total PRESENT VALUE of all payments of principal and interest will equal the principal amount of the obligation. However, if the stated rate of interest on the note is less than the current market rate of interest, the present value of the amounts payable is accordingly less.
>
> While it is true that the value of the security is an important factor in placing a value on debt obligations, the rate of return and the length of time to maturity are also important factors. When interest rates increase, the effective rate of return on existing debt obligations correspondingly decreases. Thus, the existing obligations decrease in value because their effective rate of return will be less than the rate of return on just-issued debt obligations bearing interest at the now higher rate of interest.

> The effect that changes in the market rate of interest have on the market value of debt obligations is clearly seen in the market for outstanding United States Treasury Notes or Bonds. A U.S. government bond bearing 8 per cent interest issued at par in 1978 was worth substantially less a year later, when the interest rates on newly-issued U.S. government bonds had risen to 10 per cent or higher. Moreover, the security factor for United States Bonds or Notes is considered the highest possible in the marketplace.
>
> Although there is a sentence in Rev. Rul. 67-276 that indicates a mortgage that is amply secured must be valued at face value, the sentence must be read in context with the entire Ruling and not standing alone. When so considered, we find that the meaning of Rev. Rul. 67-276 is that the proper way to value notes and mortgages is to consider all available financial data and all relevant factors affecting the fair market value. Thus, one factor alone, such as collateral, is insufficient to set a proper value on a note or mortgage. If the collateral is ample and all other factors indicate face value, then the mortgage or note must be valued at face value. Although not stated in words, Rev. Rul. 67-276 implicitly assumes that at the date of death (or alternate valuation date) the mortgage will bear an adequate interest rate, that is, approximately the current interest rate. Understood in this light, the Ruling does not and can not change the provision of section 20.2031-4 that, although there is a presumption of face value, the presumption may be rebutted by convincing evidence to the contrary. A finding of ample security, by itself alone, does not change this rule.
>
> **Conclusion**
>
> A promissory note receivable that is fully secured is not necessarily to be valued under section 2031 at face value.
>
> The value of the note depends upon an analysis of all available data and all relevant factors affecting the value. This determination is a factual one which is not made by this office.

However, discounts may generate the equivalent of taxable interest when the principal is collected. A promissory note[7069] whose principal exceeds its basis immediately after its acquisition by the taxpayer is a “market discount bond;” that excess is “market discount.”[7070]

Note that Code § 1278(a)(1)(D)(i), “In general,” provides:[7071]

> Except as otherwise provided in this subparagraph or in regulations, the term “market discount bond” shall not include any bond acquired by the taxpayer at its original issue.

[7069] Code § 1278(a)(3), “Bond,” provides:

> The term “bond” means any bond, debenture, note, certificate, or other evidence of indebtedness.

[7070] Code § 1278(a)(2)(A), “In general,” provides:

> The term “market discount” means the excess (if any) of -
> (i) the stated redemption price of the bond at maturity, over
> (ii) the basis of such bond immediately after its acquisition by the taxpayer.

[7071] The legislative history provides:

> The bill clarifies that, except as provided by statute or by regulation, no market discount is created on the original issuance of a bond.

Query whether a note involving a grantor trust that terminates by reason of the deemed owner's death is deemed to have been issued to the holder as of the deemed owner's death or whether a note held by an estate is deemed issued by the estate because the estate starts over as a new taxpayer.

Note that Code § 1278(a)(1)(D)(iv), "Treatment of certain transferred basis property," provides:[7072]

> For purposes of clause (i), if the adjusted basis of any bond in the hands of the taxpayer is determined by reference to the adjusted basis of such bond in the hands of a person who acquired such bond at its original issue, such bond shall be treated as acquired by the taxpayer at its original issue.

Code § 1276(a), "Ordinary income," provides:

> (1) *In general*. Except as otherwise provided in this section , gain on the disposition of any market discount bond shall be treated as ordinary income to the extent it does

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Under the bill, two statutory exceptions are provided. The first exception relates to bonds that are part of an issue that is publicly offered. Because the Act provides that the issue price of publicly offered bonds (other than bonds issued for property) is the price at which a substantial amount of the bonds are sold, the OID provisions are inapplicable to a portion of the OID with respect to bonds acquired on original issue by large investors at "wholesale" prices (at deeper discounts than those available to "retail" customers). Under the bill, market discount is created on original issuance of a bond if the holder has a cost basis determined under section 1012, and such basis is less than the issue price of the bond. The difference between the holder's issue price and basis is treated as market discount.

The second statutory exception applies to a bond that is issued in exchange for a market discount bond pursuant to a plan of reorganization. This exception is intended to prevent the holder of a market discount bond from eliminating the taint of unaccrued market discount by swapping the bond for a new bond (e.g., in a recapitalization). Solely for purposes of the interest characterization rule, however, this exception is inapplicable to a bond issued in exchange for a pre-enactment market discount bond where term and interest rate of the new bond is identical to that of the old bond.

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not exceed the accrued market discount on such bond. Such gain shall be recognized notwithstanding any other provision of this subtitle.

(2) *Dispositions other than sales, etc.* For purposes of paragraph (1), a person disposing of any market discount bond in any transaction other than a sale, exchange, or involuntary conversion shall be treated as realizing an amount equal to the fair market value of the bond.

(3) *Treatment of partial principal payments*.

(A) *In general*. Any partial principal payment on a market discount bond shall be included in gross income as ordinary income to the extent such payment does not exceed the accrued market discount on such bond.

(B) *Adjustment*. If subparagraph (A) applies to any partial principal payment on any market discount bond, for purposes of applying this section to any disposition of (or subsequent partial principal payment on) such bond, the amount of accrued market discount shall be reduced by the amount of such partial principal payment included in gross income under subparagraph (A).

(4) *Gain treated as interest for certain purposes*. Except for purposes of sections 103, 871(a) ,881, 1441, 1442, and 6049 (and such other provisions as may be specified in regulations), any amount treated as ordinary income under paragraph (1) or (3) shall be treated as interest for purposes of this title.

Given that federal[7073] and state income tax rates tend to exceed estate tax rates, one might actually pay more tax overall by pursuing this strategy – in addition to angering an IRS examiner when one takes full credit for the note for gift tax purposes and reports a lower value for estate tax purposes.

[7073] Including the Code § 1411 tax on net investment income; see part II.I 3.8% Tax on Excess Net Investment Income.

A gift[7074] or bequest[7075] of a promissory note to the borrower usually would not result in cancellation of debt income.

See also part III.B.1.a.i.(d) Refinancing or Cancelling Loans.

III.B.5.c. Income Payable to Decedent or Assets Included in Estate

Interest and rents accrued at the date of the decedent's death constitute a part of the gross estate.[7076]

Regarding dividends:

[7074] *Bosse v. Commissioner*, T.C. Memo. 1970-355. For a discussion of not only intra-family but also commercial cases treating the cancellation of loans as income-tax-free gifts, see Bittker & Lokken, ¶7.4. Spurious Cancellations of Indebtedness, *Federal Taxation of Income, Estates, and Gifts* (WG&L). What is the result when a trust holding a promissory note merges with the trust that owes the note? Although it did not address this issue, Letter Ruling 200552009 held:

> It is consistent with the Supreme Court's opinion in *Cottage Savings* to find that the interests of the beneficiaries of the New Trusts will not differ materially from their interests in Trust 4, Trust 2, Trust 3 and Trust 4 before the merger and division. Each beneficiary will continue to hold, through his or her interest in a New Trust, the same beneficial interest in each asset of Trust 4, Trust 2, Trust 3 and Trust 4 that he or she held before the merger and division, and each interest in the divided trust will contain substantially the same terms. Accordingly, the proposed trust merger and division will not result in a material difference in kind or extent of the legal entitlements, and no gain or loss is recognized on the trust merger and division by any trust or trust beneficiary for purposes of § 1001(a).

Note that the ruling addressed Code § 1001(a), regarding gain on the sale or exchange of assets, and did not address Code § 61(a)(12), Income from discharge of indebtedness.

[7075] Letter Ruling 9240003 held:

> A testamentary cancellation of any intrafamily debt is an example of the detached and disinterested generosity . . . affection, respect, admiration, charity or like impulses that characterize a gift excludable from the recipient's income. *See, Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960). It is well settled that cancellation of a debt can be the means of effecting a gift. *See, e.g., Helvering v. American Dental*, 318 U.S. 322 (1943), which holds that where a creditor gratuitously forgives a debt, the forgiveness is a gift and not income. *Compare Commissioner v. Jacobson*, 336 U.S. 28 (1949), which holds that where a creditor cancels a debt involuntarily in an arm's length setting, the cancellation is income and not a gift. A testamentary cancellation of a debt owing to the decedent can similarly be the means of effecting a gift in the form of a bequest.
>
> The issue is primarily a question of fact, and under some circumstances -- for example, where donative intent is absent -- a testamentary cancellation of a note may result in discharge of indebtedness income. In some circumstances, other requirements of making a testamentary gift may not be met. *See Bosse v. Commissioner*, T.C. Memo. 1970-355, which involved, among other issues, whether certain actions and statements of the decedent effected a testamentary gift under state law. However, in this case, there is no evidence that anything other than donative intent was involved in the cancellation of the note. Therefore, the cancellation qualifies as a testamentary bequest under section 102 of the Code.
>
> Further, the estate would not realize cancellation-of- indebtedness income, because the estate was never an obligor on the note.
>
> Accordingly, the decedent's cancellation of the note was in the nature of a testamentary bequest excludable from gross income under section 102 of the Code rather than a discharge of a debt giving rise to discharge of indebtedness income under section 61(a)(12).

[7076] Reg. § 20.2033-1(b).

- Dividends declared on publicly-traded shares of stock before the decedent's death but payable to stockholders of record on a date after the decedent's death are not includible in the decedent's gross estate.[7077] However, if the stock is selling "ex-dividend" on the date of the decedent's death, the amount of the dividend is added to the ex-dividend quotation in determining the fair market value of the stock as of the date of the decedent's death.[7078]

- Dividends payable to the decedent or estate, by reason of the fact that on or before the date of the decedent's death the decedent was a stockholder of record (but which have not been collected at death), constitute a part of the gross estate.[7079] However, the dividends need to have been declared before death to be includible.[7080]

For purposes of the alternate valuation rules, Reg. § 20.2032-1(d)(4) provides:

> *Stock of a corporation*. Shares of stock in a corporation and dividends declared to stockholders of record on or before the date of the decedent's death and not collected at the date of death constitute "included property" of the estate. On the other hand, ordinary dividends out of earnings and profits (whether in cash, shares of the corporation, or other property) declared to stockholders of record after the date of the decedent's death are "excluded property" and are not to be valued under the alternate valuation method. If, however, dividends are declared to stockholders of record after the date of the decedent's death with the effect that the shares of stock at the subsequent valuation date do not reasonably represent the same "included property" of the gross estate as existed at the date of the decedent's death, the dividends are "included property", except to the extent that they are out of earnings of the corporation after the date of the decedent's death. For example, if a corporation makes a distribution in partial liquidation to stockholders of record during the alternate valuation period which is not accompanied by a surrender of a stock certificate for cancellation, the amount of the distribution received on stock included in the gross estate is itself "included property", except to the extent that the distribution was out of earnings and profits since the date of the decedent's death. Similarly, if a corporation, in which the decedent owned a substantial interest and which possessed at the date of the decedent's death accumulated earnings and profits equal to its paid-in capital, distributed all of its accumulated earnings and profits as a cash dividend to shareholders of record during

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[7077] Rev. Rul. 54-399, citing *Estate of George McNaught Lockie v. Commissioner*, 21 T.C. 64 (1953) (a reviewed decision), *acq.* 1954-1 C.B. 5.
[7078] Reg. § 20.2031-2(i), which regulation was upheld as valid by *Estate of McNary v. Commissioner*, 47 T.C. 467 (1967). Presumably, this reference to selling ex-dividend has its roots in Rev. Rul. 54-399, which applied that rule to stock that is being traded on an exchange. If the decedent dies on a weekend and stocks began selling ex-dividend on the trading day immediately after death, the amount of the dividend is added to the post-mortem price that is being averaged. Rev. Rul. 68-610.
[7079] Reg. § 20.2033-1(b), which regulation was upheld as valid by *Estate of McNary v. Commissioner*, 47 T.C. 467 (1967).
[7080] A rule including dividends declared after death would make no sense, in that only rights that exist at death are measured. However, a very close reading of Reg. § 20.2033-1(b) is required for this result:

> Interest and rents accrued at the date of the decedent's death constitute a part of the gross estate. Similarly, dividends which are payable to the decedent or his estate by reason of the fact that on or before the date of the decedent's death he was a stockholder of record (but which have not been collected at death) constitute a part of the gross estate.

Similarly implies that the dividends are accrued the way that interest and rents were accrued. A dividend is not accrued until it is declared. Therefore, a dividend must be declared before it is includible under Reg. § 20.2033-1(b).

the alternate valuation period, the amount of the dividends received on stock includible in the gross estate will be included in the gross estate under the alternate valuation method. Likewise, a stock dividend distributed under such circumstances is "included property".

Also, where an estate holds publicly-traded stocks selling ex-dividend on the alternate valuation date, and that date comes after a declaration of dividends, but before the record date, the value of the stock includes the amount of the dividends declared.[7081]

Parts of Code § 2041, dealing with a general power of appointment causing estate inclusion, are discussed in part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.

III.B.5.d. Farmland or Other Closely-Held Business Property

Code § 2032A allows for using a reduced value for real property used as a farm for farming purposes or used in a trade or business other than farming. The estate tax value applies for date-of-death income tax basis determinations as well.[7082]

For the interplay of Code § 2032A with marital deduction issues, see TAMs 8240015 and 8314005.[7083]

The aggregate decrease in the value of qualified real property taken into account for estate tax purposes with respect to any decedent is limited to $750,000, indexed for post-1997 inflation.[7084] The 2014 limitation was $1,090,000.[7085]

Given this limitation on the valuation reduction, if it appears that the surviving spouse's estate will (or perhaps might) be subject to estate tax, consider making the Code § 2032A election on the first spouse's estate tax return so that two Code § 2032A reductions can be made.

[7081] *Estate of Fleming v. Commissioner*, T.C. Memo. 1974-307. Rev. Rul. 60-124 held:

> … in the determination of the value of a decedent's gross estate, dividends declared before death, on stock includible in the gross estate, payable to stockholders of record after the date of the decedent's death must be considered in making an adjustment in the ex-dividend quotation of the stock at the date of the decedent's death. Such dividends may not be included in the gross estate under the alternate method of valuing the gross estate either as a separate asset or as an adjustment of the ex-dividend quoted value of the stock as of one year after the date of the decedent's death or as of some intermediate date.
>
> Under the alternate method of valuing the gross estate, stock includible in the gross estate and selling ex-dividend is to be valued at its ex-dividend quoted selling price as of one year after the date of the decedent's death or at any intermediate valuation date, increased by the amount of dividends declared on the stock during the alternate valuation period payable to stockholders of record subsequent to the date which is one year after the date of the decedent's death or such intermediate date. No part of the value so determined is deemed to be excluded property in determining the value of the gross estate.

[7082] Code § 1014(a)(3); *Van Alen v. Commissioner*, T.C. Memo. 2013-235 (beneficiaries were barred from contesting alternate valuation, especially with the estate tax statute of limitations having expired; 20% accuracy-related penalty imposed).

[7083] ACTEC Fellow Ed Hertenstein procured TAM 8314005.

[7084] Code § 2032A(a)(3).

[7085] Rev. Proc. 2013-35, Section 3.33.

However, the trade-off between a known basis reduction and a possible estate tax reduction might require a difficult judgment call.

A Code § 2032A election may be made on a late Form 706, so long as it is the first estate tax return filed for that decedent. *U.S. v. Parks*, 130 A.F.T.R.2d 2022-6492 (E.D. Mich. 11/18/2022).

III.B.5.e. Estate Tax Deferral or Financing; Tax Liens

III.B.5.e.i. Overview of Discretionary Extensions Under Section 6161

Use IRS Form 4768 to request the extensions of time to pay described below.[7086]

III.B.5.e.i.(a). Extensions for Tax Shown on the Return

Code § 6161(a)(2) provides for tax reported by the executor:

> The Secretary may, for reasonable cause, extend the time for payment of—
>
> (A) any part of the amount determined by the executor as the tax imposed by chapter 11, or
>
> (B) any part of any installment under section 6166 (including any part of a deficiency prorated to any installment under such section),
>
> for a reasonable period not in excess of 10 years from the date prescribed by section 6151(a) for payment of the tax (or, in the case of an amount referred to in subparagraph (b), if later, not beyond the date which is 12 months after the due date for the last installment).

Reg § 20.6161-1(a)(1) provides a "reasonable cause" extension for tax shown on the return:

> [An] extension of time beyond the due date to pay any part of the tax shown on the estate tax return may be granted for a reasonable period of time, not to exceed 12 months by the district director or the director of a service center, at the request of the executor, if an examination of all the facts and circumstances discloses that such request is based upon reasonable cause.

Below are examples of "reasonable cause" under Reg § 20.6161-1(a):

> *Example (1)*. An estate includes sufficient liquid assets to pay the estate tax when otherwise due. The liquid assets, however, are located in several jurisdictions and are

[7086] Although an extension of time to pay is authorized under a different statute than an extension of time to pay, they are generally requested on the same form, so a comment about an extension of time to file might be helpful. A taxpayer may request an extension of time to file using IRS Form 4768 after the deadline, if it contains a detailed explanation of why it is impossible or impractical to file a reasonably complete return by the due date, as well as good cause for not requesting the automatic extension. Reg. § 20.6081-1(c). The IRS must consider the estate's good cause explanation; it cannot just reject it out-of-hand for being late. *Estate of Paul Proske v. United States*, No. 2:09-cv-00670 (D. N.J. 5/25/2010).

> not immediately subject to the control of the executor. Consequently, such assets cannot readily be marshaled by the executor, even with the exercise of due diligence.
>
> *Example (2)*. An estate is comprised in substantial part of assets consisting of rights to receive payments in the future (i.e., annuities, copyright royalties, contingent fees, or accounts receivable). These assets provide insufficient present cash with which to pay the estate tax when otherwise due and the estate cannot borrow against these assets except upon terms which would inflict loss upon the estate.
>
> *Example (3)*. An estate includes a claim to substantial assets which cannot be collected without litigation. Consequently, the size of the gross estate is unascertainable as of the time the tax is otherwise due.
>
> *Example (4)*. An estate does not have sufficient funds (without borrowing at a rate of interest higher than that generally available) with which to pay the entire estate tax when otherwise due, to provide a reasonable allowance during the remaining period of administration of the estate for the decedent's widow and dependent children, and to satisfy claims against the estate that are due and payable. Furthermore, the executor has made a reasonable effort to convert assets in his possession (other than an interest in a closely held business to which section 6166 applies) into cash.

Reg § 20.6161-1(a)(2)(i) provides an "undue hardship" extension for tax shown on the return:

> [I]n any case where the district director finds that payment on the due date of any part of the tax shown on the return, or payment of any part of an installment under section 6166 (including any part of a deficiency prorated to an installment the date for payment of which had not arrived) on the date fixed for payment thereof, would impose undue hardship upon the estate, he may extend the time for payment for a period or periods not to exceed one year for any one period and for all periods not to exceed 10 years from the date prescribed in section 6151(a) for payment of the tax.

Reg § 20.6161-1(a)(2)(ii) defines "undue hardship" relating to tax shown on the return:

> The extension provided [for] undue hardship … will not be granted upon a general statement of hardship or merely upon a showing of reasonable cause. The term "undue hardship" means more than an inconvenience to the estate. A sale of property at a price equal to its current fair market value, where a market exists, is not ordinarily considered as resulting in an undue hardship to the estate. The following examples illustrate cases in which an extension of time will be granted based on undue hardship pursuant to this paragraph:
>
> *Example (1)*. A farm (or other closely held business) comprises a significant portion of an estate, but the percentage requirements of section 6166(a) (relating to an extension where the estate includes a closely held business) are not satisfied and, therefore, that section does not apply. Sufficient funds for the payment of the estate tax when otherwise due are not readily available. The farm (or closely held business) could be sold to unrelated persons at a price equal to its fair market value, but the executor seeks an extension of time to facilitate the raising of funds from other sources for the payment of the estate tax.

> *Example (2)*. The assets in the gross estate which must be liquidated to pay the estate tax can only be sold at a sacrifice price or in a depressed market if the tax is to be paid when otherwise due.

Reg § 20.6161-1(b) explains the procedural issues when filing the appropriate form, highlights of which include:

> …. An application for an extension of time for payment of the tax, or of an installment under section 6166 … will not be considered unless the extension is applied for on or before the date fixed for payment of the tax or installment…. The granting of the extension of time for paying the tax is discretionary with the appropriate internal revenue officer and his authority will be exercised under such conditions as he may deem advisable. However, if a request for an extension of time for payment of estate tax under this section is denied by a district director or a director of a service center, a written appeal may be made … to the regional commissioner with authority over such district director or service center director within 10 days after the denial is mailed to the executor…. When received, the appeal will be examined, and if possible, within 30 days will be denied, granted, or tentatively granted subject to certain conditions of which the executor will be notified.

The phrase "undue hardship" was in the statute when the regulations were promulgated but has since been removed. Presumably the regulations should be updated to remove the requirement of "undue hardship."

III.B.5.e.i.(b). Deficiencies Resulting from IRS Audit

Code § 6161(b)(2) provides for tax assessed by the IRS:

> Under regulations prescribed by the Secretary, the Secretary may, for reasonable cause, extend the time for the payment of any deficiency of a tax imposed by chapter 11 for a reasonable period not to exceed 4 years from the date otherwise fixed for the payment of the deficiency.

Reg § 20.6161-2 is much more stringent for tax arising from a deficiency. An extension may be granted for "undue hardship" only. Furthermore, Reg § 20.6161-2(b) provides for a more stringent definition of "undue hardship":

> The extension will not be granted upon a general statement of hardship. The term "undue hardship" means more than an inconvenience to the estate. It must appear that a substantial financial loss, for example, due to the sale of property at a sacrifice price, will result to the estate from making payment of the deficiency at the date prescribed therefor. If a market exists, a sale of property at the current market price is not ordinarily considered as resulting in an undue hardship. No extension will be granted if the deficiency is due to negligence or intentional disregard of rules and regulations or to fraud with intent to evade the tax.

The phrase "undue hardship" was in the statute when the regulations were promulgated but has since been removed. Presumably the regulations should be updated to remove the requirement of "undue hardship."

Reg § 20.6161-2(c) procedural requirements include:

> … When received, [the application for extension] will be examined, and, if possible, within thirty days will be denied, granted, or tentatively granted subject to certain conditions of which the executor will be notified. The district director will not consider an application for such an extension unless it is applied for on or before the date prescribed for payment of the deficiency, as shown by the notice and demand from the district director…. The granting of the extension of time for paying the deficiency is discretionary with the district director.

Internal Revenue Manual ("IRM") 5.5.5.5(1) requires a denial of an extension to notify the taxpayer:

> A written appeal may be made to the Examination Area Director within 10 days from the time the denial is mailed. Show the CSCO address for the Appeals office address unless the liability was created by an examination.

Whether the extension is for tax shown on the return or for a deficiency, the IRS grants the extension only one year at a time.

IRM 5.5.5.8 provides:

> (6) In addition to establishing reasonable cause, these cases require an analysis of the progress of efforts being made to borrow or liquidate assets or to otherwise pay the amounts to be extended. Some suggested additional information required in this analysis include:
>
> > a. Balance sheets listing all assets, disbursements, liabilities and earnings for the estate and relating to the prior extension period. Real estate should be listed with the value and location identified (city, county, and state).
> >
> > b. An accounting of the actions taken during the past extension period to resolve the indebtedness. Examples include marketing property, resolving suits, or seeking loans.
> >
> > c. Information on the executor's proposal to make partial payments during the extension being requested.
>
> (7) Contact the executor within 30 days of the date of the extension request to
>
> > a. advise them that you are reviewing the request,
> >
> > b. gather information to support your determination, and
> >
> > c. estimate the date of completion….
>
> (10) Most requests for an extension to pay are necessary because the estate representative or executor needs additional time to liquidate what are often very valuable properties that cannot be marketed within the 9 month period following the death of the taxpayer. Provided the executors verify that all steps necessary to sell property to pay the tax are being taken in an expeditious manner, and that all liquid assets not needed

> for the payment of anticipated administrative expenses are paid over, extensions to pay should generally be granted….
>
> (12) When evaluating extension to pay requests bear in mind that denial of the request may have adverse financial ramifications to the estate far in excess of the failure to pay penalty which will begin to accrue if the request is denied….

III.B.5.e.i.(c). Additional Extensions; Miscellaneous Rules

For additional extensions, IRM 5.5.5.3 instructs, "Evaluate progress of efforts made by the executor to borrow, liquidate assets, or otherwise pay the amount to be extended."

Code § 6161(d) provides additional rules:

> (1) *Period of limitation*. For extension of the period of limitation in case of an extension under subsection (a)(2) or subsection (b)(2), see section 6503(d).
>
> (2) *Security*. For authority of the Secretary to require security in case of an extension under subsection (a)(2) or subsection (b), see section 6165.
>
> (3) *Postponement of certain acts*. For time for performing certain acts postponed by reason of war, see section 7508, and by reason of Presidentially declared disaster or terroristic or military action, see section 7508A.

Code § 6503(d) suspends the statute of limitations while an extension is in effect. However, when a default occurs during the extension period, the statute of limitations begins to run again.[7087]

Code § 6165 provides:

> In the event the Secretary grants any extension of time within which to pay any tax or any deficiency therein, the Secretary may require the taxpayer to furnish a bond in such amount (not exceeding double the amount with respect to which the extension is granted) conditioned upon the payment of the amount extended in accordance with the terms of such extension.

However, bonds generally are not practical.

III.B.5.e.ii. Code § 6166 Deferral

For a verbal discussion of the consequences of relying on this strategy, see the first segment of my free webinar, Liens from Deferred Estate Tax; Grantor Trusts & Basis Step-Up; Gifts of Business Interests (4/24/2023), and the last segment of my free webinar, Gift Tax Return Adequate Disclosure; Constructive Dividends; Transferee Liability (7/25/2023).

[7087] *U.S. v. Johnson*, 109 A.F.T.R.2d 2012-2253 (D.C. UT) (Code § 6166 election tolled the statute of limitations for beginning an action against the estate, but a default of an installment payment stopped the tolling of the statute of limitations).

Code § 6166 allows the payment of estate tax to be deferred for certain closely-held businesses,[7088] if the value of such businesses exceeds 35% of the adjusted gross estate.[7089] For this calculation, "adjusted gross estate" means the value of the gross estate reduced by deductions under Code § 2053 or Code § 2054.[7090] Code § 2053(a) authorizes deductions for funeral expenses, administration expenses, claims against the estate, and certain debts. Claims include a pledge to the extent that either (1) the liability was contracted bona fide and for an adequate and full consideration in cash (or its equivalent) or (2) payment of the pledge would

[7088] For nuances of the ownership tests, see Gorin et al., "Internal Revenue Code Section 6166: Comments To Tax Counsel For The Senate Finance Committee," 41 *Real Property, Probate & Trust Journal* 73 (Spring 2006); see also Rev. Rul. 2006-34, which was issued after that article was published. See also Blattmachr, Gans, and Madden, Untangling Installment Payments of Estate Tax Under Section 6166, *Estate Planning Journal* (7/2009) (which discusses Rev. Rul. 2006-34). As to nuances of certain attribution rules in Code § 6166, see Letter Ruling 8428088. For a good summary of various aspects of Code § 6166, see Madden, *Tax Planning for Highly Compensated Individuals* (WG&L), ¶ 10.07 Installment Payment of Estate Taxes - Section 6166.
[7089] Code § 6166(a)(1).
[7090] Code § 6166(b)(6).

have constituted an allowable charitable deduction under Code § 2055 if it had been a bequest.[7091] Code § 6166(g) accelerates estate tax if certain changes occur post-mortem.[7092]

Failure to fully comply with ***<u>all</u>*** of the requirements for making an election on a timely filed return (including extensions) invalidates the election.[7093]

[7091] Reg. § 20.2053-5(a). Reg. § 20.2053-1(b)(2), "Bona fide requirement," provides:

(i) *In general*. Amounts allowed as deductions under section 2053(a) and (b) must be expenses and claims that are bona fide in nature. No deduction is permissible to the extent it is founded on a transfer that is essentially donative in character (a mere cloak for a gift or bequest) except to the extent the deduction is for a claim that would be allowable as a deduction under section 2055 as a charitable bequest.

(ii) *Claims and expenses involving family members*. Factors indicative (but not necessarily determinative) of the bona fide nature of a claim or expense involving a family member of a decedent, a related entity, or a beneficiary of a decedent's estate or revocable trust, in relevant instances, may include, but are not limited to, the following -

(A) The transaction underlying the claim or expense occurs in the ordinary course of business, is negotiated at arm's length, and is free from donative intent.

(B) The nature of the claim or expense is not related to an expectation or claim of inheritance.

(C) The claim or expense originates pursuant to an agreement between the decedent and the family member, related entity, or beneficiary, and the agreement is substantiated with contemporaneous evidence.

(D) Performance by the claimant is pursuant to the terms of an agreement between the decedent and the family member, related entity, or beneficiary and the performance and the agreement can be substantiated.

(E) All amounts paid in satisfaction or settlement of a claim or expense are reported by each party for Federal income and employment tax purposes, to the extent appropriate, in a manner that is consistent with the reported nature of the claim or expense.

(iii) *Definitions*. The following definitions apply for purposes of this paragraph (b)(2):

(A) Family members include the spouse of the decedent; the grandparents, parents, siblings, and lineal descendants of the decedent or of the decedent's spouse; and the spouse and lineal descendants of any such grandparent, parent, and sibling. Family members include adopted individuals.

(B) A related entity is an entity in which the decedent, either directly or indirectly, had a beneficial ownership interest at the time of the decedent's death or at any time during the three-year period ending on the decedent's date of death. Such an entity, however, shall not include a publicly-traded entity nor shall it include a closely-held entity in which the combined beneficial interest, either direct or indirect, of the decedent and the decedent's family members, collectively, is less than 30 percent of the beneficial ownership interests (whether voting or non-voting and whether an interest in stock, capital and/or profits), as determined at the time a claim described in this section is being asserted. Notwithstanding the foregoing, an entity in which the decedent, directly or indirectly, had any managing interest (for example, as a general partner of a partnership or as a managing member of a limited liability company) at the time of the decedent's death shall be considered a related entity.

(C) Beneficiaries of a decedent's estate include beneficiaries of a trust of the decedent.

[7092] Letter Ruling 201403012, allowing the reorganization of a business not to cause acceleration under Code § 6166(g), demonstrates the continued vitality of Rev. Rul. 66-62 and the legitimacy of looking to regulations under former Code § 6166A to help construe current Code § 6166. However, Letter Ruling 200613020 indicates that Code § 6166(g)(1)(D) is more favorable than the old regulations.

[7093] Reg. § 20.6166-1(b) provides:

If there is any doubt whether the estate might not qualify for a Code § 6166 deferral and the return is being extended, consider filing for an extension of time to pay as well, explaining the issue. Otherwise, when the return is filed, if the estate does not qualify for the Code § 6166 deferral then the IRS might assert penalties for late payment.[7094]

Some business owners rely on estate tax deferral for their business interests. Most of them are unaware of automatic secret liens and how the IRS' need to secure payment of estate tax may interfere with their businesses' ability to retain and expand loans or fidelity bonds. As described in part III.B.5.e.iv Federal Estate Tax Liens, Code § 6324(a)(2) imposes a secret, automatic estate tax lien against the personal assets of the trustee of a revocable trust that holds the business interest; for a probate estate, the lien attaches to the estate's property and continues to apply to that property once it is sold (with certain exception described in part III.B.5.e.iv.(b) Exceptions to the Estate Tax Lien. This lien lasts for 10 years except if and to the extent it is removed by property expressly subjected to a substitute lien. TIGTA directed the IRS to address the gap between the estate tax deferral period and the 10-year duration of the estate tax lien. Consider that the automatic or later express lien might ruin a business' ability to retain its borrowings or borrow other funds and may destroy the business - see part III.B.5.e.iv.(i) Effect of Liens on Dealings with Third Parties.

An August 2013 email from another estate planning lawyer suggested that an IRS source in Cincinnati stated that a Code § 6166 election will automatically draw an audit. Given that the number of estate tax returns reporting tax due has dramatically decreased, that suggestion is not to be taken lightly.

For a variety of issues regarding Code § 6166, see ACTEC submits a Report with recommendations to revise IRC Section 6166 and to propose the enactment of a new IRC Section 6166A to address important issues related to providing deferral treatment for federal estate tax and generation-skipping transfer tax attributable to closely held business interests (May 17, 2021). I served on the subcommittee that prepared that report.

It appears that the closely-held business interest passing to a marital deduction trust qualifies the estate for estate tax deferral, even though no estate tax is payable with respect to the

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> *Time and manner of election*. The election provided under section 6166(a) is made by attaching to a timely filed estate tax return a notice of election containing the following information:
> (1) The decedent's name and taxpayer identification number as they appear on the estate tax return;
> (2) The amount of tax which is to be paid in installments;
> (3) The date selected for payment of the first installment;
> (4) The number of annual installments, including the first installment, in which the tax is to be paid;
> (5) The properties shown on the estate tax return which constitute the closely held business interest (identified by schedule and item number); and
> (6) The facts which formed the basis for the executor's conclusion that the estate qualifies for payment of the estate tax in installments.

Woodbury v. Commissioner, T.C. Memo. 2014-66, held that failure to comply with (5) and (6) invalidated the election. The court was not sympathetic to arguments of substantial compliance, because those provisions were essential to provide information the IRS could use to decide whether to audit the return.

[7094] The IRS attempted to impose such penalties in *Estate of John R.H. Thouron v. U.S.*, 752 F.3d 311 (3rd Cir. 2014), *rev'g* 110 A.F.T.R.2d 2012-6572 (E.D. Pa.). Applying Reg. § 301.6651-1(c)(1), the Third Circuit held that, although one cannot rely on a tax advisor to perform ministerial filing acts, a taxpayer's reliance on the advice of a tax expert may constitute reasonable cause for failure to pay by the deadline if the taxpayer can also show either an inability to pay or undue hardship from paying at the deadline.

closely-held business interest. However, given the likely tax apportionment clause, I would view subjecting the marital deduction trust to an estate tax lien would be an obvious breach of the trustee's fiduciary duties in most cases. Absent the election, the estate tax would be paid by the liquid assets, and there would be no lien. The trustee would be trying to create an investment advantage to the nonmarital assets – paying interest at the Code § 6166 rate rather than commercial borrowing – and subjecting the marital deduction assets to a risk that is easily avoidable. I don't see how the trustee can favor the nonmarital assets in this way when the decedent did not intend the marital assets to be burdened by estate tax.

III.B.5.e.ii.(a). What is a Business?

The IRS views the decedent's real property as being a closely-held business if it is used in the decedent's business or if the decedent, directly or through a company that the decedent managed and in which the decedent owned a 1% general partner interest and a 20% limited partnership interest, reasoning:[7095]

> In determining whether the activities of the decedent, partnership, LLC or corporation constitute an active trade or business, the activities of agents and employees of the decedent, the partnership, LLC or corporation are also taken into consideration. The fact that some of the activities are conducted by third parties such as independent contractors who are neither agents nor employees of the decedent, partnership, LLC or corporation, will not prevent the business from qualifying as an active trade or business so long as these third-party activities are not of such a nature that the activities of the decedent, partnership, LLC or corporation (and their respective agents and employees) are reduced to the level of merely holding investment property.
>
> Often, day-to-day real estate operations and activities are performed by independent contractors, such as property management companies. If a decedent, partnership, LLC, or corporation uses an unrelated property management company to perform most of the activities associated with the real estate interests, that fact suggests that an active trade or business does not exist.
>
> To determine whether a decedent's interest in real property is an interest in an asset used in an active trade or business, the Service will consider all the facts and circumstances, including the activities of agents and employees, the activities of management companies or other third parties, and the decedent's ownership interest in any management company or other third party. The Service will consider the following nonexclusive list of factors:
>
> - The amount of time the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) devoted to the trade or business;
>
> - Whether an office was maintained from which the activities of the decedent, partnership, LLC, or corporation were conducted or coordinated, and whether the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) maintained regular business hours for that purpose;

[7095] Rev. Rul. 2006-34, which was analyzed in Planning for the Payment of Estate Taxes for Illiquid Estates Owning Real Estate-The Code § 6166 Deferral, *Probate & Property* (March/April 2009). Rev. Rul. 2006-34 revoked all of Rev. Rul. 75-365 and the portion of Rev. Rul. 75-367 relating to the eight rental homes.

- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) was actively involved in finding new tenants and negotiating and executing leases;

- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises;

- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) personally made, arranged for, performed, or supervised repairs and maintenance to the property (whether or not performed by independent contractors), including without limitation painting, carpentry, and plumbing; and

- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) handled tenant repair requests and complaints.

No single factor is dispositive of whether a decedent's activities with respect to the real property (or the activities of a partnership, LLC, or corporation through which decedent owns the real property) constitute an interest in a closely held business for purposes of section 6166.

The IRS applied these factors as follows:

(1) In Situation 1, A provided significant services to the strip mall tenants. A personally handled the day-to-day operation, management and maintenance of the strip mall. A's activities went beyond those of a mere investor collecting profits from a passive asset. Moreover, even in situations in which A hired independent contractors to perform repairs that A could not perform personally, A was involved in the selection of the contractors and reviewed and approved the work performed. Under these circumstances, the use of independent contractors on occasions when A could not personally perform the work does not prevent A's activities from rising to the level of the conduct of an active trade or business. Thus, A's ownership of the strip mall qualifies as an interest in a closely held business for purposes of section 6166. (The result would be the same if the strip mall had instead been held in a single-member LLC owned by A, and the LLC were disregarded as an entity that is separate from its owner under §§ 301.7701-1 through 3 of the Procedure and Administration Regulations.)

(2) In Situation 2, in determining whether B was a proprietor carrying on an active trade or business with respect to B's interest in the office park, the activities of DEF Management Corporation (DEF) and its relationship with B are taken into account. DEF and its employees provided all necessary services for B's office park. B had no ownership interest in DEF. B's reliance on DEF to perform all necessary services, B's lack of any significant participation in the management or oversight of the property, and B's lack of any ownership interest in DEF are all factors that weigh heavily against a finding that the office park was used by B in an active trade or business. Thus, B was not a proprietor in an active trade or business and B's interest in the office park does not qualify as an interest in a closely held business for purposes of section 6166.

(3) In Situation 3, DEF provided all necessary services with regard to the management and maintenance of the office park, including advertising to attract new tenants, showing the property to prospective tenants, negotiating and administering leases, collecting the monthly rent, and arranging for third party independent contractors to provide all necessary services to maintain the buildings and grounds of the office park, including snow removal, security, and janitorial services. These activities are sufficient to conclude that DEF was actively managing the office park. Because B owned a significant interest in DEF, the activities of DEF with regard to the office park allow B's interest in the office park to qualify as an interest in a closely held business for purposes of section 6166.

(4) In Situation 4, the determination of whether the limited partnership was carrying on a trade or business for purposes of section 6166 is made with reference to the partnership's activities. Because the limited partnership, rather than C, owned the interest in the strip malls, the nature and level of the activities of the limited partnership must be evaluated. The limited partnership, acting through its general partner C, handled the day-to-day operations and management of the strip malls. The activities of C on behalf of the limited partnership included (either personally or with the assistance of employees or agents) performing daily maintenance of and repairs to the strip malls (or hiring, reviewing and approving the work of third party independent contractors for such work), collecting rental payments, negotiating leases, and making decisions regarding periodic renovations of the strip malls. Thus, the limited partnership carried on an active trade or business. Because the strip malls were used in carrying on the partnership's active trade or business, they are not passive assets under section 6166(b)(9) and their value is not excluded from the value of C's interest in the partnership for purposes of section 6166. C's interest in the limited partnership qualifies as an interest in a closely held business for purposes of section 6166. (Because C owned at least 20 percent of the partnership, the conclusion would be the same even if C's activities were instead performed by another employee, partner or agent of the partnership).

(5) In Situation 5, MNO was engaged in an automobile dealership business. Thus, MNO was conducting an active trade or business at the time of D's death. Consequently, D's 100 percent stock interest in MNO qualifies as an interest in a closely held business. In addition, Real Property P was used exclusively in the business of MNO under a net lease from D. As in Situation 3, because D owned a significant interest in MNO, whose activities with regard to Real Property P constituted active management, D's interest in Real Property P also qualifies as an interest in a closely held business.

I disagree with requiring the decedent to have been active to determine whether a trade or business exists. Here's a perceptive comment from a tax lawyer:[7096]

> Although section 6166 uses the term "trade or business" without the modifier "active," the IRS concluded that the provision requires an active trade or business, apparently

[7096] Peter Genz (King & Spalding, LLP), pages 9-10 of his paper for "Real Estate Trade or Business – When Does it Matter under Tax Reform?" in the Fall 2018 meeting of the Real Estate Committee of the American Bar Association's Section of Taxation.

> because section 6166(b)(9)(A) excludes the value of "passive assets" used in the trade or business from the amount of the interest in the closely held business.

Letter Ruling 201343004 approved Code § 6166 treatment for businesses that engaged in personal and real estate rental activities. Rev. Rul. 75-366 approved a crop-sharing arrangement as eligible for Code § 6166 deferral.[7097]

Letter Ruling 201928007 considered whether the activities of various operating units of a corporation ("Company 1") that reported its operating units on an annual consolidated income tax return constituted an active trade or business for purposes of Code § 6166. It analyzed Operating Unit 2, a division of Operating Unit 1, as follows:

> According to the facts provided, Operating Unit 2 is responsible for providing remarketing, management and support services regarding equipment owned by Operating Unit 1 and Division 1 (a division of Operating Unit 1), and equipment owned by outside lessors. Operating Unit 2 has Number 1 full-time-equivalent employees that are involved in management, support, remarketing, sale and re-lease of the equipment. Operating Unit 2 has Number 2 locations and Number 3 off-site warehouse maintained where activities are conducted. Most lessees and customers are secured through direct activities of Operating Unit 2, and the repair of equipment is either arranged for, performed by, or supervised by an employee of Operating Unit 2.
>
> Although Revenue Ruling 2006-34 addresses interests in real estate, not in the management of personal property, the factors in the revenue ruling are helpful in evaluating whether the employees of Operating Unit 2 are engaged in a trade or business. Operating Unit 2 maintains several offices and a warehouse from which the employees conduct business. The employees of Operating Unit 2: negotiate new leases and monitor current leases; market and sell, or re-lease, used equipment; and, store and maintain equipment for sale or re-lease. Accordingly, the activities of Operating Unit 2 constitute an active trade or business for purposes of section 6166.[1]
>
> [1] This ruling does not address whether decedent's interest in Operating Unit 2 qualifies as an interest in a closely-held business for purposes of section 6166(a)(1).

[7097] The facts were:

> The farms were operated by tenant farmers under agreements whereby the decedent received 40 percent of the crops and bore 40 percent of the expenses. The decedent had participated with the tenants in important management decisions, such as what crops to plant, what fields to plant or pasture, how to utilize the subsidy program, what steps to take as to weed control, etc. The decedent had lived several miles from the farms but had made almost daily visits to inspect and discuss operations, and occasionally delivered supplies to the tenants.

In ruling in favor of the real estate being a Code § 6166 business interest, the IRS reasoned:

> An individual is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant, and if he receives a rental based upon farm production rather than a fixed rental. Farming under these circumstances is a productive enterprise which is like a manufacturing enterprise as distinguished from management of investment assets.
>
> In the present case the decedent had participated in the management of the farming operations and his income was based upon the farm production rather than on a fixed rental.

It analyzed Operating Unit 3, a division of the parent corporation, as follows:

> The facts provide that employees of Operating Unit 3 are involved in day-to-day operations, management, and maintenance of commercial class properties. Operating Unit 3 has Number 4 full-time-equivalent employees that work out of company offices in City, State. The employees of Operating Unit 3: find new tenants; negotiate and execute leases; arrange for, perform, and supervise property repairs and maintenance; and, handle tenant repair and maintenance requests, and complaints. Additionally, the employees hire and supervise independent contractors for substantial repairs and capital improvements, and services such as snow removal, landscaping, security, janitorial, and cafeteria services.
>
> Applying the factors discussed in Revenue Ruling 2006-34, Operating Unit 3 has a significant number of full-time employees that are involved in the day-to-day operations, management, and maintenance of real estate. Therefore, the activities of Operating Unit 3 constitute the carrying on of a trade or business for purposes of section 6166.[2]
>
> > [2] This ruling does not address whether decedent's interest in Operating Unit 3 qualifies as an interest in a closely-held business for purposes of section 6166(a)(1).

It analyzed Operating Unit 5, which operates under a holding company, the sole member of which is the parent corporation, as follows:

> The facts given provide that the Operating Unit 5 has Number 5 full-time equivalent non-owner employees overseeing all facets of construction and supervising operations of Company 2, an independent property management firm.
>
> Applying Revenue Ruling 2006-34 to this situation, it appears that Company 2 is acting as an independent contractor of Operating Unit 5. The use of independent contractors to perform work does not prevent the business activities from rising to the level of the conduct of an active trade or business provided that the third-party activities do not reduce the activities of the corporation to merely holding investment property. From the facts provided, Operating Unit 5 involves non-owner employees of Company 1 actively overseeing construction of the subject properties and actively supervising the actions of Company 2. Therefore the activities of Operating Unit 5 constitute the carrying on of a trade or business for purposes of section 6166.[3]
>
> > [3] This ruling does not address whether decedent's interest in Operating Unit 5 qualifies as an interest in a closely-held business for purposes of section 6166(a)(1).

It analyzed Operating Unit 6, the sole member of which is the parent corporation, as follows:

> The facts presented provide that Operating Unit 6 relies on Company 3, their hotel management company, to operate and manage the subject hotel and restaurant. Operating Unit 6 has no ownership interest in Company 3. However, the facts provide that even though Company 3 operates, maintains, services, and improves the hotel, employees of Operating Unit 6 are involved in a daily basis in all aspects of the management and food service of the hotel.
>
> Applying Revenue Ruling 2006-34 to this situation, it appears that Company 3 is acting as an independent contractor of Operating Unit 6. The use of independent contractors

> to perform work does not prevent the business activities from rising to the level of the conduct of an active trade or business provided that the third-party activities do not reduce the activities of the corporation to merely holding investment property. Even though Company 3 is involved in the management of the hotel, Operating Unit 6 is not merely holding an investment property. Therefore, the activities of Operating Unit 6 constitute the carrying on of a trade or business for purposes of section 6166.[4]
>
> > [4] This ruling does not address whether decedent's interest in Operating Unit 6 qualifies as an interest in a closely-held business for purposes of section 6166(a)(1).

It appears to me that the parent corporation operated through divisions, one or more subsidiary corporations, and one or more LLCs, and the IRS did not seem to care what type of entity each subsidiary was. Although Company 3 was referred to as "their hotel management company," the ruling seemed to treat it as an independent contractor that might not have operated directly or indirectly under the parent corporation.

Outside of the Code § 6166 context, see part II.G.26.b Real Estate as a Trade or Business.

Because a promissory note does not qualify for Code § 6166 deferral, consider using life insurance when engaging in a sale to an irrevocable grantor trust.[7098]

III.B.5.e.ii.(b). Tiered Structures

In determining what is eligible for Code § 6166 deferral, the value of any interest in a closely held business shall not include the value of that portion of such interest which is attributable to passive assets held by the business.[7099] "Passive asset" means any asset not used in carrying on a trade or business.[7100]

Any "stock in another corporation"[7101] is a passive asset unless a certain holding company election is made[7102] or a certain active corporation exception applies.[7103]

Another exception might apply in the case of S corporations – an exception that might make an S corporation structure better for Code § 6166 purposes than a partnership or C corporation. It appears that the assets of a qualified subchapter S subsidiary are treated as directly owned by

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[7098] See text accompanying fn 6491 in part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust.
[7099] Code § 6166(b)(9)(A).
[7100] Code § 6166(b)(9)(B)(i).
[7101] By referring to another corporation, Code § 6166(b)(9)(B)(ii) seems to apply only to a corporation holding stock in another corporation and not to a partnership holding stock in a corporation.
[7102] Code § 6166(b)(9)(B)(ii) excludes from passive asset treatment stock that a Code § 6166(b)(8) election treats as held by the decedent and qualified under Code § 6166(a)(1).
[7103] Code § 6166(b)(9)(B)(iii) provides:

> *Exception for active corporations*. If—
> (I) a corporation owns 20 percent or more in value of the voting stock of another corporation, or such other corporation has 45 or fewer shareholders, and
> (II) 80 percent or more of the value of the assets of each such corporation is attributable to assets used in carrying on a trade or business,
>
> then such corporations shall be treated as 1 corporation for purposes of clause (ii). For purposes of applying subclause (II) to the corporation holding the stock of the other corporation, such stock shall not be taken into account.

its ultimate parent; see part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders.[7104]

If one uses a tiered partnership structure, one does not receive the benefit of these safe harbors.[7105] Generally, one would want to make the case that the partnership structure was one integrated business. Query whether making that case might undermine the protection from creditors that having separate entities tends to provide.[7106] This asset protection inquiry has two aspects:

1. One is always responsible for one's own actions. If a parent actively manages its subsidiary, the parent will be responsible in tort for the parent's actions.

2. Entity structures protect one from strict liability. For example, suppose the parent is responsible for strategic management but not daily operations. Generally, the parent might be responsible for the actions of those it directly supervises if and to the extent that the parent failed to exercise sufficient care in hiring or supervising them, but the parent would not be responsible for their actions or the actions of others in the company beyond that. The parent also would not be responsible for any liabilities arising from the subsidiary's mere ownership of the property or for any of the subsidiary's contractual obligations. However, this strict liability protection might break down if the subsidiary is not run in a financially responsible way, so the parent would want to make sure that the subsidiary has sufficient capital needed to run its daily operations and fulfill its recurring obligations, as well as sufficient insurance protection.

A parent might very well be able to run its subsidiaries as part of a single strategic business operation while managing these concerns. Although this process appears manageable, I would prefer to use estate planning tools to avoid estate tax and consider insurance to fund potential estate tax payments until the estate planning tools have succeeded.

III.B.5.e.ii.(c). Terms of Extension

Generally, interest is paid on the 1st through 4th anniversary of the estate tax return due date, and interest and one-tenth of the principal are paid on the 5th through 14th anniversary of the estate tax return due date. Failure to make a payment when due terminates the election[7107] unless paid 6 months late with a penalty,[7108] and impossibility is not a defense.[7109] The election does not apply to GST tax imposed on a taxable termination.[7110] The election must be made on a timely filed return.[7111]

[7104] Especially the text accompanying fns. 96-98
[7105] Code § 6166 needs serious updating regarding its application to partnerships. See Gorin et al., Internal Revenue Code Section 6166: Comments To Tax Counsel For The Senate Finance Committee, 41 *Real Property, Probate & Trust Journal* 73 (Spring 2006).
[7106] For more on using separate entities for asset protection, see part II.F Asset Protection Planning.
[7107] Code § 6166(g)(3)(A).
[7108] Code § 6166(g)(3)(B).
[7109] *Estate of Adell v. Commissioner*, T.C. Memo. 2013-228.
[7110] Letter Ruling 200939003.
[7111] Code § 6166(d). Because the deadline is statutory, Letter Ruling 201015003 denied Code § 9100 relief on a return that was filed late, even though it held that the estate was entitled to elect special use valuation for the farm property under Code § 2032A and to have its farm property treated as a qualified family owned business interest under Code § 2057.

For adjustments on audit, see Rev. Rul. 81-294. If an estate makes a protective election but does not make a final election when audited, the protective election does not constitute a Code § 6166 election; accordingly, the IRS cannot collect tax as if the extension had been made.[7112]

If an estate overpays its non-deferred estate tax liability, the overpayment is not refunded but instead is applied to the deferred tax.[7113]

Also, if any portion of an interest in a closely held business, for which the Code § 6166 election is made, is distributed, sold, exchanged, or otherwise disposed of[7114] or money and other property attributable to such an interest is withdrawn from such trade or business, and the aggregate of such distributions, sales, exchanges, or other dispositions and withdrawals equals or exceeds 50% of the value of such interest, then the Code § 6166 extension of time for payment of tax shall cease to apply, and the unpaid portion of the tax payable in installments shall be paid upon notice and demand from the IRS.[7115] This rule does not apply to certain reorganizations,[7116] nor does it apply to a transfer of property of the decedent to a person entitled by reason of the decedent's death to receive such property under the decedent's will, the applicable law of descent and distribution, or a trust created by the decedent or to certain subsequent transfers of the property by reason of death to certain family members.[7117]

For a discussion of liens associated with Code § 6166 elections, see parts III.B.3.c.iv Liens: Selected Internal Revenue Manual Materials and III.B.3.c.iv Effect of Liens on Dealings with Third Parties.

III.B.5.e.ii.(d). Effect of Code § 6166 Election on Statute of Limitations for Collection

A Code § 6166 election, among others, suspends the statute of limitations for collecting estate tax.[7118]

If the IRS sends the taxpayer a notice that it is treating the Code § 6166 as terminated, the statute of limitations is no longer suspended.[7119]

7112 *U.S. v. Baileys*, 113 A.F.T.R.2d 2014-1838 (D. Central Ca. 3/25/2014).
7113 *Estate of Adell v. Commissioner*, T.C. Memo. 2014-89, interpreting Code § 6403; *Estate of McNeely v. U.S.*, 113 AFTR.2d 2014-2520 (D. Minn. 6/12/2014), interpreting Code §§ 6402, 6403
7114 For dispositions of holding companies or of their interests in the relevant business, see Code § 6166(g)(1)(E), (F).
7115 Code § 6166(g)(1)(A). For the extent to which a redemption to pay estate tax, administrative expenses, etc. constitutes a disposition, see Code § 6166(g)(1)(B).
7116 Code § 6166(g)(1)(C).
7117 Code § 6166(g)(1)(D).
7118 Code § 6503(d) provides:

> The running of the period of limitation for collection of any tax imposed by chapter 11 shall be suspended for the period of any extension of time for payment granted under the provisions of section 6161(a)(2) or (b)(2) or under the provisions of section 6163 or 6166.

7119 *U.S. v. Godley, Jr.*, 116 A.F.T.R.2d 2015-6302 (D. N.C. 2015).

III.B.5.e.iii. Graegin Loans

III.B.5.e.iii.(a). *Graegin* Loans: Tax Issues

In Rev. Rul. 84-75, the IRS ruled:

- If a loan is obtained to avoid a forced sale of assets, the loan is reasonably and necessarily incurred in administering the estate. Therefore, interest incurred on the loan is deductible as an expense of administration under Code § 2053(a)(2).[7120]

- However, in situations where the estate's obligation to make installment payments may be accelerated, the amount of future interest that will be paid is indefinite because a premature repayment will stop the accrual of interest. Therefore, for purposes of Code § 2053, a deduction is not allowable for the estimated amount of interest that will accrue upon funds borrowed by an executor on behalf of an estate to pay the federal estate tax if repayment of the loan could be accelerated. The interest is deductible as an administrative expense only to the extent it has accrued.

In *Estate of Graegin v. Commissioner*,[7121] a related corporation loaned money to the estate to pay estate tax, because the estate did not have sufficient liquidity to pay estate tax. It was a balloon note, payable in 15 years, which was the decedent's widow's life expectancy. The loan was not prepayable, so the Tax Court allowed the estate to deduct the entire 15-years' interest, which was payable at the then-15% prime rate. This resulted in a tremendous estate tax saving. The downside is that, during estate administration, the family member lender has interest income and the estate cannot deduct the interest for income tax purposes (because it was already deducted for estate tax purposes).[7122]

A year later, the IRS said that it will challenge deductions for balloon payments:[7123]

- when there is doubt as to the bona fide nature of the indebtedness,

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[7120] A paper by Steve Akers and Phil Hayes of Bessemer Trust pointed out: Various cases have permitted deduction of interest on amounts borrowed to pay federal estate tax, in situations where the loan was necessary to avoid a forced sale of assets, citing *Estate of Todd v. Commissioner*, 57 T.C. 288 (1971), *acq.* 1973-2 C.B. 4; *Estate of Sturgis v. Commissioner*, T.C. Memo. 1987-415; *Hipp v. United States*, 1972-1 U.S.T.C. ¶12824 (D. S.C. 1971); *Estate of Webster v. Commissioner*, 65 T.C. 968 (1976); *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477; *Estate of Huntington v. Commissioner*, 36 B.T.A. 698, 726 (1937).

[7121] T.C. Memo. 1988-477.

[7122] Code § 642(g). If an estate incorrectly deducts the interest for income tax purposes after deducting it for estate tax purposes, that's an income tax issue that does not affect the estate tax deduction. *Estate of Stick v. Commissioner*, T.C. Memo 2010-192.

[7123] Litigation Guideline Memorandum TL-65 (1989). CC 2017-001 obsoleted all LGMs but stated:

> While LGMs are no longer directly applicable to cases handled by Chief Counsel attorneys, they can serve as useful research tools and historical records of positions previously taken by the Office of Chief Counsel on issues in litigation. Redacted versions of LGMs remain publicly available on commercial on-line services such as Lexis and WestLaw. Attorneys seeking current guidance on issues that were previously the subject of an LGM should determine whether updated guidance has been provided in the form of a Chief Counsel Notice or other Chief Counsel work products, or request formal or informal Chief Counsel advice from the Office of Associate Chief Counsel with subject matter jurisdiction over the issues.

- where the liability for interest is not certain or for a reasonably estimable amount, or
- when a convincing argument can be made that borrowing is unnecessary.[7124]

Letter Ruling 9449011 involved the following:

> D died on January 22, 1990. The Estate contained liquid assets in the form of listed stocks and bonds on various exchanges in the amount of a and cash in the amount of b. On April 22, 1991, the Estate filed its federal estate tax return (Form 706) on the extended due date. The estate tax return reflected an estate tax liability of c. An additional d was payable to the State of X as state inheritance tax. On April 15, 1991, a loan secured by certain real property of the Estate, in the amount of e, was obtained from a bank. Interest payments on the loan will be made for approximately 20 years after the payment of the estate tax and, therefore, may occur after the expiration of the statute of limitations. The loan was used to pay federal and state death taxes of D, administrative expenses and debts, and to make necessary cash distributions to beneficiaries so that the Estate could be closed. The Estate contends that it was necessary for the Estate to borrow e in order to avoid selling stocks, bonds, land, or other assets of the Estate at depressed prices to meet all of the Estate's obligations. During the year 1993, the Estate incurred and paid interest on the loan in the amount of f. The Estate has not filed and does not plan to file its fiduciary income tax return (Form 1041) for 1993 until October 15, 1994.
>
> The taxpayer requests a ruling that the interest is deductible on the 1993 income tax return provided the Estate files the statement required by section 1.642(g)-1 of the income Tax Regulations, and that the interest does not constitute nondeductible personal interest under section 163(h) of the Internal Revenue Code. Furthermore, if future interest paid on funds borrowed to pay estate taxes are not currently deducted on Form 1041, or on the returns of the beneficiaries, how will the Estate protect its right to refund of estate taxes paid (based upon future interest deductions) after the expiration of the time period prescribed by section 6511?

Letter Ruling 9449011 reasoned and held:

> Section 301.6402-2(b)(1) of the Procedure and Administration Regulations provides that no refund will be allowed after the expiration of the statutory period of limitation except upon one or more of the grounds set forth in a claim filed before the expiration of such period. The regulation requires that the taxpayer set forth the claim with sufficient detail to apprise the Internal Revenue Service of the exact basis for making the claim.
>
> Section 301.6402-2(c) of the regulations provides that claims for estate tax refunds are to be made by filing Form 843.
>
> Under section 6511(a) and section 301.6511(a)-1 of the regulations, claims for refund must generally be filed within the later of 3 years from the time the return was filed or 2 years from the time when the tax was paid.

[7124] If an estate has liquid assets sufficient to pay funeral and administration expenses, and federal and state death taxes, borrowing to pay estate tax is not necessary and therefore not deductible. *Estate of Stick v. Commissioner*, T.C. Memo 2010-192.

Therefore, in order to protect the right to a refund of estate taxes based on payments of interest after the statutory period, the taxpayer must file a Form 843, constituting a protective claim, before the expiration of the statutory period of limitation, setting forth the basis of the claim. In each succeeding year in which interest payments are made, the taxpayer must file a Form 843 setting forth the grounds for the claim, the factual basis of the claim, required verification under penalties of perjury and an appropriate reference to the original protective claim. See Rev. Rul. 83-15, 1983-1 C.B. 224.

Section 2053(a)(2) of the Code provides that the value of the taxable estate is to be determined by deducting from the value of the gross estate such amounts for administration expenses as are allowable by the laws of the jurisdiction under which the estate is being administered.

Section 20.2053-3(a) of the Estate Tax Regulations provides that the amounts deductible as "administration expenses" are limited to such expenses as are actually incurred in the administration of the decedent's estate; that is, in the collection of assets, payment of debts and distribution of property to the persons entitled to it. The expenses contemplated in the law are such only as attend the settlement of an estate and the transfer of the property of the estate to individual beneficiaries or to a trustee, whether the trustee is the executor or some other person. Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions.

[summarizing Rev. Rul. 84-75]

Rev. Rul. 77-461, 1977-2 C.B. 324, holds that payments of interest accruing after a decedent's death attributable to installment obligations contracted by the decedent during his life, the interest upon which accrued after his death, are not deductible as administration expenses under section 2053(a)(2) of the Code. Such interest relates to an obligation of the decedent that he would have been obligated to pay had the decedent lived, unrelated to the settlement of the estate and the transfer of the property of the estate to the beneficiaries. However, if the executor had obtained an extension of the decedent's obligation, in order to avoid a sacrifice sale of estate assets, any ADDITIONAL interest could be deductible as an administration expense, if local law regarded the extension as necessary to the administration of the estate, where the interest was not merely paid on account of a pre-death obligation incurred by the decedent.

The determination of whether the loan obtained by the Estate in the amount of e was in fact necessary to avoid a forced sale of assets or whether it was obtained, at least in part, to pay interest accruing after the decedent's death on obligations incurred prior to death, or otherwise for the individual benefit of the beneficiaries of the Estate, is a factual question that is within the jurisdiction of the District Director to determine. If the District Director determines that it was necessary for the Estate to borrow e to pay federal and state taxes in order to avoid a forced sale of assets, the interest on the loan is deductible as an expense of administration under section 2053(a)(2) of the Code.

Lasarzig v. Commissioner, T.C. Memo. 1999-307, held that, because the trust beneficiaries chose to distribute estate assets and secure the loan with the distributed assets, the loan benefited the trust beneficiaries and not the decedent's estate and therefore was not an administrative expense of the estate. Facts:

> The QTIP trust was obligated to pay its share of the Federal estate tax over to the estate and failed to do so because the QTIP trustee (who was also a beneficiary of the estate) made the decision that the value of the realty was depressed, and it was not a good time to liquidate. Instead, the realty was distributed to the beneficiaries, and they placed the property into their own family trusts. Thereafter, the beneficiaries continued to believe that market conditions were not right, and so they borrowed (through their family trusts) the money to pay the QTIP's share of the estate's tax burden.[4] Respondent had filed a notice of his lien in 1998, and the lien was satisfied from the proceeds of the beneficiaries' family trusts' loan at the loan settlement/closing. After the payment of the outstanding estate tax liability, there remained no disputes concerning the estate tax liability that had been reported on the estate's return. Likewise, at that juncture, there remained no assets in the estate to administer on behalf of or to distribute to the estate's beneficiaries. Under these facts, it is difficult to see how the estate could meet the requirement of section 2053 and the underlying regulations.
>
> [4] We note that it is within respondent's discretion, as provided by Congress in sec. 6161, to extend the period for payment of the tax for up to 10 years. In that regard, under the circumstances of this case, respondent was not unreasonable in the exercise of his discretion. Respondent granted five extensions, and the payment of the tax was delayed for about 5 years, which seems to be a sufficient time to raise the funds to pay an agreed tax obligation.

Two 1999 Letter Rulings allowed deductions for interest for a loan from a commercial bank (the latter guaranteed by the family business), but each qualified the deduction:[7125]

> Accordingly, in view of the terms of the loan, we conclude that a deduction may be claimed on the Form 706 for the entire amount of the post-death interest expense to be incurred by the estate, provided the expense is necessarily incurred in the administration of the estate within the meaning of section 20.2053-3(a) and is allowable under local law. Whether the interest expense will be necessarily incurred in the administration of the estate is a factual determination and we are specifically not ruling on this issue.

On the other hand, Technical Advice Memorandum 200513028 disallowed deductions for interest on a loan from a family limited partnership that held marketable securities (57.6%), real property (17.5%) and personal notes on the partnership's prior sale of real estate (24.7%).

In *Estate of Murphy v. United States*,[7126] a family limited partnership was formed with approximately $91 million of restricted publicly-traded stock, of which the decedent contributed $89 million and the general partner LLC (to which the decedent contributed 49% and two children contributed the balance) contributed approximately $2 million. The estate borrowed $11 million from the partnership to pay estate tax, committing to pay $3 million of interest. The IRS claimed that the partnership's assets were includible in the estate under Code § 2036 and disallowed the interest. The court rejected both arguments and allowed the estate to deduct the interest.

[7125] Letter Rulings 199903038 and 199952039.
[7126] 104 AFTR 2d 2009-7703 (D. Ark. 2009).

In *Estate of Black v. Commissioner,*[7127] the interest on the loan was payable in a lump sum on the due date, more than 4 years from the date of the loan, and was deducted in full on the estate tax return. The court held that a loan from a limited partnership to the estate was not "necessarily incurred in the administration of the decedent's estate":

> Even assuming equivalent income and distributions to partners between February 25, 2003, the date of the loan, and November 30, 2007, the purported due date for repayment of the loan, timely repayment by the borrowers of the $71 million loan principal out of partnership distributions (derived almost entirely from dividends on Black LP's Erie stock) was, on the date of the loan, inconceivable. Thus, the borrowers knew (or should have known) that, on the loan date, payment of the promissory note, according to its terms, could not occur without resort to Black LP's Erie stock attributable to the borrowers' class B limited partnership interests in Black LP. Our conclusion that repayment of the note necessarily would require a sale of the Erie stock attributable to the borrowers' partnership interests in Black LP is premised on the assumption that, on the date they executed the promissory note, the borrowers intended to repay the loan in full on Nov. 30, 2007. Petitioner does not argue to the contrary. He argues only that the eventual decision to refinance the loan does not alter its status as a bona fide loan.
>
> Petitioner argues that the borrowers had no right under the partnership agreement to require a distribution to them of assets (i.e., Erie stock) either as part of a pro rata distribution to partners or in partial redemption of their partnership interests. But the partnership agreement provided for the modification thereof, and a modification permitting either a pro rata distribution of Erie stock to the partners or a partial redemption of the borrowers' partnership interests would not have violated petitioner's fiduciary duties, as managing partner, to any of the partners.

Estate of Duncan v. Commissioner[7128] clarified *Black*, permitting a (formerly) revocable trust to deduct interest paid to an irrevocable trust that had identical trustees and beneficiaries. The trustees determined the interest rate by asking the corporate trustee's loan department what rate would normally be charged; the rate was above the AFR and below the prime rate. The court rejected the IRS' argument that the parties needed to negotiate the interest rate with each other, since such a negotiation would have been meaningless. The court rejected the IRS' argument that the revocable trust should have sold assets to the irrevocable trust, given their identity of interest; the court recognized that, under Illinois, the two trusts must be respected as separate, and the court refused to require a sale at the discount that would have been required. In refusing to require a sale, the court distinguished *Black*:

> [In *Black*, we] did not hold that the loan was unnecessary because the estate could have sold stock. We held the loan was unnecessary because the estate would have had to sell the stock under any circumstance. The sale of the stock was inevitable, and the estate therefore could not have entered into the loan for the purpose of avoiding that sale.

[7127] 133 T.C. 340 (2009). The taxpayer prevailed on the IRS' assertion Code § 2036 inclusion regarding the limited partnership, so in some ways the case was a taxpayer victory.
[7128] T.C. Memo. 2011-255. Carol Harrington represented the taxpayer.

Similarly, the court rejected the IRS' argument that the parties could get together and agree to prepay the note that, by its terms, was not prepayable; again, the party that had the benefit of an interest rate above or below prevailing rates would not want to give up that benefit.

In *Keller v. United States*,[7129] a family limited partnership was formed with approximately $250 million in bonds. The estate borrowed from the partnership to pay federal estate taxes, Texas inheritance taxes, and other debts and obligations arising from the partnership. The note totaled $114 million and was due approximately 8-9 years from the date the estate tax return was filed, with 5% interest. The interest payments made on the note amounted to approximately $30 million, were paid to the partnership, reported as income to the partnership, passed through to its owners, each of whom paid income tax on such amounts. The IRS claimed that the partnership's assets were includible in the estate under Code § 2036 and disallowed the interest. The court rejected both arguments and allowed the estate to deduct the interest.

In affirming the District Court, the Fifth Circuit held:[7130]

> Disregarding the Estate's remaining illiquid assets, the Government instead re-urges that the loan between the FLP and the Estate could have been characterized another way, *e.g.*, as a distribution, rendering the loan (and its interest) "unnecessary." This position, as just noted, takes *Black* too far. The Government also contends that the Estate's and FLP's common control between related entities renders any potential economic distinctions between the Estate and FLP as well as the chosen financing structure little more than a legal pretense or an indirect use. What this ignores is that after the effective transfer of the Community Property bonds to the FLP, they were no longer property of the Estate. The Estate, having realized it improperly disposed of bonds belonging to another legal entity (the FLP was actually controlled by other family members), was forced to rectify its mistake using the assets it had available — largely illiquid land and mineral holdings. In lieu of liquidating these holdings, it borrowed from the FLP. As did *Graegin*, we refuse to collapse the Estate and FLP to functionally the same entity simply because they share substantial (though not complete) common control. The district court correctly permitted a deduction for the interest on the resulting loan.

Finally, if the beneficiaries have cash sufficient to pay the interest while the estate is looking for an unrelated buyer, the estate could avoid the *Graegin* controversy and sell enough of the illiquid assets to the beneficiaries to pay the interest. One might need to place the illiquid assets in an LLC first, so that the trustee can continue to control the sale of the underlying assets; the LLC idea would not work with an S corporation, but selling nonvoting stock to the beneficiaries and having a binding shareholders' agreement would probably be sufficient to address the control concern.

Koons v. Commissioner[7131] involved what appears to be a greedy taxpayer. In 2006, an LLC owned over 70% by the decedent's revocable trust loaned the trust $10,750,000 in exchange for a term promissory note in the principal amount of $10,750,000 at 9.5% per year interest with principal and interest due in 14 equal installments of approximately $5.9 million each between 2024 and 2031 (note the 18-year deferral of any payments). The terms of the loan prohibited prepayment. The total interest component of the 14 installments was $71,419,497. The proceeds of the loan were used to make a payment toward the estate and gift tax liabilities, and

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[7129] 104 AFTR.2d 2009-6015 (S.D. Texas 2009).
[7130] 110 AFTR.2d 2012-5312 (5th Cir. 2012).
[7131] T.C. Memo. 2013-94.

the taxpayer attempted to deduct the interest. The court held that the trust would need to use LLC distributions to repay the loan and the loan would unduly prolong estate administration, so there was no point to loaning the money instead of distributing it. In affirming, the Eleventh Circuit summarized the *Graegin* line of cases:[7132]

> Interest payments are not necessary expenses where: (1) the entity from which the estate obtained the loan has sufficient liquid assets that the estate can use to pay the tax liability in the first instance; and (2) the estate lacked other assets such that it would be required to eventually resort to those liquid assets to repay the loan.

A few other cases have addressed deductions for borrowing from related parties to pay estate tax.[7133]

From a tax-planning perspective, the point to a *Graegin* loan is to obtain an immediate estate tax deduction for the entire amount of interest to be paid, without any discounting for the time value of money. Note that the interest on a *Graegin* note is taxable income, and an income tax deduction would not be allowed because the interest was used to pay taxes, making it nondeductible personal interest (although it might be considered an administration expense). The income tax deferral, compared to the immediate estate tax benefit, is what makes it attractive. On the other hand, federal and state income tax rates in the year of repayment might exceed the estate tax rate. If the interest deduction is disallowed on the estate tax return, then the lender is stuck with ordinary income with the possibility of no offsetting deduction. A *Graegin* loan might very well draw an audit and a court date, as the IRS continues to litigate these cases. Trying to mitigate the income tax inclusion of the disallowed interest is quite uncertain.[7134]

Before doing a seller-financed *Graegin* loan, consider looking for one from a bank. The lack of an intra-family transaction should reduce exposure. If one then decides that a seller-financed *Graegin* loan is desirable, one can document the reasons relative to the potential bank loan that was rejected.

[7132] 119 A.F.T.R.2d 2017-1609 (11th Cir. 4/27/2017).

[7133] *Estate of Kahanic v. Commissioner*, T.C. Memo. 2012-81 (loan by surviving spouse when estate had sufficient assets to pay tax, but they were illiquid, and lender refrained from collecting until after estate tax proceedings were concluded); *Beat v. U.S.*, 107 A.F.T.R.2d 2011-1804 (D.C. Kan.) (IRS did not object to deduction of future interest on *Graegin* loan when summary judgment was ruled upon; when it later noticed its omission, its appeal to the court was rejected rather summarily, the court holding that the loan was necessary and beneficial to the Estate); *McKee v. Commissioner*, T.C. Memo. 1996-362 (It is not our province, and we are not prepared, to second guess the business judgments of the executors, for the executors have not been shown to have acted other than in the best interests of the estate. We believe that the executors' decision not to make a section 6166 election was prudent because, among other reasons, the estate benefited from increases in value to the Company stock and, consequently, decedent's estate was in a better situation to face contingencies such as an increased estate or gift tax liability. These loans allowed the estate to pay its Federal estate obligation in full shortly after decedent's death.); *Estate of Thompson v. Commissioner*, T.C. Memo. 1998-325 (the regulations under section 2053 do not require that an estate totally deplete its liquid assets before an interest expense can be considered necessary.).

[7134] See text accompanying and following fn 1421 in part II.G.4.m.i Code § 1341 Claim of Right Deduction and text accompanying fn 1426 in part II.G.4.m.ii Equitable Recoupment.

III.B.5.e.iii.(b). *Graegin* Loans: Using a Commercial Lender

Except for home mortgages and certain other transactions, commercial lenders tend to avoid fixed rate loans.

If one encounters that, consider obtaining an interest rate swap contract that allows the estate's overall interest obligation to be fixed and locked in during the desired term.[7135]

III.B.5.e.iv. Federal Estate Tax Liens

The discussion on liens below focuses on liens that are placed on transfers. This part III.B.5.e.iv includes parts:

- III.B.5.e.iv.(a) Imposition of the Estate Tax Lien
- III.B.5.e.iv.(b) Exceptions to the Estate Tax Lien
- III.B.5.e.iv.(c) Priority of the Estate Tax Lien
- III.B.5.e.iv.(d) Ten-year Duration of Automatic Estate Tax Lien
- III.B.5.e.iv.(e) Which Estates Are Affected by the Estate Tax Lien?
- III.B.5.e.iv.(f) Divestment of Lien Property and Release of Liens
- III.B.5.e.iv.(g) How to Avoid the Pitfalls of the Estate Tax Lien
- III.B.5.e.iv.(h) Liens: Selected Internal Revenue Manual Materials
- III.B.5.e.iv.(i) Effect of Liens on Dealings with Third Parties
- III.B.5.e.iv.(j) Wrongful Levy
- III.B.5.e.iv.(k) Effect on Trust of Federal Tax Lien Against Beneficiary
- III.B.5.e.iv.(l) Code §§ 6324(a)(1), 6324(a)(2) and Collection Due Process (CDP) Rights

See Bekerman 832-3rd T.M. Estate Tax Payments, Liabilities, and Liens (Sections 6161 and 6166). See also St. Amand, *The Intersection of Estate Tax Deferral, Liens, and Transferee Liability, Part II: The Complex Consequences of Deferral of Estate Tax Under § 6166*, 48 Tax Mgmt. Est., Gifts & Tr. J. No. 3 (May 11, 2023).[7136]

The Internal Revenue Manual provides guidance to its personnel about liens, Part 5, Collecting Process, found at https://www.irs.gov/irm/part5/index.html, which includes subpart 5.5, Decedent Estates and Estate Taxes, including:

[7135] See our Firm File Manager internal electronic files for client 5586/47287, which have a separate folder for the loan. Those would need to be sanitized before providing them externally.
[7136] Thompson Coburn LLP document no. 29,808,625.

- 5.5.8 Advisory Responsibilities for Processing Estate Tax Liens, found at https://www.irs.gov/irm/part5/irm_05-005-008.html (last revised December 16, 2022 when I checked April 2, 2023).

- 5.5.9 Collecting Gift Tax and Generation-Skipping Transfer Tax, found at https://www.irs.gov/irm/part5/irm_05-005-009.html (last revised December 16, 2022 when I checked April 2, 2023).

The concepts of "nominee", "transferee", and "alter ego" are independent bases for attaching the property of a third party in satisfaction of a delinquent taxpayer's liability.[7137] If the

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[7137] *Oxford Capital Corp. v. U.S.*, 211 F.3d 280 (5th Cir. 2000), explaining:

> A nominee theory involves the determination of the true beneficial ownership of property. An alter ego theory focuses more on those facts associated with a piercing the corporate veil analysis. In contrast, a transferee theory requires (1) an intent to defraud the Internal Revenue Service as a creditor or (2) a transfer without consideration which rendered the taxpayer insolvent. These issues are fact-intensive and involve imprecise legal rules. William D. Elliot, *Federal Tax Collections, Liens and Levies* 6 9.10[2] (2nd Ed. 2000). Specific property in which a third person has legal title may be levied upon as a nominee of the taxpayer if the taxpayer in fact has beneficial ownership of the property. See, *e.g.*, *Towe Antique Ford Foundation v. Internal Revenue Service*, 791 F.Supp. 1450, 1454 (D. Mont. 1992), *aff'd* w/o opinion, 999 F.2d 1387 (9th Cir. 1993).[2] Under the alter ego doctrine, however, all the assets of an alter ego corporation may be levied upon to satisfy the tax liabilities of a delinquent taxpayer-shareholder if the separate corporate identity is merely a sham, i.e., it does not exist independent of its controlling shareholder and that it was established for no reasonable business purpose or for fraudulent purposes. See *United States v. Jon-T Chemicals*, 768 F.2d 686 (5th Cir. 1985).[3] Cause to believe that a third party is holding particular property of the taxpayer as a nominee, without cause to believe alter ego status, justifies a levy upon the property of the third party only with respect to that specific property held as a nominee.
>
> [2] The court in *Towe* listed the following factors that are generally considered in determining nominee status: (a) No consideration or inadequate consideration paid by the nominee; (b) Property placed in the name of the nominee in anticipation of a suit or occurrence of liabilities while the transferor continues to exercise control over the property; (c) Close relationship between transferor and the nominee; (d) Failure to record conveyance; (e) Retention of possession by the transferor; and (f) Continued enjoyment by the transferor of benefits of the transferred property. *Towe Antique Ford Foundation*, 791 F.Supp. at 1454 (citing *United States v. Miller Bros. Constr. Co.*, 505 F.2d 1031 (10th Cir. 1974)).
>
> [3] While adopting a totality of the circumstances test, this circuit has developed a non-exhaustive list of factors to consider: (1) the parent and subsidiary have common stock ownership; (2) the parent and subsidiary have common directors or officers; (3) the parent and subsidiary have common business departments; (4) the parent and subsidiary file consolidated financial statements; (5) the parent finances the subsidiary; (6) the parent caused the incorporation of the subsidiary; (7) the subsidiary operated with grossly inadequate capital; (8) the parent pays salaries and other expenses of subsidiary; (9) the subsidiary receives no business except that given by the parent; (10) the parent uses the subsidiary's property as its own; (11) the daily operations of the two corporations are not kept separate; (12) the subsidiary does not observe corporate formalities. See *Century Hotels*, 952 F.2d at 110 n.5 (5th Cir. 1992).

Fourth Inv. LP v. United States, 720 F.3d 1058, 1069–70 (9th Cir. 2013) provides the following factors for nominee status:

(1) whether inadequate or no consideration was paid by the nominees;
(2) whether the properties were placed in the nominees' names in anticipation of a lawsuit or other liability while the transferor remains in control of the property;
(3) whether there is a close relationship between the nominees and the transferor;
(4) failure to record the conveyances;

government asserts that a trust in which the settlor had no legal rights was really a nominee for the settlor, the nominee issues– "the taxpayer has engaged in a legal fiction by placing legal title to property in the hands of a third party while actually retaining some or all of the benefits of true ownership" - is a question of fact, especially where the trust lacked a bank account, the settlor paid expenses from his personal account, and the settlor used the trust's property.[7138] The nominee theory applies when a debtor transfers his residence to a joint revocable trust.[7139]

For more information, see "The Devil is in the Details: Important Tax Administration and Procedural Rules for Estate Planners," Chapter 9 of the 2015 Heckerling Institute on Estate Planning,[7140] as well as a 2009 law review article on tax liens' applications to trusts,[7141] an AICPA Tax Section presentation April 30, 2015,[7142] and the IRS' web page.[7143] See also the first segment of my April 23, 2023 webinar, Liens from Deferred Estate Tax; Grantor Trusts & Basis Step-Up; Gifts of Business Interests.

III.B.5.e.iv.(a). Imposition of the Estate Tax Lien

The estate tax lien has some surprising aspects that affect not only probate and trust lawyers but also real property lawyers who represent buyers of property subject to this (generally unrecorded) lien. These surprises extend to lenders who rely on such property as collateral.

If assets pass on a person's death and are included in the decedent's gross estate for federal estate tax purposes ("included property"), and the total of the included property (that is, the gross estate), reduced by certain debts, expenses, and losses, exceeds a threshold, federal estate tax is required to be paid within nine months of the decedent's death.

To ensure that the entire estate tax is paid, Code § 6324(a)(1) provides for an estate tax lien on probate property for 10 years after the decedent's death. The lien automatically attaches to all probate property not used to pay charges against the estate and its administrative expenses.[7144]

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(5) whether the transferor retained possession; and

(6) whether the transferor continues to enjoy the benefits of the transferred property.

U.S. v. Acacia Corporate Management, LLC, 119 A.F.T.R.2d 2017-1931 (9th Cir. 5/23/2017), confirmed that the Ninth Circuit still uses that test.

[7138] *U.S. v. Kimball, Jr.*, 117 A.F.T.R.2d 2016-2234 (D. Me. 6/24/2016). The court was looking to applicable local law – that of Maine. The quote was the court quoting *Berkshire Bank v. Town of Ludlow*, 708 F.3d 249, 254 (1st Cir. 2013), which in turn was quoting *Holman v. United States*, 505 F.3d 1060, 1067-68 (10th Cir. 2007). The court further said that the nominee issue is fact-intensive and involves the totality of the circumstances, quoting *Dalton v. Commissioner*, 682 F.3d 149, 158 (1st Cir. 2012).

[7139] *U.S. v. Peeler*, 118 A.F.T.R.2d 2016-XXXX (D. MS 11/29/2016), citing *Oxford Capital* (fn. 7137).

[7140] See Thompson Coburn LLP document number 6141610.

[7141] Much of this is from Gorin and Reynolds, Estate Tax Liens: The Surprising Truth That Estate Planning and Real Estate Lawyers Often Ignore, *Probate & Property* (January/February 2007). Jonathan Blattmachr made some useful suggestions when we wrote the article, including referring to the Code § 6324 lien as the secret estate tax lien.

[7142] See http://www.aicpa.org/InterestAreas/Tax/CPEAndEvents/DownloadableDocuments/2015-04-30-Advanced-Tax-Quarterly-Understanding-the-IRS-IRM-and-Collection-Process-Presentation-Slides.pdf, which is saved as Thompson Coburn LLP document number 6174129.

[7143] Understanding a Federal Tax Lien, found at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Understanding-a-Federal-Tax-Lien.

[7144] A similar lien applies for gift tax purposes, Code § 6324(b), capping the principal of the donee's liability at the value of the gift. The donee is also liable for interest, which the Eleventh Circuit says is not

More important, this estate tax lien need not be recorded to be effective and enforceable, and no record need be kept of an estate tax lien's release.[7145] This estate tax lien (sometimes called the "secret estate tax lien") differs from the Code § 6321 general tax lien. The general tax lien attaches only when the taxpayer neglects or refuses to pay tax after demand. Reg. § 301.6321-1. The priority of Code § 6321 lien is discussed by Freyermuth, Does a Federal Tax Lien Take Priority over a Mortgagee's Lien on Rents? *Bloomfield State Bank v. United States*, *Probate & Property* (p. 58, Sept./Oct. 2011); the case is at 644 F.3d 521 (7th Cir. 2011). Code § 6321 imposes a lien upon all property and rights to property, whether real or personal, belonging to the taxpayer. A disclaimer cannot frustrate this lien. *Drye v. U.S.*, 528 U.S. 49 (1999), which included a far-reaching footnote 7:

> In recognizing that state-law rights that have pecuniary value and are transferable fall within § 6321, we do not mean to suggest that transferability is essential to the existence of property or rights to property under that section. For example, although we do not here decide the matter, we note that an interest in a spendthrift trust has been held to constitute 'property' for purposes of § 6321 even though the beneficiary may not transfer that interest to third parties. See *Bank One*, 80 F.3d, at 176. Nor do we mean to suggest that an expectancy that has pecuniary value and is transferable under state law would fall within § 6321 prior to the time it ripens into a present estate.

Code § 6321 also reaches assets held as tenants by the entirety, *U.S. v. Craft*, 535 U.S. 274 (2002); Notice 2003-60 explains how the IRS enforces liens in light of *Craft*. Update on *Craft* and Litigation of Tenancy by Entirety Property, presented at the ABA Tax/RPTE 2014 Joint Fall Meeting, explained that, on foreclosure of TBE property to satisfy a tax lien, generally the sale proceeds are divided evenly, but the non-debtor spouse can argue that TBE gave her the right to use the property for the rest of her life and that she should obtain a settlement based on actuarial values; see Thompson Coburn LLP document no. 6091970. *U.S. v. Bogart*, 125 A.F.T.R.2d 2020-378 (3rd Cir. 1/7/2020) approved the sale of property owned by debtor and debtor's spouse.

Whether the tax lien would automatically be extinguished when the debtor dies is a matter of state law. *NPA Associates, LLC, v. Estate of Cunning*, 114 A.F.T.R.2d 2014-6400 (D. V.I. 2014) (lien extinguished); *U.S. v. Mattox*, 113 A.F.T.R.2d 2014-444 (E.D. Wis.) (lien continued).

For more on foreclosure when more than one person has an interest, see part III.B.3.c.iv Effect of Liens on Dealings with Third Parties, especially fn. 7197.

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capped at the gift's value but the Third, Fifth, and Eighth Circuits say is capped at the gift's value. *U.S. v. Marshall*, 798 F.3d 296 (5th Cir. 2015); *Baptiste v. Commissioner*, 29 F.3d 1533 (11th Cir. 1994), *Baptiste v. Commissioner*, 29 F.3d 433 (8th Cir. 1994), and *Poinier v. Commissioner*, 858 F.2d 917 (3rd Cir. 1988). *Marshall* also held that the gift tax lien applies to the income beneficiary but not the remaindermen. Code § 6324(b) uses different language than Code § 6324(a), the latter imposing a lien on the trustee, not the beneficiaries. For how Code § 6324(b) applies to indirect donees, see part III.B.1 Transfers During Life.

[7145] Internal Revenue Manual § 5.5.8, Estate Tax Liens.

The lien may also attach to both halves of community property[7146] or other joint revocable trust.[7147]

The lien applies only to property rights at the time this tax lien becomes effective. If the debtor transferred property before the lien became effective, the government cannot enforce the lien

[7146] See Code § 66 and *U.S. v. Smith*, 117 A.F.T.R.2d 2016-663 (D. Wash. 2016). In *U.S. v. McGrew*, 118 A.F.T.R.2d 2016-6149 (9th Cir. 10/17/2016), the IRS was able to satisfy ex-husband's tax debt by foreclosing on community property awarded to wife in their divorce:

> McGrew asserts that the liens which the United States seeks to foreclose do not cover the residence at this time. We disagree. The residence was the community property of McGrew and Kenneth, although it is now hers alone. In general, the whole of the community estate is liable for a debt incurred by either spouse before or during marriage. Cal. Fam. Code § 910(a); see also *Lezine v. Sec. Pac. Fin. Servs., Inc.*, 14 Cal.4th 56, 63–64, 925 P.2d 1002, 1006, 58 Cal. Rptr.2d 76, 80 (1996). That means that the community estate is liable for debts incurred by either spouse for the period preceding their separation. See Cal. Fam. Code § 910(b); *McIntyre v. United States* (*In re McIntyre*), 222 F.3d 655, 658 (9th Cir. 2000); *Babb v. Schmidt*, 496 F.2d 957, 959-60 (9th Cir. 1974).

[7147] *U.S. v. Gibbons*, 132 A.F.T.R.2d 2023-5249 (D. MA 7/20/2023), reasoning:

> "[U]nder the federal tax lien statute, state law determines what interest a taxpayer possesses with respect to property...[b]ut federal law determines *whether* that state-law-created interest constitutes `property' or `rights to property' under the federal lien statute." *United States v. Murray*, 217 F.3d 59, 63 (1st Cir. 2000) (emphasis in original) (citation omitted). In other words, the "bundle of rights" that defendant has in relation to the property depends on Massachusetts law, but "federal law determines whether this interest rises to the level of `property' or `rights to property' for purposes of the federal tax lien statute." *See id*.
>
> Defendant has an interest in the property under Massachusetts law. When a "settlor retains dominion" over property that is "at least as great as a power of appointment," that property is "considered part of his assets." *State St. Bank & Tr. Co. v. Reiser*, 7 Mass. App. Ct. 633, 637 (1979). Here, defendant deeded the property to a trust. (TAC ¶ 7). He is currently the sole beneficiary of that trust and maintains total control over the trustee's actions. (See Stipulation ¶ 10; Declaration of Trust ¶ 2.2). Thus, the trust instrument gives defendant "such extensive powers over the trust property that it [is] in effect [his] own under Massachusetts law." *See Markham v. Fay*, 74 F.3d 1347, 1356 (1st Cir. 1996).
>
> Because defendant enjoys complete control over the trust while also being "the sole beneficiary, the legal title and equitable interest...merge and thereby terminate the trust." *See id.* at 1357; *see also O'Brien v. Commissioner*, 86 T.C.M. (CCH) 461, at *7 (T.C. 2003) (holding that when "a beneficiary can force a trustee to act...the beneficiary has an interest in property subject to [f]ederal tax lien[s]"). Accordingly, under federal law, the government can enforce its tax liens against the property and seek its entire value. See *Markham*, 74 F.3d at 1364 (explaining that where a person creates a trust for his own benefit, his "creditors can reach the maximum amount which the trustee under the terms of the trust could pay to [him]"); *Murray*, 217 F.3d at 65 ("It is against public policy to permit a man to tie up his own property in such a way that he can still enjoy it but can prevent his creditors from reaching it.").
>
> Defendant, however, contends that the trust should not collapse because James Gibbons was a valid beneficiary of the trust from its inception in 2009 until he disclaimed his interest in 2022. That argument is inapposite. The degree to which the government can reach the property held in defendant's self-settled trust turns on his present interest in the trust, regardless of the existence of other beneficiaries at some earlier moment in time. *See Murray*, 217 F.3d at 65 (holding that debtor-beneficiary's present "interest in income and corpus [of a trust] constitutes property for purposes of the federal tax lien statute, even if" he could have been divested of his interest in the past). Because defendant is the only current beneficiary of the trust, and he has total control over the trustee's actions, the trust has collapsed, and the government can reach the property.

against that property unless the government first obtains a judgment that the conveyance constituted a fraudulent transfer under applicable state law.[7148]

The general tax lien arises on assessment and is effective until the assessed taxes are paid or the lien becomes unenforceable because of a lapse of time.[7149] The IRS is required to give notice and an opportunity for a hearing.[7150] In contrast, the secret estate tax lien need not be recorded and the estate need not be given notice; therefore, an executor or other persons receiving included property, either by sale, distribution, or other transfer, might not be aware that an estate tax lien exists. On the other hand, administrative expenses, being enumerated as an exception to a Code § 6324(a) lien but not a Code § 6321 lien, are subject to the Code § 6321 lien, even if arising before the Code § 6321 lien was imposed.[7151]

Also, if the estate does not have the capacity to pay the estate tax or for other reasons would like to delay payment of the tax, the executor may request an extension under Code § 6161 by filing IRS Form 4768. This extension is granted for reasonable cause for an initial period of 12 months, but additional 12-month extension requests can be granted for up to 10 years. If the estate has an interest in a closely held business and the interest exceeds 35% of the adjusted gross estate, the estate may elect to pay the estate tax on such business in installments under Code § 6166; see part III.B.5.e.ii Code § 6166 Deferral. Section 6166 extensions may lead to liens recorded under Code § 6324A.

In any event, consider that an executor who distributes assets before all tax liabilities of the estate (or includible trust) are satisfied, the executor may be personally liable for paying the estate tax.[7152]

III.B.5.e.iv.(b). Exceptions to the Estate Tax Lien

A lien will not apply the following types of purchasers or transactions:[7153]

- a purchaser of stock, bonds, or other securities who had no actual notice or knowledge of the lien at the time of the purchase;

- a purchaser of a motor vehicle who has no actual notice or knowledge of the lien at the time of the purchase and taking possession;

7148 *U.S. v. Baker*, 114 A.F.T.R.2d 2014-6158 (D.C. N.H. 2014) (under local law, divorce decree transferred all of the transferor's rights to the subject real estate). In *Baker*, the government complained that the transferor had not recorded the deed before the Code § 6321 lien was filed. Citing a First Circuit case, the court held that:

> any effect that an unrecorded property transfer has on a subsequent bona fide purchaser or creditor has no bearing on whether a grantor retains any rights to property previously conveyed for purposes of 26 U.S.C. § 6321.

The judge later awarded attorney fees to the taxpayer, holding that the government had no justification for its position. 115 A.F.T.R.2d 2015-379 (D.C. N.H. 2015).

7149 Code § 6322.

7150 Code § 6320.

7151 *U.S. v. Spoor*, 118 A.F.T.R.2d 2016-6018 (11th Cir. 10/4/2016).

7152 See fn. 7167.

7153 Code § 6324(c), incorporating by reference certain important exceptions found in Code § 6323(b).

- a purchaser of tangible personal property sold at retail in the ordinary course of business (which might be relevant to an executor who continues to operate

- a business owned by the decedent as a sole proprietor; and

- a purchaser of household goods, personal effects, or certain other tangible personal property at a "casual sale" (and not for resale) for less than $1,000, if the purchaser has no actual notice or knowledge of the lien, or that the sale is one of a series of sales.

III.B.5.e.iv.(c). Priority of the Estate Tax Lien

Liens attaching before decedent's death have priority over the estate tax lien. The estate tax lien has priority over liens that attach to included assets after the date of death (other than liens for much personal property and certain other items excluded under Code § 6323(b)).[7154] If the estate has a Code § 6166 election in place to defer estate tax on closely held business interests, and a Code § 6324A lien is recorded, the Code § 6324A lien releases the secret estate tax lien and is subordinate to all liens that attached before the Code § 6324A lien attached.[7155] Thus, included property might be subject to liens that start out junior (or subordinate) to the secret estate tax lien but are senior (that is, take priority) to the Code § 6324A lien.

However, the Code § 6324A lien is subject to the following liens, even if they would otherwise be junior to the Code § 6324A lien:[7156]

(A) Certain real property tax and special assessment liens.[7157]

(B) Certain real property subject to a mechanic's lien for repairs and improvements, unless the mechanic's lien came into existence after the IRS accelerated the deferred amount under Code § 6166(g).

(C) Certain real property construction or improvement financing agreement giving rise to a security interest, whether such security interest came into existence before or after the tax

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[7154] However, if real estate was subject to a mortgage at the decedent's death and a bona fide purchaser buys the property after death with knowledge of the secret estate tax lien, the purchaser steps into the senior secured creditor's shoes to the extent that the purchase price discharged the senior debt, if the state law principle of equitable subrogation applies. *Spear v. U.S.*, 111 A.F.T.R.2d 2013-1064 (D. Ariz.).

[7155] See part III.B.3.c.iv Liens: Selected Internal Revenue Manual Materials.

[7156] Code § 6324A(d)(3).

[7157] Referring to Code § 6323(b)(6), which refers to:

> With respect to real property, as against a holder of a lien upon such property, if such lien is entitled under local law to priority over security interests in such property which are prior in time, and such lien secures payment of—
>
> (A) a tax of general application levied by any taxing authority based upon the value of such property;
>
> (B) a special assessment imposed directly upon such property by any taxing authority, if such assessment is imposed for the purpose of defraying the cost of any public improvement; or
>
> (C) charges for utilities or public services furnished to such property by the United States, a State or political subdivision thereof, or an instrumentality of any one or more of the foregoing.

lien was filed, unless the security interest came into existence after the IRS accelerated the deferred amount under Code § 6166(g).[7158]

Note that the above exceptions are more narrow than the exceptions to a Code § 6324(a) lien. Administrative expenses, being enumerated as an exception to a Code § 6324(a) lien but not a Code § 6324A lien, are subject to the Code § 6324A lien, even if arising before the Code § 6324A lien was imposed.[7159]

As described further below, the estate tax lien has a 10-year duration. After it expires, the IRS must rely on the general tax lien. The general tax lien's priority is not based on date of death; instead, its priority is based on notice required under Code § 6323. As to Code § 6323, I.R.M. 5.17.13.3(1) provides:

> The Federal Priority Statute does not apply if, before the insolvency proceeding begins, another person has obtained an interest in the property that would prevail over the federal tax lien under IRC § 6323. *United States v. Estate of Romani*, 523 U.S. 517 (1998).
>
> a. If the interest of a creditor prevails over the federal tax lien under IRC § 6323(a), (b), (c), or (d), then the federal claim does not have priority over the creditor's interest.
>
> b. Under IRC § 6323(a), the following creditors prevail unless the IRS has filed a Notice of Federal Tax Lien: (a) purchasers, (b) holders of security interests, (c) mechanic's lienors, and (d) judgment lien creditors. Generally, creditors meeting the requirements in IRC § 6323(a), (b), (c), or (d), will have a higher priority claim than the IRS if the creditor's interest arises prior to the insolvency proceeding and prior to the filing of the Notice of Federal Tax Lien. See Note, below.
>
> c. In *Estate of Romani*, the Supreme Court held that a judgment lien creditor who recorded its liens on real property before the IRS filed its Notices of Federal Tax Lien prevailed over the IRS's tax claims in an insolvent decedent's estate case.

[7158] Code§ 6323(c)(3), which provides:

For purposes of this subsection—

(A) *Definition*. The term real property construction or improvement financing agreement means an agreement to make cash disbursements to finance—

(i) the construction or improvement of real property,

(ii) a contract to construct or improve real property, or

(iii) the raising or harvesting of a farm crop or the raising of livestock or other animals.

For purposes of clause (iii), the furnishing of goods and services shall be treated as the disbursement of cash.

(B) *Limitation on qualified property*. The term qualified property, when used with respect to a real property construction or improvement financing agreement, includes only—

(i) in the case of subparagraph (A)(i), the real property with respect to which the construction or improvement has been or is to be made,

(ii) in the case of subparagraph (A)(ii) , the proceeds of the contract described therein, and

(iii) in the case of subparagraph (A)(iii), property subject to the lien imposed by section 6321 at the time of tax lien filing and the crop or the livestock or other animals referred to in subparagraph (A)(iii).

[7159] *U.S. v. Spoor*, 118 A.F.T.R.2d 2016-6018 (11th Cir. 10/4/2016).

d. The general rule is that if the creditor would prevail against the IRS under IRC § 6323 outside of an insolvency, it will also prevail against the IRS in the insolvency.

e. Under *Estate of Romani*, many priority disputes in insolvency proceedings will be resolved by determining lien priorities under IRC § 6323.

Note: The *Romani* case applies only where the Government is relying on a claim for which a lien arose under IRC § 6321 and the competing interest is one identified in § 6323. In *Law Offices of Jonathan A. Stein v. Cadle Company*, 250 F.3d 716 (9th Cir. 2001), the Service levied the compensation of the president and CEO of an insolvent company. The company ignored the levy and continued to pay the president. The Service then sued the company to enforce the levy, and obtained a judgement under IRC § 6332(d). A third party also obtained a judgement against the company. The company then received a damages award to which the Service and the third party both claimed priority. In the ensuing interpleader proceeding, the Government claimed priority under 31 USC § 3713. The third party claimed priority by virtue of a judgement lien under IRC § 6323. The district court held for the Government under 31 USC § 3713, and the appellate court affirmed, finding that under *Romani*, the judgement lien would have priority if the United States were relying on claim for which a tax lien arose under IRC § 6321. However, in this case, the IRS did not have a federal tax lien claim against the company, so section 6323 did not apply. The Government won because section 3713 gave its claim priority over the third party's judgement lien.

In re: Estate of Frederick Alan Simmons, 120 A.F.T.R.2d ¶ 2017-5109 (D. IN 7/31/2017), held that, even though administrative expenses had higher priority under applicable state law, Code § 6323 did not give administrative expenses priority, so the Code § 6323 tax lien came first. Rev. Rul. 80-112 provides:

FACTS.

An individual died in September 1978, leaving property insufficient to pay taxes owed the United States for which it had no lien and other debts including funeral and administrative expenses, doctor's bills from the decedent's last illness, and wages due a household employee.

The state in which the decedent resided provides that a reasonable one-year family allowance be paid out of a decedent estate.

Under the laws of the state, claims against the estate of a deceased debtor are to be paid in the following order: administration expenses, funeral expenses, costs of last illness, family allowances, wages of household employees, and all other claims.

LAW AND ANALYSIS.

Section 3466 of the Revised Statutes (31 U.S.C. section 191, 1970) provides that whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied.

Funeral and administrative expenses and the one-year family allowance provided by state law are under state law not debts of the decedent, but are charges against the property of the decedent to be deducted before the payment of debts. Costs of the decedent's last illness and the wages of household servants are debts from the decedent.

HOLDING.

The claims against the decedent's estate for funeral and administrative expenses and the family allowance have priority over federal tax claims of the government for which it has no lien. However, such federal tax claims are superior to claims against a decedent's estate for doctor's bills from the decedent's last illness and wages due a household employee.

Karl v. Rettig, 131 A.F.T.R.2d 2023-XXXX (E.D. Va. 6/27/2023), denied the IRS' motion to dismiss the following assertion of priority over the IRS' estate tax lien (refences to paragraphs I of the complaint omitted):

Plaintiff Karl is an attorney who previously represented Linda J. Solomon ("Solomon") in employment litigation against the United States Department of Agriculture ("USDA")…. Solomon then allegedly breached the contract she had with Karl and refused to pay him $739,670 2 as owed for legal fees, $8,281.76 as owed in costs, and by not having the settlement amount paid into Karl's attorney trust account.

Karl asked the district court to impose an equitable lien on the settlement proceeds, but the court rejected that request because the District of Columbia has no statutory lien provision. Instead, the district court suggested Karl file suit in D.C. Superior Court, which he then did.. After Solomon failed to show up at the first two trial dates, she died on her way to the third trial. A representative for the Estate was appointed, and the D.C. Superior Court ultimately entered judgment in the amount of $747,951.76 in Karl's favor in March 2019, and in November 2019 the court ordered that the judgment "shall bear interest at the legal rate from March 14, 2019." Karl filed a copy of the judgment in Fairfax County Circuit Court in May 2019 and the post-judgment interest award in November 2021.

The Estate is currently being administrated by the Commissioner of Accounts of the Circuit Court of Fairfax County (the "Commissioner") in accordance with Virginia law. The Commissioner filed a report on January 24, 2023 finding that Karl's claim against the estate did not constitute an attorneys' fee lien or judgment creditor's lien, and he determined the IRS had priority over Karl's claim with respect to any taxes owed. Karl filed his objections to the report, which are now pending before the Fairfax County Circuit Court.

On January 6, 2023, Karl filed a three Count Complaint to establish the priority of his judgment lien over any federal tax lien, asserting federal question jurisdiction under 28 U.S.C. § 1331 based on federal the Tax Lien Act, 26 U.S.C. § 6323 and the full faith and credit clause of the U.S. Constitution. More specifically, in Court One, Karl seeks relief under the Tax Lien Act, 26 U.S.C. § 6323(a), which provides in relevant part as follows:

> The lien imposed [in favor of the United States] by section 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary.

26 U.S.C. § 6323(a). Section 6321, referenced therein, states:

> If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

26 U.S.C. § 6321. In support of this claim, Karl contends that (1) he qualifies as a judgment lien creditor under § 6323(a); (2) before any notice of tax lien by the IRS was filed, he filed notice of his judgment and interest with the Fairfax County Circuit Court Clerk, and therefore met the requirements of § 6323(f), as required in § 6323(a); and (3) he is entitled to priority over the IRS. In Count Two, Karl alleges that, in any event, he is entitled to super priority over an IRS tax lien under § 6323(b)(8), which provides as follows:

> Even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid ... [w]ith respect to a judgment or other amount in settlement of a claim or of a cause of action, as against an attorney who, under local law, holds a lien upon or a contract enforceable against such judgment or amount, to the extent of his reasonable compensation for obtaining such judgment or procuring such settlement, except that this paragraph shall not apply to any judgment or amount in settlement of a claim or of a cause of action against the United States to the extent that the United States offsets such judgment or amount against any liability of the taxpayer to the United States.

26 U.S.C. § 6323(b)(8). In Court Three, Karl alleges that the judgment he obtained in the D.C. Superior Court has priority over any federal tax lien under the Full Faith and Credit Clause.

III.B.5.e.iv.(d). Ten-year Duration of Automatic Estate Tax Lien

Code § 6324(a)(1) provides that the estate tax lien applies for 10 years from the date of death, unless estate tax is paid in full sooner or becomes unenforceable by reason of the lapse of time. Most courts follow the reasoning of *United States v. Cleavenger*,[7160] which held that litigation concerning enforceability of the lien must be completed within 10 years of the decedent's death or the IRS loses the ability to enforce the secret estate tax lien. The court held that the IRS should process a general tax lien if it wants to maintain a lien on unpaid estate taxes. Courts generally follow the *Cleavenger* case.[7161]

But, in *United States v. Saleh*,[7162] the court sharply disagreed with *Cleavenger*'s analysis of the secret estate tax lien and held that the IRS could extend the estate tax lien by suing for payment

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[7160] 325 F.Supp. 871 (N.D. Ind. 1971), *aff'd* 517 F.2d 230 (7th Cir. 1975).
[7161] See *New England Acceptance Corp. v. United States*, 35 F.Supp.2d 53, 55–56 (D.N.H. 1997).
[7162] 514 F.Supp. 8 (D.N.J. 1980).

of taxes, even if that required the lien to run past the 10 years. Similarly, in *United States v. Warner*,[7163] the court reasoned that if Code § 6502, which states that an assessed tax may be collected by levy or court proceedings as long as the proceedings or levy is instituted within 10 years after the assessment, is satisfied, the IRS can enforce the lien even if the proceedings extend beyond 10 years after the decedent's death.

Thus, depending on the jurisdiction, an estate may become encumbered by the secret estate tax lien for a period well past the 10-year time frame expressed in the literal language of Code § 6324.

III.B.5.e.iv.(e). Which Estates Are Affected by the Estate Tax Lien?

Code § 6324 applies to all included property, whether passing through probate or otherwise. But whether a property is held in a probate estate or passes outside of probate is an important distinction.

Probate Assets

Under Code § 6324(a)(2), the estate tax lien automatically attaches to any included property that is transferred from a probate estate, whether to a beneficiary or purchaser. As a result, if a person purchases probate property that is subject to the secret estate tax lien, whether or not that person is aware of it, the purchased or transferred property is still subject to the lien in that person's possession. Moreover, as described above, the secret estate tax lien is superior to the interests of the purchaser or lender if the lender's security interest arises after the decedent's death. The government may seize the encumbered property and sell it to recover any unpaid taxes.[7164] Code § 6324 "provides for the substantive liability of the transferees of estates with respect to the estate tax without regard to State law."[7165] The latter includes surviving joint tenants who contributed nothing toward the purchase of the joint property.[7166]

Although Code § 6324(a)(1) places a 10-year limit on its lien, Code § 6324(a)(2) does not expressly refer to a limit. However, the IRS views the Code 6324(a)(2) lien as having the same limit; see part III.B.5.e.iv.(h) Liens: Selected Internal Revenue Manual Materials.

Under 31 U.S.C. § 3713(b), the executor of a decedent's estate is liable for paying a creditor or making a distribution before paying any claim of the U.S. government, including estate taxes, unless the payment is permitted under another federal law.[7167] The executor, however, would not be liable for a bona fide sale, because the sale proceeds are subject to the same rules.

[7163] No. 83-CIV3717 (LBS), 1985 WL 2575 (S.D.N.Y. 9/18/1985).
[7164] Treas. Reg. § 301.6331-1(a).
[7165] *Groetzinger v. Commissioner*, 69 T.C. 309, 316 (1977), citing:
Schuster Nason, TC Memo 1986-297, 312 F.2d 311 (9th Cir. 1962), *affg.* 32 T.C. 998 (1959); *cf.* section 6901(h). See also *Commissioner v. Stern*, *supra*.
The citation for *Stern* is 357 U.S. 39 (1958).
[7166] *U.S. v. Ringling*, 123 A.F.T.R.2d 2019-2019-814 (D. S.D. 2/21/2019), citing *Groetzinger* from fn 7165 and *Nason v. Commissioner*, T.C. Memo. 1986-297.
[7167] *U.S. v. Estate of Reitano*, 114 A.F.T.R.2d 2014-5919 (D. Mass. 2014), citing *United States v. Renda*, 709 F.3d 472, 480 notes 9-10 (5th Cir. 2013), and *United States v. Coppola*, 85 F.3d 1015, 1020 (2nd Cir. 1996), held that the following three elements are required to prosecute a 31 U.S.C. § 3713(b) claim:

If an executor makes a written request to be discharged of personal liability for payment of estate taxes under Code § 2204 and the IRS does not respond within nine months or if the discharge is granted, the executor or personal representative is no longer personally responsible for payment of the tax.[7168] The release of the executor does not release the estate tax lien on the estate's assets, but the lien will not apply to property transferred to a purchaser

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(1) A fiduciary of the debtor or the debtor's Estate transferred assets of the debtor or the Estate;
(2) At the time of the transfer, the debtor or the Estate was insolvent or was rendered insolvent by the transfer; and
(3) Before making the transfer, the fiduciary knew of a debt due the United States, or had notice of facts that would lead a reasonably prudent person to inquire as to the existence of such a debt.

The executor, McNicol, essentially admitted that these elements were present. The court described her defense:

> McNicol does not contest the elements, but instead argues that family allowances and funeral and administrative expenses take priority over plaintiff's claim. The trouble with this argument, however, is that the statute penalizes the transfer of the assets. Had McNicol left the assets in the estate and paid family allowances and expenses therefrom, this might be a different case.[8] But that did not happen. McNicol transferred the shares of stock to herself, and at that moment, she violated the statute. Summary judgment is proper on Count 2.[9]
>
> [8] Of course, I take no position on whether the allowances and expenses McNicol identifies do, in fact, take priority over a federal tax debt.
>
> [9] Plaintiff requests an award of prejudgment interest on McNicol's liability in Count 2, a matter which, it agrees, is left to my discretion… (citing *United States v. Golden Acres, Inc.*, 702 F.Supp. 1097, 1109 (D. Del. 1988)). I decline to award interest.

In affirming *Reitano*, *U.S. v. McNicol*, 118 A.F.T.R.2d 2016-5150 (1st Cir. 2016), *cert. denied* 1/9/2017, acknowledged that family allowances and administrative expenses may take priority over federal tax obligations but held that any such expenditures were not substantiated:

> We do not gainsay that a personal representative of an estate that is indebted to the United States for unpaid taxes may nonetheless use estate assets to defray certain types of expenses without contravening the statutory priority. The IRS itself acknowledges that there are exceptions to the priority created by section 3713(a) for family allowances and administrative expenses (such as expenses incurred for the general welfare of creditors, expenses incurred to collect and preserve assets, court costs, and funeral expenses). See *Internal Revenue Manual*, 34.4.1.7 (Aug. 11, 2004). The case law reinforces this view. See *Estate of Jenner v. C.I.R.,* 577 F.2d 1100, 1106 (7th Cir. 1978); *Schwartz v. C.I.R.*, 560 F.2d 311, 314 n.7 (8th Cir. 1977); *Abrams v. United States*, 274 F.2d 8, 12 (8th Cir. 1960).
>
> Despite this promising provenance, however, the appellant's argument for an equitable exception fails. Even if we assume that an equitable exception to the priority statute may exist — a matter on which we take no view — the appellant's prospects would not improve.
>
> As a threshold matter, the summary judgment record flatly contradicts the appellant's assertion that she transferred the stock to herself for the purpose of paying administrative expenses of the estate.

Administrative expenses, being enumerated as an exception to a Code § 6324(a) lien but not a Code § 6321 or 6324A lien, are subject to the Code § 6321 or 6324A lien, even if arising before the Code § 6321 or 6324A lien was imposed. *U.S. v. Spoor*, 118 A.F.T.R.2d 2016-6018 (11th Cir. 10/4/2016). Following *Coppola*, *United States v. Read*, 2016 WL 310721, 117 A.F.T.R.2d 2016-541 (D. Conn. 2016), awarded prejudgment interest from the dates on which the trustee made distributions, knowing of the tax debt to the United States.

The IRS has the burden of proving all three elements, and the fiduciary may use equitable apportionment contribution rights as assets in determining insolvency. *Singer v. Commissioner*, T.C. Memo. 2016-48. See also *United States v. Tyler*, 528 F.App'x 193, 200-02 (3d Cir. 2013), citing *Coppola*.

[7168] For details about Code § 2204 discharge, see part III.A.6 Post-Mortem Trust and Estate Administration.

or holder of a security interest. Instead, the lien will apply to the consideration received from the purchaser or holder.[7169]

Nonprobate Assets

Trustees of trusts included in the decedent's estate and other recipients of nonprobate included property may have personal liability under not only 31 U.S.C. § 3713(b)[7170] but also Code § 6324(a)(2); not all courts agree that assets held in a revocable trust at death are subject to Code § 6324(a)(2).[7171] Code § 6324(a)(2), "Liability of transferees and others," provides:

> If the estate tax imposed by chapter 11 is not paid when due, then the spouse, transferee, trustee (except the trustee of an employees' trust which meets the requirements of section 401(a)), surviving tenant, person in possession of the property by reason of the exercise, nonexercise, or release of a power of appointment, or beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under sections 2034 to 2042, inclusive, to the extent of the value, at the time of the decedent's death, of such property, shall be personally liable for such tax. Any part of such property transferred by (or transferred by a transferee of) such spouse, transferee, trustee, surviving tenant, person in possession, or beneficiary, to a purchaser or holder of a security interest shall be divested of the lien provided in paragraph (1) and a like lien shall then attach to all the property of such spouse, transferee, trustee, surviving tenant, person in possession, or beneficiary, or transferee of any such person, except any part transferred to a purchaser or a holder of a security interest.

Thus, among others affected by the above, when the settlor of a revocable trust dies, the trustee becomes a personal guarantor of estate tax, even if the trust's assets decrease in value without any fault of the trustee. The trustee is not the only guarantor - *U.S. v. Paulson*,

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[7169] Code § 6324(a)(3).

[7170] See text accompanying fn. 7229. See fn. 7167 for the requirements to make a claim under 31 U.S.C. § 3713(b).

[7171] Code § 6324(a)(2) applies to property included in the gross estate under sections 2034 to 2042. Relying on Rev. Rul. 75-553, *U.S. v. Johnson*, 118 A.F.T.R.2d 2016-6781 (D.C. UT 12/1/2016), reversing under a motion for reconsideration its prior decision under 112 A.F.T.R.2d 2013-5474 (D.C. UT), held that assets held in a revocable trust at death pass under Code § 2033, not Code §§ 2036-2038; *U.S. v. Johnson*, 121 A.F.T.R.2d 2018-341 (D.C. UT 2018) awarded attorney fees to the taxpayer when the IRS claimed that trustees couldn't have received valid discharge of personal liability under Code § 2204 as result of furnishing Code § 6324A special lien because they didn't use certain application (see fn 6194). Rev. Rul. 75-553 held that the trustee of a revocable trust, which trust passed to the grantor's estate at death, was not subject to Code § 6324(a)(2):

> Although sections 2036, 2037, and 2038 of the Code include in a decedent's gross estate the value of any interest in property transferred by the decedent, in trust or otherwise, where a life estate, reversionary interest, or power to alter, amend or revoke is retained by the decedent, these provisions of the Code do not become operative unless someone other than the decedent receives a beneficial interest in the transferred property. The transfer of property to a trustee acting as agent for the transferor, without a third party receiving any interest in the property, would not fall within the scope of sections 2036, 2037, and 2038. In the instant case the trust corpus is payable to the decedent's estate and is property of the decedent within the meaning of section 2033 and is includible in the gross estate only under that section.

It is odd that a revocable trust pouring into the grantor's estate is not be treated the same as a revocable trust that does not pour into the decedent's estate or a revocable trust that receives assets from the estate.

131 A.F.T.R.2d 2023-1743 (9th Cir. 5/17/2023) (majority opinion), described the case that came to the court and its conclusion:

> Allen Paulson died with an estate valued at nearly $200 million, with most of his assets placed in a living trust. But years later more than $10 million in estate taxes, interest, and penalties remained unpaid. The United States of America (the United States or the government) sued several of Paulson's heirs - John Michael Paulson, James D. Paulson, Vikki E. Paulson, Crystal Christensen, and Madeleine Pickens - alleging that they controlled the trust, as trustees, or received estate property, as transferees or beneficiaries, and thus are personally liable for the estate taxes under § 6324(a)(2) of the Internal Revenue Code, 26 U.S.C. § 6324(a)(2). The United States also alleged that Vikki Paulson and Crystal Christensen, as co-trustees of the living trust, were liable for unpaid estate taxes under section 19001 of the California Probate Code.
>
> As relevant to this appeal, the district court granted in part Vikki Paulson's Crystal Christensen's, and Madeleine Pickens's motions to dismiss, concluding that they were not liable for the estate taxes under § 6324(a)(2) as trustees, transferees, or beneficiaries, and later ruled on several motions for summary judgment. Based on the reasoning in its order granting the motions to dismiss in part, the court ruled in favor of Madeleine Pickens and James Paulson on the United States' remaining claims under § 6324(a)(2), concluding that they were not personally liable for the estate taxes. The court entered summary judgment in favor of the United States on its claims under the California Probate Code. The United States appeals the rulings in favor of the defendants on the § 6324(a)(2) claims, and Vikki Paulson and Crystal Christensen cross-appeal the judgment holding them liable for the unpaid estate taxes under section 19001.[1] We have jurisdiction over these appeals under 28 U.S.C. § 1291.
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>> [1] The district court concluded that John Michael Paulson was liable for the unpaid estate taxes as executor and trustee of the living trust, but concluded that he had successfully discharged his liability for the estate taxes under 26 U.S.C. §§ 2204. The United States does not dispute that finding on appeal.[7172] Therefore, only its claims against James Paulson, Vikki Paulson, Crystal Christensen, and Madeleine Pickens are at issue.
>
> We hold that § 6324(a)(2) imposes personal liability for unpaid estate taxes on the categories of persons listed in the statute who have or receive estate property, either on the date of the decedent's death or at any time thereafter, subject to the applicable statute of limitations. We further hold that the defendants were within the categories of persons listed in § 6324(a) when they had or received estate property, and thus are liable for the unpaid estate taxes as trustees and beneficiaries.[7173] Therefore, we reverse the district court's judgment in favor of the defendants on the United States' claims under § 6324(a)(2), and remand to the district court with instructions to enter judgment in favor of the government on these claims with any further proceedings necessary to determine the amount of each defendant's liability for the unpaid taxes. Because our conclusion on

[7172] [my footnote:] For a Code § 2204 discharge, see text accompanying fn 7183 in part III.B.5.e.iv.(g) How to Avoid the Pitfalls of the Estate Tax Lien, which also explains how John Michael Paulson (court also used the shortened "Michael Paulson").

[7173] [my footnote:] This analysis is a separate issue from what is described in part III.B.5.e.v Transferee Liability.

> the federal tax claims arising from the Internal Revenue Code resolves this matter, we do not reach the parties' dispute over the interpretation of the California Probate Code.

Before reviewing the majority's reasoning, let's add some color to the case's setting. The dissent criticized the IRS' handling of this case:

> In this case, the estate elected to defer payments over fourteen years. But the government failed to use the options available to protect its unsecured interests in deferred payments. *See supra*, at 59. It also failed to hold Michael Paulson, the trustee of the decedent's trust on the date of the decedent's death, personally liable for the estate taxes due, *United States v. Paulson*, 445 F.Supp.3d 824, 831 (S.D. Cal. 2020), even though such liability may extend after the expiration of the ten-year estate tax lien provided for in § 6324(a)(1). *See, e.g.*, Internal Revenue Manual 5.5.8.3 (June 23, 2005) (stating that 26 U.S.C. §§ 6502 applies to assess personal liability under § 6324(a)(2)); 26 U.S.C. §§ 6502(a) (providing for ten-year period after assessment of taxes for collection); *Id*. § 6503(d) (tolling ten-year period when 26 U.S.C. §§ 6166 election is made).
>
> To compensate for its failures to use the available statutory options to collect estate taxes, the government here adopted a novel reading of § 6324(a)(2). Although the accepted reading of this language (as noted in *Garrett*, 67 T.C.M. (CCH) at *14) is that it imposes personal liability for estate taxes on any person who receives (or has) property on the decedent's date of death, the government for the first time reads this language as imposing liability on a person "who receives" property of the estate at any time, even years after the decedent's death. Under this interpretation, the government calculates the estate tax based on the value of property on the date of decedent's death, and then imposes personal liability for this tax on a person who receives the property years later. This means that the individual's tax liability may be completely disproportionate to the value of the property when the individual eventually receives it.

The Ninth Circuit opened its analysis:

> Section 2001 of the Internal Revenue Code imposes a tax on a decedent's taxable estate, which the executor is required to pay. 26 U.S.C., §§ 2001(a), 2002. Section 6324, in turn, operates to protect the government's ability to collect estate and gift taxes. See 26 U.S.C. §§ 6324(a); see also *United States v. Vohland*, 675 F.2d 1071, (9th Cir. 1982) ("[Section] 6324 is structured to assure collection of the estate tax."). To this end, the statute imposes a lien on the decedent's gross estate for the unpaid estate taxes in § 6324(a)(1) and imposes personal liability for such taxes on those who receive or have estate property in § 6324(a)(2).10 26 U.S.C. and §§ 6324(a)(1) and (2); *see also United States v. Geniviva*, 16 F.3d 522, 524 (3d Cir. 1994) (explaining that § 6324(a)(2) "affords the Government a separate remedy against the beneficiaries of an estate when the estate divests itself of the assets necessary to satisfy its tax obligations").
>
> The statutory provision at issue here, § 6324(a)(2), as stated in its title, imposes personal liability on "transferees and others" who receive or have property from an estate. The statute provides that:
>
>> If the estate tax imposed by chapter 11 is not paid when due, then the spouse, transferee, trustee (except the trustee of an employees' trust which meets the requirements of section 401(a)), surviving tenant, person in possession of the

> property by reason of the exercise, nonexercise, or release of a power of appointment, or beneficiary, *who receives, or has on the date of the decedent's death*, property included in the gross estate under sections 2034 to 2042, inclusive, to the extent of the value, at the time of decedent's death, of such property, shall be personally liable for such tax.

26 U.S.C. §§ 6324(a)(2) (emphasis added). The question before us is whether the phrase "on the date of the decedent's death" modifies only the immediately preceding verb "has," or if it also modifies the more remote verb, "receives."

The United States argues the limiting phrase "on the date of decedent's death" modifies only the immediately preceding verb "has," and not the more remote verb "receives." Therefore, in its view, the statute imposes personal liability on those listed in the statute who (1) receive estate property at any time on or after the date of the decedent's death, or (2) have estate property on the date of the decedent's death. Thus, it contends, § 6324(a)(2) imposes personal liability for the unpaid estate taxes in this case on successor trustees and beneficiaries of the living trust, including those who have or received estate property after the date of decedent Allen Paulson's death.

The defendants, in contrast, argue that the limiting phrase "on the date of the decedent's death" modifies both the immediately preceding verb "has," and the more remote verb "receives." Thus, under their interpretation, the statute imposes personal liability for the unpaid estate taxes only on those who receive or have property included in the gross estate on the date of the decedent's death. But those who receive property from the estate at any point after the date of the decedent's death have no personal liability for the unpaid estate taxes.

We conclude that the most natural reading of the statutory text, and other indicia of its meaning, supports the United States' interpretation. Therefore, we hold that § 6324(a)(2) imposes personal liability for unpaid estate taxes on the categories of persons listed in the statute who have or receive estate property, either on the date of the decedent's death or at any time thereafter, subject to the applicable statute of limitations.

The Ninth Circuit described the argument that its holding may generate an unfair liability and dismissed that concern:

The defendants' second argument also fails. The defendants correctly state that the statutory language imposes estate tax liability "to the extent of the value, at the time of the decedent's death, of such property." *Id*. § 6324(a)(2). The modifier "at the time of the decedent's death" applies to "the extent of the value." Id. This language plainly means that tax liability is calculated based on the value of the estate property at the time of decedent's death. *Id*. As the government acknowledges, this provision favors the taxpayer by limiting liability for any unpaid estate taxes to the value of the property at the time of the decedent's death, even if the property increases in value after the decedent's death.[19] *See id*. Thus, the statutory language anticipates, and allows, a potential windfall for a person who receives estate property that increases in value after the date of the decedent's death.

[19] In its briefing, the government stated that the "property is valued 'at the time of the decedent's death,'" and that "language simply caps potential liability under

§ 6324(a)(2) by preventing liability from exceeding the value of the non-probate property at the time of the decedent's death."

The defendants, however, dispute that Congress could have also anticipated that estate property could depreciate after the date of the decedent's death and thus potentially result in tax liability for the recipient that exceeds the property's value.[20] The defendants argue that an interpretation of § 6324(a)(2) that would allow the government to impose personal liability for the estate taxes "for a greater amount of money than they ever held," would lead to "a nonsensical result."[21] But "[t]o avoid absurdity, the plain text of Congress's statute need only produce 'rational' results, not 'wise' results." *Lopez*, 998 F.3d at 438 (citing *Hokulani Square*, 776 F.3d at 1088). Thus, a statute's text may lead to results that are "not wise," and that we may even consider "harsh and misguided," but a statute is not absurd if "it is at least rational." *Hokulani Square*, 776 F.3d at 1088 (rejecting the argument that bankruptcy code provision was absurd because whether trustee received a fee for his services or worked for free turned on trivialities). And "the bar for 'rational' is quite low." *Lopez*, 998 F.3d at 438 (citing *Griffin*, 458 U.S. at 575–76).

[20] If, as the defendants suggest, estate property continued to depreciate after the transferee or other beneficiary accepted it, such that the tax liability eventually exceeded the value of the property received, that risk of loss would apply equally to those who receive estate property on the date of the decedent's death and to those who receive estate property after the date of the decedent's death. There is nothing about the risk of accepting property that may decline in value that would apply unfairly to those who receive such property after the date of the decedent's death.

[21] The hypotheticals defendants assert to support their arguments are speculative and are not supported by the record. For example, they argue that the value of the estate assets here "almost certainly" declined because the estate included "uniquely depreciative horses in the Trust's possession." But this argument does not account for the living trust provisions mandating that "upon the [decedent's] death" the trustee "shall sell promptly the entire interest of the trust" in certain assets, including "all horses."

This is not a situation where it is "quite impossible" that Congress could have intended the result. See *Lopez*, 998 F.3d at 438 (citation omitted). Here, Congress clearly could have anticipated that the value of estate property could change after the date of the decedent's death—either by increasing or decreasing in value—and thus could have anticipated that the value of some estate assets could depreciate below the amount of the estate tax liability. Indeed, as discussed more fully below, Congress included several provisions in the tax code that mitigate the risk that a transferee's, beneficiary's, or other person's tax liability could exceed the value of the property they received, including: 26 U.S.C. §§ 2001 (tax rate based on a percentage of the taxable estate),[22] § 2002, 26 C.F.R. § 20.2002-1 (executor's duty to pay the estate tax before distributing estate property and liability for failing to do so), § 2518 (disclaimer), and § 6502(a)(1) (statute of limitations).

[22] The taxable estate is determined by deducting from the value of the gross estate the deductions provided in Title 26, Part IV. 26 U.S.C. §§ 2051.

And while it is “not our job to find reasons for what Congress has plainly done,” *Lopez*, 998 F.3d at 447 (M. Smith, J., concurring) (internal quotation marks and citation omitted), Congress rationally could have concluded that such risk is acceptable or is effectively mitigated by other provisions of the tax code, and thus is outweighed by the benefit of ensuring the collection of estate taxes. This is not an irrational tax policy. Indeed, we have previously recognized that “[§] 6324 is structured to assure collection of the estate tax.” *Vohland*, 675 F.2d at 1076. Moreover, even if it were to conclude that such a policy is “odd,” or “not wise,” *Lopez*, 998 F.3d at 447 (M. Smith, J., concurring) (citation omitted), or simply unfair, we cannot rewrite the statute to advance a different policy, *id*. at 440 (majority opinion). See also *Hokulani Square*, 776 F.3d at 1088 (“The absurdity canon isn’t a license for us to disregard statutory text where it conflicts with our policy preferences”). And if Congress determines that its tax policy leads to unintended or unfair results, it is for Congress, not the courts, to rewrite the tax code. See *Crooks*, 282 U.S. at 60; *Griffin*, 458 U.S. at 576. Therefore, we conclude that applying the rule of the last antecedent to § 6324(a)(2) does not result in an absurd interpretation of the statute….

But our conclusion—that this is not the “exceptional” case where we can invoke the absurdity canon to reject the interpretation of a statute that is most consistent with its text, structure, punctuation, and other indicia of meaning—does not mean that the defendants’ “the sky is falling”[23] arguments are based on anything other than remote hypotheticals. And even if the defendants could demonstrate that applying § 6324(a)(2) to those who receive estate property after the date of the decedent’s death could result in what they characterize as an “absurd situation,” that situation will not arise here.[24]

[23] “Chicken Little,” Merriam-Webster.com Dictionary, https://www.merriam-webster.com/dictionary, last visited May 10, 2023.

[24] When Madeleine Pickens received assets from the estate, including two residences, personal property, and cash, the value of those assets exceeded the estate tax liability. Indeed, the government asserts that when Madeleine Pickens received this property it was worth $19 million, and Vikki Paulson and Crystal Christensen assert it was worth $42 million. Madeleine Pickens does not dispute these valuations. Crystal Christensen received a non-depreciating bequest of cash, and the trustee distributed $990,125 to her. And even if Vikki Paulson and Crystal Christensen can establish that the estate’s tax liability exceeded the value of the estate assets when they became trustees, they cannot establish that it is absurd or unfair to impose tax liability on successor trustees because, as the terms of the living trust make clear, trustees serve only if they are “willing.”

As an initial matter, before those who receive estate property could be subjected to tax liability that exceeds the value of the property they received, all the following events, some of which are remote and unlikely, must occur.

First, the property must have depreciated after the date of the decedent’s death to the point that it is worth less than the tax liability, which is calculated as a percentage of the amount of the taxable estate.[25] See 26 U.S.C. §§ 2001 (setting rate schedule of 18% to 40%, depending on the amount of the taxable estate).

[25] For example, in this case, at the time of Allen Paulson’s death, although his estate reported a gross taxable estate of $187,729,626, his net taxable estate was reported

at a substantially lower amount, $9,234,172, and the tax liability was initially reported as $4,459,051. After the IRS successfully asserted a deficiency, the Tax Court determined that the estate owed an additional $6,669,477 in estate taxes. Thus, the tax liability was a fraction of the gross taxable estate.

Second, the executor must have failed to pay the estate tax before distributing estate property. See 26 U.S.C., §§ 2001(a), 2002; *id*. § 6324(a)(2) (imposing personal liability on transferee and others when "estate tax imposed by chapter 11 is not paid when due"); 26 C.F.R. § 20.2002-1 (imposing personal liability on executor for distributing any portion of the estate before all estate tax is paid).

Third, the estate must have "divest[ed] itself of the assets necessary to satisfy its tax obligations," *Geniviva*, 16 F.3d at 524, thus defeating the lien for estate taxes under that would apply under § 6324(a)(1).

Fourth, the statute of limitations must not have expired by the time the property is distributed or the government attempts collection. See 26 U.S.C. §§ 6502(a)(1).

Fifth, a transferee, beneficiary, or other recipient of the estate property must not have disclaimed or refused the property. See 26 U.S.C. §§ 2518; 26 C.F.R. § 25.2518-2.[26]

[26] A disclaimer must be in writing, made within nine months of the transfer creating the interest or when the recipient reaches age 21, whichever is later, and before the transferee accepts any of the interest or its benefits. 26 U.S.C. §§ 2518(b). The regulations further explain that the nine-month period for making a disclaimer "generally is to be determined with reference to the transfer creating the interest in the disclaimant." 26 C.F.R. § 25.2518-2(c)(3)(i). For transfers made by a decedent at death, the transfer creating the interest occurs on the date of the decedent's death. *Id*.

Sixth, the government must successfully seek to impose tax liability on a transferee, beneficiary, or other recipient of estate property in an amount that exceeds the value of the property they received.

Focusing on the final factor - whether the government would later seek to impose tax liability that exceeds the value of the property received and would be successful in advancing that argument - we rely on the government's avowals in its briefing and at oral argument that estate tax liability cannot exceed the value of the property received. Specifically, the government asserted in its briefing that the language in § 6324(a)(2) that the estate property is valued at the time of the decedent's death, "does not expose a person to liability that exceeds the value of the property that he or she personally had or received." The government further emphasized this point, explaining that: "[i]nstead, a person will be liable under § 6324(a)(2) only to the extent that he or she actually 'receives' or 'has' non-probate property, viz. , the person's liability is capped at the value of the property had or received."[27]

[27] To support its position, the government cites *United States v. Marshall*, 798 F.3d 296, 315 (5th Cir. 2015) (holding that a donee's personal liability for gift tax under § 6324(b) "is capped by the amount of the gift"). Although the language of these subsections of § 6324 differ, with subsection (a)(2) limiting personal liability for estate taxes "to the extent of the value, at the time of the decedent's death," 26 U.S.C. §§ 6324(a)(2), and subsection (b) limiting gift tax liability "to the extent of the value of

such gift," *id*. § 6324(b), estate and gift taxes "are in pari materia and must be construed together." *Sanford v. Comm'r*, 308 U.S. 39, 44 (1939); see also *Chambers v. Comm'r*, 87 T.C. 225, 231 (1986) (same). Thus, while the government's citation to Marshall is not authoritative, it does provide persuasive support for the government's position.

These representations, coupled with the doctrine of judicial estoppel, provide additional safeguards against the hypothetically unfair application of personal liability under § 6324(a)(2), which the defendants posit. Although the application of judicial estoppel is discretionary, it could be applied to bar the government from later arguing, in this case or a future case, that it can recover more than the value of the property that the taxpayer received.[28] See *New Hampshire v. Maine*, 532 U.S. 742, 750 (2001) (explaining that judicial estoppel "is an equitable doctrine invoked by a court at its discretion" (internal quotation marks and citation omitted)). The doctrine exists to "to protect the integrity of the judicial process by prohibiting parties from deliberately changing positions according to the exigencies of the moment."[29] *Id*. at 749-50 (internal quotation marks and citations omitted).

[28] We have long recognized that "[t]he application of judicial estoppel is not limited to bar the assertion of inconsistent positions in the same litigation, but is also appropriate to bar litigants from making incompatible statements in two different cases." *Hamilton v. State Farm Fire & Cas. Co.*, 270 F.3d 778, 783 (9th Cir. 2001) (citations omitted).

[29] Importantly, judicial estoppel differs significantly from other estoppel doctrines, such as equitable estoppel. *See Teledyne Indus., Inc. v. NLRB*, 911 F.2d 1214, 1219 (6th Cir. 1990) ("Although each of these doctrines deals with the preclusive effect of previous legal actions, the similarity ends there."). "Judicial estoppel exists to protect the courts from the perversion of judicial machinery through a party's attempt to take advantage of both sides of a factual issue at different stages of the proceedings." *Id*. at 1220 (internal quotation marks and citation omitted). "In contrast, equitable estoppel serves to protect litigants from unscrupulous opponents who induce a litigant's reliance on a position, then reverse themselves to argue that they win under the opposite scenario." Id. (citation omitted). And while the Supreme Court has explained, in the context of equitable estoppel, that "it is well settled that the Government may not be estopped on the same terms as any other litigant," *Heckler v. Cmty. Health. Servs. of Crawford Cnty., Inc.*, 467 U.S. 51, 60 (1984), judicial estoppel may be applied to prevent the government from asserting inconsistent legal arguments, *United States v. Liquidators of Eur. Fed. Credit Bank*, 630 F.3d 1139, 1147-49 (9th Cir. 2011) (holding that judicial estoppel barred the government from arguing that defendant could not raise legal claims challenging forfeitability in ancillary proceedings, after earlier arguing that defendant could raise their arguments during ancillary proceedings).

The Court has identified three non-exclusive factors that should "inform" a court's decision whether to apply judicial estoppel: (1) "a party's later position must be 'clearly inconsistent' with its earlier position"; (2) "the party has succeeded in persuading a court to accept that party's earlier position, so that judicial acceptance of an inconsistent position in a later proceeding would create 'the perception that either the first or the second court was misled'"; and (3) "the party seeking to assert an inconsistent position would derive an unfair advantage or impose an unfair detriment on the opposing party if not estopped." *Id*. at 750-51 (internal quotation marks and citations omitted).

If these considerations were applied to the government's representations here - that § 6324(a)(2) does not allow the government to impose personal liability for unpaid estate taxes in an amount that exceeds the value of the property received - judicial estoppel could be applied to prevent the government from taking a contrary position in later litigation. First, such a position would be contrary to the government's position in this case. Second, the government has succeeded in persuading us to accept its position, and judicial acceptance of an inconsistent position in a later proceeding would create the impression that either we, or the later court, were misled. Third, allowing the government to take a contrary position in later litigation would unfairly prejudice the taxpayers in the subsequent litigation, who may have relied on the government's position, and would also prejudice the second court. See *Rissetto v. Plumbers & Steamfitters Local 343*, 94 F.3d 597, 604 (9th Cir. 1996) (explaining that "the interests of the second court are uniquely implicated and threatened by the taking of an incompatible position").

Moreover, there are cases that, while not directly addressing the issue before us now, include statements that lend support to the government's argument that it does not seek to impose liability for estate taxes that exceed the value of the property received. See *Geniviva*, 16 F.3d at 523 (construing § 6324(a)(2) and noting that "[t]his section provides that if estate taxes are not paid when due, the beneficiaries are liable up to the amount received from the estate"); *Schuster v. Comm'r*, 312 F.2d 311, 315 (9th Cir. 1962) (considering § 827(b), a predecessor statute that included the same language as § 6324(a)(2), and explaining that the statute imposed some limitations on a transferee's liability because "it requires that a deficiency be due from the estate, and that his [or her] liability therefor is limited to the value of the estate corpus which he [or she] received").

Finally, defendants have not identified, and our research has not uncovered, any case in which the government has attempted to impose personal liability for estate taxes that exceeded the value of the property received. The absence of any case law on this point supports the conclusion that this situation has never been litigated because the government has never taken this position, which in turn, supports the conclusion that it is unlikely that the government will attempt to assert this argument in future litigation.

Thus, we conclude that applying the rule of the last antecedent does not lead to absurd results, but instead results in the most natural reading of the statute, consistent with its structure and context….

The defendants also argue that to interpret the statute we must consider its purpose and intent. Madeleine Pickens argues that "the purpose of [§] 6324(a)(2) is to provide the Government with the same avenue to collect taxes from non-probate property that it has with respect to probate property." She reasons that just as probate property must "pass[] through the hands of the executor," the "beneficiaries of a decedent's trust can only take possession of trust property after it has passed through the hands of the trustee." Thus, she concludes that the government's interests "are fully protected when [§] 6324(a)(2) imposes personal liability on a trustee of the decedent's trust who distributes property to a trust beneficiary without first paying the tax."

But nothing in the statutory text supports her argument that Congress's purpose in enacting §6324(a)(2) was to impose personal liability for unpaid estate taxes on those persons, "including trustees," who "stand in the same position as the executor." The statute does not impose personal liability for unpaid estate taxes based on the existence or exercise of a fiduciary duty to the estate.[30] Instead, § 6324(a)(b) imposes personal liability, based on receipt or possession of property from the gross estate, on the categories of persons listed in the statute, and that list does not include executors or administrators. And while the list includes trustees, it also includes transferees, spouses, beneficiaries, and others who do not act as fiduciaries or administrators of the estate. 26 U.S.C. §§ 6324(a)(2). We therefore find no basis to conclude that personal liability for unpaid estate taxes on non-probate property under § 6324(a)(2) is intended to mirror an executor's liability for distributions of probate property.

[30] Indeed, other sections of the tax code and regulations address the collection of taxes from fiduciaries. See 26 U.S.C. §§ 6901 (providing methods of collection of taxes from transferees and fiduciaries); 26 C.F.R. § 20.2002-1 (explaining the liability of executors, administrators, and others).

The Ninth Circuit continued:

Our holding that § 6324(a)(2) imposes personal liability on those listed in the statute, who have or receive estate property on or after the date of the decedent's death, does not completely resolve this matter. We must determine whether the defendants fall within the categories of persons listed in the statute and are thus liable for the unpaid estate taxes.

A

The government argues that the defendants are liable under the statute as trustees, transferees, and beneficiaries. Vikki Paulson and Crystal Christensen acknowledge that they are successor trustees, and James Paulson has not submitted a brief contesting the district court's finding that he was a successor trustee. Thus, these defendants do not dispute that, if § 6324(a)(2) applies to those who receive or have estate property after the date of the decedent's death, they are liable as "trustees" under § 6324(a)(2).

We therefore conclude that James Paulson, Vikki Paulson, and Crystal Christensen are liable, as trustees, for the unpaid estate taxes on property from the gross estate, held in the living trust, "to the extent of the value, at the time of the decedent's death, of such property." 26 U.S.C. §§ 6324(a)(2). But, as previously discussed and as conceded by the government, see *supra* Section III.C.2.b, that liability is capped at the value of estate property in the living trust at the time of Allen Paulson's death, and each defendants' liability cannot exceed the value of the property at the time that they received or had it as trustees.

B

The government also argues that the ordinary meaning of "beneficiary" includes "trust beneficiaries" and therefore Crystal Christensen and Madeleine Pickens are liable as beneficiaries under § 6324(a)(2) for the unpaid estate taxes.[33] These defendants acknowledge that they are "trust beneficiaries," but they argue that they are not "beneficiar[ies]," as that term is used in § 6324(a)(2). Instead, they argue that "beneficiary" in § 6324(a)(2) has a narrow meaning and applies only to life insurance beneficiaries.[34]

[33] Because we conclude that Crystal Christensen and Madeleine Pickens are liable for the unpaid estate taxes as beneficiaries under § 6324(a)(2), we need not address whether they are also liable as "transferees," as that term is used in the statute.

[34] As we discuss later, infra, at n.36, Madeleine Pickens acknowledges that beneficiaries may also include beneficiaries of annuity payments.

Because the statute does not define "beneficiary," "we look first to the word's ordinary meaning." *See Schindler Elevator Crop. v. United States*, 563 U.S. 401, 407 (2011) (citing *Gross v. FBL Fin. Servs.*, 557 U.S. 167, 175 (2009) ("Statutory construction must begin with the language employed by Congress and the assumption that the ordinary meaning of that language accurately expresses the legislative purpose" (internal quotation marks omitted)); *Asgrow Seed Co. v. Winterboer*, 513 U.S. 179, 187 (1995) ("When terms used in a statute are undefined, we give them their ordinary meaning"). At this first step, we conclude that dictionary definitions support the government's broad interpretation, rather than the defendants' narrow interpretation limiting liability to insurance beneficiaries. See Beneficiary, BLACK'S LAW DICTIONARY (11th ed. 2019) (defining "beneficiary" as "[s]omeone who is designated to receive the advantages from an action or change; esp., one designated to benefit from an appointment, disposition, or assignment (as in a will, insurance policy, etc.), or to receive something as a result of a legal arrangement or instrument," and "[s]omeone designated to receive money or property from a person who has died"); see also Beneficiary, AMERICAN HERITAGE DICTIONARY (5th ed. 2018) ("One that receives a benefit" or "the recipient of funds, property, or other benefits, as from an insurance policy or trust"); Beneficiary , WEBSTER'S NEW WORLD COLLEGE DICTIONARY (5th ed 2014) ("[A]nyone receiving benefit" or "a person named to receive the income or inheritance from a will, insurance policy, trust, etc...."); Beneficiary , WEBSTER'S NEW WORLD DICTIONARY (4th ed. 2003) ("[A]nyone receiving or to receive benefits, as funds from a will or insurance policy...."); Beneficiary, 2 OXFORD ENGLISH DICTIONARY (2d ed. 1989) ("[O]ne who receives benefits or favours; a debtor to another's bounty...."). Therefore, we conclude that the ordinary meaning of "beneficiary" includes a "trust beneficiary."

C

But we must also consider whether "there is any textual basis for adopting a narrower definition" of "beneficiary." See *Schindler*, 63 U.S. at 409; *see also* SCALIA & GARNER, supra, at 70 ("One should assume the contextually appropriate ordinary meaning unless there is reason to think otherwise. Sometimes there is reason to think otherwise, which ordinarily comes from context." (emphasis in original)). The government argues that the *text* of § 6324(a)(2) does not indicate that "beneficiary" has a narrower meaning than its ordinary meaning. The defendants, however, argue that the *context and structure* of the statute support a narrower interpretation.

The defendants rely on two cases interpreting predecessor versions of the statute, *Higley v. Commissioner*, 69 F.2d 160 (8th Cir. 1934), and *Englert*, 32 T.C. 1008 (1959), and two cases applying the reasoning of these earlier cases to interpret § 6324(a)(2), *Garrett v. Commissioner*, T.C. Memo. 1994-70 (1994), and *Johnson*, 2013 WL 3924087 (D. Utah 2013). As we explain next, we are not persuaded by these cases, or the defendants' arguments, that the structure or context of the statute support a narrow interpretation that overcomes the ordinary meaning of beneficiary.

We start with *Higley v. Commissioner*, in which the Eighth Circuit interpreted the word "beneficiary" in § 315(b) of the Revenue Act of 1926. 69 F.2d at 162. The text of this predecessor statute, however, differs significantly from the text of § 6324(a)(2), and so § 315(b)'s relevance to our analysis is limited. Section 315(b) provided:

> If (1) *the decedent makes a transfer, by trust or otherwise*, of any property in contemplation of or intended to take effect in possession or enjoyment at or after his death...or (2) *if insurance passes under a contract executed by the decedent in favor of a specific beneficiary*, and if in either case the tax in respect thereto is not paid when due, then *the transferee, trustee, or beneficiary shall be personally liable* for such tax[.]

Id. (quoting 26 U.S.C. §§ 1115(b) (emphasis added)). As the court recognized in its analysis of the statute, § 315(b) expressly addressed two types of property dispositions: (1) "transfers," including "trusts," and (2) "insurance," and imposed liability on the "transferee, trustee, or beneficiary." *Id*. Indeed, the statute specifically referred to "insurance...in favor of a specific beneficiary." *Id*. The court concluded that this structure meant that the word "trustee" was "employed in connection with trust only," and the word "beneficiary" "applies only to insurance policy beneficiaries." *Id*.

But this direct textual and structural correlation between (1) dispositions by "transfers" and" trusts" to the liability of a "transferee" or "trustee," and (2) dispositions of "insurance...in favor of a specific beneficiary" to the liability of a "beneficiary," is not present in § 6324(a)(2). We therefore conclude that the court's analysis in *Higley*, based on the text and structure of § 315(b), does not support the defendants' narrow interpretation of "beneficiary" in § 6324(a)(2).

We next consider *Englert v. Commissioner*, in which the Tax Court interpreted another predecessor statute, § 827(b) of the Internal Revenue Code of 1939, as amended by the Revenue Act of 1942. 32 T.C. at 1012-13, 1015. The structure of this predecessor statute also differs from § 6324(a)(2). Section 879(b), in relevant part, provided:

> If the tax herein imposed is not paid when due, then the spouse, transferee, trustee, surviving tenant, person in possession of the property by reason of the exercise, nonexercise, or release of a power of appointment, or beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under section 811(b), (c), (d), (e), (f), or (g), to the extent of the value, at the time of the decedent's death, of such property, shall be personally liable for such tax.

Id. at 1017, n.4 (quoting 26 U.S.C. §§ 827(b)).

As the Tax Court noted, § 827(b) "names six classes of persons who, ...may be personally liable for the unpaid tax." *Id*. at 1012. These six classes - (1) spouse, (2) transferee, (3) trustee, (4) surviving tenant, (5) person in possession, and (6) beneficiary - correspond directly to, and in the same order as, the property included in the gross estate in §§ 811 (b), (c), (d), (e), (f), or (g). *Id*. at 1012, 1016 ("In a single sentence of section 827(b) it is provided that there may be liable six classifications of persons who hold property includible in the estate under six specific subsections of section 811 of the Code.").

The court stated its belief that Congress "studiously chose a classification applicable to each of such subsections and included them in section 827(b) in the same order as the related property interests appeal in subsections (b) through (g), inclusive, of section 811." *Id*. at 1016. Applying this reasoning, and as petitioner argued, the court concluded that a person liable under the statute as a beneficiary would be limited to the beneficiary of a life insurance policy under § 811(g). See *id*. at 1013, 1016.

But § 6324(a)(2) does not include § 827(b)'s precise correspondence between categories of liable persons and types of property. As the defendants acknowledge, the statute now lists six categories of liable persons, but then incorporates nine categories of properties included in the gross estate. The defendants argue that these changes to the text and structure of the statute do not change the analysis, the differing statutory provisions are "substantially the same," and the differences in the text should be considered "minor adjustments." We are not persuaded by these arguments.

As an initial matter, in *Englert*, the tax court found compelling the direct correlation of the six categories of persons liable to the six categories of property included in the gross estate, and concluded it was the result of Congress's "studious[] cho[ice.]" *Id*. at 1016. That direct correlation is not present in § 6324(a)(2) and we cannot simply brush aside the differences in the statute's structure and text.[35] But even more importantly, § 6324(a)(2) differs substantively from its predecessor statutes by incorporating § 2039, which includes in the gross estate "an annuity of other payment receivable by any beneficiary," thus explicitly applying the word "beneficiary" beyond life insurance beneficiaries.[36] Therefore, the court's reasoning in Englert does not provide a textual or structural basis for us to conclude that the word "beneficiary" in § 6324(a)(2) should be limited to beneficiaries of life insurance.

[35] Madeleine Pickens suggests that Congress was aware of Englert when it enacted § 6324(a)(2) and if it had intended to change the meaning of the text "it would have stated as much explicitly." But *Englert* was decided in 1959, five years after Congress enacted § 6324(a)(2). See Internal Revenue Code of 1954, § 6324, 68A stat. i, 780 (1954).

[36] Madeleine Pickens acknowledges that although "prior cases have held that the term 'beneficiary' in section 6324(a)(2) means only the beneficiary of life insurance proceeds, the addition of section 2039 and its incorporation into section 6324(a)(2) likely means that a beneficiary of annuity payments would also be considered a 'beneficiary' under section 6324(a)(2)." She recognizes this is a "substantive" difference. But she suggests this is not important to our interpretation of the statute because "that question was not before the District Court, is not before this Court, and need not be decided in order to dispose of the appeal." We disagree. This substantive difference between the statutes is highly relevant and important to their interpretation.

Despite the textual and structural differences between § 6324(a)(2) and its predecessor statutes, the defendants rely on two more recent cases, *Garrett* and *Johnson*, to argue that the reasoning of *Higley* and *Englert* "apply with equal force" to § 6324(a)(2). In *Garrett*, the court applied the reasoning of *Higley* and *Englert* to conclude that the word "beneficiary" in § 6324(a)(2) refers only to life insurance beneficiaries.[37] *Garrett*, T.C. Memo. 1994-70 at *12-*14. But the court did not provide any analysis of the text or structure of § 6324(a)(2), and instead concluded that it found "nothing in the current statutory language that would warrant a more expansive definition of 'beneficiary' or [a]

> departure from earlier precedent under section 827(b)." *Id*. at *14. This conclusion is refuted by the substantive differences between the predecessor statutes, § 315(b) and § 827(b), and the current statute, § 6324(a)(2), including the current statute's explicit expansion of the meaning of the word beneficiary through the incorporation of § 2039….
>
> > [37] In *Johnson*, the court simply adopted the reasoning of *Garrett*, without any additional analysis, 2013 WL 3924087, at *8; we therefore reject its conclusions for the same reasons we reject the reasoning of *Garrett*.
>
> We conclude that the ordinary meaning of beneficiary, which includes trust beneficiaries, applies to § 6324(a)(2), and we are not persuaded that the structure or context of the statute, or policy considerations, require a narrower interpretation as the defendants argue. Moreover, applying the presumption of consistent usage further supports our conclusion that the term beneficiary in the tax code includes trust beneficiaries. Therefore, we conclude that Crystal Christensen and Madeleine Pickens are liable for the unpaid estate taxes under § 6324(a)(2) as beneficiaries. However, the liability of each of these defendants cannot exceed the value of the estate property at the time of decedent's death, or the value of that property at the time they received it.

The Ninth Circuit held:

> Because § 6324(a)(2) imposes personal liability for unpaid estate taxes on the categories of persons listed in the statute who receive or have estate property, either on the date of the decedent's death or at any time thereafter, subject to the applicable statute of limitations, and the defendants were within the categories of persons listed in the statute when they received or had estate property, we conclude that they are liable for the unpaid estate taxes as trustees and beneficiaries. We therefore reverse the district court's judgment in favor of the defendants on the United States' claims under § 6324(a)(2), and remand to the district court with instructions to enter judgment in favor of the government on these claims with any further proceedings necessary to determine the amount of each defendant's liability for the unpaid taxes.

On June 30, 2023, Defendants-Appellees Vikki E. Paulson and Crystal Christensen submitted a Petition for Rehearing En Banc.[7174]

This case is not the first to impose a Code § 6324(a)(2) lien on beneficiaries. See text accompanying fns 7224-7228 in part III.B.5.e.v.(b) Transferee Liability Extends Past Original Estate Tax Lien. However, it is the first to say that a person who does not directly receive property upon the decedent's death (or was in possession when the decedent died) is subject to the Code § 6324(a)(2) lien. Of course, it is only the Ninth Circuit's opinion; how other courts would rule may vary. For example, the District Court in *Johnson* held that assets held in a revocable trust at the time of the grantor's death are not considered to have passed to the trustee at death and therefore the trustee is not subject to Code § 6324(a)(2).

The estate tax lien does not continue to apply to included property that is transferred by the trustee or other recipient if the transfer is to a purchaser or holder of a security interest, but a lien is then imposed on all the property of the trustee or other nonprobate recipient who

[7174] Ninth Circuit's docket for case #: 21-55197.

transferred the included property. A recipient of includible life insurance is also liable under Code § 6324(a)(2).[7175]

Furthermore, under Code § 6324(a)(2) proceeds from the sale of included property are subject to the estate tax lien as if the proceeds were included property (a "like" lien).

III.B.5.e.iv.(f). Divestment of Lien Property and Release of Liens

A seller cannot give clear title to property encumbered by the secret estate tax lien until the lien is discharged or released.   A taxpayer may request that certain property be discharged from the lien by filing IRS Form 4422[7176] with the IRS if:[7177]

- the remaining property in the estate has a value that is double the amount owed to the IRS,
- the government receives a payment equal in amount to the value of the property requested to be discharged,
- the government does not have a valuable interest in the specific property, or
- the sale proceeds are to be substituted for the discharged property.

In all of these cases, the property that is discharged is no longer subject to the secret estate tax lien. A like lien, however, may attach to any proceeds from the sale or transfer of the discharged property.

Also, Code § 6325(a) mandates that a lien must be released when:

- the liability assessed has been fully satisfied,
- the liability has become legally unenforceable (the time has expired within which the IRS can enforce the lien, for example), or
- a bond has been furnished by the payee guaranteeing payment.

If any of these conditions is met and the lien is released, the property is no longer subject to the lien. Note that, unlike the situation in which certain property has been discharged, when the estate tax lien is released under Code § 6325(a), the entire estate (not just certain items) is free of the secret estate tax lien.

Thus, if the estate tax is unpaid, generally four ways exist to divest included property of the estate tax lien even though the estate is subject to the estate tax:

[7175] *Baptiste v. Commissioner*, 29 F.3d 1533 (11th Cir. 1994) (life insurance beneficiary liable and must pay interest), *aff'g* T.C. Memo. 1992-198 (life insurance beneficiary liable) and 100 T.C. 252 (1993) (recipient also liable for interest).
[7176] For the time frame for filing Form 4422, see text accompanying fn. 7188, found in part III.B.5.e.iv.(g) How to Avoid the Pitfalls of the Estate Tax Lien.
[7177] Code § 6325(b).

- Included property that is used to pay for estate expenses and other amounts owed by the estate will not be subject to the lien.[7178]

- Nonprobate property transferred to a purchaser or holder of a security interest is no longer subject to the lien, although a like lien attaches to all of the transferor's property.[7179]

- The lien is divested from included property that is probate property and has been transferred to a purchaser of probate property if the personal representative has been discharged of personal liability under Code § 2204, although a like lien attaches to the proceeds of the sale.[7180]

- Property that has been discharged under Code § 6325(a) is no longer subject to the lien.

III.B.5.e.iv.(g). How to Avoid the Pitfalls of the Estate Tax Lien

Ideally, an executor or trustee should not distribute or sell property included in the gross estate until the IRS has issued a "closing letter" or generated a transcript stating that the estate tax has been satisfied and the matter is closed.[7181] At this point, the estate tax lien is removed if the estate tax has been paid,[7182] although no official record verifies its release.

Although it will not release the estate tax lien, an executor (and a trustee who is an executor within the meaning of Code § 2203) should ordinarily submit a written request to the IRS for an assessment of the estate tax due and to be discharged of personal liability under Code § 2204. Reg. § 20.2204-1, "Discharge of executor from personal liability," provides (highlighting added):

> (a) *General rule*. The executor of a decedent's estate may make written application to the applicable internal revenue officer with whom the estate tax return is required to be filed, as provided in §20.6091-1, for a determination of the Federal estate tax and for a discharge of personal liability therefrom. Within 9 months after receipt of the application, or if the application is made before the return is filed then within 9 months after the return is filed, the executor will be notified of the amount of the tax and, upon payment thereof, he will be discharged from personal liability for any deficiency in the tax thereafter found to be due. If no such notification is received, the

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[7178] Code § 6324(a)(1).
[7179] Code § 6324(a)(2).
[7180] Code § 6324(a)(3).
[7181] Notice 2017-12 states:

> Estates and their authorized representatives may request an account transcript by filing Form 4506-T, Request for Transcript of Tax Return. Currently, Form 4506-T can be filed with the IRS via mail or facsimile (per the instructions on the form). Although account transcripts for estate tax returns are not currently available through the IRS's online Transcript Delivery System, the IRS website, www.irs.gov, will have current information should an automated method become operational. To allow time for processing the estate tax return, requests should be made no earlier than four months after filing the estate tax return.
> For those who wish to continue to receive estate tax closing letters, estates and their authorized representatives may call the IRS at (866) 699-4083 to request an estate tax closing letter no earlier than four months after the filing of the estate tax return.

See also https://www.irs.gov/businesses/small-businesses-self-employed/transcripts-in-lieu-of-estate-tax-closing-letters,the 4/27/2023 version of which contained detailed instructions how to get a transcript.
[7182] The executor may request a duplicate receipt as an official record that an estate tax payment was made. Code § 6314(b) and Reg. § 301.6314-1. I am unaware of any form, so presumably a letter to the IRS would suffice.

executor is discharged at the end of such 9 month period from personal liability for any deficiency thereafter found to be due. The discharge of the executor from personal liability under this section applies only to him in his personal capacity and to his personal assets. The discharge is not applicable to his liability as executor to the extent of the assets of the estate in his possession or control. Further, the discharge is not to operate as a release of any part of the gross estate from the lien for estate tax for any deficiency that may thereafter be determined to be due.

(b) *Special rule in the case of extension of time for payment of tax*. In addition to the provisions of paragraph (a) of this section, an executor of the estate of a decedent dying after December 31, 1970, may make written application to be discharged from personal liability for the amount of Federal estate tax for which the time for payment has been extended under § 6161, 6163, or 6166. In such a case, the executor will be notified of the amount of bond, if any, to be furnished within 9 months after receipt of the application, or, if the application is made before the return is filed, within 9 months after the return is filed. The amount of any bond required under the provisions of this paragraph shall not exceed the amount of tax the payment of which has been extended. Upon furnishing the bond in the form required under §301.7101-1 of this chapter (Regulations on Procedure and Administration), or upon receipt of the notification that no bond is required, the executor will be discharged from personal liability for the tax the payment of which has been extended. If no notification is received, the executor is discharged at the end of such 9 month period from personal liability for the tax the payment of which has been extended.

Reg. § 20.2204-2, "Discharge of fiduciary other than executor from personal liability," provides (highlighting added):

(a) A fiduciary (not including a fiduciary of the estate of a nonresident decedent), other than the executor, who as a fiduciary holds, or has held at any time since the decedent's death, property transferred to the fiduciary from a decedent dying after December 31, 1970, or his estate, may make written application to the applicable internal revenue officer with whom the estate tax return is required to be filed, as provided in § 20.6091-1, for a determination of the Federal estate tax liability with respect to such property and for a discharge of personal liability therefrom. The application must be accompanied by a copy of the instrument, if any, under which the fiduciary is acting, a description of all the property transferred to the fiduciary from the decedent or his estate, and any other information that would be relevant to a determination of the fiduciary's tax liability.

(b) Upon the discharge of the executor from personal liability under § 20.2204-1, or, if later, within 6 months after the receipt of the application filed by a fiduciary pursuant to the provisions of paragraph (a) of this section, such fiduciary will be notified either (1) of the amount of tax for which it has been determined the fiduciary is liable, or (2) that it has been determined that the fiduciary is not liable for any such tax. The fiduciary will also be notified of the amount of bond, if any, to be furnished for any Federal estate tax for which the time for payment has been extended under § 6161, 6163, or 6166. The amount of any bond required under the provisions of this paragraph shall not exceed the amount of tax the payment of which has been so extended. Upon payment of the amount for which it has been determined the fiduciary is liable, and upon furnishing any bond required under this paragraph in the form specified under §301.7101-1 of this chapter (Regulations on Procedure and

> Administration), or upon receipt by the fiduciary of notification of a determination that he is not liable for such tax or that a bond is not required, the fiduciary will be discharged from personal liability for any deficiency in the tax thereafter found to be due. If no such notification is received, the fiduciary is discharged at the end of such 6 months (or upon discharge of the executor, if later) from personal liability for any deficiency thereafter found to be due. The discharge of the fiduciary from personal liability under this section applies only to him in his personal capacity and to his personal assets. The discharge is not applicable to his liability as a fiduciary (such as a trustee) to the extent of the assets of the estate in his possession or control. Further, the discharge is not to operate as a release of any part of the gross estate from the lien for estate tax for any deficiency that may thereafter be determined to be due.

Given that it seems to me that the IRS rarely responds within the 9-month or 6-month deadlines highlighted in Reg. §§ 20.2204-1 and 20.2204-2, sending a letter requesting the Code § 2204 discharge seems an effective way to protect an executor or other fiduciary. In *U.S. v. Paulson*, 131 A.F.T.R.2d 2023-1743 (9th Cir. 5/17/2023), the IRS assumed – and the Ninth Circuit accepted – that a Code § 2204 discharge eliminated Code § 6324 liens to the extent that they arose solely from a person's status as an executor or other fiduciary.[7183] The lower court - District Court for the Southern District of California – explained how that trustee protected himself in *U.S. v. Paulson*, 445 F.Supp.3d 824 (2020):

> Plaintiff contends that though Michael Paulson was discharged from personal liability arising out of his position as Executor, he was not discharged from personal liability arising out of his role as Trustee of the Living Trust pursuant to 26 U.S.C. § 2204. (Doc. No. 191-1 at 12.) However, Michael Paulson argues that he followed all of the required procedures to be discharged as both executor of the Estate and trustee of the Trust. (Doc. No. 189-1 at 6.)
>
> Section 2204 states:
>
>> ((a)) General Rule.—If the executor makes written application to the Secretary for determination of the amount of the tax and discharge from personal liability therefor, the Secretary (as soon as possible, and in any event within 9 months after the making of such application, or, if the application is made before the return is filed, then within 9 months after the return is filed, but not after the expiration of the period prescribed for the assessment of the tax in section 6501) shall notify the executor of the amount of the tax. The executor, on payment of the amount of which he is notified ... and on furnishing any bond with may be required for any amount ... shall be discharged from personal liability for any deficiency in tax ...
>>
>> ((B)) Fiduciary other than the executor.—If a fiduciary other than the executor makes written application to the Secretary for determination of the amount of any estate tax for which the fiduciary may be personally liable, and for discharge from personal liability therefor, the Secretary upon the discharge of the executor from personal liability under subsection (a), or upon the expiration of 6 months after the making of such application by the fiduciary, if later, shall notify the fiduciary (1) of the amount of such tax for which it has been determined the fiduciary is liable, or (2) that it has

[7183] See text accompanying fn 7172 in part III.B.5.e.iv.(e) Which Estates Are Affected by the Estate Tax Lien?

> been determined that the fiduciary is not liable for any such tax. Such application shall be accompanied by a copy of the instrument, if any, under which such fiduciary is acting, a description of the property held by the fiduciary, and such other information for purposes of carrying out the provisions of this section as the Secretary may require by regulations....

26 U.S.C. § 2204(a), (b).

The crux of the issue here is whether Michael Paulson followed the procedures outlined above to be discharged of personal liability arising out of his role as Trustee of the Living Trust. Plaintiff argues that Michael Paulson failed to follow these procedures.

Prior to 1970, Section 2204 was titled "Discharge of Executor from Personal Liability," and in fact, only allowed for the executor to discharge their personal liability. United States Statutes at Large, Pub. L. No. 91-614, 84 Stat. 1836. In 1970, however, it was re-titled "by striking out 'EXECUTOR' in the heading of such section and inserting in lieu thereof 'FIDUCIARY.'" *Id*. Subsection (b) was added to allow fiduciaries to apply for discharge of liability. It is not clear to the Court that the congressional intent by adding subsection (b) was that Congress recognized that there are instances where a fiduciary, such as a trustee, administering the trust continue to remain personally liable for tax even though the executor of the estate may have been discharged from personal liability as a result of filing of an application for discharge under Section 2204 as Plaintiff asserts in its opposition. (Doc. No. 191-1 at 14.) Accordingly, this argument regarding congressional intent is unpersuasive.

Plaintiff asserts that Michael Paulson did not submit any written application in his capacity as a fiduciary other than the executor. (Doc. No. 191-1 at 14.) Specifically, Plaintiff points to the following facts: Michael Paulson signed the letter as "J. Michael Paulson, Co-Executor of the Will of Allen E. Paulson, Deceased"; he did not sign the letter personally or in all capacities; and he requested nine months as described for executors under Section 2204(a) rather than the six-month time frame for fiduciaries. (*Id*. at 15-16.)

As Michael Paulson points out, in contrast to Plaintiff's arguments that none of the procedures were followed, the letter sent to the IRS tells a different story. First, the title of the letter is "Request for discharge of fiduciaries from personal liability." (Doc. No. 189-1 at 8.) The plural form of fiduciary may indicate that Michael Paulson sought to be discharged as a trustee and executor. Second, the letter enclosed (1) a copy of Federal Form 4768; (2) co-executor's Section 6166 election for deferral of federal estate tax; and (3) co-executor's request for discharge from personal liability pursuant to I.R.C. Section 2204. (Doc. No. 172 at 21.) As to the request for discharge, the letter is not specific as to whether Michael Paulson was requesting discharge under parts (a) or (b) or both of Section 2204. (*Id*.) Further, requesting the longer time frame of nine months was likely appropriate as it encompassed both the time frame to be discharged as a fiduciary and as an executor.

26 U.S.C. § 2204 does not specify how Michael Paulson was to sign the letter. Plaintiff produces no case law to support its position that the way in which Michael Paulson signed the letter only exhibits that he signed it only as an executor. Michael Paulson argues that he signed using the term "Co-Executor" as a way to identify Michael Paulson's title in a manner consistent with his title appearing on the federal estate tax

return. (Doc. No. 189-1 at 11.) Currently, there is no authority that requires specific format, form or wording to make an application for discharge. See *United States v. Johnson*, 224 F.Supp.3d 1220, 1237 (D. Utah 2016) ("*Johnson II*"), reversed on other grounds *United States v. Johnson*, 920 F.3d 639 (10th Cir. 2019). However, Plaintiff argues that Michael Paulson signed various documents in different capacities and sometimes would sign the same document multiple times in his differing capacities. (Doc. No. 191-1 at 19-21.) There is no such requirement, however, how to sign the letter nor is there a requirement that Michael Paulson was supposed to provide two letters to the IRS.

Plaintiff argues that *Johnson II* clearly treated the discharge provisions of Section 2204(a) and (b) separately. *Id*. at 1237. However, it is unclear how the district court in Johnson II treated those two provisions separately. The district court did not address Section 2204(b) and the defendants in that case were offered a special lien under Section 6324A, which is not at issue in the instant litigation. Accordingly, the Court find this argument unpersuasive.

Further, it is stipulated that

> Mr. Loeb would testify that the letter was prepared based upon a Loeb & Loeb form document, the purpose of which is to begin the nine-month period within which the IRS has to issue a notification of the estate tax due or suffer the consequence of losing the right to impose personal liability upon persons acting in any and all fiduciary roles at the time the letter is sent ... It was (and remains) his belief that such a letter operates to discharge an executor/trustee such as Michael Paulson both in his capacity as a co-executor and as a trustee.

(Doc. No. 188 ¶ 16.) However, Plaintiff argues that intent does not matter. (Doc. No. 191-1 at 18.) Plaintiff argues that the IRS cannot be expected to infer intent from a letter that does not mention the Living Trust. (*Id*. at 18-19.) Further, Plaintiff points to the fact that Mr. Loeb entitled the letter "Co-Executor's Request for Discharge from Personal Liability Pursuant to I.R.C. Section 2204" and did not mention Michael Paulson's capacity as a trustee. (*Id*. at 21.)

However, the Living Trust, not the Estate, held all of the assets at the time of the letter. There was not a separate a tax return for the Living Trust. The Living Trust, therefore, was to make the payments on the tax obligations of the Estate. Further, the subject line of the letter read: "Request for discharge of fiduciaries from personal liability." (Doc. No. 111-10 at 7.) Logically, the Court finds that Michael Paulson was seeking to discharge his personal liability as trustee of the Living Trust.

Further, the IRS never contacted Michael Paulson regarding any confusion over the letter. In fact, the IRS never responded to the letter. The IRS is "to notify the fiduciary (1) of the amount of such tax for which it has been determined the fiduciary is liable, or (2) that it has been determined that the fiduciary is not liable for any such tax." 26 U.S.C. § 2204. If there was any confusion, Plaintiff argues that the IRS should have alerted the fiduciary that he remained liable for the full amount of "any estate tax for which the fiduciary may be personally liable." The Court agrees. Plaintiff should not have waited twelve years to raise this issue in litigation….

> Based on the foregoing, the Court ORDERS Michael Paulson to be discharged of personal liability under 26 U.S.C. § 2204 as a trustee of the Allen E. Paulson Living Trust.

Filing IRS Forms 4810 and 5495 will help discharge the executor from liabilities relating to not only estate tax but also gift and income tax. Although Form 5495 could also include income tax returns, that applies for purposes of Code §§ 2204, 6905 and not necessarily for purposes of 31 U.S.C. § 3713(b); filing Form 4810 lets the executor know whether any outstanding income or gift tax liabilities are owed. Form 5495 may be used to acquire a Code § 2204 discharge, but a letter is also acceptable;[7184] I specifically refer to both subsections (a) and (b) of Code § 2204 when I draft the letter if a revocable trust is involved. As to tax liabilities, if the executor knows that some amount of tax is due, the executor needs to find out the finally determined amount of liabilities to make sure that they are paid in full; the executor cannot just assume that the executor's lawyer (even one who has received all IRS notices) would let the executor know about any tax liabilities that are due.[7185] Ironically, the executor is not necessarily able to file or defend audits of gift tax[7186] or income tax returns.[7187]

[7184] In addition to the *Paulson* 2020 District Court opinion above, see text accompanying fn 5191 in part III.A.6 Post-Mortem Trust and Estate Administration.

[7185] *U.S. v. Shriner*, 2014 WL 992300, 113 A.F.T.R.2d 2014-1360 (D.C. MD) (holding executors liable under 31 U.S.C. § 3713(b) for making distributions before all debts owed the U.S. have been fully repaid). See fn. 7167 for the requirements to make a claim under 31 U.S.C. § 3713(b).

[7186] See fn 7051 in part III.B.4 Adequate Disclosure on Gift Tax Returns.

[7187] *Sander v. Commissioner*, T.C. Memo. 2022-103, held that the trustee of a decedent's revocable trust was not authorized to act regarding the decedent's income tax matters:

> The question of whether Leda was authorized to file a Petition on behalf of Sandra depends on whether state law authorizes her to file a Petition for Sandra. See Rule 60(c); *Fehrs v. Commissioner*, 65 T.C. 346, 349 (1975); *Estate of Peterson v. Commissioner*, 45 T.C. 497, 500 (1966). Leda has the burden of proving that she was so authorized. See *Fehrs*, 65 T.C. at 348.

Further below, the court concluded that state law did not authorize her involvement on behalf of ter probate estate and continued:

> … "trust property" is not directly involved in this case. This case involves then redetermination of the income tax deficiencies of Sandra for the 2013 and 2014 tax years. See § 6214(a). As part of the decision about the deficiencies, the Court would necessarily redetermine Sandra's tax liabilities for those years. See § 6211. To then collect these liabilities from the Sandra E. Sander Lifetime Trust, the IRS would need to invoke transferee liability concepts and show that the Sandra E. Sander Lifetime Trust is a liable transferee of Sandra. But such liability is a "secondary liability." Steve R. Johnson, Unfinished Business on the Taxpayer Rights Agenda: Achieving Fairness in Transferee Liability Cases, 19 Va. Tax. Rev. 403, 409 n.28 (2000). To allow the Sandra E. Sander Lifetime Trust to litigate this case merely because of its secondary liability would elevate that entity over all other persons who might be held secondarily liable for the income tax liabilities.[9]
>
> > [9] Leda makes the following contention: "Except for the assets of Sandra's Living Trust [*i.e.*, the Sandra E. Sander Lifetime Trust] there are no assets to pay Sandra's potential 2013 and 2014 income tax liabilities." The record does not prove this statement. Leda testified that, by the time of our hearing, there were no assets in her mother's name. But even if that were so, the income tax liabilities can be collected from any person to whom Sandra's assets were transferred after the income tax liabilities arose.
> >
> > The assets from which the IRS can collect the 2013 and 2014 income tax liabilities are not limited to the assets held by Sandra at the time of our motions hearing. The IRS can assert theories of transferee liability to collect the 2013 and 2014 income tax liabilities from persons to whom Sandra transferred her assets after the liabilities arose. See Michael I. Saltzman & Leslie Book, *IRS Practice and Procedure* 17.01 (rev. 2d ed. 2018) (describing theories of transferee liability,

If the estate tax has not been paid in full, included property needs to be sold, and none of the exceptions described in Code § 6323(b) will apply, the executor or trustee should request that the lien be released and applied to substituted property. See generally the IRS pages, Understanding a Federal Tax Lien and Sell Real Property of a Deceased Person's Estate. IRS Publication 783 instructs us how to file IRS Form 4422 to apply for a discharge of an estate tax lien (or IRS Form 14135 for other tax liens); submit Form 4422 at least 45 days before the transaction date that the certificate of discharge is needed.[7188] As discussed further above, however, the remaining assets are still encumbered by the lien.

When going after an estate, the IRS considers not only how much the estate can pay but also how much liability the executor has. *Estate of Kwang Lee v. Commissioner*, T.C. Memo. 2021-92, approved the IRS' actions described below:

> In December 2016, the estate submitted Form 433-A, Collection Information Statement for Wage Earners and Self-Employed Individuals, which showed that the estate's only asset was a checking account with a balance of $182,941. The estate also submitted an OIC in the same amount to the Appeals Office settlement officer (SO) assigned to the estate's CDP case. In reviewing the estate's OIC and upon the advice of respondent's Collection Division and Office of Chief Counsel, the SO determined that: (1) the IRS could potentially collect the distributed amounts from Mr. Frese using a fiduciary liability

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> including liabilities enforced under the procedures of section 6901); *id*. 17.02[2] (explaining that a requirement for transferee liability under section 6901 is that "the taxpayer/transferor is liable for a tax both at the time of the transfer and at the time the transferee liability is asserted"). Sandra's 2013 and 2014 income tax liabilities arose on April 15, 2014 and 2015, respectively, the dates that the returns were due. See §§ 6151(a), 6072(a). If she transferred property after these respective dates, the recipients of the property are potentially liable for income tax for the respective tax years under the principles of transferee liability. The record is unclear as to what assets Sandra owned when the 2013 and 2014 income tax liabilities arose and to whom she transferred them. It is therefore speculative to conclude that there is no transferee other than the Sandra E. Sander Lifetime Trust from whom the IRS can collect the 2013 and 2014 income tax liabilities. We do not imply that such a conclusion would be relevant.
>
> Leda also contends that any payment of the income tax liabilities for 2013 and 2014 will be made from the Sandra E. Sander Lifetime Trust. This contention is based on Leda's testimony that, as trustee of the Sandra E. Sander Lifetime Trust, she will direct the trust to pay any income tax liabilities. Leda may well intend to direct the Sandra E. Sander Lifetime Trust to pay the income tax liabilities. But this unenforceable intention is insufficient to protect the legal rights of other parties. If we were to grant Leda's Motion for Substitution and therefore allow her to litigate the amounts of the income tax liabilities, our decision about the amounts of the income tax liabilities would be binding on any persons against whom the IRS might assert transferee liability. See *Krueger v. Commissioner*, 48 T.C. 824, 829-30 (1967).

However, *Galloway v. Commissioner*, 103 T.C. 700 (1994) took a different approach, based on state law:

> California is one of many States that have adopted simplified procedures for administration of estates when a formal probate proceeding is not necessary. See, *e.g.*, Cal. Prob. Code secs. 13000-13660 (West 1991); *Pitner v. United States*, 388 F.2d 651, 655 (5th Cir. 1967). We discern no reason why heirs of a decedent should be required to choose between costly probate proceedings or cumbersome joinder of all beneficiaries in order to maintain a proceeding in this Court. Rule 60(c) and all other Rules of this Court "shall be construed to secure the just, speedy, and inexpensive determination of every case." Rule 1(b). Given the authority by Cal. Civ. Proc. Code sec. 377.33, supra, we will make an order appointing Armijo as a special administrator of decedent's estate solely for purposes of this action. Respondent's Motion to Dismiss for Lack of Jurisdiction shall be denied. Based on respondent's concession,

[7188] The time framework is from the Instructions for Completing Form 4422 (Rev. 2-2018) (I visited 7/2/2023).

> theory under 31 U.S.C. sec. 3713 and from the beneficiaries as transferees under section 6324(a)(2); (2) the period of limitations to collect from both Mr. Frese and the beneficiaries remained open; and (3) these potentially collectible amounts had to be included in the estate's reasonable collection potential (RCP) calculation for purposes of reviewing the estate's OIC per Internal Revenue Manual pt. 5.8.4.3.(Apr. 30, 2015). Including the distributed amounts in the RCP formula yielded a collection potential that exceeded the estate's unpaid estate tax liability. Consequently, the SO rejected the estate's OIC and sustained the filing of the notice of Federal tax lien. As part of the summary report attached to the notice of determination, the SO noted that he had "verified the requirements of any applicable law or administrative procedure were met" and confirmed through IRS records that all required notices were properly issued to the estate.

Finally, if for compelling reasons an executor or trustee decides to make distributions before discharge or release under Code § 6325, the executor or trustee probably should seek indemnification from the beneficiaries. However, as a practical matter, indemnification is only as good as the executor's/trustee's ability to collect from the beneficiaries, which may be beyond the executor's/trustee's control. On the other hand, if the estate/trust passes in trust (a "downstream trust") and the executor/trustee serves as trustee of each downstream trust, then the executor/trustee should be able to enforce the indemnification agreement.

CCA 202142010 pointed out that a closing letter does not have the binding effect of a closing agreement:

> We agree with your conclusion that the issuance of a Letter 627 to [Redacted Text] does not preclude the IRS from examining the return.
>
> There is no legal prohibition on the IRS's examination of the return. There was no examination of the return (either original or supplemental) for purposes of section 7605(b) and, by extension, Rev. Proc. 2005-32. Prior to the issuance of the opening letter to the estate, the IRS never inspected [Redacted Text] books of account (nor did the IRS even request such records); thus, the prohibition of "only one inspection" in section 7605(b) does not apply. Rather, the IRS accepted the return as filed, issued a refund, and sent a Letter 627. Acceptance of a return as filed does not constitute an examination. See Rev. Proc. 2005-32, § 4.03(1)(a) (looking at a return is not an examination). The minimal contacts/communications between the IRS and here easily fall into the category of "narrow, limited contacts between the Service and a taxpayer that do not involve the Service inspecting the taxpayer's books of account" that do not constitute an examination or inspection. See Rev. Proc. 2005-32, §§ 4.03, 4.03(1).
>
> In response to the opening letter, [Redacted Text] attorney contends that the IRS has not followed the reopening procedures in Rev. Proc. 2005-32, § 5. However, these procedures apply only to the reopening of a closed examination. See Rev. Proc. 2005-32, § 5.01 (the IRS "will not reopen a case closed after examination to make an adjustment to liability unfavorable to the taxpayer unless" at least one of three criteria is met) (emphasis added); see also Treas. Reg. § 601.105(j) (same). Because there was no examination in the first place, the opening letter is not a reopening of a closed examination.
>
> The prior advice from P&A that a Letter 627 is not a closing agreement supports our conclusion here that the IRS is not legally prohibited from examining the return.

It is the IRS's business decision to determine the factors that should or must be considered when examining a return that was previously accepted as filed. That said, there's a consideration about IRM 4.25.14.8.1 and Letter 627 that we'd like to discuss with you. Please let [Redacted Text] know your availability for this and next week and we will send a meeting invitation.

III.B.5.e.iv.(h). Liens: Selected Internal Revenue Manual Materials

IRM 5.1.19.1.1 points out:

> Each tax assessment has a Collection Statute Expiration Date (CSED). Internal Revenue Code section 6502 provides that the length of the period for collection after assessment of a tax liability is 10 years. The collection statute expiration ends the government's right to pursue collection of a liability.

IRM 5.5.7.11,[7189] "Liens on Estate Tax Liabilities," explains:

(1) The chart below provides information on liens associated with estate tax, the assets they encumber, and the duration of the liens.

Lien:	**Attaches to:**	**Duration:**
IRC 6324(a)(1) Estate Tax Lien	If there is an estate tax return filing requirement, this unrecorded lien attaches to all assets includable in the decedent's gross estate, plus any appreciation on those assets.	Lien goes into effect at the date of the decedent's death, and it lasts for ten years from date of death. Nothing extends the duration of the lien.
IRC 6324(a)(2) "Like Lien" for Estate Tax	When a recipient of **non-probate** property transfers that property to a purchaser or security interest holder, the transferred property is divested of the IRC 6324(a)(1) estate tax lien, and an IRC 6324(a)(2) "like lien" then attaches to all the transferee's other property. This lien is not recorded.	The "like lien" arises when the transfer to the purchaser or security interest holder occurs. The duration of the "like lien" is the same as an estate tax lien which is ten years from date of death. Nothing extends the duration of the lien.
IRC 6321 Assessment Lien	Assets that were in the probate estate at the date of the tax assessment. Does not attach to non-	Arises on date of assessment and remains until the liability is satisfied or the collection statute expires.

[7189] The link was not working when I tried. Go to IRM 5.5.7 Collecting Estate Tax and drill down.

Lien:	Attaches to:	Duration:
	probate assets even if they were included in the gross estate. To compete against other creditors, a Notice of Federal Tax Lien (NFTL) can be recorded in the name of the taxpayer estate.	
IRC 6324A, Special lien for estate tax deferred under IRC 6166	Specific property described in the lien agreement (Form 13925). Form 668-J, Notice of Federal Estate Tax Lien Under Internal Revenue Code Section 6324A, is recorded on the property listed on the Form 13925 lien agreement.	Coincides with the CSED.
IRC 6324B, Special lien for additional estate tax attributable to farm, etc. valuation, created by the IRC 2032A special use valuation election	Specific property designated in the lien agreement on Schedule A-1 of Form 706. Form 668-H, Notice of Federal Estate Tax Lien Under Internal Revenue Code Section 6324B, is recorded on the property that qualified the estate for the IRC 2032A election.	The lien is created when an estate makes an IRC 2032A election, and it continues until one of the following occurs: • The IRS has confirmed that no event occurred to trigger the tax during the ten year period following the decedent's death; or • If the additional estate tax is triggered and assessed on Form 706-A, United States Additional Estate Tax Return, the lien continues until the tax is paid or through the Form 706-A collection statute expiration date (CSED).

(2) The assessment lien under IRC 6321 and the estate tax lien under IRC 6324(a)(1) are not exclusive of each other. They are independent and cumulative. The IRC 6324(a)(1) estate tax lien is broader than the IRC 6321 assessment lien because an assessment lien only attaches to probate property, but the estate tax lien attaches to both probate and non-probate property that is includable in the gross estate. See IRM 5.5.7.11.1 for a discussion of the estate tax lien. See IRM 5.5.7.11.3 for a discussion of the IRC 6321 assessment lien.

(3) Collection action on the IRC 6324A lien due to an IRC 6166 election and on the IRC 6324B lien due to an IRC 2032A election are discussed in IRM 5.5.6, Collection on Accounts with Special Estate Tax Elections. These Notices of Federal Estate Tax Liens are not on the Automated Lien System (ALS) since they are manually prepared and manually released because they are property specific. If the collection statute is suspended or extended, these liens do not need to be refiled since there is no refiling date on the recorded documents.

IRM 5.5.7.11.1, "Estate Tax Lien," explains:

(1) An unrecorded IRC 6324(a)(1) estate tax lien attaches to all property included in the gross estate for ten years from the date of the decedent's death. An assessment, notice, or demand are not necessary to create the lien. The estate tax lien only pertains to Form 706 and Form 706-NA estate tax. It does not pertain to Form 1040, Form 941, Form 1041, or any other tax owed by the decedent or by the decedent's estate.

(2) Features of the IRC 6324(a)(1) estate tax lien include the following:

- Lien arises at the date of death of the decedent and attaches to all the estate assets even if the estate tax return is not filed.
- Lasts for ten years from the date of decedent's death. Nothing can extend the duration of this lien.
- The lien attaches automatically to all the assets includable in the estate. This includes both probate and non-probate assets.
- The estate tax lien is unrecorded.
- Since the lien attaches automatically, and it is not recorded, the estate does not receive Collection Due Process (CDP) or Collection Appeals Program (CAP) rights on this lien.

(3) When there is an estate tax return filing requirement, the IRC 6324(a)(1) estate tax lien attaches to all the estate assets includable in the decedent's gross estate no matter how the assets were titled at date of death. This includes any assets in the name of the decedent, assets held in a revocable trust created by the decedent, and the decedent's interest in assets owned jointly with right of survivor.

(4) The IRC 6324(a)(1) estate tax lien attaches to the extent of the current value of the property. The property may appreciate or depreciate after the date of the decedent's death.

(5) The estate tax lien is inferior to superpriority liens described in IRC 6323(b), Validity and Priority Against Certain Persons, such as mechanics liens and ad valorem property tax liens. It is also inferior to pre-existing encumbrances that were in effect at date of death such as mortgages or pledges that attached to assets during the decedent's lifetime.

(6) If **probate** property is transferred, sold, or encumbered by the executor, the IRC 6324(a)(1) estate tax lien will continue to encumber the property unless the lien expires, or the estate receives a discharge of the property from the lien.

This description is consistent with case law as well.[7190]

IRM 5.5.7.11.1.1, "Exceptions to Estate Tax Lien," explains:

(1) In certain circumstances, the estate tax lien may be divested from assets used for the payment of charges against the estate and expenses of administration allowed by any court having jurisdiction over the estate. Review court records for such orders and consult with Counsel, if necessary, if you need assistance with determining if this applies in your case. The decision by an executor to use estate assets to pay expenses of administration does not divest those assets of the estate tax lien unless approved by a court.

(2) An executor can request a discharge from personal liability under IRC 2204 by making written application for determination of the amount of the tax and discharge from personal liability. See IRM 5.5.7.22.3.2, Estate Tax Liability of Fiduciary, for more information on an IRC 2204 discharge of fiduciary from personal liability. If the executor that was granted an IRC 2204 discharge from personal liability transfers property to a purchaser (i.e., by selling the property for fair market value) or to a security interest holder (i.e., by encumbering the property and removing the recipient's equity), and the tax due as originally reported on the estate tax return was paid, the IRC 6324(a)(1) estate tax lien will be divested from the asset. The estate tax lien will then attach to the consideration received from the purchaser or holder of the security interest so that the IRS can collect from these proceeds to pay any examination assessments. See IRC 6324(a)(3), Continuation after discharge of fiduciary.

IRM 5.5.7.11.1.2, "Discharge of Property from Estate Tax Lien," explains:

(1) An executor can apply for a discharge of property from **estate tax lien** by submitting Form 4422, Application for Certificate Discharging Property Subject to Estate Tax Lien, with the documents listed in the instructions on Form 4422.

(2) The Advisory Estate Tax Lien Group processes estate tax lien discharge requests, provides conditional commitments to discharge property from federal estate tax lien, and issues Form 792, U.S. Certificate Discharging Property Subject to Estate Tax Lien. If the sale of property occurred prior to June 2016, the discharge application may also have been processed by Estate and Gift Examination since they were previously working some discharge of property from estate tax lien requests.

(3) Determine if a discharge of property from the estate tax lien was issued by the IRS by doing the following:

- Check public records for a copy of the recorded discharge document.

[7190] *United States v. Vohland*, 675 F.2d 1071 (9th Cir. 1982); *United States v. Estate of Young*, 592 F.Supp. 1478 (E.D. Pa. 1984); *Metz v. United States*, 933 F.2d 802 (10th Cir. 1991).

- Contact the Advisory Estate Tax Lien Group for copies of any discharge applications, or case activity may be documented in the case history on Integrated Collection System (ICS).

- A copy of the discharge document may be with the estate tax return if the discharge was provided by Estate and Gift Examination.

- Request copies of discharge documents from the estate executor or representative.

(4) If **probate** property included in the gross estate is transferred to a purchaser (i.e., by selling the property for fair market value) or to a security interest holder (i.e., by encumbering the property and removing the equity), and the estate did not receive a discharge of property from the estate tax lien, the IRC 6324(a)(1) estate tax lien will continue to attach to the property. In that case, collection by levy or seizure can be pursued against the property. Secure or summons for copies of closing documents from the title company when pursuing a seizure of property that was not discharged from the estate tax lien. Typically, if the title company has issued a title policy, they will pay the sale proceeds to the IRS to clear the title. If necessary, a suit to foreclose the tax lien can be referred through Advisory and Counsel to request Department of Justice to enforce the government's lien position.

(5) An estate does not need to request a discharge of property from estate tax lien when **non-probate property** is transferred to a purchaser (i.e., by selling the property for fair market value) or security interest holder (i.e., by encumbering the property and removing the equity). Non-probate property is automatically divested of the IRC 6324(a)(1) estate tax lien when it is transferred to a purchaser or security interest holder, and a "like lien" is then created on the personal assets of the recipient of the non-probate property. See IRM 5.5.7.11.2, IRC 6324(a)(2) Like Lien.

IRM 5.5.7.11.1.3, "Estate Tax Lien Expiration," explains:

(1) The IRC 6324(a)(1) estate tax lien expires ten years from the decedent's date of death and cannot be extended or suspended. All enforcement action (seizure, sale, levy) and litigation against estate assets based on the estate tax lien must be completed before the expiration of the lien.

(2) If the estate tax lien expires, collection action based on the IRC 6321 assessment lien may still be possible.

IRM 5.5.7.11.2, "IRC 6324(a)(2) Like Lien," explains:

(1) Non-probate property may be part of the gross estate assets. This includes property that passed directly to a specified person by designation or by operation of law. It also includes property the deceased taxpayer had transferred prior to death that is includable in the decedent's gross estate under IRC 2034 to IRC 2042, inclusive, such as property the decedent transferred to a trust and retained a power or interest.

(2) If the recipient of non-probate property transfers property includable in the decedent's gross estate to a purchaser (i.e., by selling the property for fair market value) or to a security interest holder (i.e., by encumbering the property and

removing the recipient's equity), the transferred property is divested of the IRC 6324(a)(1) estate tax lien, and an unrecorded IRC 6324(a)(2) "like lien" then attaches to all the personal assets of the recipient that sold or encumbered the property.

Note: In addition to the "like lien" created under IRC 6324(a)(2), this Internal Revenue Code section also creates a personal liability of the recipient of non-probate assets to the extent of the date of death value of the asset received by the recipient. See IRM 5.5.7.22.3.1, Estate Tax Liability of Transferees.

(3) The IRC 6324(a)(2) "like lien" expires ten years from the decedent's date of death. This lien cannot be suspended or extended. The government can take administrative enforcement action using the IRC 6324(a)(2) "like lien", or the government can file a suit to collect on this lien. See IRM 5.5.7.22.1.4, Seizure and Levy Based on IRC 6324(a)(2) Like Lien, and see IRM 5.5.7.22.4, Preparing Suit Referrals on Estate Tax.

Thus, nonprobate assets are not subject to the same hazards as probate estates. However, those who receive nonprobate assets, including the trustees of revocable trusts, are in peril, as shown in the language I highlighted above.

IRM 5.5.7.11.3, "Estate Tax IRC 6321 Assessment Lien," explains:

(1) After the estate tax has been assessed, notice and demand is given, and there is a neglect or refusal to pay, the IRC 6321 assessment lien arises and attaches to the probate assets in the estate at the time of assessment. The unrecorded IRC 6324(a)(1) estate tax lien operates separately and independently of the IRC 6321 assessment lien. If the IRC 6324(a)(1) estate tax lien expires, the IRS can still use the IRC 6321 assessment lien to collect the liability. The IRC 6324(a)(1) estate tax lien and the IRC 6321 assessment lien are cumulative. The IRS has the right to use either lien to collect on an estate tax liability. See IRM 5.5.7.11.1 for a discussion of the IRC 6324(a)(1) lien.

(2) If there is a neglect or refusal to pay, a Notice of Federal Tax Lien (NFTL) may be filed to protect the interest of the government against purchasers and other creditors. The NFTL should only include the name of the estate, and it should not include the name of the executor. Filing the NFTL will put other creditors, potential buyers, transferees, and title companies on notice of unpaid estate tax. The IRS may lose its lien priority in assets between the expiration of the IRC 6324(a)(1) estate tax lien and the filing of the IRC 6321 assessment lien. See IRM 5.12.1, Lien Program Overview, and IRM 5.17.2, Federal Tax Liens, for more information on the IRC 6321 assessment lien.

(3) NFTLs must be filed in the proper jurisdiction to protect the government's interest against other creditors. State law dictates the place of filing. See IRM Exhibit 5.12.7-2, State and Territory Filing Locations.

(4) The IRC 6321 assessment lien applies for ten years from the date of assessment unless an event occurs to suspend or extend the collection statute. A NFTL can be refiled if the collection statute has been suspended or extended. See IRM 5.5.7.6,

Collection Statute Expiration Dates, for more information on actions that suspend or extend the collection statute on estate tax cases.

(5) Administrative levy or seizure may be taken to enforce the lien when a NFTL has been filed. For judicial enforcement, a suit to foreclose the IRC 6321 assessment lien may be referred to Department of Justice. See IRM 5.17.12, Investigations and Reports, IRM 5.5.7.22.4, Preparing Suit Referrals on Estate Tax, IRM 25.3.2, Suits by the United States, and Knowledge Management Litigation for more information on suits.

(6) If the estate is selling an asset subject to the IRC 6321 assessment lien, the estate may apply for a discharge of the property from the lien by completing Form 14135, Application for Certificate of Discharge of Property from Federal Tax Lien. The Advisory Estate Tax Lien Group handles any lien discharges on Form 706 or Form 706-NA estate tax liabilities.

Let’s take a moment to compare liens resulting from Code § 6166 to Code § 6324(a) liens:

- The Code § 6324(a) lien is very strong. However, as an unrecorded lien, it is not likely to impair assets as a practical business matter until creditors request a representation that no liens are on property included in the decedent’s gross estate. When switching from a lender who made a loan before death to refinance with a new lender after death, one should have the first lender assign its loan to the new lender, hoping that the underlying security interest’s priority over the Code § 6324(a) will survive the change.

- Code § 6324A liens on Code § 6166 property cause the Code § 6324(a) lien to be released from that particular property.[7191] Procedurally, this occurs when the property is listed on a recorded IRS Form 668-J.[7192] Recording the § 6324A lien also discharges the executor or other fiduciary.[7193] Code § 6324A liens are not valid against a purchaser, holder of a security interest, mechanic’s lienor, or judgment lien creditor until notice of the lien is filed.[7194]

A TIGTA report on Code § 6166 liens made the following general comment:[7195]

> The IRS needs to enhance its current process to ensure a bond or an I.R.C. § 6324A special lien is obtained and filed in all I.R.C. § 6166 installment cases in which the IRS determines that there is a credit risk to the Federal Government and all special liens are appropriately monitored and tracked. Where an estate has elected to pay the estate tax attributable to its interest in a closely held business in installments over a period of up to 14 years under I.R.C. § 6166, the IRS could be left without lien protection for 4 years or more if a bond or an I.R.C. § 6324A special lien is not obtained and recorded with the appropriate local government office before the 10-year period of the general estate tax lien expires.

[7191] Code § 6324A(d)(4); IRM 5.5.8.5(4)(d).
[7192] IRM 5.5.8.1(4)(b).
[7193] Reg. § 20.2204-3; IRM 5.5.8.5(4)(e).
[7194] Reg. § 20.6324A-1(c)(2). Once filed, the notice of lien remains effective without being refiled. *Id.*
[7195] http://www.treas.gov/tigta/auditreports/2007reports/200730174fr.pdf.

TIGTA acknowledged the *Roski* case:

> As a result of the Treasury Inspector General for Tax Administration's prior report, the IRS began instituting procedures to require a bond or an I.R.C. § 6324A lien from all estates making I.R.C. § 6166 elections. However, in *Estate of Roski v. Commissioner*, 128 T.C. No. 10 (April 12, 2007), the Tax Court held that the IRS may not require a bond or I.R.C. § 6324A special estate tax lien in every case but may determine on a case-by-case basis whether credit risks justify requiring security to protect the Federal Government's interest in the deferred estate tax. Accordingly, a bond or special lien may no longer be required in every case.

Note that the emphasis is on being unprotected after the Code § 6324 10-year lien has expired. Since the 10-year lien is unrecorded, it poses less of a problem regarding adverse publicity - third parties who see a Code § 6324A recorded tax lien might jump to the unwarranted conclusion that the business is in trouble.

Notice 2007-90 announced that procedural changes would be made regarding liens securing Code § 6166 elections. These were integrated into the Internal Revenue Manual on June 1, 2010.

IRM 5.5.7.6.2, "CSED - IRC 6166 Deferred Tax," explains:

> (1) An estate may make an IRC 6166 election for an extension of time to pay estate tax that is attributable to an interest in a closely held business when the estate files a timely Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, or on a Form 706 examination assessment. The IRC 6166 election allows for the deferral of payment of estate tax when an estate has an interest in a closely held business or businesses that exceeds 35% of the adjusted gross estate assets. Estates must meet certain criteria, as approved by an Estate & Gift (E&G) examiner, to be granted the IRC 6166 election.
>
> (2) The IRC 6166 election typically allows for an estate to pay up to four years in annual interest only installments then up to ten years of annual principal and interest installments. Some IRC 6166 elections are for shorter periods as determined by an E&G examiner. See IRM 5.5.6, Collection on Accounts with Special Estate Tax Elections, and IRM 5.5.8, Advisory Responsibilities for Processing Estate Tax Liens, for more information on IRC 6166 Elections.
>
> (3) The collection statute that is based on the assessment of tax is suspended while an IRC 6166 election is in effect. See IRC 6503(d), Suspension of running of period of limitations, Extensions of time for payment of estate tax. However, the statute on the unrecorded IRC 6324(a) estate tax lien is not suspended when the IRC 6166 election is in effect. See IRM 5.5.7.11.1, IRC 6324(a)(1) Estate Tax Lien, for a discussion of this lien.
>
> (4) Some indicators on Integrated Data Retrieval System (IDRS) that an estate had been granted an IRC 6166 election include the following:
>
> - If Submission Processing correctly identifies the IRC 6166 election, the account will have a payment indicator 1, which restricts the account and places it in Status 14. This payment indicator is on TXMOD and shown as **PYMT-IND>1**.

- If Submission Processing did not input **PYMT-IND>1**, Campus E&G will input a TC 488 to put the account into status 14.

- Accounts with annual TC 340 assessments of interest with associated TC 290 assessments.

- Accounts that were in status 14 on IDRS. However, this can also be an indicator of an IRC 6161, Extension of Time for Paying Tax.

- TXMOD history with statements such as "6166 SETUP" , "To 6166" , "Default 6166" , or "950-H Letter."

- TC 489 input on IDRS. This is the date that the IRC 6166 election went into default.

- TC 582 input with the note "Special Lien."

(5) The estate may have an IRC 6166 election on all the estate tax due or on only a portion of the estate tax due. For the portion of tax that the estate does not have an IRC 6166 election, the tax is due by the return due date.

(6) Form 4349, Computation of Estate Tax Due with Return and Annual Installment, is completed by Estate & Gift (E&G) Examination, Campus E&G, or IRS Independent Office of Appeals. It will show the amount of tax that was deferred under IRC 6166, and the amount of tax that was not deferred. Campus E&G may have this information on their database, Advisory Estate Tax Lien Group may have this information, or the form may be with the tax return. To contact Campus Examination E&G on IRC 6166 accounts, see IRM 4.25.2.9.6.2(1), Payoff Requests, for their e-mail information. To contact Advisory Estate Tax Lien Group, see Knowledge Management Advisory Estate Tax Lien Group. To order a copy of the estate tax return, see IRM 5.5.7.8, Ordering Estate Tax Returns.

(7) An estate can request an IRC 6161 extension of time for paying tax on an IRC 6166 installment payment for up to one year at a time. Both the IRC 6166 election and the IRC 6161 election suspend the collection statute. When more than one action suspends the running of the collection statute, and the suspensions overlap, the collection statute is suspended only once. See IRM 5.1.19.3, Case Actions That Can Suspend And/Or Extend A CSED. In these situations, the calculation of the CSED should be based on the time that the estate had the IRC 6166 election since the IRC 6161 extension of time to pay the annual installment would overlap with the IRC 6166 election.

(8) To update the CSED on Integrated Collection System (ICS), see IRM 5.5.7.6, Estate Tax Collection Statute Expiration Date.

Additional explanations are in IRM 5.5.7.6.2.1, "CSED - All Tax Deferred Under IRC 6166," and IRM 5.5.7.6.2.2, "Multiple CSEDs - Tax Deferred Under IRC 6166 and Tax Non-Deferred."

Below are details from IRM 5.5.6, "Collection on Accounts with Special Estate Tax Elections," June 19, 2013, which I last checked April 2, 2023.

IRM 5.5.6.2, “IRC Section 6166,” explains:

(1) IRC section 6166 provides an extension of time to pay Form 706 estate tax in **annual** installments. Generally the maximum amount of time for payment of deferred tax is 10 years. The executor may select a shorter period, in which case the deferment will be the period selected. It allows executors a fourteen year period to pay estate tax attributable to an estate’s interest in a closely held business. It grants the estate a deferral period to make “interest only” payments for the first four years. The first tax payment along with interest payment is due on the 5th anniversary of the due date of the return. See IRM 4.25.2.1.10, *IRC Section 6166 Interest-Only Installment Payment Period - General Process*.

(2) The IRC section 6166 estate tax installment plans are approved by Exam Estate & Gift Specialty Tax. The Estate & Gift Tax Campus unit will make a preliminary determination if the estate qualifies for the installment payment privilege. This election should not be confused with the one year IRC section 6161, Extensions of Time to Pay Estate Taxes, which are approved by Advisory (see IRM 5.5.5). Collection function does not have authority to approve deferred installments plans under IRC section 6166.

(3) The election to pay in installments must be made on a timely filed Form 706 on page 2, Part 3 Elections by the Executor, Line 3 and by attaching a notice of election to the return containing the information specified in Treas. Reg. § 20.6166-1(b). Late filing of the return invalidates the election. However, if a return is timely filed without the election but an amended return containing the election is filed within 6 months of the **unextended** due date of the Form 706, the election is considered timely.

(4) If the deferred tax due is the result of an examination deficiency, the estate must make the election within 60 days after issuance of notice and demand.

IRM 5.5.6.3, “Qualification for IRC 6166,” explains:

(1) The criteria for qualifying for installment payments are:

- Decedent was a citizen or resident of the United States on the date of death.
- The Value of interest in closely held business must exceed 35 percent of the adjusted gross estate.
- The return is **timely** filed and the IRC section 6166 election request was included on the **timely** filed return or an amended return within 6 months of the **unextended** due date of the return.

(2) An interest in closely held business is defined as:

- A proprietorship that carries on a trade or business.
- An interest in a partnership that carries on a trade or business. Deceased partner’s interest that is included in the gross estate must be 20 percent or more of the total capital interest in the partnership or the partnership has 45 or fewer partners.

- Stock in a corporation carrying on a trade or business if 20 percent or more of the value of voting stock of the corporation is included in the gross estate, or the corporation has 45 or fewer shareholders.

(3) For more details on qualification see IRC section 6166 or IRM 4.25.2.1.6, *Estate Installment Privileges under IRC Section 6166*.

(4) IRC section 6166(h) provides for the election to defer the deficiency tax resulting from an examination, if the estate is not already making payments under IRC section 6166. The IRC section 6166(h)(2) election must be made within 60 days of the issuance of the notice and demand. The deficiency is prorated per the formula in IRC section 6166(a). The estate cannot defer more than the deficiency. The estate may not elect to defer any portion of a deficiency that was due to negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax.

(5) IRC section 6166(e) provides for the proration of deficiency installments if the estate is paying in installments under IRC section 6166 when the assessment is made. The part of the deficiency attributable to the closely-held business shall be prorated and added to the installments. The deficiency portion of an installment that is due and payable when the deficiency assessment is made shall be paid upon notice and demand.

(6) **Non-deferred tax** must be paid by the return due date, unless the estate has an extension of time to pay under IRC section 6161. If the estate does not pay the non-deferred tax, procedures in IRM 4.25.2.1.9, *Estate Qualifies for IRC Section 6166 Election and Fails to Pay or Underpays the Non-Deferred Tax*, will be taken by the Estate & Gift Tax Campus unit.

(7) These accounts can be identified on IDRS by status 14 or transaction code (TC) 488. The TC 488 indicates the account is in installment and/or manual billing and updates the module to status 14.

IRM 5.5.6.4, “Acceleration of IRC 6166 Tax Payments,” explains:

(1) IRC section 6166(g)(1) provides for acceleration of installments. The balance of installments are accelerated upon notice and demand if:

- any portion of an interest in the qualifying business is distributed, sold, exchanged or otherwise disposed of, or money or property attributable to the interest is withdrawn from the business and the aggregate of such distributions, withdrawals, etc. equals or exceeds 50 percent of the value of the entire interest, measured at the value reported on the Form 706 or as adjusted. Dispositions are cumulative, so a record should be kept of dispositions.

- the estate fails to make all of an annual installment payment within 6 months of the due date.

- The election may be terminated because the estate fails to provide security (lien or bond) to the Service for tax due, if the Service has determined that security is necessary. The Service may make this determination at the time of the estate’s IRC section 6166 election or it may make the determination at some point during the IRC section 6166 installment agreement. Most likely this will happen when the estate has failed to pay after requesting an extension of an annual installment payment or when the Service determines that the underlying business may be in financial difficulty.

(2) When accelerated, the estate will be sent a series of letters from the Advisory Estate Tax Lien group and the Campus concerning termination and demand for the tax due. Advisory procedures are explained in IRM 5.5.8.5, *Special Lien Under IRC § 6324A for Estate Tax Deferred under IRC Section 6166*, and Campus procedures in IRM 4.25.2.1.16, *Miscellaneous IRC Section 6166 Campus Termination Issues*.

(3) Copies of termination letters provide a payoff of the full amount of tax due to a specified date. This payoff can be used for collection purposes until the estate provides a date it will pay the account in full. Since the account was in Status 14, the campus will need to provide a payoff when necessary. Advisory should also have copies of termination letters in their case files and copies of liens, bonds or financial information secured from the estate.

(4) Once an account has been accelerated, it cannot be reinstated for reasonable cause. An account can be reinstated only if a valid extension of time to pay (under IRC section 6161) has been filed for the amount in question prior to the due date or the account was erroneously accelerated due to a processing error. A processing error is one in which a timely payment was treated as late or posted to the wrong account or type of tax. These errors should be rare and an account should be reinstated only if it meets these guidelines. Neither Examination nor Collection has the authority to request reinstatement of an account other than in the above circumstances.

IRM 5.5.6.5, “Tax Court Cases,” explains”:

(1) A balance due account may be assigned to the field while the estate is appealing allowance of the IRC section 6166 election. IRC section 7479 does not prevent collection of the tax while the taxpayer is appealing the Secretary’s determination regarding the estate’s section 6166 election to the Tax Court.

(2) Section 7421(a) generally prevents any court from stopping collection unless one of the exceptions applies. An exception applies if the taxpayer has not yet been given an opportunity for hearing under section 6330, or if the taxpayer has timely requested a hearing. Except in cases of jeopardy, levy is prohibited until the taxpayer is issued a notice giving the taxpayer a right to a hearing to contest levy and the taxpayer fails to make a timely hearing request. Levy is also prohibited during a timely requested hearing and judicial review of the determination resulting from that hearing. During the administrative hearing or court proceeding, the Tax Court may permit levy under section 6330(e)(2) if liability is not at issue and the Service shows good cause. Good cause exists when the Service shows that the taxpayer is maintaining the hearing or proceeding for purposes of delay, the taxpayer is raising frivolous arguments, or the government will be harmed by the suspension. In this regard, special attention should be given to whether the levy suspension will harm the government’s ability to enforce its Section 6324 lien rights before they expire.

(3) Section 7485 allows for collection of an amount determined as a deficiency while a Tax Court decision is being appealed to the Circuit Court unless the taxpayer posts a bond.

(4) Should you receive an account to collect estate taxes and the IRC 6166 election is either in Appeals or Tax Court for reconsideration, consult with the Counsel attorney assigned the case to determine if collection can proceed or should be withheld.

(5) Counsel should consider whether the underlying tax amount is in dispute, how much time remains on the IRC section 6324(a) lien and collection potential on remaining estate assets when providing guidance concerning continuation of collection.

IRM 5.5.6.6, "Special Liens and Bonds for IRC 6166," explains:

(1) The laws granting the estate tax installment election provide the Service certain options to secure eventual payment. These options include:

a. Requiring the estate to furnish a performance bond in an amount equal to the estate tax and interest being deferred. Bonds must be renewed annually and documentation provided to the Service verifying renewal.

b. Allowing the estate to substitute the bond with the filing of a special lien under IRC section 6324A (Form 668-J) pledging their right, title, and interest to specific property to the government.

(2) The Advisory Estate Tax Lien group is responsible for making determinations concerning securing special election liens or bonds to protect the Governments interest during the extended deferral period. See IRM 5.5.8.5.1, *Advisory Bond/Lien Determinations for Estate Tax Deferred under IRC Section 6166*.

(3) For IRC section 6166 elections, the Form 668-J *Notice of Federal Estate Tax Lien Under Internal Revenue Laws*, is secured and recorded by Advisory. The Form 13925, IRC Section 6324A Lien Agreement Form, reflects specific property that is pledged as collateral, the value, encumbrances and parties who consented to the lien. This lien is not recorded on the Automated Lien System (ALS) since the CSED is extended beyond the normal 10-year expiration date. A TC 582 may be on the account to reflect a lien has been recorded. You may find information in the ICS case history of Advisory actions.

LIEN	**ATTACHES**	**DURATION**
Section 6324A for Section 6166 extended payout cases.	Specific property described in the lien agreement (Forms 13925 or on 668-J)	Coincides with CSED. Must be recorded.

(4) There will not be a IRC section 6324A lien in every case where the Service has agreed to a IRC section 6166 installment election. The Service will make a determination after the election whether it will need security based on the facts and circumstances of each case. The Service may require the estate to secure a bond. The estate may elect the IRC section 6324A lien in lieu of securing a bond.

(5) The IRC 6324A lien is a consensual lien. Therefore, the estate does not have CDP rights. A bond may be substituted for the lien. See IRM 5.5.8.5.1, *Advisory Bond/Lien Determinations for Estate Tax Deferred under IRC Section 6166*.

(6) When the election has been terminated and the tax accelerated, collection action may be taken on the asset pledged on this lien agreement. Advisory can provide copies of their lien case files to assist with collection of the tax due. Advisory will also provide the lien release when necessary. To determine the duration of the lien, the CSED is extended for the period of time that the tax was deferred, including any extensions to pay that may have been granted.

(7) If the property described on Form 668-J is insufficient to pay the estate tax in full, then any other property that remains attached by the IRC section 6324(a) lien (including the like lien) and/ or the IRC section 6321 liens are subject to enforcement action. Distributees of the estate property also may he held liable as transferees.

See F.A.A. 20070801F regarding how the IRS expects this security interest to be established with respect to a partnership or LLC interest. Also note that a protective election does not toll the statute of limitations under Code § 6502 if the taxpayer does not finalize the Code § 6166 election on audit; see fn. 7112.

IRM 5.5.6.7, "Collection Statute Expiration Date," explains:

(1) **Always** check the Collection Statute Expiration Date (CSED) when working estate tax accounts. IDRS does not accurately reflect the CSED when multiple assessments are involved or when an IRC section 6166 election has been granted.

(2) For accounts with an approved IRC section 6166 election, the CSED is suspended for the period during which payment of the tax is deferred, see IRC section 6503(d). **However, running of the IRC section 6324(a) estate tax lien is not suspended.**

(3) Generally the additional time to add to the CSED is the period of time between the input of the TC 488 and the TC 489. If there is no TC 488 on the account use the date the status 14 was input, found in the TXMOD history.

(4) If an extension to pay under IRC section 6161 was granted for the annual installment due under IRC section 6166, the extended time for payment would also be calculated into the CSED.

(5) It is possible to have multiple CSEDs if a TC 300 was assessed and a portion or all of the deficiency was deferred under IRC section 6166. If it was deferred add in the time payment was deferred - which will be different for the TC 150 and the TC 300. Determine if the payments received paid off the TC 150 (deferred) amount - in that case you would only have to deal with the CSED on the TC 300.

(6) Any tax due that was not deferred under IRC section 6166 will have a different CSED date. The Form 4349, Computation of Estate Tax Due With Return and Annual Installment, will show what tax was deferred under IRC section 6166. The E&G Campus unit may have this information on its database or the form may be with the tax return.

Note: In some instances the deferred amount may change due to an Appeals or Tax Court decision. The E&G Campus unit should have the most current information on the deferred amount since they prepare the annual installment billings.

(7) TC 520's input as a result of CDPs or OICs filed can extend CSEDs. The following transaction Codes for judgment/litigation also impact CSEDs:

- TC 520 with closing code 70 through 75 does not suspend the CSED.
- TC 520 with closing code 76 through 81 and closing code 84 suspends the CSED

See IRM 5.1.19, *Collection Statute Expiration*, for additional information.

(8) Once you determine the correct CSED, document your ICS history with the new CSED and how you arrived at the date. Be sure that the module is also updated on ICS.

IRM 5.5.6.8, "Payoffs," explains:

(1) Payoffs for IRC section 6166 accounts will need to be secured from the Campus E&G unit. Once an account goes into status 14 you can no longer get a payoff through IDRS. If IDRS reflects manual assessments of penalty and interest, accrued penalties and interest need to be computed. For campus contacts see: http://mysbse.web.irs.gov/Collection/toolsprocesses/EstateTax/EstateTax/default.aspx

(2) After an IRC section 6166 account is accelerated the Campus closes their case file. Partial information regarding these accounts are maintained on their database. The Campus may need to secure additional information from the collection case file or order their closed file in order to provide a payoff.

(3) Copies of termination letters issued by the Campus provide a payoff of the full amount of tax due to a specified date. This payoff can be used for collection purposes until the estate provides a date it will pay the account in full. Advisory should also have copies of termination letters in their case files and copies of liens, bonds or financial information secured from the estate.

(4) Once the status 14 is input, FTP and interest need to be calculated and manually input. The last TC 340 on the account will reflect to what date the interest has been updated. When a collection account assigned to the field is paid in full the revenue officer is required to request input of the penalties and interest to the date of payment to prevent refunds.

(5) The manual assessment can be requested on Form 3244 when posting funds received or if the funds have posted request the assessment on Form 4844.

(6) Submit a Form 4844, *Request for Terminal Action*, to the CCP Fort to request assessment of accruals once the balance due is paid. If there is a TC 421 beginning with a DLN 17 on the account, send your request to the Cincinnati CCP Unit at *SBSE CCP Exam Cincinnati. If the return has not been examined, send your request to CCP Fort in Philadelphia.

(7) Do not abate penalties or interest assessments made by the Campus in accordance with their IRM provisions - unless you verify there was a Service error.

IRM 5.5.6.8.1, "Interrelated Payoff Computation," explains:

(1) When computing payoffs on estate tax accounts, be aware that the estate may qualify for an interrelated payoff computation.

(2) When Form 706 is filed, deductions against the gross estate have been claimed for the expenses incurred in administering the estate. After the return has been filed, additional expenses may be incurred for which the estate can claim a deduction by filing an amended return. Such expenses include attorney fees, accounting fees, interest due on state estate tax liabilities unpaid at the time returns are filed, and state death tax credits that have been paid in installments. Allowable expenses are explained in IRC section 2053.

(3) Any additional deductions, including interest as a debt, must be requested in writing by the estate or by submitting a supplemental return. On a balance due account, interest as a debt may be limited to only the interest that has been paid, instead of all interest that is due.

(4) If all or a portion of the estate tax has been deferred under IRC section 6166, the estate may request a recomputation of the tax due based on allowed additional expenses. The supplemental return with documented expenses must be provided to the E&G 6166 unit at the Campus in order to do the interrelated computation with special software and provide a payoff.

(5) Tax decreases on amended and/or interrelated computations, will not be input without the taxpayer's agreement and/or payment in full per the new computation.

(6) Until a determination on a supplemental return is made by the Campus, the tax is still due.

IRM 5.5.6.9, "Working A Terminated IRC 6166 Account," explains:

(1) When conducting your initial analysis of the account check TXMOD for the following:

- check the last TC 340, interest was assessed to this date only
- is there a TC 582 lien indicator or a TC 360 for a lien fee? (is it an IRC section 6321 lien or IRC section 6324A lien – you may see "special lien" indicated. Check ICS history, archive history, or with Advisory for previous action on the account.
- How much time, if any, remains on the IRC section 6324 (a) lien? During the time the taxes were in status 14 the 10-year estate tax lien continued to run.
- check for TC 468, status 14 input and TC 488/489, compute the CSED and document the CSED date in your ICS history

- check for transaction codes and TXMOD/ENMOD history for appeals, penalty abatement requests, amended returns, etc. (educate yourself on what happened with this account before it came to you – it will help you make future decisions)

(2) Secure copies of the following documents:

- letters from Campus/Advisory terminating the election (Letter 950-H or I, Letter 6335-F for balance due amounts – see IRM 5.5.8.5, IRM 4.25.2.1.15 and 4.25.2.1.16 concerning IRC 6166 procedures)

- any related appeals or Tax Court decision or settlement (is it pending or resolved?)

- liens filed by Advisory to determine what property was pledged as collateral on deferred tax due (Form 668-J and Form 13925) and any correspondence pertinent to collection of the tax due

- copy of any bond secured by Advisory

(3) As part of your collection investigation:

- Research the status of the business – is it sold, bankrupt, expanding and funds went elsewhere? Investing funds hoping for big payback later? Do an internet search for information on the business. The estate had a large interest in a closely held business to qualify for this election.

- Determine if the business was sold – if so did IRS receive any of the sale proceeds? If not where are the sale proceeds? (if more than fifty percent of the closely held business was sold the election is terminated)

- Find out where funds used to make installments payments were coming from? (may provide a potential levy source)

- Contact Advisory, their case file may have financial information on the business and/or estate assets used for lien collateral evaluation. Secure and review this information for collection potential.

- Secure the 706 return. Campus and/or Advisory may be able to provide partial copies of the 706 return, until you receive the entire tax return for review.

- Determine if the executor or other fiduciary received a discharge of liability under IRC section 2204. The application for discharge and the letter granting it, should be attached to the Form 706.

(4) If a special lien was secured:

- collateral listed on 668-J lien and/or Form 13925 will provide legal description of property pledged as collateral for tax due – this is the asset to pursue for collection of tax due;

- determine the current status of property pledged as collateral;

- make demand for payment, the amount in the Letter 6335-F may be used until the estate requests a payoff, send pre-levy notice if there is seizure potential.

(5) If a special lien was not secured:

- Was a section 6165 bond provided?
- What is date of death – did the IRC section 6324(a) lien expire?
- Was an IRC section 6321 lien recorded? What does it attach to?
- What estate assets remain to collect from?
- If property was sold, was a discharge of the property from any liens recorded?
- Contact executor and/or responsible parties to pay installment payments, demand payment, determine what remains to collect from
- Consider transferee against those who received estate assets or fiduciary liability against those that were liable to pay installments (see 6166 election information in the 706 return or to whom letters were sent from the Campus for annual installments)

(6) After conducting your fact finding, contact the estate representative and determine how the estate will pay the tax due.

IRM 5.5.8.5 and its subparts were last revised December 16, 2022, based on my review on April 3, 2023.

IRM 5.5.8.5, "Collateral from Estates with IRC 6166 Elections," explains:

(1) The IRC 6166 election allows an extension of time to pay estate tax that is attributable to an interest in a closely held business. To qualify, at least 35% of the assets in the gross estate must consist of an interest in a closely held business or businesses. Estate and Gift (E&G) examiners make determinations if estates qualify for this special election. With this election, most estates will make four annual payments of interest only then they will make ten annual payments of principle and interest. In these cases, the first annual payment is due a year after the due date of the return. Subsequent payments are due each year thereafter until the account is paid in full. Estates can also elect to pay the deferred tax in a shorter period. An estate with an IRC 6166 election may qualify for a reduced interest rate under IRC 6601(j).

(2) Some estates, such as estates in which the IRC 6166 qualifying asset is an interest in a holding company, may only qualify to pay their tax for a shorter period. For these estates, they must begin paying their annual installments on the principle, plus interest, immediately. They do not get the additional four years to make only interest payments.

(3) For the tax that is reported on Form 706, the IRC 6166 election must be made with a timely filed estate tax return. Late filing of the return invalidates the election. If the tax

that qualifies for the IRC 6166 election is the result of an examination deficiency, the estate must make the IRC 6166 election within 60 days after issuance of notice and demand for the additional tax.

(4) The portion of the tax that is owed due to the examination deficiency will be prorated (subject to the limitations of section 6166(a)(2)) as if the election had been made with a timely filed return. The estate must pay the past due installments, and they must pay future annual installments in order to keep the IRC 6166 election.

(5) When an estate has an IRC 6166 election, Campus E&G puts the account into status 14 on Integrated Data Retrieval System (IDRS) which keeps the account out of collection status.

(6) Campus E&G monitors estates with IRC 6166 elections. They send annual bills to the estate along with a Certificate of Unchanged Status. The estate must sign the Certificate of Unchanged Status to annually certify if there has been a disposition of 50% or more of the IRC 6166 qualifying assets. Such a disposition would cause the IRC 6166 election to go into default. Campus E&G confirms that the annual IRC 6166 payments are made. If the estate doesn't make their payments, Campus E&G will send a series of bills which allow the estate at least six months to make the installment before the election goes into default. If the estate still does not pay, Campus E&G will terminate the IRC 6166 election, and the full tax liability will be immediately due.

(7) Under IRC 6503(d) the collection statute is suspended for the period during which payment of the tax is deferred under IRC 6166. However, running of the unrecorded IRC 6324(a) estate tax lien is not suspended. See IRM 5.5.8.3, General Estate Tax Lien under IRC 6324(a).

(8) When the examining office determines that an estate is eligible for the IRC 6166 extension of time to pay estate tax that is attributable to an interest in a closely held business, a case is referred to Advisory to contact the estate to request a surety bond or a consent to the creation and filing of a Notice of Federal Estate Tax Lien. The origin of the referral depends on which unit approved the IRC 6166 election or accepted the return as filed with the election:

- If the return was accepted as filed or surveyed before assignment to E&G Examination, the referral will come from Campus E&G. They will hold the original estate tax return for 90 days after their referral in case Advisory needs additional information from the return.

- If the return was examined or surveyed by E&G Examination, the referral will come from E&G Examination.

- If the final tax was determined by IRS Independent Office of Appeals or in Tax Court, the referral will come from Appeals Account and Processing Support (APS).

(9) The following items will be included with the referral:

a. Pages 1, 2, and 3 of Form 706 and schedules A, B, F, & G with any attachments, including other pertinent schedules listing assets or encumbrances.

b. Form 4349, Computation of Estate Tax Due With Return and Annual Installment.

c. Form 1273, Report of Estate Tax Examination Changes, and Form 6180, Line Adjustments - Estate Tax, if the estate tax return was examined.

d. The examiner's narrative report of examination changes (Form 886-A, Explanation of Items, or similar documentation) if the estate tax return was examined.

e. Form 2848, Power of Attorney and Declaration of Representative, if applicable.

f. IRC 6166 election and attachments to the election.

g. List of all the businesses that qualified the estate for the IRC 6166 election as shown on the estate tax return including the business name and employer identification number (EIN). This information may be provided separately or on the related estate tax return schedule where the business is listed.

(10) Advisory will open a Non-Field Other Investigation (NFOI) 195, 668J Lien (IRC 6166), on Integrated Collection System (ICS) when they receive a referral due to an IRC 6166 election.

(11) Advisory will contact the estate's executor or power of attorney within 60 days of receipt of the referral package to request the estate to voluntarily provide collateral during the IRC 6166 payment period. Collateral is requested to protect the government with an asset to collect on if the IRC 6166 election goes into default. The estate can provide a surety bond, or they can provide a consent to the creation and filing of an IRC 6324A lien by providing a signed Form 13925, Notice of Election and Agreement to Internal Revenue Code (IRC) 6324A Lien.

(12) In some cases, the estate may respond that no collateral should be required because the government is not at risk during the IRC 6166 payment period. If that occurs, or if the estate does not respond to Advisory's request for collateral, see *IRM 5.5.8.5.1*, Risk Reviews on Estates with IRC 6166 Elections, for procedures to follow.

(13) Key elements of the consent to the creation and filing of the IRC 6324A Notice of Federal Estate Tax Lien, include the following:

- To agree to the Notice of Federal Estate Tax Lien, the estate must provide Form 13925, Notice of Election and Agreement to Internal Revenue (IRC) 6324A Lien. The agreement must list the specific property that will be subject to the Notice of Federal Estate Tax Lien, and it must be signed by all individuals with an interest in the designated property.

- Any property may be listed on Form 13925 to consent to the filing of a Notice of Federal Estate Tax Lien. The property may, or may not, be part of the estate assets.

- Although real property is preferred, any property, either real or personal, with equity equal to the deferred taxes plus interest, that can be expected to survive the deferral period, may be designated in the agreement.

  Note: Even though the property offered by the estate as security for the Notice of Federal Estate Tax Lien may be, if necessary, difficult to enforce against (such as stock in a closely held corporation), distrainability is not a factor in determining the adequacy of the value of the property offered. If the requirements under IRC 6166(a)(1) as to the value of the property have been met, and the asset is expected to survive through the deferral period, whatever property the estate offers as security for the lien is acceptable.

- By signing Form 13925, the owners of the property agree to the filing of a lien on the property included in the lien agreement. Form 668-J, Notice of Federal Estate Tax Lien Under Internal Revenue Code Section 6324A, is then recorded listing the property from the lien agreement.

- Any property that is part of the decedent's gross estate that is part of the lien agreement and described on the recorded Notice of Federal Estate Tax Lien is no longer subject to the unrecorded IRC 6324(a)(1) estate tax lien.

- The lien agreement must include the contact information for a designated agent. That individual is responsible for notifying the IRS if there is any change to the property that qualified the estate for the IRC 6166 election or to the asset that is being used as collateral for the Form 668-J Notice of Federal Estate Tax Lien.

- Filing of the Notice of Federal Estate Tax Lien acts as a discharge of personal liability of the executor or fiduciary under IRC 2204 on the IRC 6166 qualifying tax. See 26 CFR 20.2204-3.

(14) If the estate provides a lien consent form other than Form 13925, Advisory will consult with Area Counsel for the state of the decedent's last domicile for approval of the alternate lien consent form. Area Counsel can also be consulted when unusual assets are pledged on Form 13925, such as art or collectibles.

(15) The IRS may file a Notice of Federal Estate Tax Lien Under Internal Revenue Code Section 6324A on shares of stock. If possible, the IRS should take possession of the certificates to protect the government's lien interest. See IRM 5.6.1, Collateral Agreement and Security Type Collateral, for guidance on collateral.

(16) The IRC 6324A Notice of Federal Estate Tax Lien is property specific. The property to which the Notice of Federal Estate Tax Lien attaches should be listed in detail on Form 668-J or as an attachment to Form 668-J.

(17) If the real or personal property subject to the Notice of Federal Estate Tax Lien is held by an entity other than the estate, then the entity name should be identified on the Notice of Federal Estate Tax Lien under the owner's name so that the lien is

properly indexed in the public records. The owner/entity's taxpayer identification number should not be included on the Notice of Federal Estate Tax Lien.

(18) Form 13925 must be signed by all individuals with an interest in the designated property (whether or not in possession) which will be described on the Notice of Federal Estate Tax Lien.

(19) If the asset is owned by a partnership, LLC, corporation, trust, etc., Advisory must request and review documents that confirm the names of the individuals that can pledge property and have authority to act on behalf of the entity to confirm all these individuals signed Form 13925. If the estate does not provide these documents, or the individuals with authority to pledge property do not sign Form 13925 agreeing to the filing of the Notice of Federal Estate Tax Lien, the IRS will not accept that asset as collateral.

(20) The IRS may file a Notice of Federal Estate Tax Lien that attaches to an interest in a corporation, partnership, limited liability company (LLC), or trust. However, caution should be exercised. The Notice of Federal Estate Tax Lien attaches to whatever rights the interest entails. If those rights do not include the right to sell the interest, the IRS will be unable to sell the interest. The IRS may be left with whatever rights to payment, distributions, or liquidation that the interest includes. On the other hand, if the interest includes the right to sell the interest, the IRS can also sell the interest (upon termination of the IRC 6166 election), if the interest is marketable. Oftentimes there are restrictions on the transfer of such interests. For example, a partnership agreement, LLC agreement, or state law may contain provisions as to the manner in which a decedent's interest is handled upon death, or there may be a restriction to encumber property owned by the partnership or LLC. General guidance on ownership of LLCs, operating agreements, documents that outline ownership, and authorities of LLC members is in IRM 5.1.21, Collecting from Limited Liability Companies.

(21) If the property to which the Notice of Federal Estate Tax Lien attaches is an interest in a corporation, partnership, LLC, or trust, etc., the recorded Notice of Federal Estate Tax Lien should include a description of the covered property as the interest in the entity, the nature of the interest, and the address of the entity.

(22) For state and territory filing locations, see IRM Exhibit 5.12.7-2, State and Territory Filing Location. Multiple Notices of Federal Estate tax Liens may need to be filed in different filing locations if there is more than one asset provided as collateral and those assets are in different locations. The location to file the Notice of Federal Estate Tax Lien is the one office within the state, as designated by the laws of such state, in which the property subject to the lien is situated. See IRC 6323(f):

- For personal property owned by a corporation, partnership, trust, etc., the property will be deemed to be the place at which the principal executive office of the entity that owns the assets is located. It is the place where the major management decisions are made. Do not confuse the principal executive office with the principal place of business. See IRM 5.12.7.10, Filing the Notice of Federal Tax Lien.

- For personal property that is an interest in a corporation, partnership, LLC, trust, etc., the filing location is deemed to be situated at the residence of each of the individuals that own the interest. If the estate has not yet distributed the property, then the location for filing the Notice of Federal Estate Tax Lien is the decedent's last address and the executor's residence.

(23) If the estate provides signed Form 13925 agreeing to the filing of a Notice of Federal Estate Tax Lien, Advisory must verify the value of the asset pledged as collateral and determine if there are any encumbrances on the property to confirm there is sufficient equity to cover the deferred tax and interest. Advisory may utilize sources such as appraisals, Accurint, UCC filings, public records, etc. to verify the asset value and encumbrances. Advisory may also request for the estate to provide verification of the value of an asset or verify encumbrance information (including title reports, owner and encumbrances reports, etc.). Advisory will document the ICS history with their analysis of equity in the collateral. See IRC 6324A(b)(2), Maximum value of required property.

(24) Once Advisory has determined that all required information has been provided to file Form 668-J, Notice of Federal Estate Tax Lien Under Internal Revenue Code Section 6324A, they will follow the procedures in IRM 5.5.8.5.4, Processing of Lien Form 668-J and Form 668-K, to file the lien.

(25) If the estate provides a completed Form 13925, Advisory will send a copy of the lien agreement to Campus E&G for association with their IRC 6166 file.

(26) If, at any time, the value of the property covered by the agreement becomes less than the IRC 6166 qualifying tax, plus interest, the IRS can require the addition of property to the agreement. Advisory will send Letter 4346, Additional Collateral. If the estate does not provide the additional collateral within 90 days, Advisory will notify Campus E&G to terminate the IRC 6166 election. See IRC 6324A(d)(5), Additional lien property required in certain cases.

(27) If the executor chooses to provide a bond as collateral, see IRM 5.6.1.3.1, Bonds, for information regarding bond requirements. If needed, Advisory may consult with Counsel to draft and review the bond agreement. Advisory will follow the procedures in IRM 5.6.1, Collateral Agreement and Security Type Collateral, to process the bond which will be held in the Advisory safe for safekeeping.

IRM 5.5.8.5.1, "Risk Reviews on Estates with IRC 6166 Elections," explains:

(1) If the estate declines to provide a bond or consent to a Notice of Federal Estate Tax Lien, or the estate does not respond to Advisory's request for collateral, Advisory will conduct a risk analysis to determine if the IRS should require collateral. Advisory will document the Integrated Collection System (ICS) history regarding the estate's refusal. If possible, Advisory will secure a written statement from the estate as to their reasons for refusing to provide collateral.

(2) When an IRC 6166 extension of time to pay estate tax that is attributable to an interest in a closely held business election is granted, the IRS can require an estate to provide a bond if the government is at risk during the deferral period. However, the estate can choose to provide a consent to the filing of an estate tax lien, in lieu of the

bond, by completing Form 13925 and providing the required information as described in IRM 5.5.8.5, Collateral from Estates with IRC 6166 Elections. Advisory will determine whether a bond should be required by an estate based on a review and analysis of applicable factors listed below and any other relevant facts and circumstances. This is not an exclusive list:

Factor	**Information to consider**	**Examples of Information to Review**
Duration and stability of the closely held business	Determine the likelihood of the success and survival of the closely held business through the deferral period. Consider the following: • Nature of the closely held business. • Assets in the closely held business. • Age of the business. • Relevant market factors that will impact the future success of the business. • Recent financial history. • Continuity and stability of the management of the business. • Determine whether the decedent owned a majority or minority interest in the business. If the decedent owned a minority interest, the financial information pertaining to the business may not be as relevant because the estate may not force distributions to pay the estate tax. In this case, consider if there are other assets in the estate and other income available to pay the estate tax.	• Appraisals, financial statements, and Securities and Exchange Commission (SEC) filings. • Information regarding any outstanding liens, judgments, and pending or anticipated lawsuits. • Other claims against the business. • The estate may use an affidavit or other document to provide this information.
Ability to timely pay the annual installments	This factor considers how the estate expects to be able to make the annual payments of tax and interest as due, and the objective likelihood of realizing that expectation. Facts relevant to this factor may include the following: • Nature of the significant assets and liabilities of the business. • Type of debts (subordinated, related party, guaranteed, payment terms).	• Assets that may be liquidated to pay the installments. • Income as shown on the business income tax return. Secure a copy of the return or review information from Integrated Data Retrieval System (IDRS).

Factor	Information to consider	Examples of Information to Review
	• The cash flow of the business (both historical and anticipated) to determine if funds will likely be available to pay future deferred tax installments. • Consider prior IRC 6161 extension of time to pay requests. If a request was made on an IRC 6166 installment, or if multiple requests were made on tax that was not deferred under IRC 6166, this may indicate an inability to pay. See IRM 5.5.5. Processing Estate and Gift Tax Extensions. • Advanced payments on the principle installments may indicate an ability to pay. • If the decedent had less than 100% interest in a business entity, only consider the decedent's percent interest when reviewing financial statements of the closely held business to determine the estate's ability to pay. For example, if the decedent had a 50% interest in a corporation, only consider 50% of the net income of the corporation.	• Income and expense statements of the closely held business and/or estate. • If the estate is holding a cash reserve to have funds available for future installments, review bank records, brokerage accounts, etc., to confirm this information.
Compliance history	Addresses the compliance history of the business and the estate with all federal tax payment and tax filing requirements to determine whether the business, its management, and the executor respect and comply with all tax requirements on a regular basis. The relevance of the closely held business's filing and payment compliance is proportional to the estate's ownership interest and control of the business.	Conduct a compliance check on Integrated Data Retrieval System (IDRS) for tax filing and payment compliance of the estate, related trusts, and closely held business entities.

(3) The following internal sources may provide sufficient information for Advisory to make a risk determination. If additional information is needed, Advisory can request

the estate to provide further information. The Advisor will document the ICS case history to address all items that were reviewed and the findings from the review:

Item to Review:	**Include:**
Documents from the lien referral package that was provided to Advisory	• Employer identification numbers of the closely held businesses to conduct a compliance check • Type of IRC 6166 qualifying closely held business and valuations to determine duration and stability of the closely held business • Any other sources of payment available to the estate that can be used to pay the annual installments • Any other documents in the case file that provide information on the duration/stability of the closely held business, ability to make annual installment payments, or compliance history
Prior case activity	• Prior Form 4768 requests for extension of time to pay estate tax to determine if additional time has previously been requested to pay the tax. More than one request may indicate the estate has had difficulty paying the tax in the past. Look for IDRS transaction codes 468 and review the prior Integrated Collection System (ICS) case history. • Prior lien discharge and subordination applications to determine remaining estate assets and to confirm there has not been a disposition of 50% or more of the IRC 6166 qualifying assets since that would cause the election to default. • Any other documentation in the history related to the duration and stability of the closely held business, the compliance history, and the estate's ability to timely pay the deferred tax payments.
IDRS to check estate's compliance history	Check the following for compliance with filing and/or payment requirements: • Annual IRC 6166 installment payments. • Estate tax that did not qualify for the IRC 6166 election. • Form 709 gift tax. • Any pre-death liabilities such as Form 1040, trust fund recovery penalty assessments, and sole-proprietorship business returns. • Form 1041 for income reported on an estate or trust, if applicable. If there are assets on Form 706, Schedule G, the estate may have assets held in a trust which may indicate a Form 1041 filing and paying requirement. • Any returns associated with the closely held business such as Form 1120, Form 1120S, Form 1065, Form 940, Form 941, or other returns.
Available public records	• Internet search of the closely held business for indications of stability or insolvency of the business • Secretary of State and UCC filings, if available online, to ensure the business is still active and for possible creditor information • Accurint which may have information on corporate filings, business search, asset information, court bankruptcy, civil court, official records, and sometimes credit information

Item to Review:	Include:
	• County public real estate or official records, if they are available online, for liens, judgements, litigation, assets, and/or claims against the estate or business

(4) If additional information is necessary, Advisory will send a request to the estate for any additional items needed to determine whether the government is at risk during the deferral period to make a risk determination. Information requested from the estate may include copies of tax returns, financial statements, list of assets and encumbrances, status of litigation, and any other information Advisory determines is needed to conduct a risk review. The estate may also submit any additional documentation they believe will support their position that collateral should not be required.

(5) Advisory will document the case file history with their findings to include the following:

a. A brief history outlining the taxpayer's response to the request for a bond or lien consent.

b. List factors and information considered in the risk analysis to determine if collateral should be required during the deferral period.

c. If collateral is required, Advisory will provide a detailed explanation regarding why a bond was required to protect the government's interest and the amount of the required bond. The explanation should address the factor or factors that Advisory relied upon when they determined that the government is at risk during the deferral period.

d. If collateral is not required, Advisory will provide a detailed explanation why the government is not at risk during the deferral period based on the risk factors of compliance, ability to pay the annual installments, and duration/stability of the closely held business with a summary of why no collateral should be required based on each of these factors.

(6) After Advisory has made their risk determination, Advisory will send Letter 4283, Notification Regarding Internal Revenue Code Section 6166 Security Requirement. The Advisory manager must sign Letter 4283. When preparing the letter, Advisory will select one of the optional paragraphs:

- Optional paragraph (1) will be selected to notify the estate that no bond is required. This paragraph also notifies the estate that the IRS may conduct a future review of financial information, and that a bond may still be required in the future, or

- Optional paragraph (2) to notify the estate that a bond is required after reviewing the information provided by the estate, or

- Optional paragraph (3) to notify the estate that a bond is required because the estate did not provide the information requested by Advisory to make a risk determination.

(7) If optional paragraph (1) is selected, Advisory will close the non-field other investigation (NFOI) 195, 668J Lien (IRC 6166), on ICS, and they will open a NFOI 196 Special No Lien case. Advisory will input an initial follow-up date for six years from the return due date to make an updated risk analysis. See *IRM 5.5.8.5.3*, Monitoring Accounts During the Deferral Period, for actions required to conduct periodic review of these cases.

(8) If optional paragraph (2) or (3) is selected, Advisory will include Form 13925, Notice of Election and Agreement to Internal Revenue Code (IRC) 6324A Lien, with Letter 4283. The estate has 30 days to respond when the IRS requires a bond. The estate can also provide a consent to an IRC 6324A lien in lieu of providing a bond. Advisory will input a follow-up date on ICS to monitor the case for a response to Letter 4283 and will maintain a copy of the letter in the case file.

(9) After the 30-day period on Letter 4283 expires, if the estate still refuses to provide a bond or lien consent, Advisory will prepare Letter 950-I, Preliminary Internal Revenue Code Section 6166 Determination Letter, which must be signed by the group manager. Letter 950-I notifies the estate of its right to appeal the determination that a bond is required. The letter will be sent by certified mail and a copy will be maintained in the case file along with a notation in the case history of the date the letter is sent. Advisory will schedule a follow-up date on ICS to monitor the case for a response to Letter 950-I. An appeal of the determination must be postmarked by the deadline on Letter 950-I for the appeal to be timely. If the deadline is on a Saturday, Sunday, or federal holiday, the deadline is the next following business day.

(10) If the estate does not appeal the preliminary determination within the 30-day appeal period, or if the estate sends an untimely post-marked protest, Advisory will provide a memorandum to Campus Estate and Gift (E&G), with a copy of Letter 950-I, requesting termination of the IRC 6166 election. Advisory will request that Campus E&G also send Letter 6335-F, Notice of IRC 6166 Denial or Termination, to the estate via certified mail, with return receipt requested, as a demand letter for payment. Letter 6335-F will include the current balance due as calculated by Campus E&G. Advisory will monitor the account for the termination of the IRC 6166 election. Once Advisory confirms the election has been terminated, they can close their NFOI 195, 668J Lien (IRC 6166), on ICS. The Advisory manager may notify a Field Collection revenue officer manager of the tax due to request revenue officer case assignment. While there is a balance due, Advisory will maintain a case file since the file may contain documents to assist the revenue officer with collection of the tax.

(11) If the estate submits an Appeal, Advisory will date stamp the protest and document in the case file history that the protest was received. If the protest contains new issues to consider in the risk analysis, Advisory will determine the validity of the new issues. If Advisory disagrees with the estate on the new issues, they will prepare a response to the protest to include the determination reached on the new issues. Advisory will send the response to the protest to the estate and will include it in the package to be transmitted to IRS Independent Office of Appeals (Appeals). Advisory

will forward the following items to Appeals within 30 days from the postmark date of the protest letter:

a. Letter 4283, Notification Regarding Internal Revenue Code Section 6166 Security Requirement

b. Documentation considered in analyzing whether the bond or lien was required

c. Letter 950-I, Preliminary Internal Revenue Code Section 6166 Determination Letter

d. Protest letter with any attachments

e. Advisory response to the protest letter if new issues were addressed

f. Case file history

g. Any pertinent correspondence with the taxpayer

h. Any documents considered in the risk analysis

(12) Advisory will send the appeal package with Form 3210, Document Transmittal, to Appeals. The location to route the package is located on the IRS Independent Office of Appeals Website. Advisory will notify E&G Campus by secure e-mail that a protest has been forwarded to Appeals so that Letter 6335-F is not sent prematurely.

(13) Advisory will input a 90-day follow-up. If no response is received, Advisory will check the status of the appeal on the Appeals Centralized Database System (ACDS). If there is no record on the system, Advisory may contact *AP Inquiries for information.

(14) IRS Independent Office of Appeals will send the case file with the Appeals Case Memorandum (ACM) to Advisory once a decision is final. If they allow the election to continue because they have determined the government is not at risk during the deferral period, Advisory will notify Campus E&G that Appeals has determined the estate is entitled to the election. Advisory will then close the NFOI 195, 668J Lien (IRC 6166), on ICS, and they will open a NFOI 196, Special No Lien Case.

(15) If Appeals determines that the election should be terminated because the government is at risk during the deferral period, and collateral wasn't provided, Advisory will notify Campus E&G to terminate the IRC 6166 election as described in (10) in this IRM section.

IRM 5.5.8.5.2, "Miscellaneous Documentation From Campus or Appeals" (07-24-2018), provides procedures when a scheduled payment is not made timely.

IRM 5.5.8.5.3, "Monitoring Accounts During The Deferral Period" (07-24-2018), explains (yellow highlights are mine):

(1) Informational documents received from the E&G Campus should be reviewed within 30 days of receipt. The advisor's evaluation of impact or harm to the Government's

interest should be documented in the ICS history. This documentation may dictate frequency of monitoring an account.

(2) Notice of late installment payments, preliminary IRC 6166 election terminations or extensions to pay on IRC 6166 installment payments (see IRM 5.5.5.5) should be considered as a factor in lien determination and monitoring. Accounts should be re-evaluated if any of the above actions occur.

(3) Encumbrances must be checked to determine adequacy of collateral. The advisor may use sources such as Accurint, Secretary of State, UCC filings, etc. to verify encumbrances.

(4) All IRC 6166 accounts will be re-evaluated six years into the deferral period. Schedule a follow up through the ICS system. Advisors will consider the factors described in *IRM 5.5.8.5.1* and should also look at subsequent actions below to determine if additional action should be taken to protect the Government's interest:

a. What assets have been distributed?

b. Has the estate distributed, sold, exchanged, or otherwise disposed of 50 percent or more of the value of the estate's interest in the closely held business?

c. What assets have been discharged or subordinated?

d. Has the estate made installment payments timely and in the full amount due?

e. Has the estate requested extensions to pay installments?

f. Has the estate defaulted on other financing?

g. Has the estate made additional payments toward the tax liability?

h. Does the closely held business appear to be financially stable and able to make future installment payments?

i. Is the estate in compliance with filing and paying requirements?

(5) Annual monitoring, considering the above factors should be conducted as the Service nears expiration of the IRC 6324(a) lien. Each year that Advisory conducts a review, the Advisor must document their analysis and recommendations to adequately protect the Government's interest. As the Service gets closer to expiration of the IRC 6324(a) lien, the advisor must consider securing a "replacement lien" (IRC 6324A lien or bond) to cover the additional deferral period and the amount of deferred tax due in order to protect the Government's interest.

(6) Advisory **must be aware** that if a determination is made that the government is at risk of not collecting the remaining tax due, appropriate action (for example, a bond or lien or enforced collection action) **must be taken and completed prior to expiration of the IRC 6324(a) lien.** Consideration must be given to allow time for the executor to exhaust any allowable appeals and potential litigation time if the estate petitions the Tax Court under IRC 7479. If the account is accelerated, this

process generally requires a minimum of six months to be completed. Timeframes of acceleration, appeals and litigation must be considered in order to complete collection actions prior to expiration of the IRC 6324(a) lien.

(7) If the advisor determines that a lien is required the advisor will send the executor Letter 4283. Follow procedures in *IRM 5.5.8.5.1*

(8) In consideration of accounts where the estate has been in compliance with timely payment of installments, as the Service gets closer to expiration of the IRC 6324(a) lien, the advisor must consider securing a “replacement lien” (IRC 6324A lien or bond) to cover the additional deferral period and the amount of deferred tax due in order to protect the Government’s interest.

(9) Advisory must ensure annually that the value of the collateral securing the lien is equal to the outstanding IRC 6166 balance on the account. In accordance with the Form 13925, the designated agent is required to send current valuation information annually with respect to the pledged property listed in the agreement. If the executor has provided an IRC 6324A lien, Advisory must review the annual valuation information report from the designated agent to confirm that the value of the collateral securing the lien is equal to the outstanding IRC 6166 balance on the account. If the financial information is not received from the designated agent, the Advisor may contact the designated agent to request that information.

(10) Advisory will use Letter 4345, Collateral Valuation, to request current valuation information with respect to property pledged on the lien agreement.

(11) Advisory will use Letter 4346, Additional Collateral, as notice and demand for additional collateral to secure the special lien.

Thus, starting 6 years into the deferral period and annually after that, the IRS considers the need for replacing the secret Code § 6324 lien with an express Code § 6324A lien.

Additional IRM guidance includes:

- IRM 5.5.8.5.4, “Processing of Lien Form 668-J and Form 668-K” (07-24-2018)
- IRM 5.5.8.5.5, “Requesting Payoffs for Lien Form 668-J” (07-24-2018)
- IRM 5.5.8.5.6, “Processing Requests for Release, Discharge of Property From, or Subordination of IRC 6324A Form 668-J” (03-01-2006)

When negotiating with the IRS, one might consider requesting a delay in recording a Code § 6324A tax lien until closer to when the 10-year period expires, if publicity is a concern. Sometimes, however, a recorded Code § 6324A lien is more favorable for the taxpayer - unlike the Code § 6324 lien, it is junior to post-mortem liens placed on property before the Code § 6324A lien.

Also, if imposing an IRS lien would impair the business' ability to earn the money necessary to pay the tax, the IRS must consider whether imposing the lien is penny-wise and pound-foolish.[7196]

III.B.5.e.iv.(i). Effect of Liens on Dealings with Third Parties

If ownership of a business is subjected to an IRS lien, the owners may violate loan covenants as guarantors of the business' line of credit or other borrowings. Furthermore, a trustee on whom the secret estate tax lien is imposed – generally for 10 years from the date of death – will need to disclose the liens when applying for credit (loans or loan guarantees). Some businesses require fidelity bonds (for example, a construction company), rely on a line of credit to finance inventory, or simply have long term loans from the purchase of buildings or equipment, and the acceleration of payment obligations or other loss of credit may ruin the business.

If a loan is being refinanced with a new lender and the lender's security interest arose before the decedent's death, so that it is senior to the IRS' automatic lien, consider having the original lender assign that senior security interest to maintain its priority over the estate tax lien.

Franchise agreements tend to restrict transfer of ownership and might look unfavorably upon liens.

Also, generally the IRS may force the sale of real property a debtor owns as a co-tenant, even if the co-tenant is innocent;[7197] if property is held as tenants by the entirety, the innocent party should consider whether she is entitled to more than half of the property.[7198] However, a court

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[7196] *Alessio Azzari, Inc. v. Commissioner*, 136 T.C. 178 (2011) (Code §§ 6159, 6320, 6323, and 6325).

[7197] *U.S. v. Adent*, 821 F.3d 911 (7th Cir. 2016), in allowing such a sale, held:

> The United States Supreme Court addressed the issue of an innocent third-party interest in the context of a forced sale in *United States v. Rodgers*, 461 U.S. 677 (1983). There, the Supreme Court found that the plain language of § 7403 contemplates the sale of the entire property, including innocent third-party interests in that property, and that the Supremacy Clause precludes protection of innocent third-party interests via state law. *Id.* At 693–94, 703–04. Further, § 7403 protects an innocent third party's interest by providing for distribution of the proceeds from the court-ordered sale to the innocent third party to compensate them for their interest. *Id….*
> Additionally, the Supreme Court provided a non-exhaustive list of four factors to consider when an innocent third party has an interest in the property to be sold, recognizing that financial compensation may not always be a completely adequate substitute for a roof over one's head. *Id.* at 704. These factors include: (1) the prejudice to the government's interest as the result of a partial, rather than a total, sale; (2) whether the third party with a non-liable separate interest in the property would, in the normal course of events ... have a legally recognized expectation that that separate property would not be subject to forced sale by the delinquent taxpayer or his or her creditors; (3) the prejudice to the third party as the result of a total sale; and (4) the relative character and value of the non-liable and liable interests held in the property. *Id.* at 710–11….
> The other *Rodgers* factors also weigh in favor of the government. Derek, the non-delinquent co-owner of Parcel B, has no legally recognized expectation that his interest would not be subject to a forced sale due to Leonard's delinquency. Also, the prejudice to Derek as the result of a sale is minimal; Derek does not reside in Parcel B, so dislocation is not a consideration. After the sale, Derek will be compensated for his half interest. Further, Derek may bid on Parcel B at the foreclosure auction, either to gain the property outright or to attempt to increase the final sale price. Finally, the relative character and value of the non-liable and liable interests does not weigh in any party's favor. The non-liable interest of Derek is equal to the liable interest of Leonard.

[7198] See article on procedures developed in light of *Craft*, cited in part III.B.3.c.iv Imposition of the Estate Tax Lien.

may consider imposing a rent obligation rather than requiring a sale.[7199] Ideally, the parties would present evidence whether the property can be partitioned without reducing the value of the government's proceeds – rather than selling the whole thing and paying the government its share; however, a lack of that showing is neutral, and other factors may prevail.[7200]

As described above, the estate tax lien is imposed automatically as of the owner's death on the assets that the owner holds. One might consider placing the assets in a holding company so that the lien will be imposed on the holding company rather than the business assets. On the other hand, using a holding company may reduce or eliminate the estate's ability to obtain an automatic deferral of estate tax under Code § 6166.[7201]

When the IRS seeks to obtain an express lien under Code § 6324A to secure Code § 6166 payments, the estate can select the security to be provided.[7202] When doing so, the estate might consider which property causes the least disruption with existing lenders or others with whom one does business and also reduces the cost of keeping the IRS updated.

III.B.5.e.iv.(j). Wrongful Levy

If a levy has been made on property or property has been sold pursuant to a levy, any person (other than the person against whom is assessed the tax out of which such levy arose) who claims an interest in or lien on such property and that such property was wrongfully levied upon may bring a civil action against the U.S. in a federal district court.[7203] This action may be brought without regard to whether such property has been surrendered to or sold by the IRS.[7204] If the IRS sold the property, a junior lienholder may sue the U.S. to receiver any surplus sale proceeds.[7205]

Oxford Capital Corp. v. U.S., 211 F.3d 280 (5th Cir. 2000), held:

> The elements of a wrongful levy action under section 7426 are well settled - to establish a wrongful levy claim a plaintiff must show (1) that the IRS filed a levy with respect to a taxpayer's liability against property held by the non-taxpayer plaintiff, (2) the plaintiff had an interest in that property superior to that of the IRS and (3) the levy was wrongful. See *Texas Commerce Bank-Fort Worth v. United States*, 896 F.2d 152, 156 (5th Cir. 1990). To prove that a levy is wrongful, (1) a plaintiff must first show some interest in the property to establish standing, (2) the burden then shifts to the IRS to prove a nexus between the property and the taxpayer, and (3) the burden then shifts back to the plaintiff to prove the levy was wrongful, *e.g.*, that the property in fact did not belong to the taxpayer. See *Century Hotels v. United States*, 952 F.2d 107, 109 (5th Cir. 1992).
>
> The Fifth Circuit, joined by the majority of the other circuits addressing the issue, has held that the IRS must prove a nexus between the property levied upon and the taxpayer by substantial evidence while a minority of circuits have required only proof by a

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[7199] *U.S. v. Cardaci*, 119 A.F.T.R.2d 2017-1735 (3rd Cir. 5/08/2017).
[7200] *U.S. v. Dase*, 125 A.F.T.R. 2d 2020-1079 (D. Alabama 2/27/2020) (approving sale where debtor resided in the property but co-tenant did not).
[7201] See Code § 6166(b)(8), (9) and part III.B.5.e.ii Code § 6166 Deferral.
[7202] For the taxpayer's choices, see part III.B.3.c.iv Liens: Selected Internal Revenue Manual Materials.
[7203] Code § 7426(a)(1). See Langstraat, Coyne, and Palmer, Third parties' right to sue on erroneous levies, 125 *Journal of Taxation* 30 (July 2016).
[7204] Code § 7426(a)(1).
[7205] Code § 7426(a)(2).

preponderance of the evidence. See, *e.g.*, *LiButti v. United States*, 107 F.3d 110, 118 (2nd Cir. 1997) ("If the government satisfied that substantial evidence burden, meaning that the evidence was "considerably more than a preponderance but less than clear and convincing proof" the plaintiff would have the "ultimate burden" to prove that the levy was wrongful.") (citing *Century Hotels*, 952 F.2d at 109). The policy behind requiring such a heightened standard of proof is that the government has unique access to the information it used as a basis for its levy and, after an opportunity to fully develop the factual record, fairness mandates that the government come forward with substantial evidence of the connection between the property levied upon and the taxpayer. See *Valley Finance, Inc. v. United States*, 629 F.2d 162, 171 n. 19 (D.C. Cir. 1980) ("Considerations of fairness impel us to conclude that once the factual record has been fully developed over time...the government must establish its asserted nexus between taxpayer and a third party by substantial evidence."); *Flores v. United States*, 551 F.2d 1169, 1175-76 (9th Cir. 1977) ("Principles of fair play and common sense dictate the result which we reach.").

If a person whose account was levied for the debt of another person seeks a Taxpayer Assistance Order through the Taxpayer Advocate Service, that process tolls the statute of limitations for suing the IRS (5th Cir. divided panel).[7206]

U.S. v. Firestone, 131 A.F.T.R.2d 2023-1983 (D. WA 6/12/2023) explains:

The Federal Debt Collection Procedures Act ("FDCPA"), 28 U.S.C. §§ 3001–3308, establishes standards and procedures for the collection of debt owed to the United States. One available post-judgment remedy under FDCPA is a writ of execution: "All property in which the judgment debtor has a substantial nonexempt interest shall be subject to levy pursuant to a writ of execution." 28 U.S.C. § 3203(a); see Fed. R. Civ. P. 69(a)(1) ("A money judgment is enforced by a writ of execution, unless the court directs otherwise.").

Under FDCPA, "property" is broadly defined: "any present or future interest, whether legal or equitable, in real, personal (including choses in action), or mixed property, tangible or intangible, vested or contingent, wherever located and however held (including community property and property held in trust (including spendthrift and pension trusts))," with narrowly defined exceptions. 28 U.S.C. § 3002(12); see *United States v. Nat'l Bank of Com.*, 472 U.S. 713, 720 (1985) (observing that broad property language in statutes governing tax liens "reveals on its face that Congress meant to reach every interest in property that a taxpayer might have"); *United States v. Bourseau*, No. C03-0907, 2009 WL 1072036, at *2 (S.D. Cal. Aug. 20, 2009) ("The sheer breadth of the definition reflects an effort to encompass any substantial interest a debtor has that might satisfy the judgment owed to the United States."). A debtor may claim statutory exemptions for their property. See 28 U.S.C. §§ 3202(d)(1), 3014.

U.S. v. Firestone, 131 A.F.T.R.2d 2023-1983 (D. WA 6/12/2023) explains:

… "The FDCPA provides no time limit for the collection of debts by writ of execution." *United States v. Gianelli*, 543 F.3d 1178, 1183 (9th Cir. 2008) (holding that FDCPA preempts California state law precluding enforcement of a restitution judgment after 10 years); see also *United States v. Pierce*, 231 B.R. 890, 893 (E.D.N.C. 1998) ("[T]his

[7206] *Rothkamm v. U.S.*, 802 F.3d 699 (5th Cir. 2015).

> silence cannot be construed as unintentional, but rather as the intention for execution procedures to track the indefinite life of a judgment in favor of the [Government].”). Therefore, the instant matter is not barred by a statute of limitations.

III.B.5.e.iv.(k). Effect on Trust of Federal Tax Lien Against Beneficiary

A federal tax lien against a beneficiary on the beneficiary’s interest in the trust might very well disrupt trust administration in a big way, which a law review article explains.[7207] *Duckett v. Enomoto*, 117 A.F.T.R.2d 2016-1358 (D. AZ 2016), held that a federal tax lien attached to the following beneficial interest:

> The Trustee shall pay to DENNIS MASAKI ENOMOTO so much or all of the net income and principal of the trust as in the sole discretion of the Trustee may be required for support in the beneficiary’s accustomed manner of living, for medical, dental, hospital, and nursing expenses, or for reasonable expenses of education, including study at college and graduate levels. Any income not so paid shall be accumulated and added to the principal of such trust at the end of the trust’s tax year. In the Trustee’s sole discretion and to the extent the Trustee deems advisable, the Trustee may consider or disregard the funds available to the beneficiary from other sources or the duty of anyone to support the beneficiary. Should the principal of the trust drop below $10,000, the Trustee shall distribute the balance of the principal, together with the undistributed income therefrom to DENNIS MASAKI ENOMOTO.

The case considered various possible beneficial interests. Footnote 1 suggested:

> For a more thorough discussion of beneficiary rights in trust assets for purposes of the federal tax lien, see 4 William D. Elliott, *Federal Tax Collections, Liens & Levies* ¶ 9.09[3][j] (2016 update) and sources cited therein.

Determining his bundle of rights:

> Trusts of this nature—directing payment under a general standard while leaving specific calculations to the trustee—are sometimes referred to as discretionary support trusts or hybrid trusts. *See* Evelyn Ginsberg Abravanel, *Discretionary Support Trusts*, 68 Iowa L. Rev. 273, 277-80 (1983). As with traditional support trusts, the trustee must pay Dr. Enomoto in accordance with an ascertainable standard. But as with traditional discretionary trusts, the trustee’s determination of exactly how much payment is required is reviewable only for abuse of discretion. The result is essentially a traditional support trust, but with deferential judicial review. That is, a trustee applying the payment standard in Ms. Enomoto’s testamentary trust has more leeway than a trustee applying the equivalent standard in a traditional support trust. *See id.* at 290. Thus, Dr. Enomoto’s right to the trust funds is a *right to payments the withholding of which would constitute an abuse of discretion in applying an ascertainable standard*.

[7207] Camp, Protecting Trust Assets from the Federal Tax Lien, *Estate Planning & Community Property Law Journal*, Vol. 1, p. 295, 2009, Texas Tech Law School Research Paper No. 2010-09, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1424666&http://www.actec.org/private/committees/ShowMinutes.asp?MinID=748.

Although state laws might indicate that an interest in a trust is not a property interest because they want to avoid creditor attachment, this court reasoned:

> The question whether a state-law right constitutes 'property' or 'rights to property' is a matter of federal law. *United States v. Nat'l Bank of Commerce*, 472 U.S. 713, 727 (1985). The statute itself provides little guidance on the matter. It merely imposes a lien on all property and rights to property, whether real or personal, belonging to the delinquent taxpayer. 26 U.S.C. § 6321. It does not define the terms property or rights to property….
>
> The Supreme Court has provided some limited direction. In determining whether a federal taxpayer's state-law rights constitute 'property' or 'rights to property,' '[t]he important consideration is the breadth of the control the [taxpayer] could exercise over the property.' *Drye v. United States*, 528 U.S. 49, 61 (1999) (quoting *Morgan v. Com'r of Internal Revenue*, 309 U.S. 78, 83 (1940)) (alterations in original).

The court held:

> … although Dr. Enomoto is the trust's sole beneficiary, the parties have not adequately briefed the trust consequences of his death[4] and the trust does not permit him to unilaterally terminate the trust and retain all assets. Therefore it is less clear whether Dr. Enomoto's right extends to all the trust funds.
>
> [4] The only relevant assertion from either party is a sentence in Dr. Enomoto's Reply brief: Pursuant to A.R.S. § 14-2604(A), at Dr. Enomoto's decease, the remaining Trust assets would pour back into the residuary under the Will, to be distributed to the other two beneficiaries (Dr. Enomoto's sisters). (Doc. 74 at 4.) The sentence is not followed by any citation to authority.
>
> For this reason, the IRS' summary judgment motion will be (1) granted to the extent it seeks a judgment that the federal tax lien attaches to Dr. Enomoto's right to the trust funds but (2) denied without prejudice to the extent it seeks a transfer of those funds to the United States. More evidence would be necessary to justify the latter conclusion. *See Taylor*, 254 F.Supp. At 758 (allowing additional hearings or proceedings to effectuate foreclosure of federal tax lien); *accord Magavern*, 415 F.Supp. at 221 (holding federal tax levy valid but stating determination of the actual amount of trust income and/or principal reached by the levy must await trial).
>
> Admittedly, this outcome is somewhat unsatisfactory. Both parties have advanced simpler, more practicable positions: the IRS says it is entitled to all the trust funds, and Dr. Enomoto says it is not entitled to any. But both of these positions oversimplify the facts and the law. In reality, Dr. Enomoto's right to the trust funds gives him enough control to trigger tax lien attachment, but it is too circumstance-dependent to allow enforcement of the lien as to any specific amount on the current record.

The IRS asked the court to amend its judgment in light of the court's comments about the consequences of death not having been adequately briefed, but in an order dated June 6, 2016 (docket no. CV-14-01771-PHX-NVW), the court rejected the request, saying, The mention of inadequate briefing was not an invitation for more briefing, any more than a D on a student's report card is an invitation for extra-credit work. However, the court appeared receptive to additional enforcement action:

> On the last page of its reply in support of its present motion, the IRS refers to evidence of Dr. Enomoto's current needs and living demands. (Doc. 100 at 11.) This is a step in the right direction. As the Court noted in its judgment, the IRS's lien is enforceable as to the amount to which [Dr.] Enomoto's right extends, i.e., the amount the trustee's withholding of which would be an abuse of discretion in applying the trust's standard of payment. (Doc. 96 at 1.) Evidence of Dr. Enomoto's overall financial situation is the sort of evidence that might show that the trustee's withholding of payment would be an abuse of discretion. Such evidence might support a separate motion to order one or more distributions to the United States. (*Id.* at 2.) That motion would be a motion to enforce the judgment, not a motion to alter or amend the judgment.

The Arizona statute stated that a creditor may not compel distribution that is subject to a trustee's discretion but does not state that a beneficial interest does not constitute an interest in property or an enforceable right. Whether a federal court would respect the latter declaration or would disregard it and look to the beneficiary's rights was not discussed.

In an earlier iteration of the case, 116 A.F.T.R.2d 2015-6788, the IRS asked the court to attach funds in an estate before the estate had distributed them to the testamentary trust in which the debtor had an interest. The court refused, because the testamentary trust had not yet been funded (emphasis in the original):

> The IRS summary judgment motion does not fully appreciate the fact that the funds are not yet held in trust. Instead, the IRS claims this case is on point with *United States v. Delano*, 182 F.Supp.2d 1020, 1023 (D. Colo. 2001). (Doc. 48 at 11.) But the issue in *Delano* was whether a testamentary trust beneficiary's interest in the trust constituted property for federal tax purposes. 182 F.Supp.2d at 1021. Here, the issue is whether a testamentary trust beneficiary's interest in funds *designated to the trust but held by the personal representative* constitutes property for federal tax purposes. Whatever Dr. Enomoto's interest in the Trust, it does not extend to funds outside the Trust.

Delano, also found at 88 A.F.T.R.2d 2001-7071, found an interest in a discretionary trust:

> The court rejects the argument that the sole and absolute discretion given the Co-Trustees permits discretion to make no payments. See Co Trustees' Mot. At 5. In this trust instrument, the word shall directly precedes the word pay while the sole and absolute discretion follows so much of the income or principal, or both. Accordingly, the court concludes that the settlor intended the trustees' discretion to relate only to the amount of the payment and whether it came from trust income, principal, or both. The court finds nothing in this interpretation which is either internally inconsistent or contrary to law or public policy. Furthermore, this interpretation is in accord with the construction applied by other courts. See *Magavern v. United States*, 550 F.2d 797, 801 (2nd Cir. 1977) (concluding that the language Trustee shall pay over or use, apply and expend whatever part or all of the net income or principal creates a property right, not a discretionary trust, because it does not give [the trustee] the authority to deny a particular beneficiary anything at all); *La Salle Nat'l Bank v. United States*, 636 F.Supp 874, 876 (N.D. Ill. 1986) (concluding that the word shall indicated the settlor's intent that the trustee was obligated to pay); *United States v. Taylor*, 254 F.Supp. 752, 755-56 (N.D. Cal. 1966) (determining that the discretionary language related only to the trustees' determination of the amounts to be payed); *State ex rel. Sec'y of Soc. Rehab. & Servs. v. Jackson*, 822 P.2d 1033, 1038-39 (Kan. 1991) (concluding that the instrument which contained both mandatory and discretionary

> language did not create a discretionary trust because the mandatory language controlled the distribution and the discretionary language controlled only the amount and timing of the payments).
>
> The Co-Trustees further argue that when discretion is tied to a determination of need, a trustee may, in his discretion, determine that no funds are needed. See *Myers v. Kansas Dep't of Soc. & Rehab. Servs.*, 866 P.2d 1052, 1057 (Kan. 1994) (determining that where disbursement is tied to a discretionary determination of need, the trustee has no duty to pay a specific sum or any sum at all). And see *Texas Commerce Bank Nat'l Ass'n v. United States*, 908 F.Supp 453, 458-59 (S.D. Tx 1995) (interpreting similar language as creating a discretionary trust). Although the court finds the *Myers* analysis compelling, the court is not persuaded that Anna Delano intended her trust provision be so construed.
>
> The language of the Anna Delano Trust is distinguishable from the trust in *Myers* in two important ways. First, the Anna Delano Trust expressly authorizes the Trustee to disregard the beneficiary's financial need. See Will at Art. IV 4.2(a) (My Trustee may, but need not, consider all funds known to my Trustee to be available to him.) (Ex. A to Co-Trustees' Mot.) Based upon this language and the entire will instrument, the court concludes that Anna Delano did not intend her Trustee to withhold all payments if he determined that the beneficiary did not need the funds. Second, the court notes that the *Myers* Trustee was an independent professional entity. Where, as here, the settler names the sole beneficiary as Co-Trustee, it is far less compelling that a discretionary determination of need would result in no payment at all. *Cf. Jones*, 812 P.2d at 1156-57 (reasoning that a beneficiary's satisfaction is highly speculative because he cannot force the trustee to pay income or principal); *Texas Commerce Bank Nat'l Ass'n*, 908 F. Supp. at 458 (finding a pure discretionary trust based on the reasoning that where property is given to trustees to be applied, in their discretion, to the use of a third person, no interest goes to the third person until the trustees have exercised this discretion) (emphasis added). Where a Trustee exercises discretion for his own benefit rather than that of a third party, the beneficiary's satisfaction is no longer highly speculative.

In *U.S. v. Hovnanian*, 130 A.F.T.R.2d 2022-6796 (D. N.J. 12/27/2022), the beneficiary Shant owed $16M+ of tax after the IRS busted his tax shelters. His mother gifted a home to a trust that he had created for his children. The court held that the trustee held the home as nominee for Shant, enabling the government to place a lien on the home:

> In its Motion for Partial Summary Judgment against Pachava, the Government argues that, given the facts of this case, it is seeking a determination that Pachava is Shant's nominee and that the tax liens assessed against him consequently attach to the Navesink Property. (Gov. Moving Br. against Pachava at 4.) To that extent, the Government argues that Pachava simply held title of the Navesink Property and Shant actually had control over the property, as evidenced by him paying the property's bills, living on the property, and being the decisionmaker for anything that had to do with the property. (*Id*. at 2.)
>
> "When there is a tax lien on a taxpayer's property, the Government may seek to satisfy it by levying upon property the taxpayer controls." *United States v. Patras*, 544 F. App'x 137, 140 (3d Cir. 2013). When the "Government seeks to reach" real property, the Court must determine what rights the taxpayer has in such property to determine if it is subject to the lien. *Drye v. United States*, 528 U.S. 49, 58 (1999). If the property is under the

control of a third party found to be the delinquent taxpayer's nominee or alter ego, it can be subject to a tax lien. *G.M. Leasing Corp. v. United States*, 429 U.S. 338, 350–51 (1977). A third party is a taxpayer's nominee where "the taxpayer has engaged in a legal fiction by placing legal title to property in the hands of [that] third party while actually retaining some or all of the benefits of true ownership." *Patras*, 544 F.App'x at 141 (citing *Holman v. United States*, 505 F.3d 1060, 1065 (10th Cir. 2007)); see also *Fourth Inv. LP v. United States*, 720 F.3d 1058, 1066 & n.3 (9th Cir. 2013).

As laid out in *Patras*, the test for a nominee relationship under both federal and New Jersey law is generally set out with six factors:

(1.) Whether the nominee paid adequate consideration for the property;

(2.) Whether the property was placed in the nominee's name in anticipation of a suit or other liabilities while the taxpayer continued to control...the property;

(3.) The relationship between the taxpayer and the nominee;

(4.) The failure to record the conveyance;

(5.) Whether the property remained in the taxpayer's possession; and

(6.) The taxpayer's continued enjoyment of the benefits of the property.

Hovnanian, 2019 WL 1233082, at *7–8 (quoting *Patras*, 544 F. App'x at 141–42). These factors should not be applied rigidly or mechanically. *In re Richards*, 231 B.R. 571, 579 (E.D. Pa. 1999). The overarching key to the nominee test is determining if a party exercises "active" or "substantial" control over the property. *In re Richards*, 231 B.R. at 579. If a taxpayer is the true owner of the property, that property is subject to the tax lien.

At this juncture, it is worth noting that Pachava's Opposition brief is identical to the one that it filed for its Motion for Summary Judgment against the Government. For this reason, the Court will address both Pachava's Opposition and its Motion for Summary Judgment together. Defendant Pachava first argues that "the IRS's theory of the case is that the real property transactions wherein the Properties were transferred to the Pachava Asset Trusts were the result of fraudulent conveyances." (Pachava Opp'n to Gov. Motion at 18; Pachava MSJ at 16.) Pachava goes on to argue that the Government's claims fall under the New Jersey's Fraudulent Transfer Act ("FTA"), which has a four-year statute of limitations and the Government has waited beyond those four years to file its claim, thus precluding them from pursuing the nominee lien. (*Id*. at 19-20; *Id*. at 16-17.) Although the Government never asserts any alter ego liability in its Motion for Partial Summary Judgment, Pachava argues that the Government's alter ego claim fails. Defendant next argues that the nominee claim fails because "Shant was never in title to the Properties, and a 'federal tax lien does not arise or attach to property in which a person has no interest under state law.'" (*Id*. at 22-23; *Id*. at 19-20.)

Pachava also adopts faulty arguments that Shant does not satisfy the *Patras* factors. (*Id*. at 32; *Id*. at 29.) It claims the first factor is not satisfied because "the property never belonged to the taxpayer." (*Id*.; *Id*.) The second factor is not met because the second factor relates to the transfer of property by the transferor, not the transferee, such that the analysis would be that Shant's parents were the persons seeking to avoid a claim.

(Id. at 33; Id. at 30.) According to Pachava, the third factor is not met because the analysis looks at the relationship between the nominee and the transferor and there is no relationship between Shant's mother and the Pachava Trust. (*Id*.; *Id*.) Lastly, factor four is not satisfied because the conveyance was recorded and factors five and six are not met because there is no showing that Shant lived at the Navesink Property. (*Id*.; *Id*.) Based on these arguments, Pachava argues that the Government's Motion for Partial Summary Judgment against Pachava should be denied, and instead Pachava's Motion for Summary Judgment should be granted.

Pachava's arguments are largely mistaken. "While related, the concepts of 'nominee[,]' 'transferee[,]' and 'alter ego' are independent bases for attaching the property of a third party in satisfaction of a delinquent taxpayer's liability." *E.g.*, *Oxford Cap. Corp. v. United States*, 211 F.3d 280, 284 (5th Cir. 2000). Although a nominee has "true beneficial ownership of property," a fraudulent transfer seeks to avoid a transfer made to generally hinder, delay, or defraud creditors. Id. The Government can enforce its liens against the taxpayer's property, including property held by a nominee or alter ego. *Hovnanian*, 2022 WL 909868 [129 AFTR 2d 2022-1288], *3 ("the right to foreclose on these liens extends to property held by third parties who are 'acting as a nominee or alter ego....'") (quoting *United States v. Wunder*, Civ. No. 16-9452, 2019 WL 2928842, *4 (D.N.J. July 8, 2019), *aff'd*, 829 F. App'x 589 (3d Cir. 2020)). That said, the Government did not need to - nor did it - bring any claims under alter ego liability or the FTA. Thus, the statute of limitations with respect to the FTA and the arguments against alter ego liability are misplaced.

Pachava's arguments that the nominee claims are insufficient are also mistaken. Pachava seems to conflate the plain language of the rule set forth in Patras. For example, factor one asks whether the nominee - in this case, Pachava - paid adequate consideration, not the taxpayer as Pachava asserts. *Patras*, 544 F. App'x at 142. As for the second factor, courts are clear that the proper analysis is whether the nominee purchased the property in anticipation of a suit or other liabilities and nothing to do with the transferor, as Pachava claims. *Id*. Pachava also misapplies the third Patras factor because the rule clearly states that the Court needs to consider "the relationship between the taxpayer and the nominee", not the taxpayer and the transferor as argued by Pachava. *Id*. at 141 (emphasis added). Accordingly, the Court rejects Pachava's arguments.

Turning to the *Patras* factors themselves, the first, second, and fourth factors focus on the mechanics of the transfer and, for the reasons set forth below, they favor a conclusion that Pachava was just Shant's nominee. The first factor is satisfied because it is undisputed that the transfer from Shant's mother to Pachava was only for one dollar (Gov. Pachava SUMF ¶ 20;) - clearly, a nominal amount. (Ex. 101, Deed, at 1.) See *Coles v. Osback*, 92 A.2d 35, 36 (N.J. Super. Ct. App. Div. 1952) (holding that the first factor was satisfied because the sale price of the property was below market value). Moreover, the second factor is satisfied because it is likewise undisputed that the Hovnanians recorded the transfer of the Navesink Property after Shant lost a case before the United States Tax Court with regard to his tax liabilities (Ex. 101, Deed, at 1; Gov. Pachava SUMF ¶ 17). See *id*. (holding that the second factor was satisfied after the debtor placed the property in his son's name after suit was filed against him). As for the fourth factor, the conveyance was recorded, which does militate against finding Pachava is a nominee, but this factor alone is not dispositive. *Patras*, 544 F. App'x at 142. See also *Gilchinsky v. National Westminster Bank N.J.*, 732 A.2d 482, 491 (N.J.

1999) (lack of concealment was "only marginally relevant" in NJFTA case); *In re Richards*, 231 B.R. 571, 579 (E.D. Pa. 1999) (according the fact that the transfer was recorded "relatively little weight"). On balance, factors one, two, and four (and the relevant undisputed evidence before the Court) therefore favor a conclusion that Pachava is a mere nominee.

Patras factors three, five and six examine the relationship between the nominee and taxpayer, as well as whether the taxpayer retained possession and enjoyed the benefits and bore the burdens of owning the property. *Patras*, 544 F. App'x at 141. Factor three looks at the relationship between the taxpayer and the nominee. Here, factor three is satisfied because Shant is so closely intertwined with everyone involved in Pachava. Namely, Shant "was the one who settled the Pachava Trust," "his mother contributed the property," his wife at the time served as the original trustee, his cousin followed his wife as trustee following the divorce, "his sister [currently] serves as trustee, and his children are the sole beneficiaries." (Pachava Dep. at 27:21-25.) *Hovnanian*, 2019 WL 1233082, at *6. Factors five and six look at whether the property remained in the taxpayer's possession, and whether the taxpayer's continued to enjoy the benefits of the property. As proof of factors five and six, the Government's evidence includes unrebutted deposition testimony it elicited from Shant's wife at the time, Hilde Jenssen ("Hilde Dep.", ECF No. 122-9), and corroborated by deposition testimony from, Jennifer Generoso, a corporate designee-witness for Morgan Stanley, the firm that managed Pachava's financial account ("Generoso Dep.", ECF No. 122-5). Specifically, Hilde's testimony was that the Navesink Property was Shant's primary residence starting in 2008 where he, she, and their children all resided2 (Hilde Dep. 19:5-17; "Generoso Dep.", ECF No. 122-5, at 10:4-25), Shant did not pay rent while residing there (id. at 20:9-11), and he paid for all of the property's expenses (id. at 19:18-21:13; "Gandolfo Dep.", ECF no. 122-7, at 53-5–54:9). See *Patras*, 511 F. App'x at 142 (fifth factor satisfied because it was established that the defendant resided in the property uninterrupted and without a lease to support his assertion that payments he was making constituted rent).

In summation, the undisputed record indicates that: the transfer was made for minimal consideration (factor one), the transfer happened after Shant lost a case before the United States Tax Court (factor two), Shant had a close relationship via familial relations with each of the trustees (factor three), and the property remained in Shant's possession as it was his primary residence for the time in question (factors five and six). This is consistent with the Government's position that Pachava is a mere nominee. See *Jugan v. Friedman*, 646 A.2d 1112, 1119 (N.J. Super. Ct. App. Div. 1994) (a debtor's wife was a nominee because the debtor had transferred the property at issue to his wife (factor 3) without receiving any consideration (factor 1) for the purpose of evading his creditors (factor 2) while continuing to control and enjoy the benefits of the property (factors 5 and 6)); *Coles*, 92 A.2d at 38-40 (a son was the nominee owner of property for the benefit of his parents (factor 3), who lived there (factors 5 and 6); that the sale price of the property was below market value (factor 1); and that the debtor placed the property in his son's name after suit was filed against him (factor 2)); *Sweney v. Carroll*, 178 A. 539, 542-44 (N.J. Ch. 1935) (considering similar factors); *cf. Holman*, 505 F.3d at 1065 (a third party is a nominee where the taxpayer retains the benefit of ownership); *Shades Ridge Holding Co. v. United States*, 888 F.2d 725, 728-29 (11th Cir. 1989) (weighing similar factors to determine "who has 'active' or 'substantial' control" (citation omitted).

For these reasons, the Court concludes that there is no genuine dispute that the Pachava Trust is Shant's nominee and Shant is the beneficial owner of the Navesink

> Property - effectively subjecting the Navesink Property to the tax lien. Accordingly, the Court will grant the Government's Motion for Partial Summary Judgment against the Pachava Asset Trust and deny Defendant Pachava's Motion for Summary Judgment.

Disturbing is that the trust was treated as nominee when the debtor's mother – not the debtor – contributed the home to the trust. I did not see anything in the facts indicating that the debtor had paid for the home to which his mother had title. That the debtor originally settled the trust does not make the debtor the settlor with respect to the home – an issue that does not appear to have been addressed. On the other hand, the debtor was manipulating all sorts of asset transfers, so the court might not have given much credence to the mother's ownership before the home was conveyed to the trust. Furthermore, the court described the trust as being for the benefit of the debtor's children, and the debtor and his wife lived in the home without paying rent to the trust.

III.B.5.e.iv.(l). Code §§ 6324(a)(1), 6324(a)(2) and Collection Due Process (CDP) Rights

PMTA 2013-014 provides the IRS' position:

> **ISSUE**
>
> Whether collection due process (CDP) rights must be given to a transferee of a taxable estate when the Service seeks to levy or seize property to enforce either the general estate tax lien arising under I.R.C. § 6324(a)(1), or the "like lien" described in section 6324(a)(2)?
>
> **CONCLUSION**
>
> The transferee is not entitled to CDP rights under either scenario. This is a change from our prior position.
>
> **LAW AND ANALYSIS**
>
> Section 6324(a)(1) establishes a federal tax lien upon the property included in the gross estate of a decedent for 10 years after the decedent's date of death. The gross estate includes probate and non-probate property. Non-probate property is the property described in sections 2034-2042. The section 6324(a)(1) estate tax lien remains on all property included in the gross estate unless it is replaced by a section 6324(a)(2) like lien, or attached to other property under section 6324(a)(3). Non-probate property in the hands of a trustee or transferee is encumbered by the estate tax lien and the Service may levy upon the property to collect unpaid estate tax based on the lien. If the transferee transferred the non-probate property to a purchaser or the holder of a security interest, the section 6324(a)(1) lien is divested from that property and a section 6324(a)(2) like lien is created upon all of the transferee's other property, including after-acquired property. Section 301.6324-1(a)(2)(ii); *United States v. Chapel Chase Joint Venture, Inc.*, 753 F.Supp. 179 (D. Md. 1990).
>
> Section 6324(a)(2) provides another means of estate tax collection. This provision imposes personal liability for any estate tax not paid when due, up to the value of the property received (as of the date of death), on a trustee or transferee who receives on the date of death non-probate property included in the gross estate of the decedent. The personal liability under section 6324(a)(2) is a separate liability of the transferee, not the estate tax liability. See *Baptiste v. Commissioner*, 29 F.3d 1533, 1541 (11th Cir. 1994).

Section 6324(a)(2) does not create a lien upon the transferee's property to collect the personal liability.

The Service possesses two options to collect personal liability from a transferee under section 6324(a)(2). The Service may use the transferee liability procedures provided by section 6901 to assess and collect a transferee liability in the same manner as the estate tax liability. In the alternative, the Service may file a suit under section 7402 in a United States district court. See *United States v. Russell*, 461 F.2d 605, 606 (10th Cir. 1972); *United States v. Degroft*, 539 F.Supp. 42, 44-45 (D. Md. 1981).

If there is a section 6324(a)(1) estate tax lien or a section 6324(a)(2) like lien attached to the property against which the Service would like to pursue administrative collection, the Service is not first required to pursue a section 6901 assessment or court proceeding to impose personal liability on a transferee. The IRS can enforce these liens through the use of a levy or seizure issued in the name of the estate against property subject to that tax lien in the hands of the transferee. This action is authorized by section 6331(a) and section 301.6331-1(a).

Under section 301.6330-1(b)(2) Q&A B5, persons who hold property subject to a section 6324(a)(1) lien or section 6324(a)(2) like lien are not entitled to a CDP notice and hearing prior to or after levy. This provision is intended to cover all transferees of property subject to a federal tax lien. The regulation takes the position that the only persons entitled to CDP notices and hearings are "taxpayers." See Section 301.6330-1(a)(3) Q&A A1. This interpretation is based on the legislative history of the IRS Restructuring and Reform Act of 1998, and is consistent with sections 6320 and 6331(a), which Congress contemplated would operate in tandem with section 6330. Transferees are not taxpayers under section 6324; the estate is the taxpayer. Personal liability does not become a "tax" liability for purposes of section 6330 subject to administrative collection action until assessed through the section 6901 procedures. See Section 6901(a). The basis for collection from the transferee's assets is the enforcement of the estate tax lien or the like lien attached to those assets, not the collection of the personal liability. In this circumstance, the transferee is not a "taxpayer" under the CDP regulations. As such, a transferee is not entitled to a CDP notice or hearing when the Service seeks to levy or seize distributed property subject to the estate tax lien. Similarly, a transferee is not entitled to a CDP notice or hearing when the Service seeks to levy on the transferee's other property subject to the like lien. A CDP notice does need to be given to the taxpayer (estate) before the levy on assets in the hands of the transferee to which the estate tax lien or like lien attaches.

In prior advice issued by this office in 2001, before the final CDP regulations were adopted by the Department of Treasury, we concluded that a CDP notice must be provided to a transferee when levying based upon the like lien that arises under section 6324(a)(2) upon transfer of non-probate property by the initial transferees described in section 6324(a)(2) to a purchaser or security interest holder. Upon such transfer, the estate tax lien is divested from the transferred property and a like lien arises and attaches to all other property of the initial transferee.

We concluded in 2001 that a levy based upon the like lien was distinguishable from a levy on property received subject to the section 6324(a)(1) estate tax lien because the Service could levy any of the transferor's property, including after-acquired property. In this respect, we concluded that providing CDP rights in the "like lien" scenario would be more justifiable. For example, the transferor may be able to propose collection alternatives regarding which property should be levied. In addition, we reasoned that levies based upon the like lien should be treated consistently with levies based upon transferee assessments under section 6901 and the resulting section 6321 federal tax lien, where the assessed party would be a "taxpayer" entitled to CDP rights. Because section 6901 and section 6324(a)(2) are different mechanisms to collect the same transferee liability, it would arguably be equitable to provide CDP rights in both cases.

We have reconsidered our 2001 advice and now conclude that our prior position was incorrect. We mischaracterized the like lien as a mechanism analogous to transferee liability under section 6901 for the purpose of collecting personal liability of the transferee. Rather, the section 6324(a)(2) like lien is not independent of, and is merely a substitute for, the section 6324(a)(1) estate tax lien. Neither the Code nor the regulations explicitly address this issue, but a plain meaning construction of the phrase supports the conclusion that the like lien of section 6324(a)(2) is identical to the special estate tax lien created in section 6324(a)(1).[1] See Armstrong v. Commissioner, 114 T.C. 94, 101 (2000) (estate lien and like lien are "identical"). See also United States v. Rotherham, 836 F.2d 359 (7th Cir. 1988) (discussing the relationship between the general tax lien of section 6321 and the special estate tax liens created in section 6324(a)(1) and (a)(2)). Accord Beaty v. United States, 90-1 USTC ¶ 60,004 (E.D. Tenn. ¶1989) and United States v. Warner, 85-2 USTC ¶ 13,641 (S.D. N.Y. 1985).

[1] As a result, the section 6324(a)(1) estate tax lien and section 6324(a)(2) like lien have the same collection statute of limitations period: ten years from the decedent's date of death. The collection statute of limitations for collecting the personal liability of the transferee, on the other hand, under section 6901 or by district court suit, is ten years from the date of assessment of the personal liability or assessment of the estate tax liability, respectively. See Section 6502(a)(1); *Degroft*, 539 F.Supp. at 44.

The legislative history of section 6324(a)(2) supports this conclusion. Section 315(a) of the Revenue Act of 1926 provided that "[u]nless the tax is sooner paid in full, it shall be a lien for ten years upon the gross estate of the decedent... ." P.L. 68-176. The first sentence of section 315(b) of the Act provided that if property was transferred by a decedent (A) by trust or otherwise, in contemplation of or intended to take effect at or after his or her death, or (B) to a beneficiary under a life insurance contract, and the estate tax is not paid when due, the transferee, trustee or beneficiary "shall be personally liable for such tax, and such property... shall be subject to a like lien equal to the amount of such tax." *Id*. The second sentence of section 315(b) directed that "[a]ny part of such property described in the first sentence sold by the transferee or trustee to a bona fide purchaser for adequate and full consideration in money or money's worth shall be divested of the lien and a like lien shall then attach to all the property of such transferee or trustee... ." When the Internal Revenue Code of 1939 was enacted, section 827(a) and (b) of the Code incorporated all of section 315(a) and (b) of the Revenue Act of 1926.[2] P.L. 76-1.

[2] Section 827(b) was also amended to add other pieces of non-probate property to the existing list.

Section 827(b) was subsequently amended by the Revenue Act of 1942. Section 827(a) and (b), as amended by the Revenue Act of 1942, was the predecessor to current section 6324(a)(1) and (a)(2). See *Armstrong v. Commissioner*, 114 T.C. 94, 101 (2000). Section 411 of the Revenue Act of 1942 amended section 827(b) to eliminate "and such property... shall be subject to a like lien equal to the amount of such tax."[3] P.L. 77-743. The second sentence was amended to add a specific reference to the estate tax lien provided in section 827(a) but otherwise remained unchanged: “Any part of such property sold... shall be divested of the lien provided in section 827(a) and a like lien shall then attach to all property” of the transferee. *Id*. The Senate report describing changes made to the 1939 Code explains that the reference to the estate tax lien imposed by section 827(a) in the second sentence made the reference to like lien in the first sentence unnecessary, and therefore the reference to the like lien was eliminated. S. Rep. No. 69-52, Part 1, page 38. The reference to the like lien in the first sentence would only be unnecessary if such lien was identical or equivalent to the section 827(a) general estate tax lien. If the like lien eliminated from the first sentence of section 827(b) was identical or equivalent to the section 827(a) estate tax lien, then it is reasonable to conclude that Congress intended the like lien attached to all of the transferee’s property, described in the second sentence of section 827(b), also to be identical or equivalent to the estate tax lien. Accordingly, the like lien described in section 6324(a)(2) on all of the transferee’s property is for the collection of the estate tax, rather than the transferee’s personal liability.

[3] Section 411 of the Revenue Act of 1942 also amended section 827(b) to replace the list of non-probate property with citations to newly added Code provisions describing the non-probate property.

Under this analysis, the section 6324(a)(2) like lien is for the in rem collection of the estate tax from property subject to the lien, and not for collection of the transferee’s personal liability. The estate tax lien shifts to other property, but the estate remains the only taxpayer. The transferee under section 6324(a)(2) is not the taxpayer, but is holding property subject to the tax lien for collection of another person’s (the estate’s) taxes. Under the CDP regulations, the transferee would not be a “taxpayer” entitled to CDP rights.

We recognize that the section 6324(a)(2) like lien is different from other types of tax liens because it attaches to property other than that transferred by the taxpayer estate, including wages, bank accounts and after-acquired property. It is true that the transferor, if given CDP rights, would be able to propose alternatives to collection from certain types of property. However, although not entitled to CDP rights, such party would be entitled to collection appeal program (CAP) rights to propose collection alternatives and raise any other issues pertaining to the levies or proposed levies. IRM 8.24.1.2 (10-01-2012). For other issues that could be raised in CDP, such as the underlying tax liability, it would be counterintuitive to offer CDP rights to a non-taxpayer. If the estate tax were assessed from the estate tax return, for example, nothing would preclude the transferee given CDP levy rights from contesting that estate tax liability. See section 6330(c)(2)(B). Furthermore, a transferee has the ability to prevent imposition of the like lien by not selling or encumbering the estate assets prior to satisfaction of the estate tax.

It is possible that a party in possession of non-probate property subject to the estate tax lien may not be aware of this unrecorded lien and may, therefore, also be unaware of the imposition of the like lien upon the sale or further encumbrance of the non-probate property. In this respect, the party whose property is subject to a like lien is really no different than a purchaser of or holder of security interest in probate property encumbered by an unrecorded estate tax lien who is unaware of that lien. See section 6324(a)(3); *United States v. Vohland*, 675 F.2d 1071, 1075 (9th Cir. 1982) (estate tax lien remained attached to probate property sold to purchaser without notice of lien when fiduciary of estate had not received a section 2204 discharge at time of sale). It is not disputed that a purchaser or security interest holder under those circumstances would not be entitled to CDP rights prior to or after levy.

For these reasons, a transferee of non-probate property is not entitled to a CDP notice or hearing prior to or after levy upon property subject to either the section 6324(a)(1) estate tax lien or the section 6324(a)(2) like lien. Under the CDP regulations, parties holding property subject to a federal tax lien are not "taxpayers" entitled to CDP rights. As this is a change from our prior advice in 2001, [Redacted Text] [Redacted Text] [Redacted Text].

III.B.5.e.v. Transferee Liability

This part III.B.5.e.v describes liability that arises when the IRS assesses a beneficiary or other transferee under Code § 6901.

In addition to the discussion of this part III.B.5.e.v, Code § 6324(a)(2) provides remedies against beneficiaries in certain situations; see *U.S. v. Paulson*, 131 A.F.T.R.2d 2023-1743 (9th Cir. 5/17/2023), excerpts from which are in the text accompanying and following fn 7173 in part III.B.5.e.iv.(e) Which Estates Are Affected by the Estate Tax Lien? The Ninth Circuit pointed out that a beneficiary may avoid transferee liability by disclaiming; see part III.B.3.e Disclaimers. The Ninth Circuit did not mention the impracticality of the beneficiary of a QTIP trust disclaiming.[7208] Moving beyond the QTIP scenario, does the Ninth Circuit's view on disclaimers mean the executor or other fiduciary has a duty to notify all beneficiaries - no matter how remote - that they should consider disclaiming in case the estate tax situation unexpectedly blows up? On the other hand, if the liability is limited to the bequeathed property's value at the time of distribution to the beneficiary (which is my best guess of the *Paulson* majority's intent), then disclaiming would seem to be an overreaction.

Although a Code § 6324(a)(2) transferee is also a transferee under Code § 6901(h), courts have held that Code § 6324 liability arises automatically – that no assessment is required to impose that liability. Courts and the IRS view Code § 6324 liability as a secret, automatic lien. For probate property, Code § 6324(a)(1) provides that the lien arises as of the date of the decedent's death. For nonprobate property, the lien appears to arise whenever the transferee receives the property, which may be the date of the decedent's death or sometime later.

A trustee or other fiduciary can protect his/her/its assets by seeking Code § 2204 relief, which is described in part III.A.6 Post-Mortem Trust and Estate Administration. That relief is relatively easy to get and can protect the trustee or other fiduciary starting just a few years after the decedent's death. Given that under *Paulson* a beneficiary is subject to liability automatically and immediately when first coming into possession of included property, an executor or other fiduciary might consider not making any distribution to a beneficiary until the fiduciary is highly confident that no estate tax is owed – either because of confidence in values being well below the estate tax threshold (or not subject to being challenged above the estate tax return value, because they are easy-to-value assets) or because a closing letter or estate tax transcript shows that the IRS contemplates no further action.

Given that beneficiaries apply for credit – whether as business owners (not only as borrowers themselves but also as guarantors of business loans or surety bonds required for some businesses to survive), home purchasers, or consumers – the need to disclose liabilities can be

[7208] See text accompanying and immediately preceding fn 7011 in part III.B.3.e.i Disclaimers – Code and Regulations.

a very serious matter. With Code § 6324(a)(2) not requiring an IRS assessment, each beneficiary of an estate that is subject to estate tax has at least a contingent liability that may need to be disclosed to the credit provider. The IRS can go after any beneficiary who possesses or has received property actual passing or deemed to pass from the decedent, and the beneficiary has the burden of recovering from others their respective fair share of any tax, interest, and penalties. Thus, tax apportionment is important in determining beneficiaries' rights against each other but does not – as a technical matter – affect how much the IRS can collect from each beneficiary. A beneficiary's right to recover from others may be strong or weak - depending on the other beneficiaries' financial posture and ability to hide assets:

- A beneficiary may need to disclose this contingent liability and explain to the credit provider how much out-of-pocket risk the beneficiary has. See part III.B.5.e.iv.(i) Effect of Liens on Dealings with Third Parties. *Paulson* held that "the liability of each of these defendants cannot exceed the value of the estate property at the time of decedent's death, or the value of that property at the time they received it," which presumably means the lesser of those two amounts.

- If a beneficiary receives a distribution of property included in the estate of a decedent, where estate tax is or may be due, when applying for credit presumably the beneficiary should include at least a contingent liability when listing the property as an asset.

- If a downstream trust is a beneficiary, presumably the trustee should consider seeking Code § 2204 relief to protect the trustee from the IRS. When the trust makes a distribution to a beneficiary, presumably the trustee should inform the beneficiary that the distribution triggers the liability and that the liability may prospectively impair all of the beneficiary's assets to the extent of any unpaid estate tax, interest, and penalties.

See also part III.B.5.e.iv.(h) Liens: Selected Internal Revenue Manual Materials. For information beyond what is in my materials below, see "The Devil is in the Details: Important Tax Administration and Procedural Rules for Estate Planners," Chapter 9 of the 2015 Heckerling Institute on Estate Planning.

III.B.5.e.v.(a). General Rules Regarding Transferee Liability

Generally, income tax, estate tax, and gift tax liabilities are assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred.[7209]

The IRS may assess an initial transferee's liability within one year after the expiration of the period of limitation for assessment against the transferor.[7210] The IRS may assess the liability of a transferee of a transferee, within one year after the expiration of the period of limitation for assessment against the preceding transferee, but not more than three years after the expiration of the period of limitation for assessment against the initial transferor.[7211] However, if, before the expiration of the period of limitation for the assessment of the liability of the transferee, a court proceeding for the collection of the tax or liability in respect thereof has been begun against the initial transferor or the last preceding transferee, respectively, then the period of

[7209] Code § 6901(a)(1).
[7210] Code § 6901(c)(1).
[7211] Code § 6901(c)(2).

limitation for assessment of the liability of the transferee expires one year after the return of execution in the court proceeding.[7212]

The IRS may assess a fiduciary not later than one year after the liability arises or not later than the expiration of the period for collection of the tax in respect of which such liability arises, whichever is later.[7213]

"Transferee" includes donee, heir, legatee, devisee, and distributee, and with respect to estate taxes, also includes any person who, under Code § 6324(a)(2), is personally liable for any part of such tax.[7214] "Distributee" includes the distributee of an estate of a deceased person, the shareholder of a dissolved corporation, the assignee or donee of an insolvent person, the successor of a corporation, a party to a reorganization as defined in Code § 368, and all other classes of distributees.[7215] When assets pass in trust by reason of death, the trustee has Code § 6324(a)(2) personal liability, and generally the beneficiaries do not[7216] (the latter being a conclusion that was undermined by *U.S. v. Paulson*, 131 A.F.T.R.2d 2023-1743 (9th Cir. 5/17/2023), which is found in the text accompanying and following fn 7173 in part III.B.5.e.iv.(e) Which Estates Are Affected by the Estate Tax Lien?).

Whether a person is liable under state law is determined independently of whether the person is a transferee under federal law. Similarly, fraudulent transfer remedies under Code § 6901 are based on state law fraudulent transfer remedies.

As to liability under state law being determined independently of whether the person is a transferee under federal law, see *Frank Sawyer Trust of May 1992 v. Commissioner*, 712 F.3d 597 (1st Cir. 2013); *Starnes v. Commissioner*, 680 F.3d 417 (4th Cir. 2012); *Diebold Foundation, Inc v. Commissioner*, 736 F.3d 172 (2nd Cir. 2013); *Salus Mundi Foundation v. Commissioner*, 776 F.3d. 1010 (9th Cir. 2014) (shareholders had constructive knowledge of the fraudulent tax avoidance scheme at issue; series of transactions collapsed; shareholders made a fraudulent conveyance under state law), following *Diebold* and *rev'g* T.C. Memo. 2012-61. On remand, *Frank Sawyer Trust of May 1992 v. Commissioner*, T.C. Memo. 2014-59, held that, under Massachusetts law, a good-faith transferee of a fraudulent transfer was liable only to the extent that the fair market value of what it received exceeded the price that it paid; the taxpayer obtained additional relief (that did not change the reasoning of that case) at T.C. Memo. 2014-128.

All the sparring described in this footnote is described by *Alterman Trust v. Commissioner*, T.C. Memo. 2015-231 (12/1/2015):

> The fact patterns of these cases are similar. Someone sells an interest in a corporation for a good price; the corporation doesn't pay its taxes; and the Internal Revenue Service (IRS) goes after the former shareholder for the taxes.
>
> The outcomes of these cases vary. Many taxpayers have prevailed at the trial court, but many of those taxpayers have seen their victories turned to defeat on appeal.[2] The IRS

[7212] Flush language at the end of Code § 6901(c)(1) and (2).
[7213] Code §6901(c)(3).
[7214] Code § 6901(h).
[7215] Reg. § 301.6901-1(b).
[7216] See fn. 7171, found in part III.B.5.e.iv.(e) Which Estates Are Affected by the Estate Tax Lien? Thus, trustees of revocable trusts need to do everything in their power to make sure estate taxes are paid, because they are personally on the hook.

has likewise prevailed at the trial court, and its victories have uniformly survived appeal.[3] Rarest of all is the taxpayer victory that survives appeal.[4]

[2] *Slone v. Commissioner*, ___ F.3d ___, 2015 WL 5061315 (9th Cir. Aug. 28, 2015), vacating and remanding T.C. Memo. 2012-57; *Salus Mundi Found. v. Commissioner*, 776 F.3d 1010 (9th Cir. 2014), *rev'g and remanding* T.C. Memo. 2012-61; *Diebold Found., Inc. v. Commissioner*, 736 F.3d 172 (2d Cir. 2013), *vacating and remanding Salus Mundi Found. v. Commissioner*, T.C. Memo. 2012-61; *Frank Sawyer Trust of May 1992 v. Commissioner*, 712 F.3d 597 (1st Cir. 2013), *rev'g and remanding* T.C. Memo. 2011-298.

[3] For a recent example, see Feldman v. Commissioner, 779 F.3d 448 (7th Cir. 2015), *aff'g* T.C. Memo. 2011-297.

[4] *Starnes v. Commissioner*, 680 F.3d 417 (4th Cir. 2012), *aff'g* T.C. Memo. 2011-63.

But each case stands on its own. Outcomes are determined by the facts of each specific case and what is established by the record.[5]

[5] See, *e.g.*, *Holden v. Commissioner*, T.C. Memo. 2015-83, at *2 n.2; *Holden v. Commissioner*, T.C. Memo. 2015-131, at *2 n.1 (noting that separate cases involving the same taxpayer and issues each turn on the facts established by the record in each separate case); see also *Feldman v. Commissioner*, T.C. Memo. 2011-297, 2011 WL 6781006, at *17 (noting different outcomes in *Midco* cases because of the distinct facts and circumstances of each case).

Slone v. Commissioner, 788 F.3d 1049 (9th Cir. 8/29/2015), set forth the Ninth Circuit's test:

> The question before us is whether the Slone Broadcasting shareholders can be held liable for taxes on Slone Broadcasting's sale of assets to Citadel because the shareholders were transferees of the proceeds of that sale.
>
> Under 26 U.S.C. § 6901, the Commissioner can assess tax liability against a taxpayer who is the transferee of assets of a taxpayer who owes income tax. *Salus Mundi Found. v. Comm'r*, 776 F.3d 1010, 1017 (9th Cir. 2014). Tax liabilities on transferred assets shall, with certain exceptions, be assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the cases of taxes with respect to which the liabilities were incurred. 26 U.S.C. § 6901.
>
> While federal law provides the procedure for collecting tax liabilities from a transferee, state law answers the question whether the alleged transferee is substantively liable for the tax. *Comm'r v. Stern*, 357 U.S. 39, 44–45 (1958). Therefore, in order to impose tax liability on a transferee, a court must engage in a two-pronged inquiry, see *Salus Mundi*, 776 F.3d at 1018 (citing *Stern*, 357 U.S. at 42, 44–45), which is sometimes called the *Stern* test. The first prong asks: is the party a transferee under § 6901 and federal tax law? *Id.* Under federal law, a transferee is defined as including a donee, heir, legatee, devisee, [or] distributee. 26 U.S.C. § 6901(h). Treasury regulations further define the term transferee to include the shareholder of a dissolved corporation. 26 C.F.R. § 301.6901-1(b).

> The second prong of the *Stern* test asks: is the party substantively liable for the transferor's unpaid taxes under state law? *Salus Mundi*, 776 F.3d at 1018. The test for this second prong depends on the law of the state where the transfer occurred. See, *e.g.*, *id.* (Under the [New York Uniform Fraudulent Conveyance Act], a party seeking to recharacterize a transaction must show that the transferee had actual or constructive knowledge of the entire scheme that renders [its] exchange with the debtor fraudulent.) (alterations in original) (quoting *Diebold Found., Inc. v. Comm'r*, 736 F.3d 172, 184–85 (2d Cir. 2013)). The two *Stern* test prongs are separate and independent inquiries. *Salus Mundi*, 776 F.3d at 1012.

Slone continued:

> Although we have not previously considered how a court should analyze a transaction for purposes of transferee liability under § 6901, both the Supreme Court cases, and our own precedent, require us to look through the form of a transaction to consider its substance.

Slone concluded:

> We cannot resolve this dispute because the tax court failed to apply the correct legal standard for characterizing the stock sale transaction for the purposes of federal transferee liability. The court did not address either the subjective or objective factors we apply in characterizing a transaction for tax purposes, as it failed to make any finding on whether the shareholders had a business purpose for entering into the stock purchase transaction other than tax avoidance, or whether the stock purchase transaction had economic substance other than shielding the Slone Broadcasting shareholders from tax liability. Instead, the tax court focused its factual inquiry and analysis on factors that might be relevant to the second prong of the Stern test for assessing transferee liability, whether a party is substantively liable for the transferor's unpaid taxes as a matter of state law. For instance, the tax court's findings that the shareholders had not orchestrated the asset sale and the stock sale as a single scheme for tax evasion purposes, that Fortrend and its third-party service provider were legitimate players in the debt collection industry, and that the shareholders had no reason to believe that Fortrend was using illegitimate tax evasion methods and had no duty to inquire further all relate to the question whether the shareholders lacked actual or constructive knowledge of the entire tax evasion scheme that rendered their transaction with Fortrend fraudulent under state law. See *Salus Mundi*, 776 F.3d at 1020. But the tax court did not use these factual findings to analyze the shareholders' liability under the applicable state law; it instead concluded, based on these findings, that the form of the stock sale should be respected for the shareholders' transferee status under the first prong of the *Stern* test. This was an error.
>
> Because the tax court applied the wrong legal standard to the question of transferee liability, it failed to make findings relating to the relevant factors for determining whether the Commissioner could properly disregard the form of the transaction. The tax court should make these determinations in the first instance. See *Lewis v. Comm'r*, 560 F.2d 973, 978 (9th Cir. 1977) (reversing and remanding when the tax court did not make proper factual findings). On remand, the tax court should make the findings necessary to apply the Stern test correctly. Under the first prong of this test, the tax court should apply the relevant subjective and objective factors to determine whether the Commissioner erred in disregarding the form of the transaction in order to impose tax

> liability on the shareholders as transferees under § 6901. Under the second prong of the Stern test, the tax court should analyze whether the shareholders are liable under state law for Slone Broadcasting/Arizona Media's unpaid tax liability. See *Salus Mundi*, 776 F.3d at 1018, 1020. The tax court may begin its analysis with either prong. The Commissioner may hold the shareholders liable as transferees under § 6901 only if both prongs of the Stern test are satisfied. See *id.* [5]
>
> [5] Costs are awarded to the Commissioner.

On remand, *Slone v. Commissioner*, T.C. Memo. 2016-115, addressed the second prong to determine whether the taxpayers were substantively liable for the transferor's unpaid taxes under state law. The court held that Arizona law required the IRS to prove that the taxpayers had actual or constructive knowledge of the entire scheme, and the IRS proved neither. After determining that the form of the stock sale must be respected, the court applied the UFTA to the transaction to determine whether the taxpayers may be held substantively liable for the corporation's unpaid taxes under Arizona law. The court held that the taxpayers did not commit either constructive or actual fraud under Arizona fraudulent transfer law.

Swords Trust v. Commissioner, 142 T.C. No. 19 (2014), rejected the IRS' proposed approaches:

> Respondent urges the Court to adopt the following two-step analysis to determine whether petitioner trusts, as transferees from Davreyn, are liable for Davreyn's unpaid tax: (1) analyze whether the subject transactions are recast under Federal law, here primarily the Federal substance over form doctrine, and then (2) apply State law to the transactions as recast under Federal law. One or more transactions are recast or otherwise disregarded under the Federal substance over form doctrine where the transactions, taken as a whole, show that the transactions are shams or have no purpose, substance, or utility apart from their anticipated tax consequences. … The effect of this doctrine is that the substance and not the form of the transactions determines their tax consequences…. Alternatively, respondent contends, petitioner trusts, as transferees from Davreyn and without regard to the Federal law characterization of the transactions, are liable for Davreyn's debts under applicable State law or State equity principles. Petitioner trusts argue that they are not liable for Davreyn's tax liability because, they contend, (1) the transactions may be recast only under applicable State law, which does not provide for any such recast, and (2) respondent failed to show that they are liable for Davreyn's debts under applicable State law or State equity principles….
>
> In the setting at hand, respondent bears the burden of establishing that the … State's highest Court, would apply a substance over form doctrine to recast the series of transactions as a transfer between each of petitioner trusts and Davreyn.
>
> Respondent has failed to establish that an independent basis exists under applicable State law or State equity principles for holding petitioner trusts liable for Davreyn's unpaid tax. Accordingly, we hold that section 6901 does not apply to these cases.

These cases seem inconsistent with *Slone v. Commissioner*, which held that form over substance applies to Code § 6901 and held that:

> when the Commissioner claims a taxpayer was the shareholder of a dissolved corporation for purposes of 26 C.F.R. § 301.6901-1(b), but the taxpayer did not receive a liquidating distribution if the form of the transaction is respected, a court must consider the relevant subjective and objective factors to determine whether the formal transaction had any practical economic effects other than the creation of income tax losses.

Following this evolution of case law, *Tricarichi v. Commissioner*, T.C. Memo. 2015-201 reasoned and held

> In performing this substance over form inquiry, the Ninth Circuit does not engage in a rigid two-step analysis. Rather, it focuses holistically on whether the transaction had any practical economic effects other than the creation of income tax losses. *Id.* (quoting *Reddam*, 755 F.3d at 1060). Following a commonsense review of the transaction, if the court concludes that the transaction lacks a nontax business purpose, has no economic substance, and was entered into solely to generate illegitimate tax benefits, the Commissioner may disregard the form the parties have selected and tax the transaction on the basis of its underlying economic substance. *Id.* at __, 2015 WL 5061315, at *5-*6.
>
> For the reasons discussed previously, we find that the transaction by which Nob Hill purchased petitioner's West Side stock relied on sham transactions, had no economic substance, had no bona fide business purpose, and was entered into solely to evade West Side's Federal and Ohio tax liabilities. See *supra* p. 40 and note 11 and pp. 41-55. We therefore disregard the form of the transaction and find that petitioner in substance was a direct recipient of West Side's cash, *i.e.*, as a distributee, the shareholder of a dissolved corporation, or the assignee … of an insolvent person. Sec. 6901(h); sec. 301.6901-1(b), Proced. & Admin. Regs. In any of those capacities, he was a transferee of West Side within the meaning of section 6901.

Stuart v. Commissioner, 144 T.C. 235 (2015), followed *Swords Trust* in rejecting the IRS' two-step approach but nevertheless found a fraudulent transfer under state law and upheld imposition of transferee liability. The Eighth Circuit reversed, holding that the Tax Court should have considered whether the stock sale should be recharacterized under state law, 841 F.3d 777 (8th Cir. 2016). The Eighth Circuit remanded to the Tax Court for consideration of whether the IRS is entitled to a full recovery from the former shareholders as transferees under Nebraska law.

As to fraudulent transfer remedies under Code § 6901 being based on state law fraudulent transfer remedies, see *Schussel v. Werfel*, 758 F.3d 82 (1st Cir. 2014); *Alterman Trust v. Commissioner*, T.C. Memo. 2015-231. In *Alterman Trust*, based on detailed analysis of Florida's Uniform Fraudulent Transfer Act, the court held:

> The Commissioner seeks to impute transferee liability to petitioners for taxes that went unpaid by a corporation in which they previously owned an interest. Petitioners took steps to ensure those taxes would get paid. The corporation itself remained solvent even after the shareholders sold their interests, leaving the Commissioner to argue that petitioners should be liable under a transferee of a transferee theory. But the Commissioner failed to show that any of the transferors were insolvent at any of the relevant times.

The IRS is not required to pursue collection efforts against one transferee before seeking to collect from another transferee.[7217]

III.B.5.e.v.(b). Transferee Liability Extends Past Original Estate Tax Lien

In *United States v. Kulhanek*,[7218] the decedent died in 1991, and the estate tax return was due in 1992. The estate tax return made a Code § 6166 election to defer estate tax. In 1999, the closely-held business sold all of its assets, making all of the estate tax due upon the IRS' notice and demand.[7219] The IRS sued the transferees in 2008. The transferees argued that the action was for collection of estate tax and was untimely, because it was brought more than ten years after date of death.[7220] The U.S. District Court held that the collection action was timely, because it was a transferee liability case,[7221] not an estate tax collection case, and was brought less than ten years[7222] after the event that accelerated payment of the estate tax.[7223]

Thus, transferees of estates that have made Code § 6166 elections might be liable until as long as 24 years and 9 months after death (ten years after the fourteen-year deferral under Code § 6166 of taxes due nine months after death).

Similarly, in *Mangiardi v. Commissioner*,[7224] the IRS gave an estate six annual Code § 6161 extensions of time to pay estate tax on the grounds of hardship. Concerned that the ten-year statute of limitations under Code § 6324(a)(1) was coming up, the IRS granted the seventh request of time, but only for a couple of months, explaining:

> The extension to pay is only being allowed until 12/5/2004 because, if the liability is not paid in full by that date, the IRS will begin making transferee assessments against the heirs of the estate that received assets and have not paid to the IRS their portion of the estate tax and interest owed. We can not provide any additional time because we must ensure that the transferee assessments are made prior to the assessment expiration date to make those assessments.

The IRS sent a notice of intent to levy to the estate when the estate did not meet the deadline. When appealing the notice of intent to levy, the estate claimed that the IRS was precluded from collecting the estate tax liability from beneficiaries because the time for making a transferee assessment under Code § 6901 had expired. Thus, the estate suggested an offer-in-

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[7217] *Tricarichi v. Commissioner*, T.C. Memo. 2015-201 (10/14/2015) held:

> Transferee liability is several under section 6901. *Alexander v. Commissioner*, 61 T.C. 278, 295 (1973); *Cullifer v. Commissioner*, T.C. Memo. 2014-208, at *74 (same). It is well settled that a transferee is severally liable for the unpaid tax of the transferor to the extent of the assets received and other stockholders or transferees need not be joined. *Estate of Harrison v. Commissioner*, 16 T.C. 727, 731 (1951) (citing *Phillips v. Commissioner*, 283 U.S. 589 (1931) (construing predecessor statute)). In the event that one transferee is called upon to pay more than his pro rata share of the tax, he is left to his rights of contribution from the other transferees. *Id.*

[7218] 106 A.F.T.R.2d 2010-7263 (W.D. Pa.).

[7219] Code § 6166(g)(1)(A).

[7220] Relying on Code § 6324(a)(1).

[7221] Relying on Code § 6324(a)(2).

[7222] Relying on Code § 6502(a)(1).

[7223] Citing *United States v. Botefuhr*, 309 F.3d 1263, 1277 (10th Cir. 2002), *United States v. Degroft*, 539 F.Supp. 42, 44 (D. Md. 1981), and *United States v. Bevins*, 2008 WL 5179099, 102 A.F.T.R.2d 2008-7268 (E.D. Cal. 2008).

[7224] T.C. Memo. 2011-24.

compromise in which the estate would offer a reduced amount based on doubt as to collectability of the remaining assets in the revocable trust.

Although the IRS originally thought it needed to make transferee assessments against the beneficiaries, before the Code § 6901 assessment expiration date, it never made those assessments and later asserted that a Code § 6901 assessment against transferees was not required before personal liability could be imposed under Code § 6324(a)(2).

The Tax Court ruled that it could not evaluate the legitimacy of the IRS' denial of the Code § 6161 extension, although it seemed to view the IRS' actions as pretty lame. However, that issue was moot because the court issued its judgment after the latest date for a Code § 6161 extension, so the court did not further address that issue.

The court pointed out that the Third and Tenth Circuit Courts of Appeals have held that the IRS may collect estate tax from a transferee pursuant to Code § 6324(a)(2) without a prior assessment against the transferee under Code § 6901[7225] and that the Tax Court has found those cases to be persuasive and well-reasoned.[7226] However, the court noted, "We also sympathize with the beneficiaries of decedent's estate in that years later they find themselves at risk of forfeiting their inheritance without prior notice, especially after respondent had ample opportunity to make assessments against them." Nevertheless, the court sustained the levy as lawful.

Regarding the offer-in-compromise:

> Petitioner offered the remaining assets in the estate (approximately $700,000) as an offer-in-compromise; however, respondent determined petitioner's reasonable collection potential to be at least $3 million given that the beneficiaries received $3,433,007 in IRA distributions. Because petitioner did not offer an acceptable amount, respondent did not abuse his discretion in rejecting petitioner's offer-in-compromise.

Thus, the court sustained the IRS' proposed collection actions. Then, when a beneficiary of the IRA challenged the IRS' collection efforts against her, a U.S. District Court upheld the IRS' action.[7227]

Another Code § 6166 case gave the following explanations:[7228]

> Upon an initial reading, section 6901 appears to mandate how the IRS may assess and collect taxes from those personally liable under section 6324(a)(2). The Tenth Circuit, however, has stated that section 6901 is only one method of collecting against transferees because "the collection procedures of § 6901 are cumulative and alternative—not exclusive or mandatory." [citing *Russell* - see fn. 7225]. As a result, "an individual assessment under 26 U.S.C. § 6901 is not a prerequisite to an action to impose transferee liability under 26 U.S.C. § 6324(a)(2)." [citing *Geniviva* - see fn. 7225]

[7225] Citing *United States v. Geniviva*, 16 F.3d 522, 525 (3d Cir. 1994) and *United States v. Russell*, 461 F.2d 605, 607 (10th Cir. 1972). See also *U.S. v. Estate of Elson*, 124 A.F.T.R.2d 2019-6333 (D. N.J. 10/9/2019).
[7226] Citing *Ripley v. Commissioner*, 102 T.C. 654, 659 (1994).
[7227] *U.S. v. Mangiardi*, 112 A.F.T.R.2d ¶ 2013-5108 (S.D. Fla. 2013).
[7228] *U.S. v. Johnson*, 109 A.F.T.R.2d 2012-2253 (D.C. UT).

> …. Tenth Circuit precedent is clear that as long as the period of time is open for collecting against an estate, it is open for collecting against a section 6324(a)(2) Distributee.

That case also held that refunding agreements (agreements with beneficiaries to pay estate tax) do not relieve the executor from liability for having made a distribution before estate tax is paid:[7229]

> One of section 3731's purposes is to provide a clear path for recourse when a representative distributes assets of an estate before paying estate taxes. Were courts to excuse personal representatives from liability when they secure contribution agreements, the Government would have to bring an action in contract, prove it is a third-party beneficiary of the agreement, and then establish its right of contribution. Section 3713(b) is designed to avoid such complications. It provides a straightforward way to collect unpaid taxes from the very individuals who dispersed the estate's assets without having satisfied the tax liability. In this case, the individuals who distributed the Estate's assets accepted the risk that the Heirs may fail to pay the tax. The Personal Representative, rather than the Government, is in the best position to seek reimbursement from the individuals who accepted the assets with a deferred obligation to pay the tax. The court therefore concludes the Government has stated a cognizable claim under section 3713(b) and denies the motion to dismiss this cause of action.

For more information, see "The Devil is in the Details: Important Tax Administration and Procedural Rules for Estate Planners," Chapter 9 of the 2015 Heckerling Institute on Estate Planning.

[7229] In an amended opinion at 112 A.F.T.R.2d 2013-5474, the court reaffirmed its holding, In this case, the individuals who distributed the Estate's assets accepted the risk that the Heirs may fail to pay the tax. Now that the risk has been realized, the Government may proceed on its claim against the Personal Representatives. See fn. 7167 for the requirements to make a claim under 31 U.S.C. § 3713(b).

III.B.5.e.v.(c). Transferee's Inability to Contest the Merits of the Assessment

Collection due process (CDP) rights[7230] do not apply to a transferee of a taxable estate when the IRS seeks to levy or seize property to enforce either the general estate tax lien arising under Code § 6324(a)(1) or the "like lien" described in Code § 6324(a)(2).[7231]

[7230] Reg. § 301.6330-1(e)(3), Q&A-E2 provides:

> Q-E2. When is a taxpayer entitled to challenge the existence or amount of the tax liability specified in the CDP Notice?
>
> A-E2. A taxpayer is entitled to challenge the existence or amount of the underlying liability for any tax period specified on the CDP Notice if the taxpayer did not receive a statutory notice of deficiency for such liability or did not otherwise have an opportunity to dispute such liability. Receipt of a statutory notice of deficiency for this purpose means receipt in time to petition the Tax Court for a redetermination of the deficiency determined in the notice of deficiency. An opportunity to dispute the underlying liability includes a prior opportunity for a conference with Appeals that was offered either before or after the assessment of the liability. An opportunity for a conference with Appeals prior to the assessment of a tax subject to deficiency procedures is not a prior opportunity for this purpose.

Lander v. Commissioner, 154 T.C. No. 7 (2020), quoted this regulation and stated:

> In *Lewis v. Commissioner*, 128 T.C. 48, 61 (2007), the Court upheld an earlier version of this regulation as a reasonable interpretation of section 6330 in the context of the assessment and collection of a tax not subject to the deficiency procedures. The Courts of Appeals that have reviewed the regulation have reached the same conclusion. See *Our Country Home Enters., Inc. v. Commissioner*, 855 F.3d 773, 787 (7th Cir. 2017), *aff'g* 145 T.C. 1 (2015); *Keller Tank Servs. II, Inc. v. Commissioner*, 854 F.3d 1178, 1199 (10th Cir. 2017); *Iames v. Commissioner*, 850 F.3d 160, 164 (4th Cir. 2017) ….
>
> The record shows that petitioners were fully engaged with [the Appeals Officer], that he reviewed the evidence and arguments that they presented to him, and that in the end petitioners enjoyed a full and fair opportunity to challenge their underlying tax liability before the Appeals Office during the course of the audit reconsideration process. Under the circumstances the Court is satisfied that the Appeals Office correctly determined, within the context of the collection review process, that petitioners had an opportunity to dispute their tax liability within the meaning of section 6330(c)(2)(B).[10]
>
> [10] Petitioners are not left without an opportunity for judicial review. Petitioners may pay the tax, file a claim for refund, and if that claim is denied, file a refund suit in a Federal District Court or the Court of Federal Claims. See sec. 7422(a).

[7231] Program Manager Technical Assistance (PMTA) 2013-014 (7/10/2013). This was a change from the IRS' previous position. The IRS' reasoning explains various parties' rights in proceedings:

> …the section 6324(a)(2) like lien is for the in rem collection of the estate tax from property subject to the lien, and not for collection of the transferee's personal liability. The estate tax lien shifts to other property, but the estate remains the only taxpayer. The transferee under section 6324(a)(2) is not the taxpayer, but is holding property subject to the tax lien for collection of another person's (the estate's) taxes. Under the CDP regulations, the transferee would not be a taxpayer entitled to CDP rights.
>
> We recognize that the section 6324(a)(2) like lien is different from other types of tax liens because it attaches to property other than that transferred by the taxpayer estate, including wages, bank accounts and after-acquired property. It is true that the transferor, if given CDP rights, would be able to propose alternatives to collection from certain types of property. However, although not entitled to CDP rights, such party would be entitled to collection appeal program (CAP) rights to propose collection alternatives and raise any other issues pertaining to the levies or proposed levies. IRM 8.24.1.2 (10-01-2012). For other issues that could be raised in CDP, such as the underlying tax liability, it would be counterintuitive to offer CDP rights to a non-taxpayer. If the estate tax were assessed from the estate tax return, for example, nothing would

Only the estate itself, and not an interested third party, may contest the tax assessment.[7232]

For more information, see "The Devil is in the Details: Important Tax Administration and Procedural Rules for Estate Planners," Chapter 9 of the 2015 Heckerling Institute on Estate Planning.

III.B.5.e.vi. "String Provisions" of Code §§ 2035, 2036, 2038, and 2042

Code § 2035, "Adjustments for certain gifts made within 3 years of decedent's death," provides:

> (a) *Inclusion of certain property in gross estate*. If -
>
> > (1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and
> >
> > (2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036 , 2037 , 2038 , or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death,
>
> the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.
>
> (b) *Inclusion of gift tax on gifts made during 3 years before decedent's death*. The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his

---

> preclude the transferee given CDP levy rights from contesting that estate tax liability. See section 6330(c)(2)(B). Furthermore, a transferee has the ability to prevent imposition of the like lien by not selling or encumbering the estate assets prior to satisfaction of the estate tax.
>
> It is possible that a party in possession of non-probate property subject to the estate tax lien may not be aware of this unrecorded lien and may, therefore, also be unaware of the imposition of the like lien upon the sale or further encumbrance of the non-probate property. In this respect, the party whose property is subject to a like lien is really no different than a purchaser of or holder of security interest in probate property encumbered by an unrecorded estate tax lien who is unaware of that lien. See section 6324(a)(3); *United States v. Vohland*, 675 F.2d 1071, 1075 (9th Cir. 1982) (estate tax lien remained attached to probate property sold to purchaser without notice of lien when fiduciary of estate had not received a section 2204 discharge at time of sale). It is not disputed that a purchaser or security interest holder under those circumstances would not be entitled to CDP rights prior to or after levy.
>
> For these reasons, a transferee of non-probate property is not entitled to a CDP notice or hearing prior to or after levy upon property subject to either the section 6324(a)(1) estate tax lien or the section 6324(a)(2) like lien. Under the CDP regulations, parties holding property subject to a federal tax lien are not taxpayers entitled to CDP rights.

[7232] *U.S. v. Cowles-Reed*, 114 A.F.T.R.2d 2014-5612 (9th Cir. 2014) (designated not for official publication) (surviving joint tenant from whom the IRS seeks to collect estate tax as a transferee); *Greenoak Holdings Limited v. Commissioner*, 143 T.C. 170 (2014) (offshore trust), the latter holding:

> We hold that a person, other than the taxpayer, who alleges an ownership interest in property which the Commissioner seeks to levy upon is not entitled to receive a notice of intent to levy and is not able to seek judicial review in this Court pursuant to a notice of determination issued to a delinquent taxpayer. Accordingly, we lack jurisdiction under section 6330(d) to hear petitioners' appeal.

estate on any gift made by the decedent or his spouse during the 3-year period ending on the date of the decedent's death.

(c) *Other rules relating to transfers within 3 years of death*.

(1) For purposes of -

(A) section 303(b) (relating to distributions in redemption of stock to pay death taxes),

(B) section 2032A (relating to special valuation of certain farms, etc., real property), and

(C) subchapter C of chapter 64 (relating to lien for taxes),

the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death.

(2) *Coordination with section 6166*. An estate shall be treated as meeting the 35 percent of adjusted gross estate requirement of section 6166(a)(1) only if the estate meets such requirement both with and without the application of subsection (a).

(3) *Marital and small transfers*. Paragraph (1) shall not apply to any transfer (other than a transfer with respect to a life insurance policy) made during a calendar year to any donee if the decedent was not required by section 6019 (other than by reason of section 6019(2)) to file any gift tax return for such year with respect to transfers to such donee.

(d) *Exception*. Subsection (a) and paragraph (1) of subsection (c) shall not apply to any bona fide sale for an adequate and full consideration in money or money's worth.

(e) *Treatment of certain transfers from revocable trusts*. For purposes of this section and section 2038, any transfer from any portion of a trust during any period that such portion was treated under section 676 as owned by the decedent by reason of a power in the grantor (determined without regard to section 672(e)) shall be treated as a transfer made directly by the decedent.

See parts III.C Code § 2036, III.D Code § 2038, and II.Q.4.i.ii Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity (Code § 2042).

Estate of Lillian L. Halpern v. Commissioner, T.C. Memo. 1995-352, held:

For it to make sense, we must interpret section 2038(a)(1) to require that the transfer of which it speaks have happened before (or at any rate not later than) the existence at death or relinquishment of the decedent's power and be from the decedent's own property. The structure of subtitle B — Estate and Gift Taxes — requires the contrary interpretation that sections 2038 and 2041 are mutually exclusive: sections 2035 through 2038 all concern transfers made by the decedent from the decedent's property during life. 5 Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts*, par. 126.1, at 126-3, par. 128.1, at 128-4 (2d ed. 1993). Section 2041 has always been taken to be the section of subtitle B that has to do with the powers of a grantee, as opposed to a grantor, as sections 2036 through 2038 have to do with the powers of a grantor. Dukeminier & Johanson, *Wills, Trusts, and Estates* 985 (4th ed. 1990). Sections 2036, 2037, and 2038 are all ultimately descended from the same provision in the 1916 estate tax statute that included in the gross estate any transfer by trust or otherwise "intended to take effect in possession or enjoyment at or after death". Revenue Act of 1916, ch. 463, sec. 202(b), 39 Stat. 777-778; Bittker & Clark, *Federal Estate and Gift Taxation* 204-205, 247, 299 (6th ed. 1990).[10] This ancestor subsection was held not to apply to interests subject to an exercised general power of appointment in *United States v. Field*, 255 U.S. 257, 264 (1921).[11] Since the predecessor of current section 2041 was extended to cover all general powers of appointment in 1942, respondent seems never to have argued until now — and courts never to have held — that section 2038 applies to a transfer that was not from the decedent's own property.[12] We regard respondent's insistence on amending her answer to include section 2041 as an alternative ground for her determination as a confession of lack of confidence in her section 2038 argument. For all these reasons, we hold that the mere fact that property has been transferred through the exercise or release of a general power of appointment does not make that property subject to section 2038.

[10] The omission of a provision for general powers of appointment was quickly repaired, but in a different subsection. Revenue Act of 1918, ch. 18, sec. 402(e), 40 Stat. 1097-1098; Bittker & Clark, *Federal Estate and Gift Taxation* 383 (6th ed. 1990). The powers covered by the current secs. 2036-2038 remained in a separate ancestor subsection, sec. 402(c). It is interesting to note that sec. 202(b) of the Revenue Act of 1916, ch. 463, 39 Stat. 777-778, and sec. 402(c) of the Revenue Act of 1918, 40 Stat. 1097, while they did not cover general powers of appointment, did cover transfers made "in contemplation of death", the ancestor of the current sec. 2035. Bittker & Clark, *Federal Estate and Gift Taxation* 195-196 (6th ed. 1990). Subsecs. (c) and (e) of sec. 402 of the Revenue Act of 1918 were separated by subsec. (d) on joint interests (already present in the Revenue Act of 1916 as sec. 202(c)), just as secs. 2035-2038 (now joined by sec. 2039 on annuities, a new kind of transfer from the grantor) are now separated from sec. 2041 by the current section on joint interests, sec. 2040. All of this supports the view that the subject matters of secs. 2038 and 2041 are mutually exclusive.

[11] The issue of whether it would also apply to an unexercised power of appointment seems never to have arisen, which is to be expected, inasmuch as the tainted transfer presupposed by sec. 2038 would presumably not arise without the exercise of the power.

[12] The Commissioner has on one occasion, in *Ellis v. United States*, 280 F.Supp. 786, 788 (D. Md. 1968), argued in the alternative for the application of sec. 2036 (pertaining to interests with retained life estate) to part of a trust established by the decedent's grandmother in which the decedent had a life estate and the general power of appointment over which decedent had released (partially, but sufficiently for sec. 2041). The Commissioner's first argument in that case was for the application of sec. 2033. The court properly rejected both arguments. "The provisions of section 2041 as to partial release would be rendered meaningless if a general power

> of appointment that had been properly limited could be taxed under section 2033 or section 2036." *Id.* at 795.

Reg. § 20.2041-1(b)(2), "Relation to other sections," provides:

> For purposes of §§ 20.2041-1 to 20.2041-3, the term "power of appointment" does not include powers reserved by the decedent to himself within the concept of sections 2036 through 2038. (See §§ 20.2036-1 to 20.2038-1.) No provision of section 2041 or of §§ 20.2041-1 to 20.2041-3 is to be construed as in any way limiting the application of any other section of the Internal Revenue Code or of these regulations. The power of the owner of a property interest already possessed by him to dispose of his interest, and nothing more, is not a power of appointment, and the interest is includible in his gross estate to the extent it would be includible under section 2033 or some other provision of part III of subchapter A of chapter 11. For example, if a trust created by S provides for payment of the income to A for life with power in A to appoint the remainder by will and, in default of such appointment for payment of the income to A's widow, W, for her life and for payment of the remainder to A's estate, the value of A's interest in the remainder is includible in his gross estate under section 2033 regardless of its includibility under section 2041.

However, subject to any contrary savings clause, presumably the holder of a power to amend a trust or of a power of appointment could grant the settlor a general power of appointment.

III.B.5.f. State Death Taxes

III.B.5.f.i. State Death Tax - Generally

ACTEC's web page includes a chart maintained by former ACTEC president Charles "Skip" Fox, https://www.actec.org/resources/state-death-tax-chart.

For nonresidents, assume that the exemption is pro-rated compared to the entire taxable estate and then applied to property located in that estate.

As of 10/13/2020, the chart showed the following states imposed estate tax, with exemption levels following:

- Connecticut 2020: $5.1 million; 2021: $7.1 million; 2022: $9.1 million;2023: federal exemption for deaths on or after January 1, 2023 – all capped at estates of approximately $129 million.
- D.C. $5.6 million adjusted for inflation retroactive to January 1, 2018
- Hawaii $5 million adjusted for inflation retroactive to January 1, 2018; 20% rate for estates over $10 million
- Illinois $4 million, with separate state QTIP election, the latter confirmed by 35 ILCS 405/2(b-1).
- Maine $5.8 million – explained as federal exemption for decedents dying on or after January 1, 2016

- Maryland $5 million <u>not</u> adjusted for inflation
- Massachusetts $1 million
- Minnesota $3 million
- Nebraska county inheritance tax only
- New Jersey inheritance tax only
- New York $5 million adjusted for inflation
- Oregon $1 million
- Pennsylvania inheritance tax only, with separate state QTIP election
- Rhode Island $1.5 million indexed for inflation
- Vermont $5 million in 2021+
- Washington $2 million indexed for inflation

III.B.5.f.ii. State Death Tax – Business Entity Issues

Generally, an interest in a business entity is intangible personal property and is sitused to the owner's domicile. Generally, any property the business entity holds in another state would generate state income tax but not state estate tax.

However, some states purport to look through a business entity for state estate tax purposes. See below. Whether these states' laws are constitutional has not necessarily been tested. Morrow, Blattmachr and Shenkman, "Using Decanting and BDOT Provisions to Avoid a Peppercorn of Income Potentially Triggering State Income Tax on a Trust's Entire Income," *Steve Leimberg's Income Tax Planning Email Newsletter* Archive Message #205 (15-Sep-20) includes:

> Maine and Connecticut, for example, are trying to impose a state estate tax on real estate sitused in state even if it is owned in an LLC considered as intangible personal property of a non-resident decedent.[13]
>
> > [13] 36 M.R.S. § 4104, discussed in Maine Revenue Services' Estate Tax FAQ #9. Connecticut General Statues 12-391(e)(2)(B).
> >
> > [14] In *First National Bank v. Maine*, 284 U.S. 312, 52 S. Ct. 174, 76 L. Ed. 313 (U.S. 1932), the Supreme Court denied Maine the ability to levy an estate tax on a Massachusetts resident decedent who had owned stock in a Maine corporation that owned assets in Maine, under the due process clause of the Fourteenth Amendment to the Constitution. This case was overruled by *State Tax Comm'n of Utah v. Aldrich*, 316 U.S. 174 (1942), where the Court found that the state of incorporation also had enough nexus to levy an estate tax on the stock of a non-resident decedent who had owned stock in a corporation incorporated there (Utah). The Court's rationale for overruling *First National Bank v. Maine* completely focused on the laws of the state of

> incorporation (Utah in the latter case) creating the existence of the corporation, the nature and extent of the rights of the corporation and its shareholders and the legal protections Utah afforded as the state of incorporation – where the corporation owned property was not even mentioned, not even in the concurring opinion. Thus, following *Aldrich*, if someone places Maine or Connecticut real estate or other tangible property in an entity incorporated in the same state, those states could Constitutionally levy an estate tax at the shareholder/member's death. This begs the question – can Maine and Connecticut (or any other state with an estate tax) Constitutionally tax a non-resident decedent owning an LP/LLC/corporation that in turn owns property there, but that is NOT incorporated in that state (unlike Aldrich), without violating due process jurisprudence? Probably not, but it may in turn depend on whether the entity is required to register, or has registered, as a foreign entity, which states often require for entities that transact business in state (even if this rule may often be ignored). See *e.g.*, Uniform Limited Liability Company Act, § 902, § 905. The Court in *Aldrich* stated that a state that "has extended benefits or protection, or … can demonstrate "the practical fact of its power" or sovereignty as respects the shares, may likewise constitutionally make its exaction [*i.e.* estate tax]." An out-of-state LLC owning a vacation home would typically not be "transacting business" and therefore not be required to register as a foreign entity, but an LLC owning property used in business would be, and an LLC owning investment property could be, depending on the level of activity. *Id* at § 905(10) and comments. Wouldn't it be wise, considering the above two cases, for anyone with a potentially taxable estate owning vacation or passive investment property in a different state with an estate tax such as Maine or Connecticut, to own the property through an entity incorporated in a state without an estate tax?

For more constitutional issues, see part II.G.3 State Income Taxation (which includes resources as to issues other than income tax) and II.J.3.e.ii When a State Can or Does Tax a Trust's Income (which is focused on state income tax but can be relevant for estate tax purposes).

The list of states below is not intended to be comprehensive; it's just responses I have seen to this question generally.

III.B.5.f.ii.(a). Connecticut

Connecticut General Statues Chapter 217, "Estate Tax," is found at https://www.cga.ct.gov/current/pub/chap_217.htm.

Section 12-391(e)(2) provides:

> For a nonresident estate, the state shall have the power to levy the estate tax upon all real property situated in this state and tangible personal property having an actual situs in this state. The state is permitted to calculate the estate tax and levy said tax to the fullest extent permitted by the Constitution of the United States.

III.B.5.f.ii.(b). Maine

Maine Revenue Services, "Estate Tax FAQ," provides at https://www.maine.gov/revenue/faq/estate-tax#Q9 (Rev. 02/26/15):

9. **Maine property in a trust, LLC or pass-through entity is included in the estate of a nonresident decedent. What Maine property held by the trust, LLC or pass-through entity is sourced to Maine under 36 M.R.S. § 4104?**

Generally, Maine property held by a pass-through entity is sourced to Maine, if included in a nonresident decedent's estate, and:

1) The entity does not carry on a business for the purpose of profit and gain;

2) The ownership of the property in the entity was not for a valid business purpose; or

3) The property was acquired by other than a bona fide sale for full and adequate consideration and the decedent retained a power with respect to or interest in the property that would bring the real or tangible personal property located in this state within the decedent's adjusted federal gross estate.

See MRS Rule 603 for further, more comprehensive, information.

MRS Rule 603, "Maine Estate Tax After 2012," is found at https://www.maine.gov/revenue/sites/maine.gov.revenue/files/inline-files/Rule6032016-05-24.pdf, with Rule 603.01.B, "Pass-through entity," providing:[7233]

> "Pass-through entity" means a trust, a corporation that for the applicable tax year is treated as an S corporation under the Code or a general partnership, limited partnership, limited liability partnership, limited liability company or similar entity, that for the applicable tax year is not taxed as a C corporation for federal tax purposes.

III.B.5.f.ii.(c). Massachusetts

On November 24, 2020, a Massachusetts attorney I respect answered an inquiry, "Massachusetts Real Property in an LLC," as follows:

> So far as we can predict, the Massachusetts DOR currently does not seek to include real property situated in Massachusetts which is owned through an LLC as Massachusetts real estate subject to Massachusetts estate tax when owned by a non-Massachusetts resident; the LLC interests are treated as intangible personal property for Massachusetts estate tax purposes and not subject to Massachusetts estate tax is when owned by a nonresident.
>
> Note, however, that because the LLC interests are not includable for Massachusetts estate tax purposes, no Massachusetts estate tax return is required to be filed, and, therefore, there is no statute of limitations on the DOR's ability to seek to collect tax in the future in the event that the DOR decides to look through the entity and seek to collect tax on the value of the underlying real property. In 1986, proposed regulations were prepared that would have allowed such taxation of real property owned by Massachusetts partnerships owned by nonresident individuals; those regulations still exist but have never been finalized; Limited Liability Companies were not yet in use and are not mentioned in these regulations.

[7233] Rule 603.01, "Definitions," begins with, "The following definitions apply with respect to this rule and 36 M.R.S., Chapter 577, except as the context may otherwise require."

> We recommended, if your client decides to utilize an LLC as a vehicle to hold title to Massachusetts real estate, she planned to establish a multimember LLC in order that the LLC not be a disregarded entity for federal tax purposes.

III.B.5.f.ii.(d). Minnesota

2020 Minnesota Statutes § 291.005 (https://www.revisor.mn.gov/statutes/cite/291.005) provides in subsection (8):

> For a nonresident decedent with an ownership interest in a pass-through entity with assets that include real or tangible personal property, situs of the real or tangible personal property, including qualified works of art, is determined as if the pass-through entity does not exist and the real or tangible personal property is personally owned by the decedent. If the pass-through entity is owned by a person or persons in addition to the decedent, ownership of the property is attributed to the decedent in proportion to the decedent's capital ownership share of the pass-through entity.

It further provides in subsection (9):

> (9) "Pass-through entity" includes the following:
>
> (i) an entity electing S corporation status under section 1362 of the Internal Revenue Code;
>
> (ii) an entity taxed as a partnership under subchapter K of the Internal Revenue Code;
>
> (iii) a single-member limited liability company or similar entity, regardless of whether it is taxed as an association or is disregarded for federal income tax purposes under Code of Federal Regulations, title 26, section 301.7701-3; or
>
> (iv) a trust to the extent the property is includable in the decedent's federal gross estate; but excludes
>
> (v) an entity whose ownership interest securities are traded on an exchange regulated by the Securities and Exchange Commission as a national securities exchange under section 6 of the Securities Exchange Act, United States Code, title 15, section 78f.

Query what happens when a pass-through entity holds an interest in such property through another pass-through entity rather than directly.

Minnesota Department of Revenue Notice # 17-05, "Estate Tax – Pass-Through Entities – Calculation of Minnesota Gross Estate," is found at https://www.revenue.state.mn.us/revenue-notice/17-05-estate-tax-pass-through-entities-calculation-minnesota-gross-estate.

III.B.5.f.ii.(e). Oregon

On November 13, 2020, an Oregon attorney I respect answered an inquiry, "Oregon Fellows: Single Member LLC and Oregon Estate Tax," responding that holding an Oregon vacation residence in “a single member LLC will permit his estate to avoid Oregon estate tax on the value of the Oregon property.” This is confirmed by a comment in part III.B.5.f.ii.(f) Washington.

III.B.5.f.ii.(f). Washington

On October 22, 2020, an Oregon attorney I respect (who lives across the river from Washington) answered an inquiry, “State Estate Tax on Pass-Thru Owning Property in That State,” responding:

> Oregon and Washington honor entities such as LLCs and do not treat the underlying real estate as a tangible asset of the decedent. For Washington, this is a new policy starting 6/1/20.

The next day, a Spokane, Washington attorney responded:

> Actually Washington law has long provided that ownership interests in business entities (pass through or not) are treated as intangible personal property located in the state of the decedent’s domicile. But several years ago DOR slipped into the instructions to the return a provision that such would be the case only if the entity had a “business purpose”, and that the location of the underlying real estate would control if there was no business purpose. There was simply no authority for that position, and I suspect most practitioners ignored it when it was in their clients’ best interest to do so. What changed June 1 of this year is DOR announce that it had abandoned that business purpose test.

III.B.5.f.iii. Moving Property Outside of State Estate Tax System

If the pass-through entity is taxed as a partnership, the entity might distribute the property to its owners – usually on an income tax-free basis. See part II.Q.8.b.i Distribution of Property by a Partnership.

Once the property is outside of the entity, consider transferring using a leveraged estate planning technique. See part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

If that planning doesn’t seem to work, consider trying to freeze the value. See parts II.Q.7.h.viii Value Freeze as Conservative Alternative and II.E.7 Migrating into Partnership Structure.

Also consider borrowing all of the equity out of the entity. See part II.H.10 Extracting Equity to Fund Large Gift, which applies to more than just gifting.

III.B.5.g. Preserving Income Tax Benefits from Estate Tax Audits

An IRS audit (examination) may increase a taxable estate by increasing value or through inclusion described in part III.B.5.e.vi “String Provisions” of Code §§ 2035, 2036, 2038, and 2042, which is further described in parts III.C Code § 2036, III.D Code § 2038, and II.Q.4.i.ii Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity (Code § 2042).

When an audit disregards an entity and includes that entity's assets in the decedent's gross estate, those assets directly get a basis step-up.[7234]

When a business interest is included in the gross estate, see part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations, which explains when an entity's assets get a basis step-up, as described in part II.Q.8.e.iii.(a) Illustration of Inside Basis Issue.

- If a partnership interest is included in the gross estate, the partnership's assets can get a basis step-up through part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

- If S corporation stock is included in the gross estate, consider whether you can find any help from part II.H.8.a Depreciable Real Estate in an S Corporation – Possible Way to Replicate Effect of Basis Step-Up If the Stars Align Correctly, which is found in part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation; Possible Way to Attain Basis Step-Up.

Suppose Decedent died December 1, 2022 and the estate tax return, which ordinarily would have been due August 1, 2023, is extended by 6 months to February 1, 2024. The statute of limitations for auditing the estate tax return would ordinarily run February 1, 2027. The IRS can audit the return before then, and if the case goes to court then it might not conclude until much later than that.

Suppose further that, after December 1, 2022, Decedent's (formerly) revocable trust sells or depreciates or amortized (or would have depreciated or amortized) an asset that was directly or indirectly included in Decedent's gross estate – whether the estate tax return claimed that inclusion or an IRS audit or court decision determined that inclusion. Code § 1016(a)(2) reduces an assets basis by the amount of depreciation or amortization allowable, even if the taxpayer did not actually deduction the depreciation or amortization, so preserving the right to deduct these items is as important as (but generally of a smaller magnitude than) claiming basis on the sale of an asset.

If a taxpayer cannot yet amend an income tax return with Form 1040-X (or other relevant form),[7235] then consider filing a protective claim for refund. IRS Publication 556 describes the process:[7236]

> **Protective claim for refund.** If your right to a refund is contingent on future events and may not be determinable until after the time period for filing a claim for refund expires, you can file a protective claim for refund. A protective claim can be either a formal claim or an amended return for credit or refund. Protective claims are often based on current litigation or expected changes in the tax law, other legislation, or regulations. A protective claim preserves your right to claim a refund when the contingency is resolved.

[7234] See fn 5695 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).
[7235] https://www.irs.gov/forms-pubs/about-form-1040x (last checked 1/8/2023).
[7236] https://www.irs.gov/publications/p556#en_US_201312_publink1000177001 (last checked 1/8/2023).

A protective claim does not have to state a particular dollar amount or demand an immediate refund. However, to be valid, a protective claim must:

- Be in writing and be signed,
- Include your name, address, social security number or individual taxpayer identification number, and other contact information,
- Identify and describe the contingencies affecting the claim,
- Clearly alert the IRS to the essential nature of the claim, and
- Identify the specific year(s) for which a refund is sought.

Generally, the IRS will delay action on the protective claim until the contingency is resolved. Once the contingency is resolved, the IRS may obtain additional information necessary to process the claim and then either allow or disallow the claim.

Mail your protective claim for refund to the address listed in the instructions for Form 1040X, under Where To File.

If a partnership interest is includible in a decedent's gross estate, check to see whether this partnership and every partnership in which it directly or indirectly has interest has made a Code § 754 election and is aware of the need to protect the right to make further adjustments. See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000. In fact, each decedent's estate, revocable trust, etc. is required to notify the partnership of the decedent's death.[7237]

When an amended return can't generate tax fairness, a taxpayer may seek the relief described in part II.G.4.m Fixing Unfair Income Tax Results. However, *O'Neill Trust v. Commissioner*, T.C. Memo. 2022-108,[7238] gave the taxpayer no relief because the taxpayer failed to preserve its rights.

III.B.5.h. Penalties for Failure to File Estate Tax Return

U.S. v. Boyle, 469 U.S. 241, 246 (1985), held that a taxpayer cannot rely on an expert as to the deadline for filing a tax return:

> We need not dwell on the similarities or differences in the facts presented by the conflicting holdings. The time has come for a rule with as "bright" a line as can be drawn consistent with the statute and implementing regulations.[6] Deadlines are inherently arbitrary; fixed dates, however, are often essential to accomplish necessary results. The government has millions of taxpayers to monitor, and our system of self-assessment in the initial calculation of a tax simply cannot work on any basis other than one of strict filing standards. Any less rigid standard would risk encouraging a lax attitude toward

[7237] See fns 5716-5717 and accompanying text in part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.
[7238] For relevant excerpts from the case, see part II.G.4.m.i Code § 1341 Claim of Right Deduction.

filing dates.[7] Prompt payment of taxes is imperative to the government, which should not have to assume the burden of unnecessary ad hoc determinations.[8]

[6] The administrative regulations and practices exempt late filings from the penalty when the tardiness results from postal delays, illness, and other factors largely beyond the taxpayer's control. See supra, at 2-3, and n. 1. The principle underlying the IRS regulations and practices—that a taxpayer should not be penalized for circumstances beyond his control—already recognizes a range of exceptions which there is no reason for us to pass on today. This principle might well cover a filing default by a taxpayer who relied on an attorney or accountant because the taxpayer was, for some reason, incapable by objective standards of meeting the criteria of "ordinary business care and prudence." In that situation, however, the disability alone could well be an acceptable excuse for a late filing.

But this case does not involve the effect of a taxpayer's disability; it involves the effect of a taxpayer's reliance on an agent employed by the taxpayer, and our holding necessarily is limited to that issue rather than the wide range of issues that might arise in future cases under the statute and regulations. Those potential future cases are purely hypothetical at the moment and simply have no bearing on the issue now before us. The concurring opinion seems to agree in part. After four pages of discussion, it concludes:

> "Because the respondent here was fully capable of meeting the required standard of ordinary business care and prudence, we need not decide the issue of whether and under what circumstances a taxpayer who presents evidence that he was unable to adhere to the required standard might be entitled to relief from the penalty." Post, at 4.

This conclusion is unquestionably correct. See also, e.g., *Reed v. Ross*, __ U.S. __, __, n. 5 (1984); *Heckler v. Day*, __ U.S. __, __, nn. 33 and 34 (1984); *Kosak v. United States*, __ U.S. __, __, n. 8 (1984); *Bell v. New Jersey*, __ U.S. __, __, n. 4 (1983).

[7] Many systems that do not collect taxes on a self-assessment basis have difficulties in administering tax collection. See J. Wagner, France's Soak-the-Rich Tax, Congressional Quarterly (Editorial Research Reports), Oct. 12, 1982; Dodging Taxes in the Old World, Time, Mar. 28, 1983, p. 32.

[8] A number of courts have indicated that "reasonable cause" is a question of fact, to be determined only from the particular situation presented in each particular case. See, e.g., *Estate of Mayer v. Commissioner*, 351 F.2d 617, 617 (CA2 1965) (per curiam), *cert. denied*, 383 U.S. 935 (1966); *Coates v. Commissioner*, 234 F.2d 459, 462 (CA8 1956). This view is not entirely correct. Whether the elements that constitute "reasonable cause" are present in a given situation is a question of fact, but what elements must be present to constitute "reasonable cause" is a question of law. See, e.g., *Haywood Lumber & Mining Co. v. Commissioner*, 178 F.2d 769, 772 (CA2 1950); *Daley v. United States*, 480 F. Supp. 808, 811 [45 AFTR2d 80-1717] (ND 1979). When faced with a recurring situation, such as that presented by the instant case, the Courts of Appeals should not be reluctant to formulate a clear rule of law to deal with that situation.

Congress has placed the burden of prompt filing on the executor, not on some agent or employee of the executor. The duty is fixed and clear; Congress intended to place upon the taxpayer an obligation to ascertain the statutory deadline and then to meet that deadline, except in a very narrow range of situations. Engaging an attorney to assist in the probate proceedings is plainly an exercise of the "ordinary business care and prudence" prescribed by the regulations, 26 CFR §301.6651-1(c)(1) (1984), but that does not provide an answer to the question we face here. To say that it was "reasonable" for the executor to assume that the attorney would comply with the statute may resolve the matter as between them, but not with respect to the executor's obligations under the statute. Congress has charged the executor with an unambiguous, precisely defined duty to file the return within nine months; extensions are granted fairly routinely. That the attorney, as the executor's agent, was expected to attend the matter does not relieve the principal of his duty to comply with the statute.

This case is not one in which a taxpayer has relied on the erroneous advice of counsel concerning a question of law. Courts have frequently held that "reasonable cause" is established when a taxpayer shows that he reasonably relied on the advice of an accountant or attorney that it was unnecessary to file a return, even when such advice turned out to have been mistaken. See, e.g., *United States v. Kroll*, 547 F.2d 393, 395-396, (CA7 1977); *Commissioner v. American Association of Engineers Employment, Inc.*, 204 F.2d 19, 21 (CA7 1953); *Burton Swartz Land Corp. v. Commissioner*, 198 F.2d 558, 560 (CA5 1952); *Haywood Lumber & Mining Co. v. Commissioner*, 178 F.2d 769, 771 (CA2 1950); *Orient Investment & Finance Co. v. Commissioner*, 166 F.2d 601, 603 (CADC 1948); *Hatfried, Inc. v. Commissioner*, 162 F.2d 628, 633-635 (CA3 1947); *Girard Investment Co. v. Commissioner*, 122 F.2d 843, 848 (CA3 1941); *Dayton Bronze Bearing Co. v. Gilligan*, 281 F. 709, 712 (CA6 1922). This Court also has implied that, in such a situation, reliance on the opinion of a tax advisor may constitute reasonable cause for failure to file a return. See *Commissioner v. Lane-Wells, Co.*, 321 U.S. 219 (1944) (remanding for determination whether failure to file return was due to reasonable cause, when taxpayer was advised that filing was not required).[9]

[9] Courts have differed over whether a taxpayer demonstrates "reasonable cause" when, in reliance on the advice of his accountant or attorney, the taxpayer files a return after the actual due date but within the time the advisor erroneously told him was available. Compare *Sanderling, Inc. v. Commissioner*, 571 F.2d 174, 178-179 (CA3 1978) (finding "reasonable cause" in such a situation); *Estate of Rapelje v. Commissioner*, 73 T.C. 82, 90 n. 9 (1979) (same); *Estate of DiPalma v. Commissioner*, 71 T.C. 324, 327 (1978) (same), acq., 1979-1 Cum. Bull. 1; *Estate of Bradley v. Commissioner*, 33 TCM 70, 72-73 (1974) (same) *aff'd* 511 F.2d 527 (CA6 1975), with *Estate of Kerber v. United States*, 717 F.2d 454, 454-455, and n. 1 (CA8 1983) (per curiam) (no "reasonable cause"), *cert. pending*, No. 83-1038; *Smith v. United States*, 702 F.2d 741, 742 (CA8 1983) (same); *Sarto v. United States*, 563 F.Supp. 476, 478 [(ND Cal. 1983) (same). We need not and do not address ourselves to this issue.

When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. See

> *Haywood Lumber*, 178 F.2d, at 771. “Ordinary business care and prudence” does not demand such actions.
>
> By contrast, one does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due. In short, tax returns imply deadlines. Reliance by a lay person on a lawyer is of course common; but that reliance cannot function as a substitute for compliance with an unambiguous statute. Among the first duties of the representative of a decedent’s estate is to identify and assemble the assets of the decedent and to ascertain tax obligations. Although it is common practice for an executor to engage a professional to prepare and file an estate tax return, a person experienced in business matters can perform that task personally. It is not unknown for an executor to prepare tax returns, take inventories, and carry out other significant steps in the probate of an estate. It is even not uncommon for an executor to conduct probate proceedings without counsel.
>
> It requires no special training or effort to ascertain a deadline and make sure that it is met. The failure to make a timely filing of a tax return is not excused by the taxpayer’s reliance on an agent, and such reliance is not “reasonable cause” for a late filing under §6651(a)(1).

Leighton v. U.S., 155 Fed. Cl. 543 (Ct. Fed. Cl. 2021), denied the government’s motion to dismiss the taxpayer’s claim for refund of a penalty for late filing of an estate tax return when the income tax preparers had not informed the executor of the decedent’s prior gift tax returns, so that the executor’s tax advisor did not know that adjusted taxable gifts had pushed the estate above filing levels (highlighting below is mine):

> **i. Reasonable Cause**
>
> Before discussing whether the Executor’s pleadings establish a viable claim, the Court will briefly discuss what constitutes “reasonable cause.” I.R.C. § 6651(a) specifies that penalties shall not be imposed if the failure to timely file the return at issue is due to reasonable cause and not willful neglect. The implementing regulation provides: “If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return [or pay the tax] within the prescribed time, then the delay is due to a reasonable cause.” Treas. Reg. § 301.6651-1(c)(1).
>
> “Reasonable cause” is interpreted to “make the absence of fault a prerequisite to avoidance of the [failure-to-file and failure-to-deposit] penalt[ies].” *Boyle*, 469 U.S. at 246 n.4. Taken together with the requirement that the failure not be due to “willful neglect,” the taxpayer seeking a refund must allege that its untimely filing or payment “was the result neither of carelessness, reckless indifference, nor intentional failure.” *Id*. Essentially, a failure to file must have been “beyond the taxpayer’s control” in order to avoid penalty. *Id*. at 248 n.6. “Reasonable cause” must be shown by demonstrating “the taxpayer exercised ordinary business care and prudence” but was nevertheless unable to file the return or pay the tax within the prescribed time. Treas. Reg. § 301.6651-1(c)(1). The taxpayer’s claim must not be based on mere negligence, nor forgivable mistake, but must allege compliance was thwarted by events beyond the taxpayer’s control. *All Stacked Up Masonry, Inc.*, 150 Fed. Cl. at 548.
>
> Other provisions of IRS regulations state that “[t]he determination of whether a taxpayer acted with reasonable cause...is made on a case-by-case basis, taking into account all

pertinent facts and circumstances." Treas. Reg. § 1.6664-4(b)(1). The regulations further state that "[c]ircumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer." *Id*. The regulations advise that "[r]eliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith[,]" unless, "under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith." *Id*.

ii. Adequate Pleading of Reasonable Cause

The Court must now decide if the Executor's pleading, when taken as true, could plausibly establish reasonable cause for the estate's belated tax filing. The United States argues that this belated filing was unreasonable at every turn - Mr. Allen's advice was unreasonable, Executor's reliance on the advice was unreasonable, and the unavailability of the tax information itself was unreasonable. (See generally Def.'s Mot.). Each of those arguments is based on the finding that someone, somewhere should have known about the 2012 gift tax form. As explained below, the Court is not able to make that decision at this nascent stage of litigation.

When evaluating whether reasonable cause exists, the Federal Circuit focuses its analysis of whether the advice was that of a competent and independent professional advisor on several factors. Those factors include: (1) whether "the advice was based on all pertinent facts and circumstances and the law as it relates to those facts and circumstances"; (2) whether the advice was based on any "unreasonable factual or legal assumptions," or "unreasonably [relied] on the representations, statements, findings, or agreements of the taxpayer or any other person"; and (3) whether the taxpayer's reliance on the advice was "objectively reasonable." *Stobie Creek Invs. LLC v. United States*, 608 F.3d 1366, 1381 (Fed. Cir. 2010). Whether these factors are present in each situation is a question of fact, but what elements must be present to constitute reasonable cause is a question of law. *Estate of Liftin*, 111 Fed. Cl. at 13 (citing 26 U.S.C.A. §§ 6651(a)(1)). Generally, a taxpayer may establish reasonable cause for failing to file a timely return to avoid penalty by establishing reasonable reliance on the advice of an accountant or attorney, even if it is later established that such advice was erroneous or mistaken. *Thomas v. Comm'r*, 82 T.C.M. (CCH) 449 (T.C. 2001), 2001 WL 919858 (citing 26 U.S.C. §§ 6651(a)(1)).

The United States argues that the advice that Executor received pertaining to whether he needed to file an estate tax return was objectively unreasonable. (Def.'s Mot. at 10). First, the United States asserts that Mr. Allen's advice was not "based on all the pertinent facts and circumstances" because that advice did not account for the 2012 gifts made by the Decedent. (*Id*. at 11). This circular argument is unavailing. A finding for the United States on this point would also mean that missing information could never constitute reasonable cause because advice would necessarily not be based on all pertinent facts and circumstances. As such, this argument is not a valid reason for dismissal.

The United States goes on to argue that Mr. Allen's tax advice was unreasonable because his "blind faith in JDJ Services regarding the Decedent's lifetime gifts" does not constitute due diligence. (*Id*. at 11, 12). The Federal Circuit has found that a failure to perform due diligence amounts to unreasonable reliance on the statements of others.

Russian Recovery Fund Limited v. United States, 851 F.3d 1253 (Fed. Cir. 2017). *Russian Recovery Fund* involved a situation where the plaintiff's outside accounting firm "did no independent investigation into the factual accuracy of the information that [a related individual] supplied." 851 F.3d at 1269. The facts differ from this case because, in *Russian Recovery Fund*, the taxpayer provided its tax preparation firm with a "self-interested" version of the relevant facts "orchestrated by [the taxpayer] to achieve a desired result and were not critically evaluated by [the tax preparer]." *Id*. (quoting *Russian Recovery Fund Ltd. v. United States*, 122 Fed. Cl. 600, 622 (2015)). In this situation, the Amended Complaint enumerates various steps taken in coordinating the estate, including an exchange of a questionnaire about the valuation of the estate. (Am. Compl. at 3-4). At this stage, the Court must accept as true that the steps outlined in the pleadings were taken to their most reasonable extent. Requiring a more detailed recount of those events runs counter to this Court's well-established pleading standards. Tax advisors cannot reasonably give advice on unavailable information. While the Court accepts as true that Mr. Allen's investigation did not reveal the existence of the 2012 trusts, without more evidence, the Court is unable to discern whether that factual investigation constituted reasonable due diligence.

The United States goes on to argue that, because Executor is the sole party responsible for the belated filings, he therefore cannot demonstrate reasonable reliance on the advice of his agent. (Def.'s Mot. at 14-15). Taxpayers are free to hire an agent of their choosing in the preparation of their taxes, but that does not relieve the taxpayer of its legal obligations under the tax code, and any carelessness, reckless indifference, or intentional failure by the taxpayer's agent or employee is attributable to the taxpayer. See *Boyle*, 469 U.S. at 250. Further, reliance on advisors is generally an insufficient excuse for relief from the late-filing and late-payment penalties because filing and payment deadlines are unambiguous. *Id*. at 249. The Boyle Court recognized other scenarios which could establish reasonable cause. For instance, the Supreme Court held that taxpayers may reasonably rely on advice concerning whether - but not when - a return must be filed. 469 U.S. at 250-51, see also *Carmean v. United States*, 4 Cl. Ct. 181, 185 (1983) ("[W]hen there is no question that a return must be filed, the taxpayer has a personal, non-delegable duty to file the return when due."). In the scenarios contemplated by *Boyle*, the Supreme Court does not address misapprehensions of fact or the responsibility of taxpayers in tendering relevant information to their tax advisors. The question that is left open is whether reasonable cause can be established when, as in this case, the taxpayer and its agents act on incorrect information.

A taxpayer has acted reasonably when they have "exercised ordinary business care and prudence...." I.R.M.4 § 20.1.1.3.2.2.3. Ultimately it is the duty of a taxpayer to provide the information available to agents authorized in preparation of their taxes, thus the Court must examine whether the position taken by the taxpayer is reasonable. It is a pillar of the tax code that a taxpayer is expected to file a timely return based on the best information available and then file an amended return if necessary. See *Thomas*, 82 T.C.M. (CCH) 449. As a general rule, a taxpayer is not obliged to share details with a tax preparer that a reasonably prudent taxpayer would not know; neither is the taxpayer obligated to share details that he himself would neither know nor reasonably should know are relevant. *Pankratz v. Comm'r of Internal Revenue*, 121 T.C.M. (CCH) 1178 (T.C. 2021) (citing 26 C.F.R. § 1.6664-4(c)(1)(i)). In determining whether a taxpayer's behavior was reasonable, important considerations, however, include "[w]hy the records were unavailable and what steps were taken to secure the records," "[w]hen and how the taxpayer became aware that [it] did not have the necessary records," whether "other means were explored to secure needed information," whether "the taxpayer contacted the IRS for instructions on what to do about missing information," and the effort expended to obtain the missing information. I.R.M. § 20.1.1.3.2.2.3. The determination of whether a taxpayer acted with reasonable cause and in good faith is a factual issue. Treas. Reg. § 1.6664-4(b)(1). If a taxpayer fails to disclose a fact that it reasonably should know that would affect the tax treatment of an item, then the taxpayer cannot be considered to have relied in good faith upon the preparer's advice. *Neonatology Associates, P.A. v. C.I.R.*, 115 T.C. 43, Tax Ct. Rep. Dec. (RIA) 115.5, 2000 WL 1048512 (2000), *decision aff'd*, 299 F.3d 221, (3d Cir. 2002).

There is no dispute that the Decedent's lifetime gifts impacted whether an estate tax return was required and that Mr. Allen acted promptly once he obtained a copy of the 2012 gift tax return. Thus, the inquiry as to whether the Executor acted reasonably is largely dependent on the availability of the missing 2012 gift tax return. The United States argues that the 2012 gift tax return was in Freshwater's possession all along, thus it should have also been reasonably known by the Executor. This involves a factual inquiry beyond the record before the Court. The Amended Complaint alleges that the Executor made a diligent effort to identify lifetime gifts made by the Decedent, including making inquiries to Freshwater. What were the circumstances surrounding the gift tax form? Was it misfiled, intentionally hidden, willfully ignored? The Court is unclear at what point the availability of the document and exhaustive searching becomes enough to rise to the level of reasonable cause for a late filing. The specific details surrounding the inquiries to Freshwater are not pled before the Court, nor are they required at this stage. Whether those inquiries were actually diligent presents a question of fact not suitable at the dismissal stage. At this point, the Amended Complaint alleges sufficient facts to raise an expectation that discovery may reveal evidence to support the Executor's allegations.

The United States' arguments fail because each of them presupposes that one or more of the parties should have known that the estate's valuation went beyond the threshold for filing an estate tax form. The marrow of the Executor's case cannot be summarily described as "bad tax advice," but instead as advice without all pertinent information and based on a misapprehension of fact. Therefore, the United States' arguments can be affirmed or negated by answering a single question: should the Executor or his tax advisors have known about the Decedent's funded trusts prior to their unveiling in 2019? There is simply not enough information to answer that question. At the pleading stage, the Court must take the Executor's allegations as true and view them in the light most favorable to him. To the extent the United States dispute these allegations, that is a factual inquiry not suitable for resolution on a motion to dismiss.

III.B.6. Marital Deduction Considerations and Related Planning

A gift to a spouse did not qualify for the marital deduction when all parties expected the spouse to make a subsequent gift, the spouse was not a permitted transferee and the transfer to the spouse was not consented to, and the affected partnership return did not report the spouse as an owner for even one day. *Smaldino v. Commissioner*, T.C. Memo. 2021-127.

III.B.6.a. Trusts Qualifying for the Marital Deduction

In most cases, a marital trust should authorize the surviving spouse to direct the trustee to make the property productive.

Buy-sell agreements can ruin the marital deduction if they have the effect of transferring property away from the surviving spouse for less than adequate and full consideration.

The spouse must be entitled to income for life and must be the sole person who may receive principal during the spouse's life (subject to the surviving spouse having an inter vivos power of appointment for a general power of appointment marital deduction trust under Code § 2056(b)(5)). "Among the powers which if subject to reasonable limitations will not disqualify the interest passing in trust" is "the power to apply the income or corpus for the benefit of the spouse."[7239] Thus, to provide asset protection from creditors (to the extent available) and for distributions upon the spouse's incapacity, a marital deduction trust may provide language authorizing payments to or for the benefit of the spouse.[7240]

III.B.6.b. Discount Planning Related to Marital Deduction Trusts

Marital trusts are included in the surviving spouse's gross estate at the surviving spouse's death. A QTIP trust is included under Code § 2044; however, their assets are not aggregated with the surviving spouse's other assets.[7241] For example, suppose a QTIP trust owned 30% of the voting stock of a corporation, and the surviving spouse owned 40% of the voting stock outright. Even though 70% of the voting stock is included in the surviving spouse's gross estate, each block is valued separately as stock that lacks control.

Contrast this with a general power of appointment trust, which is included in the surviving spouse's gross estate under Code § 2041. Assets included under Code § 2041 are aggregated with other assets. In the example above, if the marital trust were a general power of appointment trust instead of a QTIP trust, the surviving spouse's gross estate would be deemed to own a controlling 70% voting bloc.

If the spouses have a high degree of trust in each other, the author tends to include in a QTIP trust a 5% withdrawal right exercisable only during a limited duration each year (two weeks, for example). The enables the surviving spouse to withdraw stock and make gifts without having to justify a principal encroachment. If the surviving spouse dies during the period in which the surviving spouse can withdraw 5%, the withdrawal right is considered a general power of

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[7239] Reg. § 20.2056(b)-5(f)(4).

[7240] Rev. Rul. 85-35 approved a marital deduction for the following situation:

> State X has a statute that provides that the trustee has the discretion to pay any sum distributable to a beneficiary under legal disability, without liability to the trustee, by paying the sum to the beneficiary or by paying the sum for the use of the beneficiary either to a legal representative appointed by the court, or if none, to a relative.
>
> A similar provision relating to trustee powers appeared in the trust instrument, which also specifically requires the trust income to be paid at least annually to the spouse, legal representative, or relative of the spouse. Further, the fiduciary standards imposed by state X prevent the abuse of the powers by the trustee and constrain the conduct of any third party distributee.

Estate of Whiting v. Commissioner, T.C. Memo. 2004-68, held that, although a disability clause permitted accumulation of income, that clause was superseded by the marital deduction savings clause. Letter Ruling 201117005 approved a marital deduction in which the trustee could pay or apply for the benefit of the spouse, as well as having some elaborate unitrust options. Letter Ruling 8901008 45 denied a marital deduction when the trustee was to distribute as much income as the trustee deemed necessary and prudent. Thus, all of the income must be distributed annually, but distributions may be in the form of paying the spouse's bills or paying to others who must spend it for the spouse's benefit. Highlighted excerpts of all of the above are in Thompson Coburn LLP doc. no. 6507787.

[7241] See part II.O.2, Spousal Issues in Buy-Sell Agreements and Related Tax Implications, footnote 3792.

appointment, with all the negative consequences described above, but only with respect to 5% of the trust. If the withdrawal right lapses, the lapse is not treated as a release of a general power of appointment, and the entire trust retains its QTIP segregation for estate valuation purposes.

Another strategy a surviving spouse can use is to sell a voting interest to a credit shelter trust. If the surviving spouse is a beneficiary of the credit shelter trust, consider having the trust overpay for the voting stock, documenting the transaction as part sale, part distribution. This should preclude the IRS from successfully arguing that the surviving spouse made a gift to the trust (if the IRS were to successfully revalue the stock as worth more than what the surviving spouse thought it was worth); such a gift could create future Code § 2036 inclusion issues.

III.B.6.c. Irrevocable Inter Vivos QTIP Trust

An irrevocable inter vivos QTIP trust can also come in handy when one spouse wants to leave the business directly to children instead of to the other spouse. Suppose Husband has $1 million in cash or marketable securities, and Wife owns the closely-held business. Husband transfers that to an irrevocable inter vivos QTIP trust for wife where Wife is the trustee and has a special power of appointment. After recapitalizing the corporation into voting and nonvoting stock, Wife sells voting stock with an estimated fair market value for $600,000 to the trust in exchange for $1 million. The sale should not be not subject to income tax.[7242] The $400,000 excess of value over purchase price is a distribution from the trust to Wife. If the IRS audits the transfer, it can increase the voting stock's value to as much as $1 million before considering any adverse estate tax consequences under Code §§ 2036 and 2038.[7243]

An inter vivos QTIP trust can also come in handy when transferring assets shortly before death. Code § 1014(e) prevents a basis step-up when one spouse gives assets to another within one year of the donee's death.[7244] Whether an outright sale from the surviving spouse to the almost-deceased spouse works depends on whether the treatment of a sale between spouses as a transfer by gift under Code § 1014 applies for purposes of Code § 1014(e)(1)(A). However, a sale to an inter vivos QTIP trust that is deemed owned by the grantor who is the soon-to-be surviving spouse, can convincingly prevent Code § 1014(e) from applying:

- If Code § 1014(e)(1)(A) looks to transfers for income tax purposes, then nothing has happened at the time of the sale (disregarded transaction rather than transfer by gift), so Code § 1014(e)(1)(A) would not apply. Disregarding the sale for income tax purposes is founded on Rev. Rul. 85-13 and confirmed by Letter Ruling 200408015.[7245]

[7242] For more details on the tax treatment, see part III.B.2.i.xv Sale to Trust Created by Spouse.
[7243] An adverse tax consequence could occur if wife did not receive adequate and full consideration for the stock she transferred to the trust.
[7244] For more on Code § 1014(e), see Letter Rulings 9026036, 9321050, 200210051 and 200101021 and read Siegel, "Section 1014(e) and Gifted Property Reconveyed in Trust," 27 *Akron Tax Journal* 33 (2012). Generally, if the decedent sets up a trust for the person who transferred property to the decedent within one year before the decedent's death, the basis step-up would be disallowed to the extent of the value of the transferor's beneficial interest. For valuing a beneficial interest, see parts III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts and III.B.7.d Code § 2702 Overview.
[7245] Letter Ruling 200408015 is discussed further in fn. 7398, found in part III.B.7.d Code § 2702 Overview.

- If Code § 1014(e)(1)(A) looks to transfers for state law purposes, then Code § 1041 would not apply because that is an income tax rule and does not change the status for state law purposes. For state law purposes, the sale to the QTIP trust is a sale, not a gift. Therefore, Code § 1014(e)(1)(A) would not apply.

Also, after the donee spouse dies, if the property passes back to a trust for the grantor, then the trust is deemed owned by the grantor for income tax purposes; if this trust is outside of the estate tax system at that time, then one has a powerful tool – a trust outside of the estate tax system that is taxed to the original grantor (so long as the donee spouse did not exercise a general power of appointment,[7246] which is unlikely to be present in a QTIP trust).[7247]

When an inter vivos QTIP trust holds stock in an S corporation, consider making an ESBT election while both spouses are living.[7248]

III.B.6.d. Divorce as an Opportunity to Transfer

Code § 2516, "Certain property settlements," protects certain transfers that are solely between spouses from gift tax consequences:

> Where a husband and wife enter into a written agreement relative to their marital and before such agreement is entered into (whether or not such agreement is approved by the divorce decree), any transfers of property or interests in property made pursuant to such agreement -
>
> (1) to either spouse in settlement of his or her marital or property rights, or
>
> (2) to provide a reasonable allowance for the support of issue of the marriage during minority,
>
> shall be deemed to be transfers made for a full and adequate consideration in money or money's worth.

The modification of a qualifying decree outside of that 3-year period may be respected.[7249]

[7246] Reg. § 1.671-2(e)(5), which is reproduced in fn 6620 in part III.B.2.h.i Who Is the Grantor.

[7247] See Gans, Blattmachr & Zeydel, "Supercharged Credit Shelter Trust," 21 *Prob. & Prop.* 52 (July/Aug. 2007).

[7248] See part III.A.3.a.iii Steps an S Corporation Might Take to Avoid a Trust Falling Short, especially fns. 5881-5882.

[7249] Letter Ruling 201901003 held:

> In this case, the divorce of A and B occurred less than 1 year before Stipulation and Order 1 was entered by Court. Therefore, stipulations governing Property under Stipulation Order 1 are within the purview of section 2516. Accordingly, transfers that A and B make pursuant to Stipulation and Order 1 are deemed made for full and adequate consideration in money or money's worth and, thus, are not subject to the gift tax.
>
> The purchase price stipulated in Stipulation and Order 2 is consistent with the purchase stipulated in Stipulation and Order 1. Both Stipulation and Order 1 and Stipulation and Order 2 call for the transfer of a one-half interest in Property in exchange for a purchase price equal to one-half of the fair market value of Property, calculated after A and B share equally the cost of paying off the mortgage and the costs related to maintenance, upkeep, remediation and repair of Property. Court entered Stipulation and Order 2 to effectuate, under changed circumstances, transfers

However, including children or others as transferees generates a gift from the spouse whose marital rights are foregone in exchange for including the children or other transferees.[7250] Bequests to non-spouse beneficiaries pursuant to a prenuptial agreement are not deductible claims against the estate.[7251]

Code § 2702 has complementary rules.[7252]

The resulting legal obligation can be a deductible claim against the estate of an owner who was legally bound to make such a transfer.[7253]

See also parts III.B.7.b.iv Divorce Planning to Avoid Code § 2701 and II.O.2.b Divorce – Income Tax Issues Relating to Buy-Sell Agreements.

On the other end, Rev. Rul. 69-347 held that the date of marriage is the effective date of a gift of property made pursuant to a legally enforceable antenuptial agreement:

> In 1965, a taxpayer and his intended wife entered into a written antenuptial agreement which provided that, in consideration of the marriage and the wife's relinquishment of her marital rights in her husband's property, the husband would pay her a fixed amount per year beginning one year after the date of their marriage and continuing for twenty years thereafter or until the wife's death, whichever event occurred first. The taxpayer and his wife were married in 1966 and the husband made the first payment in 1967.
>
> Although antenuptial agreements are enforceable under state law when consummated by marriage, 3 Williston on Contracts, section 270B (3d ed.1959), transfers made pursuant to such agreements are not made for an adequate and full consideration in money or money's worth within the meaning of section 2512(b) of the Internal Revenue Code of 1954. Commissioner v. William H. Wemyss, 324 U.S. 303 (1945), Ct. D. 1634, C.B. 1945, 416. Such consideration as love and affection, promise of marriage, or relinquishment of dower or other marital rights is to be wholly disregarded and the entire value of the property transferred constitutes a gift. Section 25.2512-8 of the Gift Tax Regulations.
>
> Section 2501 of the Code imposes a tax on the transfer of property by gift by any individual. The gift tax is not imposed upon the receipt of property by the donee, nor is it

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> contemplated in Stipulation and Order 1 to resolve ultimate ownership of Property. Therefore, section 2516 is applicable to transfers A and B made pursuant to Stipulation and Order 2, and these transfers are deemed made for full and adequate consideration in money or money's worth and, thus, are not subject to the gift tax.
> Accordingly, based on the facts submitted and representations made, we conclude that the payment by A to B of the Net Purchase Price and the corresponding transfer by B to A of B's 50 percent interest in Property constitute transfers for full and adequate consideration in money or money's worth under section 2516 that do not result in a taxable gift by either A or B.

[7250] Rev. Ruls. 68-379, 77-314, and 79-363.

[7251] *Estate of Spizzirri v. Commissioner*, T.C. Memo. 2023-25, citing *Estate of Pollard v. Commissioner*, 52 T.C. 741 (1969) and *Estate of Herrmann v. Commissioner*, T.C. Memo. 1995-90, *aff'd* 85 F.3d 1032 (2d Cir. 1996).

[7252] Regs. §§ 25.2702-1(c)(7) (no consequences if only the spouses are involved), 25.2702-4(d), Example (5) (remainder to children not protected by this exception); Letter Ruling 9235032 (giving spouse a qualified retained interest ascribes value to it for purposes of Code § 2516).

[7253] I have been told that support for this position is in *Estate of Kosow v. Commissioner*, 45 F.3d 1524 (11th Cir. 1995).

necessarily determined by the measure of enrichment resulting to the donee at the time of the transfer. The tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches at the time such property passes, regardless of the fact that the identity of the donee may not then be known or ascertainable. Section 25.2511-2(a) of the regulations. See also *Meta B. Robinette v. Helvering*, 318 U.S. 184 (1943), Ct. D. 1574, C.B. 1943, 1141.

The gift tax is aimed at every kind and type of transfer by way of gift, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible. Section 25.2511-1(a) of the regulations. Generally, a gift is complete when the donor has so parted with dominion or control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another. Section 25.2511-2(b) of the regulations.

In *John D. Archbold v. Commissioner*, 42 B.T.A. 453 (1940) (acquiescence in result only, page 20, this Bulletin) the taxpayer and his intended wife entered into an antenuptial agreement in 1936. Under the terms of the agreement, the taxpayer agreed to transfer 10x dollars to a trust for the benefit of his wife in each of the next nine years. The agreement did not become legally enforceable until the marriage, which took place in 1937. The Service asserted a gift tax deficiency for 1936, rather than for 1937, when the promise to make the payments described became legally enforceable.

The Board of Tax Appeals held that the taxpayer's promise to make future transfers of stated amounts did not constitute a taxable gift in 1936 (the taxable year in litigation), stating that the Commissioner had not rebutted the contention of the taxpayer that "a promise to make a gift in the future is not a present gift, even though the promise may be an enforceable one …", 42 B.T.A. 453, 455. Based on this statement the Service assumed that the Board considered that the promise before it was in fact an enforceable one in 1936.

In *Estate of Ira C. Copley, et al. v. Commissioner*, 15 T.C. 17 (1950), *affirmed* 194 F.2d 364 (1952), *acquiescence*, C.B. 1965-2, 4, the petitioner and his intended wife entered into an antenuptial agreement in 1931. Under the terms of the agreement, the petitioner promised to give his future wife a specified sum of money in consideration of the marriage and in lieu of all of her martial rights in his property. No date was specified for the transfer of such sum. The agreement became legally enforceable under state law on the date of the petitioner's marriage, which was also in 1931. The petitioner transferred part of the sum in 1936 and the remainder in 1944.

The Service relied on the *Archbold* opinion in contending that the 1936 and 1944 transfers were subject to a gift tax in such years. However, the Tax Court concluded that the petitioner's transfers were not subject to Federal gift taxes in 1936 and 1944, but that a gift tax would have been due in 1931 if there had been a gift tax law in effect at that time. The court stated:

> "Once the antenuptial contract became binding by the marriage, Copley became bound to make all of the payments and did not make a new gift each time he made a payment. 15 T.C. 17, 20."

> Having stated that the transfer took place when the contract became binding, the Tax Court accordingly rejected the Commissioner's reliance upon the *Archbold* case, in which, as noted above, the Board was not faced with a binding contract in the taxable year in litigation.
>
> The Tax Court also based its decision in *Copley* on *Cornelia Harris v. Commissioner*, 178 F. 2d 861 (1949), *reversed on other grounds*, 340 U.S. 106, Ct. D. 1737, C.B. 1950-2, 77. In *Harris*, the Court of Appeals held that a promise to make a gift becomes taxable in the year in which the obligation becomes binding and not when the discharging payments are made. In *Paul Rosenthal v. Commissioner*, 205 F. 2d 505 (1953), the court held that the fact that the donee's possession and enjoyment had not yet fully ripened did not postpone the effective date of a gift made subject to a contingency, provided the contingency was susceptible of actuarial appraisal.
>
> In the instant case, the taxpayer became legally obligated to perform according to the terms of the agreement at the time of his marriage in 1966. Since the instant gift is payable over a term of years, subject only to the wife's death, the value of the taxpayer's gift is determinable on the basis of recognized actuarial principles. See section 25.2512-5 of the regulations. It follows, therefore, that the effective date of his gift for Federal gift tax purposes is in 1966.

When a taxpayer sells property to a spouse, as described below, Code § 1041 would cause nonrecognition of the gain on sale;[7254] this treatment also applies when the taxpayer's grantor trust sells property to the spouse's grantor trust.[7255] The interest income and expense would be recognized for income tax purposes,[7256] with the interest deduction being based on the nature of the property transferred rather than being disallowed as a gift.[7257] However, neither

[7254] If the sale is for a loss, the basis would not be decreased to fair market value for purposes of calculating a loss. See Reg. § 1.1041-T(d), Q/A 11, expressly distinguishing Code § 1015(a). Also, the possible interaction between Code § 1041 nonrecognition and Code § 897 taxing the gain of a nonresident alien from the disposition of a U.S. real property interest. Thompson Coburn doc. no. 6236395 describes these issues and why an expert believes that Code § 1041 nonrecognition should prevail.

[7255] Letter Ruling 201927003. The trusts were grantor trusts under Code § 675(4), and the IRS cited Rev. Rul. 85-13 for treating the grantor of each trust as the owner of that trust's assets.

[7256] Code § 1041 provides that sales between spouses are not taxable. However, Code § 1041 does not provide for the exclusion of income; it merely provides for the nonrecognition of gain or loss. *Gibbs v. Commissioner*, T.C. Memo. 1997-196 (recognizing interest income), followed by *Craven v. U.S.*, 70 F.Supp.2d 1323 (D.C. Ga. 1999); *Yankwich v. Commissioner*, T.C. Memo. 2002-37 (interest income recognized); TAM 200624065 (compensation for the delay in the payment of the stated principal amount of amount awarded in divorce decree constituted stated interest). The *Gibbs* court pointed out that, although under certain circumstances specific statutes (such as Code §§ 104(a)(2) and 1033) control the Federal income tax consequences of certain awards, judgments, or payments, the statutes do not necessarily control the Federal income tax consequences of interest paid to the taxpayer in connection with such awards, judgments, or payments.

[7257] *Seymour v. Commissioner*, 109 T.C. 279 (1997), rebuffed the IRS' argument that interest expense was per se nondeductible personal interest and required looking at the use of the loan proceeds based on the interest tracing rule; allowed an interest deduction based on tracing. *Armacost v. Commissioner*, T.C. Memo. 1998-150, followed *Seymour* and held that interest was deductible to the extent that loan proceeds were used for taxable investments.

Code § 7872[7258] nor the original issue discount (OID) rule[7259] requires interest to be charged between spouses. Because Code § 7872 does not apply to such payments, we need to look to the common law, which does require charging interest to avoid gift taxation.[7260]

Code § 1041(a) provides that no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or a former spouse, but only if the transfer is incident to the divorce. For purposes of the latter, a transfer of property is incident to the divorce if such transfer occurs within one year after the date on which the marriage ceases, or is related to the marriage's cessation.[7261] Being related to the marriage's cessation is presumed if within 6 years after divorce and is pursuant to the divorce or separation instrument; the taxpayer must overcome a presumption of no relatedness outside of that window.[7262]

[7258] Effectuating Code § 7872(f)(7), Prop. Reg. § 1.7872-11(c), provides:

> *Husband and wife treated as 1 person*. Section 7872(f)(7) provides that a husband and wife shall be treated as 1 person. Accordingly, all loans to or from the husband will be combined with all loans to or from the wife for purposes of applying section 7872. All loans between a husband and a wife are disregarded for purposes of section 7872.

[7259] Code § 1272(a)(1) imputes original issue discount (OID) income when annual stated interest payments are below the true economic interest. However, Code § 1272(a)(2)(D)(iii) provides that Code § 1272(a)(1) does not apply to certain loans between natural persons, including:

> *Treatment of husband and wife*. For purposes of this subparagraph, a husband and wife shall be treated as 1 person. The preceding sentence shall not apply where the spouses lived apart at all times during the taxable year in which the loan is made.

Effectuating this, Reg. § 1.1272-1(a)(2), "Debt instruments not subject to OID inclusion rules," provides:

> Sections 1272(a)(2) and 1272(c) list exceptions to the general inclusion rule of section 1272(a)(1). For purposes of section 1272(a)(2)(E) (relating to certain loans between natural persons), a loan does not include a stripped bond or stripped coupon within the meaning of section 1286(e), and the rule in section 1272(a)(2)(E)(iii), which treats a husband and wife as 1 person, does not apply to loans made between a husband and wife.

Also, Reg. § 1.1274-1(b)(3)(iii), "Certain transfers subject to section 1041," provides:

> Section 1274 does not apply to any debt instrument issued in consideration for a transfer of property subject to section 1041 (relating to transfers of property between spouses or incident to divorce).

[7260] *Dickman v. Commissioner*, 465 U.S. 330 (1984), discussed in fns 6209-6210 in part III.B.1.a Business Opportunities.

[7261] Code § 1041(c).

[7262] Reg. § 1.1041-1T(b), Q&A 7, provides:

> A transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument, as defined in section 71(b)(2), and the transfer occurs not more than 6 years after the date on which the marriage ceases. A divorce or separation instrument includes a modification or amendment to such decree or instrument. Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than 6 years after the cessation of the marriage is presumed to be not related to the cessation of the marriage. This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. For example, the presumption may be rebutted by showing that (a) the transfer was not made within the one- and six-year periods described above because of factors which hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage, and (b) the transfer is effected promptly after the impediment to transfer is removed.

2017 tax reform repealed Code § 71 for post-2018 divorces. Presumably the old definition continues to apply, although I am not aware of any authority on that point.

Letter Ruling 201901003 held:

If Code § 1041(a) applies, the property is treated as acquired by the transferee by gift for income tax purposes,[7263] and the transferee's basis in the property is the transferor's adjusted basis.[7264] Qualifying deferred payments are nontaxable to the extent they do not constitute interest.[7265]

> The transfer of B's undivided one-half interest in Property from B to A and the transfer of Net Purchase Price from A to B are pursuant to a divorce or separation instrument, as defined in section 71(b)(2) of the Code. While the transfers occurred more than 6 years after the date on which the marriage ceased, the Stipulation and Order 2 were a modification and amendment to Stipulation and Order 1. The transfers were made to effect the division of property owned by the former spouses at the time of the cessation of their marriage. Accordingly, based on the facts submitted and the representations made, the payment by A to B of the Net Purchase Price and the transfer of B's undivided one-half interest in Property from B to A constitutes transfers between former spouses that are `incident to divorce' under § 1041 of the Code.

Letter Ruling 9235026 explained why the taxpayer rebutted the "presumption that a transfer of property occurring more than six years after the cessation of marriage is not related to the cessation of the marriage":

> First, the transfer of Business C and the related property was made in order to effect the division of property owned at the time of the cessation of the marriage. Secondly, the reason the transfer was not effected within the six year period was due to a dispute concerning the purchase price and the terms of the payments relating to the transfer of Business C and the related property. This dispute resulted in litigation, which was finally settled more than six years after the date on which the marriage ceased. Q&A-7 of section 1.1041-1T(b) of the temporary regulations specifically provides that the presumption may be rebutted if factors such as "disputes concerning the value of the property" to be transferred prevented an earlier transfer. Finally, the transfer of Business C and the related property was effected promptly after the purchase price dispute was resolved.

[7263] This reference to treatment as a gift can be confusing. To clarify, Reg. § 1.1041-1T, A-11 includes:

> This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of transfer (or the value of any consideration provided by the transferee) and applies for purposes of determining loss as well as gain upon the subsequent disposition of the property by the transferee. Thus, this rule is different from the rule applied in section 1015(a) for determining the basis of property acquired by gift.

[7264] Code § 1041(b).

[7265] Letter Ruling 9123053 stated:

> The instrument executed in Year B did not give Wife title to one-half of Husband's Benefits in Business B. Rather, in consideration for wife's community property interest, the instrument required Husband to pay Wife the cash equivalent of one-half of the Benefits. Accordingly, the payments are transfers of property between an individual and a former spouse, incident to divorce, and are non-taxable under section 1041 of the Code.
>
> Some of the payments will be made more than six years after the cessation of the marriage, and, as such, under section 1.1041-1T(b), Q6A-7 of the temporary regulations, there is a rebuttable presumption that those payments are not related to the cessation of the marriage. It is clear, however, that the transfers occurring more than six years after the divorce are being made to effect the division of property owned by the former spouses at the time of the divorce. The former spouses have simply chosen to extend the transfers over a period that will be more than six years after the cessation of the marriage. Accordingly, all of the payments are related to the cessation of the marriage under section 1041(c)(2) of the Code….
>
> The payments to Wife pursuant to the instrument executed in Year B by Husband and Wife, to the extent those payments constitute the principal of the $X wife is to receive, are non-taxable transfers of property under section 1041 of the Code. We express no opinion as to the tax consequences of the payments of interest received by Wife.

Code § 1041(a) nonrecognition does not apply if the spouse (or former spouse) of the individual making the transfer is a nonresident alien.[7266]

Code § 1041(a) nonrecognition also does not apply to the transfer of property in trust to the extent that the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred.[7267] Any gain recognized by reason of the preceding sentence affects basis.[7268] For transfers directly between spouses, liabilities in excess of basis do not generate recognition.[7269] Presumably grantor trusts are disregarded for purposes of this rule.[7270]

A comprehensive article on Code § 1041 is cited in part III.B.2.i.xv Sale to Trust Created by Spouse.

III.B.7. Chapter 14

Congress enacted much of Chapter 14 to avoid perceived abuses in valuing transfers of family-controlled business entities. Below this portion considers how retained equity interests are valued (and how to avoid such valuation), and the circumstances under which agreements to require or restrict transfers are considered in determining the value of what is transferred. We will focus on how Chapter 14 might affect the beneficial equity structures and deferred compensation techniques described in part II Income Tax Flexibility. After focusing on this interaction, the portion further below after this one brings the Code §409A overlay into play and tries to find some "sweet spots" which one might seek in structuring businesses.

Running the gift tax statute of limitations for Chapter 14 transfers requires filing a gift tax return that provides:[7271]

(i) A description of the transactions, including a description of transferred and retained interests and the method (or methods) used to value each;

(ii) The identity of, and relationship between, the transferor, transferee, all other persons participating in the transactions, and all parties related to the transferor holding an equity interest in any entity involved in the transactions; and

(iii) A detailed description (including all actuarial factors and discount rates used) of the method used to determine the amount of the gift arising from the transfer (or taxable

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[7266] Code § 1041(d).
[7267] Code § 1041(e).
[7268] Code § 1041(e).
[7269] Reg. § 1.1041-1T includes:

Q-12. Do the rules described in A-10 and A-11 apply even if the transferred property is subject to liabilities which exceed the adjusted basis of the property?

A-12. Yes. For example, assume A owns property having a fair market value of $10,000 and an adjusted basis of $1,000. In contemplation of making a transfer of this property incident to a divorce from B, A borrows $5,000 from a bank, using the property as security for the borrowing. A then transfers the property to B and B assumes, or takes the property subject to, the liability to pay the $5,000 debt. Under section 1041, A recognizes no gain or loss upon the transfer of the property, and the adjusted basis of the property in the hands of B is $1,000.

[7270] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.
[7271] Reg. § 301.6501(c)-1(e)(2). Reg. § 301.6501(c)-1(e)(1) prevents us from relying on the income tax return exception that Reg. § 301.6501(c)-1(f)(4) provides for transactions in the ordinary course of business.

event), including, in the case of an equity interest that is not actively traded, the financial and other data used in determining value. Financial data should generally include balance sheets and statements of net earnings, operating results, and dividends paid for each of the 5 years immediately before the valuation date.

III.B.7.a. Overview of Chapter 14 Rules Regarding Family-Controlled Business Entities

Generally, Code § 2701 values transfers from older family members to younger family members. Code § 2703 allows the IRS to disregard buy-sell and transfer restrictions in many situations. Code § 2704 allows the IRS to disregard restrictions on liquidating an entity in certain situations.

Does Chapter 14 apply to interests in family-controlled business entities when they are transferred as compensation for services rendered by a family member? The regulations governing transfers in the ordinary course of business are expressly subject to Chapter 14.[7272] Furthermore, those regulations generally apply to protect transactions made between unrelated parties from gift tax scrutiny, whereas transactions between related parties are subjected to the usual scrutiny even if the business is an operating business.[7273]

III.B.7.b. Code § 2701 Overview

Code § 2701 applies for gift tax purposes.[7274]

[7272] See the last sentence of Reg. § 25.2512-8.

[7273] See Rev. Ruls. 68-558 (no gift tax on citizens' contributions to company to entice it to invest to create jobs in the community), 72-583 (ignore subjective intent), 77-131 (ignore subjective intent), 80-196 (no gift tax when shareholders transferred stock to unrelated key employees; note that Reg. § 1.83-6(d)(1) treats such transactions for income tax purposes as a contribution to the capital of the corporation followed by compensation paid by the corporation to the employees) (see part II.M.4.c.i When a Gift to a Service Provider Is Compensation and Not a Gift), and 81-54 (transaction that had legitimate business purpose was done in a manner that constituted a taxable gift to children, with ongoing annual gifts to the extent of profits paid to the children); *Estate of Cullison v. Commissioner*, T.C. Memo. 1998-216 (applying the following standards in holding for the IRS: Transfers of property in the ordinary course of business … are not subject to gift tax. …. To qualify, the transaction must be bona fide, at arm's length, and free from donative intent. …. As we further noted in *Harwood v. Commissioner*…: 'Transactions within a family group are subject to special scrutiny, and the presumption is that a transfer between family members is a gift.), *aff'd* 221 F.3d 1347 (9th Cir. 2000); *Estate of Ellie B. Williams v. Commissioner*, T.C. Memo. 1998-59 (transfers were gifts, not compensation for services, in light of (a) the fact that decedent did not agree to transfer property to petitioner as part of their business relationship, (b) decedent's personal relationship with petitioner, (c) her history of making gifts to him, and (d) the estate's signing of the gift tax returns); Letter Rulings 9117035 (ESOP transaction that indirectly benefited son deemed gift), 9253018 (applying Code § 2701 in a different ESOP transaction), 199928013 (bonuses to son were not gifts because they were part of a larger plan that primarily benefited employees not related to the principal shareholder), and 200014004 (excess compensation for services rendered as trustee was a gift); and *Blount v. Commissioner*, 428 F.3d 1338 (11th Cir. 2005) (when an ESOP and decedent were the only shareholders in the company, the estate would have been required to pay estate taxes for having made a bargain sale to the ESOP; however, requirement to use death benefit to buy stock offset that difference), *aff'g in part and rev'g in part* T.C. Memo. 2004-116; but see *Estate of Pearl I. Amlie v. Commissioner*, T.C. Memo. 2006-76 (Code § 2703(b)(1) business purpose was also a business purpose under Reg. § 25.2512-8; business purposes included hedging the holdings of a conservatorship estate and planning for future liquidity needs of the decedent's estate).

[7274] See fn. 2108, found in part II.H.2.j Effect of Chapter 14 on Basis Step-Up.

Extreme caution is required when using irrevocable grantor trusts.[7275]

Rev. Rul. 83-120 provides general rules for valuing preferred stock (or presumably an interest in a preferred partnership). Also, if a recapitalization of a closely held corporation causes a shift in the value of the interests of the beneficiaries of trusts that own stock in the corporation, the shift is treated as a transfer for estate and gift tax purposes.[7276] With these general rules as background, consider that Code § 2701 imprints an additional layer of rules when preferred stock or an interest in a preferred partnership is involved.

Furthermore, it treats as held by an individual any equity interest "to the extent the interest is held indirectly through a corporation, partnership, estate, trust, or other entity."[7277]

Also note that Code § 2701 does not apply for purposes of the tax on generation-skipping transfers.[7278]

Practical uses of preferred partnerships include:

- Part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.
- Migrating from a corporation into the structure described in part II.E Recommended Structure for Entities. See parts II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure and II.Q.7.h Distributing Assets; Drop-Down into Partnership, the latter including part II.Q.7.h.viii Value Freeze as Conservative Alternative.

Code § 2036 should not apply to a transaction covered by Code § 2701.[7279]

III.B.7.b.i. Code § 2701 Definitions

Code § 2701(a)(1) values "transfers" when a transferor or "applicable family member" (the older generation) holds an "applicable retained interest" (a preferential distribution or liquidation right) after making a transfer of an interest in a corporation or partnership[7280] to a "member of the

[7275] See fns 7309-7310 in part III.B.7.b.i Code § 2701 Definitions.
[7276] Rev. Rul. 86-39, reproduced in part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary.
[7277] Reg. § 25.2701-6(a)(1), which goes on to say, If an equity interest is treated as held by a particular individual in more than one capacity, the interest is treated as held by the individual in the manner that attributes the largest total ownership of the equity interest.
[7278] See part II.H.11.e Using Preferred Partnership that Intentionally Violates Code § 2701, especially fn. 2228
[7279] See fn. 2209.
[7280] Prop. Reg. § 25.2701-2(b)(5)(i) would provide:

> For purposes of section 2701, a controlled entity is a corporation, partnership, or any other entity or arrangement that is a business entity within the meaning of § 301.7701-2(a) of this chapter controlled, immediately before a transfer, by the transferor, applicable family members, and/or any lineal descendants of the parents of the transferor or the transferor's spouse. The form of the entity determines the applicable test for control. For purposes of determining the form of the entity, any business entity described in § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B) is a corporation. For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. In the case of any business entity that is not a corporation under these provisions, the form of the entity is determined under local law, regardless of how the entity is classified for federal tax

transferor's family" (a younger generation); an example of such a transfer is a preferred stock or preferred partnership freeze.[7281] Let's examine the meaning of these quoted terms and consider exceptions to these rules.

"Transfer" generally includes a contribution to capital, a capital structure transaction such as redemption, recapitalization, or other change in the capital structure of a corporation or partnership, or certain terminations of an indirect holding in the entity.[7282] However, it does not include:[7283]

- A capital structure transaction, if the transferor, each applicable family member, and each member of the transferor's family holds substantially the same interest after the transaction as that individual held before the transaction.[7284]

- A shift of rights due to a Code § 2518 qualified disclaimer.

- A shift of rights occurring upon the release, exercise, or lapse of a nongeneral power of appointment, except to the extent the release, exercise, or lapse would otherwise be a transfer for gift tax purposes.

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purposes or whether it is disregarded as an entity separate from its owner for federal tax purposes. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under whose laws the entity is created or organized.

[7281] For more information on preferred partnerships, see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

[7282] See Code § 2701(e)(5) and Reg. § 25.2701-1(b)(2)(i), the latter providing:

In general. Except as provided in paragraph (b)(3) of this section, for purposes of section 2701, transfer includes the following transactions:

(A) A contribution to the capital of a new or existing entity;

(B) A redemption, recapitalization, or other change in the capital structure of an entity (a capital structure transaction), if-

(1) The transferor or an applicable family member receives an applicable retained interest in the capital structure transaction;

(2) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest that is junior to the applicable retained interest (a subordinate interest) and receives property other than an applicable retained interest; or

(3) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest in the entity (other than a subordinate interest) and the fair market value of the applicable retained interest is increased; or

(C) The termination of an indirect holding in an entity (as defined in § 25.2701-6), (or contribution to capital by an entity to the extent an individual indirectly holds an interest in the entity), if-

(1) The property is held in a trust as to which the indirect holder is treated as the owner under subchapter J of chapter 1 of the Internal Revenue Code; or

(2) If the termination (or contribution) is not treated as a transfer under paragraph (b)(2)(i)(C)(1) of this section, to the extent the value of the indirectly-held interest would have been included in the value of the indirect holder's gross estate for Federal estate tax purposes if the indirect holder died immediately prior to the termination.

[7283] Reg. § 25.2701-1(b)(3).

[7284] See part III.B.7.b.iii Capital Structure Transaction, If Each Individual Holds Substantially the Same Interest After the Transaction as That Individual Held Before the Transaction.

For most purposes of Code § 2701, "applicable family member" means "the transferor's spouse, an ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor."[7285] ***Multigenerational partnerships can be quite tricky, in that every transfer the second generation makes needs to consider the interests retained by not only the second generation but also the first generation.***

"Member of the family" means "the transferor's spouse, a lineal descendant of the transferor or the transferor's spouse, and the spouse of any such descendant."[7286]

"Applicable retained interest" includes the following:

- <u>A "distribution right," but only if, immediately before the transfer, the transferor and applicable family members "control" the entity</u>:[7287]

    - A "distribution right" is a right to distributions from an entity with respect to stock in a corporation or a partner's interest in a partnership.[7288] However, it does not include:[7289]

        - a right to distributions with respect to an interest that is of the same class or subordinate to the transferred interest,

        - an extraordinary payment right (a liquidation, put, call, or conversion right), or

        - a right to receive guaranteed payments from a partnership of a fixed amount.

    - "Control" means:

        - In the case of a corporation, at least 50%, by vote or value, of the corporation's stock.[7290] To be considered, voting rights must extend beyond the right to vote in liquidation, merger, or a similar event.[7291] A person is considered to own a voting right if that person can exercise that right alone or in conjunction with another person.[7292] Permissible recipients of income from the equity interest and other beneficiaries, rather than the trustee, are considered to hold voting rights that are in trust.[7293] Voting rights subject to a contingency that has not occurred do not count unless the holder of the right can control the contingency.[7294]

        - In the case of a partnership:[7295]

[7285] Code § 2701(e)(2); see Reg. § 25.2701-1(d)(2).
[7286] Code § 2701(e)(1); see Reg. § 25.2701-1(d)(1).
[7287] Code § 2701(b)(1)(A); Reg. § 25.2701-2(b)(1)(ii).
[7288] Code § 2701(c)(1)(A).
[7289] Code § 2701(c)(1)(B); Reg. § 25.2701-2(b)(3).
[7290] Code § 2701(b)(2)(A).
[7291] Reg. § 25.2701-2(b)(5)(ii)(B).
[7292] Reg. § 25.2701-2(b)(5)(ii)(B).
[7293] Reg. § 25.2701-2(b)(5)(ii)(B).
[7294] Reg. § 25.2701-2(b)(5)(ii)(B).
[7295] Code § 2701(b)(2)(B). See Letter Ruling 9639054 for one limited partnership scenario, involving ownership of the corporate general partner. Jonathan Blattmachr said that he obtained it after bringing in the author of the regulations and holding four meetings.

- ❖ At least 50% of the capital or profits interests, or

- ❖ In the case of a limited partnership, any interest as a general partner.[7296]

- ➢ Under proposed regulations,[7297] for any other entity:

  - ❖ Holding at least 50% of either the capital interests or the profits interests in the entity or arrangement, or

  - ❖ Holding any equity interest with the ability to cause the liquidation of the entity or arrangement in whole or in part.

The above excludes any Code § 707(c) guaranteed payment of a fixed amount.[7298] *Smaldino v. Commissioner*, T.C. Memo. 2021-127, respected a guaranteed payment that was later canceled when the IRS did not argue Code § 2701 and did not assert that turning off the guaranteed payment was a gift. The donor who retained the guaranteed payment wanted to use a low interest rate in determining the discounted present value of the payments, but the court noted that the partnership agreement required him to contribute to the partnership if there is a shortfall in the payments, so the interest rate used for present value calculations had to reflect the partnership's risk.

Solely for purposes of this "control" test, "applicable family member" includes any descendant of any parent of the transferor or the transferor's spouse.[7299]

- An extraordinary payment right.[7300] Generally, an extraordinary payment right includes a liquidation, put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or non-exercise of which affects the transferred interest's value.[7301] A "call right" includes any warrant, option, or other right to acquire one or more equity interests.[7302]

Notwithstanding the above, certain rights are not applicable retained interests:[7303]

- A mandatory payment right.[7304] This is a right to receive a payment at a specific time (including a date certain or the holder's death) for a specific amount.

7296 Reg. § 25.2701-2(b)(5)(iii).
7297 Prop. Reg. § 25.2701-2(b)(5)(iv).
7298 Reg. § 25.2701-2(b)(5)(iii). See text accompanying footnote 7306. For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.
7299 Code § 2701(b)(2)(C).
7300 Reg. § 25.2701-2(b)(1)(i), (b)(2); see Code § 2701(b)(1)(B).
7301 Reg. § 25.2701-2(b)(1)(i), (b)(2).
7302 Reg. § 25.2701-2(b)(2).
7303 Reg. § 25.2701-2(b)(4).
7304 Reg. § 25.2701-2(b)(4)(i). Letter Ruling 9535026 conditioned the non-application of Code § 2701 to a sale for a note on the note not being characterized as equity; however, the ruling did not address that notes would be excluded from Code § 2701 as mandatory payment rights. As to valuing the notes, it held:

> In *Frazee v. Commissioner*, 98 T.C. 554 (1992), the Tax Court addressed the issue of whether, for gift tax purposes, the fair market value of a promissory note issued by children to their parents in exchange for real property must be determined by use of a discount rate prescribed under

- A liquidation participation right.[7305] This is a right to participate in a liquidating distribution. However, generally the right to ***compel*** liquidation is treated as if it did not exist if the transferor, members of the transferor's family, or applicable family members have the ability to compel liquidation.

- A right to a guaranteed payment of a fixed amount under Code § 707(c).[7306] The time and amount of payment must be fixed. The amount is considered fixed if determined at a fixed rate, including a rate that bears a fixed relationship to a specified market interest rate.

- A non-lapsing conversion right.[7307] This is a non-lapsing right to convert an equity interest:

  - Into a fixed number or fixed percentage of shares in a corporation that are the same class as the transferred interest.

  - Into a specified interest in the partnership (not represented by a fixed dollar amount) that is the same class as the transferred interest.

In both cases:

- Differences in voting rights are ignored.

- The conversion right must be subject to proportionate adjustments:

  - For a corporation, such adjustments must be made with respect to splits, combinations, reclassifications, and similar changes in capital stock.

  - For a partnership, the equity interest must be protected from dilution resulting from changes in partnership structure.

In testing who holds an applicable retained interest, consider the broad attribution rules of Reg. § 25.2701-6, which attribute an interest held indirectly through a corporation, partnership, estate, trust, or other entity,[7308] even to the extent of attributing an interest held through a

section 7872, or the safe-harbor rate provided under section 483(e). The court also considered the application of the rates prescribed under section 1274. The court concluded that section 7872 applied in determining the gift tax treatment of below-market loans regardless of whether the transaction involved a sale of property or a cash loan. The court reaffirmed its earlier position in *Krabbenhoft v. Commissioner*, 94 T.C. 887 (1990), *aff'd* 939 F.2d 529 (8th Cir. 1991), that section 483 does not apply for gift tax purposes. In concluding that section 1274 was not applicable in valuing the note for gift tax purposes, the court stated that section 1274 characterizes installment payments as principal or interest and, where stated interest is inadequate, it imputes interest. On the other hand, the court noted section 7872 was enacted specifically to address the gift tax treatment of below-market loans. Thus, the court concluded that the application of section 7872 is not limited to loans of cash. Rather, the term "loan" under section 7872 is broadly interpreted to include any extension of credit.

See also fn 7067 in part III.B.5.b Promissory Notes.

[7305] Reg. § 25.2701-2(b)(4)(ii).

[7306] Reg. § 25.2701-2(b)(4)(iii). For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.

[7307] Reg. § 25.2701-2(b)(4)(iv).

[7308] Reg. § 25.2701-6(a)(1).

grantor trust in which the grantor holds no beneficial interest.[7309] Grantor trust attribution takes first priority in determining who owns applicable retained interest but takes a back seat to the actual transferee in determining who owns subordinate interests.[7310]

III.B.7.b.ii. Certain Exclusions from Code § 2701

Code § 2701 does not apply to:

- Transferred interests that are marketable securities.[7311]
- Applicable retained interests that are marketable securities.[7312]
- A capital structure transaction, if the transferor, each applicable family member, and each member of the transferor's family holds substantially the same interest after the transaction as that individual held before the transaction.[7313] Letter Ruling 9321046 held that this exception did not apply to an irrevocable trust that was deemed owned by the grantor, because attribution rules deem the grantor to own any senior interests and the trust to own any subordinate interests.[7314]

[7309] Reg. § 25.2701-6(a)(4)(ii)(C). And, if one has a beneficial interest in a trust, one must assume maximum exercise of the trustee's discretion in the beneficiary's favor. See the text accompanying fn 7390, found in part III.B.7.d Code § 2702 Overview, but also see fn. 7310 for limitations on that.

[7310] Reg. § 25.2701-6(a)(5) provides:

(i) *Applicable retained interests*. If this section attributes an applicable retained interest to more than one individual in a class consisting of the transferor and one or more applicable family members, the interest is attributed within that class in the following order—
   (A) If the interest is held in a grantor trust, to the individual treated as the holder thereof;
   (B) To the transferor;
   (C) To the transferor's spouse; or
   (D) To each applicable family member on a pro rata basis.

(ii) *Subordinate equity interests*. If this section attributes a subordinate equity interest to more than one individual in a class consisting of the transferor, applicable family members, and members of the transferor's family, the interest is attributed within that class in the following order—
   (A) To the transferee;
   (B) To each member of the transferor's family on a pro rata basis;
   (C) If the interest is held in a grantor trust, to the individual treated as the holder thereof;
   (D) To the transferor;
   (E) To the transferor's spouse; or
   (F) To each applicable family member on a pro rata basis.

[7311] Reg. § 25.2701-1(c)(1).

[7312] Reg. § 25.2701-1(c)(2).

[7313] Reg. § 25.2701-1(b)(3)(i).

[7314] See fn. 7310. Zaritsky & Aucutt, ¶ 2.02[4] Indirect Transfers, *Structuring Estate Freezes: Analysis With Forms* (WG&L), refer to the Letter Ruling as a fascinating and informative application of the indirect-holdings and indirect-transfer rules. Note that the ruling held, The taxpayer is treated as making a gift to the extent that the value of her life estate in the common stock held by her prior to the recapitalization exceeds the value of her life estate in the preferred and common stock received in the recapitalization, not mentioning the possible application of Code § 2702 to the transferor's retained interest in the trust. However, Code § 2702 might be unnecessary to protect the government's interest in a Code § 2701 case. See the text accompanying fn 7390, found in part III.B.7.d Code § 2702 Overview, but also see fn. 7310 for limitations on that.

- A retained interest that is of the same class of equity as the transferred interest or if the retained interest is of a class that is proportional to the class of the transferred interest.[7315]

- A transfer by an individual to a member of the individual's family of equity interests to the extent the transfer by that individual results in a proportionate reduction of each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer.[7316]

III.B.7.b.iii. Capital Structure Transaction, If Each Individual Holds Substantially the Same Interest After the Transaction as That Individual Held Before the Transaction

Among various exceptions, a capital structure transaction is not subject to Code § 2701 if the transferor, each applicable family member, and each member of the transferor's family holds substantially the same interest after the transaction as that individual held before the transaction.[7317] For this purpose, common stock with non-lapsing voting rights and nonvoting common stock are interests that are substantially the same.

Letter Ruling 9427023 invoked this exception when partners in a straight-up partnership made additional capital contributions in proportion to their then-current interests. Letter Ruling 200026011 invoked this exception when an S corporation underwent a Code § 368(a)(1)(E) recapitalization in which the shareholders received one share of voting and ten shares of nonvoting common stock for every share of voting common stock currently held. Letter Rulings 9414012 and 9414013 invoked this exception when an S corporation issued nonvoting stock and when the senior generation gave nonvoting stock (with identical distribution and liquidation rights) to the next generation. None of the above letter rulings sheds any light on this exception, because all of these entities were straight-up: each ownership interest had identical distribution and liquidation rights, so Code § 2701 really did not apply anyway.

In Code § 355 spin-offs involving applicable retained interests, Letter Ruling 9843010 invoked this exception because "the shareholders will have substantially the same interests, rights, and limitations in the new entities and in Corporation, and with respect to the underlying assets of each, as each shareholder had before the transaction."

Letter Ruling 9309018 invoked this exception to approve a reverse split intended to avoid Delaware franchise tax:

> In the instant case, each preferred stockholder would hold the same percentage of the issued and outstanding preferred stock and the same overall percentage interest in the equity of the corporation after the proposed recapitalization as he or she would prior to the proposed recapitalization. In similar fashion, each common stockholder would hold the same percentage of the issued and outstanding common stock and the same overall percentage interest in the equity of the corporation after the proposed

[7315] See Reg. § 25.2701-1(c)(3), reproduced in the text accompanying fn. 7351 and further analyzed in part III.B.7.c.iii Same Class Exception - Possible Application to Profits Interest.

[7316] Reg. § 25.2701-1(c)(4), which further provides:

> Thus, for example, section 2701 does not apply if P owns 50 percent of each class of equity interest in a corporation and transfers a portion of each class to P's child in a manner that reduces each interest held by P and any applicable family members, in the aggregate, by 10 percent even if the transfer does not proportionately reduce P's interest in each class. See § 25.2701-6 regarding indirect holding of interests.

[7317] Reg. § 25.2701-1(b)(3)(i).

> recapitalization as he or she would prior to the proposed recapitalization. Thus, each stockholder of [the corporation] would hold substantially the same interest in the corporation after the proposed transaction as he or she did prior to the proposed transaction.

Letter Ruling 199947034 invoked this exception to approve a Code § 368(a)(1)(F) reorganization of a C corporation, that had a complicated capital structure, from corporate form to an LLC so that:

> Taxpayer and the other shareholders of Corporation will exchange their shares in Corporation for an identical number of units in LLC with rights, preferences, and restrictions identical to the rights, preferences, and restrictions each shareholder held in Corporation before the transfer.

In ruling that Code § 2701 did not apply, the IRS reasoned:

> In this case, each share of stock held by Taxpayer carries the same rights and restrictions as every other share of stock held by Taxpayer including voting rights that will lapse if that share is transferred. Thus, because Taxpayer's entire interest in the Corporation is an interest in one class, if Taxpayer transfers less than Taxpayer's entire interest in the Corporation, the retained interest will be of the same class as the transferred interest.

The Conference Committee Report on which this exception presumably is based said:

> The conference agreement provides, however, that the provision would not apply to a change in capital structure other than a contribution to capital if the interests held by the transferor, applicable family members, and family members are substantially identical before and after the change. The provision would not apply, for example, to a recapitalization not involving a contribution to capital if all shareholders held substantially identical interests both before and after the recapitalization. Nor would it apply to a change in corporate name. In addition, the conferees intend that the addition of capital to an existing partnership or corporation would result in the application of these rules only to the extent of such contribution.

This exception is in some ways similar to the exception invoked when the retained interest that is of the same class of equity as the transferred interest, which is described in part III.B.7.c.iii Same Class Exception - Possible Application to Profits Interest.

III.B.7.b.iv. Divorce Planning to Avoid Code § 2701

The lack of family relationship between former spouses can create planning opportunities. Consider this example:[7318]

> If two individuals who are married to each other want to use this planning device for the benefit of their children, a divorce prior to implementing the plan would avoid the disadvantages of § 2701. For example, if spouse A owns preferred and common stock in corporation X, a divorce from spouse B would enable him or her to sell the preferred

[7318] C. McCaffrey & J. McCaffrey, *Obergefell* and the Authority of the IRS to Challenge Valid Marriages and Divorces, *Steve Leimberg's Estate Planning Email Newsletter*, No. 2345 (9/21/2015).

stock to B while simultaneously giving the common to their children because B will no longer be a family member of A.

See also part III.B.6.d Divorce as an Opportunity to Transfer.

III.B.7.c. Code § 2701 Interaction with Income Tax Planning

How does Code § 2701 inform the discussion further above on ways to plan for entity transfers? Below is a qualitative analysis; quantifying these amounts using the complicated subtraction method[7319] is beyond the scope of these materials, although an application is described in part III.B.7.c.i.(b) CCA 201442053 Discusses Profits Interest in a Partnership That Was a Straight-Up Partnership before the Transfer.

Our discussion begins with profits interests, which are favorable treated for income tax purposes and are not subject to the restrictions that Code § 409A places on deferred compensation.[7320] When we discover the Code § 2701 problems they present, we will discuss alternatives, which themselves can present challenges of Code § 409 or 2703.

III.B.7.c.i. Profits Interest in a Partnership that Was a Straight-Up Partnership before the Transfer

Some take the position that Code § 2701 would not apply to the issuance of profits interests.[7321] In planning, I would rather explore the IRS' possible arguments and work around the problem than argue which approach is correct.

III.B.7.c.i.(a). General Discussion of Implications of Profits Interest in a Partnership that Was a Straight-Up Partnership before the Transfer

Suppose a parent transfers a profits interest to a child and retains the parent's capital account. The IRS would argue that the parent's capital account would be an applicable retained interest, valued at significantly less than its face amount, so that the transfer to the child will be treated as a transfer of much of the parent's capital account as well.[7322] However:

- This rule will not apply if the following, added together, are less than 50% of the partnership's income and less than 50% of the partnership's capital:
  - The parent's and child's interests, and
  - Interests of any combination of:

[7319] Reg. § 25.2701-3(b). The lack of family attribution under the *Bright* case, which the IRS conceded in Rev. Rul. 93-12, was decided after this regulation was issued, so presumably that trumps certain aspects of the subtraction method. The person who pointed this out to me said that he has prepared Form 8275-R taking this position one time, and the tax return was not audited.
[7320] See part II.M.4.f Issuing a Profits Interest to a .
[7321] Dees, Profits Interests Gifts under Section 2701: 'I Am Not a Monster,' *Tax Notes* 5/11/2009, also found at http://www.mwe.com/info/pubs/profits.pdf. For a less optimistic view, see Wendel and Hatcher, How to Profit without Getting Carried Away: Carried Interests, Profits Interests, Or Black Holes? 2009 *ACTEC Annual Meeting* (paper dated 1/14/2009).
[7322] In determining the value of the payment of the retained capital account, one must ignore the family's right to compel liquidation. See text accompanying footnote 7305.

- Applicable family members (the parent's spouse, an ancestor of the parent or of the parent's spouse, and the spouse of any such ancestor), and

- Descendants of the parents of the parent or the parent's spouse (in other words, the parent's and parent's spouse's siblings and the descendants of the parent, of the parent's spouse, or of such siblings).

- The parent may reduce the gift based on the discounted present value of the right to receive the capital account if either:

  - The partnership must pay the capital account to the parent at a "specific time," such as a specific date or the parent's death, or

  - One does not rely on liquidation (at which time the capital account would be paid to the parent) being compelled by any combination of:

    - The parent,

    - Members of the parent's family (the parent's spouse, a descendant of the parent or the parent's spouse, and the spouse of any such descendant), and

    - Applicable family members (the parent's spouse, an ancestor of the parent or of the parent's spouse, and the spouse of any such ancestor).

The parent can enhance the retained capital account's present value by retaining a cumulative distribution right with respect to the capital account. For example, if the partnership were required to pay the parent annually 7% of the parent's capital account and that right either was not contingent on profits[7323] or was cumulative,[7324] then the parent could also reduce the gift on account of the present value of that payment right.

The value of a junior equity interest cannot be valued at less than 10% of the sum of the total value of all equity interests in the partnership and the total amount of the partnership's indebtedness to the parent and other applicable family members.[7325] In a partnership, "junior equity interest" means any partnership interest under which the rights to income and capital are

[7323] Thereby constituting a guaranteed payment right under Reg. § 25.2701-2(b)(4)(iii). Instead of using 7% (arbitrarily selected for this example), one could use the prime rate or some other market rate.
[7324] Thereby constituting a qualified payment under Code § 2701(c)(3)(C)(i) (first sentence) and Reg. § 25.2701-2(b)(6)(ii). The transferor or an applicable family member who holds a distribution right that does not qualify may nevertheless treat the right as a qualified payment if he or she makes a special election under Code § 2701(c)(3)(C)(i) (second sentence) and Reg. § 25.2701-2(c)(4). Finally, additional gift tax may be imposed under Code § 2701(d) if the qualified payment is not made within the four-year grace period allowed under Code § 2701(d)(2)(C).
[7325] Code § 2701(a)(4); Reg. § 25.2701-3(c). Such indebtedness does not include short-term indebtedness incurred with respect to the current conduct of the entity's trade or business (such as amounts payable for current services); indebtedness owed to a third party solely because it is guaranteed by the transferor or an applicable family member; amounts permanently set aside in a qualified deferred compensation arrangement, to the extent the amounts are unavailable for use by the entity; or a qualified lease. Reg. § 25.2701-3(c)(3). A lease of property is not indebtedness, without regard to the length of the lease term, if the lease payments represent full and adequate consideration for use of the property. Lease payments are considered full and adequate consideration if a good faith effort is made to determine the fair rental value under the lease and the terms of the lease conform to the value so determined. Arrearages with respect to a lease are indebtedness.

junior to the rights of all other classes of partnership interests.[7326] Although a profits interest typically would be junior with respect to capital, generally it would not be junior with respect to income.[7327] Thus, generally the 10% minimum value rule would not apply to profits interests. However, as a practical matter, often appraisers of qualified retained interests require junior interests to be worth at least 20% of the entity to give full valuation effect to the stated payments, so avoiding the 10% minimum value rule would not necessarily be helpful.

On the other hand, if one needs to go through all of this complexity, one might consider abandoning the profits interest idea and instead using a GRAT.[7328] If the parent wants to transfer only a small portion, the parent could transfer a vertical slice (described further below) of what the parent owns and place a ceiling on the amount that is ultimately transferred to the child. If the parent's goal in transferring a profits interest is to incentivize the child, the GRAT's ceiling could be based on objective business performance measures.

- The issuance of a pure profits interest[7329] does not have Code § 409A implications.[7330] The Code § 409A analysis is not affected by whether the profits interest is junior to another interest.

- Suppose the partnership issues the interest to the child, instead of the parent transferring the interest. Code § 2701 applies to a "change in the capital structure" of a partnership or corporation in certain situations.[7331] However, Code § 2701 applies to a change in capital structure only if:[7332]

  (1) The transferor or an applicable family member receives an applicable retained interest in the capital structure transaction;

  (2) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest that is junior to the applicable retained interest (a "subordinate interest") and receives property other than an applicable retained interest; or

  (3) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest in the entity (other than a subordinate interest) and the fair market value of the applicable retained interest is increased.

In this variation, the parent does not hold an applicable retained interest before the transaction. Thus, we look to paragraph (1) and not to paragraphs (2) or (3). Because the parent has

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[7326] Code § 2701(a)(4)(B); Reg. § 25.2701-3(c)(2).
[7327] However, if the parent retained a cumulative distribution as recommended above, then the profits interest would be junior as to income, and presumably the 10% minimum value rule would apply.
[7328] The author remembers the late Mil Hatcher for his creativity in suggesting the GRAT alternatives described here.
[7329] By pure profits interest the author means a partnership interest that would be allocated nothing if liquidation were to occur at the time of transfer of such interest.
[7330] See II.M.4.f Issuing a Profits Interest to a .
[7331] Code § 2701(e)(5).
[7332] Reg. § 25.2701-1(b)(2)(i)(B).

retained the capital account that he had before the transaction, rather than receiving a capital account,[7333] has the parent "received" an applicable retained interest in the transaction?

Suppose a client has acquired a preferred interest in a partnership controlled by the next generation, but lots of others have invested in the partnership? Although Code § 2701 applies, the transaction might not constitute a gift, because it was done in the ordinary course of business.[7334] I would not plan a partnership assuming that exception applied, because the facts-and-circumstances nature makes the result uncertain, but it can provide relief when taxpayers business-motivations predominate.

III.B.7.c.i.(b). CCA 201442053 Discusses Profits Interest in a Partnership That Was a Straight-Up Partnership before the Transfer

Code § 7872 generally does not apply to transactions between partnerships and partners. See part II.G.4.a.i Loans to Businesses – Whether AFR Is Required.

CCA 201442053[7335] was essentially an attempt to make a 20-year interest-free loan to children using a partnership. The CCA applied Code § 2701 to fulfill the role of Code § 2701 in backstopping Code § 7872. After reviewing what the IRS said, this memo will discuss why this attempt was such a bad idea and that the taxpayers would have been better off simply loaning the money instead of messing around with a partnership structure.

In CCA 201442053, after forming and operating a straight-up partnership:

> …at a time when Donor held an X percent ownership interest, Child A and Child B each held a Y percent ownership interest and Donor's grandchildren collectively held the remaining Z percent ownership interest, Company was recapitalized. In exchange for the agreement of Child A and Child B to manage Company, the operating agreement was amended to provide that henceforth all profit and loss, including all gain or loss attributable to Company's assets, would be allocated equally to Child A and Child B. After the recapitalization, Donor's and the grandchildren's sole equity interest in Company was the right to distributions based on their capital account balances as they existed immediately prior to the recapitalization.
>
> The gift tax liability of the grandchildren is not at issue herein, and will not be further discussed.

The CCA concluded that the shifting of the profits interests constituted a gift:

> For purposes of § 2701, a transfer includes a recapitalization or other change in the capital structure of an entity if the transferor holding an applicable retained interest before the capital structure transaction surrenders a subordinate interest and receives

[7333] This approach cannot be taken if done in conjunction with a contribution to capital. Reg. § 25.2701-1(b)(2)(i)(A).

[7334] See text accompanying fns. 7272 (ordinary course of business exception is subject to Chapter 14) and 7273 (when the exception has or has not been applied).

[7335] I have heard that, although this is designated a CCA, it really was an informal legal memorandum, without any input from the taxpayer or other procedural safeguards.

property other than an applicable retained interest. section 25.2701-1(b)(2)(B)(2).[7336] An applicable retained interest is an interest in a family-controlled entity with respect to which there is a distribution right. section 25.2701-2(b)(1)(ii). A subordinate interest is an interest as to which an applicable retained interest is a senior interest. section 25.2701-3(a)(2)(iii). A senior interest is an interest that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest. section 25.2701-3(a)(2)(ii). The term "property" includes every species of right or interest protected by law and having an exchangeable value.

Here, at all relevant times, Donor and her family controlled Company. On Date 3, Company was recapitalized and Donor surrendered her right to participate in future profit and loss, including future gain or loss attributable to Company's assets. Both before and after the recapitalization, Donor held an applicable retained interest, an equity interest in Company coupled with a distribution right.[7337] Donor's interest, which carried a right to

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[7336] [my footnote, not the CCA's:] Dees, Is Chief Counsel Resurrecting the Chapter 14 'Monster'? *Tax Notes* (12/15/2014 at p. 1279), argues that the regulations exceed their statutory mandate by applying Code § 2701 to this recapitalization. Judge for yourself by reading Code § 2701(e)(5), which provides:

> Except as provided in regulations, a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership shall be treated as a transfer of an interest in such entity to which this section applies if the taxpayer or an applicable family member—
>
> (A) receives an applicable retained interest in such entity pursuant to such transaction, or
>
> (B) under regulations, otherwise holds, immediately after such transactions, an applicable retained interest in such entity.
>
> This paragraph shall not apply to any transaction (other than a contribution to capital) if the interests in the entity held by the transferor, applicable family members, and members of the transferor's family before and after the transaction are substantially identical.

[7337] [my footnote, not the CCA's:] Dees, Is Chief Counsel Resurrecting the Chapter 14 'Monster'? *Tax Notes* (12/15/2014 at p. 1279), criticizes the CCA for referring to Donors' equity interest as an applicable retained interest. His analysis correctly points out that the CCA's fails to discuss extraordinary payment rights (EPRs) in its shorthand description of the definition an applicable retained interest (ARI). However, let's look past that sloppy shorthand and apply the definition of an ARI to the original interest and to the retained interest; refer to the analysis in part III.B.7.b.i Code § 2701 Definitions.

ARI means an equity interest with respect to which there is either an EPR ***<u>or</u>*** a distribution right, so all the CCA needed to find was either an EPR or a distribution right. Reg. § 25.2701-2(b)(1). Key to his analysis regarding the original rights is Reg. § 25.2701-2(b)(3)(i), which says that distribution right does not include any right to receive distributions with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest. In this case, the original interest was a right to receive a capital account on liquidation, coupled with a right to profits. The transferred interest was a right to profits. Using the same reasoning as in fn. 7338, the original interest is not subordinate to the transferred interest. Thus, the remaining question in determining whether the original interest included a distribution right is whether it is the same class as the transferred interest. Dees views them as the same class, presumably because both interests have rights in the same assets and have no payment preferences. However, the IRS might argue that Dees' approach is too narrow, because Reg. § 25.2701-1(c)(3) seizes on any differences whatsoever other than voting rights and limitations on liability:

> A class is the same class as (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability).

Presumably, the IRS would argue that the rights to the original and transferred interests were not identical, and that they were not proportional because the zero capital account associated with the transferred interest did not bear the same relationship to profits as the capital account of the original

> distributions based upon an existing capital account balance, is senior to the transferred interests, which carried only a right to distributions based on future profit and gain. Donor received property in the form of the agreement of Child A and Child B to manage Company. Accordingly, the recapitalization constitutes a transfer by Donor for purposes of § 2701.

The statement, "Donor's interest, which carried a right to distributions based upon an existing capital account balance, is senior to the transferred interests, which carried only a right to distributions based on future profit and gain," is an incorrect conclusion. Although the original interest had more rights than the transferred interest, the original interest had no rights that entitled it to payment earlier (higher in priority) than the transferred interest.[7338]

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interest had to profits. Dees has a lot of background and experience with Code § 2701 and the regulations and, upon audit, would make a persuasive argument for the approach he takes. However, at the planning stage, I would not assume that they are the same class.

The donor retained no rights to ongoing distributions after the recapitalization, so I agree with Dees that the CCA erred in calling the retained interest a distribution right and that the only analysis of it is as an EPR. See Reg. § 25.2701-1(a)(2)(ii) (an example of a distribution right is a right to receive dividends), combined with the exclusion of EPRs from the definition of distribution rights. Dees argues that bells and whistles need to attach to a set of rights to make them constitute EPRs. He does not view the retained capital account as an EPR. His view would be correct if the capital account was not required to be paid by a date certain and therefore would, absent any distribution tights, have a value for regular gift tax purposes approaching zero. However, in the CCA, the LLC had a fixed 20-year term. The IRS might have been thinking that the donor retained the right to compel liquidation in 20 years, and the retained bare capital account was an EPR. On the other hand, the LLC's fixed terms could also be viewed as a mandatory payment right, which I view as being more correct. Weighing these two approaches, presumably the IRS would argue that an abuse that Code § 2701 wanted to prevent is saying that the entity had a term of a period of years, getting value ascribed to the retained right to payments on that liquidation, and then extending the term, claiming that the extension was not a gift; therefore, the IRS would argue, the right to receive the capital account at the end of the stated term is an EPR.

Thus, although Dees' arguments would be good ones to make in an audit and the IRS' view is probably wrong, for planning purposes one might be very conservative and assume that the CCA is correct in its conclusion that the original interest and the retained interests are ARIs.

[7338] Dees, Is Chief Counsel Resurrecting the Chapter 14 'Monster'? *Tax Notes* (12/15/2014 at p. 1279), criticizes the CCA for referring to the original interest as senior to the transferred interest. Let's compare this to Reg. § 25.2701-3(a)(2)(ii), which provides:

> Senior equity interest means an equity interest in the entity that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest.

The original interest and the transferred interest had identical rights to distributions of income, so the only distinction was a right to capital. Nowhere do the regulations define preferred. However, they refer to preferred stock in various places, and traditionally preferred stock carries the right to receive dividends before any dividends are paid to the holders of common stock. Therefore, I believe that the better reading is looking to see whether one interest in capital receives its payment of capital before another interest does. The CCA leaps to the conclusion that an interest that includes a current capital account balance is senior in capital to an interest that has a zero capital account, a conclusion that ignores the timing assumption that appears to be inherent in the word preferred. The CCA's facts state, "No member has priority over any other member as to … the return of capital contributions." Furthermore, the CCA inherently assumes that a profits interest never has a capital account. Although the pure profits interest transferred here had a zero initial capital account (see part II.M.4.f Issuing a Profits Interest to a), a partnership is required to maintain a capital account for each partner. Reg. § 1.704-1(b)(2)(iv)(a). When a partner is allocated profits, the allocation increases the partner's capital account. Reg. § 1.704-1(b)(2)(iv)(b)(3). Distributions of those profits decrease the partner's capital account. Reg. § 1.704-1(b)(2)(iv)(b)(4). It is not uncommon for a partnership to reinvest part of its earnings for contingencies or

The CCA calculated the gift applying the subtraction method of Reg. § 25.2701-3(b):

> If § 2701 applies to a transfer, the amount of the transferor's gift, if any, is determined using a subtraction method of valuation. Under this method, the amount of the gift is determined by subtracting the value of any family-held applicable retained interests and other non-transferred equity interests from the aggregate value of the family-held interests. In determining the value of any applicable retained interest held by the transferor or an applicable family member, any distribution right in a controlled entity (*e.g.*, a right to receive dividends) is generally valued at zero.
>
> Step 1 - Determine the fair market value of all family-held equity interests in the entity immediately after the transfer assuming that the interests are held by one individual, using a consistent set of assumptions. Here, all equity interests are held by Donor, her children, and her grandchildren, all of whom are members of Donor's family. The result of Step 1 is an amount equal to the fair market value of 100 percent of the Company interests valued as if they were held by a single holder.
>
> Step 2 - Subtract: (A) the sum of the fair market value of all family-held senior equity interests determined after the transfer as if all interests were held by a single holder; and (B) the value determined under § 25.2701-2 of all applicable retained interests held by the transferor and any applicable family members. A senior equity interest is an interest that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest. Section 25.2701-3(a)(2)(ii). The interests of Child A, Child B and the grandchildren are senior to the transferred interests in that each carried a right to distributions based upon an existing capital account balance, whereas the transferred interests did not. Accordingly, the amount determined in Step 1 is reduced by the fair market value of Child A's, Child B's and the grandchildren's interests. The amount determined in Step 1 is further reduced by the value of Donor's postrecapitalization applicable retained interest. In valuing Donor's interest, the distribution right, which does not constitute a qualified payment right, is valued at zero, and the liquidation participation right is valued as if the family's ability to compel liquidation did not exist.

The sentence, "The interests of Child A, Child B and the grandchildren are senior to the transferred interests in that each carried a right to distributions based upon an existing capital account balance, whereas the transferred interests did not," is incorrect (because there are no senior interests).[7339] Therefore, subtracting the value of the interests of Child A, Child B, and the grandchildren's interests is incorrect, and the CCA understates the value remaining to which Step 3 would apply.

The CCA continues:

> Step 3 - Allocate the remaining amount among the transferred interest and other non-transferred subordinate equity interests held by the transferor, applicable family members, and members of the transferor's family. A subordinate equity interest is an interest as to which an applicable retained interest is a senior interest. section 25.2701-3(a)(2)(iii). Here, all applicable retained interests carried a distribution right based upon an existing capital account balance, whereas the interest transferred by the

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to expand its capital base (to grow the business or to create economies of scale in investing marketable securities). Thus, Dees correctly criticizes the CCA for calling the original interest senior.

[7339] See fn. 7338.

grandchildren did not. This interest, which was not transferred by Donor, is a subordinate equity interest. Based on Donor and the grandchildren's relative ownership percentages immediately prior to the recapitalization, X / X+Z percent of the Step 2 amount is allocated to the transferred interest. Donor is treated as transferring one-half of this amount to Child A and one-half to Child B.

Again, the CCA errs by viewing certain interests as subordinate.[7340] Therefore, all of the remaining amount would be allocated to the retained interest.

> Step 4 - If the value of the transferred interest determined without regard to § 2701 would be determined after application of a minority discount, the Step 3 amount is reduced by a pro rata portion of the fair market value of the family-held interests of the same class determined as if they were held by one person, over the fair market value of a transferred interest. The Step 3 amount is also reduced by the amount, if any, of any consideration in money or money's worth received by the transferor. Here, Donor transferred an interest to each of two transferees, implicating a minority discount. The reduction for each gift is the excess, if any, of a pro rata portion of the fair market value of the transferred interests determined as if all voting rights were held by a single holder over the fair market value of a single transferred interest. In the event that Donor establishes the value in money or money's worth of any consideration provided by either Child A or Child B, a further reduction may be appropriate.

The analysis of Step 4 appears correct and introduces an element not discussed in previous rulings. Let's read together the highlighted parts in the facts[7341] and in Step 4:

- Donor received property in the form of the agreement of Child A and Child B to manage Company.

- In the event that Donor establishes the value in money or money's worth of any consideration provided by either Child A or Child B, a further reduction may be appropriate.

These statements suggest to me that the fair market value of the children's services to be performed over the LLC's life will be subtracted at the end, if the Donor can prove that value. However, in this particular case, the children are benefitting only themselves by managing the partnership, so query how much value will be assigned to their services. This case represents an extreme example. Generally, a service provider in a venture capital arrangement receives a 2% management fee and then, after the investors have recovered their investment and a threshold rate of return, 20% of the profits.[7342]

Note in Step 2 that the Donor's right to receive the Donor's capital account – referred to as a "liquidation participation right" - is properly valued as if the family's ability to compel liquidation did not exist. However, if, contrary to the CCA's approach, the partnership's fixed term were construed as a mandatory payment right, it would set an outside date at which the partners would receive their capital accounts – in this case, 20 years. If an appropriate discount rate for

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[7340] See fn. 7338.
[7341] Donor received property in the form of the agreement of Child A and Child B to manage Company.
[7342] Arrangements vary from deal to deal. To determine what is market, one should talk with a corporate lawyer who advises in a large number of venture capital cases or consult an online service, such as Thompson Reuter's *Practical Law* (formerly known as the Practical Law Company).

equity were 8%, the right to receive $100.00 in 20 years would be worth $21.45.[7343] Thus, whether or not the CCA's valuation approach applies, if Code § 2701 applies then the Donor has made a substantial gift.

Going through the complex subtraction method, obtaining the requisite appraisals, and using an equity rate of return to discount the Donor's interest might very well provide a much less favorable result than if the Donor had simply done a loan to the children at the AFR.

CCA 201442053 appears to shut the door on a potentially abusive transaction. It also illustrates how the IRS approaches the subtraction method. However, it is full of errors (and my understanding is that the IRS showed a lower Code § 2701 gift than one computed using the gift tax principles that would normally apply), making one wonder how the IRS will next attempt to apply Code § 2701. Profits interests do not fit neatly with the scheme of Code § 2701, so issuing them in a family-controlled partnership can generate uncertain results.

Partnerships play an important role in our economy, particularly in the venture capital/private equity area. However, for family transactions, they require applying a complex regime. Therefore, first try using AFR loans; then see whether a GRAT works; and, if those do not suffice, then perhaps consider using a partnership with commercially reasonable terms, making sure that the donor retains a preferred partnership interest, makes a Code § 2701(c)(3)(C) election, or retains Code § 707(c) guaranteed payments[7344] so that the donor can get credit for the donor's retained stream of payments.

III.B.7.c.ii. Profits Interest in a Partnership in Which Transferor and Applicable Family Members Initially Hold Only a Profits Interest

Suppose a parent is buying a partnership owned by an unrelated third party. The unrelated third party retains all of his capital interest and receives preferred payments of income in liquidation of the value of his interest in excess of his capital account. The parent is entitled to 100% of the profits in excess of the preferred payments. As discussion further above, preferred payments of income to the third party can be very beneficial to the parent who is buying the business, if the preferred payments are taxed to the third party as a distributive share of income under Code § 736(a) so that the parent is using pre-tax dollars to buy out the third party.

- Initially establishing this capital/income structure will not have Code § 2701 implications, because the parent is not a member of the third party's family.

- The partnership's capital/income structure could have Code § 2701 implications if the parent transfers an interest to his child or any other member of the parent's family.

    - Does the parent own at least "50% of the profits interests" that would be required for Code § 2701 to be considered (since the parent has no capital account yet) if the partnership is a general partnership? The statute and regulations do not clearly answer

[7343] As of October 2014, a typical preferred return would be 8% or 9%. That assumes an annual distribution. Where no distribution is made for 20 years, presumably the discount rate would be higher. Thus, the illustration of $21.45 value for every $100 probably overstates the value of the Donor's retained interest.

[7344] For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.

the question.[7345] If the partnership is a limited partnership and the parent is a general partner, then Code § 2701 must be considered no matter what the parent's economic interests are.[7346] If the partnership is a manager-managed limited liability company, and the parent is a manager, would that be the same as being a general partner in a limited partnership?

- Even if one assumes that the parent's partnership interest is sufficient to make one consider Code § 2701, if the parent transfers a vertical slice of the parent's right to income and the same vertical slice of the parent's right to capital to his child, Code § 2701 should not apply to that transfer.[7347] Suppose, for example, that the parent owns 60% of the income and 10% of the capital and wants to give a vertical slice of 1/10 of his interest to his child.[7348] In that case, the parent would give the child a 6% income (60% multiplied by 1/10) and 1% capital interest (10% multiplied by 1/10) and would retain a 54% income and 9% capital interest. The vertical slice should be structured so that the child succeeds to 1/10 of every item of the parent's rights to distributions and financial obligations. For example, if the parent is obligated to leave a portion of his share of income in the partnership, the child should have a proportionate obligation to leave income in the partnership; the parent's leaving profits in the partnership might[7349] constitute a contribution to capital, triggering Code § 2701,[7350] in which case one needs to find an exception to Code § 2701, such as transactions involving proportionate vertical slices.

III.B.7.c.iii. Same Class Exception - Possible Application to Profits Interests and Other Situations

Not much guidance explains how to implement the regulations under Code § 2701. The "same class" exception provides:[7351]

> Section 2701 does not apply if the retained interest is of the same class of equity as the transferred interest or if the retained interest is of a class that is proportional to the class of the transferred interest. A class is the same class as (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability). For purposes of this section, non-lapsing provisions necessary to comply with partnership allocation requirements of the Internal Revenue Code (*e.g.*, section 704(b)) are non-lapsing differences with respect to limitations on liability. A right that lapses by

[7345] Code § 2701(b)(2)(B)(i); Reg. § 25.2701-2(b)(5)(iii).
[7346] Code § 2701(b)(2)(B)(ii); Reg. § 25.2701-2(b)(5)(iii).
[7347] See Reg. § 25.2701-1(c)(3), (4).
[7348] In the example, the parent starts with a pure profits interest and no capital. However, the parent is likely to leave some income in the partnership, especially since the reinvested income might be used to buy the third party's capital account. The cumulative effect would be to decrease the third party's capital account and increase the parent's capital account until the third party's capital account and income interest have decreased to zero.
[7349] The next paragraph of text suggests a difference between the parent transferring a partnership interest and the partnership issuing a partnership interest. Therefore, the author's concern about leaving profits in the partnership could be creating an issue where there is none, because the parent is not transferring property to the child. Thus, this recommendation is an attempt to be very conservative.
[7350] Reg. § 25.2701-1(b)(2)(i)(A).
[7351] Reg. § 25.2701-1(c)(3).

> reason of Federal or State law is treated as a non-lapsing right unless the Secretary determines, by regulation or by published revenue ruling, that it is necessary to treat such a right as a lapsing right to accomplish the purposes of section 2701. An interest in a partnership is not an interest in the same class as the transferred interest if the transferor or applicable family members have the right to alter the liability of the transferee.

Relying on Reg. § 25.2701-1(c)(3), the IRS has ruled that a merger that did not change the parties' economic rights did not cause Code § 2701 valuation to apply "because the transaction involves a mere change in the form of Taxpayer's holdings in the business activity."[7352]

Private Letter Ruling 9451051 applied this exception to a corporate arrangement that seems very much like a profits interest. The preferred stock did not have any preferences on dividends. The only preference was as follows:

> Upon liquidation, dissolution, or winding up of Corporation, the holders of the Class A preferred stock are entitled to be paid out of the assets of Corporation then available for distribution an amount equal to a liquidation preference of $10 per share. If after the payments have been made there remain assets available for distribution, then all of the assets are to be distributed pro rata among the holders of the common stock and the convertible preferred stock as if each share of convertible preferred had been converted into common stock. However, there shall be subtracted from any residual distribution to the holders of the Class A preferred an amount equal to the liquidation preference received by each holder.

The IRS ruled that the preferred stock was "substantially the same" as the transferred common stock.

This exception is in some ways similar to the exception described in part III.B.7.b.iii Capital Structure Transaction, If Each Individual Holds Substantially the Same Interest After the Transaction as That Individual Held Before the Transaction.

It has been suggested that a profits interest is analogous to common stock in this letter ruling and therefore are not subject to Code § 2701.[7353] However, in the letter ruling, after the preferred owners receive their preferred liquidation payment, the common would receive the proportionate make-up payments; whereas the holder of a profits interest would not receive

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[7352] Letter Ruling 9352012 approved a merger of Corporation B into Corporation A under the following facts, in which the taxpayer held only preferred stock (and all the preferred stock):

> The rights with respect to Corporation B common and preferred stock are identical to the rights of the common and preferred stock of Corporation A except that the Corporation B preferred stock is entitled to receive 85 percent of par value upon liquidation and is redeemable by the corporation at 85 percent of par.
>
> Under the proposed merger, Taxpayer will exchange her Corporation B preferred stock for an equal number of shares of new Class C preferred stock to be issued by Corporation A. The rights of the Class C shareholder will be identical to those of the Corporation B preferred shareholders, and the Class C shares will be redeemable for 85 percent of par value. The common stockholders of Corporation B will exchange their stock for common stock of Corporation A of equal value.

[7353] Robinson, Business Succession Planning, Profits Interests and § 2701, *ACTEC Journal* (Spring 2009).

make-up payments, absent a capital account. It might be possible to make up this difference by specially allocating to the holders of profits interests:

- Gain on liquidation to the holder of the profits interests. Whether that would make the profits interests close enough is unclear; presumably it would depend on the likelihood of that gain occurring.

- Current income first, then to gain on liquidation. That would certainly increase the likelihood of the capital accounts increasing until they are proportionate to those of the original partners. That would make the profits interests be preferred as to current income, but presumably the holders of the profits interests would be in a lower generation and therefore Code § 2701 would not apply to this reverse freeze.

One should also consider an earlier technical advice memorandum that refused to apply the same class exception:[7354]

> Underlying the statute and regulations, the legislative history states that a "retained interest is valued under present law if it is of a class which is proportionally the same as the transferred interest but for nonlapsing differences in voting power (or, in the case of a partnership, nonlapsing differences with respect to management and limitations on liability)." H.R. Rep. No. 101-964, at 1133 (1990). Further, the legislative history notes that section 2701 generally does not affect the valuation of a gift of a partnership interest if all interests in the partnership share equally in all items of income, deduction, loss and gain in the same proportion (i.e., straight-up allocations). See 136 Cong. Rec. 515681 (daily ed. October 18, 1990) (1990 Senate Report on Proposed Revision of Estate Freeze Rules). However, the legislative history also notes that the exception to the valuation rules of section 2701 "would not apply to a partnership with both a general and limited partner if one partner had a preference with respect to distributions." H.R. Rep. No. 101-964, at 1133 (1990). Thus, if either the transferred or applicable retained interest in Partnership enjoy a preference as to distributions, the applicable retained interest in Partnership will be valued under the rules of section 2701. See *Id.*
>
> In the present case, the Partnership Agreement provides that proceeds from capital transactions shall be distributed first to the limited partners until their Adjusted Capital Contributions are reduced to zero, then to the general partner until its Adjusted Capital Contribution is reduced to zero. The balance of any proceeds, if any, shall be distributed to the partners in proportion to their partnership interests. On its face, this provision in the Partnership Agreement is a preference enjoyed by the limited partner (Trust) with respect to distributions of proceeds from capital transactions. Thus, the transfers at issue are not excluded from the special valuation rules of section 2701(a)(1) because Donor's applicable retained interest is not of the same class of equity as the transferred interest, nor is Donor's applicable retained interest of a class that is proportional to the class of the transferred interest.

With this contrast, I would want to have a special allocation of profits to the holder of the profits interest as soon as possible, to try to make it look more like the letter ruling and less like the TAM, so long as that did not constitute an unacceptable change to the business deal.

[7354] TAM 199933002.

I would still rather avoid the issue altogether, by using a loan to the service provider at the AFR so that the service provider could simply start with a proportionate capital account. The service provider could then have compensation incentives to enable him or her to repay the loan.

III.B.7.c.iv. Transfers When Owner Holds Profits Interest/Carried Interest and Other Interests

How might one deal complexities of planning with profits interests discussed in part III.B.7.b Code § 2701 Overview and the discussion in the previous parts of this part III.B.7.c Code § 2701 Interaction with Income Tax Planning? (Generally, a "carried interest" is a profits interest that provides an interest in profits only after the partners who provided the capital have received cash as part of an agreed-upon return.)

One method would be transferring all of the person's interest into a single entity, such as an LLC, so that the person's interest is held as a single package. Then one might transfer an interest in that single entity, to satisfy the vertical slice exception described in part III.B.7.c.iii Same Class Exception - Possible Application to Profits Interest.

An owner can combine this vertical slice planning with transfers that include more than just a straight gift. For example, an owner might place the LLC into a GRAT[7355] or transfer it in exchange for a note or an interest in preferred partnership.[7356]

III.B.7.c.v. Income Tax Dynamics of Using Deferred Compensation Instead of Profits Interest

Suppose that the moneyed partners – who we will call the service recipient (SR) – agree to pay compensation to the partner who is providing the services – the service provider (SP), instead of giving the SP a profits interest.

The SR would receive any capital gain treatment from the SP's portion of the profits. However, they would be able to use the tax benefits from an ordinary deduction to gross-up the SP's payment.

Suppose, for example, that ordinary income were taxable at a 40% rate and capital gain at a 20% rate. For every $100 the SP would receive, the SP would have expected to net $80, after subtracting $20 capital gain tax. Instead, the partnership pays the SP $133. The SP receives the same $80, which consists of $133 minus $53 (40% of $133) ordinary income tax. The SR receives a $133 ordinary income tax deduction, which costs the SR only $80 ($133 minus $53 ordinary income tax benefit); this $80 cost to the SR matches the $100 sale proceeds the SR receives less the $20 capital gain tax that the SR pays.

Thus, the lack of capital gain treatment to the SP should not an obstacle to the transaction. This assumes that the SR has other ordinary income against which to deduct the payment to the SP. If that is not the case, the benefit of the deduction might be at capital gain rates that are less than the ordinary income tax that the SP would be required to pay.

[7355] The late Mil Hatcher suggested this idea to me. For information on GRATs, see part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust.
[7356] See Angkatavanich and Stein, Going Non-Vertical with Fund Interests - Creative Carried Interest Transfer Planning When The 'Vertical Slice' Won't 'Cut It,' *Trusts and Estates* (11/2010), saved as Thompson Coburn LLP document no. 6174249.

One would also want to compare whether the deduction to the SR is against the SR's self-employment income and whether the payment to the SP is subject to self-employment tax.

Because changes to deferred compensation plans must meet certain requirements or trigger significant tax consequences, using a profits interest is much more flexible than paying deferred compensation.

III.B.7.c.vi. Deferred Compensation

Although deferred compensation is not equity, it reduces the entity's value for many purposes and makes it easier to sell; it also creates an income stream for the older generation without constituting an asset subject to estate tax (assuming that the deferred compensation payments are spent and do not promote the recipient's other assets to grow to exceed the recipient's unused estate tax exemption).[7357] It is realistically available only if the entity earns sufficient income. For draconian rules that apply to deferred compensation, see part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

Suppose a parent is 55 years old and wants to retire in 10 years. The business entity (same analysis whether partnership or corporation) agrees to make the following series of payments:

- Retirement Payment. $100,000 per year for life,[7358] but only if the parent continues to work for the entity until the parent attains age 65.[7359] This should not violate Code § 409A; of course, to satisfy other tax issues, the retirement payment must, when combined with other compensation, constitute reasonable compensation for future services.[7360] Similarly, as a payment that is fixed in amount at a specific time, it is not subject to Code § 2701,[7361] whether or not the IRS attempts to classify it as equity.

- Disability Payment. The parent receives $100,000 for life if the parent becomes disabled before attaining age 65. If disability is defined consistent with Code § 409A(a)(2)(A)(ii) and (a)(2)(C) and the pronouncements thereunder, the payment would not violate Code § 409A. Unfortunately, this definition is more stringent than most good disability policies, and one might consider paying a bonus to the parent so that the parent can buy disability insurance instead.[7362]

[7357] For a married couple, the survivor's interest in the deferred compensation automatically qualifies for the marital deduction. Code § 2056(b)(7)(C).

[7358] If instead the payment were for a fixed period of years instead of for life, more planning opportunities are available if the arrangement provides at all times that the right to the series of installment payments is to be treated as a right to a series of separate payments. Reg. § 1.409A-2(b)(2)(iii).

[7359] When the parent reaches 65, the present value of the retirement payments vests for FICA purposes, and a lump-sum FICA tax payment is due. Reg. § 31.3121(v)(2)-1(c)(2). Although this might sound onerous, it is actually quite beneficial. See discussion at part II.Q.1.d Nonqualified Deferred Compensation

[7360] In this example, the requirement that the parent work for 10 years is an attempt to spread the period of earning the compensation for the purposes of determining reasonable compensation.

[7361] Reg. § 25.2701-2(b)(4)(i) (in the case of a corporation) or (iii) (in the case of a partnership).

[7362] A good disability policy will provide benefits if the disabled person cannot work in his or her ***own occupation***. Contrast this with Code § 409A(a)(2)(C), which provides (emphasis added):

> For purposes of subparagraph (A)(ii), a participant shall be considered disabled if the participant -

- Death Benefit. A death benefit to replace the disability and retirement payments would not violate Code § 409A.

The discussion in part III.B.7.c.viii Creative Bonus Arrangements convinces the author that none of the above would constitute an equity interest. Therefore, such arrangements would not constitute an "applicable retained interest" that would taint a transfer by the parent to a child.[7363]

Note that any liability to pay the amounts described above generally would be a liability that would reduce the business' value when planning transfers of an interest in the business. See part II.Q.1.d.ii.(b) Balance Sheet Effects of Deferred Compensation in part II.Q.1.d Nonqualified Deferred Compensation.

Suppose the plan described above did not offer a death benefit, so all benefits stopped at death. In that case, nothing related to those payments is includible in the parent's estate.[7364] The ability to receive an income stream without estate inclusion is a powerful tool. Caveat: the payments need to be, in substance, reasonable compensation, or the IRS might argue that they are an interest in the business.

III.B.7.c.vii. Stock Options

Stock options exercisable at a price that is at least the underlying stock's value on the date of grant generally are not subject to Code § 409A.[7365] Similar rules apply to partnerships.

(i) is unable to engage in ***any substantial gainful activity*** by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, or

(ii) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than 3 months under an accident and health plan covering employees of the participant's employer.

[7363] Code § 2701 applies only when the parent or a member of the parent's family holds an applicable retained interest. An applicable retained interest includes only a right to equity. See Code § 2701(b), (c)(1), (c)(2).

[7364] Reg. § 1.2039-1(b)(2), Example (4) provides:

> Pursuant to a retirement plan, the employer made contributions to a fund which was to provide the employee, upon his retirement at age 60, with an annuity for life, and which was to provide his designated beneficiary, upon the employee's death after retirement, with a similar annuity for life, and which was to provide his designated beneficiary, upon the employee's death after retirement, with a similar annuity for life. The plan provided, however, that no benefits were payable in the event of the employee's death before retirement. The retirement plan at no time met the requirements of section 401(a) (relating to qualified plans). Assume that the employee died at age 59 but that the employer nevertheless started payment of an annuity in a slightly reduced amount to the designated beneficiary. The value of the annuity is not includible in the decedent's gross estate under section 2039(a) and (b). Since the employee died before reaching the retirement age, the employer was under no obligation to pay the annuity to the employee's designated beneficiary. Therefore, the annuity was not paid under a "contract or agreement" as that term is used in section 2039(a). If, however, it can be established that the employer has consistently paid an annuity under such circumstances, the annuity will be considered as having been paid under a "contract or agreement".

[7365] See part II.M.4.f.iv Alternative If a Prospective Partner Wants a Capital Interest Instead of a Profits Interest.

In addition to being subject to FICA, nonqualified stock options are subject to tax under the Railroad Retirement Tax Act.[7366]

For purposes of Code § 2701, the IRS tends to view options as compensation, not equity:[7367]

> Until the options are exercised, the holder of the option has no right to receive dividends and no right to vote shares of the corporation. The holder has only the right to purchase an equity interest (i.e., shares of stock). In purchasing the shares of stock, the holder would then obtain an equity interest in which he would have these rights. The holder of the options, thus, does not hold an equity interest in the corporation and a transfer of the options is not subject to section 2701 of the Code.

Income tax cases have held than an option to acquire a partnership interest does not constitute an equity interest in the partnership.[7368] The author has not discovered Code § 2701 cases addressing that question.

However, options are subject to Code § 2703, which deals primarily with buy-sell agreements.[7369]

Code § 1014(a) applies to a testamentary option to buy stock for less than fair market value, so that the option has basis and any stock bought in exercising it receives basis equal to the option's basis and exercise price.[7370] However, a lapse of the option is treated as having been disclaimed or renounced.[7371] This treatment would also apply to real estate.[7372]

III.B.7.c.viii. Creative Bonus Arrangements

Suppose an employee who is a family member is entitled to receive a bonus based on the entity's profitability. If the bonus is required to be paid on March 15 following the calendar year

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[7366] *Wisconsin Central Ltd. v. U.S.*, 118 A.F.T.R.2d 2016-XXXX (N.D. Ill. 7/8/2016), in holding that nonqualified stock options are subject to the RRTA, stated:

> Similar suits have been filed in recent years. See *BNSF Ry. Co. v. United States*, 775 F.3d 743 (5th Cir. 2015); *Union Pac. R.R. Co. v. United States*, No. 8:14-cv-00237, slip op. (D. Neb. Jul. 1, 2016) (reproduced at Doc. 35-1); *CSX Corp. v. United States*, No. 3:15-cv-00427 (M.D. Fla. filed Apr. 3, 2015). In the two judgments issued thus far, the Fifth Circuit in *BNSF Railway* and the District of Nebraska in *Union Pacific* both upheld the Treasury Department's interpretation of any form of money remuneration to include non-qualified stock options. For the following reasons, this court reaches the same result.

[7367] Letter Ruling 199952012 and CCA 199927002; see Letter Ruling 9616035. The IRS also compares the stock with respect to which the option is granted with the stock that the transferor retained. See Letter Ruling 9725032 (option related to publicly traded stock, and such stock is not subject to Code § 2701) and 9722022 (stock subject to option was same class as stock the transferor retained, so Code § 2701 did not apply).

[7368] *Dorman v. U.S.*, 296 F.2d 27 (9th Cir. 1961) (option was a capital asset but not a partnership interest); *Vestal v. U.S.*, 498 F.2d 487 (8th Cir. 1974) (option was neither a capital asset [because its value was too speculative] nor a partnership interest); *Mayhew v. Commissioner*, T.C. Memo. 1992-68 (option and right to bonus did not constitute a profits interest).

[7369] See text accompanying footnotes 4584-4591.

[7370] Rev. Rul. 67-96.

[7371] Rev. Rul. 67-96.

[7372] Letter Ruling 200340019 applied Rev. Rul. 67-96 to a testamentary option to buy a house. Regarding options involved in Code § 1031 tax-free exchanges of real estate, see Rev. Rul. 84-121, discussed in fn. 1638 in part II.G.16 Like-Kind Exchanges.

the results of which are being measured, the bonus plan generally would not be subject to Code § 409A. If this bonus is based on the entity's income, would the bonus plan constitute an equity interest?

The author is not aware of Code § 2701 cases addressing this issue, so the author has summarized selected income tax cases.

As in other areas, state law determines rights, but tax law determines the effect of those rights; whether a partnership exists depends on a weighting of several factors.[7373]

Some very entrepreneurial taxpayers have been treated as employees and not as owners when they:

- Received salary plus 50% of the profits.[7374]

- Developed a new product line, not only thinking of the idea but also reducing it to practical application and sales to the general public, receiving a percentage of sales.[7375]

The above tests all assume that the service provider is an employee. In a corporate setting, a shareholder who works in the business has two different capacities: an owner and an employee. The author is aware of only one situation in which the IRS combined the two concepts, and that was a clearly abusive situation.[7376] The discussion further above about S corporations compensating employees with stock options provide insight about when, for income tax purposes, an option constitutes equity in the corporation. Absent guidance in a Code § 2701 setting, the author suggests relying on the income tax principles, possibly requesting a Letter Ruling in appropriate situations.

Contrast that with a partnership setting: For income tax purposes, all partner compensation is considered in conjunction with the partner's equity interest. See part II.C.8.a Code § 707 - Compensating a Partner for Services Performed. The author suggests the following guidelines for partnerships:

- If the service provider has a clearly-defined vested[7377] equity interest in the partnership, any additional compensation constituting a guaranteed payment will be reported on the service provider's Schedule K-1.[7378] If the IRS audits an applicable family member's estate tax return and obtains partnership income tax returns, an agent is likely to argue that the service provider's guaranteed payments are part of the service provider's total equity interest and might argue that a testamentary or prior transfer of equity to the service provider should

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[7373] See part II.C.10 Whether Tenancy-in-Common or other Arrangement Constitutes a Partnership.
[7374] *Friednash v. Commissioner*, 209 F.2d 601 (9th Cir 1954); *Duley v. Commissioner*, T.C. Memo. 1981-246.
[7375] *Luna v. Commissioner*, 42 T.C. 1067 (1964). This is one of many cases in which insurance agents unsuccessfully attempted to treat as the sale of a capital asset payments commuting their future commissions or similar contract rights.
[7376] In TAM 9352001, son-in-law was given an employment contract that paid him cash of at least three or four times the market value of his services, for a management position for which he was not qualified, as well as issuing him a control block of voting stock as part of his compensation. The IRS ruled that the stock was cumulative preferred stock, with the excess compensation constituting the preference.
[7377] See text accompanying fn. 3757 in part II.M.4.f.ii Tax Effects of Profits Interest for issues relating to a wholly unvested interest in partnership capital and profits.
[7378] See footnote 528.

have been valued considering this additional compensation. One should carefully consider the extent to which the service provider has the right as a partner to make these payments to himself/herself.

- Contrast this to a corporate setting, where these incentive payments are reported on Forms W-2. The IRS' main inquiry is likely to be whether the incentive payments constituted reasonable compensation. Although the IRS might argue that the payments were part of the service provider's rights as a shareholder, in most corporate settings the shareholder would need to elect a director to protect his/her interest, and then prove that the director would have conspired with the other directors to order the corporation's president to pay such compensation.[7379]

III.B.7.c.ix. Debt vs. Equity

Generally, for gift tax purposes courts look to income tax cases to determine when a transaction rises to the level of granting an equity interest. For income tax principles, see part II.G.20 Debt vs. Equity; Potential Denial of Deduction for Business Interest Expense.

III.B.7.d. Code § 2702 Overview

Code § 2702(a), "Valuation rules," provides:

(1) *In general*. Solely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), the value of any interest in such trust retained by the transferor or any applicable family member (as defined in section 2701(e)(2))[7380] shall be determined as provided in paragraph (2).

(2) *Valuation of retained interests*.

(A) *In general*. The value of any retained interest which is not a qualified interest shall be treated as being zero.

(B) *Valuation of qualified interest*. The value of any retained interest which is a qualified interest shall be determined under section 7520.

(3) *Exceptions*.

(A) *In general*. This subsection shall not apply to any transfer -

(i) if such transfer is an incomplete gift,

(ii) if such transfer involves the transfer of an interest in trust all the property in which consists of a residence to be used as a personal residence by persons holding term interests in such trust, or

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[7379] Many states have statutory close corporation provisions allowing a corporation to abolish such formalities; see fn 1138. Furthermore, a shareholders' agreement can purport to lock-in such arrangements; however, the general rule is that no agreement can legally bind future directors to a particular course of action.
[7380] See fn 7286 in part III.B.7.b.i Code § 2701 Definitions.

(iii) to the extent that regulations provide that such transfer is not inconsistent with the purposes of this section.

(B) *Incomplete gift*. For purposes of subparagraph (A), the term “incomplete gift” means any transfer which would not be treated as a gift whether or not consideration was received for such transfer.

Code § 2702(b), “Qualified interest,” provides:

For purposes of this section, the term “qualified interest” means-

(1) any interest which consists of the right to receive fixed amounts payable not less frequently than annually,

(2) any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually), and

(3) any noncontingent remainder interest if all of the other interests in the trust consist of interests described in paragraph (1) or (2).

Code § 2702(c), “Certain property treated as held in trust,” provides:

For purposes of this section -

(1) *In general*. The transfer of an interest in property with respect to which there is 1 or more term interests shall be treated as a transfer of an interest in a trust.

(2) *Joint purchases*. If 2 or more members of the same family acquire interests in any property described in paragraph (1) in the same transaction (or a series of related transactions), the person (or persons) acquiring the term interests in such property shall be treated as having acquired the entire property and then transferred to the other persons the interests acquired by such other persons in the transaction (or series of transactions). Such transfer shall be treated as made in exchange for the consideration (if any) provided by such other persons for the acquisition of their interests in such property.

(3) *Term interest*. The term “term interest” means -

(A) a life interest in property, or

(B) an interest in property for a term of years.

(4) *Valuation rule for certain term interests*. If the nonexercise of rights under a term interest in tangible property would not have a substantial effect on the valuation of the remainder interest in such property -

(A) subparagraph (A) of subsection (a)(2) shall not apply to such term interest, and

(B) the value of such term interest for purposes of applying subsection (a)(1)shall be the amount which the holder of the term interest establishes as the amount for which such interest could be sold to an unrelated third party.

Code § 2702(d), "Treatment of transfers of interests in portion of trust," provides:

> In the case of a transfer of an income or remainder interest with respect to a specified portion of the property in a trust, only such portion shall be taken into account in applying this section to such transfer.

Code § 2702(e), "Member of the family," provides:

> For purposes of this section, the term "member of the family" shall have the meaning given such term by section 2704(c)(2).

Code § 2702(b)(1) and the regulations thereunder govern grantor retained annuity trusts (GRATs). See part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust.

When the grantor retains an interest that is not a qualified interest, see part III.B.2.c Grantor Retained Income Trust (GRIT).

CCA 201208026 discussed the interaction of completed gift concepts and Code § 2702. It is reproduced in part in the completed gift discussion of part III.B.2.c.iii GRIT When Code § 2702 Applies.

Regulations under Code § 2702 also might create unexpected gift tax issues when trusts are modified, decanted, or otherwise adjusted. Code § 2702 provides special rules to determine the amount of the gift when an individual makes a transfer in trust to (or for the benefit of) a member of the individual's family and the individual or an applicable family member retains an interest in the trust.[7381] If Code § 2702 applies to a transfer, the value of any interest in the trust retained by the transferor or any applicable family member is determined under Reg. § 25.2702-2(b).[7382] The amount of the gift, if any, is then determined by subtracting the value of the interests retained by the transferor or any applicable family member from the value of the transferred property.[7383] If the retained interest is not a qualified interest,[7384] the retained interest is generally valued at zero, and the amount of the gift is the entire value of the property.[7385]

A potential trap is that a "transfer in trust" includes "a transfer to a new or existing trust and an assignment of an interest in an existing trust."[7386] An "assignment of an interest in an existing trust" is not explicitly limited to a transfer of the beneficiary's interest to a new trust, so the IRS might argue that it applies to a shift in beneficial interest from one beneficiary to a new or existing beneficiary. If all of a trust is decanted by being transferred to another trust, the beneficiary's entire interest is being transferred, and the IRS might assert that any diminishment in the beneficiary's interest is a gift of the value of the beneficiary's entire interest in a trust, without being reduced for any beneficial interest that the beneficiary retains except to the extent that the retained interest qualifies under Code § 2702 (such as a qualified annuity interest). However:

[7381] Reg. § 25.2702-1(a).
[7382] Reg. § 25.2702-1(b).
[7383] Reg. § 25.2702-1(b).
[7384] As defined in Reg. § 25.2702-3.
[7385] Reg. § 25.2702-1(b).
[7386] Reg. § 25.2702-2(a)(2).

- A “transfer in trust” does not include the exercise, release or lapse of a power of appointment over trust property that is not a transfer under the usual gift tax rules[7387] and does not include a Code § 2518 qualified disclaimer.[7388]

- Letter Ruling 9321046 did not apply Code § 2702 when applying Code § 2701 to a freeze transaction engaged in by a trust, making the gift equal to the difference in the beneficiary’s life estate before and after the freeze.[7389] On the other hand, if Code § 2701 applies, “A person is considered to hold an equity interest held by or for an estate or trust to the extent the person’s beneficial interest therein may be satisfied by the equity interest held by the estate or trust, or the income or proceeds thereof, assuming the maximum exercise of discretion in favor of the person.”[7390]

- Rev. Rul. 93-12 (see text accompanying fn 6337 in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts) looks to the property that each transferee separately receives. If the transferee receives an interest in the entire trust, the IRS might argue that the entire beneficial interest was transferred. On the other hand, if the amount the transferee receives has a solid limit, presumably that would limit the gift’s value.

- “If a transfer is wholly incomplete as to an undivided fractional share of the property transferred (without regard to any consideration received by the transferor), for purposes of this paragraph the transfer is treated as incomplete as to that share.”[7391] So, if the transfer caps distributions to the transferee to certain percentage of the trust and is subject to the transferor beneficiary’s veto,[7392] the gift may be incomplete and measured based on actual distributions.

A common planning tool is for the beneficiary to hold such powers in the new trust as would make a gift of the beneficial interest in the old trust be an incomplete gift. See part III.B.1.c.iii Incomplete Gift. Note that this causes estate inclusion and may be inappropriate in a trust that was intended to be excluded from the beneficiary’s gross estate because it is grandfathered from GST tax or that is protected from GST tax by reason of the transferor allocating GST exemption.

Code § 2702 does not apply to a transfer in trust if the transfer of an interest to a spouse is deemed to be for full and adequate consideration by reason of Code § 2516 (relating to certain property settlements) and the remaining interests in the trust are retained by the other spouse.[7393] However, a settlement that provides benefits to the persons other than the couple,

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[7387] Reg. § 25.2702-2(a)(2)(i).
[7388] Reg. § 25.2702-2(a)(2)(ii).
[7389] See fn. 7314. Whether the IRS overlooked the issue or decided that Code § 2702 did not apply is unclear. The ruling did not mention any consideration of Code § 2702.
[7390] Reg. § 25.2701-6(a)(4), but also see fn. 7310 for limitations on that.
[7391] Reg. § 25.2702-1(c)(1).
[7392] Reg. § 25.2511-2(e) provides:

> A donor is considered as himself having a power if it is exercisable by him in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom. A trustee, as such, is not a person having an adverse interest in the disposition of the trust property or its income.

[7393] Reg. § 25.2702-1(c)(7). Reg. § 25.2702-4(d), Example (5), provides:

> H and W enter into a written agreement relative to their marital and property rights that requires W to transfer property to an irrevocable trust, the terms of which provide that the income

such as their children, constitutes either a gift by the transferring spouse to the those other persons,[7394] a relinquishment by the transferee spouse of the transferee's marital rights,[7395] or some combination of those.[7396] In such a settlement involving other persons, Code § 2702 applies,[7397] and the beneficiary spouse's rights must be a qualified interest in order for them to be valued.[7398]

> of the trust will be paid to H for 10 years. On the expiration of the 10-year term, the trust is to terminate and the trust corpus is to be paid to W. H and W divorce within two years after the agreement is entered into. Pursuant to section 2516, the transfer to H would otherwise be deemed to be for full and adequate consideration. Section 2702 does not apply to the acquisition of the term interest by H because no member of H's family acquired an interest in the property in the same transaction or series of transactions. The result would not be the same if, on the termination of H's interest in the trust, the trust corpus were distributable to the children of H and W rather than W.

[7394] Rev. Rul. 79-363.

[7395] Rev. Rul. 77-314, Situation 2.

[7396] Reg. § 25.2702-4(c) applies to joint purchases:

> Solely for purposes of section 2702, if an individual acquires a term interest in property and, in the same transaction or series of transactions, one or more members of the individual's family acquire an interest in the same property, the individual acquiring the term interest is treated as acquiring the entire property so acquired, and transferring to each of those family members the interests acquired by that family member in exchange for any consideration paid by that family member. For purposes of this paragraph (c), the amount of the individual's gift will not exceed the amount of consideration furnished by that individual for all interests in the property.

Thus, if a transferee spouse acquires a term interest in the trust, and the children also acquire an interest, Code § 2702 would apply. However, if the transfer involves children of the transferee spouse and not of the transferor spouse and occurs after the divorce but pursuant to the divorce decree, the transferee spouse and the transferee spouse's children are not considered members of transferor spouse's family, so perhaps Code § 2702 would not apply.

[7397] See the last sentence of Reg. § 25.2702-4(d), Example (5), which fn. 7393 reproduces in full.

[7398] Letter Ruling 200408015 did not apply Code § 2702 when the transferee spouse had the right to annuity payments from the trust's income and principal and the remainder would pass to the transferor spouse's children. It ruled that that, to the extent of the transferee spouse's annuity interest, the transfer to the trust would constitute a transfer for full and adequate consideration under Code § 2516, and the only taxable gift transferor spouse Settlor will be the gift of the trust remainder's to the transferor spouse's children under Code § 2511. Letter Ruling 200408015 also held that creating the trust to discharge the transferor trust's support rights did not subject the transferor spouse to income tax:

> In this case, Settlor proposes to transfer funds to Trust pursuant to the Modification. In the event Trust is treated as a grantor trust, Settlor is treated as the owner of the Trust. Therefore, Settlor will not be considered to have made a transfer of property for federal income tax purposes and there is no section 1041 issue to consider. Thus, if Trust is a grantor trust, no gain or loss would be realized by Husband under section 1001.
>
> Alternatively, if Trust is not treated as a grantor trust, Settlor will be considered to have made a transfer of property, but no gain or loss would be recognized by Settlor under section 1001. To the extent that Settlor's proposed transfer of assets to the Trust is for the benefit of Wife, any realized gain on the transfer would not be recognized under section 1041(a). To the extent that Settlor's transfer of assets to the Trust is considered as a gift to Settlor's children, no gain or loss would be recognized.
>
> The transfer of property will be made pursuant to the Modification. Settlor's transfer of property to Trust for Wife's benefit is a transfer that is incident to the divorce within the meaning of section 1041(a)(2) and section 1.1041-1T, Q&A-7. The transfer is pursuant to a divorce or separation instrument and occurs not more than 6 years after the date on which the marriage ceased. Thus, no gain or loss is recognized on such transfer.

III.B.7.e. Code § 2703 Overview

See discussion in part II.Q.4.h Establishing Estate Tax Values.

Regulations assert that Code § 2703 applies for estate, gift, and generation-skipping transfer tax purposes, but one court held that it applies only to transfers at death.[7399]

Estate of Morrissette v. Commissioner, T.C. Memo. 2021-60, held that Code § 2703 did not apply to the split-dollar arrangement at issue:[7400]

> The first step in the valuation process is to determine the property includible in the gross estate. The parties agree that the split-dollar rights are assets that are includible in the gross estate. The estate included the split-dollar rights in the gross estate but reported values for the rights substantially discounted from the $30 million in premiums that the CMM trust paid. By doing so, the estate significantly undervalued the split-dollar rights. Before we determine the fair market values of the split-dollar rights, we must consider application of the special valuation rules of section 2703. Section 2703(a) provides that the value of any asset includible in the gross estate shall be determined without regard to (1) any option, agreement, or other right to acquire or use the property at a price less than its fair market value or (2) any restriction on the right to sell or use such property. Section 2703(b) provides an exception where the restriction is a bona fide business arrangement, not a device to transfer property to members of the decedent's family for

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It also addressed the interaction of the transferor spouse's swap power (see part III.B.2.h.i Who Is the Grantor), which made the trust a grantor trust as to the transferor spouse, with Code § 682, which taxes the transferee spouse on amounts paid, credited, or required to be paid to the transferee spouse (see the paragraph accompanying fn. 5973, found in part III.A.3.e.i.(a) QSSTs Generally):

> The circumstances surrounding Trust's administration will determine whether the power of administration is exercisable in a fiduciary or a nonfiduciary capacity. This is a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved have been examined by the office with responsibility for such examination. Provided that the circumstances surrounding Trust's administration indicate that the power of administration held by Settlor over Trust *(i.e.*, the power to substitute assets for assets of equivalent value) is exercisable by Settlor in a nonfiduciary capacity without the approval or consent of a person in a fiduciary capacity, Settlor will be treated as the owner of Trust. We further conclude that while both Settlor and Wife are alive, section 682 governs the income taxation of Trust. Accordingly, distributions from Trust to Wife are deductible by Trust and includible by Wife in her gross income to the extent provided in sections 661 and 662. Under the terms of Trust, capital gains are not includible in the distributions to Wife. Accordingly, capital gains are not included in the distributions to Wife and are included in the gross income of Settlor under section 675(4) (subject to the conditions noted above regarding section 675(4)).
>
> We further conclude that if Wife predeceases Settlor, upon the death of Wife, section 682 would no longer apply and Trust will be treated as a grantor trust with Settlor as owner, provided that, after the death of Wife, Settlor retains the same powers of administration that cause Trust to be a grantor trust under section 675(4) (subject to the conditions noted above regarding section 675(4)). If Settlor predeceases Wife, section 682 no longer applies and payments to Wife will be deductible to Trust under section 661 and includible in Wife's gross income under section 662. Income allocable to principal will be taxable to Trust. If neither Settlor nor Wife are alive, then the income taxation of Trust is also governed by the rules of subchapter J, other than the grantor trust rules and section 682.

[7399] See fn. 4588, found in part II.Q.4.h Establishing Estate Tax Values.

[7400] See part II.Q.4.f Split-Dollar Arrangements, especially part II.Q.4.f.v Estate Tax Consequences of Split-Dollar Agreements.

less than adequate and full consideration, and comparable to the terms of similar arrangements in arm's-length transactions.

The parties filed cross-motions for partial summary judgment with respect to the application of section 2703(a). We denied both motions in an order dated February 19, 2019, citing *Estate of Cahill v. Commissioner*, at *28. We held that section 2703(a) would apply to disregard the mutual termination restriction unless the section 2703(b) exception is satisfied.[12] Petitioners have established that the section 2703(b) exception applies in this case. Under the exception, the restriction must be part of a bona fide business arrangement, not a device to transfer property at less than adequate and full consideration, and for terms comparable to similar arrangements entered into at arm's length. Sec. 2703(b); sec. 25.2703-1(b)(4), Gift Tax Regs.

[12] Respondent contends that once we disregard the mutual termination restriction, the split-dollar rights would have values equal to the cash surrender values. Because the sec. 2703(b) exception applies, we do not need to determine the values of the split-dollar rights under the assumption of a unilateral termination right.

1. Bona Fide Business Arrangement

A bona fide business arrangement is not defined in the Code or the regulations. Sec. 2703(b)(1). We have held that a restrictive arrangement must further some business purpose. *Amlie v. Commissioner*, T.C. Memo. 2006-76. As discussed above, the family members credibly testified that the split-dollar agreements were entered into for valid business purposes and the mutual termination restriction was added so that no brother could jeopardize the valid business purposes of the agreements. The split-dollar agreements were intended to address flaws in the 1996 plan, past disputes, and Interstate's future management while attempting to accomplish Mrs. Morrissette's wish for the company remain within her family for generations. See *Estate of Gloeckner v. Commissioner*, 152 F.3d 208, 214 (2d Cir. 1998), *rev'g on other grounds* T.C. Memo. 1996-148; *Kress v. United States*, 382 F. Supp. 3d 820, 839 (E.D. Wis. 2019) (recognizing maintenance of family ownership and control of a business as a valid business purpose).

The family members credibly testified about the difficulties created within Interstate's management and for its employees. Ken credibly testified that he would have engaged in the split-dollar agreements even if they had not provided any estate tax saving. It is not clear that the brothers would have agreed to terminate the split-dollar agreements during Mrs. Morrissette's life so that the CMM trust would receive repayment. Assuming that the split-dollar agreements are viewed as written, the dynasty trusts would receive nothing upon a termination of the split-dollar agreements.

Furthermore, the CMM trust had valid business reasons for entering into the split-dollar agreements. Planning for future liquidity needs of a decedent's estate constitutes a business purpose under section 2703(b)(1). *Amlie v. Commissioner*, T.C. Memo. 2006-76. We find that the mutual termination restriction furthered the business purposes of the split-dollar agreements and had a significant effect in supporting those business purposes.

2. Testamentary Device

Under the second prong of the exception, the restriction must not be a device to transfer property for less than adequate and full consideration in money or money's worth. Sec. 2703(b)(2). Some facts indicate a testamentary purpose of the split-dollar agreements. However, under the second prong of the exception, we consider whether the mutual termination restriction is a device, not whether the split-dollar agreements in their entirety were a device. Whether a restriction constitutes a testamentary device depends in part on the fairness of the consideration received by the transferor when it executed the transaction. See *Estate of True v. Commissioner*, T.C. Memo. 2001-167, *aff'd*, 390 F.3d 1210 (10th Cir. 2004). Respondent does not seek to disregard the split-dollar agreements in their entirety.

Under the totality of the facts and circumstances, we find that the mutual termination restriction was not a device to transfer funds at less than adequate and full consideration. As discussed above, the split-dollar agreements contained repayment terms that a reasonable investor would have accepted. They provided inside buildup at a guaranteed interest rate of 3% and in fact provided interest between 4.75% and 5.4%, higher than the CMM trust had been earning on the transferred funds. The inside buildup appreciated at rates comparable to those of long-term bonds. The split-dollar agreements were stable investments that also provided for tax deferral on the inside buildup. Petitioners argue that the inside buildup would have been tax exempt although we do not decide that question. Each of these facts negates a finding that the mutual termination restriction was a device to transfer property for less than adequate and full consideration.

The gift tax treatment of the split-dollar agreements does not change our conclusion that split-dollar agreements entered into at arm's length between unrelated parties would contain a mutual termination restriction comparable to the one at issue here. To do otherwise, we would need to ignore the insureds were also senior executives in a successful 75-year-old business who had not only run the company for nearly 40 years but also significantly developed it.

For reasons stated above with respect to the section 2036 and 2038 exceptions, the CMM Trust received other financial benefits from the premium payments. The CMM trust received value through continued family control and management succession and avoidance of uncertainty including possible future litigation. The turmoil among the family members who served as senior management executives exposed the fair market value of Interstate to risk that a prudent investor would have considered. Buddy, who was Interstate's CEO, had sought a buyout for years, and the split-dollar agreements provided for one. In respondent's view, the CMM trust benefited only because of estate tax saving. This is clearly not the case, on the basis of the record. The CMM trust received adequate and full consideration when it executed the split-dollar agreements. The CMM trust relinquished rights over the transferred amounts for additional certainty about Interstate's future.

Petitioners argue that the split-dollar agreements were not devices to evade tax because the net death rights were transferred in accordance with the split-dollar regulations. Compliance with the regulations does not itself establish that the split-dollar agreements were not a device to evade tax. See *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84. First, we note that the exception focuses not on the restriction as part of a bona fide business arrangement and not on the split-dollar agreements as a whole. Irrespective of the statutory or regulatory wording, the fact that the split-dollar agreements reduced the estate tax on Mrs. Morrissette's estate does not require a finding that the agreements were testamentary devices. The CMM trust through its cotrustees did not enter into the split-dollar agreements with an intent to evade estate tax. The cotrustees believed the terms to be fair at the time the CMM trust executed the split-dollar agreements including the mutual termination restriction. Accordingly, the mutual termination restriction satisfies the second requirement of the exception.

3. Comparability With Arm's-Length Transactions

The comparability prong requires that the restriction would have been part of an arm's-length transaction between unrelated parties. Sec. 2703(b)(3); sec. 25.2703-1(b)(4)(i), Gift Tax Regs. Thus, the issue for the third prong of the section 2703 exception is whether unrelated parties in an arm's-length transaction would include a mutual termination restriction in a split-dollar agreement that is comparable to the mutual termination restriction at issue.

The regulations instruct that the restriction must be comparable to one struck in a fair bargain among unrelated parties in the same business and that such a bargain occurs when it conforms with the general practices of negotiated agreements in that same business. Sec. 25.2703-1(b)(4)(i), Gift Tax Regs. The regulations caution against using "isolated comparables". *Id*. subdiv. (ii). We have described the third prong of the exception as "more of a safe harbor than an absolute requirement that multiple comparables be shown." *Amlie v. Commissioner*, T.C. Memo. 2006-76, slip op. at 41.

Respondent offered split-dollar agreements entered into as employee compensation by publicly traded corporations. Public corporations do not necessarily meet the regulations' directive to consider the same business. Mr. Burns did not provide an analysis of the business of the public corporations or whether any were in the same business as Interstate. The fact that the corporations were public alone causes us to question whether we should rely on the agreements as comparable. Interstate has been a family business for over 75 years. Split-dollar agreements entered into by public corporations have little relevance to ascertaining whether a closely held corporation or its majority shareholder would include a mutual termination restriction in a split-dollar agreement. In 2006 Mrs. Morrissette owned 75% of Interstate directly or indirectly.

However, this is not the only problem that we have with the corporate filings. On respondent's instruction, Mr. Burns limited his review to policies owned by the employer. Here, Interstate did not own the policies and did not have any ownership rights to the policies. The dynasty trusts owned the policies, and the split-dollar agreements placed restrictions on their ownership rights. They did not convey any ownership rights in the policies to the CMM trust. The fact that the economic benefit regime deems the CMM trust the policy owner for gift or income tax purposes is irrelevant. We consider the agreements as written just as Mr. Burns considered the public split-dollar agreements as written. Respondent has not articulated a convincing reason for placing such a restriction on Mr. Burns' testimony. [*105] Finally, we do not agree with Mr. Burns' characterization that 84% of the reviewed agreements provide a unilateral termination right to the employer or gave the employer full unilateral access to the cash surrender values. Twenty-six agreements provided some type of restriction of the employers' rights to unilaterally terminate the split-dollar agreements. Vesting for years of service is one such restriction which is particularly relevant here given the fact that the brothers were senior executives. Petitioners ask us to consider whether a closely held corporation would provide life insurance benefits to its senior executives who had worked within the business for over 40 years. Such consideration is appropriate. Long-term senior executives would likely demand a mutual termination restriction comparable to the one at issue, and the reviewed agreements provide vesting provisions. The mutual termination restriction would ensure the executives' rights to the net death benefits similar to vesting in employment compensation packages on the basis of years of service. In total, approximately 30% of the public agreements imposed some restriction on the employer's termination rights. The termination rights of another 13% are not as clear as respondent argues.

As discussed above, on these facts we hold the split-dollar agreements were entered into at arm's length especially in the light of the brothers' acrimonious [*106] relationships and disputes over Interstate's ownership. We are satisfied that a split-dollar agreement entered into by a closely held business and its long-term senior executives at arm's length may contain a mutual termination restriction similar to the one in the split-dollar agreements at issue. Accordingly, we hold that the third requirement of the section 2703(b)(3) exception has been met.

On this record, we conclude that the requirements of the section 2703(b) exception are satisfied and section 2703 does not require disregard of the mutual termination restriction for purposes of determining the fair market values of the split-dollar rights.

III.B.7.f. Code § 2704 Overview

Code § 2704 applies for estate, gift, and generation-skipping transfer tax purposes.[7401]

III.B.7.f.i. Code § 2704 – Current Law

In a family-controlled business, Code § 2704(a) treats as a transfer the lapse of any voting or liquidation right in a corporation or partnership.[7402] When valuing transfers, Code § 2704(b) disregards restrictions on liquidation that are not commercially reasonable and are more restrictive than state law defaults. In other words, Code § 2704(a) values what is not transferred but rather goes away, and Code § 2704(b) values what is transferred; in both cases, the true economic value is modified by federal tax law.

If the entity is not family-controlled (using a combination of Code § 2701 and 2704 principles), then Code § 2704 does not apply.

Code § 2704(a) provides that, if there is a lapse of any voting or liquidation right in a corporation or partnership, and the individual holding such right immediately before the lapse and members of such individual's family hold, both before and after the lapse, control of the entity, the lapse is treated as a transfer by the individual by gift, or a transfer which is includible in the gross estate

[7401] See fn. 2110, found in part II.H.2.j Effect of Chapter 14 on Basis Step-Up.
[7402] The lapse of voting rights at death was includible in the decedent's gross estate in the *Estate of Rankin Smith v. U.S.*, 103 Fed. Cl. 533 (2012). Why the decedent did not do a voting/nonvoting right recap and plan accordingly is not mentioned. The bona fide business arrangement is an exception to Code § 2703, not Code § 2704.

of the decedent, whichever applies.[7403] The amount of this transfer is the excess (if any) of (A) the value of all interests in the entity held by the individual immediately before the lapse (determined as if the voting and liquidation rights were nonlapsing), over (B) the value of such interests immediately after the lapse.[7404]

In the context of an affirmative transfer of an equity interest, existing regulations apply only regarding one's right to liquidate the entity.[7405] Proposed regulations would expand this to apply these rules to the ability to liquidate one's interest in the business.[7406]

Code § 2704(b) provides that, if there is a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family, and the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity, any applicable restriction shall be disregarded in determining the value of the transferred interest:[7407]

- An "applicable restriction" is any restriction which effectively limits the ability of the corporation or partnership to liquidate, and with respect to which either:[7408]

  (i) the restriction lapses, in whole or in part, after the transfer, or

  (ii) the transferor or any member of the transferor's family, either alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction.

- "Applicable restriction" does not include:[7409]

  (A) any commercially reasonable restriction which arises as part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee, or a member of the family of either, or

  (B) any restriction imposed, or required to be imposed, by any Federal or State law.

- Regulations may disregard other restrictions "in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest" for estate, gift, and generation-skipping transfer tax purposes "but does not ultimately reduce the value of such interest to the transferee."[7410]

III.B.7.f.ii. 2016 Proposed Regulations (Withdrawn)

For many years, taxpayers have been placing nonbusiness assets in business entities. Because business entities that are not publicly traded are illiquid and certain ownership interests

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[7403] Code § 2704(a)(1). Code § 2704(a)(3) authorizes regulations to apply Code § 2704(a) to rights similar to voting and liquidation rights.
[7404] Code § 2704(a)(2).
[7405] *Kerr*, 292 F.3d 490 (5th Cir. 2002); compare Reg. § 25.2704-2(b) (for a transferred interest, an applicable restriction is a limitation on the ability to liquidate the entity) with Reg. § 25.2704-1(a)(2)(v) (for a lapse, liquidation right means right to compel the entity to redeem the interest).
[7406] See part III.B.7.f.ii.(a) Prop. Reg. § 25.2704-1 Regarding .
[7407] Code § 2704(b)(1).
[7408] Code § 2704(b)(2).
[7409] Code § 2704(b)(3).
[7410] Code § 2704(b)(4).

lack input into how the entities are run, the ownership interests are worth much less than a pro rata share of the entities' assets. The IRS has had only limited success increasing the value to a pro rata share of the entities' assets.

Fourteen years after losing a case in which the court suggested that the government consider changing the relevant regulations, the government took action.

REG-163113-02 (10/17/2017) withdrew the proposed regulations.

Further below are discussions of the following parts of the withdrawn proposed regulations:

- III.B.7.f.ii.(a) Prop. Reg. § 25.2704-1 Regarding Value That Disappears Without Being Transferred, including value that permanently disappears because of a change in rights and value that, if one dies too soon after the transfer, is brought back into one's estate because it reduced the value of one's retained interest in the entity by reason of losing control.

- III.B.7.f.ii.(c) Prop. Reg. § 25.2704-2 Disregarding "Applicable Restrictions" That Later Lapse or Can Be Removed.

- III.B.7.f.ii.(d) Prop. Reg. § 25.2704-3 Disregarding Restrictions under Governing Documents and State Law that Could Have Been Removed All Along.

The latter is very controversial and would not apply until 30 days after being finalized. Code § 2704(b)(4) authorizes the government to promulgate regulations disregarding a restriction "if such restriction has the effect of reducing the value of the transferred interest … but does not ultimately reduce the value of such interest to the transferee." If, as generally is the case for operating businesses, cashing in an owner's interest or liquidating the entity would decrease the value of the owner's interest, a regulation that assumes greater liquidity than is actually the case would seem to violate the regulation's authority.

Note that any value that the latter treats as being transferred would not be taxed as gifts under the first two proposed rules, because the value never disappeared. Also, to the extent that other tax attributes of transferred property are derived from gifts, they would apply to what the transferee received under the latter but have uncertain application to value treated as disappearing under the first two.

III.B.7.f.ii.(a). Prop. Reg. § 25.2704-1 Regarding Value That Disappears Without Being Transferred

The new rules apply only if the entity is controlled by the holder and/or members of the holder's family immediately before and after the lapse.[7411]

[7411] Prop. Reg. § 25.2704-1(a)(1). Prop. Reg. § 25.2704-1(a)(2)(i) would add the following to the end of existing Reg. § 25.2704-1(a)(2)(i):

> For purposes of determining whether the group consisting of the holder, the holder's estate and members of the holder's family control the entity, a member of the group is also treated as holding any interest held indirectly by such member through a corporation, partnership, trust, or other entity under the rules contained in § 25.2701-6.

Prop. Reg. § 25.2704-1(a)(2)(i) would add the following before the third sentence of existing Reg. § 25.2704-1(a)(2)(iii):

For purposes of subtitle B (relating to estate, gift, and generation-skipping transfer taxes), the lapse of a voting or a liquidation right[7412] in a corporation or a partnership (an entity),[7413] whether domestic or foreign, is a transfer by the individual directly or indirectly holding the right immediately before its lapse (the holder) to the extent provided in the rules below.[7414]

A lapse includes a transfer that results in the restriction or elimination of the transferee's ability to exercise the voting or liquidation rights that were associated with the interest while held by the transferor, specifically including the transfer of a voting partnership interest to an assignee who cannot vote.[7415]

Notwithstanding the repeal of rules against transfers in contemplation of death and the limitation of a 3-year rule in Code § 2035, the new rule would impose Code § 2704 estate inclusion on the lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor's death.[7416]

Whether an interest can be liquidated immediately after the lapse is determined under the local law generally applicable to the entity, as modified by the governing documents of the entity, but without regard to any restriction (in the governing documents, applicable local law, or otherwise) described in Code § 2704(b) and the regulations thereunder.[7417] See part III.B.7.f.ii.(b) Prop. Reg. §§ 25.2704-2 and 25.2704-3 Increasing Value.

In the case of a limited liability company, the right of a member to participate in company management is a voting right.

[7412] Prop. Reg. § 25.2704-1(a)(4) provides:

Source of right or lapse. A voting right or a liquidation right may be conferred by or lapse by reason of local law, the governing documents, an agreement, or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs voting or liquidation rights.

[7413] Prop. Reg. § 25.2704-1(a)(1) provides:

For purposes of this section, a corporation is any business entity described in § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. A partnership is any other business entity within the meaning of § 301.7701-2(a) of this chapter regardless of how that entity is classified for federal tax purposes. Thus, for example, the term partnership includes a limited liability company that is not an S corporation, whether or not it is disregarded as an entity separate from its owner for federal tax purposes.

[7414] Prop. Reg. § 25.2704-1(a)(1).

[7415] Prop. Reg. § 25.2704-1(a)(5).

[7416] Prop. Reg. § 25.2704-1(c)(1).

[7417] Prop. Reg. § 25.2704-1(c)(2)(i)(B), which further provides:

The manner in which the interest may be liquidated is irrelevant for this purpose, whether by voting, taking other action authorized by the governing documents or applicable local law, revising the governing documents, merging the entity with an entity whose governing documents permit liquidation of the interest, terminating the entity, or otherwise. For purposes of making this determination, an interest held by a person other than a member of the holder's family (a nonfamilymember interest) may be disregarded. Whether a nonfamily-member interest is disregarded is determined under § 25.2704-3(b)(4), applying that section as if, by its terms, it also applies to the question of whether the holder (or the holder's estate) and members of the holder's family may liquidate an interest immediately after the lapse.

Transfers made within 3 years of death might also constitute a lapse,[7418] including transfers approved by Rev. Rul. 93-12.[7419]

The three-year period was purportedly to capture transfers in contemplation of death. However, it would apply if a very healthy person died accidentally and could have unfair results. For example, a young, healthy married person with a marital deduction designed to generate no estate tax transfers assets subject to this rule. The transferor is hit by a bus two years later. The phantom asset in the transferor's estate does not pass to the spouse and therefore might generate estate tax. My understanding is that comments would suggest that this be changed to whether, using Code § 7520 principles, the taxpayer is expected to live at least one year, which would still benefit the government more than current law.

The effective date of the lapse provision is unclear. If a transferor dies within three years, the lapse is treated as occurring at the date of death. If the transfer is made before the regulations' effective date and the transferor dies after the regulations' effective date, would the regulations capture the lapse? My understanding is that the final regulations are expected to clarify that the answer is no.

Note that selling one's interest to an unrelated third party in a sale that results in the transferor losing control may constitute a lapse that this provision reaches.

III.B.7.f.ii.(b). Prop. Reg. §§ 25.2704-2 and 25.2704-3 Increasing Value Transferred

III.B.7.f.ii.(c). Prop. Reg. § 25.2704-2 Disregarding "Applicable Restrictions" That Later Lapse or Can Be Removed

If an interest in an entity is transferred to or for the benefit of a member of the transferor's family, and the transferor and/or members of the transferor's family control the entity immediately before the transfer, any applicable restriction is disregarded in valuing the transferred interest.[7420]

"Applicable restriction" means "a limitation on the ability to liquidate the entity, in whole or in part (as opposed to a particular holder's interest in the entity), if, after the transfer, that limitation either lapses or may be removed by the transferor, the transferor's estate, and/or any member of the transferor's family, either alone or collectively."[7421]

[7418] Prop. Reg. § 25.2704-1(f), Example (7), would revise the third and fourth sentences and add a new conclusion:

> More than three years before D's death, D transfers 30 shares of common stock to D's child. The transfer is not a lapse of a liquidation right with respect to the common stock because the voting rights that enabled D to liquidate prior to the transfer are not restricted or eliminated, and the transfer occurs more than three years before D's death. * * * However, had the transfer occurred within three years of D's death, the transfer would have been treated as the lapse of D's liquidation right with respect to the common stock occurring at D's death.

[7419] See the regulation accompanied by a paragraph explaining Rev. Rul. 93-12 in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts.

[7420] Prop. Reg. § 25.2704-2(a).

[7421] Prop. Reg. § 25.2704-2(b)(1), which further provides, "See § 25.2704-3 for restrictions on the ability to liquidate a particular holder's interest in the entity."

An "applicable restriction" may arise under an entity's governing documents or applicable law.[7422] Almost every law is subject to being disregarded.[7423]

"A restriction is an applicable restriction only to the extent that either the restriction by its terms will lapse at any time after the transfer, or the restriction may be removed after the transfer by any one or more members, either alone or collectively, of the group consisting of the transferor, the transferor's estate, and members of the transferor's family."[7424]

[7422] Prop. Reg. § 25.2704-2(b)(2) provides:

> *Source of limitation*. An applicable restriction includes a restriction that is imposed under the terms of the governing documents (for example, the corporation's by-laws, the partnership agreement, or other governing documents), a buy-sell agreement, a redemption agreement, or an assignment or deed of gift, or any other document, agreement, or arrangement; and a restriction imposed under local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs the applicability of the restriction. For an exception for restrictions imposed or required to be imposed by federal or state law, see paragraph (b)(4)(ii) of this section.

[7423] Prop. Reg. § 25.2704-2(b)(4)(ii) provides:

> *Imposed by federal or state law*. An applicable restriction does not include a restriction imposed or required to be imposed by federal or state law. For this purpose, federal or state law means the laws of the United States, of any state thereof, or of the District of Columbia, but does not include the laws of any other jurisdiction. A provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded with regard to a particular entity (whether by the shareholders, partners, members and/or managers of the entity or otherwise) is not a restriction that is imposed or required to be imposed by federal or state law. A law that is limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in section 2704, is not a restriction that is imposed or required to be imposed by federal or state law. For example, a law requiring a restriction that may not be removed or superseded and that applies only to family-controlled entities that otherwise would be subject to the rules of section 2704 is an applicable restriction. In addition, a restriction is not imposed or required to be imposed by federal or state law if that law also provides (either at the time the entity was organized or at some subsequent time) an optional provision that does not include the restriction or that allows it to be removed or overridden, or that provides a different statute for the creation and governance of that same type of entity that does not mandate the restriction, makes the restriction
>
> n optional, or permits the restriction to be superseded, whether by the entity's governing documents or otherwise. For purposes of determining the type of entity, there are only three types of entities, specifically, the three categories of entities described in § 25.2701-2(b)(5): corporations; partnerships (including limited partnerships); and other business entities.

[7424] Prop. Reg. § 25.2704-2(b)(3), which further provides:

> For purposes of determining whether the ability to remove the restriction is held by any member(s) of this group, members are treated as holding the interests attributed to them under the rules contained in § 25.2701-6, in addition to interests held directly. The manner in which the restriction may be removed is irrelevant f or this purpose, whether by voting, taking other action authorized by the governing documents or applicable local law, removing the restriction from the governing documents, revising the governing documents to override the restriction prescribed under local law in the absence of a contrary provision in the governing documents, merging the entity with an entity whose governing documents do not contain the restriction, terminating the entity, or otherwise.

However, an "applicable restriction does not include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations, whether in the form of debt or equity."[7425]

"An option, right to use property, or agreement that is subject to section 2703 is not an applicable restriction."[7426]

Also, a put right as described further below is not an "applicable restriction."[7427]

Some of the calculations in examples need clarification or correction.

III.B.7.f.ii.(d). Prop. Reg. § 25.2704-3 Disregarding Restrictions under Governing Documents and State Law that Could Have Been Removed All Along

For purposes of subtitle B (relating to estate, gift and generation-skipping transfer taxes), and notwithstanding Reg. § 25.2704-2, if an interest in an entity is transferred to or for the benefit of a member of the transferor's family,[7428] and the transferor and/or members of the transferor's family control the entity immediately before the transfer, certain restrictions are disregarded and the transferred interest is valued using special rules.[7429]

A "disregarded restriction" is a restriction that is a limitation on the ability to redeem or liquidate an interest in an entity that is described as follows, if the restriction, in whole or in part, either lapses after the transfer or can be removed by the transferor or any member of the transferor's family (subject to certain exceptions), either alone or collectively:[7430]

1. The provision limits or permits the limitation of the ability of the holder of the interest to compel liquidation or redemption of the interest.[7431]

2. The provision limits or permits the limitation of the amount that may be received by the holder of the interest on liquidation or redemption of the interest to an amount that is less than a minimum value (described further below).[7432]

3. The provision defers or permits the deferral of the payment of the full amount of the liquidation or redemption proceeds for more than six months after the date the holder gives

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[7425] Prop. Reg. § 25.2704-2(b)(4)(i), which further provides:

> An unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in section 267(b), provided that for purposes of this section the term *fiduciary of a trust* as used in section 267(b) does not include a bank as defined in section 581 that is publicly held.

[7426] Prop. Reg. § 25.2704-2(b)(4)(iii).
[7427] Prop. Reg. § 25.2704-2(b)(4)(iv), referring to Reg. § 25.2704-3(b)(6), which is described in the text accompanying fn. 7455 in part III.B.7.f.ii.(d) Prop. Reg. § 25.2704-3 Disregarding Restrictions under Governing Documents and State Law .
[7428] Prop. Reg. § 25.2704-3(c) includes as family members descendants of the transferor's siblings when determining whether the entity is controlled by the transferor and the transferor's family but does not when determining family members otherwise.
[7429] Prop. Reg. § 25.2704-3(a).
[7430] Prop. Reg. § 25.2704-3(b)(1).
[7431] Prop. Reg. § 25.2704-3(b)(1)(i).
[7432] Prop. Reg. § 25.2704-3(b)(1)(ii).

notice to the entity of the holder's intent to have the holder's interest liquidated or redeemed.[7433]

4. The provision authorizes or permits the payment of any portion of the full amount of the liquidation or redemption proceeds in any manner other than in cash or property (described further below).[7434]

"Minimum value" means the interest's share of the net value of the entity determined on the date of liquidation or redemption:[7435]

- The net value of the entity is the fair market value, as determined under Code § 2031 or 2512 and the applicable regulations, of the property held by the entity, reduced by the outstanding obligations of the entity.

- Solely for purposes of determining minimum value, the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under Code § 2053 if those obligations instead were claims against an estate.

- Subject to the above limitation on outstanding obligations, if the entity holds an operating business, the rules of Reg. § 20.2031-2(f)(2) or 20.2031-3 apply in the case of a testamentary transfer and the rules of Reg. § 25.2512-2(f)(2) or 25.2512-3 apply in the case of an inter vivos transfer. This proposed rule modifying the valuation under those regulations by taking into account only Code § 2053 deductions is heavily criticized. Sound valuation principles, as well as the fundamental Rev. Rul. 59-60, require considering various business risks across the continuum, many of which do not even rise to the level of a contingent liability. Although a regulation can certainly overrule a revenue ruling, this rule would seem punitive as applied to operating businesses.

- The minimum value of the interest is the net value of the entity multiplied by the interest's share of the entity. The interest's share takes into account any capital, profits, and other rights inherent in the interest in the entity. If the property held by the entity directly or indirectly includes an interest in another entity, and if a transfer of an interest in that other entity by the same transferor (had that transferor owned the interest directly) would be subject to Code § 2704(b), then the entity will be treated as owning a share of the property held by the other entity, determined and valued in accordance with the provisions of Code § 2704(b) and the regulations thereunder.

- Note that the above rules do not describe how one defines "net value." Does it consider business risks, even though obligations other than Code § 2053 deductions are ignored? Does it consider whether the interest being valued is a minority interest that cannot control related-party transaction that reduce the entity's value as a going concern but that would be normalized if the whole business were sold to a controlling owner? Does it assume that the business is liquidated to satisfy the put rights that the proposed regulations encourage?

[7433] Prop. Reg. § 25.2704-3(b)(1)(iii).
[7434] Prop. Reg. § 25.2704-3(b)(1)(iv).
[7435] Prop. Reg. § 25.2704-3(b)(1)(ii).

The prohibition against paying other than in cash or property referred to further above is subject to the following rules:[7436]

- For purposes of this prohibition, a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by a person related to either the entity or any holder of an interest in the entity, is deemed not to be property. In this context, a related person is any person whose relationship to the entity or to any holder of an interest in the entity is described in Code § 267(b).[7437]

- However, if the entity is engaged in an active trade or business, at least 60% of whose value consists of the nonpassive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of Code § 6166(b)(9)(B), those proceeds may include such a note or other obligation if such note or other obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds. See Reg. § 25.2512-8.

The above test seems harsh. If the note is from an unrelated party, shouldn't it be respected regardless of whether the entity is an active trade or business?

A disregarded restriction includes a restriction that is:[7438]

- imposed under:
  - the terms of the governing documents (for example, the corporation's by-laws, the partnership agreement, or other governing documents),
  - a buy-sell agreement,
  - a redemption agreement,
  - an assignment or deed of gift, or any other document, agreement, or arrangement; and
- a restriction imposed under local law, regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise:
  - For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, which governs the applicability of the restriction.
  - Mandatory restrictions under federal or state law.

Mandatory restrictions are those imposed or required to be imposed by federal or state law:[7439]

[7436] Prop. Reg. § 25.2704-3(b)(1)(iv).
[7437] However, in applying the related party rule, the term fiduciary of a trust as used in Code § 267(b) does not include a bank as defined in Code § 581 that is publicly held. Code § 267(b) is reproduced in part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses.
[7438] Prop. Reg. § 25.2704-3(b)(2).
[7439] Prop. Reg. § 25.2704-3(b)(5)(iii).

- "Federal or state law" means the laws of the United States, of any state thereof, or of the District of Columbia, but does not include the laws of any other jurisdiction.

- A provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded with regard to a particular entity (whether by owners, managers, or otherwise) is not a restriction that is imposed or required to be imposed by law.

- A law that is limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in Code § 2704, is not a restriction that is imposed or required to be imposed by law. For example, a law requiring a restriction that may not be removed or superseded and that applies only to family-controlled entities that otherwise would be subject to Code § 2704 is a disregarded restriction.

- For purposes of determining the type of entity, the three categories of entities are corporations, partnerships (including limited partnerships), and other business entities.

- A restriction is not imposed or required to be imposed by law if that law also provides (either at the time the entity was organized or at some later time) an optional provision that:

    - does not include the restriction or that allows it to be removed or overridden, or

    - provides a different statute for the creation and governance of that same type of entity that:

        - does not mandate the restriction,

        - makes the restriction optional, or

        - permits the restriction to be superseded, whether by the entity's governing documents or otherwise.

This last provision – that an optional provision is disregarded – proves too much. All states have rules for creating and terminating entities. All of the owners can get together to vote to liquidate. Thus, any restriction on liquidation can be overridden and is therefore disregarded. Many commentators view this as creating a deemed put right – a result that government representatives emphatically deny. My understanding is that the government intended for "provision" to apply to anything requiring more than a majority vote to liquidate. Of course, those representatives will not be looking over an IRS examiner's shoulder or whispering into a judge's ear, so that understanding is worthless until the government integrates it into final regulations.

Those who say that these concerns exaggerate the proposed regulations' impact argue that, even if one ignored these restrictions, the owners would need to negotiate with each other over the terms of that liquidation. However, as will be seen later, the very existence of some owners is ignored. Even those who are left would need to negotiate on the basis of their legal rights. If their legal rights to block liquidation are ignored, then what is the basis for these negotiations? All that would remain is a slight delay in marshalling assets. Again, government representatives assure the public that is not the case, but skeptics will continue to assume the worse until final regulations clearly rebut this concern.

Returning to the proposed regulation's rules, a restriction is disregarded only to the extent that the restriction either will lapse by its terms at any time after the transfer or may be removed after the transfer by any one or more members, either alone or collectively, of the group consisting of the transferor, the transferor's estate, and members of the transferor's family:[7440]

- For purposes of determining whether the ability to remove the restriction is held by any one or more members of this group, members are treated as holding interests attributed to them under the rules contained in Reg. § 25.2701-6,[7441] in addition to interests held directly. As described further below, the interests of nonfamily members will be disregarded because the proposed regulations provide unrealistic requirements for considering them.[7442] Thus, the transferor and the transferor's family members will be deemed to have the power to remove restrictions.

- The manner in which the restriction may be removed is irrelevant for this purpose, whether by:

  - voting,

  - taking other action authorized by the governing documents or applicable local law,

  - removing the restriction from the governing documents,

  - revising the governing documents to override the restriction prescribed under local law in the absence of a contrary provision in the governing documents,

  - merging the entity with an entity whose governing documents do not contain the restriction,

  - terminating the entity, or

  - otherwise.

In the case of a transfer to or for the benefit of a member of the transferor's family, for purposes of determining whether the transferor (or the transferor's estate) or any member of the transferor's family, either alone or collectively, may remove a restriction under Prop. Reg. § 25.2704-3(b), a nonfamily-member's ownership is disregarded unless all of the following are satisfied:[7443]

(A) The interest has been held by the nonfamily member for at least three years immediately before the transfer;

(B) On the date of the transfer, in the case of a corporation, the interest constitutes at least 10% of the value of all of the equity interests in the corporation, and, in the case of a business entity[7444] other than a corporation, the interest constitutes at least a 10% interest in the business entity, for example, a 10% interest in the capital and profits of a partnership;

[7440] Prop. Reg. § 25.2704-3(b)(3).
[7441] See fns. 7308-7310, found in part III.B.7.b.i Code § 2701 Definitions.
[7442] Prop. Reg. § 25.2704-3(b)(4).
[7443] Prop. Reg. § 25.2704-3(b)(4)(i).
[7444] Within the meaning of Reg. § 301.7701-2(a).

(C) On the date of the transfer, in the case of a corporation, the total of the equity interests in the corporation held by shareholders who are not members of the transferor's family constitutes at least 20% of the value of all of the equity interests in the corporation, and, in the case of a business entity[7445] other than a corporation, the total interests in the entity held by owners who are not members of the transferor's family is at least 20% of all the interests in the entity, for example, a 20% interest in the capital and profits of a partnership; and

(D) Each nonfamily member, as owner, has a put right as described in Reg. § 25.2704-3(b)(6).

In applying the 10% and 20% tests when the property held by the corporation or other business entity is, in whole or in part, an interest in another entity, the attribution rules of Reg. § 25.2704-3(d) (described further below) apply in:[7446]

- determining the interest held by a nonfamily member, and
- measuring the interests owned through other entities.

The three-year holding requirement of (A) above is not unreasonable, except that it should be the lesser of three years or since the entity's inception, to avoid prejudicing start-up businesses. The Reg. § 25.2704-3(b)(6) put right described further below in is totally unrealistic, as operating businesses cannot afford to set aside liquidity to cash out owners without impairing their ability to operate, grow, and hopefully fulfill The American Dream.

If a nonfamily-member interest is disregarded under the above rule, Reg. § 25.2704-3 applies as if all interests other than disregarded nonfamily-member interests constitute all of the interests in the entity.[7447]

The following are not applicable restrictions:[7448]

- An applicable restriction on the liquidation of the entity as defined in and governed by Reg. § 25.2704-2.[7449]
- A commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations whether in the form of debt or equity,[7450] and an unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in Code § 267(b).[7451] Given that the restriction is being imposed by an unrelated person, one wonders why the proposed regulations regulate the use of the funds.
- A mandatory restriction under federal or state law.[7452]

[7445] Within the meaning of Reg. § 301.7701-2(a).
[7446] Prop. Reg. § 25.2704-3(b)(4)(iii).
[7447] Prop. Reg. § 25.2704-3(b)(4)(ii).
[7448] Prop. Reg. § 25.2704-3(b)(5).
[7449] Prop. Reg. § 25.2704-3(b)(5)(i).
[7450] Prop. Reg. § 25.2704-3(b)(5)(ii).
[7451] As applied here, fiduciary of a trust under Code § 267(b) does not include a is publicly held bank under Code § 581. Code § 267(b) is reproduced in part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses.
[7452] Prop. Reg. § 25.2704-3(b)(5)(iii), as described in the text accompanying fn. 7439.

- An option, right to use property, or agreement that is subject to Code § 2703.[7453]

- A put right (described immediately below).[7454]

"Put right" means a right, enforceable under applicable local law, to receive from the entity or from one or more other holders, on liquidation or redemption of the holder's interest, within six months after the date the holder gives notice of the holder's intent to withdraw, cash and/or other property with a value that is at least equal to the minimum value of the interest determined as of the date of the liquidation or redemption:[7455]

- For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs liquidation or redemption rights with regard to interests in the entity.

- For purposes of this definition, the term other property does not include a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by one or more persons related either to the entity or to any holder of an interest in the entity. However, if the entity is engaged in an active trade or business, at least 60% of whose value consists of the non-passive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of Code § 6166(b)(9)(B), "other property" does include a note or other obligation if such note or other obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds. See Reg. § 25.2512-8.

- The minimum value of the interest is the interest's share of the net value of the entity, as described above.[7456]

As mentioned above in the text accompanying fn. 7443, failure to give a put right to an unrelated person means that the unrelated person is treated as not being an owner.[7457] Furthermore, if a restriction is disregarded under Reg. § 25.2704-3, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the disregarded restriction does not exist in the governing documents, local law, or otherwise.[7458]

When applying Code § 2704(b), if part of a decedent's interest in an entity includible in the gross estate passes by reason of death to one or more members of the decedent's family and part of that includible interest passes to one or more persons who are nonfamily members of the decedent, and if the part passing to the members of the decedent's family is to be valued as if the disregarded restriction does not exist in the governing documents, local law, or otherwise, then that part is treated as a single, separate property interest.[7459] In that case, the part passing

[7453] Prop. Reg. § 25.2704-3(b)(5)(iv).
[7454] Prop. Reg. § 25.2704-3(b)(5)(v).
[7455] Reg. § 25.2704-3(b)(6).
[7456] Reg. § 25.2704-3(b)(1)(ii), described in the text accompanying fn. 7435.
[7457] Reg. § 25.2704-3(b)(4)(ii) provides:

> *Effect of disregarding a nonfamily-member interest*. If a nonfamily-member interest is disregarded under this section, the rules of this section are applied as if all interests other than disregarded nonfamily-member interests constitute all of the interests in the entity.

[7458] Reg. § 25.2704-3(f), which further provides, For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under which the entity is created or organized.
[7459] Reg. § 25.2704-3(e).

to one or more persons who are not members of the decedent's family is also treated as a single, separate property interest.[7460]

Given that nonfamily members' interests will be disregarded because nobody will ever qualify and that which legal restrictions are given effect is unclear, one might argue that Prop. Reg. § 25.2704-3 treats the transferor and the transferor's family as if no restrictions on liquidating their interest existed. One might also argue that "provisions" of governing law that do not apply are a much narrower range, so that most aspects of the governing are given effect and far-reaching liquidation rights are not assumed. In light of this uncertainty, one might want to hope for the best and plan for the worst.

Although the proposed regulations encourage a put right for minimum value, they do not deem that right to exist. They merely use it as benchmarks for determining whether various restrictions exist. Although disregarded obligations that are not Code § 2035 debts might cause minimum value to be much higher than fair market value, consider that, if the entity liquidated, its owners could not collectively obtain more than fair market value. One of the best appraisers in the country suggested that this fair market value maximum is itself a mandatory restriction under applicable law that would be respected. Other comments appraisers have made include:

- Does one consider tenancy in common or restricted management agreements? How about rights of first refusal?

- A history of redemptions would tend to affect value.

- For an at-will general partnership, examiners argue under current law no discounts. However, the process required to liquidate can cause delay and uncertainty and require valuation adjustments. Although that adjustment might be relatively low, one appraiser reported settling for 20% where the liquidation process was going to be cumbersome and lengthy.

- Scrutinize control premiums, because merely deriving them public market minority discounts does not tell the whole story. Fair value would have normalized expenses, whereas fair market value might not. Control means different things for different types of businesses or investment portfolios.

- Environmental liabilities, key man risks, agreements that lock in executive compensation, and other business risks need to be considered in valuing a business. These can be larger issues than discounts, and minimum value should not disregard them the way that they might be doing under the proposed regulations.

- Family members do not necessarily work together. Although the proposed regulations may require that one assumes that they act together when deciding whether to liquidate, they might not agree how to operate the business or how to liquidate.

- What happens to the business when it sells assets to fund a redemption? Consider the tax and other economic issues.

[7460] Reg. § 25.2704-3(e), which references Reg. § 25.2704-3(g), Example 4.

- For pass-through entities, consider owners bargaining with each other and Code § 336, 338(h)(10) elections.[7461]

- How much of the value is based on a particular owner's vision and skills? Consider personal goodwill and similar issues.[7462]

- How about a lender's restrictions on the ability to liquidate? Although the proposed regulations provide an exception, the exception is not necessarily available. Furthermore, even if the family member is deemed to have a liquidation right, would liquidating the family member's interest generate a fire sale, due to the lender's restrictions?

- The right to a minority oppression lawsuit adds value under current law, and disregarding minority discounts also disregards the value given to that premium.

- If the family is cohesive, they might not let an unrelated party withdraw or might impose a withdrawal penalty.

- An owner who is difficult to deal with or imposes reputational risk to the business might reduce value.

- The proposed regulations' increasing the value in appraisals done for estate planning purposes might provide arguments for dissenting owners to argue to be bought out at a higher price.

- Complexity of corporate structure may reduce value.[7463]

- Be careful when comparing the business' value against hedge funds' values. Hedge fund managers have incentive to be fair, because they want to sell future hedge funds, whereas a family member might not have that incentive. Hedge fund restrictions on withdrawal allowed them to weather market downturns so that they didn't have to liquidate assets at depressed values.

- One would need to do a liquidity analysis regarding cashing out owners.

III.B.7.f.ii.(e). Practical Planning Implications of Controversial 2016 Proposed Regulations

Generally, practitioners assumed that the regulations would attack entities formed to hold nonbusiness assets. However, the proposed regulations apply to operating businesses. They would ignore any restrictions on an owner's ability to cash out in six months or to cause the business to liquidate if the family could remove those restrictions. Furthermore, they do not distinguish between restrictions under the entity's governing documents and restrictions imposed by "provisions" of state law. Consider that all state laws provide rules for forming and liquidating an entity, the latter of course having the effect of liquidating each owner's interest in the entity. Although the government agrees that it cannot create rights, disregarding restrictions on exercising rights might have the effect of granting rights. State law expressly prohibiting a

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[7461] See part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.
[7462] See part II.Q.1.c Personal Goodwill and Covenants Not to Compete.
[7463] *Estate of Newhouse v. Commissioner*, 94 T.C. 193 (1990).

limited partner from withdrawing and being cashed out absent a contrary provision in the partnership agreement is a "provision" that would be disregarded. Is a shareholder's inability to withdraw and cash out (including placing a term governing the entity's dissolution date) a "provision," given that this inability is implicit and not explicit? I have seen some of the top estate planning lawyers in the country lock horns on this issue. My understanding is that the government did not intend to eliminate all minority discounts or to impose a deemed put right. However, that intent is not clear from the proposed regulation. Thus, one might hope that the government would clarify these positions, while at the same time one would prepare for the possibility that the final regulations might not sufficiently clarify this intent and that an examiner or a judge would take a different view.

Any person who owns, or whose family owns, at least half of the entity would be subject to these rules. In determining whether an owner of that entity can cash out, one must assume that the family will act together to remove a covered restriction on cashing out and that nonfamily members cannot vote unless together they own at least 20% and are qualified: To count a nonfamily member's ownership, the person must have been an owner for at least 3 years, own at least 10%, and have a right to cash out with six months' notice for "minimum value" in exchange for a note at market interest rates that is adequately secured and requires periodic payments on a non-deferred basis. As a practical matter, a business is not going to want to let its owners cash out whenever they wish, and the proposed regulations disregard any covered restrictions on a person who owns, or whose family owns, at least half of the entity. Furthermore, this "minimum value" would not respect any contingent liabilities, without any explanation how one would draw the line between business risks that affect the business' going concern value and contingent liabilities.

The proposed regulations also provide that, if a person transfers part or all of the controlling interest within 3 years of death, that person's estate is treated as holding that level of control at death. For example, a sale to an unrelated party could create a lapse, given that the unrelated party held the property for less than 3 years and therefore is disregarded. However, the estate would not receive a marital or charitable deduction for that level of control, because that level of control does not pass to the surviving spouse or charity.

The proposed regulations apply to restrictions created after October 8, 1990, occurring either one or after day that, or at least 30 days after, the proposed regulations are finalized, depending on the provision of the proposed regulation. Written comments are due November 2, and on December 1 the government will hold a hearing, granting each speaker 10 minutes. My understanding is that, as of October 18, 2016, the government had processed 200 comments and had received but not yet processed another 3,200 comments. The usual process is to cross-reference each comment to each provision it references, although many of the comments express general dissatisfaction with the proposed regulations and do not provide comments on any particular provision. My understanding is that regulations usually take a year to finalize and that comments of this complexity might take three years to finalize. That being said, the regulations under Code § 385 were quite complex (over 500 pages between preamble and final regulations governing international financing transactions) but took just over 6 months to finalize. Given that a political announcement accompanied the proposed regulations, the prospect of a change in Administration might affect the timing. My understanding is that the government could have given 60 days for comments but chose to provide 90 days, a sign that the government did not appear to want to rush comments. As Yogi Berra said, "It's hard to predict – especially the future."

Effective dates:

- The amendments to Reg. § 25.2701-2 are proposed to be effective on and after the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register.

- The amendments to Reg. § 25.2704-1 are proposed to apply to lapses of rights created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the Federal Register. My understanding is that the final regulations would clarify that the amendments to this regulation would apply to lapses if the transfer occurred on or after that publication, not if the death triggering the lapse treatment occurred on or after that publication.

- The amendments to Reg. § 25.2704-2 are proposed to apply to transfers of property subject to restrictions created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the Federal Register.

- Prop. Reg. § 25.2704-3 is proposed to apply to transfers of property subject to restrictions created after October 8, 1990, occurring 30 or more days after the date these regulations are published as final regulations in the Federal Register.

Action items include:

1. Consider making transfers before the proposed regulations become final. These transfers might be gifts, sales, or perhaps using other estate planning tools. This might be of all of the client's interest, of enough to reduce the client's interest below 50%, or of enough to reduce the client's holding to below the liquidation right threshold. Revise the governing documents to require a level of consent for liquidation higher than whatever the client owns now.

2. Note that owning property 50/50 would cause the proposed regulations to apply. One lawyer suggested to me that each owner contribute an equal amount to a Code § 501(c)(4) organization. See part II.Q.6.g Gift Tax Exclusion for Gifts to Certain Noncharitable Organizations.

3. Review buy-sell agreements to consider whether any additional estate tax would apply under these rules and plan for who should pay that tax. Exercise caution in changing any provisions that existed on October 8, 1990.

4. The proposed regulations respect "a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations, whether in the form of debt or equity," so consider documenting the extent of those restrictions. When reviewing commercial loan agreements, carefully review any covenants that affect the owners' ability to cash out and document the extent to which these covenants require buy-sell provisions to prevent cashing out.

5. Some planners have suggested holding real estate as tenants in common instead of in an LLC or other entity, to avoid the new rules that would apply to business entities. Active rental can cause a tenant-in-common arrangement to be treated for state law purposes and tax purposes as a general partnership. General partners are subject to joint and several liability and have rights to cash out of their arrangements that would undermine valuation discounts, so expert advice is required before delving into this area. See part II.C.10 Whether Tenancy-in-Common or other Arrangement Constitutes a Partnership.

Note, also, that the proposed regulations under Code § 2704 are vague as to what is an "arrangement" that constitutes a business entity.

Appraisers might need to do more than one appraisal per transfer.

When preparing gift tax returns reporting transfers after the August 2016 promulgation of the proposed regulations, consider whether to attach a statement describing any position taken that is contrary to any proposed regulations published at the time of the transfer.[7464] Given that the proposed regulations were not proposed to apply to that period, this does not appear necessary, but each person can develop his or her own comfort level.

Also see part II.H.2.j Effect of Chapter 14 on Basis Step-Up, suggesting that taxpayers file an estate tax return to take advantage of the basis step-up for this inflated value.

III.C. Code § 2036

Code § 2036, "Transfers with retained life estate," provides:

(a) *General rule*. The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

(b) *Voting rights*.

(1) *In general*. For purposes of subsection (a)(1), the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property.

(2) *Controlled corporation*. For purposes of paragraph (1), a corporation shall be treated as a controlled corporation if, at any time after the transfer of the property and during the 3-year period ending on the date of the decedent's death, the decedent owned (with the application of section 318), or had the right (either alone or in conjunction with any person) to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock.

(3) *Coordination with section 2035*. For purposes of applying section 2035 with respect to paragraph (1), the relinquishment or cessation of voting rights shall be treated as a transfer of property made by the decedent.

(c) *Limitation on application of general rule*. This section shall not apply to a transfer made before March 4, 1931; nor to a transfer made after March 3, 1931, and before

[7464] Reg. § 301.6501(c)-1(f)(2)(v).

June 7, 1932, unless the property transferred would have been includible in the decedent's gross estate by reason of the amendatory language of the joint resolution of March 3, 1931 (46 Stat. 1516).

III.C.1. Whether Code § 2036 Applies

A settlor participating in a trust modification should not implicate Code § 2036 or 2038,[7465] so long as the settlor does not do so often enough to appear to be controlling the trust's terms.

The Official Tax Court Syllabus of *Estate of Linderme v. Commissioner*, 52 T.C. 305 (1969), stated:[7466]

> In 1956, decedent executed a quitclaim deed of his residence in favor of his three sons. He continued his exclusive occupancy of the premises until he entered a nursing home in March 1963. The residence thereafter remained vacant until October 1964. *Held*, under all the facts and circumstances, decedent retained the "possession or enjoyment" of the residence until his death and the property is includable in his gross estate under sec. 2036(a)(1), I.R.C. 1954. *Estate of Allen D. Gutchess*, 46 T.C. 554 (1966), distinguished.

Guynn v. U.S., 437 F.2d 1148 (4th Cir. 1971), held:[7467]

> While the issue of implied agreement must turn on all the circumstances of each transaction, the continued exclusive possession by the donor, and the withholding of possession from the donee, are highly significant factors. On this basis, we distinguish those cases where a residence jointly occupied by the donor and the donee has been held not includable in the donor's gross estate.[2] The Tax Court has made the same distinction. Compare *Estate of Linderme*, 52 T.C. 305 (1969) with *Estate of Gutchess*, 46 T.C. 554 (1966).
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> [2] *Union Planters Nat'l Bank v. United States*, 361 F.2d 662 (6th Cir. 1966); *Estate of Binkley v. United States*, 358 F.2d 639 (3d Cir. 1966); *Stephenson v. United States*, 238 F.Supp. 660 (W.D. Va. 1965); *Diehl v. United States*, 21 AFTR 2d 1607, 68-1 U.S.T.C. ¶ 12,506 (W.D. Tenn. 1967); *Estate of Gutchess*, 46 T.C. 554 (1966). See Rev. Rul. 70-155 (April 6, 1970).

The Official Tax Court Syllabus of *Estate of Reichardt v. Commissioner*, 114 TC 144, 145 (2000), stated:[7468]

> Decedent (D) had two children, C and W. On June 17, 1993, D formed a revocable family trust (the trust) and a family limited partnership (the partnership). The trust was the general partner of the partnership. D, C, and W were named cotrustees, but only D performed any functions as trustee.

[7465] See text accompanying fn 7483 in part III.D Code § 2038.

[7466] *Estate of Linderme v. Commissioner* is cited by the text accompanying fn 2057 in part II.H.2.c QTIP Trusts - Code § 2519 Trap.

[7467] *Guynn v. U.S.* is cited by the text accompanying fn 2058 in part II.H.2.c QTIP Trusts - Code § 2519 Trap.

[7468] *Estate of Reichardt v. Commissioner* is cited by the text accompanying fn 2060 in part II.H.2.c QTIP Trusts - Code § 2519 Trap.

> D transferred his residence and all of his other property (except for his car, personal property, and some cash) to the partnership through the trust. D's transfer was not a bona fide sale for full and adequate consideration. On Oct. 22, 1993, D gave C and W each a 30.4-percent interest in the limited partnership. D retained possession and enjoyment of and the right to here income from the property he transferred to the partnership until he died on Aug. 21, 1994.
>
> *Held*: The fair market value at D's date of death of assets D transferred to the partnership is included in D's gross estate. See sec. 2036(a), I.R.C.

The IRS has attacked (and courts have agreed) a donor's retention of control when transferring a business entity, unless the grantor can prove a legitimate and significant nontax reason for forming the entity. See *Bongard v. Commissioner*, 124 T.C. 95 (reviewed decision, 2005),[7469] and a host of other cases before and after, including *Purdue v. Commissioner*, T.C. Memo. 2015-249, and another reviewed decision, *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017). For what happens when a taxpayer argues in favor of estate tax inclusion to try to get a basis step-up, see fn 5699 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

Estate of Morrissette v. Commissioner, T.C. Memo. 2021-60, held that the split-dollar arrangement at issue[7470] had a legitimate nontax purpose:

> The first prong of the bona fide sale exception asks whether Mrs. Morrissette had a legitimate and significant nontax motive for entering into the split-dollar agreement. See *Estate of Bongard v. Commissioner*, 124 T.C. at 113, 118; *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278. The nontax purpose must be an actual motivation, not a theoretical justification, and we require some objective proof that the nontax reason was a significant factor that motivated the transfer. *Estate of Bongard v. Commissioner*, 124 T.C. at 118. We also recognize that "[l]egitimate nontax purposes are often inextricably interwoven with testamentary objectives." *Id*. at 121. Thus, a finding that the decedent sought to save estate tax does not preclude a finding of a bona

[7469] At 118-119, the majority held:

> In the context of family limited partnerships, the bona fide sale for adequate and full consideration exception is met where the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership, and the transferors received partnership interests proportionate to the value of the property transferred. See, e.g., *Estate of Stone v. Commissioner*, *supra*; *Estate of Harrison v. Commissioner*, *supra*. The objective evidence must indicate that the nontax reason was a significant factor that motivated the partnership's creation. See *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121; *Estate of Harrison v. Commissioner*, *supra*. A significant purpose must be an actual motivation, not a theoretical justification.
>
> By contrast, the bona fide sale exception is not applicable where the facts fail to establish that the transaction was motivated by a legitimate and significant nontax purpose. See *Estate of Hillgren v. Commissioner*, *supra*; *Estate of Thompson v. Commissioner*, *supra*; *Estate of Harper v. Commissioner*, *supra*; see also *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000). A list of factors that support such a finding includes the taxpayer standing on both sides of the transaction, *Estate of Hillgren v. Commissioner*, *supra*; the taxpayer's financial dependence on distributions from the partnership, *Estate of Thompson v. Commissioner*, *supra*; *Estate of Harper v. Commissioner*, *supra*; the partners' commingling of partnership funds with their own, *Estate of Harper v. Commissioner*, *supra*, and the taxpayer's actual failure to transfer the property to the partnership, *Estate of Hillgren v. Commissioner*, *supra*.

[7470] See part II.Q.4.f Split-Dollar Arrangements, especially part II.Q.4.f.v Estate Tax Consequences of Split-Dollar Agreements.

fide sale so long as saving estate tax is not the predominant motive. *Estate of Black v. Commissioner*, 133 T.C. at 362-363. The bona fide sale exception further requires that the transfer be made in good faith. *Estate of Bongard v. Commissioner*, 124 T.C. at 118; see also sec. 20.2043-1(a), Estate Tax Regs. In the context of transfers with respect to business entities, we and other courts have held that efficient, active management of the business and management succession may be legitimate, nontax purposes. *Estate of Bigelow v. Commissioner*, 503 F.3d 955, 972 (9th Cir. 2007), *aff'g* T.C. Memo. 2005-65; *Estate of Strangi v. Commissioner*, 417 F.3d at 481; *Estate of Reynolds v. Commissioner*, 55 T.C. 172, 194 (1970). Maintaining control over a family business can also be a legitimate, nontax purpose. *Estate of Bischoff v. Commissioner*, 69 T.C. 32, 39-41 (1977). We have found that closely held, family entities can provide a legitimate, nontax purpose even where the entity does not have an active business and was formed merely to perpetuate the decedent's buy-hold investment philosophy with respect to publicly traded stock. *Estate of Schutt v. Commissioner*, T.C. Memo. 2005-126, 2005 WL 1244686, at *25. Management of family assets can also be a valid nontax purpose. See, *e.g.*, *Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004); *Estate of Mirowski v. Commissioner*, T.C. Memo. 2008-74; *Estate of Stone v. Commissioner*, T.C. Memo. 2003-309; *Estate of Harrison v. Commissioner*, T.C. Memo. 1987-8.

Mrs. Morrissette's desire to keep Interstate in her family is a legitimate, nontax reason for purposes of the bona fide sale exceptions. She put a premium on maintaining control over Interstate and passing on that control to future generations. At trial, petitioners established that the 1996 plan was seriously flawed and the 2006 plan corrected those flaws. The split-dollar agreements were instrumental to ensuring that Interstate's ownership remained in her family after her sons died. The brothers had the CMM trust enter into the split-dollar agreements in good faith.

The brothers wanted to honor their parents' wish that the three brothers inherit Interstate equally and pass the company on to their children. However, they were also realistic about the need to pay estate tax and the possibility that they would need to sell part of Interstate to pay it. They believed that there was a significant chance that the family would lose control of Interstate if their families were not given this option especially in the light of the history of the fighting and continued hard feelings from Ken and Don's buyout nearly 20 years before. They recognized other problems with the 1996 plan. The split-dollar agreements provided each brother's children with the option to exit the business and cash out their interests after the brother's death and at the same time allowed the remaining brothers and their families to purchase the interests by funding the buyout. The buy-sell provision also prevented the brothers from selling their Interstate stock to outsiders as a means to retaliate against one another for past disputes. The split-dollar agreements also served a second legitimate, nontax purpose, a smooth transition in Interstate's management. Bud and J.D. had dedicated their careers to Interstate and wanted to remain with the company for their professional futures. They had institutional knowledge. Bud and J.D. credibly testified about their concerns about the transition of Interstate's management to them. J.D. had considered leaving Interstate in 2005 because of these concerns and tried to talk to Buddy about them. Whenever Bud and J.D. raised management succession planning with Buddy, he was dismissive. Bud and J.D. had actually resorted to writing letters to Buddy because their attempts to discuss the issue with Buddy were not productive. Both Bud and J.D. had experienced the consequences in their jobs from the long-held grudges among the brothers.

Bud and J.D. also believed that their futures at Interstate could be jeopardized by the deficiencies in the 1996 plan, and they wanted better protection of Interstate as a family business. The 2006 plan helped to reduce the uncertainty of Bud and J.D.'s futures within Interstate by ensuring it would remain a family business. Bud and J.D. remained as executives and took over Interstate's management when the time came.

The family members faced a situation where many of them knew that the 1996 plan did not adequately protect Interstate and there was a significant risk that the family would lose control over the business after Mrs. Morrissette's death or the brothers' deaths. Yet Buddy refused to fix the deficiencies in the 1996 plan until he, his brothers, and his sons met Mr. Meltzer and Mr. McNair. Family members credibly testified about their concerns with the 1996 plan. Mr. and Mrs. Morrissette had devised the 1996 plan to ease the tensions among the brothers, but it did little to improve the brothers' relationships. In fact, the plan caused Buddy to have more hard feelings. He felt cheated and believed that his parents did not recognize or reward his loyalty.

For years family members believed that they needed a better plan to protect Interstate as a family business. They understood that the 1996 plan could negatively affect Interstate's financial stability and its Government contracts, which accounted for a substantial portion of its business. Interstate's accountant tried to warn Buddy about the potential problems with the 1996 plan, but Buddy refused to do anything. In fact, after meeting Mr. McNair, Buddy initially refused to discuss any changes to the 1996 plan because of past family animosity. It is not clear what changed Buddy's mind. But Bud's meeting Mr. Meltzer finally moved the family forward to establish a long overdue succession plan for Interstate and Mrs. Morrissette's real estate holdings. It is also clear to us that the split-dollar agreements were part of an estate tax saving strategy. The brothers were in part motivated by estate tax saving. It was not their only motivation, however. Respondent focuses on Mr. Meltzer's and Mr. McNair's marketing of the split-dollar arrangements as an estate tax saving strategy and the initial communications between the meeting attendances as evidence of tax motivations. The advisers' motives or marketing does not control our view of the purpose of the split-dollar agreements. Respondent also points to the fact that the brothers quickly decided to engage Mr. McNair after the June meeting as evidence of tax motivation. He ignores that it took approximately another five months to implement the transaction and it was not complete until approximately eight months after Bud first met Mr. Meltzer.

Our caselaw requires the presence of a legitimate, nontax purpose; it does not require the absence of a tax saving motivation. Tax saving was not the primary motivation. Significantly, Ken, who made most decisions relating to the split-dollar agreements, credibly testified that he would have engaged in the split-dollar agreements even if they had not provided any estate tax saving because of the nontax financial benefits that they provided. The record establishes decades of fighting among the brothers including over ownership and inheritance of Interstate. These are not simply theoretical justifications and were established by the witnesses' credible testimony. Respondent wants us to ignore credible testimony in favor of the initial communications among the family members, Mr. Meltzer, and Mr. McNair after the June meeting. We do not restrict our findings in such a manner.

The brothers, acting as the cotrustees of the CMM trust, sought to ensure that Mrs. Morrissette's wishes with respect to the future ownership of Interstate were met to the extent practical given business realities and family dynamics. The changes made as part of the 2006 plan went against Mrs. Morrissette's wishes, not only by allowing the sale of a brother's stock after his death but also by allowing adopted children and spouses to inherit Interstate stock. Under the 1996 plan, each brother also had a general power of appointment over the assets in his AEM subtrust which he could use to distribute assets in a manner that went against the parents' wishes. Another flaw with that plan.

The fact that the changes made by the 2006 plan were inconsistent with Mr. and Mrs. Morrissette's wishes does not cause us to find a lack of a significant, legitimate nontax purpose. The brothers did their best to honor their parents' wishes. On the basis of the above facts and the family members' credible testimony, we find a legitimate, nontax purpose.[8] Ken credibly testified at trial that he would have had the CMM trust enter the split-dollar arrangements even if there had been no tax saving.

[8] Respondent contends that Ken and Don made statements inconsistent with their trial testimony during informal interviews. Upon our review of interview transcripts, trial testimony, and the documents in the record, we find the brothers' trial testimony credible. We do not agree that Ken and Don made inconsistent statements during the interviews.

We dismiss respondent's arguments to the contrary. Respondent speculates that Mrs. Morrissette disapproved of the 2006 plan and was unwilling to pay the premiums, which is the reason the brothers had a conservator appointed. The facts in the record do not support that presumption. The circuit court appointing the conservator determined that Mrs. Morrissette was incapable of making financial decisions. Credible testimony establishes that the brothers decided to use a conservator to protect against future legal disputes over the 2006 plan and to protect against one brother's backing out of the plan at the last minute.

Respondent argues that the brothers stood on both sides of the split-dollar agreements. A taxpayer's standing on both sides of a transaction can indicate there is no legitimate, nontax purpose for the transfer. *Estate of Hillgren v. Commissioner*, T.C. Memo. 2004-46. Intrafamily transactions often involve a party's standing on both sides of the transactions, but such transactions can still satisfy the bona fide sale exception. *Estate of Thompson v. Commissioner*, 382 F.3d at 382. An intrafamily transfer requires heightened scrutiny to ensure that the transfer is not a sham or a disguised gift but does not foreclose the existence of a bona fide sale. *Estate of Bongard v. Commissioner*, 124 T.C. at 119. For an intrafamily transfer, even the absence of negotiations is not a compelling factor when other objective factors establish the bona fides of the transaction. *Kimbell*, 371 F.3d at 263. The brothers' presence on both sides of the split-dollar agreements does not change our factual determination of a bona fide transfer particularly in the light of the brothers' contentious relationship, which sometimes might have been more accurately described as hostile. It is likely that at least one brother would have objected to anything that another brother proposed even if it was in the objecting brother's best interest or a brother would object just to spite his brothers. See *Estate of Stone v. Commissioner*, T.C. Memo. 2003-309 (holding that resolving intrafamily disputes that had led to litigation in the past is a legitimate, nontax purpose).

More problematic is the distribution of the split-dollar agreements to the counterparty to the agreement. After that time, the brothers had complete control over the policies and could cancel them at any time although Ken credibly testified that he did not intend to do so. Respondent argues that the brothers understood that the dynasty trusts would inherit the split-dollar rights and the brothers would have complete control over the policies to surrender them at any time. We disagree for two reasons. The CMM trust agreement gave to the brothers as cotrustees the discretion to distribute each split-dollar agreement, and, given their relationships, distribution was not guaranteed. More importantly, the effects of the possible distribution of the split-dollar agreements after Mrs. Morrissette's death are more relevant to our determination of the fair market value of the split-dollar rights on the valuation date and not whether the transfers qualified as bona fide sales. The brothers also understood their future obligations under the buy-sell provision, and Ken and Don credibly testified that there was no prearranged plan to terminate the split-dollar agreements upon their mother's death.

Respondent also argues that the type of life insurance policies purchased, ones with high initial cash values and modest death benefits, is proof of the tax motivations of the split-dollar agreements. He argues that the high initial cash surrender values removed more assets from the gross estate. However, the brothers credibly explained the reasons they choose policies with high initial cash surrender values. They wanted to ensure that the CMM trust would be adequately compensated for financing the premiums from the outset, *i.e.*, that the CMM trust would earn interest for funding the premiums through inside buildup. Respondent also argues that the fact that Buddy's children retained his stock after his death establishes that the buy-sell provision was not a legitimate reason for the CMM trust's transfer of the premiums. He also cites the fact that the insurance proceeds were redistributed equally among the three dynasty trusts. But the buy-sell provision had substance. It makes sense that Bud and J.D. wanted to retain their father's voting stock as they worked at Interstate. They wanted the 2006 plan to protect their careers at Interstate. Even though they chose not to sell when their father died, the buy-sell provision and the split-dollar agreements protected them by giving them a chance to buy their uncles' stock. Moreover, respondent ignores Buddy's cashout of his nonvoting stock before Mrs. Morrissette died, making a buyout after his death less important from a financial standpoint.

Finally, respondent argues that the Van Lines loan used to pay the premiums is evidence that the split-dollar agreements were tax motivated. He speculates that the loan was not repaid and questions the CMM trust's ability to repay it. We agree with petitioners that the issue of nonpayment is a new issue raised on brief and is not properly before the Court.[9] A party may not raise a new issue on brief where consideration of the issue would surprise or prejudice the opposing party. *Smalley v. Commissioner*, 116 T.C. 450, 456 (2001). Furthermore, the loan was secured, and interest was charged and paid. The loan was treated as an advance of Interstate's shareholder distribution and was used to fund a small portion of the total premiums. The CMM trust had assets sufficient to repay the loan at its maturity apart from the insurance proceeds. The estate reported the loan, which was due after Mrs. Morrissette's death, as a liability. Upon distribution of the split-dollar rights, the dynasty trusts executed notes to Van Lines. Under the totality of the facts, use of the loan does not preclude a finding of legitimate, nontax purposes.

[9] Respondent also argues that the estate's reporting of the loan effectively reduced the reported value of the split-dollar rights by the loan amount for a net value of $3.3 million for the split-dollar rights. The netting argument is also a new issue not properly before the Court. We cannot evaluate respondent's netting argument unless petitioners had the opportunity to address relevant evidence such as whether the loan

> was reported as an asset of Interstate that would increase Interstate's value and the value of the gross estate.

> Taking into account the totality of the facts and circumstances, the CMM trust had legitimate and significant nontax purposes for entering into the split-dollar agreements and funding payment of the premiums in exchange for repayment plus interest in the form of inside buildup. An important purpose of the transfer was to promote the management succession and efficiency and to protect corporate profits for the accumulation of capital to develop the business. On the basis of the record before us, we find that unrelated parties would have agreed to similar terms. Respondent has not argued otherwise.

Thus, the Tax Court accepted the legitimacy of the sons appointing their employee to authorize them to cause their mother's revocable trust to enter into the split-dollar agreements.

The court also held that the split-dollar agreements were entered into for adequate and full consideration in money or money's worth:

> To qualify for the bona fide sale exceptions, the transfer must have been made for adequate and full consideration in money or money's worth. Secs. 20.2036-1(a), 20.2038-1(a), Estate Tax Regs. Adequate and full consideration for purposes of sections 2036 and 2038 requires an exchange of a roughly equivalent value that does not deplete the estate. *Estate of Bongard v. Commissioner*, 124 T.C. at 119; see also *Kimbell*, 371 F.3d at 262, 265 (describing adequate and full consideration as an exchange of a "commensurate (monetary) amount" that "does not deplete the estate"); Wheeler v. United States, 116 F.3d 744, 759 (5th Cir. 1997) (stating adequate and full consideration requires that the sale not deplete the gross estate). Petitioners have the burden to prove that the CMM trust received adequate and full consideration upon the execution of the split-dollar agreements. See *Estate of Bongard v. Commissioner*, 124 T.C. at 118.
>
> **a. Economic Benefit Regime**
>
> Before addressing whether the CMM trust received adequate and full consideration, we first address petitioners' argument that satisfaction of the economic benefit regime means that there was adequate and full consideration. Petitioners argue that estate tax consequences of the split-dollar agreements should be consistent with the economic benefit regime. The CMM trust's payment of the premiums was not a gift for gift tax purposes, which means, according to petitioners, the transfer was an exchange for adequate and full consideration.
>
> Compliance with the economic benefit regime does not mean that the adequate and full consideration requirement is met. *Estate of Cahill v. Commissioner*, at *33. Under the plain text of the regulations, the economic benefit regime does not apply for estate tax purposes. The regime is set out in the income tax regulations, and the regulations state that the regime applies for income, gift, employment, and self-employment tax purposes. Sec. 1.61-22(a), Income Tax Regs. Estate tax is not listed. The economic benefit regime does not use the phrase "adequate and full consideration" or otherwise invoke the concept of adequate and full consideration. Rather, it addresses a separate fundamental question of gift tax, whether there is a completed transfer. See sec. 2512 (requiring a completed transfer of property to impose gift tax). The economic benefit regime does not

require a comparison of the amount of the premium payment with the value of the rights that the CMM trust received in exchange. Accordingly, petitioners cannot rely on the economic benefit regime to establish that the CMM trust received adequate and full consideration.

b. Definition of Adequate and Full Consideration

Respondent argues that adequate and full consideration is determined on the basis of a willing buyer and a willing seller who are hypothetical persons dedicated to achieving maximum economic advantage. See *Estate of Bright v. United States*, 658 F.2d 999, 1005-1006 (5th Cir. 1981) (describing a willing buyer and a willing seller as hypothetical persons); *Estate of Davis v. Commissioner*, 110 T.C. 530, 535 (1998). He argues, and may be correct, that a hypothetical investor would demand a higher return than the CMM trust to account for the split-dollar agreement's lack of marketability and the risk associated with the brothers' unknown health or the uncertainty of their life expectancies. The CMM trust would discount such factors especially as we find, on the basis of the brothers' credible testimony, that the brothers' dynasty trusts and the CMM trust intended to retain the split-dollar agreements.

The adequacy of consideration is not defined on the basis of a willing buyer and willing seller and is not judged from the perspective of hypothetical persons. See *Kimbell*, 371 F.3d at 266. Rather, such concepts are part of the definition of fair market value. Id. Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts. *United States v. Cartwright*, 411 U.S. 546, 551 (1973); sec. 20.2031-1(b), Estate Tax Regs.

The bona fide sale exception does not require an arm's-length transaction, and an intrafamily transfer can constitute a bona fide sale. *Estate of Bongard v. Commissioner*, 124 T.C. at 122-123; see secs. 2036, 2038; secs. 20.2036-1(a), 20.2038-1(a), Estate Tax Regs.; see also *Estate of Thompson v. Commissioner*, 382 F.3d at 382-383. However, intrafamily transfers require heightened scrutiny. *Estate of Bongard v. Commissioner*, 124 T.C. at 122-123; see also *Estate of Thompson v. Commissioner*, 382 F.3d at 382-383; *Kimbell*, 371 F.2d at 262-263. Adequacy of consideration is ascertained on the basis of what would occur in an arm's-length transaction. *Estate of Bongard v. Commissioner*, 124 T.C. at 122- 123. We consider whether "the terms of transaction differed from those of two unrelated parties negotiating at arm's length." *Id*. at 123.

Respondent inappropriately conflates the definition of adequate and full consideration with that of fair market value. To the extent that respondent argues that adequate and full consideration should be defined as fair market value for purposes of this case, we disagree. Respondent contends without any support in the record that Mrs. Morrissette's unwillingness to enter into the split-dollar agreements is the reason the brothers sought the appointment of the conservator. The brothers credibly testified that they sought the appointment because of the past conflict among the brothers.

The parties' experts agree that an investor *may* make investment choices for reasons other than maximizing financial return. In Kimbell, 371 F.3d at 265-266, the Court of Appeals for the Fifth Circuit recognized that there was "nothing inconsistent" with acknowledging that an investor received a partnership interest for adequate and full consideration and the partnership interest had a substantially lower fair market value than the assets contributed to the partnership (a 50% discount in that case).[10] The court described the exchange as “a classic informed trade-off.” *Id*. at 266; see *Estate of Thompson v. Commissioner*, 382 F.3d at 381 (recognizing that the discounted value of the partnership interest does not automatically constitute inadequate consideration). It stated that the exchange involved financial considerations other than the transferor’s ability to immediately sell the newly acquired assets “for 100 cents on the dollar.” *Kimbell*, 371 F.3d at 266. It noted that investors who make such an investment do so for benefits such as management expertise, security or preservation of assets, and capital appreciation. *Id*. Petitioners refer to these financial benefits as intangible benefits.

[10] Petitioners incorrectly argue that Kimbell rejected the roughly equivalent test when the transferor receives financial benefits other than the purchase price. The court in Kimbell recognized the roughly equivalent test. None of the Court of Appeals cases cited by petitioners expressly rejected the roughly equivalent test.

As discussed above with respect to the legitimate, nontax purposes of the split-dollar agreements, the split-dollar agreements provided financial benefits other than the ability to immediately sell the split-dollar rights or to collect on the split-dollar rights, *i.e.*, repayment plus inside buildup, such as management succession and efficiency and capital accumulation. The split-dollar agreements as part of the 2006 plan provided incentives for Bud and J.D. to remain at Interstate. Overall, the 2006 plan protected against foreseeable risks to Interstate’s business.

An underlying problem of respondent’s case is that he did not provide expert testimony on the value of the split-dollar rights on the transfer date except for a rebuttal of Mr. Stephanson’s investment value, described *infra*.[11] He argued that consideration should be based on a fair market value standard but did not provide expert testimony on the split-dollar rights’ fair market value on the transfer date. Instead, he argues that the value that the estate reported for the split-dollar rights approximately three years later establishes that the CMM trust did not receive adequate and full consideration. We agree with respondent that a rational investor would not give up approximately $23 million in value to achieve the nontax purposes achieved through the split-dollar agreements. However, we do not rely on the estate’s reported value to determine the amount of consideration in the bargained-for exchange on the transfer date and do not agree that the claimed value is the fair market value of the split-dollar rights.

[11] Mr. Stephanson determined a discount rate of 4.54% for the investment value on the basis of yields on tax-exempt municipal bonds. Respondent argues that the death benefits would have been taxed when paid to the CMM trust because it was not a beneficiary of the policies. Petitioners argue that it was a beneficiary. Mr. Burns’ rebuttal changed only the tax treatment of the death benefits, increased the discount rate to 6.1% to account for the tax, and determined an investment value of approximately $21.2 million. We do not need to determine either whether the CMM trust was a beneficiary or the correct tax treatment of a payout of death benefits to the CMM trust because we do not adopt the investment value. Nor is it necessary to address respondent’s alternative argument that the opined investment value, $27 million, is not roughly equivalent to the $30 million in premium payments.

We measure the adequacy of consideration on the transfer date, not the decedent's death date. *Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309, 313 (3d Cir. 1996), *rev'g* 105 T.C. 252 (1995). As the Court of Appeals for the Third Circuit there observed:

> There is no way to know ex ante what the value of an asset will be at the death of a testator; although the date of death can be estimated through the use of actuarial tables, the actual appreciation of the property is unknowable…. Consequently, there is no way to ever be certain in advance whether the consideration is adequate and thus no way to know what tax treatment a transfer will receive… *Id*.

We first consider whether the CMM trust received adequate and full consideration as part of a bona fide sale on the transfer date and, if it did, we then decide the fair market values of the split-dollar rights on the valuation date.

When we examine intervening events between the transfer date and the valuation date, which were significant, it is clear that the fair market values were not the same on the two dates. Don credibly testified that although Mrs. Morrissette had been diagnosed with Alzheimer's disease the previous year, she was in good health. Ken was diagnosed with terminal cancer and was no longer insurable. We would be remiss not to at least acknowledge that Mrs. Morrissette could have outlived any one of her sons. The split-dollar agreements were a safe investment with an adequate interest rate.

c. Investment Value Standard

Petitioners presented an investment value of $27 million as a measure of adequate and full consideration. Investment value measures value on the basis of the perspective of the individual investor and thus differs from fair market value, which relies on the perspective of hypothetical persons. Petitioners argue that we should consider Mrs. Morrissette's unique investment goals and individual circumstances when determining whether she received adequate and full consideration. To support this proposition, petitioners cite caselaw, including Kimbell, holding that adequate and full consideration is not determined on the basis of the willing buyer and willing seller standard.

Kimbell recognizes that an intrafamily transfer does not automatically disqualify a transfer from the bona fide sale exception. To this end, *Kimbell* and our caselaw establish an arm's-length standard. The adequate and full consideration requirement is met where the exchange is on terms similar to those that would occur in an arm's-length transaction. *Estate of Bongard v. Commissioner*, 124 T.C. at 122-123.

As the experts testified, a transferor for adequate and full consideration may have financial considerations other than obtaining the highest price. See *Kimbell*, 371 F.3d at 266. Such financial considerations are measurable by objective evidence without the need to adopt a value from Mrs. Morrissette's perspective. Accordingly, we do not adopt the investment value offered by Mr. Stephanson.

d. Adequacy of the Consideration

We hold that the CMM trust received adequate and full consideration on the basis of the split-dollar agreements' repayment terms that included interest earned in the form of inside buildup of the insurance policies. The minimum interest rates and the actual appreciation in the policies' cash values were higher than the interest rates that the

CMM trust had been earning on the money. Respondent does not argue that the repayment terms were inadequate. The split-dollar agreements also provide the additional benefit of deferral of tax on the policies' inside buildup and the tax-exempt payout of the death benefits to the beneficiaries.

Respondent argues that *Estate of Cahill* involved "essentially the exact same circumstances". In that case, the decedent, at age 90, obtained a five-year bank loan to pay the entire amount of the $10 million in premiums. Here we have a 75-year-old family business and a decedent with assets sufficient to pay a substantial portion of the premiums. Here also, the decedent owned assets and other sources of income to repay the small loan she did obtain.

In addition, *Estate of Cahill* did not involve active business operations with related financial considerations such as management efficiency and succession, capital accumulation and long-held grudges that put those financial considerations at risk. The split-dollar agreements provided financial benefits similar to those present in *Kimbell* including management expertise, security and preservation of assets, and capital appreciation. *Kimbell*, 371 F.3d at 266. *Kimbell* accepted these types of financial benefits as reducible to a money value.

The CMM trust and Mrs. Morrissette received financial benefits from the split-dollar agreements including retained family control over Interstate, a smooth management succession, organizational stability, and protection of Interstate's capital by providing a source of funding to pay estate tax on the brothers' deaths. Mrs. Morrissette placed a high value on keeping Interstate within the family. The financial benefits were significant and are relevant to ascertaining the consideration received. Kimbell accepted similar benefits without quantifying them. Id. at 266-267 (finding that partnership interest discounted at 50% of the value of the assets contributed to the partnership was adequate and full consideration without quantifying the value of the other financial benefits present).

Finally, respondent argues that the aggregate reported value of $7.5 million demonstrated the lack of adequate and full consideration. We do not rely on the reported values of the split-dollar rights to determine the amount of the consideration received and, for the reasons stated below, find that the estate substantially undervalued the split-dollar rights for reporting purposes. With the expert testimony, there is no need for us to rely on the reported value three years after the transfer date to ascertain the adequacy of the consideration.

Estate tax saving was not achieved through execution of the split-dollar agreements alone but rather through the undervaluation of the split-dollar rights. In exchange for $30 million, the dynasty trusts agreed to purchase life insurance and repay the CMM trust. The transactions created contract rights, and Mrs. Morrissette retained the contract rights during her lifetime and held them at the time of her death. She no longer had use of or access to the $30 million. The split-dollar agreements changed the nature of the CMM trust's relationship with the funds it transferred. See *Estate of Thompson v. Commissioner*, 382 F.3d at 377 (finding the decedent's relationship to the transferred assets remained the same after the transfer).

Thus, the disconnect between gift tax value and estate tax value did not disturb the court.

III.C.2. Planning Using Code § 2036

What if one's gross estate is way below the estate tax exemption, and one would like to include the transferred assets in the gross estate to get a free basis step-up?[7471]

- If taxpayer wants to engage in an uphill battle to argue that Code § 2036 causes estate tax inclusion,[7472] see fn 5699 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

- I have had the CPA prepare the 706 because I do not want to be on record with IRS as disregarding any partnership I'm involved with. If this is truly "nothing ventured, nothing gained," then consider making the argument on the estate tax return and explain why. All of the above is contingent on the income tax return preparer being comfortable with it and on warning the client about possible penalties for overstatement of basis when an asset is sold. I would ask the income tax return preparer to take the lead on the penalty issue, because (s)he will be signing the returns that claim the higher basis and will know when those transactions occur and can take any steps (s)he deems appropriate when preparing those returns. My strategy of having the CPA prepare the 706 reinforces the responsibility for the penalty issue.

Reg. § 20.2036-1(c)(1), "Amount included in gross estate," provides:[7473]

> (i) *In general*. If the decedent retained or reserved an interest or right with respect to all of the property transferred by him, the amount to be included in his gross estate under section 2036 is the value of the entire property, less only the value of any outstanding income interest which is not subject to the decedent's interest or right and which is actually being enjoyed by another person at the time of the decedent's death. If the decedent retained or reserved an interest or right with respect to a part only of the property transferred by him, the amount to be included in his gross estate under section 2036 is only a corresponding proportion of the amount described in the preceding sentence. An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred. If this section applies to an interest retained by the decedent in a trust or otherwise and the terms of the trust or other governing instrument provide that, after the decedent's death, payments the decedent was receiving during life are to continue to be made to the decedent's estate for a specified period (as opposed to payments that were payable to the decedent prior to the decedent's death but were not actually paid until after the decedent's death), such payments that become payable after the decedent's death are not includible in the decedent's gross estate under section 2033 because they are properly reflected in the value of the trust corpus included under this section. Payments that become payable to the decedent prior to the decedent's date of

[7471] See part II.H.3 Valuation Discounts – Friend or Enemy.

[7472] For when an entity is disregarded and Code § 2036 (an issue into which this document does not delve), see fn 91 in part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders.

[7473] Reg. § 20.2036-1(c)(1)(i) is cited by the text accompanying fn 2056 in part II.H.2.c QTIP Trusts - Code § 2519 Trap.

death, but are not paid until after the decedent's date of death, are includible in the decedent's gross estate under section 2033.

(ii) *Examples*. The application of paragraph (c)(1)(i) of this section is illustrated in the following examples:

Example (1). Decedent (D) creates an irrevocable inter vivos trust. The terms of the trust provide that all of the trust income is to be paid to D and D's child, C, in equal shares during their joint lives and, on the death of the first to die of D and C, all of the trust income is to be paid to the survivor. On the death of the survivor of D and C, the remainder is to be paid to another individual, F. Subsequently, D dies survived by C. Fifty percent of the value of the trust corpus is includible in D's gross estate under section 2036(a)(1) because, under the terms of the trust, D retained the right to receive one-half of the trust income for D's life. In addition, the excess (if any) of the value of the remaining 50 percent of the trust corpus, over the present value of C's outstanding life estate in that 50 percent of trust corpus, also is includible in D's gross estate under section 2036(a)(1), because D retained the right to receive all of the trust income for such time as D survived C. If C had predeceased D, then 100 percent of the trust corpus would have been includible in D's gross estate.

Example (2). D transferred D's personal residence to D's child (C), but retained the right to use the residence for a term of years. D dies during the term. At D's death, the fair market value of the personal residence is includible in D's gross estate under section 2036(a)(1) because D retained the right to use the residence for a period that did not in fact end before D's death.

For a variety of strategies relating to basis step-up, see Bramwell & Madden, "Toggling Gross Estate Inclusion On and Off: A Powerful Strategy," *Estate Planning Journal* (3/2017),[7474] which describes strategies relevant to parts:

- II.H.2.c QTIP Trusts - Code § 2519 Trap
- III.C Code § 2036
- III.D Code § 2038.

See the companion for Code § 2036 in part III.D Code § 2038.

III.C.3. Safe Harbor re Right to Change Trustee - Rev. Rul. 95-58

Rev. Rul. 95-58 explained what prompted its issuance:

> The Internal Revenue Service has reconsidered whether a grantor's reservation of an unqualified power to remove a trustee and appoint a new trustee (other than the grantor) is tantamount to a reservation by the grantor of the trustee's discretionary powers of distribution. This issue is presented in Rev. Rul. 79-353, 1979-2 C.B. 325, as modified by Rev. Rul. 81-51, 1981-1 C.B. 458. An analogous issue is presented in Rev. Rul. 77-182, 1977-1 C.B. 273. The reconsideration is caused by the recent court decisions in

[7474] Excerpts accompany fn 2053 in part II.H.2.c QTIP Trusts - Code § 2519 Trap.

Estate of Wall v. Commissioner, 101 T.C. 300 (1993), and *Estate of Vak v. Commissioner*, 973 F.2d 1409 (8th Cir. 1992), *rev'g* T.C. Memo 1991-503.

Rev. Rul. 95-58 reasoned:

Section 2036(a) of the Internal Revenue Code, in general, provides that the value of the gross estate includes the value of all property to the extent of any interest in the property that was transferred by the decedent (for less than adequate consideration) if the decedent has retained for life the right, alone or in conjunction with any person, to designate the person who shall possess or enjoy the property or the income therefrom.

Section 2038(a)(1), in general, provides that the value of the gross estate includes the value of all property to the extent of any interest in the property that was transferred by the decedent (for less than adequate consideration) if the decedent held a power, exercisable alone or in conjunction with any person, to change the enjoyment of the property through the exercise of a power to alter, amend, revoke, or terminate.

Section 25.2511-2(c) of the Gift Tax Regulations provides that a gift of property is incomplete to the extent that the donor reserves the power to revest the beneficial title to the property in himself or herself or the power (other than a fiduciary power limited by a fixed or ascertainable standard) to name new beneficiaries or to change the interest of the beneficiaries among themselves. See also section 25.2511-2(f).

For purposes of sections 2036 and 2038, it is immaterial in what capacity the power was exercisable by the decedent. Thus, if a decedent transferred property in trust while retaining, as trustee, the discretionary power to distribute the principal and income, the trust property will be includible in the decedent's gross estate under sections 2036 and 2038. The regulations under sections 2036 and 2038 explain that a decedent is regarded as having possessed the powers of a trustee if the decedent possessed an unrestricted power to remove the trustee and appoint anyone (including the decedent) as trustee. Sections 20.2036-1(b)(3) and 20.2038-1(a) of the Estate Tax Regulations.

Rev. Rul. 79-353 concludes that, for purposes of sections 2036(a)(2) and 2038(a)(1), the reservation by a decedent-settlor of the unrestricted power to remove a corporate trustee and appoint a successor corporate trustee is equivalent to the decedent-settlor's reservation of the trustee's discretionary powers.

Rev. Rul. 81-51 modifies Rev. Rul. 79-353 so that it does not apply to a transfer or addition to a trust made before October 29, 1979, the publication date of Rev. Rul. 79-353, if the trust was irrevocable on October 28, 1979.

Rev. Rul. 77-182 concludes that a decedent's power to appoint a successor corporate trustee only in the event of the resignation or removal by judicial process of the original trustee did not amount to a power to remove the original trustee that would have endowed the decedent with the trustee's discretionary control over trust income.

In *Estate of Wall*, the decedent had created a trust for the benefit of others and designated an independent corporate fiduciary as trustee. The trustee possessed broad discretionary powers of distribution. The decedent reserved the right to remove and replace the corporate trustee with another independent corporate trustee. The court concluded that the decedent's retained power was not equivalent to a power to affect the beneficial enjoyment of the trust property as contemplated by sections 2036 and 2038. See also *Estate of Headrick v. Commissioner*, 93 T.C. 171 (1989), *aff'd* 918 F.2d 1263 (6th Cir. 1990).

> In *Estate of Vak*, the decedent had created a trust and appointed family members as the trustees with discretionary powers of distribution. The decedent reserved the right to remove and replace the trustees with successor trustees who were not related or subordinate to the decedent. The decedent was also a discretionary distributee. Three years later, the trust was amended to eliminate both the decedent's power to remove and replace the trustees and the decedent's eligibility to receive discretionary distributions.
>
> The issue considered in *Estate of Vak* was whether the decedent's gift in trust was complete when the decedent created the trust and transferred the property to it or, instead, when the decedent relinquished the removal and replacement power and his eligibility to receive discretionary distributions. The Eighth Circuit concluded that the decedent had not retained dominion and control over the transferred assets by reason of his removal and replacement power. Accordingly, the court held that under section 25.2511-2(c) the gift was complete when the decedent created the trust and transferred the assets to it.

Rev. Rul. 95-58 held:

> In view of the decisions in the above cases, Rev. Rul. 79-353 and Rev. Rul. 81-51 are revoked. Rev. Rul. 77-182 is modified to hold that even if the decedent had possessed the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent (within the meaning of section 672(c)), the decedent would not have retained a trustee's discretionary control over trust income.

Letter rulings have also applied Rev. Rul. 95-58 to Code § 2041 (general power of appointment) and Code § 2042 (life insurance incidents of ownership).[7475]

What if a beneficiary can control the corporate trustee? Letter Ruling 202120003 was a Code § 2041 ruling that looked to Rev. Rul. 95-58 and provided insight:

> Pursuant to Trust, Court may only appoint a national bank as successor trustee. Son represents that, from the viewpoint of voting control, Son does not own significant holdings of stock in any national bank; Son is not an executive of any national bank; and Son will not during his remaining lifetime purchase significant (from the viewpoint of voting control) holdings of stock in any national bank or become an executive of any national bank. Therefore, Son will not, at any time, have a significant interest in a national bank. Accordingly, Son will never possess the power, through the trustee, to distribute property of Trust to himself. Therefore, we conclude that Son's possession of the power to remove the trustee is not a general power of appointment for purposes of § 2041(b).

[7475] See part II.Q.4.i.ii.(a) Trust Ownership of Policy (Code § 2042 life insurance) and fn 6713 in part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts (Code § 2041 general power of appointment).

III.C.4. Avoiding Possible Code § 2036(a)(2) Powers

Diana Zeydel suggested keeping any "Benefits Decision" away from anyone whose powers might be attributed to a family member that might give the IRS a hook to argue Code § 2036(a)(2) inclusion:[7476]

"Benefits Decision" means at any time with relation to any Entity (including, without limitation, the Company), any and all decisions, actions, determinations, approvals, consents, votes or undertakings of any kind, including, without limitation, decisions not to act, determine, approve, consent, vote or engage in any undertaking, of such Entity relating to any one or more of the following:

(i) all Distributions, whether arising from operations or capital transactions, including, without limitation, whether or not to make Distributions to the Interest Holders of such Entity and the timing and amounts of any such Distributions;

(ii) any funds set aside or amounts allocated to reserves, with respect to any fiscal period, for any purpose, including, without limitation, for working capital and to pay insurance, debt service, or other costs or expenses incident to the ownership or operation of the business of such Entity;

(iii) any determination of the fair market value of any property (other than cash) contributed to such Entity by any Interest Holder of such Entity or any other asset or liability of such Entity, including, without limitation, any determination of the manner in which securities or other instruments with a publicly quoted price shall be valued;

(iv) any loan or guarantee of a loan by such Entity to or for any Interest Holder of such Entity or any Affiliate of an Interest Holder of such Entity (or to or for (a) any Indirect Interest Holder of such Entity or (b) any other Entity in which an Interest Holder or Indirect Interest Holder of such Entity has any interest, direct or indirect), either with or without adequate interest and security, including, without limitation, any right to set off any Distributions otherwise payable to such Interest Holder in the event that any amount due to such Entity pursuant to the terms of such loan is not timely paid;

(v) withdrawal or resignation of any Interest Holder of such Entity, in whole or in part, or withdrawal of any portion of the capital contribution or capital account balance of any Interest Holder of such Entity;

(vi) dissolution or liquidation of such Entity, in whole or in part, including, without limitation, whether or not, at any time or times, to cause such Entity to dissolve or liquidate, in whole or in part, the establishment of reserves (if any) in relation thereto and any and all Distributions relating thereto;

(vii) the exercise of any discretion (including, but without limitation, any discretion which would constitute an "incident of ownership" within the meaning of Section 2042(2) of the Code) with respect to any insurance policy held by such Entity on the life of any Interest Holder of such Entity or any Indirect Interest Holder of such Entity;

[7476] "Drafting to Avoid the Application of Section 2036(a)(2) After *Powell*," ACTEC webinar *Estate Planning in This Election Year* (9/23/2020), reproduced with Diana's permission.

(viii) any voting stock held by such Entity which would be includable in the estate of any Interest Holder of such Entity or any Indirect Interest Holder of such Entity under Section 2036(b) of the Code, if such Interest Holder or Indirect Interest Holder held at or within three (3) years of his or her death the power to vote such stock;

(ix) any action, decision, or transaction by or on behalf of such entity in which an individual manager of such entity shall be directly or indirectly interested in his or her individual capacity, including, without limitation, negotiation, amendment, modification, execution and delivery of any and all agreements, documents, instruments and certifications in connection with, or in furtherance of, such action, decision or transaction, together with any amendments or modifications thereto, and all such other acts and things, payments and remittances, in connection with, or in furtherance of, such action, decision or transaction;

(x) any amendment to the governing instruments of such Entity with respect to any matter relating to one or more of the items described in the preceding clauses (i) through (ix); and

(xi) any action or decision to be taken or made by or on behalf of a Subsidiary that, if taken or made by or on behalf of the Company (x) would constitute a Benefits Decision and (y) would otherwise require the direction or approval of a Benefits Manager under this Agreement.

Let's give further thought to item (i) – the timing and amounts of distributions. Income tax elections[7477] or provisions for settling audits may affect the timing and amounts of distributions or income tax liability itself.[7478] To avoid possible IRS assertions of various transfer tax provisions,[7479] consider including tax elections in this list of Benefits Decisions. The latter's importance is a matter of an advisor's judgment; for example:

- Rev. Rul. 2004-64 did not view the ability to turn off grantor trust treatment as having gift tax consequences; see text accompanying fns. 6961-6980 in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner.

- Timing differences in distributions arising from income tax withholding are not considered to change rights to distributions in the S corporation arena; see part II.A.2.i.ii Temporary Timing Differences; Other Varying Differences.

To the extent practical, try to grant the authority to make Benefits Decisions to a person satisfying part III.C.3 Safe Harbor re Right to Change Trustee - Rev. Rul. 95-58.

[7477] See text accompanying fns 1439-1446 in part II.G.4.n Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax.

[7478] For procedures for settling IRS audits of entities taxed as partnerships, including options relating to the impact of an audit on the owners, see part II.G.19.c Audits of Partnership Returns.

[7479] See Justak, "Remember Federal Transfer Tax Considerations When Electing into a State's Pass-Through Entity Tax," *Estate Planning Journal* (WG&L) (6/2022). That author is especially concerned whether authority to elect to have the entity instead of the owners pay tax might be relieving the tax burden of a deemed owner of a grantor trust that owns an interest in the entity; for deemed ownership, see part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust, especially part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

III.C.5. Holding Voting Stock under Code § 2036(b)

Code § 2036(b), “Voting rights,” provides:

> (1) *In general*. For purposes of subsection (a)(1) , the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property.
>
> (2) *Controlled corporation*. For purposes of paragraph (1) , a corporation shall be treated as a controlled corporation if, at any time after the transfer of the property and during the 3-year period ending on the date of the decedent’s death, the decedent owned (with the application of section 318), or had the right (either alone or in conjunction with any person) to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock.
>
> (3) *Coordination with section 2035*. For purposes of applying section 2035 with respect to paragraph (1) , the relinquishment or cessation of voting rights shall be treated as a transfer of property made by the decedent.

The House explanation of the 1976 enactment of Code § 2036(b) explains its intent to overrule *Byrum* in certain situations:

> Your committee believes that the voting rights are so significant with respect to corporate stock that the retention of voting rights by a donor should be treated as the retention of the enjoyment of the stock for estate tax purposes. Your committee believes that this treatment is necessary to prevent the avoidance of the estate and gift taxes.[3]
>
> > [3] One commentator has suggested that “[t]he “ultimate” in estate planning for most controlling stockholders of closely held corporations is the avoidance of a Federal estate tax on corporate voting shares that they have transferred to a trust in which they have reserved the uninterrupted right to continue voting the shares.” Pressmen. “Effect of Tax Court’s Gilman Decision on Estate Planning for the Close Corporation,” 44 “The Journal of Taxation,” 160 (March 1976). This commentator further suggests that the value of the gift might be reduced by the value attributable to the retained voting rights. If this is done, the value attributed to voting rights would not be subject to either the gift tax at the time of the gift or, under the *Byrum* decision, the estate tax upon the death of the donor.
>
> The bill would provide that the retention of voting rights in transferred stock is to be treated as a retention of the enjoyment of the stock. The stock is to be includible in a decedent’s gross estate if the decedent retained the voting rights for his life, for any period not ascertainable without reference to his death, or for any period which does not in fact end before his death. The provision is to apply even if the stock is issued by a corporation which had not been directly or indirectly controlled by the decedent. For purposes of the provision, the capacity in which the decedent exercised the voting rights is immaterial.

The Senate explanation of the 1978 changes to Code § 2036(b) explains:

> The bill...makes two amendments to the rule contained in the 1976 Act. First, the bill restricts the rule to stock in corporations which are controlled by the decedent and his

> relatives. Second, the bill clarifies the rule under the 1976 Act that indirect transfers are subject to the rule.
>
> Under the bill, the rule requiring inclusion in the gross estate only applies to stock in a “controlled corporation.” Where the stock is not in a “controlled corporation”, the stock is not included in the gross estate of the decedent even if the decedent directly held the power to vote those shares.
>
> A “controlled corporation” is defined to mean a corporation where the decedent and his relatives owned, or had the power to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock. The constructive ownership rules of section 318 apply solely for purposes of determining whether the corporation is a controlled corporation. In addition, in order for the corporation to be controlled, the ownership of, or power to vote, 20 percent of the total combined voting power of all classes of stock had to occur any time after the transfer of the property and during the 3-year period ending on the date of the decedent’s death.
>
> The rule requiring inclusion in the gross estate of stock of a controlled corporation applies where the decedent retained the voting rights of the stock which was directly or indirectly transferred by him. Thus, where the decedent transferred cash or other property prior to his death to a trust of which he is trustee within 3 years of his death, and then the trust uses that cash or other property to purchase stock in a controlled corporation from himself, the value of the stock would be included in his gross estate. In addition, the indirect retention of voting rights in the case of reciprocal transfers of stock in trust would result in the inclusion of the stock with respect to which the decedent had voting rights as trustee. However, voting rights in stock transferred in trust by the decedent will not be considered to have been retained by the decedent merely because a relative was the trustee who voted the stock. In these cases, the voting rights would be considered to have been indirectly retained by the decedent if in substance the decedent had retained such voting rights, *e.g.*, there had been an arrangement or agreement for the trustee to vote the stock in accordance with directions from the decedent.
>
> The rule would not apply to the transfer of stock in a controlled corporation where the decedent could not vote the transferred stock. For example, where a decedent transfers stock in a controlled corporation to his son and does not have the power to vote the stock any time during the 3-year period before his death, the rule does not apply even where the decedent owned, or could vote, a majority of the stock. Similarly, where the decedent owned both voting and nonvoting stock and transferred the nonvoting stock to another person, the rule does not apply to the nonvoting stock simply because of the decedent’s ownership of the voting stock.

Prop. Reg. § 20.2036-2 would elaborate on and expand the ideas set forth in the legislative history. However, Prop. Reg. § 20.2036-2(a) provides that Prop. Reg. § 20.2036-2 “does not require inclusion of stock in the gross estate if the transferred stock has not voting rights or if the donor has not retained voting rights in the stock transferred.”

III.D. Code § 2038

Code § 2038 is a companion to part III.C Code § 2036 that creates inclusion when a donor retains too many strings. Courts also tend to look to Code § 2038 when deciding whether an insured held incidents of ownership under Code § 2042; see part II.Q.4.i.ii Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity.

Code § 2038(a) provides that the value of the gross estate includes the value of all property:

> (1) *Transfers after June 22, 1936*. To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.
>
> (2) *Transfers on or before June 22, 1936*. To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power during the 3-year period ending on the date of the decedent's death. Except in the case of transfers made after June 22, 1936, no interest of the decedent of which he has made a transfer shall be included in the gross estate under paragraph (1) unless it is includible under this paragraph.

Reg. § 20.2038-1(a) provides:

> *In general*. A decedent's gross estate includes under section 2038 the value of any interest in property transferred by the decedent, whether in trust or otherwise, if the enjoyment of the interest was subject at the date of the decedent's death to any change through the exercise of a power by the decedent to alter, amend, revoke, or terminate, or if the decedent relinquished such a power in contemplation of death.[7480] However, section 2038 does not apply -
>
> (1) To the extent that the transfer was for an adequate and full consideration in money or money's worth (see § 20.2043-1);
>
> (2) If the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law; or

[7480] [My footnote:] Reg. § 20.2038-1 was last amended in 1962, and Code § 2035 was amended in 1976 to change "contemplation of death" to "during the 3-year period ending on the date of the decedent's death."

(3) To a power held solely by a person other than the decedent. But, for example, if the decedent had the unrestricted power to remove or discharge a trustee at any time and appoint himself trustee, the decedent is considered as having the powers of the trustee. However, this result would not follow if he only had the power to appoint himself trustee under limited conditions which did not exist at the time of his death. (See last two sentences of paragraph (b) of this section.)

Except as provided in this paragraph, it is immaterial in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent; whether the power was exercisable alone or only in conjunction with another person or persons, whether or not having an adverse interest (unless the transfer was made before June 2, 1924; see paragraph (d) of this section); and at what time or from what source the decedent acquired his power (unless the transfer was made before June 23, 1936; see paragraph (c) of this section). Section 2038 is applicable to any power affecting the time or manner of enjoyment of property or its income, even though the identity of the beneficiary is not affected. For example, section 2038 is applicable to a power reserved by the grantor of a trust to accumulate income or distribute it to A, and to distribute corpus to A, even though the remainder is vested in A or his estate, and no other person has any beneficial interest in the trust. However, only the value of an interest in property subject to a power to which section 2038 applies is included in the decedent's gross estate under section 2038.

Code § 2038 does not apply to the grantor's power as a fiduciary to make distributions using an ascertainable standard or to exercise various administrative powers. *Estate of Ford v. Commissioner*, 53 T.C. 114 (1969) (a reviewed case), *acq. in part* 1978-2 C.B. 2, *nonacq. in part* 1978-2 C.B. 3, *aff'd per curiam*, 450 F.2d 878 (2d Cir. 1971), held:

Respondent argues that the powers reserved to the trustee under the instant trust instrument are so broad as to require the inclusion of the principal of the trust in the decedent's gross estate pursuant to the provisions of sections 2036(a)(2)[6] and/or 2038(a)(1).[7] Petitioner contends that the reserved powers are limited by judicially enforceable external standards sufficient to place the trust property beyond the reach of these inclusionary provisions. We agree with the petitioner….

[6] [quoting Code § 2036(a)(2)]

[7] [quoting Code § 2038(a)(1)]

a. Invasion Power

Under the terms of the trust instrument, the grantor-trustee has the power to invade corpus for Edward's benefit "for the purpose of defraying expenses occasioned by illness, infirmity or disability, either mental or physical, or for his support, maintenance, education, welfare and happiness." In support of his position that the trustee herein was given unusually broad discretionary power over the trust property, respondent stresses the trustee's power as enumerated above to invade corpus for the "happiness" of the income beneficiary. Undoubtedly, the word "happiness" standing alone, or in conjunction with language exhorting the trustee to administer the trust liberally for the benefit of one beneficiary over another, does not provide an ascertainable standard enforceable in a court of equity. *Cf. Merchants Bank v. Commissioner*, 320 U.S. 256, 261-263 (1943). But that is not the case here.[8]

[8] The invasion provision in issue does contain a clause advising the trustee that he should "consider primarily the welfare" of the income beneficiary, and not "*unduly* conserve the principal for later distribution to him or others having contingent remainder interests." (Emphasis supplied.) However, this language is not nearly so sweeping as that involved in the *Merchants Bank* case cited above.

However, the respondent would have us ignore the fact that the foregoing language is circumscribed by the precondition that, when the trustee is satisfied that the income beneficiary is "in need of funds in excess of the income which may then be available," then he may invade principal to "relieve or contribute toward the relief of *any such need*." (Emphasis added.) Thus, the instrument in question places a fiduciary responsibility on the trustee to determine "need" before he may invade principal for any of the prescribed reasons, *i.e.*, for the "illness, infirmity, or disability, either mental or physical" or for the "support, maintenance, education, welfare and happiness" of the income beneficiary. In its usual sense, the term "need" is synonymous with "necessity" or "exigency," and denotes an "urgency" or a "pressing lack of something essential." *Webster's New Collegiate Dictionary* (7th ed. 1965), based on *Webster's New International Dictionary* (3d ed. 1961). There is no indication that the word "need," as used in the trust instrument, was intended to carry any other than its customary meaning.

By virtue of the presence of the term "happiness" in the trust instrument, respondent would have us conclude that the grantor-trustee herein had unbridled discretion to invade corpus upon the whim of the income beneficiary. To the contrary, we do not accord this single word such as talismanic effect. A word, such as "happiness," must be construed in the context in which it appears "because its meaning may be affected by the words it accompanies." *Estate of Marvin L. Pardee*, 49 T.C. 140, 144 (1967). Viewing the invasion provision in its entirety, we conclude that its emphasis on "need" delimits "happiness" as well as the other enumerated terms, and provides an external, objective standard enforceable against the grantor-trustee in a court of equity. *United States v. Powell*, 307 F.2d 821, 826-828 (C.A. 10, 1962). It is well settled that where the trust instrument contains such a standard, the grantor-trustee is not deemed to have retained sufficient dispositive discretion to activate the operative provisions of either section 2036 or section 2038. *Jennings v. Smith*, 161 F.2d 74, 77-78 (C.A. 2, 1947). *Estate of C. Dudley Wilson*, 13 T.C. 869, 872-873 (1949), affirmed per curiam 187 F.2d 145 (C.A. 3, 1951); and *Delancey v. United States*, 264 F. Supp. 904, 907 (W.D. Ark. 1967).

Moreover, an examination of the applicable State law[9] reveals that an aggrieved beneficiary[10] could indeed enforce his rights against an imprudent or wrongdoing trustee. There is an abundance of New York authority stating that a trustee owes a duty of equal loyalty to all beneficiaries. See for example: *Matter of Dickson's Estate*, 38 Misc.2d 678, 237 N.Y.S.2d 572) (N.Y. Co. Surr. Ct. 1963); *Matter of Heinrich's Will*, 195 Misc. 803, N.Y.S.2d 875 (Monroe Co. Surr. Ct. 1949); and *Matter of James' Estate*, 86 N.Y.S.2d 78, 89 (N.Y. Co. Surr. Ct. 1948). The language of the Court of Appeals of New York in *Matter of Hubbell's Will*, 302 N.Y. 246, 254, 97 N.E.2d 888, 891 (1951), reflects the position taken by the New York courts on this question:

[9] The 12th provision of the trust indenture provides that "questions with respect to the administration of the trust estate shall be governed by the laws of the State of New York."

[10] In this case the aggrieved beneficiary could be, in terms of lives in being, the grantor's daughter. The fact that she is only a contingent beneficiary would not deter a New York court from hearing her plea that the trust assets are being despoiled in contravention of the trust provisions. *Klein v. Klein*, 64 N.Y.S.2d 96, 98 (Sup. Ct. 1946), and the cases cited therein.

> In judging the conduct of trustees, the basic consideration is the fiduciary obligation which they owe to all of the beneficiaries whom they represent… "A trustee", this court said in *Meinhard v. Salmon*, … "is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions…. ." [Citations omitted.]

Finally, as we said in *Estate of Lillie Macmunn Stewart*, 52 T.C. 830 (1969), in discussing a similar issue arising under section 2055, "The thrust of New York law is further reflected in a statutory provision declaring void any provision exonerating a fiduciary 'from liability for failure to exercise reasonable care, diligence, and prudence.'" N.Y. Est., Powers & Trust Law, sec. 11-1.7(a)(1) (McKinney 1967). It is patent from the foregoing authority that should the grantor-trustee overstep the boundaries of his discretion to favor one beneficiary over another, the New York courts would compel his "obedience to the great principles of equity which are the life of every trust." *Carrier v. Carrier*, 226 N.Y. 114, 123 N.E. 135, 138 (1919).

Thus, although we deem the question to be a close one, we conclude that the grantor-trustee herein did not have untrammeled discretion to invade corpus at his own whim or that of the income beneficiary. Consequently, the presence of the invasion power in the trust indenture does not in our view operate to trigger the provisions of sections 2036(a)(2) and/or 2038(a)(1).

b. The Administrative and Management Powers

Respondent next invites our attention to the administrative and management powers conferred upon the trustee, particularly stressing the power to allocate receipts, losses, and expenditures of the trust between income and principal. This latter provision is commonly included in trust instruments "to give the trustee some discretion so that he would not be required to seek court guidance in making doubtful allocations." *Estate of Marvin L. Pardee*, *supra* at 146. See also *State Street Trust Co. v. United States*, 263 F.2d 635, 638 (C.A. 1, 1959). The trustee herein is directed to exercise this power in an "advantageous and equitable" manner. Of course, should he abuse his discretion by classifying an obvious item of principal as income, he would be subject to equity court review. *Cf. Frances Carroll Brown*, 30 T.C. 831, 836-837 (1958); and *Caroline Gove Doty*, 3 T.C. 1013, 1017 (1944), *affd.* 148 F.2d 503 (C.A. 1, 1945).

Similarly, we find nothing unusual in the remaining administrative and management powers entrusted to the fiduciary's controlled discretion. For instance, this Court has found on more than one occasion that the power to invest in "nonlegals" (*i.e.*, investments not classified under a particular State law or ruling of the pertinent court as legal investments for trust funds) and the power to sell or exchange the trust property do

> not amount to a right to designate who shall enjoy the trust property or a right to alter, amend, or revoke the terms of the trust. See *Estate of Ralph Budd*, 49 T.C. 468, 475-476 (1968); *Estate of James H. Graham*, 46 T.C. 415, 429 (1966); and the cases cited in these two opinions.
>
> Respondent also relies on the fourth provision of the trust instrument giving the grantor's daughter the right to terminate the trust at any time before the income beneficiary attains age 25 by filing a written instrument with the trustee. We are at a loss to understand, and respondent fails to explain, how this power, which is reserved to the daughter alone, can be attributed to the grantor. It is clear from a fair reading of the statutory provisions here involved that the right or power must be reserved for the exercise of the decedent-grantor himself, either alone or in conjunction with another, before such provisions become operative. Secs. 2036(a)(2) and 2038(a)(1), I.R.C. 1954.
>
> Finally, respondent cites *State Street Trust Co. v. United States*, *supra*, for the proposition that although none of the reserved powers in itself may require the result he seeks, when such powers are viewed as a whole, they lodge such broad discretionary authority in the grantor-trustee as to require inclusion of the trust property in his gross estate. Due to our conclusion that a New York court of equity could, and would if called upon, contain the trustee within the bounds of his equal fiduciary responsibility to every beneficiary under the trust, we do not feel that the exceptional rule of the *State Street* case here applies. See *Estate of Willard V. King*, 37 T.C. 973, 978 (1962). Thus it is our view that, under the facts of the instant case, the whole is no greater than the sum of its parts.
>
> In view of the foregoing, we hold that no portion of the trust property, or the income therefrom, is includable in the decedent's estate under the provisions of sections 2036(a)(2) and 2038(a)(1) of the 1954 Code.

Note that Code § 2036(a) applies to any property "of which the decedent has *at any time* made a transfer" (emphasis added) unless the transfer was a bona fide sale, etc. What happens if the decedent makes an outright gift – no direct or indirect strings attached - and the donee later decides to make arrangements that grants the decedent a power of appointment? The IRS might take the position that Code § 2038 requires only that the decedent hold such a power – not that the decedent retained such a power. If one spouse gives property to another and the donee spouse gives that particular property to a trust for the donor spouse,[7481] the IRS might argue that Code § 2038 applies, even if the IRS cannot prove a step transaction. For example, Rev. Rul. 70-348 involved the following facts and held:

> The donor transferred securities to his wife as custodian for their minor children under the Uniform Gifts to Minors Act. After serving in this capacity for several years, the wife resigned and the donor was appointed successor custodian. He was serving in that capacity at the time of his death.
>
> Section 2038 of the Code provides that the gross estate shall include the value of all property transferred by the decedent, in trust or otherwise, over which he holds at the date of his death, either alone or in conjunction with any other person, the power to alter, amend, revoke, or terminate the enjoyment of the beneficial interest. It is immaterial in

[7481] This may inform whether property is gifted to fund a trust or is sold, the latter as described in part III.B.2.i.xv Sale to Trust Created by Spouse: An Alternative Way to Have a Trust Benefitting Client.

> what capacity the power is exercisable or when or from what source the decedent acquired such power.
>
> Revenue Ruling 59-357, C.B. 1959-2, 212, at 214, holds that the value of property transferred to a minor under the Uniform Gifts to Minors Act, or other similar legislation, is includible in the gross estate of the donor for Federal estate tax purposes if the donor appoints himself custodian and dies while serving in that capacity and before the donee attains the age of 21 years. See also *Estate of Jennie Vanderpool v. Commissioner*, 54 T.C. No. 52 (1970). However, it is not necessary that the power to alter, amend, revoke, or terminate the enjoyment of the beneficial interests be retained by the donor at the time of the transfer. The mere possession thereof by the donor at the time of death is the factor that results in the inclusion of the value of the transferred property in his gross estate. Section 20.2038-1(a) of the Estate Tax Regulations.
>
> Accordingly, it is held that, since the decedent transferred shares of stock to his minor children under the Uniform Gifts to Minors Act and died holding these shares as successor custodian for such minor children, the value of the stock is includible in his gross estate under section 2038 of the Code.

Skifter, a 1972 Code § 2042 case that viewed Code § 2038 as relevant to analyzing Code § 2042 incidents of ownership, approached Code § 2038 as not applying when the transferor parted completely with the property and the trust was created totally independently from the decedent's prior ownership.[7482]

In furtherance of Reg. § 20.2038-1(a)(2), Letter Rulings 200919008, 200919009, and 200919010 held that the modification of an irrevocable trust by the settlor and all interested parties did not implicate Code § 2038.[7483] Letter Rulings 200247037 and 200303016 reached the same conclusion and – without any further analysis – also ruled that Code § 2036 did not apply.

Estate of Tully v. United States, 528 F.2d 1401 (Ct. Cl. 1976), held that the ability to cancel a death benefit by divorcing one's spouse does not generate Code § 2038(a)(1) inclusion. For other examples of this general idea, see part III.B.1.i Transfers with Contingencies Based on Acts of Independent Significance.

Reg. § 20.2038-1(c), "Transfers made before June 23, 1936," provides:

> Notwithstanding anything to the contrary in paragraphs (a) and (b) of this section, the value of an interest in property transferred by a decedent before June 23, 1936, is not included in his gross estate under section 2038 unless the power to alter, amend, revoke, or terminate was reserved at the time of the transfer. For purposes of this paragraph, the phrase "reserved at the time of the transfer" has reference to a power (arising either by the express terms of the instrument of transfer or by operation of law) to which the transfer was subject when made and which continued to the date of the decedent's death (see paragraph (b) of this section) to be exercisable by the decedent alone or by the decedent in conjunction with any other person or persons. The phrase

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[7482] See text accompanying fn 4604 in part II.Q.4.i.ii.(a) Trust Ownership of Policy.
[7483] This is important in designing trusts under part II.H.2.b.ii Marital Estate Trust, as pointed out in fn 2048.

> also has reference to any understanding, express or implied, had in connection with the making of the transfer that the power would later be created or conferred.

Code § 2038(b), "Date of existence of power," provides:

> For purposes of this section, the power to alter, amend, revoke, or terminate shall be considered to exist on the date of the decedent's death even though the exercise of the power is subject to a precedent giving of notice or even though the alteration, amendment, revocation, or termination takes effect only on the expiration of a stated period after the exercise of the power, whether or not on or before the date of the decedent's death notice has been given or the power has been exercised. In such cases proper adjustment shall be made representing the interests which would have been excluded from the power if the decedent had lived, and for such purpose, if the notice has not been given or the power has not been exercised on or before the date of his death, such notice shall be considered to have been given, or the power exercised, on the date of his death.

Reg. § 20.2038-1(b), "Date of existence of power," essentially restates the first sentence of Code § 2036(b) and then provides:

> In determining the value of the gross estate in such cases, the full value of the property transferred subject to the power is discounted for the period required to elapse between the date of the decedent's death and the date upon which the alteration, amendment, revocation, or termination could take effect. In this connection, see especially § 20.2031-7. However, section 2038 is not applicable to a power the exercise of which was subject to a contingency beyond the decedent's control which did not occur before his death (*e.g.*, the death of another person during the decedent's life). See, however, section 2036(a)(2) for the inclusion of property in the decedent's gross estate on account of such a power.

A powerful positive application of Code § 2038 is in part II.H.2.b.ii Marital Estate Trust, allowing residents of common law states to obtain a full basis step-up of all of a couple's property in the trust when the first spouse dies.[7484]

In *Estate of Reed v. U.S.*, 36 A.F.T.R.2d 75-6413 (M.D. Fla. 1975), the decedent gave stock to a custodianship for a child under the Uniform Gifts to Minors Act. After the child reached 21 and therefore owned the stock outright, the child created a trust and named the decedent as a trustee. In holding that the trust was not includible in the decedent's estate under Code § 2038, the court listed the following legal conclusions:

> (5.) The outcome of the issue raised in this case is controlled by the meaning and scope of section 2038(a)(1) as amended in 1936 to include a provision that applicability of the statutory provision is to be determined "without regard to when or from what source the decedent acquired" the power or control contemplated by the statute.
>
> (6.) The Court finds as a matter of law that section 2038(a)(1), aforesaid, is intended and thus does apply only where the power or control contemplated therein derives either from a direct reservation retained by the decedent at the time of the transfer from him

[7484] See fn 2048.

of the property contemplated or from the conditions of the original transfer from the decedent.

(7.) In *White v. Poor*, 296 U.S. 98 (1935), the United States Supreme Court held a transfer from a decedent to a trust created by the decedent, under which the decedent was not a trustee and had no power for a time, but subsequently under which the decedent was serving as a trustee at her death, was not includible in the decedent's tax estate notwithstanding the predecessor statute to section 2038(a)(1) [the predecessor statute to section 2038(a)(1) now in essence appears as section 2038(a)(2) of the 1954 Code]. In the *White v. Poor* situation, the decedent's power or control enjoyed at death grew out of her original transfer in trust or was derived from the conditions of the original transfer from the decedent. Concluding that the Court had misapprehended its intent, Congress amended the statute to its form now appearing as section 2038(a)(1).

(8.) At all times prior and subsequent to the statutory amendment of 1936, now appearing in section 2038(a)(1), the provision relating to revocable transfers has apparently been construed and applied to bring into the gross estate of a transferor (for Federal estate tax purposes) the values of property interests over which the transferor retained or reserved certain powers or control at the time of his original transfer. Section 2038(a)(1) thus seems to be designed to apply to situations where the transferor-decedent himself sets the machinery in motion that purposefully allows fiduciary powers over the property interest to subsequently return to him, such as by an incomplete transfer. *Estate of Skifter v. Commissioner of Internal Revenue*, 468 F.2d 699, 703-705 (2d Cir. 1972). Section 2038(a)(1) does not seem to be intended to reach the value of a property interest of which the decedent, prior to his death, made a complete, absolute disposition simply because, at the time of his death, by a totally unrelated and fortuitous reconveyance, he had some degree of fiduciary power or control over the interest. *Estate of Lumpkin v. Commissioner*, 474 F.2d 1092, 1097, 73-1 USTC ¶12,909 (5th Cir. 1973); *Estate of Skifter*, *supra*; *Howard v. United States*, 125 F.2d 986, 42-1 USTC ¶10,134 (5th Cir. 1942); *Rose v. United States*, 511 F.2d 259 (5th Cir. April 11, 1975).

(9.) The Court finds as a matter of law that there should not be included in the gross estate (for Federal estate tax purposes) of the decedent herein any part of the 384 shares of A-B Distributors, Inc., stock representing Marilynn Reed's stock interest in that corporation some or all of which may have been held as assets of the trust under agreement dated May 27, 1964, under which the decedent was a trustee at his death.

For other Code § 2038 analysis, see parts II.H.2.c QTIP Trusts - Code § 2519 Trap and II.Q.4.i.ii.(a) Trust Ownership of Policy. For a variety of strategies relating to basis step-up, see Bramwell & Madden, "Toggling Gross Estate Inclusion On and Off: A Powerful Strategy," *Estate Planning Journal* (3/2017), which describes strategies relevant to parts:

- II.H.2.c QTIP Trusts - Code § 2519 Trap
- III.C Code § 2036
- III.D Code § 2038.

III.E. Fairness Within Families; Valuation

A succession plan can be one of the most important factors contributing to the long-term success of a family business, yet the importance of these plans is often overlooked until it is too late. In many cases, the plans are technically sufficient, but the drafters have failed to consider the relationships that drive the business itself – the family.[7485] While the technical issues underlying family business succession plans are usually similar from case to case, the family issues are unique in every case. No two families are the same, and successful business succession plans consider those differences. The stakeholders in the business have to be treated fairly for the plan to succeed; thus, the plan has to consider the interests of family, non-family owners, and the employees.

The starting point for any business succession plan is determining an accurate valuation of the business. If the plan involves keeping the business in the family, it is important to have an accurate determination of its value in order to allocate wealth fairly among family members involved in the business and those who are not involved. Or, if the plan involves some sort of sale, accurate valuation will ensure the sellers receive fair compensation for their interests. And, regardless of whether the business stays in the family or is sold, an accurate valuation can help parties estimate a significant expense of the succession process – the transfer tax cost of the succession. See part II.H.3 Valuation Discounts – Friend or Enemy.

The general principle underlying business valuation is the “willing buyer – willing seller test”. Regulations define fair market value in the context of estate transfers as “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.”[7486] The test is easy to apply when dealing with publicly traded stock - one simply takes the mean between the highest and lowest quoted sales prices on the valuation date. In the context of non-publicly traded securities, ready-made market for the stocks exists, so valuation is more challenging. The Code states that the value of such stocks should be determined by examining numerous factors, including the value of stocks of corporations “engaged in the same or a similar line of business which are listed on an exchange.”[7487] Regulations expand on the factors to be considered, mentioning the company’s net worth, prospective earning power and dividend paying capacity and list other relevant factors, including the good will of the business, the economic outlook in a particular industry, the company’s position in the industry, the degree of control of the business represented by the block of stock to be valued, and the value of stock of other corporations engaged in similar lines of business which are listed on a stock exchange.[7488] Revenue Ruling 59-60 mirrors the Regulations and lists eight fundamental factors that should be considered in valuation cases: the nature of the business and the history of the enterprise; the general economic outlook and the business’ specific industry outlook; the book value of the stock and the company’s financial condition; the company’s earning capacity; the company’s dividend paying capacity; goodwill; sales of the stock and the size of the block of stock to be valued; and the market price of companies in similar lines of business with actively traded stock.

[7485] The discussion in this section comes in large part from some materials provided by James D. Spratt, Jr. of Djuric Spratt (https://djuricspratt.com/bio/jim-spratt), who is not responsible for whatever use this author made of his materials.
[7486] Reg. §§ 20.2031-1(b), 25.2512-1.
[7487] Code §2031(b).
[7488] Reg. §20.2031-2(f)(2) and §25.2512-2(f)(2).

If the business has a contingent claim against it, consider making a protective claim for refund to deduct the amount actually paid.[7489]

In applying these factors, three methods are commonly used in business valuations: the net asset method, the market value method, and the earnings method. These methods are often used in conjunction with one another to come up with the best possible valuation of the business.

The net asset method (or the "underlying asset" method) is based on the accounting concept of net book value. Net book value of a company is the historical cost of the company's assets less its liabilities. Under this method, each asset and liability must be analyzed to determine if the historical balance sheet treatment needs to be restated. This approach is not always accurate when valuing operating companies, since the method does not consider the company's goodwill, so this method is usually considered to give a picture of the minimum value of a company and may be useful where a company is in financial distress with liquidation in its future. However, this method can be quite useful in valuing companies with little goodwill, like holding companies.

The market value method involves an analysis of the value of similar, publicly traded companies or of similar companies that have been recently acquired in private transactions. The comparison values are based on stock prices or transaction prices, which are then divided by a specific earnings parameter or balance sheet parameter. That multiple is then applied to the subject company's same parameter to get an estimated company value. Because the valuation's accuracy depends on the level of similarity between the two companies, this valuation method becomes less appropriate as the subject company becomes more unique and will be hard to apply in many cases.

The earnings method bases valuation on a company's cash flow capacity and earnings to determine the present value of the future economic benefits the company will bring to its investors. This valuation can be determined two ways, either through the discounted cash flow method or through the capitalization of earnings method. When a company has a past earnings stream that is not expected to indicate future earnings prospects, the discounted cash flow method is used. This entails projecting the business' future cash flows and discounting them to present value using an appropriate discount rate, usually the weighted average cost of capital (WACC), the rate of return the company's capital providers require on their investment. When a company has consistent historical earnings and expects that trend to continue, the capitalization of earnings method is often used. This method entails multiplying a normalized level of earnings by a capitalization factor, the inverse of the company's WACC.

Once the company's value has been established using any combination of the valuation methods, the value of the particular interest in the company has to be determined. In many cases, the value of the particular business interest will not be the proportionate share of the entire business value. Instead, adjustments often need to be made to get an accurate value of the interest. For example, a 51% interest may be just two percentage points larger than a 49% interest, but the 51% interest has more than just a two percentage point value advantage over the 49% interest, since the 51% interest is a controlling interest. Thus, controlling interests often are increased by a control premium, while minority interests are decreased by a minority interest discount. Other examples of valuation adjustments include a key employee discount, a non-voting stock discount or a blockage discount. When making these adjustments it is

[7489] Notice 2009-84.

important to consider whether the discount has already been taken into consideration in determining the company value as a whole. If it has, then the discount should be ignored for the particular business interest valuation. For example, a controlling interest valued using earnings will be based on the company's dividend paying capacity. On the other hand, a minority interest tends to be valued using dividends paid, since a holder of a minority interest may have difficulty forcing dividends to be paid and keeping compensation reasonable.

Restrictive agreements can also play a role in determining interest values. Buy-sell agreements, by definition, involve setting a price at which a particular business interest will be purchased or redeemed. Price can be set a number of ways: by using a formula, by agreement, or by an appraisal procedure.

The formula method usually involves applying some multiple to asset value or earnings, and the decision on whether to use asset value or earnings is usually dependent upon the particular business industry. The multiple applied to that factor will vary depending upon the company and the general business cycle, so finding the appropriate multiple can be challenging. Some of this difficulty can be eased if the company is similar to publicly traded companies, that would give the valuation expert a guideline in determining the multiple.

The agreed value method is exactly what one would assume – it involves the business owners agreeing to a buy-sell purchase price. The most important aspect of this method is the certificate of value itself. Owners must make sure the certificate is updated on a regular basis to ensure the agreed upon price is in fact fair. It is best if the agreement itself provides for an alternate method of valuation if the certificate is not kept up to date. Another potential problem with this approach comes into play where the relative bargaining power of the owners is not equal. In such a case, this method can lead to inequitable results.

The appraisal procedure is usually the most fair method of valuation, but many times it is not used because it can be very expensive. Additionally, because the method requires many judgment calls, no two appraisers are likely to come to the same conclusion about the company's value. Thus, results can be very uncertain, and a company and its owners need to be prepared to pay for multiple appraisals if the interested parties are not satisfied with the initial results.

Two other issues also need to be addressed in buy-sell agreements: whether the interest will be valued at fair market value or fair value, and whether contingent payments will be an option. These issues both address fairness to the parties involved in the transaction.[7490]

Fair value can be the appropriate measure to be used in buy-sell agreements. The goal of fair value is to reach a fair result for the party whose interest is being cashed out involuntarily. On the other hand, fair market value derives from the "willing buyer, willing seller" test, and involves the previously discussed valuation adjustments. But many business interest disposals are triggered by involuntary events, like a family death, meaning the seller is often not the "willing seller" referred to in the fair market value context and applying valuation adjustments could lead to inequitable results. A countervailing argument is that cashing out an owner disrupts the cash flow of a business or its owners, so paying fair market value provides some relief from that disruption. Ultimately, one might consider whether advance planning can provide the needed

[7490] See Cavendish and Kammerer, Determining the Fair Value of Minority Ownership Interests in Closely Held Corporations: Are Discounts for Lack of Control and Lack of Marketability Applicable? *The Florida Bar Journal*, Vol. 82, No. 2, at 10 (2/2008).

cash flow, whether the party who controls the event or the party whose wrongful conduct creates the event should bear the consequences, and who should bear the burden of events that are beyond everyone's control.

A buy-sell agreement also should include a contingent payment provision. Such a provision will come into play when a company undertakes a sale or merger after the triggering event of the buy-sell agreement. In many cases, the sale or merger will be based on a significantly different value than the one used in the buy-sell agreement. If this happens, the party who is bought out in the buy-sell agreement could end up receiving inequitable compensation for his interest. A contingent payment provision can correct this inequity by providing for additional consideration to be paid to those whose interests were retired under the buy-sell agreement within a certain amount of time before the sale or merger.

The valuation issue is so important in family business settings because of personal issues arising within a family business. These businesses' success can depend on how well the older generation plans and how clearly they delineate those plans to the younger generation. This is especially critical when family members actively participate in the business. It is highly unlikely that all of those members involved in the business participate equally in the success of the business; and, when a patriarch dies, arguments may quickly break out about those contributions. If the business owner does not deal with these issues, the business may fail. Family members involved in the business should take over, and other family members should receive other bequests. To divide assets fairly among family members, one has to know the assets' value. In funding bequests, a beneficiary who receives an interest to which discounts apply might argue strongly that they will bear the costs of any situation that requires agreements that are not easily achieved,[7491] whereas the other beneficiaries might argue that merely getting along with others allows the recipient to attain full value and the recipient should not be able to assume that bad things will happen and therefore should be charged with a fair value approach. Non-family owners and employees are also critical to a company's success, and their needs are important to address so that they will continue to be productive.

In addition to the valuation process discussed previously, consider expansion of the professional and business team, employment agreements, compensation, life insurance, ways to reduce estate taxes, capital structure, voting control, and communication.

When developing a business succession plan, professionals might help deal with family dynamics. These professionals usually have training areas like cultural anthropology, psychology or organizational dynamics and can help the business owner prepare for situations he or she would otherwise fail to see coming.

A successful succession plan may also integrate increased depth at the management level. Common sense would tell you that a company is more likely to succeed when the managers taking over have business experience, and succession planning should take that into consideration. It can also be helpful to incorporate outside directors into the board of directors. These "neutral" parties can not only help family members make smart business decisions after the patriarch's death, but can also help reassure the employees. In addition to having non-family board members, it may also be helpful to have a board of advisors. These advisors would not assume any fiduciary duty to the company, but can provide an impartial review of the

[7491] See *Zoldan v. Zohlman*, 11 So.3d 982 (Fla. App. 3rd D. 2009) (ACTEC Fellow David Pratt testified for the winning side that discounts applied).

company's operations and can be a significant aide to new family members or outside management who take over the company after the patriarch's death.

Employment agreements can help ease the anxieties surrounding their futures after a business owner's death. Key employees may be concerned about being run out or demoted by new family members who take over the business. Employment agreements can help to lessen these concerns by including protection from "without cause" terminations and by allowing for compensation if the employee resigns for "good reason." These agreements may also include a clause similar to a "retention bonus" that gives the employee additional compensation for staying on after the death of an owner to help the business complete the transition period.[7492]

In addition to addressing compensation in employment agreements, a succession plan should address compensation decisions. All parties involved need to know and understand who will make compensation decisions in the new management scheme and how abuses of the compensation system will be prevented.

Life insurance can help with liquidity issues that may arise at the time of an owner's death in two ways. First, the proceeds can assist in achieving fairness in the estate distribution process if the estate does not hold sufficient liquid assets. The proceeds can provide assets for family members who are not involved in the family business (or can provide liquidity for those who are involved so that they have a cushion if the business declines), while the business itself passes to interested family members. Additionally, if the estate does hold liquid assets, then the proceeds can provide liquidity for the business itself in the time of transition. Finally, life insurance payable to the company upon the death of key management can be used to help the company in retaining or recruiting management during the transition.

A business succession plan should include estate planning strategies to help preserve family wealth, thereby increasing the likelihood of continued success of the business. Some of these strategies are discussed elsewhere in these materials.

A business' capital structure can also be arranged to ensure fairness among owners. A plan needs to consider all owners' needs and determine what business structure gives the company and owners the most flexibility in meeting those needs. In addition, a business plan can use capital structure to segregate assets for estate planning purposes. For example, an LLC can be created to hold real estate, which it can lease to the operating company in exchange for rent. The real estate LLC can provide rental income to family members who are not active in the business. Long-term leases with inflation adjustments can provide stability for all interested parties.

Voting control allocation can also assist in the success of a fair business succession plan. A balance needs to be struck between giving the active family members enough power to fulfill their responsibilities and not giving them too much authority so as to enable abuse of power situations. A voting/non-voting interest dichotomy or a limited partnership structure can achieve this balance.[7493] In both cases, active family members can take control of the company,

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[7492] Deferred compensation agreements are subject to Code §409A (added by the American Jobs Creation Act of 2004), which accelerates an employee's recognition of income and imposes a 20% penalty when such agreements do not satisfy its requirements. Payments contingent on future performance of services frequently satisfy its requirements.

[7493] State law often restricts a plan's ability to dictate corporate directors' actions. LLC statutes provide much more flexibility. Statutory close corporation rules can provide a fair amount of flexibility if a corporate form is essential; see fn. 1138.

regardless of how much of the company they actually own themselves. Family members who are not in control also need rights that give them some input into major company issues or at least some way to get out of the company if they are not satisfied with how management is running it. This could be accomplished by setting a level of performance of management, and if management falls below that performance level, then minority or non-controlling members would have the right to cash out their interest.

Essentially all of these issues come together under one theme – communication. Business owners need to address as many potential issues as they can and make sure all interested parties know and understand how those issues are to be resolved. This can be achieved through a clearly delineated business succession plan that is communicated to family members, non-family owners, key employees and the board of directors or advisors. Finally, when the plan involves keeping the business in the family under the control of certain family members, the client needs to make sure the family knows the reasoning behind the decisions, to minimize future conflict.

III.F. Hypothetical

III.F.1. Facts

Harvey Decedent died in 2002, leaving four children by his first marriage and a second wife, Wanda.[7494] All four children (Angie, Bob, Cindy, and Dan) are in their late thirties, and each has two children of his/her own. Harvey was diligent during his life in moving assets to his children, so that at his death all his business assets were held in family entities in which his children participated. Following estate administration virtually all the estate's assets ended up in a QTIP for Wanda with the remainder to Harvey's descendants per stirpes.

A) The Trust. The QTIP holds assets which include the following:

1) Approximately $5,000,000 in marketable securities.

2) An 80% interest in Cow Town LLC, an entity (taxable as a partnership) that owns the real estate and improvements of Cow Town Hotel, a well-known and valuable but aging urban hotel in Texas. The real estate is valued at $10,000,000 but is encumbered by a $4,000,000 mortgage that currently bears interest at 5% per annum. Payments are currently interest only for the next 3 years, until it balloons. The Hotel earns approximately $1.5 million per year in taxable income after management fees, but has been distributing only 50% of that amount to its members, the balance going to badly needed capital improvements. The remaining 20% of the LLC is owned in equal shares by the four children, two of whom are desperate for cash due to their wastrel ways and two of whom are the key employees of Cow Town, Inc., discussed below.

3) A 40% interest in Cow Town, Inc., an S corporation established by Harvey to manage the Hotel and, during his life, to provide cash flow to his kids from Hotel operations. The corporation has no assets other than a management agreement on the hotel which has 2 years to run before it must be renegotiated. The remaining 60% of the stock is held 15% each by the four children. To date the contract calls for a management fee equal to 50% of the Hotel's "profit," an amount deemed by dad to be equal to taxable

[7494] This hypothetical is based on a presentation done by Steve Salley, Jonathan Lander, Steve Kirkpatrick, and the author at the 2004 ABA RPPT/Tax Joint Fall Meeting.

income. Thus, the corporation has enjoyed $1,500,000/year in management fees, which after salaries and expenses of $500,000 annually, was distributed pro rata to the shareholders. The two key employees of the corporation and, indirectly, of the Hotel are Angie and Bob Decedent who have received the same $100,000/year salary since Harvey died. They complain about doing all the work for the benefit of their brother, sister, and Wanda and are demanding significant salary concessions to continue managing the hotel.

B) The Trustees. The QTIP has three trustees, Sam Tortte (Harvey's long-time lawyer), Tom Penny (Harvey's CPA), and FiDuc., a nationally known commercial trust company first nominated to serve under Harvey's will with no prior experience with the family.

C) The Problems.

1) The mortgage holder on Cow Town LLC has offered to extend the mortgage to a 15-year term with straight amortization and a 4.5% interest rate but only if the Trust, as the largest equity holder and source of liquidity, guarantees the mortgage.

2) FiDuc is requesting that the management agreement and the compensation of Angie and Bob be reviewed by an outside "expert" to determine reasonability; but the four kids threaten to stymie any efforts to change the ownership or cash flow for the benefit of Wanda, whom they believe is more than well taken care of from the trust's other assets.

3) The hotel is desperately in need of a new roof at a cost of $1,000,000, which will either have to come from the hotel's "profit" or a second mortgage. A second mortgage will require additional collateral beyond the guarantee of the Trust, including, perhaps, a pledge of a portion of the Trust's marketable securities.

4) FiDuc has demanded that any collateral or guarantee by the trust of Hotel debt must be accompanied by a loan agreement that assures the Trust control of the Board of Directors of Cow Town Inc. and the status of "sole managing member" of the LLC.

The trust is domiciled in a state that has adopted the most recent uniform trust-related laws. The trustees desire a "roadmap" of issues to be addressed in the upcoming negotiations.

III.F.2. Trust Accounting and Taxation

The QTIP trust holds an 80% interest in a partnership. As a QTIP trust, it must distribute all of its income. The partnership earns approximately $1.5 million in the current year, but distributes only 50% of that amount to its partners. Thus, the trust receives a K-1 with $1,200,000 of income (80% of $1,500,000), but receives only $600,000 in cash (50% of $1,200,000). Initially, one might think the entire $600,000 is distributable net income and must be distributed to the beneficiary, because under Uniform Principal and Income Act § 401, a trustee must allocate money received from an entity to income.[7495] However, if the trust does distribute the entire

[7495] See also RSMo §469.423.2. Uniform Principal and Income Act § 401 is found at http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008) and provides:

(a) In this section, "entity" means a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or any other organization in which a trustee has an interest other than a trust or estate to which amount, it will be unable to pay the tax on the other $600,000 of "phantom" taxable income from the K-1 that it could not distribute. So, the trust must retain some of the cash it received from the partnership. This withholding is supported by the language of § 505(c) of the Uniform Principal and Income Act,[7496] which states that taxes required to be paid by a trustee on a trust's share of an entity's taxable income are to be paid proportionately from income and principal based on the extent that receipts from the entity are allocated to each.

In this hypothetical, all $600,000 of cash received was properly allocated to income, so 100% of the tax due on the trust taxable income must come out of income. Thus, the trustee has to do a circular calculation to determine how much of the $600,000 must be withheld in order to cover the tax on that amount.

Assuming a 40% combined federal and state income tax rate, the trust will end up withholding $400,000 of the cash and distributing $200,000 to the beneficiary. This leaves the trust with $1,000,000 of taxable income ($1,200,000 K-1 income minus the $200,000 distribution deduction), resulting in a $400,000 tax due, which the trust will be able to pay with the $400,000 cash it retained. The beneficiary will receive $200,000 and pay $80,000 tax on that amount, leaving the beneficiary with $120,000.

Put another way, the K-1 income was $1,200,000, requiring $480,000 of tax to be paid by somebody, and $120,000 to be retained by the income beneficiary after tax ($600,000 cash distribution from the partnership minus $480,000 tax paid). Of the $480,000 tax to be paid, $400,000 is paid by the trust and $80,000 by the beneficiary (out of the beneficiary's $200,000 distribution).

Section 402 applies, a business or activity to which Section 403 applies, or an asset-backed security to which Section 415 applies.

(b) Except as otherwise provided in this section, a trustee shall allocate to income money received from an entity.

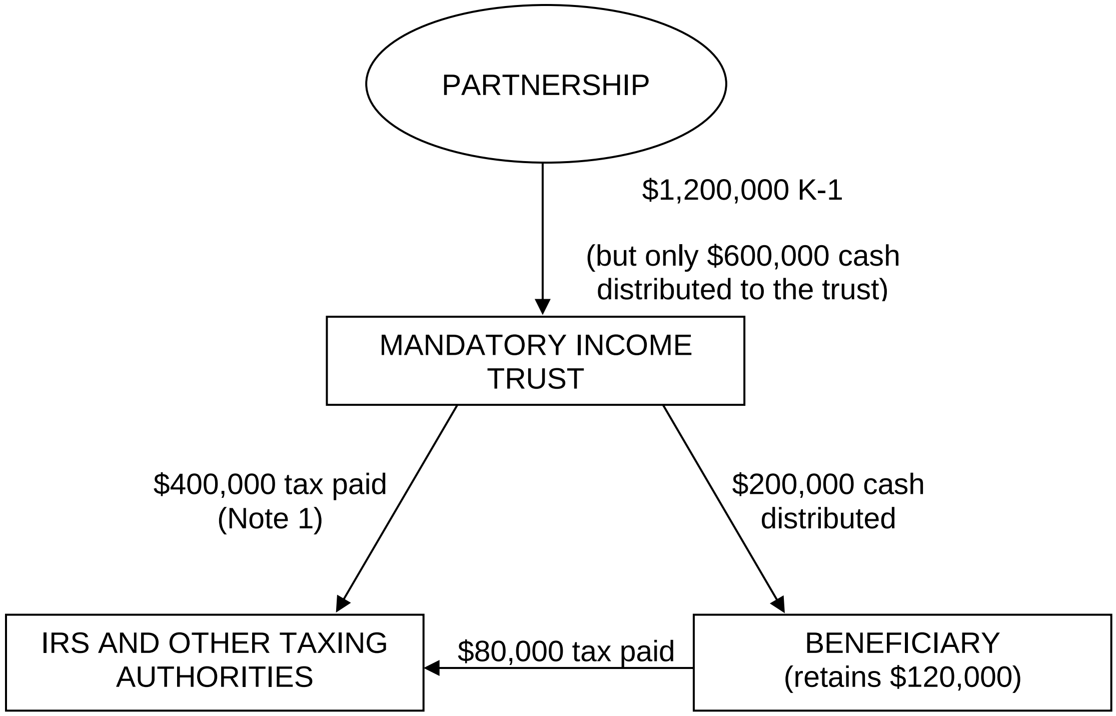
(c) A trustee shall allocate the following receipts from an entity to principal:
  - (1) property other than money;
  - (2) money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;
  - (3) money received in total or partial liquidation of the entity; and
  - (4) money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

(d) Money is received in partial liquidation:
  - (1) to the extent that the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation; or
  - (2) if the total amount of money and property received in a distribution or series of related distributions is greater than 20 percent of the entity's gross assets, as shown by the entity's year-end financial statements immediately preceding the initial receipt.

(e) Money is not received in partial liquidation, nor may it be taken into account under subsection (d)(2), to the extent that it does not exceed the amount of income tax that a trustee or beneficiary must pay on taxable income of the entity that distributes the money.

(f) A trustee may rely upon a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity's board of directors or other person or group of persons authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors.

[7496] See part III.A.4 Trust Accounting Income Regarding Business Interests. See also RSMo § 469.459.3.



Note 1: $1,200,000 K-1 income minus $200,000 income distribution deduction equals $1,000,000 taxable income. This example assumes a combined federal and state tax rate of 40%.